INTERNATIONAL CONFERENCE "CENTRAL BANK INDEPENDENCE: PROGRESS AND CHALLENGES" ORGANIZED BY THE BANK OF MEXICO

Presentation by José Darío Uribe, Governor of the Banco de la República de Colombia in Session 5: Independence of Central Banks: Design and Implementation

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INTRODUCTION

I would like to begin by congratulating the Bank of Mexico for its twenty years of independence and by expressing my gratitude to the Bank's governor, Agustin Carstens, for the kind invitation he extended me to participate in this conference.

In the following presentation I will first summarize the institutional framework in which the *Banco de la República de Colombia* has operated since the 1991 Colombian Constitution. Then, I will present the main macroeconomic results obtained since 1992 while contrasting them with those observed in previous periods. Finally, I will identify what I consider have been the most useful arrangements for protecting the Colombian Central Bank from political interference.

I. INSTITUTIONAL FRAMEWORK

The current institutional framework of the *Banco de la República* is defined in the Constitution of 1991, in Act 31 of 1992, and in the Constitutional Court rulings that have set an important precedent on the subject. The main elements of this framework include: i) the objectives of monetary policy, ii) the decision-making body, iii) autonomy from the various branches of power, and iv) accountability. In the following section I will briefly describe each of these elements.

i. **Objectives of monetary policy**: The Colombian Constitution[i] states that the government, through the Central Bank, must ensure the stability of the currency's purchasing power. Price stability is considered a citizen's right, the duty of the State, and the responsibility of the Central Bank.

   The Act[ii] specifies that the Central Bank shall adopt specific inflation targets to meet this objective.[iii] This function must be exercised in coordination with the general economic policy. The Act also states that although the primary purpose of the activity of the Central

Bank is price stability, the institution cannot be indifferent to other policy objectives enshrined in the Constitution, such as the pursuit of full employment.[iv]

In other words, in the exercise of monetary policy, the Constitution and the law commit the Central Bank to the objective of price stability and warn it must also consider other goals, such as sustainable output growth and employment. This is the way the Colombian institutional framework approaches the "flexible inflation target" regime employed for several years in a number of advanced and emerging countries.

ii. **Decision-making body:** The highest governing body of the Central Bank is its Board of Directors, which is responsible for the direction and execution of the functions of the institution. This collegial body consists of seven members: the Minister of Finance, who presides over the Board, the Governor of Bank who is appointed by the Board, and five full-time members (Codirectors) appointed by the President. The appointments for the Board of Directors do not require Congressional approval.

The Governor and the other five full-time members of the Board are appointed for fixed terms of four years and are renewable for up to a maximum of 12 years. The Board shall also be partially renewed every four years. Therefore, the President is responsible for the replacement of two of the five members one year and a half before the end of his term. The remaining three members continue for a period of four years. Members of the Board represent only the interests of the nation (and not sectorial or union interests).[v]

All Board members are entitled to a say and a vote and can propose policies that lie within the scope of the Central Bank. The Board meets at least once a month; the topics are defined in advance and always require a written opinion from the Bank's technical team. Moreover, each decision requires the affirmative vote of at least four Board members.

iii. **Autonomy:** The Central Bank's legal nature is unique within the Colombian state, and it is administratively and technically independent from the legislative, executive, and judicial powers as well as from electoral oversight.[vi]

The Bank has a corporate governance structure that allows it to make autonomous decisions on monetary policy. Its Board of Directors has the ability to freely discuss monetary phenomena and design tools to achieve price stability without interference from the legislative or executive powers.[vii]

The role of countering inflation, however, has formal and material boundaries:

- The formal limit is in the law, which sets out the objectives, instruments, and general operating criteria of the Bank. Congress cannot enact laws that pertain to issues of the Board of the Central Bank because this would limit the Bank's autonomy.[viii]

- The material boundary is in the necessary coordination between the Bank's monetary and exchange policies and the fiscal, wage, and employment policies that are the

responsibility of the national government. In practice, the presence of the Minister of Finance on the Board and the technical preparatory meetings for each session are part of this coordination. In the exercise of this coordination, the State's responsibility to ensure purchasing power stability cannot be compromised[ix] - the duty of fighting inflation is not only the responsibility of the Bank but also of the Executive Branch, which is responsible for overall economic policy.

Furthermore, in order to safeguard monetary policy from sectorial pressures that could jeopardize the Bank's decisions, the Constitution states that lending operations to the State require unanimous approval from the Board with the exception of open market operations.[x] Moreover, Congress may not order credit quotas for the State or individuals, and the Board cannot establish credit quotas or guarantees for individuals except in the case of temporary liquidity support or intermediation for external credit placement through credit institutions.

Finally, the law establishes certain quality, inability, and incompatibility criteria applicable to members of the Board (except the Minister of Finance).[xi] As mentioned previously, Board members represent the general interest of the nation and are dedicated exclusively to working for the Central Bank. Furthermore, they cannot have kinship with legal representatives of entities supervised by the Colombian Financial Superintendency. They cannot be appointed ministers or ambassadors until at least one year after they have left their position at the bank, or be involved with political propaganda. All this is to avoid conflicts of interest and be independent of regulated political parties and the national government.

iv. **Accountability:** The technical, budgetary, and administrative independence of the Bank demands its accountability. Congress, as the representative of society, is the first entity to which the Bank is accountable.

