RESEARCH

Economic Outlook

Colombia

Fourth Quarter 2013
Economic Analysis

- **The global economic cycle is improving,** but it is still far from reflecting a strong recovery.
- **GDP growth in the second quarter provided a positive surprise.** However, we maintain our growth forecast of 4.1% for 2013 and a consolidation at 4.7% in 2014.
- **Inflation will be slightly below the midpoint of the target range in 2013 and increase steadily in 2014 to 3.2%.** We anticipate the first change in the monetary stance in the second quarter of next year.
- **The elections in 2014 and the withdrawal of monetary stimulus measures in the United States will generate volatility** in local markets. We expect a slight depreciation of the Colombian peso.

Index

Closing date: November 7, 2013

1. Summary

The global economic cycle is improving, but it is still far from reflecting a strong recovery. We have revised down by 0.2 pp the expected growth for the global economy in 2013 to 2.9% and in 2014 to 3.6%. The revision was the result of the worse figures registered in the U.S. as well as the slowdown experienced in some of the countries in emerging Asia.

The fears of a sharp slowdown in emerging markets have eased. However, the impact of tapering will probably mean greater discrimination in flows to emerging markets depending on their fundamentals. The long-term financing of Colombia's current account deficit is a positive factor in this respect.

Colombia's GDP growth in the second quarter (up 4.2%) provided a positive surprise for analysts and the central bank. Despite this we maintain our growth forecast of 4.1% for 2013, which implies a second half of the year that is less robust than estimated three months ago, though still positive.

Private consumption will extend its process of recovery until next year and investment growth will continue. We have increased private consumption forecasts for 2013 to 3.9% and 2014 to 4.4%. Fixed investment will grow 6.3% in 2013 and 7.1% in 2014, implying an upward revision in 2013 and downward in 2014. The first adjustment is due to an increased balance of investment in construction, while the second adjustment is a result of weaker private commercial investment and a higher statistical base affecting civil works.

Our scenario expects that starting in 2014 the government will use investment as a variable for adjustment to comply with the fiscal rule. With the aim of achieving the deficit target of 2.3% of GDP set by the fiscal rule in 2014, investment by central government will be cut from 3% of GDP in 2013 to 2% in 2014.

The output gap moved into negative territory in 2013 and will remain at similar levels in 2014. It is expected to close completely by the end of 2015. The process will be slow from the end of 2014 due to the simultaneous expansion of the rate of investment and employment, and thus growth of the economy's potential GDP.

We expect annual inflation to speed up in December. The boost will be led by a significant base effect and a sustained recovery in economic activity, which will continue in 2014. Consumer inflation will be under an annual 3.0% in the first half of 2014 and end the year at 3.2%.

We maintain our forecast of an initial increase in interest rates by the central bank in April 2014, following confirmation of the positive growth in 4Q13 and examination of leading indicators for 1Q14. We expect a gradual increase of 100 bps in 2014 as economic activity gains strength, but remaining expansive. Monetary conditions should return to normal in 2015, when the neutral rate of 5.25% is achieved (a real 2.25%) toward the end of the year.

Finally, **the Colombian economy faces uncertainties that add a downward bias to our forecasts**. The first of these is a new and lasting deterioration in confidence. Second is a lack of consolidation of recovery in industry and a global environment that undermines expectations of export growth. And third is an insufficient execution of civil works at the end of 2013 and in 2014.

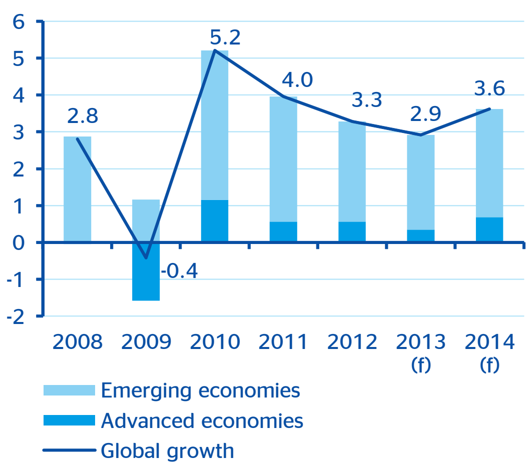
2. A slow global recovery with downside risks

