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Intelligence Report

Office of Asian Pacific and Latin American Analysis *16 March 2000*

Colombia: Modest Economic Growth Through 2002 [redacted]

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Summary

The Pastrana administration has laid the groundwork for a moderate recovery from the deep recession last year. The economy will grow by 2 to 3 percent in 2000—and strengthen slightly in the following years—if Bogotá stays the course on economic policy and exports remain healthy.

- ***The administration is committed to sound economic policy, but politically sensitive austerity measures will be watered down or delayed by Congress, which could undermine investor confidence.***

- ***The economy's likely growth rates are too modest to sharply raise per capita income or to substantially reverse jumps in unemployment and poverty last year.*** [redacted]

The poor security situation will prevent growth from exceeding the recent historical average of about 4 percent. The government estimates that the economic cost of the insurgency is 3 to 4 percent of GDP per year, so rapid progress in peace talks—still a dubious proposition—would have a substantial dividend.

- ***On the downside, a surge in violence would slow growth but not ignite another recession unless the administration simultaneously abandoned sound economic policy and the external environment for trade and financing turned unfavorable.*** [redacted]

Successful implementation of Plan Colombia will reinforce recovery prospects. The plan's economic strategies embrace the policies that are key to sustained growth, and its peace components address the critical security concerns that deter investment and commerce.

- ***At the same time, an improving economy will bolster President Pastrana's political support and supply budgetary resources needed to carry out the plan. Even in the best case, however, the budget will be constrained by the need for fiscal austerity.*** [redacted]

APLA IR 2000-41011

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Economy To Recover Gradually From Worst Ever Recession

The Colombian Government, in its recent loan agreement with the IMF, forecasts that GDP will increase by 3.0 percent in 2000, 3.8 percent in 2001, and 4.8 percent in 2002. Slowly improving growth would represent a strengthening of the nascent recovery from Colombia's worst recession ever recorded—GDP fell by about 5 percent in 1999, the first year-on-year decrease since 1931.[1] The social consequences of the recession are immense:

- Unemployment soared to more than 20 percent in the third quarter from 12 percent at the end of 1997.

- The recession wiped out gains made in the 1990s in poverty reduction. After falling throughout most of the decade, the rate of indigence—income insufficient for even a basic food basket—rose sharply in 1999 to more than 20 percent, about where it was in 1991.

The government's targets are optimistic, and the economy will grow at a slower rate unless the administration makes rapid progress on its economic agenda and exports are unusually strong. Local and foreign private-sector analysts are generally less sanguine than the government and forecast a more modest recovery—about 2 percent this year, for example. The per capita outlook is not encouraging:

- Given a population growth rate of about 2 percent, per capita GDP growth will be minimal in 2000.

- By 2002, per capita GDP will still be about what it was in 1997, even if the government's higher growth forecasts are correct.

Successful implementation of Plan Colombia will boost the economy because the plan's economic, fiscal, and financial strategies embrace the sound policies already advocated by the Pastrana administration. At the same time, an improving economy will increase support for Pastrana—the public is most concerned about unemployment and other economic issues, according to a variety of polls—and supply tax revenues needed to fund Bogotá's contribution to the plan.

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[1] See APLA IR 2000-41006 (Confidential NF), 28 February 2000, *Colombia: Fragile Recovery Under Way, but Violence Limits Economic Potential*.

This assessment of the prospects for Colombia's economic growth was prepared by the Office of Asian Pacific and Latin American Analysis

Good Fiscal and Monetary Policies Underpin Growth Prospects
The Pastrana administration's clear commitment to responsible economic policy is helping to restore investor confidence, which waned during the Samper era and hit bottom last August when international credit rating agencies stripped Colombia of its investment-grade status. The challenges are significant, but Bogotá has started to take steps to address the root causes of Colombia's economic problems:

- The administration has made improving Colombia's fiscal health a priority, but its deficit-reduction efforts were thwarted last year because of a recession-induced drop in tax revenue and unforeseen spending requirements, such as rebuilding from a devastating earthquake in Quindio Department in January 1999.

- The government has eased monetary policy and shored up ailing banks to foster an expansion of credit, which dried up last year because of the recession. The financial system's loan portfolio contracted in 1999, and it suffered losses equivalent to about 1.5 percent of GDP.

Deficit Reduction Will Proceed, Slowed by Opposition. The Pastrana administration will build on momentum from late 1999, when it passed an austere budget for 2000 and a law to reform the pension system for local governments. The administration also signed an agreement with the IMF in which it pledged to gradually reduce its fiscal deficit, which exceeded 6 percent of GDP last year. Reforms necessary to meet deficit-reduction goals are politically sensitive, however, and will be watered down or delayed as Congress takes up key legislation beginning on 16 March:

- Regulation of territorial expenditure will improve control of the fiscal balances of departments and municipalities, which are generally profligate and highly indebted. Opposition to new oversight will rise as local elections approach in October.

