

Box 1

Banco de la República's 100th Anniversary

The Bank is celebrating its 100th anniversary since its foundation and the trajectory that has established it as the one independent state institution that generates the greatest confidence among Colombians¹ due to its transparency, management capabilities, and effective compliance with the central banking and cultural responsibilities entrusted to it by the Constitution and the law.

Banco de la República's mandate was established in the National Constitutional Assembly of 1991, whose members represented the Colombian people. Citizens had the opportunity to elect those who would occupy the seventy seats tasked with drafting a new constitution for Colombia. Members of the Liberal Party, followed by those of the M-19 Democratic Alliance (*Alianza Democrática M-19*) (a political party that emerged from the peace negotiations and demobilization of the M-19 guerrilla), and representatives of the National Salvation Movement (*Movimiento de Salvación Nacional*) obtained the highest number of votes. Some representatives of the Conservative Party, the Christian Union, the *Unión Patriótica*, and indigenous movements also occupied seats. The leaders of the three political movements that received the most votes² were elected presidents of the Assembly. This tripartite presidency was intended to reflect the plurality and the need for consensus among the different political forces to move the reform forward (taken from: Gonzalez Jacome, 2022: 100-101).

Monetary stability was the reason why the decision was made to include the issue of central banking in the 1991 National Constitutional Assembly and to provide Banco de la República with the necessary autonomy to use the instruments for which they are responsible without interference from other authorities. The constituent members understood that ensuring price stability is a duty of the state and that the entity responsible for this task must be enshrined in the Constitution and have the technical capability and institutional independence necessary to adopt the decisions they deem appropriate to achieve this fundamental objective in coordination with the general economic policy. *Banco de la República* would be the autonomous constitutional body in charge of preserving the purchasing power of the currency. This provision coincided with the central banking system adopted by countries that have been successful in controlling inflation.

The Constitutional Court stated in its 1999 Ruling 481 that “the duty to maintain the purchasing power of the currency is not only predicated on the monetary, credit, and exchange authority, i.e., the Board of *Banco de la República*, but also on those who have responsibilities in the formulation and implementation of the general economic policy of the country” and that “the basic constitutional purpose of *Banco de la República* is the protection of a sound currency. However, this authority must consider the other economic objectives of state intervention such as full employment in their decisions since these functions must be coordinated with the general economic policy.” All this means that the responsibility that falls on the government and *Banco de la República* in the management of inflation and its effects on growth and employment is mutual, in the sense that the government may not ignore inflation, nor the Bank ignore the impact of its decisions on real economic activity.

1. Historical Perspective

***Banco de la República* was created in 1923 through Act 25, as Colombia's central bank within the parameters defined by the Kemmerer Mission.** This mission consisted of a group of U.S. financial experts hired by President Pedro Nel Ospina to advise the government on the modernization of public finances and the financial system. The monetary disorder that the country experienced at the beginning of the 20th century associated with the go-

1 In November 2022, the Opinion Panel of the *Cifras y Conceptos* company, which consults opinion leaders in Bogotá and different urban areas of the country, revealed that *Banco de la República* was recognized as the institution that inspires the most confidence in the nation. This distinction has been awarded to the Bank for thirteen consecutive years.

2 Horacio Serpa (Liberal Party), Antonio Navarro (Democratic Alliance of the M-19), and Alvaro Gomez (National Salvation) were elected presidents of the Assembly.

vernment's management of issuance made it evident that there was a need for an entity that could separate monetary management from fiscal management. Under the guidelines of the Kemmerer Mission, Act 25/1923 entrusted *Banco de la República* with the exclusive power to issue legal Colombian currency and, in addition, it was established as a bank of banks, lender of last resort, administrator of foreign reserves,³ and as a bank and fiscal agent of the government.

In the late 1940s, following the suggestions of the Federal Reserve Mission, the Bank was thought to be able to implement a pro-development model by channeling credit to sectors that were considered strategic.⁴ During the following decades, the Bank's monetary policy was split between expanding credit for development and controlling money to ensure macroeconomic stability. This debate became clearer in the 1950s when the Bank's Board of Directors was dominated by members of the banking sector who were responsible for monetary regulation and, at the same time, the main beneficiaries of the Bank's primary credit.

