

# **Globalization and Colombia's Policy Framework**

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## **I. Introduction**

The rapid expansion of the world economy in recent years has contributed to the positive performance of the Colombian economy, but has also created new and diverse economic policy challenges. I would like to highlight the following challenges:

- To continue reducing inflation and to keep economic growth at a sustainable level.
- To help the economy adjust to a sharp real peso appreciation and to worldwide changes in relative prices.

All these phenomena are connected. They are also associated with a period of rapid growth in the world economy and with the entry of China, India and the Eastern European countries into the global economy. A good share of policy challenges arises from the uncertainty about how long the world economy will continue to expand and from the difficulties in particular sectors or with groups of individuals associated with sharp and rapid changes in some relative prices.

I will now briefly describe the main effects of globalization on the Colombian economy, before analyzing how, in the past, favorable changes in terms of trade and capital flows have been the impulses for large swings in economic growth in Colombia. Lastly, I will identify the principal elements of an economic policy framework that helps to smooth economic cycles, placing special emphasis on the role monetary policy plays in that process.

## **II. Some economic effects of increased globalization**

As is well known, over the last four years the world economy has been expanding at a pace not seen since several decades ago. In addition, this expansion,

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has (at least) two elements that make it different from previous experiences. First, the strong contribution that China and –to a lesser degree- India have made to global economic growth. These countries have an abundant labor force but are scarce in natural resources.

Second, this economic growth phase has been almost even across countries and regions, and unlike what happened at the beginning of the seventies, it has not been accompanied by strong inflationary pressures, up until now. This could mean that the current growth phase of the world economy will last longer than the growth spurt of the seventies (Krueger, 2007).

Colombia, like many other countries, has benefited greatly from the rapid world economic growth and the greater commercial and financial interdependence between countries. The scale of growth in the world economy, coupled with the rapid rise in output in China, India and the Eastern European economies have led to a substantial increase in the demand for oil, coal and ferronickel, which are Colombia's three leading export products.

Also as we shifted to import more from countries such as China, where wage and production costs are low, the prices of our manufactured imported goods have dropped or increased at relatively low rates for several years on a row. That is the case for instance, of prices for clothing, household electrical appliances, automobiles and computers, but also many other items.

Consequently, prices for imported goods have declined compared to those for exports. Thus the terms of trade have improved and the Colombian economy has received a positive boost to its income and real wealth. The latter has facilitated the growth in consumer, corporate and government spending.

In addition, with high oil prices, the economy of Venezuela, Colombia's second most important trading partner, has been growing at a high rate and has imported large quantities of food products and manufactured goods from Colombia. Similarly, the larger world economic growth has led to an increase in exports from Colombia to countries other than the United States and Venezuela of about 60% over the last 4 years.

On its own, foreign net direct investment has increased from annual average levels of US \$2873 million in 2004 to more than US\$ 5365 million in 2006. This extra investment has been used to expand the production of basic commodities, and more generally exports. It has even been used to take advantage of business opportunities created by domestic growth itself. This is the case, for example, with

foreign investment in commerce and the financial services sector, both of which have experienced an important increases in productivity.

The combination of high international prices for our main export products, the strong demand for exports and the increase in confidence levels and security, has meant that the growth of both investment and household consumption have accelerated, raising real economic growth. Following two consecutive years when the economy grew at annual rates close to 5%, in 2006 it expanded 6.8%, and during the first semester of this year at a rate of 7.6%.

The improvement in the terms of trade together with capital inflows in the form of foreign direct investment has induced a sharp peso appreciation against the dollar and against a basket of currencies. I will return to talk about this later.

Turning now to inflation, the expansion of demand arising from the improvement of terms of trade placed moderate pressure on production capacity. There have also been rises in the price of fuel. And more recently, a strong demand for food exports to Venezuela has pushed up the domestic price of certain foodstuffs. These latter two factors are changes in relative prices, and what happens in the future with the general price level will depend on monetary policy decisions.

On a more structural level, the increased competition from economies with an abundant supply of cheap labor has made it more difficult for domestic producers to raise prices, even in an environment characterized by strong growth in demand. Likewise, more competition in some productive sectors has curbed wage increases, exerted downward pressure on the costs of other inputs, and encouraged gains in productive efficiency. All of these could eventually imply that inflation in Colombia becomes less sensitive to changes in the domestic output gap, but more responsive to changes in the world output gap.

