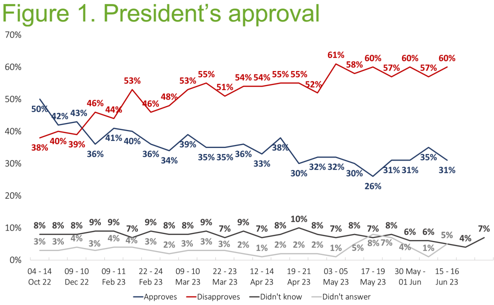
Colombia: Quarterly Investment Outlook

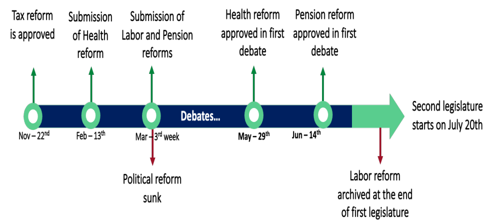
Q2, 2023

Figure 1. President's approval



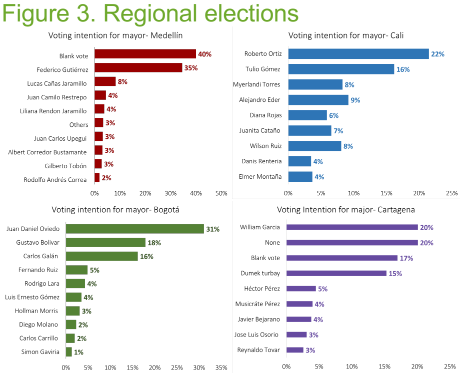
Source: Datexco. Produced by EConcept.

Figure 2. Reform timeline



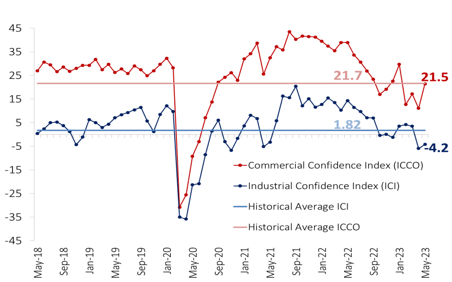
Source: Produced by EConcept.

Figure 3. Regional elections



Source: Produced by EConcept.

Figure 4. Industrial and Commercial Confidence Index



Source: Fedesarrollo. Produced by EConcept.

Political Outlook

Public discontent has characterized the first semester of 2023 (Figure 1). Disproportionate Twitter use, disarray in decisions by the executive branch of the state, poor coordintation among ministers, and political scandals related to Petro's family and closest associates have proven to be a substantial liability. His administration so far has ignited investors' and households' uncertainty. Institutions have proven resilient.

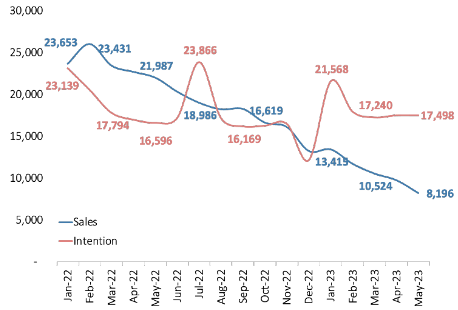
Petro's promise to 'change' Colombia is characterized by strong initial moves and the eagerness to push everything through Congress. The November tax reform approval ironically complicated the passage of Pension, Health, and Labor reforms. Political reform sunk in March and, at the end of Congress' first legislature, the Labor reform sunk as well with expectations of being re-submitted in the second half of this year (Figure 2). We estimate that Pension reform will pass with a 30% watering down and Healthcare reform could pass with a stronger dilution of 60%.

The coming regional elections are key for president Petro's leadership across the country. However, voting intentions in major cities as Medellín, Bogotá, Cali, and Cartagena show opposition candidates with higher favorability than those from "Pacto Histórico". In the capital, Juan Daniel Oviedo, and Carlos Fernando Galán, surpass Gustavo Bolívar in vote intention in some polls. The same is happening in Medellín and Cali.

Despite a troubled political outlook, government weakness has reflected positively on the private sector. Commercial Confidence Index (ICCO) rose 10 pp between April and May (Figure 4). This is mainly explained by Colombia's institutional strength as "expectations for the next quarter" is the main driver. Nevertheless, Industrial confidence index (ICI) has been falling for 20 months.

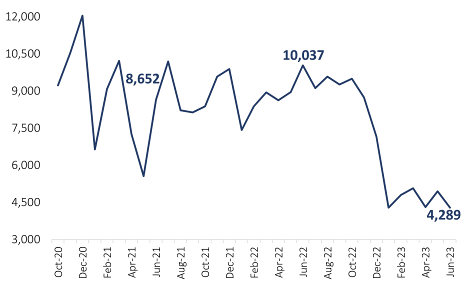
Andrés Escobar President EConcept
Juan Carlos Echeverry Partner EConcept

Figure 5. Potential demand and new home sales



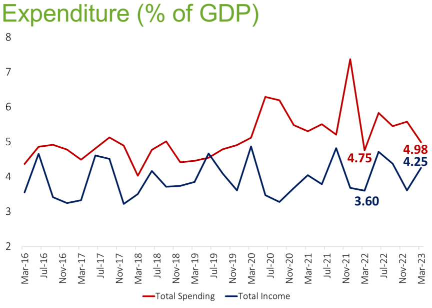
Source: Camacol.

Figure 6. Car sales: new automobile license plates



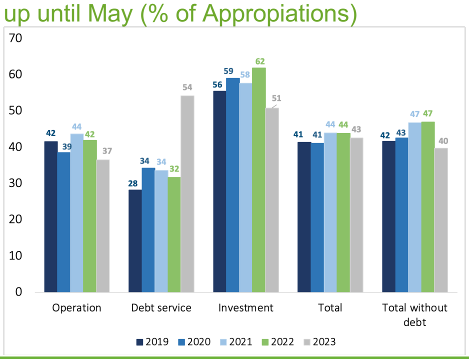
Source: Fenalco. Produced by EConcept.

Figure 7. Government's Income and Expenditure (% of GDP)



Source: Ministerio de Hacienda. Produced by EConcept.

Figure 8. National Government Plan execution up until May (% of Appropiations)



All the factors mentioned above are also punishing consumption, especially on durable goods. Figure 5 shows the gap of more than 9,000 units between buying intention and actual home sales. This is driven by the adjustments made in social housing subsidies. The "Mi Casa Ya" program has been unreliable over the past year and is currently undergoing a restructuring. Furthermore, Figure 6 shows a decline of new car sales, which are way below 2020 levels and experienced an annual decline of -57.3% in June.

Fiscal Policy

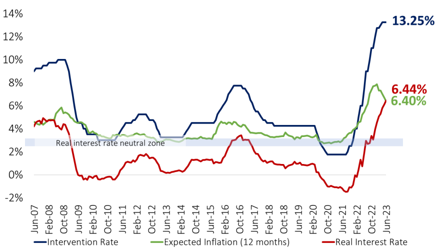
In the first quarter of 2023, the Government total revenue increased 18% compared to March of 2022, which is good news for social expenditure programs. On the other hand, total expenditure increased just 4.8% (Figure 7). There are still doubts about compliance with the fiscal rule, especially for 2024. As we believe deviating from the fiscal rule would be very costly, many campaign promises could probably end up unfulfilled.

Gasoline subsidies' debt was a substantial driver of government spending during the year. The new path set for paying the fuel price stabilization fund (FEPC) implies the payment of COP $36 trillion accumulated since 2022. However, diesel subsidies will still complicate fiscal performance in 2024.

After the 2022 tax reform, which was expected to generate a revenue of COP 21.5 trillion in 2023, in June 2023 a budget addition was approved in Congress, adding only COP 16.9 trillion of spending capacity. These resources were allocated to social spending and economic recovery for the second half of the year. With the approved addition it is estimated that the Central National Government's fiscal deficit (CNG) will close at 4.3% of GDP in

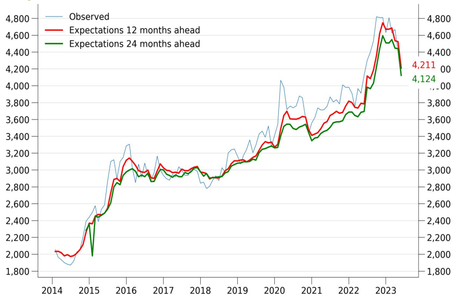
Source: Ministerio de Hacienda. Produced by EConcept.

Figure 9. Intervention rate, real interest rate and expected inflation



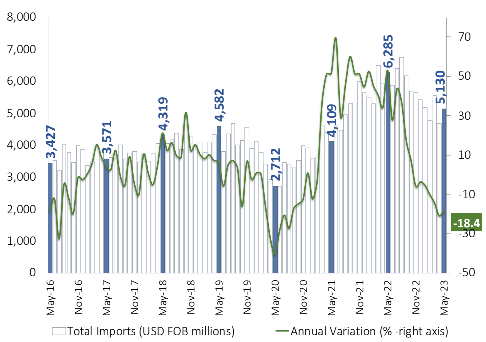
Source: Banco de la República. Produced by EConcept.

Figure 10. Exchange rate, observed and expectations data as of June 2023



Source: Banco de la República. Produced by EConcept.

Figure 11. Total Imports (USD FOB millions) and Annual Variation (%)



Source: DANE. Produced by EConcept.

2023, 1% of GDP lower than in 2022, a figure consistent with the fiscal rule.

