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Does Independence Matter? Case Studies from Colombia

BY

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Does Independence Matter?
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PART I. DOES INDEPENDENCE MATTER? THE CASE OF THE COLOMBIAN CENTRAL BANK[1]

Abstract

Why has Colombia been a case of low output variability and moderate-to-high inflation? This paper argues that regardless of the institutional arrangement, monetary authorities have stabilized the business cycle, and inflation control has not been the only objective of monetary policy. The government-controlled *Junta Monetaria* (1963-1991) often ignored the advice of the *Asesores*, an anti-inflation group of technocrats who had no voting powers. Since 1991 the independent and powerful members of *Junta Directiva* (1991-) are engaged in inflation targeting but continue to place weight on output and employment stabilization in their objective function. The institutional reform has implied a slow reduction in inflation. For a faster decline, the current system requires either greater accountability (for not meeting the inflation targets) or less weight on output stabilization.

[1] This paper is part of a regional research project sponsored by the InterAmerican Development Bank. We would like to thank Barry Eichengreen, Janet Kelly, Roberto Steiner, Leonardo Villar as well as other participants at seminars organized by the IDB and Fedesarrollo. The usual caveat applies.

1 INTRODUCTION

Colombia is known for its remarkable macroeconomic stability. Several authors have shown that the amplitude of the Colombian business cycle has been lower than in other nations. A number of studies have argued that the institutional design of the country, especially in relation to fiscal policy, has played a major role in explaining that outcome. For example, Cárdenas (1992) argues that the relative stability is the result of well designed counter-cyclical fiscal policies[2]. In turn, Hommes (1996) examines the evolution and rationality of budget institutions in Colombia since the middle of the 19th century. The conclusion is that the Minister of Finance has been at center-stage in budget matters, with considerably more power relative to other cabinet members in this regard. The arrangement has led to sound macroeconomic performance and to the satisfaction and support of the private sector.

Along similar lines, Urrutia (1996) points out that traditionally the Minister of Finance has not been a politician, but almost always a professional economist. This has been possible because of the highly competitive nature of Colombian democracy. Consensus over economic policies has arisen because politicians would rather have a technocrat occupy this ministry than a potential rival, due to the immense power associated with this position[3]. A similar scenario takes place in the National Planning Department, an institution that has substantial influence over the budget[4]. In sum, the literature has emphasized that the low variability in output typical of the Colombian economy has been the result of well designed fiscal policies, which arise from adequate budgetary institutions. However, as discussed in Cárdenas and Partow (1998) this stability is now threatened as the number of powerful interest groups in the economy expands. This is arguably what has occurred in Colombia with the gradual decline in the importance of coffee to the economy, making the achievement of consensus more difficult (see Junguito, 1996).

The Colombian economy is also known for its long-lasting, moderate and stable inflation. In fact, inflation rates have been in the 20 to 30% range during the past 25 years. Focusing on monetary institutions, and the policies that emerge from the different arrangements, this paper explores the reasons for greater success in regard to output variability relative to inflation control. Legal innovations with respect to the structure and mandate of the monetary authority have been enacted over the years. The paper concentrates on the most recent change in the institutional arrangement, from a high degree of government control during the Monetary Board (*Junta Monetaria*) years (1963-1991) to the current independent status of the *Junta Directiva del Banco de la República* granted by the 1991 constitutional reform.

The changes introduced in the new constitution were, in a *formal* sense, far-reaching. First, a clearer and narrower mandate was adopted, with provisions for conflict resolution that favor inflation control. Second, the government's influence on the composition and naming of

[2] In particular, Cárdenas (1994) points out that the incentive structure of the National Coffee Fund (NCF) is essential for understanding the determination of domestic coffee prices (a key variable behind private consumption) and, more generally, of the public sector deficit.

[3] See, also, Meisel (1996a).

[4] This experience reaffirms the results of Alesina, Hausmann, Hommes and Stein (1995). Based on an empirical exercise with data for 20 Latin-American countries they found that greater transparency and hierarchy within budgetary institutions lead to a better fiscal performance.

the *Junta* was diminished, making board members less vulnerable to political vicissitudes. Third, conditions for Bank lending to the government were severely restricted. Also, the fact that the independence of the Central Bank is consecrated in the Constitution imbues the decision with certain weightiness. Constitutional reform is a far more cumbersome process than a change or abrogation of a law, making it more difficult to alter the new status of the Bank.

In one of the few studies on the subject, Escobar (1996) found that during the period of government control over monetary policy (1963-1991), money growth in Colombia was higher (on average) than during periods of central bank autonomy. In the same spirit, this paper measures the degree of legal and formal central bank independence and its consequences for monetary policy. From a theoretical viewpoint, it is well known that central bank independence is not a sufficient condition for inflation control. In the approach of Rogoff (1985), the central banker has to be concerned about reputation or, alternatively, has to be more conservative than society as whole in the sense of weighting inflation deviations more heavily than in the social welfare function. In the principal-agent approach of Walsh (1995) and Persson and Tabellini (1993), imposing pecuniary costs on central bankers when inflation deviates from the target level solves the inflationary-bias problem. In New Zealand, the Reserve Bank Governor's job is at risk if inflation is higher than 3 percent per year or lower than 0. In the U.K. the Chancellor of the Exchequer recently announced that if inflation is 1 percentage point higher or lower than the inflation target, the Governor of the Bank of England should explain in a public letter why the divergence has occurred and what steps will be taken in response.[5]

In sum, formal central bank independence should lead to lower inflation when the central banker genuinely has a greater dislike of inflation than society in general or, alternatively, when contracts penalize central bankers that do not meet the inflation targets. In the conservative-central-banker approach, the central bank has independence in setting the inflation goal, as well as in the instruments used to pursue it. The central banker in the principal-agent approach is given well-defined goals as well as complete control over the instruments to achieve them, and is held accountable for the outcome. Accountability is necessary to set the proper incentives for the central bank to meet its goals and to provide political control over a powerful institution.

This paper analyzes whether formal changes in the degree of central bank independence in Colombia have affected the performance of the institution relative to its objective function. Our methodology emphasizes the instances of conflict between the goals of output and employment stabilization *vis-à-vis* inflation. The conflict resolution provides valuable information to infer the preferences of the members of the board as well as on the costs of not meeting the inflation targets. We do this by discussing in detail the monetary policy decision-making process. In addition, we perform some empirical exercises in order to assess the nature of monetary policy in Colombia. In particular, we analyze the type of monetary policy implemented during the peaks and troughs of the business cycle.

The paper is structured in five sections. Section 2 discusses the legal changes regarding the mandate of the central bank, as well as on the government's influence on the composition

[5] See Fischer (1995). In the case of the U.K., as well as in Canada, the penalty for excess inflation can be interpreted as the loss of reputation.

and naming of the Board, and the conditions for Bank lending to the Government. This section also presents a measure of the degree of independence along the lines suggested by Cukierman et al. (1992). Section 3 deals with the political process behind the origins of an independent central bank in Colombia. Section 4 explores the degree of real autonomy by looking at the minutes of the meetings of the *Junta Monetaria*. The analysis focuses on the resolution of conflicts within the monetary authorities and the nature of monetary policy. In addition, some empirical evidence on the counter-cyclical character of monetary policy, and the influence of political and institutional factors is also presented. The paper ends in Section 5 with some conclusions.

2 FORMAL CENTRAL BANK INDEPENDENCE IN COLOMBIA

The *Banco de la República* (created in 1923) is the second oldest central bank in Latin America[6]. Over the past 64 years, it has undergone a number of important changes in its autonomy with respect to the central Government: from a private, independent bank, to a state-run "dependent" monetary authority, and most recently, to a public, independent Central Bank. Until 1963, the Bank was a private and independent entity, although not always with a clear mandate regarding price stability. In particular, in 1951, the objective of working towards accelerating the growth of the economy was introduced, and until quite recently enjoyed at least equal importance to the goal of price stability.[7]

The *Junta Monetaria* was created in 1963 as the country's monetary, foreign exchange and credit authority, without, however, any provisions for its independence from the Government. At the time, there was growing awareness of the inherent contradictions, in terms of conflicts of interest, of a situation where an essentially private Bank enjoyed significant influence over national economic policy. The decision was made to separate the *design* of monetary policy, as well as the issuing of economic *regulation*, in the hands of the *Junta*, from the *implementation* of those regulations by the Bank[8]. As mentioned in the introduction, the 1991 constitutional reform enhanced the degree of central bank independence in Colombia. The main formal changes affected the clarity of mandate, the composition of the board of directors, and the conditions for bank lending to the government.

i. Clarity of Mandate

The granting of independence to the *Banco de la República* was associated with a clear change in the institution's objectives. Prior to the constitutional reform the responsibilities of the Monetary Authority explicitly included a broad spectrum of macroeconomic issues. In addition to the control of inflation, monetary authorities pursued employment and output stability. With the new constitution, the weights allocated to these objectives have undergone a shift. The Board of the new Bank continues in its role as the country's monetary, exchange and credit authority; however, the overriding *legal* objective of the *Banco de la República* is now

[6] Peru's central bank was created in 1922.
[7] Meisel (1996b) discusses the Colombian historical experience in regard to central bank independence.
[8] With the nationalization in 1973 of the Bank's capital and its transformation into a public institution, the practical reasons for a division between the Bank and the Monetary Board disappeared. It was only until 1991, however, that the legal framework of the two institutions was rationalized by eliminating the separation between the two bodies.

inflation control. Moreover, and strengthening this mandate, is the provision that in situations of a *conflict* of interest between the Government and the Bank, the objective of inflation control must take precedence.[9]

ii. Composition of the Board of Directors

A central criticism of the old *Junta Monetaria* was its composition. As we will show, with three cabinet ministers on the Board (Finance, Agriculture, and Development) as well as the Director of the National Planning Department, the demands on the Board for financing of Government programs and stabilizing employment, particularly by the sectoral ministers, were many[10]. In addition, two *Asesores* attended, without voting rights. Despite their generally high technical attributes, the advisors did not have enough power within the *Junta Monetaria*.

Table 1 displays the list of advisors to the *Junta Monetaria*. As can be seen, many of them came from the ranks of the central bank and held Ph.D. degrees. The evidence gathered in this paper is suggestive of the fact that the advisors were more willing to fight inflation than the government. In this sense, we will characterize the *Junta Monetaria* as an arrangement where the conservative-central-banker was not granted enough power and independence to carry out policies.

The new *Junta del Banco de la República* includes the Minister of Finance, who is its Chairman, along with the Managing Director of the Bank and five members appointed by the President for a fixed term of four years. The Board elects the Bank's Managing Director[11]. An innovation in the Constitution was the legal requirement that the five appointed members have a full-time dedication to their posts, and that they not represent any particular sector of the economy. The independence of the Board was further bolstered with the provision that each President could name two members of the Board during his term in office (apart from the Minister of Finance).

This is a significant improvement relative to conditions prior to the Constitutional reform. However, the ability to name two of its members, in addition to the Minister of Finance, means that the President may have a direct influence on three of the seven votes on the Board. If conditions permit, as happened in 1995-96, when one of the Directors resigned before the end of her term, thus allowing the President to appoint another member, this influence may be even greater. As for the length of tenure of the Directors, although it is fixed to four years and is renewable, it suffers from the provision that the new President can remove any two of the five Directors named by his predecessor. This in effect introduces a high degree of uncertainty of tenure for *all* Directors, leading to the possibility of government's capture of those willing to be reappointed.

[9]In relation to the Bank's mandate, a new provision in the Constitution is one that calls for Board decisions to be made in *coordination* with general macroeconomic policy. It is arguable that this provision dilutes the clarity of mandate; this point will be addressed below.

[10] Other members were the Managing Director of the Bank, the Director of Incomex (Instituto de Comercio Exterior or Foreign Trade Institute), and the Banking Superintendent. The latter, as well as the Economic Secretary of the President were invited and non-voting members.

[11] The salaries of the members of the board are set by the President of the Republic. The remaining employees of the central bank follow the Codigo Sustantivo del Trabajo, as any private employee.

Table 1

Regulation	Institution	Country
General Regulation	Parliament	All Countries
Specific Regulation		
Financial	Central Bank	All Countries
Institutional	Parliament	All Countries
Prudential	Parliament	Ecuador
	Government	Colombia
	Superintendency of Banks	Chile, Peru
	Parliament and SB	Venezuela
	Central Bank	Argentina, Bolivia, Paraguay
	Parliament and Central Bank	Uruguay
	Collegial Institution	Brazil, Mexico

In addition to the guidelines specified in the Constitution regarding the naming of Board members, a number of further disqualifications were also included in Law 31 of 1992[12]. According to the law, persons who during the previous year had acted as legal representatives of a supervised institution in the financial sector or those who have close relatives amongst other members of the Board or in the Boards of credit-granting institutions are barred from membership in the Bank's Board. Members cannot engage in party politics or in the representation of any supervised institution, and during one year following their tenure, they are prohibited from any form of employment in the financial sector or in the Government.[13]

Table 2 displays the list of members of the new *Junta*, as well as some of their previous positions. The appointment of members of the *Junta del Banco de la República* has become a critical issue for Colombian economic policy. The information is illustrative because it shows that Presidents have chosen individuals with rich and varied exposure to the public sector, often as ministers or vice-ministers. A few of them have been presidents of business associations or directors of Fedesarrollo. It is hard to judge from this information whether the preferences of the directors match the conservative-central-banker type. However, according to the information

[12] This is an ordinary law (i.e. there are no special requirements for its abrogation).
[13] Other restrictions exist, including those dealing with national origin, professional experience and qualifications, criminal records and so on.

contained in Tables 1 and 2, the profiles of the members of the independent *Junta Directiva* and the Advisors of the government-controlled *Junta Monetaria* are somewhat different in the sense that the former have more exposure to high-ranking positions within the Executive.

Table 2

Type of Supervisory Agency	Country
Mixed	Panama
Public	
Collegial	Mexico
Shared	United States
Individual	Bolivia, Colombia, Chile, Ecuador, Paraguay, Peru and Venezuela
Central Bank	Argentina, Brazil, Uruguay

This is an endogenous selection in a country that emphasizes the benefits of output and employment stability. As mentioned before, the lack of voting rights of the *Asesores* allowed the authorities to appoint a group of advisors less inclined to compromise, and committed to inflation control. The flaw of the arrangement was that their advice was frequently ignored. With the powers granted to the independent *Junta Directiva*, and the weak form of accountability established in the Colombian legislation, the appointment of members of the board has been a delicate issue.

iii. *Restrictions on Government Financing*

Strict limitations to lending by the Central Bank to the public sector enhance autonomy and independence in order to pursue the objective of price stability. As mentioned above, during the *Junta Monetaria* days there were few restrictions to Government financing. A consensus regarding the problems associated with this practice was a major impetus for the move to grant independence. After the constitutional reform, however, government's financing can now only be undertaken subject to a unanimous vote of the Board, signaling that this is no longer a routine procedure, but rather one that is to be viewed as a final recourse under exceptional circumstances. Other decisions require only a simple majority (four favorable votes, out of seven). Financing of the private sector is prohibited.