- Constitutional reform of territorial financing—which requires an amendment that must be passed by two consecutive Congressional sessions—will limit the mandated transfer of federal revenue to local governments. The administration has backed away from freezing transfers in real terms and now proposes a slight increase to make this unpopular reform more palatable; local governments are as reluctant to give up the gravy train as they are to suffer increased regulation.

- Tax and pension reforms will raise government revenues and improve the solvency of the state pension fund, which has unfunded liabilities that exceed GDP. Both reforms are widely unpopular; unions plan to protest pension benefit reductions and higher retirement ages.

The administration will also push forward with the privatization of public assets, from which it expects to raise almost $2 billion this year—revenues that are critical to reducing the fiscal deficit. Bogotá's privatization efforts stalled last year and will continue to face the same obstacles, which will cause delays or lower bids:

- The weak economy has reduced foreign investors' enthusiasm for the sale of state assets, especially those that are losing money, such as the electrical generation company ISAGEN.

- Insurgent violence directed at companies up for sale has likewise dampened investors' interest. In the past year, insurgents have downed more than 200 electrical towers belonging to transmission company ISA partly to protest its pending privatization.

- Political wrangling, regulatory changes, and judicial challenges have caused repeated setbacks in the privatization timetable. Concerned about layoffs, workers have been particularly active in their attempts to derail the sale of public companies.

Interest Rates and Exchange Rates Will Stabilize. The Central Bank and Finance Ministry will work to keep interest rates near their current levels, which are close to record lows. Monetary authorities will increasingly use interest rates to control inflation, free from the need to defend the peso's exchange rate band:

- Inflation fell to about 9 percent last year, the lowest rate in 30 years. As long as inflation remains on a generally downward trend, the Bank will be able to keep interest rates low.

- The Bank last September floated the peso rather than raise interest rates to relieve pressure on the exchange rate band, which had been under steady attack despite two devaluations in a 12-month span. The move was widely praised by financial analysts. The peso strengthened after it was floated—there was no "overshooting"—and has since remained fairly stable.

The Financial System Is on the Long Road to Recovery. The government has made considerable progress in shoring up the shellshocked financial system and will continue with the difficult job of getting weak institutions back on their feet so they can resume lending—or closing them, if they are beyond help.[2]

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2 See OTI IR 2000-031 (~~Secret~~, 29 February 2000, *Assessing Banking Sector Reform in Emerging Markets*, which compares Colombia's reform efforts favorably to the efforts of nine other developing countries.

State-owned financial institutions are in far worse shape than those in the private sector, and most will be sold off. Even relatively strong private banks are still trying to clean up their balance sheets, however, so credit expansion will be cautious at best. To encourage new credits, the government will provide loan guarantees to reluctant lenders and assistance to troubled debtors. The total cost of cleaning up the financial system will be spread out over several years but is still significant—estimates range from 5 to 8 percent of GDP. Colombia is receiving loans from the World Bank and Inter-American Development Bank to help cover some of these costs.

Export Engine Humming But Running Low on Gas

The government says that exports will lead the recovery—export revenues increased by 6.5 percent last year, largely because of higher oil prices, helping to restore economic growth. Nevertheless, strong export growth will be problematic given volatile prices for Colombia's leading exports, oil and coffee, and near-term supply constraints—which Bogotá is trying to overcome:

- The administration is sweetening contract terms for foreign investment in the exploration and production of oil. The success of a bidding round this year is critical to the industry's long-term survival. Oil production peaked in 1999 at about 815,000 barrels per day and is beginning to decline; without new discoveries, the country could become a net oil importer by 2005. Fortunately for Colombia, the revenue impact of lower production will be reduced as long as prices remain high.

- The government is working with growers to boost Colombia's coffee production, which declined in the 1990s because of aging plantations, inefficient farming, and a series of natural disasters. Bogotá has also broached output limits with Brazil, the world's largest coffee producer, to push up sagging prices.

The administration will continue to promote exports by putting pressure on its trading partners to grant improved market access, which it sees as key to boosting nontraditional products. Bogotá will continue its multifaceted approach toward the United States, its most important trading partner, particularly by requesting parity with the Caribbean Basin Initiative and expansion of the Andean Trade Preferences Act. Colombia will seek accession to NAFTA under the next US administration—after approval of Plan Colombia—to increase exports and to encourage local producers to become more competitive. The government is also lobbying the European Union for trade benefits as part of EU economic support for Plan Colombia.

