BBVA | RESEARCH

Country Report

Colombia

Bogotá, 2011
Economic Analysis

Executive Summary

The country is currently experiencing a promising outlook based on substantial improvements in macroeconomic, political and social stability. This is seen in the economic results from recent years, the economic outlook set out in this report and market forecasts due to recently approved reforms.

Colombia is the third largest economy in Latin America in terms of population and the fifth by output; in addition, it increased GDP per capital by 63% over the last decade, above the average for Latin America (55%). In turn, it has been one of the economies with the highest levels of political and economical stability in Latin America since the mid-20th century, without any coups, deep recessions, hyperinflation or debt moratoria. Around a year ago there was a peaceful handover of power between the government of Álvaro Uribe and the then Minister of Defense and current president Juan Manuel Santos. The new president has proved himself to be a rational reformer, gaining approval for ambitious fiscal, social and social protection reforms guided by the prevailing technocratic vision among his cabinet.

Handling of the wider economy has been responsible, in large part supported by economic policies which have evolved in line with the requirements of the economy. In the last 30 years, Colombia grew on average by 3.5% y/y while the region expanded at a 3.0% annual rate. The country currently enjoys price stability and a flexible exchange rate that allow it to absorb part of the international impacts in the different stages of the economic cycle, as seen in the international crisis in 2007 and 2008 where Colombia managed to expand in 2009 while few similar economies were able to do so.

The new government has been fiscally conservative and prudent which has meant the country has met its obligations without changing tax rates. Indeed, the budget deficit has remained in order even in the face of several natural disasters. Macroeconomic coordination between the new government and the central bank has been highly positive. This has reduced the cost of lowering inflation by limiting higher strengthening in the exchange rate. This has been performed in a framework of government respect for the central bank's independence.

The outlook for foreign trade is positive. Despite commercial difficulties with Venezuela, Colombia has managed to diversify its export sector with the potential to extend further based on major trade agreements with the U.S., Canada, the European Union, South Korea, Turkey, Panama, EFTA nations (Switzerland, Iceland, Norway, Liechtenstein), Chile and the countries in the northern triangle (Guatemala, Honduras and El Salvador). The treaty with the United States was approved in October and will come into force in 2013. Meanwhile, the agreements with the EFTA nations and Canada came into effect in July and August 2011 respectively. These advances in trade relations are set to increase the opening-up of the economy measured as the relationship between total exports and imports in GDP, currently at 28%, slightly below the regional average of 32%.

The financial sector is solidly regulated ensuring stability; this is accompanied by a consolidation process as a consequence of merger and acquisition processes mainly in the banking sector. The stock market has expanded with prospects of deepening further through the integration of the Colombia Stock Market with the equity markets in Chile and Peru via the Integrated Latin American Market (MILA). This integration started trading in May 2011 and already has a stock exchange index - the S&P MILA 40.

The foreign trade structure has diversified, increasing the role of manufactured products in exports and the role of non-traditional commodities. The mining and energy sector has been the main receiver of foreign direct investment, contributing to the major growth in production. The country currently has major oil, gas and coal reserves while promoting the production of biofuels

from sugar cane and African palm which, as has been observed, are highly attractive to foreign investors. In turn, Colombia's climate and geographical location give it the potential to become a hydraulic energy generation and transmission powerhouse in the region.

The recent security improvements have undeniably aided economic growth. Although the country still faces drug-trafficking problems and conflict with illegal armed groups, the huge progress on both fronts is undeniable. This leads us to believe that a post-conflict process has begun where appropriate institutions are being consolidated to develop a thriving market economy.

The positive outlook for Colombia was confirmed by Standard and Poor's in March, Moody's in May and Fitch in June, re-awarding the country the investment grade status, which it had lost after the financial crisis in 1999. The arguments spelled out by the rating agencies are in line with our views in seeing Colombia as an economy with stable public finances, the ability to make responsible and temporary structural adjustments to deal with external shocks similar to those in 2008-2009 and with a sustainable medium-term growth outlook, which should converge around 5.8% according to our potential GDP estimates, from the estimated 5% seen in 2011.

Colombia faces several challenges which the economic authorities have identified. In financial matters, the level of banking penetration among the population is still low compared to other economies in the region, partly explained by some restrictions in credit supply. The stock market is still small and mainly oriented to the participation of large companies.

There are several distortions in the labor market that are seen in high informality and which have made a higher reduction in the jobless rate, more in line with the favorable economic scenario, more difficult. Labor costs, as well as the rigid minimum wage framework, stop the jobs markets from being more dynamic.

The investment in public works in recent years stands out; however, the country still suffers from a deficit in infrastructure, especially transport, which it needs to cover if it wants to increase productivity and competitiveness in the medium-term. The success of the trade agreements signed, such as with the U.S., depends largely on modernizing national roads and reducing transport costs.

The reform agenda of the new government is ambitious meaning President Santos's capacity for maintaining his coalition in Congress is important. Part of the reforms include the revision of the justice system, improvements to the tax system, reforms of the health system and pensions, changes to the higher education system and guaranteeing citizens' safety. The president should test his ability to uphold the political consensus he has enjoyed in his first year of government so as to be able to move his ambitious reform agenda forward.

With regard to security, it is undeniable that illegal armed groups (albeit severely weakened) still have influence in some areas of the country, something not seen in other countries in the region. The challenge for the country is to consolidate its strategy to reign in organized crime and drug trafficking, improving the safety of the population in both rural and urban areas. The economy should respond positively to improvements in this area, as has been the case recently.

Publication date: November 4, 2011

1. Introduction

Colombia has a population of 45.5 million with a working population of around 20 million. The Colombian economy is the fifth largest in Latin America in terms of GDP. However, in terms of GDP per capita[1], around 8,900 dollars PPP, it ranks below the region's average. Colombia was 73rd out of 169 in the Human Development Index[2] in 2010, 73rd out of 144 in the Global Competitiveness Index[3] and 78th out of 178 in the Corruption Perceptions Index[4] in 2010.

