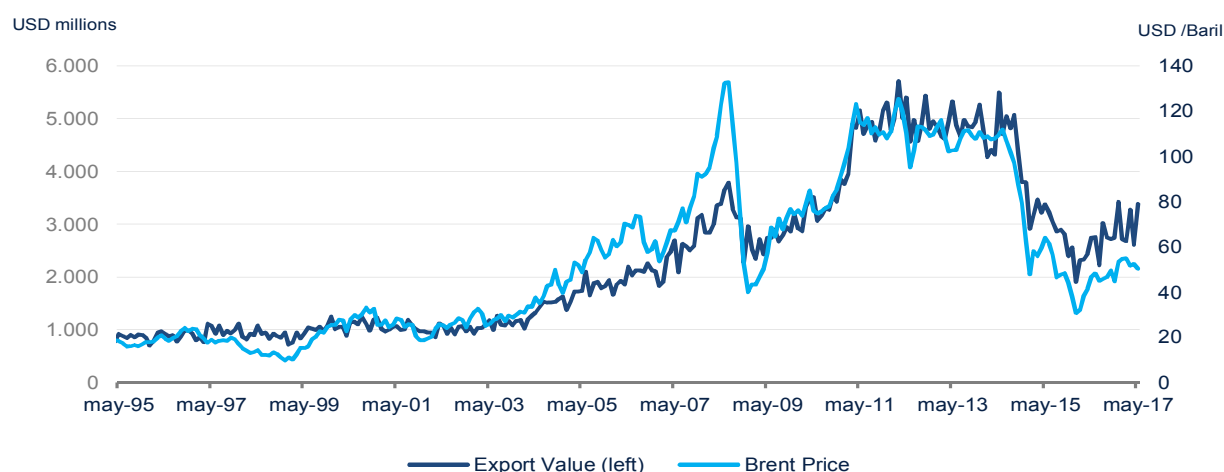


3. Colombia is continuing to feel the effects of a shock unprecedented in recent times

There are few historical precedents for the recent shock to Colombia's terms of trade, making it a unique event.

There have been very few shocks of a similar scale and significance to that suffered by Colombia's exports. To find examples, we need to go back to the last century, to the Great Depression of 1928-1932, when export values contracted by 50%. Or to a time of civil war - Colombia's War of a Thousand Days - when exports contracted by 45% between 1898 and 1902¹. These two episodes - the first of which left an indelible mark on humanity, and the second a deep wound in the country - are the only comparable episodes (since such records began) to the 48% contraction in exports between 2012 and 2016 (Figure 3.1)

Figure 3.1 The oil price and value of Colombia's exports



Source: Bloomberg, National Administrative Department for Statistics (DANE)

On this occasion, the sharp fall in oil prices (Brent) from an average of \$108.76 per barrel in 2013 to a low of \$33.52 per barrel in February 2016 resulted in a significant realignment of forces in Colombia's economy, many of which persist to this day and are reflected in the macroeconomics figures for 2017: this may well continue to have an impact for the rest of the decade. In principle, this shock should have had little impact on the economy due to the weight of the oil sector in GDP - which at its peak hardly reached 5.5% - compared to other economies in the region, such as Chile and Peru. However, because of its many facets, this sector is very important for Colombia's economy, representing 55% of total exports at their peak in 2013, and 32% of direct foreign investment that year. But this was also an important source of revenue for the government, bringing in 23 trillion pesos, around 20% of government revenues in 2013, excluding royalties. These figures leave oil exports today at scarcely 33% of the total, while direct

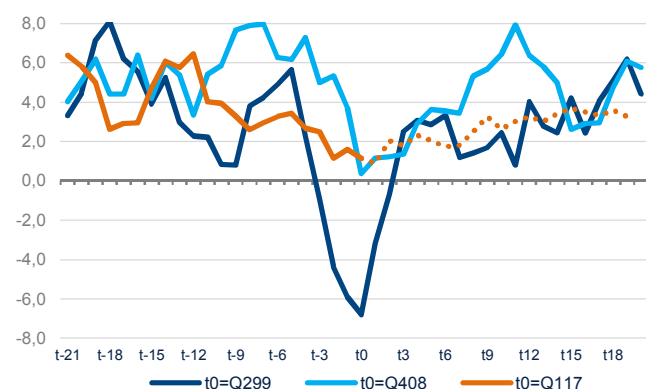
1: From the Treasury's "Macro achievements" presentation. Source: Fedesarrollo.

foreign investment in the mining-energy sector, which averaged 16% of the total over the last 2 years, made no contribution to the public finances in 2016.

