Blog <em lang="es">BanRep: The Role of <em lang="es">Banco de la República as a Development Bank

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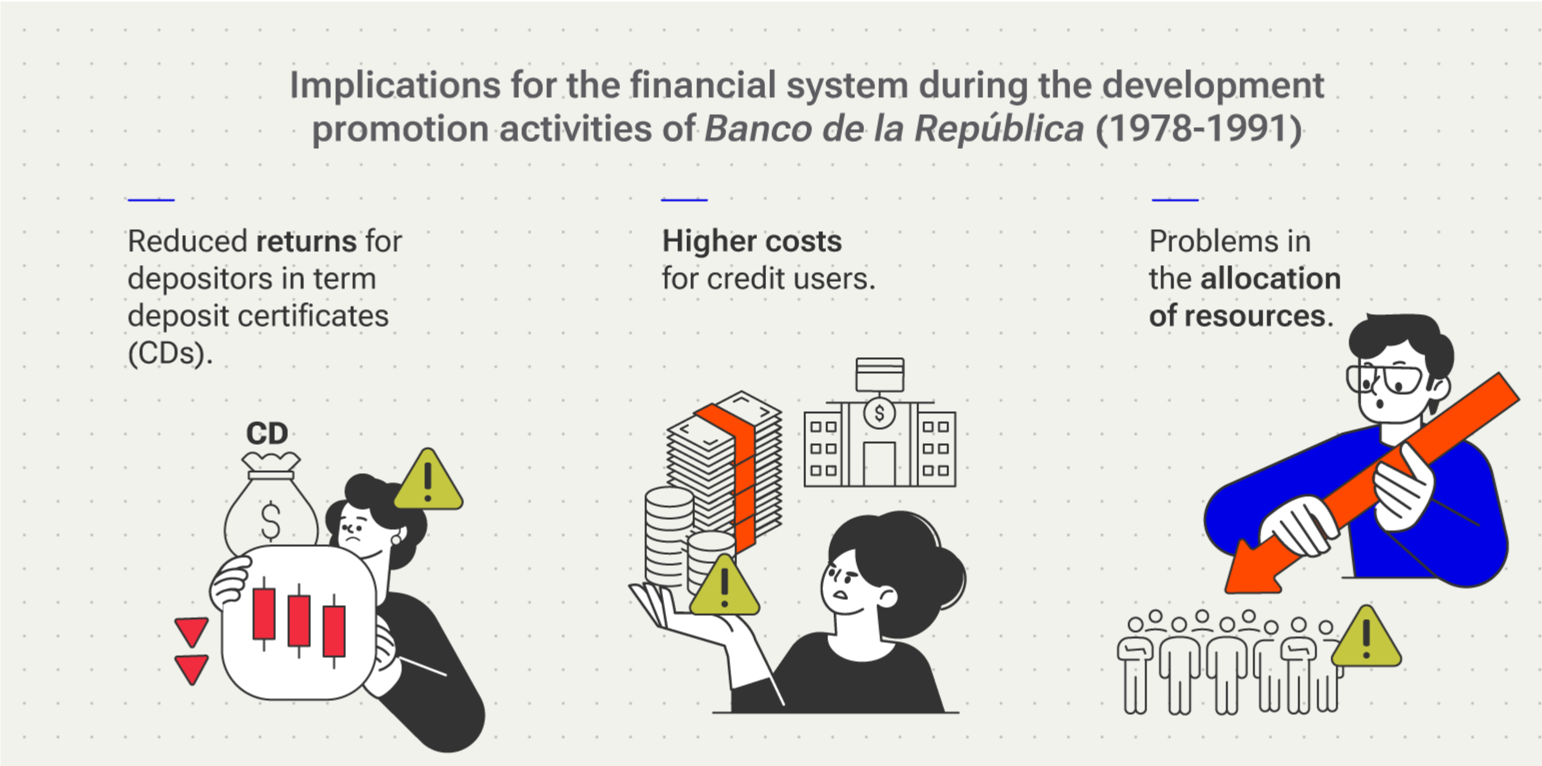
According to the prevailing view in Latin America of the mid-20th century—which saw active state intervention as essential for promoting development—central banks were assigned a significant role as development banks. On this basis, they were expected to direct part of domestic savings under favorable conditions to key productive sectors to boost economic growth.