Security Problems Shackle Economic Possibilities
Even if the administration successfully pursues sound economic policies and exports are strong, Colombia's economic growth will be constrained for the foreseeable future by the poor security situation. The government estimates that the economic cost of the insurgency is 3 to 4 percent of GDP per year. This includes direct costs, such as loss of life and property damage from insurgent attacks, as well as indirect costs such as foregone investment.

Until the security situation improves, Colombia will not reach the high growth rates that developing countries need to achieve substantial improvements in social welfare. The Inter-American Development Bank warns that Latin America must double its 3.5-percent growth rate or risk falling behind in global economic development.

There is a clear consensus in Colombia that insurgent violence is an obstacle to sustained growth. Business elites, once relatively isolated from the insurgency, are increasingly affected in multiple ways—including kidnapping, lower investment, higher costs, and reduced international competitiveness. The public is sensitized to the costs of the violence and roundly rejects attacks on the country's economic infrastructure. A surge in violence would slow growth but not ignite another recession, however, unless Bogotá simultaneously abandoned sound economic policy and the external environment for trade and financing turned unfavorable.

The government, the business sector, and the insurgents all agree in the abstract on the need for economic growth, job creation, and social development. Nevertheless, finding a development model acceptable to all that achieves these goals within a global framework will be elusive and potentially unsettling to the economy:

- The government has little maneuvering room in which to satisfy insurgent demands. Backpedaling on fiscal austerity, privatization, or free trade would precipitate a plunge in investor confidence.

- The business sector says that it is willing to invest in peace—paying more taxes for social development, for example—but conditions this on an end to the violence.

- Leaders of the Revolutionary Armed Forces of Colombia (FARC) claim to be openminded about economic models, but the group's actions—especially kidnappings and attacks on energy infrastructure—still reflect its Marxist ideology and history of rural banditry. They say that peace must follow, not precede, economic growth.

COLOMBIA

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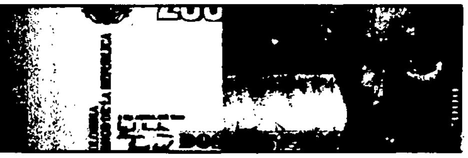

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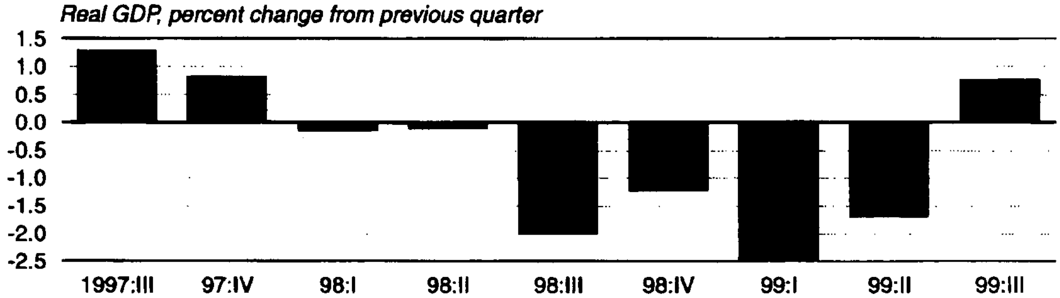

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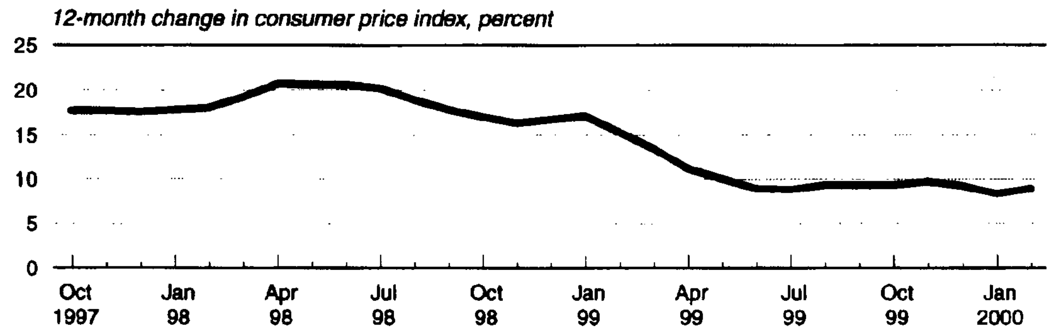