The last three negative economic cycles: positive and negative differences

Economic growth 2.0% or less is very rare in Colombia's economic history. The current cycle is one of those periods, with some aspects comparable to the 2009 international financial crisis, which led to annual economic growth of 1.7%. And it is also similar to the recovery cycle from the crisis at the end of the last century. Although there was an economic contraction on that occasion that we do not expect to be repeated this time, the recovery involved several years of low growth, which is what we expect in the current cycle (Figure 3.2). One way of looking at these similarities is through the shape we expect the cycle to take. We do not believe there to be sufficiently strong exogenous or endogenous factors to achieve a rapid recovery. As a result, the current cycle will not take the **V** shape seen in 2008-2010. However, we believe that the recovery will share many of the aspects of the emergence from the 1999 recession, with slow growth and a positive slope but very soft output, as with a crisis of confidence. Thus, we expect the current cycle to take an extended **L**.

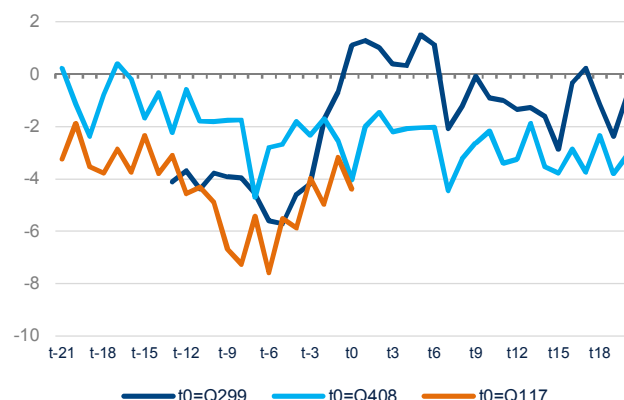
Figure 3.2 Economic cycles in Colombia* (%)



Source: DANE and BBVA Research

* includes our growth forecasts for the cycle t0=1Q17

Figure 3.3 Colombia current account (%)



Source: Central Bank of Colombia and BBVA Research calculations

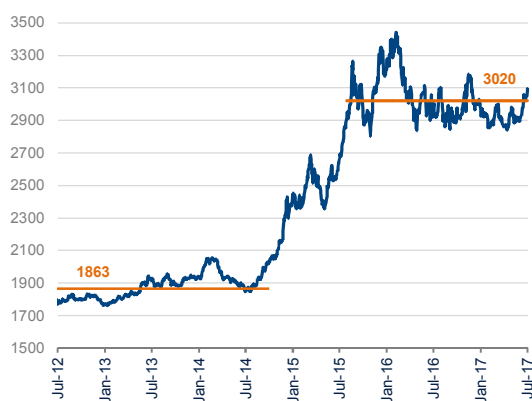
The current cycle shares a number of positive and negative differences with its two predecessors, differentiating it from both of them. Starting with the negative differences, there is no significant support for the current cycle in the form of economic stimuli from our trading partners. It should be remembered that, following a brief crisis in 2001, the US economy began a strong growth cycle, driven by new technologies and rising house prices. This enabled Colombia to emerge from its cycle of stagnation in around 2003. The situation was more obvious in 2009, with the rapid recovery in growth in China and, as a result, commodity prices, including oil. This led to a rapid recovery in our economy, with 4.0% growth in 2010. However, in the current cycle developed economies are facing long periods of slow growth, as a result of the financial crisis and its ramifications. Without China playing a leading role, emerging economies are facing a difficult panorama. In fact, we are seeing a cycle of contraction in our regional partners, who will struggle to achieve even slightly positive readings in 2017. Another negative difference, which we discuss in more detail in the next chapter, was the capacity of both the Government and the Central Bank to implement countercyclical

