Economic Outlook

Colombia

Third Quarter 2013
Economic Analysis

- **Growth slowed in emerging economies,** but a gradual recovery is consolidating in developed economies.
- **The Colombian economy lost some momentum in the first quarter,** but this did not compromise our GDP growth forecast of 4.1% for 2013. We expect growth to consolidate in 2014 to 4.7%.
- **Inflation will be slightly below the midpoint of the target range in 2013 (2.7%) and higher in 2014 (3.2%).** We do not expect a change in monetary policy until the second quarter of 2014.
- **The withdrawal of monetary stimulus in the United States may continue to generate volatility in local markets.** As the Colombian economy consolidates, we expect an appreciation of the Colombian peso in 2014.

Index

Closing date: August 13, 2013

1. Summary

The global economy is showing signs of a cyclical downturn, especially in emerging markets. The global economic scenario is less favorable than three months ago and has led us to revise our global growth forecasts to 3.1% for 2013 and 3.8% for 2014, 0.2 percentage points down on the previous quarter's forecasts.

Growth is recovering steadily in developed countries and an end to monetary expansion in the United States is in sight for mid-2014. Tighter financial conditions are due to market reaction to the Fed's announcement in May that it is starting to slow the pace of quantitative easing (QE3). If the United States economic recovery continues to strengthen, bond purchases are expected to decrease after September 2013. Quantitative easing is anticipated to end in the second quarter of 2014 and the first increase in Fed Funds rates is expected in September 2015.

Global uncertainty has generated financial volatility in Colombia, without major effects on macroeconomic fundamentals. The local financial market reacted to the announcement of the upcoming change of monetary policy in the United States. TES bond holders lost COP 11 trillion between May and June without this representing a systemic risk. Meanwhile, capital flows reduced temporarily, then regained, and even exceeded, the levels observed prior to the increase in volatility.

Colombia's GDP growth forecast remains at 4.1% for 2013, despite lower than expected domestic demand. Weak domestic demand in the first quarter is the result of a decline in private consumption and non-residential investment during the period, not offset by an upturn in investment in construction. However, GDP grew as expected due to a strong fall in imports linked to weaker private consumption and non-residential investment.

The growth forecast for 2014 is down from 5% to 4.7% due to weakened private consumption and a lower volume of coal and oil production. Slower expansion in private consumption is due to the reduced influence of low interest rates on the decision to purchase durable goods, partly because the devaluation process offset the benefits from lower interest rates. After 2014 we expect GDP growth to reamin above 5.0%, in line with its estimated potential level.

Inflation will remain at the lower part of the target range for 2013 and will reach 3.2% in 2014. June inflation was slightly higher than anticipated in April of this year and we have therefore revised our inflation forecast for December 2013 up to 2.7%. Stronger private consumption and a low comparison base in early 2013 will lead consumer inflation to end 2014 at 3.2%.

The output gap is expected to close at the end of 2015 with a gradual normalization of monetary conditions. We anticipate that Colombia's Central Bank will keep its intervention rate at 3.25% for the rest of the year, with an initial increase in April 2014. After this, a gradual increase is expected, reaching a neutral rate of 5.25% in 2015, consistent with the closing of the output gap.

An unexpected deterioration in global growth or a sudden contraction of global liquidity could jeopardize the local recovery. A greater than expected decline in China's growth, leading to a fall in global demand for basic goods, would affect the terms of trade and growth expectations for Colombia negatively in 2013 and 2014. On the other hand, if growth in the United States accelerates and there is steady growth in emerging economies, one would expect the Fed to withdraw its monetary stimulus, and financing costs for the region to increase.

2. Global environment: deceleration in China and uncertainty about the withdrawal of the stimuli in the U.S.

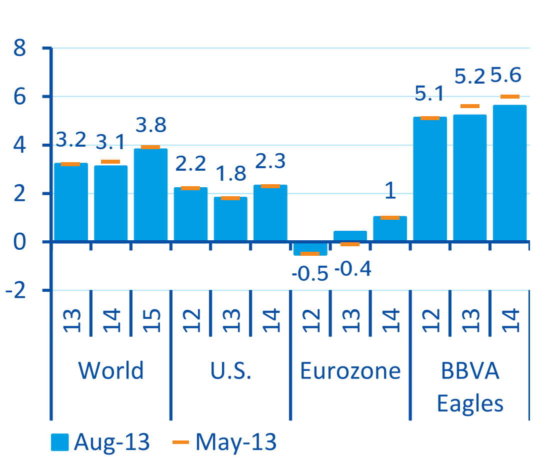
The global economy is showing cyclical weakness, above all in emerging markets, and is facing more difficult financial conditions

The global economic situation is less favorable than it was three months ago, when we issued our previous growth forecasts. We have therefore revised down our global GDP growth outlook to 3.1% in 2013, 0.2 percentage points below the forecasts three months ago. For 2014, we maintain our expectations of continued expansion, in this case at 3.8%, 0.2 pp below the figure we forecast in the last quarter. At least two reasons lie behind this deterioration and the resulting revision of our forecasts. First, the emerging markets are experiencing a sharper slowdown than expected, reflected in a greater downward revision of its growth forecasts (Chart 1). Above all, they include a more moderate growth in China, due to its global implications beyond Asia, for example on the South American economies. Second, there has been an unexpected event, at least at the time when it occurred: the tightening of financial conditions at a global level. This increased stress has been the result of market reaction to the communication of the details given by the Fed of its steady reduction and subsequent reversion of the third round of its quantitative easing program.

Making the markets used to less liquidity: the greatest impact will be on emerging economies with bigger short-term financing needs

Although the reasons for this may be varied, most of the shift in financing conditions at global level took place in mid-May, with the details announced by the Fed of its plans to limit and then put an end to its program of monetary expansion. The Fed has also reaffirmed its commitment to maintaining interest rates very low for an extended period and, perhaps more importantly, conditional on economic recovery: i.e. on the economy continuing at "cruising speed".

