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The Colombian Devaluation of 1962:
A Case Study

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A country experiencing a chronic balance of payments deficit and suffering a drain on its international reserves may for a time avoid taking remedial action by obtaining credits abroad. But eventually it will have to confront the problem. A frequently recommended course of action for such a country is to devalue its currency.

History is full of cases in which devaluation has afforded only temporary relief, and the problem has reappeared in much the same form as before. Some have concluded from this that devaluation is not an appropriate remedy and have advocated other solutions, usually involving some form of exchange control. But it is clear that these solutions have often failed to work and that they have done severe damage to the structure of the economy and to the pace of economic activity in the countries that have resorted to them for long periods. Experience shows that the artificial suppression of a disequilibrium by means of controls is tolerable only for brief periods. As such, it does not represent a permanent solution.

The disillusionment felt by some regarding the effectiveness of devaluation as a corrective remedy would seem to be based on an incomplete analysis of the reasons why many of the devaluations, particularly those undertaken in developing countries, have failed to bring about a lasting restoration of equilibrium. A strong case can be made that these failures were due to the inadequacy of the supporting policies followed after devaluation.

A typical example where this clearly appears to be so is provided by Colombia, which devalued its peso by 25.5 per cent[1/] in November 1962. This devaluation was a failure. It restored neither financial stability nor confidence. Brought on by an excess of money creation stemming from an unbalanced development budget, the devaluation was succeeded by a combination of excessive wage increases and continued expansionary policies sufficient to wipe out the expected benefits. Exports expanded little; imports contracted only slightly, and the balance of payments deficit continued. The economic situation deteriorated from November 1962 to September 1965, the date of the next exchange adjustment.

There is much to be learned from this experience, especially when it is contrasted with the relative success of the previous Colombian devaluation, only five years earlier. The 1957 devaluation was accompanied by a sound stabilization program and did indeed bring about a degree of financial stability.

1/ This is the devaluation percentage applying to the principal selling rate. Other rates in Colombia's multiple rate system were devalued somewhat less.

Restrictive monetary and fiscal policies along with restrictions on imports produced a delicate economic equilibrium. Although increases in the cost of living were large immediately following the devaluation, they greatly diminished in 1959 and 1960 when they were 8.2 and 5.7 per cent respectively. A balance of payments surplus was achieved in 1957, 1958 and 1959. In these three years, gold and foreign exchange reserves increased $80 million, and Colombia repaid $230 million of short and medium-term indebtedness. This result was obtained even though average export earnings for the period were 20 per cent lower than the average of the preceding three-year period owing to the fall in coffee prices. Restrictive policies were effective enough to lower imports 34 per cent from the level of the precding three years. For the three-year period through 1960, the public sector as a whole achieved a cumulative surplus, and commercial bank credit expansion averaged only 4-1/2 per cent in each of 1958 and 1959. Gross domestic product increased 2.5 per cent in in 1958 and 7.0 per cent in 1959.

However, this favorable situation was short-lived, and a deterioration set in, most noticeably after the government majority was reduced in the congressional elections held in the spring of 1960.

The deterioration of 1960-62

The 1957 stabilization effort began to be relaxed apparently because the authorities feared that continuation of the austerity policies might begin to undermine the future economic growth of Colombia. In particular, the authorities relaxed credit policies, reduced import restrictions, introduced tax reforms which entailed a reduction in certain public revenues, and embarked on an ambitious development program. In retrospect, it can perhaps be said that the authorities did not understand the tenuous nature of the financial equilibrium achieved by stabilization policies. The result of these changes was a rapid expansion of commercial bank credit to the private sector, the reappearance of a public sector deficit, requiring heavy financing by the Bank of the Republic, and a balance of payments deficit.

Credit restrictions were eased after the second quarter of 1960. Among other measures taken, the authorities liberalized central bank rediscount facilities in August after having tightened them in May, and restored the link between a bank's rediscount quotas and its capital and surplus. This link had been abandoned in February 1958 because it had seriously interfered with the implementation of monetary controls. The relaxation enabled commercial banks to increase their borrowing from the central bank approximately 50 per cent in 1960. This supply of funds in turn enabled commercial banks to expand credit to the private sector around 20 per cent in 1960 compared to an increase of slightly less than 6 per cent in the preceding year.

