BBVA | RESEARCH

Economic Outlook

Colombia

First Quarter 2013

Economic Analysis

- **The global economic climate is looking better** due to less financial stress in Europe, the deal to avoid the so-called “fiscal cliff” in the United States and the resilience shown by emerging markets.

- **Colombia’s economy will increase its growth rate in 2013 and 2014 by 4.1% and 5.0% a year, respectively, after having bottomed out at the end of last year.** Private consumption will be the main factor behind the recovery, along with an optimistic outlook on infrastructure projects during both years.

- **Inflation is likely to stay below the midpoint of the inflation target range in 2013 and converge at 3% in 2014.** We expect the Central Bank to hang onto its expansionary stance in 2013 and start increasing rates in the second quarter of 2014.

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Closing date: Februrary 12, 2013

1. Summary

The outlook on the global economic scenario improved in the last quarter due to the continued ease in global financial stress. Global growth will increase from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014. However, for the recovery to continue, the appropriate policies need to be implemented in the US and the Eurozone.

In Colombia, GDP slowed down and bottomed out in the last quarter of 2012. In line with forecasts, growth in private demand fell from 9.4% to 4.9% between 2011 and 2012. Nonetheless, bottlenecks in mining and low public investment caused the slowed GDP growth to extend, beyond expectations. The economy is likely to have grown by 3.7% in 2012.

The economy should grow by 4.1% and 5.0% in 2013 and 2014. This result will be sustained by higher consumption, from 4.3% in 2012 to 4.7% in 2013 and 4.8% in 2014. Civil works will see an average annual growth of 10% in 2013-14. Private investment will slow down from 6.9% in 2012 to an annual average of 5.3% in 2013-14. Exports will be sustained by the mining-energy sector.

Private demand will see an average annual growth of 4.9% between 2013 and 2014 due to recent cuts of policy rates, improvements in the labor market and high confidence levels in the country. Non-residential investment will depend on the industrial recovery process, which will not be consolidated until 2014.

The growth gap is expected to have become negative (by 0.3% of the potential) by the end of 2012. In 2013 this gap should increase to -0.8%. The gap will have closed completely by the end of 2015.

The current-account deficit was above 3% of GDP in 2012. BBVA Research forecasts a gradual closing of the current-account deficit over the next two years, standing at 2.7% of GDP in 2013 and 2.3% of GDP in 2014. The main source of financing for the trade deficit will be direct foreign investment, which will stabilize at around 4% of GDP.

A review of activity and lower oil prices pushed up our forecast of the fiscal deficit in 2013 and 2014. In 2013, we forecast a similar level to 2012, but we expect this to increase to 2.6% in 2014 with the lower tax revenue caused by 2013 activity and the introduction of business tax cuts under the tax reform. In the medium-term, we hold onto our fiscal consolidation forecast.

Consumer inflation surprised us by falling at the end of 2012, leading to a review of this heading in 2013 and 2014 due to an ease in demand pressure, lower oil prices and less likelihood of supply shocks (El Niño phenomenon). **We expect inflation to remain below the midpoint of the inflation target range (3%) in 2013, with a slow comeback from the second half of 2013 onwards and converging to 3% in 2014.** Surpluses in global liquidity and lower taxes on offshore capital flows will continue to put appreciation pressures on the exchange rate in 2013. The Central Bank will maintain its foreign exchange interventions during the year, with a limited effect on the currency's medium-term evolution.

The Central Bank took an expansionary stance at the end of 2012, which it is likely to pursue in 2013. The inflationary room will allow at least another cut in the first quarter, with an expansionary monetary policy pause during the rest of the year. Later, in the second quarter of 2014, we expect it to change its monetary stance, when local and external activity return to medium-term growth.

Uncertainty surrounding the global economic scenario continues on its downward trend, moving toward global growth of around 2.5% and 3.0% in 2013 and 2014. This risk scenario is less likely and has a lower impact now than was estimated three months ago, in light of the progress made in the definition and implementation of policies in more developed areas and the resilience shown by growth in emerging markets.

In the coming years, Colombia will hold onto its outstanding position in Latin America, but it must solve some public and institutional policy issues in order to increase its growth potential. Issues that must be tackled include peace talks, institutional reforms (political, social and economic), consolidation and irrigation of the mining and oil boom, making significant progress on infrastructure developments, strengthening the industry and formalizing the economy.

2. Global economic outlook improves

The global economic outlook improved in the last quarter thanks to the continual decline in global financial tensions, especially in Europe, and the agreement avoiding the so-called “fiscal cliff” in the US

Confidence indicators have picked up across all major economic areas and data for output and spending continue to point to limited global growth. Europe has seen financial tensions ease for six months now, with markets gradually, albeit not fully, offering funding to financial and non-financial businesses in certain peripheral economies in the euro area.

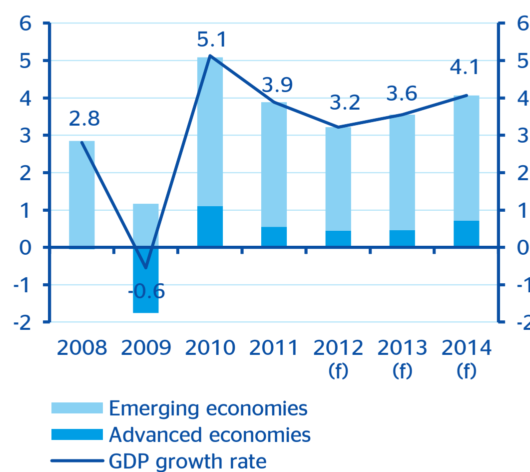
The mood in financial markets improved steadily in recent months thanks to three factors: (i) data show that China is not heading for a hard landing, as some analysts had expected; (ii) the US did not fall off the cliff and, in fact, its economy is withstanding uncertainty remarkably well; and (iii) Europe continued to progress towards a the banking union, reinforcing the commitment to preserve the euro.

Nonetheless, improvement in market perception does not make up for lack of improvement in fundamentals, and growth will remain weak in developed countries. Therefore, global growth is set to rise from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014 - almost the same forecast as three months ago (Chart 1). In 2013, the downward revision of Brazilian growth and the unchanged scenario in the eurozone and the US should be offset by better forecasts for China, Mexico and some Latin American economies (Chart 2).

The recovery will only continue if the appropriate policies are implemented in the US and the eurozone. The US needs to do more than just soften the impact of imminent tax rises and should dispel any uncertainty surrounding debt repayment and how the burden of fiscal consolidation is to be shared. With respect to the eurozone, progress in governance, especially with respect to the banking union, must continue, both through additional agreements and the effective implementation of the agreements reached on banking supervision and resolution procedures.

