

A POSITIVE VIEW OF COLOMBIA

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INTRODUCTION

Colombia has never defaulted on its debt and will continue to honor its obligations. No matter what, our reputation in international financial markets will be preserved because such reputation is a critical component of our nation's wealth.

Despite the value of reputation in international financial markets, in the last few weeks market sentiment towards Colombian sovereign debt has been hostile, to say the least. An increase in risk aversion towards financial claims on the Colombian government has induced a plunge of sovereign bonds' prices and a rise in yields that has made external financial markets prohibitive or virtually closed to the new administration.

Uncertainty regarding the fiscal balance and debt sustainability of the country, together with the fear of contagion from other Latin American economies, has articulated this unfortunate turn of events or market perception towards Colombia. Fortunately, Colombia's solvency is not at stake and any liquidity shortage has been tackled with a number of instruments that this administration has explored and prepared, including strong support from multilateral organizations. Put another way, *even if the government's financing scenario for next year is tight, our reputation in international financial markets will be preserved and debts will be honored because alternative sources of funds are at hand.*

Furthermore, there is clear evidence that Colombia still exhibits a solid financial, monetary and balance of payments system relative to other Latin American economies that have already collapsed (Argentina, Uruguay) or that seem financially fragile (Brazil). This has guaranteed sufficient insulation against any possibility of contagion from recent crises in the region and should also protect the economy from the effects that could stem from a potential collapse in other Latin American economies.

EXPOSURE OF THE PUBLIC SECTOR TO CAPITAL FLIGHTS

One of the variables that markets monitor more closely in order to evaluate the solvency of a government is public debt as a fraction of GDP and its currency structure. At June of 2002 total public debt in Colombia represents 48.9% of the country's GDP. 51.3% of total public debt is denominated in foreign currency. To put these numbers in perspective, we can compare them against the level and currency structure of public indebtedness of other countries in the region (see Table 1). The numbers for Argentina and Uruguay refer to pre-crisis levels.

Table 1

Public Debt* (% GDP)		
	USD	Local Currency
Uruguay	57,0	0,2
Argentina	54,0	1,0
Brazil	32,0	26,0
Colombia	25,1	23,8
Chile	4,0	15,0

* Non financial public sector

Source: IADB, Ministry of Finance

Colombia's current level of public indebtedness (48.9%) is somewhat lower than that of Argentina (55%) and Uruguay (57.2%) right before these economies suffered massive capital outflows and their exchange rate regimes collapsed. It is also lower than Brazil's current level of public indebtedness (58%). Chile's level of public indebtedness is, by far, the lowest among the five countries (19%).

Yet, there is one critical difference between the debt structure of the Colombian government and that of the Argentine and Uruguayan governments on the eve of collapse. While 98.2% and 99.7% of Argentina's and Uruguay's pre-crisis public debts, respectively, were denominated in foreign currency, only 51.3% of the Colombian government's total debt is foreign currency-denominated.

This difference in the currency structure of public debt is a key indicator of a government's exposure to capital flights. Given that any real exchange rate depreciation inflates away foreign-currency (or tradable) denominated debt, the bigger the share of public debt that is denominated in foreign currency, the bigger the fiscal contingency or fragility associated to massive capital outflows and real exchange rate depreciations. Of course, the bigger the fiscal contingency to massive capital flights, the higher the probability that these capital flights are validated and that the price of sovereign debt is eroded.

Thus, while sharing somewhat similar (actually lower) levels of public indebtedness with pre-crisis Argentina and Uruguay, the Colombian public sector does not exhibit such a severe and dangerous currency mismatch in its balance sheet (neither does Brazil's). In consequence, the Colombian fiscal stance is not as fragile and vulnerable to real exchange rate depreciation as were Argentina's and Uruguay's on the eve of their economic collapse. Once the crises occurred in these two countries, the high degree of public sector exposure to capital flights deteriorated even more their fiscal stance and debt payment capacity. In a way, this level of public sector exposure to currency risk helped validate the original capital flights from these two countries.

