

# Economic Outlook

## Colombia

Second Quarter 2011  
Economic Analysis

- **The global economy continues to grow rapidly**, driven by the emerging economies. Oil prices will remain high in 2011, although their effect on global growth will be limited.
- **The economic performance in 2010 and leading indicators allow us to maintain our growth forecasts** of 5.0% for 2011 and 5.5% for 2012.
- **The Central Bank will maintain its policy of gradual increases in the benchmark rate in 2011 and 2012** to control inflationary expectations in a context of strong activity.
- **The risk that consumption may not slow down as quickly as we anticipate** could lead to an additional toughening of monetary policy to check inflationary pressures.
- **Greater political risk in the Middle East** would push up oil prices and boost growth in Colombia in the short term; but increased inflationary pressure would require a stronger macroeconomic adjustment, with a greater impact on the exchange rate.

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## 1. Global outlook: recovery, global shocks and vulnerabilities

### **The global economy will continue growing strongly, but risks are tilted to the downside**

The global economy continues to grow at a robust pace, and is still expected to expand by 4.4% both in 2011 and 2012, supported primarily by emerging economies (Chart 1). However, the threat coming from high commodity prices (especially oil) increases the uncertainty and introduces a risk to growth and inflation in most regions, even to some of those that might benefit directly from high commodity export prices. At the same time, local risks identified in the previous issue of the Global Economic Outlook continue more or less unchanged. In particular, financial stress in Europe is likely to continue, especially for Greece, Portugal and Ireland. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even as we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although going forward they will be more of a concern in South America, given tailwinds from commodity prices.

### **While high commodity prices pose risks they are unlikely to dent growth**

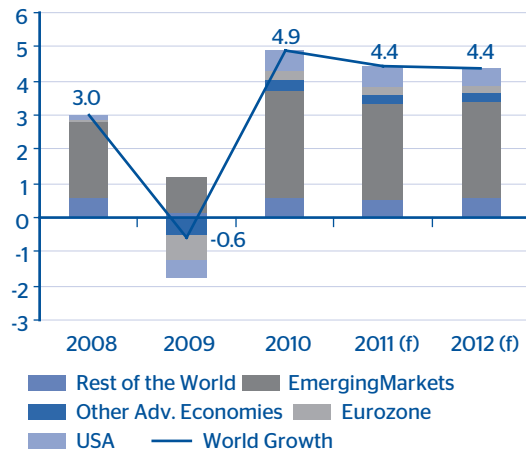
The greatest global risk stems from the rise in oil prices since the beginning of the year, caused mainly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, in our view, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will gradually be reduced, given ample OPEC spare capacity and OECD inventories, both above historical means. Nonetheless, oil prices may remain high at around US\$110-120 per barrel during most of 2011, before receding gradually to around US\$100 in 2012.

Given a rise in the price of other commodities such as food and metals as well, the main negatively affected regions will be the major developed countries and most of emerging Asia, the main importers of raw materials. On the other hand, the main beneficiaries of improved terms of trade would be the Middle East and Latin America, which will recycle part of this windfall revenue. However, a shock of this magnitude will be absorbed by the global economy without significantly affecting economic activity. This, together with relatively strong data in the first quarter of 2011, justifies relatively unchanged growth forecasts in most areas, as compared to our February Global Economic Outlook. The main exceptions are Mexico and South America, where strong data in the first quarter of 2011 and better terms of trade warrant a moderate upward revision of our growth forecasts for 2011. Core countries in Europe, as opposed to those in the periphery, will continue to grow, while risks to the U.S. forecasts shift from being biased upwards three months ago to be more balanced now because of higher oil prices.

### **High oil prices will push up headline inflation, necessitating earlier central bank interest rate increases in most regions**