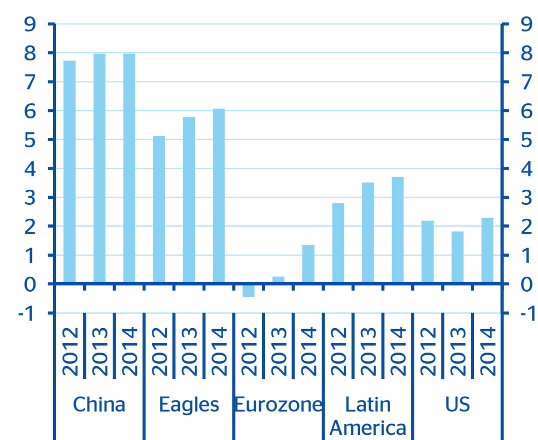
Although positive surprises are not out of the question, the uncertainty surrounding the global economic outlook looks set to remain high. Reduced global growth would be the consequence of increased financial tensions and a drop in confidence if doubts reappeared as to the European authorities’ commitment to shore up the euro, which have been contained for now both thanks to the ECB’s statement last July and the agreements reached between the countries in the eurozone in support of the single currency. If these tensions did emerge, new agreements on financial safeguards would be necessary and the recession in the eurozone would continue throughout 2013. The risk in the US would arise if the contagion arising from the European risk was added to the disagreements regarding fiscal consolidation or the debt ceiling. In that case, and with the support of emerging markets, the global GDP would range from 2.5% to 3% in 2013 and 2014. This risk scenario is less likely and the impact is lower than estimated three months ago. This is thanks to the progress that has been made in implementing policies in the most developed regions, and the resilience demonstrated by the emerging economies.

Chart 1
World GDP growth rate



Source: BBVA Research

Chart 2
GDP growth rate



(*) Eagles: Emerging and Growth-Leading Economies, emerging economies leading global growth. Included China, India, Brazil, Indonesia, Korea, Russia, Turkey, Mexico and Taiwan.
Source: BBVA Research

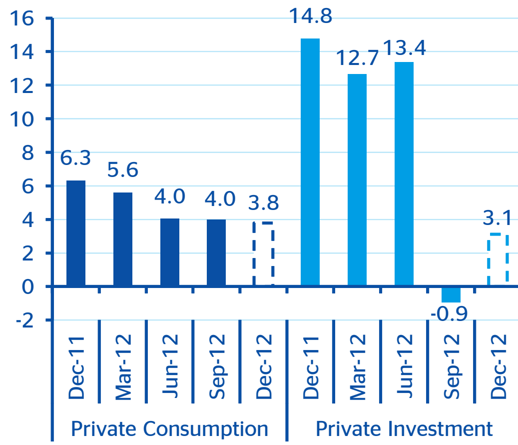
3. . Colombia to step up its growth rate in 2013 and 2014

2012 closes with more pronounced slowdown than predicted

In 2012, the Colombian economy slowed down, which helped to avoid excess inflation and financial imbalances for households and businesses (Chart 3). In line with expectations, growth in private demand fell from 9.4% to 4.9% (e) between 2011 and 2012, mainly caused by a slowdown in private investment from 20.5% to 6.9% (e) during those years. Household consumption saw its growth decline more gradually, from 6.5% to 4.3% (e), mainly due to the recent adjustment in durable goods, partly offset by the increased growth in service consumption (see Table 1).

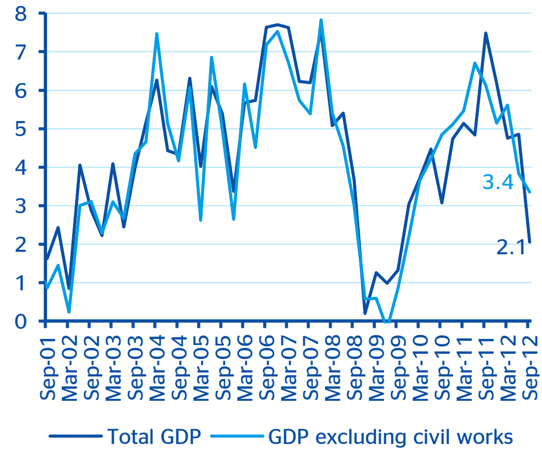
However, some temporary factors caused the slowed GDP growth to extend in the second half of the year, beyond expectations. In particular, there were some logistic bottlenecks in the mining sector and low levels of public investment in infrastructure. As a result, while GDP growth was 4.8% during the first half of the year, the estimate for the second half is 2.6% annual growth. This is a reflection of highly volatile public investment. Indeed, the GDP for civil works grew 6.4% in the first half but only 0.7% by the September cut-off (Chart 4). Overall, the economy grew by 3.7% in 2012, caused by a more intense slowdown in some sectors (Chart 5).

Chart 3
Private demand: consumption and investment
Year-on-year change



Source: DANE and BBVA Research

Chart 4
Total GDP excluding civil works
Year-on-year change



Source: DANE and BBVA Research.

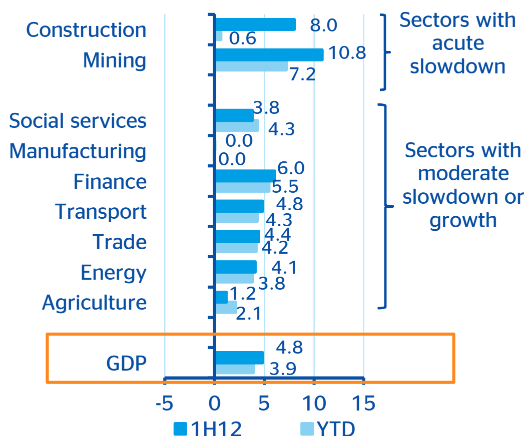
Slowing economy bottomed out in the last quarter of 2012

The leading indicators at the end of 2012 showed a return to maximum activity levels in the mining sector, very close to the goal of producing one million oil barrels per day, which was finally achieved in January 2013 (Chart 6). Coal exports also returned to the average levels seen before the third quarter, although this was once again affected by abnormal activity by the leading coal-producing companies in the country during February.

The adjustment in household consumption ended due to the monetary stimulus and positive labor results in the first part of the year. This left the possibility open for a recovery in household spending in 2013, in line with our growth estimates (see Table 1). Likewise, private construction projects performed better in the fourth quarter since this period saw the completion of many of the projects that received a license one year earlier, when construction permits reached their maximum levels.

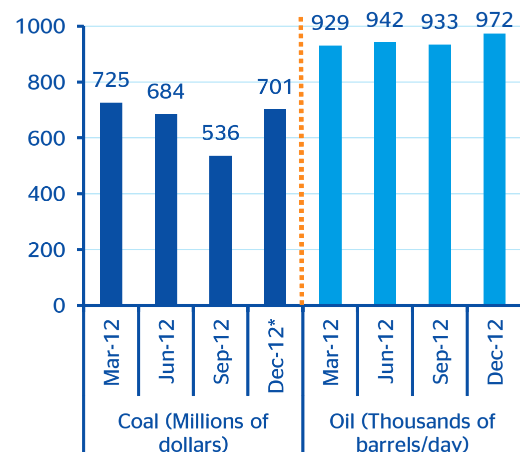
However, the main source of uncertainty was still civil works. Although some budget execution indicators revealed accelerated growth in the National Government's investment resources at the year-end, there are no up-to-date figures on the progress of regional and local government works. Against this background, we estimate low growth levels in the fourth quarter, around 3%.

