BBVA | RESEARCH

Colombia Economic Outlook

Second quarter 2015
Colombia

- The global recovery continues, but the improvement is hampered by the slowdown in the emerging economies. Global GDP will quicken from 3.5% in 2015 to 3.9% in 2016.
- We expect GDP growth of 3.1% for 2015 and 3.6% for 2016. These downward revisions are due to the prospect of lower investment and less dynamic private consumption.
- Lower revenues from taxes and dividends deepen cuts in public spending. Ecopetrol's poor results and lower-than-expected revenue collection anticipate further cuts in spending and investment.
- Inflation will spend a large part of 2015 at over 4%. High food prices and the effects of the currency depreciation on imports account for this behaviour. We expect inflation to come back to within the target range and stand at 3.6% and 3.2% at the end of 2015 and 2016 respectively.
- The central bank will leave its benchmark rate unchanged at 4.5% in the medium term. Higher inflation expectations, a drop in the economy's potential growth and low real interest rates justify this view.

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Closing date: 30 April 2015

1 Overview

April saw capital flows reverse their fall of March. In that month the share of foreign capital funds in holdings of public debt fell back while TES (peso-denominated treasury bond) rates rose, thereby accentuating both depreciation of the exchange rate and downward movements in the stock market index, whereas in April, along with capital flows, market trends staged a turnaround. **Looking ahead, the Federal Reserve rate hikes will represent a major challenge for the Colombian economy**.

2014 closed with GDP growth of 4.6%. **We still believe that the Colombian economy will slow down compared to previous years because of the lower oil price, although we now think that the deceleration will be sharper than previously expected:** consumer confidence has deteriorated very quickly, the fiscal accounts need a cut-back in investment and the monetary stimulus which we incorporated into our previous scenario now looks less plausible.

The government's fiscal accounts are in decline relative to our January scenario. Ecopetrol's poor 4Q14 results, the smaller percentage of distributable profits for 2015, and the lower revenue collection observed in 2014, lead to the conclusion that government revenues have declined and that spending should be reined in. Although in our last scenario we discussed the need for reforms to be made of the order of 0.5% of GDP for 2016, current circumstances might call for these to be more ambitious. A halfway and viable solution could be a tax reform that lifts revenues and for the government to simultaneously cut back on spending. The new scenario will, in any case, have adverse effects on the economy.

2015 growth will thus be 3.1% (vs. the previous forecast of 3.6%). For 2016 we have also revised our growth figure down, from 4.0% to 3.6%. For the medium term we have redefined our path for the economy's potential GDP to bring ourselves more into line with the new oil industry situation.

The current account deficit should be 5.1% of GDP in 2015 and 3.7% in 2016. The fall in Foreign Direct Investment (FDI) and the thinner inflow of portfolio capital could lead to a decumulation of international reserves of less than 1% of GDP or greater foreign debt in 2015. In 2016 there will be enough financing to cover the external deficit.

Inflation will stand at over 4% for a large part of 2015. The surge in food prices and feed-through from the exchange rate to prices has taken inflation to over 4%. We expect inflation to come back to within the target range in 3Q15 and end the year at 3.6%. **Recent price movements raised inflation expectations for 2015**, although these remain anchored in the medium term. For the end of 2016, we see inflation standing at 3.2%.

We are changing our monetary policy outlook and we now think that rates will hold stable at 4.5%, instead of the 50bp cut which we envisaged in our previous scenario. The rise in inflation expectations, as well as high credit growth rates, among other reasons, account for our change of prognosis. Any change of monetary stance will hinge on the data on the economy and we do not rule out a rate cut if activity slows down by more than we expect.

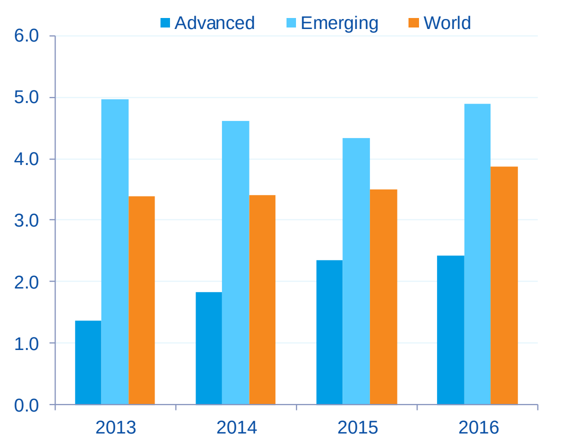
A further fall in the oil price and failure of the economy's recovery to consolidate in the developed countries are the major external risks. Domestically the risks loom on four fronts: a downturn in domestic confidence, a bigger current account deficit, poor investment execution by the government~~,~~ and a misfire in industry's attempts to get off the ground despite the exchange rate depreciation.

2 World growth is suffering from the slowdown in the emerging economies

World growth lost momentum in the first quarter of 2015

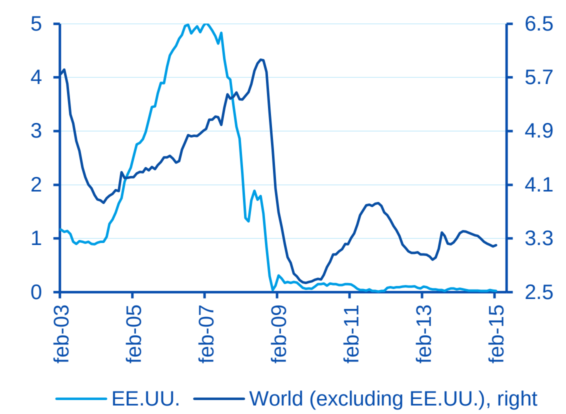
The first quarter slowdown in world growth was prompted by the slowdown in the US economy, the reduced dynamism of China, and the decline in activity in certain key emerging economies (such as Russia and Brazil). The consolidation of growth among the developed countries contrasts with the almost general loss of steam among the emerging countries, which is more intense in Asia and Latin America than in Eastern Europe.

Figure 2.1
World GDP growth (%): 2015-16 forecasts



Source: BBVA Research

Figure 2.2
Nominal short-term interest rates (%)



Source: BBVA Research

We are therefore revising world growth for 2015 to 3.5%, 0.1pp less than forecast in January and only 0.1pp more than the 2014 level (Figure 2.1). In 2016, world GDP should record an average growth of 3.9%, partly as a result of the expansive monetary policies in the developed countries, which ought to achieve their best registered figure since 2010. The emerging economies should, within a scenario of a trend of gradual slowdown in China, manage to reverse the current decline thanks to the positive spill-overs from the developed economies, the steady increase of commodity prices and a cycle of interest rate hikes by the Fed that will be more gradual than in previous episodes.

The progressive rise in commodity prices, in line with our forecasts, and the reinforcement of loose monetary policies have been two of the most remarkable elements in the economic global picture in recent months. There has actually been a greater degree of proactive moves by central banks, in both developed and emerging economies. Even if the Fed might have decided on a strategy of gradual monetary tightening, the emerging economies have chosen to give priority to kick-starting their domestic demand by looking to cut interest rates

(Figure 2.2), in some cases at the cost of accepting greater exchange-rate volatility and running the risk of reduced incentives for foreign capital inflows.

On balance, and although economic policies will continue to be accommodative, the risks to the downside persist for world growth. The most significant of these rest with the extent of the slowdown in China and the spill-overs coming from the beginning of the Fed's rate normalisation process. The deflationary pressures associated with the oil price, geopolitical tensions and any failure of the ECB to reactivate inflation expectations in the eurozone are risks that, despite appearing less likely and less significant in terms of expected impact than some months ago, cannot be ruled out. Finally, a risk which still lurks in the wings is that of a failure to reach agreement between the Greek government and the European institutions and the IMF on how to refinance its debt.

US growth dampened in the first quarter...

The United States has begun 2015 with a substantial slowdown in its growth rate to an annualised quarterly rate of 0.2%, which compares with an average increase in the previous three quarters of 1%. The unusually harsh weather conditions account for a portion of the slowdown, added to which are the lower oil price, with its impact on the energy sector, and the early effects of the dollar appreciation on exports. Overall, the strength still shown by the labour market should continue to support household income and private consumption. US YoY growth could therefore reach 2.9% in 2015 and hold at rates approaching 3% as well in 2016.