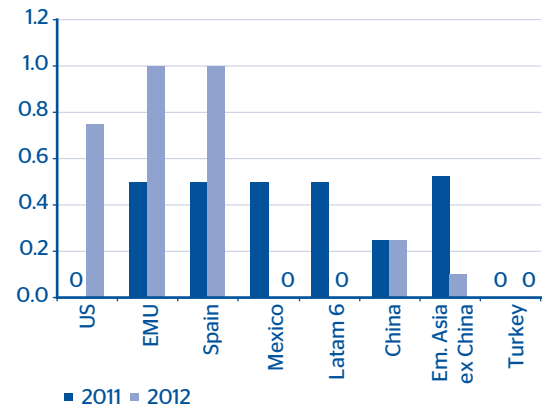
The main effect of the oil shock will be felt on prices. Higher inflation in most economies in 2011-12 will prompt monetary authorities to bring forward, and in some cases push for more aggressive, paths of interest rate increases (Chart 2). Nevertheless, there is still a wide heterogeneity in central bank approaches to the risks stemming from high oil and other commodity prices. In particular, in the US and euro zone, central banks are shifting—to varying degrees—their focus from supporting growth or preventing a tail risk scenario of very low growth and deflation, toward keeping inflation expectations well-anchored, particularly considering that the monetary policy stances are very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of early hikes. The timing of the first hike depends on the perceived need to react to potential risks of second-round effects. The ECB's hawkish approach is to avoid any risk by being pre-emptive (and thus its first hike in April). On the other hand, the Fed, focusing more on the lack of sustainability in the recovery, prefers to wait and act only if risks materialize. Between these two approaches, emerging economies seem open to more front-loaded hikes if needed, but with an eye also on avoiding excessive capital inflows and exchange rate appreciation.

Chart 1  
Global GDP growth and contributions



Source: : BBVA Research and IMF

Chart 2  
Changes in year-end expected official interest rates relative to February 2011



Source: BBVA Research

### Financial tensions in the periphery of Europe will remain high

As long as doubts persist about the solvency of countries in difficulty, namely Greece, Ireland, and Portugal, and risk of debt restructurings linger, headwinds to private sector funding to these economies and high sovereign spreads and could spread to other countries. Thus, a comprehensive and carefully designed approach to debt resolution—one that does not risk contagion to the rest of Europe—is urgently needed.

### In the US, fiscal consolidation will likely be achieved

In the U.S., the political process to reach a sustainable path for public debt involves difficult negotiations between two opposing approaches to deficit reduction. In the end, fiscal consolidation will have to come either from a reduction of entitlements or from higher tax revenues. In our opinion, both parties will reach an agreement that translates into lower deficits and a sustainable debt path, but the political process will be protracted.

### Overheating concerns continue in emerging economies

Emerging economies continue to show risks of overheating, but with marked heterogeneity. Some countries are beginning to confront these risks through more restrictive monetary policy, for example, in the important cases of China and Brazil. We think overheating risks are manageable but, going forward, they may become more pronounced in South America, to the extent that commodity price increases are a tailwind, but act as a headwind for emerging Asia. In addition, doubts about the extent of the slowdown in Japan could weigh on economic activity in most of Asia, given extensive trade links and integrated production chains. Furthermore, current account surpluses in much of Asia provide a buffer for the region, as compared to South America.

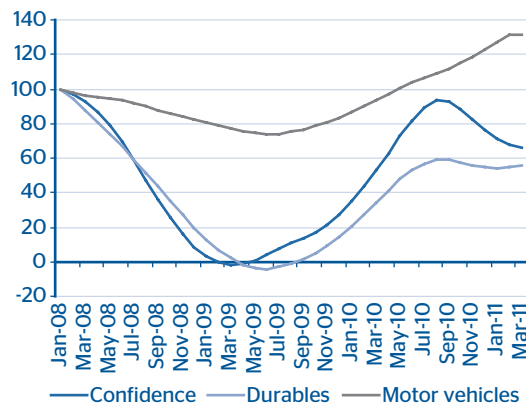
## 2. Economic activity remains strong driven by domestic demand

So far in 2011, economic growth has been driven by domestic demand, as was the case in 2010. In particular, household consumption has been boosted by the strength of durable goods and the major increase in car sales, which increased by 58% year-on-year in the first quarter. At the same time there are signs of improvement in the components with the greatest weight in the consumer basket, such as services and tourism. In addition, consumers' willingness to spend continues at high levels, given the improved labor market conditions, with a moderate upturn in salaried employment and a steady reduction in the unemployment rate, as well as the effect of low interest rates on the household financial burden.