In addition to the above-mentioned changes, the Constitution granted the Bank powers in a number of other areas considered crucial to firmly establishing its autonomy. The new Bank is an *administratively autonomous* entity, free to design and execute economic policies in the areas under its responsibility, although it is under the obligation to coordinate its regulations and actions with other economic authorities. *Financial autonomy* implies that the Bank can dispose of its own assets as it sees fit, investing and using profits according to what the law prescribes. The Bank, of course, continues to enjoy some of the same functions as it did prior to the

Constitutional reform, namely, its status as the sole issuer of money, bank of banks, lender of last resort, administrator of international reserves, as well as fiscal agent for the Government. Importantly, it lost its function as a development bank, an activity that had been widely criticized as a highly inflationary and detrimental to the development of the capital market in Colombia[14].

iv. Budget

There are now clear-cut provisions regarding budgetary procedures. The Board, must approve the budget of the Central Bank (which requires a non-binding concept from the Government). The law establishes the mechanism for payment of the losses by the central government, or the transfer of profits.

v. Accountability

One key issue in relation to central bank independence is the system of checks and balances that the legislation places on an institution that wields so much power. Since central bankers are not infallible it is critical to exercise some form of control, especially in an institution that normally operates under secrecy[15]. In Colombia, according to the 1991 Constitution, the President of the Republic is responsible for the supervision of the central bank while Congress exercises its political control. The central bank is required by law to report to Congress twice a year, at the beginning of regular sessions. In addition, when called, members of the Junta must attend meetings of the different Congressional Committees[16]. However, Congress does not have veto power over the members of the Junta. The Comptroller General does not oversee the Bank. Rather, a special auditor and the Superintendency of Banks play that role. The Attorney General has the power to investigate any member of the staff on disciplinary grounds.

Although the law requires the central bank to set an inflation target for each year that must be lower than the one for the previous year, there are, however, no provisions for sanctions if those targets are not met. In this way, the conceptual framework for the Colombian central bank is more in line with the conservative-central-banker approach, rather than the principal-agent model that penalizes central banks that do not meet their targets. Clearly, this fact reinforces the importance of appointing members with low tolerance for inflation.

vi. Summary: Measuring the Degree of Independence

We attempt to quantify the degree of Central Bank independence by updating the index constructed by Cukierman et al. (1992) to cover the post-constitutional reform period. In addition to being a measure of the theoretical degree of independence of a central bank, formal legal independence is of interest because it "suggests the degree of independence that legislators *meant to confer*" (Cukierman, 1992), thus serving as an indicator of the seriousness of

[14] On the development of the non-bank segment of the market see Ministerio de Hacienda, Banco Mundial, and Fedesarrollo (1996).
[15] See Stiglitz (1997) for a critical view of central bank independence in a democratic society.
[16] On different occasions, the Constitutional Court has clarified these obligations of the Junta. See Hernández (1997).

institutional reform. Colombia was one of the countries originally included in this index, which is based on a variety of variables similar to those outlined in this section. The results of this exercise are summarized in Table 3. The change in the index of formal and legal independence is dramatic: on a scale of 0 to 1, with 0 representing the lowest degree of independence and 1 the highest, the Monetary Board's index was at 0.27, while that of the current structure doubled to 0.53. Appendix 1 details the way the coding was carried out and how the variables were weighted and aggregated into the final index.

In sum, while formal independence has undeniably increased, gaps remain. As already mentioned, the President maintains significant powers over the naming of Board Directors, whose length of tenure, while fixed, remains somewhat short by international standards, and vulnerable to Presidential power. The presence of the Minister of Finance, with full voting powers, on the Board is another weakness. These drawbacks are a result of the emphasis on consensus in decision-making, which is also present in the constitutional provision regarding the imperative of coordinating the Bank’s decisions with those of the Government. In a way, this emphasis reflects the importance given in Colombia to output stabilization relative to inflation reduction.

3 The Origins of an Independent Central Bank in Colombia

This section describes, from a political economy point of view, the origins of central bank independence in Colombia. We argue that the degree of independence of the Colombian Central Bank has been strongly path dependent, mainly because institutional change has arisen from within the bank itself, rather than imposed by outside pressures.

Some preliminary discussion on the need for reform of the *Junta Monetaria* took place in the early 1980s in light of the consequences of the monetary financing of the fiscal deficit. The removal of sectoral ministers from the Board, traditionally those who had most pressured for Bank financing of the government, was proposed.[17] Concern was also expressed regarding some activities of the Bank itself (as opposed to the *Junta Monetaria*), in particular the granting of development credits, which were viewed as highly inflationary, and hindered the development of a long-term capital market. It is notable that while the containment of inflation was certainly an issue, its *reduction* from the 20-30% level was not a major concern.

The ideal opportunity for pushing forward changes in the legal character of the monetary authority arose with the convening of the Constituent Assembly in 1991. Despite fortunate timing and the general national sentiment supportive of change, the process of reforming the Bank was not always smooth. While there was support for the elimination of routine financing by the Bank of the government and the private sector, the consensus was much weaker regarding the desirability of complete independence of the Bank from the government in the formulation of monetary, exchange and credit policies.[18]

The initial proposal for reform of the legal status of the Bank came from the *administration of the Bank itself*. This proposal was then modified in the Presidency before being officially submitted to the Assembly. The differences between these two proposals shed

[17] Steiner, 1995, p. 4.
[18] Steiner, 1995, p.5.

light on a number of points of contention, and reflect the various divisions amongst policy makers regarding their visions of the role of a new, independent, central bank. Interestingly, the final approved version was closest to the Bank's original proposal, which placed greater emphasis on the need to ensure autonomy in a number of areas. Yet due to the lobbying efforts of the Bank's administration with the members of the Constituent Assembly, its original initiative became the *de facto* basis for discussions, strengthening the proposal significantly.

The main points of contention concerned the proposed pre-eminence of the new Central Bank in exchange and credit matters. The Bank, in its own document, had envisioned a modern independent central bank responsible for the country's monetary exchange rate policies. In contrast, the Government's watered-down version seemed to be chiefly concerned with more limited changes regarding administrative and technical autonomy. With this goal in mind, the government wanted to isolate the Bank from interest groups and political pressures. The idea was to remove sectoral ministers from the Board, while transferring some of the functions of the *Junta Monetaria* to the Bank. In fact, the reaction of the Ministry of Finance to the Bank's proposal was negative, largely due to the fact that the Ministry would be stripped of its pre-eminence in exchange and credits matters. The Bank's proposal was explicit in granting the new institution the ability to establish the *regulations* regarding monetary, foreign exchange and credit policies. In contrast, the Government's proposal referred only to the Bank's *execution* of policies determined by its Board of Directors which was to be, according to the government, the monetary authority.

In terms of responsibility for the exchange rate, for example, the final agreement was that the Board would be the exchange authority, but subject to the laws issued by Congress at the initiative of the government. In other words, the Bank would determine the exchange rate in accordance with the exchange regime defined by the government through Congress[19]. In practice, this gives the Bank day-to-day management of the nominal exchange rate as well as market interventions.

A similar hesitation to grant the Bank a completely free reign to pursue the objectives consecrated in the constitution can be seen in the inclusion by the Constituent Assembly of a number of its own provisions, which were not explicitly included in either the Bank or Government proposals. Two of the most relevant address the Bank's mandate and policy coordination with the Government. Regarding the mandate of the Bank, the Assembly established that it was the State, through the Bank, which had the obligation of maintaining the purchasing power of money. In a positive sense, this requirement in theory obliges the government to promote a fiscal policy in accordance to the goal of price stability.

The Constitutional reform requires the Bank to coordinate its decisions with the Government, meaning that the Bank should not completely sacrifice other objectives to price stability. While coordination of policies is certainly desirable, its inclusion as a requirement in the constitutional reform merely enhances the impression that the anti-inflationary objective is

[19] There is controversy on the roles of the government and the central bank regarding the exchange rate regime. The Constitution places the 'regulation' of the exchange rate regime in the central bank. The Constitutional Court and the State Council have issued sentences that state that the role of the government is only 'indicative' in this regard. See Hernández (1997).

not overriding. The requirement to coordinate in the management of the key variables is equivalent to saying that these will not be used exclusively for the reduction of inflation, and introduces a short-run bias to the Bank's policies. Arguably, this requirement undermined the credibility of the independent central bank.

The lessons of this experience are various. On the positive side, there was clear support for the need to modify the existing arrangement, especially regarding the monetary financing of the government. The objective of controlling inflation enjoyed relatively wide acceptance, at least in principle. In other words, the objectives preceded the institutional design. Some consensus on the basics existed, namely on the fact that sectoral ministers should not be involved in the Board. Also, the central role played by the Bank itself was crucial, strengthening the proposals for independence and building a support lobby for its approval. The rest was a consensus-building process where the involvement of large number of parties was central. This process had costs and benefits.

In relation to the latter, the consensual origin of the reform resulted in greater public acceptance of independence. Although there have been threats to independence, there is growing opposition to counter-reforms in this area. On the other hand, it is precisely this faith in the importance of consensus building over rules, which weakened the final proposal for an independent Central Bank. Some examples are the inclusion of the Minister of Finance in the Board of Directors, as well clause calling for coordination between the Bank and the Government.

4 INFLATION CONTROL: DOES AUTONOMY MATTER?

As mentioned in the introduction, greater formal independence is neither a sufficient nor a necessary condition for low inflation. Institutional changes, by themselves, do not buy lower inflation. For example, in addition to an independent central bank, Germany has a culture that is averse to inflation. The Indian central bank has no provisions for independence and yet delivers a low inflation. In fact, in order to lower inflation it is necessary to either appoint conservative-central-bankers that are allowed to act in an autonomous fashion or, alternatively, to have well-specified contracts that penalize bankers that do not accomplish what they announce.

This section looks at the Colombian experience before and after the adoption of central bank independence. As has already been discussed, prior to the 1991 constitutional reforms, the Central Bank did not possess a clear mandate to concentrate on inflation control as its sole objective. An evaluation based on its performance in reigning-in inflation during the 1970s and 1980s is instructive as an overview of the decisions that were made and how they were arrived at by the Monetary Board. It is also useful for comparison with the post-reform era and illustrative of the types of influences and pressures that weighed on the decision-makers. Such a review is also indicative of the conditions that induced the Monetary Board to act in a concerted manner to reduce inflation, and those that did not.

The overall lesson is that at crucial moments in time when the reduction of inflation should have been its key preoccupation -- as stated time and again in the Advisors' Documents -

- the Monetary Board was not firm in its anti-inflationary stance. A gamut of concerns resulted in the relegation of the fight against inflation to back seat status. These included the stimulation of economic activity and employment, the reluctance to use the exchange rate as an anti-inflation tool for fear of jeopardizing the competitiveness of Colombian exports, apart from general concerns regarding the profitability of the financial sector. We start by looking at the minutes of the Monetary Board, and then move to some empirical exercises aimed at understanding the determinants of monetary policy.

4.1 A REVIEW OF THE MINUTES FROM THE MONETARY BOARD

One explanation for Colombia's 20-30% inflation level over the past 25 years is the accommodating behavior of the monetary authority in response to inflationary shocks. In this section we review the Minutes of the Monetary Board and look in depth at the responses of the monetary authorities to these shocks. We adopt a methodology similar to Echeverry (1995), who has shown that foreign exchange reserves[20] and food supply shocks are the main explanation for Colombian inflation, in conjunction with the response of policy-makers to these shocks.[21]

In the event of an unexpected increase in international reserves, an independent and "strong" monetary policy aimed at reducing inflation would be expected to adopt a contractionary package. The package would include a real revaluation of the currency and, when the increase in reserves is not the result of higher capital flows, higher interest rates. Although in modern times central banks are less inclined to increases in the required reserves ratio, in the past this instrument was used actively. If autonomy can be partially defined as the ability to implement difficult or unpopular measures, then a "strong" policy maker would be equivalent to an autonomous one.

The evidence suggests that "strong" responses by the Central Bank to inflation were determined by the magnitude of the inflation shock. In other words, the preferences of the policy makers were such that strong responses were taken only when inflation rates increased rapidly and dramatically, regardless of the degree of formal autonomy. In fact, in its response to all but one of the episodes over the two decades under study, the Monetary Board was unable or unwilling to take the measures necessary for neutralizing the inflationary effects of the shocks to international reserves. There appears not to be much concern for reducing inflation so much as for avoiding its further acceleration. On one such occasion, the then President of Colombia said it clearly: 'it is [only] possible...to *reduce the acceleration* of the current inflationary process, since certain factors of [an] external character are affecting it'[22].

For example, this was the case after the inflow of foreign reserves in 1973, when inflation jumped from 7% in 1971 to 21% in 1973. Reactions by the Monetary Board to later shocks were similar. While an increase in food prices can be blamed for generating inflationary pressures at the end of the 1970s, it is also clear that the Monetary Board did not adhere to

[20] However, treating shocks to international reserves are exogenous may not be correct if policy responses are also crucial for the balance of payments.
[21] He characterizes policy-makers' response to eight episodes of shocks to international reserves between 1971 and 1991, and traces the behavior of policy tools available to the Monetary Board in the aftermath of those shocks.
[22] Quoted by Echeverry (1995).

inflation-control measures, but merely aimed at ***containing*** the increases in the price level.[23] The Advisors to the Board, in a summary of economic conditions for 1979, state that a 24.3% growth in the Monetary Base can be considered a satisfactory accomplishment given the expansionary pressures resulting from the accumulation of international reserves, despite a clear acknowledgment of the danger, in terms of the public's expectations and the implied difficulty of future reductions in inflation, of validating such levels (near 29% in 1979).[24]

In 1986, following an international reserves shock, the decision was made not to sacrifice the real exchange rate and reserves were consciously accumulated. The Advisors argued that bank lending to the government and access to profits of the *Cuenta Especial de Cambios*[25] were highly expansionary and should be abolished. The Board rejected the Advisors' arguments, citing the ***high level of unemployment at the time.*** The Minister of Finance argued that denying the Government access to these resources would force it to turn to Congress for approval of further financing allocations from the Central Bank.[26] The goal in terms of expansion of M1 was set at 24% for the following year (1987), with the argument that such an increase would ensure that ***productive activities*** could expand without hindrance.[27]

Policy-making in 1988, another year with an international reserves shock and high inflation, was equally lax. In June of that year, inflation reached a level of over 30%. While there was a concern that monetary policy should not validate this level of inflation, the Board was distracted by other concerns, including what it considered to be high interest rates, poor profitability of the financial sector, and lack of liquidity in the economy. In their document of May 18th, the Advisors go so far as to admit that while monetary policy has been complacent with respect to average inflation levels, "...it at least has not been oriented towards the validation of the highest levels of inflation observed at each moment in time."[28]

On one occasion, however, the Monetary Board did unequivocally show a strong anti-inflation stance: during the events following the large reserves shocks of 1976-1978, which were mainly the result of high international coffee prices. The impact on inflation was severe: it skyrocketed from 15% in January 1976 to 34% in mid-1977. The situation was worsened by the refusal of the government to increase taxes on the coffee sector, thus allowing the full transmission of the shock to the domestic economy. Also, a widespread drought affected national agricultural production.

