Economic Outlook

Colombia

Second Quarter 2013
Economic Analysis

- **Global growth continues its steady recovery,** but uneven prospects for the developed economies are limiting the strength of GDP growth in 2013 and 2014.
- **The economy will gradually pick up pace at the end of 2013 and in 2014. We maintain our growth forecast for 2013 at 4.1%.** The negative effects of the first quarter will be fully offset by the greater economic policy stimuli.
- **The Central Bank will maintain current monetary conditions for the rest of 2013 and part of 2014.** There will be steady convergence of inflation towards the center of the target range in 2013 and 2014.

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Closing date: May 9, 2013

1. Summary

Global growth continues its steady recovery, but uneven prospects for the developed economies are limiting the strength of GDP growth in 2013 and 2014.

In the Euro Zone, the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling of the Portuguese Constitutional Court.

Leading indicators of the Colombian economy show low growth in the first quarter of 2013, similar to that of the second half of last year. At the end of 2012, the signs of stability in the economy came from private consumption, which increased its quarterly rate of growth from 1.2% in 3Q12 to 1.4% in 4Q12. However, the full positive impact of the lower Central Bank interest rates on household spending decisions will be effective in 2013 and 2014.

Starting in the second quarter, the economy will begin a gradual process of acceleration, which will consolidate in the third and fourth quarters with growth rates at above potential GDP levels. As a result, while in the first half year growth will be an annual average of 2.7% (2.3% in 1Q and 3.1% in 2Q), in the second half of the year it will speed up to an annual 5.4% (5.3% in 3Q and 5.5% in 4Q).

Overall, 2013 growth will be at 4.1%, the same figure as the forecast in our previous Colombia Economic Outlook. We expect the greater economic policy stimuli will fully offset the negative shocks of the first quarter. In particular, the PIPE plan will contribute 0.2 percentage points to growth in 2013, and the additional reduction of interest rates in 2013 will contribute 0.1 pp.

The boost to growth in the second half of the year will consolidate in 2014. Household consumption will continue to gain pace in 2014 to an annual 4.5%. This positive trend is the result of improvements in the labor market, with greater job creation.

Over the next few months, inflation is set to remain at the bottom of the target range. For the upcoming months, we expect inflation to remain in the lower part of the target range, with a slow year-on-year recovery in the second half of 2013. The main driver of recovery will be the low base prices already seen in 4Q12 and 1Q13. As a result, 2013 expected to end at 2.56%, with a swift return to the mid-point of the target range in 1Q14, and above this in 2Q14.

The current interest-rate scenario is compatible with the expected closure of the output gap in the second half of 2014. We expect the cycle of interest-rate cuts has reached its end. The intervention rate is already sufficiently expansive (a real 1.23% in April vs. a neutral 2.25%), thus providing monetary support to economic activity.

2. A more varied global scenario

Global growth continues its steady recovery, but the very different prospects for the developed economies are halting the strength of improvement in GDP in 2013 and 2014. Quarterly global GDP growth, estimated at 0.7% by BBVA Research at the start of 2013, will have been slightly over 0.6% in the last quarter of 2012, but available indicators point to a growing dispersion of activity, particularly between the most developed economies, where the euro zone is once more lagging behind the U.S. and even Japan. Emerging economies will continue to underpin global growth. Overall, **the rate of global growth in 2013 is expected to be at 3.3%, only 0.1 points above the figure estimated for 2012 (Chart 1).** In 2014, the rate will be close to 4%, although the risks continue to be downside.

In the Euro Zone, the recovery has been delayed until 2014, despite the role of the ECB as a firewall for financial tensions, aided by the boost provided to banking union. The ECB has been surprisingly effective as guarantor of the euro against shocks such as the disordered bailout of Cyprus, the political situation in Italy and the ruling by the Portuguese Constitutional Court. As a result, the markets and financial tensions have only reacted to these events to a limited extent (Chart 2). On the negative side, economic indicators show **a general cyclical weakness beyond the European periphery,** which justifies the ECB's recent **interest-rate cut.**

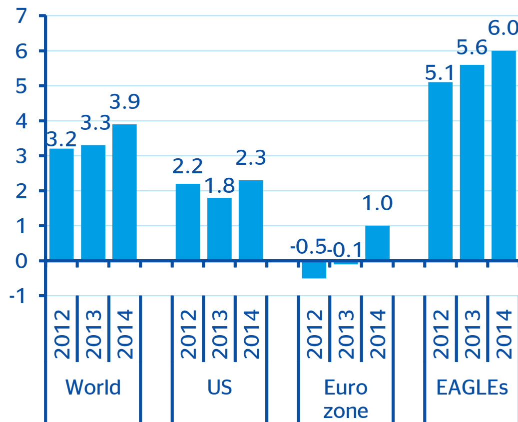
This is a positive measure, although it **is unlikely in itself to reduce the financial fragmentation** that is already having less impact on sovereign issuers and even large corporations, but is continuing to affect households and companies due to the **uneven operation of the banking channel.** The conditions of credit supply in the area as a whole continue to tighten while demand for credit is falling in peripheral countries. More is needed than the extension in the liquidity line for banks at least until 2014; measures currently being studied have to be implemented to boost finance for business, with the participation of institutions such as the European Investment Bank.

In this context, our scenario includes a downward revision of growth for the euro zone. We estimate GDP will fall by 0.1% in 2013 and rise 1% in 2014, 0.4 and 0.3 points, respectively, below the figure forecast in our January publication. In any event, the risks continue to have a downside bias. A key point is that Germany must not remain the only source of growth in the area thanks to its easy access to finance, high level of competitiveness and greater exposure to the best performing sources of global demand.

An additional consequence of the weakness of the European cycle is the growing debate on the appropriate level of fiscal consolidation. A path that achieves a credible timetable for cutting the deficit without leading to a short-term growth deterioration that makes useless the adjustment effort. The European Commission's support for the postponement of the public deficit targets in some European countries is in line with the idea of stressing the quality and composition of the fiscal adjustment and emphasizing structural reforms above short-term objectives. **What is Europe missing?** More determined progress towards banking union, shifting the debate on deficit targets to structural measures, and a firmer commitment to the reforms in the peripheral countries.