Chart 5
Sector growth:
first half of the year and YTD. As a %



Source: DANE and BBVA Research

Chart 6
Coal exports and oil production. In millions of dollars and thousands of barrels a day



*October-November average.
Source: DANE, ANH and BBVA Research

Box 1. Household spending on vehicles and real estate

Slowing household spending in 2012 was widespread across all types of consumption. Most of the slowdown in private spending was concentrated in the motor vehicle and housing sectors however, because these constitute the longest-term household decisions, that is, those that they are only willing to undertake in optimistic circumstances.

Car sales, which grew 28% in 2011, declined 2.7% in 2012. However, by component, the slowdown was more acute if we exclude commercial motor vehicles, which grew by more than 20%. The remainder, related to private purchases, recorded a 13% fall. This performance reflected the low growth levels of durable goods consumption, which only increased by 0.4% between January and September, against a 24.7% increase in 2011 (see: Colombia Automobile Market Outlook 2012, available in the Colombia section on BBVAResearch.com)

House sales went from 12.7% growth in 2011 to a 3.8% fall in 2012. The most negative figures were recorded in Bogotá (24.1% fall) and Cartagena (down 16.1%). The slowdown was mainly associated with uncertainty regarding the renewal of some economic policy incentives and with fewer investment purchasers entering the market. (see: Colombia Real Estate Watch 2012, available in the Colombia section on BBVAResearch.com)

The outlook in both sectors is moderately optimistic, although the motor vehicle sector showed a notably positive performance. In this sector, we expect sales to come in at 315,000 and 325,000 in 2013 and 2014, respectively. Our sales forecasts show a recovery in private automobile transactions, but not reaching the peaks seen in 2011. At the same time, we expect a slight fall in the cargo vehicle market, given the high level of installed capacity built up by the industry over recent years.

Colombia's vehicle stock will increase by 3.5 million vehicles between 2010 and 2020, a doubling of current levels. As in some Asian countries, car sales in Colombia are subject to high-income elasticity, a common phenomenon in expanding countries.

Prospects for the residential sector are for a continuing expansion cycle, although much more moderate than previously. In fact, while in the 1990s buildings generated a positive growth gap of more than 7% with respect to the potential level, between 2013 and 2016 the sector will only grow slightly above its long-term level. This performance guarantees greater sustainability of the sector as risks of oversupply and cost pressures in the value chain fall.

The BBVA Research estimates for investment in buildings are for 3.8% annual growth in the 2013-2016 period. This forecast includes a slowing of high-end house sales, offset by an increase in commercial demand and social housing.

The same factors will sustain the performance of both the motor vehicle and residential sectors. The cut in interest rates by Banco de la República will increase banking penetration regarding the financing of durable goods and housing purchases and will buoy up credit demand. Increased consumer confidence, in terms of the country's and household expectations, will encourage household purchasing decisions, although they will be dependent on the performance of the labor market.

Gradual recovery in 2013 to consolidate in 2014

The main catalyst of economic recovery will be household consumption, which will cash in the most on the cut in interest rates. In order to measure this, we conducted a statistical study in which we calculated the effect of a 75 bp fall in the BanRep intervention rate between the end of 2012 and the start of 2013, staying low until the second quarter of 2014. The results showed that the lower rates had a positive effect of 0.2 and 0.5 percentage points on the growth rate of private consumption in 2013 and 2014, respectively, in relation to a scenario that did not consider rate cuts.

Consumer and retailer confidence indicators confirm expectations of stronger private consumption in both years. Households have improved their assessment of the future situation (12-month period) since August, when the lowest confidence level, seasonally-adjusted, was recorded. Retailers perceive high demand, equivalent to more than twice the historical average of this indicator (Chart 7).

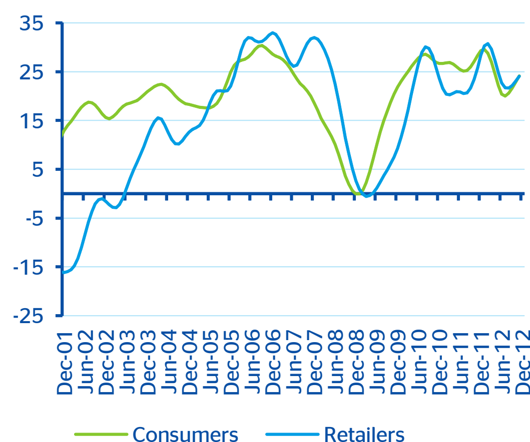
This positive consumption outlook is combined with growth prospects in the construction sector, both public and private. In the public sector, infrastructure projects already underway, together with more progress in regional and local initiatives in the second and third year of government (2013 and 2014) and new national tenders, will play a key role in job creation and ties with other production sectors, such as cement, iron, glass and ceramics. In the private sector, in spite of the domestic slowdown in residential buildings, commercial and logistics projects and social housing will receive a significant boost, mainly in 2014 (see Box 1).

The performance of non-residential investment will be dependent upon the industrial recovery process, which will not consolidate until 2014, according to the low expectation levels anticipated among business owners in the sector. During the first half of 2013, the adjustment in fixed investment will continue, sustained by mining and energy activity, but limited by slower growth in the manufacturing sector. From that time on, the improved industrial balance will be added to the boost given to investment from the extractive industry, based on the positive impact that currency appreciation has on the costs of importing machinery and equipment and on lower interest rates.

Colombia will therefore be able to increase its investment level again in 2013 and 2014, even at a higher rate than in 2012, due to the contribution from infrastructure projects. It will go from a rate of 26.6% of GDP in 2011 to 27.9% in 2014 (see Table 2).

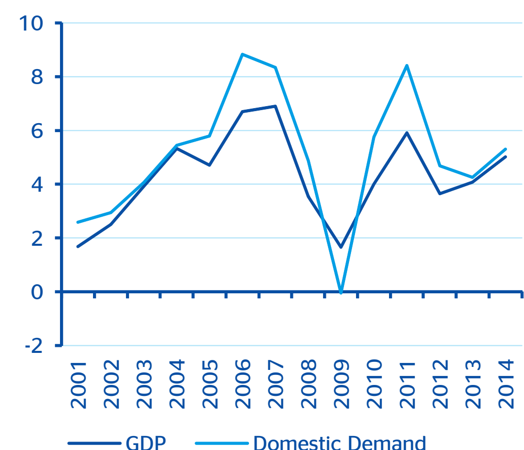
The economic sectors leading growth in 2013 and 2014, apart from infrastructure, will be mining, transport and commerce. Daily oil production will increase to 1.15 million barrels a day in 2014 and coal exports will grow between 14% and 16% in accumulated terms this and next year, depending on whether partial company inactivity in the sector is long-lasting or short-term, respectively. Transport will benefit from increased foreign trade. Finally, domestic trade will follow a recovery trend, in line with the private consumption outlook.