Beginning late in 1959, import restrictions were increasingly relaxed. The list of prohibited imports was shortened as products were allowed to enter subject to the issuance of a license. At the same time, the requirement of prior licensing was eliminated for a growing list of products to which it had applied. In early 1960, the advance import deposits began to be drastically reduced from the upper rate of 130 per cent. For example, in August 1960, the required deposit on livestock and some plant, machinery and electrical equipment imports was reduced for 130 per cent to 20 per cent. The net effect of this was to allow more capital goods to enter, reflecting the growing emphasis on industrialization. Capital goods imports as a proportion of total imports increased from 27 per cent in 1959 to 30 per cent in 1960.

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The monetary relaxation and trade liberalization measures had a strong effect on the balance of payments. Imports increased more than 20 per cent in 1960. This was accompanied by a 6 per cent decline in exports and only a slight increase in the capital inflow. The net result was a change from a balance of payments surplus of $90 million in 1959, to a deficit of $51.3 million in 1960 and a fall in gross international reserves from $215 million to $178 million.

Beginning in 1961, fiscal measures accelerated the financial deterioration. Several tax reforms resulted in a substantial loss of revenue from certain taxes for the Central Government. Late in 1960, the structure of income taxes was made more progressive but at the expense of yield. In 1961, export taxes on coffee were reduced from 15 per cent ad valorem to 9 per cent, and in 1962 they were completely eliminated. Consequently, Government revenues rose only about 3 per cent in 1961 and actually fell 2.5 per cent in 1962.(See Table 1)

At the same time, the Government was embarking on an ambitious industrial development program which necessitated an increase in public investment expenditures. This program aimed at increasing gross domestic product 5.6 per cent per year over the first five years. It required a large increase in domestic savings and investment. The latter was supposed to rise from 18 to 24 per cent of gross domestic product. In accordance with this plan, government investment spending more than doubled in 1961, accounting for 47 per cent of total expenditures. Although government investment spending declined in 1962, it was still about 70 per cent higher than in 1960.

Increases in operating expenditures accompanied the increase in investment spending. Personnel costs rose 22 per cent in 1961 and 21 per cent in 1962. Transfers to the rest of the public sector rose 43 per cent in 1961.

The sizable increases in expenditures at a time when revenues were stagnating resulted in a sizable government deficit in 1961 and 1962. To cover the deficit, the Government resorted to a large increase in net internal borrowing, mainly from the Central Bank. Net central bank credit to the Government expanded about 17.5 per cent in 1961 and almost 65 per cent in 1962 (See Table 2).

The large injection of liquidity into the banking system through Central Bank financing of the Government enabled the commercial banks to step up the rate of credit expansion to the private sector to nearly 25 per cent in 1961. In 1962, this rate was lower as the liquidity generated by Government borrowings at the Central Bank gave rise to larger payments and transfers abroad. Overall, total bank credit expansion was over 23 per cent in 1961 and 1962, approximately double the rate of increase of money national income.

During the 1961-62 period, the balance of payments deteriorated further. (See Table 3). In 1961, imports rose further while exports fell. Attempts to reverse the trend of rising imports did not begin until after the first half of 1962, when imports were 6 per cent higher and exports only 3 per cent higher than in the same period of 1961. By September 1962 all imports were again subject to prior licensing. During the period of increased imports, the ratio of consumer imports to total imports increased, a reversal of the earlier trend. Part of the large rise in imports in late 1961 and early 1962 undoubtedly reflected orders to hedge against an expected devaluation. At the same time, private short-term foreign credits for imports fell, and capital flight developed, mainly in 1962, partly because the deteriorating situation undermined confidence and partly because of uncertainties associated with the 1962 presidential election. Increased government borrowings covered some of the deterioration, but the overall balance of payments deficit rose from $51 million in 1960 to $67 million in 1961 and $79 million in 1962. At the end of September 1962, gross official reserves had shrunk to $122 million from $149 million at the end of December 1961, an 18 per cent decline.

During the 1960-62 period of financial deterioration, the free market exchange rate depreciated. It moved from Col.$6.85 per U.S. dollar in April of 1960 to Col.$8.30 per U.S. dollar in May of 1961. (See Chart A). In the first six months of 1962, it averaged Col.$8.77 and by the end of October it had reached Col.$9.12 per U.S. dollar. At that time, the spread between the free and official selling rate of exchange was 36 per cent, a drastic deterioration from the 1 per cent spread prevailing prior to the expansionary measures. The depreciation in the free market had occurred even though the central bank intervened and sold foreign exchange there on numerous occasions.

