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TRADE POLICY IN COLOMBIA

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INTRODUCTION

In order to understand and evaluate Colombia's current trade policy, one must first understand the most significant economic reforms in the nation's recent history. These reforms took place in the early 1990s and went well beyond trade policies, shaping much of today's economic and political views in Colombia.

Until the 1980s, and like most of Latin America, Colombia remained an inward looking economy. By international standards tariffs were extremely high, with average rates of 36.8% between 1984 and 1989. At the time other non tariff barriers were also widely used contributing to high protection levels that characterized the Colombian economy. In 1989, during its last year in power, the Barco administration very timidly began to relax both tariff and non tariff barriers. However, the liberalization plan was a modest one that was never fully implemented.

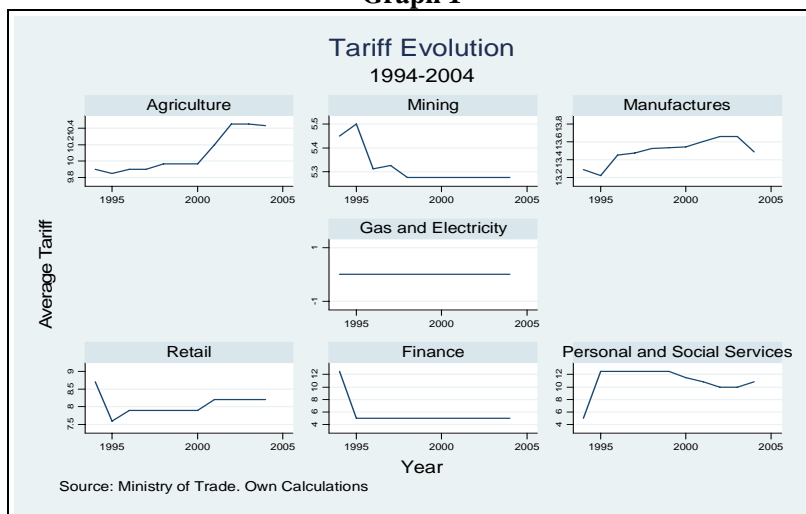
In August of 1990 the liberal Gaviria administration came into power. The new administration's ideas strongly matched those of international multilateral organizations such as the International Monetary Fund and the World Bank. This ideological emphasis on economic liberalization was well-conceived to give the necessary push to the long-awaited structural reform program in Colombia. The overall reform package went well beyond economic reforms. For example, in 1991 a new constitution replaced the one adopted in 1886. Among the economic reforms were a labor reform, fiscal reforms and, of course, a trade reform. The latter also included adoption of policy mechanisms to promote foreign direct investment (FDI) in Colombia.

The trade liberalization program was one of the more radical initiatives of the entire reform package. Originally it was designed to be implemented during Gaviria's administration, with gradual tariff reductions between 1991 and 1994. The incremental bias of the program was critical as it would allow local firms to adjust to foreign competition. However, as the first year of the administration ended, things were not going as planned. While aggregate levels of imports had increased, their composition was not the expected one. Instead of capital goods the market was flooded with consumer goods. Exports, on the contrary, stagnated. The official explanation of this puzzling phenomenon was that entrepreneurs were strategically postponing their investment decisions in anticipation of the tariffs to be set at the lowest expected levels. Therefore, in the last quarter of 1992, tariffs were reduced to the 1994 expected levels. As a result, the average nominal tariff dropped in 1992 to just above 12%.

TARIFFS

Tariffs are by far the most commonly used trade policy instrument. Over the past ten years, the entire tariff structure in Colombia has remained relatively constant. Graph 1 shows the evolution of tariffs over the past 10 years in the different sectors of the Colombian economy. Tariffs on goods and services in the key sectors, both for political and economic reasons, are higher than average. In 2004, for example, the average nominal tariff for agricultural and manufacturing sectors was on average 10.4% and 13.5%. The contrast is clear with the financial, retail or mining sectors that respectively have an average nominal tariff of 5, 8.2 and 5.3 percent. Noting the scale, the graph also shows that changes over the past decade have been very small.

