The board of directors' report to the Congress of Colombia

March 2010

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Board of Directors
Report to Congress

March 2010

Banco de la República
CENTRAL BANK OF COLOMBIA
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Bogota, D.C. March 26, 2010

Honorable Chairmen and Members
Third Standing Constitutional Committees of
The Senate and
The House of Representatives

Gentlemen:

In compliance with Article 5, Act of Congress 31/1992, the Board of Directors of the Banco de la República hereby submits to the Congress of the Republic a Report on the macroeconomic results for 2009 and for the beginning of 2010 for its consideration. Likewise, the targets adopted by the Board of Directors for the current year as well as the outlook for various macroeconomic variables are shown. The last two chapters report on the composition of the international reserves and the projections for the Banco de la República's financial situation in 2010.

Cordially,

José Darío Uribe Escobar
Governor

Introduction

The crisis in the world economy will go down in history as the most severe one since the Second World War. In an environment as difficult as this, the growth of the GDP in Colombia was 0.4% in 2009, which is better than the registers of developed economies (-3.2%) and than the average for Latin America (-2.3%). Reaching a low inflation in Colombia is a historical event. It is an asset that must be preserved for the future.

The crisis in the world economy which started in the last quarter of 2008 and hit its worst point in the first half of 2009 will go down in history as the most severe one since the Second World War. In the first half of last year, the global economy shrank 4.3%, the total volume of trade fell 18.4%, industrial production plunged 20.4% and unemployment in developed economies rose close to 2.4 percentage points (pp) in comparison to the levels prior to the crisis. However, in spite of the intensity that the international crisis had developed around March, 2009 after the bankruptcy of important financial entities, the general collapse of confidence and the sharp fall in the prices of assets, the worse scenario that many analysts feared would not have materialized: an economic crisis similar in magnitude to the Great Depression of the Thirties, which it took ten years for the world to recover. Actually, in the second half of 2009, production and world trade reversed their trend, financial and real market confidence returned, the prices for assets rose and final demand was strengthened. Thus, the fall in the gross domestic product (GDP) for the world in 2009 turned out to be less than what had been forecast by the International Monetary Fund (IMF). As a result, its projections for 2010 are now more optimistic.

The basic reason for the significant change in the trend for the world economy in the the second half of 2009 was a policy of unprecedented macroeconomic stimulus. The monetary policy in the majority of the advanced countries and in many of the emerging ones was broadly expansionary with reductions in the interest rates to historically low levels and an sharp increase in the balance sheets of the central banks of the main developed countries. The fiscal policy also played a definitive role in supporting the world economy with expenditure expansion programs and, in some cases, reductions in taxes, all of which significantly widened the fiscal deficit and public debt in developed

countries and in some emerging countries. Specifically, the timely support that the monetary and fiscal policy succssfully supplied to the financial sector in the United States and in some European countries was a crucial ingredient in detaining the vicious negative cycle between the real and the financial sectors that threatened to create a second Great Depression.

In a world environment as difficult as this, the Colombian economy had a GDP growth of 0.4% in 2009, a performance that is relatively favorable if it is compared to the fall seen in advanced economies (-3.2%) or to the Latin American average (-2.3%). Of course, Colombia was not immune to the crisis since, if its growth last year is compared to the average growth in 2007 and 2008, the slowdown in 2009 was 4.6%. The main channels through which the international crisis affected the economic performance of Colombia were the contraction in foreign demand for our exports products along with the deterioration on the domestic level in consumer and business confidence. This slowed down household consumption and caused a sharp drop in investment. The effects of the international crisis on the Colombian economy which began to be strongly felt in the last quarter of 2008 –with a 1% shrinkage in the GDP– continued to seriously affect the economic performance during the first half of 2009 when a 0.4% fall in the GDP in annual terms was registered. This contraction, although significant, turned out to be lower in magnitude than that observed in the last quarter of 2008. This showed the strength of the Colombian economy compared to the external crisis which was going through its worst period during those months. The slowdown in growth was reflected in an increase in the unemployment rate which reached 12.3% for the 13 main metropolitan areas in the last quarter of 2009 compared to 10.7% for the same period in 2008. For the national total, unemployment figures were 11.3% compared to 10.5% for the same periods. As is discussed in this *Report*, the higher unemployment was the consequence of a rise in the labor supply in 2009 which was cnot offset for by an increase in the demand for workers.

In the second half of 2009, some signs of reactivation linked to the recovery of the world economy, the effects of the expansionary monetary policy that have been in effect since the end of 2008, the counter-cyclical management of fiscal policy, particularly investment in civil works projects and the improvement in available household income resulting form the fall in inflation began to become evident. In spite of the above, the shrinking sales to Venezuela associated with sharp drop in their domestic demand and the trade restrictions that country imposed worked against the reactivation and the performance of the local economy in the second half of the year.

Just like the handling of the crisis in the rest of the world, in the case of Colombia, macroeconomic policy supplied a strong stimulus which was undoubtedly a fundamental element in preventing a more serious deterioration in the Colombian economy. On one hand, the monetary policy acted decisively and in a timely fashion with a reduction of 650 basis points (bp) –from 10% to 3.5%– in the intervention interest rate. It started on December, 2008 (50 bp) and became more intensified in the first half of 2009 (500 bp) when the GDP registered the largest annual falls and inflation declined beyond what was expected. This was possible thanks to the fact that Banco de la República's policies prevented an excess in private debt and of inflation expectations

between 2006 and 2008. On the other hand, the fiscal policy acted counter-cyclically by keeping the government's level of expenditure, which had been established previously in the Financial Plan for 2009, unchanged in spite of the imminent fall in tax revenue. Thus, a cutback in governmental expenditure was avoided at a time in which private demand was shrinking. This fiscal posture was possible thanks to the fact that the government started from a level of moderate debt and maintained access to the foreign and domestic financial markets. This made it possible for them to finance the larger deficit.

The results of the effort by monetary and fiscal policy to buffer the effect of the international crisis on the Colombian economy were evident over the course of 2009. As is explained in detail in this document, the reduction in Banco de la República's intervention interest rate was almost fully transmitted to the interest rates on deposits and even more than proportionally to the majority of the lending rates. This led the financial system's gross loan portfolio in national currency to reach a growth of 4.9% in 2009 in spite of the sharp contraction that the demand for credit suffered as a result of the economic slowdown.

In turn, the fiscal policy stimulus for economic activity was mainly given through the expansion of civil works projects (34%) which, along with other items, includes the construction of roads, ports, dams, pipe lines, etc. that for the most part are public projects. This led the construction sector to exhibit a growth of 12.8% in spite of the contraction that was seen in buildings (housing, shopping centers and warehouses). From the demand side, the growth civil works partly offset the drop that occurred in the rest of gross fixed capital formation (-12.4%) thus easing the fall in investment (-1.6%). Furthermore, a moderate expansion in government consumption (2.9%) and an almost zero growth in household consumption (0.1%) was also seen. This allowed the total consumption to rise 0.7%. Therefore, the expansion in public demand and the monetary stimulus described, helped to support the aggregate demand of the economy which had been acutely weakened by the contagion of the international crisis and the reduction in trade with Venezuela. If it had not been for that, there is no doubt that the figure for GDP growth would have been negative and unemployment higher than what was seen.

In the context of a reversal of the food and fuel price shocks and a reduction in the inflation expectations experienced in 2009, the expansionary macroeconomic policy did not generate inflationary pressures. Thus, at the end of the year consumer inflation stood at 2%, wich is much lower than that registered in December, 2008 (7.7%) and the lowest since November, 1955. As a result, inflation's rising trend in 2007 and 2008 was broken and it was at the floor of the long term target range (between 2% and 4%). The drop in inflation was associated with the international recession which led to a significant reduction in the international prices for fuel and regulated goods, raw materials and food. In Colombia, the strongest effect was felt in the prices for food, which, after having hit 13.2% inflation in 2008, registered -0.3% in 2009. However, in addition to food, the weakening of domestic demand resulted in a decline in inflationary pressures on many other items in the consumer basket. Consequently, core inflation also declined over the last year. Thus, the average of the four indicators that are regularly estimated by Banco

de la República was 3.1% at the close of 2009 compared to 5.6% at the end of 2008. Among these, the drop from 5.1% in 2008 to 2.9% at the end of 2009 that was registered for the consumer price index (CPI) excluding food should be mentioned.

Reaching an inflation as low as it was in 2009 is a historic event. When the 1991 Constitution gave the Board of Directors of the Banco de la República (JDBR) the mandate to preserve the purchasing power of the currency, annual inflation was 30.5%. Almost two decades went by before the country achieved price stability and inflation reached its long term target established as a range of between 2% and 4%. This is an asset that should be maintained in the future. That is why this Report has dedicated a box that emphazises the importance of keeping low, stable inflation. Being aware of this, the Board decided as of 2010 to adopt the long term target by means of which inflation expectations will be anchored and the country will enter a stage of price stability.

The outlook for the world economy for 2010 is the continuation of the recovery process that started in the second half of 2009. However, it is expected that this will be very unequal between countries and regions around the world since it will depend on the initial conditions before the shock, the responses of the monetary policy, and the particular characteristics of each economy. For the advanced economies, the IMF predicts that after the 3.2% contraction in 2009, there will be an expansion of 2% in 2010. This is a recovery that is still very weak since it will continue to be affected by the high rates of unemployment and public debt, a financial system that is still weak and in some cases, a level of household indebtedness that is still high. Emerging economies have a more encouraging outlook. This is a rate of growth that in 2010 could reach 6% thanks to the strength of their economic fundamentals and the rapid response of the economic policy to the crisis. Within this group, the developing economies in Asia will lead the recovery with an expected growth of 8.4% in 2010. In the case of Latin America, an average growth of 3.7% in 2010 is estimated. The countries for which better performance is expected are Brazil, with a growth of 5.6%, Chile (4.8%), and Peru (4.8%).

For the Colombian economy, the technical staff at Banco de la República estimates that the growth in 2010 will be within a range of 2% to 4%. The boost in emerging economies and some developed ones will promote Colombian growth since it will stimulate the demand for our exports. Likewise, the expected increase in the price of commodities as global demand strengthens will favor Colombian exports. Nevertheless, the favorable outlook for Colombia in international trade will be overshadowed by the drop in the trade with Venezuela due to the trade restrictions imposed by that country, the devaluation of the bolivar and the slow growth that is estimated for that economy. Another factor that could contribute to the growth of the output in Colombia would be the recovery of household consumption stimulated by the low interest rates and the positive effect on disposable income that the sharp fall in the interest rates has meant. However, the high rate of unemployment will continue to hinder the increase in household consumption. Still, even though public demand is expected to continue supporting growth, it is likely that its contribution will be lower in magnitude that what was seen in 2009 given the austerity in government expenditure intended to prevent an unsustainable

increase in public debt. Finally, other factors that will exercise a positive influence are foreign direct investment (FDI) targeting the mining sector as well as investments other than civil works that will be stimulated by the low interest rates and the recovery of business sector confidence.

This *Report* contains four chapters. The first one describes the world economic situation and its outlook for 2010. The second discusses the situation of the Colombian economy and highlights the results in 2009 and the outlook for this year. The third chapter analyzes the international reserves with regards to their composition and the recent performance of the investments. The fourth chapter gives the financial situation of the Banco de la República. Furthermore, the *Report* includes various boxes that delve into specific topics that are considered important.

I. World Crisis and Recovery: Achievements and Risks

Although the World GDP contracted for three consecutive quarters, it began to recover slightly in the second half of 2009 thanks to the timely fiscal and monetary stimuli.
There is widespread uncertainty about the possibility that the developed economies will quickly return to a sustained growth in view of the absence of fiscal aid.
The medium and long term outlook for the developing countries are more favorable than for advanced economies since their financial systems were less exposed to the international crisis, the majority did not have a mortgage crisis and the households seem to be less indebted.

A. Performance of the developed economies compared to what was expected in 2009

Around the last quarter of 2008 and beginning of 2009, after the bankruptcy of Lehman Brothers and the uncertainty regarding the actual scope of the various fiscal programs in developed countries, the market expected one of the largest economic crises in recent times, one that would probably be as severe as the Great Depression in the Thirties. The poor performance of economic activity in developed countries and in various developing countries has had no precedent since World War II. In particular, the recession of the last two years has been the harshest and deepest for the United States since the post-war.

In Table 1 the *subprime* mortgage crisis (between December, 2007 and August, 2009[1]) is compared to the different recessions that have occurred in the United States since 1948. As can be seen, industrial production plunged close to 20% in the recent crisis while the worst performance for this indicator that had been seen previously was in 1974 with a decline of 15%. Likewise, non-agricultural

1 Possible date on which the National Bureau of Economic Research (NBER) could declare the economic recession in the United States to be over.

Table 1
Economic Activity in the United States During Different Cycles since World War II

Peak	Trough	Percentage change between the peak and trough		
		GDP	Industrial production	Non-agricultural employment
December 2007	**August, 2009**	**(3.9)**	**(19.2)**	**(6.2)**
March, 2001	November, 2001	(0.4)	(6.3)	(2.0)
July, 1990	March, 1991	(1.3)	(4.3)	(1.5)
July, 1981	November, 1982	(2.9)	(9.5)	(3.1)
January, 1980	July 1980,	(2.2)	(6.2)	(1.3)
November, 1973	March, 1975	(3.1)	(14.8)	(2.7)
December, 1969	November, 1970	(1.0)	(5.8)	(1.4)
April, 1960	February, 1961	(1.3)	(6.2)	(2.3)
August, 1957	April, 1958	(3.8)	(12.7)	(4.4)
July, 1953	Mayo, 1954	(2.7)	(9.0)	(3.3)
November, 1948	October, 1949	(1.7)	(8.6)	(5.1)
Average		(2.0)	(8.3)	(2.7)

Sources: NBER, BEA, FBR, and Moody's Economy.com.

employment declined 6% during the subprime crisis,[2] a figure that is similar to that seen in 1948 when there was a fall of 5%. Finally, the contraction of the GDP (-3.9%[3]) during this crisis was similar to the one in the period with the largest drop (-3.8% in 1958).

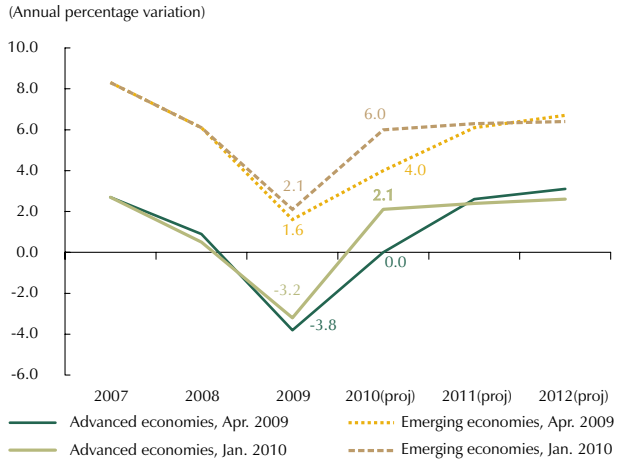
Although the world GDP shrank for three consecutive quarters, it began to see a slight recovery in the second half of 2009 due to the timely fiscal and monetary stimuli in, primarily, developed countries as well as the positive performance of several emerging economies. Thus, the deterioration of the world economy in 2009 was less severe than what was expected by the analysts (including the IMF) who began to rule out the possibility of a situation similar to that which existed in the Great Depression of the Thirties (Graph 1). Likewise, current projections for 2010 are more optimistic given that the new information regarding the developments in global economic activity suggests a recovery this year. Nevertheless, starting in 2011 and continuing into the future, the forecasts for developed countries (like those made in April 2009) still show growth that is slow and below its potential (Graph 1). Empirical evidence shows that recessions that coincide with mortgage or financial crises in not only developed but also emerging countries are followed by very slow output recoveries.[4]

2 Unemployment rose for almost twenty consecutive months.

3 This contraction of the GDP refers to the II quarter of 2009 in comparison to the IV quarter of 2007.

4 Rogoff and Reinhart, "The Aftermath of Financial Crises," working document no. 14656, NBER 2009.

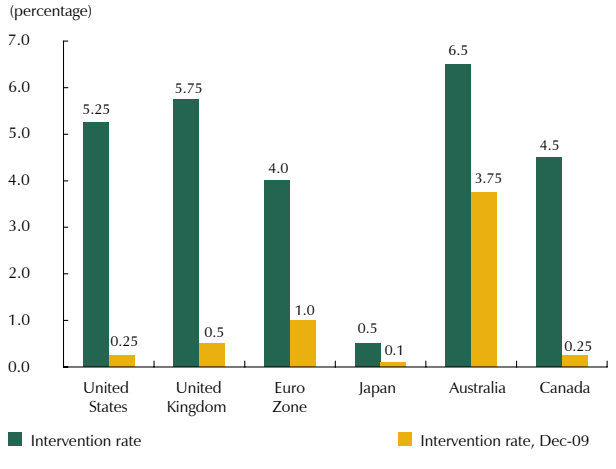
Graph 1
Change in the Forecast for GDP Growth



(proj) projected.
Source: IMF.

Graph 2

A. Central Banks' Intervention Interest Rate



B. Central Banks' Assets as a Percentage of the GDP

Source: Bloomberg.

The sharp plunge in aggregate demand, the widening of the negative output gap, and the decline in prices for commodities compared to those seen in mid-2008 generated a pronounced drop in total inflation in developed countries in 2009. This situation gave the monetary authorities the opportunity to use both conventional and non-conventional tools in order to stimulate the economy and provide the needed liquidity to jumpstart the financial markets.

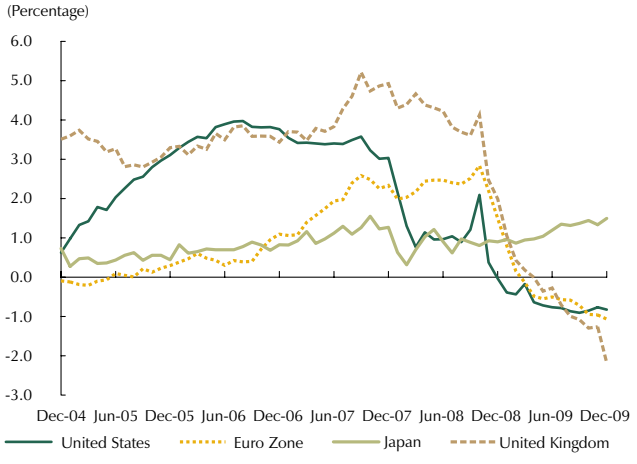
Thus, in addition to sharply reducing their intervention rates, the central banks expanded their balance sheets and provided the loan entities with liquidity in national and foreign currency (Graph 2). They also relaxed the required collateral, extended the stipulated deadlines for financing operations and made purchases of securities issued by governments, agencies and corporations. Last of all, they kept markets that were essential to the economy functioning, for example, the short term money market and the commercial paper market.

Even though credit remains depressed in the developed economies, the efforts made by central banks helped to mitigate the liquidity risks and to restore confidence in the financial system. As a result, the interbank interest rates declined after having reached high levels. In the case of nominal rates, these returned to numbers close to those registered before the crisis while the real ones hit negative territory (Graph 3). Subsequently, to the extent conditions of liquidity have allowed, some market agents have stopped using several of the central bank support mechanisms.

The fiscal policy in both developed and emerging economies has supplied strong stimuli in response to the plunge in output. The IMF estimates that between 2009 and 2010 the average fiscal global deficit will rise 6 GDP percentage points compared to the levels in 2007. Graph 4 shows the fiscal expansion in 2009 in comparison to the 2007 pre-crisis levels.

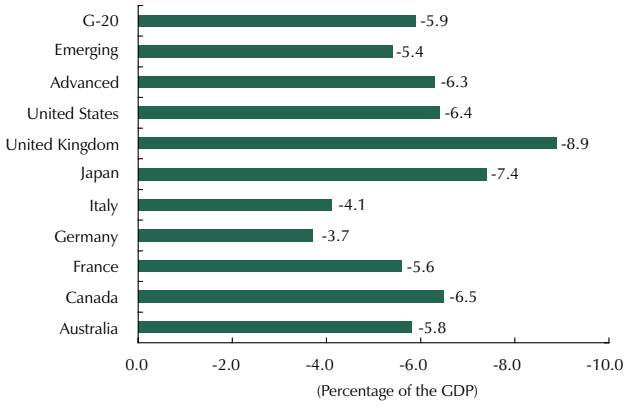
Fiscal expansion has been more intense in those developed countries where the crisis started. The automatic stabilizers such as lower income taxes and higher unemployment benefits were the first

Graph 3
Real Short Term, 3-month Interest Rates



Source: Bloomberg.

Graph 4
Fiscal Expansion
(change in the fiscal deficit between 2007 and 2009)



Source: IMF.

ones to go into effect in 2009.[5] Fiscal stimulus policies that have a high multiplier effect –such as infrastructure programs– were only used in the second half of 2009 and will continue in 2010 according to the US Congressional Budget Office (CBO) calculations.

In the case of that country, the main fiscal stimulus package provided US$787 billion (b) in 2009 which was equivalent to 5.5% of the GDP[6] (Table 2). This stimulus was made up of tax reductions, assistance for different states and programs for the unemployed, health, education, public utilities and the "green agenda."[7] According to the United States Treasury Department figures, as of March 2010, 37% of the fiscal stimulus resources from 2009 will have been used (Graph 5).

In 2009 in the euro zone, the main package was close to €200 b, which is equivalent to 1.5% of the GDP. According to various analysts, the internal discussions about the size of the fiscal boost and the possibility that some of the countries in the euro zone would take advantage of the fiscal efforts of other members led to the stimulus turning out to be insufficient to deal with the sharp contraction in output in these economies. In Germany, the fiscal resources have been focused on giving incentives to private investment projects through tax reductions as well as loan guarantees to businesses. In contrast, the fiscal package in the United Kingdom, which is close to 1.5% of the GDP, has been focused on tax reductions. Finally, in the case of the Japanese, the 2009 fiscal package reached 3% of the GDP.

Moreover, the governments of the developed countries also intervened decisively in the financial sector to prevent a systemic collapse and thus restore confidence in the markets. The measures incorporated guarantees for bank deposits, capitalization of financial institutions and programs to remove toxic assets from the balances of these financial entities. These measures were fully described in last year's *Report to Congress*.

5 The measures of fiscal injection have included tax cuts for households and companies as well as expenditure programs on workers, public utilities and infrastructure.

6 In 2008, the US GDP was US$14,441,400 million (m) and in 2009, it was US$14,258,200 m.

7 Two of the most prominent programs in 2009 were one that was designed to promote the sales of cars (Cash for Clunkers) and the one intended to encourage the mortgage market (First time home buyer tax credit). Both measures had a positive impact on, primarily, the GDP for the third and fourth quarters of 2009.

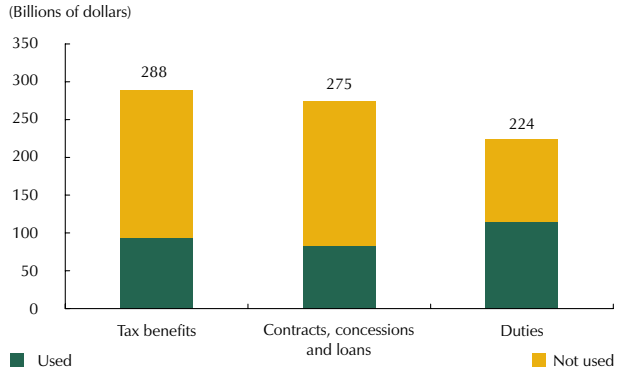
Table 2
Fiscal Stimulus and Financial Stability Programs in the United States

Fiscal Stimulus Programs	Year	President	Amount (millions of dollars)	Percentage of the GDP
Economic Stimulus Act	2008	W. Bush	165,000	1.1
American Recovery and Reinvestment Act (ARRA)[a/]	2009	Obama	787,000	5.5

Financial System Stability Program	Year	President	Amount (millions of dollars)	Percentage of the GDP
The Troubled Asset Relief Program (TARP)[b/]	2008	W. Bush	700,000	4.8

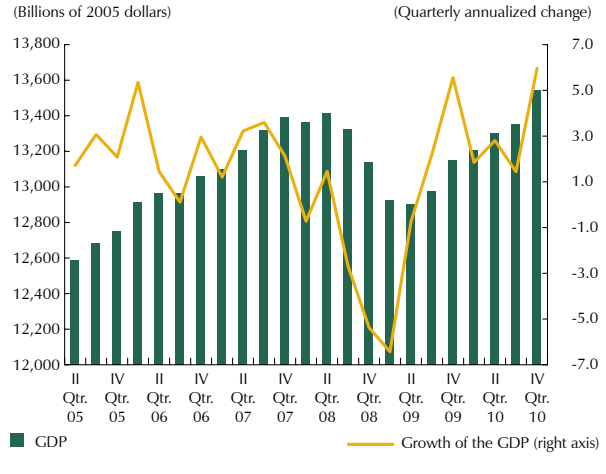
a/ The ARRA program had used close to 40% as of February, 2010
b/ Analysts estimate that the final cost of TARP for citizens could be close to US$150,000 million.
Whether or not what has been recovered from TARP resources scould be used as a new fiscal stimulus in 2010 is currently under debate in Congress.
Sources: Congressional Budget Office (CBO) and www.recovery.gov.

Graph 5
Distribution and Use of Funds from the United States Fiscal Stimulus in 2009 (American Recovery and Reinvestment Act)



Sources: Treasury Department and United States federal agencies.

Graph 6
United States GDP



Note: The information given for 2010 corresponds to projections.
Sources: Bureau of Economic Analysis and Focus Economics.

B. DEVELOPMEN OF AND OUTLOOK FOR DEVELOPED ECONOMIES

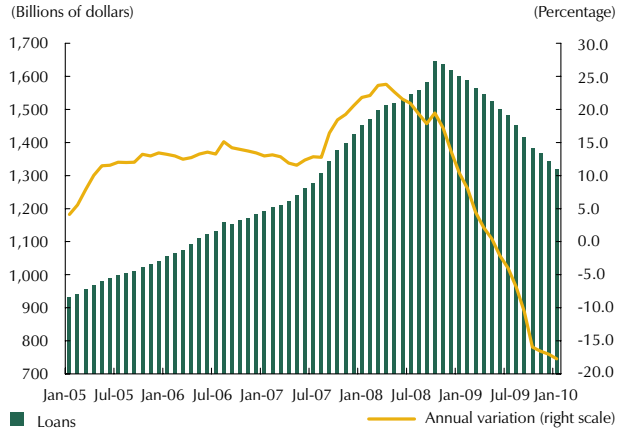
In the second half of 2009, economic activity in the developed countries began to expand. The recovery has been most noticeable in the case of the United States and was slower in Europe and Japan. In particular, in the first economy there was a growth in output (quarterly annualized rate) of 2.2% and 5.6% for the third and fourth quarters of 2009 respectively (Graph 6). This trend was led mainly by the fiscal stimuli and the strength of the inventories. Likewise, in the last few months, various economic indicators have shown improvement, especially those related to trade abroad, the real estate market and the state of the companies (such as requests for new orders).

However, there are doubts about the strength and speed of this recovery for the developed economies. Industrial production, which had improved since the second half of last year, has lost momentum in the last few months. Indeed, in October, this indicator showed downswings again in the case of the euro zone. Likewise, retail sales in the majority of the industrialized countries are still stagnant with the exception of the United States (where some recovery has been seen).

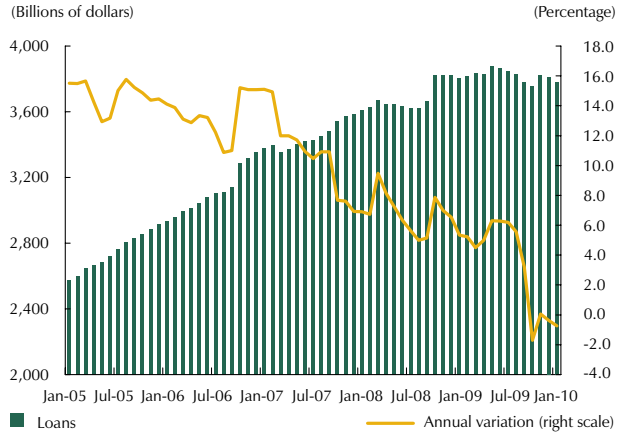
With respect to the credit channel, this has not been restored yet and in some developed countries, it has continued to shrink (Graphs 7 and 8). This has been the case for both the loans intended for consumption and those for financing commercial activities and investment. Various surveys show that although the commercial bank requirements for granting loans have been eased, they are still high. At the same

Graph 7

A. Commercial and Industrial Loans in the United States

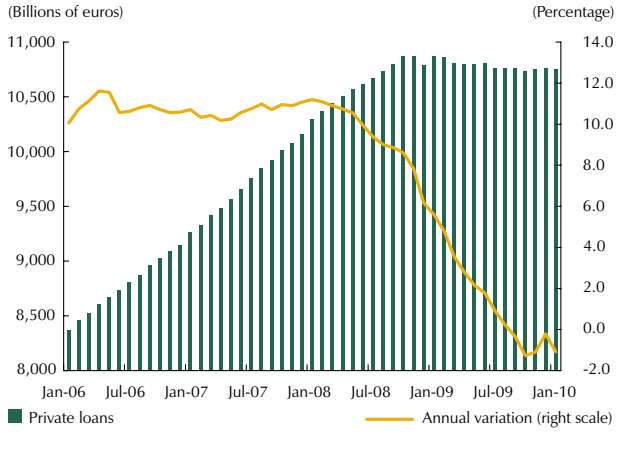


B. Mortgage Loans in the United States



Source: St. Louis Federal Reserve.

Graph 8
Private Loans in Europe



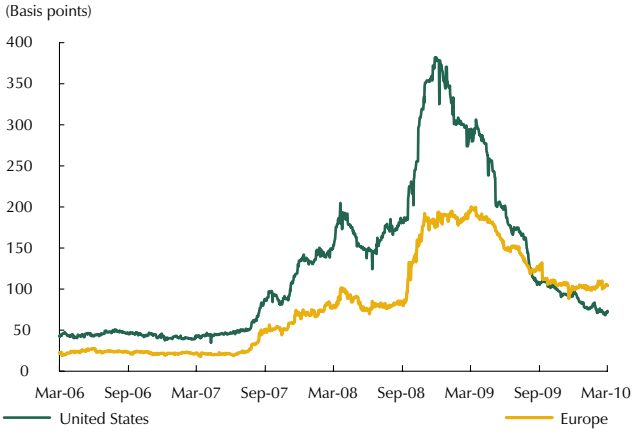
Sources: European Central Bank.

time, in spite of the improvements seen in risk perception and the willingness to lend, they have not reached the pre-crisis levels yet (Graph 9).

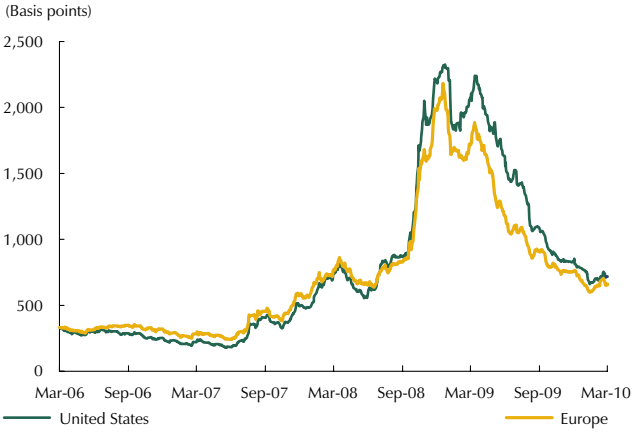
The low momentun of credit, the high level of business and household indebtedness together with the deterioration in the labor market could hinder the recovery. At the end of 2009, although the unemployment rates had not shown new rises and had even declined a little in some countries, the situation does not seem to be better since employment has continued to decline in the majority of them (Graph 10). Specifically, although the unemployment rate went from 10% in December, 2009 to 9.7% in January, 2010 in the United States, approximately 170,000 employment positions disappeared in those two months.

Graph 9

A. Spread Between AA Bonds and 2-year Treasury Bonds

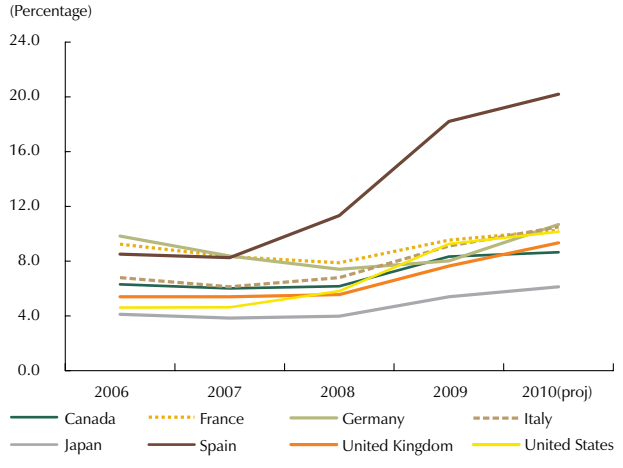


B. Spread Between High Yield Bonds and Treasury Bonds



Sources: Bloomberg and Merrill Lynch.

Graph 10
Change in Unemployment During the Crisis



(proj) projected.
Source: IMF.

Because of the above, there is a lot of uncertainty about whether or not the developed economies will soon return to a sustained growth in the absence of fiscal help. On average, analysts expect the United States, the euro zone, the United Kingdom and Japan to have growth that is positive, although slow, in 2010 and possibly below their potential in the coming years. In the case of the United States, the IMF projects an annual growth of around 2.7% for 2010 most of which will be due to an increase in inventory and government expenditure since private investment and consumption will continue to register low growth. Therefore, for 2011, this economy could lose its strength (see the shaded portion of pg. 23). Thus, the IMF forecast of 2.4% annual growth of the GDP for this country is below it potential growth (Table 3).

After five quarters of negative output growth, the euro zone recovered in the second half of 2009 and pulled out of the technical recession.[8] Nevertheless, the weak performance of economic activity in Germany (the largest economy in the region) in the fourth quarter of the year confirms the prediction of a slow recovery for this zone. In fact, the IMF expects the euro zone to have a growth of 1.0% (Table 3) led by exports, the sell off of inventory and the implementation of previously agreed fiscal stimuli in 2010. The demand from emerging countries and the slight recovery of US consumption make it possible to expect a favorable outlook for European exports. The inevitable contraction of domestic demand in countries like Spain, Portugal, Ireland, and Greece, in turn, will have an impact on the rest of the continent due to the way that the European Union domestic market weighs heavily on total foreign trade.

Table 3
Forecasts of Annual Economic Growth for Developed Countries (percentage)

	2009	2010	2011
IMF			
United States	(2.5)	2.7	2.4
Euro Zone	(3.9)	1.0	1.6
United Kingdom	(4.8)	1.3	2.7
Japan	(5.3)	1.7	2.2
Focus Economics			
United States	(2.4)	2.8	3.0
Euro Zone	(3.9)	1.4	1.7
United Kingdom	(4.8)	1.2	2.0
Japan	(5.3)	1.5	1.5

Sources: IMF and Focus Economics.

8 When the GDP shows two consecutive periods of negative quarterly growth, this is technically considered recession.

For the United Kingdom, recent information shows that their economy has still not succeeded in recovering since an anemic annual increase in the GDP (0.3%) was reported for the fourth quarter of 2009 while the market expected a more dynamic recovery. Just as in the rest of Europe, their growth in 2010 will be determined by improvements in exports and inventory. However, domestic demand will remain weak as a result of the indebtedness of households, restrictions on loans, higher taxes, the high levels of unemployment and the erosion of purchasing power given the recent high inflation.

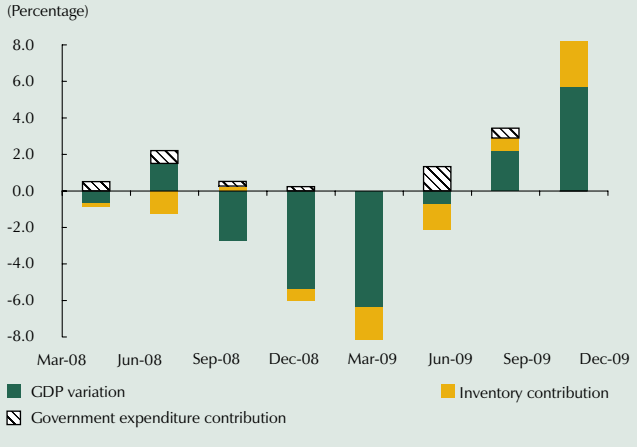
With respect to inflation in advanced economies, it is expected to remain low and stable for 2010. According to the IMF, inflation will go from 0% in 2009 to 1.3% this year. The widening of the negative output gap, the historically low levels of used installed capacity and the high indices of unemployment in these countries will hold down the inflationary pressure that could result from rises in the prices for electricity and commodities. Furthemore, inflation expectations are expected to remain anchored since the market does not anticipate rises in the interest rates, at least during the first half of 2010.

WHAT ASPECTS WILL BOOST THE UNITED STATES GDP IN 2010?

The largest impact of fiscal policy on the growth of output in the United States was felt in the third quarter of 2009 and a little less so at the end of the year. Although the current programs will continue to be carried out in 2010 and there could be new fiscal injections, their impact on the growth of economic activity will be lower than that of the previous year. In addition, local government expenditures may be reduced in 2010 given the poor state of the fiscal balances of several important states.

Another component that made a positive contribution to the trend of this country's economic activity in the last quarter of 2009 was the smaller drop in the changes in companies' inventories (Graph A). After having risen considerably up to August, 2008, inventories fell sharply to levels consistent with lower sales. Towards the end of 2009, inventory stock had returned to pre-crisis levels in relation to sales (Graph B). This suggests that around 2010 there could be an inventory accumulation that will contribute positively to output. However, its effect could be moderate while demand continues to be weak.

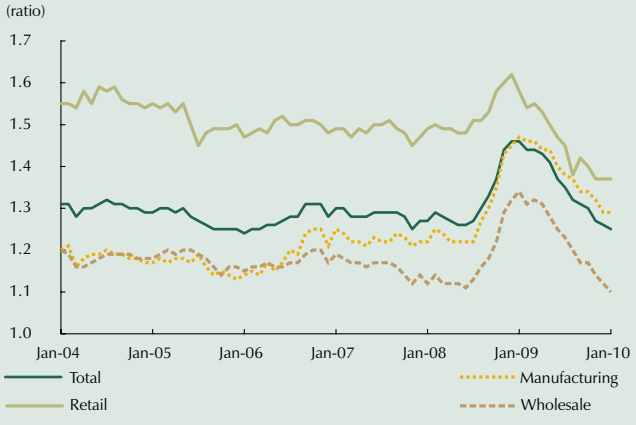
Graph A
Growth of the GDP in the United States and the Contribution of Inventory and Government Expenditure



Source: Census Bureau.

The recovery of the private sector in 2010 will depend on how companies react to the increases in sales in the last few months. To the degree in which the fiscal impact on output begins to disappear, the companies

Graph B
Ratio of Inventory to Sales



Source: Census Bureau.

should cover this void through hiring more worker's and investment. However, this kind of trend has not been seen so far.

In this respect, although the huge losses of employment[1] have moderated, the report as of January 2010 showed that this situation was due to a lower number of lay offs not to renewed hiring of employees. There is usually a lag between the increases in production and generation of employment. In the interval until hiring starts again, firms usually increase the number of hours worked and temporary hiring but this has not occurred to any regular degree either in the last few months.

Given this labor panorama, which is shared by the majority of the developed economies, the banks could keep loans restricted, especially to household with low credit ratings. Several factors would curb a reactivation of credit in developed countries: i) the banks continue to prefer asset liquidity on their balance sheets, ii) the portfolio provisions and penalties remain high (this situation is intensified given the deterioration of commercial real estate) and securitization markets remain closed due to a lack of investor confidence. With regards to demand, the deleveraging of household, in turn, is an additional obstacle to the strength of credit in 2010.

The above context for the labor and credit market together with the possible increase in the household savings rate as a precaution could cast a shadow over the recovery of consumption in industrialized economies in 2010.[2] That being the case, it would be investment and net exports that would make a sustained contribution to US economic growth this year. In the first case, non-residential investment would be the one that would have to boost this while residential investment remains depressed. With respect to net exports, this contribution could be positive but there is quite a bit of uncertainty about that. It is probable that a weaker dollar compared to the currencies some of the developed countries and the majority of the emerging economies would provide an incentive for this country's exports. However, it should be kept in mind that the share that the foreign sector has of the United States GDP is small and is not comparable to that of other economies that are export-oriented.

Last of all, growth in 2010 in the United States will continue to depend mainly on inventory accumulation and the fiscal stimulus. For 2011, those effects on the GDP will be reduced and the growth of the economy could lose momentum. An additional fiscal increase during the current year could change this panorama although it would complicate public finances for the coming years.

1 Since the beginning of the recession in December, 2007, 8.4 million jobs have been lost.

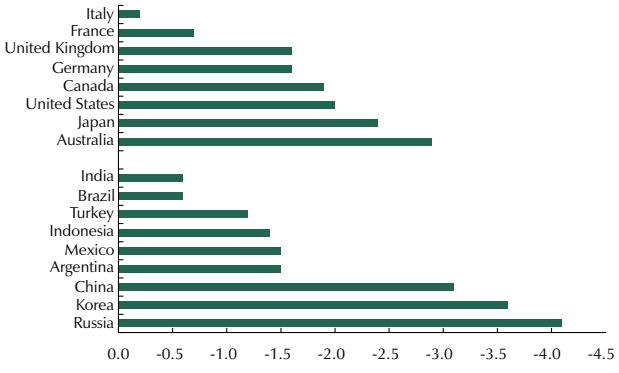
2 Although a little gain in household wealth has been generated in the last few quarters due to stock appreciation, a possible relapse in housing prices in several countries could decrease these gains in wealth. This contraction of prices for housing would be primarily due to the lack of fiscal programs to reactivate the market together with an increase in supply given that the foreclosures have continued in the last few months.