The interpretation which the Fed makes of whether the lower first-quarter growth is transitory or permanent will define how it reacts from now on. The most likely scenario is that the first rise in the Fed funds rate will occur in September 2015, with a subsequent gradual rise, reaching not more than 1.5% at the end of 2016.

... as it also did in China

In China, the economic slowdown has accelerated in the last few months, with growth of 7% YoY in 1Q15 and an adjustment in industrial production and investment, though there was a better relative performance from private consumption. The slowdown was brought about by the correction underway in the real estate market, the political uncertainty ahead of the National People's Congress in March, the decline in competitiveness abroad from the appreciation of the renminbi worldwide and the effects of fiscal consolidation of local authorities which began in 2014.

The structural nature of the factors mentioned above supports our assessment that China should grow more slowly in the medium term and with greater volatility. The target annual growth rate of 7% for 2015 which was set by the Chinese authorities relies on implementation of new stimulus measures, both monetary and fiscal. In 2016 growth will continue to adjust at 6.6%.

The eurozone has shown the most recovery in recent months

Of the developed economies, the eurozone is the one which has put in the best relative performance as 2015 gets underway. GDP could have grown at the quickest pace since mid-2011, with Germany and Spain heading up growth for the area as a whole. The recovery has been driven by the better financing conditions and the euro's depreciation, both of these triggered by the ECB's quantitative easing programme, together with the drop in the oil price. The less restrictive nature of fiscal policy and containment of falling nominal wages in the countries on the periphery are also helping to promote growth again. YoY GDP growth should thus be 1.6% in 2015, rising to 2.2% in 2016.

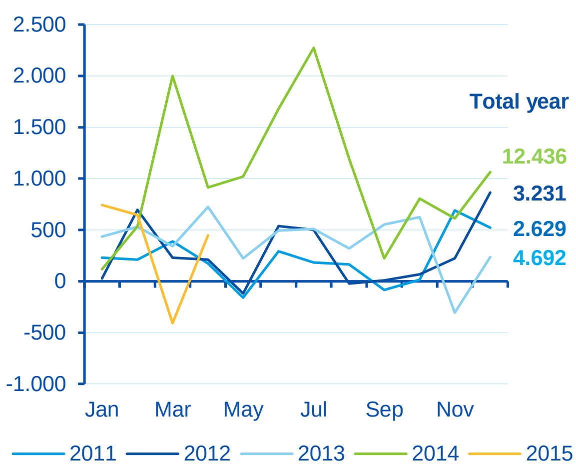
3 Capital flows and stock market performance hit by the low oil price

Capital inflows will become thinner in 2015

Capital flows waned in March, in terms of both FDI and portfolio investment. In the former case, according to the balance for foreign exchange, capital inflows in March totalled USD978mn, which was down on February's figure of USD1.042bn. This meant that in Q1 FDI stood at USD4.474bn, which is 25% below the level from the previous year. We estimate that, over the whole of 2015, FDI will come to USD10.4bn and feature a change in its composition, where funds invested in industrial and commercial activities, and to a lesser extent services, will take up a larger share to the detriment of the portion accounted for by oil investment (30% of FDI in 2014).

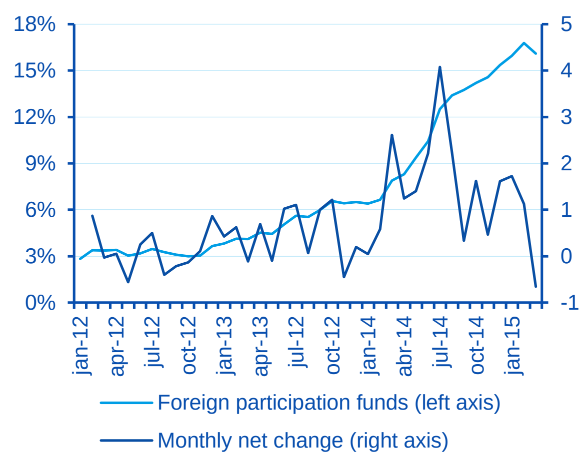
The slowdown in portfolio capital flows has been erratic. In March there were outflows of foreign investment capital (see Figure 3.1), which is something unseen since November 2013, when markets were anticipating tapering in the United States. Down too were holdings of government bonds by foreign capital funds, which had not happened since December 2013, where these lost out on 0.7pp in share between February and March, which took the portion accounted for by them to 16.1% (see Figure 3.2). This trend was to be expected given the historic inflow of capital in 2014 after Colombia was given a higher weighting in JP Morgan's government bond indices.

Figure 3.1
Foreign capital inflows by Portfolio (USD billions)



Source: Banco de la República and BBVA Research

Figure 3.2
Foreign participation in domestic public debt (%) and net change in position (COP trillions)



Source: Ministerio de Hacienda and BBVA Research

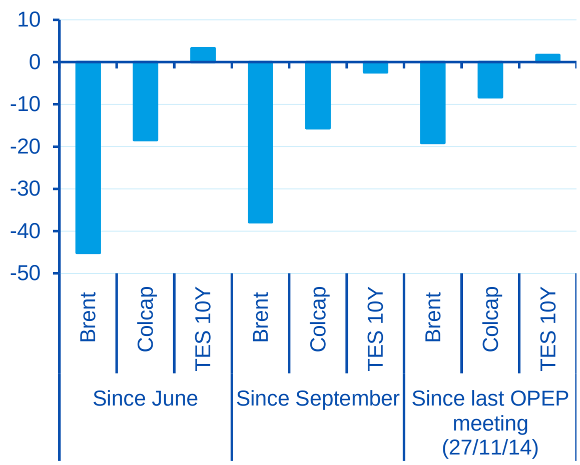
As a result of these events, in March TES prices lost ground, the exchange rate weakened and the stock market index saw slippage. As regards government bond prices in the market, the average rate on 10-year TES bonds in March was 6.90%, while in January and February the figures were 6.77% and 6.59% respectively. On the other hand, the USD hit a high in March, as we had predicted (see Section 5). The ColCap stock market index sank to its lowest level since November 2009 in March, and then began a gradual upturn.

These trends were slightly reversed in April, thanks to capital inflows, major companies raising cash to pay a substantial corporate income tax bill and a rise in the oil price (see Figure 3.3). According to figures as of 17 April, portfolio capital inflows amounted to USD447mn, which completely made up for the March outflow. Moreover, looking ahead, the stock market's performance could be boosted by exporter companies, which stand to benefit from the currency depreciation and external economic growth. All in all, for 2015 we estimate that portfolio capital inflows from investors abroad will be USD4.3bn, which is less than the inflows of USD12.4bn in 2014.

Finally, liquidity in the Colombian economy is still holding at an acceptable level: interbank rates and the DTF (fixed term deposit rate) remain very close to the central bank's benchmark intervention rate, which reflects the high availability of funds attracted from the public (see Figure 3.4).

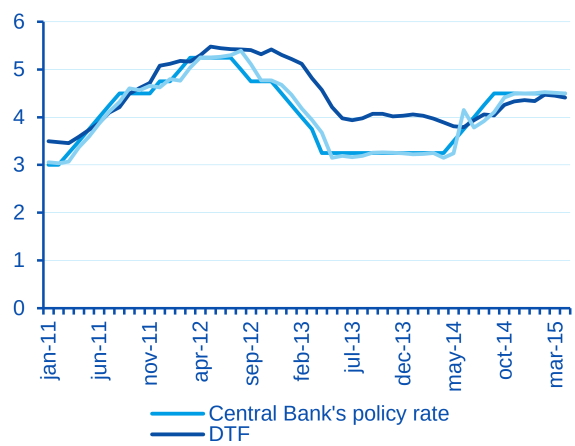
Further ahead, the Federal Reserve's rate hikes will pose a major challenge for the Colombian economy. Compensating for this, we think that the monetary expansion in Europe will have a positive effect on capital inflows into the Colombian economy, although these will be not nearly as heavy as those observed when a similar policy was pursued in the United States. In other words, the liquidity in the economy could be less voluminous, putting upward pressure on domestic interest rates, both in the credit market and in government bond trading. Given this situation, the government and certain Colombian companies have looked to international markets to ensure that their funding needs for the year are satisfied once and for all, since this is still a good time to find healthy international demand and low interest rates.

