BBVA | RESEARCH

Economic Outlook

Colombia

Second Quarter 2012
Economic Analysis

- **The global economy will pick up steadily in 2012** thanks to higher growth in Asia, while Europe will suffer a slight recession.
- **Colombia's economy will grow at 5% in 2012** in a healthy slowdown in which growth will gradually converge closer to its potential.
- **Inflation will remain stable** after a good first quarter that has put a check on expectations.
- **The Central Bank will keep an eye on local and global indicators,** and if there are any signs of global return to normal conditions, it will move to a more neutral stance.

Index

Closing date: May 16, 2012

1. Summary: global recovery, but risks reignite

Global economic activity will gradually recover, with wider regional growth differentials and risks tilted to the downside

After a gradual deceleration in 2011, especially in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex-China (including Japan) and Latin America, and sustained –but modest– dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will be heterogeneous, with widening growth differentials between key economic areas.

The increase in growth will be more evident in Asia, given the rebound from natural disasters in Thailand and Japan (affecting regional supply chains) and some reversal of policy tightening measures implemented through mid-2011. Also, growth in Latin America is likely to pick up, on easier monetary policy in Brazil and sustained growth in Mexico helped by US demand. The US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. This will still be a relatively strong performance compared to stagnant activity in the euro-area in 2012, dragged by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, emerging economies will recover their growth differential vis-à-vis developed economies, of around 4 percentage points, for the whole of 2012 and 2013. In turn, growth gaps between Europe and the US also will continue to increase even as financial tensions slowly lower in the former from expected decisive policy actions.

All in all, our growth projections are not very different from those of our previous Global Economic Outlook (published in February). We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of the increase in global activity (Chart 1). But this scenario is conditioned on a benign evolution of the crisis in Europe, and thus risks to our projections are still strongly tilted to the downside.

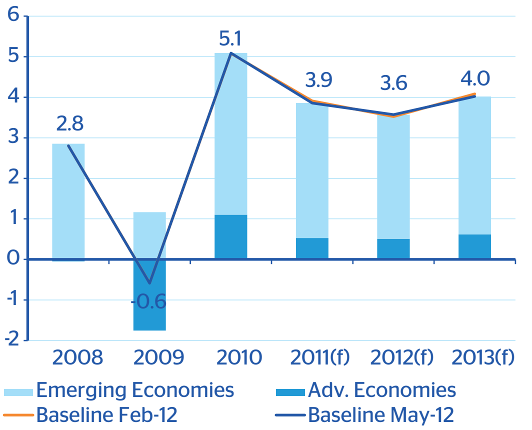
Monetary policies in advanced economies will continue to be very accommodative for an extended period. However, the effectiveness of further policy intervention (conventional or not) is decreasing, while at the same time the costs are increasing, including the risk of reduced central bank independence and the collateral damage from unconventional measures.. Policymakers in the US and Europe will need to take up part of the burden of reviving growth by implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue providing support for an adequate functioning of the monetary transmission mechanism.

Easy monetary policies in advanced economies will mean favourable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and an uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America –declining in the former but stable in the latter- will condition a different outlook for monetary policies. We expect limited further easing in emerging Asia, and a cautious tightening bias in most of Latin America, except in Brazil.

There have been some advances towards the solution to the European crisis, but crucial steps are still to be taken

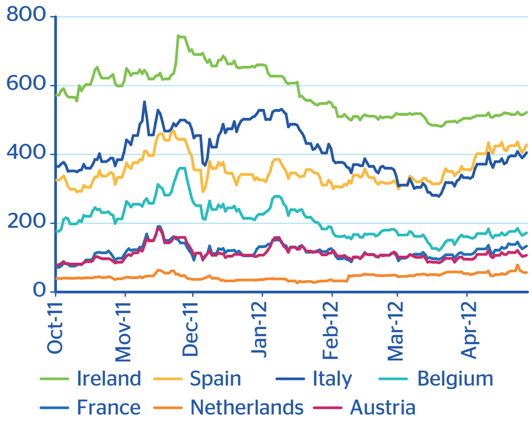
Europe needs a clear roadmap to end the crisis. Despite some advances in recent months, there are still many important pending issues. First, while Greek sovereign debt held by the private sector was restructured, substantial doubts about long-run sustainability persist, due to reform fatigue and a possible deeper recession than projected. Second, the European Stabilization mechanism (ESM) has been provided with a fresh lending capacity of 500bn EUR (on top of 200bn already committed by the EFSF). However, that has not been enough to quell market anxiety, given Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders. Further, it was not clear to what extent the increase in IMF resources of 430bn USD could be targeted to European countries. And third, there remain questions about the strength of the fiscal compact that sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP. Although it is a significant change towards controlling member's budgets, the allowance for deviations to the rule under "exceptional circumstances" may undermine its perceived its perceived strengths among hardliners at the ECB. In addition, there have been no advances towards a fiscal union or Eurobonds.

Chart 1
Global GDP growth (%qoq)



Source: BBVA Research

Chart 2
European sovereign risk premia (10yr bond spreads to Germany, bps)



Source: Datastream and BBVA Research

A new flare-up of the European crisis is still the main global risk

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries. But these positive effects proved temporary as risk premia have increased rapidly since March in Italy and Spain (Chart 2).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, ECB actions can only bridge the short-run while the underlying economic and institutional problems are tackled. Economic reforms should be pushed forward, while core countries stimulate demand in the Eurozone. Second, it is imperative to reconsider near-term fiscal consolidation paths in a more gradual trajectory in exchange for comprehensive, detailed medium-term consolidation plans.