The Board of the Central Bank must submit two detailed written reports to Congress on the implementation of policies in its charge 10 days after the March legislative sessions begin and in July of each year at the latest.[xii] The Governor must present the Report to Congress and this is evaluated and discussed in the economic committees of the Senate and the House of Representatives. The Bank's Board of Directors is also asked to be present in order to answer questions or concerns from Members of Congress. The Board may also be cited or called to appear before the economic committees to discuss matters within its competence and may be invited to the Senate and House for non-economic sessions.

The Board's Report to Congress includes the general guidelines of the Bank's policies, an evaluation of the results achieved in the previous period and objectives, purposes, and goals for the next. In addition, it must always include chapters on international reserves management and the Bank's income statements. If there are drastic changes in the management of the Bank's policies, the Board should explain the rationale for these changes in a special report to Congress. So far it has only done so once. This was in

October 1999 after the Board left the exchange rate band system and adopted the flexible exchange rate system. The review and discussion of these reports is the primary mechanism for Congress' political control of the Board.

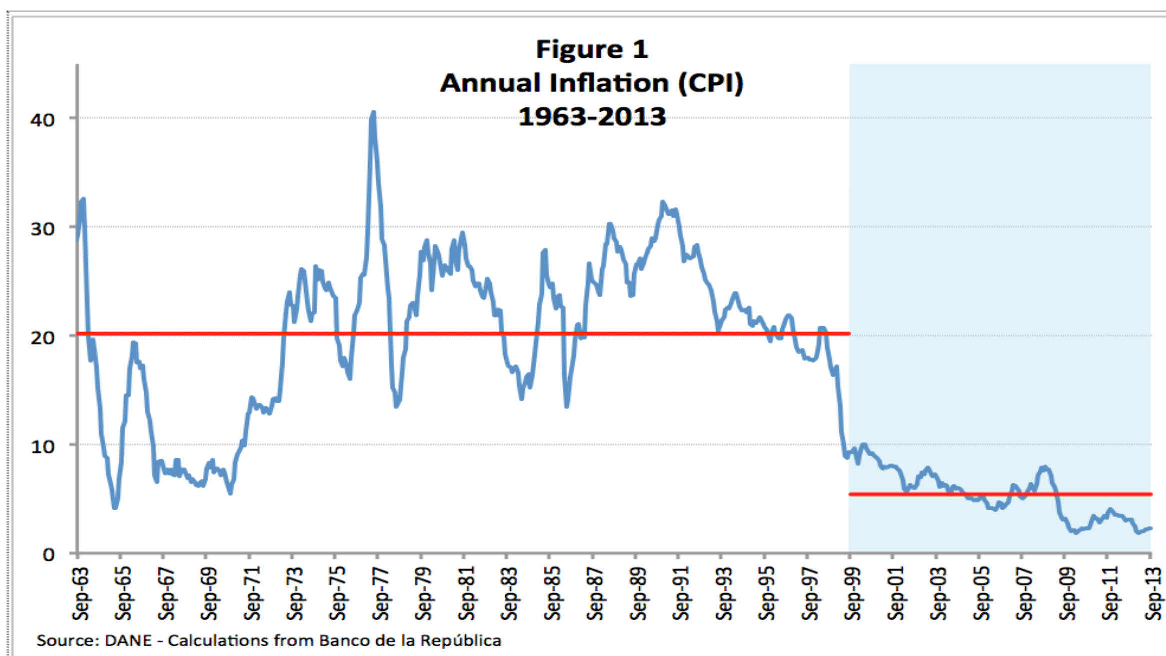
The President has the obligation of inspecting and supervising the Bank's decisions, a responsibility that is delegated to the Financial Superintendence of Colombia. Also, the President appoints an Auditor to supervise/monitor the Bank.[xiii]

II. MACROECONOMIC RESULTS

A. FACTS

Since the Constitution of 1991, the primary objective of the Central Bank's monetary policy is price stability. Therefore, the natural starting point for macroeconomic analysis is inflation dynamics before and after 1991.

Figure 1 shows the annual consumer inflation (CPI) from January 1963 to September 2013. Between 1963 and 1991, the Monetary Board, which consisted of the Minister of Finance, the Governor of the Bank, the Head of the National Planning Department and several ministers of spending, controlled monetary policy. In addition, inflation control was not an explicit objective of monetary policy.



The following details are noteworthy:

- Inflation diminished during the early years of the Monetary Board's existence and remained at relatively low levels between 1967 and 1970. However, starting in 1971, it increased systematically and fluctuated around 23% on average. In the 1970s, Colombia became a country of "moderate inflation" and developed strong mechanisms for indexation and inflation inertia that later made it particularly difficult to reduce inflation.

- The dynamics of inflation since the Bank became autonomous contrast with that observed during the years under the Monetary Board. After gradual reductions between 1992 and 1998, inflation fell sharply in 1999 to single-digit rates. Since 2009, inflation has been averaged around 3%.

The increase in inflation in the 70s was accompanied by gradual reductions in the growth rate of the economy. Figure 2 shows the fifth order moving averages of inflation and growth in GDP per capita over the 1963 to 2012 period. Note that since the 1970s there is a negative correlation between these two variables: inflation increases and then moves between 18% and 32%, and GDP per capita growth gradually weaken. This changed in the second half of the 90s and early 2000s when inflation and growth fell simultaneously. Subsequently, since 2003 there is a negative correlation again, but in this case, GDP per capita growth increases while inflation continues to fall until it reaches price stability (3% + / - one percentage point).

