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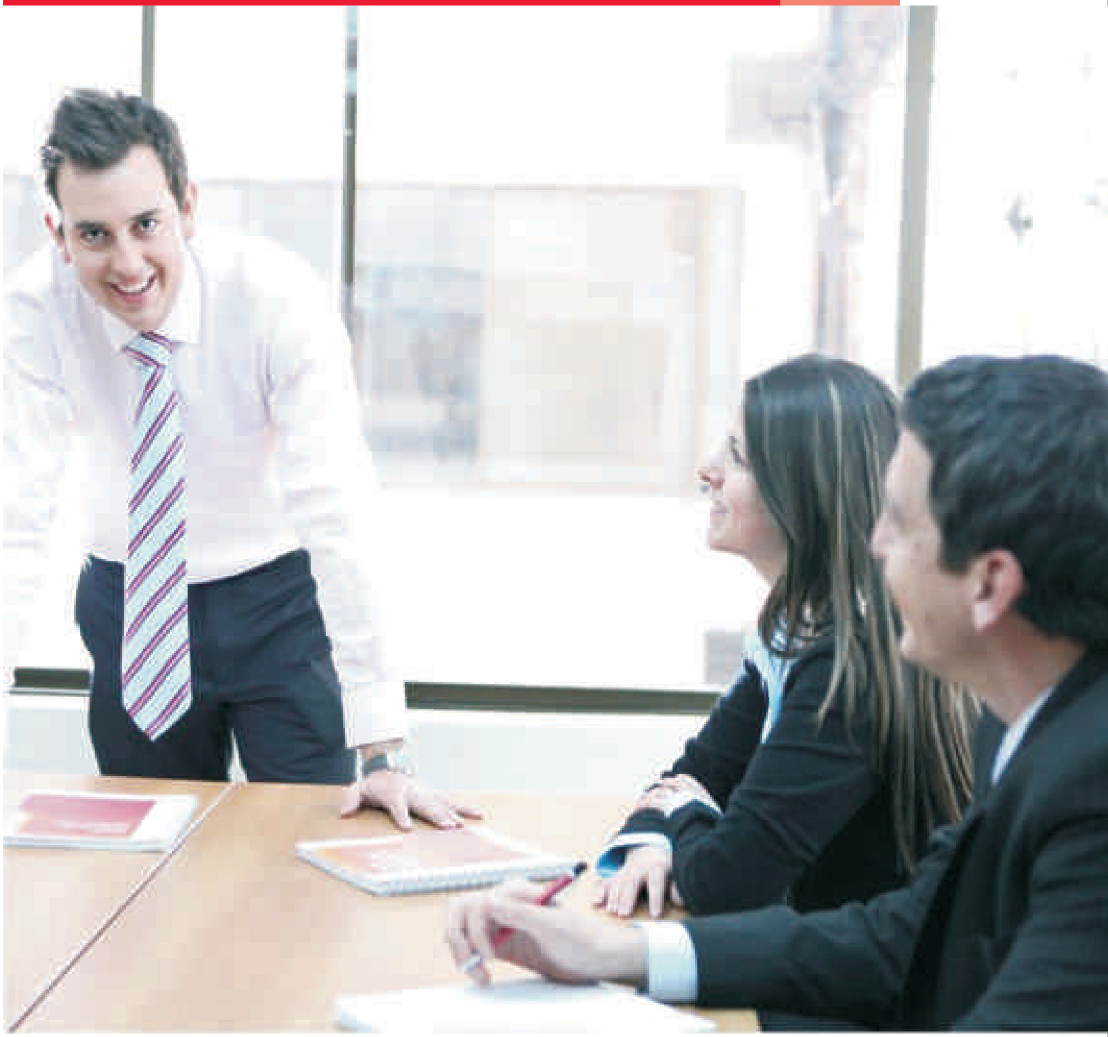
Highlights of Colombia

2010 Financial analysis and projections for 2011



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Wrap up 2010

After the slowdown faced by the Colombian economy in 2009 as a consequence of the international financial crisis arisen by late 2008, Colombia showed a good response capability in 2010. The positive result may be explained by two main factors. Firstly, an outstanding macroeconomic stability as a result of structural reforms in previous years; secondly, and as a consequence of the above, the implementation of anti-cyclical economic policies to foster recovery of the economic dynamism.