The Monetary Board was created in 1963 so that the Colombian State could regain its authority over currency and credit⁵. It was comprised by the main people responsible for the country's macroeconomic policy, i.e., the Minister of the Treasury (who chaired it), the head of National Planning, the Governor of *Banco de la República*, the Director of the Colombian Institute of Foreign Trade, and the Ministers of Development and Agriculture.⁶ Thus, the Monetary Board was entrusted with the orientation of monetary, foreign exchange, and credit policies, and *Banco de la República* was in charge of their implementation under the direction and administrative control of the Board of Directors. By the end of the 1980s, it was clear that the existence of various functions that were difficult to harmonize, such as the regulation of monetary circulation, foreign exchange control, and the allocation of development credits through financial funds managed by the Bank made it difficult to implement policies consistent with price stability. It was also clear that this model generated higher inflation, more frequent exchange rate adjustments, and delayed capital market development.

The 1991 Constitution gave greater autonomy and independence to *Banco de la República* and established the preservation of the purchasing power of the currency as its objective. The experience accumulated throughout the 1980s raised serious questions regarding the role played by *Banco de la República* and the Monetary Board. In this context, several countries, including Colombia, embarked on reforms to the central banking regime in order to consolidate its autonomy and independence and move it from a model with multiple objectives to a single one – to maintain the stability of the purchasing power of the currency in coordination with general economic policy.⁷

2. Central Banking Constitutional Regime

The reforms to *Banco de la República* agreed upon in the Constitutional Assembly of 1991 can be summarized in the following aspects: 1) the Bank was assigned a specific mandate: to maintain the purchasing power of the currency in coordination with the general economic policy; 2) the Board of Directors of *Banco de la República* was defined as the country's monetary, foreign exchange, and credit authority; 3) the Bank and its Board of Directors

³ *Banco de la República* deposited foreign reserves in foreign banks. The management of foreign reserves was explicitly established in Decree 340/1980.

⁴ Decree 1407/1948, Legislative Decree 756/1951, and subsequent regulations.

⁵ Act 21/1963 provided for the creation of the Monetary Board and empowered the government to determine its organization and main attributes.

⁶ Decree Act 2206/1963. Decrees 2976/1968 and 151/1976 determined that the director of the Colombian Institute of Foreign Trade (Incomex) would also be a member.

⁷ This main function was corroborated by the Constitutional Court in Ruling C-481/1999, where it was concluded that the basic constitutional purpose of *Banco de la República* is the protection of the sound currency. However, this authority must take the other economic objectives of state intervention such as full employment into consideration in their decisions since these functions must be coordinated with the general economic policy.

were granted a significant degree of independence from the government; 4) in matters of financing for the government and individuals, the following was decreed:

“The Bank may not set credit limits, nor grant guarantees in favor of individuals except in the case of intermediation of foreign credit for placement through credit establishments, or temporary liquidity support for them.” Financing transactions in favor of the State shall require the unanimous approval of the Board of Directors unless they are open market transactions. In no case may the legislature order credit quotas in favor of the State or individuals;⁸

5) Congress was appointed, on behalf of society, as the main addressee of the Bank's reporting exercise, and 6) the responsibility for inspection, surveillance, and control over *Banco de la República* was delegated to the President of the Republic.

3. The Importance of Low and Stable Inflation

The Board of Directors of Banco de la República has established 3.0% as the inflation target. In compliance with the constitutional mandate granted to *Banco de la República* to preserve the purchasing power of the peso and contribute to improving the welfare of the people, the goal of monetary policy in Colombia is to maintain a low and stable inflation rate and to achieve the maximum sustainable level of output and employment. *Banco de la República* follows an inflation targeting regime under a flexible exchange rate regime to achieve their objectives.⁹ Under this approach, monetary policy actions are intended to ensure that future inflation is within the target set in the policy horizon (3.0%).¹⁰ There are several reasons why this monetary policy plan, which aims at price stability, is the best contribution the central bank can make to public welfare.

Low inflation promotes the efficient use of productive resources, which ensures greater growth and well-being for the population in general. In contrast, when inflation is high, a portion of individuals' time and the economy's resources are invested in the search for mechanisms to defend against it. For example, companies and households could protect themselves from price growth by buying fixed assets (such as a house or a warehouse), as opposed to postponing a productive investment, which would not be optimal because it reduces the generation of employment and economic growth of the country.

