BBVA | RESEARCH

Economic Outlook

Colombia

First Quarter 2012
Economic Analysis

- **Slowdown of the world economy.** Emerging markets will continue to lead the way. Growth will recover in the second half of 2012.
- **A healthy incipient slowdown towards the end of 2011** enables the economy to start on a path of more sustainable growth with less pressure from inflation.
- **For Colombia we expect growth of 5% in 2012,** once more sustained by domestic demand and with a greater stimulus from public investment.
- **The cycle of interest-rate rises by the Central Bank is not complete.** We expect new rises in the second half of the year.

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Closing date: February 15, 2012

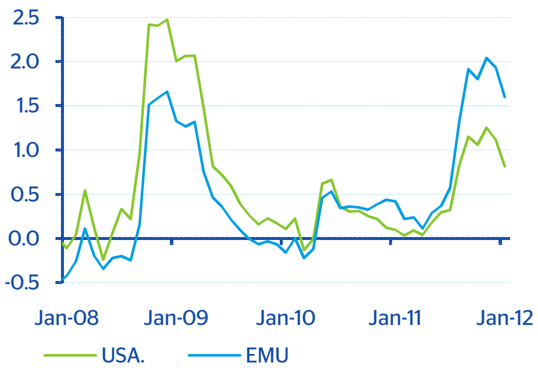
1. Global slowdown and a recession in Europe

The global economy slowed down at the end of 2011, but should rebound in the second half of 2012, led by emerging economies

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (already negative in Q4) and a deceleration in emerging economies, to around 1% quarter-on-quarter at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration differed. Europe has been feeling the effects of persistently high financial tensions since September (see Chart 1), owing to the lack of major advances to solve the sovereign and financial crisis. On the other hand, the slowdown in emerging economies, in addition to the headwinds from developed economies, is partly the result of previous policy tightening through the first half of 2011 to avoid overheating.

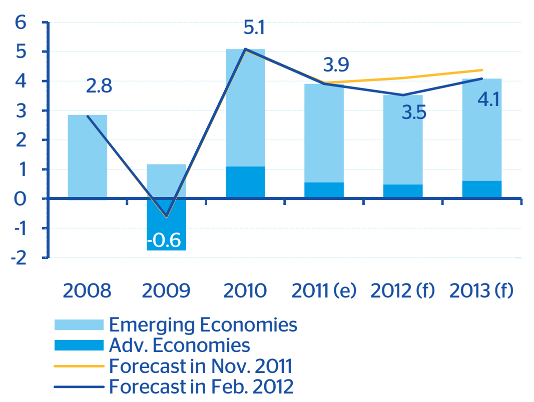
Going forward, decisive action expected by the European authorities should slowly reduce financial tensions and global risk aversion, facilitating a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their policies turn more growth-supportive. At the same time, even though the US will grow more slowly than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, relative to our previous Global Economic Outlook published in November, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 2).

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

The euro area is still the main risk to the global outlook

Even after the downward revision of growth rates in Europe and emerging economies, risks remain titled to the downside. These risks hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on three main lines. First, on the sovereign debt front, concerns about the solvency of Greece need to be addressed by completing the deal with private sector bondholders. At the same time, sizable and credible sovereign firewalls should be erected to prevent contagion to less liquid countries. Second, macroeconomic reforms should be pushed forward to raise growth prospects, including those aimed at repairing financial institutions' balance sheets, while taking care to avoid a sudden a reduction in credit to the private sector. Finally, further advances in euro area governance are needed to strengthen the monetary union, including a clear roadmap to a fiscal union.

In line to these three points, European economic prospects would be greatly improved if the agreed fiscal compact were approved at the national level and convincingly implemented after the March EU summit, together with reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth prospects.

Sustained financial tensions have pushed Europe into recession

Financial tensions in Europe continue at levels higher than after the fall of Lehman Brothers in 2008 (Chart 1). Given this, and together with the effect of fiscal adjustment in peripheral countries, we have revised down our growth projections for Europe, incorporating negative growth at least through the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. It is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress. The divergence in performance between the core and the periphery in Europe will continue to be wide, partly because of the large fiscal adjustment in the latter.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, the recovery is weaker than typical post-recession cycles, and is influenced by the risks from Europe as well as the domestic risk of policy uncertainty, including a possible fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts are implemented). In addition, weak housing conditions, tight credit markets and ongoing deleveraging will create headwinds to consumption spending.

