

Notes on Colombia.
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After two days of learning in Colombia (and a lot of help from Alvaro Riascos), and so positive but still extremely limited knowledge, here are some reactions and suggestions. Most are likely to be naïve and off the mark, but some may be marginally useful.

Monetary policy.

1. I suspect that much of the current unemployment rate is cyclical, not structural. That it is the legacy of the deep recession of the late 1990s. It just takes a lot of growth to undo a period of low or negative growth. (The only obvious potential culprit I can see for a large increase in structural unemployment is the increase in payroll taxes, by about 10% of wages from the early to the late 1990s. While this increase is relevant, I am skeptical that this can explain a large increase in the structural rate of unemployment. It surely does not explain the timing of the large and sudden increase in unemployment in the late 1990s.)

Thus, I believe that, if for any reason, demand grew faster, Colombia could achieve in the short run growth rates of 6-8% (to pick a number) without significant tensions. (These growth rates are not infrequent elsewhere when an economy rebounds for a deep recession). This suggests that there may be room for more expansionary policy and a lower nominal interest rate.

The way to assess whether an economy is close to the natural/structural rate, is typically to look at inflation—whether it is increasing or decreasing. I was struck however by the weakness of the estimated relation between measures of activity (especially unemployment) and inflation dynamics. How much hard evidence do you have that, if monetary policy was more expansionary, and growth was higher, there would be pressure on inflation?

2. I am worried about the recent shift in foreign exchange intervention policy. If my understanding is correct, the bank has shifted from relying on the auction of options approach to relying on direct intervention in the spot market. This is fine, except that the conceptual rules governing this direct intervention appear unclear (and surely appeared unclear to the staff of the bank). The talk is still of pure inflation targeting, but the reality seems more mixed, with the use of both (sterilized?) foreign exchange intervention and nominal interest rate setting.

Here is how I think about these issues:

If we think of the nominal interest rate set by the central bank as responding to both some measure of activity and some measure of inflation, this implies that the central bank will

respond to movements in the real exchange rate, even if it does not care about the exchange rate directly. An appreciation induced by a capital inflow leads both to lower activity and lower inflation, and so leads to a decline in the interest rate.

There may well be a case for caring directly about the exchange rate, and so to have the interest rate respond to the real exchange rate (as always, the interest rate rule can be explicit or implicit; this is not the issue here) *in addition to* the two measures of activity and inflation. The rationale may be that one cares not only about aggregates, but also about the composition of activity, between tradables and non tradables, between exportables and importables. In this case, a real appreciation may lead to a stronger reaction of the nominal interest rate than in the previous case.

If there is perfect capital mobility, then focusing on the nominal interest rate alone is appropriate. If there is imperfect capital mobility, then the optimal policy mix is to use both the nominal interest rate and foreign exchange intervention. This leads one to think of two rules, one for the nominal interest rate, and one for intervention. At this stage, the first one is relatively clearly defined in Colombia, the second one is not.

Some progress could be made, by having the research department look at how such a pair of optimal rules may look like for Colombia. Maybe one can get a sense of what the right exchange rate should be, and have rules for the interest rate and the exchange rate which depend on distance of the exchange rate from the target. Maybe this target is so difficult to pin down (as opposed, say, to an inflation target) that it should be ignored altogether both in the nominal interest rate and the foreign exchange intervention rules. This is largely an empirical question, which can be better answered than it is now.

Labor markets.

Even if part of the unemployment is cyclical, a good part is likely to be structural. I have no clue as to the proportions. And labor market institutions seem less than optimal in a number of respects:

1. The cost of labor in the formal sector at the low end of the wage distribution.

Based on the bunching of the wage distribution at the minimum wage, the minimum wage may well be too high, and a major source of both unemployment and informality.

If, as seems to be the case, there is social/political little room to reduce it, there is still something which can be done: to reduce or even eliminate payroll taxes at the lower end of the wage distribution.

This actually has been done in France. The idea is that, at the minimum wage, firms pay less or no payroll tax. Payroll taxes are phased in as the wage increases, and reach their standard level at some multiple of the minimum wage, for example 1.5 times the

minimum wage. The phase out range needs to be large enough to avoid perverse effects, and too high marginal tax rates in that range, and small enough not to lead to too much of a loss in taxes.