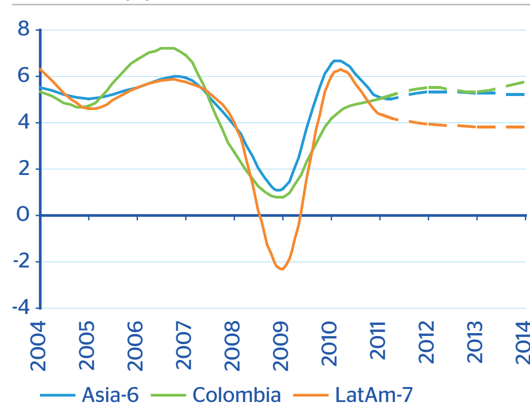
Colombia's credit rating was recently upgraded to BBB- investment level with a stable outlook - a sign of confidence from ratings agencies Standard and Poor's, Moody's, and Fitch on the macroeconomic fundamentals and medium-term sustainable growth outlook.

2. Economy

The Colombian economy is characterized by stable growth over the last 60 years and is based on solid foundations leading to expected growth around its potential level over the coming decade

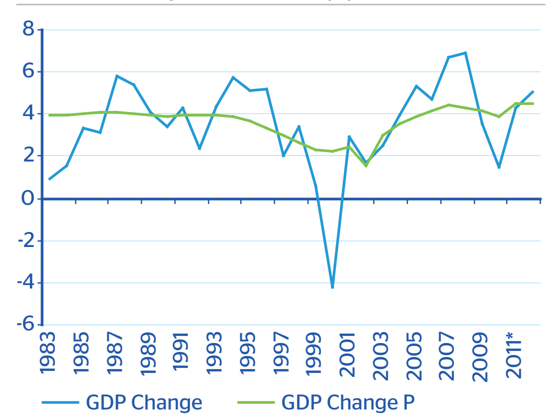
The Colombian economy has recorded an average annual growth of around 4.2% for the last 60 years, brought about by overall progress in the workforce and in physical and human capital allocation. Physical capital has increased slightly above human capital (3.7% vs. 3.5% since 1970). In turn, the factors of production, which saw a slowdown since the 1970s, have recorded an upturn in recent years due to the sharp growth in capital investment (Posada 2008). Further, GDP per capita in real terms has posted an average growth of 1.9% in the last 20 years, versus 1.2% for the main industrialized economies (U.S., Japan and Germany). This means Colombia has improved its situation compared with the rest of the developed world.

Chart 1
Economic growth - Colombia and developing countries (y/y, %)



Source: IMF and BBVA Research

Chart 2
Observed and potential GDP (y/y, %)

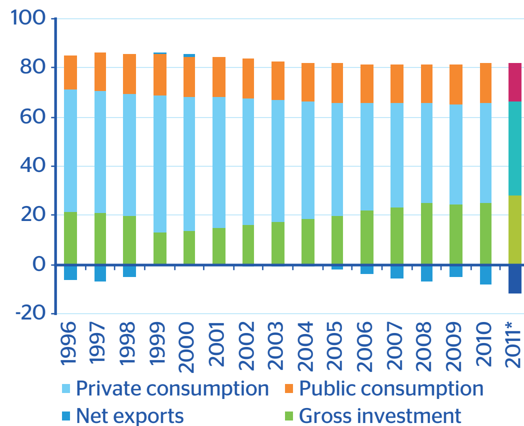


* Forecast.
Source: IMF and BBVA Research

During the 20th century, the Colombian economy only recorded negative growth in 1999, due to 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 Government has always met its debt payment obligations.

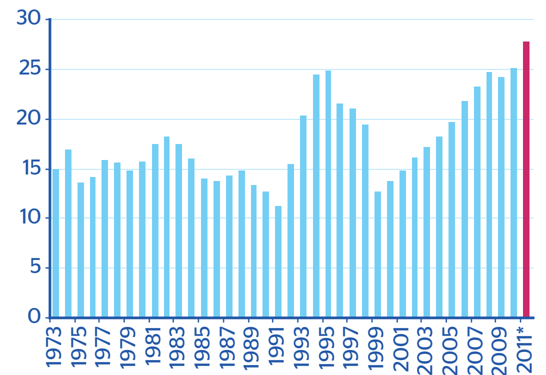
1: IMF in terms of dollars PPP.
2: UNPD- 2010.
3: Global Competitiveness Report 2010-2011. World Economic Forum.
4: International Transparency 2010.

Chart 3
GDP components (share, %)



* Forecast.
Source: Banco de la República, DANE and BBVA Research

Chart 4
Gross investment (% GDP)



* Forecast.
Source: GRECO, DANE and BBVA Research.

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 financial 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 the crisis in Colombia was the Russian debt moratorium which caused the global capital market to 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.

During the early years of the past decade, the Colombian economy expanded its investment rate, nearly doubling its starting level. This led to an increase in its potential growth rate from 2.0% to above 4.0%. Nonetheless, this growth cycle was interrupted due to the deterioration of the global financial crisis in the fourth quarter of 2008, which led to a major reduction in international commodity prices and lower external demand for manufactured products. This meant a dent in the confidence of business and consumers, which was manifested through reduced domestic demand, particularly in private-sector investment.

However, the Colombian economy was one of the few in the region to see positive GDP growth in 2009, the year of lowest global economic growth, based on the implementation of counter-cyclical economic policy both with low interest rates and an increase in the fiscal implementation of investment resources. Further, the effect of this crisis on the economy was moderated insofar as household and company balance sheets were not seriously affected during the period.

From a demand perspective, private consumption represents 65% of GDP while investment has increased from 15% of GDP at the start of the decade to 26% in 2010. As part of the latter, foreign direct investment has also recorded positive performance over recent years, representing 3.2% of GDP, mainly directed to oil, hydrocarbons, and mining. In turn, government spending has remained at relatively stable levels, wavering around 16% of GDP despite the temporary increase in 2009 to compensate for the effects of the 2008-2009 international crisis.

From the point of view of supply, the manufacturing sector and commerce represent around 25% of GDP, with each sector representing a similar share. The agricultural sector accounts for around 6% while mining and energy represent 11% of GDP. The construction and transport sectors represent 6% and 8% of the GDP, respectively. The financial, real estate and other corporate services sectors play an important role, accounting for around 19% of total GDP. Finally, state social services have had a 15% share of GDP in recent years, while the tax take has increased its share to around 10% of GDP.

