

Colombia Economic Outlook

Third quarter 2015
Colombia Unit

- We are standing by our estimate of GDP growth for 2015 of 3.1% and revising growth for 2016 down to 3.1%. Lower growth for our regional trading partners and weak private consumption are behind this revised figure for 2016.
- Greater than expected currency depreciation will prevent inflation from coming back within the target range in 2015. We expect inflation to stand at 4.1% at the end of 2015. The lower growth in 2016 will help inflation to return to the target level, leaving it at 3.2% in 2016.
- The fiscal rule will allow expenditure as a percentage of GDP to hold steady at levels approaching those of 2014. This does, however, mean cutting back on central government investment, which will be offset by investment by regional governments and the 4G infrastructure plan.
- The central bank will leave its intervention rate on hold in 2015 and 2016. This policy is warranted by the high current account deficit and an inflation rate that will remain at over 4% in the coming months.

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Closing date: 3 August 2015

1 Overview

Expectations over Fed decisions, lower oil prices, the stock market problems in China, uncertainty prompted by the Greek crisis, and the downward correction of world growth have sparked **volatility in local markets and battered domestic asset prices**.

We continue to forecast GDP growth of 3.1% in 2015, but we have altered our interpretation of the domestic sources of this, and consider that the increased weakness that we see in private consumption will be offset by greater public-sector investment.

We are bringing down our growth forecast for 2016 to 3.1%, which is below the figure of 3.6% in the previous scenario. The growth profile for 2016 will still benefit from increased public-sector demand. On the other hand, the smaller contribution by private demand will continue to shrink, given oil price weakness and lower growth among regional trading partners, who are key to non-traditional exports.

Execution of the fourth generation infrastructure plan and the headway being made in employment will provide support for the economy as it comes back onto a course of growth with higher rates from 2017. **We expect average growth between 2017 and 2020 to be 4.6% YoY**.

We predict that the current account deficit will be 5.6% of GDP in 2015 and 4.7% in 2016. The smaller deficit in 2016 will arise from the narrower trade deficit, reduction of the factor income deficit and increased remittances.

In 2015 and 2016 the fiscal rule will alleviate the economic slowdown and help to keep public-sector expenditure by the national central government as a percentage of GDP at 2014 levels. This entails a cut-back in central government investment, which will be compensated by the pace of public works execution by regional governments in 2015 and a start on infrastructure work under the 4G programme in 2016.

Steeper than expected currency depreciation will stop inflation from falling back within the target band in 2015. We expect inflation to stand at 4.1% at the end of this year, while in 2016 weaker economic activity, in combination with a high base effect left by price growth in 2015, will combine to bring down inflation. **We forecast that inflation will be 3.2% by late 2016**.

The expected movements in inflation and the current account deficit restrict the scope for cutting the monetary policy rate (MPR). Even so, greater than expected pass-through from exchange rate depreciation to prices could provoke the risk of more restrictive monetary policy. **Nonetheless, our central scenario assumes an unchanged intervention rate over the rest of 2015 and 2016**.

We expect the exchange rate to remain at a high level with substantial volatility over the second half of the year, especially in the third quarter. Anticipated moves by the US Federal Reserve, oil prices, the international situation and the weakness of Colombia's external figures will all hold the rate up.

The risks the economy faces could be both from outside and domestic. On the external front are: a further drop in the oil price, a disorderly monetary normalisation process orchestrated by the Fed, and an undesirable outcome of the recent problems in Greece and China. Within Colombia, the biggest risk comes from additional deterioration of consumer confidence, although we will have to see how events unfold as regards execution of works within public investment.

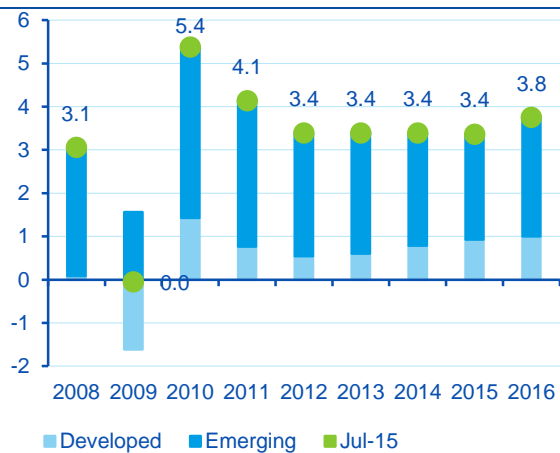
2 Global environment: moderation in world growth and a marked deceleration in the emerging economies

We have revised our forecast for 2015 world growth downwards, to 3.4%. This will recover to 3.8% in 2016

After a poor first quarter, world growth appears to be more dynamic in 2Q15, on the back of the recovery in the US (after the stagnation in GDP observed in the first few months of the year), euro area strength and GDP growth in China of 7% YoY, the same reading as in the first quarter. Despite this, world GDP is likely to have grown at under 3% YoY in the first half of the year, thus justifying our downward revision of growth for 2015 as a whole (to 3.4%, which is 0.1pp below what we were predicting in April). Looking to 2016, the world economy could pick up pace and attain growth of 3.8%.

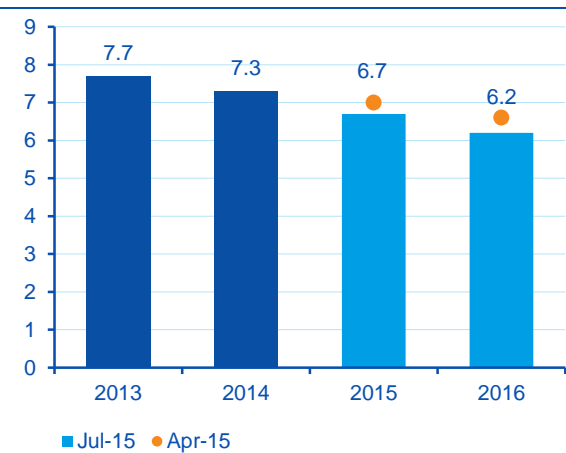
The developed economies continue to share encouraging growth prospects, which will contribute to mitigate the impact on world activity and trade of the current slowdown among the key emerging economies. Specifically, while in 2015 the developed nations have the potential to grow at their fastest pace since 2010, at a shade over 2% YoY, the major emerging markets could see weaker growth again for the fifth year in succession.

Figure 2.1
World growth, % annual change



Source: BBVA Research

Figure 2.2
China: economic growth, % annual change



Source: BBVA Research

Besides the downward revision of growth forecasts for the world economy, a hallmark of the global context in the last quarter has been the manifestation of some of the risk events that we singled out three months ago and, if they take a turn for the worse, this could bring the global economic recovery to a halt. The first of these involves the bout of financial instability in China. This was brought about by the sharp correction of its stock market, within a situation of trend deceleration in growth, which has drawn on substantial borrowing, and a process of financial liberalisation still underway. The second, which is equally significant, is the Greek crisis, and the constraints to reach an agreement that ensures that the country will face its financial commitments in the short term, as well as the sustainability of its debt via reforms to enhance the economy's capacity to grow in the long term.

The combination of these two risk events, together with the approach of the Fed's first rate, has heightened financial disruption the world over, particularly in the form of greater volatility in stock and currency markets, with a heavier impact on the euro area and Asia.

The disappointing growth in the first half of the year justifies our downward revision for growth in the US in 2015 ...

In the US, GDP growth contracted in the first quarter, followed by modest growth in the second, judging by the available indicator readings for activity and confidence. This justifies our downward revision for growth for 2015 as a whole, which we think could reach 2.5%, or some 0.4pp below the level we forecast in April. The uncertainty over how the economic cycle will perform in the coming quarters has now been heightened bearing in mind the impact of the persistent dollar appreciation on exports, the weakness of private investment and the deterioration in the global situation. Even so, US GDP could grow by 2.8% in 2016.