Chart 1
GDP growth in the main regions



* EAGLEs: Emerging and Growth-Leading Economies. The group is made up of China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan
Source: BBVA Research

Chart 2
Yield on 10-year US public debt (%)

Source: BBVA Research and Bloomberg

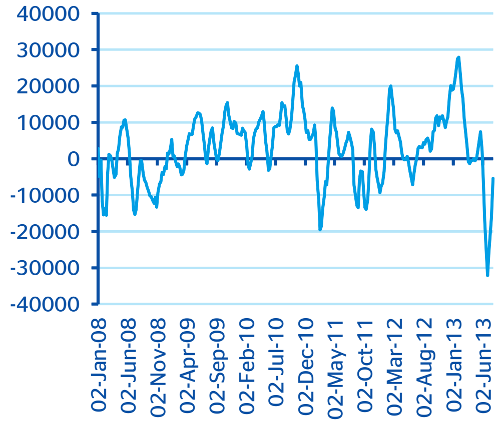
However, market reaction to this plan (even after being clarified in all its details) has been stronger than probably desired by the Fed. As can be seen in Chart 2, long-term interest rates increased by more than 100 basis points, while futures now discount the first rise in the monetary policy rate for the start of 2015, practically one year before it was expected two months ago. In our opinion, what has been seen in the financial markets is probably in part an over-reaction, as shown by recent downward moves in both long-term rates and expectations of shorter-term rates. Even so, the implementation of the mechanism has generated a process of restructuring of portfolios in the face of the end of abundant liquidity, and thus of extra demand for bonds that kept interest rates at exceptionally low levels. In our opinion, therefore, we are being faced with the start of a cycle of normalization of financial conditions, with higher interest rates and lower demand for risky assets.

Emerging markets have been most affected by the recent upsurge of financial stress. The situation has clearly reversed the positive funding conditions prevailing previously, with capital outflows from emerging markets (Chart 3). As well as falls in the stock markets and bond prices, there has also been a general depreciation in their currencies.

There are various factors behind these major capital outflows. As well as an immediate anticipation of the new global liquidity scenario through a restructuring of portfolios, the cyclical weakness of some large emerging markets and the growing risk of a steeper slowdown in China are factors pointing in the same direction. Moreover, monetary expansion in Japan has done little to generate the expected capital flows to emerging markets in search of higher returns.

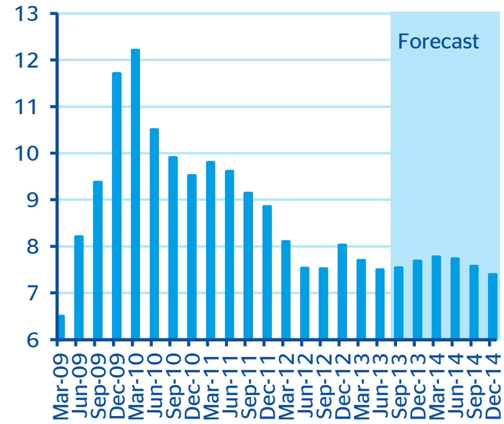
Overall, although the rate of capital outflow from emerging markets is very high, there are reasons for optimism. First, the most recent data on capital flows show more moderate outflows over recent weeks. Second, the profile of investors who have led the outflows is of a shorter-term investment horizon compared to that of institutional investors. Finally, the portfolio reorganization has to take into account that if we are moving towards an environment of lower central-bank support for liquidity, this is because the global economic cycle is tending to improve. We should also not forget the fundamentals that emerging markets have constructed in terms of their policy certainty and comparative advantages against the most developed countries with respect to their solvency ratios.

Chart 3
Capital flows to emerging markets (USD million, moving four-week average)



Capital flows to fixed-income and equity
Source: BBVA Research and EPFR

Chart 4
China GDP growth (y/y %)



Source: BBVA Research and CEIC

Slowdown in China: sluggish external demand and steps to limit indebtedness and the scope of shadow banking

The recent tightening in the Chinese interbank lending market is an example of the side effects of the Chinese authorities' efforts to limit rapid credit growth, both in the official banking sector and by the shadow banking, which is unregulated. The commitment of the authorities to achieve this goal has been made clear over recent months, as they have notably allowed a liquidity squeeze in the interbank system.

The baseline scenario is still one of a continued moderate slowdown (Chart 4). The measures taken to limit credit growth will act as a constraint to some extent, but even so, the Chinese authorities appear comfortable with current GDP growth rates, as they are the result of changes that make for more sustainable (and healthier) medium and long-term growth. Even so, we still consider that the government has room for maneuver if growth slips below official targets. The authorities have the instruments to prevent any accident to the financial system, at least in the short term, and we do not rule out new economic stimulus measures.

More diversified global risk events, but with less potential impact

This highly likely global baseline scenario still has some uncertain ranges somewhat more tilted towards the downside than to the upside, but with no high probability disruptive events that would prevent an outlook of at least sustained global growth in 2013 and 2014 near to 2012 levels. This diagnosis is a sign of a return to normality in the economic landscape.

The downside risks that could once again delay global recovery (relatively less likely than on other occasions) would be the persistence of events that complicated the outlook last quarter to the point of generating additional tensions in access to finance and a decline in the confidence of economic agents. This could be due to: i) a new, intense and continued fall in the price of risk-less assets like the U.S. Treasury bond as a result of a market less compliant with the wishes of the Federal Reserve; ii) a resurgence of doubts about the progress towards banking union and the "exceptional nature" of Greece; and iii) a sharper downturn in the Chinese economy amid its necessary process of economic rebalancing and adjustment of the size of its financial system. Although it is true that the authorities have room for maneuver to prevent "tail" events, the process of change faced by China is notable and requires extensive, ongoing and decisive reforms.

3. Colombia's growth forecast remains at 4.1% for 2013 but is reduced to 4.7% for 2014

Global uncertainty generates financial volatility, without major effects on macroeconomic fundamentals

The local financial market has reacted to the upcoming change of monetary policy in the United States. Expectations about lower global liquidity weakened the Colombian peso, in turn increasing risk premiums with respect to the developed world. The expected slowdown in purchases of US bonds by the Fed generated a steep climb in US Treasury bonds, which was transferred by arbitrage opportunities to the curves of emerging countries (Chart 5). The main financial variables showed a rise in volatility levels, given the uncertainty about the new monetary policy's timeline.

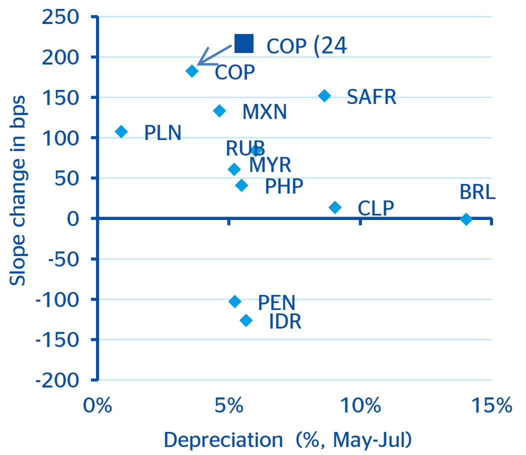
At the same time, a regulatory proposal was discussed in Colombia to modify the minimum return of pension funds managed by Private Pension Fund Administrators (the main local institutional investor). The proposal sought to diversify savings in the pension system, creating a bias towards uncovered foreign-currency investment instead of investment in local assets. The financial market took on board both pieces of news at the same time, adding two sources of uncertainty simultaneously.