C. PERFORMANCE AND OUTLOOK FOR EMERGING COUNTRIES

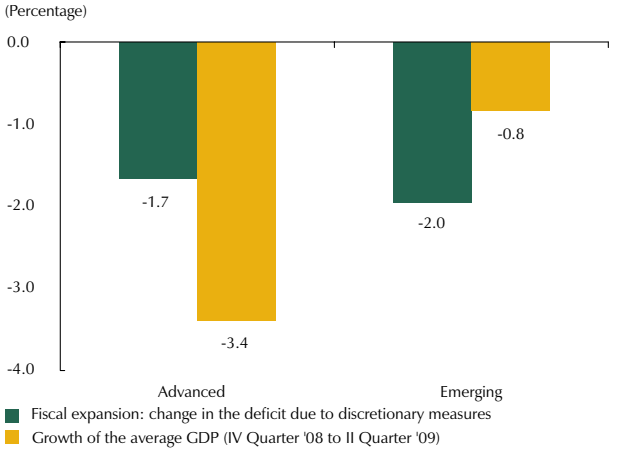
Throughout the course of the crisis, the trend of economic activity in emerging countries has been heterogeneous. On the one hand, there are the countries in Eastern Europe that are still suffering from the consequences of the crisis and on the other, there are the Asiatic countries that have shown signs of recovery.

Graph 11

A. Change in the Fiscal Deficit Due to Discretionary Stimuli (percentage of the GDP)



B. Fiscal Expansion and Growth of the GDP



Source: IMF.

In general, except for Eastern Europe,[9] the medium and long term outlook for the developing countries is more favorable than for the advanced economies since their financial systems were less exposed to the international crisis, the majority did not have a mortgage crisis and the households seem to be less indebted.

The economic recovery has been led mainly by the Asian countries, especially India and China. The performance of the latter country, which reported an annual growth of 8.7% in 2009, was outstanding and well above what was anticipated at the beginning of the year (6.6%).[10] India, in turn, had an annual GDP growth of 7.9% in the third quarter of 2009 in comparison to the 5.8% registered in the first.

The contraction in the emerging countries was not greater thanks to the strong support that the governments provided. Based on Graph 11, in spite of the fact that the contraction of the GDP in the emerging countries at the beginning of the financial crisis was lower than that for the industrialized ones,[11] the fiscal packages of the former were significant thus preventing a more serious plunge and stimulating a more dynamic recovery. As a result, the countries with sufficient fiscal leeway at the beginning of the crisis were the ones that had stronger stimuli, which showed that fiscal discipline offers the opportunity to act at difficult times without risking public finances.

The countries in Latin America that have held firm to their commitment to reduce inflation through fiscal responsibility, a healthy financial system and through better supervision were able to carry out counter-cyclical policies and face the crisis more easily than in the past. Thus, the central banks reduced their interest rates sharply to reactivate domestic demand without causing abrupt outflows of capital, significant depreciation of their currencies or increases in inflation expectations as has usually happened in previous years. Likewise, the governments raised their expenditures to ease the external shock without this being detrimental to the quality of their debt.

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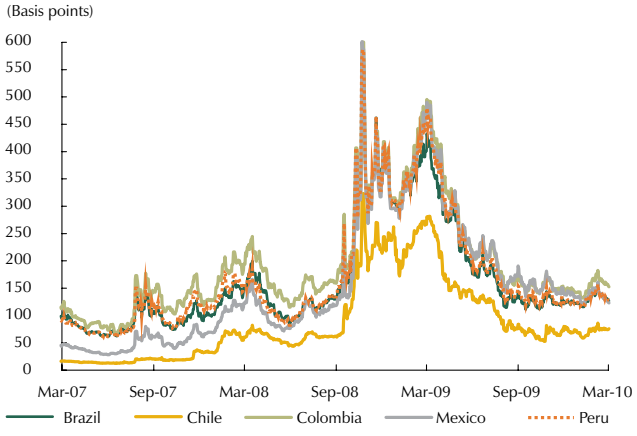
9 The macroeconomic imbalances in this region were documented in last year's *Report to Congress*.

10 Towards the end of December last year, the fears of asset bubbles in China (stocks and property prices) led authorities in that country to harden monetary policy (the Central Bank of China issued bonds and raised the level of the reserves required for commercial banks while leaving the benchmark rate unchanged). These measures sought to reduce the liquidity generated by the monetary stimulus in order to contain the excessive growth of credit.

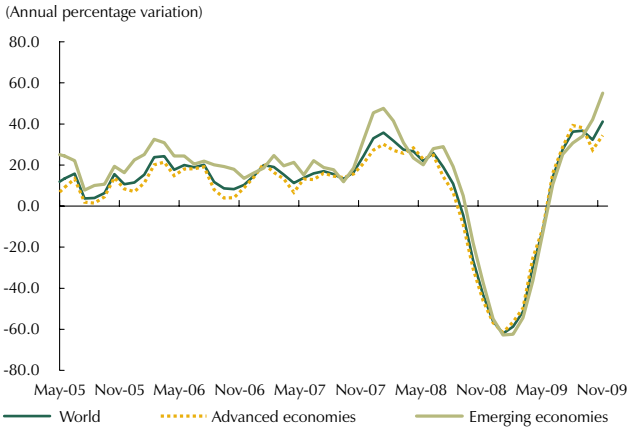
11 Between fourth quarter of 2008 and the second quarter of 2009, the GDP in emerging economies pulled back 0.8% on average while in industrialized countries, it declined 3.4%.

Graph 12
5-year Credit Default Swaps [a/]



a/ This is a financial instrument by means of which the credit rating of a bond is negotiated. The holder pays a premium (basis points over the nominal value of the bond) to the entity that is offering the CDS on the condition that the entity takes responsibility for the nominal value if the issuer defaults. The valuation of a CDS is done on basis points over the nominal value of the bond and has a direct relationship with the level of risk aversion that investors have.
Source: Bloomberg.

Graph 13
Exports of Goods in Dollars



Source: IMF.

With respect to emerging countries financial markets, the risk perception has been improving just like it has been in the developed countries. Although the majority of the governments in Latin America used counter-cyclical fiscal policies, the deterioration in their balance was lower as a result of which the risk premiums have remained stable and are at levels similar to those registered before the bankruptcy of Lehman brothers (Graph 12). The lower risk perception and uncertainty in Asian and Latin American countries are also related to the lower exposure that their banking systems had to toxic assets and to the lower level of consumer, business and government debt.

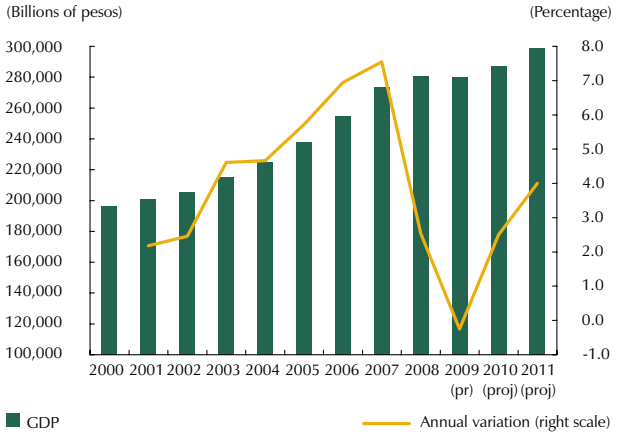
In addition, the improvement in the terms of trade in the final months of 2009 associated with the rally in the prices for some commodities has favored the strength of exports in emerging countries–above all in Latin America (Graph 13). While exports and industrial production have recovered in countries like Brazil and Chile, in Mexico, clear signs of stabilizing have not been seen yet. As of the third quarter of 2009, several Latin American countries had reached the GDP levels for 2008, something that has not occurred in the developed countries yet.

Given the solid economic fundamentals and the large policy stimuli, a rapid recovery is expected in 2010 for the developing countries in Asia. According to the IMF forecast, the GDP for emerging Asia grew 6.5% in 2009 and could increase 8.4% this year. Specifically, this would be the result of investment, resupply of inventory and more exports. The capital flows are returning to the region and the advances in the local financial market will continue to strengthen the recovery. For 2011, the growth of the GDP could be slightly lower since the excess capacity in the manufacturing sector will continue and the increase in worldwide trade will probably be moderate.

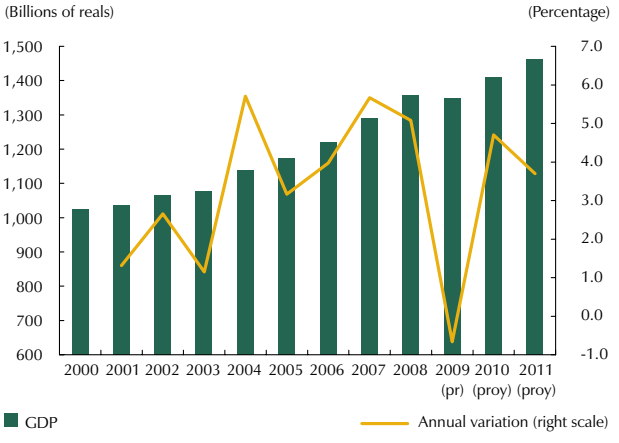
After a fall of approximately 2.3% of the GDP in 2009, Latin American production will rise close to 3.7% in 2010 according to the IMF predictions. Nevertheless, in the majority of the countries in this region, the growth will be below their potential (Graph 14). The shrinking of investment could prevent growth from reaching the levels it had during the boom period. Likewise, it has been predicted that remittances and, to a lesser degree, tourism will recover only moderately in the 2010-2011 period due to the weakened condition of the labor market in the United States and other developed countries.

Graph 14
GDP at Constant Prices

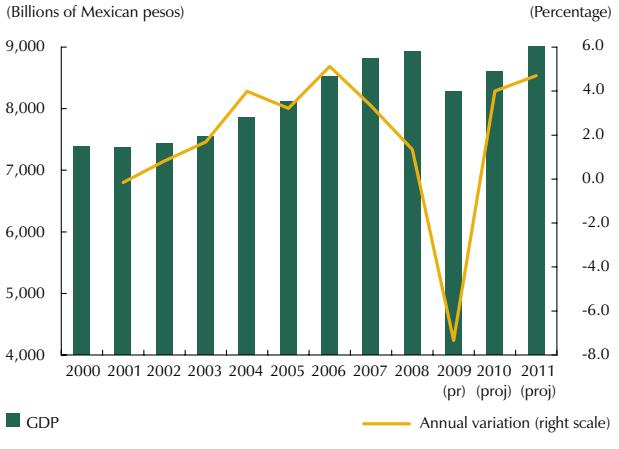
A. Colombia



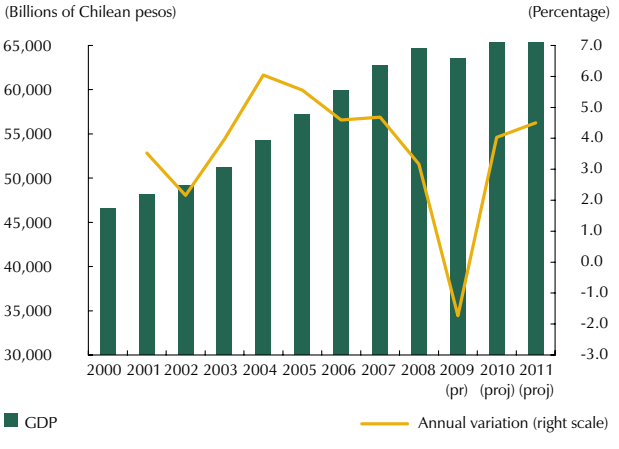
B. Brazil



C. Mexico



D. Chile



(pr) preliminar.
(proj) projected.
Source: IMF.

D. MAIN LONG TERM RISKS AND THE WITHDRAWAL OF THE STIMULI

For the next few years, the industrialized countries have two huge challenges. The first one is to identify the appropriate time and the pace at which fiscal and monetary stimuli should be withdrawn to prevent them from becoming an obstacle to growth in the long term. The second one consists of making the adjustments and reforms that are necessary to keep public debt at sustainable levels.

Not meeting the first challenge could lead to a second collapse of the economy because of the premature withdrawal of the stimuli, rises in inflation or distortions in the financial market due to keeping liquidity at excessive levels. A high public debt could generate expectations of default, rises in risk perception and in interest rates. At the same time, the public sector's high demand for credit could reduce or crowd out the private sector's access to financing. If these risks should materialize, they would constitute an obstacle to the growth

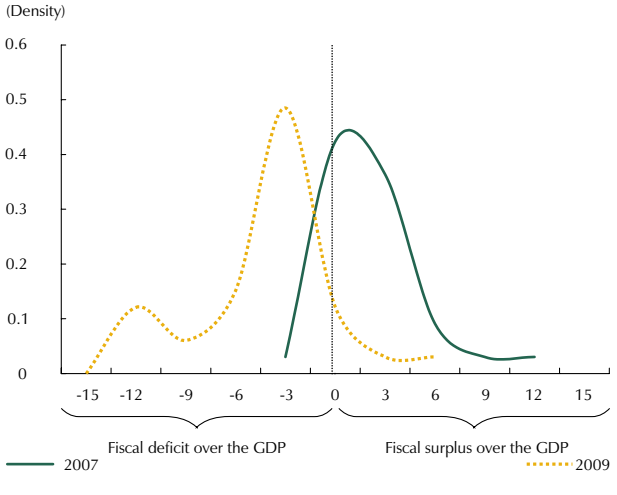
of the industrialized countries and affect the developing countries through a lower world demand and a higher cost for foreign financing.

On the monetary front, it is probable that the Federal Reserve of the United States (Fed) will not renew the purchase of "toxic" assets nor the easy terms for commercial banks this year. These were the stimuli that were used to stabilize the interbank market at the deepest point of the financial crisis. The same thing could also occur in the United Kingdom and the countries in the euro zone. With respect to the stance of the monetary policy, the analysts predict that the first moves towards raising the interest rates on the part of the Fed will be made towards the end of the year.

The fiscal stimuli should be eliminated as the economies show signs of a self-sustaining growth. In practice, it is probable that this task will not be as easy and quick since approximately 50% of the tax cuts that were implemented during the crisis were permanent. Raising them again would require structural reforms that would have to go through the procedures in the respective congresses. Therefore, it is possible that the fiscal adjustment will mostly be done through a reduction in outlays rather than in increase in income.

In spite of the fact that the market expects fiscal adjustments, the greatest long term risk continues to be the sustainability of public debt (see the shaded portion pg. 30). As is shown in Graph 15, the deterioration in the balances of the governments of advanced economies was general. While in 2007, 54% of these economies had a surplus in their fiscal balance, in 2009, this figure had declined to 6%. During the same period, the percentage of countries that had fiscal deficits above 2.5% of the GDP went from 18% to 87%. To be specific, several European countries are clearly surpassing the thresholds established in the Treaty of Maastricht in which the maximum limit on fiscal deficit is 3% of the GDP.

Graph 15
Distribution of the Fiscal Balance in Advanced Economies

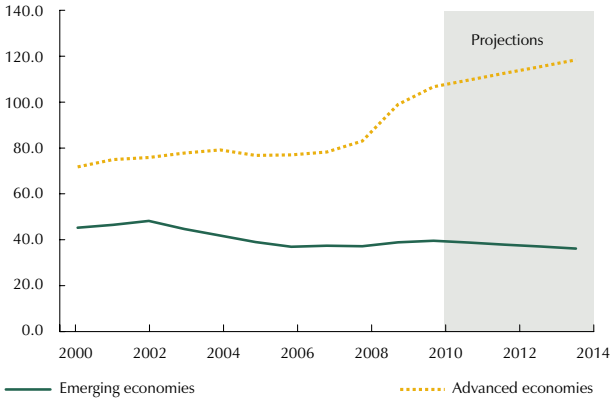


Source: IMF (WEO).

According to the IMF, in 2014, the debt of countries in the G-20 could reach 118% of the GDP (Graph 16) as a result of which, servicing it will take a significant proportion of their expenditures (Table 4). Even if we assume large fiscal adjustments, it will not be until about 2030 that it will be possible to reduce the debt to close to 60% of the GDP. This will be one of the biggest challenges for the next few years in the industrialized economies. Countries like Japan, Ireland, the United Kingdom, Greece and Spain will have to make the strongest efforts to reach prudent levels of debt by 2030.

The macroeconomic adjustments of the developed economies could end up affecting the emerging ones. The World Bank predicts that, in the next five to ten years, the increase in risk aversion and the stricter regulatory conditions could cause a scarcity of capital and an increase in its cost for developing countries. According to the same entity, the rates of growth for the latter may

Graph 16
Public Debt as a Percentage of the GDP



Source: IMF.

be lower (between 0.2% and 0.7%) than those that would have been seen if the financing had been maintained.

Table 4
Payment of Interest and Public Debt in Developed Countries

	Payment of net interest over expenditure		Public debt over fiscal revenue	
	2007	2014 (proj)	2007	2014 (proj)
Germany	5.4	4.8	144.5	203.4
Canada	1.5	0.5	158.4	166.8
United States	6.6	12.4	206.9	364.4
France	4.5	5.9	128.7	197.2
Italy	10.3	13.1	220.7	272.9
Japan	1.6	8.1	604	446
United Kingdom	3.9	7	116.8	267.4
G-20 Advanced countries	5.2	8.8	225.5	300.5
G-20 Developing countries	9.6	8.3	142.3	137.1

(proj) projected.
Source: IMF.

PRESSURES ON THE SOVEREIGN DEBT OF SOME COUNTRIES IN EUROPE

The sharp increase of public debt of developed countries could be an obstacle to a vigorous recovery. This will probably be reflected in an increase in the need for financing and a rise in the market interest rates.[1] Thus the fiscal measures in the advanced economies that are helping to reestablish economic activity in the short term could end up as an attack against macroeconomic stability and against the soundness of the currencies. The latter is being seen in countries like Greece and, to a lesser degree, in Ireland, Portugal, and Spain. These economies, which are traditionally considered stable, are seeing not only their credit rating but also their risk premiums affected due to the economic deterioration and the pressures on their Treasury.

1 If expenditures in these countries are not reduced or their revenue does not increase within a reasonable period of time.

The spreads in the sovereign debt of some countries in the euro zone in comparison to Germany widened recently with the most notable case being that of Greece (Graph A). This trend is due to the severe pressure on the Greek treasury for which a fiscal deficit of around 13% of the GDP is predicted. The European Commission has declared that Greece needs to act immediately to correct their fiscal imbalance since that country had not taken sufficient measures to solve it. As a result, the situation could be unsustainable. It should be mentioned that according to the Maastricht Treaty, the countries of the euro zone should keep their budgetary deficits under 3% of the GDP.[2]

The sharp deterioration of Greek finances together with the Commission's announcements concerning fiscal consolidation plans[3] have generated quite a bit of uncertainty in the financial markets for the first few months of the year. Likewise, this situation has brought pressures on the euro, which has weakened about 5.2% so far in 2010 and has fed fears regarding a possible debt crisis that would affect the rest of the countries in the European Community. That is why the risk premiums, which are measured by the credit default swaps,[4] (CDS) rose considerably at the beginning of the year, especially for Greece, Spain and Portugal and reached levels that were above those seen in the boom before the *subprime* crisis. Although that tendency has reversed recently, these premiums are still above those seen before the beginning of the crisis (Graph B).

Graph A
Spread of the 10 Year Sovereign Debt with Respect to the German Debt

Source: Bloomberg.

Graph B
5-year Credit Default Swaps

Source: Bloomberg.

2 Nevertheless, the majority of the countries in the euro zone have failed to comply with this limit as a result of the crisis.

3 The deficit of the countries in the euro zone was 0.8% of the GDP in 2007 and 2.3% in 2008. The forecasts indicate that in 2009, it will triple (rise to 6.9%) and will reach 7.5% this year. The Commission has proposed different deadlines (between 2012 and 2015) for the European countries to reach a fiscal deficit that is 3% of the GDP. These recommendations still require the Council's approval.

4 This is a financial instrument by means of which the credit rating of a bond is negotiated. The holder pays a premium (basis points over the nominal value of the bond) to the entity that is offering the CDS on the condition that the entity take responsibility for the nominal value if the issuer defaults. The valuation of a CDS is done on basis points over the nominal value of the bond and has a direct relationship with the level of risk aversion that investors have.

II. The Colombian Economy: Results in 2009 and Outlook

In 2009, the growth of the GDP in Colombia was 0.4%, an outcome that is higher than the one seen by the global economy (-0.8%). The sharp upsurge in investment in civil works projects and, to a lesser degree, the increase in government consumption were the largest supports for that growth. Household consumption, which in the first half of the year showed a negative rate of growth, recovered in the last two quarters of 2009.

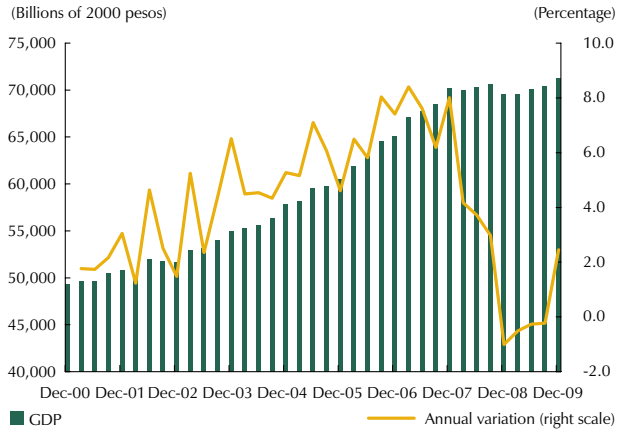
Unlike what happened in the developed economies, the financial system in Colombia remained healthy. The reduction of the Banco de la República's benchmark interest rate by 650 basis points was transmitted to the savings and loan rates.

A. ECONOMIC ACTIVITY

In 2009, the Colombian economy registered a growth of 0.4%. This rate, which is similar to that predicted by the Banco de la República, turned out to be better than what was seen in the world economy (-0.8%). The lower foreign demand for our products together with the internal deterioration of consumer and business confidence, which curbed household consumption and caused a sharp contraction in investment, were the primary transmission mechanisms of the international crisis to the economic performance of Colombia.

The international crisis started to hit the Colombia economy harder as of the fourth quarter of 2008 and continued to do so until the second quarter of 2009. When the quarterly growth is examined, the only relevant setback of the GDP that is found is the one that occurred towards the end of 2008 and which, in the first quarter of 2009, remained stagnant. However, as of the second quarter, an expansion is seen again although it is at a slow pace. In annual terms, this trend made it possible to show a positive growth of 2.5% for the fourth quarter (Graph 17).

Graph 17
Gross Domestic Product (GDP)



Source: DANE.

In addition to the signs of reactivation linked to the recovery of the world economy, other circumstances that had positive effects on the Colombian economy in the second half of the year were: i) the expansionary monetary policy started in late 2008, ii) the increase in public expenditures and in investment in civil works projects,[12] iii) the improvement in disposable household income as a result of the reduction of inflation.[13] However, the drop in sales to Venezuela associated with the plunge in their domestic demand and the trade restrictions imposed by that country worked against the reactivation and performance of the Colombian economy in the second half of the year.

It is probable that the above stimuli and restrictions will continue in 2010 and will be the ones that determine the speed at which the economy recovers. Keeping these risks in mind, an annual change of between 2% and 4% of the GDP is expected for 2010.

1. Growth of the GDP by Type of Expenditure in 2009

The poor performance of the GDP in 2009 was associated with a very small expansion of private consumption and a strong contraction of investment apart from civil works as well as a shrinking in exports. These trends were partially offset by a significant increase in investment in civil works projects and government consumption which, although its performance was not outstanding, it did grow beyond the GDP (Table 5).

With respect to private consumption, there was a slight tightening in the first half of the year but a recovery in the second half, which was especially marked in the fourth quarter. That was when this variable grew at an annual rate of 1.0% and stood at levels that were above the highest ones seen before the crisis (Table 5). The improvement in household consumption starting in the third quarter coincided with a rise in consumer confidence. The fall in inflation and the reduction in the interest rates because of the loose monetary policy should have had a positive influence on the disposable income of the families and hence stimulated their consumption.

By type of goods, the strongest contraction was in the consumption of durable goods in 2009, as was to be expected, since this demand is usually more sensitive to the variations in household income and to changes in economic outlook. This expense is the only one that was below pre-crisis levels at the end close of 2009. In other consumption area such as non-durable goods, semi-

12 This group which has a significant public component, helped to mitigate the plunge in expenditure on other types of investments.

13 The lower inflation served as a stimulating component for private consumption.

Table 5
Real Annual Growth of the GDP by Type of Expenditure (percentage)

	Full year				2009				
	2005	2006	2007	2008	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Full year
Consumption	**5.1**	**6.2**	**6.9**	**2.3**	**(0.4)**	**0.2**	**1.2**	**2.0**	**0.7**
Household consumption	4.7	6.8	7.6	2.5	(0.6)	(0.1)	0.2	1.0	0.1
Government consumption	6.4	4.2	4.5	1.3	0.3	1.1	4.7	5.3	2.9
Gross Capital Formation	**19.9**	**19.1**	**13.7**	**7.5**	**(3.7)**	**(9.4)**	**(10.0)**	**3.0**	**(5.2)**
Gross fixed capital formation	21.2	17.2	15.2	4.7	(2.9)	(1.4)	(2.3)	0.3	(1.6)
GFCF other than civil works	21.4	17.4	13.0	11.1	(5.9)	(14.5)	(15.8)	(13.5)	(12.4)
GFCF in civil works	20.7	16.7	21.5	(11.8)	6.9	41.9	41.0	44.7	33.9
Inventory	9.0	36.8	2.0	32.3	(9.7)	(60.5)	(53.6)	26.4	(30.4)
Final domestic demand	**7.8**	**8.9**	**8.5**	**3.5**	**(1.2)**	**(2.2)**	**(1.7)**	**2.2**	**(0.7)**
Exports	**7.2**	**8.0**	**11.4**	**7.2**	**1.4**	**(4.9)**	**(10.8)**	**(18.0)**	**(8.2)**
Imports	**17.0**	**16.2**	**13.9**	**9.8**	**(2.0)**	**(10.6)**	**(12.0)**	**(11.4)**	**(9.1)**
GDP	**5.7**	**6.9**	**7.5**	**2.4**	**(0.5)**	**(0.3)**	**(0.2)**	**2.5**	**0.4**

Sources: DANE, Banco de la República calculations.

durable ones and services, the results of the fourth quarter in 2009 surpassed those seen in the third quarter of 2008.

In 2009, the drop in gross fixed capital formation was 5.2% and was concentrated in investment other than civil works projects and inventory (-12.4%) (Table 5). To a great extent, this trend was because of the loss of investor confidence (a result of the international crisis[14]) as well as the excess of spare productive capacity that emerged due to the deterioration in foreign and domestic demand since mid-2008 (See the next section). The shrinking of this investment in 2009 is the first that has been seen in this decade and, unlike what happened with private consumption, this variable did not show signs of recovery in the second half of the year. In fact, towards the end of the year, its levels were equivalent to those seen in 2006. Within this aggregate, the expenditure that was hit the worst was investment in machinery and equipment, which is mainly oriented to the industrial sector.

Exports, in turn, fell 8.2% for the entire year. The lower strength of foreign demand reflected the sharp plunge in trade flows which occurred in most of the countries in the world and primarily affected the volumes of industrial goods that were exported (Table 5). In the second half of the year, this situation became more acute due to the contraction of coffee exports[15] and the plunge

14 This fact was recorded on the opinion surveys given to people in the industrial sector.

15 The lower coffee exports were also linked to a lower domestic production.

in sales to Venezuela related to the dive in their domestic demand and the hardening of the trade restrictions imposed by that country. These last facts prevented a clearer recovery of output from occurring towards the end of the year.

Among the factors that stimulated growth, public consumption was the one that expanded persistently over the course of the entire year with its maximum annual rate of growth in the fourth quarter. Investment in civil works was the aggregate that exhibite the greatest momentum in 2009.[16] The expenditures on port projects and mining construction that were done in the first half of the year and the investment in roads, streets and bridges (mainly on the inter-urban level) in the second caused the investment in public works to grow at an annual rate of 33.9%. Just like in 2008, part of these projects from last year came out of FDI.

Given the above, domestic demand fell 0.7% over the entire year which contrasts with the expansion of the GDP. Net foreign demand (exports minus imports), in turn, contributed positively to growth due to the fact that the downswing in imports was greater than the one in exports. Imports maintained a declining trend in 2009 and fell 9.1% over the entire year (Table 5). The purchases that were the most affected were the metallurgical products and machinery which are associated with the poor performance of investment. In constant pesos, import levels grew mildly in the second half of last year. Nevertheless, they were still around 10% below the maximum historical values seen towards the end of 2008.

2. Growth of the GDP by Economic Activity in 2009

In 2009, the manufacturing industry showed a decline of 6.3% and was the economic activity that made the largest negative contribution to growth (Table 6). This sector was the one that was the most affected by the deterioration in foreign demand given that its performance is tightly linked to that of world trade. The downward plunge of sales to Venezuela also contributed to industry's poor performance in the second half of the year mainly in sub-sectors like yarn and thread, clothing, leather, machinery and equipment. In spite of the above, the total level of the manufacturing GDP tended to be recover although very moderately, as of the third quarter.

The other sectors that registered significant annual downswings in 2009 were building construction, trade and transportation (Table 6). In the first case, the sector was obviously affected by the fall of work in progress, particularly that for housing other than social housing and the declines in work on offices, commercial premises and warehouses. The better trend for construction work on social housing, which would have been induced by the subsidies granted by the government for the purchase of new housing, prevented this sector from seeing a more serious drop. The poor performance of trade and

16 This aggregate combines public and private investment.

Table 6
Real, annual growth of the GDP by economic activity
(percentage)

	Full year				2009				
	2005	2006	2007	2008	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Full year
Agriculture, forestry, hunting and fishing	2.4	3.9	3.9	2.6	0.4	(0.4)	1.4	2.8	1.0
Mining and quarrying	1.7	3.2	2.9	7.3	11.0	10.2	8.8	15.0	11.3
Manufacturing industry	5.4	6.8	9.5	(1.8)	(7.6)	(10.2)	(5.6)	(1.4)	(6.3)
Electricity, gas and water	3.0	3.1	3.7	1.2	0.4	(0.0)	1.7	2.9	1.2
Construction	12.8	13.5	11.5	(0.3)	(2.9)	17.8	14.5	22.0	12.8
Buildings	4.7	11.8	1.1	18.2	(13.8)	(10.4)	(17.1)	(7.6)	(12.4)
Public works	19.7	14.8	19.1	(11.8)	6.9	41.9	41.0	44.7	33.9
Trade, repairs, restaurants and hotels	7.3	8.7	8.7	1.7	(2.5)	(4.9)	(4.3)	0.1	(2.9)
Transportation, storage and communication	8.7	9.2	11.0	4.0	(0.4)	(0.7)	(3.3)	(0.2)	(1.2)
Financial establishments, insurance, real estate corporate services	5.5	6.7	7.3	5.6	4.9	4.2	0.7	2.8	3.1
Social, communal and personal services	4.6	4.7	4.7	2.1	0.4	1.7	1.4	1.8	1.3
Subtotal aggregate value	5.5	6.5	7.2	2.4	(0.1)	0.2	0.2	3.0	0.8
Taxes - subsidies	8.0	11.6	11.5	3.2	(4.3)	(5.3)	(4.2)	(3.7)	(4.4)
GDP	5.7	6.9	7.5	2.4	(0.5)	(0.3)	(0.2)	2.5	0.4

Sources: Dane, Banco de la República calculations.

transportation, in turn, is due to the slump in industrial production, the poor rate of consumption and the deterioration in foreign trade.

Furthermore, from the accounting perspective, the 4.4% drop in the government's real net tax collection (taxes minus subsidies) was a heavy blow to growth. Excluding this variable from the GDP calculations, the aggregate value produced by the total of the branches of activity, which expanded 0.8% in 2009, is procured.

In contrast, the economic activities that had the best performance in the midst of the global crisis were construction of civil works projects, mining and the financial services sector (Table 6). In addition to the significant support from construction work on public projects (both public and private), the mining sector also contributed significantly to the growth of the GDP due to oil-petroleum production. The latter, in particular, benefitted from the abundant inflows of foreign investment over the last few years which, together with a price for oil that remained at relatively high levels, made it possible to raise its production and sustain it in 2009. Last of all, the appreciation of the TES and the stocks, along with the other assets in the investment portfolios held by financial brokers, allowed significant growth for the financial services sector GDP. The fact that the local banks were not seriously affected by the foreign crisis contributed also and, therefore, they were able to keep offering loans.

3. Outlook for Economic Activity in 2010

Although the external risks are still high, everything suggest that the most serious effects of the international financial crisis would have been overcome towards the end of 2009 and that this will continue in 2010. This situation, which has been reflected in the emergence of signs that several emerging economies and some developed ones are reactivating, should favor Colombian growth in 2010 by stimulating foreign demand for our products and maintaining or increasing the prices for the commodities exported by our country.

Unfortunately, these favorable perspectives which are derived from better international trade are partly shadowed by Venezuela's poor economic performance. Although the uncertainty about that country's growth in 2010 remains very high, a large set of variables indicates that the most probable outcome is that its growth will be under 2.0%. If we add to this the recent devaluation of the bolivar and the trade restrictions that have been in force since 2009, then all of the above, if it persists, would make Colombian products even less competitive in our neighboring country and could make the recovery of sectors such as the industrial one slower and more prolonged.

Therefore, even though it is hoped that exports will show a significant recovery with respect to what was seen in 2009, the weak demand from Venezuela will make the strength of exports in 2010 less favorable than it could have been with the predicted recovery in the world economy. This circumstance will make it more difficult for 2010 to see the same levels (in constant pesos) that were seen in 2008, the year with the highest value exported in the history of the country according to the national accounting done by the National Statistics office (DANE in Spanish). It should be pointed out that the process of substituting sales to other markets for exports to Venezuela or of exporting other products has not been very successful, at least in the short term.

The growth of output for the current year will also be driven by private consumption. Given that the changes in the interest rates have a lagged effect on consumption, it is expected that the reductions that were seen in the policy rate in 2009 and had some impact on this type of expenditure towards the end of the year will also have a favorable effect in 2010. The effect of the low rates on private consumption occurs through various channels such as the reduction in outlays to service the debt (which frees up income for consumption) or the increase in demand for loans to finance expenditures, etc. In spite of the above, the expansion pace of consumption will be limited by some adverse circumstances. Among those that stand out is the deterioration that the labor market could continue to exhibit with very little or no growth in regular employment. This would very probably limit the growth of private consumption and cause it to end up below its historical average.

The trend of public consumption would also have a positive influence on the annual growth of output but to a lesser extent than its private counterpart. The annual change in investment will offer a significant rally compared to 2009. In 2010, it is expected that the greater contribution to this aggregate will come from investments other than civil works projects. This investment

will be driven, in turn, by FDI going to the mining sector–oil in particular. The investment in public works (partly private and partly public) will show positive growth again in 2010 although it will be lower than what was seen in 2009. The latter is due to the fact that public investment will be reduced according to the announcements made by the government that expenditures will be deferred.

Last of all, imports will show positive growth after the steep plunge registered in 2009. This rally will be associated with the reactivation of consumption and investment and will put purchases of foreign products at levels close to those that were registered before the crisis.

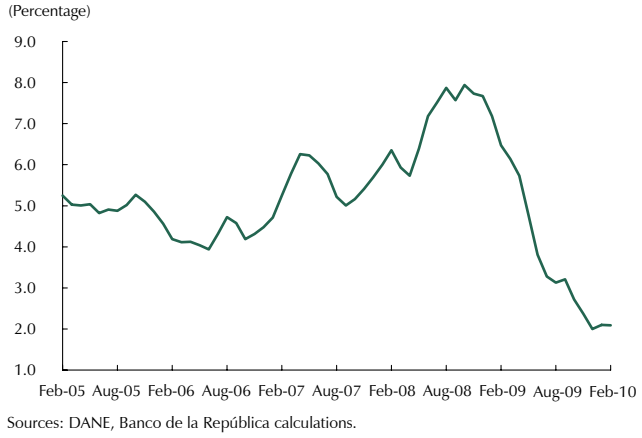
Given the above, it is expected that the recovery of the GDP this year, of which signs began to appear as of the second half of 2009, will continue in 2010 and that the growth of the economy will be between 2% and 4%. This expansion, however, is turning out to be lower than the average seen in the last few years and below what is expected for other Latin American countries. Nevertheless, it should be mentioned that there was a drop in the GDP in 2009 in the majority of those economies, something that did not happen in Colombia. At the same time, in the case of Colombia, there is an additional negative factor which is the plunge in sales to Venezuela.

B. INFLATION

1. Inflation in 2009

In 2009, various internal and external factors resulted in a substantial downswing in annual consumer inflation in Colombia. For a large part of the year, inflation was well below the target range established by the Board (between 4.5% and 5.5%). The shocks, not all of which were forecast, were added to the lagged effects of the restrictive monetary policy that was adopted between mid-2006 and mid-2008.

Graph 18
Annual Consumer Inflation

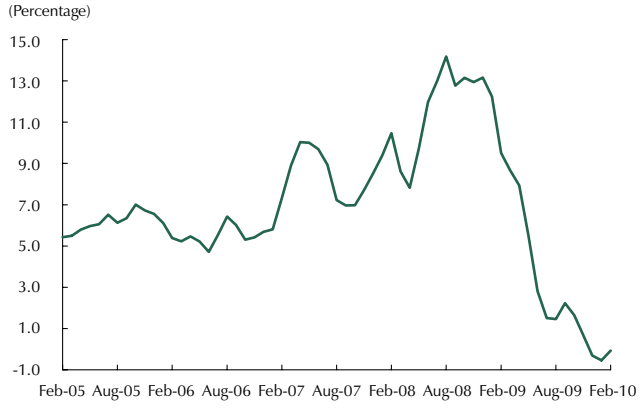


Sources: DANE, Banco de la República calculations.

Last December, consumer inflation was at 2% (Graph 18), a level that was much lower than that registered the year before (7.7%) and the lowest since November, 1955. With that figure, end of the year inflation broke the rising trend from 2007 and 2008 and, in addition, it was at the floor of the long term target range (between 2% and 4%).

The international recession, which caused a significant drop in international prices for fuel, other commodities and food, especially since the end of 2008 and during the first half of 2009, was a decisive factor in the decline of inflationary pressures in Colombia just as it was in the majority of the developed and emerging economies. In this country, the strongest effect occurred in food prices. The annual CPI variation for this basket of goods

Graph 19
Annual Inflation of Food Prices



Sources: DANE, Banco de la República calculations.

plunged more than was predicted initially, going from 13.2% in December, 2008 to -0.3% a year later (Graph 19). With this, a large part of the upward shock from 2008 was reversed. As a matter of fact, while the drop in total inflation was 90% due to food in 2009, the prices for this same group had been the explanation for 99% of the rise a year previously (Table 7).

The world recession also caused drops in the prices of other goods such as fuel and energy. Likewise, the slump in exports reduced the demand for various tradable and non-tradable goods and services. All of the preceding also contributed the decline of core inflation declining over the last year. Thus, the average of the four core indicators that are regularly

Table 7
Breakdown of Inflation Based on Upward Pressures as of December, 2009

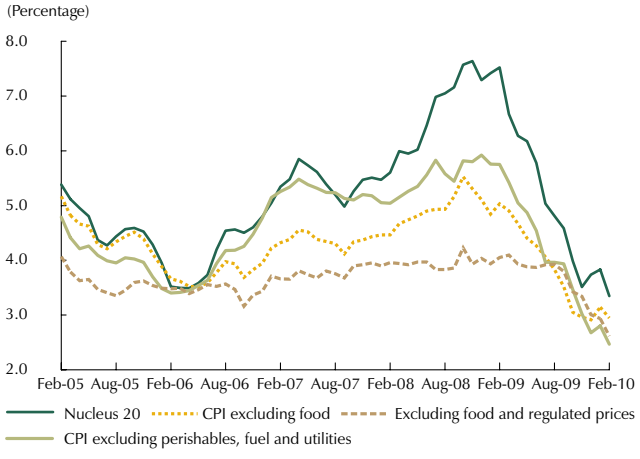
Description	Weight	Annual growth					Percentage share of the slowdown in the IV quarter	Percentage share of the slowdown for the full year
		Dec-08	Mar-09	Jun-09	Sep-09	Dec-09		
Inflation								
Total	100.00	7.67	6.14	3.81	3.21	2.00	100.00	100.00
Excluding food	71.79	5.11	4.90	4.27	3.52	2.91	37.76	29.29
Tradables	26.00	2.37	2.45	2.78	2.68	1.36	29.88	4.91
Non-tradables	30.52	5.24	5.36	4.73	4.76	4.41	9.30	4.77
Regulated prices	15.26	9.45	8.11	5.85	2.47	2.58	(1.42)	19.61
Food	28.21	13.17	8.67	2.81	2.23	(0.31)	62.24	70.71
Vegetables, fruit, tubers and milk	5.12	21.94	12.28	(3.68)	(3.40)	(4.24)	3.40	24.72
Grain, oil and others	8.03	19.02	12.89	5.29	0.91	(5.27)	38.99	35.94
Eating out and others	11.59	7.27	6.71	5.99	5.74	5.02	6.57	4.81
Beef and its substitutes	3.47	6.45	4.17	4.56	3.11	(1.76)	13.28	5.25

Source: DANE, Banco de la República calculations.

estimated by Banco de la República closed 2009 at 3.1% compared to 5.6% at the end of 2008. Among them, it is worth mentioning the fall registered by the CPI excluding food that went from 5.1% at the end of 2008 to 2.9% towards the end of 2009 and that of the CPI excluding food and regulated prices which went from 4.0% to 3.0% during the period under study. These indicators were at the lowest levels that have been registered in the last few years (Graph 20).