Figure 3.3
Recent behavior of some financial assets and commodities (variation, %)



Source: Banco de la República, BVC and BBVA Research

Figure 3.4
Interbank rates (E.A.R %)



Source: Ministerio de Hacienda and BBVA Research

4 The Colombian economy will grow at 3.1% and 3.6% in 2015 and 2016

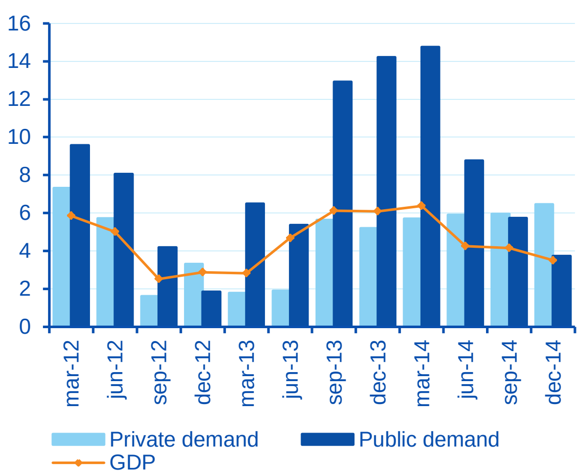
The 2014 close showed signs of economic slowdown

2014 closed with GDP growth at 4.6%, after a considerable slowdown in the final quarter (see Figure 4.1). Specifically, over the October to December period growth was 3.5% YoY (0.7% QoQ), held back by a lower increase in public works (public demand) and wilting demand from abroad (see Figure 4.2). In 2014 both of these items suffered a negative variation for the whole year, for the first time since 2009.

Meanwhile, private consumption picked up towards the end of 2014 in response to greater household spending on durable goods, especially private cars (see Figure 4.1). Consumers made the most of the low interest rates and the weak transmission of currency depreciation through to domestic prices to make purchases. Private investment also grew apace, driven by construction and capital goods, where some economic agents brought forward part of their planned investment for 2015 to avoid higher future costs of importing these.

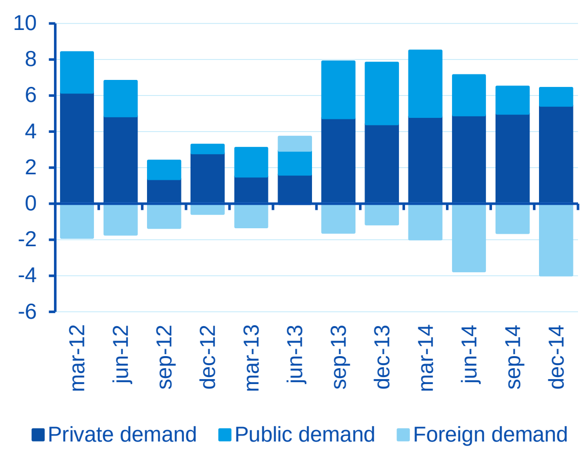
In the sector breakdown, in Q4 it was construction, wholesale and retail trade, personal and communal services and the financial sector, in that order, which experienced the most growth, with annual variations topping 4%. On the other hand, public works construction slowed down notably after the central government spending cuts in response to the oil price fall and its effects on revenue collection (see Section 6), while this could also have been due to the decline in investment by the country's oil companies. Mining and quarrying growth actually dropped back for three quarters in a row, and the fall in 4Q14 was the hardest in the last 10 years.

Figure 4.1
GDP by some components of demand (%, YoY)



Source: DANE and BBVA Research forecast

Figure 4.2
GDP by some components of demand (contribution to annual growth , pp)



Source: DANE and BBVA Research forecast

The overall balance for 2014 showed an industrial sector at a low ebb, hit by the closure of the Cartagena refinery (which is being modernised) and the painfully slow recovery in the other manufacturing sectors in spite of the exchange rate depreciation and the brighter performance by the United States. Overall, industry ended

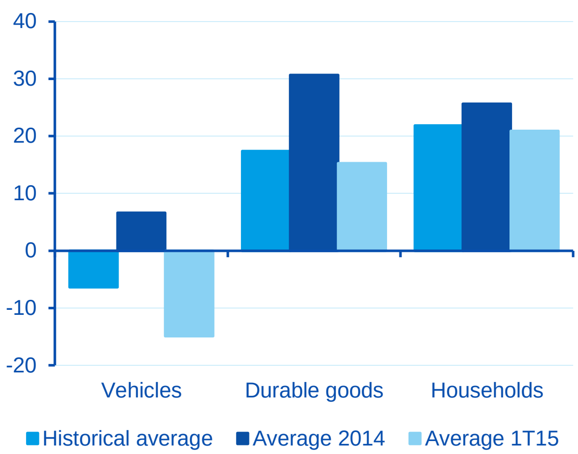
2014 with growth of 0.2%, with the refining industry, which accounts for 19% of industrial production, slipping by 8.7%. Construction was the sector marking the highest growth (9.9%), followed by social services and government (5.5%), social services and business (4.9%) and wholesale and retail trade (4.6%). The Colombian economy thus grew 4.6% in 2014, which is slightly lower than the rate of 4.9% in 2013.

Less buoyant private consumption and public investment mean a downward revision for economic growth in 2015 and 2016

As was the case three months ago, we still think that the Colombian economy will slow down compared to previous years, because of the lower oil price. We now believe, however, that this could mean a sharper-than-expected loss of momentum. The most recent consumer confidence data show that there was an extra unexpected decline and that households could be putting off their spending decisions. This relates to the heightened fear of job-loss which households feel, despite the healthy current state of the labour market (see Box 1). As a result, intended purchases of durable goods and homes have fallen considerably, where the reduction in this figure has been sharpest as regards willingness to buy vehicles (see Figure 4.3). At the same time, retail sales in the opening two months of the year eased up more notably than had been predicted by the market and BBVA.

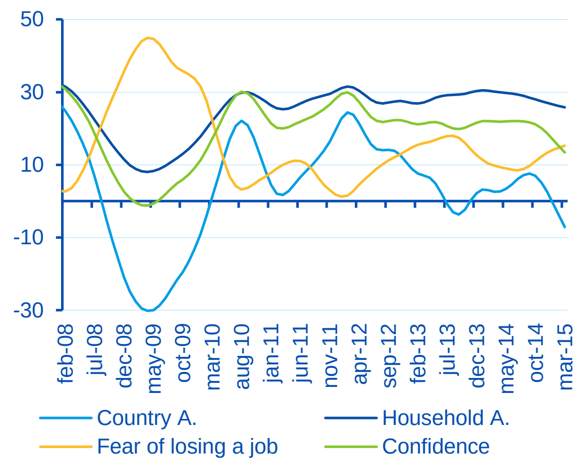
Consumer confidence stood at 2.3 for March, a level on a par with that seen in 2009, but the deferring back of current spending is unlikely to be comparable with the situation at that time. There is a key difference at the moment, which is that the lack of confidence is almost wholly explainable by the expected course which economic conditions are expected to take, while expectations of conditions affecting households declined to a lesser degree (see Figure 4.4). The continued strength displayed by the labour market means that households still show a positive outlook. Be this as it may, fears of losing jobs have become more in evidence, although this phenomenon is presently a long way short of the level reported during the 2009 crisis.

Figure 4.3
Willingness to buy households by type of good (net balance of responses)



Source: Fedesarrollo and BBVA Research

Figure 4.4
Household confidence (decomposition of ratings, net balance of responses)



*A.: assessment
Source: Fedesarrollo and BBVA Research

An additional reason for our revision for private consumption concerns monetary policy decisions. We are no longer anticipating a rate cut by the central bank this year, although we do think that the likelihood of this happening will hinge on how the economy responds to the lower revenues that are entering the national coffers due to the lower oil price. There is no doubt that a very sudden slowdown, that is more dramatic than we are counting on in this Outlook, would increase the likelihood of a cut. Yet the current set of conditions, with evidence that credit is still soaring ahead and inflation has surprised on the high side and pushed up expectations of its future course, while the external (current account) deficit is substantial, justify intervention rate stability (see Section 6). This shift in the monetary scenario will have an adverse impact on investment and consumption in 2016.

