Contribution to the Panel Discussion
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We are going into a massive global crisis and there is little we can do about that. Of course we cannot hope to anticipate exactly how this crisis will hit us. Nor would we expect to emerge unscathed from it.

But as this conference shows, we can manage some risks. We can pick out the more likely or more painful risks and try and prepare for them. Then there are unknown risks. Here, I want to argue that during the boom phases of the cycle, we should try and gain some flexibility so that we are free to act when needed.

My contribution to this panel discussion will be to tell you about the recent Colombian experience. I am going to begin by describing the macroeconomic context. Then I will go on to talk about our exposure to the current crisis.

A summary is that Colombia's fundamentals and policy structure are both in reasonably good shape. In particular our growth is now sustainable and the balance sheet of our private sector is reasonably healthy. We have improved our regulatory framework and honed our crisis management strategy. Growth will be low next year, but on the back of these underlying strengths, we would at least to expect to recover more quickly.

In part we reached this stability because we have been tightening during a large part of the up-phase of this cycle, since 2006. I want to emphasize that it is a policymaker's job in countries such as ours to try and make sure that we are always facing the right way when a crisis hits. One simple rule of thumb is to lean against the wind as far as possible. In that way we keep pushing the economy back towards a sustainable path even in the face of very large external shocks. As I shall explain, that means sometimes working along both monetary policy and financial stability dimensions.

Let me take you back to 2004 and 2005. The Colombian economy had just finished recovering from the long and deep recession that we fell into following the Asian and Russian crises. But by early 2006, that recovery was very quickly transforming into a boom. Inflation was picking up, and domestic demand was growing much faster than GDP. The current account deficit was widening even as our terms of trade were improving. And then there was a sudden burst of credit growth in the second half of 2006, which brought in new, more risky borrowers into the credit system and weakened the balance sheets of our firms and households.

Without the benefit of hindsight, it is often hard to assess the sustainability of the path followed by an economy, especially one in which the security and external conditions have improved so markedly as in Colombia in recent years. It could be argued that a surge in FDI was a natural consequence of the improved security and confidence in the country. Similarly, financial deepening was a welcome development in a country that was emerging from a financial crisis and where the access to financial system services is still very limited for a large fraction of the population.

In our case, we were alerted that the economy was straying from its sustainable path simply because of the sheer *speed* at which some of these phenomena were occurring. For example, financial system loans' real annual growth went from 10% in December 2005 to 27% in December 2006. The average of five core CPI annual inflation measures increased from 3.5% in April 2006 to 4.8% in April 2007. The current account deficit widened from 1.8% of GDP in the second half of 2006 to 3.6% of GDP in the first half of 2007.

Excessive booms damage both macroeconomic and financial stability. So we responded by raising interest rates. In all, we put up interest rates by 400 basis points between April 2006 and July 2008.

Yet demand and credit were expanding so quickly, that just was not enough. Also, the authorities were concerned about the appearance or deterioration of currency mismatches in the private and public sectors´ balance sheets, a lesson painfully learnt in the late nineteen nineties.

So, in addition to the central bank interest rate increases, in 2007, we raised marginal reserve requirements to slow down the flow of bank credit. On top of this, our financial stability authority raised banks required provisions for credit and implemented a new system of administering credit risk.

We also stepped our accumulating international reserves during this up-phase, and in 2007, we imposed measures to make it more costly to borrow short-term from abroad, as well as to limit currency mismatches and foreign currency liquidity risk. More specifically:

- We already had limits on the net foreign currency- denominated asset position of Banks and other financial institutions as a fraction of their net worth. These limits are meant to curb currency mismatches of financial intermediaries.

- Banks are allowed to borrow from abroad only to make foreign currency-denominated loans in Colombia or to hedge forward purchases of foreign currency. In both cases the maturity of the external funding must be longer than the term of the loan or the forward foreign currency purchase. This limits the currency and maturity mismatch of local banks.

