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Colombia Ecomomic Outlook

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Closing date: 11 July 2017

1. Editorial

Our outlook for global growth remains 3.3% in 2017 and 3.4% in 2018. We expect slower growth in the USA, due to weak figures in the first quarter and difficulties in getting expansionary policies through, while economic policies in China have enabled stronger growth, leading us to revise our projections upwards, as is also the case for Europe.

There are few historical precedents for the shock to the terms of trade experienced by Colombia in 2015 and 2016, making it a unique event. On this occasion, confidence in Colombian institutions enabled the country to attract foreign funding, smoothing out the spending cycle, particularly for consumption, stopping the shock developing into a recession. But unlike past cycles, there are no clear exogenous factors supporting recovery, meaning the cycle is likely to show an extended **L** shape, with a very slow recovery.

The economic slowdown has continued into 2017, with YoY growth of 1.1% in the first quarter, and signs of similar, but slower, growth in the second quarter. The conditions for low growth are in place for the recovery phase. We see a number of fiscal and monetary policy restrictions on injection of a robust stimulus to the economy. On the fiscal side, this is due to the drop in revenues and the limits imposed by the fiscal rule, with a deficit that should fall from 4.0% in 2016 to 3.1% in 2018. On the monetary side, this is due to risks of persistent inflation and foreign trade balances which remain high. These will enable interest rates to be reduced to 5.25% in 2017 and 4.50% in 2018, falling in territory between slightly expansionary and neutral. Inflation will stand at 4.3% at year-end 2017 and 3.2%, in 2018, largely due to reversal of the 2016 supply-side shocks.

Lower interest rates and inflation will boost the purchasing power of consumers, whose confidence and spending could gradually return to normal, once they get used to the new tax conditions, with growth in household consumption of 1.6% in 2017 and 2.3% in 2018. Turning to companies, investment will start to adjust to positive territory after two years of contraction. However, expansion will be moderate - at just 1.9% in 2017 and 3.1% in 2018 - due to continuing weakness in demand. This being the case, we expect the economy to grow by 1.5% in 2017, an additional slowdown following the 2.0% recorded in 2016. We expect a slight recovery in activity in 2018, with growth returning to 2.0%, continuing a prolonged cycle of low growth similar to that from 2000 to 2003.

The main risk to the economy is the longer than expected duration of the current cycle. Against this backdrop, the labour market could deteriorate by more than expected, amplifying the negative cycle of business and consumer confidence, and postponing the expected increases in activity. On the external front, the main risk may come from an unexpected adjustment to capital flows, whether resulting from a faster adjustment of US monetary policy or from yields on the financial instruments of countries that are about to embark upon downward rate cycles. However, it should be noted that the vulnerability of the Colombian economy has decreased significantly, with a reduction in the current account deficit of around 2 pp between 2015 and 2016, and expectations of additional improvements in 2017 and 2018.

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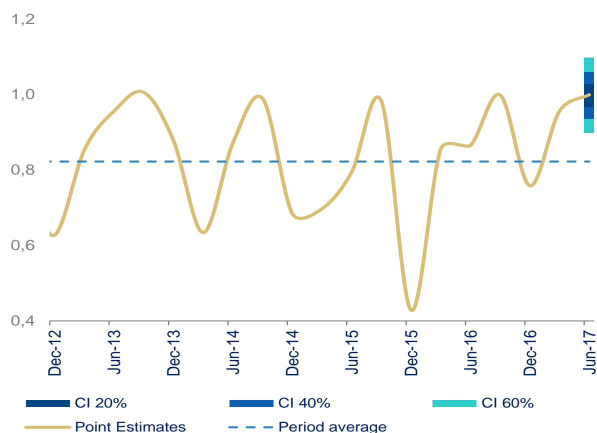
2. The positive global environment is trending toward stabilisation

Growth is tending to stabilise in developed economies, while Latin America is emerging from slowdown more slowly than anticipated.

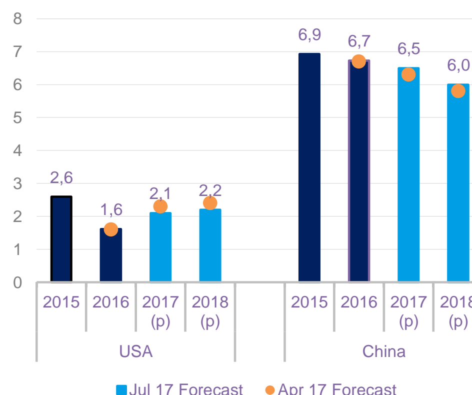
The world economy has been picking up in recent quarters and has approached growth rates of 1% QoQ (Figure 2.1), although it is trending towards stabilisation. This positive dynamic is attributable, among other things, to economic policy stimuli in China, which have driven growth in its economy and led to a knock-on effect on other Asian countries and the global economy. Other supports to the strong cyclical behaviour include very accommodative monetary policies in most advanced economies, fiscal policy which has been neutral or expansionary, and relatively moderate commodity prices, against a backdrop of calm in financial markets. On the other hand, emerging economies have performed less positively, with slower than expected emergence from the slowdown in Latin America, and in a more dispersed way, due to differing levels of dependence on commodity revenues.

Figure 2.1 Global GDP growth. Forecasts based on BBVA-GAIN (%, QoQ)



Source: BBVA Research

Figure 2.2 GDP growth in the USA and China (%)



Source: BBVA Research, CEIC and BEA

The tone in the financial markets has been upbeat, with volatility at historic lows in spite of persistent economic, political and geopolitical uncertainty, as well as lower expectations of a fiscal boost in the United States. This has meant that long term interest rates have remained anchored and corrected a portion of the rises in previous quarters. However, despite still being accommodative, the tone of monetary policy has inclined more towards the steps required for normalisation over the last quarter. This does not seem to have had a significant effect on the markets.

