BBVA | RESEARCH

Colombia Outlook

First Quarter 2015
Colombia Unit

- The world economy continues to grow, albeit slowly and unevenly, with growth in the US offset by the weakness of Japan and the Eurozone. The risks to world growth continue to impose downward pressures.
- We expect to see GDP grow by 3.6% in 2015 and 4.0% in 2016. Public consumption and spending will assist growth this year. In 2016, the main driver of growth will be exports, while private consumption will experience a slowdown.
- Inflation will reach 3.5% by the end of 2015. As regards devaluation, the first six months of the year will see inflation at around 4%, though this will slow over the second half of the year as the economy slows down.
- The Bank of the Republic will cut its intervention rate by 50 basis points. This cut will be conditional on the projected inflation rate remaining absolutely on target over the long term.
- The central government deficit will stand at 2.8% in 2015, falling to 2.5% in 2016. Cyclical factors will mean that deficits will exceed the levels mandated by the Fiscal Rule. Despite the higher deficit figure, we believe that 2015 will be decisive in fiscal terms. Further tax reforms will be required in 2016, together with an adjustment in spending.

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Closing date: 6 February 2015

1 Summary

The world economy continues to grow, albeit slowly. Consolidated growth in the US will offset the poor levels of growth in Japan and the Eurozone and the gradual slowdown in China and other emerging economies. **We estimate that world growth will reach 3.6% and 3.8% in 2015 and 2016 respectively.**

Oil was an important source of growth in recent years. **Now that oil prices are lower, the economy will suffer negative shocks from the mining and energy sectors.** However, the effects will be contained due to their reduced influence on GDP and the offsetting of other activities.

We expect to see GDP grow by 3.6% in 2015. Consumption will be the main driver for domestic demand in 2015, growing 4.3% year-on-year. Another important factor for domestic demand will be the maintenance of high levels of public spending.

We do not expect lower oil prices to have a direct effect on the economy in 2016. However, the fiscal adjustments introduced in 2016 as a result of lower oil revenues in 2015 will mean a (potential) rise in VAT, with negative effects on private consumption, along with cuts in public spending. **In total, we expect growth of 4.0%, thanks to the positive effects of exports.**

We forecast further devaluation of the Colombian peso in response to the fall in the price of oil. The fall in the oil price was sharper than we expected, and prices have remained very low. However, we believe that the oil price will bottom out and the exchange rate will reach its highest level during 1Q15. From 2Q15, the price of crude will gradually recover, and the exchange rate will therefore see a partial correction to its recent increase.

Inflation will temporarily stray above the target range during the first half of 2015. The devaluation experienced during the last months of 2014 will force prices up over the first six months of this year. **However, slower economic growth in 2015 will in turn slow the rise in prices, bringing inflation to 3.5% by the end of the year.** In 2016 we expect to see inflation fall to 3.3%.

The current account deficit is expected to stand at 4.9% of GDP in 2015 and 3.7% of GDP in 2016. Exports in sectors other than mining (industry and agriculture) will benefit from the devaluation of the exchange rate in real terms and the greater demand from developed countries, though these will be more than offset by the lower average oil price. Imports will remain stable in dollar terms during 2015, experiencing an upturn of 7% year-on-year in 2016. Finally, factor income will be high in 2015, though this will see a notable correction in 2016 as a result of reduced profits in the mining industry.

The lower level of growth caused by the oil price shock and inflation within the target range will afford more flexibility to the Bank of the Republic's monetary policy in 2015. We expect the monetary policy rate to be cut by 50bp to 4.0% during the second half of the year, provided that the projected inflation rate remains absolutely on target over the long term.

2015 will be a quiet year for the finances of the Colombian National Government, thanks to the higher levels of revenue obtained as a result of the tax reforms implemented at the end of 2014, the flexibility introduced by the fiscal rule allowing the observed deficit to be higher than the structural deficit, and the room available for financing a higher deficit. **The fiscal situation will be tighter in 2016**, requiring an adjustment in spending and higher revenues, measures that should combine to ease government finances by 0.7% of GDP. The higher revenues will come from the **tax reforms that should increase the VAT rate by 2 points**.

2 Global environment: increasing divergence between the main economic areas

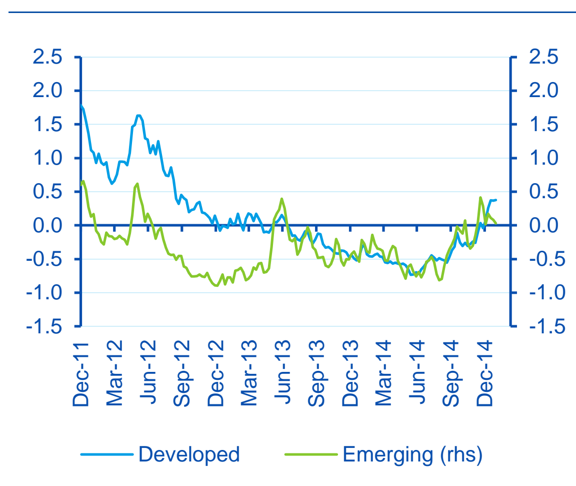
Global growth should increase to 3.6% in 2015 and 3.8% in 2016

The world economy grew in the fourth quarter of 2014 at a similar pace to the third. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the eurozone, and the progressive deceleration of China and other emerging economies. Hence, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution over the three previous years, and the EMs continuing to decelerate.

One of the biggest pieces of news in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the eurozone and China) offsets the reduced activity in the principal producer countries.

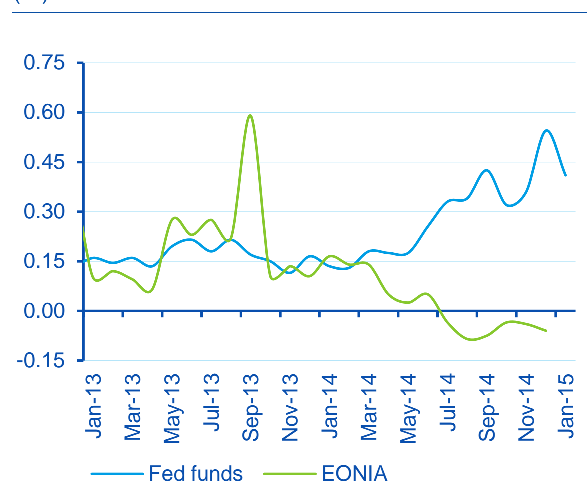
The increased volatility in financial markets, which has now reached the same level as in mid-2013, according to the BBVA Financial Tensions Index (Figure 2.1), is another of the highlights of the quarter, and one the EMs and the DMs have in common as a consequence of two factors: i) doubts about the economic development of many EMs, and ii) the uncertainty around the Fed's rate-hiking cycle.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

Figure 2.2
Monetary policy expectations: 12M fwd interest rates (%)



Source: BBVA Research and Bloomberg

In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ (with the Fed and the Bank of England on the one side, and the ECB and the PBoC on the other (Figure 2.2)).