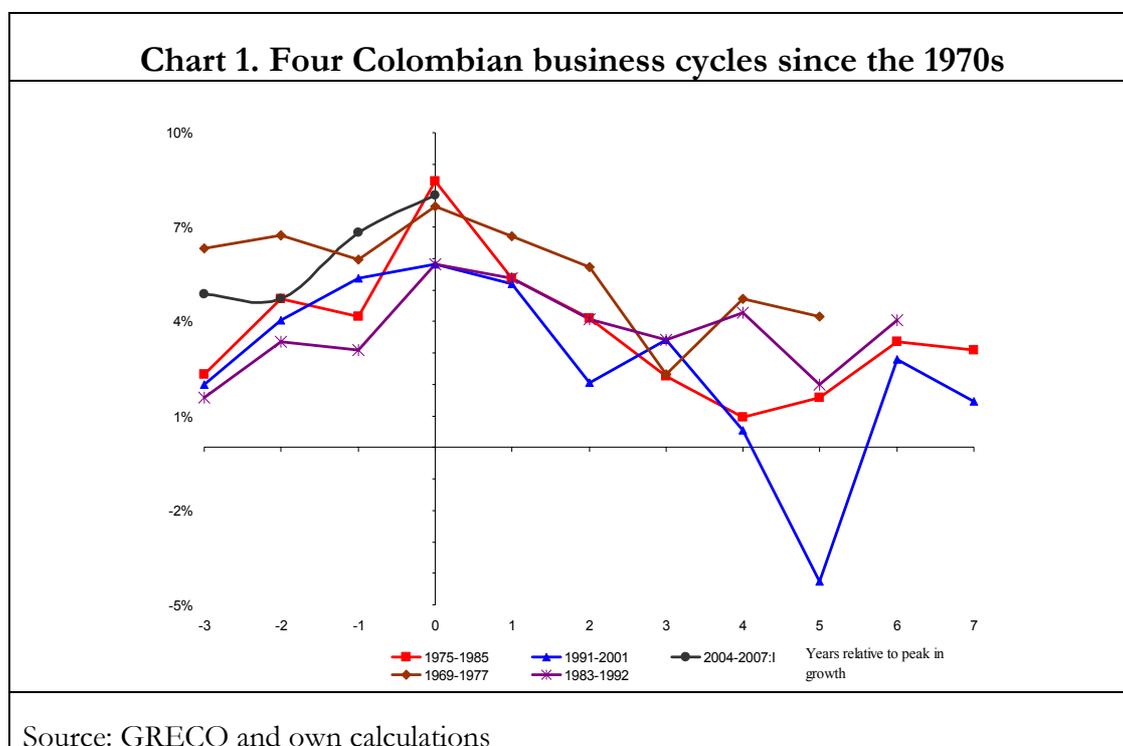
In short, the combination of an improvement in the terms of trade and capital flows in the form of foreign direct investment has contributed to a strong economic expansion. Similar episodes, however, have occurred in the past, even before the deepening of the globalization process. In each case the years of high growth have been followed by years of low growth and often crisis. That is why one of the fundamental challenges of the current economic policy must be to prevent cycles of boom and bust from building up and, in doing this, to ensure that the Colombian economy makes the most of the globalization process. With this in mind, in the next section I will spend some time on the causes of our past business cycles.

### III. Terms of trade, capital flows and business cycles

Chart 1 plots the four Colombian business cycles since the 1970s in terms of growth rates. It seems that very high growth rates were in all cases followed by a slowdown to much lower rates a few years later. GDP per capita fell for at least one year during the slowdown.

When we look into the source of these cycles what is interesting is that we see that either favorable terms of trade movements or inflows of capital and sometimes both acted as impulses for each cycle.

Chart 2 plots the Colombian terms of trade against the GDP growth. Before the 1990s, coffee was the main export of Colombia. Rises in the world coffee price in 1976-7 and 1986 stimulated demand in Colombia almost a year later. Recent estimates within the Banco de la República confirms that the correlation of the terms of trade cycle of three quarters ago with the GDP cycle now is 0.6 for data since 1994 (Parra, 2007).