**Leading indicators of investment suggest the economy will perform well in 2011**

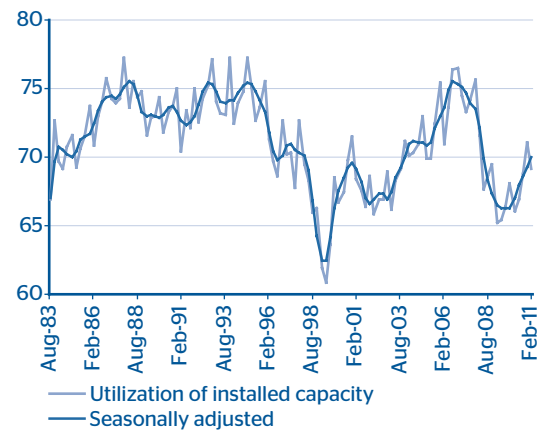
At the same time, sustained increases in installed capacity utilization since the end of 2009 to levels close to the historical average has been reflected in spending on capital goods, which continues at historically high levels according to recent data on capital goods imports and commercial lending (up in February at year-on-year rates of 32.4% and 22.2% respectively). Finally, the construction sector improved its pace of recovery in the second half of 2010, based on a major increase in the construction of social housing and the renewed strength of higher-value housing.

Chart 3  
**Indicators of consumption: confidence, purchase of durable goods and car sales (seasonally adjusted series)**



Source: Fedesarrollo, Econometría Ltda and BBVA Research

Chart 4  
**Installed capacity utilization**



Source: Fedesarrollo and BBVA Research

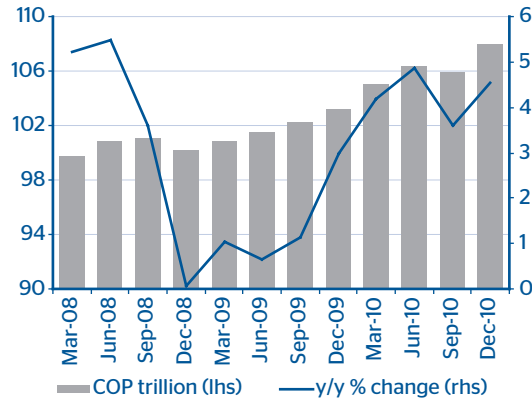
**Industrial output continues strong, but there is still room for growth**

Industry data for the first part of 2011 also confirm the positive trend in the economy. Industrial output in February was up by around 4.0% y/y (seasonally adjusted), boosted by higher manufacturing exports to new destinations in Central America, Brazil, Chile and Peru, consistent with sustained improvement in business confidence. Retail sales were also up 13.0% y/y (seasonally adjusted), thus confirming consumer and retailer expectations, which remain at the highs of the start of 2011. In addition, tax revenues were up 11.2% y/y in 1Q11, mainly due to higher receipts from customs duties.

**Colombia set to grow at around 5% in 2011 and 5.5% in 2012**

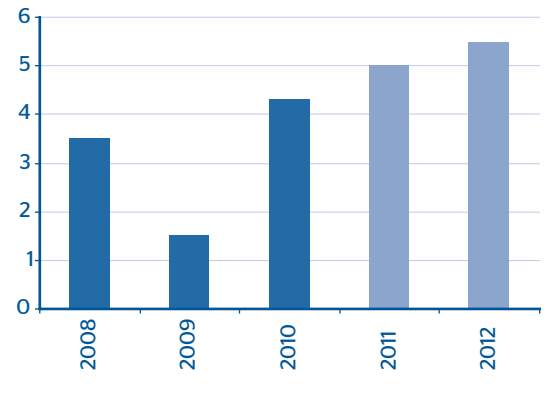
In line with these indicators for 2011 and the end of 2010, BBVA Research is maintaining its growth outlook for 2011 at 5.0% and 2012 at 5.5%. Investment in construction, including both private and public, will be key to achieve this result. The latter will be driven by investment in hydrocarbons and mining, the reconstruction plan for infrastructure affected by the strong rainy season, and the expected increase in spending by regional and local governments in the last year of their terms in office. Furthermore, foreign direct investment is expected to continue to fuel investment in hydrocarbons and mining. At the same time, recovery in industrial exports will pick up through greater penetration of Latin American markets and a steady increase in global demand.

Chart 5  
Gross Domestic Product



Source: DANE and BBVA Research

Chart 6  
GDP growth (y/y %)



Source: DANE and BBVA Research

We are therefore optimistic about an improvement in industrial performance over the coming months, and that the positive leading indicators of investment and energy consumption will be reflected in the figures to be released in the sector. Industry represents 13% of GDP and has not yet recovered the strength it showed a few years earlier, with the resulting effect on employment and other sectors.