Graph 1



TRADE BALANCE

Graph 2 shows Colombia's exports and imports as the share of gross domestic product (GDP) for the 1991-2004 period. The results support the facts presented above. During the early nineties, exports as percentage of GDP actually dropped despite the strong reforms implemented at the time. On the contrary, imports grew in a relatively constant fashion, except for the years 1999-2001, a time of significant economic crisis. During the past few years, as the economy recovered from the crisis, trade has been gaining importance in the Colombian economy; particularly important has been the increase in exports as a percentage of GDP.

Graph 2



Graph 3 shows the evolution of exports and imports in Colombia since 1991. As with Graph 2, this graph clearly illustrates the overall behavior of the economy during the early nineties. Imports rose steadily while exports did not. This trend was further

strengthened by the appreciation of the real exchange rate, thus making imports relatively cheaper and exports relatively more expensive. This situation has been replicated again over the past few years. In fact, in 2003, for the first time in recent history, the nominal exchange rate appreciated.¹ The effects on trade, however, could only be partially predicted by the economic theory. While imports, pressed by the stronger Colombian peso, increased as predicted, exports also increased. In fact exports increased by almost 26% between 2003 and 2004, by far the largest increment in the last ten years. Such behavior can be plausibly explained by the strong increase in the international commodity prices, particularly oil and coal. However, other important export products, such as agricultural goods, steel and iron and even apparel grew 27, 25 and 57 percent in dollar terms respectively.

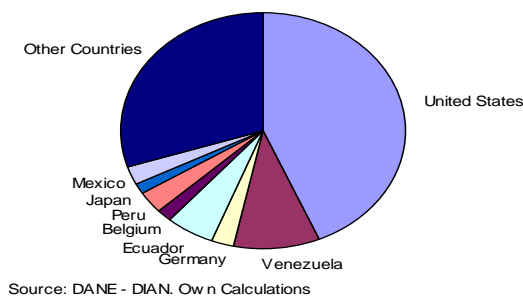
Graph 3



Historically, Colombia’s main trade partner has been the United States, serving as the final destination of almost 40% of the country’s exports in 2004. Venezuela ranks second as it received 9.7% of Colombia’s exports in 2004. In third place is Ecuador, which receives 6% of exports. Graph 4 shows that on average these three nations remain Colombia’s main trade partners.

Graph 4

Main Export Partners
Average 2000-2004

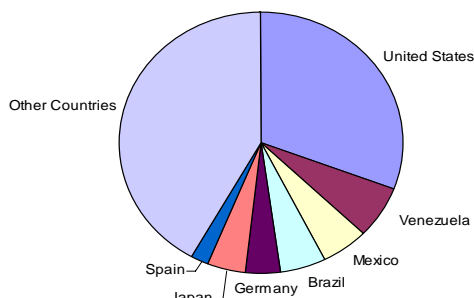


¹ The nominal appreciation between December 2002 and December 2003 was 3%. The appreciation was stronger and in 2004 it reached 14%.

In terms of imports the United States is by far the most important partner. Of every dollar imported, 29 cents originate in the US. Venezuela, Mexico and Brazil follow, each accounting for around 6% of total imports. Graph 5 shows the main import partners in recent years.

Graph 5

Main Import Partners
Average 2000-2004



Source: DANE - DIAN. Own Calculations

TRADE AGREEMENTS

As shown above in Graph 1, Colombia's average nominal tariffs have remained relatively unchanged since the significant structural changes of the early 1990s. However, at the bilateral (or multilateral) level, Colombia has been very active over the past 10 years. As a consequence, Colombia is a partner of the Andean Community and the Group of Three Free Trade Agreement (G-3). Furthermore, it has bilateral agreements with countries and regions like Chile, the Caribbean Region via CARICOM, MERCOSUR (Argentina, Brazil, Uruguay and Paraguay), and several Central American nations.