Chart 7
Consumer and retailer confidence. Seasonally-adjusted balance



Source: Fedesarrollo and BBVA Research

Chart 8
Growth forecasts: GDP and domestic demand. Annual change



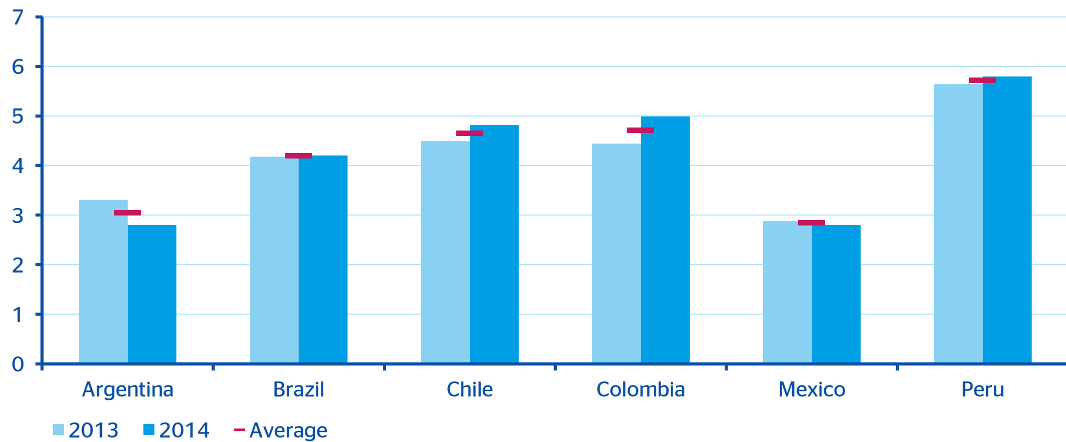
Source: DANE and BBVA Research

Consequently, the economy would grow by 4.1% and 5.0% in 2013 and 2014 (Chart 8). This growth trend is above the Latin American average, where we will see changes of 3.6% and 3.7%, respectively. In fact, Colombia's accelerated growth in 2014 will mean it is the second fastest growing regional economy, second only to Peru (Chart 9).

The forecast includes a downward revision in 2013, from 4.4% in our previous Colombia Economic Outlook. This is in keeping with recent indicators, which show less drive in private investment. This will see its growth curbed from the 6.9% estimated in 2012 to an annual average of 5.3% in 2013 and 2014. On the other hand, private consumption will increase from the 4.3% estimated for 2012 to 4.7% in 2013 and 4.8% in 2014. Civil works will also receive a significant boost, from a slight decline in 2012 to annual growth of over 10% on average in 2013-14.

The mining and energy sectors will sustain aggregate exports, with sales making a very gradual comeback in other sectors. These exports, including exports in the manufacturing sector, will record slower growth at the end of 2013, when Europe will start making a stronger recovery and the United States will consolidate its growth with rates over 2%.

Chart 9
GDP growth in Latin America. Annual change



Source: BBVA Research.

Box 2. Estimate of potential GDP in Colombia: the negative output gap will last until 2015

Medium-term growth and potential GDP

In the last 30 years, the Colombian economy has grown by an annual 3.5% on average. This resulted in an accumulated increase in real GDP per capita of 84% over the same period (1.9% annual). Since 2003, the growth rate accelerated to a 4.6% average in the following ten years, in line with the economy's better fundamentals. The growth variability was also reduced to half, from a relative deviation (standard deviation/average growth *100) of 61% throughout the period to 35%.

In general, the countries with less volatility are those which achieved a longer development period (Table 1). A comparison between emerging and developed economies shows how the latter have achieved slightly more steady growth rates over time. Therefore, guaranteeing a high, steady growth rate must be two joint objectives for the Colombian economy. To achieve this, the country must make its growth sustainable in the medium-term by increasing the potential GDP, so that demand growth becomes greater growth and does not result in inflationary pressure or heavy cyclical movements.

Table 1
Average growth and volatility by country group

Indicator	G7	45 Emerging markets	Colombia
Average growth	2,1	4,2	3,5
Relative deviation*	98	119	61

* (Standard deviation/average growth) * 100.
Source: BBVA Research.

Calculation of potential GDP in Colombia: state of the art and our results

Several studies have estimated Colombia's potential GDP. The methodologies have included time series (VAR and structural VAR), filter methods (Hodrick-Prescott, Band-pass, Kalman, among others) and structural models (Table 2). The potential GDP estimates in these studies range between 3.8% and 4.7%, depending on the time period included in the estimate. These studies also show an increase in the potential GDP up until the mid 1990s, a decline at the end of the century to an annual rate of below 4%, and a return to the upper part of the estimated range at the end of the previous decade.

The BBVA Research methodology is structural, via a Cobb-Douglas production function. Our results show a progressive increase in the potential GDP over the previous decade, from an average 3.0% following the 1998 crisis to 4.7% estimated for 2013 and 5.3% which will be reached in 2017 (Chart 10).

Contributions by production factor changed over time, according to the results of our model. The component that will most contribute to the potential GDP until 2017 is capital, due to the high investment rates achieved recently and the Government's focus on infrastructure in the coming years. This factor accounted for 43% of the total change in the last decade and will now account for around 50%.

Higher potential GDP growth in terms of productivity growth

Achieving a potential GDP growth above 5% means increasing the productivity growth rate to a 1.1% average between 2013 and 2017 (compared to 0.5% between 2005 and 2012), since the labor market will gradually reduce its contribution to the potential growth given that the additional decreases in the urban unemployment rate will be marginal. Productivity should account for around 20% of the potential growth, while employment will account for 30%. In the previous decade, these percentages were 12% and 45%, respectively.

Some the necessary measures to increase productivity growth include consolidating the development of transport infrastructure, linking the mining and energy boom to some national industrial branches (to guarantee more homogenous growth among economic sectors), continuing with the investment rate upward trend and modifying the exports structure to reduce reliance on primary goods.

Negative growth gap to close faster than on previous occasions

The growth gap became slightly negative (by 0.3% of the potential) in the second half of 2012, given the low GDP growth during that period. In 2013 this is expected to increase to -0.8%, given that activity will continue to fall short of the potential. After 2014, the observed GDP will start moving toward the potential, with the gap being fully closed at the end of 2015 (Chart 11).

In historical terms, these gaps are at low levels. For instance, in the 1980s the negative gap was an average 1.3% and during the late 1990s crisis a negative gap of over 5% was recorded. Therefore, unlike this last crisis, when the gap took seven years to close, this time it will take just over three years to close.