Using measures that involve from an increase in public demand to a preventive supervision and intervention by the Colombian Central Bank (Banco de la República), both in the exchange and stock markets, served as tools to offset the negative impact of the international economic situation. Nevertheless, such instruments have been cautious enough not to produce unbalances by drawing away from the long-term fiscal targets.

During 2010, the Colombian economy showed an increase in public demand, greater availability of resources on concept of external sales of the oil and energy industry, a slight but positive improvement of industrial activity, recovery of direct foreign investment (DFI) flows and lower interest rates. On the other hand, an increased inflationary pressure was felt with a persistent revaluation trend that, in spite of favoring foreign credit, continued affecting the exporting industry.

Adding to the above is the gradual and more positive perception of risk for Colombia in the international markets. The Country is seeking to obtain the "investment degree[1]" profile granted by the risk rating agencies; while this goal is achieved, the country remains part of the so called CIVETS[2] group, which is made of countries deemed as emerging that have shown good economic performance and have the greatest expectations of growth over the next decade.

On the other hand, and although good economic results exceed previous expectations, the Colombian economy had to fight headwind from a decreased commercial activity with Venezuela. This was compounded by one of the most severe rainy seasons over the past 30 years which left about two million victims, affected part of the territory's infrastructure and caused inflationary pressure through food prices and transportation costs..

Economic Growth

According to reports of DANE (The National Statistics Administration Department), during the first nine months of the year the Colombian economy grew 4.1% compared with the same period of the previous year. This growth was lead by the mining industry (12.7%), followed by the manufacturing industry (5.4%) commerce, repairs, restoration and hotels (5.3%). Only two sectors showed a slight drop: construction (-0.8%) and agricultural sector (-0.8%).

The positive behavior of the mining industry was generated mainly by increase in production of crude oil, natural gas and other minerals, compounded by favorable prices in the international markets. As far as the manufacturing industry, unlike the previous year, there were good signs of recovery; the most outstanding sectors in sales increase include automotive, auto parts, iron, steel, shoes and chemical industries.

[1] *Macroeconomic stability with potential risks.*

[2] *CIVETS, acronym for Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa*

Inflation

2010 closes with a 3.17% inflation rate, exceeding the expectations of the National Government. Nevertheless, the figures remained within the range foreseen by Banco de la República, between 2% and 4%.

As shown by the figures of the National Statistics Administration Department (DANE, per its Spanish Acronym), the four groups that showed the most significant percentage variance were the following: health (4.31%), food (4.09%), education (4.01%) and housing (3.69%), being food and housing the elements with the highest contribution to the total variance. Meanwhile, the two groups that experienced a drop in price levels were communications (-0.28%) and clothing (-0.30%), where the latter continued with the same lowering trend showed in the previous year.

For 2011 the inflation is expected to continue increasing, part of the forecast is based on increases in food and fuel prices. The target range foreseen by Banco de la República remains between 2% and 4%.

Interest Rate

In 2010 the interest rates maintained the decreasing trend that had been occurring since 2009. The 90-day Fixed Term Deposit rate (DTF) reached 3.4%, 0.7 percentage points below the rate in the previous year. The placement rate closed in 8.1%, 100 base points below the rate in 2009. The intervention interest rate of Banco de la República remained in 3%, a figure that is worth saying became the minimum historic value. This trend was also reflected in a lower cost of consumer and preferential credits. Although a lower intervention rate is not transferred fully to all credit rates offered by commercial banks, in 2010 there was a credit increase of 14%.

For 2011, forecasts of interest rates show an increase between 1 and 2.6 percentage points. It is likely that the Central Bank considers appropriate to increase the intervention rate as a measure to control inflationary pressure.

Exchange Rate

During 2010 the exchange rate was not free of a volatile behavior. At the end of the year, the Market Representative Exchange Rate (TRM) reached COP 1,914 per USD 1, showing a revaluation of 5.1% compared to the previous year. This trend was more apparent between May and September, when the exchange rate reached its minimum in two years ($1,800). Revaluation continues to be the regional trend, but the Colombian peso shows one of the most significant appreciations. The above results from increased amounts of foreign currency in coming on concept of DFI, an increase in exports of crude oil and mining products, and lower intervention by monetary authorities in the exchange market with respect to 2009.