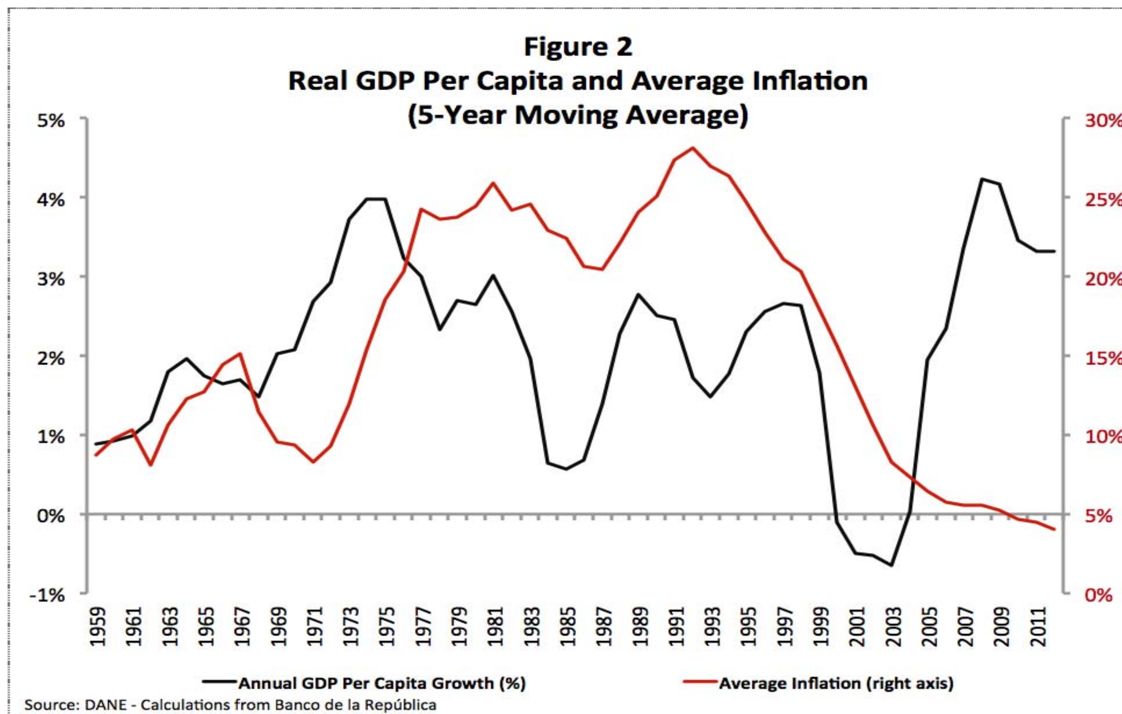
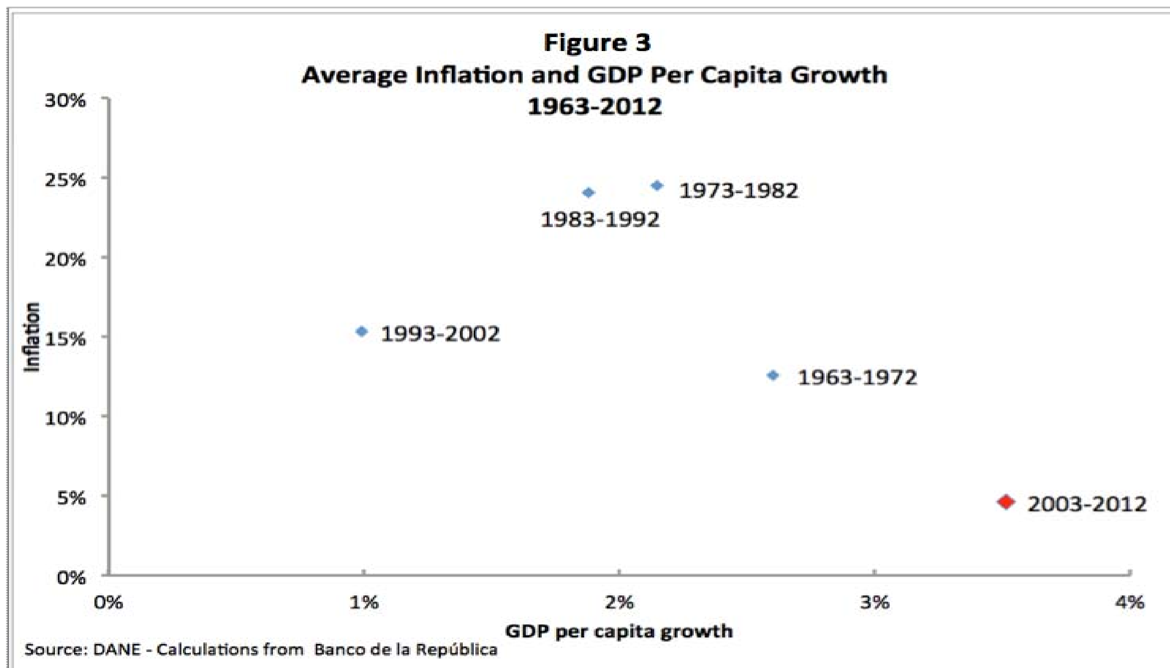
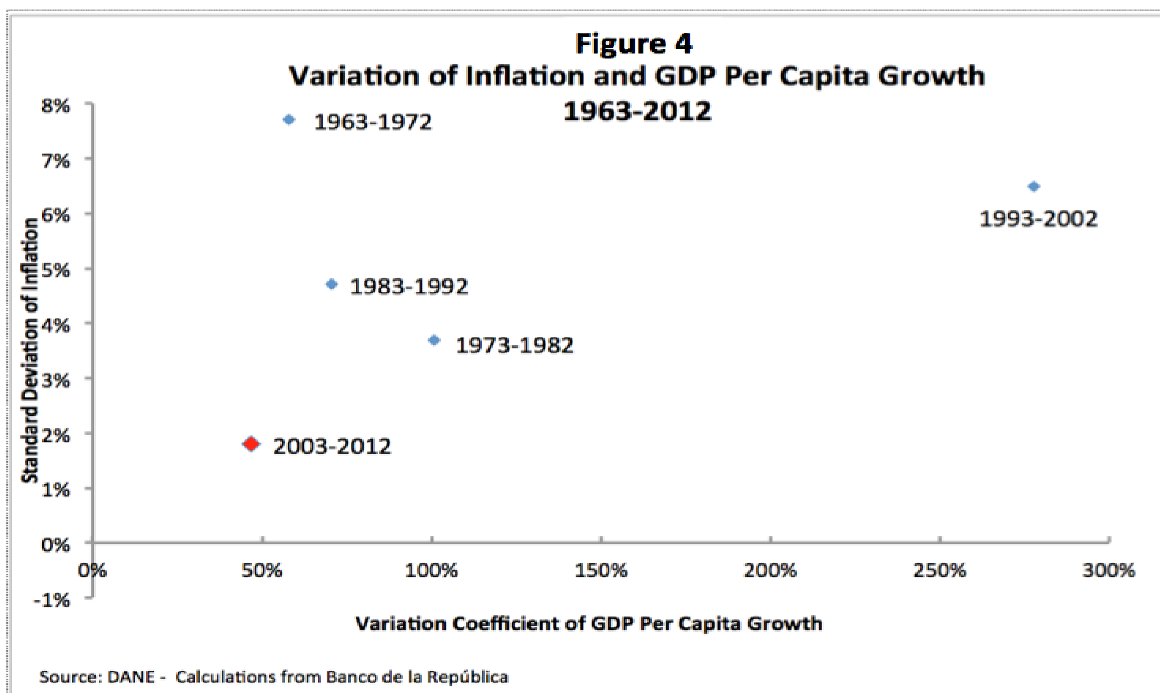