- We require Banks and other financial institutions to have a positive net "cash" foreign currency-denominated asset position of as a fraction of their net worth. This ensures that foreign currency liquid assets exceed liquid foreign currency liabilities, thus reducing the foreign currency liquidity risk of the financial system. There is also an upper bound for the net “cash” foreign currency-denominated asset position to avoid excessive pressure on the exchange rate in episodes of rapid depreciation.

- We reactivated a deposit requirement on foreign debt and portfolio investment in order to discourage short-term capital inflows and reduce the vulnerability of the economy in the face of a sudden reversal of those flows.

- We imposed a limit on the gross foreign exchange derivative position of Banks and other financial institutions as a fraction of their net worth. This limit was aimed at reducing the counterparty risk of financial intermediaries in the FX derivative market.

These measures have paid off. We are in a better position as we go into this crisis. Our domestic demand growth has cooled. The growth rate for the first half of 2008 is 4.9% above the same six months of 2007. In conjunction, our current account deficit has stopped widening. Real credit growth for our financial sector as a whole has slowed from over 20% to a healthier 13%. Our financial system has a 13.9% risk weighted capital ratio, well above the Basle II minimum recommendation. Banks have expanded their provisions substantially, following the new legislation. International reserves are now equivalent to about 35% of the deposits in our financial system.

The above-mentioned foreign exchange regulations restricted the foreign currency intermediation activities of local banks. At the same time, those regulations limited short-term foreign currency indebtedness and currency mismatches of the private sector, as well as its scope to hold large foreign exchange speculative positions. As a result, the foreign currency liquidity risk was largely contained in Colombia.

Last but not least, it is true that our inflation rate is still high. But we are hoping that we will see firmer signs of that receding quite soon. I will come back to that shortly.

All in all, I think we have gained enough room to react actively to a crisis however it hits us**,** due mainly to a set of preventive measures that we took in view of the risks that were accumulating during the upward phase of the cycle.

I should say that the deceleration of our growth from a very high rate of 8% in 2007 to what could be somewhere in between 3 or 4% in 2008 is much, much sharper than what we had expected or wanted. But not all of that slowdown could have been due to our policy measures.

In fact, another very important factor that cut down on our growth was inflation itself. The sharp rises in prices that we experienced in this up phase began to weigh heavily on the real incomes of consumers by 2008. In countries such as Colombia where access to the financial sector is limited, consumption follows real income closely.

In this sense, this sharp slowdown in real income was unavoidable as it was driven by a one-off upward adjustment in relative food and energy prices at a global level. But there is still a responsibility for the central bank and that is to make sure that this relative price adjustment is not allowed to spread to a generalized and unruly inflation. Otherwise growth would have been affected even more.

The reason why I digress to mention this is to caution against expecting that we can gain much in terms of growth in the future by letting inflation escape, at least in countries like Colombia. That should matter in the discussions we have about risk management.

Let me now turn to how I see our financial risks in Colombia. Specifically how can this crisis affect Colombia?

Up until, the main effect has been more costly international finance. In recent months the risk premium on our external borrowing has risen, our currency has depreciated and our bonds and stocks have fallen in value.

Looking forward, this is likely to intensify. We would also expect much less remittances and foreign direct investment inflows than in the past. This scarcity will feed through to raise the internal cost of borrowing for households and firms.

