BBVA | RESEARCH

Colombia Economic Outlook

4th QUARTER 2015 | COLOMBIA UNIT

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Global growth is suffering from the drop in dynamism among the emerging markets

02
Colombia is coping with the oil shock well and will manage to keep moving ahead at reasonable rates with its improved growth profile

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Depreciation and the El Niño weather phenomenon will delay inflation's convergence with its target band

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The central bank is raising its intervention rate and trying to hasten the correction of inflation to within its target range

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1 Overview

Local assets were hit by a whole raft of shocks in the last quarter, notable among which were the lower growth of China's economy, uncertainty over the Fed's decision, and the surprise increase in inflation and the COP exchange rate, which led to a rise in the central bank's rate.

Colombia's economy suffered a powerful shock to its sources of growth in the past two years. Nonetheless, thanks to the ability of other sectors to expand and the institutional framework which has enabled a free-floating COP exchange rate and a rise in the fiscal deficit, it will manage to keep up GDP growth, even if this is more modest than in previous years. **Overall, the economy will grow at 2.7% in 2015 and 2.4% in 2016.**

Growth will, moreover, be more balanced overall and the acceleration will be less focused on only a few economic sectors. In 2016, we expect final consumption to ease up, especially with respect to public spending. Growth in 2016 will, therefore, be based on a profile that is less reliant on mining and government stimulus, and it will benefit from import substitution as well as an improvement in the country's industrial installed capacity and infrastructure.

The anticipated current account deficit is 6.4% of GDP in 2015 and 5.5% of GDP in 2016. Correction will chiefly come from the factor income account, which includes dividends sent abroad. Whereas in 2014 this account was responsible for 65% of the current account deficit, this will be 37% in 2015 and 43% in 2016. On the other hand, the balance of trade will be the account that makes the largest contribution to the deficit, this moving from 23% in 2014 to 72% in 2015, and then 55% in 2016.

We are raising our inflation forecast to 5.9% for 2015 and to 3.7% in 2016. The 2015 increase owes itself to both the effects of the El Niño weather phenomenon on food inflation and the 11% depreciation in the COP exchange rate over July to August, while the rise in 2016 arises from higher index-linking of prices and the effects of the tail-end of El Niño on food inflation.

Trends in inflation expectations, and the fact that inflation has been closing in on its long-term target level more sluggishly, led the central bank to hike its benchmark intervention rate in September and October. Given the commitment which the central bank has shown to keeping inflation expectations anchored, our central scenario embraces the possibility of a further policy rate hike of 25bp in the fourth quarter of 2015 to take the overall level up to 5.50%. In 2016, monetary policy should continue to be highly data-dependent, mainly focusing on expectations and how fast inflation is moving towards its target band.

The COP exchange rate should continue to be mainly influenced by oil price movements and the international setting. **It is important to make the point that exchange rate flexibility continues to prove an appropriate policy strategy that partly softens the effects of the terms of trade shock and speeds up correction of the current account deficit**.

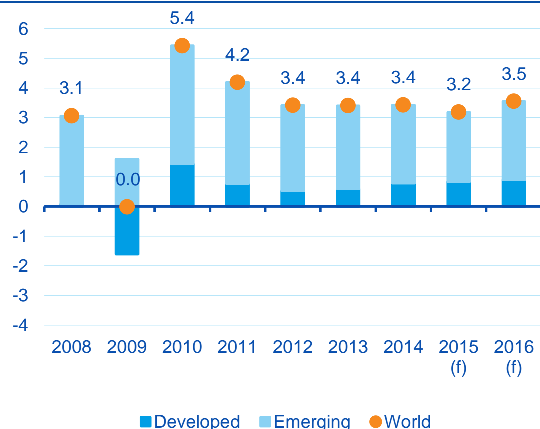
In the latest fiscal accounts published in mid-October, the government revealed its intention to engage in "belt-tightening" in 2016. If we factor in the spending reduction disclosed by the government, our path for the deficit is very similar to that of three months ago, despite the greater pressure to open up the deficit further in the current scenario compared to that in July. The new figures offered by the government provide evidence of its commitment to fiscal discipline.

2 Slowdown in global growth in 2015 and marginal improvement in 2016

According to our estimates, global GDP has grown four consecutive quarters below the 2010-14 average, mainly due to the ongoing deceleration in the principal emerging economies, in a context in which doubts over the strength of the economic cycle and the financial stability of China have triggered a significant spike in financial tensions and further corrections in commodity prices.

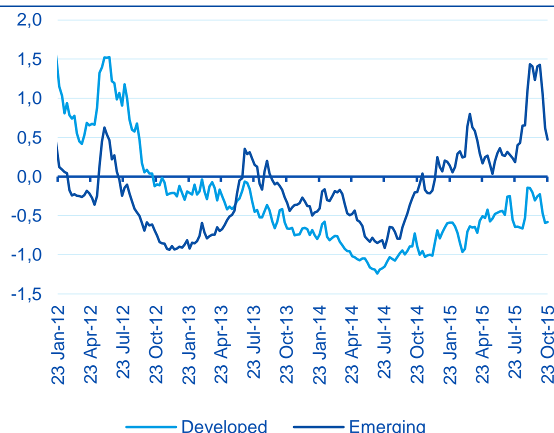
Global GDP growth could close 2015 at an annualised 3.2% (0.2% less than what we forecasted three months ago), the lowest since 2009 (see Figure 2.1). The gradual recovery of the developed block will not be sufficient to offset the moderation in the emerging, given that the latter will grow barely 4%, compared with the average growth in the five previous years of more than 5.5%. The outlook for 2016 is slightly more favourable (global growth could recover to 3.5%, 0.3% below our forecast three months ago), sustained by a better relative performance of both the developed and the emerging economies.

Figure 2.1
World GDP: annual growth (%). Forecasts 2015-16



Source: BBVA Research

Figure 2.2
BBVA Financial Tensions Index



Source: BBVA Research

All in all, the stabilisation of commodity prices at low levels and the sustained rise in financial tensions in the emerging economies (Figure 2.5) - accompanied by heavy capital outflows, sharp currency depreciation and a widening of sovereign spreads - are evidence that the balance of global risks is still to the downside. Even when monetary policy in developed economies could mitigate the impact of a scenario of slower growth on global financial conditions, the scope it has to kick-start the economic cycle is reduced, taking into account the low levels of interest rates and the high volume of liquidity already in existence. The combination of a financial shock in China, which takes its annual growth well below 6%, with an even slower recovery of the developed economies block than observed to date is a significant risk scenario, both because of its plausibility (limited, but not negligible) and its severity, given its potential impact on the world economy in general and on Latam in particular (see Box 1).

USA: downwards revision to GDP growth expected for 2016 due to the deterioration in the external environment

As regards the detailed analysis of the principal economies, it is notable the stabilisation of economic growth in the US at lower rates than in other recovery episodes. Private consumption remains key to the healthy momentum of economic recovery; although not sufficient to offset the drops in both exports and investment in the energy sector (the fall in production and the erosion of oil companies' profitability anticipate a sharper correction in investment in the sector). GDP growth could reach 2.5% in 2015 and 2016.

The risks for the US economy in a more unfavourable global environment are determining the Fed's reaction function, and the start of the first interest rate hike, which would take place in December. In any case, the pace of rate increases is expected to be very gradual, probably reaching levels at end-2016 below those that we expected a quarter ago, and no higher than 1%.

China: upwards revision of GDP growth expected for 2015, although this will not dispel the uncertainties over the pace of future economic deceleration

China's cyclical position is obviously one of the principal variables to watch at a global level. The sharp stock market correction in August served as a warning of the risks posed by a financial shock in the country of a severity to compromise the growth in domestic spending. The magnitude of the capital outflows and the spike in financial volatility resulted in the introduction of a considerable battery of monetary policy measures directed at easing the deterioration in liquidity and its potential impact on the financing model of the corporate sector, which is heavily leveraged. The unexpected official announcement regarding the daily yuan exchange rate and the progressive cuts in reference rates fall into the same context, and are also characterised by a progressive deceleration of the economic activity, which has taken GDP growth below 7% YoY in the third quarter.

