Economic Outlook

Colombia

Fourth Quarter 2012
Economic Analysis

- **Global growth will improve in 2013,** supported by the policy measures of the central banks and European authorities.
- **The Colombian economy will grow by 4.3% in 2012 and 4.4% in 2013.** The slowdown in private demand will be compensated by increased execution of public works.
- **The Central Bank will continue to watch the global situation and how this is passed on to the local economy.** The exchange rate will remain under pressure from foreign direct investment inflows and greater international liquidity.
- **Progress will continue in consolidating the fiscal balance,** while public investment will remain buoyant throughout 2012 and 2013.

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Closing date: November 20, 2012

1. Summary

Decisive intervention by central banks in developed countries has limited the possibility of a systemic risk scenario occurring. The ECB has dissipated fears about the future of the common currency and forged a path for continued progress toward a new institutional framework. The Federal Reserve's injection of liquidity has anticipated the potential impact of a major fiscal adjustment in the U.S. at the start of next year. To sum up, global uncertainty has receded. In this context, we expect the world economy to continue to recover steadily, with rates of growth of between 3% and 3.5% in 2012 and 2013.

In the first half of 2012 the Colombian economy grew at an annual 4.8%, with a significant boost from public works starting in April.

The growth forecast for 2012 has been revised upward slightly from 4.1% to 4.3%, but we have maintained the forecast for 2013 unchanged at 4.4%. These forecasts are based on strong rise in investment over the two years, which more than doubled GDP growth, and an increase in private consumption in line with GDP levels, in part offset by the high negative contribution of net trade.

The balance of leading indicators anticipates a bigger slowdown in the private and external components for the rest of this year and in 2013. Concern about unemployment among households has increased. As a result are less likely to spend, thus contributing still further to the weakening investment in manufacturing industry. Exports will be affected by the lower international price of coal, some domestic supply shocks in the mining/energy sector and falling trade in industrial goods with developed countries.

The growth forecasts for 2012 and 2013 depend critically on the level of execution of government investment in public works. According to our forecasts, public works will increase by 9.7% on average over 2012-2013, providing a boost to other related sectors and to unskilled labor. These figures are based on two factors: the better expected performance by regional and local governments (those lagging behind most in terms of spending in the first half of 2012), thanks to bigger royalty transfers; and on the recently approved investment budget for 2013.

The slowdown in figures for domestic growth, together with the monetary room for maneuver provided by the maintenance of inflation and credit growth indicators under control, have led the Central Bank to implement a slight monetary easing in the third quarter of the year. **In the future the recovery of domestic growth and more positive policy measures by the economic authorities at the international level suggest there will be a global recovery that will not require an additional boost from monetary policy. We therefore expect stable interest rates for the rest of the year and until the third quarter of 2013.**

The Central Bank will face an exchange-rate policy dilemma in the second part of 2013, with greater international liquidity and a recovery in domestic demand. In this scenario, the Central Bank could extend its exchange-rate intervention, although it will be limited by not having sufficient monetary sterilization instruments to prevent inflationary pressures.

The probability of an adverse event in developed countries is now less likely. However, if were a deep global recession, the country would have the instruments to limit the local effects of the slowdown. The automatic public expenditure stabilizers and the government's contingent credit facility with the IMF would provide fiscal support to the economy, while the current monetary policy pause would permit an effective reduction of the Central Bank's intervention rate. The current account deficit would continue to be supported by foreign direct investment inflows, and cushioned by exchange-rate flexibility and the possibility of a future disaccumulation of international reserves.

2. Central bank actions reduce tail risks

Bold actions by central banks have reduced uncertainties in the global economic outlook, but challenges remain

The world economy is expected to continue its soft recovery, with GDP growth of 3.5% in 2013, up from 3.2% in 2012. The outlook is supported by lower risk aversion after influential decisions taken by central banks, especially the ECB. However, three factors stand out that could undermine the outlook: first is the risk of a re-emergence of euro break-up fears; second is the threat of the so-called US fiscal cliff (a spending-cut and tax-hike package worth 4% of GDP) due to take effect at the beginning of 2013 that would push the US economy back into recession; and third, is the risk of a slowdown in the emerging economies, especially in China..

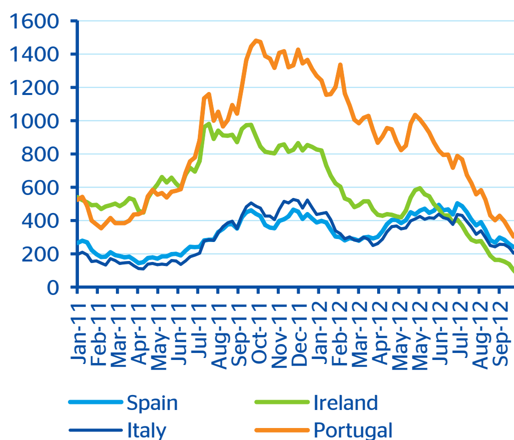
Central banks to the rescue; other policy makers should follow

Against a backdrop of uncertainty and threats to the world economy, policy makers – in particular central banks in the eurozone and the US – have taken steps to avert a systemic event that could have been comparable in scale to the financial crisis of late 2008..

"... whatever it takes..."

