BBVA | RESEARCH

Colombia Economic Outlook

2ND QUARTER 2016 | COLOMBIA UNIT

01
Global growth is still weak and dependent on the Chinese economy

02
Internal demand continues to shrink with an additional slowdown in consumer spending

03
The industrial sector has reacted, taking advantage of exchange rates to replace some imports

04
Colombian growth will be slower in the medium term but will also be more sustainable and ensured by a more balanced economic structure

1 Editorial

The relative improvement to the global economic scenario over the past quarter continues to be weak, dependent on how the Chinese economy progresses and solutions being found to the causes of geopolitical instability in various locations across Europe. In any event, the re-emergence of incidents of financial volatility, as was the case earlier in the year, cannot be ruled out, within a context of considerable uncertainty regarding the capacity of the emerging block to deal with this downturn and the central banks in developed economies to kickstart growth.

The adjustment to the Colombian economy after the collapse of oil prices will continue in 2016. In 2015 we saw a significant fall-off in investment growth, from 9.8% in 2014 to just 2.8% in 2015. In 2016, consumer spending was the variable that meant domestic demand continued to shrink, with growth falling from 3.9% to 2.6% between 2015 and 2016.

This will be the last year of economic deceleration. With the commencement of work on the 4G infrastructure program in the second half of the year, public investment will speed up in the coming years. Furthermore, this year will see the foundations laid for industrial recovery, driven by a strategy based on reducing imports which should continue in the medium term. **On this base of industrial recovery and investment, economic growth will pick up to over 4% by the end of the decade**. It will be a slower growth compared to the one of the last decade, but it will also be more sustainable and ensured by a more balanced economic structure.

The exchange rate has been a key factor in this process. As well as serving to buffer the peso against lower oil prices, it has helped to contain imports, allowing a gradual improvement to the current account and aid industrial recovery. **This year, there will be a 6.3% deficit in the GDP current account**, down from 6.5% in 2015. 2017 will see a further fall to below 6%. **Industry, growing at a rate of 8%, will be the most dynamic sector this year**, with REFICAR accounting for half this figure.

The prolonged drought caused by the El Niño effect and the record high exchange rates at the start of the year have meant that inflation will remain high. These two factors will continue to have an impact on inflation over the coming months. We will only see a fall in prices in the second half of the year, when food prices are corrected and the effect of exchange rates becomes less marked. **We expect to see 2016 and 2017 inflation levels at 6.2% and 4.1% respectively**.

With oil prices on the up, the exchange rate will slowly fall in the medium term. In the short term, despite the aforesaid volatility, its level will be influenced by the US Federal Reserve's interest rate rises, preventing exchange rates from trending downward.

The cycle of increases to the monetary policy rate will end shortly. The recent firming-up of the exchange rate, the normalization of agricultural supply and the slowdown in consumer spending (including credit) are all factors that will determine the downturn in the inflation rate by the end of the year. In the current context, the most important variables for monetary policy discussions will be the relative speed at which domestic demand - especially private consumption – will decelerate compared to GDP, the interpretation of mixed signals of some leading indicators, the credit growth, and the inflation expectations dynamic.

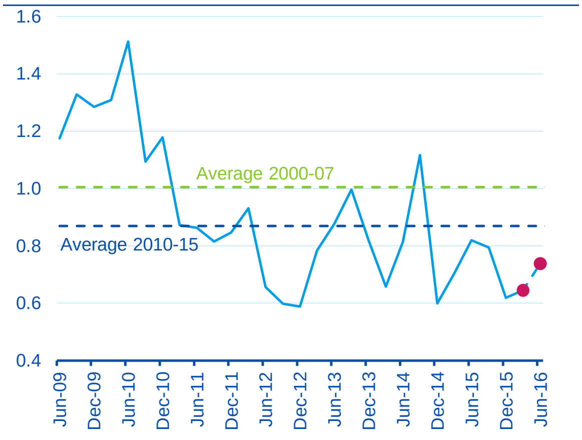
Finally, crucial in this transition process is the implementation of a structural tax reform that increases fiscal revenue and improves the economy competitiveness.

2 Global environment: fragile and China-dependent growth

The information available for the first quarter of 2016 supports our view that global growth will stabilize at low levels, although not as low as at the end of 2015. Our BBVA-GAIN[1] indicator shows that quarterly global GDP reached 0.6% at the beginning of the year (2.6% at an annualized rate), much lower than recorded between 2010 and 2015 (Figure 2.1). This growth rate, which could slightly accelerate in the second quarter, if the evidence provided by recent indicators of production, trade and business confidence is reinforced, is still insufficient for the annual progress of the worldwide economy to reach approximately 3.2% (our estimate for the whole of 2016).

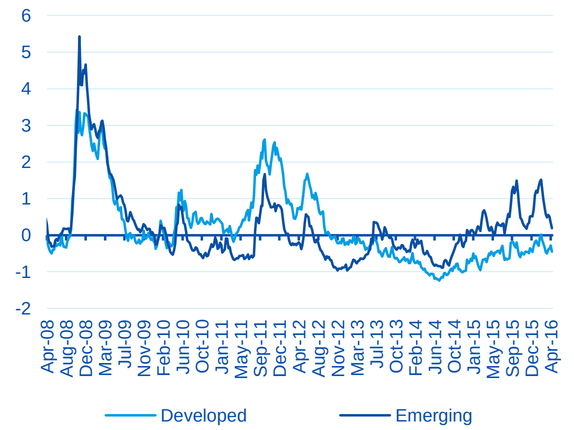
The significant increase in financial volatility observed between December 2015 and February 2016, in addition to responding to the downturn in global activity, threatens to be substantial if it continues with the same intensity and ends by being reflected in a tightening of spending decisions. The better than expected assessment for the economic indicators in China, together with the decreased downward pressure on the price of the Yuan, the recovery of prices for raw materials and the moderation of the expectations for a rise in interest rates by the Fed have been fundamental in the remission of financial stress from then onwards and in lessening, in turn, the probability of a stressful short-term scenario occurring on an international scale.