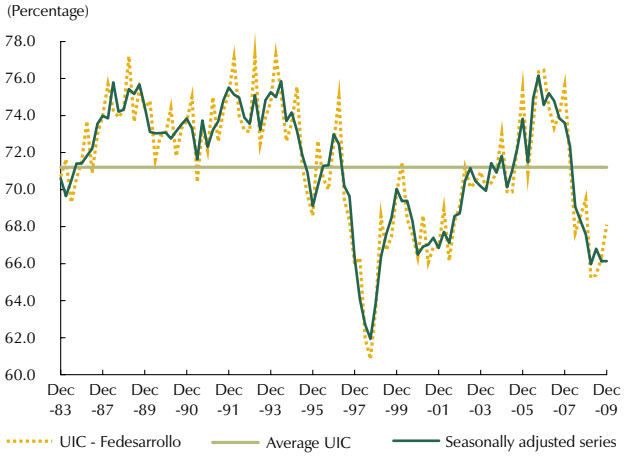
Among the internal factors that made the marked slowdown of inflation in Colombia possible, the weakness of private demand in the areas of both consumption and investment stands out. This, together with the downswing in exports generated an excess of productive capacity and a lower use of the

Graph 20
Annual Core Inflation Indicators



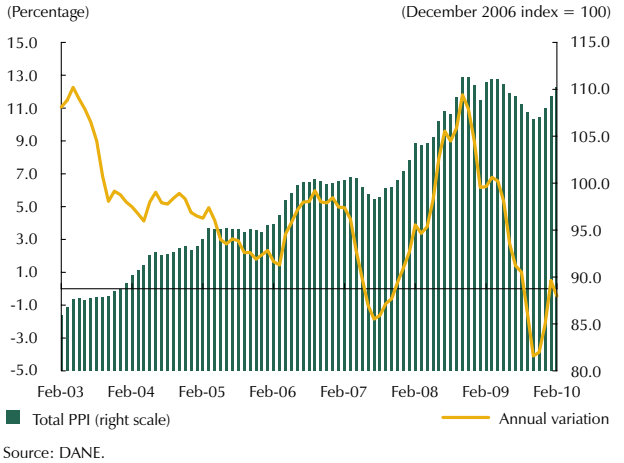
Source: DANE, Banco de la República calculations.

Graph 21
Use of Installed Capacity (UIC)



Source: Fedesarrollo.

Graph 22
Total PPI



Source: DANE.

installed capacity in sectors such as industry (Graph 21).

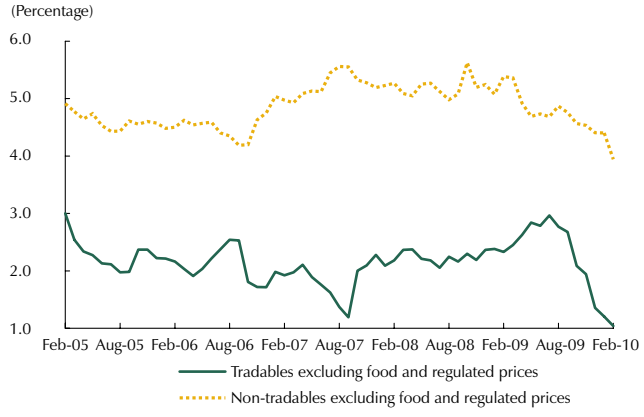
The cost pressures also declined significantly in 2009 partly because of the fall in international prices and commodity prices due to the appreciation of the foreign exchange rate as of March. Because of that, annual inflation for producers went into negative territory in the last few months of the year and was at -2.2% in December after having reached 9.0% towards the end of 2008 (Graph 22). The reductions appeared in both the producer price index (PPI) for imports and in the PPI for the country's produced and consumed goods.

Inflation expectations gradually declined over the course of 2009 which probably also contributed to moderating the rises in several tradable and non-tradable prices especially during the second half of the year when they converged to the long term target. Various indicators show that the expected 12-month inflation had gone from levels of above 5.0% towards the end of 2008 to numbers close to 4.5% in mid-2009. In addition, it had gone below 4.0% for last December which was clearly within the long term target range.

All of these downward pressures resulted in a significant reduction in the annual change of the CPIs for tradables and non-tradables excluding food and regulated prices. In the case of tradable goods, the number for the end of the year was only 1.4%, which was the lowest for the entire decade, with the exception of September, 2007. For the non-tradable goods, the recorded figure was below 5% as of April, a level that has not been seen since 2006, and ended at 4.4% in December. This was even in spite of the fact that within this basket several prices for services that are usually highly indexed (such as those for education, health and finances) maintained annual adjustments that were close to 7% over the course of the entire year (Graphs 23 and 24).

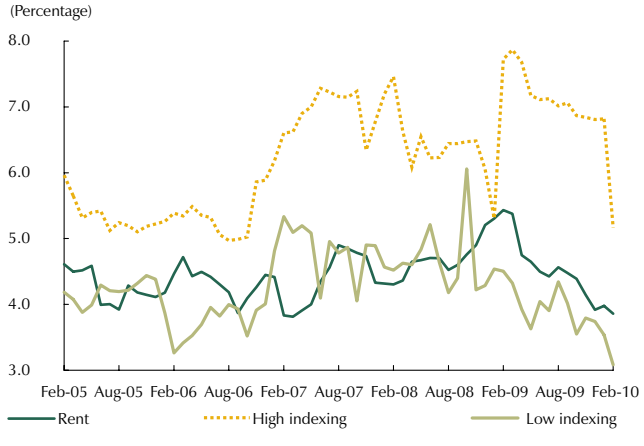
In the case of regulated prices, there was a significant decline that was greater than expected. The annual change in this case went from 9.5% to 2.6% between December, 2008 and December, 2009 (Graph 25). Just as in the case of food, the downswing in this basket was primarily due to the reversal of the shocks in international and local prices for fuel and

Graph 23
Annual Inflation of Tradables and Non-tradables Excluding Food and Regulated Prices



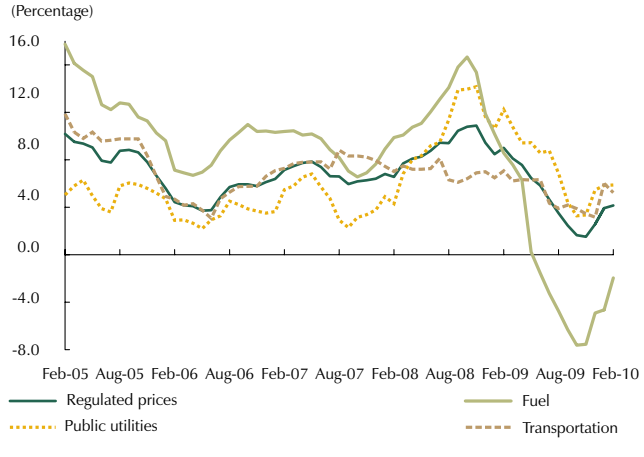
Source: DANE, Banco de la República calculations.

Graph 24
Annual Inflation of Non-tradables Excluding Food and Regulated Prices



Source: DANE, Banco de la República calculations.

Graph 25
Annual Inflation of Regulated Prices and by Components



Sources: DANE, Banco de la República calculations.

energy. This generated a reduction of approximately 5% for the entire year in the price for gasoline.

Apart from the above mentioned factors, there were deflationary pressures as a result of the blow the country suffered from exports to Venezuela in the second half of the year. This situation not only contributed to maintaining a high excess of productive capacity in industry but also helped to widen that of other sectors, such as agriculture, which produced cuts in the prices for several goods, especially food. The most prominent case was that of meat, the price for which fell almost 7% in the second half of the year.

That being the case, the downswing in inflation was steeper than what had been expected at the beginning of the year. Although the reduction of international prices and the lower foreign demand excluding Venezuela had mostly been predicted, this occurred in an environment of higher appreciation than expected, especially in the second half of the year. Likewise, demand –especially that of consumption and private investment– was weakened more than expected partly due to the effects of the plunge in sales to Venezuela as of August.

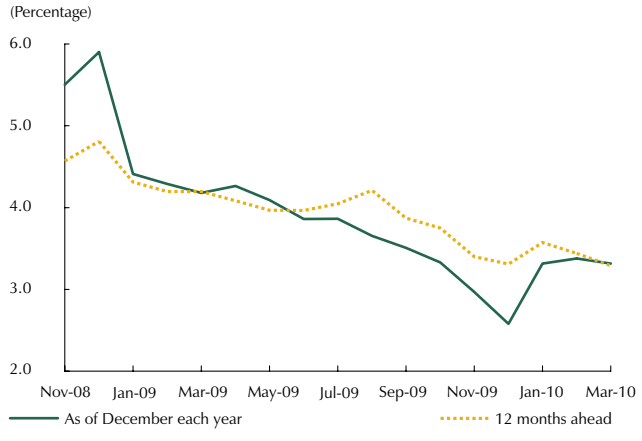
2. Outlook for inflation in 2010

The majority of the structural factors that allowed inflation to decline last year should still be acting in 2010. Specifically, demand pressures due to domestic growth are not expected since this will remain close to or below its potential growth (Graph 21). Because of that, the excess of productive capacity from the large accumulated investment made in previous years will continue to be large.

Pressures towards higher inflation from the exchange rate are not expected either. This, in general, reduces the risks of increases in the costs of commodities and of imported and tradable goods. Likewise, increases in wages will not jeopardize price stability either since there will still be a comfortable margin in the labor market and the increase in the minimum wage (3.6%) that was approved was within the long term target range (between 2% and 4%).

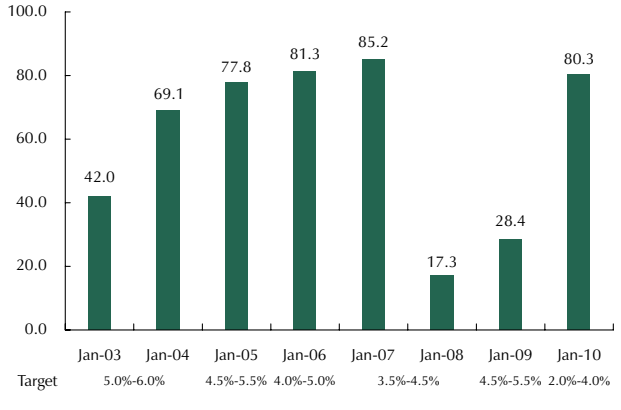
On the foreign front, although a recovery in world demand is expected, it will be modest and will not

Graph 26
Expectations of Annual Inflation Excluding Food According to Banks and Stock Brokers



Source: Banco de la República calculations.

Graph 27
Inflation Target's Percentage of Credibility 2003 to 2010
(survey done in January of each year)



Source: Banco de la República.

put excessive pressure on the commodity markets. Because of that, it is feasible to expect moderate rises in the international prices for fuel, minerals and food. Furthermore, the difficult situation that trade will continue to face with Venezuela will limit the growth of foreign sales and reduce the possibility that demand pressures will emerge from this.

Last of all, inflation expectations began the year at levels that were compatible with the target range just as was suggested by the results from the surveys that Banco de la República conducted. According to the monthly survey given to financial market brokers in February, the expected inflation 12 months ahead was still below 4.0% (Graph 26). The quarterly survey in January that was done to a broader spectrum of people, including businessmen, indicated that the people questioned expected inflation to be at 3.3% in 12 months. This same survey showed that a high percentage of people believe that it is feasible to reach the target set by the Board, something that has not occurred in the two previous years (Graph 27).

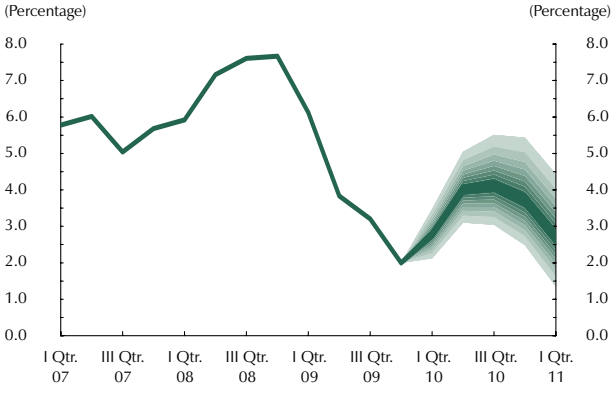
That being the case, the conditions exist in principle for inflation to stay within the long term target range (2% to 4%) in 2010. However, it is highly feasible that the prices for food and regulated goods will be hammered by the El Niño phenomenon which reappeared in the middle of last year and the effects of which, through the reduction in the amount of rain and changes in temperature, started to be themselves felt in some of the prices towards the end of 2009.

The impact of El Niño on prices has not been homogenous in the past since it has also depended on other factors such as the trend of the exchange rate, international prices for commodities and food as well as the state of the demand. In situations that are similar to the current one in which pressures on international prices or the exchange rate are not expected and demand is weak, it has been the norm to see a transitory impact on prices, especially those for food. A similar combination of events has been seen in other El Niño episodes such as those of 1977-1978, 1991-1992 and 1997-1998. On those occasions, consumer inflation received a transitory impact which was concentrated in the second year but did not extend into the following years.

If the pattern that was experienced on those occasions is repeated, food prices, especially those for perishables, should rise between the first half of the year and the middle of the third quarter, and then drop rapidly towards the end of 2010 and beginning of 2011. Therefore, the price changes will return to low

levels. Something similar, although less marked, could occur with the fees for public utilities if El Niño causes increases in the cost of generating electricity due to a need to replace hydroelectric power with thermal electricity.

Graph 28
Fan Chart of Total Inflation [a/]



a/ The forecasts are made under a monetary policy that seeks to guarantee that the long term target range is met.
Source: Banco de la República calculations.

According to the estimates made by Banco de la República, El Niño could produce a rise in consumer inflation until September which, although it would be significant, would not push it above the target range. The final result will depend on how prolonged and intense the phenomenon ends up being and if other unexpected pressures on prices emerge (Graph 28).

For 2010, other supply shocks are predicted which will result from the increase in some indirect taxes, the evening out of electricity fees in several regions, the updating of fuel and public transportation prices and from the rises in the prices for private education that are above the target based on what has been authorized by the government. These small shocks do not represent a significant risk for the fulfilment of the target.

Up until February, consumer inflation had shown an upward trend that was less pronounced than what had been predicted and was at 2.1% (Graphs 19, 20 and 21). As was expected, so far this year the pressures have come primarily from regulated prices and food although, in the latter case, the increases have been lower than what was predicted and the annual variation stayed in negative territory (-0.1%). In the case of tradables and non-tradables excluding food and regulated prices, the annual changes continued declining thanks to the few exchange rate pressure, the low use of the installed productive capacity and the low inflation expectations. As a consequence the results have adjusted more to those that were predicted.

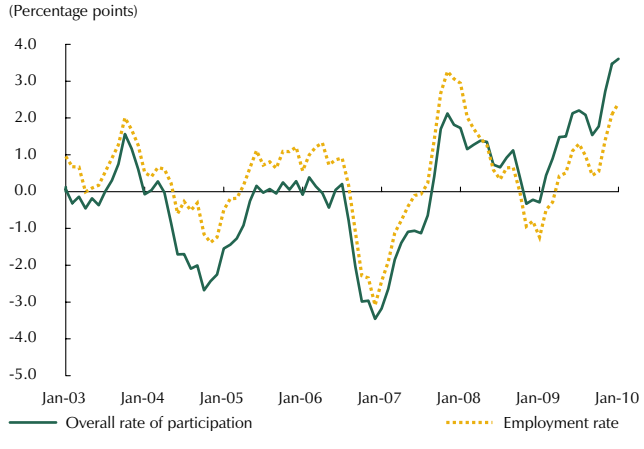
Nonetheless, as is usual with all predictions, this one has a margin of uncertainty since not all of the risks can be identified clearly. For 2010, the main risk may come from higher upswings than predicted in the international prices for commodities and in the exchange rate. A situation like that would tend to put pressure on domestic prices and prolong the increases for food and regulated prices generated by El Niño beyond 2010 and the beginning of 2011. In that case, the possibility that inflation would surpass the ceiling of the target rises significantly.

The risk of a downturn would be caused by the trade situation with Venezuela and its effect on domestic growth. In the scenarios of a greater reduction in exports and in view of the limited possibilities for replacing that market, the prices of tradables, non-tradables and even food could show lower adjustments or even reductions that were not taken into consideration in the forecasts. Some of this was seen in January and February when the prices for meat and some processed foods continued dropping. In this scenario, the probability that inflation will be in the lower part of the target range rises.

C. LABOR MARKET

The year 2009 was characterized by a deterioration in the labor market associated with the lower level of economic activity. As a result, household income and stability in employment were affected leading agents other than the head of the household to enter the labor market. This resulted in an increase of the unemployment rate (UR) during the year, since the labor supply broadly exceeded demand. Likewise, even though employment grew, its quality may have been affected as indicated by a possible increase in the underground employment.

Graph 29
Annual Change in the Global Rate of Participation and the Employment Rate (13 areas, quarterly moving average)



Source: DANE (GEIH).

Over the course of the year, the UR rose as a consequence of the increase in the labor supply (measured with the global rate of participation) which was not offset by an increase in demand[17] (measured by the employment rate). This situation did not change in the first month of 2010 (Graph 29). In addition, the labor market showed signs of deterioration with respect to the quality of employment created and the characteristics and duration of the unemployment.

According to the General Integrated Household Survey (GEIH in Spanish), the rise in the UR began in 2008 and conincided with the slowdown in production. In the first quarter of 2009, the unemployment situation became worse and caused the UR to hit, on average, 12.9% for the national total and 14% in the 13 main areas between January and March. In the second quarter of 2009, the UR showed a slight stabilization. However, in the third and fourth quarters, unemployment climbed again between October and December and reached an average of 11.3% for the national total and 12.3% in the 13 cities (figures that are 0.8 pp and 1.5 pp higher with respect to the fourth quarter of 2008). In January of 2010, the UR was at 14.6% for the national total and 15.3% in the 13 areas. Although these numbers are high, they represent an annual increase that is lower than that seen for all of 2009 (Table 8). Graph 30 illustrates the deterioration of unemployment (using the seasonally adjusted UR[18]) between 2008 and the last quarter of 2009. In January, the slowdown in UR was corroborated and its seasonally adjusted value slightly declined.

Labor participation in Colombia has been determined by the employment stability of the head of the household and by the household income, the

17 This situation is common to all of the GEIH domains (national total, remainder [also called the rural area], main cities and, among them, the 13 main metropolitan areas). However, given the better quality of the information available, there will be special emphasis on the thirteen main areas in this report.

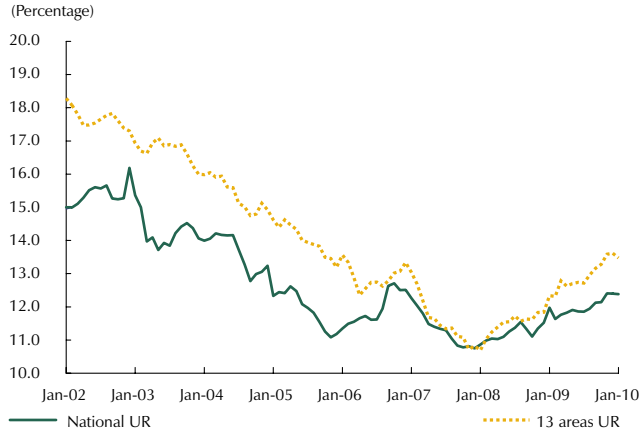
18 The information about the labor market usually has problems with seasonal adjustment. For example, the UR is usually high at the beginning of the year and tends to decline over the rest of the year. Therefore, it is advisable to analyze the seasonally adjusted series.

Table 8
Unemployment Rate

	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	January, 2010
			National total		
2008	12.1	11.1	11.4	10.5	
2009	12.9	11.7	12.2	11.3	14.2
2010					14.6
			13 areas		
2008	12.3	11.6	11.5	10.7	
2009	14.0	12.8	13.0	12.3	14.9
2010					15.3

Source: DANE, (GEIH).

Graph 30
Unemployment Rate
(quarterly moving average, seasonally adjusted series)



Source: DANE (GEIH), Banco de la República calculations.

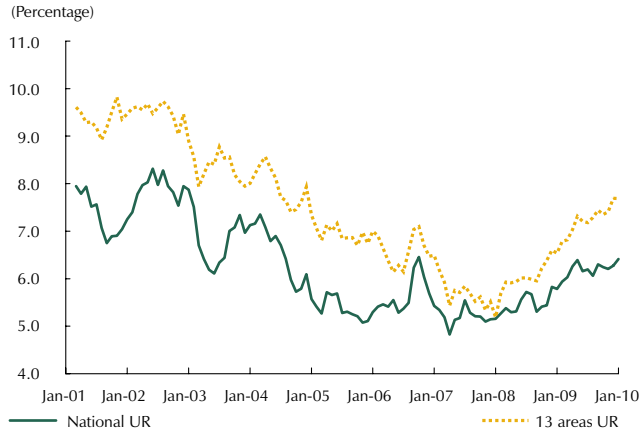
factors that were affected in 2009. This situation has been in effect since 2007 when the UR for heads of households began to rise significantly not only in the national total but also in the 13 areas (Graph 31). Once the employment stability and quality for the head of the household is seen to be threatened, those who depend on him tend to abandon their regular activities and go out to look for a job. This situation seems to have gotten worse in 2009 as is shown by the direct relationship between the underemployment rate (UDR) for heads of households and the participation in the work force that people other than heads of households have (Graph 32).

Likewise, a fall in household income tends to increase the labor supply. According to the information registered up to the third quarter of 2009, and in spite of the contribution that the decline in inflation made to the real household income, these households were affected not only by the reduction in economic activity but also by a decline in the number of hours worked.[19] For the fourth quarter of the year, the upswing in the global rate of participation indicates that household income continues to be affected. Therefore, the growth of labor supply so far this year is mainly explained by the extra or additional workers that entered the market in order to stabilize the family income.

As was stated above, the growing labor supply was not totally absorbed by the economy in spite of the fact that the demand for laborers has expanded. According to GEIH, there was a significant increase in the number of

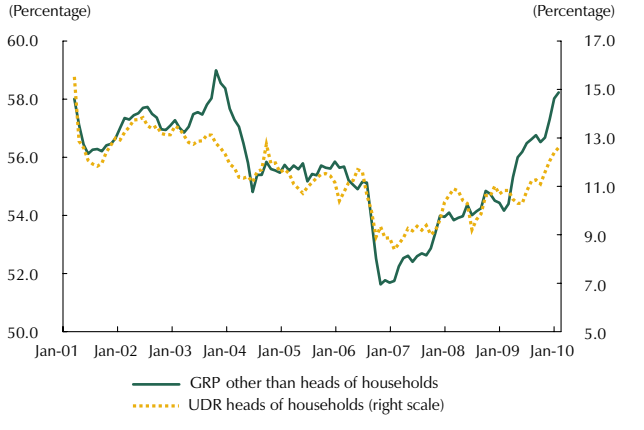
19 For example, the number of hours that employees without higher education worked showed an annual contraction starting in the second quarter of 2009. This would have had an impact on the reduction of their income, which is evident when the median of the total income is examined. This fell 5.4% annually in the second quarter and 1% annually in the third.

Graph 31
Unemployment Rate for Heads of Households
(quarterly moving average, seasonally adjusted series)



Source: DANE (GEIH), Banco de la República calculations.

Graph 32
Rate of Underemployment (UDR) for Heads of Households Compared to the Global Rate of Participation (GRP) of Agents Other than the Head of the Household (13 areas, quarterly moving average, seasonally adjusted series)



Note: The UDR corresponds to the rate of objective underemployment.
Source: DANE (GEIH), Banco de la República calculations.

employeeson both the national scale and in the 13 areas in the first half of 2009. Although it came to a standstill at this level in the third quarter, and a growing trend started up again in the fourth (Graph 33) when the number of people employed grew at an annual rate of 9.3% for the national total and of 5.6% for the 13 main metropolitan areas. In January of this year, employment continued growing.

Nevertheless, when employment is broken down by type of job, a deterioration in its quality is seen since non-salaried employment grew sharply while salaried employment came to a standstill in the second half of the year, especially in the fourth quarter (Graph 34). Given that the former type of employment is primarily self-employment –generally associated with jobs that are lower in quality, less stable and have little access to medical insurance and pension plans– it can be assumed that underground employment rose in Colombia during 2009. The performance of salaried employment, in turn, was consistent with the lower economic activity seen that year and with the increase in real salaries produced by the drop in inflation, especially towards the second half of 2009 and January, 2010 (Graph 35).

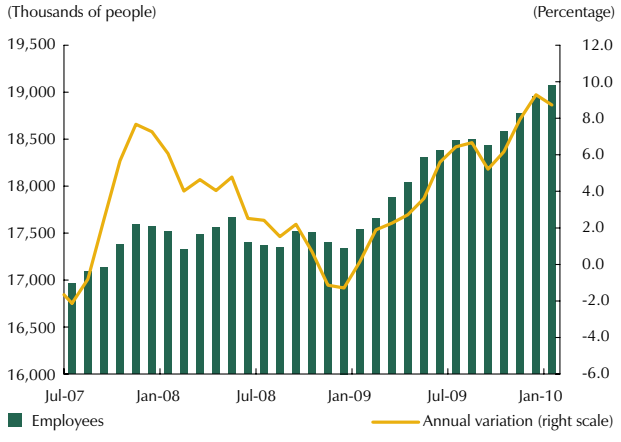
Furthermore, if the number of those employed is broken down by the level of education, what is found is that all of the employment created up to the third quarter of the year was concentrated in unskilled workers, or in other words, those with less than 12 years of education. In contrast, jobs requiring skilled workers decreased during the same period as the annual change in the number of employees based on skills shows (Graph 36).

Beyond the problems with the quality of employment, there are other indicators of the deterioration in the labor market conditions. In the first place, the nature of the new workers in the labor market is not encouraging since this new group of workers is made up of students or people who had been doing housework.[20] Thus, while there was a significant influx of students entering the labor market in the first half of 2009, which is a situation that affects the accumulation of human capital, the increase in the work force was primarily due to people who abandoned their work in the home in the second half of

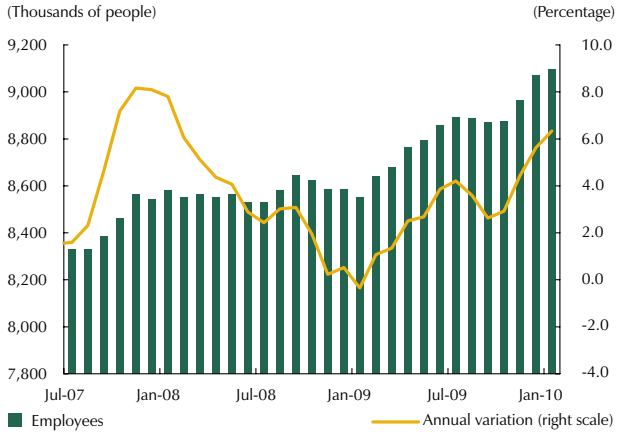
20 Just as has been shown for the 13 areas, the negative annual change in the number of people who are not working (those who are of working age but are not employed because they do not need a job, cannot work, or are not interested in having a remunerated activity). A negative change implies that people who were not interested or did not need to be involved in a productive activity have begun to look for work.

Graph 33

A. National Total of Employees (quarterly moving average, seasonally adjusted series)

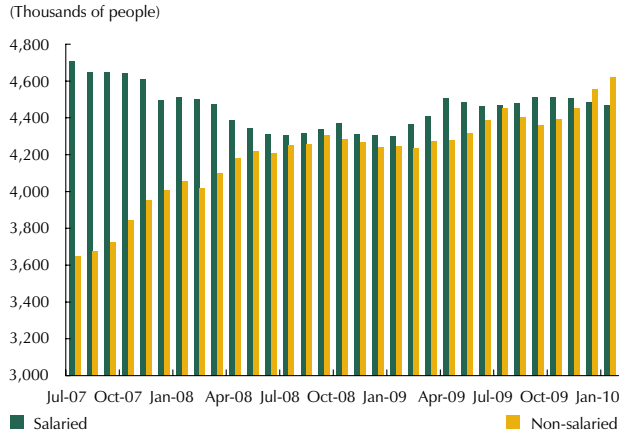


B. Jobholders in the 13 areas (quarterly moving average, seasonally adjusted series)



Note: The UDR corresponds to the rate of objective underemployment
Source: DANE (GEIH), Banco de la República calculations.

Graph 34
Employees by Type of Employment (13 areas, quarterly moving average, seasonally adjusted series)



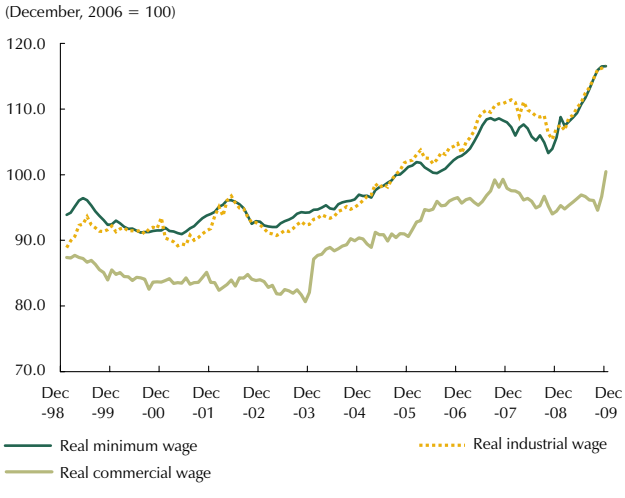
Source: DANE (GEIH), Banco de la República calculations.

the year and the beginning of 2010 (Graph 37). The experience in Colombia has shown that the flow of workers that come from those who had been taking care of their own homes usually end up working informally and their withdrawal from the active work force takes several quarters. The above agrees with the hypothesis that in 2009 informal work increased. Therefore, it should be expected that the participation of this segment of the population in the labor force will remain high in the medium term and will continue to put pressure on unemployment.

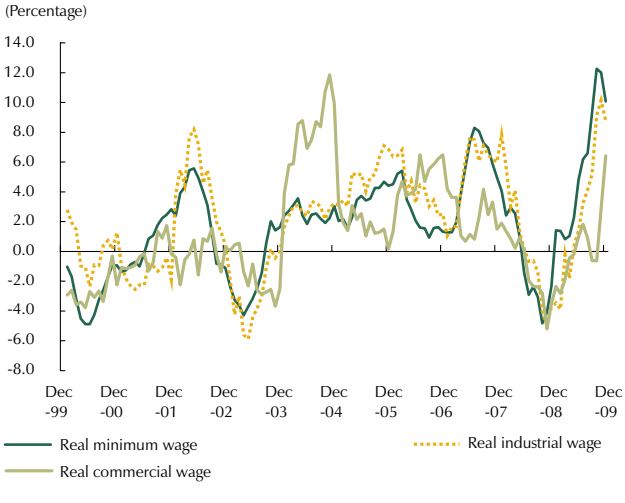
In the second place, when unemployment is broken down by age groups, the highest surge in the number of unemployed people was in the group of

Graph 35

A. Real Wages (seasonally adjusted series)

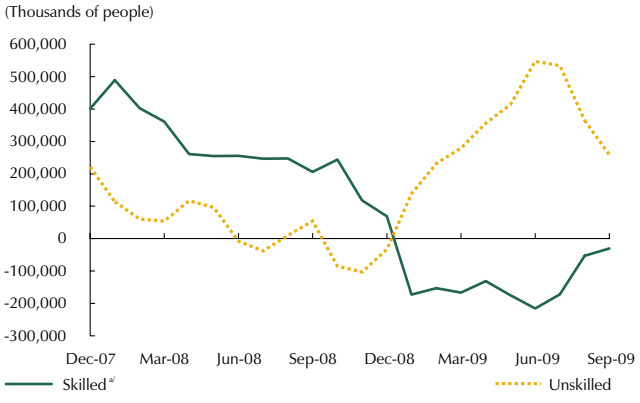


B. Annual Variation of Real Wages



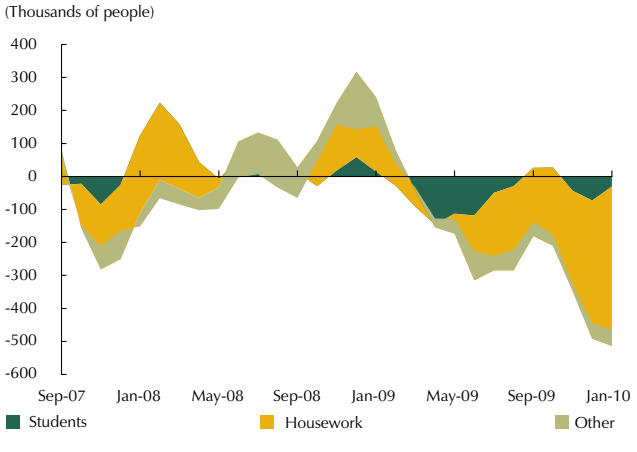
Note: The real minumum wage is calculated with the total CPI, the real industrial wage with the industrial PPI and the real commercial wage with the CPI.
Source: DANE and Ministry of Social Protection; Banco de la República calculations.

Graph 36
Annual Variation of People Employed
(13 areas, quarterly moving average)



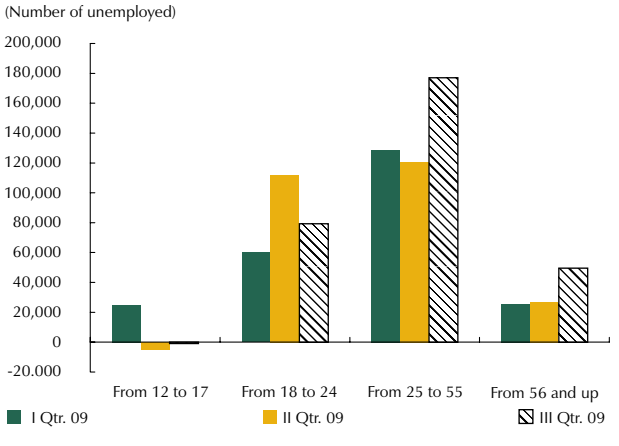
a/ With higher education
Source: DANE (GEIH), Banco de la República calculations.

Graph 37
Annual Variation of Non-workers
(13 areas, quarterly moving average)



Source: DANE (GEIH), Banco de la República calculations.

Graph 38
Annual Variation of Unemployed People by Age Group
(main cities)

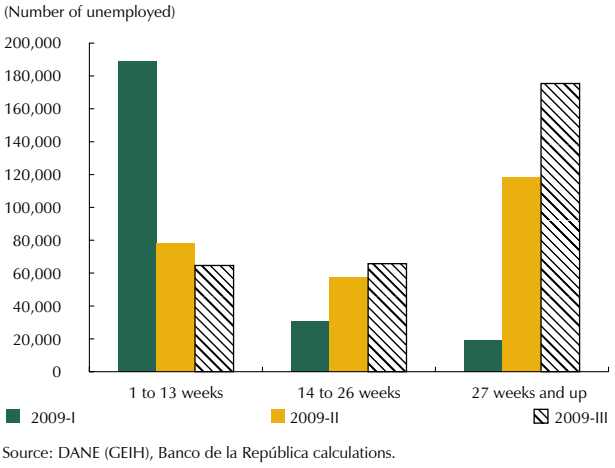


Source: DANE (GEIH), Banco de la República calculations.

people who are over 25 years of age. Thus, in the first three quarters of 2009, the absolute increase in the number of unemployed between 25 and 55 years of age was significantly higher than that seen for other age ranges (Graph 38). Furthermore, when the percentage variation is calculated, the population group in which the number of unemployed rose the most in proportion to its size is seen to be that of people who are over 56 years of age. In the third place, the concentration of unemployment began to move towards long term unemployment also called structural unemployment.[21] Thus, while in the first quarter of 2009, the number of new unemployed workers included mainly those who had looked for work for one to three weeks, in the next two quarters, the unemployed people began to concentrate in the group that had spent a higher number of weeks looking for a job. Thus, in the third quarter, a large proportion of those who were unemployed had been searching for work for more than 27 weeks (that is, more than six months) (Graph 39). Given that the people who remain unemployed usually have more difficulty finding a job and since they tend to lose their skills over time, this could have a negative impact on the labor productivity of the economy.

Finally, the relationship between the Fedesarrollo consumer confidence index (CCI) and the number of salaried jobs per inhabitant in the thirteen areas (which is ahead of the CCI by three months)

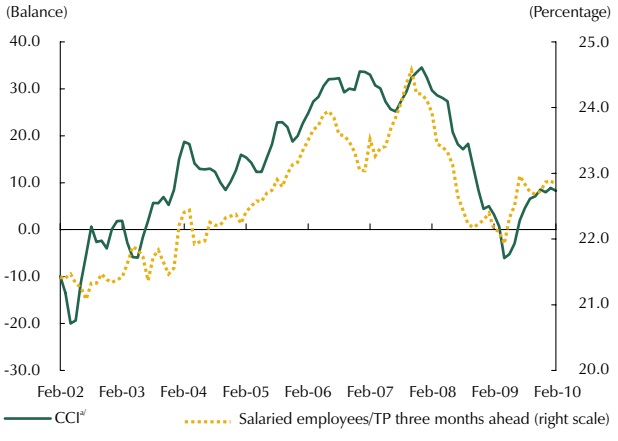
Graph 39
Weeks Looking for Work (main cities, annual variation)



Source: DANE (GEIH), Banco de la República calculations.

21 The annual change in the number of weeks spent looking for a job gives an indication of the length of unemployment.

Graph 40
Salaried Employees as a Proportion of the Total Population (TP) and CCI [a/] (13 areas, seasonally adjusted quarterly moving average)



a/ Fedesarrollo Consumer Confidence Index
Source: DANE and Fedesarrollo, Banco de la República calculations.

suggests that at the beginning of 2009, consumer confidence was affected by the lack of access to quality jobs (Graph 40). Although in the third quarter, confidence recovered together with the increase in the salaried positions per inhabitant, towards the end of 2009 and in January, 2010 both variables were far below the levels of the 2006-2008 period. This poor performance of the labor market could be an obstacle to the recovery of consumption in the short and medium term.

D. MONETARY POLICY AND THE FINANCIAL SECTOR

1. Monetary Policy Decisions in 2009

The steep plunge in the world economy became evident in the last quarter of 2008. After the bankruptcy of Lehman brothers, the majority of the countries began to show significant reductions in their economic growth and, in the case of developed economies, significant drops in their GDP.

In Colombia, one of the channels through which the international crisis was transmitted was the loss of confidence of both families and companies. This reduced consumption and investment and weakened productive activities, especially in industry and commerce. The impact of the crisis was also transmitted through the lower performance of exports, of the terms of trade and of remittances. As a result, at the end of 2008, the economic indicators for the country showed weakness in the aggregate demand at the same time as the inflation forecasts showed that this variable would drop to the target established for 2009 (between 4.5% and 5.5%).

Because of the above, the Board decided to make a change in the stance of the monetary policy by starting a reduction phase in the intervention interest rate. Thus, in December, 2008, the interest rate for overnight repos was reduced 50 bp and set at 9.5%. Between January and November, 2009 there were 600 bp in sequential reductions as a result of which, it went from 9.5% to 3.5%. The pace of the decline in the benchmark interest rate was faster in the first half of 2009 (500 bp). This was the period in which the GDP registered annual falls and inflation declined consecutively and more than was expected.[22] In the second half of the year, the reduction in the benchmark interest rate was 100 bp.[23]

22 The timetable for the reduction of rates in the first half of 2009 was: 50 bp in January, 100 bp each in February, March, April and May and 50 bp in June. Thus, towards the end of June, 2009, the benchmark interest rate was 4.5%.

23 Two reductions of 50 bp, one in September and another in November thus going from 4.5% to 3.5%.

The above decisions were based on an inflation that continued declining persistently as well as on the lower inflationary pressures. These were the result of the weakness of domestic and foreign demand, the lower inflation expectations and the slump in international prices for commodities. In the second half of the year, in addition to the above, there was a correction in the sharp depreciation of the exchange rate seen in the first half of 2009 and loan portfolio in national currency continued slowing down, especially the consumer and commercial loan portfolios. At the same time, Venezuela experienced a plunge in its domestic demand and increased the restrictions on imports. All of this suggested that the recovery of economic activity in Colombia was going to be slow.

The above outlook resulted in the adoption of another important decision. In October, 2009, the Board fixed the long term target as the inflation target for 2010 – between 2% and 4% with 3% as the specific target for legal purposes. In their announcement, the Board stated that the economic conditions would allow inflation to be within this range in the future. Concerning liquidity, they also decided that the majority of the monetary expansion at the end of 2009 would be done through the purchase of dollars or TES to the amount of three trillion pesos.

In their session on February 26 of the present year, the Board of Directors of Banco de la República decided to resume the accumulation of international reserves. On March 3, they announced that daily purchases of US$20 m would be made through competitive auctions over the course of this half of the year. The measure is a response to indications of misalignment in the exchange rate.