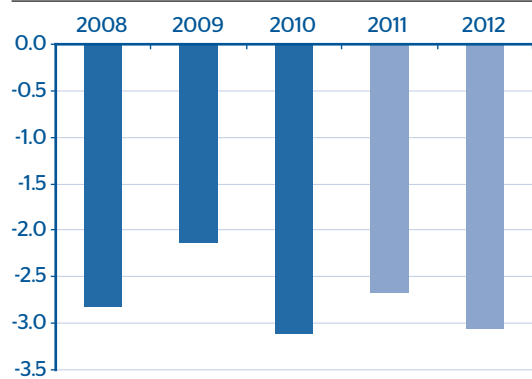
A recovery in industrial strength and thus investment related to this sector will further improve Colombia's economic performance in 2012. Consumption of durable goods and services will also have a positive effect in this respect.

### An external deficit easily financed by foreign investment

The high international prices expected for commodities exported by Colombia, in particular oil, will maintain a trade surplus over the coming years, despite the greater demand for imports resulting from the strength of domestic demand. However, a slight increase in the current-account deficit is expected in the medium term as some oil producers outside Ecopetrol gain export shares in the country and increase the amount of dividends sent abroad, while other foreign-capital companies in the real sector consolidate their business in Colombia. As a result, the current-account deficit will remain at levels close to 3% of GDP in 2011 and 2012.

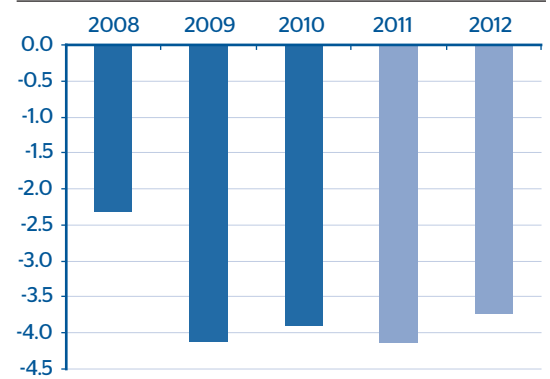
These levels of current-account deficit will be financed easily by expected inflows of foreign direct investment, which will maintain their levels for the remainder of 2011. In the medium term there will also be an increase in private foreign debt flows, as has been observed recently. We expect that Colombia will continue to receive foreign direct investment aimed primarily at the oil and mining sector, stimulated by high international prices and improved conditions for local exploration. Moreover, we are optimistic about increasing inflows of foreign investment into retail trade, tourism, and construction over the coming years.

Chart 7  
Current-account deficit (% GDP)



Source: Central Bank of Colombia and BBVA Research

Chart 8  
Central-government budget deficit (% of GDP)



Source: Ministry of Finance and BBVA Research

### **The disaster caused by the harsh weather conditions create challenges for the fiscal balance**

The disaster caused by severe winter weather conditions and their effect on the population and infrastructure will continue to create challenges for the fiscal balance this year and next. For 2011, the expected higher spending due to the weather effects at the end of 2010 will be offset by factors including increased revenues from changes in taxation on wealth and financial transactions and a stronger economy than initially expected by the government. Increased revenues have in fact already been reflected in the level of compliance with the March target (104.8%). But it is still early to estimate the additional spending expected due to the effects of the continued hard weather conditions in March and April 2011 and those expected for the rest of the second quarter. Thus we maintain our forecast for the central-government deficit at 4.1% of GDP for 2011.

This level of budget deficit is expected to ease over the coming years, and gradually adjust to the conditions of the fiscal rule that is currently being approved by the Colombian Congress. The improved deficit will arise from a consolidation of increased tax revenues and a reduction in some items of structural spending, as well as a possible reduction in pressure caused by the winter disaster. In the medium term, fiscal adjustment depends on the swift approval of major reforms related to the fiscal balance, the fiscal rule and the reform of the system of royalties. The announcement made by members of the government regarding reforms to the tax and pension systems also has to be reflected in specific proposals.

The favorable prospects for these adjustments and reforms combined with the country's recent economic performance has led Standard & Poor's to upgrade Colombia's sovereign debt to investment grade (BBB-). At least one more agency is expected to endorse this decision in the very near future.

