COLOMBIA:
STRONG POLICY FRAMEWORK, RESILIENCE AND GROWTH UNDER NEW EXTERNAL CONDITIONS

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The Colombian economy performed remarkably well in the last decade, both in terms of its own history and with respect to other economies in the region. Per-capita GDP grew 3.5% between 2004 and 2014, which is higher than in the previous four decades. At the same time, the economy confronted the Global Financial Crisis better than other strong external shocks in the past. It managed to grow 1.7% in 2009, a year in which several advanced and emerging economies experienced contractions or nil growth, and recovered fast thereafter.

This positive outcome was the result of a combination of both favorable external conditions and marked improvements in the policy framework. A long period of high and rising commodity prices, especially oil prices, rendered strong increases in the terms of trade and national income as well as large inflows of FDI. The latter was also encouraged by ample international liquidity, low external interest rates, and compressed risk premia. Consequently, FDI more than financed the country's savings-investment gap for several years and it flowed not only to the oil and mining sectors, but also to banking, retail and communications.

The policy framework has been strengthened since 1999, making each of its three pillars—fiscal, monetary and financial policy—more robust. Reforms to the pension system and the regional transfer regime, the establishment of a Medium Term Fiscal Framework and a Fiscal Rule, and a scheme for royalty savings and distribution contributed to ensuring the sustainability of public finances. The adoption of a full-fledged inflation-targeting regime was instrumental in the achievement of a credible 3% long-term inflation target. Strong, preventive financial regulation helped enhance the solvency and liquidity of the financial system. Moreover, market and credit risk buildup was contained in a timely fashion while currency and FX term mismatches were controlled by means of appropriate regulation and the flexibility of the exchange rate. External liquidity was maintained through reserve accumulation and access to the IMF's FCL.

These improvements were essential for at least three reasons. First, by focusing on the long-term stability of the currency, the public finances, and the financial system, they enhanced the credibility of the overall policy framework and contributed to the substantial rise in the investment ratio and FDI flows Colombia has experienced since 2004. As such, they were instrumental in the achievement of higher growth rates. Second, by design, they limited the formation of expenditure and financial excesses in the economy and contributed to building buffers to be used in bad times. And third, as a consequence of greater credibility, they allowed the adoption of countercyclical policy responses to external shocks. This partly explains the relatively positive performance of the Colombian economy during the Global Financial Crisis low point in 2009.

The external conditions that supported the success of the Colombian economy in the last decade started to change last year. Oil prices have dropped dramatically since July 2014 and the expectation of monetary policy normalization in the US has slowed down capital inflows in 2015. The oil price shock affects the economy in various ways. It represents a significant deterioration in the terms of trade and a decrease in national income. It also implies a substantial reduction of FDI in the oil sector and lower demand for Colombian non-oil exports to neighboring oil-dependent markets. All this is occurring at the same time as the possibility rises that external financial conditions may tighten with the expected and effective changes in US monetary policy.

These shifts in the external environment are likely to be persistent. Thus, the drop in national income requires a corresponding adjustment in expenditure which will take place through the fall in fixed capital investment and FDI in the oil and mining sectors, the deterioration of confidence in some areas, and either tax increases or government expenditure cuts, or both. Simultaneously, a real depreciation is necessary as part of the adjustment of the external position of the country to new conditions.

The design and operation of our policy framework requires the authorities to acknowledge that the above-mentioned external shocks are persistent and react accordingly in order to guarantee the external, financial, and nominal stability of the economy. For example, explicit assumptions on future oil prices are key parameters in the Fiscal Rule. Based on this framework, the Central Government increased taxes and cut expenditures in 2015 in order to cope with lower oil-related revenues.

Similarly, the Inflation Targeting Strategy requires informed assumptions on the future paths of crucial exogenous variables including oil prices and the external interest rates. Hence, the definition of the stance of monetary policy takes into account the required adjustment in domestic demand in response to the income shock as well as the evidence on the anchoring of inflation and inflation expectations to the 3% inflation target. The specific monetary policy response to the current shocks will, therefore, depend on whether the slowdown of the economy exceeds or falls short of the required long-term adjustment of aggregate expenditure, and on whether inflation and inflation expectations remain anchored to the target.