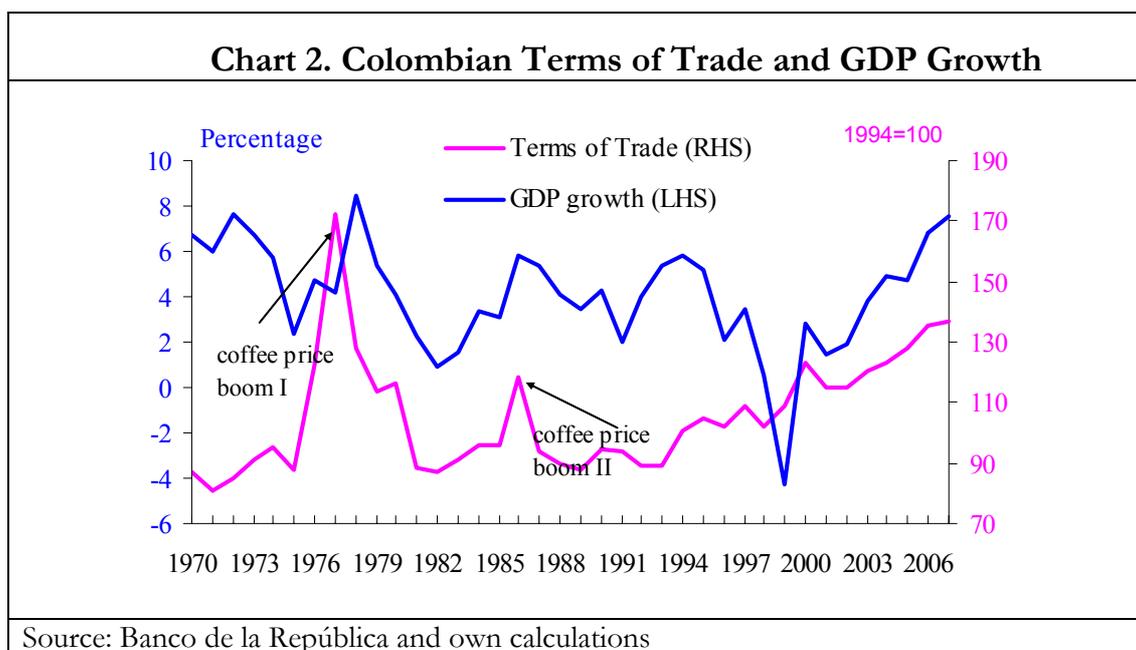
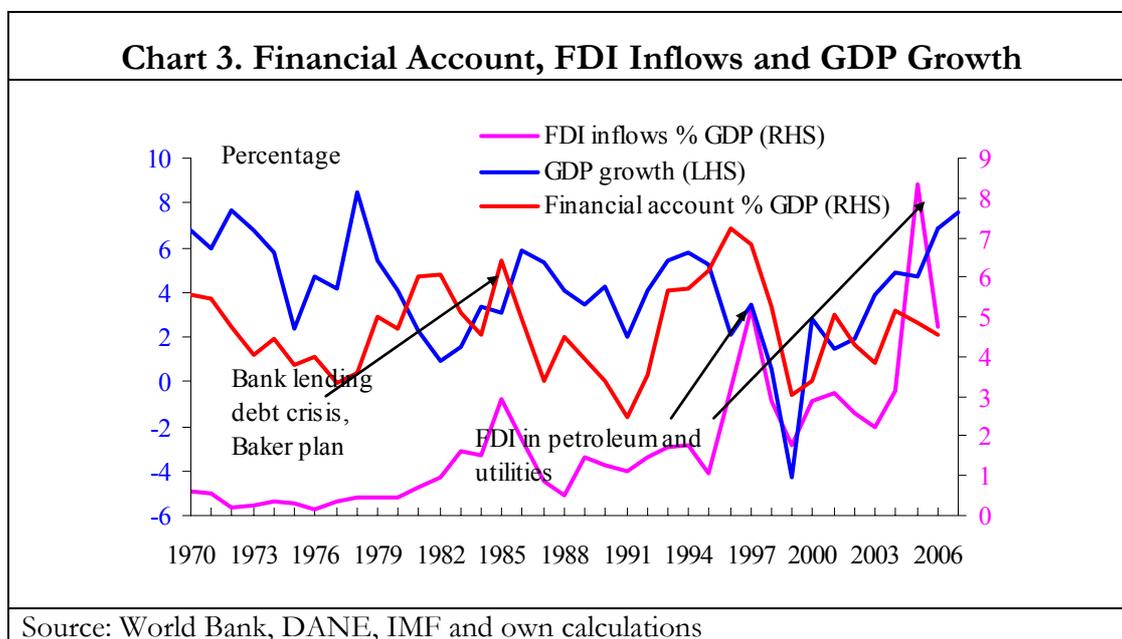