### **3. The gradual withdrawal of the monetary stimulus will continue in 2011 and 2012 in a strong-peso scenario**

Despite the major upturn in inflation at the start of the year due to the effects of the severe weather, inflationary pressure has moderated in recent months. The CPI was up 1.79% between December and March, very close to the figure for the same period in 2010 (1.77%). This favorable inflation performance was the result of transitory corrections in food prices as weather conditions improved temporarily, as well as subdued demand pressures, which in turn allowed core inflation to remain relatively stable.

Despite this better than expected result, the inflation scenario for the rest of the year shows significant upward risks. Inflation during this period will be boosted by the effects of high international commodity prices, including food and fuels, which will be only partially offset by exchange-rate appreciation. At the same time, strong domestic demand will exercise greater pressure, particularly with the closure of the output gap expected in the second half of 2011. Furthermore, additional pressure on food prices cannot be ruled out due to the damage caused by the ongoing rainy season, which could last until June according to recent weather forecasts.

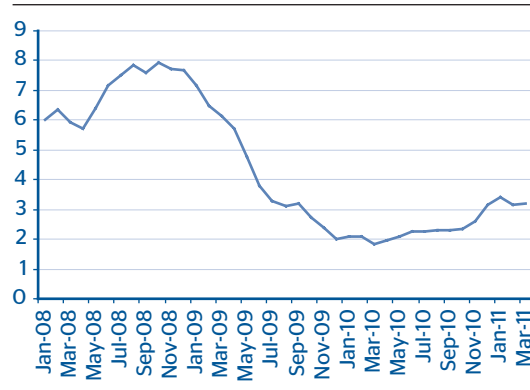
In this scenario, we consider that inflation will reach a level of 3.5% at the end of 2011. This forecast includes a slight upward revision of 0.1 pp on the previous forecast due to the lower CPI figure observed in the first quarter, which is offset by stronger expected increases in fuel prices. It is worth noting that inflation will be affected by the basis of comparison. The result will be a rise in the third quarter, given the favorable performance of prices in the same period last year, and moderation at the end of 2011, due to the sharp rise of food prices seen at the end of 2010.

### **The Central Bank will maintain the gradual withdrawal of its monetary stimulus to prevent sudden future increases**

In this context, we forecast that the gradual increases in the benchmark interest rate will continue over the coming months, in line with the tightening cycle started in February. This restrictive shift in monetary policy was a response to the rising pace of inflation (from 2.3% y/y in October 2010 to 3.4% y/y in January 2011), with the resulting deviation from the target of short and long-term inflationary expectations, and the prospect of the output gap closing in the second half of 2011.

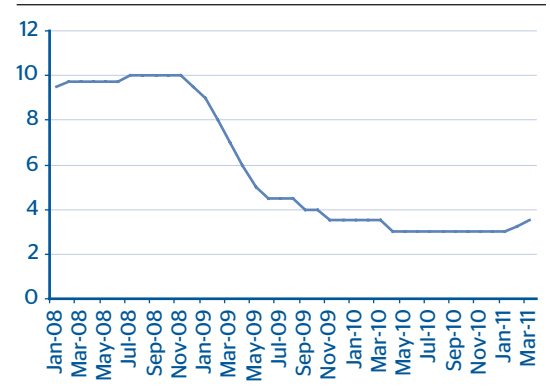
We consider that the process of continued increases in the benchmark rate will be necessary, as recent economic figures suggest a balance of risks biased towards greater growth in domestic demand rather than to a weakness in the sources of growth. At the same time, rising rates will maintain control over inflationary expectations and reduce the possibility of more severe adjustments in the future, should inflation deteriorate further. However, we consider that the benchmark rate will remain under its estimated equilibrium level in 2011 (around a nominal 6%) and thus continue to support economic growth in an environment that still presents vulnerabilities such as the low growth rate of non-traditional exports, the slow recovery of industry and continued weaknesses in the global scenario.

Chart 9  
Inflation rate (y/y, %)



Source: DANE and BBVA Research

Chart 10  
Intervention interest rate (AER, %)



Source: Central Bank of Colombia and BBVA Research

### Upward pressure on the peso will continue to grow due to high international liquidity levels and commodity prices

Similarly to other countries in the region, Colombia is currently facing the challenges posed by increased foreign capital inflows. These have been attracted by the higher interest rate differentials with developed countries, high levels of global liquidity and increased international commodity prices, leading to higher direct investment flows into producer countries. So far this year, the official data reveals that greater capital flows have focused on foreign direct investment and foreign debt. We consider that despite the government's commitment to avoid monetization of reserves in 2011, pressure on appreciation will remain throughout the year. This poses a challenge to the economic authorities, which must counter exchange-rate pressure to avoid strong effects on tradable sectors, while maintaining inflationary expectations in check to guarantee ordered economic growth.