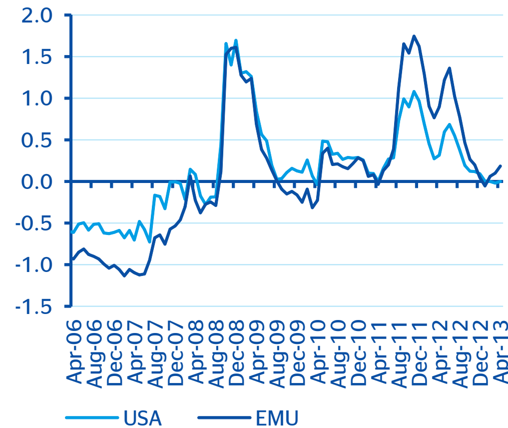
In the U.S., the strength of private demand is sustaining growth prospects despite the brake of fiscal adjustment. Uncertainty regarding fiscal policy in the short term has receded in terms of scenarios that included the closure of government offices (although without undertaking credible long-term fiscal consolidation measures). The elimination of some tax breaks and the entry into force of expenditure cuts have not triggered alarms in the financial markets (Chart 2), nor do they appear finally to have provided a substantial brake on private expenditure, thanks to **monetary expansion that is maintaining very favorable financing conditions** and is contributing to the improvement of income and wealth. Thus it is reasonable to maintain growth prospects for 2013 at 1.8%, despite the downward surprise of public demand in the GDP figures for the last two quarters.

Chart 1
GDP growth



The EAGLEs are the emerging countries that will contribute most to growth over the next 10 years. They are: China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research

Chart 2
BBVA Financial Stress Indicator



Source: BBVA Research

The Chinese economy has lost steam in the first quarter of 2013, with a negative surprise of weak investment, despite the greater strength of foreign demand and growth remaining in line with the government's target of 7.5% for 2013. The measures implemented to limit domestic financial fragility appear to have contributed to the slowdown. However, the change in the growth model towards a greater weight of consumption continues. With inflation also lower than expected, there is less pressure for making monetary conditions tougher, so authorities have room for maneuver given their commitment to sustainable growth for achieving the announced growth target. That is why our growth forecast for China remains unaltered at 8% for 2013 and 2014.

The path of sustained monetary expansion, which the Central Bank of Japan has now joined, involves challenging problems. The idea that investors looking for returns should move to more risky assets may favor valuations in some markets that are a long way from their long-term fundamentals, which could lead to disordered adjustments when the stimuli are withdrawn. This risk is growing because of the lack of coordination between the central banks with quantitative expansion policies, each of them looking to its respective domestic anchored inflation targets and sustainable growth. In the case of emerging economies, although for now they are supporting the major capital inflows well, it is essential to maintain vigilance over the domestic excesses this could generate.

3. Colombia: the economy will pick up speed steadily toward the end of 2013 and in 2014

Slowdown of economic activity in the second half of 2012

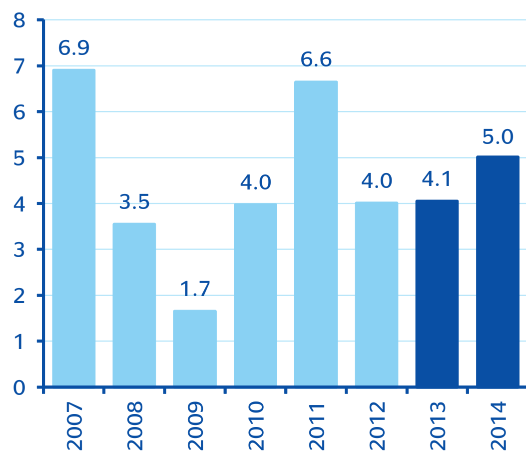
In 2012, the Colombian economy grew by 4.0%, slower than the 6.6% observed a year before (Chart 3). In line with expectations, economic activity continued a process of moderation, heightened in the second half of 2012, mainly in the investment and exports components. The year-on-year increases in these items fell from an annual 9.7% and 6.6% in the first half of the

year to 2.5% and 4.1% in the second half, respectively, with the result that GDP growth fell from 5.1% to 2.9% in the same period (Chart 4).

The main causes include the major slowdown in manufacturing industry, the supply shock in the mining sector in 3Q12 and the lower rate of execution of civil works. Civil works in particular led to a high level of volatility in the GDP, as they depended on not only the capacity for public management of investment, but also some methodological changes in measurement that has included new contractors in the quarterly sample.

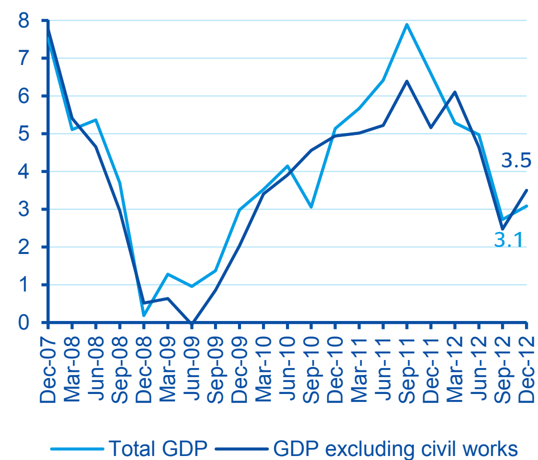
The sectors leading growth were oil, retail trade, transport and finance; i.e., as well as hydrocarbons, all the other leading sectors associated with the service sector. In contrast, there was less strength in agriculture and industry, particularly at the end of the year. These movements increased the difference between the sectors in the fourth quarter of 2012, when the tradable branches, excluding mining, recorded a fall, which had not taken place since September 2010.

Chart 3
Total annual GDP Year-on-year change, %



Source: DANE and BBVA Research

Chart 4
Total GDP and excluding civil works. Year-on-year change, %



Source: DANE and BBVA Research

Leading indicators show low growth in the first quarter of 2013, similar to that of the second half of last year

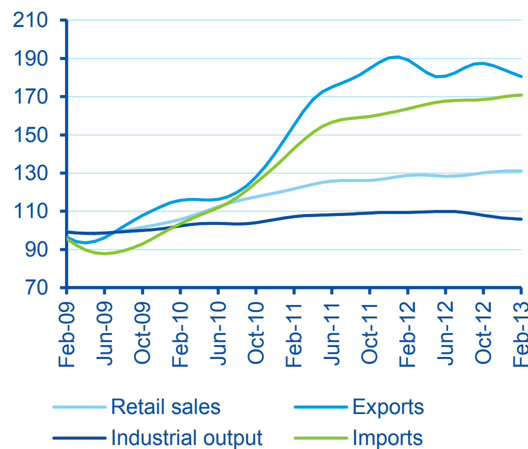
At the end of 2012, the signs of stability in the economy came from private consumption, which increased its quarterly rate of growth from 1.2% in 3Q12 to 1.4% in 4Q12. However, the positive impact of the Central Bank's interest rate cuts on household spending decisions will speed 2013 and 2014 growth. The effect will focus on durable goods, although there may be a special impact on car purchases, which is a market that has slowed in 1Q13.