Chart 3 plots the financial account and FDI net inflows against growth in Colombia. Fluctuations in international lending precede or coincide with fluctuations in GDP growth in the 1980s. In the late 1990s, just as recently, FDI inflows were attracted especially by the petroleum and communication sectors. Capital flows were another source of impulses for some of these cycles, again just as now.



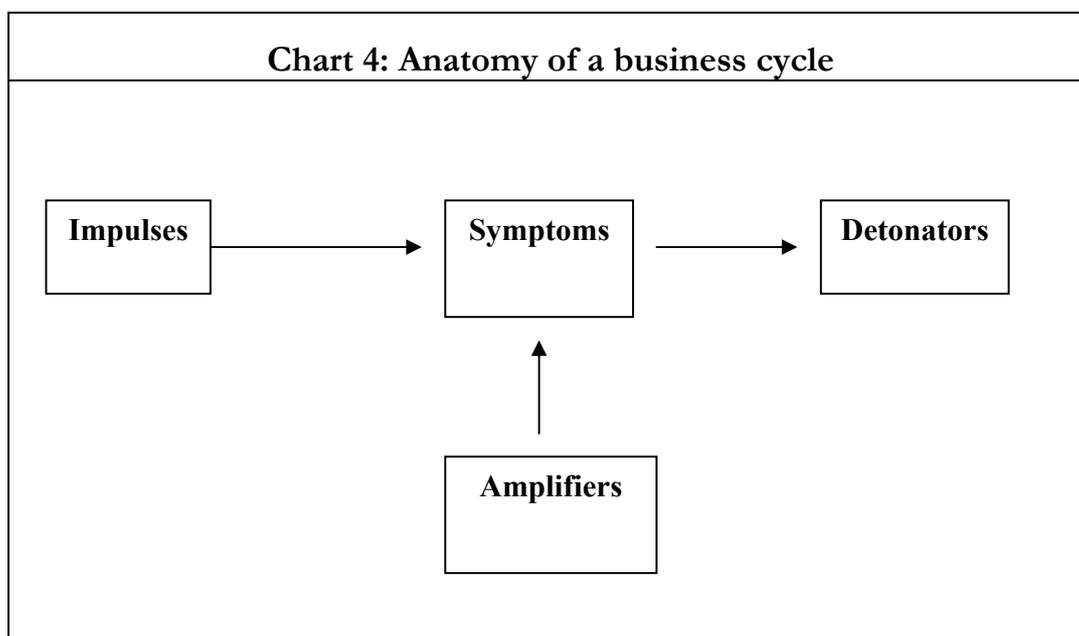
The charts also illustrate that terms of trade and international lending flows to Colombia are volatile and can reverse. They have acted first as impulses to these booms and then often reversed to act as detonators to expose the vulnerability built up in the intervening years. For example in 1998 a sharp rise in international market spreads associated with the Asian crisis triggered a recession here.

The literature confirms that this pattern of impulse and detonation is common to developing countries. The consensus is that terms of trade shocks are an important source of shocks to growth in emerging market countries (Mendoza, 1995). Others have found evidence that capital inflows are procyclical (Reinhart, Végh and Kaminsky, 2004).

The question relevant to then and now is: If terms of trade fluctuations and capital inflows are so volatile, why do we not save during the sunny days for the rainy days?

To understand this, Lavan Mahadeva, at the Banco de la República, has offered me a simple scheme to differentiate roles in the drama of the business cycle. He classifies variables into impulses, amplifiers, symptoms and detonators. See Chart 4. Impulses start the cycle. Amplifiers are those factors that generate unsustainable outcomes from what should be favorable impulses. The symptoms

are data that reveal the growing vulnerability. Detonators trigger crises by exposing those vulnerabilities.



