Participation Notes for José Darío Uribe, Governor of the Banco de la República, for the seminar entitled "From the Breakdown of the Bretton Woods System to a New Era of Macro Prudential Oversight?", organized by the Central Reserve Bank of Peru (BCRP) and The Reinventing Bretton Woods Committee (RBWC)

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Session V - A New Era of Cross-Border Flows: A Return of Financial Repression?

- Forty years ago several countries undertook processes of financial liberalization for good reasons. Those reasons are still valid. We need deep financial systems and an ample supply of risk spreading instruments to improve welfare by enhancing growth and smoothing consumption. A natural corollary of those processes was the liberalization of cross border flows.

- Some problems with the last stage of liberalization prior to the global financial crisis were excessive confidence in the markets' ability to deal with financial risk and excessive disregard for the dangerous incentives that could be generated in the presence of asymmetrical information and other market imperfections.

- This leaves us in a situation in which we want to keep the benefits of financial liberalization, but, at the same time, to macro-regulate financial markets in order to minimize the possibility of a financial crisis.

- In this context, it is important to distinguish between macro-financial regulation and financial repression. The latter was understood in a background of fiscal or quasi-fiscal motives to intervene in the financial system, or in a model of state-oriented credit allocation. Clearly, we are not going back to those days. Unlike some developed economies, most Latin American emerging markets have

managed to achieve and sustain relatively low levels of public debt. This means that the old-fashioned way out of the debt overhang based on inflation and financial repression is not part of the foreseeable future for the region.

- In contrast, macro-financial regulation exists to avoid protracted and costly swings in output and expenditure, often related to financial booms and busts. In particular, macro-regulation of cross-border flows may be necessary to reap their long term benefits while limiting possible real and financial complications that arise in the presence of unsustainable bouts of inflows with risky characteristics in terms of the maturity, currency and recipient sector.

- Specifically in Colombia, this takes the form of measures aimed at:
    - ✓ Ensuring a good macroeconomic adjustment to exogenous (often external) shocks.
    - ✓ Preventing or minimizing financial excesses or mismatches that could cause risks of financial instability.

- Regarding the first objective (good macroeconomic adjustment to external shocks), Inflation Targeting with exchange rate flexibility is regarded as an essential piece of the policy framework. Most of the shocks that hit the Colombian economy are real shocks from abroad (external demand, terms of trade, risk premium, real foreign interest rate etc.) or foreign price shocks that are better absorbed by the exchange rate in a flexible regime, than by output and spending in a fixed regime. In addition, the existence of a flexible exchange rate and a credible IT strategy makes a countercyclical monetary policy response to the shocks possible.

- The ability to allow a high degree of exchange rate flexibility is determined to a great extent by the absence of large currency and FX term mismatches. This is,

in turn, more easily achieved with (i) No or low financial dollarization; (ii) Regulation of the mismatches of financial intermediaries; and (iii) Exchange rate flexibility itself, as the volatility of the currency induces private agents to internalize FX risk and limit currency mismatches endogenously.

- With respect to the second objective (prevent financial excesses), the policy strategy starts with a close and careful monitoring of the financial conditions of the economy. In particular, it is vital to be mindful of credit and leverage build-ups that may increase the fragility of the financial system and the economy and, therefore, their susceptibility to shocks and introduce large and costly economic fluctuations. Also, risky financing conditions (high term mismatches, collateral overvaluation etc.) must be detected in a timely fashion. This must be done not only for the local financial system but also for the economy as a whole, which implies a close monitoring of net and gross capital flows in terms of their nature, maturity and recipient/originating sector.

- When a risky situation or one with an excess is perceived, macro-prudential policy instruments must be considered, including reserve requirements on local deposits and capital inflows, countercyclical provisioning and capital requirements, countercyclical LTV limits etc.

- We are aware that the policy measures envisaged for the aforementioned two objectives imply costs because they restrict the benefits of financial liberalization, openness and cross border flows.

- That is why, in Colombia, the policy strategy in this regard is based on a cost/benefit approach. In this approach some measures are permanent because their benefits are perceived to be larger than their costs in most circumstances and states of the economy. This is the case with the permanent restrictions on

currency and FX term mismatches of the financial system and the strong limits on financial dollarization. To a large extent, the benefits of these regulations are certain because they are effective. In turn, their effectiveness has to do with the significant importance of the financial system in the intermediation of domestic and external savings.

- Other measures are temporary because their benefits exceed their costs only in some states of the economy. Thus, when circumstances change, they are deactivated. This is the case of temporary RR on local deposits or URR on foreign indebtedness.