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"Exchange Rate Bands and Shifts in the Stabilization Policy Regime: Issues Suggested by the Experience of Colombia" by Alberto Carrasquilla

For 25 years, Colombia's monetary and exchange rate policies were built around a crawling peg regime aimed at maintaining stable inflation rates in the moderate range. In early 1994, the authorities decided to replace that regime with a system of exchange rate bands. In other countries, exchange rate bands were introduced as part of ongoing stabilization efforts to reduce inflation rates of over 100 percent. In contrast, Colombia viewed them as a mechanism or an initial condition for disinflation. The timing and objectives of the policy shift are interesting in themselves.

The paper argues that the policy shift represents a change in perception about the costs of inflation to Colombia. To test this, a simple analytical model of optimal policy is presented, with the initial results suggesting that inflation is indeed deemed costlier by the Colombian authorities than was the case before. The purpose of the paper, therefore, is to discuss the post-1989 period, evaluating the stated hypothesis and pinpointing general issues of exchange rate policy, and of bands in particular, that may prove to be of broader analytical interest and practical relevance.

Since the early 1970s, Colombia has traded off higher inflation for an institutional setup in which inflation would hover in the 20-30 percent range. Monetary, fiscal, commercial, and exchange rate policies were designed to maintain this situation. In return, the government obtained substantial inflationary finance throughout the period; from average (but volatile) rates of around 0.8 percent of GDP, the inflation tax rose to a (stable) rate of over 2 percent of GDP during 1980-93. These funds were an important component in the financing of central bank credit and help explain why the Colombian public sector debt, at 30 percent of GDP, is low by international standards.

Efforts initiated at the beginning of the 1990s to liberalize the current and capital accounts, the financial sector, and the labor market show that the authorities gradually accepted that inflation could not remain at conventional levels. Furthermore, given that important disinflation was occurring in other countries of the region, they realized that inflation must come down. Accordingly, they set out to make the central bank independent, achieving this goal with the establishment of the new constitution in 1991. The new central bank abandoned active sterilization, began issuing dollar-denominated debt, and decided to abandon the crawling peg in favor of a relatively complex exchange rate regime. In January 1994, explicit exchange rate bands were put in place to allow exchange rate flexibility and to obtain independence for the conduct of monetary policy. At the same time, external and internal shocks--enhanced capital inflows and an expenditure boom--have led to an appreciation of the real exchange rate. Concerns with competitiveness have been traded off against gains in disinflation.

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