Colombia is far away from such a degree of public sector exposure to capital flights given that almost half of its public debt is denominated in local currency. Furthermore,

79% of the local currency denominated debt yields a fixed interest rate (this represents 39% of the total stock of public debt, Source: Ministry of Finance). This proves that domestic financial markets, despite recent turmoil, have always believed in Colombia's well-behaved fiscal/monetary authorities and macroeconomic stability. In short, the currency and interest rate structure of the Colombian public debt reflects our reputation in financial markets, both domestic and international. This reputation will be preserved.

EXPOSURE OF THE PRIVATE SECTOR TO CAPITAL FLIGHTS

In addition to the public sector's exposure to capital flights, it is very important to also evaluate the vulnerability of the private sector to massive capital outflows and real exchange rate depreciation. If the private sector is highly exposed to currency risk, any economic contraction after capital flies and external savings are choked will be magnified through a balance sheet effect channel that stems from the real exchange rate depreciation. This immediately translates into a fiscal contingency given that less growth and higher interest rates endanger public debt sustainability and payment capacity (as higher primary surplus levels are required).

Table 2 portrays the stock of external debt of the non-financial private sector as a fraction of the total debt stock for several Latin American countries. This indicator measures the private sector's level of exposure to capital flights. Again, the numbers for Argentina and Uruguay refer to pre-crisis levels.

Table 2

External debt as a % of total debt of the non financial private sector	
Argentina	77.0%
Uruguay	66.0%
Brazil	46.0%
Colombia	41.2%
Chile	40.0%

Source: IADB, Banco de la República

It is important to highlight that, among the five countries, Colombia's non-financial private sector exhibits one of the smallest degrees of exposure to capital flights (41.2%). In contrast, on the eve of their financial and economic collapse, 77% and 66% of the total debt of the Argentine and Uruguayan non-financial private sectors, respectively, was owed to the rest of the world. This high level of private sector exposure to currency risk magnified the economic contraction and fiscal crisis of these two countries once capital fled. Public and private debt payment capacity was further endangered.

Colombia is clearly protected against this perverse mechanism due to the low fraction of the private sector's debt that is a liability with the rest of the world. This questions even

more the rationale for further capital flights and sovereign debt price erosion for the Colombian economy.

EXPOSURE OF THE FINANCIAL SYSTEM TO FISCAL PERFORMANCE

When a domestic financial system is over-exposed to the public sector (i.e. to its bonds), a fiscal collapse also triggers a crisis in the financial system. Such a crisis feeds back into a deeper fiscal problem if the government or the central bank insures deposits (implicitly or explicitly).

Table 3 exhibits, for the same Latin American countries, the fraction of the domestic financial system's assets that represents credit to the government. The numbers for Argentina and Uruguay correspond to pre-crisis levels.

Table 3

Credit to the public sector as % of the financial sector's assets	
Brazil	23,5%
Argentina	22,0%
Colombia	12,2%
Uruguay	12,0%
Chile	11,0%

Source: IADB, Superintendencia Bancaria,
Banco de la República

12.2% of assets in the Colombian financial system represent credit to the public sector. This number is much smaller than that of Argentina's financial system on the eve of collapse (22%) and than that of Brazil's financial system nowadays (23.5%). The number is close to that of Uruguay's pre-crisis financial system¹ and not far away from that of the Chilean financial sector (11%).

Clearly, the domestic financial system of Colombia is not over-exposed to the public sector. This is critical because it proves that financial intermediation is not at stake even if public bond prices (say, TES) were to further depreciate. Indeed, only 8.2% and 72.6% of the financial system's assets and net worth, respectively, are allocated in form of TES (Source: Ministry of Finance, calculations based on Superbancaria and Banco de la República de Colombia, Fiduciaria de Valores). Hence, the financial sector is not a fiscal contingency in itself if domestic public debt remains at low prices.

¹ Of course, Uruguay's financial system was not over-exposed either to the public sector before its economic collapse. Had it been over-exposed the crisis would have been magnified.

LIQUIDITY NEEDS

Any country's financial fragility is a function of its liquidity or short-term financing needs. A simple way to measure this is by computing the volume of public debt that has to be repaid in the near future. Table 4 depicts, for the same set of Latin American countries, the percentage of external public debt that is due in 2003, 2004 and thereafter.

