Colombia: Staff Concluding Statement of the 2019 Article IV Mission

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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.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

A Resilient Recovery with Medium-run Challenges

Colombia's economy continues to gain momentum despite less favorable global conditions. Led by domestic demand, growth is expected to rise to 3½ percent in 2019—benefitting from policy support, improving credit market conditions, and recovering investment. Mirroring the demand-led recovery, external deficits are widening. Substantial migration flows from Venezuela carry some adjustment costs but should raise potential over time. Rising fiscal challenges should be addressed soon, while structural reforms remain instrumental to boost inclusive growth and external competitiveness.

1. **Colombia's recovery is gaining momentum despite slowing global growth**. Led by domestic demand, economic activity is accelerating in 2019. Growth is expected to pick-up to 3½ percent from 2.7 percent in 2018, underpinned by strong private consumption and a long-awaited recovery in business investment as policies have remained supportive. Against weaker-than-expected external demand and volatile oil prices, Colombia's resilient outlook benefits from continued moderate monetary policy support, a lower tax burden for corporates from the Financing Law, and higher fiscal spending. Substantial migration inflows from Venezuela have added to demand, especially for services. Alongside an expanding economy, credit growth, especially for firms, should also improve. Inflation ended the year close to the Central Bank's inflation target and price pressures remain contained.

2. **With demand-driven growth, external imbalances are widening**. The current account deficit was 3.8 percent of GDP in 2018 and external imbalances are likely to remain elevated this year—as recovering domestic demand has spurred imports, including for investment goods, while non-oil exports remain sluggish. Nevertheless, the current account has been comfortably financed, mainly by stable foreign direct investment and robust portfolio inflows from a more diversified foreign investor base. In the absence of additional policy actions or higher oil prices, however, external adjustment to appreciably reduce the trade and current account deficits will be challenging over the medium term.

3. **Colombia remains on the front lines responding to the severe humanitarian crisis in Venezuela**. Remarkably, more than 1 million migrants from Venezuela currently reside in Colombia and many more have either passed through the country in transit or crossed the border temporarily. Commendably, Colombia has shown an unwavering commitment to provide humanitarian support such as health care, education, as well as granting labor rights to migrants to help integrate them into the economy. The associated fiscal costs are estimated to be around ½ percent of GDP in the near term. Looking beyond short-run adjustment costs, recent migration flows should raise over time Colombia’s growth potential.

4. **Heightened external risks may weigh on the recovery**. Lower global growth, amid rising protectionism, poses risks to Colombia’s exports. And while market expectations for higher US interest rates have receded, a sudden tightening in global financial conditions remains a risk. On the domestic front, the projected rebound in investment by Colombian businesses may not fully materialize, particularly if infrastructure spending and construction remain sluggish.

Rising Fiscal Challenges on the Horizon

5. **Fiscal policy should adopt a broadly neutral stance in 2019**. Against a background of robust domestic demand growth and widening external deficits, the central government should reduce the fiscal deficit to 2.4 percent in line with the fiscal rule. If fiscal costs from migration turn out to be larger and more persistent, however, flexibility within the rule through the escape clause can be considered under strict conditions to safeguard the Medium-term Fiscal Framework (MTFF).[1] At the subnational level, higher spending by local governments—which have more fiscal space given past under executions of their budgets—may provide helpful stimulus to the ongoing recovery.

6. **Rising fiscal challenges are approaching and will require structural policy efforts**. At the heart of Colombia’s strong policy frameworks, the MTFF includes the fiscal rule’s structural deficit goal of one percent of GDP by 2022. Within this tightening budgetary envelope, spending pressures from migration-related fiscal costs may persist for some time. Meanwhile, the Financing Law should boost investment but may lead to revenue shortfalls as lower corporate tax burdens are realized from 2020 onwards. Against this backdrop, Colombia should consider undertaking structural measures, on both revenues and spending, to reinforce its MTFF:

- **Steady efforts to lift tax revenues structurally would build fiscal space**. A medium-term objective to gradually raise tax revenues collected by the central government by 2-3 percent of GDP would help protect key spending on public investment and social programs, build fiscal buffers, and reduce public indebtedness over the medium term. Measures includes *tax simplification*, such as eliminating many preferential regimes for businesses; *base broadening* for personal income taxes and VAT, with due attention to progressivity and protection for the poor; and enhancing *efficiency* of tax administration and collection. Here, the mission welcomes the authorities' efforts to improve DIAN's IT systems, staffing and training.