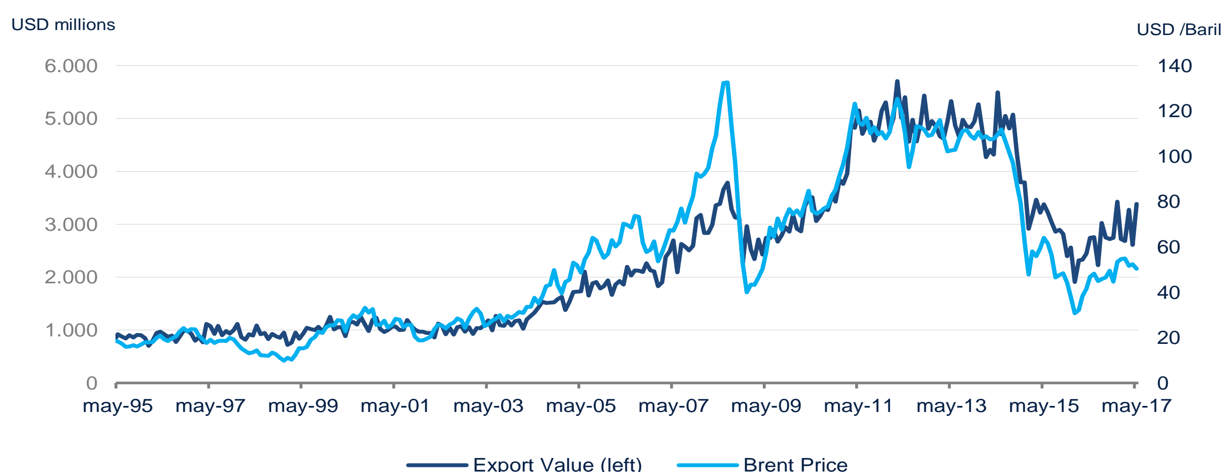
Our new forecasts maintain global growth at 3.3% in 2017 and 3.4% in 2018. However, we have revised growth upwards for both China and Europe, by 0.2 pp and 0.3 pp respectively (Figure 2.2), while reducing the forecast for US growth to 2.1% in 2017 and 2.2% in 2018, due to weak performance in the first quarter and difficulties in gaining approval for the expansionary measures proposed during the campaign.

3. Colombia is continuing to feel the effects of a shock unprecedented in recent times

There are few historical precedents for the recent shock to Colombia's terms of trade, making it a unique event.

There have been very few shocks of a similar scale and significance to that suffered by Colombia's exports. To find examples, we need to go back to the last century, to the Great Depression of 1928-1932, when export values contracted by 50%. Or to a time of civil war - Colombia's War of a Thousand Days - when exports contracted by 45% between 1898 and 1902[1]. These two episodes - the first of which left an indelible mark on humanity, and the second a deep wound in the country - are the only comparable episodes (since such records began) to the 48% contraction in exports between 2012 and 2016 (Figure 3.1)

Figure 3.1 The oil price and value of Colombia's exports



Source: Bloomberg, National Administrative Department for Statistics (DANE)

On this occasion, the sharp fall in oil prices (Brent) from an average of $108.76 per barrel in 2013 to a low of $33.52 per barrel in February 2016 resulted in a significant realignment of forces in Colombia's economy, many of which persist to this day and are reflected in the macroeconomics figures for 2017: this may well continue to have an impact for the rest of the decade. In principle, this shock should have had little impact on the economy due to the weight of the oil sector in GDP - which at its peak hardly reached 5.5% - compared to other economies in the region, such as Chile and Peru. However, because of its many facets, this sector is very important for Colombia's economy, representing 55% of total exports at their peak in 2013, and 32% of direct foreign investment that year. But this was also an important source of revenue for the government, bringing in 23 trillion pesos, around 20% of government revenues in 2013, excluding royalties. These figures leave oil exports today at scarcely 33% of the total, while direct

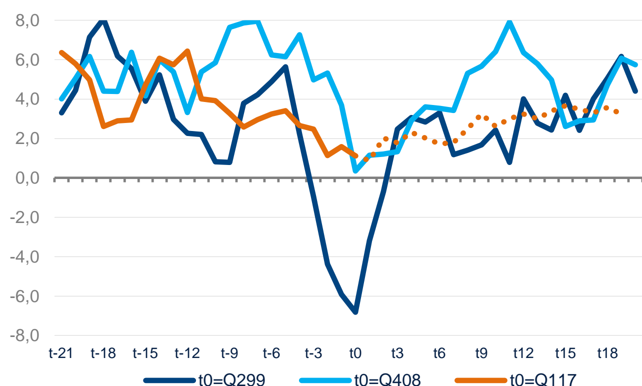
1: From the Treasury's “Macro achievements” presentation. Source: Fedesarrollo.

foreign investment in the mining-energy sector, which averaged 16% of the total over the last 2 years, made no contribution to the public finances in 2016.

The last three negative economic cycles: positive and negative differences

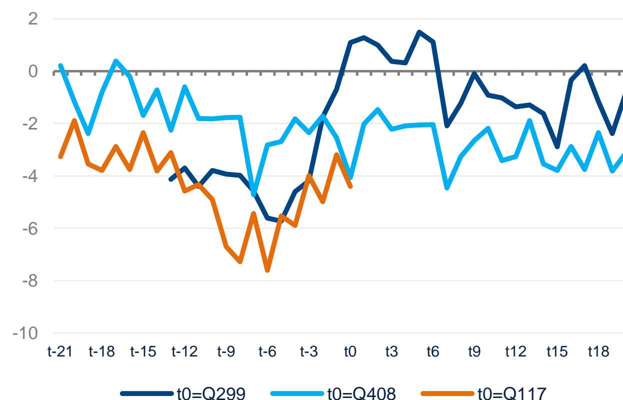
Economic growth 2.0% or less is very rare in Colombia's economic history. The current cycle is one of those periods, with some aspects comparable to the 2009 international financial crisis, which led to annual economic growth of 1.7%. And it is also similar to the recovery cycle from the crisis at the end of the last century. Although there was an economic contraction on that occasion that we do not expect to be repeated this time, the recovery involved several years of low growth, which is what we expect in the current cycle (Figure 3.2). One way of looking at these similarities is through the shape we expect the cycle to take. We do not believe there to be sufficiently strong exogenous or endogenous factors to achieve a rapid recovery. As a result, the current cycle will not take the **V** shape seen in 2008-2010. However, we believe that the recovery will share many of the aspects of the emergence from the 1999 recession, with slow growth and a positive slope but very soft output, as with a crisis of confidence. Thus, we expect the current cycle to take an extended **L**.

