BBVA Research

Colombia

Economic Outlook

Third Quarter of 2010

Economic Analysis

- The improved performance of the Colombian economy in 1Q10 made possible a revision of the BBVA Research growth forecast from 3.0% y-o-y to 4.2% for 2010. The growth was fueled by a stronger recovery of private investment and a moderate increase in consumption.
- The Central Bank shall maintain its current monetary policy until the end of 2010, with inflationary pressure determined by exchange rate appreciation and the continuing negative output gap.
- Better than expected growth and the substantial increase in oil production will make possible a reduction in the fiscal deficit in 2010-2011; however, greater risk aversion linked to sovereign debt in Europe could create a negative bias against the growth forecast and jeopardize the fiscal deficit reduction objective.
- The main challenge of the government will be to implement a fiscal regime that is compatible with debt reduction and a decrease in exchange rate distortions resulting from public financing operations.

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1. Reassessing the risks for the global economy

Before turning to the outlook for Asia, it is useful to review the main risks facing the global economy, all the more so given heightened uncertainties and the important role of financial and trade links between the rest of the world and the region

The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated

One of the most important channels through which the fiscal crisis has affected the European economy has been the loss of confidence, and a prerequisite to restore confidence is fiscal prudence, given the high public deficits experienced in many of these countries. Consolidation plans in Europe are being implemented according to schedules presented to the EC at the beginning of 2010. Fiscal consolidation in Europe needs to focus on the structural side, but a positive factor is that the planned adjustment is fast and tilted towards reducing expenditure, which will boost confidence and almost compensate the negative effect on growth from reduced public demand. Thus, as long as the determination on fiscal consolidation is maintained, the impact on European economic activity will be limited and transitory. On the other hand, other advanced economies, where fiscal impulses have been substantial and debt levels have increased at a pace similar to that in Europe, are relatively slow in coming to grips with reducing deficits and –at least– stabilizing debt levels. This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates is highly non-linear, and there is a risk –with uncertain timing– of a sudden increase in long-term rates and a displacement of private demand; exactly the opposite effect intended by the fiscal stimulus packages.

The main risk to the global outlook is still coming from financial markets. Stress tests have had positive –though asymmetric– impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable

Financial risks, which stemmed from sovereign debt concerns, formed a feedback loop that ended up increasing market risk and drying up liquidity, especially in Europe. Nonetheless the sharp increase in financial tensions in Europe in the second quarter is starting to abate (see Chart 1). The release of European stress tests results has had positive effects on lowering tensions, although there has been a clear differentiation across countries. In particular, it may act as a powerful driver for removing uncertainty surrounding the Spanish financial system, as the implementation of the exercise looks rigorous and the outcome seems credible and is very informative. Undoubtedly the risk to Europe and the global economy coming from financial markets is still the main source of concern.

Increasing divergence in monetary policy strategies. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America

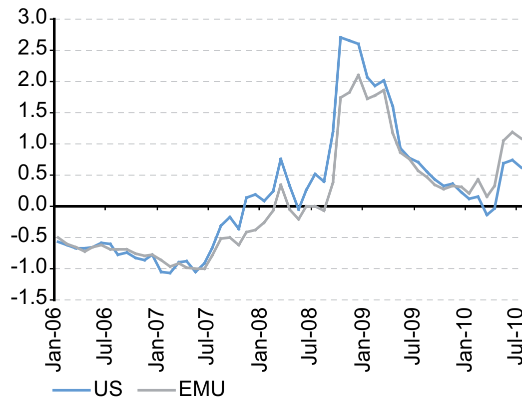
Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period. Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies. Nonetheless, a faster recovery in the US will mean that the monetary exit will be earlier there than in Europe, and both factors will weigh down on the euro. Although both central banks will postpone monetary tightening, communication and the assessment of risks continue to differentiate both institutions, limiting the ECB's relative capacity to react, in particular to deflationary risks. On the other hand, in emerging economies monetary tightening is resuming, after a pause as the European debt crisis unfolded. This will help reduce inflationary pressures in Asia – where they were starting to build – and prevent potential pressures from developing later in the year in South America. An important exception is Banco de México, likely to hold rates until the second quarter of 2011. Even when inflation edges up in the last months of this year, it will remain within Banxico's forecasted range and long-term inflation expectations are still well anchored.