Monetary Policy

Even though inflation is starting to ease after its peak in 2022 and inflation expectations are falling, the Central Bank seems keen to keep its monetary hawkish stance by maintaining the intervention rate at 13.25% (Figure 9). The Central Bank considers that it is dangerous to underestimate future risks like El Niño phenomenon, the increase in fuel prices, and shocks coming from the global economy. The Central Bank decided to keep its monetary policy rate. We expect that the Central Bank may start to cut its benchmark interest rate in September.

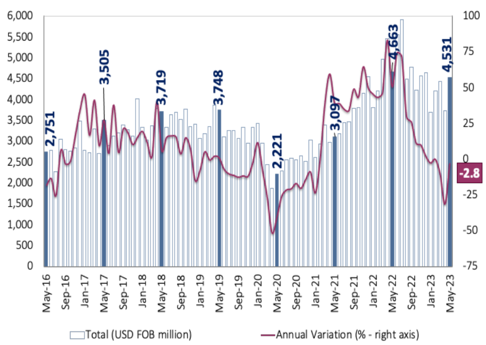
External Sector

The COP/USD exchange rate strengthened since the beginning of 2023. After reaching a historic peak of COP 5,005 per USD in November 2022, the currency returned to levels not seen since July 2022, reaching less than 4,000 recently (Figure 10). Almost a year into the Petro administration, lack of cohesion in the president's cabinet, a disbanded congressional coalition and a stalemate in economic and political reforms has led the markets to perceive less risk in Colombia than originally anticipated. However, we expect an average exchange rate around COP 4,400-4,500 at the end of 2023.

World recession risks seem less threatening, which led to less tight foreign lending conditions. This has been positive for foreign direct investment in Colombia. However, the tepid performance of the world economy is not a thing of the past just yet.

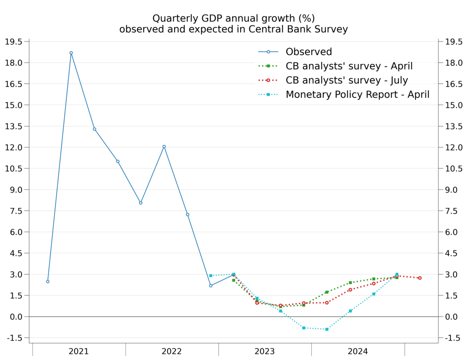
The first quarter of the year showed a correction of the current account deficit (-to reach 4.2 %GDP) due to a contraction in

Figure 12. Total Exports (USD FOB millions) and Annual Variation (%)



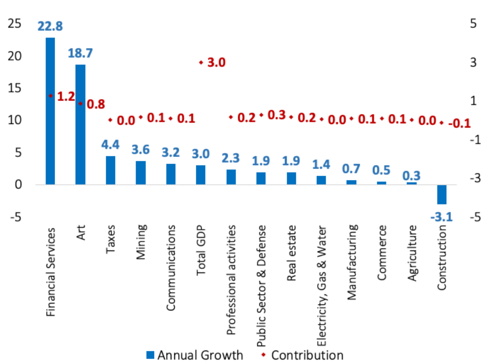
Source: DANE. Produced by EConcept.

Figure 13. Quarterly GDP annual growth (%) observed and expected in Central Bank Survey



Source: Colombia Central Bank. Produced by EConcept.

Figure 14. GDP annual growth (%) by sectors and contribution to the GDP (pp)



Source: DANE. Produced by EConcept.

imports, especially of intermediate and capital goods, linked to lower domestic investment. Imports have decreased by 18.4% in May 2023 compared to same month last year (Figure 11).

Exports also contracted, but less rapidly. As mining and energy sector represent, on average, more than half of total exports, high commodity prices have prevented a larger drop in exports. Total exports declined by 2.8% since May 2022 (Figure 12).

GDP

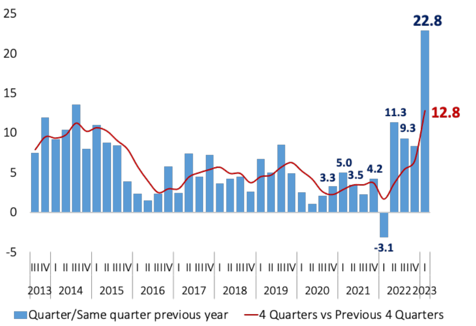
The Central Bank's analyst's survey published in July show GDP growth expectations at 1.4% for the end of 2023 and 2.1% for 2024. However, in the last Monetary Policy Report (April), it was expected that the potential GDP could reach 3.1 % in 2023 and 2.6% in 2024 (Figure 13). Recently, Ricardo Bonilla, Minister of Finance, adjusted his GDP growth forecast from 1.3% to 1.8%.

President Petro stated that financial services do not create value, a surprising opinion. Now, it appears that President Petro's efforts to develop the agricultural and manufacturing sectors, the ones he believes do create value, are not as significant as the sectors he underestimates. Agriculture and manufacturing grew 0.3% and 0.7%, respectively (Figure 14).

In contrast, the Financial Services sector was growing the most (22.8%) and contributed 1.2 pp to total GDP growth (Figure 15). This sector had its strongest annual performance in the last decade, in part due to the pension funds, which were the main generators of returns, followed by insurance companies. The arts and entertainment sectors grew 18.7%, contributing 0.8 pp to total GDP growth (Figure 16).

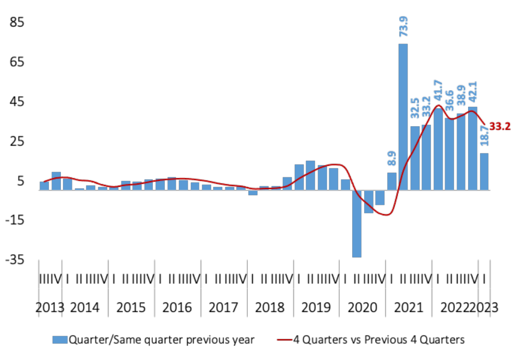
In the short run, the economy grew between May 2022 to May 2023 0.65% (Figure 17), and 0.88% compared to April 2023. As mentioned before, tertiary activities are still the ones that have

Figure 15. Finance Services sector annual growth (%)



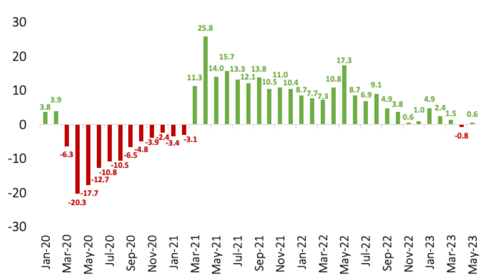
Source: DANE. Produced by EConcept.

Figure 16. Arts sector annual growth (%)



Source: DANE. Produced by EConcept.

Figure 17. Economy Tracking Indicator annual growth (%)



Source: DANE. Produced by EConcept.

grown the most, while the primary and secondary activities lag the Economy Tracking Indicator (Figure 18).

The Construction sector was the only one contracting (-3.1%). High inflation and increasing Central Bank and market interest rates have demand for loans; public policy has lacked determination, leaving this sector struggling to obtain resources to develop new projects. Additionally, the government's lack of interest in investing in 5G highways is also taking its toll.

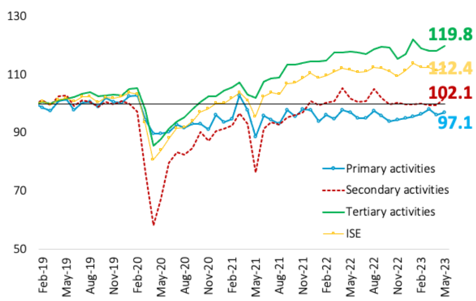
Economic Outlook

While running for president, one of Petro's main proposals was implementing energy transition and reducing Colombia's economy dependence on fossil fuels. In his first 5 months in Office, despite statements by members of his cabinet against the extractive industries, oil production did not show a significant change compared to 2021. On the contrary, it increased, making it the second consecutive year of production growth since 2018 (Figure 20).

There is another challenge looming for the government this year, El Niño phenomenon. In June 2023, the probability of El Niño is close to 100% (Figure 21). Droughts are likely to affect harvests and could lead to a supply shock, increasing consumer prices. The anti-fossil fuels stance does not seem to be a timely strategy for energy security during Al Niño.

After increasing during the pandemic, the Multidimensional Poverty Index (MPI) dropped in 2022, reaching 12.9% (Figure 22). This indicates that the impact of COVID on multidimensional poverty was temporary. Since 2010, Colombia has achieved a reduction of almost 18 pp in the MPI. Several aspects showed outstanding

Figure 18. Economy Tracking Indicator by activities (base Jan-19=100, Seasonally adjusted)

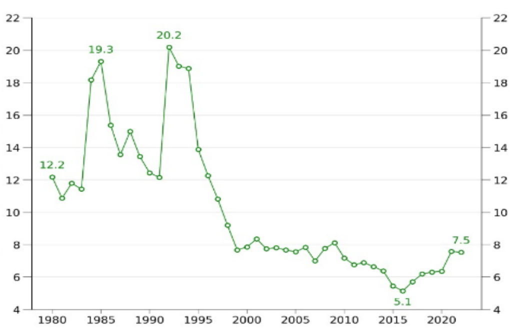


Source: DANE. Produced by EConcept.

Figure 19. Economy Tracking Indicator and Energy Demand annual growth (%)

Source: DANE and Sinergox. Produced by EConcept.

Figure 20. Oil: reserves/production ratio (years) 1980 - 2022



Source: Banco de la República. Produced by EConcept.

