The Use of Reserve Requirements and Other Macroprudential Policies in Colombia

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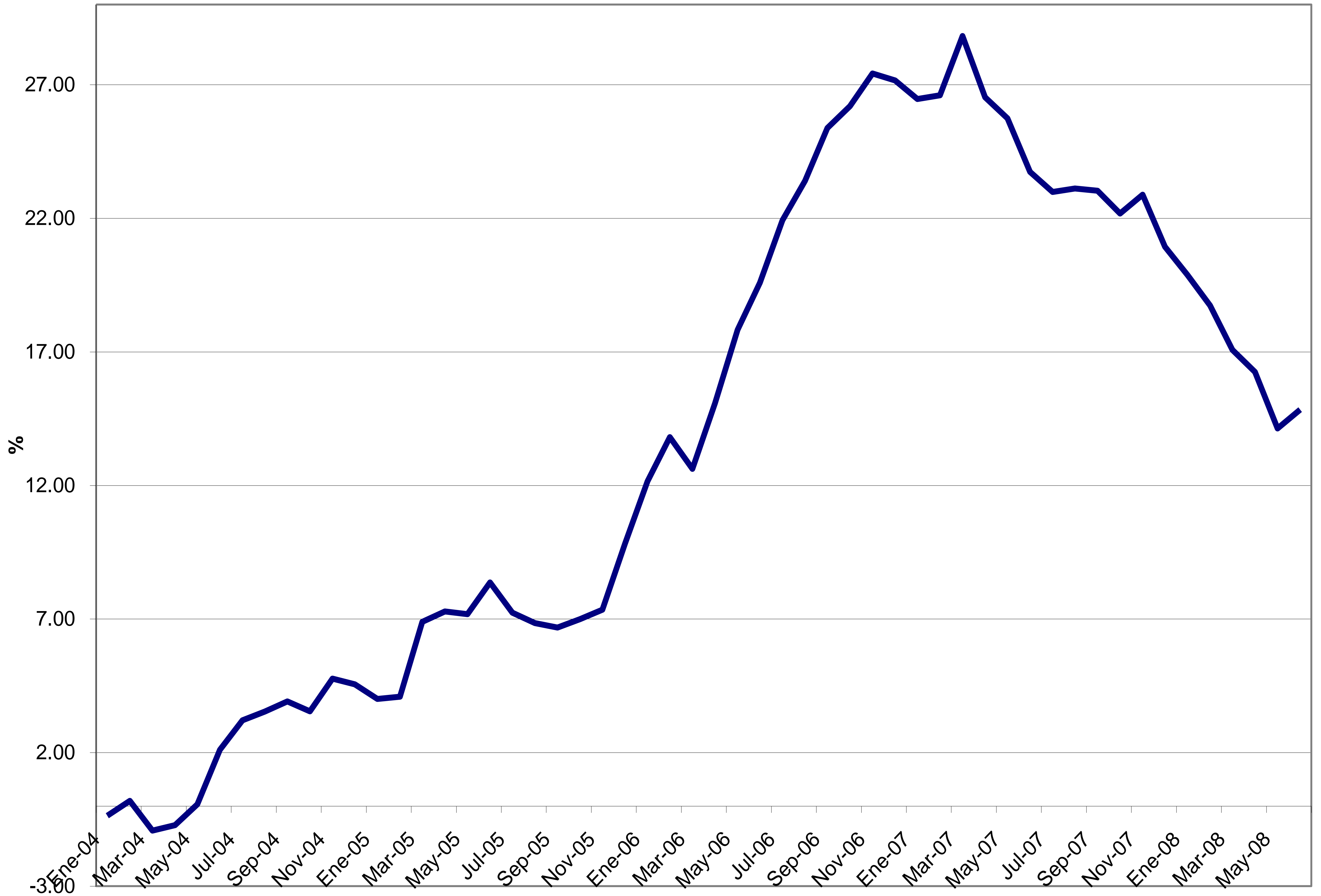
- Reserve requirements (RR) were widely used in Colombia as a monetary policy tool up the 1990s in the context of a repressed financial system with a relatively closed capital account
- During the 1990s, RR were decreased, homogenized and remunerated. Their use as a monetary policy tool was also reduced as the CB relied upon more "market-based" instruments (OMO)
- The idea was to reduce the distortions caused by them in a newly liberalized financial system

- In 1999 a full-fledged Inflation targeting regime was adopted with the short term interest rate as the main policy instrument
- RR were kept low (less than 6% on average) and stable until 2007
- Between 2006 and 2007 the Colombian economy experienced strong aggregate demand growth and inflationary pressures
- This prompted a series of interest rate hikes by the Central Bank

