BBVA

Country Report

Economic Research Department

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Economic Research Department

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Colombia BBVA

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Colombia

Executive Summary

Colombia has been one of the economies with the highest levels of political and economical stability in Latin America over recent years, without experiencing any coups, deep recessions, hyperinflation or debt moratoriums. Over the last few years, the increase in the share of investment in the GDP has been noteworthy. However, the country still suffers from a deficit in infrastructure, especially transport, which it needs to cover if it is to increase productivity and competitiveness in the medium-term.

One of the country's idiosyncrasies is the coexistence of productive activity and the formal economy with an internal armed conflict and a black economy specializing in cultivating and selling narcotics. The Colombian internal conflict has its recent origins in the armed peasant struggles of the mid-20th Century, who fought for better land distribution. For the last sixty years the conflict has escalated from the formation of guerrilla groups with strong political ideals and aims of taking power to guerrilla groups who see drug trafficking and kidnapping as a method of financing and who clash with private paramilitary groups who are just as bloodthirsty as or even more so than the guerrilla groups themselves and who defend local economic and political interests. Since 2002, the armed forces' new strategy of confronting illegal armed groups and controlling national territory has diluted the conflict and weakened the underground armed groups. At the present time, security levels for the population are much higher and programs are being launched to encourage the reinsertion of the part of society that is caught in this conflict.

The majority of the Colombian population lives in urban centers as a result of a migration process that accelerated during the late 20th Century. Basic education coverage is almost universal and major progress has been made to achieve the same result for secondary education. The challenge at the moment is to increase secondary education coverage, which is poor compared to other countries in the region. There are several distortions in the labor market that have prevented the unemployment rate from being lowered structurally in spite of the favorable economic conditions. This is an ongoing task for the country, not only to increase growth, but also to bring down poverty levels and improve social security coverage.

A large part of Colombia's macroeconomic stability is based on its economic policies. Foreign exchange and monetary policies have evolved alongside the economy's needs and the country currently has price stability and a flexible exchange rate that allows it to absorb some of the international impacts in the different stages of the economic cycle. The efficient tax management undertaken in recent years has allowed the country to fulfill its obligations and it has been able to double collections without harming the economy. At any rate, the country still faces the challenge of simplifying its tax system and increasing revenue with a view to achieving greater fiscal flexibility.

The foreign trade structure has changed, increasing the role of manufactured products in imports and the role of non-traditional basic products. At the moment, Colombia is seeking to increase its trade openness by signing trade agreements with strategic partners that allow it to diversify the destination of its exports. China is a key country in this sense, although Colombia is also about to sign the FTA with the US, its main partner alongside Venezuela.

The energy sector in Colombia has been the main receiver of foreign investment during the recent cycle. The country currently has some oil reserves, but it mainly has natural gas reserves. The country is promoting the production of biofuels from sugarcane and African oil palm. Finally, Colombia's climate and geographical location give it the potential to become a hydraulic energy generation and transmission power in the region.

There is strong financial sector regulation that guarantees stability. There has also been a strong consolidation process as the result of M&A processes. The securities market has also become deeper. In spite of the foregoing, there are still challenges to be faced in the medium-term. The population's level of banking is still low and the securities market is targeted at large companies. .

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Introduction

The Republic of Colombia, in the north of South America, has a population of 45 million with a working population of around 20 million. The Colombian economy is ranked fifth in Latin America, although when it is compared in terms of GDP per capita[1], around 8,200 dollars PPP, it ranks below the region's average. Colombia was 80th out of 177 in the Human Development Index[2] in 2006, 62nd out of 122 in the Global Competitivity Index[3] and 70th out of 179 in the Corruption Perceptions Index[4] in 2008.

Main indicators	2008
Population (million)	43,4
Urban (%)	73
Rural(%)	27
GDP (USD million)	244.064
GDP growth (yoy)	2,5
Urban unemployment rate (%)	10,9

Source: DANE

Colombia's credit rating is BB+ with a stable outlook, one step short of investment grade. Risk evaluation companies have increased Colombia's rating over recent years as a result of its positive economic results.

From a political point of view, Colombia is an organized Welfare State in the form of a unitary republic with political centralization and administrative decentralization. Over history, Colombia has kept up its democracy and institutions have held onto their credibility and independence. However, the country has suffered different types of violent conflicts since the second half of the 20th Century. Recently, the conflict has mainly been linked to the drug trafficking business and the main players have been the mafia, guerrilla groups and paramilitary groups.

Over the past few years, the country has undergone an expansive economic cycle with improvements in the security system that took the country to record levels of foreign direct investment and share of investment in the GDP.

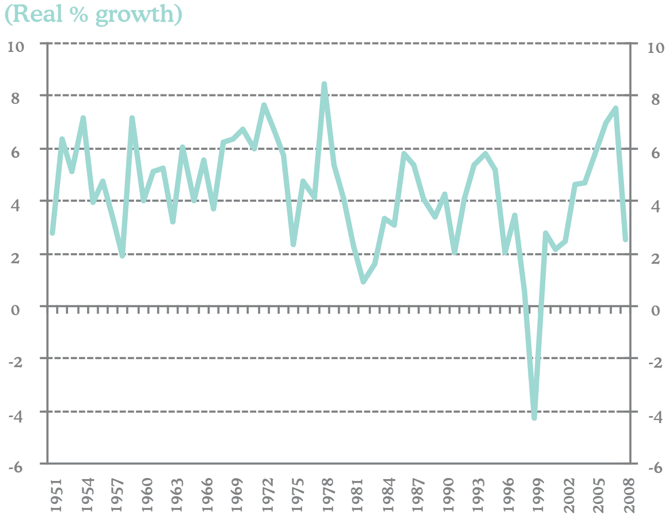
The purpose of this report is to concisely explain the most important issues of the Colombian economy. The report is divided into four chapters. The first one deals with the economy structure, policies and economic growth, the second with demographics and the labor market, the third contains an analysis by sector, and finally, the fourth chapter describes the country's political situation and internal conflict.

1 MF dollars PPP
2 UNPD- 2008
3 Global competitiveness report 2008-2009. World Economic Forum
4 International Transparency 2008

Economy

The Colombian economy has recorded an average annual growth of around 4.3% for the last 60 years, brought about by overall progress in the workforce and in physical and human capital allocation. The increase in physical capital has been quicker than human capital, and the productivity of the factors that had slowed down since the 1970s have recorded an upturn in recent years due to the sharp growth in capital investment (Posada 2008). GDP per capita in real terms has posted an average growth of 0.1% in the last 20 years, versus 1.8% for the main industrialized economies. This means that the economy has not converged with the developed world.

Colombia GDP
(Real % growth)



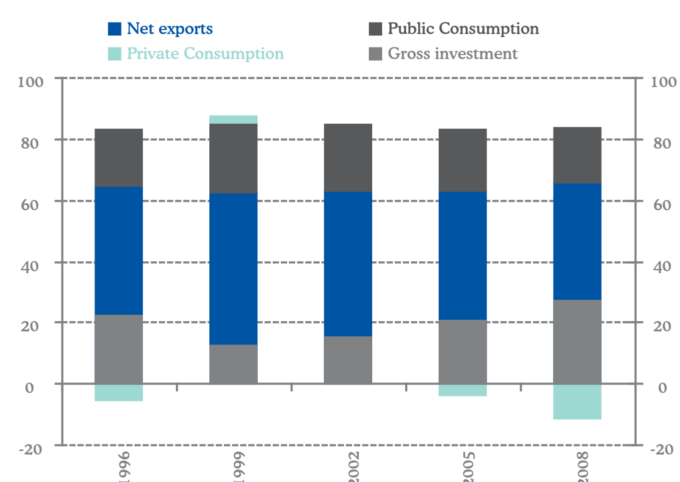
Source: Greco BBVA ERD

It is worth noting that during the 20th Century the Colombian economy only recorded negative growth one year, in 1999, caused by the Asian crisis. During other crisis periods, the Colombian economy only experienced reductions in its growth rate, never falls. When compared with the region, Colombia is noted for its traditional macroeconomic stability. Unlike most countries in the region, the Colombian State has always met its debt payment obligations.

The crisis at the turn of the century took a heavy toll due to excess government spending, funded through an unsustainable growth in public debt, which led to a similar increase in the current account deficit. At the same time, the low regulation standards and the unsustainable growth in household spending, funded through the financial system, led to the formation of a bubble, especially in the mortgage sector. The element that triggered off the crisis in Colombia was the Russian debt moratorium which caused the global capital market to be shut down. The end to the crisis for the country marked out a new era in terms of regulation and created a new institutional framework that to a large extent is the one that prevails today.

As regards demand, private consumption represents around 66% of the GDP, while investment has risen from 15% of the GDP at the start of the decade to 28% at the moment. Foreign direct investment has recorded positive results over recent years. The main destination of this investment is the oil, hydrocarbon and mining sector. Government spending has stayed at relatively stable levels, at around 19% of the GDP.

GDP components
(Share %)



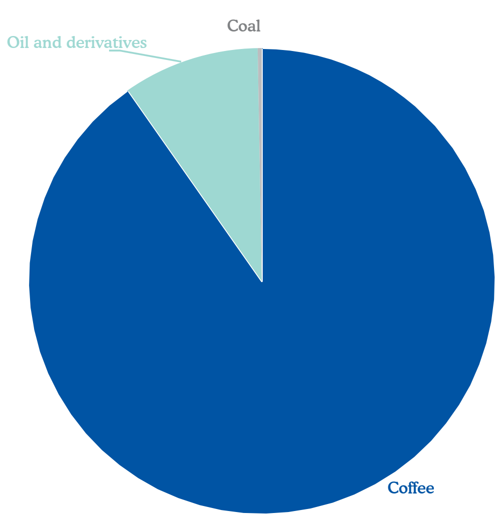
Source: DANE BBVA ERD

From the point of view of supply, the manufacturing sector and trade represent around 27% of the GDP, with each sector representing almost the same share. The agricultural sector accounts for around 9% and mining and energy have a 7% share of the GDP. The construction and transport sectors represent 5% and 7% of the GDP respectively. The important role that the financial, real estate and other corporate services sectors play, which account for around 17% of the total GDP, should be mentioned. Finally, state social services have had a 20% share of the GDP in recent years.

