MINISTERIO DE HACIENDA Y CRÉDITO PÚBLICO

Macroeconomic overview and economic policy challenges

Ministry of Finance and Public Credit

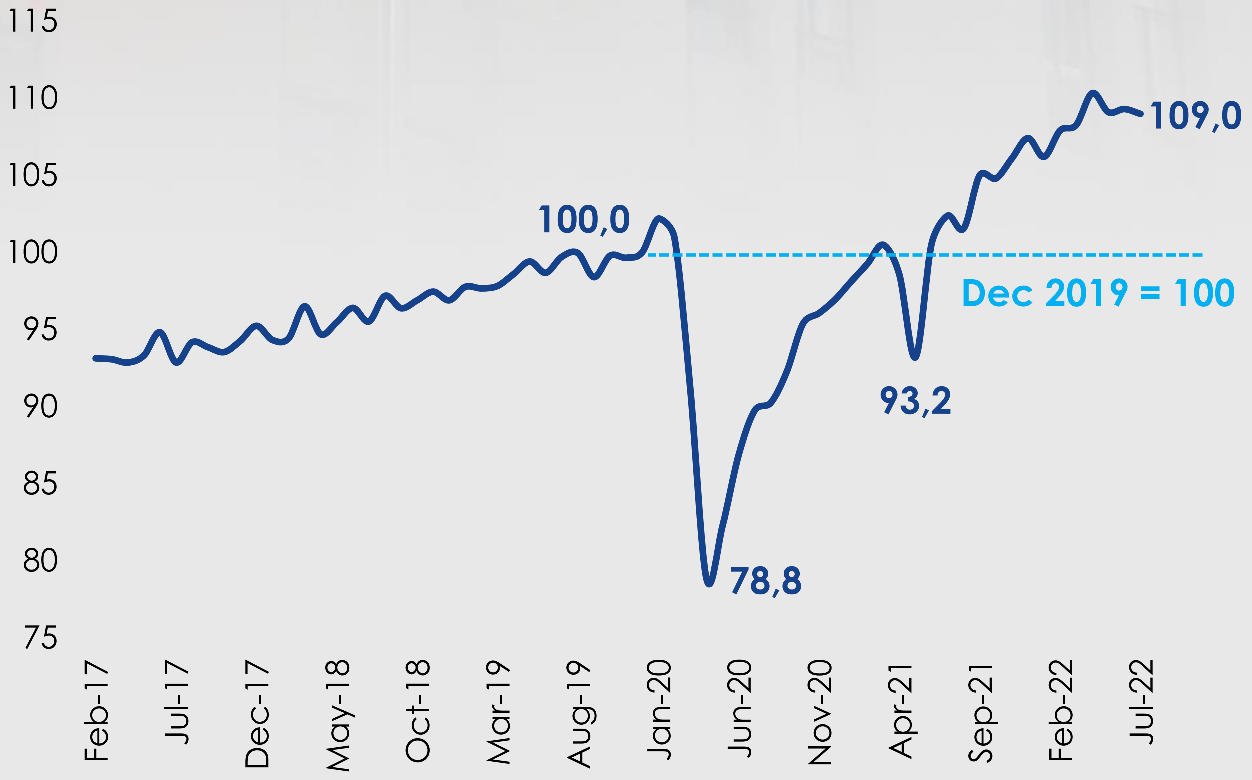
October 2022

1.

The Colombian economy has shown a strong rebound and positive performance

Economic activity has shown a significant rebound, with a dynamism that has extended throughout 2022

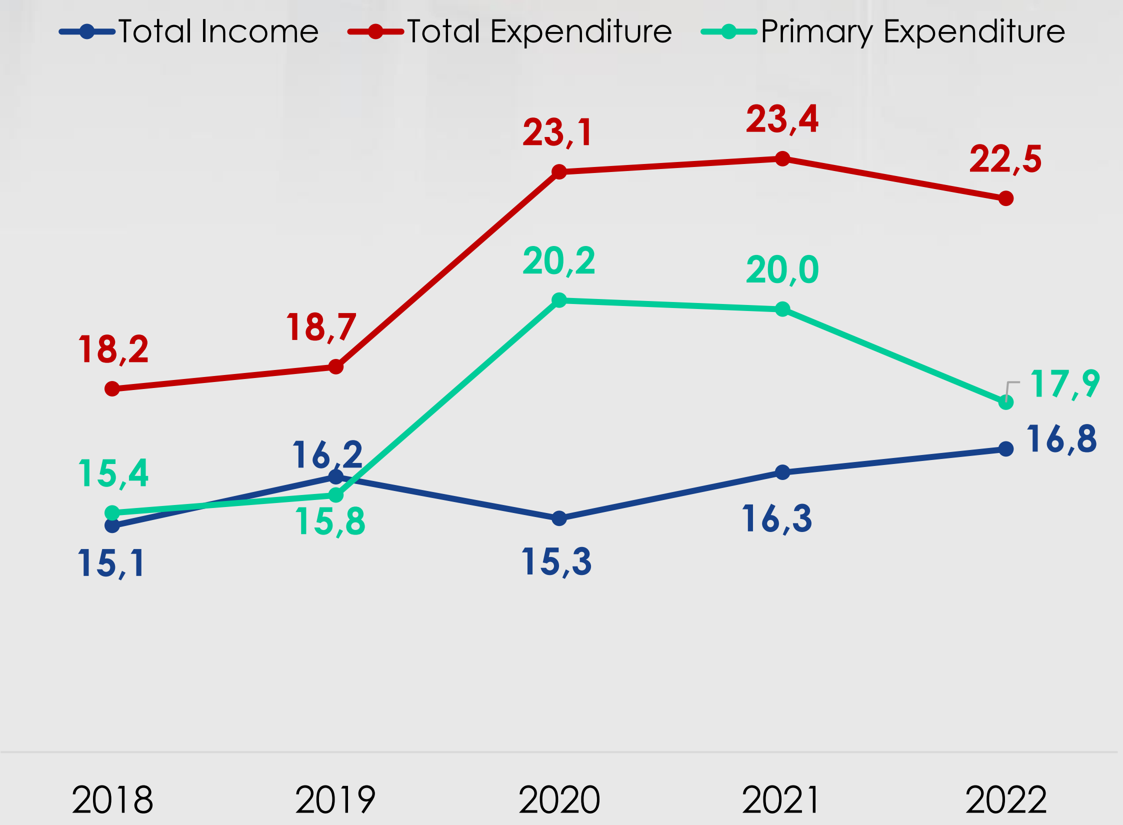
Leading Economic Activity Index (ISE)
(Dec 2019 = 100, Seasonally adjusted)



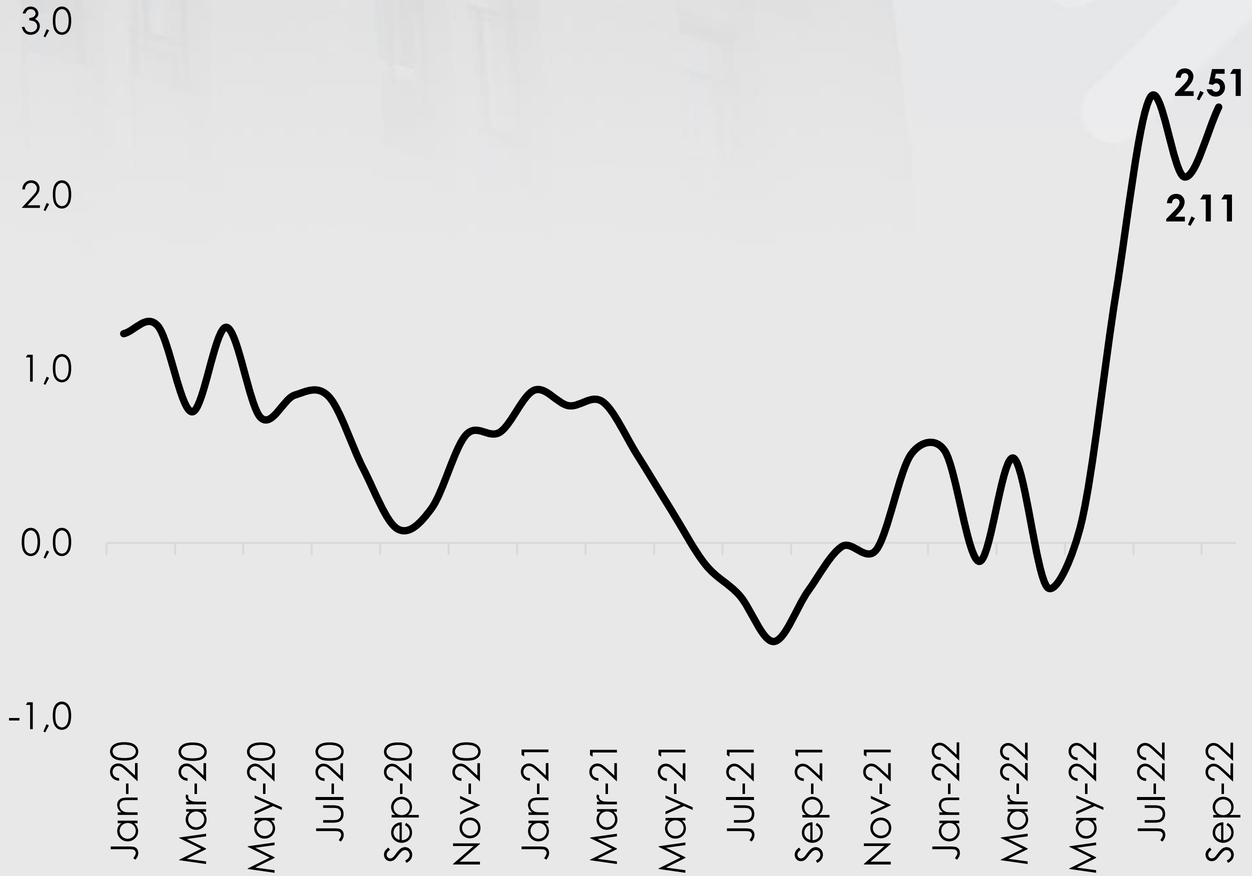
Source: DANE. Ministry of Finance calculations.

The economic reactivation has been leveraged on expansionary fiscal and monetary policies

Total Income and Expenditure Central Government
(% of GDP)