Figure 2.1
World GDP (QoQ%). Forecasts for 1Q16 and 2Q16 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2
BBVA index of financial tensions (normalized values)



Source: BBVA Research and Haver

China: lower short-term risk, but more doubts in the long term

The reinforcement of incentive policies, both monetary and fiscal, by the Chinese authorities have contributed toward softening the effects of the manufacturing sector's readjustment to aggregate output and, therefore, to the trade flows of the country with the rest of the world. In the short term, the implementation of counter-cyclical measures may enable a more gradual than expected downturn in the economy. Nevertheless, if this similarly brings about a delay in the correction of fundamental imbalances, such as the increased leverage of the corporate sector or the oversupply in some areas of industry and construction, the financial vulnerability of China in the event of shocks like the one observed in summer 2015 would increase and, with it, its potential for destabilizing the rest of the world. Taken overall, these factors lead us to an upward revision of the growth estimates for China in 2016, up to 6.4% in 2016, and to sustained growth of 5.8% in 2017.

[1] See https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-remains-stuck-at-2-6-yoy-in-q1-less-cloudy-outlook-but-the-same-risks/

The international context conditions the decisions of the Fed and contributes to alleviating the pressures on emerging blocks

The weight granted by the agents of the worsening international context on the reaction of the Fed explains the delay in the expectations for the next rise in interest rates. In the face of the two increases forecast by the members of the FOMC for 2016, the market has postponed the next increase to the beginning of 2017. The reaction of the dollar, depreciating despite the relatively good behaviour that domestic demand in the United States is continuing to display, and the relaxation of the long sections of the dollar curve have contributed to alleviating the financing restrictions on the emergent block, as reflected in: (i) the BBVA rate of financial stress for this region, which has corrected the entire upturn observed for the first months of 2016 (Figure 2.2), and (ii) the reactivation of foreign capital inflows, in which net capital inflows have been produced in the emerging countries since the middle of February due, in part, to the relocation of investment flows to instruments with greater profitability.

Furthermore, since the central banks in developed economies have maintained the same tone for their monetary policies as in recent months (reinforcement or maintenance of the stimulus in the case of the ECB and the Bank of Japan; caution in the normalization of interest rates in the case of the Fed), the emergent authorities will have a greater margin for manoeuvre when prioritizing, among other objectives, economic recovery. The expected gradualism of the FED (which is a factor supporting capital flows into the region) and the recent recovery of currencies (which restricts the possible increase in inflation due to increases in the price of imported goods) limit the need to undertake aggressive increases in interest rates.

All in all, the relative improvement in the global economic scenario over the last quarter continues to be fragile and conditioned, in the short term, by both the progress of the Chinese economy and the resolution of the points of geopolitical instability that are present in Europe. In any case, in a context of high uncertainty about the capacity of the emergent block to sidestep economic deceleration and the ability of the central banks in the developed countries to relaunch growth, the occurrence of new periods of financial volatility, like the one observed at the beginning of this year, is not unlikely

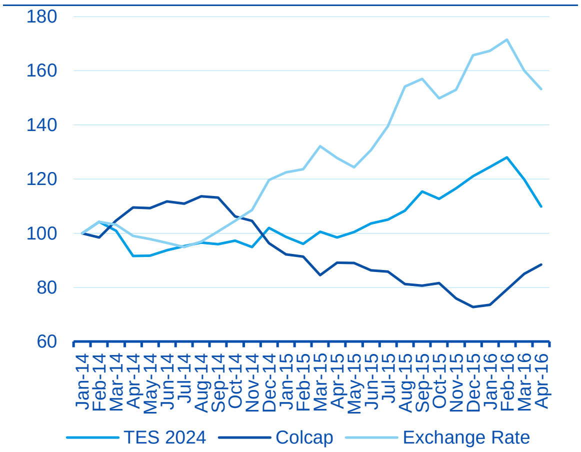
3 The tradable goods sector picks up as domestic demand continues to shrink

After a somewhat tense start to the year, markets and commodity prices recovered

After a flood of bad news due to turbulence in financial markets in China at the start of the year, financial assets calmed and returned to profit by the close of the first quarter. Increases in oil prices and the monetary policy decisions taken in developed countries further highlighted this positive trend. In the first case, oil prices are on the rise after record lows in February, increasing by 62% since then. Central banks in the United States and Europe, meanwhile, have confirmed forecasts for lower rate increases in 2016 and greater monetary expansion, respectively.

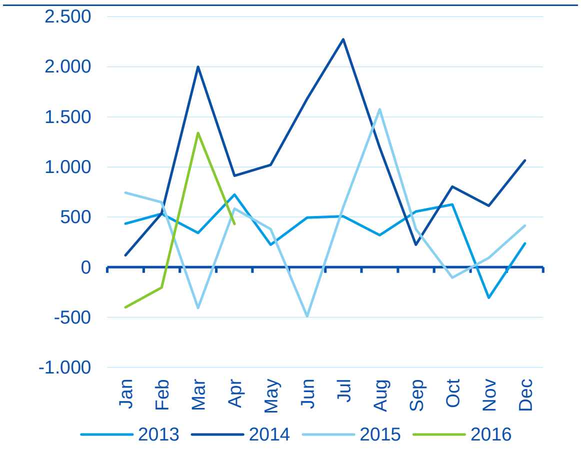
At the same time, domestic interest rates on the public debt curve fell significantly (110 base points since their February highs), accompanied by a reduction of 158 base points in the national risk premium measured using the EMBI (Figure 3.1). These corrections could turn out to be permanent in a medium-term scenario in which oil prices will be higher and economic growth more dynamic, with monetary authority interest rates falling to their natural level. Finally, the exchange rate saw a 18% depreciation rise), in line with major portfolio capital flows deposited into emerging economies, including Colombia, from the second half of February onward. External capital took advantage of the low price of public debt and shares, buying up both types of assets, with a greater concentration on the former (Figure 3.2).