The depreciation of the exchange rate against the dollar peaked at 9% through June, accompanied by a slower rate of portfolio flows ,but maintaining positive net inflow values. The depreciation was accompanied by a greater exchange exposure by private pension fund administrators (AFPs) (Chart 6), who earned the gains from depreciation and anticipated the regulatory proposal. Risk premiums – EMBI – increased from 130 to 200 between May and June, then corrected themselves to 179 in July.

The biggest reaction was seen in sovereign curves, with a sharp climb of 330 basis points (bps) for 1 and 10-year securities (110 bps in early May). Losses for TES holders between May and June totaled COP 11 trillion (down 8%), long-term bonds being the most affected. AFPs moderated their rate of sovereign exposure, presumably in response to the needs of greater exchange-rate exposure.

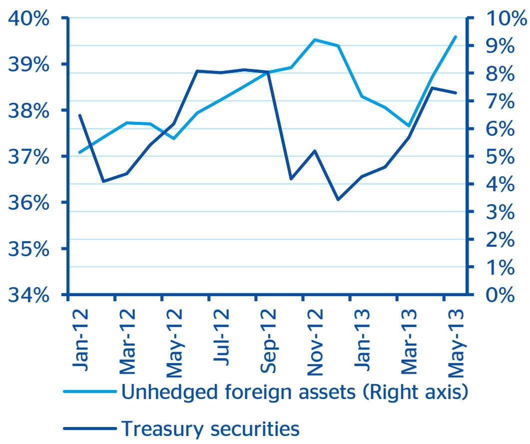
Increased tension was limited to the stock market, with some momentary difficulties in completing the sovereign issue plan, and moderation in corporate debt issues that sought to avoid the rising costs of indebtedness. Volatility and shocks in financial variables were partially corrected as a result of greater clarity about the course of withdrawal of global liquidity. The Ministry of Finance also played down the urgency of regulating the AFPs and therefore moderated this source of uncertainty.

Chart 5
Change in the curve and exchange-rate depreciation against the dollar (May 1-Jul 31) Selected emerging countries



Source: Bloomberg and BBVA Research

Chart 6
Exposure of AFPs to uncovered foreign currency assets and TES bonds % of portfolio



Source: Superfinanciera and BBVA Research

The situation was faced comfortably despite the increase in sovereign borrowing costs. High interbank liquidity allowed the banking sector to limit its level of financial stress. Some institutional investors saw gains drop in May and June (with a partial correction in July), without systemic episodes being generated for other players in the system. The average weighted cost of sovereign debt increased by 170 bps in May and June, with demand in debt auctions declining. The increase in the cost of borrowing, while important for future long-term debt issues, does not significantly compromise the stability of the fiscal balance.

In the coming months, the course of withdrawal of monetary stimulus in the U.S. and AFP regulation constitute a risk. Although the situation was tackled comfortably, a hasty removal in the future of monetary stimulus by the Fed, coupled with an accelerated implementation of AFP regulations, could affect the volatility of the financial market once again (see the section on monetary policy).

Capital flows to Colombia have remained strong

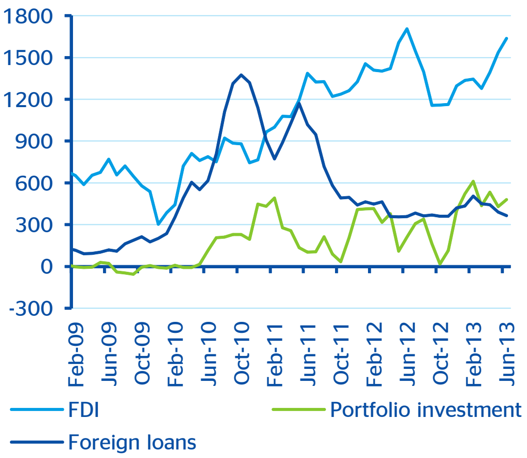
Colombia did not record any strong and persistent capital outflows during the period of increased U.S. Treasury interest rates. At this time (data for the end of July), total inflows are significantly above the value recorded in April, prior to initial market reactions to the possible cutback in the Fed's monetary expansion. Indeed, portfolio investments increased by more than 148% compared to the end of March, and by almost 60% compared to the end of April.

Foreign Direct Investment (FDI) reported in the foreign exchange balance also remained strong, with weekly inflows very similar to those observed in the first quarter (Chart 7). Results in this area suggest that investment projects, largely in mining and energy, depend on the economy's structural conditions and on expectations for global recovery, rather than on short-term variation in the markets.

GDP growth remained weak during the first quarter of the year

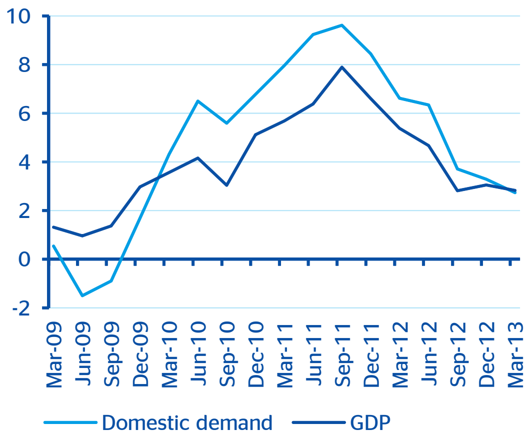
GDP growth stood at an annual 2.8% in the first quarter of 2013, which was higher than our estimate of 2.3%. However, this result came in a context of lower domestic demand and a consequent fall in imports, leading to a less negative effect from net foreign demand and a sharp plunge in inventories (Chart 8). Weaker domestic spending resulted from a bigger slowdown than expected in private consumption and a plunge in non-residential investment, which is mainly imported and was not fully offset by an upturn in investment in construction (Chart 9). Both public works and commercial and residential building experienced record growth of over 17% per annum at the beginning of the year.

Chart 7
FDI flows and portfolio for foreign exchange balance (Million USD)



Source: BanRep and BBVA Research

Chart 8
GDP and domestic demand Year-on-year change, %

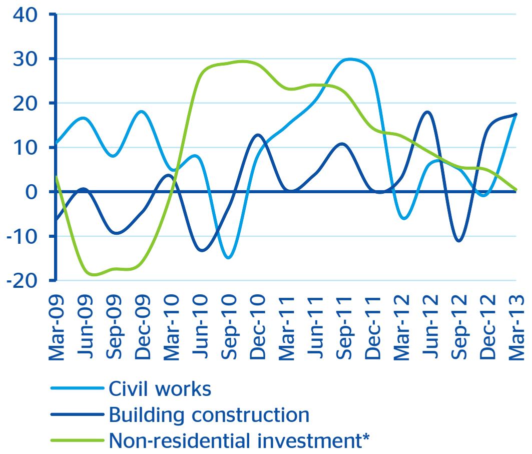


Source: DANE and BBVA Research

Exports, as expected, were slightly down because of the temporary shock in the coal sector and despite the improved performance of manufactured exports. Meanwhile, lower commodity prices also restricted foreign trade growth.