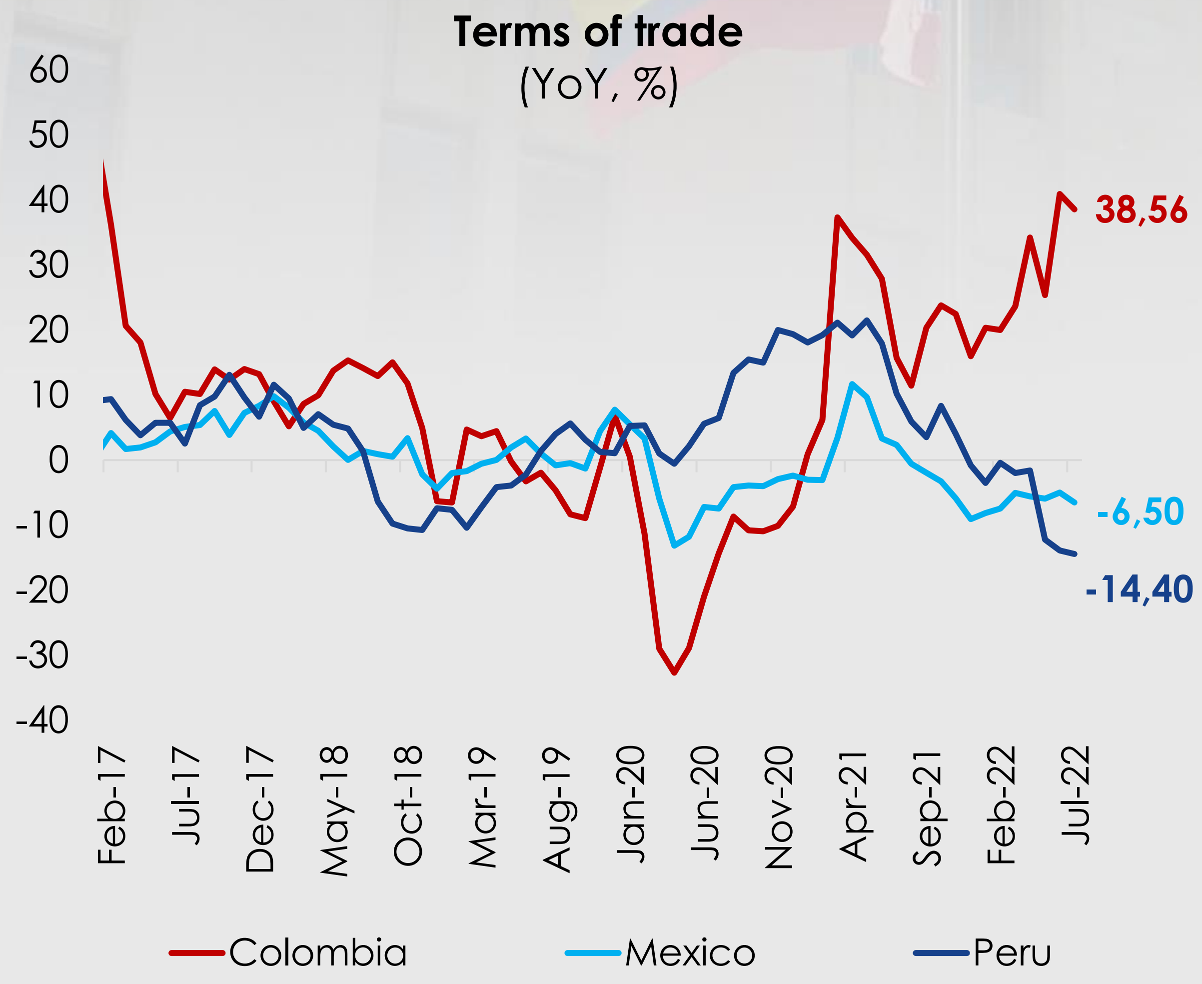


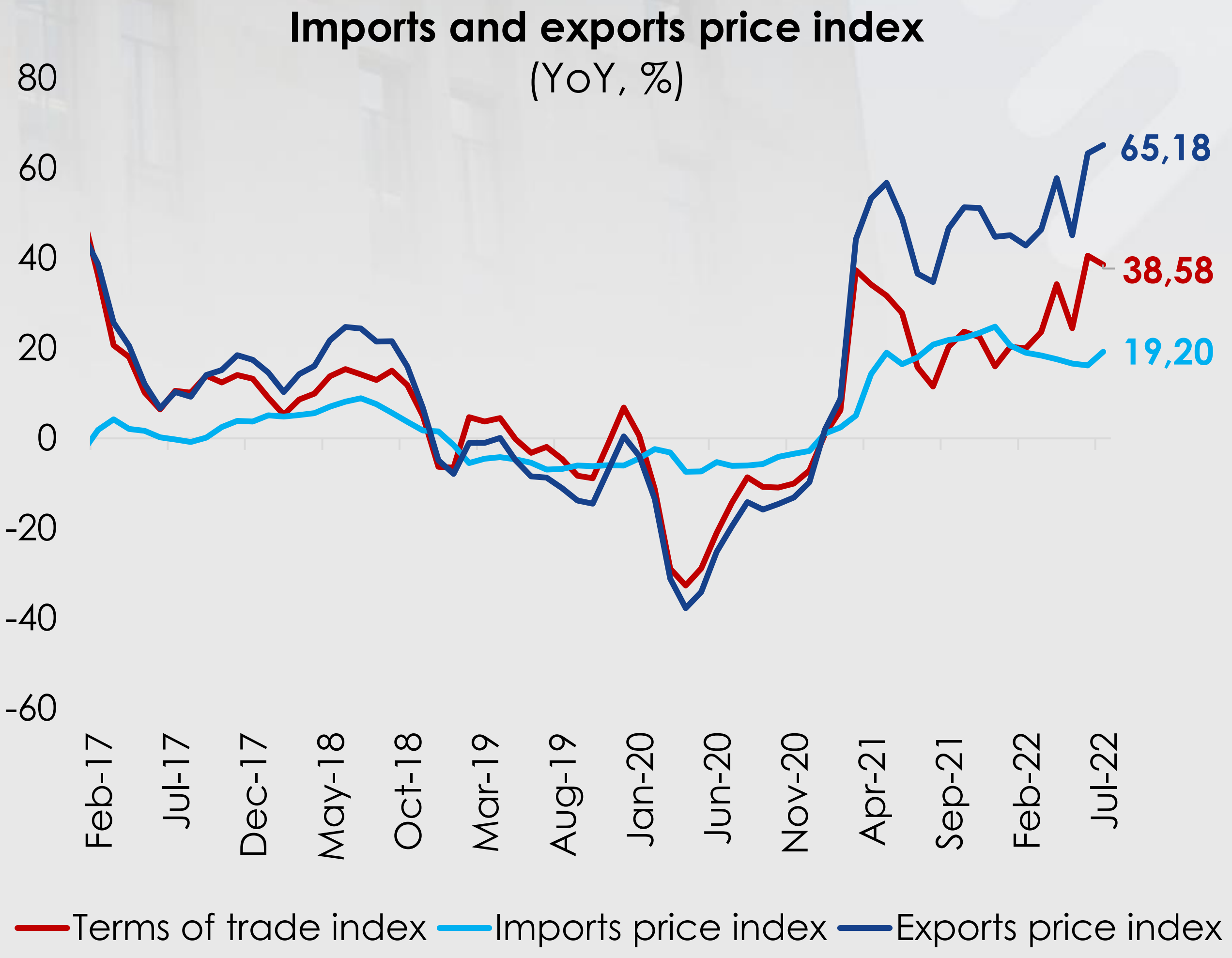
Real monetary policy rate
(Deflated with core inflation, %)



Source: DANE & Central Bank.
* 2022 MTFF Projection.

The strengthening of Colombia's terms of trade, relative to its regional peers, has also contributed to the recovery process

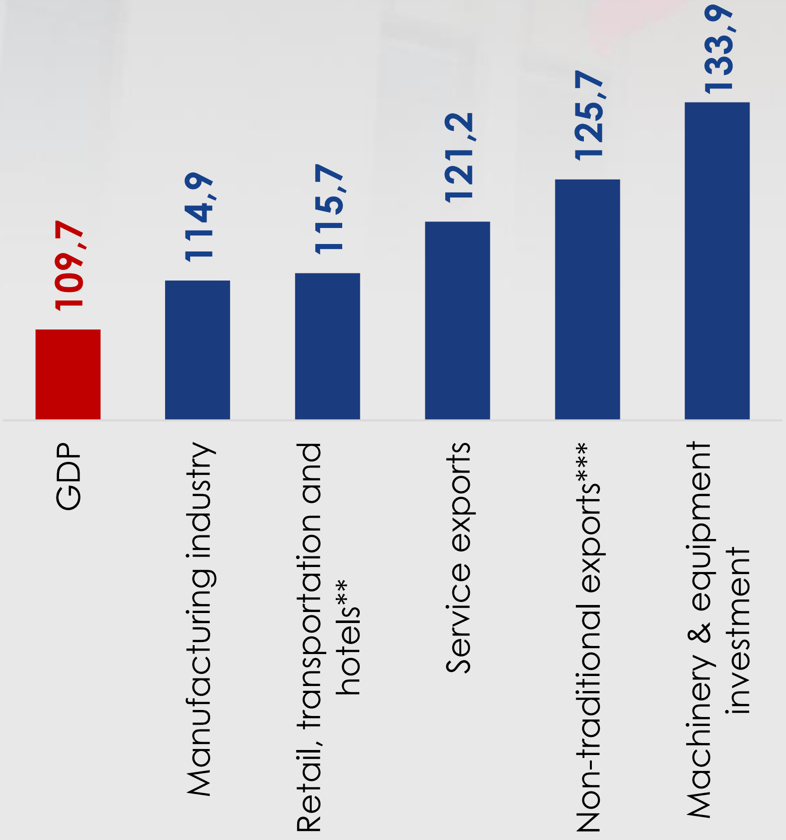




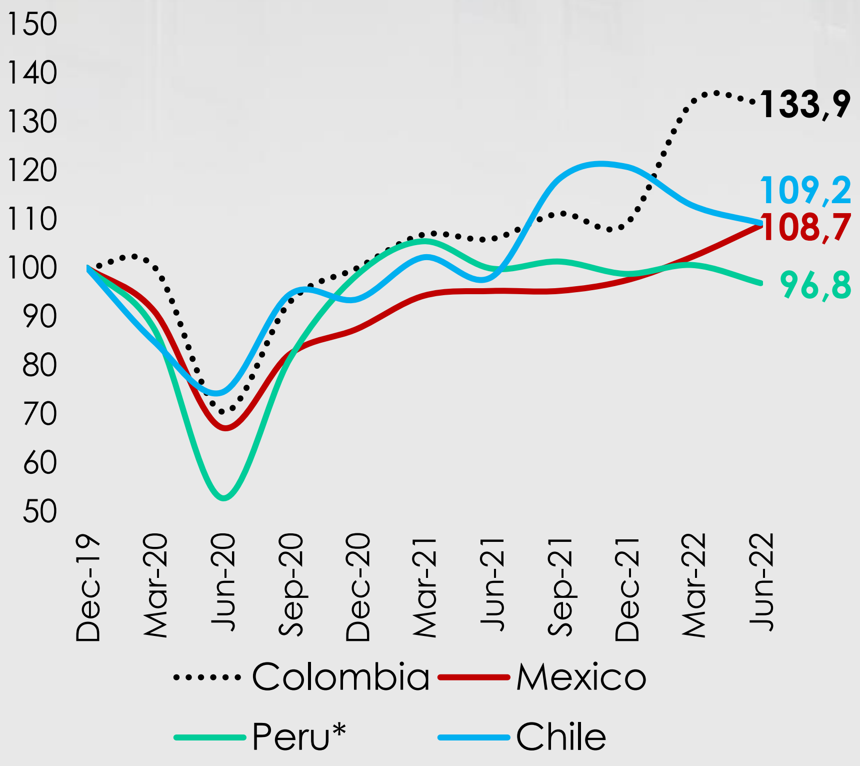
Source: Central Banks and statistical institutes of each country.

Manufacturing industry, retail and hotels, machinery & equipment investment and non-traditional and service exports have been the main economic drivers

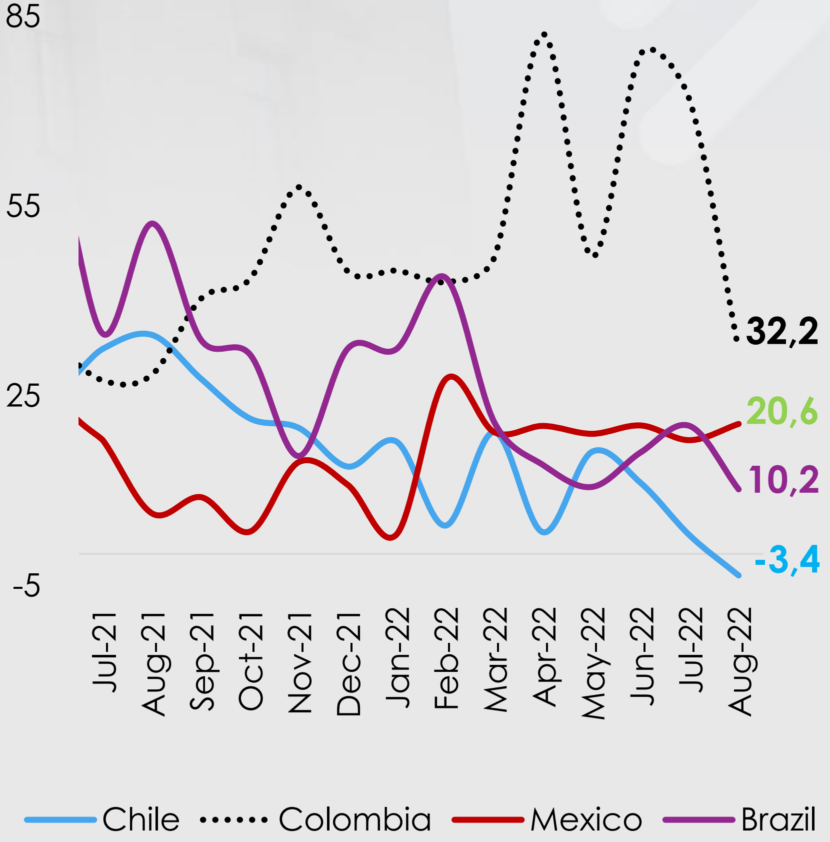
Real level 2022-2Q vs. pre-pandemic
(2019-4Q=100)



Gross fixed capital formation in machinery and equipment
(Seasonally adjusted series, 2019-4Q=100)



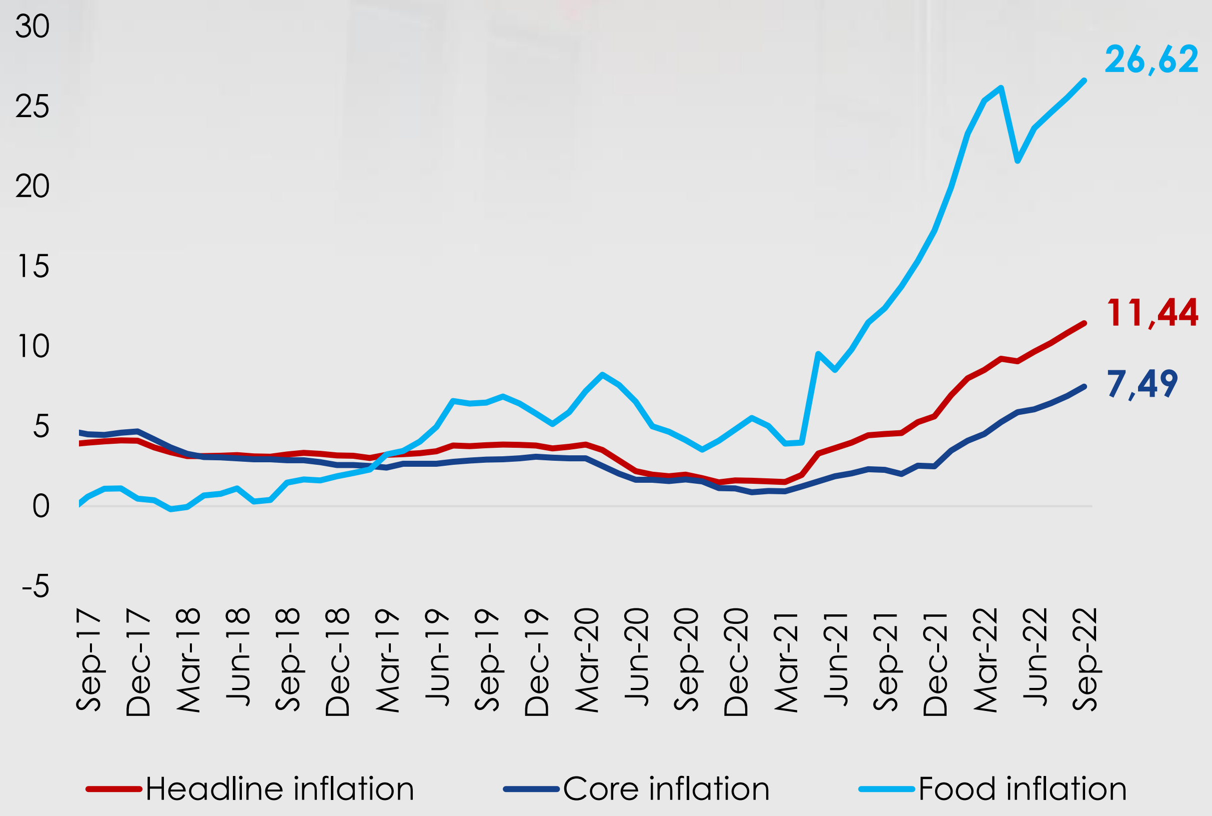
Exports of goods
(YoY, %)



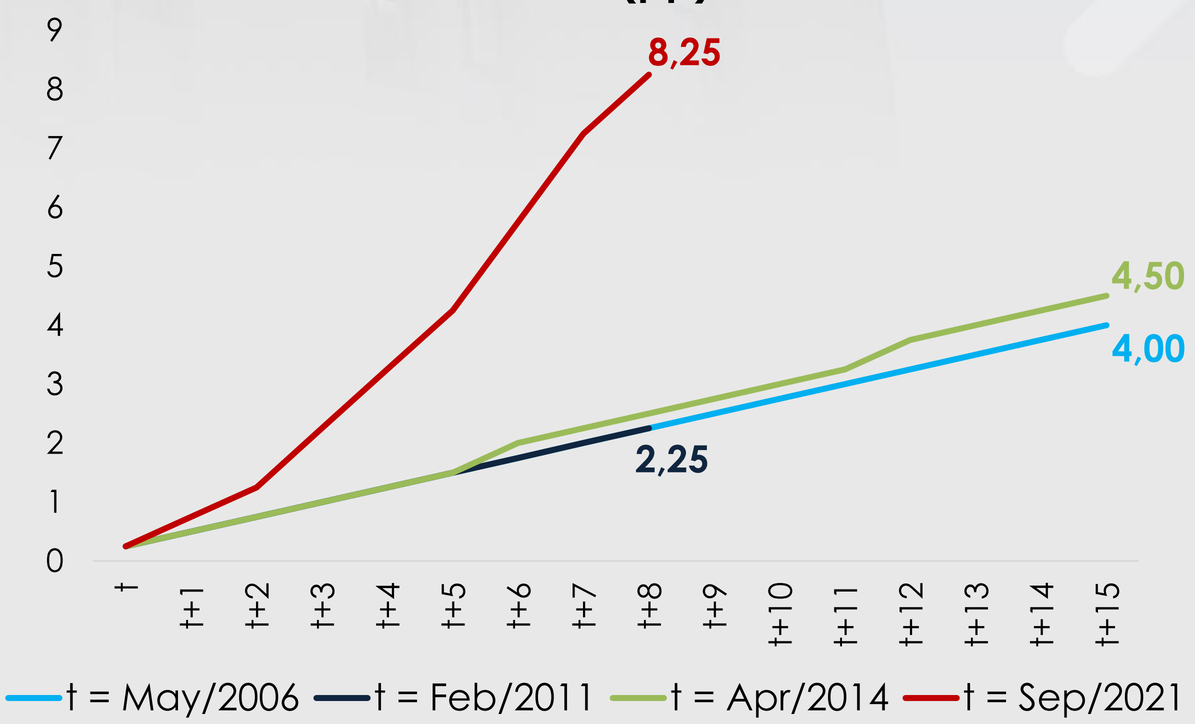
*Gross fixed capital formation in machinery and equipment of Peru is only available as non-seasonally adjusted data.
**Includes wholesale and retail trade; transportation, storage, accommodation and food service activities.
***Calculation based on the external trade monthly database.
Source: DANE, OECD & Statistical institutes of each country.

