



THE BOARD OF DIRECTORS' REPORT TO THE
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BOARD OF DIRECTORS

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Governor

José Darío Uribe Escobar

Bogota, August 3, 2010

Honorable Chairman and Members of the
Third Constitutional Standing Committees of the
Senate and the House of Representatives

Dear Sirs,

Pursuant to Law 31 of 1992, Article 5, the Board of Directors of the Banco de la República hereby submits for consideration by Congress a report on the country's macroeconomic results so far in 2010. The report also presents the Board's targets for this year and the outlook for the different macroeconomic variables.

The last two chapters describe the composition of the international reserves and discuss projections for Banco de la República's financial situation in 2010.

Sincerely,



José Darío Uribe Escobar
Governor

INTRODUCTION

In the first quarter of 2010, the global economy reached an annualized growth above 5%, showing a significant response to the fiscal and monetary stimuli given in 2008 and 2009. The robust expansion of the Asian economies has led this dynamic, mainly due to the performance of China and India. In this context of world recovery, the Colombian economy, with an annual growth of 4.4% in the first quarter of 2010, was together with Brazil and Peru, one of the countries with the highest growth in Latin America.

In the first quarter of 2010, the global economy reached an annualized growth above 5% showing a significant response to the fiscal and monetary stimuli given in 2008 and 2009. Because of this better than expected result, the International Monetary Fund (IMF) revised their growth projection for 2010 upward by 0.4 percentage points (pp) which placed it at 4.6% and kept the one for 2011 unchanged at 4.3%. The global indicators for real activity continued their recovery in April and May with high increases in industrial production and in world trade which could confirm the better outlook for this year despite the problems that still exist in many countries.

However, the recovery of the global economy has been, unequal from one region to another. The robust growth of Asia has led that dynamic, mainly due to the performance of China and India, whose annual growth rates were 11.9% and 8.6% respectively in the first quarter of 2010. Among the emerging economies apart from those in Asia, the strong recovery of several countries in Latin American such as Brazil, with an annual growth in the first quarter of 8.9%; Peru, 6% and Colombia, 4.4% stands out. However, among the developed countries, the US economy, which had achieved an annualized quarterly growth of 5.6% in the last quarter of 2009, had a lower one in the first quarter of 2010 (2.7%). This is in line with the expectations of a sustained but moderate recovery. Finally, the economies in the euro zone continued to show a slow and unequal recovery, pointing to an average growth of around 1% in 2010.

The initial recovery of the world economy has been over-shadowed by the financial turbulence product of the markets' concern about the fiscal sustainability of some European economies and the effectiveness of their policy responses to deal with the situation. This uncertainty was caused by the problems Greece had in covering its public debt and the fears that this would spread to other vulnerable economies in the euro zone such as Portugal, Italy, Ireland and Spain. The loss of confidence in the sovereign debt of some European countries was reflected in the hike in their risk premiums and in the drop in the value of the euro. This situation had a negative impact on the stock market indexes and on commodity prices and reached the point where it generated doubts about the strength of the recovery of the global economy.

Even if the uncertainty about the potential effect this financial tension in Europe could have on the global economy continues, what has occurred so far indicates that its contagion to other regions around the world has been limited and, except for temporary fears, capital flows towards emerging economies have continued. Under these conditions and even recognizing the risks in a scenario of turbulence where additional financial deterioration is possible, the IMF did not modify their growth estimate for 2011. Nevertheless, much of this depends on the success of the new European stabilization mechanism that was created in order to preserve financial stability and to effectively coordinate the policies intended to rebuild confidence in the banking system.

In this context of world recovery, the Colombian economy, which had an annual growth of 4.4% in the first quarter of 2010, was one of the countries together with Brazil and Peru with the highest growth in Latin America. This result was higher than expected by the analysts and by the Banco de la República due to both methodological changes and better performance. From the demand side, this positive surprise was explained by the trend of gross fixed capital formation, which grew 8% (the highest number since 2007). Government consumption with a rise of 6.1% was another important factor that simulated domestic demand. Finally, although it is still in the process of recovery, the 3.5% upswing in household consumption during the first quarter of the year compares favorably to its poor performance in 2009 (1.1%). The improved trend in consumer confidence makes it possible to expect that household consumption will continue to strengthen.

With respect to the different branches of activity, the performance of the mining and quarrying sector which had an annual growth of 13.2% should be highlighted as well as that of construction which grew 15.9% in the first quarter of the year. Like in 2009, this latter sector continues to lead by public works projects, an area that surged 37.5% in the first quarter. The industrial manufacturing sector, in turn, showed growth of 3.9% during the same period, which is positive performance if compared to last year's drop of 5.9%. The most recent data from the monthly manufacturing sample (MMS) of the National Bureau of Statistics (DANE in Spanish) show that industrial activity is becoming stronger and had an annual growth of 7.5% in May.

The performance of the Colombian economy in the first quarter, as well as the positive indicators for economic activity in the second quarter and the vigorous recovery of consumer and business confidence reflected in the most recent surveys suggest that the upward turn that was predicted in the initial projections has materialized. As a consequence, the technical staff at the Banco de la República has modified their forecast for the gross domestic product (GDP) for 2010 from a range of 2% to 4% to a new one of 3.5% to 5.5%.

The economic recovery in Colombia and the return of consumer and investor confidence is appearing in a context of low inflation which ensures that it will remain within the long term target range (2% to 4%). With respect to this, it is worth mentioning that in the initial forecast for 2010, consumer inflation was expected to rise as a result of the El Niño phenomenon and its effects on the prices for food and for some regulated utilities such as electricity. However, the low pressure from domestic and foreign demand (the latter is partly due to the trade restrictions with Venezuela), together with an exchange rate that has appreciated and more favorable prices abroad than were predicted, offset the effects of the climatic phenomenon. Thus, at the end of the first half of the year, annual consumer inflation was at 2.3% and the predictions for the end of the year place it around the middle of the target range (3%).

In this context of low inflationary pressure in an economy that is growing at a pace that is below its potential capacity, the Board of Directors of the Banco de la República (JDBR in Spanish) believed that there is enough space to carry out a more expansionary monetary policy that would stimulate growth without jeopardizing the inflation target or macroeconomic stability. Because of that, in their meeting on April 30, 2010 the Board reduced the policy interest rate by 50 basis points (bp) which left it at 3%. This latest decision, which is added to the monetary stimulus policy that was carried out in 2009, has been almost completely transmitted to the market interest rates. In fact, between January and June 2010, the DTF interest rates and CD deposit rates declined 50 bp and 40 bp respectively. Something similar has happened to the interest rates for the different types of credit such as commercial, consumer and mortgages which saw reductions of 80 bp, 196 bp and 116 bp respectively since the beginning of this year.

In response to this stimulus and the improvement in the levels of confidence, credit has begun to react. Thus, the pace of growth of the consumer loan portfolio has seen a significant recovery and at the end of June 2010, its balance had increased 8.9% in annual terms. This was 6.1 pp above what had been seen for the same month in 2009. For the same date, the nominal annual rise for the micro-credit loan portfolio reached 11.7% while the mortgage portfolio that had been adjusted through securitizations grew 22.2% in nominal terms, which was 8.2 pp more than the pace registered the year before. Only the commercial loan portfolio continued to show weak performance as it registered an annual change of 0.9% this past June compared to 18.3% a year ago.

Along with this economic recovery, signs of stabilization in the labor market conditions began to appear. First of all, the unemployment rate began fall since December 2009, especially in the large urban areas. This was associated with a labor supply that had diminished possibly as a result of the better situation of households, at the same time as the quality of employment has been improving. Nevertheless, some facts that are worrying still persist, mainly all the duration of unemployment, which indicates that the improvements in labor conditions still need to become stronger.

As a complement to these positive developments on the fronts of economic recovery and inflation, market confidence has risen because of the recent fiscal policy announcements that have cleared up doubts about the sustainability of public finances in the medium term. On one hand, the Medium Term Fiscal Framework (MTMF) shows that starting in 2011, the fiscal stimulus that temporarily drove the economy during the crisis years will begin to be reduced. As a result, the national central government (NG) deficit is expected to go from 4.4% of the GDP in 2010 to 3.9% in 2011. Likewise, the deficit of the non-financial public sector (SPNF in Spanish) will drop from 3.6% to 3.1% of the GDP during these same years. In addition the government proposal to adopt a fiscal rule starting in 2011 which was well-received by the market. As is explained in this Report, the fiscal regulation is a policy plan that commits the authorities to a disciplined management of public finances. The purpose is to ensure a sustainable level of public debt, allow for a counter-cyclical management of fiscal policy and facilitate coordination in the design of economic policy. The fiscal rule will be an essential instrument in ensuring a prudential macroeconomic management of the mining-energy bonanza at the same time as it improves the fiscal indicators that will allow the country to recover its degree of investment.

This Report has four chapters. In the first one, the global economic recovery and the public debt crisis in Europe is described. The second chapter discusses the results of the Colombian economy during the first quarter and the outlook for 2010. A new section that has an analysis of the performance of the regional economy in Colombia is also included there. The third chapter describes the management of the international reserves and the fourth evaluates the financial situation of the Banco de la República. In addition, five that delve into analyze technical topics considered current and important are included.

I. THE ECONOMIC RECOVERY AND THE PUBLIC DEBT CRISIS IN EUROPE

After the worst economic and financial crisis that has been experienced since World War II, the global economy has begun to show some signs of recovery. However, the credit constraints, the high level of private indebtedness and the deterioration of the labor market witnessed in some developed economies, together with the risks related to acute unresolved macroeconomic imbalances, might jeopardize the recovery in the medium term.

After the worst economic and financial crisis that has been experienced since World War (WWII), the world economy has begun to show some signs of recovery. Since mid-2009, a better performance of retail sales and of industrial production has been observed in some developed and emerging economies as well as an upswing in the confidence of companies and consumers. Likewise, after a 12.2% contraction in the volume of world trade between 2008 and 2009, this has registered a significant recovery. According to the World Trade Organization (WTO), it is anticipated that the volume of exports from developed countries will rise 7.5% and exports from emerging countries, 11% this year.

However, the credit restrictions, the high levels of private indebtedness and the deterioration in the labor market that some developed economies still face together with the risks related to the acute macroeconomic imbalances that have not been solved could undermine the recovery in the medium term. Furthermore, the rescue programs and the government efforts to reactivate the economy have generated intense pressure on public finances, especially in developed countries. Thus, the worries about the sustainability of the government debt have been added to the problems of the private sector in some economies. In this sense, given the fears that have emerged due to the high levels of indebtedness of Greece and other countries in the European

Union, the uncertainty and the risk perception that have affected the world financial markets in the last few months could become an impediment to worldwide recovery.

In spite of the problems in Europe, the outlook for world growth still remains favorable. The estimates of some international entities (Organization for Economic Cooperation and Development [OECD], the World Bank, etc.) show that the world economy could grow around 4% in the next two years. The IMF, in turn, expects 4.6% in 2010 and 4.3% in 2011 after the contraction of 0.6% in 2009. Unlike past crises, the emerging countries are the ones that are leading the current economic reactivation. That being the case, the IMF estimates that these economies will grow 6.8% and 6.4% in 2010 and 2011 respectively while the developed economies will grow 2.6% and 2.4%.

Specifically, the growth of the United States in the last two quarters has been better than expected. However, this performance could be affected in the second half of 2010 when the impact of the fiscal and monetary stimulus disappears and the positive effect of the inventory cycle declines. A slow recovery, in turn, is expected for the Euro Zone given that it faces a much less favorable situation due to the high levels of indebtedness of some of the countries in the region have (Table 1).

Table 1
GDP Forecasts
(annual variation)

	2008	2009	Projections	
			2010	2011
World GDP	3.0	(0.6)	4.6	4.3
Advanced economies	0.5	(3.2)	2.6	2.4
United States	0.4	(2.4)	3.3	2.9
Euro Zone	0.6	(4.1)	1.0	1.3
Japan	(1.2)	(5.2)	2.4	1.8
United Kingdom	0.5	(4.9)	1.2	2.1
Emerging and developing economies	6.1	2.5	6.8	6.4
Eastern and Central Europe	3.1	(3.6)	3.2	3.4
Developing Asia	7.7	6.9	9.2	8.5
China	9.6	9.1	10.5	9.6
India	6.4	5.7	9.4	8.4
Latinoamérica and the Caribbean	4.2	(1.8)	4.8	4.0

Source: IMF.

A. THE RECOVERY OF THE UNITED STATES

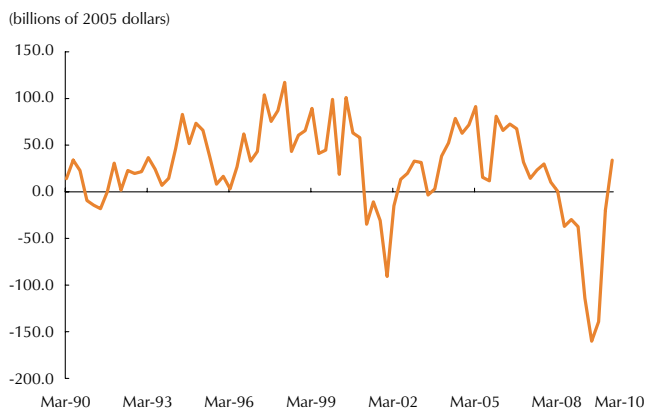
In spite of the fact that the epicenter of the international financial crisis was the US economy, the rapid and vigorous monetary and fiscal intervention by the

Graph 1
Contribution to the Growth of the GDP in the United States



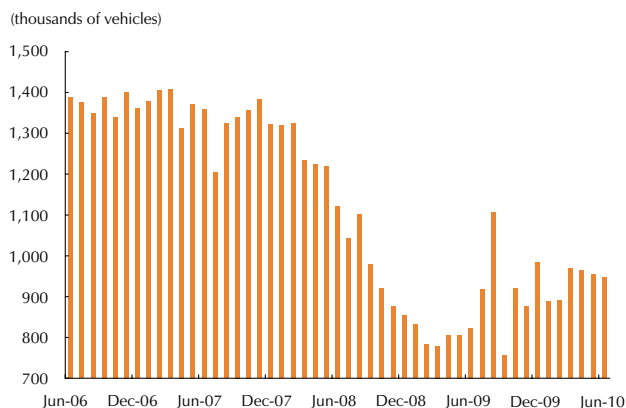
Source: Bureau of Economic Analysis (BEA).

Graph 2
United States Inventories



Source: Bloomberg.

Graph 3
Vehicle Sales in the United States
(seasonally adjusted series)



Source: Bloomberg, Banco de la República calculations.

authorities prevented the occurrence of a recession as severe as the Great Depression. The policies that were put into effect, which have been described in previous reports, were effective in stabilizing the local financial market and concerns easing international. At the same time, they prevented a much more severe plunge in economic activity.¹

The stimuli granted by the economic authorities, the replacement of inventory and, to a lesser degree, the incipient recovery of consumption, investment and exports allowed this economy to show one of the highest growths among the developed countries for the last two quarters. In the fourth quarter of 2009, the US GDP grew 5.6% annualized rate and in the first quarter of 2010, 2.7% a/q (Graph 1).

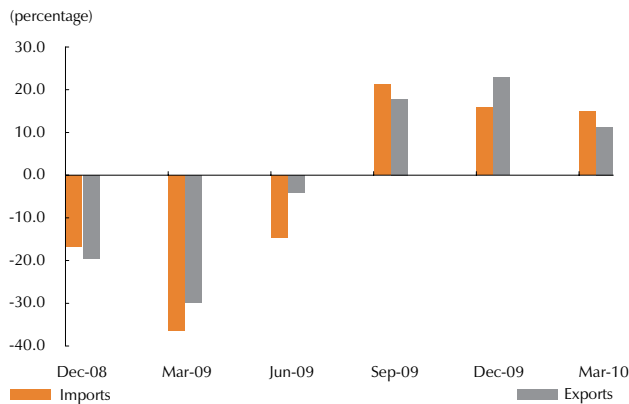
Since the third quarter of 2009, the new orders from companies have gone back to a rising trend which, together with the improved economic outlook, drove a new accumulation of inventory after the sharp setback that had been seen in this area since the second half of 2008 (Graph 2). About the same date, consumption began a recovery driven primarily by the fiscal stimuli.² The above, together with a higher consumer confidence and an acceptable level of credit, has sustained car sales so far in 2010 (Graph 3). With regards to investment, the nonresidential real estate continues to show a slight improvement while residential, which had shown a rally in the second half of 2009, tumbled again in the first quarter of 2010 thus reflecting the limited impact of the programs for stabilizing the housing market.

In the first quarter of 2010, the real exports for the United States showed a growth of 11.3% a/q at the same time that real imports were growing 14.8%

1 The United States GDP shrank 2.4% in 2009 while during the Great Depression of 1929, the plunge in production was around an average of 10% annually between 1929 and 1932 as a result the recovery took a decade to occur.

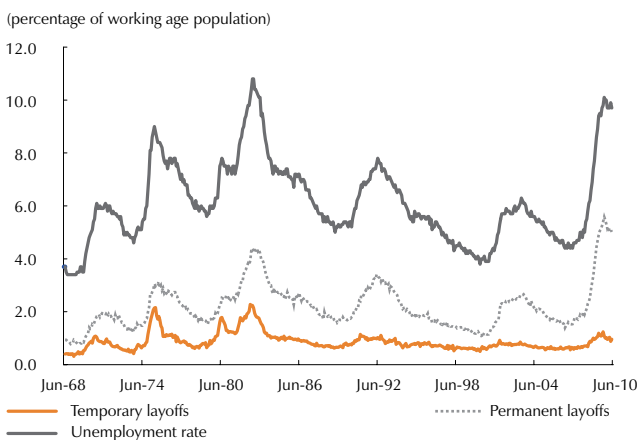
2 Such as the government program to replace old with new cars. The *car allowance rebate system* (CARS) program also known as *cash for clunkers* made around US\$3.000 million (m) in subsidies.

Graph 4
Growth of Real Exports and Imports in the United States ^{a/}



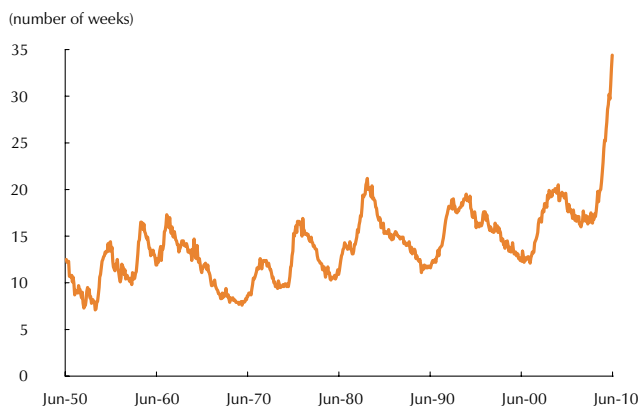
a/ Annualized quarterly growth.
Source: Bloomberg.

Graph 5
Unemployment and Layoff Rates in the United States



Source: Bureau of Labor Statistics.

Graph 6
Duration of Unemployment in the United States



Source: Bloomberg.

a/q. This recovery has been in effect since the third quarter of 2009 after the contractions of 30% and 40% seen during the crisis (Graph 4).

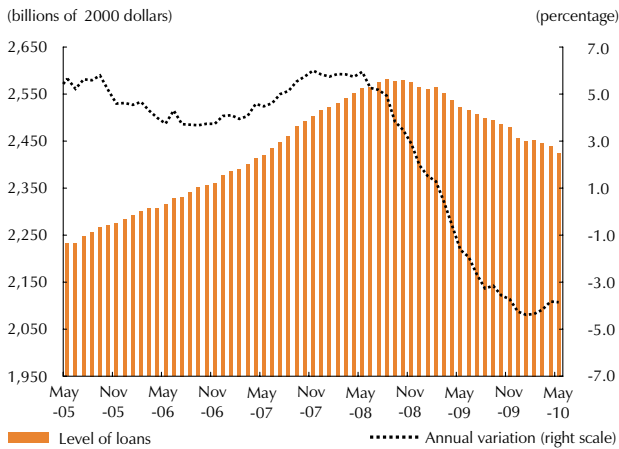
In general, supply indicators such as new orders, existing orders, industrial production, etc. have been improving since the beginning of the year. This has improved business confidence and has caused many analysts to keep their growth projections for the United States at around 3.2% for 2010. Nevertheless, in spite of the favorable signs in this area, the sustainability of the recovery is still uncertain since this country continues to face significant risks. The main one is related to the economy's ability to generate sustained growth on its own as well as the uncertainty about how strong and lasting the reactivation of the private sector might be given that a large part of the positive results seen so far are due to the fiscal stimuli.

Another risk is associated with the deterioration of the labor market since, even though there was a net creation of 431,000 jobs³ in May, a month later there was net loss of 125,000 jobs again. Claims for jobless benefits also rose during the last quarter and the unemployment rate remained at high levels –around 9.5%– in June. Therefore, if production recovery continues without generating a significant amount of employment, the high levels of unemployment that are seen today could become chronic. The upswing that has been registered in the rate of permanent layoffs and in the duration of unemployment, which have reached historical maximums, point in that direction (graphs 5 and 6).

In addition to the rising unemployment, another risk for US growth has to do with the high level of indebtedness that companies and households have along with the deterioration of the credit channel, which has not been fully re-established. Although various surveys done by the Federal Reserve of the United States (Fed) show that the requirements of commercial banks on new loans were lowered

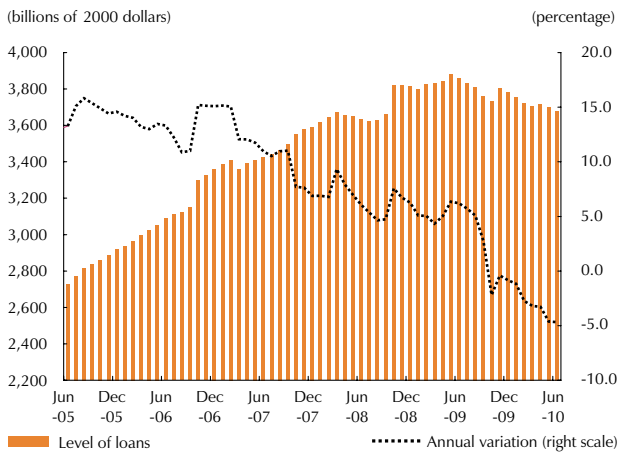
³ In May, generation of employment was mostly driven by the government since a population census was done during that period.

Graph 7
Real Consumer Loans in the United States



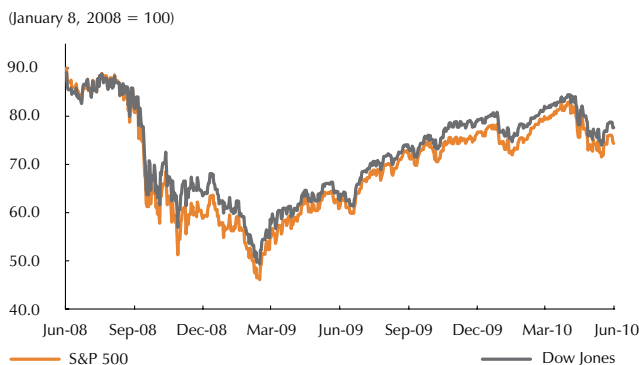
Source: Federal Reserve Bank of St. Louis.

Graph 8
Real Loans for Real Estate in the United States^{a/}



a/ This corresponds to the loans granted by commercial banks.
Source: Federal Bank of St. Louis.

Graph 9
Stock Indices in the United States^{a/}



a/ Figures to June 30.
Source: Bloomberg.

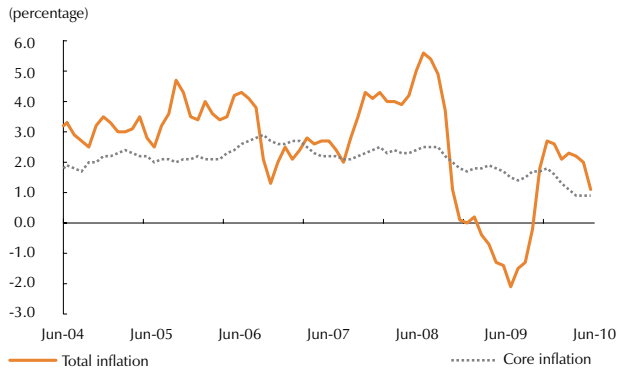
in 2009 and the first months of 2010, credit for consumption, financing of commercial activities and investment has continued to shrink (graphs 7 and 8).

Although commercial banks have recorded earnings in the last few quarters, these may not be sustainable and they could be hit again by problems such as the persistent unemployment and its effects on the loan portfolios as well as by the doubts that have emerged about the loans granted in the commercial real estate sector. It is worth mentioning that this sector is being strictly monitored these days by the market since the high investment that was made in the past and the plunge in demand because of the crisis have brought the materialization of earnings into question. Furthermore, it is not clear yet whether or not the losses from toxic assets have been totally reflected in the balances of the financial firms.

Finally, the possibility that the growing uncertainty resulting from the sovereign debt problems in some of the European countries could have an impact on financial and real activity cannot be ruled out. This would be a blow, in turn, to the bank balances. An example of that is the drops that the global stock markets have faced so far this year. In some cases, these have lost the gains seen in 2009 (Graph 9). In the next few quarters, if there is a more serious deterioration in the European countries and the euro continues weakening in comparison to the US dollar, US growth could be negatively affected given the tight commercial and financial relationships between the two economies.

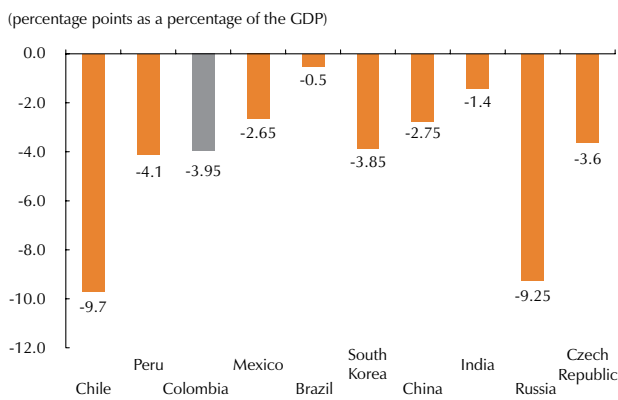
That being the case, in spite of the fact that many of the indicators for real activity in the United States have shown positive performance so far this year and growth of more than 3% in 2010 is predicted, the risks that have been reported suggest that the recovery of consumption and investment will continue to be slow over the next few quarters. In this environment, both total and core inflation have remained at low levels without showing additional significant downswings. As a result of that, the risks of deflation seem to be under control for the

Graph 10
Inflation in the United States



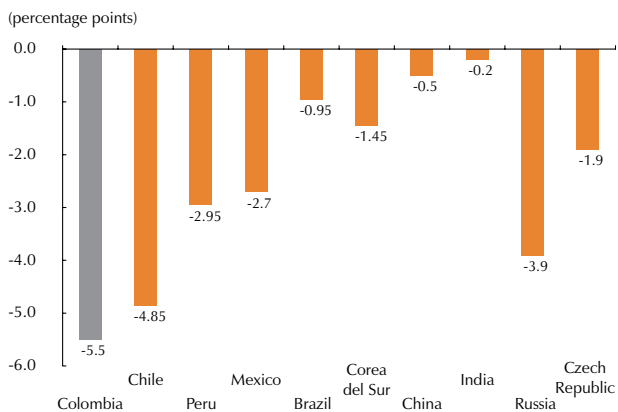
Source: Bloomberg.

Graph 11
Change in the Fiscal Balance: 2010 vs. 2007-2008



Source: Consensus Economics.

Graph 12
Change in the Interest Rate: 2010 vs. 2007-2008



Source: Consensus Economics, Banco de la República calculations.

moment (Graph 10). This, together with the low use of installed capacity and the moderate growth that is expected in the medium term, will allow the Fed to keep its nominal interest rate at levels that are close to zero in 2010.⁴

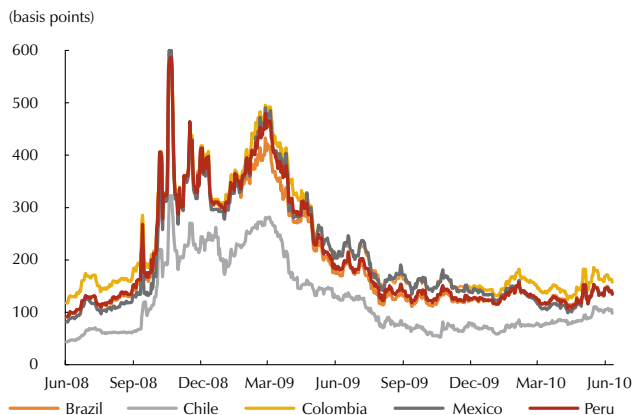
B. THE RECOVERY OF EMERGING ECONOMIES

Unlike previous crises, the current one occurred at a time in which emerging economies in Asia and Latin America had favorable economic conditions. Many of these countries had made pronounced structural adjustments due to the crisis that they faced gone through in the nineties, which made it possible for them to dodge the most recent worldwide shock satisfactorily. When the crisis began, the majority of these economies had a series of favorable macroeconomic such as: among which low levels of inflation, a lower level of household and business indebtedness and positive fiscal and commercial balances. At the same time, the majority of the countries had floating exchange rates and had accumulated international reserves that allowed them to respond to the external shock. Moreover, it should be emphasized that they had healthy and solid financial systems that had little exposure to the toxic foreign assets. As a result of this, the expansionary monetary policies of each country had considerable impact.

The macroeconomic adjustments that were made by these countries a decade before gave the monetary and fiscal authorities a larger margin within which to manoeuvre during the recent crisis (graphs 11 and 12). That being the case, although the majority of the governments of emerging countries carried out counter-cyclical fiscal policies, these did not seriously harm their balances because their risk premiums remained stable and, in some cases, they are already at the levels they had before the bankruptcy of Lehman Brothers (graphs 13 and

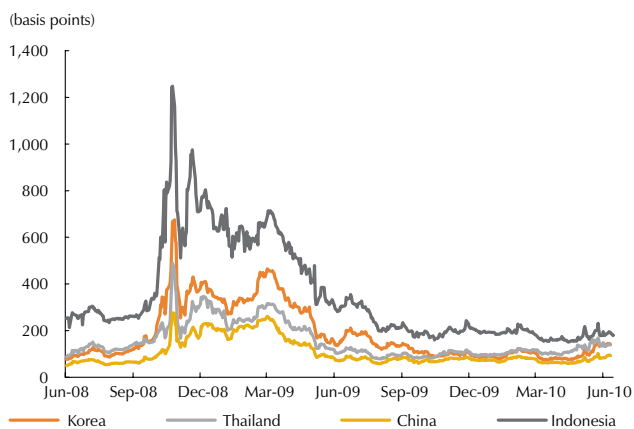
4 International analysts expect an increase in the US benchmark rate at the end of the year.

Graph 13
5-year Credit Default Swaps (CDS) in Latin America ^{a/}



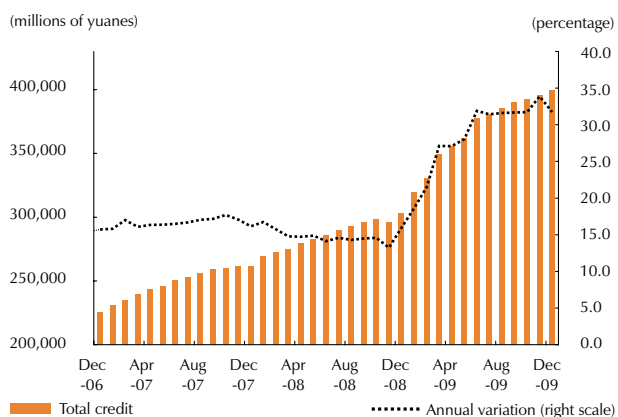
a/ Data as of June 30.
Source: Bloomberg.

Graph 14
5-year Credit Default Swaps (CDS) in Asia ^{a/}



a/ Data as of June 30.
Source: Bloomberg.

Graph 15
Total Credit in China



Source: Central Bank of the People's Republic of China.

14). Controlled inflation, fiscal discipline, lower macroeconomic imbalances, the low exposure of their banking systems and the lower level of consumer, business and government debt explain the international confidence on the countries and their access to foreign financing in the midst of the financial turbulence of 2008 and 2009.

Concerning monetary policy, the majority of Latin American countries had low and stable inflation⁵ and a negative output gap. This allowed them to maintain an expansionary, monetary posture in 2008 and 2009. Recently, the greater growth seen and the emergence of some inflationary pressures have led some countries in the region to raise their interest rates as is the case of Brazil, Peru and Chile.

In the Asian economies something similar has occurred. Although not many changes have been seen, the performance of some countries has generated a tightening of their monetary policy. Some examples of that are the increase in the benchmark rate in India and the hike in the levels of reserve requirements for commercial banks in China.⁶ In the latter country, the measures seek to reduce the liquidity generated by the monetary stimuli in order to restrain the excessive growth of loans, which could be causing an overheating of that economy (Graph 15).

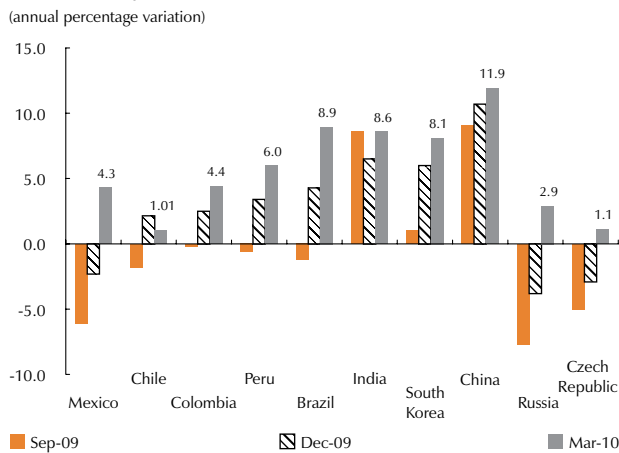
As has been said with respect to growth, the emerging economies and mainly the Asian ones, are leading the recovery of worldwide demand. The rapid growth of China's and India's GDPs at annual rates of 11.9% and 8.6% respectively in the first quarter of 2010⁷ stands out from the others (Graph 16). For the same period, the economies of Latin America have also shown a strong recovery. Brazil,

5 Except for Venezuela, which registered an annual inflation of 31% in May, and possibly Argentina.

6 The economic authorities of China have raised the reserve requirements by 150 bp since December, 2009. For the moment, the benchmark rate set by the central bank of China has remained unaltered.

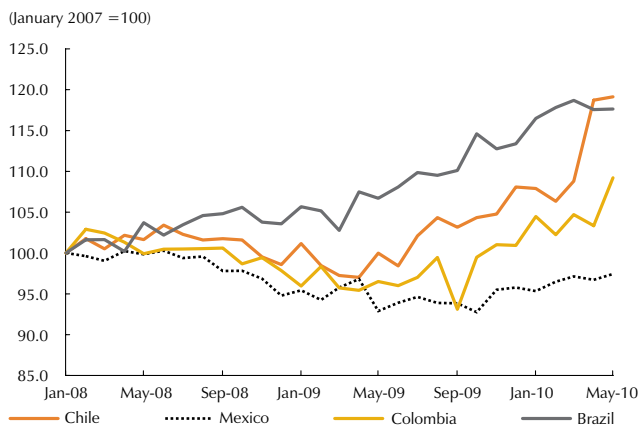
7 The data on the annual growth of the GDP for China for the second quarter of 2010 was published recently. It was at 10.3%.

Graph 16
GDP of Emerging Economies of Latin America, Asia and Eastern Europe



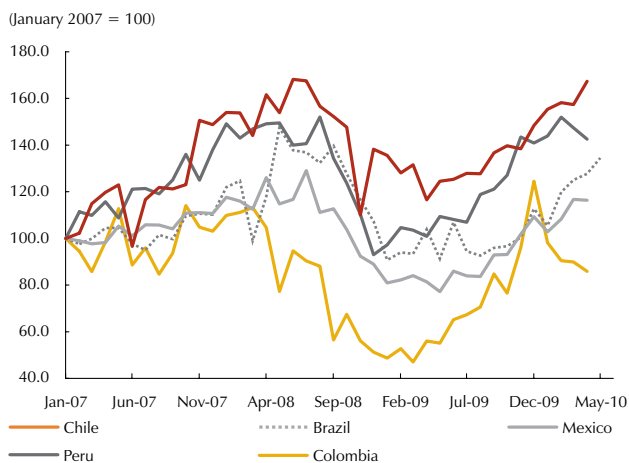
Source: Bloomberg.

Graph 17
Retail Sales in Latin America



Source: Statistics institutes in each country.

Graph 18
Total Nominal Exports in Latin America



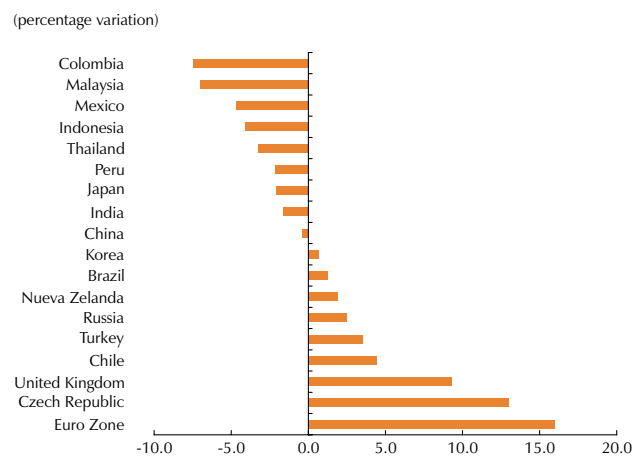
Source: Statistics Institutes and central banks in each country.

Peru and Colombia are the most noticeable with annual recoveries of 9%, 6% and 4.4%.⁸

Indicators such as retail sales, industrial production and exports have recovered in emerging countries. In Latin America, retail sales in the majority of the countries (except Mexico and Venezuela) have reached and even surpassed the levels seen before the crisis (Graph 17). With respect to the exports, these have improved considerably following the rising trend of world trade (Graph 18). This performance is primarily a result of the strength of commodity prices since the majority of these countries are net exporters of these materials.

So far this year, the currencies of emerging countries have shown a mixed performance (Graph 19). In Latin America, a depreciation of the real and the Chilean peso have been observed while in Mexico and Colombia the local currency appreciated. In the case of the Colombian peso, its appreciation with respect to the dollar came to 7.5% in the first half of the year. There were important news for the foreign exchange market when the Chinese monetary authorities made an announcement that they were

Graph 19
Trend of Each Currency with Respect to the Dollar^{a/} (to date)



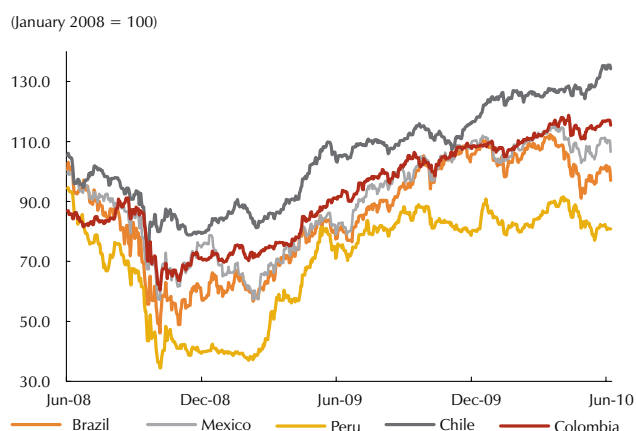
a/ Data as of June 30.
Source: Bloomberg.

8 Chile grew 1% in spite of having suffered from a high magnitude earthquake.

going to make their currency more flexible. This will help reduce the global macroeconomic imbalances a little since the expected appreciation of the yuan will make it possible to reduce the surplus that this economy has had in the last few years.

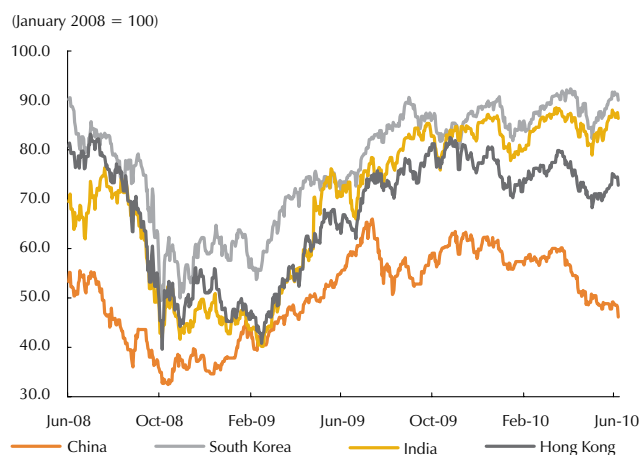
Although the financial turbulence in Europe has not affected the public financing of Asian and Latin American countries, the stock markets have felt

Graph 20
Stock Indices for Some Countries in Latin America ^{a/}



a/ Datos a 30 de junio.
Source: Bloomberg.

Graph 21
Stock Indices for Some Countries in Emerging Asia ^{a/}



a/ Data as of June 30.
Source: Bloomberg.

something of an impact. Latin America has been one of the least affected regions with the stock market performance in Brazil and Colombia being the most outstanding. These have considerably surpassed those of the developed countries (Graph 20). Something similar has been occurring in the Asian countries where, except for China, there have been slight downswings so far this year (Graph 21). In the latter, the concerns about the economy overheating, the fears of asset price bubbles and some inflationary pressures have generated a deterioration in stock market performance since the end of last year.⁹

Thus, the strengthening of emerging economies and the lower perception of risk that they are seen to have will continue to reactivate capital inflows. However, as the World Bank has pointed out, the possibility that the developed economies' greater needs for financing will counteract the strength of the capital flows to emerging economies in the future cannot be disregarded. In that case, given that a more serious competition for resources could occur, the resources would become more expensive and make access to financing more difficult for developing economies (see the shaded area pg. 24).

In general terms, the information available to date points to the recovery of emerging economies being faster and better supported than that of the developed countries. Moreover, the finances of their governments have remained stable and there have been no reductions in their credit ratings (in some countries they have even been upgraded). This has

offset any possible contagion of the European debt crisis.

9 Between January and June, 2010 the stock market in China fell around 27%.

RECENT TREND IN CAPITAL FLOWS TO EMERGING ECONOMIES

In the last five years, the trend of capital flows to emerging economies has been characterized by three phases. In the first phase, there was a boom and considerable capital inflows until 2007. After that, there was a downswing for the next two years and finally, a recovery in the first months of 2010. Between 2005 and 2007, the higher interest rates in emerging markets, the decline in risk premiums and the significant upswing in the international commodity prices attracted foreign direct investment and made it possible to finance private debt, especially in Asian and Latin American countries.

This capital inflows halted in 2008 as a result of the financial turbulence in the United States and other developed countries. This generated a rupture in the credit channels and in international financing. In that highly uncertain environment, the risk premiums climbed to historically high levels and the international prices for commodities plummeted (Graphs A and B). All of this was reflected in a significant cutback in the capital flows towards emerging economies (Graph C).

In the future, the outlook for capital flows indicates that the reactivation of these flows towards emerging economies will continue, especially to Asia and Latin America, which have shown a significant rally in economic activity. In the most recent report issued by the World Bank¹¹ a recovery of these flows to developing economies is projected to go from US\$454.000 million (m) in 2009 to US\$771.000 m for 2012. In spite of that, they will not reach the levels seen before the crisis (Graph C). According to that report, the needs that the highly indebted developed countries have for financing are included among the factors that could counteract the recovery of capital flows to emerging economies since the competition for resources will make them more expensive.

Graph A
Sovereign Risk of Emerging Economies
(EMBI^{a/} + global)

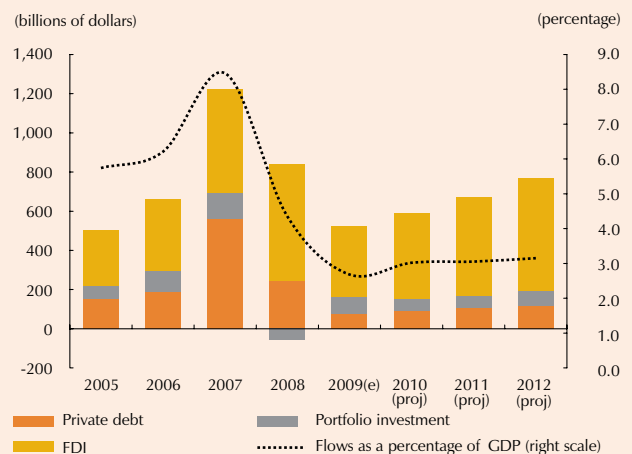


Graph B
Index of International Commodity Prices



a/ Emerging Markets Bond Index.
Source: Bloomberg.

Graph C
Capital Flows to Emerging Economies



(e) estimated.
(proj) projected.
Sources: World Bank, Global Economic Prospects Summer: Fiscal Headwinds Recovery, 2010.

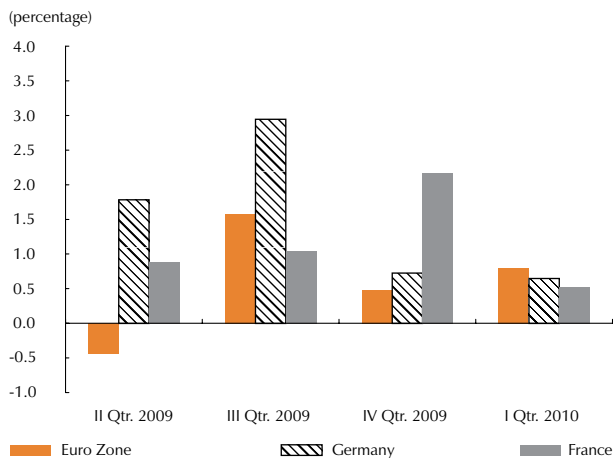
1 World Bank, Global Economic Prospects Summer: Fiscal Headwinds Recovery, 2010.

C. THE PUBLIC DEBT CRISIS IN EUROPE

Unlike the United States, Japan and the emerging economies in Asia and Latin America, the economy in the Euro Zone has shown very weak signs of recovery. In fact, in the last few months, the outlook has deteriorated due to the debt problems that some countries in the region face. In spite of the aid announced by the European Commission (EC), the European Central Bank (ECB) and the IMF, the implementation of these measures makes it seriously challenging for these countries to be able to face the current difficulties and generate a sustained growth. That being the case, the economic panorama

in the medium term for the Euro Zone remains uncertain and growth in 2010 and 2011 is expected to be moderate.¹⁰

Graph 22
Growth of the GDP in the Developed Countries of Europe
(annualized quarter)



Source: Bloomberg.

Graph 23
Growth of the GDP of Other Countries in the Euro Zone
(annualized quarter)



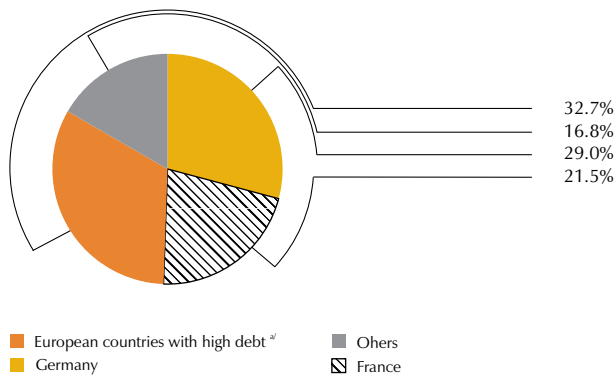
Source: Eurostat.

In spite of the fact that the Euro Zone GDP showed its first positive growth in the third quarter of 2009 after having contracted sharply for five consecutive quarters, the recovery of this economy has been very weak since its growth has been lower than 1% a/q in the last two quarters (Graph 22). Up to now, the performance of the countries in the region has been varied as a consequence of the impact of the fiscal adjustment, the differences in the inventory cycle and the presence of macroeconomic imbalances. The largest economies in the region (Germany and France) have not been able to generate enough growth to strengthen the economy of the zone. On the contrary, they have shown a slowdown in the last two quarters (graphs 22 and 23).

Even if the policies carried out by the governments in the region to deal with the crisis of 2008 allowed them to stabilize the financial system and reactivate the economy in the short term, the structural imbalances of some countries have not been solved yet. This has been especially evident for countries such as Greece, Portugal, Ireland, Spain and Italy, which have high levels of debt and face severe fiscal imbalances. The macroeconomic vulnerability of those countries was more evident because of the sharp contraction in 2008 and 2009 as well as the outlook for low growth in the future.

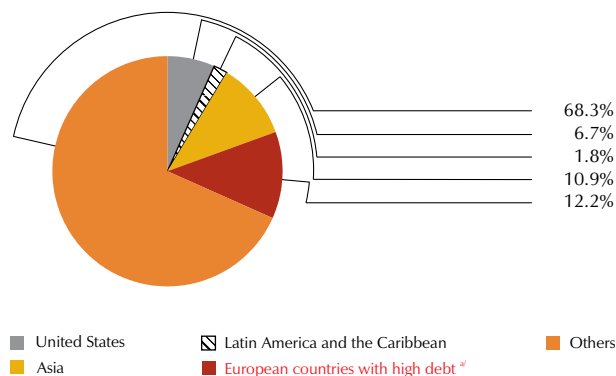
10 According to the IMF it could be 1% in 2010 and 1.3% in 2011.

Graph 24
Share of the Euro Zone GDP, 2009



a/ Greece, Portugal, Ireland, Spain and Italy.
Source: Eurostat.

Graph 25
Share of Exports from Germany, 2009



a/ Greece, Portugal, Ireland, Spain and Italy.
Source: Federal Statistics Office, Germany.

Graph 26
Performance of the Euro^{a/}
(currency per euro)



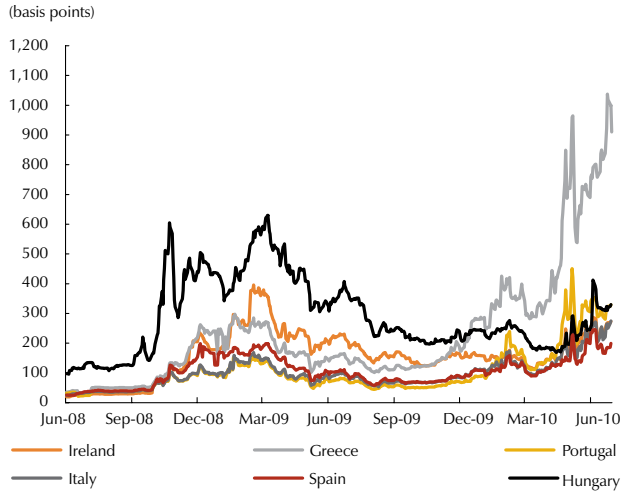
a/ Data as of June 30.
Source: Bloomberg.

