Colombia: Staff Concluding Statement of the 2024 Article IV Mission

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.

Managing the Transition to a More Sustainable Future

Bogotá, Colombia

The Colombian economy is well-advanced in reaching a more sustainable level of economic activity, with marked reductions in inflation and the external current account deficit. Appropriately tight macroeconomic policies over the last two years have allowed for an impressive reduction in domestic and external imbalances that had built up during 2021-22. Real GDP growth is estimated to have slowed to 1.2 percent in 2023 from the post-pandemic unsustainable high levels, led by a slowdown in domestic demand. Meanwhile, inflation has fallen from its peak of 13.3 percent (y/y) last March to 8.4 percent (y/y) in January this year, notwithstanding the effects of the significant but necessary increase in regulated prices. Credit growth has also moderated from its peak of 18 percent (y/y) in August 2022 to 3 percent (y/y) in December 2023, owing not only to tight macroeconomic policies, but also higher provisioning requirements for consumer loans, and tightened lending standards. Finally, the current account deficit is estimated to have narrowed sharply to below 3 percent of GDP in 2023, from over 6 percent in 2022, owing to lower imports and strong tourism receipts, despite less favorable terms of trade.

The economy is set to continue along this trend in 2024 before reaching its potential over the medium term.. Real GDP is expected to expand by 1.3 percent this year as macroeconomic policies gradually normalize. Private consumption, currently above pre-pandemic levels, is expected to moderate this year as households deleverage and labor market conditions soften, while private investment is expected to gradually recover, albeit remaining below pre-pandemic levels. Inflation is projected to continue to decline, reaching around the 3-percent target by end-2025. The current account deficit is projected to increase slightly in 2024 to around 3¼ percent of GDP mainly on account of a recovery in imports, gradually converging to about 3¾ percent of GDP in the following years, largely financed by foreign direct investment. Over the medium-term, real GDP growth is projected to converge to 3 percent, supported also by large-scale infrastructure projects, further recovery in private investment, and the economic gains from integrating Venezuelan migrants.

While risks have receded, there are still more downside risks to the economy. Risk to the global economy have moderated, although they remain high. An intensification of geopolitical tensions around the world could further tighten global financial conditions, disrupt supply chains, and raise global food prices, adversely impacting Colombia's growth outlook and adding to inflation pressures. Domestically, a stronger-than-expected

El Niño could also hinder economic activity and raise inflation. Weaker-than-expected private demand due to tighter financial conditions and/or a softer labor market also pose downside risks to growth. While risk premia have declined from last year, uncertainties about social and energy transition reforms could raise borrowing costs and undermine private investment. Notwithstanding these risks, maintaining adequate buffers and a sustained track record of very strong policy implementation, including by continuing to adhere to the fiscal rule and the inflation targeting framework, would mitigate risks and continue to support Colombia's resilience.

Monetary Policy – Proceed with Caution

Inflation and inflation expectations are gradually falling as expected. The central bank has appropriately kept the policy rate steady for most of 2023 while inflation and expectations came down, effectively tightening the stance during the year. This policy significantly helped to reduce inflation and inflation expectations and should keep them on a downward trend in the period ahead.

Monetary policy normalization should continue to proceed with caution. Notwithstanding the improvements noted above, inflation remains well above peers' and has shown more persistence than expected, even after considering the impact of the commendable regulated price adjustments. Similarly, inflation expectations, while falling, have remained above the central bank's inflation target of 3 percent since July 2021. Given upside risks to inflation, including from El Nino and high indexation, it will be necessary to proceed with caution in future policy rate reductions. As inflation and inflation expectations decline, adjusting the policy rate in a data dependent way, aiming to bring inflation firmly to the 3 percent target by mid-2025, would strike a good balance between safeguarding economic activity and policy credibility.

Enhanced communication could help better anchor expectations. Focusing on the inflation target level and the expected time horizon to bring inflation to that target, while recognizing risks and uncertainties, can help more strongly anchor inflation expectations. The exchange rate should continue to flexibly respond to shocks, as it appropriately has done, unless disorderly market conditions arise. Given global risks, the central bank's welcomed international reserve purchase plan would gradually strengthen international reserves and maintain healthy liquidity buffers. The IMF's Flexible Credit Line provides additional external buffers and enhances market confidence.

Fiscal Policy – Prudent Fiscal Management is Justified

The further strengthening of public finances during 2023 was appropriate. The National Central Government (NCG) and the Consolidated Public Sector (CPS) deficits were reduced for the second consecutive year, commendably over-complying with the fiscal rule. This reflected mainly gains from the 2021-22 tax reforms and continued unwinding of fuel subsidies. The smaller deficits helped reduce public debt as a ratio of GDP, which fell largely on account of the appreciation of the peso..

