

SM/07/397
Correction 2

January 22, 2008

To: Members of the Executive Board
From: The Secretary
Subject: **Colombia—Staff Report for the 2007 Article IV Consultation**

The attached corrections to SM/07/397 (12/26/07) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 7, second bullet, line 1: for “In early May” read “In May”

Page 25, para. 38, lines 3 and 4: for “entry for foreign banks and insurance companies”
read “the insurance sector”

Questions may be referred to Mr. Clements (ext. 36950) and Mr. Abrego (ext. 38754) in WHD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

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Department Heads

3. Strong capital inflows intensified pressures for currency appreciation in the first half of 2007, which the authorities tried to resist with heavy foreign exchange (FX) intervention and capital controls.

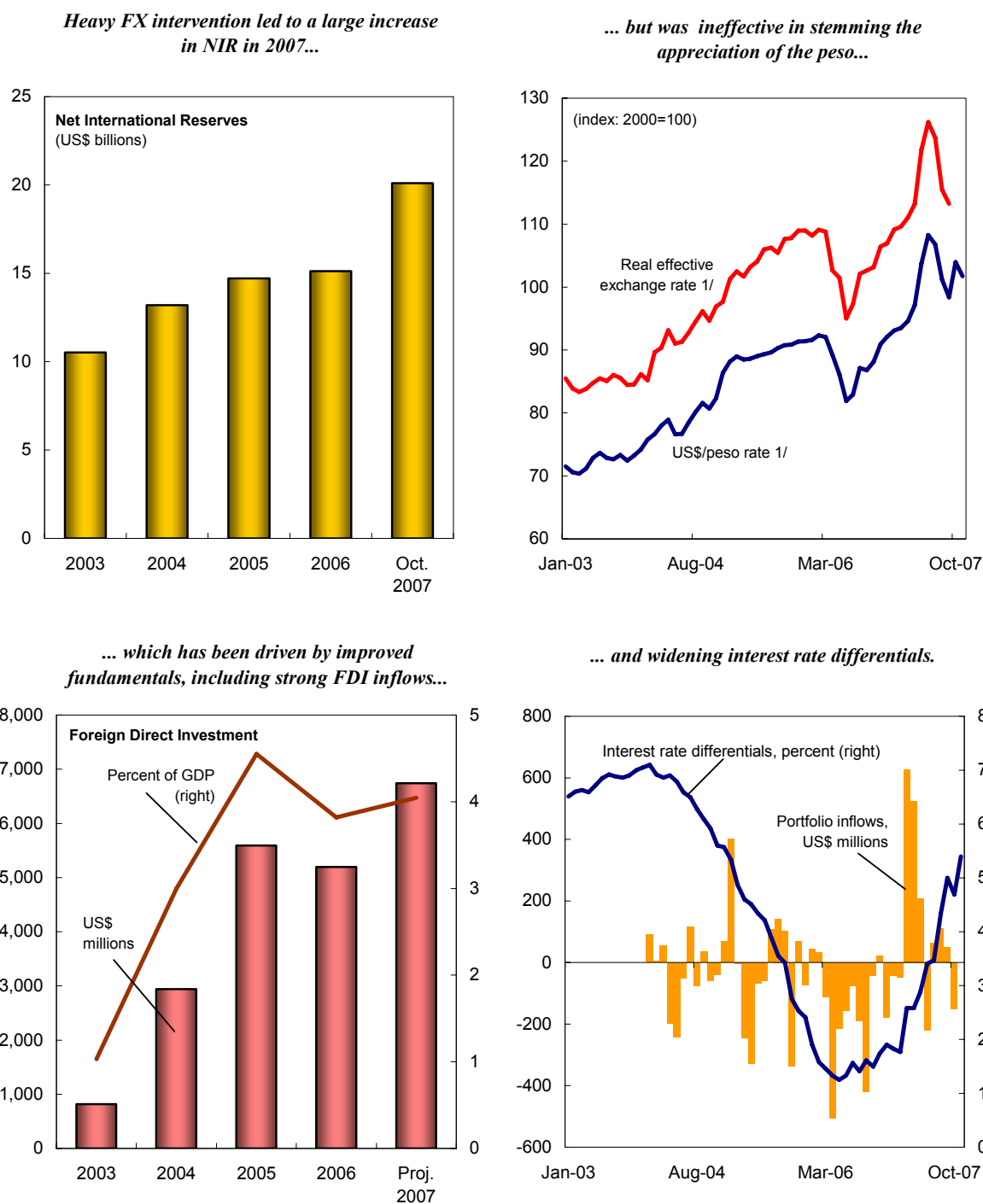
- The nominal exchange rate vis-à-vis the U.S. dollar, and the real effective rate, appreciated sharply in the first half of the year (Figure 4). The authorities attempted to alleviate these pressures during January–April with sterilized intervention amounting to US\$4.5 billion (38 percent of base money). Since end-April, however, the BdR has not intervened, indicating that sterilized foreign currency purchases had become more difficult over time, and that continued intervention would have compromised achieving its inflation objectives.¹
- In ~~early~~ May, capital controls were implemented with an unremunerated reserve requirement (URR) of 40 percent on external borrowing and portfolio inflows. To limit inflows seeking to take advantage of interest rate differentials, a ceiling on banks' gross positions in derivative markets was also imposed. Capital inflows have slowed, although this also reflected other developments. Capital controls were relaxed somewhat in mid-December.