Thus, the improvement in global growth will continue in 2015 and 2016, by more than 3.5% on average, but there will be a significant differentiation between areas, given the asymmetric effect of falling commodity

prices and monetary policy divergence in the development bloc, with these being the two effects that mark *a priori* the prospects for the global economic scenario.

All in all, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been exacerbated by those associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

The US consolidates its recovery and the Fed is ready to raise interest rates

Momentum in the US recovered over the course of 2014, based on the strength of domestic demand and also lower oil prices. Looking forward, US growth could reach 2.9% in 2015 which, together with low inflation, will accentuate the Fed's dilemma when it comes to start its monetary normalisation process. In this context, our forecast date for the first increase in the Fed funds rate remains 3Q15.

The controlled slowdown in China continues

In China, the slow deceleration in activity continued, with an estimated growth of 7.2% in the fourth quarter, the slowest since 2009 due to the loss of momentum in fixed capital investment, the deterioration in external competitiveness which was driving the yuan's appreciation and the correction in the real estate sector.

Although we have left our forecast for growth in 2015 unchanged at 7%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market and the doubts about the capacity ofpolicies to achieve a correction in the present imbalances with economic liberalisation underway. It is important to remember that the authorities have started to show more tolerance towards economic deceleration, provided that job-creation moves in line with the active population.

Finally, the downward pressures on inflation in Europe continue

Of the large economic areas, the eurozone is the most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. In particular, an increase of 0.8% in 2014 is anticipated, which could increase up to 1.3% in 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to the ECB's actions.

Among the main focus-points of downside risks is the increased tension in Russia's sphere of influence. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the ECB's support in fostering growth. Finally, another risk is that medium-term inflation expectations will continue to fall, discouraging consumption in the short term, and leading to a negative feedback loop.

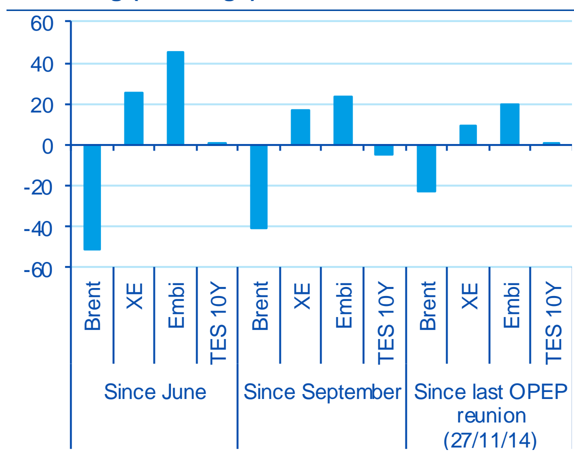
3 Local markets react to the lower oil price

The price of oil (Brent) has fallen by around 54% from its highest level in the middle of 2014 (Figure 3.1). The fall was most marked during December and January, once it became known that OPEC was not going to cut production levels in order to boost prices, lest it see a reduction in its worldwide market share. This was not countered by an increase in oil production in Colombia, thus limiting the country's capacity to generate foreign currency in this sector.

There was also a rapid devaluation in the exchange rate, which was more marked that that of other emerging economies, in reaction to the equally accelerated fall in oil prices at the end of 2014 and the overall strength of the dollar (Figure 3.1). In addition to this, and in close correlation with the oil price, the Colombian peso shoed high levels of volatility with a partial correction of the reaction seen in the fourth quarter of 2014. Another factor influencing the sharp devaluation of the peso was the currency's low level (base effect) in the middle of 2014. This was due to the rise in the exchange rate which resulted from Colombia's higher weighting in the JP Morgan index for investment in public debt in emerging economies.

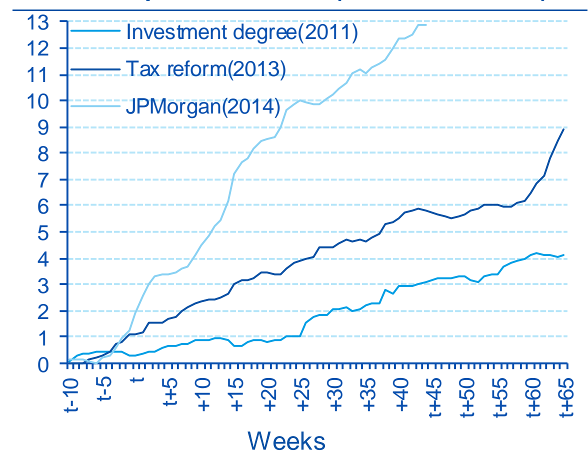
Similarly, the country's risk premium rose from the third quarter of 2014. The Colombian EMBI rose from 130 base points to around 240 (Figure 3.1). Part of this rise was connected with the higher levels of volatility around the world and greater uncertainty in the world markets, with capital flowing towards more secure assets, but it was also the result of the current and future impact of the oil price on public finances and the country's external accounts (see sections 5 and 6). Indeed, interest rates on government debt rose by around 100 basis points over the six months to December 2014. Subsequently, following the approval of tax reforms and the shoring up of fiscal revenues for 2015, the rates came back down, almost returning to their original level (Figure 3.1).

Figure 3.1
Oil, devaluation, country risk and public borrowing (% change)



Source: BBVA Research, Bloomberg and Bank of the Republic

Figure 3.2
Portfolio capital investment (billions of dollars)[a]



Source: BBVA Research and Bank of the Republic
[a] Data from 23 January 2015.

In addition, the stock market fell significantly as the value of oil-related stocks worsened, which even led to a reduction in the number of shares from this sector quoted on the Colcap index. For example, Ecopetrol's weighting on the index fell from 19.7% in February 2014 to 17.3% in June of the same year, falling further to 12.4% in February 2015. This meant that its shares lost more than 7% of their value in just one year, and it moved from first to third place in the process, behind Bancolombia and Suramericana. Similarly, shares in Pacific Rubiales now account for just 0.3% of the index, lying in 18th place out of the 20 shares quoted on

the Colcap, having fallen from 8th position and a share of the index of 4% in 2014. Since June, when the fall in the oil price was strongest, shares in Ecopetrol and Pacific have fallen by 38.3% and 78.9% respectively.