3. Economic Policy

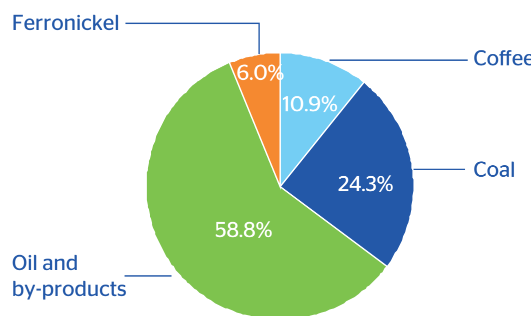
3.1 International Trade

Colombia's current exports are concentrated in the mining and energy sector given the lower demand from the Venezuelan market for manufactured products. The recent signing of trade treaties and the structuring of new future agreements should allow export and industrial market diversification

The Colombian economy is noted for exporting raw materials. Traditional exports (oil, coal, coffee and ferronickel) have had a share above 50% since 1970. Venezuela has been a natural partner for domestic industry although trade has been affected by diplomatic disagreements between the two nations since 2009. With the arrival of President Santos's new government, the nations have reconciled their diplomatic differences, which has aided partial payment of Venezuela debts to Colombian exporters. Nonetheless, trade between the two countries remains low.

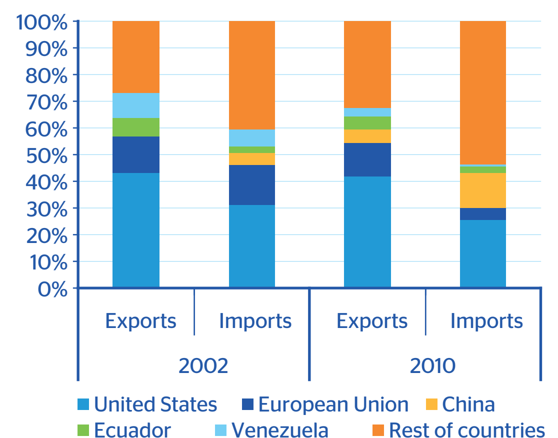
Colombia has gone from an economy exporting mainly coffee to one with heavy reliance on oil, coal, gold and emeralds. The discovery of major precious metal deposits together with increased hydrocarbon and coal output capacity increased the mining sector's share of total GDP. The structure of non-traditional exports has also changed in favor of manufactured goods, which currently represent 66% of total non-traditional exports, with clothing, chemicals, tobacco and flowers representing a large share.

Chart 5
Breakdown of traditional exports (Average 2000-2010)



Source: DANE and BBVA Research

Chart 6
Exports and imports by origin and destination

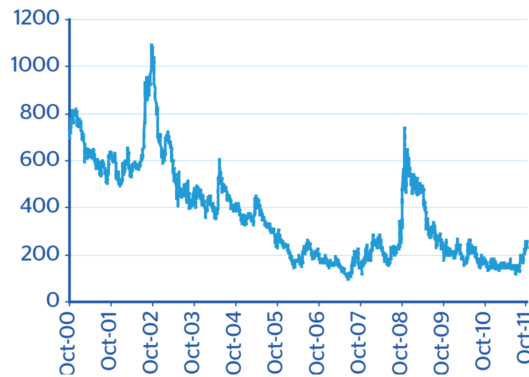


Source: DANE and BBVA Research

Main imports are intermediate goods (40% of the total) while 86.5% of capital goods are imported. Consumer goods imports are mostly durable goods such as motor vehicles and electrical appliances.

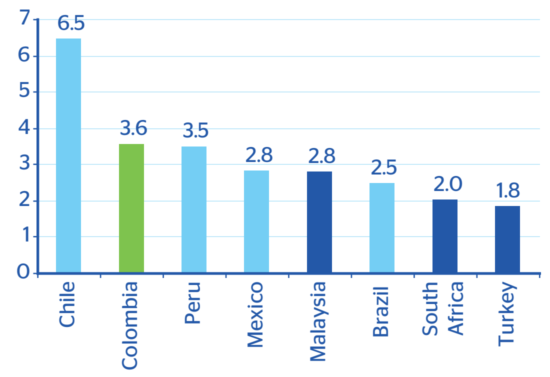
The trade balance in the Colombian economy has traditionally been negative, except for some periods with strongly favorable terms of trade. In turn, the current account has also traditionally recorded a deficit, largely explained by factor income, specifically by the dividends and utilities category. At present, current account dangers are reigned in by the fact that financing is mainly through long-term resources (FDI). However, the increased share in traditional exports in the current context of high international commodity prices, augment external vulnerability of the Colombian economy in the face of abrupt declines in international prices.

Chart 7
EMBI: Colombia



Source: JP Morgan and BBVA Research

Chart 8
FDI (% of GDP, average 2000-2009)



Source: World Bank and BBVA Research

Colombia is an open economy and its main trade partners are the United States (37% of total exports), the European Union (15%), China (5%) and Ecuador (3%). The aim in the future is to diversify products and export destinations, seeking out new markets for the goods once exported to Venezuela, mainly industrial goods.

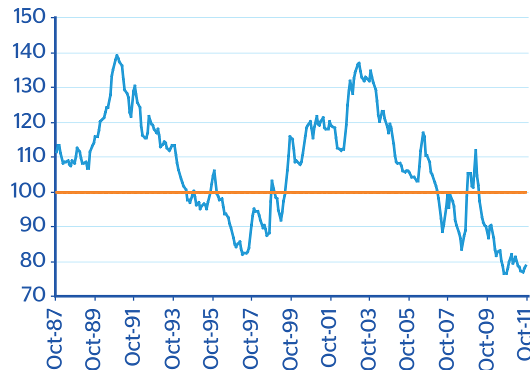
Trade policy over recent years has focused on seeking trade agreements with the world's major economies. The country has also moved forward in negotiating trade agreements with South Korea, Turkey and Panama; it is expecting passing of the treaty with the European Union and has signed agreements with the U.S., Canada, EFTA nations (Switzerland, Iceland, Norway, Liechtenstein), Chile, Mexico and the countries in the northern triangle (Guatemala, Honduras and El Salvador). The agreements with EFTA nations and Canada came into effect in July and August 2011 respectively, while the agreement with the U.S. will do so in 2013. In turn, tax stability agreements have been signed with strategic partners such as China, seeking to attract direct foreign investment; this is the first step to signing a trade agreement.

