

Will Peace Implementation Result in a Downgrade for Colombia?

- **Although in the short-run peace implementation may be rating-negative, we do not think Colombia will lose its investment grade.**

On November 24th, 2016, the Colombian government signed a controversial peace agreement with the Revolutionary Armed Forces of Colombia (FARC for its acronym in Spanish). From that moment on, high expectations were established in terms of the benefits it would bring to the country in areas like security, development, growth and, eventually, fiscal sustainability. Today, just over two years from the signing and with the conviction that peace will always be a desirable end, it is important to measure the real impact it has had on the economy and markets development.

One of the key points of discussion is related to the impact on public finances of additional expenses arising from the peace agreement and whether those expenses jeopardize compliance with the plan established in the fiscal rule to reach a budget deficit of 1% of GDP in 2027. This is a problem that is divided into the current military spending and the additional projected expenditure that would ensure peacekeeping.

First of all, as can be seen in figure 1, Colombia is characterized as a country with recurrent and high military spending. On average, in the last 20 years 3.35% of GDP has been allocated annually in this area (around US\$10 billion every year). Several experts have pointed out that this expense should not be reduced in the next 10 years for three fundamental reasons:

1. The State must be present in the regions previously occupied by the FARC to prevent them from being reoccupied by outlaw groups.
2. Military pressure must be maintained against dissidents of the FARC, the ELN and common crime itself.
3. The fight against drug trafficking remains central. In 2017 the cultivated land dedicated to coca crops for cocaine reached 170,000 hectares, the highest level in the last 18 years.

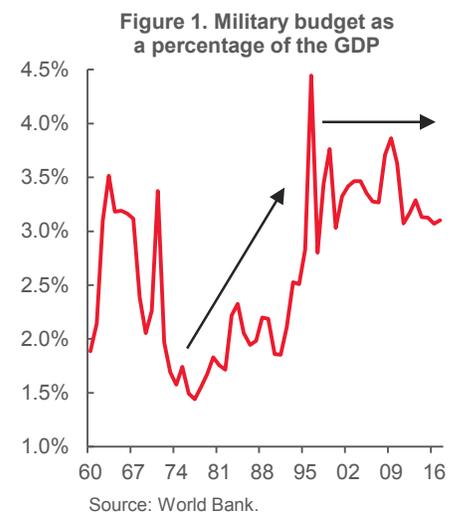
Added to this existing situation is the emergence of new financial needs focused on the sustainability of peace, such as: the implementation of land reform in the rural areas, creating a transitional legal framework, the compensation of ex-combatants, and reparation for the victims of the conflict. Estimates suggest that these costs would get to US\$42 billion that would be used in the next 15 years and that would increase the nation's fiscal burden by about 0.9% of GDP annually.

Some economists in Colombia have proposed a modification to the original fiscal rule so that it reflects the reality of a new country in a post-conflict period. For the time being, these suggestions have not been acted upon and, as a consequence, fiscal sustainability and the reduction of the country's debt have become the central point of market analysis.

CONTACTS

Sergio Olarte, Senior Economist
 57.1.745.6300 (Colombia)
 Scotiabank Colombia
sergio.olarte@co.scotiabank.com

Juan E. Barco Echeverri, Wealth Management Economist
 57.1.745.6300 (Colombia)
 Scotiabank Colombia
juan.barco@co.scotiabank.com

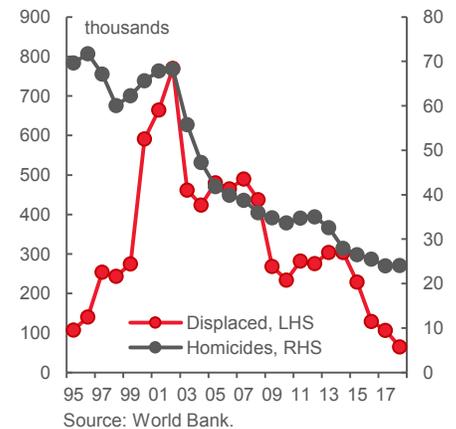


Although in the foreseeable future peace implementation represents high fiscal costs and social challenges due to the incremental increase in common crime—especially in cities—perception of Colombia has improved. In fact tourism from abroad has improved indicating a recognition of higher security. Tourism GDP services has grown 1% higher than total GDP for the last five years and foreign direct investment (FDI) for this sector more than tripled since the peace process started, according to balance of payments statistics. This foreign trust in Colombia coincides with a more than 70 % reduction in kidnappings, 25% fewer homicides, and a 78% reduction in those displaced by conflict (figure 2).

Off course, conflict reduction is not the only factor that brought off-shore FDI to Colombia. Strong financial institutions, pro-market economic policy and recent COP depreciation helped tourism in recent years. Having said that, improved perception of domestic security definitely is key for increased foreign and domestic tourism and for companies to decide to choose Colombia as an investment destination. In the longer-run perspective, this post-conflict process will help potential GDP. While that happens, fiscal authorities will need to measure and prioritize military expenses and post-conflict costs that could raise concerns with regard to fiscal sustainability and, potentially, a reduction of at least one notch to BBB- but still investment grade.

In conclusion, despite recent concerns about the post-conflict process in Colombia, we think that in the end this is part of the process and will be positive for the long-run growth. In fact FDI has remained the main current account deficit source of financing, and tourism from abroad has increased significantly indicating confidence in Colombia. Having said that, for the near future, fiscal challenges are high since small outlaw groups continue committing crimes and drug dealing business has increased, and therefore military expenditure in the short run cannot be cut, while ex guerrillas re-incorporation to civil life and a costly land reform program put a lot of pressure on fiscal accounts. We think that due to higher required fiscal expenditure, post-conflict costs put in jeopardy fiscal rule compliance which could result in an international rating agencies downgrade (Moody's and FITCH).

Figure 2. Homicides for every one hundred thousand inhabitants and displaced by violence



FDI in Tourism & Commerce



This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.