The severity of the increase in inflation between 1976 and 1977, however, appears to have induced concerted action: on all fronts, the response of the Monetary Board was unequivocally that of a "strong" policy maker. The ordinary required reserves ratio was increased by 3 percentage points and an additional marginal ratio of 100% was implemented, Government expenditures were reduced and revenues increased through taxation. Anticipated

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[23] Echeverry (1995) pp. 33-34.
[24] Advisors' Documents, Doc. A-4, January 16, 1980, pp. 36-42.
[25] Throughout the years this account (created in 1935) served the purpose of registering the profits derived from the depreciation of the currency (and the appreciation of gold holdings) and the net return on international reserves. Profits derived from the multiple exchange system and taxes on coffee exports and overall remittances were also part of the Account. These profits were transferred as current revenues of the government, representing -at their peak- 23% of total central government's current income. See Jaramillo and Montenegro (1984).
[26] Acta de la Junta Monetaria, number 12599, October 29, 1986.
[27] Advisors' Documents, Doc. A-27, March 1987.
[28] Advisors' Documents, Doc. A-066, May 1988, p. 2.

Imports Deposits were increased, and Exchange Certificates, bonds exchanged for foreign exchange revenues, were put in place. The combined effect of these measures, in addition to the effects of a fiscal surplus, was a halving of the Monetary Base. One year later, inflation had been forced down to 12.6%.

It is interesting to note at this point that in the midst of this particular episode there were no changes either of the Managing Director of the Central Bank or of the Advisors to the Board. Neither were there any significant legal changes that allowed the Board to act in a more autonomous manner. Strong action against inflation was possible due to a ***consensus*** among policy makers at the time that the level of inflation, well above 30%, was inadmissible[29]. However, this need for consensus is a clear indication of the *lack of real autonomy*. Lower levels of inflation had not resulted in a similar effort, and would not do so in the future.

To sum, in the absence of consensus any increase in inflation was necessarily validated by weak or non-committal monetary policy. The emphasis on inflation containment rather than inflation reduction indicates that the Monetary Board had always possessed the instruments to fight inflation; what it lacked was the conviction of all parties that the fight was worth the effort. Tough measures were postponed due to pressures from the sectoral ministers as well as interest groups. The Advisors repeatedly complained of the inconsistency in the application of monetary policy by the Board. The Advisors to the Board openly referred, at the time, to the need to continue resisting political pressures on a number of fronts[30]. In fact, the minutes indicate specific decisions were often taken, "'... in response to pressures from the regions and industry and trade associations", that are counter to general objectives.[31]

How has this situation changed in the years following the creation of an independent Central Bank? The removal of sectoral ministers from the Board of Directors was an important step towards the isolation of monetary policy from political pressures favoring expansion. Similarly, the prohibition of Central Bank financing of the Government in all but the most exceptional circumstances has increased the ability of the Board of Directors to withstand clearly expansionary demands. In this regard, the real autonomy of the Central Bank has unequivocally increased. But, has the greater autonomy resolved the inflationary bias?

It is tempting to argue that the consequences of this enhanced independence are clearly visible in the behavior of the Colombian inflation rate. Figure 1 shows the decline in inflation in the 1990s. It may be arguable that the acceptable upper threshold has fallen from a level of 30% to one closer to the lower twenties, although such an assertion is difficult to support until such a threshold is seriously challenged. However, a final evaluation of the actions of the *Junta del Banco de la República* requires access to the minutes of the meetings of this institution, which have not been disclosed yet[32]. Also, the ability of monetary and credit policy to achieve inflation reduction has been severely crippled due to the fact that fiscal adjustment is not forthcoming. This was the case in Colombia during 1996 and 1997, and as such, the conclusions regarding the results of monetary policy must be tempered by this fact.

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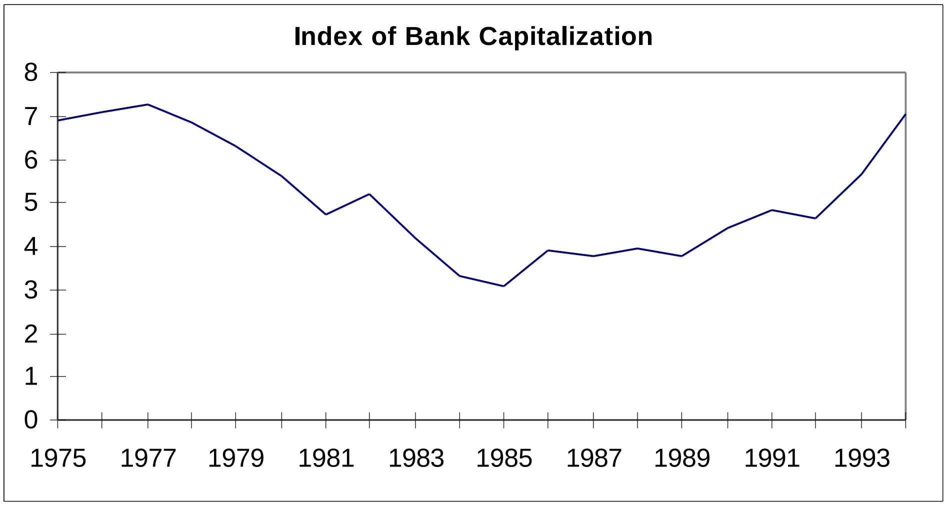
[29] Advisors' Documents, Doc. A-094, August 22, 1990, p.12.
[30] Advisors' Documents, Doc. A-99, November 22, 1979, pp. 3-6; Doc. A-102, November 28, 1979, p. 5; and Echeverry (1995), Summary of the Minutes of the Monetary Board, pp. 27-30.
[31] ibid, p.20.
[32] These minutes are reserved documents protected by the Constitution (Article 15).

Figure 1



4.2 EMPIRICAL ANALYSIS

In this section we present results of various econometric exercises that attempt to determine whether measures taken by the Bank can be characterized as pro- or counter-cyclical. Also, we are interested in knowing whether monetary policy has been influenced by the different institutional arrangements and by other political factors, such as the occurrence of elections and the type of political party in power. We start by looking at annual data for the period 1947-1996. The main results are given by the following equation:

$$\underset{(6.9)^{***}}{\dot{m}_t = 0.175} \underset{(-2.4)^{**}}{- 1.025\dot{y}_{t-1}} + \underset{(0.4)}{0.159\dot{y}_{t-1} * DJM} \underset{(-1.96)^{*}}{- 0.067DJD} + \underset{(2.3)^{**}}{.002t} + \underset{(1.9)^{*}}{.001t * DLIB} + e_t,$$

R^2=0.58; DW=1.86; n=50. *(**)[***] denotes significance at 10%(5%)[1%] level.

$\dot{m}_t$ is the percentage change in M1, $\dot{y}_t$ is GDP's growth rate, *DJM* is a dummy variable that takes a value of 1 during the *Junta Monetaria* years (1963-1991), *DJD* is a dummy variable that takes a value of 1 during the independent *Junta Directiva* years (1992-1996), *t* is a time trend, and *DLIB* is a dummy variable that takes a unitary variable during liberal governments.

This regression is of interest because it indicates that, on average, monetary policy has been counter-cyclical in Colombia. A one-percentage point increase in economic growth at time *t-1* is followed at time *t* with a decrease in monetary growth by 1.03 percentage points. Furthermore, this result has been invariant to the institutional arrangement. However, during the period of independence of the central bank, annual money growth has been, on average, 6.7% lower than before. It is interesting to note that money growth has accelerated throughout the period at a rate of 0.2 percentage points per year. Moreover, this rate of acceleration has been 0.3 percentage points per year during Liberal governments, indicating that partisan cycles have influenced monetary policy[33].

[33] This is not true for political business cycles that suggest greater expansion at election years.

We performed a similar exercise using GDP deviations from trend as a measure of the business cycle:

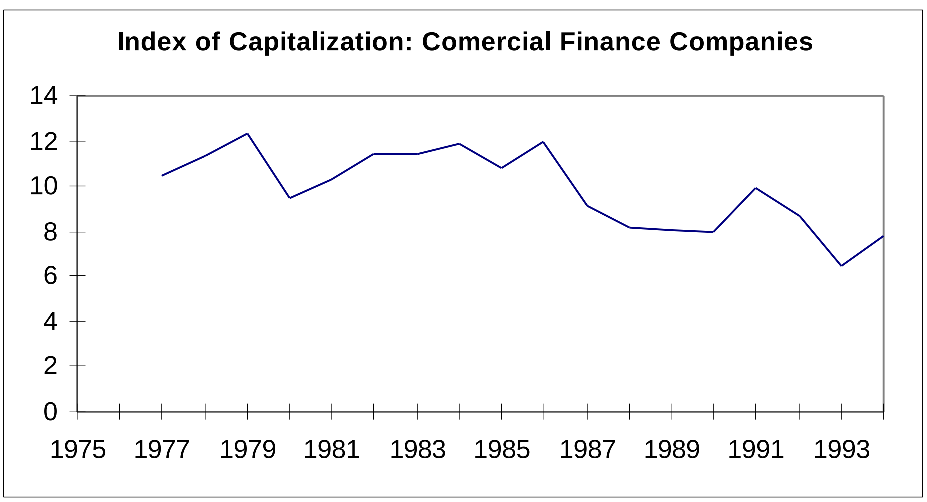
$$\dot{m}_t = 0.134 - 0.715\bar{y}_{t-1} - 0.024DJM - 0.13DJD - 0.042DLIB + .002t + .002t * DLIB + e_t$$
$$(8.5)^{***} \quad (-1.74)^{*} \quad (-1.1) \quad (-3.47)^{***} \quad (-1.22) \quad (2.5)^{**} \quad (1.75)^{*}$$

R^2=0.57; DW=2.00; n=50,

where $\bar{y}$ denotes the (log) deviations from a Hodrick-Prescott GDP trend. Again, the results suggest the counter-cyclical character of monetary policy and the secular acceleration in money growth (especially during liberal administrations). Also, monetary expansion has been lower after independence. These results are consistent with Escobar (1996) who found greater monetary expansion during liberal governments. In sum, the legal changes introduced in the Constitution of 1991 had a permanent effect of monetary policy. In a way, they lowered the average annual growth in money, but did not eliminate the acceleracionist bias, which is more palpable during liberal administrations.

To further analyze these issues we identified five periods of interest over the past two decades. During these periods the rate of growth of GDP was particularly high -- above 6% for at least two consecutive quarters -- or low, below 2%, again for at least two consecutive quarters. As can be seen in Figure 2, three of these incidents took place prior to the granting of independence to the Central Bank, and two following independence. Two of the five periods were booms (1978.II-1979.I and 1993.III-1995.III), while three were recessions (1981.IV-1983.II, 1990.III-1991.III, and the current downturn in the economy which began in 1996).

Figure 2

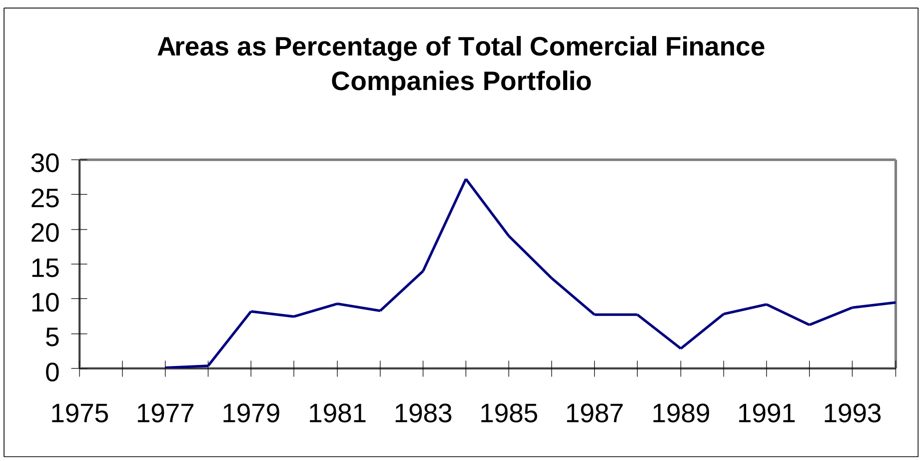


The exercise traced the behavior of five variables, namely the real exchange rate, the interest rate, the required reserves ratio, as well as M1 and inflation, over an 18-month period following the realizations of exceptionally high or low growth rates. The methodology follows Romer and Romer (1989) and estimates univariate forecasting equations for each variable, and then examines the difference between their forecasted and actual behavior during the five periods.[34] The forecast indicates the behavior of the variable that would have occurred without any intervention. Should, for instance, actual interest rates be higher than the forecast, one may conclude that the Central Bank had followed a contractionary policy with respect to that variable.

We use quarterly data from 1969:1 until 1996:2 (with the exception of the series for required reserves, which extends until 1996:4). Definitions of each of the variables, as well as results of Dickey-Fuller unit root tests can be found in Table 4. The forecast is made using an autoregressive model that takes into account 24 lags. By using two years of information we try to control for the possibility that the economy may *naturally* experience a downturn (expansion) following periods of high (low) growth, regardless of the policies pursued by the Central Bank. Thus, the lag structure reduces the bias in the forecasts.

The results indicate that the forecast equations are adequate in capturing the behavior of the five series.[35] Dynamic forecasts are then carried out for the 18-months following the initiation of each of the five periods mentioned above. The differences between these forecasts and the actual behavior of each of the variables are shown in figures 3-7. The dates indicate the quarter of initiation of the recession or boom.

Figure 3



[34] Echeverry (1995) also uses this method in his work on foreign exchange reserve shocks and inflation in Colombia.
[35] Q-statistics show that no problems of serial correlation persist with 24 lags.