Despite this, and in spite of its acknowledgement of a higher fiscal deficit for 2015 (see Section 5), the Colombian government still managed to achieve favourable results when seeking financing on the international markets. In January it issued bonds worth USD1.5bn, maturing at 30 years. The return on this bonds issue (5.06%) is the third lowest in history for this kind of bond, an indication of the trust placed in the proper management of the Colombian economy. Some of this trust is due to the country's institutionalised fiscal policy, which is supported by reforms such as those relating to royalties and fiscal regulation, which led to the levels of investment experienced in 2011.

Comparing the rates offered for government bonds issued before and after the enactment of Law 1473, which implemented the fiscal rule, one can see a substantial reduction. In effect, the return on 10-year external bonds fell from 7.5% for an issue made in January 2009 to 3.673% in January 2014. As a result, both the cost of government financing and the opportunity cost for investors have fallen, and this has combined with the stable and credible performance of public finances to boost long-term investment in Colombia and with it economic growth.

Another differentiating factor for the Colombian economy was incoming capital investment, which remained strong during the final months of 2014 and at the beginning of 2015 (Figure 3.2). The average weekly incoming capital investment figure between October 2014 and January 2015 was USD190mn, which compares positively with the USD255mn weekly average for the first nine months of 2014, given the country's upward correction in the JP Morgan index. As a result, foreign holdings in TES bonds rose to 16% in January 2015 from just 6.4% one year earlier. This will be very beneficial for the government's planned diversification of its debt, with less exposure to local investors (particularly pension plans) and a greater proportion of foreign capital.

4 Economic growth: lower but more balanced

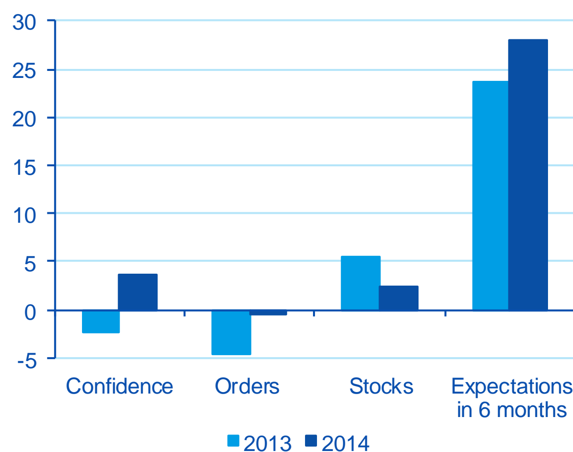
The oil shock will be favourably absorbed in 2015 and 2016

Oil has been an important source of growth in recent years, mainly over the period between 2008 and 2011, when the economy faced up to and overcame the international crisis. However, the other trading sectors, industry and agriculture all showed low levels of growth over the same period, the result of problems of structural competitiveness that continue to persist to a certain extent, and the lower stimulus that has resulted from a rise in exchange rates in real terms.

Now that oil prices are lower and will remain below USD100 a barrel over the medium term, the economy will suffer negative shocks from the mining and energy sectors. However, the effects will be contained due to their reduced influence on GDP and the offsetting of other activities.

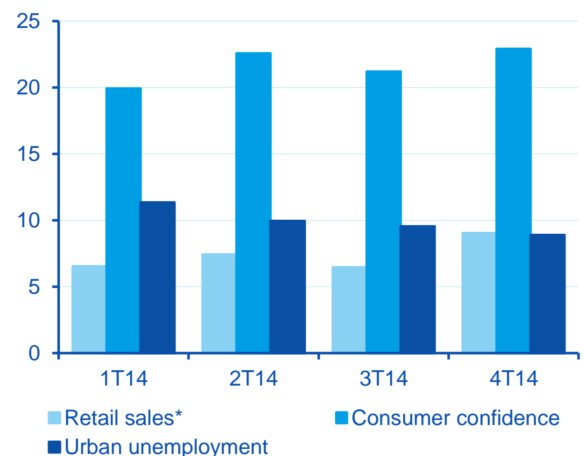
In direct terms, oil accounts for 5% of GDP. Indirectly, it represents an incentive for foreign direct investment (FDI) and for investment in public works. Foreign direct investment in the oil industry accounted for 19.3% of the total FDI attracted by the country over the last 10 years, and investment in public mining works (which extend beyond oil) is given a 40% weighting in the index that measures this type of spending in the country's public accounts, spending that amounts to no more than 8% of GDP. The lower oil price could also have a collateral effect on the non-residential construction sector and the high-end residential market, though there is no precise measure in this regard and the effects can therefore be considered residual and anecdotal.

Figure 4.1
Manufacturing indicators: confidence, orders, stocks, and expectations (average annual balance)



Source: BBVA Research and Fedesarrollo.

Figure 4.2
Consumer indicators: confidence, unemployment, retail growth (average for the quarter, shown as %)



Source: BBVA Research, DANE and Fedesarrollo. *Data to November

The negative effects due to the oil price will be moderated by the resurgence in new sources of growth, which will lead to a more evenly spread balance sheet with industry and agriculture heading up the expansion process. The devaluation of the exchange rate, a better than expected recovery in the US economy and improved growth in Europe in 2015 as compared with 2014 will all be decisive factors. In a period of contained inflation in Colombia, the exchange rate will act to devaluate the currency in real terms and improve the relative position of Colombian products in the US and Europe. The higher exchange rate will also significantly reduce imports (and smuggling) which, in a continuing context of strong consumer demand, could incentivise domestic production.

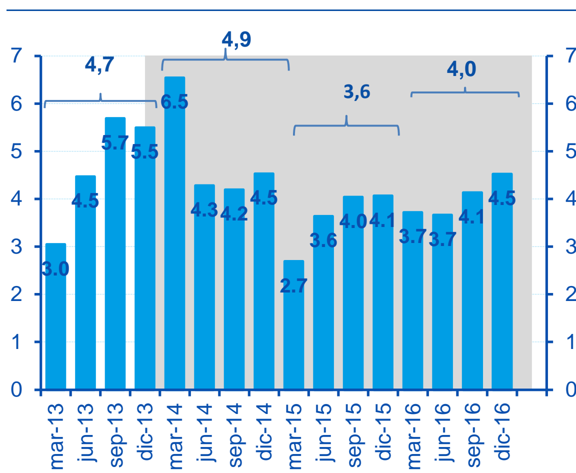
Consumption will be the main driver for domestic demand in 2015, growing 4.3% year-on-year (Figure 4.4). The strong performance of spending by individual households will be the consequence of the improved levels of confidence and significant improvements in the labour markets. The average unemployment rate for 2014 was 9.1% across the country as a whole and 9.9% in the main cities down from 9.6% and 10.6% respectively in 2013. Urban employment also rose by 3% year-on-year (as compared with 2% in 2013), with a 2.2% annual rise for the country as a whole (1.7% in 2013).

