**Meeting on Governance, Transparency and Accountability in Financial Institutions and Regulatory Bodies**
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# Governance, Transparency and Accountability in Colombian Central Bank and Financial Regulation

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- Question for the Panel: Did problems of governance, transparency and accountability contribute to the inadequacy of efforts to prevent the global financial crisis affecting developing countries, as well as managing it better?

- The answer I will provide is entirely based on the Colombian experience but I think may be applicable to several other Latin-American economies.

- It may be summarized as follows: Contrary to what happened in previous crises, the central bank, which is independent from the government, was able to act in a countercyclical way, tightening monetary policy during the boom period and loosening it during the current crisis. In contrast, it has been extremely difficult to introduce countercyclical macro-prudential features in financial regulation, which depends on the Government.

- I would argue in this context that the classical dilemma between independent central banks, on one hand, and short-run

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accountability to public opinion, on the other, did work in Colombia in favor of the former. As argued in Stiglitz (1998), this may not be true in the case of developed economies or other economies with a long tradition of low rates of inflation. For a country like Colombia that experienced double-digit inflation rates during the last 25 years of the twentieth century, the advantages of an independent central bank were extremely important.[1]

- Delinking monetary policy from short-run considerations was key to get a much desired countercyclical monetary policy. In terms of financial regulation, much could be gained if there was a better governance structure with a longer horizon for policy-decision taking. More specifically, much could be gained with an accountability scheme in which regulators and supervisors are not judged by the short-run results of the financial sector, but by the degree of financial stability measured through the full extent of a complete economic cycle.

- I will organize my remaining comments in two parts. First, I will expand on the reasons why I think that the independence of the central bank in Colombia has helped to improve the quality of monetary policy and to introduce a countercyclical framework. Later on, I will make some comments on financial regulation.

[1] As mentioned in Stiglitz (1998), societies that had experienced “recent bouts with high inflation are likely to be enticed into having central banks with a greater degree of independence, structured in ways that signal a greater commitment to fight inflation. Those with a more favourable recent history will have harder choices to make” ( p.224)

## Central Bank Independence and Countercyclical monetary policy

- The independence provided to the Colombian central bank by the 1991 Constitution received strong criticism during many years due in part to the pro-cyclical role that monetary policy played in Colombia during the deep economic cycle of the 1990s, as also happened in many other Latin American economies. In fact, interest rates were very low during the capital-inflows boom of the mid-1990s and extremely high during the crisis of the end of the century.

- This criticism is however unfair as it does not reflect the fact that monetary policy had been also procyclical before the central bank got its independence. This procyclicality of monetary policy in the Colombian case has been documented by Miguel Urrutia and Cristina Fernandez (2003) with data since the 1920s, when the Colombian central bank was created. Urrutia and Fernandez show that monetary policy was tighter than normal during all of the episodes of GDP deceleration or recession in the twentieth century. In a more general way, Kaminsky, Reinhart and Vegh (2004) have shown that both monetary policy and fiscal policy are typically procyclical in emerging economies and Ocampo and Vos (2008) illustrate how damaging this is to long-run growth.

- As argued in Urrutia and Fernández, monetary policy was procyclical during the twentieth century in Colombia as a result of the combination of three main factors, which may be common to many other emerging economies. The first one is that GDP growth in Colombia is mostly explained by external factors.[2] The second one is that good external conditions,

[2] This feature has been largely documented in several papers by José Antonio Ocampo and most recently by Mahadeva and Gómez (2009). Graph 1 in Annex 1, taken from the Urrutia and Fernandez paper, shows that the four largest crises during the last century, as measured

namely high terms of trade and large (exogenous) capital inflows are closely associated with pressures towards domestic currency appreciation. Together with the first factor, this implies that domestic currency appreciation typically occurs during boom periods and domestic currency depreciations during the bust periods. The third factor has to do with the association between the exchange rate behavior and inflation expectations, which was quite strong during most of the twentieth century in a context of unstable and relatively high inflation.

- With these three factors, monetary policy was forced to act in a procyclical way. Whenever there was an externally led GDP boom, it was accompanied by a domestic currency appreciation and low levels of inflation. Under these circumstances, the central bank was bound to lower interest rates in order to mitigate the currency appreciation. When the opposite happened and the economy was facing an externally driven bust, the central bank was typically concerned about the depreciation of the domestic currency and the corresponding upward pressure on inflation, so that it typically tightened monetary policy, aggravating the negative effects of the external crisis on the domestic economy.[3]

- This type of behavior of the Central Bank changed in a drastic way in recent years. Between 2006 and the first half of 2008, when the economy was growing above its historical average, interest rates were increased and monetary policy was further tightened with higher reserve requirements on bank deposits. This policy was adopted in a context in which the Colombian

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by the cyclical behavior of per-capita GDP (1930-31, 1940-43, 1980-85 and 1998-2000) clearly coincided with the sharpest drops in foreign capital inflows.

[3] Graph 2, also borrowed from Urrutia and Fernandez (2003) shows that, exception made of the second world war period, money growth was exceptionally low in all of large crises of the twentieth century.

peso was experiencing an important process of appreciation as a consequence of extraordinarily high terms of trade and huge capital inflows to emerging economies. In contrast with previous episodes of currency appreciation and economic boom, the central bank did not react by loosening monetary policy, but by a very important process of international-reserve accumulation and a reserve requirement on foreign capital inflows.

- More recently, since mid-2008, when it became evident that the international crisis was affecting emerging economies, the Colombian central bank has been able to loosen monetary policy by reducing interest rates and reserve requirements. Despite the fact that the peso has depreciated by nearly 50% in less than a year, the central bank target for the short-run interest rate has been reduced by 300 (¿400?) basis points and is now at one of the lowest levels in the Colombian history, 7% (6%) in nominal terms and 1% (0%) in real terms.