Emerging economies are heading for a soft landing

In contrast to the aftermath of the fall of Lehman Brothers in 2008, confidence has remained resilient in emerging economies, including in Asia as described below. This has allowed domestic demand in emerging economies to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets through lower capital inflows, tighter trade finance, and reduced asset prices.

The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, somewhat below the historical 4 percentage points since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will turn more growth supportive, in contrast with the tightening experienced in the first part of 2011. This will sustain domestic demand in the face of external headwinds from weakness in demand from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be in emerging markets in Europe, due to their closer trade and financial links to the euro area.

2. Colombia on the path to more sustainable expansion

In 2011 the Colombian economy grew by around 5.5%, sustained by the strength of private demand and the upturn in public investment in the second half of the year. This performance was accompanied by a significant fall in the average rate of unemployment (1.0 percentage points) and an increase in the balance of outstanding credit of more than 20% in real terms at the close of the year.

Healthy slowdown in private demand in 2012

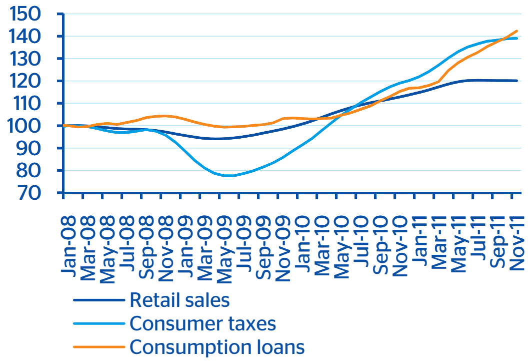
Leading indicators available for the last quarter of the year suggest there will be a healthy slowdown in private demand in 2012, more so in consumption than investment. This moderation in household consumption is the result of the end of the expansion cycle in durable goods, which lasted throughout 2010 and most of 2011, and the sluggish recovery in other consumer items (Chart 3). For example, car sales grew only by an annual 4.4%between November 2011 and January 2012, compared with a rate of 36% in the 10 months through October last year. At the same time, while the growth of imports of non-durable goods rose from 20% in 2010 to nearly 30% in 2011, purchases of durable goods slowed from a rise of 48% to 27% over the same period.

Private investment will maintain recent strength, while public investment will gain momentum to become the main source of growth in 2012

We do not expect much slowdown in investment, as it has room for growth, particularly in the manufacturing, construction and transport sectors. Utilization of installed capacity in the manufacturing sector, with rates of expansion of around an annual 5%, is above its historical average. The large number of construction permits granted, also guarantee a high rate of execution of private buildings in 2012, especially housing, with around 220,000 units. Finally, commercial aircraft fleet renewal plans will continue throughout the year, and there will be ample room for growth in land freight transport specialized in the mining sector.

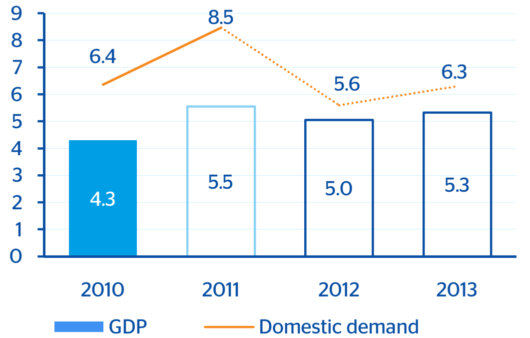
However, the main source of growth in 2012 will be investment in public works, judging by the government's infrastructure plans and the increased budget of companies in the hydrocarbon and mining sector. In fact, the government has budgeted COP 6.6 billion for infrastructure spending in 2012 (compared with COP 4.5 billion in 2011). At the same time, the regions will have an additional COP 1 billion from royalties for spending on infrastructure. On the corporate front, the domestic investment budget of Ecopetrol in 2012 is COP 8.0 billion, and foreign capital inflows of USD 5.7 billion are expected from mining companies with a presence in Colombia.

