COLOMBIA:

RECENT ECONOMIC PERFORMANCE AND PROSPECTS

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1. Introduction

Colombia is the fourth largest economy in Latin America (Figure 1), and its mid-term growth prospects remain strong by regional standards. After overcoming a deep economic and financial crisis by the end of the nineties, the Colombian economy has followed a path of higher growth based on greater export and investment rates. This process has been driven by both local and external structural factors. At the same time, the economy has proven to be more resilient to external shocks than in the past within a sound policy framework that has enabled both monetary and fiscal policies to work counter-cyclically. This framework has been developed based on lessons from past experiences, and is an essential element to higher average growth, thanks to its contribution to the reduction of macroeconomic volatility and financial stability.

In the following presentation I will describe the evolution of the Colombian economy in recent years and highlight the importance of the monetary policy regime. I will also discuss the medium-term outlook with an emphasis on upcoming challenges, as well as the role of a policy framework to deal with them.

2. Higher Growth and Greater Resilience

During the first decade of the XXI century economic growth in Colombia exceeded the average growth rate for Latin America and the Caribbean, as well as its own historical growth average

(Figures 2 and 3). As a result, the Colombian economy now belongs to the group of upper-middle income countries (Figure 4).

Two factors were instrumental for this accomplishment: first, an upward trend in the share of investment with respect to output (Figure 5); and second, the continuous insertion of Colombia into the world economy, both through international trade (exports and imports) and investment inflows (Figure 6). Behind these achievements lie local factors such as significant improvements in matters of security and fiscal management, as well as the attainment of a low, stable inflation. The improved fiscal situation reinforced the market's perception that the public debt is sustainable and significantly decreased the uncertainty of future taxation and financing costs. Low, stable inflation implied lower long-term real interest rates (due to nominal stability and a smaller inflation risk), better resource allocation and productivity, and increased safety for investors.

External factors have also been important for the new phase of growth in Colombia. Structural changes in the world economy, such as the rapid industrialization and urbanization process in China and India together with the growing income of several emerging market economies, meant a greater demand for commodities and a rise in their prices. This stimulated investment in resource-rich countries, raised their terms of trade and national incomes and diminished their perceived riskiness. In the case of Colombia, findings of oil and mineral reserves increased the positive impact of these events, since the combination of higher production volumes and prices enhanced expectations of future export and fiscal revenues.

Besides increasing its potential growth through the 2000s, the Colombian economy has exhibited a remarkable resilience to the difficult external conditions of the last few years. This has been possible thanks to the enhancing ability to perform monetary and fiscal countercyclical policies, coupled with favorable macroeconomic conditions such as low inflation, sustainable public debt, and a stable financial system in the context of a flexible exchange rate regime. This increasing resilience was evident in the reaction of the Colombian economy to the collapse of Lehman Brothers and the ensuing global financial crisis. In contrast to its dismal response to the Asian and Russian crises of the late nineties, the Colombian economy kept growing in 2008-2009 and recovered rapidly in 2010-2011 (Figure 7). As a result, growth volatility has been substantially subdued and is now lower than the average for Latin America (Figure 8).

Overall, improvements in the Colombian macroeconomic policy framework were central to driving the economy along a higher growth path as well as to increasing its resilience in the face of adverse shocks. Most importantly, stability strengthens the incentives to undertake long-term productive investment projects. As I will explain next, the Central Bank's strategy for implementing its monetary policy has played a key role in achieving these results.

3. Monetary Policy: Low and Stable Inflation and Smoothing Output Fluctuations

Since 1999, *Banco de la República* has used a flexible inflation-targeting regime. The objectives of this strategy are to maintain a low and stable inflation and to smooth output fluctuations around a sustainable growth path. Inflation has been gradually reduced from two-digit levels to the official long-term target of 3%, with a control range of 1 +/- one percentage point, and it is currently hovering at around 2%, reflecting the absence of inflationary pressures (Figure 9).

The possibility of simultaneously maintaining inflation on-target and smoothing output fluctuations depends on the Central Bank's capacity to anchor inflation expectations (Figure 10). If public expectations deviate significantly from the inflation target, monetary policy loses its ability to dampen the business cycles. Thus, the Bank's credibility is crucial for the success of monetary policy. Credibility comes from developing the proper policy framework and building a track record of success in achieving and maintaining a low and stable inflation.

The Bank's main instrument for monetary policy is the short-term interest rate. When aggregate demand falls below its sustainable level and the economy faces lower inflation, the appropriate policy reaction is to lower interest rates. For instance, after the collapse of Lehman Brothers and the subsequent shock in September 2008, the Board of Directors of the Central Bank reduced the policy rate from 10% to 3% (Figure 11). The combination of this extraordinary monetary stimulus and a financial sector that continued to provide credit to households and businesses, as well as a moderate fiscal expansion resulted in a growth rate of 1.7% in 2009, the highest among large Latin American countries in that year (Figure 12). In contrast, once the economy recovered its growth pace and faced a strong increase in consumer credit, the Central Bank moved off its exceptional policy and increased interest rates from 3% in January 2011 to the "more normal" level of 5.25% in February of 2012.