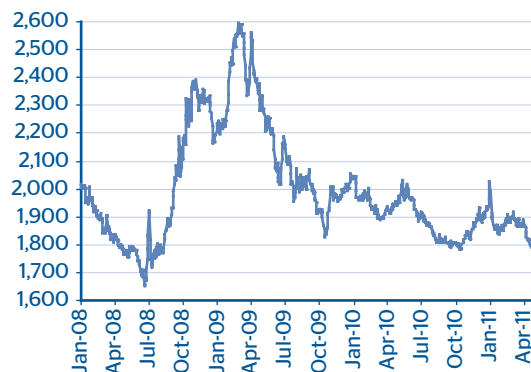
### A context of greater inflationary pressures and exchange-rate appreciation will be tackled by coordinated strategies between the government and the Central Bank

To counter exchange-rate pressure, the Central Bank of Colombia accumulated nearly USD 3 billion between mid-September 2010 and the end of April 2011; in fact, this is a moderate strategy compared with interventions in other economies. For most of this period, the currency successfully resisted the appreciation trend arising from local and external factors. This result was also influenced by reduced foreign-currency liquidity among foreign-exchange intermediaries. More recently, demand for domestic currency has increased, partly to cover tax payments due in the recent period, and foreign capital flows strengthened, leading to a renewed appreciation in the peso.

During this period the government has supported intervention by accumulating deposits in the Central Bank, which reached all-time highs in April (around COP 18 trillion) following the first payment of taxes by major contributors. However, these deposits will be reduced in mid-May to pay maturities on public debt (TES) during this period (around COP 10 trillion, including amortization and interest). This will involve an expansion of liquidity in the financial system and impose the need to consider alternative mechanisms for exchange-rate sterilization.

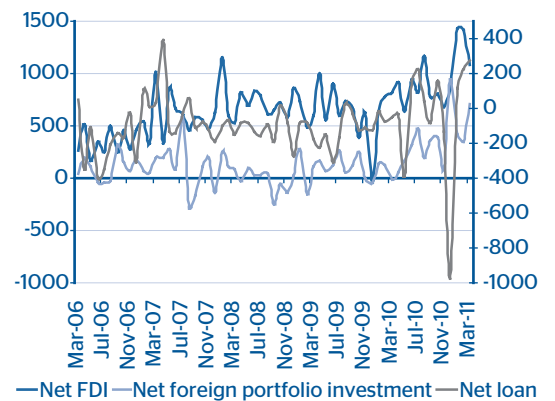


Chart 11  
COP/USD exchange rate



Source: Central Bank of Colombia and BBVA Research

Chart 12  
Exchange-rate balance: capital flows



Source: Central Bank of Colombia and BBVA Research

As a measure of macroeconomic coordination, the government announced at the end of April the accumulation of up to USD 1.2 billion in a fund abroad to pay external debt coming due in January 2012, as well as its decision to avoid the monetization of foreign assets for the rest of 2011. However, in a scenario of continued capital inflows and a stronger peso, it cannot be ruled out that the Central Bank may extend the program of reserve accumulation beyond the current planned date of June. Anticipating this possibility, the government has announced the creation of a new mechanism for monetary control consisting of securities issued by the Ministry of Finance that may be used by the Central Bank for liquidity operations. This prevents competition in the issuance of securities between the Central Bank and the Ministry of Finance. Over the coming weeks, an announcement is expected with the details of this mechanism, such as the maturities and yields of the securities in question.

Finally, it should be noted that if capital inflows speed up and there is a sustained appreciation of the peso below levels coherent with its fundamentals, we do not rule out the implementation of capital controls as a prudential measure to prevent possible imbalances in the financial system, such as the generation of asset-price bubbles and accelerated credit growth.

To sum up, our forecast considers a scenario with an increase in inflationary pressure in 2011 and a process of gradual adjustment in the intervention rate (to 4.5% in June and stable until the end of the year), which should anchor expectations and maintain inflation in line with the target. The increase in the intervention rate will take place in a scenario of greater capital inflows and a stronger peso (appreciation of 4% in 2011). These factors would be moderated by an extension of the reserve accumulation program, probably accompanied by sterilization measures in the second half of the year. Finally, we consider that the economic authorities will use possible restrictions on capital flows as a last resort and only under exceptional circumstances. This is coherent with the exchange-rate policy followed by the economic authorities over the last year.

