Credible Exchange Rate Flexibility and FX Macroprudential Policy in Colombia

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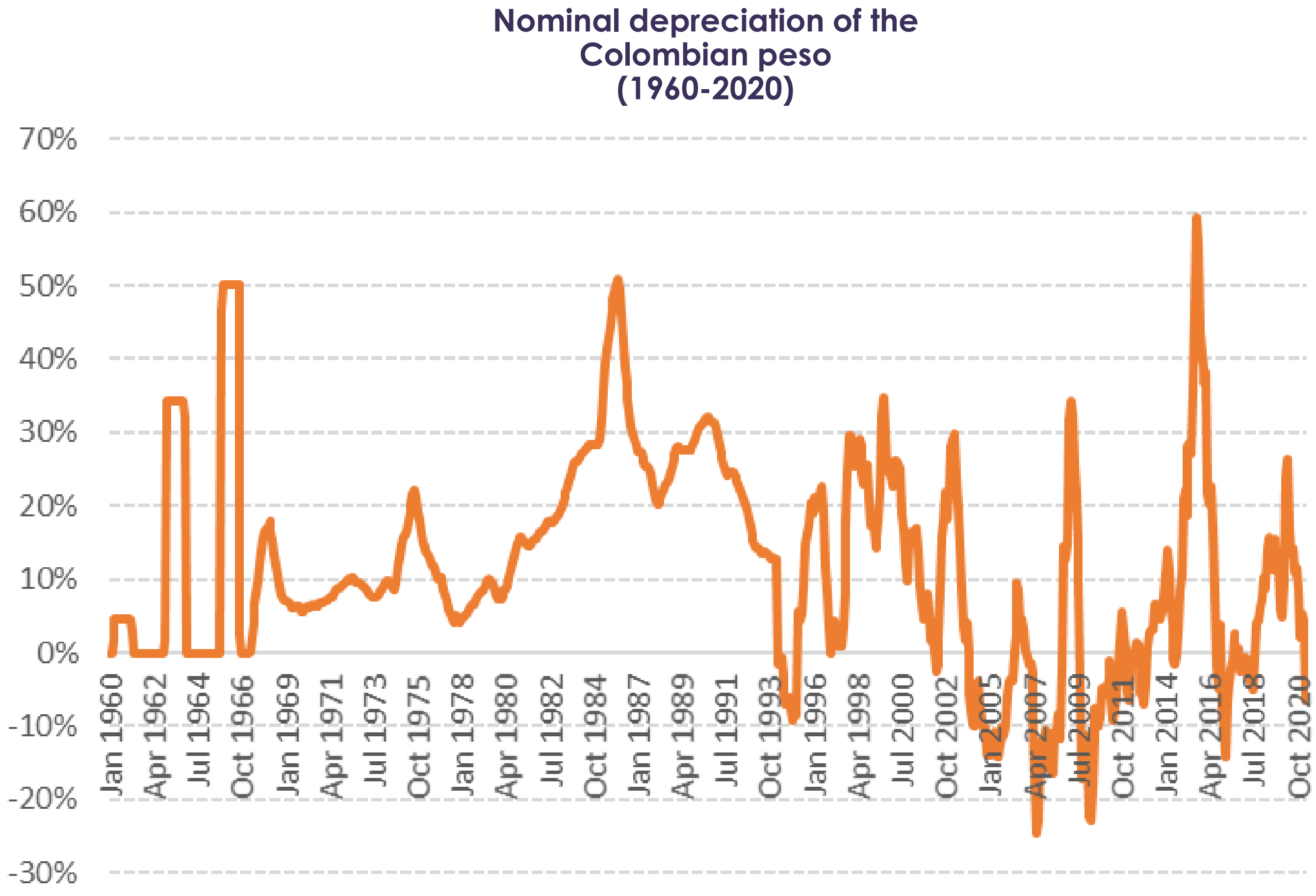
Key Takeaways

- In theory, the nominal exchange rate might play a shock-absorbing role, minimizing the response of output to external shocks.
- This has prerrequisites:
  - Credible exchange rate flexibility
  - Reduced exposure to currency risk
- The Colombian experience at this respect is a success story.
- Challenges: internationalization and international standards.

Exchange rate flexibility as shock absorber



Source: IMF.

The largest nominal depreciation of the last 50 years was in late 2015, with an output response nowhere near that observed in comparable depreciation periods of the past.

How can this work?