Figure 3.2 Economic cycles in Colombia* (%)



Source: DANE and BBVA Research
* includes our growth forecasts for the cycle t0=1Q17

Figure 3.3 Colombia current account (%)



Source: Central Bank of Colombia and BBVA Research calculations

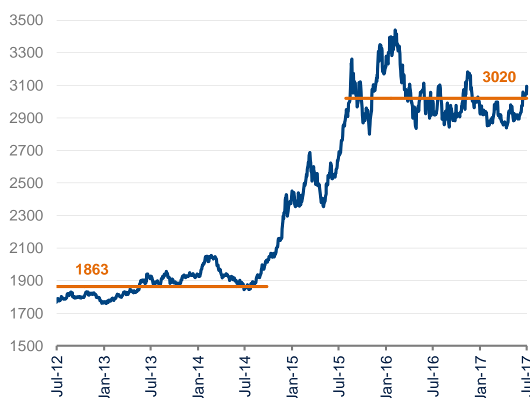
The current cycle shares a number of positive and negative differences with its two predecessors, differentiating it from both of them. Starting with the negative differences, there is no significant support for the current cycle in the form of economic stimuli from our trading partners. It should be remembered that, following a brief crisis in 2001, the US economy began a strong growth cycle, driven by new technologies and rising house prices. This enabled Colombia to emerge from its cycle of stagnation in around 2003. The situation was more obvious in 2009, with the rapid recovery in growth in China and, as a result, commodity prices, including oil. This led to a rapid recovery in our economy, with 4.0% growth in 2010. However, in the current cycle developed economies are facing long periods of slow growth, as a result of the financial crisis and its ramifications. Without China playing a leading role, emerging economies are facing a difficult panorama. In fact, we are seeing a cycle of contraction in our regional partners, who will struggle to achieve even slightly positive readings in 2017. Another negative difference, which we discuss in more detail in the next chapter, was the capacity of both the Government and the Central Bank to implement countercyclical

policies in 2009. This advantage did not exist in 1999. In the best cases, politics then acted as a brake on the economy, while now it would tend to be neutral, particularly during the recovery cycle. In 2009, the Central Bank reduced its policy rates by more than 700 basis points (bp). At the same time, the government permitted the fiscal deficit to expand to more than 4% of GDP, maintaining the path of public spending and taking advantage of the funds flowing in from the oil sector.

Turning to the positive differences, external funding is available in the current cycle, as it was in 2009(Figure 3.3), and there has been a very rapid correction of risk premiums to normal levels. The availability of this funding has partly offset the impact of the cycle on domestic demand, particularly in terms of consumption. This situation did not exist in 1999, when the markets closed their doors to emerging economies, resulting in very substantial adjustments, with investment contracting and consumption stagnating for several years.

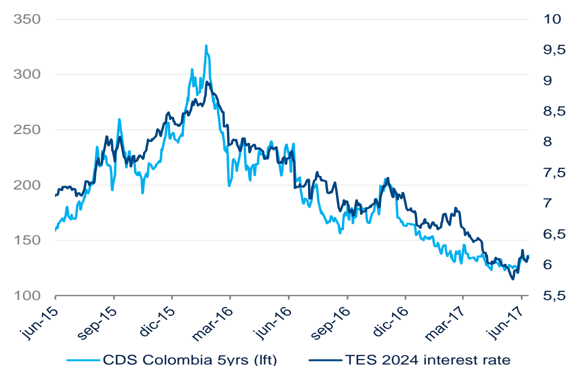
The flexibility of the exchange rate was also key in offsetting some of the negative effects on local revenue from export sectors. This factor also provided positive support in the 2009 cycle, which, by its nature, permitted a relatively rapid reversion of the exchange rate. This did not happen in 1999. At that time, in the midst of strong pressure on the Central Bank, the exchange rate band had to be abandoned for a flexible regime that had been brewing in the initial years of the crisis at the end of the last century (Figure 3.4). Finally, the responsible and prudential approach to economic policy over recently years has borne fruit in terms of credibility. This has meant that funding is still available on good terms and expectations are anchored. The capacity to smooth out the cycle has been increased and a more gradual adjustment has been achieved than in earlier periods, such as 1999.

Figure 3.4 Colombia exchange rates (pesos per dollar)



Source: Bloomberg

Figure 3.5 5-year CDS and 2024 Treasury bond (TES) (%), Colombia



Source: Bloomberg

Against this backdrop, capital and FX markets continue to show positive signs and resilience

The behaviour of capital markets remained positive in the quarter, with an appreciation of the public debt curve (Figure 3.5) and increasing participation by foreign investors in the domestic market. Foreign investors now hold 36% of Colombia's public debt in pesos. This has led to much of the curve being below monetary policy rates over most of the last year and a half. This appetite is understood to be due to ample global liquidity and yield spreads that still favour Colombia over similar alternatives and options in developed economies. Furthermore, the risk premium has remained low and, together with the exchange rate, has been less volatile than in the past, limiting risks for foreign investors. Domestically, the slowdown in inflation and reductions in monetary policy rates have also had a favourable impact, increasing the attractiveness of fixed income assets.

Finally, the exchange rate has absorbed must of the adjustment of the current shock, moving from around 1800 pesos per dollar before the shock to an average of between 2850 and 3100 pesos per dollar over recent months. This level correlates strongly with the crude oil price, which exhibited a downward trend over the last quarter, fostering a depreciation of the exchange rate compared to the start of the quarter. This behaviour was complemented by the Fed's decision to increase interest rates in June and the announcement of a reversal of its monetary relaxation from October. This could lead to lower liquidity and the possibility of a flight to quality towards the USA over the coming years.

4. Inertia in growth: towards a slow recovery cycle

The economic slowdown has continued into 2017, with YoY growth of 1.1% in the first quarter, and signs of similar performance in the second quarter.

The shock to the terms of trade has produced a major adjustment to national income, firstly through the oil sector and the government. As the economy adjusted to this new situation, the effect on income spread gradually among private agents, first to companies - through investment - and then to consumers. This has led to growth slowing significantly, to 2.0% in 2016 and 1.1% in the first quarter of 2017. The economy is currently in transition back to recovery, but no powerful drivers of growth are apparent that would foster a rapid adjustment in economic activity. Quite the contrary. We believe that the recovery cycle will be slow, taking an **L** shape, with inertia in the recovery as natural growth in spending and population growth boost activity.