Table 4

External Public Debt Amortization Profile			
	Percentage due in		
	2003	2004	2005 and beyond
Argentina	22,7%	16,3%	61,1%
Brazil	13,8%	13,9%	72,4%
Uruguay	11,3%	7,7%	81,0%
Colombia	13,6%	8,8%	77,6%
Chile*	0,1%	3,6%	96,3%

* For Chile, from 2003-2005 and 2006 and forward

Sources: Ministry of Finance (Argentina, Colombia and Chile) and Central Banks of Brazil and Uruguay

It is important to highlight that only 13.6% and 8.8% of the Colombian external public debt is due in 2003 and 2004, respectively. Nevertheless, the year 2003 is abnormally high in amortizations. Still, 77.6% of the total stock of debt is concentrated in the post-2004 period. Moreover, external public debt concentration in Colombia is in much better shape than that of other countries in the region (Argentina: 22.7% in 2003, 16.3% in 2004 and 61.1% in 2005 or later; Brazil: 13.8% in 2003, 13.9% in 2004 and 72.4% in 2005 or later).

How can we deal with the year 2003 that is abnormally high in amortizations? As stated in the introduction, any liquidity shortage in 2003 can be tackled with a number of instruments that this administration has explored and prepared if needed. Table 5 depicts the 2003 financing needs of the Colombian government. Alternative sources of funds that could close the gap in the sources and uses table are: more access to multilateral funds (IDB emergency window), FAEP, and oil securitization.

Table 5
2003 Financial Plan

		US\$Million	
Sources	8884	Uses	8884
Disbursements	8266	Fiscal Deficit	3860
External	3659	(with adjustment)	
Bonds	1000	Revenues	12505
Others (multilaterals)	2659	Expenditures	16365
Domestic	4607	Amortizations	5024
Other sources	341		
Cut expenditure in decentralized sector	278		

Source: Ministry of Finance

Table 6 exhibits yet another way to explore liquidity needs of the Colombian government. It compares potential liquidity needs of the Colombian government with the stock of international reserves available at the Central Bank. Potential liquidity needs include not only the fiscal deficit and public debt amortizations but also the money base. The latter is included to capture a worst-case scenario in which agents decide to run against the COP and the Central bank intervenes up to the monetary base it is liable for.

Table 6
CENTRAL GOVERNMENT POTENTIAL LIQUIDITY NEEDS
(Millions of US\$)

	Jul-Dec 02	2003
I. Fiscal Deficit (with adjustment in 2003)	2279	3860
II. Public Debt Amortizations	2156	5024
Domestic Debt	982	2624
External Debt	1174	2400
III. (I)+(II)	4435	8884
IV. Monetary Base	4151	4303
V. Potential Liquidity Requirements	8586	13187
International Reserves (Aug 2002)	10670	10670
As a % of liquidity requirements	124%	81%

Source: Ministry of Finance, Banco de la República

Note that during the remaining of this year potential liquidity needs fall short of international reserves. During 2003 the stock of international reserves account for 81% of the potential liquidity needs. Put another way, the stock of international reserves more than covers potential liquidity needs during 2002 and covers 81% of potential liquidity needs during 2003. If we were to include additional available reserves attributable to an IMF program, the coverage would look even better. This proves that Colombia is in very good shape from the international reserve point of view. Indeed, in 2003 we have enough

reserves to pay more than eleven months of goods' imports and almost seven months of imports of goods and services (Source: Banco de la República).

PUBLIC DEBT SUSTAINABILITY

To evaluate the sustainability of any country's public debt we can simply calculate the *permanent* primary surplus that is required to stabilize such debt at a certain fraction of GDP. Table 7 portrays such exercise.

Table 7

Fiscal Sustainability

Public Debt* (% GDP)	Interest Rate	Growth Rate	Required Primary Balance (a)	Observed Primary Balance
47,7%	8,0%	2,5%	2,6%	0,7%

* Net consolidated debt from the Ministry of Finance's debt model

Note that to maintain the current level of Colombia's stock of public debt as a fraction of GDP it is necessary to generate a primary surplus equivalent to 2.6% of GDP. It is estimated that the observed primary balance of the non financial public sector will be 3% in 2003, 3.1% in 2004, 3.2% in 2005, and 2.6% in 2006 (Source: Ministry of Finance).