The global economy is on track for a mild and differentiated slowdown. In China and elsewhere in Asia, a moderating growth trend should reduce the risks of overheating. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis

Spillovers from the European financial crisis to other geographical zones have been relatively limited. Nonetheless, the global economy will slow down going forward (see Chart 2). The severity of financial tensions in Europe will affect confidence and reduce growth in the second half of 2010 and the beginning of 2011. Moreover, external demand will not be as strong as it was in the first half of the year, although it will provide some support for economic activity. In the US, the recovery is likely to lose momentum on account of softening labor and housing markets. This shows the limits of private demand taking over as

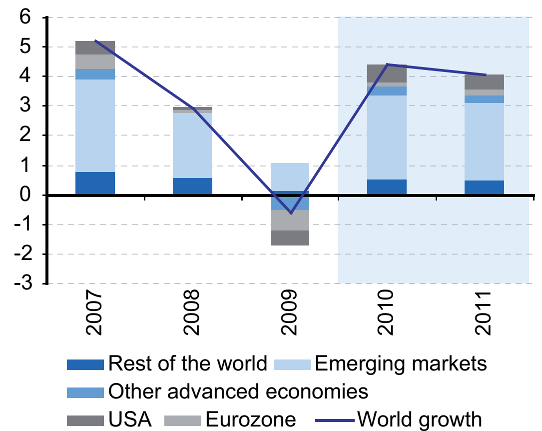
an autonomous driver of growth. In China, slowing GDP growth in the second quarter and moderating activity indicators are evidence that the authorities' tightening measures are being effective to steer the economy toward a soft landing in the second half of the year. Latin America will also slow down in 2011, but keep robust growth rates going forward. Therefore divergences will continue to widen both between advanced and emerging economies and within each of those groups.

Chart 1
Financial Stress Index for US and EMU*



* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets
Source: BBVA Research

Chart 2
Contributions to Global GDP growth



Source: BBVA Research based on national accounts and IMF

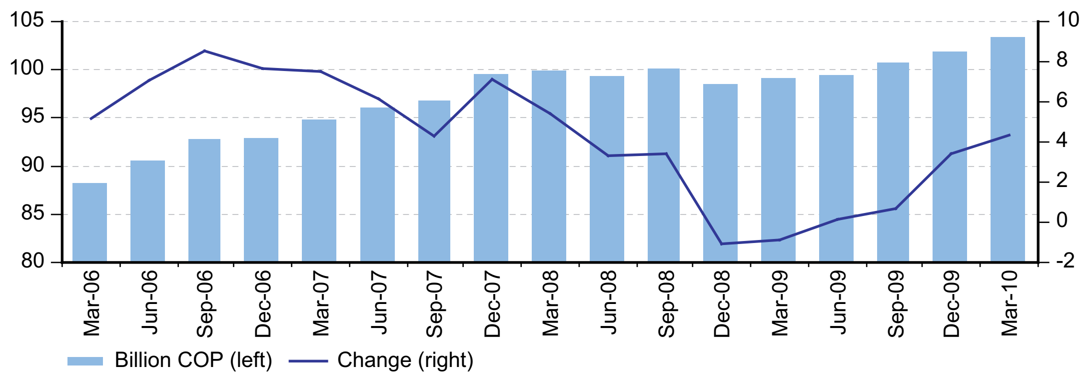
Although there were some steps in the right direction, going forward the necessary global rebalancing of demand and the narrowing of global imbalances is still pending.

