Performance and Challenges of the Colombian Economy

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The Colombian economy has experienced reasonable economic growth since the major reform efforts of the early 1990s. However, the growth witnessed during this period can best be characterized as slower and more volatile than growth prior to 1980. The Colombian economy also has experienced a significant restructuring, characterized by greater integration into the world economy, growing importance of oil and mining exports and of mining and services in GDP. In addition, Colombia has experience larger private sector participation in economic activity but also larger state spending, particularly in social services. As of 2013, Colombia faces various challenges associated with managing an uncertain international economic environment and reversing adverse long-term trends, notably high domestic inequalities and the weakening of its manufacturing and agricultural sectors. Even more importantly, it must reform its economic and social policies to implement the outcome of the ongoing peace process.

This article analyzes how the interaction between domestic and external factors has affected the Colombian economy over the past decades and derives from that analysis the major challenges that the Colombian economy faces today. It is divided in five sections. The first briefly summarizes the major domestic and external factors affecting the economy. The second examines what I will refer to as the "dual-track" reform agenda that the country has followed since the early 1990s. The third and fourth analyze in detail the macroeconomic performance and

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the evolution of economic structure. Some social outcomes are discussed in the second and third sections, but this is not the central focus of this essay, as this issue is considered in other chapters in this volume. The last section highlights the major challenges that Colombia faces. Several comparisons are made throughout the paper with Latin America, mainly based on data from the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), which is simply referred to as ECLAC data.[1]

Factors Affecting the Colombian Economy

The evolution of the Colombian economy has been affected over the past quarter century by two set of factors. The first are the major reforms implemented in the early 1990s, which in fact responded, in a sort of dual track, to entirely different challenges that the country faced at the time. On the one hand, a series of market liberalization reforms were enacted, aimed at more fully integrating Colombia into the global economy and expanding private sector development. According to the authorities, these reforms were aimed at overcoming the inefficiencies that the inward-looking development model with heavy state interventions had generated, which were constraining productivity and therefore economic growth. On the other hand, the demands for a more equitable society, which were also seen as part of a peace-building effort,[2] led to the decision to convene a Constitutional Assembly in 1991 that changed the century-old 1886 Constitution. In economic and social terms, the 1991 Constitution placed economic and social rights as the center of public policies and created a more decentralized system of social service

[1] The associated data is extracted from the ECLAC website or from the Statistical Appendix of the *Economic Survey of Latin America and the Caribbean 2013*, Santiago: ECLAC, and earlier editions.
[2] Negotiations led to several successful peace agreements with M-19, EPL and Quintin Lame, but also to the failure of negotiations with the largest guerrilla group, FARC.

provision, along with reforms that can be considered as part of the market liberalization agenda, notably the creation of an autonomous central bank (Banco de la República).

The second set of factors that have affected the performance of the Colombian economy have external origins. The most favorable were: the very high (super-cycle) of commodity, particularly of energy and mineral prices since 2004;[3] the boom of international trade that characterized the 1986-2007 period; the ample (though still somewhat unstable) access to financing from international capital markets at exceptional conditions in terms of costs and maturity since the mid-2000s, which included the return, in 2011, to the investment-grade status that the economy had lost in 1999; and the opportunities that the United States and Spain offered for (regular and irregular) migration up to 2007, which also led to a rapid growth of migrants' remittances. The most adverse external factors have been two major international crises: the succession of emerging-country financial crises that started in East Asia in 1997, and the global (or, better, North-Atlantic) financial crisis, which started with the collapse of subprime lending in the United States and the bankruptcy of some European banks during the summer of 2007, and was speeded up with the collapse of the investment bank Lehman Brothers in September 2008.

The September 2008 shock led to the most dramatic global financial meltdown since that of Wall Street in October 1929, to a deep global recession –now called the "Great Recession" by many analysts— and to a collapse of international trade that was initially steeper than during the Great Depression of the 1930s.[4] Although the global economy and global trade have experienced since the 2nd/3rd quarters of 2009 a "multi-speed" recovery, to use International Monetary Fund's

[3] Bilge Erten and José Antonio Ocampo, "Super Cycles of Commodity Prices Since the Mid-Nineteenth Century", *World Development*, Vol. 44, pp. 14-30, 2013.

[4] See Barry Eichengreen and Kevin O'Rourke, "A Tale of Two Depressions", *Vox*, April 6, 2009, and "What Do the New Data Tell Us?", *Vox*, March 8, 2010. The two are available at http://www.voxeu.org/article/tale-two-depressions-what-do-new-data-tell-us-february-2010-update

terminology, there are two effects that are more permanent: it has sharply slowed down the growth of international trade[5] and closed the opportunities for migrants. It may also be starting to affect a third: a weakening of commodity prices, leading perhaps to the end of the super-cycle of commodity prices that the world economy has experienced over the past decade. In this way, among the very favorable trends experienced until 2007-2008, only remains firmly in place: ample access to external financing, though at somewhat less exceptional conditions since mid-2013, due to the tendency of US interest rates to normalize.

The Dual-Track Reform Agenda

The reform agenda that Colombia adopted in the early 1990s is clearly atypical by the standards of the market reforms that Latin American and other developing countries adopted during the last two decades of the twentieth century. Indeed, the mix of a market liberalization agenda with a more active state intervention to guarantee economic and social rights is peculiar by international standards. For this reason, it is hard to refer to these reforms as a “neo-liberal” agenda –although the first component did contain some neo-liberal elements. Also, although some reforms were initiated in the mid-1980s under World Bank pressure as well as the weight of ideological trends and demonstration effects from other countries in the region, the reforms had a clearly *domestic* origin, as reflected not in the particular mix of policies but also the modalities that some of them adopted.

As already indicated, the first part of the agenda aimed at overcoming the inefficiencies and slow economic growth that, according to the authorities, had been the result of excessive

[5] This issue is not widely recognized. Using United Nations and, for the most recent period, International Monetary Fund data, it can be estimated that global trade (as measured by exports) grew at an real annual rate of 7.3 percent in 1986-2007, only slightly lower than the rate of growth during the 1950-74 post-Second World War boom, but then slowed down to only 2.7 percent in 2007-12.

protection and state intervention. In this view, market reforms would accelerate productivity and therefore GDP growth.[6] This was reflected, first of all, in the trade liberalization that was launched by the Barco Administration in 1990 and was radicalized and accelerated by the Gaviria Administration in 1990-1991. As a result, average tariffs fell in a short period of time –from an average of 44 percent prior to the 1990 reforms to 12 percent by March 1992—, quantitative import restrictions were essentially eliminated –except during a transition for sensitive agricultural goods—, and export incentives were reduced to make them consistent with World Trade Organization (WTO) rules.

This was accompanied by the revitalization of the Andean Group (transformed into the Andean Community in 1997) starting with the Presidential summit in the Galápagos Islands in December 1989, which led to (mostly) full trade liberalization among its members, and the subscription of free trade agreements with several Latin American countries. Andean decisions led to a boom of trade in the 1990s, particularly with Venezuela and Ecuador, whereas the second increased trade with other Latin American countries. This would be joined by a broader set of free trade agreements with non-regional partners, particularly with Canada, the United States, and the European Union (in historical order of implementation), with that with Korea still subject to Congressional approval and others under negotiation.[7] However, political tensions among members of the Andean Community on the consistency of the integration arrangements with free trade agreements with extra-regional partners, led to Venezuela's decision to withdraw from the Community in 2006. In turn, bilateral political tensions resulted in sharp reduction in exports to Venezuela between 2008 and 2010 (see below).

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[6] The most articulate version of this view was that of the Development Plan of the Gaviria Administration (1990-1994). See Departamento Nacional de Planeación (DNP), *La revolución pacífica*, Bogotá, 1990.
[7] Free-trade agreements are currently being negotiated with Israel, Japan and Turkey.

Trade liberalization was accompanied with liberalization of foreign direct investment (FDI), which implied the elimination of sectorial limitations (with very few exceptions[8]) and of the restrictions on profit remittances that the Andean Community had established in the 1970s. Colombian firms and investors also became increasingly active abroad, particularly in other Latin American countries. This was accompanied, furthermore, by the elimination of the exchange controls that the country had held, in one form or another, since 1931. This was reflected, in particular, in the liberalization of financial flows in 1993, though subject to a system of reserve requirements on capital inflows that forced investors to hold deposits in the central bank proportionally to the amount of funds they brought into the country or pay a tax equivalent to the opportunity costs of those deposits. These mechanisms were eliminated in 2000 but reestablished temporarily in 2007-2008. As a result of the liberalization of capital flows, Colombia would experience greater access to both FDI and financial flows, but also the volatility associated with the latter.

