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Abstract

In the last decade the issue of the optimal degree of central bank independence has been at the center of attention of academics and policymakers in many countries. The direction of institutional reform has almost universally been toward making central banks more independent from political pressure. The motivation of this move is linked to an increased emphasis on price stability as the main or only goal of monetary policy after two decades of exceptionally high inflation rates. Colombia has made an effort in reforming a complex set of monetary institutions, which for over two decades delivered a persistent, moderate rate of inflation. The central bank reform -along with the elimination of many indexation practices, the liberalization of financial activity and the reduction of trade and capital account barriers- delivered substantial progress. This paper argues that a reduced set of "second generation" reforms aimed at correcting limitations that were maintained may further deepen these accomplishments. We propose to make the board of the bank smaller and to remove any members of the executive from it. An appropriate timing of appointments should also create stability in the board. Lengthening the appointment tenure of the governor and board members, together with a staggering of terms, reduces the risk that every new executive brings about an entire new board, or at least a new majority in the board of the bank. The central bank should also have a clear mandate that sets inflation control as its overarching goal. This is important because the recent involvement of the Constitutional Court in the matter of the relative precedence of inflation control over other goals raises much confusion. Finally, we conclude that the central bank is the institution better suited to supervise the financial sector. While arguments pro and against using the central bank as the financial regulator certainly exist, on balance we conclude that for a middle-income country this is the best solution.

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I. Introduction

In the last decade the issue of the optimal degree of central bank independence has been at the center of attention of academics and (more importantly) of policymakers in many OECD and developing countries. This is an issue of great and burning importance, especially in two situations: in the case of countries that have experienced macroeconomic imbalances and are implementing "structural reforms"; and, second, in the case of the creation of new political entities, in need of new monetary institutions, like the European Union and several newly born countries around the globe[1].

The direction of institutional reform has almost universally been toward making central banks more independent from political pressure. Recent examples include the United Kingdom, Canada and New Zealand in the OECD and Chile (1989), El Salvador (1991), Argentina (1992), and Mexico (1993) in Latin America. The new European Central Bank, modeled to the Bundesbank, is one of the most autonomous central banks in the world. The motivation of this move is linked to an increased emphasis on price stability as the main or only goal of monetary policy after two decades - the seventies and eighties - of exceptionally high inflation rates in both developing and OECD countries.

Colombia had its own central bank reform in 1991. The intention of the legislators was to increase the degree of independence of the central bank, but the reform, which was the result of conflicting pressures, produced an unsatisfactory institutional arrangement. For instance, the presence of the treasury minister in the board of the central bank, the timing and procedures of appointments, and the lack of a clearly specified goal for monetary policy, are features that are normally NOT thought of as indicators of independence of the monetary authorities. In addition, as in many other areas of policy, the Colombian Constitution is very detailed in the norms that regulate the central bank. Virtually any significant change in the institutional rule governing the central bank requires a Constitutional reform.

Our proposal revolves around three issues: changes in the appointment procedures for the board and the governor of the bank; a clearer legislative definition of the mandate of the central bank and the goal of monetary and exchange rate policy; the definition of the central bank as the supervising entity of the financial sector.

We propose to make the board of the bank smaller and to remove any members of the executive from it. An appropriate timing of appointments should also create stability in the board. Lengthening the appointment tenure of the governor and board members, together with a staggering of terms, reduces the risk that every new executive brings about an entire new board, or at least a new majority in the board of the bank. These reforms are meant to increase the stability and independence of monetary policy. For the same reason, the central bank should also have a clear mandate that sets inflation control as its overarching goal. This is important because the recent involvement of the Constitutional Court in the matter of the relative precedence of inflation control over other goals raises much confusion[2]. Finally, we conclude that the central bank is the institution better suited to supervise the financial and banking sector. While arguments pro and against using the central bank as the financial regulator certainly exist, on balance we conclude that for a middle-income country this is the best solution.

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[1] In 1946, there were 76 independent countries in the world; there are 193 today.

[2] Other chapters in this project have noted how the excessive involvement of Courts has created problems for the conduct of policy. For a general discussion of the role of the constitutional court in the checks and balances created by the Colombian Constitution see Kugler and Rosenthal (2000).

The chapter is organized as follows: In section II, we discuss the rational for central bank independence and question what are the institutional features that make a central bank more or less independent. In section III we describe the current institutional situation of the Colombian central bank. In section IV we formulate a proposal for institutional reform. The last section concludes.

II. Why independent central banks?

A. The issues

The rationale for independent central banks is that if politicians (the legislature and / or the executive) have a direct, everyday control and supervision over monetary policy, they may be tempted to jeopardize long run monetary stability for short run benefits. A few examples of these political incentives include:

- Unanticipated monetary expansions may lead to temporary reduction in unemployment, through a Phillips curve effect. This temporary expansion soon disappears, as market expectations adjust and the economy is trapped in a high-inflation equilibrium[3]. Politicians interested in a short run burst of growth (and reduction of unemployment) would choose the temporary expansion, even at the costs of compromising long-term monetary stability. A variant of this argument is that when monetary tightening is necessary from the point of view of optimal stabilization policy, the government may postpone or water down the monetary restriction.

- In a period of fiscal imbalance, political pressures might imply monetization of deficits, to the extent that the inflation tax is "hidden" relative to other forms of taxation. In fact, fiscally induced loose monetary policies have been one of the main causes of high inflation episodes in Latin America.

- The incentives to pursue short run goals as in points a) and b) are particularly high in election years and may create sub optimal cycles related to elections[4].