Figure 3 shows the relationship between inflation and economic growth (GDP per capita) with the period from 1963 to 2012 divided into five sub periods: 1963-1972, 1973-1982, 1983-1992, 1993-2002 and 2003-2012. It shows the relative positions of the sub-periods before and after 1991. The ideal position is the lower right, where growth is high and inflation is low. In contrast, in the upper left inflation is high and growth is low. According to the graph, macroeconomic performance has been best in the current century, followed by the first decade of the Monetary Board (1963 -1972). Closer to the top left are the sub periods 1973-1982, 1983-1992 and 1993-2002; the last one had lower inflation and lower growth than the first two.



Additionally, Figure 4 shows the stability of growth and inflation in the five sub periods described above. Again, the best macroeconomic performance was between the years 2003-2012, a period of high inflation stability and growth. The worst performer was the 1992-2002 period, years in which growth variability was considerably higher due to the strong contraction of GDP in 1999, and inflation variability was second only to that observed between 1963 and 1972. However, the high inflation variability in these two sub periods occurred because inflation fell from levels close to 30% to single-digit rates (although volatility also rose during the Monetary Board period due to rising inflation in 1971 and 1972).



B. INTERPRETATION

Using this data, what can we state about Colombian macroeconomic performance before and after the independence of the Bank? At least three facts seem undeniable. The first is that inflation fell from levels close to 30% in the early 90s to an average rate of 3.1% between January 2009 and September 2013. Three percent is the definition of price stability of the Bank's Board of Directors, with a control range of + / - one percent. Therefore, the central bank's independence ended consecutive decades of moderate-to-high inflation.

The second is that the period of disinflation (1992-2000) was traumatic in terms of economic growth and volatility. This fact may be associated with the emergence of macroeconomic problems simultaneous to disinflation such as the increase in public spending as a share of GDP, an unsustainable rise in public debt, excessive credit expansion that fueled a housing bubble, and the occurrence of important/significant exchange-rate mismatches. The presence of indexation mechanisms, generated in the extended period of "moderate inflation," exacerbated the effects of these imbalances on production and employment when external financing to emerging economies in the region suddenly stopped in the late nineties.