Table 8

NFPS Primary Balance

Year	Projected (b)	Gap (a) - (b)
2003	3,0%	-0,4%
2004	3,1%	-0,5%
2005	3,2%	-0,6%
2006	2,6%	0,0%

Source: Ministry of Finance

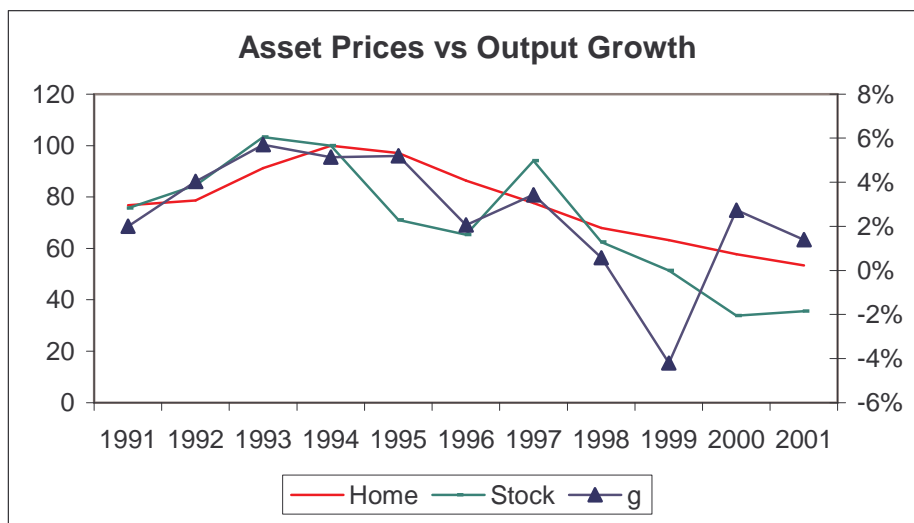
Now, higher economic growth (which also induces lower real interest rates) reduces the required permanent primary surplus. Indeed, one percentage point of additional growth reduces the required permanent primary surplus in 0.49 percentage points (Source: Ministry of Finance). Moreover, a reduction of one percentage point in the real interest rate reduces the required permanent primary surplus in 0.47 percentage points (Source: Ministry of Finance). Nevertheless, if growth and interest rates do not do the job, there is a strong commitment by this administration to take additional fiscal measures beyond those already implemented or proposed to Congress to guarantee public debt sustainability.

THE PATH TOWARDS HIGHER GROWTH

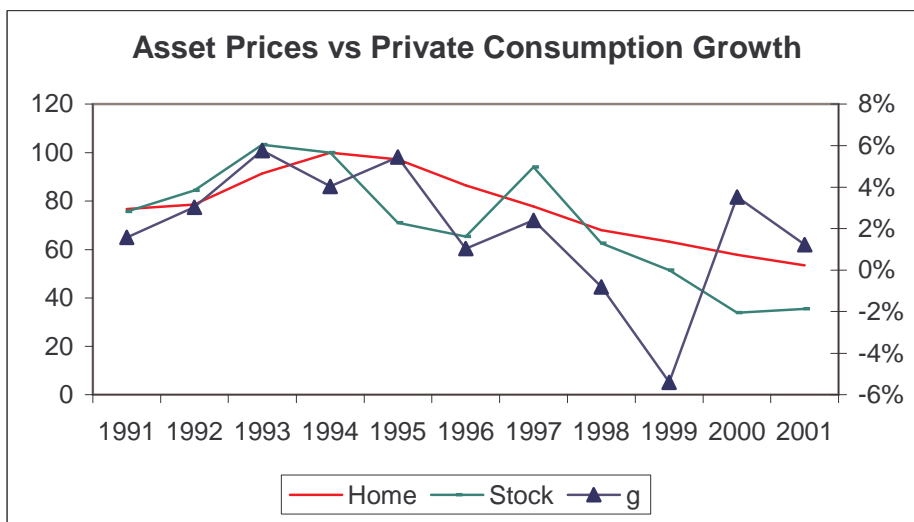
A major stylized fact is that the slowdown of economic growth in Colombia has been accompanied by a severe plunge of asset prices (stock, land, homes, etc.). The following