Recently, a variety of shocks of different nature and duration have affected prices and production. Positive agricultural supply shocks, a strong peso, reductions in the value added tax, and a weaker aggregate demand have led to a significant reduction in the inflation rate and inflation forecasts, currently placing them below the long term target of 3%. Meanwhile, an unexpected contraction in gross capital formation, particularly in civil works and construction, associated with regulatory and administrative factors, led to a negative output gap at the close of 2012. For the same reason, projections for GDP growth in 2013 fall below the full potential of the economy. These factors prompted the Bank to lower the interest rate from 5.25% in June 2012 to 3.75% last February, which will provide a necessary stimulus in the current circumstances without putting the inflation target at risk.

The floating exchange rate is also an integral part of the Bank's strategy for implementing monetary policy (Figure 13). In a commodity-exporting, small, open economy with price and wage rigidities like Colombia, most shocks are better absorbed by the exchange rate. For example, in the second semester of 2008 the policy response to the Lehman shock prompted the exchange rate to respond endogenously - it fell sharply, by more than 40% - which was an expansionary impulse for the economy. Moreover, exchange rate flexibility facilitates the adoption of a countercyclical monetary policy and makes the private sector more prudent in its decisions of foreign indebtedness.

4. Medium-Term Outlook for the Colombian Economy: Opportunities and Challenges

The last decade witnessed an increase in production and exports of oil, coal and other mining products, as Colombia strengthened its stance as a commodity exporter. In 2011 and 2012 exports from the mining sector attained a historically high share of 71% of total exports (Figure 14). This export pattern has allowed the Colombian economy to benefit from the changing structure of the global economy. In fact, strong international demand and high commodity prices have resulted in favorable terms of trade for Colombia (Figure 15), a positive impact on national income and large FDI inflows into mining activities (Figure 16).

The volume of production of oil and coal (which accounts for 70% and 20% of the production of the mining sector respectively), are expected to continue rising for several years ahead, although at a decreasing rate. Official forecasts estimate oil production annual growth to be around 9.1% between 2011 and 2015, and 2.7% between 2016 and 2020 (Figure 17). Coal production annual growth could be 6.1% and 0.9% for the same periods respectively (Figure 18). Moreover, while a high level of the terms of trade will continue adding to the level of our national income, we are likely to be entering a new phase in which we can no longer expect that rising terms of trade will translate to growth in GDP per capita. Because of the volatility of commodity prices and the uncertainty of future discoveries of oil and mining, a policy framework that focuses on increasing the saving rate in good times and boosting productivity is necessary.

Policies thus far have focused on mitigating the risks of volatile commodity revenues, and effectively spreading royalties from mining and oil production into numerous regions in the country. For that purpose Congress has approved a fiscal rule and a new system to distribute royalties, named *Sistema General de Regalías*. By implementing the fiscal rule, the Government is expected to save a significant portion of the energy-related revenue windfall and to achieve an important reduction in its debt-to-GDP ratio while considerably improving its fiscal balance (Figures 19 and 20). As for the *Sistema General de Regalías,* its aim is to achieve a fairer distribution of revenues across regions and a more efficient use of these funds to promote productivity and regional development.

From a macroeconomic standpoint, these measures are crucial to ensuring stability in the face of higher commodity-related export and fiscal revenues. First, the improved fiscal situation will reduce the vulnerability of the economy to adverse shocks and will enhance the credibility of the inflation target. Second, the savings generated by both the fiscal rule and the system for distributing royalties will mitigate the real appreciation of the currency that naturally follows from a commodity boom, hence alleviating concerns of the Dutch disease. And third, the fiscal rule will contribute to the adoption of countercyclical fiscal policies and support the role that monetary policy plays in this respect.

The country is also likely to attract large capital inflows due to an improved risk perception. Authorities face the challenge of maximizing the return on large, potentially volatile capital flows, and on this regard structural policies aimed at boosting productivity will be helpful. For its part, the *Banco de la República* will maintain a flexible exchange rate but accelerate the accumulation of international reserves to counter a higher probability of misalignment of the exchange rate, help curb the risks of the recent slowdown of the global economy, and aid the current Colombian expansionary monetary policy.