Figure 4

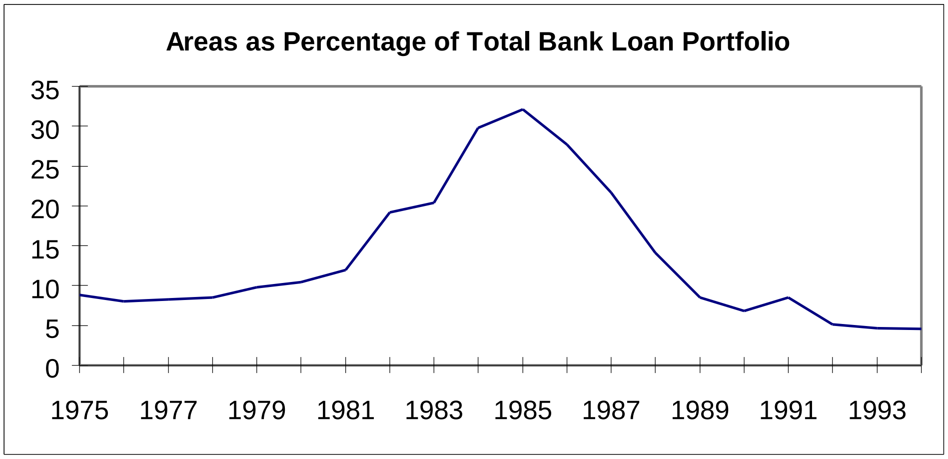


Figure 5

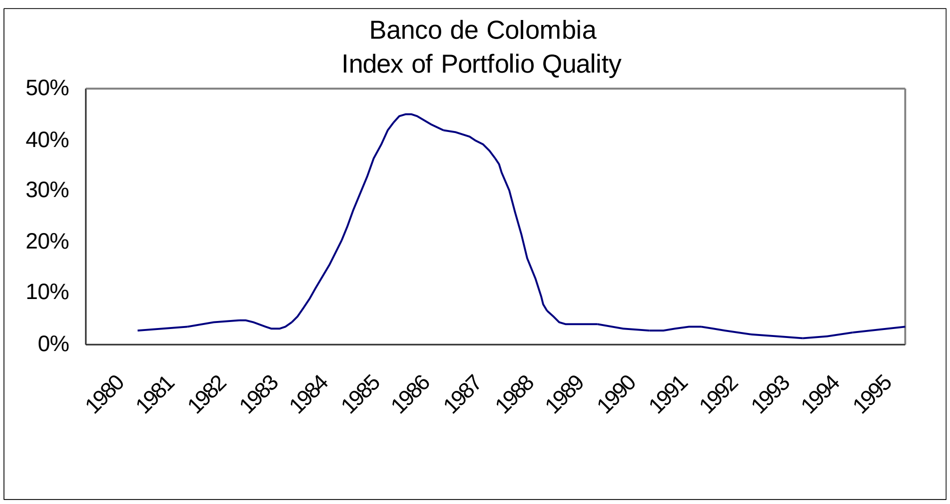


Figure 6

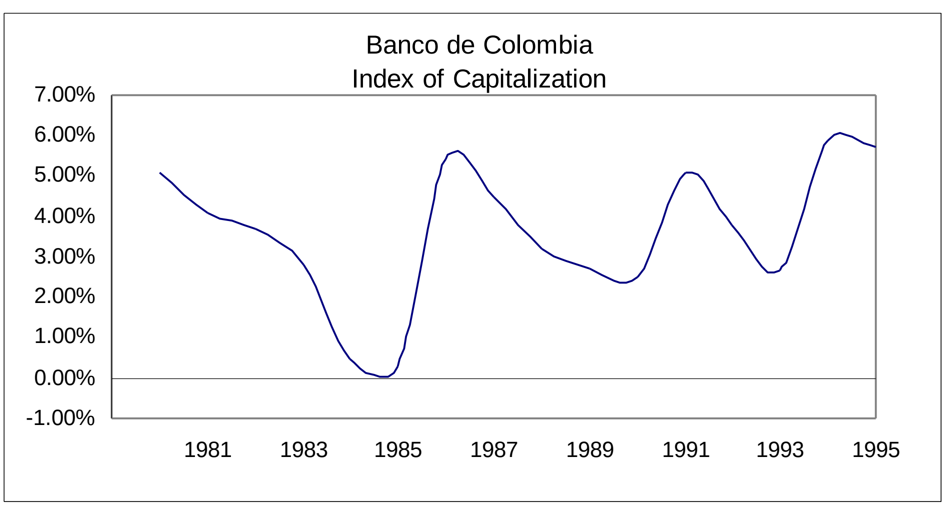
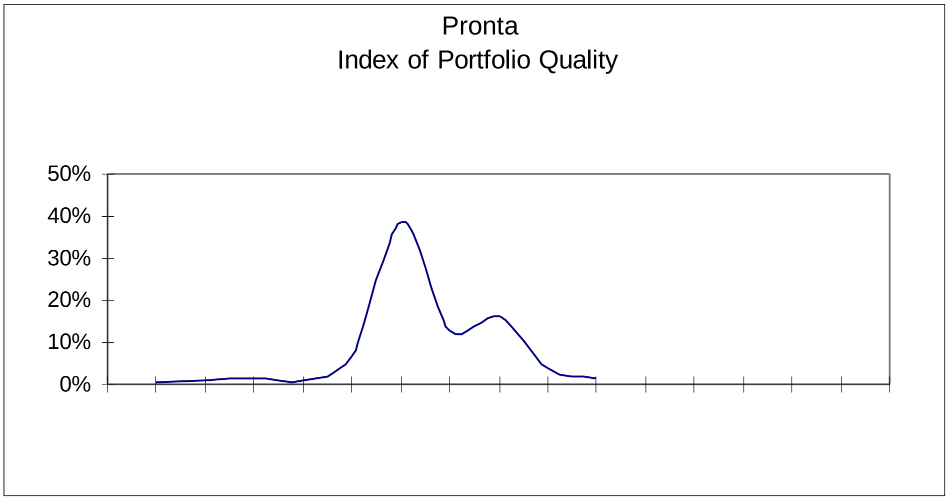


Figure 7



Again, our interest lies in characterizing the behavior of the Central Bank as pro- or counter-cyclical. In boom times, a "strong" policy maker would be expected to raise nominal interest rates and to lower the growth of M1. Thus, the package would lead to a real revaluation of the currency and a decline in the growth of inflation. Similarly, a conservative Central Bank will give more weight to inflation reduction than to the recovery of the economy (compared to the government's preferences). In other words, although there is some room for monetary expansion, the central banker would not jeopardize inflationary targets during recessions.

During the two periods where growth rates accelerated, namely in the 1978-79 period and the 1993-95 years, the behavior of the Bank's policy instruments was similar. Real exchange rates behaved as expected (revalued) but actual M1 was higher than forecasted for both periods. Interest rates in 1978 were initially below forecast values, but increased later (8 periods into the shock). In 1993, interest rates increased only one year following the initiation of the expansion and required reserves were held below their forecast value throughout the expansion. Interest rates did not increase immediately because of the fear that they would exacerbate capital inflows.

In this sense, the implementation of a contractionary package relied more heavily on the appreciation of the currency, which in turn did not curb the consumption boom. However, the results in terms of inflation were favorable both in 1978 and in 1993, although for the first period inflation began to rise again 12 months following the coffee shock. Later, in mid-1994 a fully counter-cyclical contractionary package was implemented, including an increase in interest rates[36]. Nonetheless, as similar actions were taken in 1978/79, one cannot make the claim that this was necessarily due to a tougher, more independent, institution.

We also analyzed three periods where (annualized) quarterly growth rates fell to below 2% for at least two consecutive quarters. Two of these incidents, those that occurred in 1981

[36] The 1993 expansion was, to a large extent, induced by fiscal and monetary policy, and not the result of terms of trade shocks, as in the late 1970s. However, exogenous capital inflows were also a major force leading to the expansion in 1993.

and in 1990, took place prior to the granting of independence, and one followed the Constitutional reforms of 1991. The results are mixed. On the exchange rate, interest rate and M1 fronts, there are no clear signs of expansionist behavior prior to independence. As for the required reserves ratio, the behavior of the *Banco de la República* may be seen as counter-cyclical (in terms of GDP) during 1990. In fact, the actual ratio was approximately 5 points below what would be expected according to the forecast. Not surprisingly, in terms of inflation results, 1981 was slightly below forecast, whereas 1990 was above.

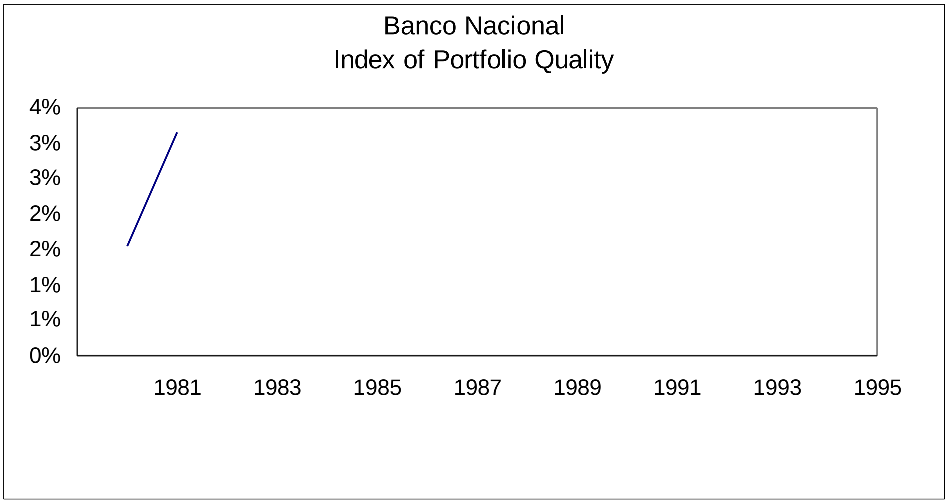
Since 1996 the economy has been experiencing a slowdown. This is the first episode since the granting of independence to the *Banco de la República*. On the positive side, growth in M1 has been consistently below forecasts, in line with the results obtained with the annual data. Also, the difference between the actual real exchange rate and its forecast is negative, indicating a revaluation. It must be noted, however, that in all five episodes analyzed, both booms and recessions, the exchange rate has been revalued.

The behavior of the remaining three variables is of interest. Actual interest rates fell below their forecasted values two periods after the shock and have continued their decline since. Throughout 1996, the Government worked towards garnering the support of the private sector and Congress to influence a more expansive monetary policy. The presence of the Minister of Finance on the Board of Directors, ostensibly for coordination purposes between the Bank and the Government, in fact translated into a voice expressing the Government's concerns regarding the decline in productive activity, and the impact of restrictions on liquidity and of high interest rates. Clearly, the arguments used go beyond the Board's mandate of inflation reduction, and undermine the isolation of the Board from political pressures.[37] Although there was some room for a reduction in interest rates, the end result was inconsistent with the inflation goal set for 1996 (see Figure 8). The magnitude of the reduction in interest rates is suggestive of the presence of short-term expansionist pressures, rather than responding to long-term objectives befitting an independent central bank. This is even more worrisome in the context of a growing fiscal deficit that created additional difficulties for economic adjustment. In fact, the difficulties experienced by the financial sector during 1996 posed what was perhaps the greatest restriction on the imposition of a tight monetary policy.[38]

Also, throughout 1996 and 1997 the required reserve ratio was steadily reduced. As can be seen in figure 5, this ratio plunged four months following the shock to levels significantly below those forecasted. However, this reduction cannot entirely be attributed to pressures for monetary expansion, as there were technical arguments to bring these requirements in line with international standards. At any rate, inflation rates following the 1996 shock were significantly *above* their forecast based on the autoregressive model.

[37] In the middle of 1996 the Minister of Finance made public statements regarding the failure in the achievement of the Board's intermediate targets for the year, in particular in terms of credit growth and monetary aggregates which were considered to be too low.
[38] Overdue accounts receivable were at particularly high levels for the system as a whole, and in particular for the commercial finance companies, where overdue accounts represented over 13% of the total, the highest level for the decade.

Figure 8



In sum, the results of this section indicate that monetary policy has played a counter-cyclical role in Colombia, regardless of the institutional design. However, during the period of an independent *Junta* monetary expansion has been, on average, lower than before. Possibly, this result is a direct consequence of the elimination of lending operations to the public and private sectors. Despite the clarity of mandate to preserve the value of money, monetary policy in practice still is influenced by a multiplicity of objectives, particularly during recessions or periods of low growth. As was the case prior to independence, these concerns include productive activity, employment generation and the health of the financial sector.

5 CONCLUSIONS

This study has shown that the government-controlled *Junta Monetaria* adopted truly anti-inflationary policies only when inflation rates increased rapidly and dramatically. Strong action against inflation was possible only after a *consensus* among policymakers was reached (the consensus being that a rate of inflation above 30% was inadmissible). This need for consensus is a clear indication of the *lack of real autonomy* on the part of the central bank. The end result, as is clearly observable in the Colombian case, was a shift from the emphasis on inflation reduction to inflation containment, combined with an active use of monetary policy for output stabilization. In other words, the *Junta Monetaria* always possessed the instruments to fight inflation; what it lacked was the conviction of all parties that the fight was worth the effort.

In relation to the legally independent *Junta Directiva*, the paper concludes that money growth has been lower after 1992, mainly due to the Constitutional restrictions on central bank lending to the private and public sectors. However, inflation control has not been the only objective of monetary policy. In this sense, the central bank has not been isolated from the consensual nature of economic policy making in Colombia.

Thus, the institutional reform has not implied a dramatic reduction in inflation. The government-controlled *Junta Monetaria* often ignored the advice of the *Asesores de la Junta*, a conservative group of technocrats that had no voting powers. The preferences of the independent members of *Junta Directiva* reveal less tolerance for inflation than under the previous regime, but continue to place weight on output and employment stabilization in their objective function. The end result has been a gradual and slow decline in inflation.

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Part II. Does Independence improve Performance? The Colombian Superintendency of Banks[39]

1. Introduction

It is increasingly accepted that the main purpose of banking regulation and supervision should be the encouragement of efficient banking, while at the same time ensuring the protection of depositors and safeguarding the financial system and the payment mechanism. Many countries have seen a recent shift in their regulatory frameworks, from a stress on repressive measures comprising strict controls over the financial system to a systems based on preventive or prudential regulation. Prudential regulation is oriented to the detection of poor performance, and to the promotion of risk diversification. All the while stressing the need to allow market forces to function with relative freedom in order to promote competition and to enhance efficiency in the industry.

In addition to regulation, supervision and control are also required to monitor the performance of financial institutions. This is where the issue of autonomy becomes relevant. Independence of the supervisory agency from pressure groups is essential in order to insulate it from the interests of regulated institutions. This is particularly the case if the supervisory framework relies on a large measure of *discretion* rather than rules to determine the timing of interventions in problematic banks. In the words of David Folkerts-Landau (1996) "the political challenge is to establish a *credible independent* supervisor with regulatory powers, cease and desist powers, on-site inspection ability, licensing powers and the ability to remove managers who are not fit and proper."[40] In other words, supervisors should have the tools to implement corrective measures and the political independence necessary to act.