In a small open economy, these incentives would make it very difficult, if not impossible, to maintain a fixed exchange rate system. Therefore, maintaining a fixed rate system without an independent monetary authority firmly committed to price stability is particularly problematic. This point underscores the close link between monetary institutions and exchange rate regimes.

An additional effect of a direct political control on the central bank is that every time a government changes, monetary policy would follow the specific preferences of the new administration. This feature may add some undesirable lack of predictability on monetary policy[5].

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3 See Barro and Gordon (1983) for a formalization of this argument.

4 A large literature has discussed these kind of political business cycles; see Alesina, Roubini and Cohen (1997) for a detailed treatment of this are of research. Shi and Svensson (2000) show that political business cycles are actually larger and more common in developing countries than in the OECD.

5 See Alesina, Roubini and Cohen (1997) on this point.

B. How could an independent central bank help?

A central bank that is not under the everyday control of the executive or the legislature may shield monetary policy from the incentives described above, which lead to policies excessively concerned with the short term. One should be clear about what to expect from laws, since, after all, men and women make monetary policy, not institutions. Generally, we do not approve of dictatorships, although some dictators may actually follow good policies. The point is that even an objectionable institution can occasionally produce good policies. However, we do not like dictatorships because in the hands of most people this institution may lead to very poor outcomes. The argument for «good» institutions is that they help well-intentioned politicians do "the right things" and create obstacles for not so well intentioned ones to do the "wrong things".

1. ¿How can one measure political independence?

Political independence of central banks around the world has been evaluated in two ways[6]. The first one is by examining the laws that regulate the relationship between the bank, the executive and the legislature. One set of rules concerns the composition of the governing board of the central bank. The presence of members of the government in the Board of the bank is viewed as a sign of low independence. Short terms of appointments of board members are also taken as indication of low independence, since the latter are frequently in a position of seeking reappointment and pleasing their political sponsors. The possibility of each new executive to appoint ex novo the entire board (or a majority of its members) also reduces continuity and stability in the conduct of monetary policy. A staggered system of appointments in policy committees insures policy stability and policy "moderation", avoiding extreme swings in the composition of the committee, and therefore, in its policies[7]. Restrictions on who may or may not serve as a board member also can insure independence.

With an eye on the Colombian case, it is worth noting that the presence of members of the executive in the board of the bank is considered as one of the most obvious and clear indicators of low independence by these cross-country indices. The international evidence on this point is quite striking. In no OECD country, any member of the executive is a voting member of the board of the central bank. In no country in Latin America is the Treasury Minister a member of the board, let alone its President. Therefore, the Colombian arrangement in which the Treasury Minister is the chairman of the board of the bank is extremely unusual.

A second set of rules refers to the relationship between government finances and monetary policy. Obviously, any rule that requires the central bank to buy government debt reduces the ability of the bank to pursue an independent monetary policy. Rules that regulate the relationship between monetary policy and the fiscal balance vary across countries, and sometimes complicated wordings and hidden rules may make more or less obscure the basic issue of how much the central bank is committed to "help out" with monetization of deficits.

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[6] A vast literature has addressed this issue. With special reference to measurement of central bank independence in OECD countries see Grilli, Masciandaro and Tabellini (1991) and Alesina and Summers (1993). For developing countries see Cukierman (1992) and the references cited therein. Most of this literature (especially that on non-OECD countries) is based on data that ends in the early nineties. Given that the Colombian institutional occurred in 1991, the available international comparisons are not very relevant.

[7] See, for instance, Waller (2000).

A third legislative area relates to the written goals for monetary policy. If the law explicitly attributes to the monetary authority the goal of maintaining price stability, the central bank has the legislative support necessary to deflect political interference[8]. A legislative goal of price stability does not mean that the central bank will follow in every instant a policy of zero inflation at all costs, but that price stability is the goal that has to be achieved *"cum grano salis"* in the medium run. There is, of course, a margin of ambiguity here. Several economists argue that this 'ambiguity' should be eliminated and a goal of price stability should be explicitly pursued at any instant by the central bank. Others argue for a more flexible approach, according to which a "zero inflation" target has to be achieved in the medium run, thus allowing for some moderate role for monetary stabilization policies[9]. The point is, however, that an explicit goal of price stability in the law of the bank is normally taken as an indication of "independence" of the monetary authorities[10]. In other words, an independent central bank may choose once in a while to abandon the goal of price stability, but having an explicit goal of price stability shields the bank from undesired pressures. A vast literature has investigated the pros and cons of inflation targeting in OECD countries[11]. In a recent review of experiences in emerging markets, Mishkin (2000) argues "that although inflation targeting is not a panacea...it can be a highly useful monetary policy strategy", even for developing countries. More on this point, below.

2. ¿Do laws "work"?

An important question is whether the actual degree of central bank independence heavily depends on the laws regulating the institutional position of the bank or whether its "de facto" behavior is unrelated to those laws and regulations. Research on OECD countries has convincingly shown that central bank laws are closely associated with the expected outcomes. More specifically, independent central banks (by law) have been associated with relatively low inflation and macroeconomic stability. Interestingly, these benefits of stability have not been associated with the costs of lower average growth or more growth that is variable[12]. Alesina and Summers (1993) highlight a strong and negative association between the average level of inflation and the degree of central bank independence in a sample of OECD countries. The same authors show that, instead, there is no relationship between central bank independence and variability of GDP growth.

Results for non-OECD countries are less clear-cut. Many central banks, which by law appear quite independent, have not behaved in ways consistent with their status, and vice versa. In other words, plotting a measure of the legal independence of central banks against measures of inflation would not show a clear relationship. On the other hand, researches have noted that the frequency of changes in the leadership of the central bank has been positively associated with poor monetary management and inflationary pressures. In other words, countries with frequent changes of central bank governors have experienced high and variable inflation[13]. There is, of course, an issue of what causes what, but it would appear that causality runs both ways.