Recent free trade agreements (FTA) with the United States, Colombia's largest trading partner with 38% of exports, and South Korea, are welcome measures to strengthen competitiveness in tradable sectors other than mining and oil. The FTA with South Korea will deepen the insertion of Colombia into the Asian market, which could promote a positive correlation between commodity prices and demand for Colombian agriculture and manufacturing exports, and in turn would help reduce the negative consequences of fluctuations in commodity prices on tradable sectors different from energy-mining. In addition, Colombia has signed free trade agreements with other countries in the Americas and a FTA with the European Union is close to ratification.

While the unemployment rate has declined in Colombia, it remains high for Latin American standards, and a high proportion of the Colombian work force lies in informal, often low-productivity jobs. The Ministry of Finance proposed a tax reform that was approved by Congress in December of 2012, which seeks to increase revenue while decreasing the effective cost of hiring labor, and to allow for a more efficient and progressive system.

Colombia is in the process of implementing a modern macro-prudential regulation aimed at fostering financial deepening and introducing valuable financial products while preventing undue leveraging or risk. On this regard, it is worth mentioning the timely introduction of countercyclical provisions for commercial and consumer credit ahead of the international financial crisis. In addition, a liquidity requirement similar to the one proposed by Basel III was implemented in 2009. Most recently, capital requirements matching the standard suggested by Basel III were introduced to be complied by banks in August this year. These measures are essential to increase the resilience of the banking sector and help consolidate the system. As a matter of fact, Colombian banks are now expanding abroad following important investments in Central America by some financial groups.

Looking ahead new challenges arise. Financial supervision must adapt to a growing financial system. In particular, it will be necessary to extend full supervisory and regulatory powers to holding companies of financial institutions, strengthen supervision of broker-dealers and collective investment schemes and of Colombian banks that have branches abroad. Banking penetration must also increase.

5. Conclusion

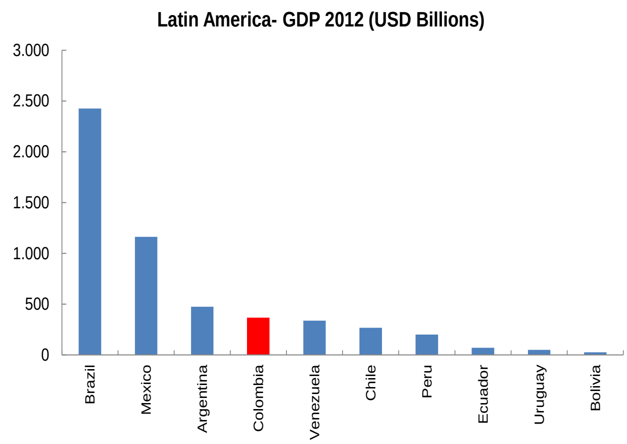
The mid-term outlook for the Colombian economy looks promising. As I explained previously, this favorable perspective is due in part to a permanently greater demand for commodities and high commodity prices, as well as the expansion of the mining and energy sectors in Colombia. But the significant improvements in the macroeconomic framework have also been fundamental, as well as the continuous insertion of Colombia into the world economy and the strengthening of our institutions.

Authorities face two key policy challenges to ensure sustainable and inclusive growth in the medium-term: adjusting to an always evolving commodity boom and boosting productivity growth. As part of the strategy to confront these challenges properly, Colombia has devised an adequate macroeconomic policy framework. Specifically, monetary policy is based on an inflation-targeting regime, which anchors inflation expectations and helps smooth the economic cycle. This is coupled with a floating exchange rate policy that also plays a stabilizing role for the economy and a sound banking sector.

The adoption of a fiscal rule contribute to the exercise of a countercyclical macroeconomic policy, while the royalty distribution law help save a portion of oil revenues and ensure a fairer and more efficient distribution system. This will reduce the impact of rising oil revenue on domestic demand as well as on inflation and on the exchange rate.