graphs compare real growth of output, private consumption and total investment (right axis) with the price level of homes and of the stock market index (also in real terms; left axis) during the nineties. Note that there is close correlation between asset price evolution and economic activity in Colombia. Indeed, during the consumption and investment boom of the early nineties (1991-1995) asset prices also boomed in real terms. In contrast, after 1998, when asset prices finally adjusted to the pre-boom threshold but continued to plunge, economic activity stagnated (of course, the sudden stop of 1999 explains part of the deep recession during that year).

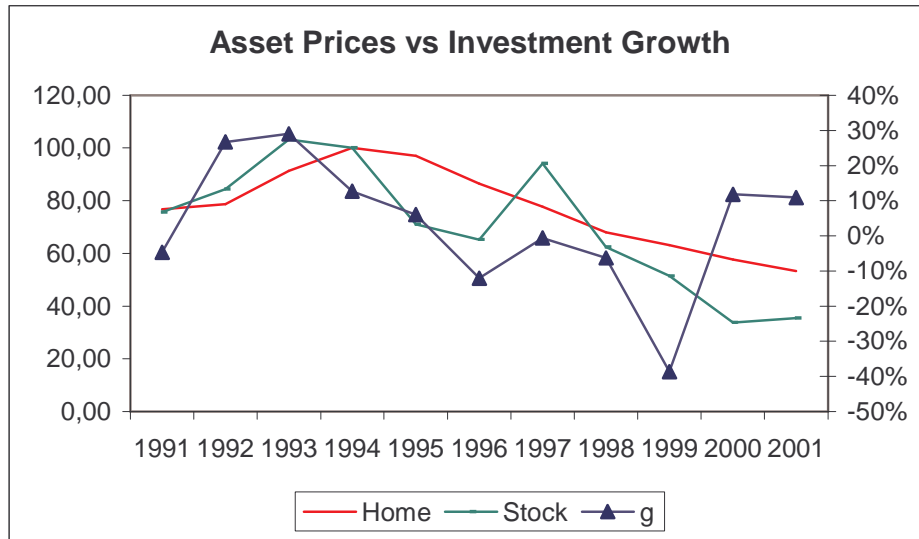
Graph 1



Graph 2



Graph 3



It is important to note that the recent plunge of asset prices in Colombia coincides with a dramatic deterioration of the internal conflict since 1999. For instance, the annual average of attacks against oil ducts during the period 1986-1998 is 44.2. Yet, during the period 1999-2001 the average increases to 115 (a 160% increase). Similarly, the annual average of blown energy lines during the period 1985-1998 is 28. However, during the period 1999-2001 the average increases to 218 (a 679% increase). Moreover, the annual average of kidnappings during the period 1990-1998 is 1488.8. During the period 1999-2001 this average rises to 3363.3 (a 126% rise).

The relation between the deterioration of domestic security and the asset price plunge is not spurious and has a simple economic explanation where two channels are at work. The first channel has to do with productivity. Certainly, attacks against infrastructure constitute negative productivity shocks to investment projects in Colombia. Given that the price of an asset is the expected present discounted value of its forever flow of rental payments, these negative productivity shocks reduce asset prices on impact. The second channel has to do with investors' expectations. Attacks and kidnappings coordinate expectations of foreign and domestic investors towards an equilibrium where capital is pulled out of the country and investment stagnates. The lower demand for investment projects in the country induces an asset price plunge.

Just as the slowdown of economic growth in Colombia has been accompanied by a severe plunge of asset prices, higher economic growth rates must be accompanied by a recovery of asset prices. Two channels are relevant. The first one comes under the permanent income hypothesis. If credit markets are perfect and agents are forward looking an agent's optimal consumption path is determined by his/her permanent income. The latter is defined as the annuity yield of the total stock of wealth and, therefore, is an increasing

function of asset prices. Thus, any rise of asset prices induces a rise of permanent income that translates into a rise in consumption. The rise in consumption is translated into (or a reflection of) higher economic growth.

