The Fiscal and Monetary History of Colombia: 1963-2012

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1The views expressed in this paper are those of the authors and do not represent those of the Banco de la República Colombia or its Board of Directors.
Introduction

Hypothesis of project:

- Bad fiscal and monetary policies led to macroeconomic instability
- Macroeconomic instability was responsible for low growth and poor economic performance
Introduction

In Colombia: Inverse of first holds, second doesn’t
- Not so bad fiscal and monetary policies led to macroeconomic stability
- Macroeconomic stability did not lead to growth and good economic performance
Colombia: Low(er) macro volatility

Low volatility in growth

- Kodama (2013): lowest volatility in Latin America
- Few recessions
Real GDP growth
Colombia: Low(er) macro volatility

Low volatility in growth

- Kodama (2013): lowest volatility in Latin America
- Few recessions

High and persistent inflation, but no hyperinflation
Real GDP per capita growth
Our hypothesis:

- Colombia was able to implement not so bad policies due to a small government
- Financial repression helped to control monetary aggregates and avoid instability: cause of low economic growth
What we do

- Characterize the joint history of monetary and fiscal policies in Colombia since 1963
- Follow the general framework by Kehoe et al (2013)
Cycles of government financing

- 1963-1975: Foreign debt
- 1976-1991: Monetary emission
- 1991-2012: Domestic debt
Before 1991

- Monetary Board had no independence from government
- Central Bank was a development bank
- Increasing tolerance towards inflation
- Various forms of armed conflict (also after 1991)
- Reserve requirements were used to counteract increases in monetary base
1991

- New Political Constitution
- Central Bank independent from government
  - Explicit objective: low inflation
  - Difficult to lend to government
  - Cannot lend to private sector

\[ B_t - B_{t-1} + b_t^* - b_{t-1}^* + M_t - M_{t-1} + T_t \]
\[ = D_t + B_{t-1}R_{t-1} + b_{t-1}^*r_{t-1}^* \]

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\]

\(B_t\): Government debt issued domestically

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\( b_t^* \): Government debt issued abroad

\[ B_t - B_{t-1} + b^*_t - b^*_{t-1} + M_t - M_{t-1} + T_t = D_t + B_{t-1}R_{t-1} + b^*_{t-1}r^*_{t-1} \]

\( M_t \): Monetary emission
Accounting unit

- National central government (NCG)
- We don’t include local governments
  - Main source of revenue of local governments is transfers from NCG
  - Debt of local governments is around 3% of debt of NCG and is bounded by law
Government debt

- We identify place of issuance, not currency
  - Domestic: Issued in Colombia, mostly in Colombian pesos
  - Foreign: Issued abroad, mostly in US dollars
- Indexed government debt is very recent and small
- Implied interest rates
Debt and adjusted debt by RER to GDP

![Debt and adjusted debt by RER to GDP](image-url)
Monetary emission

Prior to 1991
- Net credit from the central bank to the government
- Special Exchange Accounts (CEC)

After 1991
- Profits from the central bank
CEC

- 1938-1993
- Resources derived from movements in exchange rate
  - Profits from management of foreign exchange
- Taxes on coffee exports and remittances
- 1993: Became a fund of foreign exchange reserves
Data sources

Financing of fiscal deficit
- 1990 - 2002: DTIE at Banco de la República Colombia
- 2003 - 2012: Ministry of Finance and Public Credit

Expenditures on interest on debt
- Junguito and Rincón (2007)
Government expenditures and tax revenue

- Government expenditures
- Tax revenue

(% of GDP)

Fiscal deficit
Primary deficit and interest payments
Financing

\[ \frac{\Delta M}{Y} \]

\[ \frac{\Delta B}{Y} \]

\[ \frac{T}{Y} \]
Inflation
Burst in inflation in 1963

1950’s: Monetary and fiscal expansion
- 1953-1957: Military dictatorship
- Rise in price of coffee: 70% of exports
Price of coffee
Burst in inflation in 1963

Early 1960’s

- Lower price of coffee
- Law in 1961: higher expenditures, lower tax revenues
- Sources of financing:
  - Money emission:
  - Foreign debt: Launch of Alliance for Progress and US Agency for International Development
- Major rise in wages: around 25% on average across sectors.
1963-1975

- Smallest of the cycles we analyze: deficit peaked at 1.2% of GDP
- Financing mainly through foreign debt
- Begins: Establishment of Monetary Board
- Ends: Before boom of the price of coffee
Monetary Board