... while the financial volatility in China has also led us to revise our growth forecasts for 2015 and 2016

In China, the pace of economic growth is likely to slow owing to the impact of the recent bout of financial tensions. Besides the negative effect on the confidence of the private sector, there might also potentially be some reversal of consumption decisions as a result of the drop in households' financial wealth. More than anything though, there is likely to be a deterioration in financing conditions for corporates, which is associated with both the suspension of new placements and the loss of value of collateral backing bank loans. These are the factors responsible for the downward revision in the growth forecast for China in 2015 and 2016 to 6.7% and 6.2% respectively (0.3pp and 0.4pp lower than in our April scenario, see Figure 2.2). The battery of stimulus measures implemented by the country's authorities to stave off the possibility of even worse contagion to the economic activity cycle is the reason why we do not expect a more intense correction to the rate of economic growth.

Economic growth in the euro area continues to recover despite the Greek crisis

The pattern in the euro area is still one of sustained recovery, with quarterly GDP growth rates in the order of 0.4% in the first two quarters of the year. The improved dynamics in France and Italy are combining with the strength of Germany and Spanish GDP growth, which is advancing at a quarterly pace of close to 1%. The emergence of certain risk hotspots with differing impacts on the region could slightly reduce estimated growth for 2015 and 2016 but, even so, the forecasts are still positive (+1.4% in 2015 and +1.9% in 2016, 0.1pp and 0.3pp below those we forecast in April). Altogether, without a doubt the most significant challenge is to try and dispel any scepticism about the irreversibility of the monetary union project.

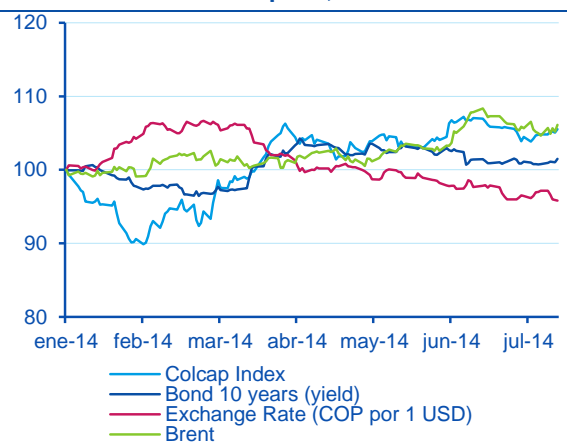
3 International turmoil and lower oil prices are taking their toll on local markets

The lower oil price, stock market problems in China and spells of great uncertainty in negotiations over Greece have rattled increasingly see-saw domestic equity, fixed-income and FX markets (Figure 3.1). Similarly, expectations of a Fed rate hike in September have made such matters worse in the short term and account for some of the recent volatility, as the market is already factoring-in the potential effects of higher interest rates. The effects of the Fed decision on the exchange rate and flows of foreign capital will be more long-lasting than the three factors mentioned above, although the impact is likely to wear off gradually once the market has digested the new monetary situation.

At the same time as asset prices have been in retreat, non-resident capital flows have turned negative (net outflows) in some weeks since May (Figure 3.2) and certain domestic residents have made the most of the currency depreciation by bringing capital into the country. Obviously this has been a widespread phenomenon shared by several emerging markets which could be more of a response to global factors (such as the Fed's decision) than any local considerations.

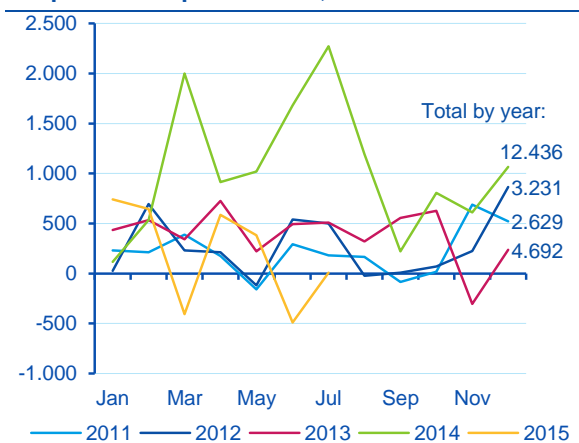
As a result, the rapid growth of the share of foreign funds in holdings of domestic government bonds which had begun in 2014 has ground to a halt. This share might even drop given that JP Morgan has announced a marginal reduction in Colombia's weighting in its government bond index for emerging markets (from 6.50% to 6.42%). Coupled with the rise in the risk premiums of emerging markets and higher interest rates in the developed economies, this could drive up domestic government bond rates, mainly at the long end. Foreseeing a more restrictive borrowing scenario from now on, the central government has auctioned off (as of July) the entire amount of its proposed issuance target for 2015, with a view to softening the blow for the average rate on primary market issuance in 2015.

Figure 3.1
Local assets and Brent price, index Jan-14 = 100



Source: BBVA Research

Figure 3.2
Net portfolio capital inflows, USD millions



Source: BBVA Research

The asset price falls have been generally significant (Figure 3.1). In equities, the Colcap index has shed 14% since the start of the year. Yields on 10-year fixed-income bonds are 180 basis points higher than at the end of December, while the exchange rate has suffered a 21% depreciation in the year to date, hitting its highest level since 2003 (See section 9 for exchange-rate forecasts).

Going forward, the major drivers of the country's financial variables will continue to be international factors, such as monetary policy abroad, commodity prices and market volatility. On top of this, external capital flows could also depend on domestic tax decisions, such as the tax paid by foreigners on gains on portfolio assets. The tax rate, which currently stands at 14%, might be reduced, according to recent statements by certain members of the central government, to support capital inflows.

4 The Colombian economy's adjustment to the lower oil price will last for at least two years: 2015 and 2016

We are standing by the growth figure for 2015, although this now incorporates stronger public-sector investment, which makes up for weaker private consumption

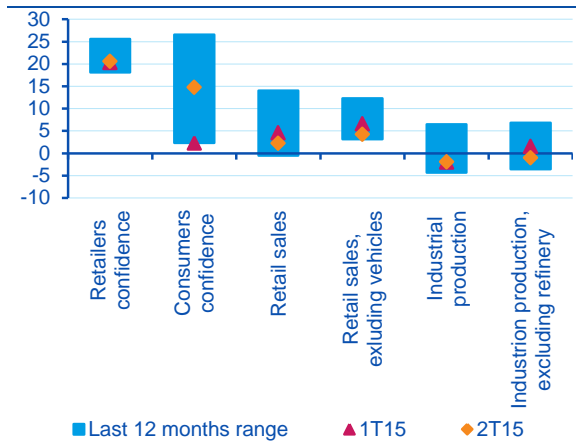
The process of a deceleration of private demand that had begun in late 2014 continued over 1Q15. This trend was partly offset by the contribution from the public works segment. Ahead of our forecasts, regional and local expenditure (in municipalities and departments) was very strong at the start of the year and should remain so throughout the whole of 2015, since this is the final year in office of the regional governments. Conversely, public expenditure by the central government will be restrained, due to the budget cuts, the restrictions on revenue imposed by the lower oil price and the economic slowdown (see section 6).

Sector-wise, in Q1 it was again non-tradable components which led the field within GDP's performance, with commercial and construction activities prominent. The tradable sectors disappointed, notably both industrial activity and mining, which should bottom-out in the first half of the year.

