

# INTRODUCTION

*The adverse world economic situation has affected the performance of the economy in Colombia and in many other emerging countries. Nevertheless, the performance of the gross domestic product during the first quarter of 2009 shows the Colombian economy has managed to resist the harsh effects of that the crisis better than many other emerging countries with a similar level of development.*

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During the first quarter of 2009, after the financial crisis in the United States and in other developed countries accentuated due to the failure of Lehman Brothers in September 2008, the world economy continued to face the consequences of the crisis, with ups and downs in its intensity and in the way different groups of countries have been affected. The growth figures for the first quarter of 2009 showed a contraction in the industrialized countries; in most cases, it was greater than the downturn observed during the last part of 2008. The Euro Zone and Japan, in particular, posted quarterly annualized reductions in economic activity of 9.7% and 14.2%, respectively, a situation without precedents in recent history. The U.S. economy contracted 5.5%, which is similar to the slump witnessed in the final quarter of 2008.

The crisis in the developed world had serious repercussions on productive activity in emerging economies, which declined 4% as a whole during the first quarter compared to the same period in 2008. In this case, the Eastern European countries experienced the sharpest drop, nearly 15% in annual terms, due to pronounced capital outflows generated by major macroeconomic imbalances and the absence of exchange flexibility. Likewise, a number of emerging economies in Asia, such as South Korea, Hong Kong and Taiwan, posted dramatic slowdowns, as they depend heavily on international trade. However, relatively good performance by China and India, thanks to macroeconomic incentives and the size of their internal markets, managed to offset to some of the contraction in the region. Finally,

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in the case of Latin America, the Mexican economy slumped sharply (8.2%), given its close commercial and financial ties with the United States. Brazil, Chile and Colombia also experienced setbacks, but not as pronounced. Peru grew 1.8%, much less than the year before. The situation in Venezuela and Ecuador was similar, with 0.3% and 1.2% respective growth during the first quarter.

For the second half of 2009, the leading indicators of industrial production and international trade suggest that the contraction in the world economy will begin to ease and the global economy could begin to stabilize, supported by the strong counter-cyclical measures adopted by governments and central banks around the world. The improvement in U.S. and European business and consumer expectations for six months and one year out confirm this perception. In fact, the International Monetary Fund (IMF) announced on June 8 that it had raised its forecasts for world economic growth, which is now expected to reach 2.5% in 2010. This surpasses the 1.9% forecast in April. However, the IMF warns that economic recovery will be slow and highly uneven. After a 3.8% contraction anticipated for 2009, the advanced economies would see no recovery in economic activity until the second half of 2010, when annual growth is expected to reach 0.6%. However, this is better than the estimate of 0% forecast in April. The emerging economies are expected to be back on a positive track in the second half of 2009, although with notable regional differences, and are expected to grow 4.7% in 2010. The forecast in April was 4%.

These types of forecasts are surrounded by considerable uncertainty. As indicated by the IMF, world economic recovery will depend on a complex balance of forces. The negative impact on growth as a result of the financial shock, the plunge in global trade, heightened uncertainty and the collapse of confidence are diminishing gradually. Nevertheless, the housing markets are still in the process of adjusting, the financial markets remain fragile and financial institutions still need to clean up their balance sheets and many also need to restructure. Although policy interest rate cuts and broad liquidity provision have provided support for intermediation and reduced the possibility of systemic failure, the improvements are not the same in all markets and countries, and credit remains tight.

This context of world economic contraction, confidence losses, cutbacks in foreign trade and weak financial markets has affected economic performance in Colombia and in many other emerging market economies. Even so, the information on gross domestic product (GDP) in the first quarter of 2009, released recently by the National Statistics Office (DANE, in Spanish), shows Colombian economy has managed to resist the harsh effects of the crisis, better than many other emerging countries. A 0.6% reduction in Colombia's economic activity during the first quarter, compared to the same period in 2008, is less than the contraction of the economies of Brazil (-1.8%), Chile (-2.1%) and Mexico (-8.2%). By the same token, the moderate downturn in the Colombian

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*The channels through which the international financial crisis has affected the Colombian economy are associated largely with the deterioration in consumer and business confidence, and with the cutback in the disposable income of the economy.*

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economy also compares favorably to the decline in output experienced by the emerging countries in Eastern Europe and some in Asia.

