Colombia Economic Outlook

Third Quarter 2014
Colombia Unit

- The global recovery is more sluggish because of slower growth in the US and China in the first quarter of 2014. Nevertheless, some indicators are consistent with a gradual recovery, despite the uncertainty about the effect of higher rates in the US.
- The Colombian economy will grow by 4.9% and 4.8% in 2014 and 2015. However, the momentum over the first quarter of 2014, driven at first by strong public demand, will be U-shaped, decelerating at the end of this year; in 2015 growth will gradually accelerate as exports grow, together with investment in machinery, equipment and infrastructure.
- Inflation on the up in 2014 and 2015. The first half of 2014 saw greater demand-side pressure and surprises on food prices which were reflected in higher inflation. We are raising our inflation forecast to 3.4% by the end of next year, in response to El Niño weather events and its effects on food prices.
- Monetary policy normalisation: the central bank, Banco de la República (BanRep), will lift its rate to 4.50% in August 2014, then pause because of a slowdown in economic growth, and continue with further increases from May 2015 onwards, up to 5.25%.

Index

Closing date: August 5, 2014

1 Summary

Global growth will improve after the slowdown in the first half of 2014 with an acceleration in the US and the eurozone, and a gentle deceleration in China. However, a correction in agents' balances, which has yet to happen, may signal another halt in the recovery in the medium term.

The scenario on the international markets is a complex one. The risk of a hard landing in China is small and the Fed is keeping financial volatility anchored, but there are geopolitical risks appearing all over the place, as well as uncertainty about the onset of the normalisation of US monetary policy.

Colombia has enjoyed portfolio capital inflows of USD7,650mn since February, partly as a result of the country's greater weighting in the JP Morgan indices. This has enlarged the amount of treasury securities used for monetary control purposes (TES in its Spanish acronym) held by foreigners to 10.4% of the total, increased the value of medium- and long-term TES, caused the currency to gain 4% in value so far this year and encouraged the accumulation of international reserves to the value of 12.1% of GDP (+0.6%) in the year.

We expect an exchange rate of USDCOP 1,960 by the end of 2014. The lower growth and moderation in capital flows in 2H14 which will follow, now that Colombia's share in the JP Morgan index has been stabilised, will drive the exchange rate to this level. **By the end of 2015, the normalisation of monetary policy in the US will be the principal determinant taking the exchange rate to USDCOP2,000**.

The economy grew 6.4% YoY in the first quarter, thanks to the momentum in public demand. The most recent data show public demand, residential investment and private consumption all slowing. On the other hand, private demand will continue to expand at a fast pace, in line with the country's positive confidence indicators.

We estimate GDP growth of 4.9% in 2014. Private consumption (3.3pp) and civil engineering (1.4pp) will contribute most to growth. **In 2015 the recovery will continue to be visible in non-residential private investment and exports, keeping growth up at 4.8%**, despite the slackening momentum in the public sector. In the medium-term the infrastructure plan has to be executed, informality needs to be further reduced and the external market consolidated in order to keep growth above 5% (see Box 1).

In the first quarter of 2014, the current account deficit was 4.6% of GDP, its highest value since 2010. This has led us to increase our deficit forecast for 2014 from 3.1% to 3.5% of GDP. In the medium term the current account deficit will stay close to 3% of GDP and will primarily be funded by long-term flows.

We are raising our central government (Gobierno Nacional Central: GNC) deficit forecast to 2.4% of GDP (+0.1%), due to lower oil production and the more limited correction to government spending than its own February forecasts predicted. In the future, our route map for the deficit has deteriorated slightly from our April projections because of lower domestic production of oil, offset by higher oil prices.

We see two risks to growth: an increase in the current account deficit and further delays in executing the infrastructure projects. However, the likelihood of this risk scenario is low because of the uptick in exports and the fact that six (of a total of eleven) of the large-scale, fourth generation, infrastructure projects have already been awarded.

We have increased our inflation forecasts to 3.5% and 3.4% for 2014 and 2015, respectively. The 30bp and 20bp hikes are due to inflation shocks in food and public services in 2014 and to the impact of El Niño on food prices in the first few months of 2015.

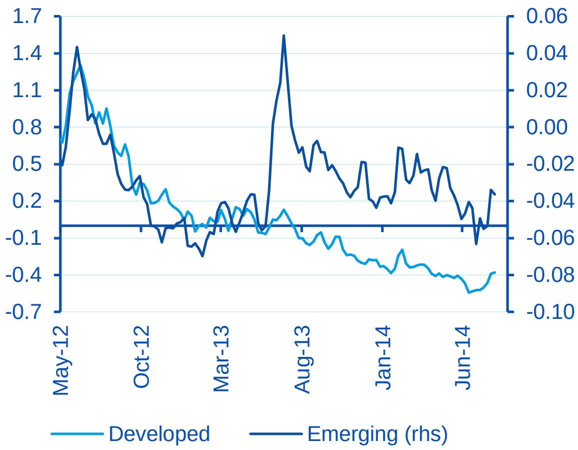
We are expecting an additional 25bp increase in the central bank's policy rate over the rest of the year, peaking at 4.50% at the end of August. Higher than expected inflation, low real interest rates and dynamic economic activity are the main reasons for this increased policy rate. **Then there will be a pause due to a slower economic growth, which will last until mid-2015, when we expect an initial rise of 25bp in the policy rate in May, followed by two more, up to the neutral 5.25% point in July.**

2 Global Scenario

Low financial tensions, dominated by the Fed, support a favourable scenario for growth

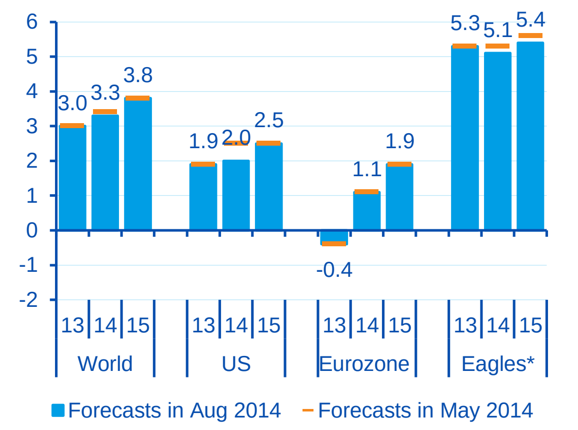
The global leading indicators are consistent with a favourable scenario for growth. First, tensions in financial markets remain low, according to our indicators, in both emerging and developed markets (Figure 2.1) – the recent uptick is due specifically to Russia. Second, industrial activity and global trade are keeping up a good momentum. All of this is taking place in a global environment in which geopolitical risk events, while not causing outright disruption to economic activity, are cropping up everywhere, and as such increasing uncertainty. For the moment, financial volatility is at historically low levels, since the factor dominating the behaviour of global financial markets is the Fed, and this institution is carefully managing a very gradual exit from the exceptional monetary measures implemented in the last few years.