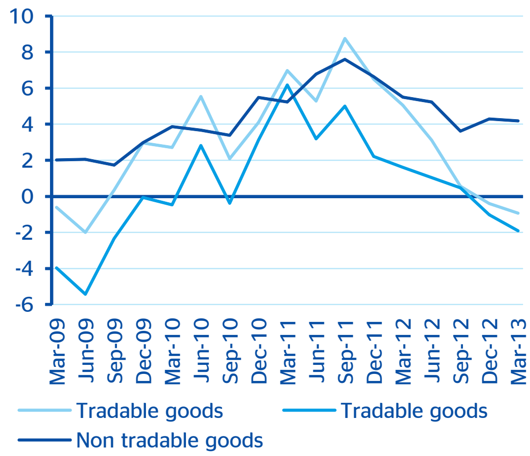
Exports could improve their outlook for the rest of the year. According to our estimates, average oil production will end this year at 1,041,000 barrels per day (up 7.1% compared to December 2012) and quarterly coal exports will be above the 2012 average (19.4 million tons) by the end of year (20.8 million tons).

Chart 9
Gross fixed capital formation by component
Year-on-year change, %



* Agriculture, machinery and equipment, transport equipment and services. Amounts to 48.2% of total investment
Source: DANE and BBVA Research

Chart 10
GDP by economic sector
Year-on-year change, %



* Tradable goods: mining, agriculture and manufacturing. Non-tradable goods: other sectors
Source: DANE and BBVA Research

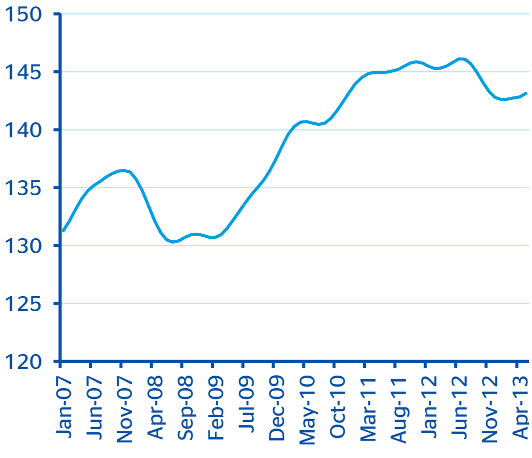
Manufacturing was the only sector to show a fall in production in annual terms, while the other tradable activities, agriculture and mining, grew below the average recorded in 2012 (Chart 10). The continued lull in the manufacturing sector, which has grown below GDP since 2007, may be associated with issues of productivity, as suggested by an average labor productivity indicator constructed on a monthly manufacturing sample. This indicator fell by 2% between June 2012 and May 2013, returning to levels seen in 2010 (Chart 11). Finally, the sectors heading GDP growth were construction (up an annual 16.9%) and, some way behind, social services (up an annual 4.5%).

Weak recovery of leading indicators in the second quarter of 2013

The second quarter saw continued differences between the growth of private consumption and non-residential investment. Indicators associated with consumption showed a stronger recovery, although limited by lower purchases of durable goods (5% of total consumption). In particular, vehicle sales this year have fallen 6.8% to July, and consumers did not show significantly more intention of buying durable goods until June, suggesting that the more sustained recovery will occur in the second half of the year. Indicators associated with the consumption of non-durable goods (33% of consumption), such as imports and retail sales, showed significant upturns.

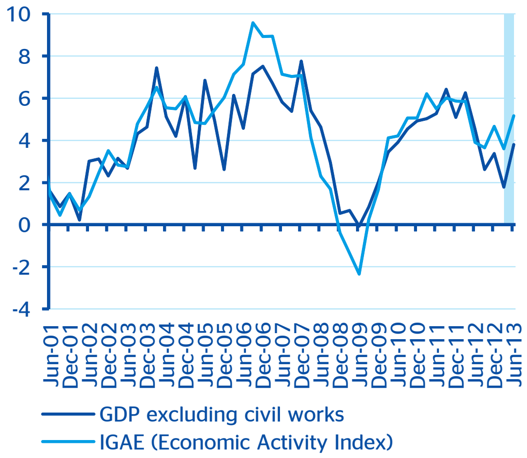
Investment indicators were less optimistic. Capital goods imports went from annual growth of 5.2% in the first quarter to an average fall of 2.1% in April and May. Moreover, utilization of installed capacity and the assessment of investment conditions remained below recent averages and the levels seen during periods of economic expansion. Similarly, the level of confidence in the manufacturing sector suggests that non-residential investment will not gain strength until the second half of the year. This is the conclusion of the most recent surveys, which show a more positive assessment of future economic activity than of current performance. The surveys show that economic activity in the sector is expected to grow for the next three to six months. In contrast, the assessment of productive activity in the second quarter was generally negative.

Chart 11
Average labor productivity in the manufacturing sector 2001=100



* Quotient between industrial output index and industrial employment index
Source: BBVA Research

Chart 12
General Economic Activity Index (IGAE) and GDP, excluding civil works. Annual % change



* The projection period for GDP excluding civil works is shaded.
IGAE (Economic Activity Index) data to May for 2Q13
Source: DANE and BBVA Research

One element that will support industrial recovery, and thus non-residential private investment, will be the increase in foreign and domestic demand (more moderate in the case of the latter). Total exports fell an annual 6.3% this year through May, but unevenly between mining and manufacturing. Mining exports fell 8.9% annually, while manufacturing exports remained stable with respect to the same period in 2012. Other highlights were the exports of medium and high technology industrial products (up 14.2% and 14.8% annually, respectively) and the acceleration of manufacturing exports in May to an annual 5.3%, though the total still fell by 2.5%.

On the domestic front, retail sales improved and, consequently, sales of consumer goods produced domestically. While between January and March real sales in this sector fell on average by 2.5% annually, between April and May they averaged a positive 6.6%. Therefore, the manufacturing sector is likely to respond in the future to the reduced inventories resulting from higher demand with increased production and greater utilization of installed capacity. However, this growth will remain sluggish as the manufacturing sector has lagged behind in responding to the economic recovery.

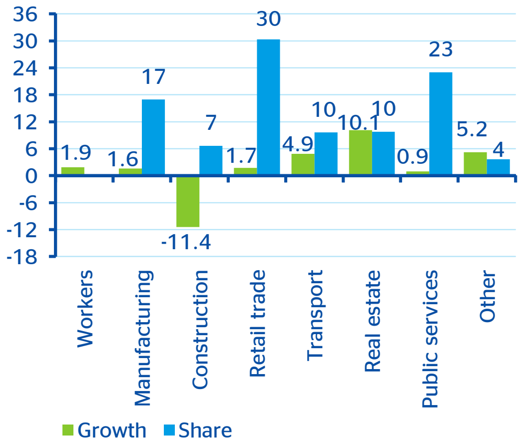
The economic activity index (IGAE) constructed by BBVA Research, summarizing the most important monthly leading economic indicators, shows the recovery is underway, mainly in indicators of consumption (Chart 12).