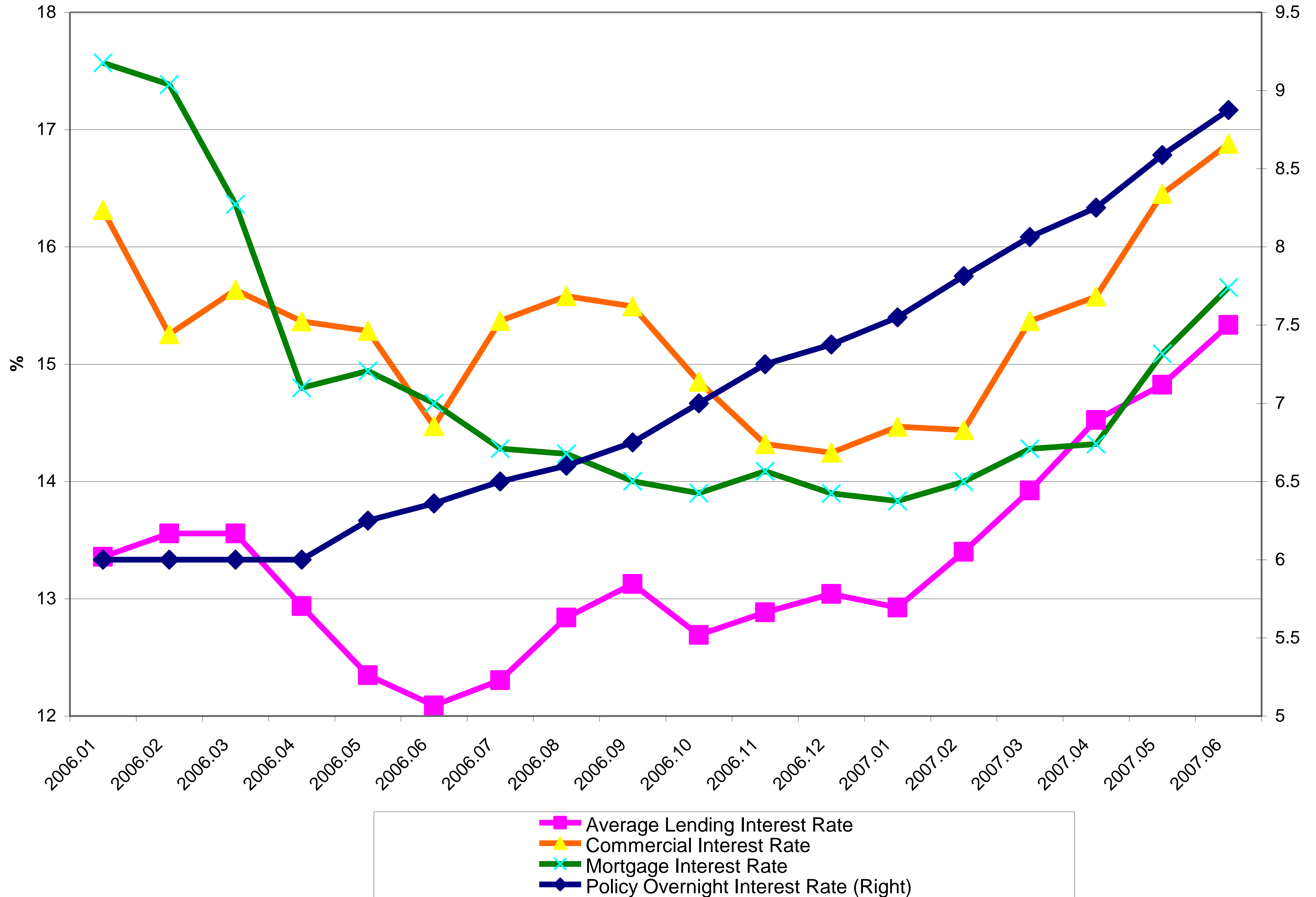
- However, at the same time there was a big credit supply shock
- Banks held a significant portion of their asset portfolios in Government bonds (around 30%) and experienced large market losses after a spike in international risk aversion early in 2006
- Consequently, they rapidly shifted their portfolio toward loans, producing a boost in credit growth and a disturbance of the transmission of the policy rate hikes

- Commercial loan interest rates and average lending rates did not increase for a year
- Consumer loan rates actually declined while policy rates were increased
- Overall leverage jumped, especially household leverage
- Aggregate demand continued growing above potential
- There were signs of low quality lending (especially in the consumer loan segment)