Foreign Trade

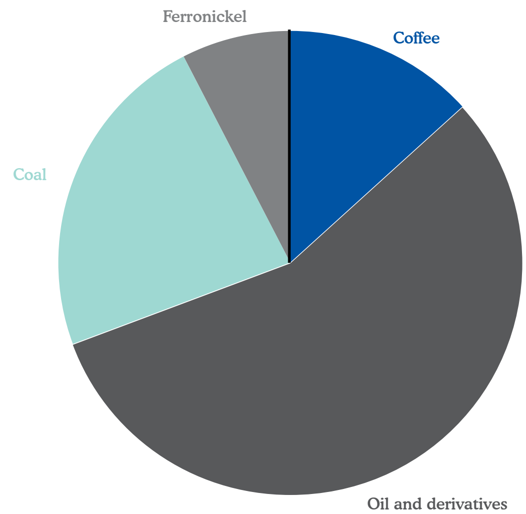
The Colombian economy is noted for exporting raw materials. Over the last 40 years, traditional exports have represented more than 50%, although recently non-traditional exports have increased their share of the total. Although during the 1970s they represented 38.5%, more recently they have accounted for 49% of the total. The structure of traditional shares has changed dramatically in recent years. The Colombian economy has gone from being an economy in which the main exported product was coffee to an economy in which exports rely heavily on oil and coal. The structure of non-traditional exports has also changed in favor of manufactured goods, which currently represent 75% of total non-traditional exports, with textiles, chemicals and food representing a large share.

Composition of traditional exports in the 1970s



Source: DANE BBVA ERD

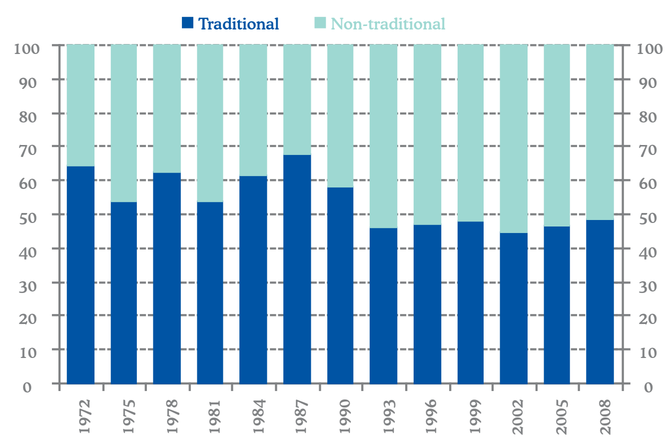
Composition of traditional exports 2008



Source: DANE BBVA ERD

The main imports are intermediate goods (45% of the total) and capital goods purchased abroad recently represented around 90% of the country's total investment in this type of goods. The above shows that imports are largely linked to manufacturing sector output. Consumer goods imports are mostly durable goods such as motor vehicles and electrical appliances.

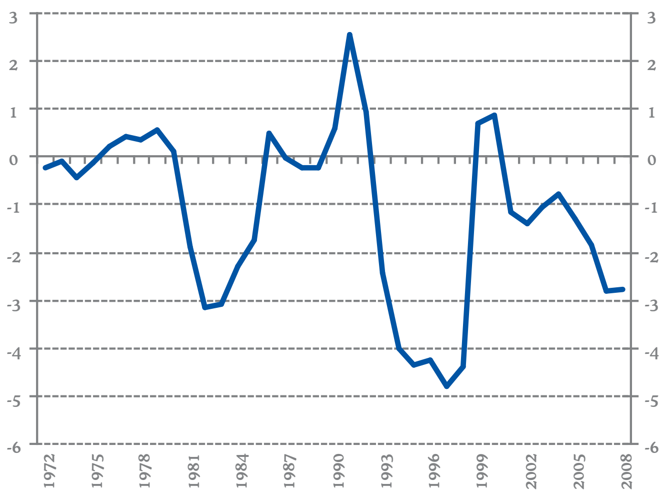
Traditional and non-traditional exports
(% of total)



Source: DANE BBVA ERD

The trade balance in the Colombian economy has traditionally been negative, except for some periods during which terms of trade were in the country's favor. The current account has also recorded a persistent deficit, largely explained by factor income, specifically by the dividends and utilities category. It can be said then that the Colombian economy has traditionally turned to foreign savings to fund its excess spending, which is in keeping with its status as a developing country. This situation became more acute during the second half of the 1990s and it was one of the factors that triggered off the crisis in view of the shutting down of the capital market and the later offsetting of this deficit.

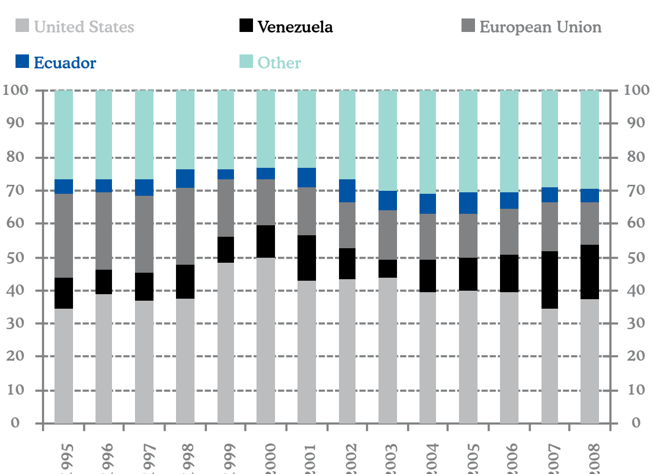
Current-account deficit
(% of GDP)



Source: Banco de la República, DANE BBVA ERD

At the moment, Colombia is an open economy and its main trade partners are the United States (30% of total exports), the European Union (22%), Venezuela (16%) and Ecuador (4%).. The future challenge will be to diversify products and the destination of exports. In particular, alternative markets for the goods exported to Venezuela and to Ecuador must be found, most of which are part of non-traditional exports, because their high dependency makes Colombia's foreign trade more vulnerable insofar as these two economies present a difficult outlook in the short-term in terms of the sustainability of their development model and their ability to fund their consumption.

Exports by country of destination
(Share %)



Fuente: DANE SEE BBVA

Part of the country's trade policy in recent years has focused on seeking Free Trade Agreements and trade agreements with the leading world economies. High on the agenda is the signing of the FTA with the United States, which was negotiated in 2007. The country has made parallel progress on the negotiation of trade agreements with other partners such as Canada and the European Union, and it has already signed agreements with Chile and the Northern Triangle (Guatemala, Honduras and El Salvador). In the case of the FTA with the United States and Canada, Colombia is waiting for approval from Congress in those countries. Another area of trade policy that has been fostered recently has been the signing of tax stability agreements with other strategic partners, including China, to attract foreign direct investment and that could be seen as the first step towards entering a trade agreement.

Foreign Exchange Policy

Over the past few decades, the foreign exchange policy in Colombia has moved towards exchange rate flexibility. Over the last 40 years, there have been four different exchange rate regimes, starting with fixed parity and ending with a flexible exchange rate, which is the one in force at present. It must be noted that, like other regions in the world, the exchange rate is a highly sensitive issue, over which exporters have had a major influence throughout history.

Real Exchange Rate Index
(Base 1994)

Source: Banco de la República BBVA ERD

In 1967, as a result of growing instability in terms of exporter income, the estatuto cambiario (foreign exchange statute) was set up, based on foreign exchange regulation during the last 25 years. This regime, known as Crawling peg, allowed periods of heavy capital inflows and outflows to be faced, such as the bonanza cafetera (the most successful coffee harvest in country's history) in the 1970s and the Latin American debt crisis, the effects of which spilled over into most of the 1980s. Later, in the midst of the crisis at the turn of the century and with a strong devaluation pressure on the currency that led to a significant deaccumulation of international reserves, the country opted for a floating exchange rate.

International reserves
(% of GDP)

Source: Banco de la República, DANE BBVA ERD

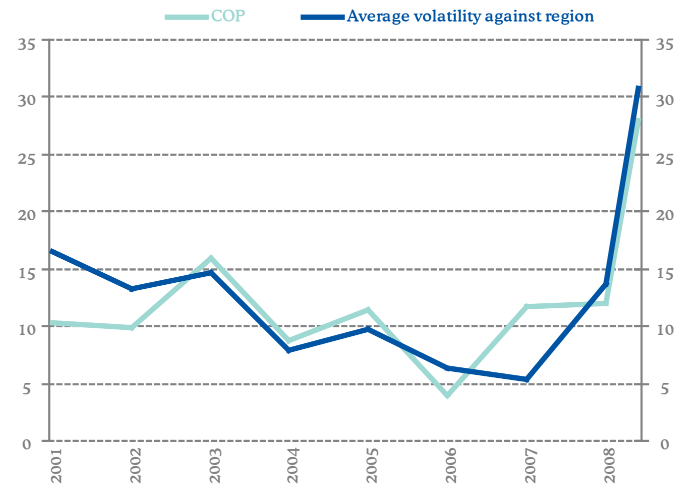
Since the flexible exchange rate was adopted, the Colombian currency has experienced two very different cycles. The first was until mid-2002 when the currencies of emerging countries suffered heavy depreciation, linked to a period of high risk premiums. The second period was an appreciation between 2002 and mid-2008 caused by greater investment flows into the region and a major improvement in terms of trade.

Colombia EMBI

Source: JP Morgan BBVA ERD

Empirical evidence shows that Colombia's exchange rate fluctuations are countercyclical, meaning that each stage lasts for a long time.