The second channel considers imperfect credit markets. The idea is that enforceability problems imply that credit constraints are imposed on the productive sector of the economy (entrepreneurs or firms). The constraint is an increasing function of the firm's volume of collateral. Of course, the latter is an increasing function of asset prices. Consequently, when asset prices go up, collateral increases, the credit limit is loosened and the firm's ability to expand its production plan is enhanced. A higher level of production and investment increases asset demand (and asset prices) thus increasing even further the value of the firm's collateral. The firm's ability to expand its production plan is increased even more. The story is repeated again and again. A virtuous circle of asset price appreciation and economic growth is articulated. This self-feeding, internal finance mechanism is called financial acceleration. It amplifies and propagates the original asset price shock. As a result, a rise in asset prices not only triggers economic growth but also amplifies it and propagates it into the future.

Will a positive asset price shock be observed in near future so that economic growth picks up? The answer is yes. First, under the current circumstances of Colombia increased domestic security and a considerable reduction of the internal conflict are equivalent to a positive productivity shock to any investment project in the country. This stimulates asset prices on impact. Second, more security, less attacks and less kidnappings coordinate investors towards an equilibrium where capital flows into the country and demand for investment projects picks up. This will also induce a hike of asset prices.

Third, a new code that enforces property rights in the real estate market is running its way through Congress (Código de Procedimiento Civil). This code accelerates the process of eviction of tenants with unpaid rents (currently, eviction takes more than three years on average but with the new code the process will speed up to one year). If Congress approves the new code, real estate prices will react positively. Fourth, a modification to the Law of Rents is also running its way through Congress. This modification seeks to eliminate rigidities in the real estate market. For instance, it eliminates an upper bound on rent of 1% of the commercial value of the property. It loosens the conditions for automatic extension of the rent contract. This law also facilitates eviction. If Congress approves the modification to the Law of Rents the price of real estate will exhibit further recovery.

Markets also share this view:

“Our market weight position on Colombia in our model portfolio reflects our view that the Uribe administration will likely capitalize on this opportunity to improve the country's fundamentals, potentially offering long-term upside for asset prices.” Credit Suisse, First Boston, August 19, 2002.

“If Colombia were to twist the perception of investors regarding the future security situation of the country, hardly any adjustment on the fiscal front would be needed to stabilize debt ratios, on increased growth.” IDEAglobal, August 20, 2002.

“The election of Alvaro Uribe, Junguito’s conviction towards fiscal discipline and the ongoing war against terror helped garner the unconditional support of the U.S. government. As a result, Colombia may have an easier time in meeting its financing needs. (...) Not surprisingly, the multilaterals announced last week more than \$4 billion in additional credits.” BCP Securities, Latin American Adviser, October 2, 2002.

“Colombia is well positioned to overcome the economic contagion from Brazil in the months ahead. (...)the high level of public support for President Uribe compares favorably with the much weaker governments of its main Andean neighbors. Washington's commitment to provide Colombia with the official financing resources it needs to close its 2003 funding gap is credible. The conclusion, Colombia should not have serious problems securing the financing it requires for 2003(...)” Bear, Sterns & Co, October 3, 2002.

“Colombia became the favorite: Official announcements about substantial multilateral aid reinforced the improving trend in sentiment; the consensus appears to have shifted toward our overall constructive view of the credit. (...)Previously, there had been significant concern regarding the government's ability to close its 2003 financing gap of about \$10 bn. The official aid announcements combined with the strongly positive impression made by the new team essentially took this concern off the table.” CSFB, Key Themes of the WB/IMF Annual Meetings, October 2, 2002.

“The Uribe administration’s economic strategy received a clear endorsement from the international financial institutions. In fact, the endorsement was so evident and large that it demonstrated everybody’s expectations short.” IDEAglobal, October 2, 2002.

