

## Sovereign Macro-BANREP Preview, A tight 25

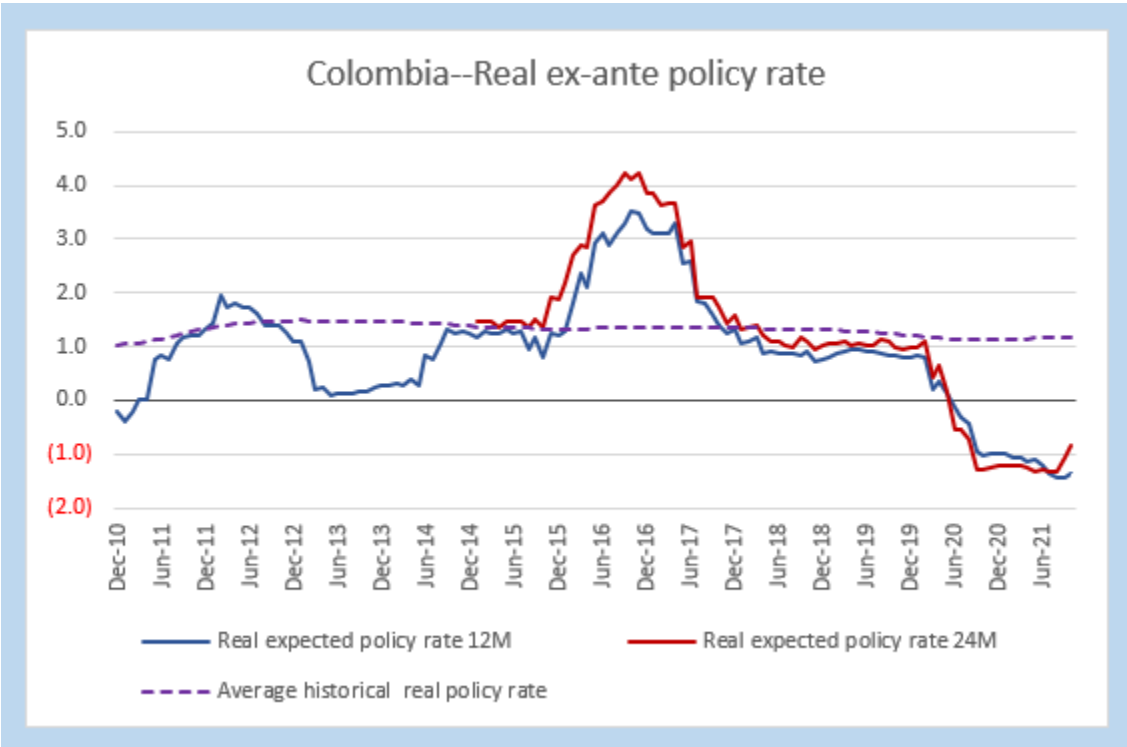
October 27, 2021

Bottom line: Recent communications from board members and recent inflation data indicate that the hurdle to accelerate the policy normalization is somewhat higher than I expected but a 50 bp hike is clearly on the table. Deputy governors Steiner and Jaramillo as well as governor Villar appear comfortable with the inflation outlook and risks. In the last policy decision, all members agreed to hike 25bp with 3 members voting to do 50 bp. This means that one vote is necessary to tilt the balance to accelerate the pace this week, it will be a close call again. Governor Villar is likely to be the swing vote since he tends to emphasize more the external risks which are clearly growing as financial conditions tighten and central banks, including those in DM, are hiking sooner than expected as the inflation outlook turns more challenging. I expect that Steiner and Jaramillo will vote for 25 and Restrepo is likely to support it. Inflation remains under control with the average of the 3 measures of core wrapped around 3%. Expectations are also reasonably anchored and rate expectations exclude a 50bp hike throughout the next two years. One should keep in mind that in the September decision there were large revisions to the projections which prompted some members to support a 50bp hike. It is unlikely that we will see significant revisions in this week's decision. All in, I am calling for a 25 bp hike this week and for the foreseeable future with a view to end the cycle at around 4.5% by end 2022 which would bring the policy rate close to neutral.

Details:

- Deputy governor Jaramillo explained that about 1.5 points of the 4.5% annual headline inflation came from disruptions from the road blockades, the normalization of tariff subsidies and imported goods. He said that the hiking would be gradual, and policy would be less expansionary and unlikely to be either neutral or restrictive, meaning less than the 1.7% real rate that the Bank considers to be neutral. He is concerned about expectations and believes surveys could be misleading. To accelerate the pace, Jaramillo would be looking at inflation data, indexation, the output gap and what is happening to rates globally. The last two factors, a faster than anticipated recovery and a global trend to normalize policy rates especially in DM, could push him to reconsider.

- Steiner said that the 24-month inflation annualized was close to 3%. He underscored that Banrep has a dual mandate, and the charter emphasizes that Banrep must keep inflation low and stable but by no means this was a bigger priority than supporting growth. He believes that expectations are reasonably well anchored. In the October survey they were at 3.7% and 3.1% in 12 and 24 months ahead on headline, and 3.2 and 3% respectively for core. Steiner said that it would be premature to say where rates would be in a year's time and emphasized that risks were mostly external.
- Governor Villar was clear since the press conference in September that Banrep needed to start a process of gradual normalization of the policy rate. He believed that "in a year's time" the policy rate would be at an appropriate level, but rejected the idea, like Steiner and Jaramillo, that it would be at a neutral level and certainly not restrictive.
- The question of accelerating the pace is tricky. Since normalization is in the early stages, I believe that if Banrep wanted to accelerate the pace, it would be better to do it early to get ahead of the curve. That said, the most recent inflation data are not as concerning and justifying a 50 bp hike, while possible, is difficult (for instance COP has performed extremely well since the last meeting). Expectations have gone up slightly, but it is not obvious that Banrep needs to act imminently. No central bank wants to do more than necessary. Moreover, if the pace quickens, it will be difficult to slow later, so "why do 50 in October and slow to 25 in December?". It would make no sense and complicate the message. If they do 50 on Friday, one should expect at least another 50 in December by which time the policy rate would be at 3% with perhaps another 100bp to go (since the board appears reluctant to get to a neutral rate) and finish normalization around mid 2022.
- The most compelling reason to do 50 in my view is that the real ex-ante policy rate is at extremely accommodative levels (see below). Assuming they do 25, the real ex-ante policy rate at 12 and 24 months will be between 1 and 1.5% which is the most accommodative level since at least the last 10 years. In an economy that is growing fast, such degree of support seems a bit extreme.



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