Colombian peso volatility against the region
(Year-on-year percentage change)

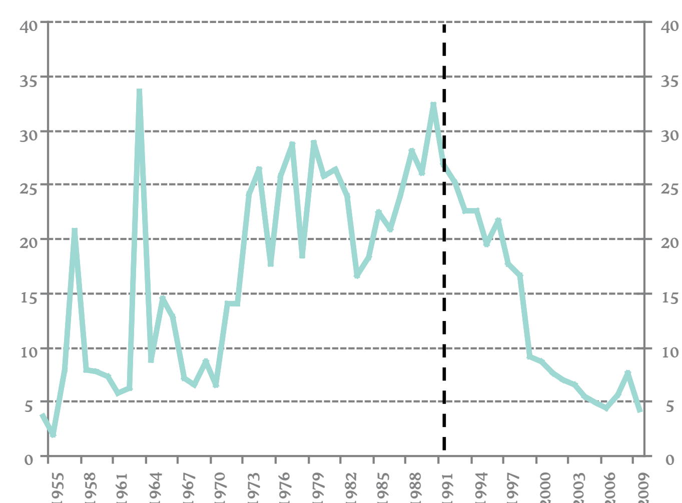


Source: Bloomberg BBVA ERD

Monetary Policy

Unlike other countries in the region, over the course of the 20th Century, not once did the Colombian economy experience hyperinflation. The inflation trend for the last 40 years is described in three stages. From the 1950s until the early 1970s it was low, with an annual average of around 10%, but with high volatility levels. Then, between 1973 and 1990 there was a period of moderate inflation, around 23% in terms of annual average, but with low volatility levels. Finally, from 1991 onwards there was an ongoing process of slowing inflation that saw it drop to below the one-digit level during the first decade of the 21st Century. At the moment, the Colombian economy is close to reaching the long-term target that was established, which is between 2% and 4% in annual terms.

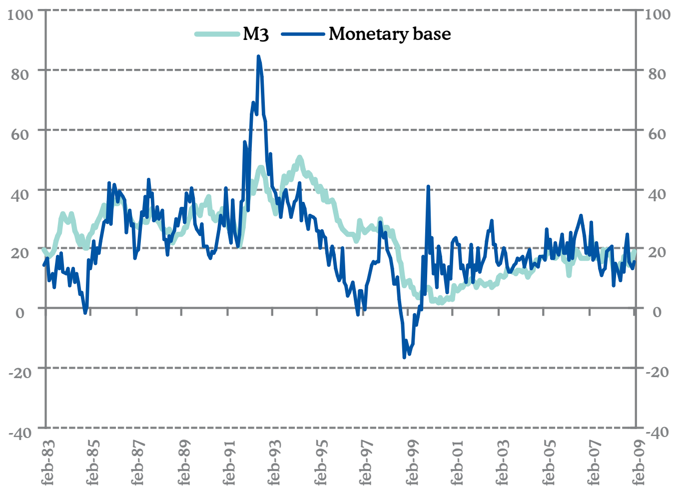
Annual inflation
(%)



Source: Banco de la República BBVA ERD

The objectives of the monetary policy in Colombia changed radically with the entering into force of the Constitution of 1991. Before that, decisions were aimed at backing the crawling peg regime. The new constitution order granted independence to BanRep and set it the primary goal of keeping the purchasing power of the currency, i.e. reaching a low, stable inflation rate.

Monetary Aggregates
(Year-on-year percentage change)



Source: Banco de la República BBVA ERD

The Board of Directors of BanRep (BDBR) is the collegial body in charge of taking monetary, exchange rate and credit policy decisions.

To meet its primary goal, BanRep has implemented different monetary policy strategies over the past 20 years. From 1999 onwards, with the easing of the exchange rate, the monetary policy strategy changed due to the target inflation strategy, where the main instrument is the short-term policy rate (REPO). Another instrument used to speed up rate spread are reserves, which in the last five years have been changed on more than four occasions.

REPO rates Banco de la República
(% E.A)

Source: Banco de la República BBVA ERD

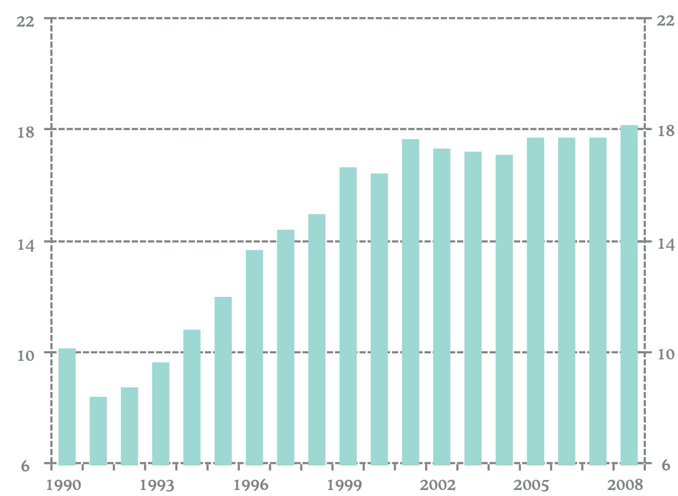
The monetary policy challenges for the coming years include reaching and consolidating compliance with the long-term inflation target, ending the disinflation process that started 20 years ago.

The heavy cut in inflation and the widespread acknowledgement of the central bank's competence have validated its actions and the importance of its independence, which is practically unquestioned today.

Fiscal Policy

Over the past few decades, the government has recorded persistently negative fiscal results caused by an increase in spending that has not been offset by a similar growth in income. This imbalance resulted in a rapid growth in public debt, both domestic and foreign, during the 1990s. While in 1994 the National Central Government's debt was 16.4% of the GDP, in 2003 it reached its all-time high at around 50% of the GDP. Over the course of this century, major efforts have been made to put these imbalances right and at the end of 2008 debt was lowered to 36.4% of the GDP.

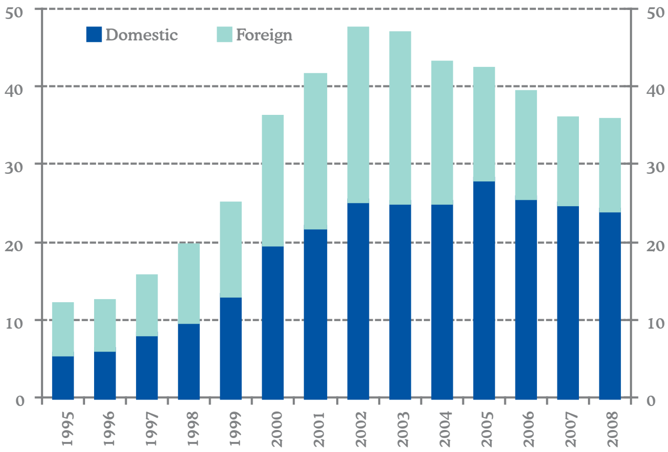
Total spending Central Government
(% of GDP)



Source: CONFIS BBVA ERD

Various strategies have also been implemented to change the public debt structure and to lengthen the debt maturity profile. In the former case, the percentage of foreign debt has been brought down to 25% of the total, reducing the country's exposure to periods of heavy devaluation or the shutting down of the capital market. In the latter case, the average length of the debt portfolio dropped from 5.4 years in 2000 to 5.9 years in 2008.

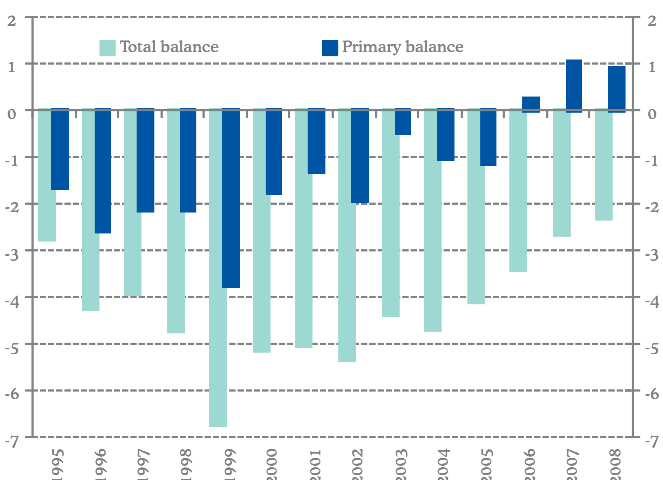
Total debt of the National Central Government
(% of GDP)



Source: Banco de la República — BBVA ERD

Most of government spending in Colombia is inflexible and around 70% is subject to constitutional regulations. Part of it is used to fulfill education and health obligations and other transfers. Another part is used to cover the growing pension liability that was not fully provided for, and so ended up being charged to the state budget. These factors dramatically limit the room for maneuver regarding the fiscal policy and narrow the margin that governments have to implement a countercyclical policy.

Primary fiscal balance and Central Government total
(% of GDP)



Fuente: CONFIS — SEE BBVA

Another factor that explains the problem is tax income. Colombia has been known to have a complicated tax structure, with constant changes to the system and exemptions for certain groups depending on the development policy in force. Since the 1970s, when structure reforms to the system began, on average a tax reform has been introduced every three years,[5] casting many structural problems aside, such as the high dependence on indirect taxation. At the moment the government's income is made up by 49.4% in direct taxes (after representing just 37% in 1980) and 50.6% in indirect taxes, of which 18% refer to foreign taxes. However, there are two significant breakthroughs in tax policy management in Colombia. Firstly, the successive changes to the tax structure allowed collections to be doubled in the last two decades, from 7% to 14% of the GDP, without significantly distorting the performance of the private sector. Secondly, in terms of funding, the government has deepened the domestic public debt market and has had opportune foreign bond issuances, at historically low interest rates. Likewise, unlike other countries in the region, Colombia has not declared a debt moratorium in the last 60 years, which has allowed it to keep its credit facilities open with the main multilateral institutions and with the capital market.