Table 4.1 GDP demand and supply (%)

	2015	2016	I 2016	II 2016	III 2016	IV 2016	I 2017
GDP	**3.1**	**2.0**	**2.7**	**2.5**	**1.1**	**1.6**	**1.1**
Demand							
Private consumption	3.2	2.1	2.8	2.1	1.1	2.3	1.1
Public consumption	5.0	1.8	3.9	3.1	0.2	0.2	2.1
Fixed investment	1.8	-3.6	-4.0	-4.0	-3.6	-2.9	-0.7
Exports	1.2	-0.9	0.7	2.1	-3.0	-3.3	-3.6
Imports	1.4	-6.2	-5.8	-3.5	-10.9	-4.3	-0.4
Supply							
Agriculture	2.5	0.5	0.0	0.4	-0.5	2.0	7.7
Mining	0.2	-6.5	-4.6	-6.8	-6.5	-8.3	-9.4
Industry	1.7	3.0	4.3	5.3	1.3	1.0	0.3
Electricity, gas and water	3.0	0.1	2.9	-0.7	-1.4	-0.6	-0.6
Construction	3.7	4.1	5.5	0.7	6.8	3.4	-1.4
Trade, restaurants, hotels	4.6	1.8	2.8	1.9	0.7	1.8	-0.5
Transport and telecommunications	2.6	-0.1	0.9	0.2	-1.4	-0.3	-0.3
Financial and business services	5.1	5.0	4.9	5.4	4.4	5.1	4.4
Social and communal services	3.1	2.2	3.5	3.2	1.3	0.9	2.2
Taxes	0.7	2.2	1.3	4.1	0.4	2.9	2.7

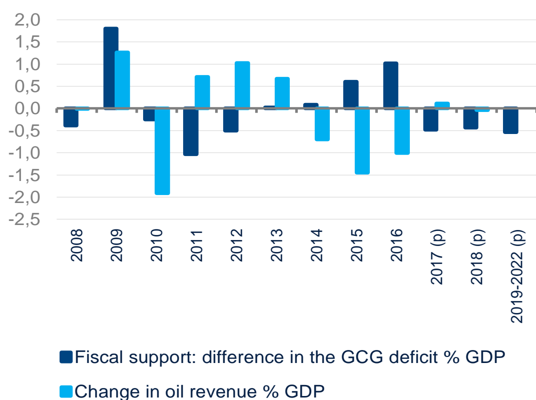
Source: DANE

Fiscal and monetary policy restrictions on robust stimuli to the economy

Fiscal policy has historically been one of the major sources of short-term growth for economies that have suffered significant slowdowns and see their growth rates threatened. However, this time, the government's hands are tied over fiscal policy. The government has seen the fall in oil prices reduce its revenue from the oil sector from 3.3% of GDP in 2013 to 0.1% in 2016 (excluding royalties). However, while the fiscal deficit increased from 2.3% to 4.0% over

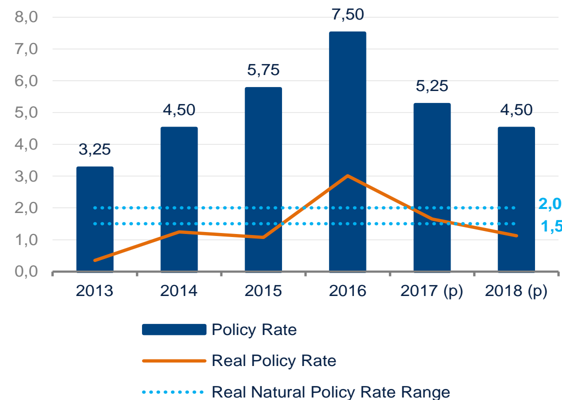
this period as a result of the fiscal rule, this was not sufficient to offset the negative effect of the loss of revenues. In order to meet its commitments and maintain a positive environment for investors, the government also had to cut spending and introduce tax reforms in 2014. The government's impact on growth in this cycle has therefore been negative (Figure 4.1).

Figure 4.1 Fiscal contribution and oil revenues (%)



Source: Treasury and BBVA Research calculations
Note: the forecasts of the fiscal deficit are by the Treasury; the oil revenue forecasts are from BBVA Research

Figure 4.2 Monetary policy rate (%, end of period)



Source: Central Bank of Colombia and BBVA Research calculations

The government introduced a new tax reform in 2016, enabling it to maintain its spending as a percentage of GDP in 2017 and meets its fiscal rule. However, central government will have to cut its spending in terms of GDP in order to comply with the fiscal rule in 2018. The commission responsible for the fiscal rule has also announced a change to the methodology for calculating the output gap: this involves moving from a non-parametric deficit target imposed by the Fiscal Rule Committee to a deficit limited by the new methodology. Under this, the government can run larger deficits of 3.6% in 2017 (previously 3.3%) and 3.1% in 2018 (previously 2.7%), largely because of the correction to the current account deficit.

The revenues from the tax reform, together with the greater flexibility on the deficit, mean that central government spending can be less restrictive than previously expected, although it must still fall as a percentage of GDP, due to the adjustment of the fiscal deficit from 4.0% in 2016 to 3.6% of GDP in 2017. In the opposite direction, the spending of regional governments - which are in the second year of their term - accelerated in 2017 compared to 2016, providing a boost to growth. Even so, figures for implementation of investment remain low at the moment, whilst spending has rebounded. We expect actual annual growth in public consumption of 2.6% in 2017, exceeding GDP growth. We expect actual annual growth of 1.5% in 2018, supported by regional spending. This is below the average historical growth rate.

The Central Bank has cut its monetary policy rate, but by less than the adjustment in inflation. Whilst the policy rate has been cut by 200 basis points, inflation has corrected by almost 500 basis points: even using measures of expected inflation, the real rate remains above the natural rate (Figure 4.2). The limitations on monetary policy making a more decisive contribution to reigniting the economy are based on fears of possible outbreaks of inflation, due to the inertia or persistence of inflation in the system. However, there are also concerns that the economy may yet require

further structural adjustment towards a balance that is sustainable over time. This adjustment could come through the current account, with an equilibrium deficit of around 2.0%-2.5% (as mentioned by the IMF in its most recent report on Colombia's economy), compared to an actual deficit of 4.4% in 2016 and 6.4% in 2015. Even so, the Bank has released some of the pressure on demand by reducing its interest rate almost continually since December 2016. This effect is starting to be felt in market rates, particularly for the corporate sector. However, growth in lending to companies remains low: quite possibly this is because companies have opted for cheaper liabilities to foster investment or production, rather than increasing debt.