Low and stable inflation reduces uncertainty and stimulates investment. Inflation is an indicator of macroeconomic stability that helps agents make decisions confidently. The most important economic decisions made by individuals and companies are usually long-term: building a factory, starting a business, accessing education, and buying a home. These are crucially dependent on the degree of uncertainty about the future. Price stability reduces the inflationary risk premium in interest rates, thus lowering the level of nominal interest rates and increasing incentives to invest (Gerdesmeier, 2009). Low inflation also reduces uncertainty and provides more certainty about future investment returns. Economies with high inflation have also been found to suffer from more variable inflation (Balls and O'Donnell, 2002; Chowdhury, 1991). Increased uncertainty can negatively affect the expected return on investment and, therefore, long-term growth. This situation could affect companies, for example, by generating high wage cost increases that erode their profits and tend to make wage negotiations between employers and workers more difficult.

Low inflation avoids arbitrary redistribution of income and wealth, especially against the poorest population. Even though high inflation affects the real income of society as a whole, its impact is much more harmful to lower-income families since they are more likely to

⁸ Article 373 of the Constitution of Colombia shall read as follows:

⁹ The inflation targeting approach has been, in general, a successful monetary policy strategy (Villar, 2023). Countries with inflation targeting plans score higher, compared to any other monetary policy regime, on indicators that provide a multidimensional characterization of monetary policy frameworks. These include pillars such as independence and accountability, operational strategy, and communication (Unsal, Papageorgiou and Garbers, 2022).

¹⁰ Between 1991 and 2001, the BDBR established specific yearly inflation goals. In November 2001, the BDBR reported that the long-term target for inflation was 3.0% and explained that maintaining this goal would be equivalent to pursuing price stability for the country. Beginning in 2002, it began to announce an acceptable range around the specific target for the following year, the latter being the midpoint of that range. In mid-2009 inflation was around 3.0%, and since 2010, the inflation target has been centered on the long-term target (3%).

have fewer defense mechanisms such as real estate against inflation. In addition, in poor households, consumption is concentrated in essential or basic goods and services and, generally, they run the risk, when inflation is high, of not being able to replace the goods and services that have increased in price with cheaper ones. This is not the case for the high-income population whose consumption pattern can be adjusted in response to increases in the prices of goods or services. Moreover, compared to high-income households, poor and vulnerable households generally spend a higher percentage of their income on indexed items (i.e., tied to actual inflation). For example, the weight of the utilities and rent components is 3.5 and 9.26 percentage points (pp) higher respectively in the consumption basket of poor households compared to high-income households.¹¹ Thus, a runaway inflation would generate a persistent cycle of unwanted price increases in a significant portion of the basic consumer basket, especially among the poor and vulnerable population. For all of the above reasons, inflation is described as a regressive “tax” that affects lower-income people more without forgetting that the real income of the entire population is affected. Likewise, high inflation rates correlate with political instability because people, particularly those most affected by rising inflation, feel cheated and hold the government in office responsible for the economic performance of the country (Gerdesmeier, 2009; Paldam, 1987).

The constitutional mandate to maintain the purchasing power of the currency has contributed to a more stable macroeconomic environment. This has favored sustained economic growth and ensured financial stability, the development of the capital market, and the proper functioning of the payment systems. In this environment, inflation decreased significantly after persistently hovering in double-digit figures prior to the 1990s. The inflation targeting regime implemented as of 2000 was fundamental to this process of inflation reduction. Thus, in spite of the fact that in the last twenty years several shocks have impacted the Colombian economy such as the international financial crisis in 2008, the El Niño phenomenon in 2016, and the COVID-19 pandemic, inflation has stayed around the target most of the time. Lower inflation has contributed to reductions in the inflation risk premium¹² (Graph B1.1, panel B), lower TES interest rates (Graph B1.1, panel C), and loans (Graph B1.1, panel D). At the same time, the duration of public domestic debt rose significantly as it went from 2.27 years in December 2002 to 5.86 years in December 2022 (Graph B1.1, panel E), and financial deepening, measured as the level of the portfolio as a percentage of the GDP went from around 20% in the mid-1990s to values above 45% in recent years (Graph B1.1, panel F). As suggested by the stress indicator for banking establishments, all of the above has occurred in a healthy environment for credit institutions (Graph B1.1, panel G). In this context, there was a reduction of income inequality as measured by the Gini coefficient which went from 58.7 in 1998 to 51.3 in the year prior to the pandemic (Graph B1.1, panel H).