2. Trend of the Interest Rate in 2009

a. *Intervention Interest Rate and Interbank Interest Rate* (IIR)

As was mentioned, the Bank's intervention interest rate was lowered by 600 bp in 2009 as it went from 9.5% in December, 2008 to 3.5% in November, 2009. Although this reduction was transmitted to the IIR, the level of the latter was 45 bp lower than that of Banco de la República's interest rate towards the end of 2009 (Graph 41). The Bank's net debtor position with the financial system and the non-reserve interest-bearing deposits disabled unfunded explain the majority of this trend[24] (Graph 42). Because of this, in order to bring the level of the IIR closer to the policy rate, these auctions were opened again as of January, 2010. As a result, the deviation of the IIR was significantly corrected (14 bp on the average between February and March).[25]

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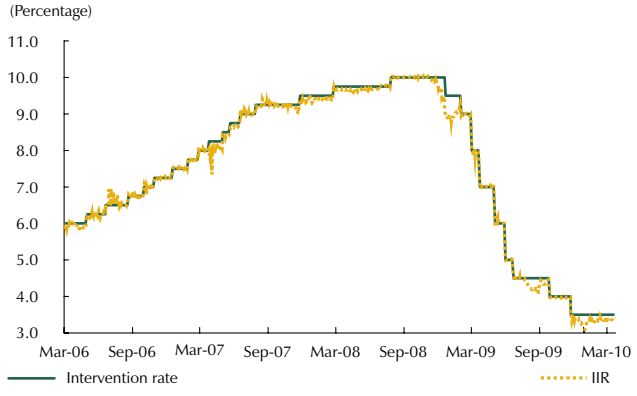
24 The same thing occurred towards the end of December, 2008 when Banco de la República also had a net debtor position with the financial system and the IIR was below the benchmark interest rate by close to 67 bp.

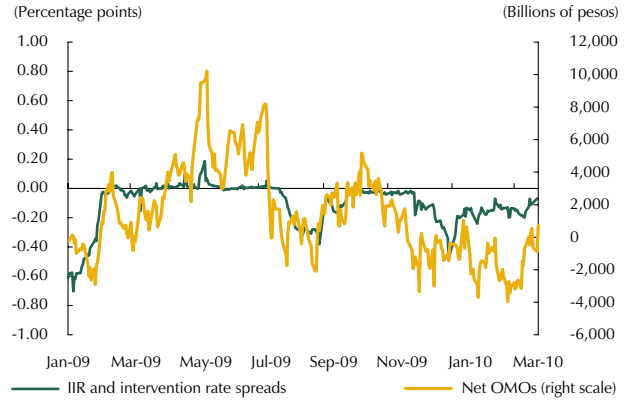
25 This average is calculated for the working days between February 1 and March 24.

Graph 41
Banco de La República Intervention Interest Rate and Interbank Interest Rate (IIR) 2006-2010 a/



a/ The figures correspond to data from work days. The latest datum corresponds to March 24, 2010.
Source: Financial Superintendence of Colombia and Banco de la República.

Graph 42
Difference Between the Interbank Interest Rate and Banco De La República Intervention Rate and the Net Creditor Position of the Banco de la República a/



Note: The latest datum corresponds to March 24, 2010
a/ The net creditor position of the Banco de la República is calculated as the difference between expansion repos and liquidity contraction deposits that are not part of the financial system bank reserves in the Banco de la República. If this difference is positive (negative), it means that the Banco de la República is a net creditor (net debtor) of the financial system.
Source: Banco de la República and Financial Superintendence of Colombia.

b. Interest Rate on Deposits

In 2009, the 600 bp reduction in the policy interest rate was almost completely transmitted to the interest rates on deposits in the market[26] (Graph 43). That year the DTF interest rates and CD deposit rates were reduced 581 bp and 569 bp respectively.[27] Towards the end of 2009, the first interest rate was at 3.92% and the second, at 4.21%.[28]

c. Interest Rates on Loans

The average interest rate for loans declined at a faster pace than the Bank's intervation rate. This was primarily due to the sharp slowdown in interest rates for commercial loans and, to a lesser degree, the reduction in those for loans granted to households (consumer and mortgage). The drop in inflation as well as that in inflation expectations also contributed to this trend. Thus, on December 30, 2009, the average lending rate[29] was at 9.63% which implied a reduction of 818 bp in comparison to that registered a year earlier (Graph 44A).

By type of loan, commercial loans were those that showed the greatest reduction in interest rates in 2009. This was partly explained by a high basis of comparison due to the international financial crisis. In fact, towards the end of 2008, the bankruptcy of Lehman Brothers raised the worldwide perception of risk. As a result, the major exporting companies faced a larger degree of uncertainty regarding the availability of financing. These facts, which Colombia was not free from, contributed to the increase in the interest rates for commercial loans towards the end of 2008. With that being the case, the reduction in the interest rates for commercial

26 To calculate the annual change in the deposit and lending interest rates, January 1, 2009 is used as the annual closing of 2008 and January 2, 2010 as the annual closing of 2009.

27 The DTF corresponds to the 90-day CD deposit rates in banks, financial corporations and commercial financing companies. The CD deposit rates correspond to all of the maturities reported by all of the credit establishments to the Financial Superintendence of Colombia.

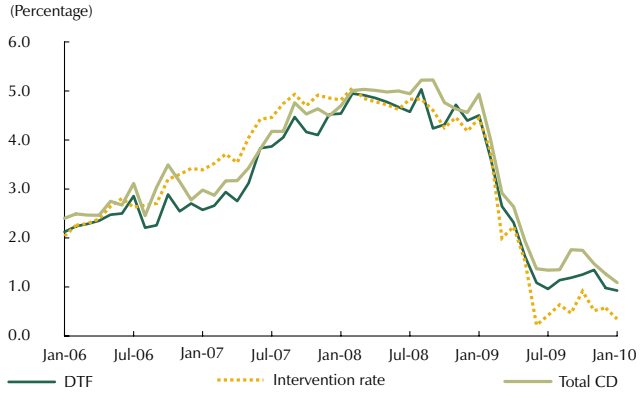
28 The December 30 DTF is the one that is in effect for the week after that (from the 4th to the 10th of January, 2010).

29 The lending rate calculated by the Banco de la República is obtained as the weighted average of the sum of the consumer, prime, ordinary and treasury rates. Due to the high turnover of Treasury loans, its weight is established as a fifth of its disbursement. Information about credit card interest rates, housing loans (builder and buyer) and micro-credit is not included within this calculation.

Graph 43
Deposit Interest Rates [a/] and the Banco de la República's Intervention Interest Rate

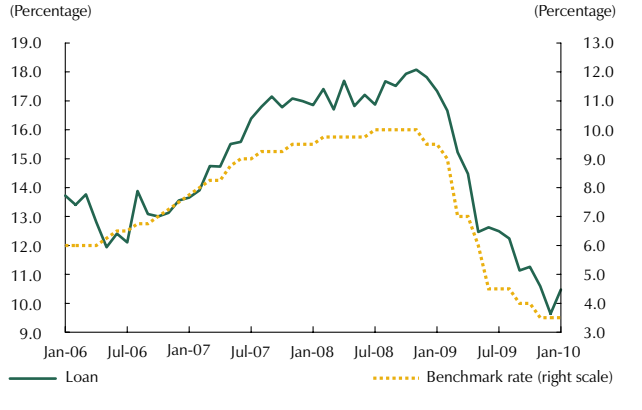
A. Nominal

B. Real [b/]



a/ This information corresponds to end-of-month data. The DTF is the rate at the moment the deposit is taken (operation) which takes effect the following week.
b/ For the real calculation, the variation of the CPI excluding food was used.
Sources: Financial Superintendence of Colombia, Banco de la República calculations.

Graph 44A
Nominal Banco de la República Intervention Interest Rates and Loan Interest Rates [a/]



a/ The data corresponds to the end of the month. The loan rate is the weighted average of the sum of the consumer, prime, ordinary and Treasury loan rates. Due to the high turn over of Treasury loans, their weighting is calculated using a fifth of their disbursement.
Source: Financial Superintendence of Colombia, Banco de la República calculations.

loans over the course of 2009 was due to not only the decline in the Bank's Intervention interest rates but also the normalization of credit risk.

The interest rate for the commercial loan portfolio went from 16.85% in December, 2008 to 8.55% towards the end of December, 2009 thus completing a reduction of 830 bp (Graph 44B).[30] Within this modality, the interest rate for Treasury loans in the same period was the one that declined the most when it went from 15.65% to 6.47% (-918 bp). The rate for loans followed (-786 bp) and ordinary ones (-784 bp). The rates for these fell in the same order from 15.56% to 7.70% and from 17.85% to 10.01%.

In 2009, the interest rates for loans granted to households also declined but at a slower pace than the intervention interest rate. In December, 2009, the interest rate for consumer loans[31] was at 20.23% a level that was 530 bp lower than that registered a year previously. The rate for credit cards[32] declined 534 bp and towards the end of December last year, it stood at 25.21% (Graph 44C). With respect to the interest rate for housing loans, which went from 17.45% in December, 2008 to 13.93% for the same month in 2009, the decline was 352 bp. Finally the interest rate for micro-credit remained, on average, at levels similar to those seen in 2008, thus becoming the one type of loan portfolio for which the interest rate did not drop in response to the reductions in the Bank's intervention interest rates (Graph 44D).

3. Changes in the Local Public Debt Market in 2009

In the year 2009, the zero coupon rates for TES denominated in pesos fell, on average, 552 bp, 334 bp and 229 bp between 1 and 2 years, between 2 and 5 years, and between 5 and 15 years respectively[33] (Graph 45).

30 Due to the high turnover in Treasury loans, its weight is established as a fifth of its disbursement.

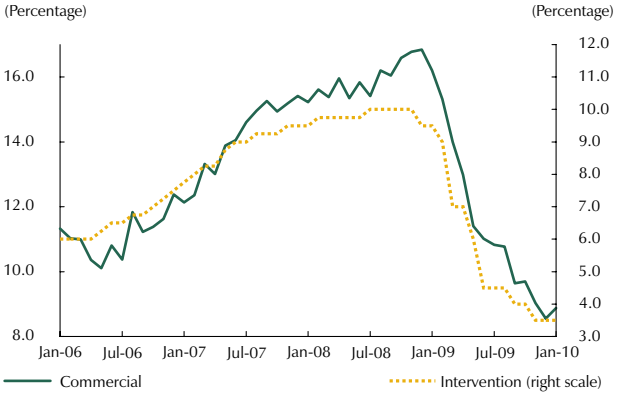
31 Excluding credit cards.

32 Excluding purchases at 1 month and cash advances.

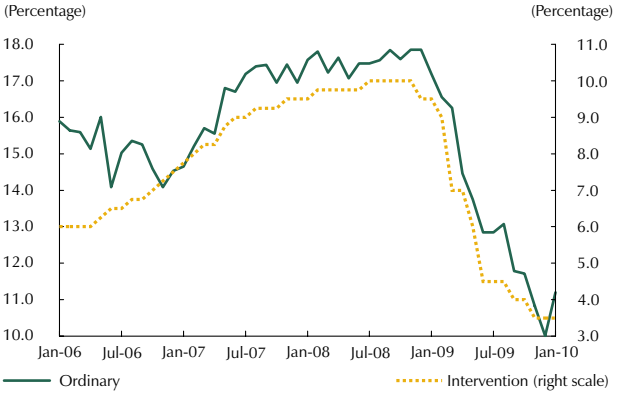
33 These data are extracted from zero-coupon curve for the fixed rate TES calculated by the Bank using the Nelson and Siegel methodology (1987).

Graph 44B

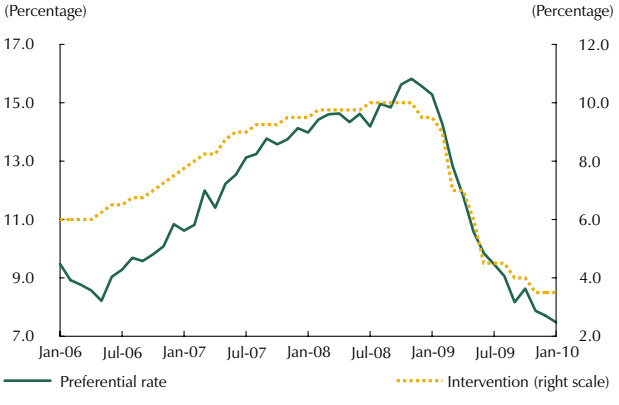
B1. Nominal Interest Rates for Commercial Loans and Banco de la República Intervention Rate [a/]



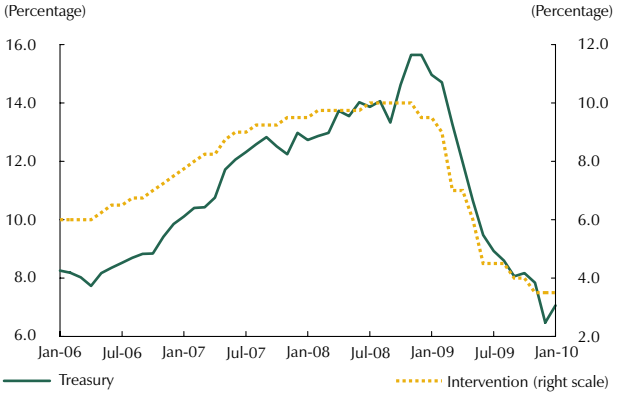
B2. Nominal Interest Rates for Ordinary Loans and Banco de la República Intervention Rate [a/]



B3. Nominal Interest Rates for Preferential Loans and Banco de la República Intervention Rate [a/]



B4. Nominal Interest Rates for Treasury Loans and Banco de la República Intervention Rate [a/]



a/ Data at the end of the monetary month.
b/ The interest rate does not include purchases at 1 month nor advances in cash.
Source: Financial Superintendence of Colombia and Banco de la República.

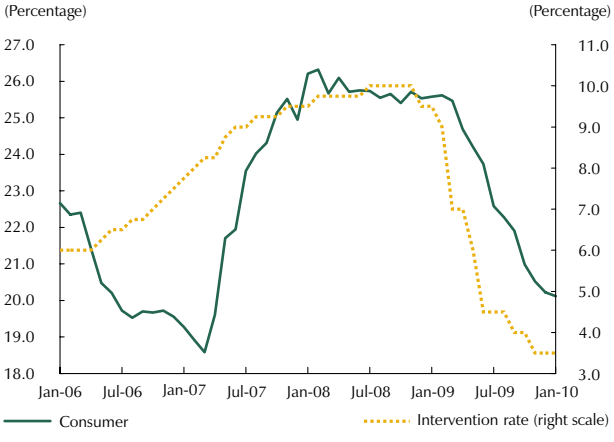
The general appreciation of the TES, especially the short term ones, occurred as the market agents incorporated the successive reductions that Banco de la República made in the intervention rate. The decline in the rates was also associated with the inflation data that became known over the course of the year and turned out to be lower than what was expected. Likewise, the surveys that were done by Banco de la República as well as the difference that developed between the rates for the fixed rate TES and the UVR TES demonstrated that inflation expectations had declined during 2009.

The improvement in the risk perception in view of the positive international environment also contributed to the downward trend of the TES rates. For example, in 2009 the *credit default swaps* (CDS) of Colombian 5 and 10 year debt registered declines of 166 bp and 172 bp respectively.

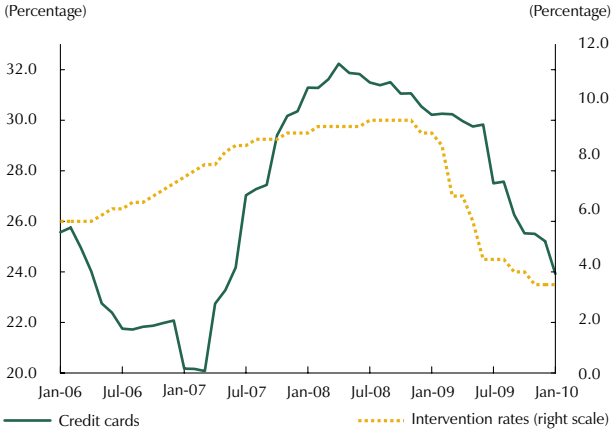
In November, the reduction in the rates was reinforced by the management operations for domestic debt carried out by the Ministry of the Treasury and Public Credit in order to prudently anticipate maturities for the year 2010.

Graph 44C

C1. Nominal Interest Rates for Consumer Loans and the Banco de la República Intervention Rate [a/]



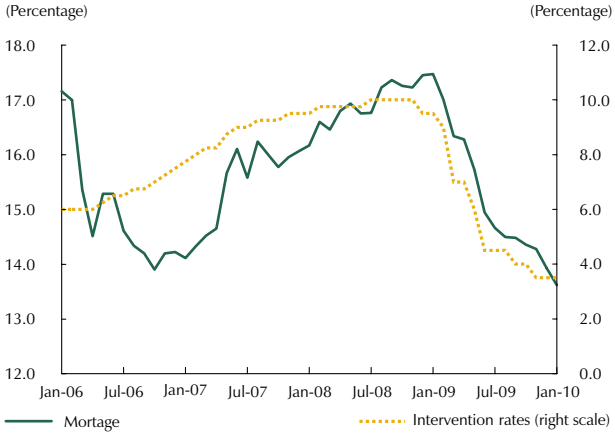
C2. Nominal Interest Rates for Credit Card Loans and Banco De La República Intervention Rates [a/b/]



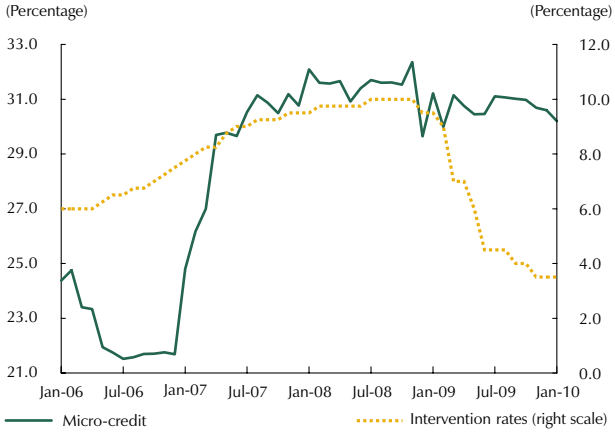
a/ The interest rate does not include purchases at 1 month nor advances in cash.
Sources: Financial Superintendence of Colombia and Banco de la República.

Graph 44D

D1. Nominal Interest Rates for Mortage Loans and Banco de la República Intervention Rates [a/b/]

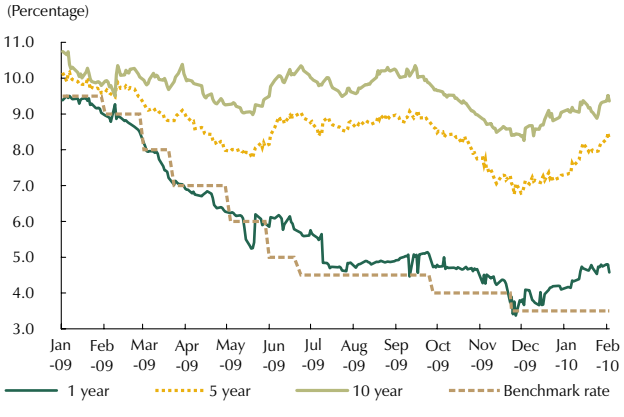


D2. Nominal Interest Rates for Micro-credits and Banco de la República Intervention Rates [b/]



a/ Data at the end of the monetary month.
b/ This corresponds to the interest rate for purchases of housing other than VIS.
Sources: Financial Superintendence of Colombia, DANE and Banco de la República.

Graph 45
Zero Coupon Peso TES Rate and the Intervention Rate



Sources: Colombian Electronic System for Negotiating and Electronic Market, Banco de la República calculations.

They were also affected by the rise in the demand for TES after the Board announced that the majority of the monetary expansion at the end of the year would be done through the purchase of dollars or of TES in the amount of COL$3 trillion (t).

4. Monetary Base, Credit and the Financial System's Sources of Financing

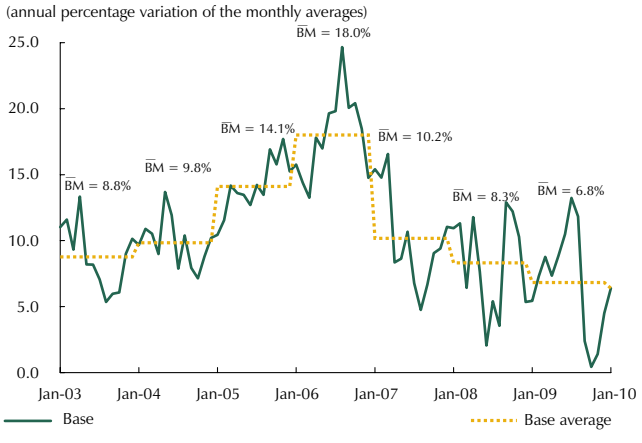
In the plans for current monetary management, the central bank takes responsibility for keeping the overnight interest rate at the level fixed by the Board and provides all the liquidity that the

agents need at that rate. This means that the trend of the monetary base is determined primarily by the needs of families and the financial system in the primary liquidity market while that of M3 is determined by the money demand decisions that agents make. The performance of credit, in turn, reflects the expenditure needs of consumers and companies.

a. Monetary Base: uses and sources

i. Uses

Graph 46
Real Monetary Base



Source: Banco de la República.

In 2009, the monetary base showed an average annual variation of 11.4%, which is equivalent to 6.8% in real terms (Graph 46). This real variation was close to 1.5 pp lower than that seen in 2008 and is the product of the higher real demand for cash and the lower real growth of the banking reserve.

Although the average nominal growth of the demand for cash in 2009 (8.8%) was similar to that seen in 2008 (8.6%), its real annual change in 2009 was 4.4%, or in other words, 2.9 pp above that of the previous year as a result of the drop in inflation. In 2009, there was a significant slowdown in economic activity that had a negative impact on the demand for cash, a phenomenon that was offset by lower interest rates and lower inflation.

The banking reserves, in turn, climbed 16.7% on average in nominal terms (11.9% real) in 2009. This figure is 16.3 pp lower with respect to the nominal growth seen in 2008 (12.4 pp of lower real growth). The lower growth was the result of the reserve requirement reduction measures that the Board adopted towards the end of 2008. This translated into a lower growth of the banking reserve balance in 2009.

ii. Sources of Base Expansion

The primary liquidity in the economy is supplied by the Bank through transactions with the rest of the agents, especially with financial entities. The Bank injects liquidity into the economy when it acquires assets (for example, TES or foreign currency) or loans resources to the financial system. Conversely, the Bank withdraws liquidity when it sells assets or allows the financial system to build up deposits in Banco de la República.

Between the end of 2008 and 2009, the monetary base rose COL$3.352 b with an annual growth of 9.3%. Based on Table 9 the main sources that supplied this liquidity in pesos in 2009 were:

1. Definitive net purchases and the maturity of the TES held by Banco de la República which totaled COL$2.444 b. This value includes COL$3

Table 9
Sources of the Monetary Base
Quarterly Variation
(billions of pesos)

	2008					2009				
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Total	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Total
I. Government	**(4,187)**	**271**	**2,936**	**4,539**	**3,559**	**(3,945)**	**(4,784)**	**2,474**	**6,424**	**169**
Transfer of profits [a/]	1,415	0	0	0	1,415	0	0	0	0	0
Pesos	1,415				1,415					0
Deposits in the Banco de la República	(5,602)	271	2,936	4,539	2,144	(3,945)	(4,784)	2,474	6,424	169
II. Regulation TES	**(147)**	**(993)**	**(0)**	**616**	**(524)**	**(501)**	**(20)**	**(4)**	**2.968**	**2.444**
Definitive purchases	0	0	0	625	625	0	0	0	3.000	3.000
Definitive sales	(137)	(823)	0	0	(960)	(499)	0	0	0	(499)
Matured	(10)	(170)	(0)	(9)	(189)	(1)	(20)	(4)	(32)	(57)
III. Banco de la República liquidity transactions	**(1,571)**	**733**	**(5,077)**	**693**	**(5,221)**	**1,698**	**5,438**	**(4,362)**	**(3,068)**	**(293)**
Expansion [b/]	(1,713)	1,102	(3,439)	193	(3,856)	1,194	4,484	(2,690)	(4,075)	(1,087)
Contraction	142	(369)	(1,638)	500	(1,365)	505	954	(1,672)	1,007	794
					0					0
IV. Foreign exchange [c/]	505	1,346	2,404	(356)	3,899	(460)	369	355	0	265
Put options to control volatility	505	422	0	5	932	429	369	355	0	1,154
Call options to control volatility	0	0	0	(535)	(535)	(888)	0	0	0	(888)
Options to accumulate reserves	0	798	0	0	798	0	0	0	0	0
Direct purchase auction	0	126	2,404	174	2,705	0	0	0	0	0
Discretional intervention	0	0	0	0	0	0	0	0	0	0
Foreign currency sold to the government	0	0	0	0	0	0	0	0	0	0
V. Other [d/]	**275**	**466**	**890**	**434**	**2,065**	**242**	**190**	**193**	**142**	**766**
Total change in the base	**(5,124)**	**1,823**	**1,154**	**5,925**	**3,778**	**(2,965)**	**1,194**	**(1,343)**	**6,466**	**3,352**
Balance of the monetary base	**27,290**	**29,114**	**30,268**	**36,193**	**36,193**	**33,228**	**34,422**	**33,078**	**39,545**	**39,545**

a/ On February 27, 2009 government revenue was transferred in dollars (US$320.4 b, or in other words, COL$818.6 b).
b/ Includes overnight repos, overnight and medium term repos.
c/ Excluding operations with international entities.
d/ The monetary effect of the Banco de la República's P and L as well as the monetary effect of the deposits resulting from debt and foreign portfolios are the main ones found under others.
Source: Banco de la República.

t in purchases that Banco de la República made in the market towards the end of 2009 as part of the program to supply the end-of-the-year liquidity that the Board had announced in October.

2. Net purchases of COL$265 b (US$171 m) in foreign currency that Banco de la República made in the foreign exchange market by exercising *put* (purchases of foreign currency) and *call* (sales of foreign currency) options to control exchange rate volatility.

3. Reducing the government deposits in Banco de la República by COL$169 b.

4. The increase of COL$766 b was explained by other factors among which the net expansionary effect of Banco de la República's P and L operations are found.

The above expansion was partly offset by the lower amount of liquidity granted by the Bank in operations with the financial system (COL$293 b). To be specific, the annual balance of repos declined COL$1.087 b in December, 2009 and that of the non-reserve interest-bearing deposits was COL$794 b lower.

b. Sources and Uses of the Financial System

i. Sources

The financial system's main sources of financing (or liabilities subject to reserve requirements LSR) are savings, checking accounts and CDs that families, companies and the government have in credit establishments.[34] These establishments utilize the deposits or LSR to grant loans or invest them in public (TES) or private securities. As will be explained in greater detail in this section, in 2009 the increase in the financial system's deposit was primarily used to purchase investments and, to a lesser degree, to increase the loan portfolio.

In 2009, the LSRs rose COL$12.706 b, which is equivalent to an annual growth rate of 8%. The deposit instrument that was the weakest was CDs which had an annual reduction of 1.4% while they had grown 36.7% in 2008. In contrast, the deposits for bonds and checking accounts were those that had the most growth with annual variations of 39.4% and 10.9% respectively. They were 5.5 pp and 5.3 pp higher, in that order, compared to 2008. Finally, deposits in savings accounts showed an annual change of 9.7% in 2009 which was similar to that seen a year previously (Table 10).

The trend of the LSR and the greater strength of cash explain the 7.6% annual growth of M3 in 2009 (9.8% in real terms) (Graph 47).

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34 Other sources of financing for the financial system are, for example, the issuing of bonds and short term loans acquired from Banco de la República through repos.

Table 10
Main Balance Sheet Accounts of Credit Establishments [a/]
(billions of pesos)

	Balances at the end of			Absolute annual variation		Annual percentage variation	
	Dec-07	Dec-08	Dec-09	Dec-08	Dec-09	Dec-08	Dec-09
Balances							
Assets							
Own cash position [b/]	3,315	1,708	1,246	(1,758)	(328)	(53,0)	(19,2)
Bank reserve	10,075	11,580	13,755	1,505	2,175	14,9	18,8
Banco de la República's OMO liabilities and non-reserve interest-bearing deposits	221	1,677	746	1,456	(931)	658,1	(55,5)
Total gross portfolio with leasing in national currency	117,600	138,607	144,450	21,007	5,843	17,9	4,2
Gross portfolio	106,675	126,046	131,149	19,371	5,104	18,2	4,0
Gross leasing portfolio	10,925	12,561	13,301	1,636	740	15,0	5,9
Investments	34,262	37,905	49,561	3,642	11,657	10,6	30,8
Other net assets (ONA) [c/]	(25,910)	(30,601)	(37,625)	(4,539)	(7,158)	17,5	23,4
Total	**139,564**	**160,877**	**172,134**	**21,313**	**11,257**	**15,3**	**7,0**
Liabilities							
Repos with Banco de la República	5,300	1,889	441	(3,411)	(1,448)	(64,4)	(76,7)
LSR	134,264	158,987	171,693	24,724	12,706	18,4	8,0
Savings	54,707	59,933	65,748	5,226	5,815	9,6	9,7
Checking accounts	23,022	24,313	26,967	1,291	2,654	5,6	10,9
CDs	43,990	60,130	59,312	16,140	(818)	36,7	(1,4)
Trust deposits	3,471	3,320	4,044	(150)	723	(4,3)	21,8
Demand deposits	2,754	2,691	3,554	(63)	863	(2,3)	32,1
Bonds	6,161	8,251	11,502	2,089	3,251	33,9	39,4
Repos with the real sector	158	350	567	192	217	121,5	62,1
Total	**139,564**	**160,877**	**172,134**	**21,313**	**11,257**	**15,3**	**7,0**

a/ To calculate the annual variations the following closings are taken: 2008; - January 1, 2009; 2009; January 2, 2010. Bancoldex and Findeter are included in the special financial entities.
b/ Excluding stock brokers. Absolute variations correspond to variations in dollars multiplied by average exchange rate for the period.
c/ The variation of the other net assets brings together the changes in asset, liability and equity accounts (including the profits from the period) which are not differentiated in this Table together with the changes in the Bank's own cash position, which are not explained by the variation in the account balance.
Sources: Financial Superintendence of Colombia Weekly Format 281, Banco de la República calculations

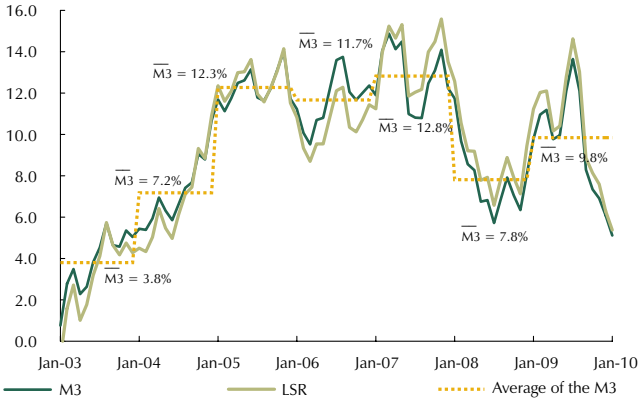
In Table 11 the figures for the M3 are differentiated into private and public sectors. As of the year closing in December, 2009, the annual growth of the private M3 was 8.6% and the public, 3%. Comparing these results with the average changes over the year, a significant slowdown in the last part of the year can be seen.

ii Uses

In 2009, there was a change in the composition of the assets held by the credit establishments which favored the increase in the investment balance (Table 10 and Graph 48). Specifically, this balance showed an annual change

Graph 47
Real Broad M3 Aggregate

(annual percentage variation of the monthly average)



Source: Banco de la República.

of COL$11.657 b (30.8%) while the increase in the balance of the gross loan portfolio in national currency was COL$5.843 b (4.2%). Both the increase in investment and that of the loan portfolio was financed by the higher LSR (COL$12.706 b) and by the credit establishments' profits, which has risen to COL$5.568 b in 2009. The latter had net profits[35] due to the investment valuation of COL$3.664 b.

The balance of the gross loan portfolio in national currency held by credit establishments rose COL$5.843 b in 2009. However, if the loans written off the portfolio[36] and the higher securitizations[37] are included, that annual variation will rise to COL$9.014 b, which is equivalent to 6.5% annually.

As has been mentioned in previous reports, between 2005 and 2007, a vigorous expansion of credit in legal currency was registered. During this period, the total, adjusted gross loan portfolio[38] grew an annual average of 23.4% (in nominal terms), a record that surpassed the rise in the nominal GDP for those years by more than double. This expansion was strongest in the consumer loan portfolio which had an average annual growth of 41.4% during that period. Later, between 2008 and 2009, the total gross loan portfolio went into a slowdown phase and registered, in that order, average annual rises of 21.2% and 12.2%. In these last two years, the consumer portfolio was the one that showed the steepest fall in its pace of growth with an average annual growth of 22.8% and 4.1% respectively.

At the end of 2009, the sharpest slowdown in the loan portfolio in national currency occurred in the consumer and commercial loan portfolios which, in nominal terms, reported annual variations of 1.3% and 3.5% respectively in comparison with 12.2% and 20.4% a year prior to that. The annual growth of the adjusted mortgage portfolio with securitization, in turn, was 18.2% in nominal terms. This figure is 1.4 pp above that registered the previous year. Finally, the nominal annual increase for the micro-credit portfolio was 24.6% at the end of last year[39] (Table 12).

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35 The profits are incorporated into other net assets (ONA). Specifically, they are recorded in the entities' equity and this latter data is entered as a negative value in the ONA balances.

36 This refers to the value of the portfolio written off the entities' balances when they consider them irrecoverable or lost in accordance with the legal requirements in effect. In 2009 their annual variation came to COL$1.997 b.

37 This corresponds to the sales of this type of portfolio to the Colombian Mortgage Securitization Company and its value is removed from the balances of these credit establishments (See note a/ Table 12). The net balance of mortgage portfolio securitizations rose almost COL$1.173 b in 2009.

38 The adjustment is done on the mortgage portfolio to include the securitizations.

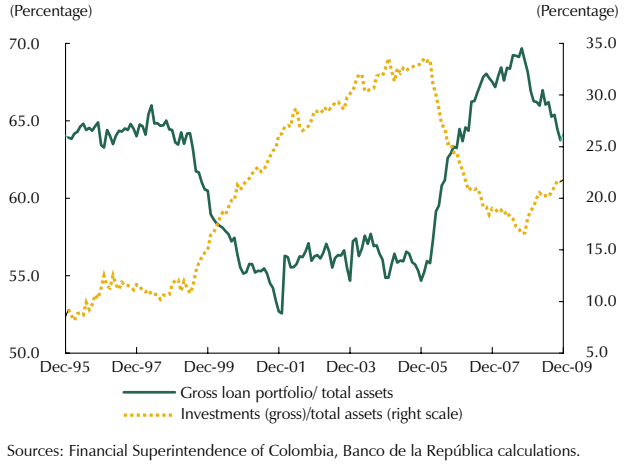
39 The change in the micro-credit portfolio has a statistical effect incorporated since the credit establishments should reclassify some current loans into this category. That is why the balance for these loans rose significantly in 2008 (Decree 919, 2009).

Table 11
Broad Money: Public and Private M3
(billions of pesos)

	Balances as of December		Percentage variation
	2008	2009	
Private M3	**153,786**	**166,938**	**8.6**
Cash	24,371	25,688	5.4
LSR	129,415	141,250	9,.1
Checking accounts	18,012	19,829	10.1
CDs	56,313	55,975	(0.6)
Savings	45,168	51,868	14.8
Others	8,313	12,237	47.2
Public M3	**29,675**	**30,555**	**3.0**
Checking accounts	6,899	7,156	3.7
CDs	3,761	3,326	(11.6)
Savings	13,467	13,913	3.3
Others	6,900	6,932	0.5
Total M3	**183,461**	**197,492**	**7.6**
Cash	24,371	25,688	5.4
LSR	159,090	171,804	8.0
Checking accounts	24,911	26,984	8.3
CDs	60,074	59,301	(1.3)
Savings	58,635	65,781	12,2
Others	15,470	19,738	27,6

Sources: Banco de la República and Financial Superintendence of Colombia.

Graph 48
Percentage of Gross Investments and Loan Portfolio (Gross) as a Share of the Total Assets of Credit Establishments



Sources: Financial Superintendence of Colombia, Banco de la República calculations.

In real terms, the total loan portfolio continued slowing down significantly just as it had been since the beginning of 2007. In 2009, the average annual real growth for the gross loan portfolio was 5.1% and as of December it was 0.4%, figures that are 8.1 and 9.0 pp lower compared to those registered the year before. The lower economic activity led mainly to a slowdown in the momentum of the commercial[40] and consumer loan portfolios. The first registered a real drop of 1.6% annually in December, 2009 in comparison to an increase of 12.9% the previous year. The expansion of the consumer loan portfolio, in turn, showed a deterioration when it went from 4.1% in 2008 to -0.4% in December, 2009.

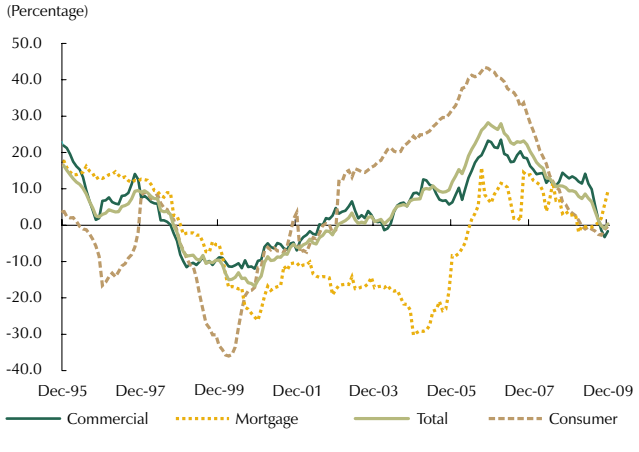
40 The commercial portfolio represented 55.0% of the total portfolio in December, 2009.

Table 12
Financial System Gross Loan Portfolio [a/]

	Balance in billions of pesos end of December			Annual percentage growth end of December		
	2007	2008	2009	2007	2008	2009
Based on the balances of credit establishments						
A. National currency (n/c)	**117,600**	**138,607**	**144,450**	**25.1**	**17.9**	**4.2**
Commercial	69,527	83,730	86,681	20.9	20.4	3.5
Consumer	36,225	40,649	41,198	35.8	12.2	1.3
Mortgage	9,866	11,144	12,730	24.0	12.9	14.2
Micro-credit	1,982	3,083	3,842	17.6	55.6	24.6
B. Foreign currency (f/c)	**6,553**	**7,550**	**4,720**	**70.9**	**15.2**	**(37.5)**
Total (A+B)	**124,153**	**146,157**	**149,171**	**26.8**	**17.7**	**2.1**
Adjustment by securitization [b/]						
Adjusted mortgage portfolio	12,949	15,125	17,884	22.2	16.8	18.2
Portfolio in national currency adjusted by securitizations	120,683	142,589	149,605	25.1	18.2	4.9
Total portfolio (n/c + f/c) adjusted by securitizations	127,236	150,139	154,325	26.8	18.0	2.8

a/ Excluding FEN, special financial entities, and entities in the process of liquidating. To calculate the annual variations, the following closings were taken: 2008 - January 1, 2009 and 2009 - January 2, 2010.
b/ The mortgage securitizations correspond to the sales of this type of portfolio that are made to the Colombian Mortgage Securitization Company. Therefore, this value is subtracted from the balances of the credit establishments' mortgage portfolio and later appears as an investment in securities derived from the securitization process.
Sources: Financial Superintendence of Colombia Weekly Format 281, Banco de la República calculations.

Graph 49
Real Annual Growth of the Gross Loan Portfolio by Type



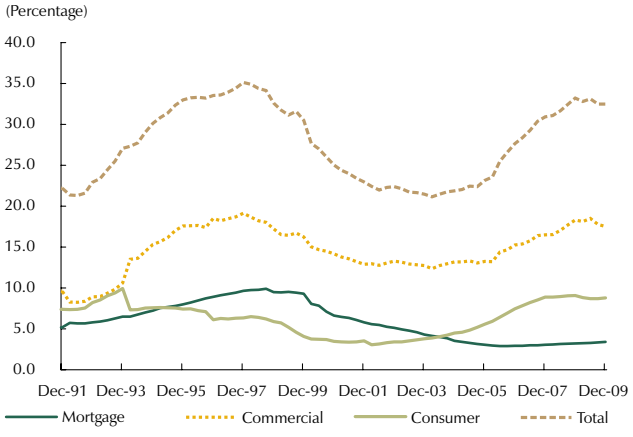
Sources: Financial Superintendence of Colombia, Banco de la República calculations.

Over the past year, the mortgage portfolio showed a recovery in its growth by going from an increase of 2.7% in December, 2008 to 9.2% a year later (Graph 49). This trend was partly the result of the upswing in the demand for housing which was generated by the different subsidies in interest rates granted by the government.

Over the course of 2009, the financial deepening index, measured as the ratio of the loan portfolio to the GDP, declined slightly as it went from 33.2% in December, 2008 to 32.5% in the same month in 2009. This trend is explained by the commercial and consumer loan portfolios for which this indicator went from 18.3% to 17.5% and from 9.1% to 8.8% respectively. However, for the mortgage modality, the financial deepening indicator rose 21 bp and stood at 3.4% in December last year. It should be noted that, except for the mortgage portfolio, the levels of these indicators are still above those registered during the period right after the crisis in the latter part of the nineties (Graph 50).