A major short-term risk is rising inflation especially in food prices. Since September 2021, Colombia's Central Bank began a strong process of monetary normalization

Annual inflation (%)

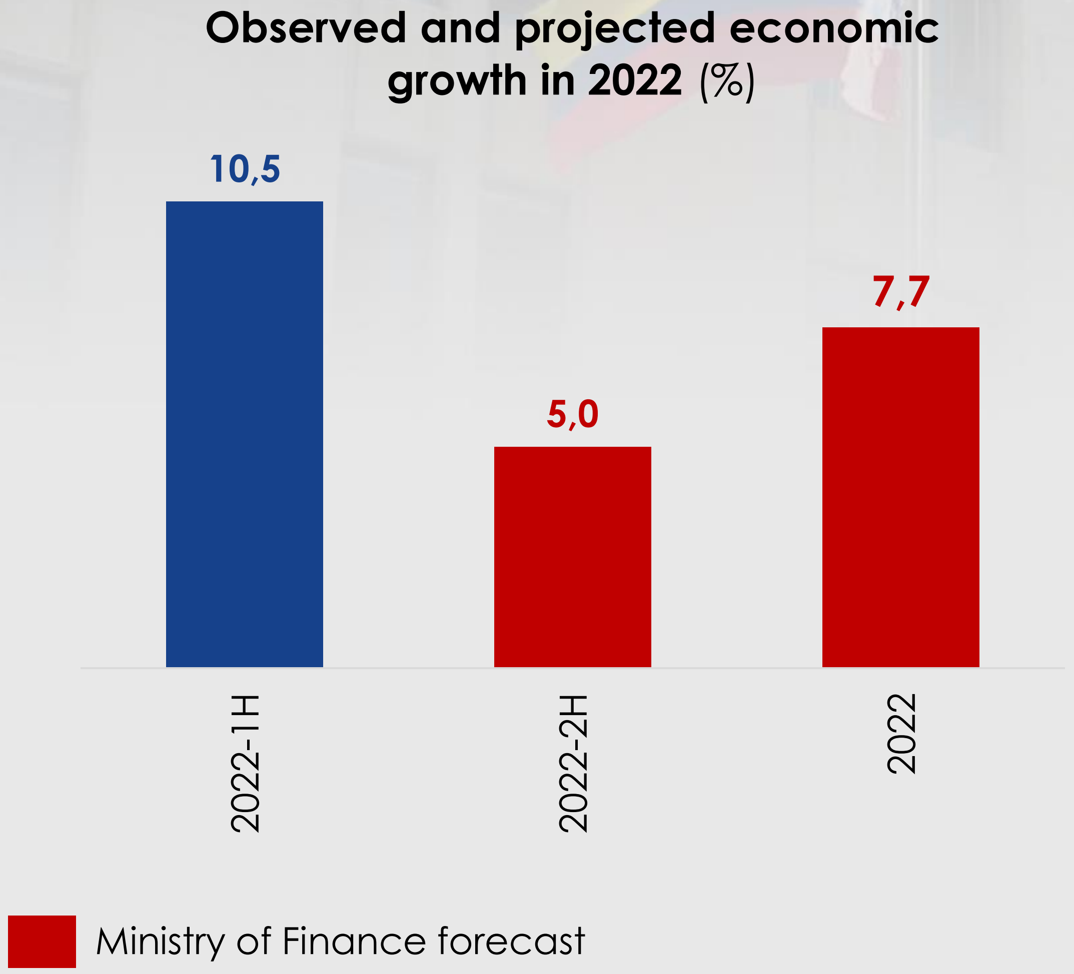


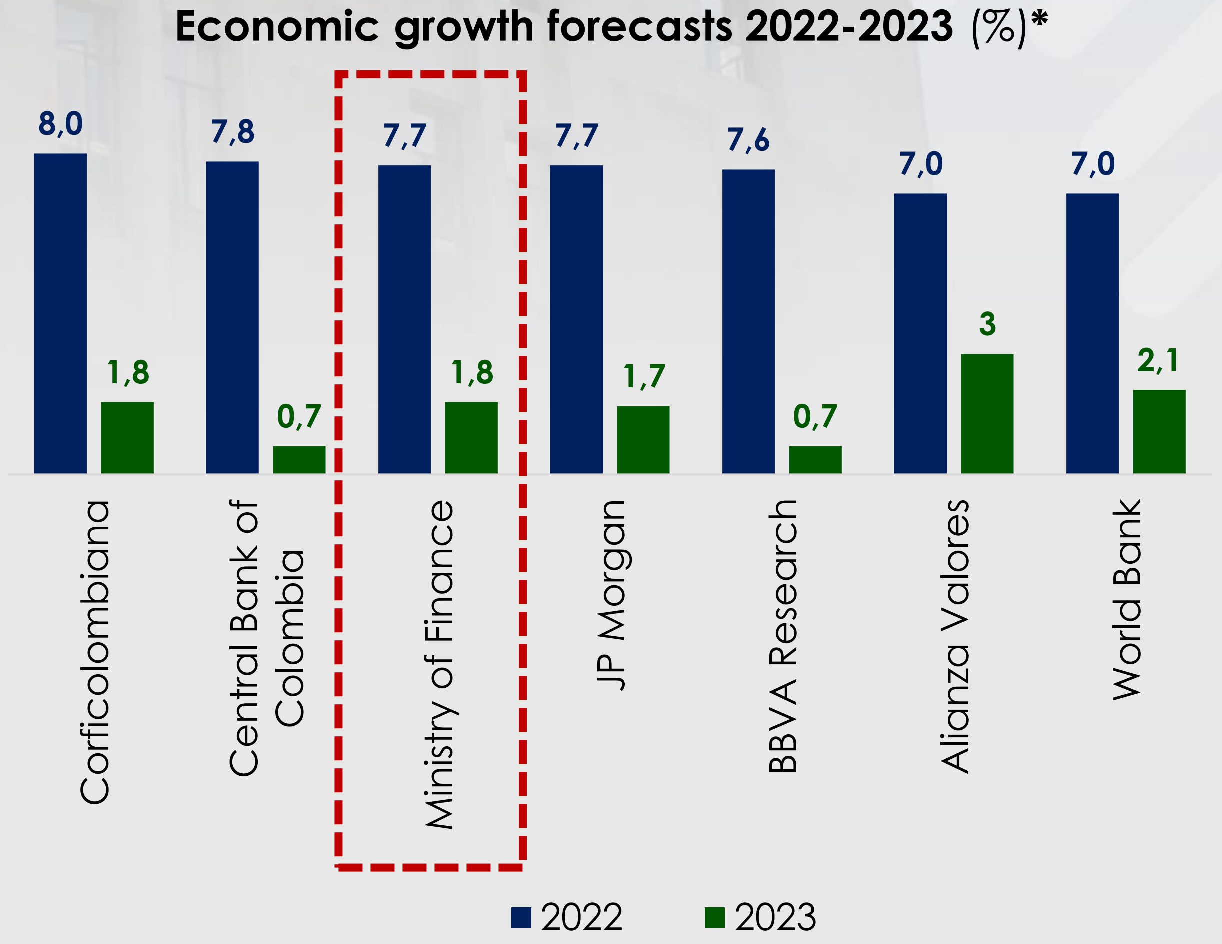
Accumulated increases in monetary policy rate during periods of monetary normalization (pp)



Source: Colombian Central Bank.

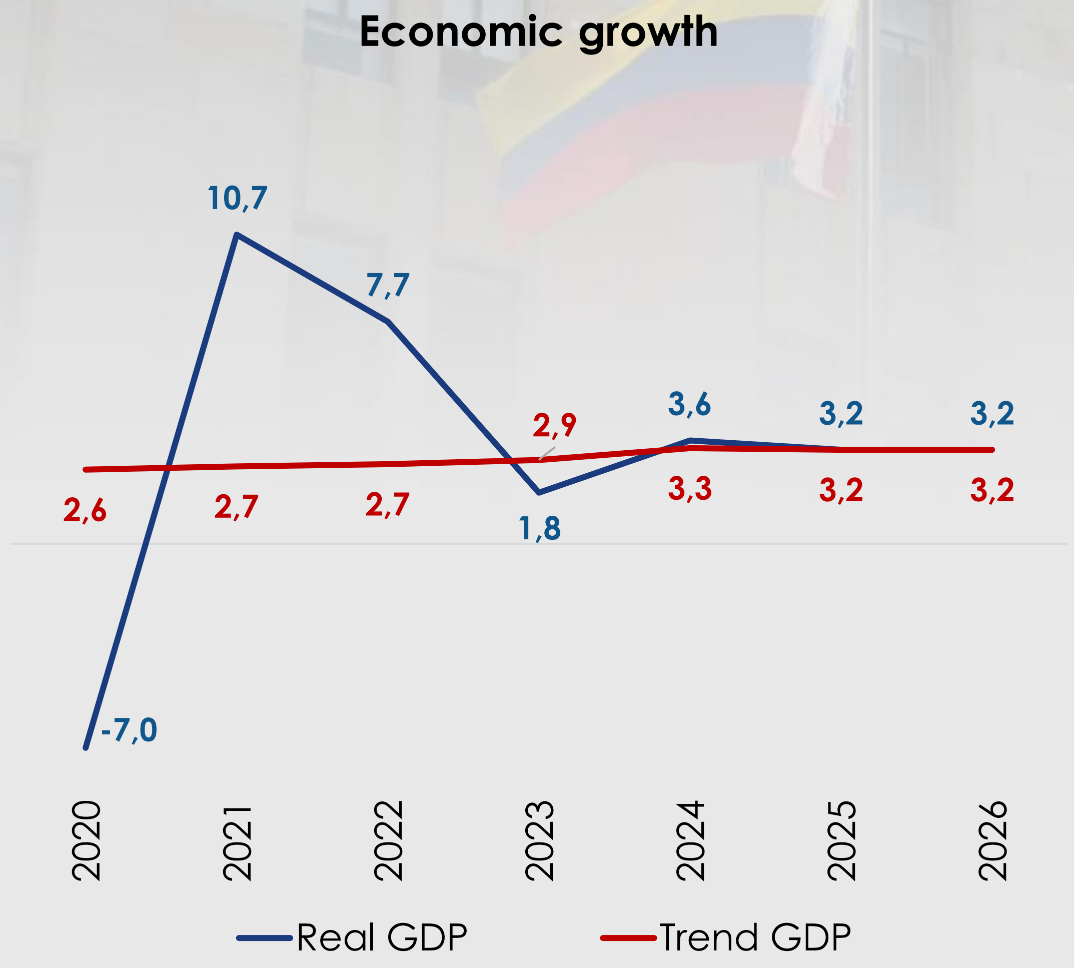
Growth is being constrained in 2023 by global risks

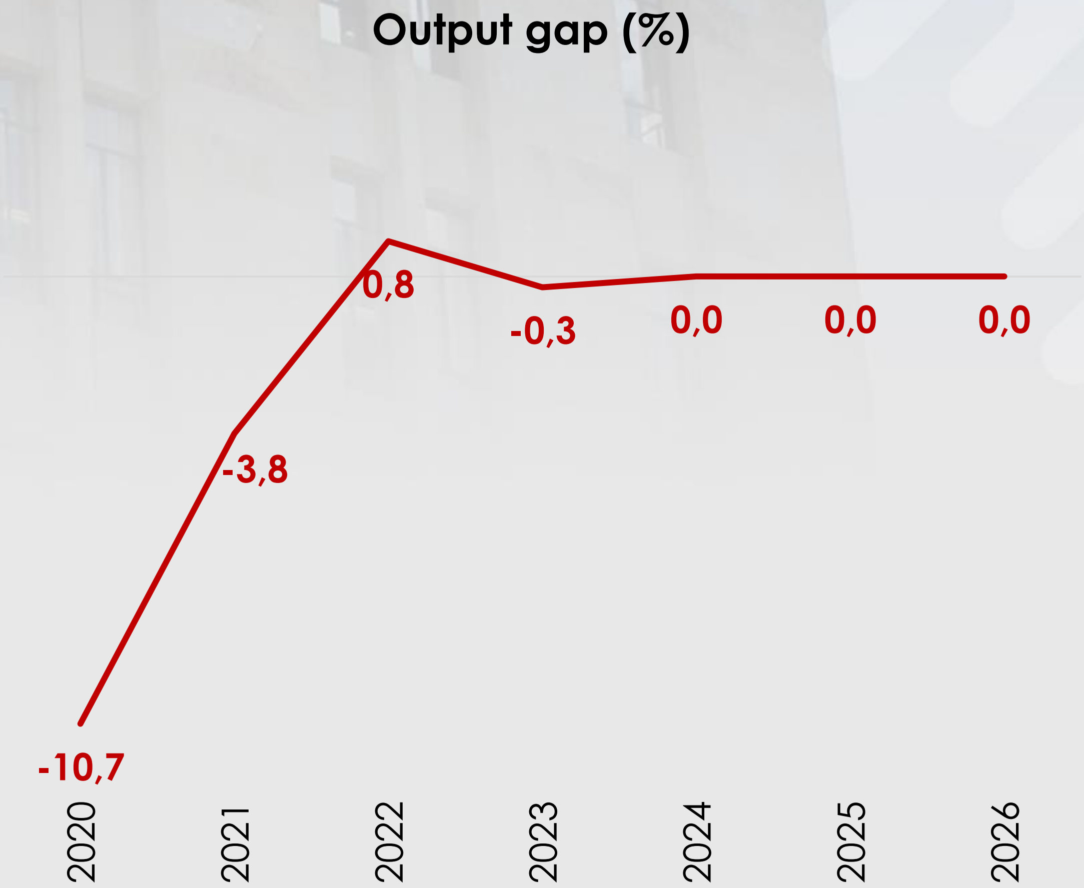




Source: Analyst's webpages. Ministry of Finance calculations.
*Includes analysts/agencies whose growth forecast was updated after the 2nd quarter GDP growth release.
**Corresponds to the average between the high and low range projected by the analyst.

