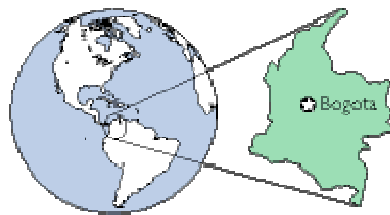


COUNTRY REVIEW

Colombia



3 May 2011

ANALYST: David Atkinson

EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- A functioning, well established institutional framework with accepted transfer of power through democratic elections.
- Strong popular support and political consensus domestically for the hard-line approach to insurgency, plus support from US (including financial).
- Orthodox reform minded government and prudent fiscal policy.
- Strong external liquidity position.
- Above average Structural Business Environment.

Weaknesses

- Long running internal insurgency and related illegal drug trade has a debilitating impact on the economy and the institutional framework and is a constraint on long-term growth
- Vulnerability to shifts in world commodity prices.
- Relatively high external debt service ratio.

Country Risk Assessment

Ratings	Colombia		Median Grade BB	Mexico	Peers	
	Latest	Previous			Peru	Brazil
Systemic Political Risk:	P2-	P2-	P2-	P2-	P2-	P2+
Systemic Economic Risk:	E3	E4	E3	E3	E3	E3
ME rating:	ME3	ME4	ME3	ME3	ME3	ME3
<i>Structure</i>	4.0	4.0	4.5	2.8	4.0	2.3
<i>Policy</i>	4.6	4.3	4.2	3.3	2.8	5.2
<i>Solvency</i>	1.7	3.5	1.3	2.0	2.2	2.2
<i>External Liquidity</i>	2.2	2.2	3.0	1.3	1.0	2.8
SBE rating:	SBE3	SBE3	SBE2	SBE3	SBE3	SBE3
COUNTRY GRADE:	BB	B	BB	BB	BB	BB

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Bogota
Population:	45.66 mn (2009)
GDP:	USD 232272 mn (2009)
Currency:	Colombian peso (COP)
Form of state:	Republic
Head of government:	President Juan Manuel Santos
Next elections:	Presidential 2014

Major Industries (% of GDP at market prices, 2009)	Global Assumptions	2010	2011	
Agriculture, forestry & fishing	7.4%	Real GDP grth (% yr/yr) *	3.3	2.9
Mining	6.5%	Inflation (% av) *	1.2	1.4
Manufacturing	14.1%	Dated Brent (USD/b)	80	110
Construction & Utilities	13.4%	* World		
Services	58.6%			

Main Exports (% of total, 2010)	Main Imports (% of total, 2010)		
Petroleum & Derivatives	41.4%	Consumer goods	22.2%
Coal	15.1%	Raw materials & intermediate goods	40.6%
Chemicals	7.3%	Capital goods	37.2%
Gold	5.3%		
Coffee	4.7%		

Basic indicators

Selected economic indicators	2007	2008	2009	2010e	2011f
Nominal GDP (USD mn)	219,076	243,214	232,272	284,964	292,267
Population (mn)	44.36	45.01	45.66	46.31	46.96
GDP per capita (USD)	4,939	5,404	5,087	6,153	6,224
Real GDP growth (% yr/yr)	6.9	3.5	1.5	4.3	4.0
Inflation (% eop)	5.5	7.7	2.0	3.2	3.5
Fiscal balance (% of GDP)	-0.4	0.5	-2.2	-3.0	-3.1
Current account balance (% of GDP)	-2.7	-2.8	-2.2	-3.1	-3.0
External debt/GDP (%)	20	19	23	23	23
External debt/Exports of goods & services (%)	112	96	124	128	123
Interest payments/Exports of goods & services (%)	7	6	7	6	6
Foreign exchange reserves (USD mn)	20,767	23,479	24,748	27,766	28,627
Import cover (months)	7.3	6.4	7.8	7.4	6.7
Exchange rate assumption, COP:USD (av)	2,078	1,968	2,167	1,899	1,990
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes

Political Stability

A long-running three-way armed conflict among left-wing guerrilla groups (FARC and ELN) right-wing paramilitaries (UAC) and government security forces, complicated by the inter-related illegal drugs trade, has affected internal security over a long period. Nonetheless, there is a well-established, functioning institutional framework and an accepted means of transferring power through democratic elections. The security situation improved markedly under President Uribe, who stepped down in August 2010, having served the maximum two consecutive terms. The paramilitaries were disbanded and the main guerrilla group, FARC, pushed back into more remote rural areas. However, criminal gangs, which include some former members of the paramilitaries are becoming a serious problem. While it is unlikely that the insurgent groups can be totally eradicated by military force, it is possible that they could be weakened sufficiently to enter into serious negotiations at some point. It is also unlikely that in the near-term, however, the insurgency could bring about institutional breakdown.

Presidential and legislative elections in 2010 were won by Uribe's chosen successor, former defence minister Juan Manuel Santos, ensuring broad policy continuity, including those related to security issues. Having won the election under the sponsorship of the popular Uribe and as a former defence minister in the Uribe administration, Santos has continued his predecessor's security policies, though he is distancing himself from some of the more authoritarian approaches and has adopted a less combative style. President Santos has tried to repair relations with the judiciary, for example, which had deteriorated significantly under Uribe. President Santos has a strong mandate, having secured 69% of the vote in the election run-off, and his coalition of the centre-right Partido de la U, Partido Conservador and the Cambio Radical (CR) plus a majority of the members of the centre-left Partido Liberal (PL) control 80% of the upper house and 90% of the lower house of congress. He also retains relatively high current approval ratings. This should facilitate effective implementation of the president's policies and may allow him to make headway on his reform programme, which includes the health system, management of mining and energy royalties, and land reform, though the coalition could still prove unwieldy on some issues. It also remains to be seen if Santos has the popular touch of his predecessor.

