

SUMMARY AND CONCLUSIONS

The July 2003 Financial Stability Report stated that the pick-up in credit growth resulted from positive behavior by both credit supply and credit demand. These developments intensified over the second half of 2003 and, combined with a more favorable external environment, allowed the financial system to continue growing stronger and the credit business to keep on accelerating.

A description follows of the macroeconomic setting in which these events occurred, the main risks faced by the financial system's major debtors and, lastly, the trends and risks discernible in the system's balance sheet.

MACROECONOMIC ENVIRONMENT

✕ The real sector of the economy performed well, better than predicted by official projections or private agents' expectations, reducing the credit risk to the financial system from firms and individuals alike. This improved performance was reflected by acceleration in both domestic spending and gross domestic product, especially in the nontradables sectors. Likewise, stronger economic growth brought improvement in labor-market conditions. The findings of expectations surveys show that higher domestic demand, one of the main drivers of this growth, may still be a driving force in 2004.

✕ The international financial environment has continued to be favorable to all emerging economies, including Colombia. It has thus allowed aggregate spending to expand without greater pressure arising from external financing. The effect on domestic financial variables has been positive, helping to keep interest rates low and stable.

✕ The prevailing financial climate and the behavior of demand have played their part in lifting domestic-asset prices. The stockmarket and house have risen in real terms in relation to the consumer price index, improving the quality and quantity of safeguards for the financial system. However, the levels and growth of relative prices for domestic assets are far removed from what they were during the financial bubble of the early 1990s, so that asset prices currently show no sign of posing a threat to the financial system's stability.

✕ On the fiscal front, there has been a slight improvement in the indicators of fiscal deficit and public debt as well as in the financial conditions of debt, which has benefited the financial system's performance. But further efforts need to be made to reduce the fiscal deficit and the nonfinancial public sector's demand for funds. This would preclude a reversal of the region's economic prospects from strongly affecting the public sector's sustainability and thereby the stability of the financial system, which still holds a large part of its assets in public securities.

THE SYSTEM'S MAJOR DEBTORS AND RISK EXPOSURE

Real-sector debt

✕ In 2002, the real sector's gross debt grew rapidly, largely driven by higher domestic borrowing, and by the price effect that devaluation in the second half of the year had on foreign debt. In September 2003, growth in real-sector debt slackened, partly because of lower private external borrowing in dollars and the price effect of real revaluation.

✕ The nonfinancial private sector increased its overall debt for the first time since 1998, albeit by a low rate, with growth in its domestic debt produced mainly by a shift from external to domestic debt.

Private corporate sector

✕ Credit institutions increased their exposure to the private corporate sector; consistent with growth in overall commercial loans and the country's greater economic activity in January-September 2003. This higher exposure was accompanied by a lower level of concentration, which signifies more resources furnished to previously restricted debtors.

✕ In September 2003, the major private debtors displayed strong loan quality and a trend toward higher borrowing.

✕ The findings of the Securities Superintendency's business sample show a corporate sector that has gained strength since the 1999 crisis. Nontradables firms stand out for their positive performance, produced by a rapid rise in profitability, capital strengthening and lower interest-rate exposure. Profitability for tradables firms has remained stable. Both groups have improved their debt profiles and have become less vulnerable to exchange-rate shocks.

✕ According to expectations surveys, both output and business investment are expected to rise in 2004. As long as the readiness to borrow and lend continues to improve and runs high—currently higher than in recent years—, commercial credit may be expected to go on expanding as it did throughout 2003. High levels of

readiness will depend on both loan quality and the supply of funds by credit institution maintaining their rising trends.

Households

✕ Household debt grew marginally in 2003, but its share of the system's overall assets fell. The expansion in consumer loans offset the fall in mortgage loans, signifying a shift in household debt, in terms of loan type, toward consumer loans and, in terms of type of entity, toward commercial banks.

✕ Loan quality has continued to improve, though a marked difference is discernible between the portfolio of banks specializing in mortgages and the portfolio of other intermediaries. Higher loan quality has coincided with an improvement in households' ability to pay brought about by lower unemployment and persistently high levels of real wages.

✕ Mortgage loans still present high delinquency levels, connected with the large stock of bad loans from the crisis period. Fresh loans can be expected to perform better, given the satisfactory behavior of prices for new housing.

✕ In contrast to the corporate sector, households have not increased their domestic borrowing, despite the pick-up in their ability to pay.