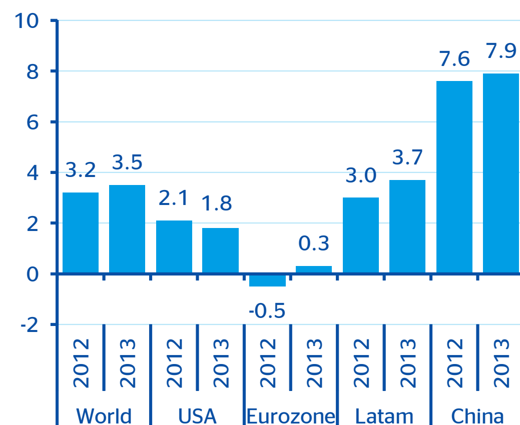
In our view, European Central Bank (ECB) President Mario Draghi's announcement of a new bond-purchase program (Outright Monetary Transactions, or OMT) in late July was a decisive step toward ending the debt crisis in Europe. Under certain conditions, the ECB could intervene in secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached agreement on a broad roadmap towards a single banking supervisor, far-reaching plans on fiscal issues, and growth-supporting measures. The ECB has committed itself to buy unlimited quantities of sovereign bonds of those countries that seek financial aid from Europe's funds (European Financial Stability Fund & European Stability Mechanism) with "strict and effective conditionality." Tensions in financial markets have eased significantly since June (see Chart 1).

Chart 1
Financial Stress Index for eurozone countries[1]



Source: BBVA Research

Chart 2
GDP growth rate (%)



Source: Bloomberg and BBVA Research

1: The Financial Stress Index (FSI) is a synthetic indicator of: risk measures (5-year CDS, CDS of non-financial corporations and financial debt), volatility (stocks, interest rates and exchange rates) and liquidity stress (3-month spread between interbank and risk-free asset).

Other elements have recently reinforced the currency union in Europe. First, the permanent fund that will deal with any new bailout in the eurozone (the ESM) has been put in place. Second, the process for achieving a banking union in Europe continues moving forward, albeit slowly.

We expect the eurozone to come up with a full package eventually that will reinforce its governance. As we have long argued, such a package should comprise a banking union, a fiscal union, and a lender of last resort facility. Progress has been made on all of these fronts which, though not ambitious enough yet to revert the current dynamic quickly, will alleviate pressures over time. In the short term, the ECB's program and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations that countries such as Italy and Spain could face. At the same time, effective implementation of the banking-union plans and further definition of the fiscal-union design will be key to the long-term sustainability of the eurozone.

"… as long as needed…"

With the US economy growing slowly, unemployment remaining persistently high, and amid huge uncertainty in Europe, a pre-electoral gridlock over how to bring the US deficit down was the last thing the US economy needed. Against this backdrop, the Fed did not hesitate to act. First, and in accordance with its "forward-guidance policy," the Fed announced that it intends to keep rates at their current low levels until at least mid-2015. Second, the Fed announced a new round of quantitative easing (QE) to support growth and employment recovery. This further monetary loosening will be different from previous rounds: the Fed will purchase mortgage-backed securities (MBS) rather than Treasuries, and it will continue with this policy for a considerable period of time, even after the recovery strengthens.

In our view, by embarking on QE3 and extending policy guidance, the Fed is buying insurance against the "fiscal cliff," but it is not a silver bullet. In our baseline scenario, an agreement will be reached to avoid the complete package of automatic spending cuts and tax hikes from taking place. Yet we also expect some form of fiscal consolidation that will act as a drag on growth. The Fed has done its part to give the economy the boost it needs to avoid slipping back into recession in 2013. As previous QE programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs

Central bank responses are not enough for a firm expansion

The world economy may have avoided decelerating to its slowest growth of the last 30 years (apart from the 2009 great recession) but a low growth environment continues. The advanced economies have been losing momentum since 2011. More recently the emerging economies have been hit too (see Chart 3). Brazil's economy almost stalled in the first half of the year; India's GDP grew by 5.3 and 5.5% y/y in the first and second quarter, respectively, the slowest pace since the beginning of 2009; and in the third quarter of the year the Chinese economy slowed to a rate of 7.4%, the lowest growth rate since 2009 although the more recent data points to a bottoming-out.

Under our baseline scenario, growth in the eurozone is likely to gain momentum in 2013. Although GDP will contract in 2012 (-0.5%), it should rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will still remain close to 8% in both years due to policy stimulus. Other emerging economies will make up for this slack: the outlook for growth in Latin America is revised slightly upwards in 2013, when the region will grow by 3.7%, up from a 3% growth rate in 2012.

All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions, in particular on whether European policy makers will deliver on their commitments. In the meantime, the

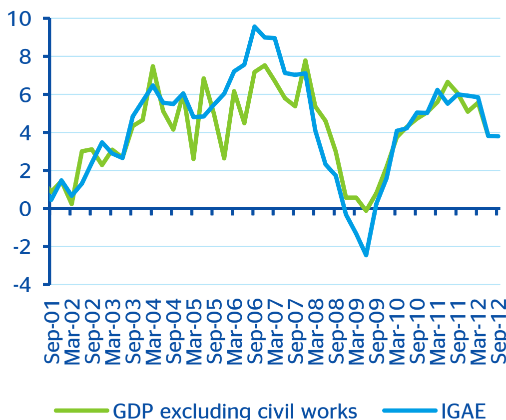
ESM/ECB's intervention should be enough to bring Spanish and Italian yields back to levels consistent with the mid-term sustainability of the public debt. This implies that both countries retain investment-grade ratings and deliver on their fiscal commitments (or are granted extensions to meet them, hopefully on structural balances). Finally, in this scenario, Greece should remain in the euro, which would, in turn, require further support from Europe in the form of additional funding and/or a longer period to fulfil fiscal conditionality. Based on past experience, many things can still go wrong, but policy makers have shown a tendency to find solutions when crunch time approaches.