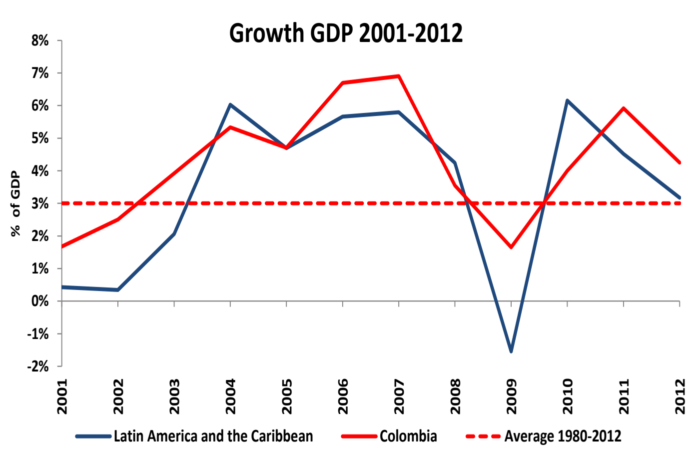
APÉNDICE

Figure 1



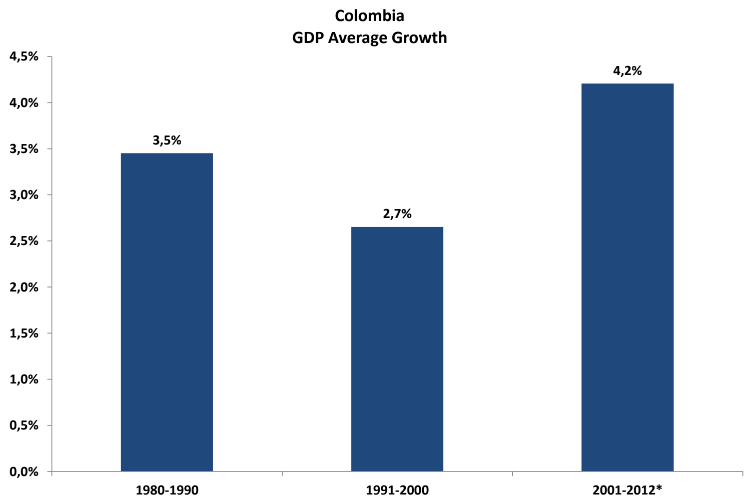
Source: IMF-WEO October 2012

Figure 2



Source: DANE and IMF

Figure 3



Source: DANE and Banco de la República (IV quarter of 2012* estimated)

Figure 4

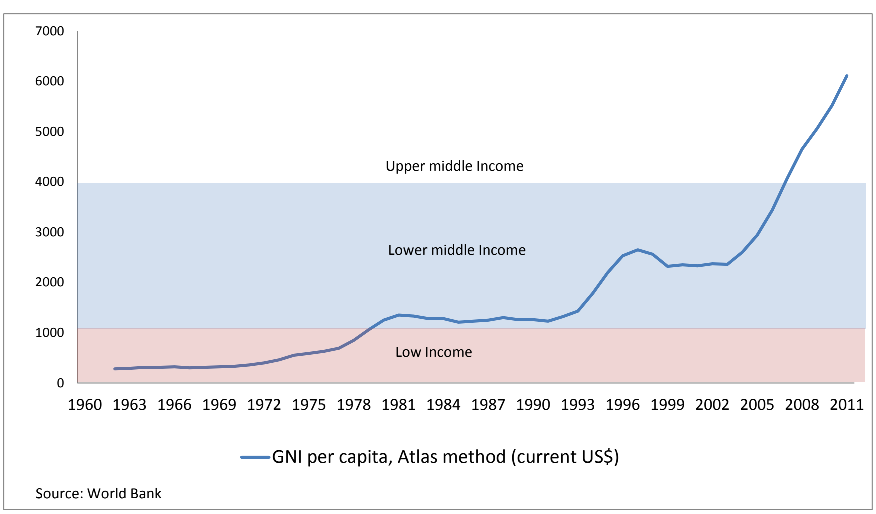
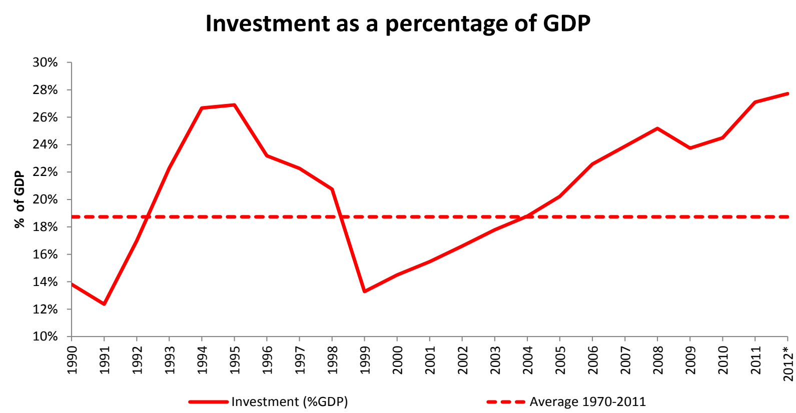
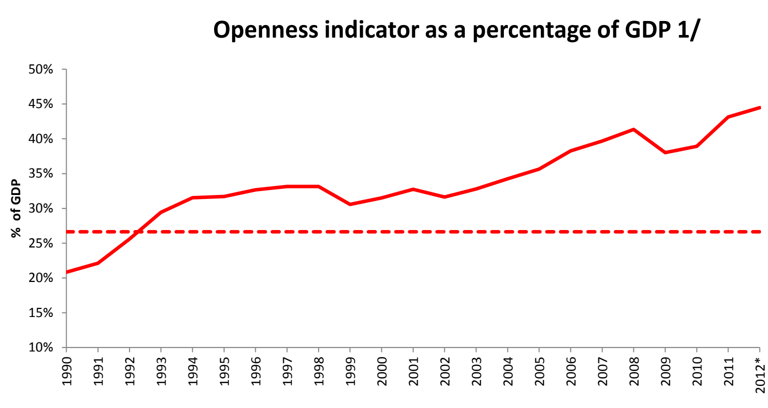