It seems that the authorities will continue to employ monetary stimulus measures (further interest-rate cuts have not been ruled out, in spite of the fact that there have already been five such cuts in the year to date) and to exploit the central government's scope to use fiscal policy to ensure that economic growth does not fall below 6% YoY. Our forecasts suggest GDP growth of 6.9% for 2015 and 6.2% for 2016.

Eurozone: resilient domestic demand with the ECB ready to avoid further declines in inflation

In the Eurozone, the economic recovery continues although the pace has not intensified as we anticipated three months ago. The pace of Eurozone GDP growth could increase to 1.8% in 2016 (barely less than we expected last quarter). Italy and France should explain the improvement in the overall figure. The accentuation of the risks to the downside to inflation forecasts -largely due to cheaper imported goods- together with the recent appreciation of the euro, once again raises the question as to how much room for improvement there is in monetary conditions in the Eurozone. The ECB is extremely sensitive to this scenario, and this would justify the adoption of new stimulus measures in the short term.

3 High volatility in local markets

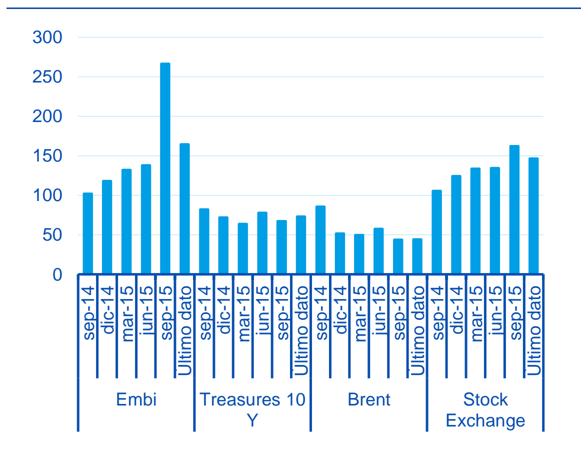
The recent correction failed to turn round the market losses since August

Local assets were hit by several shocks, both from outside and within. On the external front, the international situation deteriorated notably over summertime in the northern hemisphere. As a result, the risk premiums of emerging markets increased, owing to the side-effects in connection with commodity prices. In particular, the oil price gave back all the ground it had regained over the second quarter of the year and hovered close to its low of recent years for several weeks. Then in October, albeit in erratic fashion, it returned to an average level which topped that observed in 3Q15 (Figure 3.1).

Fears over a hard landing for China have also been a feature of markets. Although Q3 growth was a fraction more than expected, the GDP variation will continue to correct itself down to levels of close to 6% in the medium term, as we have seen in the previous section. Finally, US T-bond rates have exhibited marked volatility since August, on the back of the prospect of Fed rate hikes. More recently, volatility has settled down a bit, owing to the lower probability of a hike that is implied in market trading, yet investors remain very much alert to the consequences that imminent lift-off will have, the likelihood of this having increased since the FOMC statement at its October meeting.

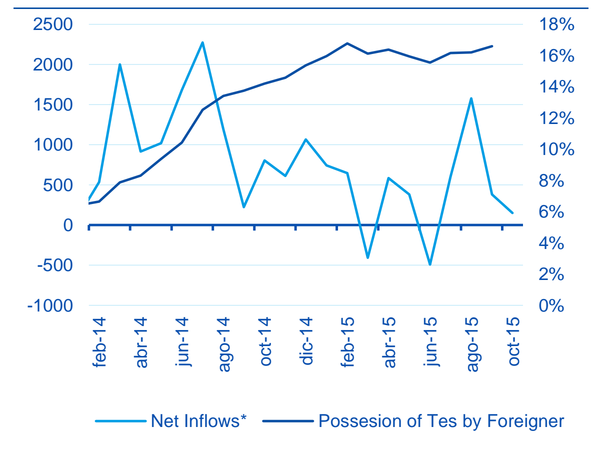
In the course of these external shocks, capital inflows to Colombia held in positive territory, even managing historically high levels in August, which is remarkable given the current scenario of capital outflows from several of the emerging economies. They are also indicative of international investor confidence in the institutional framework (target inflation, a floating exchange rate and a fiscal rule) on which Colombian macroeconomic policy is supported (Figure 3.2).

Figure 3.1
EMBI, 10-year T-bond rates, Brent crude price and the exchange rate (December 2013=100)



Latest figure is as of 3 November
Source: BBVA Research.*EMBI Colombia and USD/COP rate

Figure 3.2
Capital flows (USD bn) and TES bonds held by foreigners (% of total)



- Data as of 16 October

Source: BBVA Research and Bloomberg

These global pressures recently relented, although they remained at a level of greater stress than was observed in 2Q15. In response, Colombia's country risk (as measured through the EMBI) diminished, coming down from 320 basis points (bp) at the end of September after sudden rises in global risk aversion to the present level of 272bp (Figure 3.1).

The shock on a local level was the surprise increase in the inflation and COP exchange rates, which prompted a rise in the central bank's reference rate. This shock fuelled further losses for local assets over August and September, and has limited the impact of the recent improvement in the global environment. As a result, the domestic government bond curve, which had seen notable rate rises at both the short and long ends since July (more over the long section, which made it steepen going out), saw slight price gains at the long end, while the price dipped again at the short end. Thus, although all along it the TES curve is still showing yields above levels midway through the year, it has recently flattened out (Figure 3.3). On the other hand, the rate on the benchmark due 2017 for TES bonds index-linked through the RVU (Real Value Unit, or *UVR* in Spanish) has been pared down by 121bp since July, thus offsetting the spike in the inflation rate.

Erratic behaviour by the COP exchange rate and the stock market index will persist in the coming months

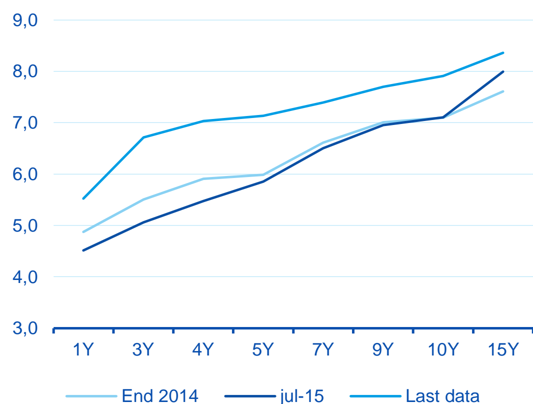
The COP exchange rate has likewise been depreciating heavily since the end of July in a process that only seems to have halted in the past month. Its unmistakable correlation with the oil price and risk aversion was what led to this, besides its flexibility to adjust to the Colombian economy's greater external imbalances (a more negative balance of trade in Q3 than in Q2).

More recently, on top of the partial correction in international conditions, a regulatory change by the central bank has accompanied a more helpful dollar trend. Exchange rate policy allowed the financial system to run a short (or negative) own cash position of up to 20% of the regulatory capital of the banks in September. Since then, the banks' cash in dollars has dropped to record lows (of around USD700mn). With this measure, the banks requirement for dollars purchased in the spot market when their cash levels are low (as is currently the case) has been reduced, which limits the financial system's demand for dollars. Nonetheless, as we will see in section 9, we still expect high exchange rate volatility in the coming months.

Finally, the Colombian stock market index saw an additional change to its composition in the past quarter, which further accentuated the loss of relative weight suffered by oil stocks since the slump in commodity prices began (Figure 3.4).

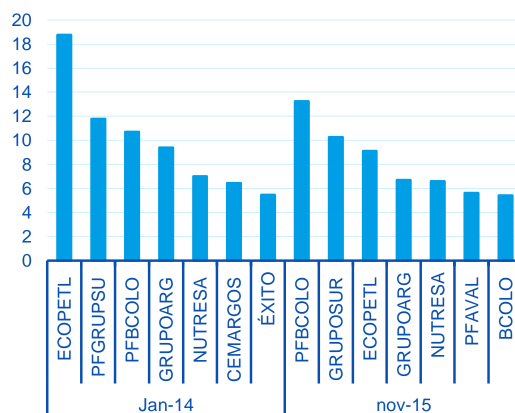
Going forward, the key elements on the international scene will still give rise to volatility in the domestic market, above all as far as decisions by the Federal Reserve are concerned (see Section 2). Local investors will likewise continue to hedge their portfolios against any additional increase in inflation in Colombia and monetary policy responses to these.