In general, authorities are aware that a temporary reduction in expenditure and output growth must be accepted and should not be offset by policy actions. They also acknowledge that a long-lasting lower level of the real exchange rate is part of the new macroeconomic equilibrium, a feature that is easily obtained in our flexible exchange rate regime through nominal exchange rate devaluation of the peso. Both the expenditure and exchange rate adjustments are necessary for a correction of the current account deficit and the sustainability of the external position of the country.

The adjustment of the Colombian economy to the above-mentioned changes has been smooth. The economy went from operating above its productive capacity before the oil shock to doing so slightly below its potential. The latest available data shows slower growth of imports, consistent with the weakening of domestic demand and the real depreciation of the peso. Levels of consumer and producer confidence remain close to the average for the past decade and national and international analysts' GDP growth projections for 2015 are between 3% and 3.6%, which is below the average growth of the last 10 years but significantly above the average for the region.

The Colombian economy has adapted well to the new external environment partly due to the strength of the financial system. The real exchange rate movement is taking place without any deterioration of financial stability thanks to the absence of significant currency and FX liquidity mismatches. Likewise, the reduction in output growth should not entail a significant threat to the solvency or liquidity of the banks given the strong financial position of the intermediaries and the absence of over-leveraged households or firms.

Looking forward, even in a world of lower oil and commodity prices, higher growth will be restored in the Colombian economy thanks to the effects of expected important developments. First, the outcome of the peace process will enhance total factor productivity and capital accumulation, especially in rural areas.

Second, we expect an ambitious infrastructure program to be accomplished. This has been promoted by improvements in project selection criteria, contract design, and appropriate risk sharing between the public and private sectors. As oil sector investment declines, infrastructure investment will be strengthened, thus supporting aggregate demand during the construction phase and augmenting the economy's supply capacity in the long run.

Third, the sectoral shift in production and consumption stemming from the adjustment in the real exchange rate will be positive. As is well known, the decline in the local currency helps the adjustment to new external conditions by offering a price incentive to substitute towards domestically produced goods and services and increases the purchasing power of foreigners over local capital and labor.

There are complementarities between these three factors. For example, agriculture, a tradable sector, will benefit from the peace process, a more depreciated exchange rate, and better transportation from/to input and output markets. The same applies to manufacturing, a tradable sector that strongly increased productivity and lowered costs during the long period of real exchange rate appreciation of the peso.

Reaping these benefits will be possible by maintaining our strong policy framework. Higher investment in the tradable sectors requires the confidence provided by the credibility in macroeconomic policy that served us well in the past decade. The fiscal pressures and risks arising from infrastructure development and the peace process should be embedded in the Medium Term Fiscal Framework and the Fiscal Rule. The financial structuring of infrastructure projects is being carefully studied so that no undue exposures are imposed on domestic financial intermediaries. Furthermore, monetary policy is offering moderate support to demand as the Colombian economy moves slightly below the conventional estimates of "potential" output.

Over the longer term, productivity and growth will be enhanced by policies applied today to increase competition and capital accumulation. Competition promotes innovation, entrepreneurship, and efficiency. Human and physical capital accumulation, including investment in infrastructure, increases the productive capacity of the economy. Further advances will be possible when the country tackles the barriers to adequate functioning of factor markets and when it undertakes additional efforts to heighten its participation in the world economy.

In sum, the Colombian economy showed a strong performance in the last decade owing to favorable terms of trade, ample access to external finance and marked improvements to the overall policy framework. External conditions have become less benign for what seems likely to be a protracted period of time. The economy is adjusting to these new conditions thanks to the absence of large expenditure or financial imbalances, which were prevented by the operation of the policy framework. The latter will also ensure that strong growth will resume in the wake of fundamental transformations in Colombia as a result of the peace process, the improvement in physical infrastructure, the response of non-oil tradable sectors, and the long-term effects of progress in public policies focused on competition and human and physical capital accumulation, among others.