These reforms were accompanied by the privatization of a number of state-owned enterprises (SOEs), and the opening up of several public sector services to private investments, including a concession program for private investments in infrastructure. Given the nature of the SOEs inherited from the past, most of the privatizations occurred in mining, public utilities, ports and the financial sector –including, in the latter case, some banks that had been nationalized during the domestic financial crisis of the early 1980s. However, the privatization process included different modalities (total private and mixed public-private ownership, as well as private administration of mixed or state-owned firms and assets) and left a significant number of SOEs, which in a sense were considered to be "strategic". This included the state oil company

[8] The exceptions are national defense and security, disposal of toxic wastes and a 40% limit on ownership of broadcasting services.

(Ecopetrol), national and local utility firms (e.g., Interconexión Eléctrica S.A., Isagen, Telecom, Empresa de Energía de Bogotá[9], and Empresas Públicas de Medellín, among others), the network of five (now four) development banks[10] and a commercial bank (Banco Agrario, a transformation of the previously existing Caja Agraria). Since the mid-2000s, the government has opened up some of the SOEs (Ecopetrol and Interconexión Eléctrica S.A.) to partial private ownership through the issuance of shares, and has privatized two of them (Telecom in 2006 and Isagen, under privatization at the time of writing). One of the major implications of the privatization process, and more generally of the opening up of utilities to private investment, is that the regulation of utilities became a specialized function of three regulatory commissions –for energy, telecommunications, and water and sanitation— comprised of various ministers and independent experts.

The modalities of central bank independence defined by the 1991 Constitution were also peculiar by international standards. So, although it determined that inflation should be the main objective of Banco de la República, and it gave it autonomy to manage monetary and foreign exchange policy, it also required that it had to exercise its functions in "coordination with the general economic policy," which is the responsibility of the government. To guarantee this coordination, it determined that the Minister of Finance would chair the central bank board, although as the only government representative in the seven-member board. The Constitutional Court decreed in 1999 that the obligation of coordination implied that, although a stable purchasing power of the peso should be the major objective of monetary policy, such policy

[9] This is a holding company with investment in Colombia and several other Latin American countries. The energy operations of Bogotá are in the hands of the private group Endesa, which has a slight minority share but the right to manage energy generation and distribution under the operating firm, Emgesa.

[10] This includes Banco de Comercio Exterior de Colombia, Bancoldex, which absorbed the previous industrial development bank, Instituto de Fomento Industrial, IFI; Fondo para el Financiamiento del Sector Agropecuario, Finagro; Financiera de Desarrollo Territorial, Findeter; and the Financiera Eléctrica Nacional being recently transformed into Financiera de Desarrollo Nacional with broader objectives associated with infrastructure financing.

could not ignore other economic policy objectives, particularly employment generation and economic growth.[11]

The other track of the reform agenda was the expansion of the responsibilities to guarantee access to social services, which were decreed by the 1991 Constitutions as "social rights." The reform process also opened up opportunities for private agents (many of them non-profit institutions) to participate in the provision of these services. Such participation followed different models. In the case of housing, public sector provision was replaced by direct subsidies to poor households (which includes, since 2012, a program with 100% subsidy). In pensions, a private capitalization system was put in place in competition with the old pay-as-go public-sector system. In health insurance (social security health), private agents were allowed to participate in competition with public sector institutions, both in the contributory and subsidized sub-systems.[12] In education, the attempt to gradually introduce a voucher system, particularly for secondary schooling, was soon suspended, but several municipalities introduced a mechanism by which private agents were allowed to manage public sector schools. Of course, fully private schools and non-social security health services were permitted, as in the past.

The decision to expand state responsibilities in the social area was accompanied with a significant decentralization, by which departments and municipalities were given greater participation in national rents[13] that they would then allocate to different social services according to the legal allocation rules; however, some flexibility was kept for the use of these resources. This system was more redistributive than the preexisting one, and it particulary

[11] See the Sentence 481/99 on Banco de la República in http://www.corteconstitucional.gov.co/relatoria/1999/C-481-99.htm

[12] Law 100 of 1993 created two sub-systems of social security health: one financed with contributions from firms and workers, and another subsidized by the government.

[13] Following national terminology, I refer here to "participation in national revenues" rather than "transfers", although economically speaking the latter term may be appropriate.

increased the resources available to poor by municipalities. Although there have been later attempts to strengthen controls by the central government, the decentralization process has been largely resilient to this centralization backlash. In practice, it means that the level of decentralization of public sector spending in Colombia is only somewhat lower than in two of the federal countries of the region, Argentina and Brazil, but larger than in the two remaining federations, Mexico and Venezuela.

There have been two major implications of this second track of the reform agenda: a significant increase in access to public sector services and an equally significant expansion in the size of public sector spending, which in turn resulted in various tax reforms to finance rising spending. Access to public sector services has indeed expanded and has improved living standards, particularly in rural areas. The most dramatic has been access to health social security, which increased from 24 percent in 1993 to 91 percent in 2012 (a bit over half of them in the subsidized sub-system). In turn, the coverage of secondary education increased from 43 percent to 72 percent over the same period.[14] If measured by the unsatisfied basic needs, poverty decreased from 45 percent in 1993 to 26 percent in 1998 and 18 percent in 2005, with a much larger absolute decline in rural areas (see Table 1). This also reflects the fact that access to clean water and electricity increased much more in rural than urban areas, where coverage was high in 1993. Measured by the new multidimensional index, which also measures access to basic public services as well as labor market conditions, poverty decreased from 60 percent in 1997 to 27 percent in 2012, again with stronger absolute gains in rural areas (see again Table 1). According to this index, the most important advances have occurred in access to health insurance, and the

[14] These are official estimates from the Ministries of Health and Education, respectively. In the latter case, it refers to net school attendance; the 1993 was calculated based on data from gross attendance and the difference between gross and net attendance in 1996.

major remaining problems are labor market informality and low educational performance, with some improvements in the latter case but a very limited one in reducing the weight of informality.

Table 1			
Multidimensional poverty indicators			
A. Unsatisfied basic needs (%)			
	National	**Urban**	**Rural**
1985	45.0	32.3	71.8
1993	37.2	26.8	62.5
1997	25.9	17.8	46.5
2003	21.7	16.0	37.4
2005	17.5	11.8	33.2
B. Multidimensional poverty (%)			
	National	**Urban**	**Rural**
1997	60.4	50.7	86.0
2003	49.2	39.8	76.8
2008	34.7	26.9	59.6
2012	27.0	20.6	48.3

Source: DANE. Data for 1985 and 1993 refers to population censuses. The rest to household surveys

In any case, major gaps in access by different social groups remain in all social areas. This includes low access to some services, notably pensions, where it remains very low: 32 percent of the working population in 2012, according to the national household survey. There are also large differences in quality and strong segmentation in the provision of social services received by the rich vs. the poor. The administration of service provision also remains a problem, notably in the case of social security health.

In turn, following a step-wise increase, consolidated primary public sector spending increased from 16-17 percent to 20 percent in the late 1970s and early 1980s and to 26-28 percent in the 1990s and early 2000s.[15] Whereas the first of these increases was concentrated in

[15] See José Antonio Ocampo, "Un siglo de desarrollo pausado e inequitativo: La economía colombiana, 1910-2010", in María Teresa Calderón and Isabela Restrepo (eds.), *Colombia 1919-2010*, Bogotá: Taurus, pp. 119 – 196, Table 3.

infrastructure spending, the spending of the 1990s focused on social spending and was associated with the implementation of the reforms introduced by the 1991 Constitution. This led to various major tax reforms designed to public sector revenues to finance increases in spending. Eleven major tax reforms have been adopted since 1990,[16] – which is an average almost one every two years. Most of these reforms have sought to increase public sector revenues. At the same time, a myriad of tax benefits were introduced during the Uribe Administrations (2002-2010), eroding the effort to increase revenues and making the tax structure less horizontally equitable than was typical up to the early 2000s.

In sum, the two-track reform agenda can be understood as a competition between two paradigms on the role of the State in the economy, and has generated a continuous confrontation between the defenders of one or the other vision.[17] Whereas defenders of the concept of social rights have wanted to scrap the liberalization agenda, defenders of the latter have been extremely critical of the rising public sector spending that is essential to implement the social reform agenda. The two tracks have, in any case, continued to be in place.