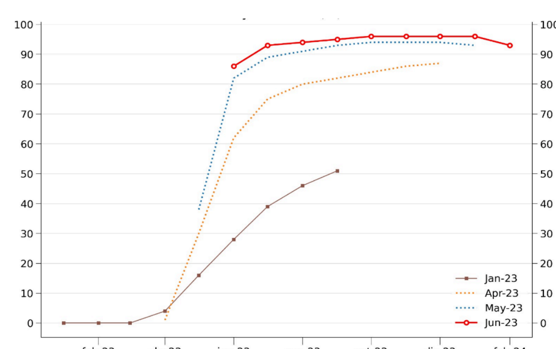
improvement, such as reductions in school absenteeism after the COVID quarantines ended.

Unlike multidimensional poverty, food safety has not shown an effective recovery after the pandemic. In 23 capital cities, only 70% of households have access to three meals per day, compared to 97% before the lockdown (Figure 23). However, some cities have experienced a strong recovery, such as Barranquilla, which improved 60 p.p. The cities heavily reliant on informal jobs, related to lower-paid activities, are the ones where food safety has decreased the most after the pandemic.

To address the issue, the Petro administration is planning to merge several conditional and non-conditional cash transfer programs under the so-called ‘Renta Ciudadana’.

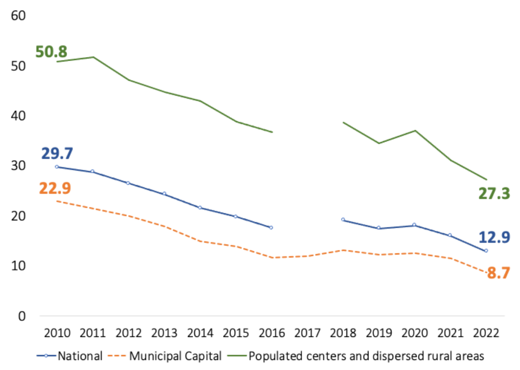
However, employment informality could rise due to the labor reform presented to Congress; according to Colombia's Central Bank, that bill could reduce formal employment rate between 0.7 p.p and 3.4 p.p., and cost as much as 450 thousand jobs.

Figure 21. Probability of El Niño (%)



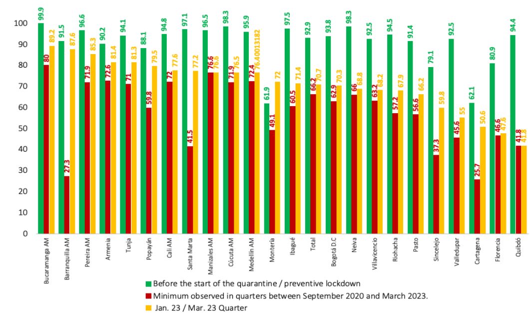
Source: NOAA. Produced by EConcept.

Figure 22. Households in multidimensional poverty situation (%)



Source: DANE. Produced by EConcept.

Figure 23. Households with 3 meals a day (%). October 2022/December 2022 quarter – Total of 23 cities and their metropolitan areas.



Source: DANE. Produced by EConcept.

Pensions: bread for today, hunger for tomorrow

Pension systems are extremely cumbersome and hard to understand. Add to that the well-known fact that youngsters don't care much about what happens when they retire. Then add the next layer to the cake: dispassionate, rational, and informed discussions about pension reforms are practically impossible in developing countries and rich and better-educated nations such as France. Finally, put the cherry on top: a populist government offering additional coverage for Colombians in their white hair years, in a country where less than 30% of those in retirement age have access to old-age protection of some kind. This section takes a look at the potential impacts of the pension bill recently presented to Congress by the Petro administration, trying to take into account the many facets the topic warrants.

A brief summary of the reform

The bill submitted to Congress has 91 articles. Its intention is to create, starting on January 1st 2025[1], a new and ambitious old-age protection system, of which the current pension system (which covers people in the formal labor market during their active years) is only a chapter. Regarding the latter, the reform does not intend to introduce any modifications to fundamental parameters: retirement ages remain the same (57 for women, and 62 for men); contributions during working life remain for the most part unchanged; the income base used to compute the pension is not addressed, nor are the replacement rates (percentage of the income base paid as a monthly pension) the system offers, or the system of indexation thereafter; the dual system Colombia created back in 1993 (pay-as-you-go + private pension funds), modified between 2003 and 2005 will all continue in force.

Yet the proposed changes are wide-ranging. Old-age coverage outside the pension system will be dramatically boosted (at a tremendous fiscal cost), and the way people in the formal labor market contribute to the dual pension system will be turned upside down. Private pension funds will shrink dramatically, not only because by design the reform intends for that to happen, but also because the bill opens up a new window for people less than 10 years away from retirement to switch to the generous (i.e. fiscally costly) pay-as-you-go system administered by Colpensiones.

The old-age protection system the draft bill intends to create consists of three pillars:

- **Solidarity pillar**: entirely funded by the government's budget, it intends to give a subsidy equivalent to the extreme poverty line (currently COP 233.000 or $50 per month) to 2.3 million people aged 65 years or more.

- **Semi-contributive pillar**: intended for people also aged 65 years or above, eligible for the solidarity pillar or not, who have managed to either 1) save some money through the BEPS program[2] or 2) have

[1] Article 90 of the draft bill sets January 1st, 2025, as the beginning of the functioning of the new Old-Age Protection System.

[2] The Periodic Economic Benefits program (BEPS for its Spanish acronym) was created back in 2005 to receive voluntary contributions from workers earning less than 1 minimum wage (not eligible to contribute to the pension system). These voluntary contributions,

contributed for between 150 and 1,000 weeks to the pension system but are not eligible to receive a pension. They will receive an annuity, depending on their capacity to save, ranging between the extreme poverty line and 80% of the minimum wage (currently COP 928.000 or $190 per month)

- **Contributive pillar**, in turn, comprises two components:
    - a **pay-as-you-go** component, administered by Colpensiones, receiving contributions from all workers in the formal labor market related to their first 3 minimum wages.
    - an **individual complementary component**, administered by private pension funds, receiving contributions from incomes exceeding 3 minimum wages.

To try to clarify how this new system might play out, consider two workers: worker A earning 2 minimum wages and worker B earning 9 minimum wages. Since worker A earns less than 3 minimum wages, all the contributions she (and her employer) makes would go to the pay-as-you-go component. Worker B's contributions to the pension system must be split in two: those corresponding to its first 3 minimum wages would go to the pay-as-you-go system, while those above the 3
minimum wages would go to a private pension fund of her choosing.

An additional change is introduced in the draft reform bill regarding the contributive pillar. People that have already contributed 1,000 weeks (slightly more than 19 years) to the pension system would continue to contribute as if nothing had happened: no split in their contributions at the 3 minimum-wage thresholds, i.e. they can keep contributing fully to either Colpensiones or to the private pension funds.[3] But there's more in the draft bill: since the pensions awarded by Colpensiones are higher (subsidized approximately in 40%) and a lot of people with less than 10 years from getting a pension, currently locked in private pension funds, would very much like to switch there, the reform opens up a two-year window during which this switch can take place; expect lots of people to use this window without hesitation.

The changes introduced to the contributive pillar (i.e. the current pension system) are substantial because today people choose whether to contribute exclusively to the pay-as-you-go system or to the private pension fund chapter. With this reform people will not get to choose unless they earn more than 3 minimum wages; if they belong to this group, they will only choose where to send their above-3-minimum-wage contributions.

Potential impacts of the reform and alternative scenarios

The potential impacts of this reform now under Congress consideration, summarized in Table 1, are game-changing, at least. Massive movements of people and monies will be generated, and the fiscal impacts are considerable. The rightmost column in Table 1 simulates the reform as it was presented to Congress (i.e., with a

complemented by a 20% matching contribution from the government, intends to create an annuity (capped at below 1 minimum wage) to be received once retirement age is reached. People that, while contributing to the pension system during their active work life don't manage to get a pension, can take to BEPS the lump-sum given back by either Colpensiones or private pension funds. The BEPS system is administered by Colpensiones.

[3] Again, according to article 90 of the draft bill, this 1,000-week requirement does not have to be met once the reform is approved, but on January 1st, 2025, which is the date this article sets as the beginning of the functioning of the new Old-Age Protection System.

threshold salary of 3 minimum wages to split the contributions between the pay-as-you-go and the private pension funds systems); we added two more columns, with the threshold at 1 and 2 minimum wages, in order to look at both the differential impacts and to contemplate possible changes to the reform in Congress. Experts and some political parties have advocated for either of those possibilities, with 1 or 2 minimum wages as the key threshold.

Let us first look at how people actively[4] contributing to the pension system will shift. To do that, we used data published by Superintendencia Financiera for December 2022. Out of the 12 million active contributors registered at the end of last year, 3.2 million (27%) have chosen Colpensiones and 8.8 million chose private pension funds. If the minimum-wage threshold to split contributions is set at 1 minimum wage, the composition is completely the inverse: 8.8 million (74%) would contribute fully to Colpensiones while 3.2 would remain contributing above the threshold to private pension funds. With the threshold set at 2 minimum wages, 11 million people (92%) would contribute fully to Colpensiones. Under the current reform 3 minimum-wage threshold proposal, the number would go up to 11.5 million (96%).