The 1962 devaluation

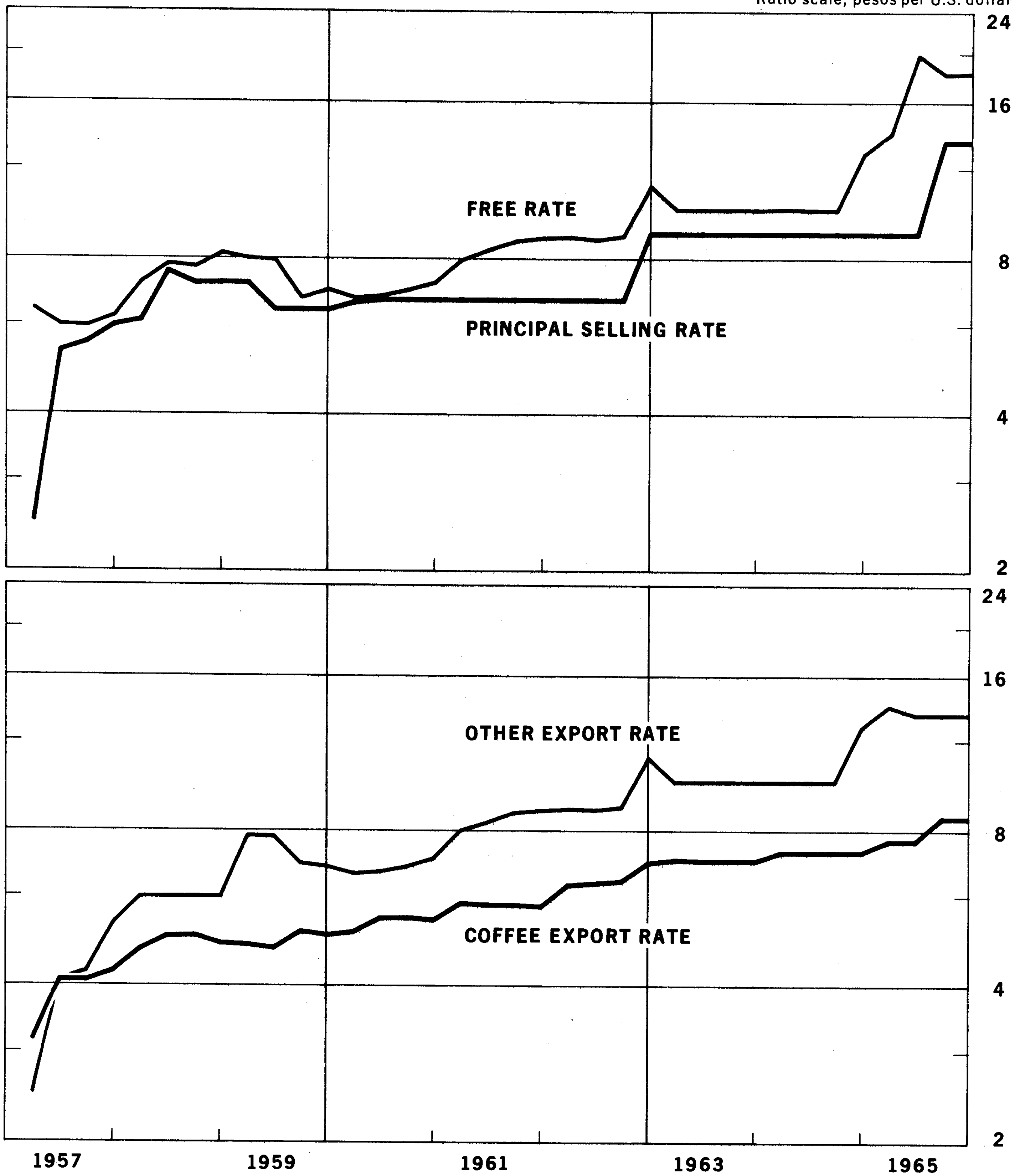
A newly elected President took office in August 1962 and, within three months, the process of devaluation began. On November 20, the official selling rate, referred to as the auction rate, was adjusted

Chart A

COLOMBIAN EXCHANGE RATES

End of quarter

Ratio scale, pesos per U.S. dollar



Sources: International Monetary Fund, International Financial Statistics, Supplement to 1966/67 Issues, Supplement to 1967/68 Issues, September, 1967 Issue, Washington, D.C.

from Col.$6.70 per U.S. dollar to Col.$9.00. This rate applied to import payments, 80 per cent of freight costs, government payments, and student remittances. On December 21, the buying rate applicable to "major" exports (coffee, bananas, raw cowhides, precious metals,[1/] and manufactured products with an imported component of more than 50 per cent) and to capital brought in by metal extracting companies and by foreign petroleum companies was raised from Col.$6.50 to Col.$7.10 per dollar. The free market was retained for invisibles and for capital transactions not eligible for one of the official rates. Proceeds from minor exports were made subject to an exchange rate equal to the average rate in the free market during the preceding week. The free market rate, which had stood at Col.$9.12 per U.S. dollar at the end of October 1962 began to fall steadily, reaching a level of Col.$11.70 per U.S. dollar on January 11, 1963. Beginning January 16, 1963, the Central Bank intervened to hold this rate between Col.$9.98 and Col.$9.99 per U.S. dollar.