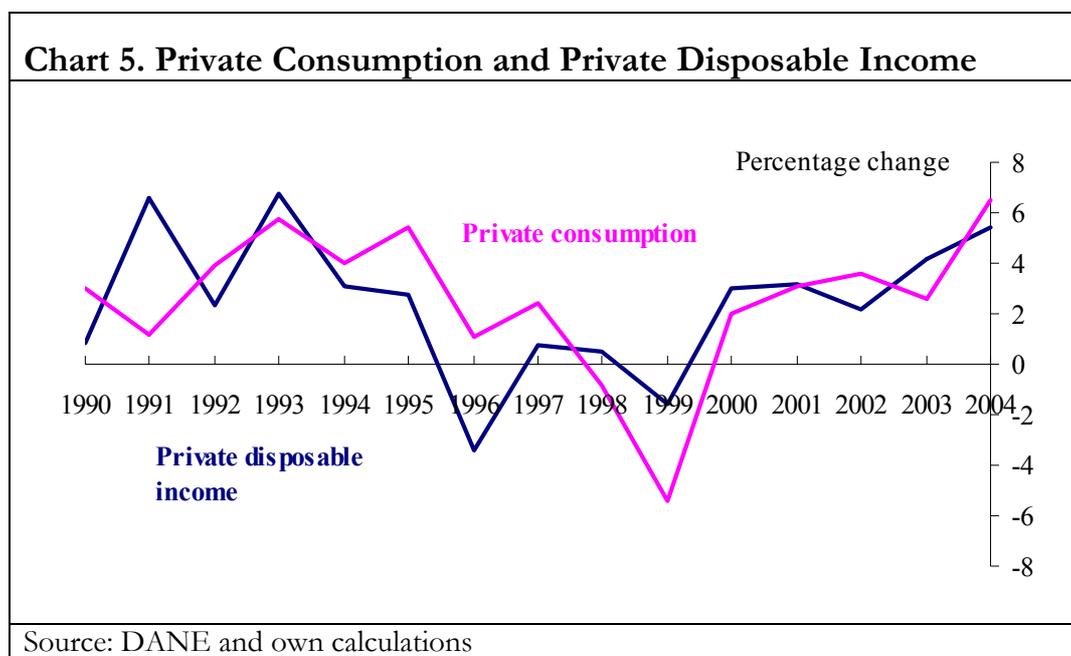
The point is that impulse and detonators, which as we have seen are typically international factors, are inevitable. A developing country like Colombia cannot shut itself off from them.

On the other hand, symptoms of ill health such as an unsustainable current account deficit, or an appreciating exchange rate, can be treated, but sometimes that treatment is worse than the disease.

Our focus is therefore on amplifiers where we think there is a clear responsibility for domestic policy.

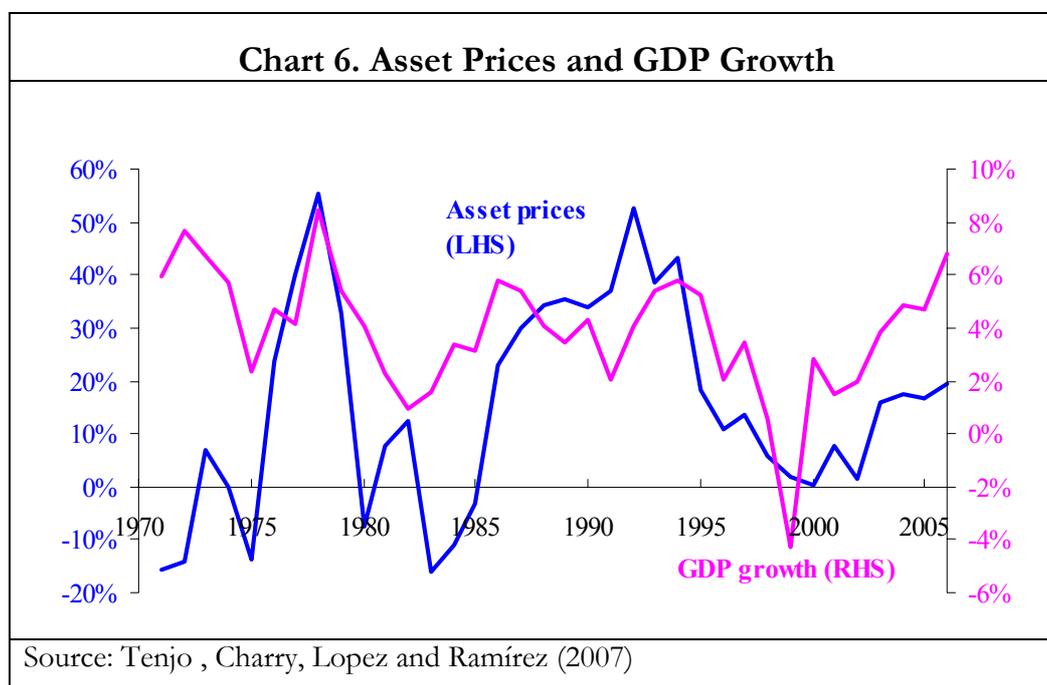
What could be an amplifier? Intertemporal consumption theory provides a simple answer. An amplifier is any factor that prevents consumption smoothing in response to a favorable income impulse. Chart 5 plots real private consumption against real private disposable income for when we have data. Clearly there is a failure of consumption smoothing: both follow each other closely. If consumption smoothing worked in Colombia, we would save in the sunny days for the rainy days that will surely follow. Only then could we make full advantage of