In fact, there were two negative surprises between January and March. First, vehicle sales slowed significantly, with an annual fall of 18.5% in the first three months of the year. In addition, the supply shock on the mining sector, associated with labor and environmental decisions, limited the growth of coal output. The slowdown in vehicle sales restricted the incipient economic recovery, while reduced mining production cut exports. They also combined with the slowing trend in the manufacturing sector since the end of 2012 and the negative effect of fewer working days in the first quarter (Chart 5).

As a result, confidence in the economy suffered a setback. Although consumers maintained a positive outlook, even above historical averages, they reflected a deterioration in the evaluation of the current situation, only limited by the high likelihood to buy durable goods, which continues to grow in seasonally adjusted terms (Chart 6). In contrast, industrial opinions report low orders and a growth in inventories, while noting a limited utilization of installed capacity.

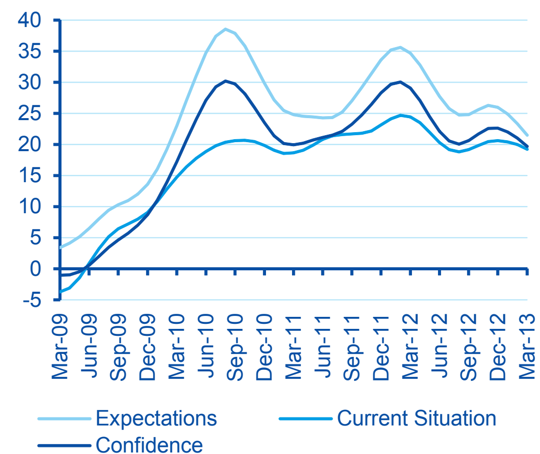
Industrial optimism has fallen despite the upturn in manufacturing exports at the start of 2013, mainly those from the medium and high technology branches. In addition, this was in a quarter with a high level of fiscal execution, at 17.6% of the annual budget, compared with 13.8% in 2012 and 13.0% in 2011. The expenditure items that grew most were investment in the transport and housing sectors.

Chart 5
Selected leading indicators. Seasonally adjusted indexes, Jan 09 = 100



Source: DANE and BBVA Research

Chart 6
Confidence: current situation and household expectations. Net responses



Source: Fedesarrollo and BBVA Research

We expect the economy to pick up pace starting in the second half of 2013

Starting in the second quarter, the economy will begin a gradual process of acceleration, which will consolidate in the third and fourth quarter with growth rates at above potential GDP levels. As a result, while in the first half year growth will be an annual average of 2.7% (2.3% in 1Q and 3.1% in 2Q), in the second half of the year it will speed up to an annual 5.4% (5.3% in 3Q and 5.5% in 4Q).

Several factors justify a recovery starting in the second quarter. First, the supply shocks at the start of the year will not recur, with more working days than in the same period of 2012. Second, the monetary stimulus will have a larger impact on consumption and investment, as it fully transmits to other interest rates. Third, the effects of the fiscal stimulus plan on productivity and employment (PIPE) will be largest at the end of the year, with a notable increase in private buildings construction (see Box 1). Finally, developed countries will begin a process of sustained recovery, which will result in increased exports and improved terms of trade for the Colombian economy, with particular support for industrial exports.

We are maintaining our growth forecast for 2013 at 4.1%

Overall, 2013 growth will be at 4.1%, the same figure as the forecast in our previous Colombia Economic Outlook. We expect the greater stimuli from economic policy to offset the negative temporary effects of the first quarter. In particular, the PIPE plan will contribute 0.2 percentage points to growth in 2013, and the additional reduction of interest rates in 2013 will contribute 0.1 pp.

The forecast for 2013 is based on expansion of 4.3% in private consumption, with relatively stable growth during the year; and 5.9% in private investment, with a notable change in speed between the first and second half-year (an annual 3.3% in the first half and 8.6% in the second half of 2013). There will also be a positive impact on civil works, which will grow at an annual

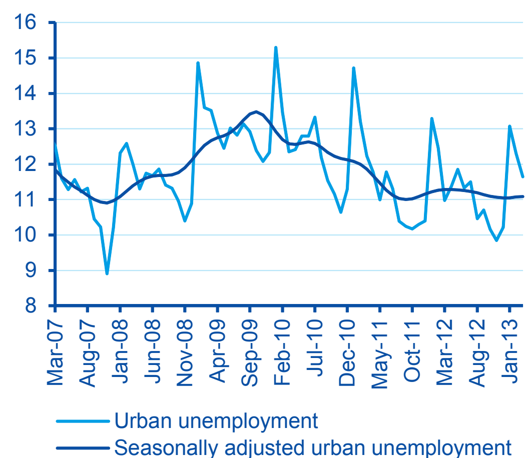
9.4% this year. However, they are also the biggest source of uncertainty in the forecasts for 2013 and 2014, as they depend on the level of execution of public and private infrastructure works, as well as probable methodological changes.

Overall, GDP growth will be supported by the strength of domestic demand, at an annual 4.5%, while there will be a negative impact from net trade given the steady upturn in exports, which will only be consolidated at the end of the year.

The boost to growth in the second half of the year will consolidate in 2014

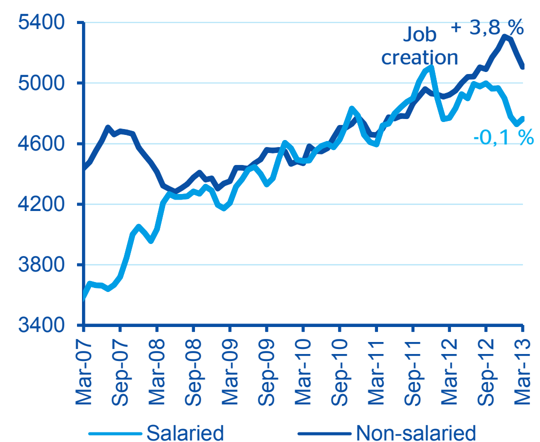
Household consumption will continue to gather pace in 2014 to an annual 4.5%. This strength is the result of improvements in the labor market (Chart 7), with greater job creation. While in 4Q12 urban employment grew at an average annual rate of 1.7%, in 1Q13 the average was 1.9%. In addition, employment of good quality led the changing trend in the labor market. Salaried workers increased as a proportion of total workers from 50.9% in 2012 to 51.7% now, due to a rate of expansion of an annual 3.8% in the first quarter (Chart 8). If this trend continues, the country's poverty and inequality situation will improve, with positive impacts on the formation of the middle classes and capacity for consumption (see Box 2).