Figure 3.3
TES curve on selected dates (yields)



Source: BBVA Research and Bloomberg

Figure 3.4
Change in the composition of the ColCap stock market index, January 2014 to the present



Source: BBVA Research and Bloomberg

4 The oil shock will bring about a change in the Colombian economy's growth profile

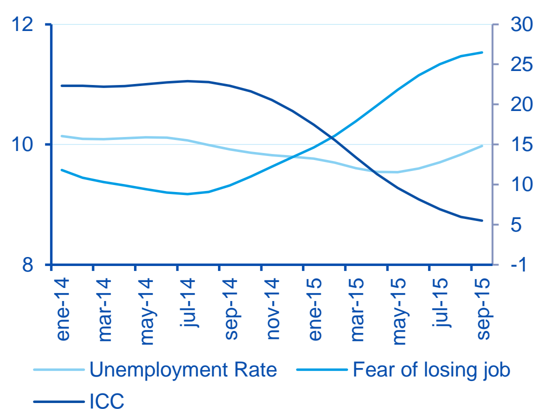
Growth of the economy in 2015 has been driven by construction and the labour market's partial resilience to the economic slowdown

The economy should have grown by 2.7% YoY in 2015. The slowdown was more marked in the case of foreign trade and investment in sectors other than construction. Household consumption also lost steam, although it managed to keep up exceptional growth rates in certain groups of goods and services, with even the odd temporary acceleration in Q3. Overall, the economy grew by 2.9% in the first half of the year and some additional deceleration is expected, especially in the final quarter of 2015.

Household confidence and the labour market have both seen deterioration, particularly from the second half of the year. Consumer expectations have receded, principally because of the gloomier view of current and expected economic conditions in Colombia, but there has also been a drop in optimism (albeit a more moderate one) in relation to labour conditions, willingness to buy durable goods (especially vehicle purchases) and assessments of the household economy. The decline in the labour market has been evidenced by two simultaneous elements: the deterioration in the quality of employment, in the sense that informal employment has grown more, and a rise in the unemployment rate (Figure 4.1).

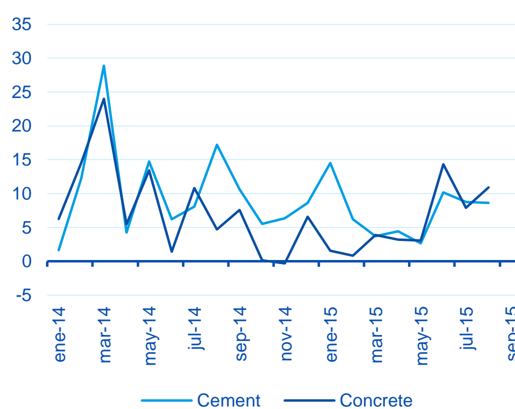
The construction sector has been pivotal in offsetting the lower growth of the components above, in terms of both building construction and public works. In the first case, growth was sustained by the non-residential activity that goes back to 2014 (commercial premises, offices and warehouses and stores), which provides more value added to GDP than housing itself. Public works also showed notable growth owing to better execution of the investment budget, which is a typical feature of the final year in office of regional and local governments, and which was boosted by the additional contribution of the royalty revenues that had amassed from previous years (Figure 4.2).

Figure 4.1
Household confidence (net index), fear of job-loss (net index) and unemployment rate (%)



Source: Fedesarrollo and DANE

Figure 4.2
Growth in cement shipments and concrete production (% var. YoY)



Source: DANE and BBVA Research

Looking at the relative sectors, construction has grown the most in 2015, followed by trade, restaurants and hotels, which sectors benefited from the sound labour market indicators recorded over a large part of the year. Financial and business services, and agriculture (thanks to record crops for coffee), all grew ahead of

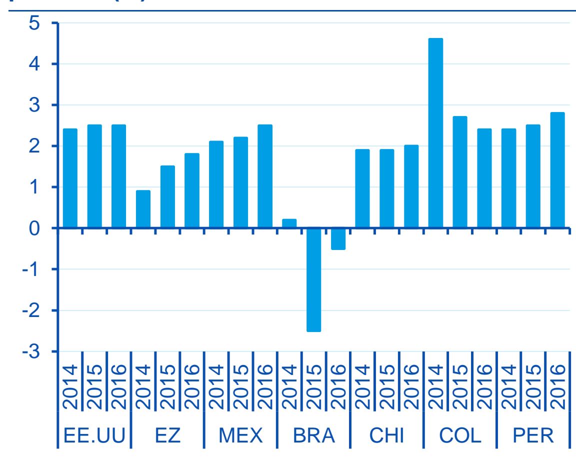
the national average on balance. Industry saw growth of 1%, a rate which was not even over the whole year and gained from the opening of REFICAR (the Cartagena refinery) in the final quarter of the year.

The slowdown in private and public consumption will not be offset by industry's rebound and construction growth in 2016

Colombia's economy suffered a major shock to its sources of growth of previous years. Even so, thanks to the ability to grow of other sectors, such as construction, and the positive effect from automatic shock-absorbers, such as the currency depreciation on tradable goods sectors, it will manage to keep up rates where GDP is growing, though these will be more modest than in previous years. Consequently, growth will be generally more balanced and acceleration will be less concentrated on only a few economic sectors.

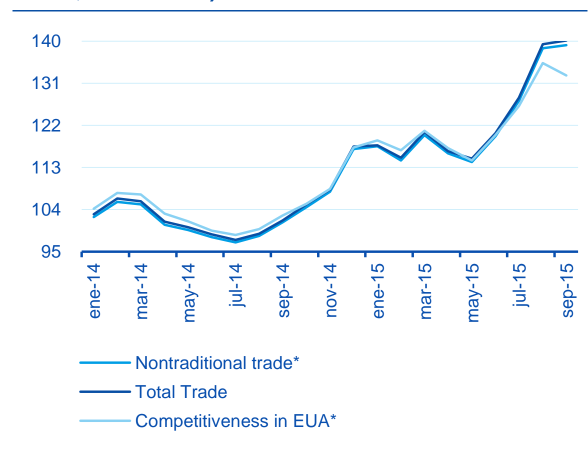
Turning to 2016, growth trends will be present a slight divergence from what we have observed this year. First, investment other than in construction and exports will pick up notably, moving from negative variations to growth rates of close to 5% YoY in both cases. The mainstay of private investment will be the better industrial production scenario and the boost to the mining sector from firmer oil prices. Meanwhile exports will be helped by increased growth among the developed countries, the gradual recovery for Colombia's regional trading partners (Figure 4.3), the sustained depreciation of the real COP exchange rate (Figure 4.4) and improved industrial capacity.

Figure 4.3
Expected economy growth for some trading partners (%)



Source: BBVA Research

Figure 4.4
Real exchange rate by type of goods (geometric mean, 2000 = 100)



Source: BBVA Research and Bloomberg

With respect to the industrial improvement, Box 1 illustrates the significance of the opening of the Cartagena refinery. It is important in terms of fuel import substitution, adding value in the petrochemical supply chain and the surpluses which Colombia will have available to export oil derivative products. This more than outweighs the reduction in crude surpluses sent abroad, owing to greater domestic demand and adding value. Moreover, in 2016 execution will begin of the infrastructure works that were put out to tender under the format of fourth generation concessions. Although the execution and outlay levels for these are bell-shaped, where the middle years take up the lion's share of the project expenditure, the first year will mean an injection of close to COP2trn (between 0.2 and 0.3 percentage points of GDP growth) into the economy.

On the other hand, final consumption will see a substantial additional deceleration. Household spending will rise in 2016 at below the level in 2015 because the slowdown will be by a long way in durable goods other than vehicles and for certain semi-durable goods. The dampening of this kind of consumption was still only

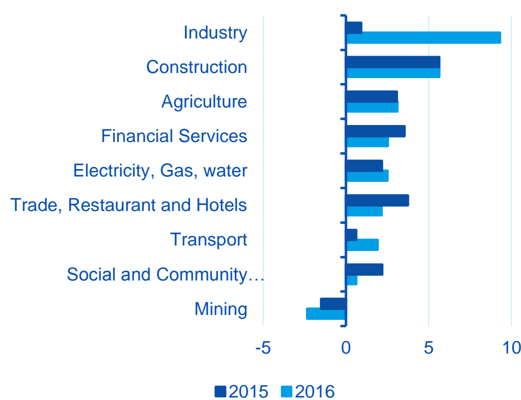
timid in 2015 and out of touch with the confidence indicators in negative terrain and the progressive deterioration in the formal employment picture. Furthermore, the higher interest rates in the wake of the central bank's intervention rate hike will bring down the demand for consumer goods. We therefore expect the full adjustment to take place from the end of 2015 and over most of 2016.