Finally, consolidation of the labor market will present a challenge to economic recovery. Job creation from September 2012 to June 2013 was slower (an annual 1.7%) than in the period from January to August 2012 (4.4%). While the trend was marginally corrected in the second quarter of 2013 to an annual 1.9%, this was not sufficient to improve employment quality, as the number of salaried employees is growing slower than the number of self-employed workers. An improved balance sheet for the construction sector and the recovery in manufacturing in the second half of the year should improve employment figures from now on (Chart 13).

Growth in 2013 will be less sustained by domestic demand

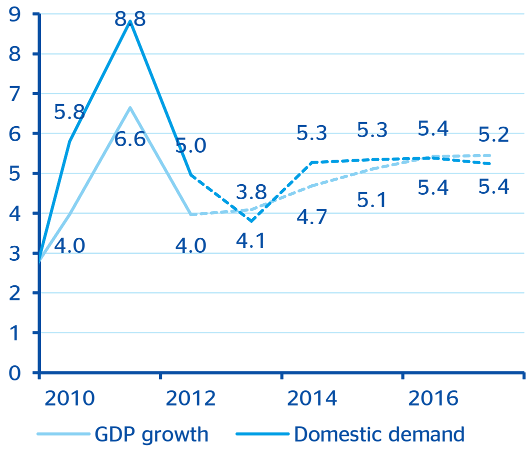
GDP growth in 2013 will remain at an annual 4.1%, a forecast identical to our estimate of three months ago (Chart 14). The expected expansion implies an acceleration in the growth rate in the second quarter, although still weak between April and June (annual 3.3%), then consolidating at higher rates starting in the second half of the year (5.0% on average). The greater buoyancy will come from the construction sector, both in housing and public works, which will contribute 1.2 percentage points to GDP growth, a contribution equivalent to the average seen between 2006 and 2008 in a period of high residential growth. The acceleration of growth in the second half of the year will also be supported by the low statistical base in the same period in 2012, when the economy grew just 2.9%.

Chart 13
Urban employment by economic sectors. Year-on-year change and breakdown to June, %



* Others include agriculture, mining, financial institutions and gas and water services
Source: DANE and BBVA Research

Chart 14
GDP and domestic demand Annual % change



Source: DANE and BBVA Research

For other components of GDP, such as private consumption, non-residential investment and exports, we expect a smaller change than previously forecasted. The downward adjustment of these expenditure groups is consistent with slower growth in the first quarter and the weak recovery of the relevant leading indicators. Overall, domestic demand will grow an annual 3.8% in 2013, a figure that would be below overall GDP for the first time since 2009 and lower than our previous forecast (4.5%). Offsetting this weaker domestic growth, imports will adjust up strongly. This has been verified by various data analysis techniques that show that the elasticity of imports to domestic performance is greater than one (Zuccardi, 2001, Oliveros and Silva, 2001), i.e. foreign purchases overreact to a slowdown in consumption and domestic investment.

The outlook for exports this year is positive, but less so for GDP. Its growth will be limited by a lower growth in manufacturing industry (and its foreign sales), the slow recovery of mining production after the supply shock in the first half of the year, and lower commodity prices. In total, exports will expand an annual 3.7% and imports 2.7%.

The Colombian economy will grow 4.7% in 2014

In 2014, the economy will continue on its process of recovery to reach annual growth of 4.7%, slightly less than the 5% we estimated in May. The downward revision is explained by lower private consumption and, to a lesser extent, by a decrease in volumes of coal and crude oil, in line with the less optimistic estimates of the medium-term fiscal framework (MTFF) presented by the Colombian Government. In turn, slower expansion in private consumption is a consequence of the low interest rates not having had much effect on the decision to purchase durable goods, partly because of the currency depreciation at the beginning of 2013, which will be maintained, though more moderately, in 2014.

Overall, private consumption will grow an annual 4.1% and private investment 7.7%. Private investment will combine the recovery of non-residential investment – in light of better manufacturing performance and progressive closing of the output gap – with the positive effects on the construction industry of economic policy: low interest rates for middle-class housing and the construction of 100,000 homes for poorer members of the population as part of the Plan to Promote Productivity and Employment (PIPE). At the same time, exports recovered strongly (an annual 6.2%) due to the better economic performance of the United States. FTA ties will be strengthened in the future with the U.S., which accounts for around 35% of exports. Finally, the recovery of domestic demand (to an annual 5.3%) will imply improved imports (up 8.0%).

Our estimates of public investment in 2014 are contingent on the success of the 4G strategy in initiating major infrastructure projects and on the implementation of projects in the country's major mining companies, including Ecopetrol. The government has taken a first step in this direction by announcing the sale of its stake in ISAGEN (the energy generating company), which would raise about COP 4.5 trillion to finance 4G works.

In line with our forecasts for 2013 and 2014, the output gap with respect to potential GDP will remain negative in both years, but will begin to close in late 2014. As a result, some inflationary pressures would begin to appear on the demand side influencing the stance taken on monetary policy, as discussed below.

In the medium term, after 2014, we expect GDP growth to be above 5.0%, in line with estimated potential growth. With this, the Colombian economy will be able to close its output gap completely sometime between late 2015 and early 2016. The Central Bank's interest rate will therefore have to reach its neutral level prior to these dates to avoid inflationary pressures.

The current-account deficit will remain at 3.1% of GDP in 2013 and 2.7% in 2014

We have revised up our forecast in the May report for the current-account deficit in 2013, from 2.9% of GDP (Chart 15). Two reasons support this decision. First, the terms of trade, especially crude oil and coal prices, will be below those seen in 2012. Second, the volumes of exports of these two goods will be lower than estimated three months ago. However, widening of the deficit will be reduced by the damping effect, albeit partial, of lower imports and lower flows of profits abroad.

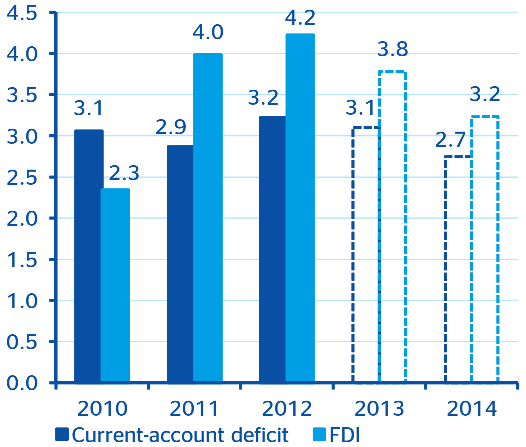
This latter component of the current account will continue to reduce until 2014, due to lower revenues received in 2013 by companies in the mining and energy sector, leading to the external deficit for the next year being reduced to 2.7% of GDP.

