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Estimating Credibility in Colombia's Exchange Rate Target Zone

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This paper analyzes credibility in the Colombian exchange rate target zone. A model of imperfect credibility, in the spirit of Bertola and Svensson (1993) is derived, and is used to explain why the exchange rate in Colombia has remained for prolonged periods neathe borders of the zone. The main feature of the model is that central parity depreciation expectations are endogenous with respect to the position of the exchange rate inside the target zone. The Krugman (1991) perfectly credible setup turns out to be a particular case of this general model. One of the main impliations of the model is that depreciation expectations increase rather than decrease as the exchange rate approaches the upper band. Hence a model as the one presented in this paper, is useful to explain the recent dynamics of interest rates in Colombia. It is also shown, that this model shares empirical feactures with the basic target zone model. Hence, policy makers might be misled when trying to recognize their credibility stance. A structural estimation of the underlying parameters of the model, using McFadden's (1989) method of simulated moments, is suggestedto identify the presence of non credibility issues. Econometric evidence suggest that Colombia's exchange rate target zone is properly described by a model of this nature.

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