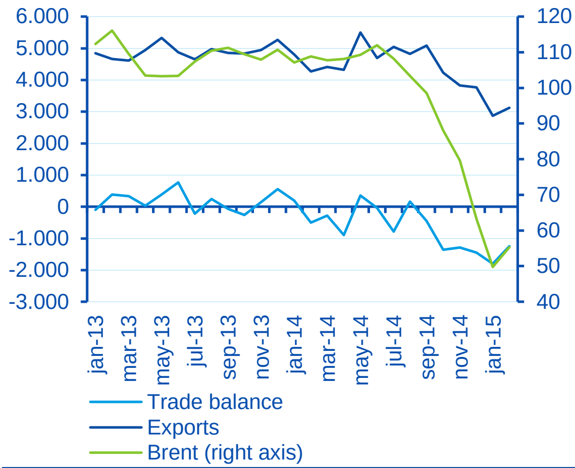
By our reckoning, every time the intervention rate goes up by one percentage point (100 basis points), private consumption slows down with a lag compared to the alternative scenario, featuring the absence of a rate cut, by 0.7pp. With regard to 2015 the effect of stable rates is almost unnoticeable, because apart from the fact that this is barely 50bp, the impact would probably start in November. Looking at 2016, the effect of higher rates does mean choking consumption growth by at least 0.3pp, which comes on top of the already noted adverse impact of a possible rise in VAT from January 2016.

Overall, adding in the dampening effect on consumption heralded by the decline in consumer confidence which we were envisaging in our previous scenario due to the withdrawal of the monetary stimulus, we think that private consumption will grow by 3.6% YoY in both 2015 and 2016. These are below the growth rates of 4.3% and 3.9% which we were estimating in our previous Outlook.

The effect of monetary policy will also be felt within private investment. A major portion of the rally in non-residential investment over 2015 and 2016 (25%) was incorporated as a result of lower interest rates. Since this driver has now been removed, we think that non-residential private investment will grow at rates of 1.3% and 4.0% YoY in 2015 and 2016 respectively, which compare with the rates of 1.3% and 5.4% from our previous scenario.

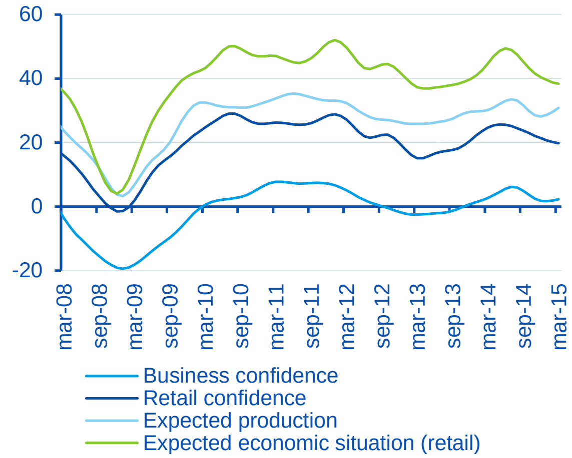
The other economic figures out to date have been in line with our expectations. Exports have still fallen away sharply, which is almost wholly attributable to oil price weakness (see Figure 4.5). Meanwhile, other headings show mild recoveries for specific products. On the one hand, industrial production performed negatively in Q1, in line with our prediction of a gradual recovery. If we take out oil refining, which showed a fall of 19% in the year to February, the industrial sector would indicate growth of 1%. Likewise, business confidence remains in positive territory, both as regards industry, and wholesale and retail trade, the latter revealing satisfactory opinions on future sales. Moreover, industry shows growing optimism over production in three months (see Figure 4.6).

Figure 4.5
Foreign trade (USD billions) and oil prices (USD)



Source: DANE and BBVA Research

Figure 4.6
Business confidence and expectations (net balance of responses – seasonally adjusted)



Source: Fedesarrollo and BBVA Research

We feel that industry and agriculture should be well-placed to recover towards H2 because of the exchange rate depreciation and stronger growth among the developed countries. It should be recalled that the United States and Europe together account for 42% of Colombian exports and 43% of non-fuel exports (cumulative data for January and February 2015). Furthermore, the Cartagena refinery should open in Q3, providing a final shove for industrial performance from that moment onwards. On the other hand, agriculture will grow at around 4.8% in 2015, pulled up by the rise in coffee production, especially in 2H15.

On the other hand, the government announced public spending cuts for 2015 ("postponed" expenditure of COP6trn) due to lower tax revenues and dividends from Ecopetrol, as well as to lower-than-expected growth of collected tax revenues in 2014[1]. The macroeconomic effect of this lower spending level was already evident to a large degree towards the end of 2014 in the slowdown in investment in public works, but we think that it could have a further impact over this year, especially on the investment item. We have, in fact, brought down our growth forecasts for public works in 2015 from 4.4% to 3.8% YoY. For 2016 we also cut this figure from 5.8% to 2.9%, owing to a correction which we have made in relation to available funds from royalties.

Specifically, the royalties which will be used in budget implementation in 2015 will represent a 25% increase over execution in 2014 of COP5trn. These funds will be vital to the success of regional and local governments in the final year of their mandates, even when subject to any restrictions on spending which the Electoral Guarantees Law might involve. We think that, because of the experience which governments have had in works contracting under such legal restrictions, they might have less adverse effects. Overall, funds from royalties and implementation will be the factors that will enable growth in public works this year, although at a low rate, by offsetting the reduced level of spending by central government.

On the other hand, in 2016 royalties will not be a factor behind any acceleration as they will be stable in nominal terms at COP6.3trn. Furthermore, regional and local governments will be in their first year of office. At the outset, the level of spending is always lower, as is witnessed by Colombia's economic and political cycle. Therefore

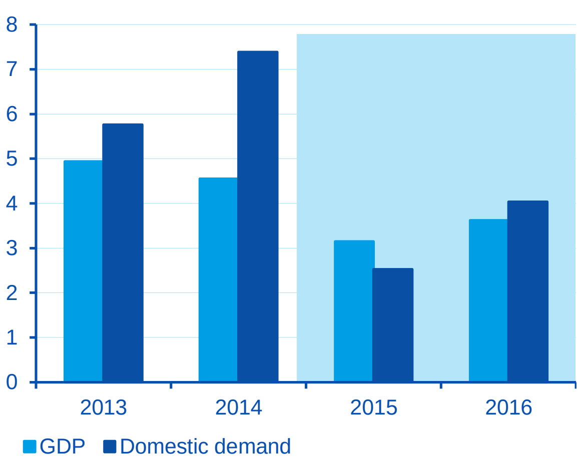
[1] The government was hoping for COP113trn and the actual sum collected in 2014 was COP108trn. Given this outcome, we think that the government might revise its levels of expected tax revenues down for 2015 and 2016.

growth in public works will be purely sustained by the start on fourth generation infrastructure works, although this will not be enough to achieve rates ahead of those of GDP growth. These works projects have already been put under contract and signed, while the funding for a large part of them has been pledged under guarantee.

Finally, we now believe that 2015 growth will be 3.1% (see Figure 4.7), which is below the previous figure of 3.6%. Construction in the non-residential (already having permits and involving premises, offices and warehouses and stores) and subsidised housing (under central government plans) categories will provide the biggest boost for GDP (see Figure 4.8), which will also be true for 2016, and construction investment will actually grow by an average 5.7% YoY over 2015 and 2016. Although we are revising down the performance by consumption, this will be key in 2015 to growth in the services and wholesale and retail trade sectors, keeping up the buoyant trend which they have been following up to now and making a sizeable contribution to growth in 2015 (see Figure 4.8). For 2016 we have also revised our growth figure down, from 4.0% to 3.6%, mainly due to the cut in our forecast for growth in public investment and private consumption.