Figure 2.1
BBVA Research Financial Stress Index



Source: BBVA Research

Figure 2.2
GDP growth forecasts (%)



Source: BBVA Research

In China, the risk of a hard landing is receding, with growth set to remain above 7%

The risk of a hard landing in China, predicted by some a few months ago, is receding, thanks to the improvement in exports and in fiscal and monetary support measures. Increased external demand and the brake put on the appreciation of the yuan have helped exports to recover, while monetary policy has been relaxed by cutting the bank reserve ratios, thus favouring credit. Shadow banking sector controls and plans to liberalise the more regulated part of the banking sector are enabling most of this new financing to be provided by the latter segment. This combination of supervisory measures and simultaneous liberalisation to help traditional banking entities compete (freedom to set interest rates, easing the entry of private investment, promoting lending to private companies over those in the public sector) should enable the deleveraging process to take place in an orderly manner, without any sharp corrections. Finally, more focused fiscal policy measures than on other occasions have also been introduced, above all in reaction to the increase in infrastructure spending.

All in all, our outlook is for a very controlled deceleration, with growth easing to 7% in 2015, from 7.7% in 2013. Furthermore, this movement is linked to a long-term trend of an increase in household consumption over business investment, while at the same time the Chinese currency returns to its previous appreciation trend against the dollar. In short, an economic rebalancing, with a moderate increase in debt, for which the authorities have the room for manoeuvre provided by their high level of reserves and control of their current account, together with high levels of private savings and relatively low public-sector debt.

Temporary set-back in US growth. The Fed's communication policy will be a key tool in minimising market volatility

The fall in US GDP during the first quarter of 2014 was mainly due to transitory factors, but the intensity of the correction led us to revise our growth forecast downward for 2014 from 2.5% to 2% (Figure 2.2). The 2.1% drop, in annual terms, of US GDP is the sharpest of the historical series in a cyclical growth phase. The most recent information on the situation (Figure 2.3) shows that the US economy has recovered from the intense, but transitory, effect of the bad weather and from the steep fall in the accumulation of inventories.

There is more uncertainty about the perspective of monetary tightening by the Fed and, in particular, about the global impact this will have on financial markets. The Fed will stop expanding its balance sheet in October, starting a phase in which rates and monetary measures will be determined based on the incoming information about the strength of the economic cycle and the anchoring of inflationary outlooks. In our most likely scenario, the first rise in the Fed funds rate will be in 3Q15, with a bias towards this happening closer to the middle of that year. In this scenario, the US central bank's communication policy on its view of the economic situation will become more important; as such, an increase in global financial market uncertainty is also a possibility.

Supportive domestic demand policies and progress in banking union are improving the outlook in the eurozone

Leading indicators in the eurozone are consistent with a slight recovery in GDP, in line with our forecast of 1.1% for the year as a whole, the first annual growth since 2011. Sustained improvement in access to financial markets, particularly for more stressed economies on the periphery of the eurozone, is the main factor supporting the area's growth, together with the relaxation in public deficit targets in the short term and an external environment which, with the ups and downs and uncertainties described above, is nevertheless more positive. Ultimately, there are essentially two reasons for this virtuous circle. First, the confidence gained as a result of the decisions taken by the eurozone authorities to strengthen the single market in the financial sector, and the ECB's reinforcement of monetary policy, which goes beyond what might have been foreseen just a few quarters ago. The ECB is aiming to anchor interest rates at low levels, support bank funding and, at the same time, open up credit availability for households and companies. Second is the anchoring of global financial tensions at minimum levels. In addition, the reforms undertaken in the markets of productive factors in some economies, designed to improve competitiveness, are another positive factor.

All in all, although we are sticking to our growth forecasts of 1.1% in 2014 and 1.9% for 2015, (Figure 2.2), , the bias for these is to the upside if the potential impact of the measures announced by the ECB is taken into account.

All of the above does not, however, rule out the existence of risks to the downside which could be triggered by the worsening crisis in the Ukraine and the knock-on effects of economic sanctions imposed on Russia, to which the eurozone would be far from immune.

In summary, global growth will increase from the second half of 2014 onwards

In our most likely scenario, the slowdown in global growth in the first part of 2014 has already ended. The most recent indicators of cyclical confidence and financial volatility are consistent with a gradual improvement, which should enable worldwide growth to reach 3.3% in 2014, 30bp higher than in 2013 (Figure 2.2). Maintaining favourable global financing conditions and supporting economic demand policies will help growth to accelerate faster in 2015 at rates close to 3.8%, with an increase in the contribution made by the more developed economies, which could gradually start positioning themselves for the withdrawal of the exceptional stimulus of the last few years.

The uncertainty within this baseline scenario continues to the downside because of the re-emergence of geopolitical risks and the doubts about the global impact on capital flows and asset prices caused by the proximity of interest-rate hikes in the US.

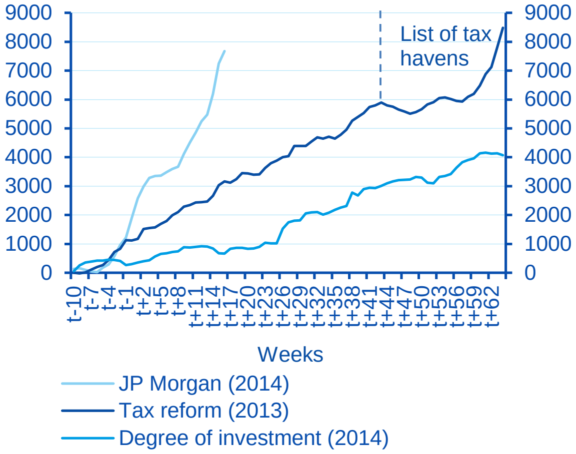
3 Capital inflows boosted the currency exchange rate and reduced yields from domestic public debt

Capital inflows spiked in the second quarter and foreign ownership of TES is at an all-time high

Colombia's greater weighting in the JP Morgan sovereign debt index has resulted in levels of capital inflow not seen in recent years, and an increase in foreign ownership of TES. Since March 19th, when the progressive change of the COP in the index was announced, until the second week of July (latest data available), portfolio capital inflows by non-residents, according to the balance of payments, stood at USD5.8bn. However, if we add capital inflows from the end of February to this figure, which can be linked because of the anticipation of this news, the flow reached USD 7.65bn (Figure 3.1), beating the capital flows for 2013 (USD4.7bn) and 2014 (USD4.7bn) by a wide margin. This being so, we estimate probable revenues of USD10bn over the course of 2014.

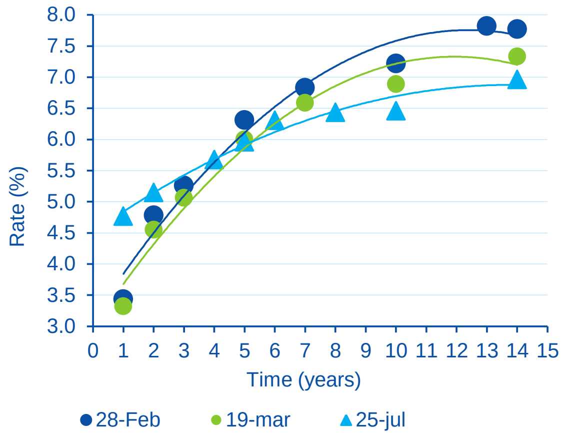
At the end of June, 10.4% of total TES were held by foreigners, nearly 4pp above the level at the end of February (6.6%), representing a further COP7.2trn in TES purchases. By contrast, the banks' stake in public debt fell from 22.8% to 19.7% over the same period, since they expanded the proportion of their assets to loans as a response to the greater demand for credit in recent months. On the other hand, pension fund ownership stagnated at 27% of the total, as an increase in FX investments prompted a quest for more diversified portfolios. In addition, pension funds are readying themselves for a reform to their investment system, where foreign investments will have greater weighting.