According to the recent overview of leading indicators (Figure 4.1), together with our assessment of the outlook, we will continue to see a slowdown of consumption and private investment for the rest of the year, while there could be a gradual pick-up in exports. In the case of consumption, the figures observed in the second quarter reveal a marked drop in spending on durable goods, especially vehicles (although this is healthy given the high current account deficit), which was bigger than we had been expecting. Such behaviour might relate to the fall in consumer confidence, especially as regards perceptions of Colombia's economy (less so from the household perspective). Moreover, expected spending by consumers at the end of 2014 could also have contributed to the weaker showing by consumption in the opening months of the year, owing to the effect that the depreciation of the COP was anticipated to have on the prices of imported goods. Other spending categories, such as household appliances and electronic equipment, exhibited a smaller growth rate, though this was with a far more moderate slowdown.

Figure 4.1

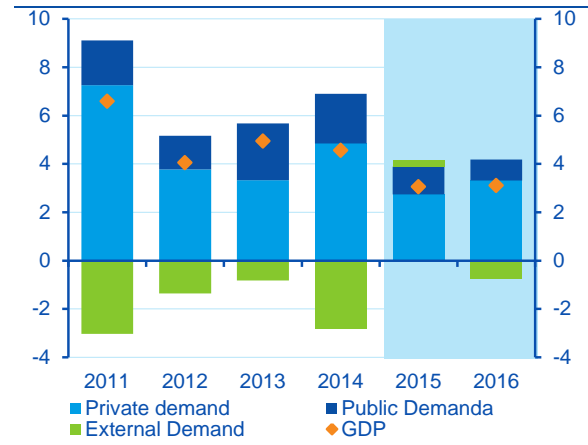
**Colombian leading indicators.
Confidence indexes and annual growth for retail sales and industrial production**



Source: BBVA Research

Figure 4.2

GDP growth by demand side, percentage points



Source: BBVA Research

The reduction in the unemployment rate which we were seeing has stagnated somewhat. Between January and May 2014 urban unemployment averaged 10.7% and over the same period in 2015 this was 10.4%. The participation rate has grown of late and we think that it could continue to rise in the coming months as the economic slowdown bites into household incomes and obliges an additional member of the family other than the head of the household to seek work. This increase in participation will hamper progress as regards unemployment and could even bring about a YoY rise in the unemployment rate towards the end of the year and a decline in the job formalisation situation. This would thus make it reasonable to expect a further slowdown in private consumption, not just in 2015, but also in 1H16.

Investment, on the other hand, will also grow more slowly on account of the low level of installed capacity utilisation which persists in the manufacturing industry, reduced incentives to invest in the mining sector (via the price of oil and other products), and the drop in foreign direct investment. The upturn in private investment will not come about until 2016, when industry produces better results and the oil price comes back above USD65/bbl. The slowdown in consumption and investment will result in lower imports, for which growth rates (both in real terms and in COP) will be very close to zero over 2015.

As happened with the positive surprise in Q1, public works will continue to be the mainstay of growth in 2015, and this item is itself expected to grow at 7.9% YoY in 2015. The driver of this works activity will be better execution levels in departments and municipalities, not only of their own funds but also of royalty revenues that have remained unallocated from previous terms and which will be added to the current term's budget.

Finally, exports have performed erratically in terms of their dollar value. Examination of prices and volumes in connection with these reveals that the poorer showing in recent months is more on account of the fall of world commodity prices than any drop in the amount of goods shipped abroad. Indeed, oil exports increased when this is measured in barrels and the volumes for non-mining products reached levels on a par with those seen in 1Q14. Whatever the case, there is no evidence yet that non-mining exports have benefited at all (in volume terms) from depreciation of the COP's exchange rate, which supports the view that the effect will be slow and delayed until 2016. Moreover, commodity prices will continue to be a major stumbling block to export recovery,

even though production levels and the boost from the lower peso value of shipments abroad will help to prop up a steady recuperation of domestic productive activity. On top of this, they will alter the profile of domestic demand, shifting it towards non-tradables and domestically produced goods.

We still forecast GDP growth of 3.1% in 2015, but we have changed our view of where this will come from on the domestic front. The increased weakness which we see in private consumption will be offset by greater public-sector investment, which is a variable that provided us with a positive surprise in Q1 and which we expect to see out the year as dynamically as it started it. In spite of this, in 2015 and 2016 the contribution by public works projects to growth will be the lowest in recent years because of the fiscal restrictions which the central government has had to face (Figure 4.2). Finally, net demand from abroad should make a positive contribution to growth for the first time since 2009 due to the larger setback both seen and expected in imports and the stability of volumes that is being confirmed as regards exports.

On a sector level, we expect agriculture, financial services, the tourism industry (hotels and restaurants) and construction to grow ahead of the economy on average. On the other hand, given the decline in private consumption and the deceleration of growth in certain countries that are trading partners of Colombia, industry will show a barely positive growth rate, which will creep up slightly at yearend with the gradual opening of the Cartagena Refinery (Figure 4.3).

We are cutting our forecast for economic growth in 2016 on a lower oil price and reduced economic growth among Colombia's trading partners

We have revised down growth for 2016 due to an outlook of lower oil prices than were expected three months ago, weaker private consumption and a deterioration in growth among certain trading partners.

The lower oil price can be explained by both supply and demand factors. On the supply side, at BBVA we are revising our forecast for world crude production upwards. This will be driven by the gains in productivity exhibited by shale oil production in the United States, the larger than expected rise in OPEC production, especially due to the spike in Iraq, and the latent supply that will hit the market from Iran following the deal to lift current trade restrictions. Furthermore, on the demand side, the cuts in expected growth for China in 2016 suggest lower world demand for crude. The blend of these two factors underlies the revision of the average price of Brent from USD75/bbl to USD69/bbl in 2016 under the new scenario.

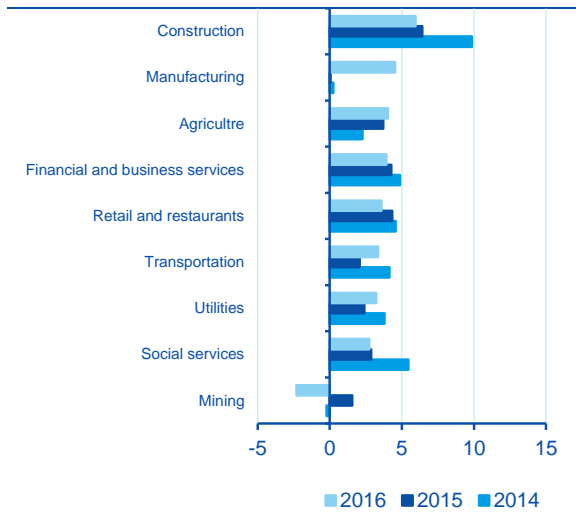
On the other hand, exports will perform better in 2016 than in 2015, thanks to improved growth for the developed countries which are trading partners of Colombia and the gradual rise of the oil price. That said, the prospects of weaker growth for certain emerging economies that are trading partners, such as Ecuador, Peru, Chile and Brazil, which are major destinations for industrial exports, will have an adverse impact on non-mining export activity.

As a result, the industrial sector will recover, only more slowly than we previously predicted. This will happen in spite of the larger share of domestic production in sales nationwide, given the effective protection provided by the weaker COP exchange rate, and the greater demand from the United States and Europe. This will translate into poorer momentum for national income, with negative consequences for the growth rates of private consumption and net exports. On the other hand, private investment will pick up over 2015 and 2016, based on the brighter outlook for the mining sector, given the steady recovery of commodity prices and improved industry growth. At the same time, investment in public works will only rise on the back of fourth generation programme work.

All in all, we are trimming our growth forecast for 2016 to 3.1%, down from 3.6% in the previous scenario. There has also been a change in the growth profile for 2016, where the prospects for public demand growth are still encouraging, while the contribution from private demand should be even smaller (Figure 4.2).