policies in 2009. This advantage did not exist in 1999. In the best cases, politics then acted as a brake on the economy, while now it would tend to be neutral, particularly during the recovery cycle. In 2009, the Central Bank reduced its policy rates by more than 700 basis points (bp). At the same time, the government permitted the fiscal deficit to expand to more than 4% of GDP, maintaining the path of public spending and taking advantage of the funds flowing in from the oil sector.

Turning to the positive differences, external funding is available in the current cycle, as it was in 2009 (Figure 3.3), and there has been a very rapid correction of risk premiums to normal levels. The availability of this funding has partly offset the impact of the cycle on domestic demand, particularly in terms of consumption. This situation did not exist in 1999, when the markets closed their doors to emerging economies, resulting in very substantial adjustments, with investment contracting and consumption stagnating for several years.

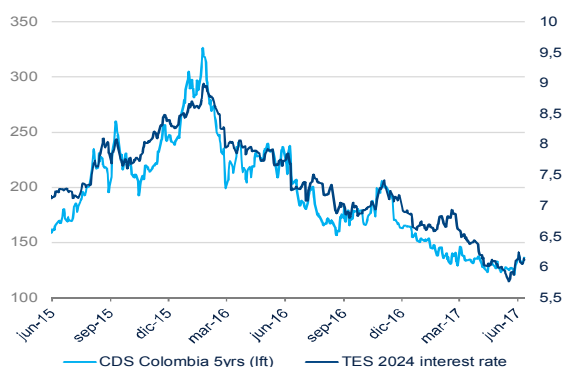
The flexibility of the exchange rate was also key in offsetting some of the negative effects on local revenue from export sectors. This factor also provided positive support in the 2009 cycle, which, by its nature, permitted a relatively rapid reversion of the exchange rate. This did not happen in 1999. At that time, in the midst of strong pressure on the Central Bank, the exchange rate band had to be abandoned for a flexible regime that had been brewing in the initial years of the crisis at the end of the last century (Figure 3.4). Finally, the responsible and prudent approach to economic policy over recently years has borne fruit in terms of credibility. This has meant that funding is still available on good terms and expectations are anchored. The capacity to smooth out the cycle has been increased and a more gradual adjustment has been achieved than in earlier periods, such as 1999.

Figure 3.4 Colombia exchange rates (pesos per dollar)



Source: Bloomberg

Figure 3.5 5-year CDS and 2024 Treasury bond (TES) (%), Colombia



Source: Bloomberg

Against this backdrop, capital and FX markets continue to show positive signs and resilience

The behaviour of capital markets remained positive in the quarter, with an appreciation of the public debt curve (Figure 3.5) and increasing participation by foreign investors in the domestic market. Foreign investors now hold 36% of Colombia's public debt in pesos. This has led to much of the curve being below monetary policy rates over most of the last year and a half. This appetite is understood to be due to ample global liquidity and yield spreads that still favour Colombia over similar alternatives and options in developed economies. Furthermore, the risk premium has remained low and, together with the exchange rate, has been less volatile than in the past, limiting risks for foreign investors. Domestically, the slowdown in inflation and reductions in monetary policy rates have also had a favourable impact, increasing the attractiveness of fixed income assets.

Finally, the exchange rate has absorbed most of the adjustment of the current shock, moving from around 1800 pesos per dollar before the shock to an average of between 2850 and 3100 pesos per dollar over recent months. This level correlates strongly with the crude oil price, which exhibited a downward trend over the last quarter, fostering a depreciation of the exchange rate compared to the start of the quarter. This behaviour was complemented by the Fed's decision to increase interest rates in June and the announcement of a reversal of its monetary relaxation from October. This could lead to lower liquidity and the possibility of a flight to quality towards the USA over the coming years.