As a result, the growing doubts about the macroeconomic stability of several countries in the region, the rise in unemployment and the limited availability of loans has caused a lot of uncertainty about the economic recovery of the euro zone. In addition, some of the countries that have put austerity measures in place have had significant slumps in the growth of the GDP as is the case of Ireland. Thus, the deterioration in the countries listed, which generate around a third of the GDP for the euro zone and represent a large proportion of the trade between those countries, could have a significant impact on the region's growth (Graph 24). With respect to Germany's exports, for example, the share those countries have of it is around 12% (Graph 25).

The higher level of uncertainty in Europe as well as the possibilities of these problems spreading to others have led to a weakening of the euro with respect to the dollar and other currencies. Thus, in the first half of 2010, the euro depreciated about 15% compared to the dollar and 18% in comparison to the yen (Graph 26). The sovereign risk premiums, in turn, for the most vulnerable countries have surged to significantly high levels thus generating upward pressure on the interest rates of the medium and long term public debt securities and giving their solvency levels an even heavier blow. In the case of Greece, for example, the debt it has resulted in the loss of its investment grade rating at the beginning of April while Portugal and Spain saw a significant decline in their rating (graphs 27 and 28).

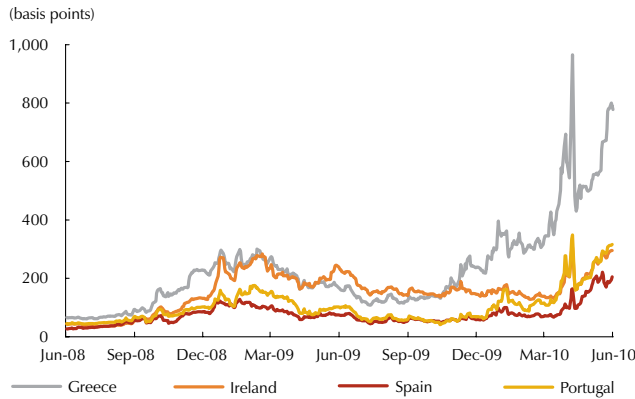
In this context, investors liquidated risky positions of not only variable income instruments but also public debt securities of European countries with high levels of indebtedness and moved into assets that were considered safer such as debt securities of the United States and Germany. This situation caused a significant reduction in the medium and long term interest rates for the economies that are considered the solidest in the world (Graph 29) at the same time as the majority of the stock markets in European countries were experiencing steep plunges over the course of the year (Graph 30). As a result, global uncertainty and the perception of risk in international financial markets have risen,

Graph 27
5-year Credit Default Swaps in Europe ^{a/}



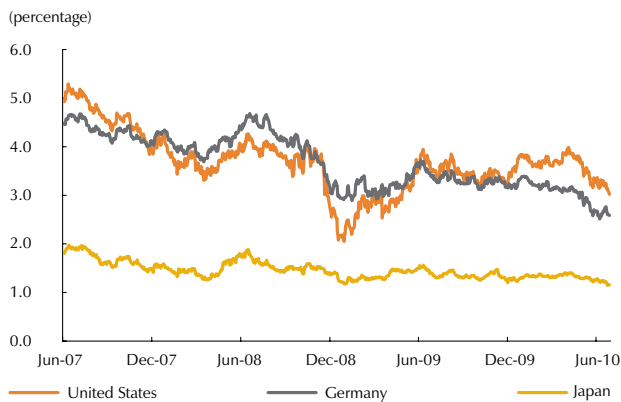
a/ Data as of June 30.
Source: Bloomberg.

Graph 28
10-year Sovereign Spread Germany ^{a/}



a/ Data as of June 30.
Source: Bloomberg.

Graph 29
Long Term Interest Rates in Developed Economies ^{a/ b/}

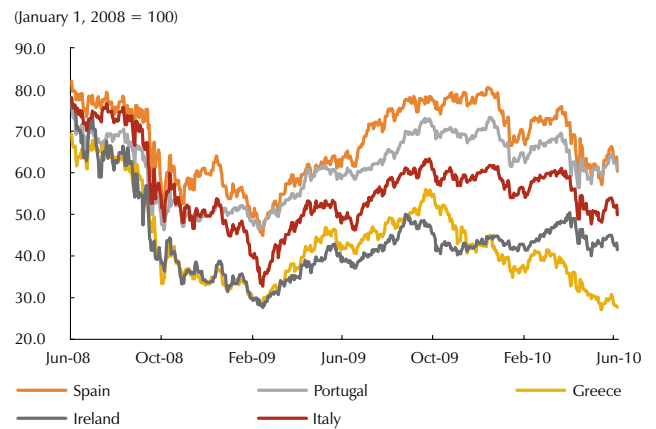


a/ This corresponds to the 10-year government bond rates.
b/ Data as of June 30.
Source: Bloomberg.

especially in the developed economies (Graph 31) while there has been little effect on the emerging markets.

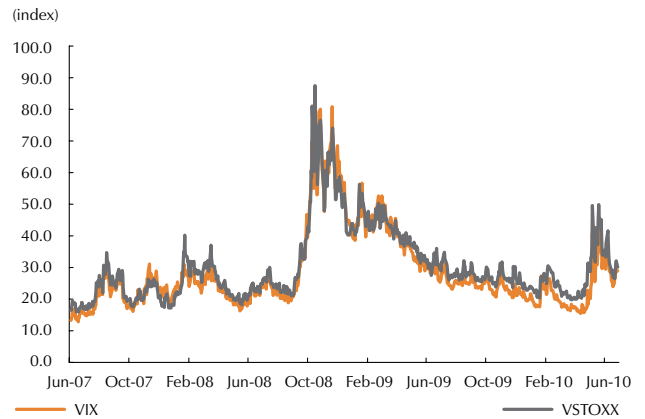
The concerns that other countries will be affected have also been raised because of the exposure to Greek assets and those of other countries that are highly indebted. Although France, Germany and the United States have the most exposure to the Greek banking sector (Table 2),¹¹ these proportions are

Graph 30
Stock Indexes of Some European Countries ^{a/}



a/ Data as of June 30.
Source: Bloomberg.

Graph 31
Volatility Indicators for Developed Economies ^{a/ b/}



a/ VIX (volatility index) is a financial indicator that measures the volatility of US S&P 500 options while the VSTOXX does something similar for the EURO STOXX 50 in the euro zone.
b/ Data as of June 30.
Source: Bloomberg.

11 This exposure does not refer exclusively to government bonds but includes other financial claims that can represent significant quantities such as in the case of France where a fifth of Greece's total loans are held by French banks.

relatively small with respect to the total foreign exposure that these countries have. However, if losses also arise from the assets from Portugal and Spain, the impact on the capital that the banks have could also be greater. Specifically, France and Germany seem to be more exposed since the share of Greek, Portuguese and Spanish assets in the total amount of loans granted by their banks is around 9.1% and 10.1% respectively. Meanwhile, in the United States the share that these assets have is only 3.2% (Table 2).

Table 2
Bank Holdings of Greek and Southern European Assets

	France	Germany	United States
Holdings of Greek Assets			
Value (billions of dollars)	78.8	45.0	16.6
Share of the external claims of the banking sector in the total (percentage)	2.1	1.4	0.7
Share of the banking sector in the total assets (percentage)	0.8	0.5	0.1
Holdings of Greek, Portuguese and Spanish Assets			
Value (billions of dollars)	334.9	330.4	79.3
Share of the external claims of the banking sector in the total (percentage)	9.1	10.1	3.2
Share of the banking sector in the total assets (percentage)	3.6	3.7	0.6

Sources: BIS Locational and Consolidated Banking Statistics, April 2010 and OCDE Banking Statistics, 2009.

As a consequence of the instability generated by the debt problems in some European countries, the economic authorities have put a series of measures into place to soothe the turmoil in the international financial markets, control the steep drop of the euro and prevent the possible impacts on the economic growth of the region and the worldwide economy (See the shaded portion, pg. 29). However, in spite of the positive response of the markets to the aid package announced by the authorities, the doubts about the implementation of that package began to raise the indicators of sovereign risk again. Therefore, the challenges for the European economies in the medium term are still considerable since it has become necessary to guarantee austerity in expenditure as well as to have greater fiscal coordination.¹²

12 In the past, the region has failed to impose strong, credible sanctions on the countries that have violated the fiscal limits.

The member countries of the Euro zone have the obligation to comply with a pact to guarantee the stability of the region.¹ Part of that agreement involves maximum limits on public debt which a few countries failed to comply with initially and Greece failed to do so to a greater degree. In view of that situation, the IMF, the EC and the ECB decided to announce a package of measures to prevent the crisis from broadening and threatening the stability of the Euro zone. However, these announcements were rated as insufficient by the markets and because of that, the European authorities found themselves forced to offer an aid package that was unprecedented. Below, the development of the crisis and the aid package is described.

In Ireland, the problems with fiscal sustainability started to be evident when, over a period of two years, the fiscal balance deteriorated from a surplus of 0.05% of the GDP in 2007 to a deficit of 11.7% in 2009 while, at the same time, the public debt went from 25% of the GDP to an estimated 65% last year. In response to that situation, the Irish government proposed a series of measures to reduce the public expenditures in 2009 and thus restore market confidence and reduce the cost of their indebtedness. In order to do this, a fiscal adjustment plan was implemented last year Ireland to a deficit level that would be below 3% in 2014. To reach this goal, measures were introduced such as: a 13% cut in the salaries of public workers, the creation of a tax on pensions, an increase in the number of workers that pay taxes on their salaries,² cutbacks on the social security benefits and an increase in taxes. As a consequence, public expenditures shrank by 4.9% of the GDP in 2009 and a cut of 2.5% of the GDP is also expected this year. Nevertheless, even though Ireland began to implement fiscal austerity measures before the other countries, their challenges are still huge since, this year, the output is expected to fall for the third consecutive

year. This will keep up the pressure on fiscal sustainability and has forced the government to continue enacting new adjustments.

At the beginning of 2010, Greece, in turn, announced an economic and financial adjustment program which was intended to re-establish market confidence in the sustainability of their public finances. The program includes a fiscal cutback of 11 pp of the GDP until 2013 (with additional cutbacks if they do not manage to get the deficit below 3% in 2014), a salary and pension freeze for three years and a hike in taxes in order to get the debt on a declining trajectory as of 2013. Furthermore, the government made a commitment to implement policies to re-establish competitiveness and guarantee financial stability as well as to reform the social security system, modernize the public sector, fight corruption and make the labor market flexible. The EC, the ECB and the IMF committed themselves to providing Greece with financial aid based on strict requirements and the Greek government's commitment to comply with the adjustment program that has been put into effect. Consequently, these entities will give Greece €110.000 m within the next three years to guarantee the country's solvency.³

In spite of the fact that the austerity announcement by Greek government led to a reduction in the risk premiums, the uncertainty about the scope of the adjustment along with the fiscal problems of other countries in the region caused the risk of Greece's sovereign debt to reach a historical maximum (Graph 27).

The above lead to a package of unprecedented fiscal and monetary aid, which was allocated for all of the countries in the region that have debt problems, being announced. As a result, on May 10, 2010, the ECB, EC and the IMF announced a rescue package of €750.000 m to help the countries in the euro zone that face problems refinancing their debt. The aid includes, first of all, €440.000 m in loans and guarantees, using the rescue package for Greece as a model, from the countries in the region for a period of three years. Nevertheless, there is a lot of uncertainty regarding the activation of these resources since, in spite of the fact that the EC has stated that this can be done in a matter of weeks, each state must approve the resources

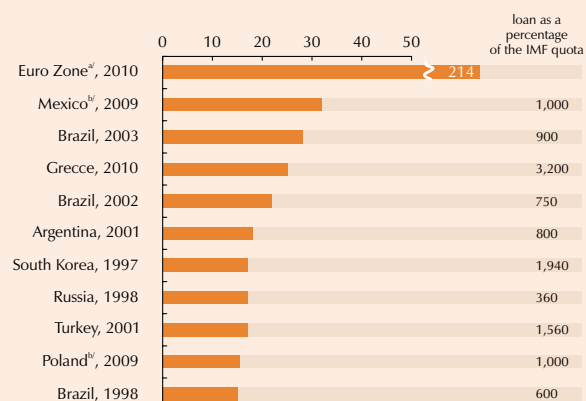
1 The stability and growth pact is an agreement between the member states of the euro zone with regards to their fiscal policy. The core objective for it is to facilitate and maintain the economic and monetary union. The Pact consists of fiscal supervision of the member countries and of a statute for applying sanctions for failing to comply with what the pact itself demands. Within the pact, limits of 3% of the GDP on the fiscal deficit and 60% as a percentage of the GDP for public debt are imposed.

2 Before this measure, 40% of the Irish workers received a salary that was below the minimum at which a tax must be paid. Therefore, that law sought to have all workers pay taxes on their salary.

3 Of this sum, €80.000 m will be granted by the EC and €30.000 by the IMF.

in its respective congress. The second part of the rescue fund consists of €60.000 m from the balance of payments financial aid mechanism of the EC.⁴ These resources will be the first ones to be available since they can be activated rapidly due to the fact that this is a community instrument. In the current crisis, this mechanism has been used to help Hungary, Romania and Lithuania and its use (which was prohibited for the euro zone economies) was authorized for the countries in that region that needed it. Last of all, the IMF will make €250.000 m available to the new rescue fund. However, given that an amount of this magnitude has not been lent before by this entity (Graph A), the debenture loan will depend on not only the capacity it has to make loans but also the acquiring of new capital since the IMF does not have that amount currently available.⁵

Graph A
Largest IMF Loans
(billions of SDR^{c/})



a/ Proposed.
b/ Precautionary agreements.
c/ SDR: Special drawing rights.
Sources: The Economist and IMF.

The ECB, in turn, announced interventions in the European public and private debt markets to limit the spread of the Greek debt crisis, ensure the liquidity of those securities and re-establish the transmission channels for monetary

policy. Likewise, they established an option of unlimited auctions at a fixed rate and reactivated a line of foreign exchange loans with the Fed and other central banks to stabilize the euro-dollar convertibility.

As a counterpart to this assistance, the countries with debt problems committed themselves to implement more severe fiscal adjustment measures. In addition to the ones that have already been mentioned for Ireland and Greece, Spain agreed to reduce their fiscal outlays by 0.5% of the GDP in 2010 and by 1% in 2011 through a 5% cut in public sector salaries⁶ and a €6.000 m reduction in public investment. Thus Spain's fiscal deficit is expected to be reduced from 11.2% of the GDP in 2009 to 6% in 2011. Portugal, in turn, made a commitment to reduce their deficit from 9.4% of the GDP in 2009 to 7.3% in 2010 and to 4.6% in 2011 until they reach the goal of 2.8% in 2013. In order to do this, they dropped all of the counter-cyclical stimulus measures implemented in previous years and will postpone some of the investment in public works projects. The salaries will be cut by 5%, transfer payments to local government will be reduced, central government expenditures will be decreased and unemployment subsidies will be restructured. With respect to revenue, tax exemptions will be eliminated and taxes will be raised.⁷

In spite of the above, there are various doubts and criticisms of the package of measures. In the first place, there is a lack of details about the implementation of the aid that has been offered. The independence of the ECB is also being questioned given their decision to buy the debt of the countries in crisis as well as the problems in the medium term that this could generate. Last of all, the package itself entails a poor incentive (called moral) on the part of the governments to comply with the fiscal adjustment agreements since the purchases of debt securities together with the resources available for the countries in trouble take pressure off of the governments and, as a consequence, the fiscal cutbacks could be delayed.⁸

4 The money will be lent to the needy country at an interest rate of around 5%.

5 There is a lot of uncertainty about this part of the resources since, according to the IMF, this is a hypothetical number based on the participation that institution has had in the aid packages in Europe (approximately a third). As of last May 6, the IMF's capacity to make loans was €215.000 m. Nevertheless, the Administrative Council recently approved an expansion of their permanent agreements to acquire more than US\$500.000 m in debenture loans from governments and central banks (however, about half of this amount is already included in their current loan capacity). Although the IMF has other options for acquiring capital, this would take time since it implies that the governments would have to get legislative approval.

6 These will remain frozen until 2011.

7 The VAT would rise 1 pp and income tax would go up for both individuals and companies with high incomes.

8 With the support measures, the governments with problematic fiscal situations know that now they have a place to resort to if a crisis is triggered and, therefore, the aid could be seen as an invitation to make fewer adjustments than what is required.

II. THE COLOMBIAN ECONOMY: RESULTS AND OUTLOOK FOR 2010

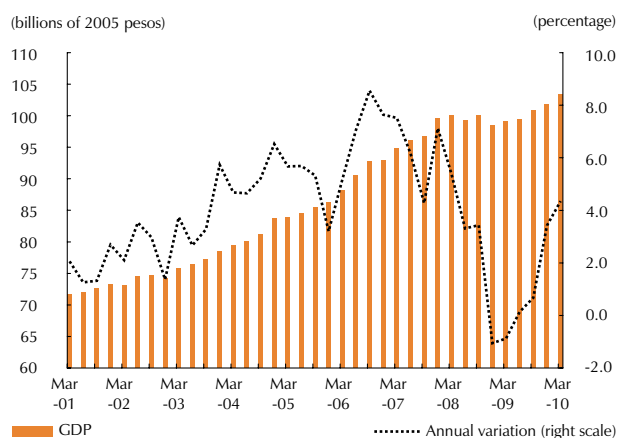
In the first three months, the GDP grew 4.4% in annual terms, which in terms of growth points to a very good beginning for 2010. The favorable figures of economic activity are explained by the momentum of private demand and by the stimulus that the public demand has provided the economy since mid 2009. The information of the GDP in the first quarter suggests that the reactivation of its components (consumption and investment) will be more pronounced than initially expected.

A. ECONOMIC ACTIVITY

In the first half of the year, the information available about the real sector revealed a faster reactivation of economic activity in Colombia than was initially foreseen. In the first three months, the GDP grew 4.4% in annual terms (Graph 32) which in terms of growth points to a very good beginning for 2010. This rate, even if it is not as high as what has been seen in other countries in the region, is higher than what was expected a few months ago by the market consensus and by the Banco de la República in the *March Report on Inflation*.

It should be pointed out that close to half of the difference between the observed performance of the GDP and the expected performance was associated with the change in the reference year from 2000 to 2005 for national accounts together with other methodological modifications that are important in its calculation. These innovations,

Graph 32
Gross Domestic Product (GDP)



Source: DANE.

which are internationally common and are made to get a better approximation of the change in the aggregate value of the different sectors as well as the contribution of different agents to national production, required a revision of the growth for 2009 (from 0.4% to 0.8% largely related to the change in the annual growth of the fourth quarter, which went from 2.5% to 3.4%) and a change in the different shares of the productive sectors as is illustrated on the shaded page 33.

Irrespective of the methodological changes, the better numbers for economic activity so far this year, in comparison to those predicted, are largely the result of a combination of various factors. The first one is that private demand began to react dynamically as a result of the rapid return of confidence and an expansionary monetary policy, which in a context of moderate inflation and of active transmission channels for the interest rate, has generated an acceleration of household consumption decisions. This fact is combined with the boost that public demand has been providing growth since mid-2009 allowing total domestic demand to be the growth engine during the recovery.

Also, businessmen have responded to the plunge in demand from Venezuela through a process of gradually substituting for other markets. This, in a context of high terms of trade that impede the deterioration of the available income through prices, has allowed the impact of the shrinking trade with Venezuela on employment and national revenue to be smaller than what had initially been expected.

Although it is anticipated that the above factors will continue to favor the performance of the Colombian economy throughout 2010, risks that cannot be underestimated still persist, especially on the foreign front. Specifically, the nervousness of the capital markets with respect to the debt problems of some European countries could generate greater volatility in Colombian risk premiums with an adverse effect on foreign financing. In a scenario like this, trade flows and terms of trade could also be affected negatively. All of that could have an effect on consumer and investor confidence, on the national disposable income and, finally, on domestic growth.

1. Growth of the GDP by Type of Expenditure in the First Quarter of 2010

In the first quarter of 2010, the largest contribution to growth was made by household consumption. Unlike what was registered the previous year, the support of this type of expenditure significantly surpassed that provided by public consumption during this period and, therefore, indicates that growth is again being led by the private sector.

Household consumption rose 3.5% with the help of each one of its components (Table 3). The performance of durable goods purchases, which grew 14.5% in

CHANGE IN THE GDP BASE

At the end of June, DANE announced the annual growth of the GDP for the first quarter of 2010, which was calculated using a new base year as a reference point for the national accounts (it went from 2000 to 2005) and which had important methodological modifications. These innovations intend to approximate the calculation methods to the standards of the most developed countries and are done in order to be able to provide a better approximation of the development and the participation of the aggregate value which the different agents generate within national production.

The main methodological innovation consisted of the introduction of chain indexes to measure the real changes in the GDP and its components. The advantage of this method is that it updates the weighting of the elements that the GDP is made up of on a yearly basis, which allows a more faithful picture of its real performance. This improved methodology, however, comes at a cost, since the chain indexes lack the property of additivity. Consequently, unlike what was used before, the value of the GDP with the new 2005 base does not correspond to the sum of its components, which, therefore, generates a statistical discrepancy. This discrepancy is inherent in the process of estimating and calculating the GDP, and is present in the national accounts of other countries that use the chain methodology such as USA, Japan and a significant number of the European nations.

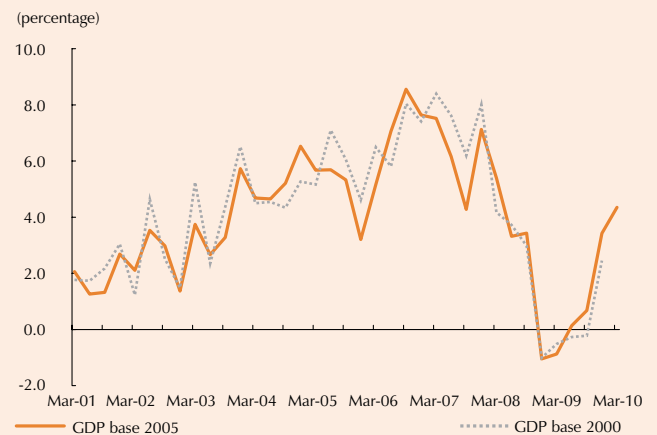
In addition to the implementation of chain indexes and of the updating of the base reference year, several modifications were made to the calculation methods for some of the GDP components. Among them, the following stand out:

1. In financial services, the appreciation of securities was excluded (TES, bonds, etc.) from the calculation of the GDP and more detailed information was incorporated.
2. The financial transaction tax (4 per thousand) was included as a specific tax.
3. In the branch of housing rentals, the methodology for calculating the supply of housing was updated using the 2005 census.
4. In agriculture, the calendar year was employed and not the agricultural year, as was done previously.
5. The change in inventory was estimated directly.

6. The final household consumption was calculated based on the national income and expense survey.

As can be seen in Graph A, the changes carried out using 2005 as the base generate an average annual growth of the GDP that is 0.2 pp lower than what had been registered using the old base. This was so for the period between 2000 and 2009 for which the results using both bases are available.

Graph A
Gross Domestic Product (GDP)
(annual growth)



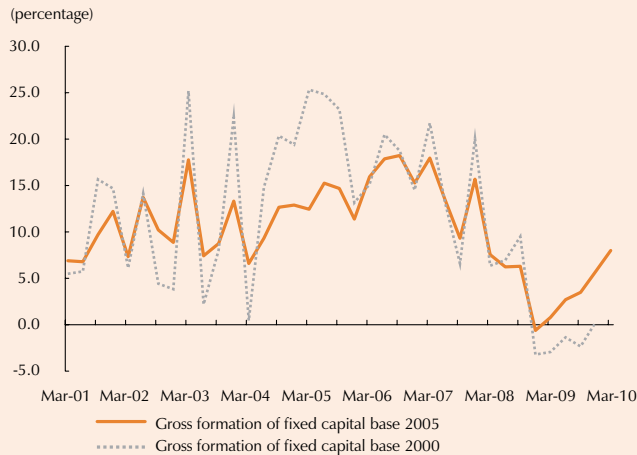
Source: DANE.

The review of the series of the different types of expenses, resulting from the new base, is particularly clear in the growth of government spending and of the gross formation of fixed capital. In the 2005 base, the investment in fixed capital (which does not account for the change in inventories) shows less volatility and, in general, rates of growth which fluctuate within a more limited range (Chart B). Growth that is more modest was noticeable during 2004 and 2005 as was a less pronounced fall in the latter year. This indicates that the international financial crisis, the effects of which were felt primarily during 2009, would not have affected this type of investment to the extent that was initially recorded.

Lower volatility can also be seen in the growth of Government spending. This aggregate showed the largest difference with respect to base 2000 during the 2001-2002 period and did not register serious changes in the last two years (Graph C).

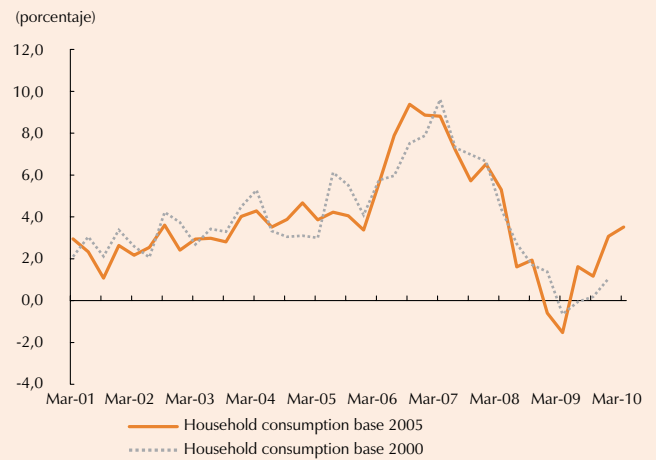
Household consumption, in turn, showed minor adjustments with the exception of the period starting

Graph B
Gross Formation of Fixed Capital
(annual growth)



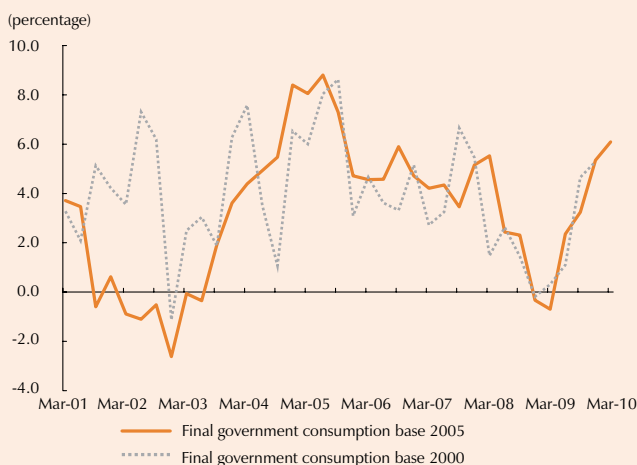
Source: DANE.

Graph D
Household consumption
(annual growth)



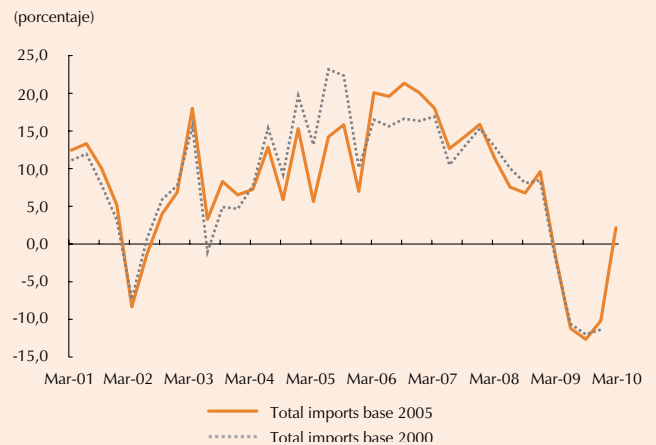
Source: DANE.

Graph C
Public consumption
(annual growth)



Source: DANE.

Graph E
Imports
(annual growth)



Source: DANE.

with the third quarter of 2008. During this period, the fall in private spending was greater using the new base (approximately 1 pp) but, at the same time, the recovery would have been more pronounced (Graph D).

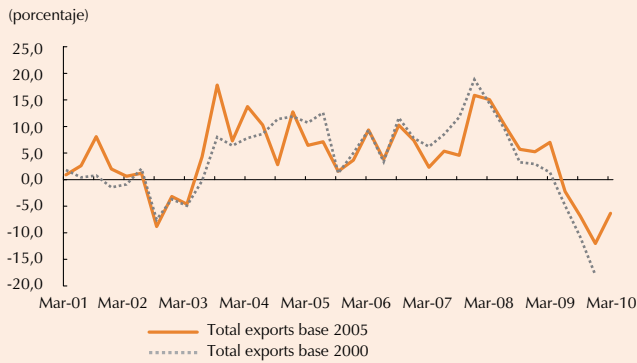
Imports show similar growth with the two bases, particularly in the last few quarters (Graph E). In contrast, the change in the export series was greater, specifically in the last year, since the exports would have fallen by a smaller percentage using the data from the 2005 base (Graph F). Finally, it is necessary to highlight the decrease in the importance of net exports¹ as a percentage of the

GDP. In base 2005, the deficit is lower for the entire period (Graph G).

Finally, from the point of view of supply, the major branches of economic activity which had the largest changes were the financial establishments and agriculture as can be seen in Graph H, panels 1 and 2. Comparing the sector participation of the two bases for the last available year (2009), it is evident that the sectors which increased their share the most under the new calculation were construction, mining and electricity, gas and water, while those which declined the most were agriculture and social, communal and personal services (Graph I).

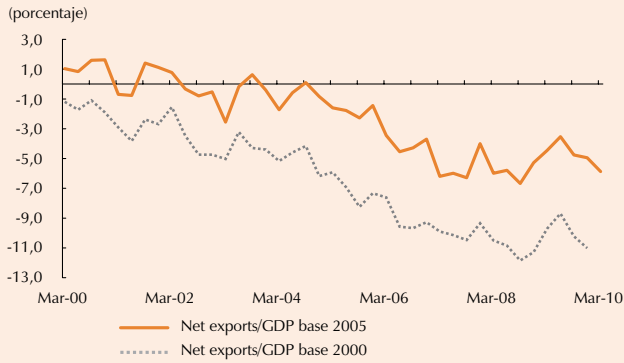
1 To calculate this aggregate with base 2005, it is assumed that the statistical discrepancies are equal to zero.

Graph F
Exports
(annual growth)



Source: DANE.

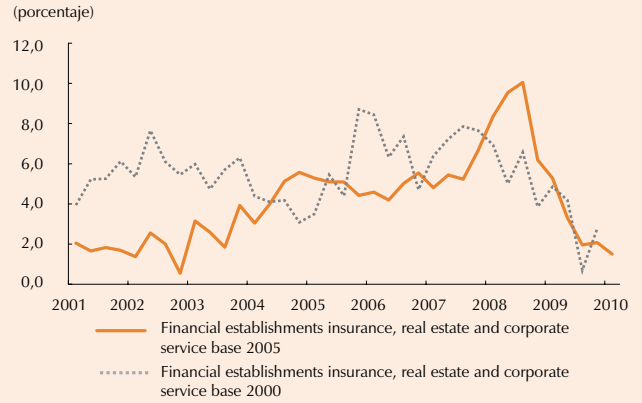
Graph G
Net Exports as a Percentage of the GDP



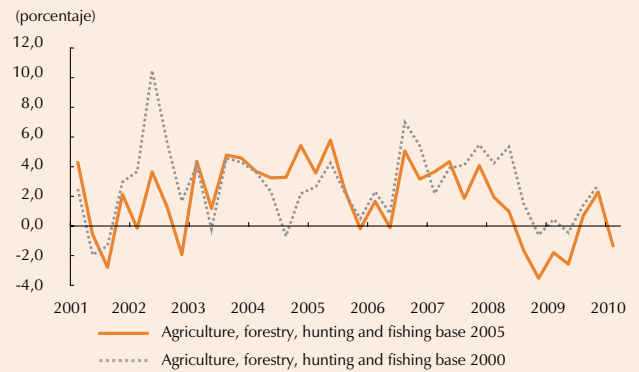
Source: DANE.

Graph H

1. Financial Establishments, Insurance, Real Estate and Corporate Services
(annual growth)

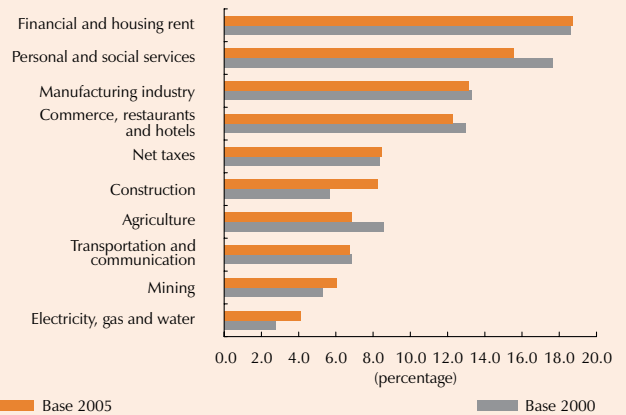


2. Agriculture, Forestry, Hunting and Fishing
(annual growth)



Source: DANE.

Graph I
Shares of the Economic Activities in the GDP for 2009
(current prices)



Source: DANE.

annual terms, was especially notable. This was largely driven by the acquisition of cars.

Table 3
Real Annual Growth of the GDP by Type of Expenditure
(percentage)

	2009				2009	2010	1 quarter of 2010 contributions (pp) ^{a/}
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Full year	I Qtr.	
Total consumption	(0.0)	1.4	1.3	2.5	1.3	4.0	3.2
Final government consumption	(0.7)	2.4	3.2	5.3	2.6	6.1	0.9
Household consumption	(1.5)	1.6	1.2	3.1	1.1	3.5	2.3
Gross capital formation							
Gross fixed capital formation	0.8	2.7	3.5	5.7	3.2	8.0	1.9
Total exports	7.0	(2.2)	(6.8)	(12.0)	(3.9)	(6.3)	(1.2)
Total imports	(1.6)	(11.2)	(12.7)	(10.2)	(9.0)	2.2	(0.5)
Gross domestic product	(0.9)	0.1	0.7	3.4	0.8	4.4	4.4

a/ Banco de la Republica calculations
Source: DANE.

In general, consumers had favorable conditions during the first quarter which were reflected in a sustained rise in confidence. In addition to the effect of the low interest rates and inflation that were mentioned, there was a surge in the level of employment during the period, which stimulated household income, as well as an appreciation of the currency, which created a greater capacity for purchasing imported goods.

Public consumption, in turn, maintained the momentum that has been seen since the second half of 2009 with an annual growth of 6.1% after the contraction that was registered in the last quarter of 2008 and the first one of 2009 (Table 3). Government expenditures have not only expanded since then but their rate of growth has also been climbing.

With respect to investment, a jump in its level as well as a significant annual growth (8.0%) was seen in the first quarter. On this occasion, just as has occurred in the last few quarters, the largest investment was the one aimed to civil works. The annual growth in this sector was 37.5%, which was concentrated in highways and ports. With regards to investment other than civil works projects, the figures show an increase in the national production of machinery and equipment and a slight recovery in housing construction compared to the quarter immediately before. This could be due to the stimulus generated by the government subsidy of the interest rates for new housing loans.

The development of foreign trade was characterized by a slowdown in the fall of exports and by growth in imports (2.2%) for the first time in four quarters. Sales abroad registered a decline of 6.3% in annual terms but, for the first time since the end of 2008, the slump is smaller than that seen in the immediately preceding quarter. This suggests that the worst period for exports has been left behind. This recovery is due to the better terms of trade as well as to the relative success in replacing the Venezuelan market with different markets for our exports. Imports, in turn, had better performance than they did at the end of last year. The purchases of products from abroad were concentrated mainly in intermediate and consumer goods in line with the recovery that has been seen in the expenditures of households and industry.

2. Growth of the GDP by Branches of Activity in the First Quarter of 2010

In the first quarter of 2010, construction was the economic activity that contributed the most to the annual growth of the GDP by surging 16% with respect to the same period the year before (Table 4). When this sector is broken down by type, it can be seen that the significant momentum observed was the result of the performance of civil works projects (as has already been pointed out). The GDP of buildings that includes the aggregate value generated by

Table 4
Real Annual Growth of the GDP by Economic Activity
(percentage)

	2009				2009 Full year	2010 I Qtr.	1 quarter of 2010 contributions (pp) ^{a/}
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.			
Agriculture, forestry, hunting and fishing	(1.8)	(2.6)	0.7	2.3	(0.4)	(1.3)	(0.1)
Mining and quarrying	10.3	8.6	7.5	11.9	9.6	13.2	0.8
Manufacturing industry	(7.9)	(9.9)	(4.9)	(0.5)	(5.9)	3.9	0.5
Electricity, gas and water	(0.6)	(0.5)	2.1	4.6	1.4	6.5	0.2
Construction	1.1	18.3	14.7	25.2	14.6	15.9	1.0
Commerce, repairs, restaurants and hotels	(2.7)	(2.0)	(3.2)	(1.1)	(2.3)	3.6	0.4
Transportation, storage and communication	0.8	0.6	(2.0)	0.7	0.0	2.6	0.2
Financial, insurance, real estate and business services establishments	5.3	3.3	1.9	2.0	3.1	1.5	0.3
Social, communal and personal services	0.5	0.7	2.5	1.6	1.3	4.1	0.6
Aggregate value subtotal	(0.5)	0.3	1.2	4.0	1.2	4.6	4.0
Taxes minus subsidies	(4.7)	(4.9)	(4.5)	(2.5)	(4.2)	3.7	0.3
Gross Domestic Product	(0.9)	0.1	0.7	3.4	0.8	4.4	4.4

a/ Banco de la República calculations.
Source: DANE.

the construction of housing, offices, stores and warehouses, etc. showed an annual contraction (-2.3%) for the sixth consecutive quarter. Nevertheless, this aggregate registered a minimal increase with respect to the previous quarter that was partly associated with the expansion that social housing (VIS in Spanish) achieved. This compensated for the mediocre performance of the other types.

After construction, mining, which expanded 13.2% in annual terms, was the second economic activity to contribute to the growth of the GDP. The positive performance of the mining sector continues to be the result of the persistent increase in oil production. This is the consequence of the significant amounts of resources –both foreign and national– that have been invested in this sector in the last few years. Likewise, the mining of other products such as coal and non-metallic products in particular (which are mainly intended for construction) remained strong and grew at rates of above 5% annually.

Other sectors that have made a not negligible contribution to growth were services, commerce and industry. In the cases of the last two, there were clear signs of reactivation after their very poor performance in 2009. In commerce, the appreciable growth of domestic consumption of durable goods was reflected in a substantial upswing in retail sales of automobiles, appliances, computer systems which, together with the considerable strength in hotel and restaurant services, explained the expansion of the sector's GDP at an annual rate of 3.6%.

In the first quarter of 2010, industry, the sector which was the most affected during the contraction phase of the economy associated with the international crisis, showed an appreciable rally with respect to the level at the end of last year by growing at an annual rate of 3.9%. In spite of that, industrial sales abroad are still being affected by the lower demand from Venezuela, which was the result of both the trade restrictions that were imposed in the second half of 2009 and the weak performance of their domestic demand. The preceding suggests that domestic industrial sales together with the process of market substitution, which is gradually being done in some segments of industry, especially to Ecuador, Brazil and Central America, has largely sustained the recovery of productive activity in that sector.

In contrast, the sector with the worst performance in the first three months of 2010 was agriculture, where economic activity contracted 1.3% in annual terms. The drop in the GDP for agriculture in the first quarter was due to the fact that part of the production of temporary crops and cattle was affected by the El Niño phenomenon just as has occurred at other points in history. Furthermore, coffee production continued to show very low levels compared to the first quarter of last year and to its historical average.

3. Outlook for Economic Activity for the Rest of 2010

For the rest of 2010, the expansion of economic activity is expected to continue to be driven in large part by domestic demand. Therefore, although the risks in the international context that have already been mentioned are still there, especially those associated with the repercussions of the sovereign debt problems of some European countries in foreign financing, it is hoped that the strength of domestic demand will help mitigate a possible adverse effect provided that the recovery of agents' confidence continues to strengthen as it occurred in the first half of the year.

That being the case, it is expected that most of the contribution to growth will come from private consumption this year. The trend of household expenditures will be basically stimulated by five factors: i) the low interest rates that consumers will receive as a result of the lagged effects of monetary policy, ii) the low levels of inflation, iii) the rapid reactivation of agents' confidence, iv) the better trend seen in employment, especially salaried employment, v) the greater availability of credit as suggested by the different opinion surveys applied to the financial system.

Just like last year, public consumption will contribute to a large degree to the growth of the GDP in spite of the fact that in 2010, its contribution is anticipated to be only slightly higher than that registered in 2009. Thus, the relative importance of this type of expenditure will be lower since, unlike what happened last year, its contribution to the growth of national production will be surpassed by household consumption.

Investment will be the second type of expenditure with a larger contribution to the growth of the economy. To be specific, investment in fixed capital is expected to follow the same trend that it kept up throughout all of last year when it registered positive although low growth compared to what was observed before 2008. This trend will be the consequence of a surge in expenditures for capital goods for industry and transportation starting in the second quarter. In addition, investment in civil works projects, another component of the gross formation of fixed capital, will continue at the levels that were reached in the first quarter for the rest of the year. Given that the basis of comparison is high, this could imply negative annual growth.

The contribution of net foreign demand will be negative as a result of a higher growth of imports compared to the performance of exports. Throughout the year, purchases from abroad will continue to climb just as they did towards the end of 2009. However, although exports will also grow, it will be to a lesser degree since it is expected that the effect that the recovery of sales to Ecuador will have on annual growth will not start to be felt until the second half of the year. The reactivation of export performance will also depend on the success of the plan to place local products on Asian markets as well as those of Brazil, Peru and Central America.

In summary, domestic demand will be the primary engine for the recovery of the Colombian economy in 2010 and to a lesser degree, the better performance of our main trading partners will also contribute. With respect to the trend for the first, the GDP information from the first quarter makes it possible to predict that the reactivation of its components, consumption and investment, will be much more accentuated than what was estimated months ago. That is why the Banco de la República raised the expected growth for this year to a range between 3.5% and 5.5%, which is higher than what was anticipated before (between 2% and 4%).

B. LABOR MARKET

The first months of the year were characterized by a stabilization in the labor market conditions. On one hand, the unemployment rates (UR) began to fall since December 2009, especially in the large urban areas. This was associated with a labor supply that has declined possibly as the consequence of a better situation for households. Furthermore, the quality of the employment has been rising. Nevertheless, some worrying factors persist, especially in the duration of unemployment. Therefore, the improvements in labor conditions are still at an early stage.

1. Unemployment

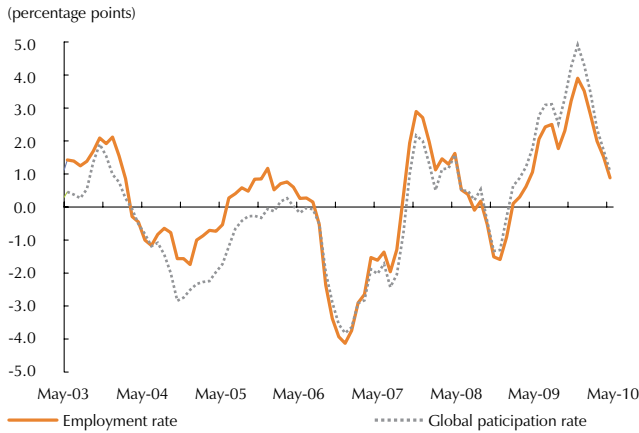
The movements of the UR are determined by the trend of the supply (measured by the global participation rate [GPR]) and the demand for workers (measured by the employment rate [ER]). The deterioration in the labor market that was seen towards the end of 2008 and for a large part of 2009 was characterized by a sharp expansion in the labor supply. This translated into a flow of people who entered the market seeking to make up for the family income that had been affected by the economic crisis. This higher labor participation could not be absorbed by the economy and in spite of an increase in jobs, unemployment rose.

This situation seems to have come to an end in 2010. According to the General Integrated Household Survey (GEIH in Spanish), the expansion of the labor supply hit its highest point in December 2009 and had been dropping until the moving quarter that ended in May. The national total was characterized by this situation (Graph 33, panel A) and it was even clearer in the thirteen main areas, a domain in which jobs have grown faster than participation since February, 2010 (Graph 33, panel B).

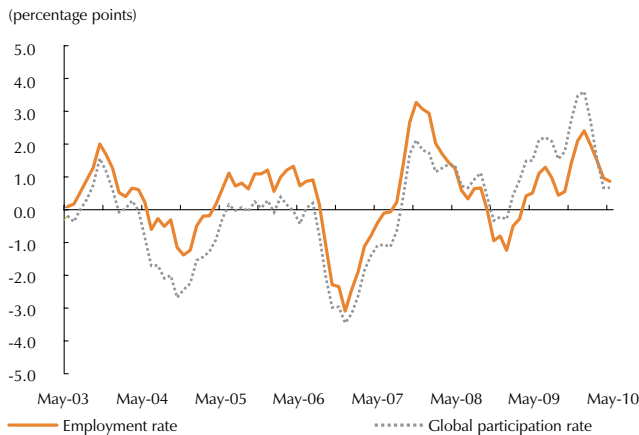
The above resulted in a UR that began to stabilize within the national total and decline in annual terms for the urban areas. Based on information from the moving average for the months of March to May, unemployment in the national total was 12.0% which is slightly above than the one seen in the

Graph 33
Absolute Annual Variation of the Global Participation Rate and Employment Rate

A. National Total, moving quarter

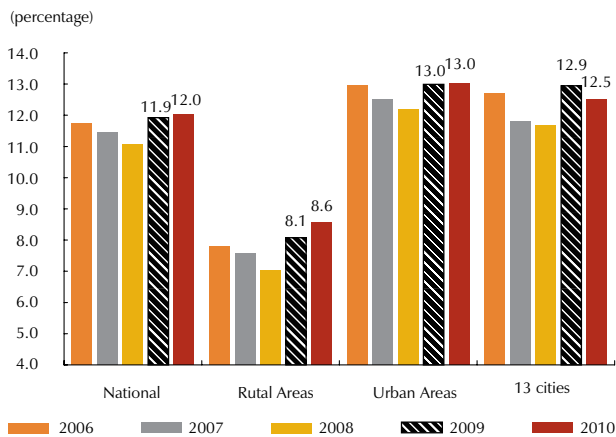


B. 13 areas, moving quarter



Source: DANE (GEIH).

Graph 34
Unemployment Rate by Area
(March, April and May moving average)

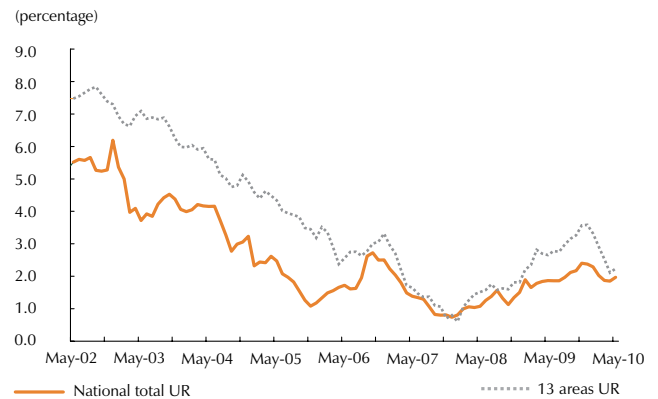


Source: DANE (GEIH).

same period of 2009. For the thirteen main cities, unemployment was 12.5% compared to the 12.9% that it had reached a year ago. However, the UR for the rural areas reached 8.6% which was higher than the 8.1% seen a year ago and caused this to be the only geographic area that still shows a worsening of the employment situation (Graph 34).

When the seasonally adjusted series is examined¹³ for the national total and the thirteen areas, it can be seen that the UR is declining from the peaks that were reached in the last few months of 2009 (Graph 35). Although unemployment showed a small jump in May, it is probable that this will turn out to be a transitory increase for various reasons. First of all, the UR for heads of households did not stop its declining trend in the month of May which could be evidence that the limited deterioration of employment that month was not generalized (Graph 36). Secondly, the higher economic growth that is projected for 2010 and the indices of productive activity that have recovered so far this year seem to give reason to believe that the reduction in unemployment will continue.

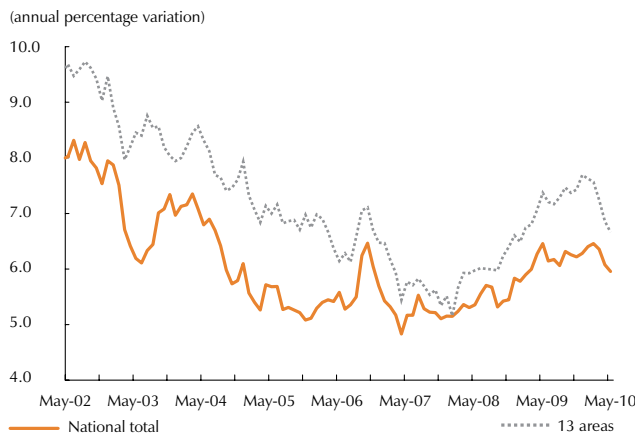
Graph 35
Unemployment Rate (UR)
(moving quarter, seasonally adjusted series)



Sources: DANE (GEIH), Banco de la Republica calculations.

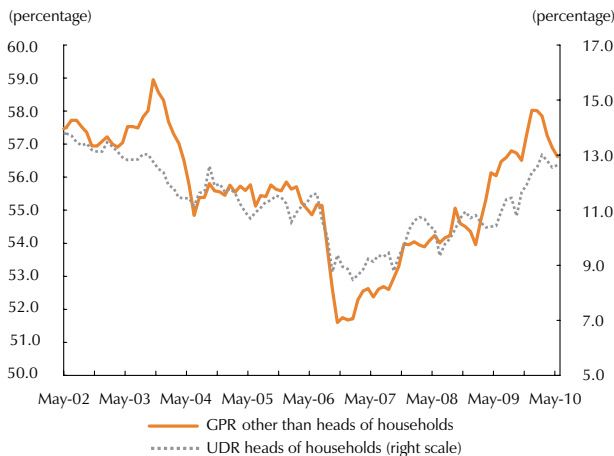
13 The labor market information usually presents seasonal adjustment problems. For example, the UR tends to be high at the beginning of a year and to decline over the course of it. That is why it is advisable to analyze the seasonally adjusted series.

Graph 36
Unemployment Rate for Heads of Household
(moving quarterly average, seasonally adjusted series)



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

Graph 37
Rate of Underemployment (UDR) for Heads of Households
Compared to the Global Participation Rate (GPR) 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 Republica calculations.