3. The Colombian economy will grow by 4.3% in 2012 and 4.4% in 2013, with a bigger boost from public demand

We have revised our growth forecasts for 2012 to 4.3% and for 2013 to 4.4%

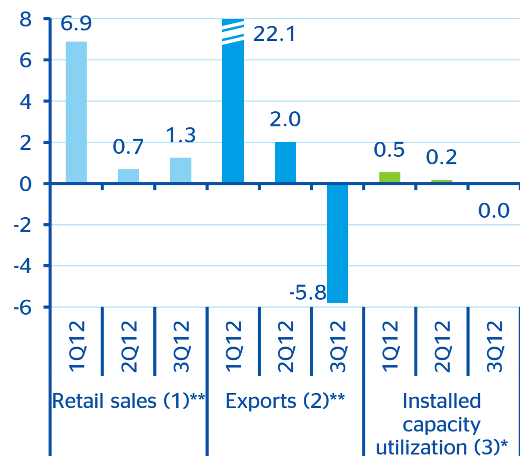
The balance of the leading indicators, according to our General Economic Activity Index (IGAE) anticipates a bigger slowdown of the private and external components for the rest of the year and in 2013 (Chart 3). In the case of private component, the confidence data reveal greater concern by households about losing their jobs, and as a result less likelihood to spend, as seen in the retail sales figures. At the same time, businesses have reduced their investment plans, as shown by the surveys of expectations and the low utilization of installed capacity, with the mining sector providing the only boost to non-residential investment (Chart 4). Even so, the mining sector is big enough to consolidate better than expected growth in expenditure on plant and equipment, in part due to greater foreign direct investment inflows during the rest of this year and 2013.

Chart 3
IGAE vs. GDP, not including public works. Main component and annual % change



Source: BBVA Research

Chart 4
Leading economic indicators. Annual change (1) and (2) and deviation from the mean (3)



*Deviation from the historical mean. A positive value means high installed capacity utilization. Other figures are for annual change.
**Data through August 2012, %
Source: DANE, Fedesarrollo and BBVA Research

Private building is another component of private demand with a faster pace of growth compared with earlier data. In fact, the completion of the high level of building stock begun last year will add around 0.7 percentage points to the 2012 GDP. This is related to the structure of measuring aggregate value in the sector, where the finishing and masonry stage has a bigger effect than the initial phases.

However, the outlook for this sector in 2013 is worse than expected, as the replacement rate of completed housing is below 1%. In this case, the key will be what happens to commercial buildings, which have picked up significantly, mainly offices and warehouses (Chart 5).

On the foreign front, the recovery of exports has been conditioned by domestic bottlenecks of oil and coal production and distribution. At the same time, growth in China at below the levels posted a few years ago is keeping coal prices low and WTI oil prices flat. These two factors led to a negative performance of fuel exports of an annual 10% between July and August.

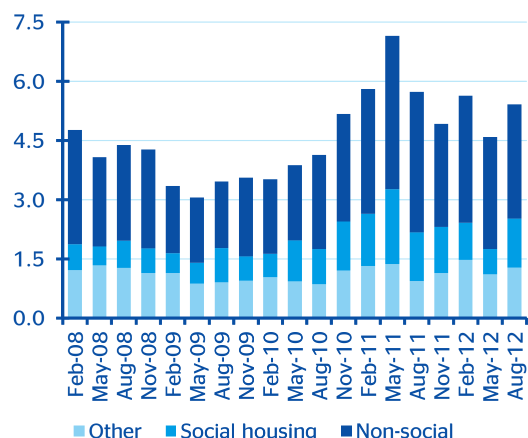
Industrial exports have recovered slowly, based solely on improved regional trade, with an annual rise of 5.1% in the first two months of the third quarter (compared with an annual 2.4% in the second quarter). However, their share of total exports is under 30%, so they will not offset the slowdown in mining and energy exports. As a result, exports will slow further toward the end of the year and at the start of 2013.

A level of growth equivalent to the economy's potential would only be possible if positive news came with respect to the execution of public investment expenditure. Expectations in this respect are optimistic, as the regional and local governments, which lagged behind in terms of expenditure in the first half of 2012, have begun to receive transfers from royalties for specific projects that will be executed over the coming quarters. At the same time, the general government's investment budget for this year and next will increase at a similar rate to nominal GDP between 2012 and 2013, at an average of 7.4%. This gives room for improving on the execution levels of 2011, which were low, and guarantees a significant increase in expenditure on infrastructure.

Given this backdrop we have revised our forecast for 2012 slightly up and maintain that for 2013 unchanged, although in both years we have made corrections in the composition of growth (Chart 6). The annual expected rate of 4.3% for 2012, which we have increased from 4.1%, is based on an increased rate of investment (both public and private) of an annual 10.5%, and an annual 4.1% growth in private consumption, equivalent to our forecast in the previous issue of Colombia Economic Outlook. However, this positive performance will be partly negated by a higher negative contribution from net trade, which is explained by the reduced growth of exports in an environment of increased imports of capital goods.

