Colombia | Economic Analysis

Banco de la Republica reduced its policy rate by 50 bp to 9.75%

Alejandro Reyes González

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The Board of Banrep reduced its monetary policy rate by 50 bps, bringing it to 9.75%. This decision was split, with 4 members in favor of the 50 bp reduction and three members voting for a larger reduction of 75 bp. The balance reached at the last meeting remain unchanged, despite the greater exchange rate pressures and fiscal concerns, which maintains the possibility of a more accelerated reduction in the coming months, especially if exchange rate and fiscal pressures are reduced. With this decision, the policy rate has fallen nearly 350bp since the tightening process began in December 2023.

- **The statement issued by Banrep's Board highlights the decrease in inflation in September, reaching 5.8%, although it emphasized that inflation without food or administered prices remained stable in the last month.** Regarding the behavior of inflation, it was noted that core inflation continues to be pressured by the persistence of services. Expectations remain anchored and stable within the target range, with those derived from public debt instruments at around 3.0% and those from analyst surveys at around 3.8%. It is also noteworthy that the Banco de la República's team revised downwards its inflation expectation for the end of 2024, from 5.7% to 5.3%. On this occasion, both in the press release and in the press conference, inflation risks for 2025 were less mentioned.
- **Activity continues to show a better performance than that observed at the end of 2023 and in the first part of the year, leading the Central Bank's technical team to increase its growth forecast for 2024 to 1.9% from 1.8% previously (0.9% at the beginning of the year) and in 2025 to 2.9% compared to 2.7% previously.** On this front, the Minister highlighted that part of the economy's performance in 2023 was inherited and that they have observed a rebound in activity in recent months. At the press conference, the Governor was asked about the expected behavior of the potential GDP, to which he responded that the impact of the Central Bank on potential growth subscribes to the confidence and tranquility of macroeconomic stability, low rates, low inflation.
- **The press release highlights the recent behavior of the financial markets, recognizing that greater volatility is observed in international and local markets.** In this particular, it is commented that despite the beginning of rate reductions from the US Federal Reserve, a weakening of the Colombian peso was observed and that if this pressure is maintained over time it could exert upward pressure on inflation and limit the space to continue the relaxation of monetary policy, even below the pace that has been maintained. At the press conference, it was highlighted on several occasions that several external risks are being faced that have generated a less propitious scenario to achieve greater adjustments in the policy rate, among them the uncertainty associated with the electoral process in the United States, but also the uncertainty stemming from the conflict in the Middle East.

On the local front, it should also be noted that greater uncertainty has been observed on the fiscal front, both due to the recent discussions on the budget, but especially in recent weeks due to the discussion of transfers to the regions, which in the Bank Governor's opinion could, if relevant, generate some upward pressure on the neutral interest rate.

