Development Challenges in Colombia

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Medium-Term Economic and Social Trends

Prudent management of monetary and fiscal policies over the last decade has allowed for stable growth and an environment favorable to private investment. In fiscal matters, rules established in 2012 should help to reduce procyclical behavior, smooth spending and limit fiscal deficits leading to a sustainable debt profile and acyclical fiscal policy. In monetary matters, since 2001 the Colombian central bank (*Banco de la República*) has implemented a scheme of inflation targets that has achieved low and stable inflation rates. Despite oil price volatility, external conditions helped drive investment and growth. The terms of trade improved by 50% between 2006 and 2014, driven by price increases in oil and minerals. Capital flows (foreign direct investment and portfolio) grew substantially, from US$3.9 billion in 2000 to US$35 billion in 2014. At the same time, urban and rural security improved. The combination of these elements made greater investment one of the main drivers of growth.

Thus, prior to the fall in oil prices, the Colombian economy grew at an average rate of 4.2% between 2008 and 2014. On the supply side, except for extractive industries, it was the non-tradable sector that supported GDP growth. Construction, financial activity, and commerce stand out as the main drivers. On the demand side, household consumption and investment showed the strongest growth.

Since the oil price shock, the Colombian economy has been gravitating towards a new macroeconomic equilibrium with weaker growth. In 2015, the fiscal deficit began to increase (although spending also began to adjust and tax collection improved) as the exchange rate depreciated sharply. The latter, together with food price shocks, led to an increase in the inflation rate, forcing the Banco de la República to adopt tighter monetary policy. Contractionary policies along with the external shocks impacted the level of economic activity, with GDP growth gradually falling from 4.6% per annum in 2014 to 1.8% in 2017. In turn, real depreciation between 2014 and 2016 and the performance of domestic demand have facilitated improvements in the external accounts since 2016. In this context, the labor market and the financial system have been resilient to deterioration in economic activity, rising inflation and exchange rate depreciation.

Social indicators also displayed positive progress over the last 10 years. Colombia has traditionally been a country with very low social mobility. Over the last decade, however, there has been a major shift away from poverty in favor of a marked increase in the middle class. In the period 2008-2017 unemployment fell from 11.3% to 9.4%. Inequality, as measured by the Gini coefficient, improved marginally from 0.57 to 0.52 in the period 2008-2016. At the same time, poverty declined from 42% in 2008 to 28% in 2016, while extreme poverty halved in that period, falling to 8.5% in 2016. According to IDB estimations, the middle class rose from 44% to 67% between 2006 and 2016, although around 60% of the middle class remains in a vulnerable situation. Most of these advances took place during the period of rising oil prices.[1] Ongoing challenges but include the lack of formal employment, shortcomings in education, and insufficient pension system coverage.

[1] Obando Rozo and Andrián (2016) show that the income effect accounts for more than 90% of the fall in moderate and extreme poverty in the period 2002-2013.

Medium-Term Economic and Social Outlook

The medium-term outlook is positive for Colombia, though with more moderate growth rates than the ones observed between 2008 and 2014. In a scenario of peace, private and official projections foresee economic recovery, with GDP growing at 2.6% in 2018 and gradually reaching 3.5% in 2022. The main drivers of this anticipated recovery are domestic demand through the expansion of private investment, increased household consumption and infrastructure construction. The implementation of the PPP-based Fourth Generation Road Concessions Program (4G) plays a particularly important role in this regard. Oil prices of around US$60 per barrel will help sustain the pace of growth and close fiscal and external deficits. In turn, inflation is projected to be in the target range (2-4%), giving Banco de la República space to support growth.

Under the baseline scenario, external and fiscal imbalances are expected to close in the medium term. On the fiscal front, the government plans to meet the medium-term goal imposed by fiscal rules through the gradual reduction of the fiscal deficit from 3.1% of GDP in 2018 to 1% of GDP in 2022. On the external front, the current account deficit would converge by 2022 to its historical average of 3% of GDP, where the reduction of imports, the increase in exports and workers' remittances will be the determining factors.

Without reforms or measures to address vulnerabilities affecting Colombian citizens, the pace of improvement in social indicators will mainly follow macroeconomic fluctuations. For example, Obando Rozo and Andrián (2016) show that more than 90% of poverty reduction between 2002 and 2013 is explained by economic growth. Without public policies that improve the social safety net (pensions, unemployment insurance, education, among others), poverty reduction and the strengthening of the middle class will continue to depend on good economic performance.

Risk Factors

The external environment and the fiscal outlook are the main sources of uncertainty. In the short and medium term, risk factors for Colombia include i) Venezuela's social and economic crisis; ii) the instability of oil prices that affects fiscal and external accounts, and the worsening of external financial conditions; and iii) uncertainty related to the electoral process approaching in the first half of 2018. First, Venezuela's deep crisis had caused approximately 550,000 Venezuelan citizens to migrate to the country by December 2017, according to the Colombian customs agency *Migración Colombia*. Because of this, the Colombian government took a series of measures to control the excessive movement of people to Colombia. In addition, mass migration may place a burden upon the public health system. Second, uncertainty regarding oil prices means that actions must be taken to mitigate potential adverse effects. The sharp fall in oil prices in 2014 affected Colombia more than peer countries in the region. Measures including structural tax reform had to be taken to correct the fiscal imbalance caused by the loss of oil revenues. Also, an increase in the cost of borrowing can undermine the path of reducing fiscal and external deficits, forcing the economy to make severe adjustments. Finally, it is important to highlight that policy changes in the short term will be fundamental for credit stability, since they determine to a large extent whether rating firms will maintain the country's investment grade status. The new government's position on the fiscal rule and pension reform will be of great relevance to these issues.