Consolidating the inflation targeting regime has made it possible to implement countercyclical monetary policies. After the 1999 economic crisis, *Banco de la República* implemented several measures to consolidate the inflation targeting system. First of all, they abandoned the exchange band system and adopted a free-floating exchange rate system. They also established 3.0% as the long-term inflation target and used the monetary policy interest rate as the main monetary policy instrument, thus leaving behind the monetary brokers who had lost their explanatory power over inflation. They also strengthened the country's statistical system by constructing new indicators to measure the changes in important macroeconomic variables.¹³ They also built economic models to diagnose the present and future state of the economy, and thus evaluate the persistence of inflation deviations and expectations for it with respect to the 3.0% target. The implementation of this entire rigorous inflation targeting regime helped the country to face strong shocks with the lowest possible costs in terms of output and employment such as the international financial crisis of 2008 and the economic crisis that was caused by the COVID-19 pandemic in 2020. In the case of the international financial crisis and its effects on global confidence, the macro-prudential measures implemented in this country at the beginning of the first decade of the 21st century that were intended to strengthen the health of the financial system as well as the credibility of monetary policy in its task of defending purchasing power were fundamental to dealing with this shock. Given the exceptional nature of the shock produced by the COVID-19 pandemic, in turn, the Bank first ensured the liquidity of the economy, the stability of the payment

11 Information on CPI weighting can be found at <https://www.dane.gov.co/index.php/estadisticas-por-tema/precios-y-costos/indice-de-precios-al-consumidor-ipc/ipc-actualizacion-metodologica-2019/ipc-ponderadores>

12 Derived from the breakdown of breakeven inflation expectations (BEI).

13 Such as, for example, housing prices, inflation expectations, consumer confidence, exchange rate mismatches, liquidity, and financial system risks, etc.

Graph B1.1
Historical Performance of some Macroeconomic Variables in Colombia (annual change)

A. Consumer Price Index (CPI)



Source: DANE.

B. Inflation Risk Premium from the Break-even Inflation Breakdown^{a/}



a/ According to Abrahams *et al.* (2015) "Decomposing real and nominal yield curves" and Espinosa *et al.* (2015) "Inflation expectations, inflation risk premium and liquidity premium: a break-even inflation breakdown for Colombian government bonds," inflation expectations net of premia are calculated as the spread between nominal and real risk-free rates extracted from local government bond markets at different maturities. In this respect, the so-called "inflationary risk premium" arises from subtracting the term premium of the TES curve in UVR from the term premium of the TES curve in pesos. Spreads in these forward premia may be reflecting uncertainty about future inflation. However, they may also be influenced by frictions particular to each market such as the preferences of some agents to invest in certain types of securities.

Sources: Precia; calculations by Banco de la República.

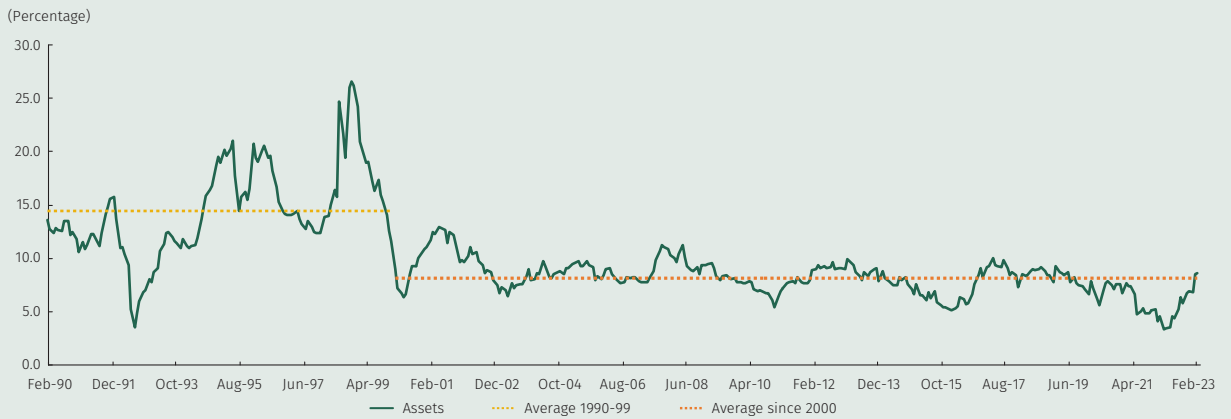
C. TES rates



Sources: SEN (electronic trading system) and MEC (Colombian electronic market), Calculations by Banco de la República.