Figure 3.1
Dynamic of TES 2024, COLCAP and exchange Rate (index Jan 14=100)



Source: Bloomberg and BBVA Research

Figure 3.2
Portfolio capital inflows by non-residents (monthly value, USD millions)*



*: The April 2016 data correspond to the information available until the second week of this month
Source: Banco de la República and BBVA Research

In 2016, the fall-off in domestic demand will continue, at the same time that the foundations for the industry recovery are laid

Although its trend from the previous year toward a notable slowdown continued, there was an important upturn in the first quarter in the household consumption of food, drink, textiles and services – goods that have a greater weight on the total consumer shopping basket, compensating the performance of other product groups. At the same time, imports fell by 26% in the first quarter, although the impact was diminished by the exchange-rate devaluation.

The balance between still-growing consumer demand and a supply side restricted by imports was achieved through a process of recovery in domestic industry over the first two months of the year. Manufacturing activities results were good beyond the Cartagena Refinery, with more positive sources than expected. This confirmed the propriety of the ongoing strategy of reducing imports in the Colombian economy, the result of changes to relative prices stemming from devaluation (See Box 1: Substitution of imports: Is industry on the up?).

As far as the rest of the year is concerned, we expect domestic demand to continue the adjustment process that coincides with a fall in national income. However, unlike 2015, when the shrinkage was mainly due to investment, we expect consumer spending to lead the slowdown, while investment will undergo a slight acceleration compared to growth levels last year. Higher interest rates, lower household credit and less consumer confidence are all unmistakable signs of slower consumer growth. The deterioration in the labour market, which is typical in a period in which there is low economic growth, results in a slowdown in the creation of employment and a redrawing of the map, with a higher level of job informality, as shown in Box 2. We feel that this decline will have a negative impact on consumer spending in 2016.

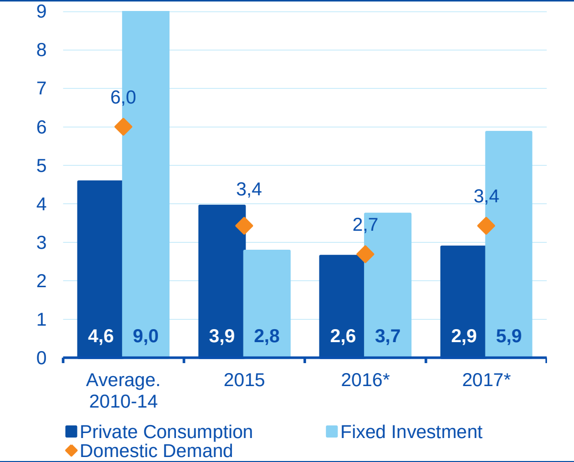
Investment will gradually accelerate thanks to improved domestic production results, a good balance on the housing markets driven by state subsidies on the mortgage interest rate towards middle-price houses and the commencement of work on the 4G infrastructure in the second half of the year. Nevertheless, first quarters are somewhat slow in terms of public investment due to the low level of execution that characterizes the first years of local and regional government and the problems of structuring and project execution experienced by territories with royalty resources. We expect to see total economic activity growth of 2% in 2016, with fixed investment performing better (annual growth of 3.7% compared to 2.6% in 2015) than final consumption (2% vs. 3.8% in 2015), accompanied by less imports (down 0.1%) and a slight upturn in exports (up to 1.8% from -0.7% in 2015) (Figure 3.3).

In 2017, growth will increase to 3%. With an increase of 5.9%, fixed investment will continue to be at the forefront of the trend. This will be the result of the ongoing 4G infrastructure work, at a more intense level than in 2016, and a consolidated recovery of tradable goods sectors. Final consumption growth will increase to 2.6%, with a composition that will favour household spending (annual growth of 2.9%) over higher public expenditure (1.3%). Consumer spending will be limited by a possible 2% increase in VAT in 2017.

Domestic demand will grow a total of 3.4% in 2017, with imports showing annual growth of 4.7%, exceeding export performance, which will increase 3.1%. With regard to this latter component of GDP, we expect to see lower levels of oil production and exports (thousands of barrels per day) and a gradual increase in the sales of other non-mining goods, albeit limited by the low growth of our main trading partners.

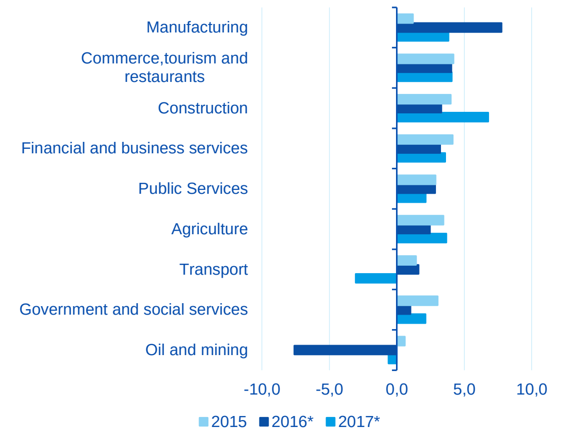
On a sector level, the reshaping of GDP will continue over the next two years, with the tradable goods sector becoming increasingly important (see Box 1 showing industrial recovery). Industry and agriculture will grow faster than the average for the economy as a whole, thanks to the reduced level of imports and higher exchange rates. Industrial output will grow 8% in 2016 on the back of the opening of Reficar which will account for half of this figure and the sectors taking advantage of the new exchange rate: food and drink, textiles, vehicles and certain chemical products (pharmaceutics, plastics, personal care products). Agriculture will continue to be driven by good coffee harvests in the first half of 2016 and the normalisation of agricultural supply in 2H2016. In the non-tradable goods sector, construction growth will accelerate thanks to work on the 4G infrastructure and subsidies for the construction of middle-class housing. Tourism will again perform well, as in 2015, helping to ensure that the restaurant and hotel sector continue to be dynamic (Figure 3.4).

Figure 3.3
Domestic demand, private consumption and fixed investment (annual variation, %)



*: BBVA Research Estimates
Source: DANE

Figure 3.4
GDP growth on the supply side (annual variation, %)



*:BBVA Research Estimates
Source: DANE

Lower economic growth and higher oil prices will help to reduce the current account deficit

In 2016, Colombia's current account deficit will be reduced, both as a percentage of GDP and in terms of its value in dollars. In the case of the former, it will fall from 6.5% of GDP in 2015 to 6.3% of GDP in 2016. In the latter case, it will fall from 18.9 billion USD to 17.6 billion USD. This improvement cannot be explained by increased exports, whose dollar value is 4.8% lower compared to 2015, but rather by a significant adjustment that can be seen in external aspects, such as imports and factor income (Figure 3.5).