The differential between the fixed buying rate of Col.$7.10 per U.S. dollar and the selling rate of Col.$9.00 was a form of substitute taxation. Of this Col.$1.90 differential, Col.$1.40 was to go to the National Government, almost all earmarked for investment spending; Col.$0.10 was to go to local governments and government entities; and Col.$0.40 was to go to the National Coffee Federation.

1/ On December 26, exports of bananas, raw cowhides, and platinum were shifted from the list of major exports to that of minor exports and became eligible for an even more depreciated rate.

The aftermath of devaluation

The immediate effect of the devaluation on domestic prices was less than might have been expected. The cost of living index of laborers rose only 1.5 per cent from October to December 1962. This probably reflected two factors: agricultural imports accounted for only two per cent of total domestic agricultural consumption, and the Government issued a decree penalizing hoarding, speculating and unjustified price rises for a wide range of commodities.

However, the wage law of February 1963 provided for liberal adjustments in salaries, wages and fringe benefits. Minimum wages were raised, minimum agricultural wages were set, and an escalator clause was inserted which provided for semi-annual wage adjustments whenever the consumer price index increased 5 per cent or more in a six-month period. In addition, social security benefits were increased and transportation allowances paid to some workers were increased to accommodate the transportation fare increases. It is estimated that the increased wages and fringe benefits in the private sector raised labor cost of production 20-25 per cent and increased the public sector wage bill around 30 per cent.

At the same time regulated prices were increased. Urban bus fares went up 50-75 per cent; taxi fares, 25 per cent; inter-urban public transportation, 33 per cent; gasoline prices, 20 per cent, and in early March 1963, milk, sugar, cigarette and cement prices were raised 15 to 30 per cent. The support prices for rice, corn and wheat increased by 15 per cent and that of beans by 90 per cent. In mid-February the National Coffee Federation raised its coffee buying price 13 per cent.

All told, the cost of living index of laborers rose 26 per cent during the first six months of 1963 and another 8 per cent during the last six months of the year.

The wage and price increases had several deleterious effects on the economy which seriously damaged confidence. They partially nullified the balance-of-payments relief expected from devaluation, by raising costs of production of Colombian products and by generating increased demand for imports. The wage and price increases are estimated to have absorbed one-half of the beneficial effect of the devaluation on the Government budget, preventing its elimination. In addition, the banking system came under strong pressure to expand credit.

Price increases of 20 to 25 per cent in manufacturing costs counteracted much of the beneficial effect which the devaluation should have had on the export of manufactures, a sector which contributed 17 per cent to gross domestic product. Miscellaneous exports, which included some industrial products, did increase 14 per cent in 1963. But this was far less than eventually became possible after a further exchange adjustment increased the remuneration from such exports. As Table 3 shows, total exports increased only 2 per cent in 1963. This reflected a small increase in coffee exports and reduction of cotton and sugar exports. The failure of coffee exports to rise more was not the fault of the exchange rate, but rising domestic consumption did contribute to the fall in sugar and cotton exports.

The increased import restrictions, introduced after mid-1962, succeeded in reducing imports 5 per cent in the last half of 1962. The higher cost of imports resulting from the November 1962 devaluation helped to produce another 7 per cent decline in 1963. As a result, the trade deficit was reduced from $61 million in 1962 to $12 million in 1963. There was also a large increase in the inflow of long-term private capital. The combined effect of these factors was to produce a recorded balance of payments surplus of $38 million in 1963, but this was more than offset by large unrecorded net payments, in contrast to unrecorded net receipts in 1962. International reserves remained under pressure.

The situation deteriorated again in 1964 when imports rose nearly 16 per cent. Exports rose over 30 per cent as coffee prices firmed, and there was a larger recorded inflow of capital. But confidence was affected by uncertainties about whether the authorities would deal effectively with the fiscal and monetary problems, and as a result, the unrecorded net payments rose substantially further. The pressure on international reserves continued.