Another important factor for domestic demand will be the maintenance of high levels of public spending. This will be in line with past estimates (as set out in our previous Colombia Outlook), a situation made possible thanks to the negative cyclical component created by the fiscal rule (see section 5), which in turn generates confidence in the international markets as a result of the structural deficit restrictions imposed by central government. In this way, both central government and regional authorities will be able to complete most of their planned public spending projects. In the case of local government, 2015 marks the end of this spending period, which is the one that has seen the most projects completed in the country's history.

We forecast a gradual recovery in GDP growth that will compare favourably with the rest of the world

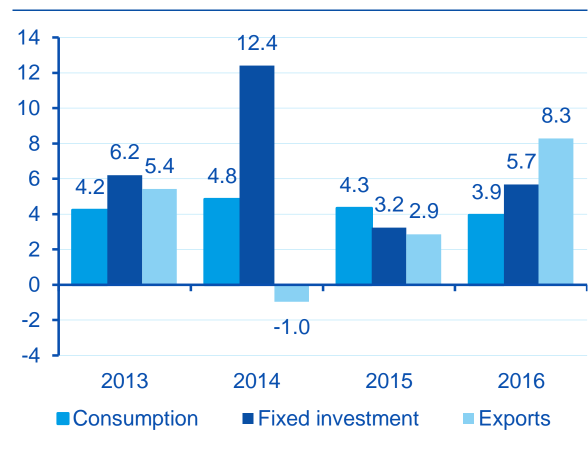
We expect to see growth of 3.6% in 2015 (Figure 4.3). New sources of growth will be essential if this result is to be achieved. Industry and agriculture will play an important role, along with continuing strong levels of private consumption that will benefit trade, and active spending by government authorities.

Figure 4.3
Observed and estimated GDP



Source: BBVA Research and DANE.

Figure 4.4
GDP: observed and estimated



Source: BBVA Research and DANE.

We do not expect lower oil prices to have a direct effect on the economy in 2016, since prices will be on an upward curve. However, there will be a notable indirect effect: the fiscal adjustment that will have to be made as a result of lower oil revenues (see section 5). This will have two implications. Firstly, the potential rise in the VAT rate in 2016 will cause growth in consumption to slow to 3.9% in 2016, down from 4.3% in 2015. Secondly, the adjustment in public spending by both central and local government (through lower royalties, for example) will have a negative effect on current spending and public investment, with the resulting reduction in the GDP growth rate.

In total, in 2016 we expect to see growth of 4.0%, lower than we forecast three months ago (5.0%), with greater balance across the sectors and relatively close to the potential level for the country's economy, which by then will have fallen to 4.3%-4.4%. The main thrust will come from exports (Figure 4.4), with year-on-year growth of 7.6% thanks to an upturn in oil prices and the greater advantage taken by the industrial and

agricultural sectors of the free trade agreements with Europe and the US, against a background of a real-terms devaluation in the exchange rate lasting more than two years (part of 2014, 2015 and 2016).

Given these results, the country will experience a slightly negative trade gap over 2015 and 2016, after enjoying a basically balanced phase for most of 2014. In this context, inflationary pressures caused by the intensity of demand will be only slight (or non-existent) over the coming two years.

5 Fiscal accounts: tax reform in 2016

2015 will be a quiet year for the finances of the Colombian National Government

Although the government's Medium-Term Fiscal Plan (MFMP) provided for a considerable fall in mining and oil revenues (due to factors other than lower crude prices), contemplating a fall, according to the government's own accounts, from 20% of its income in 2013 to 15% in 2014, these calculations did not include a fall in the oil price. Based on this scenario, and without considering a lower oil price, the government foresaw a reduction in dividends from Ecopetrol, amounting to a decrease from 1.9% of GDP in 2013 to 1% in 2015.

As a result, the Tax Reforms went beyond covering the hole left by the dismantling of the tax on wealth and financial transactions and sought to counteract the lower revenues from oil. However, the reforms did not take account of a scenario involving lower oil prices, so the government was forced to update the deficit forecast for 2015. This deficit rose from 2.4% of GDP (forecast in the MFMP in June 2014) to 2.8% in the new environment of less favourable oil prices. This difference is equivalent to requiring additional resources amounting to COP3.6trn in 2015.

Of this amount, COP1.7trn will be funded by internal borrowing, by greater net resources generated by the higher exchange rate, and by dollar resources obtained in 2014 with the aim of pre-financing 2015. However, if the 2014 issue was financing for 2015, the issues that the government planned for 2015 will have to be reduced. Nevertheless, according to its most recent Financial Plan, the government is not going to reduce issues in dollars in 2015, and these resources will therefore finance part of the higher deficit. It should be noted that there is enough room domestically to finance this higher deficit in 2015, since domestic debt swaps and debt management transactions were carried out with the National Treasury in 2014, and these considerably reduced repayments for 2015.

Based on the above accounts, financing the greater deficit would seem highly feasible, and would presumably not affect the markets. As mentioned in section 3, January saw an issue on the international markets of USD1.5bn, from a total amount of USD2.5bn planned for 2015, at a highly favourable rate and with demand that considerably outstripped the government's expectations (the total amount of external financing for 2015 is USD5.1bn, USD2.5bn in bonds and USD2.6bn with multilateral institutions).

In short, it seems 2015 will be a quiet year for the finances of the Colombian National Government, thanks to the higher levels of revenue obtained as a result of the tax reforms implemented at the end of 2014, the flexibility introduced by the fiscal rule allowing the observed deficit to be higher than the structural deficit (due to the mining energy and economic cycle), and the space available for financing a higher deficit (Figure 5.1). The fiscal situation will be tighter in 2016. The deficit that must be met under the fiscal rule will require greater income and/or an adjustment in spending that will amount to the equivalent of 0.7% of GDP. We believe that the majority of this adjustment could come from income generated by tax reforms that could raise VAT by 2 percentage points.

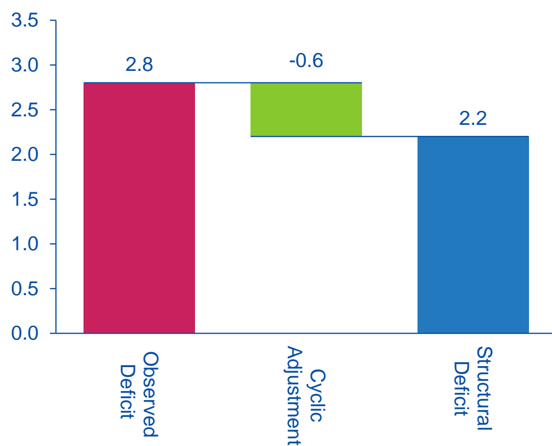
Tax reforms will be required in 2016.