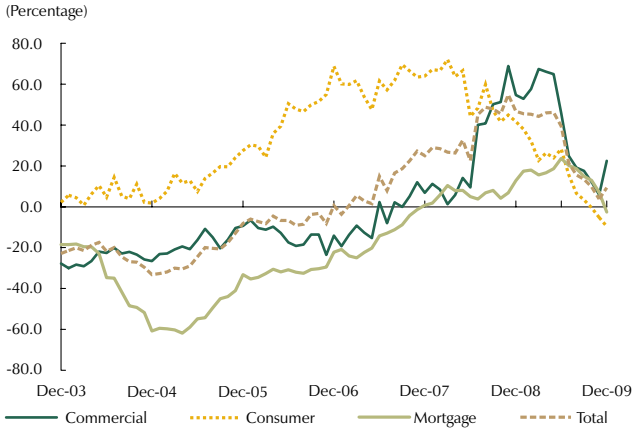
With respect to the quality of the loan portfolio, those that are assigned a rating that is other than A are called risky. As of December, the risky loan portfolio had

Graph 50
Financial Depth (Loan Portfolio/GDP)



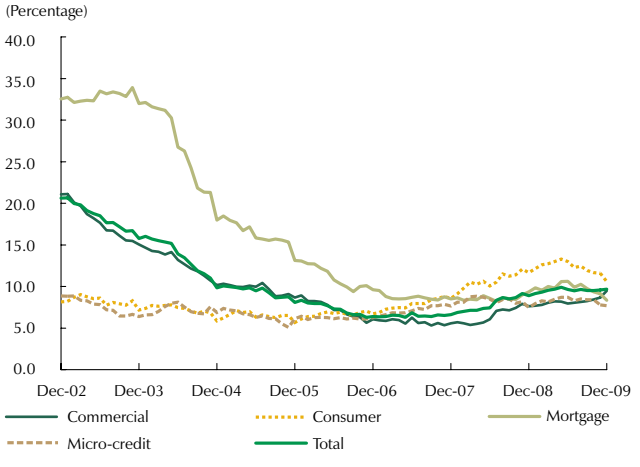
Sources: Financial Superintendence of Colombia and DANE, Banco de la República calculations.

Graph 51
Real Growth of the Risky Loan Portfolio



Sources: Financial Superintendence de Colombia, Banco de la República calculations.

Graph 52
Portfolio Quality by Type of Loan
(risky loan portfolio/gross loan portfolio)



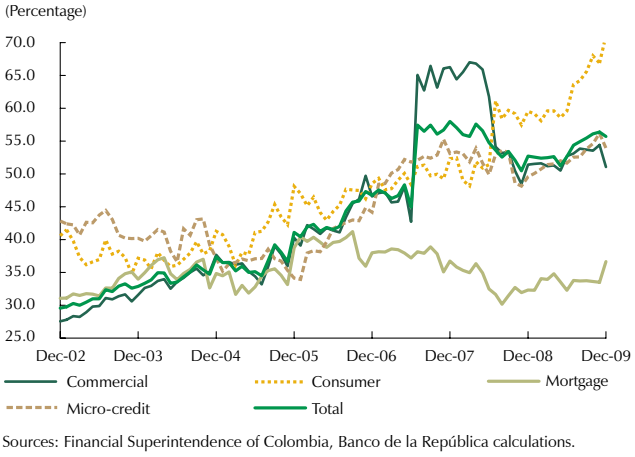
Sources: Financial Superintendence de Colombia, Banco de la República calculations.

a real annual growth of 9.3%, that is 37.4 pp less than the real annual change from the year before (Graph 51). By modality, the risky portfolio, which showed the strongest slowdown in its real annual pace of growth between the end of 2008 and 2009, was the consumer portfolio which went from growing 41.6% to -9.6%.[41] Between the same dates, the commercial portfolio went from 54.7% to 22.4% and the mortgage one from 12.7% to -2.5%.

The portfolio quality indicator (QI), measured as the ratio of risky loan portfolio to the gross loan portfolio, stayed relatively constant in 2009. By modality, an improvement in the QI of the consumer and mortgage portfolios was seen. In fact, between December 2008 and the same month in 2009, the QI for the consumer portfolio went from 11.7% to 10.6% and the mortgage portfolio went from 9.3% to 8.3%. Almost the opposite happened to the commercial portfolio which saw its QI climb as it went from 7.6% to 9.5% (Graph 52).

Between the end of 2008 and the end of 2009, the loan portfolio coverage indicator, measured as the ratio of the provisions to risky portfolio, rose 3 pp as it went from 52.7% to 55.7%. This was due to the steeper fall in the growth of the risky portfolio in relationship to the growth of the provisions (Graph 53). Between the same dates, the consumer, mortgage

Graph 53
Coverage Indicator
(provisions/risky loan portfolio)



Sources: Financial Superintendence of Colombia, Banco de la República calculations.

41 The sharp upsurge in loans seen between 2005 and 2007 occurred mainly in consumption, a loan portfolio that was largely funded by the financial system. In 2009, several credit entities wrote off the bad loan portfolio that had been provisioned in their balances. This partly explains the improvements in the loan portfolio indicators.

and commercial loan portfolios exhibited hikes in that indicator of 13.6 pp, 4.7 pp and 2.6 pp respectively and stood at 71.0%, 36.6% and 51.1%, in the same order, last December.

With respect to the profitability indicator for the financial system ROA,[42] This was relatively constant at 2.4% in 2009. The solvency relationship, in turn, remained above the average for the decade (13.5%) and reached a level of 14.9% in December that year. This figure is 1.3 pp higher than that registered during the same month in 2008. The performance of this indicator suggests that the financial brokerage activities are not restricted by capital requirements.

The low interest rates and liquidity conditions in the market favor other sources of financing for large companies such as, for example, issuing bonds. Specifically, the placing of bonds, commercial paper and credit securities by the real sector through the Colombian Stock Market (CSM) amounted to COL$7.469 b in 2009 in comparison with the COL$1.787 b in 2008 (Table 13).

Table 13
Issuing of bonds, commercial paper and credit securities by the real sector through the Colombian Stock Market, 2008-2009
(billions of pesos)

	Total placed	
	2009	2008
1. Total bonds	5,632	1,130
2. Total commercial paper	340	657
3. Credit securities	1,497	0
Total placed	7,469	1,787

Source: Colombian Stock Market.

In the March 2010 *Report on Financial Stability*, a detailed and up to date analysis is given of the different risks that the financial system faces.

E. FOREIGN SECTOR

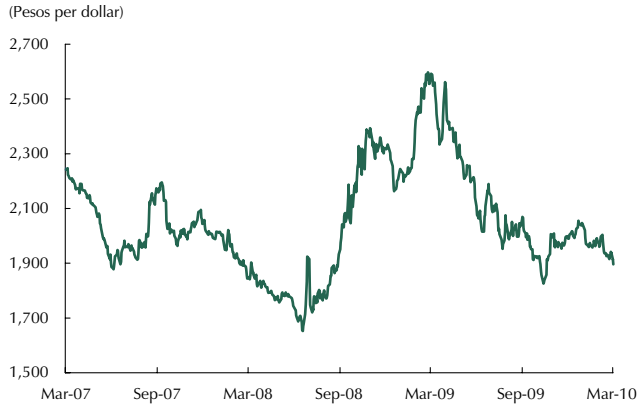
1. Development in the Exchange Rate in 2009

a. Nominal Exchange Rate

Throughout most of 2009, the nominal exchange rate (peso/dollar) appreciated. Nevertheless, the depreciation at the beginning of the year caused the Colombian peso to depreciate an average of 9.4% (Graph 54). At the end of last year, the exchange rate was at COL$2,044 per dollar which, when it is compared to the level reached in December, 2008 (COL$2,244 per dollar), implied a nominal

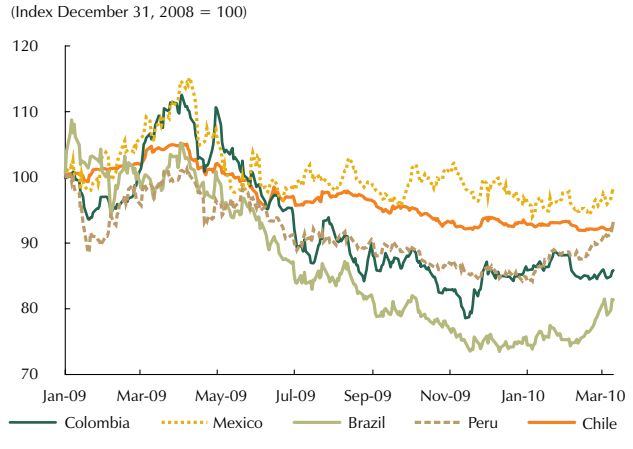
42 The ROA is defined as the ratio between profit and average asset.

Graph 54
Nominal Exchange Rate



Source: Banco de la República.

Graph 55
Nominal Exchange Rate Indices for Latin American Countries



Sources: Bloomberg, Banco de la República calculations.

appreciation of 8.9% annually[43] (Graph 54). This was above that registered by Mexico's and Peru's currencies (5% and 8%) and below the appreciation of Chile's and Brazil's (21% and 25%) (Graph 55 and Table 14).

The trend of the exchange rate throughout 2009 was heterogenous given that the factors that determined it in each period were different. In the first two months of 2009, the exchange rate continued rising just as it had been doing since mid-2008 due to the high levels of risk aversion that existed at that time. From the end of February to about mid-October, the exchange rate showed a downward trend and began to register, after the Brazilian real, the highest year-to-date appreciation in the region.[44] The appreciation of the currencies was associated with the weakening of the dollar on the international level (as the figures that gave signs of stabilization in the world economy were published[45]), the increase in the prices for commodities which had fallen in the second half of 2008 (Graph 56) and the reduction in the risk premiums for countries in the region (Graph 57).

In the last quarter of 2009, the dollar became stronger internationally and the appreciation trend reversed for several currencies in the region.[46] The Colombian peso showed a larger depreciation than that seen in neighboring countries due to: i) announcements by the national government not to monetize for the rest of 2009, to eliminate the tariffs on imports of commodities that are not produced in Colombia until the end of the year and to retain the Ecopetrol payments to the government in accounts abroad, and ii) the announcement of the Board in their October meeting that they would supply the majority of the end-of-the-year monetary expansion through the purchase of dollars or TES in the amount of COL$3.0 t.

43 Calculated with the market exchange rate (TRM in Spanish)) that is in effect on the last day of 2008 and of 2009.

44 Up until October 13, 2009 Brazil's currency had appreciated 26%, Colombia's 19%, Chile's 14%, Peru's 9% and Mexico's 5%.

45 The pace of the contraction of the GDP of the main economies stopped towards the end of the year with economic growth that was higher than expected by the market. In addition, the confidence indicators and the real estate and industrial sector indicators maintained a rising trend.

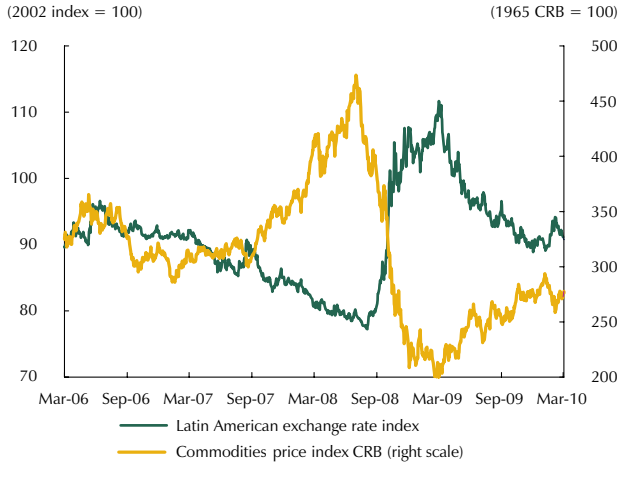
46 Between October 13 and December 30, 2009, Colombian currency depreciated 12%. Brazilian and Chilean currency depreciated 1% and Mexican 0%.

Table 14
Percentage Variation of the Nominal Exchange Rate: Foreign Currency Compared to the Dollar [a/]

	2003-2008	2009 Average Compared to the 2008 Average	End of Year 2009 Compared to End of Year 2008	Year up to March, 2010 Compared to December, 2009
Euro zone	(26.3)	4.7	(2.0)	4.7
Mexico	32.6	21.0	(4.9)	(0.1)
Peru	(10.3)	2.9	(8.1)	(0.9)
Colombia	**(21.1)**	**9.4**	**(8.9)**	**(3.3)**
United Kingdom	10.6	16.7	(10.4)	3.0
Chile	(10.6)	6.7	(21.0)	2.7
Brazil	(34.0)	8.7	(25.2)	3.0

a/ Negative indicates revaluation
Source: Bloomberg.

Graph 56
Commodities Price Index (CRB[a/]) and Latin American Exchange Rate Index (LACI[b/])



a/ Commodities Research Bureau
b/ Index created by JP Morgan that captures the trend of Latin American currencies. It corresponds to an average, weighted by liquidity and operations, of the spot rate for the currencies of six countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru). On this graph, the evolution of the quotient 1/LACI is taken to be comparable to the rate calculated for Colombia (pesos per dollar).
Source: Bloomberg, Banco de la República calculations.

Graph 57
EMBI + Colombia and Latin America

Source: Bloomberg.

With respect to Banco de la República's intervention in the foreign exchange market, the Bank sold US$368.5 m between January and February, 2009 when the conditions were right for auctions of *call* options to control volatility. Between March and July, in turn, auctions of put options were activated and Banco de la República made purchases of US$539.4 m. Thus, the central bank made net purchases of US$171 m in the local foreign exchange market in 2009 (Table 15).

b. Real exchange rate

As has been mentioned in previous *Reports to Congress* and in various publications issued by Banco de la República,[47] it is necessary to keep in mind the changes in foreign and domestic prices in order to measure the implications that the performance of the Colombian peso has on the country's competitiveness. The real exchange rate (RER) that compares the foreign and domestic inflation in the same currency could be interpreted as a differential of production costs or as changes in the competitiveness of two economies. The RER can be calculated bilaterally with respect to each country which we trade or compete with and can be aggregated in a multilateral measurement which gives information about the country's competitiveness compared to the trading partners as a whole or to competitors in third markets.

47 See the Reports to Congress for July 2008, March 2009, and July 2009 and Bank Reports for October, 2009.

Table 15
Banco de la República Purchases and Sales of Foreign Currency
(millions of dollars)

Item	Acumulated Jan-Dec 2008	2009								
		Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	August to December	Accumulated as of December
Purchases	**2.381.3**	**0.0**	**0.0**	**179.9**	**0.0**	**0.0**	**180.0**	**179.5**	**0.0**	**539.4**
Put options	**965.5**	**0.0**	**0.0**	**179.9**	**0.0**	**0.0**	**180.0**	**179.5**	**0.0**	**539.4**
To accumulate international reserves	450.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
To control volatility	515.5	0.0	0.0	179.9	0.0	0.0	180.0	179.5	0.0	539.4
Direct purchase auctions	**1.415.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Discretional intervention	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Sales	**234.6**	**175.0**	**193.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**368.5**
Call options	**234.6**	**175.0**	**193.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**368.5**
To control volatility	234.6	175.0	193.5	0.0	0.0	0.0	0.0	0.0	0.0	368.5
National government	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Net purchases	**2.146.7**	**(175.0)**	**(193.5)**	**179.9**	**0.0**	**0.0**	**180.0**	**179.5**	**0.0**	**170.9**

Source: Banco de la República.

The bilateral RER indices show that the Colombian peso appreciated in comparison to the dollar and to the currencies of Mexico, Brazil, Canada, England as well as to the euro in 2009. At the same time, it depreciated significantly with respect to the bolivar, the Ecuadorian dollar and the yen (Table 16). The multilateral RERI measurements that are traditionally published by Banco de la República showed a real, average, annual depreaciated of 6.4% for the one that uses the CPI and of 4.3% for that calculated with the PPI for 2009. The index that measures the changes in Colombia's competitiveness in the US market for a group of goods (coffee, flowers, bananas and textiles [RERI-C]) showed a devaluation of 3.2% on average for 2009 (Graph 58).

Graph 59 gives the trend for the RERI-PPI in 2009 where the 8% depreciation the first few months of the year, the 14% appreciation between February and October and a mild recovery starting that month can be seen. In the first few months of 2009, the nominal depreciation took the RERI to levels that were only surpassed by those registered in 2003. In the following months, the steep fall in the nominal rate and the later rises in competitiveness through prices led the RERI to end the year at levels near the average for the last two decades.

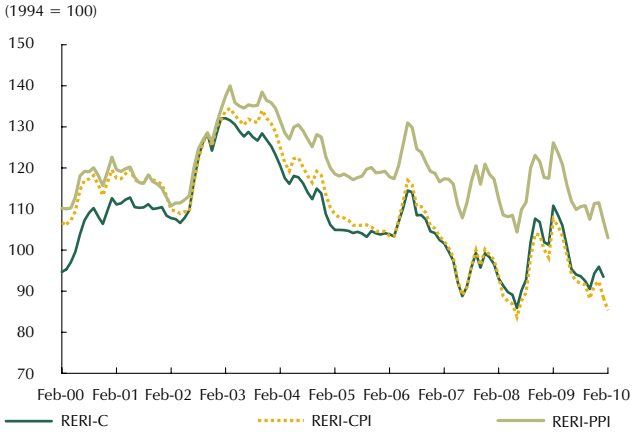
Banco de la República has calculated a series of alternative measurements of the RER in order to make a better diagnosis of the country's competitiveness. Some of these involve alternative price indicators such as the PPI for

Table 16
Real Bilateral Exchange Rate: Colombian Peso Compared to Foreign Currency [a/ b/]

	Average annual percentage variations				
	2003-2009	2009	January to June, 2009	July to December, 2009	As of February, 2010
United States	(2.4)	(1.4)	7.5	(9.7)	(11.7)
Venezuela	2.5	10.7	16.8	4.1	(21.3)
Ecuador	(1.6)	13.4	27.8	0.3	(13.8)
Mexico	(5.1)	(6.3)	(0.8)	(11.6)	(9.2)
Brazil	7.8	(1.6)	(3.8)	0.4	2.4
Euro zone	1.7	(2.0)	2.7	(6.5)	(14.1)
Peru	(1.1)	2.9	12.2	(5.8)	(9.4)
Japan	(1.2)	12.9	27.1	(0.4)	(18.1)
Chile	4.2	0.7	6.8	(5.0)	(13.0)
Canada	(0.5)	(2.7)	(1.7)	(3.7)	(3.2)
United Kingdom	(2.7)	(7.5)	(8.5)	(6.6)	(5.5)

a/ Deflated with the PPI
b/ Negative indicates appreciation
Source: Banco de la República.

Graph 58
Real Exchange Rate Index



Note: The RERI include the different types of foreign exchange in effect in Venezuela.
Source: Banco de la República.

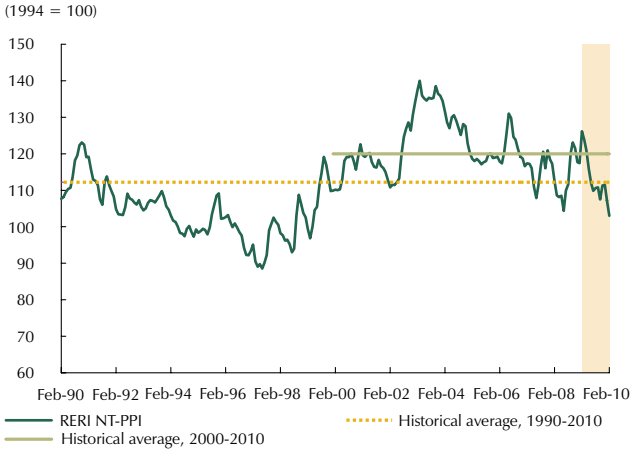
exported and imported goods. Graph 60 compares the traditional indices (RERI-PPI and RERI-CPI) with an alternative measurement that calculates the competitiveness through the prices of Colombian exports.[48] Based on the latter one, the average annual depreciation in 2009 was 3.6%, which was lower than the depreciation estimated using the CPI and the PPI. In the last few months of 2009, in contrast to the traditional measurements, the alternative RERI did not show improvements in competitiveness. On the contrary, it has deteriorated due to significant increases in the PPI for Colombian exports.

c. Factors That Have Had an Impacted on the Performance of the Currency

The performance of the Colombian peso in 2009 was marked by the changes in the world economic environment. Thus, while in the first half of the year the uncertainty about the impact of the crisis made investors take refuge in US Treasury bonds, which depreciated the peso sharply; in the second half of the year, the lower risk aversion on the part of the investors, the recovery of confidence in the world economy and the improvement in the prices of *commodities* appreciated Colombian currency.

48 This index uses the export PPI for domestic prices and the import PPI as a measurement of prices abroad. For a more detailed explanation see *Reportes del Emisor* (Bank Reports) October, 2009.

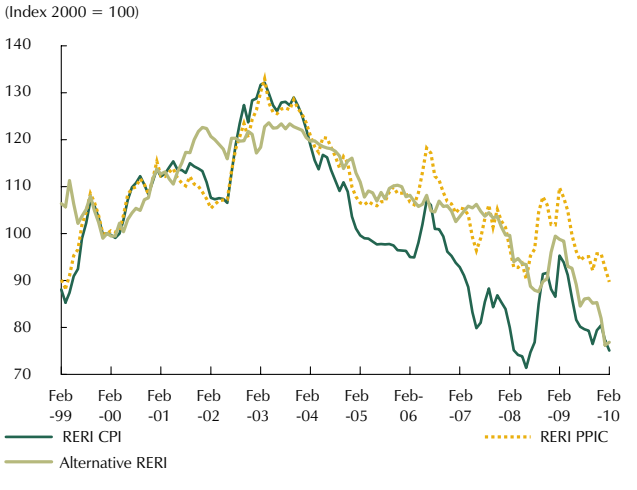
Graph 59
Index of the Real Exchange Rate (PPI) Compared to its Historical Averages



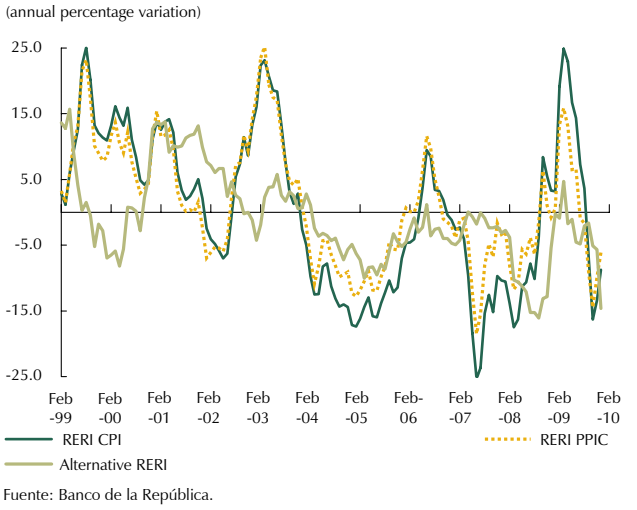
Source: Banco de la República.

Graph 60
Indices of the Real Exchange Rate and Annual Variation: Traditional and Alternative Measurements

A.



B.



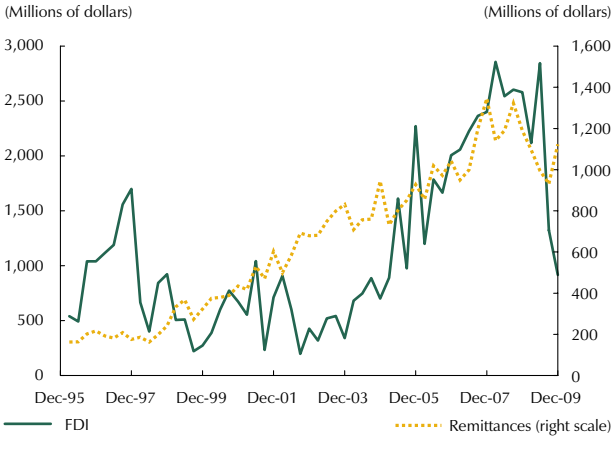
Fuente: Banco de la República.

In comparison to what was observed in 2008, the inflows of foreign investment into Colombia, the remittances from workers abroad and the net flows of private capital showed a decline (Graph 61). This lower income was compensated by the upswing in the net reimbursement of official capital through current accounts and special transactions. As a result, the strengthening of the Colombian peso in the second half of 2009 was associated mainly with the monetization on the part of the central national government (CNG) and Ecopetrol.

The factors, in turn, that influenced the behavior of the RERI in 2009 are related to variables that affect the relative prices and the performance of the Colombian economy as well as that of the countries it trades with. In this sense, Colombia registered improvements in its terms of trade which had become accentuated in the last few months of 2009 (after a steep fall at the beginning of the year) as a result of the high international prices for export commodities such as coffee, oil, coal and ferronickel (Graph 62). Likewise, in the last few months of the year, Colombian exports gained in competitiveness through prices since the country's inflation was below the majority of its competitors and trading partners.

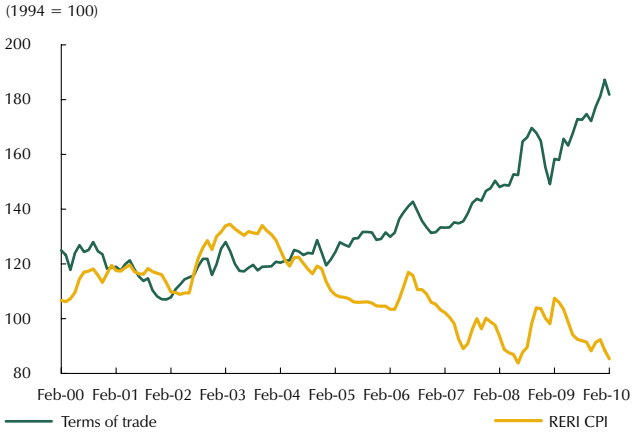
Graphs 63 and 64 show the changes in the annual variation of relative prices. If the series takes positive values, inflation in the respective market is higher than inflation in Colombia and, as a consequence, Colombian exports show a rise in competitiveness.

Graph 61
Gross Foreign Direct Investment in Colombia and Remittances (quarterly data)



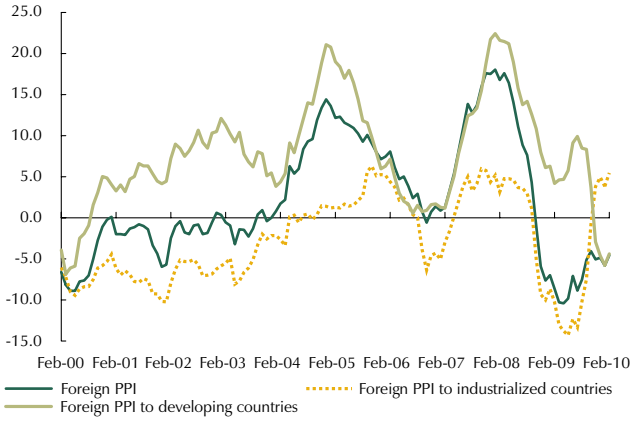
Note: The FDI data from the last quarter of 2005 excludes the Bavaria transaction that had a value of US$4.502 m.
Source: Banco de la República (balance of payments).

Graph 62
Terms of Trade and Real Exchange Rate



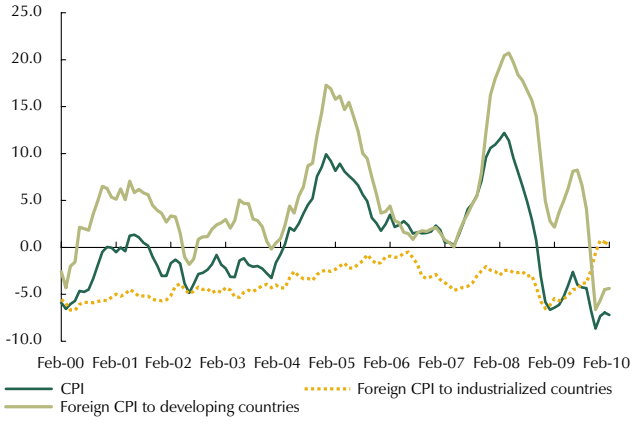
Source: Banco de la República.

Graph 63
Annual Percentage Variation of the Relative PPI Prices



Source: Banco de la República.

Graph 64
Annual Percentage Variation of the Relative CPI Prices



Source: Banco de la República.

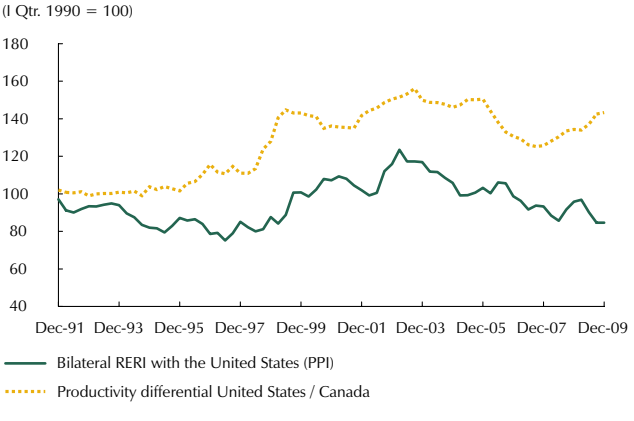
Based on the relative prices measured with the PPI, Colombia has gained in competitiveness since October, 2009 in the market of industrialized countries due to a producer inflation which is lower than that of those economies. With respect to emerging countries, during the last few years Colombia has registered continuous gains in competitiveness. However, since November, 2009 the significant deflations that have occurred in developed economies changed this situation. Also for the first time in this decade, the annual change in relative prices measured with the CPI shows gains in competitiveness compared to industrialized countries.

Finally, the competitiveness of a country is not only determined by the costs of production but also by the efficiency of the tradable sector. An increase in the productivity of the tradable sector raises real salaries and, therefore, the costs of the non-tradable sector. This is reflected in the higher relative prices for non-tradable goods and, as a result, the final effect will be a real appreciation of the currency. Preliminary calculations show losses in the relative productivity of Colombia compared to the United States in the 2007-2009 period that have not been associated with gains in competitiveness through RER in Colombia (Graph 65).

2. Performance of the Colombian Balance of Payments in 2009

The effects of the slowdown of the world economy in 2009 were evident in the reduction of the deficit

Graph 65
Differential in Industrial Productivity Compared to Bilateral RERI



Sources: DANE, BLS and Banco de la República.

in the country's current account which went from 2.8% of the GDP in 2008 to 2.2% of the GDP in 2009. The deterioration in the international prices of our commodity exports, the shrinkage of our trading partners' real GDP, the trade restrictions with Venezuela and the weakness of domestic demand were factors that contributed to the poor performance of the trade of goods, to the limited transfer of profits and dividends from multinational companies located in Colombia and the slump in income from workers' remittances.

The main results of the balance of payments in 2009 were: i) a deficit of US$5.146 m (2.2% of the GDP[49]) in the current account, US$1.737 m lower than that seen the year before when it was at US$6.883 m (2.8% of the GDP); ii) a surplus of US$6.784 m (2.9% of the GDP) in the capital and financial account which is US$2.700 m lower than that registered in 2008 when it reached US$9.485 m (3.9% of the GDP) and iii) an accumulation of US$1.324 m in gross international reserves (Table 17).

a. Current Account

In 2009, the deficit in the current account declined with respect to that registered in 2008 given that the fall in current expenditures (US$7.390 m) surpassed the reduction in revenue (US$5.653 m). The drop in expenditures can be explained by: i) a lower level of imports of goods (US$6.090 m) due to the weakness in domestic demand for, mainly, intermediate goods; ii) the reduction in the transfer of factor income (US$1.217 m) from multinational companies due to lower export prices for oil, coal and ferronickel and iii) the downswing of imports of services (US$317 m) that are related to the behavior of the freights for transporting goods.

In contrast, the lower value of the current income in annual terms came primarily from : i) the shrinking of goods exports (US$4.506 m) due to the lower international prices and the slump in sales to the United States, Venezuela and Ecuador and ii) the reduction in income from workers' remittances (US$697 m) due to the economic slowdown in the countries that these come from.

Last of all, it is worth mentioning that the trade balance of goods showed a surplus of US$2.560 m as the result of an annual reduction in imports (-16.2%) that is larger than that of exports (-11.7%).

b. Capital and financial account

At the end of 2009, the capital and financial account had a surplus of US$6.784 m, which was US$2.700 m lower than that reported in 2008. The lower capital inflows were associated with the reduction in the inflows of net foreign direct investment, higher debt payments and Colombian investments abroad.

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49 The GDP corresponds to the preliminary information from DANE.

Table 17
Balance of Payments for Colombia
(millions of dollars)

	2008 Jan-Dec (pr)	2009 Jan-Dec (pr)	Variation
I. Current account	**(6,883)**	**(5,146)**	**1,737**
Income	50,312	44,659	(5,653)
Expenditures	57,195	49,805	(7,390)
A. Non-factor goods and services	(2,075)	(121)	1,954
Income	42,669	38,217	(4,452)
Expenditures	44,744	38,337	(6,406)
1. Goods	976	2,560	1,584
Income	38,531	34,026	(4,506)
Expenditures	37,556	31,466	(6,090)
2. Non-factor services	(3,051)	(2,680)	370
Income	4,137	4,191	54
Expenditures	7,188	6,871	(317)
B. Factor income	(10,320)	(9,644)	676
Income	1,745	1,204	(541)
Expenditures	12,065	10,848	(1,217)
C. Transfers	5,512	4,619	(893)
Income	5,898	5,238	(660)
Workers' remittances	4,842	4,145	(697)
Other transfers	1,056	1,093	37
Expenditures	386	619	233
II. Capital and financial account (a + b)	**9,485**	**6,784**	**(2,700)**
A. Financial account (1 + 2)	9,485	6,784	(2,700)
1. Long term financial flows (b + c - a)	9,913	12,501	2,588
a. Assets	**2,253**	**3,016**	**763**
i. Net Colombian investment abroad	2,254	3,025	771
Direct	2,254	3,025	771
Portfolio	-	-	-
ii. Loans	-	-	-
iii. Commercial loans	-	-	-
iv. Other assets	(1)	(9)	(8)
b. Liabilities	**12,167**	**15,525**	**3,358**
i. Foreign investment in Colombia	10,388	12,023	1,635
Direct	10,583	7,201	(3,382)
Portfolio	(195)	4,822	5,017
ii. Loans	1,319	1,571	253
iii. Commercial loans	188	227	39

Table 17 (continuation)
Balance of Payments for Colombia
(millions of dollars)

	2008 Jan-Dec(pr)	2009 EJan-Dec(pr)	Variation
iv. Other liabilities	0	976	976
c. Other long term financial movements	**(1)**	**(8)**	**(7)**
2. Short term financial flows (b - a)	(428)	(5,716)	(5,288)
a. Assets	(83)	4,166	4,249
i. Portfolio investment	(188)	3,181	3,369
ii. Commercial loans	173	71	(101)
iii. Loans	45	99	54
iv. Other assets	(113)	814	927
b. Liabilities	(512)	(1,551)	(1,039)
i. Portfolio investment	(1,001)	(154)	847
ii. Commercial loans	291	(642)	(933)
iii. Loans	189	(796)	(984)
iv. Other liabilities	9	41	32
B. Special capital flows	-	-	-
III. Net errors and omissions	**21**	**(291)**	**(312)**
IV. Variation in gross international reserves	**2,623**	**1,347**	**(1,275)**
V. Balance of gross international reserves	**24,041**	**25,365**	**1,324**
Number of months of goods imports	5.8	7.3	1
Number of months of goods and services imports	4.8	6.0	1
VI. Balance of net international reserves	**24,030**	**25,356**	**1,326**
VII. Variation in net international reserves	**2,618**	**1,349**	**(1,268)**

(pr) preliminary
Source: Banco de la República.

In the period under analysis, Colombia received US$7.201 m (3.1% of the GDP) in net revenue through foreign direct investment, an amount that is US$3.382 m lower than that seen a year ago when the country received US$10.583 m. The lower investments are noticeable in the oil sector (US$758 m) as well as in other sectors such as commerce, manufacturing, transportation and communications (US$2.624 m). These declines were partly offset by the increase of US$1.085 m in foreign capital going to companies in the coal mining

sector. Direct investments abroad made by Colombians, in turn, amounted to US$3.025 m which was US$771 m higher than what was registered in 2008. Colombian investors acquired stock in, primarily, companies in the mining sector located in the United States and some Latin American countries

With respect to long term foreign debt, the country received net disbursements of US$8.323 m which mainly corresponded to new loans acquired by public entities by placing bonds on the international market and obtaining loans from the multilateral banking system. The private sector also increased its foreign debt although to a lesser degree through financial leasing transactions.

In 2009, the net short term capital flows registered outflows of US$5.716 m that were basically caused by the adquisition of assets abroad and the payment of loans and commercial obligations mostly on the part of private sector companies.

c. International reserves

At the end of 2009, US$1.347 m in gross international reserves had been accumulated as a result of income from net returns of US$319 m, net purchases of US$171 m in foreign currency from foreign exchange brokers and of net income from other Banco de la República transactions in the amount of US$857 m. In the latter, the assignment of special drawing rights (SDR) on the part of the IMF stood at US$976 m, which raised the balance of the reserves by that amount. Considering the appreciation of the reserves by price and exchange rate (-US$23 m), the change in the gross reserves comes to US$1.324 m.

3. Outlook for the Balance of Payments for 2010

The forecast for the balance of payments in 2010 assumes a recovery of real world growth which, based on the IMF projections, could be 3.9% compared to -0.8% in 2009. The prediction of the weighted real growth for Colombia's trading partners is 1.5% in 2010, which is higher than that observed in 2009 (-2.3%). Implicit in this assumption is the higher growth expected for the United States (2.7% in 2010 vs. -2.4% in 2009) and for Venezuela (-0.4% in 2010 vs. -3.3% in 2009).

In addition, according to some analysts, international prices for the main export products will show a favorable trend for Colombia. This includes prices that are even higher than those seen in 2009, which would be in line with the positive growth of the world GDP. However, non-traditional exports will be affected by the poor economic performance in Venezuela and the deterioration of the trade relationship with that country, as well as by the slow rate at which new markets are replacing it, and the modest recovery of the rest of our trading partners. As a result, income in dollars for total exports in goods could rise by approximately 8.0% in annual terms.

In contrast, it is estimated that the country's imports could grow approximately 15.0% in dollars. This would be associated with not only the investment

projects in the oil sector but also the infrastructure projects in civil works. This inflow of imports is consistent with the most probable growth scenario for the Colombian economy, which was mentioned in the first section of this chapter.

Consequently, and keeping in mind the size of the US recovery and its possible effects on world growth and on the international prices of commodities, the projection for the balance of payments for 2010 shows an expansion of the deficit in the current account with respect to that estimated for 2009 (-2.2% of the GDP). Based on that, the deficit will reach a value of US$8.107 m in 2010, which is equivalent to 3.0% of the GDP. This result would be primarily due to the larger trade imbalance which would go from a surplus of US$2.560 m (1.1% of the GDP) in 2009 to a deficit of US$521 (-0.2% of the GDP) in 2010 (Table 18).

For the area of factor income, a lower deficit is forecast in 2010 in comparison to the one registered in 2009. Based on the forecast, the deficit in current account would be largely financed by resources coming from FDI, which will

Table 18
Forecast of Colombia's Balance of Payments

	Millions of dollars				Percentage of GDP			
	2007	2008	2009 (pr)	2010 (proj)	2007	2008	2009 (pr)	2010 (proj)
I. Current account	**(5,977)**	**(6,883)**	**(5,146)**	**(8,107)**	**(2.9)**	**(2.8)**	**(2.2)**	**(3.0)**
A. Non-factor goods and services	**(3,203)**	**(2,075)**	**(121)**	**(3,545)**	**(1.5)**	**(0.9)**	**(0.1)**	**(1.3)**
1. Goods	(596)	976	2,560	(521)	(0.3)	0.4	1.1	(0.2)
2. Non-factor services	(2,607)	(3,051)	(2,680)	(3,025)	(1.3)	(1.3)	(1.2)	(1.1)
B. Factor income	**(8,002)**	**(10,320)**	**(9,644)**	**(9,010)**	**(3.8)**	**(4.2)**	**(4.2)**	**(3.3)**
C. Transfers	**5,228**	**5,512**	**4,619**	**4,449**	**2.5**	**2.3**	**2.0**	**1.6**
II. Capital and financial account	**10,347**	**9,485**	**6,784**	**8,574**	**5.0**	**3.9**	**2.9**	**3.2**
A. Private sector: net direct investment and other capital flows [a/]	8,128	9,148	3,211	4,433	3.9	3.8	1.4	1.6
B. Public sector [b/]	2,218	337	3,574	4,141	1.1	0.1	1.6	1.5
III. Errors and omissions	328	21	(291)	0	0.2	0.0	(0.1)	0.0
IV. Variation in gross international reserves [c/]	**4,698**	**2,623**	**1,347**	**467**	**2.3**	**1.1**	**0.6**	**0.2**

(pr) preliminary
(proj) projected
a/ Includes net flows of Foreign Direct Investment, portfolio, net foreign debt transactions.
b/ As of 2008 Ecopetrol transactions are not included.
c/ The balance of net international reserves includes contributions to the Latin America Reserve Fund (FLAR in Spanish)
Source: Banco de la República.

reach a value equivalent to 2.5% of the GDP.[50] That level will be higher than that registered last year given the lower investments made by Colombians abroad.

Likewise, the forecast includes foreign financing on the part of the public sector (excluding Ecopetrol) in 2010 that will be higher than that seen in 2009, which will be the result of net transactions in foreign loans to the amount of US$4.141 m. Last of all, the annual estimate of the change in the country's gross international reserves takes into account the financial return but not the US$20 m in daily purchases announced by the Board on March 3, 2010.

4. Indicators of Foreign Vulnerability

The Banco de la República's strategy of accumulating international reserves recognizes the importance of having an appropriate level of international liquidity to face possible outflows of capital from the country. These could be caused by factors such as the deterioration of the terms of trade, financial panics or financing crises in neighboring countries. In that context, maintaining an adequate level of international reserves helps to improve confidence in the country and hence, to be in a better position to face a crisis in foreign markets.[51] In order to determine whether or not a country's international reserves are enough to prevent and defend against external shocks, various indicators of vulnerability are used among which are included: i) the ratio between international reserves and monetary aggregates, and ii) the ratio between reserves and the debt payment during the next twelve months. Comparing the reserves with monetary aggregates such as M2 or M3, the purpose is to establish the capacity of the economy to respond to outflows of capital caused by speculative attacks. The indicator of reserves to total foreign debt repayment and the deficit in the current account, in turn, indicates the country's ability to respond to its loan obligations to the rest of the world in an extreme scenario in which its access to international financing is completely cut off. In general, international markets think that low values for these indicators could be warning signs about the foreign vulnerability of those economies.