The economic cycle is improving, above all in advanced economies, although it is still far from being a strong recovery

Two general features have characterized the last quarter from the macroeconomic point of view. First, the confidence indicators of economic agents and the volatility of the financial markets have continued to reflect the low possibility of tail risk events that could be disruptive for the global situation. Thus the economic recovery is continuing to gain strength and there is less risk of it worsening. However, there have also been events over the quarter that have contributed to a scenario of weak global recovery that is limited within a one or two-year horizon. They are events with a present impact (the partial closure of the US government) but also a future one (the more or less early exit from the exceptional liquidity support measures).

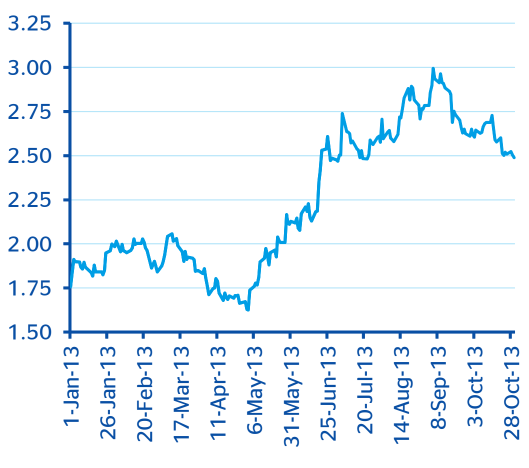
Overall, we have revised down by 0.2 pp the expected growth for the global economy in 2013 to 2.9% and in 2014 to 3.6%. The revision of 2013 growth is due to the worse figures recorded in the U.S., and the slowdown in some of the countries in developing Asia, which are also affected by financial turbulence in the wake of the Fed's announcement of an imminent cut in the rate of asset purchases ("tapering") in its quantitative easing (QE) program. Growth in 2014 has also been revised down to 3.6%. The emerging markets are behind this downward revision, (except for China, where we stick to our forecasts), although they will continue to be the biggest contributors to global growth (Chart 1). The higher rate of global growth in 2014 is backed by an acceleration of the economy in all geographical areas, except for Asia, where growth is expected to remain at the same levels.

Chart 1
World growth and contribution by regions



Source: BBVA Research and IMF

Chart 2
U.S.: yield on 10-year U.S. government debt



Source: BBVA Research and IMF

The tensions in the financial markets caused by the announcement of the Fed's tapering ease, providing a boost not only in the U.S.

The Fed raised a few eyebrows when in September it decided not to start the process of reducing the rate of asset purchase in its quantitative easing (QE) program. Through this delay, it has reinforced the nature of the "data-dependent" program, and also heightened the effect of the uncertainty on the negotiation of the fiscal deficit and the debt ceiling.

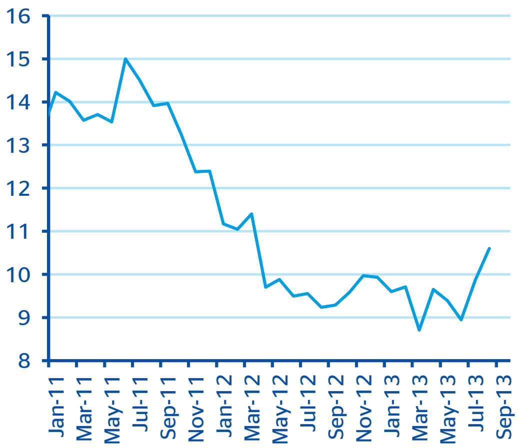
The clarifications on the process of tapering, which the Fed's members are preparing in the light of the unexpected reaction of the market to their first announcement and its delay until (possibly) the start of 2014, have reduced the risks of a derailment in the recovery. This is because a significant proportion of the rise in interest rates recorded since May has been reversed (Chart 2), and markets now do not anticipate interest rate hikes until 2015. In addition, volatility and financial tensions have eased at global level, especially with regard to the emerging regions of Asia and Latin America, also affected by lower capital inflows. Thus, fears of a "sharp landing" in emerging markets have gradually eased, while emerging markets show some indications of a recovery in confidence, after the check in the middle of the year.