3.2. Exchange Rate Policy

The current flexible exchange rate policy has proven its ability to absorb external shocks, avoiding major adjustments to domestic demand as occurred at the end of the 1990s under a different exchange rate policy

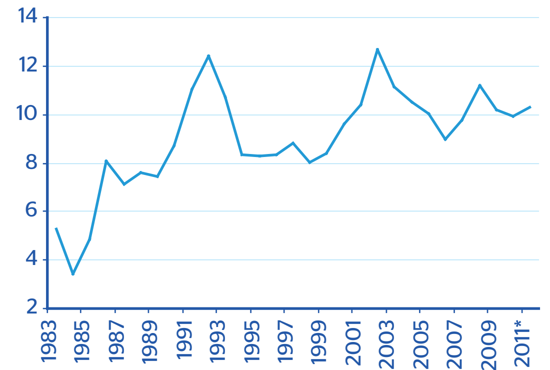
Over the past few decades, the exchange rate policy has moved towards exchange rate easing. There have been four different exchange rate systems in the last 40 years, beginning with fixed parity (leading to the coffee bonanza in the 1970s) and ending with a flexible exchange rate which has been in place since the crisis at the end of the 20th century.

Chart 9
Real Exchange Rate Index (Base 1994)



Source: Banco de la República and BBVA Research

Chart 10
International reserves (% GDP)



* Forecast.
Source: Banco de la República and BBVA Research

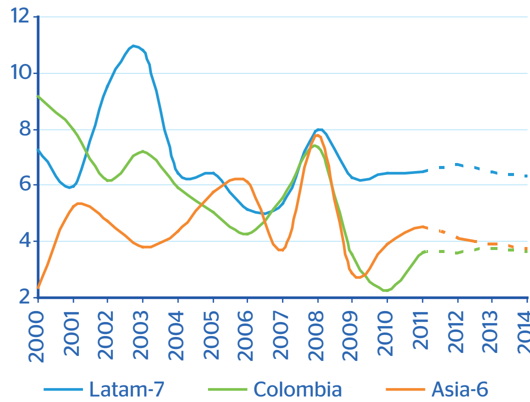
Since the flexible exchange rate was adopted, the Colombian currency has experienced two very different cycles. The first was until mid-2002 when the currencies of emerging countries suffered heavy depreciation, linked to a period of high risk premiums. The second period was an appreciation between 2002 and the present caused by greater investment flows into the region and a major improvement in terms of trade. Nonetheless, this second exchange rate cycle saw a temporary deviation due to the overseas crisis at the end of 2008 and mid-2009. In this period, high global uncertainty tested the flexible exchange rate and its ability to deal with external shocks to the current account; this led to the adjustment in domestic spending being much lower than that seen during the crisis at the end of the 1990s.

3.3. Monetary Policy

The Colombian central bank, which is independent since 1991, has been able to reduce inflation to low and stable rates based on its inflation targeting strategy

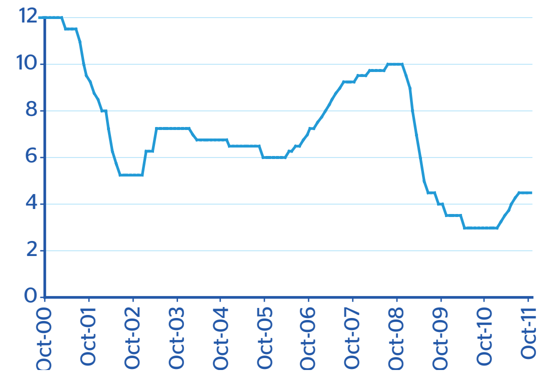
Unlike other countries in the region, over the course of the 20th century, the Colombian economy did not experience any hyperinflation episodes. In fact, since 1991 the objectives of Colombian monetary policy changed radically with the Political Constitution coming into effect. The new constitution order granted independence to Banco de la República and set it the primary goal of keeping the purchasing power of the currency, i.e. reaching a low, stable inflation rate. From 1991 onwards, there was an ongoing process of slowing inflation that saw it drop to below a single digit level during the first decade of the 21st century, after the central bank set a system of inflation targets from 2002 on (see chart 11).

Chart 11
Inflation in Colombia and developing countries



Source: IMF and BBVA Research

Chart 12
Banco de la República REPO rates (%, E.A)



Source: IMF and BBVA Research

The Board of Directors of Banco de la República is the collegial body in charge of taking monetary, exchange rate and credit policy decisions. 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). Similarly, another mechanism used to speed up the transmission of rates is the percentage of required reserves, which was modified on four occasions between May 2007 and October 2008. The major fall in inflation, the counter-cyclical policy response in the setting of the international crisis of 2007-2008, and the general recognition of the central bank's competence have validated its actions and the importance of its independence.

Inflation is presently within the long-term target range set between 2% and 4% per year by the central bank. At the same time, characteristic monetary orthodoxy in Colombia is expected to allow inflation to remain in this target range in coming years, despite greater price pressure from the narrowing of the output gap and the sustained increase in international commodity prices.

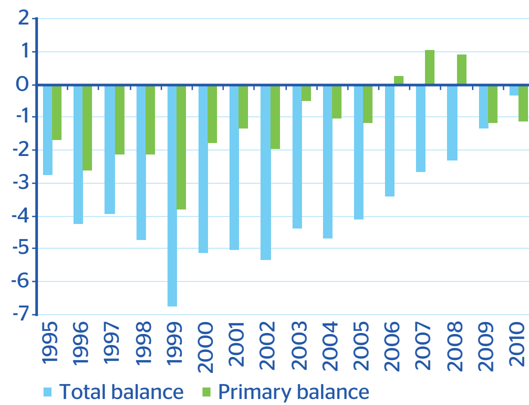
One of the main challenges for monetary policy in the coming years will be outlining the removal of the monetary stimulus process without affecting the economy's sustainable growth path. Further, this process should control pressures of a strengthening in the exchange rate which would lead to a considerable divergence with regard to its balance value. .