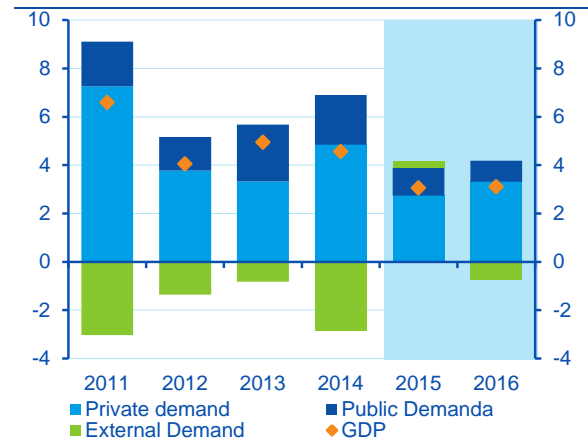
In sector terms, we expect industry to show the biggest growth, boosted by oil refining (accounts for 19% of industry) and increased production of non-metallic minerals (a share of 9% in industry). The opening of the Cartagena Refinery and the greater demand for construction materials that will arise from the work on the 4G programme will be key to achieving this outcome. Agriculture will be the other sector that ought to drive growth in 2016, supported by the currency depreciation and the high food prices recorded in the domestic market in 2015. On the other hand, mining will see negative growth due to lower oil production, which will bring with it a further reduction via the cuts in investment and exploration that have been observed in the sector since 2014 (Figure 4.3).

Figure 4.3
GDP growth by sectors: observed and forecasted, %



Source: BBVA Research

Figure 4.4
GDP growth by demand side, percentage points



Source: BBVA Research

In the medium term the economy should return to growth rates of over 4%

The oil shock caused the economy to go through two successive years of correction with growth levels of 3.1% YoY. Nonetheless, the potential for growth is above these levels. Implementation of the fourth generation plan and progress in employment will give the economy sufficient wings to make a return to the path of growth at higher rates. In fact we are expecting average growth for 2017-20 to be 4.6% YoY.

This figure for average long-term growth is below the level that was anticipated previously, of closer to 5%. This is because the oil shock will be relatively permanent, which means that prices will not return to the levels touched before the shock and this will force the economy to search out new sources of growth. Over the transition process high growth rates of over 5% will be hard to attain. Only in 2020 will the variation in potential GDP equal observed GDP growth thanks to the improvements in productivity which will be brought about by the higher investment rate arising from the infrastructure plan (Figure 4.4).

5 A more gradual adjustment of the current account deficit

Adverse external conditions will delay improvement of the current account

We have raised our forecasts for the current account deficit for both 2015 and 2016. There were several factors which have brought about this revision to the expected deficit. First, the oil price will now recover more slowly even though the estimates are being kept higher. Second, the more sluggish than expected recovery of non-mining exports, which was already apparent in the first half, could drag on until 2016. Even so, our estimates indicate that total exports (both of oil and non-mining) will be greater in 2016 than in 2015, which will help to close up the current account in the new year. The reasons for the rally in shipments abroad will be the rise in demand from the United States and Europe, which will consolidate their recovery over the next few quarters. The increased currency weakness should also have a positive effect on non-mining goods. Nonetheless, our estimates (of a J-curve for technical purposes) show that the impact is not that strong and that external growth is more significant in generating industrial and agricultural exports.

Third, remittances sent home by Colombians are still not reacting positively to the stronger growth in the developed countries, although they are expected to continue rising steadily along the same path as exports. Finally, there is a “price effect” from the currency depreciation which will lower the dollar value of GDP, thus limiting correction of the current account deficit when this is measured as a percentage of GDP in the short term.

In dynamic terms, we still think that the current account deficit will remain on a downward course. Besides the recovery of exports and remittances (though with the odd delay with respect to predictions, as we said earlier), the import adjustment is taking place within estimates on account of the decline in domestic demand, which will go on into mid-2016. According to our forecasts, it will actually only be in 2017 when the high for imports that was reached in 2014 will be overtaken.

Another aspect in the adjustment of the current account deficit, in both 2015 and in 2016, will be the lower factor income deficit. This deficit, which reached its highest point in 2014 (of USD12.7bn), began to adjust from Q4 last year. Given the lower profits of companies with a foreign parent domiciled in Colombia, transfers of profits abroad (key in the factor income account) are expected to continue to come down. Our estimated factor income deficit this year is USD8.1bn, with USD7.7bn in 2016.

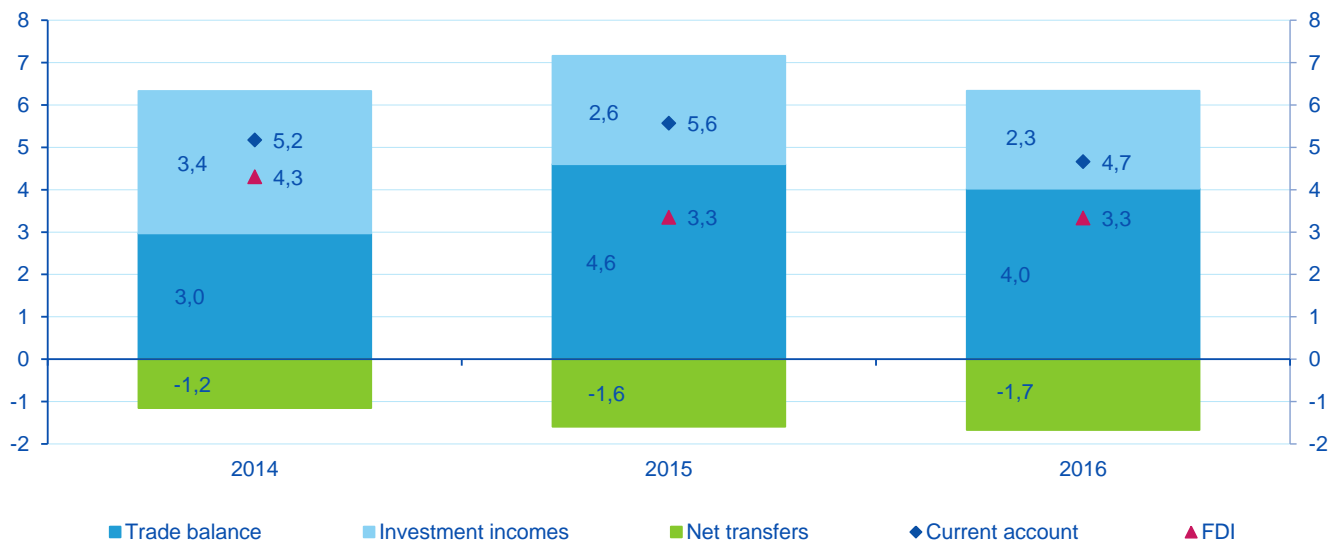
Overall we expect the current account deficit to be 5.6% of GDP in 2015 and 4.7% of GDP in 2016. The lower deficit expected in 2016 will be as a result of the lower trade deficit and the adjustment in the factor income deficit, mostly. Only after 2017 will the current account deficit return to levels below 4% of GDP.

The financing of the current account will not be ample in 2015 and 2016, but it will be enough to avoid a significant rise in foreign borrowing or excessive decumulation of foreign reserves, which could happen, though there is a medium probability of this. Foreign direct investment (FDI) in 2015 and 2016 will be 3.3% of GDP in either year, which means that unlike in previous years, it will not finance a high percentage of the current account deficit. Moreover, its mix will change, as has already been happening since 2014, and now there will be a larger share from sectors other than mining.