The output gap is expected to close in 2024. Between 2024 and 2026, real GDP growth would be 3.3%, and per capita GDP growth would be 2.3%*, on average





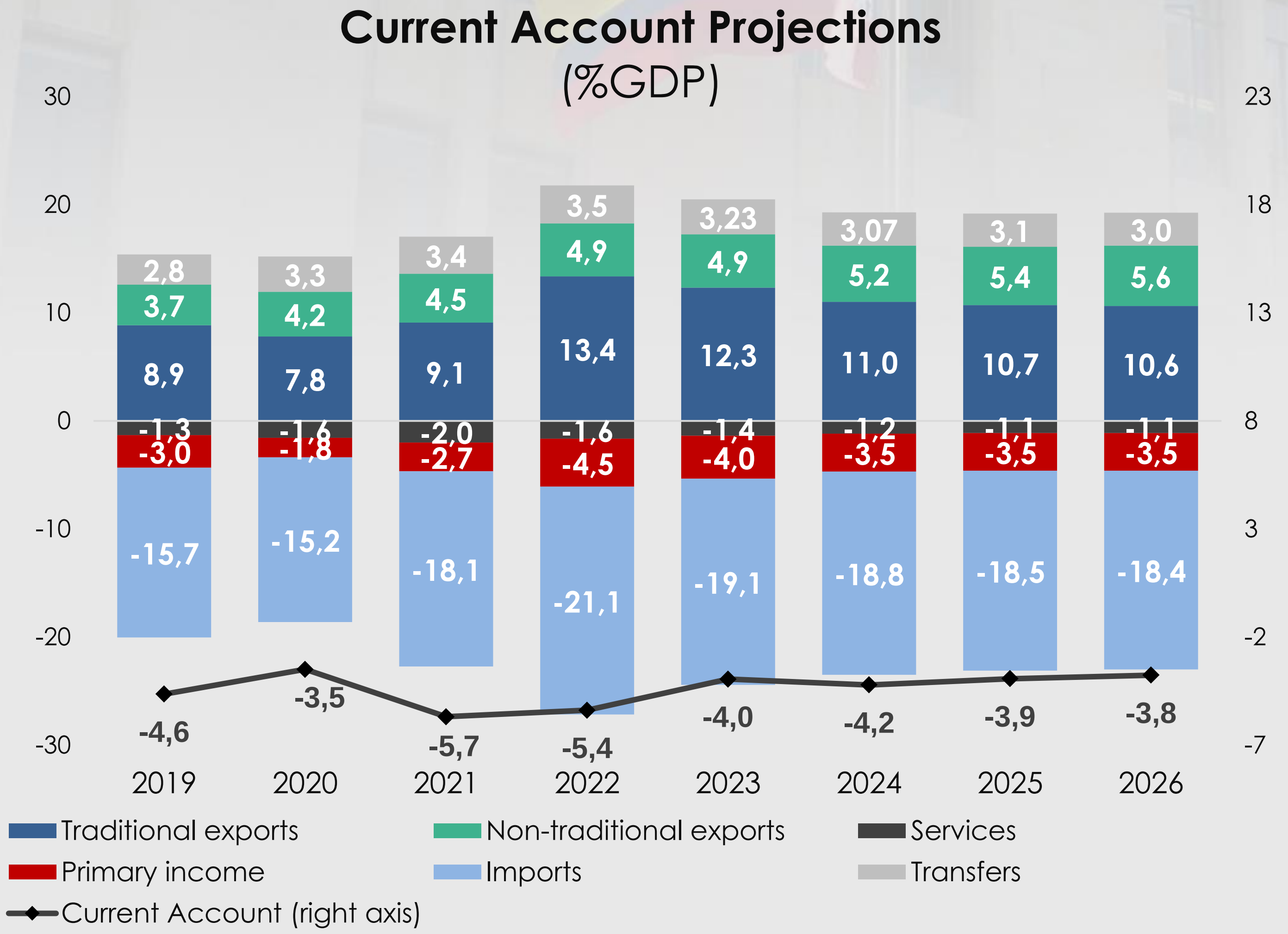
The output gap consistent with the Central Bank's current 2023 growth forecast (0,7%), would be around **-1,3% of GDP in 2023.**

Source: DANE & CARF. Ministry of Finance projections
*Consistent with the projected real GDP in pesos, and expected population growth of 1% between 2024 and 2026 (according to DANE).

2.

Medium-term external adjustment in the context of the productive transformation process

The external imbalance is expected to adjust in the medium term due to the productive transformation process, the moderation of the domestic demand and the correction of international prices



Source: Colombia's Central Bank. Projections: MHCP-DGPM.

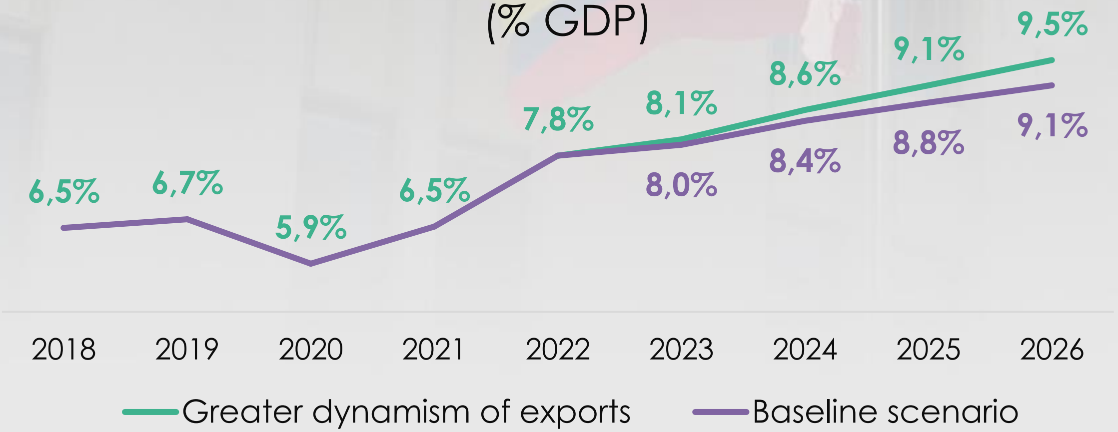
*The prices of the main export products (oil and coal) are expected to decrease from 2023 onwards.

The expected adjustment in the external deficit would be led by:

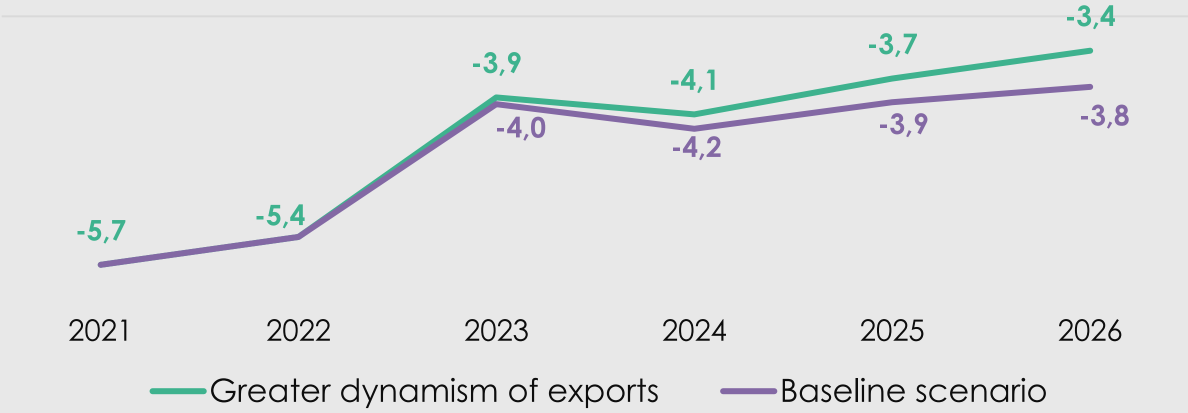
- **Dynamism of non-traditional** exports and services, in line with the **productive transformation process**.
- **Lower pressures in the primary income deficit.**
- **Partial correction** in the prices of goods and services **imports**.

A greater dynamism of non-traditional and services exports would accelerate the correction of the external deficit.

Non-traditional and services exports
(% GDP)



Current account balance
(% GDP)



Source: Colombia's Central Bank. Projections: MHCP-DGPM.

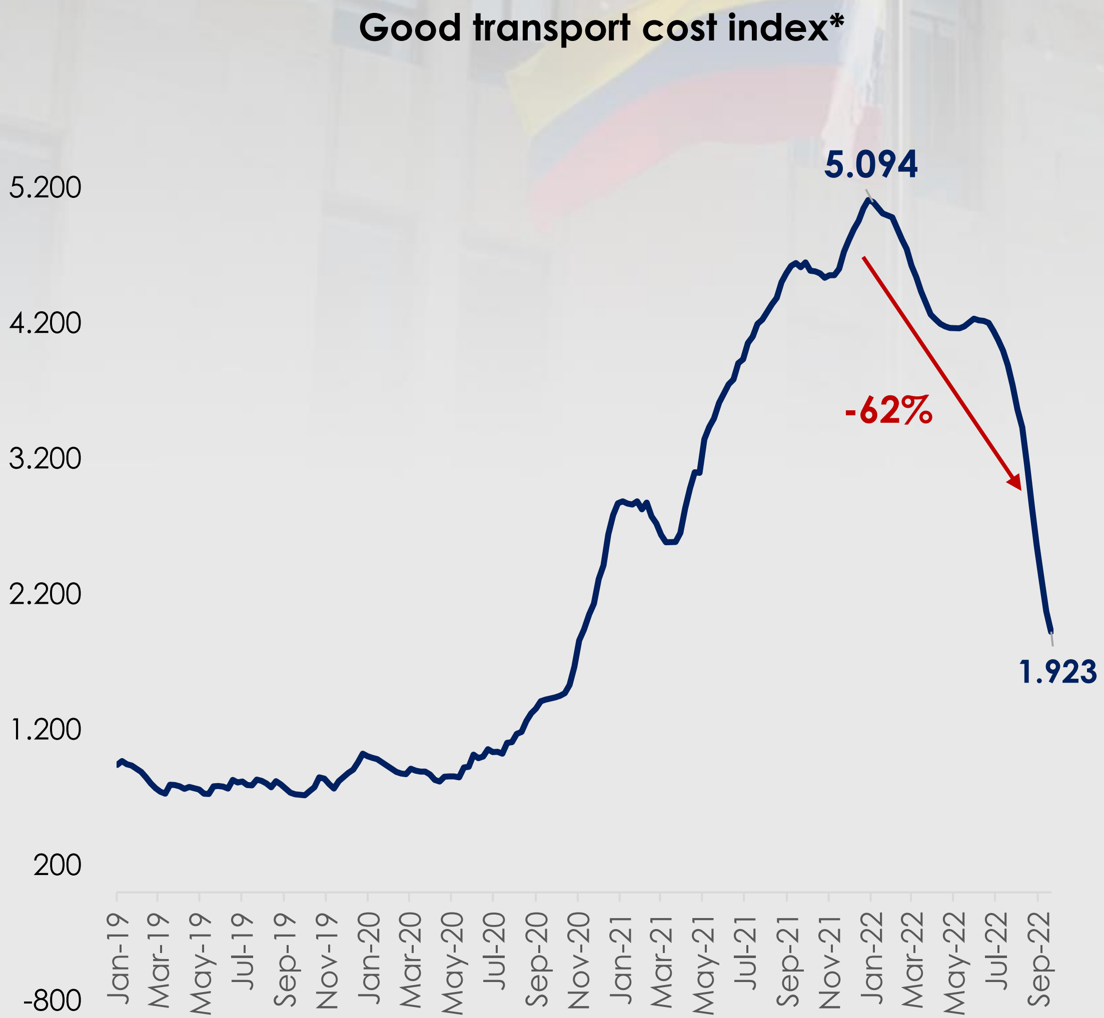
Under a more optimistic scenario for non-traditional exports and services, **the current account deficit would converge to 3.4% in 2026** (0.4pp lower than expected in the central scenario).