Chart 5

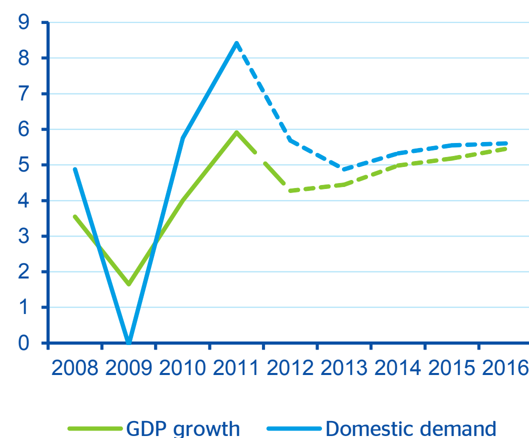
Building permits by purpose. Million m², cumulative quarterly total



Source: DANE and BBVA Research

Chart 6

GDP forecasts and domestic demand. Annual % change



Source: DANE and BBVA Research

Our outlook of 4.4% for 2013 is based on a recovery in consumption to an annual rate of 4.5% and a rise in exports from 2.5% in 2012 to 5.3% in 2013. In contrast, there will be downward pressure in private, housing and equipment goods investment, slowing growth in imports and thus leading to a less negative contribution from net trade.

In regional terms, Colombia will be one of the three economies with the biggest growth over the next two years, behind Peru and Chile (Chart 7). This will allow it to consolidate its status as one of the most popular destinations for foreign investment.

The construction and mining sectors lead the way in 2012 and 2013

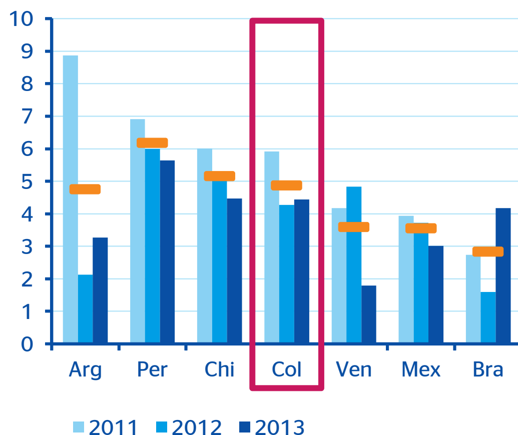
In 2012 the construction, mining and financial sectors headed up expansion. Construction was boosted by public works and residential building, while in mining precious metals such as gold and emeralds made a significant contribution. In contrast, sectors such as retail trade and energy will grow below GDP: in the case of retail, as a result of reduced household consumption, particularly in durable goods; and due to sluggish manufacturing industry in the case of energy.

Manufacturing industry will maintain weak growth for the rest of 2012 and in 2013

The manufacturing sector has grown sluggishly so far this year, at only an annual 0.7% between January and August (Chart 8). Advance data suggest improved performance in the future, but do not reflect a return to rates of growth of over 4% in 2012 and 2013. The results for the manufacturing sector are related directly to foreign trade and lower demand from developed countries.

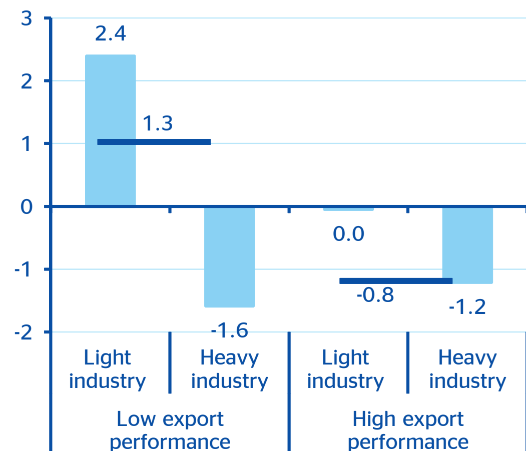
In fact, the index of industrial confidence is significantly lower in exporting companies, which also record the highest levels of inventories and smallest order books in the whole manufacturing sector. However, the fall in heavy industry is across the board, including both companies with a high export exposure and those with a predominantly domestic market. This is related to the slowdown in consumption of durable goods in Colombia (and other countries in the region) and the strong competition from imports of capital goods.

Chart 7
GDP growth in Latam countries. Annual % change



Source: BBVA Research

Chart 8
Performance of industrial branches. Annual % change



Source: DANE and BBVA Research

This difference between the branches focused on domestic trade and those geared more towards export has generated a major differentiation in the development of industrial structure, and provided an incentive for recent monetary policy actions and the implementation of public strategies to support industry. Among them are a reduction of tariffs on commodities in the sector not produced domestically, and a lower energy tariff. At the same time, a new tax reform has been prepared. Among its aims are a relaxation of tax pressure on labor-intensive sectors such as industry and a reduction of supply costs in agriculture, the other sector lagging behind in growth over the last decade.