Other generally agreed upon requirements is that the supervisory agency be universal and preventive. Universality implies that supervision encompass *all* financial institutions within the market. A preventive system is preferred to one based on punishment, implying that supervisors should not focus merely on compliance, but also be able to judge the quality of managerial assets as well as the capacity of banks to deal with risk.

There is less agreement on two other issues. First, whether the institution should be specialized in the supervision of financial intermediaries remains as an open question. Second, there is no consensual view on who should be responsible for the regulatory and supervisory framework: whether the regulatory responsibility should lie within the legislative or the executive branches of government, and if a public or mixed agency should carry out supervisory functions. The degree of independence from the executive is controversial.

This paper addresses these issues by looking at the Colombian experience where regulation is developed within the executive branch of government, as in Chile, Peru and

[39] This paper is part of a regional research project sponsored by the InterAmerican Development Bank. We would like to thank Claudia Piras and Gerardo Hernández for comments and suggestions.
[40] David-Folkerts Landau (1996), Commentary to Aristobolo de Juan's paper on "The Roots of Banking Crises: Microeconomic Issues".

Venezuela. In terms of the development of *rules and regulations* for the financial sector, Ecuador is the only Latin American country where specific regulations for the financial sector are developed within the legislative branch. Central banks determine the rules on financial regulation and supervision in Argentina, Bolivia and Paraguay. Brazil and Mexico are exceptions to the rule: financial sector regulation is relegated to a collective body or college known as the banking commission in which both the executive and the central bank participate. (See Table 1).

Table 1

Regulation	Institution	Country
General Regulation	Parliament	All Countries
Specific Regulation		
Financial	Central Bank	All Countries
Institutional	Parliament	All Countries
Prudential	Parliament	Ecuador
	Government	Colombia
	Superintendency of Banks	Chile, Peru
	Parliament and SB	Venezuela
	Central Bank	Argentina, Bolivia, Paraguay
	Parliament and Central Bank	Uruguay
	Collegial Institution	Brazil, Mexico

An effective regulatory structure is accompanied by an institution that performs *supervision and control* of the financial sector. Agencies dedicated to supervision may be divided in two categories: publicly run or mixed agencies (see Table 2). In Latin America, mixed agencies are less common than publicly run agencies; in fact, Panama is the only country where supervision is performed by a mixed committee of seven members, three of whom are representatives of the private sector. This has generally led to conflicts of interest that have resulted in an ineffective supervisory system.

Table 2

Type of Superivsory Agency	Country
Mixed	Panama
Public	
Collegial	Mexico
Shared	United States
Individual	Bolivia, Colombia, Chile, Ecuador, Paraguay, Peru and Venezuela
Central Bank	Argentina, Brazil, Uruguay

Supervision by the public sector can be of three types: colleges, shared supervision among a number of agencies (the US is an example of this) and individual institutions. The prevalent structure in Latin America is the latter: an individual government agency, which supervises financial institutions. Countries are, however, divided among those where supervision is performed by the central bank and those with an institution dedicated solely to that task. In the former group are Argentina, Brazil and Uruguay which have their supervisory agency within the central bank, while in Bolivia, Colombia, Chile, Ecuador, Mexico, Paraguay, Peru and Venezuela there is a free-standing governmental agency dedicated to supervision and control. In Mexico a college whose membership is made up of Central Bank and Cabinet representatives practices control[41]. Within this type of structure it is usually the central banks duty to carry out the *in situ* inspection of each financial institution.

In some Latin American countries, an additional institution exists within the regulatory and supervisory structure. These are support authorities that offer deposit insurance to the public. In Latin America, Colombia, Chile, El Salvador and Venezuela have support authorities within their systems.

2. Banking Regulation and Supervision in Colombia

The Colombian Superintendency of Banks (SB) was created in 1923[42] as a branch of the central government and was given the faculty to implement all laws related to commercial banks, mortgage banks, the Central Bank and most, though not all, financial intermediaries. Since its creation, the SB has not been a formally independent entity, but rather one that reports directly to the Ministry of Finance. In this paper we will try to assess the degree of ex-post *real autonomy* of this institution. In particular, our emphasis will be on the interaction between autonomy, the sectorial context within which the SB operates, and the various potential pressure groups with interests in the SB's decisions.

Since its creation, the Superintendency has undergone various changes. The obligation of implementing annual visits to the financial intermediaries was introduced in 1941 (Law 57), as well as the criteria for intervention. The inspection of official public institutions was introduced in 1950 (Decree 975)[43].

Colombia's support authority (Fondo de Garantías de Institutciones Financieras, FOGAFIN) was created by Law 117 of 1985. This institution is responsible of carrying out all the decisions enacted by the SB concerning the intervention of institutions. Additionally, FOGAFIN manages the assets within the sector that are property of the state, and the system of deposit insurance.

Given the tight relationship between the development of the SB and the evolution of the financial sector, it is necessary to summarize some of the main events that have taken place over the years and the changing character of both the sector and the SB. As in many other Latin American countries, Colombia's experience with financial intervention can be divided into two periods, before and after the financial crisis of 1982 when adverse macroeconomic conditions affected the operation and asset quality in the sector. However, the limited effectiveness of the

[41] France, Belgium and Italy are examples of non Latin American countries that have this type of structure within their markets.

[42] In 1922 Congress authorized the government to hire five foreign advisors on financial and taxation matters in what later became the Kemmerer Mission. Following its recommendations, Law 45 of 1923 created the Superintendency of Banks.

[43] The Superintendency has been restructured several times by the following Decrees: a. No. 294 (1959) established four divisions (banks, insurance and capitalization funds, administration, and technical studies). B. No. 125 (1976) created thirteen divisions. c. No. 1939 (1986) established two delegated superintendents. d. No. 1033 (1991) added another delegated superintendency. e. No. 2359 (1993) established 5 delegated superintendencies.

regulatory and supervisory framework led to a loosening of banking standards, which exacerbated the crisis.

Figures 1 and 2 show the levels of capitalization in the years around the crisis. Clearly, the lack of adequate regulation made the financial sector more vulnerable to macroeconomic shocks. As a consequence, portfolio quality declined rapidly (Figures 3 and 4) and banks found themselves unable to attend to the public's demand for withdrawals. The crisis forced the nationalization of the *Banco de Colombia* and the intervention of the *Banco de Bogotá*, the country's two largest banks, as well as that of a number of other institutions.

Figure 1

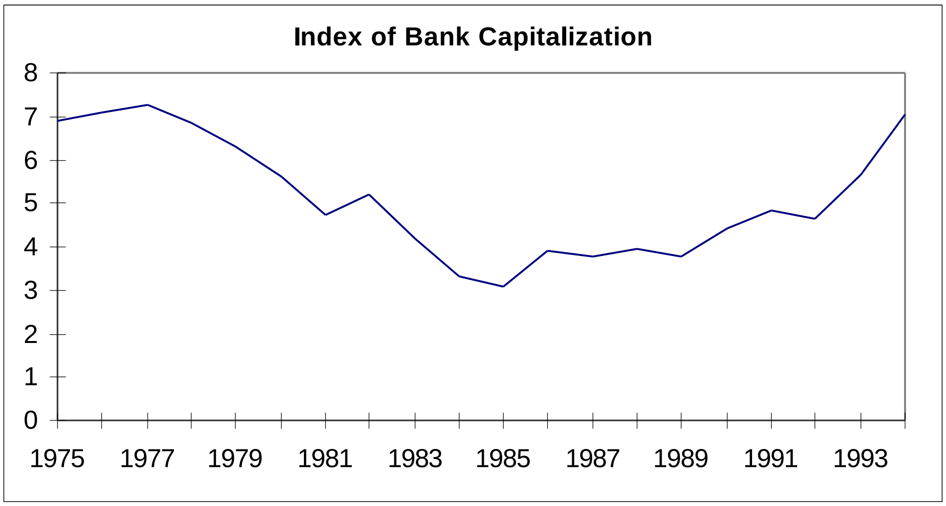


Figure 2

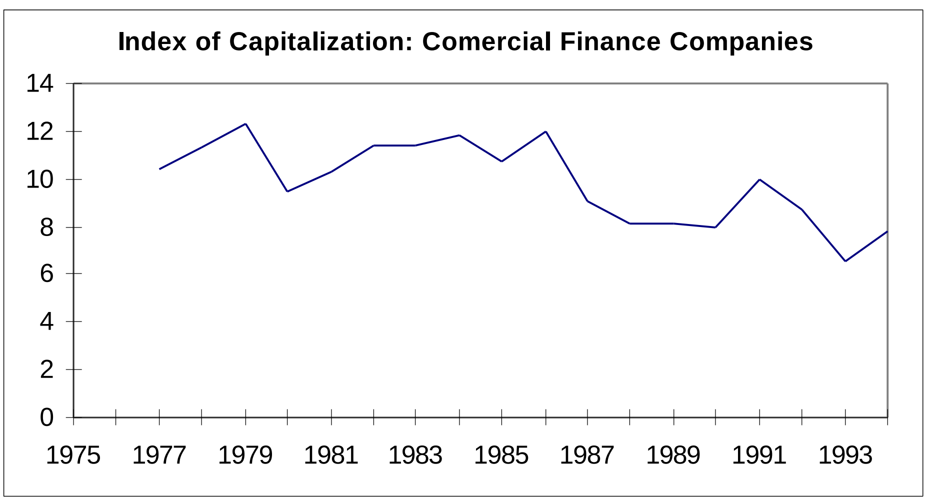


Figure 3

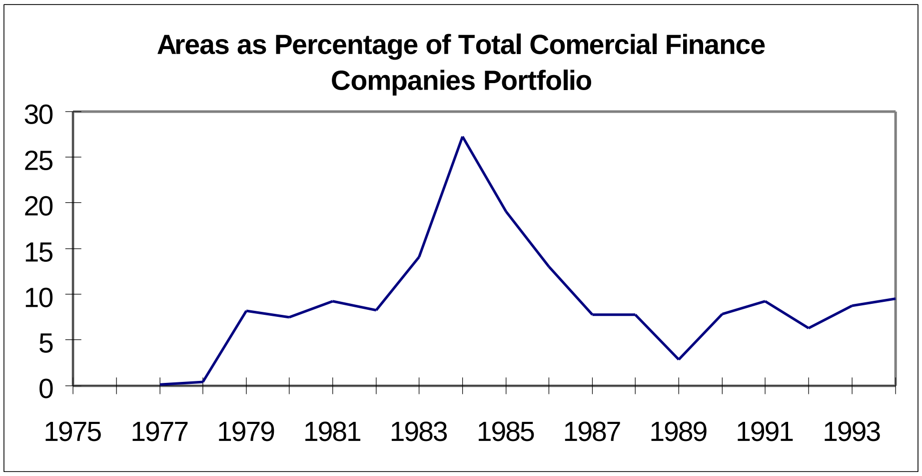
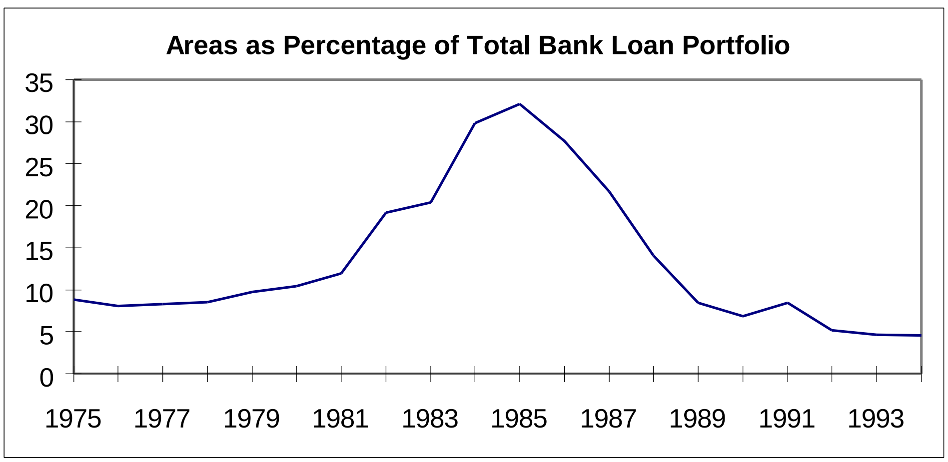


Figure 4



Authorities became aware that the existing structure of intervention was not efficient in the timely detection of problems in the sector or in their prevention. The instruments used for supervising and regulating the financial sector were obsolete and ineffective, and a general consensus was formed to the effect that intervention should in the future be preventive and prudential, rather than relying on reserve requirements and compulsory investments as decreed by the Monetary Board[44]. Since then, a number of changes have been enacted to leave behind a system whose emphasis was on using the financial system as a vehicle to promote wider economic objectives at the cost of its health and stability.[45]

The financial reform law, enacted in 1990 (Ley 45), was aimed at the creation of a financial system which would operate under conditions of greater freedom, solidity and efficiency, thus supporting the goals of internationalization and modernization of the economy as

[44] The Monetary Board, until 1991, was the body responsible for monetary management in the country.
[45] A summary of these changes is available from the authors.

a whole. Measures were taken to encourage the recuperation and consolidation of the sector by adjusting towards international standards in prudential regulation. The promotion of transparency, an increased participation of foreign investment in the financial sector, the dismantling of a variety of quasi-fiscal burdens which had hampered the operation of agents in the system, were also included in the law. In addition, the proportion of public interests in the financial sector began to decline from their levels in the early nineties.

Nevertheless, while the goals of regulation and supervision have undergone great changes, from repressive measures to preventive controls, the institutional structure of the SB has remained relatively unaltered, and continues to be characterized by a low level of formal independence.

3. Institutional Design

Table 3 summarizes the main institutional features of the SB. As mentioned above, the SB was created through the introduction of a law. This confers relative stability to the institution's structure and objectives, as Congress must approve any adjustment, although laws are easier to abrogate than are constitutional amendments. The Superintendent is appointed by the President of Colombia, but can be dismissed at will. There are no requirements in terms of experience or professional background. The actual average tenure is much shorter, however, as will be seen below. The President also appoints and dismisses the delegated superintendents who are the officials with the next highest status within the SB's hierarchy. The power of the President to appoint and remove the Superintendent at will has been reflected in the number of superintendents over the years. Since 1974, there have been 12 Superintendents, while 7 Presidents were elected over the same period (Table 4). This translates into an average tenure of less than two years, half of the Presidential term.

Traditionally, the Superintendent has not been a politician, but almost always a professional economist or a lawyer with expertise in the financial sector. In recent years, superintendents have come from the central bank or the ministry of finance. Moreover, in many instances superintendents have been promoted to higher ranking positions within the government. Importantly, the Superintendent has not been removed during the last two presidential changes. The delegated superintendents have frequently been career professionals from with the superintendency.