In Colombia, these development-related activities of the *Banco de la República* (the Central Bank of Colombia) were formalized through Decree 756 of 1951, which granted it the power to establish special quotas for rediscounting development loan operations to encourage various sectors of the economy. Subsequently, with the creation of the Monetary Board in 1963, a new stage began in which this body assumed responsibility for development loans. This included determining the creation of rediscount funds or quotas, the sources of their resources, the sectors chosen, and the financial conditions of the loans, both for financial intermediaries and for the final beneficiaries. A comprehensive review of the background and evolution of development loans in Colombia and its relationship with the Bank can be found in Chapter 18 of the book *Banco de la República: antecedentes, evolución y estructura* by former member of the Board of Directors Hernando José Gómez.

During the 1960s and 1970s, the Bank’s development activities expanded and were secured with the creation of several financial funds specialized in channeling resources to specific sectors. Among the most important were the Industrial Financial Fund (FFI for its Spanish acronym), the Fund for Private Investments (FIP), the Agricultural Financial Fund (FFAP), the Export Promotion Fund (Proexpo), and the Business Capitalization Fund. Although it was intended that each fund would have a specific and permanent source of resources from domestic savings, the growing volume of loan applications—attracted by the high-interest-rate subsidies—made it necessary, on several occasions, to cover their shortfalls with resources issued by *Banco de la República*. This had important implications for the country’s monetary stability and contributed to inflationary pressures. In this context, annual inflation was highly volatile in the 1960s and showed an upward trend in the 1970s, reaching levels above 20% per year that persisted for nearly two decades.

In an attempt to overcome these difficulties, beginning in 1978, the Monetary Board created new sources of resources to finance the funds through mandatory investments by financial institutions, determined as a percentage of funds raised through certificates of deposit (CDs). These resources were complemented by instruments designed to capture market funding, such as agro-industrial securities. This reduced the inflationary impact of financial funds operations during the 1980s, when they averaged a surplus. However, it also introduced significant distortions in financial intermediation, while the distortions associated with subsidized credit policies persisted.

Specifically, the costs of financing the funds fell excessively on users of the financial system. Not only was the return received by depositors in CDs reduced—later extended to other types of deposits—but, in order to cover the cost of mandatory investments, financial intermediaries charged higher interest rates on their ordinary loans. This widened their intermediation margins and imposed an additional cost on loan users. In addition, the problem of resource allocation persisted, since the scheme reduced transparency in the use of public resources and allowed a significant portion of them to be used for subsidies that were difficult to justify in terms of their risk–social return trade-off.



Moreover, the role of *Banco de la República* as a development bank diverted the Monetary Board from its primary duty of maintaining monetary control over the economy, as it faced strong pressures to grant subsidized loans to the economic sectors represented by some of its member1. Another important factor that limited monetary control was the obligation of the Bank to finance part of the fiscal deficit of the National Government, as well as the commitment to maintain a managed exchange rate in compliance with the Exchange Law of 1967.

This situation, which restricted *Banco de la República*'s capacity to perform its functions as monetary authority and guardian of the purchasing power of the currency, was corrected by the 1991 Constitution, which established three fundamental provisions for *Banco de la República*: (1) the prohibition on establishing loan quotas or granting guarantees in favor of private parties; (2) limiting financing operations in favor of the State to cases approved unanimously by the Board of Directors; and (3) ensure the preservation of the purchasing power of the currency. These provisions eliminated the role of *Banco de la República* as a development bank through the granting of subsidized loans to the private sector, concentrating this role in the Executive branch in a more transparent manner, and limiting central bank credit to the Government under exceptional circumstances.