The monetary policy should therefore start retracting the monetary stimulus from 2014 onwards, anticipating that the gap will be closed the following year and possible inflationary pressures as a consequence (see highlighted text in Table 2, Misas and López 1998).

Table 2

Estimates of potential GDP and output gap in Colombia

Author	Methodology	Results
Birchenall (1997)	Leading indicators system cyclical periods. Categorical variable for each cycle and productivity as regressors.	Economic phases are extreme and their beginning and end cannot be determined accurately. Average potential GDP: 4.5% (1964 to 1995)
Melo and Riascos (1997)	Hodrick-Prescott Filter and expectations-augmented Phillips curve. Filter generalization based on structural VAR. The configuration that best adjusts inflation was chosen.	The impact of demand shocks changed significantly in 1985 and 1989.
Misas and López (1998)	Structural VAR developed by Shapiro and Watson and Blanchard and Quah. The shocks that define the economy's long-term behavior are identified.	Non-symmetrical inflationary pressure in the cycle. When it is negative, pressure starts before it closes completely. Estimate 4.7% (1993 to 1996)
Rodríguez-Perilla and Reyes (2004)	By quarter, ratio between employment and output and between capital and output. Annually, Cobb-Douglas and CES.	Constant yield to scale. Negative gap in 2004. Potential GDP between 3.8% and 4.4% (2004).
Campos (2006)	Structural VAR for quarterly data (1994-2005).	Slight negative gap in 2006. Potential GDP between 4.0% and 4.1% (2005).
Torres (2007)	Evaluates methodology validity (production function, structural VAR, Kalman filter, main components) with out-of-sample forecasts of the basic inflation for non-transferable goods on a hybrid Phillips curve.	The gap obtained with Hodrick and Prescott gives worse forecasts for all of the horizons than the other methodologies.
Márquez (2011)	With annual data (1950-2010) a Hodrick-Prescott filter is estimated. Using quarterly data, a Cobb-Douglas production function is estimated.	Similar results were found using both methodologies: 4.3%

Source: BBVA Research

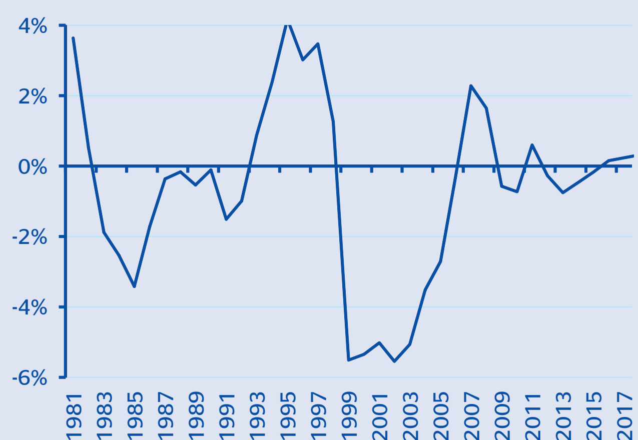
Chart 10

Breakdown of potential GDP growth. Contribution to annual change

Source: BBVA Research

Chart 11

Growth gap. As a percentage of potential GDP growth



Source: BBVA Research

Gradual closing of the current account in 2013 and 2014

The current-account deficit ended at above 3% of GDP in 2012, due to a heavy slowdown in mining exports during the third quarter. In 2013 and 2014, the reduced bottlenecks in the mining sector will determine an increase in the trade balance surplus, accentuated by the slowdown in capital goods imports, according to estimates for investment.

In 2012, the business balance was below the record levels posted a year earlier. This trend should not reverse before 2014. There will therefore be fewer dividends sent abroad in 2013 and 2014, generating lower deficit pressure on the factor income balance.

BBVA Research expects a gradual closing of the current-account deficit over the next two years, standing at 2.7% of GDP in 2013 and 2.3% of GDP in 2014. However, persisting problems in the coal sector during the first quarter could increase the current-account deficit to 2.9% in 2013.

Direct foreign investment will stabilize around 4% of GDP in the coming years, due to mining projects (Ronda Colombia), growth in the retail sector and the upturn in infrastructure. This flow of resources will be facilitated by current high liquidity volumes around the world (Chart 12). The Colombian economy will continue to accumulate international reserves (1.4% of GDP each year), reaching a level of reserves of over 11% of GDP in 2014. Therefore, Banco de la República will have room to intervene in the exchange market up to a maximum of USD 5.5 billion in 2013 (1.4% of GDP), of which it already announced it will buy USD 3.5 billion (0.9% of GDP) between January and May.

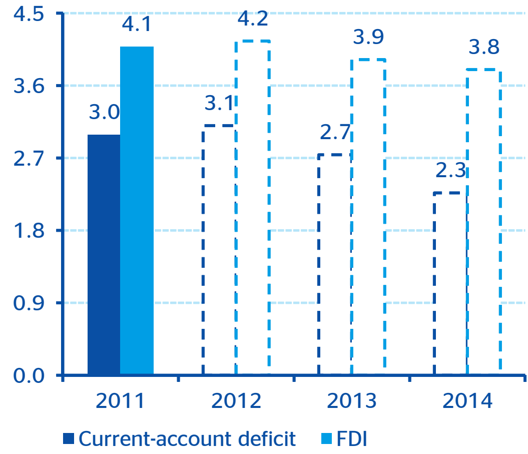
Fiscal balance will adjust gradually in 2013 and 2014 until primary balance surplus is achieved

In 2012 the fiscal balance continued to consolidate, although not as strongly as observed in 2011. Continued improvements in internal revenue were offset by lower revenue from mining and energy activity and the generalized and unexpected curb in aggregate production. The Central Government's fiscal deficit ended at 2.3% (e) in 2012, lower than the 2.8% recorded in 2011 and significantly lower than the 3.9% seen following the international crisis in 2010.

For 2013 and 2014 we anticipate a slight curb in tax consolidation. For 2013, the downward revision in activity, and in oil prices and production, should be offset by increased collection resulting from the tax reform, allowing the fiscal deficit to stabilize at 2.3%. For 2014, the deficit is likely to increase marginally to 2.6% with the lower tax collection made in 2013 due to the slight increase in activity, and driven by the negative effect that the introduction of corporate income tax cuts under the tax reform will have on that year (see Table 3). From 2015 onward we expect fiscal consolidation in line with the activity trend, although accompanied by a primary budget surplus which would reflect the strength of the fiscal balance in Colombia (Chart 13).