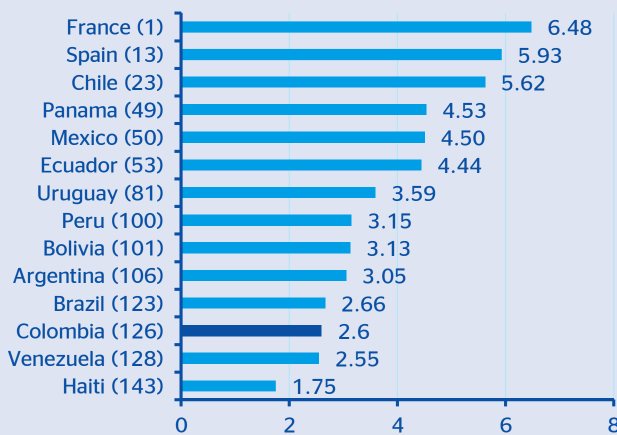
The sluggish industrial performance has led to deterioration in the labor market over recent months, although partially offset by more jobs created in retail trade, real-estate activities and transport. However, in the case of retail trade, the jobs are largely informal and do not provide a boost for private consumption, in line with the forecasts presented above. In addition, the pull effect of the real-estate sector and transport could lose steam. This is already suggested by the slowdown in new housing construction permits and exports to developed countries, together with the extension of temporary supply shocks in the mining sector, which is a major customer for transport services.

The sectors that will boost growth in 2013 will again be construction and mining. In the case of construction, there will be a greater contribution from infrastructure works and commercial building (see Box). In the case of mining, a recovery is expected in the WTI oil price to levels to USD 100 per barrel. There are also plans for increased production resulting from the Colombia Round, which will grant new exploration sites at the end of this year and the start of 2013. New hydrocarbon projects are expected to generate investment of USD 2.3 billion in 109 oil blocks.

Box. Transport revolution in Colombia: ambitious projects will improve the quality of domestic transport*

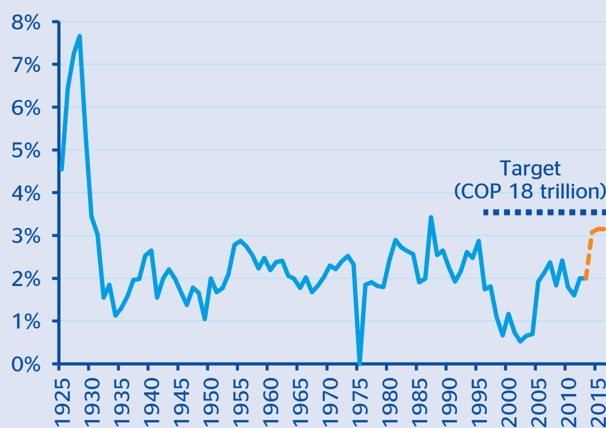
Budget restrictions and the topographical problems in the Andes have meant that the country is lagging behind in transport infrastructure. In 2012, Colombia was in 126th place out of 144 countries in terms of transport quality (Chart 9). This situation generates extra logistical costs for foreign trade. Colombia is the most expensive country in the region for transporting a standard 20 TEU container, at USD 1,808 (World Bank), while in other countries in the region and its direct competitors in the international markets the cost is much lower (USD 1,200 in Venezuela; USD 450 in Chile).

Chart 9
Ranking of road infrastructure quality in countries in the region (ranking of 144 countries and rating: 7=max, 0=min)



Source: Word Economic Forum and BBVA Research

Chart 10
Ranking of road infrastructure quality in countries in the Public and private road and rail transport investment: 1925-2016 (f) (% GDP)



Source: Ramírez (1999), GRECO (1999), DANE and BBVA Research

Revolution underway: major highway works will extend the primary road network

To tackle the difficulties in domestic transport, President Uribe's last administration and that of the current president Santos made progress in extending the primary road network. The last Uribe administration developed the designs for the "Mountain Highways" (or "Prosperity Routes") by 773 km, as well as stretches of the Ruta del Sol (1,071 km dual carriageway) that will link the center of the country with the Caribbean coast.

The current Santos administration has focused on strengthening the legal framework of concessions, making the bidding process more transparent through a law governing Public-Private Associations. It has also dedicated more funds and time to improving the legal, financial and technical structure of infrastructure projects.

Once the legal framework was established, the current administration is ready to present some ambitious infrastructure projects. The new generation of concessions will take advantage of the new institutional and public financing framework to invest COP 43 trillion starting in 2014 (around 3% of GDP per year). This is a record in recent Colombian history (Chart 10). The projects aim to work on 8,170 km of highways, mainly improving highway traffic to the interior of the country.

The government will also aim to modernize the financing of road infrastructure. The plan is to finance part of the investment through the capital markets, making better and more flexible use of financing alternatives and copying successful schemes implemented in other countries such as Peru and Chile.

The future of infrastructure is promising. The country has the legal framework, resources and political will to revolutionize domestic transport, as well as boosting productivity and long-term potential growth.

*For more information on the subject, see the Economic Outlook "Revolución del transporte en Colombia", November 2012.

The current account deficit will remain bounded, financed by foreign direct investment

We have revised slightly up our current-account deficit forecast for 2012 from 3.1% to 3.3% of GDP and for 2013 from 2.4% to 2.5%. This change of outlook is associated with less optimistic expectations for foreign trade. In fact, we have reduced export forecasts for 2012 from USD 64 billion to USD 59 billion, and for 2013 from USD 69 billion to USD 68 billion. At the same time, imports will grow strongly, mainly associated with purchases of capital goods by the mining industry.