Box 4.1: Potential GDP and the cycle

One of the complex arguments about Colombia's economy is the level of its potential GDP. Whenever there is a shock such as the "El Niño", it is usually assumed that the impact will be temporary and that it has no effect on potential GDP. However, we are currently dealing with a permanent supply-side shock - the fall in oil prices. This has happened in an economy that has spent almost a decade pushing investment in the oil sector and leveraging growth through the hydrocarbons.

The major contraction in investment could have cut potential growth to below 3.0% in 2017 and to 3.3% for the five year period, well below the level expected for our economy prior to the shock (around 4.4%). This reduction of around 1.5 percentage points in potential growth (in 2017) reduces the scope for a monetary-policy response, as the difference between actual and potential GDP will not be as large as would be suggested simply by the behaviour of the GDP cycle, as both will slow. The uncertainty about this variable is further increased by the potential impact of recent investment in the hydrocarbons sector, which could reduce the economy's potential growth rate even further, at least during the transition to a new growth path.

The adverse scenario for consumers is reflected in their confidence

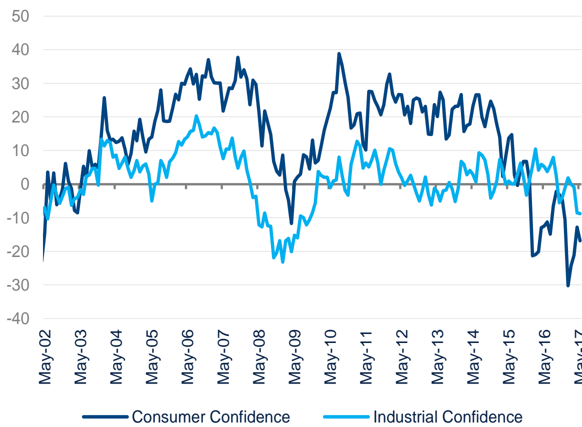
The policy restrictions do not only affect those who formulate them, but also all other economic agents. The Central Bank's increased interest rates to contain expectations of inflation, and this has also had a significant effect on consumers and businesses. It increases the cost of their debts, whilst their purchasing power is being diminished by rising food prices.

The government's need to balance its books through tax reform also affects consumer confidence. The tax reform increased the general VAT rate from 16% to 19%, and reduced some personal income tax allowances. The government's actions - together with a number of negative shocks to households over the last 2 years - have had a significant effect on consumer confidence (Figure 4.3). This has increased precautionary saving and slowed private spending. Growth in household consumption fell from 2.8% YoY in the first half 2016 to 1.1% in the first quarter of 2017 (Table 4.1).

The confidence and spending capacity of households has also been limited by a deteriorating the labour market, although this is heavily concentrated in urban areas, particularly Bogotá, where there have been 7 consecutive months of job losses. The urban unemployment rate reached 10.2% in May 2017, an increase of 1.2 percentage points on 2016 and 2015 (Figure 4.4). The labour market will therefore have a negative effect on future consumption.

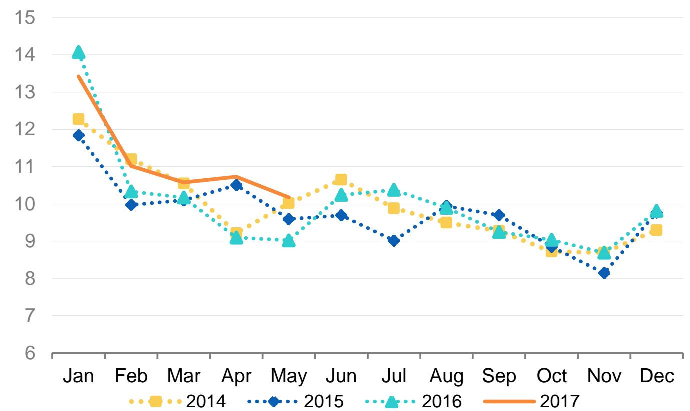
This will partially negate the positive effects of the reduction in interest rates and lower inflation we have started to see in 2017.

Figure 4.3 Consumer and industrial confidence



Source: Fedesarrollo

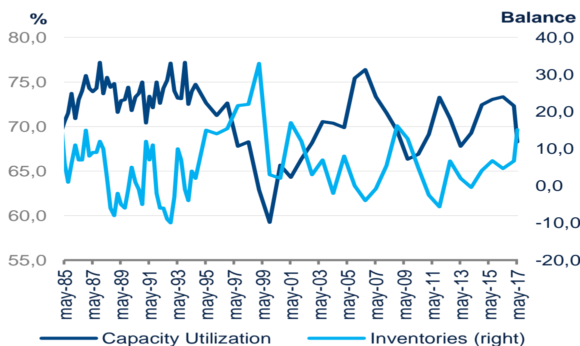
Figure 4.4 Unemployment rate, 13 cities (%)



Source: DANE

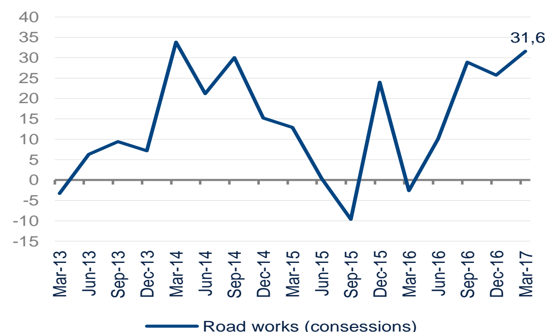
Business confidence has also fallen sharply, as a result of the weakness of the cycle and lack of demand (Figure 4.3). This has led to plans to expand production capacity being postponed, undermining investment. The most recent figures show a fall in utilisation of installed capacity and in increase in stocks and inventories (Figure 4.5). This demonstrates the current weakness of demand, enabling companies to take advantage of current low interest rates to improve their funding costs, rather than expanding production capacity. Figures for investment in the first quarter remain weak, with a YoY contraction of 0.7%: while this is an improvement on the 3.6% contraction in 2016, it is less than expected.