The consequences of these provisions were far-reaching. The financial funds created within *Banco de la República* to finance development loans were transferred to specialized institutions such as the Agricultural Sector Financing Fund (Finagro), the Banco Agrario, and Bancóldex, which focus on financing agricultural and export-related activities, recognizing the particular characteristics of these sectors. Credit to the industrial sector and other private activities was absorbed by commercial banks and other institutions such as financial corporations, which leveraged their expertise in identifying viable projects based on their risk–return characteristics. The Government developed a public debt market that today constitutes a pillar of the country's capital market. Finally, *Banco de la República* was able to concentrate on its objective of reducing inflation and stabilizing economic growth within the inflation-targeting framework, as explained in a blog post on this topic.

1 ? The Monetary Board was composed of the Ministers of Finance, Economic Development, and Agriculture; the head of the National Planning Department (DNP for its Spanish acronym); the director of the Foreign Trade Institute (Incomex); and the General Manager of *Banco de la República*.

Relevant economic concepts

- Development Loan
  - Loans granted under preferential conditions (such as lower interest rates, longer maturities, or grace periods) to promote strategic sectors of the economy.
- Rediscount quotas
  - A type of line of credit that a financial institution (usually smaller) obtains from another financial institution or from the central bank in order to extend loans to companies or individuals under favorable conditions.
- Interest rate subsidy
  - A payment made by the government to a financial institution so that it can offer a lower interest rate to the borrower. The difference between the market rate and the rate paid by the borrower is covered by the government through the subsidy.
- Mandatory investments
  - Obligations imposed on financial institutions requiring them to allocate a percentage of their deposits (such as certificates of deposit CDs) to the purchase of certain instruments defined by the government, such as securities issued by specialized financial funds or development funds.
- Agro-industrial securities
  - Debt instruments issued to raise funds in the market to finance agricultural and agro-industrial activities.
- Surplus
  - A situation in which the income of an entity (for example, a financial fund, a company, or the government) exceeds its expenditures.
- Intermediation margin
  - The difference between the interest rate that financial intermediaries charge on loans and the rate they pay on deposits.
- Fiscal deficit
  - The negative difference between government revenues (such as taxes) and public expenditures in a given period. It is generally financed through public debt, that is, by issuing government bonds such as TES.
- Guarantee
  - A commitment or form of collateral provided to ensure the fulfillment of an obligation.

Related questions and answers

Why were central banks in Latin America assigned the role of development banks in the mid-twentieth century?

Because at that time, the prevailing view was that the State should actively intervene to encourage economic development. From this perspective—before fully understanding the costs and risks of such strategies—central banks were expected to direct savings toward strategic sectors through loans granted on preferential terms, aiming to accelerate economic growth.

How did *Banco de la República* begin its role as a promoter of development in Colombia?

This role began to be formalized with Decree 756 of 1951, which granted the Bank the power to establish special quotas for development credit to different sectors of the economy. Later, in 1963, the Monetary Board assumed responsibility for defining the rediscount funds, their sources of financing, the sectors to be supported, and the financial conditions of the loans.

What measures did the Monetary Board take to address these problems, and what effects did they have?

Beginning in 1978, the Monetary Board created mandatory investments that required financial institutions to allocate part of the resources they raised (such as those obtained through certificates of deposit (CDs) to financing the development funds. Although this reduced the inflationary impact, it also generated distortions: it reduced returns for savers, increased interest rates on ordinary loans, and raised borrowing costs for credit users. Problems of transparency and efficiency in the allocation of public resources also persisted.

What changes did the 1991 Constitution introduce regarding the role of *Banco de la República*?

The Constitution eliminated the Bank's role as a development bank and strengthened its function as a monetary authority. It established that the Bank cannot grant credit quotas or guarantees to private parties; that it may only finance the State with the unanimous approval of the Board of Directors; and that its primary objective is to preserve the purchasing power of the currency.

As a result, development banking activities were transferred to the Executive branch, which increased transparency in the system. Development funds were assigned to specialized institutions such as *Finagro, Banco Agrario, and Bancóldex,* while *Banco de la República* was able to concentrate on controlling inflation under the inflation-targeting framework.

Fuente: https://www.banrep.gov.co/en/blog/role-development-bank