Table 19 shows the performance of the different indicators for the net international reserves during the 2004-2010 period in the case of Colombia.[52] The indicators for groups A and B are above one, the level suggested by the

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50 This takes into account about US$8.200 m (3.1% of the GDP) in resources from foreign investors and would be primarily going to the oil, mining and quarrying, sectors, etc.

51 In this respect, on May 11, 2009, the IMF approved a line of potential financing in the amount of US$10.400 m for Colombia for a period of one year. This has been offered by that entity to member countries with good economic performance, prudent policies and a solid economic policy framework. Although the authorities do not anticipate making use of these resources, they consider it prudent to have them available in the event of a sudden stop in foreign financing. See the Editorial Note in the Banco de la República Magazine, num. 978, April, 2009.

52 The projected level of reserves for Colombia for 2010 does not include the decision that Banco de la República made last March 3.

Table 19
International Reserves Indicators for Colombia

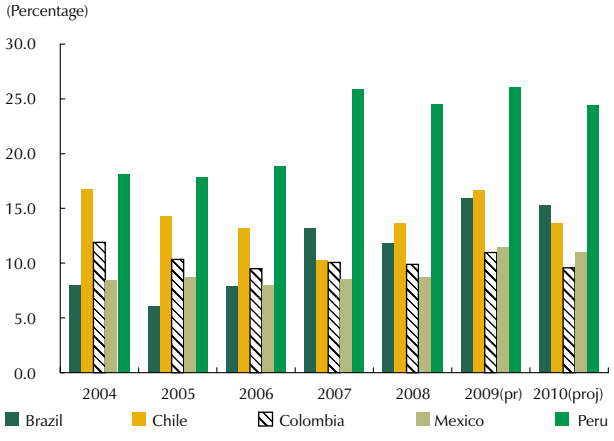
	2004	2005	2006	2007	2008	2009 (pr)	2010 (proj)
Balance							
Net international reserves (millions of dollars) [a/. b/]	**13,536**	**14,947**	**15,436**	**20,949**	**24,030**	**25,356**	**25,823**
Indicators							
A. Indicator of foreign debt repayment							
Foreign debt repayment (millions of dollars)	8,688	13,068	13,189	10,237	10,368	11,418	11,175
Net reserves/repayments of foreign debt in the current year	1.56	1.14	1.17	2.05	2.32	2.22	2.31
Net reserves/repayments of foreign debt in the coming year	1.04	1.13	1.51	2.02	2.10	2.37	2.48
B. Suitable external liquidity position							
NIR/servicing the debt, current year	1.21	0.93	0.96	1.56	1.76	1.75	1.72
NIR/servicing the debt, coming year	0.85	0.93	1.15	1.53	1.66	1.73	1.78
NIR/(payments on the debt in the current year + current year current account deficit)	1.41	1.00	0.95	1.29	1.39	1.53	1.34
NIR/(payments on the debt in the coming year + coming year current account deficit)	0.91	0.92	0.95	1.21	1.45	1.43	1.34
C. Other international reserve indicators							
NIR as months of goods imports [c/]	10.2	8.9	7.5	8.1	7.7	9.7	8.6
NIR/M3 (percentage) [d/]	33.1	30.1	26.1	27.0	29.2	26.2	22.5
NIR/GDP (percentage) [e/]	11.9	10.3	9.5	10.1	9.9	11.0	9.6

(pr) preliminary
(proj) projected
a/ Estimate of the net international reserves balance for 2010.
b/ The balance of the net international reserves includes contributions to the Latin American Reserves Fund (FLAR).
c/ The value of imported goods corresponds to that projected for 2010.
d/ Balance of the broad M3 corresponds to that projected for 2010.
e/ The value of the GDP in dollars corresponds to an estimate for 2010.
Source: Banco de la República estimates.

IMF in the study published in the *World Economic Outlook* for 2003.[53] It can also be seen that all of the indicators for these groups have shown a substantial improvement during the period. In another case, the ratios for group C have remained stable and are at adequate levels. In particular, the ratio of net reserves to imports of goods, one of the measurements that is mostly used, is estimated at 8.6 months.

53 IMF (2003), *World Economic Outlook*, Sept., pp. 65-105.

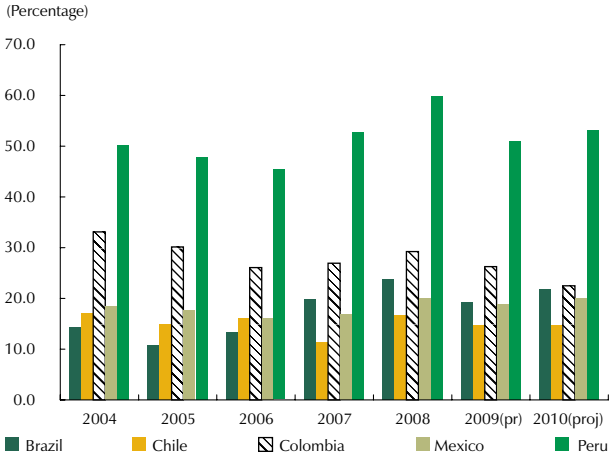
Graph 66
International Reserves/GDP



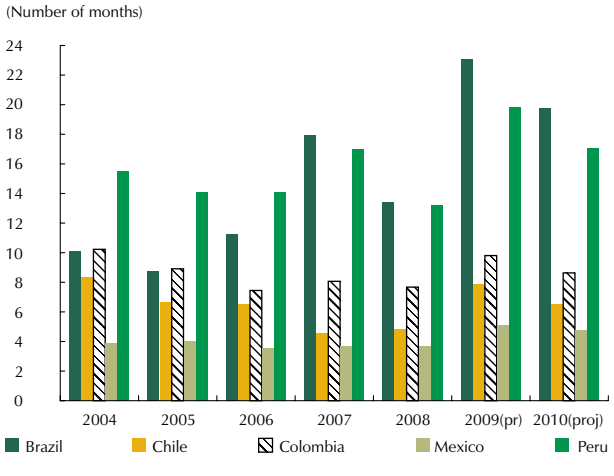
(proj) projected
Sources: central banks, The Economist Intelligence Unit and Banco de la República.

Graph 67

A. International Reserves /M3



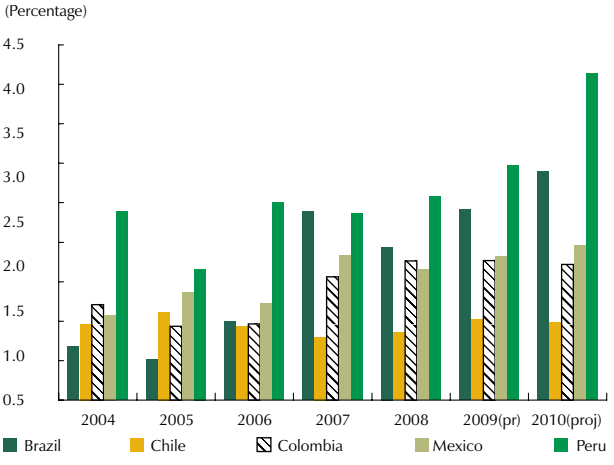
B. International Reserves as Months of Goods Imports



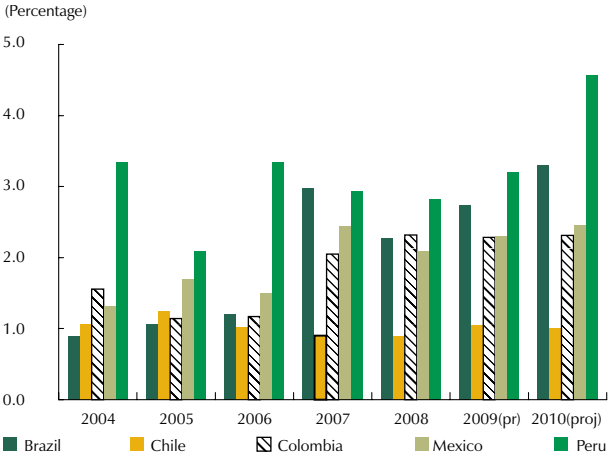
Sources: central banks, The Economist Intelligence Unit and Banco de la República.

Graph 68

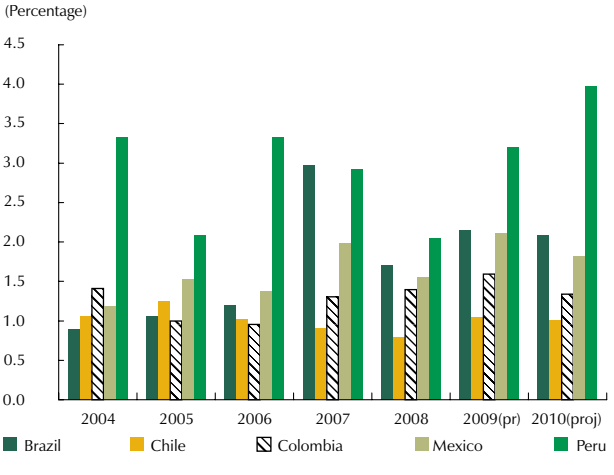
A. International Reserves/Servicing the Foreign Debt



B. International Reserves/debt Repayment



C. International Reserves /(Deficit in Current Account + Debt Repayment)



(pr) preliminary
(proj) projected
Sources: central banks, The Economist Intelligence Unit and Banco de la República.

Comparing various indicators of Colombia's international liquidity with respect to other countries in the region, it can be seen that the quotient of reserves to GDP is at levels close to those registered by Mexico, and below those of Chile, Brazil and Peru. The growth and level of this ratio for Peru stands out due to the fact that the local banks can take deposits in dollars and the reserve requirement for these deposits are put on the books as reserves in this country (Graph 66).

In the case of the indicator of reserves to M3, Colombia registers levels that are above those of Chile, Mexico and Brazil but lower than Peru's. With respect to the reserves measured in months of imports of goods, these show that Colombia has a position that is relatively higher than that of Chile and Mexico while lower than that of Brazil and Peru (Graph 67).

In the relationship between the international reserves and debt repayment, debt servicing and deficit in the current account plus repayment, Colombia shows levels that are above those of Chile and similar to or lower than those of Mexico, Brazil and Peru (Graph 68).

F. FISCAL POLICY

1. Fiscal Results in 2009

At the end of 2009, the consolidated public sector had accumulated a fiscal deficit of COL$13.694 b, which is equivalent to 2.8% of the GDP. With respect to 2008, this result demonstrates a deterioration in the fiscal situation due to the slowdown in economic growth which weakened tax collection. By sector, the national government reached a deficit of 4.2% of the GDP and the decentralized public sector had a surplus of 1.6% of the GDP. Banco de la República and the Financial Institution Guarantee Fund (Fogafin in Spanish) registered a surplus fiscal balance of 0.1% and 0.2% of the GDP respectively. The costs of restructuring the financial system came to 0.2% of the GDP[54] (Table 20).

It should be remembered that over a large part of this decade, Colombian public finances have experienced a process of gradual adjustment through the adoption of different reforms in terms of income and expenditure. As a result, in 2005, a situation of fiscal equilibrium was registered which was caused to a great extent by the decentralized sector which had hit a surplus that was close to four GDP points, the highest one in the decade. Between 2006 and 2008, a relatively stable fiscal situation was seen as a result of an expanding economy and the higher income generated by oil production. During this period, the national government reduced the size of the deficit from 4.1% of the GDP in 2005 to 2.3% of the GDP in 2008.

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54 These costs correspond to interest payments, debt repayments and indexing associated with the financial crisis in the late 90s, which were assumed by the national government.

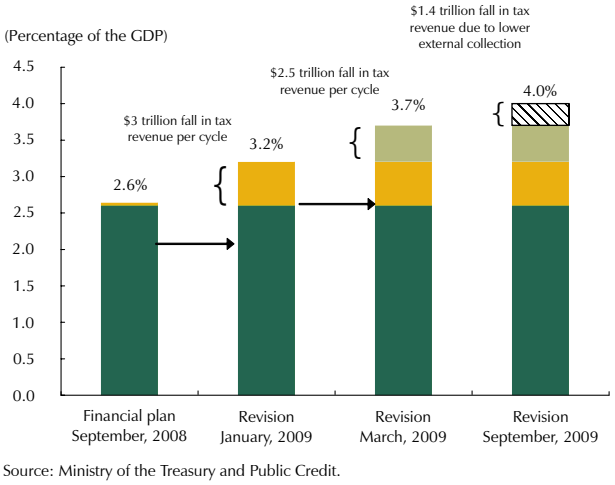
Table 20
Consolidated Public Sector
Fiscal Balance 2008 and 2009

Item	Billions of pesos		Percentage of GDP	
	2008	2009 (pr)	2008	2009 (pr)
A. Total non-financial public sector (SPNF in Spanish) (1 + 2)	**343**	**(12,865)**	**0.1**	**(2.6)**
1. National government	**(11,067)**	**(20,715)**	**(2.3)**	**(4.2)**
2. Decentralized sector subtotal [a/]	**11,411**	**7,851**	**2.4**	**1.6**
Electric	500	51	0.1	0.0
Emcali	89	46	0.0	0.0
EPM	(93)	(512)	(0.0)	(0.1)
FAEP	(1,898)	(1,024)	(0.4)	(0.2)
Other entities	2,472	2,060	0.5	0.4
Social security	5,140	6,451	1.1	1.3
Regional and local	5,201	779	1.1	0.2
B. Quasi-fiscal Balance of the Banco de la República	1,306	599	0.3	0.1
C. Fogafin Balance	502	926	0.1	0.2
D. Costs of financial restructuring	(1,270)	(1,117)	(0.3)	(0.2)
E. Adjustments	(1,558)	(1,237)	(0.3)	(0.2)
F. Total consolidated public sector (A + B + C + D + E)	**(678)**	**(13,694)**	**(0.1)**	**(2.8)**

(pr) preliminary
a/ Excluding the Ecopetrol and Isagen balances
Note: Deficit (-) or surplus (+)
Source: Ministry of the Treasury and Public Debt.

The economic slowdown derived from the recent international crisis changed the course of public finances and imposed new challenges to the authorities. Since the beginning of 2009, a drop in tax collection has been observed. Nevertheless, the national government decided to keep the level of expenditure programmed in its financial plan for 2009 unaltered in order to avoid a cutback just when private demand was shrinking. The purpose of this was to prevent a steeper fall in the aggregate demand and the GDP. This decision was possible due to the fact that the government maintained its access to the foreign and domestic financial markets which made it possible to finance the deficit, which widened over the course of the year as the fall in tax collection accentuated (Graph 69).

Graph 69
Adjustments to the NG Fiscal Balance 2009

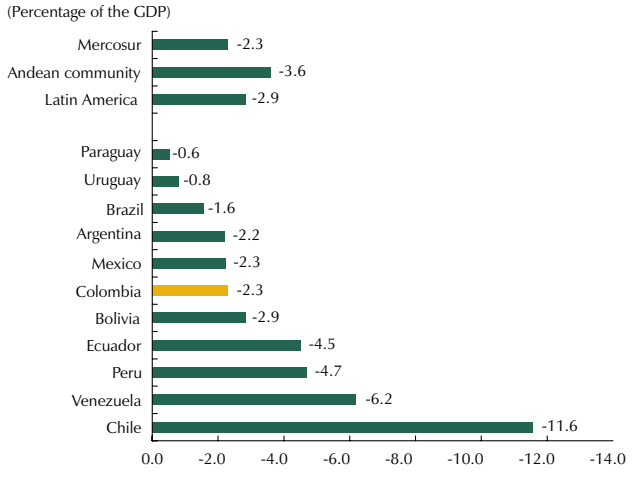


Source: Ministry of the Treasury and Public Credit.

In addition, the government reoriented the expenses towards infrastructure and social development programs in an effort to maximize their impact on the final demand. An approximation of this impact is almost 10% growth registered by the total consumption of public administrations and the

investment in public works (part of the latter is private). If these two items, which grew more than expected by the government, are excluded, the GDP in 2009 would have registered a drop of 2.7%. This fiscal posture contrasts significantly with the management of public finances in previous crises such as the one in the late 90s when the impossibility of getting access to foreign financing forced the government to cutback on expenditures which caused the fiscal policy to act pro-cyclically and thus accentuated the economic collapse.

Graph 70
Fiscal Stimulus Indicator [a/]



Note: For Colombia the fiscal balance corresponds to the non-financial public sector (SPNF in Spanish) published by the Ministry of the Treasury and Public Credit. For the rest of the countries, the SPNF balance published in the Latin Focus Consensus Forecast was taken.
a/ Change in the fiscal balance (FB) = FB 2009 - average FB (2007-2008)
Source: Focus Economics and Ministry of the Treasury and Public Credit, Banco de la República calculations.

The lack of a savings mechanism in the expanding phase of the cycle prevented a stronger counter-cyclical fiscal policy from being carried out. Nevertheless, if the annual variation of the fiscal deficit as a proportion of the GDP in 2009 with respect to the 2007-2008 average (the so-called 'fiscal boost') is compared to the rest of Latin America, Colombia is seen to be one of the countries in the region with the highest fiscal stimulus (Graph 70).

To summarize, maintaining the level of expenditure, the authorities carried out a fiscal policy that contributed to the buffering of the effects of the world economic crisis without compromising the fiscal sustainability of the country nor generating macroeconomic instability. It should be emphasized that raising the expenditures excessively would have put the medium term sustainability of the debt at risk.

From the accounting point of view, the national government operations in 2009 showed a growth of 2.8% in revenue and 13.6% in expenditures. The income from tax collection rose barely 1.3% due to the effect of the economic slowdown on the collection of VAT, financial transaction tax and the tax on gasoline. In spite of the crisis, income tax grew 13.9% largely due to the amount of tax borne by Ecopetrol, which reached a value equivalent to 0.8% of the GDP. Capital resources grew 13.8% due to the payment of financial surpluses on the part of state-owned companies and particularly Ecopetrol, the entity which transferred COL$7.905 b in dividends. With respect to this operation, it is important to remember that since 2007 the government has entered the gross dividends paid by that company on the books as income and registered the subsidy for fuel consumption as an expenditure[55] (Table 21).

The national government expenses in 2009 grew 4.7% in interest on the debt, 17.8% in operations and 8.6% in investment. Among the outlays for operations, personal services rose 13.7%, overhead 0.1% and transfers 20.1%. The latter item was boosted by the General Allocation System (SGP in Spanish) which reached COL$24.731 b with a growth of 31.4% and, because of the transfers for pensions which came to COL$21.809 b, with an

55 Up until 2006, Ecopetrol transferred a net dividend of the subsidy to the government.

Table 21
National Government
Fiscal Balance, 2008 and 2009
(billions of pesos)

	2008	2009 (pr)	Growth 2008-2009
I. Total revenue (A + B + C + D + E)	**75.064**	**77.156**	**2.8**
A. Tax revenue	64.349	65.196	1.3
Income	25.217	28.728	13.9
Domestic VAT	17.650	17.609	(0.2)
External VAT	9.414	8.301	(11.8)
Duty	4.292	4.001	(6.8)
Gasoline	1.288	1.291	0.3
Financial transaction	3.200	3.121	(2.4)
Wealth	3.200	2.023	(36.8)
Others	89	121	36.0
B. Non-tax	649	463	(28.7)
C. Special Funds	894	1.061	18.7
D. Capital resources	9.154	10.418	13.8
Financial returns	851	624	(26.7)
Financial surplus	5.398	8.568	58.7
Other	2.905	1.226	(57.8)
E. Accrued earnings	17	17	0.0
II. Total Expenditures (A + B + C + D + E)	**86.131**	**97.871**	**13.6**
A. Interest	13.923	14.583	4.7
Foreign	3.662	3.846	5.0
Domestic	10.261	10.737	4.6
B. Operational expenses	59.345	69.921	17.8
Personal services	9.822	11.163	13.7
General overhead	3.674	3.676	0.1
Transfers	45.849	55.082	20.1
C. Investment	10.437	11.338	8.6
D. Net loan	171	176	3.1
E. Accrued payments [a/]	2.255	1.853	(17.8)
III. Deficit (-) or surplus (+) (I-II) [b/]	**(11.067)**	**(20.715)**	**87.2**
Cost of financial restructuring	**1.270**	**1.117**	**(12.0)**
IV. Financing (A + B + C + D + E)	**12.338**	**21.832**	**77.0**
A. Net foreign credit	2.502	9.242	269.4
Disbursements	5.866	11.925	103.3
Repayments	3.364	2.683	(20.2)

Table 21 (continuation)
National Government
Fiscal Balance, 2008 and 2009
(billions of pesos)

	2008	2009 (pr)	Growth 2008-2009
B. Net domestic credit	7.004	11.513	64.4
Disbursements	30.777	32.519	5.7
Repayments	23.773	21.006	(11.6)
C. Banco de la República Profits	1.415	819	(42.2)
D. Privatization	2.052	923	(55.0)
E. Other	(636)	(680)	6.9
V. Deficit as a percentage of the GDP	**(2.3)**	**(4.2)**	

(pr) preliminary.
a/ Excluding the change in the budgetary reserves.
b/ Excluding the cost of financial restructuring.
Source: Ministry of the Treasury and Public Credit.

increase of 31%. Among the latter, COL$5.237 b for the Institute of Social Security (ISS) is included. The payment of subsidies for fuel consumption came to COL$4.906 b for the year. With respect to investment, the national government used COL$11.338 b in resources which were allocated to infrastructure projects that would have a high impact on the aggregate demand and social development programs.

The national government deficit, including the costs of restructuring the financial system, reached COL$21.832 b which is equivalent to 4.4% of the GDP. Net foreign financing hit COL$9.242 b with disbursements of COL$11.925 b and debt repayments of COL$2.683 b. Net domestic credit, in turn, was COL$11.513 b with the placing of COL$32.519 b in securities compared to debt repayments of COL$21.006 b. Banco de la República earnings came to COL$819 b and privatizations, COL$923 b. It is important to note that the privatization of Isagen, which is estimated at COL$3.000 b, was postponed to 2010. With the financing operations described here, the balance of the national government debt went from 35.6% of the GDP in 2008 to 37.5% of the GDP at the end of 2009. The domestic component of the debt was at 25.6% of the GDP and the foreign one was at 11.9% of the GDP.

The fiscal results for the decentralized sector, in turn, were boosted by Social Security with a surplus of 1.3% of the GDP and by the regional and local public sector. This sector improved significantly the management of its programs and investment projects. As a result, the amount of accrued resources in the financial system accounts declined.

Finally, it should be mentioned that Act 1370 of December, 2009 for the future development of public finances was approved. This law introduced some adjustments with respect to national taxes. Specifically, that law reduced the percentage of the income tax deduction for investment in fixed assets from 40% to 30%, extended the tax on wealth into the 2011-2014 period and limited the benefits for free trade zones, which are only allowed to apply a special tariff of 15% in income tax.

2. Financial plan for 2010

The fiscal deficit target for the public sector for 2010 was set at 3.7% of the GDP which means an additional imbalance of close to a percentage point of the output with respect to the end of 2009.[56] This target was defined on the basis of a deficit in the national government finances that was 4.5% of the GDP and a surplus in the decentralized sector that was 0.8% of the GDP. Also in doing the projection, cash profits for Fogafin were assumed to be 0.2% of the GDP and the costs of financial restructuring, 0.1% of the GDP (Table 22).

Table 22
Consolidated Public Sector
Fiscal Balance, 2009 and 2010

Item	Billions of pesos		Percentage of the GDP	
	2009 (pr)	2010 (proj)	2009 (pr)	2010 (proj)
A. Total non-financial public sector (SPNF) (1 + 2)	(12,865)	(19,510)	(2.6)	(3.8)
1. National government	(20,715)	(23,585)	(4.2)	(4.5)
2. Decentralized sector subtotal	7,851	4,075	1.6	0.8
Electric	51	179	0.0	0.0
Emcali	46	77	0.0	0.0
EPM	(512)	29	(0.1)	0.0
FAEP	(1,024)	(387)	(0.2)	(0.1)
Remainder of the entities	2,060	(1,447)	0.4	(0.3)
Social security	6,451	4,582	1.3	0.9
Regional and local	779	1,042	0.2	0.2
B. Banco de la República quasi-fiscal balance	599	0	0.1	0.0
C. Fogafin balance	926	901	0.2	0.2
D. Cost of financial restructuring	(1,117)	(499)	(0.2)	(0.1)
E. Adjustments	(1,237)	0	(0.2)	0.0
F. Total consolidated public sector (A + B + C + D + E)	(13,694)	(19,107)	(2.8)	(3.7)

(pr) preliminary
(proj) projected
Note: deficit (-) or surplus (+)
Source: Ministry of the Treasury and Public Credit.

The government believes that the fiscal deficit target for 2010 is coherent with the beginning of Colombia's economic recovery. A higher deficit would affect the credibility of the fiscal management and demandthe acquisition of more financing resources. This would limit the private sector's opportunity for loans and generate adverse effects on the interest rate and exchange rate.

In view of the reduction in projections for the national government tax collection in 2010, the government postponed COL$5.800 b in outlays from the general national budget in January in order to comply with the deficit target announced in the medium term fiscal framework. However, this measure does not harm the work on the main public investment programs and projects. The

56 The financial plan for 2010 was given in the Confis advisory document No. 01 of February 8, 2010.

adjustment was made considering that it was necessary to maintain confidence in the fiscal policy and avoid replacing private investment, which would be affected by a broadening of the need to get domestic financing for the public sector. Likewise, the government adopted a prudent position since there is still uncertainly about the expectations of the recovery of the world economy. A deterioration in the current expectations could limit access to international financial markets which would raise the cost of indebtedness. The budget adjustment would fall on the foreign debt, operational and investment costs.

Based on the figures in the financial plan, the national government finances in 2010 will see a 3.8% reduction in revenue and stable performance in expenditures. The change in income will be influenced by an estimated fall of 7.4% in income tax collection and the plunge (40.8%) in the financial surplus of companies. The lower direct taxation is a consequence of the slowdown in economic activity in 2009 and of the lower payment of taxes borne by Ecopetrol. This is estimated to be 0.2% of the GDP which is lower by a half percentage point with respect to that made the previous year. The rest of the taxes will register acceptable increases, especially in the case of the domestic VAT (8.5%) and the financial transactions tax (8.6%). This year the last transfer of Oil Stabilization and Savings Fund resources, US$187 m, to the government will be made.

In 2010, national government expenses will show an increase of 10.9% in interest and 3.7% in operations. Within the latter appropriation, personal services will grow 2.9%, general expenses will climb 22.1% and transfers will go up 2.6%. The low momentum of transfers reflects the fact that expenditures for fuel consumption subsidies are not being considered for this year. In 2009, this appropriation came to 1.0% of the GDP. The SGP was allocated COL$22.810 b and COL$22.756 b was set apart for pension payments. Of the latter, close to COL$8.000 b was transferred to the ISS. Outlays for investment will experience a plunge of 30.9%, especially due to the lower expenditures on military equipment. A large part of the public investment will be carried out by the regions and some of the state entities and companies. Ecopetrol, which has programmed expenditures of close to COL$15.000 b, stands out among these.

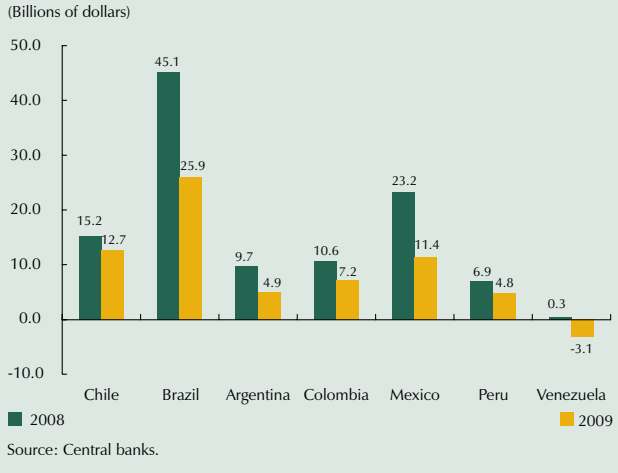
The national government deficit, including the costs of financial restructuring will reach COL$24.084 b, which represents 4.6% of the GDP. Net foreign financing will come to COL$1.244 b, the result of disbursements of COL$4.609 b and debt repayments of COL$3.365 b. Net domestic credit, in turn, will amount to COL$11.573 b with a placing of COL$26.049 b in securities and COL$14.476 b in debt repayment. The portfolio resources in the General Treasury of the Nation are estimated at COL$6.867 b and the privatizations at COL$4.400 b. The latter include the sale of Isagen for a value of close to COL$3.000 b.

BOX 1
DIRECT FOREIGN INVESTMENT IN COLOMBIA

This box shows the general overview of Foreign Direct Investment (DFI) for some countries in Latin America in 2009 and summarizes the main facts in relation to those cash flows in Colombia.

There was a general reduction of the FDI in all the countries of Latin America in 2009 as a consequence of the global financial crisis which occurred in 2008 (Graph B1.1). In spite of this, the FDI income remained the chief source of financing for the current account deficit of the countries in this region. The largest drops in FDI income occurred in Brazil, Mexico and Argentina and varied between US$4.8 and US$19.1 b. Meanwhile, Colombia, Chile and Peru recorded lower drops in FDI that were between US$2.2 and US$3.4 b. The case of Venezuela stands out as the only country in the region that showed disinvestment in 2009.

Graph B1.1
Foreign Direct Investment in Latin America



Source: Central banks.

The estimate of FDI flows in the balance of payments for Colombia, compiled by Banco de la República, considers different investment categories such as: i) capital contributions in foreign currency and, ii) contributions received in kind (imports of goods and services). Additionally, the calculation methodology incorporates the estimate of the profits reinvested by the companies which have foreign-owned stock as well as the capital transferred by these firms back to their head offices. The amount in capital contributions in foreign currency is calculated by using the data from the foreign exchange balance and the contributions in kind are estimated by using the records on imports and the surveys of foreign trade in off-shore services. The sector and accounting information from the companies is used for both the calculation of profits (reinvested and transferred) and the calculation of capital reimbursement.

Based on the estimates from the balance of payments, the gross FDI[1] income in Colombia came to US$16.057 m in 2009, of which US$14.125 m corresponded to new capital contributions from the head office and US$1.931 m to reinvestment of profits. The expenditures of capital due to reimbursements[2] are deducted from this gross income and are estimated at US$8.856 m, which means that Colombia received US$7.201m in net FDI cash flows during the year. This amount, which represents 3.1% of the estimated annual GDP, was down 32% or US$3.382 m with respect to the data for 2008 when the country received US$10.583 m (Table B1.1).

Table B1.2 shows US$758 m less investments in the oil sector as well as US$2.624 m in other activities mainly in the sectors of manufacturing, electricity, financial corporations, transportation and communications, trade, etc. It is important to emphasize that these sectors made high levels of reimbursement of capital, especially some of the companies in the electricity sector. Regarding the reimbursement of capital in industrial activity accounting, some of the companies that stand out are foreign and are involved in production of cement, chemicals and textiles. In contrast, companies dedicated to coal mining and other related activities received larger investments of up to US$1.296 m in 2009 with respect to the previous year. This partially offset the drop experienced by the other sectors.

Graph B1.2 presents the flows of FDI for 2009 based on economic activity. This graph shows that the entire mining sector accounts for 79.53% of the FDI income (36.56% allocated to the oil sector and 42.97% to the other mining activities). Other areas that attract flows of FDI are transportation, storage and communications, manufacturing industry, commerce and financial corporations. These activities recorded high sums of capital reimbursement, particularly in the last quarter of the year.

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1 This category includes the new contributions of capital represented in foreign currency and in kind made by non-residents in Colombia as well as the reinvestment of profits done by companies that have foreign capital. The companies receive financial flows that do not correspond to the definition of gross formation of fixed capital used in the national accounts.

2 This includes the liquidation of investments generated by the sale of stock owned by foreign investors to Colombian residents and also the reimbursement of capital that foreign-owned companies periodically remit to their head offices.

Table B1.1
Net Flows of Direct Investment
(Millions of dollars)

	2008	2009	Annual Percentage Variation
I. Net flows of Foreign Direct Investment in Colombia (A+B)	**10,583**	**7,201**	**(32.0)**
A. Income due to gross Foreign Direct Investment in Colombia (a+b)	17,773	16,057	(9.7)
a. New investment	15,439	14,125	(8.5)
b. Reinvestment of profits	2,334	1,931	(17.3)
B. Expenditures due to reimbursement of capital	(7,190)	(8,856)	23.2
II. Net flows of direct Colombian investment abroad	**2,254**	**3,025**	**34.2**
III. Flows of net direct investment (I-II)	**8,329**	**4,177**	**(49.9)**

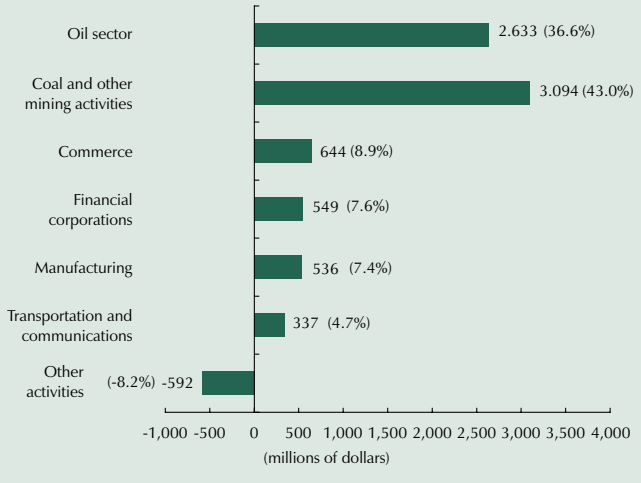
Source: Banco de la República (balance of payments).

Table B1.2
Net Flows of Foreign Direct Investment in Colombia, Balance of Payments
(Millions of dollars)

Activity	2008	2009	Absolute variation	Annual percentage variation
Oil sector	3,392	2.633	(758)	(22.4)
Coal and other mining activities	1,798	3.094	1,296	72.1
Commerce	1,049	644	(404)	(38.6)
Financial corporations	1,095	549	(546)	(49.8)
Manufacturing	1,748	536	(1,212)	(69.4)
Transportation and communications	853	337	(516)	(60.5)
Other activities	649	(592)	(1,241)	(191.3)
Total	**10,583**	**7,201**	**(3,382)**	**(32.0)**

Source: Banco de la República (balance of payments).

Graph B1.2
Net DFI Flows by Economic Activity



Note: The FDI is shown by economic activity as a percentage of the total in parenthesis.
Source: Banco de la República.

In 2009, Colombian investors bought productive foreign assets for US$3.025 m, which was equivalent to a 34% annual increase. These investments were mainly made by Colombian mining sector companies, which acquired shares of stock in the economies of the United States and some Latin American countries, especially in businesses related to fuel distribution and drilling and extraction of oil.

Given the net FDI income of US$7.201 m in the country and US$3.025m in direct Colombian investments abroad, the flows of net direct investment in 2009 amounted to US$4.177 m with an annual reduction equivalent to US$4.153 m (50%) (Table B1.1).

Box 2
EFFECTS OF THE COMMERCIAL CRISIS WITH VENEZUELA

This box analyzes the effects of the trade crisis with Venezuela on the performance of exports and the stability of the Colombian financial system in 2009.

1. Change in Exports to Venezuela

The Venezuelan market has historically been an important market for Colombian exports. This dependency was intensified between 2005 and 2008 by the increase in demand for our products in Venezuela, which was associated with the increase in oil prices and their internal shortage.[1] The geographical proximity, the tariff advantages, commercial tradition and high profitability, along with other factors, helped national exporters to secure a sizeable portion of the growing demand from Venezuela.

Indeed, sales to Venezuela tripled between 2005 and 2008 by going from US$2.098 m to US$6.092 m and thus registering significant increases for most of the exported goods during this period (Table B2.1). This contributed, on average, a quarter of the total growth of the country's exports denominated in dollars between 2006 and 2008. Furthermore, the bilateral trade showed a positive balance for Colombia, which, due to its size, offset the deficits with other countries (China, Japan, Germany, Mexico, Brazil, etc.).

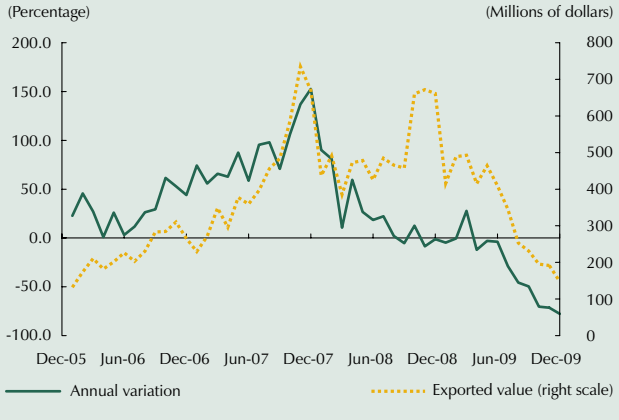
The lower demand for imports due to the effects of the drop in oil prices in comparison to their levels for the 2007-2008 period,[2] the resulting restriction that Venezuela has faced in terms of foreign currency and the political differences between the two countries that took place in 2009 significantly affected the pattern and the structure of Colombian exports to that market. As a result of those factors, sales plummeted 33.5% during the year. At the end of 2009, the value exported was similar to that for early 2006 and lower than the value recorded for the previous two years (Graph B2.1)

Between January and June 2009, there was an average of US$447 m per month in exports to Venezuela and a -0.2% annual rate of variation. The shipping of food and beverages, metal products and natural gas rose and this was offset by the decline in exports of other products, among which clothing, automobiles and auto parts, and agricultural products stood out (Table B2.2)

The decline in sales to Venezuela intensified in the second half of the year. In fact, the exported value in the first half of 2009 registered a level similar to that of one year before. In the second half, a downward trend was observed with respect to the purchases made by this neighboring country from Colombia and it reached an annual reduction equivalent to 71% during the last few months of the year. It is important to remember that between July and December last year, the drop in oil prices made evident the serious foreign liquidity problems that the Venezuelan economy is facing, which is the opposite of what happened in the 2004-2008 period. These restrictions forced the authorities of that country to impose harsher controls on the pegging of currencies to the official exchange rate, which made foreign purchases more expensive. At the same time, there were delays in administrative procedures, such as in the case of health certifications for some food and cosmetic products.

In the second half of the year, the facts mentioned above were reflected by an exports average of US$ 220 m per

Graph B2.1
Monthly Exports to Venezuela



Source: DANE, Banco de la República calculations.

* The document written by Pilar Esguerra et al. (2010) served as the base for writing this box: "El comercio colombo-venezolano: características y evolución reciente" (Colombo-Venezuelan trade: features and recent changes), internal document, Banco de la República.

1 In reference to the characteristics of the recent performance of the Venezuelan economy, see the Box "The Venezuelan economy and the impact of the slump in bilateral trade on the Colombian economy" in the Report on Inflation, September 2009.

2 The prices of oil reached their highest levels historically in 2007 and 2008. However, they dropped in the first half of 2009 and rose again in the second half although without reaching the levels they had had in previous years.

Table B2.1
Colombian Exports: Total and to Venezuela

	2005	2006	2007	2008	2009
Millions of dollars					
Total exports	21,190	24,391	29,991	37,626	32,853
Exports to Venezuela	2,098	2,702	5,210	6,092	4,050
Annual percentage variation					
Total Exports	26.65	15.10	22.96	25.46	(12.69)
Exports to Venezuela	29.20	28.80	92.85	16.91	(33.52)
Share					
Of the exports to Venezuela in the total exports	9.90	11.08	17.37	16.19	12.33
Of the exports to Venezuela in the non-traditional industrial exports	22.57	24.72	37.34	36.71	29.35
Venezuela's contribution to the variation in total exports	2.83	2.85	10.28	2.94	(5.43)

Sources: DANE, Banco de la República calculations.

Table B2.2
Exports to Venezuela by Sectors (CIIU Classification, Revision 3)

Sector	January-June			July-December			December		
	2008	2009	Variation (%)	2008	2009	Variation (%)	2008	2009	Variation (%)
Food and beverages	461	647	40.4	684	171	(74.9)	146	20	(86.5)
Leather and shoes	180	128	(28.9)	301	24	(92.0)	49	1	(97.9)
Textiles	335	314	(6.4)	358	89	(75.1)	75	9	(87.4)
Clothing	314	88	(72.1)	238	84	(64.5)	35	11	(67.7)
Metal products	47	107	127.0	157	26	(83.7)	33	3	(92.2)
Automobiles and auto parts	137	39	(71.7)	156	42	(73.4)	34	5	(84.5)
Agricultural products	147	53	(64.0)	111	15	(86.3)	12	0	(99.3)
Chemicals	281	288	2.6	347	242	(30.3)	60	22	(63.2)
Electric appliances and machinery	85	87	1.9	110	57	(48.5)	17	8	(51.2)
Rubber and plastics	93	89	(4.4)	107	59	(45.1)	23	8	(63.0)
Non-metallic minerals	87	76	(13.0)	95	51	(45.7)	18	8	(57.2)
Publishing and printing	45	46	3.1	59	19	(67.2)	12	3	(71.5)
Furniture	65	38	(42.2)	63	29	(53.3)	13	4	(65.9)
Machinery and equipment	119	189	58.5	208	100	(52.0)	41	8	(79.7)
Paper and cardboard	97	157	61.1	143	94	(34.0)	28	10	(62.9)
Crude oil and natural gas	33	132	300.9	92	128	40.0	26	13	(52.3)
Other	162	209	28.7	174	133	(23.7)	40	13	(67.8)
Total	**2,690**	**2,686**	**(0.2)**	**3,401**	**1,364**	**(59.9)**	**662**	**148**	**(77.7)**

Source: DANE, Banco de la República calculations.

month and an annual variation equivalent to -60%, which was characterized by a strong declining trend in total exports and a general decrease in goods shipped, such as leather and shoes, food and beverages, textiles and clothing, etc. (Table B2.2). At the beginning of 2010, the exports to Venezuela maintained their marked declining trend.