Current oil prices will have only a moderate impact on global growth, although a price spike poses a significant risk

A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced in part to tightening supply and demand fundamentals and also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, due to tensions about Iran and limited market buffers (oil inventories and producer's spare capacity).

In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 15% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries view this as a temporary shock and will maintain accommodative policies. Nevertheless, should the conflict in the Gulf escalate, there could be a very large spike in oil prices, and even if central banks do not react, growth could be damaged through the associated increase in global risk aversion.

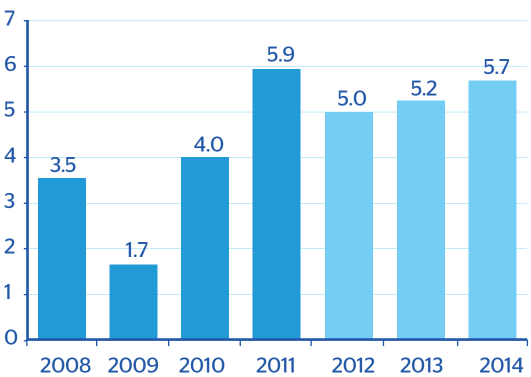
2. Colombia's growth converges closer to its potential

In 2011 the Colombian economy grew by an annual 5.9%. This rate was mainly the result of a strong expansion in private demand (annual 9.4%) and the upturn in public investment in the second half of the year. This led to growth picking up from an annual 5.1% in the first half of the year to 6.8% in the second half (Chart 3).

Leading indicators confirm a healthy slowdown in private demand

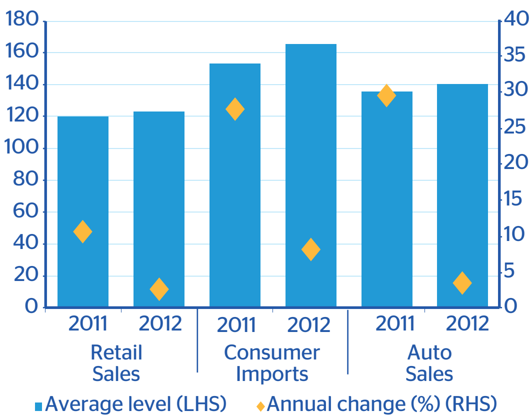
Indicators released so far suggest moderation in economic activity in the first quarter of 2012, in line with BBVA Research's forecast. In the case of consumption, retail sales, imports and vehicle sales posted rates of growth that were below the average for 2011, with spending on durable goods showing the biggest slowdown. However, the overall levels in these variables continue at record highs (Chart 4).

Chart 3
GDP growth, Annual % change



Source: DANE and BBVA Research

Chart 4
Private consumption indicators
Seasonally adjusted index (Jan 2008=100)



* The figure for 2012 is the average for January and February in the case of retail sales and imports. Vehicle sales include data from January through March
Source: DANE, Econometría Ltda and BBVA Research

The growth figures of the other components of consumption (non-durables and semi-durables) are strong, thus limiting the moderation in total household spending. Improvements in the labor market are having a similar influence. The rate of urban unemployment does not have much additional room to fall; in fact, it has stabilized at around its natural level (between 10% and 11%). Growth in formal employment is leading the way (and will continue to do so this year) in the creation of new jobs, thus improving the profile of household consumption.

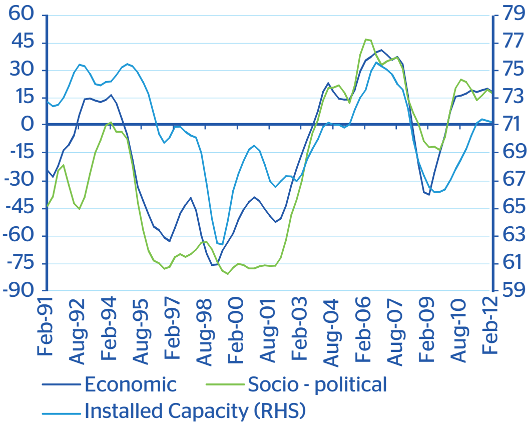
Although aggregate investment is slowing moderately, currently its composition is shifting in favor of residential expenditure. In particular, while imports of capital goods increased in 2011 at an annual average of 38%, they are currently rising at rates of an annual 17%. At the same time, according to CAMACOL data, new housing construction projects at the end of 2011, which will be executed mostly in 2012, were 2% up on the figure for December 2010. They are also now more concentrated on higher-end housing, which has a greater contribution to GDP growth and a higher speed of execution.

The indicators of consumer and business confidence have stabilized at high levels, reflecting that the signs of moderation in economic activity are mostly the result of the economy returning to normal than unfavorable results from any sector. The index of household expectations is nearly double its historical average; the short-term outlook for retail sales is slightly below the average in 2007, while the industrial indicators suggest a high utilization of installed capacity with appropriate conditions for investment (Chart 5). The level of industrial confidence suggest expansion and support the idea of an expected upturn in the manufacturing sector over the coming quarters, boosted by strong order books in the domestic market and a positive balance of exports.

In fact, in the first two months of 2012 exports from Colombia increased by an annual 23%, boosted once more by hydrocarbons, mining and precious metals sales (up an annual 26%), and with a satisfactory balance in its other components (10%). However, prospects for the global economy, suggesting flat US growth and a slight recession in Europe, may have a negative impact on exports. This impact should be limited by the new expanding markets in which Colombia is entering with greatest force: China as a buyer of raw materials and the Latin American Integration Association (LAIA) as a market for manufactured products (see Box 1). In fact, LAIA was the only market that showed strength at the start of 2012 for exports of non-mining-energy products (Chart 6).