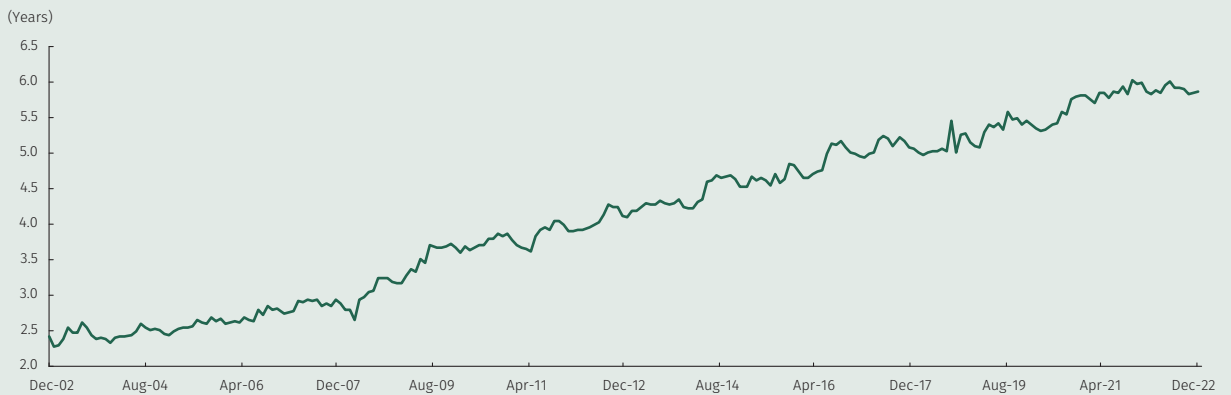
Graph B1.1 (continued)
Historical Performance of some Macroeconomic Variables in Colombia

D. Real lending interest rate^{b/}



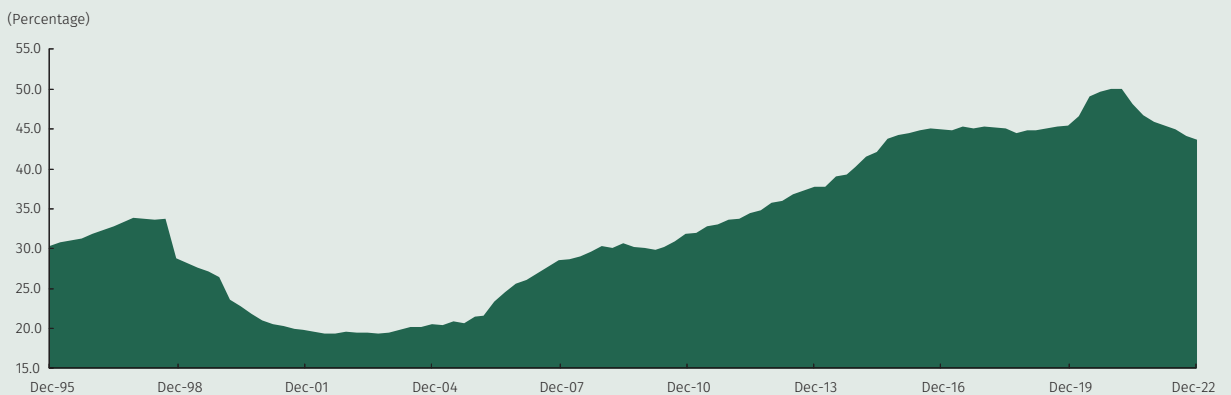
b/ Deflator: Total CPI.
Source: Office of the Financial Superintendent of Colombia; calculations by Banco de la República.

E. Duration of domestic debt



Source: Ministry of the Treasury and Public Credit.