Figure 3.1
Non-resident portfolio capital inflows in Colombia (USDmn)



Data at 11 July 2014
Source: Bloomberg and BBVA Research

Figure 3.2
Sovereign debt performance in Colombia. Selected dates (%)



Source: Bloomberg, central bank and BBVA Research

The exchange rate has appreciated as a result of this greater capital flow. However, the lower liquidity that will come with monetary normalisation in the US will drive the exchange rate to nearly COP2,000

As a result of greater capital inflows and the positive economic outlook, the COP has appreciated since March more than any other currency in the region, with an accumulated variation over the year to the first week of August of -4%, offsetting the depreciation in the first two months. Furthermore, these inflows produced a significant flattening of the domestic bond curve, with rising short-term yields determined by monetary policy decisions and decreasing medium- and long-term yields caused by the greater demand for TES (Figure 3.2). This gave the government a reason to raise domestic issuance in those references with low interest rates, to pre-finance the 2015 fiscal period (as we will explain below).

Capital flows, in a context of currency appreciation, enabled the central bank to increase its daily dollar purchases so as to accumulate international reserves. Thus, it moved from a daily average of USD10mn between January and April, to an average daily purchase of USD19mn from then onwards until the end of June. From that moment on, from the first working day in July, purchases shot up to USD 31mn a day, and the bank hopes to keep them at that level until September, in order to accumulate up to USD2bn in the next three months, unless the FX market changes drastically. In all, international reserves have increased by USD 2.4bn in the year to 23 July (an equivalent of 0.6% of GDP) to a total of USD46bn (12.1% of GDP).

Our perspective for the exchange rate sees less scope for more accumulation in the country's foreign exchange reserves in the fourth quarter, since we continue to believe that the exchange rate is as low as it will go this year, and that the trend from now onwards ought to be upward. Our estimate for the end of the year is USDCOP 1,960, driven by domestic and external factors, the latter carrying greater impact. On the internal front, capital inflows may moderate drastically after September, once the correction to the JP Morgan index is complete. Furthermore, economic growth in the second half will be lower than in the first half of the year and will not require additional monetary policy interventions in the fourth quarter (see our section on monetary policy). In the external context, we will see the ending of monthly bond purchases by the Fed, the acceleration in US growth and the markets preparing for the first interest rate hike there. This last factor will be more important next year and will put pressure on the exchange rate to levels close to COP 2,000 by the end of 2015.

Finally, we should point out that as this edition was closing, the credit rating agency Moody’s Investors raised its rating for long-term sovereign debt in foreign currency from Baa3 to Baa2, and the short-term rating from P-3 to P-2. This upgrade aligns Moody’s with the rating assigned by other rating agencies such as Fitch and Standard & Poor’s, which had already classified Colombia as a BBB/Baa2 risk, putting the country two notches above the investment grade. This change ratifies not only the confidence felt by the markets but also the agencies’ confidence that the Colombian economy is sound.

4 Colombia's economic growth will come in at around its potential in 2014 and 2015

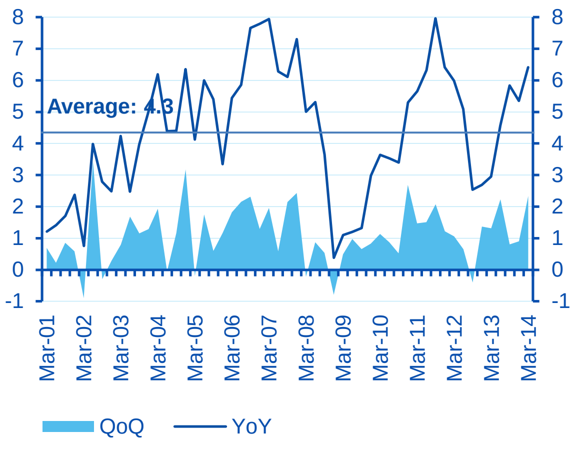
Outstanding momentum in 1Q14

The economy grew by 6.4% YoY in the first quarter, after a strong QoQ acceleration of 2.3% (Figure 4.1). Public demand was crucial in the impressive GDP print, with a 25.4% YoY leap in investment in civil engineering projects and 7.5% growth in public consumption. In addition, the strength of private consumption was confirmed, growing at 5.1%, in line with the positive results from the labour market and the gradual bounce-back of non-residential investment. Similarly, private demand remained the biggest contributor to growth (5.3pp out of the 6.4%), followed by public demand (3.4pp), offsetting between them the negative contribution of net external demand (-3.2pp) (Figure 4.2)[1].

The negative result of external demand in the first quarter is a result of the strong growth of internal demand (8.7% a year), partly accounted for by (i) the uptick in investment and (ii) the consumption of durable goods, two components with a high percentage of imports. In the first case, the positive results are thanks to mining (5.6% YoY) and industry (3.3%). These two sectors performed well at the beginning of the year, giving them an incentive to roll out their investment plans: in the case of mining because the sector concluded that the supply shock affecting its activity between January and April was transitory, and thus stuck to its positive expectations. And industry because little by little it is returning to average activity levels thanks to the increase in domestic sales, although not in foreign ones. In the second case, consumption of durable goods grew, driven by the low rates of interest and the better labour market scenario.

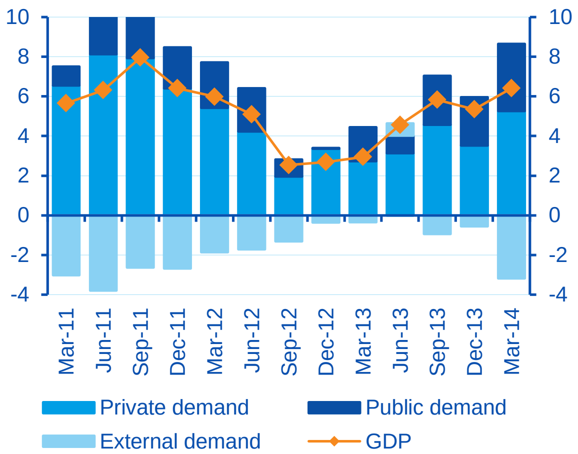
Other high-performing sectors were construction (17.2% YoY) and agriculture (6.1%). As well as civil engineering projects, the construction sector also benefited from above-GDP performance in private-sector building, which focused on social housing and non-residential building for business and commercial use. Agriculture is still being driven by coffee (annual 14.9%), but it also showed growth, albeit more moderate, in other sector activities.

Figure 4.1
Colombia GDP: annual and quarterly growth (%)



Source: DANE and BBVA Research

Figure 4.2
Composition of economic growth (pp)[1]



Source: Bloomberg and BBVA Research

1: They do not add up to the exact total because inventory accumulation (0.6pp) is not included, nor measurement errors due to linking factors (0.3pp).

The economy will continue to grow at a good pace for the rest of the year, but will start to moderate in order to converge with its potential

The most recent data on economic activity reveal a slight slowdown. For example, the new economic tracking index, the ISE, pointed to a YoY expansion of 5.1% in April, below its average of 5.4% in the first quarter (Figure 4.3). This means that private demand will continue to expand at a high rate, in line with the country's positive confidence indicators (Figure 4.4).