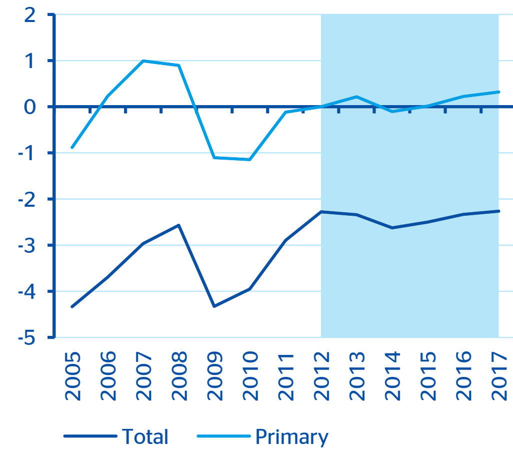
The fiscal position for 2013 and 2014 is strong compared to the slow recovery in activity. Its fiscal room is the same as the one observed during the 2009-2010 crisis, which will allow it to assume a counter-cyclical position should activity require this. A boost in activity would nevertheless be limited by the Central Government's capacity for execution. A greater curb, whether local or external, would be mostly supported by the Central Government's payment of royalties to local governments, considering that a large part of the Government's infrastructure projects would be implemented in 2014 and bearing in mind that local governments are already at the end of their two-year mandate, meaning they would be in a position to swiftly execute local infrastructure investment resources.

Chart 12
Current-account deficit and gross FDI. As percentage of GDP



Source: BanRep and BBVA Research

Chart 13
Total deficit and Central Government primary balance. As percentage of GDP



Source: Ministry of Finance and BBVA Research

Box 3. What can we expect from the recently-approved tax reform?

The Congress of the Republic approved a new Tax Reform, which introduced changes to the tax structure for businesses and individuals. The main objectives were to make the tax code fairer and reduce some inflexibilities in the labor market. Simultaneously, other changes include the simplification of value-added tax (VAT) and a tax cut to offshore portfolio flows from 33% to 14% (25% for countries classified as tax havens), among others.

As regards labor flexibility, the reform cut payroll taxes by 13.5%, seeking to reduce the economy's informal nature and structural unemployment. The reduction in payroll taxes was offset in terms of tax revenue by a change in taxes on corporate profits. Corporate income tax was reduced from 33% to 25%, with a new 8% tax being created, called "CREE". In this tax, the basis for collection does not include the exemptions that apply to traditional income tax. Companies therefore pay 25% income tax under traditional deductions, while in addition they pay 8% tax on their profits, but without being able to apply the same deductions to this tax as they have traditionally done on income tax.

In terms of progressive taxation, the reform created two taxes for individual income tax. The first, the Alternative National Minimum Tax (IMAN), establishes a minimum tax for wage earners that they must pay, being compared to the value derived from the ordinary income tax (or under the current income tax return system based on traditional deductions and exemptions). The second is the Alternative Simplified Minimum Tax (IMAS), which is a high-value tax that individuals (employees with monthly income of over COP 20 million) can pay and which would be supervised in a simplified manner by the Colombian tax department (DIAN).

Likewise, the reform restricts deductions applicable to income tax related to mandatory and voluntary pension contributions and to home saver accounts (AFC) by 30% and $102 million per year. It also increases from 5 to 10 years the minimum duration to allow savings in voluntary pensions and AFC accounts to be freely drawn and not lose the existing tax benefit. This was commonly used by high-income individuals, who set aside part of their salary for savings more for tax reasons than to save for their retirement.

The reform was approved with a neutral impact on tax collection, posting the years 2013 and 2014 together in the accounts (Ministry of Finance). In 2013, the Government expects to collect an additional COP 1.2 billion as a result of the reform, largely due to greater withholdings on individual income tax. For 2014, the lower collection of corporate income tax should be partly offset by the greater collection of individual income tax, resulting in a COP 1.3 billion reduction in tax collection, which when added to the greater collection in 2013 results in tax neutrality.

The tax reform focused on a specific area of taxation: fairness and labor flexibility. However, as part of the problems of redistribution it pushed some aspects aside to further reinforce the progressive nature of the tax code. As regards tax fairness, the reform maintained deductions on dividend gains from investment income. Colombia has kept dividend taxes exempt, which is reasonable from the point of view of economic efficiency of dual taxation (see Atkinson and Stiglitz, 1976), but which in public policy and international tax practice has been accepted as efficient considering aggregate social welfare and as a redistribution mechanism (see Piketty and Saez, 2012) in a country with high income inequality levels like Colombia (GINI=0.57 in 2011).

On the labor front, the reform maintained the payroll tax which goes to Family Compensation Funds (Cajas de Compensación Familiar). The contribution is equivalent to 3% of the monthly salary, which is used to finance recreation, education, credit and health services that could easily be offered by the private sector or even be funded in a less regressive manner. Also, although the reform cut payroll taxes, labor inflexibility will continue to pose a problem insofar as the minimum wage continues to be high (54% of average labor productivity), which could be restrictive in the medium-term if its indexation mechanism continues to grow in real terms.

Global economy tail risks have diminished

As we have seen, against a background of increased global volatility, with small likelihood of occurring, global growth would range from 2.5% to 3.0% in 2013 and 2014. This growth would differ among Colombia's main trade partners, with a better performance seen in emerging markets and some more serious problems in the United States. The country would thus face a reduction in terms of trade and a decrease in demand for industrial products. Against this backdrop, Colombia might also face an external confidence shock, although cushioned by better structural conditions in the country in terms of both economic policy and financial credit terms in the private sector. The Colombian economy would therefore maintain a growth rate of above 3%, even in this worst-case scenario.

4. Central bank to hang on to expansionary stance in 2013

Closing of output gap and inflationary area allow extension of expansionary monetary policy

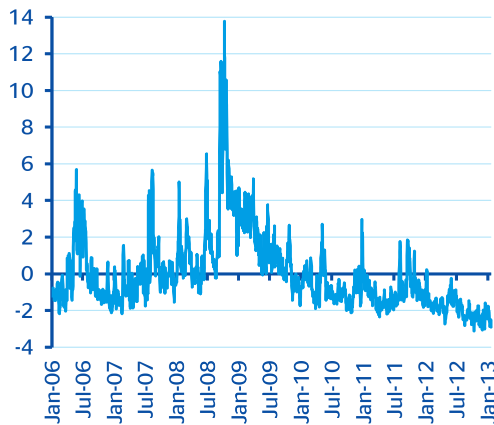
Banco de la República extended its expansionary stance in the latter part of 2012. The first round of cuts undertaken in July and August 2012 were a response to a curb in local demand, but they were cautious due to the persistent uncertainty of foreign activity. In fact, the Central Bank made its cuts conditional on the development of turbulence on the foreign market, which appeared as high levels of financial stress but which were more or less restrained locally (Chart 14). Global turbulence traveled through the real channel instead of the financial channel, with output recording a surprise in the third quarter which immediately led to a round of interest rate cuts by the Central Bank.