As is the case with national GDP accounts, imports will respond to lower domestic demand and will adjust to the exchange rate devaluation. We expect to see a 7.3% fall in their dollar value. In the factor income account, low oil prices will continue to limit dividends paid abroad by foreign companies working in Colombia, mainly in the oil and mining sectors.

In 2017, the current account deficit will stand at USD 18.6 billion, 5.7% of GDP. This will represent an increase in the value of the deficit, although a proportional reduction with respect to GDP between 2016 and 2017. The explanation is simple: GDP value will increase more than the deficit due to the appreciation of the exchange rate which we expect to remain within the same range for the next two years, which will have a positive impact on domestic accounts in dollars.

In 2017, the dollar value of exports will rise by 14.5%, returning to levels above USD 41 billion. Oil prices will account for a good part of the positive performance (oil exports up 25.8% for the year), but also a recovery in non-mining exports, although to a lesser extent (up 6.8%). These good results will offset the growth in imports (+ 6.7%) to levels above USD 51 billion, with increased dividends paid abroad rising to USD 8.4 billion (+17%).

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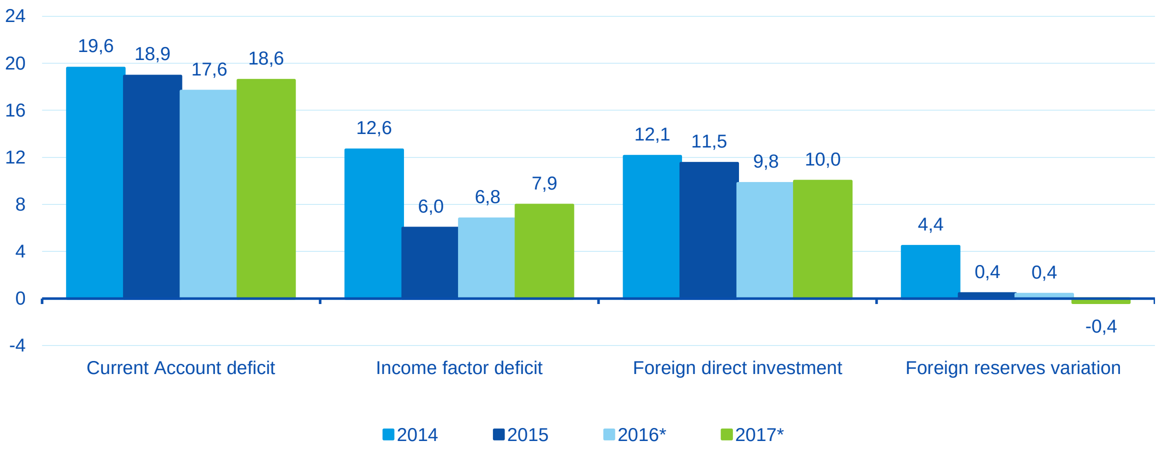
The financing of the current account will not be painless, although neither will it prove to be troublesome. The process will be an exact one. A significant part of the deficit will be covered by direct foreign investment, which will amount to USD 11.5 billion in 2016 and USD 9.8 billion in 2017. Furthermore, portfolio capital will rise to USD 5 billion in 2016 and USD 8.1 billion in 2017. Other public and private sector credit will balance the difference between financing needs and capital inflow, guaranteeing relative stability to international dollar reserves for the 2015-2017 period. On a sector level, we expect to see continued IED involvement in construction, tourism (hotels and restaurants), agriculture (driven by the peace process) and an upturn in investment in mining with the recovery of oil prices.

Figure 3.5
Current Account and its financing (USD thousands of million)



*: BBVA Research Estimates
Source: Banco de la República

Essential for the fiscal deficit path: tax reform

The Colombian Government's fiscal results for 2016 and 2017 are forecasted to be -3.9% and -3.6% of GDP respectively. This balance will continue to be tight despite of taking the tax administration's improvements into account in terms of internal and external tax collection efficiency (0.3% of GDP for both years). In 2016 the Government's oil revenue will be 0.1% of GDP, a figure limited to tax funds. In line with the measures introduced by the Government (Central Government spending cuts equivalent to 0.6% of GDP have been announced by MinHacienda), the balance includes cost cutting in terms of the sum initially budgeted for by the Government when Colombia's General Budget was approved.

This scenario takes into account higher transfers paid to the country's regions en 2017, as it will be necessary to compensate the lower transfers paid in 2016 (which were underestimated due to higher than expected 2015 inflation). The lower exchange rate, which reduces pressure on interest payments, and the higher oil prices allow Colombia to compensate for this increased transfer expenditure.

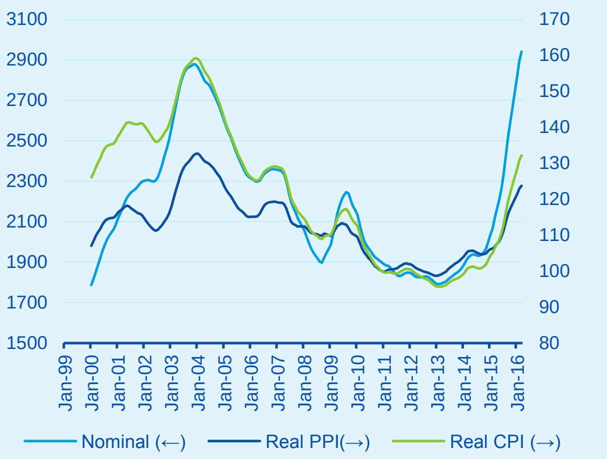
For 2017, our forecast continues to be based on a 2% increase in VAT, as part of the Government's tax reforms to be introduced in the second half of the year, which in conjunction with the higher revenue coming from increased efficiency of 0.3% of GDP, would leave the fiscal deficit around 3.6% of GDP.