What will be the impact of the asset price recovery over growth? To answer this question we have used housing prices (in real terms) as a proxy for society’s stock of real wealth. It has been estimated that if housing prices rise 1%, consumption growth increases 0.17 percentage points. The next table presents an exercise with different estimates of higher economic growth due to higher housing prices. The upper bound on potential housing price appreciation is the average annual increase of housing prices in real terms during the 1991-1995 period –the real estate boom- (6% per year). The first column presents hypothetical potential annual increases of housing prices (in real terms). The second column reports the effect over growth (in additional percentage points).

Table 9: Additional Percentage Points of Growth due to Housing Price Appreciation

Δ Housing Price per yr	Δg_y per yr
6%	1.02
5%	0.85
4%	0.68
3%	0.51
2%	0.34
1%	0.17

Note that the impact over growth of a rise in housing prices ranges between one and one fifth of additional percentage points of economic growth. The next table exhibits an interval of potential increase in economic growth due to the sole appreciation of housing prices.

Table 10: Potential Growth due to Housing Price Appreciation

	2003	2004	2005	2006
Official estimate of economic growth	2%	3.3%	3.7%	3.9%
Lower bound	2.2%	3.5%	3.9%	4.1%
Upper bound	3%	4.3%	4.7%	4.9%

Clearly, the sole appreciation of housing prices could boost the real rate of economic growth to any number that ranges between 2.2% and 3.5% in 2003 to any number between 4.1% and 4.9% in 2006. Such rates of economic growth and their endogenous impact over real interest and exchange rates should be sufficient to stabilize the stock of public debt in Colombia in the medium term.

ADDITIONAL ENGINES OF GROWTH

Besides the asset price appreciation that should result from the domestic security policy, other engines of growth are present in the Colombian economy: i) the fiscal adjustment itself, ii) exports and iii) oil.

Fiscal Adjustment

The strong commitments to fiscal adjustment by the current administration will not only stabilize public debt but will also open ample space for economic growth coming from the private sector. Indeed, a significant correction of the fiscal imbalance will alleviate the crowding-out phenomenon that has been observed in recent years. Less fiscal imbalance implies more access by the private sector to domestic credit markets and, thereby, more private sector-led economic growth. Put another way, the fiscal adjustment is a necessary condition for the credit channel of monetary policy to be reactivated. The

following table presents a list of the measures that this administration has taken to correct the systematic fiscal imbalance observed during the last decade.

Table 11

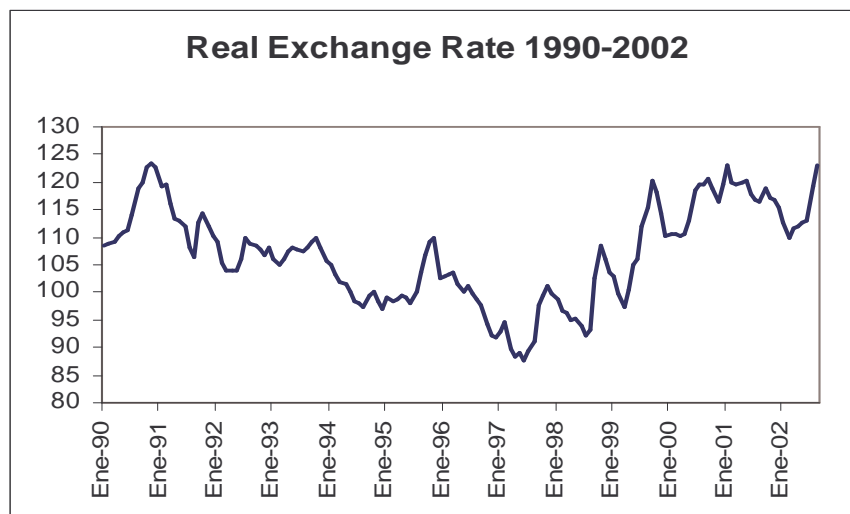
Schedule in Congress	First Round		Second Round		Approval date *
	Commission	Plenary	Commission	Plenary	
Security tax on net worth	Issued by "Estado de conmoción"				Ü Aug. '02
Referendum	Senate				Mar. '03
Tax Reform	Chamber				Dec.15 '02
Fiscal Responsibility Law	Ü Chamber				Dec.15 '02
Pension Reform	Senate				Dec.15 '02
Labor Reform	Senate				2003
State Reform	Ü Senate				2003

* Expected

Exports

Several indicators show that exports will constitute a critical engine of growth for the Colombian economy in the years to come. First of all, the real exchange rate is currently at a historical peak, at least since 1990, and continues to rise (see graph 4). This should guarantee the export sector with an important source of competitiveness for the next couple of years.