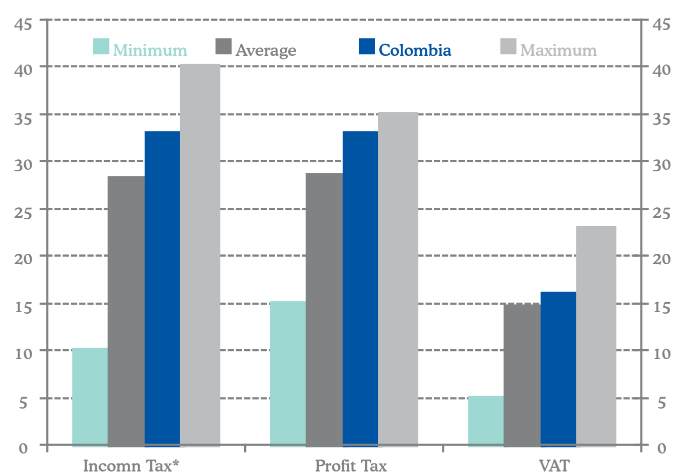
5 Garay (1998)

Effective collection of taxes in South America
(% of GDP)

	1990-99	2000-07	2007
Chile	15,6	16,7	18,9
Uruguay	14,7	16,6	18,0
Bolivia	12,2	15,7	17,4
Brazil	11,4	15,6	17,3
Venezuela	14,5	13,2	16,1
Peru	12,9	13,4	15,7
Colombia	8,7	12,2	13,7
Argentina	7,6	11,4	12,7
Paraguay	10,6	11,2	11,7
Ecuador	7,4	10,4	10,7

Source: CEPAL and BBVA ERD calculations

Proportional to income tax and value added tax in Latin America



* Maximum permitted rate
Source: CEPAL and BBVA ERD calculations — BBVA ERD

At the moment, the main challenge for the fiscal policy is to offset the structure deficit in order to generate savings in the high part of the economic cycle that allow a countercyclical fiscal policy to be implemented. This is a policy instrument that the Colombian economy has not had in recent years.

Production and productivity factors

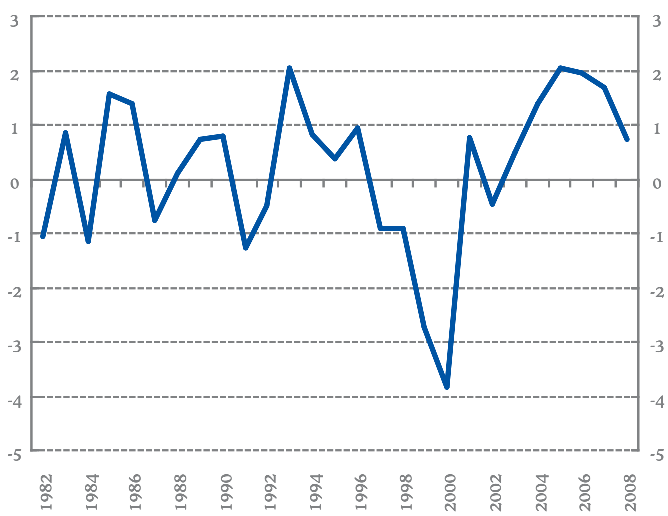
Colombian economic growth has been 4.3% on average since the second half of the 20th Century and has been largely due to the overall contribution from capital and labor, while the total factor productivity represented a very low or even negative contribution during some parts of the period analyzed.

Colombia Growth Accounting

Period	Average growth	Contribution to growth		
		L	K	A
1982-1988	3,46%	1,38%	1,78%	0,30%
1989-1996	4,07%	1,73%	2,14%	0,20%
1997-2003	1,71%	1,68%	1,30%	-1,27%
2004-2008	5,45%	2,04%	1,71%	1,70%

Source: Calculations of BBVA ERD

Solow Residual
(Year-on-year percentage change)

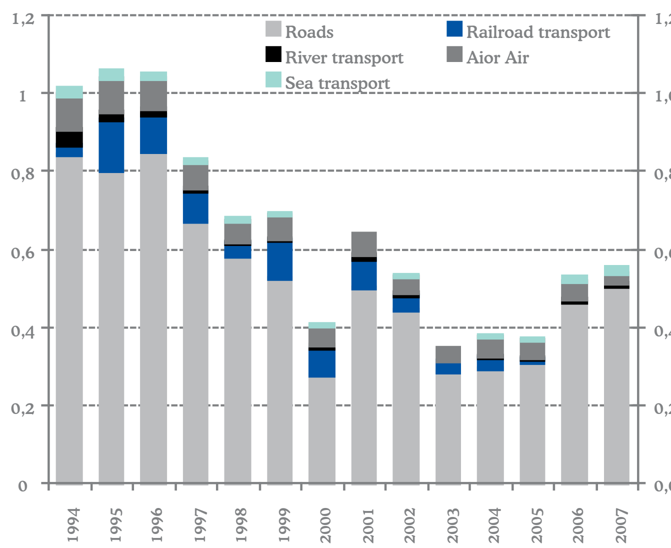


Source: BBVA ERD calculations BBVA ERD

The internal conflict and the delay in both transport infrastructure and education (the topic of the next section) were responsible for the small change in productivity. An essential factor to increase potential output and therefore the long-term growth rate is a reduction in the country's current infrastructure deficit.

Currently, 91% of investment in infrastructure is allocated to land transport. During the 20th Century most of the river and railway transport resources were re-allocated to the national road network. In spite of this effort there is a land transport infrastructure deficit caused by topography and violence, and also due to delays in national project plans for competitiveness. The limited capacity to design and structure infrastructure projects has kept the delay up and prevented the investment capacity that was generated with the growing pension saving in the hands of private funds being transferred to this type of project. Over the past seven years there has been stagnation in initiatives in this field and the National Government's efforts were focused on projects with a low aggregate impact, such as local roads, which did not fall under its competency; they were the responsibility of regional or local governments. As a result, Colombia has one of the lowest rates of kilometers of tarmaced road per hundred thousand inhabitants[6], even though 80% of inland cargo transport is via road[7].

Public investment in the transport sector
(% of GDP)



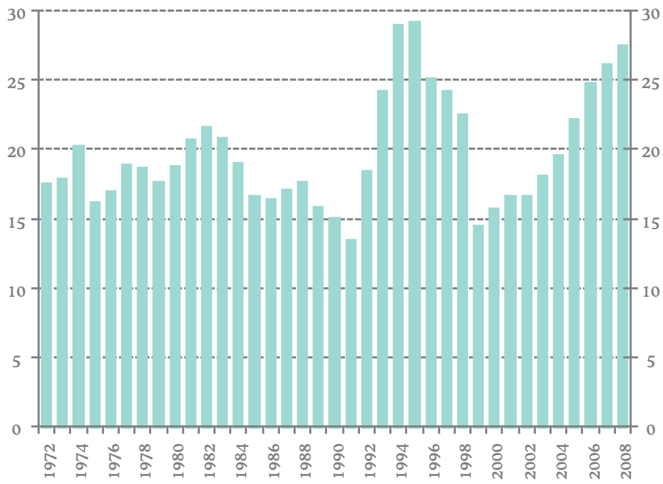
Source: Ministerio de transporte BBVA ERD

The economic openness and integration agreements that the country anticipates require better road, ports and airport facilities. Bearing in mind that around 95% of Colombian foreign trade is via river transport, the country's main ports have been privatized (Barranquilla, Santa Marta, Cartagena and Buenaventura) to contract their modernization and operation out. Over the past few decades, Colombia has also increased its airport facilities and modernized the existing terminals.

In the last 5 years, due to better security and high investment rates, the economy has recorded higher growth rates, which are reflected in a better performance in productivity and an increase in the economy's growth potential. During the recent cycle, a lot of investment growth was due to the increase in the private sector's installed capacity and the country did not use this cycle to close the infrastructure deficit.

6 World Bank (2006)
7 State Ministry of Transport (2009).

Gross investment
(% of GDP)



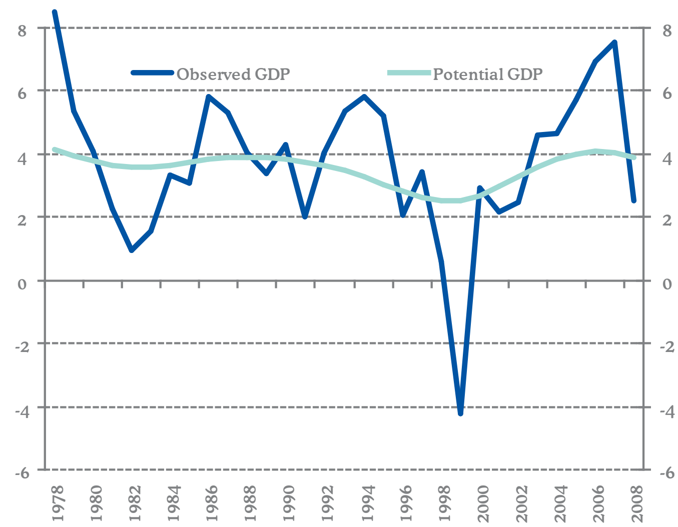
Source: GRECO and DANE. BBVA ERD calculations BBVA ERD

Also, the achievements in terms of macroeconomic and institutional stability and security conditions, as well as the greater capital inflow from abroad and higher confidence levels, consolidated all-time high investment rates in recent years. The economy's investment as a percentage of GDP was 28% at the end of 2008, far off its historical highs (29%). This allowed an upturn in total factor productivity. Also, the reduction in the population dependency rate and better access to higher education allowed better workforce training and prompted the country to become involved in sectors with higher technical requirements and aggregate value[8].

The medium-term growth outlook for the Colombian economy, once the current crisis is over, is relatively bright. Our own potential growth forecasts show that it could be around 4.5% in annual terms. Should this growth be confirmed and be sustained for the next 20 years, the Colombian GDP per capita would double.

At any rate, reaching this potential growth –and especially beating it– needs a high investment rate to be maintained in the middle of a climate of corporate confidence and security, and the implementation infrastructure works that solve the existing bottlenecks to be fostered. The internal competitiveness agenda also needs to be consolidated to create the necessary conditions to make the most of the trade agreements that are currently in force and those that are being negotiated at the moment.