Figure 5



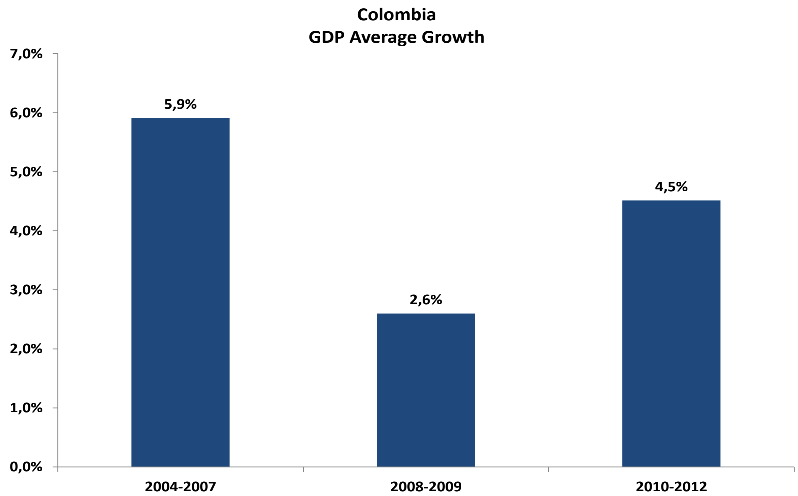
Source: DANE and Banco de la República's calculations.
* Data for 2012 corresponds to the sum of the first three quarters of the year.

Figure 6



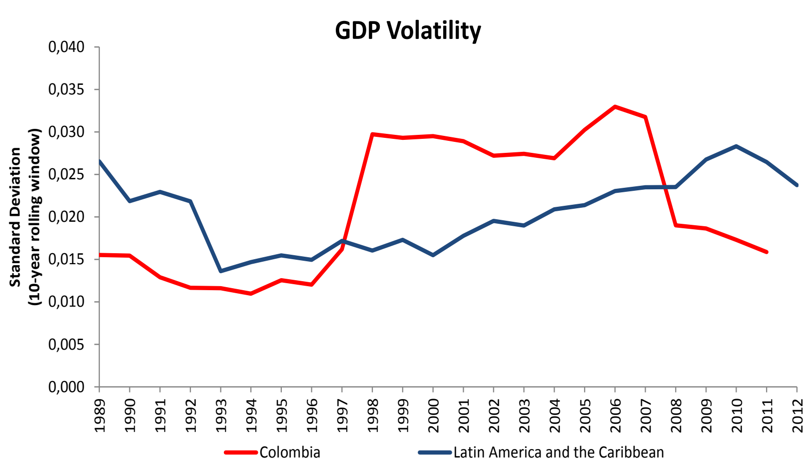
Source: DANE and Banco de la República's calculations.
1/ (Imports + Exports)/GDP.

Figure 7



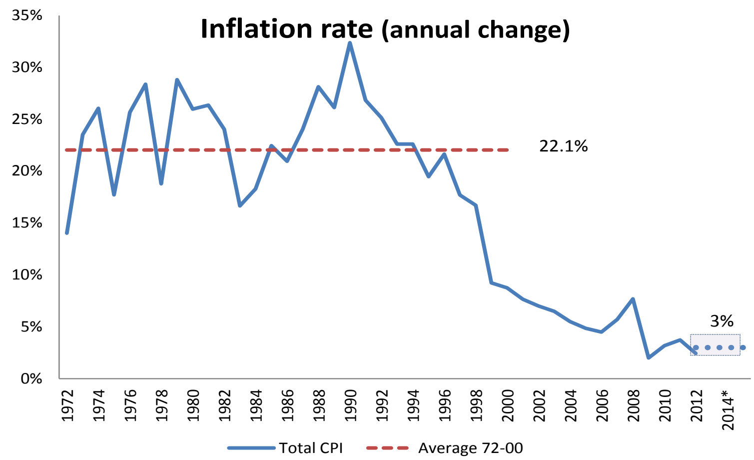
Source: DANE and Banco de la República (projections for IV quarter of 2012)