✕ The outlook for mortgage credit is not clear, for in spite of the housing market's positive price performance, Fedesarrollo's consumer survey shows slackened growth in "favorable buying opportunity" during the fourth quarter of 2003. In contrast, "favorable buying opportunity" for durable goods rose all through the year, which may have boosted the performance of consumer performance loans. If this trend is confirmed, the shift in household debt described above may become deeper.

Nonfinancial public sector

✕ The financial system's exposure to public debt increased slightly in September 2003, having declined between 2001 and 2002. The increase is largely attributable to banks specializing in mortgages. Commercial banks remain the entities most directly exposed to nonfinancial public sector debt.

✕ The financial conditions of public debt have improved, as has perception of the government's solvency. This is reflected in a reduction of interest rates on public debt, which has benefited the financial entities' balance sheets through valuation gains on debt holdings. It is also evidenced by lower spreads on external public debt. Note, however, that these developments have occurred across emerging markets and are not exclusive to Colombia.

¹ Much of the improvement up to 2002 resulted from the application of Law 617 of 2000, Law 550 of 1999 and the tax reform of 2000. This tax reform authorized withdrawals from the Oil Stabilization Fund to repay debt owed by departments and municipalities.

✕ Nonfinancial public sector debt moderated its growth in September 2003, partly because of a reduction in external debt caused by the price effect of lower devaluation. As a result, the debt/GDP ratio remained steady.

✕ The central government's indebtedness, both domestic and foreign, expanded more slowly, but at rates that are still high. The ratio of government debt to GDP showed moderate growth.

✕ It should be noted that, though the general conditions for debt have improved, sustainability indicators have not. The government will therefore need to continue taking measures to adjust public finances.

✕ In September 2003, subnational debt continued to exhibit the falling trend begun in 1997 and improved in quality,¹ reducing the risk it posed to the financial system. However, although the quality of subnational debt has improved consistently since 2000, it is still not as good as debt quality for the rest of the system.

RECENT FINANCIAL SYSTEM DEVELOPMENTS

Pension fund managers

✕ The portfolio administered by pension fund managers continued to increase all through 2003 and is still strongly concentrated in public-debt investments.

✕ The maturity mismatch between the fund managers' portfolio assets and future pension payments still persists, though new long-term assets have been developed, for example through mortgage-debt securitizations. Tax incentives will need to be revised to make investments of this kind attractive to pension fund managers, who are their natural buyers.

Credit institutions

✕ Credit institutions continued to increase their loan portfolio in 2003, as they had been doing since mid-2002. All types of loans, except home loans, have contributed to consolidating credit recovery.

✕ Similarly, the sector's profitability is now around levels seen before the 1998-1999 crisis, having continued to rise in 2003 thanks largely to a shift in assets toward productive business (loans and investments), as well as higher financial margins, and the satisfactory price performance of public-debt securities.

✕ Moreover, credit establishments are still registering widespread reductions in the different risks intrinsic to their business.

✕ In the case of credit risk, all maturity, risk and provisioning indicators exhibit highly satisfactory behavior, so that the system currently presents a historically low perception of counterparty risk.

- ✕ To maintain this satisfactory environment, controls that ensure appropriate allocation of fresh credits must not be relaxed. This is particularly important in the case of the fastest growing types of credit.

- ✕ The credit establishments' market risk arising from price fluctuations in their major asset and liability positions has remained stable as a share of their overall risk. But there has been a shift within market risk, with the interest-rate risk of financial products falling and the rate risk of TES securities rising, as a result of amended regulations adopted in the aftermath of the TES-price crisis of July and August 2002.

- ✕ The credit sector's liquidity levels were adequate in November 2003, thanks to adequate growth in placements in the second half of the year and a satisfactory external environment. As long as this situation lasts, credit institutions are not expected to have any liquidity problems in the medium term.

- ✕ Given the reduction of a good many credit-sector risks, and the adequate levels of capital throughout 2003, the entities' capital soundness will ensure further expansion in credit business over the short term as long as there is demand.

- ✕ To sum up, credit business continued to register increasingly favorable growth in 2003. And, despite the rise so far in disbursements, the available evidence does not point to any reheating of the system that jeopardizes financial stability. This assertion derives from the fact that, in spite of large increases in the system's assets and loans and strong absorption by the economy, neither stocks nor growth rates have yet reached the atypically high levels that can trigger a financial bubble.

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