4. Monetary policy has aimed to restrain strong demand growth and contain rising inflation, while the fiscal stance has been neutral. The BdR has raised its policy interest rate to 9½ percent (a 350 basis point increase since April 2006). With lending rates and credit growth showing little response to monetary tightening through early 2007, and inflation still high, the BdR also imposed an unremunerated reserve requirement on new deposits in May. For the central government, the fiscal deficit is projected to decline in 2007, and the primary structural balance is expected to improve. For the nonfinancial public sector (NFPS), however, the primary structural balance is projected to remain broadly unchanged following a weakening in 2006 (Figure 5).

5. Overheating pressures are expected to ease in the wake of monetary tightening. Reflecting in part the new unremunerated reserve requirement, lending rates have risen sharply since mid-2007 and are at 6-year highs in real terms. For the second half of the year, the economy is projected to expand at about 5 percent. There are already incipient signs of a slowdown in the second quarter, particularly in construction. Third quarter figures on industrial production also suggest an easing of the pace of activity.

¹ Chapter 3 of the Selected Issues paper concludes that discretionary intervention in 2007 had no lasting effect on the exchange rate, owing in part to market expectations that monetary policy would remain committed to reducing inflation.

Figure 4. Colombia: Exchange Rate Developments



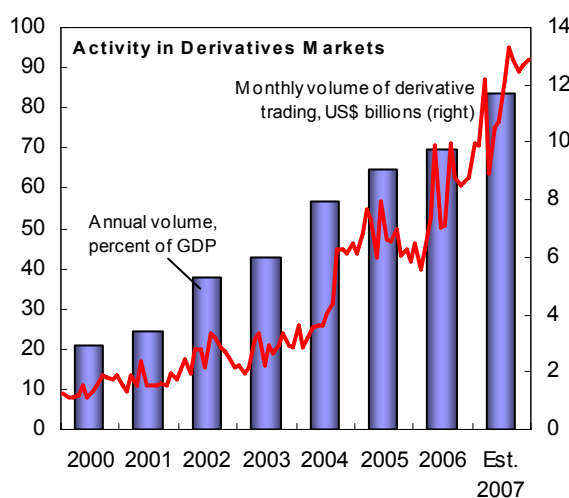
Sources: Banco de la República; Information Notice System; and Fund staff estimates and projections.

1/ An increase denotes appreciation.

37. **The staff welcomed the authorities' plans to strengthen further their capacity for risk-based supervision.** The planned sequencing of reforms—to invest substantially in training before implementing the Basel II risk-based supervisory framework—is appropriate. The new risk-based framework is being implemented gradually, with banks now being allowed to submit their credit risk models for commercial loans this year, while consumer credit and mortgage-based models would be eligible for submission in 2008 and 2009, respectively.