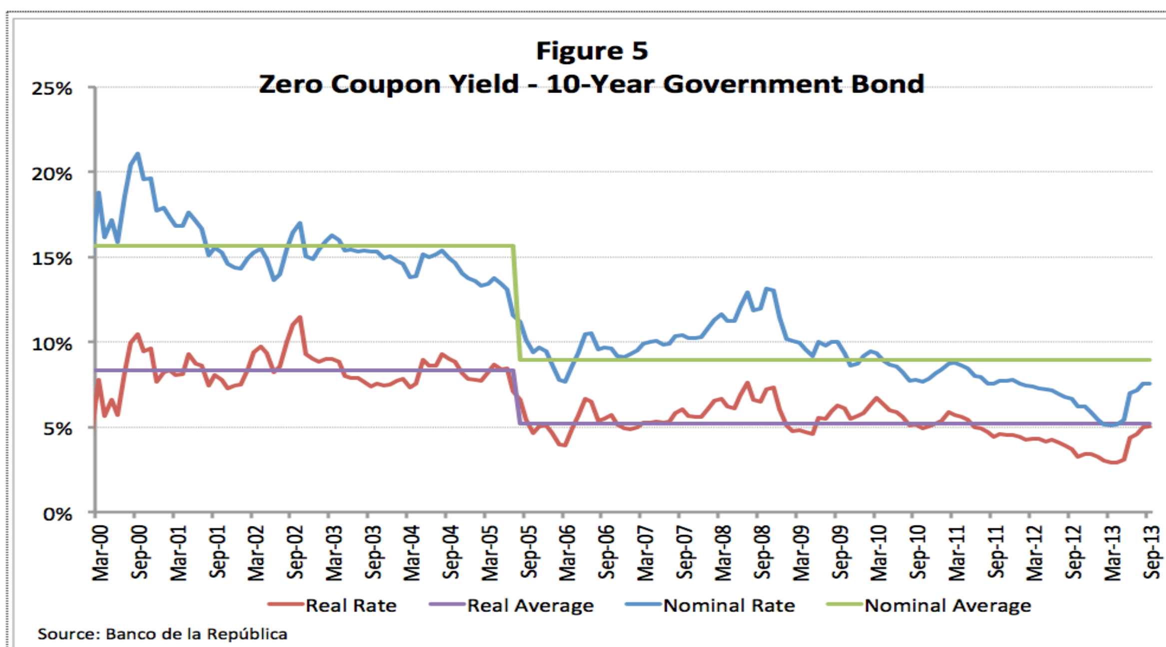
The third salient fact is that, so far in this century, inflation and economic growth have been exceptionally stable. It is often supposed that to keep inflation on target, it is necessary to allow major changes in interest rates and GDP growth. In that case, policymakers face a trade-off between accepting higher inflation stability or greater GDP growth stability. But in the last decade, Colombia achieved price stability while GDP growth variability fell significantly. This

may have occurred either because the economy did not face strong shocks - as part of the phenomenon of "Great Global Moderation"[xiv] - or because the shocks were better absorbed.

The absence of shocks is an improbable explanation for the higher aggregate stability in this century. In recent years the Colombian economy received high intensity shocks of diverse origins. For example, in 2003 and in 2009 trade between Venezuela and Colombia collapsed (for various reasons), and in 2006 and 2007 international commodity prices rose significantly. The peso declined nearly 50% between May 2002 and February 2003, and by a similar amount between June 2008 and February 2009. The global crisis of 2008 and 2009 greatly affected trade, terms of trade, capital flows, and trust. In 2010 and 2011, the weather phenomena known as El Niño and La Niña adversely affected food production and transportation. Some of these shocks were as strong or stronger than those observed in the previous century.

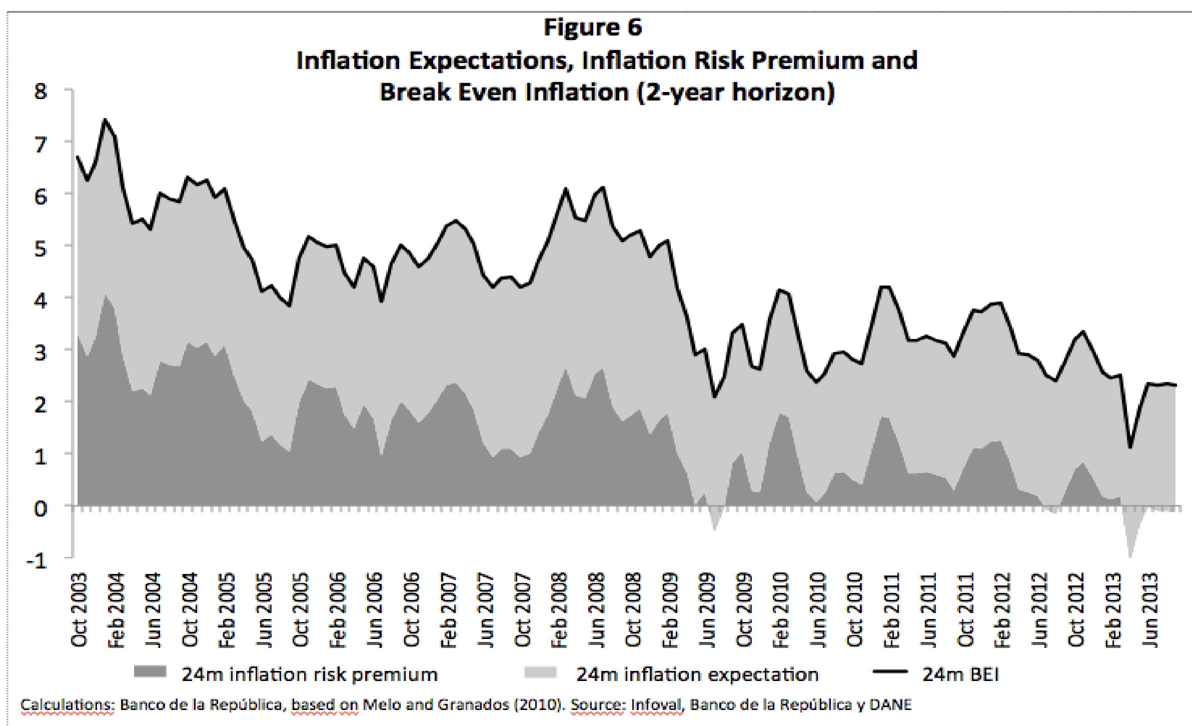
Hence, the greater growth stability and inflation is better explained by improvements in the policy framework employed by the independent central bank, which allow the economy to absorb shocks more than before (and perhaps also to a bit of luck). Consider the following two graphs:

- Figure 5 shows the nominal and real interest rates derived from the zero-coupon yield curve of Colombian government bonds (TES) from January 2000 until now. The sharp drop in the level of nominal and real rates implies, among other things, that investors' inflation expectations have declined over the medium term, as has the premium they demand in compensation for the risk of a rise in inflation in the future. This "anchoring" of inflation expectations happens because, making use of its independence, the Board changes its policy interest rate consistently and decisively when it foresees deviations from the inflation target.



- Figure 6 shows an estimate of the break-even inflation (an inflation compensation measure) for Colombia, calculated from the yield of government bonds in local currency (TES). The compensation can be disaggregated into expectations and inflation risk.[xv] As shown in the graph, the inflation expectations component has been converging towards 3%, the goal of long-term inflation, and inflation risk to 0. The latter means that the probability perceived by the market for a sustained increase in inflation is almost null. The behavior of both the expectations and the risk components reinforce the thoughts explained in the previous paragraph.

Figure 6
Inflation Expectations, Inflation Risk Premium and Break Even Inflation (2-year horizon)



Calculations: Banco de la República, based on Melo and Granados (2010). Source: Infoval, Banco de la República y DANE

With improvements to the credibility of monetary policy and the anchoring of inflation expectations to the target, along with exchange rate flexibility, the Colombian economy has gained resistance to external negative shocks. What happened during the international financial crisis, and its comparison with the experience at the end of the 90s, is descriptive of this phenomenon. As is evident in Figure 7, monetary policy was strongly counter-cyclical after the bankruptcy of Lehman Brothers. The interbank lending rate, which closely follows the policy interest rate, diminished rapidly since December 2008; thus the domestic economy received a boost when the change in external conditions threatened to dip the country into recession during the international crisis. In contrast, as shown in Figure 8, in the second half of the 90s the behavior of the interbank interest rate was procyclical: the interest rate and the country risk premium moved in the same direction.