For the nominal exchange rate to play an effective role as a shock absorber, some key prerrequisites must be fulfilled:

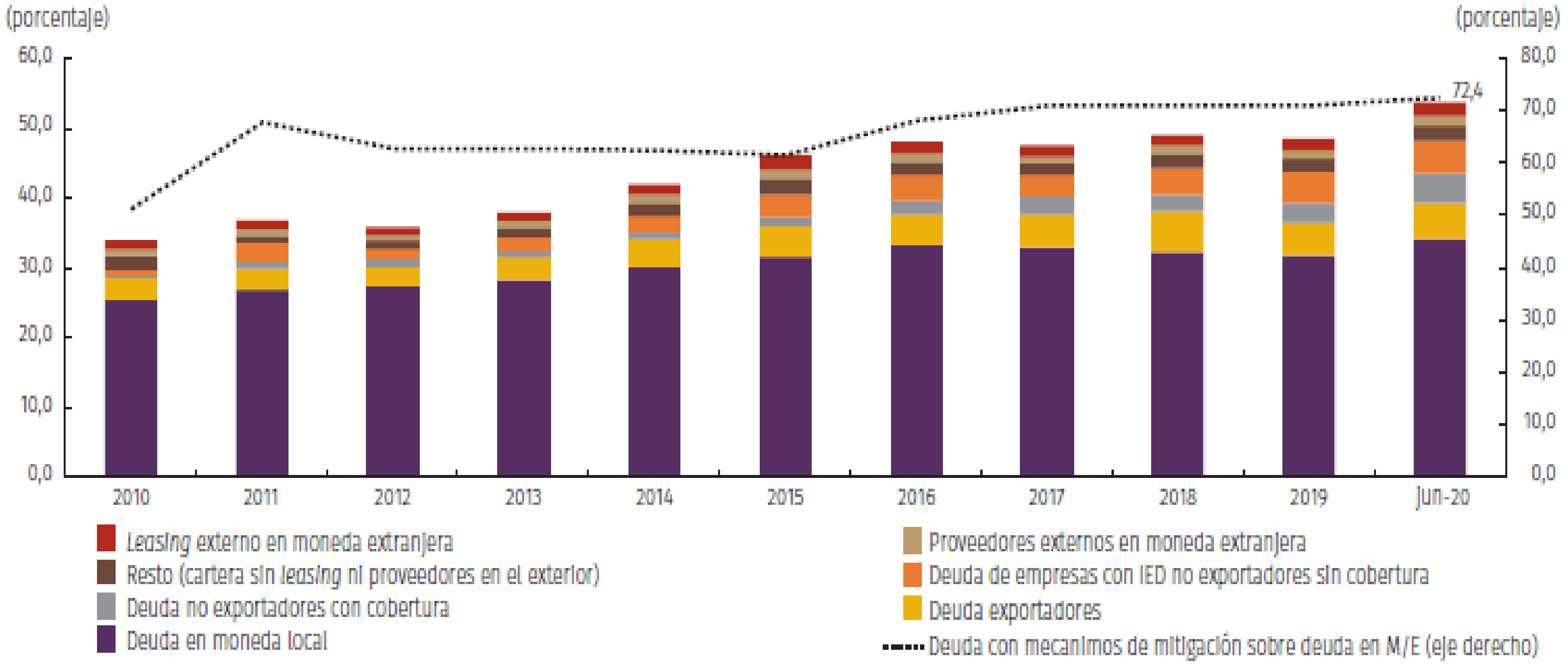
1. Credible flexibility.
   - Adequacy of reserves (Bortz, 2021)
2. Tight control of currency mismatches in the financial and nonfinancial sectors of the economy.
   - FX Macroprudential policy

In Colombia, FX MPP on the financial systemcan be traced back to early 2000s:

- Limits to open net FX position
- LCR taking into account liquidity needs in different currencies.
- Capital requirements for currency risk.

Currency risk in NFC

Nonfinancial Corporate Sector Debt
(% of GDP)
Colombia



Source: Superintendencia Financiera de Colombia, Banco de la República.

The lion's share of NFC debt is either in local currency or in FX hedged (either naturally or financially). This reinforces the credibility of the exchange rate regime.

Challenges

This equilibrium faces challenges:

1. The internationalization of the Colombian financial system
   - A large portion of the financial system in Central America is owned by Colombian conglomerates.
   - A solution: capital requirements on currency risk (currently imposed in some form by Banco de la República)
2. International standards:
   - Basel III did not appropriately tackle currency risk in capital requirements (not very relevant for advanced economies).
   - Emerging economies face a disadvantage in that respect: risk vs competitiveness.