The medium-term rebalancing of the Chinese economy towards more internal demand (particularly consumption) has begun, and the recent renewal of currency flexibility should help. Further reforms are needed to help boost consumption. Other advanced surplus countries also need to implement reforms to increase domestic demand, most notably in the service sector. On the other hand, the US and other countries with substantial external financing need to switch from a consumption-led growth model to investment, especially in tradable sectors. The recent financial crisis has shown the limits to foreign financing of growth. Economies with high external financing needs are highly vulnerable to an upsurge of international financial tensions, and the resulting sudden movements in exchange rates risk undermining global financial stability.

2. Colombian economic prospects set to improve due to strong internal demand

In spite of a worsening of risk aversion in the second quarter of the year, the Colombian economy maintained its dynamism in the first months of the year, when GDP growth exceeded the expectations of BBVA and market consensus. The aforementioned led to a revision of our growth forecast from 3.0% to 4.2% in 2010 and from 4.4% to 5.0% in 2011. This new scenario is based essentially in greater than expected internal demand growth, boosted by improvement in the levels of private investment and the sustained recovery of household consumption (see Chart 3).

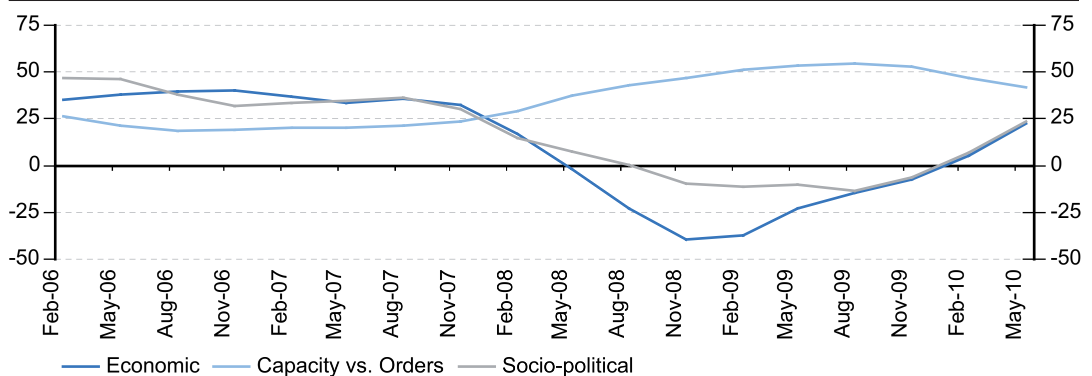
Chart 3
Gross Domestic Product Colombia



Source: DANE and BBVA Research

As regards investment, entrepreneur confidence can be highlighted, which over the last months has been boosted not only by the improvement in expectations regarding the future, but also by a more positive perception on the state of stocks and orders, as reflected in reduced idle capacity (see Chart 4). Therefore, the recovery of private investment would compensate the reduced contribution of civil works spending expected for the second trimester of the year. The recovery of private consumption, for its part, will continue to be boosted by the clear improvement in household confidence and the reduction of the financial burden on the latter resulting from low interest rates. However, the growth of consumption will be limited as a result of the minor adjustment seen in this area during the deceleration cycle on one hand, and labor uncertainty on the other, as unemployment is set to hover around 12%.

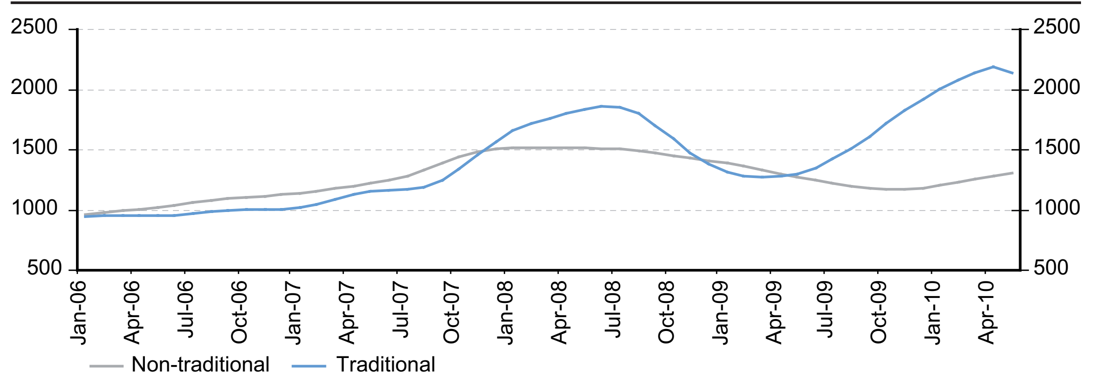
Chart 4
Main private investment indicators