Figure 8



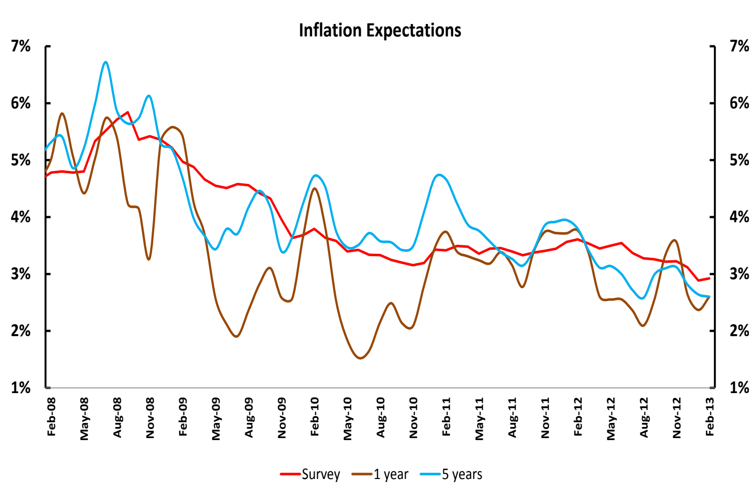
Source: Banco de la República and IMF

Figure 9



Source: DANE. *Projected

Figure 10



Source: MEC, SEN and Banco de la República

Figure 11

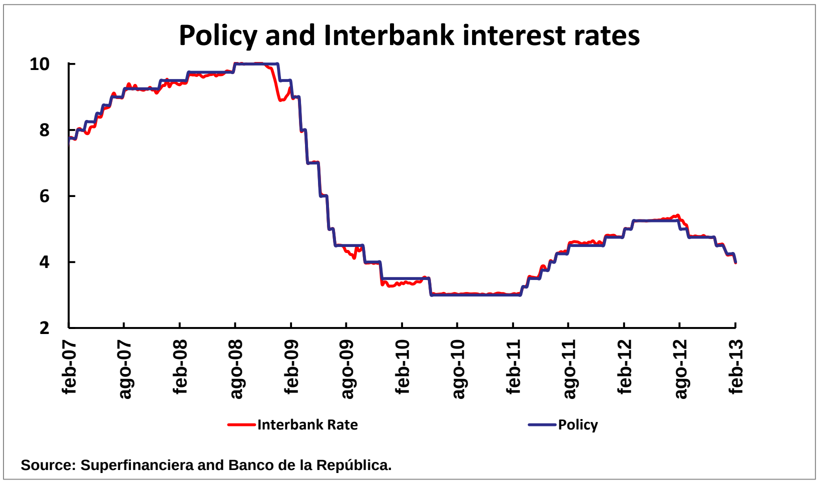
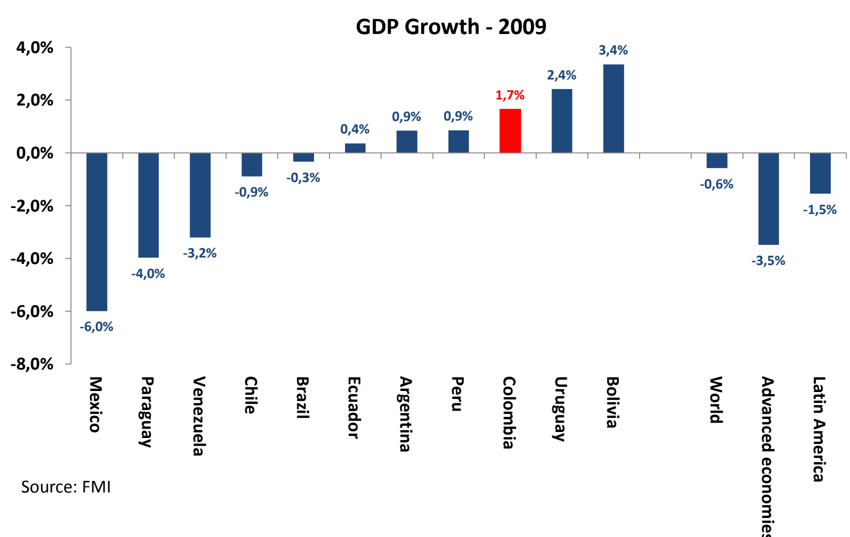
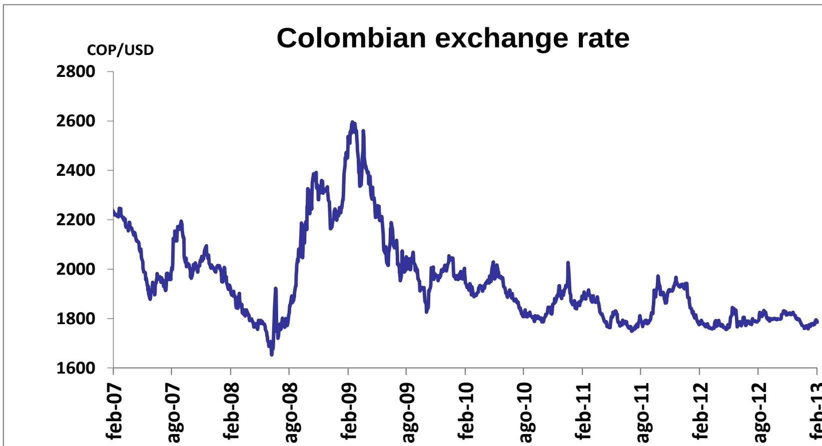