Although the SB was changed with the monitoring of the financial sector it was not granted initially the ability to create rules and regulations on its own. Until the financial crisis of 1982 all rules were created jointly by the Monetary Board and the SB. The legal changes that took place in terms of regulation of the financial sector, Law 35 of 1993 modified the institutional structure of intervention. A new body, the Technical Viceministry, was created within the Ministry of Finance and was made responsible for the drafting of rules and regulation in the sector. Some regulatory faculties that had been under the charge of the SB were transferred to the Technical Viceminister of Finance. Regulations concerning accounting within banks, the creation of new banks, and mergers or acquisitions of existing ones are still in the hands of the Superintendent.

As in other public agencies, the Superintendency issues administrative acts that can be appealed to the Superintendency or demanded to the judiciary system. The Superintendent does not have a special legal immunity and can be denounced. In fact, during the 1980s one of the Superintendents was removed form his post by the Attorney General, on the grounds of errors in the supervision.

The Minister of Finance is ultimately responsible for all spending decisions within the SB (see Table 3 for the details). Its budget has relied solely on obligatory contributions made by the institutions within the sector. The amount to be contributed is determined by the Superintendent but must be approved by the Minister of Finance.[46] These contributions are placed in a fund that is part of the general budget to be later transferred to the SB. The central government may keep some of the resources.

The Ministry of Finance must approve all of the SB's expenses. The Superintendent has no independence of decision-making regarding long-term investment projects. The lack of budgetary autonomy in the SB has often been criticized because of the negative consequences for the agency's ability to strengthen its technical capacity to fulfill its responsibilities.

The Superintendent must present an annual report of activities to the Minister of Finance[47] and a detailed monthly report of its expenditures to the *Contralor General de la República.* The annual report has been presented promptly and published annually. It has been incorporated into the report that the Ministry of Finance is obliged to present before Congress every year. The Superintendency is also required to publish the financial statements of the intermediaries under its control and supervision.

Hence, after a long process of reforms, the financial sector's regulatory and supervisory structure currently consists of a Superintendency of Banks within the executive branch whose objectives are to supervise and control the intermediaries, a support authority known as FOGAFIN, the Technical Vice Ministry in charge of enacting all the regulation with the sector, supported by a set of prudential rules and regulations. Throughout the years the institutional structure of the SB has undergone few changes, in particular with respect to its degree of formal independence which has remained low. The questions we seek to answer in what follows relate to how the low level of independence has translated into the degree of real autonomy and how the performance of the Superintendency has been affected by it. The question remains, however, as to whether the SB's lack of formal autonomy has been reflected in the agency's fulfillment of its monitoring and control responsibilities towards the financial sector. In order to do so, we now turn to a discussion of the sectorial context within which the SB operates.

[46] Art. 329 literal c (see Table 3).
[47] Art. 329 literal d.

Table 3 Design of the Superintendency of Banks

Design Variables		
Legal Structure	Created by Law 45 of 1923	The amendments of laws must be done through Congress. The constitution is the most difficult structure to amend, and within the hierarchy, laws follow. Congress is responsible for the creation or abolition of the different superintendencies. This does not rule out the possibility for Congress to entitle the executive to restructure the organization of the state, including the superintendencies.
Specific Nature of the Legislation	Decree 2359/93 Art.1	The Superintendency of Banks is a technical organization subscribed to the Ministry of Finance and is responsible for the accomplishment of the following objectives: a) Ensure the public's confidence in the financial system and certify that the institutions maintain solid economic performance and appropriate liquidity coefficients. b) Supervise integrally, the activity of the institutions under their control, to ensure the compliance with financial regulation and to assure adherence with foreign currency obligations. c) Guarantee that the institutions under their control deliver adequately their services to the public under strict conditions of transparency, security and efficiency. d) Prevent that unauthorized people carry out activities that are restricted to the supervised institutions. e) Prevent adverse circumstances that can lead to the loss of trust of the public in the financial institutions. f) Supervise that the institutions of the sector comply with the mechanisms of prudential regulation. g) Guarantee that the supervised institutions adhere to the norms established by the Central Bank. h) Ensure that the supervised institutions carry out activities that do not restrict free market competition, and that are within the limits of good faith. i) Adopt inspection policies that allow financial institutions to adjust their activities to new technological advances.
Appointment of Authorities	Law 45 of 1923 Art. 19 Art. 329 literal (a) [48]	The Superintendent of Banks will be appointed and removed freely by the President of Colombia. The Superintendent of Banks can: (a) Name, remove and distribute the staff of the institution in accordance with legal dispositions, except for the delegated superintendents who will be appointed and removed by the President of Colombia.
Removal of Authorities	Law 45 of 1923 Art. 19 Art. 329	(See appointment of authorities) (See appointment of authorities)
Term	Law 45 de 1923 Art. 19	The Superintendent of Banks (…) will be appointed for a period of 4 years.
Re- election of Authorities		There are no restrictions for the re-election of authorities within the Superintendency
Personnel		The SB follows the same personnel regime as the rest of the public sector.

[48] All articles are from the Estatuto Organico del Sistema Financiero unless otherwise specified.

Regime		
Constraints for Employment	Law 45 de 1923 Art. 19 Art. 337	The Superintendent of Banks (…) cannot be employee, manager, or stockholder of any institution that is protected by this law, or be a proprietor directly or indirectly of any of these institutions. The Superintendent of Banks must be a Colombian citizen.
Personnel Management	Art. 337	(8) *Personnel Management*. All the pertinent matters related to the management of personnel in aspects such as the selection process, distribution of responsibilities, placement of personnel and in general any internal matters concerning the global management of the institution, will be done by the superintendent who can entrust this functions when necessary.
Financial Means	Art. 329 literal c)	It is the duty of the superintendent to … c) Determine the amount of the contributions to be done by the supervised institutions, with previous approval of the Minister of Finance. These contributions will constitute the means of financing of the agency.
Budgetary Process	Art. 337	*Management of the Contributions.* The General Direction of Treasury, and the Ministry of Finance will manage the contributions done by financial intermediaries for the maintenance of the Superintendency of Banks. 1. *Entrusting expenditures.* The Minister of Finance can delegate the approval of expenditures to the General Secretary or the Manager of Finances of the Superintendency of Banks.
Supervision	Art. 329 literal d) Art. 24 Law 45 of 1923	It is the duty of the superintendent to … d) Present an annual report of the activities of the Superintendency to the Minister of Finance. At the end of each month, the superintendent of banks will present to the Contralor General de la República a detailed report of the verified operations executed with the funds of the Superintendency.
Publications		The annual report presented by the Superintendent to the Minister of Finance has been published regularly.

Table 4 Superintendents and Presidents of Colombia 1974-77

PRESIDENTS			SUPERINTENDENTS
Misael Pastrana	I.74	1	Vicente Noguera
	II.74		Vicente Noguera
	III.74		Ramon Madriñan
	IV.74		Ramon Madriñan
	I.75	2	Ramon Madriñan
	II.75		Ramon Madriñan
	III.75		Ramon Madriñan
	IV.75		Ramon Madriñan
	I.76		Christian Mosquera
	II.76	3	Christian Mosquera
Alfonso Lopez Michelsen	III.76		Christian Mosquera
	IV.76		Christian Mosquera
	I.77	4	Juan Camilo Restrepo
	II.77		Juan Camilo Restrepo
	III.77		Juan Camilo Restrepo
	IV.77		Juan Camilo Restrepo
	I.78		Juan Camilo Restrepo
	II.78		Juan Camilo Restrepo
	III.78	5	Franciso Morris Ordoñez
Julio Cesar Turbay	IV.78		Franciso Morris Ordoñez
	I.79		Franciso Morris Ordoñez
	II.79		Franciso Morris Ordoñez
	III.79		Franciso Morris Ordoñez
	IV.79		Franciso Morris Ordoñez
	I.80		Franciso Morris Ordoñez
	II.80		Franciso Morris Ordoñez
	III.80		Franciso Morris Ordoñez
	IV.80		Franciso Morris Ordoñez
	I.81		Franciso Morris Ordoñez
	II.81		Franciso Morris Ordoñez
	III.81		Franciso Morris Ordoñez
	IV.81		Franciso Morris Ordoñez
	I.82	6	German Botero de los Rios
	II.82		German Botero de los Rios
	III.82		German Botero de los Rios
Belisario Betancurt	IV.82		German Botero de los Rios
	I.83		German Botero de los Rios
	II.83		German Botero de los Rios
	III.83		German Botero de los Rios
	IV.83	7	German Tabares
	I.84		German Tabares
	II.84		German Tabares
	III.84		German Tabares
	IV.84		German Tabares
	I.85		German Tabares
	II.85		German Tabares
	III.85		German Tabares
	IV.85		German Tabares
	I.86		German Tabares
	II.86		German Tabares
	III.86		Ernesto Aguirre Carrillo
Virgilio Barco	IV.86	8	Ernesto Aguirre Carrillo
	I.87		Ernesto Aguirre Carrillo
	II.87		Ernesto Aguirre Carrillo
	III.87		Ernesto Aguirre Carrillo
	IV.87		Ernesto Aguirre Carrillo
	I.88	9	Nestor Humberto Martinez
	II.88		Nestor Humberto Martinez
	III.88		Nestor Humberto Martinez
	IV.88		Nestor Humberto Martinez
	I.89		Nestor Humberto Martinez
	II.89		Nestor Humberto Martinez

	III.89		Nestor Humberto Martinez
	IV.89		Nestor Humberto Martinez
	I.90		Nestor Humberto Martinez
	II.90		Nestor Humberto Martinez
	III.90		Nestor Humberto Martinez
	IV.90		Nestor Humberto Martinez
	I.91		Nestor Humberto Martinez
	II.91		Nestor Humberto Martinez
	III.91		Nestor Humberto Martinez
	IV.91	10	Jose Elias Melo
	I.92		Jose Elias Melo
	II.92		Jose Elias Melo
	III.92		Jose Elias Melo
Cesar Gaviria	IV.92		Jose Elias Melo
	I.93		Jose Elias Melo
	II.93		Jose Elias Melo
	III.93		Jose Elias Melo
	IV.93		Jose Elias Melo
	I.94		Jose Elias Melo
	II.94		Jose Elias Melo
	III.94	11	Jorge Castellanos
	IV.94		Jorge Castellanos
	I.95		Jorge Castellanos
	II.95		Jorge Castellanos
	III.95		Jorge Castellanos
	IV.95	12	Maria Luisa Chiappe
Ernesto Samper	I.96		Maria Luisa Chiappe
	II.96		Maria Luisa Chiappe
	III.96		Maria Luisa Chiappe
	IV.96		Maria Luisa Chiappe
	I.97		Maria Luisa Chiappe
	II.97		Maria Luisa Chiappe

4. Context: Structure of the Financial Sector

Although the SB supervises over ninety institutions, the degree of concentration within the financial sector is relatively high, and points to the possibility of the existence of a number of powerful interest groups which might seek to pressure the SB. In 1995, for example, six economic consortia owned 71.2% of total assets of the sector (see Table 5). Nevertheless, the fact that the law grants the SB ample powers of supervision and intervention[49], and given the visibility of the SB's decisions as well as the presence of a number of independent agencies that evaluate risk, it is difficult to reach any clear conclusion regarding the true ability of the SB to withstand pressures of existing interest groups. In order to assess the real autonomy of the SB it is necessary to evaluate the SB's performance over time and with respect to the specific groups.

[49] Art 114, 326 (table 4).

Table 5   Context of the SB's Actions

Context Variables		
Number of Supervised Institutions		90
Concentration of the Sector		At the end of 1995, the biggest economical groups within the sector where: *Sindicato Antioqueño,* 16 institutions, owning 20.5% of total assets of the financial market. *Grupo Sarmiento Angulo* 14.1% of total assets, owning 15 institutions *Grupo Cafetero* 11.3% of total assets and 11 institutions. *Grupo Ganadero* 9.2% of total assets and 5 institutions *Grupo Santodomingo* 7.4% of total assets and 13 institutions *Grupo Gilinsky* 8.7% of total assets and 5 institutions ***6 groups had 71.2% of total assets in 1995***[50]
Privately vs. Publicly ran Institutions		In 1995 78% of total assets where privately owned, and the other 22% were owned by publicly ran or mixed institutions. (1)
Legal Instruments	For: Supervision Art. 326 literal (4)	(4) The Superintendency of Banks can: (a) Practice visits of inspection when there is evidence of irregular practices within the institutions. (b) Obtain information from people that are not part of the financial sector if considered relevant for the duties of supervision. (c) Question, under oath, any person whose testimony can be helpful in clarifying the truth about any legal procedure done by the Superintendency.
	Prevention and Sanctions Art. 326 literal 5	(5) The Superintendency of Banks can: (a) Formulate the necessary instructions in order to suspend non-authorized practices. (b) Impose one or many of the preventive measures granted in article 108 literal 1 of this law, to the people that execute financial activities that are exclusive of institutions that are supervised and controlled by the agency. (c) Adopt any of the following actions, to prevent the seizure of any of the supervised institutions - Establish a special supervisory regime. -Coordinate with the Fondo de Garantias the necessary actions in accordance with the law -Ordain the capitalization of the institution in accordance with legal requirements -Promote the partial or total cession of the assets, liabilities or contracts or the expropriation of its commercial establishments to another institution. -Promote for the fusion of the institution (d) Take immediate possession of the goods and businesses of a supervised institution when one of the events mentioned in the article 114 of this law occurs, granted that a previous concept and approval of the minister of finance is given. (e) Transfer to FOGAFIN or to the competent judge the businesses and

[50] Jaramillo, C. F. (1996)

	Seizure Art. 114	goods of the intervened institution for their liquidation (f) To order that the legal representatives of the institutions under special supervision refrain from carrying out agreements between themselves or promote financial association or any practice that has as objective to impede free competition within the financial sector. Reasons that justify Seizure: When an institution fails to pay their legal contribution to the SB When an institution refuses to submit their archives, accounting books, and other documents for inspection by the SB When the legal representative or manager of an institution refuses to be interrogated with relationship with his activities within the sector. When the institution breaks the law contemplated in the Estatuto Organico del Sector Financiero. When an unlawful handling of the institution persists after being notified. When the net assets is lower than 50% of the subscribed capital.
Visibility of the SB's decisions		All of the decisions made by the SB are completely visible. They are communicated to the institutions involved through a legal instrument known as *circulares externas*, and these *ciruclares* are published regularly in a magazine called Legislacion Economica.
Number of agencies that evaluate risks		In Colombia, there are 2 agencies that evaluate risk of financial institutions.