Meanwhile public spending will have negligible real growth in 2016. This less bright outlook factors in the budget restrictions recognised by the government in the 2016 expenditure plan and the lower execution rates typical of regional bodies at the start of a new term in office. This lower level of regional spending will also affect traditional public works carried out under contract, which will be limited by the lower mining and oil royalty revenues controlled by the regions due to the low oil prices prevailing during 2015-16.

In sector terms, growth in 2016 will be driven by industry's expansion at 9.3%, boosted by REFICAR and the recovery of other sectors such as textiles and the petrochemical industry. As in 2015, construction will make a positive contribution to growth, but this time it will be more marked by the building construction component than public works. Building construction will be boosted by the government's active public policy, which is mostly designed around the PIPE 2.0 plan: interest rate cover for 50,000 new homes in the middle to high price-range from 2016, continuation and broadening of the free housing and VIPA (homes for savers) programmes, and a project for the building over the next three years of 32,000 school classrooms. Our forecasts fully factor in the first two of these policies and the last one in part.

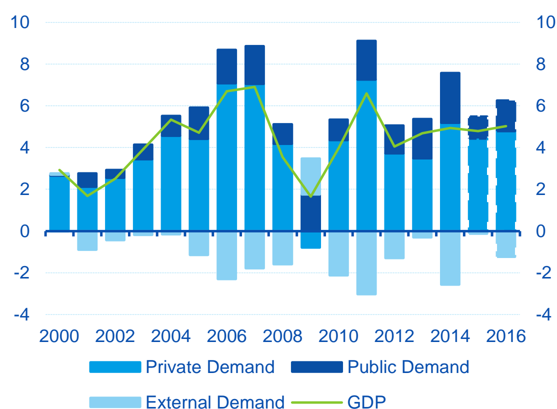
Agriculture will also contribute positively, with growth ahead of GDP overall, thanks to the rise in harvests that ought to have been inspired by the high food prices at the end of 2015. The other sectors should see a slowdown relative to their performances of the previous year, offsetting the upturn for industry and the fine showing by construction. Notable among these is mining, which should see a contraction of 2.3% due to the drop in oil production that we anticipate next year and the marked flagging that will be observed in business activity and public consumption (Figure 4.5).

Figure 4.5
Sector forecasts for 2015 and 2016 (% var. YoY)



Source: DANE and BBVA Research

Figure 4.6
GDP, public and private sector demand, and the net external balance (contribution to var. YoY)



Source: BBVA Research and Bloomberg

To conclude, in 2016 we expect a slowdown in final consumption, especially as regards public spending. Thus the greater evenness of growth on balance in 2016 is based on a profile that is less mining-dependent and reliant on government stimulus. It will moreover be underpinned by exports with a greater value-added component and an improvement in terms of industrial installed capacity and infrastructure nationwide, which will lead to more diversified growth spread among several sectors in the economy (Figure 4.6).

All in all, we estimate that GDP growth in 2016 will be 2.4%. This rate will be higher than the growth anticipated for Latin America (0.5%), owing to the strongly negative contribution from Brazil and still low growth in the other Andean countries in South America.

Key to the transition of Colombia's economy which we outline is the role of the macroeconomic institutional framework that enabled currency flotation and the temporary rise in the fiscal deficit. Both factors have allowed a soft landing, while the former has sown the seeds for the tradable goods sector to gain in strength in the medium term and join the sectors that are front-runners of growth.

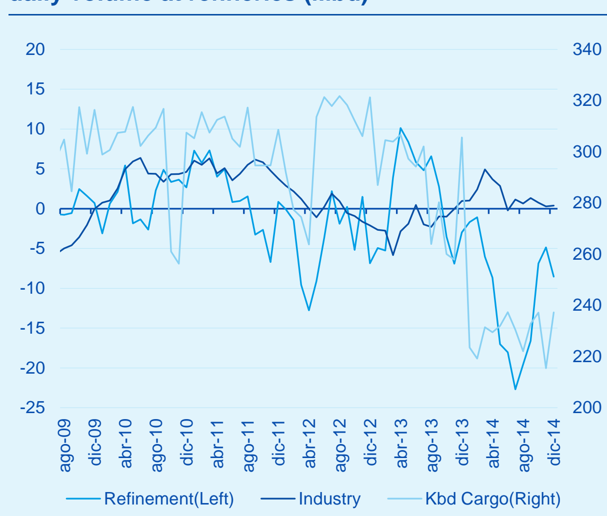
We are revising the economy's growth potential downwards

Over the medium term, we have also made some downward corrections of GDP growth rates, which are based on the lower estimated growth potential according to our most recent models. According to these, the economy's potential to expand only moves back above 4.0% at the end of the decade, all of which hinges on execution of the fourth generation infrastructure works being done at a reasonable pace (according to an execution profile which BBVA Research has and which is less optimistic than that suggested by the government). We now estimate growth over 2017 to 2020 will be at an annual average rate of 4.1%, which is down from the figure of 4.6% that was ventured three months ago.

Box 1. REFICAR will lift GDP growth by 0.7 percentage points in 2016

The expansion and modernisation of the Cartagena Refinery (REFICAR) began in mid-2012, and in its final phase REFICAR completely suspended production in early March 2014. As a result, the volume at refineries came down from 303,000 barrels a day (Mbd) to 229Mbd over 2012 to 2014, thus weighing on the industry's performance over a large part of 2014 (Figure B.1.1).

Figure B.1.1
Industry and oil refining growth (% var. YoY) vs. daily volume at refineries (Mbd)



Source: DANE and UPME

Besides raising its installed capacity from 85 to 165 Mbd, the modernisation of REFICAR improves the conversion factor from 74% to 95%, significantly decreasing the cost per barrel of producing refined products. Moreover, the sulphur content of the fuels produced there will be reduced, which has a positive environmental impact. Diesel, for example, will come to have less than 10 parts per million of sulphur, which is far below the pre-modernisation figure of 2,400.

The refinery is ready to come into service and partial filling of the tanks was begun in October. It is estimated that in November REFICAR will start to process 80Mbd, while in January the volume should increase to 120Mbd and by March the refinery should be operating at full capacity. The positive impact on the industry will thus start to be felt from 4Q15.

We should recall that refining is Colombia's most important industrial segment, with a 19% share of industrial production and 2% of GDP in 2014. For this reason, REFICAR's phase-in will have a major impact on the growth of the economy.

Following the timeline described above, REFICAR's opening in 4Q15 should lift the volume for the country's refineries by 50 Mbd to a total of 275Mbd (Table B.1.1). REFICAR should therefore raise industrial GDP by 2.6 percentage points (pp), and make a contribution to total GDP growth in 4Q15 of 0.3pp. We note that its impact will be most keenly felt in the first three quarters of 2016, with a contribution of over 7pp of growth to industry and around 0.8pp to GDP (Table B.1.1). Overall, we expect REFICAR to provide 0.7pp to GDP growth in 2016.

Table B.1.1
Volume at refineries and its impact on GDP and industry

Quarter	Volume (Mbd)	Contribution to industry (pp)	Contribution to GDP (pp)
4Q14	230	-1.3	-0.2
1Q15	225	-2.2	-0.2
2Q15	226	-0.9	-0.1
3Q15	225	0.4	0.0
4Q15	275	2.7	0.3
1Q16	345	5.8	0.6
2Q16	386	7.5	0.8
3Q16	386	8.0	0.9
4Q16	386	4.8	0.6

Source: DANE, UPME, Ecopetrol and BBVA Research

The calculations above do not include the positive effects that REFICAR will have on other branches of industry. For example, the chemical industry will benefit from the greater availability of sulphur to manufacture soaps, fungicides and fertilisers. Similarly, the increased availability of raw materials produced by REFICAR will incentivise

investment in manufacturing synthetic materials (fibres, textiles, nylon), polypropylene products (toys, auto parts, plastic containers) and those made of polyethylene (bags, food and drinks packaging). REFICAR will thus become a hub for the development of a petrochemical industry cluster in the Colombian Caribbean.