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[8] Normally, "price stability" is defined as a target of inflation below say, 2 percent a year, or similar.

[9] Obviously, how long this medium run is leaves a bit of flexibility and ambiguity in the operation of the central bank.

[10] For instance, this is the goal of the European Central Bank.

[11] We cannot even begin to summarize this literature. The reader is referred to Taylor (1999).

[12] For results along this line, see Alesina and Summers (1993), Grilli, Masciandaro and Tabellini (1991) and Cukierman (1992)

The point, for our purposes here, is that "laws" may not be enough to guarantee central bank independence. The actual practice of monetary policy may vary even holding constant the institutional status of the central bank. However, this consideration should not stop the legislator from setting up appropriate institutions concerning central bank independence. Nevertheless, one has to be aware that independent central banks alone cannot guarantee monetary stability.

3. ¿How about democratic control over monetary policy?

The ideas of "democracy" and of delegation are not in conflict with each other. Democratic control over the conduct of monetary policy is achieved by periodic appointments of the board (see below) and by the setting of a goal for monetary policy. In this respect, a distinction is made between "goal independence" and "instrument independence"[14]. The former implies that the central bank would choose the goals for monetary policy and the instruments to achieve them. The latter implies that the goals for monetary policy are chosen by the legislature (and / or the executive) and the central bank can independently choose the instruments.

Very few disagree with the idea that central banks should have «instrument independence». It would be hard to imagine a legislature debating on the appropriate use of M2 or M3, or about which interest rates to target. However, "instrument independence" may not be enough. Suppose that a legislature decides that an appropriate goal for monetary policy is to monetize the deficit, a policy that would certainly result in high inflation. The fact that the central bank is free to choose which instruments to use to monetize does not help much.

A standard objection to "goal independence" is that, in a democracy, elected officials should choose policy goals. Thus, how does one insure democratic control over monetary policy, insulating the latter from the ebb and flows of politics? Democratic control over monetary policy is achieved in two ways. One is the appointment procedure, through which an executive / legislative interaction delivers the selection of members of the Board. The second is by the "democratic delegation" to the central bank of a goal of inflation control, which, ultimately, is the only objective that monetary policy can deliver. An interesting analogy is with an independent judiciary. No one would argue that an independent judicial system is in conflict with the idea of democracy, while in most democracies "justice" is administered by independent institutions.

Several commentators argue that central banks have to be "accountable". One has to be clear on this point. If an "accountable" central bank is one that has to seek approval for every policy decision, then an "accountable" central bank is a non-independent one. Independence means that the central bank is "accountable" in the general, broad sense described above, but it is "not accountable" in day to day policy decisions, however important they might be.

4. ¿What about monetary and fiscal policy coordination?

One common objection to the idea of central bank independence is that it makes it difficult to coordinate monetary and fiscal policy, thus leading the economy to higher interest rates and slower

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[13] A case in point is Argentina. Although the law established that the tenure of the Governor was 4 years, during the 1980's the average tenure was around 10 months.

[14] See, for instance, Fischer (1995).

growth than would otherwise be the case. In reality, often the idea of "coordination" is nothing more than an attempt to loosen the government's budget constraint and open the door for political pressures on the central bank to monetize deficits. In fact, an explicit "lack of coordination" may create incentives for the fiscal authority to follow more prudent polices. In many cases of fiscal adjustment in highly indebted OECD countries, the independence of monetary policy helped reinforce the more prudent fiscal incentives.

Avoiding an explicit requirement of "coordination" does not mean that central banks' policies are oblivious to anything happening in the economy. For example, in the case of banking crises, the central bank may choose interventions that may jeopardize in the short run the goal of price stability. However, this is very different from requiring an explicit coordination of monetary and fiscal policy. An explicit insistence on active coordination paves the way for supremacy of the government in the monetary / fiscal policy package.

5. Monetary policy rules and exchange rate policy

In a small open economy exchange rate policies and the exchange rate regime are crucial elements of monetary arrangements. It would be hard to envision a central bank in a small open economy trying to achieve monetary stability without being in charge of exchange rate policy.

Even from a political-economy point of view, it makes sense that the central bank should be in charge of exchange rate policy. In an economy where import / export constitute a large fraction of GDP, the interests of distinct industries regarding the exchange rate are typically different. The interests of "consumers", namely a large but unorganized group, may be underrepresented in a political process heavily influenced by lobbying groups. Politico-economic theory suggests that if the benefits of a policy are concentrated and the costs diffuse, the policy may be implemented even if socially inefficient, because of the concentrated lobbying effort in favor of the policy. This argument has been raised especially with reference to trade policy. Similar arguments may apply to exchange rate policy, although the exchange rate is much less directly under policy control than, say, tariff rates[15]. The concern for political pressures over exchange rate policies is especially relevant in countries like Colombia, where exporters are very concentrated in a few sectors, well organized and politically influential. In this environment, it is appropriate to keep political pressures on the exchange rates at arms' length. A way of doing so is to empower the central bank with the right of choosing the exchange rate regime and exchange rate policies.

The choice of an exchange rate regime and of a monetary policy rule is also clearly linked to the question of enforcing the "credibility" of the price stability policy of the central bank. At one end of the spectrum of possibilities, one can envision a system of flexible rates, accompanied by an inflation target rule for the central bank. In this arrangement, the credibility of the low inflation policy is in the "hands" of the central bank, and, therefore, the independence of this institution is particularly essential. The advantage of inflation targeting rules is that, although they guarantee low inflation, they allow for some short run stabilization policies. The problem of this arrangement is that nothing other than the "reputation" of the central bank guarantees the credibility of the rule. In other words, nothing prevents the central bank from abandoning the inflation target, other than the fear of loosing reputation.