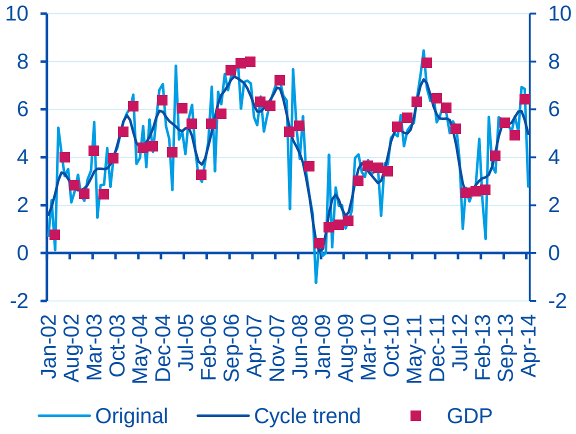
Nevertheless, there will be a correction, almost certainly on account of residential investment and private consumption, while external demand will continue making a negative contribution to growth. Investment will be less dynamic, on account of fewer new project starts (-4.2% YoY in the first quarter in the 16 areas measured by the building census), particularly of flats, commercial outlets, warehouses and buildings for public bodies. Consumption, meanwhile, will be less buoyant because improvements in the labour market will be more modest in the next few months (Figure 4.5) and because of the effects of the monetary normalisation process (increased interest rates) on household decisions. Furthermore, the appreciating exchange rate has an unfavourable effect (in accounting terms) on the quarter's exports, while internal demand remains at positive levels, pushing up imports.

However, the principal factor in GDP's convergence towards its potential (which is 4.7% for 2014) is public demand. The first half of the year saw a high level of project executions in the regions thanks to greater execution of royalty resources: the value of contracts in execution jumped from COP4.4trn in December 2013 to COP7.1trn in April 2014, an increase of over 60% in the execution of approved projects. Furthermore, this was helped by good stewardship on the part of central government during the pre-electoral period. Now this period of record spending is over, the second half will be much slower in terms of public contracts, unless local governments speed up their execution significantly of royalty resources, or unless Bogotá, which has suffered from very low levels of execution so far this year, improves its investment management.

We estimate average growth of 4.4% over the next three quarters of 2014. Better performance of non-residential investment in the fourth quarter, as a result of industrial recovery and an acceleration in mining, and of exports in the second half, thanks to the momentum from the US, did not manage to offset the smaller contribution made by civil engineering products, public spending, residential investment and private consumption (Figure 4.6). This means that growth will converge steadily towards its potential. In total, expansion for the whole of 2014 will be 4.9%, 2bp above our previous estimate of 4.7% (Figure 4.6). By components, despite moderation in the second half, it will be private consumption (3.3pp) and civil projects (1.4pp), in that order, which will contribute most to growth this year.

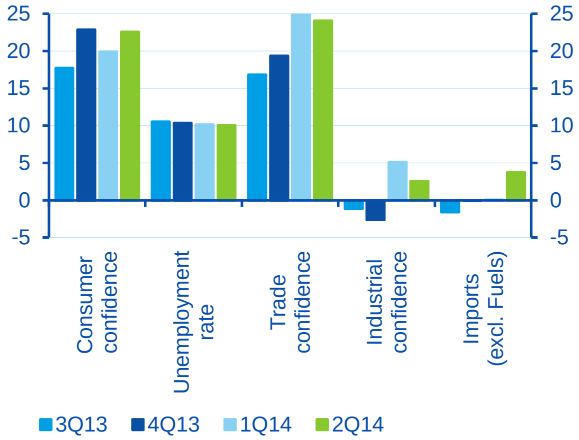
The Colombian economy's growth in 2014 stands out in its regional context, not just because it has grown the most of the seven biggest economies in the region, but also because its economic cycle is in the ascendant, in contrast to the sharp economic slowdown in some countries, such as Peru, Chile and Mexico, in the first half of this year (see Latin America Economic Outlook 3Q14).

Figure 4.3
Economic Tracking Index (ISE) and Colombian GDP (var., YoY)



Source: DANE and BBVA Research

Figure 4.4
Economic activity indicators (% and balance of replies)



Source: DANE, Fedesarrollo and BBVA Research

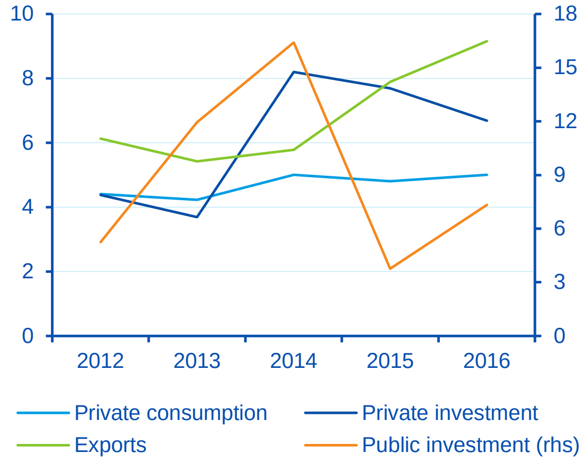
The economy will grow 4.8% in 2015, with less contribution from public demand

In 2015 non-residential private investment and exports will confirm their recovery, with both components growing at rates above their averages between 2012 and 2014, while private consumption will continue to grow at a very similar pace to GDP. The increase in production and sales in the mining and industrial sectors, together with greater external demand from industrialised countries, will be decisive in keeping up the momentum in investment and exports. At the same time, private consumption will receive less of a boost from monetary policy and its expansion will therefore slow down.

The construction sector will be less crucial for GDP growth in 2015 principally because of lower central government spending on civil building projects in the first half of the year. Thus, average GDP growth in the first and second quarters of 2015 will be 4.2%. Furthermore, fourth generation infrastructure projects which are currently being put out for tender by the government will not begin until the second half of 2015, at which point they will contribute to growth and mark the acceleration in GDP expansion to over 5%. 2015 will thus begin with moderate growth which will accelerate when the infrastructure projects begin in the second half.

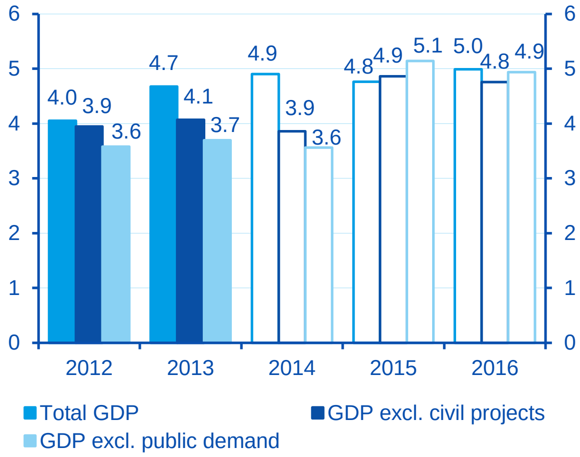
All in all, the 4.8% growth rate in 2015 will not depend that heavily on public spending, unlike in 2013 and the beginning of 2014 (Figure 4.6). By contrast, private demand (investment, in particular) and external demand will be the main supports underpinning this expansion.