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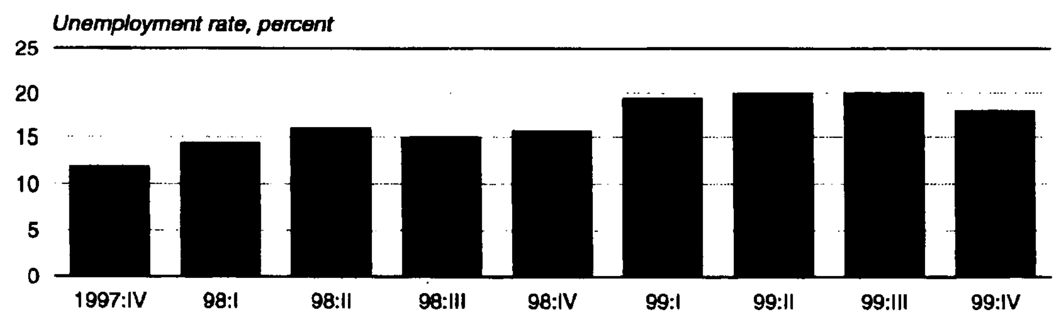
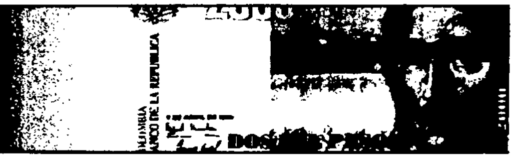
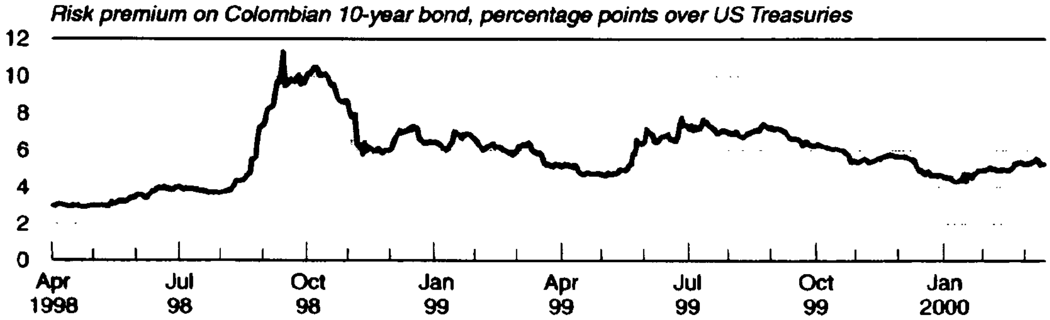


COLOMBIA

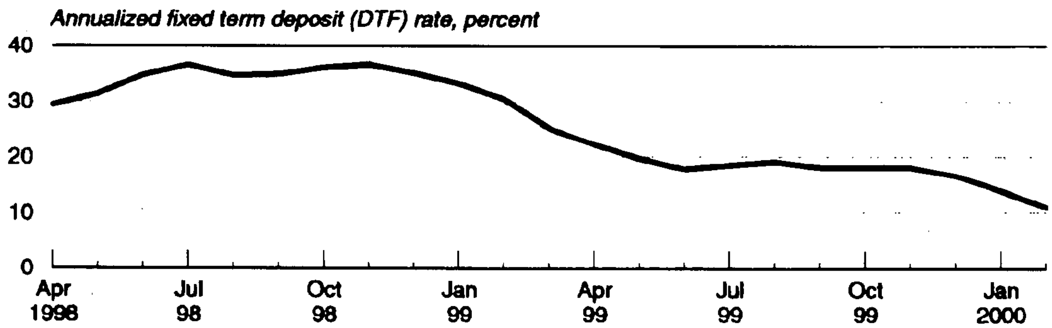
Confidence Returning Slowly U/



Investors grew more bullish toward the end of last year, but they remain wary.

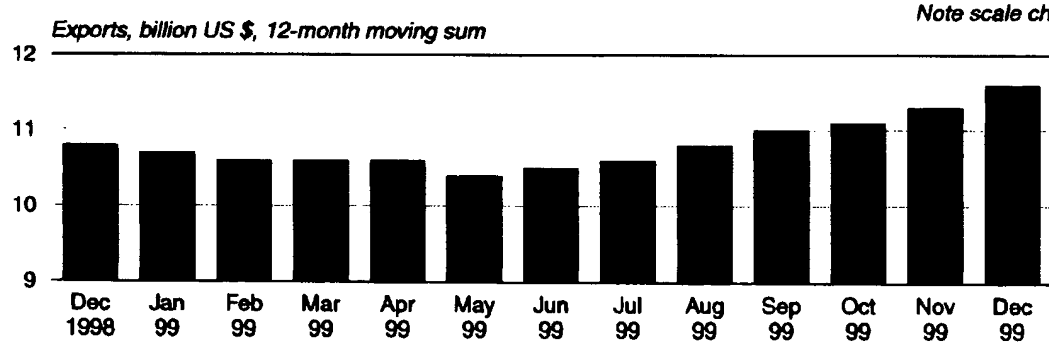


A key benchmark [illegible]



Export revenues are up sharply, largely reflecting the windfall from higher oil prices.

Note scale change



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