#### 4. Balance of risks: stronger growth in the Colombian economy would increase inflationary pressure and lead to an early monetary adjustment

We consider that this need for an early increase in the benchmark rate by the Central Bank is a latent risk for the Colombian economy in the context of its improved performance due to local factors. In fact, we cannot rule out the probability of a continuation of the expansive cycle of consumption as observed since the end of 2010, combined with greater than expected improvement in investment in capital goods.

At the same time, there is a chance of increased public investment if the plan for the reconstruction of the damage caused by the harsh winter is executed at a higher rate than expected during the second half of 2011 and the first half of 2012.

This would increase demand pressure, close the output gap earlier and increase inflationary expectations. As a result, the Central Bank's increase in the benchmark rate would come earlier and be steeper, reaching the equilibrium rate by the end of 2011. In this scenario, the monetary policy reaction would be influenced by the behavior of consumer and retail credit, the levels of household and firms indebtedness and the pace of increase in housing prices.

### There is also a risk of escalated conflict in the Middle East, which would increase the oil price and reduce the strength of global recovery

At the international level, the global economy is watchful of the risk of greater political instability in the Middle East. The protests and conflicts in the region have remained relatively limited so far, but the contagion could increase over the coming months, drawing new countries into a similar situation. This would lead to renewed rises in the oil price to levels of USD 150/barrel over the rest of 2011 and in 2012. In our global analysis we give this risk scenario a very low probability, however its effects on financial and real variables at a global level cannot be ruled out.

These price increases would affect economic activity in developed and emerging countries that are not oil exporters, reduce aggregate demand and affect the pace recovery observed in 2010 and the start of 2011. The slowdown would occur in a scenario of rising domestic prices and put the monetary authorities in the dilemma of containing inflationary pressures in a scenario of weakening economic activity.

### In Colombia the effect would be the reverse, with an increase in growth and inflationary pressures

Latin America would not be unaffected by this situation and would experience a slowdown in its growth together with increased inflationary pressure. However, oil exporters such as Venezuela and Colombia would be benefited by a positive shock. In the case of Colombia, the gross domestic product could grow on average at above 6% in 2011-2012, despite the negative effect on non-traditional exports due to a slump in the performance of key trading partners. However, pressures on domestic inflation would rise, due to increased fuel prices and greater demand pressure. This would oblige the Central Bank to perform a less gradual withdrawal of the monetary stimulus and raise the intervention rate early to its natural level in 2011.

## 5. Tables

Table 1  
Annual macroeconomic forecasts

	2010	2011	2012
GDP (% yoy)	4.3	5.0	5.5
Inflation (% yoy, average)	2.3	3.5	3.7
Exchange rate (vs. USD, average)	1899	1819	1800
REPO interest rate (% average)	3.1	4.2	5.3
Private consumption (% yoy)	4.3	5.0	5.5
Public consumption (% yoy)	4.7	5.1	2.9
Investment (% yoy)	7.1	13.4	8.7
Fiscal deficit (% GDP)	-3.9	-4.1	-3.7
Current account (% GDP)	-3.1	-2.7	-3.1

Source: DANE, Ministry of Finance, Central Bank of Colombia and BBVA Research

Table 2  
 Quarterly macroeconomic forecasts

	<b>GDP (% y/y)</b>	<b>Inflation (% y/y, avg.)</b>	<b>Exchange rate (vs. USD, avg.)</b>	<b>REPO rate (%, EoP)</b>
Q1 10	4.2	2.0	1947	3.50
Q2 10	4.9	2.1	1950	3.00
Q3 10	3.6	2.3	1833	3.00
Q4 10	4.6	2.7	1866	3.00
Q1 11	4.8	3.3	1878	3.50
Q2 11	4.7	3.4	1787	4.25
Q3 11	5.7	3.6	1796	4.50
Q4 11	5.0	3.8	1815	4.50
Q1 12	4.8	3.6	1783	5.00
Q2 12	6.1	3.7	1790	5.25
Q3 12	4.9	3.7	1805	5.50
Q4 12	6.1	3.6	1822	5.50

Source: DANE, Central Bank of Colombia and BBVA Research

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