The oldest and the deepest, in economic terms, of these memberships has been with the Andean Community that was originally founded as a free trade area in 1969. However, it was never fully realized and by 1976 one of its founders, Chile, abandoned the group.

Despite its structural and organizational problems, the Andean Community never ceased its existence (though it is true that it never functioned properly), and, aided by the new global free trade movement of the 1990s, it was revived. In 1989 Colombia, Bolivia, Ecuador, Peru and Venezuela decided to simplify the liberalization program, which over the years had become too complex and cumbersome to implement. As a consequence, in 1992, Colombia, Bolivia and Venezuela finished the process of opening their markets by removing the tariffs on products traded between each other. Just a few months later, in 1993, Ecuador ended the process. Peru, on the other hand, abandoned the liberalization program in 1992. However, in 1997 it reached an agreement with the other members to fully incorporate into the free trade area. The process is expected to be fully operational by the end of 2005.

As a result, and at least as perceived by the Colombian government, the Andean Community has been an operational customs union since 1995.² At the time, the common external tariff approved by Colombia, Ecuador and Venezuela had four basic levels, 5, 10, 15 and 20 percent.³ In 2002, presidents of the member countries decided to apply a common external tariff organized into four levels, 0, 5, 10 and 20 percent (Bolivia received special treatment and was exempt from the 20% tariff level). In practice, as late as 2004, the member countries are still postponing the effective date of the new common external tariff. Internal tariffs however, are rapidly converging to 0 percent.

Colombia is currently a full-fledged member of the denominated Group of Three Free Trade Agreement (G-3). The agreement, signed in June of 1994 by Colombia, Mexico and Venezuela came into effect in 1995. The main objective of the G-3 was to guarantee free and secure access to each others' internal markets through a process of gradual tariff reduction. Such reduction was expected to take place linearly over a ten year period, with the pace of implementation depending on the sensitivity of specific sectors. In fact, at the time of signing, tariffs of around 40% on the entire universe of products was immediately reduced to zero between Colombia and Mexico. It was expected that by July 2004 the entire range of products would have zero tariffs. Though many of the products currently have zero tariffs, the completion of the tariff reduction program has been postponed for several vulnerable sectors such as the automotive sector and several products in the agricultural sector.⁴

Table 1 shows the evolution of international trade between Colombia, Mexico and Venezuela. Although when comparing figures of 2004 versus those of 1994 trade has increased by 98%, the annual averages are less optimistic, reaching slightly more than 10%. In order to be fair, we must stress that in the late 1990s and early 2000s, Colombia faced the deepest recessions since the great depression era of the 1930s. Venezuela also suffered from intense macroeconomic problems during the start of the 21st century.

Table 1 - Trade between Colombia, Mexico and Venezuela
Million of Dollars

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Exports	654	1,057	869	1,104	1,274	1,125	1,538	2,004	1,439	1,056
Imports	1,492	1,892	1,828	2,187	1,944	1,335	1,494	1,379	1,462	1472

Source: DANE. Own Calculations.

Colombia has also several bilateral free trade agreements, the most important of which is the one signed with Chile in December 1993. The agreement had five different lists for tariff reductions and a general 3 year tariff reduction list. The reduction in tariffs on the general list was completely achieved in December 1996. Currently, there is a list of products under liberalization, a process that was designed to be completed between 2002 and 2006. Included in this list are goods such as petroleum and its derivatives, as well as copper products. Other more sensitive products, mostly agricultural goods, will

² Custom unions are defined in the trade literature as an arrangement in which a group of countries eliminates internal tariff barriers and establishes common tariffs for the rest of the world.

³ Bolivia had preferential treatment and only applied levels of 5 and 10 percent.

