Colombia

Economics

Economic

Credit Rating:

Moody's: Ba2

S&P: BB+

Fitch: BB

Nominal GDP (2006):

USD 131.8bn

Population (2006):

46.3mn

Total Trade / GDP:

37.5%

Currency:

Colombian Peso

Exchange regime:

Managed Float

Merchandise Imports from Canada (2006):

CAD 447.5mn

Main sources of Foreign Exchange (excl. FDI):

Petroleum and related products

Largest Merchandise Trading Partner:

United States

Main imports:

Intermediate goods

Capital Goods

Risks to the Outlook:

Movement on the reform agenda

Fiscal slippage and security deterioration

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Market Spotlight: Despite of the fact that inflation has been decelerating since April, it remains well-above the central bank's target. Therefore we expect the tightening bias to continue through the rest of the year. The *peso* continues to strengthen, impacting negatively on the current account balance. Given these conditions, it is expected that GDP growth will decelerate over the forecasted period.

Real Sector: Colombia's GDP decelerated in the second quarter, growing by 6.9% y/y. As macroeconomic stability and improving labor market conditions continue to enhance household wealth, domestic consumption grew by a sturdy 6.5%. But strong domestic demand was ultimately driven by the 20.24% y/y surge in gross capital formation – a good sign going forward. Improved business confidence and strong fundamentals also helped drive a 16.3% y/y jump in imports in Q2, with capital goods increasing 23.4% y/y. Industrial Production has been resilient to interest rates hikes, as July IP grew by 12.4% y/y. Due to the rapid appreciation of the *peso* and the emerging global slowdown, exports grew by 4.3% y/y, versus 8.6% and 12.4% in two previous quarters. Import growth is still way above that of exports. Growth hit a well-balanced 6.8% in 2006 as a whole, the strongest expansion since 1978. But as the central bank continues to tighten the monetary reins, we expect growth to pull back to more sustainable levels.

External Sector: The strong *peso* pulled Colombia's trade balance into deficit in Q2. An uncompetitive currency, moderating commodity prices, and slower growth in the US will likely push the current account deficit to around 1.0% of GDP in 2007. While FDI fell to US$6.3bn in 2006, from a peak of US$10.3bn in 2005, foreign investment should remain strong over the forecast horizon due to continued privatization, new investments in mining and energy, and the coming FTA with the US. Reserves stand at US$20bn, which equals 6 months of current account debits. We expect Colombia's external debt to hover around US$35bn over the forecast horizon, bringing the debt servicing ratio to 21%, from 43.5% in 2003.

Monetary: Thanks to lower food prices, inflation decreased to 5% in September, the lowest since January. Nevertheless it is still above the target range of 3.5%-4.5% as a result of 21 consecutive quarters of strong growth, heavy central bank intervention in defense of the *peso*, and rising regional food prices. As such, we expect the BRC to continue raising rates until it sees evidence of cooling domestic demand. The Bank appears concerned that monetary tightening, however, is having little effect on market interest rates, credit demand, and economic activity. As a result of these transmission problems, authorities recently increased reserve requirements for domestic banks, an effort that will likely not show results for another few months.

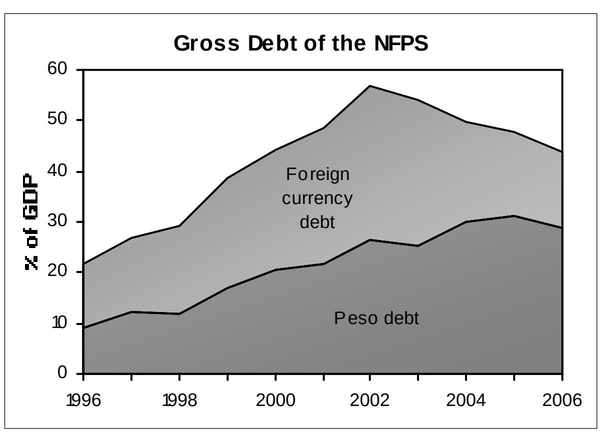
Fiscal: The NFPS balance went from deficit in the fourth quarter of 2006 to surplus in the first quarter of 2007. However, Colombia's fiscal position remains vulnerable to rigidities – including mandated transfers to local governments and public pension systems, as well as interest payments on debt. Pending reform of the transfer system would be an improvement, as would tax and pension reforms.

Debt: Net foreign currency repayments, as well as local currency issuances at fixed rates and longer maturities, have improved the profile of government obligations. Debt management will seek further reductions to exchange and rollover risk. We expect total public debt to fall to 43% of GDP by 2008, from 57% in 2002, as a result of the rise in privatization receipts. In fact, the government has already expressed its intention to engage in more debt buybacks this year.