Given the smaller inflow of FDI funds, portfolio capital inflows and borrowing will be needed to cover the current account deficit. For portfolio capital we are expecting around USD5bn this year (1.6% of GDP) and USD8bn in 2016 (2.6% of GDP). These values mark a return to historical averages, after a value of over USD18bn in 2014

(3.8% of GDP) due to extraordinary conditions for Colombia as regards the international investor scenario (e.g. an increase in Colombia's weighting in JP Morgan's bond investment indexes). A portion of the borrowing required will also be issued by the government, with USD5.081bn in 2015 (1.6% of GDP) and USD6bn in 2016 (1.8% of GDP).

Figure 5.1
Current account components and the foreign direct investment, observed and forecasted, % of GDP



Source: Banco de la República and BBVA Research forecasts

6 The fiscal rule will mitigate the economic slowdown

In 2015 and 2016 the fiscal rule will contribute to keeping the central government's public-sector expenditure as a percentage of GDP at 2014 levels, in spite of the weaker figures for both tax collection and oil dividends due to the lower oil price. Thus the central government deficit will be 3% of GDP in 2015 and 3.6% of GDP in 2016, in both cases higher than the structural deficit (2.2% of GDP), deviation from which is allowed under the fiscal rule in any period where the oil price and economic growth are below their long-term levels. The figures for expenditure in 2015 and 2016, however, include a restructuring with respect to 2014, with a reduction in investment expenditure to make up for greater operating and debt-servicing expenditure, all as a percentage of GDP. This restructuring translates into less buoyant public investment expenditure by central government. This will nevertheless be offset by budget execution in public works by local and regional governments in 2015 and a start on infrastructure work in the first wave of the 4G programme in 2016, where funding is guaranteed.

Despite the oil shock, the fiscal rule enables expenditure as a percentage of GDP to be maintained

In 2015 the gap between the observed deficit (3% of GDP) and the structural level required under the fiscal rule (2.2% of GDP) mostly derives from the energy cycle and, to a lesser extent, the economic cycle. As Figure 6.1 illustrates, in 2015 the energy cycle allows a deviation of 0.5 percentage points (pp) of GDP, whereas the economic cycle permits one of 0.2pp of this.

2015 expenditure shows an increase in its operating item (of 0.2% of GDP) and interest caption (of 0.3% of GDP) and a reduction in investment (of 0.4% of GDP) compared to those in 2014. We should note that despite the higher deficit allowed under the fiscal rule, holding expenditure steady as a percentage of GDP requires a cut in investment. We should also not forget that a portion of the rise in operating costs over 2014 and 2015 is because of the fact that in the 2012 reform the government assumed part of the payment of non-wage costs that used to fall to employers (known as CREE), which item has risen from 1% of GDP in 2014 to 1.3% of GDP in 2015 and is a permanent expense.

For 2016 we are expecting a deficit of 3.6% of GDP. As in 2015, the deviation from the structural deficit of 2.2% is largely explained by the economic and the oil cycle, although to a greater extent, since in 2015 the oil price is straying further from its long term levels, which affects the dividends that the government will receive in 2016. Indeed, for this year and according to the government's calculations, the oil cycle aspect stands at 1.1% of GDP, compared to 0.5% of GDP in 2015 (Figure 6.1).

In spite of the lower oil revenues, 2016 expenditure as a percentage of GDP is also being kept at levels similar to those of 2014 and 2015. Maintaining these spending levels will be manageable thanks to the scope opened up by the fiscal rule and the higher revenues which the government is budgeting for from more effective handling of tax collection (0.5% of GDP).

In 2016 interest-servicing and operating expenditure will rise, which again calls for an investment cut to maintain overall expenditure in terms of GDP at levels similar to those in 2015. According to the Medium Term Fiscal Framework (MFMP in its Spanish acronym) for 2015, central government investment should be coming down from 2.6% to 1.8% of GDP over 2015 and 2016. It should be noted, however, that in spite of the reduction in central government investment expenditure, its funds for investment in 4G are guaranteed over future terms.

The fiscal rule will allow fiscal expenditure to be smoothed out over the next nine years, although, in spite of the rule, a tax reform is required in the medium term

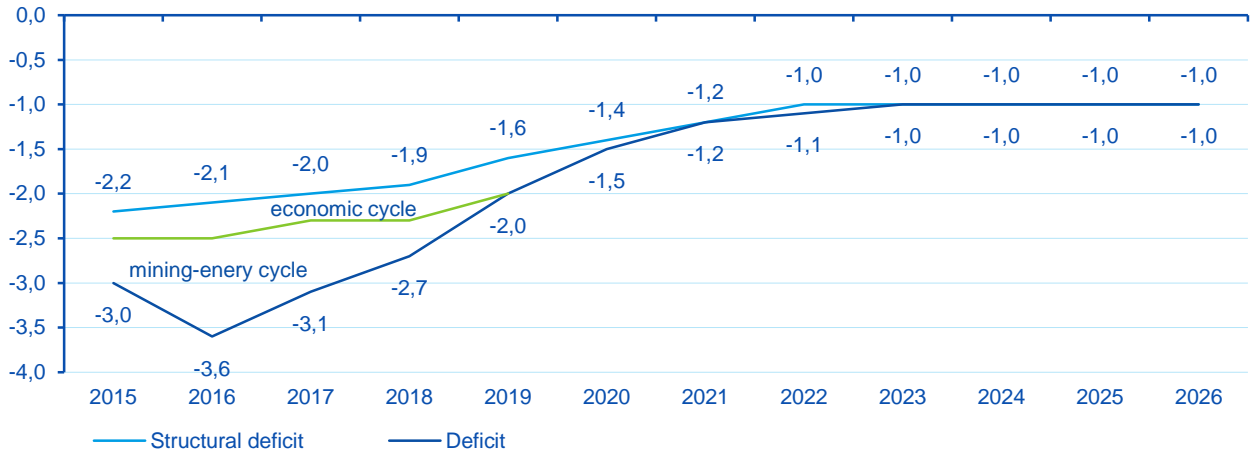
In short, for 2015 and 2016 the fiscal rule should enable some alleviation of the economic slowdown at a time of lower revenues from the oil sector since it helps to keep up levels of expenditure as a proportion of GDP even though revenue is short. It is nonetheless important to point out that some sort of drive in terms of management on the part of the government is called for in 2016, to lift its revenues by 0.5% of GDP, in keeping with the MFMP.

In the medium to long term the projections published by the Ministry of Finance indicate that the misalignment of the observed deficit in relation to its structural counterpart will persist up to 2023, in which year the overall central government and structural balances will be on an equal footing, thus bringing to an end the negative cycle brought about by lower oil prices and low economic growth (Figure 6.1). Nonetheless there are signs that such a course requires a structural tax reform in the medium term. In fact, according to government projections in the MFMP, in 2019 funds that represent 1.7% of GDP are needed. After 2019, required funds are closer to 3% of GDP.

In attempting to analyse what kind of reform is required, one can turn to certain ostensibly consensus views regarding the Colombian tax system as a starting point. There is some agreement that the Colombian tax system is not progressive, in the sense that exemptions, deductions and credits, among other “exceptions”, often work to the detriment of progressivity, horizontal equity, simplicity and the system’s ability to effect collection. There is also agreement on the distorting property of certain taxes such as the Levy on Financial Movements and wealth tax. In this regard the reform that will be needed in the medium term must tend towards a more even-handed, efficient and straightforward system, while additionally ensuring greater revenues¹.

1: Certain peculiarities of the Colombian tax system were examined in Box 2 of our report for the fourth quarter of 2014.

Figure 6.1
Decomposition of the fiscal balance



Source: Banco de la República

7 Inflation will remain at over 4% in 2015 and will come back to within the target range in 2016

More severe currency depreciation than expected will prevent inflation from returning to the target band in 2015

Inflation averaged 4.5% in the second quarter, outstripping the first quarter reading of 4.2%. A good part of the rise in the second quarter was due to the figure for April, when inflation was 4.64%, being pushed up by food prices as it had been in Q1 (Figure 7.1). Under our scenario this rise should mark the high for the entire year given that food prices have been starting to right themselves since May and we expect this trend to continue over the coming months. In particular, we forecast bumper harvests of rice (which accounts for 6% of the foods group) in the second half, inspired by the high prices in the first half.