Chart 7
Urban unemployment rate. As percentage of labor supply



Source: DANE and BBVA Research

Chart 8
Salaried and non-salaried employment. Number (thousands) and annual change, %



Source: DANE and BBVA Research

In addition, BanRep's interest rate cuts will support private consumption. According to our calculations, the additional 50 basis points by which the rate fell in March (a change not included in our forecast three months ago) will have a positive effect on consumption of 0.2 pp, which will in turn improve GDP by 0.15 pp in 2014. At the same time, the slower withdrawal of the monetary stimulus in upcoming years, given the lower level from which the new cycle of increases began, will provide additional support to domestic demand at the end of 2014. Finally, a marginal effect from the PIPE plan is expected in 2014, limited to the start of 100,000 new low-cost homes that are co-paid by the beneficiary families, and the reduction of stock in the middle-class real-estate market due to the interest-rate subsidy offered under the fiscal plan (see Box 1).

Overall, the Colombian economy will grow by 5.0% in 2014, with a significant contribution from investment and exports. Investment will pick up pace from 6.9% in 2013 to 7.7% in 2014, thanks to the consolidation of industrial recovery and its positive impact on commercial private investment. The improved global situation will support aggregate exports, which will help increase the benefits from the free trade agreements and speed up exports from 4.2% in 2013 to 7.0% in 2014.

In line with our forecasts for 2013 and 2014, the output gap with potential GDP will remain negative for the two years, although it will begin to close starting in the second half of 2013. The gap will close completely between the end of 2014 and the start of 2015, and will once more be positive at the end of 2015. The Central Bank will closely watch the economic dynamic in making its future monetary policy decisions and anticipating any inflationary pressure from the demand side.

The current-account deficit will remain at 2.9% of GDP in 2013 and 3.0% in 2014

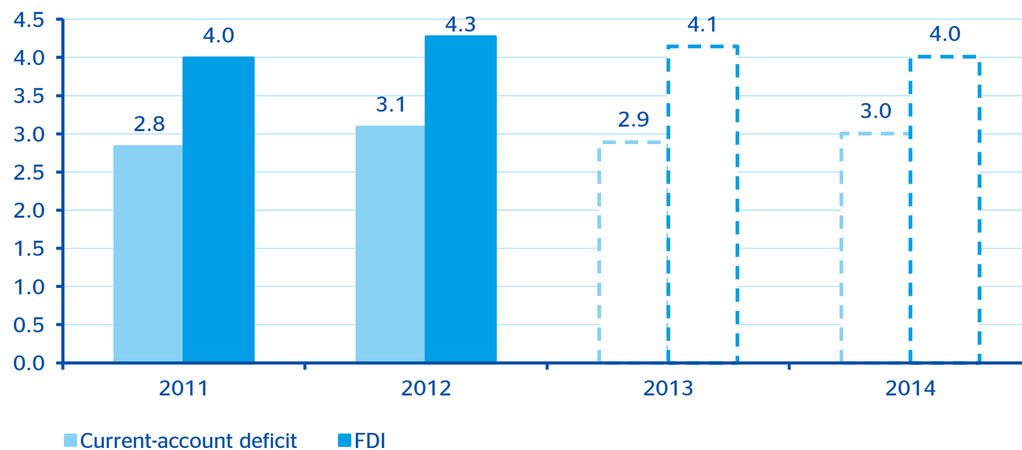
The current-account deficit closed 2012 at 3.1% of GDP, in line with expectations. In 2013 and 2014 the deficit will not be very different from this figure (Chart 9). The reduced terms of trade in these years compared with 2012 will be offset by moderation in imports in 2013 and the lower flows of profits abroad in 2013 and 2014.

However, comparing the new figures with our forecast three months ago, we estimate a greater current-account deficit, as we have reduced our expectations for exports of coal and industrial products. In the case of coal, the reduced forecast is both of volumes, due to the supply shock in the first quarter and the gradual recovery over time, and lower expected prices, as given by coal futures. Lower manufacturing sales are a result of reduced domestic activity in the sector and the slight downward correction in global growth, as we saw in section two above.

In any event, external capital flows will continue to be high and will easily finance the current-account deficit (Chart 9). In fact, according to our estimates, between 2013 and 2014 international reserves will increase by USD 12.1 billion thanks to FDI of USD 33 billion and high rates of portfolio capital inflows boosted by monetary expansion in developed countries.

Chart 9

Current-account deficit and foreign direct investment (FDI). Percentage of GDP



Source: Bank of the Republic and BBVA Research

Box 1. Expected effects of the Plan to Promote Productivity and Employment (PIPE)

The Government announced its Plan to Promote Productivity and Employment (PIPE), which will speed up economic growth through a package of policy measures.

The biggest boost will be for the housing sector. The Government has offered interest-rate subsidies for the purchase of 50,000 new homes worth between COP 80 million and 200 million. It also approved the expansion of the program of 100,000 homes, with subsidies on the initial payment and on interest rate for "Homes of Priority Interest" (under COP 42 million). Other measures with less impact include special credit facilities for the retail and agricultural sectors; faster execution levels of road infrastructure; incentives for the modernization of the freight vehicle fleet; greater control of smuggling; improvements in shipping ports; maintenance of a zero customs tariff for capital goods not produced internally; and an earlier than expected (by one month) reduction of payroll taxes approved in the tax reform.

Other measures will be regulated later, the most notable being the regulatory change governing the minimum return on private pension funds, and the diversification of the State pension portfolio FONPET, both designed to depreciate the exchange rate.

Emergency plan to contribute 0.2% to GDP in 2013 and 0.1% in 2014

The plan is ambitious with respect to the mortgage market, inducing an upward bias for construction and GDP growth in the second half of 2013 and in 2014. We estimate an impact of 0.2% on GDP in 2013 and 0.1% in 2014, creating 100,000 jobs, mainly in the construction sector. It will boost GDP growth in the construction sector by 4 pp in 2013 and 1.7 pp in 2014. The estimate is based on the experience of the counter-cyclical plan of 2009, which was successful in boosting activity in the face of a slowdown in external demand.

The interest-rate subsidy for 32,000 mortgages (extended to 50,000 in 2014) will speed the construction of middle-class homes, whose value-added has a significant impact on activity by creating incentives for the construction of medium-value homes. Equally, the start of construction of the 100,000 homes co-financed by families and the government will begin to have its main impact in 4Q13 and in 2014. Around 20% of the aggregate value is expected to be generated in 2013 and 80% in 2014. In addition, the 100,000 free homes currently being constructed will help (although to a lesser extent) the building sector, whose level of execution has been greater than expected, at 90% this year compared with the 50% budgeted by the Government.