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[15] For discussion of exchange rate politics in Latin America see Frieden, Ghezzi and Stein (1999). The case of Colombia is analyzed in Jaramillo, Steiner and Salazar (1999).

Fixed rate regimes have been advocated as a way of anchoring the currency to enforce law inflation. However, recent experiences of fixed rate regimes (or exchange bands) have shown that they lack credibility and they may cause more problems than they solve. Risk premia and the threat of speculative attacks against a fixed rate may cause serious disruption to financial transactions and may have serious negative real effects. Therefore, "credibility" may come at a very high cost and may not be sustainable.

More extreme versions of fixed rates regimes, like currency boards or "dollarization" (i.e. the adoption of a foreign currency) are becoming increasingly popular[16]. This is due to increased world economic integration and to the emphasis on price stability. These types of arrangements increase credibility, but remove monetary policy from direct domestic control. In other words, in a "dollarized" regime, threats of speculative attacks or risk premia are much less of a problem than in the case of a simple fixed exchange regime, and this is a big advantage. On the other hand, the country that "dollarizes" delegates monetary policy to another country, and gives up a policy instrument. The country that provides the currency would be in charge of monetary policy. Thus, the monetary policy of the anchor country would not respond to the specific needs of the "home country".

6. Supervision of the financial sector

Different countries have different arrangements concerning the supervision of the financial sector. Generally, the supervising body is either i) the treasury; ii) an independent regulatory body, iii) the central bank.

Table 1 shows that central banks play a key role in the supervision of the banking sector, especially in non-OECD countries.

In a vast majority of countries (about 75 percent), the supervision of the financial sector is performed directly by the central bank. The preponderance of the central bank as the supervisor is even more marked in developing countries. In very few countries is the Treasury "officially" and directly in control of financial supervision. In fact, in most countries where the central bank is not involved in supervision, an "independent" agency performs this function.

How truly "independent" these agencies are vary from country to country. In the case of Colombia, for instance, the Government heavily influences the Bank Superintendency in several ways. First, it is directly dependent on the Presidency and the President not only appoints the Superintendent, but also has the power of removing her from office. Additionally, the agency has a governing board presided by the Deputy Minister of Finance, on delegation from the President. Since this situation is not unique to Colombia, Table 1 underestimates the role of treasury ministers through their influence over the "independent" agencies. In South America, countries are evenly split amongst those with central bank supervision and those without. In Argentina, Brazil, Paraguay, and Uruguay, the Central Bank is the supervisor. In Bolivia, Colombia, Ecuador, Mexico, Peru and Venezuela, it is not. In Chile, the central bank issues bank regulations, although an independent agency performs the supervision.

[16] For example, Argentina and Hong Kong have a currency board vis a vis the dollar. Bulgaria and Estonia have a currency board with the Euro. Ecuador is actively considering full dollarization and Panama is already dollarized. See Alesina and Barro (2000) for a recent discussion of the pros and cons of "currency unions".

Table 1. Banking Supervision in the World

	Total No Countries	Central Bank	Treasury	Independent Regulator	Mixed
All Sample (% of total)	106	73	2	26	5
	-	(68.9)	(1.9)	(24.5)	(4.8)
Non OECD (% of total)	77	64	1	12	0
	-	(83.1)	(1.3)	(15.6)	-
Below Median Income (% of total)	53	46	0	7	0
	-	(86.8)	(0.0)	(13.2)	-
Latin America Excl. Central America (% of total)	11	4	0	7	0
	-	(36.4)	-	(63.7)	-
High Income	29	11	1	13	4
Upper Middle Income	17	13	1	2	1
Lower Middle Income	35	25	0	10	0
Low Income	24	24	0	1	0

Theory suggests that the Treasury should not be in charge of the supervision of the banking sector: it may have conflict of interests, since the public sector may need financing from the banking sector. Therefore, the Treasury may be tempted to introduce legislation that favors bank leading to the government, to public institutions or to local governments. This issue is particularly important if publicly owned banks are a large fraction of the banking sector, like in Colombia, where they hold around 20 percent of total assets. Therefore, keeping the Treasury at arms' length from the banking sector may insure an appropriate finance policy for governmental agencies.

The choice between having an independent agency or to have it as a part of the central bank is not simple. On the one hand, as the central bank is also in charge of monetary policy and acts as the lender of last resort, there may be a bias towards leniency on the banks. The lender of last resort must always exercise subjective judgment when a particular bank is in trouble, as it is frequently unclear whether a particular case involves liquidity or solvency problems. If the perception is that the problem is liquidity, the first best is to lend. If things come out wrong and the bank turns out to be insolvent, the bank fails and there is an over expansion of the money supply. On the other hand, if the perception is a solvency problem, the first best is not to lend. If things come out wrong and it was a liquidity issue, the bank fails and may generate contagion. One may argue that with a strict anti inflation mandate, the central bank, acting as lender of last resort, will tend to bias its decision against lending: there is overestimation of insolvency, and, possibly a bias toward underestimating the risk of banking crises.

On the other hand, if acting as the Bank Supervisor, the central bank is judged based on how many banks fail, then each case of banking difficulty poses a policy dilemma. As the lender of last resort, the central bank will be biased against lending, but as a bank supervisor, it will be biased towards lending. For any reasonable sequence of uncertain types of problems (solvency and liquidity) that it faces, it can be hypothesized that a central bank that also acts as bank supervisor will be more inflation-prone than a bank that does not. If this is the case, the two conflicting biases on the central bank doing the supervision may balance each other out.