Another factor behind the increased inflation, though less significant, is the rise in prices of tradables (a group which represents 26% of the CPI). After the harsh currency depreciation at the end of 2014, prices for this group of goods surged in February and March, showing MoM variations of close to 1% (Figure 7.2). From February, MoM inflation among tradables began to ease up, slipping to a rise of 0.3% in May and suggesting that the depreciation shock had been melting away. Even so, in June inflation for this component rebounded by 0.5% MoM, which was more a reflection of a correction in vehicle prices (which represent 4.4% of the CPI) than any general rise among the goods classified as tradables.

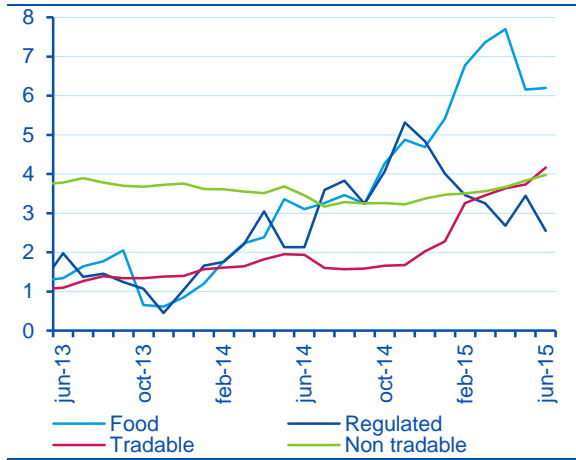
The rise in the exchange rate over recent months could prolong the pass-through from this to prices, which could cause the above-mentioned rally in June tradable prices to last for a few more months. This would temporarily give tradable inflation, which showed a rate of 4.1% YoY in June that was 2.1pp above the reading of 2.0% in December, additional scope to continue to climb over the next few months.

The three basic inflation indicators that we monitor have continued to show rises and over April to June they rose from 3.8% to 4.1% YoY on average. Here we should note that these have been influenced by the currency depreciation and should not be interpreted within any context of demand pull. Their recent movements in monthly terms closely shadow trends for tradables and this is why we also see a slowdown in these indicators in the last few months (Figure 7.2). Our calculations suggest that the indicators will continue to rise MoM for a few more months, though by steadily decreasing amounts until their AGRs peak at the end of the third quarter. For example, non-food inflation, which registered 3.7% YoY in June, will accelerate slightly up to a ceiling of 4% in September, whereupon it will fall back to rates of around 3% in the second part of 2016.

The central bank's inflation forecasts for the end of this year show stabilisation at around 3.9% in the readings for May, June and July. This, together with the fact that economic agents are keeping their inflation outlook for the next 12 and 24 months at close to 3%, is evidence that expectations remain anchored and that the market sees the recent rise in prices as a temporary phenomenon.

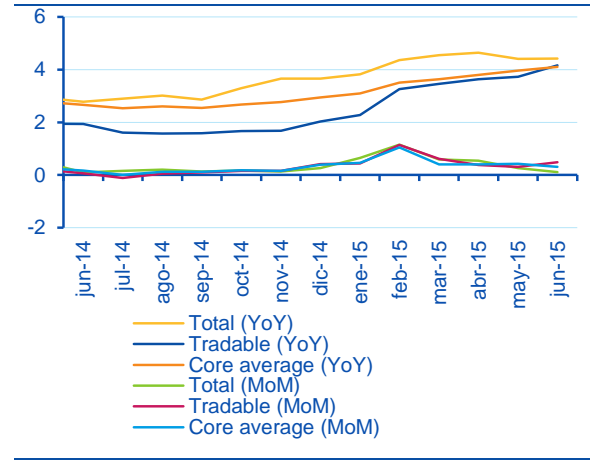
Our revision of the path of the exchange rate has meant that we will see a rise in the average currency depreciation in 2015 from 22% to 29%. We therefore expect the exchange rate to impact on prices for a longer time. This, together with the surprise on the high side for food prices in April that we saw, causes our inflation forecast for 2015 to rise to 4.1%. Nonetheless, in the current circumstances of great volatility, significantly high exchange rate levels for prolonged periods could leave inflation at a higher rate.

Figure 7.1
Inflation by category of product, % YoY



Source: DANE and BBVA Research

Figure 7.2
Inflation: total, tradable and basic (annual and monthly variations)

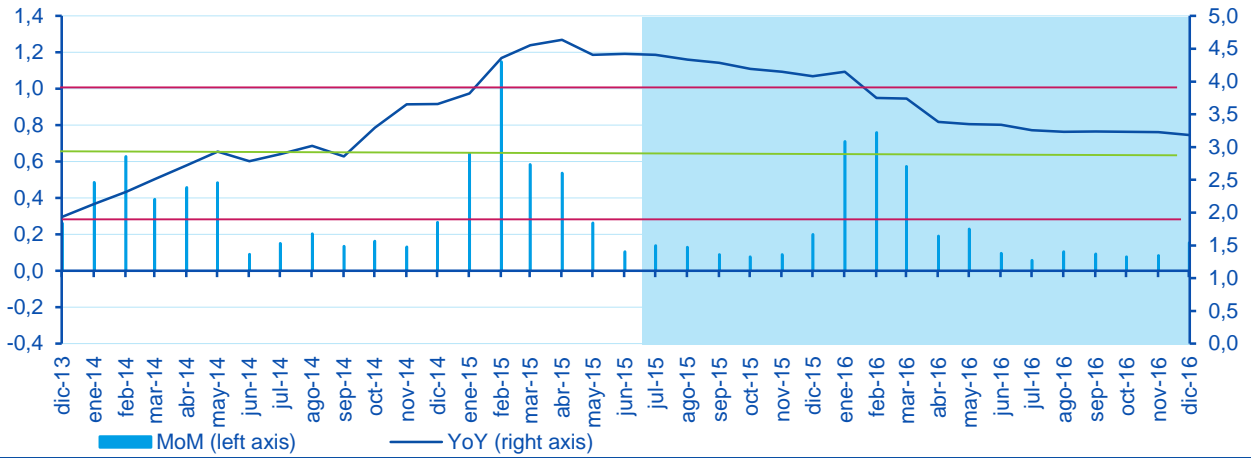


Source: DANE and BBVA Research

Low forecasts for economic growth will help inflation to approach its 3% target in 2016

The 50bp cut in economic growth in 2016 will lead to weaker demand, which will speed up the drop in inflation. Moreover, a high base effect left by inflation in 2015 will help price rises to home in on the inflation target more swiftly. We do, however, anticipate that indexing of prices in 2016 will be greater than in the past, not only because 2015 inflation will be higher than in 2014, but also on account of the high levels at around the 2,600 mark for USDCOP at the turn of the year. In this context, inflation should return to the target range in the first half and stand at 3.2% YoY at yearend. (Figure 7.3).

