COLOMBIAN POLITICAL RISK: A CASE STUDY

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WHY STUDY POLITICAL RISK IN COLOMBIA?

• COUNTRIES LIKE COLOMBIA ARE CAPITAL POOR
• HIGH POLITICAL RISK CAN BE A BARRIER TO NEEDED FOREIGN DIRECT INVESTMENT (FDI)
• HIGH POLITICAL RISK CAN LEAD TO HIGHER COST OF CAPITAL, LOWER GDP GROWTH
• POLITICAL RISK MEASURES HAVE LIMITATIONS
COLOMBIA FDI / OIL PRICES

FOREIGN DIRECT INVESTMENT: 2015-2018

OIL PRICE: 2/14/2018

MAIN OBJECTIVES

• PROVIDE A PRIMER ON COLOMBIA AS A COUNTRY INCLUDING DOUGLAS NORTH’S TAXONOMY
• EXAMINE AND EVALUATE THE POLITICAL RISK CONCEPT AND APPLY IT TO COLOMBIA (A CASE STUDY)
• REVIEW PUBLISHED STUDIES AND STATISTICS
• FORM SOME CONCLUSIONS AND RECOMMENDATIONS FOR FURTHER RESEARCH
2nd LARGEST IN SOUTH AMERICA

VITALS CAN BE FOUND IN:

BACKGROUND TO POLITICAL RISK
BACKGROUND TO POLITICAL RISK

• Colombia broadly fits Douglas North’s “Limited Access Orders” country taxonomy (North, et al., 2009)
  – Elite control of the political and economic systems
  – Limited violence;
  – Lack of competition and innovation; and,
  – Stunted economic growth
• However,
  • Colombian elites failed to control economy
  • Violence has continually erupted further stunting economic growth
• Colombia path’s to “open access orders, "the second stage, composed of advanced market economies, seems distant at best.

• Acemoglu, Daron and
BACKGROUND TO POLITICAL RISK II

- Is a middle ($14,000 per capita) income country*
- It’s highly urbanized
- Has huge disparities in wealth and income but has reduced poverty levels according to World Bank
- Has a growing middle class
- Is being considered for Membership in OECD
- Undertook Plan Colombia and signed a peace agreement with the Revolutionary Armed Forces of Colombia, or FARC
- Borders on the world’s largest river, the Amazon

- Illegal crops remain important
- Highly dependent on oil exports
- “Banana Republic” syndrome
- Huge “Informal” Economy

BACKGROUND TO POLITICAL RISK III

OUTSIZED ACTORS INVOLVED

PEACE ACCORD’S MAJOR AIMS

ACCORD’S IMPLEMENTATION WILL INVOLVE GOVERNMENT PROGRAMS OF GIGANTIC PROPORTIONS, ALBEIT WITH SOME INTERNATIONAL ASSISTANCE

MANY PLUSSSES

SOME NEGATIVES; PUSHBACKS

Colombian President (left); Raul Castro (center); Guerrilla leader (right)
MEASURES OF RISK: EQUITY RISK PREMIUM; CREDIT DEFAULT SWAP RATES; BONDS TERM PREMIA; OTHER
POLITICAL RISK AS MEASURED BY EQUITY RISK PREMIUM

• Colombian country risk premium over time is rising.

Equity Risk Premium is the difference between the expected return on a market portfolio and the risk-free rate. Market Risk Premium – Investopedia.

CREDIT DEFAULT SWAPS: DEFINITION, TYPES

Contracts where one party to the contract pays a small periodic premium to the other, in return for protection against a credit event (financial difficulty) of a known reference entity (company, or country).