Other measures with less impact, without strong support for the manufacturing sector

The other policy measures are not very different from those already budgeted by the government. The special credit facilities do not represent major support for the retail and agricultural sector, while the message of speeding up infrastructure works is similar to announcements made earlier. The maintenance of a zero customs tariff on capital goods is consistent with the extension approved in previous years, and does not involve a major difference compared with the expectations of the manufacturing sector. The measures to improve shipping ports and scrap metal processing may be desirable for competitiveness in the sector, but their impact is lower in macroeconomic terms.

Gradual impact of foreign-exchange measures

The shock measures are less than needed by the manufacturing sector. The main impact on the sector will be that derived from foreign-exchange measures, which we do not consider will occur quickly.

The implementation of foreign-exchange support measures will materialize through regulatory changes proposed by the Ministry of Finance, which, if approved, will be executed over a period of more than two years. In the case of the change to the minimum return requirement for AFPs, the government presented a project that will enter into force in 3Q14, which will require a steady realignment of the portfolio towards the purchase of foreign assets. The regulation does not oblige AFPs to purchase dollars, but it does encourage them to buy foreign assets to avoid not achieving the minimum returns set by benchmark portfolios. The measure is at the discussion stage, and there is uncertainty about when it will be approved.

The Government expects the measures as a whole to involve combined purchases totaling USD 5 billion by the FONPET and the AFPs. This level is high compared with the accumulated international reserves in 2012 (USD 5.4 billion), the expected accumulated level for 2013 (USD 6.5 billion) and the purchases programmed to May by the Bank of the Republic (USD 3.5 billion), with uncertainty in turn regarding the time when the portfolio realignment will be executed.

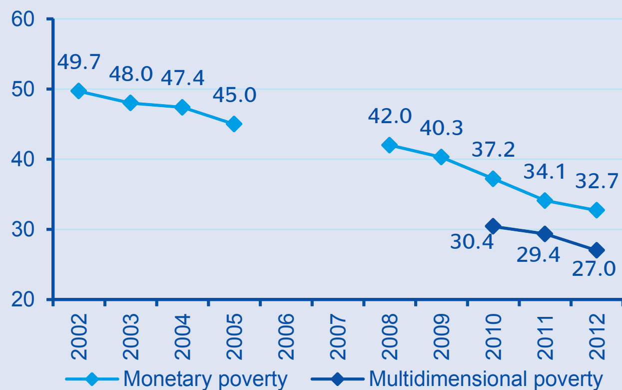
If the measure is approved as proposed by the Government, we do not expect it to impact the foreign-exchange market immediately. The realignment of portfolios will be gradual, and we do not consider that it will involve a sudden purchase of dollars (in less than a year) to the value expected by the Government. Equally, the measure does not oblige dollar purchases, so some administrators may choose to maintain their portfolios, if the expected values of risk-adjusted returns on current portfolios are higher than the benchmark portfolios biased for external assets.

Box 2. Poverty: lower rate and low convergence between the rural and urban areas

So far this century, poverty in Colombia has tended to fall, with significant results in terms of the number of people who have emerged out of it. Between 2002 and 2012 the number of poor people fell by 5.3 million, and the number of people in extreme poverty by 2.4 million. In percentage terms, poverty fell by 17 pp, from 49.7% in 2002 to 32.7% in 2012, and extreme poverty by 7.3 pp from 17.7% to 10.4% (Chart 10).

Chart 10

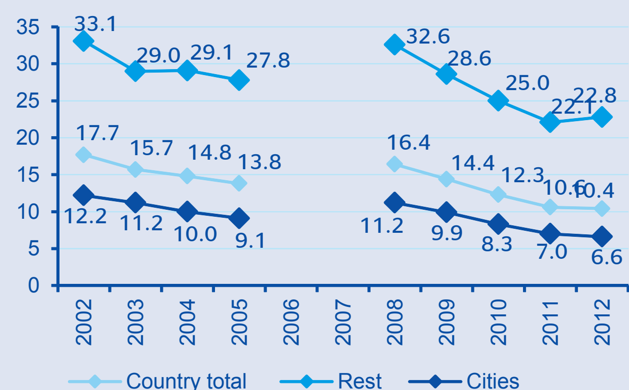
Rate of monetary and multidimensional poverty



* Poverty rate: % of the population who do not have a household per capita income to achieve an adequate standard of living, according in line with the geographical area. **The multidimensional poverty rate is based on five dimensions that involve 15 indicators. Households that are deprived in at least 5 of the 15 indicators are considered poor.
Source: DANE and BBVA Research

Chart 11

Rate of extreme poverty



* Extreme poverty rate: extreme % of the population who do not have a household per capita income to achieve subsistence level, in line with the geographical area. **Other: refers to rural areas, ***Cities: geographical area defined by an urban perimeter.
Source: DANE and BBVA Research

In addition, the Multidimensional Poverty Index (IPM), recently introduced in Colombia, has shown significant improvement in living conditions for the poorest people, with a reduction of the number of poor people by 1.2 million people between 2010 and 2012. This indicator has been in place since 2010 and complements the monetary poverty indicator, as it measures poverty directly in dimensions such as education, health, and living conditions. The main progress made between 2010 and 2012 was due to improvements in the living conditions of households, mainly access to health, primary infant care, educational achievement and improved housing infrastructure.