Figure 7.3
Inflation forecast



Source: DANE and BBVA Research Forecasts

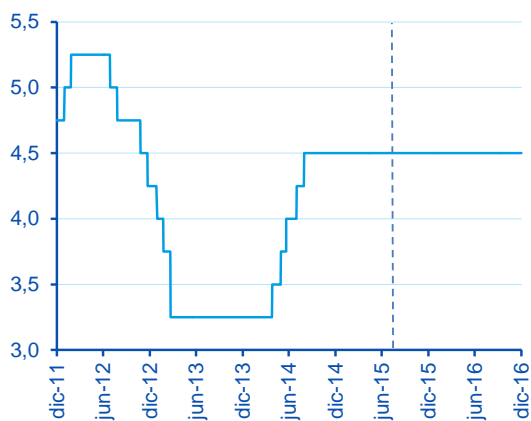
8 Monetary policy: stable rates

Expected movements in inflation and the current account deficit limit the scope for cutting the policy rate

At its latest meetings, the board (JDBR, in its Spanish acronym) of the central bank has held the reference rate stable and the language in its statements has been relatively neutral, which is much as expected. Nonetheless, two important points have been touched on in the latest statements and minutes. First, the JDBR considers that current interest rate levels are slightly expansionary. Indeed, a look at real rates using various different deflators reveals that they stand at relatively low levels below their historical averages. Second, concern over present current account levels has been at the heart of debate over monetary policy.

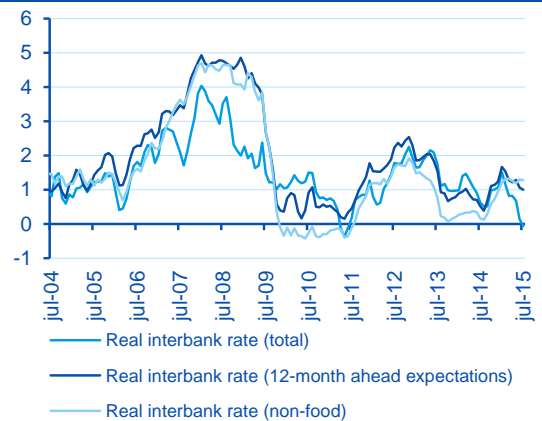
Although the weak showing by GDP would make it desirable to pursue an expansionary monetary policy, the JDBR sees the current episode of macroeconomic deceleration as an orderly shift to lower growth rates, which justifies its current stance on interest rates. Added to this, there are still several factors which straightjacket the central bank's options to act counter-cyclically. Among the variables currently standing in the way of a policy rate cut are the high current account deficit and the fact that inflation stands at above the central bank's target band. With respect to these elements, the latest minutes and statements from certain members of the JDBR have stressed that developments in connection with the current account have been key in recent monetary policy discussions. The baseline scenario therefore assumes that the optimum policy response by the central bank will be to hold its benchmark at 4.50% in 2015 and 2016.

Figure 8.1
Monetary policy rate



Source: DANE and BBVA Research

Figure 8.2
Interbank rate deflated with different inflation measures



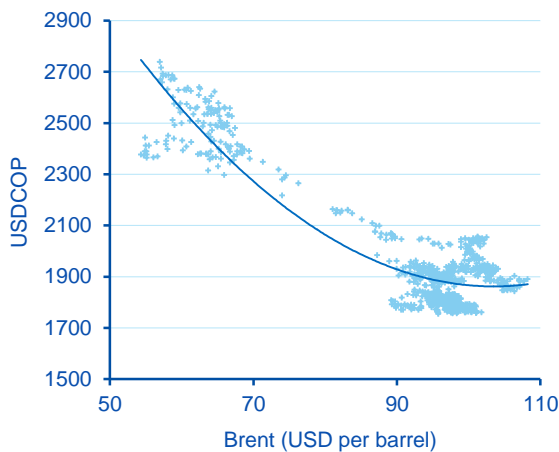
Source: DANE and BBVA Research

9 The exchange rate: further depreciation and high levels of volatility

Exchange rate reflects great uncertainty and the see-sawing oil prices and external conditions

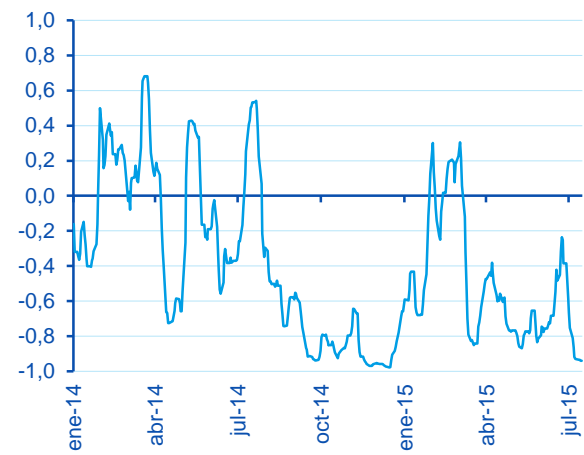
One of the main stylised facts with regard to the behaviour of the exchange rate in Colombia is the high correlation between the oil price and the exchange rate (Figure 9.1). This is nonetheless not constant over time and can present a significant range of variability. As Figure 9.2 illustrates, the observed correlation between the oil price and the exchange rate in the second quarter and early July 2015 has remained at a high level. Thus recent movements in the oil price, combined with high volatility levels in emerging markets, have had a significant impact on dynamics regarding the exchange rate, causing there to be a significant change in both its level and volatility so far in 2015 (see Box 1: Determinants of exchange rate volatility).

Gráfico 9.1
USDCOP vs. Brent price (2011 -2015)



Source: Bloomberg and BBVA Research

Gráfico 9.2
Correlation between the Brent price and the exchange rate (20-days window)



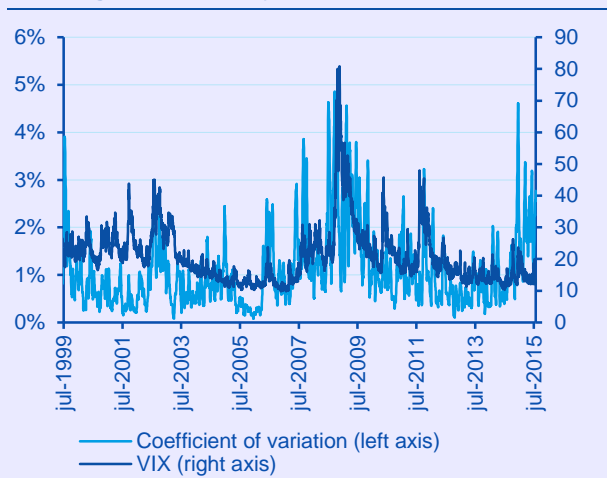
Source: BBVA Research

In such a context we expect the exchange rate to hold at high levels with high volatility in the final months of the year (Figures 9.3 and 9.4). Among the elements giving rise to this pattern are the anticipated moves by the US Federal Reserve, the oil price, the external situation and the weakness of Colombia's foreign figures. To be precise, for 2015 we expect the peso's average depreciation for the whole year to be 28.8%. This would give an average annual dollar rate of COP2,578. For 2016, we predict a marginal normalisation of its level, with an average annual dollar rate of COP2,513.

Box 1. Determinants of exchange rate volatility

One of the salient aspects of recent dynamics regarding the exchange rate has been the marked increase in its volatility. Empirical studies of Colombia's case have shown that the key determinants of volatility have in general been associated with external variables and episodes of risk aversion in world financial markets. Along these lines, a study conducted by Lega et al. (2007)² using an EGARCH model found evidence of the impact of country risk perception (measured by the EMBI) and forward currency depreciation on how exchange rate volatility behaves.