Chart 5

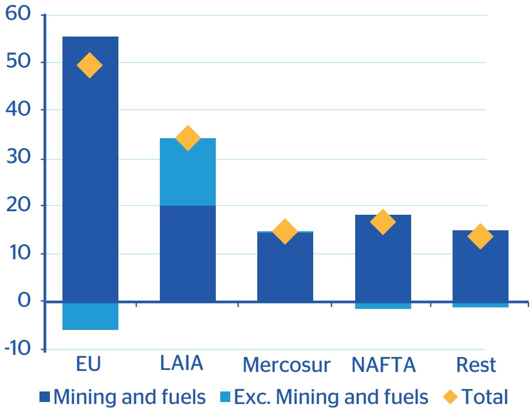
Installed capacity and conditions for investment. Seasonally adjusted indexes, %



Source: Fedesarrollo and BBVA Research

Chart 6

Destination of exports Annual change, YTD February 2012



Source: DANE, DIAN and BBVA Research

Colombia will grow by 5% in 2012, boosted by domestic demand

This figure is above the LatAm average (3.7%) and shows a steady convergence with the Colombian economy's potential growth rate. The forecast is based on a strong leading role for investment, which will once more increase its share of GDP from 26.6% to 28.0% between 2011 and 2012. Consumption will grow in line with GDP and so cut the excessive demand pressures on installed capacity and inflation.

In 2011 the non-tradable sectors and mining led growth, based on expansion of private demand and high international commodity prices. In recent months, despite the slowdown in oil production (though still above the 2011 average), positive coal production figures have enabled mining to grow at above GDP in the first quarter. At the same time, construction has a strong potential for expansion, both in terms of private supply (housing and other buildings) and in public works, with a significant contribution from public infrastructure investment.

The retail trade and financial sectors show lower rates of growth associated with the slowdown in some of the components of consumption and credit. However, the outlook for them is positive, with healthy corporate results in the sector at the end of 2011 and some positive figures released at the start of 2012. Finally, manufacturing industry and agriculture will be two of the sectors that will probably grow below GDP this year. In the case of the manufacturing sector, growth rates of between 4.0% and 4.5% are expected, while agriculture will have only a slightly positive growth.

The current-account deficit will remain stable over the coming years

In 2012 two opposing factors are expected to maintain the current-account deficit relatively stable compared with the figure for 2010 and 2011. First, exports will grow this year at under the 2011 figure (9.2% vs. 43.1%), as commodity prices will not increase as much as last year, and demand for industrial products in Europe will be low. In addition, a new record is expected for dividends transferred abroad in 2012, after the good corporate earnings figures last year. This will put pressure on the current-account deficit, as in the case of exports. However, the slowdown of domestic spending, mainly in the components that require most products from abroad (consumption of durable goods and investment in transport equipment) will also lead to imports rising only at a low rate of around 10%.

In short, we expect the deficit to be around 3.0% of GDP in 2012 and 2013. This figure will be easily financed from strong FDI inflows. According to data from the foreign exchange balance FDI is now less concentrated in the hydrocarbon and mining sectors (73% vs. 87% in 2011), and this diversification will provide more room for its expansion this year and in the future.

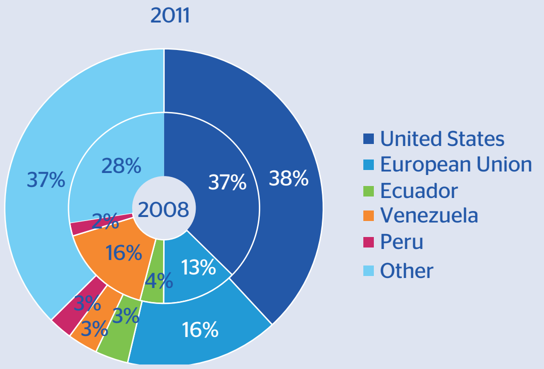
Colombia will continue to grow, even if the situation in Europe worsens

The main channel through which the Colombian economy would be negatively affected if the European economy deteriorates, would be foreign trade and greater risk aversion through lower private confidence. This would lead to downward adjustments in household and corporate demand, although less than was the case in 2008. At that time, the economy showed its soundness in the face of the Lehman Brothers shock and maintained positive rates of growth. In fact, the lower current correlation between domestic confidence indexes and global risk aversion confirm this hypothesis. Nevertheless, we have to be watchful of signs of a worsening global situation that could affect domestic confidence.

Box 1: Exports to a variety of markets but concentrated on a small number of products

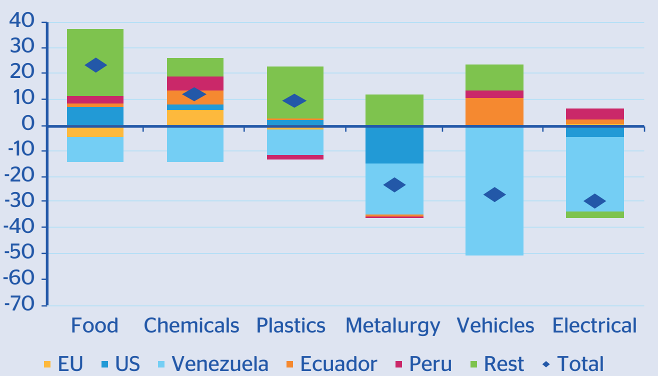
In 2011, non-traditional exports (other than oil, coffee, coal and ferronickel) were at a similar level to the all-time high of 2008, but their destinations are different now (Chart 7). The Venezuelan market contracted strongly, the United States increased its share in some manufactured products and advantage was taken of expanding neighboring markets. By type of product, only three sectors of the 15 other than fuel and precious metals managed to exceed the export levels of 2008: food, chemicals and plastics (Chart 8). In these cases there was a significant atomization of export destinations in recent years, with a major participation by new trading partners from South America and Europe. However, these markets are being explored without significant progress being made in product diversification.