- **The authorities' focus on spending efficiency is welcome and important**. Efficiency improvements in line with the recommendations made by the expert commission on spending should be pursued, including improved targeting of energy subsidies and stronger project selection for public investment. The mission welcomes the objective in the national development plan to unify the budgetary process to improve consistency and further integrate it with medium and long-term programs.

Appropriate Monetary Accommodation and Reserve Accumulation

7.**Moderately accommodative monetary policy is providing helpful support to demand**. Inflation is projected to end 2019 at 3.2 percent—close to the Central Bank's objective. While supply shocks could lead to temporary price pressures, services inflation should ease further. Given inflation close to target, anchored inflation expectations, and the prevailing negative output gap, monetary policy should remain accommodative. If credit markets and GDP strengthen as expected, monetary policy can shift to a less accommodative stance in the second half of the year.

8. **The Central Bank's reserve accumulation program is a proactive step to build external buffers**. Reserves are currently adequate according to the IMF's standard metrics but will need to rise over time to provide a sufficient buffer given growing external financing needs and risks. The program's market-based mechanism has allowed the build-up of US$ 1.2 billion in reserves without disrupting a smooth functioning of the foreign exchange market, while permitting the flexible exchange rate to remain the first line of defense against external shocks. Also, in a one-off transaction in February, the Central Bank purchased US$1 billion from the Treasury at the prevailing market rate. The Central Bank continues to sterilize accumulated reserves, as needed, to keep interest rates close to the policy rate and this would be important as the economy strengthens to maintain inflation close to target.

Strengthening Financial Stability and Promoting Growth

9. **Colombia's credit cycle should improve alongside its economic recovery**. Credit growth should pick up with the investment recovery and as non-performing loans (NPLs) decline. Despite the credit quality deterioration in the first half of 2018, banks remain well capitalized with stable provisions and show an increased willingness to lend. Given elevated NPLs, the financial supervisor (SFC) needs to remain alert and proactive to ensure that problem assets continue to be sufficiently provisioned for. The SFC is committed to continue closely monitoring the modified loans portfolio to avoid build-up of excess credit risk.

10. **The authorities' continued efforts to strengthen financial stability and further improve the regulatory framework are welcome**. The SFC presented a new schedule for implementing the Conglomerates Law and Basel III capital standards. The mission supports the authorities' timelines and stresses the importance of adhering to them. The plan to gradually introduce additional capital buffers over a four-year period is appropriate and should prevent credit supply bottlenecks while strengthening financial stability. Given that the capital ratio will be redefined in 2020, while additional capital buffers are only introduced gradually, heightened supervisory vigilance would be appropriate during the transitional period.

11. **Structural reforms are needed to boost inclusive growth and enhance external competitiveness**. Colombia has made impressive progress in reducing poverty and inequality over the past fifteen years. Better targeted subsidies, closing infrastructure gaps, and reducing skills mismatches would help cement social gains. Emphasis on entrepreneurship and improving the business environment take on renewed importance given the need to strengthen external competitiveness. Strengthening the rule of law and reducing corruption is also an important challenge. The national development plan rightly identifies many of these issues, providing a strategic roadmap for reforms—including fighting informality, improving efficiency, and enhancing productivity. In addition, pension reform that improves progressivity and coverage while guaranteeing sustainability of pension benefits remains crucial.

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

Also, the mission welcomes the emphasis of the National Development Plan in fighting informality, improving efficiency and enhancing productivity.

[1]In the wake of an exceptional migration shock from Venezuela, the rule's escape clause can be considered if triggers, deviations, and correction were to be well defined. In that case, the escape clause would be invoked to deal with migration- specific costs, temporary deviations should be commensurate with these costs and complemented by a well-defined plan that specifies fiscal measures needed to return to the rule's deficit path after a few years.

To read the full press release, please visit: https://www.imf.org/en/News/Articles/2019/03/08/mcs030819-colombia-staf…

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