Outlook: *Colombia's significantly improved growth sustainability is the result of a sharp rise in investment. A responsible policy tack, declining external vulnerabilities, and improvements in productivity and financial viability make it among the region's best candidates for investment-grade status.*

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	3.5	6.3	5.0	4.3
Inflation (%chg, avg.)	6.5	4.3	4.5	4.0
Fiscal Balance (% of GDP)	-2.3	-0.8	-1.5	-2.0
Exports (%, comp. annual growth)	9.6	15.3	7.5	5.5
Imports (%, comp. annual growth)	12.7	21.2	5.0	8.0
Current Account (% of GDP)	-1.3	-1.7	-1.0	-1.2
Reserves (months of curr. debits)	6.2	4.9	4.9	4.7
External Debt (% of GDP)	39.7	26.4	23.9	23.4
Debt Service Ratio (due)	35.4	23.0	22.9	22.0
Exchange Rate (to USD; eop)	2521.6	2238.8	2288.0	2375.0



Political

Political Structure
Democratic republic (ruled by coalition)

President
Alvaro Uribe Velez (ran as independent candidate)

Legislative Bodies
- National: Congress (161 seats), Senate (102 seats)
- Local: 32 departments and approximately 1000 municipalities

Major Parties
Partido Liberal (PL) (holds majorities in both houses of Congress)
Partido Conservador Colombiano (PCC)
Polo Democratico Independiente (PDI)

Last Elections
- Presidential: May 28, 2006
- Legislative: March 14, 2006

Next Elections
- Presidential: 2010
- Legislative: 2010

Press Freedom Survey:
- 2006 Score: 57 Partly Free

(0: Free; 100: Not Free)
freedomhouse.org

Control of Corruption Index:
- 2006 Score: -0.22

(-2.5: Worst; +2.5: Best)
worldbank.org

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General Political Environment:

President Alvaro Uribe, a political independent, was re-elected in May 2006 by a landslide victory: The election was notable for the increase in support for the left-wing *Polo Democratico Independiente*'s (PDI) candidate Carlos Gaviria who received 22% of the vote. Although the election occurred in a peaceful climate, the Revolutionary Armed Forces of Colombia (FARC) has vowed to destabilize the government in Uribe's second term through the protraction of their insurgency.

Uribe's sustained high popularity stems from his hard-line militaristic approach to Colombia's civil conflict. As a result of this policy, there has been an increased sense of physical security in key areas of the country. Although Uribe's efforts may further tilt the balance in favour of the armed forces, it is unlikely they will succeed in defeating all armed groups through military means. Indeed, illegal armed groups will remain destabilizing forces that contribute to a high degree of political violence in Colombia.

Given Uribe's renewed popular mandate and the majority enjoyed by pro-Uribe parties in both the Senate and the Congress since the March 2006 legislative elections, it is expected that the President will pursue his hard-line security policy with renewed vigour.

Substantial concerns remain with regards to the negative human rights implications of the government's hard-line approach. Human rights issues are a serious concern in Colombia. As a direct consequence of the longstanding civil conflict, cases of violence, kidnappings, homicide, extra-judicial executions, enforced disappearances and internal displacements are continuously reported in high numbers. The US and Colombia signed a bilateral FTA in February 2006. The implementation of the agreement is pending ratification in the US. A growing scandal (see *Political Outlook* below) is likely derail timely ratification, if not reject it altogether.

President Uribe visited the US subsequent to the recent congressional elections in view of lobbying the new Congress for continued aid and trade cooperation. Despite these efforts, given the interests of the Democrats, the US involvement in Colombia could start to wane.

Colombia, under the leadership of President Uribe, stands in stark contrast to other South American countries in which populist politicians have an increasingly important political clout.

Investment Environment:

Foreign investors are officially accorded national treatment and can obtain judicial stability for investment contracts of up to 20 years on private investment exceeding USD 1 million. There are few restrictions on the repatriation of profits but the government reserves the right to restrict remittances if international reserves fall below three months of import cover.

There is a strict separation of powers between the executive, legislative, and judicial branches, but corruption, intimidation, and inefficiency render outcomes unpredictable. It is generally acknowledged that corruption is problematic in most areas of Colombian public administration.

Political Violence:

Since the late 1960s, Colombia's government has faced chronic insurgency. Despite military and financial assistance from the United States over the years, the situation has degenerated into an irregular and prolonged armed conflict in which guerrilla groups such as the FARC and the National Liberation Army (ELN) engage in military actions to gain political and economic power. These leftist groups are also waging a parallel battle against right-wing paramilitary groups. Using brutal tactics and drawing support from drug traffickers and the economic elites who feel threatened by the guerrillas, the paramilitary groups have focused their attacks on individuals and institutions that promote left-wing ideology. All of these groups are involved in illegal activities such as drug trafficking.

In June 2005, Colombia's Congress passed the controversial *Justice and Peace Act* to establish a legal framework for demobilizing these illegal groups. Despite the shortfalls of the framework, it has enabled significant paramilitary disbandment and has brought the ELN to peace talks. Notwithstanding this measure of success, it is believed that the paramilitary's illegal activities will continue beyond the demobilization efforts and that successful disarmament of the ELN remains a distant prospect.

Political Outlook

President Uribe is currently facing the biggest scandal of his presidency: seventeen politicians in total have been implicated and are under investigation for paramilitary links. Dubbed "para-gate", the scandal is around alleged government ties to rightwing drug-trafficking paramilitary movements, with allegations rising all the way to the close circle around President Uribe. These allegations are particularly damning and come at a very difficult time for the Uribe administration as it tries to convince the Democrats in Congress to support the US-Colombia Free Trade Agreement and as the right-wing paramilitary AUC withdraws its cooperation with prosecutors due to their rejection of a recent Supreme Court ruling around leniency.