Figure 12



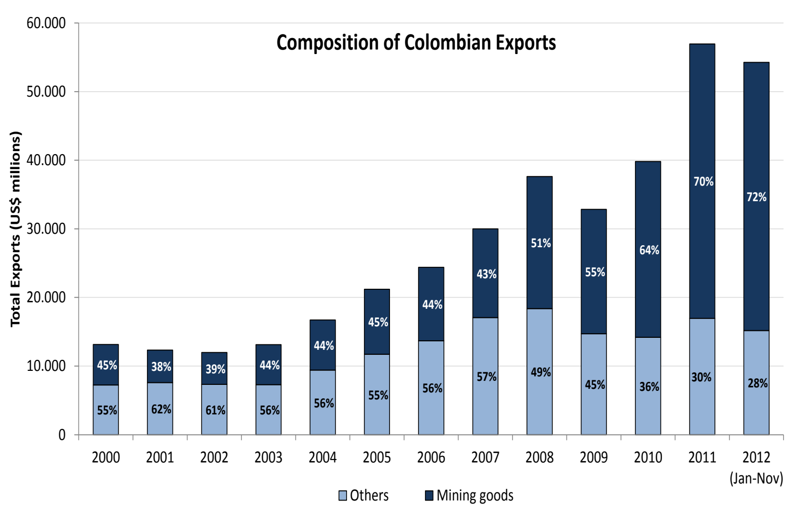
Source: FMI

Figure 13



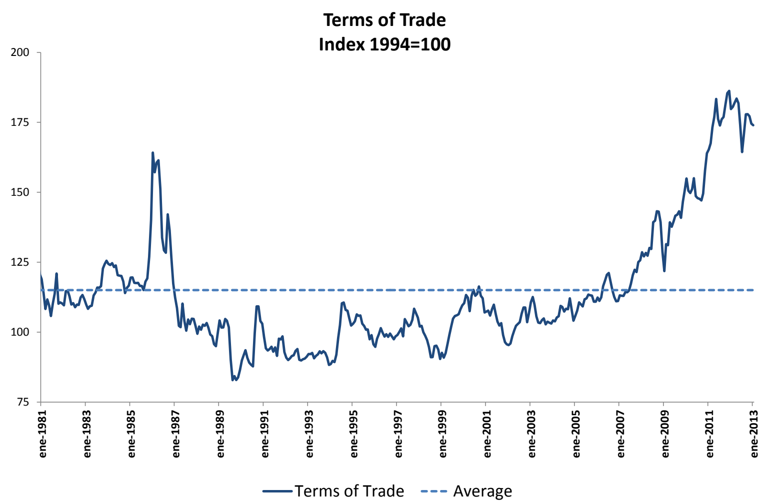
Source: Banco de la República.

Figure 14



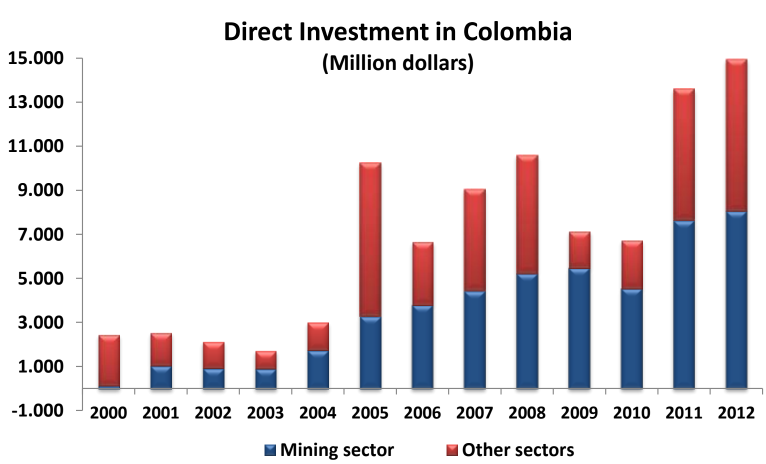
Source: DANE - DIAN

Figure 15



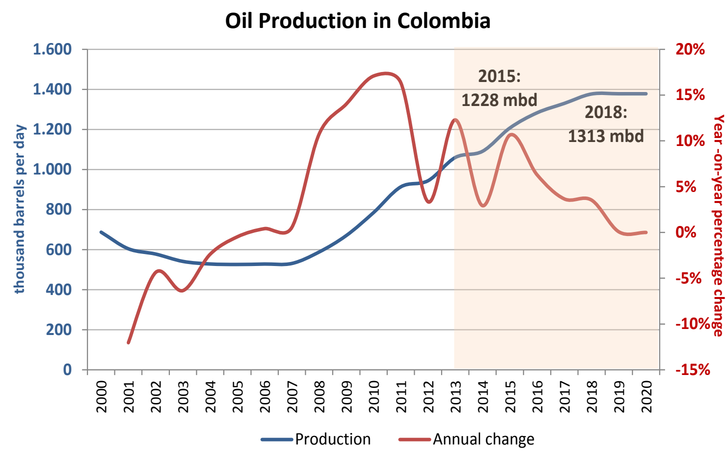
Source: Banco de la República.