An independent regulatory agency runs the risk of being "captured" by the industry it is regulating. Also, how truly independent an agency is and can be from the executive remains to be seen. If the regulation of the banking sector is delegated to a strong and independent central bank, the risk of regulatory capture is mitigated. There are also informational reasons why it may be appro-priate for the central bank to be in charge of supervision. After all, detailed information about the banking sector is critical for the conduct of monetary policy.

The degree to which a regulatory agency can be truly independent, effective, and technically competent may vary by country and by level of development. The choice between the central bank and an independent agency may be different for, say, OECD countries or emerging markets. For the latter, our judgment call is that the central bank as the supervising agency is the superior choice. More on this point, below.

III. The institutional position of Colombia's Central Bank

A. The background

Before the 1991 Constitution, monetary and exchange rate policies were implemented by the Central Bank, but conceived within the Monetary Board (Junta Monetaria), created in 1963. The Monetary Board was made up of several Ministers and other high level Government officials. This institutional arrangement delivered a remarkable level of macroeconomic stability, if compared to other Latin American countries, but also a persistent level of inflation of about 20 percent. Colombia managed to cope well with moderate (by Latin American standards) levels of inflation in the seventies and eighties, thanks to many financial restrictions and regulations.

First, since 1967, extensive capital controls were in place. Second, there were explicit prohibitions as to the creation of dollar denominated liabilities (deposits) for the banking system. Third, indexation of selected contracts solved many of the problems that inflation creates. For example, it was possible to fund long-term mortgage loans with short-term deposits because a monopoly was established wherein all indexed deposits were earmarked to fund them; the labor code introduced wage indexation as early as 1972; the nominal exchange rate was managed through a crawl which, to a large extent, attempted to index the rate of nominal depreciation to the rate of inflation.

During the eighties and (especially) the nineties, many of these institutions were called into question, as they were viewed as inconsistent with a more open and competitive economy. In fact, the reform of the central bank achieved with the Constitutional reform of 1991 was part of a more comprehensive set of reforms that included, among others, trade liberalization, the elimination of most capital controls and the elimination of a monopoly, on the part of mortgage banks, for indexed deposits.

Before the reform of 1991, the fact that monetary policy was designed by a board, which included several ministers, was seen in some circles, particularly within the central bank itself, as a bias towards inflation. Particularly relevant to this argument was the debate regarding how to understand the bank's profit and loss account and, in particular, the " capital gains" stemming from nominal devaluation (*Cuenta Especial de Cambios*). The issue is the following: within an economy in which there is recurrent devaluation, dollar denominated assets yield profits. These profits can be either capitalized or monetized. Traditionally, these profits were monetized, largely through credits, which the central bank issued in favor of the Government. Around 1984 an intense debate occurred between the government and the central bank on the issue, with several bank officials being against monetization.

The outcome of this debate, which was largely won by the government, made it clear to Governor Francisco Ortega and his staff that the monetary board was inflationary.

The tide turned in 1990, when an assembly was called in order to write a new Constitution, which was to substitute the one written in 1886. Very quickly, Mr. Ortega and his staff realized that the opportunity for substantive changes in the Central Bank charter was there. They capitalized on the fact that -at the time- the economics profession was explicitly dealing with the issue of central bank independence and results were consistent with the idea that independence brings about low and stable inflation, as discussed in section II. It is clear from the documentary evidence that the Central Bank was the main advocate of independence. A paper entitled «Proposal for a monetary regime in the Constitutional reform» was written by the staff of the bank and circulated to the government in December 1990. This draft was the fundamental proposal, which, by and large, dominated the discussion.

B. The 1991 Reform

The 1991 Constitution radically changed the institutional features of the Central Bank. Implementation of the Constitutional mandate was derived from Law 31 (1992).

As with the rest of the very long and verbose Constitution, the articles which create and bind the operation of the central bank are largely the result of consensus-building among two positions: those who advocated a very independent monetary policy and those who preferred to see a central bank which depended upon "general economic policy". This tension has been noted by many of the members of the Constitutional assembly. For example, Lleras (a member of the assembly), in a paper entitled "The Central Banking Regime in the 1991 Constitution: In Search of Consensus", gives a detailed account of how the differing positions converged upon a consensus based text[17].

One critical point of discussion was the exchange rate. The question was about who should be the exchange authority? If the central bank was not the only institution in charge, what type of rules should be adopted in order to get the government and / or congress involved in the set of issues posed by the exchange rate regime? This was a very important discussion, because traditionally the exchange rate was an instrument through which resources were redistributed across sectors, to some extent in a discretionary manner.

The solution to the tension between central bank autonomy and the politicians' desire to be involved in monetary, and especially in exchange rate policy, was to make the government part of the board. Largely, this is the origin of the current (very odd) arrangement wherein the minister of finance is the president of the board of the independent central bank. In other words, on the one hand the Constitutional assembly recognized the need for independence. On the other hand, given the important political role played by the exchange rate, the assembly wanted to make sure that the bank had to "coordinate" with the government —i.e. bargain about exchange rate polices and, thus, ultimately about inflation and stabilization polices.

C. Consequences

The Constitution establishes Colombia's Central Bank as a very high-level institution, indeed it is as essential to Constitutional mandate as, inter alia, congress, the courts and the presidency. Very rarely

[17] Lleras (1995).

is the figure of an independent central bank an essential part of the nation's Constitution. For example, Argentina's currency board is a legal figure, not a Constitutional principle.