Observed and potential GDP
(Year-on-year percentage change)



Source: DANE and BBVA ERD BBVA ERD

Poverty and inequality

In terms of income levels, the rates of poverty and extreme poverty in Colombia are above the average in Latin America. The figures vary with the economic cycle. In 2005 they were 49.2% and 23.7% respectively, compared with 44.0% and 19.4% in the region as a whole[9]. Statistics indicate that poverty rates are higher in rural areas, at 78.1% and 48.6% respectively. Another feature of income in Colombia is its unequal distribution compared with other countries in the region. If we examine the Gini[10] coefficient in a sample of countries in the region, it can be seen that together with Brazil, Colombia has the highest levels of inequality.

GINI index in Latin America

Country	Year	Indice
Argentina	2004	51,3
Brasil	2004	57,0
Chile	2003	54,9
Colombia	2004	58,6
Mexico	2004	46,1
Peru	2003	52,0
Uruguay	2003	44,9
Venezuela	2003	48,2

Source: World Bank WDI 2007

8 The dependency rate is the proportion between the population under 14 years old and over 65 years old, in relation to the population between 15 and 64 years old.

9 See Cede et al. (2009)

10 This coefficient measures income distribution within a country. It shows the degree of inequality on a scale of 0 to 1, with 1 being the highest possible.

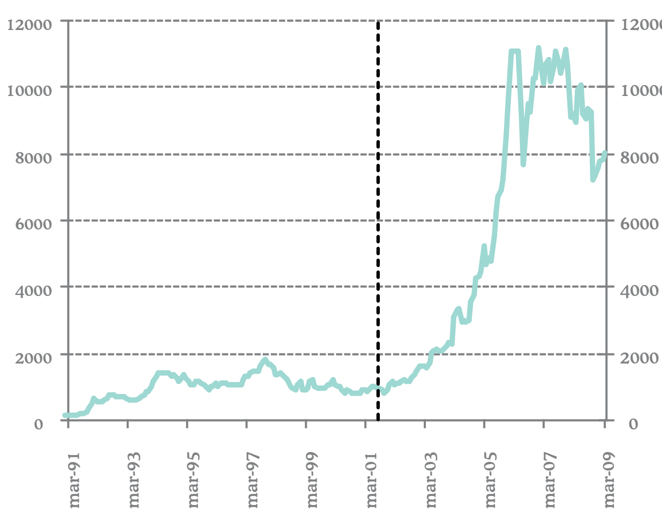
The results are different when poverty is measured by type of household and its access to public services, using the Basic Unsatisfied Needs (NBI) indicator. The Colombian government has made an enormous effort to extend the coverage of public services. It launched a number of structural reforms at the start of the 1990s, and the National Constitution of 1991 enshrined the policy of specific targeting of resources to provide education, health, drinking water and sewage services. All these efforts are reflected in the poverty rates as measured by the NBI. Whereas in 1985 more than 50% of homes were considered poor according to this criterion, the percentage had fallen to 27% by 2005.

The Financial Sector

The Colombian financial system has been substantially transformed in recent decades, with the main agents being banks and pension funds. A number of other institutions apart from banks can provide credit. These can be divided into four groups: financial corporations, commercial finance companies, cooperatives and Special Official Institutions. Between them, these institutions have over recent years provided around 15% of the credit portfolio.

The financial system was reformed in the wake of the two recent financial crises, one in the mid-1980s and the other at the end of the 1990s. The latter was much deeper and with more implications for regulation. The pension system also underwent a major reform in 1993, when private pension funds were created and Colombia moved from a public system to a mixed system that combines individual savings with an average-premium defined-benefit system.

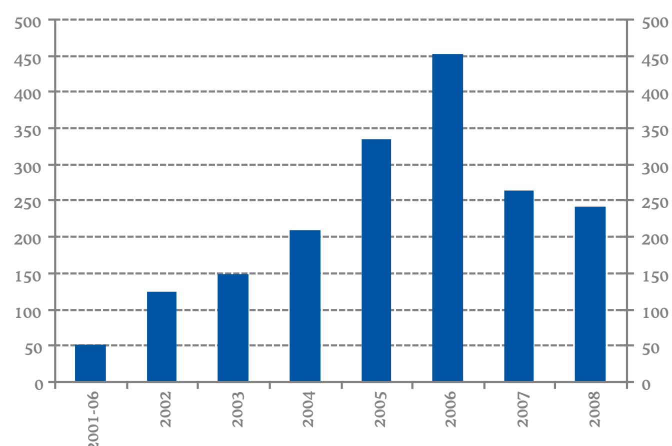
Performance of the Colombia Stock Market index



Source: BVC-Banco de la República. BBVA ERD

The capital market in Colombia has evolved positively, but it is still a limited source of finance for companies, and only a few of the major corporations have access to this funding vehicle. The stock market underwent a profound change in 2001 when the main stock markets in the country's major cities (Bogota, Medellín and Cali) decided to merge and created the Colombia Stock Exchange (BVC). This improved the efficiency and depth of the Colombian market. Since then, progress has been significant, both in terms of profitability and size.

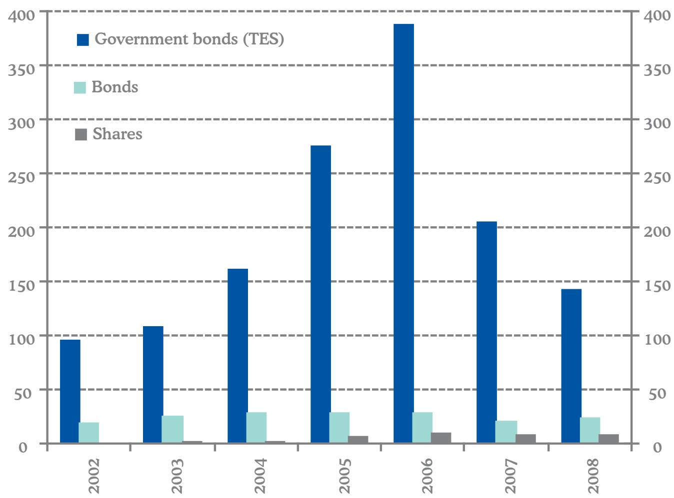
Total trading BVC
(% GDP)



Source: Colombia Stock Exchange (BVC) BBVA ERD

But there are still many restrictions on the use of this market, as well as a certain reluctance, particularly among family businesses that do not want to change their corporate governance structure. There is an incipient market in standardized exchange-rate derivatives and Treasury bonds (TES) in Colombia. Its development is vital for the deep expansion of the country's securities market and the development of hedging products.

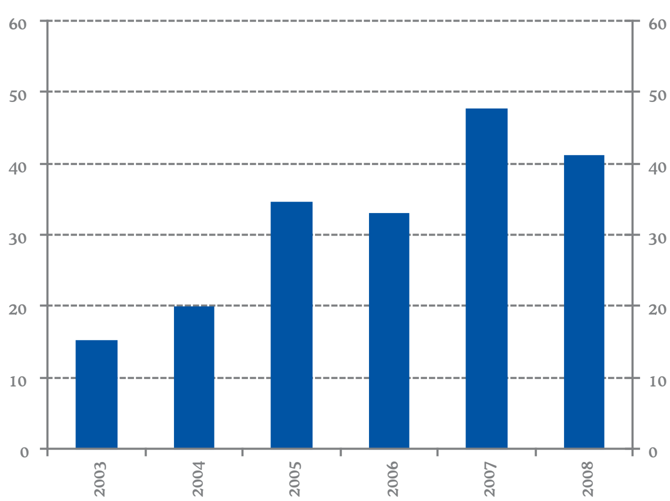
Total traded by type of asset
(% DGP)



Source: Colombia Stock Exchange (BVC) BBVA ERD

The most important securities in the Colombian capital market are internal government bonds (TES). The trading volume and depth of the TES market are both substantially greater than the rest of the country's financial assets because of the relatively high stock of debt, which is also increasingly being targeted at the domestic market. This development has allowed the Colombian government to diversify its debt terms and achieve an efficient yield curve with different maturities and a maximum term of 15 years. Currently there are plans by the government to extend the maturity of the yield curve as the market continues to develop.

Market capitalization
(% GDP)



Source: Colombia Stock Exchange (BVC) BBVA ERD

The Banking System

The banking system is made up of 18 banks, of which 9 are private local banks holding 72% of the assets, 8 are private foreign banks with 22% of the assets and one is a state-owned bank with 6% of the assets.

The system is the result of major consolidation in the sector in the wake of the worst financial crisis in the country's history at the end of the 1990s. The number of banks in late 1989 was 40, but by a number of privatizations, mergers and acquisitions and, to a lesser extent, bankruptcies, this number has been falling. The assets in the system are also concentrated in only a few banks, with the four biggest being private and holding nearly 60% of the total assets in the system. This contrasts with the situation at the start of the 1990s, when the main banks in terms of assets were state-owned institutions.

The consolidation in the system has taken place not only in financial institutions, but also in regulatory bodies. The regulator of the Colombian financial system is the Superintendencia Financiera de Colombia, a body that is the result of a merger in 2005 between the Superintendencia Bancaria and the Superintendencia de Valores.

Some of the rules exceed what is required for prudential regulation and clearly distort the banking system. Examples are the imposition of a ceiling to the interest rate that can be charged on loans, known as the "usury rate" and calculated at 1.5 times the current bank interest rate[11]. In addition, banking transactions are subject to a tax (IBC), currently at 0.04%. This tax was designed as a temporary emergency measure designed to capitalize the Financial Institution Guarantee Fund (Fogafin) in 1999. Once the crisis was over, the tax on banking transactions became a permanent tax, as it was easy to collect and helped to compensate Colombia's low tax flexibility.

With regard to prudential regulation, apart from following international trends in terms of capital requirements, a system of countercyclical provisions was introduced in 2007. Under this, the financial institutions have to increase their levels of provisions in high-income years. Finally, deposits are protected through insurance provided by Fogafin on deposits of up to COP 20 million. This currently covers 98.5% of the users of the system.