• TYPES OF CREDIT DEFAULT SWAPS:
  • SENIOR, THE MOST SECURED;
  • JUNIOR SUBORDINATED, THE LEAST SECURE
Series of credit default swap rates for Colombia over time Republic of Colombia 1 Year Senior Credit Default Swaps

Found in Bloomberg website.
Credit Default Swap (CDS) of Colombian Bonds After Peace Treaty

• Findings of rigorous study (Castañeda, Andrés & Juan F. Vargas, 2012) on the effect of Peace Treaty suggest that:
  – In general, the impact of conflict on the foreign perception of sovereign risk is sizable but rather idiosyncratic
CDS PRICE (CREDIT DEFAULT): COLOMBIA VS. ARGENTINA, (Sep. ‘17-Feb. ’18)

COLOMBIA: LESS VARIATION, LOWER PEAKS

ARGENTINA: OVER 2X THE RISK

https://www.assetmacro.com/colombia/credit-default-swaps-cds/columbia-cds/  Sourced April 18, 2018
L.A. Bonds Term Premia

• Study (Espinosa-Torres, Juan Andrés, et al., 2016) on the effect of shocks of the United States government bonds term premium on Latin American government bonds term premia found:
  • Latin American countries’ term premia respond permanently to changes in United States term premium.
  • However, responses are:
    – Larger for Brazil and Colombia
    – Mexico exhibited the lowest response for the four economies in study
COLOMBIA’S POLITICAL RISK:
FAVORABLE TRENDS

• Risk has been trending lower; Colombia CDS are considerably cheaper than those for countries like Argentina

• Sound macroeconomic policies are being followed
• Country negotiated (2016) peace with major, 50-yr old guerrila group
• The Economist, among other publications, gives economy high marks
• Likely Presidential contender (center right) favored to win
COLOMBIA’S POLITICAL RISK: UNFAVORABLE TRENDS, UNCERTAINTY

• IDIOSYNCRATIC EVENTS CAN HAVE SIGNIFICANT EFFECTS (BANCO DE LA REPUBLICA STUDY)
• GARGANTUAN TASK OF IMPLEMENTING PEACE AGREEMENT NOT MADE EASIER BY POLITICAL BICKERING; HEATED PRESIDENTIAL CAMPAIGN RHETORIC
• LARGE FOLLOWING FOR EX-GUERRILLA PRESIDENTIAL CONTENDER (PETRO)
• WEAK OIL PRICES AND REVENUES INCREASING DEFICITS AND TOTAL BORROWING;
• LITTLE PROGRESS IN NEEDED TAX REFORM
• MONETARY POLICY CHALLENGES
• RISING UNEMPLOYMENT; CRIMINAL GANGS; CONTINUED DRUG TRAFFICKING
• UNPREDICTABLE US TRADE POLICIES

TWO MAJOR PRESIDENTIAL CONTENDERS: PRIETO (LEFTIST); DUQUE (RIGHT WING)
PRELIMINARY CONCLUSIONS

CONTINUING DRAGS
SOCIO-POLITICAL BARRIERS
• Slow advancement in reforms will result in slow growth; sustained violence
• Return to political strife and violence is possible
REGIONAL/INTERNATIONAL SHOCKS POSSIBLE
• US Administration trade repeal
• World crises
• Over dependence on commodities

MEDIUM TERM VIABILITY
• Economic fundamentals will be maintained
• Government scope and effectiveness should grow
• Slow integration of combatants should continue
• OECD ascension; Growing international confidence; Improvement in Political Risk assessment?
• Novel social science tools and policies for violence reduction
Trump and Colombia?

- COLOMBIA’S POLITICAL RISK DEPENDS HEAVILY ON US FAVORABLE OR UNFAVORABLE STANDS
- COLOMBIA’S DRUG EXPORTS ARE A THORN ON HIS SIDE (Of course, the consumers are here!)
- FAVORABLE POLICIES TOWARDS COLOMBIA UNLIKELY

(TRUMP’S INTEREST IN COLOMBIA SEEMS TO HAVE BEEN IN PURCHASING A SOCCER TEAM (2016)!)
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Any errors and maybe unpopular statements that remain are solely my responsibility.

Alex.

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SELECTED SOURCES