Source: Fedesarrollo and BBVA Research

In keeping with our previous forecast, net external demand will have a negative impact on growth. However, this is more a consequence of increased imports than the negative growth of exports, given that so far this year the latter have decelerated at a slower rate than anticipated, thanks to the recovery of the country's main trading partners in addition to advances in the diversification of external trade markets, for instance toward countries of Central and South America (see Chart 5). On the other hand, the commercial restrictions imposed by Venezuela will continue this year. These restrictions have meant that sales to that country have fallen to their minimum levels since 2005. A shift in relations with this neighboring country, especially in light of the change of government on August 7th, could initiate a process of normalization in commercial relations that would bring with it a tendency for positive growth, although at moderate levels given the recession now endured by Venezuela.

Chart 5
Traditional and non-traditional exports



Source: DANE and BBVA Research

During 2010, the withdrawal of the fiscal stimulus will take place. This will translate into a reduction in the growth of public demand (government consumption and investment in civil works) from the 11.6% y-o-y observed in 2009 to close to 1% in 2010.The fiscal deficit expected[1] this year is 4.2% of GDP, slightly less than the government's objective and in keeping with the tax collection improvements, which should exceed the calculation of the public budget, which assume an economic growth rate of 3.0%. In addition, it is anticipated that the recently announced change with regard to government financing sources, which contemplates the issuance of internal and external debt so as to substitute reduced flows by privatizations, will have a moderate impact on internal liquidity given that the debt rollover ratio will be below 100% in the second half of the year.

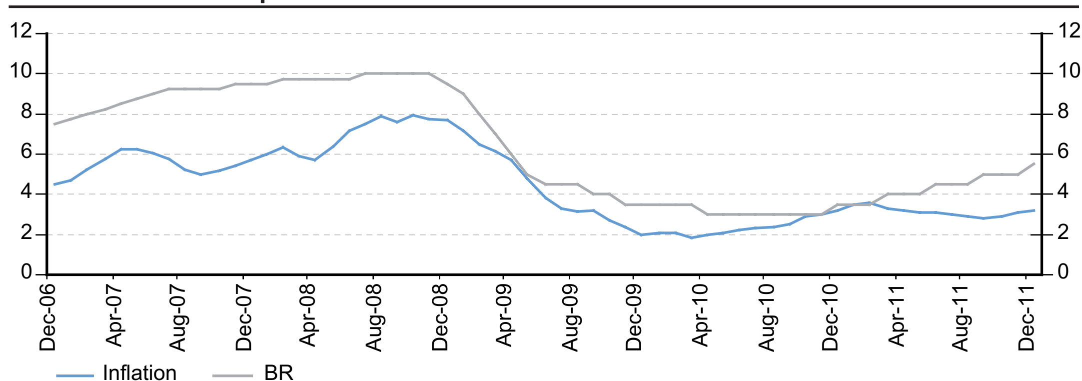
The improvement in domestic demand and the effect on imports will cause a slight deterioration in the current account deficit, which is forecast at 2.1% of GDP for 2010. The trade surplus will continue to be boosted by high exchange rates and the recovery of global demand even though the external economic environment points to a reduced rate of increase of these variables in the second part of the year. This high level of foreign currencies will be offset by greater outflows connected to outbound transfers by foreign companies operating in the country. Long-term flows will be the main source of funding for the financing of the external deficit, although they will remain concentrated in mining and hydrocarbon in light of the greater oil production foreseen for the coming years.

