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Colombia Introduces Capital Controls as Peso Climbs in Value

by LADB Staff
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The government of Colombian President Alvaro Uribe has introduced measures to control capital flight and slow the rapid appreciation of the peso relative to the US dollar. As Colombia's peso reached highs that it had not seen in years, exporters and manufacturers sought relief from the government. On May 24, Uribe's economy team set requirements on investors to deposit 40% of their purchases with the Banco de la Republica, the country's central bank, for six months.

The move did not reverse the peso's upward climb, although it seemed to briefly slow its growth somewhat. Economic growth estimates for 2007 are now around 6%. Investors required to deposit in Banco Central Finance Minister Oscar Ivan Zuluaga said the 40% deposits with the central bank would not earn interest and investors could avoid the forced deposit by paying a 9.4% fee. The controls were imposed by presidential decree.

"The Colombian government is committed to stemming the entrance of short-term capital because Colombia, along with Brazil, has the most appreciated currency in Latin America," Zuluaga said. He said the steps "won't affect at all flows of foreign direct investment (FDI)."

The announcement came one day after Uribe called for further measures to "control capital that comes into the country to make a short-term profit," seeking to curb a rally that is eroding exporters' profitability.

The central bank on May 6 imposed lending limits to curb inflation and prevent the peso from strengthening further. It ordered companies and investors taking loans abroad to deposit 40% of the amount with the bank for six months in a bid to reduce "the incentive to bring in short-term capital as interest rates rise."

"The measure should be a short-term palliative that will slow down the speed of appreciation of the currency, but not powerful enough to reverse the appreciation trend," Goldman Sachs analyst Alberto Ramos said in a research note the day the controls were set in place. On May 18, policymakers had raised the overnight lending rate to 8.75%, the highest since November 2001, in another effort to blunt inflation.

The bank has raised the rate 11 times since April 2006 from a three-year low of 6% as it sought to bring inflation within the target range. By June 15, policymakers had raised the rate to 9%. Speculative capital, known in Spanish as "golondrina" (swallow) capital because it comes and goes like the bird, can wreak havoc on small economic powers like those of Latin America when investors become collectively spooked by some aspect of a nation's economy and all withdraw investment at once.
Yet regulating investment inflows, according to conventional wisdom, discourages international companies from investing at all. Analysts, including Rupert Stebbings, a trader at Asesores en Valores brokerage in Medellin, say that longer-term investment accounts for most of the peso's gain and that capital controls imposed by the government create a disincentive for investors.

"If Uribe wants a place at the table of investor credibility he is going a strange way around it by making it more difficult for them to invest," Stebbings said. The Uribe government is counting on developing long-term foreign investment in Colombia by convincing the US Congress to ratify the free-trade agreement (FTA) the two governments have negotiated (see NotiSur, 2006-03-10).

Uribe is meeting some opposition in the US Congress, however, with prominent Democratic Party members highly critical of the deal's implications for workers and concerned because of allegations against Uribe for ties to paramilitary death squads (see NotiSur, 2007-05-04). Peso drops below 1,900 to the dollar On June 12, the peso fell 0.6% to 1,931.6 per US dollar. The currency had dropped from 1,873.05 on June 5, the strongest since January 2000. The peso has risen almost 16% this year, the most among 72 currencies tracked by Bloomberg. In the past year it has risen about 31%.

Manufacturers and exporters of goods like bananas, coffee, and flowers have a harder time selling their goods the stronger the Colombian currency gets. As the peso has risen, these business sectors have pressured the government for help. Walter T. Molano, writing for the Latin Business Chronicle, accused Uribe of favoring a narrow group of business interests from his political-geographic base at the expense of the broader Colombian economy.

"The benefits created by these light industries are limited," argued Molano. "They employ a relatively small percentage of the population and most of the economic benefits are realized by a few urban centers. Therefore, the country does not generate sufficient export earnings to cover the costs of its imports, and it constantly reports a trade deficit. Colombia, for example, posted a trade deficit of US$272 million in March; meanwhile, most of its peers were reporting huge trade surpluses."

Molano claims that Colombia would do better to profit from the global boom in commodities, whereas it would be unable to compete with Asian countries in light manufacturing. Uribe said the government had no plans to impose further restraints on short-term capital inflows and would not impose any controls on FDI as it sought to stem the peso's rally. "I am convinced, I am certain, that we cannot put capital controls on foreign direct investment," Uribe said in a June 5 interview.

"So far, we haven't thought of any new ideas, and my concern now, my focus, is on how to protect jobs." Annual inflation in Colombia quickened to 6.2% in May as the economy grew at its fastest in almost 30 years. The rate is above the central bank's 3.5% to 4.5% target range. "We have taken important steps to stop inflation, now we are at the right time to stop inflation without undermining the trend of economic growth," Uribe said. "We hope that the measures will be temporary and that we can soon re-establish the opening of our markets," Zuluaga said in mid-June.
**Growth estimated at 6.5% in first quarter of 2007**

The central bank said May 22 that Colombia had received US$5.5 billion in net capital inflows so far this year, up from just US$360 million in the same period a year ago. A little more than half came from FDI, which economists say is the main force behind the peso's sharp rise. Zuluaga expects the economy to grow "well above" 6.5% in the first quarter, driven by a surge in consumer spending and industrial investment. "We are going to see very ample growth in the first quarter," he said June 20. "It's going to be a very positive surprise."

Uribe's clampdown on drug violence has reportedly bolstered investor confidence and prompted Colombians to buy more durable goods, such as cars and refrigerators. The economy last year grew at its fastest rate in almost three decades and growth is expected at 7.05% in the first quarter, according to the median estimate of 12 economists surveyed by Bloomberg. "It's strong and sustainable growth," said Zuluaga, who took office March 8 after acting as Uribe's economic adviser.

"Growth is opening the doors to new investment." Colombia's economy may grow at least 6% in 2007, led by consumer spending, which helped push up industrial sales about 15% and construction 20% in the first quarter, Zuluaga said. "That speaks very well of our economy because it's sustainable," he said. Increased spending in Latin America's fifth-biggest economy has pushed annual inflation to its fastest since 2004, leading the central bank to raise the overnight lending rate 3 percentage points since April 2006.

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