Figure 4.5 Capacity utilisation (%) and inventories



Source: ANDI

Figure 4.6 Other civil engineering work–concessions (%)



Source: DANE and BBVA Research calculations

Short- and medium-term drivers of recovery

One of the main engines of growth - which to date is only firing on one its four cylinders - is the 4G infrastructure programme. As of March, 6 projects had made progress of more than 10%, with some already having achieved almost 30%. This group of projects was responsible for the boost to public investment in the first quarter of 2017, with actual growth of 31.6%. Progress on these projects, together with 2 others for which funding is now in place, will support part of the expansion of GDP in 2017 and 2018. However, there are 3 other cylinders that can be used to power the economy: the 2nd and 3rd waves of the 4G work, and private projects. No new funding has been put in place for these as of the date of this publication and we believe that they could be delayed. We believe that the government's proposed 48.8 trillion peso programme will not be completed to schedule and will overrun. We have decided to extend the period for execution of the programme to the period 2016 to 2022 in our forecasts, with 2019 being the peak year for spending on the programme and its contribution to GDP.

In addition, the government has announced the relaunch of its Frech programme of interest-rate subsidies for house purchases: 2.5 percentage points for mortgages on homes of up to 320 million pesos (previously 250 million pesos). This programme, together with the initiative by most commercial banks to cut their mortgage interest rates, should boost the construction sector. There will be an initial phase during which current inventories will be run down: once this has completed, new projects will start to be developed in 2018 and 2019. Whilst the effects of this programme will be felt in the medium term, previous versions of this programme have had considerable impact on the growth of the sector and the labour market.

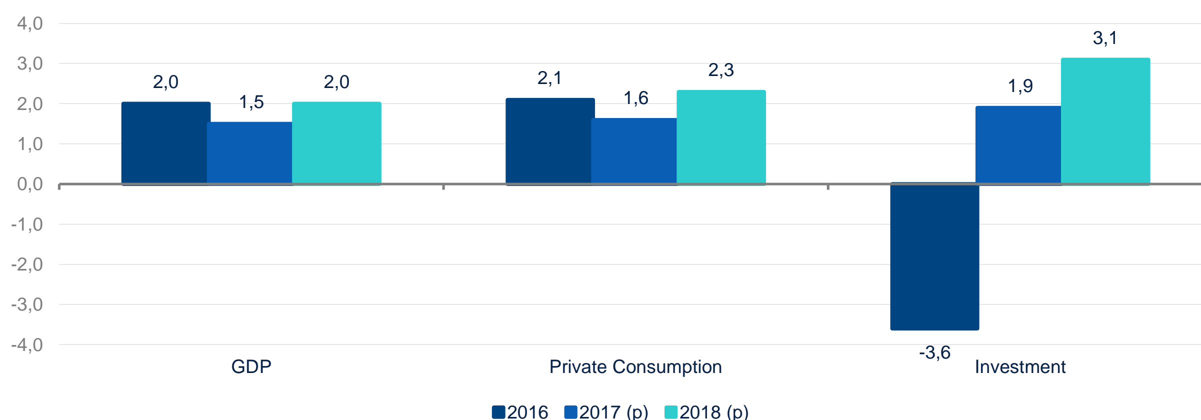
With the recent recovery in oil prices to between USD 45 and USD 55 per barrel (Brent), Colombia's oil sector has changed its attitude to investment in both extraction and exploration. A number of companies have announced increased investment, which they will start to roll out in 2017. However, no major changes have yet been seen in imported capital goods or investment in the sector's infrastructure. This should be noticed in the second half of the year, possibly after the government legislates for the special tax conditions for the sector, in addition to the VAT discount for capital goods included in the tax reform. These special measures include: VAT discounts for off-shore exploration; a yet-to-be-defined percentage of costs incurred in successful explorations; and the possibility to discount depreciation of intangible assets required for successful exploration projects. As can be seen, these tax incentives seek to foster successful exploration and investment in this field.

Finally, exports are one of the sectors we expect to perform most strongly, particularly in 2018, taking advantage of the exchange rate becoming consolidated in a more stable range at significantly more competitive levels, with gains in relative competitiveness from depreciation of the real exchange rate against our trading partners. We expect exports to grow by 0.4% in 2017. This is slow, due to a number of ad hoc supply factors affecting the oil sector and some agricultural products, but we expect it to pick up to 3.1% in 2018. The gradual recovery in domestic demand, particularly from investment, will lead to stronger performance by imports. However, this will still be much weaker than seen so far this century. We expect 0.3% growth in 2017, and 3.6% growth in 2018. With export demand performing in this way, we expect a slower improvement in the current account, with estimated deficits of 3.9% in 2017 and 3.5% in 2018.

Waiting on a slow recovery cycle

We expect 1.5% GDP growth in 2017, and 2.0% in 2018 (Figure 4.7). Our low expectations for growth are based on delays in the reanimation of investment and household spending, and a prolongation of adverse consumer- and business-confidence cycles. Thus, we expect gradual improvements in investment, from a 3.6% contraction in 2016, to growth of 1.9% in 2017 and 3.1% in 2018. Public investment will play an important role in this uniformly positive performance, through the 4G projects, a recovery in housing investment in 2018 and a gradual return to growth in investment in equipment. We expect 1.6% growth in household consumption in 2017, with the recovery slightly outperforming GDP growth in 2018, at 2.3%. The balance points to the floor of the slowdown in consumption being hit in 2017, but the recovery will be drawn out.