In the medium term, further funds totalling 1.5% of GDP will be needed, as 2018 will see the end of the transitional taxes (a temporary CREE surtax, a wealth tax [in 2018] and the gradual dismantling of the Tax on Financial Transactions [starting in 2019]).

Box 1. Substitution of imports: Is industry on the up?

With the oil boom, Colombia underwent a long process of a nominal and real appreciation of its exchange rates, lasting ten years, from 2003 to 2013. (Figure B.1.1) As a result, the price of imported products fell in comparison to local prices, which had a negative impact on Colombia's industry.

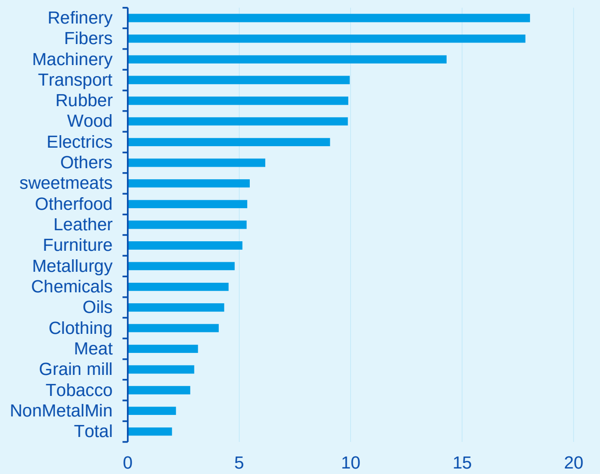
Figure B.1.1
Index of real exchange rate and nominal exchange rate* (Real Index: 2005 = 100, Nominal Rate: Monthly average, all series are 12-month moving average)



*: the index of real exchange rate corresponds to non-traditional goods
Source: DANE and BBVA Research

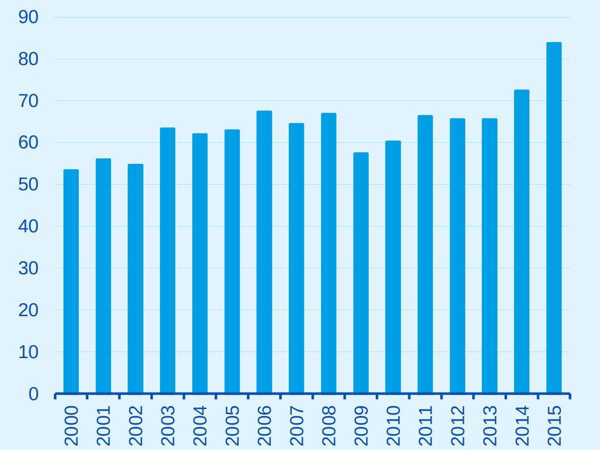
The fall in the price of imported goods meant that their significance in terms of domestic supply increased. In the textile fibre, machinery, transport equipment, rubber and wood products, the imported product quota increased over 10% in terms of the local supply of these products between 2000 and 2014. This increase could be seen in both finished and intermediate products, where the participation of imported inputs in the added value increased over 20% for this period, as shown in Figure B.1.2 and B.1.3.

Figure B.1.2
Change in the share of imports in domestic supply between 2000 and 2014 (pp)*



*: sectors with high changes
Source: DANE and BBVA Research

Figure B.1.3
Imports of intermediate goods and of capital by the industry (as a % of the total added value)

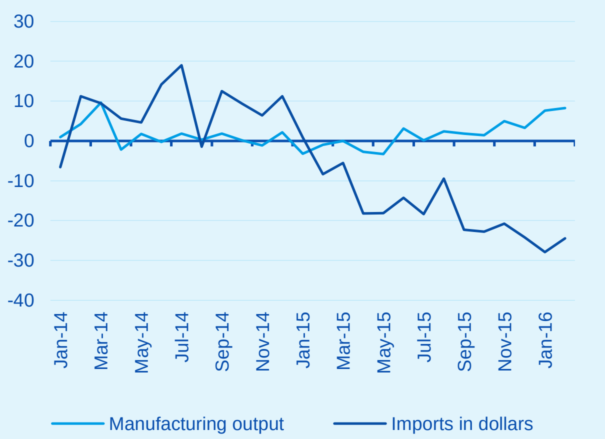


Source: DANE, BanRep and BBVA Research calculations

Current exchange rate levels, both nominal and real, represent an opportunity for industrial recovery, which may well reverse the trend described above. So far this year, industry has grown 7.9% (5% if we exclude REFICAR), while imports have continue to fall. This would seem to show a turnaround in the anaemic tendency afflicting industrial production, which could be interpreted as the start of a process of substituting imports. The moment of the definitive break was between the third quarter in 2015 and the first quarter of 2016, despite the devaluation of the exchange rate, the end of a trend that had begun in mid-2014. The catalyst was the fast, sharp fall in oil prices (Figure B.1.4).

The positive effect of currency devaluation on domestic supply on replacing imports took its time in materialising. Domestic industry had to adapt to the new dollar price. As the importance of imports increased within the total supply of goods (intermediate and final), industry's foreign purchases of inputs and capital goods also rose. Subsequently, the initial impact of devaluation on domestic production was somewhat ambiguous. The value of inputs and the percentage of value added to industry increased, while industrial competitiveness improved in comparison to foreign products with the modification of relative prices which determined the new exchange rate

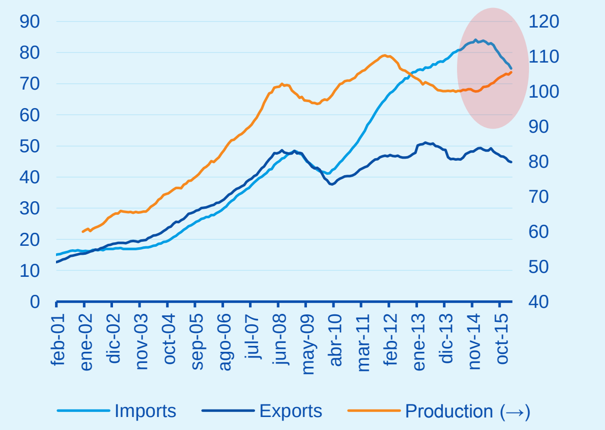
Figure B.1.4
Industry and Imports Growth (Annual growth, %)



Source: DANE, Banrep and BBVA Research calculations

A clear example of this can be seen in the plastics industry. Production and exports in this sector grew constantly until 2008. Since then, these areas have stagnated due to the appreciation of the peso. Only recently, with the fall-off in imports and the weakness of the exchange rate, production has shown signs of picking up (Figure B.1.5).