Figure B.1
Exchange rate volatility vs. the VIX



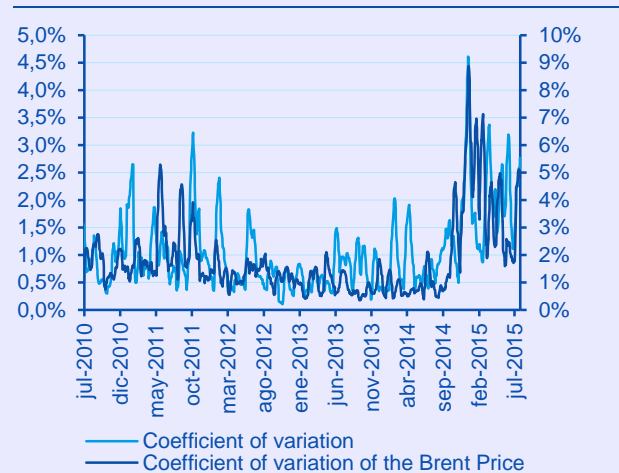
Source: BBVA Research and Bloomberg

A relationship of this kind can easily be seen by glancing at a graphical juxtaposition of volatility and external variables, such as the VIX for example. The recent outbreak of volatility has, however, erred a little from this behaviour, which suggests that there must be additional factors that account for the pattern at the moment. One such element could be oil price dynamics in their own right.

Even though the change in the exchange rate level has been associated with the fall in the oil price (as

was illustrated in Figure 9.1), when we examine the recent volatility in the USD/COP rate and the Brent price, it appears that there is also an impact on exchange rate volatility levels, as can be seen from Figure B.2.

Figure B. 2
Exchange rate volatility vs. Brent volatility



Source: BBVA Research and Bloomberg

To test this hypothesis, a similar model to the one proposed by Lega et al (2007) was estimated, where the exchange rate variance equation (volatility) was explained by the change in the EMBI, the forward currency depreciation and the change in the oil price. The results for the 2010-15 estimation window are to be found in Table B.1. As is evident, the change in the oil price is statistically significant in explaining exchange rate variance. Put simply, there is evidence that the oil price fall has had an impact on both the level and volatility of the exchange rate.

2: Lega, P. F., Murcia, A., Vásquez, D., & Venegas, T. (2007). Nominal exchange rate volatility in Colombia and how it relates to certain variables (No. 473). Banco de la Republica de Colombia.

Table B. 1

Variance equation (EGARCH)

Parameters	Coefficient	Standard Error	P-Value
α_0	(0.19)	0.03	0.0000
α_1	0.08	0.01	0.0000
α_2	0.05	0.01	0.0000
α_3	0.99	0.00	0.0000
α_4 (DLog_EMBI)	0.01	0.00	0.0047
α_5 (Forward currency depreciation)	(0.03)	0.01	0.0000
α_6 (Dlog_Brent)	(3.95)	0.84	0.0000

Source: BBVA Research

10 Risks

A lower oil price and disorderly monetary normalisation by the Fed would have an adverse effect on the economy

There is a set of global risks in the coming quarters which Colombia's economy will have to face. The first of these is the chance that the oil price will fail to rally. Although the probability of this is only limited, it cannot be ruled out, and as a result it could widen Colombia's current account deficit and create problems in raising funding abroad. This would therefore simultaneously force a greater adjustment of domestic demand. The second factor is a potential disorderly exit by the Fed, with fallout for Colombia's current account, and world financial and credit markets. Nonetheless, this has become increasingly unlikely. The third factor will take into account how Greece and China fare. With respect to Greece, this entails an upturn in financial volatility while its predicament plays out to its full extent. In China's case, there are negative effects on commodity prices.

Further erosion of consumer confidence would hit consumption hardest

There is also another set of local or idiosyncratic risks. The most important of these concerns developments in consumer confidence. This received a battering in April and lingered at low levels in May and June. Any additional setbacks for confidence would lead to lower private consumption. The other risk relates to progress in the ability to execute public investment projects, both traditional ones and under the fourth generation programme. In this case it should be added that maintaining growth in 2016 partly owes itself to expectations of a substantial positive contribution from public works construction, especially within the fourth generation (4G) programme. Finally, greater than anticipated exchange rate depreciation pass-through to prices, arising from either a higher pass-through rate or significantly higher exchange rate levels, could bring the risk of a more restrictive monetary stance.

11 Table with projections

Tabla 11.1

Annual macroeconomic forecasts

	2013	2014	2015	2016
GDP (% YoY)	4,9	4,6	3,1	3,1
Private Consumption (%YoY)	3,8	4,4	3,1	3,5
Public Consumption (%YoY)	9,2	6,2	2,7	3,0
Investment (%YoY)	6,0	10,9	4,8	4,8
Inflation (%YoY, eop)	1,9	3,7	4,1	3,2
Inflation (%YoY, average)	2,0	2,9	4,3	3,4
Exchange Rate (vs. USD, eop)	1.927	2.392	2.596	2.503
Devaluation (vs. USD, eop)	9,0%	24,1%	8,5%	-3,6%
Exchange Rate (vs. USD, average)	1.869	2.001	2.578	2.513
Devaluation (vs. USD, average)	3,9%	7,1%	28,8%	-2,5%
Central Bank Interest Rate (% eop)	3,25	4,50	4,50	4,50
FTD Interest Rate (% eop)	4,06	4,34	4,61	4,66
Unemployment rate (% eop)	9,7	9,3	9,9	10,3
Fiscal Balance (% PIB)	-2,4	-2,4	-3,0	-3,6
Current Account (% PIB)	-3,2	-5,2	-5,6	-4,7

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

Tabla 8.2

Quarterly macroeconomic forecasts

	GDP (YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD, eop)	Monetary policy rate (%, fdp)
T1 13	2,9	1,9	1.832	3,25
T2 13	4,7	2,2	1.929	3,25
T3 13	6,1	2,3	1.915	3,25
T4 13	6,0	1,9	1.927	3,25
T1 14	6,5	2,5	1.965	3,25
T2 14	4,1	2,8	1.881	4,00
T3 14	4,2	2,9	2.028	4,50
T4 14	3,5	3,7	2.392	4,50
T1 15	2,8	4,6	2.576	4,50
T2 15	3,5	4,4	2.585	4,50
T3 15	2,9	4,3	2.725	4,50
T4 15	3,0	4,1	2.596	4,50
T1 16	2,9	3,7	2.520	4,50
T2 16	2,9	3,3	2.501	4,50
T3 16	3,3	3,2	2.502	4,50
T4 16	3,3	3,2	2.503	4,50

Source: DANE, Banco de la República y BBVA Research

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This report has been produced by the Colombia Unit:

Chief Economist for Developed Economies

Juana Téllez
juana.tellez@bbva.com

Fabián García
fabianmauricio.garcia@bbva.com

José Vicente Romero
josevicente.romero@bbva.com

Mauricio Hernández
mauricio.hernandez@bbva.com

María Claudia Llanes
maria.llanes@bbva.com

Interns:

Sebastián León
juansebastian.leon@bbva.com

BBVA Research

Group Chief Economist

Jorge Sicilia Serrano

Developed Economies Area

Rafael Doménech
r.domenech@bbva.com

Spain

Miguel Cardoso
miguel.cardoso@bbva.com

Europe

Miguel Jiménez
mjimenezg@bbva.com

US

Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets

Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia

Le Xia
le.xia@bbva.com

Mexico

Carlos Serrano
carlos.serranoh@bbva.com

LATAM Coordination

Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina

Gloria Sorensen
gsorensen@bbva.com

Chile

Jorge Selaive
jselaive@bbva.com

Colombia

Juana Téllez
juana.tellez@bbva.com

Peru

Hugo Perea
hperea@bbva.com

Venezuela

Oswaldo López
oswaldo.lopez@bbva.com

Financial Systems and Regulation Area

Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems

Ana Rubio
arubiog@bbva.com

Financial Inclusion

David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy

María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy

José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination

Matías Viola
matias.viola@bbva.com

Global Areas

Economic Scenarios

Julián Cubero
juan.cubero@bbva.com

Financial Scenarios

Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes

Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research Colombia

Carrera 9 No 72-21 Piso 10
Bogotá, Colombia
Tel: 3471600 ext 11448
E-mail: bbvaresearch_colombia@bbva.com
www.bbvaresearch.com