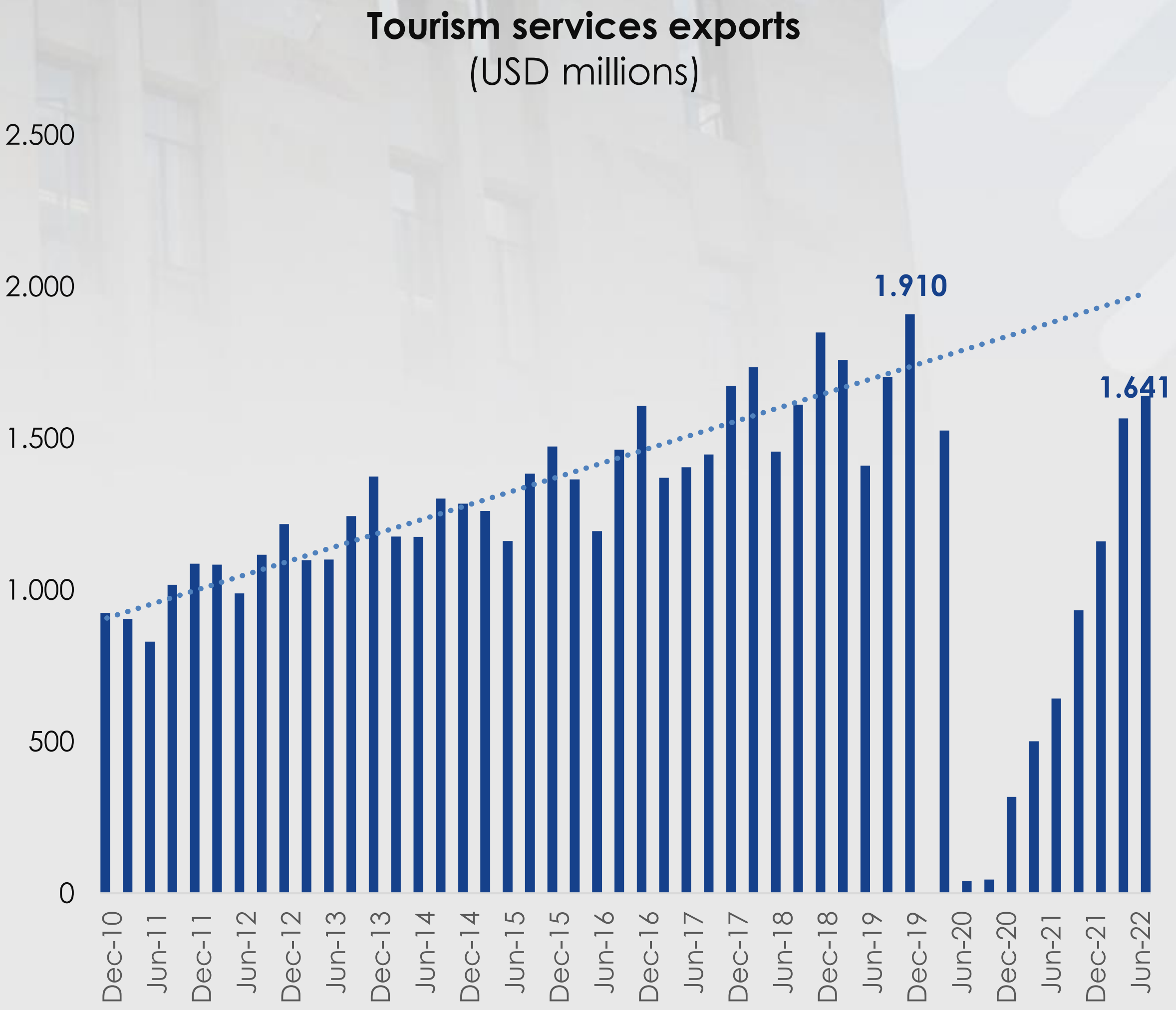
Non-traditional exports would grow 2.2pps more compared to the baseline scenario, on average between 2023 and 2026, due to:

- **Recovery of trade relations with Venezuela.**
- **Dynamism of exports:** agriculture exports and minerals for the energy transition (copper in particular).
- **Increase of manufactured exports,** thanks to the process of productive transformation and reindustrialization.
- **The tax reform measures related to free trade zones** would result in an incentive for the internationalization of companies.

Anchoring the growth of **services exports** to the historical performance, **their growth would be 2.2pps higher than expected in the baseline scenario**, on average between 2023 and 2026.

The current account will improve going forward

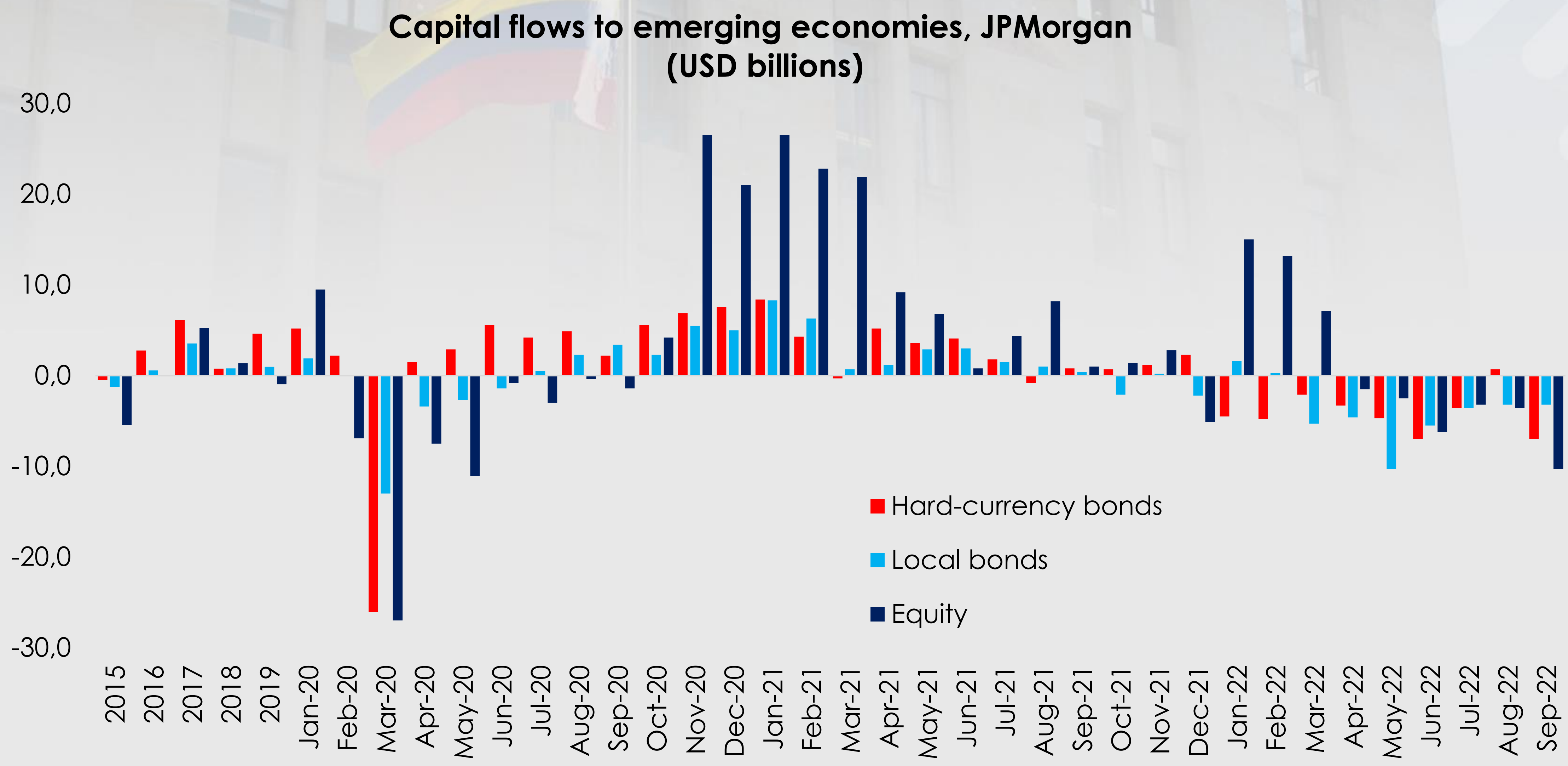




*Weighted freight and container cost index for 15 shipping routes in Shanghai.
Source: Bloomberg. Ministry of Finance calculations.

Source: Central bank. Ministry of Finance calculations.

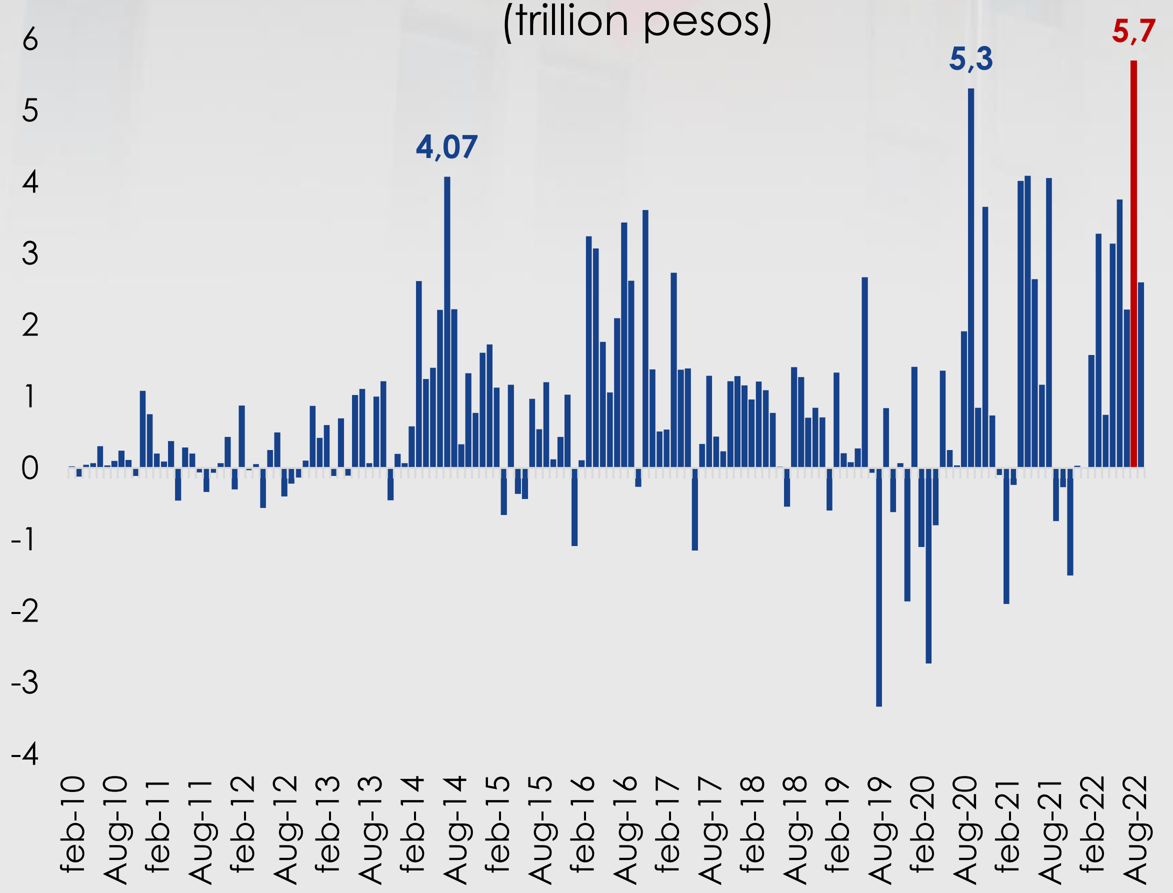
Capital flows to emerging markets have been declining…



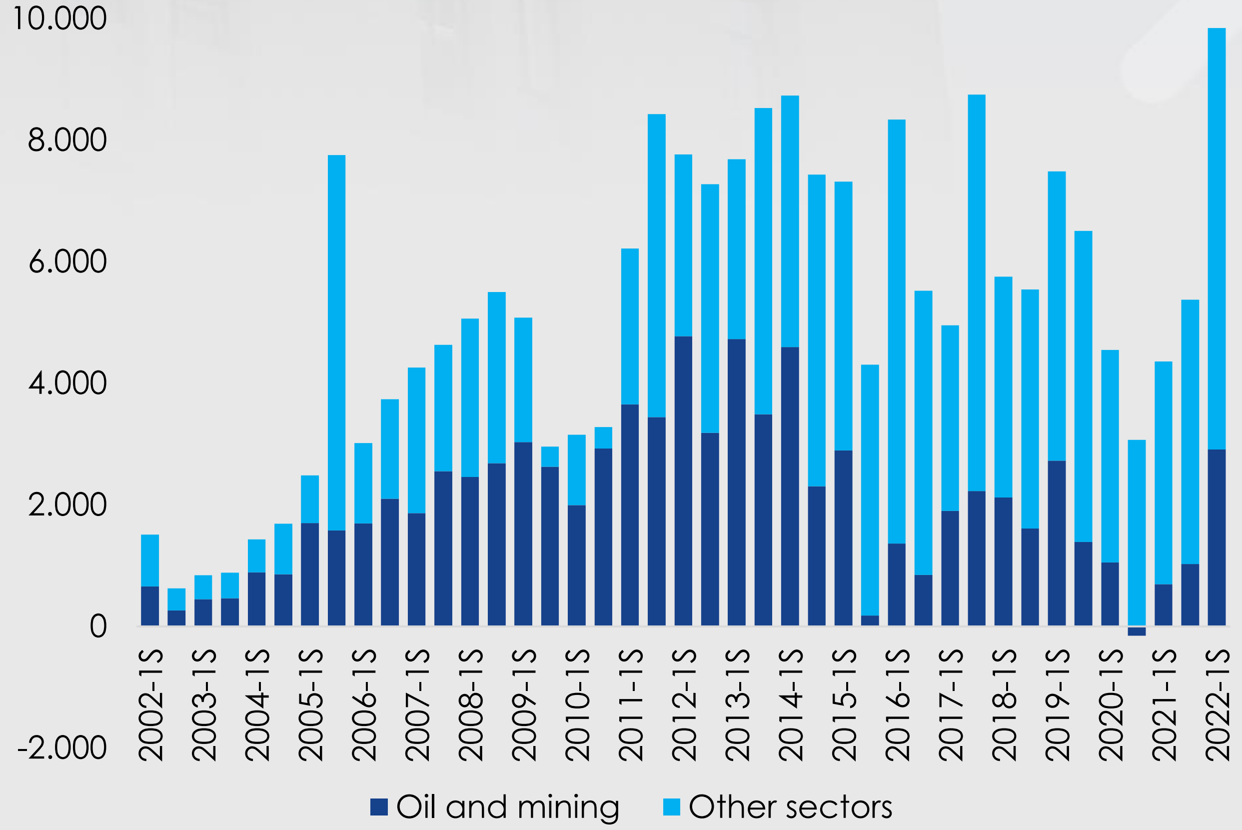
Source: JP Morgan.