The recent cuts were relatively more anticipated by the market than in the first part of the second half of the year, which were also supported by the large inflationary room following the positive surprises in this regard during the final months of the year. The Central Bank undertook a total of four 25 bp cuts in 2012, backed by additional cuts in the early part of 2013 in order to boost activity. Chart 15 shows how the market's expansionary expectations have been adjusted, reflected in the probability that the intervention rate will be cut by 25 bp implicit in the 3-month interbank lending rate. The chart shows how in recent months (in particular January and February) the market has anticipated the increased monetary stimulus aimed at activity, in light of the surprisingly low GDP figure in the third quarter (published in December 21st) and surprising decreases in inflation.

Inflation outlook within the target range for 2013 and 2014 without expectations of negative surprises

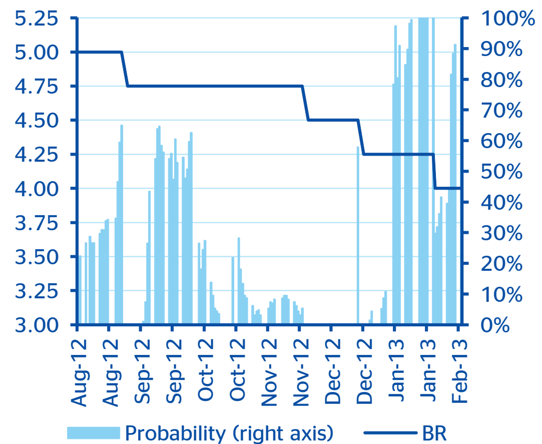
In the last months of 2012, inflation surprised by decreasing as a result of less supply pressure on the prices of food and regulated goods, ending the year at 2.4%. Month-on-month changes in recent months were also driven by the currency appreciation and the permanent reduction in gasoline taxes. However, in line with the curb in activity, inflation has also suggested less demand pressure compared to that observed twelve months earlier, reflected in a reduction in basic inflation indicators.

Chart 14
Financial stress indicator in Colombi



Source: BBVA Research

Chart 15
Intervention rate and probability of 25 bp cut implicit in 3-month interbank lending rate



Source: BBVA Research

For 2013 we expect inflation to remain in the lower part of the target range, some months bordering on the lowest limit. In the first months of the year, demand pressure should continue to affect prices, while indexation factors (after ending 2012 with low inflation) and the smaller increase in wages compared to the previous year should encourage prices to lower. The main upward risks lie in a reversal of the supply factors that have underpinned the fall in inflation (food and regulated goods). In the case of food, these are now less likely due to the less significant risk of the El Niño phenomenon occurring. For 2014, inflation is expected to converge at the midway point of the target range, in line with greater demand pressure than observed in 2013 and in turn supported by lower base prices in the same year (Chart 16).

Foreign exchange measures and lower taxes help contain appreciation of Colombian peso

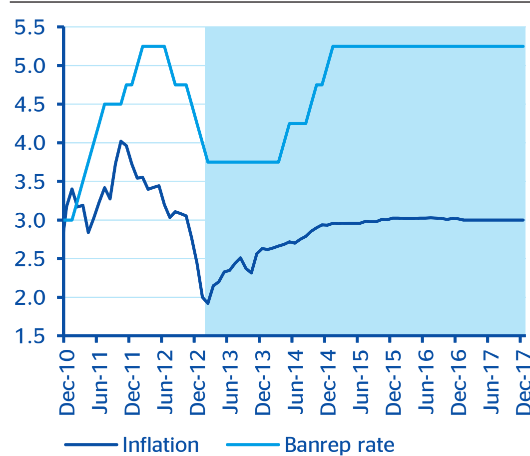
The exchange rate continued to apply downward pressure during the year, helped by a reduced global risk and liquidity surpluses from developed countries. The exchange rate appreciated by 9% in 2102 (EoP), showing signs of continuing to exert a similar pressure in 2013. Banco de la República remained alert during the year and intervened in the foreign exchange market, aiming to (partly) contain the currency's appreciation. The Central Bank's interventionism was clear in daily purchase programs, which were expanded periodically in accordance with market expectations and totaled USD 4.8 billion, the highest annual level of purchases since 2000. The daily purchase programs were accompanied by verbal interventions from the Ministry of Finance and the Central Bank, dollar purchases by the State Treasury, and interest rate cuts which, although in response to a curb in activity, might have contributed in a marginal way toward avoiding a greater appreciation.

Record purchases of international reserves were partly sterilized with the issue of COP 6 billion in monetary control bonds, issued by the Central Government and deposited at the Central Bank. This tool was used as we had anticipated three months earlier, helping to fulfill the foreign exchange mandate through price stability.

In 2013 and 2014 the high levels of international liquidity will continue to apply pressure on a currency appreciation. This will be backed by expectations of an increased portfolio investment flow following the reduction of taxes on offshore investments from 33% to 14% (25% if the country of origin is classified as a tax haven), with a limited intervention space (which we estimate at USD 5.5 billion during the year) and limited effectiveness on the regular behavior of the

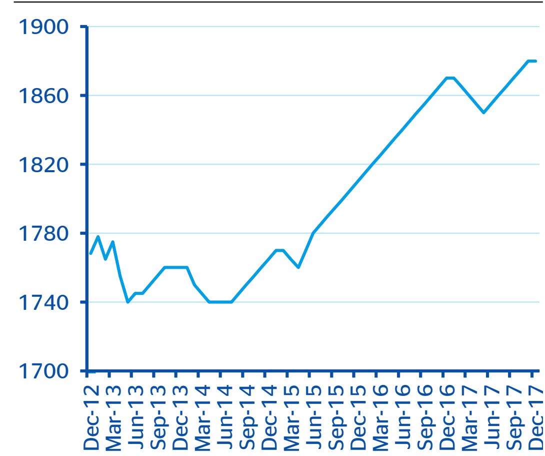
exchange rate. Although the Central Bank and the Ministry of Finance will continue to assume the quasi-fiscal cost of interventions, they seem to be less effective, with the risk of exacerbating the credit market's behavior and asset prices if they are not properly sterilized (see Vargas, González y Rodríguez. 2013). With the reduction in interest spreads and the withdrawal of international liquidity, the exchange rate is expected to go back to depreciating slowly to its long-term value of around COP/USD 1,880 (Chart 17).

Chart 16
Annual inflation and Central Bank intervention rate. As a percentage



Source: DANE, BanRep and BBVA Research

Chart 17
Peso/dollar exchange rate



Source: BanRep and BBVA Research

BanRep to commence monetary normalization cycle in 2Q2014

The recent interest rate cuts have slowly been transmitted to activity. The quickest transmission has been in the interbank lending and public debt markets, responding to and even anticipating movements in the Central Bank's cuts. The average rate of 90-day bank deposits (DTF) has been more inflexible to a decrease, which is nonetheless typical of the expansionary phase of the monetary cycle and historically has been witnessed in past cycles. The Central Bank will therefore have time to wait until its monetary stimulus is transmitted to the credit market. The total transmission should be completed around six months after the last cut has been made.