Active and passive rates
(Real, %)

Source: Banco de la República BBVA ERD

11 The IBC is calculated on a quarterly basis as a weighted average of the sum of the interest rates on ordinary credit, including consumer loans and credit cards.

Increasing banking depth in Colombia is a process that is still pending. While in 1995 the average of the total credit portfolio as a percentage of GDP was 27%, currently this figure is 25%. It should be pointed out that this ratio reached a maximum at the end of the 1990s, just before the financial crisis. Thus it could be argued that the greater coverage of the portfolio at the time was not thanks to the system reaching a greater number of people, but to a greater indebtedness of the same users. Bank use by the population is still very low, according to a study by ASOBANCARIA[12], which states that only 53% of people have access to a checking account, while only 17% of the population over the age of 18 have access to a credit product of some kind.

Total portfolio
(% GDP)

Source: Banco de la República BBVA ERD

Pension system

The pension system in Colombia underwent a structural change with the reform implemented through Law 100 of 1993. This opened the way for an individual savings system that coexists with the traditional system of average premiums and defined benefits. Numerous efforts were made to modify the regulations after this reform in order to bolster the system. This reform of the whole pension system has had positive effects for contributors, pensioners and the macroeconomic performance of the country.

However, there are still significant challenges to be tackled in terms of coverage and the performance of the system. The improvements made in the system's coverage have so far been marginal. This is reflected by the characteristics of the Colombian labor system, with its high rates of informal employment.

The reform corrected some problems of the traditional system of average premiums with defined benefits, but despite the efforts made there is still a great inequity in terms of the relation between contributions and benefits. The financing of the system also requires a great fiscal effort by the national government.

Private pension funds represented around 14% of GDP in December 2008, and their size has been growing steadily faster since their creation in 1993, when they represented less than 1% of GDP. Private pension funds are active participants in the capital market, and since their creation the Colombian debt markets have gained depth.

The growth of these funds has certainly helped finance the public and private sectors. However, the lack of development of the capital market still limits the ability of funds to become active players in funding the infrastructure projects that will be of vital importance for the development of the country.

12 Banking Association of Colombia

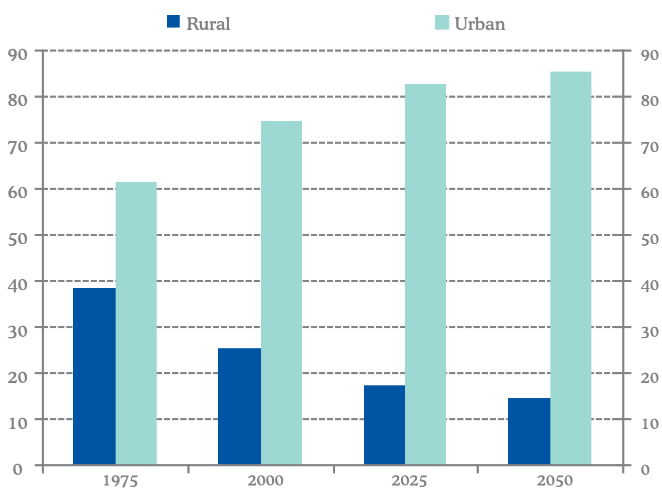
Colombia

Demography & Labor Markets

Population dynamics

The population of Colombia in 2009 is around 45 million inhabitants. It is concentrated in urban centers (around 76% of the total), as a result of the process of migration of the rural population to the cities during the 20th century. (In 1950, 61.3% of the population lived in rural areas.) As in the rest of the world, the rate of population growth has been falling over time from 2.7% in 1960 to 1.6% in 2000. The figure is expected to be under 0.5% by 2050. The main result of this process is the ageing population, with the number of people aged under 19 falling from 51.7% of the total population in 1950 to 41.1% in 2000 and a forecast figure of under 23% in 2050[13]. This demographic change represents both a challenge and opportunity for economic growth over the next 40 years. On the one hand, it means there is a need to strengthen the mechanisms of social protection for needs related to the age and health of the population. On the other, it implies a significant reduction in the dependency rate, which should be reflected in an increased potential growth of the economy.

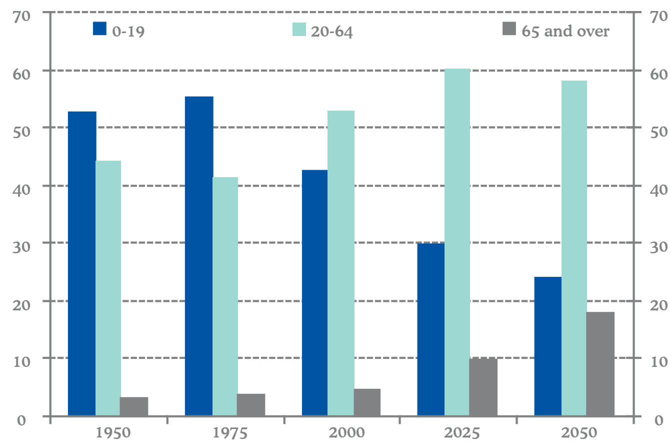
Geographical distribution of the Colombian population (%)



Source: Celade BBVA ERD

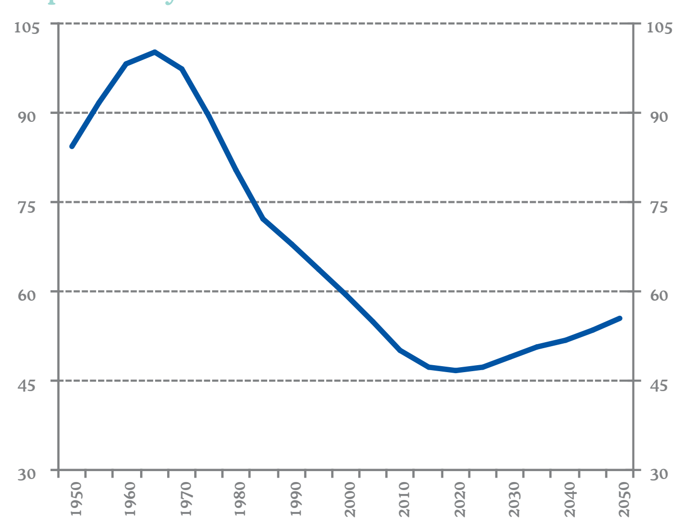
13 According to CELADE forecasts

Distribution of the Colombian population by age groups (%)



Source: Celade BBVA ERD

Dependency Rate %



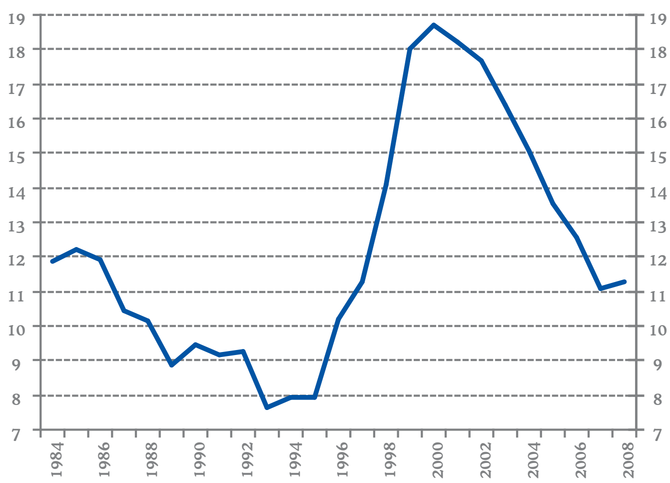
Fuente: Celade SEE BBVA

Labor market

One of the features of the Colombian economy is its high rate of unemployment. This situation reflects a number of distortions in the labor market that prevent a structural reduction in unemployment. For example, despite the high growth rate of the economy in 2006 and 2007 (the highest in the last 30 years), the unemployment rate for the 7 biggest cities in the country did not manage to fall to the levels of the mid-1990s.

Among the many restrictions that prevent a more efficient adjustment of the labor market are the high tax wedge on wages and the rigidity in the minimum wage, which in Colombia stems from the country's constitution. In the former case, social security contributions and payroll taxes now represent an extra wage cost of nearly 60%, when at the start of the 1990s it was less than 40%[14]. In the case of the minimum wage, in 1999 the Constitutional Court ruled that in Colombia the minimum wage could not be increased less than by the inflation rate. It thus made it impossible to reduce it in real terms, and as a result it is one of the highest in Latin America, at around 50% of the average wage[15]. As a result of this court decision, adjustments to the labor market are made by job numbers and not by cost, so increases in unemployment are more frequent, stronger and more persistent.

Urban unemployment rate (%)

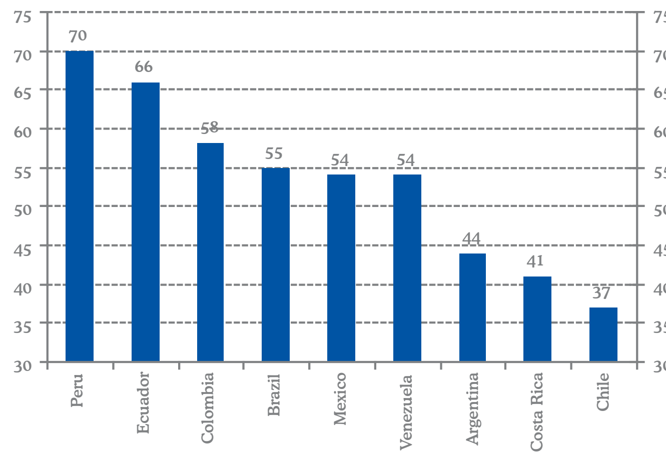


Source: DANE BBVA ERD

But these distortions are not only reflected in a higher unemployment rate. They have also had an impact on the quality of Colombian employment. The country now has one of the highest rates of informal employment in the region. In the case of Colombia, it is women, the young and unskilled workers who are most likely to find themselves in this sector of the labor market.