Chart 7
Export destinations, 2008 and 2011. Percentage



Source: DANE, DIAN and BBVA Research

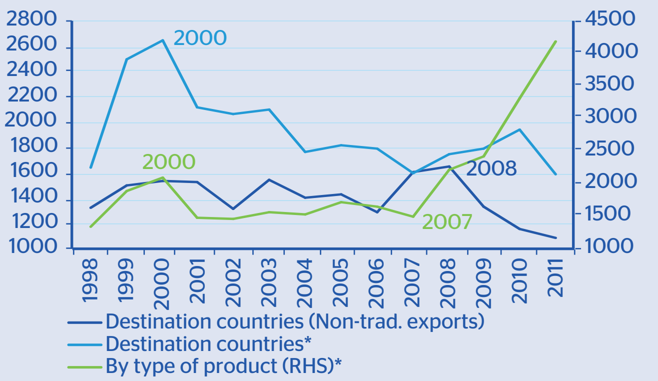
Chart 8
Sector growth 2008-2001
Contribution to change, %



Source: DANE and BBVA Research

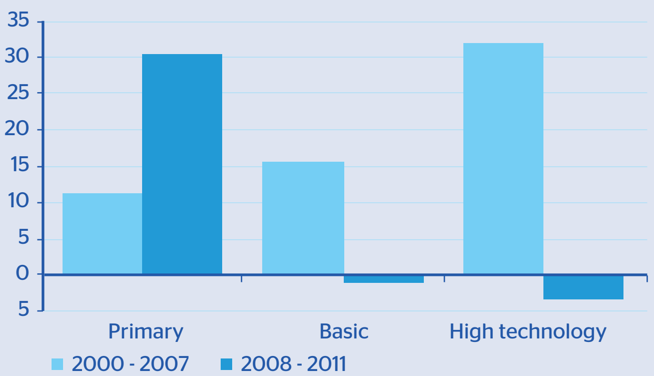
A Herfindahl index constructed to evaluate the level of concentration of exports among destination countries and types of goods concludes there has been greater diversification of the destinations of exports after 2008, but shows how they have concentrated strongly on a few products since that date (Chart 9). According to this analysis, between 2008 and 2011, only sales of primary goods grew and increased their share of total trade in volume terms, while high-technology manufacturing fell by nearly 5% (Chart 10).

Chart 9
ÍHerfindahl index of market concentration
Index from 0 (no concentration) to 10,000 (concentrated)



Source: DANE, DIAN and BBVA Research

Chart 10
Colombia: export growth by type of goods
Accumulated change in the period indicated, %



Source: DANE, DIAN and BBVA Research

This makes Colombia notably different from the countries in the region that are most open to international trade. In recent years Peru and Chile have steadily lessened their exposure to exports of primary goods. The difference between these countries and Colombia is their greater determination to conclude free-trade agreements. Chile, for example, is the country with the greatest number of free trade agreements in the world. They are with economic areas that represent nearly 90% of the world's population (NAFTA, European Union, EFTA, South Korea, China, etc.).

To sum up, Colombian exports have grown rapidly in recent years, boosted by a combination of more external markets and significant increases in the sales of raw materials such as oil and coal, but without significant progress in products with a greater technological input. At the same time, the result depends to a large extent on higher international prices, with incipient progress in terms of export volumes. This has increased the country's exposure to shocks in terms of trade that have historically affected the economy of Colombia and Latin America. Even so, the measures taken by Colombia in foreign trade, through free-trade agreements concluded in the past and being negotiated now, are steps in the right direction. They aim to take advantage of those regions with high current demand (such as the United States and Europe), but also to take advantage of countries in a strong expansion phase (such as Chile, Peru, Mexico and Turkey).

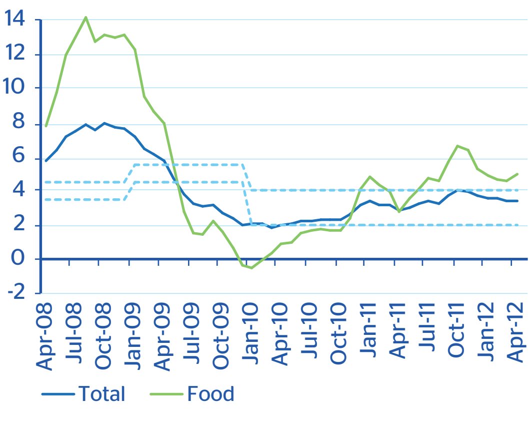
3. Inflation will remain stable after a good first quarter

Reduction in inflationary expectations

Following the upturn in inflation at the end of 2011, largely due to the supply shocks affecting food and regulated prices, inflation in 1Q12 fell more than expected to 3.4% (Chart 11). Thus, inflation has been more consistent with the aim of reaching the middle of the target range (between 2% and 4%) in the medium term, and this has been reflected in a significant improvement in expectations. In this context, we expect inflation to remain limited for the rest of the year, although we believe that there will still be some pressure making difficult a convergence of inflation towards rates closer to 3.0%.