Foreign direct investment will remain buoyant, at around 4% of GDP. It will thus support the process of extending the structure of output. Total FDI will increase from 26.6% of GDP in 2011 to 29.1% of GDP in 2013. This performance of external flows will guarantee accumulation of international reserves this year and next, and increase the external balance by over USD 3.6 billion in the two years compared with the closing value of 2011.

We await additional improvements in the public balances

The fiscal balance has improved again. Fiscal revenues as of 3Q12 posted a surprising rise, mainly due to those related to corporate income tax payments. As a result, tax revenues have continued to improve, with an increase of 1.5% of GDP in the last two years. These improvements have led to a downward revision of the fiscal deficit for 2012 from 2.4% to 2.1%, and maintained the medium-term horizon for fiscal consolidation.

In the future changes in taxation and possible revisions of Colombia's credit rating will be contingent on the outcome of the tax reform bill. Although it is premature to analyze the effects of the project, it is expected to be revenue-neutral. It will aim to make the labor market more flexible and balance the tax burden between natural persons and corporate entities. The tax burden and problems in the labor market are the two issues that have been pointed out by the rating agencies as factors that are a drag on the economy. Any improvements in this area will therefore be welcomed by the agencies.

Fiscal reform proposals traditionally carry an element of political risk related to proposals that could be included by certain lobby groups or the government itself. This factor therefore could limit the success of the tax reform.

4. The central bank will maintain its monetary pause until the second half of 2013

Inflation in the middle of the target range in 2013

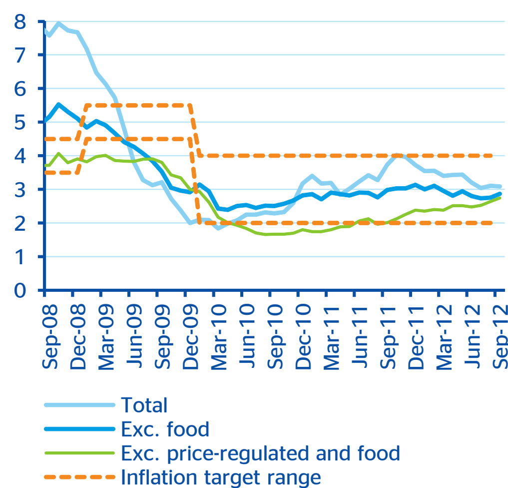
Colombia has continued to meet its inflation target. Prices have been within the range of 2-4% since June 2009 and core inflation indicators are under control and below the middle of the target range (Chart 11). Inflation excluding food in September stood at 2.8%, down on the figure of 3.0% 12 months earlier. The moderation in the core inflation indicators and inflationary expectations suggest that inflation will be marginally down at the end of the year, at 2.9%. However, in 2013 and the medium term, it will be close to the middle of the target range (Chart 12).

The main future risk factors putting upward pressure on inflation derive from the El Niño effect and the inflationary impact of the tax reform. With respect to El Niño, the meteorological agencies in Colombia and South America consider that its probability is low. This climate phenomenon

generates below-normal levels of rain, with temporary results mainly on food prices. The national meteorological agency IDEAM estimates the chance of the El Niño effect occurring is 55% (earlier estimates were 65% and 81%). Its severity would also be lower than that initially forecast. In any event, if the phenomenon does occur, it would be in the first half of 2013, with temporary effects on food prices.

With respect to the tax reform, the initiative aims to simplify value added tax by reducing the number of rates from seven to three (0%, 5% and 16%). The products in the household basket (e.g. food) will continue subject to a rate of 0%, so the reform will not have any significant effect on this component. Agricultural supplies will be taxed at 5%, while the maximum rate will remain at 16%. In addition, a consumption tax will be introduced, focused on high-value products such as vehicles and cell phones. This will be balanced by a reduction in the VAT on these products.

Chart 11
Headline inflation and core inflation indicators: 2008-2012 (October, %)



Source: DANE and BBVA Research

Chart 12
1 and 5-year inflation expectations (implied by TES curves in UVR and COP - Nelson-Siegel)

Source: Infoval and BBVA Research

The tax on gasoline has also been cut by around 200 COP/gallon, or 2.3%. The measure will reduce the price of fuels and regulated prices. The proposed VAT rates have been modified a number of times by the government, so the net impact in terms of inflation is still uncertain. Some lobby groups and members of the government have been trying to cut rates on some items, so there is still some political uncertainty regarding the effect of the reform on inflation.

Continued upward pressure on the Colombian peso

Unsterilized purchases have been the main tool used by the Central Bank for its foreign-exchange intervention. The level of purchases through October 2012 (USD 3.9 billion) was higher than the figure in 2011 (USD 3.7 billion). Among the countries in the region with inflation target systems, Colombia has been more aggressive in its interventions as a proportion of its international reserves than Brazil, Mexico and Chile, and second only to Peru, which has also posted a record year of interventions.

The monetary authority has announced that the intervention will continue into 2013. Purchases will total USD 3 billion between October 2012 and March 2013. The country's Treasury, which is aiming to collect funds for the proposed Royalty Stabilization Fund, has supported these interventions; it has also made explicit statements backing the Central Bank and in favor of a weaker exchange rate.