Macroeconomic Performance

The expectation of the supporters of the liberalization agenda that reforms would lead to rapid productivity and economic growth have not materialized. Table 2 presents the performance in terms of GDP growth and the volatility of this variable during the post-reform period (1990-2012) compared to the historical performance during the period of state-led industrialization

[16] Major tax reforms were adopted in 1990, 1992, 1995, 1998, 2000, 2002, 2003, 2006, 2009, 2010 and 2012.
[17] See, in this regard, José Antonio Ocampo, "Reforma del Estado y el desarrollo económico y social en Colombia", *Análisis Político*, No. 17, September-December 1992, which was reproduced in a shortened versión in José Antonio Ocampo, *Entre las reformas y el conflicto: Economía y política en Colombia*, Bogotá: Grupo Editorial Norma, 2004, Essay 1.

(1950-1980).[18] The decrease in economic growth in Colombia, from an average of 5.1 to 3.7 percent is stronger than the unweighted average for Latin America, though more moderate than the slowdown of the region's weighted average, which is heavily influenced by the poor performance of the two largest economies (Brazil and Mexico) in recent decades. As a result, whereas Colombia's performance was somewhat better than the unweighted regional average in the earlier period, it has been somewhat worse since 1990. The slowdown in productivity growth is also a major feature of the post-reform period compared to state-led industrialization, again defeating the expectations of the supporters of the liberalization agenda; this is not inconsistent with the significant modernization of many firms and sectors, but rather shows the growing underutilization of resources, notably of labor, which has experienced increased informality.[19] What is equally important, the tradition of stable economic growth in the earlier historical period has given way to greater GDP volatility –though still somewhat lower than that typical in other Latin American countries.

Table 2
GDP growth: dynamics and volatility

Weighted average	Average growth	Standard deviation	Coefficient of variation
1950-1980	5.5%	1.7%	31.3%
1990-2012	3.3%	2.3%	69.4%
Simple average			
1950-1980	4.9%	3.7%	75.0%
1990-2012	3.9%	3.2%	80.8%
Colombia			
1950-1980	5.1%	1.6%	31.6%
1990-2012	3.7%	2.5%	68.7%

Source: Author's estimates based on GDP data from ECLAC. Data excludes Cuba and Haiti.

[18] I prefer this concept over "import-substitution industrialization" for the reasons that are explained at length in Luis Bértola and José Antonio Ocampo, *The Economic Development of Latin America since Independence*, Oxford: Oxford University Press, 2012.
[19] See Ocampo, "Un siglo…", *op. cit.*, Table 1.

The economy has experienced three business cycles since 1990, with the third still ongoing (see Figure 1.A). The first was particularly sharp, and indeed sharper than that of Latin America as a whole. It was characterized by an initial boom fuelled by the expansionary fiscal and monetary policies that accompanied the launch of market reforms. After a domestically-induced slowdown in 1995 (which thus had different origins to the regional one generated by the December 1994 Mexican crisis), the economy recovered but then was plunged in 1999 into the worst crisis of the twentieth century and the first recession in almost seven decades.

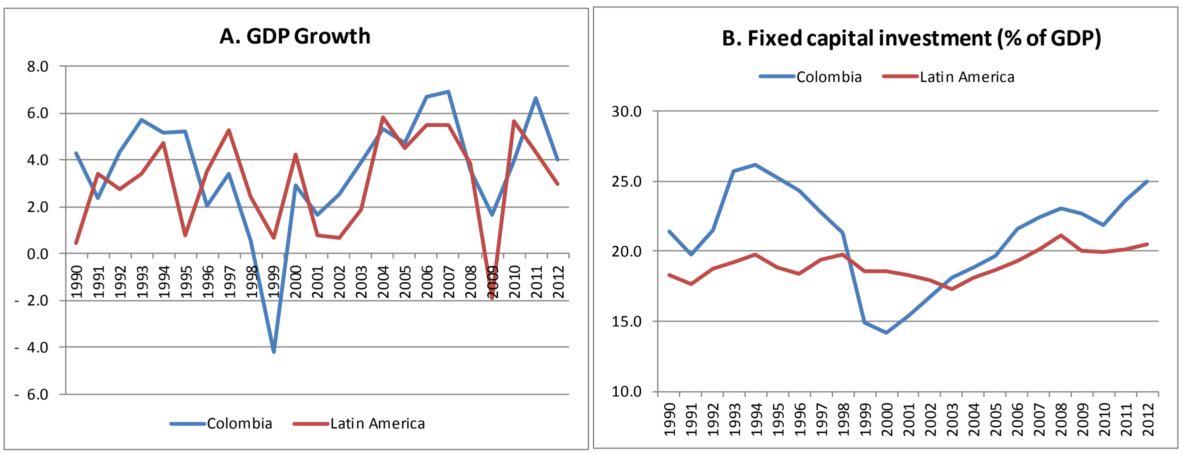
The recovery was somewhat faster than the average of the region and was followed by a boom in 2005-2007. Although some analysts would underscore the positive effects of the enhanced domestic security environment generated by the Uribe Administrations,[20] the reasons for the boom were similar to that which the region as a whole experienced: the very favorable external conditions that characterized those years, including the beginning of upward phase of a super-cycle of commodity prices that would significantly benefit the energy and mineral exporters, Colombia among them (see a closer analysis of this issue in the next section). The 2008-2009 global crisis hit Colombia as Latin America and the whole world, but the country was able to perform in this occasion better than the regional average. The country then lagged in the strong regional post-crisis recovery, but then performed better during the 2011-2013 slowdown, which affected the region and the emerging world as a whole.

The poor performance of Colombia during the first cycle explains its somewhat poorer growth relative to the unweighted Latin American average: 2.7 percent between 1990 and 2003

[20] In fact, it is hard to see any clear influence of political and security events on economic performance. Despite the recurrent estimates of the costs of the internal conflict, Colombian GDP trends and cycles mimic regional trends –particularly those of market reforms and external shocks, both positive and negative—, and should thus be better explained in terms of those factors.

compared to an unweighted regional average of 3.2 percent. Between 2003 and 2012 both Colombia's and the regional average are similar: 4.9% percent and much stronger in 2003-2007 than in 2007-2012. Improved performance since 2003 is associated, again, to exceptional terms of trade conditions and, during 2003-2007, to the broader set of favorable externals conditions analyzed in a previous section. Also, thanks to slower population growth, performance in terms of GDP per capita reached one of the highest historical rates in 2003-2007 (4.3% a year) and slightly exceeded in 2007-2012 the 1950-1980 average (2.5% vs. 2.2%).[21]

Figure 1: Macroeconomic Performance, 1990-2012



Source: ECLAC

The high level of GDP volatility reflects the weaker counter-cyclical tools that the country has used to manage external shocks relative to its own past. During the liberalization period, Colombia abandoned the use of trade and balance of payments instruments that were typical of past macroeconomic management, particularly the tendency to liberalize imports during booms and restrict them during crises, to increase non-traditional export incentives to manage decreases in coffee revenues, and to manage exchange controls in an equally counter-cyclical fashion. The mild instruments of capital account management that were kept after the

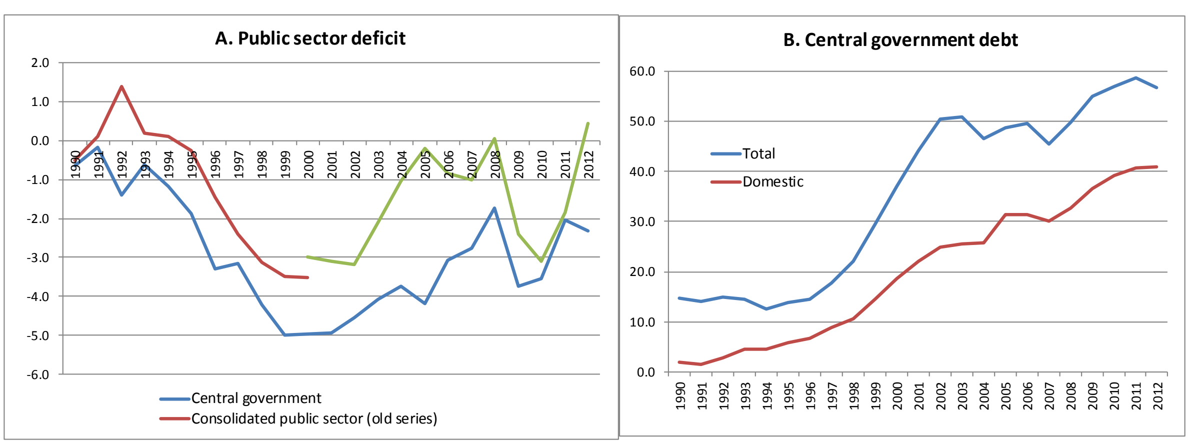
[21] Indeed, the country only requires now a 3.6% GDP growth to reach the per capita performance of 1950-1980, and 4.9% to reach the record of that period, reached in 1967-1974.

dismantling of exchange controls have been used rather sparingly and have been clearly insufficient to smooth out the sharp capital account fluctuations. Given the rising commitments in terms of social spending, fiscal policy has faced many difficulties in exercising a counter-cyclical role. In turn, monetary policy has been successful in keeping low levels of inflation over the past decade, but much less effective in smoothing aggregate demand and GDP cycles, and in avoiding significant level of real exchange appreciation during booms.