On the fiscal side, (see Table 1), the wage and salary increases of early 1963 raised public expenditures. This reopened the fiscal gap that was supposed to have been filled by the proceeds from the exchange differential between the buying and selling rate allocated to the National Government. Corrective measures were not taken until

August 1963, 10 months following the devaluation. Eventually, the Government imposed a 20 per cent income tax surcharge to be collected on 1963 and 1964 income taxes, increased stamp and inheritance taxes, instituted a small gasoline tax, and eliminated the right to offset livestock losses against gains in other areas of activity.

Total public revenues rose 51 per cent in 1963. Operating expenditures rose slightly less than 37 per cent and investment expenditures remained almost constant (declined in real terms). The deficit was thus reduced, and the Government's net borrowings from the Central Bank increased only 3 per cent. But the deficit remained large. In 1964, revenues rose another 28 per cent, and the rise of expenditures was held to 11 per cent. Although the deficit was smaller than in 1963, the Government was forced to rely more heavily on central bank credit as new borrowings abroad fell below the amortization of external public debts.

On the banking side, the rise in internal costs exerted strong pressures for credit expansion to the private sector. Measures initiated to control the expansion were largely ineffective. First, between November 1962 and March 1963, the legal reserve requirements for most peso and short-term deposit obligations were gradually increased from 21 to 27 per cent. Second, a 100 per cent marginal legal reserve requirement against peso sight and time deposits over the early December 1962 levels was instituted. Finally, rediscount quotas were frozen at the end of 1962 level and were reduced a further 30 per cent in January 1963. Emergency rediscounts, however, were made available for sudden deposit withdrawals, and on these, the rate was lowered.

These actions did not succeed in forcing the commercial banks to operate within their own resources, and central bank accommodations to the commercial banks actually increased 18 per cent in the first four months of 1963. The legal reserve requirements were used as a means of selective as well as quantitative control by allowing banks to invest up to five percentage points of their required reserves in specified securities and agricultural loans. This had the effect of considerably relaxing credit tightness. Second, the 100 per cent marginal reserve requirement was calculated from a base date on which deposits were artificially swollen. Since there were subsequently massive deposit withdrawals as a result of exchange speculation, the marginal reserve requirement was inoperative for a long time. Finally, the reduction of ordinary rediscount quotas only took up the banks' unused margin and did not force a contraction in borrowing from the Central Bank.

The commercial banks began to use emergency rediscount privileges to expand earning assets, but this entailed no penalty as the rate which applied to this reduced "extraordinary" quota was the same as that on the ordinary quota. In addition, delays in reporting enabled banks to use the extraordinary quota funds illegally to expand earning assets. Overall, the only effective monetary control mechanism was the average increase of prior import deposit requirements, reflecting mostly the rise in the conversion rate.

By May of 1963, it was apparent that the previous reforms were deficient and further measures were taken. Ordinary rediscount quotas were reduced, and the rediscount rates were raised significantly. But these moves were not effective because the authorities established special credit facilities for certain types of loans, for example, for the warehousing of agricultural commodities, and an unused margin of rediscount facilities continued to exist. Although changes in the several required reserve ratios resulted in a net reduction of 6 percentage points in 1963, reserve deficiencies continued. Finally, in spite of earlier reforms, the commercial banks still treated the rediscount privilege as an automatic entitlement within the quotas related to each bank's capital and surplus. This flaw was not corrected until April 1964.

The efforts made to control credit expansion in 1963 were either not initially effective or were evaded. As a result, as Table 2 shows, central bank credit to the commercial banks increased nearly 90 per cent during 1963. The commercial banks in turn expanded gross credit to the private sector over 20 per cent during the same period.

By November 1963, it was evident that serious reforms had to be implemented if the authorities were to control the credit expansion. As a first step, monetary management was transferred to a newly created Monetary Board. The authorities tightened the regulations concerning emergency rediscounting and increased the rate. They imposed the penalty of denying access to central bank credit to any bank missusing this facility. Finally, they established an overall limit on credit extended by the Caja Agraria for warehouse commodities and placed significant penalties upon reserve deficiencies.

In spite of these measures, the deterioration in the financial position continued and another devaluation became necessary in September of 1965. From November 1962 to mid-1965, the workers' cost of living rose 55 per cent. For two and one half years beginning in 1963, total domestic credit expanded Col.$4,772 million or 57 per cent, the foreign position of the Bank of the Republic deteriorated $12 million, and that of the commercial banks fell $9 million. Average money wages and salaries rose 37 per cent while real wages fell 1.5 per cent and real salaries fell 1.0 per cent.