In the future, the monetary easing measures in developed countries and the steady reduction in risk aversion as progress is made towards a solution to the crisis in Europe will put upward pressure on exchange rates in Latin America. The peso will also gain in Colombia due to the possible reduction of taxes on portfolio flows proposed in the tax reform. In this situation the Central Bank will continue to intervene on the foreign-exchange market, although it will be restricted by the difficulty of sterilization and the amount of liquidity it can provide for the economy. Another problem is an environment where the monetary aggregates cannot be relaxed too much, given that private demand is expected to recover naturally by the second half of 2013.

The Central Bank will face a monetary and exchange-rate dilemma, with very few instruments available to contain inflationary pressure without generating risks of currency gains (see Central Bank section). However, the country's Treasury will most probably support the Bank of the Republic in its foreign-exchange interventions to optimize the currency exchange-rate of its debt and making sporadic purchasing transactions in the foreign-exchange market, as it has done in 2011-2012.

Sustained growth in credit, though at lower rates

Credit has continued to moderate. It is still reacting to interest rate rises that begun at the start of 2012, as well as lower economic activity. Growth in credit fell from 17% y/y in January 2012 to 12% in August. Its moderation has been commented on positively by the Central Bank, which highlighted that its growth rate is now sustainable, compared with that of previous months. In the medium term it should continue to moderate.

Mortgage loans should be affected by slower residential investment in 2013. Consumer loans will have to face a rate of urban unemployment that refuses to drop below 10% and an interest rate cap that remains high, which mainly affects the expansion of credit cards. The commercial loans will recover in 2013, as its slowdown began before the other portfolios, although the recovery will be moderate due to the slow forecast upturn in non-residential investment in 4Q13.

Monetary policy decisions will depend on the external situation and industrial recovery

With a weaker domestic economy and external risk factors, the Central Bank made two cuts in its interest rate in July and August, reducing the policy rate by 50 bps. The monetary easing was in response to the moderation of the local economy and the persistent weakness in developed countries, with the effects already mentioned on industry and exports.

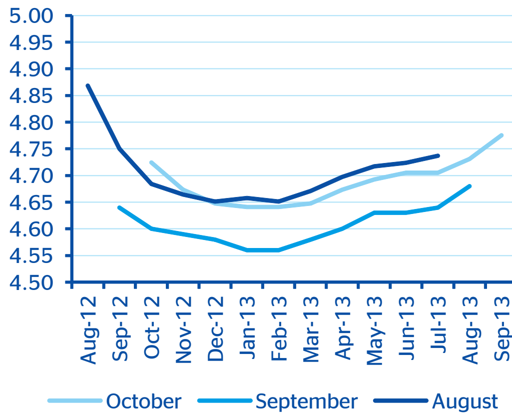
The monetary easing has been supported by the purchase of unsterilized dollars, which will continue through March 2013, at a value of 0.8% of GDP. How this measure will be passed on to output is less clear, but is equivalent to a reduction of around 15 bps in the intervention reference rate.

Recently, at its October meeting, the Central Bank projected a more positive stance. It stressed that although 3Q12 will be less positive than 2Q12, it hoped that the financial sector, labor market and household confidence will boost recovery. It explained that concern regarding the external situation has receded, given the policy actions by authorities in the developed countries, though it recognizes that this is still the biggest risk factor for the domestic economy.

The more positive local and external outlook, and the fact that weaker data for 3Q12 have been discounted, suggest that bigger cuts in interest rates will not be necessary in the short term (Chart 13), although the level of risk remains. As a result, policy decisions will largely depend on the external situation and its effect on the export recovery of the manufacturing sector.

Chart 13

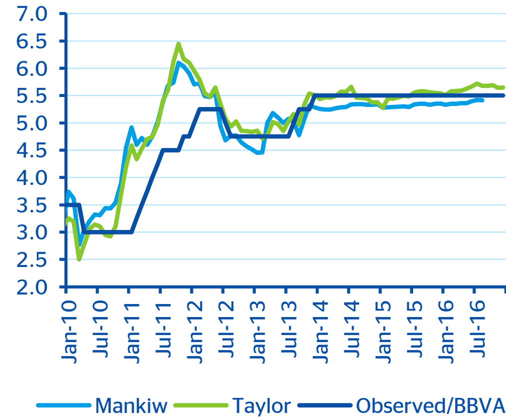
Expected average intervention rates according to the Bank of the Republic's survey of monthly expectations (%)



Source: BanRep and BBVA Research

Chart 14

Intervention rate: observed, expected by BBVA and forecast, in accordance with policy rules (Taylor Rule and Mankiw Rule)



Source: BanRep and BBVA Research

We expect the Central Bank to maintain its pause until the third quarter of 2013

The pause in the policy rate will end in 3Q13, when we expect the monetary stimulus will be withdrawn, with an initial increase of 25 bps. By then we expect growth prospects to be consolidated and the resolution of the global situation to be clearer. The policy rates will close 2013 at 5.5%, which we consider to be the neutral monetary policy rate (Chart 14).

For the second half of 2013, however, the Central Bank will be in a dilemma as to how to prevent inflationary upturns without exacerbating upward pressure on the exchange rate, given the increase of global liquidity and the continued strength of foreign direct investment (FDI) inflows. In this situation the Central Bank will continue with its foreign-exchange interventions, and expect to be supported by the government in the same way it has done throughout 2013.