Rural-urban gap

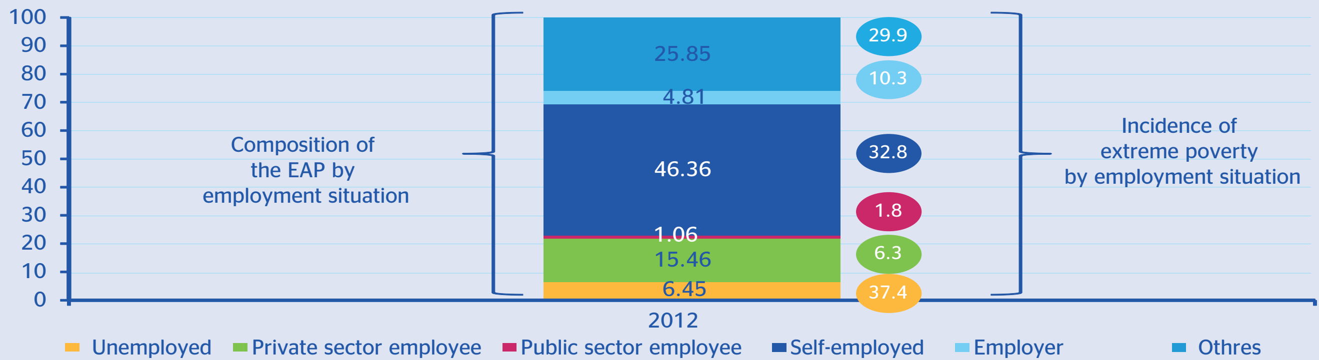
Despite the good results mentioned above, the social improvements over recent years have been impacted zones unevenly, particularly in terms of the difference between rural and urban areas. While in 2002 the incidence of rural poverty was 1.3 times that in the city, in 2012 this ratio increased to 1.6 times. In the case of extreme poverty the results are even more striking, with an average ratio for the period of 3 times, from 2.7 in 2002 to 3.4 in 2012 (Chart 11). To sum up, rural areas not only lag behind urban ones in terms of poverty, but this gap has actually widened, particularly taking into account that the poverty gap (measuring what income levels are required for poor people to reach the poverty line, or indigence line in the case of extreme poverty) in rural areas was 1.8 times that in urban areas in 2012, compared with 1.5 times in 2002. In the case of extreme rural poor, the gap was 8.4% in 2012, indicating that the average income was 8.4% under the extreme poverty line in the area. In the case of urban areas the indicator was lower, at 2.4%.

Reduction in the rate of falling poverty, extreme poverty and increased rural poverty

Another significant aspect to take into account is that the rate of the fall in poverty and extreme poverty slowed in 2012. Extreme poverty fell at an average annual 14% in the last 3 years, but only 1.9% in 2012. What is more, in 2012 the situation of extreme poverty worsened in rural areas, with an increase of 0.7 pp from 22.1% to 22.8% (Chart 11).

The question arises whether the slowdown in the fall in poverty is due to a weaker economy, or if it could also be explained by the lower impact that boom periods could have on poverty over time. In fact, once the more "contingent" poverty has been overcome, further reductions in poverty imply the overcoming of more "structural" poverty. It would be very useful in this respect to characterize the "sectors" that have posted increases in poverty levels, despite economic growth.

Chart 12
Composition of rural EAP and rate of extreme rural poverty by employment situation



Source: DANE and BBVA Research

In the case of the extremely poor in rural areas, for example, there is a high rate of extreme poverty among people who live in households with a head of household who is self-employed (32.8%) and those with jobs other than self-employed or salaried, which we have classified as "other" in Chart 12 (rate of 29.9%). These employment categories involve high rates of extreme poverty, and they also have a significant share in the structure of the economically active population (EAP) in rural areas. Thus, the "other" and self-employed categories account for 72% of the rural EAP. Combining this with the rural unemployed, who amount to 6.5% of the rural EAP, nearly 80% of the rural EAP is related to incidents of extreme poverty of 30% or more. In addition, in recent years there has been an increase in self-employment, which is the form of employment with the greatest rate of extreme rural poverty. Most of the extremely poor work in informal structures where it is more difficult to have an impact through economic growth and so require more focused policies.

Final reflections and challenges

The poverty rates over recent years show improvements in living conditions for the Colombian population. Between 2010 and 2012 1.7 million people emerged out of poverty according to the monetary poverty indicator, and 1.3 million people according to the multidimensional poverty index. However, data also show a lag between regions and suggest a challenge in terms of reducing extreme poverty, which slowed its rate of decline and even increased among the rural population. Given that most of the extreme poor work in informal structures where it is more difficult to have an impact through economic growth, reducing this type of structural poverty requires more focused policies.

4. Steady convergence of inflation toward the midpoint of the target range

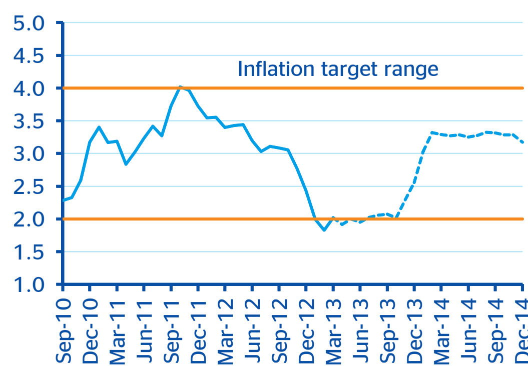
Inflation slows down faster in the first quarter of 2013

Inflation fell year-on-year in the first part of the year, due to various concurrent factors, among them supply elements, moderation in core inflation indicators and base statistical effects.

The supply shock came from the tax reform approved by Congress, which reduced taxes on gasoline and food outside the home. Food prices and regulated prices fell year-on-year, due to the reduction of international food and gasoline prices, although supported by high base prices following the cold spell in the first quarter of 2012 which had an upward effect at the time, mainly on food prices. Equally, moderation of activity helped limit core inflation indicators, but the slowdown was lower than that of the food and regulated components. The accumulated depreciation so far this year has led prices of tradable goods to rise, partly offsetting the fall in the other components of consumer prices.

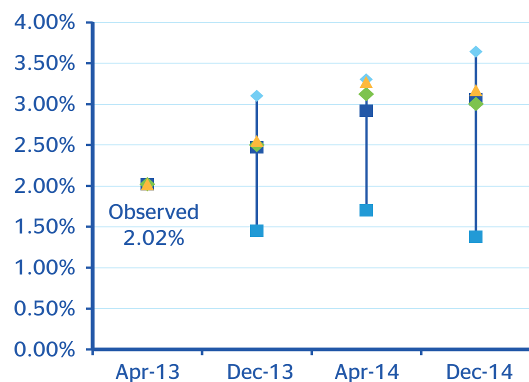
As a result, after ending 2012 at 2.43%, consumer inflation fell to 2.02% in April, having hit its lowest level in February, when it was 1.82%. Recently year-on-year rises in regulated prices have remained low (below 1% y/y), although stable and without prospects of continuing the slowdown of 1Q13. The core inflation indicators are no longer falling, with indicators of accelerating in line with a more dynamic growth prospects in 2Q13 compared with 1Q13.

Chart 13
Observed and forecast consumer inflation 2012-2014



Source: DANE and BBVA Research

Chart 14
Inflationary expectations for 2013 and 2014. Market range, consensus, 5 best informers and BBVA Research



Source: BanRep and BBVA Research

Over the next few months, inflation is set to hold at the bottom of the target range

For the upcoming months, we expect inflation to remain in the lower bound of the target range, with a slow year-on-year recovery in the second half of 2013. The main driver of recovery will be the low base prices already seen in 4Q12 and 1Q13, with 2013 expected to end at 2.56% (Chart 13) and a swift subsequent return to the mid-point of the target range in 1Q14, and above it in 2Q14. A stronger consolidation in economic activity and commodity prices will lead to indicators of core inflation and regulated prices (largely indexed to EoP inflation for 2013) boosting the recovery of inflation to the target range.