3.4. Fiscal Policy

The improved fiscal balance sheet was recently supported by international ratings agencies which awarded long-term sovereign bonds in foreign currency investment level status. The recently passed reforms in Congress allow the attainment of primary budget surplus to be expected in the medium-term

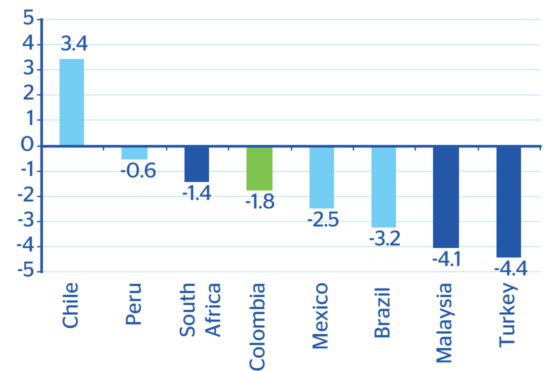
Over the past few decades, the government has recorded persistently negative fiscal results caused by an increase in spending that has not been offset by a similar growth in revenue. This imbalance resulted in a rapid growth in public debt, both domestic and foreign, during the 1990s. While in 1994 the 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. In the first half of the last decade, major efforts were undertaken to correct these imbalances leading to debt falling to 36.4% of GDP at the end of 2008, after two consecutive years with a small primary budget surplus. Nonetheless, activating automatic fiscal stabilizers since 2009 (when a high level of public spending was allowed despite a fall in revenue so as to face up to the economic slowdown) led to an increase in the fiscal deficit (from 2.3% of GDP in 2008 to nearly 4% in 2010 and 3.5% in 2011) and in public debt (up to nearly 37% of GDP currently).

Chart 13
Primary and total Central Government fiscal balance (%)



Source: Confis and BBVA Research

Chart 14
Fiscal deficit in Colombia compares favorably (% of GDP, average 2000-2010)



Source: IMF and BBVA Research

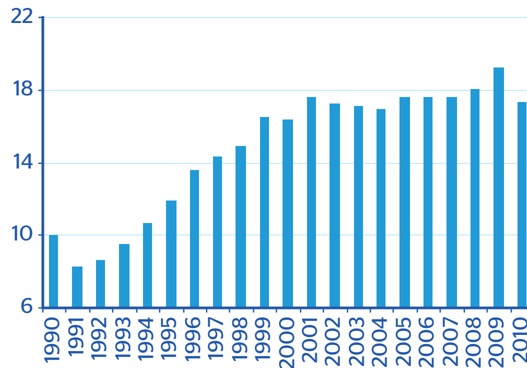
In recent years, strategies have stood out to change the public debt structure and to lengthen the debt maturity profile. In the former case, the percentage of foreign debt has been brought down to 30% of the total, from a level above 50% in 2002, thus reducing the country's exposure to periods of heavy devaluation or the shutting down of the capital market. In the latter, the average debt portfolio lifespan went from 5.4 years in 2000 to 6.7 years at present, while its duration came in at 4.6 years in comparison to 3.7 years in 2002.

Most of government spending in Colombia is inflexible and around 70% is subject to constitutional regulations linked to education, health and other transfers. In turn, 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. During the 1970s, when structural reforms to the system began, on average a tax reform was 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 12,4% of the GDP, without majorly 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.

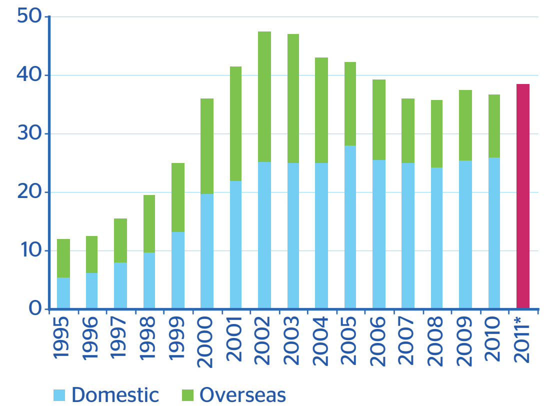
5: Garay (1998)

Chart 15
Total Central Government spending (% of GDP)



Source: Confis and BBVA Research

Chart 16
Total Central Government debt (% of GDP)

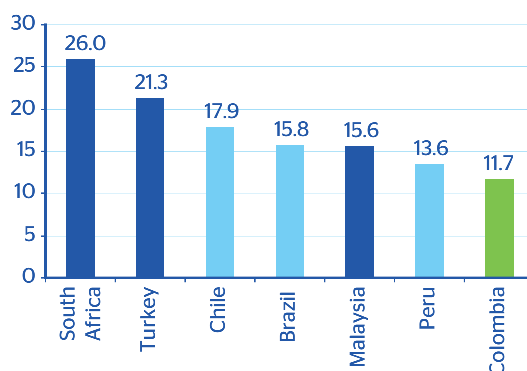


* Forecast.
Source: Banco de la República and BBVA Research

A major challenge is to reduce high current structural deficits. A move forward has been the recent approval in Congress of reforms such as the Fiscal Rule and the reform to the royalties distribution system. These laws seek to strengthen fiscal sustainability and to offset the nation's structural deficit in order to generate savings in the high part of the economic cycle and in periods of high commodity prices that allow a countercyclical fiscal policy to be implemented.

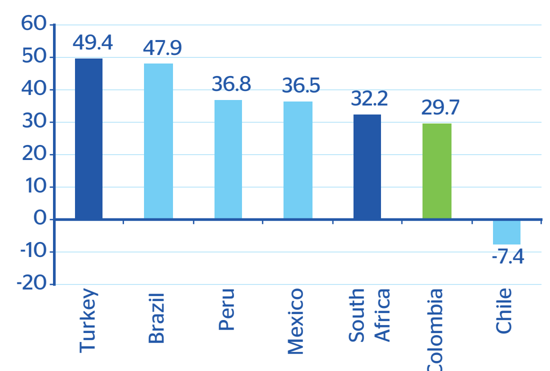
Another point pending on the government's agenda is the simplification of the tax system which currently has many exemptions and different rates. An advance here was the elimination of the tax reduction for purchasing fixed assets which had artificially stoked the relative cost of labor in recent years and may well explain the high levels of investment in capital goods in the recent cycle. In turn, the government announced it will present a tax reform to Congress in 2012 to simplify the tax system and favor competitiveness in the private sector.