However, the capacity for sterilization will be limited. Increases in liquidity must therefore be offset, either by the issue of Central Bank bonds or by the use of macroprudential measures with the financial efficiency costs applicable. The former alternative would be less costly.

The Bank of the Republic has the legal instruments to issue monetary control bonds, with which it can sterilize possible future interventions. It is still unclear whether they will be implemented, possibly because the authorities are evaluating their financial suitability and looking for a size of market in which the current TES bonds and the planned infrastructure bonds can coexist. In any event additional exchange-rate pressures in 2013-2014 would be a catalyst for the monetary authority to speed up the implementation of the bonds as an instrument for sterilization and avoid more costly and heterodox measures such as quantitative restrictions on portfolio flows.

5. High capacity for local reaction to a deterioration in the external situation

The main risk for the global economy is a deepening European debt crisis, together with the uncertainty that could be generated by the fiscal cliff in the United States. However, recent actions by central banks in Europe and the United States have made this scenario less probable.

If there was a major slowdown in global growth, with the United States and Europe entering a deep and prolonged recession, Colombia would experience a sudden halt to its growth. The main channel of contagion are exports: commodities would be valued at lower international prices, while demand for industrial goods would drop in developed countries. Export growth would fall from 6.7% to 3.3% on average between 2013 and 2014.

At the same time, a weakened global economy would lead to reduced foreign direct investment inflows to the country, from a net entry of USD 15 billion to USD 10 billion in 2013. This would imply a shock in confidence regarding domestic demand, although not as severe as what occurred in 2008-09, with a reduction in the strength of consumption and to a lesser extent private investment.

This adjustment to domestic demand would restrict import growth, but to a lesser extent than exports. As a result, we expect the current-account deficit would increase to 3.7% of GDP on average in 2013 and 2014, compared with the forecast of 2.1% of GDP in the baseline scenario. The increased foreign deficit, combined with the reduction of capital flows, could lead to a disaccumulation of international reserves of over USD 1 billion over two years, compared with the close of 2012.

In any event, devaluation in the exchange rate of over 23% in 2013 would cushion the negative effects of the external environment on domestic demand and the financing of the government and private sector. In addition, the changes in the exchange rate would prevent an excessive increase in the current-account deficit and avoid the need for an additional adjustment in domestic expenditure.

A more difficult external environment and deterioration in private domestic demand could lead to additional interest-rate cuts

Although the Central Bank has recognized that an adverse event in Europe is less probable, its stance continues to be one of expansion to prevent potential risks arising from a worsening external situation. In this scenario the monetary authority would act diligently to reduce interest rates as a countercyclical policy, with the capacity to maintain its real interest rate below 1%, as has happened in previous cases of international turbulence. The expansionary stance would be applied decisively by the members of the board of the Central Bank. In the past they have given their unanimous backing to monetary support in case of adverse external events.

Fiscal policy would have limited room to support economic growth in these two years, as the current slowdown in the economy and mining/energy resources provide a less ample cushion for tax revenues in 2012 and 2013. BBVA Research expects that automatic stabilizers in infrastructure construction will be implemented, but it rules out increased public investment, apart from what has been considered in the baseline scenario in our forecast. Thus the government could handle an increase in the fiscal deficit, but not as large as that in previous episodes of economic slowdown.

In addition to the automatic stabilizers, the flexible IMF credit facility, which was renewed in May 2012 for USD 6 billion (1.6% of GDP), would give central government room to support output, wither with more expenditure or by a temporary reduction in taxes.

To sum up, Colombia is prepared to face an external shock, although monetary policy has less room for maneuver than it did in 2008. Specifically, while at that time the intervention rate was cut by 700 bps, now it can only be reduced by 150 or 175 bps at most. In addition, given that the public budget is now more dependent on funds from commodities than in the period before the crisis triggered by the Lehman Brothers collapse, an uncertain global scenario would affect the government's balance sheet more strongly and restrict its ability to provide fiscal support.

6. Tables

Table 1
Macroeconomic forecasts annual

	2010	2011	2012	2013
GDP (y/y %)	4.0	5.9	4.3	4.4
Private consumption (y/y %)	5.0	6.5	4.1	4.5
Public consumption (y/y %)	5.5	2.6	4.4	4.7
Fixed investment (y/y %)	4.6	16.7	10.5	7.9
Inflation (y/y %, EoP)	3.2	3.7	2.9	3.2
Exchange Rate (vs. USD, EoP)	1926	1934	1800	1820
Interest rate (%, EoP)	3.00	4.75	4.75	5.50
Fiscal balance (% GDP)	-3.9	-2.9	-2.1	-2.0
Current account (% GDP)	-3.1	-3.0	-3.3	-2.5

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	5.1	3.2	1884	3.50
2Q11	4.9	3.2	1783	4.25
3Q11	7.5	3.7	1836	4.50
4Q11	6.2	3.7	1934	4.75
1Q12	4.7	3.4	1766	5.25
2Q12	4.9	3.2	1793	5.25
3Q12	3.7	3.1	1803	4.75
4Q12	3.9	2.9	1800	4.75
1Q13	3.8	3.1	1770	4.75
2Q13	3.8	3.1	1755	4.75
3Q13	4.9	2.8	1770	5.25
4Q13	5.3	3.2	1820	5.50

Source: DANE, Superfinanciera, BanRep, and BBVA Research

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