Finally, REFICAR will also have a positive impact on Colombia's external accounts. For example, its opening will mean the substitution of over one million barrels a month of fuels such as diesel, petrol and jet fuel which Colombia had been importing, thereby consolidating its energy self-sufficiency. In fact, besides meeting domestic demand, REFICAR's opening will allow Colombia to have exportable surpluses of diesel (25Mbd), naphtha (20Mbd), petrol (14Mbd) and jet fuel (5.5Mbd) (see Box B.1.2).

Table B.1.2
Principal REFICAR products and distribution of them in the domestic and external market (barrels, days)

	Production	Domestic consumption	Exportable surplus
Diesel	75,000	50,000	25,000
Nafta	30,000	10,000	20,000
Gasoline	30,000	16,000	14,000
Jet fuel	14,000	8,500	5,500
Propileno	5,000	5,000	0
GLP	4,000	4,000	0

Source: Ecopetrol

5 A larger current account deficit with a very gradual correction over the medium term

A slow adjustment of the economy's net exports and demand is delaying correction of the current account

As was to be expected, the first effect of the slump in oil prices was a mounting current account deficit, because the slowdown of domestic demand took longer and was more orderly than the sudden plunge in commodity prices. On top of this, the boost for other exports that should arise from the greater currency depreciation has still not materialised. And it could be delayed for even longer. The initial effect attributable to the change in external relative prices is import substitution involving a switch to local production, ahead of the stimulus to sales abroad of domestically produced items. The balance of trade thus saw an abrupt shift and ran into deficit at the end of 2014, after several straight years of positive contributions to the current account.

In 2016, there will be various factors that work in favour of a lower trade deficit. The oil price will move onto a path of recovery and will average USD59/bbl next year, a level around 9% above the comparable figure in 2015. Industrial exports will perform better, largely due to the new oil derivatives produced at the Cartagena refinery, as will those of the agricultural sector, while there will be a heftier adjustment of final consumption, which will have a dampening effect on import growth.

Furthermore, in 2015 and 2016 several automatic stabilisers will have partly mitigated the pressure on the current account from oil. First, the lower profits to be had by foreign oil and mining companies have led to a smaller outflow of dividends sent abroad from Colombia. This drop will equal the fall observed in foreign direct investment in 2015, but will be sharper in 2016, as the recovery of other tradable sectors and major infrastructure projects will involve the inflow of stable funding from abroad that will offset the persistence of a low level of investment in mining and oil activities and leave foreign investment stable over 2015 and 2016. Second, the lower levels of exports and imports have meant that less has been paid to foreign companies for foreign trade services. At the same time, the higher growth in developed countries, where a substantial number of Colombian emigrants are employed, has given rise to an increase in the wiring home of remittances. These will climb from representing 21% of the current account deficit in 2014 to 27% of the total deficit in 2016.

Overall, the anticipated current account deficit as a percentage of GDP is 6.4% in 2015 and 5.5% in 2016. The chief correction will come from the factor income account, which includes dividends sent abroad, since whereas in 2014 this account contributed 65% of the current account deficit, this will be 37% in 2015 and 43% in 2016. On the other hand, the balance of trade will be the account that contributes most to the deficit, the figure moving from 23% in 2014 to 72% in 2015 and 55% in 2016.

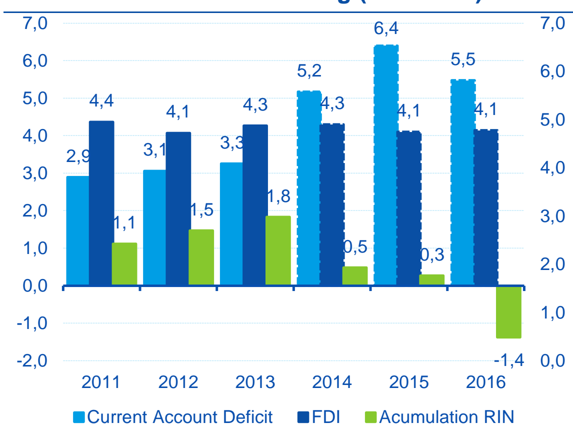
No decumulation of foreign exchange reserves is foreseen in 2015 (if anything only marginal, owing to investment portfolio valuation and volatility options). Capital flows (both portfolio and direct) were bigger than expected at the beginning of the year, which could relate to international investors having a favourable opinion of Colombia's domestic conditions. This has been confirmed by foreign issuance by the central government, which has totalled USD3.5bn, and the funding from abroad for certain private companies, which are elements that together have also helped to finance the current account.

That said, we cannot rule out decumulation of reserves in 2016, which, if this occurred, would reach USD1.5bn (0.5% of GDP) at most, as low portfolio flows are expected on account of the normalisation of monetary conditions in the United States. Moreover, foreign direct investment ought not to increase relative

to the figure that this year will show (around USD12bn) and the options for foreign issuance open to private sector interests and the government will be more limited, given the higher interest rates abroad.

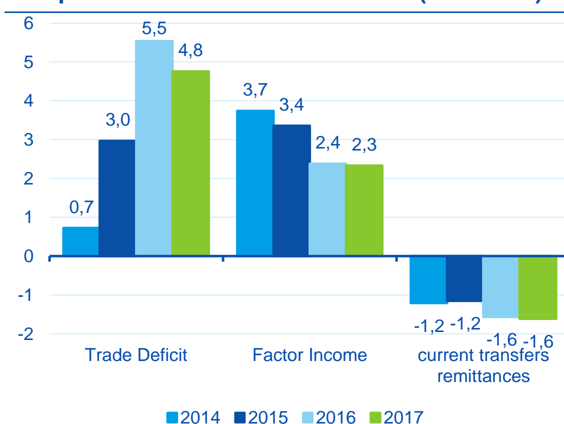
Even with this potential reduction in foreign exchange reserves, these will be at entirely healthy levels when set against the dollar value of GDP (16% of GDP) and total imports (enough to cover over 10 months of average imports). Furthermore, Colombia still has the IMF's flexible credit line in its arsenal, which guarantees the country liquidity in the event of unexpected difficulties as regards international credit and capital flows.

Figure 5.1
Current account and financing (% of GDP)



Source: Banco de la República and BBVA Research

Figure 5.2
Components of the current account (% of GDP)



Source: Banco de la República and BBVA Research

6 The spending cuts confirm the government's commitment to the fiscal rule

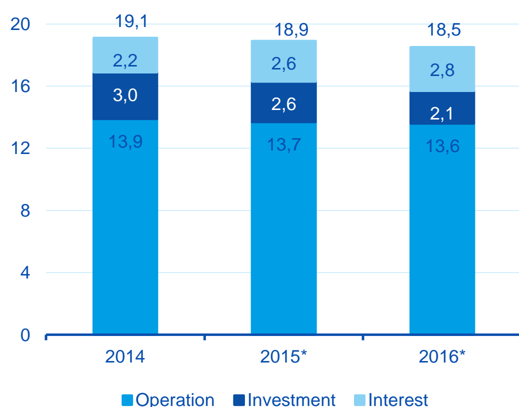
The latest fiscal accounts reduce government spending on administration

The public sector consumption figures for 2Q15 show a major slowdown in comparison with the previous year, which potentially reflects a cutback in government administrative spending. Specifically, in 2Q15 public sector consumption grew by 1.8% YoY, in contrast to annual growth of 6.9% in 2Q14. By the same token, annual governmental urban job creation showed smaller growth in 2Q15, which became even more marked over the three months from June to August, when there was growth of -2.2% YoY. This easing up of public sector consumption growth appears to be in line with the decree on the postponement of certain allocations in Colombia's General Budget (Decree 377) that was issued by the government in March 2015 and reflects the government's willingness to bring down expenditure.

Further to this, in mid-October, when the debate on the 2016 General Budget was closed, the government published a new central government assessment in which it revealed its intention not only to "implement belt-tightening" in 2015, but also to continue to do so in 2016. Such fiscal discipline was enshrined in the 2016 General Budget (*Presupuesto General de la Nación del 2016, or "PGN16"*), in which the total amount was shaved by 1 percentage point of GDP in 2016 relative to 2015, and might even turn out to be smaller in the sense that the execution of certain disbursements is subject to the requisite revenues being guaranteed so as to comply with the fiscal rule (at a time when uncertainty shrouds oil price movements).