The poor operation of the Colombian labor market has had negative effects on poverty indicators and has prevented the social security mechanisms in terms of pensions and health from working properly, thus creating a poverty trap and becoming a major inhibitor of economic growth and development.

Workers in informal unemployment as proportion of total employment (%)



Source: Banco Mundial, Gasparini - Tornarolli (2006)
Data for 2003 and 2005 BBVA ERD

One of the main challenges faced in the medium term is to reduce substantially the rate of informal employment in the economy. One of the ways of doing this is to make the formal labor market more flexible. The strategies proposed to address this challenge include making the minimum wage more flexible and reducing payroll taxes. This reduction would mean using the national budget to finance the social security programs and expenses that are currently paid for in this way.

Tax-related costs in some countries

Item	Mexico (1)	Colombia (2)	Chile (3)	Argentina (4)
Pensions (old age, disability and survivor pensions)	8,5	15,5 - 17,5	15	18,8
Health	12,5	12	3	3,6
Work-related risks	2,5	1		
Infancy (Colombian Family Welfare Institute, ICBF)	1	4		8
SENA training service		2		
Solidarity	2	0 - 1		1,1
Other (savings banks)	5	4	2,5	5,3
Unemployment benefit (cesantías)		8,3		
Total	31,5	46,8 - 49,8	20,5	36,7

(1) In Mexico, 70% is paid by the employer, 25% by the worker and 5% by the government in the case of pensions and health. The other charges are paid by the employer.
(2) In Colombia, 75% of pensions and 70% of health are paid by the employer. The solidarity funds in pensions and health are paid by the worker. The other charges are paid by the employer.
(3) In Chile the pension contributions are paid by the worker. Health is paid by the employer.
(4) In Argentina the employer pays 11% for pensions, 3% for health, 3% for solidarity. The rest is paid by the employer.
Source: International Association of Social Security and Mesa-Lago (2000)

Human capital

In general, the country has made importance advances with regard to access to elementary and secondary education. Basic educational coverage is almost universal, and secondary educational coverage exceeds

14 Montenegro and Rivas (2005)
15 Maloney and Nuñez (2001)

80%[16]. Nevertheless, an analysis of preschool and higher educational rates indicates that there is still much room for improvement. In the latter case, Colombia exhibits one of the lowest coverage rates in the region, which explains why the majority of jobs offers are for unskilled labor. Likewise, the educational system continues to manifest serious inequities, reflected both at the economic level (in the case of preschool and higher education), and at the geographic level, with regard to which one notes that school attendance in rural areas is noticeably lower than in urban areas, particularly at the secondary or higher educational level[17]. Nevertheless, taking into account the long term investment in education, it is anticipated that recent improvements in coverage will permit the correction of this gap in the coming decades.

Educational coverage rates in 2006

Country	Secondary	Higher
Argentina	85.6	64.7
Chile	90.8	47.8
Venezuela	74.4	41.2
Peru	92.4	33.9
Colombia	82.2	30.8
Mexico	84.7	25.3
Brazil	105.7	23.8

Source: World Bank (KAM) 2008

Average number of years of education of population 15 or over by zone

Year	Total	Head	Rest
1964	2.8	3.7	1.7
1978	4.6	5.7	2.4
1985	5.6	6.7	3.3
1994	6.8	7.8	3.9
2000	7.3	8.3	4.4
2003	7.6	8.5	4.9

Source: DANE, National Population Census

In addition, tests indicates that the quality of primary and secondary education is deficient. At the national level, tests given in the year 2005 showed that only 30% of students achieved a high level of competence. At the international level, according to the results of the PISA test in 2006[18],Colombia ranked 53rd out of 57 countries on the science and math tests, and 51st out of 56 countries on the reading tests.

16 Bernal et al (2009).
17 DNP (2005).

18 OECD (2006).

Energy

Colombia's mining and energy sector has become one of the country's growth locomotives in recent year, as it continues to absorb the lion's share of direct foreign investment in Colombia. Likewise, exports related to this sector constitute the principal category within Colombia's sales to international markets.

WTI oil price
(USD/barrel)

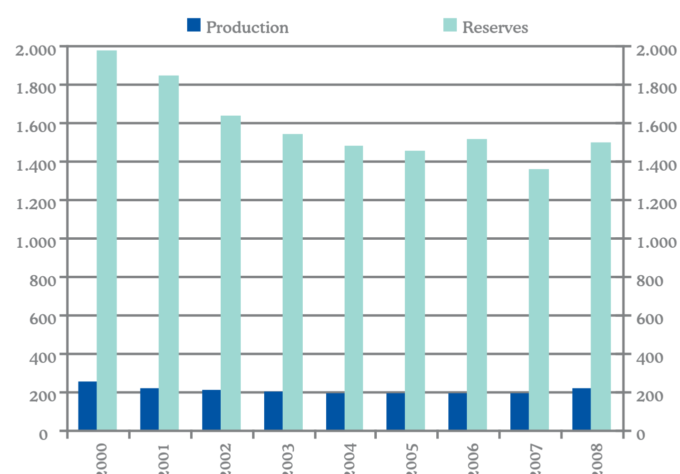
Source: Bloomberg BBVA ERD

Colombia is a country rich in hydrological sources, with large coal and natural gas reserves, along with limited Oil reserves. Nevertheless, its geographic location makes it highly probable that undiscovered oil reserves exist. The country's principal oil company is ECOPETROL, a company of a mixed legal nature, which is 90% state-owned, with 10% having been handed over to popular sovereignty in 2007. The country has been developing a series of policies whose intention is to stimulate the production of alternative fuel sources, such as African palm or sugar cane, while also turning Colombia into an important future player in the generation of renewable energy.

Oil, natural gas and mining

According to the National Hydrocarbon Agency, at the end of 2008, Colombian crude oil reserves stood at approximately 1,500 million barrels, with annual production at close to 215 million barrels, which is equivalent, when taking into account production and reserves, to a supply of nearly 7 years. Currently, crude oil barrel production per day in Colombia stands at 646 thousand, with the objective being to increase production to over one million barrels per day by 2015. One of the strategies to increase oil reserves has been to increase oil well exploration through the facilitation of the award process for this type of contract. In fact, figures show that during recent years, exploration and drilling have increased significantly through the efforts of ECOPETROL and multinational companies, which view Colombia as a possible source of reserves in the future.

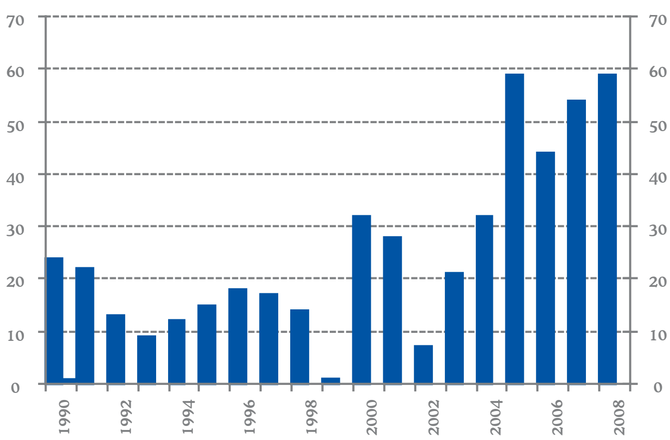
Oil reserves and annual production
(millions of barrels)



Source: ANH BBVA ERD

A large part of the country has not yet been explored, partly due to a security problem which arose in the past as a consequence of the armed conflict, a problem which continues in certain parts of the country.

Exploration, production and technical assessment projects



Source: ANH BBVA ERD

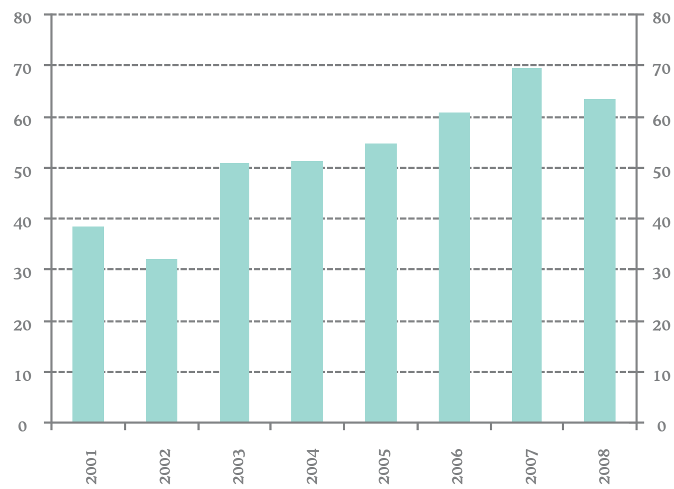
The country has two large refineries, the Barrancabermeja complex and the refinery at Cartagena. The former can process up to 250 thousand barrels per day, and, at the present time, work is beginning on the enlargement of the Cartagena refinery, which will make it possible to produce 150 thousand barrels of oil per day, while significantly improving fuel quality.

In Colombia, fuel prices are administered by the government, and they are set in accordance with international oil prices. The petrol price calculation methodology has been an object of discussion, which, during recent years, has become more heated against the backdrop of the creation of the Fuel Price Stabilization Fund.

For their part, proven natural gas reserves stand at 7,100 cubic giga-feet with production at 266 cubic giga-feet per year, equivalent to a production reserves relationship of 26.6 years. It can be demonstrated that Colombia is self-sustaining in the area of natural gas, and the consumption of this type of energy as an alternative to petrol and electrical energy has been consolidated in recent years.

In Colombia, mining operations principally involve coal extraction, and high quality, significant reserves exists, examples being the Cerrejon and La Loma mines, in addition to coalfields in the Cundiboyacense basins. The country has historically been a producer of coal, with the participation of American and South African companies. Likewise, Colombia possesses limited reserves of iron, copper and nickel.