38. **The authorities are undertaking important reforms to develop the financial system.** The government's proposed financial sector reform would help promote universal banking, develop the pension system, and further liberalize ~~entry for foreign banks and the~~ insurance ~~companies~~ sector. The staff viewed steps to strengthen the independence of the Financial Superintendent—by providing a fixed-term appointment—as among the most important of the proposed reforms. It welcomed the proposal to explicitly delineate a narrow set of conditions under which the Superintendent could be dismissed, which would be essential for ensuring independence. Staff suggested that the fixed term might also be designed so as to overlap with the presidential term, further increasing the autonomy of the Superintendent. Looking forward, it would also be useful to broaden financial sector reform by including steps to strengthen creditor rights.

39. **The government's intention to improve the framework for the regulation and supervision of derivatives markets is appropriate.** The derivatives market has grown briskly in recent years, and these instruments have played a key role as a conduit for carry trade. The Banco de la República, Financial Superintendency, and Ministry of Finance are carefully examining the recommendations of the recent IMF technical assistance mission and planning to incorporate many of them into the revised regulations. The staff noted that further cooperation across these three institutions will be necessary to make further progress in this area.



40. **Colombia maintains two exchange measures subject to Article VIII.⁹** An exchange restriction and multiple currency practice arise from a tax on remittances abroad of nonresident profits earned before 2007 and retained in the country for less than five years. The Board has approved the retention of this restriction and multiple currency practice until

⁹ See Appendix I.

January 15, 2009. Colombia also maintains an exchange restriction arising from the special regime for the hydrocarbons sector.

IV. STAFF APPRAISAL

41. **Supported by sound economic policies, Colombia's economic performance has been strong.** The economic reforms adopted since 1999 have helped to increase private investment, raise economic growth, and reduce inflation, while strengthening the public finances and the financial system. Provided that sound policies are maintained, Colombia's medium-term prospects are favorable, with solid economic growth in the context of low inflation, external stability, and declining public debt ratios.

42. **Rapid economic growth in 2006–07 has, however, led to overheating pressures.** The authorities have relied on monetary policy to address these pressures, with fiscal policy being broadly neutral in 2007, following some easing the previous year. While inflation has declined from its peak of 6¼ percent in April 2007, staff project it would close 2007 at some 5¼ percent, outside the Banco de la República's target of 3½–4½ percent. The current account deficit is forecast to double to 4 percent of GDP, one of the highest in the region.

43. **The near-term macroeconomic outlook is positive, although important risks remain.** As the effects of monetary tightening are fully realized, growth is expected to ease to a more sustainable rate in 2008, contributing to a decline in inflation. The current account deficit, however, is projected to rise to almost 5 percent of GDP, partly because of a temporary spike in security-related imports. The uncertain global environment poses an important risk to the outlook in the near term. There are also important domestic risks, as a slower-than-expected response of domestic demand to monetary tightening could lead to continued inflationary pressures.

44. **A tighter fiscal policy stance could help alleviate overheating pressures and diminish some of these risks.** The 2008 budget implies an expansionary fiscal stance in 2008, with the primary structural balance deteriorating by 1 percentage point of GDP. A tighter fiscal stance would help reduce excess demand pressures and lower the current account deficit, while easing the burden on monetary policy for demand management. At the same time, it would help to reduce public debt more rapidly and build Colombia's resilience to shocks, and improve prospects for achieving the government's goal of recovering investment grade status.

45. **Colombia's flexible exchange rate regime is consistent with the maintenance of external stability.** The recent appreciation of the peso has been driven largely by increased confidence and stronger economic fundamentals, and the real exchange rate is close to its equilibrium level. The rising external current account deficit has largely reflected the cyclical position of the economy. With prudent demand management policies in place, excess demand pressures are expected to ease and the actual current account deficit to decline gradually toward its estimated equilibrium level of about 2½–3 percent of GDP. Going