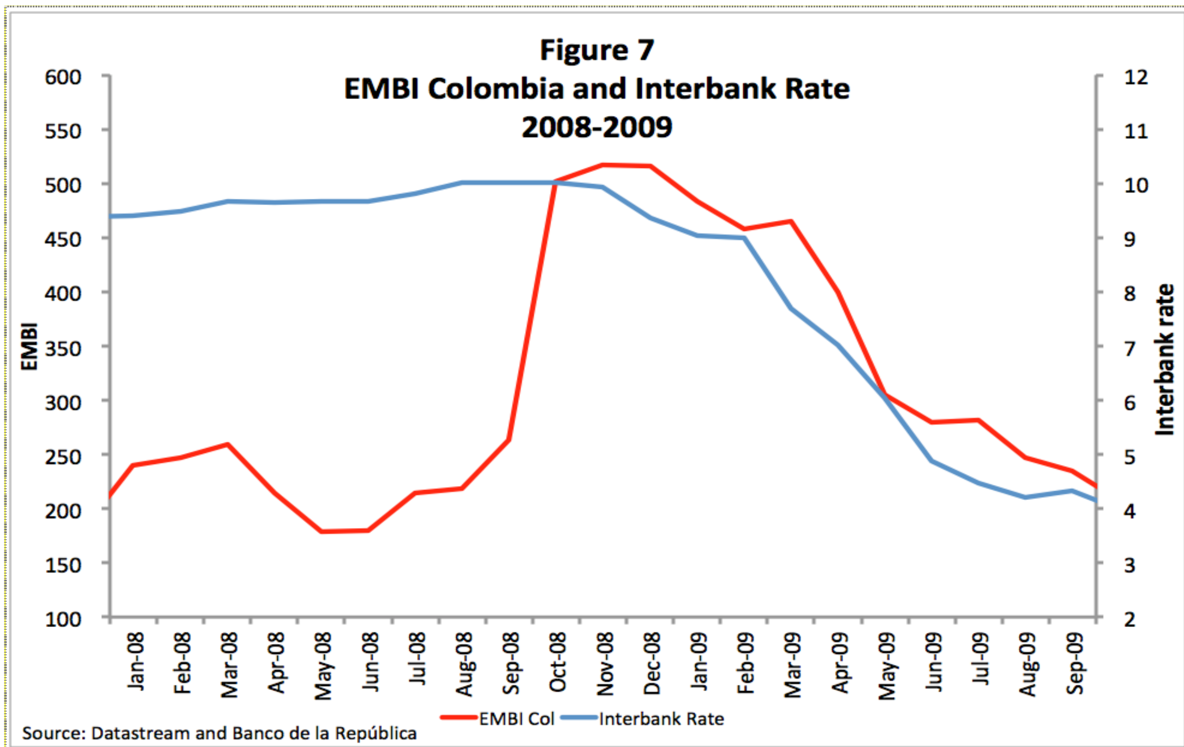


Figure 7
EMBI Colombia and Interbank Rate
2008-2009
EMBI
Interbank rate
600
550
500
450
400
350
300
250
200
150
100
12
11
10
9
8
7
6
5
4
3
2
Jan-08
Feb-08
Mar-08
Apr-08
May-08
Jun-08
Jul-08
Aug-08
Sep-08
Oct-08
Nov-08
Dec-08
Jan-09
Feb-09
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EMBI Col
Interbank Rate
Source: Datastream and Banco de la República

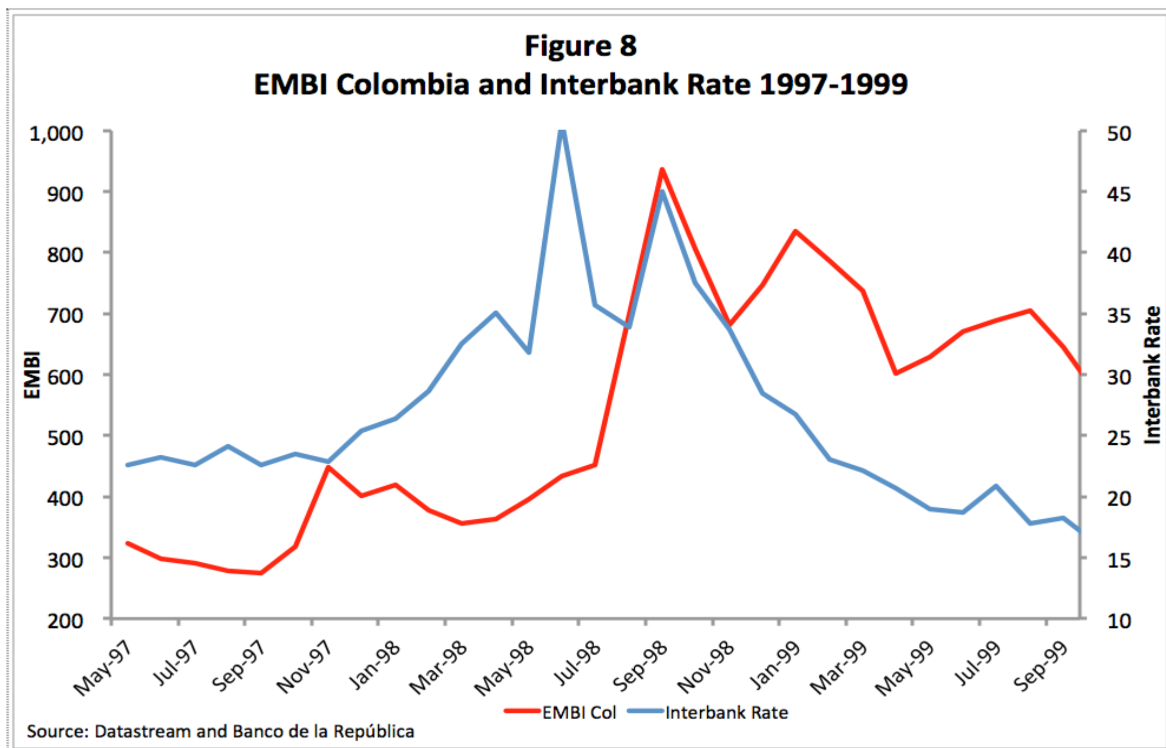
Figure 8
EMBI Colombia and Interbank Rate 1997-1999
EMBI
Interbank Rate
1,000
900
800
700
600
500
400
300
200
50
45
40
35
30
25
20
15
10
May-97
Jul-97
Sep-97
Nov-97
Jan-98
Mar-98
May-98
Jul-98
Sep-98
Nov-98
Jan-99
Mar-99
May-99
Jul-99
Sep-99
EMBI Col
Interbank Rate
Source: Datastream and Banco de la República

Additionally, the flexible exchange rate facilitated the counter-cyclical response of monetary policy and allowed the peso devaluation between June 2008 and February 2009 to act as a "buffer" to the negative external shock. In contrast, during the 1990s the exchange rate band regime - partly justified because of the existence of strong exchange-rate mismatches and inflation expectations - limited the counter-cyclical response of monetary policy and partially restricted exchange-rate movements. The two phenomena, of course, were related and joined numerous other weaknesses in the fiscal and financial fields, thus limiting the responsiveness of the Colombian economy. Consequently, Colombia's GDP contracted in 1999 for the first time since the 1930s.

Meanwhile, the anchoring of inflation expectations seems to have affected the Colombian economy's response to cost shocks. For example, in the late 80s and early 90s, the devaluation of the peso was passed through quickly and almost completely to inflation. In contrast, in this century only a fraction of the movements in the exchange rate passes through to prices. That change is partly explained by the anchoring of inflation expectations to the Board's target. Indeed, with inflation expectations anchored, companies restrict exchange rate pass-through to inflation, a phenomenon that is probably also valid for other types of cost changes and their translation into consumer prices. This suggests that cost changes are now more specifically affecting profits than prices.