Now let us turn to how the contributions will shift. Yearly gross contributions to Colpensiones added up to COP 14.3 trillion (1% of GDP), while gross contributions to private pensions totaled COP 29.1 trillion (2% of GDP); in other words, Colpensiones received a third of gross contributions. Under the 1 minimum-wage threshold scenario, Colpensiones' piece of the pie would jump to COP 33.1 trillion (2.3% of GDP or 74% of gross contributions). Under the 2 minimum-wage threshold scenario, COP 37.7 trillion (2.6 % of GDP or 87% of gross contributions. Then, finally, under the reform draft bill scenario of 3 minimum wages, Colpensiones ends up with COP 39.3 trillion (2.7% of GDP or 90% of the contributions).

So, no matter the scenario considered, the fate of private pension funds changes dramatically. The funds lose ground considerably, both in contributors and money flows. Based on the numbers shown in Table 1, they stand to lose anywhere between 47% and 69% of contributors, and 43% and 58% of gross contributions.

Table 1. Expected impacts of the pension reform draft bill under three scenarios

		Under current legislation		Reform scenarios Contribution thresholds (in minimum wages) diverted to Colpensiones		
				1	2	3
Active contributors (Millions) - December 2022	Colpensiones	3.2	Colpensiones	8.8	11.0	11.5
	Private pension funds	8.8	Private pension funds	3.2	1.0	0.5
Gross contributions (COP tn) - 2022	Colpensiones	14.3	Colpensiones	33.1	37.7	39.3
	Private pension funds	29.1	Private pension funds	10.4	5.8	4.1
Gross contributions (% of GDP) - 2022	Colpensiones	1.0	Colpensiones	2.3	2.6	2.7
	Private pension funds	2.0	Private pension funds	0.7	0.4	0.3
Fiscal contingent liability (NPV 2024-2070) as a % of GDP - according to ANIF	**Current Colpensiones retirees**	**26.0**	**Current Colpensiones retirees**	**26.0**	**26.0**	**26.0**
	Other current retirees (Colombia Mayor + BEPS + lump-sum payments) + total future retirees (including Colpensiones)	**84.0**	Solidarity pillar	24.1	24.1	24.1
			Semicontributive pillar	54.3	54.3	54.3
			Contributive pillar	52.6	124.0	130.7
			Transition window	14.2	14.2	14.2
	Total	**110.0**		**171.2**	**242.6**	**249.3**

Source: Superintendencia Financiera, ANIF

[4] Active contributors are people who made contributions to the pension abovesystem at least once during the last six months.

Now let us turn to the long-term fiscal effects. To do that, we will use numbers produced by Anif, a banking sector think tank, which very generously also simulated for us the 2 minimum-wage threshold scenarios, in addition to the 1 and 3 minimum-wage scenarios. The comparison between the current situation and the three possible scenarios shown in Table 1 are expressed in net present value (NPV), for the 2024-2070 period, using a nominal discount rate of 4%, widely used in Colombia for these types of calculations. The result is then compared to this year's GDP.

Under the current legislation, the NPV of the fiscal contingent liability of the system stands at 110% of GDP, which in turn can be split into two main components: 1) the contingent liability related only to people already receiving a pension from Colpensiones, equivalent to 26% of GDP in NPV; and 2) the contingent liability of people that will start receiving a pension from Colpensiones in the future, plus the costs of Colombia Mayor and BEPS in their current versions, equivalent to 84% of GDP in NPV. These numbers represent the unfunded part of those types of systems that would be covered by the national government budget.

Under the reform scenarios, given the massive flow of people and money to Colpensiones, and the increased coverage promised through the solidarity and semi-contributive pillars, the expected impacts are as follows:

- The contingent liability related only to people currently receiving a pension from Colpensiones stays at 26% of GDP in NPV under all three scenarios; these people don't face any change in their pensions, which means the fiscal subsidy remains intact.
- The contingent liability of everyone else (i.e. solidarity and semi-contributive pillars + new entrants to Colpensiones under the minimum wage thresholds + transition window) jumps from the 84% of GDP in NPV mentioned above, to 145.2% of GDP under the 1 minimum-wage threshold; 216.6% of GDP under the 2 minimum-wage threshold; and 223.3% of GDP under the 3 minimum-wage threshold. These are not mild increases in fiscal liabilities.
- The cost of the solidarity pillar has been computed by Anif at 24.1% of GDP in NPV; it does not change across scenarios since the minimum wage thresholds are not related to this pillar.
- The cost of the semi-contributive pillar has been computed by Anif at a whopping 54.3% of GDP in NPV; it does not change across scenarios since the minimum wage thresholds are not related to this pillar either.
- The cost of the contributive pillar is substantial and, depending on the minimum wage threshold considered, it becomes more and more onerous in fiscal terms; given that the parameters of the system don't change, the subsidies of the pay-as-you-go system remain intact and simply more people benefit from them. Under the 1 minimum-wage threshold, the fiscal cost in NPV is 52.6% of GDP; at the 2 minimum-wage threshold it goes up to 124% and, at the 3 minimum-wage threshold it climbs to 130.7%.
- Finally, the cost of the transition window, i.e. the opportunity to switch to Colpensiones despite being less than 10 years away from retirement (provided more than 1,000 weeks' worth of contributions have been made to the system) stands at 14.2% of GDP in NPV.

As pensions are such an opaque subject, very few people realize the kind of fiscal adventure the Petro administration is embarking the country into. Explaining the collective effects shown in Table 1 is going to be extremely difficult, whereas the individual benefits of higher coverage and a more generous stipend in retirement are easy sells.

Even though fiscally costly, it might be hard to argue against what the government is proposing with the solidarity and semi-contributive pillars. The costs of the pension part, namely the contributive pillar and the transition windows, are another animal altogether, as they trump the normative premise that fiscal subsidies should not be focalized on those that are relatively better off.

The government's estimates of the cost of the reform, in NPV (up until 2070) as a percentage of GDP, are substantially different from the ones shown in Table 1. According to a memo released by the Finance Ministry, the reform reduces the size of the pension liability instead of increasing it.

First, the MinFin believes that the solidarity pillar should not be included as a component of the contingent pension liability; they consider it just another subsidy program. That is why, in Table 2, we gray out the solidarity pillar column: there are no government numbers for it in NPV.[5]

Another substantial difference is the cost of the semi-contributive pillar. As opposed to Anif, who expects the NPV cost of this pillar to be 54.3% of GDP, the MinFin expects it to be a highly unlikely, and meager, 3% of GDP.

As a result of excluding the additional cost of the solidarity pillar and coming up with a substantially lower cost for the semi-contributive one, no wonder the MinFin's cost in NPV goes from 67.5% of GDP to 55.2% - once the saving fund (7.1% of GDP in NPV) is included.

Table 2. Expected impacts of the pension reform draft bill – MinFin (in NPV up until 2070, % of GDP)

	Under current legislation		Reform (draft bill presented to Congress)				
			Solidarity pillar	Semi-contributive pillar	Contributive pillar	Saving fund	Total
Revenues	51.4	Revenues		0.0	95.1	7.1	102.2
Expenditures	118.9	Expenditures		3.0	154.5	0.0	157.5
Balance	**-67.5**	**Balance**		**-3.0**	**-59.4**	**7.1**	**-55.2**

Note: the cost of the solidarity pillar is not included because the MinFin argues it is not part of the contingent pension liability. We included an empty "Solidarity pillar" to make this point clear.
Source: Finance Ministry

If the savings fund is excluded, Anif's numbers suggest the cost increase generated by the reform is equal to 139.3% of GDP (from 110% to 249.3% of GDP). Also excluding the saving fund, the MinFin says the cost is reduced by 5.2% of GDP in NPV (from 67.5% to 62.3% of GDP). The differences between both approaches are just abysmal.

[5] However, the MinFin estimates the net increase in the cost of the solidarity pillar at COP 3.8 trillion (0.24% of GDP) per year.

The discussions this difference will generate are a perfect example of how difficult it is to talk about pensions. It is beyond our understanding why the MinFin, as part of the process, did not sit down with interested parties to build a common model to compute the costs of the reform.

Savings fund

One of the big concerns surrounding the reform initiative has to do with the uses of all the money that will switch, in the margin, from private pension funds to Colpensiones. It has become evident that the Finance Ministry, alarmed by the possibility of all these resources becoming just pocket money for the government, potentially calling the fiscal rule into question and compromising the ability of the government to finance its deficit, convinced both the Labor Ministry and President Gustavo Petro to commit to saving part of these flows:

- 0.57% of GDP per year between 2025 and 2030 minus the contributions made in those years.
- 0.8% of GDP per year between 2031 and 2040 minus the contributions made in those years.
- 0.88% of GDP per year between 2041 and 2050 minus the contributions made in those years.
- 0.92% of GDP per year after 2050 minus the contributions made in those years.

However, there is a back door through which the money saved in the fund could be used. Article 24 states that in case the combined cost to the national budget of the semi-contributive and contributive pillars exceeds 1.2% of GDP per year, the excess cost could be financed using money from the fund. This might not happen soon, but for sure we will get there.[6]

The fact that there will be money saved to draw from in the future means that the fiscal contingent liabilities computed in NPV in Table 1 will not have a one-to-one impact on the deficit. However, the assets in which the money will be invested are left to the government to decide later.