- The ability of the Central Bank to undertake a countercyclical monetary policy was largely a result of two factors: First, the independence provided to the Central Bank by the Constitution in 1991 allowed its directors to have a relatively long horizon, making them less dependent on a volatile public opinion mood. Second, the clear mandate by the Constitution to have price stability as the primary role of the Central bank allowed the Colombian economy to move from the traditional exchange-rate anchor to an inflation-target anchor, with a great deal of exchange rate flexibility. A credible inflation targeting allowed the central bank to have a freer exchange rate regime. For the inflation targeting to be credible, however, the governance structure of the central bank had to be clearly delinked from the short-run pressures of the government and public opinion.

- Two years ago, when the economy was growing much above its historical average and the Colombian central bank tightened monetary policy, its decisions were not popular and were deemed by many as biased against growth. At some point, the Colombian President suggested that tightening monetary policy was an anti-democratic attitude and asked the central bank to consult its decisions with the people.

- Can it be argued that acting in a different direction of the recommendations of a very popular president was a sign of lack of accountability or an antidemocratic attitude? My own view is that the dilemma is not about accountability but about the length of the horizon with which monetary policy should be judged. Elected governments are biased towards immediate results and short-run public opinion mood. Independent central banks must be made accountable for their results but their accountability must be defined in the proper time frame.

- In the Colombian case, the Board of Directors of the central bank is appointed by the Government, although each particular President is supposed to appoint only a minority of the Board during its term in office. Every four years, the President replaces two of the five full-time members of the Board. Every eight years, therefore, the majority of the Board is renewed by an elected person, who represents public opinion under a democratic society. In this sense, political accountability of the Board members does clearly exist, although it is what I call a long-term accountability. Also, of course, there is legal accountability and the Attorney General may prosecute Board Members whenever they act against their public responsibilities.

## Financial regulation and countercyclical policies

- The positive view I have just described about the way in which monetary policy has worked in the very recent period is not so positive when dealing with the countercyclical role of financial regulation.

- The current crisis in financial systems has not reached Latin American and Caribbean Economies. The international crisis, through the fall in the terms of trade, the increased risk perception and the reduction in foreign capital inflows, have affected GDP growth and have deteriorated the balance of payments. However, so far, the domestic financial systems are healthy in the region.

- The relatively strong position of the financial systems in LAC countries partially come from the lessons of awful experiences in recent years, in particular, those of the 1999 crisis. Those experiences made banks, borrowers and regulators much more prudent than otherwise.

- Prudence is the typical behaviour during and after a crisis but it doesn´t last forever. Typically, it is forgotten in boom periods if they are long enough, as it clearly happened in the advanced countries. That is why it is so important to introduce macro-prudential and countercyclical regulation.

- Good supervision and regulation at a micro level is not enough. A macroeconomic crisis usually affects even the best managed financial institutions. Hence, macro-prudential regulation is a must. Analists at the BIS, like William White and Claudio Borio, have been alerting on this for several years now. The Spanish experience with dynamic (statistical) provisions seems to be a promising avenue when dealing with this type of problems.

- In the Colombian case, many of the arguments in favour of countercyclical macroprudential regulation of the financial system were widely known during the recent boom period.[4] However, the introduction of a Spanish type dynamic provisioning rule faced strong opposition from the financial sector. Although the regulatory and supervisory authorities were able to introduce some elements of that type of regulations, their full implementation was not possible.

- At the time of the credit boom, the introduction of restrictive regulations, namely countercyclical regulations, was perceived as a measure against the financial system, against freedom and against the widely spread idea that high rates of GDP growth were a permanent feature of a new Colombia. Arguing in favour of those regulations would not receive public support from neither the financial sector nor from workers, real sector associations or public opinion in general.

- What type of accountability should be in place in this case? Should financial regulators be liable before Congress for the short-run results of their decisions? My own perception is that they should not. Their accountability should be restricted to the long-run effects of their decisions and this implies some degree of autonomy and independence from Government and Congress in the short run. The system of long-term accountability that we have in Colombia for the central bank in dealing with monetary policy issues would be a good example for a regulatory board dealing with financial regulation.

- Of course, independence and autonomy do require a great deal of transparency. Both financial regulators and central banks

[4] See Ocampo (2003)..

need to be particularly transparent as their autonomy is larger. Explaining to the public opinion, to Congress and to the financial sector the reasons behind any decision must be an integral part of the responsibility acquired by an autonomous authority.

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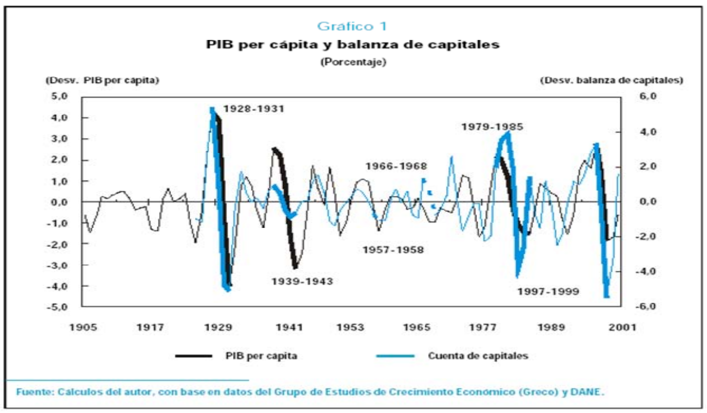
## ANNEX 1

**Graph 1: The four largest crises as measured by per-capita GDP growth since 1920 coincide with large drops in capital inflows.**




**Graph 2: Exception made of the crisis of the 1940s, real money balances experienced contractions in each of the crises, illustrating a procyclical bias of monetary policy**