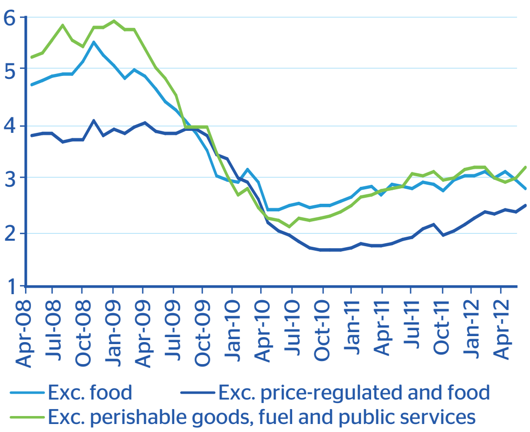
The outlook for prices this year is better than in 2011. First, because moderate increases are expected in food prices, reflecting better climate conditions. This has been observed in the early months of the year, with a steady fall in annual food inflation from 5.3% at the end of the previous year (Chart 11). The climate factor and the better local supply conditions would have a greater impact than the increase in international prices of some foods, which until now have been offset by the exchange rate appreciation. At the same time, inflation in tradable goods will continue at low rates, reflecting the behavior of the interest rate on the prices of imported goods (Chart 13). Meanwhile, increases in prices of regulated goods should be more moderate, because of the higher base of comparison.

Chart 11
Total and food inflation (annual % change)



Source: DANE, Banco de la República y BBVA Research

Chart 12
Core inflation indicators (annual % change)

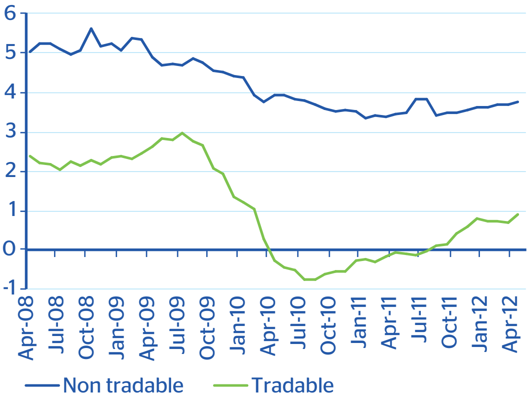


Source: DANE y BBVA Research

Inflationary pressures will thus arise mainly from the existence of a positive output gap, less slack in the labor market and the expected increase in international oil prices. Demand-sensitive prices continue to move upward, in line with growth in household spending (Chart 13). Inflation in non-tradables, in particular rental prices, has continued to grow, as have prices of meals outside the home. Some prices could be reflecting pressure from the increase in the minimum wage, consistent with a slight speeding up of wage indexes for some sectors (Chart 14). Finally, we project that international oil prices will increase in 2012. This will continue to be reflected in increased fuel prices, with the risk of heightening inflationary pressure if expectations are altered and the prices are passed on to the rest of the economy.

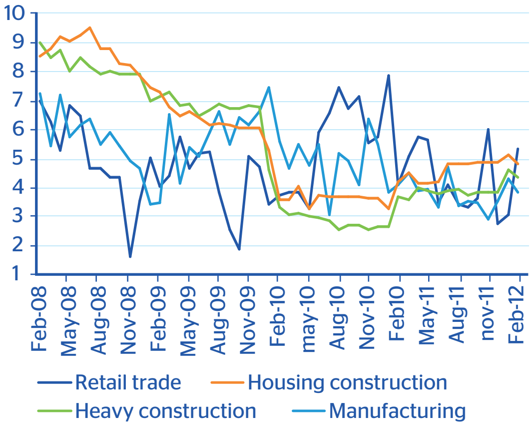
In all, we expect inflation to close 2012 at 3.4% (a downward revision of 0.1 pp on the previous scenario). For the upcoming years, we have slightly reduced our inflation forecast to rates that are closer to the inflationary target (3.0%). This reflects more anchored expectations and the prospect of a slightly more restrictive monetary policy than previously considered. In addition, it is worth noting that some aspects related to taxes could have effects on inflation in the medium term. They include changes to the VAT rate for some products in the basket as part of the tax reform expected this year.

Chart 13
Inflation of tradable and non-tradable goods (Annual % change)



Source: DANE y BBVA Research

Chart 14
Index of nominal wages. (Annual % change)



Source: DANE, Banco de la República y BBVA Research

4. The policy rate will rise in the second half of 2012 and converge to a more neutral stance

At the start of 2012, the central bank faced the dilemma of whether to increase its policy rate in response to local indicators or to maintain it stable given the high rate of external uncertainty and its possible impact on the local economy. In this situation, the domestic conditions of the economy and the upward trend of inflationary expectations gained the upper hand in the monetary authority's decision-making, and led to an increase of 50 basis points in the policy rate to 5.25%.

The most recent indicators suggest that the accumulated increases in the policy rate have reduced demand pressures observed in the third quarter of 2011, as can be seen in both the GDP data for 4Q11 and in the leading indicators for 1Q12. In this situation, the monetary authority has entered a pause mode in order to determine the scope of the combined effects of a more restrictive monetary policy, weak growth in developed economies (including the recent surge in financial tensions linked to doubts regarding the resolution of the European crisis), and the slight slowdown in emerging markets. In addition, the possible effects of a rising exchange rate on some sectors of the economy have to be evaluated.