This status implies that relatively large transaction costs (i.e. a Constitutional reform) are needed in order to change even relatively minor rules regulating the central bank. The most important of these rules are:

- The governing board is made up of 7 members.
- The Minister of Finance is a member and its president.
- The president appoints 5 members. Every four years, the president must reappoint three of the five, and do so for concomitant four-year periods.
- The board appoints the governor of the bank, who is also a member of the board.
- The Central Bank is the lender of last resort (LOLR).
- The Central Bank cannot lend money to the government, unless it is a unanimous decision by the 7 members.
- The Central Bank can never lend money to private agents, unless (a) in the capacity of LOLR or (b) in the process of intermediation of external credit (i.e. no unconvertible creation of high-powered money).
- The Law establishes that twice a year the bank has to present a report to Congress. In addition, board members are routinely required to attend hearings.

An important point of contention concerns the issue of whether Colombia's "development law" (which every newly appointed government has to submit to congress 6 months after being in office) in effect subordinates the central bank. This is important, especially when the development law is in contrast with the objective of price stability. In the context of a recent decision by the Constitutional Court, the latter makes the subordination point very explicitly:

> *"The Constitution establishes an intermediate regulation as a result of the search for consensus among differing perspectives. In light of this, though the trend that favors recognition of Central Bank autonomy prevailed, and in spite of the fact that its basic objective is the purchasing power of money, the fact remains that very important aspects, proposed by the critics of this scheme were introduced in the Constitutional text. This explains the peculiarity of the Colombian Constitutional design" (...) "the Constitution did not make a choice in favor of either of the two extreme models of a Central Bank, i.e. that in which it is dependent on the government nor that in which it is totally independent"(...) "The subordination to the Development Law (Plan de Desarrollo) is a formal limit to the autonomy of the Central Bank in the exercise of its duty of controlling inflation" (excerpts of Constitutional Court Sentence C-481-99).*

This makes clear that the current status of the Colombian central bank emerges from an equilibrium that balances two forces which were present in the discussion of the Constitutional text: (a) the idea that monetary and exchange rate policy should be independent from the government; and (b) the opposing idea that monetary policy is too important to be left to technocrats. The result is an ambiguous formal entity, lacking precision in both objectives and instruments. Though the explicit objective is the defense of purchasing power, the task is complicated by the also explicit constraint in the sense that this goal must be pursued subject to "general economic policy".

The ambiguity between "independence" and government dominance is exemplified by a number of observations. Consider, for example, the appointment of "Appointed Directors". Whereas with only one exception initial members (appointed in 1992) came from outside the government, this has not been the case since then. Currently, only one of the five appointed members came from outside the government [18].

Obviously, there is a very fundamental incentive problem embedded in the procedure that is used to appoint members. Specifically, since all 5 appointed terms expire simultaneously, compliance with the government elevates the chance of reappointment for any individual member[19].

In summary, the rhetoric that permeates the Constitution and the discussion is very "independentist" in accepting the importance of a powerful central bank in managing monetary (and exchange rate) policy. The constraints imposed, as well as the revealed preferences of governments, reflect a high degree of caution that greatly diminishes implementation of an effectively independent monetary policy.

D. A few episodes of government intervention

In what follows we argue, using some specific examples, that on occasions the government has been very involved in setting monetary policy, and that this has been detrimental for monetary stability.

1. Monetary policy in 1997

At the outset of the Samper administration (1994-98), the Government encountered a board entirely appointed by the previous administration. Quickly the Minister of Finance expressed his view that the central bank ought to be reformed and, in particular, greater control of the exchange rate regime should be in the hands of the Government. This was consistent with the new Government's idea that the real exchange rate was overvalued, and should be weakened through policy in order to foster growth. In its development plan, the Government puts it thus:

> *"The macroeconomic strategy of the Government will (...) correct the unfavorable trends which have been experienced in the last few years by the real exchange rate and private savings[20]"*

The idea was to increase the existing controls to capital inflows and to devalue the nominal exchange rate. The problem was that the institution in charge was the central bank, not the Government.

The board increased capital controls, which had them in place anyway and were strengthened. The issue of changing the exchange rate arrangement was more complicated. Internal discussions of the board repeatedly were made public, in particular in November 1994, when the exchange rate band was shifted upward (appreciated). Any reader of the financial press could conclude that the President of the Board and the other members were in disagreement over exchange rate policy. The fact is that, aided by a political crisis which occurred in 1995, the nominal exchange rate did devalue in the year, by around 20%, as the Government wished.

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[18] He was an academic, the only one ever appointed to the board of the bank.

[19] This point is highlighted by Hernandez (1991), then an independent analyst, now a member of the board of the bank.

[20] El Salto Social (1994), chapter 3.

In 1996 the economy began to experience a sharp downturn and the exchange rate began to appreciate as the fears associated with the on-going political crisis receded. This time the Government had an additional instrument: it was going to exercise its right to appoint two of the members of the board in early 1997. In addition, it was able to appoint another member due to the fact that one of the previous appointed members resigned before her term expired.

By the first quarter of 1997 the Samper Government had thus appointed three members of the board, all of them recruited from within the ranks of high government -a Minister, a Deputy Minister and a senior economic advisor to the President. Including the Finance Minister, this defined a majority.

By mid 1997 a new monetary policy based upon low interest rates and currency depreciation in order to foster growth was in place. The operational instrument was the monetary base, which increased by 25% between December 1997 and December 1998. Apparently, by year end the program was working well. Outstanding loans on the part of the financial system, which had been expanding at a rate of around 25% in 1996 and until mid 1997, shot up to over 60% by year-end[21]. The deposit interest rate slid from around 28% at year-end 1996 to 22% in September 1997; the stock index in Bogotá increased 35% in real terms between June and December 1997, and the real exchange rate depreciated by 14% in the same period. In the midst of this expansion, during the fourth quarter of 1997 the economy grew at an annual rate of 4.9%.