For 2011, the projections of the Colombian Peso to U.S. Dollar exchange rate fluctuate between $1,700 and $2,050, although few forecasts target a TRM above $2,000. It is expected that the strengthening trend of the Colombian peso with respect to the US dollar shall continue, based on a greater flow of DFI and or resources from external financing. Expectations of a greater inflation and the response of the market towards an increase in the reference rate by Banco de la República shall influence this evolution.

Trade Balance

According to the figures published by DANE, during the period January to November 2010, Colombian exports grew 21.3%, moving from US$ 29,663 million to US$ 35,974 million. This recovery attends mainly to the increase in external sales of traditional products, particularly crude oil and by-products, whose exports increased in 63.4%. On the other hand, sales of non-traditional products dropped 3.9%, where the sectors showing a less favorable behavior were livestock and textiles with a negative variance of 76.8% and 42.7%, respectively. Excluding gold sales from the nontraditional exports, decrease of the group is of 8.4%.

During the referred period, the destination with a greater increase in exports was United States with a variance of 21.3%, mainly due to the sale of fuel and mineral oils. The second buyer in terms of variance was China, a country that over the past years has gained weight within the exports destinations. Exports to the Asian country increased in127%, particularly from two groups as follows: fuels and mineral oils, and copper and related manufacturing. Behavior of exports to Venezuela, the second trading partner of Colombia, continues with a discouraging dynamic, external sales to the neighboring country fell 67%, mainly due to the total restriction of sales of meat and edible remains.

According to the figures of DANE, between January and October 2010, the Colombian purchases overseas amounted to US$ 32,897.1 million CIF, equivalent to a 21,8% increase with respect to the US$ 27,010 million recorded in the same period of the previous year. Imports of boilers and machines had a 14,4% participation in the total imports; followed in second place by the group of electrical, recording or image devices and materials (9,8%); then followed by vehicles and parts (9,7%), and fuel and mineral oils and related products (5,2%).

During the first 10 months there was a surplus of US$ 1,548.6. The greatest surpluses took place with Venezuela (US$ 3,255.5), United States (US$ 2,915.3) and the Netherlands (US$ 915.1); whereas deepest deficits occurred in trade balances with China (US$ -2,187.4), Mexico (US$ -1,314.4) and Argentina (US$ -752.1).

Foreign Debt and Net International Reserves

According to the last report published b y the Central Bank, at September 2010 the total foreign indebtedness amounted to US$61,777 million, equivalent to 21.5% of the GDP. From the total figure, the share of the public sector is US$38,432 million (62.2% while the share of the private sector amounted to US$ 23,346 million (37.8%). Regarding the figures at the same month in 2009, private indebtedness grew 44.7%, while the public debt increased 9.2%.

Whilst over the last two years foreign debt has increased due to a counter-cycle economic policy intending to foster the economy, the new government is aiming to revert the trend in the coming years.

At the end of 2010, international reserves reached a record level with US$ 28,445, equivalent to a 12.2% increase with respect to the figure reported in 2009 (US$25,355). This increase is the result of intervention by Banco de la República in the acquisition of foreign currency in the Exchange market to offset revaluation of the Colombian peso.

Direct Foreign Investment

According to data published by Banco de la República, in the period January through September 2010 the amount of the Direct Foreign Investment - DFI- reached US$ 6,524 million, which is equivalent to a 3.2% increase compared to the same period in the previous year. Preliminary figures show that for the end of the year that amount would reach US$ 7,769.2, showing a yearly variance of about 7.8%. It is an encouraging result, considering that for 2010 it is estimated that the global DFI shall only increase 0.7%, as stated in the UNCTAD[3] report.

Between January and September 2010, the crude oil industry attracted 30.8% of foreign flows, followed by the mining and stone pits sector with 29.6% participation, and the manufacturing industry with 13.6%. While the crude oil and mining sectors perceived lower investment flows, the manufacturing sector shows the most outstanding recovery, with an increase in both participation (5 percentage points more) and the amount of DFI received (US$ 888 million).