We expect the Central Bank to keep an expansionary stance in 2013, keeping its rates stable following the cuts made in the first quarter of the year. A persistent negative output gap (see Box 2) and low inflation will allow the Central Bank to keep its rate below the neutral level, allowing domestic demand to return to its potential growth.

Anticipating the gradual closing of the output gap and foreseeing some new inflationary outbreaks, the Central Bank is expected to reverse its monetary stance during 2Q2014, also responding to the normalization of foreign activity and a curb in fiscal uncertainty in developed countries. Locally, the most conclusive results regarding recovery in the final months of 2013 and 1Q2014 should encourage the Central Bank to slowly reverse its expansionary monetary stance, nevertheless being prudent in light of the incipient recovery of activity (Chart 17).

The increases in the policy rate are consistent with the trend in other central banks in the region, which will commence their increases in the first part of 2014. In the case of Colombia though, it is expected to be in an earlier phase of the activity cycle and therefore its monetary stance will reverse later than the other countries in the region which follow a target inflation scheme. The policy rate increases cycle is expected to end at 5.25%. We consider this to be neutral under a long-term inflation of 3%.

5. Economic policy challenges in 2013-2014

Colombia will continue to stand out in Latin America but will not consolidate its economic leadership if it does not make progress on some key issues in 2013-14

Colombia has positive growth prospects for the coming years, as mentioned earlier. The figures that we expect will mean that the country will continue to stand out in Latin America, but we believe that Colombia will only increase its growth potential and consolidate its economic leadership in the region if some public policy issues are resolved in the coming years. In many fields, these will be defining years in which we will put the institutional, political and economic changes introduced in recent years to the test, and the need to introduce further changes will become evident.

Breakthroughs in peace talks are hot on the political agenda in 2013-14 and the results could affect the course of some areas of public policy in the coming years. Debates will also be held during these years on institutional needs in political, social and economic terms in a country with a greater capacity for growth. Although we consider all of the above important, we will focus our analysis on economic policy challenges.

Reversal of the slowdown in short-term growth and strengthening of sources of growth

Our estimates show that the slowdown of the Colombian economy bottomed out at the end of 2012, and growth will gradually pick up in 2013. This forecast assumes that the bottlenecks in the oil and mining, public works and private construction sectors can be closed and they accounted for a small amount of the aggregate value during 2H2012.

In the case of mining and oil, the challenge is to maintain steady production levels and not repeating the supply shocks witnessed last year. Major issues related to transport and commodities must be solved in the coming years so that the transitory supply shocks do not become permanent and delay the sector's excellent prospects from materializing. We are moderately optimistic that this challenge can be met and insofar as labor conflicts or transport problems arise, such as those that have recently occurred in the coal sector, they will change our forecast in a negative sense.

In the case of oil, the challenge is to resume steady, high production levels and solve infrastructure needs that consequently arise. Major progress in the construction of oil pipelines and the design of new ones will be high on the agenda of authorities in 2013-2014.

As regards public works, in the coming years the new institutional system will be tested in terms of fourth generation (4G) concessions and the capacity to implement royalty resources on a local and departmental level. As far as new concessions are concerned, the breakthroughs made in the first stage of the project, which the authorities have called "early victories" and represent around 10%, will reveal whether the new institutional system is appropriate. In particular, the ability to attract major, first-class construction companies and the necessary financing are two of the issues on trial. The new concessions will have an insignificant impact on the economy's aggregate value during these years, but more importantly for the future, if things go well they will become a major source of growth for the Colombian economy in the coming years.

In the short term, the pace of implementation of public works underway needs to be stepped up and the method of posting them in the national accounts needs to be changed in order to reduce the uncertainty that this is causing for GDP.

Along these lines, following changes in legislation regarding royalties, the challenge is for municipalities, departments and/or regions to commence their implementation process in 2013 and contribute toward boosting the public works sector.

Strengthening an efficient and productive manufacturing sector

The manufacturing sector is expected to record low growth levels in 2013, based on almost zero growth during 2012. This poses challenges in terms of strengthening the sector's performance and preparing it to compete efficiently and productively under the new free trade treaties and the problems that a strong Colombian peso present. In particular, in keeping with some of the Ministry of Finance's decisions, the sector's entire cost scheme must be reviewed to increase its competitive edge. There have already been some breakthroughs, such as the elimination of the energy extra charges that the productive sector paid, but further reductions can be made in the cost of other types of energy that the manufacturing sector uses. In addition, and linked to the above challenge, improvements in road and port infrastructures and foreign trade logistics will help the sector to go back to contributing positively toward Colombia's growth and creating quality jobs.

Further improvements in the labor market

In relation to employment, the tax reform evaluates the expected benefit that reducing some of the payroll charges has on formal job hiring and helps to reduce labor costs. All of this has expected benefits on the manufacturing sector. The economy's challenge in terms of labor is creating good quality jobs in order to increase the workforce and avoid reducing it. The Government's policy is aimed in this direction. Proof of this are the Formalization and First Job Act and the recent reduction in non-wage costs included in the tax reform, which are aimed precisely at creating formal employment. The Government's estimates regarding formal employment creation as a result of the tax reform are between 400,000 and 1 million jobs. In accordance with Botero (2011) and Modragón, Peña & Wills (2010), we believe that the effects of cutting payroll taxes are a little lower, between 350,000 and 800,000 jobs.

6. Tablas

Table 3
Macroeconomic forecast annual

	2010	2011	2012	2013	2014
GDP (y/y %)	4.0	5.9	3.7	4.1	5.0
Private Consumption (y/y %)	5.0	6.5	4.3	4.7	4.8
Public Consumption (y/y %)	5.5	2.6	4.5	5.0	4.8
Fixed Investment (y/y %)	4.6	16.7	4.6	6.2	6.9
Inflation (y/y % EoP)	3.2	3.7	2.4	2.6	2.9
Exchange Rate (vs. USD, EoP)	1926	1934	1768	1760	1765
Interest Rate (%, EoP)	3.0	4.75	4.25	3.8	5.0
Fiscal Balance (% GDP)	-3.9	-2.9	-2.3	-2.3	-2.6
Current Account (% GDP)	-3.1	-3.0	-3.1	-2.7	-2.3

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

Table 4
Macroeconomic Forecast Quarterly

	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	2.1	3.1	1803	4.75
4Q12	3.0	2.4	1768	4.30
1Q13	3.3	2.2	1775	3.75
2Q13	3.4	2.3	1745	3.75
3Q13	5.2	2.4	1755	3.75
4Q13	4.4	2.6	1760	3.75
1Q14	4.8	2.7	1745	3.75
2Q14	5.1	2.7	1740	4.25
3Q14	4.7	2.9	1750	4.50
4Q14	5.5	2.9	1765	5.00

Source: DANE, BanRep and BBVA Research Colombia

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