Two success stories of macroeconomic performance have been inflation and investment. In the first case, the moderate inflation that had characterized the Colombian economy since the mid-1970s ended during the strong recession at the turn of the century. This was associated much more with the strength of the recession than with monetary policy itself, but policy is, no doubt, behind the maintenance of low inflation. Fixed capital formation has exceeded the Latin American average, except during the late twentieth century recession (Figure 1.B). However, since this has coincided with lower rates of growth relative to the historical average, this implies that the capital-output ratio has been significantly higher than in the past, reflecting the high capital intensity of the booming sectors, oil and mining.

In contrast to these success stories, fiscal policy has been overburdened by the additional responsibilities given to the state by the 1991 Constitution. Despite increasing revenues generated by the initial tax reforms, the budget deficit began to increase in the mid-1990s and reached its highest levels during the recession of the late 1990s (Figure 2.A). Since the central government had to assume most of the increased spending responsibilities, it was the source of the rising deficit. Indeed, the central government has run consistent deficits since then, which have been compensated partly (in some years fully) by surpluses in the rest of the public sector (particularly the social security administration). The large deficits at the end of the 1990s were, however, more the *result* of the strong recession, and led to a massive increase in public sector indebtedness: from less than 20 percent prior to 1997 to slightly over 50 percent by 2002 (Figure 2.B). With the fiscal adjustments implemented during the crisis, particularly to increase revenues, the additional income and transfers to the government generated in recent years by the state-oil company (Ecopetrol), the greater stability of central government spending and the additional fiscal surpluses in the rest of the public sector (which now include in a few years large surpluses from local governments), the fiscal situation improved significantly during the 2003-2007 expansion, and has remained strong since the mid-2000s, with just a temporary reversal during the 2009 growth slowdown. As a result of these improvements in the fiscal accounts, the central government public sector debt stabilized, though it increased again during the Great Recession. In turn, the consolidated public sector debt started to decline, though at a much slower rate than the rest of Latin America, leading to a situation in which, in contrast to the past, the public sector debt now exceeds the Latin American average (39.1 percent of GDP in 2012 for the consolidated public sector vs. a regional average of 32.2 percent according to ECLAC).

Figure 2: Public sector accounts (% of GDP at current prices)



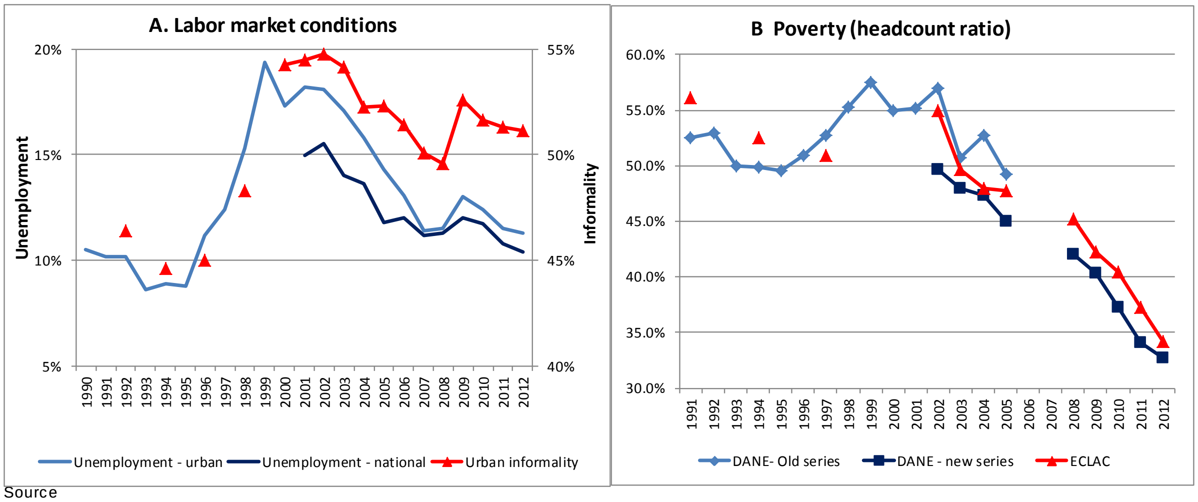
Source: A. Ministry of Finance. B. Banco de la República

The social effects of macroeconomic performance belong to the category of mixed performance, and remarkably so during the first cycle. This is particularly reflected in the evolution of the labor market indicators. Although the strong expansion of domestic demand and, therefore, of economic growth after the liberalization process facilitated a temporary improvement in employment conditions, a sharp deterioration started in the mid-1990s and peaked in 1999-2002 in terms of both open unemployment and informality (Figure 3.A). Faster growth rates facilitated a significant recovery in labor markets, particularly during the 2003-2007 boom, when unemployment fell sharply and the quality of employment increased, as reflected, in particular, in the falling share of informality.

However, labor market conditions experienced a long-term deterioration, as evidenced by the facts that open unemployment remained above 10% and informality continued to be high. This is also reflected in the estimates of "modern employment" (defined as wage labor plus highly educated independent workers, which is the inverse of ECLAC's definition of "low productivity employment"), which reached 63 percent of employment in 2010 in the seven major cities compared to 69 percent in 1994.[22] In both dimensions, labor market conditions continued to be worse than Latin America's averages. It must be underscored, however, that labor market participation is much higher in Colombia than in the region, and for that reason Colombia actually has a *higher* employment rate (percentage of working age population employed, including in informal occupations) than the regional average: 57.9 percent in 2012 compared to a regional average of 55.8 percent according to ECLAC.

[22] See Hugo López, "El Mercado laboral colombiano, tendencias de largo plazo", in Luis Eduardo Arango and Franz Hamann (eds.), *El Mercado de trabajo en Colombia: Hechos, tendencias e instituciones*, Bogotá: Banco de la República, 2012, ch. 2, who provides an excellent analysis of trends in the labor market since the mid-1980s.

Figure 3: Labor market conditions and poverty



Source
A. Urban unemployment according to ECLAC (7 cities up to 2000, 13 cities since then). National unemployment and informality according to Departamento Nacional de Estadistica (DANE).
B. ECLAC and DANE. Old series refers to MERDP; new series to MESEP.

The evolution of poverty also shows the contrast between the first post-reform business cycle and performance since 2003.[23] After experiencing just a mild improvement during the expansion of the first half of the 1990s, poverty increased sharply during the crisis of the late twentieth century, peaking in the early 2000s. With faster growth, it fell sharply after 2003, by an accumulated 17 percentage points from 2002 to 2012 according to the national estimates reproduced in Figure 3.B. These trends, though positive, imply a lag vis-à-vis the strong performance in the region as a whole, which was particularly true in 2003-2008.[24] The basic difference is the fact that Colombia does not belong to the countries that have experienced significant improvements in income distribution over the past decade.[25] Domestic sources as well as international estimates do show some improvement in this regard, but they lag those in the region. For example, ECLAC data shows an improvement of one percentage point in the Gini

[23] For an analysis of these trends, see Hugo López and Jairo Núñez, *Pobreza y desigualdad en Colombia: diagnóstico y estrategias, Bogotá:* DNP 2007, and official estimates of poverty by Departamento Adminstrativo Nacional de Estadistica (DANE).
[24] See ECLAC, *Social Panorama of Latin America 2012*, Statistical Appendix, Table 4, which shows a weaker reduction of Colombia than the regional average in 2002-2008 but a stronger one in 2008-2011.
[25] The best known study for Latin America is Luis Felipe López-Calva and Nora Lustig (eds.), *Declining Inequality in Latin America: A Decade of Progress.* Washington D. C. and New York: Brookings Institution Press and UNDP, 2010.

coefficient between 2002 and 2010, but this lags the 3.5 points reduction in the unweighted average for Latin America. Recent estimates also show an extremely high concentration of income at the top one percent of earners (which concentrate around 20 percent of income since 1993), implying that the Gini coefficient adjusted upwards when this factor is taken into account –from 0.554 to 0.587 in 2010, both of course among the highest in the world.[26]

Furthermore, in contrast to improvements in living conditions associated with the expansion of social services and public utilities, reduction in income poverty in urban areas has been stronger in relative terms than in rural areas (16.5 vs. 10.0 percentage points between 2003 and 2012), and the rural-urban gap has thus significantly increased. On a broader basis, the past decade shows a strong polarization between improvements in income poverty and distribution in the 13 largest metropolitan areas and the rest of the country.[27] Regional studies also show that Bogotá has been the greatest winner of developments patterns over the past decades, thanks to its role as the central provider of services in the country.[28] Indeed, the bias of economic restructuring toward services, which are heavily concentrated in larger cities, has been a source of both rising rural-urban gaps and of the strong demand for skilled labor, which has been the major factor leading to rising income inequality –though compensated by other, positive trends.