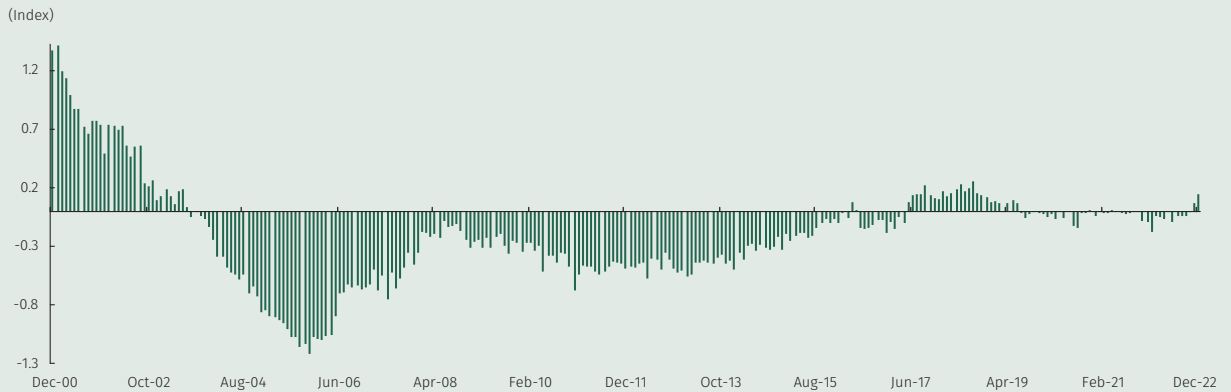
F. Portfolio balance in national currency as a percentage of GDP



Source: Office of the Financial Superintendent of Colombia, DANE; calculations by Banco de la República.

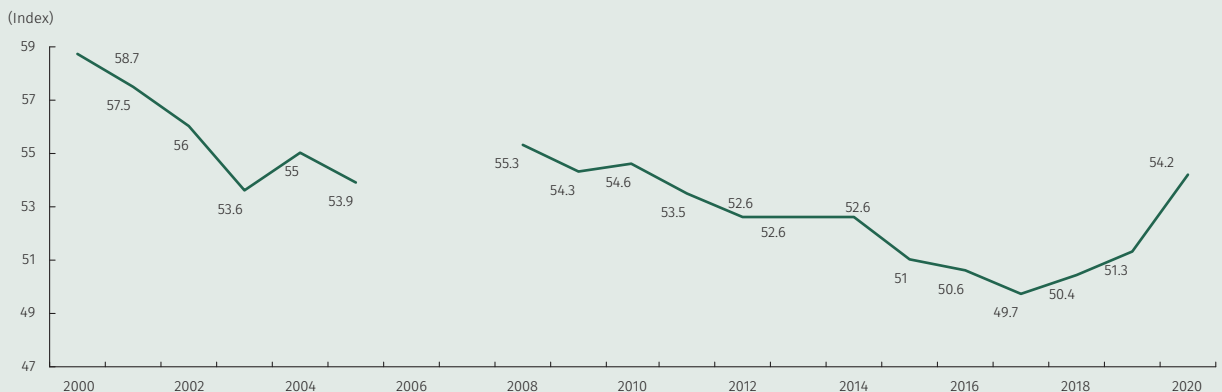
Graph B1.1 (continued)
Historical Performance of some Macroeconomic Variables in Colombia

G. Financial stress indicator for credit institutions^{c/}



^{c/} This indicator is obtained by weighting the following variables using the equal variance method: ROA, ROE, ICM (non-performing/gross portfolio), non-performing/gross portfolio, ex-post margin, liquid liabilities/liquid assets, interbank funds/liquid assets and the ratio of unhedged liabilities (RPNC). Negative values indicate periods of greater financial stability.
Source: Office of the Financial Superintendent of Colombia; calculations by Banco de la República.

H. Colombia's Gini Coefficient



Source: World Bank.

system, and the money and exchange market, and then pursued an expansionary monetary policy that was a crucial element for the country's economic recovery.

During its 100 years, Banco de la República has become one of the most credible institutions in the country as it ensures the macroeconomic stability of the nation and the purchasing power of the currency. In spite of the different economic crises the country has faced, the Colombian peso has maintained its credibility throughout the years and has positioned itself as the only means of payment accepted throughout the Colombian territory. Going forward and recognizing the role of technological advances in the digital transformation of economies and the redefinition of the way agents interact and transact, *Banco de la República* has included the decision to foster a new immediate payment system as part of its agenda of future projects along with other initiatives. This initiative seeks to move towards a system for immediate, secure, and efficient transfers that is fully interoperable and contributes to market competitiveness, financial inclusion, and the country's development.

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