Market expectations are in line with the forecasts of BBVA Research (Chart 14), anticipating rising inflation starting in 2Q13, with a bias for exceeding the mid-point of the target inflation range in 2Q14 favored by low base prices already observed in 2013, together with a stronger recovery in economic activity.

The low base prices have an implicit risk factor for controlling inflation in 2014. If a supply shock (climate or regulatory) occurs, inflation could easily exceed the target range. This situation is not within our baseline forecasts, but they are a risk factor to take into account if there are unexpected supply shocks.

5. The Central Bank will maintain current monetary conditions for the rest of 2013 and part of 2014

The current interest-rate scenario is compatible with an expected closure of the output gap in the second half of 2014

The Central Bank has accumulated a reduction of 200 bps since July 2012 in its intervention rate, 100 of the pbs in the first quarter of this year. The policy actions responded to the fall in inflation and slowing economic activity. The latest rate cut was in March, at 50 bps, which was surprising in view of the new composition of the central bank's managing board, with two new members with a more expansive bias compared with those leaving.

The central bank has maintained a downward stance in the second half of 2012, with particular concern for the development of the manufacturing sector, and recently for private consumption. In an environment of controlled levels of debt burden and moderation in the growth of different credit portfolios, BanRep decided to support private sector debt in the face of the inflationary area and a negative output gap that demanded monetary and fiscal stimulus, such as that provided by the government. Equally, the Ministry of Finance mentioned that the lower interest-rate gap compared with other countries would favor the weakness of the COP, thus suggesting that the recent policy measures might have been also motivated by exchange-rate elements.

We expect the interest-rate cut cycle to have reached its conclusion. The intervention rate is already sufficiently expansive (a real 1.23% in April vs. the neutral 2.25%), thus providing monetary support to economic activity. This is consistent with the most recent press statements by the central bank, which has mentioned that both monetary and fiscal policy "will help ensure that output will be close to the productive capacity of the economy in 2013 and inflation will converge to the long-term target."

Some of the leading indicators due to be published in 2Q13 related to 1Q13 will once more be weak, but they should not lead to a further cut in interest rates. In fact, the Central Bank has already anticipated weak growth in the economy in 1Q13, which in turn will be consistent with its policy decisions.

The intervention rate will remain at 3.25% throughout the year, with a change in the monetary stance in 2Q14, accompanied by the steady closure of the output gap and a recovery in consumer inflation. Although the tone of the central bank is still downside, the expected trend in economic activity and its statements to the press suggest that an additional cut in interest rates will not be necessary. In fact, the main risk factor lies with an anticipated change in monetary policy, based on a swifter than expected upturn in inflation, given the low base prices observed in 4Q12. A swifter recovery of inflation to the target range could reduce real interest rates, in turn leading the Central Bank to increase its nominal policy rate.

The Central Bank will extend its dollar purchase program

The exchange rate has depreciated by 4% YtD. The weakness of the COP has led to increased intervention on the foreign-exchange markets by BanRep and the Ministry of Finance, and to macroeconomic factors that have weakened the inflow of dollars into the economy.

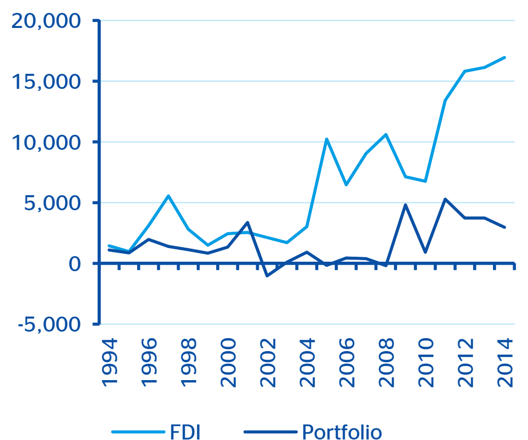
In January, the Central Bank undertook to carry out an intervention on the foreign-exchange markets through purchases of USD 3 billion between February and May this year. The intervention has been supported by the Ministry of Finance, which changed its financing structure, reducing its external borrowing and undertaking to pay part of its foreign debt early. Through its stake in the state-owned oil company Ecopetrol, the government also modified its financing structure in 2013, with a bias towards less foreign-currency debt.

The foreign-exchange measures have been combined with lower terms of trade after the reduction in international prices of coal and coffee, unexpected cuts in the intervention rate that helped reduce the positive interest-rate spread in Colombia compared with other countries, and a slowdown of foreign direct investment flows (though offset by greater portfolio entry flows). The moderation of FDI flows will be temporary, and in the future will continue to take the lead over portfolio flows (Chart 15).

Both the Central Bank and the Ministry of Finance have maintained a policy of weakening the COP. The Ministry of Finance and the General Director of the Bank of the Republic have made public that they consider the current exchange rate to be below its equilibrium level, which the Ministry of Finance estimates should be close to COP 1,950/USD. Thus, the foreign-currency interventionist stance is currently maintained. This will lead to both authorities to try to increase their current intervention on the foreign-exchange market.

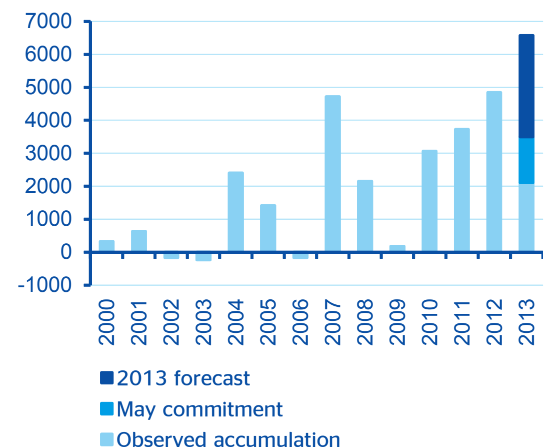
The Central Bank's main policy instrument has been the accumulation of international reserves. The current purchasing program ends on May 31, and we expect it to be extended through 3Q13, with a limited capacity for accumulation that we estimate at USD 6.5 billion, implying that the Central Bank will have room for intervention for the rest of the year of USD 3 billion (Chart 16). This room is based on the equilibrium level of the accumulation of international reserves that is consistent with the intervention level observed in previous years.