Chart 17
Tax receipts in Colombia and developing countries (% of GDP)



Source: World Bank and BBVA Research

Chart 18
Public debt (% of GDP, average 2000-2010)



Source: IMF, Central Reserve Bank of Peru and BBVA Research

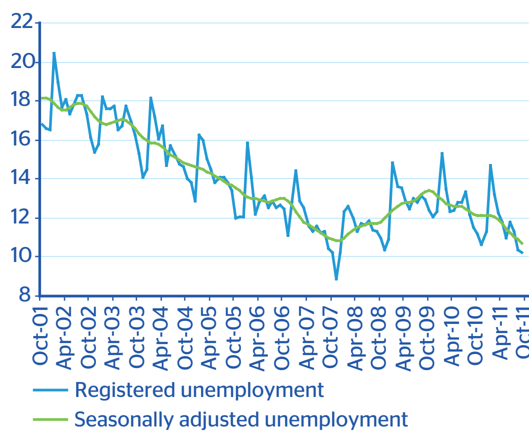
4. Labor Market

The jobless rate in the last decade has fallen from nearly 20% to around 10%. However, additional reductions in the rate require structural reforms in terms of non-salary costs and the minimum wage

One of the features of the Colombian economy is its high rate of unemployment (chart 19). This situation reflects the different distortions facing the labor market which impede a structural reduction in unemployment including the high non-salary costs (Social Security contributions, the National Apprenticeship Service and the Colombian Institute of Family Wellbeing), which make up 60% of a minimum wage, and the latter's true rigidity which is indexed to inflation as set out in the constitution and currently represents 55% of the average salary. This meant that, 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, in spite of growth in the workforce similar to the historical average.

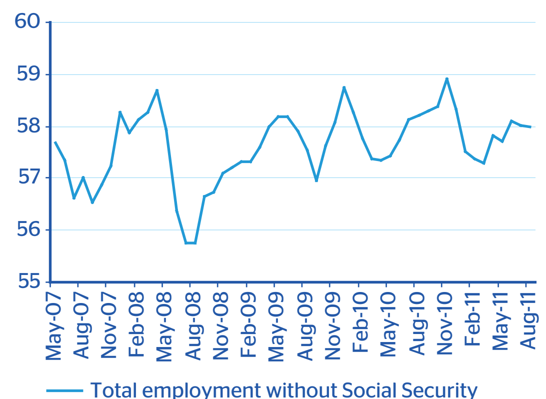
These distortions have also affected the quality of Colombian employment, so much so that the country has one of the highest informality rates in the region with women, young people and workers with no qualifications being those most likely to fall in this sector of the labor market.

Chart 19
Unemployment rate (national total, %)



Source: DANE and BBVA Research

Chart 20
Informal employment
(Total employed without Social Security, %)



Source: DANE and BBVA Research

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 one of the main inhibitors of economic growth and development.

One of the main challenges faced in the medium term is to reduce substantially the rate of informal employment. This requires making 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.

5. Sector analysis

In recent years, the reduced share of agriculture and industry has been accompanied by an increased share of total GDP for mining and the financial sector. Therefore, a challenge for the economy is to attain balanced sector growth where mining resources could be catalysts for expanding other activities.

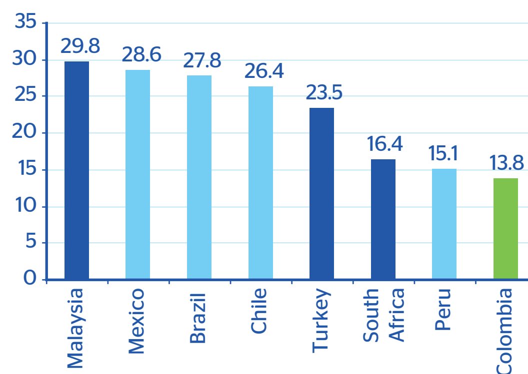
Manufacturing

The emergence of manufacturing in Colombia was one of the earliest to be seen in Latin America, in part due to the public policies aimed at substituting imports from the mid-20th century. The most representative sectors in manufacturing output in 2010 were food and drink (22.5% of total industry), chemicals (17.6%), textiles and clothing (10.3%) and cement and other non-metal minerals (7.6%) which grouped almost 60% of total manufacturing.

Manufacturing has lost share in national output. While mid-decade it represented 14.2% of GDP, it currently stands at 12.4% of GDP. This lower share deepened due to the consecutive declines in the sector in 2008 and 2009 (5% on average) while the economy expanded 1.8% on average. One of the reasons for this lower share was undoubtedly the closure of the Venezuelan market for most manufactured products.

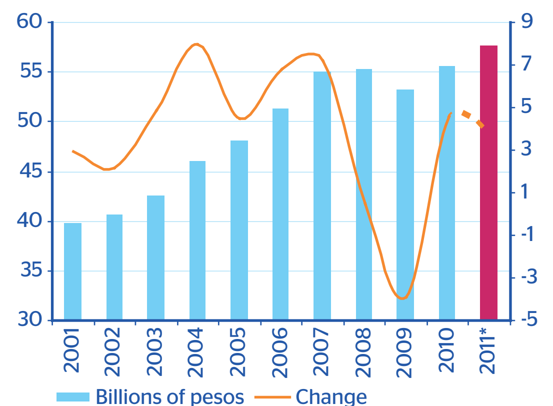
Lower foreign demand has meant that the recovery in manufacturing which started mid-2009 is imbalanced, with major differences between production sectors in line with their exposure to foreign trade. In this way, the outlook for the sector will depend on its strategy in overseas markets since in recent years domestic demand has been proven insufficient to compensate for lower export performance. The recently signed free trade treaties, as well as the coming ratification of the FTA with the United States, are a major chance to expand Colombia's exports to developed nations.

Chart 21
Manufacturing share (average 2000-2009, %)



Source: World Bank and BBVA Research

Chart 22
Manufacturing growth (y/y, %)



* Forecast.
Source: DANE and BBVA Research

Construction

The construction sector makes up 6.4% of GDP, split between public works (55%) and property construction (45%). In recent years, the public works sector increased its share in the sector due to the higher level of committed resources from the government since 2009 for investment in infrastructure. However, the country continues to see a lag in roads and transport. Closing this gap requires joint state and private sector action so that improvements in the key work tender system for the country's development can be consolidated. The infrastructure sector will be key for the country's development in coming years and for the success of current and future trade agreements.

The property construction sector is one of the sectors to lead growth in 2011 and will be so in 2012. This sector is currently supported by experienced companies with better financial and economic planning leading to greater strength in the face of construction cycles. The presales payment scheme through real estate trusts has reduced construction company, buyer, and financier risks.