… but in Colombia, throughout 2022 capital inflows have shown great dynamism

Net monthly purchases of TES by foreigners
(trillion pesos)



Flows of foreign direct investment
($US millions)

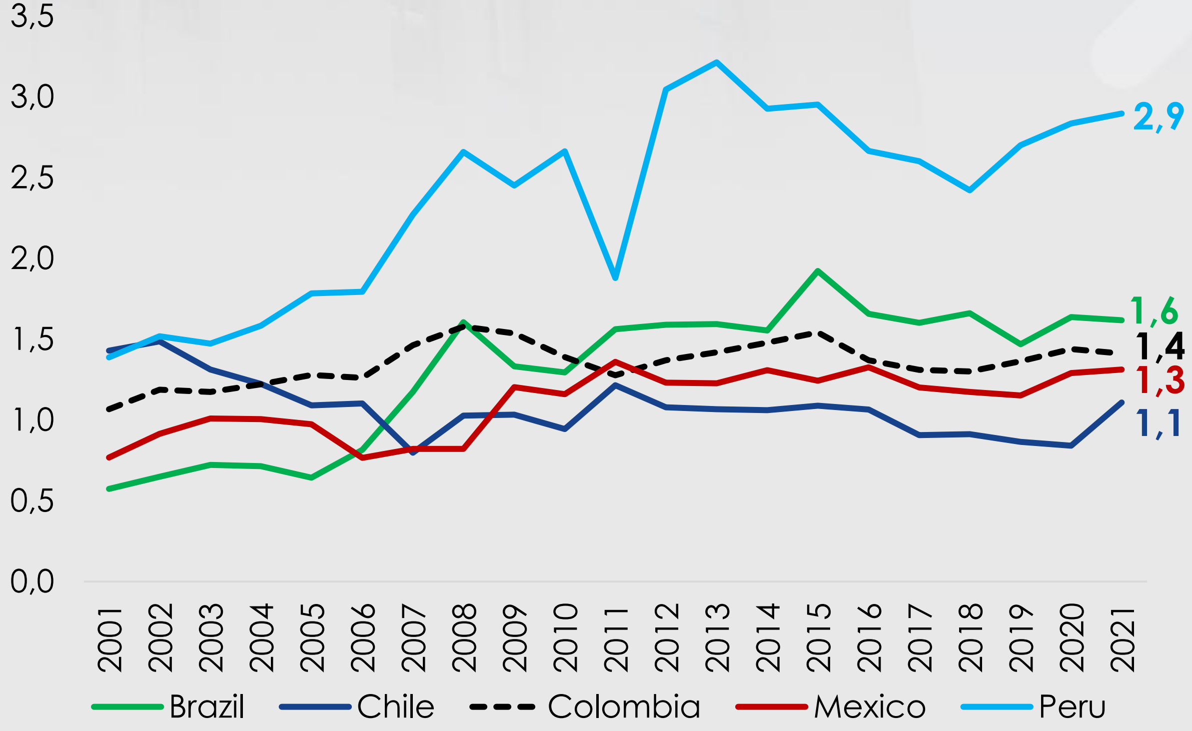


*Negative values represent monthly sales of TES by foreigners.
Source: Investor Relations Colombia (IRC), Ministry of Finance. Colombian Central Bank.

Colombia relies on solid external buffers, such as an adequate reserve level (its reserves/ARA metric indicator is 1,4) and access to the IMF's Flexible Credit Line

Foreign Exchange Reserves
(% GDP)

Reserve adequacy
(Reserves / ARA metric*)



*The ARA metric (Assessing Reserve Adequacy) defines the required level of foreign exchange reserves based on the weighted average of four indicators: (1) short-term external debt, (2) portfolio liabilities and other long-term external debt, (3) monetary aggregates, (4) exports.
Source: IMF. Colombian Central Bank.

3.

Fiscal strategy

While public debt is at historical highs, and some fiscal risks have materialized recently Colombia has a strong institutional framework

Law 819 of 2003
Medium-Term Fiscal Framework

The Government will publish yearly a 10-year macroeconomic and fiscal roadmap, the Medium-Term Fiscal Framework, to guide policy decisions, while ensuring fiscal sustainability

Law 1473 of 2011 and Law 2155 of 2021
Fiscal Rule and Autonomous Fiscal Rule Committee

From 2022, the new Fiscal Rule sets specific targets for the fiscal balance and the debt of the National Government. This framework strengthens the link to fiscal sustainability, particularly by setting a debt limit and anchor

Law 2155 created the **Autonomous Committee of the Fiscal Rule**, as a technical, permanent and independent body, **whose purpose will be to monitor the fiscal rule and provide analysis on public finance sustainability**

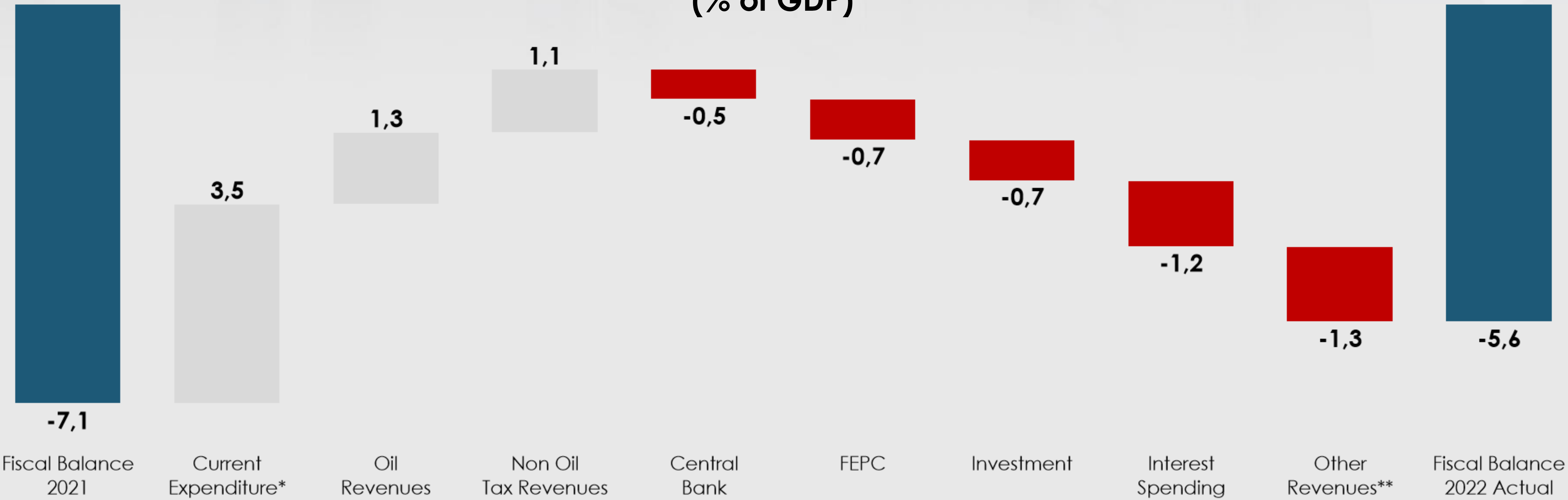
The fiscal rule is materialized through the Medium-Term Fiscal Framework. The Government's financial planning instruments **must be consistent with the fiscal rule contained in the Medium-Term Fiscal Framework.**

Improvements in 2022 Central Government finances

1. A **fiscal deficit of 5.6% of GDP is forecasted for 2022**, consistent with an **overcompliance** of the fiscal rule's target of **3.0pp of GDP**

2. Compared to 2021, the projected fiscal balance has a reduction in current expenditure, **higher oil revenues and non-oil tax revenues** (better macroeconomic outlook), that drive a reduction in the fiscal deficit.

Decomposition of 2021-2022 fiscal adjustment (% of GDP)



*Mainly explained by expenditures related to the Covid-19 pandemic (1.8pp), pensions (0.7pp), regional transfers (0.5pp), wages (0.2pp),acquisition of goods and services (0.2pp), and energy subsidies (0.1pp)

** Revenues from the sale of ISA

Source: Ministry of Finance.

2023 Central Government Fiscal Balance*

The **reduction in the fiscal deficit** between 2022 and 2023 is driven by **higher tax revenues** resulting from the 2021 tax reform, higher oil revenues and DIAN's modernization, **despite an increase in current expenditures**.

Decomposition of 2022-2023 fiscal adjustment (% of GDP)

The increase in current expenditure is explained by wages (0.4pp), pensions (0.3pp), transfers to ICBF and SENA (0.2pp), regional transfers (0.2pp) and other transfers (0.3pp)

*This scenario does not include revenues resulting from the tax reform

Source: Ministry of Finance.

A fiscal deficit of 4.0% of GDP is forecasted for 2023, which is 1.6pp less than the 2022 fiscal deficit (5.6% of GDP) and is consistent with a primary surplus of 0.2% of GDP

This scenario is consistent with the compliance of the Fiscal Rule and it does not include yet the Tax Reform's effects

2023 Central Government Fiscal Balance

Trillion COP

CONCEPT	2022 (1)	2023 (2)	(2-1)
Total Revenues	**234.978**	**289.855**	**54.877**
Tax Revenues	210.288	252.276	41.989
Other revenues	24.691	37.578	12.888
Total Expenditures	**313.272**	**349.103**	**35.831**
Interest	63.296	62.875	-421
Primary Expenditure	249.976	286.228	36.252
Current expenditure	209.400	245.157	35.757
FEPC	14.249	19.600	5.350
Other	195.150	225.557	30.407
Investment	40.577	41.071	494
Primary Balance	**-14.998**	**3.627**	**18.625**
Total Balance	**-78.294**	**-59.248**	**19.046**
Total Balance in compliance with the Fiscal Rule	**-120.052**	**-59.248**	**60.804**
Surplus(+)/Adjustment (-)	**41.758**	**0**	**-41.758**

% of GDP

CONCEPT	2022 (1)	2023 (2)	(2-1)
Total Revenues	**16,8**	**19,8**	**3,0**
Tax Revenues	15,1	17,2	2,1
Other revenues	1,8	2,6	0,8
Total Expenditures	**22,5**	**23,8**	**1,3**
Interest	4,5	4,3	-0,2
Primary Expenditure	17,9	19,5	1,6
Current expenditure	15,0	16,7	1,7
FEPC	1,0	1,3	0,3
Other	14,0	15,4	1,4
Investment	2,9	2,8	-0,1
Primary Balance	**-1,1**	**0,2**	**1,3**
Total Balance	**-5,6**	**-4,0**	**1,6**
Total Balance in compliance with the Fiscal Rule	**-5,6**	**-4,0**	**1,6**
Surplus(+)/Adjustment (-)	**0,0**	**0,0**	**0,0**

Source: Ministry of Finance.

Sources and Uses 2023

Sources	USD	trillion 99.012	Uses	USD	trillion 99.012
Disbursements		**62.789**	**Deficit to be Financed**		**59.248**
External	(US$ 4.500 mill.)	18.860	Of which:		
Internal		43.929	Internal Interest		48.481
			External Interest	(US$ 3.150 mill.)	14.394
Treasury Operations		**3.321**			
			Amortizations		**30.430**
Accrual Adjustments		**18.754**	External	(US$ 2.553 mill.)	11.665
			Internal		18.765
			Liability Payments (Court rulings, Health, Others)		**250**
Initial Availability		**14.149**	**Final Availability**		**9.084**

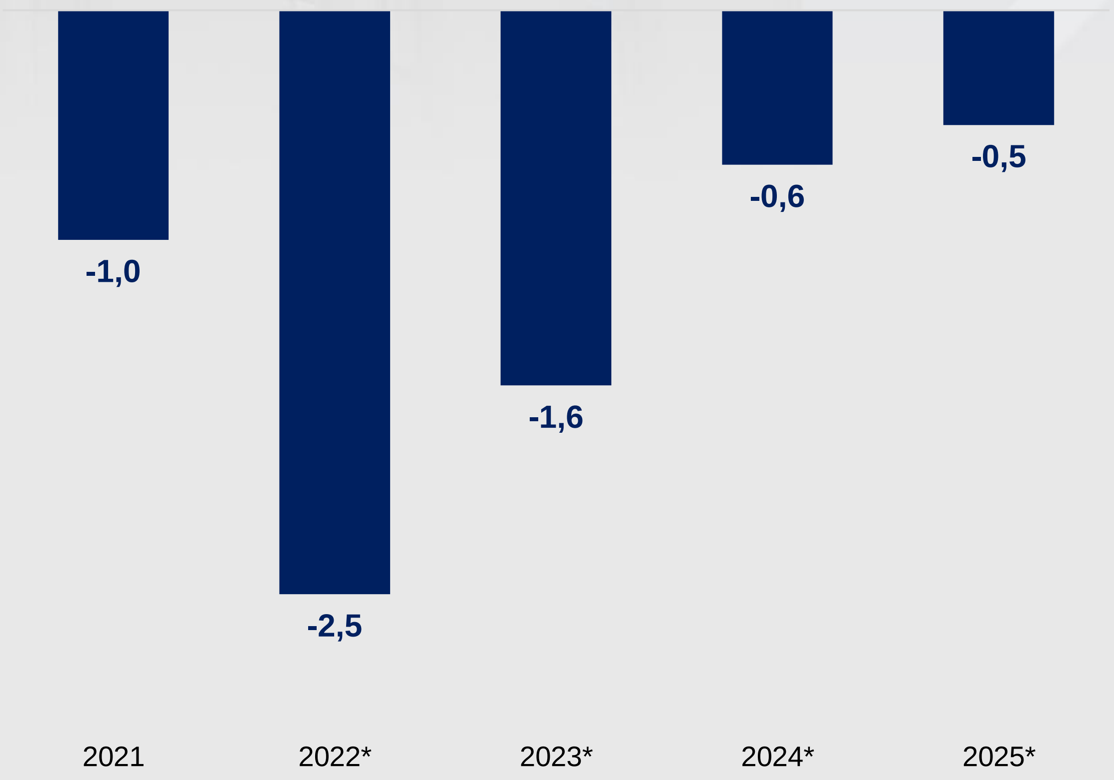
Source: Ministry of Finance September 10, 2022.

Proportional increases allow smaller adjustments in the short-term, that increase over time, which is consistent with the challenges presented by current high inflation levels

- This proposal considers paths **of higher increases in the prices of gasoline, and smaller increases in diesel**.