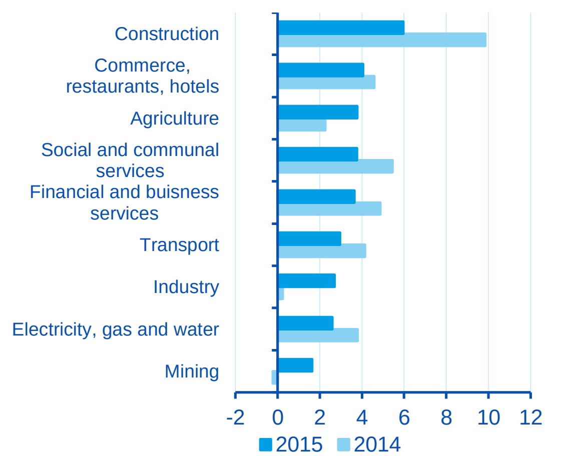
In the medium term, we have adapted our forecast course for the economy's potential GDP to the new situation in the oil sector, which implies a slowdown in growth for investment, and by extension the economy. The results of this exercise are to be found in Box 2.

Figure 4.7
GDP and domestic demand (%, YoY)



Source: DANE and BBVA Research forecast

Figure 4.8
Sectoral GDP (%, YoY)

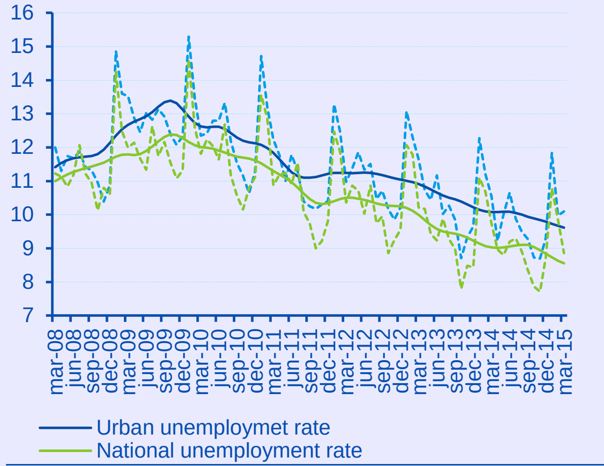


Source: DANE and BBVA Research forecast

Box 1. Recent improvements in the labour market will serve to cushion the economic slowdown

The unemployment rate has exhibited a falling trend since 2009, moving from double-digit figures (11.5% and 13% on average over 2008 and 2009) to a single digit one (9.9% in 2014) (see Figure B.1.1). The natural rate of unemployment came down for the period, which was attributable to a slowdown in growth of the supply of labour (further details are available from "La NAIRU en Colombia cae y se acerca a tasas de un dígito" ("The NAIRU in Colombia is falling and close to single-digit rates"). According to Arango (2014), this is on account of "the higher level of household income; the fine performance by the demand for labour in 2011 and 2012; the larger anti-poverty and training subsidies under the *familias en acción* and *jóvenes en acción* programmes; the healthy trends in remittances; an increase in waged employment, etc.". The tax reform could also have had a similar effect by bringing down non-wage costs, thereby boosting waged (as opposed to non-waged) employment and thus productivity and income.

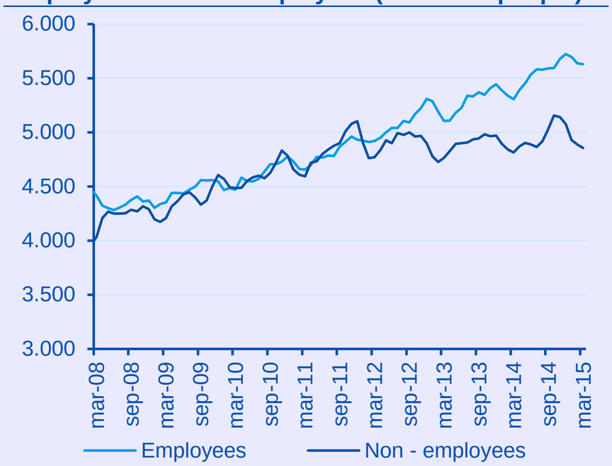
Figure B.1.1
National and urban unemployment rate (%)



Source: DANE and BBVA Research

This all leads one to deduce that there is a structural component behind the reduction in unemployment. Given its structural character, it is to be hoped that this fall does not become completely reversed in tougher economic scenarios. In this regard, the greater solidity achieved by the labour market since 2008 might endow it with greater "stabilising" power than it had in years gone by. Moreover, in recent years the composition of those in work has tended towards a more formal type of employment, involving more stable and better-paid jobs (See Figure B.1.2). Even though between 2008 and 2011 the proportion of waged workers (an employment situation which correlates positively with formal job status) out of total employment was 50%, in 2014 this stood at 53%. This could have a significant correlation with the positive economic cycle, although once again one cannot rule out this having a structural element owing to the reduction in non-wage costs that was brought in with the 2012 tax reform.

Figure B.1.2
Employees and non-employees (thousand people)



Source: DANE and BBVA Research

Our estimate for urban unemployment for 2015 is 9.6% (December 2015), which is a higher level than was seen in 2014 (9.3%) when we had been growing at 4% (2011-14), although this is lower than in 2011 (10.4%) despite the fact that in that year we had been growing at rates averaging 5% (2008-11). On the other hand, in line with our growth estimates by sector, we think that those segments which will mark employment in 2015 will be wholesale and retail trade, agriculture and services. Employment in the sectors of transport (with a share of 9% of the total) and industry (12% of the total) will perform well, judging by our growth estimates by sector. Construction, which is the sector that will head up growth across all sectors, will also contribute to employment generation, although its input will be less substantial given its share of 6% out of total employment. On the other hand, employment in mining and quarrying will continue to lag behind in 2015, having plummeted by 9.2% in February with respect to one year ago, although its share of overall employment is scarcely 0.9%.

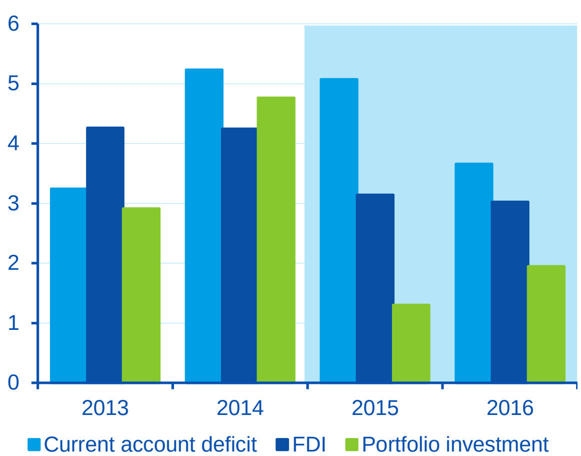
5 The current account adjustment will not happen before 2016

The current account deficit will be 5.1% and 3.7% in 2015 and 2016

In 2014 the current account deficit was 5.2% of GDP (see Figure 5.1). At the end of the year, imports did not make the adjustment which they had been expected after the depreciation in the exchange rate. On the other hand, the prospects of greater depreciation pushed up buying from abroad of capital equipment and commodities. The component which did react by correcting was factor income (the primary income item), which is mainly dividend remittances by companies having their parent company abroad, this moving from 3.7% of GDP in 2013 to 3.4% of GDP in 2014.

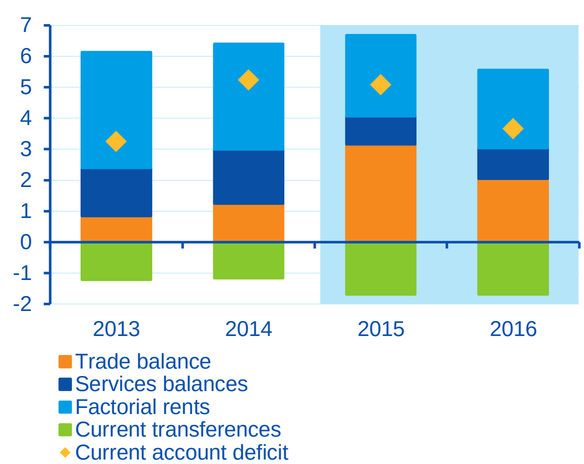
This year, the correction as regards imports will be more in evidence and these will drop by 3.5% YoY. Likewise the correction in dividend remittances abroad will continue, mainly because of the lower profits in 2014 and 2015 of companies in oil-related lines of business, making a contribution to the deficit of 2.6% of GDP (instead of 3.4% in 2014). As well as this, the item covering exports other than mining and oil (+20% YoY) is expected to see an improved performance, although it will not manage to offset the drop in traditional sales (-18% YoY). Overall, exports will fall by 15% YoY. Finally, remittances by Colombians living abroad could rise from 1.2% of GDP in 2014 to 1.7% in 2015 (see Figure 5.2).