In summary, the behavior of the Colombian economy has significantly improved so far this century. In recent years the combination of both the levels and the variability of inflation and economic growth compare favorably with those observed in previous decades. Although several factors may have contributed to this improvement, it is clear that the monetary policy framework employed by the independent central bank has played a key role in this process as it gained credibility and managed to anchor inflation expectations. This widened the Central Bank's margin of maneuver and changed the response of Colombian companies to costs, thus contributing to the stability of economic growth.

III. AUTONOMY IN PRACTICE

Finally, let's consider the following question posed by the conference organizers: What have the most effective institutional arrangements been with respect to protecting the Central Bank from political interference and helping it achieve the macroeconomic accomplishments described previously?

Some elements of the legal framework have been especially helpful. First, a clear and strong commitment to price stability. There is no ambiguity in the law: price stability is the primary objective of monetary policy and each year the Board of Directors must define and publish a quantitative inflation target. Price stability is also a constitutional citizens' right and the State, through the members of the Board of Directors of the Central Bank, has the responsibility to guard it.

Second, the Board of Directors' autonomy to ensure price stability. The Board is not subject to orders from the President of Colombia. It is a self-funded entity that does not depend for its operation on the nation's general budget and cannot be forced to assign direct credit to the government (for this, a unanimous vote of the Board would be necessary). It also has complete autonomy to manage policy instruments and has technical and administrative independence.

However, as we saw before, the Board is headed by the Minister of Finance and cannot be indifferent to other economic policy objectives such as output growth and employment. What other arrangements, formal and informal, protect the autonomy of the Central Bank and its commitment to price stability? I consider the following four points to be particularly important:

- The legal obligation of the Board to announce a quantitative inflation target generates a specific responsibility and offers society a parameter for evaluating its performance that is visible and easily understood. This reduces the incentive of the Board to misuse the non-neutrality of monetary policy in the short term.
- The Governor and the five Codirectors of the Board have the necessary conditions to make autonomous decisions. First, they are appointed for a term of four years and cannot be removed before their period ends. That gives them continuity. Second, their period overlaps with that of the President, which enhances their independence. Third, because when the President replaces two of the five Codirectors, the other three are automatically nominated for another four years. Thus, the probability of remaining on the board for eight years is relatively high, and this is expected to raise the members' sense of long-term liability.
- The Minister of Finance as well as each member of the Board has one vote out of a total of seven. Consequently, none can evade a decision they do not support nor impose one on the rest of the Board. In turn, the Minister's presence on the Board, justified by the constitutional mandate to coordinate the Bank's policies with "general economic policy," facilitates management. For the Bank, it is easier to coordinate with a single member of Government than it would be with several, and this is better achieved within the Board than outside of it. Furthermore, the definition of the quantitative inflation target must be defined by mutual agreement with the Government, and there is a close link between the policies of the two institutions; for example, between monetary and fiscal policy, or between the condition of lender of last resort and financial regulation and supervision.
- The Board of Directors' discussion always begins with a document prepared by the Bank's technical staff, and Codirectors and the Governor regularly share with each other and with the Bank's technical staff information, analyses, opinions, and experiences relevant to making monetary policy decisions. This generates a kind of fellowship that focuses much of the policy discussion on technical aspects, reducing the risk of making improvised decisions or enacting choices that are biased by the pressures or horizons of the political system. It also requires that members of the technical staff and Board be highly qualified and autonomous. With this in mind, the Bank invests considerable resources in staff member's education, and promotes open discussions and diverse opinions, as well as different academic backgrounds.

CONCLUSION

The case of Colombia is valuable in understanding the benefits and importance of central bank independence. As we saw in the second part of this presentation, the autonomy of the Central Bank ended decades of moderate to high inflation levels that negatively affected the country's GDP growth. The implementation of this scheme requires, as mentioned in the first part of this presentation, legal and regulatory elements that safeguard the autonomy of the Board and the Institution's capacity to make its own organizational decisions. But these elements are not enough to protect the autonomy of the Central Bank and its commitment to price stability. Independence also requires that members of the technical staff and Board be highly qualified and autonomous. Fortunately, this has been achieved within the Bank and, at a larger scale, Colombian society has demonstrated it values these technical traits immensely.

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[i] Art. 373 CP.
[ii]Parágrafo del artículo 2 de la Ley 31 de 1992
[iii] Art. 371 CP.
[iv] Sentencia C 481 de 1999.
[v] Art. 372 CP.
[vi] Art. 371 CP.
[vii] Sentencia C529 de 1993.
[viii] Sentencia C489 de 1997.
[ix]Art 4. Ley 31 de 1992 y Art. 16 lit i) Ley 31 de 1992.
[x] Art. 373 CP.
[xi] Art. 372 CP.
[xii] Art. 371 CP. Art 5 Ley 31 de 1992.
[xiii] Art. 372, Arts 47 y 48 Ley 31 de 1992.
[xiv]See Perri, F. y V. Quadrini (2008) "Understanding the international great moderation". Meeting Papers 1057, Society for Economic Dynamics y Borio, C. y A. Filardo (2007) "Globalisation and inflation: New cross-country evidence on the global determinants of domestic inflation".
[xv] This disaggregation is based on the model by Melo and Granados (2010).