According to our estimates, the deficit in 2016 will reach 2.5% of GDP; of this, 0.3% of GDP will be due to the lower cyclical revenues resulting from the fiscal rule and 2.2% will correspond to the structural deficit (Figure 5.2). Without the restriction on the deficit imposed by the fiscal rule, the deficit would reach 3.2% of GDP, 1% higher than the structural deficit for this year. This higher deficit is basically accounted for by lower than expected oil prices in 2015 (compared with the prices expected by the government in June 2014), and to a greater extent by higher interest payments and less efficient revenue collection than was expected by the government. To cover the difference between the deficit of 3.2% of GDP that would be recorded if the

fiscal rule did not exist, and the deficit allowed under the fiscal rule, the government could, on the one hand, raise the VAT rate (a two point internal and external rate rise would bring 0.5% of GDP) and, on the other, reduce spending by 0.2% of GDP. BBVA Research does not under any circumstances consider that the fiscal rule will not be honoured, given the benefits it has clearly brought.

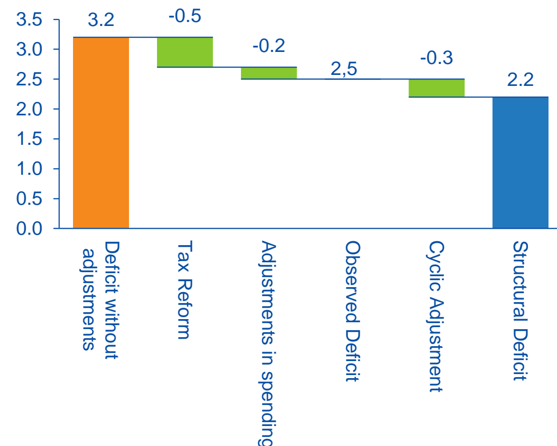
We must stress the importance of the fiscal rule for softening and moderating the impact of commodity prices and economic cycles on both the government's accounts and the macroeconomy. At times of economic expansion or a boom in the oil sector, the rule encourages contractionary fiscal policies and thus stops the economy from overheating, while in periods of economic contraction or a decline in the oil industry, the rule promotes an expansionist fiscal policy and thus lessens any potential economic slowdown. In this regard, the fiscal rule and monetary policy are fairly well aligned. Another important aspect of the fiscal rule is the way it treats resources generated by commodities, by requiring the reserving of any resources that exceed long-term forecast thresholds and their use during periods of lower revenues (below the threshold). The fiscal rule therefore allows for the smoothing out of the economic cycle, and this reduced macro volatility, combined with the lower capital costs and greater general stability that it brings, strengthens economic growth in the long term. Finally, but no less important, there is the credibility in the markets afforded by the fiscal rule, which as we have already mentioned resulted in the placement of the most recent external bond issue at an excellent rate, despite acknowledgement of a higher fiscal deficit for 2015.

Figure 5.1
Breakdown of the deficit in 2015



Source: BBVA Research and the Tax Ministry

Figure 5.2
Breakdown of the deficit in 2016



Source: BBVA Research and the Tax Ministry

6 The increase in the current account deficit is a contained risk and will correct itself in 2016

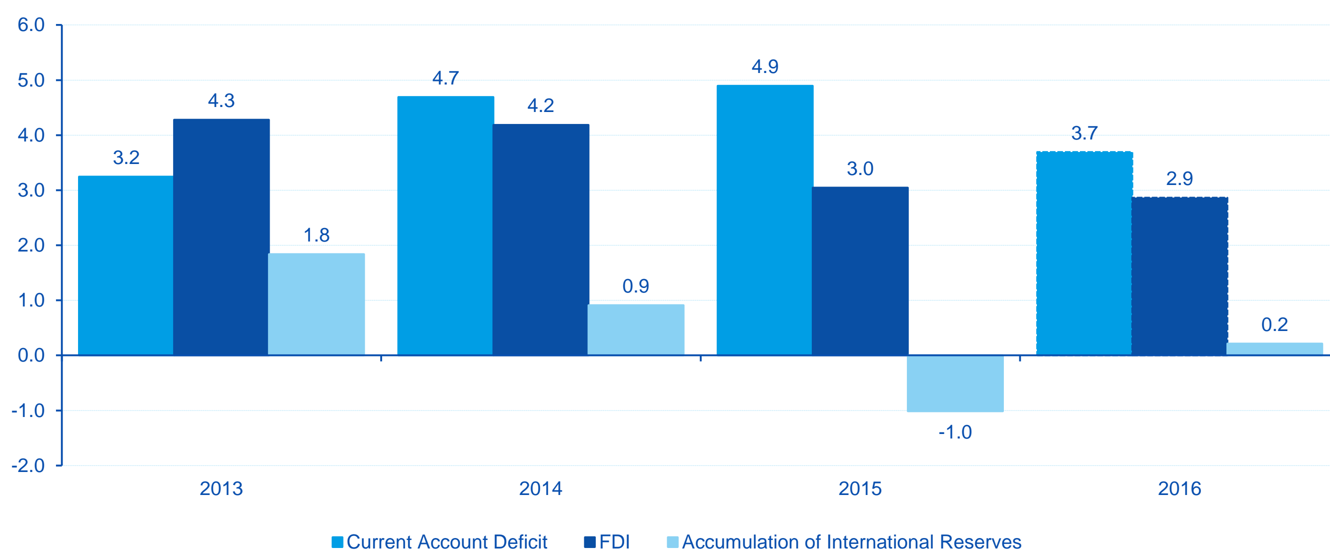
The lower oil price will reduce the value of exports

2014 saw strong domestic demand lead to high levels of imports, and this combined with shocks in the mining sector and a falling oil price to reduce exports. As a result, the current account deficit grew notably, reaching around 4.7% of GDP by the end of the year, according to our own estimates.

Looking ahead to 2015, the supply-side bottlenecks suffered in 2014 in the mining sector (coal and oil) have now been resolved, especially the environmental issues relating to the transportation of coal. Exports in sectors other than mining (industry and agriculture) will benefit from the devaluation in the real exchange rate and the greater demand from developed countries. However, the average oil price will fall on average by around 34% from its 2014 value, and this will have an effect on the revenues from total exports. As a result, exports in dollars will experience an 11.1% year-on-year fall in 2015, despite a rise of 12.7% in non-traditional exports (37% of the total). In 2016, exports will recover their strength and grow by 14.7% year-on-year, with similar levels of growth recorded in both mining and non-mining activities, the former driven by a recovering oil price and the latter by increased external demand, helped by even greater devaluation.