Coal exports
(Millions of metric tons net)



Source: DANE BBVA ERD

Alternative sources

For several years, the government has been undertaking a series of projects in order to promote the generation of alternative energy sources, ranging from tax exemptions for biomass crops to a national policy dictating that the petrol consumed domestically must contain 10% alcohol fuel[19] and that diesel must contain 5% biodiesel.

Ethanol production in Colombia stood at approximately 1% of total worldwide ethanol production, with 274 million litres in 2006. This production comes from 5 sugarcane refineries located in the Cauca valley and consumed close to 17% of the total amount of cane produced in the country. In Colombia, ethanol production is still significantly more expensive than in the world's main ethanol producing countries.

For its part, industrial production of biodiesel in Colombia began in January of 2008, with a plant which had the capacity to produce 0.33 million barrels per year. At the present time, 6 more plants are being completed, as a result of which production capacity will reach 3 million barrels per year. All of these plants will use palm oil as their raw material.

Energy generation

As a country rich in hydrological resources, Colombia also ranks high in the generation of clean energy. Hydroelectric energy is the main energy source by means of which the country's energy demand is met. Despite its wealth of resources, in the middle of the nineties, the country suffered through a period of energy scarcity, which resulted in compulsory rationing. In order to prevent similar occurrences in Colombia's future, the government has been reforming energy market contracting mechanisms.

19 Different types of alcohol fuels exist, including ethanol, methanol and butane.

During 2008, a process of long term energy auctions was initiated, whose purpose is to guarantee energy generation investment and, therefore, the long term supply.

The country has an installed capacity of 13,406 MW and a total of 23,324 Km of transmission lines. For its part, the maximum energy power demand[20] over the last five years has, on average, equaled 65% of the effective installed capacity. Colombia currently exports energy to Ecuador, Venezuela, Peru and certain countries in Central America, with Ecuador being the main partner. Over the medium term, the country seeks to increase its exports to Central American countries by means of more interconnection lines and should seek to increase efficiency in the face of projects to increase installed energy generation capacity, both in Ecuador as well as in Central America.

The country has the potential to become a major player in regional electrical energy generation. Its wealth of hydrological resources, its increased energy generation capacity, its natural gas reserves and the quality and size of its coal reserves provide the country with the opportunity to become a strategic player in the energy market. Likewise, those policies designed to stimulate energy production through alternative sources seek to increase the country's production capacity. Nevertheless, while production is increasing, efforts should be made to increase efficiency in order to enter into competition with the stars of the worldwide bio fuel market.

20 Maximum power demand refers to the highest level of energy demand required of the generation system over a period of time

BBVA

Politics and internal conflict

Colombian is a State in which the rule of law prevails, organized as a single republic, which is politically centralized and administratively decentralized. Power is distributed across three branches: legislative, judicial and executive. The legislative branch is composed of a bicameral Congress which includes the Senate with 102 seats, subject to a nationwide ballot, and a Chamber with 166 seats, subject to a regional ballot, in accordance with the population of each of the departments into which the country is divided, with five seats reserved for minorities. The judicial system includes a Constitutional Court, the Supreme Court of Justice, the Council of State and the Higher Judiciary Council. The executive branch is headed by the President, who is also the head of state and of the government. He is elected for periods of four years and may be immediately re-elected for an additional period.

President Alvaro Uribe Velez initiated his second four-year term in August of 2006. Uribe was re-elected after a change in Colombian's Political Constitution permitted the immediate re-election of the President of the Republic. This constitutional change was promoted during President Uribe's first term by the parties which supported him in the Republic's Congress.

Uribe is a politician of liberal origin who rose out of the ranks of the Colombian Liberal Party. He held offices through popular election in representation of said party, one of these office being the Governorship of Antioquia. In order to be elected to his first term, President Uribe withdrew from the Liberal Party, alleging a lack of guarantees for the internal referendum to choose a single candidate, and he ran as an independent candidate with multiparty support, which included the Radical Change and Conservative Party, amongst others.

In his first election campaign, Uribe focused on directly attacking the peace process which was underway between the government of President Pastrana and the FARC guerrilla movement (Colombian Revolutionary Armed Forces) and which ended in January 2002, with highly questionable results for the future of peace in Colombian. Uribe's proposal was based on a Democratic Security project which would return complete control of the entire nation to official institutions.

The 2002 elections highlighted the political growth of left-wing forces. In the face of Uribe's unbeatable candidacy and his message of security, left-wing forces unite in a coalition known as the PDI and manage to become the third most important electoral force.

Those elections also led to a tragic situation for the nation, with the kidnapping, during the first half of 2002, of the presidential candidate, Ingrid Betancourt, by FARC. The candidate Betancourt, after the breakdown of peace conversations between FARC and the Pastrana Government, travelled, despite the security warnings given by the authorities, to the former DMZ where she was kidnapped. Ingrid Betancourt was liberated by the National Army in 2008, in an unprecedented military operation.

The 2006 elections

During his first term, President Uribe made definite improvements in internal security levels, which increased confidence in Colombian's institutions and promoted substantial increases in productive investment. His approval rating remained above 60% throughout his term, according to different indicators. His popularity and a shared desire to continue with the democratic security project led him, along with his supporters, to promote a constitutional reform which would permit immediate re-election as President of the Republic.

In the elections of 2006, Alvaro Uribe obtained nearly 62% of the vote and was re-elected in the first round. On this occasion, his candidacy was supported by the following parties: Alas Equipo Colombia, Cambio Radical, Colombia Democrática, Partido de la U, Partido Conservador and Por el País que Soñamos.

In this way, opposition to President Uribe's Government is composed of the Colombian Liberal Party and the PDA (the former PDI with certain new internal corrections). Both the Liberal party as well as the PDA hold onto power in a substantial percentage of mayoralties and departments. In particular, Bogota's mayoralty (the second most important electoral position in the country) has been under PDA control since 2003.

The 2010 elections

Colombian's general elections will take place during the first semester of 2010. On this occasion, members of the Republic's Congress, as well as the President will be chosen. The forces and candidates have aligned their positions, but there is still a lot of uncertainty with regard to party alliances and independent candidates, given that the country is awaiting President Uribe's decision regarding his intention to seek, or not, a new presidential term of office, which would require a new amendment to the Constitution.

Internal and post conflict

One of the country's idiosyncrasies is the coexistence of productive activity and the formal economy alongside an internal armed conflict and an illegal economy revolving around the cultivation and marketing of narcotics. The origins of Colombian's internal conflict go back to the middle of the twentieth century, to armed peasant uprisings whose objective was a more equitable redistribution of agricultural lands. The conflict of those years evolved into a confrontation with armed guerrillas, ideologically close to the Soviet Union and Cuba, who fought for greater political power which would enable them to promote a more equitable distribution of resources. At the end of the eighties, events in the Soviet Union and the resultant effects on the Cuban economy impacted the Colombian guerrillas' ideological and financial support structures, forcing them to seek an alliance with drug traffickers, whose position had already improved. In this fashion, drug trafficking became an important source of financing for illegal armed groups, as a result of which they lost part of their political motivation.

The explosive combination of drug trafficking and guerrilla activity in rural areas gives rise to private defense (paramilitary groups), who become the new actors in the conflict, using techniques as violent, if not more so, than the guerrillas to obtain their objectives.

Since the year 2002, a new strategy of confrontation with illegal armed groups and control of the national territory on the part of Colombian's armed forces has resulted in a lowering of the intensity of the conflict and a weakening of the armed groups operating outside of the law. The population currently enjoys much higher security levels, and post-conflict issues are being dealt with in such a way that additional improvements are anticipated in the near future.

In this way, while engaging in armed conflict with groups operating outside of the law, Colombian is also undergoing a post-conflict process which involves the construction of the bases for victim reparations and national reconciliation. More important recent events in Colombian include the coexistence in the political arena of issues related to the internal conflict, the peace process with paramilitary groups, as well as judicial proceedings with regard to the relationship between politicians, members of Congress and paramilitary groups.

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Indicator	2004	2005	2006	2007	2008
Population (million)	41,4	41,9	42,4	42,9	43,4
GDP (USD million)	113.877	144.584	162.564	207.780	244.064
GDP Growth (yoy %)	4,7	5,7	6,9	7,5	2,5
Per capita GDP (USD PPP)	6.265	6.745	7.329	7.967	8.215
Urban unemployment rate (%)	12,8	12	12,8	10,2	10,9
Exports (USD million)	16.788	21.190	24.391	29.991	37.626
Imports (USD million)	15.649	19.799	24.534	30.816	37.155
Trade balance (USD million)	1.140	1.392	-143	-824	470
Degree of openness (% GDP)	28,5	28,3	30,1	29,3	30,6
Foreign direct investment (USD million)	3.016	10.240	6.464	9.049	10.600
Remittances (USD million)	3.170	3.314	3.890	4.493	4.842
Current account balance (% GDP)	-0,8	-1,3	-1,8	-2,8	-2,8
Exchange rate (COP/USD end of period)	2.350	2.285	2.240	2.020	2.254
Exchange rate variation (yoy %)	-15,4	-4,5	-2	-8,8	11,6
International reserves (% GDP)	11,9	10,3	9,5	10,1	9,9
Country risk (EMBI)	334	238	161	195	474
Inflation (%)	5,5	4,85	4,48	5,69	7,67
Base inflation (%)	5,52	4,12	3,94	4,43	5,11
Official interest rates (%)	6,5	6	7,5	9,5	9,5
Fiscal balance (Central Government % GDP)	-4,7	-4,1	-3,4	-2,7	-2,3
Foreign Debt (Non-financial public sector %	20	15,9	15,1	13	13,4
Credit (includes securitization % GDP)	19,3	19,5	22,6	25,2	26,9
Deposits (% GDP)	23,8	24,8	25,6	26,8	28,6
IGBC	4.346	9.513	11.161	10.694	7.561
IGBC change (yoy %)	86,2	108,9	17,3	-4,2	-29,3
IGBC market capitalization (% GDP)	19,8	34,4	32,8	47,6	41,1

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