- Foreign exchange, monetary and credit authority
- Established in 1963. Lasted until 1990
- Objective
  - Theory: Get back monetary sovereignty for the government
  - Practice: Central Bank became a development bank
- Members: Ministers, head of the Central Bank, two advisors
Inflation

Although high, it was “socially acceptable”

- Indexed wages
- Decreasing mortgage real rates
Inflation

(%)
Financing
Financing

- Colombia was not the exception in taking advantage of foreign credit
- Most loans from multilateral entities (CAF, IDB, etc): low interest rates
Interest rates on government debt

![Graph showing interest rates on government debt over periods from 1964 to 1974. The graph includes lines for Ave R, Ave r*, and Mg r.](image-url)
Small government
Foreign exchange policy

- Multiple exchange rates prior to 1967
- Crawling peg and capital controls since 1967
Nominal exchange rate

COP/USD

Jan65 Jul67 Jan70 Jul72 Jan75

COP/USD

Jan65 Jul67 Jan70 Jul72 Jan75
Real exchange rate
UPAC system

- Established in 1974
- Two objectives:
  - Develop mortgage sector: construction and home ownership
  - Develop mortgage loan market: long maturity loans
- Special financial entities (CAV’s) that lent and took deposits in UPAC, not pesos
1976–1991

- Financing mainly through monetary emission
- Begins: Rise in price of coffee
- Ends: Before promulgation of new political constitution in 1991
- 80’s were not a lost decade for Colombia: average growth 3.3%
Price of coffee
Foreign exchange policy

Up to early 1980’s

- Fixed exchange rate (crawling peg)
- “The boom is for coffee growers”: President López Michelsen
- Real appreciation
- High and persistent inflation
Foreign exchange policy

1980’s

- Fixed exchange rate (crawling peg)
- Steeper nominal devaluation
- Real depreciation
- High and persistent inflation
Real exchange rate
“Crisis” of 1982

- GDP growth: 0.9%
- Due to coffee boom, Colombia only borrowed abroad for a short time
- Foreign debt remained low
- Banking crisis
Interest rates on government debt
Financing

Mainly through monetary emission

- Profits from exchange rate policy
- Central Bank rescued state-owned banks during early 1980’s banking crisis
Financing
1991-2012

- Financing mainly through domestic debt
- Begins: Promulgation of new political constitution in 1991
- Economic crisis of 1999: -4.2%
Changes to Central Bank

- Monetary board ceased to exist
- Independent board of directors, even though the Minister of Finance is the head
- Difficult to lend to government
- Prohibited to lend to private sector
- Seignorage limited to profits of Central Bank
“La Apertura”

- Liberalized capital account
- More liberal financial sector: Foreigners can own banks
- Pressure on CAV’s
Government

- Central government had to transfer increasing resources to regional governments
- Size of government increased
Government expenditures and tax revenue

Graph showing government expenditures and tax revenue (% of GDP) from 1995 to 2010.
1990’s

Monetary and foreign exchange policy
- Crawling peg was replaced by a moving band
- Monetary policy: target growth of monetary base
- Monetary policy depended on foreign exchange policy
1990’s

- Increasing fiscal deficit
- Increasing current account deficit
- Increasing foreign debt
Crisis of 1999

- GDP real growth: -4.2%
- Financial crisis: bank runs
- Mortgage crisis
Nominal exchange rate
Real exchange rate
After 1999

- Free floating of exchange rate
- Inflation targeting: policy instrument is interest rate
Financing

- Development of domestic government debt market: TES
- Deepening of interbank market, specially after 1999
Financing
1963-1991

- No institutions to control inflation
  - Monetary board: credit and monetary authority, members belonged to government
- Inflation did not go over 30%
Financial repression in avoiding hyperinflation

- When monetary base grew, the money multiplier decreased
- Money multiplier followed reserve requirements
Growth of monetary base and change of money multiplier
Reserve requirements and inverse of money multiplier
Conclusion

- Colombia had macro stability
  - Small government for most of its history
  - Used reserve requirements to counteract monetary expansions: one reason for not so great economic performance
- Growth of Colombia was not better than other Latin American countries
- We identify three cycles of government financing, each characterized by a different source
Conclusion

Reasons for “exceptionalism” of Colombia

- Luck: i.e. Coffee boom
- Role of advisors of the Monetary Board
- Political clientelism: Robinson and Urrutia (2007)
Real exchange rate