Conclusion

Colombia's exchange adjustment in November 1962 did not bring all the benefits that proponents of devaluation claim for this policy tool. The balance of payments deficit was reduced, but tightened import controls were partly responsible. Prices, wages and costs were far from stabilized. However, this was not the fault of the devaluation per se but rather the fault of the failure to make sure that sufficient complementary policy measures accompanied this devaluation. The attempts to reduce the level of government spending and increase revenues were not enough to counteract the effects of excessive wage and regulated price increases and s system of monetary controls which was unable to restrain credit expansion.

The lesson from this experience is that devaluation is not in any way a substitute for correcting monetary, fiscal and income policies that produce economic overheating. The pain of devaluation will be incurred in vain if the authorities do not restrain the excessive expansionary forces that created the need for the exchange rate adjustment in the first place.

Table 1

Central Government Finance
1959-1964
(in millions of pesos)

	1959	1960	1961	1962	1963	1964
Revenues						
Direct taxes	947	1,112	1,140	1,201	1,683	2,332
Indirect taxes	664	817	847	736	839	1,033
Exchange Differential	-	-	-	-	469	626
Other	305	203	212	206	245	172
Total	1,916	2,132	2,199	2,143	3,236	4,163
Expenditures						
Current Exp.						
Personnel	555	643	785	949	1,282	1,419
Supplies, Equipment and travel	180	222	281	259	248	265
Transfers	257	430	616	661	1,009	941
Interest on Public Debt	61	67	69	120	174	264
Sub Total	1,053	1,362	1,751	1,989	2,713	2,889
Investment Exp.	671	730	1,532	1,243	1,237	1,488
Total	1,724	2,092	3,283	3,232	3,950	4,377
Deficit(-) or Surplus	192	40	-1,084	-1,089	- 714	- 214

Source: Controlaría General de la República, Informe Financiero.

Table 2

Bank Credit Outstanding
at end of 1959-1964
(in millions of pesos)

	1959	1960	1961	1962	1963	1964
Bank of the Republic Credit (net)	2,060	2,205	2,578	2,835	3,769	4,141
to Government	1,118	1,094	1,330	2,562	2,412	2,337
less Gov. Deposits	142	116	180	667	451	243
to Government (net)	976	978	1,150	1,895	1,961	2,094
to Development Banks	352	348	492	626	772	940
to Commercial Banks	382	561	488	543	1,024	1,092
sub-total	734	909	980	1,169	1,796	2,032
Less Bankers' Deposits	314	326	326	842	513	805
to Banks (net)	420	583	664	327	1,283	1,227
to Business and Indiv.	664	664	764	613	525	820
Commercial Bank Credit	2,810	3,396	4,239	5,086	6,202	7,208
to Business and Indiv.	2,483	3,073	3,796	4,494	5,465	6,038
to Development Banks	327	323	443	592	737	1,170
Development Bank Credit to Business and Indiv.	2,110	2,421	2,824	3,181	3,824	4,294

Source: IMF, International Financial Statistics, Supplement to 1966-67 Issues.

Table 3

Balance of Payments
1959-64
(in millions of dollars)

	1959	1960	1961	1962	1963	1964
Merchandise (f.o.b.)						
Exports	527.9	495.3	476.5	475.8	485.4	636.0
Imports	-402.5	-496.4	-530.8	-536.9	-497.5	-575.4
Trade Balance	125.4	- 1.1	- 54.3	- 61.1	- 12.1	60.6
Net Services and Private Transfers	- 64.6	- 83.4	- 87.5	-109.3	-125.0	-192.0
Current Acct. Balance	60.8	- 84.5	-141.8	-170.4	-137.1	-131.4
Net Private Capital						
Short term	4.4	- 11.7	31.0	- 4.1	- 13.0	69.4
Long term	28.7	44.2	- 9.2	50.0	127.5	153.5
Net Government Capital	- 3.5	0.7	53.2	45.8	60.3	49.0
Net Capital Account	29.6	33.2	75.0	91.7	174.8	271.9
Overall Balance	90.4	- 51.3	- 66.8	- 78.7	37.7	140.5
Net Errors & Omissions	- 4.2	44.0	- 9.3	33.1	- 74.2	-156.5
Monetary Movements	- 86.2	7.3	76.1	42.6	36.5	16.0

Source: IMF, Balance of Payments Yearbook, Vol. 18.