[26] Facundo Alvaredo and Juliana Londoño Vélez, "High incomes and personal taxation in a developing country: Colombia 1993-2010, Commitment to Equity Program of the Inter-American Dialogue, Center for Inter-American Policy and Research and Tulane University, March 2013, Table 4. Available at: http://www.emod.ox.ac.uk/sites/emod.ox.ac.uk/files/CEQWPNo12%20HighTaxationDevEconColombia1993-2010_19March2013.pdf

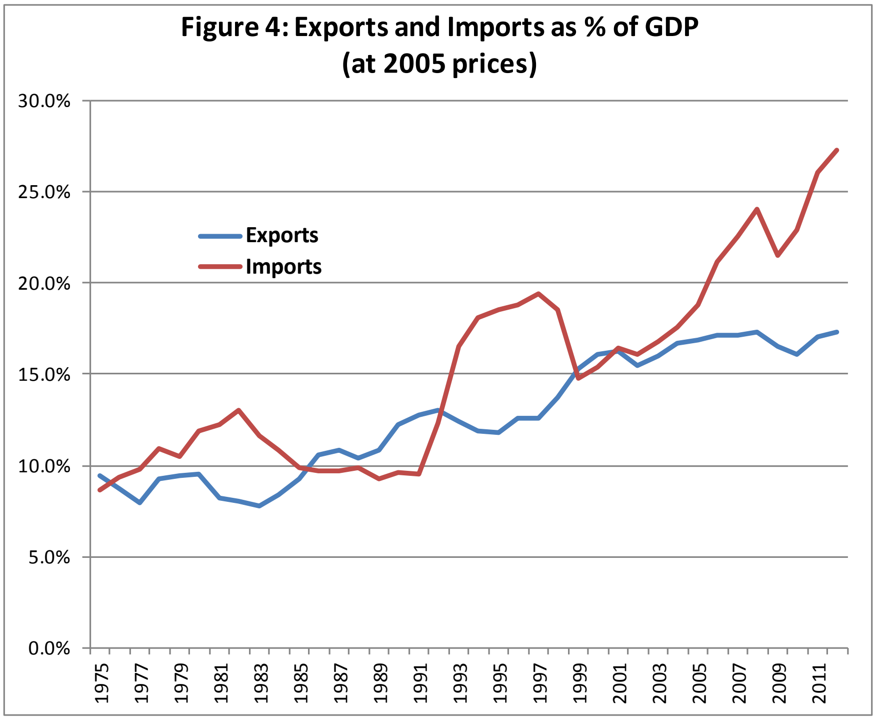
[27] See the Santos Administration Development Plan: DNP, *Prosperidad para todos*, ch. 4, Bogota 2010.

[28] Jaime Bonet and Adolfo Meisel Roca, "Polarización del ingreso per cápita departamental en Colombia", *Ensayos sobre Política Económica*, Vol. 25, No. 54, June 2007.

Changing Structural Patterns

Economic structures have changed significantly as a result of the liberalization reforms but also of external shocks, particularly the commodity-price boom that took off in 2004. As a result, Colombia is more open to trade and foreign investment, some Colombian firms have expanded abroad, the private sector plays a growing role in activities that were previously reserved for the state, the share of mining and services in GDP has increased at the cost of agriculture and manufacturing, and oil and mining have come to dominate exports.

Rising trade coefficients (estimated at constant prices) are shown in Figure 4. Export coefficients have increased in a step-wise fashion, with two major jumps: the first one during the second half of the 1980s, and thus prior to the trade liberalization proper, and the second during the crisis at the turn of the century. It is remarkable that exports in real terms have growth at a similar rate than overall GDP during the major periods of expansion (1991-1997 and since 2003), making it difficult to claim that trade liberalization has generated export-led growth. Import coefficients show a steeper but unstable rise, with sharp increases during periods of expansion that were not entirely reversed during the crisis of the late twentieth century. As we will see, the mix of these export and import patterns has been a sharp deterioration of external accounts during periods of economic growth. They have also affected changes in economic structure.

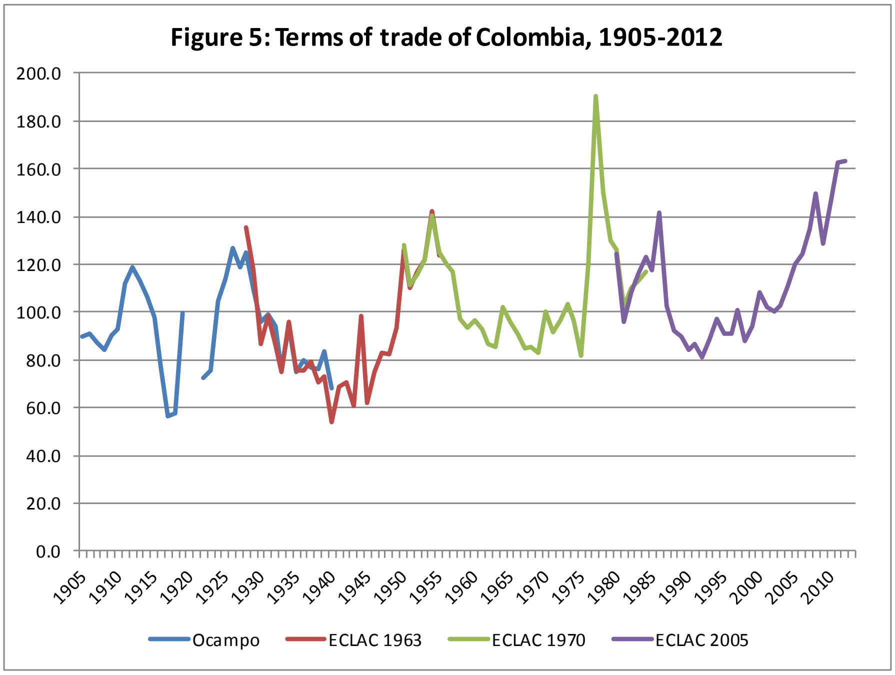


Source: Estimated on the basis of DANE data.

As a result of liberalization reforms, the role of foreign direct investment (FDI) has also increased. According to ECLAC data, FDI has represented, on average, 2.2 percent of GDP since 1994, the year when it showed the first significant jump vis-à-vis the fraction of one percentage point that it had represented until then. This is similar to the Latin American average (2.3 percent in 1994-2012 according to ECLAC data). FDI mainly focused on services in the second half of the 1990s and in oil and mining in the 2000s.[29] With a lag, Colombian firms have also expanded abroad, particularly in Latin America but also in the U.S. and some European countries, with a

[29] See ECLAC, *La inversión extranjera directa en América Latina y el Caribe 2002*, Santiago: CEPAL, ch. 2, and annual follow-ups of this report, and Miguel Posada Betancourt, "Inward FDI in Colombia and its policy context *Columbia FDI Profiles*, Vale Columbia Center on Sustainable International Investment, November 10, 2010, available at http://www.vcc.columbia.edu/files/vale/documents/Colombia_IFDI_updated_Nov_10_2010_final.pdf

select group of Colombian firms –both private and public— joining the ranks of the "multilatinas" (Latin multinationals).[30]



Source: ECLAC and for the first series, José Antonio Ocampo y Santiago Montenegro, *Crisis mundial, protección e industrialización: Ensayos de historia económica colombiana*, Bogotá: CEREC, 1984, ch. 2.