The main sectors with an interest in pressuring decisions by the SB are private economic consortia, a variety of financial sector associations and of course, the government. Table 6 shows the evolution of the associations of financial institutions in Colombia since the 1960s. In the 1980's there were four organizations of financial intermediaries: the Banking Association of Colombia (ASOBANCARIA)[51], the National Association of Financial Institutions (ANIF), the National Association of Insurance Companies (FASECOLDA) and the Colombian Institution of Housing and Savings (ICAV)[52]. There is general agreement that these organizations have not been concerned with the formation of lobbies for specific group interests[53]. Urrutia (1983), for example, concludes that the ASOBANCARIA (the largest financial association in Colombia, whose members represent 80% of total assets of the financial sector[54]) has served mainly as an association to provide services to its members. Similarly, ANIF[55] did not function as a traditional association in the sector because it basically served as an instrument of opinion for its presidents. Therefore, one may conclude that the main objective of the associations within the financial sector has not been restricted to influencing the supervision that affects their members. The same

[51] The National Association of Banks was created in 1936 and is one of the oldest and most traditional associations in the country. In 1981 it comprised 22 banks, 19 Corporaciones Financieras, 7 almacenes generales de depósitos and 3 corporaciones de ahorro y vivienda as members of the association. The Association employed about 165 people.
[52] ANIF was created at the end of the 1970s by the head of the Grupo Grancolombiano, Jaime Michelsen. Urrutia (1983) believes that the motive behind the creation of the new association within the sector was that many newly established non-traditional financial intermediaries were not well received within ASOBANCARIA because their objectives were to evade governmental restrictions. Therefore these new institutions joined with some traditional ones to create the new association.
[53] ASOBANCARIA and ANIF are the associations of the sector which are most recognized. In an interview with high officials of the Central Bank, those were the only two associations recognized as existing. The other four institutions that exist today as associations of the sector were not even mentioned.
[54] Interview with employees of the ASOBANCARIA.
[55] ANIF is a relatively small association with 31 highly heterogeneous members, representing all types of institutions within the sector.

conclusions can be made regarding the more recently formed associations. In sum, the Superintendency has been a technical entity with large autonomy. There are natural pressures on the Superintendent, but the financial associations have been more committed to a sound supervision, rather than to the defense of particular interests on behalf of their affiliates.

Table 6 Evolution of Colombia´s Financial Sector Associations

Colombia's Financial Sector Associations				
	1961	1970	1980	1997
Asociacion Bancaria de Colombia (ASOBANCARIA)	x	x	x	x
Asociacion Nacional de Instituciones Financieras (ANIF)			x	x
Asociacion Colombiana de Aseguradores (Fasecolda)	x	x	x	x
Instituto Colombiano de Ahorro y Vivienda (ICAV)			x	x
Asociacion Nacional de Fondos de Pensiones (ASOFONDOS)				x
Fedeleasing				x
Comercial Financing Companies				x
Asociacion de Fiduciarias				x

5. The Superintendency in Practice - Private Sector

Evidence on the performance of the SB during the financial crisis of the 1980s indicates that with respect to private economic groups the Superintendency has acted independently. As was the case in a number of Latin American countries, several Colombian banks were intervened during the financial crisis of the 1980s.

A good example is that of the Grupo Grancolombiano, one of the largest groupings within the financial sector, with 13 institutions representing close to 10% of the sector's total assets at the time. The SB intervened in the three largest companies owned by the group: the Banco de Colombia, the Corporación Financiera Grancolombiana, and a commercial finance company the Grancolombiana de Promociones "Pronta". The three companies represented a majority, 77.1%, of the group's total assets within the financial sector. The indexes of quality of the loan portfolio and of capitalization clearly reveal the necessity of the interventions. The Banco de Colombia's index of portfolio quality shows a distinct deterioration, from 4.17% of loans in arrears in 1983, to a maximum of 43.84% in 1985 (Figure 5). Simultaneously, its index of capitalization reached its lowest point, 0.27% in the same year, revealing the institution's poor response capacity to demands for withdrawals from the public (Figure 6). In the case of Pronta, the quality of its loan portfolio had also deteriorated dramatically, from 6.8% in 1984 to 38.4% in 1985 (Figure 7).

Interviews conducted with members of the financial sector support the assertion that the SB has acted in a largely independent manner with respect to the financial sector.[56] Table 7 presents a summary of interview results. Without exception all responses expressed the belief

[56] Interviews with a number of participants within the sector were an important source of information for this section.

that the SB is indeed independent in its decisions from the pressures of private interest groups, and particularly from economic groups.

Figure 5

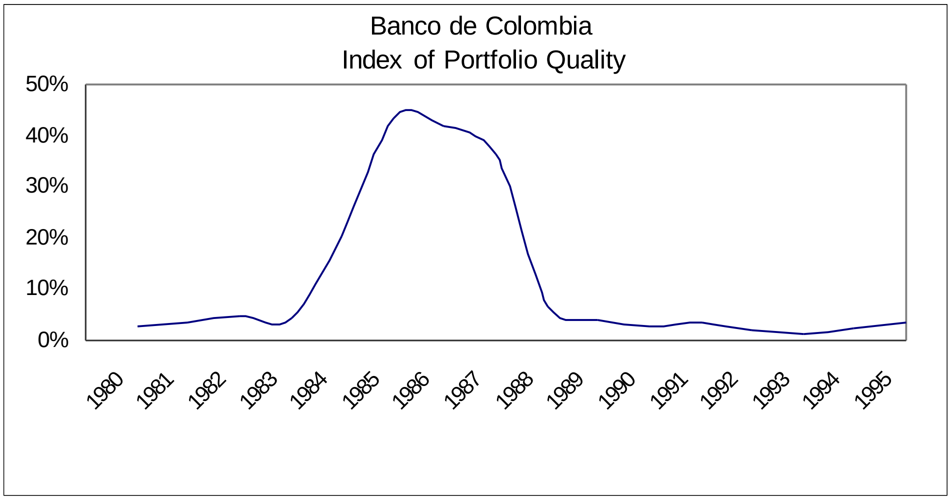
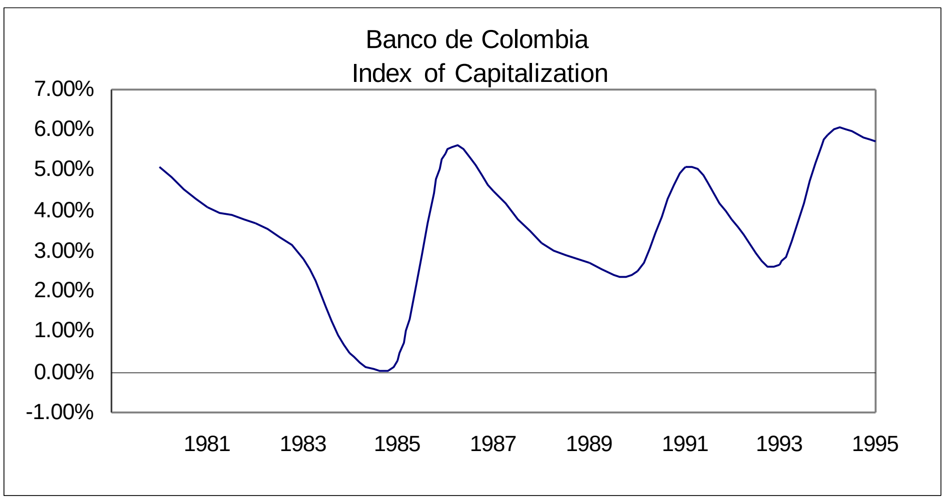


Figure 6

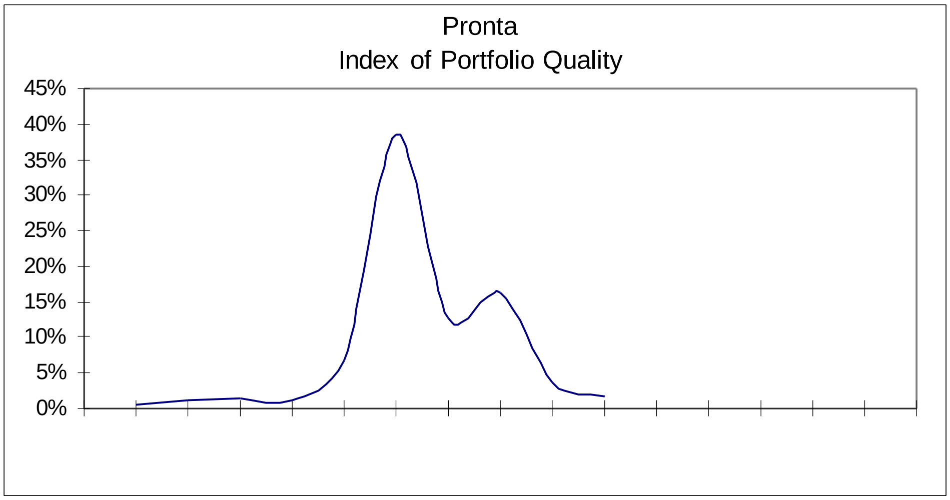


It is important to mention that although the available evidence points towards the independence of the SB from pressures of private interest groups this is a surprising conclusion given the concentration of property within the sector.[57] One issue that does emerge from the review of events, however, is the delay by the SB in taking action. As mentioned above, the Superintendency -- in both the case of the Banco de Colombia and in that of Pronta -- waited until loans in arrears reached nearly 44% in the former and 38% in the latter. While the SB may not be subject to strong pressures on the part of private banks, the incentives for the

[57] It is even more surprising if we consider the evidence from a recent study by Steiner et al. (1997), in which the authors find that the financial sector presents evidence of monopolistic behavior. Institutions within the sector fix the interest rate about 20% above the marginal cost.

Superintendent to take decisive and timely action seem to be absent. An explanation may lie in the combination of a high level of discretion -- the absence of clear rules or thresholds for intervention -- and the requirement that the Minister of Finance approve all decisions.

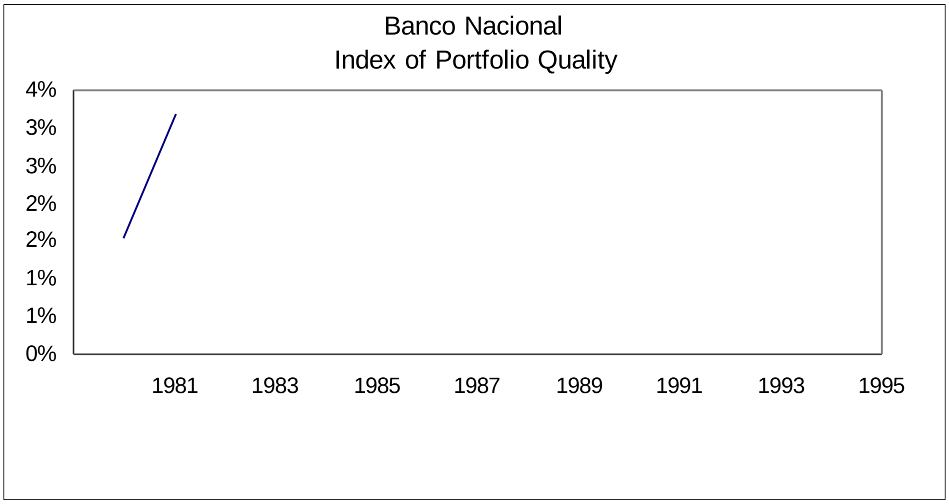
Figure 7



The SB enjoys a high degree of discretion in the type of intervention it chooses to undertake. Article 114 of the *Estatuto Orgánico del Sistema Financiero* lists the grounds for intervening an institution, which basically grants the Superintendent the ability to decide based upon his own judgment. In the 1980s the means of intervention varied depending on the level of deterioration in performance in each institution. Different methods were used: one bank was liquidated, while some banks were nationalized, with the government taking over the banks' activities and assets. In other cases, the management of the financial intermediary was transferred to the SB, and after the institution-regained stability, the shareholders again took control of operations. The first case of intervention was that of the Banco Nacional, liquidated in 1982. Indicators such as portfolio quality and an index of capitalization both show a clear deterioration in the performance of the institution (Figure 8 and 9). The Superintendent also justified the decision to liquidate on the basis of the high concentration of the institution's portfolio in companies that were part of the very group that owned 85% of the bank. Other intermediaries whose performance according to the above-mentioned indicators was even poorer were nationalized rather than liquidated. Nationalization was regarded as a better alternative, avoiding the threat of a generalized bank run, and one that did not require immediate outlays.[58]

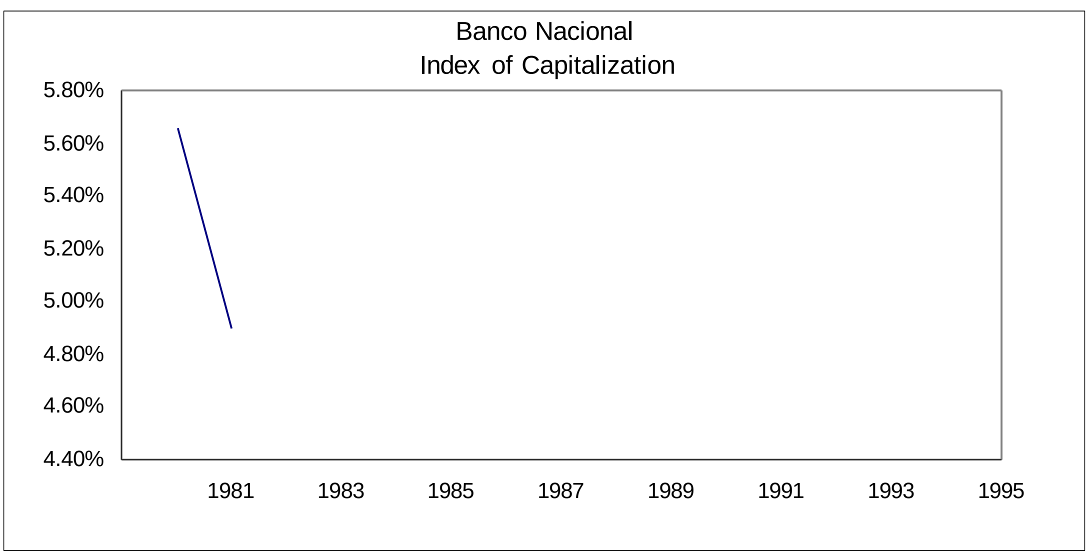
[58] Five banks were nationalized during this period: Banco de Colombia, Banco del Estado, Banco de Comercio, Banco Tequendama and Banco de los Trabajadores. Many commercial financing companies were also intervened, with the administration of the instituions handed over to the SB until their recovery.

Figure 8



The fact that the SB's intervention in the financial sector is discretionary need not necessarily be considered a weakness. There is little consensus regarding the preference for discretion over rules within the context of banking supervision. Whereas rules impart clarity and credibility they sacrifice flexibility. Discretion is by definition flexible and enhances the regulator's ability to respond to specific situations, and to take into account "soft" indicators (e.g. managerial quality) which help in making the decision as to which course of action is most appropriate in a given case. However, the incentives for a Superintendent to take a timely decision may be reduced if a lack of clear rules and thresholds for intervention is combined with a lack of independence, as exemplified by the requirement for an approval by the Minister of Finance of a Superintendent's decision to intervene.