Forecasts of DFI for 2011 are optimistic considering that while the global financial crisis, accentuated in developed countries, has decreased investment flows in industrialized economies, the emerging economies in Latin America and Asia shine with bright light in the foreign investors' radars. In this scenario, Colombia has been doing its part to be recognized in aspects such as protection for investors and easier procedures to close deals, as shown in the improved position of Colombia within the measures stated in the World Bank's publication “Doing Business”. It is expected that this year Colombia reaches an investment level close to US$ 10,500 million.

Employment

Although the economy has recovered during 2010, unemployment persists as one of the most significant problems with one of the most unfavorable figures in the region. In November, the global unemployment rate was 10.8%. This scenario is compounded by an increase of informality of 51.7% in the 13 most important cities country wide. This means that economy is not only bearing a high number of people unemployed, but also facing an increase in poor quality occupation where informal workers do not have social benefits.

The cities with the highest unemployment rate over the revolving quarter September - November 2010 were Quibdó (18.9%), Ibagué (18.7%) and Pereira, (18.3%).

As far as the legal minimum monthly salary, Government has decided to adjust the initial 3.4% increase to 4%, after the results seen regarding inflation. In 2011 the amount received each month by about seven million Colombian workers is $535.600 (US$279.8), which represents an increase of $20,600 with respect to the previous year. Transportation subsidy increased from $61,500 to $63,600 (US$33.2).

Public Finances

Public finances in 2010 have been worn out in part due to the implementation of anti-cyclical economic policy. Although growth in public demand was able to compensate the internal economy slowdown, the ratio debt/GDP was increased.

According to the Spending and Economy Strategy report 2010-2014[4], the deficit of the Consolidated Public Sector (SPC, per its Spanish acronym) is -3.6% of the 2010 GDP. That report indicates that the deficit of the Central National Government (GNC, per its Spanish acronym) closes in 4.3% of the GDP.

For 2011, the Government is targeting the retrieval of the trend in public finances and the reduction of indebtedness. Estimated deficit spending corresponds to 3.4% in SPC and to 4.1% in GNC. These projections differ from those included in the report at June 2010, which expected a deficit of 3% in SPC

[3] *United Nations Conference on Trade and Development*

[4] *Document published by the Ministry of Finances in November 2010*

and of 3.9% in GNC. The new adjustments consider a change in the expenditure composition that includes more expenses to execute the national development plan, a lower expense regarding pension payments, more resources to assist displaced population and higher costs to restructure the financial system.

In order to achieve the new goals, a set of measures has been adopted, including amendments to royalties, a public spending standard that intends to save more and spend less, a restructuring of the finances in the healthcare sector, and studying a strategy to generate funds for programs to assist displaced population.

Although the Government shall incur in greater expenditure for reconstructing the infrastructure affected with the heavy rains, the spending targets are maintained as alternatives have been planned to generate income which include selling between 1% and 2% of Ecopetrol shares and broadening the span of taxpayers subject to tax on equity as well as extending the tax on financial transactions over the time.

Political Environment

2010 featured significant transformation in political matters. Presidential and legislative elections framed the most relevant events. This election year began with the Constitutional Court's rejection to the referendum for reelection that would have enabled former President Álvaro Uribe Vélez to run for president for a third period in a row. This event resulted in an intense presidential campaign in which Juan Manuel Santos, official candidate from U Party (Partido de la U) ended first in the second round against Antanas Mockus, candidate for the independent Green Party (Partido Verde). On the other hand, legislative elections held in April confirmed the leading role of the governing party , as well as leadership of the conservative and liberal parties.

The beginning of the new office revealed a more conciliatory and centralized tone within the political spectrum. Reestablishment of diplomatic relations with Venezuela and Ecuador and settlement of a Major Agreement for National Unity with the most significant political forces in the country to approve and drive forward reforms and projects serve to confirm this trend. Within the new legislative agenda, reform to the Support to victims of the armed conflict Act and the bill for Land Distribution Act, both aiming to repair victims of the armed conflict in Colombia, are two of the most outstanding elements among the projects of the Executive.