Figure 4.7 Projections of GDP growth, private consumption and investment (%)



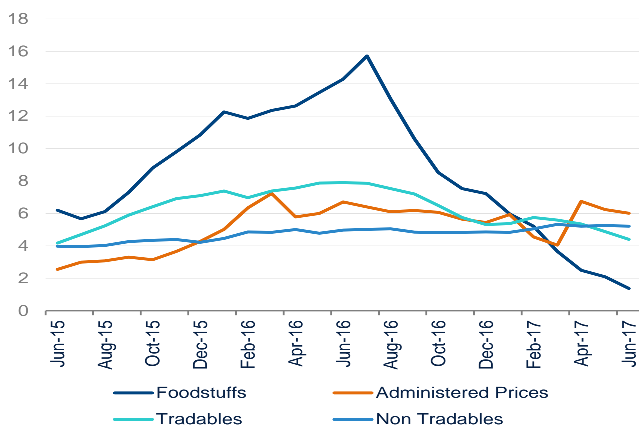
Source: DANE and BBVA Research

5. Inflation is falling, shaking off supply-side shocks

The supply-side shocks are being diluted, and overall inflation is slowing, whilst headline inflation remains slightly high

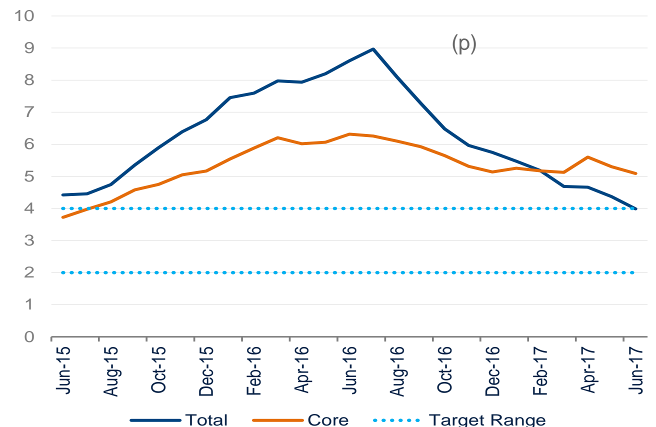
The two main shocks that increased inflation in 2015 and 2016 - the "*El Niño*" phenomenon and the depreciation of the exchange rate as a result of the shock to the terms of trade - are continuing to dilute. Normal rainfall in 2017 has resulted in food inflation correcting from 14.2% to 1.4% over the last year (Figure 5.1). In 2017, the exchange rate has fallen below its average level in 2016. This has reduced the cost of imported products, enabling the inflation rate for tradable products to slow from 7.9% to 4.4% in the last 12 months. It should be noted that this deceleration was slowed somewhat by the VAT increase at the start of the year, which mainly affected tradable products.

Figure 5.1 Inflation by product type (%)



Source: DANE

Figure 5.2 Total and headline inflation (%)



Source: DANE and BBVA Research

Although total inflation has fallen by around 500 bp since its peak last year, the Central Banks still has some concerns about the behaviour of certain prices. The most important of these involves inflation for non-tradable items, which should be slowing at a time at a time when demand is cooling. However, inflation for these items has accelerated over the year as a result of price increases for some services related to health, education and, to a lesser extent, leasing. This behaviour has avoided a sharper fall in headline inflation (Figure 5.2) and may, according to the Central Bank, represent a risk to convergence on its long-term target. However, two very different pressures may be lurking. Firstly, Colombia's economy is still facing some stubborn contributors to inflation, such as those from regulated construction and the permitted adjustment to inflation-linked rents. Secondly, it may be evidence that the slowdown in activity has also affected the potential growth rate: in this regard, the excess demand expected could be lower, despite the cut (Box 4.1). The policy response would be different in both cases: whilst the persistence of inflation should be temporary, the slowdown in inflation would help convergence, but only over a longer period. In the second case, the policy response cannot be loose, because this runs the risk of stoking inflation. This means the Central Bank would need to act cautiously, seeking out evidence that demand has in effect weakened.

Supported by the stability of the exchange rate, inflation will converge on the target range in 2018, creating room to cut rates to 4.5%

We expect the downward trend in inflation to continue in 2017 and 2018, standing at 4.3% and 3.2% at year end, respectively. Total inflation will continue to fall more rapidly than headline inflation in 2017, until June at least, with the decline in the headline rate accelerating in 2018 (Figure 5.2). Behind this trend, the exchange rate will play a key role. The currency will remain relatively stable in 2017 and 2018, at around 2980 pesos per dollar, ensuring that inflation for imported products will continue to fall. This trend will be reinforced by the weakness of demand we expect to see over these two years.

The downside surprises to activity in the first quarter (the Central Bank expected 1.3% growth), with economic activity continuing to grow at less than its potential rate in 2017 and 2018, as it did in 2016, together with the downward trend in inflation, seem to tilt the balance towards more aggressive monetary policy. However, the slow decrease in headline inflation and the behaviour of inflation for the non-tradable basket are sufficient counterweights for the Central Bank to act cautiously. Its strategy will continue to focus on reducing its policy rate, as inflation slips back, but without overstepping the line of the neutral rate, which we estimate to be a real interest rate of between 1.5% and 2.0%. The Central Bank will cut its policy rate to 5.25% in 2017 and to 4.50% in 2018. The pause in cuts is justified by the slow decline in headline inflation in 2017, which will not start to correct rapidly until the start of 2018.

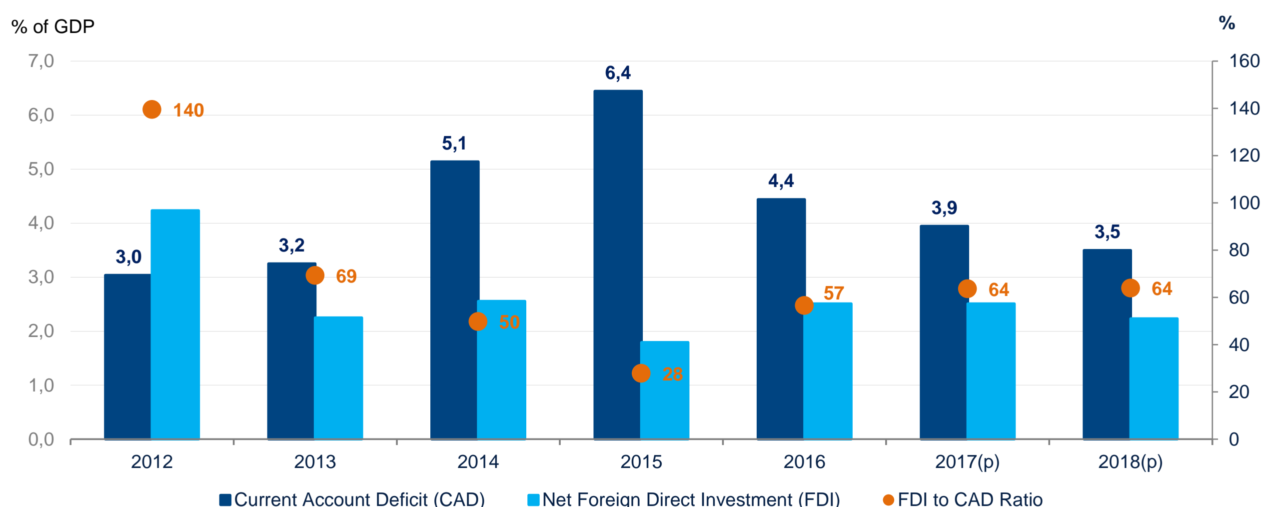
6. The path of improvements in the structural balance must continue over the medium term