Foreign Direct Investment (FDI) will continue to be the main source of financing the current account, although we expect flows to return toward historical averages. While FDI in 2012 stood at 4.2% of GDP, this year it could fall to 3.8%, and in 2014 to 3.2%, of GDP, still exceeding the current-account deficit, but less comfortably than before. In terms of value, these lower percentages imply average annual falls of 8% in the two year. Nevertheless, the amounts are among the all-time highs for the country (second highest in 2013 and fourth in 2014).

If the recent trend continues, FDI will be less concentrated in mining and crude oil in the coming years. These two sectors' share of total FDI reached a peak of 76.4% in 2009, when other sectors were badly affected by the global and domestic economic slowdown. A process of systematic reduction of this proportion then began. It fell to 44.7% in the first quarter of this year, which reflected a recovery of flows to sectors other than commodities rather than a fall in flows to the latter.

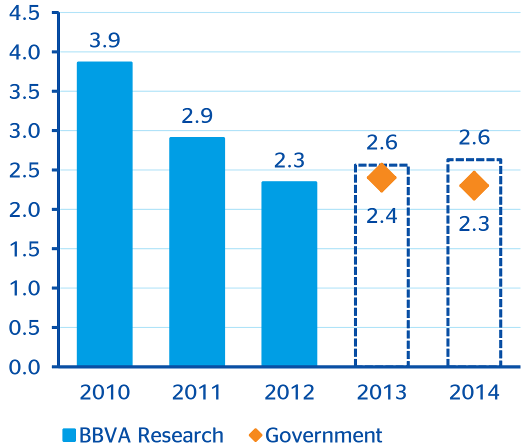
Another important source of financing will be portfolio capital, which will be taxed at a lower rate on its returns in Colombia, according to the tax reform in late 2012. The tax reduction set was from 33% to 14% for capital from countries not considered a tax haven, and from 33% to 25% for investments from tax havens. The regulations governing which countries will be put on one list or the other have not yet been issued by the Colombian Government, but this new regulation is certain to remove the negative differentiation between this country and its peers in the region with regard to taxation of foreign capital.

Chart 15
Current-account deficit and financing
As percentage of GDP



Source: Banco de la República and BBVA Research

Chart 16
CNG* Fiscal deficit: BBVA Research forecast and National Government. Percentage of GDP



* Central National Government
Source: MinHacienda and BBVA Research

Lower revenues will affect the fiscal deficit forecast for 2013 and will require spending cuts in 2014

The downward revisions of domestic demand and mining exports in 2013 led to a reduction in tax revenues and capital income for 2013 and 2014. As a result, we anticipate a slight increase in the fiscal deficit for 2013 to 2.6% of GDP (Chart 16). In 2014, a cut in spending of 0.6% of GDP announced by the government will offset lower tax revenues, keeping the deficit at 2.6% of GDP. Our forecast is slightly different from the Government's, which anticipates higher GDP growth in 2013 (4.5%). This would lead to higher tax revenues, to be disbursed in 2014.

The public works that will contribute to the good position of construction this year are related to the development plan, road maintenance, projects funded regionally through royalties, the national budget and resources allocated through the Productivity and Employment Enhancement Plan (PIPE). This schedule does not yet include large infrastructure objectives outlined in the fourth generation (4G) agenda, which would not affect growth until the second half of 2014.

The good outlook for investment in 2014 will be maintained despite a reduced public investment budget for this year, down to 5.2% of GDP from 6.1% of GDP in 2013, according to the draft budget. The new government proposal means that the annual value assigned is down by 7% on 2013, with a fall of 0.4 points of GDP compared to the figure estimated for 2014 in the 2012 MTFF. However, this does not preclude the possibility of maintaining future commitments that were established previously, amounting to 1.5% of GDP. Works include road and airport infrastructure concessions (0.3% of GDP), housing policy (0.1% of GDP) and mass transit systems (0.03% of GDP), with budget allocations that would, in any case, represent a fall of 3.7% on what was approved for 2013.

Growth risks for the Colombian economy remain manageable

As in the global scenario, our baseline scenario of economic recovery, as set out above, has a high probability of occurrence and the most recent data seems to point to its consolidation. However, the economic recovery could have some low probability risks.

First, a sharp drop in asset prices in the United States, causing a considerable increase in interest rates in Colombia, would limit transmission of the expansionary monetary policy to economic activity and would delay the process of improving investment and the consumption of durable goods. Second, taking longer to find solutions to key institutional issues in Europe, such as banking union, would have only a limited effect on Colombia in the context of a recovery in the United States, the country's most important trading partner by far. Finally, a slowdown in the Chinese economy would affect mining exports through lower prices, adding to the importance of the manufacturing sector's performance.

Meanwhile, domestically attention needs to focus on the pace of execution of public investment. This factor will serve to verify the construction sector's positive contribution to economic recovery in the second half of the year. The outlook seems clearer than in past occasions. This year income from royalties has been better managed and transferred through the DNP and, according to the public budget execution report, the pace of expenditure is faster than the average for the last 10 years, very close to the best execution levels in 2008. Finally, the mining sector's performance will depend on overcoming certain bottlenecks related to labor, which have emerged in recent months.

Box 1. Outlook for the Free Trade Agreement with the European Union

After four years of negotiation, Colombia and the European Union signed a free trade agreement aimed at strengthening trade relations between the two economies. The agreement is another of the Colombian trade initiatives that seek to improve its poor level of openness compared to peers in the region and emerging economies (Exports and imports of 40% GDP; 50% in Latam; 73% in Chile).

Under the treaty, the average tariff applied to European exports to Colombia will be reduced from 14.2% to 0% within eleven years, the biggest reduction being applied in the first year of the Agreement. The change will be less for the tariff on Colombian exports to Europe (from 4.2% to 0% within ten years), as a large proportion of the tariff headings already had preferential rates.

Impact studies are not very recent, but they are conclusive in pointing to the treaty's positive net effect. The impact on growth in Colombia is estimated to be between 0.2% and 0.6% of GDP in the short term and between 0.5% and 1.3% of GDP in the long term. However, the impact on Europe is modest compared to the size of its economy. In terms of sectors, the treaty represents an opportunity for agricultural products, some of them (e.g. fresh fruit and vegetables) being among the most protected by European commercial law.