The heavy expansion, induced from the central bank, sharply reverted in 1998 and the economy was left with a much more vulnerable financial system, more heavily indebted firms and households, and no fiscal adjustment. In 1998 the economy entered its worst recession in recent history. To be fair, the entire region was in a precarious stage because of the Asian crisis, but the poor performance of the Colombian economy clearly had a domestic component. The Colombian performance in terms of growth was one of the worst in Latin America. In addition, the relative spread on Colombian debt with respect to other Latin American Countries increased in 1998 and debt ratings were downgraded by most agencies in 1999 (see Figure 1 and Table 2).

Our hypothesis is that more "arm-length" relationship between government and central bank might have made monetary policy more prudent and reduced the business cycle swing.

2. Financial policies in 2000

Colombia's banking sector has been under stress since at least 1998. At present, non-performing loans represent about 13% of total assets and the banking system as a whole experienced significant losses in both 1998 and 1999.

Government owned banks, which hold around 20% of total assets, have been capitalized, credit lines have been opened for private banks and important debt write-offs for mortgage loans have been put in place. These institutions have been experiencing significant and systematic losses for the last two years, notwithstanding all the efforts put in place by the relevant authorities. These banks are unable to obtain liquid funds in the market. The central bank has been funding them through discount facilities that have been established for the purpose of very short-term open market interventions. The idea is to have the central bank put in place a REPO operation with any bank that exhibits liquidity shortfalls. These operations are either overnight or 14-day agreements.

[21] This is the annualized monthly rate of nominal growth.

Figure 1. Latinamerican Debt Spreads (30 years bonds)

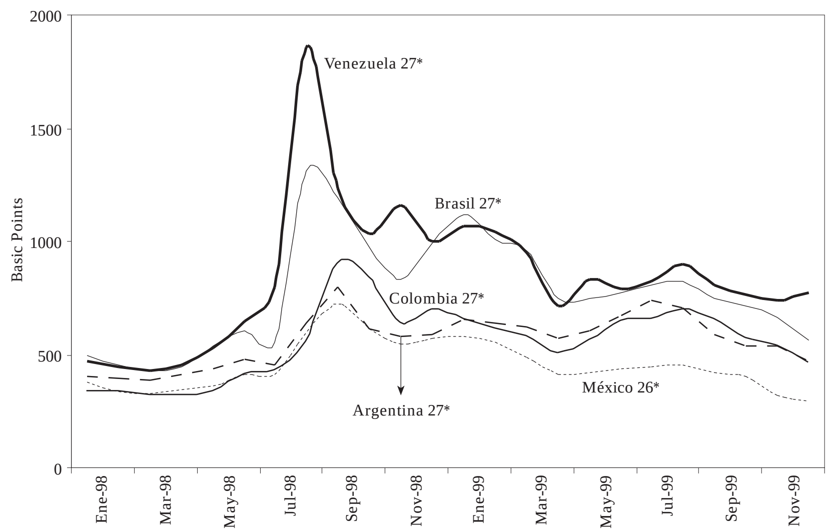

Table 2. Colombian Sovereign Debt Ratings

	Total No Countries	Central Bank
Moody's		
1994	-	Bal
1995	Bal	Baa3
11/08/1999	Baa3	Ba2
Standard & Poor's		
1994	-	BBB
21/09/1999	BBB-	BB+
24/05/2000	BBB+	BB
Duff & Phelps		
1994	-	BBB
08/09/1999	BBB	BBB-
17/02/2000	BBB-	BB+

Source: Ministerio de Hacienda.

The mechanism has been supporting a process for which it was not designed. Namely, it has shifted from a system designed to deal with temporary liquidity problems, to a system wherein Government owned banks have, in fact, received a permanent loan. In fact, the public banks receive bonds issued by the Government. With the help of these bonds, it is able to meet capital requirements imposed by the Superintendency of Banks. These banks are, therefore, considered solvent in accounting terms, though its peers do not think so and do not supply them with liquidity, fearing default. Unable to receive liquidity in the market, the Government-owned bank then goes to the central bank for cash in return for the same bonds that the government previously issued in order to "capitalize" it. It receives this cash by agreeing to repurchase the bonds it surrenders.

The process has been ongoing since 1999 and the stock of paper that the central bank was in effect rolling over almost daily amounted to some 20% of the monetary base in late February 2000. In March 2000 the bank decided to permanently purchase about 30% of the stock that it had been previously using in REPO operations.

Under prevailing arrangements, the central bank has no option but to lend to these banks, since they are declared to be "solvent" by the regulatory agency, which is, basically, a government institution.

IV. Proposals

We focus our proposals on institutional reform of monetary institutions for Colombia in three areas: i) the system of appointments for the Board and the Governor of the central bank; ii) the definition of the bank's monetary policy goals; iii) the definition of the bank's role in financial market regulation.

A. The Appointment System

In order to achieve the goal of independence of the Central Bank, the following institutional reforms are deemed necessary:

1. Composition of the Board

a) ***Removal of any member of the executive from the board of the central bank***
This implies removing the Treasury Minister from his current role in the board. Implementation of this reform implies a Constitutional amendment, changing Article 372 of the Constitution.

b) ***Reduction from the current 5 members of the board to 3 plus the chairman. The latter would cast the tie-breaking vote***
The rationale for this reform is two fold. First, it reduces the risk that too many voices «speak» for the bank, creating market uncertainty and confusion. Second, it attributes a stronger role for the chairman, thus making the conduct of monetary policy more centralized. This proposal implies a constitutional change.