The acceleration of demand will not generate inflationary pressures above the target range established for 2010 by the Banco de la República, which coincides with the long-term objective (between 2.0 and 4.0 percent). In fact, during the first half of the year, inflation unexpectedly dropped due to the reduced supply factors connected to the "El Niño" phenomenon. In future, although the improved economic activity and the low basis for comparison with 2009 are factors that would play in favor of an increase in annual inflation, these will be compensated by the effects of currency appreciation and the lower prices of some agricultural and livestock products, while the output gap will continue to be negative throughout the year, which will translate into low demand pressures. In keeping with the aforementioned, we expect inflation to be 3.2% at the close of 2010, which constitutes a revision of our previous estimate of 3.4% y-o-y. Against this backdrop monetary policy will continue an expansive path during most of 2010. The Banco de la República will start a new cycle of increases of the policy rate toward the end of the year, in reaction to the economic cycle boost and in expectation of an acceleration of inflation in the first months of 2011.

Credit will continue to grow moderately, with greater activity in the mortgage market and, to a lesser extent, in the consumer market. This upturn will be motivated by the home buying assistance policy (in vigor from December 2011, or before if available quotas are reached), by the greater willingness to purchase durable goods on the part of households, and by the prospects of low interest rates. The recovery of the commercial portfolio will be slower due to increased financing of companies with corporate debt issues, boosted by attractive market conditions. In general the credit growth trend will be accompanied by improvements in the quality indicators.

1: With the methodological change in national accounts to the new 2005 basis, the fiscal deficit would be approximately 3.9% of GDP.

Chart 6
Inflation and BanRep intervention rate



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

In the second part of the year, the exchange rate will remain at levels below that seen in the first half of the year, given that in addition to the factors that had been fueling the currency appreciation over previous months, there are better growth prospects together and lower risk perceptions in the country, the latter even leading risk assessors to issue positive statements on the sovereign debt outlook. In addition, the Banco de la Republica decided not to renew its currency exchange program in vigor between the months of March and June, an announcement that contributed to the accentuation of the local currency's appreciation tendency. In future, the bank's exchange rate policy will be influenced by the evolution of the external situation, in particular, by the continuity of risk aversion associated with fiscal problems in Europe, as well as by the degree of cyclical deceleration of the U.S. economy, which recently generated a global depreciation of the dollar. Should the peso continue to increase in value, the bank would have to take new exchange rate intervention measures, taking into account that the real exchange rate is now at its minimum levels historically.

3. Spillover risks arising from the increase in risk premiums in Europe

Under a scenario in which financial risks associated with sovereign debt issues in Europe results in a new global slump, the Colombian economy would confront a reduction in its own growth rate and a delay in the national accounts consolidation process.

On one hand, a deceleration in the advanced economies would imply a decrease in external demand and a greater negative impact of the latter on growth, at the same time as greater global uncertainty would translate into a relapse into wariness on the part of consumers that would affect household spending. In a context of falling commodity prices, benefits associated to the important increase in oil production and the moderate decrease of foreign direct investment in the mining and hydrocarbon sectors would be reduced, even though these flows proved particularly resistant during the global slump of 2008-2009. For their parts, lower exchange rates would generate pressure on public accounts, keeping in mind that although mining only represents 6% of the total national product, this activity generates important tax revenues, contributing a third of corporate income tax and sales tax, in addition to dividends paid by Ecopetrol and considerable royalties from the territorial entities. This situation would impair the reduction in the fiscal deficit counted on for this year and delay the public finances consolidation process, especially given the objective of achieving fiscal balance in 2014, as the government elect has been proposing and according to the stipulations of the fiscal rule project.

Furthermore, although the vulnerability of external accounts would be limited because the current account deficit has diminished compared to the levels of previous years and its financing is mainly based in long-term flows, the country would not be spared from the effects of a possible shock resulting from greater access cost to external financing. The adjustment required would be helped by the flexibility of the exchange rate and would not cause excessive concerns as long as the country has sufficient international reserves and counts with its flexible a IMF credit line of USD 3.5 billion up to May 2011, which could be used should the capital markets close.