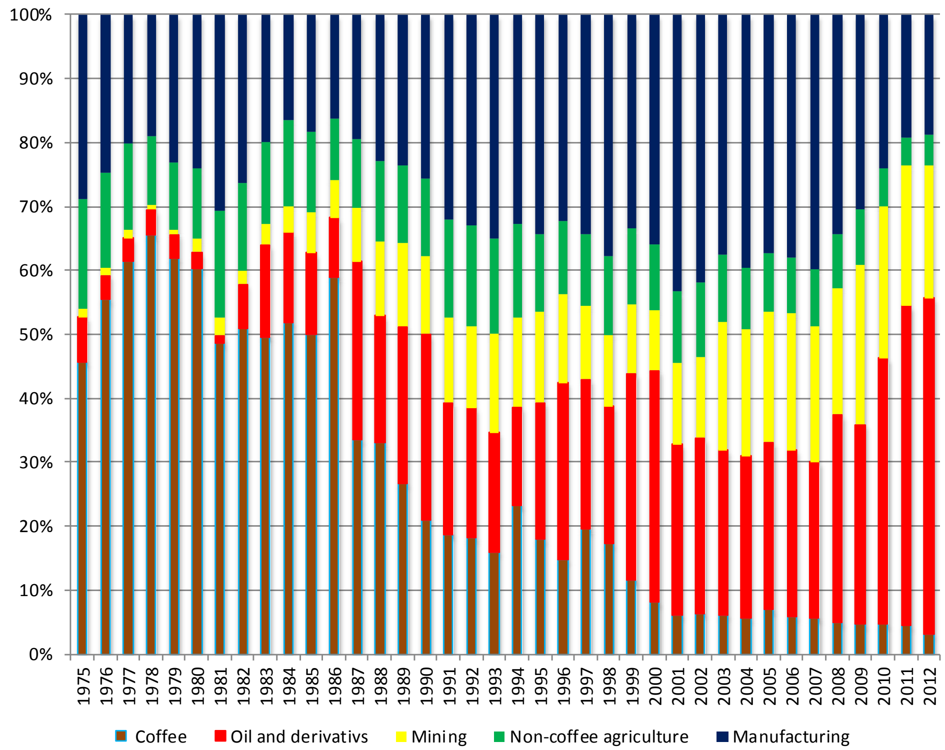
The external factor that has had the strongest effects on the economic structure is the commodity price boom which took off in 2004, and which was particularly strong in the energy and mining sectors. To understand the strength of this boom, Figure 5 shows the terms of trade of Colombia since the early twentieth century. As it is clear, the still ongoing boom has been stronger than any the economy experienced in the twentieth century. This can be shown by how many years the terms of trade index has exceeded by 20 percent the value in the base year (1970

[30] See Ana María Poveda Garcés, "Outward FDI from Colombia and its policy context", *Columbia FDI Profiles*, Vale Columbia Center on Sustainable International Investment, September 1, 2011, available at http://www.vcc.columbia.edu/files/vale/documents/Colombia_OFDI_-_1_Sept_2011_-_FINAL_-_REV_2.pdf. The stock of outward investment grew from $3 billion in 2000 to $23 billion in 2010. It has involved both private companies, financial (Bancolombia, Colpatria and Grupo Aval, among others) as well as non-financial (Carvajal, Cementos Argos, Hoteles Decamerón, Nutresa and Repsol, among others; we should also add Avianca, although it is now controlled now by a Brazilian investor), as well as public sector firms, both public (Ecopetrol, Interconexión Eléctrica S.A) and local (Empresas Públicas de Medellín and Empresa de Energía de Bogotá).

in the graph): *eight* years during the recent boom vs. five in 1976-1980, three in the period 1950-1954 and only two in the second half of the 1920s. Booming oil and mineral prices have, of course, fed into export as well as fiscal revenues, in the latter case through the rise in income taxes of mining companies in general and the profits of Ecopetrol transferred to the central government.

The mix of these trends has been a boom in oil and mining exports, which have come to dominate Colombia's export basket. Oil and mining exports had already experienced a strong expansion in the 1980s, and represented over 30 percent of the country's exports since the later part of that decade (Figure 6). The major coal and nickel projects that the government had promoted since the 1970s had added these two commodities to list of mining products in the 1980s to the renewed exports of oil and derivatives, and the ancestral though highly cyclical gold exports (which are not fully reflected in trade statistics). Oil itself benefitted from the more private-sector friendly and, particularly, FDI-friendly contracts introduced in the mid-1970s. The Uribe Administrations placed the encouragement of FDI in mining at the center of its economic policy, to the point of approving (entirely unnecessary) tax incentives for investments in the sector, and the Santos Administration used the term "mining locomotive" its Development Plan to refer to the priority placed on this sector. The share of oil and mining exports continued to increase through the 1990s and then speeded up during the recent commodity boom to reach over 70 percent of Colombian exports in 2011-2012 –enhanced, of course, by the high oil and mining prices in place. The great loser was the traditional staple of Colombia, coffee, which has come to represent in recent years almost a marginal share in the export basket.

Figure 6: Export Composition (% of total exports)



Source: Banco de la República on the basis of information collected by DANE.

"Non-traditional," and particularly manufacturing exports, are destined in a high proportion to other Latin American countries. They had been the great success story of the second half of the 1980s, and further increased in the 1990s thanks to the liberalization of Andean trade and the multiplication of trade agreements with other countries in the region. However, they have faced two adverse trends: periodic real exchange rate appreciations (see below) and the instability of sales to some countries, notably Venezuela. Thus, exports to this country boomed in 1990-1998 but then experienced a period of high instability, with sharp falls in some years (1999 and, particularly, 2003). They increased again from 2003 to 2008 but then became victim to the political tensions between the two countries and fell by 77 percent over the next two years; although they have recovered thereafter, they remained at 42 percent of their 2008 peak in 2012. Both the 2004-2008 export boom to Venezuela as well as the 2008-2010 contraction were major external shocks for Colombia.[31] Overall, the net result of trends in the share of non-traditional exports is that after peaking at over two-fifths of total exports, the share of manufacturing exports fell to less than one-fifth in recent years. Non-coffee exports peaked earlier, in 1991-1992, at over 15 percent of total exports but then fell in a steady manner to 4-5 percent.

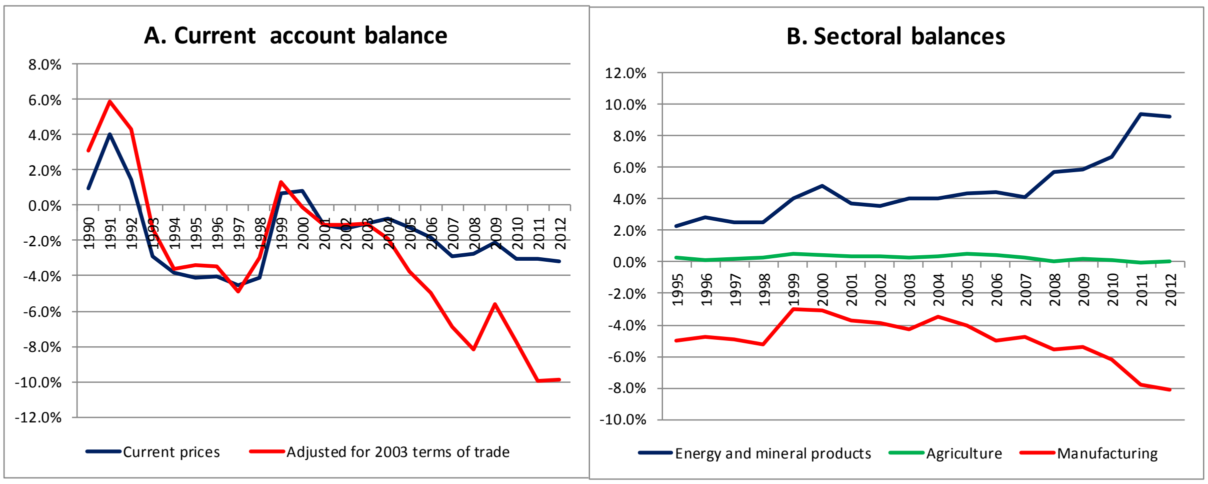
The net effect of export and import trends has been a highly cyclical balance of payments: current account balances have tended to deteriorate massively during booms and adjust during crises. Since the current account of the balance of payments is the counterpart of changes in domestic production and aggregate demand, this highly cyclical behavior implies that aggregate demand has been more volatile than GDP, indicating again that attempts by natural authorities to smooth demand fluctuations –counter-cyclical macroeconomic policy—has not been particularly effective.