Figure 4.5
Annual growth forecasts for GDP components (%)



Source: DANE and BBVA Research

Figure 4.6
Annual growth of total GDP total, excl. civil building projects and public demand[1] (%)



1: Public demand includes civil building projects and public consumption
Source: DANE and BBVA Research forecasts

Medium-term growth will be around 5%

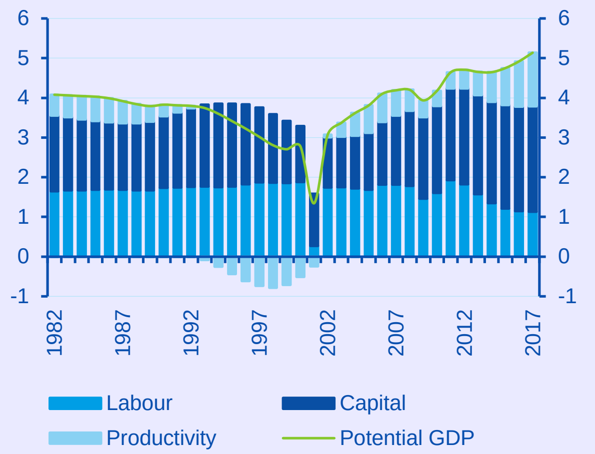
Two conditions must be satisfied if the Colombian economy is to maintain growth above 5% in the medium term: foreign trade needs to perform well and the infrastructure programme must be carried out. Foreign trade must go beyond basic products, although an increase in the export volumes of minerals and hydrocarbons is needed too, and manufactured goods exports should be extended as well, hopefully with more high-tech and more added value. Without the developments being planned in infraestructure as part of the domestic economic integration agenda, it is difficult to make the most of the free trade agreements the country has signed. In addition, we need them to increase total factor productivity, which has to contribute more than its historical average in the coming years if we are to ensure potential GDP stabilised at over 5% YoY (see 1).

Box 1. Growth potential in the Colombian economy depends on improvements in infrastructure and productivity

The growth potential of an economy depends on several factors: capital structure, employment levels, human capital formation, the scientific development of its production chain and innovation in processes, management and products, among many others. However, in order to simplify the analysis, we can focus on three factors: capital, labour and productivity, with the last of these being the sum of all the elements not included in the first two, from the quality of education to the technology of production, and including available infrastructure. Thus, an efficient and comprehensive combination of these three factors, correcting for natural unemployment and the capital utilisation rate, takes us directly to the figure for Colombia's growth potential.

Our most recent estimates indicate that the country's GDP growth potential will rise from its current 4.7% up to 5.5% in 2020. These calculations are slightly lower than our results for 2020 from a year ago, when we estimated potential GDP could rise to 5.7% in 2020, but they are identical for 2014.

Figure B.1
Potential GDP and determinants: contribution to annual variation (%)



Source: BBVA Research

What might account for this potential growth?

The reply is straightforward: if there is no improvement in productivity, the results estimated here will be impossible to achieve. This has to happen because the contribution of employment will continue to fall gradually, given that the country's demographic bonus is in its last decade, coming to an end in 2019. Likewise, it is unlikely that capital will make a higher contribution than it is at present, given that the investment rate is already stabilising as a percentage of GDP, after an impressive jump from 14% of GDP in 2000 up to an estimated 29% by the end of this year (Figure B.1).

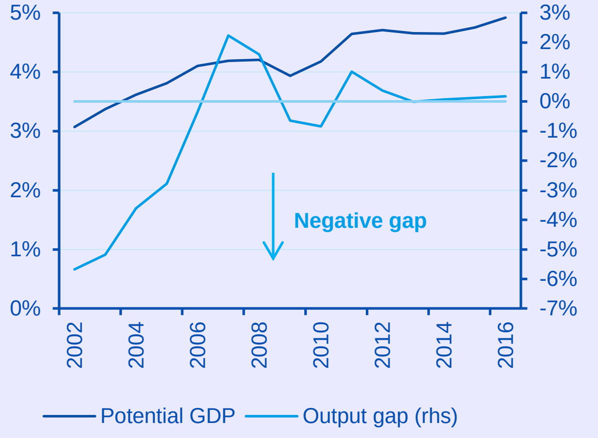
There are at least two ways of increasing productivity, which are reachable if we go by the government's plans. In the first place, it is crucial to execute the fourth generation infrastructure plan, which will give an additional impulse to economic activity, with clear improvement in the production processes and transport of raw materials and end-use goods. The second way is to increase formal jobs and companies. A labour force without social security and subject to a series of risks is less productive and creates disincentives to the accumulation of human capital. On the other hand, companies which are unable to access loans and large markets operate on a less than optimal scale and operate without sources of innovation which might increase their productivity.

These two elements, which are underway and are included in our potential GDP calculations, should lead productivity to rise to an all-time high. For example, although in the most recent expansion period, between 2005 and 2007, productivity contributed 0.7pp to potential GDP, as an annual average, between 2015 and 2020, this factor should contribute 1.4pp every year, that is, twice the amount achieved in an expansive phase of the cycle. On the contrary, potential GDP will grow at rates similar to current ones. Indeed, a boost to productivity of no more than 0.7pp would leave growth potential at between 4.5% and 4.7% a year.

When is the output gap going to close?

The output gap was slightly negative in 2013, that is, the value of real GDP was less than the value of potential GDP. Thanks to high growth rates at the end of 2013 and the beginning of 2014, our estimates suggest that the output gap closed at the end of the first half of the year, with the corresponding inflationary pressures on the demand side that this brings. Nevertheless, given that real growth will be very similar to potential growth in the coming years, that is, only slightly above 5%, the output gap will not widen noticeably in the positive quadrant, where real growth is greater than potential growth. On the contrary, the real level will remain very close to the potential, giving breathing room to the central bank in its monetary policy decisions at the end of this year (Figure B.2).

Figure B.2
Potential GDP and output gap[1]



1: Gap: percentage difference between real and potential GDP
Source: BBVA Research

Conclusions

This major leap in productivity is needed if we are to ensure growth of over 5% in the medium term. If the infrastructure programme does not go ahead, and the formalisation of labour and tax reforms is thwarted, it will be impossible to overcome this barrier and Colombia will continue growing between 4.5% and 4.7% until 2020. On the other hand, if progress is made, Colombia will guarantee a propitious scenario for consolidating the macroeconomic indicators which have differentiated the country in recent years. The country's credit rating will continue to rise and borrowing costs will fall in the public and private sectors.

5 The current account deficit is widening because of falling exports of basic products and higher internal demand

The current account deficit has increased in the first quarter of 2014

In 1Q14 the current account deficit rose to 4.6% of GDP, higher than its average since 2011 (3%). This increase in the external deficit is mainly accounted for by the trade balance, which was negative for the first time since 2010. In the first quarter, exports disappointed, because of the supply-side shocks in mining production (oil pipelines blown up and infrastructure upgrades for coal freight) and because of the lower foreign demand for manufactured goods, particularly from the automotive sector. In addition, imports remained strong thanks to the momentum of internal demand and because of the need to import fuel of an environmental standard not available domestically. In earlier periods, the trade surplus partly offset the revenue deficit factor, the latter being explained by foreign firms operating in Colombia repatriating their profits.

For the first time since the Lehman Brothers crash, foreign direct investment (FDI) was insufficient to cover the current account deficit. FDI flows came to USD3,408mn (3.7% of GDP and 40.4% of the entire financial account), a fall of 6.6% YoY. By economic sector, oil and mining represented 43% of this figure, followed by those involved in manufacturing industries (20%), transport (19%), and trade (6%). Even so, international reserves stood at USD677mn, thanks to a stock issue of external debt (55.2% of the entire financial account).