4. Challenges: appreciation of the peso and fiscal rule

The pressures resulting from the appreciation of the Colombian peso will continue over the coming months. Although the Banco de la República was able, with its exchange rate intervention, to moderate the appreciation of the Colombian peso without generating a large liquidity increase, monetary-exchange rate intervention is more complex in the second part of the year. Indeed, because the exchange rate intervention is repeated, the monetary authority will have to resort to sterilizing operations in light of the high internal public debt payments remaining this year and their expansive impact on liquidity, in a context of inflation increase expectations. This problem would be significantly accentuated should an improvement occur of the qualification prospects of the sovereign debt, which would bring more capital flows into the country.

The government faces the challenge of upholding the credibility of the fiscal policy. This is even more important in the present context given that, in a greater risk aversion climate, regional differentiation could leave Colombia exposed given its high fiscal deficit compared to other Latin American countries, forcing an adjustment earlier than planned. In addition, in case of a global deceleration, Colombia would have little margin to implement an anti-cyclical fiscal policy, given that incentives to activity would have to be the remit of monetary policy, extending the use of low interest rates for a longer period than expected.

The government has announced that in light of the growth expectations and high probability of a mining-energy boom over the coming years, excess funds from greater income shall be used to reduce public debt and, subsequently, for the creation of a stabilization fund. With this objective, a fiscal rule is being designed that will be presented before Congress by the next government, in addition to a reform of the royalties system. The fiscal rule is created with two main objectives: i) to reduce the risk of adopting pro-cyclical fiscal strategies, by setting a primary deficit objective corrected for the economic cycle and ii) to determine foreseeable policy actions that stop undesirable fluctuations in public spending, taxes, and economic activity associated to price shocks or quantities of produced brent. Without doubt, these initiatives will tend to strengthen the general framework of macroeconomic policy in Colombia over the coming years, helping exchange rate flexibility and a greater coordination between monetary and fiscal policy. Still, BBVA Research does not rule out that in a less favorable global outlook or facing the situation of lower oil production than expected, it will be necessary to implement further structural reforms, aimed at increasing tax collection and making public spending more flexible, so as to continue on the path of public debt reduction to levels comparable to investment grade countries.

5. Tables

Table 1

Macroeconomic Forecasts: Annual

	2009	2010	2011
GDP (% y/y)	0.8	4.2	5.0
Inflation (% y/y, average)	3.8	2.5	3.1
Exchange Rate (vs. USD, average)	2157	1942	1887
Interest Rate (%, average)	4.75	3.25	4.75
Private Consumption (% y/y)	1.1	4.0	5.0
Government Consumption (% y/y)	2.6	3.0	1.3
Investment (% y/y)	3.2	7.9	7.7
Fiscal Balance (% GDP)	-3.8	-3.9	-3.3
Current Account (% GDP)	-2.0	-2.1	-1.8

Source: BBVA Research

Table 2

Macroeconomic Forecasts: Quarterly

	GDP (% y/y)	Inflation (% y/y, average)	Exchange Rate (vs. USD, average)	Interest Rate (%, average)
Q1 09	-0.9	6.1	2415	7.00
Q2 09	0.1	3.8	2233	4.50
Q3 09	0.7	3.2	2017	4.00
Q4 09	3.4	2.0	1965	3.50
Q1 10	4.4	1.8	1947	3.50
Q2 10	4.2	2.2	1950	3.00
Q3 10	4.0	2.5	1940	3.00
Q4 10	4.3	3.2	1930	3.50
Q1 11	4.3	3.3	1915	4.00
Q2 11	5.0	3.1	1900	4.50
Q3 11	5.2	2.8	1852	5.00
Q4 11	5.4	3.2	1880	5.50

Source: BBVA Research

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