Although the arguments presented in the recent minutes of the central bank's meetings are in line with the need for a short-term pause, they also show that there is considerable discussion about whether the increases already made in the interest rate will be sufficient to maintain inflation in line with the central bank's target. In fact, the complexity of the external environment and recent structural changes in the Colombian economy will determine the position that will have to be adopted by monetary policy in the medium term.

To the extent that the economy has begun a path of convergence toward its potential growth after a strong recovery in 2011, which will coincide with the stabilization of global financial tensions starting in the second half of this year, the monetary policy should be geared towards a neutral stance.

Recent decisions by the central bank are steps in this direction, but we consider that additional adjustments are needed.

First, although the strong recent levels of investment will have been reflected in expansion of the economy's output capacity, the high rate of growth registered in 2011 would probably have contributed to widening the output gap. This means the gap will take some time to return back to its potential level. In addition, the recent rise in the interest rate and the reduction in inflation has led the policy rate to increase in real terms to around 2.0%. This level is actually below our estimate for the natural rate of interest, which is closer to 3,0%. Finally, although short-term indicators all suggest that there is a moderate slowdown in economic activity, in the relevant policy horizon the external scenario brings with it major challenges and benefits for the country that must be administered through prudent policies by the monetary and fiscal authority. In the most probable scenario activity will continue to be boosted by high terms of trade and strong capital inflows. These conditions will tend to strengthen domestic demand, and require a slightly tighter monetary policy. They will also lead to dilemmas for the central bank in terms of generating more capital flows into the country.

In this situation, we expect additional increases in the policy rate in the second half of 2012 to 5.75%, sustained by the greater room for maneuver provided by the relaxation of financial tensions in Europe and the expected upturn in global growth. Given the expected behavior of inflation, we consider that at this level the real policy interest rate will be very close to our estimate of a neutral rate. In addition, our expectations of an improvement in growth in 2013 and an inflation rate above the middle of the target range will trigger additional adjustments in the policy rate in 2013.

However, the grounds for these increases would dissipate if there was an additional deterioration or prolonged financial tension in the fiscal crisis in Europe, or a weakening of growth in the United States. This negative scenario would imply a downward bias in our growth estimates, and thus to the expected trend in interest rates.

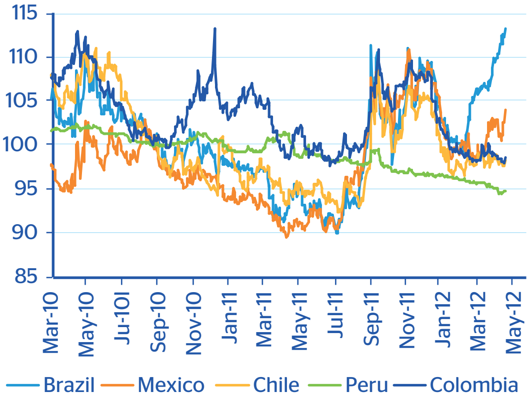
With respect to the credit situation, we consider that the central bank has considered positively the recent moderate growth of the portfolio, although it will continue to watch closely for any possible inflationary pressures and signs of financial imbalances in a situation of sustained credit expansion and strength in domestic demand. Credit growth continued to moderate in the first quarter of the year. The outlook is for this trend to continue, and for the growth to ease towards a more sustainable rate. Although so far the moderation has been the result of the corporate portfolio (60% of total credit) in the second half of the year we expect the consumer portfolio and mortgage lending to join the slowdown.

5. The Colombian peso will continue to gain over the coming months

In the short term, the peso will continue to appreciate, boosted by continuing capital inflows, which have not been significantly affected by the high levels of global risk aversion (Chart 15). In fact, although renewed doubts about the sustainability of debt in peripheral European countries have led to a reduction in investment flows to some emerging markets, in Colombia these flows continue to be favorable. In particular, FDI inflows in 1Q12 amounted to USD 4,208 million, with an annual rate of growth of 30.2%, according to figures from the foreign-exchange balance (Chart 16). These FDI inflows have not been offset by investments by Colombians abroad, to the extent that only a small proportion of these flows pass through the foreign-exchange market. In addition, net portfolio flows and external borrowing are still at positive levels, although their share has fallen compared with FDI, and thus contributed to an excess of dollars in the economy.

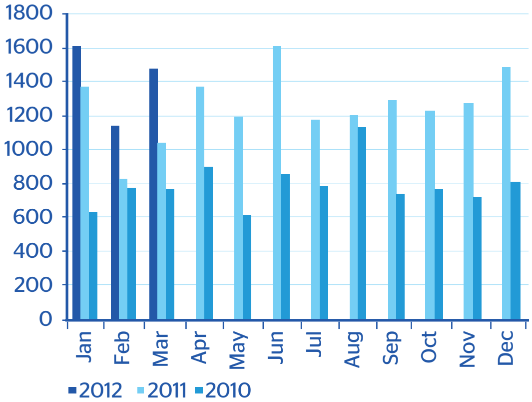
It is worth noting that the central government has not injected dollars into the economy this year. As was the case in 2011, it has supported the central bank's policy of foreign-exchange intervention by maintaining a high balance of deposits in the Central Bank (between COP 9 trillion and COP 11 trillion). This has helped offset the pressures on liquidity from the accumulation of international reserves. The recent regulation by the Central Bank has introduced greater flexibility and credibility to the strategy of foreign-exchange intervention, as it diversifies the instruments that can be used to counter the effects on liquidity. It is an alternative to the use of the stock of public debt securities in the hands of the treasury and the monetary control of TES (domestic debt securities), and provides more room for the central bank to increase the amount of intervention if required. It is also worth noting that the country would have room to increase its stock of international reserves, to the extent that reserve accumulation in Colombia has not been as strong as in other countries in the region, and they remain at relatively low levels as a proportion of GDP (Charts 17 and 18). On the fiscal front, a key element will be for the Government to continue to consolidate the reforms favoring greater public savings and thus contribute to moderate domestic demand and support a sustainable real exchange rate.