Imports will remain stable in dollar terms during 2015 (0.0% annual growth): the slowdown in internal demand variables, including consumption, will be less pronounced than in exports. There will also be continuing demand for investment from industry, which is satisfied for the most part by imports. In 2016, imports will be moderated by the slowdown in private consumption, though they will jump by around 7% YoY, a figure that is low compared with previous periods of recovery. Finally, the profits earned by foreign companies in 2014 will guarantee that earnings remitted abroad during 2015 will remain high, though this will see a notable correction in 2016 as a result of reduced profits in the mining industry. The remittance of earnings will therefore bring more pressure to bear on the country's external accounts in 2015 than in 2016. As a result, the current account deficit is expected to stand at 4.9% of GDP in 2015 and 3.7% of GDP in 2016 (Figure 6.1).

Figure 6.1
Macroeconomic conditions in Colombia: 2014 and forecast for 2015



Source: BBVA Research and Bank of the Republic

The slight decumulation of international reserves does not compromise macro-economic stability

During 2015, the financing of the current account will not be fully met by external sources. On the one hand, FDI will account for 3.0% of GDP (vs. 4.2% of GDP in 2014), due to a slowdown in investment flows directed towards the mining industry. On the other hand, other resources such as portfolio capital and borrowings will cover around 1% of GDP, which is also less than the 1.4% recorded in 2014. Thus, while the current account will stand at 4.9% of GDP, external capital resources will only reach 4.0%. We therefore expect a decumulation of international reserves amounting to around 1% of GDP over the course of the year (equivalent to a sale of foreign reserves worth USD3.4bn).

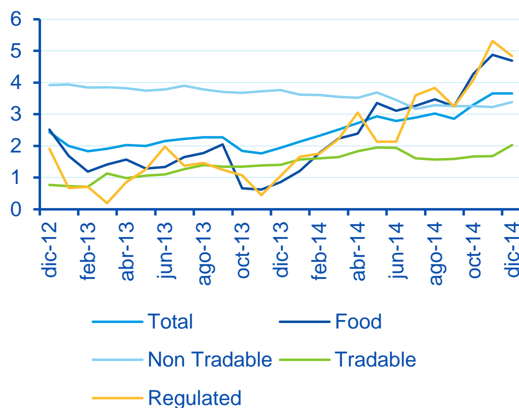
This fall in the level of international reserves will not be a threat to the economy. Reserves will remain equivalent to nine months'-worth of imports and, as a percentage of GDP, will stand at 12.9%, remaining above the level of 10% of GDP recorded in 2010 and 2011.

7 Inflation in 2015 and 2016 will stay at the top part of the target range

Inflation in 2014 ended higher, more as the result of supply factors than due to pressures of demand.

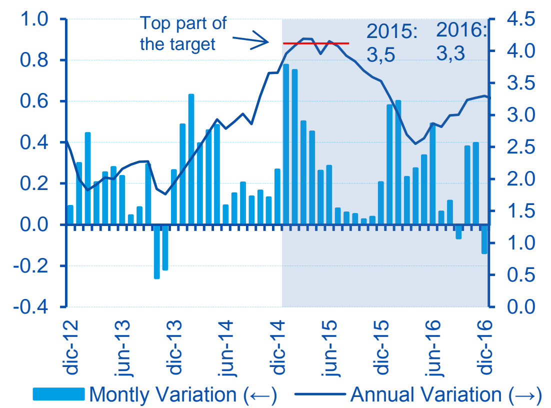
The overall inflation figure for 2014 stood at 3.7%, driven by a rise in food price inflation which ended the year at 4.7% (compared with 0.9% in December 2013) and regulated items (increases in public utilities, particularly gas and energy), which recorded a rise of 4.8% (compared with 1% at December 2013). The inflation figure excluding food and regulated items (one of the indicators of basic inflation that serves as a barometer for measuring demand pressures) rose slightly from 2.7% to 2.8% between December 2013 and December 2014. However, other basic inflation indicators that we have been following showed more pronounced changes, and an average of all of these indicators shows a rise of 2.9%, 50 basis points higher than at the end of 2013. Another factor that influenced inflation was the rise in tradable goods prices, which accelerated over the second half of 2014 as a result of devaluation, rising from an annual rate of 1,6% in August to 2.0% in December (see Figure 7.1).

Figure 7.1
Inflation in 2014 by group (year-on-year change, %)



Source: BBVA Research and DANE

Figure 7.2
Inflation forecast through to 2016 (%)



Source: BBVA Research and DANE

The transfer effect from devaluation to inflation is low and will furthermore be offset by the slowdown in economic growth.

In 2015 we expect to see devaluation at an average annual rate of 20.6% (16 pp above our forecast in the previous outlook report), with the exchange rate reaching maximum levels during the first quarter of the year. This effect, combined with the sharp devaluation seen during the second half of 2014, will push inflation upwards during the first half of this year. We therefore expect inflation to reach around 4%, and at some points during the first six months of the year it will rise above the upper limit of the Bank of the Republic's target range (Figure 7.2). It should be noted that these rises are happening in the context of a slowing economy, and they will also take in the effects, though marginal, of the rising food prices that could result from the El Niño phenomenon. Finally, the effects of this depreciation will disappear over the latter part of the year, meaning that inflation during the second six months will be lower (averaging 3.8%). As a result, price rises will be temporary and the inflation rate at the end of 2015 will be running at 3.5%, 20bp above the rate forecast in our last Outlook.

A potential increase in VAT in 2016 will prevent inflation from attaining the Bank of the Republic's mid-point target

We forecast that the potential tax reforms planned for the end of this year will include an increase of two percentage points in the VAT rate. We calculate that this increase will push inflation up by 20bp in 2016. This pressure on prices will be offset by a slower growth rate and by a more significant base effect than we estimated in our last Colombia Outlook. We therefore expect inflation in 2016 to run at around 3.3%, an identical rate to the one forecast in our previous outlook.

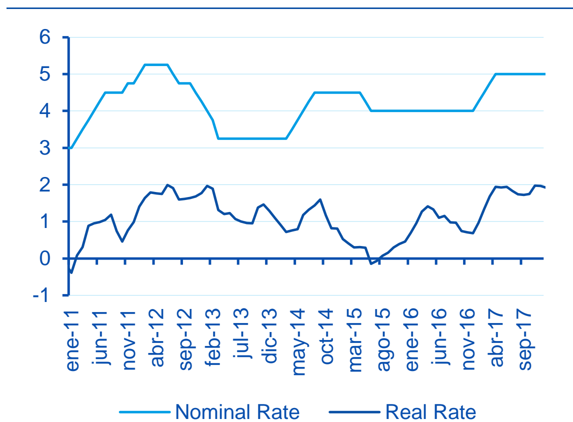
8 Monetary policy: a boost for economic activity

The slowdown in growth and a contained inflation rate offer the Bank of the Republic some room for manoeuvre.