Work on adjusting the external balance must continue, although it is likely that the pace will slow

Some of the low growth expected in 2017 and 2018 is explained by a weak outlook for exports. The real devaluation of the exchange increased optimism about the outlook for sales of products other than commodities (and industrial products). However, the value of non-traditional products exported in 2016 (USD 13,600 million) was lower than in 2014 (USD 15,400 million), when the depreciation of the exchange rate began. So far in 2017, there has only been a significant increase in May. Some of this poor performance is explained by low growth in some of the country's trading partners in the region, although the competitiveness issues affecting the country's industry should not be overlooked.

Moreover, expected oil production is down on previous years. This will continue falling, reaching 790 thousand barrels per day in 2020, offsetting some of the gains from the higher oil price we expect to prevail in future. We expect exports to rebound, although more slowly this time, as GDP accelerates in our regional trading partners and because of higher oil prices. These adjustments will slow the external adjustment of Colombia's economy slightly. The current account deficit will stand at 3.9% of GDP in 2017, and 3.5% of GDP in 2018. A large percentage of this will continue to be funded by direct foreign investment (Figure 6.1).

Figure 6.1 Current account deficit and net direct foreign investment (%)



Source: Central Bank of Colombia and BBVA Research

A larger negative effect on the labour market and a cycle of pessimism on the part of consumers are the main risks facing the economy in the coming quarters

The main risks to the economy continue to be domestic. A sharper than anticipated deterioration in the labour market could keep consumer confidence in negative territory for longer, impacting consumption growth in the country. Likewise, a persistent deterioration in business confidence could further delay investment decisions by businesses. Furthermore, while we have been quite conservative in our projections for roll out of the 4G infrastructure programme, there could also be additional delays that would set progress back.

On the international front, one of the main risks - which, while remote, should be assessed now - is the high share of domestic public debt held by foreign investors. There may be a number of explanations for their decision to invest in a country such as Colombia, including that its domestic debt is a more attractive alternative than that of other emerging economies, and even some developed economies. This relative value for long-term holders of debt is maintained through the higher interest on such purchases than they could receive from other investments. However, some investors are motivated by relative value through the extent to which their investment might have revaluation potential in the local market, if there are forces driving the value of the debt upwards. In current circumstances, the drop in inflation and reductions in the Central Bank's rates have driven such a revaluation of the debt. However, we are reaching the limits of this revaluation, and this could potentially lead to investors selling their holdings. This issue has become more relevant, among other factors, because of the Fed's recent announcement that it will start to gradually run down its balance sheet from October. This will involve it making fewer purchases in capital markets, reducing perceptions of liquidity in the market over the medium term, and causing debt to depreciate, motivating the second type of investor to move out of economies such as Colombia. This could lead to some temporary exchange rate risk and a depreciation of domestic debt, whilst making government funding more expensive.

7. Forecast tables

Annual macroeconomic forecasts

	2013	2014	2015	2016	2017(f)	2018(f)
GDP (YoY, %)	4.9	4.4	3.1	2.0	1.5	2.0
Private consumption (YoY, %)	3.4	4.3	3.2	2.1	1.6	2.3
Public consumption (YoY, %)	9.2	4.7	5.0	1.8	2.6	1.5
Fixed investment (YoY, %)	6.8	9.8	1.8	-3.6	1.9	3.1
Inflation (% YoY, eop)	1.9	3.7	6.8	5.7	4.3	3.2
Inflation (% YoY, average)	2.0	2.9	5.0	7.5	4.4	3.4
Exchange rate (eop)	1,927	2,392	3,149	3,001	3,047	2,950
Devaluation (%, eop)	9.0	24.1	31.6	-4.7	1.5	-1.4
Exchange rate (average)	1,869	2,001	2,742	3,055	2,977	2,985
Devaluation (%, average)	3.9	7.1	37.0	11.4	-2.5	0.3
BanRep interest rate (%, eop)	3.25	4.50	5.75	5.75	5.25	4.50
Deposit interest rate (%, eop)	4.1	4.3	5.2	6.9	5.3	4.8
Fiscal nalance (% GDP)	-2.3	-2.4	-3.0	-4.0	-3.6	-3.1
Current account balance (% GDP)	-3.2	-5.2	-6.5	-4.4	-3.9	-3.5
Unemployment rate (%, eop)	9.7	9.3	9.8	9.8	10.6	11.2

Source: Banco de la República, DANE and BBVA Research

Table 7.2 Quarterly macroeconomic forecasts

	GDP (%, YoY)	Inflation (% YoY, eop)	Exchange rate (COP/1USD, eop)	Policy rate (%, eop)
T1 14	6.4	2.5	1,965	3.25
T2 14	4.0	2.8	1,881	4.00
T3 14	3.9	2.8	2,028	4.50
T4 14	3.3	3.7	2,392	4.50
T1 15	2.6	4.6	2,576	4.50
T2 15	3.0	4.4	2,585	4.50
T3 15	3.2	5.4	3,122	4.75
T4 15	3.4	6.8	3,149	5.75
T1 16	2.6	8.0	3,022	6.50
T2 16	2.4	8.6	2,916	7.50
T3 16	1.2	7.3	2,880	7.75
T4 16	1.6	5.7	3,001	7.50
T1 17	1.1	4.7	2,880	7.00
T2 17	0.9	4.0	3,038	7.00
T3 17	2.0	4.2	3,050	5.75
T4 17	1.8	4.3	3,047	5.25
T1 18	2.3	3.5	3,013	4.75
T2 18	2.0	3.2	2,991	4.50
T3 18	1.7	3.3	2,952	4.50
T4 18	1.8	3.2	2,950	4.50

Source: Banco de la República, DANE and BBVA Research