2. Supply and demand for work

Some of the factors determining the expansion of the labor supply in 2008 and 2009 were the stability and quality of employment for the head of the household. The information available indicates that these factors have shown an improvement in 2010, which could be behind the easing of labor participation. On the one hand, as has been mentioned, the UR for heads of household has declined in seasonally adjusted terms since February this year. This gives signs of greater stability in employment for this population group (Graph 37). On the other hand, the quality of the employment for heads of household could also be improving as is shown by the reduction in the underemployment rate since February (Graph 37). The combination of both factors could be influencing the secondary household agents not to enter the market in search of complementary employment. This is made evident by the GPR of agents other than the head of the household which has shown declines since the beginning of 2010 (Graph 38).

With respect to the demand for labor, the trend has been different based on the geographic domain that is analyzed. According to the GEIH, since January 2010, the number of employees in the national total has been declining (in seasonally adjusted terms). Nevertheless, the number of people employed in the thirteen main areas rose between November last year and February, 2010 (Graph 38, panels A and B). In spite of a few decreases in March and April, in May the number of employees grew again and climbed to levels that were higher than those seen throughout all of 2009. Just as in the case of the unemployment rate, the preceding is consistent

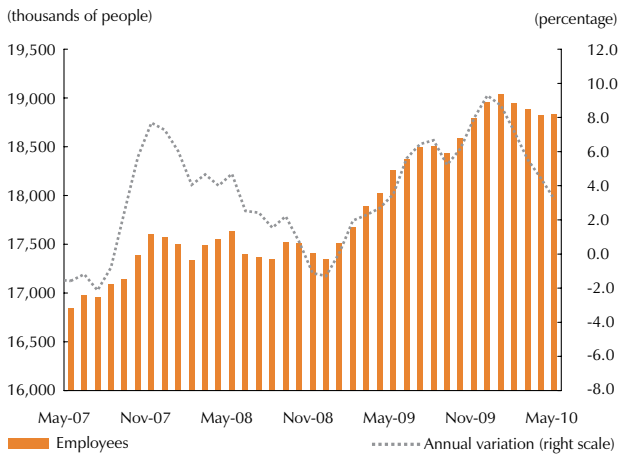
with the idea that the recovery of the labor market has been seen more clearly in the large cities.

3. Quality of Employment and Labor Conditions

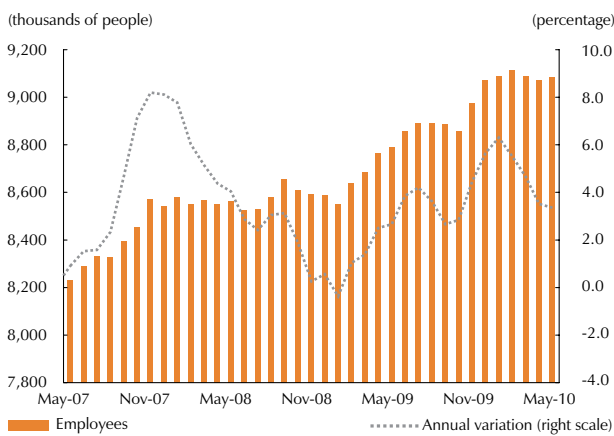
The available information indicates that the employment that is created in the urban areas is high quality. When the number of employees is broken down by type of job, it can be seen that non-salaried employment has declined since the moving quarter ending in January, while salaried employment

Graph 38

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

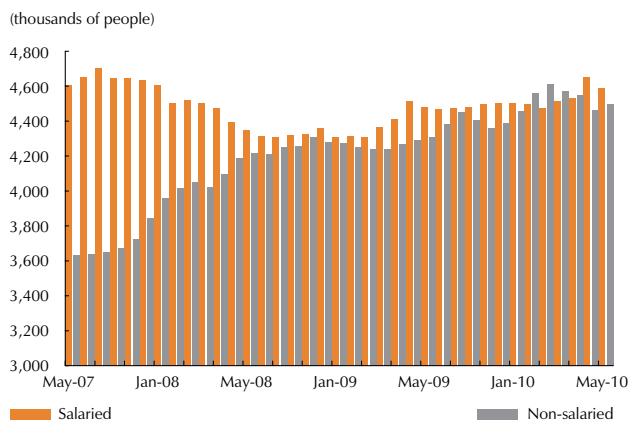


B. Employees in the 13 areas
(quarterly moving average, seasonally adjusted series)



Source: DANE (GEIH); cálculos del Banco de la República.

Graph 39
Employees by Type of Employment
(13 areas, quarterly moving average, seasonally adjusted series)

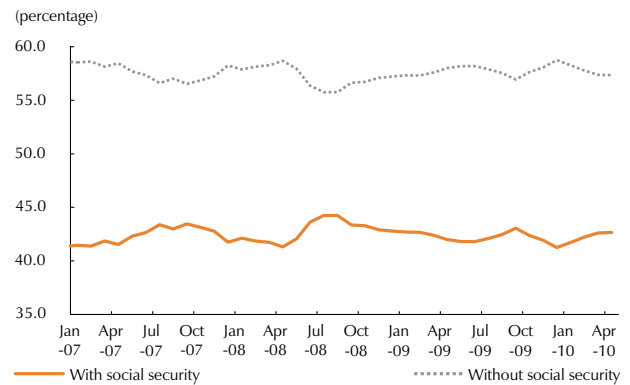


Source: DANE (GEIH), Banco de la Republica calculations.

has grown from January to this point in 2010 in comparison to the levels at the end of 2009¹⁴ (Graph 39). Given that this latter type of employment is associated with stable jobs and with access to social security, the above indicates that formal employment has gone up in Colombia over the course of this year. This information is corroborated by the DANE report on the shadow economy, which records that the percentage of the working labor force in the thirteen areas that has access to social security (in other words, health coverage and pension) rose as it went from 41.3% in the moving quarter ending in December to 42.7% in the one ending in April¹⁵ (Graph 40).

To understand the factors that could be behind this trend in employment, it is worth looking at the historical evidence. In eras of economic recovery, high quality employment tends to respond significantly to the GDP and, to a lesser degree, to salaries. As a result, the trend of salaried employment has been coherent with a higher growth in productive activity and with the reduction in the annual adjustment of

Graph 40
Proportion of Employees Based on Access to Social Security



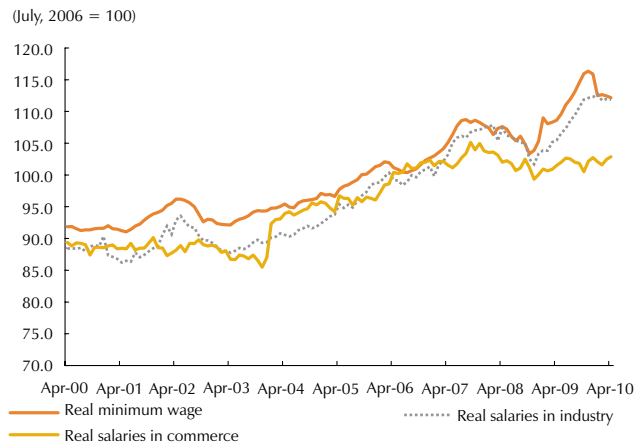
Source: DANE.

14 Although salaried employment showed a slump in May, there is not enough information to state that this is a change in the trend. It is more probable that it is a statistical correction given the sharp rise in April.

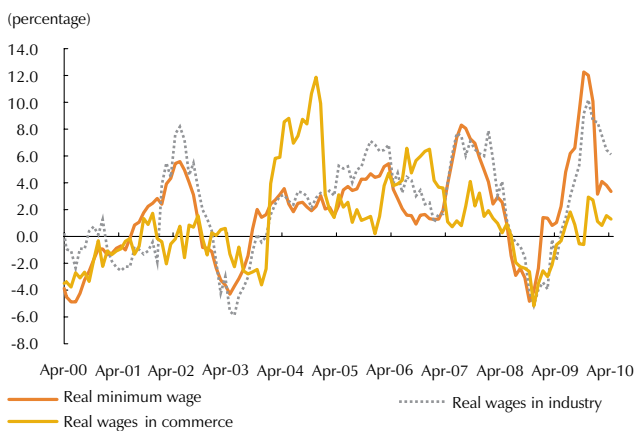
15 It should be noted that the legal rules which cover the integrated contribution payment form (PILA in Spanish) and which require the payment of health insurance and pensions together could have helped to prevent access to social security from having significant reductions in 2008 and 2009 in spite of the lower economic activity.

Graph 41

A. Real Wage
(seasonally adjusted series)

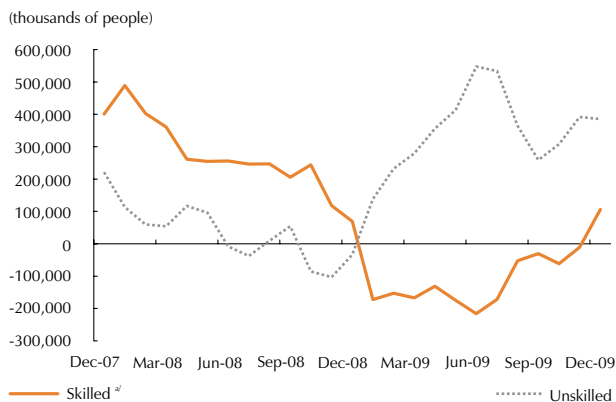


B. Annual Variation of Real Salaries Wages



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

Graph 42
Annual Absolute Variation of Employees



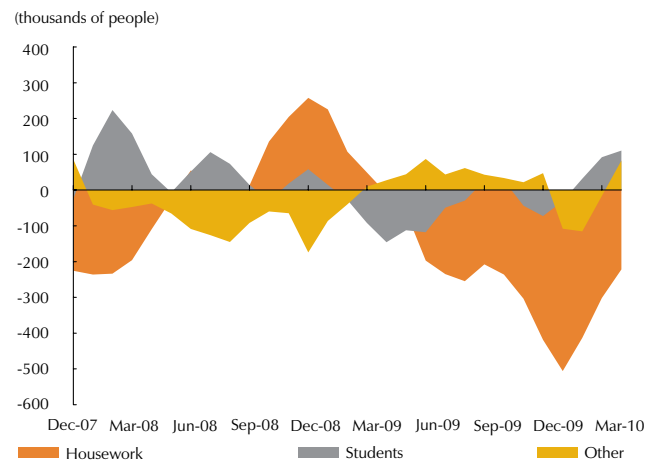
a/ With higher education.
Source: DANE (GEIH), Banco de la Republica calculations.

real salaries in the first few months of 2010 (Graph 41).

Furthermore, upon breaking down the number of employees by level of education based on information from December 2009, we see that the creation of employment occurred for both unskilled workers and skilled workers or, in other words, those with more than 12 years of education. In spite of the fact that the number of new jobs for lower educational levels is greater than those for higher education, this latter segment has been surging and has turned positive since the end of last year (Graph 42).

In addition to the improvement in employment quality, there are additional signs of the stabilization and recovery of the labor market. In the first place, while there was a flow of students who quit their studies and entered the work force in 2009 (a fact that is prejudicial to the accumulation of human capital), this process has reversed since January 2010. Thus, as is shown in Graph 43, the number of non-working people who are studying has risen in annual terms.¹⁶ Likewise, the number of people

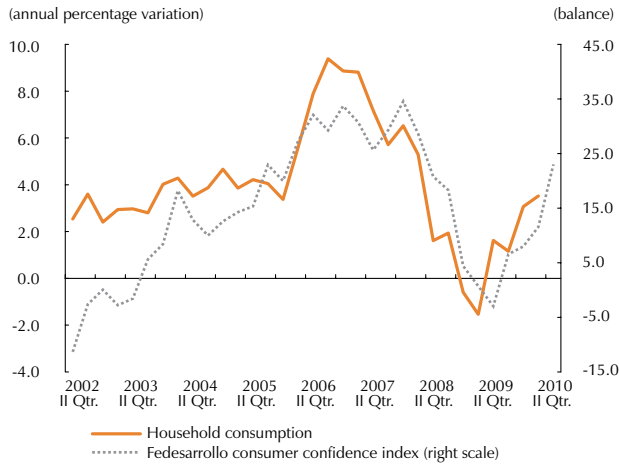
Graph 43
Annual Absolute Variation of Non-workers
(13 areas, quarterly moving average)



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

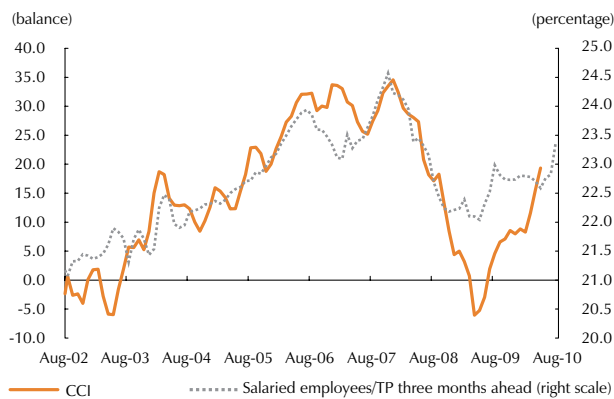
16 Non-working people are those who, being of working age, do not hold jobs because they do not need one, cannot work or are not interested in having a remunerated job. A positive change implies that those who were offering their labor have stopped doing so whether it is because they are not interested or do not need to have a productive activity.

Graph 44
Household Consumption and the Fedesarrollo Indicator



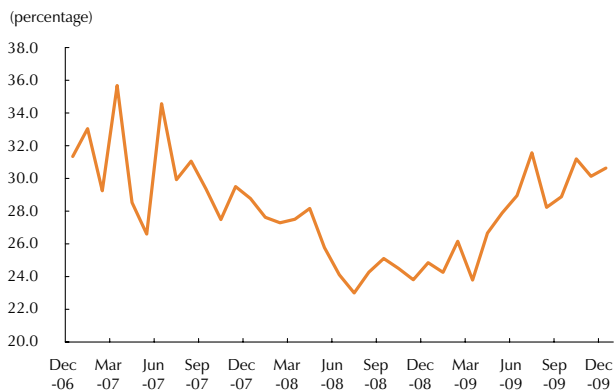
Note: The CCI corresponds to the moving average for three months.
Sources: DANE and Fedesarrollo.

Graph 45
Salaried Employees as a Proportion of the Total Population (TP) and CCI
(13 areas, quarterly moving average, seasonally adjusted series)



Note: The CCI corresponds to the moving average for three months and salaried employees correspond to seasonally adjusted series.
Source: DANE and Fedesarrollo, Banco de la Republica calculations.

Graph 46
Percentage of Unemployed People Looking for Work for More than 26 Weeks
(moving quarter, seasonally adjusted series)



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

entering the labor market who had been taking care of the home has dropped off. This is consistent with the hypothesis that once an improvement in the employment stability and income of the head of the household is seen, the secondary agents withdraw from that market. This is significant since, as was mentioned in the last *Report to Congress*, experience in Colombia has shown that the flow of people looking for work who have been doing housework usually find jobs in the underground economy.

Secondly, the quality of employment could also be positively affecting household consumption. In general terms, there are different determiners of consumption in the GDP and one of them is household confidence (Graph 44). This could be related to the stability of household income and the quality of employment because, to the degree that greater availability of salaried jobs is seen, improvements in confidence can be expected. Therefore, the close relationship between the Fedesarrollo consumer confidence index (CCI) and the number of salaried job positions per inhabitant in the thirteen areas¹⁷ would indicate that better access to quality jobs was one of the engines for the recovery of household consumption during the first quarter of the year (Graph 45).

In spite of the positive signs in the labor market, some precarious conditions still persist in it. The number of unemployed people who have been looking for work for more than 26 weeks has been climbing. Thus, in the fourth quarter of 2009, close to 31% of those who are unemployed had been looking for work for more than six months, a figure that is higher than what had been observed for the majority of the year (Graph 46). This indicates that unemployment continues to be concentrated in the long term unemployment, which is also considered structural unemployment. Given that the people who remained unemployed for a long period usually have more difficulty finding work and tend

17 The number of salaried jobs per inhabitant in the thirteen areas leads the CCI by four lagged months.

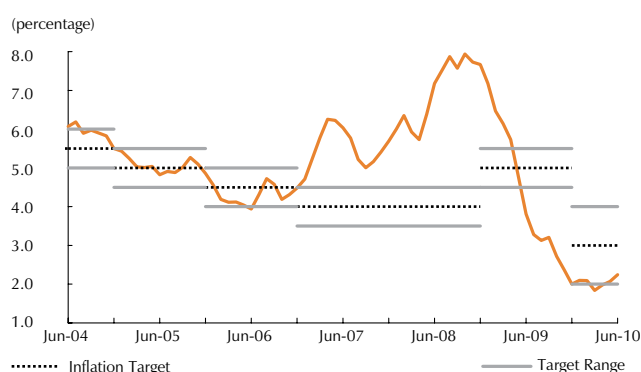
to lose their skills, this could have a negative impact on the economy's labor productivity.

Finally, the unemployment and underemployment indicators are still at historically high levels in spite of the declines in the last few months. Moreover, the confidence and the quality of employment indicators are still lower than those seen during the years prior to the shrinking of economic activity and the upswing of workers with access to social security is still very meager. Because of that, progress in terms of the labor market should be taken cautiously and it is probable that only a more sustained recovery will generate a significant reduction in unemployment and a substantial improvement in the creation of formal employment.

C. INFLATION

1. Inflation in the First Half of 2010

Graph 47
Annual Consumer Inflation



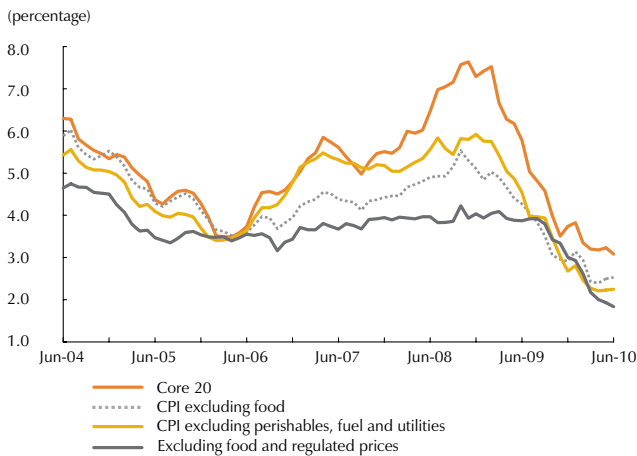
Source: DANE, Banco de la Republica calculations.

Inflationary pressures were restrained during the first half of 2010. For the majority of that period, annual consumer inflation fluctuated around 2% which corresponds to the floor of the target range defined by the Board for this year. In the last two months, a slight trend upward has been observed, which was expected and which put inflation at 2.3% in June (Graph 47).

In general, the results of these first six months were below the projections made by the market and by Banco de la República in previous documents. Towards the end of 2009 and beginning of 2010, it was believed that consumer inflation could rise significantly, especially during the second quarter, as a result of the effect the El Niño phenomenon would have on food prices and some of the regulated utilities such as electricity. However, factors related to the low pressure from domestic and foreign demand (the latter being due to the deflationary impact of the block on trade with Venezuela which had been underestimated) together with a peso that has been strengthened and prices abroad for manufactured products that are lower than expected offset the effects of the climatic phenomenon. A lower vulnerability of agricultural prices to climatic variations could have been added to the above as will be explained below.

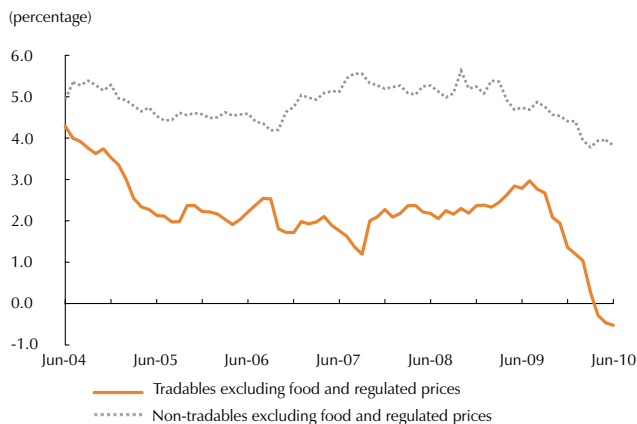
Likewise, it must be remembered that during previous episodes of El Niño, consumer prices were not always affected the same way due to the fact that the intensity and duration of this phenomenon tend to vary over the course of time. This makes it difficult to anticipate its effects.

Graph 48
Annual Core Inflation Indicators



Source: DANE, Banco de la Republica calculations.

Graph 49
Annual Inflation of Tradables and Non-tradables Excluding Food and Regulated Prices



Source: DANE, Banco de la Republica calculations.

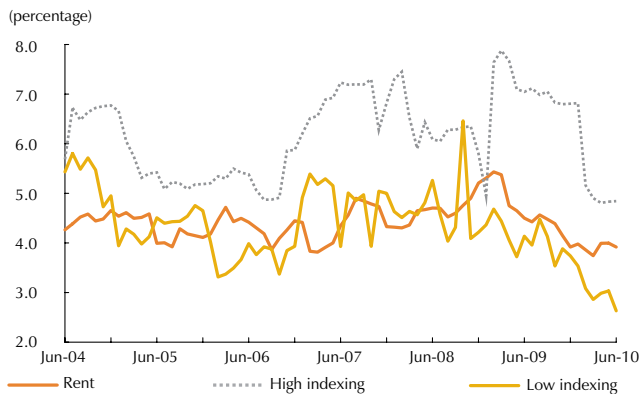
In the case of consumer inflation, the prediction errors were concentrated in food prices. In the CPI excluding food and in the other core inflation indicators, the trend was in line with what had been predicted by Banco de la República and the market. Therefore, the annual variation in the CPI excluding food went from 2.9% in December, 2009 to 2.5% in June of the current year (Graph 48). Similar declines were seen in all of the other three indicators calculated by the Bank, which allowed the average to be at 2.4% compared to the 3.1% in December. As of June, all of the indicators for core inflation were within or below the long term target range, which corroborates the absence of significant inflationary pressures in the first half of the year (Graph 48).

The decline in core inflation and particularly, annual inflation excluding food so far this year was concentrated in the prices for goods and services that have a tighter connection to the trend of the exchange rate or, in other words, with the annual variation of the CPI for tradables excluding food and regulated prices. The annual change for this last group, which had already shown low levels towards the end of 2009, kept falling in the first half of 2010 until it reached a negative value for the first time since records have been kept and that was well below the Bank's predictions. As of June, the result was -0.5% in comparison to 1.4% for December of last year (Graph 49).

In addition to the appreciation that has accumulated since the middle of last year, which has slowly passed through to domestic prices, a factor that could have an influence on the trend of the CPI of tradables excluding food and regulated prices were the few hikes that were registered in international prices for manufactured products as a result of the weakness in global demand. This has allowed absolute reductions in prices for a broad set of imported merchandise, with automobiles, electronic and communications devices leading the declines. The level of domestic demand, which has been below its potential since 2008, has had a similar impact as has the collapse of exports of manufactured goods to Venezuela. Among these, the automobile segment was one of the most important ones.

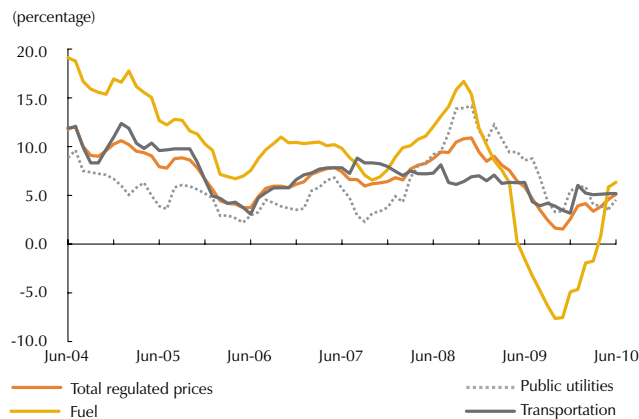
The relative weakness of domestic demand and the dropping inflation expectations along with the indexing of prices and wages are the reasons for the lower adjustments seen in the CPI for non-tradables excluding food and regulated prices for the first half of this year compared the same period

Graph 50
Annual Inflation of Non-tradables Excluding Food and Regulated Prices



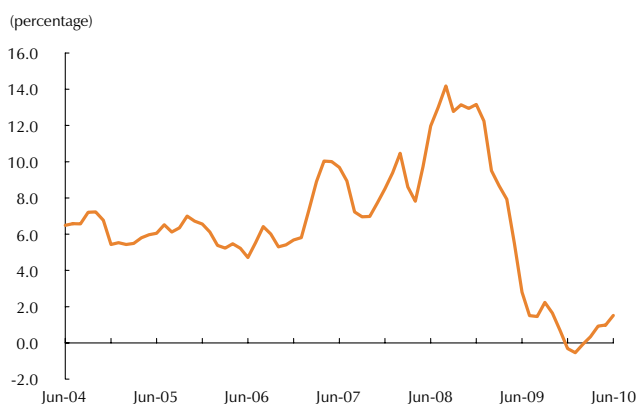
Source: DANE; cálculos del Banco de la República.

Graph 51
Annual Inflation of Regulated Prices and by Components



Sources: DANE, Banco de la Republica calculations.

Graph 52
Annual Inflation of Food Prices



Source: DANE, Banco de la Republica calculations.

in 2009. This resulted in a reduction in the annual change for this index from 4.5% in December, 2009 to 4.4% in June 2010, which was largely anticipated by the Bank (Graph 49). Breaking this basket down, it can be seen that a significant part of the decline is attributable to services that have been highly indexed in the past such as education, health and finances, etc. In the case of rent, where there has also been a highly indexed component, the lower inflation at the end of 2009 has not translated into a decline in the adjustments so far in 2010 (Graph 50).

Within the CPI excluding food, the main upward pressures in the first half of the year came from the regulated prices (utilities, public transportation and fuel) (Graph 51). This situation, which was widely expected, is attributable to the increases in the price of gas decreed by the government to close the gap between the domestic and foreign prices as well as to the adjustments of the fees for electricity. In this latter case, the hikes were caused by the rising costs of generating electricity as a result of the risk that was imposed by the El Niño phenomenon¹⁸ and to the fact that the differences in fees between urban zones and rural ones were closed in Bogota and the eastern part of the country.

In addition to the regulated prices, the annual change in the CPI for food also rose over these six months but at a much slower pace than what had been initially anticipated by Banco de la República and the market. Between December, 2009 and June, 2010 that change went from -0.3% to 1.5% (Graph 52).

The unusually dry period that various areas of the country went through due to the El Niño phenomenon led to a surge in the prices for several perishables just as was expected. However, these increases were lower than those from previous episodes of El Niño

18 The ability to generate electricity from water sources is reduced in El Niño periods when the volume of rainfall drops below the normal rate. On these occasions, the reservoirs fall to critical levels which makes it necessary to replace them with thermal energy, which is more expensive. The electrical companies in Colombia are able to pass part of these higher costs on to the consumers by raising the fees.

and were transmitted to total inflation to a lesser degree than before for various reasons. One of those that stands out is the lower origin weight currently that food from agricultural have in the CPI basket. Their share in the current basket is 3.9% while in 1988 and 1998, their share was 20.4% and 5.6% respectively. Likewise, it is possible that other factors, which could include anything from more use of technology in agriculture with the greater availability of irrigation to a broadening or change in the agricultural frontier, could have helped to explain this result.

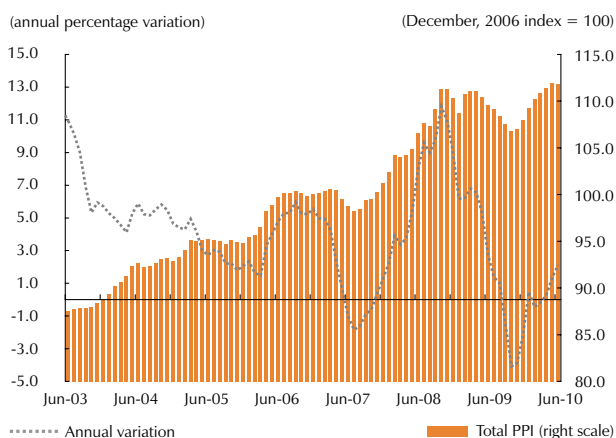
For processed or semi-processed food, the rises tended to be minimal and there were even some reductions in the first few months of 2010 in products such as meat, just like what happened in the second half of last year. This trend, which was linked to the cutoff of sales to Venezuela, showed a tendency started to reverse in April when surges in prices were seen again. These could have been the result of a reactivation of domestic demand and a somewhat weakened supply resulting from the deterioration in the profit margins in previous months.

2. Inflation Outlook in 2010

In general, the Bank's models indicate that meeting the inflation goal for the end of 2010 is highly probable. Although it is expected that recovery of economic activity will take place at a faster pace than what had been predicted a few months ago, it is believed that for the rest of the year, the economy will continue to have sufficient excess installed capacity that will allow it to absorb the greater demand without generating pressure on prices. In a scenario in which the international financial stability is being re-established, inflationary pressures resulting from the exchange rate or international of raw materials and transportation have not appeared either since none of these variables should show serious upsurges for the remainder of the year or the beginning of 2011.

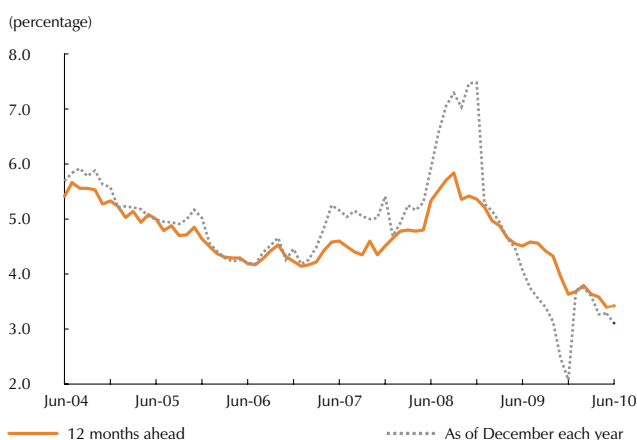
Concerning non-labor costs, significant increases that would jeopardize hitting the long term goal in 2010 and for 2011 are not anticipated. Although the annual inflation for producer prices (PPI) has risen recently (it went from -2.2% in December, 2009 to 2.1% in June 2010) and could continue rising for the next few months. This is in large part consequence of a very low basis of comparison from last year rather than the result of a sustained increase in the level of prices. The upswings that have occurred recently were concentrated in the prices of perishables and are the result of the less favorable climatic conditions or of the normal cycle for these products. Due to the above and since hikes in international prices should not occur given the weakness of worldwide demand, it is not expected that the rise in annual inflation for the PPI, which has been seen in the last few months, is going to be permanent. It is expected that it will give way towards the end of the year (Graph 53).

Graph 53
Total PPI



Source: DANE.

Graph 54
Forecast for Annual Inflation According to Banks and Stock Brokers



Source: Banco de la Republica calculations.

A fundamental factor that makes it possible to be confident that the long term inflation target will be met this year and in 2011 is the trend of inflation expectations. So far this year the monthly survey of financial operators done by the Bank shows that the expectations for the end of 2010 went from 3.7% in January to 3.1% in June while the expectations for 12 months from now dropped from 3.7% to 3.3% for the same period (Graph 54). The Bank's quarterly survey that was done of a broader group of agents, which includes businessmen in the real sector, and the survey of expectations derived from the differential between the rates for the unit of real value (UVR in Spanish) TES and the fixed rate TES also showed a similar trend.

Another aspect that could contribute to keep inflation within the target range in the medium term is indexation because by law or as a custom many contracts for prices and wages in Colombia (including the minimum wage) still take past inflation into account to determine the future price adjustments. Under the current conditions, when inflation has reached a low level, these circumstances should contribute to keep it at levels that are compatible with the long term target range.

Given the above, baskets such as those for tradables or non-tradables excluding food and regulated prices that, currently, show an annual change that is within or below the target range will tend to remain at low levels for the next few quarters. This will decisively contribute to the fulfillment of the target. Due to that, it can be expected that inflation excluding food and other indicators for core inflation will slowly converge to the mid-point of the target range over the course of the rest of the year and into 2011.

The Bank models also suggest that, in the second half of this year, there could be a surge in annual inflation of food prices that would be the result of not so much the effects of El Niño, which will have already disappeared by that date, but rather the cyclical trend of the food supply. According to the models, this trend will continue into the first months of 2011 and then partly reverse.

The temporary rise in the CPI for food should have an effect on total inflation in the next few months and place it at levels close to the mid-point of the long term inflation target range. That being the case, the Bank's outlook suggests

that the result will be around 3.0% for the end of this year. A hike in inflation is not expected for 2011 given the conditions that have been expressed.

The above prediction, just like any prediction, faces both upside and downside risks. With respect to the upside, it includes the possibility that there would be a stronger than anticipated recovery of the Colombian economy as well as an increase in the prices for commodities and manufactured products from China if the growth of the emerging countries turns out to be higher than expected. Nevertheless, the effects on domestic prices from these two shocks would be more likely to materialize in 2011, in particular, given the excess in productive capacity that the Colombian economy has today.

Among the downward risks, a possible worsening of the financial instability that several developed countries are facing and that could end up affecting their economic growth must be highlighted. In this environment, downswings in the prices for commodities, in the demand for our exports, and in consumer and investor confidence could occur. All of this would tend to reduce inflation just like it did towards the end of 2008 and beginning of 2009. Although that scenario could translate into a depreciation of the peso, the possibility that this phenomenon could generate surges in domestic prices is limited since its transmission to inflation is low when the demand is weak.

Given the above, it is estimated that the risk that inflation could be diverted from the long term targets in the next year and a half are low. A more detailed analysis of inflation trends can be found in the June edition of the *Inflation Report* that should be available in the next few weeks.

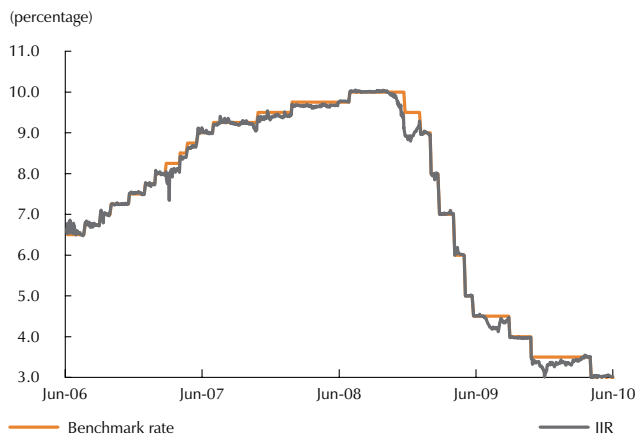
D. MONETARY POLICY, INTEREST RATES AND FINANCIAL SECTOR

1. Monetary Policy Decisions Thus Far in 2010

In the first half of 2010, the Colombian economy showed a favorable performance in terms of inflation and economic growth. In March 2010, annual consumer inflation was lower than what the market and the Banco de la República's technical staff had expected and it dropped below the lower limit of the target range. In addition, the forecast for the end of this and the coming year suggest that inflation will remain within that range (between 2% and 4%).

Concerning economic activity, the figures showed that the recovery continued and that growth could be around the mid-point of the range predicted for 2010 (between 2% and 4%). In spite of that, the extra room in installed capacity that industry has as well as the weakness in the labor market and in foreign demand suggest that the GDP could remain at a level that is lower than what is sustainable in the long run (negative output gap).

Graph 55
Banco de la Republica Intervention Interest Rate and
Interbanking Interest Rate (IIR) ^{a/}



a/ The figures correspond to data from working days. The latest datum corresponds to June 30, 2010.
Source: Banco de la Republica and Financial Superintendence of Colombia.

The Board believes that this macroeconomic context in which there is a negative output gap and a lower observed and projected inflation than was initially expected will allow monetary policy to be more expansionary. This will stimulate growth without jeopardizing the inflation target and macroeconomic stability. That is why, in their April 30, 2010 session, the Board reduced the policy interest rate by 50 bp to 3%.

Over the course of the second quarter of the current year, inflation has risen slightly and in June it was at 2.3%. In spite of this rise, the projections for 2010 and 2011 continued to show a high probability that inflation would stay within the target range. The economic activity figures, in turn, again reflected a stronger growth than was initially anticipated.

Under these conditions, the Board decided to keep the benchmark interest rate unchanged at 3%.

In addition to the decisions regarding the interest rate, on March 3, 2010, the Board reported that they would resume the accumulation of international reserves through competitive auctions for US\$20 m daily until June, 2010. However, given the higher deposits of the General National Treasury (TGN in Spanish) in the Banco de la República, the Board decided to suspend the sales of TES that they had been making monthly to counteract the monetary effect of the accumulation of reserves.

2. Trend of Interest Rates in 2010

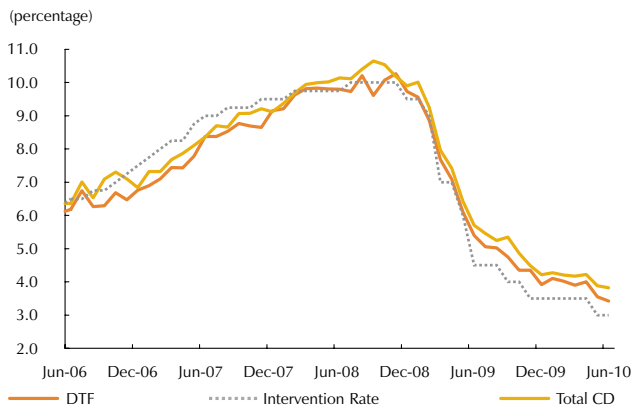
a. Market Interest Rates

Since the change in the monetary policy posture, which began in December 2008, interest rates for the different types of savings and loans have responded to the reductions in the Bank's intervention interest rate and exhibited a declining trend.

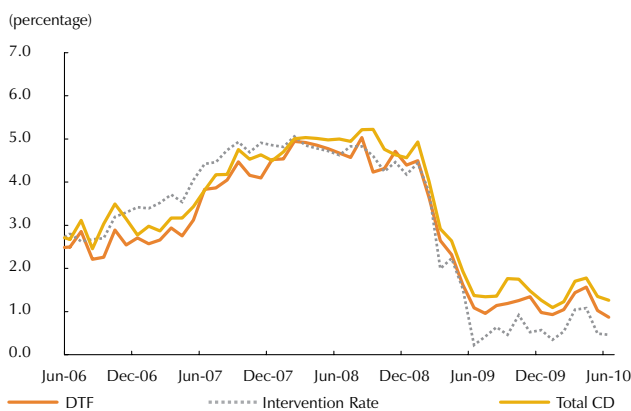
In the first quarter of 2010, the benchmark interest rate remained at 3.5% and towards the end of April, the Board lowered it 50 bp thus placing it at 3%. The overnight interbanking interest rate (IIR) converged with this level in spite of the fact that in the first few months of the year, it had been below that. A misalignment like this was induced by the net debtor position that the Banco de la República had with the financial system and which was corrected through the opening of auctions of non-reserve interest-bearing deposits (NRIBD) and the higher TGN deposits in the Banco de la República (Graph 55).

Graph 56
Deposit Interest Rates and the Banco de la Republica
Intervention Rate ^{a/}

A. Nominal



B. Real^{b/}



a/ The information corresponds to end of the month data. The DTF corresponds to the rate at time of the deposit (operation), which is in effect the following week.

b/ The information corresponds to end of the month data, deflated with CPI excluding food.

Sources: Financial Superintendency of Colombia and DANE, Banco de la Republica calculations.

So far in 2010, the transmission of the policy interest rate to the deposit interest rates on the market was reactivated by the reduction agreed by the Board in April (Graph 56). Specifically, between January and June 2010, the DTF interest rate and the CD deposit rates declined 50 bp and 40 bp respectively,¹⁹ and at the end of June, their levels were at 3.42% and 3.82%.²⁰

With respect to interest rates on lending, the stimulus of monetary policy has been sparse with the decline in the interest rates for loans allocated to households standing out. As a result, the interest rate for the commercial loan portfolio declined 80 bp as it went from 8.55% to 7.76% in the first half of the year.²¹ In this category, the interest rate that declined the most was the one of preferential loans (139 bp) which went from 7.7% to 6.31%. Interest rates for treasury and ordinary loans were also reduced by 42 bp and 2 bp respectively (Graph 57).

At the end of June, in the segment of loans to households, consumer interest rates²² and credit cards²³ were at 18.27% and 22.33% in that order with reductions of 196 bp and 288 bp so far this year (Graph 58).²⁴ Up to this point in 2010, the interest rate for mortgage loans plunged 116 bp as they went from 13.93% in December, 2009 to 12.77% in June, 2010. The larger monthly reduction in the mortgage rates occurred in the months of May and June as a result of the new policies for mortgage loans led by a few banks as a replacement for the subsidies

19 The DTF corresponds to the 90-day CD deposit rate at banks, financial corporations and commercial financing companies. The CD deposit rate corresponds to the rate for all of the periods reported by all of the credit establishments to the Financial Superintendency of Colombia.

20 The DTF for December 30 is the one in effect for the week following it (January 4 to 10, 2010). During this period, the DTF was at 3.92% and the total CD at 4.21%.

21 Due to the high turnover of Treasury loans, their weight is established as a fifth of their disbursement.

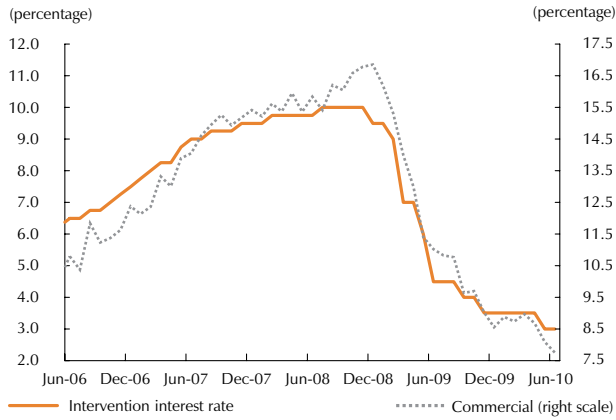
22 Excluding credit cards.

23 Excluding purchases at 1 month and cash advances.

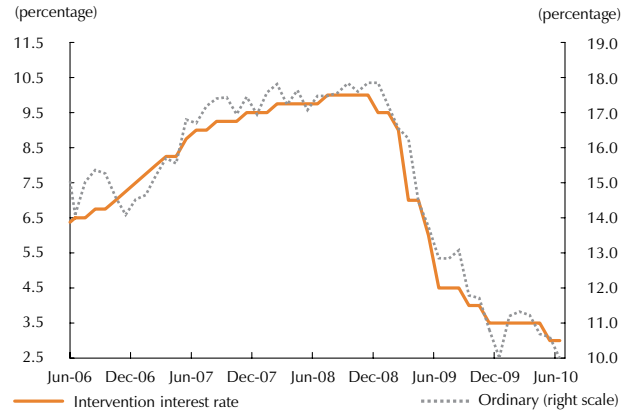
24 This last rate closely follows the changes in the usury interest rate which exhibited a reduction of 296 bp during the same period.

Graph 57
Nominal Loan Interest Rates and Banco de la República
Intervention Rate ^{a/}

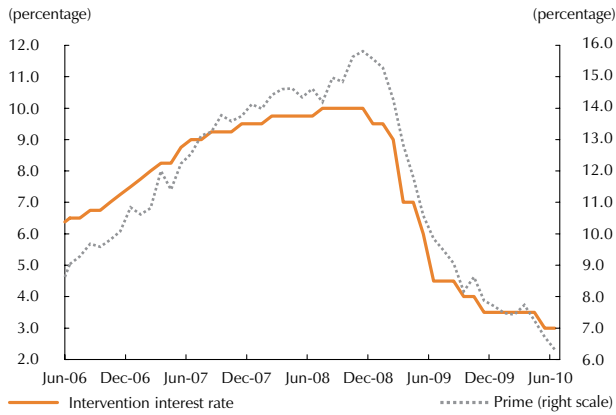
A. Commercial ^{a/ b/}



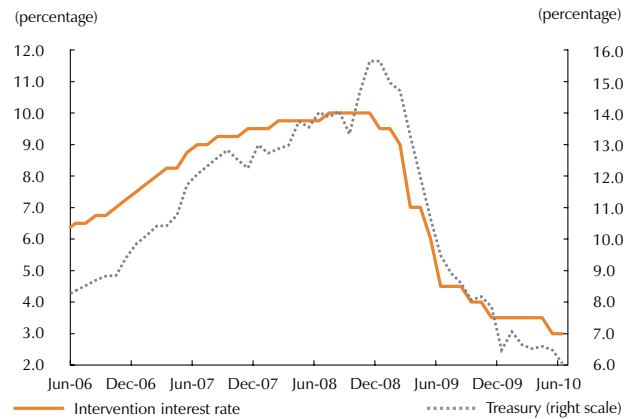
B. Ordinary ^{a/}



C. Preferential ^{a/}



D. Treasury ^{a/}



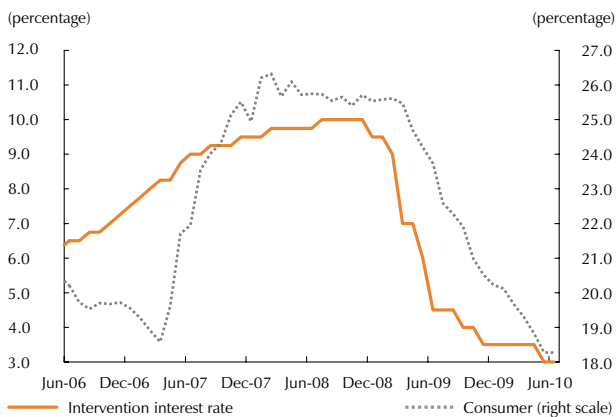
a/ The data as of the end of the monetary month.

b/ Includes ordinary, preferential and treasury. Due to its high turnover, the weight for the latter is established as the fifth of its disbursement.

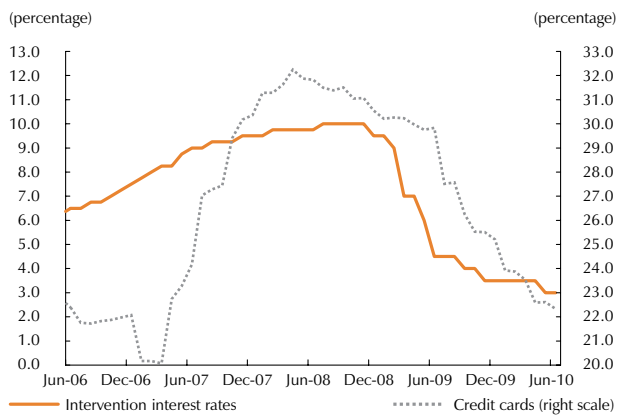
Sources: Banco de la República and Financial Superintendency of Colombia.

Graph 58

A. Nominal Interest Rates for Consumer Loans and
Banco De La República Intervention Rate ^{a/}



B. Nominal Interest Rates for Credit Card and Banco
De La República Intervention Rate ^{a/}

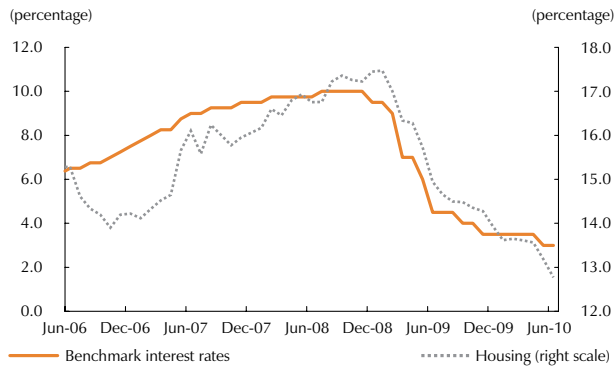


a/ The interest rate does not include purchases at 1 month nor advances in cash

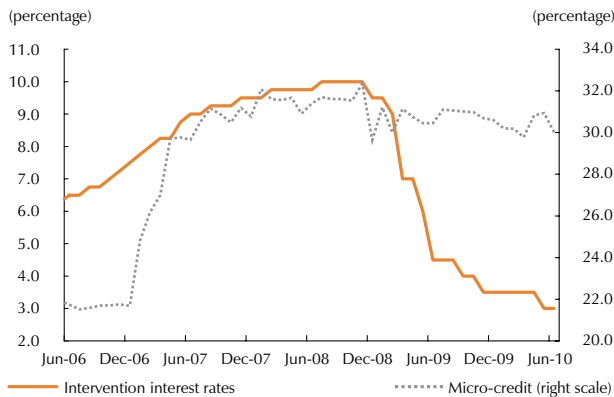
Sources: Financial Superintendency de Colombia and Banco de la República

Graph 59

A. Nominal Interest Rates for Housing Loans and Banco De La República Intervention Rate ^{a/b/}

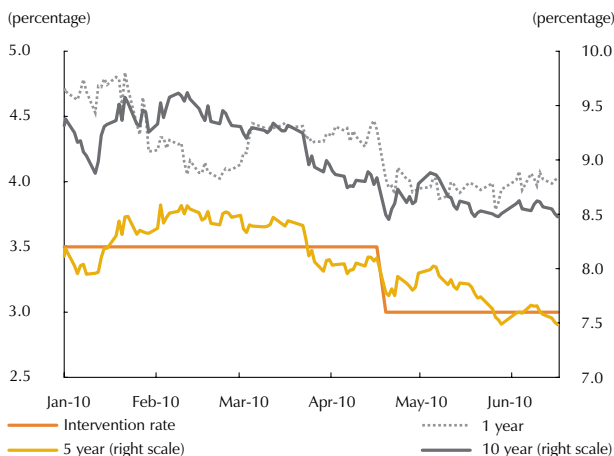


B. Nominal Interest Rates for Micro-credits and Banco De La República Intervention Rate ^{a/}



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 and Banco de la Republica calculations.

Graph 60
 Benchmark Rate and the Zero Coupon Peso TES Rate



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

granted by the government, which ended last April (Graph 59).

Finally, in 2010, the micro-credit interest rate remained, on average, at levels similar to those seen at the end of 2009. This makes it the only type of loan portfolio which has not seen its interest rate respond to the reductions in the Banco de la República's benchmark interest rate that started close to the end of 2008 (Graph 59).

b. The Public Debt Market

The trend of the price for the TES is explained by both the global economic conditions and factors of domestic supply and demand. An international economic environment with low interest rates and lower risk aversion could stimulate the demand for domestic assets. The opposite could create an incentive for an outflow of capital that affects the price of the TES.

On the domestic level, the prices for public debt securities reflect the decisions and preferences of the agents who participate in this market. In order for agents to evaluate the government securities, the expectations that they have formed about the future trend of variables such as economic growth, inflation, the fiscal deficit, regulation and trajectory of the short term interest rates, etc. are relevant.