We have changed our forecast for the current account deficit for 2014, from 3.1% to 3.5% of GDP. This is due to the lower trade surplus expected for 2014, due to the supply-side shocks mentioned above and a slow recovery in exports, which will strengthen by the end of this year. However, we believe that FDI flows to the end of the year will be enough to cover the shortfall in the external accounts, unlike what happened in the first quarter. This is due more to a reduction in the current account deficit, than to an uptick in FDI. The current account correction is accounted for by the stronger trade balance, led by a recovery in industrial exports and basic products which we are expecting for the second half of the year. By May the balance of trade had returned to positive territory, with USD595mn, heralding the current account's return to deficit levels closer to 3% of GDP. As such, we believe that accumulated international reserves at the end of the year may be USD5.400bn.

In the medium term the current account deficit will remain at levels close to, although slightly above, 3% of GDP. This level will be financed with long-term flows, since the short-term flows will be reduced in a less expansive monetary environment in the US and the completion of the adjustment of the JP Morgan index in Colombia.

6 Slight rise in government deficit due to spending inflexibility and lower oil production

The public deficit is larger in 2014 but within the legal limit

The government presented its fiscal figures recently (the medium-term fiscal framework, known by its acronym of MFMP2014), revealing that it did not manage to correct spending so as entirely to offset lower revenues in 2014 - which would have kept the real deficit at 2.3% of GDP - on account of lower income tax payments. In February, the government had planned to reduce operating expenses, a reduction it did not altogether achieve, according to the last MFMP. For this reason, in the MFMP2014, the government is forecasting a deficit of 2.4% of GDP.

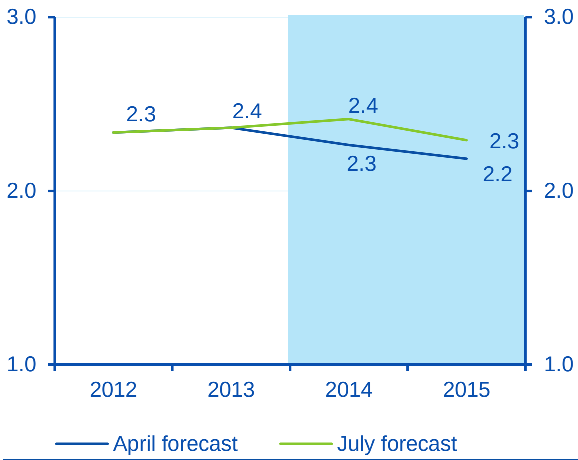
This deficit is aligned with the fiscal rule goal which establishes a structural deficit of 2.3% of GDP. The government estimates that for 2014 the economy will grow at 4.7%, 0.1pp below its estimate of potential growth (4.8%). By this measurement, given that growth expected by the government would come in under potential, real fiscal revenues in 2014 would be less than structural revenues. With a negative output gap (as estimated by the government for 2014), the country's central government cyclical revenues would be negative, bringing the real deficit above the structural deficit by 0.1% of GDP (the effective deficit would be 2.4% of GDP compared to 2.3% of the structural shortfall). According to our estimates, as mentioned in Box 1, the output gap will be closed during 2014.

BBVA forecasts show a trend towards higher central government deficit

Our forecast for the real deficit for 2014 was 2.3% of GDP, according to the spending correction presented by the government in February. Nevertheless, the figures given in the MFMP2014 reveal that this adjustment is not complete. Furthermore, in 2014, the lower revenues resulting from diminished domestic oil production are only partly offset by the upward path of oil prices and increased GDP in our new scenario. For this reason, we have raised our deficit estimate from 2.3% to 2.4% of GDP for 2014 (Figure 6.1). In the future, our deficit projection shows a slight deterioration compared to our forecast in April, of around 0.1% of GDP, due, once again, to lower oil production. Note that the deficit curve is decreasing and complies with the fiscal rule.

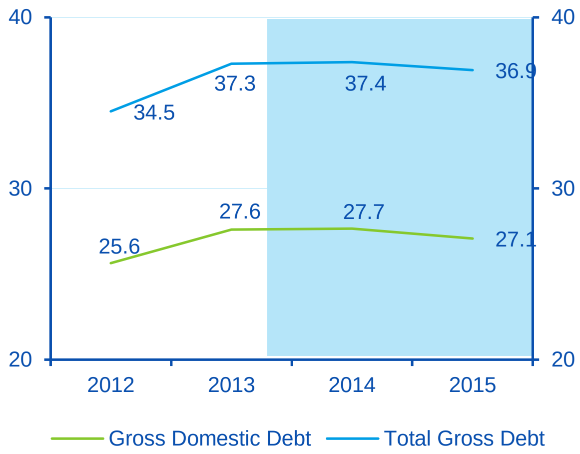
We should emphasise, as we have done in earlier editions of Colombia Economic Outlook, that the results from 2015 onwards take into account a tax reform which abolishes the 4x1000 and the wealth tax as it exists currently. However, this reform will not take into consideration the potential expense of making a peace agreement work, which according to some experts could come to 1% of GDP, to cover the formalisation of land ownership, the deployment of judges specialised in rural affairs and the creation of a special land fund (Fedesarrollo, 2014).

Figure 6.1
Central government fiscal deficit (% of GDP)



Source: Ministry of Finance and BBVA Research

Figure 6.2
Central government gross domestic debt and total gross debt (% of GDP)



Source: DANE and BBVA Research forecasts

In 2014 the government will withdraw liquidity from the economy

In terms of funding, the latest data presented by the government reveal an increase of COP2.9trn in the sources of internal funding in 2014 (going from 30.3trn in February to COP 33.2trn in June), corresponding to a COP1trn increase in TES auctions (rising from COP18.3trn to COP19.3trn), and to an increase of COP1.9trn in the debt issued by the public authorities. For the end of 2014, the government's estimates show a final central government balance which is COP3.8trn higher than February's forecasts, appearing to indicate that the greater internal funding is a result of early financing for 2015, more than a need to cover the commitments of the current year (the central government deficit for 2014 expanded by COP0,6trn from February's estimate). Another factor contributing to the increase in the final balance in pesos, although to a lesser extent than the greater domestic debt issuance, is the reduction in domestic debt amortisation (COP1trn). The increase in TES emissions and lower amortisation have effects on both the domestic debt balance and on the economy's liquidity.

With these changes, the central government's net domestic debt in 2014 will be slightly higher than its own estimates in February and will come in at similar levels to those at the end of 2013 (25.4% of GDP). This debt registered smaller changes between 2012 and 2013 when the balance increased by 0.7pp of GDP. By contrast, gross domestic debt levels presented more significant differences, increasing by around 2pp between 2012 and 2013 (Figure 6.2), as a result of the increase in the balance of TES, rising from COP2trn (0.3% of GDP) to COP10trn (1.4% of GDP), respectively. We should remember, however, that the resources obtained from issuing TES are deposited in the central bank; this converts them into a mechanism for monetary sterilisation and not for financing expenditure. In this way, the increase in gross domestic debt is more a measure of monetary policy, and its budgetary effect will be limited to the interest that will have to be paid on TES (financed indirectly by the central government). According to our estimates, the balance of TES will be a little over COP9trn by the end of 2014, given that the maturities on these TES during 2014 will be around COP7trn and that a COP6trn issue has been authorised for the 2014 fiscal year. Thus, issuing monetary control TES will not put pressure to the upside on gross domestic debt during 2014.

The central government's latest funding figures for 2014 show a ratio between TES issues and servicing debt of 111%, a percentage which the government estimated at 96% in their February forecasts. So, while the current figures for the issues are higher than debt servicing by COP3.3trn, in February they were lower than the debt servicing figure by COP 1.3trn. The latest projections show, therefore, that the government is withdrawing liquidity from the economy, the opposite of what was expected with the February figures.