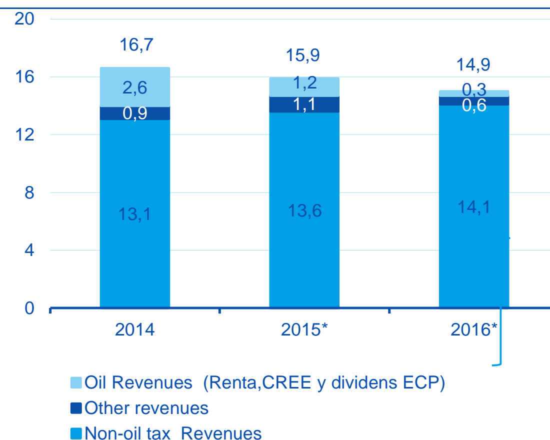
The new government accounts show central government spending as a percentage of GDP coming down from the 2014 level of 19.1% to one of 18.9% in 2015 and 18.5% in 2016 (Figure 6.1). This spending cut is achieved with a relatively stable outlay on administration as a percentage of GDP, which contrasts with the old pattern of rising expenditure on administration which the government exhibited in the Medium Term Fiscal Framework 2015 (*MFMP15*). The reduction in investment that these figures include had already been envisaged in the MFMP15.

Figure 6.1
Itemisation of central government expenditure (% of GDP)



Source: Ministry of Finance and BBVA Research.

Figure 6.2
Sources of central government revenue (% of GDP)



Source: Ministry of Finance and BBVA Research.

Besides the above-mentioned spending cuts, the government's new figures feature a reduction of revenues, which leaves the forecast deficit unchanged with respect to the MFMP15 (3% of GDP in 2015 and 3.6% of GDP in 2016, deficits that are in line with the fiscal rule). The lower government revenues in 2016 with respect to the scenario in the MFMP15 arise from lower oil revenues (0.1% of GDP) and lower non-oil tax revenues (0.6% of GDP). The latter could have partly been brought down on account of the lower expected economic growth which the government expects compared to that in the MFMP15, and also partly because there could be some uncertainty over the additional revenues which the government seeks to obtain from the enhancements to administration and supervision in combating tax evasion (this extra revenue is calculated to be 0.5% of GDP in the MFMP15) (Figure 6.2.).

The government deficit will be 3.1% in 2015 and 3.6% in 2016

Our predicted course for the deficit is very similar to that of three months ago: 3.1% (+0.1% of GDP) in 2015 and 3.6% (the same) in 2016. Although there has been pressure for a widening of the deficit when we compare this scenario with that foreseen in July, the deficit remains the same, given that the new scenario factors in the spending cuts brought into its accounts by the government. This pressure on the deficit to open up has been brought about by the lower oil price, higher interest and lower level of activity.

The 2016 deficit of 3.6% of GDP is subject to it being possible to implement the spending cuts in their entirety. In 2017, compliance with the fiscal rule requires additional revenues via a tax reform, which focuses more this time round on individuals (rather than corporates). In 2019, when the levies that were approved under the most recent tax reform expire, it will be imperative to find new sources of funding.

In short, the government confirms its commitment to fiscal discipline

Compliance with the new fiscal scenario advanced by the government requires an effort in terms of reining in spending on administration and is thus proof of the government's commitment to fiscal discipline. In this regard, these new figures presented by the government represent its acknowledgement of how important it is for the country to hold onto the benefits which the soundness of the fiscal institutional framework has brought with it (the Fiscal Rule, the Royalties Law and the Fiscal Sustainability Law). Among such advantages of this institutional approach are greater international confidence, lower borrowing costs and consistency with monetary policy, among others.

7 Inflation ends higher in 2015 but is set to return to its target band late in 2016

The higher COP exchange rate and the El Niño phenomenon have pushed up 2015 year-end inflation

Two unexpected factors affected the path taken by inflation in 3Q15. The first of these was the 11% COP depreciation over July to August, which once again brought exchange rate pressure to bear on prices (Figure 7.1). Consequently, tradable goods inflation picked up steam, rising from an annual growth rate of 4.7% in July to 5.9% in September. The COP exchange rate not only hit the cost of tradables but also other products in the basket of basic goods and services. For example, gas rates are pegged to how the dollar moves, and this explains why they have risen by 22% over the past year. The price of air fares has also gone up (12% in the last year), due to the fact that a high percentage of carrier costs is in dollars. These rises that we have seen in tradables are not because exchange rate pass-through to prices has increased, but rather they arise from the very scale of the exchange rate depreciation (in September the COP exchange rate depreciated by 56% YoY). In fact, recent empirical evidence indicates that in Colombia's case the pass-through coefficient has remained at the level of 5% which we estimated over a year ago (See our recently published piece Has exchange rate pass-through to prices increased in Latin America?)

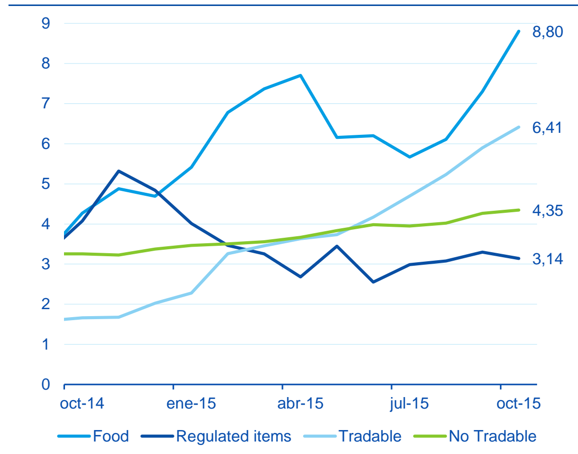
The second factor is the rise in food prices linked to the shortage of rainfall in the country in recent months. As a result of this, inflation of perishables streaked ahead from 7.5% to 18.1% YoY over July to October, while the rate in the *meat and meat substitutes* category jumped from 2.2% to 4.6% over the same time (Table 7.1). Overall, the foods CPI reached an annual growth rate of 8.8% in September (Figure 7.1), contributing 2.1pp to the total CPI variation of 5.9%. This makes foods the chief driver of inflation in 2015, when it accounted for 42% of the annual variation to October (Table 7.1).

The adverse weather conditions are associated with the El Niño phenomenon, the presence of which was confirmed in August. Forecasts of how this will develop suggest that this will be strong, which will lead to a more severe lack of rainfall and high temperatures over a large swathe of Colombia. There is reckoned to be a high chance that the phenomenon will run on into 2Q16, which will push up on food prices over the coming months. A side effect of this is that the dry weather has brought down the water level in reservoirs, which means that power generation will rely more on thermo-electric sources, in turn raising production costs. Fortunately, nearly 85% of the energy that reaches homes is covered by medium-term contracts and will not be affected by the increase in generation costs, which thus offsets a high proportion of the impact on prices in Colombia via energy utility rates.

Inflation among the non-tradables segment has also risen, although at a much smaller rate than was registered for the foods and tradables categories. Over July to October this segment saw a 40bp rise, taking growth for prices in it to 4.3% in the past month (Figure 7.1). Responsible for this was the increase among entertainment services, especially in television services (7.3% YoY) and the other entertainment-related services group (19.5% YoY). Finally, the group of regulated goods is the one which has seen the least inflation (3.3% YoY in October), thanks to the fall in the petrol price over the year which has made up for the rises in rates for gas for domestic use (Figure 7.1).

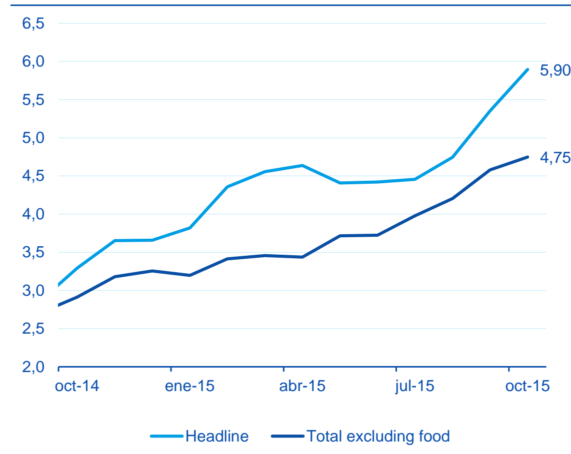
From the above it is evident that core inflation, the measure which strips out movements in food prices, has mainly risen due to the jump in tradable goods inflation, which has in turn increased (as we have pointed out) on the back of the higher absolute COP exchange rate. To September, core inflation showed growth of 4.7%, 1pp above its June reading (Figure 7.2).