The oil price shock will have a significant impact on economic growth during the first three quarters of the year, with the result that growth will fail to reach its potential levels over the coming two years [see Section 4]. On the other hand, inflation will rise during the first few months of the year as a result of the devaluation seen at the end of 2014 and the beginning of 2015, along with the impact of the El Niño phenomenon on food prices and some energy items. This is a supply-side shock and a temporary one, and the Bank of the Republic's reaction should therefore be limited, especially if market forecasts for inflation remain fixed within the target range for the coming years. To this extent, the slowdown in the economy and the supply-side shock on inflation with its fixed forecasts offer the Bank of the Republic some room to make its monetary policy more flexible.

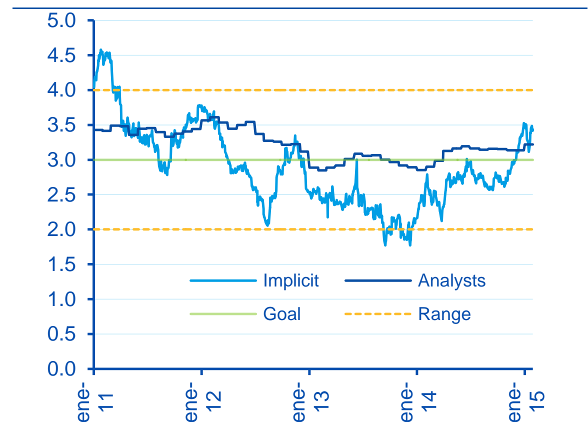
By contrast, three months ago we expected to see interest rate rises over the coming year, but given the state of the oil price, its prospects over the next few years and the impact that this will have on growth, we now anticipate a possible reduction of 25bp in intervention interest rates in both May and June, bringing the rate down to 4.0% (see Figure 8.1). This additional boost will be necessary in order to limit the impact of lower oil prices on levels of private investment, as well as to stimulate industrial confidence (which would seem to have been affected by the tax reforms) and prevent a further slowdown in consumption. If not, the contraction in aggregate demand could result in the country continuing to fail to achieve its true growth potential.

Figure 8.1
Nominal and real intervention rate (%)



Source: BBVA Research and Bank of the Republic

Figure 8.2
Inflation forecast at one year (%)[1]



Source: BBVA Research and Bank of the Republic
[1] Underlying inflation rate calculated on one-year government bonds

Forecasts for inflation condition the use of monetary policy

We believe that despite the highly probable slowdown in growth over the first quarter of the year, the Bank of the Republic will not be able to react until the second quarter, due to a lack of substantiation in the growth data and an inflation figure that will rise slightly above the upper limits of the target range during the first few months of the year. Only when the annual inflation rate seems to be coming down, around March (even though it may remain above the target range), would we expect the Bank of the Republic to be able to reduce the interest rate without significantly affecting the prospects for inflation.

Subsequently, monetary policy will remain expansive and at the same level for a prolonged period of time, due to the fact that growth in GDP will remain below its potential level until the end of 2016. We expect the process for the normalisation of monetary conditions towards a neutral rate to begin from January 2017.

The rise in interest rates by the US Federal Reserve could be absorbed by the economy without adverse effects

In our global outlook we expect to see a preliminary rise of 25bp in the Federal Reserve rate during the second half of the year, in line with the normalisation of monetary conditions and consolidation of the recovery of growth in the United States. This will represent a challenge for developing countries, as capital costs will increase and this will lead to a reduction in the attractiveness of emerging economies. Colombia will not be immune from this risk, though we believe that the country's economy displays the necessary conditions to withstand it without too many adverse effects.

First and foremost, the flexibility of the country's exchange rate will allow the economy to adjust to the new international financial conditions and partially offset the reduced attraction for international investors arising from the higher differential in interest rates, since the price of Colombian assets will fall for those buying in foreign currency.

Secondly, the reduction in intervention interest rates during the second quarter of the year will increase the interest rate differential with the US, which will most probably make the inflow of portfolio capital into the country less attractive. Nevertheless, even in the face of the Bank of the Republic's anticipated reduction of the interest rate to 4.0%, this rate will still remain attractive to international investors who either want or are forced to maintain exposure in Latin America. This is due in particular to the lower rates maintained in real terms in other countries in the region with equivalent levels of perceived risk.

Thirdly, the Bank of the Republic has repeatedly highlighted the limited risk of mismatches in the corporate and financial sectors (the latter as a result of existing macroprudential regulation), meaning that the sharp depreciations have not been a source of concern for the central bank. In contrast to the experiences of 1998, the appreciation of the Colombian peso between 2010 and the middle of 2013 did not lead to a disproportionate rise in foreign currency borrowing in the corporate sector. Furthermore, the proportion of government borrowing held in foreign currency fell during 2014 and currently accounts for no more than 30% of the total, a factor that will also limit the impact of any additional devaluation on the fiscal accounts, as well as limiting any pressures that could arise due to the containment of greater devaluation.

Finally, the impact of devaluation on inflation has been low, and will probably remain so during 2015 as a result of the expected slowdown in the economy and the low proportion of tradable goods (26%) in the average basket of consumer products bought by Colombians. This affords the Bank of the Republic some room for manoeuvre and means that the pass-through will be limited and will not compromise the inflation target.