Development Challenges

The most important development challenges for Colombia are i) how to increase productivity; ii) how to strengthen public institutions; and iii) how to strengthen social mobility.[2]

In the last decade the contribution of total factor productivity to GDP growth has been almost zero. Several factors related to low productivity have to do with workforce characteristics, the degree of development and depth of the financial sector, and informality. Other underlying causes of this phenomenon are social exclusion and inequality (which directly affect the development of human capital), infrastructure, climate change, institutional and policy frameworks and insecurity in some regions. Measures to address these problems may include i) stimulating innovation and entrepreneurial and agricultural development; ii) improving the quality of education and giving priority to the most vulnerable population; and iii) raising the quality of infrastructure to reduce transaction and transport costs of the economy.

Public institutions present challenges in terms of spending efficiency and scarce resources to finance public goods. Colombia has relatively low capacity for the execution of public spending as well as challenges to ensure high quality in investment and the provision of public services. In the World Economic Forum's index of government efficiency (World Economic Forum, 2017), Colombia is below the average of LAC-5[3] and other developing countries. Factors explaining this low efficiency include i) institutional weaknesses; ii) civil service management problems; and iii) limited accountability mechanisms. Taxes collected by Colombia's central government in recent years as a percentage of GDP amount to 15%, and those collected by sub-national governments amount to an additional 2 to 3%. Colombia had 13.5 GDP percentage points less in tax revenue than the OECD average (34.3% of GDP) in 2015. Tax evasion is one of the main problems with Colombia's tax structure, and is estimated at 4% of GDP when accounting for income tax and value-added tax (VAT). The 2016 structural tax reform is aiming to increase tax revenues and reach the fiscal rule deficit targets. The government increased the VAT rate and taxed dividends to raise revenue, and it allowed a partial discount of VAT on the purchase of capital goods and a reduction in corporate income tax rate in order to encourage investment. However, the financial transaction tax was maintained, and exemptions on income tax and VAT have not been reduced or eliminated, which keeps tax expenditure high.

Finally, social mobility is a major factor in underpinning development. The main social challenges stem from i) the reduction of moderate poverty and the elimination of extreme poverty, ii) high levels of business and labor informality, iii) the consolidation of a sustainable and inclusive pension system, and iv) access to quality basic services. While Colombia has made progress on reducing poverty and destitution, there is a high incidence of extreme poverty among the rural population. Extreme poverty stands at 8.5%. Some 16% of the extremely poor live in the 13 metropolitan areas, 35% in non-metropolitan urban areas and 49% in rural areas. The gap between urban and rural areas appears even deeper if other quality-of-life indicators are taken into account. For example, in 2016, household water connections reached only 17% in rural areas, compared to 94% in urban areas.

[2] This section is based on IDB (2015).
[3] Argentina, Brazil, Chile, Colombia and Peru.

Conclusion

Colombia has made significant social progress over the past decade, but there is still a long way to go. Colombia has significantly increased the size of its middle class, in turn raising domestic demand, while the vulnerable population has decreased and substantial improvements have been made in well-being and quality of life. Between 2010 and 2016, 4.3 million Colombians were lifted out of poverty. Improvements in formal employment and social security systems are an important sign of economic and social progress, as employment has both increased and shown resilience to the economic slowdown. Women's participation in the labor market has also increased.

Investment in infrastructure is expected to be an engine of economic growth in the short and medium term. Sustained growth is closely related to the state of infrastructure, physical connectivity and logistics services, and the government's efforts will be fundamental to increasing the public endowment for infrastructure, services and logistics. With an estimated investment of US$23.0 billion, the 4G Program foresees the execution of more than 30 concession projects, with the construction of nearly 7,000 km of roads, 1,200 km of which would be dual carriageway highways.

The solvency of the financial system and the commitment of institutions and government to fiscal and monetary policy has been effective. The financial system has proven to be resilient to currency depreciation and the slowdown in activity. Greater efforts to increase financial depth will provide further economic impetus. The commitment to fiscal rules has been a sign of credibility, and expenditure control has helped to steer the fiscal deficit adjustment towards the target of 1% of GDP by 2022. On the monetary policy side, the independence of the Banco de la República has been respected, and the management of monetary policy has served to control inflation and anchor expectations within the target range over the last two years. The flexible exchange rate regime has functioned as an automatic stabilizer against external shocks. It has allowed an adjustment on the external accounts by decreasing imports and promoting the industrial sector.

Finally, the prospect of sustainable peace offers the opportunity to reap social and economic dividends. Ending the armed confrontation with the FARC promises to advance security and human rights in Colombia. It is also expected to help curb drug trafficking. A Colombian government study estimated that achieving peace could boost annual GDP growth by up to 0.3% over the next ten years, thanks to related increases in foreign and domestic investment, consumption and the redistribution of resources from military spending to other sectors. Various business sectors could be expanded in remote regions, leading to much-needed rural job creation, infrastructure development and a boost to tourism.

References

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