Statement by Ms. Maria Angelica Arbelaez, Alternate Executive Director for Colombia
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On behalf of the Colombian authorities, I would like to thank staff and management for their continued support and the positive response to their request for a new Flexible Credit Line (FCL). I would also like to express the authorities' gratitude to the Board for the previous FCL arrangements approved for Colombia since 2009. Colombia belongs to a group of countries where special swap lines are not available, and regional liquidity arrangements do not provide adequate coverage. Consequently, the FCLs have been instrumental to cope with heightened external risks and commodity price shocks in recent years and have suited well the country's need for liquidity risk coverage in a highly uncertain environment.

The FCL arrangements have served as a complement to the wide range of policy responses based on maintaining exchange rate flexibility, adopting appropriate fiscal and monetary policies, and securing precautionary external funding through keeping an adequate level of international reserves. They have also signaled the strength of the economy and policy framework with positive impact on the markets.

The Colombian economy has been hard hit by the sharp decline in the terms of trade since 2014, weaker growth among trading partners—notably Venezuela and Ecuador—tighter and volatile financial conditions, and a severe weather-related supply shock. As a result of these coincident shocks, the Colombian peso depreciated significantly, the current account deficit widened as a percentage of GDP, the sovereign bond spreads rose, and inflation and fiscal pressures emerged. The authorities have responded by tightening monetary policy and undertaking fiscal adjustments in order to preserve macroeconomic and external stability while fostering confidence.

External shocks have also taken their toll on economic growth. Growth slowed down in 2015 to 3.1 percent, and the adjustment is expected to continue in 2016. However, the economy has shown resilience as the infrastructure agenda and the re-entrance into operation of the Cartagena oil refinery have partially offset the negative impact of shocks and policy responses. Looking ahead, and considering the new lower oil prices reality, the authorities have also adopted structural reforms to boost non-traditional exports that will contribute to the adjustment of the current account deficit, help transition to a more diversified growth model and sustain growth.

At the same time, significant external risks persist stemming from instability and higher volatility in global financial conditions, disorderly slowdown in China, rising vulnerabilities in emerging markets, further decline in oil prices and weaker growth in Colombian trading partners. Because of the presence of these downside risks, the authorities strongly believe that the FCL continues to be an important protection tool to support an orderly and smooth structural adjustment of the economy.

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Recent developments and policy responses

For the Colombian authorities the first line of defense against the outcomes of these shocks is a strong macroeconomic policy framework that provides resilience to the country. This framework rests on three pillars, namely: an inflation targeting regime with exchange rate flexibility; a sustainable fiscal policy; and a strong financial system.

Inflation targeting guides the conduct of monetary policy. As a result of the supply shock and the depreciation of the Colombian peso, inflation breached the upper bound of the target in 2015 (range of 2-4 percent) and continued to increase in 2016. In September 2015, the central bank started increasing the policy rate to contain temporary inflation pressures and anchor inflation expectations. Inflation is expected to return to the target range in 2017 as supply shocks recede and the pass-through from depreciation fades.

Exchange rate flexibility has been the main shock absorber and the peso depreciated strongly until early 2016. In October 2015 the central bank put in place an FX auction program aiming at mitigating excess volatility that has been recently discontinued. The current account deficit widened last year to 6.5 percent of GDP (although in nominal terms remains at the 2014 level), and is expected to narrow gradually as domestic absorption adjusts and expenditure switching effects take place. For 2016 the deficit is projected at 6 percent of GDP, comfortably financed by FDI and portfolio inflows, and to decline to around 4.3 percent in 2017.

The fiscal stance is well anchored by the fiscal rule whose compliance is a priority for the authorities. The shortfall of fiscal revenues that emerged from the drop in oil prices was absorbed through higher revenues and spending cuts. These adjustments have allowed the government to meet the headline deficit of 3 percent of GDP in 2015 and 3.6 percent of GDP in 2016, according to the fiscal rule targets. In order to continue complying with the fiscal rule, while preserving social and investment spending in the years to come, a structural tax reform will be submitted to Congress for approval no later than December 2016. Public debt remains sustainable and will decline gradually in accordance to fiscal rule targets.

The financial sector remains sound, liquid, profitable, well provisioned and capitalized, with sufficient buffers to cope with shocks. The authorities continue to push ahead with the reform agenda and are finalizing the implementation of the FSAP recommendations. They are also moving forward with the adoption of best practices in line with Basel III. In addition, since December 2015 the supervisor has the authority to request higher buffers (levels of capital and liquidity) for individual financial institutions that reveal higher risks. Finally, an important law that grants more power to regulate and supervise financial conglomerates is currently being discussed in Congress.

The authorities continue to closely monitor financial stability risks. Corporate debt has increased as well as that of households in line with deeper financial inclusion, but both

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remain low by international standards. In addition, the share of foreign currency denominated debt of corporate is low (1/3 of total debt) with no evidence of large currency mismatches. The regulation of foreign currency in banks' balance sheets is stringent, so their exposure and currency mismatches are contained. The Central Bank has recently tightened the regulation to limit currency mismatches and extended it to conglomerates, and has also imposed liquidity requirements at a consolidated level, all important steps to manage cross-border risks.

Request for FCL

Given the presence of heightened downside risks, the authorities strongly believe the FCL will continue to play a significant role in supporting a smooth adjustment of the economy. For this reason, they are cancelling the current arrangement and requesting a new two-year FCL with higher access.

Based on the quantification of the potential impact of the aforementioned shocks that would result in much larger financing needs than in previous arrangements, the authorities are requesting a new arrangement with an access of 8.2 billion SDR (400 percent of the quota). This access level would help cover an important part of financing needs in an adverse scenario, and the remaining would be absorbed through international reserves. The current level of reserves, although within adequate ranges, would fall short of absorbing the bulk of the impact of this tail event while maintaining reserves at a prudent level.

The new precautionary arrangement would complement our strategy to cope with global financial risks consisting of maintaining a solid institutional framework, good macroeconomic policies, floating exchange rate, improving our external position, and ensuring financial stability.

The authorities want to reiterate that they consider the FCL to be a temporary facility and its exit dependent on external conditions. Consistent with this, Colombia lowered the access in 2010, and since then it has remained almost half of the amount requested in 2009.

As mentioned in the formal request letter, they expect that as the growth transition in China progresses smoothly, investor concerns about stressed emerging market economies recede, and monetary policy normalizes in advanced countries, uncertainties will abate and associated commodity price and global financial risks will recede. They also expect the outlook for regional trading partners to improve gradually as they undergo adjustments to restore internal and external balance. With substantial reduction of some of the global risks affecting Colombia, they would intend to reduce access to Fund resources in any subsequent FCL arrangements, and to phase out Colombia's use of the facility. Successful adjustment to permanently lower oil prices and the ongoing productive transformation of the economy should also build resilience and reduce future access to Fund resources.

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