In foreign policy, President Santos has adopted a pragmatic stance, maintaining close relations with the US while improving strained relations with Venezuela and Ecuador. However, relations with Venezuela will probably continue to be volatile, though the risk of outright military conflict between the two remains a low probability. Strong US support is likely to continue. The new government has also passed labour rights legislation that should provide momentum to passage by the US of the stalled Free Trade Agreement with the US. Access to international financing is good, including IFI support.

Economic Stability

Colombia is an upper middle income economy with an estimated GDP per capita of USD 6,153 in 2010. Oil, coal, coffee and ferro-nickel account for more than 50% of exports, leaving the economy vulnerable to commodity price movements, although the commodity base is relatively diverse. Annual average growth of real GDP per capita was 2.8% in the past ten years.

Annual average growth of GDP in 2003-07 was 5.5%, but slowed to 2.7% in 2008 and 0.8% in 2009. The economy has recovered well, after the global financial crisis and recession had contributed to a contraction of GDP in Q4 2008 and Q1 2009. In 2010 real GDP increased by an estimated 4.3% supported by higher commodity prices, expansionary fiscal and monetary policies, a relatively stable banking system and confidence underpinned by access to international financing. Growth is likely to remain around 4% in 2011.

The non-financial public sector (NFPS) deficit was less than 1% of GDP in 2004-2008, but widened to 2.4% of GDP in 2009, as the central government deficit increased to 4.1% of GDP and the decentralised sector surplus fell to 1.7% of GDP. In 2010 the NFPS widened to 3.1%, as the decentralised surplus fell further to 0.7% of GDP, more than offsetting a reduction in the central government deficit to 3.8% (including winter emergency spending of 0.2% of GDP related to bad weather). The central government deficit target for 2011 is 4.1%, but is 3.7% if emergency spending is excluded. Increased revenues allow an increase in planned investment expenditure. The NFPS deficit target is 3.1%. The NPFS public debt-GDP ratio increased, but to a still moderate 44.8% in 2010 (42.8% in 2009).

Monetary policy is based on inflation targeting and a managed floating exchange rate. The target for 2011 is 2-4%. Since dropping to 1.8% yr/yr in March 2010, inflation has accelerated and was 3.2%

yr/yr in April 2011, but is still within target and the central bank's expectations survey for end-2011 suggests that it should remain within the range. Exchange rate appreciation is providing a strong dampening effect, though credit expansion has strengthened. The benchmark policy interest rate was lowered from a peak of 10% in July 2008 to 3% in May 2010, but, reflecting higher inflation and stronger credit growth, has since been raised in three 25bps steps to 3.75%. However, real interest rates remain relatively low and monetary policy accommodative. Further interest rate increases are likely, but should be limited if current inflation expectations are fulfilled.

The exchange depreciated sharply at the height of the global crisis, weakening from 1792 per USD at end-July 2008 to 2561 at end-March 2009 (43%) but since then has strengthened and the authorities are having to manage strong capital inflows and a real exchange rate that is back into significantly overvalued territory.

The knock-on effects of the global banking crisis were limited by the relatively small role of foreign banks in the banking system (about one-fifth) and as a whole the banking system's reliance on external financing is also relatively low, though net foreign assets are mildly negative. The banking system overall is seen as relatively sound. Non-performing loans fell to 3.2% in December 2010 from 4.4% in June 2010. Return on assets has been fairly stable.

The current account deficit widened in 2010, as import growth exceeded that of exports, after both had fallen in 2009, but was still a moderate 3.1% of GDP (-2.2% 2009). Inward remittances remained relatively weak, particularly from recession-hit Spain. In 2011 strong commodity prices, particularly energy, should offset import growth and the current account deficit as a proportion of GDP should remain around 3. FDI inflows remained subdued in 2010 and an increase in outflows meant that net FDI coverage of the current account deficit was very low. Assuming that FDI outflows return to a more usual level in 2011 net FDI flows should cover only a relatively low 50% of the projected current account deficit. FX reserves provide 6.8 months of imports of goods and services and 190% of external debt due in 2011. Total FX reserves also amount to 118% of the sum of our projected current account deficit for 2011 plus principal repayments on medium-term plus short term debt outstanding at end-2010. Not only is there a substantial cushion in the FX reserves, Colombia qualifies for and has recently renewed for 2011 the IMF flexible credit line (FCL) on a precautionary basis (available only to economies with sound policies and sustainable debt dynamics).

External debt ratios are moderate, though the debt service ratio is on the high side. The external debt-GDP ratio at end-2010 was 23% and the external debt-exports of goods and services ratio was 123%, while interest payments due were around 6% of exports of goods and services.

Overall, the economy proved well placed to recover in line with the sustained recovery in key commodity prices, particularly energy and avoid wider balance of payments crisis, underpinned by the sound policy framework and sustainable debt dynamics. While much depends on commodity prices to maintain growth prospects, the sound policy framework can be expected to remain in place.

Structural Business Environment

The Structural Business Environment is above average in our assessment, but falls short of the strongest ratings overall.

Based on data and definitions from the World Bank's 2011 Doing Business Survey, Paying Taxes and Trading Across Borders were weaker areas, ranking below average, and Enforcing Contracts was particularly weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality, Control of Corruption and Rule of Law above average for the Latin American Region. Transparency International's Corruption Perception Index, 2009, assigns Colombia a score of 3.7—on a scale of 1 (bad) to 10 (good)—and a ranking of 78= out of 178 (the same as China, Thailand and Peru among others). As a broad measure of the pro-business environment The Heritage Foundation's 2011 Index of Economic Freedom ranks Colombia 45 out of 179

David Atkinson

London: +44 (0)20 7860 2807

Charts