Chart 15
Foreign direct investment and portfolio flows (USD million)



Source: DANE and BBVA Research

Chart 16
Foreign-exchange market intervention by BanRep and expected accumulation of international reserves in 2013



Source: BBVA Research

Low expectation from the effects of the PIPE plan on the exchange rate

The government has presented a regulatory proposal that modifies the minimum return required from private pension funds (see Box 1). The minimum return proposed is measured as the lowest of a combination of benchmark portfolios within a 12-month horizon. The proposed portfolios are biased towards foreign assets, compared with the current composition of pension portfolios. The measure is under discussion with the pension industry. If it is approved it will enter into force in 3Q14.

The government expects pension funds to rearrange their portfolios through the purchase of around USD 4 billion (of a total of USD 69 billion assets under management) to match the minimum return of the benchmark portfolios, as the cost of obtaining a return below the minimum is significantly high for portfolio administrators. The measure is under discussion, but we expect that if it is approved, the realignment of the AFP portfolios will be gradual, over a period of more than two years (see Box 1). The foreign-exchange market has reacted to the measure with skepticism, suggesting that if the portfolios were realigned, their impact on the flow of dollar purchases would not be significant, but rather gradual. Equally, some local control bodies have already announced their opposition to the measure, arguing that pension assets should not be used as an exchange-rate instrument. This could in turn make it difficult for the Ministry of Finance to approve the measure, fearing a protest from the control bodies.

6. Extensive global liquidity and the European economic situation are the main challenges faced by the Colombia economy

Increases in liquidity at a global level will contribute toward greater appreciation

The US Federal Reserve has maintained its monetary stimulus for the economy, contributing to the current high levels of international liquidity. These excesses have been transferred to the fastest-growing emerging economies such as Colombia, reflected in a growth of 28% in portfolio income so far in 2013. The excess liquidity has put downward pressure on the exchange rate, and if this is maintained or extended, it could offset the recent weakness of the peso derived from lower terms of trade and the narrower interest-rate gap.

Although the US Federal Reserve will soon end its monetary expansion program, the Bank of Japan is to extend its monetary base at a level that is similar to the expansion granted by the United States through QE3. The excess liquidity will mainly affect Asia, with limited effects on Colombia. However, a greater than expected expansion could lead to a strengthening of the currencies in the region, including Colombia. Equally, it will lead to challenges in terms of controlling inflation, growth in credit and monetary control by the Bank of the Republic, which will have to maintain its control of target inflation anchored to inflation expectations without compromising economic growth.

Colombia maintains room for maneuver for fiscal policy in the event of global shocks

The greatest risk to global growth is the consolidation of a deeper and more lasting recession in Europe. However, the probability of this scenario has been reduced in recent months. The effect on the Colombian economy of this lower global growth would depend on monetary policy actions. Also, on the extent to which the global shock is passed on to domestic confidence and spending decisions in the country.

On the local front, BanRep extended its expansionary stance at the end of 2012 and in the first quarter of 2013, in an attempt to support domestic growth. However, this policy action reduced the Central Bank's capacity to tighten its countercyclical policy in case of a global shock. The Bank's intervention rate is 3.25%, lower than during the Lehman Brothers episode (10%), so in case of a greater external shock, Colombia could lose the use of its monetary instrument and face "liquidity trap" problems.

In contrast, there is ample fiscal policy room, which will allow the government to make use of its automatic stabilizers. The Government has reduced its fiscal deficit to a similar level to that before the Lehman Brothers shock in 2008 (-2.3% of GDP in 2012). As a result, the public sector's capacity to act is similar to what it had then. In other words, it will not have room to increase its public expenditure on its initial budget, but it will be able to maintain it despite lower tax revenues. In this way, unlike what happened in the 1990s and 1980s, the Government will not have to use fiscal adjustment during an economic slowdown.

Impacts of a greater slowdown in Europe on domestic growth

In the event of a global shock in Europe in the second half of 2013, the Colombian economy's growth rate would only be reduced to a limited extent. This reflects the expectations of an external shock of lower intensity than in 2008, its reduced probability of occurrence and the lower effect of such a shock on domestic confidence.

The episodes of intense external turmoil suggest such an impact would be limited. Following the bailouts of some European countries and weak output in the euro zone, business and consumer confidence remained high in Colombia, and limited the correction in domestic private expenditure.

Thus, given that growth has fallen back little and continues in positive territory, the current account may deteriorate and be more negative in 2014 than in 2013. This is the result of the greater contraction in exports since the end of 2013 with respect to the moderation of domestic demand. Domestic demand would receive the support of monetary and fiscal policy, while exports would face a significant reduction in the terms of trade and foreign demand for non-mining products. The depreciation of the flexible exchange rate, estimated at more than an annual 20% at the time of greatest global turbulence, would limit the increase in the current-account deficit, although it would not prevent a reduction of international reserves in 2014 of USD 2,231 million.

7. Tables

Table 1

Macroeconomic forecast annual

	2011	2012	2013	2014
GDP (y/y %)	6.6	4.0	4.1	5.0
Private Consumption (y/y %)	5.9	4.3	4.3	4.5
Public Consumption (y/y %)	3.6	5.1	5.0	4.8
Fixed Investment (y/y %)	18.7	6.0	6.9	7.7
Inflation (y/y % EoP)	3.7	2.4	2.6	3.2
Exchange Rate (vs. USD, EoP)	1934	1794	1825	1815
Interest Rate (%, EoP)	4.75	4.25	3.25	4.25
Fiscal Balance (% GDP)	-2.9	-2.3	-2.5	-2.6
Current Account (% GDP)	-2.8	-3.1	-2.9	-3.0

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

Table 2

Macroeconomic Forecast Quarterly

	GDP (y/y %)	Inflation (y/y %, EoP)	Exchange Rate (vs. USD, EoP)	REPO rate (%, EoP)
1Q11	5.7	3.2	1884.4	3.50
2Q11	6.4	3.2	1782.5	4.25
3Q11	7.9	3.7	1836.2	4.50
4Q11	6.6	3.7	1934.1	4.75
1Q12	5.3	3.4	1766.3	5.25
2Q12	5.0	3.2	1792.6	5.25
3Q12	2.7	3.1	1803.2	4.75
4Q12	3.1	2.4	1793.9	4.25
1Q13	2.3	1.9	1809.9	3.25
2Q13	3.1	1.9	1811.0	3.25
3Q13	5.3	2.1	1820.0	3.25
4Q13	5.5	2.6	1825.0	3.25
1Q14	6.9	3.3	1808.0	3.25
2Q14	5.4	3.2	1803.0	3.75
3Q14	4.6	3.3	1811.0	4.00
4Q14	3.2	3.2	1815.0	4.25

Source: DANE, BanRep and BBVA Research Colombia

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