- F**iscal issues were at the center of the discussion at the press conference.** It was emphasized that the transfer bill, being a legislative act, does not require the government's fiscal endorsement nor does it require the government's veto option. What had been approved up to the fifth debate of the initiative, the Minister mentioned, was fiscally unsustainable, for which reason he mentioned that the discussion in the sixth debate included some adjustments that incorporate in the debate the issues associated with sustainability. Among them, the lower threshold, the broader transition and in particular the discussion of spending powers, which although they cannot be explicitly included and must be dealt with in a separate project, a proposal was included to include the formulation of this law before the new transfer scheme comes into force. The Minister commented that he hopes to be able to lower the threshold further and achieve a longer transition in the remaining discussions of the project. Regarding the requirements of the law of competencies, the Minister pointed out that this would be an ordinary law, which would allow a more succinct debate and the eventual possibility of voting on it if it does not achieve the minimum objectives considered by the Executive and if it is considered that it implies some fiscal risk. Regarding this project, the Bank's Governor pointed out that he is concerned about a scenario of higher spending in the regions and that it may imply pressures on the fiscal stability of the country.
- Within the fiscal issues, the Minister also highlighted that even though the budget has not been approved by Congress, the Government must define the budget by decree before December 30 and the budget must be submitted in July. This budget requires a discussion of financing through a law that must be processed in Congress, but if it is not approved or discussed, the Government must reduce the budget by the amount not financed. With this explanation, the Minister emphasized that the Government's objectives are to contribute to a better economic growth with a better distribution, but also to comply with the Fiscal Rule.
- Regarding spending and revenues for 2024, the Minister highlighted that in May a 20 billion pesos suspension of spending had been made, which is pending to be converted into a reduction of spending in the coming months. However, he emphasized that revenues have been lower than anticipated and that they are evaluating the need to make an additional adjustment to the already proposed expenditure.
- **At the press conference it was highlighted that the full Board supports the rate cut and that differences remain on the required magnitude.** The Governor pointed out that the real interest rate with the decision taken in October fell: if total inflation is taken, the reduction was 31bp, less than the 50bp by which the policy rate was reduced. If inflation excluding food and regulated items is taken, it remained stable, so the real rate was reduced further. He also highlighted that market interest rates have fallen more than the Bank of the Republic's rate, which reflects, in his view, a high confidence that policy rates will continue to fall and therefore they incorporate this in the setting of market rates. The Governor also highlighted that current conditions require a policy rate in contractionary terrain, in order to seek the convergence of inflation to its target, but that the stance has gradually migrated to less contractionary terrain and that this has begun to support the performance of the economy. The Minister, for his part, highlighted that his stance favored a more pronounced reduction in the BanRep's rate, but that external conditions, mainly, truncated this possibility. In addition, he commented that he expects rates to continue to fall and thus expects the market to continue lowering rates to support the economy.
- **The Bank announced the completion of its reserve accumulation program.** At the press conference, when asked a question, the Bank's Governor highlighted that the reserve accumulation program established in

December 2023 with the objective of reaching an accumulation of US$1.5 billion reached its target and therefore announced its termination. It is worth noting that the objective of this program was to improve the level of reserves in part associated with the possibility that the International Monetary Fund would reduce the flexible credit line assigned to Colombia. For the Governor, the current level of reserves is adequate to meet the needs of the Colombian economy.

Our take:

- In the last two months, analysts and the market have been divided as to the magnitude of possible rate cuts from the Central Bank. In September, based on the start of the Fed's rate cuts and lower inflation, and in October, also due to lower inflation and the change of vote of one of the co-directors, in favor of further cuts. However, on both occasions, the Bank has maintained the pace of rate cuts that it has been implementing in most of its meetings since the beginning of the cycle. On this occasion and partly also in September, the justification was focused on market volatility, particularly the depreciation of the exchange rate, the increase in the risk premium and the uncertainty stemming from fiscal issues (in September associated with the budget discussions and in October with those associated with the transfers to the regions). This still shows a doubt about the size of the adjustment and acceleration in the pace of reductions and therefore, and in view of the uncertainty that remains in the environment with the US elections in the coming days and the fiscal discussions still alive in Colombia, there has been a preference of the Board for gradualness.
- However, the change in the balance of the vote, from 5 to 2 members in favor of 50bp cuts to 4 to 3, points to the fact that the discussion on the speed of adjustment is a relevant and central issue. We believe that it will continue to be so and that to the extent that volatility in financial markets is reduced and that inflation continues on its path of reductions, especially from the core and in it from services, this discussion could lead to a change in the balance in favor of larger reductions. However, if we continue in a context of volatility and weakness of the Colombian peso and/or inflation shows greater risks and eventually a reversal in its trend, the scenario of acceleration in the reductions will wither and may, as mentioned in the communiqué, reduce the margin even for the reductions to continue at the current pace. This second case is not our central scenario, so we believe that there will eventually be room for further rate cuts.
- In any case, we see that the path of rate reductions will continue, at a greater or lesser pace, until reaching a terminal rate of around 6.0% in the second part of 2025. This result would be in line with the anticipated behavior of inflation, reducing in the coming months and years, and an activity that is gradually improving its dynamics, although with still relatively low levels of investment.

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INTERESADOS DIRIGIRSE A:
BBVA Research Colombia Carrera 9 No 72-21, piso 10. Bogotá, (Colombia).
Tel.: 3471600 ext 11448
www.bbvaresearch.com