On the other hand, the new Government presented its economic strategy within the framework of the National Development Plan 2010-2014, focusing on achieving better economic growth rates, reduce poverty, generate employment and consolidate improvements in security matters. The extensive legislative agenda continues with a long list of debates such as changes to the royalties system, adoption of a spending standard, reforms to the healthcare system and adjustments to tax regulations. The reform to custom duties, the measures to reduce the impact of revaluation and the Territory Classification Act are additional issues in the discussion. A provision already enacted by Congress in 2010 is the Labor Formalization and First Employment Fostering Act. Other significant and rather controversial project is the Justice Reform, which intends to provide a more flexible and efficient judicial order to the country's legal system.

As far as security matters is concerned, the death of the second in command at the FARC guerillas, known as 'Mono Jojoy', as a result of a bombing from the Colombian Army, confirmed the continuity of a security strategy with the Santos Government and the decay of the guerrilla. The year closed with the election of the Nation's Attorney General after a long 16-month process characterized by a lack of consensus between the Supreme Justice Court and the Executive. The lawyer and former congress woman Viviane Morales was appointed for that position.

Other political events that received great display were the accusations and current investigations to former high rank employees of the preceding government related to nepotism and espionage to opponents; likewise, investigations to former congress men about alleged relations with groups outside the law are ongoing

Perspectives for 2011

For 2011, analysts expect favorable growth perspectives; the Colombian economy shall continue on the recovery path with projections between 4.5% y 6%. Although the intense rainy season in the country demands giving priority to the assistance for injured populations and reconstruction of the affected infrastructure, such recovery process becomes an opportunity to encourage economic growth.

Potential inflationary pressures, higher interest rates, higher exchange rates due to greater capital in coming and increase of exports, particularly in the crude oil and mining sector are foreseen for this year.

It is also expected that the pace of consumption continues growing but gradually, as inflationary pressures in food, healthcare, housing and education might limit acquisition of luxury goods. Regarding private investment, growth fostered by purchase of capital assets with favorable exchange rates is anticipated.

Similarly, this year anticipates a gradual withdrawal of tax incentives as part of the anti-cyclical policy in order to provide an opportunity for recovery of the private sector.

Regarding the trade balance, a positive result is expected, as mentioned earlier, given that traditional exports are leading this dynamic with an increase both in volume and prices. Increase in non-traditional exports might be less visible considering the status of commercial relations with Venezuela and the exchange rates revaluation trend; in this scenario, the sector continues facing challenges such as market diversification and increase of competitiveness.

Colombia's participation in the so called CIVETS group, places the country at hotspot within foreign investors' interests who find significant growth opportunities in the emerging markets. Aspects such as increased security, macroeconomic stability, easier access to raw materials and a young population are features that encourage greater DFI.

Among the tasks pending are the priority actions to reduce unemployment that is currently showing one of the highest figures in the region, to increase formal employment and reduce poverty, paired with compliance with the aforementioned and ambitious legislative agenda.

Colombia: Macroeconomic Indicators

	2009	2010	2011 py
GROSS DOMESTIC PRODUCT			
Actual growth (%)	0.8	4.5 (py)	4.6
Constant prices (Billions of US dollars)	235	n.d.	n.d.
Dollars per capita (average market representative exchange rate)	4,791	n.d.	n.d.
POPULATION			
Millions	44.9	45.5	46
INFLATION			
Var. GPD Dec-Dec (%)	2	3.1	3.5
INTEREST RATES			
Fixed term deposit -DTF(**) 90 days (end of year)	4.1	3.4	5.4
Placement	9.1	8.1	10.1
EXCHANGE RATE (end of year)			
December	2,043	1,914	1,840
Devaluation	-8.9	-5.1	-3.9
PAYMENT BALANCE			
Trade balance (US$ 000)	-1,665.2	1.387,5 (ene-nov)	1,898.0
Exports (US$ 000 FOB)	32,853.0	35.974 (ene-nov)	43,364.9
Imports (US$ 000 FOB)	31,187.7	34.586,4 (ene-nov)	41,466.5
Net International Reserves (US$ 000)	25,355	28,445	30,162
PUBLIC FINANCES			
Central National Government (% GDP)	-4.1	-4.3	-4.1
Consolidated Public Sector (% GDP)	-2.8	-3.6	-3.2
Foreign debt (% GDP)	23	21.5	20.2
URBAN UNEMPLOYMENT RATE (%)	12.0	10.8 (Nov)	9.5

Source: Dane, Banco de la República, Ministerio de Hacienda y Crédito Público.

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