Chart 15
Colombia and LatAm exchange rate (Sep 14 2010 = 100)



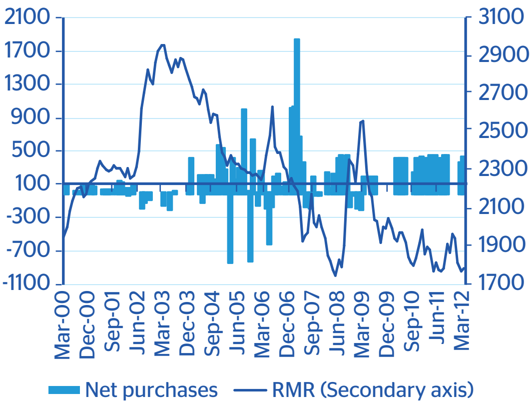
Source: Bloomberg, Bank of the Republic and BBVA Research

Chart 16
Foreign direct investment (USD million/month)



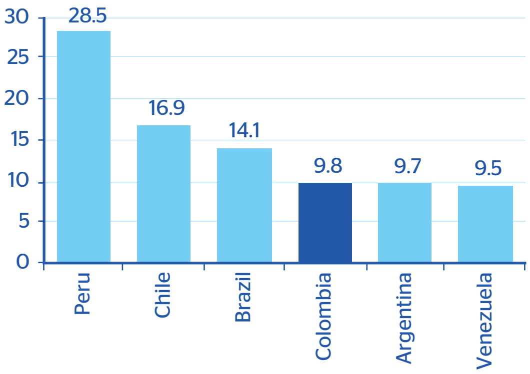
Source: Bank of the Republic and BBVA Research

Chart 17
Peso/dollar exchange rate and net purchases of international reserves (USD million)



Source: Bloomberg, Bank of the Republic and BBVA Research

Chart 18
International reserves in Colombia and LatAm (as percentage of GDP)



Source: Bank of the Republic and BBVA Research

6. The Government's reforms will favor growth in the medium term

The central government's fiscal deficit this year is estimated at 2.9% of GDP. It is favored by domestic demand and the high level of revenues associated with the mining and energy sector. The result of above-target receipts so far this year and more efficient tax administration will strengthen the good results expected for 2012.

On regulatory questions, the regulation of the law governing the royalties' administration was finally approved and its implementation is expected to contribute to regional growth in the medium term. The regulation maintains the distribution of resources in five funds covering external savings, pension payments, science and technology, regional development and poverty reduction. It sets up a governing board whose duty is to define the general policy for the system of royalties and to prioritize those investment projects that are to be financed with royalties. In this regulatory framework the COP 9.7 trillion a year expected to be received as royalties on average until 2016 will be invested in projects that meet the needs of municipalities and regional departments. Also under scrutiny will be the operation of the joint bodies responsible for the oversight of funds. It is hoped that this oversight role does not complicate the approval of infrastructure projects demanded by the country.

Other regulatory issues of great importance will be discussed in the second quarter of the year. First, President Santos announced the creation of a program to provide subsidies amounting to 100% of the value of homes for low-income families. The program will be launched following authorization from the Congress by a bill that provides the Ministry of Housing with the discretionary powers to distribute the budget of the National Housing Fund (Fonvivienda) to finance housing of priority interest. The program will focus on the delivery of 100,000 homes per year to the poorest families, at a cost of around COP 4 trillion per year (0.7% of GDP). However, it is uncertain whether the program will be extended for more years and whether the number of families benefiting will be increased.

In addition, the national government expects to discuss a tax reform bill. The reform modifies the tax code to make it simpler. It reduces some tax allowances and aims to increase the level of progressive taxation so that there is a greater relationship between income and tax payable. Some pressure groups have already announced their disagreement with the withdrawal of some benefits, such as in the case of the mining sector. The Ministry of Finance estimates that the impact of the project on the fiscal balance will be neutral. However, as is usually the case with tax reforms, it is very likely that the final law passed by Congress will be far from the current bill, and will generate unanticipated fiscal effects.

Regulatory progress in 2012 should help improve Colombia's sovereign credit rating by agencies. In February 2012 the agency BRC changed its outlook on Colombia from stable to positive, though it maintained its BBB- rating. The agency argued that factors such as the rate of labor informality, lack of flexibility in public expenditure, the compensation and resocialization of victims of violence, and the infrastructure deficit, all continue to be a challenge for Colombia. Public announcements by Fitch Ratings point in the same direction. They argue that the high level of dependence of exports and the fiscal balance on raw materials, the low level of international reserves given the structural current-account deficit, the low tax revenue base and the lack of flexibility in public expenditure, are all factors that Colombia has to improve to increase its credit rating.

The government is tackling some of these factors. The tax reform will extend the revenue base and make public expenditure more flexible by eliminating some tax benefits. The infrastructure projects for 7,700 km of highways with participation by the private sector should improve the current infrastructure deficit. The process of compensating victims initiated in 2011 is moving the country towards a post-conflict situation. Equally, the regulation of the law on royalties and the fiscal rule will reduce the procyclical effect of oil on output and the fiscal balance. We do not believe that this progress will be reflected in the fundamentals in 2012, so we do not anticipate an improvement in the credit rating in the short term. However, we maintain a positive outlook, knowing the efforts being made by the government to make progress in this area. In addition, the implementation in mid-May 2012 of the free trade agreement with the United States will favor the economy's long-term growth (see Box 2).