If I take the wedge in Colombia to be around 50% of the wage, the full elimination of all payroll taxes at the minimum wage level is equivalent, in terms of costs to the firm, to a decrease of the minimum wage of 50%. This can go a long way towards increasing employment... It is also likely to give incentives for informal firms to become formal. If, as is more realistic, payroll taxes are reduced but not eliminated (say health and pension contributions are kept), the effects on the cost of unskilled worker are still substantial. And any shift of informal firms to the formal sector will, other things equal, increase tax revenues, partially offsetting the loss due to the reduction in rates.

2. The architecture of severance payments, unemployment benefits, and individual unemployment accounts.

My understanding of the existing system is roughly the following:

Severance payments (payments from firms to workers at the time of layoff) were very high. Since a reform in the 1990s, they have been reduced but they remain high (45 days after a year of seniority, and then 15 to 40 days per year of work depending on seniority?).

There is a limited system of unemployment insurance (the Cajas de compensacion familiar), which is financed by payroll taxes (4% contribution rate), and run by a non profit organization, which represents unions and firms. This system is however widely seen as inefficient and corrupt.

There is a system of unemployment accounts, financed through payroll contributions by firms on behalf of their workers (9.3% contribution rate). Workers are allowed to take the funds out not only in case of unemployment, but also for housing and education.

3. If this description is roughly correct, my reactions are the following (this applies some of the themes of my talk at the bank to Colombia):

Severance payments can be thought of a crude system of unemployment insurance: Laid-off workers receive a lump sum when they are laid off. It is crude in a number of ways: If firms go bankrupt, workers receive nothing. These payments, which are lump sum, do not protect workers against unemployment duration uncertainty. Workers with low seniority receive too little, workers with high seniority too much.

For this reason, all countries, as they become richer, shift to some form of explicit unemployment insurance. One can think of two main routes. Individual accounts (self insurance), or state provided insurance.

Individual accounts are a false good solution. Individual *retirement* accounts make sense: They accumulate funds for an event which is both fully predictable (retirement), and far in the future. Individual *unemployment* accounts do not: Unemployment risk is very different from retirement risk. It can happen early in working life, before funds have been accumulated. It can lead to a large loss.

The result is that these accounts do not work. If allowed, workers take the money out for other purposes, and there is little left in case of unemployment. (The alternative, not followed by Colombia, is that workers are not allowed to take the money out for other purposes. This leads to inefficiently large accumulation). This lack of funds leads to political pressure to help the unemployed in other ways. Better to think about the other ways in the first place.

The best solution is, I believe, state provided unemployment insurance. It can be provided relatively simply, to start. This suggests the following directions of reform:

4. Elimination of individual accounts. Allowing workers with positive balances to either cash them out, or transfer them to their individual retirement accounts.

5. Introduction of a state provided unemployment insurance system. Replacing and extending the Cajas de Compensacion. Providing benefits to workers laid off by firms who have paid unemployment contributions (so excluding workers in the informal sector).

With, for example, the following structure:

Unemployment benefits for up to six months. Possibly lower for young workers, both in terms of length and level. Possibly extended after six months depending on the labor market. Possibly requiring that the unemployed take a publicly provided job after six months, to avoid cumulation of informal work and benefits (the solution introduced by the last Hartz reform in Germany).

Unemployment contributions paid by firms. Theory strongly suggests here that the contributions should depend on the layoff behavior of firms. Put another way, firms should take into account the social cost of unemployment, and the payments of unemployment benefits by the state. This suggests the use of layoff taxes (equivalently, unemployment contributions paid by firms for each layoff. The timing of the payment of the tax can be separated from the timing of the layoff itself) rather than payroll taxes.

Implementation can be achieved in various ways, along the lines of a bonus-malus system, or experience rating. The relevant experience here is that of the United States, which relies on such a system to finance unemployment benefits.

6. A parallel decrease in the schedule of severance payments as unemployment insurance is introduced and extended, so that the cost of separation (severance payments plus contributions to the unemployment fund) for firms remains the same or comes down. This, to me, is the needed quid pro quo. Better unemployment insurance in exchange for lower severance payments.

Severance payments should not (and in any way cannot) be eliminated. There is a rationale for keeping some severance payments as a function of seniority. Conceptually, these should reflect the financial costs of losing a long held job, leaving aside the costs of becoming unemployed.