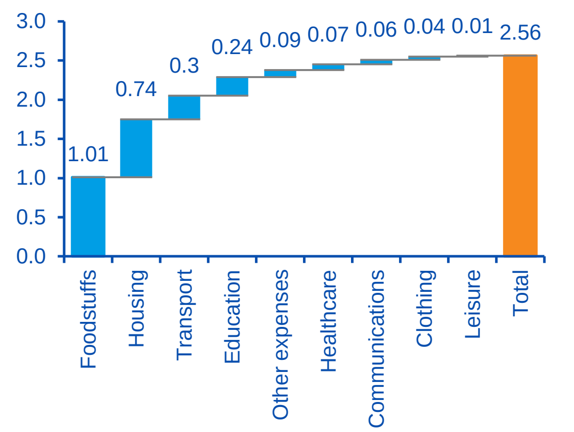
7 We are raising our inflation forecast for 2014 and 2015

Surprises in food and public services prices drove up inflation in the first part of the year

In the first five months of the year, all the inflation results were higher than the market had anticipated. The surprise over these months lies in the foodstuff and housing groups, where some perishable products (particularly tubers) and the cost of public services (especially energy) increased noticeably in price. With this momentum, inflation registered accumulated growth in the first half of 2.57%. 68% of this growth is accounted for by the behaviour of the housing and foodstuffs groups, which contributed 1.75pp to the total variation in inflation over the half (Figure 7.1).

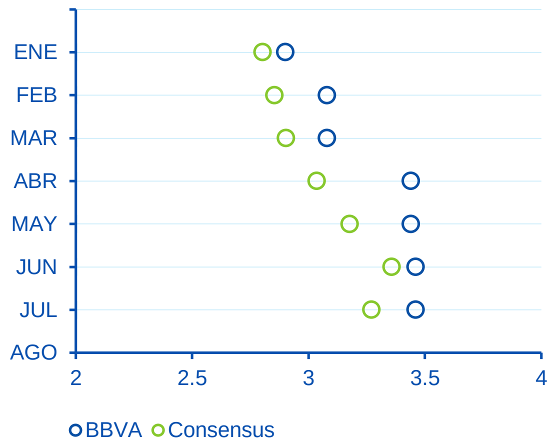
As the year moved on, and with the surprises in inflation rates in the first few months, the market raised its inflation expectations for the end of the year (Figure 7.2). Currently these expectations stand at 3.3% according to the July survey published by the central bank, retreating slightly from the level reached the month before because of the marginal variation in June inflation (+0.09% MoM).

Figure 7.1
Accumulated inflation to June by expenditure group (pp)



Source: DANE and BBVA Research

Figure 7.2
Inflation forecasts for the end of 2014 (%)



Source: Central bank and BBVA Research

Basic inflation, excluding regulated goods and the more volatile components of inflation, continues to rise although it has been showing a slight slowdown in the last few months. However, the extraordinary growth of the economy in the first quarter led to the output gap closing, or even going into positive territory. With growth close to potential in the next few months and lending rates still absorbing the increases expected in the central bank's reference rate, demand pressures will continue actively putting pressure on inflation.

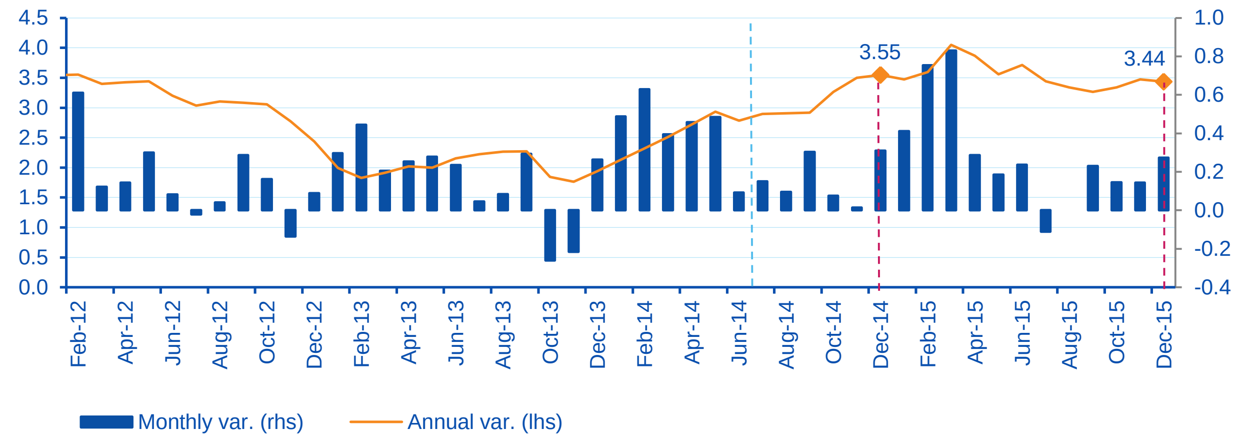
It was not only the inflationary surprises in the first few months of the year and the increase in basic inflation which have led us to raise our inflation forecast to 3.5% for the end of the year. We also expect additional hikes in the cost of energy, resulting from a more extensive (and more costly) use of thermal sources in the country's electricity generation. Generation from this source represented 35% of energy supplied in May, 18pp above its share a year ago. This change in the mix of generation sources is in an attempt to husband water resources (reservoirs) against another El Niño phenomenon.

Our forecast would have been higher were it not for the stabilisation (at around 1.9% YoY) in the acceleration of the tradable component and because of a downwards correction to our path of food prices. Nevertheless, we acknowledge that there are risks which might lead to higher inflation by the end of the year and which depend on how the conflict in Iraq develops and its impact on the oil prices, and also that the impact of El Niño, which we expect in the first quarter of next year, is not brought forward.

The El Niño Effect has led us to raise our 2015 inflation forecast by 20bp

Our economic outlook has not changed for 2015 in terms of increased activity. The only correction we have made in response to the increased probability of this weather event occurring in the next few months, has been to steepen the inflationary path we foresee for food; we believe it will grow faster in 1Q15 and will impact headline inflation at the end of next year. So we have raised our inflation forecast for the end of 2015 from 3.2% to 3.4%.

Figure 7.3
Inflation forecasts for 2014 and 2015 (YoY and MoM growth, %)



Source: DANE and BBVA Research

8 Rising headline inflation and inflation expectations anticipate further increases in the central bank's interest rate

We are expecting an additional 25bp increase in the central bank's policy rate for the rest of the year, up to 4.50% by the end of August. There are three reasons for this expected increase, which is why we have raised our forecast.

First, as we mentioned earlier, accumulated inflation for the year so far has surprised the market and the central bank, reaching 2.56% in June. This implies that in real terms the central bank's policy rate has remained stable, despite the 100bp rise since April, and continues to be as expansive as it was at the beginning of the change in monetary policy (Figure 8.1).

Second, the economy's real interest rates are at low levels, not seen since 2000, which implies that the effect of the change in monetary policy has not yet been entirely transferred to the economy's remaining interest rates: for this reason they continue boosting the economy.

Third, so far this year, and particularly in the first quarter, the economy has performed better than both our and market forecasts. This solid performance makes it likely that the output gap, the gap between real GDP and what is considered potential GDP, reached its lowest point (ie. closed) in June. In the future we expect less robust growth, slightly below the economy's potential, which will reduce inflationary pressures. This would justify a pause in the hikes to the policy rate from August until May 2015 (Figure 8.2). We expect an acceleration in growth for the second half of 2015, which implies that it is likely that the policy rate will again edge further towards its long-term level, considered its neutral level, in the coming year (i.e. 5.25%).