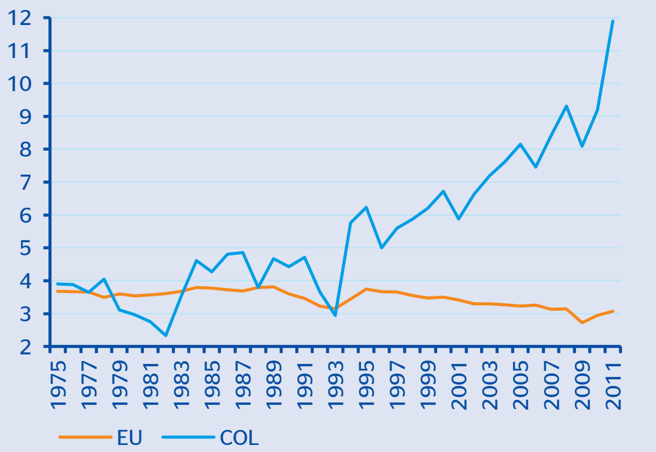
With regard to the manufacturing sector, impact studies indicate a positive net effect for Colombia in the auto parts and metal products sectors, with the possibility of absorbing the effect on manufacturing technology, machinery and equipment, since these sectors show a net gain for Europe.

This is consistent with the current pattern of Colombia's trade with the EU (Chart 17), where there is a strong relative advantage compared to Europe with a trade surplus in the agricultural sector, while the country will have potential to take advantage of Europe's industrial strength, as shown by the current trade deficit in the sector.

Chart 17
Trade balance of Colombia with the EU by product group (% GDP)

Source: Mincomercio, DANE and BBVA Research

Chart 18
Exports & imports of services %GDP



Source: World Bank and BBVA Research

The services sector has a high level of complementarity between the economies. In the past two decades, Europe has become a region with a significant level of openness in the service sector, and strong tourism, financial, professional (e.g. consulting) and logistical services. Meanwhile, with the mining and energy boom, Colombia has specialized in the trade of goods, without significant progress in trade in services (Chart 18). It is precisely in these fields that impact studies anticipate net gains for Europe, with Colombia in turn benefiting from European skilled labor for the provision of services with high human capital content.

Further consolidation of the trade agenda remains for the future. Trade openness in Colombia remains low, with limited trade with some important regions such as Asia. Given the recent weakness in the manufacturing sector and signs of high foreign competition in the local market, the government announced that it will slow the pace of new trade agreements in the future. The decision is unfortunate, given Colombia's high potential to benefit from the productivity and efficiency gains of free trade by signing treaties with strategic countries.

4. Inflation leaves room for low intervention rates until 2014

Inflation will gradually increase in the second half of the year, but well within the target range in 2013 and 2014

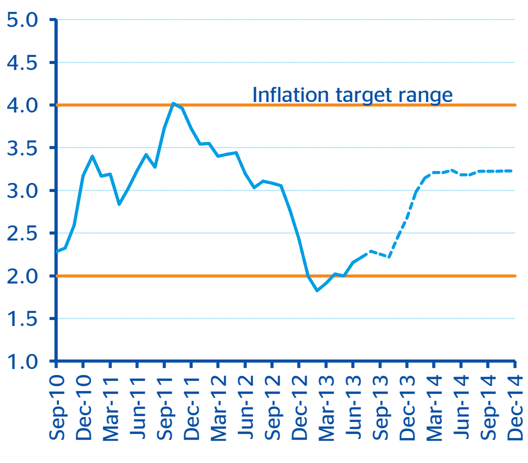
After surprising downturns in 1Q13, consumer inflation began to take an upward path. Between January and March, inflation fell momentarily below the target range (2%-4%), after specific shocks in administered prices, higher base prices and a moderation in core inflation indicators. These temporary effects having been overcome, inflation throughout 2Q13 has shown year-on-year increases, some slightly higher than expected by the market consensus.

The main driver of inflation in 2Q13 has been administered prices, backed by a strong drive to lower base prices in June and July 2012. Meanwhile, food prices have remained low (around an annual 1.4% on average during the quarter) and the acceleration of core inflation at the end of 2Q13, while moderating its fall, has not been strong enough to provide greater dynamism to aggregate prices.

In the coming quarters we anticipate sustained increases in inflation (Chart 19), but without fears arising from significant inflationary pressure, ending the year at 2.7%. Core inflation indicators should gain momentum with the recovery of private consumption, while 4Q13 should find new support in the low base prices of a year before. We anticipate that the recent currency depreciation will be transmitted to a limited extent to consumer prices. BBVA Research calculations have found that a depreciation of 10% is transmitted significantly to producer prices (about 2.5%), while the transmission to consumer prices is less clear, at around 0.2% in the long term and 0.1% in the short term. Therefore, if the depreciation seen so far this year continues, it should have an impact of 0.12% in the long term (Chart 20).

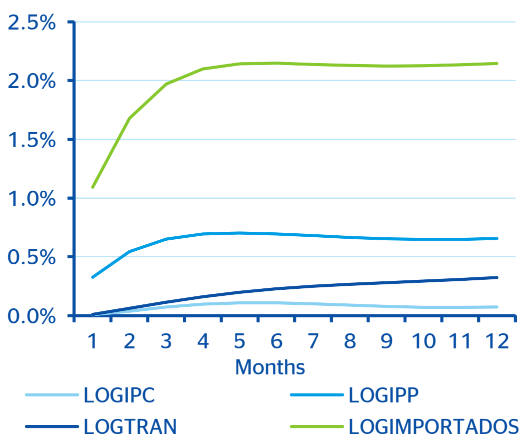
For 2014, we anticipate a more consolidated increase in consumer prices, exceeding the mid point of the target range (3%). Higher inflationary pressures should result from increased momentum in private consumption, the low price base from early 2013 and significant room for an upturn in food prices, with the result that consumer inflation will close 2014 at 3.2%. Subsequently, inflation will reach its long term value of 3%, consistent with the mid point of Colombia's Central Bank target.

Chart 19
Observed and forecast consumer inflation 2010-2014 (%)



Source: DANE and BBVA Research

Chart 20
Transmission of a change of one standard deviation (4%) in the exchange rate to main prices



* LOGIPC: natural logarithm of the consumer price index, LOGIPP: natural logarithm of the producer price index, LOGTRAN: natural logarithm of the tradable goods price index, LOGIMPORTADOS: natural logarithm of the producer price index of imported raw materials
Source: BBVA Research

The current intervention rate is consistent with the output gap closing in 2015 and a change in monetary policy from 2Q14

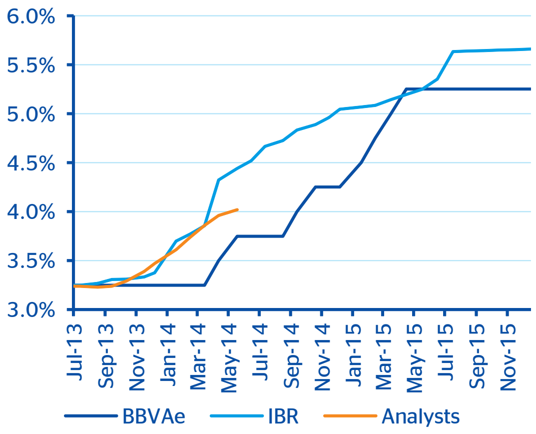
The Central Bank has maintained its expansionary stance since the rate cuts in 1Q13. The bank's tone has been one of cautious optimism, recognizing that output remains below its potential level, and that, although leading indicators show a better growth in 2Q13 than in 1Q13, the recovery is not strong enough to initiate a change to its expansionary stance. There is uncertainty about when the Central Bank will make its first interest rate hike.