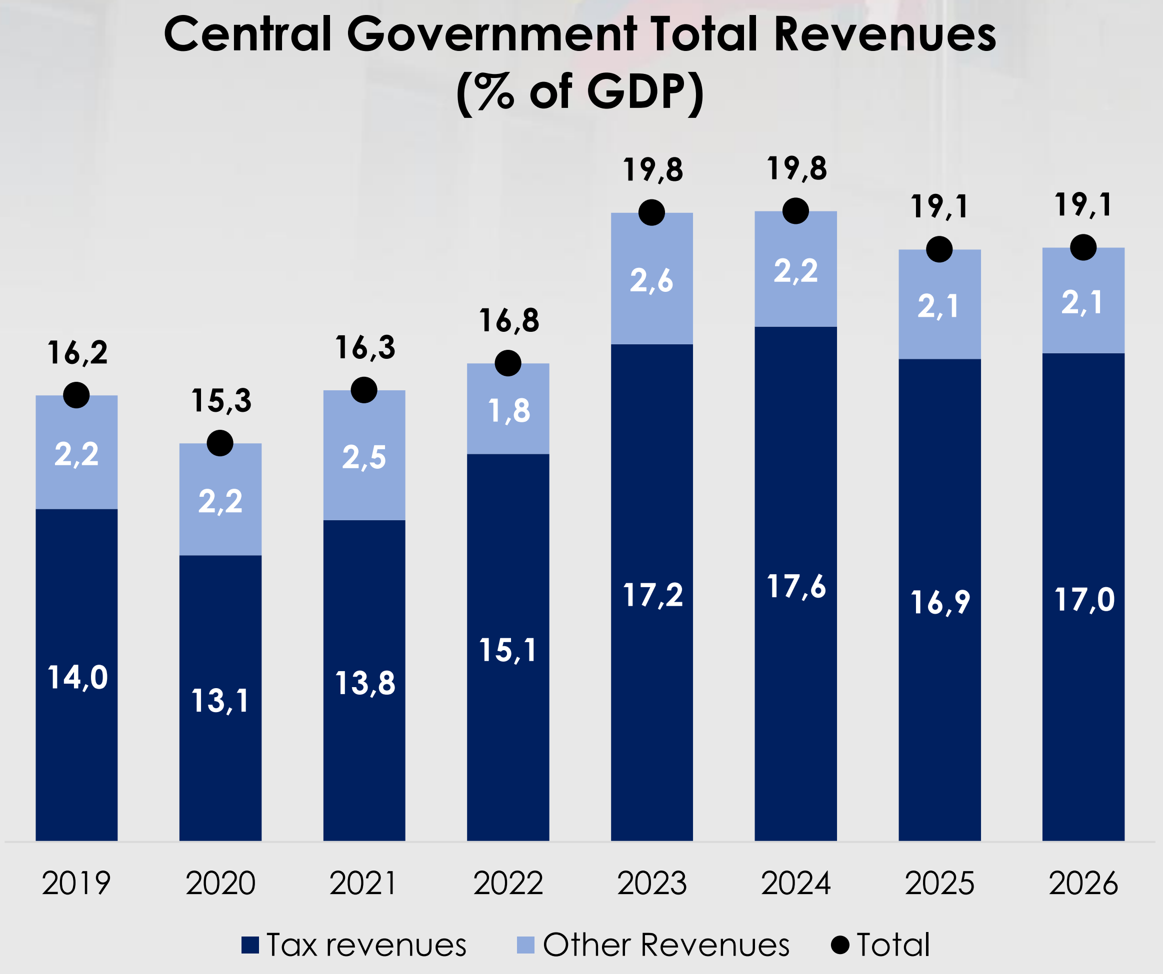
- This plan is consistent with the expectation that current inflationary pressures will be reduced in the following months, **so that the purchasing power of households and firms' cost structure is not excessively affected**.

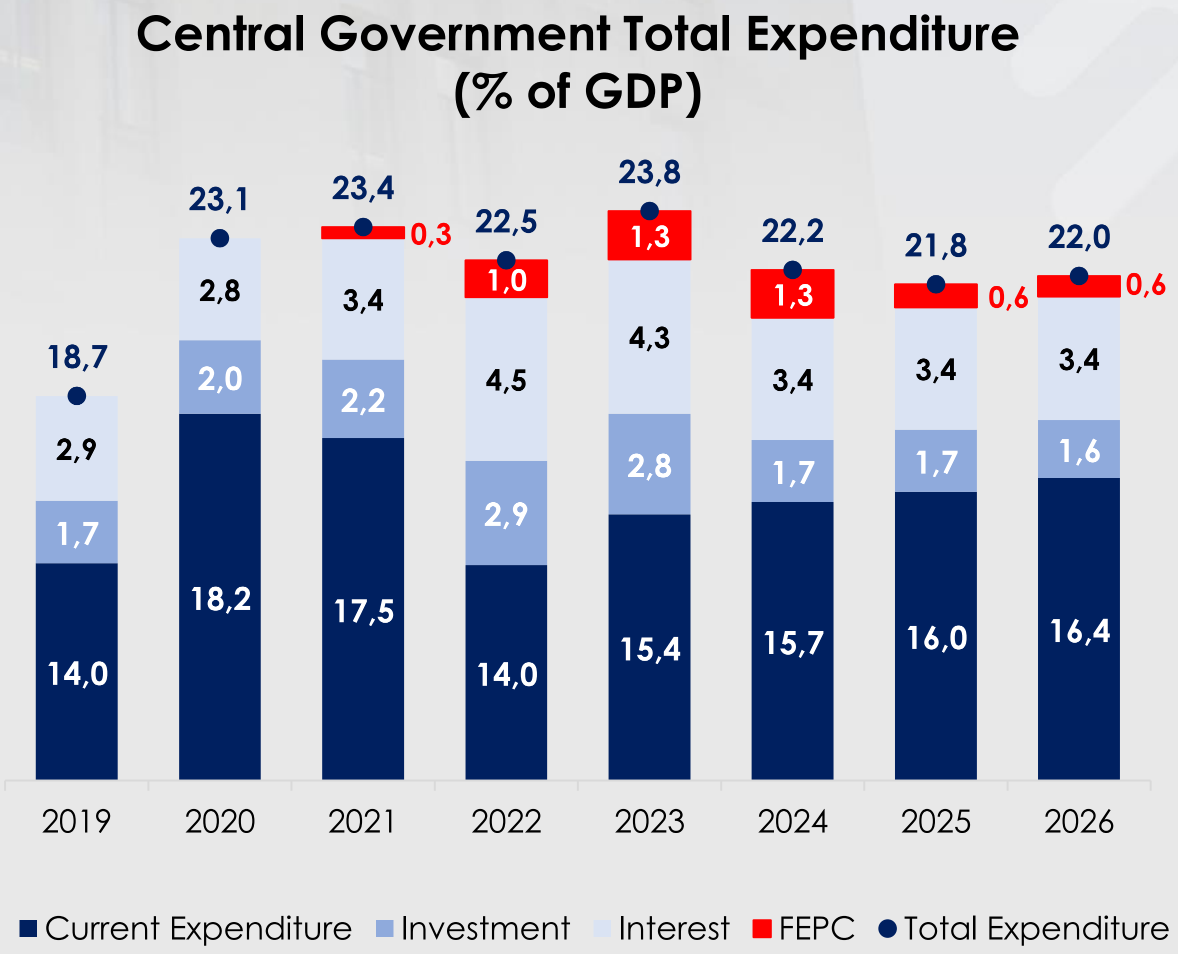
FEPC compensation differential with price adjustments
% of GDP



Source: Ministry of Finance.
* Projected figures
** The monthly price increments mentioned refer to the Producer Income (*Ingreso al Productor – IP*), which is the price paid to refiners and importers of fuel

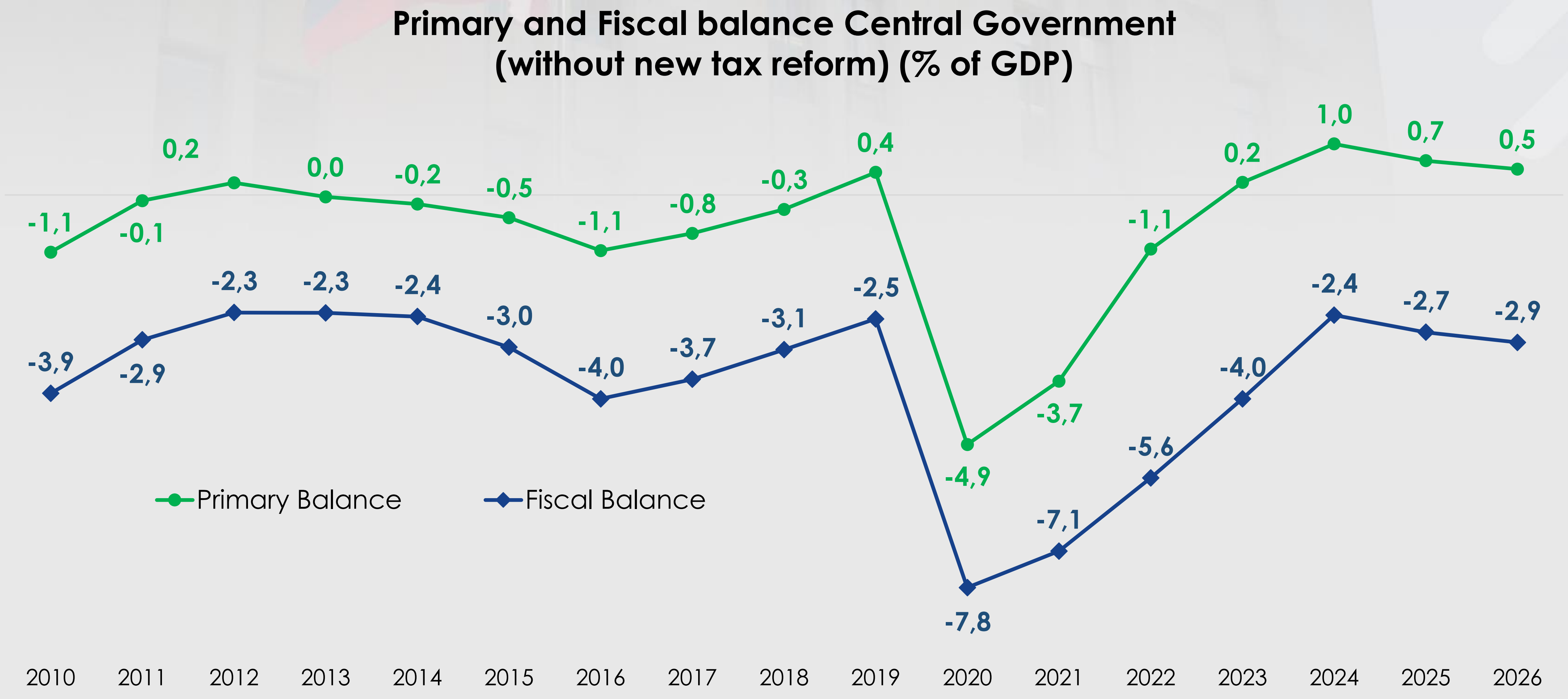
From 2023 onwards, tax revenues will increase permanently (even without the new reform), while total expenditures remain relatively stable





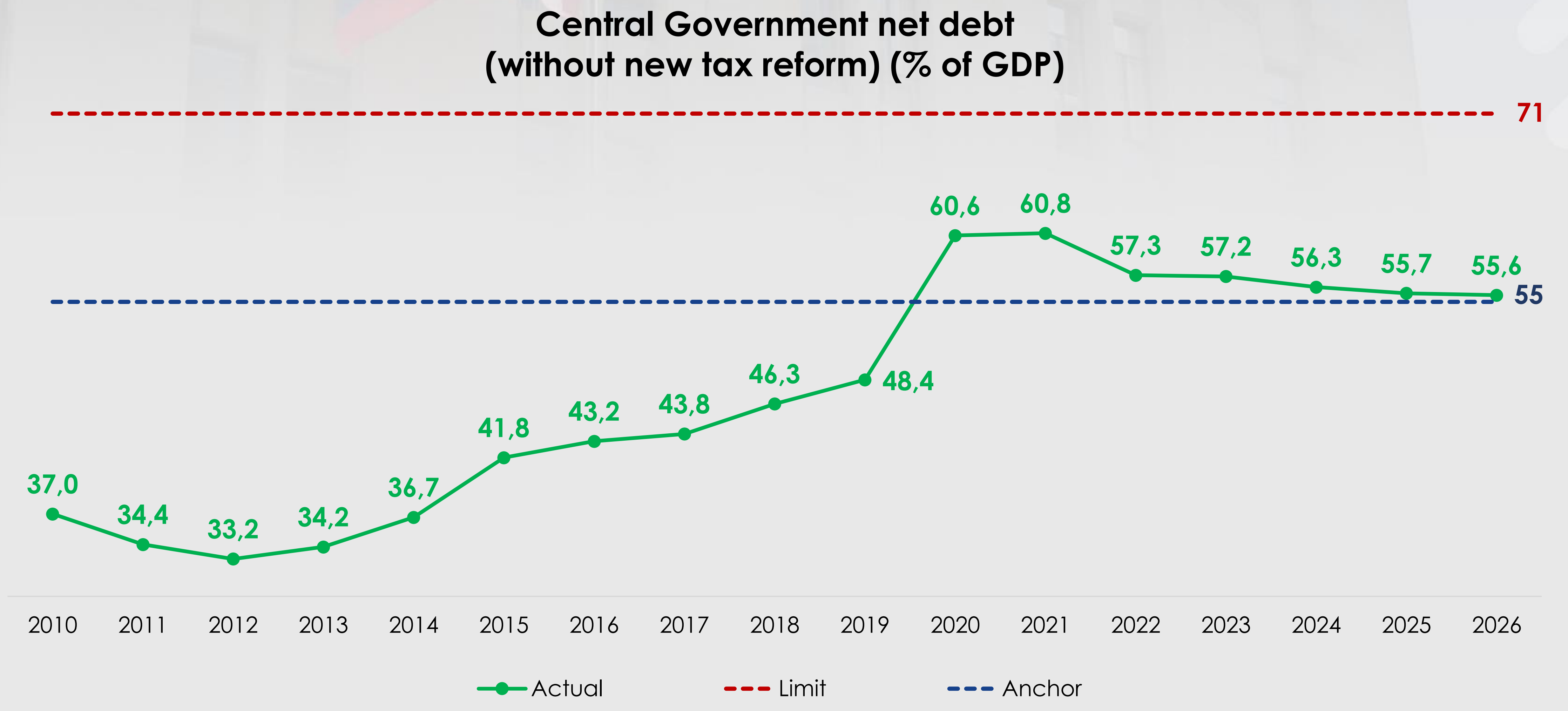
Source: Ministry of Finance.

In the medium term, the Central Government will achieve primary surpluses and a reduction in the fiscal deficit, consistent with compliance of the fiscal rule.