The supply and demand of sovereign debt securities have also been seen to be affected by the harmonizing of agent preferences between profitability and risk in their portfolio profiles. Furthermore, the TES market is also subject to the expectations of new issues and management operations of government debt, to liquidity in the monetary market, and to the particular seasonal adjustments in the local market.

So far in 2010, the zero coupon rates for the TES denominated in pesos showed a mixed performance. At the beginning of the year, all of the rates rose and after that declined. In the case of short and long term bonds, they received net gains. The rates between 1- and 2- year and those between 5- and 15 year

securities registered on average downswings of 7 bp and 57 bp respectively. In contrast, the negotiating rate for securities with maturities between two and five years rose an average of 20 bp²⁵ (Graph 60).

The general devaluation of the TES in January was associated with expectations of higher inflation caused by El Niño. In February, in spite of the lower than expected inflation, the devaluation trend continued for the TES because of the market worries about the financing of the government fiscal deficit. This was due to questions related to tax collection and uncertainty with respect to the sale of Isagen. Moreover, the demand for TES from important market participants declined while the supply from other agents rose.²⁶

The later appreciation of the TES was associated to several factors. The most outstanding among them were: the general downswing of inflation expectations caused by the publication of data that was lower than what had been predicted and the relaxing of fiscal fears after a general bond had been placed²⁷ and a debt swap had been made by the government.²⁸ Another fiscal announcement by the government that eased market fears with respect to the need to issue public debt securities domestically²⁹ was the decrease in the estimate of the TES placements in 2010 that went from COL\$26 t to COL\$25.5 t.

The 50 bp cutback in the intervention rate of Banco de la República in the April meeting and the decision of the Board to suspend sales of TES also contributed to the appreciation of the securities.³⁰ Furthermore, the lower corporate debt bond placement in the second quarter of the year reduced the investment options with respect to public debt securities. Last of all, the improvement in

25 These data are extracted from the zero-coupon curve of the fixed rate TES calculated by the Bank using the Nelson and Siegel methodology.

26 On April 12, 2010, the Banco de la República announced that in the months of February and March, final sales of COL\$800 b in TES had been made and that their balance in securities had gone from COL\$3.5 trillion (t) to COL\$2.7 t in that period.

27 On April 7, the Ministry of the Treasury announced the successful issuing of a general TES denominated in pesos and payable in dollars that would mature in 2021 (11 years) for a nominal amount of COL\$1.5 t. The entity indicated that with this issue of approximately US\$800 m, foreign financing through bonds, US\$500 m of which had been planned for the year 2010, was complete and that, in addition, disbursements from multilateral entities were replaced with US\$300 m that had been contemplated in the financial plan for the same year. The announcement noted that the yield was the lowest of the general TES placements that the nation had made up to that time (Colombia has not participated in the primary market for general TES since 2007).

28 On April 21, the Ministry of the Treasury announced a management operation for domestic debt in which it exchanged COL\$3.5 t by collecting securities with maturities in 2010 and 2015 and handing over securities denominated in UVR that mature in 2013 and 2023. This operation reduced the 2010 financing needs by COL\$1.3 t.

29 The Interparliamentary Commission for Public Credit approved the issuance of foreign debt bonds for up to US\$800 m. The financial plan included the issuing of US\$500 m in bonds.

30 In their official communiqué on April 30, the Board indicated that due to the larger TGN deposits, they had made the decision to suspend sales of TES that they were holding every month to counteract the monetary effect of accumulating reserves.

the local economic outlook could encourage agents to charge the government lower risk premiums.³¹

3. Monetary Base, Credit, and Financial System Sources of Financing

The performance of the financial system's liquidity, deposits and credit is the product of the interaction between different economic agents, which ends up being directly affected by the monetary authority's policy measures. It also takes into consideration the changes in the macroeconomic outlook where economic activity and inflation are emphasized.

When the central bank fixes an intervention interest rate, this influences the demand for primary liquidity on the part of the real sector and the financial system while the performance of credit reflects the expenditure needs that all of the agents have and the M3 reveals their demand for money.

a. Monetary Base: Sources and Uses

i. Sources for expanding the base

Primary liquidity for the economy is supplied by Banco de la República when it acquires assets, reduces liabilities or lends resources to the financial system and vice versa. From the beginning of this year to June, the monetary base declined COL\$607 billion (b) (for this last date, the annual growth was 13.1%). The main sources for the tightening liquidity in pesos up to June, 2010 were i) the COL\$6.277 b rise in the balance of the government deposits in Banco de la República, ii) the final sales of the TES in the hands of Banco de la República for COL\$1.999 b and iii) the COL\$56 b in net maturities of TES (Table 5).

The above was partly offset by transactions that implied an increase in the monetary base such as: i) the purchases of foreign currency on the foreign exchange market on the part the Banco de la República starting March 3 by means of daily auctions of US\$20 m (a total of US\$1.600 m) which represented a COL\$3.103 b increase in the primary liquidity and ii) COL\$4.208 b in operations with the financial system. Specifically, the repo balance came to COL\$3.700 b between December, 2009 and June 2010 at the same time that

31 The economic outlook of several agents improved after learning that the economic growth for the fourth quarter of 2009 had been 2.5%, which was higher than what had been predicted by the analysts (1.7%). Furthermore, in April, the Ministry of the Treasury announced the possibility of upwardly revising the growth projections for Colombia in June. This was done on June 15 when the growth forecast for 2010 went from 2.5% to 3.0%. Afterwards, it was discovered that the Colombian economy had registered a growth of 4.4% in the first quarter of 2010 compared to the same period the year before thus surpassing the amount expected by analysts (3.6%). Likewise, the industrial production index and commercial retail sales have shown better results than expected.

Table 5
Sources of the Monetary Base, Quarterly Variation ^{a/}
(billions of pesos)

Item	2008					2009					2010		
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Total	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Total	I Qtr.	II Qtr.	Total
I. Government	(4,187)	271	2,936	4,539	3,559	(3,945)	(4,784)	2,474	6,424	169	(3,363)	(2,914)	(6,277)
Transfer of profits ^{b/}	1,415	0	0	0	1,415	0	0	0	0	0	0	0	0
Pesos	1,415				1,415					0	0	0	0
Deposits in Banco de la República	(5,602)	271	2,936	4,539	2,144	(3,945)	(4,784)	2,474	6,424	169	(3,363)	(2,914)	(6,277)
II. TES regulation	(147)	(993)	(0)	616	(524)	(501)	(20)	(4)	2,968	2,444	(805)	(1,250)	(2,055)
Definitive purchases	0	0	0	625	625	0	0	0	3,000	3,000	0	0	0
Definitive sales	(137)	(823)	0	0	(960)	(499)	0	0	0	(499)	(800)	(1,199)	(1,999)
Matured	(10)	(170)	(0)	(9)	(189)	(1)	(20)	(4)	(32)	(57)	(5)	(52)	(56)
III. Banco de la República liquidity transactions	(1,571)	733	(5,077)	693	(5,221)	1,698	5,438	(4,362)	(3,068)	(293)	(158)	4,366	4,208
Expansion ^{c/}	(1,713)	1,102	(3,439)	193	(3,856)	1,194	4,484	(2,690)	(4,075)	(1,087)	526	3,174	3,700
Contraction	142	(369)	(1,638)	500	(1,365)	505	954	(1,672)	1,007	794	(683)	1,192	509
IV. Foreign exchange ^{d/}	505	1,346	2,404	(356)	3,899	(460)	369	355	0	265	763	2,340	3,103
Put options to control volatility	505	422	0	5	932	429	369	355	0	1,154	0	0	0
Call options to control volatility	0	0	0	(535)	(535)	(888)	0	0	0	(888)	0	0	0
Options to accumulate reserves	0	798	0	0	798	0	0	0	0	0	0	0	0
Direct purchase auction	0	126	2,404	174	2,705	0	0	0	0	0	763	2,340	3,103
Discretionary intervention	0	0	0	0	0	0	0	0	0	0	0	0	0
Sales of foreign currency to the government	0	0	0	0	0	0	0	0	0	0	0	0	0
V. Other ^{e/}	275	466	890	434	2,065	242	190	193	142	766	239	174	414
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	(3,323)	2,716	(607)
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	36,222	38,937	38,937

a/ These figures correspond to the close of the calendar month.

b/ On February 27, 2009 the profits were transferred to the government in dollars (US\$320.4 m or, in other words, COL\$818.6 b). On February 28, 2007, profits were transferred to the government in dollars (US\$533m or, in other words, COL\$1.186 b).

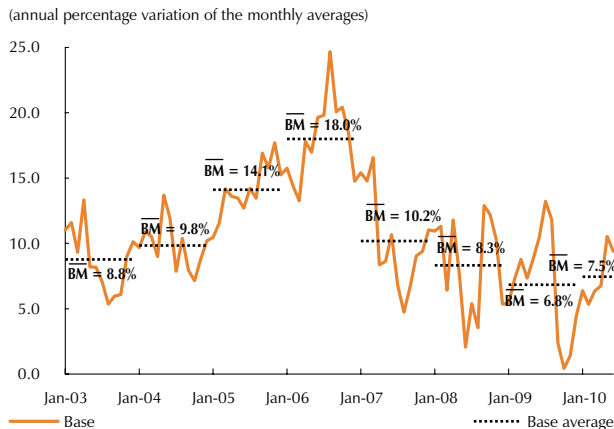
c/ Includes overnight repos, overnight and medium term repos.

d/ Excluding operations with international entities.

e/ 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 included under others.

Source: Banco de la República.

Graph 61
Real Monetary Base



the level of the NRIBD dropped COL\$509 b in the same period. Other factors, among which the most important one is the net expansionary effect of the P and L operations of the Banco de la República, explain the COL\$414 b expansion (Table 5).

ii. Uses of the monetary base

From the beginning of 2010 to June, the monetary base showed an average annual change of 9.7% which is 4.5 pp lower than what was registered between January and June in 2009. In real terms, this result implied an annual rise that is equivalent to 7.5% (Graph 61).

By component, between January and June 2010, the average annual growth of cash and of the banking reserves were 6.9% and 14.9% respectively, which is 4.0 pp and 6.2 pp lower than those registered the year before. However, analyzing the increase in real terms, the differences were minor with variations of 0.2 pp for cash and 2 pp for the reserves.

b. Sources and Uses of Credit Establishments

i. Sources

Up to June 2010, the primary source of financing for the credit establishments was the liabilities subject to reserve requirements (LSR) which include deposits in checking and savings accounts, CDs, bonds and trust deposits, etc. (Table 6). To be specific, in June 2010, the LSR balance showed an annual surge of COL\$13.662 b (8.3%). The largest contribution to this amount was COL\$11.211 b in savings deposits, which had an annual rate of growth of 18.5%, followed by COL\$3.821 b in checking accounts and COL\$3.131 b in bonds which are among the most important ones. In contrast, the balance for CDs declined COL\$6.291 b, which is equivalent to an annual contraction of 9.6%.

The trend of the LSR drove the M3 to an average annual growth of 7.3% between January and June, 2010 (5.1% in real terms) (Graph 62). In addition, as can be seen in Table 7 that has information as of May 2010,³² when the M3 is divided between public and private sectors, the annual growth for each was

32 This information is the most recent information available on the balances of the financial brokers.

Table 6
Main Balance Sheet Accounts of Credit Establishments
(billions of pesos)

	End of the Month Balances			Absolute annual variation		Annual percentage variation	
	Jun-08	Jun-09	Jun-10	Jun-09	Jun-10	Jun-09	Jun-10
Balances							
Assets							
Own cash position ^{a/}	2,757	3,955	415	603	(3,282)	21.9	(83.0)
Banking reserve	9,577	11,783	13,464	2,206	1,682	23.0	14.3
Banco de la Republica's OMO liabilities and non- reserve interest-bearing deposits	0	14	708	14	693		4,792,8
Total gross portfolio with leasing in national currency	126,680	143,499	151,034	16,819	7,535	13.3	5.3
Portfolio	114,995	130,639	137,500	15,644	6,861	13.6	5.3
Leasing portfolio	11,686	12,861	13,535	1,175	674	10.1	5.2
Investments ^{b/}	34,689	44,761	53,651	10,072	8,890	29.0	19.9
Other net assets (ONA) ^{c/}	(28,942)	(32,773)	(37,959)	(3,236)	(5,444)	11.2	16.6
Total	144,761	171,240	181,313	26,479	10,074	18.3	5.9
Liabilities							
Repos with Banco de la Republica	4,456	7,298	3,709	2,842	(3,589)	63.8	(49.2)
LSR	140,305	163,941	177,604	23,637	13,662	16.8	8.3
Savings	55,068	60,645	71,856	5,577	11,211	10.1	18.5
Checking accounts	20,140	21,706	25,526	1,566	3,821	7.8	17.6
CDs	52,028	65,369	59,077	13,341	(6,291)	25.6	(9.6)
Bonds	6,819	9,818	12,950	2,999	3,131	44.0	31.9
Trust deposits	3,671	3,777	5,151	107	1,374	2.9	36.4
Demand deposits	2,070	2,394	2,747	324	353	15.6	14.7
Repos with the real sector	508	232	296	(275)	63	(54.2)	27.1
Total	144,761	171,240	181,313	26,479	10,074	18.3	5.9

a/ Excluding stock brokers. Absolute variations correspond to variations in dollars multiplied by average exchange rate for the period.

b/ Excluding the securitizations of the mortgage portfolio. These are included in investments.

c/ The variation of the ONA compiles 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 entity's own cash position, which are not explained by the variation in the account balance.

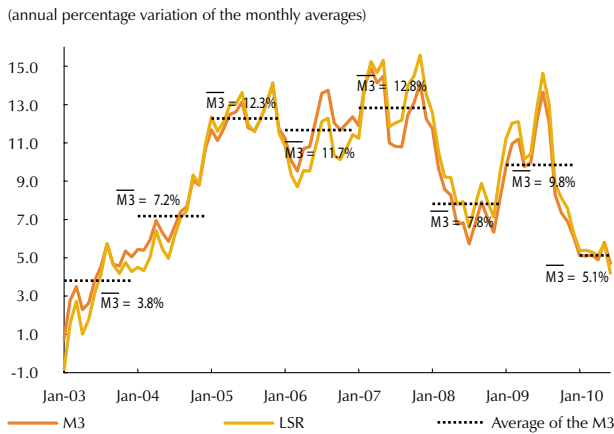
Sources: Financial Superintendence of Colombia, Banco de la Republica calculations.

6.2% and 8.4% respectively. Therefore, comparing it with the average annual change of the total M3, the public component registered a significant surge.

ii. Uses

From the beginning of 2010 to June, there has been a change in the composition of the credit establishment's assets in favor of investments (Table 7 and Graph 63). The latter showed an annual change of COL\$8.890 b (19.9%) in their balance while the rise in the gross loan portfolio in national currency was

Graph 62
Real Broad Money Aggregate



Source: Financial Superintendence of Colombia, Banco de la Republica calculations.

COL\$7.535 b (5.3%). Including the securitizations within the portfolio, the balance for the credit establishments' gross portfolio in national currency was COL\$156.467 b with an annual variation of COL\$8.333 b (5.6%) (Table 8).³³

Based on the sector the credit is going to, a significant slowdown has been seen in the commercial loan portfolio in national currency since the annual variation at the end of the first half of the year was 0.9% compared to 18.3% for the same period last year. This is in contrast to the mortgage portfolio adjusted with securitizations which has seen an annual growth 22.2% that was 8.2 pp above what had been registered a year ago. The consumer loan

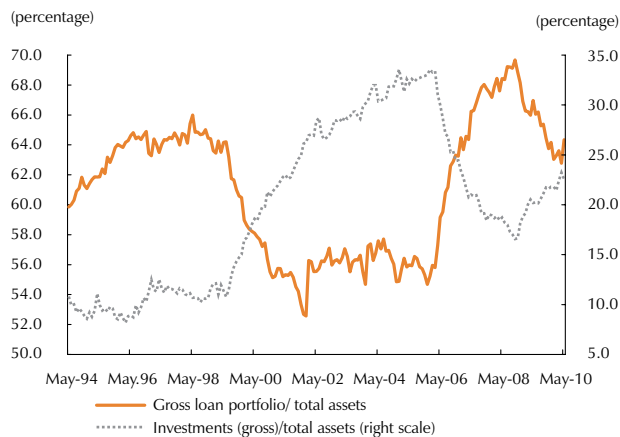
Table 7
Broad Money: Public and Private M3
(billions of pesos)

	Balances as of May		Annual growth (percentage)
	2009	2010	
Private M3	152,909	162,430	6.2
Cash	21,236	22,997	8.3
LSR	131,673	139,433	5.9
Checking accounts	14,840	17,175	15.7
CDs	61,920	54,553	(11.9)
Savings	43,060	52,725	22.4
Others	11,853	14,980	26.4
Public M3	32,998	35,760	8.4
Checking accounts	6,105	7,365	20.6
CDs	3,992	3,471	(13.1)
Savings	16,081	17,759	10.4
Others	6,820	7,165	5.1
Total M3	185,907	198,190	6.6
Cash	21,236	22,997	8.3
LSR	164,670	175,193	6.4
Checking accounts	20,945	24,540	17.2
CDS	65,912	58,024	(12.0)
Savings	59,141	70,484	19.2
Others	18,673	22,145	18.6

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

33 This balance was negatively affected by the writeoffs on the portfolio which has seen an annual change of close to COL\$2 t on average between January and May, 2010.

Graph 63
Investments and Loan Portfolio as a Share of the Total Assets
of Credit Establishments ^{a/}



a/ Excluding special financial entities.
Sources: Financial Superintendency of Colombia, Banco de la Republica calculations.

portfolio also showed an increasing trend this year. Its balance at the end of June came to 8.9% annually or, in other words, 6.1 pp more than was seen for the same month in 2009. Finally, the annual growth for the micro-credit portfolio was 11.7% at the end of the first half of 2010.³⁴

The combination of the nominal growth of the national currency portfolio together with the lower inflation this year explain the recovery of the loan portfolio in real terms. This represented a change in the negative trend that had been seen since the beginning of 2007. Based on the balance sheets of the credit establishments, the real annual growth of the portfolio was 2.0% in May.

Table 8
Gross Loan Portfolio of the Financial System ^{a/}

	Balance in billions of pesos end of June			Annual percentage growth end of June		
	2008	2009	2010	2008	2009	2010
A. National currency	130,034	148,133	156,467	21	14	6
Commercial ^{b/}	75,196	88,921	89,753	20	18	1
Consumer ^{c/}	38,530	39,622	43,151	22	3	9
Adjusted mortgage ^{d/}	14,102	16,071	19,633	21	14	22
Micro-credit ^{e/}	2,205	3,518	3,930	20	60	12
B. Foreign currency	6,577	4,688	5,657	15	(29)	21
Total adjusted loan portfolio (A + B) ^{d/}	136,611	152,821	162,124	20	12	6
Memorandum item						
Mortgage ^{f/}	10,749	11,438	14,200	22	6	24

a/ Excluding FEN, excluding special financial entities and excluding entities going through liquidation. Includes leasing. To calculate the annual variations, the following closings were taken into account: 2008: January 1, 2009 and 2009: January 2, 2010.

b/ Loans other than those for housing, consumption and micro-credit defined in items a, b, c, d and e.

c/ Loans granted to people who intend to finance the purchases of consumer goods or to pay for services that are not for commercial or business purposes no matter what the amount may be.

d/ These are housing loans, no matter what amount they are for, which were granted to people for the purpose of buying new or used housing or for the construction of individual houses. They correspond to the credit establishments' mortgage loan accounts adjusted for securitization.

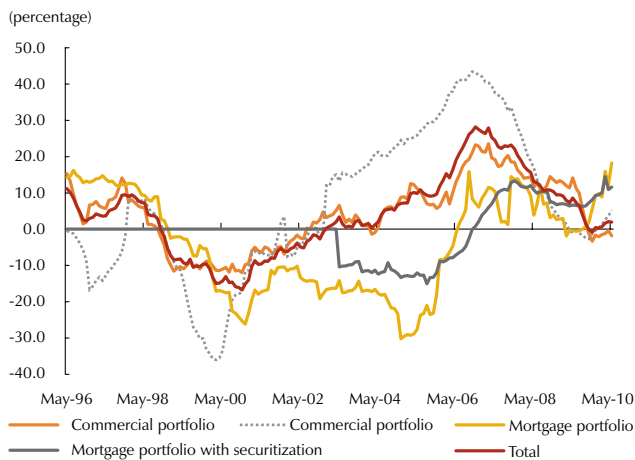
e/ Loans granted to micro-companies whose debt balance with the respective lending entity does not surpass 120 legal minimum monthly salaries that are currently in effect. (Decree 919, 2008)

f/ These are housing loans, no matter what amount they are for, which are granted to people for the purchase of new or used housing or for building a house. They correspond to the credit establishments' mortgage loan accounts.

Source: Financial Superintendency of Colombia, Banco de la Republica calculations.

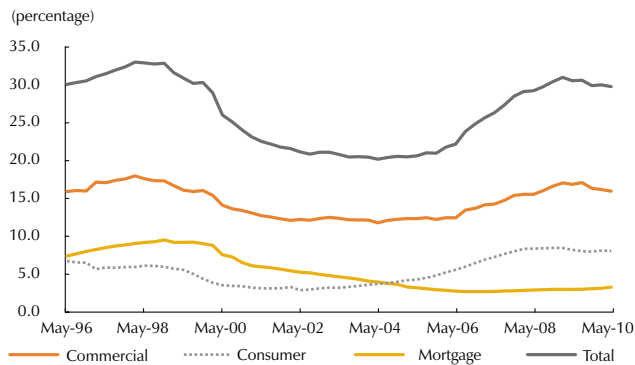
34 It should be clarified that, in the measurement of the micro-credit portfolio, there is a variation that has a statistical effect incorporated due to the fact that according to Decree 919, 2008, the credit establishments were supposed to reclassify some current loans into this loan category. That is why this balance rose significantly in 2008.

Graph 64
Real Annual Growth of Credit Establishments' Gross Portfolio



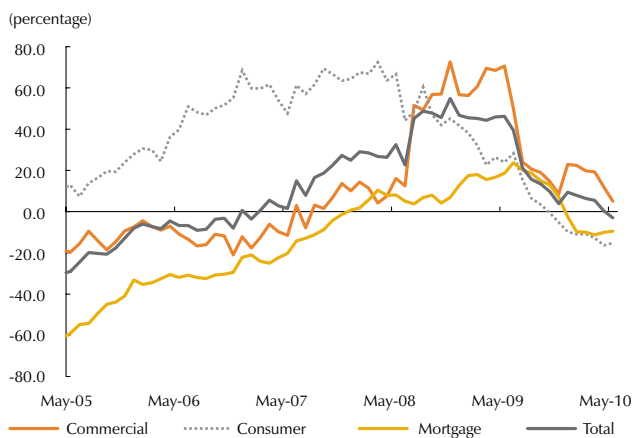
Sources: Financial Superintendency of Colombia and DANE, Banco de la Republica calculations.

Graph 65
Financial depth (loan portfolio/GDP)



Sources: Financial Superintendency and DANE, Banco de la Republica calculations.

Graph 66
Real Annual Growth of the Risky Loan Portfolio



Note: This includes financial leasing operations.
Sources: Financial Superintendency of Colombia and DANE, Banco de la Republica calculations.

During the same month, a growing trend in real terms was registered for the different types of loan portfolios (with the exception of the commercial one). In the cases of the consumer and mortgage portfolios (with and without securitization), the real annual variations in May were 5.2%, 11.6% and 18.3% respectively. The commercial loan portfolio, in turn, continues to register a negative growth of 1.8%. The performance of the consumer and mortgage portfolios is the result of the greater strength of economic activity, the upswing in the demand for housing generated by the different subsidies granted by the government for the purchase of new housing, and by the lower level of the interest rates (Graph 64).

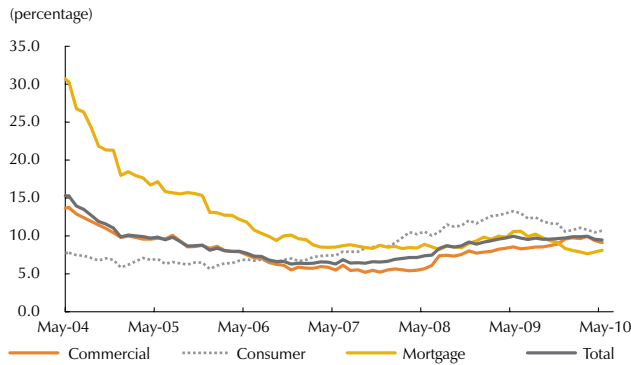
c. Financial Stability Indicators

The upswing in the portfolio occurred together with a higher growth in the GDP, which explains why the financial depth index (measured as a ratio of the loan portfolio to the GDP), did not show large variations over the course of the year. In May, this indicator was at 29.8%. By types of portfolio, it can be seen that for the commercial portfolio, the financial depth indicator reached a level of 16.0% in May, which is 20 bp lower than what was observed in December, 2009 (16.2%). In addition, for the mortgage and consumer portfolios, the indicator showed a minor change. These were at levels of 3.3% and 8.1% respectively (Graph 65).

With respect to the loans classified as risky (ratings that are lower than A), their slowdown is evident since they went from growing 46.1% in May, 2009 to -3.4% for the same month in 2010 (Graph 66). This performance is associated particularly with the lower strength of the risky commercial portfolio which saw its annual rate drop from 70.5% to 5% during this period.

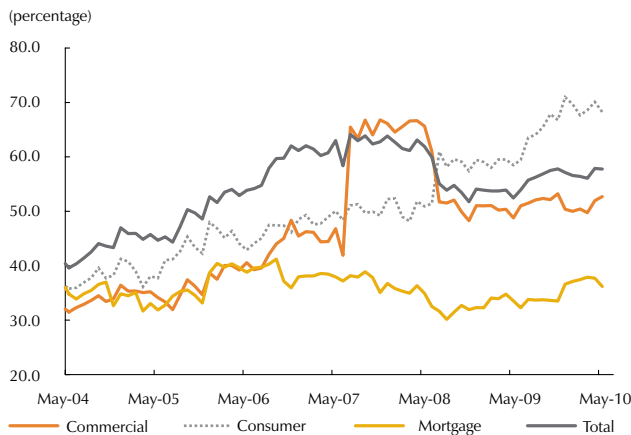
The portfolio quality indicator (QI) measured as the ratio of the risky portfolio to the gross loan portfolio has remained at around 9.7% over the course of the year. Looking at them by type, improvements in the QI of the consumer portfolio and mortgage portfolio

Graph 67
Portfolio Quality by Type of Loan
(risky portfolio/to gross loan portfolio)



Note: This includes financial leasing operations.
Sources: Financial Superintendence of Colombia, Banco de la Republica calculations.

Graph 68
Coverage Indicator
(provisions/risky portfolio)



Note: This includes financial leasing operations.
Sources: Financial Superintendence of Colombia, Banco de la Republica calculations.

can be seen as they dropped from 13.2% and 10.5% in May, 2009 to 10.7% and 8.1% respectively for the same month in 2010. This result is favorable given the heightened pace of growth that the mortgage portfolio has had in recent months. In contrast to the previous types of credit, the QI for the commercial portfolio has climbed 60 bp by going from 8.5% to 9.1% between May, 2009 and the same month in 2010 (Graph 67).

The indicator for loan portfolio coverage, measured as the ratio between the loan loss provisioning and the risky portfolio, showed a rising trend in the consumer and mortgage portfolios types. This raised the coverage for the total loan portfolio by 5.5 pp as it went from 52.5% in May, 2009 to 58% during the same month for 2010 (Graph 68).

With respect to the profitability of the financial system, so far in 2010, the ROA³⁵ has remained relatively constant at 2.4%. The solvency ratio, in turn, was above the average for the decade (13.5%) and reached an average level of 15.5% for this period. This figure is 80 bp higher than the one registered for the same month in 2009. The performance of this indicator suggests that financial intermediation has is not restricted by capital requirements.

One of the credit types that has gained more relevance in the last few years is micro-credit. Even if it still represents a minor share within the total amount of loans, it surpasses the rest of the types of portfolios due to the number of debtors (1,037,664

as of December, 2009). The latter makes it pertinent to study its development in terms of both growth and credit risk.

The micro-credit loan portfolio has suffered a sharp slowdown in its pace of growth as it has gone from rising at a real 54.9% per year in May, 2009 to 10.6% for the same month in 2010. At the same time, its portfolio quality indicator has deteriorated and hit 9.1% in April, 2010, a level that has not been seen since August, 2002 when it was at 10.5%.

35 The profitability indicator for the financial system is defined as the ratio between profits and average asset.

With respect to the loan market conditions, the perception of the financial brokers, which is collected in the *Report on the Loan Situation in Colombia* (RSCC in Spanish), indicates that the banks are warning of a greater demand for all of the different types of loans while according to the cooperatives, the demand is contracting. The commercial financing companies (CFC) showed a heterogeneous performance for demand based on the type of loan.

With respect to the policies for allocating new loans, some brokers have begun to lower the requirements. As a result, there is a greater willingness on the part of the establishments to grant loans. However, a significant number of the entities have maintained their requirements for the consumer and commercial

loan portfolios. Finally, the RSCC indicates that prior knowledge about the client and a good credit history together with the profitability and low credit risk continue to be very important considerations for approving new loans.

In the *Report on Financial Stability*, which will be published in September 2010, a detailed and up-to-date analysis of the different risks that the financial system faces will be given.

E. FOREIGN SECTOR

1. Changes in the Exchange Rate

a. Nominal exchange rate

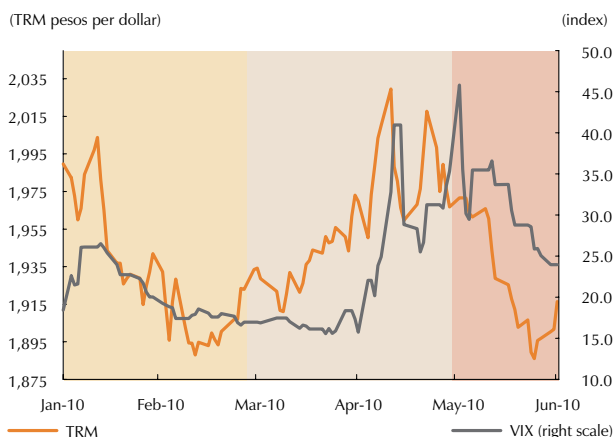
In the first half of 2010, the trend of the Colombian peso, like that of various currencies in the region, was determined by the perception of international risk, which changed as the news about the economies of industrialized countries and the public debt crisis in several European countries became known (Graph 69).³⁶ Other determinants of changes in the exchange rate were the rise in the terms of trade and the larger volume in Colombian exports from the mining sector. These contributed to a lower deficit in the current account and increased the supply of dollars in the domestic market. The inflow of foreign currency through the capital account, which was intended primarily for financing the government

Graph 69
Exchange Rate and Volatility Index (VIX)

A. Exchange Rate and Volatility Index (VIX), 2008-2010



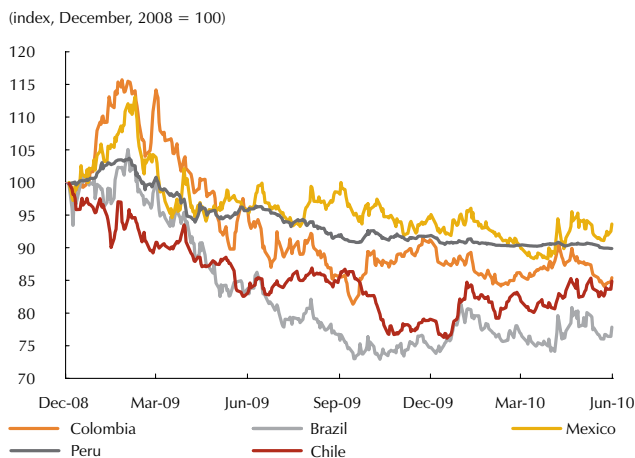
B. Exchange Rate and Volatility Index (VIX), 2010



Sources: Banco de la Republica and Bloomberg.

36 The VIX is a financial index that measures the ratio of volatility to the S&P 500 put options. In addition, it is a measurement of market risk that is widely used.

Graph 70
Indices of Nominal Exchange Rates for Latin America
Countries



Sources: Banco de la Republica and Bloomberg.

Table 9
Percentage Variation of the Nominal Exchange Rate:
foreign currency with respect to the dollar ^{a/}

	2003-2008 (average)	2009 (annual)	First half of 2010 vs. Dec. 2009
Euro Zone	(26.3)	(2.0)	17.2
United Kingdom	10.6	(10.4)	7.6
Japan	(24.8)	2.3	(4.3)
Colombia	(21.1)	(8.9)	(6.3)
Brazil	(34.0)	(25.2)	3.6
Mexico	32.6	(4.9)	(1.1)
Peru	(10.3)	(8.1)	(2.1)
Chile	(10.6)	(21.0)	7.6

a/ Negative indicates appreciation.

Sources: Banco de la Republica and Bloomberg.

and petroleum investment and which exceeded the amount of the deficit in the current account, also explains the performance of the exchange rate. As has been noted, between March and June, the Banco de la República accumulated US\$1.600 m in international reserves through competitive auctions of US\$20 m per day.

When the nominal exchange rate for June 30, 2010 is compared to that of December 31, 2009, the Colombia peso (6.3%), the Peruvian sol (2.1%) and the Mexican peso (1.1%) appreciated with respect to the dollar while the Chilean peso (7.6%) and the Brazilian real (3.6%) depreciated. The euro and the pound, in turn, showed a depreciation with respect to the dollar of 17.2% and 7.6% respectively while the yen appreciated 4.3% (Graph 70 and Table 9).

The changes in the exchange rate in the first six months of the year can be divided into three periods (shaded in Graph 69). At the end of the first quarter of 2010, the Colombian peso was 6% stronger with respect to the dollar. This trend, which also showed up to different degrees in several countries in Latin America and Asia, was associated with external factors such as the decline in international risk aversion. This was an incentive for some investors to sell assets that were considered to be safe havens³⁷ and substitute them for higher risk assets in emerging markets. This external factor was added to the expectations of a larger supply of dollars being offered in the local market by the public sector. The appreciation of the peso in comparison with other strong currencies such as the euro and the British

pound was higher due to the fears related to the fiscal situation in some European countries.

In April and May, the exchange rate showed a rising trend in a context of rising international risk aversion and of foreign exchange intervention on the part of Banco de la República. Among the factors that introduced a great deal of uncertainty and nervousness into the markets, three stand out. The first was the doubts about the ability of Greece, Spain, Portugal, Italy and Ireland to pay their debts, which led to drops in the sovereign ratings of the first three. Secondly, there was the beginning of the investigations of various financial

37 For example, securities issued by the United States government.

entities in the United States for fraud and, last of all, the release of the news about solvency problems in Spain's financial sector.

The upswing in the perception of risk reversed, although temporarily, when the IMF announced that they would give Greece a loan to provide them with liquidity and thus prevent a possible default. Nevertheless, the uncertainty persisted because the markets judged the loan to be insufficient and the risk that it would spread to other financial markets was high. After that, the IMF and the European Union announced a stabilization fund for the entire region and the countries reported on additional steps they were taking to reduce their fiscal deficit. Other measures were necessary to reduce the volatility and limit the manipulation of market prices for certain securities. Among these first steps, the regulation of speculative funds in Europe and the prohibition of uncovered short selling in Germany, were the most important.

At the end of the first half of the year, the price of the dollar went back to a downward trend in an environment in which the perception of international risk was declining. Factors such as the ECB's decision to stimulate the economy of that region,³⁸ the improved expectations of economic growth in the United States,³⁹ positive performance of the Chinese exports⁴⁰ and their announcement that they were going to give their currency more flexibility contributed to reducing the perception of international risk. On the domestic front, several news items raised people's confidence⁴¹ and explain part of the trend of the exchange rate in June. First of all, the new information on economic activity suggested a better than expected growth of the GDP. The latter was confirmed by the Ministry of the Treasury when they raised their estimate of economic growth for 2010 and lowered their projections for the fiscal deficit. It was also confirmed when, at the same time, they mentioned expectations of a boom in the energy-related mining sector (according to the MFMP) and later, when DANE published the data on the change in the GDP for the first quarter of the year, which was higher than the analysts had expected.⁴² In any case, the 2.8% appreciation of the Colombian peso during that period was in line with that of other Latin American currencies (Brazil -0.9% and Peru -0.7%).

Another factor that contributed to the strengthening of the Colombian peso with respect to the dollar was the upswing in the prices for some of the commodities

38 In their June meeting, the ECB announced that the emergency loans to banks would move ahead until September of the current year and that they would continue the purchases of sovereign bonds.

39 In his speech to the Budget Committee in the House of Representatives, Ben Bernanke said that the US economy would continue to expand this year and next.

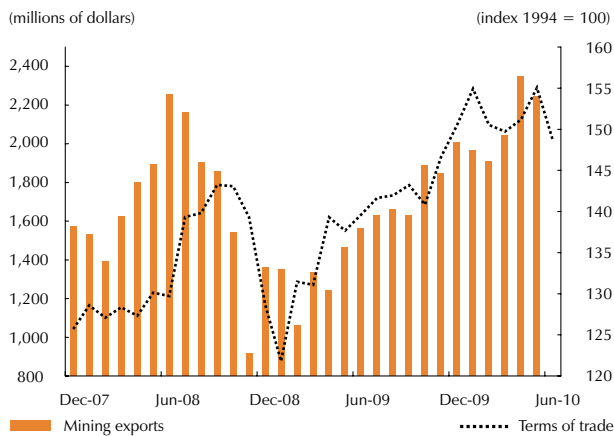
40 In May, exports from China grew more than the analysts expected and jumped 48.5% with respect to the same month the previous year (expected: 32%, previous year: 30.5%).

41 The confidence index calculated by Fedesarrollo reached its highest level in two years.

42 Growth in the first quarter of 2010 was 4.4% compared to an expected 3.4%.

Graph 71

A. Value of Mining Exports and Terms of Trade Index



B. Index of Latin American Exchange Rates (LACI) ^{a/} and Index of Prices for Commodities (CRB) ^{b/}



a/ An index created by JP Morgan that brings together the trends of Latin American currencies. It is an average weighted by liquidity and operations of the spot rate for the currencies of six countries (Argentina, Brazil, Chile, Colombia, Mexico and Peru). In this graph, the evolution of the 1/LACI quotient is taken to be compared to the rate calculated for Colombia (pesos per dollar).

b/ Commodities Research Bureau.

Sources: Banco de la Republica, DANE and Bloomberg.

that Colombia exports such as coal, coffee, oil and ferronickel. The rise in the terms of trade together with the higher volume of mining exports, especially oil, mitigated the deficit in the current account and raised the supply of foreign currency in the domestic market (Graph 71 and Table 9).

As the figures in the foreign exchange balance reveal,⁴³ (Table 10) from the beginning of 2010 up to June, the inflow of private (US\$2.641 m) and public capital (US\$3.361 m) surpassed the outflows of foreign currency from current transactions (US\$4.854 m). Of the total amount of the outflows of foreign currency for current transactions, 80% correspond to transactions other than the return of the international reserves and the payments of the interest on the government's foreign debt. In the private capital account, the income from foreign direct investment (FDI) (US\$4.326 m) is the most outstanding, especially that intended for the oil and mining sectors. This represented a monetization of US\$3.953 m. The transactions involving indebtedness, net portfolio investment and the reimbursement or transfers from or to current accounts abroad showed a total of US\$1.685 m in outflows which partly offset the income from direct investment.⁴⁴

As a consequence, the trend in the peso price was also determined by the higher FDI revenue that was going specifically towards mining as well as by the greater foreign financing for the public sector and Ecopetrol that is needed to finance expenditures and investment respectively. Thus, the total income through the capital account (public and private)

surpassed the deficit in the current account and contributed to the appreciation of the peso.

43 Excluding clearing accounts.

44 It is important to point out that, compared to what had been seen in the January-June, 2009 period, all of the items in the private capital account have shown a recovery so far in 2010 except for direct investment in sectors other than oil and mining.

Table 10
Foreign Exchange Balance ^{a/}
(millions of dollars)

	January- June 2009	January- June 2010	Absolute variation
I. Net reimbursements of the current account (1 + 2 + 3)	(2,540)	(4,854)	(2,313)
1. Return of international reserves	264	(3)	(266)
2. Treasury debt interest	(911)	(968)	(57)
3. Remainder (i + ii + iii) ^{b/}	(1,893)	(3,883)	(1,990)
i. Trade balance of goods (a + b)	(3,135)	(4,196)	(1,060)
a. Exports of goods	3,647	3,728	81
b. Imports of goods	(6,783)	(7,924)	(1,141)
ii. Net reimbursements for financial services	(790)	(1,142)	(352)
iii. Net reimbursements for non-financial services	2,032	1,455	(577)
II. Net reimbursements of private capital (1 + 2 + 3 + 4)	983	2,641	1,658
1. Net loan	(1,033)	(411)	622
2. Net foreign direct investment in Colombia (i + ii)	3,865	4,326	461
i. Foreign in Colombia (a + b)	4,076	4,534	458
a. Oil and mining	3,393	3,953	560
b. Direct and supplementary other sectors	683	581	(102)
ii. Colombian abroad	(211)	(208)	3
3. Net portfolio foreign investment (i + ii)	(510)	(136)	375
i. Oil in Colombia	42	322	280
ii. Colombian abroad	(552)	(458)	95
4. Net current accounts ^{c/}	(1,339)	(1,138)	201
III. Net reimbursements of official capital ^{d/}	3,042	3,361	319
IV. Other special operations ^{e/}	(1,797)	(102)	1,695
V. Variation in gross international reserves (I + II + III + IV)	(312)	1,047	1,359

a/ Excluding clearing accounts.

b/ Includes other current operations of the Banco de la Republica and of the TGN such as the payment of non-financial services.

c/ This registers the movements of foreign currency coming from the current clearing accounts, purchase/sale of transacted free account balances.

d/ The majority of the TGN transactions are channeled through their deposit accounts in foreign currency at the Banco de la Republica. Due to that they do not have an impact on the exchange rate.

e/ This includes Banco de la Republica liabilities, purchase and sale transactions of foreign currency carried out by the Bank in the foreign exchange market as well as to the TGN, the transfer of Banco de la Republica profits in dollars to the TGN and accrual and active valuation of the international reserves. It also includes the purchase-sale of foreign currency between the real sector and the IMCs, the purchase-sale of foreign currency in the foreign exchange market to take care of risk coverage transactions resulting from fluctuations of the exchange rate and statistical errors and omissions.

Source: Banco de la Republica.

b. *Real Exchange Rate*

The analysis of the implications that the trend of the exchange rate has on the country's competitiveness must take into account the changes in domestic and foreign prices. The real exchange rate (RER) that compares foreign and domestic inflation in the same currency is an indicator that makes it possible to do that analysis. Changes in the RER can be interpreted as changes in the competitiveness between two countries or as a differential in production costs.

From the beginning of the year to June, the bilateral indices of the RER that use the CPI or the PPI as price measurements reveal that in comparison to the main trading partners (the United States, Venezuela, the euro zone and Ecuador) and after the significant real depreciation for the same period last year, the Colombian peso appreciated and lost competitiveness. For the same period, our currency has gained ground only with respect to the Brazilian real by accumulating a real annual devaluation of 2.8% according to the RERI-PPI and 5.4% according to the RERI-CPI (Table 11).

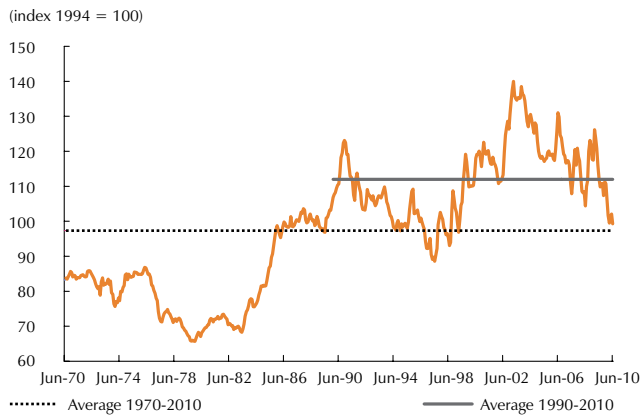
Table 11
Real Bilateral Exchange Rate: Colombian Peso with Respect to Foreign Currencies

	Average, annual percentage variations					
	2003-2009		2009 ^{a/}		2010 ^{a/}	
	PPI	CPI	PPI	CPI	PPI	CPI
United States	(1.6)	(4.5)	7.5	18.9	(10.1)	(16.0)
Venezuela	2.7	(1.3)	17.4	16.8	(23.0)	(23.0)
Ecuador	(0.3)	(0.8)	27.7	27.6	(13.4)	(14.7)
Mexico	(4.5)	(7.5)	(0.8)	(2.7)	(6.0)	(6.2)
Brazil	7.5	(2.1)	(3.8)	(2.4)	2.8	5.4
Euro Zone	2.2	0.2	2.6	4.6	(17.5)	(17.2)
Peru	(0.4)	(2.5)	12.1	15.0	(8.8)	(9.4)
Japan	(0.1)	(2.6)	26.8	30.8	(13.3)	(14.8)
Chile	4.8	4.4	6.7	(0.7)	(11.9)	(7.1)
Canada	(0.3)	(0.5)	(1.7)	0.6	(2.6)	(2.7)
United Kingdom	(2.6)	(3.6)	(8.4)	(10.4)	(10.1)	(12.6)

a/ January-June average variations
Source: Banco de la Republica

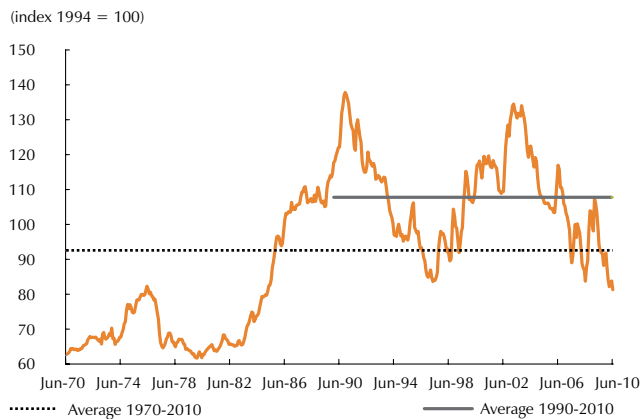
The performance of the RERI-PPI and the RERI-CPI are given in graphs 72 and 73. These indicators correspond to the weighted average of the bilateral indices based on the commercial importance that each country has to Colombia. In both cases, there is a drop in the index which implies a 14.8% average, annual, real appreciation as of June based on the RERI-PPI and of 17.3% based on the RERI-CPI.

Graph 72
RERI (PPI) With Respect to Their Historical Averages



Source: Banco de la República.

Graph 73
RERI (CPI) With Respect to Their Historical Averages



Source: Banco de la República.

Graph 74
Real Exchange Rate Indices



Source: Banco de la República.

This appreciation has taken the RER to levels that are close or below their historical levels. The improvements in the terms of among other factors, help to explain this downswing.

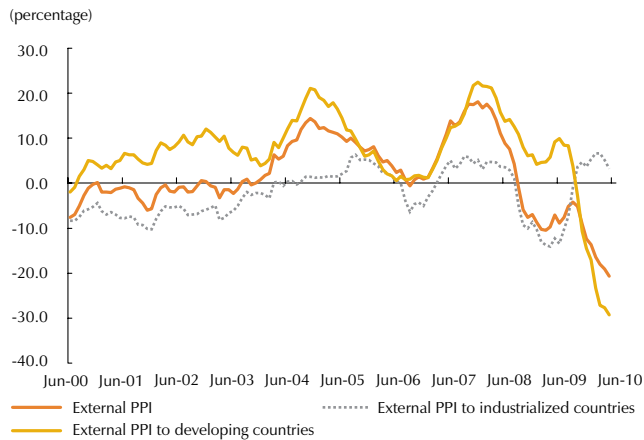
The RERI-C, which represents a real, multilateral exchange rate with respect to the countries that compete with our main export products (coffee, bananas, flowers and textiles) in the US market, is another indicator of competitiveness. This indicator reflects a lower loss of competitiveness. Between January and June 2010, the RERI appreciated 9.6% in annual terms and, in the last few months, the index has remained stable in contrast to the traditional RERI which is showing a tendency to appreciate (Graph 74).

One of the factors that explains our loss of competitiveness from the beginning of 2010 to June was the trend of relative prices (based on the CPI or PPI) that are calculated as a weighted average of the inflation of our trading partners with respect to domestic inflation. This loss, which appeared primarily in the average of the developing countries, was due to a statistical effect and is explained by the decline in the weighting for Venezuela, a country which was a very competitive market for our national products because of its high inflation.

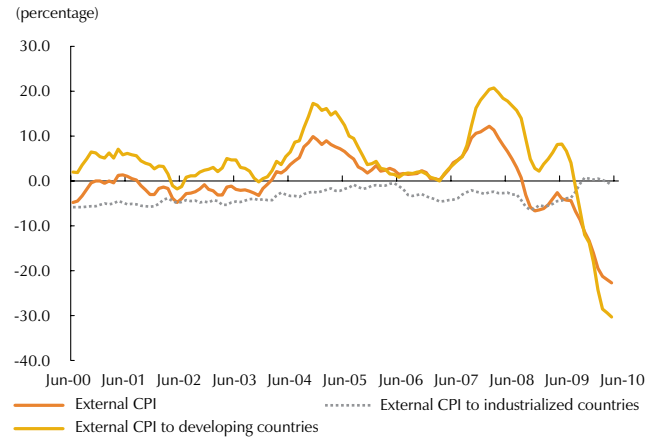
If Venezuela is excluded from the calculations of the annual change in relative prices up to June, we find that the loss in competitiveness through prices with respect to emerging countries goes from -29% to a gain of 0.5% in the case of the PPI and from -30% to -0.9% for the CPI. With respect to the entire group of trading partners, it turns out that Colombia is gaining in competitiveness as it has gone from -20% to 2% if the prices are measured with the PPI and, in the case of the CPI, the loss is reduced from -22% to -0.7%. Regarding our relative prices compared to the industrialized countries measured by the PPI, gains in competitiveness have been acquired by this route in the last five months as a result of the greater slowdown in domestic inflation compared to the average registered in those countries (Graph 75).