In reference to the composition of the basket of exports, significant changes have been registered in the last three years. In 2006, the first three products exported were automobiles and auto parts, food and beverages, and chemicals. In 2008, however, the restrictions on the sale of vehicles meant that the first place in sales was taken by the sector of food and beverages, followed by textiles and chemicals. During this same period, the increase in the share of sales in the sectors of clothing, leather, manufacturing and metal products were outstanding. The lower exports recorded in 2009 did not imply a change in the three top goods shipped in comparison to the previous year, but there was a larger proportion of exports for the sectors of natural gas, paper and cardboard, and machinery and equipment in the sales to Venezuela.

The decrease in foreign purchases by Venezuela was not a factor that exclusively affected Colombian exports. In fact, based on the official figures published by Venezuela, the total imports of that country for 2009 plunged 22.3% (-US$11.040 m) with respect to 2008, when this market imported US$49.482 m in merchandise. This reduction occurred mainly because of the decrease in purchases of electrical and transportation materials, agricultural products, food, plastics and manufactured products. By country of origin, the decline in Venezuelan imports mainly resulted from the reduced shipping of merchandise from Colombia, the United States, Brazil and Mexico. In spite of the drop in purchases Venezuela made from Colombia, the Colombian market was the second source of Venezuelan imports in 2009, after the United States and ahead of China, Brazil and Mexico. It is noteworthy that although Colombia surpasses China in its share of the total value of Venezuelan foreign purchases, China has become a strong competitor for Colombia in the supply of textiles, clothing and leather products.

2. Effects of the Venezuelan Crisis upon the Markets of the Firms That Export to Venezuela

The general decrease in the global demand associated with the recent economic crisis, the special features of the Venezuelan market (proximity, access roads, tariff advantages, commercial tradition, recognition of customers, profitability) and its relevance as the main or only market for a significant number of the export firms and their products (Table B2.3) have been important conditions for the increase of exports to other countries in the short term. Under these conditions, the diversity of markets becomes one of the main challenges for Colombia in the near future.

Table B2.3
Colombian Export Firms and their Percentage Distribution by Market

	Number of firms	Percentage		
		Only to Venezuela	Venezuela and others	Others
2005	11,720	5.8	15.4	78.8
2006	11,427	6.6	15.7	77.6
2007	11,433	10.0	17.3	72.7
2008	11,298	13.6	16.4	70.0
2009	10,728	13.5	14.9	71.7

Source: DANE, Banco de la República calculations.

In spite of the ongoing restrictions, between July and December of 2009, some of the firms that export food, beverages and chemicals (Table B2.4) increased the value of what they exported to other markets, among them the United States, the rest of the Latin American Integration Association (Aladi in Spanish) and Asia. Nonetheless, that increase did not offset the downswing in sales to Venezuela, but it reflects the efforts the exporters have made to compensate for the difficulties that they currently

Table B2.4
Main Industrial Products For Export[a/] by Market

Sector	Absolute variation 2008-2009 (July-December)	
	Other	Venezuela
Food and beverages	141.6	(512.6)
Chemicals	47.1	(105.1)
Electric appliances and machinery	1.6	(53.3)
Publishing and printing	(9.7)	(39.5)
Non-metallic minerals	(9.2)	(43.2)
Leather and shoes	(9.9)	(276.5)
Paper and cardboard	(12.5)	(48.4)
Machinery and equipment	(29.9)	(108.3)
Metal products	(22.3)	(131.2)
Rubber and plastics	(33.1)	(48.5)
Furniture	(25.6)	(33.5)
Textiles	(42.7)	(269.1)
Automobiles and auto parts	(60.4)	(114.9)
Clothing	(64.3)	(153.3)

a/ Excluding products refined from oil or nickel-iron
Source: DANE, Banco de la República calculations.

face with the situation in that market. Unfortunately, there was a generalized reduction of the aggregate for the products shipped to other markets, which means that the slump in exports was not a phenomenon that was exclusive to the Venezuelan market.

3. Impact on the number of exporters and their income

In the changes occurred in the bilateral trade, the number of companies exporting to the Venezuelan market has always maintained a direct correlation with the value in exports going to that market. Between 2005 and 2008, there was an increase in the number of exporters along with the growth of exports. Likewise, in 2009, the decreasing sales to the neighboring country took place simultaneously with a lower number of exporting firms. In fact, between July and December last year, the value of shipments fell almost 60% and, at the same time, the average rate of decrease per month in the number of exporters was 30%. For the entire year, the drop in the number of exporters was 7.2% (Table B2.5 and Graph B2.2).

In addition to the reduction in the number of exporters, those who continued selling to Venezuela made fewer sales than in previous years. In 2009, a minor transition from big exporters to companies that sell less than US$500.000 took place. This is the opposite of what occurred in previous years, when the firms that exported more than that amount grew significantly.

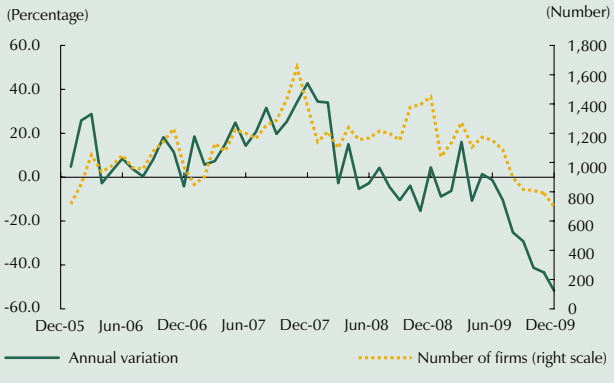
The most recent figures available show that the Venezuelan market is an important source of export revenue for the firms that were analyzed (Graph B2.3 panel A). However, for most of them the sales to Venezuela are not the main source of their operational income (Graph B2.4 panel B). Most of the companies that sell to Venezuela focus their business mainly on the domestic Colombian market. In spite of this, the exports to Venezuela boosted the total income for these export firms, especially between 2006 and 2008. Likewise and although the information for 2009 is not available yet, a negative impact on the foreign revenue of the firms is expected due to the

Table B2.5
Firms That Export To Venezuela

Year	Number	Annual percentage variation
2005	2,487	9.8
2006	2,555	2.7
2007	3,123	22.2
2008	3,386	8.4
2009	3,040	(10.2)

Source: DANE, Banco de la República calculations.

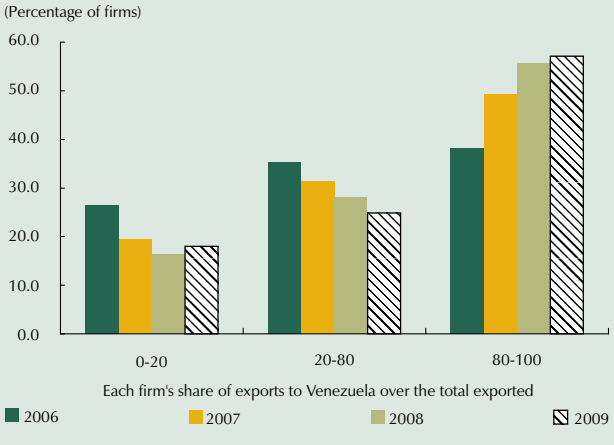
Graph B2.2
Firms That Export To Venezuela (Monthly)



Source: DANE, Banco de la República calculations.

Graph B2.3
Percentage Distribution of the Firms that Export to Venezuela

A. Based on Each Firm's Proportion of the Total Value Exported to Venezuela



B. Based on the Proportion of Each Firm's Operational Income Resulting from Sales to Venezuela

Source: DANE, Banco de la República calculations.

closing of the Venezuelan market. This will surely affect the performance of their total income, but not necessarily will imply the shutdown of the companies.

4. Debts that the companies that export to Venezuela have with the Colombian financial system.

Another aspect that requires attention is the possible impact that the substantial decline in sales to Venezuela could have on the Colombian financial system because the companies whose income is completely dependent on that market may default on their financial obligations due to the effects of the crisis.[1] Among the credit entities that grant loans to the companies that export to Venezuela, the banks, which hold a 90.7% share of those loans, stand out. Also, the loan portfolio of the companies in the sample being considered represents 16.1% of the banks' total loan portfolio.

Table B2.6 shows both the number of loans and the amount in loans granted to the companies that export to Venezuela, classified by type of entity. For commercial banks, this represents 16.1% of the loans in terms of the total amount, although the number of loans in the hands of the companies that export to Venezuela is just 1.3% of the total number. For the commercial financing companies (CFC), the share of the exporters to Venezuela in the loan portfolio based on number of loans and amount is 2.4% and 8.7% respectively. Therefore, this means that the average amount per loan is high for these companies.

In order to analyze the risk incurred by each entity, Table B2.7 shows the portfolio quality index (QI) for the commercial banks as well as for the total number of CFC's. For most of the entities, the QI for their portfolio of loans granted to the companies that export to Venezuela is better than the QI for the total of their commercial loan portfolio. A similar result occurs in the case of the CFC's.

1 The information from the commercial loan portfolio reported to the Financial Superintendence of Colombia as of December, 2009 was used to analyze the level of indebtedness that the companies that export to Venezuela have. Of the 3,040 companies that exported to that country in 2009, 2,058 had debts with entities of the Colombian financial system.

Table B2.6
Share By Amount And Number Of Loans Granted To Companies That Export To Venezuela

Entity	Portfolio of exporters		Total commercial loan portfolio		Percentage share	
	Number of loans	Amount (billions of pesos)	Number of loans	Amount (billions of pesos)	Number of loans	Amount
1	1,618	3,110	103,641	19,769	1.6	15.7
2	1,131	2,496	104,696	14,638	1.1	17.1
3	539	1,635	52,148	9,392	1.0	17.4
4	813	963	37,569	6,073	2.2	15.8
5	393	959	20,875	5,904	1.9	16.3
6	476	594	6,719	3,710	7.1	16.0
7	303	669	4,346	2,531	7.0	26.4
8	272	445	7,356	3,110	3.7	14.3
9	31	220	66,882	3,702	0.0	5.9
10	237	415	9,954	2,623	2.4	15.8
11	154	324	7,756	1,678	2.0	19.3
12	219	255	2,932	1,902	7.5	13.4
13	170	215	931	805	18.3	26.7
14	59	129	538	515	11.0	25.1
15	99	120	61,185	1,569	0.2	7.7
16	4	35	17	133	23.5	26.1
17	9	1	584	52	1.5	1.7
Total banks	**6,528**	**12,585**	**488,979**	**78,110**	**1.3**	**16.1**
Total commercial financing companies	**2,171**	**1,273**	**91,721**	**14,693**	**2.4**	**8.7**

Source: Financial Superintendence of Colombia and DANE, Banco de la República calculations.

Table B2.7
Risky Portfolio Of Companies That Export To Venezuela Versus Total Commercial Portfolio

Entity	Portfolio of exporting companies		Total commercial loan portfolio	
	Risky portfolio (billions of pesos)	Quality index	Risky portfolio (billions of pesos)	Quality index
1	135.9	4.4	1.496.2	7.6
2	310.1	12.4	1.543.1	10.5
3	36.8	2.3	637.1	6.8
4	77.3	8.0	543.9	9.0
5	26.9	2.8	471.3	8.0
6	16.5	2.8	207.4	5.6
7	9.2	1.4	72.3	2.9
8	73.5	16.5	330.0	10.6
9	3.7	1.7	681.0	18.4
10	12.7	3.1	325.9	12.4
11	3.8	1.2	88.7	5.3
12	23.0	9.0	347.0	18.2
13	22.2	10.4	44.2	5.5
14	1.3	1.0	31.0	6.0
15	1.0	0.9	229.9	14.7
16	0.0	0.0	9.8	7.4
17	0.0	0.0	3.1	5.9
Total banks	**754.1**	**6.0**	**7.062.5**	**9.0**
Total commercial financing companies	**79.8**	**6.3**	**1.782.2**	**12.1**

Source: Financial Superintendence of Colombia and DANE, Banco de la República calculations.

5. Final considerations

In summary, the impact of the situation in the Venezuelan economy and the political factors that have led to the restriction of exports from Colombia to that market have been significant and especially concentrated in the second half of 2009. In December of the same year, the exports totaled US$148 m, in contrast to the year before when they came to US$662 m. This tendency has been observed in both the performance and the composition of the trade flows as well as in the trend for the income of the exporting companies. In general, it is not expected that companies will shutdown due to the export crisis with Venezuela because for the most part, their income depends more on the domestic market than on the exports to that country. Given this scenario, some exporters who shipped food, beverages and chemical products there have started the process of substituting other markets for it although that has not compensated for the general drop of the sales to Venezuela.

With respect to the possible impact that the marked reduction in sales to Venezuela could have on the Colombian financial system, there is no serious concern that it will be significant. Based on the analysis of the portfolio quality of the companies that export to Venezuela, the conclusion drawn is that they are good debtors. In this regard, it is unlikely that there will be a generalized tendency to default that would affect the banking system.

In the short term, the trend in declining sales to Venezuela is expected to continue such that by the end of 2010, the sales could be at the levels seen in 2005. This will take place not only due to the deterioration of economic activity in Venezuela but also the growing restrictions with respect to foreign currencies as well as the commercial limitations faced in that country. For the Colombian exporters, the process of replacing that market will continue although slowly because it will be carried out in an environment in which the world economic recovery is still far from consolidating. The main markets for substituting for those sales would be the United States, Aladi and Asia.

Box 3
FISCAL RULES: NATIONAL AND INTERNATIONAL EXPERIENCE

An inter-institutional technical committee has been created by the Ministry of the Treasury and Public Credit and is staffed by officers from that entity as well as from Banco de la República, the National Planning Department and has nationally recognized experts who provide consulting services. This committee has been working on the design of new fiscal rule for Colombia.

The main objectives determined by the rule are to consolidate the fiscal adjustment and to strengthen the public finances in the long term. The rule will improve the credibility of the fiscal policy, secure a counter-cyclical fiscal management and guarantee the sustainability of the public debt over time. The Colombian government has used fiscal rules in the past to curb the growth of spending and the indebtedness of territorial entities as well as to favor the transparency and fiscal responsibility of the public sector. However, the scope of those rules has been limited because they do not guarantee a counter-cyclical management of the fiscal policy and do not include specific goals for both deficit and debt in the medium term but leave these issues in the hands of the fiscal authority.

The type of fiscal rule that can be used, their international application and the experience that Colombia has had up to now by using them is examined in this box.

1. International Evidence

The type of fiscal rule that can be used by a country depends on factors such as the degree of measurement that can be made of the intended goals, the institutional coverage and the implementation strategy. As long as a goal is easily quantified (fiscal deficit or public debt, for instance), a follow-up can be done that makes it possible to evaluate the usefulness of the fiscal rules more effectively. The countries in the European Monetary Union (EMU) and some countries in Latin America have adopted quantitative fiscal rules that are simple to quantify. Other rules emphasize prohibiting governments from financing themselves by using the central bank funds or other sources in the domestic market as well as the issue of fiscal transparency (promoted since the 1990's by governments of countries such as Canada and New Zealand).

Table B3.1 summarizes the main types of fiscal rules used internationally and Table B3.2 identifies the countries where they have been used, the dates when they went into force and the levels of government on which they are applied. It also describes the particular characteristics of the rules for each country: whether or not they have escape clauses, the type of laws that establish the rule and the penalty in the case of failing to comply with it.

The fiscal rules that seek to achieve a balance between government revenue and expenditures are the most common. They can be analyzed based on the period of time and the level of government. The rules for balance between current income and expenditures (CB), which only allows for the financing of capital expenditures, becomes a rule that secures fiscal solvency in the short term. This rule is used by the governments of political subdivisions in several countries (United States, Switzerland, Canada and Colombia) as well as by the federal and lower level governments in Germany and Brazil.

Table B3.1
Main Types Of Fiscal Rules

I. Balanced budget or deficit limit rules:
- Balance between current income and expenditures (current balance [CB]). Financing is allowed exclusively for public investment (golden rule).
- Balance between overall income and expenditures (total balance [TB]) or restriction of the overall deficit to a share of the GDP.
- Balance between structural income and expenditures (structural balance [SB]), i.e. the income and the expenditures are adjusted by cyclical variations.
- Quantitative restrictions on the structural fiscal balance (total or basic) as a share of the GDP.

II. Deficit Financing Rules:
- Prohibition of financing by the central bank.
- Restrictions on financing expressed as a share of income or expenditures.
- Prohibition of internal financing (PIF).

III. Indebtedness or Reserves Rules:
- Limit on the stock of debt (gross or net) as a proportion of the GDP. This limit could be annual (AL), permanent (PL) or future (FL).
- Goal for the reserves in contingency funds (CF) as a proportion of the annual payments of pensions or stability funds for commodities.

Source: Kopits and Simansky (1998), OCDE (2002) and Banco de la República.

In the medium term, the balance rule between total revenue and expenditures (TB) or the one that limits the total deficit as a proportion of the GDP consider both the primary balance and the payment of current and accrued interest. This rule limits the possibility of accumulating new debt and its purpose is to put the public finances on a sustainable path in the medium term.

The structural balance regulation (SB) allows the automatic stabilizers to act effectively. The medium and long term objective is to provide fiscal continuity regardless of what point in the economic cycle the economy is going through. Some countries establish the achievement of a structural surplus (SS) that generates a reduction in the stock of the public debt (e.g. Chile).

The rules for deficit financing make reference to the defining role that must exist between the monetary and fiscal policies. When the use of a financing source such as the central bank is limited or eliminated, it creates credibility and trust for both institutions. In the case of Indonesia, for instance, the government may be granted "quotas" once the fiscal stability goals are reached. In Colombia, the Constitution of 1991 stated that the central bank cannot give the government direct loans except in the case of a unanimous decision made by all the members of the Board of Directors of Banco de la República.

At the level of political subdivisions below the national government, the financing rules become more important because their implementation is less complex in political terms. This is one of the main tools used by central governments to reduce bailouts of lower level political subdivisions and to make the public finances sustainable (Argentina, Brazil, Canada, Colombia and United States).

The rule that limits the balance of debt (gross or net) is a tool that, along with the limit on the deficit (primary or total-and-structural), contributes significantly to the fiscal sustainability in the medium and long terms. This rule has won considerable international acceptance since the implementation of the Maastricht Treaty by EMU, which limited the debt/GDP ratio to 60% and the fiscal deficit to 3% of the GDP.

Some countries have established rules for the building and management of reserves of contingency and stability funds (CF) such as those created in countries with high financial dependency on the export of commodities (oil and copper). Generally, the funds are earmarked to provide their beneficiaries (public or mixed public-private entities) with solvency and to bring about macroeconomic stability when they are used as a counter-cyclical tool, i.e. to save in times of boom and to spend in times of shortage (e.g. United States, Colombia, Chile).

Table B3.2
International Experience With Fiscal Regulations

Country	Starting date [a/]	Coverage	Basic regulations	Escape clauses	Additional regulations	Statute	Penalty
Fiscal balance							
Emerging countries							
Argentina	2000	National government (central, federal) [b/]	Equilibrium of the fiscal balance, limit on the deficit	Contingent funds	Limit on the primary expenditure	Legal regulation	Repudiation
Brazil	2001	National government (central, federal), sub-national governments	Current balance		Limit on payment of salaries	Constitutional amendment, legal regulation	Judicial
Chile	2000	National government (central, federal)	Goal for the structural surplus (limits expressed as a % of annual GDP except if specified on a multiannual base)	Contingency funds, multiannual		Policy Guidelines	Repudiation

Table B3.2 (continuation)
International Experience With Fiscal Rules

Country	Starting date [a/]	Coverage	Basic rules	Escape clauses	Additional rules	Statute	Penalty
Colombia	1997, 2001	National government (central, federal), Sub-national government	Current balance	Contingent funds	Limit on payment of salaries, limit on payment of foreign debt (limits in terms of GDP or of its annual growth)	Legal regulation	Judicial, financial
Ecuador	2003	National government (central, federal)	Balance (excluding petroleum), limit on the deficit	Contingent funds	Limit on the primary expenditure	Legal regulation	Judicial
Estonia	1998	General government	Equilibrium of the fiscal balance	Contingent funds		Policy Guidelines	Repudiation
India	2004	National government (central, federal) [b/]	Current balance, limit on the deficit			Policy Guidelines	Repudiation
Indonesia	1967	General government	Prohibition on domestic financing of the deficit			Policy Guidelines	Repudiation
Mexico	1917, 2003	Sub-national government, national government (central, federal)	Current balance	Contingency funds		Constitutional amendment	Repudiation
Peru	2000	National government (central, federal)	Equilibrium of the fiscal balance, limit on the deficit	Contingent funds	Limit on the primary expenditure	Legal regulation	Judicial
Venezuela	2004	National government (central, federal)	Equilibrium of the fiscal balance	Contingent funds, multiannual	Limit on the total expenditure	Constitutional amendment, legal regulation	Repudiation
Industrialized countries							
Germany	1969	National government (central, federal), Sub-national government	Current balance			Constitutional amendment	Judicial
Canada	Various	Sub-national government	Current balance			Legal regulation	Judicial
United States	Various	Sub-national government	Current balance	Contingent funds		Constitutional amendment	Judicial
European Union	1997	General government	Equilibrium of the fiscal balance, limit on the fiscal deficit	Multiannual		International treaty	Financial
New Zealand	1994	General government	Operational balance	Multiannual		Legal regulation	Repudiation
Switzerland	Various	Sub-national government	Current balance			Constitutional amendment	Judicial

Table B3.2 (continuation)
International Experience With Fiscal Rules

Country	Starting date [a/]	Public debt: Coverage	Public debt: Basic rules	Public debt: Escape clauses	Public debt: Additional rules	Statute	Penalty
Emergent countries							
Brazil	2000	National government (central, federal), Sub-national government	Limit to the stock of future debt			Constitutional amendment, legal regulation	Judicial
Colombia	2004	Sub-national governmentl	Limit to the stock of future debt			Legal regulation	Repudiation
Ecuador	2003	National government (central, federal)	Permanent limit to the stock of debt			Legal regulation	Judicial
Poland	1998	General government, Sub-national government	Permanent limit to the stock of debt			Constitutional amendment, legal regulation	Judicial
Industrialized countries							
European Union	1997	General government	Permanent limit to the stock of debt			International treaty	Judicial
New Zealand	1994	General government	Limit on the stock of debt for a given year (limits as % of GDP or of government income)			Legal regulation	Repudiation

a/ Year in which the fiscal regulation goes into effect.
b/ Also adopted by one or several governments below the national level.
Sources: Kopits (2001, 2004) and OCDE (2002), Banco de la República.

Several types of additional rules have been adopted internationally to limit the growth of public expenditure. Specifically, rules have been implemented to control the primary expenditure (Argentina, Ecuador and Peru), the growth of expenditures on personnel (Brazil and Colombia) and in some cases, to restrict the payment of SG debt (Colombia). In many instances, they are expressed as qualitative norms or legal guidelines on the use of public funds or restrictions on using some kinds of sources of financing. In others, they are stated as quantitative goals. Sometimes they are formulated to control the use of extra revenue the State receives, liquidate financial liabilities or save. The quantitative goals can be established on the total or primary balance, or as an alternative, on those balances adjusted by the economic cycle. Based on what has been said, the fiscal rules have numerous advantages for the management of the public finances. Nonetheless, for a fiscal rule to be successful, certain conditions must be met. First of all, a fiscal rules must be credible. For this to happen it is necessary for the authorities to have previously shown their ability to control the public finances. If an effort is made to establish a regulation in a context of huge fiscal disparity, it will be unlikely to have any credibility. Likewise, the support of society is crucial for its success. Just as society values a low rate of inflation and supports the central bank's task to exercise control on it, so in the case of fiscal rule, the citizens must also value the economic stability rendered by that rule and be willing to take on the economic sacrifices it requires.

In addition, fiscal rules are subject to certain limitations. Some are technical in nature such as the difficulty of estimating the potential GDP or the output gap, which are elements that are necessary for calculating the structural fiscal balances. Other limitations are practical in origin. One of the most important of these is the inflexibility of expenditure. When expenditures are inflexible either because the law requires them or some income is

specifically earmarked or because a future allotment has been approved (authorization of budget appropriations ahead of the fiscal period), then there could be difficulties in complying with the rule. This is why one of the requirements for a fiscal rule to be successful is for it to try to limit the inflexible expenditures.

2. The case of Colombia

In Colombia, there are general principles of fiscal management as well as quantitative and qualitative rules in the Constitution, the acts of the legislature and executive decrees. The rules are applicable to the finances of the national government as well as to the finances of the territorial entities. Some of the rules are qualitative or procedural and have to do with the drawing up, approval, implementation and control of the budget. Other rules put quantitative restrictions on indebtedness and limit the growth of expenditures as well as the sources of financing for the government.

The fiscal rules that are constitutional in character are focused on the general budget of the nation, the general system of participation (GSP) and the relationship between the executive and the central bank through the mandate that bans lending to the government by using funds through issuing currency except when there is unanimous agreement on the part of the Board of Directors of Banco de la República.

The budgetary norms correspond to general principles that were gathered and developed in the constitutional statute for the budget. For instance, the norms regarding the GSP have been adjusted since 1991 to properly provide for the services of education, health and cleaning of polluted water and air in the regional territories.

Among the fiscal rules passed by the legislature, Act 358/1997, Act 617/2000 and Act 819/2003 (Table B3.3) are the most notable. By means of the so-called "Stop Light Act," the government established a set of quantitative rules to limit the indebtedness of the Sub-national governments and achieve financial solvency for them. Meanwhile, the Act of Territorial Fiscal Responsibility (AFR) created rules to curb the growth of public expenditure by the political sub-divisions and of a portion of the central government's current expenditure. The AFR was implemented in 2003. It stipulated rules to bring about fiscal transparency and responsibility throughout all of the public sector by annually presenting the medium term fiscal framework (STFF).

By means of Decree 4730/2005 and as part of the AFR rules, the government established a medium term framework for expenditures (MTFE) for a four-year period. The MTFE includes the projections for the main sector priorities and the maximum amounts in the general budget of the country for expenses distributed by sectors and components. The objective is "to build a more stable framework for the scheduling and use of public funds and, at the same time, to generate incentives to develop a budget management that is more results-oriented" (Office of the President, 2007, p. 88). The MTFE must be consistent with the ongoing rules and the government's policy priorities stated in the macroeconomic program and the MTFE itself.

The better performance on the part of the political sub-divisions could be explained to a large degree by the restrictive action of the fiscal rules adopted in 1997, which were reinforced in 2000 and 2003. The appropriate fiscal operation experienced by the governments below the national level during the current decade is largely the result of the institutional framework created by the fiscal rules that have been implemented since 1997.

The restrictions imposed by the fiscal rules established the conditions to restructure the finances of the territorial entities and to improve their fiscal management, a result which had not been achieved through discretional means. However, the larger benefits of the implemented rules will only be seen to the extent they are extended to their own organizer, i.e. the national government. In this context and from the experience of some countries in the region, the adoption of a quantitative regulation is the most suitable step to reduce the size of the deficit and the stock of debt the central government, contribute to macroeconomic stability and increase the credibility of the fiscal policy.

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Table B3.3
Main Fiscal Rules Of Colombia

- Act 358/1997 ("Stop Light Act"): introduces quantitative limits to the indebtedness of political sub-divisions by implementing indexes for financial liquidity and solvency. The liquidity index establishes that the ratio of payment of interest to operational savings cannot exceed 40% and the solvency indicator requires that the ratio of debt to current income must remain below 80%. These rules restrict the access of the sub-national governments to loans until they show a clear position of solvency that would allow them to make timely payments on their financial obligations. When these indexes show critical figures, any negotiations for new loans are subject to the authorization of the Ministry of the Treasury and Public Debt.

- Act 617/2000 (Act of Territorial Fiscal Responsibility): first of all, this sets limits to the growth of the government's current expenditure by using the annual inflation target set by Banco de la República as a benchmark. Indeed, the rules indicates that the increase in general expenditure must be below 50% of the inflation target and the expenditure on personnel below 90% for the 2000-2005 period, and after 2006, they cannot grow in real terms. Second, the law sets up quantitative limits on current expenditures by the territorial entities based on both their own revenue and the categories the norm has fixed for the country's departments and townships. In particular, the operational expenses of the territorial entities cannot exceed a given proportion of the current income that is not earmarked based on the size of each entity. In order to avoid short-term traumatic adjustments, the law granted those entities a transition period of four years to achieve the required proportion. In general, the goal of the law was to reform the territorial treasuries which had deteriorated due to excessive expenditures in the late 1990's.

- Act 819/2003 (Act of Fiscal Responsibility [AFR]): the purpose of this norm is the development of procedures of fiscal transparency and responsibility that would require the government to present a medium term fiscal framework to Congress annually. That framework must include, at a minimum, the financial plan, the multiannual macroeconomic program, the primary surplus goal for the non-financial public sector (NFPS) which would make it possible to keep the debt sustainable. It should also include an analysis of the main quasi-fiscal activities, an estimate of the fiscal cost of tax exemptions, the fiscal cost of the laws enacted in the previous period, the list of possible liabilities that could affect the financial situation of the country and indicators of budget management. In general, the act seeks to strengthen the fiscal institutions and make the government finances sustainable. Basically, the purpose of this norm was to give the national and the lower level governments the tools that would provide them with a medium term perspective on their fiscal management. Last of all, the law reinforces the controls on the indebtedness of territorial entities previously ordained in the Act 358/1997.

Source: Banco de la República.

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BOX 4
LONG TERM INFLATION TARGET: THE IMPORTANCE OF LOW INFLATION

When the Constitution of 1991 decreed that the Banco de la Republica Board of Directors were responsible for ensuring that the purchasing power of Colombians was maintained, the average of annual inflation was at 30.5%. It took almost two decades to reach inflation levels that were within the long term objective: between 2% and 4% (Graph B4.1). Given the fact that this target took such a long time to reach, it is an asset for Colombians that must be preserved for the future. Thus, the goal of this box is to underline the importance of keeping inflation low and stable.

Graph B4.1
Annual Inflation In Colombia, 1991-2009
(Percentage)

Source: Banco de la República.

1. Reasons for Keeping Low and Stable

High and volatile inflation worries economic agents because it distorts decision-making and affects economic growth. The literature also mentions different costs associated with inflation depending on whether or not the price increases are anticipated by the economic agents. Some of the costs are listed as follows:

- The inflation generated by announced increases of monetary emissions can cause problems for the distribution of income. For the people who earn their income in local currency, the higher inflation operates as a tax on the possession of cash, which could be seen as a cost of well-being. The higher uncertainty regarding the relative and absolute levels of prices also fosters the poor allocation of funds (Baley, 1956). Inflation adversely affects those individuals who receive fixed income in national currency (such as retirees and low-income workers) due to the loss of purchasing power their income suffers when the prices increase. Furthermore, they have fewer mechanisms to protect themselves from inflationary erosion and the indexation clauses in their contracts are infrequent (De Gregorio, 1998).

- Permanent and predictable increases of inflation act as a tax on the banks' possession of cash and if a portion of those costs are transferred to their customers, the real rate of a variety of assets in the economy may be reduced. The reduction of the real rate shrinks the incentives for saving and raises those for borrowing. This imbalance between savings and loans can cause credit restrictions, which works against a sustainable economic growth (Khan et al., 2001).

- Inflation that is elevated, unexpected and volatile has a regressive effect on economic activity because it hinders the economic agents from establishing long term relationships (Friedman, 1977). It generates a less stable macroeconomic environment which expands uncertainty and does not allow for long term planning. The uncertainty about future levels of inflation distorts the calculations of the profitability of long term investments and, therefore, making such investments becomes more difficult.

- The anticipated inflation induces the agents to substitute activities that do not require cash, such as leisure, for others that require it, such as consumption. The higher the long term inflation rate is, the larger the loss of purchasing power becomes and, as a consequence, consumption expenditures also decline. Moreover, because inflation indirectly levies a tax on the investment return, a high inflation rate also causes the agents to reduce their investment and, as a result, the pool of capital drops. The combination of a rise in the leisure activities (lower supply of employment) and a smaller pool of capital imply a lower level of output (Cooley and Hansen, 1989).

- Unanticipated inflation introduces distortions into the economic activity when the structure of relative prices is altered. The absolute prices do not all rise equally and, thus, getting information and allocating funds becomes difficult. As a result, inflation becomes an excuse for speculation (Lopez, 2006).

- In an environment of uncertainty, the economic agents make mistakes or incur high transaction costs more easily thus causing the economic well-being to

be worse than it would be in a scenario of higher certainty. The evidence of the effects of inflation on uncertainty is numerous and varied. For example, a study by Hess and Morris (1997) about the experience of countries that belong to the Organization for Economic Cooperation and Development (OECD) found the following results when the inflation is higher: i) the volatility of inflation itself goes up, ii) the volatility of economic growth increases, and iii) the volatility of relative prices grows.

2. Estimates for Inflation Costs

There are many studies carried out in different countries that have tried to measure the cost for a society when inflation remains high. For instance, Fisher (1981) calculated that, for the United States, a reduction of ten percentage points (pp) in the inflation rate would match a rise in well-being as a flow-per-period equivalent to 0.3% of GDP. A more recent study by Barro (1995) analyzed the impact of inflation on growth in 122 countries between 1960 and the late 1980's. According to this study, a 10 pp reduction in inflation would increase the growth from 0.2 to 0.3 pp while the investment rate would rise 0.4 to 0.6 pp.

In the case of Colombia, Carrasquilla, Galindo and Patron (1994) calculated that the loss of well-being due to an increase of inflation from 5% and 20% would be equal to 7% of GDP. Posada (1995) found that the losses of well-being associated with a 20% inflation rate are close to 3% of the GDP while for the same level of inflation, Riascos (1997) estimates them at 1.5% of the GDP. Finally, Lopez (2001) found that the loss of well-being caused when the inflation goes from 5% to 10% is 0.6% of the GDP.

3. What is Understood by Low Inflation

If it is argued that the inflation is costly, it is reasonable to ask why it should not be eliminated altogether. For example, Friedman set up a simple rule to determine the optimal inflation rate that, as will be explained, would end up in deflation.

The Friedman rule is based upon the fact that cash is not just useful to do transactions but also that possessing it implies an opportunity cost[1] because it is not invested in other, alternate financial instruments that would generate profits (for instance, bonds). As a result, consumers have an incentive to cut back on the use of cash depending on how much money they lose by keeping it. Therefore, the monetary authority should attempt to eliminate the difference between the interest rates for short term liquid instruments[2] and those for instruments contracted at longer terms. If this is accomplished, the interest rates for all maturities should be zero when the rate of yield for money is also zero. Since the nominal interest rate (*i)* is the real interest rate (*r*) plus the expected inflation ($E/\pi/$), then, if the variable is freed up, the inflation rate should be equivalent to minus (-) the real interest rate. For example, if the latter is 2% or 3%, the argument expounded by Friedman suggests an equal deflation (Lopez, 2006).

Nonetheless, there are valid reasons to think that a low but positive rate should be the medium and long term target:

- A low but positive inflation "lubricates" the functioning of the markets for labor and goods (Akerlof, Dickens and Perry 1996). In a world with rigid prices, it is easier for the real salaries to go down with a rise in the level of prices than with a drop in the nominal salaries. For instance, according to Akerlof *et al*. (1996), employment and economic activity are maximized with a level of inflation equal to 3%.

- Inflation is measured through the increase in the consumer price index (CPI). Generally, the CPI overestimates inflation with respect to the real increase in the cost of living. For instance, Molton (1996) found that, in the United States, the inflation measured by the Bureau of Statistics was approximately 2% above its real value.

- The third reason is known as the zero limit of the nominal interest rate. The core of this argument is that a zero inflation rate interferes with the attempts of the monetary policy to stimulate the economy in periods of recession because the nominal interest rate cannot drop below zero. In other words, the monetary authorities have leeway to push the real interest rate below zero when the inflation is moderately positive.

Because of the facts mentioned above, both the OECD member countries and the stable developing economies which have monetary policies based on inflation targeting have an average long term target range between 0% and 3% (Table B4.1).

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1 The cost of opportunity refers to the interest rate lost by keeping money in cash.

2 Despite the fact that this is called cash, a person could have his cash in a savings account that generates some profit, although very low, overnight.

Table B4.1
Some Countries With Inflation Targeting

	Starting	Current target	Long term target	Entity that sets the target
Australia	1993	2.0 to 3.0	Same as the current one	Government and central bank
Brazil [a/]	1999	4.5 +/- 2.0	n.a.	Government
Canada	1991	2.0 +/- 1.0	Same as the current one	Government and central bank
Chile	1999	3.0 +/- 1.0	Same as the current one	Central bank
Colombia	1999	2.0 to 4.0	Same as the current one	Central bank
Czech Republic	1997	2.0 +/- 1.0	Same as the current one	Central bank
Hungary	2001	3.0	Same as the current one	Central bank
Iceland	2001	2.5	Same as the current one	Government
Israel	1997	1.0 a 3.0	Same as the current one	Government
Mexico	2001	3.0 +/- 1.0	Same as the current one	Central bank
New Zealand	1989	1.0 a 3.0	Same as the current one	Government and central bank
Norway	2001	2.5	Same as the current one	Government
Peru	2002	2.0 +/- 1.0	Same as the current one	Central bank
Philippines [a/]	2002	4.5 +/- 1.0	n.a.	Government and central bank
Poland	1998	2.5 +/- 1.0	Same as the current one	Central bank
Korea	1998	3.0 +/- 1.0	Same as the current one	Government and central bank
South Africa	2000	3.0 to 6.0	Same as the current one	Government and central bank
Sweden	1993	2.0 +/- 1.0	Same as the current one	Central bank
Thailand	2000	0.5 to 3.0	Same as the current one	Central bank
United Kingdom	1992	2.0	Same as the current one	Government
Switzerland	2000	2.0	Same as the current one	Central bank

n.a. Not available
a/ Brazil and the Philippines have not announced an official long term target.
Source: central banks and Hammond (2010).

4. The dilemma between inflation and employment

In 1958, the economist, Arthur Phillips, argued that low inflation was accompanied by high unemployment and vice versa. This inverse relationship between inflation and unemployment is known as the Phillips curve, which suggests that to reduce the unemployment rate, a higher level of inflation must be allowed.

Accepting the above theory demands that we recognize the existence of a certain degree of monetary illusion on the part of economic agents. It is called monetary illusion because the economic decisions are influenced by nominal raises and do not take into account the increases in prices. To explain this concept, let's take for example the case of a country where the salaries and the prices rise at high rates simultaneously and, therefore, the purchasing power of workers remains constant. If the agents of this economy suffer from monetary illusion, then people will feel richer and will increase their consumption or they will buy some other products that are more expensive. Thus, output and employment grow together but at the cost of higher inflation due to the rise in the demand for goods and services. Conversely, if the agents were "rational," the individual's expenditure decisions would not be modified due to the fact that their purchasing power did not increase because their real salaries stayed constant.

The implicit theory in the Phillips curve was used by many countries to try to reach low unemployment rates at the cost of levels of inflation that may be considered high. Nevertheless, history showed that a country can have elevated levels of inflation and unemployment simultaneously, a fact known as stagflation. Examples of this were the situations experienced by the United Kingdom in 1965 and the United States in 1974.

Given this scenario, the Phillips curve theory began to be questioned. In 1967, Friedman noticed that workers were not concerned about the nominal increase in their salaries but rather about a real increase. According to Friedman, the workers kept inflation expectations in mind when they negotiated their salaries and, consequently, there was no place for monetary illusion in the long run.

In this context, the monetary and fiscal authorities cannot decide between the level of inflation and unemployment and should limit themselves to simply to control the costs of high inflation.

However, according to Akerlof and Schiller (2009), reality could be somewhere between these two theories. The economic agents are interested in having their contracts written in real terms, but in the short term, there is certain degree of monetary illusion that cannot be left out completely as Friedman expected. Some employment contracts do not hold indexation clauses or are not negotiated with expected one-to-one inflation taken into account. Another clear example of monetary illusion is the downward rigidity for the cutbacks on salaries because the employees regard them as unfair.[3]

Thus in the short term, the monetary policy of the central banks that have an inflation targeting regime takes advantage of the presence of the Phillips curve in order to ease the growth around a sustainable level. In the long term, the monetary policy is directed to reach or keep inflation low and stable in coordination with a macroeconomic policy that fosters the growth of output and employment.

3 Such downward rigidity has been found in studies done in Australia, Canada, Germany, Japan, Mexico, the United States, etc. In the case of Colombia, Iregui, Melo and Ramirez (2009) also found downward rigidity for salaries.

III. International Reserves

The measures adopted by the Banco de la República have reduced the investment portfolio risks and made it possible to guarantee that the country will have sufficient liquidity to face foreign crises. However, this resulted in a lower income from the investment of the reserves because of the direct relationship between risk and profitability or in other words, lower risk means lower profitability and vice versa.

Since the beginning of the international financial crisis, Banco de la República has adopted various measures to reduce the financial risks associated with the management of international reserves and thus to comply with their constitutional mandate to manage the investments with strict safety, liquidity and profitability criteria. Among the most important decisions made in 2008 and 2009 the following stand out: i) the end of the securities lending program,[57] ii) the elimination of all of the investments in asset backed securities (ABS) and in asset backed commercial papers (ABCP), iii) a 3-level jump in the minimum credit rating demanded for banks and corporations issuing securities (from A- to AA-), iv) an upswing in the share of securities backed by government Treasury bonds from developed economies and v) the reduction in the modified duration of 1.46 in September, 2008 to 0.51 in July, 2009.[58] Finally, the IMF was asked to authorize a flexible credit line (FCL) of approximately US$10.920 m for

57 The securities lending program was gradually suspended starting in March, 2008 when the amount in it came to US$4.177 m. As of December 31, 2009, the program had been completely closed.