Another aspect that reflects the resilience of the Colombian economy to the effects of the crisis is that, despite a difficult external context, Colombian GDP did not continue to fall during the first quarter of 2009, beyond the 1% annual drop registered during the fourth quarter of 2008. Specifically, compared to the final quarter of 2008, the Colombian economy grew 0.2%. Although it may be premature to talk about a recovery, this outcome suggests the Colombian economy would have managed to stabilize and the worst of the crisis may be over. As discussed in this report, the channels through which the international financial crisis has affected the Colombian economy are associated largely with the deterioration in consumer and business confidence, and with the cutback in disposable income to the economy as a result of lower prices for most export goods and the decline in remittances. This helps to explain the 0.5% reduction in household consumption and the 6.3% cut in private investment during the first quarter. In contrast, the financial contagion channels have not operated forcefully for Colombia, since the international crisis has not blocked the country's access to international lending markets, and it has not resulted in capital flights. In this respect, it is important to remember that the national government had no trouble placing US\$2 billion (b) in external debt bonds during the first half of the year, while an important amount of foreign direct investment continues to flow into the country, helping to finance the current account and to support the momentum in mining production, as illustrated by the GDP figures for the first quarter of 2009.

The effects of the external crisis can be identified from another standpoint through an analysis of GDP by economic activity. The productive activities linked more closely to world trade, which are classified in the so-called tradable sector of the economy, were down 1.8% in annual terms during the first quarter. This is three times more than the contraction in the economy as a whole. Particularly prominent within this group is the 7.9% decline in the manufacturing industry, owing to fewer exports from sector of the industry such as vehicles, clothing and tailored goods, milling and starches, iron and steel, and chemical substances. The agricultural sector, which falls into the tradable category, also experienced a larger decline than the rest of the economy, but slightly less (-0.8%). There was a good performance in mining, and quarrying, which are another important tradable activities, with a 10.6% increase in the first quarter, which prevented that this sector of the economy contracted even more.

In contrast, the non-tradable sector of the economy, which is oriented fundamentally towards serving the internal market, exhibited a mild expansion (0.1%) during the first quarter. This sector is apparently no stranger to the crisis; however, in this case, it had an indirect impact exerted through the loss of confidence, which undermines household consumption and investment. There was good performance of the financial system, which posted 4.1% annual growth in the first quarter.

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However, the notable performance witnessed in civil works construction (21.2%) was undoubtedly the fundamental factor that prevented the non-tradable sector from contracting, thereby avoiding an even sharper drop in the economy. Because civil works partly reflect the pattern of public investment (some mining investments are private), their considerable growth during the first quarter is evidence of the effort of the fiscal policy to create a counter-cyclical demand that helps to keep the economy moving.

The increase in unemployment is a reflection of the slowdown in economic growth. Given its social repercussions, this is clearly one of the more troubling effects of the world crisis. The latest available figures indicate that total unemployment in the March-May quarter was 11.9% nationwide and 12.9% in the thirteen major metropolitan areas. This implies respective increases of 0.9 and 1.3 percentage points (pp) compared to the same period in 2008. As discussed in this report, the rise in unemployment is due to a labor-supply increase that outpaced the rise in demand. In other words, employment in the economy has not stopped growing. In fact, during the period in question, the employment rate went from 52.9% to 54%. Nevertheless, the entry of additional workers into the labor force, in order to offset the drop in family income or to compensate for the fact that the head of the household is without work, surpassed the economy's current capacity for job creation, thereby adding to the unemployment rate. As economic growth recovers, both of these phenomena should turn around, since many additional workers would return to their usual endeavors, either at home or in school, and the economy would be in a better position to generate more jobs.

The Board of Directors of Banco de la República (BDBR) responded in a timely fashion and with flexibility in terms of the monetary policy required to buffer the negative effects of the global crisis. Moreover, it did so without departing from its constitutional mandate to preserve the buying power of domestic currency. In October 2008, a few weeks after the international financial crisis accentuated, the BDBR decided to lower the bank reserve requirement on ordinary deposits. This measure reduced the cost of financial intermediation and reduced the fears of tight liquidity. During that same period, the Board of Directors also lowered the required deposit on external borrowing to zero, so as to facilitate access to external financing at a time when it would have been more expensive because of the global crisis.

Later, in December 2008, ahead of the other central banks in Latin America, the BDBR launched an initiative to rapidly reduce the policy interest rate. By the end of June 2009, the cumulative reduction in that rate came to 550 basis points (bp). As a result, the central repo rate to supply liquidity to the banking system went from 10% to 4.5%.

