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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.**

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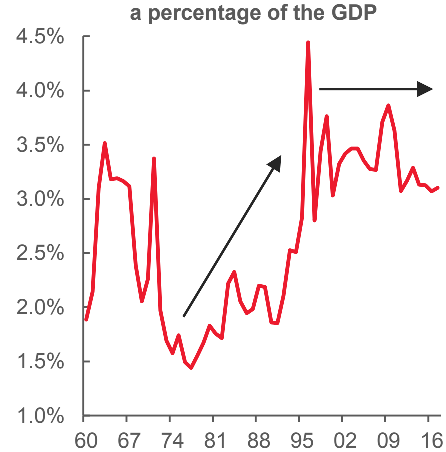
On November 24th, 2016, the Colombian government signed a controversial peace agreement with the Revolutionary Armed Forces of Colombia (FARC for its acronym in Spanish). From that moment on, high expectations were established in terms of the benefits it would bring to the country in areas like security, 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.

Figure 1. Military budget as a percentage of the GDP



Source: World Bank.

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.

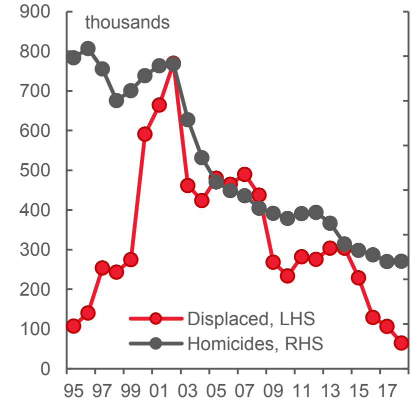
Some economists in Colombia have proposed a modification to the original fiscal rule so that it reflects the reality of a new country in a post-conflict period. For the time being, these suggestions have not been acted upon and, as a consequence, fiscal sustainability and the reduction of the country's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

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



Source: World Bank.

FDI in Tourism & Commerce

Sources: BanRep, Scotiabank Economics.