Figure 7.A shows this cyclical behavior. It estimates the current account balance in two different ways: at current prices and adjusting exports of goods and services by the changes in the terms of trade vis-à-vis 2003, the year before commodity prices started to boom. The difference was not very important up to 2003 but then became quite significant. Looking at the first period of expansion, the economy went from a boom from a peak surplus of 4 percent of GDP in 1991 to a deficit which fluctuated around 4 percent in 1994-1998. This deficit was transformed into a small surplus in 1999-2000 and small deficits in the early 2000s. The boom that ensued thereafter generated again a deficit, but the two estimates now vary widely, reflecting the terms of trade boom that the economy experienced during this period. If adjusted by the

[31] Thus, the 2004-2008 represented a positive shock of 1.8 percent of 2008 GDP in a four-year period; the 2008-2010 a negative shock of 1.6% of 2010 GDP, of course in a shorter period.

terms of trade, the deficit reaches 10 percent of GDP in 2011-2012. Since at current prices the deficit was around 3 percent of GDP, this means that the terms of trade gains since 2004 have come to represent about 7 percent of GDP, which are likely to fall in the next few years as commodity prices come down. This also means that Colombia has been *over*-spending its terms of trade increase.

Figure 7: Current account and trade balances as % of GDP



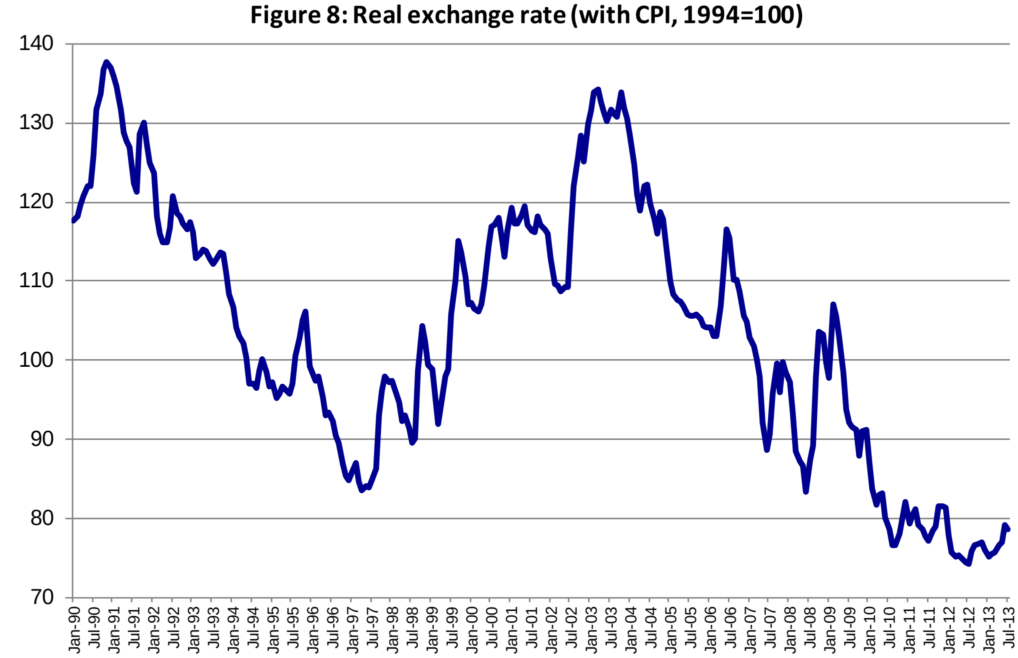
Source: A. Estimates based on ECLAC data. B. Sectoral balances according to Fedesarrollo; GDP in dollars according to ECLAC.

At the policy level, the major reflection of the strong cyclical performance of the balance of payments is the volatility of the real exchange rate. This is shown in Figure 8, which follows the Latin American tradition of estimating the real exchange rate in such a way that a rise means a depreciation and a fall an appreciation. As a comparison of Figures 7 and 8 indicates, the counterpart of the current account is the sharp fluctuations in the real exchange rate: almost persistent appreciation between 1991 and early 1997, a strong depreciation between then and 2003 and an equally strong appreciation trend until mid-2013, which has been interrupted by a few conjunctures, particularly the global financial meltdown of September 2008.[32] What is also

[32] The best analysis of appreciation over the last decade is Mauricio Cabrera, *10 años de revaluación*, Bogotá: Oveja Negra, 2013.

important, the most recent appreciation is the strongest of all. For example, if we define a strongly appreciated exchange rate –or, better, an undervalued exchange rate— as a real exchange rate that is more than 10 percent below the reference point for the graph (the year 2004), there were twelve months of strong appreciation between September 1996 and August 1997, one in 2007 (June), six in 2008 (March-August) but *thirty-one* during the most recent episode of overvaluation (January 2010-July 2012, the last month available when this chapter was written). What is equally important, the previous episodes led to strong regulations of capital flows aimed at reducing booming inflows; the most recent one did not. In all of them, there have also been central bank interventions to accumulate foreign exchange reserves, though generally weaker than similar efforts by other Latin American countries.

Figure 8: Real exchange rate (with CPI, 1994=100)



Source: Banco de la República

Since the overwhelming share of imports is comprised of manufactures, the net effect of trade trends during the recent boom has been a spectacular surplus of energy and mining exports accompanied by a massive increase in the manufacturing trade deficit, particularly in 2008-2012. The latter reached 8.2 percent of GDP in 2012 (Figure 7.B). Agriculture has continued to enjoy a small trade surplus, which almost disappeared since 2008 and represents a fraction of that which the economy enjoyed during most of the twentieth century, when coffee was king.

Although the massive manufacturing deficit has been determined, in part, by booming investment in machinery and equipment, thus bringing into the economy manufactures that do not necessarily compete with domestic production, it has also been the determinant of the large-scale de-industrialization that the country has experienced. Although de-industrialization had started in the mid-1970s, it was mild up to the beginning of trade liberalization and had actually experienced a revival in the second half of the 1980s. After liberalization, de-industrialization was extremely sharp in 1991-1994, when its share in domestic value added decreased by more than three percentage points, but continued until the end of the decade at a slower pace; it was again very strong in 2007-2012 when its share in value added fell by more than two percentage points.

The two periods of intense de-industrialization have coincided with import booms, and the associated appreciation pressures and deterioration of the current account of the balance of payments. They also coincide with periods of GDP growth, when manufacturing demand picks up, and thus cannot be associated with weak demand, such as that typical of recessions. There is, however, one exception: the 2003-2007 expansion, when the share of manufacturing in value added actually increased. As Figure 7.B indicates, the 2003-2007 was also a period of more moderate manufacturing trade deficits than the period that followed. The increase in the share of manufacturing had actually started with the adjustment of the balance of payments at the turn of the century, and reflects also the more competitive real exchange rate that characterized most of this period. It was also facilitated by growing exports to Venezuela up to 2008.