9 Exchange rate: devaluation in progress

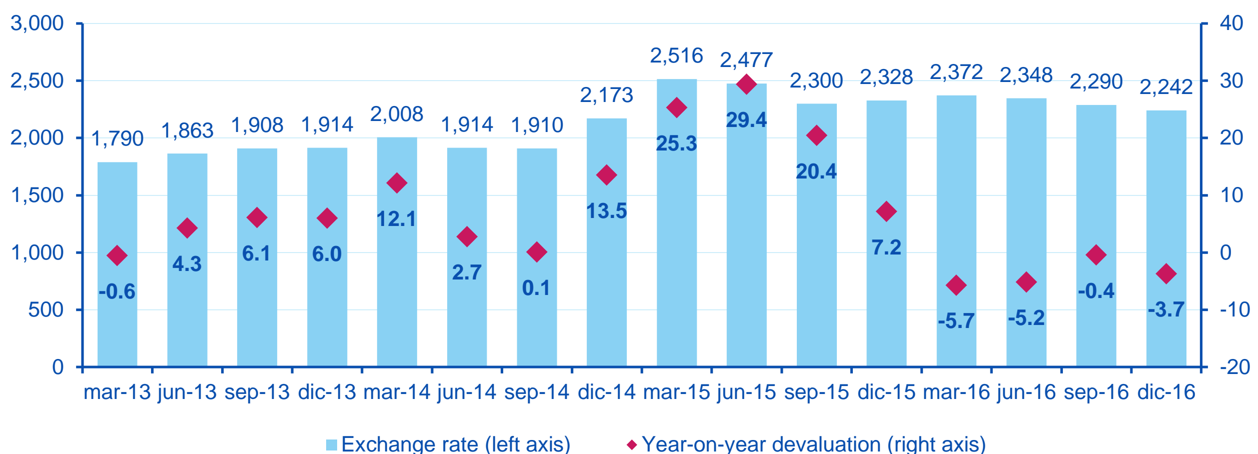
Exchange rates should reach their highest level throughout the first quarter and the beginning of the second quarter of 2015. This will be due to the oil price curve, which will reach its lowest levels during this period, as well as to expectations of a reduction in interest rates by the Bank of the Republic. From that point on, in line with higher international oil prices, the exchange rate will see a downward correction through to the third quarter, though it will remain at significantly higher levels than have been seen, on average, in recent years. During the final part of the year the exchange rate will once again show an upward trend, since the US Federal Reserve is expected to raise interest rates for the first time, in order to introduce a cycle during which monetary policy will be hardened and which will continue for several years. At the end of 2015, the observed rate will be very close to the rate recorded at the close of 2014 (Figure 9.1).

The exchange rate will continue to rise during the early part of 2016. This will be due to the decisions made by the Fed, which will continue to normalise its policies. However, there will subsequently be a slow correction as foreign currency reserves increase due to exports, given the strong recovery shown in the export sector and the increased growth in domestic GDP. The equilibrium level for the nominal exchange rate, which we currently estimate at COP2,100 to the dollar, will be reached at the end of 2017, when GDP has returned to its potential level and the monetary policy rate is neutral in relation to economic activity (at 5.0% of economic activity).

These movements in the exchange rate, which will lead to devaluation in real terms (i.e. greater competitiveness for the country), will be highly beneficial with regard to the gradual reduction of the current account deficit, since they will boost non-mining-related exports and provide a disincentive for imports. This adjustment mechanism would not be possible using any method other than the floating exchange rate system, which represents one of the country's main weapons against external shocks. Moreover, some of the strongest growth expected in 2015 and 2016 in industry and the agriculture sector are due to this shock-absorbing factor in the Colombian economy.

Figure 9.1

Exchange rate and annual devaluation rate (USDCOP, average quarterly rate; annual devaluation shown as %)



Source: BBVA Research and Bank of the Republic

10 Risks that have a downward effect on the Colombian economy

The main risk to the economy is the persisting low price of oil

Our economic outlook is based on an average Brent price of USD65 in 2015 and USD75 in 2016. However, a lower price remains within the realm of possibility, though the likelihood of this happening is less than we suggest in our central outlook. Against this background, growth in the Colombian economy could be even further reduced in 2015, though it will not fall below 3%, the level that we have set as the floor for the projections we have made in a range of different scenarios.

However, there are further distinct risks (other than the price of oil) that could also adversely affect the country's growth. Firstly, a greater widening of the current account deficit combined with lower capital inflows could lead to an adjustment in domestic demand, which would prevent private consumption from acting as a support for growth in the manner shown in our base scenario. Secondly, recovery in the industrial sector is essential if favourable levels of employment and domestic production are to be maintained. However, we have still not seen a complete recovery in this sector, and the start-up of the Cartagena refinery at full capacity still remains uncertain. Thirdly, the execution of public spending by both national and regional government must be high in 2015.

An inflation rate significantly above the target range could disappoint the economic agents' expectations and restrict monetary flexibility

In addition, an unexpected rise in inflation that brings the rate significantly above the Bank of the Republic's target range during the early part of 2015 could disappoint the expectations of economic agents and thus restrict the central bank's flexibility to combat lower growth with a more expansive monetary policy. In this scenario, the Bank of the Republic would not be able to reduce the intervention rate by the 50bp forecast but would instead be forced to increase rates in order to control inflation and bring it back within the target range. If the central bank is unable to reduce interest rates due to worries about inflation, the growth forecast for 2015 and 2016 will be lower.

11 Tables with macroeconomic forecasts

Table 11.1
Annual macroeconomic forecasts

	2013	2014	2015	2016
GDP (% YoY)	4,7	4,9	3,6	4,0
Private Consumption (% YoY)	4,2	4,8	4,3	3,9
Public Consumption (% YoY)	5,8	5,9	4,0	3,3
Fixed Investment (% YoY)	6,1	12,4	3,2	5,7
Inflation (% YoY, eop)	1,9	3,7	3,5	3,3
Inflation (% average YoY)	3,2	2,9	3,9	3,0
Exchange Rate (vs. USD, eop)	1.927	2.392	2.355	2.235
Devaluation (vs. USD, eop)	9,0%	24,0%	-1,5%	-5,1%
Exchange Rate (vs. USD, avg.)	1.869	2.001	2.414	2.313
Devaluation (vs. USD, avg.)	3,9%	7,1%	20,6%	-4,2%
Central Bank Interest Rate (%, eop)	3,25	4,50	4,00	4,00
FTD Interest Rate (% eop)	4,06	4,34	4,09	4,11
Unemployment Rate (%, eop)	9.7	9,3	9,4	9,0
Fiscal Balance (% GDP)	-2,4	-2,4	-2,8	-2,5
Current Account (% GDP)	-3,2	-4,7	-4,9	-3,7

Source: DANE, Banco de la República, Ministerio de Hacienda y BBVA Research Colombia.

Tabla 11.2
Quarterly macroeconomic forecasts

	GDP (YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD eop)	Interest rate (%, eop)
Q113	3,0	1,9	1.832	3,25
Q213	4,5	2,2	1.929	3,25
Q313	5,7	2,3	1.915	3,25
Q413	5,5	1,9	1.927	3,25
Q114	6,5	2,5	1.965	3,25
Q214	4,3	2,8	1.881	4,00
Q314	4,2	2,9	2.028	4,50
Q414	4,5	3,7	2.392	4,50
Q115	2,7	4,2	2.600	4,50
Q215	3,6	4,2	2.400	4,00
Q315	4,0	3,8	2.300	4,00
Q415	4,1	3,5	2.355	4,00
Q116	3,7	2,7	2.380	4,00
Q216	3,7	2,9	2.330	4,00
Q316	4,1	3,0	2.270	4,00
Q4 16	4,5	3,3	2.235	4,00

Source: DANE, Banco de la República y BBVA Research

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