Figure 9



Public Banks: The Caja Agraria

The *Caja Agraria* was created in 1931 and conceived as an institution with the mandate to provide loans and general services to farmers as well as to supply them with agricultural inputs. It was originally designed as a credit union with 25% of its equity held by the government, 10% by commercial banks, 4% by the National Coffee Fund and the remainder by its borrowers. The government later took over the institution.[59] A closer look at the monitoring and control of the Caja Agraria by the SB serves to illustrate the lack of autonomous decision-making power of the SB when it comes to government-owned institutions.

In its evaluation of Colombia's financial sector, the World Bank (1992) points to major problem areas of the *Caja Agraria* which were responsible for its constant financial losses. High on the list was the fact that arrears on the loan portfolio were very high and had reached over 20% of the portfolio while the banking sector as a whole averaged 5%. In 1988, for example, arrears were at 34.2% yet the institution was not intervened.[60]

In effect, an index of the portfolio quality of the Caja Agraria shows a sharp deterioration in the quality of loans. In 1987, 5% of total loans were in arrears and by 1988 this percentage had risen to 33% (Figure 10). While an index of the *Caja*'s capitalization does not indicate as negative a situation as that of other banks which were intervened (Figure 11), an analysis of these two indexes in conjunction with the *Caja Agraria*'s operational losses reveals (Figure 12) that comparing the situation of the *Caja* with that of other intermediaries that were intervened, the SB should have taken action long ago[61].

Of the twelve individuals interviewed, eight agreed that the case of the Caja Agraria was a clear example the SB's lack of autonomy from the government. An ex-superintendent indicated that during his term there had been the intention, on different occasions, to intervene in *the Caja Agraria*, but the governments political considerations interfered with the ability of the Superintendent to act. In its annual report in 1983, the then General Manager of the Caja Agraria makes the following statement (our translation): "...the accumulated losses of the institution reached such gravity that the SB notified us, in a communiqué on April 28th that: 'It is important to emphasize that losses amounting to C$16,609,939.075 [Colombian pesos] which represents 238.79% of capital and reserves, is sufficient cause for the dissolution of the *Caja* ...[62]'" He continues, "...given the situation, we appealed to the National Government, in search of the necessary resources to confront the financial crisis. Unfortunately, the Government was not able to provide these resources due to the difficult budgetary situation it was facing. We had no other alternative than to appeal directly to Congress in search of legal solutions. Fortunately, given the long record of service by the *Caja Agraria*, we found a favorable atmosphere in Congress, which

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[59] World Bank, 1992.

[60] Also, the *Caja's* non-banking activities were beyond the scope of operation of a banking institution, and its the total administration costs of the bank were abnormally high due to a very costly pension plan, overstaffing and high salaries and benefits.

[61] In the evaluation of Colombia's financial sector done by the World Bank in 1992, they report that the four major problems of the Caja Agraria that produced constant financial losses were (1) loan arrears on the loan portfolio at the bank were very high and had reached over 20% of the portfolio, while the banking sector averaged 5%. (In 1988 the arrears were of 34,2% and the institution was not intervened). (2) The Caja's non-banking activities were beyond the scope of operation of a banking institution (3) the total administration costs of the bank were abnormally high due to a very costly pension plan, overstaffing and high salaries and benefits.

[62] This is according to **ordinal** 2 of article 457 of the Code of Commerce, in accordance with the numeral 7 article 48 (Law 45 of 1923).

went on to approve Law 68 of 1983, making the Government responsible of all losses accumulated up until December 31, 1983."[63]

Figure 10

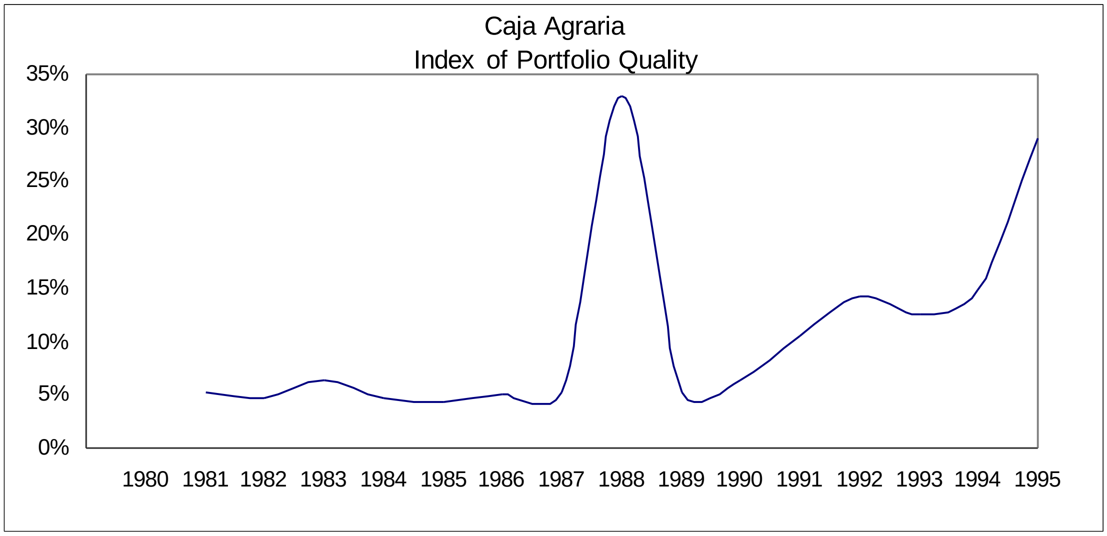
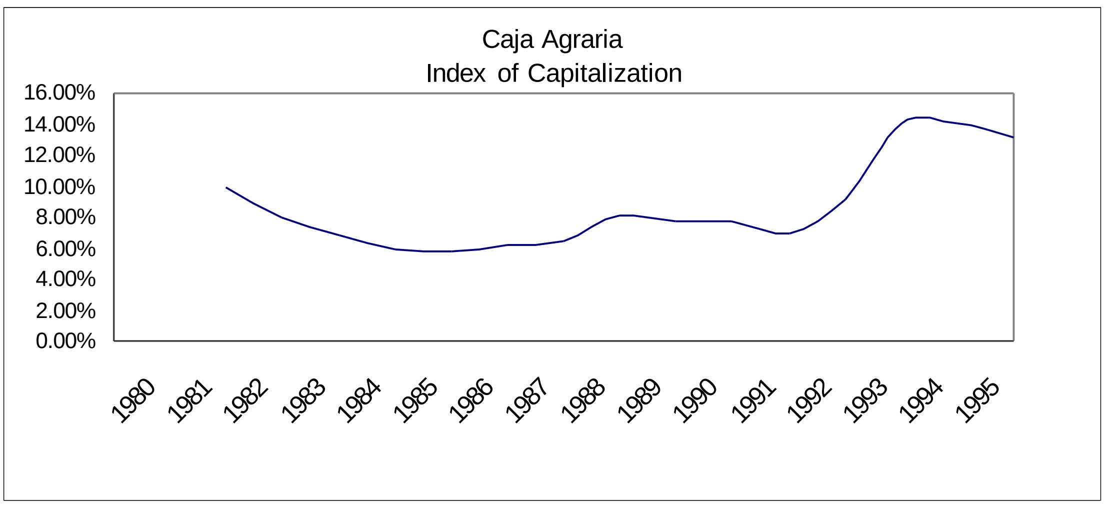
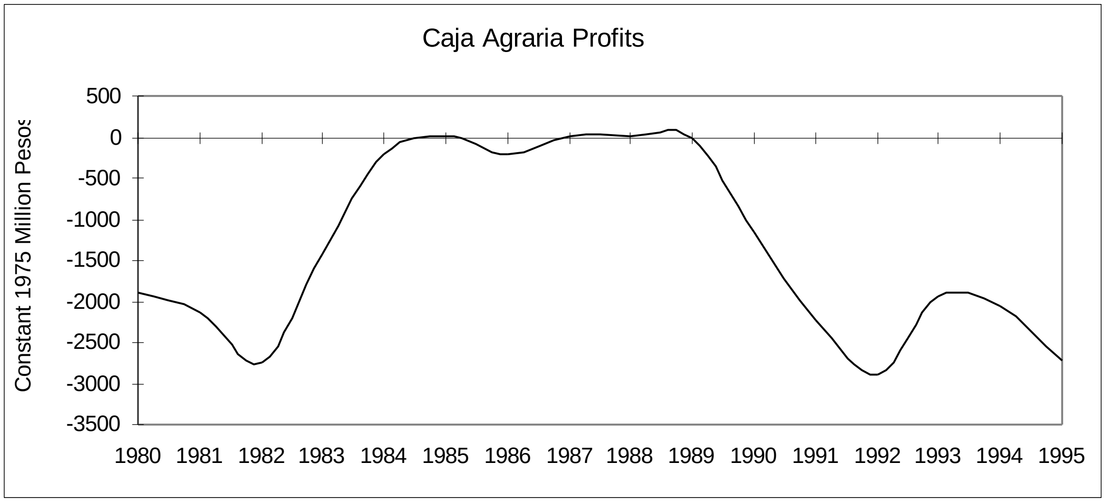


Figure 11



[63] Informe de Labores. Caja Agraria 1982-1986. p. 11.

Figure 12



In conclusion, the lack of formal and real autonomy with respect to the Government has meant that the SB's performance has been compromised when its responsibility, in terms of vigilance of the financial sector, is directly confronted with the Government's general economic and political interests. Since, by definition, formal autonomy addresses *independence from the government*, its absence has not affected the SB's fulfillment of its tasks with respect to the private sector. Although this result is surprising due to the concentration of the sector, this resilience to private pressure groups may be supported by two factors: the agency's clarity of mandate, given that its sole responsibility is the monitoring an control of financial intermediaries; and the apparent limited pressure of interest groups in the financial sector lobbying for special favors. Nevertheless, the incentives for *timely* action on the part of the Superintendent appear to be weak.

In terms of independence from the government, the Superintendency is a non-autonomous institution, and its actions have reflected this status. The law reveals the clear dependence of the SB with respect to the government, as represented by the Minister of Finance. The Ministry supervises the performance of the SB and participates in the decision-making process within the institution. The incentives created by this structure favor a Superintendent who relies heavily on the opinions of the government when taking decisions.

6. Conclusions

Colombia's existing financial regulatory and supervisory framework suffers from a number of flaws. In our interviews many voiced the opinion that aspects of today's institutional structure should be changed. According to Table 7, most considered that the SB should remain within the executive branch, while recognizing the need to grant the institution more autonomy (budgetary and in terms of interventions). As for the optimal institutional structure for financial regulation, opinions were roughly divided amongst three possibilities: keeping responsibility for regulation within the executive branch; granting the Central Bank the faculty to set the rules; or creating an autonomous board for banking regulation.

One of the flaws in Colombia's regulatory structure is that there is little coordination between the agencies that issue regulation for the sector, namely the Central Bank, the Ministry of Finance, the SB, etc. (in spite of the fact that the Superintendent attends the Central Bank's Board meetings). In order to avoid duplication of efforts and to simplify the regulatory structure it is desirable for all regulation to be grouped within a single institution. One possibility is the creation of an autonomous board for banking regulation. The members of the board should include the current actors: the Technical Vice Minister of Finance, the Technical Manager of the Central Bank, as well as a number of full-time experts dedicated solely to the formulation of rules and regulations. The Superintendent of Banks would be invited during the discussion of regulations, although without the right to vote. Such a board would need to be complemented by a strong Superintendency monitoring and controlling the sector.

The SB should remain within the executive branch. Since it is the Government that must inevitably finance the costs of bank interventions, either directly or through its ability to levy taxes, there is a general acceptance regarding the desirability of maintaining the SB within the executive branch. Moreover, separating the SB from the executive would mean embarking on a cumbersome process of institutional reform.

Nevertheless, the SB needs more autonomy from the Government. This can be achieved by changing the way the Superintendent is elected and by granting the SB greater budgetary autonomy. Separating the Superintendent's term from that of the President is one means of enhancing the former's independence. The Superintendent should ideally be named for a fixed period, of a length at least equal to that of the President (4 years). Staggering the Superintendent and President's terms would also highlight this separation. In other words, each President would name a Superintendent only halfway through his period in office. The President's ability to dismiss the Superintendent at will should be abolished as it merely promotes shortsightedness and underlines insecurity of tenure. In the naming of the Superintendent, further independence from the executive would be achieved by distancing the President from the process. An option is for the President to present a short-list of candidates to the Board of the Central Bank, who would make the final decision.

As for greater budgetary autonomy, each superintendent should have the ability to manage the SB's resources directly and not through the Finance Minister, as is the case today. To maintain some oversight of the institution, the SB might be required to present each year's budget to the autonomous board of banking regulation for approval.

With such a structure, the ability of the government to unduly influence the SB's decisions would be reduced. This would solve some important problems of the institution as it stands today: its inability to act independently with respect to the government and the difficulties of improving its technical capacity due to budgetary restrictions. The Government would nevertheless still influence the general direction of the sector through the Technical Vice Minister of Finance and through its participation in the regulatory board.

Table 7 Results of the Interviews (1)

Autonomy	Results	Independence	Results	Where should the SB be?	Where should regulation be?
Do you believe the SB is autonomous from the government?	Yes: 0 No: 11 Other: 1	Do you believe the SB is independent from pressures of interest groups?	Economical Consortia: Yes: 12 Financial Associations: Yes: 12 All of the interviewed recognized that the associations within the sector were primarily service organizations.	A. Within the Executive Branch: a. As it is today 1 b. With more autonomy 6 B. Within the Central Bank: 3 C. No Response 2	A. Within the Executive Branch: 4 B. Within the Central Bank 2 C. Autonomous Board of Regulation 3 D. No response 3
How is the lack of autonomy reflected?	Special Treatment to some institutions Caja Agraria: 7 ISS: 2 Lack of financial autonomy: 2				

(1) The people interviewed were:

Jorge Castellanos	
Jose Elias Melo	Ex- Superintendent
Armando Montenegro	President of ANIF
Andres Langebaek	Vice-President of ANIF
Cesar Gonzalez	President of ASOBANCARIA
Guillermo Gomez Estrada	President of ICAV
William R. Fadul Vergara	President of FASECOLDA
Jorge Humberto Botero	President of ASOFONDOS
Leonardo Villar	Ex-Technical Vice Minister
Ulpiano Ayala	ex- Technical Vice Minister
Hernando LçJosé gomez	Ex-Member of the Board of Directors of the Central Bank
Miguel Urrutia	General Manager of the Central Bank

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