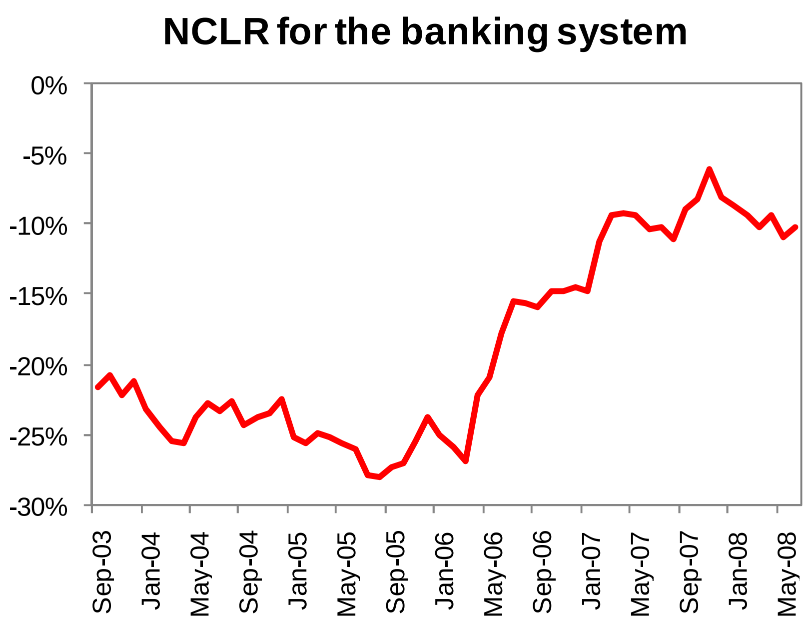
Another channel by which the crisis will affect us is through shrinking world demand. The fall in world demand growth will reduce both the real volume growth and the price of our exports and so will affect domestic production, incomes and unemployment. This will inevitably worsen the balance sheets of our private sector. All in all, this would mean a rise in **credit risk.**

But in part thanks to our preemptive actions, our households are not so indebted so as to be in risk of a significant default, as happened in the United States. There are some households on low incomes who will find debt repayment very difficult in the next few years. But the extra provisions of the banks should cope with this. In this way, the regulatory changes that our financial supervision authority has made in the last few years have helped to contain credit risk.

Broadly speaking our corporate sector is much less exposed than households**.** The percentage of their liabilities that is both short-term and foreign currency denominated is relatively small for example. The evidence is that the end-of-the-century recession in Colombia was so prolonged because firms had to quickly repay the loans that financed bad investments and they did so by cutting spending drastically. Now, this time and thanks to the foreign exchange regulation, we would not expect balance sheets to worsen so much and less sacrifice will be needed to repair balances.

A second threat is an increased **liquidity risk**. Chart 1 plots the Ratio of Non-covered Liabilities of the Colombian banking system. You can see that, measured in this way, aggregate liquidity risk remains at a low level, that is negative. But it has increased since November 2007 and, it will most likely increase further.

Chart 1. Liquidity Risk measured by the NCLR



Notes: NCLR is measured as a negative liquidity GAP to illiquid assets.

$$NCRL = \frac{(VCL + LL) - [(LA - INV) + \lambda INV]}{TA - LA}$$

Where VCL are volatile component of liabilities, LL is liquid liabilities, LA is liquid assets, INV are banks' investments, λ is the haircut to government bonds and TA are total assets.

Sources: See Financial Stability Report, Banco de la República, September 2008.

Of course we must keep monitoring liquidity risk closely because we want to prevent any liquidity problems from causing an overreaction of retail lending rates and stimulating credit risk. To this end, it is good that our new system of liquidity risk, called SARL, jointly designed with the financial supervision authority is being implemented and will be completely operational in April 2009.

Then there is **market risk**. The rise in interest rates will push down on the values of domestic bonds. But our financial institutions and banks have substantially reduced their exposure to these bonds to safer levels. A stress testing exercise of assuming a 200 basis point rise in the bond interest rate suggests that all credit issuing institutions will lose just over 10% of their annual profits.

That then is how I see our management of expected risks. But experience has taught us that we cannot anticipate exactly all risks and manage them all beforehand. So finally I want to conclude by emphasizing that it is important to have a range of instruments at our disposal.

One set of instruments are to do with financial stability. In Colombia, we have various options for providing liquidity to the markets. For example we can adjust our reserve requirements and use the lender of last resort facilities that were perfected during the last financial crisis (1998-2000).

As for monetary policy actions, here I first want to repeat that it is important that our fundamentals are sound when the crisis strikes. Second the monetary policy scheme we have in place must be sufficiently flexible to allow us to react without losing credibility. That is the case with our inflation targeting regime. As I explained earlier if we are worried about inflation now, that’s because high and volatile inflation has a real tangible cost on our growth, even in the short term. In this sense, it heightens the credit risk. Once inflation shows signs of receding, we will have even more room to react to any crisis. Third, flexibility in the foreign exchange has been beneficial, possibly due to us being able to minimize the currency mismatches.