international developments. Other amplifiers may exacerbate bursts in fixed investment or durable consumption that are triggered by external events.



One reason why consumption smoothing fails in Colombia is that businesses here face much uncertainty and cannot guarantee a steady flow of repayments to lenders. We can see that in the high risk premia and credit frictions on domestic lending. High risk premia and high discount rates tilt consumers away from smoothing temporary income flows.

The pro-cyclical behavior of financial credit also amplifies the cycles of investment and durable consumption goods. This naturally matches with evidence that asset prices (mostly house prices in Colombia) are pro-cyclical. See Chart 6 also from recent research with the Banco de la República (Tenjo, Charry, López, Ramírez, 2007).



Another reason why consumption smoothing could be failing in Colombia is that a higher proportion of shocks to income here are permanent rather than temporary. Aguiar and Gopinath recently (Aguiar y Gopinath, 2007) report that this is typical of emerging market economies and suggest that this in turn may be due to policy regime switches and volatile interest rates.

It is more difficult to prove, but still it seems likely that consumption has been pro-cyclical because policy, be that monetary policy, fiscal policy or financial stability policy, has been too pro-cyclical. If consumers or firms face low real rates and easy credit during the booms caused by favorable terms of trade and inflows, they will naturally recycle those gains into consumer demand and into risky forms of investment and not into more sustainable savings and investments.

#### **IV. Adjusting to economic change and the role of macro policies**

The Colombian experience thus suggests that the difficulty in smoothing out consumption following external shocks is important in creating our economic cycles. Moreover, it is quite likely that monetary, fiscal and financial policies were key factors in explaining the pro-cyclical expansion of expenditure. How could

these policies instead contribute to smooth economic cycles so that Colombia can obtain the maximum benefit from globalization?

Let us begin with monetary policy. The objective of the Banco de la República Board of Directors is to achieve and maintain a low and stable rate of inflation. For this purpose, monetary policy acts symmetrically. The monetary authority is prepared to induce reductions in the rate of growth of aggregate demand whenever the inflation forecast indicates that inflation could exceed the target, while it would allow a greater expenditure expansion -by lowering interest rates- when the inflation forecast undershoots the target.

In the long run, low and stable inflation means that both individuals and firms have a better understanding of the signals provided by prices, acting against the build up of large imbalances between aggregate supply and demand. This helps to prevent an excess of unproductive investments during boom periods, associated with favourable external factors. It also helps to stop the formation of asset bubbles that increase the financial risks of the economy and compromise the sustainability of its growth.

In addition, with targets of inflation that are met and that are close to the medium and long term objective (3 +/- 1 percentage point), the credibility of monetary policy is strengthened and inflation expectations are anchored. This has several positive effects. Let me highlight the following:

- Low and stable inflation rates reduce the uncertainty associated with long term investment decisions, which in turn restrain the risk premium asked by investors. As a result, both the level and volatility of long term nominal interest rates diminish, and also the volatility of inflation and economic growth are reduced. Diminished macroeconomic volatility and lower interest rates in the long run support the good quality investment that the economy needs to adapt to changes in external conditions.
- Credible central banks and economies with inflation expectations anchored to inflation targets reduce the pass through from exchange rates to prices. This implies that monetary policy should not be pro-cyclical when the economy is hit by shocks that depreciate the local currency and slow down economic activity. On the contrary, with anchored expectations and credible inflation targets, monetary policy should be rather more counter-cyclical.

