Colombia: Staff Concluding Statement of the 2022 Article IV Mission

Washington, DC: *Among the fastest recoveries in the region, Colombia's economy rebounded strongly, driven by private consumption, in 2021. With progress on vaccinations and continued reopening of the economy, strong growth momentum is expected to continue in the near term, although risks remain to the downside given that the pandemic has not ended. Despite the rapid recovery in economic activity, the recovery in jobs has lagged and key imbalances have emerged. Higher food and commodity prices, amid supply bottlenecks, have led to rising inflation and the consumption led recovery has resulted in a wider external deficit. Going forward, carefully recalibrating Colombia's policies will help sustain economic momentum and contain higher inflation, while strengthening public finances and reducing external imbalances. To aid job creation and equitably raise living standards, advancing key structural reforms and climate policies remain instrumental to secure sustainable and inclusive growth.*

1. Colombia has experienced one of the fastest recoveries in the region, underscoring its resilience to the pandemic. Colombia's very strong policy frameworks and comprehensive policy response to Covid-19 helped create the conditions for the handoff to private demand that is underway. Fiscal measures provided insurance and support to vulnerable households and firms, enabling many to replenish or build up their savings in 2020, and allowed for pent-up consumer spending to propel the recovery in 2021. This year, the economy is expected to expand by 4½ percent—with above-trend growth led by robust household consumption, as the labor market continues to gradually recover while a resilient financial system and the credit cycle enter into a new upswing. Investment and export prospects should also support growth amid higher commodity prices.

2. Uncertainty around the pandemic, however, still clouds the outlook. Vaccination progress has reached 64 percent of population, but further inroads into vaccination rates are still needed. New variants of the virus are still a threat and the need for renewed containment measures still looms. Amid ongoing supply chain disruptions, inflation continues to rise—reaching almost 7 percent in January—which will challenge the central bank to rein in prices without unduly dampening growth. With higher external financing needs due to a wider current account deficit, Colombia is vulnerable to a sharp rise in global risk premia and other external shocks in a context of elevated global uncertainty. Other downside risks include a slower implementation of the infrastructure agenda and peace accord, while upcoming elections generate political uncertainty.

A window of opportunity to strengthen public finances

3. Alongside the recovery, Colombia's public finances are showing signs of improving with scope to make further gains. As highlighted in the government's financial plan for 2022, a lower fiscal deficit (-6.2 percent of GDP) than in the medium-term fiscal framework (-7 percent of GDP) appears within reach this year given higher tax collections. Following a narrower-than-anticipated fiscal deficit in 2021, continued policy efforts would further reduce fiscal financing needs that were elevated due to the pandemic. Moreover, the unwinding of pandemic-related support measures so far has been effective, helping put public debt on a downward trajectory already in 2021 (three years earlier than previously expected). With excess capacity diminishing, added fiscal revenue from higher-than-expected GDP and tax collections should be saved and further targeting and phasing out of exceptional pandemic measures should be considered (including public loan guarantees).

4. A sustained reduction in the fiscal deficit will be key to reducing internal and external imbalances. The Social Investment Law (SIL) is an important step in the right direction and the mission welcomes the strengthening of the fiscal framework—by explicitly outlining a transition path towards a structural balance rule with a new debt anchor. This objective, underpinned by underlying fiscal efforts, would help support external adjustment and ensure that fiscal deficit limits established in the medium-term fiscal framework are respected. Strong, independent oversight by the new Autonomous Fiscal Rule Committee (CARF) will be important for guiding the goals for deficit reduction and meeting or exceeding the targets, including in 2022. Fiscal consolidation would also lessen the burden on monetary policy to ease demand pressures and help ease sovereign borrowing costs by reducing debt.

5. Colombia would benefit from deeper fiscal reforms. While the robust economic recovery has improved Colombia's fiscal outlook, the mission believes that securing new revenue sources will be paramount to safeguarding key social protection programs and public investment, while supporting a faster reduction in the debt level. Beyond the revenue gains from the SIL and DIAN modernization, further raising revenues durably by an additional 1 – 1 ½ percent of GDP over the medium term would be desirable. Revenue mobilization efforts should aim to reduce tax distortions and loopholes, increase progressivity, improve fairness, and protect poorer households using compensating measures where needed. To complement higher revenues, spending efficiency gains can be achieved by better utilizing the social benefit system (SISBEN IV) and by building a new social registry to better identify recipients, further implementing energy subsidy reforms, and advancing initiatives to

improve public procurement.

Recalibrating the pace of monetary normalization

6.To control rising consumer prices and prevent second-round effects from supply side factors, accelerated monetary tightening by the central bank is appropriate. Amid low excess capacity and real interest rates, faster monetary policy tightening is welcome. Added steps to raise interest rates in the first half of the year to sufficiently tighten monetary and financial conditions should guide inflation lower. This will help safeguard central bank credibility, anchor inflation expectations, insure against upside inflation risks, and help contain external imbalances. Monetary policy decisions and the balance of risks should continue to be clearly communicated to help guide market expectations. With high external financing needs and exposures, international reserve accumulation over time should continue to help maintain reserve adequacy and insure against external liquidity risks. The IMF's Flexible Credit Line (FCL) provides additional external buffers and enhances market confidence.

Reinforcing financial stability

7. Colombia's banks have withstood the pandemic remarkably well and the financial system remains sound. Financial regulatory support measures were introduced in 2020 to help borrowers through the pandemic and have since been successfully rolled back. Loan forbearance measures, including the Programa de Acompañamiento a Deudores (PAD), have been phased out. With a more favorable macroeconomic environment in 2021, banks exhibit strong capital and liquidity buffers, and operational profitability has recovered. Credit institutions appear well positioned to extend credit even as interest rates rise. Basel III implementation continues on track and banks have further strengthened capital adequacy.

8.The Colombian authorities have developed robust supervisory and regulatory frameworks to safeguard financial stability and certain steps would further enhance them. The IMF's Financial Sector Assessment Program (FSAP) team finds that Colombia has considerably strengthened its regulatory and supervisory system since the previous IMF assessment in 2012. Data availability and certain institutional arrangements for bank resolution and macroprudential frameworks can be enhanced. Given the upswing in credit, it would be important to continue closely monitoring the behavior of riskier loans and ensure that household and corporate leverage do not become excessive.

Structural reforms for job creation and to sustain inclusive growth.

9. Structural reforms are key to set the foundation for a sustainable and inclusive expansion. To aid job creation and bring employment closer to pre-pandemic levels, lowering barriers to firm and labor formalization would help reduce structural unemployment and enhance productivity. To extend the social safety net, the mission welcomes the introduction of the Social Protection Floor (SPF), which grants access to social security benefits for nearly 10 million workers earning less than minimum wage. The commendable Temporary Protection Status (TPS) program for Venezuela migrants should strengthen their integration and raise Colombia's economic potential. In other areas of social protection, retaining cash transfers for families but on a more targeted basis going forward can sustain income support for Colombia's most vulnerable households, particularly given the uncertain path of the pandemic. Pursuing a green recovery, identified as a key pillar of the sustainable recovery strategy within the Compromiso por Colombia plan and the recently approved Carbon Neutrality and Climate Resilience Law, will be critical for sustainable growth. Here, the successful launch of sovereign green bonds last year and the introduction of new environmental taxes, can support the government's green recovery plans by creating room for continued investment in key climate-related areas.

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

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