Figure 5.1
Current account and financing (% of GDP)



Source: Banco de la República and BBVA Research forecast

Figure 5.2
Contributions to current account deficit (% of GDP)



Source: Banco de la República and BBVA Research forecast

The current account correction will come in 2016. We expect total exports to increase by an annual 14.1% in 2016 on the oil price recovery and the boost to other sales abroad from the currency depreciation. This will cause the trade balance to shift from a deficit of 3.2% of GDP in 2015 to one of only 1.9% in 2016. Meanwhile, factor income will contribute a figure to the deficit similar to that seen in 2015 (2.5% of GDP).

Overall, the current account deficit will be 5.1% of GDP in 2015 and 3.7% in 2016 (see Figure 5.1). At the same time, the smaller inflows of capital into the Colombian economy due to the fall in both Foreign Direct Investment (FDI) and portfolio capital could give rise to a decumulation of reserves of under 1% of GDP in 2015. The decumulation of international reserves will amount to less, to the extent that the private and the public sectors have greater access to borrowing abroad.

In spite of the potential decumulation of reserves, at no time will the economy lose its ability to respond to external shocks: international reserves will remain unchanged or rise as a percentage of GDP (owing to the drop in the dollar-value of the economy) and will cover the same or a greater number of months' worth of imports (due to the adjustment in these). Finally, in 2016 financing will be sufficient to cover the current account deficit and even generate an additional accumulation of international reserves of up to 0.5% of GDP (see Figure 5.1).

A weaker exchange rate will help to bring down the current account deficit

Exchange rate levels in Q1 were in line with expectations, hitting a high in March, a month in which the dollar exchange rate stood at COP2,587 on average, which equates to a depreciation of 10.4% for the YtD and 27.9% for the last 12 months. In line with the course that the oil price is expected to take, that moment marks the beginning of a downward correction which the exchange rate will make up to Q3, although it will still remain at a significantly high level. In the last part of the year, it will embark on a new upward trend as a result of the expected moves by the Federal Reserve in the United States and the anticipated movement of capital flows towards emerging economies. All in all, by the end of 2015 the dollar exchange rate should stand at around COP2,450.

These patterns for the exchange rate will mean a real depreciation (therefore greater Colombian competitiveness) and will prove very helpful in the process of progressively closing up the current account deficit by boosting non-mining exports and making imports unattractive, particularly during the second half of 2015.

It is important to point out that the complex nature of shocks from outside and the foreseeable fluctuation of investment flows should mean that the exchange rate will be more volatile than in 2014. While we expect that the path taken by the oil price and the upturn in non-traditional exports will bring an improvement to Colombia's external balance, the exchange rate ought to remain at a high level in 2016, with the dollar rate averaging COP2,388.

Finally, it should be noted that, with the new international situation as regards fuel prices, the equilibrium level of the nominal dollar exchange rate (which we now estimate to be COP2,250) will be reached at the end of 2017, when the economy's GDP has returned to its potential level and the MPR is neutral for activity (at 5.0%, current estimate.).

6 Lower revenues from taxation and dividends force deeper public spending cuts

The government's fiscal accounts in 2015 and 2016 are looking worse with respect to our previous scenario. The poor set of results from Ecopetrol in 4Q14, the reduction in the percentage of profits to be paid out in 2015, and the lower level of revenue collection in 2014, give the impression of considerable impairment in the government's revenues and a need to make further spending cutbacks in these two years.

Although in our January scenario we had already factored in lower revenues, given the drop in revenue collection in 2014, the latest information from the Ministry of Finance appears to indicate that tax collection that year was even smaller than we were counting on. Specifically, in the Medium Term Fiscal Framework (MFMP) for 2014 taxation as a proportion of GDP for 2014 was estimated at 14.8%, but the new figures show that actual tax collection was 14.2% of GDP. Even though this lower figure was partly produced by weaker oil revenues and a lower level of activity, this is highly likely to involve something of a more permanent nature, possibly arising from changes to the tax system, which have come about since the 2012 tax reform. Here mention should be made of the fact that, with these thinner revenues, spending was brought down from 19.5% of GDP in the MFMP to 18.9% of GDP in 2014.

Furthermore, in 4Q14 Ecopetrol surprised by posting a loss of COP0.6trn, leaving the company's profits for the year at COP7.8trn, compared to the accumulated figure of COP8.4trn to September. The shock of lower profits was accompanied by a decision by the company to distribute a lower percentage of profits (70% this time) which is 10 percentage points below what it had been paying out in recent years. Given this new situation, government revenue in 2015 from Ecopetrol dividends will be COP4.9trn, compared to our January estimate of COP7.8trn. Due to this item alone, government revenues will be trimmed by around COP3trn in relation to the January estimate.

The news from Ecopetrol and on tax collection offer a vision of tighter 2015 public finances. In the previous estimates, the lower oil revenues did not call for a spending adjustment in 2015, as the 2014 tax reform and the flexibility of the fiscal rule in allowing the observed shortfall to be larger than the structural deficit (due to the mining and energy/economic cycle) would have provided enough margin to cover them. Nonetheless, the additional blow to oil revenues represents a scenario of revenue reduction which goes beyond a mere cyclical drop, and prevents the government from increasing its fiscal deficit. In the present situation, the government must therefore re-work its finances by either slashing spending or raising more revenue.

For 2015, we therefore forecast a deficit of 2.9% of GDP, accompanied by spending cuts of around COP4.5trn (0.5% of GDP). The spending cuts would have been larger were it not for the fact that reducing economic growth by 0.5 percentage points opens up the possibility of a bigger deficit as a result of lower cyclical revenues.

In 2016, the fiscal scenario is tighter because the lowest average oil prices are actually to be found in 2015, which is when dividends for 2016 are determined. The new information regarding Ecopetrol, particularly concerning the 4Q14 financial results, means that we can expect profits in 2015 to be substantially lower than in 2014. This, together with lower tax collection and maintaining a dividend policy of 70% of profits, leads one to think in terms of a further cutback in spending. If the adjustment is done purely via spending cuts, expenditure as a proportion of GDP will be lower in 2016 compared to 2015. Should it be wished to keep spending in proportion to GDP over 2015 and 2016, tax reform would be needed that lifts collections to roughly 1% of GDP. For 2016 we estimate a deficit of 2.6% of GDP, and forecast that, as with 2015, this is attributable to lower cyclical revenue arising from a situation of lower growth in the economy.

With regard to the finances in regional and local authorities, our calculations offer us more buoyant royalties in 2015 than in 2014, with an increase in implementation of 25% from one year to the next. We expect investment spending to rise from COP5trn to COP6.2trn over 2014 and 2015. This is, to a large extent, explained by the fact that funds remain from the 2013-14 two-year term which were not implemented during that time and which represent an additional source of funding for the 2015-16 budget. Moreover, since 2015 is the last year of the mandate of local governments, the investment project implementation could turn out to be particularly high. For 2016 we expect spending of this kind to be COP6.3trn. Royalties will hold steady, so these are stable in nominal terms over 2015 and 2016. In calculating 2015 royalties, we assume fairly low execution levels for the unallocated revenues from previous terms. This is because execution of these funds is subject to the issue of the decree on budget closure for 2013-14, the delay of which is preventing the Management and Decision-Making Councils (OCAD) from endorsing projects paid for out of these funds. With regard to calculation of the royalties associated with the 2015-16 term, we assumed funds of COP13.9trn (COP6.9trn for each year), which are 24% below the levels initially estimated by the government, where the adjustment is due to the difference in the oil price.

Box 2. Regional political cycles and budget implementation

On 25 October 2015 regional elections will be held in Colombia to decide who will be the governors and representatives of the country's 32 departments and mayors for the 1,099 municipalities. On the political front, the regional elections will provide a very good opportunity to take a closer look at Colombia's voting map, which takes on special importance given the current situation of ongoing peace negotiations.

