INTERNATIONAL MONETARY FUND

Colombia: Staff Concluding Statement of the 2018 Article IV Mission

March 2, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

Laying the Foundations for Sustainable Growth

The Colombian economy is at a turning point, recovering from a combination of external and domestic shocks since 2014 that lowered growth and increased inflation and the external deficit. A strong policy framework and well-executed adjustment policies were instrumental in coping with these shocks. As the recovery gathers pace, it will be essential to shift the focus to policies that lift medium term growth and make it more inclusive.

1. **Growth is beginning to recover and inflation is converging to the target.** The economy showed signs of revival in the second half of 2017, as the headwinds from the oil price shock and tight policies started to fade. Colombia's outlook is favorable. Policy easing, higher oil prices, and an improving global environment will lift growth considerably, from 1.8 percent in 2017 to 2.7 percent in 2018. Investment and exports are expected to lead the recovery. Inflation will further fall toward the target as the effect of the VAT hike in early 2017 dissipates and indexation pressures ease.

2. **External imbalances have narrowed but some risks remain.** The 2014-15 oil price shock reduced exports dramatically resulting in a widening current account deficit. Tight policies, including the 2016 tax reform and higher monetary policy rates, contributed to a necessary correction of the external imbalance. Initially, the adjustment was led by import compression, but 2017 saw an increase in exports of goods and services. The favorable global growth and oil market outlook will further boost exports, while imports will recover only gradually, leading to a narrowing of the current account deficit this year and further declines in the medium term. However, risks associated with tighter global

financial conditions remain high. The flexible exchange rate, together with ample reserves and the FCL arrangement provide strong buffers against these risks. Migratory flows stemming from the humanitarian crisis in Venezuela have been increasing and represent a fiscal risk..

3. **As the recovery takes hold the focus should shift to structural reforms.** Monetary and fiscal policies have to be fine-tuned to complete the adjustment process but the medium-term agenda should revolve around structural reforms to boost inclusive growth and productivity.

Structural Reforms for Strong and Inclusive Growth

4. **Closing the infrastructure gap and making markets more efficient are critical to diversify the economy away from oil.** Productivity growth in the non-oil sector has been lackluster even in the boom years. If Colombia is to grow above 3 percent in the medium term and create high-quality jobs, productivity needs to increase substantially. This requires reforms in a number of areas, including:

- *Infrastructure and transportation*. Poor infrastructure and inefficient transportation put Colombian firms at a competitive disadvantage. The authorities have moved decisively to address contractual problems and remove financial constraints in the infrastructure sector, but completing the 4G projects without delay is essential. The ongoing process to renew the fleet of trucks is also crucial.

- *Labor and firm informality.* Informality has fallen substantially in recent years, thanks to improvements in education and the payroll tax reform of 2012, but close to 50 percent of workers in the main cities and over 60 percent of workers nationally remain informal. Colombia improved the coverage of higher education from 37 percent in 2010 to 52 percent in 2017. Going forward, programs to further improve both access to and the quality of higher education remain key to reducing skill mismatches and increase formality. Rationalizing the functions and funding of *Cajas de Compensación Familiar* could help reduce labor taxes and thus create more formal jobs. Reducing registration fees for the *registro mercantil* for small firms and cutting red tape through the *Ventanilla Unica Empresarial* would also improve firm formality.

- *Barriers to international trade.* Despite progress in recent years, including the elimination of tariffs on some intermediate inputs and the elimination of VAT on capital goods, export costs remain high. A review of the many nontariff trade barriers adopted since 2000 could make the imports used to produce exportable goods cheaper. Tariffs are low by regional standards but dispersion needs to be reduced, especially in agriculture. Logistics in ports, including coordination with customs, needs to be further improved to reduce very long processing times.

Despite lower and volatile oil prices, investment in the oil sector continues to be critical for medium-term growth in Colombia. Measures included in the 2016 tax reform, as well as the regional development efforts associated with the peace process, have supported investment in the sector. Investment in production is expected to increase this year, especially in Ecopetrol. However, investment in exploration remains low, and continued efforts to preserve incentives for such activities and the overall competitiveness of the sector would help ensure its rebound.

Fine Tuning Monetary Policy

5. **There may be some space to further cut the policy rate as inflation converges to target and the external adjustment continues.** The central bank's response to a complex inflation environment in the last three years has been appropriate. Spare capacity in the economy and a benign inflation outlook indicate that moderately looser monetary policy would be appropriate if inflation and inflation expectations accelerate their convergence to the target and growth is lower than expected.

It is important to communicate monetary policy decisions more clearly. The complex and uncertain dynamics of the economy in the last year have contributed to a relatively large number of monetary policy decisions that were unexpected by the market. The mission welcomes the changes in the central bank decision making process that aim to strengthen the analysis behind decisions and to align Board meetings with major data releases. Going forward, the central bank should craft communications that are consistent over time and better spell out the Board's views on the evolution of policy trade-offs.

Preserving Financial Stability

6. **Banks have adjusted well to the economic downturn.** Non-performing loans increased and the quality of the credit portfolio deteriorated as a result of the economic slowdown, but banks' capital and liquidity buffers remained adequate. As the economy recovers, the non-performing loan ratio is expected to start declining during the second half of 2018. At that point, commercial credit growth will start to pick up and support the rebound in activity. In contrast, consumer credit is likely to lag the economic cycle as banks remain cautious about households' balance sheets.

7. **The regulatory and supervisory policy agenda is focused on the right issues.** The Conglomerates Law to be implemented this year that expands the supervisor's powers is an important step towards preserving financial stability. The financial supervisor introduced a new regulation to standardize loan restructuring practices and foster early detection of credit risk through the modification of loans. In this context, the supervisor revamped on-site inspections and required banks to produce loan recovery plans. The strategy is showing some early positive results. However, loan modifications need to be carefully monitored to avoid delayed recognition of asset quality deterioration. Efforts to bring regulation and supervision closer to Basel III will further strengthen the regulatory framework.

Improving the Quality of Public Spending

8. **The fiscal consolidation path under the fiscal rule will reduce public debt.** Colombia has made a lot of progress in closing the gap left by lower oil revenues. Continued efforts to improve tax administration will create space for additional public investment at the central government level, and will be complemented by stronger execution at the subnational level. If growth surprises on the downside, the fiscal rule provides some space to further smooth the adjustment in 2019-20.

9. **Better prioritization of public spending would help inclusive growth.** Ongoing efforts to improve the selection and coordination of peace-related investment projects are welcome. The executive summary report from the experts commission points to several areas for improvement. More participation of subnational governments in health and education spending would improve efficiency and progressivity. Health coverage has improved but action is needed to contain growing costs while guaranteeing high quality services. The pension system has low coverage and is highly regressive. Reducing replacement rates and equalizing the retirement age for men and women would be important steps to strengthen the system. The associated savings could be used to expand the non-contributory pillar. Deeper structural reforms to the contributory system aim to expand access to pensions, either managed by Colpensiones or the private accounts system, should be considered.

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The mission would like to thank the Colombian authorities for their cooperation and open discussions.