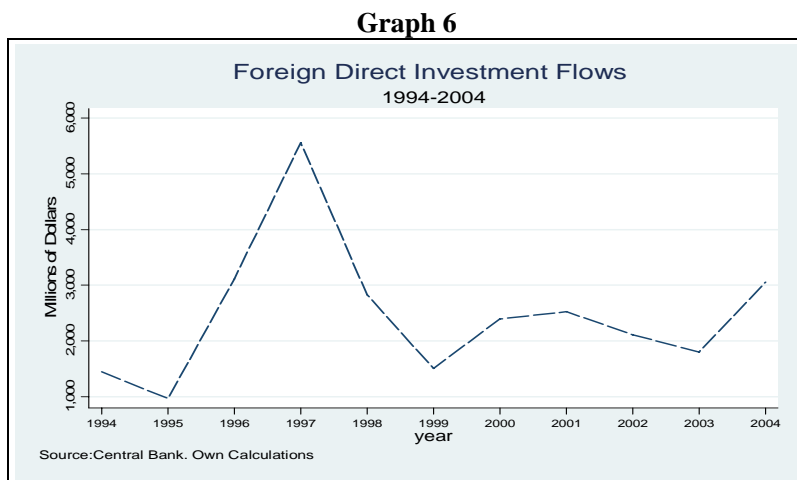
⁴ It should be noted here that the G-3 automobile chapter does apply for Colombia and Venezuela. This is regulated by the Andean Pact Customs Union.

begin the corresponding liberalization process in 2006. Tariffs should be zero for the entire universe of products by December 2011. By 2002 95% of all products traded between Colombia and Chile had zero tariffs.

On December 1991, President Bush signed the Andean Trade Preference Act (ATPA), a package that would lower trade barriers to products coming from Colombia and other Andean countries. ATPA was expanded in 2002 and was renamed the Andean Trade Promotion and Drug Eradication Act (ATPDEA). The program provides duty-free access to the United States market for approximately 5,600 products. These preferences are expected to end in 2006. Therefore, in order to guarantee long term preferential access to the U.S. market, Colombia, joined by Ecuador and Peru, are currently negotiating a Free Trade Agreement with the United States. As of today negotiations are in advanced stages, but it is still not clear when or even if the agreement will be signed.

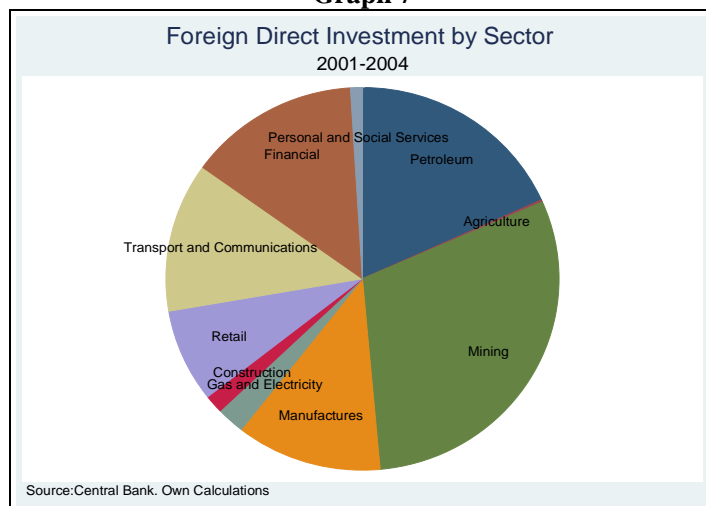
FOREIGN DIRECT INVESTMENT (FDI)

As it held true for the rest of the economy, Colombia's FDI policy went through significant reforms in the early 1990s. A new legislation was introduced in 1991 in an attempt to increase capital direct investment to Colombia. Initially, the short-term results were expected to be modest, but later on, as Graph 6 shows, FDI flows reached record levels in 1997.



The levels of foreign direct investment in 1996 and 1997 are somehow paradoxical because at the time the country was immersed in the most intense political crisis of the last 40 years. The downward trend at the end of the twentieth century can be explained by the political crisis and the associated economic crisis that hit the country the hardest in 1999. In recent years FDI flows have been increasing again, in part explained by a more optimistic view of the Colombian reforms and particularly the future of its economy.