Figure 7.1
Inflation in the four major expenditure groups (% var. YoY)



Source: DANE and BBVA Research.

Figure 7.2
Headline and core inflation (% var. YoY)



Source: DANE and BBVA Research.

The inflation surprises in recent months, which were caused by the currency depreciation and adverse weather conditions, have led us to raise our inflation forecast for 2015. We now expect inflation to end 2015 at a rate of 5.9%. Besides taking on board the surprises we have mentioned, the forecast also takes into account a rise in food inflation in the coming months as a result of the El Niño phenomenon.

Table 7.1
Inflation in the four key expenditure groups to October (%)

Group	Weighting	12 months	Contribution	YTD	Contribution
Total	**100**	**5,9**	**5,9**	**5,5**	**5,5**
Foods	**28,2**	**8,8**	**2,5**	**8,6**	**2,4**
Garden and root vegetables, fruits and milk	5,1	18,1	0,9	19,7	1,0
Cereals and fats	6,0	12,3	0,7	11,9	0,7
Meat and meat substitutes	6,1	4,6	0,3	3,9	0,2
Eating out	11,0	5,1	0,6	4,5	0,5
Ex foods	**71,8**	**4,7**	**3,4**	**4,2**	**3,0**
Tradables	26,0	6,4	1,7	5,8	1,5
Non Tradables	30,5	4,3	1,3	3,7	1,1
Regulated items	15,3	3,1	0,5	3,0	0,5
Ex foods and regulated items	**56,5**	**5,2**		**4,6**	
Ex perishable foods, fuels and public services	**76,6**	**5,5**		**4,9**	

Source: DANE and BBVA Research

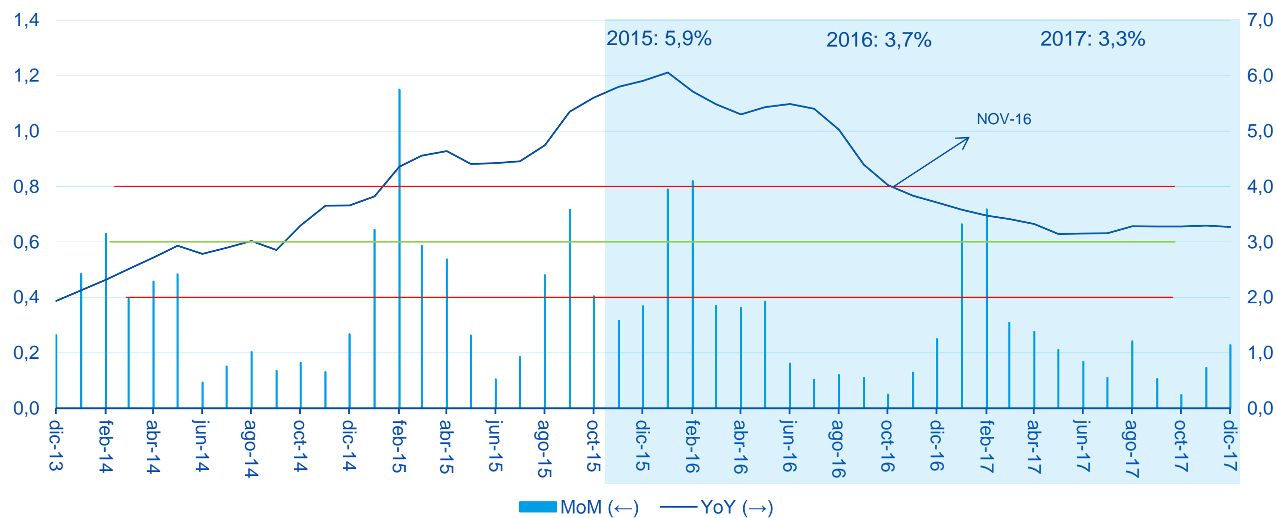
The credibility which the central bank has garnered in recent years has allowed the COP exchange rate to float unhindered, thus permitting the level to soften the blow of the lower petrol price. Despite the punishing depreciation of the COP, inflation expectations in the first half of the year failed to react in proportion to the scale of this shock, which bears testament to the strength of the institutional framework underlying macroeconomic policy. In spite of the recent rise in inflation expectations for 2016, over the medium term (24 months) they are still anchored, which is indicative of the higher level of late being only cyclical and that monetary policy credibility remains intact (Box 2).

Tying prices to 2015 inflation will delay inflation’s convergence on its target band in 2016

We are raising our forecast for inflation in 2016 too, from 3.1% to 3.7%. The high rate at the close of 2015 will also lift the indexing for certain goods and services in 2016, especially in the first half of the year, which will postpone inflation’s approach to within its target band. Besides the indexing aspect, 2015 inflation will raise the minimum wage by a considerable percentage, which could have knock-on effects via the passing on of higher costs to final sale prices.

The self-same factors which have pushed up inflation in 2015 will help it to correct itself, especially in the second half of 2016. Our scenario includes a steady correction of the dollar exchange rate over next year which will take it to COP2700 at the close of 2016. Moreover, the rise in food prices which we expect to continue in the next few months will provide a spur for agricultural production, thereby lifting the supply of food, which will lead to a fall in food prices in the second half of the year. Together with the 2015 inflation base effect and the lower economic growth which we anticipate, this will help inflation back to its target range in the final months of 2016.

Figure 7.3
The path of inflation (% var. MoM and YoY)



Source: Dane and BBVA Research

8 Monetary policy aimed at speeding up inflation's convergence on the target band

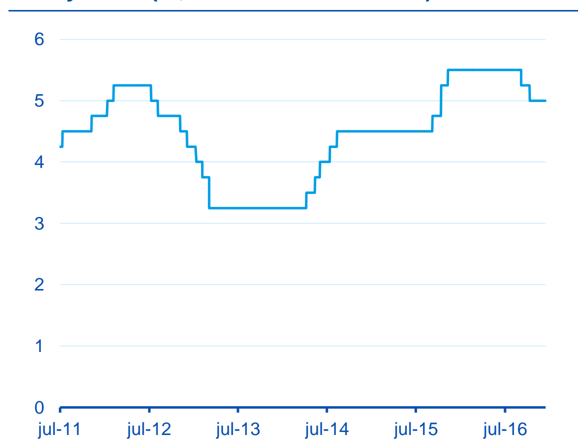
Movements in inflation expectations and a slower approach towards its long-run target by inflation prompted the central bank to hike its benchmark rate in September and October

At the end of Q3, the board of the central bank decided to raise the intervention rate for the first time since August 2014, by 25bp. Subsequently, at its October meeting, the board voted by a majority to put up the repo rate by a further 50bp to 5.25% (Figure 8.1). This change of stance was produced by the increase shown by inflation, core inflation, the low real policy rate (Figure 8.2) and fears of an "unanchoring" of inflation expectations. The latest inflation expectation readings actually continue to show rises. Specifically, measures of inflation expectations both one and two years out that were obtained from the October survey of analysts were up and now stand at 4.1% and 3.5%, respectively, while those gleaned from 2, 3 and 5-year government bonds are topping 4%, according to central bank readings. On the other hand, the board expects that the pass-through of some of the currency depreciation to consumer prices, the El Niño phenomenon and the potential triggering of indexing mechanisms will slow down inflation's convergence towards its target level.

So, although we expect monetary policy decisions to hinge on the figures to a great degree, inflation expectation dynamics and trends for the various different measures of core inflation will be the most prominent considerations in the central bank's discussions in 4Q15 and going into 2016. In this situation and given the central bank's evident commitment to battening down inflation expectations, our central scenario includes the possibility of an additional 25bp policy rate hike in 4Q15, taking this to 5.50%.