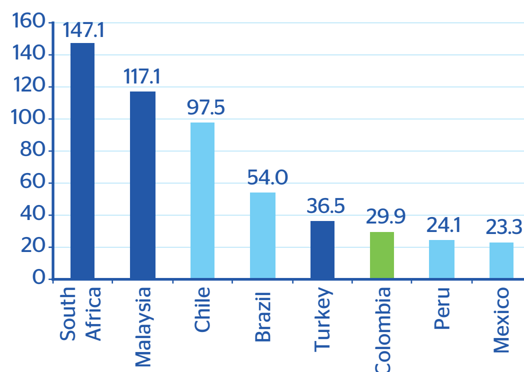
Nevertheless, the real estate business faces regulatory obstacles which impede higher growth. On the financial side, limits on interest rates and low creditor protection lead to barriers in mortgage supply. In turn, the complex regulatory framework leads to high costs for construction companies which act as a disincentive to accommodation solution supply for medium and low income families.

Financial Sector

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 transforming regulation. In turn, the pension system also underwent a reform in 1993, when private pension funds were introduced and Colombia moved from a public system to a mixed system that combines the private defined contribution system (individual savings regime with solidarity pillar) with the public system of defined benefit (pay-as-you-go).

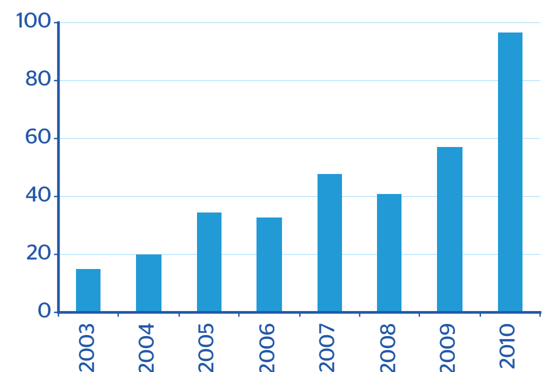
The banking system is made up of 23 banks, of which 12 are private local banks holding 69% of assets, 10 are private foreign banks with 19% of assets and one is a state-owned bank with 6% of assets. There were 40 banks in 1989 which due to privatizations, mergers and acquisitions, and to a lesser extent, liquidations, led to the current figure. The assets in the system are also concentrated in only a few banks, with the four biggest being private and holding nearly 51% 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.

Chart 23
Private sector credit (% of GDP, 2009)



Source: World Bank and BBVA Research

Chart 24
Market capitalization (% of GDP)



Source: BVC and BBVA Research

The consolidation in the financial system has taken place not only in financial institutions, but also in regulatory bodies. The financial system regulator is the Financial Superintendency of Colombia (SFC), an institution that was created from the merger of the Banking Superintendency and the Securities and Insurance Superintendency in 2005. The SFC has fulfilled its role from a technical viewpoint, overseeing the progress of the entire financial and insurance system within the framework of prudent system supervision in line with international financial regulations. The Ministry of Finance, as regulatory body of the financial system, has brought forward its intention to implement some Basel III capital and liquidity rules, although its schedule or how the regulations will be applied are not clear.

Some prudent measures have been adopted in recent months, such as closer supervision of liquidity indicators or the modification of unsecured loan provisions, without having necessarily

formally adopted Basel directives. A system of countercyclical provisions for the banking system was introduced in 2007. Under this, financial institutions have to increase their levels of provisions in high-income years. In turn, bank deposits are protected through deposit insurance provided by Fogafin (Financial Guarantee Fund) of up to COP $20 million. This currently covers 97.9% of the users of the system.

The capital market in Colombia has performed positively. In 2001 the stock exchanges in the country's main cities were merged into 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. With the coming into effect of the Integrated Latin American Market (MILA) in May 2001, integrating the equity markets of Colombia, Peru and Chile, the capital market has a promising future while becoming the top market in the region in terms of issuer numbers, the second in capitalization and the third in trading volume.

Corporate issuances on the BVC in 2010 came in at $13.8 bn (2.6% of GDP), three times that in 2006 and the highest ever recorded. However, it is still a limited source of finance for companies, and only major corporations have access to this funding vehicle, especially in issue maturities above 5 years. The most traded securities on the capital market are domestic National Government bonds (TES), surpassing the trading volumes of other financial assets by a wide margin. This has allowed the government to diversify its debt terms and achieve an efficient yield curve with different maturities and a maximum term of 15 years in the domestic market. Currently, there are plans by the government to extend the maturity of the yield curve as the market continues to develop and institutional investors demand it.

Increasing banking penetration 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 32%. This indicator reached a maximum at the end of the 1990s, just before the financial crisis, meaning the greater coverage at the time was not thanks to the system reaching a greater number of people, but to a greater indebtedness of the users. Banking penetration among the population continues to be very low. According to ASOBANCARIA (2011), only 57% of people have access to a checking account, while only 18% of the population over the age of 18 has access to a credit product of some kind. Other countries in the region show better banking penetration indicators, for example in Peru, 25% of the adult population has a bank loan while in Chile, 25% of households have a loan in the financial system.

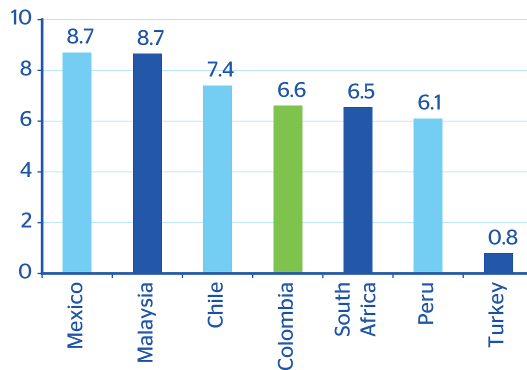
Some of the current regulations reduce banking penetration, such as the interest rate limit on loans, known as the "usury rate", calculated as 1.5 times the current bank interest rate. In addition, banking transactions are subject to a 0.04% tax, highly prejudicial for financial penetration. According to the 2011 tax reform, this tax will be gradually eliminated from 2014 until it disappears completely in 2018.

Oil, natural gas and mining

The mining and energy sector has become one of the main growth engines, being the main receiver of foreign direct investment. In turn, exports linked to the sector are the main category in overseas sales.