Graph 75
Trend of Relative Prices
(annual variation)

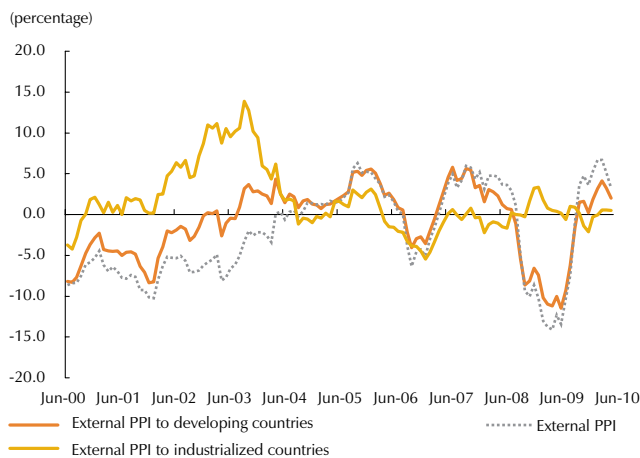
A. Measured by PPI



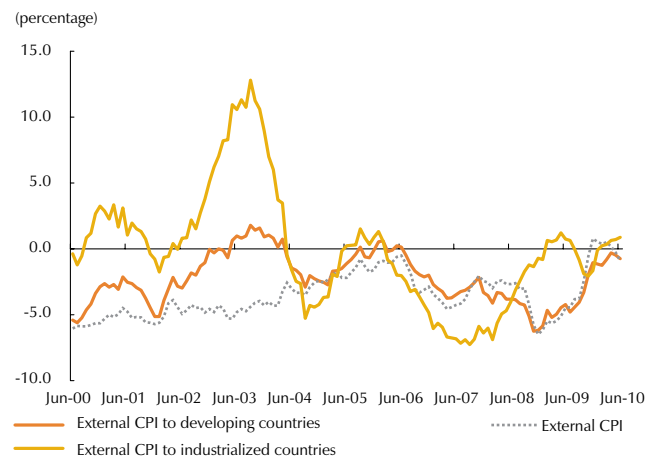
B. Measured by CPI



C. Measured by PPI (excluding Venezuela)



D. Measured by CPI (excluding Venezuela)

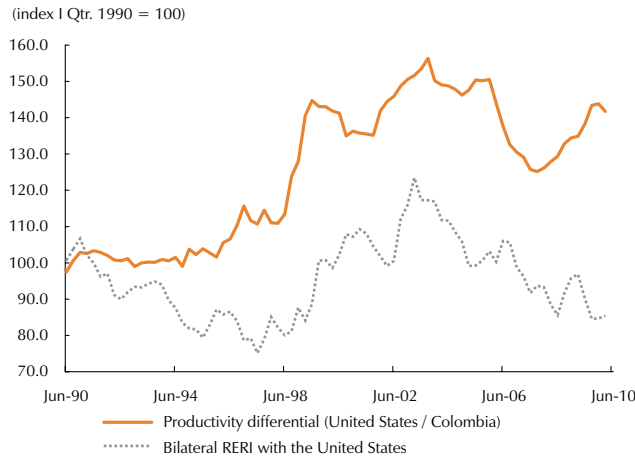


Source: DANE, Banco de la Republica calculations.

The competitiveness of a country is determined by not only the costs of production but also the efficiency of the tradable sector. In this respect, increases in the productivity in the sector of export goods will be reflected in a real appreciation of the exchange rate. As a consequence, a strengthening of the currency is not necessarily due to a loss in competitiveness since it could be the result of a gain in productivity. This is precisely what is suggested by the fall in the indicator of relative productivity in the first quarter of the year in comparison to the United States. This fall was the result of the higher growth in per hour productivity for industry in Colombia compared to the US (Graph 76).

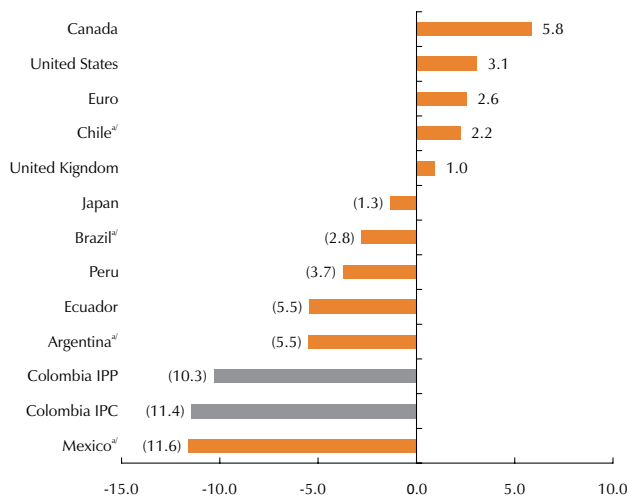
Finally, even if the different measurements of RER show that Colombia has seen a real appreciation so far this year, this phenomenon has also occurred

Graph 76
Productivity Differential in Industry vs. Bilateral RER1



Sources: Bureau of Labor Statistics and DANE, Banco de la Republica calculations.

Graph 77
Real Multilateral Exchange Rates for Each Currency with Respect to its Main Competitors and Trading Partners



a/ Countries for which the data as of June is not available.
Sources: Bureau of Labor Statistics and DANE, Banco de la Republica calculations.

in several of our trading partners (Graph 77). The greater confidence in the emerging economies, the resulting capital flows and the weakness of the dollar and the euro have strengthened several currencies in the region.

2. Developments in the Colombian Balance of Payments in the First Quarter of 2010

In the first quarter of the year, the deficit in current account widened with respect to the first quarter of 2009 as a result of the greater outflows from factor income, which came from the performance of the remittance of the profits and dividends of the multinational companies located in Colombia whose export products were priced at international prices that were higher than those seen in the same period the year before. Likewise, other factors that contributed to the expansion of the deficit were the growth in the imports of goods and services due to the recovery of domestic demand and the reduction of the income from workers' remittances due to the poor performance of the economies of the Spain and Venezuela.

The fact that the deficit in the current account was not larger was because of the higher international prices for our main export products⁴⁵ and the greater demand for them, which resulted from the rise in our trading partners' real GDP. This contributed to the generation of a trade surplus in the balance of goods in spite of the fact that the drop in output and Venezuela's trade restrictions have led to a steep decline in the exports to that country.⁴⁶

The recovery of the world economy led by emerging countries and the United States allowed capital flows to go to Latin American countries including Colombia. Thus, both foreign direct investment, especially that intended for mining, and private foreign indebtedness were the primary sources for financing the deficit in the current account.

45 The following are considered the main export products: coffee, oil and its derivatives, coal, ferronickel and gold.

46 As of the first quarter, total exports to Venezuela had fallen an annual 72.8%.

According to the estimates of the country's balance of payments, the main results in the first quarter of 2010 were: i) a US\$1.396 m (2.0% of the GDP⁴⁷) deficit in the current account which was US\$381 m higher than what was seen a year ago when it was at US\$1.015 m, 2.0% of the GDP; ii) a US\$1.499 m (2.2% of the GDP) surplus in the capital and financial account, which was US\$620 m higher than what was registered in the first quarter of 2009 when it reached US\$878 m (1.7% of the GDP), and iii) an accumulation of US\$347 m in gross international reserves (Table 12).

a. Current account

The annual comparison of the current account deficit showed that, including what had been added up to March 2010, the resulting deficit was US\$381 m higher due to the fact that the upswing in current outlays (US\$1.804 m) exceeded that of the revenue (US\$1.423 m). The higher current expenses are explained by the increase in imports of non-factor goods and services (US\$960 m), which resulted from a better trend in the domestic demand for consumer goods, intermediate goods and technical services for the mining sector. They also provided the largest transfers due to factor income (US\$820 m) from the multinational companies that quoted their export products (oil, coal and ferronickel) at international prices that were higher than those registered for the same period in 2009.

In annual terms, the higher current revenue for the first quarter of the year came from the rise in exports of products (US\$1.531 m) which was the result of the positive trend of international prices for the country's primary export goods and the upswing in the quantity of mining products shipped. However, the fact that the lower sales to Venezuela continue to affect the performance of industrial exports must be pointed out. These fell 10% annually during that period –a better analysis of the trend of Colombian trade and its possible substitutes is presented in Box 2.

It should also be mentioned that the current revenue from transfers was also affected by the reduction in workers' remittances to the country. In fact, remittances of US\$901 m (1.3% of the quarterly GDP) were US\$194 m lower in the first quarter of 2010 than those seen a year previously when they came to US\$1.095 m (2.2% of the quarterly GDP). This phenomenon continues to reflect the economic slowdown that occurred in countries such as Spain and Venezuela (Box 3).

Last of all, the trade balance for goods had a surplus of US\$1.028 m, an amount which was US\$734 m higher than what was seen a year ago. This surplus was

47 This corresponds to a quarterly GDP estimate in current dollars calculated by the Banco de la República on the basis of preliminary information from DANE.

Table 12
Balance of Payments for Colombia
(millions of dollars)

	I Quarter		Variation (dollars)
	2009	2010 (pr)	
I. Current account (A + B + C)	(1,015)	(1,396)	(381)
Income	10,599	12,022	1,423
Expenditures	11,614	13,418	1,804
A. Non-factor goods and services	(246)	351	597
Income	8,910	10,468	1,558
Expenditures	9,156	10,117	960
1. Goods	294	1,028	734
Income	7,903	9,433	1,531
Expenditures	7,609	8,405	796
2. Non-factor services	(540)	(676)	(137)
Income	1,008	1,035	27
Expenditures	1,547	1,711	164
B. Factor income	(1,985)	(2,857)	(872)
Income	358	305	(52)
Expenditures	2,343	3,163	820
C. Transfers	1,216	1,110	(107)
Income	1,331	1,248	(83)
Workers' remittances	1,095	901	(194)
Other transfers	236	347	112
Expenditures	115	139	24
II. Capital and financial account (A + B)	878	1,499	620
A. Financial account (1 + 2)	878	1,499	620
1. Long term financial flows (b + c - a)	2,893	1,260	(1,633)
a. Assets	1,170	244	(926)
i. Colombian investment abroad	1,170	244	(926)
Direct	1,170	244	(926)
Portfolio	0	0	0
ii. Loans	0	0	0
iii. Commercial loans	0	0	0
iv. Other assets	0	0	0
b. Liabilities	4,063	1,504	(2,560)
i. Foreign investment in Colombia	3,227	1,486	(1,741)
Direct	2,230	2,037	(193)
Portfolio	997	(551)	(1,548)

Table 12 (continued)
Balance of Payments for Colombia
(millions of dollars)

	I Quarter		Variation (dollars)
	2009	2010 (pr)	
ii. Loans	620	(31)	(651)
iii. Commercial loans	171	(15)	(187)
iv. Financial leasing	45	64	19
v. Other liabilities	0	0	0
c. Other long term financial movements	0	0	0
2. Short term financial flows (b - a)	(2,015)	239	2.254
a. Assets	982	231	(751)
i. Portfolio investment	(47)	232	279
ii. Commercial loans	121	(192)	(312)
iii. Loans	541	66	(475)
iv. Other assets	368	125	(244)
b. Liabilities	(1,032)	470	1.502
i. Portfolio investment	(23)	(21)	2
ii. Commercial loans	(349)	59	408
iii. Loans	(622)	366	989
iv. Other liabilities	(38)	66	103
B. Special capital flows	0	0	
III. Net errors and omissions	148	244	
IV. Variation in gross international reserves	12	347	

(pr) preliminary.
Source: Banco de la Republica.

the result of a growth in exports (19.4%) which was larger than that of imports (10.5%).

b. Capital and financial account

At the close of the first quarter of 2010, the capital and financial account showed a surplus of US\$1.499 m, which was US\$620 m higher than what was registered for the same period in 2009. The inflows of capital are mainly associated with net capital flows for direct investment. Other capital flows, which include foreign debt movements and other financial transactions, registered net outflows of US\$294 m, which are equivalent to capital outlays of US\$48 m from the public sector and US\$246 m from the private sector (Table 13).

Table 13
Balance of Payments for Colombia
Capital and Financial Account
(millions of dollars)

	I Quarter		Variation (dollars)
	2009	2010 (pr)	
Capital and financial account (A + B)	878	1,499	620
A. Direct investment (i - ii)	1,060	1,793	733
i. Foreign investment in Colombia	2,230	2,037	(193)
ii. Colombian investment abroad	1,170	244	(926)
B. Other capital flows (i + ii)	(181)	(294)	(112)
i. Public sector (a - b)	1,948	(48)	(1,996)
a. Liabilities	1,552	(868)	(2,420)
Loan portfolio investment	1,012	(622)	(1,635)
Bonds	1,000	(548)	(1,548)
Disbursements	1,000	0	(1,000)
Debt repayments	0	548	548
TES	12	(75)	(87)
Loans	551	(244)	(795)
Long term disbursements	895	248	(647)
Long term debt repayments	246	332	86
Short term	(98)	(160)	(62)
Commercial credit	(10)	(0)	9
Financial leasing	(1)	(1)	(0)
Other	0	0	0
b. Assets	(396)	(820)	(424)
Loan portfolio investment	(293)	(742)	(449)
Loans	(118)	(121)	(2)
Other	15	43	28
ii. Private sector (a - b)	(2,130)	(246)	1,884
a. Liabilities	(751)	805	1,556
Loan portfolio investment	(38)	51	89
Loans	(553)	580	1,133
Long term disbursements	273	(45)	(318)
Long term debt repayments	301	(98)	(400)
Short term	(525)	526	1,051

Table 13 (continued)
Balance of Payments for Colombia
Capital and Financial Account
(millions of dollars)

	I Quarter		Variation (dollars)
	2009	2010 (pr)	
Commercial credit	(169)	44	212
Financial leasing	47	65	19
Other	(38)	66	103
b. Assets	1,379	1,051	(327)
Loan portfolio investment	246	974	729
Loans	659	187	(472)
Commercial credit	121	(192)	(312)
Other	353	82	(271)

(pr) preliminary.
Source: Banco de la Republica.

In the first quarter of the current year, Colombia received US\$2.037 m (3.0% of the quarterly GDP) foreign direct investment (FDI) (see Box 4). This amount is US\$193 m less than what had been seen a year ago, when US\$2.230 m was received. During that period, oil drilling and the rest of the mining sector received 66% of its income from foreign investment. Other sectors that received revenue from direct investment were: transportation and communication (US\$57 m), commerce (US\$162 m), the manufacturing industry (US\$285 m) and financial activities (US\$125 m). Colombian investors, in turn, acquired US\$244 m in shares of stock in companies abroad, especially in those related to the manufacturing industry. These investments were US\$926 m lower than for the same period in 2009.

Between January and March 2010, the official entities registered US\$48 m in net outflows of capital, which corresponded to the sale of US\$820 m in foreign assets. This was used to make US\$868 m in net payments on the foreign debt. Liabilities declined due to the US\$622 m in net retirement of bonds and the US\$244 m in net payment on loans. The liquidated foreign assets were mainly loan portfolio investments of US\$742 m.

The private sector, in turn, recorded US\$246 m in capital outflows which corresponded to the acquisition of US\$1.051 m in foreign assets and to net disbursements US\$805 m in foreign loans. The majority of the composition of assets abroad relates to US\$974 m in loan portfolio investments which were made by pension funds and companies in the real sector. In another area, the surge of US\$805 m in liabilities was mainly the result of contracting new debt through loans and commercial credit: US\$580 m and US\$44 m respectively. A rise in liabilities through US\$65 m in financial leasing primarily intended for the modernization of the equipment for passenger air transportation was also seen.

c. International reserves

At the end of the first quarter of 2010, US\$347 m in gross international reserves had been accumulated as the result of the US\$42 m in income from the net return of the international reserves, the US\$400 m in net purchases of foreign currency from foreign exchange brokers and net outlays of US\$95 m in other transactions made by the Banco de la República.

3. Outlook for the Balance of Payments in 2010

As was mentioned in the first chapter, it is hoped that the United States, Japan, and the emerging economies in Asia and Latin America show an economic recovery in 2010 while the countries in the euro zone are going through an uncertain period that does not hold out any signs of a strengthening of their economies and, therefore, moderate growth is expected. As a result, to work out the forecast for the current account in 2010, a recovery of real worldwide growth is assumed which, based on the IMF projections, could be 4.6% in 2010 in comparison to -0.6% in 2009.

According to Banco de la República projections, the forecast for the real weighted growth for Colombia's trading partners is 2.8% in 2010, which is higher than what was seen in 2009 (-1.5%). Implicit in this assumption is the better growth expected for the United States (3.0% in 2010 vs. -2.4% in 2009), Venezuela (-1.0% in 2010 vs. -3.3% in 2009) and the euro zone (0.8% in 2010 vs., -4.1% in 2009).

Meanwhile, according to some analysts, the international prices for the main export products would show a favorable trend and would be even higher than those recorded in 2009. This would be in line with the positive growth of the global GDP, especially that of Asia. Although non-traditional exports will continue to be affected by the trade restrictions imposed by Venezuela, other factors such as the substitution of new markets for that one, the recovery of our trading partners and a better outlook for production and prices of the main export products suggest a recovery of the total exports. Consequently, an annual surge of 18% in dollar income is projected for the sales abroad of this country's goods.

Meanwhile, it is estimated that, in dollars, imports by the country could grow approximately 19%. This would be associated not only with the investment projects for the oil sector but also those for the infrastructure in public works. This trend in imports is consistent with the most probable scenarios for the growth of the Colombian economy mentioned in the first section of this chapter.

As a consequence and keeping in mind the size of the US recovery and its possible effects on worldwide growth and the international prices of

commodities, the projection for the balance of payments in 2010 shows a widening of the deficit in the current account with respect to that which was calculated for 2009. According to the analysis, the deficit in the current account that is projected for 2010 will reach a value of US\$6.963 m, which is equivalent to 2.4% of the GDP. This result could be explained mainly by the larger outlays in factor income, which will go from -US\$9.503 m (-4.1% of the GDP) in 2009 to -US\$9.990 m (-3.5% of the GDP) in 2010 due to more profits being remitted by the companies in the mining sector to their headquarters. This takes into account the better international prices for the export products. In the case of the income from the current transfers, a reduction of around 8.5% is projected. This is primarily in the component of workers' remittances as a result of the trend of the economic conditions in Spain and Venezuela, both of which have Colombian immigrants (Table 14).

Table 14
Forecast of Colombia's Balance of Payments

	Millions of dollars				Percentage of GDP ^{d/}			
	2007	2008	2009 (pr)	2010 (proj)	2007	2008	2009 (pr)	2010 (proj)
I. Current account	(5,965)	(6,901)	(5,033)	(6,963)	(2.9)	(2.8)	(2.1)	(2.4)
A. Non-factor goods and services	(3,191)	(2,080)	(148)	(1,138)	(1.5)	(0.9)	(0.1)	(0.4)
1. Goods	(584)	971	2,546	2,028	(0.3)	0.4	1.1	0.7
2. Non-factor services	(2,607)	(3,051)	(2,694)	(3,166)	(1.3)	(1.3)	(1.1)	(1.1)
B. Factor income	(8,002)	(10,333)	(9,503)	(9,990)	(3.9)	(4.3)	(4.1)	(3.5)
C. Transfers	5,228	5,512	4,619	4,165	2.5	2.3	2.0	1.5
II. Capital and financial account	10,347	9,492	6,480	8,424	5.0	3.9	2.8	3.0
A. Private sector: net direct investment and other capital flows ^{a/}	8,128	9,155	2,846	4,323	3.9	3.8	1.2	1.5
B. Public sector ^{b/}	2,218	337	3,633	4,101	1.1	0.1	1.6	1.4
III. Errors and omissions	316	31	(100)	244	0.2	0.0	(0.0)	0.1
IV. Variation in gross international reserves ^{c/}	4,698	2,623	1,347	1,705	2.3	1.1	0.6	0.6

(pr) preliminary.

(proj) projected.

a/ Includes net flows of FDI, 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).

d/ The real growth of the GDP for 2010 is an estimate done by the Banco de la Republica.

Source: Banco de la Republica.

The trade balance of goods in 2010 will continue to be positive with respect to what was registered in 2009. In contrast, it should be mentioned that based on the projection, the deficit in the current account will be largely financed by resources from the net FDI, which will reach a value that is equivalent to 1.9% of the GDP.⁴⁸ This level will be higher than that registered in 2009 given the lower investments of Colombians abroad.

The projection for 2010 includes foreign financing on the part of the public sector (excluding Ecopetrol) that is higher than what was seen in 2009. This will result from US\$4.100 m in net foreign loan transactions. Last of all, the annual projection for the change in the country's gross international reserves in 2010 includes the financial yield as well as the US\$1.600 m in daily purchases of foreign currency by Banco de la República.

4. Indicators of Foreign Vulnerability

Banco de la República's strategy of accumulating international reserves recognizes the importance of having an adequate level of international liquidity to be able to face possible outflows of capital from the country. These could be provoked by factors such as the deterioration in the terms of trade, financial panics or financing crises in neighboring countries. In that context, maintaining a suitable level of international reserves serves to improve confidence in the country and, therefore, to be better prepared to face a crisis in markets abroad.⁴⁹

In order to determine whether or not the international reserves of a country are enough to prevent and resist external shocks, various indicators of vulnerability are used. Among them are included: i) the ratio between the international reserves and monetary aggregates and ii) the ratio between the reserves and the payment of the debt for the next 12 months. Comparing the reserves with the monetary aggregates such as M2 or M3, an effort is made to establish the ability of the economy to respond to capital outflows caused by a speculative attack. Meanwhile, the ratio of the reserves indicator to the repayments on the total foreign debt plus the deficit in the current account indicates the country's ability to handle the obligation they have to the rest of the world to pay off their loans in an extreme scenario in which they are completely cut off from international financing. In general, the international markets think that low

48 This takes into account around US\$8.200 m in 2010 (2.9% of the GDP), resources that come from foreign investors and that will be received primarily by the oil, mining and quarrying sector, etc.

49 It should be mentioned that on May 7, 2010, the IMF approved the renewal of Colombia's access to a flexible credit line (FCL) for approximately US\$3.500 m for a year. These resources will be in addition to the country's accumulation of international reserves and will be useful for facing a substantial deterioration in foreign conditions in the face of a possible extension of the international financial crisis.

values for these indicators could be warning signs of the foreign vulnerability of an economy.

Table 15 shows the changes in the different indicators for net international reserves during the 2004-2010 period in the case of Colombia. The indicators for groups A and B were above one, the level suggested by the IMF in the study done in the *World Economic Outlook*, Sept., 2003 (pgs. 65-105). It can also be seen that all of the indicators for these groups have shown a substantial improvement over the period. At the same time, the ratios for group C have remained stable and are at acceptable levels. In particular, the ratio of net reserves to imports of goods, one of the measures that is used the most, is estimated at 8.6 months.

Table 15
International Reserves Indicators for Colombia

	2004	2005	2006	2007	2008	2009 (pr)	2010 (proj)
Balance							
Net international reserves (NIR) (millions of dollars) ^{a/b/}	13,536	14,947	15,436	20,949	24,030	25,356	26,860
Indicators							
A. Foreign debt repayment indicator							
Foreign debt repayment (millions of dollars)	8,688	13,068	13,189	10,237	10,369	11,412	10,541
Net reserves/repayments of foreign debt in the current year	1.6	1.1	1.2	2.0	2.3	2.2	2.5
Net reserves/repayments of foreign debt in the coming year	1.0	1.1	1.5	2.0	2.1	2.4	2.7
B. Suitable external liquidity position							
NIR/servicing the debt, current year	1.2	0.9	1.0	1.6	1.8	1.7	1.9
NIR/servicing the debt, coming year	0.8	0.9	1.2	1.5	1.7	1.8	2.0
NIR/(payments on the debt in the current year + current year current account deficit)	1.4	1.0	1.0	1.3	1.4	1.5	1.5
NIR/(payments on the debt in the coming year + coming year current account deficit)	0.9	0.9	1.0	1.2	1.5	1.4	1.7
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	21.9
NIR/GDP (percentage) ^{e/}	11.6	10.2	9.5	10.1	9.9	10.8	9.4

(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 FLAR.

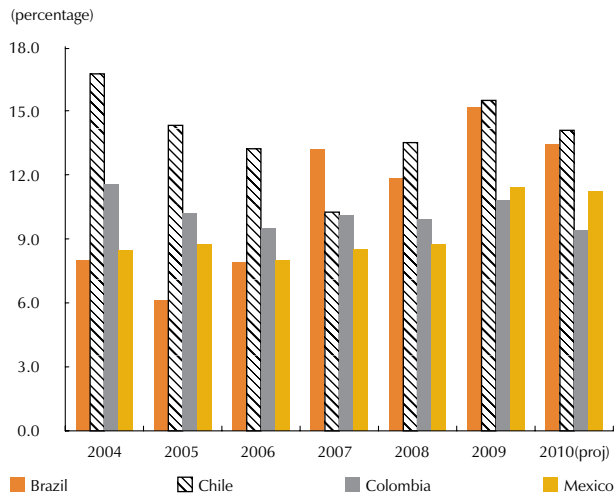
c/ The value of imports of goods corresponds to that projected for 2010.

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 Republica calculations.

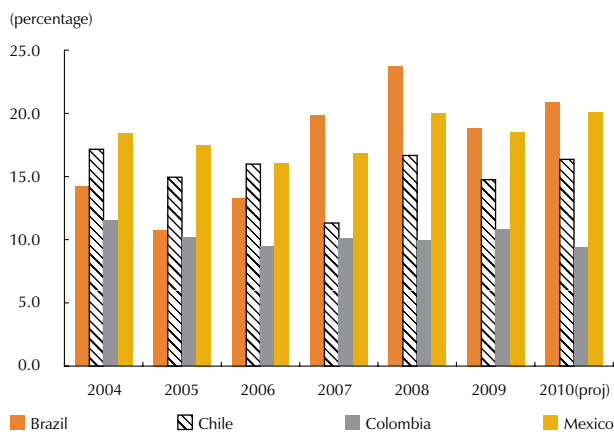
Graph 78
International Reserves / GDP



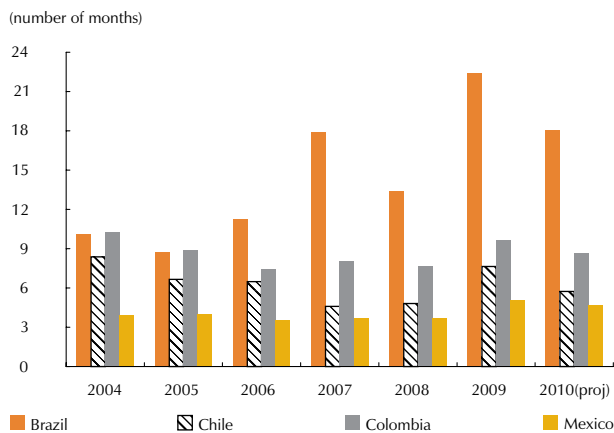
(proj): projected.
Sources: Central banks of the countries, the Economist Intelligence Unit and Banco de la Republica.

Graph 79

A. International Reserves / M3



B. International Reserves as Months of Goods Imports



Sources: Central banks of the countries, The Economist Intelligence Unit and Banco de la Republica.

When the various indicators of Colombia's international liquidity are compared to those of other countries in the region,⁵⁰ it can be seen that the ratio of reserves to the GDP is at levels that are close to those registered by Mexico and below those of Chile and Brazil (Graph 78).

In the case of the ratio of the reserves indicator to M3, Colombia is showing levels that are lower than those of Brazil, Chile and Mexico. With respect to the reserves measured in months of imports of goods, these show that Colombia is in a position that is relatively better than that of Chile and Mexico and lower than Brazil's (Graph 79).

In the ratios of the international reserves to debt repayment and servicing the debt, Colombia has higher levels than Chile and Mexico, but lower than Brazil. With regards to the indicator for the deficit in the current account plus the debt repayment for 2009, Colombia registered a position that was relatively lower than that of Mexico and Brazil and above that of Chile. In 2010, it is estimated that Colombia will have levels that are above those of Chile, Mexico and Brazil (Graph 80).

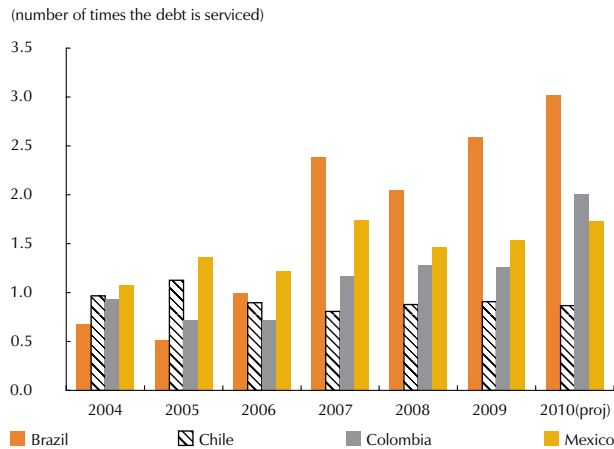
F. FISCAL POLICY

The target for the consolidated public sector (SPC in Spanish) fiscal deficit was fixed at 3.6% of the GDP for 2010 according to the MFMP presented by Congress in June. This target assumes an imbalance of 4.4% of the GDP in the national government (NG) operations and a surplus of 0.7% of the GDP in the finances of the decentralized sector. Likewise, Fogafin's cash profits were estimated to be 0.2% of the GDP and the costs of financial restructuring to be 0.1% of the GDP. With respect to the consolidated target that was announced at the beginning of the year (3.7% of the GDP), a slight adjustment can be seen in the figure that basically reflects the

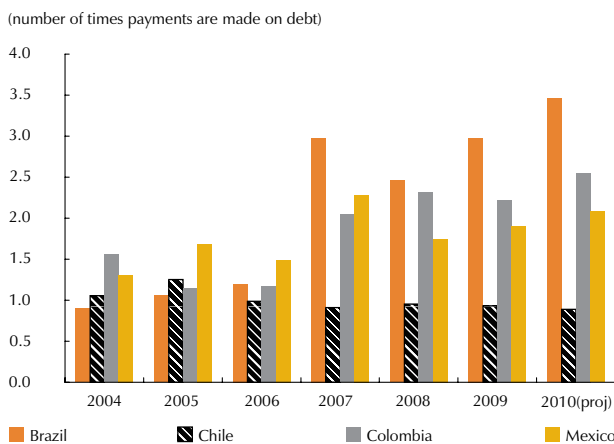
50 The case of Peru is not included in the indicators of international liquidity due to the fact that the local banks can take deposits in dollars and the reserve requirement on those deposits is put on the books as international reserves.

Graph 80

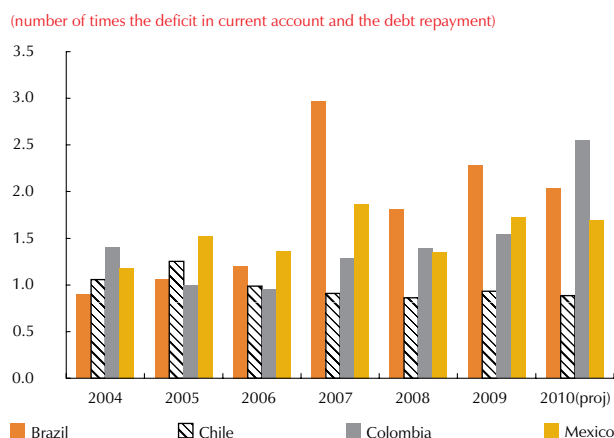
A. International Reserves / Servicing the Debt



B. International Reserves / Debt Repayment



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



(proj) projected.
Sources: Central banks of the countries, The Economist Intelligence Unit and Banco de la Republica.

change from 2.5% to 3.0% in the forecast of annual economic growth (Table 16).

As was stated in the Board of Directors' report for March, the fiscal policy for 2010 was designed on the basis of a recovery period for the Colombian economy. The international crisis that has been observed since the end of 2008 significantly affected the performance of tax revenue in 2009 and led the government to adopt an active fiscal posture by preserving the level of expenditure and redirecting public investment to projects with a high economic impact. This posture was adopted as a temporary measure in order to allow improvement in the fiscal indicators once the economy started recovering as, in fact, has been seen so far in 2010.

In the context of an economic recovery, the national government believes that the target for the consolidated fiscal deficit reflects a prudent position. An imbalance that is higher than what has been anticipated could jeopardize credibility in the government's fiscal management, and it would demand that more resources for financing be acquired as well limiting the possibilities for the recovery of the private sector. It is important to keep in mind the fact that in 2010, the revenue from income tax will drop as a result of the economic crisis and its impact on the balance sheets of the major taxpayers in 2009.⁵¹ Likewise, the fall in the international price for oil which occurred in 2009 will reduce Ecopetrol's profits and, with them, the dividends that the company will transfer to the government this year.

To prevent the slump in some of the fiscal revenue from turning into a major imbalance in public finances, the national government made the decision at the beginning of the year to postpone expenditures of COL\$5.900 b. This decision does not jeopardize the continuation of the most important programs and projects and takes into account the fact that the regions and some public companies will put into

51 It must be remembered that the declaration and payment of income tax in 2010 will be done on the income received in 2009.

Table 16
Consolidated Public Sector
Fiscal Balance 2009 and 2010

Item	Billions of pesos		Percentage del PIB	
	2009	2010 (proj)	2009	2010 (proj)
A. Total non-financial public sector (SPNF in Spanish) (1 + 2)	(12,865)	(19,412)	(2.6)	(3.7)
1. National government	(20,715)	(23,250)	(4.2)	(4.4)
2. Decentralized sector subtotal ^{a/}	7,850	3,838	1.6	0.7
Electric	51	183	0.0	0.0
Emcali	46	(110)	0.0	0.0
EPM	(512)	(282)	(0.1)	(0.1)
FAEP	(1,024)	(425)	(0.2)	(0.1)
Other entities	2,060	(608)	0.4	(0.1)
Social security	6,451	4,724	1.3	0.9
Regional and local	779	356	0.2	0.1
B. Quasi-fiscal Balance of the Banco de la Republica	599	(329)	0.1	(0.1)
C. Fogafin Balance	926	927	0.2	0.2
D. Costs of financial restructuring ^{a/}	(1,117)	(459)	(0.2)	(0.1)
E. Adjustments	(1,236)	0	(0.2)	0.0
F. Total consolidated public sector (A + B + C + D + E)	(13,694)	(19,273)	(2.8)	(3.6)

(proj) projected.

^{a/} This corresponds to interest payments, debt repayments and indexing associated with the financial crisis at the end of the nineties which were assumed by the NG.

Note: Deficit (-) or surplus (+).

Source: Ministry of the Treasury and Public Debt.

effect substantial investment budgets which will prevent a drop in the gross formation of public capital.

According to the MFMP figures, the NG finances will see a reduction of 3.7% in revenue and of 0.3% in expenditures. The fall in income is the consequence of a lower collection of income tax (5.7%) and a reduction in the financial surpluses of the companies (38.9%) especially those from Ecopetrol. These two sources of public resources, as has been noted, were affected by the slowdown in economic activity in 2009 and by the decline in the international price for petroleum. Unlike income tax, domestic VAT and the levy on financial movements will show rises of 10.8% and 8.6% respectively. The trend of these taxes reflects the economic recovery that is expected for 2010. It is worth noting that the last transfer of resources, US\$187 m, from the Oil Savings and Stabilization Fund (FAEP in Spanish) to the government will be made in 2010 (Table 17).

The NG expenditures will show a rise of 4.5% in interest and a reduction of 0.3% in operating costs. While the personal services will grow 7.8% and overhead expenses, 10.8%, transfers will grow 2.6%. The shrinking of this last expenditure item is a result of the fact that the subsidy for fuel consumption in 2010 will not be charged to the national budget but, to the degree it is generated, it will be covered by the resources in

Table 17
National Government
Fiscal Balance, 2009 and 2010
(billions of pesos)

	2009	2010 (proj)	Growth 2009-2010
I. Total revenue (A + B + C + D + E)	77,156	74,306	(3.7)
A. Tax revenue	65,196	66,079	1.4
Income	28,116	26,512	(5.7)
Domestic VAT	17,609	19,503	10.8
External VAT	8,301	8,849	6.6
Duty	4,001	4,265	6.6
Stamp	612	90	(85.3)
Gasoline	1,291	1,335	3.4
Financial transaction tax	3,121	3,390	8.6
Wealth	2,023	2,022	(0.1)
Others	121	113	(6.5)
B. Non-tax	463	408	(11.8)
C. Special Funds	1,061	1,332	25.5
D. Capital resources	10,418	6,470	(37.9)
Financial yields	758	527	(30.5)
Financial surplus	8,568	5,236	(38.9)
Other	1,092	708	(35.2)
E. Accrued earnings ^{a/}	17	17	(0.0)
II. Total Expenditures (A + B + C + D + E)	97,871	97,556	(0.3)
A. Interest	14,583	15,241	4.5
Foreign	3,846	3,913	1.7
Domestic	10,737	11,328	5.5
B. Operating expenses	71,010	70,827	(0.3)
Personal services	10,862	11,712	7.8
General overhead	3,901	4,322	10.8
Transfers	56,247	54,792	(2.6)
C. Investment	11,536	10,066	(12.7)
D. Net loan	176	277	57.1
E. Accrued payments ^{a/}	567	1,145	102.2
III. Deficit (-) or surplus (+) (I-II) ^{b/}	(20,716)	(23,250)	12.2
Cost of financial restructuring ^{c/}	1,117	459	(58.9)
IV. Financing (A + B + C + D + E)	21,832	23,709	8.6
A. Net foreign credit	9,242	3,064	(66.8)
Disbursements	11,925	6,321	(47.0)
Repayments	2,683	3,257	21.4

Table 17 (continued)
National Government
Fiscal Balance, 2009 and 2010
(billions of pesos)

	2009	2010 (proy)	Growth 2009-2010
B. Net domestic credit	11,539	16,023	38.9
Disbursements	32,545	37,301	14.6
Repayments	21,006	21,277	1.3
C. Banco de la Republica earnings	819	0	(100.0)
D. Privatization	923	531	(42.5)
E. Other	(690)	4,090	(692.9)
V. Deficit as a percentage of the GDP ^{b/}	(4.2)	(4.4)	

(proj) projected

a/ Excluding the change in the budgetary reserves

b/ Excluding the cost of financial restructuring

c/ This corresponds to interest payments, debt repayments and indexing associated with the financial crisis at the end of the nineties, which were assumed by the NG.

Source: Ministry of the Treasury and Public Credit

the Stabilization Fund for Petroleum Derived Fuel Prices (FEPC). The General System of Resource Allocation (SGP in Spanish) was assigned COL\$22.810 b with a growth of 5.9% and COL\$21.980 b for pensions of which COL\$6.940 b were transferred to the Institute for Social Security (ISS) to make up what was lacking in the obligations to retirees in the pay-as-you-go regime. It should be pointed out that the transfer of resources to the ISS was adjusted by close to COL\$1.000 b with respect to the initial projection for the transfer of affiliates from private funds to this institute. Finally, the investment payments will show a 12.7% drop due to the lower expenditures in military equipment and the postponement of some appropriations.

The NG deficit, including the financial restructuring costs will reach COL\$23.709 b, which is 4.4% of the GDP. With respect to the Board of Director's report in March, a change in the composition of the financing can be seen due to the delay in the process of privatizing some regional electric companies and the government elect's decision to suspend the transfer of ownership of Isagen. The resources derived from these transactions that would have come to COL\$4.000 b will be replaced by more foreign loans (COL\$2.000 b) and the issuing of domestic debt securities (COL\$2.000 b).

Keeping the above described adjustments in mind, the financing of the deficit will fall on the loan resources and the use of the cash that the General Office of Public Credit and the National Treasury (TGN) have available. Net foreign loans will reach COL\$3.064 b with disbursements of COL\$6.321 b and debt repayments of COL\$3.257 b. Net domestic financing, in turn, will come to COL\$16.023 b as the result of disbursements of COL\$37.301 b compared to debt repayments of COL\$21.277 b. The placing of TES B are estimated at COL\$27.500 b of which COL\$15.000 b correspond to auctions, COL\$4.990

b to contracted transactions and COL\$7.500 b to forced investments. In order to improve the features of the debt repayments, the government implemented a swap transaction of COL\$1.145 b in April on securities with maturities in September and November.

With respect to the decentralized public sector, the official projections show a surplus of 0.7% of the GDP. This is coming from the territorial entities and the social security sector which includes some public pension funds that have been accumulating surpluses in the last few years.⁵² With respect to 2009, a reduction in the decentralized sector's surplus is seen which is due, in large part, to the deterioration in the areas of health and pensions and to the deficits in some state companies and funds. Among these, the FAEP and FEPC must be emphasized. The fiscal imbalance in the area of health is related to the larger transfers from the Health Solidarity and Guarantee Fund (Fosyga in Spanish) to provide for the services and medications that are excluded from the obligatory health plan (POS in Spanish).

It should be noted that at the end of the first quarter of 2010, the SPC had accumulated a fiscal surplus of COL\$281 b, which represents 0.1% of the GDP. This result can be attributed to the national government's operations and, in particular, to the performance of revenue, which has benefitted from the domestic economic recovery seen in the first part of the year. For the remainder of 2010, the fiscal situation will turn negative especially because of the lagged impact of the crisis on the income tax collection and the dividends from Ecopetrol.

Finally, it is important to highlight the fact that at the beginning of July, the national government presented a proposal to adopt a fiscal rule in Colombia which was drawn up by an inter-institutional committee made up of experts from the Ministry of the Treasury, the Banco de la República and the DNP. The committee had the support of a group of external consultants convened by the government. The adoption of this instrument for fiscal management favors fiscal discipline, ensures the sustainability of the public debt in the medium term and makes it possible to carry through with a counter-cyclical fiscal policy.

52 Among these funds, the National Pension Fund for Territorial Entities (Fonpet), the Guaranteed Private Minimum Pension Fund and the Ecopetrol autonomous equity should be emphasized.

FISCAL RULE FOR COLOMBIA

The fiscal rule proposal that was made by the Minister of the Treasury last July 7th is a very important initiative for the country's economic policy since, if it should become part of the law of the country, it would commit the national government to a new outline for a fiscal policy that would ensure the sustainability of the public finances. Thus, the fiscal rule complements the recent legislative act introduced in Congress. By means of this, fiscal sustainability would be given the imprimatur of the collective rights of society.

The fiscal rule proposal establishes a target primary balance for the national government finances by means of which it will be able to progressively reduce the debt from the level of 39.4% of the GDP projected for 2010 to one of 28.4% in 2020. To do so it requires the government to reach a primary surplus of 1.3% of the GDP per year on average over the course of the next decade.

The exclusive application of the rule over NG operations is considered appropriate if it is taken into account that the NG imbalance is the cause of the fiscal imbalance in the non-financial public sector (SPNF in Spanish) and that the government debt currently represents about 87% of the total public debt is kept in mind, the rule's exclusive application to them is considered adequate. It is also worth remembering that territorial entities already have the appropriate laws, which have allowed them to reform and balance their finances as well as keeping control of the growth of their expenditures.

In addition, the choice of primary balance as the indicator to which the quantitative rule will be applied is also appropriate. When we consider the fact that interest payments on the debt are excluded, this is a measure that is relatively easier for the fiscal authority to control than the total balance. In fact, the primary balance is less exposed to interest rates or exchange rate shocks. Thus, it is an indicator that has a more stable relationship with income and expense decisions and with the proposed fiscal goal.

The formula for the fiscal rule that the government is proposing makes the fiscal goal and the policy decisions independent of cyclical movements in the economy, especially of output and petroleum revenue. Therefore, the rule is structural in nature. This is an important characteristic because it means that the fiscal balance that the authorities should comply with depends exclusively on their own decisions or unexpected and transitory changes in the economy that affect their finances.

Based on its design, the rule allows leeway for a counter-cyclical fiscal policy such that the fiscal authority will save during booms and spend in recessions. This will allow for a better coordination between the fiscal and monetary policies possible since during economic expansions or bonanzas in a specific sector, the rule encourages a tightening fiscal policy thus supporting the monetary authority's efforts towards stabilization through the increase in interest rates. In contrast, during recessions the rule allows for an expansionary fiscal policy which will help monetary policy to stimulate the economy through lower interest rates.

The rule also makes a suitable macroeconomic management of the potential surpluses generated by the petroleum sector possible since these should be saved when they exceed a certain threshold (by means of a lower debt or a savings fund) and can be pulled out of savings when the opposite is the case. This would allow undesirable macroeconomic effects that could occur to be cushioned if a sharp appreciation of the exchange rate were produced in view of the predicted expansion of energy-related mining.

The fiscal rule would make it possible to overcome various limitations of the Medium Term Fiscal Framework (MFMP in Spanish). For one thing, in the design of the MFMP the fiscal authorities have full discretion to fix a target for the primary balance for SPNF year after year. Failing to comply with this does not entail any type of correction for the future. With respect to that, the MFMP goals have been adjusted repeatedly in the past whether due to events that were temporary in nature or for other reasons. They have even been adjusted within the same fiscal year, which relaxes their initial commitment and affects the credibility of the policy.

In addition, even if the MFMP establishes a path that indicates the primary balance for the SPNF that the fiscal policy should invoke, the law does not establish a commitment to fix a primary surplus target for the national government, which is where the largest imbalance in Colombia's public finances is. In some fashion, this has led to diagnostics based on the consolidated results of balance and net debt not fully revealing the sources of fiscal vulnerability and, therefore, additional efforts to make adjustments in the central administration accounts have been postponed.

However, even if the MFMP invokes a standard methodology that makes it possible to define the path

for the required primary balance for the sustainability of the country's debt, it does not define the variables of the balance sheet nor other relevant parameters in the analysis of sustainability. Act 819, 2003 which created the MFMP did not include aspects that are important for accountability nor procedures for returning to the paths of programed surplus and debt either. Nor did it include escape clauses for exceptional situations that affect public finances. All of these are aspects that the fiscal rule proposal will be able to correct.

Finally, there is no warning in the MFMP of the need to adjust the goals that indicate a primary surplus for the SPNE given the influence that the economic cycle and the prices for petroleum abroad have. With respect to that it is necessary to remember that the high points of the cycle are associated with larger tax collections for the Treasury and better results in the primary balance and the debt. The opposite usually occurs in recession phases. As a consequence, since a fraction of the fiscal balance is

a result of the economic cycle, it is necessary to use an indicator that takes it into account to guide fiscal policy. The cyclically adjusted fiscal balance that is proposed by the fiscal rule fulfills this purpose and, therefore, it has the virtue of guiding fiscal policy counter-cyclically.

When the fiscal rule becomes an anchor for fiscal policy and reduces its discretionary application, it will reduce the uncertainty in the markets. This will raise the consistency of agent decisions over time and increase the credibility of the proposed goals. As a result, lower risk premiums and better conditions in the local and international financial markets can be expected. The benefit for society will be shown in lower costs for using capital, lower macroeconomic volatility and, in general, a better environment for investment. All of this will favor long term economic growth. The fiscal rule may possibly allow Colombia to recover its investment grade rating.

G. PERFORMANCE OF THE REGIONAL ECONOMY IN COLOMBIA

An analysis of the regional economies is being included in this report for the first time as the result of the effort made by the Coordinating Committee for the Economic Studies of the Branch Offices and seven Regional Centers (CREE) of the Banco de la República, which are in charge of periodic follow up on local economies. This chapter will continue to be developed and improved over the next few reports.

As was explained in the previous report to Congress, the performance of the Colombian economy in 2009 was characterized by a slowdown in the pace of economic growth which was associated with the foreign crisis. This led to high levels of unemployment, informality and under-employment. The low inflation and the timely economic measures taken by the monetary and fiscal authorities succeeded in alleviating the effects of the slowdown. This was reflected in the recovery seen since the fourth quarter of 2009.

The regional environment in 2009 was characterized by divergent trends. Thus, while some regions saw a positive performance in terms of economic activity, employment and prices, that of others was barely satisfactory. The results generally depend on the productive structure of each region and how each was impacted by the various shocks of both demand and supply. The inconsistent effects on the various regions are responses to variables such as: the degree of industrialization, the type of specialization and level of diversification in the regional industry, the use of banks, the net position of the financial

system and of foreign trade.⁵³ For example, industry and construction can be more sensitive to the economic cycle than other sectors such as mining and agriculture. Likewise, the most diversified regions tend to be less vulnerable to specific changes.

1. Distribution of the Colombia GDP by Regions⁵⁴

In the first part of Table 18, it can be seen that the share of the different regions in the national GDP in 2007 was, in the following order, Bogota (26.2%), the Northwest (15.2%), the Southwest (14.5%), the Caribbean (14.4%) and the Northeast (10.9%). The second part of the table shows the degree of diversification in the regional economies. On the national level, the sectors with the largest share correspond to non-financial services, industry, trade, construction and real estate, and agriculture. The high contribution of financial intermediation, trade and tourism in Bogota stands out as does the high dependence the Southeast region has on the agricultural and mining sectors. The high participation of agricultural activity in the Central area is also notable.

2. Regional Performance in 2009

The weakness in the market abroad in 2009 was unfavorable for the secondary sector of the economy and had negative repercussions on the most industrialized regions of the country such as Bogota, Antioquia, Valle and the Caribbean and, especially, on the departments in the area of the northeastern borders (the Santanders). Meanwhile, the positive performance of the services sector, especially those of financial brokerage and tourism drove the recovery of the economies in the coffee region, the Caribbean, the Southwest, Central, the Northeast and Antioquia. In contrast, the mining sector was the major recovery engine in the Southeast.

In order to evaluate the performance of the regional economies in 2009 and in view of the absence of regional GDP numbers, the changes in the main economic sectors, the trend of foreign trade, inflation and the labor market this year are described below.

53 Julio Romero P. (2010). "Transmisión regional de la política monetaria en Colombia" (Regional Transmission of monetary policy in Colombia), en: Jalil, M; Mahadeva, L. (eds.), *Mecanismos de transmisión de la política monetaria en Colombia* (Mechanisms for monetary policy transmission in Colombia), capítulo 14, Bogotá: Banco de la República y Universidad Externado de Colombia (en edición).

54 The regions are classified into: Bogota, Northwest (Antioquia and Choco), Southwest (Valle del Cauca, Nariño, Cauca and Putumayo), Caribbean (Bolívar, Atlántico, Magdalena, Cesar, Córdoba, Sucre, La Guajira and San Andrés y Providencia), Northeast (Santander, North Santander, Boyaca and Arauca), Central (Tolima, Huila, Cundinamarca and Caqueta), Southeast (Eastern plains and the Amazon) and the Coffee region (Caldas, Quindío and Risaralda).