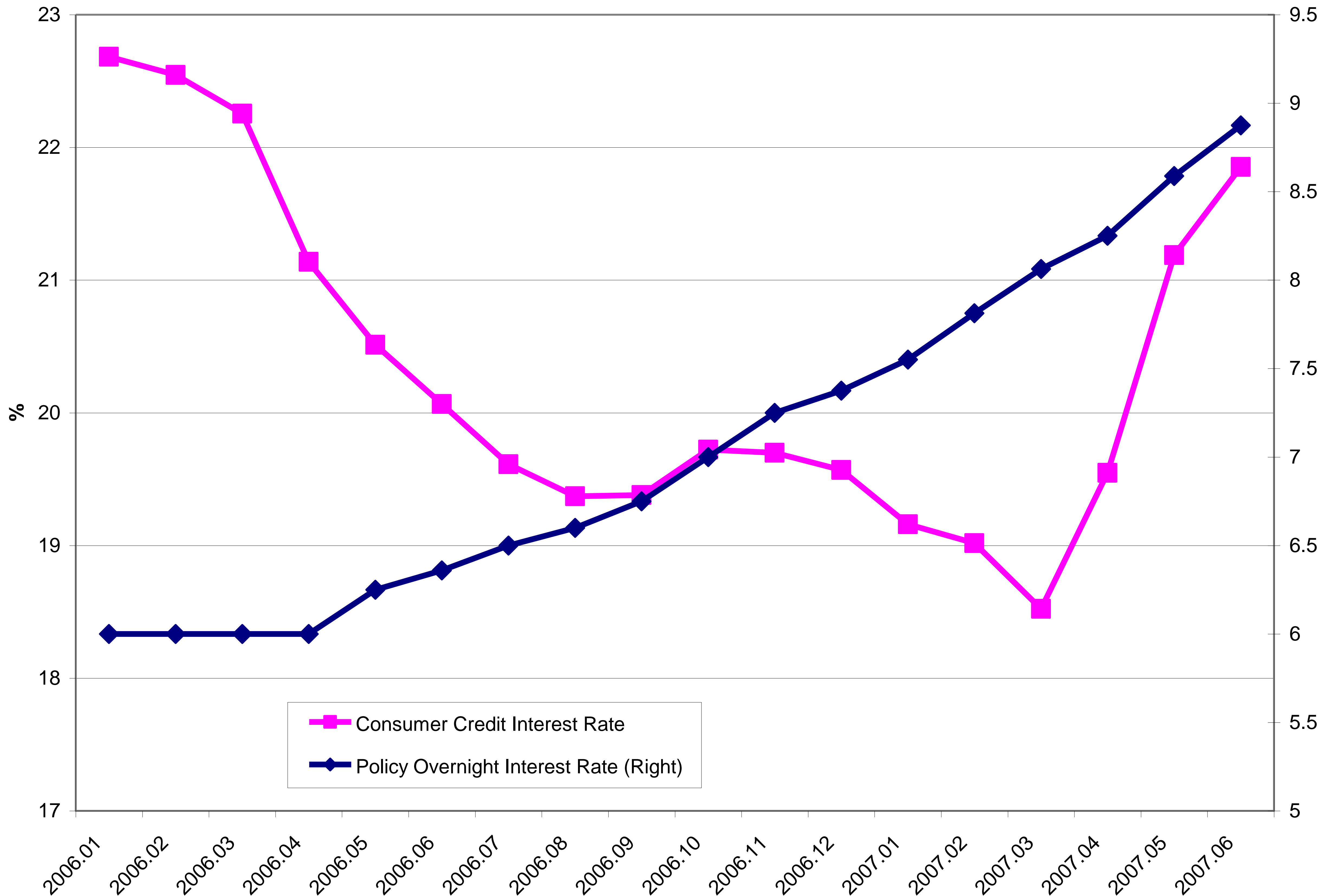
Real Bank Loan Annual Growth



Policy, Average, Commercial and Mortgage Interest Rates



Policy Interest Rate and Consumer Credit Interest Rate



- Substantial risks were building up for both financial and price stability

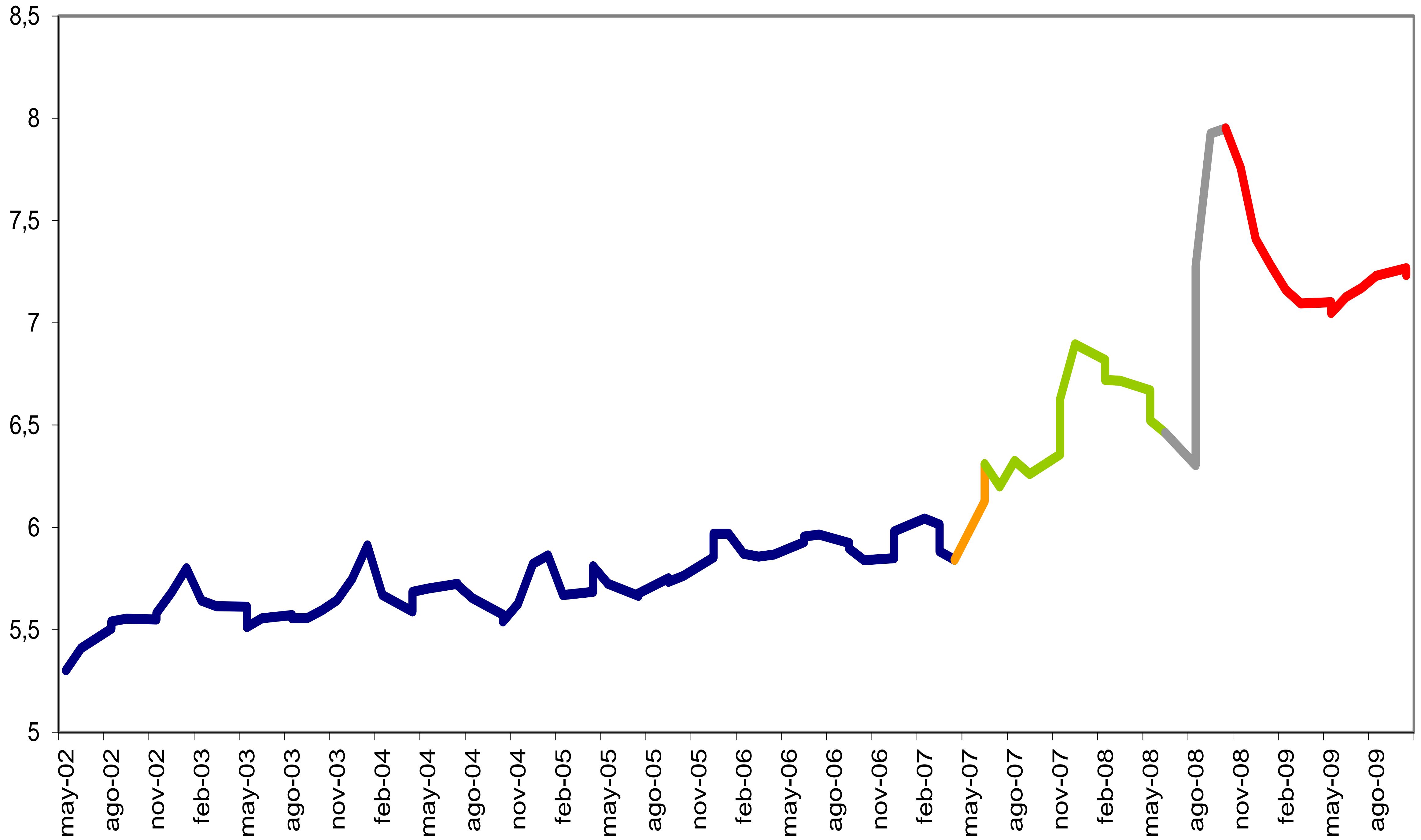
- Finally, in May and June 2007 the CB imposed marginal reserve requirements on a large portion of domestic deposits...

- ... And an unremunerated reserve requirement on foreign indebtedness

- The idea was to contain leverage and improve the transmission of policy rate movements

- These measures were coupled by a rise in provisioning requirements on consumer loans by the Financial Superintendency...
- ... And by the operation of a countercyclical dynamic provisioning system for commercial loans
- As a result, credit growth was curbed and financial vulnerabilities were controlled, avoiding a later painful adjustment of the Colombian economy after the Lehman shock

- A year later, in June 2008, RR were once again increased to help sterilize international reserves purchases due to the isufficiency of other sterilization mechanisms...
- ... But in October 2008 they were reduced to deal with heightened domestic liquidity risk perceptions following the Lehman crisis
- Since then RR have not been used as a monetary policy instrument
- New sterilization tools have been provided to the Central Bank (CB bonds, Sterilization bonds issued by the Government)
- RR are distortionary taxes on financial intermediation and their macroeconomic effects are not well understood...
- ... So they are seen as instruments to be used occasionally in the presence of large shocks or when other measures need to be complemented


Reserve Requirement Coefficient
8,5
8
7,5
7
6,5
6
5,5
5
may-02
ago-02
nov-02
feb-03
may-03
ago-03
nov-03
feb-04
may-04
ago-04
nov-04
feb-05
may-05
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- For example, during 2011credit was again accelerating
- But the concern was focused on consumer credit and household leverage, as opposed to total private sector leverage
- And, unlike 2006-2007, the quality of consumer loan vintages was not deteriorating fast
- So RR were not used
- Instead, policy rate increases (driven additionally by inflation and aggregate demand considerations) and extra provisioning requirements imposed by the Financial Superintendency have been effective to reduce consumer credit growth