Figure B.1.5
Industrial Production Index and value of exports and imports of plastic industry (Production Index 2014 = 100; exports and imports in millions of dollars. all series are 12-month moving average)



Source: DANE, Banrep and BBVA Research calculations

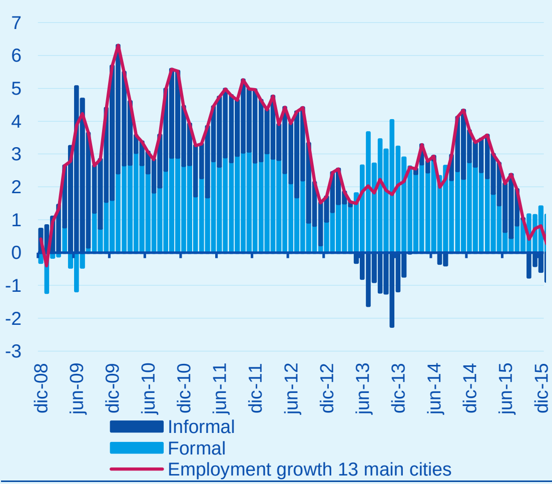
Finally, despite industry improving performance within the domestic market, there still have not been important advances in manufacturing exports. In fact, year-on-year exports continued to fall at the start of 2016. However, while the exchange rate stays at high levels compared to average 2014 levels and Colombia's main trading partners consolidate their recovery, we expect that improvements in the substitution of imports will also be confirmed in industry's foreign markets.

Box 2. Employment and economic growth: stylised facts

We can expect to see an economic slowdown due to lower labour demands. However, Colombia's recent economic slowdown showed a greater dynamic in this regard. Job creation picked up from September 2014 to May 2015, growing 3.5%, on the back of more moderate growth of 2.2% between October 2012 and August 2014 (Figure B.2.1). This drive from the labour sector stems from informal employment.

Informal employment accelerated, moving from an average annual -0.3% decrease between October 2012 and August 2014 to an average annual 2.5% growth from September 2014 to May 2015. This type of employment ceased to contribute negatively to job creation prior to the slowdown (-0.2%), returning to 1.2% growth between September 2014 and May 2015 and +1.5% between June and August 2015 (Figure B.2.1).

Figure B.2.1
Contribution to annual employment growth according to formality *(PP, 13 cities, moving quarter)



Source: DANE and BBVA Research calculations. *Definition DANE.

Formal employment showed growth rates that were slightly lower than those seen before the slowdown, from an average 4.4% YoY between September 2014 and May 2015 (compared to 4.7% between October 2012 and August 2014).

It is worth mentioning that while this time formal employment has grown at lower rates than before the downturn, formal jobs are not being destroyed as in previous cycles, as happened in the crisis of late 2008. The slowdown has now come, with lower dynamic job creation without sacrificing both formal employment and without a significant increase in informality. This has prevented a deterioration in the informality rate

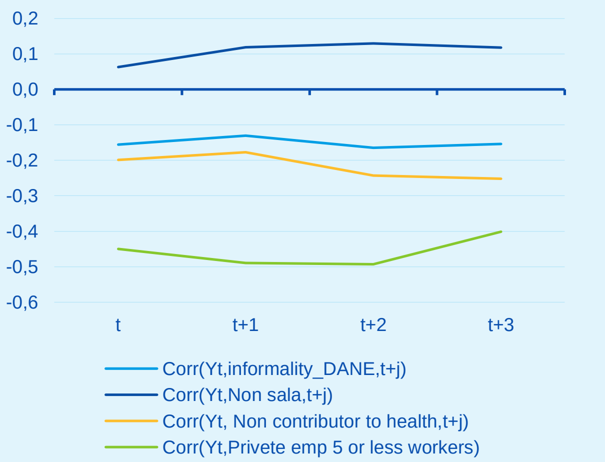
Simple correlations in the case of Colombia between January 2008 and August 2015 point to similar conclusions[2]. Correlations between economic growth and three of the informality variables used for calculation are negative (FigureR.2.2). As far as the informality calculated by DANE[3] is concerned, a negative correlation can be seen, $\rho(Y_t, \text{Informality}_{\text{DANEt}})$, equal to -0.16. The effect of economic growth in t regarding the creation of informal employment would seem to be remaining stable for some months to come, with the correlation between growth in t and growth in informal employment in t+3, $\rho(Y_t, \text{Informality}_{\text{DANEt+3}})$, equal to -0.15.

A similar result can be found in the informality variable with regard to the social security health system, measured in the same way as with affiliates to the public health system. The contemporary correlation, $\rho(Y_t, \text{Non-Affiliates}_t)$, is -0.2. The effect of growth in t continues to have a significant impact on job creation among “Non-Affiliates” in subsequent months, which could be even greater. The most negative correlation between informality and economic growth calculated stems from the measurement of informal employment creation and those working in establishments with five or fewer employees. In this case, the contemporary correlation stands at -0.45 (for the 2009-2015 period). “Non-salary

[2] For the calculation of these correlations, as the proxy for economic growth we have used the annual variation in the economic monitoring index (ISE, to use its Spanish acronym) published by the National Administrative Department for Statistics (DANE) on a monthly basis and variables such as the creation of total employment, informal employment and formal employment.
[3] DANE measures informality as employees in establishments with five or fewer workers, other than government employees and the self-employed.

earners" perform quite differently than expected, with a positive correlation[4]. .