58 The low level of interest rates in the markets of developed countries in 2009 as well as the limited leeway for them to drop further reduced the probability that the securities would appreciate and aggravated the portfolio market risk measured by the modified duration. The modified duration is the sensitivity of the value of the portfolio to movements of the interest rates. For example, a modified duration of 2 implies that the value of the portfolio will decline 2% if foreign interest rates rise 1%.

Colombia.[59] These steps were explained in detail in the July 2009 *Report to Congress*, in the *Management of International Reserves* document published in March, 2009 and in the Editorial Note in the April, 2009 issue of the *Banco de la República Magazine*.

The measures adopted by Banco de la República have reduced the risks in the investment portfolio and have made it possible to guarantee that the country will have sufficient liquidity to face foreign crises. However, this has resulted in a lower income from the investment of the reserves because of the direct relationship that exists between risk and profitability or in other words, lower risk means lower profitability and vice versa. Moreover, the low levels registered for the interest rates paid by the main central banks mean lower returns for the international reserves and have persuaded Banco de la República to reduce the reserves risk even more in order to be able to face a possible normalization of the monetary policy on the part of the main central banks. The management costs for the reserves, in turn, have climbed because of the maintenance costs of the FCL. This expense represented insurance that the country acquired to deal with extreme liquidity needs and this cost was less than it would have been to accumulate the same amount in international reserves as the amount approved by the IMF.[60]

In this chapter, the current situation with respect to Colombia's international reserves is explained and the factors that have caused the reduction in profitability are analyzed.

A. COMPOSITION OF THE INTERNATIONAL RESERVES

As of December 31, 2009, the gross international reserves amounted to US$25,364.6 m and the short term foreign liabilities came to US$8.9 m[61] as a result of which, the net international reserves totaled US$25,355.7 thus registering an upswing of US$1.326 m compared to the data observed towards the end of the previous year. This rise is mainly due to the increase of US$954.9 m in special drawing rights (SDR)[62] as a result of the allocation made by the

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59 The amount approved by the governing body of the IMF is equivalent to 6.966 m in special drawing rights (SDR), which is approximately US$10.920 m using the SDR rate as of December 31, 2009 (US$1.56769/SDR) as a reference point.

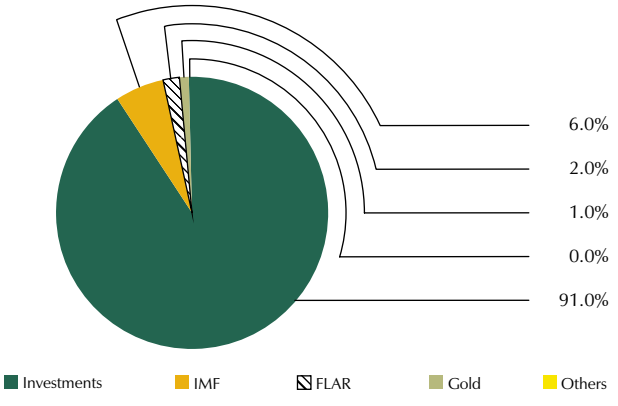
60 It is estimated that in comparative terms, the cost of US$28 m that corresponded to having immediate access to a FCL is significantly lower than the US$85 m (COL$7.5 m only in 2009) that would correspond to the cost of sterilizing additional purchases of reserves for just US$1.000 m, which, in addition, would have to be purchased gradually. If the Bank were to acquire US$10.500 m and sterilize it, the cost would be seven times higher than that amount.

61 These liabilities correspond primarily to the amounts payable for agreed investments.

62 The SDRs are reserve assets created by the IMF. Their usefulness as reserve assets is derived from the possibility that countries have to exchange them for reserve currencies (dollars, euros, pounds or yen) of other countries in order to deal with balance of payments needs or to modify the composition of the international reserves. In addition to their function as reserve assets, the SDRs serve as accounting units for the IMF.

IMF[63] and Banco de la República intervention in the foreign exchange market when they made US$171 m in net purchases of foreign currency during the year.

Graph 71
Composition of the Gross International Reserves
(as of December 31, 2009)



Source: Banco de la República.

The international reserves are divided into four parts: i) the investment portfolio which is made up of financial instruments in the international markets (US$23,116.6 m, 91.1%), ii) shares in the IMF (US$1,590.3 m, 6.3%) and in the Latin America Reserves Fund (FLAR) (US$392.7 m, 1.5%), iii) investments in gold (US$243.4 m, 0.9%) and iv) contributions to the international agreement of the Latin America Integration Association (Aladi) (US$21.5 m, 0.1%) (Graph 71).

1. Composition of the Investment Portfolio

The majority of the investment portfolio corresponds to securities issued by governments of developed countries, entities backed or associated with them[64] and by repo agreements with the Fed.

As a result of the measures taken by the Bank there was an upswing in the share of investments in governments or entities related to them as this went from 55% in June 2007 to 94% in December, 2009. The banking and corporative debt securities of industrialized countries which had been at 31% of the portfolio before the crisis currently represent around 6% and all of them have credit ratings that are equal to or greater than AA-. In 2009, the Bank completely eliminated its exposure to asset- backed securities, which had come to 11% of the investments before the crisis (Graph 72).

The issuers in which the reserves are invested have a low risk credit rating. In the case of the banking and corporative issuers, the minimum short term rating demanded is A-1/P-1/F-1,[65] which places them at the highest possible

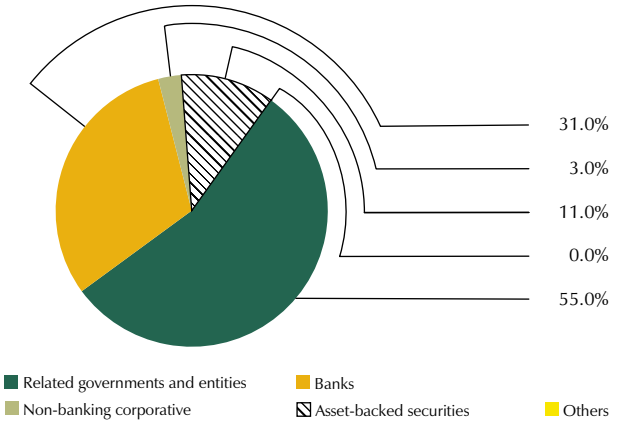
63 The IMF Board of Governors approved a general allocation of US$250 b in SDRs. Furthermore, that entity made a special allocation of US$33 b provided for in the Fourth Amendment of the Articles of Agreement. The distribution of the general SDR allocation was done in proportion to the quota of each country's share in the IMF while for the special allocation, a methodology was used that corrected for the fact that the countries that became part of the IMF after 1981 had not received an SDR allocation. With these allocations, the liquidity of the international financial network was strengthened to face crisis events by complementing the international reserves of the member countries. In the case of Colombia, the general allocation was made effective on August 28 and increased the international reserves by almost US$900 m (SDR 574 m). The special allocation, in turn, went into effect on September 9 and raised the international reserves by approximately US$79 m (SDR 50.3 m) using the SDR rate on December 31, 2009 as the reference point (US$1.56769/SDR).

64 The securities in question correspond to issues released by entities that are guaranteed or sponsored by governments (i.e. Fannie Mae and Freddie Mac), supranational entities (i.e. the World Bank, Interamerican Development Bank), and local authorities (i.e. cities and states), etc.

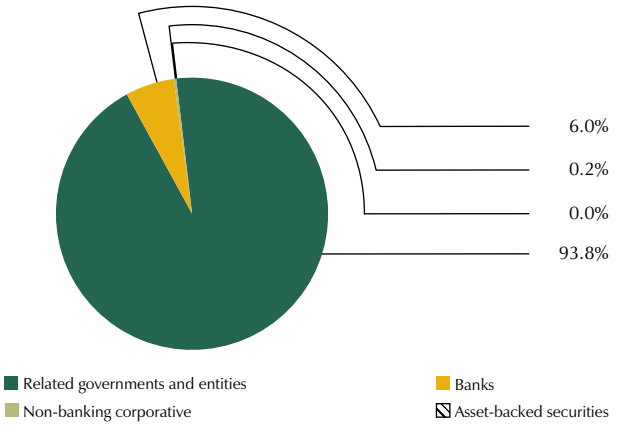
65 Investments with maturities that are less than 397 days are considered short term. Investments with longer maturity periods are considered long term.

Graph 72
Change in the Distribution of the Investment Portfolio by Type of Issuer

A. June, 2007



B. December, 2009



Source: Banco de la República.

level. The minimum long term ratings are AA- for banking and corporative issuers and A- for entities that are backed by or related to governments. In all cases, the minimum long term rating demanded by Banco de la República is at least three levels above the minimum rating required for an investment to be considered investment-grade.[66]

Currently, 100% of the short term investments in the investment portfolio have the highest credit rating and 99.5% of the long term investments have an A+ rating or above (100% have ratings above A-), which means that the probability that the issuer will default is minimal (Table 23).

Graph 73 shows the foreign exchange composition of the investment portfolio which the Bank has established as a replica of the outflows of the country's balance of payments. Currently, the targeted foreign exchange composition is 85% in US dollars, 12% in euros and 3% in Japanese yen. The current foreign exchange composition of the portfolio differs slightly from the target since the portfolios are allowed to have slight deviations within strict limits and to make investments in the currencies of other developed countries such as the British pound, Swiss franc or the Canadian dollar.

2. Investment Portfolio Market Risk

In 2009, the Bank decided to reduce the modified duration of the portfolio in order to decrease the adverse effect on the return of the international reserves that could result from a possible normalization of the monetary policy by the developed countries whose interest rates were at historically low levels. Up until June 30, 2009, the modified duration of the investment portfolio was 1.27 and starting July 31, it was lowered to 0.51 as a consequence of which, the probability of having 12-month negative returns fell to 5% compared to an estimated 29% before the measure was adopted.

This decision is justified by the current international environment which generates a considerable market risk for the return on the reserves. When the interest rates are close to zero, the accrued interest is minimal and a devaluation

66 To limit the credit risk, Banco de la República uses the credit ratings published by the most respected international agencies (S&P, Moody's and Fitch Ratings) as reference points. In the short term, the highest rating given by these agencies is A-1+/P-1/F-1+ and the lowest is D. In the long term, the highest rating is AAA and the lowest is D. For the average investor, it is considered safe to invest in investment-grade paper, that is, with ratings that are above or equal to a A-3/P-3/F-3 in the short term and a BBB- in the long term.

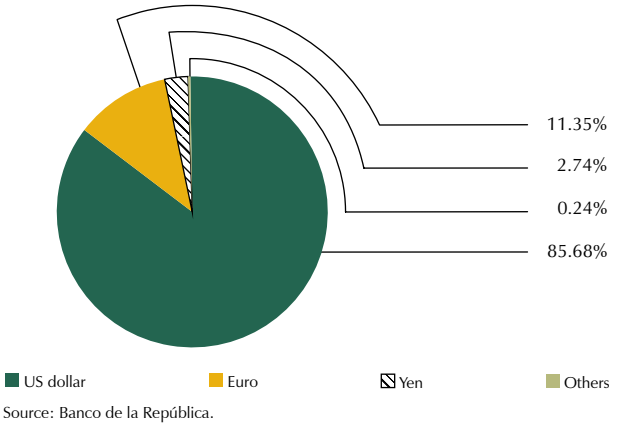
Table 23
Distribution of the Investment Portfolio by Credit Rating

Long term investments	
Rating	**Share (%)**
AAA	83.04
AA+	1.10
AA	1.71
AA-	10.62
A+	3.07
A	0.33
A -	0.14
Total	**100.00**

Short term investments	
Rating	**Share (%)**
P-1	100
Total	**100**

Source: Banco de la República.

Graph 73
Foreign Exchange Composition of the Investment Portfolio



Source: Banco de la República.

of the securities associated with a possible hike in the interest rates is to be expected. Under the current scenario, it is very difficult for the rates to decline even more but rather it is possible that they will rise in the future.

Thus, if the foreign interest rates move up, the prices for the securities will fall and will have a negative effect on the return of the reserves. In the long term, assuming a greater market risk, in other words, having a higher tolerance for price fluctuations of investments tends to generate higher returns. However, the market risk that can be accepted depends on the level of the interest rates. When the interest rates are high, more market risk can be taken on since the accrued interest can compensate for a devaluation of the investments. In contrast, when the interest rates are low, as is the current situation, a slight increase in them could wipe out the yield seen due to accrued interest.

To illustrate this situation, the results of two portfolios with the same modified duration but with different internal rates of return can be compared. A portfolio with an internal rate of return (or yield) of 5% and a modified duration of 2 will have a return of 3% with respect to a 1% rise in the rates over a year (5% for accrued interest and -2% for appreciation). In contrast, another portfolio with the same modified duration of 2 but with a 1% yield will have a return of -1% with respect to the same movement of the curve. In conclusion, as interest rates drop, it is necessary to reduce the modified duration of the portfolio to reduce the probability of having negative returns.

3. Foreign Management Program

The Banco de la República just like some central banks delegates the management of a portion of its portfolio to foreign financial institutions that have a good reputation and recognized track record. As the international

reserves have grown and the financial markets specialize, the Bank has considered it appropriate to utilize the services of entities that have broad experience in the management of third-party portfolios, abundant resources and information, a solid analytical capacity and a highly sophisticated technological and human infrastructure. This program has also made it possible to train the Bank's own personnel and facilitated access to the information necessary to support the investment policies and the follow up on the investments done by the Bank itself.

The firms contracted under this program are the following: Western Asset Management, Deutsche Bank Advisors, Goldman Sachs Asset Management, BlackRock Institutional Trust Company and Wellington Management (Table 24). Currently these entities manage 37% of the country's international reserves based on the investment guidelines clearly defined by the Bank. It should be mentioned that these managers were chosen for their high technical standards.

Table 24
Portfolio Foreign Management Program

Firm	Amount Managed (millions of dollars)
Deutsche Bank Advisors	931
Goldman Sachs Asset Management	2,068
Wellington Management	965
BlackRock Institutional Trust Company	3,672[a/]
Western Asset Management	916
Total	**8,551**

a/ In 2009, BlackRock Institutional Trust acquired Barclays Global Investors, another firm that participated in the foreign management program. Currently, BlackRock manages two portfolios with different guidelines.
Source: Banco de la República.

The Bank defines parameters to evaluate the management firms. These parameters are periodically revised[67] and depending on the success of the management, decisions such as mod ifying the amount that is handled or cancelling the contract can be made.

B. PERFORMANCE OF THE INVESTMENTS

Table 25, shows the historical returns of the international reserves since 1992. In 2009, the return of the international reserves was US$321.4 m which is equivalent to approximately 1.3%.

67 Reports on the performance of the portfolios are sent to the Reserves Committee monthly, which is the highest decision-making authority within Banco de la República. Likewise, all of the management is annually reviewed as a whole.

In 2009, US$229.5 m in earnings from the appreciation of the investments and accrued interest was registered. Due to exchange rate differential (appreciation of other currencies with respect to the dollar) the reserves earned US$91.8 million. The low profitability of the reserves which was predicted in the March and July, 2009 Reports to Congress, was the consequence of two factors:

- The interest rate remained very low in the most important developed countries. The rates for the securities issued by the US government with maturities at three months and at two years can be seen in Graph 74. The ones issued towards the end of 2008 are lowest seen in the last three decades.[68]

- The decision to have a portfolio with a more conservative risk profile entails lower profitability. Lowering the credit risk and raising the share of government securities in the portfolio result in a lower rate of return is observed. Furthermore, the shorter average maturity for the investments has also affected the returns since currently the long term rates are higher than the short term ones.

Table 25
Returns of the International Reserves

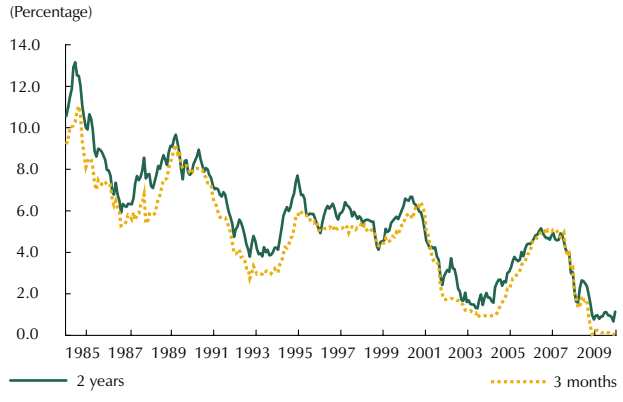
	Millions of dollars	Annual Rate of Return (percentage)
1992[a/]	319.3	4.5
1993[a/]	386.5	4.9
1994	503.0	6.3
1995	818.4	9.9
1996	200.8	2.2
1997	204.6	2.1
1998	728.9	7.8
1999	78.4	0.9
2000	505.3	5.9
2001	477.9	4.8
2002	810.5	7.7
2003	464.8	4.2
2004	324.5	2.7
2005	81.4	0.6
2006	815.2	5.5
2007	1.326.2	7.4
2008	1.004.5	4.5
2009	321.4	1.3

a/ Data from the foreign exchange balance.
Source: Banco de la República.

In addition, the administration cost for the reserves rose as a result of the cost of the credit of line at the IMF. Although no disbursements have been requested from it, the amount paid to maintain it were of approximately US$28

68 The investments in the reserves portfolio are concentrated in short term government securities.

Graph 74
Interest Rates for Securities Issued by the Government of the United States



Source: Bloomberg.

m. For 2010, the return of the reserves is expected to remain low since the Fed and other central banks have publicly announced that they will keep the rates low for most of the year.

C. THE STATE OF THE CLAIMS FROM THE CREDIT EVENTS OF 2008

As was explained in detail in the last *Report to Congress*, July 2009, in late 2008, two claims were made based on credit events: a Lehman Brothers security for US$2.7 m and a floating interest note issued by Sigma Finance for the amount of US$20 m in the security loan program managed by the Bank of New York Mellon (BNYM). An update on the state of both claims is given below.

1. Banco de la República Suit Against BNYM

On April 21, 2009 Banco de la República, represented by the law firm of Crowell & Moring LLP, brought suit against The Bank of New York Mellon Corporation, Bank of New York Mellon N.A. and Bank of New York Mellon Asset Services, B.V. The purpose of this suit is to recover a US$20 m investment made by the BNYM acting as the custodian and security loan agent in the belief that these entities failed to comply with and breached the securities entrusted to them by the Banco de la República.

After the suit was filed and replied to by the respondent, the normal judicial proceedings have followed the usual steps based on US legislation. The foreign lawyers have informed us that 2010 will be primarily dedicated to the discovery stage, which consists of each of the parties procuring relevant information about the case and requesting what could be considered evidence in court (depositions) from the other party.

2. Process of Restructuring Lehman Brothers Holdings, Inc.

As is public knowledge, Lehman Brothers Holdings, Inc. has been in a restructuring process under Chapter 11 of the US Bankruptcy Code since September 15, 2008. Under the procedures in the process, Lehman has to present a Restructuring Plan with a proposal for paying all of its creditors based on the determination of the priority that the credits and assets have. Lehman has until March 15, 2010 to present their Restructuring Plan and their creditors have until May 17, 2010 to accept it.

The Banco de la República, represented by the law firm, Morrison and Foerster LLP, filed a formal claim on August 25, 2009, which was complemented on September 9, in order to be recognized as a creditor.

IV. Financial situation of the Banco de la República[69]

In 2009 Banco de la República income statement showed profits of COL$155 b. Once the reserves are constituted and the value of the net investment in assets for cultural activity is discounted, the Board decided not to transfer the profits to the national government.

A. THE 2009 INCOME STATEMENT

In 2009, Banco de la República income statement showed profits of COL$115 b, which was the result of COL$1,291 b in income and COL$1,136 b in expenses (Table 26). In comparison to 2008, the profits declined COL$1,166 b due to both COL$1,675 b in lower income and COL$508 b in lower outlays.

Last year the income came primarily from COL$685 b in returns on the international reserves, the income from liquidity operations (COL$193 b), the appreciation of the TES held by the Bank (COL$87 b) and the commissions for banking services and trust business (COL$157 b).

In the case of the international reserves, the total return of COL$685 b (US$321 m) was the product of COL$762 b (US$344 m) in accrued interest,[70] the foreign exchange differential of COL$187 b (US$92 m) and the devaluation of

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69 The legal framework by which the Bank's accounting is governed (Act 31/1992, Decree 2520/1993, the regulations issued by the Financial Superintendence concerning this and Decree 2649/1993) was explained in the March 2009 *Report to Congress*. In addition, a description of the financial structure of the general balance and of the Institution's income statement was included in that report.

70 This corresponds to the daily interest that the investment portfolio earns on its investments.

Table 26
Banco de la República, Profit and Loss, 2008-2009
(billions of pesos)

	December, 2008 A	December, 2009 B	Annual Variation	
			Percentage B/A	Absolute B - A
I. P and L income	**2,966**	**1,291**	**(56.5)**	**(1,675)**
A. Monetary income	**2,799**	**1,134**	**(59.5)**	**(1,665)**
1. Interest and returns	2,514	1,036	(58.8)	(1,478)
International reserves	2,120	685	(67.7)	(1,435)
Other interest	14	71	425.0	57
Liquidity operations	312	193	(38.2)	(119)
Valuation of TES	68	87	27.3	19
Valuation of other securities	1	0	(99.9)	(1)
2. Exchange rate differences	225	26	(88.3)	(199)
3. Coins	47	51	8.1	4
4. Others	13	21	64.7	8
B. Corporate income	**167**	**157**	**(5.9)**	**(10)**
1. Commissions	123	140	13.8	17
Banking services	59	72	22.1	13
Trust business	49	51	3.6	2
Other commissions	15	17	14.4	2
2. Others	44	17	(61.2)	(27)
II. P and L expenses	**1,644**	**1,136**	**(30.9)**	**(508)**
A. Monetary expenses	**1,249**	**854**	**(31.6)**	**(395)**
1. Interest and returns	956	602	(37.0)	(354)
Remuneration of reserve requirements	163	69	(57.7)	(94)
Remuneration of National Treasury deposits	708	393	(44.6)	(316)
Expenses for international reserves management	16	65	315.8	49
Expenses for monetary contraction operations	68	75	9.3	6
2. Exchange rate differences	176	133	(24.4)	(43)
3. Cost of issuing and distributing banknotes and coins	114	114	0.1	0
4. Others	4	5	44.3	2
B. Corporate expenses	**322**	**333**	**3.2**	**10**
1. Personnel expenses	206	217	5.2	11
2. General expenses	47	48	0.8	0
3. Taxes	7	7	2.1	0
4. Insurance	6	6	8.0	0
5. Contributions and membership fees	5	3	(34.9)	(2)
6. Cultural expenses	9	9	5.2	0
7. Depreciation, provision and others (including deferred software expenses)	42	42	(0.1)	(0)
C. Pension expenses	**73**	**(51)**	**n.a**	**(124)**
III. Operating result (I-II)	**1,322**	**155**	**n.a**	**(1,166)**

n.a. not applicable
Source: Banco de la República.

the portfolio[71] by COL$264 b (US$115 m). The result of the foreign exchange differential mainly reflected the weakening of the euro in comparison to the dollar while the devaluation of the portfolio was the result of the increase in market interest rates which negatively affected the prices of the securities in the portfolio.

The return on the international reserves decreased COL$1,435 b in 2009 primarily due to the low interest rates in the international market last year (See the highlighted portion, pg. 123). In 2008, the foreign interest rates declined from levels that were higher than the current ones thus causing the total return for the international reserves to rise mainly due to the appreciation of the investments. During 2009, in turn, the interest rates, moved up a little from very low levels. This produced a low accrual of interest and an appreciation of COL$264 b (US$115 m) of the portfolio.

The income from liquidity operations (COL$193 b), in turn, was COL$119 b lower than those registered in 2008. This was because of the reduction in Banco de la República intervention rate in 2009 (600 bp) since the average daily balance of the expansion that year (COL$3,384 b) was similar to the one observed in 2008 (COL$3,322 b).[72]

In 2009, the expenses originated primarily from interest (COL$602 b) among which are included the remuneration for the national government deposits (COL$393 b), the remuneration for the credit establishments' reserve requirements (COL$69 b) and the costs of the monetary contraction operations (COL$75 b). Other significant expenses were the personnel expenses (COL$217 b) and the exchange rate differences (COL$133 b).

Like the income from monetary expansion operations, in 2009 the expenditures in 2009 due to the remuneration for the government deposits were lower than in 2008 (COL$316 b) mainly as a result of the reduction of the policy interest rate. The Board also eliminated the remuneration for reserve requirements (external resolutions 2 and 9, January 30 and July 24, 2009 respectively). This meant lower expenses of COL$94 compared to 2008.

The personnel expenses (COL$217 b), in turn, are the result of the increment in salaries resulting from the collective bargaining agreement and the cutback on staff. This item showed an annual growth of 5.2% in 2009 and 3.1% in real terms as a result of the inflation in 2008 (7.67%) which affected the increase in salaries and benefits.

Finally, the net pension expenses registered, on one hand, the income generated by the return from the portfolio made up with resources of the actuarial estimate of COL$238 b and, on the other, COL$187 b in pension expenses. The appreciation of the portfolio was the result of the lower negotiating rate for the

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71 The valuation of the investments is the profit or loss caused by the changes in the securities prices. With respect to the international reserves portfolio investments, the prices for these drop when the interest rates rise and vice versa

72 These data are calculated as the monthly average of daily data.

TES, securities in which approximately 75.7% of the total was invested. On the other hand, in 2009 provisions from the actuarial estimate were not made in agreement with Decree 2984, August 12, 2009 issued by the Ministry of the Treasury and Public Credit.

B. ALLOCATION TO RESERVES AND DISTRIBUTING PROFITS

In compliance with the bylaws of the Banco de la República, the remaining of Bank's profits earnings once the reserves have been allocated belongs to the nation. By virtue of the operational results seen in 2009 (COL$155 b), the Board decided that once the reserves were allocated as required by articles 60, 61 and 63 of the Bank's bylaws (Decree 2520, December 14, 1993) and the value of the net investment in assets for cultural activities was discounted, the profits would not be transferred to the national government (Table 27).

The profits for 2009 (COL$155 b) were set aside to increase the reserve for currency fluctuations since the profits from foreign exchange movements should go to that account, which can only be used when there are losses from the same concept.[73]

C. BANCO DE LA REPÚBLICA BALANCE

The changes in the Banco de la República's main asset, liability and equity items as of December 31, 2009 in comparison to the balance for the same date last year are explained below (Table 28).

1. Assets

On December 31, 2009, the Bank's assets registered a balance of COL$62.385 b which is COL$124 b (-0.2%) lower than the balance observed a year ago. The main changes in the accounts are due to the following:

- *International reserves*: At the end of 2009, the gross international reserves, valued at market prices, were COL$51,852 b (US$25,365 m). Their annual change in pesos (-COL$2,086 b or in other words, -4%) was mainly due to: i) the exchange rate adjustment resulting from the appreciation of the peso with respect to the dollar. This reduced the balance of the gross international reserves in pesos by COL$4,524 b. ii) The COL$1,996 b (US$976.4 m) increase in the holding of special drawing rights (SDR) with the IMF. The counterpart for this, IMF SDR allocation, was registered as a long term liability on August 28 and

73 In 2009, the net result due to exchange rate differentials was COL$189 b. However, the reserve for currency fluctuation is only raised up to the convergence with the total profit for the fiscal year which was COL$155 b. The balance of the reserves for currency fluctuation is COL$2.361 b which is allocated to cover possible losses due to fluctuations in the exchange rates of the dollar with respect to other reserve currencies.

Table 27
Distribution of 2009 Profit and Use of Banco de la República Reserves

	(billions of pesos)
Results for accounting year 2009	**155**
Plus: Use of reserves	**3**
Reserve for currency fluctuation	0
Reserve for monetary and exchange stabilization	1
Reserve for asset protection	2
Reserve for exchange rate results	0
Minus: allocation to reserves	**159**
Reserves for exchange results	0
Reserves for currency fluctuation	155
Reserves for monetary and exchange stabilization	0
Reserves for asset protection	0
Net investment in assets for cultural activities	3
Net result in favor of the national government	**0**

Source: Banco de la República.

Table 28
Balance Sheet - Banco de la República, classified by economic criteria (December, 2008 to December, 2009)
(billions of pesos)

Accounts	December, 2008		December, 2009		Variation	
	Balance	Participation (%)	Balance	Participation (%)	Absolute	Percentage
Assets	**62,508**	**100.0**	**62,385**	**100.0**	**(124)**	**(0.2)**
Gross international reserves	53,938	86.3	51,852	83.1	(2,086)	(3.9)
Contributions in international entities	2.538	4.1	2,802	4.5	264	10.4
Investments	900	1.4	3,597	5.8	2,697	299.6
Public sector, consolidated debt	0	0.0	0	0.0	0	0.0
Public sector, monetary regulation	864	1.4	3,580	5.7	2,716	314.2
Bonds: public bank capitalization, etc.	36	0.1	17	0.0	(19)	(52.0)
Loan portfolio	1	0.0	2	0.0	0	38.4
Public sector, national government	1	0.0	1	0.0	(0)	(27.3)
Financial corporations	0	0.0	0	0.0	0	0.0
Remainder of the financial system	0	0.0	0	0.0	0	0.0
Other loans	4	0.0	4	0.0	(0)	(5.6)
Provision	(4)	(0.0)	(3)	(0.0)	1	(22.8)
Repo agreements - temporary liquidity support	1,547	2.5	460	0.7	(1,087)	(70.3)
Accounts receivable	37	0.1	32	0.1	(6)	(14.9)
Other net assets	3,547	5.7	3,640	5.8	94	2.6

Table 28 (continuation)
Balance Sheet - Banco de la República, classified by economic criteria (December, 2008 to December, 2009)
(billions of pesos)

Accounts	December, 2008		December, 2009		Variation	
	Balance	Participation (%)	Balance	Participation (%)	Absolute	Percentage
Liabilities and equity	**62,508**	**100.0**	**62,385**	**100.0**	**(124)**	**(0.2)**
Liabilities	**43,460**	**69.5**	**48,545**	**77.8**	**5,085**	**11.7**
Foreign currency liabilities that affect international reserves	25	0.0	19	0.0	(7)	(26.0)
Monetary base	36,193	57.9	39,545	63.4	3,352	9.3
Non-reserve interest-bearing deposits	1,624	2.6	830	1.3	(794)	(48.9)
Deposit requirement on borrowing abroad and foreign-capital portfolio investment	15	0.0	0	0.0	(15)	(99.8)
Other deposits	108	0.2	62	0.1	(46)	(42.3)
National government (National Treasury Office) n/c	2,487	4.0	2,351	3.8	(136)	(5.5)
National government (National Treasury Office) f/c	151	0.2	609	1.0	458	303.2
Obligations to international entities	1,940	3.1	4,260	6.8	2,320	119.6
Accounts payable	78	0.1	99	0.2	21	27.4
Other liabilities	838	1.3	770	1.2	(68)	(8.1)
Total equity	**19,049**	**30.5**	**13,840**	**22.2**	**(5,209)**	**(27.3)**
Capital	13	0.0	13	0.0	0	0.0
Reserves	2.393	3.8	2,867	4.6	473	19.8
Surplus	15,321	24.5	10,805	17.3	(4,516)	(29.5)
Special Foreign-Exchange Account settlement	453	0.7	453	0.7	0	0.0
Foreign-exchange adjustment from 1993 onward and surplus	13,623	21.8	9,099	14.6	(4,524)	(33.2)
Others	103	0.2	133	0.2	30	29.2
Property reappraisal (art, culture and real estate)	1,142	1.8	1.120	1.8	(22)	(1.9)
Results	1,322	2.1	155	0.2	(1,166)	(88.2)
Profit / loss for previous periods	0	0.0	0	0.0	0	0.0
Profit / loss for the period	1,322	2.1	155	0.2	(1,166)	(88.2)

n/c national currency
f/c foreign currency
Source: Banco de la República.

September 9, 2009. iii) The distribution of COL$818 b (US$320.4 m) in profits to the national government in February, 2009, iv) the interest rate return, the valuation of the portfolio and exchange rate differential generated a rise of approximately COL$685 b in the reserves, v) the

higher value of the foreign currency deposits of COL$4458 in Banco de la REpública, vi) the net purchases of foreign currency made by the Bank of COL$265 (US$171 m), and vii) the payments made to the external managers of internation reserves and the COL$65 b of the commitment free of the flexible credit line with IMF.

- *Investment portfolio in national currency*: The balance for this valued at market prices was COL$3,597 b in December 2009 which is COL$2,697 b higher than in 2008. This rise was primarily due to: i) net purchases of TES of COL$2,500 b, ii) the maturity of COL$13 b and COL$56 b in principal and coupons of TES respectively, iii) the appreciation of the portfolio due to the COL$161 b decline in the market interest rates for the TES in 2009 and iv) the transfer of TES with a value of approximately COL$186 b on the part of trust companies to the Banco de la República in order to adjust the use of resources from pension liabilities.

- *Repo operations used to grant temporary liquidity*: These showed a balance of COL$460 b at the end of 2009 which meant a reduction of COL$1,087 b (-70%) with respect to the close of 2008.

2. Liabilities

As of December 31, 2009, the balance for the liabilities was COL$48.545 b, which is COL$5,085 b (12%) higher than in 2008. The main sources of the change are given below:

- *Monetary base*: At the end of 2009, the monetary base was COL$39,545 b, an amount that is COL$3,352 b (9%) higher than that observed at the closing of 2008.

- *Obligations with international entities*: The balance for this item was COL$4,260 b at the end of December, 2009 which was COL$2,320 b (120%) higher than that registered on December 31, 2008. As was mentioned, the change was mainly due to the increase in the SDR allocation by the IMF.

- *Government deposits in national currency*: These are constituted through the National Treasury Office in the Bank. They had a balance of COL$2,351 b at the close of December, 2009, an amount that is COL$136 m (-5%) lower than a year before.

3. Equity

The equity registered COL$13,840 b in December, 2009 thus showing a decline of COL$5,209 b (-27%) with respect to the same date in 2008. This reduction is basically explained by the change in the exchange rate adjustment

account which declined COL$4,524 b (-33%) as a result of the appreciation of the peso with respect to the dollar.[74]

D. INCOME AND EXPENDITURE FORECAST FOR 2010

Based on the expected return from the reserves as the main source of income for the Banco de la República, a total income of COL$313 b and expenses of COL$934 b are estimated for this year for a negative operating result of COL$621 b (Table 29).

In contrast to previous years, it is not expected that the the return on the international reserves will be the primary source of income. In fact, it is estimated that their return will be -COL$70 b because of a low foreign interest rate for the instruments that the reserves are invested in and due to the weakening of the euro with respect to the dollar so far this year. The lower return will be the result of the low interest rates paid by the main central banks and of the measures adopted by Banco de la República to face the international crisis. These measures were adopted to reduce the risks for the investment portfolio and to guarantee that the country would have sufficient liquidity to deal with the external crisis. Given the direct relationship that exists between risk and return, the above results in lower income from the investment of the reserves (both for those observed in 2009 and for those projected for 2010).

To the above are added the losses from the exchange rate differential caused by the strengthening of the dollar with respect to other reserve currencies, especially the euro and the yen, so far this year. This has reduced the dollar value of the international reserves. Specifically, between January and February, 2010 the losses from this came to US$110 m (COL$215 b).

Thus, in 2010 the primary sources of income will be the valuation of the TES portfolio of Banco de la República (COL$152 b), the commissions received (COL$106 b) and the income derived from liquidity operations (COL$43 b). This last item will be COL$150 b lower than in 2009 as a result of the lower need for liquidity of the financial system. In particular it is expected, an average daily balance of COL$1,244 b in expansion repos. This is COL$2,140 b lower than in 2009 which, as was mentioned, is the consequence of the lower government deposits in national currency at Banco de la República.

Of the total expenses projected, 48% correspond to monetary ones, which will come to COL$447 b and which is COL$407 b lower than those registered in 2009. Among them the main ones are:

1. The remuneration for the government deposits in national currency at the Bank, will amount to COL$182 b, which is COL$221 b lower than in 2009. This result is due to the fact that the average daily balance for

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74 This is reflected in a lower asset value for the gross international reserves in pesos.

Table 29
Banco de la República, profit and loss 2009 - 2010
(billions of pesos)

	December, 2009 A	Projected2010 B	Annual Variation	
			Percentage B / A	Absolute B - A
I. P and L income	**1,291**	**313**	**(75.7)**	**(978)**
A. Monetary income	**1,134**	**190**	**(83.3)**	**(944)**
1. Interest and return	1,036	126	(87.9)	(910)
International reserves	685	(70)	n.a.	(755)
Other interest	71	0	(99.3)	(70)
Liquidity operations	193	43	(77.7)	(150)
Valuation of the TES	87	152	74.9	65
2. Exchange rate differences	26	0	(100.0)	(26)
3. Coins	51	50	(1.9)	(1)
4. Others	21	14	(32.5)	(7)
B. Corporate income	**157**	**124**	**(21.4)**	**(34)**
1. Commissions	140	106	(24.3)	(34)
Banking services	72	56	(22.0)	(16)
Trust business	51	50	(2.2)	(1)
Other commissions	17	0	(100.0)	(17)
2. Others	17	18	3.0	1
II. P and L expenses	**1,136**	**934**	**(17.7)**	**(201)**
A. Monetary expenses	**854**	**447**	**(47.7)**	**(407)**
1. Interest and yield	602	292	(51.5)	(310)
Remuneration on reserve requirements	69	0	(100.0)	(69)
Remuneration on the National Treasury Office accounts	393	182	(53.8)	(211)
Expenses for international reserves management	65	85	30.2	20
Expenses for monetary contraction transactions	75	26	(65.8)	(49)
2. Exchange rate differences	133	0	(100.0)	(133)
3. Cost of issuing and distributing bills and coins	114	141	23.4	27
4. Others	5	14	161.7	9
B. Corporative expenses	**333**	**357**	**7.3**	**24**
1. Personnel costs	217	229	5.7	12
2. General expenses	48	51	5.5	3
3. Taxes	7	8	6.6	0
4. Insurance	6	7	6.4	0
5. Contributions and membership fees	3	4	45.9	1
6. Cultural expenses	9	10	7.3	1
7. Depreciation, provisions, debt repayment, etc. (including deferred software)	42	48	14.8	6
C. Pension costs	(51)	131	n.a.	182
III. Operating results (I-II)	**155**	**(621)**	**n.a.**	**(776)**

n.a. not applicable
Source: Banco de la República.

these deposits will decline from COL$7.083 b in 2009 to COL$5.320 b in 2010.

2. The cost of issuing coins and bills (COL$141 b) with a nominal annual growth of 23.4% annually based on the production program for currency for the year.

Of the corporative expenses (COL$357 b), the item with the highest contribution will be that of personnel costs which is projected to be COL$229 b. This is COL$12 b higher that what was registered in 2009 with an nominal annual growth of 5.7% (2.6% real).

Last of all, in 2010 it is estimated that the net costs for pensions will be COL$131 b as a result of the returns on the portfolio constituted with the pension liability resources (COL$97 b) and of the projected costs for allowances, support and contributions to social security for pensions (COL$228 b).

RETURN OF THE INTERNATIONAL RESERVES

The return on the international reserves in dollars depends primarily on three factors: i) the interest received on the investment, ii) the changes in the prices for the financial assets in the portfolio and iii) the movements of the exchange rate. Each one of these factors is explained below.

i) The international reserves are invested in instruments known as fixed-income, which are characterized by the fact that they pay the investor a previously defined interest for a determined period of time. The fixed-income instruments have a maturity or, in other words, an established interval in which the agent recovers the total amount of his investment.

Each fixed-income instrument has a contracted interest rate (or different coupon rates). However, the main factor that determines these rates is the monetary policy of each central bank since all of the interest rates for the instruments issued in a single currency tend to move in the same direction. This means that the returns on the international reserves invested in these instruments will be lower when the interest rates of the main central banks (the United States Federal Reserve, Central European Bank and Bank of Japan) are at low levels.

ii) The returns on the international reserves will also be affected by the changes in the prices of investments. The price of a fixed-income instrument is defined as the current value of the cash flow discounted at a specific interest rate or rate of return. For most of the fixed-income instruments, the cash flows that will be received in the future are fixed and the investor knows what they are from the beginning. That is the reason why the only factor that could cause a change in the price is the rate of return at which each paper on the market is negotiated.

The main factor that determines the performance of the interest rates on the market is the monetary policy. Thus, the international reserves investments tend to appreciate in periods when the main central banks reduce the interest rates and devalue when they tighten monetary policy. In periods when that policy remains stable, the international reserves do not show substantial losses or earnings due to that factor.

iii) With respect to the movement of the exchange rate, the international reserves are valued in dollars. However, there are investments in other currencies. That is why the fluctuations in the exchange rates also have an impact on the return of the portfolio. The foreign exchange composition of the international reserves is approximately 85% US dollars, 12% euros and 3% yen. This causes the euro/dollar and dollar/yen prices to have a stronger impact on its return. For example, if the euro becomes stronger with respect to the dollar, the value of the reserves expressed in dollars rises (the 12% denominated in euros will have appreciated when it is calculated in dollars). Nevertheless, this factor can produce losses as well as earnings for the Bank because the exchange rates have significant fluctuations in the long term that are difficult to predict.[1]

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1 As a consequence of the measures adopted by the Bank there was a hike in the share of the investments that were invested in governments or in entities that are related to them and a sharp reduction in credit risk. The banking and corporative debt securities from industrialized countries that had share of 31% 31% of the portfolio before the crisis currently represent around 6%. In 2009, the Bank eliminated its exposure to asset-backed securities, which before the crisis had amounted to 11% of the investments.