The monetary stimulus policy applied in recent months is part of the inflation targeting strategy, which is intended to keep economic activity on a long-term path that is sustainable. This implies adjusting interest rates and other

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monetary policy instruments in a counter-cyclical way to avoid sharp fluctuations in output and to guarantee low stable inflation. As in the high phase of the economic cycle, when interest rates were raised to curb the growth in spending and the credit bubble that brought inflationary pressures to bear, now, when the economy is growing below its potential capacity, and there is less pressure on prices and inflation expectations, monetary policy becomes less expansive, without endangering control over inflation. In fact, the first half of 2009 witnessed a pronounced slowdown in annual consumer inflation from 7.7% at the end of 2008 to 3.8% at the end of June, the lowest level on record since June 1962. Likewise, core inflation - which isolates temporary supply shocks such as those that occur in food or fuel prices - registered a sharp downturn from 6.1% in December to 4.9% in June, according to the average of the three indicators monitored by Banco de la República. This drop in inflation was accompanied by a plunge in inflation expectations. According to the Banco de la República's monthly survey, those expectations are around 3.5% for the end of 2009 and 4.6% for a 12-month horizon. These levels are compatible with the inflation targets.

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The policy rate cut passed through quickly to interest rates on loans from the financial system. So far this year, up to mid-June, the weighted lending rate was down 595 bp. This compares favorably to the 550 bp policy rate cut mentioned earlier. The rates on almost all types of lending have responded to a looser monetary policy, particularly the interest rate on commercial loans, with a 638 bp reduction during the same period. The consumer lending rate was the only one to show some resistance to decline, with a 221 bp reduction during the period. The relative inflexibility of this rate is due to the fact that consumer loans are the riskiest for financial institutions, as they usually have no collateral. This is a common phenomenon found in many other economies, as discussed in one of the special sections of this report.

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The reduction in the interest rate on lending and the soundness of the financial system have helped to sustain a certain amount of momentum in the total loan portfolio, which was up 14% in annual terms by the end of the first half of 2009. Considering the slowdown in the economy and the loss of consumer and investor confidence, this is a satisfactory increase in lending. The commercial loan portfolio, in particular, is more dynamic, having grown at an annual rate of 20% during the first half of the year. This clearly reflects a greater of a response to the policy rate of the interest rate for this type of lending. Commercial lending is focused on the corporate sector of the economy and helps to maintain the momentum in productive investment. Consumer lending, on the other hand, has remained almost at a standstill, registering 2.8% annual growth during the first half of the year. This should come as no surprise, considering its sharp growth in the past, the drop in household consumption during the first six months of the year, less consumer confidence, and the slow response of consumer credit rates to Banco de la República's policy rate cuts.

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The current year will go down in history as an exceptionally difficult one for the world economy, hit by an international financial crisis not seen since the Great Depression in the Thirties. As a result of economic globalization, its contagion is quick and intense. In this adverse economic environment, the Colombian economy is holding up better than many other emerging countries with a similar level of development. This is not by chance. It is a reflection of the country's good economic fundamentals and the prudent economic policy that preceded the crisis. A number of indicators reflect the increased strength of the Colombian economy in contrast to the past. The level of international reserves, the financial system's capital soundness and limited exposure to risk, less external borrowing (public and private) as a share of GDP and its profile of long-term maturity, a sustainable current account deficit, financed largely with foreign direct investment, the highest saving and investment rates in the economy, and increased capacity for potential growth in a context of low, stable inflation are some of the factors that worth mentioning in this respect. Moreover, the country has access to a US\$10.4 b flexible credit line from the IMF, which is extended to countries with good economic performance, prudent policies and a solid economic policy framework.

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It is the duty of the country's economic authorities to capitalize those strengths through prudent and effective management of the crisis, using all available tools without increasing the imbalances. The fundamental objective is to temper the effects of the external shock and to prepare the Colombian economy for recovery, once international conditions improve. Economic policy management in a context of exchange flexibility, together with a prudent counter-cyclical fiscal policy in a framework of government debt sustainability, as outlined by the government in the medium-term fiscal framework, will help to accomplish that desirable objective.

There are four chapters in this report. The first offers a description of how the world crisis evolved, its impact on economies and outlook. The second chapter delves into the performance of the Colombian economy and how it has been affected by the international crisis. The third focuses on the way international reserves are managed, their composition, the measures adopted and the status of claims filed with respect to credit events. The last chapter discusses the financial situation of Banco de la República. The report also includes several special, in-depth sections on technical matters to complement the economic analysis presented in the chapters.