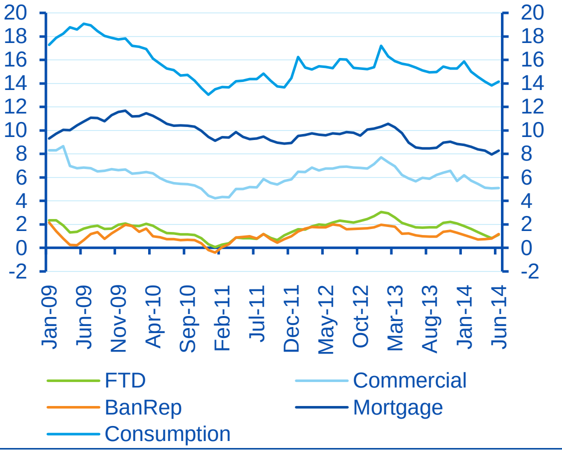
Although the rise in the policy rate supports capital inflow to an even greater extent, the central bank has accompanied these increases with USD purchases in the FX market, as mentioned above. In recent months it has actually increased, by over 60%, the average daily amount purchased in order to mitigate the appreciation of the COP.

Decelerating growth in 2H14 will lead to a pause in interest rate hikes

From August onwards we expect a pause in the increases in the central bank's policy rate until May 2015, for two reasons. First, a slowdown in the economic growth in the second half of the year which will bring growth down below potential for the last two quarters. Second, the uncertainty as to whether the output gap was closed in June 2014 or not. Given that inflation expectations are anchored at the mid-point of the central bank's tolerance threshold, this gives the bank's steering committee scope to wait and see how the 125bp increase in the rate in 2014 plays out, and not to make more of a correction than needed.

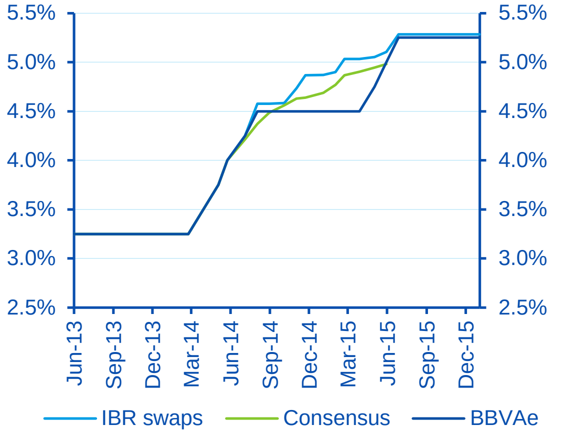
We expected the pause to end in May 2015, with three consecutive rises of 25bp each, up to a reference rate of 5.25% by the end of July. According to our models, this last rate is neutral and as such neither stimulates nor curbs growth.

Figure 8.1
Real interest rate, placement and deposit (%)



Source: BBVA Research

Figure 8.2
Central bank's policy path and market expectations (%)



Source: Boomberg, BBVA Research and central bank

9 A higher current account deficit and further delays in infrastructure projects are the biggest risks facing the economy

If the current account deficit is not corrected and remains above 4.5% of GDP, a severe correction to internal demand may become necessary, particularly in view of the uncertainty about the global impact on capital flows which an increase in US policy rates would create, as discussed in our global scenario section. In the event of a correction, Colombia would need more private and public saving, by spending less on consumption and investment activities. Households would bring to an abrupt end the expansion in durable goods, which has just begun (partly supported by monetary policy), and companies would once again postpone their investment plans, which are due to accelerate in the second half of this year.

What is more, a further delay in the fourth generation infrastructure programme, and/or in the regional execution of transport investments, could provoke a confidence shock in the private sector, while limiting the expansion of potential GDP and prejudicing medium-term outlook economic prospects. In this scenario, economic activities related to construction, which serve as leading performance indicators, would drastically reduce their production, in anticipation of lowered future demand, with negative implications for employment and labour income. This panorama could lead to a new low-confidence cycle, reinforcing the correction in domestic demand initially caused by the external deficit.

However, the likelihood of this risk scenario is low. First, exports started picking up in May and mining is expected to inject a good amount of foreign currency into the economy again. Then, as a result of a first quarter with supply shocks restricting the production of coal and oil, foreign firms' profits in the sector will be lower than previously expected. This means that the revenue deficit factor should remain moderate throughout 2015 in this context of a more controlled repatriation of dividends abroad. Next, the government has already tendered six of the major projects in the fourth generation infrastructure programme, guaranteeing a positive contribution to growth, from the projects awarded, starting in the second half of 2015 onward, as argued in our baseline scenario. Finally, the government's sale of its majority stake (57.6%) in ISAGEN will almost certainly take place this year, since the lawsuits opposing the sale have come to an end; these resources underpin the funding of a good number of the projects in the second wave of fourth generation tenders.

10 Tables

Table 10.1
Annual macroeconomic forecasts

	2012	2013	2014	2015
GDP (% YoY)	4.0	4.7	4.9	4.8
Private consumption (% YoY)	4.4	4.2	5.0	4.8
Public consumption (% YoY)	5.7	5.8	5.2	3.6
Fixed investment (% YoY)	4.6	6.1	10.7	6.4
Inflation (% YoY, eop)	2.4	1.9	3.5	3.4
Inflation (% average YoY)	3.4	3.2	2.9	3.4
Exchange rate (vs. USD, eop)	1,794	1,934	1,960	2.000
Depreciation (vs. USD, eop)	-8.8%	9.2%	1.3%	2.0%
Exchange rate (vs. USD, avg.)	1,797	1,869	1,939	1,982
Depreciation (vs. USD, avg.)	-2.7%	4.0%	3.7%	2.2%
Central bank interest rate (%, eop)	4.25	3.25	4.50	5.25
FTD interest rate (% eop)	5.22	4.06	4.62	5.32
Unemployment rate (%, eop)	10.2	9.7	9.2	8.8
Fiscal balance (% GDP)	-2.3	-2.4	-2.4	-2.3
Current account (% GDP)	-3.2	-3.4	-3.5	-3.1

Source: DANE, central bank, Treasury and BBVA Research Colombia

Table 10.2
Quarterly macroeconomic forecasts

	GDP (YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD eop)	Interest rate (%, eop)
1Q12	6.1	3.4	1,766.3	5.25
2Q12	5.1	3.2	1,792.6	5.25
3Q12	2.5	3.1	1,803.2	4.75
4Q12	2.7	2.4	1,793.9	4.25
1Q13	2.9	1.9	1,809.9	3.25
2Q13	4.6	2.2	1,909.5	3.25
3Q13	5.8	2.3	1,919.4	3.25
4Q13	5.3	1.9	1,934.1	3.25
1Q14	6.4	2.5	2.022.2	3.25
2Q14	4.5	2.8	1,888.1	4.00
3Q14	4.3	2.9	1,910.0	4.50
4Q14	4.5	3.5	1,960.0	4.50
1Q15	3.9	3.8	1,969.0	4.50
2Q15	4.5	3.2	1,977.0	5.00
3Q15	5.3	3.2	1,993.0	5.25
4Q15	5.3	3.4	2.000.0	5.25

Source: DANE, central bank and BBVA Research

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