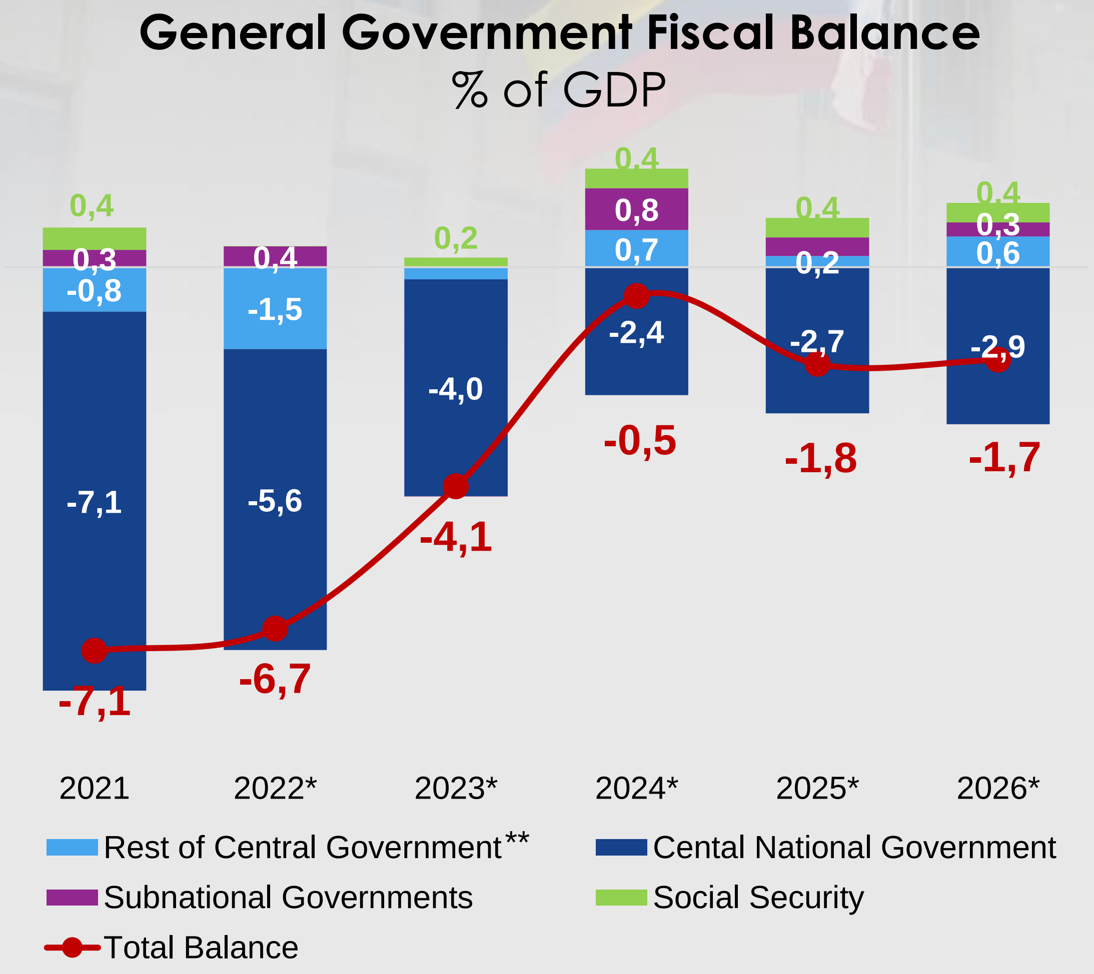
Source: Ministry of Finance.

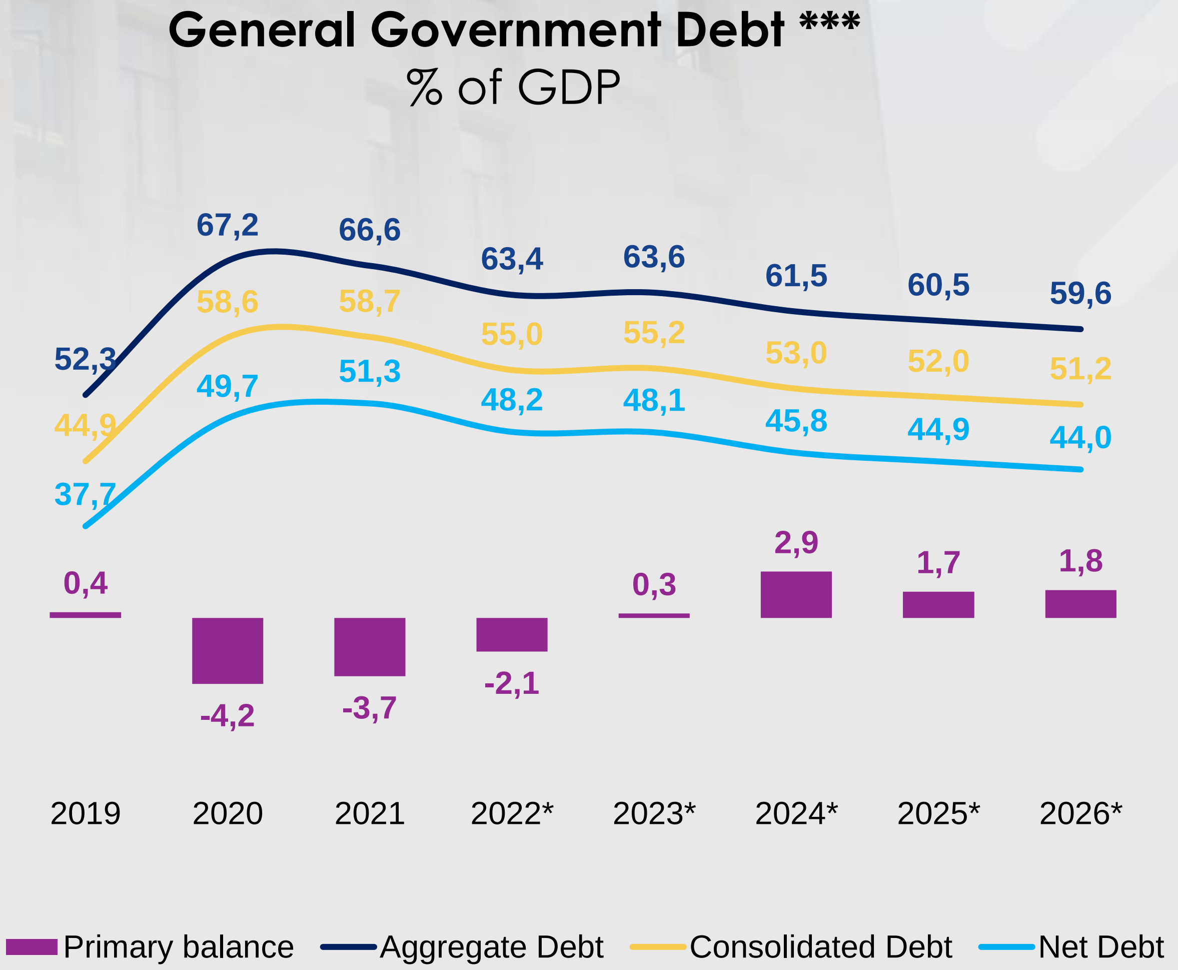
The above will lead net debt to converge to its anchor, even without the new reform



Source: Ministry of Finance.

In the medium-term, the dynamics of the General Government fiscal deficit and debt would be explained mainly by the results of the Central Government and FEPC





Source: Ministry of Finance.
* Projected figures
** The Fuel Price Stabilization Fund – FEPC is included in the Rest of Central Government.
*** The aggregate debt corresponds to the sum of all debts registered by each subsector of the General Government. Consolidated debt subtracts from aggregate debt all intragovernmental debt held among sectors of the General Government. The net debt is estimated subtracting liquid financial assets from consolidated debt

The current social situation requires higher public spending, funded with a progressive tax reform

On its first day, the new Government presented to Congress **a tax reform that aims to increase revenues by 1.5% of GDP**

Based on the approved tax reform, a fraction of the new revenue will be allocated **to social spending** (prioritizing programs to reduce poverty and inequality) and to strengthen the **fiscal adjustment**

The current social situation requires higher public spending, funded with a progressive tax reform, that would yield 1.5% of GDP.

1

Reducing tax expenditures for high income individuals, redistributing resources in favor of the most vulnerable

2

Ensuring sufficient funding for social spending through a more efficient allocation of resources, prioritizing the pillars of education, health and environmental protection

3

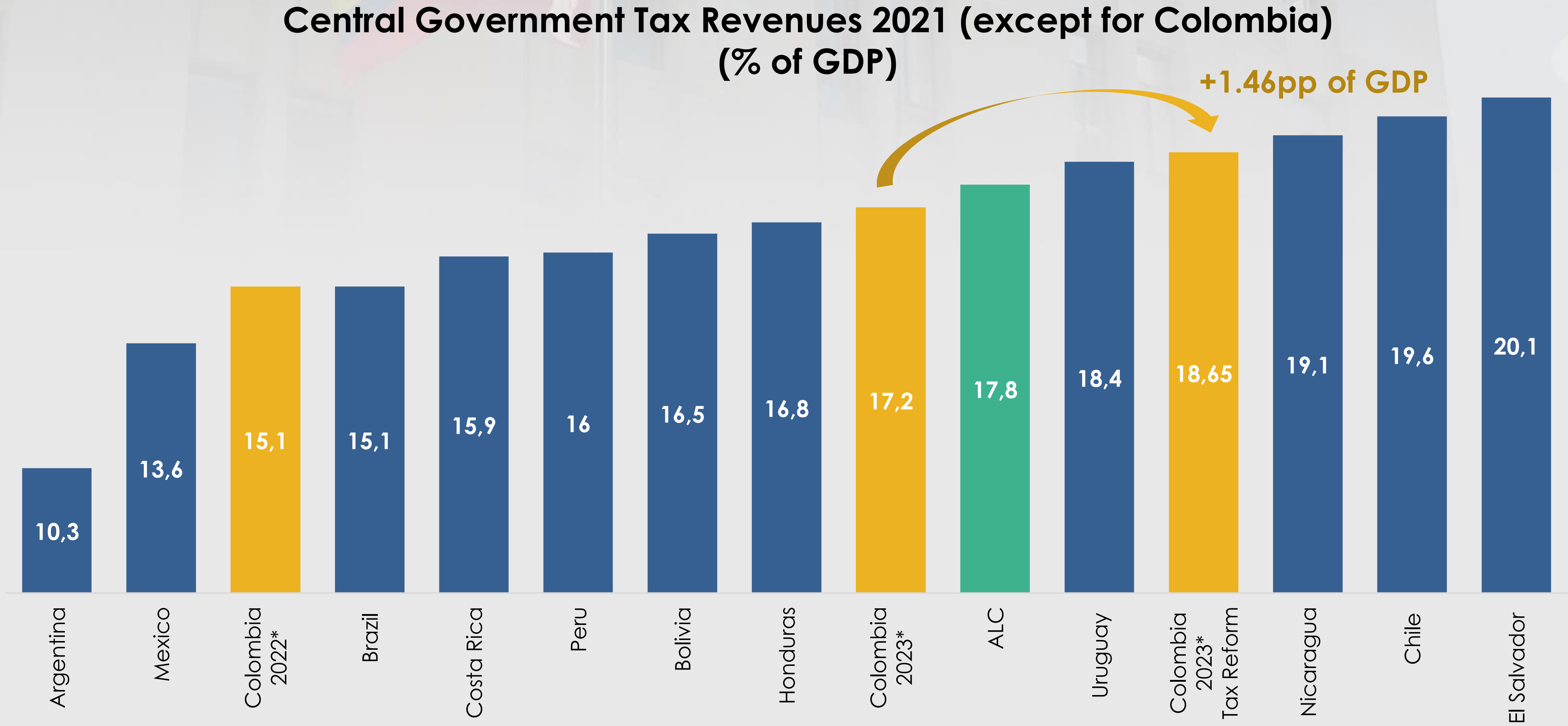
Expand revenue sources while mitigating negative externalities in health and the environment

The tax reform would achieve additional sources of $21,5 trillion COP (1.5% of GDP). An increase in collections is expected in 2026 due to improved management by the DIAN.

Tax reform				
Category	% of GDP			
	2023	2024	2025	2026
Personal income tax	0,13	0,18	0,19	0,20
Wealth tax	0,07	0,07	0,08	0,08
Corporate income tax	0,20	0,27	0,29	0,35
Natural Resources	0,77	0,61	0,45	0,42
Healthy and environmental taxes	0,09	0,19	0,28	0,30
Other measures*	0,20	0,23	0,29	0,31
Total	**1,46**	**1,46**	**1,39**	**1,38**

* Includes limit to tax benefits, free trade zones, and others.

With the tax reform, Colombia would achieve tax revenues closer to the Latin American average for the Central Government



*Forecast

Source: Ministry of Finance and Public Credit and Cepalstat.

Concluding remarks

- The Colombian economy has shown a **strong rebound and a positive performance** after the COVID-19 shock.
- **Short-term risks** include surging inflation, which has resulted in a tighter monetary policy, and harsher financial conditions. Some **structural economic policy challenges** are at the core of the economic agenda:
  - High and persistent **unemployment and informality**
  - Persistent **external imbalances**
- **In the medium-term,** the Colombian economy would converge towards a **macroeconomic equilibrium:** GDP around its trend level and a current account deficit that will gradually adjust.
- Higher tax revenues and increasing interest expenses lead to an **improvement in the primary balance** and an **increase in the fiscal deficit for 2022 and 2023. This scenario also allows an increase in public investment of 0.6pp of GDP in 2023, compared to the MTFF.**
- **The deficit generated by the FEPC represents a significant fiscal policy challenge,** requiring fuel price increases in the coming months, to ensure its sustainability.
- On its first day, the new Government presented to Congress a **tax reform that aims to increase revenues by 1.5% of GDP**, which will finance **higher social spending** and strengthen the **fiscal adjustment.**

THANKS

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Sources and Uses 2022

Sources	USD	trillion 116.485	Uses	USD	trillion 116.485
		60.049	**Deficit**		**78.294**
External	(US$ 3.401 mill.)	14.340	Of which:		
Internal		45.709	Internal Interest		51.967
			External Interest	(US$ 2.696 mill.)	11.329
Treasury Operations		**7.727**			
			Amortizations		**14.512**
Accrual Adjustments		**26.899**	External	(US$ 999 mill.)	4.208
			Internal		10.305
			Liability Payments (Court rulings, Health, Others)		**9.530**
Initial Availability		**21.809**	**Final Availability**		**14.149**

Source: Ministry of Finance September 10, 2022.

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