The consensus among market analysts is that the first change in the monetary stance is to take place between 4Q13 and the first months of 1Q14. We believe this to be rushed, given the dampened momentum of economic activity (Chart 21) and the position taken by some Central Bank co-directors, who consider it necessary to maintain the monetary stimulus during 1Q14. The Central Bank has insisted that its current monetary stance and fiscal policy actions will be sufficient for output to gain greater momentum in the remainder of the year and that it will be reversed only when there are convincing indicators of recovery.

The expansionary stance, and its maintenance throughout the year is consistent with a negative output gap in 2013 of the order of -0.4%, remaining negative in 2014 at -0.5%. Maintaining an expansionary rate will allow output to start to correct its gap in 2014 and close fully by the end of 2015.

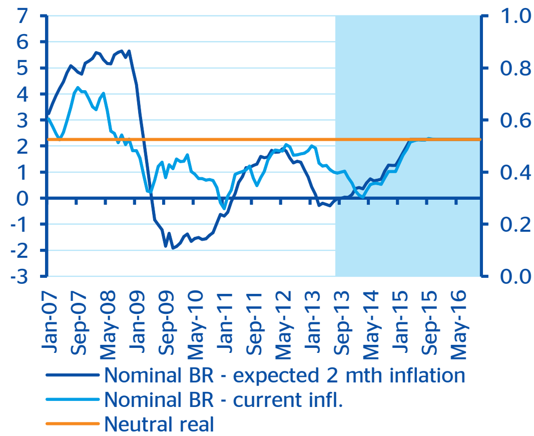
Inflation expectations remain anchored, with no difficulties arising to meet the target in 2014 and in the long term. This gives sufficient inflationary space to continue to support economic activity. We therefore believe that reference rates in real terms have room to remain expansive (Chart 21), returning to their neutral level in 2015, when the output gap is fully closed.

Chart 21
Expected intervention rate trends: implicit in the IBR SWAP* curve, analysts and BBVA consensus



* Implicit under simulations based on prices in different contracts (terms). The contracts taken are from 1 month to 5 years
Source: Bloomberg, BanRep and BBVA Research

Chart 22
Real neutral interest rate and real interest trend, discounting total inflation and expected inflation



Source: DANE, BanRep and BBVA Research

The recent depreciation of the peso poses new exchange-rate policy challenges

The recent period of monetary uncertainty has weakened the Colombian peso. After twelve months in which the exchange rate was, on average, below 1,800 COP/USD, the peso weakened in the first half of the year following the temporary shock in coal production, lower FDI flows (Chart 7) and the lower terms of trade. With the Federal Reserve's announcements on moderating its monetary expansion plan, the exchange rate weakened in line with other emerging economies, reaching a maximum depreciation YTD of 9% in June.

The sharp weakening of the peso led Colombia's Central Bank to slow down temporarily the pace of foreign-exchange intervention, reducing the amount of purchases in the exchange market for a few weeks from USD 40 million to USD 20 million. After the slight recovery in exchange rates in emerging countries and in Colombia, the Government continued with its purchase level commitment (USD 2,500 million between June and September 2013).

The Central Bank has explicitly stated that the current program of foreign-exchange intervention aims to increase the level of international reserves, although the government has suggested that the program also aims to weaken the Colombian peso.

In September, the Central Bank will again be faced with the decision about whether to continue with its foreign exchange intervention program. Given the very slight strengthening of the peso, the room for foreign-exchange intervention, the need for accumulating international reserves and the Central Bank's desire to maintain an exchange rate close to "equilibrium", we expect it to continue with its intervention program after September.

For this year, our estimates of balance of payments equilibrium suggest there is room for accumulation of international reserves to a value of USD 7,000 million, with room for an additional USD 1,000 million in 4Q13. At the same time, the need to expand international reserves (currently at 11.1% of GDP) continues, since they are still below the Central Government's estimate of what is optimal (15.3% of GDP), creating a bias towards continuing with the intervention plan not only in September but into 2014.

Our short-term forecasts are dependent on the monetary decisions taken by the Fed. We anticipate significant levels of foreign-exchange volatility in the short term, given conjectures about the timing of a change in the Fed's stance. For the remainder of the year, we expect the trend to be for a stronger COP, with the return of momentum to offshore portfolio flows and stronger domestic activity. The long-term trend, however, is for a weaker currency, as foreign interest rates begin to increase and global monetary policy returns to normal.

5. Tables

Table 1
Macroeconomic forecast annual

	2011	2012	2013	2014
GDP (y/y %)	6.6	4.0	4.1	4.7
Private Consumption (y/y %)	5.9	4.7	3.5	4.1
Public Consumption (y/y %)	5.1	3.6	4.6	4.8
Fixed Investment (y/y %)	18.7	6.1	6.0	8.4
Inflation (y/y % EoP)	3.7	2.4	2.7	3.2
Exchange Rate (vs. USD, EoP)	1934	1794	1885	1869
Interest Rate (%, EoP)	4.75	4.25	3.25	4.25
Fiscal Balance (% GDP)	-2.9	-2.3	-2.6	-2.6
Current Account (% GDP)	-2.9	-3.2	-3.1	-2.7

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	3.50
2Q11	6.4	3.2	1783	4.25
3Q11	7.9	3.7	1836	4.50
4Q11	6.6	3.7	1934	4.75
1Q12	5.4	3.4	1766	5.25
2Q12	4.7	3.2	1793	5.25
3Q12	2.8	3.1	1803	4.75
4Q12	3.1	2.4	1794	4.25
1Q13	2.8	1.9	1810	3.25
2Q13	3.3	2.2	1910	3.25
3Q13	4.9	2.3	1914	3.25
4Q13	5.3	2.7	1885	3.25
1Q14	5.7	3.2	1883	3.25
2Q14	5.2	3.2	1857	3.75
3Q14	4.5	3.2	1865	4.00
4Q14	3.3	3.2	1869	4.25

Source: DANE, BanRep and BBVA Research Colombia

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