Table 18
Percentage Distribution of the Colombian GDP (2007) a/ by Region and Aggregate Economic Activity (percentage)

Region by economic activity	Agricultural	Mining	Industry	Electricity, gas and water	Construction and real estate	Commerce, tourism and hotels	Transportation, communication and related areas	Financial brokerage	Non-financial services (social, health, education, etc.)	Taxes	Total
Bogotá	0.4	1.0	25.4	22.5	30.8	32.1	25.8	50.4	30.8	26.5	26.2
Northwest	15.0	7.0	18.4	19.8	18.2	15.7	13.6	14.7	13.4	14.9	15.2
Southwest	17.6	2.0	16.3	15.0	17.7	13.1	15.3	11.4	14.7	13.0	14.5
Caribbean	17.6	22.2	12.4	19.1	10.7	13.5	17.0	8.8	14.9	15.5	14.4
Northeast	15.3	10.8	11.5	7.8	10.2	10.3	10.9	5.9	9.2	15.4	10.9
Central	21.6	10.9	10.6	9.4	4.9	8.4	9.5	4.4	9.4	9.8	9.8
Southeast	6.1	45.3	1.2	1.4	3.0	3.0	2.9	1.3	2.8	1.2	4.6
Coffee region	6.5	0.9	4.2	5.0	4.4	3.9	4.9	3.0	4.7	3.7	4.3
National total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Region by economic activity	Agricultural	Mining	Industry	Electricity, gas and water	Construction and real estate	Commerce, tourism and hotels	Transportation, communication and related areas	Financial brokerage	Non-financial services (social, health, education, etc.)	Taxes	Total
Bogotá	0.1	0.2	14.4	2.2	14.4	15.0	8.0	9.5	27.4	8.8	100.0
Northwest	8.4	2.1	17.9	3.3	14.6	12.6	7.2	4.8	20.6	8.5	100.0
Southwest	10.3	0.6	16.6	2.6	14.9	11.0	8.5	3.9	23.7	7.8	100.0
Caribbean	10.3	7.0	12.8	3.4	9.0	11.5	9.6	3.0	24.1	9.3	100.0
Northeast	11.9	4.5	15.7	1.8	11.5	11.6	8.1	2.7	19.8	12.3	100.0
Central	18.7	5.1	16.1	2.4	6.2	10.5	7.9	2.2	22.4	8.7	100.0
Southeast	11.2	44.9	4.0	0.8	8.0	7.9	5.2	1.4	14.4	2.2	100.0
Coffee region	12.6	0.9	14.5	2.9	12.5	11.1	9.2	3.4	25.3	7.5	100.0
National total	8.5	4.6	14.8	2.5	12.2	12.2	8.1	5.0	23.3	8.7	100.0

a/ Most recent available information from DANE.

Source: DANE (department accounts from 2007 (preliminary) at constant 2000 prices), Banco de la Republica calculations.

a. *Agricultural sector*⁵⁵

In 2009 the agricultural-fishing sector had 6.8% of the national GDP. According to the national agricultural-fishing survey (ENA in Spanish) done by the International Colombian Corporation (ICC) the agricultural sector represented

55 The analysis of the agricultural-fishing sector was mainly based on the results of the National Agricultural Survey (ENA) done by the International Colombian Corporation (ICC) of the Ministry of Agriculture and Rural Development with figures as of 2009 as well as on the data from the National Federation of Coffee-growers (FNC).

7% of the total cultivatable area⁵⁶ while the fishing sector occupied 77%. The remaining percentage was allocated to forest or areas for other uses such as infrastructure and housing. During the year there were no significant changes in the distribution of the use of the land with respect to the previous year.

Permanent crops⁵⁷ take up 60% of the productive agricultural area and this grew 1% in comparison to last year. Temporary crops,⁵⁸ in turn, covered 38% of the area, which is 1% less of the area farmed in relation to 2008. The remaining 2% corresponded to areas that are lying fallow.

Among the permanent crop, it is worth highlighting, the growth of the sown area of African palms in the Caribbean, Eastern plains and Northeast (the Santanders) regions where there was an average annual rise of 8.5% was registered there. The production of bananas in tons for domestic consumption experienced a recovery of more than 30% due to the meteorological conditions favorable for agriculture that have occurred in the different banana-growing areas of the country. In contrast, the annual production of coffee declined between 22% and 32% according to the statistics reported by different sources such as the ENA and the National Federation of Coffee-growers (FNC in Spanish) respectively (Table 19). According to the ENA, this contraction was general and the largest drops were in the Central zone (Tolima, Huila and Cundinamarca) and the Coffee region. The FNC, in turn, has pointed out that the low coffee harvest of some areas was associated with the crop renovation programs, the climate, the limited fertilization and infestation by rust and coffee berry borer.

Among the temporary crops (Table 19), rice registered a mixed performance in the regions that provide 80% of the total production. Thus, while the Central zone reported a 2.3% rise, the Eastern plains showed a 3.7% reduction.⁵⁹ There was a reported annual increase of 17.3% in yucca production given the large supply in the Caribbean region (Cordoba), the Eastern plains and the Northeast (the Santanders). Among the crops that saw declines in production are corn and potatoes. The first fell 14.8% as the consequence of a reduction of approximately 30% in the Caribbean and one that was lower in proportion in the Southwest and Northwest. In spite of the rise in the amount of land that was seeded with potatoes, its production dropped 4.2%. In fact, while

56 This area corresponds to 45% of the total national territory that can be cultivated and excludes those areas where there is no farming whether it is because they are water sectors, uncultivated land, urban zones or there are law and order problems.

57 The main permanent crops are: coffee, plantain, African palm, panela sugar cane, sugar cane, fruit trees, etc. They characteristically have a long cycle with their maximum production capacity generally starting after three years.

58 The main temporary or short cycle crops are rice, yucca, corn, potatoes, sorghum, wheat, beans and cotton, etc.

59 There are other sources of information that differ from some of the figures reported by the ENA based on different measurement methodologies.

Table 19
Agricultural production by regions of Colombia ^{a/}
(thousands of tons)

Permanent crops ^{b/}												
	Panela sugar cane		Plantain		Coffee		Bananas for domestic consumption		Others		Total	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Northeast	3,576	3,218	101	150	61	52	21	23	263	305	4,021	3,748
Central	1,951	2,058	173	168	162	109	63	57	244	296	2,592	2,687
Northwest	1,852	1,553	499	403	111	86	16	26	113	118	2,591	2,187
Southwest	1,120	873	240	276	117	91	26	63	424	392	1,926	1,695
Coffee region	329	420	412	484	155	121	19	53	221	293	1,136	1,372
Eastern plains	0	0	181	233	2	0	0	0	234	140	417	373
Caribbean	132	0	261	189	12	18	31	0	232	73	668	280
Other departments	101	664	346	346	1	3	7	19	173	270	628	1,302
National total	9,059	8,786	2,213	2,247	620	481	183	242	1,904	1,887	13,979	13,644

Temporary crops												
	Rice		Yucca		Corn		Potato		Others		Total	
	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008	2009
Northeast	156	183	78	120	88	76	675	764	800	780	1,798	1,922
Central	1,216	1,244	36	44	258	281	1,052	864	426	575	2,988	3,008
Northwest	9	5	19	37	45	20	108	83	133	79	313	223
Southwest	15	0	47	46	266	255	536	560	339	308	1,204	1,170
Coffee region	0	0	36	41	8	19	1	1	177	31	222	91
Eastern plains	1,165	1,121	213	319	31	31	0	0	87	63	1,495	1,534
Caribbean	520	280	736	800	664	474	1	1	132	61	2,054	1,616
Other departments	3	98	224	224	23	23	0	0	62	116	313	461
National total	3,084	2,932	1,389	1,629	1,384	1,179	2,373	2,273	2,157	2,013	10,386	10,026

a/ Northeast (Santander, North Santander and Boyaca), Central (Tolima, Huila and Cundinamarca), Northwest (Medellin), Southwest (Valle, Cauca and Nariño), Coffee region (Caldas, Pereira and Armenia), Southeast (Meta, Casanare and Vichada), Caribbean (Bolívar, Atlántico, Magdalena, Cesar, Córdoba, Sucre and La Guajira).

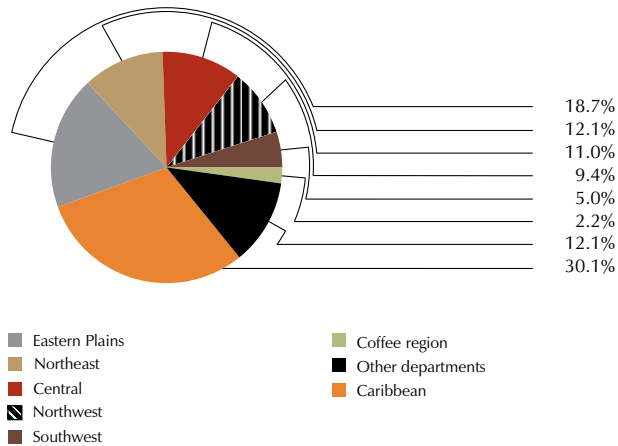
b/ Excluding figures for African palm, sugar cane and bananas for export.

Sources: (National agricultural survey, 2008-2009), International Colombian Corporation (ICC) and the Ministry of Agriculture and Rural Development (MADR in Spanish).

production grew 12.0% in Boyaca, there was a drop of 19.2% and 5.8% in Cundinamarca and Nariño respectively.

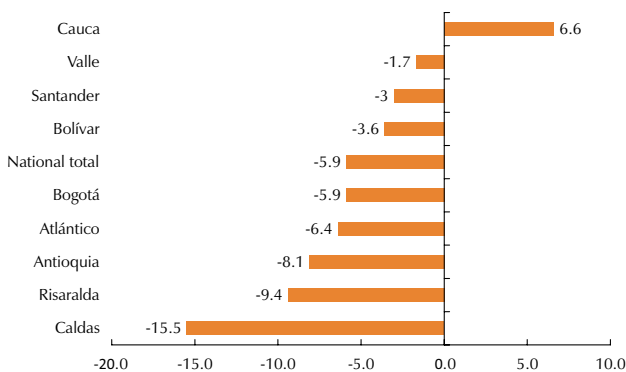
The ENA estimated a bovine population of 27,359,290 head in 2009 with an annual rate of growth of 1.8%. The main market for cattle raising was meat production with 69.5% followed by the double purpose market (meat and milk) with 28.3% and milk with 2.2%. With respect to the previous year, the number of cattle that were intended for meat production increased 5.5% with the Colombian Caribbean, which had close to a third of all the cattle

Graph 81
Percentage Distribution of the Bovine Population by
Regions in 2009



Sources: (National Agricultural Survey), International Colombian Corporation (ICC) and the Ministry of Agriculture and Rural Development, Banco de la Republica calculations.

Graph 82
Growth of Industrial Production by Department,
December, 2009
(annual percentage variation)



Source: ANDI.

in the country (Graph 81), showing the largest increase, 21.0%. The opposite trend was registered in the double purpose market which dropped 6.4% annually, a contraction that was experienced in the majority of the regions with the exception of the Eastern plains where it grew (28.4%).

b. Industrial sector

The overall effect of the international economic crisis and the slump in trade relationships with the neighboring countries generated an average annual tightening in 2009 of 5.7% in industrial production in spite of the recovery seen in the last two months. Industrial sales, according to the figures from the DANE monthly manufacturing survey (MMM in Spanish), have shown a negative average annual growth in real terms since mid-2008. This situation remained the same for the first half of 2009 and gradually began to reverse in the last few months of the year until it showed positive growth in the last few months.

According to the results of the joint industrial opinion survey (EOIC in Spanish) taken by the National Association of Industries (ANDI in Spanish), the largest reduction in industrial production for 2009 was in Caldas with 15.5%, Risaralda with 9.4% and Antioquia with 8.1%. These figures are below the national average (-5.9%) with Cauca being the only one with a positive balance at the close of the year (Graph 82).

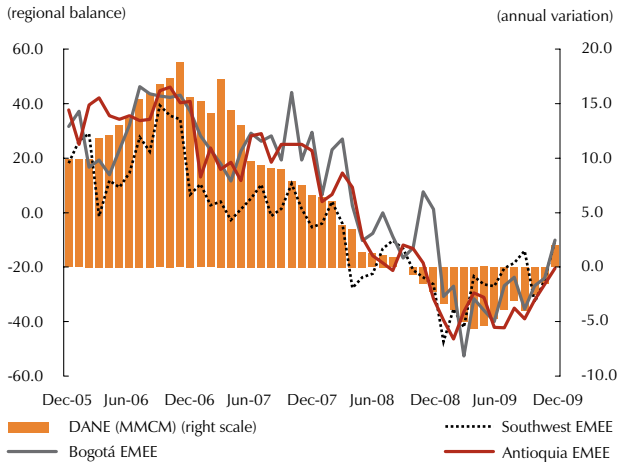
c. Commercial sector

On average, commerce registered a negative balance in 2009 based on the results of the EMEE⁶⁰ of Banco de la República. The sharpest deterioration in sales was in the Central zone and in Antioquia while the Caribbean region stood out due to the fact that it was the only region to register a positive balance (Graph 83).

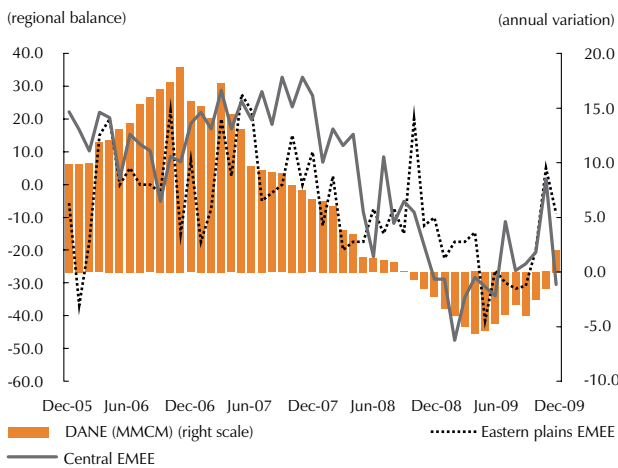
60 Banco de la República's monthly survey of economic expectations done by the National Consulting Center (CNC in Spanish).

Graph 83
Regional Balance of Real Sales vs. National Growth ^{a/}

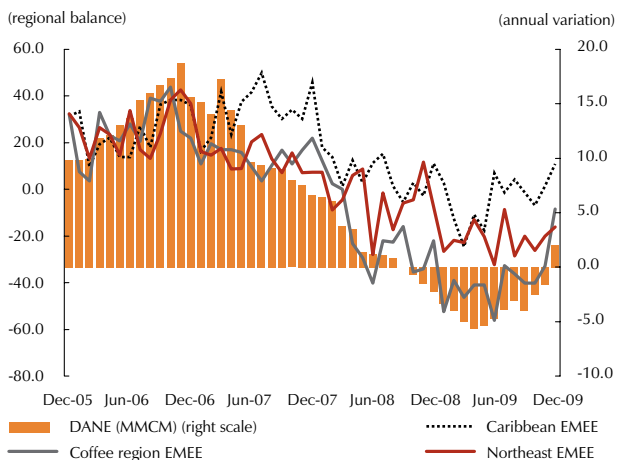
A.



B.



C.



a/ Balance: difference between the percentage of opinions regarding an annual increase in sales compared to those regarding an annual decline in sales for the month that is the point of reference. See <http://www.banrep.gov.co/informes-economicos/>. Sources: Banco de la Republica (EMEE) and DANE (MMCM).

These results are confirmed by those of the joint commercial opinion survey (EOC in Spanish) done by the National Merchants Federation (Fenalco in Spanish) for some of the capital cities. In addition, this survey found that the decline in sales in North Santander was due to the Venezuelan recession together with other border problems. In the Coffee region, the performance of sales was unsatisfactory and the rally seen in December was not enough to boost commercial activity.

At the same time, the sales of new vehicles registered an annual downswing of 15.7% in the national total. According to figures provided by Econometria, the worst performance was seen in Antioquia (-21.9%), the Southwest (-19.9%), the Coffee region (-18.5%) and Bogota (-16.5%); with some recovery in the majority of these regions in the last quarter of the year (Table 20).

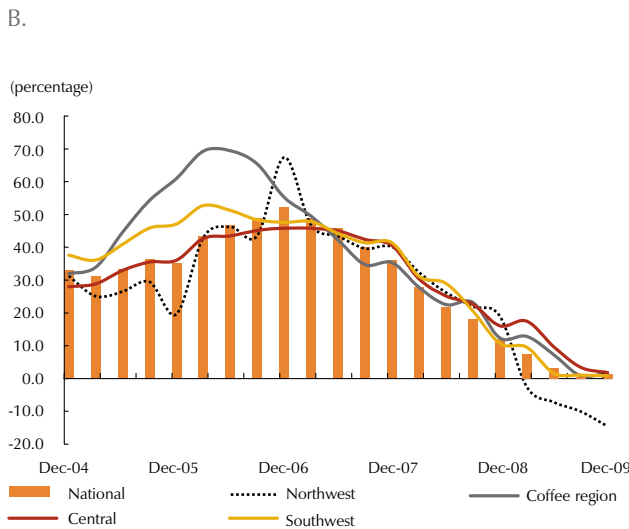
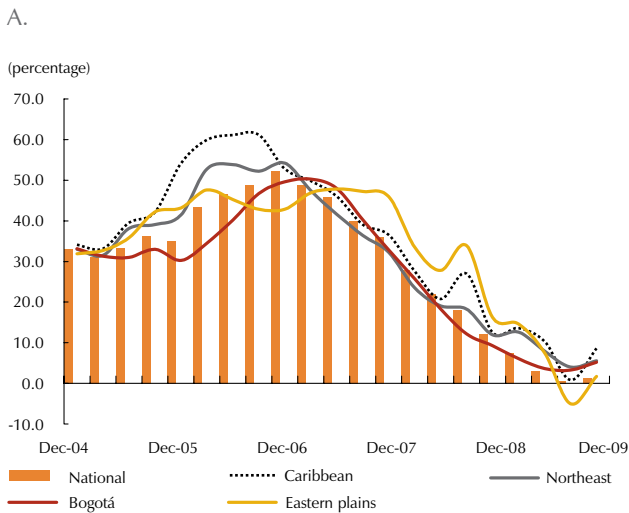
However, the growth of consumer credit reversed the falling trend that it had had since 2006 in the third quarter of 2009. This situation was seen in most regions except for Antioquia. At the end of the year the Caribbean, Northeast and Bogota recorded the largest growths with 8.6%, 5.6% and 5.2% respectively. In the Northwest (Antioquia and Choco) the downswing continued with an annual fall of 14.6% (Graph 84).

d. Tourism

The tourism sector in Colombia was one of the least affected by the worldwide economic crisis of 2009. However, the Hotel Association of Colombia (Cotelco) reported a hotel occupation rate of 51.2%, which was 3.4 pp lower than what was seen at the close of 2008. The Northeast and Bogota had the largest decline with 5.4% and 4.9% respectively.

According to the numbers from the Department of Civil Aviation (Aerocivil), air transportation for national and international passengers grew 13.1% and 6.3% respectively in 2009. The highest number

Graph 84
Annual Growth of the Consumer Loan Portfolio by Regions
(annual variation)



Source: Financial Superintendency, Banco de la Republica calculations.

of international travelers was seen in the Coffee region with an upswing of 28.5% followed by the Northwest (Medellin) with 25.9%. Other regions that had a positive balance were the Southwest with 9.9% and the Northeast (the Santander) with 8.2% (Table 21). With respect to national travel, all of the regions showed a satisfactory balance with the Caribbean leading the growth of the number of passengers arriving by air as a result of a rise of 16.5% compared to the year before. The Northeast, Southeast and Southwest also stood out.

e. Mining sector

In the last few years, mining has been gaining a larger share of the GDP and reached 6.6% in 2009. This growth has been driven by the improvement in the prices for commodities and the large inflow of investment the sector has received.

With respect to oil production, 671 thousand barrels a day (tbd) were pumped or, in other words, 14.1% more than the previous year. The Eastern plains region (Meta and Casanare) was the highest producing zone in the country (Graph 85), especially because of the boom in Meta where the surge compared to the previous year was 32.0%. The share that region has in the national total was 50.7% followed by the Northeast (Arauca, Santander, Boyaca and North Santander) with 27.5%, which is a distribution that is similar to what was seen in 2008. According to the reports

issued by the National Hydrocarbons Agency (ANH in Spanish), in spite of the positive production results, the royalties that were paid showed a slump of 23.9% in the national total.

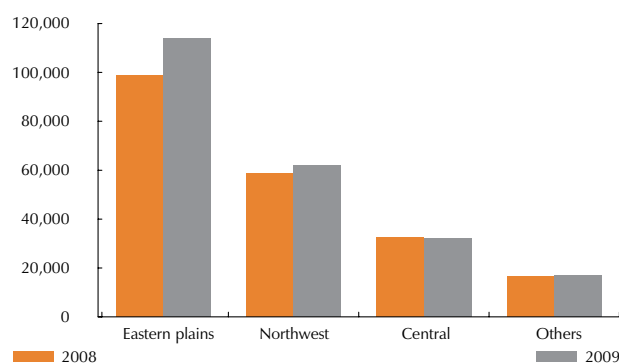
The Northwest region was notable for its boom in gold mining. According to Ingeominas figures, the departments of Antioquia and Choco provided 58.6% and 22.7% of the national production and had an annual growth of 7.8% and more than 200% respectively. Positive performance in commodities was also registered in the Caribbean, mainly coal in Cesar and La Guajira and ferronickel in Cordoba.

Table 20
Sales of Vehicles by Region ^{a/}
(units)

Region	2007		2008		2009	
	Units	Annual percentage variation	Units	Annual percentage variation	Units	Annual percentage variation
Northwest	39,046	28.0	30,478	(21.9)	23,796	(21.9)
Southwest	32,730	25.5	26,234	(19.8)	21,007	(19.9)
Coffee region	13,293	23.7	10,256	(22.8)	8,354	(18.5)
Bogota	122,298	29.4	104,522	(14.5)	87,290	(16.5)
Central	8,153	44.8	7,292	(10.6)	6,145	(15.7)
Caribbean	22,217	48.2	18,910	(14.9)	16,459	(13.0)
Southeast	3,154	87.5	3,268	3.6	2,719	(16.8)
Northeast	16,892	55.8	16,086	(4.8)	15,296	(4.9)
General total	253,034	27.7	219,498	(13.3)	185,128	(15.7)

a/ Northwest (Medellin), Southwest (Cali, Popayan and Pasto), Coffee region (Manizales, Armenia and Pereira), Bogota (Cundinamarca and Girardot), Central (Ibague and Neiva), Northeast (Bucaramanga, Cucuta and Tunja), Caribbean (Cartagena, Barranquilla, Santa Marta, Valledupar and Monteria), Southeast (Villavicencio).
Source: Econometría S.A.

Graph 85
Oil Production by Regions
(millions of barrels)



Source: Colombia Petroleum Company.

f. *Construction and real estate sector*

In 2009, the negative trend in the area of construction permits in the different regions around Colombia continued. In the last three months of the year, the Central region and Bogota registered average falls of 36.0% and 33.6% respectively. Nevertheless, signs of recovery were seen in the Northwest and Southwest where there were growths of 86.2% and 29.7% respectively at the end of 2009. The remainder of the regions had mixed results with rises and falls in the different quarters (Table 22).

With reference to employment, the recovery in the construction sector is the most notable. According to data from DANE (GEIH) there was a significant increase in the number of employees in Bogota, Barranquilla and Bucaramanga in the 2008-2009 period. However, Cali and Medellin and their metropolitan areas experienced the largest reductions during the period under analysis (Graph 86).

The momentum of the loan portfolio balances kept up a stable pace for the regions as a whole partly because of the subsidies for the mortgage interest rates. In annual terms, mortgage loans grew in various regions although in Bogota, the Coffee region and Southwest, its rise was slightly lower than the year before (Table 23).

Table 21
Arrival of National and International Passengers by Air by Region
(thousands of passengers)

Regions	National				Internacionales			
	2008	2009	Percentage participation 2009	Annual percentage variation	2008	2009	Participación porcentual 2009	Annual percentage variation
Bogota	3,381	3,886	38.3	14.9	1,673	1,713	62.1	2.4
Caribbean	1,729	2,014	19.8	16.5	283	285	10.3	0.9
Northwest	1,404	1,522	15.0	8.4	285	359	13.0	25.9
Southwest	1,044	1,156	11.4	10.8	248	273	9.9	9.9
Northeast	605	700	6.9	15.7	34	37	1.3	8.2
Coffee region	410	441	4.3	7.4	66	85	3.1	28.5
Southeast	179	199	2.0	11.4				
Central	190	198	1.9	3.8	2	2	0.1	(20.4)
Others	36	35	0.3	(1.7)	3	4	0.1	12.4
Total	8,979	10,152	100.0	13.1	2,595	2,758	100.0	6.3

Source: Aerocivil.

Table 22
Area (sq. mt.) of Construction Permits Approved by Regions
(annual percentage variation)

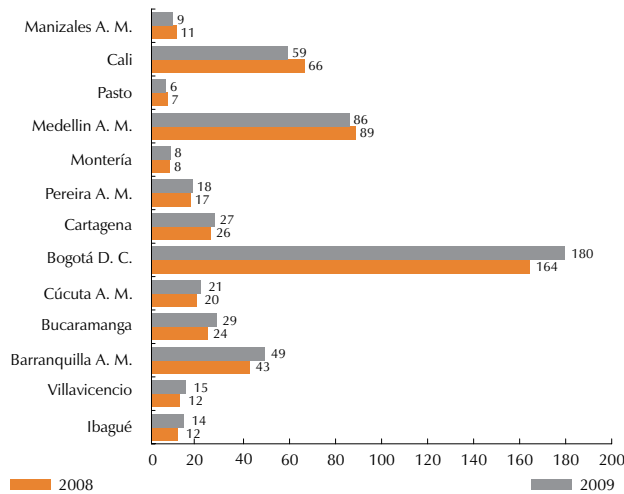
Period	Bogotá	Central	Coffee region	Caribbean	Southeast	Southwest	Northwest	Northeast
I Qtr. 2008	(8.8)	(27.2)	(60.4)	(15.0)	(26.1)	44.7	(35.8)	6.3
II Qtr. 2008	13.2	19.2	(4.0)	3.7	(24.4)	(37.1)	(26.0)	(6.7)
III Qtr. 2008	(27.8)	37.6	13.6	27.9	6.4	23.4	(30.8)	22.2
IV Qtr. 2008	(9.2)	(30.5)	(56.8)	(21.0)	(8.0)	(43.4)	(55.7)	34.3
I Qtr. 2009	(25.8)	39.7	28.6	(24.6)	80.1	(62.9)	(41.9)	4.2
II Qtr. 2009	(47.2)	(37.8)	(67.7)	13.0	227.3	(16.2)	(22.6)	4.6
III Qtr. 2009	(27.1)	(39.7)	(26.3)	(17.6)	10.2	(38.2)	5.3	(20.0)
IV Qtr. 2009	(33.6)	(23.4)	(14.0)	(6.4)	(1.3)	29.7	86.2	4.8

Source: DANE, Banco de la Republica calculations.

g. Financial sector

The annual growth of the gross loan portfolio (net portfolio plus provisions) in 2009 was in line with the changes in economic activity in the different areas of the country. In the last quarter of the year, the downward trend it had been following changed and it closed the year with significant growth for the different types of loans in almost all of the regions (Table 23). The exception to this performance was the Northwest region (Antioquia and Choco) where the deterioration continued and showed an annual slump of 10%, especially

Graph 86
Working Population in the Construction Sector by City and Metropolitan Area (A. M.)
(thousands of jobholders)



Source: DANE (GEIH).

in consumer credit (-14.6%) and commercial loans (-10.8%). The lower growth was seen in the regions where the largest balances in the national total are concentrated.

The largest surges in the mortgage loan portfolio were in the Central, the Northeast (the Santanders), Northwest (Antioquia and Choco) and Southeast (Eastern plains) regions as the latter registered 21.2%. Micro-credit grew in all of the regions but mainly in the Caribbean, Northeast and the Coffee regions all of which easily surpassed the national average of 24.4%. Commercial loans, in turn, showed a better performance in the Coffee region and the Central zone of the country.

h. Foreign trade

The deterioration in international economic activity and the trade crisis with Venezuela had mixed effects on exports from the different regions of the country (Table 24). Taking exports excluding the main products (coffee, coal, petroleum and ferronickel) the most serious impact of that crisis was in the Northeast where there was a plunge of 37.3% in their shipments abroad. This area is about 80% dependent on trade with the neighboring country. The following regions—Central, Bogota, Caribbean and Coffee region as well as the Southwest to a lesser degree—were also considerably affected. The Northwest, in turn, was the only area in the country that showed positive growth (3.4%) in spite of the slump in sales to Venezuela.

The effects themselves of the country's economic situation in 2009 were also evident in the trend of imports which declined 17.1% that year after five years of constant rises. The Central region was the one with the largest reduction, 32%, while in the Caribbean, Coffee region, Antioquia, the Southwest and Northeast average falls of 21% were registered (Table 25). The limited slump of imports in Bogota which was barely 3.0% (well below the national average) stands out. The performance of imports in the 2003-2009 for all of the regions should be highlighted in spite of the weak performance seen in the latest year (Graph 87). The Caribbean increased its purchases from abroad fivefold, followed by the Northeast which tripled them and the rest which at least doubled them.

i. Inflation

In 2009, the country registered a downswing in the level of inflation, which was generally felt in the various cities (Table 26). The Southwest (Cali and Pasto) and the Coffee region (Manizales and Armenia) registered changes that were lower than the national average (2.0%) basically because of the effect

Table 23
Annual Growth of the Net Loan Portfolio by Type and Region (excluding loan-loss provisioning)
(percentage)

Region	Net loan portfolio	As of December, 2009				
		Total	Consumer loans	Commercial loans	Housing loans	Micro-credits
Bogotá	3.5	4.5	5.2	3.6	9.6	14.8
Coffee region	9.4	9.7	1.7	14.3	8.7	29.7
Caribbean	5.1	5.5	8.6	2.8	9.4	55.5
Central	10.0	9.9	1.8	11.6	16.2	24.9
Northeast	8.0	8.0	5.7	4.8	16.1	33.9
Northwest	(11.3)	(10.0)	(14.6)	(10.8)	15.0	20.2
Southwest	1.0	1.4	0.8	0.0	11.5	13.7
Southeast	6.7	6.2	1.7	5.3	21.2	19.4
National	1.4	2.2	1.4	0.8	11.4	24.4

Region	Net loan portfolio	As of December, 2008				
		Total	Consumer loans	Commercial loans	Housing loans	Micro-credits
Bogotá	15.9	16.3	9.3	19.5	10.5	100.9
Coffee region	14.7	16.0	12.4	17.7	11.2	72.7
Caribbean	19.9	20.5	12.5	24.9	8.7	49.4
Central	12.9	14.3	16.1	10.1	8.7	31.0
Northeast	13.0	13.8	12.1	12.3	10.6	45.6
Northwest	25.4	26.1	19.0	29.0	8.5	155.0
Southwest	9.8	11.4	10.7	10.5	15.5	32.2
Southeast	13.3	15.6	16.2	14.9	7.8	31.7
National	16.8	17.5	12.1	19.9	10.5	55.8

Source: Financial Superintendency of Colombia, Banco de la Republica calculations.

Table 24
Exports by Regions Excluding Main Products ^{a/}
(millions of FOB dollars)

Regions	Exports ^{a/}		Annual percentage variation	Percentage share 2009	To Venezuela		Annual percentage variation	Percentage share 2009
	2008	2009			2008	2009		
Northwest	3,826	3,956	3.4	26.6	880	473	(46.2)	11.7
Caribbean	3,232	2,733	(15.4)	18.3	911	791	(13.1)	19.5
Bogota	3,298	2,609	(20.9)	17.5	1,328	822	(38.2)	20.3
Southwest	2,361	2,169	(8.1)	14.6	560	425	(24.1)	10.5
Central	2,210	1,600	(27.6)	10.7	505	293	(42.0)	7.2
Northeast	1,885	1,182	(37.3)	7.9	1,539	962	(37.5)	23.8
Coffee region	732	646	(11.7)	4.3	340	280	(17.4)	6.9
Eastern plains	80	5	(93.2)	0.0	29	2	(92.0)	0.1
Total	17,623	14,900	(15.4)	100.0	6,092	4,050	(33.5)	100.0

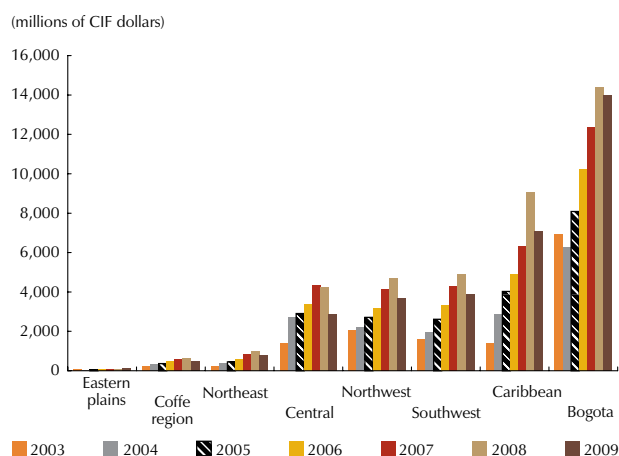
a/ Excluding coffee, petroleum, coal and ferronickel.
Source: DANE, Banco de la Republica calculations.

Table 25
Imports by Regions
(millions of dollars)

Region	2008	2009	Annual percentage variation	Participación porcentual 2009
Central	4,241	2,883	(32.0)	8.8
Coffee region	630	491	(21.9)	1.5
Caribbean	9,047	7,062	(21.9)	21.5
Northwest	4,694	3,698	(21.2)	11.2
Southwest	4,879	3,869	(20.7)	11.8
Northeast	986	809	(18.0)	2.5
Bogota	14,408	13,972	(3.0)	42.5
Southeast	58	114	98.4	0.3
Not reported	727	0	n.a.	0.0
Total imports	39,669	32,898	(17.1)	100.0

n.a. not applicable.
Sources: DIAN and DANE, Banco de la Republica calculations.

Graph 87
Imports by Regions, 2003-2009



Sources: DIAN and DANE, Banco de la Republica calculations.

of food (especially in the second half of the year), clothing and transportation. The highest inflation was in the Northeast for the cities of Cucuta (4.5%) and Bucaramanga (3.1%) due to rises in housing, education and health.

j. Labor market

The unemployment rate for 13 cities and metropolitan areas was 13.0% in 2009, a figure that is 1.5 pp higher than that registered in 2008. Cities such as Pereira, Ibague and Pasto had the highest rates of unemployment. Others such as Cucuta, Bogota, Villavicencio, Barranquilla and Bucaramanga registered rates that were below the national average. In the last eight years, in spite of what happened in 2009, the unemployment trend for cities was a declining one with the exception of mainly Pereira, one of the cities that was affected by the slump in remittances and exports to Venezuela (Table 27).

The salaried employee share in the total number of jobholders has had a declining trend in the last three years (6.8 pp) which is the opposite of what happened to non-salaried workers, a group that has grown (6.1 pp). The cities in the Coffee region (Manizales and Pereira), Bogota and Medellin stand out with a percentage of salaried workers that is higher than the total of the thirteen cities and metropolitan areas while the cities in the Caribbean region

Table 26
Annual Inflation by City
(percentage)

Region / city	Food	Housing	Clothing	Health	Education	Entertainment	Transportation	Communication	Other expenses	Total
Northeast										
Cúcuta	3.1	7.1	0.6	5.1	5.1	(1.4)	4.1	3.5	6.0	4.5
Bucaramanga	2.6	3.5	0.5	3.6	5.9	(0.8)	3.3	3.4	4.5	3.1
Tunja	1.6	4.6	(0.4)	1.2	5.9	(4.2)	(0.6)	0.1	3.4	2.2
Southwest										
Popayán	(0.5)	5.5	(2.6)	2.9	4.4	(3.2)	0.7	(0.3)	3.9	2.0
Pasto	(0.9)	4.7	0.7	3.9	4.7	(3.2)	(0.5)	2.3	5.0	1.6
Cali	(1.9)	5.3	(3.4)	4.7	5.3	(0.3)	(1.0)	(0.4)	3.5	1.2
Central										
Neiva	(0.2)	6.0	1.1	4.9	5.9	(0.9)	3.0	3.5	3.5	2.8
Ibagué	(0.6)	5.6	(1.4)	4.4	4.7	(0.1)	1.1	0.9	4.5	2.2
Florencia	(0.6)	5.6	(0.9)	3.2	0.7	(1.0)	(0.8)	0.9	2.6	1.7
Coffee region										
Pereira	(2.6)	4.3	(1.3)	5.3	5.9	2.4	1.7	2.7	5.2	1.8
Manizales	(2.6)	4.5	(1.5)	3.4	5.5	0.7	(0.1)	2.5	4.5	1.2
Armenia	(2.5)	4.5	(1.9)	4.6	2.6	1.1	0.5	(0.4)	3.9	1.1
Caribbean										
Valledupar	1.0	5.5	0.4	5.1	4.0	0.5	(1.9)	(0.1)	3.4	2.8
San Andrés	2.1	2.9	(1.8)	4.7	5.4	(9.3)	(0.4)	1.7	2.5	2.4
Cartagena	0.2	2.3	1.4	3.7	4.6	(5.6)	3.3	3.5	5.3	2.0
Barranquilla	0.3	3.1	1.2	4.7	6.3	(0.8)	(1.9)	1.8	4.8	1.8
Santa Marta	0.7	1.8	0.3	4.2	3.8	(1.0)	2.4	1.4	4.2	1.7
Sincelejo	1.9	2.4	0.7	4.5	4.5	(2.6)	(1.4)	(3.4)	4.9	1.6
Montería	(1.1)	3.5	0.6	2.5	4.9	(3.3)	1.0	1.9	3.5	1.5
Riohacha	(0.0)	2.5	0.5	2.4	2.7	(3.9)	0.0	0.6	(0.2)	1.0
Northwest										
Medellín	(1.1)	5.3	1.5	5.4	6.2	0.6	1.9	0.4	3.5	2.5
Quibdó	(0.8)	1.4	(0.2)	4.6	1.4	(1.8)	(0.7)	0.2	3.5	0.6
Northeast (Eastern plains)										
Villavicencio	0.1	4.7	(0.7)	5.6	4.4	(2.9)	2.4	1.9	4.2	2.3
Bogotá. D.C.	(0.2)	3.8	(0.4)	5.2	7.1	1.6	(0.4)	0.7	3.4	1.9
National	(0.3)	4.3	(0.3)	4.9	6.3	0.5	0.3	0.9	3.8	2.0

Source: DANE.

(Cartagena, Barranquilla and Montería) and Cucuta (in the Northeast) have higher levels of non-salaried workers.

Table 27
Unemployment rate 2002-2009. thirteen cities and metropolitan areas
(percentage)

Cities	2002	2003	2004	2005	2006	2007	2008	2009	Average variation 2002 to 2009
Pereira	17.6	18	16.9	15.8	14.2	13.5	13.8	20.4	3.5
Ibagué	23	23.5	22.2	20.9	19.9	15.7	19.4	17.2	(3.3)
Pasto	18.1	18.1	18.9	14.9	15.4	14	14.1	16.9	(0.3)
Montería	16.8	15.8	16.5	14.6	14.1	12.6	12.9	15.8	(0.3)
Medellín	17	15.7	15.1	13.8	13.4	12.1	13.6	15.7	(0.7)
Manizales	19.3	18.9	18.8	17.5	15.7	13.3	14.5	15.3	(2.9)
Cali	15.9	15.6	14.2	13	12.9	11.3	12	13.6	(1.9)
Cartagena	14.9	15	14.7	15.5	15	13.7	12	13.1	(1.6)
Cúcuta	16.6	17.8	15.5	14.6	12.7	10.9	9.3	11.9	(3.6)
Bogotá	18.3	16.6	14.8	13.1	11.5	10.4	10	11.5	(6.0)
Villavicencio	15.2	14.4	12.7	12.2	12.5	10.7	11	11.3	(3.9)
Barranquilla	16.3	16.2	14.6	13.6	12.9	11.4	10.9	10.5	(6.0)
Bucaramanga	20.4	17.9	16.9	15.4	13.9	9.7	9.5	9.3	(10.1)
Total 13 cities and metropolitan areas	17.6	16.6	15.3	13.9	12.9	11.4	11.5	13.0	(3.9)

Source: DANE (ECH and GEIH), Banco de la Republica calculations.

3. Regional Trend in the First Quarter of 2010

At the end of the first quarter of 2010, the ANDI regional numbers confirmed the annual recovery in sales and industrial production for almost all of the regions. Thus, in the Northwest, these showed growths of 10.8% and 9.8% respectively. The only region with a negative report in the period was the Coffee region.

In the commercial sector, Banco de la República (EMEE) and Fenalco surveys show together a positive balance for the first quarter of the year in which the Northwest stands out given its significant improvements in the levels of sales, orders and inventories. Likewise, the Southwest and the Caribbean showed positive changes while the Coffee region had a moderate performance in retail sales.

Furthermore, the sales of vehicles recorded an annual growth of 16% for the entire first four months of 2010. This recovery was a general one for the different areas of the country but higher in the Central, Coffee region and Caribbean.

Likewise, the re-establishment of trade relations with Ecuador has favored the western regions in contrast to what happened with Venezuela, where the exports (excluding main products) from the Northeast (the Santanders) have been affected and exhibited a fall of 77.9% in the first quarter of 2010. In the Coffee region, the total contraction up to April was 20.9% and in the Caribbean it was 11.9%. The performance of exports is improving in the Northwest and Southwest as they are growing at close to 15% and to a lesser degree, those from the Central region at 3.6%.

Last of all, a definite recovery in the net loan portfolio of the financial system could be seen in almost all of the regions at the end of the first quarter of 2010 with the exception of Antioquia, where it shrank 12.2%. By type of credit, the positive performance of mortgage loans, which has shown considerable strength in all of the regions during the period, was noteworthy just as was that for micro-credit. However, the outcome of commercial credit reached its lowest annual growth in the last nine years and was negative in Antioquia where it fell 11.3%. Consumer credit, in turn, recovered in Bogota and Antioquia but declined in the Coffee region and Southwest by 3.4% and 0.4% respectively.

BOX 1 THE MINING AND ENERGY SECTOR IN THE COLOMBIAN ECONOMY¹

The existence of natural resources in Latin America has defined a pattern of economic growth for the region that is based on the production of commodities and the inflow of foreign capital which is intended for the extraction and export of these, mainly mineral, commodities. For instance, based on the economic balance sheets for Chile, Brazil, Mexico and Peru in the last few years, mining was a fundamental part of their economic and export strength as well as for their flows of lucrative investments. Indeed, during the first quarter of 2010, the mining sector contributed more than 60% of the exported value in the cases of Chile and Peru and 17% and 24% for Mexico and Brazil respectively. In terms of the growth that was seen up to March 2010, the positive results for the economies of Mexico, Chile and Brazil were influenced by the performance of mining.

Colombia is not the exception and our economic balance for the last decade and the present outlook show the growing importance of mining in the context of the economy. This favorable development in the mining sector fits within a propitious international context with respect to the international prices of commodities, the boom in the demand for them abroad and the continuous inflow of foreign direct investment. Domestically, some changes have been made in order to make the regulations for the exchange rate, taxes and foreign investment more flexible to improve the environment for investors. For example, these regulations have especially benefitted the mining-energy companies by making it possible to grant them contracts for longer periods and under a type of “modern license contract,” which gives the investor the opportunity to operate independently and assume the risks in exchange for all the production rights once the payment of taxes and royalties has been subtracted.

Those incentives, the international context and the improvements in public security in Colombia have generated a lot of interest in exploration and extraction and have brought about record levels in the location and mining minerals. The growth of the mining sector and its impact on the economy contribute to the financing of public expenditures and the domestic and foreign expenditures of the other sectors in the economy. Given the favorable outlook for mining and energy in this country, this report briefly describes its macroeconomic

relevance with respect to its impact on the GDP and employment as well as on the country’s foreign accounts and its contribution to the government’s fiscal revenue.

1. The Mining Sector in Colombia

The importance of the mining and energy sector as the main source of current revenue and financial resources for the balance of payments has been a factor in the improvement of the terms of trade, higher fiscal revenue, financing for the other sectors of the economy and a substantial source for the supply of foreign currency. Colombia’s mining activity encompasses the production of oil and its derivatives, coal, metallic minerals (gold, ferronickel, silver, platinum, iron, etc.) and non-metallic minerals (sand, limestone, emeralds and other precious stones). Geographically, the petroleum and coal production is concentrated in the departments of Casanare, La Guajira, Meta, Cesar, Arauca, Huila and Santander, and the ferronickel and gold production is mainly located in Cordoba and Antioquia.

Between 2003 and 2007, mining activity recorded lower growth rates than those for the other economic sectors and its average share of the GDP was 6.2%. As of 2008, that trend changed to a positive one by increasing its contribution to production and becoming one of the main sources for the expansion of the economy (Graph B1.1)

During 2009 and the first quarter of this year, the share of this sector in the GDP was 6.6% and 7.0% respectively, figures which were higher than those recorded in 2007 and 2008. Regarding the economic growth, the performance of the mining production contributed significantly to the results for last year and up until March 2010, its growth rate was 13.2%, which is above the average for the other sectors.

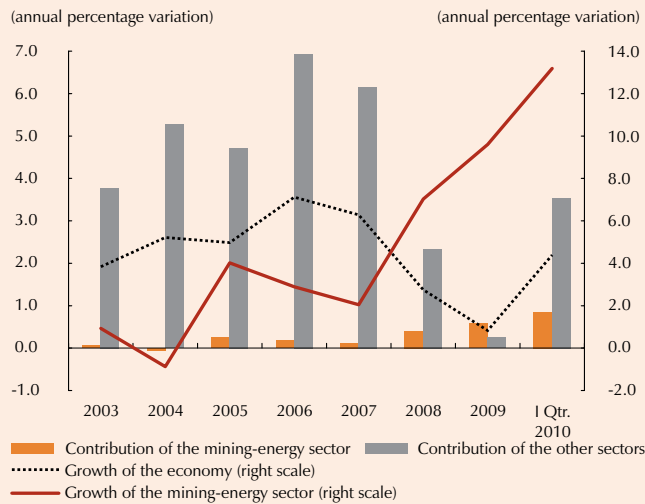
2. Structure of Production, Productive Linkage and Employment in the Mining Sector

The structure of the mining sector by activity reveals a high degree of concentration on the production of a few minerals although this tendency has slightly declined in the last few years (Graph B1.2). At the same time, in 2000, the subsector of petroleum supplied almost 80% of the mining output, but in 2009 that quantity fell to 53% while the percentage for coal went from 8% to 13%. Also, the production of metallic and non-metallic minerals took up a larger portion though to a lesser

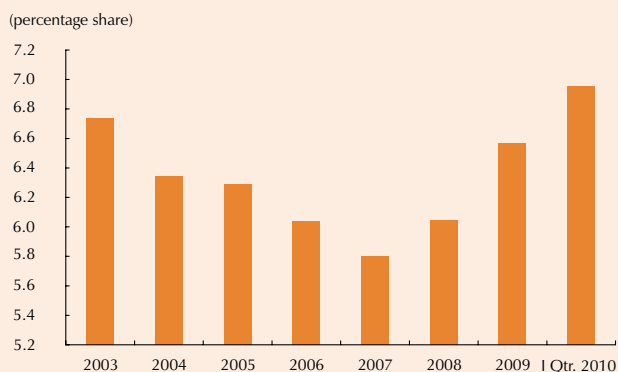
1 Based on the document Fiscal Regulation for Colombia, Banco de la Republica, Ministry of the Treasury and Public Credit and National Planning Department, July 2010.

Graph B1.1

A. Contributions to the Growth of GDP and the Mining Sector



B. Mining-Energy Sector GDP Share of the Total Real GDP



Source: DANE; Banco de la Republica calculations.

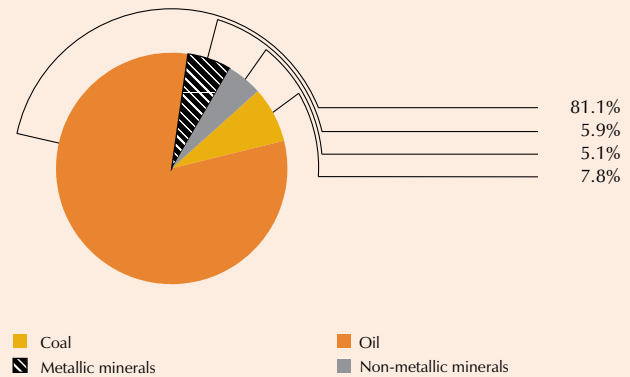
degree. It should be pointed out that mining production other than petroleum is the result of investment projects and the expansion of the productive capacity carried out over the last few years, especially in the areas of coal and gold.

The big companies that operate in the mining sector are focused on the export market, especially the ones that drill for and extract oil or mine for coal, ferronickel and gold. The exports of these firms are the main source for their operational income. In the case of petroleum and coal, their sales abroad represented more than 62% of their production up until May of this year (Table B1.1).

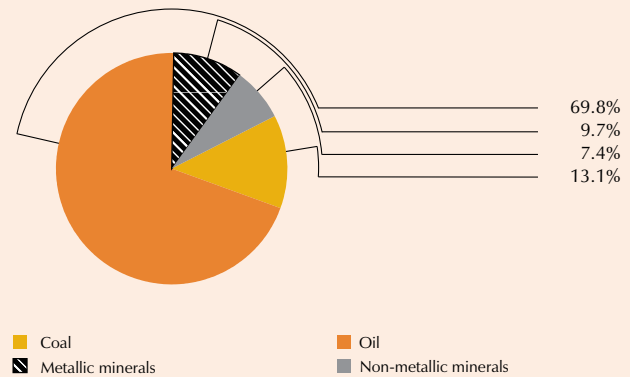
When the inter-sector relations of coal and petroleum activities with the other areas of the economy were considered, it was found that their purchases of supplies are noticeably characterized by being intra-sector and by

Graph B1.2

A. GDP of the Mining-Energy Sector of Colombia, 2000 (sector percentage share)



B. GDP of the Mining-Energy Sector of Colombia, 2009 (sector percentage share)



Source: DANE.

having a high demand for specialized technical services. Based on the estimates given in the document Fiscal Rule for Colombia, July, 2010, the coal sector mainly requires the supply of goods and services from the areas of transportation (35%), financial services (15.8%), construction (11.2%) and products from oil refining (14.1%). With respect to the demand for supplies by the oil industry, purchases from the sectors of mining (35%), transportation (27.5%) and financial services (20.8%) are the most noteworthy.

The productive structure of the mining sector is characterized by both intensive use of capital and technology and use of labor to a lesser degree. Therefore, and based on what was pointed out in the aforementioned document, more than 84% of the factor intensity corresponds to capital in the cases of mining, coal and crude oil. Based on DANE statistics, the direct employment generated by the mining sector has fluctuated between a minimum of 177,000 and a maximum of 225,000 employees and has shown a significant increase in the last two years (Graph B1.3).