Chart 3
Consumption indicators



Seasonally adjusted series, Jan 08 = 100
Source: BBVA Research, DANE and Superfinanciera

Chart 4
GDP growth and domestic demand y/y % change



Source: BBVA Research, DANE and Fedesarrollo

We expect the economy will grow by 5% in 2012

Colombia's economy will grow by around an annual 5% in 2012, a slight decline on the rate of the previous year. Domestic demand will grow by an annual 5.6%, boosted by the positive performance of investment in construction, which will partly offset the slowdown in non-residential investment. Household consumption will grow in line with GDP thanks to a moderate recovery in spending on services, which represent over 50% of private consumption (Chart 4).

Exports will be less dynamic than in 2011, with growth falling from an annual 10% to 6% as a result of greater global turmoil and its effect on foreign demand. At the same time, imports will slow their rate of growth as a result of the fall in domestic demand for imported goods, given that the more dynamic components of demand (public works and buildings) do not make intensive use of imports. These expectations imply that the negative contribution from net foreign demand to growth will be lower than that in the previous two years, when the performance of domestic expenditure was far above GDP and generated a strong demand for foreign goods.

The current-account deficit could rise in 2012 as a result of lower oil prices and increased channelling of earnings abroad by foreign-owned companies that made profits in 2011. The financing of this account will be covered by long-term investment flows, which will continue to focus on the hydrocarbon and mining sectors.

Improved global growth headed by emerging economies will push output up by 5.3% in 2013

In 2013 improved conditions abroad will ensure that the Colombian economy continues to expand, with annual growth of 5.3% (Chart 4). We expect growth of close to 9% in exports, which will have a positive effect on the performance of manufacturing and transport, with demand up due to investment in capital goods. As is the case with domestic demand, in 2013 investment will have grown above the GDP rate for four successive years, as reflected in an investment rate of close to 31%. In contrast, household consumption will stabilize its share of total output, with rates of growth similar to GDP in 2012 and 2013.

The slowdown in private demand will dampen the lending growth

The banking sector will continue to show solid growth, although less strong than in 2011. The total loan portfolio in the system grew at a fast pace in 2011, taking advantage of low real interest rates and favorable domestic conditions. As a response to the slowdown in domestic demand and the withdrawal of the monetary stimulus by the Central Bank, total credit will grow less than in 2011, but still maintain its robust long-term growth trend.

Consumer loans showed the biggest growth in 2011, mainly due to the public's appetitive for the purchase of durable goods. However, with the slowdown in domestic demand in 2012, we expect a moderation in the purchase of durable goods and thus in the growth in the consumer portfolio. The slowdown in the number of construction permits granted (returning to long-term levels) suggests the figures for mortgage lending will moderate. This will be partially offset by a boost from the major construction projects in Public Housing (VIS) and high-value homes, for which a large number of permits have been issued. Although the commercial portfolio will be affected by the increase in the Central Bank's intervention rates, it will be boosted by the financing of infrastructure works and investment by the private sector to adapt its production structures to the demands made by the free trade agreement (FTA) with the U.S.

2012: a crucial year for reducing the country's structural deficit

The government will continue with its efforts to reduce the country's structural deficit. The new tax regime (the fiscal rule and legislation on fiscal sustainability), together with political consensus on the maintenance of stable public finances, will allow the government to continue with the gradual reduction in the fiscal deficit, which is expected to end 2012 at a rate of 2.8% of GDP. In this context, the government expects to increase its tax receipts by 7.9% on what was already a successful increase in 2011. Investment expenditure will continue at 2.8% of GDP, mainly due to the infrastructure works following the damage caused by the winter storms, the planned works by central government to adapt the main highways to the upcoming needs of the FTA with the United States, and the start of some of the major road infrastructure projects on the agenda.

At the local governments' level, in 2012 a new system of royalties will enter into force. It will test the capacity of a much larger number of municipalities and departments to use the funds they receive from the mining and oil sectors. In this situation, the public finances of the public sector as a whole will run up a deficit of close to 1.8%, with the trend being downward in 2013.