However, the planned increases in the overall deficit and debt this year pose fiscal risks. The recently published 2024 Financial Plan targets an improvement in the structural net primary balance by 1.2 percentage points, as per the fiscal rule, which represents an appropriately contractionary fiscal stance in both the CG and CPS balances, helping to durably reduce remaining imbalances. That said, the overall deficit is set to increase to 5.3 percent of GDP and debt to 57 percent of GDP in 2024, as borrowing costs remain high. Moreover, the plan envisages about 1 percentage point of GDP more in primary expenditures, with the deficit level set once again at the limit of the fiscal rule as per the Ministry's calculation. The plan assumes ambitious but uncertain gains from tax administration improvements and faster resolutions of tax arbitrations. Should revenues fall short of expectations, expenditure plans would need to be scaled back, as was done in 2023, to comply with the fiscal rule.

Proactively scaling back expenditure plans would help lower borrowing costs and allow monetary policy to normalize faster. Borrowing costs have been above that of peers since Colombia lost investment grade in 2021. Scaling back expenditure plans for this year would not only reduce the risk of needing to identify spending cuts later in the year, but also lower debt and financing needs. Importantly, this strategy could help the monetary policy stance to normalize more quickly, which in turn would lower private sector borrowing costs, spur investment, and help secure competitiveness, paving the way for Colombia to regain investment grade. Continuing the exemplary path of reducing fuel subsidies would save scarce public resources and align with Colombia's goal of reducing reliance on fossil fuels. If the healthcare and pension reforms are approved, or other shocks arise that put pressure on public finances, further reductions in spending plans may be needed to comply with the fiscal rule. Given substantial budget rigidities, standing ready to activate contingency plans will be essential.

Reorienting expenditures towards investment, within a scaled back spending envelope, would support the energy transition and enhance growth potential. Colombia's ambitious climate and energy transition plans will require increased public and private investment. Shifting some of the spending envelope to infrastructure and climate-related projects would support Colombia's objective of boosting its growth potential and being a global leader in the climate transition agenda.

Financial Sector – Reinforcing Resilience

Banks remain resilient despite rising nonperforming loans (NPLs). With the economic slowdown, NPLs have risen, especially in consumer loans, and the counter-cyclical provisioning framework has been appropriately activated providing banks with welcomed breathing space. As such, the banking sector remains liquid and well-capitalized, with capital adequacy ratios well above regulatory minimum, and credit growth moderating to more sustainable levels.

Financial stability risks, however, need to continue to be carefully monitored. As the economy continues to stabilize, NPLs could continue rising, warranting close monitoring. The countercyclical provisioning framework's rules-based mechanisms should be maintained, with any needed adjustments made after careful deliberations. Given the systemically important role private pension funds play in the financial and capital markets, any potential impact of the pension reform should be carefully analyzed and inform the discussions on the reform to mitigate risks. Continuing to closely monitor liquidity and maturity risks and following international best practice in stable funding regulations will be important for containing funding pressures. As further progress is made in enhancing data coverage, expanding the macroprudential toolkit towards more borrower-based tools complement the good supervisory oversight.

Social and Structural Reforms – Lifting Productivity, Diversifying the Economy

Planned social reforms would need to be designed within the policy frameworks and appropriately balance equity and efficiency considerations. While the broader objectives of the social reforms to increase equity and inclusion in the society are welcomed, they should be designed and implemented in compliance with Colombia's fiscal frameworks, addressing problems in the current system while ensuring that economic incentives are well-aligned, and encourage investment.

Lifting productivity is essential to boosting potential growth in the medium-term. Reversing declines in Colombia's total factor productivity observed over the last three decades will require improvements in the business climate, including by simplifying regulations, lowering labor market rigidity, providing more policy certainty (e.g. on regulated prices), and removing bottlenecks that keep firms smaller and outside the recorded economy. In addition, actions to boost domestic saving—including by raising public saving—and lower the cost of capital could support higher investment.

A well-designed and executed energy transition and export diversification plan is vital to secure longer-term sustainability and resilience. The administration's goal of reducing dependence on oil and coal is commendable and rightly a priority given Colombia's declining fossil fuel reserves and the ongoing global energy transition. Diversifying exports would be an essential part of the transition strategy, which requires identifying comparative advantages across sectors and removing market frictions to foster private investment, while avoiding protectionist measures. Implementing the strategy would take time and will need strong partnerships between public and private entities, along with the proper pricing of energy. The pace and timing of the transition needs to balance achieving climate goals and preserving growth, fiscal, and external stability.

Reform efforts should be usefully complemented with further strengthening governance and transparency. Developing a comprehensive anti-corruption strategy that focuses on areas more at risk of corruption should guide advances on the governance agenda. Ensuring the continuous publication of comprehensive and easily accessible income and asset declarations of politically exposed persons and providing public access to effective beneficial ownership information would bring more transparency and accountability to the public sector. Special attention to improving the processing of grand corruption cases through the judicial system with enhanced investigation capacity could demonstrate the state's resolve in tackling corruption and foster greater trust within the public.

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

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