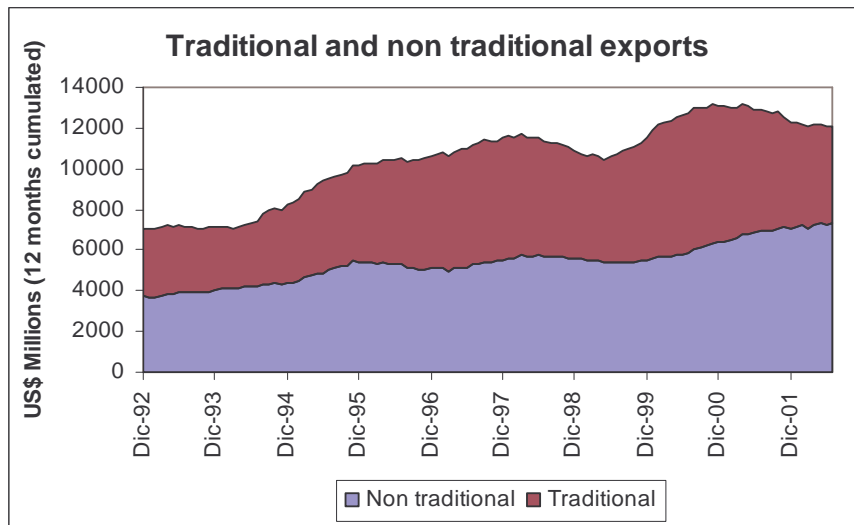
Graph 4



Source: Ministry of Finance

Second, non-traditional exports have been growing dynamically during the last few years, relative to traditional exports (see graph 5).

Graph 5



Source: DANE

Third, the Colombian export base and its destinies have been systematically widened during the last three years. For instance, in 1998 70% of Colombia's total exports included only 27 products (Source: DANE, DNP). In contrast, in 2001 that same percentage included 49 products (Source: DANE, DNP), a 81.5% increase. Additionally, in 1998 Colombia exported products to 145 countries (Source: DANE, DNP). Yet, in 2001 the Colombian economy sold products to 186 countries (Source: DANE, DNP).

Fourth, several trade agreements like ATPA (already signed and approved by U.S.) and ALCA will continue to propel export growth in the Colombian economy. For example, ATPA covers 6100 products (Source: Mincomex). It is estimated that export revenues due to this agreement could reach US\$ 1300 million (Source: Mincomex).

Oil

Another important source of potential growth for the Colombian economy during the next few years is oil production. First of all, observed oil price behavior will continue to benefit Colombia's GDP in the short run. More importantly, oil exploration prospects have increased significantly during the years 2001 and 2002. While in 1990 Colombia only counted with three exploration prospects (Source: Ecopetrol), between 2001 and 2002 the number of oil exploration prospects rose to 16 (Source: Ecopetrol).

CONCLUSION

We will conclude by restating what was said at the beginning: *Colombia has never defaulted on its debt and will continue to honor its obligations. No matter what, our reputation in international financial markets will be preserved given that this reputation is a critical component of our nation's wealth.*

Uncertainty regarding the fiscal balance and debt sustainability of the country, together with the fear of contagion from other Latin American economies, has introduced noise and uncertainty in market perception towards Colombia. We have proven that Colombia's solvency is not at stake and that any liquidity shortage can be tackled with a number of instruments that this administration has explored and prepared if needed. Even if the government's financing scenario for next year is tight, our reputation in international financial markets will be preserved and debts will be honored because alternative sources of funds are at hand.