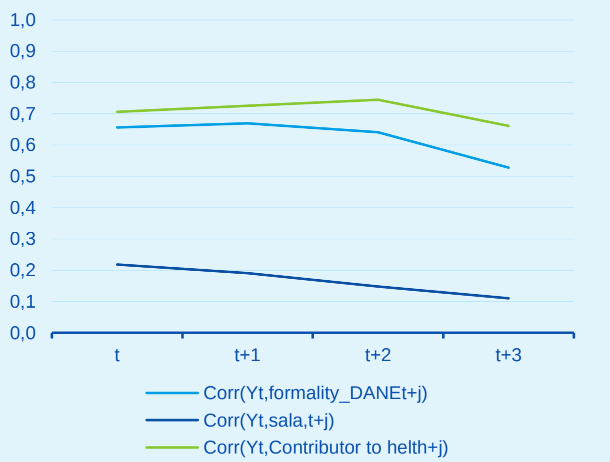
Figure B.2.2
Correlation between informality and the 2008-2015 economic cycle (Annual growth, monthly data)



Source: DANE and BBVA Research calculations

Correlations relating to formal employment variables are positive and higher in terms of absolute value than those observed through informality measurement (Figure R.2.3).

Figure B.2.3
Correlation between formality and the 2008-2015 economic cycle (Annual growth, monthly data)



Source: National Administrative Department for Statistics (DANE) and BBVA Research calculations

In the case of formality$_{DANE}$ figures show a correlation of 0.66 while for affiliates to the public health system the figure is 0.71. While ρ(Yt, Salary earners) is positive, it is lower than the two previous cases, standing at 0.22. Perhaps what characterizes this correlation is the counter-cyclical nature of private salaried employment in establishments employing five or fewer workers. Finally, the correlation between economic growth and the job creation growth is positive, although lower than in the case with formal employment (standing at 0.37).

The stylized facts seem to show a clear an positive relationship between formality and economic growth. However, the relation of growth to informality is very week and can be explained by the greater flexibility gained by the labour market after the reduction of non-wage costs in 2012. In any case, the slowing economy has negative effects on the labor market that result in lower job creation (both formal and total), with negative consequences on the consumption capacity of the population.

[4] "Non-salary earners" includes all such people except private and government employees. It therefore includes all self-employed workers, domestic workers, company owners and employers, unpaid family workers, other unpaid workers and day agricultural and construction workers.

4 The maze of monetary policy – challenges and perspectives

Inflation continues to be high, with its forecast convergence toward the target rate delayed

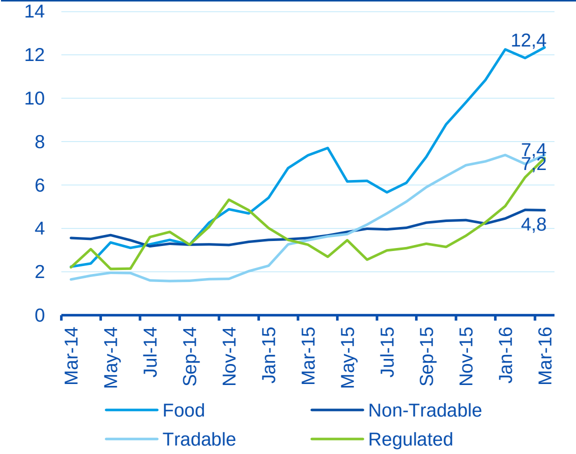
The El Niño phenomenon continues to have an impact of the cost of foodstuffs, whose prices in March increased 12.4% YoY, the highest rise in seven years. The prices of perishable products have been those most affected by the drought (up 26% YoY, 13.8% January to March), followed by the prices of cereals and oils (11,3% YoY, 7.6% January to March). Inflation also stayed high for the group of tradable goods, on the back of the exchange rate reaching record highs in the first months of the year. Inflation in this group stood at 7.4% YoY in March, with significant rises in the prices of vehicles and electrical goods.

Drought and the weak exchange rate were responsible for the rise in public services. The greater role played by thermal plants in the generation of electricity raised the share price, which led to increased energy charges in some parts of the country. The drop in the exchange rate raised the Producer Price Index (PPI) which, together with the aforementioned rate change, is used to update gas charges on a monthly basis. These two effects meant that gas and electricity charges increased by 27% and 15% YoY respectively by March.

The good news on the inflation front is that these two factors, which have driven prices up, will act in reverse and contribute to inflation falling. The strong exchange rate in recent months will help stabilise the price of tradable goods and public services and may even contribute to them falling. Meanwhile, the normalisation of the climate ensures that agricultural supply will improve in the second half of the year, reducing the price of foodstuffs. We also expect that recent increases in the monetary policy rate will slow consumer spending and hold back growth in domestic demand even further, complementing these two forces and ensuring that inflation will decelerate in the short term.

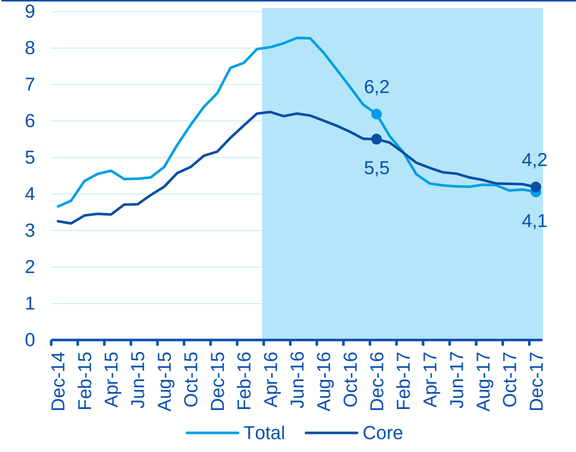
This does not mean that this relief will be noticed immediately. We can still see inflationary pressure on foodstuffs, and we feel that it will still be some time before the exchange rate affects prices. We expect inflation to stay at high levels over the first half of the year, with rates slightly above 8% in some months. Within this context, we feel that inflation will only start to fall back from 3Q16 onward, closing the year at 6.2%. As far as 2017 is concerned, inflation will continue to fall, ending the year very close to the target rate (4.1%). In the first months of 2018, inflation will finally be within the target range set by the monetary authority.