Table B1.1
Production and Markets for Mining-Energy Sector Sales

	2001		2010 ^{a/}	
	Petroleum	Coal	Petroleum	Coal
Production (mbd and mton) ^{b/}	604	43,911	764	19,151
Exports (percentage)	49.9	88.3	61.9	89.7
Sales for domestic consumption (percentage)	50.1	11.7	38.1	10.3

a/ Figures for petroleum up to May and for coal up to March.
b/ (mbd) thousands of barrels per day; (mton) millions of tons.
Source: Ingeominas (Simco).

In relation to the total employment, the share associated with mining has remained at around 1% though it reached a high of 1.2% in 2008.

Graph B1.3
Direct Employment in Mining-Energy Sector and Share in Overall Employment



Source: DANE, Ministry of the Treasury and Public Debt calculations (DGPM) (Fiscal Regulation 2010).

3. Colombian Mining Sector Foreign Accounts

In terms of the country's balance of payments, the main results from the estimates of the mining sector's foreign accounts indicate that the current surplus generated by this activity has partially offset the current expenditures of the other sectors (Table B1.2). Thus, in 2009, the mining surplus financed almost 68% of the deficit in the other sectors. Besides showing a positive balance in their current operations, the mining sector has received growing amounts of foreign capital which, in addition to financing the capital needs of the rest of the sectors, have produced an accumulation of international reserves and contributed to the appreciation of the exchange rate.

As a result of the export boom in this sector, its share in the total current revenue of the country's balance

of payments has gone from 31.2% in the 2002-2007 period to 57.2% in 2009 and to 53.1% in the first quarter of 2010 (Table B1.3). The increase in the value of mining sector exports has been driven by the surge in international prices and the growth of the quantities being sold. This situation has been reflected by the higher share the mining sector has had in the basket of exports in the last few years. In fact, the aggregate for foreign sales of mining commodities (gold, coal, ferronickel, oil and petroleum derivatives) increased the contribution this sector made to the total exported value by going from 39% in 2002 to 51% in 2008 and to 63% in the first quarter of this year.

In the case of the mining sector's current expenditures and their relative share in the total, its performance was similar to what has been described for the current revenue, but less pronounced. Their share went from 11.8% in the 2001-2007 period to 22% in the last year. This trend is associated with both the larger transfers of profits (factor revenue) stimulated by the increase in export prices for mining products and the higher imports of specialized technical services required by the sector to expand its productive capacity.

In reference to the total financial account, the capital operations in this sector provide the highest long term financing and have been the main source of funds for the balance of payments, especially those related to direct investment. The companies that belong to the mining sector received growing inflows of foreign capital that surpassed the needs of the rest of the sectors for capital and became the main source for the supply of foreign currency in the country (Graph B1.4).

The significant growth in the international prices for oil and coal as well as the flexibility of the mining regulations in Colombia which were set up in the 1990's have created favorable conditions for the inflow of foreign capital to develop and expand mining production in Colombia. Therefore, the level of direct investment rose and generated a substantial upswing in the exploration and extraction of minerals. In the case of oil, the rate of growth has been above 10% for the previous two years.

Out of the total revenue received by the country in 2009 from direct investment, 82% of it was intended for the mining sector. This is far above the average received between 2001 and 2007, when it was 28.3%. Up to March this year, the figure for that sector was 66% (Graph B1.5).

Regarding the growth of Colombian direct investment abroad in the last few years, this growth has been mainly related to the investments made by companies in the mining-energy sector by buying stock in foreign companies that have a relationship to their productive activity. In this

Table B1.2
Total Balance of the Mining Sector's and the Country's Foreign Accounts
(millions of dollars)

Item	Average flows 2000-2007	2008	2009	1 Qtr. 2010 (pr)
1. Mining sector balance	5,748	14,661	17,899	4,298
Current account	4,828	9,612	10,627	4,264
Capital and financial account	920	5,049	7,272	34
2. Balance of the remaining sectors	(4,369)	(12,038)	(16,552)	(3,951)
Current account	(6,616)	(16,513)	(15,660)	(5,661)
Capital and financial account ^{a/}	2,247	4,475	(892)	1,709
3. The country's foreign transactions				
a. Current account	(1,788)	(6,901)	(5,033)	(1,396)
b. Capital and financial account	3,167	9,524	6,380	1,743
c. Variations in the gross international reserves	1,379	2,623	1,347	347

(pr) preliminary

a/ Includes errors and omissions

Source: Banco de la Republica calculations.

Table B1.3
Current Operations of the Mining Sector
(millions of dollars and percentage)

Item	Average flows 2000-2007	2008	2009	1 Qtr. 2010 (pr)
Current operations of the mining sector	4,828	9,612	10,627	4,264
a. Current revenue of the mining sector	8,070	19,714	18,560	6,378
As a percentage of the country's current revenue	31.3	39.2	57.2	53.1
Goods and services	7,835	19,455	18,520	6,351
Factor revenue	160	259	40	27
Transferences	74	0	0	0
b. Current expenditure of the mining sector	3,242	10,101	7,933	2,114
As a percentage of the country's current expenditures	11.8	17.7	22.1	15.8
Goods	1,245	4,147	3,044	844
Services	179	506	487	44
Factor revenue	1,818	5,449	4,402	1,226

(pr) preliminary.

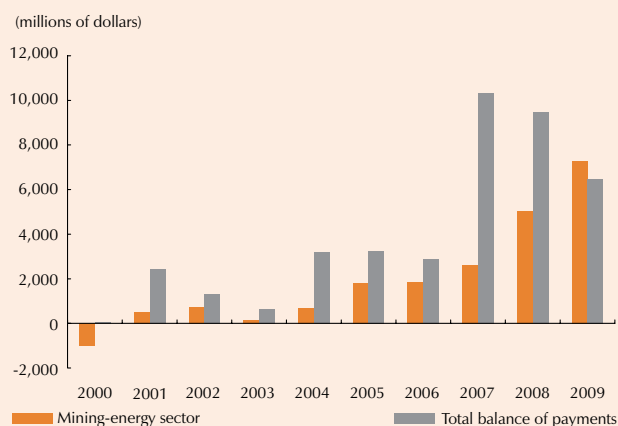
Source: Banco de la Republica calculations.

respect, between 2008 and the first quarter of this year, the accumulated flow of investment reached US\$3.771 b.

In the last two years, the mining companies sold assets abroad to finance the acquisition of firms in other countries. In contrast, as of the first quarter of 2010, there

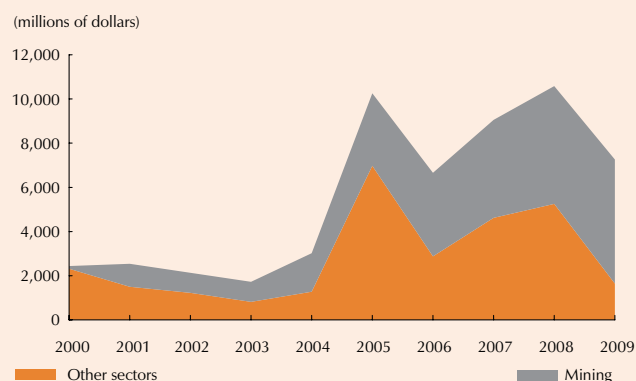
was an outflow of US\$1.262 m in capital for the purchase of foreign assets that were mainly associated with financial investments. This outflow of capital significantly offset the inflow of US\$1.347 m in direct foreign investment in Colombia.

Graph B1.4
Total Capital and Financial Account and Mining-Energy Sector Capital and Financial Account



Source: Banco de la República.

Graph B1.5
Flow of FDI into Colombia



Source: Banco de la Republica calculations.

4. Fiscal Income from the Mining Sector

The Colombian mining sector has played a fundamental role in the change and composition of the current revenue the nation and of some regions of the country receive. The sector's contribution to the public finances comes mainly through income tax, VAT, dividends and royalties. According to the document, Fiscal Rule for Colombia, the mining sector contributed 30.8% of the total amount collected in income tax in the year 2000. Of this, the petroleum industry provided the highest share (Table B1.4). Afterwards, this contribution rose to 31.3% in 2007 due to higher profits earned by the companies in that sector as a result of the favorable conditions for the international prices for mining products. However, the sector's percentage share dropped nine points when it went from 31.3% in 2007 to 22.9% in 2009. This was basically the result of the lower foreign demand and the decline in their prices.

As a proportion of the total revenue received by the national government, mining has contributed 10.6% over the last 10 years. When the dividends transferred by Ecopetrol are added to this figure, the share goes up to 15%. With respect to the royalties transferred to the departments and districts because of the extraction of natural resources, mainly petroleum and coal, there has been a growing trend in the last 10 years and a maximum value of \$6 b was reached in 2008. According to the DNP and based on the prices for 2008, the royalties directly transferred between 1995 and 2008 came to a value of \$28.3 b (24% of this was sent to Casanare) which represents 85% of all royalties. The increasing relevance of the mining sector to public finances contrasts with its low share in such variables as the GDP, employment, etc.

Finally, given the multiple impacts that mining has on the Colombian economy and the outlook for future growth, designing policies that strengthen its positive effects and reducing those that can distort a balanced economic growth is important.

Table B1.4
Share of the Mining-Energy Sector in Income Tax Collection

	2000		2007		2009 ^{a/}	
	Billions of pesos	Share in the income tax (percentage)	Billions of pesos	Share in the income tax (percentage)	Billions of pesos	Share in the income tax (percentage)
Oil	1,414	27.2	3,428	22.3	2,947	18.2
Coal	54	1.1	276	1.8	530	3.3
Nickel	66	1.3	903	5.9	187	1.2
Other mining	64	1.2	208	1.4	45	0.3
Total mining and petroleum	1,599	30.8	4,815	31.3	3,709	22.9
Total income tax	5,198		15,367		16,185	

a/ preliminary figures.

Source: DIAN, Ministry of the Treasury and Public Credit calculations (DGPM).

Box 2

EXPORTS FROM COLOMBIA TO VENEZUELA AND REPLACEMENT ALTERNATIVES

The changes in the exports from Colombia to Venezuela during the past decade generated significant effects on export performance and its composition by products and by foreign markets. Recently, the decrease in the value exported to Venezuela has brought notable changes in the outlook for Colombian exports and has especially affected the operation of the export basket, the final markets and the sales abroad of industrial goods. This box summarizes these changes and gives a brief analysis of the process of substituting other trading partners for the Venezuelan market.

1. Recent Changes in the Exports to Venezuela and Their Effects on the Outlook for Colombian Exports

a. Recent changes

After 2005, the export growth of the Colombian economy was partially stimulated by the larger foreign sales to Venezuela. Between 2005 and 2008, the dollar value exported to that market tripled as it went from US\$2.098 m to US\$ 6.092 m. Therefore, these sales contributed an average of a quarter of the total increase in the country's exports between 2006 and 2008. Moreover, the bilateral trade showed a trade surplus for Colombia which, due to its size, offset the deficits with other trading partners (Mexico, Brazil, etc.).

In 2009, the growth trend in the sales to Venezuela underwent a downturn as a result of the lower demand abroad and the currency restrictions in that country which added to the existing trade problems. Indeed, the annual value of these shipments dropped 33.5% and, since the end of last year, its monthly variation rate has been close to -70%, which has affected the performance of both total and industrial exports (Graph B2.1, panel A). As shown in panel B, at the end of last year, the monthly level of the sales value was similar to that for early 2006 and lower than the figures registered for the previous two years.

Calculating the trend of the quarterly series for the exports to Venezuela, it can be seen that the level registered between 2007 and 2009 was above the trend of the series, which means that this was an unusual increment with respect to the historical average. Likewise, the figures recorded since the second half of 2009, when the rapid plunge in exports to Venezuela began, were below the trend and reflected Venezuela's domestic problems and the trade restrictions levied against Colombia (Graph B2.1, panel D).

b. Effects of the Export Crisis with Venezuela and Changes in the Export Sector of Colombia

The declining trend in the sales to Venezuela has had relevant implications for the outlook on Colombian exports because the performance and basket of exports as well as the market for our foreign sales have been affected. As mentioned above, Venezuela was a key player in the growth of both total and industrial exports of the country between 2005 and 2008 with respect to the first aspect. At the same time, this country has also substantially influenced the reductions registered in 2009 and to date in 2010.

The results from last year indicate that of the 12.7% drop in total exports and the 22.8% reduction in sales of industrial goods, the Venezuelan market contributed -5.4% and -14.4% respectively (Graph B2.2, panels A and B). Between January and May, 2010, the foreign sales of manufactured goods declined 11.4%. Of this figure, Venezuela's share was -28.9% though this was partly offset by increased exports to other markets which added 17.5%. During this period, the total value exported surged 26.6% due to the sharp rise in the sales of petroleum and its derivatives, which compensated for the above mentioned drop.

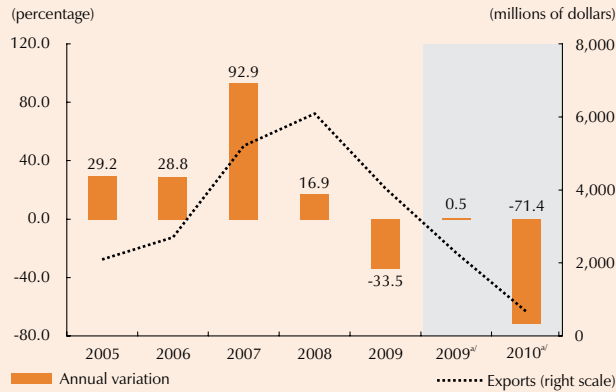
There are important changes to the composition of the export basket in which a large concentration of commodities stands out. This is partly because of the lower sales to Venezuela. Industrial products lost part of their share in the total exports by dropping from 38% in the first five months of 2009 to 27% during the same months in 2010. At the same time, petroleum and its derivatives went from 23% to 40% in the same period (Graph B2.3). It is important to note that Venezuela had absorbed 34% of the total value of industrial exports up to 2008.

The performance of exports to Venezuela has also affected the composition of the Colombian exports based on final markets. The growth of the exports to Venezuela raised the share of this market in the total value exported from 5.3% in 2003 to 16.2% in 2008 and from 11% to 34% in the case of shipments of industrial products (Table B2.1). Up to May, 2010, the lower share Venezuela had in the total value exported was partially offset by the rise in sales to the United States and China, primarily due to the higher sales of our mining products.

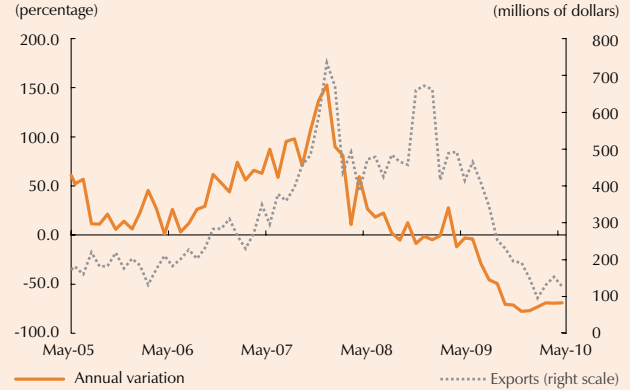
The increase in sales of manufactured goods has not been significant for the first five months of 2010 because Venezuela has not been replaced as a market for the

Graph B2.1
Exports to Venezuela

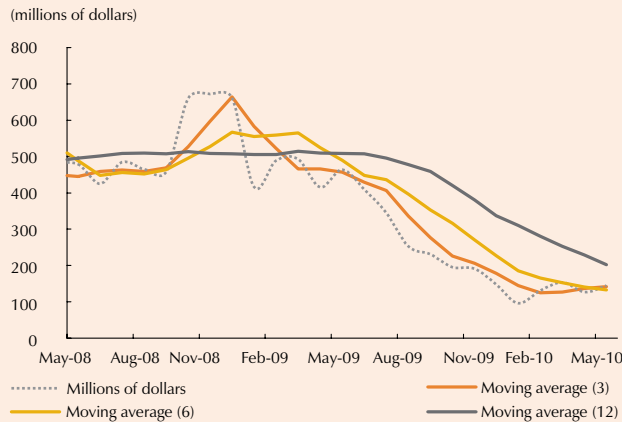
A. Annual change



B. Monthly change

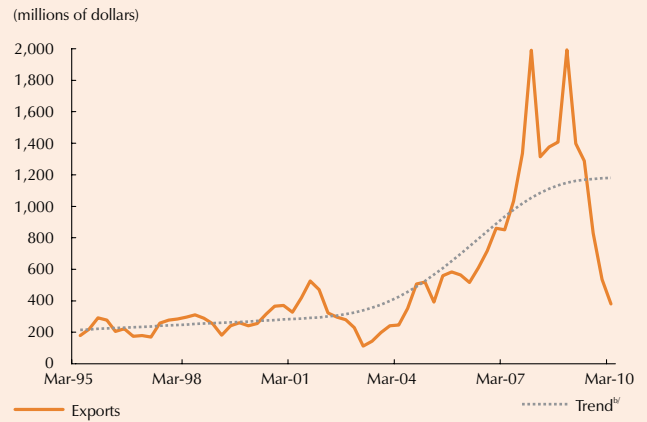


C. Moving average



a/ January to May.
b/ Hodrick-Prescott filter.
Source: DANE, Banco de la Republica calculations.

D. Trend



industrial exports. This fact has obviously been reflected in a lower concentration in the sales of manufactured products. Venezuela went from buying 41.5% of these exports in the first five months of 2009 to just 14.2% a year later.¹

2. Process of Replacing the Venezuelan Market

The analysis of the process of replacing Venezuela as market for our exports must take into account the peculiarities of that market for the foreign sales of Colombia and its high concentration of a limited number

of products as well as the situational factors that drove the growth of exports from Colombia to Venezuela. Because of this, the process of replacing Venezuela as the main market for our industrial exports is not a task that can be done immediately or an easy goal that can be reached in the short term.

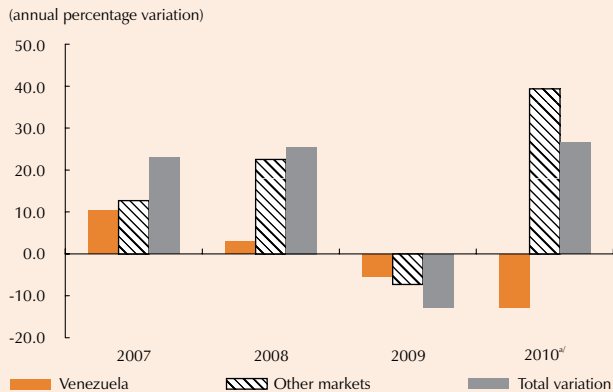
In fact, Venezuela became a natural market for our products. The tariff preferences available until 2011 for Colombian goods within the Andean Community added to the physical proximity and access routes as well as the trade tradition made Venezuela a very profitable market that had an increasing demand for foreign products and high purchasing power.

The aforementioned factors plus the fact that our sales to Venezuela are highly concentrated in a limited number of products are what are making the process of replacing Venezuela as market for Colombian industrial goods slow and complex. More than 40% of the value exported in 2008 corresponded to sales of automobiles, leather and

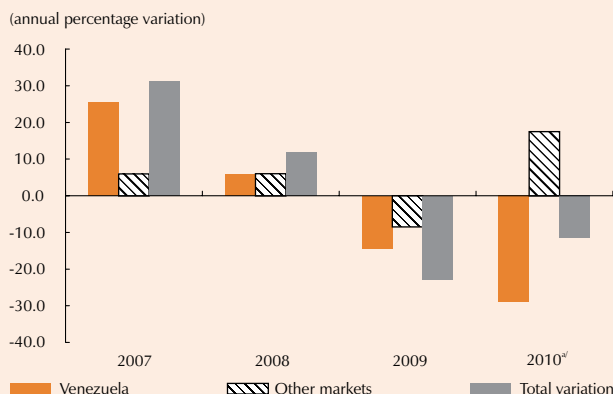
¹ Due to the fact that the lower sales to Venezuela have not been completely compensated for, there has been a statistical effect in which each market took a slightly larger share as a result of the lower total value of the industrial exports.

Graph B2.2
Venezuela's Contribution to the Variation in Colombian Exports

A. Total Exports



B. Industrial Exports



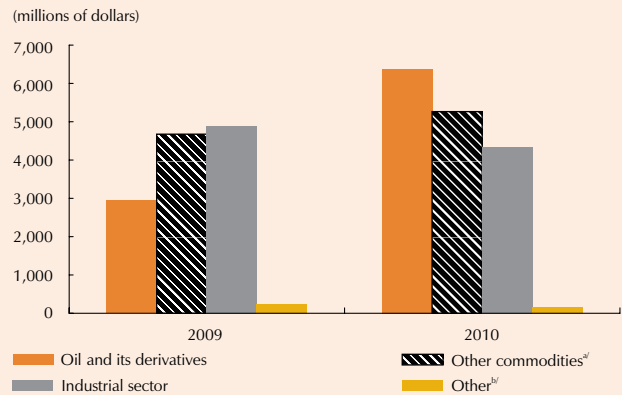
a/ January to May.
Source: DANE, Banco de la Republica calculations.

shoes, textiles and apparel, food and beverages (in 2009, the concentration level continued, although at lower rates). In 2008 in particular, 2,710 groups of products were exported. Of these 757 were sold to Venezuela and represented 51.3% of the total sales to this market.

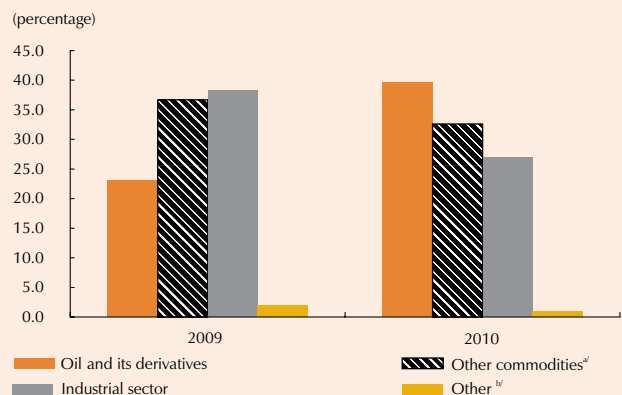
Furthermore, the significant increase in sales to Venezuela came as reaction to a remarkable improvement in the level of foreign revenue that country received between 2004-2008 as well as to a system of exchange rate control that generated currency distortions in that economy. In the last couple of years, the economic situation in Venezuela has deteriorated notoriously and this has been reflected by a decrease in the imports from all countries, not just Colombia. In fact, Venezuelan imports dropped 23% at the end of 2009 while the price for crude oil plunged 36%. In addition, the exchange rate difficulties have become more acute in this neighboring country

Graph B2.3
Composition of Exports (January to May)

A. Exported Value



B. Percentage Distribution



a/ Coal, gold, coffee, flowers, nickel-iron and bananas.
b/ Other agricultural and mining products.
Source: DANE, Banco de la Republica calculations.

and Colombian products have lost competitiveness as a consequence. Also, this is why it is difficult for industrial products to reach again the level of sales recorded in 2008 (Graph B2.4).

Replacing the Venezuelan market is critical, although difficult, for the outlook of Colombian exports, so it is worth analyzing the past performance of industrial sales to other markets in order to find tendencies that will shed light on directions and opportunities on how substitution process could work.

Information regarding the performance of industrial exports by markets between 2000 and 2010 is given in Table B2.2. The 2004-2008 period registered the highest levels of annual increases in the exported value of industrial products. Other trading partners in addition to Venezuela were also important for that growth. The most

Table B2.1
Colombian Exports by Final Market (January to May)
(millions of dollars)

A. Total exports

	Value 2009	Value 2010	Absolute variation	2009 Percentage participation	2010 Percentage participation
United States	4,258	6,875	2,617	33.4	42.6
China	255	1,180	925	2.0	7.3
Netherlands	625	634	10	4.9	3.9
Venezuela	2,277	652	(1,625)	17.9	4.0
Ecuador	505	657	152	4.0	4.1
Peru	327	445	118	2.6	2.8
Switzerland	385	339	(46)	3.0	2.1
Chile	278	296	19	2.2	1.8
United Kingdom	321	256	(65)	2.5	1.6
Czech Republic	177	338	161	1.4	2.1
Other	3,341	4,464	1,123	26.2	27.7
Total	12,747	16,137	3,389	100.0	100.0

B. Industrial Exports

	Value 2009	Value 2010	Absolute variation	2009 Percentage participation	2010 Percentage participation
United States	509	645	136	10.4	14.9
Venezuela	2,023	614	(1,409)	41.5	14.2
Ecuador	467	568	101	9.6	13.1
Peru	280	360	80	5.7	8.3
Mexico	182	225	43	3.7	5.2
Brazil	119	249	130	2.4	5.8
China	42	143	101	0.9	3.3
Chile	109	155	46	2.2	3.6
Panama	116	128	13	2.4	3.0
Costa Rica	95	108	13	1.9	2.5
Other	935	1,125	190	19.2	26.0
Total	4,877	4,320	(557)	100.0	100.0

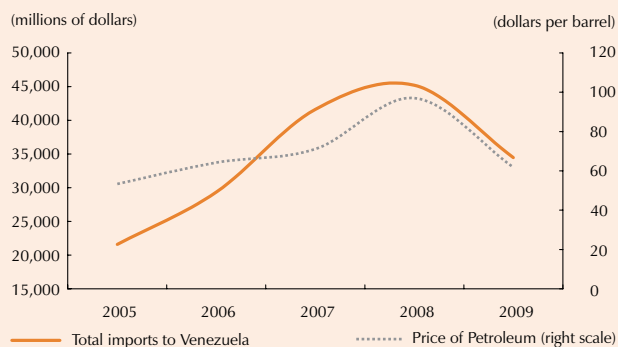
Source: DANE.

outstanding markets were the United States, Peru, Brazil, Mexico, Ecuador and China which generally increased their purchases of industrial goods from Colombia.

The trend in the exports of manufactured products during the first five months of 2010 (to May) show that in spite of the drop in sales to Venezuela, there was some growth of exports to other markets that is worth mentioning. Brazil, China, Mexico and Peru are among the countries

to which those exports were sent. From the perspective of the medium term, these same countries represented substantial contributions to the increase in industrial exports over the last decade that were very close to the recorded levels for Venezuela and the United States. Costa Rica, Panama and Chile are other markets that still have a low share of Colombia's foreign sales but have also shown significant strength and they could become some of the markets to replace the Venezuelan market.

Graph B2.4
Total Imports to Venezuela and the Oil Price



Source: Central Bank of Venezuela.

At the industrial level, the sectors that registered a higher momentum in exports over the last decade were chemicals, food, basic metal products for cars and apparel, which also provided almost 65% of the total

value exported over the last year. Some of these will have to find alternate markets because they were mostly exported to Venezuela.

When broken down by final markets, the group that concentrates almost 70% of the exported value of industrial goods (food, chemicals, textiles and apparel, automobiles, basic metal products, and rubber and plastic) shows that although the Venezuelan market was important for the increase in these sales between 2004 and 2008, other trading partners also contributed to that result and could be potential substitutes for the Venezuelan market (Table B2.3). This holds more relevance when the fact that there is an established trade channel which is well known by Colombian exporters is taken into account.

The information on exports for the first few months of the year indicates that there has been a partial start in substituting some markets and products for the Venezuelan market (Table B2.4). From the beginning

Table B2.2
Industrial Exports^{a/} from Colombia by Market from 2000 to January-May, 2010

Country	Share				Country	Contribution to growth			
	2000-2003	2004-2008	2009-2010 ^{b/}	2000-2010 ^{b/}		2000-2003	2004-2008	2009-2010 ^{b/}	2000-2010 ^{b/}
Venezuela	18.6	25.1	20.0	21.8	Venezuela	(0.8)	11.8	(21.6)	1.1
United States	23.3	19.6	16.1	20.3	United States	0.3	1.6	(0.3)	0.8
Ecuador	10.8	9.6	10.0	10.1	Ecuador	1.8	1.8	0.1	1.5
Peru	4.3	5.3	6.4	5.2	Peru	0.3	1.2	0.7	0.8
Mexico	4.4	4.2	4.4	4.3	Mexico	0.8	0.5	0.4	0.6
Germany	3.1	2.3	1.2	2.4	Germany	(0.3)	0.3	(0.5)	(0.1)
Japan	2.8	2.1	2.8	2.5	Chile	(0.1)	(0.0)	(0.1)	(0.1)
Chile	2.7	2.2	2.7	2.5	Japan	0.1	0.4	0.4	0.3
Brazil	1.6	1.6	4.6	2.2	Brazil	(0.0)	0.5	1.5	0.5
Costa Rica	2.2	1.9	2.1	2.1	Costa Rica	0.2	0.3	0.0	0.2
Panama	2.2	1.9	2.3	2.1	Panama	0.2	0.3	0.1	0.2
Czech Republic	1.9	1.3	1.4	1.5	Czech Republic	0.1	0.2	0.1	0.1
Spain	1.3	1.5	1.2	1.4	Spain	0.0	0.2	0.0	0.1
United Kingdom	1.2	1.3	1.1	1.2	Switzerland	(0.0)	0.1	(0.1)	0.0
Canada	1.3	1.2	1.5	1.3	United Kingdom	0.1	(0.0)	0.1	0.1
Italy	1.5	1.2	0.8	1.2	Canada	0.1	(0.0)	0.2	0.1
China	0.4	1.3	2.1	1.1	China	0.2	0.4	1.1	0.4
Other	16.3	16.4	19.3	16.9	Other	0.3	2.9	0.8	1.6
Total	100.0	100.0	100.0	100.0	Total	3.4	22.4	(17.1)	8.3

a/ Excluding fuel oil and its derivatives, ferronickel and non-monetary gold.

b/ The information only includes data accumulated up to May, 2010.

Source: DANE.

Table B2.3
Markets for Industrial Exports
Share and Contribution to Growth, 2004-2008

Product	Venezuela		Other countries		Total
	Percentage participation	Percentage contribution to growth	Percentage participation	Percentage contribution to growth	Absolute variation (millions of dollars)
Food and beverages	16.7	35.9	83.3	64.1	2.722
Chemicals	20.6	28.8	80.6	71.2	1.584
Apparel	35.2	114.3	69.5	(14.3)	447
Basic metal products	9.1	11.2	89.8	88.8	642
Rubber and plastic	22.6	34.0	77.3	66.0	467
Textiles	49.0	84.6	56.0	15.4	772
Automobiles	71.8	65.1	35.0	34.9	415
Other	28.5	54.1	71.5	45.9	3.405
Total	24.5	47.2	75.5	52.8	10.455

Source: DANE, Banco de la Republica calculations.

Table B2.4
Variation of Industrial Exports Classified by Market
(January-May, 2010 vs. January-May, 2009)
(millions of dollars)

	Venezuela	Variation in other markets			Total	Main countries to which exports increased
		Net	Positive	Negative		
Food and beverages	(506.6)	162.0	314.3	(152.3)	(344.6)	United States, Mexico, Chile, Peru and Syria.
Basic metal products	(10.3)	175.7	230.8	(55.1)	165.4	China, South Korea, Hong Kong and Ecuador.
Chemicals	(128.3)	264.6	415.8	(151.2)	136.3	Brazil, Peru, Ecuador, United States and Italy.
Machinery and equipment	(104.4)	9.4	75.7	(66.3)	(95.0)	Ecuador, France, Mexico, Costa Rica and Panama.
Machinery and electrical appliances	(42.2)	(30.5)	43.4	(73.9)	(72.7)	Canada, Peru, Netherlands and Puerto Rico.
Leather and shoes	(102.3)	37.8	44.9	(7.2)	(64.5)	Italy, China, United States and Ecuador.
Other transportation equipment	(7.2)	95.4	115.2	(19.8)	88.2	El Salvador, Brazil, United States and Panama.
Furniture	(8.0)	22.0	42.7	(20.8)	13.9	United States, Mexico, Switzerland, Chile and Thailand.
Textiles	(210.4)	23.5	59.1	(35.6)	(186.8)	Ecuador, United States, Peru and Costa Rica.
Rubber and plastic	(44.7)	25.9	68.7	(42.7)	(18.7)	United States, Ecuador, Brazil, Chile and Argentina.
Other	(245.1)	66.9	296.0	(229.1)	(178.1)	Ecuador, Brazil, Peru, Thailand, Spain and Chile.
Total	(1,409.3)	852.7	1,706.6	(853.9)	(556.7)	

Source: DANE, Banco de la Republica calculations.

of 2010 to May, the US\$1.409 m reduction in exports to Venezuela was partially offset by the US\$853 m net increase in the shipments of those industrial products to other countries. This figure corresponds to the difference between the positive (US\$1.707 m) and the negative (-US\$854 m) variations in the sales of manufactured products to countries other than Venezuela. The partial substitution of final markets mainly occurred in the sectors of food and beverages, basic metal products, chemicals and other transportation equipment, which were sent to the United States, China, Brazil etc. In the case of exports of machinery and equipment, machinery and electrical appliances, and textiles, the replacement of the Venezuelan market has not taken place yet.

In summary, the decline in the sales to Venezuela has had an impact on the outlook for Colombian exports since it has affected the performance of both total and industrial exports as well as the composition of both the basket of tradable goods and the export markets. The replacement of Venezuela as a primary market for manufactured goods will continue to be a gradual process due to the special features that market has and the high levels of trade that have been registered. Some exporters who sell food and beverages and chemical products have already started replacing that market even though so far it has not been enough to offset the impact of the general drop in their foreign sales.

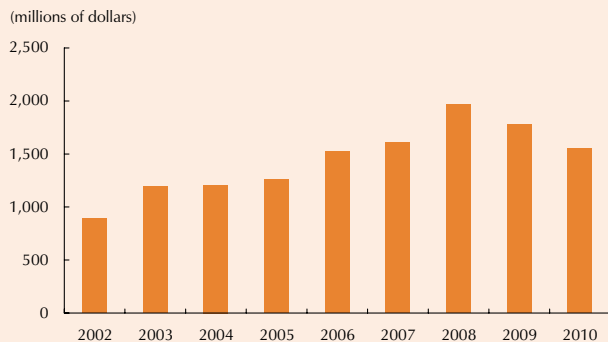
Box 3

RECENT PERFORMANCE OF WORKERS' REMITTANCES

1. Changes in Remittance Income up to May, 2010

In the first five months of 2010, the income from workers' remittances totaled US\$1.550 m and registered a US\$226.6 m annual reduction, which is equivalent to 12.8% with respect to the same period of the prior year, and a US\$412.1 (-21%) drop in reference to the maximum value of remittances received in 2008 (Graph B3.1). This level is similar to that of 2006 when the amount received reached US\$1.523 m.

Graph B3.1
Remittance Income
January-May, 2002-2010



Source: Banco de la República.

Among the countries of Latin America and the Caribbean, Colombia has registered the sharpest decline and although its fall has been lower between March and May 2010, the reduction in remittances remains higher than the one registered in 2009 (Table B3.1). In the first quarter of 2010, the remittances received by the Dominican Republic, El Salvador and Ecuador showed positive growth rates which fluctuated between 0.4% and 9.7%. Declines are still being seen in other countries in the region such as Guatemala and Brazil though they are smaller than the figures registered in 2009. A third group of countries, which includes Colombia, Mexico and Honduras, suffered a more pronounced drop in remittance revenue.

2. Performance of the Remittances by Country of Origin

Based on the information available as of March, 2010, the main countries from which Colombia receives remittances are still Spain, the United States and Venezuela and together they represent 79.7% of the total. In comparison to the percentages by country

of origin for 2008, Spain became the most important economy from which the remittances were sent when it went from 33.2% in 2008 to 37.2% in 2010. In contrast, the relative portion from the United States dropped from 36.7% to 35.5% and that of Venezuela went from 12.3% to 6.9% (Graph B3.2).

Given the relative importance of these three countries in the total inflow of remittances received by Colombia, the changes in the amounts perceptibly affect its development. Based on what had been reported as of March, 2010 in the quarterly survey of remittances done by Banco de la República, there was an annual decline of US\$190 m in remittances. In terms of their contribution to the annual variation, the remittances sent from Spain represented 42.5% of the total reduction, followed by the remittances from the United States (30% of the total) and those from Venezuela which contributed 23% of the decline (Table B3.2)

When the quarterly performance of the remittances in 2010 is considered on the basis of their amount and the number of transfers, it is clear that the deterioration in the economic conditions in the countries where the Colombian immigrants are concentrated has resulted in a reduction in both the amount and the number of transfers sent which has generated a decrease in the amount of money received. As a result, the average value of the remittance, which is calculated by the ratio of the value to the number of transfers, has declined except in the case of Venezuela (Graph B3.3).

A decline in both the number and the amount of the remittances has taken place in Venezuela as a result of the composite effect of the stronger controls applied by the foreign exchange authorities on the access to dollars supplied at a preferential rate (Cadivi),¹ as well as the lower economic performance of this country and its high inflation rate. All of this has reduced the capacity of the Colombian workers who reside there to send remittances.

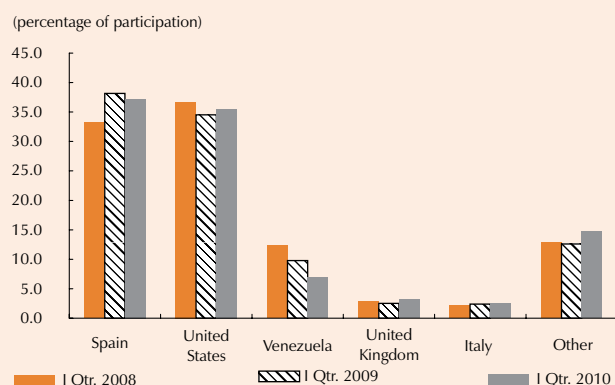
1 The monthly amount of foreign currency authorized to be sent to family members abroad was reduced and the conditions for access to Cadivi became more restrictive with respect to blood relationship and required documents.

Table B3.1
Income from Workers' Remittances in Some Latin American Countries
(millions of dollars and percentages)

	Accumulated as of			Variation 2009 (percentage)	Variation 2010 (percentage)
	2008	2009	2010		
As of March					
Jamaica	498	412	452	(17.3)	9.7
Czech Republic	777	742	783	(4.5)	5.5
El Salvador	912	843	848	(7.6)	0.6
Ecuador	760	555	557	(27.0)	0.4
Guatemala	1,001	939	908	(6.3)	(3.3)
Brazil	693	592	562	(14.6)	(5.1)
Honduras	644	625	588	(3.0)	(6.0)
Mexico	5,756	5,476	4,819	(4.9)	(12.0)
Colombia	1,141	1,095	901	(4.0)	(17.7)
As of May					
Jamaica ^{a/}	676	554	615	(18.1)	10.9
Brazil	1,152	951	929	(17.5)	(2.3)
Mexico	10,316	9,156	8,731	(11.2)	(4.6)
Colombia	1,962	1,777	1,550	(9.5)	(12.8)

a/ As of April.
Source: Balance of payments of the central banks.

Graph B3.2
Remittances by Country of Origin



Source: Banco de la Republica quarterly survey of remittances.

3. Factors that Explain the Recent Performance of Remittances

The economic literature states that remittance flows depend on the number of immigrants, the amount of time they have lived in the foreign country and their ability and willingness to remit money to their families in their

native country. The capacity is determined by the level of employment or unemployment the immigrants have as well as their income. Their willingness to send money² weakens the longer they stay and the more their bonds to their family in their native country loosen. Furthermore, for those countries which receive remittances from various economies around the world, there has been evidence of the impact on the short term fluctuation of those currencies caused by changes in the exchange rates (the currencies from which the remittances are made with respect to the currencies in which they are paid).

In the first five months of 2010, indicators such as the unemployment rate and the level of income, which affect both the possibility for Colombians who reside in Spain and the United States to send remittances to Colombia and their value, have not shown clear signs of recovery. As Table B3.3 shows, the unemployment rate for Hispanics

2 The economic literature has identified several reasons behind sending money to the country of origin among which are: altruism, investment, safety, payment of debts, etc. The altruistic motivation implies that the immigrant is concerned about the well-being of his family, although this motivation declines as the time of residence abroad gets longer.

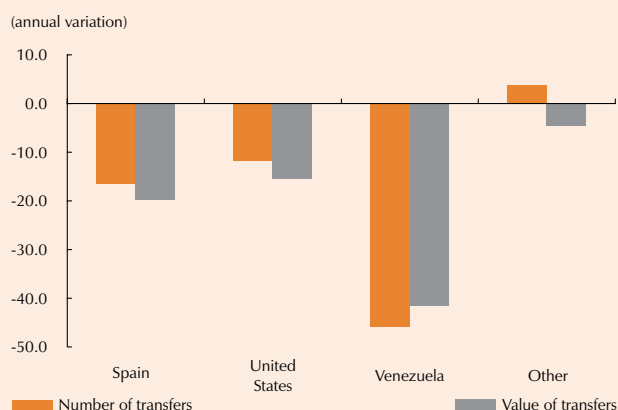
Table B3.2
Variation in Remittances by Country of Origin
(millions of dollars and percentages)

Country of Origin ^{a/}	First quarter			Variation in dollars		Contribution to the variation
	2008	2009	2010 ^{b/}	2009	2010	2010
Spain	372	410	329	38.1	(80.9)	(42.5)
United States	410	371	314	(39.3)	(57.0)	(30.0)
Venezuela	138	105	61	(32.6)	(43.8)	(23.0)
Other	199	188	180	(10.9)	(8.6)	(4.5)
Total	1,119	1,074	883	(44.8)	(190.3)	(100.0)

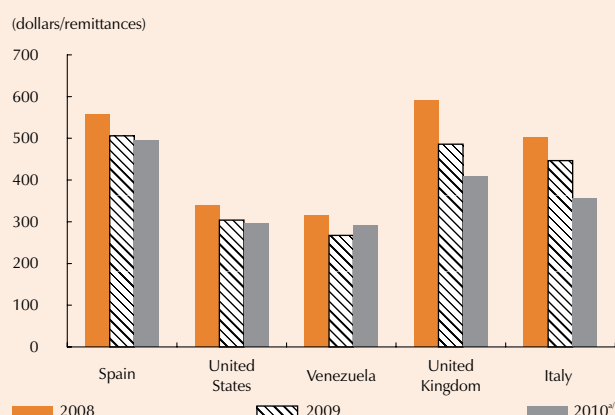
a/ Remittances channeled through exchange intermediaries.
b/ Provisional data subjected to revision.
Source: Banco de la Republica quarterly survey of remittances.

Graph B3.3

A. Variation in the Value and Number of Remittances by Country of Origin (First quarter of 2010) ^{a/}



B. Average Remittance by Country of Origin (First quarter of 2010) ^{a/}



a/ Preliminary data.
Source: Quarterly survey of remittances by Banco de la Republica.

in the United States³ as well as for foreigners who live in Spain has risen and remains at historically high levels even though the rate of decline for the annual quarterly GDP has diminished and was even positive in the case of the United States.

In Spain, where more than 70% of the Colombian immigrants work in the area of services, the unemployment has determined the changes in the remittances because the current growth in the number of unemployed people in the industrial and service sectors matches the drop in remittances sent to Colombia (Graph B3.4).

Also, the weekly income of jobholders in the United States measured in constant terms has declined and in Spain, the rise in salaries is lower in 2010 with respect to the same quarter in 2009 based on estimates of national accounts.

As of January 2010, the municipal census of Spain shows that the Colombian population living in that country has dropped an annual 2.5% as it went from 296,674 Colombians registered in 2009 to 289,296 in 2010. Taking into account the lower number of Colombians in Spain and the average remittance received from that country (US\$494), those factors could be responsible for the 1% drop in the remittances during the first quarter of 2010. Thus, when both the reduction in the number of Colombians residing in Spain and the deterioration in the

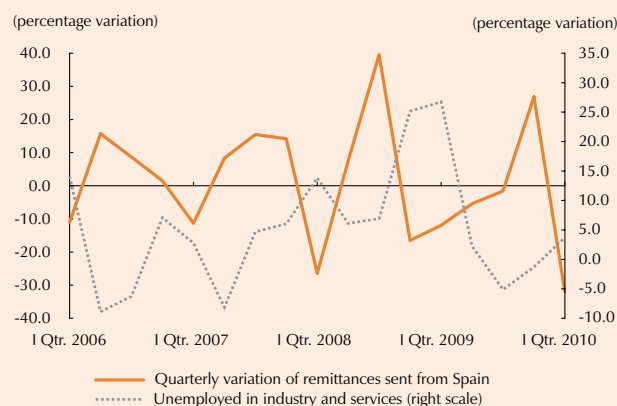
3 Based on the Bureau of Labor Statistics in the United States the average unemployment rate of Colombians who reside in that country was equivalent to 9.8% in 2009, which is lower than the one for Mexicans (11.6%), Salvadorians (12.6%), Dominicans (13.3%) and Guatemalans (11.7%). In contrast, the unemployment rate of Colombians was above what was estimated for Jamaicans (9.6%).

Table B3.3
Some Reference Indicators in Spain and the United States

	United States		Spain	
	I Qtr. 2009	I Qtr. 2010	I Qtr. 2009	I Qtr. 2010
a. Unemployment rate (percentage) ^{a/}	11.6	12.6	28.4	30.8
b. Income (percentage and dollars) ^{b/}			4.1	2.5
Current	545	554		
Constant	248	246		
c. Growth of the GDP ^{c/}	(1.4)	2.9	(3.3)	(1.3)
d. Colombian residents ^{d/}	n.d	n.d	296,674	289,296

a/ United States: unemployment rate for Hispanics; Current Population Survey, Bureau of Labor Statistics. Spain: foreign population above 16, INE data.
b/ United States: average weekly income for the full-time salaried employees, Hispanics.
c/ Spain: INE, GDP at current prices. United States: BEA, GDP at current prices.
d/ Spain: INE based on the Municipal Census, January 2010. Provisional data.
Sources: National Institute of Statistics in Spain and Bureau of Labor Statistics of the United States.

Graph B3.4
Relationship between the Market and the Official Exchange Rate in Spain and the Quarterly Value of the Remittances Sent from Spain



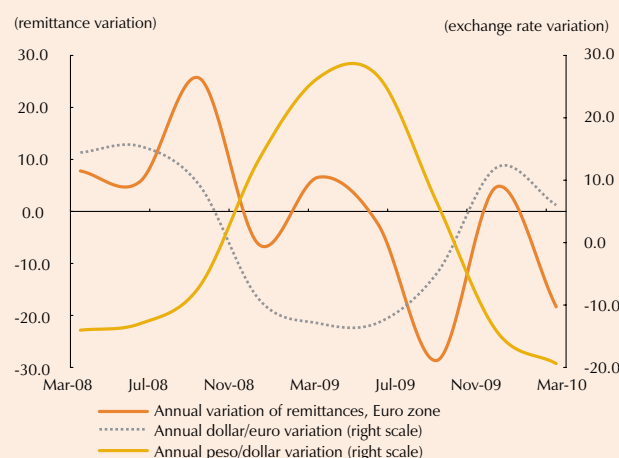
Source: National Institute of Statistics in Spain and Banco de la Republica.

variables that determine the immigrants' capacity to send money to their countries of origin is considered (such as employment and income), it is not surprising that the drop in the amount of money sent by workers from Spain explains the 42.5% decrease in the total remittances received in Colombia during the first quarter of 2010.

Another factor that helps to explain the trend in the flow of remittances to Colombia is the change in the exchange rates of the euro with respect to the dollar and the dollar

with respect to the Colombian peso.⁴ Although some transactions are made in euros, the trade practices usually cause them to be converted into dollars and after that be paid in pesos to the final beneficiary. Therefore, if the total effect is an appreciation of the peso with respect to the euro, the beneficiary will receive fewer pesos in each transfer. In the opposite case, the amount will rise. During the first quarter of 2010, the reduction in remittances sent from Europe coincided with the appreciation of both the dollar with respect to the euro and the peso with respect to the dollar, which discouraged immigrants from sending remittances (Graph B3.5).

Graph B3.5
Remittances from the Euro Zone and Exchange Rates



Source: Banco de la Republica.

In summary, the remittance income received by Colombia from the beginning to May, 2010 continued dropping at a faster rate with respect to 2009 mainly due to the reduction in the amount of money sent from Spain. This was responsible for 42.5% of the total decline in the first quarter of 2010. In that country as well as the United States and Venezuela (the main economies that employ Colombian workers) there is no clear evidence of a recovery in economic performance and employment levels. In addition, the appreciation of the dollar with respect to the euro that has been seen so far in 2010 has meant that for each euro sent from Europe Colombian families have received fewer dollars. Also, the appreciation of the peso has reduced that income in local currency.

4 Based on the information available as of March, 2010, 44% of the remittances were sent from the Euro zone.

Box 4

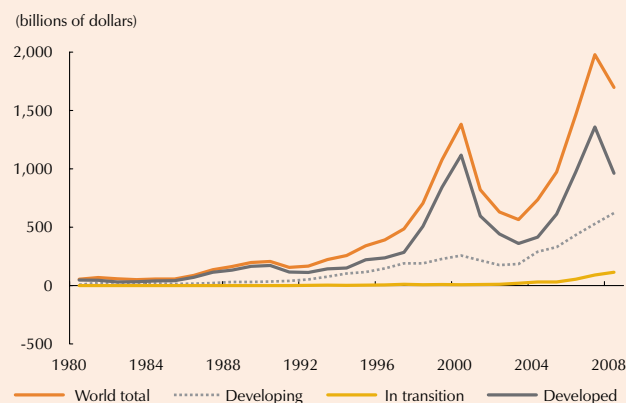
FLOWS OF GROSS FOREIGN DIRECT INVESTMENT¹ INTO COLOMBIA

This box gives a brief description and set of features for the changes in the flows of gross foreign direct investment (FDI) in the world and into Colombia.

1. FDI Flows in the Global Economy

The FDI tendencies at the global level have been determined by factors such as global economic cycles, trade liberalization and globalization processes, cases of privatization, the rise in the international prices for commodities and the advent of global financial crises, (as have been observed since 2007). Between 1980 and 2008, several stages have been seen in the FDI flows denominated in current dollars (Graph B4.1). In particular, starting in the early 80's and continuing until the mid-90's, the annual growth of FDI was relatively low. In contrast, in the last half of the 90's and between 2004 and 2007, the rate of growth for FDI global flows climbed and showed annual increases that were above 30%. However, since 2008 there has been a drop in the flows of direct investment although the average for the last two years remains far above that of the last two decades.

Graph B4.1
Gross FDI Revenue ^{a/}



Source: Unctad.

Up to the 1980's, an average of 75% of the global direct investments were made in developed countries, but since the 1990's that percentage has dropped to 68%. In 2008 as a result of the financial crisis, the flows diminished mainly due to the decrease in investments in developed

1 This refers to the long term investments that a foreign company makes in the country (income minus capital reimbursement).

countries while those for both developing and in-transition economies continued to climb.