Major structural issues on the legislative agenda for 2012

The legislative agenda for 2012 is ambitious and its success will determine progress on the major issues in the medium term. In the area of the economy the Santos government will present a tax reform in the first half of 2012. The reform will propose measures to simplify the tax system and reduce tax evasion, with the idea of increasing revenues without necessarily affecting the average tax rates. In addition, a reform to the pension system will be presented in the second half of the year. It is expected to strengthen the solidarity pillar and modify some criteria for access to pensions, with the aim of standardizing benefits under the defined-benefit and defined-contribution sub-systems.

In the regulatory field lawmakers are expected to implement the tax rule approved in 2011. This will make clearer the impact of the new tax regulations on stabilizing public finances in the medium term. The government will also issue a series of decrees and regulations to adapt to the challenges of the free trade agreement with the United States and regulate the new law on royalties.

If the international crisis deepens Colombia will continue to grow, but less strongly

A deepening crisis abroad could have an impact on the Colombian economy through lower terms of trade and reduced foreign demand for manufactured products. This would be a setback for the recent progress made by the country in foreign trade and market diversification. In terms of the effect on domestic demand, BBVA Research's estimates point to a more moderate effect of global turmoil on domestic confidence, with the fall in GDP below the levels recorded in previous crises. In fact, in this scenario the economy would grow by 3.2% in 2012 and 4.0% in 2013. This positive situation for the economy is also based on the relative strength shown by Colombia in the 2008-2009 crisis, which established a new paradigm for the effects that external shocks have on private investment and consumption decisions. In particular, it is corroborated by the weaker current correlation between business and household expectations and global financial variables.

In this context of recession in developed countries we can expect a bigger average increase in the current-account deficit to that in 2009, with imports declining less. As a result, international reserves would be used to complement external sources of finance, which would still be high due to the long-term nature of foreign direct investment inflows into the country.

3. Local factors determine the course of action for monetary policy

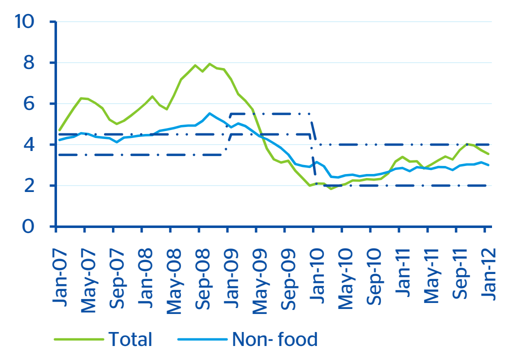
The rate of inflation for the close of 2011 (3.7%) revealed the factors that will continue to exercise pressure on inflation in the short and medium term (Chart 5). First, we calculate that the strength of domestic demand will have closed the output gap in the third quarter of 2011, as reflected in the upward trend of the various indicators of core inflation in the second half of the year. This pressure will continue to affect inflation in 2012, thanks to the expected extension of the output gap. At the same time, in a tighter labor market resulting from the sustained reduction in unemployment, wages costs are likely to increase notably, unlike in 2011 when wage growth remained in line with the inflation target.

As well as this, we expect that inflation will continue to be under pressure in the short-term from some supply factors. The delayed effects of the winter storms will continue to be felt in food prices at the start of the year. There will also be pressure from some items with regulated prices, such as gas and transport services, where prices gathered pace at the end of 2011. For the rest of the year we expect food prices to return to normal after the climate shock from the La Niña phenomenon. Cost pressures should moderate steadily due to the slowdown in international commodity prices, in particular foodstuffs and the effects of a stronger exchange rate expected for this year.

Inflation will remain high until the second quarter of 2012

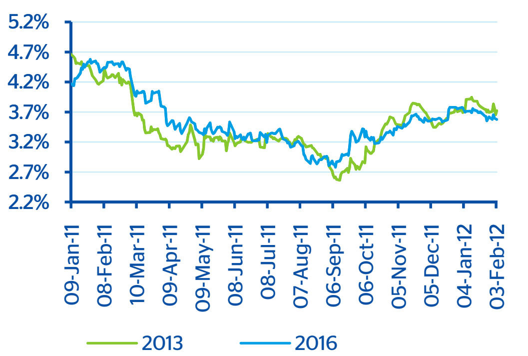
In this context, we estimate that inflation will remain high until the second quarter of 2012, but moderate in the second half of the year and end at 3.5%. The normalization underway in the economic indicators, together with the effects of the slowdown abroad, will maintain core inflation in line with the Central Bank's inflation target.