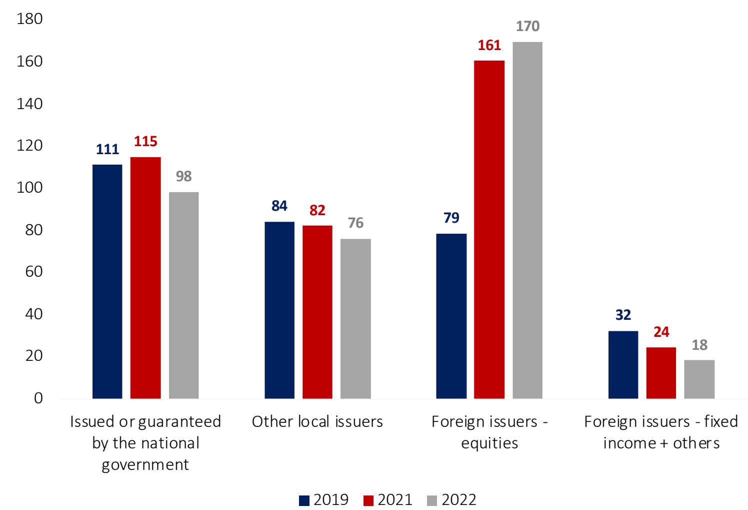
One thing is certain, though. Given the recent change in the composition of private pension fund investments (see Figure 1) and Petro's complaints about private pension funds having too much money invested abroad will result in the savings fund being more focused on local assets, especially TES. We are confident, however, that the Financial Regulatory Unit, the Finance Ministry, and the Financial Superintendency will decide on these matters in the technical way to which we are accustomed.

With the pension reform at last presented to Congress, a difficult and dangerous discussion has started. The danger is, of course, related to its potential impacts on the fiscal and capital markets fronts. Some of these impacts will be felt soon, while others will become material in the distant future. None of the future costs will be borne by Finance

[6] The day the reform was submitted to Congress, different versions of the draft bill circulated. Among the ones we saw, there was one saying nothing about being able to draw from the fund if the 1.2% of GDP threshold was reached. Even though this section of our report analyzes the version actually presented to Congress, that does talk about the 1.2%, the FinMin memo with the estimated cost of the reform includes a footnote that says this 1.2% of GDP provision ended up in the draft bill by mistake. The footnote says the correct version is that the resources saved in the fund will only be used to cover the cost of the new contributive pillar, leaving the semi-contributive pillar out of bounds (i.e. to be financed by the budget), which coincides some of the alternative versions we saw on submission day. We're sorry if this makes things harder to understand, but the government is the one to blame…

Minister José Antonio Ocampo's ministry since they would start in 2025, and others would accrue after the end of the Petro administration; they will be paid by today's unknowing youngsters and their descendants, which will, likely, remain dangerously absent from the discussion. Little did Petro's young voters know that their future would be so compromised.

Figure 1. Private pension funds' investments in 2019, 2021, and 2022 (COP billions)



In the last bar group, "others" includes local and external liquid deposits, deposits at the Central Bank, repos, and financial derivatives.
Source: Superintendencia Financiera, EConcept
Concluding remarks

Increases in coverage in the non-pension chapter of the old-age protection system are positive and welcome, even though they pose a true fiscal challenge right from the start. However, since none of the deep parameters are changed, the subsidies required by the pension chapter rise dramatically. The regressive nature of these subsidies will only become worse as time goes by.

On the pension chapter part, i.e., the part of the system aimed at people in the formal labor market who will eventually receive a pension, what has been presented to Congress is bad. Let us hope Congress wakes up, smells the coffee, and does the same kind of job they are doing with the health and political reforms and, apparently, the labor reform.

One final consideration is in order. The sustainability of old-age retirement systems needs to be looked at from three angles: actuarial, fiscal, and social/political. Focusing too much on one aspect is dangerous for the necessary triad considered as a whole. Unfortunately, the draft bill presented by the Petro administration focuses too much on the social/political angle, which might make political sense if the purpose of the reform is to please public opinion at large in the immediate future but comes at the expense of much-needed efforts on the actuarial and fiscal fronts. Recall Petro's claim: "I would resign before changing the retirement age."

By looking at the social backlash of what happens when you focus too much on the actuarial and the fiscal, namely Macron's France, a more concerted effort is required. The discussions about the Colombian pension reform draft bill should take more than the three months we have until June 20th (when Congress goes into its mid-year break) and should consider the actuarial, fiscal, and social/political triad as a whole.

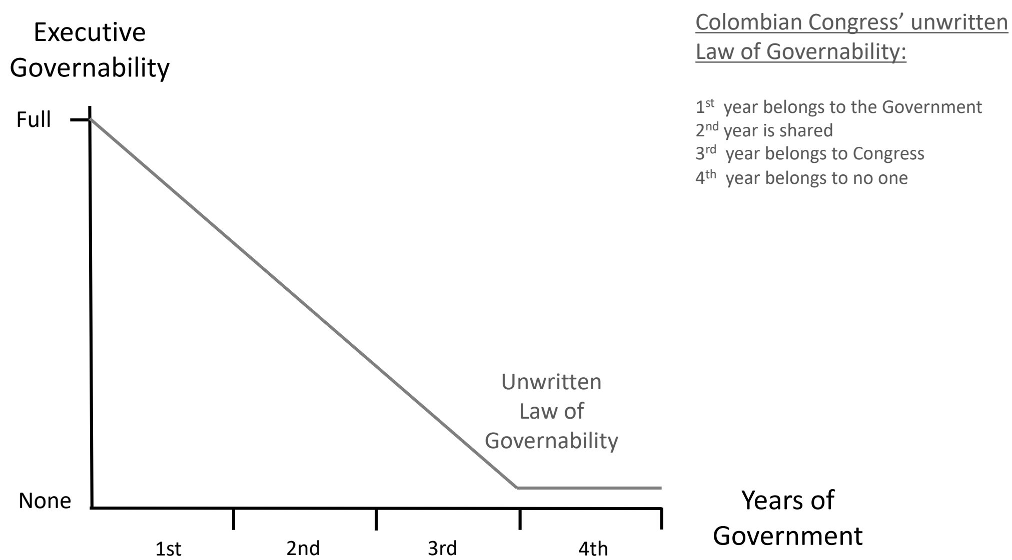
The Unwritten Law of Governability

Typically, at the beginning of a Colombian government congressmen tell the ministers who still don't know it, about the way things are handled vis-à-vis the Government in that solemn bastion of representative democracy, the National Congress. Namely, an iron law that has survived decades, and yet it isn't written on paper.

The law states that the first year belongs to the recently elected government. The second year is shared between Government and Congress. The third year belongs to Congress and the fourth and final year of the administration belongs to no one, since everyone who matters would be campaigning and people would be paying more attention to who the next president will be, rather than to the priorities of the soon-to-be ex-president.

This law can be drawn, in a simplified fashion, as a downward-sloping straight line between the maximum level of governability, attained on inauguration day, on August 7th of the first year, and heading towards almost zero at the end of its 3rd year. Figure 1 depicts such a line.

Figure 1. Who rules the Colombian Congress?



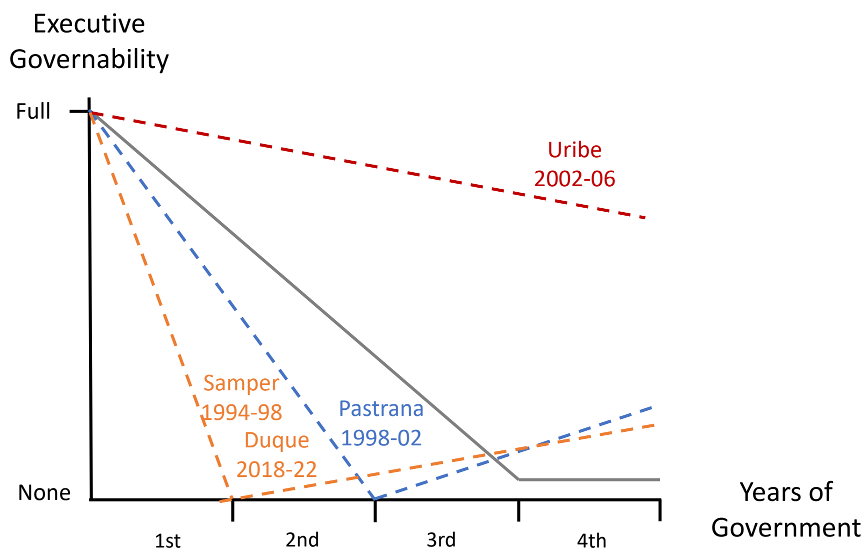
Source: Congress gossip and EConcept.

At least two things derive from this Law: first, the Government is running a race against time. Second, the slope of the gray line of Figure 1 is not fixed; hence it can take any (negative) number. Indeed, Congress has the incentive to make the slope of the gray line steeper; and eventually, yet not frequently, Government can make it flatter through efficacy, popularity across the country, and acceptability among Congressmen.

Recall that in theory, theory and practice coincide, but in practice, they don't. Hence, in Figure 2 we show our assessment of how the theoretical Law depicted in Figure 1 has worked during four administrations. Governability loss was particularly acute during the first year of the Samper and Duque administrations. The former was accused of having received campaign money from narcotraffickers, and the president was subject to a long and painstaking impeachment process. Pork-barrel politics helped to recover some governability thereafter and avoid impeachment.

In the case of Duque, the first year was characterized by a lack of experience in managing Congress, up to the point that the design of key reforms, like taxes, was mainly engineered by Congress and entrepreneurs' confederations.

Figure 2. The Unwritten Law in practice, four administrations



Source: Econcept.