In the case of Latin America and the Caribbean, the foreign capital for direct investment experienced a growing trend after the latter part of the 1980's, especially in the 1994-2000 and 2004-2008 period while there was a drop between 2001 and 2003. As shown in Graph B4.2, the FDI amount invested in the region decreased in 2009 as a consequence of the worldwide financial crisis. Although Colombia has improved its relative position as a recipient of FDI capital since 2004, and has become the fourth country after Brazil, Mexico and Chile, the FDI in Colombia for 2009 represented only 3.1% in terms of the GDP while in Chile, it was 3.7% and in Peru, 7.7%.

It is important to mention that the FDI flows received by the Latin American countries have traditionally been intended for the exploration and export of natural resources, the expansion of their foreign sales to new markets and the consolidation of exports of industrial products sent to regional markets.

2. Flows of Gross Foreign Direct Investment in Colombia²

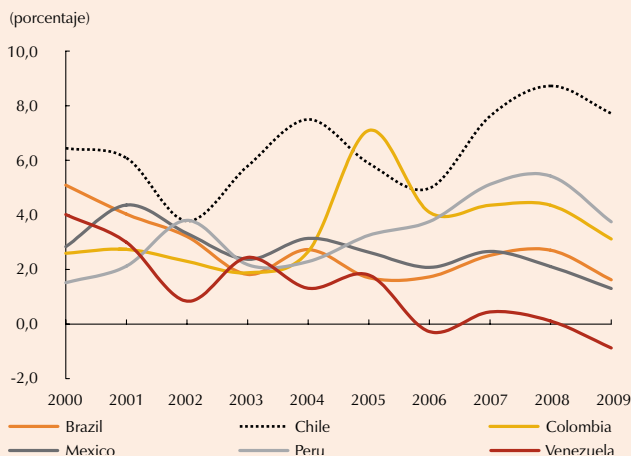
The FDI flows (income minus capital reimbursement) in Colombia³ provide one of the main sources of foreign financing for the country and are relatively concentrated in few sectors and recipient companies. Also, these funds have been channeled into activities focused on foreign markets such as the drilling for oil and mining for coal

2 In our country, the FDI and the portfolio operations are regulated by the Statute for International Investments (Decree 2080/2000). In some cases, such as that of foreign companies that work in the mining sector, there are specific norms issued and regulated by the corresponding ministries. Furthermore, they must comply with the requirements of Resolution 08/2000 issued by the Board of Directors in reference to their foreign currency transactions, which allow the international investors in the mining sector to voluntarily choose between either the general or a special exchange statute.

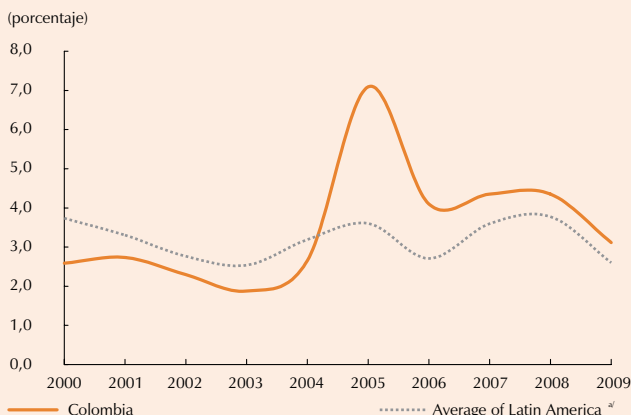
3 Banco de la República prepares the statistics for gross FDI flows in Colombia (income minus capital reimbursement). The calculation is done on the basis of international methodological criteria that facilitate the comparison of data taken from the foreign exchange balance, the customs declaration of goods and the surveys of foreign trade in services applied by Banco de la República. Also, sector and accounting information from the companies are used to that purpose.

Graph B4.2
FDI Flows in Terms of the GDP

A. Latin America



B. Latin America vs. Colombia

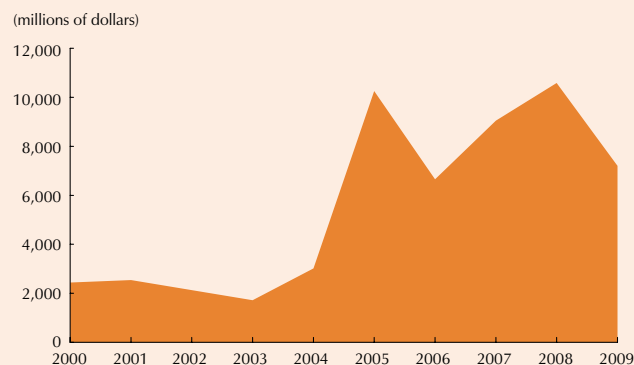


a/ Excluding Ecuador.
Source: central banks, ministries of the economy and statistics institutes, Banco de la República calculations.

and, to a lesser degree, on the sectors oriented mainly towards the domestic market, such as food and beverages, financial system and public services. By country of origin, the FDI flow statistics indicate that the funds basically come from the United States, Panama, Spain, England and the international financial centers (Virgin Islands, Cayman Islands and Anguilla).

As was mentioned above, the FDI flows into Colombia have shown significant growth since 2004 (Graph B4.3). This increase was mainly due to a higher globalization of the country, a positive performance of the Colombian economy, the sale and merging of important national companies through the use of foreign capital, the increase in output by the energy-mining sector, an upward trend for the international prices for mining products and the

Graph B4.3
Gross FDI Flows into Colombia



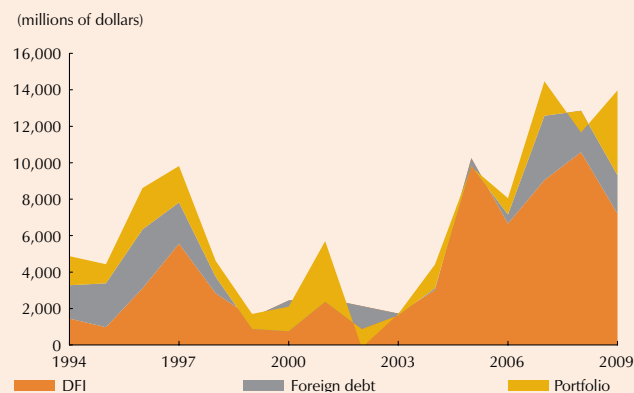
Source: Banco de la República.

expansion and modernization of the communication, transportation and commerce sectors. In 2009, the FDI flows decreased as a result of the global financial crisis, except for the flow going to the energy-mining sector.

As a result of the described performance, the FDI has been the main foreign financing source for the country since 2004 (Graph B4.4). In 2009, in spite of Colombia's higher foreign debt through public debt bonds and the reduction of the FDI revenue, the latter continued to be the main financing source for the current deficit in Colombia's balance of payments, which represents 52% of the total liabilities of the economy.

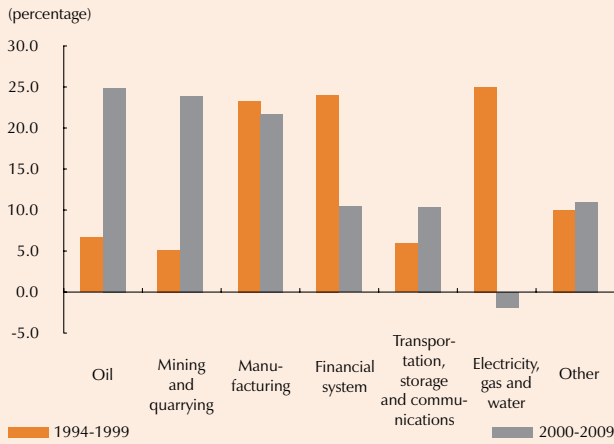
Up to the year 2000, foreign capital was increasingly channeled to the petroleum, electricity, manufacturing, financial system, transportation and communication sectors (Graph B4.5). It should be emphasized that the positive performance of the capital flows going to the oil industry was caused by the critical investments required

Graph B4.4
Structure of Liabilities in the Balance of Payments



Source: Banco de la República.

Graph B4.5
Share of Investments in the Total Gross FDI by Economic Activity



Source: Banco de la República.

for the exploration and drilling phases of the petroleum-related projects. After 2004, the structural change in the tendency of foreign investments resulted from not only the higher incentive of the mining activities but also the allocation of substantial investment flows to activities related to industry, commerce and transportation. It was only starting that year that considerable amounts that are associated with transactions of companies in the oil mining and quarrying sectors have been registered. Indeed, the oil drilling went from an average of 7% of the total FDI in the 1994-1999 period to 25% between 2000 and 2009. Likewise, the mining and quarrying sector went from 5% to 25% of the FDI in the same periods.

Finally, it must be mentioned that changes in the regulations for the oil industry, which began in Colombia back in the 90's, have created more favorable conditions for the inflow of foreign capital necessary for the development and expansion of the mining activity in the country.

III. INTERNATIONAL RESERVES

Since the beginning of the international financial crisis, Banco de la República has adopted a series of measures to reduce the financial risks associated with the management of international reserves. These measures have reduced the risks of the investment portfolio and guarantee that the country will count with sufficient liquidity to face a more prolonged crisis.

Since the beginning of the international financial crisis, Banco de la República has adopted a series of measures to reduce the financial risks associated with the management of international reserves. These measures have been explained in detail in the previous *Reports to Congress* and in the *Management of International Reserves* document for March, 2009 and the authorities have acted in pursuance of their constitutional mandate to manage the investments under the strict criteria of safety, liquidity and profitability. Furthermore, in May 2010, the IFM approved the renewal of a Flexible Credit Line of for approximately US\$3.500 m⁶¹ (See Box 5, pgs. 134-135).

The measures adopted by the Bank have reduced the investment portfolio risks and have made it possible to guarantee that the country will have enough liquidity to face an extension of the international financial crisis like what has been seen in the European markets so far in 2010. However, the low historical levels of the interest rates of the main central banks and the decline in exposure to credit and market risk caused a significant reduction in the income from the

61 The amount approved by the board of the IMF was equivalent to SDR2.322 using the SDR rate at the end of May, 2010 (US\$1.4743/SDR) as the reference.

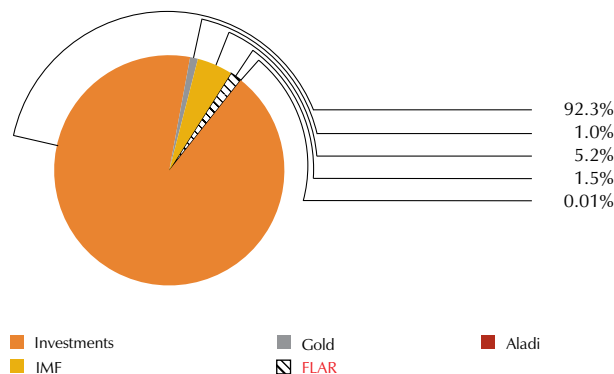
investment of the reserves. The depreciation of the also, affected the portfolio return. Nevertheless, the Bank has a large reserve for losses due to currency fluctuations, which will allow it to counteract the effect of this situation.

In this chapter, the current situation for Colombia’s international reserves is explained and the factors that have caused their low return are analyzed.

A. COMPOSITION OF THE INTERNATIONAL RESERVES AND MANAGEMENT POLICIES

In June 30, 2010, gross international reserves registered US\$26,411.7 m and the short term foreign liabilities were of US\$9.5 m,⁶² as a result of which, the net international reserves totaled US\$26,402.2 m thus registering a rise of US\$1,046.5 m with respect to the data seen at the end of last year. This change is primarily explained by Banco de la República’s intervention in the foreign exchange market. The Bank made net purchases of US\$1.600 m in foreign currency to date this year due to the losses of US\$398 m resulting from the exchange rate differential and the US\$197.7 m reduction in TGN deposits.

Graph 88
Make up of the International Reserves as of June, 2010



Source: Banco de la Republica.

The international reserves are divided into four main components: i) the investment portfolio which is made up of financial instruments in the international markets (US\$24,369.8 m which is to say 92.3%), ii) the participation in the IMF (US\$1,360.9 m or 5.2%) and in the Latin American Reserves Fund (FLAR) (for US\$405.5 m which is 1.5%), iii) investments in gold (US\$273.5 m which is 1.0%) and iv) the contributions to the international agreement of the Latin American Integration Association (Aladi) (for US\$1.9 m or 0.01%) (Graph 88).

1. Composition of the Investment Portfolio

The reserves investment portfolio is divided into two components: working capital and the investment tranche.

The purpose of the *working capital* is to cover the immediate liquidity needs of the reserves. It is the portfolio which receives the resources from intervention in the foreign exchange market and its investments are concentrated in very short term assets denominated in dollars. Given that the purpose of this tranche

62 These liabilities mainly correspond to the amounts to be paid for agreed investments.

is to give immediate liquidity in order to intervene in the foreign exchange market, the working capital is concentrated in deposits and investments that can be liquidated in a single day at a very low cost. The level of working capital fluctuates between US\$390 m and US\$2.000 m.

The *investment tranche* has a maturity and return profile that is higher than that of working capital with liquidity also being a priority. This tranche is invested in a larger number of instruments in comparison to working capital as well as in ones that have longer maturities. As of June 30, 2010, the value of the investment tranche came to US\$23.742 m.

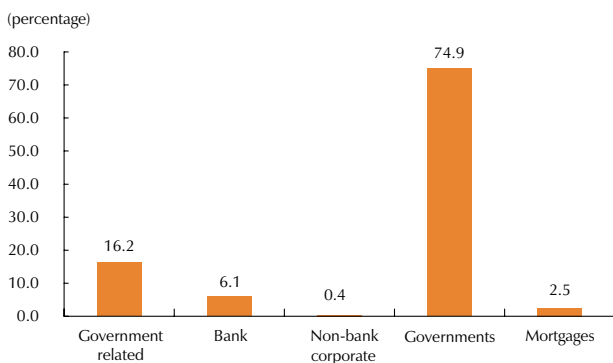
The majority of the reserves investment portfolio corresponds to investments in governments of developed economies and in quasi-governments,⁶³ which represent 91.1% of the portfolio. The banking and corporate debt securities from industrialized countries currently represent 6.4% and all of them have

credit ratings that are equal to or above A. Mortgage-backed securities constitute 2.5% of the investments and all of them are guaranteed by agencies that are backed by the US government.⁶⁴ (Graph 89).

The issuers in which the reserves are invested have a low credit risk. In the case of the bank and corporate issuers, the minimum short term rating that is required is A-1/P-1/F-1,⁶⁵ which places them at the highest possible level. The minimum long term ratings are AA- for banking, corporate and local authority issuers and A- for the remainder of the entities backed by or related to governments. In all of the cases, the minimum long term rating that is demanded by the Bank 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

Graph 89
Distribution of the Investment Portfolio by Sector



Source: Banco de la República.

63 The securities in question correspond to the ones issued by entities that were guaranteed or backed by governments (i.e. Fannie Mae and Freddie Mac), supra-nationals (i.e. the World Bank, Inter-American Development Bank) and local authorities (i.e. cities and states), etc.

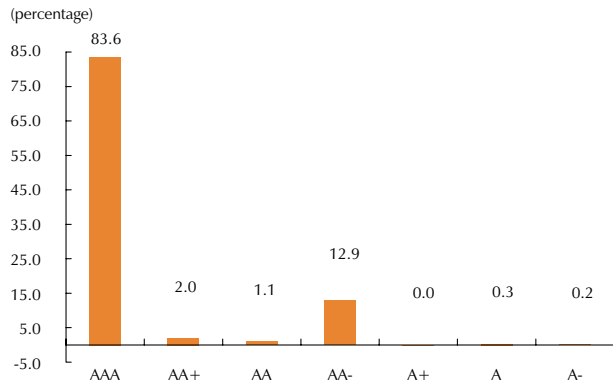
64 The agencies mentioned are Fannie Mae, Freddie Mac and Ginnie Mae. The government of the United States holds a majority interest in Fannie Mae and Freddie Mac and guarantees the total amount of Ginnie Mae's debt.

65 The investments with maturities that are less than 397 días are considered short term. Investments with maturities that are longer are considered long term.

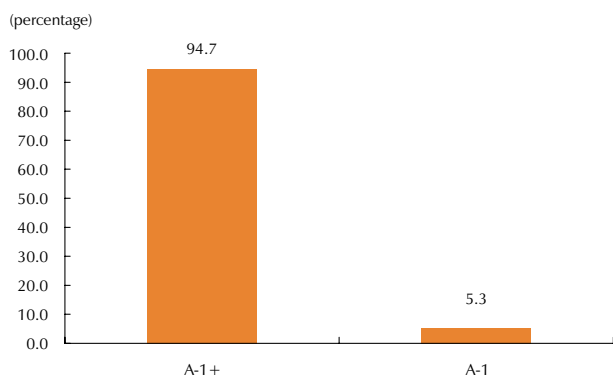
66 To limit the credit risk, Banco de la República takes the credit ratings published by the most highly respected international agencies (S&P, Moody's and Fitch Ratings) as their reference point. For the short term, the highest rating these agencies give is A-1+/P-1/F-1+ and the lowest is D. For the long term, the highest rating is AAA and the lowest is D. It is considered safe for the average investor to invest in investment grade papers or, in other words, ones that have ratings that are above or equal to A-3/P-3/F-3 in the short term and to BBB- in the long term.

Graph 90
Distribution of the Investment Portfolio by Credit Rating

A. Long term

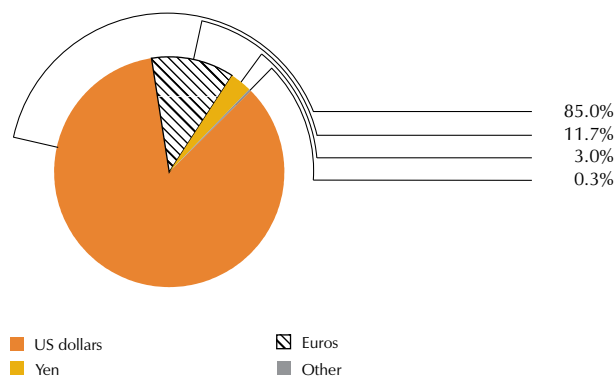


B. Short term



Source: Banco de la Republica.

Graph 91
Foreign Exchange Composition of the Investment Portfolio



Source: Banco de la Republica.

99.5% of the long term investments have ratings that are AA- or higher (100% have ratings that are above A-), which makes the probability of default by an issuer very low (Graph 90).

The Bank establishes the foreign exchange composition of the investment tranche of the reserves as a replica of the outlays for currencies in the country's balance of payments. Currently, the foreign exchange target composition is 85% US dollars, 12% euros and 3% yen. The current foreign exchange composition of the portfolio differs slightly from the target since, within strict limits and in order to improve the return, the portfolios are allowed to have slight deviations and to make investments in currencies of other developed countries such as the British pound, Swiss franc or the Canadian dollar (Graph 91).

2. Benchmark Index and Portfolio Management

The great majority of central banks around the world manage their international reserves guided by a theoretical portfolio or benchmark. In the capital markets, a benchmark is referred to as a basket of assets with predetermined weights based on certain rules that define its composition. In general, benchmark tries to duplicate the behavior of a market in financial assets as a whole and serves as an indicator of the performance of other investment portfolios in the same market.⁶⁷

The benchmark for the investment tranche of the reserves is the portfolio that duplicates the foreign exchange composition of the balance of payment outlays and complies with the strict risk criteria defined by the Banco de la Republica. This serves as a framework of reference for measuring the management of each one of the portfolios. The current composition of the reference index is given

⁶⁷ For example, some of the most well-known benchmarks on the market are the IGBC in Colombia, or the S&P 500 and the Dow Jones in the United States.

in Table 28. The modified duration⁶⁸ of the index is 0.43, which implies that the sensitivity of the investment prices to movements in the interest rate is very low.

Table 28
Composition of the Reference Index for the Investment Tranche

Currency	Type of asset	Associated index	Peso (percentage)
US dollars	Short term bank investments (money market)	<i>Merrill Lynch LIBID 1-month Constant Maturity</i>	37.1
	Investments in short term government securities	<i>Merrill Lynch T-Bill index</i>	37.8
	Investments in US government bonds	<i>Merrill Lynch 0 to 3 year Government Bond Index</i>	10.1
	Total in dollars		85.0
Euros	Investments in short term government securities	<i>Merrill Lynch German T-Bill index</i>	7.0
	Investments in German government bonds	<i>Merrill Lynch 0 to 3 Year Government Bond Index</i>	5.0
	Total in euros		12.0
Yenes	Investments in Japanese government bonds	<i>Merrill Lynch 0 to 3 year Government Bond Index</i>	3.0
	Total in yen		3.0

Source: Banco de la República.

As was mentioned, it should be remembered that since the reserves have different purposes, the investment portfolio is divided into working capital and the investment tranche. At the same time, the investment tranche is divided into two components: the indexed and non-indexed tranches.

- The *indexed tranche* seeks to duplicate the composition of the benchmark. The investments of this tranche are made exclusively in money market assets in the United States and in securities issued by the governments of the United States, Germany and Japan. As of June 30, 2010 the value of this tranche came to US\$14.804 m.
- The management of the *non-indexed or active tranche* seeks to get better return than the benchmark. To achieve this goal, the composition of the

68 The modified duration is the sensitivity of the value of the portfolio to movement in the interest rates (market risk). For example, a modified duration of 2 implies that the value of the portfolio drops 2% if the interest rates abroad rise 1%. The low levels of the interest rates in the markets of developed countries, the limited leeway for these to decline even more and the possibility that the central banks of the developed countries will revert to their normal monetary policy posture reduced the probability that the securities would appreciate and raised the market risk for the portfolio. That is why the Bank has decided to maintain a low modified duration.

portfolio in this tranche is different from that of the benchmark. Within a framework of controlled risk, the managers of this tranche apply their experience and resources to determine strategies that will increase the return on the reserves in the long term. The non-indexed tranche had a value of US\$8.938 m at the end of June, 2010.

The return of the benchmark is compared to the returns seen for the reserves investment portfolios to evaluate whether or not the managers' work has been successful. The managers' challenge is to get a return that is better than the index within the strict investment guidelines.

3. External Management Program

Banco de la República, like several other central banks, delegates the management of a portion of their portfolio to external managers that are prestigious and have a well-known track record. To the degree in which the international reserves have grown and the financial markets have specialized, the Bank has considered it appropriate to use the services of entities that have broad experience in portfolio management for third parties, that have abundant resources and information and that have solid analytical capabilities available and a technological and human infrastructure that is highly sophisticated.

Banco de la República directly manages the working capital, the indexed tranche and a portion of the non-indexed tranche (US\$1.377 m). In 1994, the external management program was adopted to manage the rest of the resources. The managers of the non-indexed tranche are authorized to invest in different assets and in proportions that are dissimilar to the benchmark based on strict policies and limits.

This program has made it possible to train the Bank's own staff and has facilitated the access to information that is necessary to support the investment policies and the follow up on the investments made internally. From its beginning, the external management program has generated an annual gross return of 0.16% compared to the benchmark. Taking into account the fees paid, the net annual return from the program has been 0.07%.

The firms under investment management agreements through the external management program are the following: Western Asset Management, Deutsche Bank Advisors, Goldman Sachs Asset Management, BlackRock Institutional Trust Company and Wellington Management (Table 29). Currently, these entities manage 31% of the country's international reserves based on the investment guidelines that are clearly defined by the Bank. These managers were selected for their high technical standards.

Table 29
External Management Program for the Portfolio

Firma	Amount managed (millions of dollars)
Deutsche Asset Management	1,080
Goldman Sachs Asset Management	1,721
Wellington Management	972
BlackRock Institutional Trust ^{a/}	2,694
Western Asset Management	1,092
Total	7,561

a/ In 2009 BlackRock International Trust acquired Barclays Global Investors, a company that also participated in the external management program. Currently, BlackRock manages two portfolios with different guidelines.
Source: Banco de la Republica.

The Bank defines the parameters for evaluating the work done by the management firms. These parameters are revised periodically⁶⁹ and depending on the success of the manager, decisions such as modifying the amount under management or canceling the agreement may be made.

B. PERFORMANCE OF THE INVESTMENTS

The historical return of the international reserves since 2005 is given in Table 30. In the first half of 2010, the return on the international reserves was negative by US\$273 m. This result was due to the loss of US\$398 m from the depreciation of other currencies with respect to the dollar, mainly the euro. There was a gain of US\$125 m from the appreciation of investments and interest accrual.

The low return on the reserves, which was expected in the March, 2010 *Report to Congress*, was the result of three factors:

- The euro weakened 14.55% with respect to the dollar in the first half of the year due to the worsening fiscal situation in Greece and in other countries in the euro zone such as Portugal, Spain, Ireland and Italy.
- The interest rates have remained very low in the most important developed economies.

69 Monthly reports are sent to the Reserves Committee with information on the performance of the portfolios. Likewise, a consolidated review of all of the management is done annually. The International Reserves Committee is in charge of setting the goals, principles and general policies of the reserves management. They ordinarily meet at least once every two months. The meeting is presided over by the General Director of the Bank and all of the full-time board members and the Minister of the Treasury and Public Credit (or his representative) participate.

Table 30
Returns on International Reserves

Year	Millions of dollars	Annual rate of return (percentage)
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
2010 ^{a/}	(273)	(1.0)

Note: Data from the foreign exchange balance.
a/ Up to June 30, 2010.
Source: Banco de la Republica.

- The decision to have a portfolio with a more conservative risk profile implies obtaining a lower return. When the credit risk is reduced and the share of government securities in the portfolio is increased, a lower rate of return is seen. In addition, when the average maturity of the investments is reduced in order to lower the market risk, the yield is also affected since currently, the short term rates are lower than the long term ones.

For the rest of the year, the return on the reserves is expected to remain low since the Fed and other central banks have publically announced that they will keep interest rates low and that the fiscal adjustments that are being made by the European governments are causing the outlook for economic growth to get worse in the medium term.

C. STATE OF THE CLAIMS FROM THE 2008 CREDIT EVENTS

As was explained in the last *Report to Congress* dated March, 2010, at the end of 2008 there were two credit events: a Lehman Brothers security for US\$2.7 m and a Sigma Finance Inc. security for US\$20 m unconditionally and irrevocably guaranteed by Sigma Finance Corporation (called Sigma hereafter) in a security lending program handled by the Bank of New York Mellon. An update on the state of the claim is given below.

1. Banco de la República Suit Against the BNYM

As was reported in March, Banco de la República, represented by the law firm of Crowell & Moring LLP, filed 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. (BNYM hereafter) before the Supreme Court of the State of New York on April 21, 2009 under the consideration that the BNYM, in carrying out the securities lending agreement, breached the obligation entrusted to it by the Banco de la República by investing in Sigma. The purpose of this suit is to recover the unpaid sum.

After the suit was filed, the response to it and other proceedings were carried out, the case was transferred to the Federal Court of the Southern District of New York at the request of BNYM at the end of January, 2010. In the hearing held in mid-March, 2010, the federal judge asked that the suit be filed again to adjust it to the new jurisdiction, which was done on April 16, 2010. Since then, the normal legal procedures have gone into effect within the proceedings

and the court hearing before the judge to define the objective of the action is pending.

The lawyers abroad have reported that the second half of 2010 will be mainly dedicated to the *Discovery* stage, which consists of each of the parties getting the relevant information about the case and requesting what could be considered evidence in court (depositions and interrogatories) from the other party.

In February, 2010, BNYM requested that four proceedings against them not only in New York, which is the Banco de la República case, but also in Washington, Oklahoma and California for similar facts related to the securities lending program and the investment in Sigma be consolidated so that the Discovery of the four separate claims could be adjudicated together before a single judge. On June 7, 2010, the respective appellate court (a panel of several judges) denied the consolidation of the actions after Banco de la República expressed its opposition. They argued that there were fundamental differences between the four proceedings and that the consolidation would benefit neither the witnesses nor the parties.

2. Restructuring Process of Lehman Brothers Holdings Inc.

Banco de la República, represented by the law firm Morrison & Foerster LLP, brought a formal claim before the New York Bankruptcy Tribunal on August 25, 2009, complemented on September 9 of the same year, to be recognized as a creditor in the restructuring process of Lehman Brothers Holdings Inc. according to Chapter 11 of the Bankruptcy Code of the United States.

Among the steps in the proceedings, Lehman must present a restructuring plan with a proposal for paying all of their creditors based on the precedence of claims and assets. Although it was expected that Lehman would present their plan on March 15, 2010 and the creditors had until May 17, 2010 to accept it, the Court has granted Lehman multiple extensions thus modifying the terms that were initially mentioned. Indeed, Lehman presented the last version of their restructuring plan on April 14, 2010, which has not been accepted by the Court yet and consequently could be modified.

Box 5 RENEWAL OF THE IMF FLEXIBLE CREDIT LINE

On May 7, 2010, the IMF approved the renewal of Colombia's access to the flexible credit line (FLC) for an amount equivalent to 300% of the country's quota in this multilateral entity (approximately US\$3.500 m) for one year. This line of credit is an instrument created by that multilateral entity to support member countries that have strong economic foundations, prudent policies and a solid institutional framework for economic policy. This instrument operates as a type of insurance that enables the countries to face a substantial deterioration in the external conditions in the case of a possible extension of the international financial crisis. Once the access to this financing mechanism is approved, the funds can be completely disbursed without the disbursement being tied to any conditions with respect to commitments regarding economic policy in contrast to what happens in the traditional programs backed by the IMF.

Colombia's application for access to the FCL was approved for the first time in May, 2009 for 900% of the Colombian quota in the IMF (approximately US\$10.400 m). At that time, the country was exposed to the effects of the international financial crisis, which had been aggravated in the third quarter of 2008 by the bankruptcy of Lehman Brothers. The GDP had declined during the fourth quarter of 2008 and the growth predictions for the entire year of 2009 were close to 0% followed by a modest recovery in 2010. The uncertainty with respect to the direction the world economy would take and the likelihood that Colombia's access to foreign financing could be restricted were factors that justified the country's application for the FCL from the IMF. The amount requested was considered enough to provide for Colombia's foreign financing for a year amidst very adverse conditions at the international level.

The economic figures registered in 2009 turned out to be more favorable than those that had been predicted at the beginning of the year (Table B5.1) and the risks perceived in the international financial markets have declined significantly. The Colombian economy recorded a growth of 0.8% in 2009 and this figure includes an annual growth rate of 3.4% in the last quarter of the year. The investors' perception of risk returned to the levels seen prior to the bankruptcy of Lehman Brothers and the risk premiums for Latin American countries, measured by the CDS and EMBI, showed a falling trend starting in March-April, 2009 (Graph B5.1).

Although the outlook for the Colombian economy is positive for 2010, there is some uncertainty. The end of fiscal and monetary stimulus programs in developed

economies, the fragility of the financial systems in some countries, the sharp fiscal adjustment required by some countries in the euro zone as well as the financing difficulties some governments are facing could affect the strength of the economic recovery and the performance of the international financial markets.

The possibility that Colombia could face difficulties in obtaining foreign financing has been reduced with respect to the 2009 scenario but has not yet disappeared. Colombia's one-year CDS have declined 65%, which could be interpreted as a lower likelihood that Colombia will suffer from an external shock compared to the time when the FCL was requested in 2009. Furthermore, the external position of the country has been strengthened by both the allocation of special drawing rights (SDRs)¹ for approximately US\$980 m granted by the IMF in the second half of 2009 and the program for daily purchases of international reserves carried out during the first half of 2010. The latter made it possible to buy US\$1.600 m in foreign currency on the market. Keeping these considerations in mind, the renewal of the FCL for 300% of Colombia's quota in the IMF (approximately US\$3.500 m) was requested. This amount represented 33% of what had been requested in 2009. The commitment premium paid to the IMF was US\$6.8 m. The agreement with the IMF is precautionary and the funds will not be used unless the conditions abroad make it necessary.

1 The SDR is a reserve asset created by the IMF. Its value is determined on the basis of a basket of currencies currently made up of the dollar, the euro, the pound and the yen. The usefulness of the SDR as reserve asset is based on the possibility that countries have to exchange it for reserve currencies in other countries in order to face the financing needs of the balance of payments or modify the composition of the international reserves.

Table B5.1
Observed Economic Figures and Projections for 2009 and 2010

	2009		Projection for 2010
	Projection in March, 2009	Observed	
Growth of global GDP ^{b/}	(1.3)	(0.6)	4.6
Growth of the GDP in the United States ^{b/}	(2.8)	(2.4)	3.3
Oil price (US dollars) ^{a/}	48	62	80
Growth of the GDP in Colombia ^{a/}	0.0)	0.8)	4.5)
Current account/GDP ^{a/}	(3.6)	(2.1)	(2.4)
Foreign debt/GDP ^{a/}	23.2)	21.8)	18.9)
Growth of Colombian exports ^{a/}	(25.0)	(12.2)	18.1)
Growth of non-traditional exports ^{a/}	(13.3)	(19.0)	0.8)
Growth of workers' remittances ^{a/}	(15.3)	(14.4)	(8.5)
Growth of imports ^{a/}	(17.3)	(16.0)	18.7)
Inflation in Colombia	Close to the floor of range 4.5 to 5.5	2.0	In the range of 2.0 to 4.0

a/ Banco de la Republica projection.

b/ IMF projection.

Sources: Banco de la Republica and IMF.

Graph B5.1
One-year Credit Default Swap (CDS) in Latin America



Source: Bloomberg.

IV. FINANCIAL SITUATION OF THE BANCO DE LA REPÚBLICA

Based on the results of the return of international results in June 2010, it is expected that the operating results will be negative in the present year. The lower expected income is mainly due to the reduction in the return of international reserves, by the weakening of the euro with respect to the dollar, and, in a lower extent, by the low interest rates.

As indicated in the *Report to Congress*, which was submitted last March, a negative operating result is predicted for the end of 2010. This is due to a decline in income resulting from the slump in the expected profitability of the international reserves that will surpass the decline in expenditures.

In the chapter dealing with the management of the international reserves (pg. 125) it was mentioned that the measures adopted by the Banco de la República have reduced the investment portfolio risks in order to guarantee the liquidity of the country and to face a possible deepening of the international financial crisis. This occurred in a framework of low interest rates of the main central banks and the depreciation of the euro. When the share of investments with lower risks is raised in the reserves portfolio, the return is lower given the direct relationship that exists between risk and return or, in other words, a lower risk means a lower return and vice versa. The depreciation of the euro, in turn, negatively affects the return of the portfolio expressed in dollars. However, the Bank has an ample reserve available for currency fluctuations which has made it possible to face this situation.

A. RESULTS AS OF JUNE, 2010

In the first half of 2010, the Banco de la República submitted a negative operating result due to a lower income (Table 31).

Table 31
Banco de la Republica, Profit and Loss
(billions of pesos)

	performance as of	
	December, 2009	June 2010
I. P and L income	1,291.1	(291.3)
A. Monetary income	1,133.8	(347.9)
1. Interest and returns	1,035.8	(421.7)
International reserves	685.0	(535.9)
Other interest	70.9	48.3
Liquidity operations	192.8	34.9
Valuation of TES	87.1	31.1
Valuation of other securities	0.0	0.0
2. Exchange rate differences	26.3	28.7
3. Coins	51.1	22.8
4. Others	20.6	22.3
B. Corporate income	157.3	56.5
1. Commissions	140.3	48.7
Banking services	72.0	23.7
Trust business	51.2	25.0
Other commissions	17.2	0.0
2. Others	17.0	7.8
II. P and L expenditures	1,135.8	508.0
A. Monetary expenditures	853.9	317.5
1. Interest and returns	601.6	162.1
Remuneration on reserve requirements	69.1	0.0
Remuneration on the National Treasury Office accounts	392.7	104.9
Flexible commitment commission with the IMF	38.4	21.2
Expenses for international reserves management	26.6	11.8
Expenses for monetary contraction operations	74.8	24.1
2. Exchange rate differences	132.9	104.2
3. Cost of issuing and distributing banknotes and coins	114.0	48.6
4. Others	5.4	2.5
B. Corporate expenditures	332.9	164.5
1. Personnel costs	216.9	110.1

Table 31 (continued)
 Banco de la Republica, Profit and Loss
 (billions of pesos)

	performance as of	
	December, 2009	June, 2010
2. Overhead	47.9	21.7
3. Taxes	7.3	3.8
4. Insurance	6.4	3.4
5. Contributions and membership dues	3.0	2.1
6. Cultural expenditures	9.1	3.6
7. Depreciation, provisioning, debt repayments and others ^{a/}	42.2	19.8
C. Pension expenses	(51.0)	26.0
3. Operating result (I-II)	155.3	(799.3)

a/ Includes deferred software.
 Source: Banco de la Republica.

The operating income registered during the period under analysis came from: i) the negative returns on the international reserves (-COL\$535.9 b), ii) the valuation of non-monetary gold (COL\$48.3 b), iii) the temporary liquidity operations (COL\$34.9 b), iv) the valuation of the TES (COL\$31.1 b) and v) the commissions that the Bank receives for banking services and trust business (COL\$48.7 b).

As of the end of June, 2010, the international reserves showed a negative return of COL\$535.9 b (US\$273.3 m). This result is due to the loss of COL\$780.7 b (US\$398 m) because of the depreciation of the currencies in the reserves compared to the dollar and COL\$178.9 b (US\$92.0 m) in income from the accrued interest as well as from the COL\$66.0 b (US\$33.3 m) from the appreciation of investments.

As was stated, the low profitability of the reserves which was anticipated in the March, 2010 *Report to Congress* is due to three factors:

- The euro was weakened by approximately 15% with respect to the dollar in the first few months of the year because of the worsening of the fiscal situation in Greece and in other countries in the euro zone such as Portugal, Spain, Ireland and Italy.
- The interest rates have been kept very low in the main developed economies.
- The decision to have a portfolio with a more conservative risk profile implies receiving a lower profit. Reducing credit risk and increasing the

share of government securities in the portfolio, results in a lower rate of return. Furthermore, when the average investment maturity is reduced to lower the market risk, the profitability is also affected since, currently, the short term interest rates are lower than the long term ones.

Non-monetary gold, in turn, registered an appreciation of COL\$48.3 b as a result of the surge in the international reference price for gold. The liquidity operations through repos generated COL\$34.9 b in income which reflected the lower demand from the financial system and the reduction in the intervention rate. The income registered due to the valuation of the monetary expansion TES (COL\$31.1 b) take into consideration the decline seen in the market negotiating rates and the sale of a portion of the portfolio. The commissions received by the Bank came to COL\$48.7 b due to the exchange rate charges on the commissions paid and the decline in the volume of operations transacted through the electronic trading system (SEN in Spanish) and the drop in the balance of the FAEP portfolio.

With respect to the expenditures, the most notable are:

- The remuneration on the TGN deposits, which came to COL\$104.9 b.
- The differences of COL\$104.2 b in the exchange rate. The performance is explained by the trend of the TRM which, in the period under analysis, showed a 6.41% appreciation of the peso in comparison to the dollar.
- The costs of issuing and distributing COL\$48.6 b in banknotes and coins, which has been carried out in accordance with the program for issuing the above.
- The expenses for the monetary contraction operations were COL\$24.1 b as a result of the lower remuneration rates. The average interest rate so far this year was an effective annual rate of 3.25%.

In the corporate expenses, compared to the same period in 2009, those for personnel (for COL\$110.1 b) continued to show a controlled performance that was directly related to the reduction in the staff and, in addition, a reduction of 2.3% in real terms was observed. The overhead, in turn, totaled COL\$21.7 b and registered a decrease of 2.6% in real terms. The expenses for pensions were COL\$26.0 b for the period analyzed.

B. BANCO DE LA REPÚBLICA'S FINANCIAL STRUCTURE

Below, the variations in the main concepts of assets, liabilities and equity the Banco de la República had as of June 30, 2010 are explained with respect to the balances registered as of December 31 last year (Table 32).

1. Assets

Banco de la República assets registered a balance of COL\$62.924 b at the end of June 2010. This figure is COL\$539 b (0.9%) higher than what was seen in December, 2009 when the assets came to COL\$62.385 b. The main changes in the asset accounts are the result of:

- *International reserves:* At the end of June, 2010, the gross international reserves valued at market prices were COL\$50.530 b (US\$26,411.7 m) which was COL\$1.322 b (-2.6%) lower with respect to the data seen December 31, 2009. This change is explained mainly by: i) the adjustment of the exchange rate as a result of the appreciation of the

Table 32
Balance Sheet - Banco de la Republica Classified by Economic Criteria (December, 2009 - June, 2010)
(billions of pesos)

Accounts	December, 2009		June, 2010		Variation	
	Balance	Percentage participation	Balance	Percentage participation	Absolute	Percentage
Assets	62,385	100.0	62,924	100.0	539	0.9
Gross international reserves	51,852	83.1	50,530	80.3	(1,322)	(2.6)
Contributions in international entities	2,802	4.5	2,798	4.4	(4)	(0.2)
Investments	3,597	5.8	1,570	2.5	(2,027)	(56.3)
Public sector, consolidated debt	0	0.0	0	0.0	0	0.0
Public sector, monetary control	3,580	5.7	1,556	2.5	(2,024)	(56.5)
Bonds: public bank capitalization, etc.	17	0.0	14	0.0	(3)	(17.9)
Loan portfolio	2	0.0	1	0.0	(0)	(11.0)
Public sector, national government	1	0.0	1	0.0	(0)	(12.5)
Other loans	4	0.0	4	0.0	(0)	(3.2)
Provision	(3)	(0.0)	(3)	(0.0)	0	(2.0)
Repo agreements - transitory liquidity support	460	0.7	4,159	6.6	3,700	804.9
Accounts receivable	32	0.1	52	0.1	21	65.4
Other net assets	3,640	5.8	3,813	6.1	173	4.7
Liabilities and equity	62,385	100.0	62,924	100.0	539	0.9
Liabilities	48,545	77.8	53,054	84.3	4,509	9.3
Foreign currency liabilities affecting international reserves	19	0.0	18	0.0	(1)	(3.9)
Monetary base	39,545	63.4	38,937	61.9	(607)	(1.5)
Cash	25,789	41.3	23,722	37.7	(2,067)	(8.0)
Reserves	13,755	22.0	15,215	24.2	1,460	10.6
Non-reserve Interest-bearing deposits	830	1.3	321	0.5	(509)	(61.3)

Table 32 (continued)
Balance Sheet - Banco de la Republica, Classified by Economic Criteria (December, 2009 to June, 2010)
(billions of pesos)

Accounts	December, 2009		June 2010		Variation	
	Balance	Percentage participation	Balance	Percentage participation	Absolute	Percentage
Deposit requirement on borrowing abroad and foreign-capital portfolio investment	0	0.0	0	0.0	0	0.0
Other deposits	62	0.1	152	0.2	89	143.2
National government (National Treasury Office) n/c	2,351	3.8	8,613	13.7	6,261	266.3
National government (National Treasury Office) f/c	609	1.0	192	0.3	(417)	(68.5)
Obligations to international entities	4,260	6.8	4,019	6.4	(241)	(5.7)
Accounts payable	99	0.2	61	0.1	(38)	(38.8)
Other liabilities	770	1.2	742	1.2	(28)	(3.6)
Total equity	13,840	22.2	9,870	15.7	(3,970)	(28.7)
Capital	13	0.0	13	0.0	0	0.0
Reserves	2,867	4.6	3,019	4.8	152	5.3
Surplus	10,805	17.3	7,638	12.1	(3,167)	(29.3)
Special Foreign-Exchange Account settlement	453	0.7	453	0.7	0	0.0
Foreign-exchange adjustment from 1993 on and surplus	9,099	14.6	5,928	9.4	(3,171)	(34.8)
Others	133	0.2	136	0.2	3	2.4
Appraisal of goods and donations	1,120	1.8	1,120	1.8	0	0.0
Results	155	0.2	(799)	(1.3)	(955)	(614.4)
Profit / loss for previous periods	0	0.0	0	0.0	0	0.0
Profit / loss for the period	155	0.2	(799)	(1.3)	(955)	(614.4)

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

peso with respect to the dollar, which lowered the balance of the gross international reserves in pesos, ii) the return on interest, the valuation due to market prices and the exchange rate differential, which produced a COL\$536 b reduction in the reserves, iii) the lower value of the deposits in foreign currency in the Banco de la República, COL\$411 b, and iv) the purchases of foreign currency made by Banco de la República that increased the value of the international reserves in pesos by COL\$3.103 b which partly compensated for the reduction described in the previous numbers.

- *Investment portfolio in national currency:* The balance for this valued at market prices came to COL\$1.570 b in June 2010 which is

COL\$2.027 b lower with respect to the end of 2009. This decline was primarily due to the sales of TES on the part of the Banco de la República for COL\$1.999 b.

Repo transactions used to grant temporary liquidity: A balance of COL\$4.159 b was submitted at the end of June, 2010 which meant an increase of COL\$3.700 b compared to the close of 2009.

2. Liabilities

As of June 30, 2010, the balance of the liabilities was COL\$53.054 b, which is COL\$4.509 b (9.3%) higher than what was registered at the end of 2009. The main sources of the change are given below:

- *Monetary base:* At the end of June, 2010, the monetary base came to COL\$38.937 b, which is COL\$607 b (-1.5%) lower than the value registered at the close of 2009.
- *The national government deposits:* made up of pesos through the TGN in the Banco de la República, had a balance of COL\$8.613 b at the close of June, 2010. This amount is COL\$6.261 b (266.3%) higher than what was seen in December, 2009.
- *Obligations to international entities:* The balance for this item was COL\$4.019 b at the end of June, 2010. This amount is COL\$241 b (-5.7%) lower than what was registered on December 31, 2009.

3. Equity

Equity came to COL\$9.870 b in June, 2010 thus showing a decline of COL\$3.970 b (-28.7%) with respect to the figure from December, 2009. This reduction is primarily explained by: i) the change in the exchange adjustment, which declined COL\$3.171 b (-34.8%) because of the appreciation of the peso with respect to the dollar and ii) the change in the losses for the period of -COL\$955 b.

C. INCOME AND EXPENDITURE FORECAST FOR 2010

Based on the results of the reserves profitability, a negative operating result of COL\$1,101.6 b is estimated for this year. This is COL\$480.6 b higher than what was predicted in the March 2010 Report to Congress (Table 33).

The lower expected income is mainly due to the decline in the returns on the international reserves resulting from the weakening of the euro with respect

Table 33
 Projected Profit and Loss for the Banco de la Republica, 2010
 (billions of pesos)

	December 2009	Projected 2010	Annual Variation	
			Percentage B / A	Absolute B - A
	A	B	B / A	B - A
1. P and L income	1,291.1	(55.1)	(104.3)	(1,346.2)
A. Monetary income	1,133.8	(173.6)	(115.3)	(1,307.4)
1. Interest and returns	1,035.8	(279.7)	(127.0)	(1,315.5)
International reserves	685.0	(500.2)	(173.0)	(1,185.2)
Other interest	70.9	48.3	(31.9)	(22.6)
Liquidity operations	192.8	93.9	(51.3)	(98.9)
Valuation of the TES	87.1	78.2	(10.1)	(8.8)
Valuation of other securities	0.0	0.0	2,232.7	0.0
2. Exchange rate differences	26.3	28.7	9.2	2.4
3. Coins	51.1	55.1	7.8	4.0
4. Others	20.6	22.3	8.3	1.7
B. Corporate income	157.3	118.5	(24.7)	(38.8)
1. Commissions	140.3	100.9	(28.1)	(39.4)
Banking services	72.0	51.9	(27.9)	(20.1)
Trust business	51.2	49.0	(4.3)	(2.2)
Other commissions	17.2	0.0	(100.0)	(17.2)
2. Others	17.0	17.6	3.3	0.6
2. P and L expenses	1,135.8	1,046.5	(7.9)	(89.3)
A. Monetary expenses	853.9	588.5	(31.1)	(265.4)
1. Interest and returns	601.6	334.0	(44.5)	(267.6)
Remuneration on reserve requirements	69.1	0.0	(100.0)	(69.1)
Remuneration on the National Treasury Office accounts	392.7	256.0	(34.8)	(136.7)
Flexible commitment commission with IMF	38.4	27.7	(27.8)	(10.7)
Expenses for international reserves management	26.6	25.7	(3.3)	(0.9)
Expenses for monetary contraction transactions	74.8	24.6	(67.1)	(50.2)
2. Exchange rate differences	132.9	104.2	(21.6)	(28.7)
3. Cost of issuing and distributing banknotes and coins	114.0	147.7	29.6	33.8
4. Others	5.4	2.5	(53.3)	(2.9)
B. Corporate expenses	332.9	352.6	5.9	19.7
1. Personnel costs	216.9	225.0	3.7	8.1
2. Overhead	47.9	50.5	5.5	2.6
3. Taxes	7.3	7.8	6.6	0.5
4. Insurance	6.4	6.9	6.4	0.4
5. Contributions and membership fees	3.0	4.3	45.9	1.4
6. Cultural expenditures	9.1	9.6	5.1	0.5
7. Depreciation, provisions, debt repayment, etc. ^{a/}	42.2	48.5	14.8	6.3
C. Pension expenses	(51.0)	105.4	n.a.	156.4
3. Operating results (I-II)	155.3	(1,101.6)	n.a.	(1,256.9)

n.a. not applicable.

a/ Includes deferred software.

Source: Banco de la Republica.

to the dollar and, to a lesser degree, from the low interest rates. In fact, their yield is estimated to be -COL\$500.2 b. This performance is the consequence of a negative result in the exchange rate differential (COL\$780.7 b), of the devaluation of the portfolio (COL\$35.3 b), of the interest accrual (COL\$256.6 b) and of the appreciation of gold (COL\$59.3 b). It is worth mentioning that the previous result does not incorporate the possible effects from changes in the exchange rates of the currencies in the reserves for the rest of the year.

The primary sources of income will probably be those derived from liquidity operations (COL\$93.9 b), the valuation of the TES portfolio of the Bank (COL\$78.2 b) and the commissions received for trust business and banking services (COL\$100.9 b).

In the forecast of expenditures, 56.2% will correspond to monetary ones, which will come to COL\$588.5 b. A decline in monetary outlays is anticipated because of the lower remuneration for TGN deposits in the Bank, which will total COL\$256 b, an amount that is COL\$136.7 b lower with respect to 2009. There will also be lower outlays for monetary contraction transactions and for the commitment commission that should be paid this year on the flexible loan approved by the IMF.

The corporate expenditures will come to COL\$352.6 b which will include COL\$225.0 b in personnel expenses, COL\$50.5 b in overhead expenses and COL\$9.6 b in cultural ones. The depreciations, provisions, debt retirement and other expenses will be COL\$67.5 b.

Last of all, COL\$105.4 b in net expenditures for retirement pensions is estimated as a result of the estimated yield of the portfolio built with funds from the actuarial estimate, (COL\$113.1 b) and pension expenses of COL\$226.5 b. Moreover, it is necessary to mention that provision for pension liabilities did not take place, in compliance with Decree 2984 of the Ministry of the Treasury Aug 12, 2009.