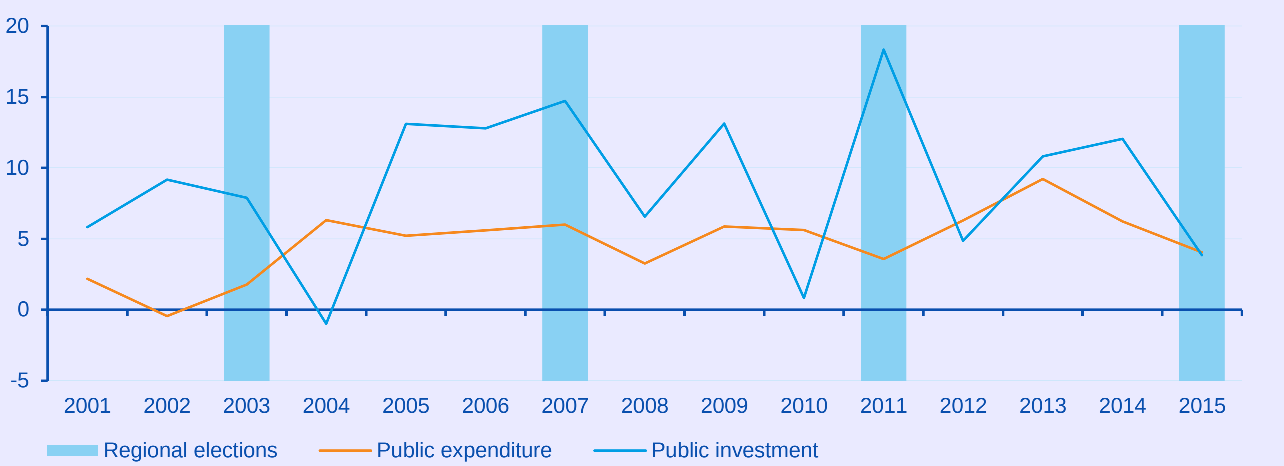
From the economic perspective, however, the regional elections might also have an impact on public investment execution, as we saw in 2007 and 2011. Although our fiscal projections are on the conservative side and, on a local and regional level, include the possibility of lower execution as a risk, on a macroeconomic level it is regional spending and investment which would make up for the spending and investment cutbacks by central government in 2015.

Our projections actually assume that there would be an increase in regional investment, chiefly marked by project execution in the final year of the terms of office of mayors and governors. This will also benefit from the execution of COP6.2trn in royalty projects, which represents a 25% increase over 2014.

On top of this, the government will continue to look for mechanisms to enable regional spending in the current situation and will try to encourage local governments to execute unallocated funds from previous terms.

In summary, our projections maintain spending and investment growth on a regional level which, although it would offset investment dynamics at the central government level, would mean that consumption and public investment only grow at 4% and 3.8% respectively.

Figure B.2.1
Trends in consumption and public investment (% var. YoY)



Source: DANE and BBVA Research

7 A food shock and pass-through of the exchange rate to prices will push inflation to over 4% over a large part of 2015

Inflation will return to its target range in 3Q15

March inflation was 4.6%, mainly driven by food prices and certain tradables. The supply of root and garden vegetables was partly affected by the fall in cultivated land area arising from the announcements in 2H14 of a potential Niño weather phenomenon early this year. The lower agricultural supply caused the prices of certain produce such as potatoes and beans to surge at rates of over 50% YoY in March. Certain cereals too, such as rice, suffered substantial rises that did not directly relate to the weather phenomenon announcement but instead to a lengthy cycle of low prices which served to disincentivise production. As a result, food inflation shot up from rates of 4.7% in December 2014 to around 7.4% in March this year (see Figure 6.1).

Another factor behind the price rises is the jump in inflation among tradables. As we were expecting, the sharp COP depreciation in 2H14 had an impact on the growth of imports of certain products[2]. Vehicle prices, for example, showed YoY growth in March of 7.2%, having closed 2014 growing at barely 2.2%. Other goods such as medicines and certain household electrical appliances have also seen major price rises. At BBVA Research, we estimate that a high percentage of the feed-through of the currency depreciation to prices took place in Q1, meaning that the recent trends in the tradables component will ease off over the course of the year.

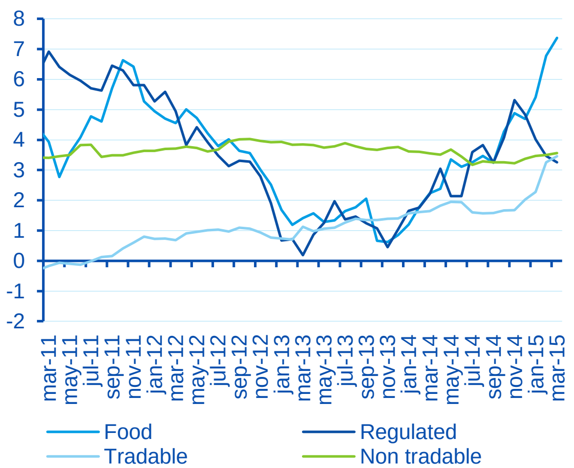
Core inflation is also gathering speed. On average, the three indicators which we follow climbed from annual growth rates of 2.9% in December 2014 to 3.6% in March this year (see Figure 7.2). Part of this increase was due to the rise for certain tradable goods that are included in this measure, and which relate more to the recent currency depreciation rather than greater demand pressure.

After the inflation shocks in the first quarter, inflation expectations rose for December 2015. According to the central bank’s survey, on average analysts raised their inflation forecasts for the end of this year from 3.3% to 3.8% between January and April, while expectations deriving from government bonds (break-even inflation) also ticked up. Expectations for the medium term, however, appear more firmly anchored: for April 2016 economic agents are expecting inflation of 3.1%, and for December 2016 they forecast a rate of 3.3%. These figures seem to indicate that the market sees the recent jump in price rises as more of a temporary than a lasting phenomenon.

At BBVA, we estimate that inflation will come back to within the target range in H2. A weak showing by domestic demand over the rest of the year, together with the conclusion of the cycle of high prices in agriculture and downward movements in the prices of certain regulated items (gas and energy), will help to correct the recent rise in the cost of living. Nonetheless, in spite of the downward revision for growth of the economy, BBVA is raising its forecast slightly for inflation at the end of 2015 from 3.5% to 3.6%, owing to the first-quarter spike in food prices.

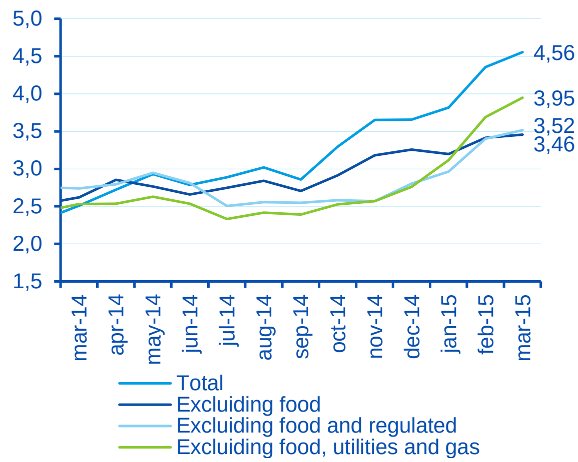
2 This year we expect the depreciation to push inflation up by 70bp and the effect of this will be counteracted by the slowdown of economic growth, especially from 2H15. Nonetheless, to judge from inflation ex foods, the transmission from the exchange rate through to prices will not be as powerful as we were initially estimating.

Gráfico 7.1
Inflation by groups (%, YoY)



Source: DANE and BBVA Research

Gráfico 7.2
Total inflation and core inflation indicators (%, YoY)



Source: DANE and BBVA Research

Lower growth in 2016 will bring inflation closer to the 3% target

We are revising inflation at the end of 2016 down by 15bp, on the lower growth for the economy forecast by BBVA for this year. This means that inflation should close 2016 marking a variation of 3.2%. Inflation during the first half, though, should be below 3% due to the base effect of the high rates recorded in the opening part of 2015. On average, inflation should thus come down from 4% to 2.9% over 2015 and 2016.