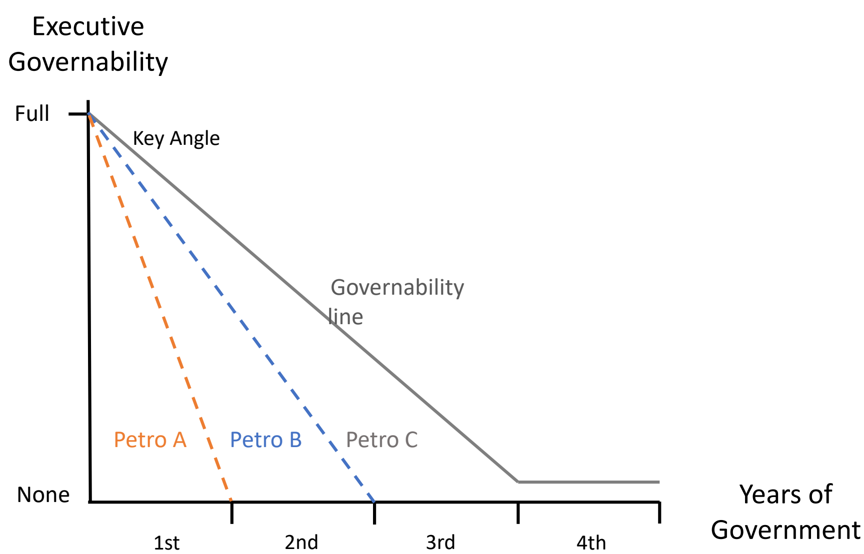
The Pastrana administration witnessed a less drastic governability loss, yet at the end of its second year, it was clear that the president had completely lost the room for maneuver in Congress. The reasons were a faltering peace process with FARC, a flawed negotiation with Congress, and finally the announcement of a referendum aimed at revoking the then Congress and convoking elections to choose a new one. Intelligently, key congressmen responded that they were willing to pass the referendum law, yet they wanted to include two questions, one for revoking the congress' mandate, and another one to revoke the president's mandate. Naturally, Pastrana was forced to backpedal, and his governability went to zero. He then appointed Juan Manuel Santos as Finance Minister and Luis Eduardo Garzon as Labor Minister. They brought renewed governability in Congress and with the labor unions for the remaining of the administration.

Finally, Uribe 2002-2006 shows, in our view, an interesting case in which governability did not decline faster than the gray line, since the government reached the third year with unprecedented momentum up to the point that it decided to change the constitution and allow for a second consecutive term. Of course, this became a dream performance of subsequent presidents. Petro could fancy with it, as former president César Gaviria recently suggested.

Is this graphic depiction useful for understanding the current predicament of Petro? The current negotiation with Congress of healthcare, pension, labor, and almost 20 other reforms can be understood as skillful maneuvering of Congressmen to test and undermine Petro's administration's governability, yielding a steeper slope, and weakening the government, forcing it to water down its reforms and to pay higher prices in terms of horse-trading and pork-barrel (mermelada, in local jargon), moving the Petro C scenario in Figure 3 to harsher ones, like Petro B or A.

The skill of Interior Minister Prada and the rest of the cabinet was key to determining the result. The key issue here is that Congress is strenuously working towards increasing its power and determining what to approve, how to approve it, and how much it costs to the government. They know their game and delays, obstacles, endless discussions, and lukewarm commitment are the tactics.

Figure 3. Scenarios of Petro governability



Source: Econcept.

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However, congressmen know that they need the government's budget resources to supply their regions with public works and sources of employment. They know that the Petro administration commands substantial liquidity from the excess 2022 tax collection, as well as two tax reforms yielding revenue in 2023 and 2024. They have to strike a balance between what they can get from the government and how they can weaken its bargaining power. It is an interesting game called politics. What is the optimal angle of decline is to be decided by events unfolding between now and the end of June.

However, on the night of April 25, Petro said enough is enough, He probably got mad at the seemingly likely collapse of its healthcare reform, like the one suffered by its political reform one month earlier. Under these circumstances, the coalition has ceased to work, and the natural response is a cabinet reshuffle in order to purge the disobedient parties.

In sum, this "behavioral model" indicates that Congress is not simply obedient and happy with any president. Congress is constantly negotiating in its favor and testing the executive's governability.

Who is the bull, and who is the matador?

The healthcare reform was approved in the first debate of four by the seventh committee of the House of Representatives. It is a disconcerting result for most of the political and technical observers of Congress. Recall that key political parties, like the Liberal, Conservative, and the U, expressed deep objections, and declared they would not support the initiative. After that impasse, President Gustavo Petro engineered a cabinet reshuffling and appointed new ministers of the interior, finance, and healthcare. Apparently, that did the trick.

So, the question remains. Was it a problem of people rather than principles? The only thing necessary to get the bill through was to replace the ideologically radical healthcare minister Carolina Corcho with a negotiator, such as current minister Jaramillo, willing to find common ground? Something similar occurred with Interior Minister Luis Fernando Velasco. He is a key dissident figure of the Liberal party, promoting a type of coup against party president Gaviria. Hence, Velasco and Jaramillo have been effective in luring away enough House representatives. End of story?

There might be another interpretation, though. Rumor has it that the government is deeply engaged in horse trading and pork-barrel politics, and is using the capote (in bullfighting, the red cloth that incites the bull to attack) of appointments, regional projects, and budget to reward supporters of its reforms, and to lure them into the government's fold. If that were the case, we would be witnessing a 'faena' (the face-to-face between the bull and the matador) in which at the end of the day Congress would pay dearly for the skills of the president-matador.

Or could it be the other way around? Namely, did Congress decide that the government is like a bull, and is willing to attack and attack under the sun, doing anything the matador asks from him, to get its reforms approved? At the end of the day, members of Congress know that, as was the case in the fifth debate of the political reform, some of those initiatives will sink, either in the plenaries or in the Constitutional Court; however, in the meantime, they would have benefitted from the largesse of pork barrel.

Then, the question remains: which is the matador, and which is the bull? We don't know. We think that both, government, and Congress, believe they are the matador and that the other one is the bull.

This is a long game that does not end with congressional approval since there seem to be serious flaws in the procedure. For instance: 1) not having consolidated several healthcare reforms proposals that have been presented; 2) presenting the bill as an ordinary one, to the seventh committee, instead of a "statutory" one (since healthcare is a "fundamental right") that should have been presented in the first constitutional committee; 3) the government has been contradictory regarding the fiscal impact of this reform, with the healthcare minister saying it is close to financially neutral and an official document of the Finance Ministry saying it could cost 0.5% of GDP permanently; 4) the bill considers giving Petro transitory powers to further reform the healthcare system, without going through Congress again, yet its approval required qualified majority, something that did not occur in the voting. Constitutional lawyers have warned that this bill, if it turns into an Act, could be suspended by the Constitutional Court even before its enacted.

Leaning against the wind

Enel, the Italian multinational, announced its decision to indefinitely suspend the Windpeshi wind project in the northern departamento of La Guajira due to insurmountable difficulties to reach a "constant construction pace due to constant road and community related blockades that prevented progressing on the planned works schedule. Only between 2021 and 2022, the works were stopped for about 50% of the working days and so far in 2023, the figure rises to 60%."

"Gone With the Wind" is the title of an op-ed piece by Nelson Amaya, a Guajiro and former deputy development minister, about the events leading to the Enel suspension, and eventually to similar problems for neighboring wind projects undertaken by EPM, Isagen and AES.

At different times throughout its history, La Guajira has lived on salt, contraband, marijuana, gas, and coal. Its people live in precarious conditions, deprived of water, in a deserted and unproductive land. Now there is the possibility to add wind to the sources of economic activity there. However, local skepticism is widespread since those mega-projects may benefit the country at large but not the communities surrounding them. So far, the new wind generation projects seem to be in a stalemate. Even the energy transmission line that will connect these wind projects to the national grid, whose construction is led by Enlaza of Grupo de Energía de Bogotá, has faced its share of challenges, including negotiations with 235 communities spread out over 400 km.

The recently approved National Development Plan stipulates that local communities should receive 6% of the gross income generated by wind projects. Such a royalty could prove to be excessive (it was originally proposed at 1%). Time and again the Petro administration has been unable to make up its mind about whether to support companies and investors or legitimize communities, or both. Such indecisiveness and ineffectiveness surely led to the Enel decision.

Apparently, Colombia, and the world at large, are approaching a serious El Niño phenomenon, which reduces rainfall and stresses the sources of hydroelectric power generation. That is a recurrent phenomenon that requires new sources of power generation. On top of that, Hidroituango, the mega hydropower project built in Antioquia is still far from ready. If the Enel decision were to be followed by the other neighboring wind projects, the energy transition agenda would suffer a huge blow, and with it one of the crucial pillars of the Petro administration.

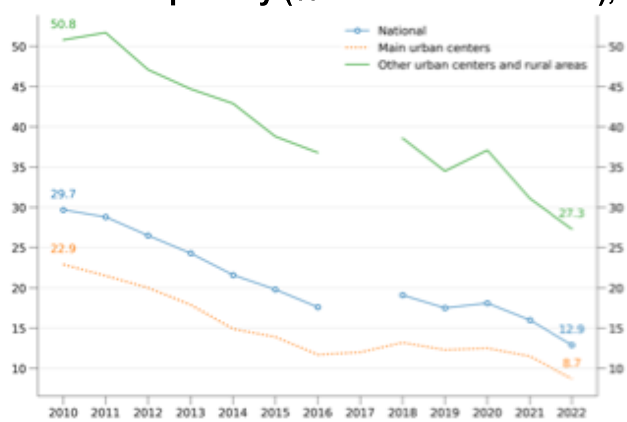
Poverty reduction is a success: though there's more to do

The latest data on multidimensional poverty was published by the national statistics agency, DANE. The survey is thorough, covering 88,300 homes and 252,000 people. Dane director Piedad Urdinola said that 6.6 million people live in poor quality of life conditions. The MPI identifies whether the level of well-being is adequate in terms of health, education, work, childhood and youth, and housing conditions. The most serious problems are not in public services or health but in informality, low educational achievement, and lagging in school-related skills. In other words, the keys are to act on Colombia's productive capacity and the labor market.