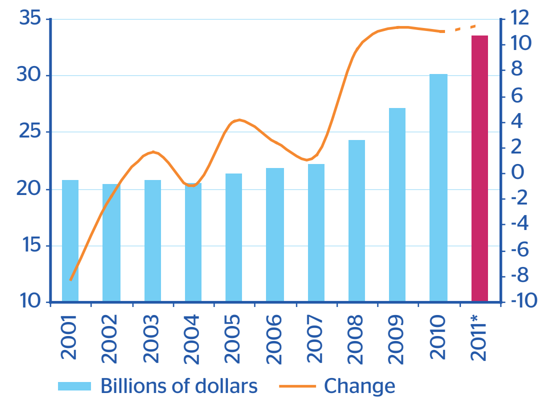
Colombia is rich in hydro resources, with major coal and natural gas reserves as well as limited oil reserves. Nevertheless, its geographical location leads us to believe that there are high chances of undiscovered oil reserves which could run to 54.7 billion barrels according to the Ministry of Finance. The country's main oil company is ECOPETROL, a public-private company where the state holds 88.2% of shares with the remaining 11.8% in private hands and traded on the Colombia Stock Market.

Chart 25
Mining share (average 2000-2010, %)



Source: Central banks and National Centers for Global Statistics and BBVA Research

Chart 26
Mining growth (%)



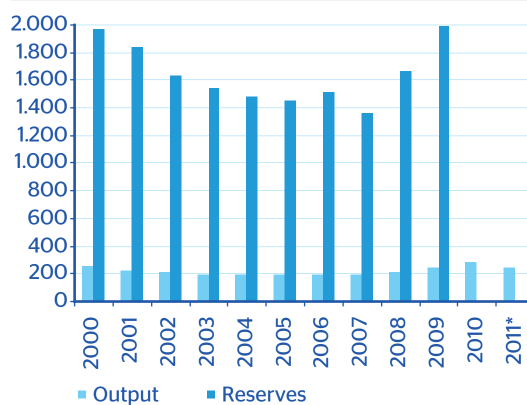
* Forecast.
Source: DANE and BBVA Research

Oil reserves were 2 billion barrels in 2009 with annual production of 245 million barrels (287 million in 2010), equivalent to a production-reserve ratio of around 7 years. Daily oil barrel production is 950,000 with a production target of over one million for 2015. One of the strategies to increase oil reserves has been to raise well drilling, facilitating the tender process for this type of contract.

Coal is the main source of mining operations and there are major top-quality reserves such as in the mines of Cerrejón and La Loma and the deposits in the Cundinamarca and Boyacá basin. The country has historically produced coal with the participation of U.S. and South African companies.

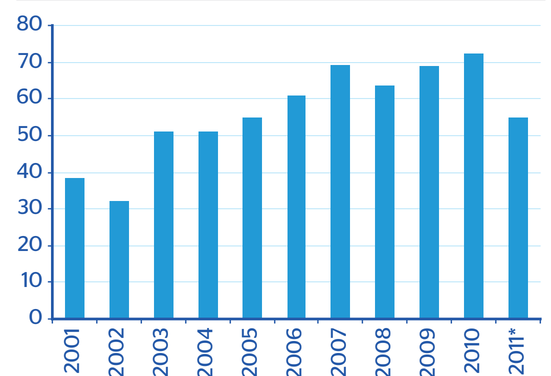
In turn, the country has been developing a series of policies seeking to stimulate the production of alternative fuel sources, such as the cultivation of African palm and sugar cane, with the aim of positioning Colombia on the renewable energy generation market.

Chart 27
Oil reserves and annual production (millions of barrels)



* 2011: This year to September
Source: ANH and BBVA Research

Chart 28
Coal Exports (millions of metric tons net)



* 2011: This year to August
Source: DANE and BBVA Research

6. Internal conflict and post-conflict

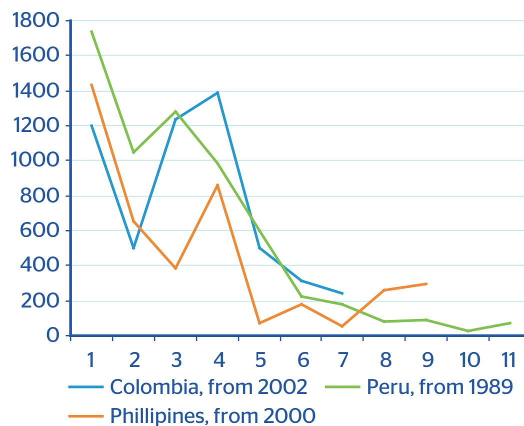
The security policy started in the previous decade has been successful in reducing levels of violence and the influence of armed groups outside the law in the country. The aim of government institutions in the current post-conflict process is to lay down the necessary groundwork for national reconciliation

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 origins in the armed peasant struggles of the mid-20th Century, who fought for better land distribution. At present, the armed groups outside the law use drug trafficking as a major source of finance and have lost some of their political motivations. The explosive combination of drug trafficking and guerrilla forces in rural areas gave rise to private defense forces (paramilitaries) which became a new player in the conflict and which use similar or more violent methods than the guerrilla to attain their goals.

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. Nowadays the safety levels for the population are much higher and programs are being developed linked to the post-conflict era which point to additional improvements in the near future.

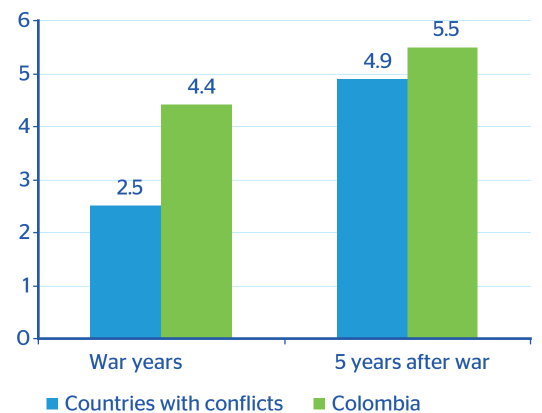
In this way, Colombia is experiencing at the same time a conflict with groups outside the law and a post-conflict process where the groundwork is being laid for a compensation process for victims and national reconciliation. These conditions add many nuances to Colombian politics but do not generally affect the performance of the Colombian economy, which reacts to its fundamental components and institutions.

Chart 29
Deaths due to the conflict from peak year Selected countries



Source: Uppsala Conflict Data Program

Chart 30
GDP growth in years of conflict and post-conflict (%, Colombia and selected countries)



*For Colombia, 2002-2010 is taken as the war period and forecasts for 2011-2015 as post-conflict.
Source: Davies (2008) and BBVA Research

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