Figure 16



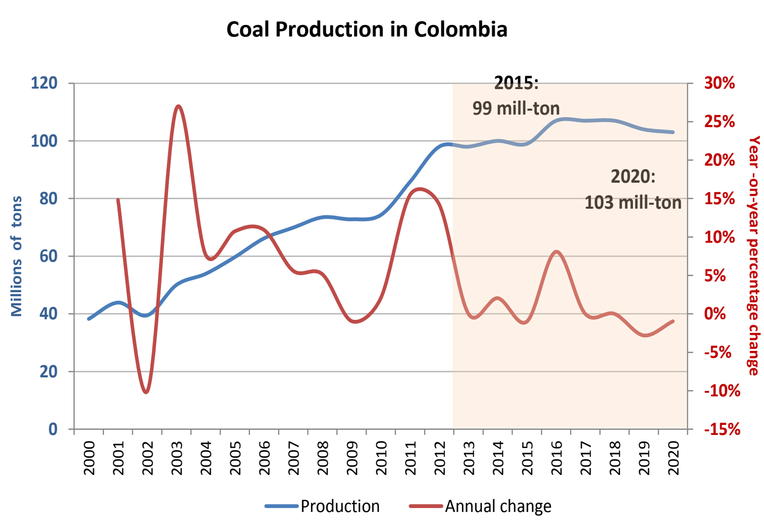
Source: Banco de la República (projectios for 2012)

Figure 17



Source: Medium Term Fiscal Framework 2012. Ministerio de Hacienda y Crédito Público.

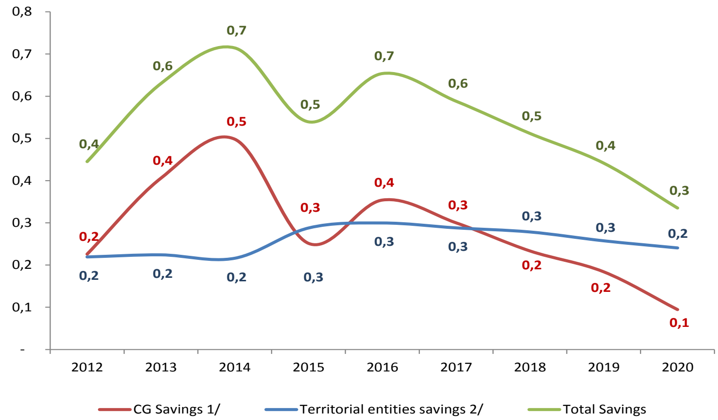
Figure 18



Source: Medium Term Fiscal Framework 2012. Ministerio de Hacienda y Crédito Público.

Figure 19

Expected savings from energy sector (% GDP)

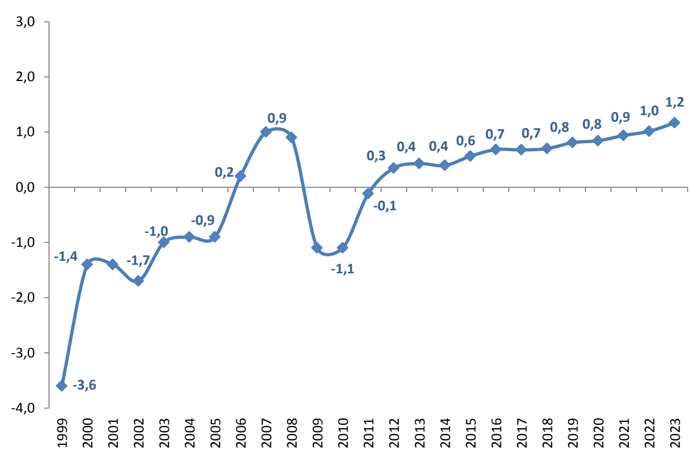


Source: Medium Term Fiscal Framework 2012. Ministerio de Hacienda y Crédito Público.

1/ Savings generated by the fiscal rule
2/ Saving and stabilization fund - FAE

Figure 20

Central Government Primary Balance 1/ (% GDP)



Source: Medium Term Fiscal Framework 2012. Ministerio de Hacienda y Crédito Público.

1/ Excludes the costs of financial restructuring.