It is important to highlight what has happened not only in the last three or four years but also in the last 12 years. In 2010, Colombia had 45 million people, 30% of whom lived in multi-dimensional poverty (Figure 1); that is, 13.3 million people. That means that in 12 years has cut it in half. These are remarkable results. In other words, Petro's criticisms that the Colombian economic system does not work for the poor are proven to be false, based upon the evidence of the last 25 years. But there are still no reasons to celebrate, because let's repeat it, there are still 6.6 million Colombians in a situation of poverty. There is a lot of homework to do.

What doesn't work in Colombia are education, and the ability to create companies that create formal jobs. This is the dramatic economic reality of the Caribbean and Pacific coasts. That is where the focus of the government should be, more than on healthcare and pension reforms.

Figure 1. Households in multidimensional poverty (% of total households), 2010-2022



Source: Dane, EConcept

Growth surprised on the upside, but downturn looms

Earlier this year, as Dane released data on its Economic Tracking Indicator (ISE in Spanish) for January and February, it became clear that GDP growth for Q1 2023 could exceed initial expectations. Finally, when the GDP gauge was released, it came indeed as a positive surprise for most, relative to the prevailing expectations on January 1st. While this is good news for everyone, a closer look at Q1's results provides, in our opinion, shreds of evidence that isolated surprises do not warrant a change in the overall outlook of what lies ahead in terms of growth.

GDP annual growth at 3% was accompanied by 2.9% in value-added; taxes (net of subsidies) grew by 4.4%. Looking behind the value-added "veil" reveals a very heterogenous picture for Q1, as Table 1 shows. Construction (5.2% of value added) was the only sector in negative territory, posting a negative 3.1% growth rate.

The other economic sectors registered positive growth but with stark differences. "Financial and insurance activities" (5.1% of value added) grew almost 23% and "Artistic activities, entertainment and recreation" (4.3% of value added) came in at around 19%. Excluding these latter two and construction, the remaining sectors (85.4% of GDP) grew a mere 1.4%.

The last column in Table 1 shows that combined, "financial and insurance activities" and "artistic activities, entertainment, and recreation" explained two-thirds of value-added growth in Q1, even though they represent less than 10% of value-added. The "remaining sectors" contributed to value-added growth as much as "Financial and insurance activities", even though the former is 17 times larger than the latter. Talk about heterogeneity…

The main driver behind 22.8% growth in "financial and insurance activities" was, as Table 1 shows, the "insurance" subsector, which grew almost 80%; the remaining subsectors' growth did not exceed 10% in any case. No possible breakdown in the "artistic activities, entertainment and recreation" (which, remember, grew 18.7% in Q1) is available, so no extra conclusions can be drawn there.

Table 1. A view of Q1-2023 growth (%)

	Q1-23 v. Q1-22 (growth, %)	Share of Value Added in Q1-2022	Contribution to value added (pp)
Financial and insurance activities	22.8	5.1	1.2
Financial intermediation services	*7.0*		
Commissions	*8.3*		
Auxiliaries	*0.2*		
Insurance	*79.5*		
Artistic activities, entertainment and recreation	18.7	4.3	0.8
Construction	-3.1	5.2	-0.2
Remaining sectors	1.4	85.4	1.2
Value added	**2.9**	**100.0**	**2.9**
GDP	**3.0**		

Source: Dane, EConcept

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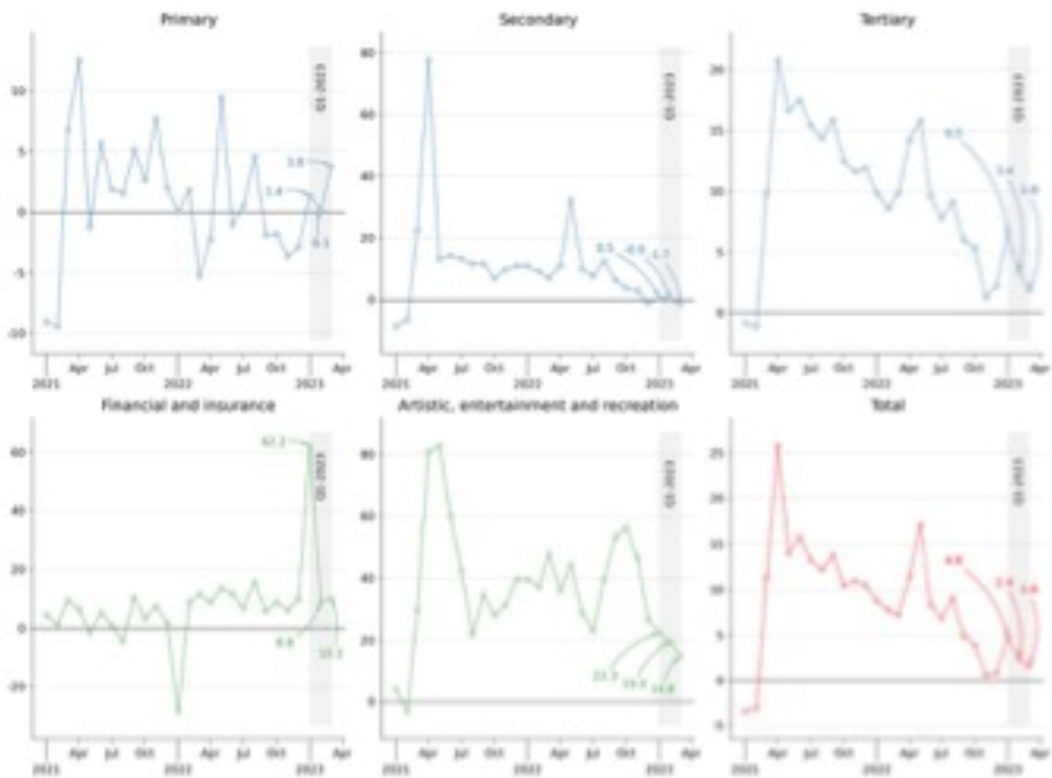
Beyond heterogeneity across sectors, the second important relevant fact about Q1 growth is that deceleration along the quarter, as Figure 2 shows using ISE data. The 3% number for the quarter resulted from 4.8% growth in January, followed by 2.4% in February and, finally 1.6% in March (see the lower right panel in Figure 2). While “Primary” activities (10% of GDP) closed edging upwards in terms of growth (3.8% in March, up from 1.4% in January and 0.1% in February), the deceleration in “secondary” and “tertiary” activities (with a combined 90% GDP share) clearly lost momentum during the quarter (see the top panel in Figure 2). “Secondary” activities even registered negative growth in March.

Figure 2. Economic Tracking Indicator growth (%) - selected sectors



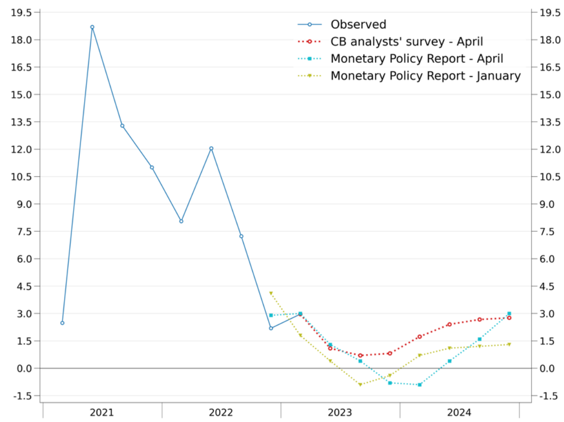
Source: Dane, EConcept

Looking at the growth champions in Q1 (“financial and insurance activities” and “artistic, entertainment and recreation”), but using ISE data, a couple of issues become evident. First, the extraordinary growth in “Financial and insurance activities” was due to something that happened in January. Second, the activities under “artistic, entertainment and recreation” did not escape the deceleration trend, even though with still high numbers in March.

So, in sum, even though the outlook for Q1 growth improved somewhat as the quarter progressed, the overall deterioration in economic momentum remains an inescapable truth. This is clear in expectations about future growth among economic analysts and the Central Bank, as Figure 3 shows.

In the case of economic analysts, surveyed by the Central Bank in the first week of May, deceleration is expected to last until Q3 of this year, followed by a recovery that will nevertheless remain below 3% even at the end of 2024. In the case of Central Bank forecasts, contained in the quarterly Monetary Policy Reports published in January and April, expectations of continued deceleration are qualitatively similar. However, comparing the January and April forecasts, the latter points to deceleration continuing into even Q1 of next year and then recovering to 3% at the end of 2024. Reaching growth rates above potential seems to be far away into the future.