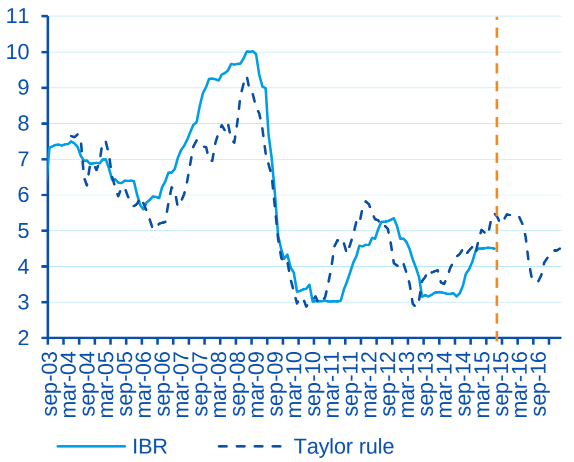
8 Monetary policy: is countercyclical action a possibility?

One of the greatest achievements of monetary policy in the last 15 years has been the systematic erosion of inflation and the capacity to react countercyclically at times of slowdown and exogenous shocks, as it showed in 2009. The nature of the present terms of trade shock, however, leaves the central bank in a difficult situation. On the one hand, the lower oil price is forcing down the country's income from abroad and thus having a negative impact on the economy's growth potential. At the same time, the weaker terms of trade are putting upward pressure on the exchange rate, disrupting the prices of tradables and therefore impacting on overall consumer price inflation. Added to this situation is the recent shock in food prices which, though of a passing nature, has taken inflation to above the ceiling of the band for target inflation. Worse still, the sharpness of the rise in food prices is likely to cause this situation to be prolonged for several months.

In this scenario and at this moment in time, monetary policy decisions are particularly complicated and there are various arguments for rate cuts as well as for more restrictive stances. Even though the timid performance expected of GDP ought to mean that it is desirable to conduct expansive monetary policy, there are several factors which place limits on the central bank's capacity to act countercyclically in the short term. Within the set of variables which advise against the option of cutting the policy rate are the high current account deficit, the healthy performance of credit growth (15.5% YoY at the March close), high levels of inflation, and the risk of these feeding expectations.

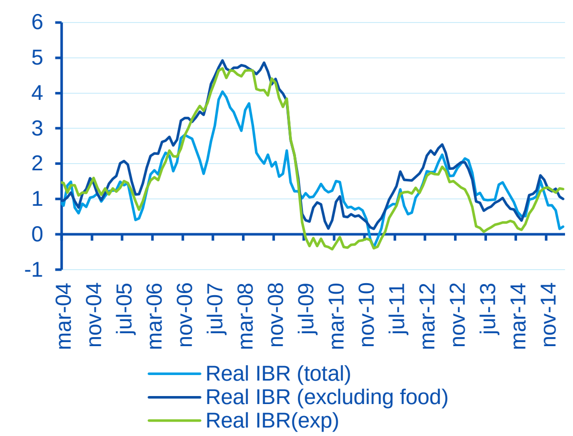
A simplified approach to analysing and summing up monetary policy decisions, and one which illustrates this straight choice one way or the other, is to be found in the Taylor Rule. Under this specification, the monetary authorities react to the GDP gap and deviations by (expected) inflation from their target level. According to our Taylor Rule estimates (see Figure 8.1), the course of expected inflation manages to more than offset the widening of the GDP gap in 2015, which limits the central bank's ability to cut its benchmark rate. Alternatively, when we look at real interest rates (see Figure 8.2) subject to different deflators, we find that these are at relatively low levels, which could cause the monetary authorities to feel ill at ease over the need to take interest rates to more expansive levels.

Figure 8.1
Interbank rate and Taylor's rule



Source: BanRep and BBVA Research

Figure 8.2
Real interest rates*



Source: BanRep and BBVA Research. *data are presented with different deflators

Thus, in our baseline scenario, it is reasonable to suggest that the right policy response by the central bank will be to hold its rate at 4.5%, at least until there is more certainty over adjustment by the economy to lower growth rates and inflation is consistently back within its long-term range. It is important to point out that in our scenario, and in spite of the relatively hawkish stances adopted by certain members of the central bank's policy committee, there is a downside bias in interest rate terms, whereby the central bank would act in a way that relies very much on information that emerges over the course of the year. In this scheme of things, it is important to keep a close eye on how inflation expectations behave, as well as how credible the target is, and how consumption and private investment perform, when it comes to estimating likely moves regarding the intervention rate.

9 Risks to economic growth relate to domestic factors

We now go on to outline the chief risks which the Colombian economy might face. Most of these are of a domestic nature and, although the likelihood of them materialising is low, their impact could have a not inconsiderable effect on our set of forecasts.

On the one hand, a sustained deterioration in consumer confidence would worsen the effect of the lower oil price on investment and private consumption. In March, confidence suffered a major decline. There thus exists a possibility, albeit still a low one given the positive labour market figures (Box 2), that there might be a sharper-than-expected slowdown in household consumption through a general reluctance to make purchases in the face of more severe conditions of uncertainty.

Another risk factor in 2015 is associated with how net exports perform. We are expecting the currency depreciation and the better US growth to have a positive effect on manufacturing and agricultural sales abroad, and that, at the same time, the higher exchange rate and lower investment will bring about an adjustment in imports. Should either of these two premises not be satisfied, or indeed neither of them, a negative bias for the economy will emerge. Our estimates, however, indicate that growth will have a floor above the level of 2.5% YoY.

In 2016, the risk to growth comes mainly from the public sector. A very low execution rate for fourth generation works, which we are assuming will get fully underway in 2016, would not be enough to offset the lower level of regional expenditure from the reduction in royalty funds and the lower execution rate typical of the first year in office of new local and regional governments.

Finally, the normalisation of Federal Reserve policy in the United States imposes a degree of uncertainty on our scenario, especially as regards the financing of the external deficit. The same situation applies regarding the great uncertainty surrounding the future movements in the oil price.

8 Table with projections

Tabla 8.1
Annual macroeconomic forecasts

	2013	2014	2015	2016
GDP (% YoY)	4.9	4.6	3.1	3.6
Private consumption (% YoY)	3.8	4.4	3.6	3.6
Public consumption (% YoY)	9.2	6.2	4.0	3.1
Fixed investment (% YoY)	6.0	10.9	3.2	4.0
Inflation (% YoY, eop)	1.9	3.7	3.6	3.2
Inflation (% average YoY)	2.0	2.9	4.0	2.9
Exchange rate (vs. USD, eop)	1.927	2.392	2.450	2.310
Devaluation (vs. USD, eop)	9.0%	24.1%	-2.4%	-5.7%
Exchange rate (vs. USD, avg.)	1.869	2.001	2.440	2.388
Devaluation (vs. USD, avg.)	3.9%	7.1%	21.9%	-2.1%
Central bank interest rate (%, eop)	3.25	4.50	4.50	4.50
FTD interest rate (% eop)	4.06	4.34	4.58	4.68
Unemployment rate (%, eop)	9.7	9.3	9.6	9.9
Fiscal balance (% GDP)	-2.4	-2.4	-2.9	-2.6
Current account (% GDP)	-3.2	-5.2	-5.1	-3.7

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

Tabla 8.2
Quarterly macroeconomic forecasts

	GDP (YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD eop)	Interest rate (%, eop)
1Q13	2.8	1.9	1.832	3.25
2Q13	4.7	2.2	1.929	3.25
3Q13	6.1	2.3	1.915	3.25
4Q13	6.1	1.9	1.927	3.25
1Q14	6.4	2.5	1.965	3.25
2Q14	4.3	2.8	1.881	4.00
3Q14	4.2	2.9	2.028	4.50
4Q14	3.5	3.7	2.392	4.50
1Q15	2.1	4.6	2.587	4.50
2Q15	2.9	4.0	2.400	4.50
3Q15	3.7	3.8	2.410	4.50
4Q15	3.9	3.6	2.450	4.50
1Q16	3.9	2.6	2.455	4.50
2Q16	3.3	2.7	2.405	4.50
3Q16	3.5	2.9	2.345	4.50
4Q16	3.8	3.2	2.310	4.50

Fuente: DANE, Banco de la República y BBVA Research

DISCLAIMER

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