Graph 7



Graph 7 above shows the variety of sectors that attract foreign direct investment. Colombia found significant petroleum reserves in the early nineties and it has been operating since the 1980s one of the biggest regional coal mines. Therefore, it should be of no surprise that over the past four years the share of FDI flows in the petroleum and mining sectors has been at around 48% of total capital investment. The other relevant sectors such as transportation, telecommunications, financial services and manufacturing depend more on specific business strategies of foreign investors and, as a consequence, vary year by year. For example, in recent years there has been a huge investment by Spanish banks in Colombian financial services and banking sectors. Similarly, the expansion of cellular industry explains much of the investment in the telecommunication sector. Therefore, in 2004 the major investor in Colombia was Spain with annual flows of \$536 million. The second largest investor in 2004 was the United States, historically one of the most important foreign investors, with annual flows of \$493 million in 2004.

Currently, the Colombian government offers several incentives for potential foreign investors. The oldest one is known as Plan Vallejo. Originally created in the late 1950s to promote exports by inducing imports, the Plan Vallejo has had several updates over the years. Today, the Plan Vallejo allows companies to procure inputs and raw materials totally or partially exempt from import tariffs and sales tax. The necessary condition to qualify for this incentive is that the imported goods must be used to produce goods or services that will be fully or partially exported. Other incentives include temporary tariff exemption on imports to be used for re-exporting of unaltered products and specific incentive packages for companies with high volumes of production committed to export.⁵

There are other types of incentives, based on the geographical location of economic activity financed by foreign investment. There are currently ten duty free zones that exist to promote industrial processing of goods and services. Users of such zones benefit from generous tax incentives. Five special economic export zones refer to a 50 year special status granted to certain border cities in Colombia. These benefits include

⁵ The latter defined as companies that export at least 30% of its production.

essentially more flexible labor regimes and tax breaks. Special custom zones offer incentives and tax benefits to new industrial development, trade and tourism on the Caribbean coast. Finally, coffee growing areas offer tax incentives for new industrial development. Similarly, there are several labor and tax incentives as well as what is known as the legal stability bill. The latter refers to the guarantee and legal commitment on behalf of the Colombian government not to change regulation policies considered crucial to local and foreign investors.

CONCLUSIONS

Colombia's recent trade history is strongly related to the early 1990s structural economic reforms. As a result of these ambitious changes Colombia is considered, even by the international standards, to be an open economy with strong global economic ties.

Even today, it is a matter of debate in highly technical academic literature whether the effects of globalization are indeed as far-reaching and promising as it appears. Thus, the raw data presented in this document is not sufficient enough to argue that the reforms have been a success or a failure. It is a consensus, however, that Colombia will not revert back from its commitment to economic liberalization reforms. In fact, the country is actively pushing towards a more globally integrated economy, particularly with the free trade agreement that is currently being negotiated with the United States.

Some conclusions extracted from the analysis presented in this document include:

- Tariffs are at historically low levels and tend to go down as more free trade agreements are signed and others (e.g., the G3) become fully operational.
- Exports and imports have been growing over the past years and are today at the all-time high levels. An indicator of the long-term structural trend is the fact that, even with a strong domestic currency appreciation, exports have steadily increased over the past 18 months.
- Despite its well-known (and arguably oversold) problems of political violence and instability, Colombia is an important destination of foreign direct investment, behind countries such as Brazil, Argentina, Mexico Chile and Venezuela.

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ABOUT THE AUTHOR

JORGE TOVAR is currently an assistant professor at the Economics Department of Los Andes University in Bogotá, Colombia. He joined the department after graduating from the Economics Department Ph.D. program at the University of California, Berkeley. Prior to studying at Berkeley he worked for three years at the Entrepreneurial Development Unit at the National Planning Department where he participated in the design and follow up of Colombia's sectoral policy. His research interests are focused on both international trade and industrial organization theory, with emphasis on policy implications on developing countries, particularly in Latin America.