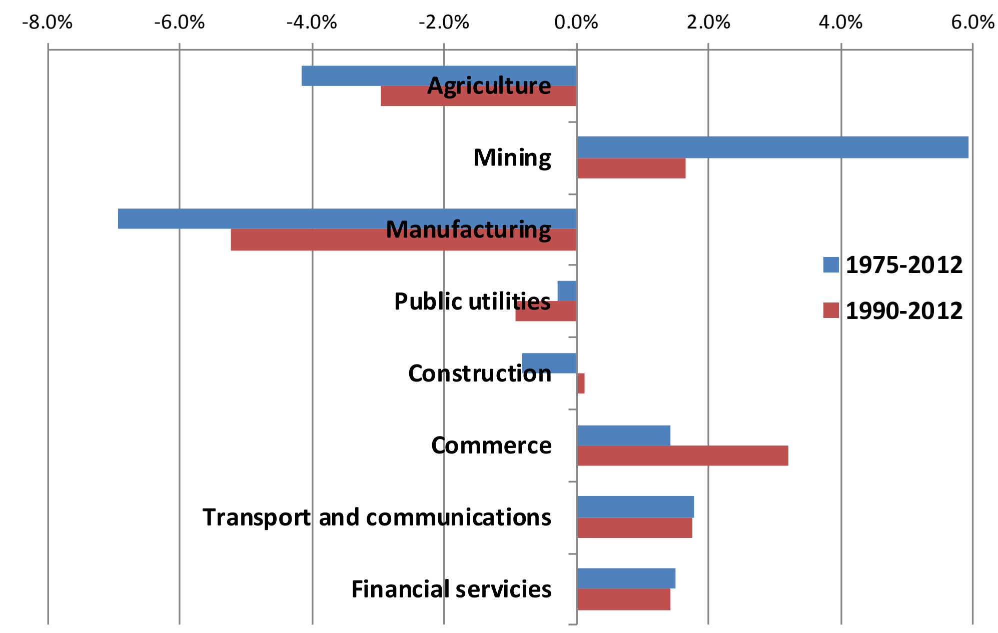
The trends in the share of manufacturing are part of a broader and massive restructuring of the Colombian economy has experienced since the liberalization policies were adopted in the early 1990s, but which partly come from the mid-1970s. Figure 9 summarizes structural changes. The two sectors that have been most adversely affected are agriculture and manufacturing. In the case of agriculture, the falling trend is a long-term feature of structural change, but it was enhanced by the liberalization reforms, which had strong negative effects on some agricultural products (particularly cotton, cereals and oilseeds). Agriculture, notably coffee, has also been affected by low international prices up to the early 2000s and by the periodic exchange rate appreciations. Overall, agriculture's participation in domestic value added has fallen by slightly over four percentage points, close to four-fifths of its 1975 share. Manufacturing has seen its own share fall by almost seven percentage points since the mid-1970s –over five since 1990. This has reduced manufacture's portion of domestic value added by over a third since 1975.[33]

The counterpart has been the rising share of mining (including, of course, oil mining), which had started to increase in the 1980s, as indicated also by its rising share in exports already analyzed. Overall, mining has more than tripled its share in domestic value added, increasing by six percentage points since 1975. The growing role of mining in both GDP and exports has been interpreted by some as the dominance of an "extractive" economic model.[34] All service sectors

[33] Following international trends, this has been partly compensated by the tertiarization of some manufacturing activities.
[34] Luis Jorge Garay Salamanca (director), *Minería en Colombia: Fundamentos para superar el modelo extractivista*, Bogotá: Contraloría General de la República, 2013.

have also expanded, by a total of over six percentage points of GDP. In short, mining and services increased at the cost of agriculture and manufacturing.

Figure 9: Changing shares in GDP (at 2005 prices)



Source: DANE

While structural change in the 1990s was driven by trade liberalization, the most recent episode can be correctly interpreted as a case of "Dutch disease" associated with the oil and mining boom. In fact, a major difference between the 1990s and recent years has been the attitude toward mining activities. In the early 1990s, the expectation of expansion of oil exports, associated with the development of recently discovered Cusiana fields, was widely accompanied by a public debate, promoted by the Gaviria Administration, on how to avoid the Dutch disease. No such debate took place in recent years. Indeed, as already indicated, both the Uribe and Santos Administration not only welcomed but actually encouraged the expansion of oil and mining.

In contrast, agriculture and manufacturing have been hurt not only by liberalization but also by the dismantling of the active production sector policies that the country developed for the promotion of both sectors during the age of state-led industrialization. There have been attempts to reconstruct policies for both sectors, but these efforts have been discontinuous and, particularly, have been relatively weak and thus unable to counteract the stronger negative shocks generated by trade liberalization (which now include a growing number of extra-regional free trade agreements) and recurrent exchange rate overvaluation.

Agricultural policies introduced in the 1990s some incentives for investment and additional sectorial funds for research, to which direct subsidies were added in the 2000s. This is also the only case in which directed credit was maintained after domestic financial liberalization. There were also attempts to reconstruct an industrial policy during the Samper (1994-1998) and Pastrana (1998-2002) Administrations, but they were discontinued during the Uribe governments. At the end of the second Uribe Administration, the seeds of new industrial policies were adopted, which were maintained by the Santos government.[35] A technology policy was also put in place by the Samper Administration but discontinued during the Pastrana government, to revive also at the end of the second Uribe Administration. During the Santos government, research and development was given a share in mining royalties, though on the basis of projects that must be negotiated at the regional level, with this model still in the process of implementation. All in all, these policies have thus an important element of discontinuity and

[35] See an analysis of these policies in Astrid Martínez and José Antonio Ocampo, *Hacia una política industrial de nueva generación para Colombia*, Bogotá: Coalición para la Promoción de la Industria Colombia, 2011, Jaime Acosta Puertas, "¿Es la política de competitividad y de innovación la nueva política industrial de Colombia?", *Report presented to the Friedrich Ebert Foundation of Colombia*, Bogotá, October 2012, and Consejo Privado de Competitividad, *Informe Nacional de Competitividad 2012-2013: Ruta a la prosperidad colectiva*, Bogotá: Consejo Privado de Competitividad, 2012, ch. 15.

have been weak relative to other factors that have adversely affected agriculture and manufacturing.

Challenges

The analysis of this chapter indicates that the best results of the dual-track reform agenda that was put in place in the early 1990s has been improved access by the poor to social services, leading to rapidly falling poverty as measured by unsatisfied basic needs and multidimensional poverty. Significant challenges remain in this area, however, in terms of access in rural areas, quality of services, and organization of service provision, particularly in health. The Colombian economy has experienced also reasonable economic growth since the early 1990s, but much weaker and more volatile than during state-led industrialization. Growth has been more dynamic since 2004, thanks to the most impressive terms of trade boom in over a century, and growth in per capita terms has been enhanced by falling population growth.

Overall, it can thus be argued that the 1991 Constitution has been more successful than economic liberalization in inducing positive trends. One deficiency of both has been, however, the incapacity to improve income distribution, and to reduce rural-urban gaps and labor market informality. It can be argued again that most of these negative trends are associated with the incapacity of the liberalization agenda to induce a growth pattern with favorable social trends.

The Colombian economy shows improvements in other areas: in reducing inflation, increasing investment, in attracting FDI and contributing to the growing family of “multilatinas” and, notably, in expanding its service economy and exploiting its mineral wealth, with the latter now dominating the country’s export basket. At the same time, countercyclical macroeconomic policy has become less capable of smoothing out external shocks –though with a better performance in this regard during the recent global financial crisis than that which hit the developing world at the end of the twentieth century. Growing mining and service sectors have also come at the cost of a weakening of agriculture and manufacturing, which were in the past the pillars of the diversification of the Colombian economy, including its regional diversity – both, no doubt, significant past strengths of the country.

This indicates that the most important challenge for Colombia lies in improving equity, particularly improving its extremely high income distribution and reducing the large rural-urban gap. Both of these challenges are central to peace-building, either if the ongoing peace negotiations succeed but also if they fail. In economic terms, a stronger agricultural sector and a re-industrialization drive based on strong production and technology policies must also be at the center of economic policy. Given the contribution that exchange rate overvaluation has played in the adverse trends experienced by agriculture and manufacturing, it is important to design a macroeconomic policy in which the objective of a competitive exchange rate is placed at the center, indeed as part of a broader effort to rebuild a stronger counter-cyclical macroeconomic policy.

The dependence of recent growth on exceptional terms of trade also pose a major problem, given the expectation that the super-cycle of commodity prices that the world economy has experienced for over a decade may have come to the end. Depending of the strength of the fall in commodity prices, this could become a major challenge, given the fact that Colombia has over-spent its commodity price boom. Macroeconomic adjustment thus faces the major challenges of reducing the current account deficit, and replacing the fiscal revenues associated with the commodity boom. In the context of the demands for public sector spending that the peace process will generate, the latter challenge implies that the country would have to continue to strengthen its tax base, largely by dismantling the massive benefits that the Uribe Administrations granted to capital income.

There are also other challenges that have not been analyzed in this paper. Notably among them are the major lags in infrastructure, particularly in transport infrastructure. According to existing studies, Colombia must at least double its past rates of investment in this area.[36] A major implication of this, together with high levels of inequality, rural-urban gaps and reversing the adverse trends in agriculture and manufacturing, is that the country may have to look more *inward* and at regional markets, where the most important opportunities for manufacturing exports lie, rather than follow the recent route of multiplying free trade agreements with extra-regional partners.

[36] See on this two recent studies: Fedesarrollo, *Infraestructura de transporte en Colombia*, Report to Cámara de Comercio de Infraestructura, Bogotá: Fedesarrollo, November 2012, and Cecilia López *et al.*, *Infraestructura y equidad*, Bogotá: Centro Internacional de Pensamiento Social y Económico (CISOE), August 2013.