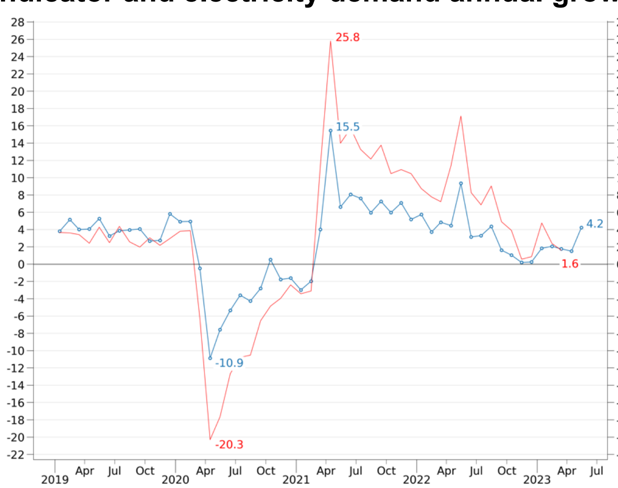
Figure 3. Quarterly GDP annual growth (%) outlook - 2023 and 2024



Source: Central Bank, EConcept

However, in the middle of this “un-rosy” picture, a caveat is warranted. Even though it might be a blip in the overall trend described above, electricity demand growth, which remained tepid in April, jumped in May to 4.2%, with data as of the 23rd of the month. As electricity demand remains an excellent leading indicator of economic activity, we all should keep an eye on what is going on this month in terms of economic activity.

Figure 4. Economic Tracking Indicator and electricity demand annual growth (%)



Source: Dane, XM, Econcept; ISE data as of March, electricity demand data as of May 23rd

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Oil and gas reserves: just seven years

Back in December, the Mining and Energy Ministry released a widely criticized assessment about the size of Colombia's gas reserves, to support the inclination of this administration to avoid signing new exploration contracts for fossil fuels. Despite all the objections to this assessment made by experts, Minister Irene Vélez stood by it, and said that Colombia had gas reserves that, provided the right policy decisions were made, could last until 2037 (15 years) and even to 2042. Leaving aside the technical objections that can be made to that December 2022 report, the fact is that Minister Vélez did not stand by the long-lasting tradition of waiting until May of each year for the National Hydrocarbons Agency (ANH) to release the official estimate of the country's oil and gas reserves.

May has finally arrived, and ANH just released its traditional official estimate. Comparing the proven reserves (1P) with last year's annual production, Colombia has 7.5 years' worth of oil production and 7.2 years for gas. This means 2030, not 2037 or 2042.

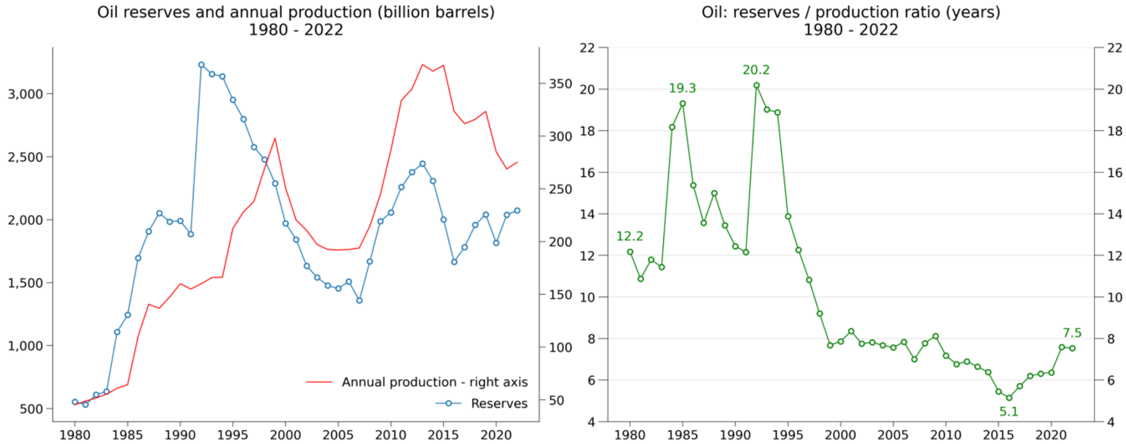
Figure 5 shows the evolution of oil reserves and production since 1980. During the 1980s Colombia added reserves at a faster pace than production, thanks to the discovery of the Caño Limón, Cusiana and Cupiagua oil fields. As a result, the ratio between 1P reserves and production (R/P) rose slightly above 20 years in 1992. Since then, increased production outpaced reserves additions and the R/P ratio fell all the way to 5.1 years in 2016. Recall that reserves are affected by whether it is economic to extract those hydrocarbons; hence, a sharp decline in prices, as the one experienced in 2014-2015 impacted their level in 2016.

During the past six years, production suffered, and reserves have risen, mainly due to a reevaluation of existing 1P reserves, based on enhanced recovery from legacy fields rather than new discoveries, driving the R/P ratio up until it reached 7.6 years in 2021. The report just released by ANH announced that the R/P declined mildly to 7.5 years in 2022.

Figure 6 shows the evolution of gas reserves and production for the 2007-2022 period. The story in this case is similar to that of oil in 2011-2016: added annual reserves declined at a faster pace than production, taking the R/P for gas from almost 14 years in 2011 to almost 11 years in 2016. After 2016 gas and oil go their separate ways: the R/P for oil edged up while the R/P for gas continued to decline. The ANH report just published shows that this continued to be the case in 2022 as the R/P ratio for gas went down from 8 to 7.2 years, the lowest for this century.

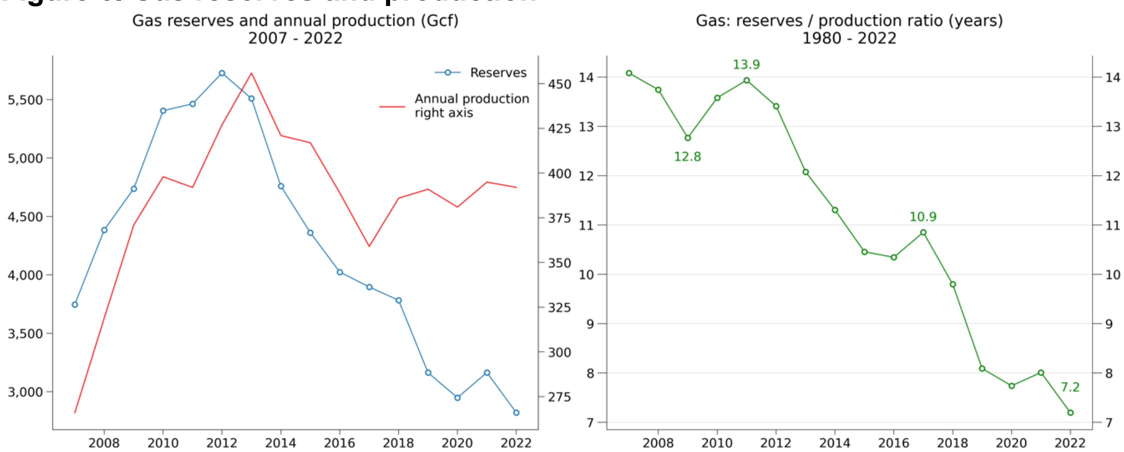
The press release with the 2022 numbers includes comments both by the Mining and Energy and the Finance ministers. Vélez insisted on the need to make existing contracts more efficient and continued work to make offshore projects a reality; in other words, no appetite for new onshore exploration contracts.

Figure 5. Oil reserves and production



Source: ANH, EConcept

Figure 6. Gas reserves and production



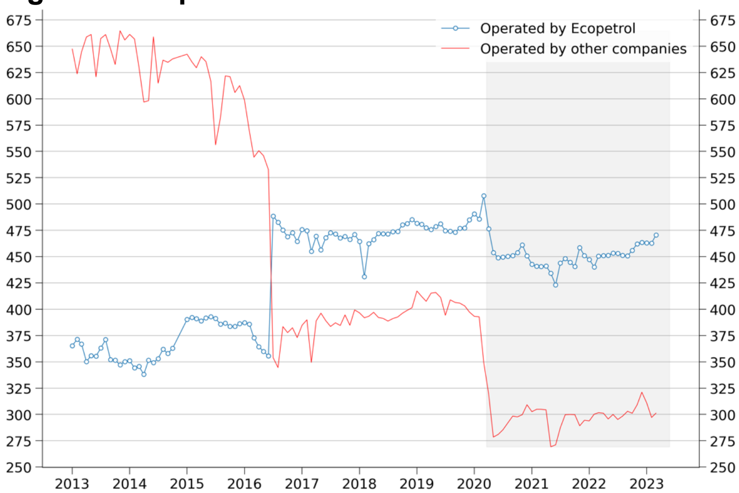
Source: Central Bank, EConcept

Bonilla said the MinFin takes these ANH numbers as key inputs for their projections to be included, among other things, in the upcoming Medium-Term Fiscal Framework. He also mentioned that the government's energy transition strategy does not seek to end oil production but to diversify the country's export basket. Not quite clear on whether he supports the signing of new exploration contracts or not. It seems the ongoing discussion within the government is still a heated one.

Finally, we'll make a brief reference to oil production in 2023. According to audited information released by ANH, oil production reached 774 kbpd in January; in February it fell to 760 kbpd, while in March it rebounded to 772 kbpd. Non-audited ANH preliminary data points to production around 785 kbpd.

This is, of course, good news for exports and fiscal revenues, as most of the recent increase in audited oil production has taken place in oil fields operated by Ecopetrol, as Figure 7 shows. On the other hand, higher production reduces the R/P ratio, which remains in non-reassuring levels for macro, fiscal and regional stability.

Figure 7. Oil production as of March 2023



Source: ANH audited production, EConcept