2. Appointment Procedures

c) ***An important issue concerns the involvement of Congress in the appointment procedures***
Currently, the executive appoints the governor and the board, without congressional confirmation. This procedure is chosen to avoid the risk that Congress may impose candidates who do not have sufficiently strong anti-inflationary credentials. This preoccupation is legitimate. However, the lack of congressional involvement in the appointment procedure may lead to the perception, on the part of Congress, that the latter has no supervision on the bank. This perception may lead to congressional attacks against the whole idea of Central Bank independence. If successful, these initiatives would worsen the current status quo.

How to balance these two considerations is not simple. One could require a congressional approval for the governor and the members of the Board proposed by the executive. A critical question is what happens if Congress rejects the candidate of the government. Repeated rejections may slow the process and lead to the elimination of too many suitable candidates. An alternative would be for the government to propose two candidates for each position of governor and board members and Congress has to choose one of the two and cannot reject both.

d) Lengthening the term of office of the Governor to seven years, renewable once

The main advantage of this reform is that, in general, it avoids the coincidence of a new executive, which can immediately choose a new central bank governor. In order to implement this goal, there must be a law modifying Law 32 of 1991. It does not imply a Constitutional amendment. One could also consider extending the appointment of the board members to seven years.

e) Institution of a staggered system of appointment for the board of the bank

Currently, all 5 appointed members, and the Governor, serve concurrent terms. In order to modify the appointment procedure, there has to be a constitutional reform.

f) Transitional issues

Under our proposals, the Board of the bank would eventually have 4 members (including the governor), all of them appointed for 7-year periods. A reasonable transitional procedure would call for the gradual phasing-in of the proposed scheme, as follows: next time that the term of the 5 appointed members expires, 2 are let go, without being replaced. The other three are re-appointed, one for 2 years, one for 4 years and a third one for 6 years. Upon expiration of their renewed terms, each re-appointed member would be replaced according the procedures described above. Regarding the governor, the next time the term in office of the current governor expire, he would be replaced following the procedures described above.

g) Restrictions on whom can be appointed in the board and as Governor.

The executive should not be allowed to nominate anyone who currently holds an executive position or has held one in the previous two years. One important way in which the government may in fact choose to limit CB independence is by strategically using its right to appoint two members, as well as by appointing replacements for members who resign before their term expires. Four of the five current members were high-level government officials at the time of their appointment.

B. The goals of monetary policy

As we argued above, stability of goals for monetary policy is important for a smooth and productive functioning of financial markets and, ultimately, of the economy. It is, therefore, important to establish by law the goal of monetary policy.

In principle, the Constitution attributes to the central bank the goal of preserving monetary stability. The Constitutional sentence C-481-99 cited above subordinates the control of inflation to the limit imposed by the Plan de Desarrollo. A legislative reform must state that if in the central bank's judgment a particular Plan de Desarrollo threaten the goal of medium run inflation control, the bank's goal of inflation control has precedence.

C. Supervision of the financial system

The central bank should assume the role of controller of the financial and banking sectors.

D. Disclosure and secrecy

The central bank should adopt a precise and binding procedure to disclose its decisions and minutes of the meetings of the board. Disclosure of information should strictly follow the procedural rules. The point of this stricter definition of procedures is that market operators should know how and when to expect "news" about monetary policy. Different central banks around the world follow different procedures about disclosures and secrecy. We do not have strong views about how much secrecy there should be, in particular with how much delay minutes should be made public. However, there should be no confusion in the markets' perception of the goal of the Central Bank, namely inflation stability. The procedures for disclosure of information should be clear and the board should speak with "one voice".

V. Conclusions

The 1991 reform of Colombia's central bank law has produced less than satisfactory institutional arrangements. The reform intended to insure independence of the monetary authority in the conduct of monetary and exchange rate policy. That goal has not been completely achieved. This is a judgment of the current institutional arrangement, and not an evaluation of any specific policy followed or decision taken by any central bank board from 1991 until today. The actual policies of the bank from 1991 onward may or may have not accommodated political pressures. This is not the point under consideration here. The question is, instead, what are appropriate institutional reforms to the Central Bank law.

We have identified three areas of reform. One is the procedure leading to the appointment of the board and the Governor of the central bank. A related point concerns the issue of restrictions on the profile of who can serve in the board. The second area is the definition of the goals of monetary policy. We have proposed an arrangement that achieves a balance between the goal of democratic control over monetary policy and that of policy independence. The third area of proposal concerns what the central bank should be in charge of. We argue that the bank should be in charge of exchange rate policy for two reasons: one is that in a small open economy, the exchange rate is a critical variable linked to inflation and monetary policy; second, political pressures concerning exchange rate policies are better kept in check if a strong and independent institution is in charge of the exchange rate.

Finally, we think that the central bank should be in charge of the supervision of the banking and financial sectors for three reasons. The first is that the «capture» of the regulated industry is less likely to occur if the bank does the supervision rather than an «independent» regulatory agency. Second, if the central bank, rather than the Treasury, performs the supervision and regulation, the incentives for the Treasury to "distort" banking practices in its favor are reduced. Finally, the informational requirement for the conduct of monetary policy suggests that the central bank may benefit from being in charge of supervising the banking sector.

Colombia has made an effort in reforming a complex set of monetary institutions, which for over two decades delivered a persistent, moderate rate of inflation. The central bank reform -along with the elimination of many indexation practices, the liberalization of financial activity and the reduction of trade and capital account barriers- delivered substantial progress. This paper argues that a reduced set of "second generation" reforms aimed at correcting limitations that were maintained may further deepen these accomplishments.

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