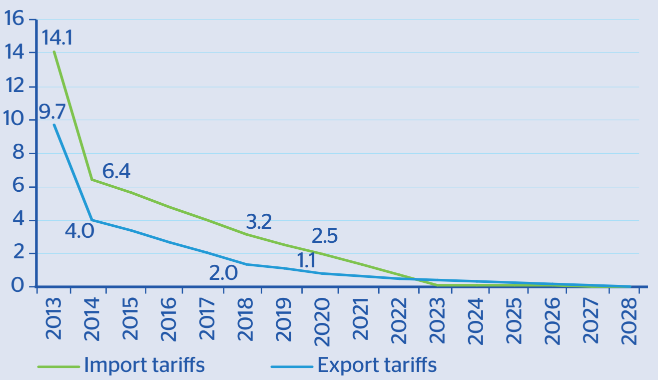
Box 2: Great expectations at the launch of the FTA with the United State

EOn April 15, during the VI Summit of the Americas in Cartagena de Indias, the presidents of the United States and Colombia announced the entry into force of the FTA on May 15, 2012.

The FTA will consolidate trade relations between the United States and Colombia, and allow some sectors that did not benefit from the preferential tariffs under the ATPDEA to enter the US market duty free. With the entry into force of the agreement, 76% of US products will be duty free in the Colombian market, as will 94% of Colombian products when they enter the US. The remaining products will be subject to a staged tariff reductions and elimination of quotas, which in all cases will be withdrawn gradually while producers adjust their production to meet the challenges of the agreement. As a result, the average Colombian weighted tariff rate will fall from 14% to 6.4% in the first year of the agreement (Chart 19).

Chart 19

Average tariff in Colombia on primary imports and products competing with exports (%)



Source: MinComercio and BBVA Research

Chart 20

Net Foreign Direct Investment in Mexico and Chile before and after NAFTA and the FTA, respectively (% GDP)

Source: World Bank and BBVA Research

Some impacts of the agreement can be foreseen, such as the extension of the variety of products available to consumers, increased domestic competitiveness leading to lower consumer prices and specialization in Colombia on products in which it can be more competitive, with positive effects on productivity.

The experience of other countries such as Mexico and Chile gives some indications about the benefits of free trade. With the entry into force of NAFTA, Mexico nearly tripled its FDI, while Chile increased its FDI from an average of 5.5% of GDP over the four years before the FTA to 7% of GDP in the four years after it (Chart 20). On this question, the government estimates that the FTA will increase the rate of investment by 2% per year, the economy will grow by an additional annual 1% and the rate of unemployment will fall by 1%.

Some existing barriers will prevent all the benefits of the treaty from being available in the short term. Colombia still lags significantly behind in infrastructure. This means that infrastructure costs are actually higher than the current tariff barriers. Equally, it is the country in the region with the highest internal transportation costs, which are equivalent to USD 1,807 per container measuring 20 TEUs, when the average for the region is USD 680. Fortunately, the government is pushing forward an ambitious plan to construct 7,700 km of highways, though these will come into operation almost three years after the entry into force of the FTA.

In addition, coordination in health and plant protection product registers between US and Colombian authorities has to be as swift and flexible as possible, so that producers from both countries can comply with the export rules for animals and vegetable products. The Colombian government is aiming to prioritize coordination for those products with the greatest potential for export. To this end, it has appointed a delegate in the Washington embassy to smooth over the process of coordination with the FDA in the United States.

7. Tables

Table 1

Macroeconomic forecasts annual

	2010	2011	2012	2013
GDP (y/y %)	4.0	5.9	5.0	5.2
Private consumption (y/y %)	5.0	6.5	4.8	5.2
Public consumption (y/y %)	5.5	2.6	3.2	3.5
Fixed investment (y/y %)	4.6	16.6	10.5	7.6
Inflation (y/y %, EoP)	3.2	3.7	3.4	3.3
Exchange Rate (vs. USD, EoP)	1926	1934	1800	1810
Interest rate (%, EoP)	3.00	4.75	5.75	6.50
Fiscal balance (% GDP)	-3.8	-2.9	-2.9	-2.5
Current account (% GDP)	-3.1	-2.7	-3.0	-3.0

Source: DANE, Ministry of Finance, Superfinanciera, BanRep, and BBVA Research

Table 2

Quarterly Macroeconomic Forecasts

	GDP (y/y %)	Inflation (y/y %, EoP)	Exchange Rate (vs. USD, EoP)	REPO rate (%, EoP)
1Q11	5.0	3.2	1884	3.5
2Q11	5.1	3.2	1783	4.3
3Q11	7.5	3.7	1836	4.5
4Q11	6.1	3.7	1934	4.8
1Q12	5.0	3.6	1766	5.3
2Q12	5.2	3.6	1750	5.3
3Q12	5.0	3.5	1725	5.8
4Q12	4.9	3.4	1800	5.8
1Q13	5.2	3.4	1760	6.3
2Q13	5.4	3.3	1730	6.5
3Q13	5.6	3.3	1750	6.5
4Q13	4.7	3.3	1810	6.5

Source: DANE, Superfinanciera, BanRep, and BBVA Research

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