Chart 5
Headline and core inflation (y/y %)



Source: DANE and BBVA Research

Chart 6
Implied inflation expectations, TES bonds (%)



Source: Banco de la República and BBVA Research

In the short term, we consider that the biggest risk for this inflation forecast is a more adverse reaction of those components indexed to the minimum wage, and the deterioration in inflationary expectations. Although inflationary expectations are still under control, they began to increase in September, and currently the indicators for different time horizons are between 3.5% and 4.0%. In the medium term, the main risk would be that a more recessionary situation in Europe was passed on more to the markets and global trade. In this case, we estimate that the main effect on inflation would be through a significant reduction in commodity prices, given that domestic demand would show some resistance compared with the previous global shock (Chart 6).

The cycle of interest-rate rises by the Central Bank is not complete, and we expect new rises in the second half of the year

In line with expectations, and giving priority to the domestic situation, Banco de la República began the year by increasing its reference rate by 25 basis points to 5.0%. From now on, we estimate that the Central Bank will implement a pause in the cycle of adjustments, given the deterioration in the prospects for global growth and the risks associated with a deepening debt crisis in Europe. In the second half of the year, in line with the expected growth of output, we expect the Central Bank to increase the reference rate by an additional 50 basis points, to end the year at 5.5%.

Greater investment opportunities in the country maintain pressure on the exchange rate

After a strong depreciation in the fourth quarter of 2011, the Colombian peso swiftly recovered ground. The recent exchange rate pressure was in response to continuous FDI inflows to the country, and in general greater global appetite for risk assets, boosted by positive surprises in the indicators of economic activity in the United States and the message of a prolonged monetary pause by the Federal Reserve. We estimate that the exchange rate in 2012 will be an average of COP 1,797 to the USD, compared with COP 1,848 in 2011.

As in 2011, the recent renewal of the program of daily dollar purchases and action by the monetary and fiscal authorities point to a coordinated plan to reduce upward pressure on the peso. Meanwhile, the government will continue to focus on improving competitiveness in the productive sector through structural reforms already underway, and preventing distortions to public financing on the foreign-exchange markets, in line with the announcements made at the monetary policy meeting at the end of January dealing with the handling of the dollar account for 2012.

4. Tables

Table 1
Annual macroeconomic forecasts

	2010	2011	2012	2013
GDP (% y-o-y)	4.3	5.5	5.0	5.3
Inflation (y/y % EoP)	3.2	3.7	3.5	3.6
Exchange rate (vs. USD, EoP)	1926	1934	1820	1800
REPO rate (%, EoP)	3.00	4.75	5.50	6.00
Private consumption (% yoy)	5.0	6.6	5.0	5.4
Public consumption (% yoy)	4.6	2.3	3.0	3.5
Investment (% yoy)	8.3	15.7	11.9	10.4
Fiscal deficit (% GDP)	-3.8	-2.9	-3.1	-2.8
Current Account (% GDP)	-3.1	-2.8	-3.2	-3.4

Source: DANE and BBVA Research

Table 2
Quarterly macroeconomic forecasts

	GDP (yoy %)	Inflation (yoy %, EoP)	Exchange Rate (vs. USD, EoP)	REPO rate (%, EoP)
1Q11	4.7	3.2	1884	3.5
2Q11	5.1	3.2	1783	4.3
3Q11	7.7	3.7	1836	4.5
4Q11	4.5	3.7	1934	4.8
1Q12	4.2	3.8	1820	5.0
2Q12	4.6	3.6	1720	5.0
3Q12	4.7	3.5	1720	5.5
4Q12	6.5	3.5	1820	5.5
1Q13	6.3	3.6	1790	5.8
2Q13	5.6	3.6	1700	6.0
3Q13	4.8	3.6	1730	6.0
4Q13	4.6	3.6	1800	6.0

Source: DANE and BBVA Research

DISCLAIMER

This report has been produced by Colombia Unit:

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