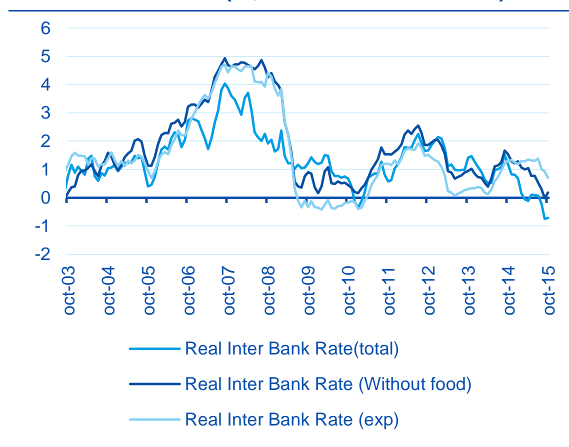
Finally, it is important to note that we think that after this adjustment in 4Q15 has been made, we will return to a scenario of interest rate stability over the first half of 2016, while in the second half attention will focus on inflation's convergence on its target band and, if events turn out as described, this would open up the possibility of the repo rate being trimmed to 5.0%.

Figure 8.1
Policy rates (%, effective annual rate)



Source: Banco de la República and BBVA Research.

Figure 8.2
Real interest rates (%, effective annual rate)



Source: Banco de la República and BBVA Research.

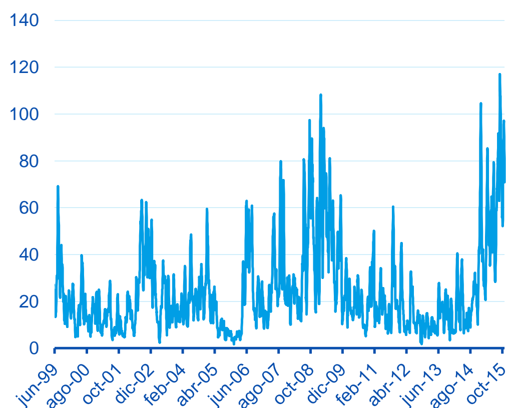
9 The exchange rate: high volatility will persist as we leave 2015 and enter 2016

The COP exchange rate should continue to be mainly affected by oil price patterns and the international context. Flexible rates still represent an appropriate policy strategy, which partly softens the blow to the terms of trade

The COP exchange rate rose rapidly in 2015, accompanied by historically high volatility (Figures 9.1 and 9.2). This trend was the product of an intricate interaction of elements (particularly external ones), most notable among which were oil price movements, uncertainty over Fed monetary policy moves and risk aversion shocks that originated in China. At the start of the fourth quarter, regulatory changes concerning currency mismatches in the financial system (own cash position), the announcement regarding the call auction mechanism for foreign exchange reserve decumulation and foreign investor appetite in the TES market (as reflected by portfolio flows) were accompanied by a correction to the trend that had been observed in the COP. Here we should make the point that currency flexibility is a suitable policy, in that it partly cushions the shock in relation to the terms of trade and helps the current account to adjust, while the recently adopted currency exchange measures suggest future movements being a little bit more gradual and rate volatility being reduced.

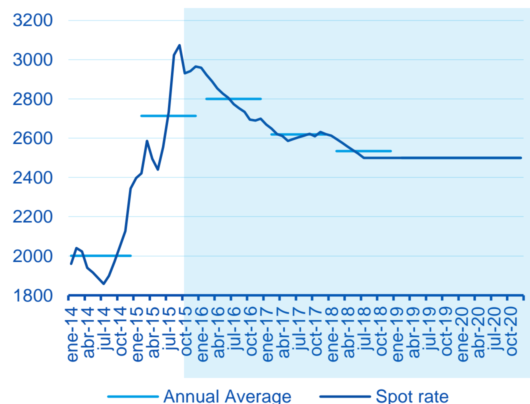
Meanwhile, our projections for the exchange rate factor in three considerations. First, the exchange rate should continue to be linked to the oil price. In this context the outlook for the oil price foretells a very gradual recovery, which is assumed in our central scenario. Second, developments in China's economy will continue to be a key element to monitor, due to both the potential impact on exchange rate volatility and the prospects they generate for commodities demand. Third, our forecasts are consistent with a slow-moving and modest adjustment in the external accounts, as we have looked at in Section 5. Thus, for 2016 we expect a gradual correction to the COP exchange rate, while overall there will be a mild depreciation (Figure 9.2)

Figure 9.1
Exchange rate volatility (standard deviation calculated using a 20-day rolling window)



Source: Banco de la República and BBVA Research.

Figure 9.2
Expected exchange rate path (USD/COP)



Source: Banco de la República. Calculations by BBVA Research.

Finally, and with regard to the medium-term exchange rate projections, these feature the forecast dynamics for Colombia’s economy, the expected correction in the external accounts and the external context (specifically the oil price and US monetary policy normalisation). Under our macroeconomic assumptions and expectations for world fuel prices, the equilibrium level for the nominal dollar exchange rate (which we now put at COP2,500) will be arrived at in 2018 (Figure 9.2).

10 Risk assessment for Colombia's economy

Our growth forecasts have the overall risk tilted to the downside. The international scenario and elements of local uncertainty show that the economy is likely to be sensitive to negative shocks to growth, although these still have only a low chance of occurring.

As for the international context, the major risks arise from commodity prices and China's growth. If the anticipated recovery of the oil market and a soft landing for China fail to transpire, there should be new adverse shocks for Colombia's growth. A gradual acceleration of the growth rates of the United States and Europe is also important, as in our baseline scenario, since these two regions are the chief sources of demand for Colombian exports.

On the local front, we identify four specific shocks. First, an additional souring of confidence and the labour market. Given this, the private consumption adjustment could be greater than expected. Second, a current account adjustment from higher levels and which is more gradual than in our benchmark scenario. Moreover, should global uncertainty increase and (with this) there is a consequential reduction in capital flows to emerging markets, the current account deficit would force a heftier than expected adjustment in domestic demand. Third, a further delay in the timeline for a start on fourth generation infrastructure works, which stops this beginning to make a positive contribution to GDP in 2016, would limit the positive impact that the construction sector is expected to make in 2016. Fourth, an acceleration of food inflation and higher energy rates as a result of a more severe and prolonged El Niño phenomenon than we are currently forecasting.

In the event of a risk scenario materialising of the nature described here (where the probability is low), the Colombian economy's growth should drop from the level of 2.4% we expect for 2016 to around 0%.

11 Tables with projections

Table 11.1
Annual macroeconomic forecasts

	2013	2014	2015	2016
GDP (% YoY)	4.9	4.6	2.7	2.4
Private consumption (% YoY)	3.8	4.4	2.8	2.3
Public consumption (% YoY)	9.2	6.2	2.0	0.2
Fixed investment (% YoY)	6.0	10.9	2.7	5.1
Inflation (% YoY, eop)	1.9	3.7	5.9	3.7
Inflation (% average YoY)	2.0	2.9	4.8	5.0
Exchange rate (vs. USD, eop)	1,927	2,392	2,965	2,700
Depreciation (vs. USD, eop)	9.0%	24.1%	23.9%	-8.9%
Exchange rate (vs. USD, avg.)	1,869	2,001	2,711	2,800
Depreciation (vs. USD, avg.)	3.9%	7.1%	35.5%	3.3%
Central bank interest rate (%, eop)	3.25	4.50	5.50	5.00
FTD interest rate (% eop)	4.06	4.34	5.35	5.17
Unemployment rate (%, eop)	9.7	9.3	10.3	10.8
Fiscal balance (% GDP)	-2.4	-2.4	-3.1	-3.6
Current account (% GDP)	-3.2	-5.2	-6.4	-5.5

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

Table 11.2
Previsiones macroeconómicas trimestrales Quarterly macroeconomic forecasts

	GDP (YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD eop)	Interest rate (%, eop)
1Q13	2.9	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	6.0	1.9	1,927	3.25
1Q14	6.5	2.5	1,965	3.25
2Q14	4.1	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	2.8	4.6	2,576	4.50
2Q15	3.0	4.4	2,585	4.50
3Q15	2.5	5.4	3,122	4.75
4Q15	2.4	5.9	2,965	5.50
1Q16	1.9	5.5	2,889	5.50
2Q16	2.1	5.5	2,806	5.50
3Q16	2.5	4.4	2,734	5.25
4Q16	3.2	3.7	2,700	5.00

Source: DANE, Banco de la República and BBVA Research

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