The other central element of the inflation targeting scheme is exchange rate flexibility. The Board of Directors of the Banco de la República does not have a

target or a preferred level for the exchange rate. When the Banco de la República intervened in the foreign exchange market between September 2004 and May 2007, it always sterilized those interventions. The short-term interest rate was maintained most of the time at a level that was considered to be coherent with the achievement of the inflation target.

The strong real appreciation of the peso over the last four years has taken place through a nominal appreciation. The exchange rate reached almost \$3,000 during the first quarter of 2003 and is now at about \$2,020. In a context of favorable terms of trade shifts, growing foreign direct investment, rising remittances from Colombians abroad, and a dollar that tends to depreciate with respect to other world currencies, a fixed exchange rate would have prevented these price signals from working. With a fixed exchange rate the burden of necessary economic adjustment would have fallen on domestic prices and wages, imposing large costs on the economy, and creating unnecessary variability of output and employment.

Similarly, the significant rise in investment in machinery and equipment in diverse sectors of the economy that we are seeing currently suggests that companies in Colombia are making the most of the peso appreciation (which lowers the peso price of capital goods imports). They are doing so in order to increase their productivity and to become more competitive. In the industrial sector, some companies are taking advantage of the low cost of imported intermediate goods, and some are concentrating on the production of goods with a higher value added. Employment and production have improved in sectors such as industry, construction and commerce, which have benefited from the rise in income and the strength of domestic demand.

From a sectoral point of view, the peso appreciation and the changes in relative prices reflect a need to adjust to the changes in the world economy. These factors have intensified pressure in some sectors that produce agricultural and manufactured goods, either because the appreciation has been accompanied by low international prices for their products or by trade barriers, or because they face strong competition from producers in other emerging economies. In some sectors, all of this has reduced income from exports and lowered the price of imports that compete with domestic output. There are cases, such as the production of flowers, footwear and specific types of wearing apparel, where plants have closed or cut back drastically on the number of jobs.

Exchange rate flexibility does not mean however, that exchange rate movements are not taken into account for devising monetary policy. On the contrary, these movements play a key role on discussions of monetary policy. Variations of the exchange rate affect aggregate demand by changing relative prices, which modifies the demand for goods and services tradables and non-tradables. In this way, movements of the exchange rate have an incidence on inflation and growth forecasts, which are the basis for decision making on interest rates.

A sound fiscal policy, focused on reducing the level of public debt as a proportion of GDP would also contribute to stabilize the economy, and to increase its capacity for withstanding external shocks. This task can be accomplished through three channels (Uribe, 2006):

- Reducing the debt/GDP ratio increases the economy's robustness and enables it to respond to negative external shocks such as changes in liquidity and foreign interest rate. This ratio is one of the main factors that rating agencies take into account when assessing the economies resilience to shocks.
- A low debt/GDP ratio enables the governments to operate counter-cyclical fiscal policy.
- A low debt/GDP ratio reduces the exposure of the public sector to foreign exchange risk and the exposure of the financial system to domestic market risk. Hence, it enhances financial stability.

Finally, the flexibility of the economy is also enhanced by a sound and efficient financial system. As is well known, domestic financial systems amplify and propagate external shocks to emerging markets economies, rather than helping smooth their effects. The build up of internal and external imbalances and the subsequent recession and financial crisis of the nineties in Colombia attest to the perils of a pro-cyclical behaviour of the financial system.

## **V. Concluding remarks**

Let me conclude with four key points:

- Colombia has benefited greatly from the strong global economic growth of recent years.
- In the past, positive terms of trade shocks and capital inflows to Colombian have ended in periods of boom and busts.
- Sound macroeconomic policies are central to maximizing the benefits of globalization, while minimizing the risks.
- Our monetary policy framework – the inflation target in concert with a relatively flexible exchange rate – has mitigated the effects of shocks and facilitated economic adjustment to new external circumstances.

Bogotá, October 4, 2007

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