Figure 4.1
Inflation by product group (YoY, %)



Source: DANE and BBVA Research

Gráfico 4.2
Total and core inflation path (YoY, %)



Source: DANE and BBVA Research

Guaranteeing the convergence of inflation within the policy horizon will define monetary policy decisions

Within a complex inflationary environment, the main challenges facing BanRep will be ensuring a reduction in inflation expectations and guaranteeing that it moves toward the target range within the policy horizon in a context in which domestic demand has shown very gradual signs of slowing down. Given the recent inflationary dynamic, the ongoing risk of deanchoring of inflation expectations, and the concern on the excess of expenditure over income, we expect further movements of the repo rate during the second quarter of 2016. Nevertheless, given the mixed signals from leading indicators over the first quarter, we still feel that the BanRep management board will act in a way that is greatly dependent on data, in order to avoid an over-reaction to economic activity but which will seek to contain inflationary pressures. Once inflation begins to show clear signs of convergence toward the target rate, we expect to see BanRep begin a very gradual process of normalisation in 2017, with the repo rate at the close of next year standing at 5.5% (Figure 4.4).

In the current context, given that the minutes have shown a division of opinions on the intensity with which adjustments should be made to the monetary policy rate, the indicators that are still central to the ongoing discussions will focus on the relative speed with which domestic demand – and particularly consumer spending – slows down in comparison to GDP, how to interpret the mixed messages coming from a number of leading indicators, portfolio dynamics and more centrally, the dynamic of expectations concerning inflation. Regarding the portfolio, it is important to point out that the most recent data available from Colombia's Financial Superintendence department shows a gradual slowdown in real terms, especially in the consumer portfolio. Furthermore, as result of the tail-off in economic activity, we expect to see quality indicators showing a moderate slide over the course of the year.

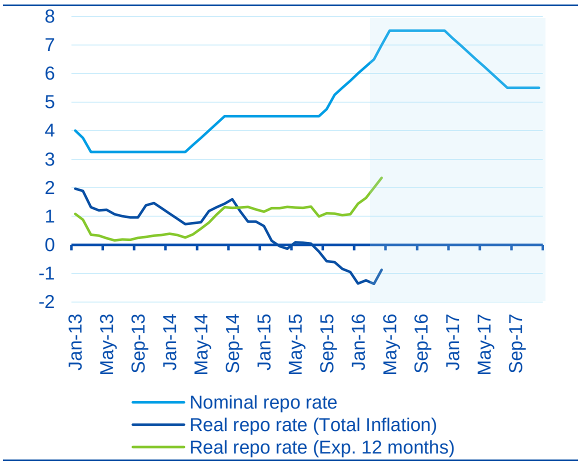
As far as exchange rates are concerned, flexibility is favourable and continues to be an appropriate policy, partially counteracting the effects of the external shock resulting from lower oil prices. Within this context, given the better forecasts for oil prices compared to at the start of the year, we expect to see an improved scenario to the one we predicted earlier, which, on average, will still be better than that seen in 2015. Our central scenario also forecasts lower exchange rate levels for the second half of 2016 than those seen by the end of April. Within this dynamic, it is important to point out that external factors – particularly the performance of the US economy, expected interest rate movements by the Fed and China and oil prices –

will continue to be the main aspects determining the level and volatility of the exchange rate. As a result, we expect to see BanRep maintain its options auction mechanism (which it has yet to activate) to prevent sharp, sudden depreciations of the exchange rate where these might occur. Finally, in 2017 we expect to see a gradual movement of the exchange rate to a level around 2,800 pesos to the dollar by the end of the year, in line with a gradual adjustment of oil prices, more stable conditions abroad and a moderate adjustment of Colombia's external accounts.

Figure 4.3
Inflation expectations (%, 12 and 24 months ahead)

Source: BanRep and BBVA Research

Figure 4.4
Banrep repo path in nominal and real terms (with observed inflation and inflation expectations)



Source: BanRep and BBVA Research

5 Tables with projections

Table 5.1
Annual macroeconomic forecasts

	2014	2015	2016	2017
GDP (% YoY)	4,4	3,1	2,0	3,0
Private consumption (% YoY)	4,2	3,9	2,6	2,9
Public consumption (% YoY)	4,7	2,8	1,1	1,3
Fixed investment (% YoY)	9,8	2,8	3,7	5,9
Inflation (% YoY, eop)	3,7	6,8	6,2	4,1
Inflation (% average YoY)	2,9	5,0	7,5	4,4
Exchange rate (vs. USD, eop)	3.392	3.149	3.100	2.800
Depreciation (vs. USD, eop)	24,2%	31,6%	1,6%	-9,7%
Exchange rate (vs. USD, avg.)	2.001	2.742	3.097	2.880
Depreciation (vs. USD, avg.)	7,1%	37,0%	13,0%	-7,0%
Central bank interest rate (%, eop)	4,50	5,75	7,50	5,50
FTD interest rate (% eop)	4,34	5,24	7,67	5,78
Unemployment rate (%, eop)	9.3	9,8	10,7	11,1
Fiscal balance (% GDP)	-2,4	-3,0	-3,9	-3,6
Current account (% GDP)	-5,2	-6,5	-6,3	-5,7

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

Table 5.2
Quarterly macroeconomic forecasts

	GDP (YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD eop)	Central bank interest rate (%, eop)
Q1 14	6,3	2,5	1.965	3,25
Q2 14	4,0	2,8	1.881	4,00
Q3 14	4,0	2,9	2.028	4,50
Q4 14	3,3	3,7	2.392	4,50
Q1 15	2,7	4,5	2.576	4,50
Q2 15	3,1	4,4	2.585	4,50
Q3 15	3,2	5,4	3.122	4,75
Q4 15	3,3	6,8	3.149	5,75
Q1 16	1,8	8,0	3.022	6,50
Q2 16	1,9	8,3	3.002	7,50
Q3 16	2,0	7,4	3.064	7,50
Q4 16	2,3	6,2	3.100	7,50
Q1 17	3,2	4,5	2.982	6,75
Q2 17	3,0	4,2	2.821	6,00
Q3 17	3,3	4,2	2.804	5,50
Q4 17	2,6	4,1	2.800	5,50

Source: DANE, Banco de la República and BBVA Research

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