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Keep in mind

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This After 1991 Colombia witnessed a sharp fall in the national savings rate (see figure 1.1), and in particular that of the private sector. Two hypotheses have been advanced for explaining this behavior. The first one stresses consumption smoothing within the Perrnanent Income Hypothesis framework (PIH). The reasons for such smoothing can be related with three major phenomena that characterized this period; namely, i. Since 1990 the government pursued an "apertura" (opening), consisting of tariff reductions, which the agents may have deemed as non-credible (transitory); hence, they exploited the advantage of purchasing imported goods at current low prices, expecting future rises in tariffs.

ii. The agents believed in the apertura, but an overshooting of capital inflows led to an overvalued exchange rate, which, they expected, should be corrected at some point in the near future, with similar effects on current imports consumption. A similar effect on the real interest rate has been also claimed to have similar effects on total consumption (see Lopes et al, 1996). And iii. a predictable increase in income originated in fairly secure and substancial oil exports starting in 1997; this could lead oil exports revenues from $ 1.4 bn. yearly in 1991 (approximately 42% of total exports), to $ 4bn. after 1997. Such expected rise in income would have caused the observed increase in consumption.

The second hypothesis is based on the relaxation of liquidity constraints (LCH), as a result of the capital inflows. Urrutia and Lopez (1994) argue that the increase in consumption was due to a relaxation in the liquidity constraints binding on an important share of the population (75% according to them). The inflow of capital experienced in the first years of the 1990s, and the monetary policy of that period would have allowed an increase in outstanding loans directed to consumption purposes. Cárdenas (1996) and Sánchez (1996) also present evidence in support of this hypothesis.

This paper presents a model of a small open economy along the lines of the PIH, which leads to an Euler equation test for the country. A representative consumer demands two goods, one that is imported and one that is non-tradeable, and maximizes expected utility intertemporally.

The model predicts that expected changes in the real exchange rate will cause a boom in current consumption. Its testable implications allow us to confront the PIH vis-a-vis the LCH with Colombian data for the years before and after the sharp shift in the savings ratio. The test nests the three possible explanations mentioned: expected price changes, relaxation of liquidity constraints, and foreseeable increase in income. The evidence provides support to the transitory appreciation of the real exchange rate, and fails to idnetify the effect of the fall in the real interest rate.

The next section discusses some facts of the Colombian economy that give support to the contending hypotheses. Section 3 presents the theoretical framework. Section 4 pursues the empirical test and section 5 concludes.