In any event, the tapering will end up arriving, and change the global scenario of liquidity injections that favored indiscriminate flows towards emerging markets. The impact of tapering, once it is effectively underway, will probably be a greater discrimination in flows toward emerging markets according to each of their fundamentals.

China once more stimulates its growth, but to a more limited extent

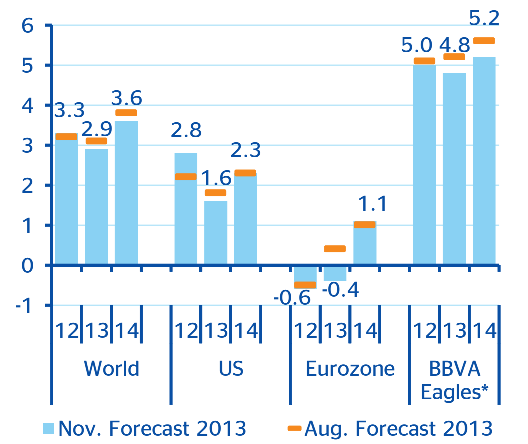
Uncertainties at the start of the year in China about the possibility of a sharp adjustment to its economy have also dissipated, at least in the short term: it has maintained its high rate of growth, and the most recent data (third quarter) point towards stronger growth in GDP (Chart 3). The better than expected figures in 2013 mean that the annual growth outlook has been revised upward slightly from 7.6% to 7.7%. Even so, doubts remain on the sustainability of growth in the medium and long term, as the recent upturn in growth has been the result of the improvement in foreign demand, but also of one-off tax policy and public spending measures with a renewed use of credit.

Chart 3
China: Industrial output (% y/y)



Source: BBVA Research and Haver

Chart 4
GDP growth estimates (%)



* The BBVA EAGLEs are the emerging countries that will contribute most to global GDP over the next 10 years. The group is made up of China, India, Indonesia, Brazil, Russia, Korea, Turkey, Mexico and Taiwan.
Source: BBVA Research and IMF

The perception on Europe is improving and the most extreme risks are being dissipated. The reforms geared toward better governance continue and growth returns

In Europe the forecasts have been confirmed and the economic situation has continued to improve, to the point that the Eurozone emerged from the recession with a growth of 0.3% in the second quarter of 2013, after six quarters of recession. A positive reading may be made of the data in two aspects, given that the recent rebound is also underpinned by improved domestic demand, while the improvement in economic activity has reached the periphery, helping to eliminate the systemic risks so typical of the preceding quarters. The recovery of activity has been helped by a reduction in financial tensions in the area and by a de facto relaxation of the more short-term targets of fiscal consolidation, which is being implicitly tolerated by the European authorities.

GDP growth in this part of the year was included in our scenario, and there has been no additional element to make us change our expectations of a weak recovery. In 2013 Europe's GDP will fall by 0.4% and grow by 1.1% in 2014. The weak recovery is consistent with the deleveraging process underway in the private sector in some economies and the financial fragmentation that is still in place, which affects the capacity of bank credit supply. The next few months will be decisive in progress toward a banking union, with the entry into operation of a single supervisor, the European Central Bank (ECB), and the definition of the mechanisms for bank resolution. The model for implementing this is still under discussion.

The fiscal agreement in the U.S. has again simply papered over the cracks. It does not address long-term fiscal sustainability and does not prevent a contractive impact in the short term

The fiscal agreement reached on October 16 in the US simply postpones the current situation, as it only guarantees that the Government will have finance until January, while the new debt ceiling will be reached in February. Intense negotiations are drawing near on cuts in discretionary expenditure and increases in taxation. The U.S. thus once more has to address an uncertain process that it has already passed through in these months on previous occasions, and this will surely have negative consequences. Most likely is that the partial closure of government for 16 days has had a relatively marginal direct effect on the GDP for the quarter, perhaps a few tenths of a percentage point. However, the threat of this process continuing may have an additional impact. In any event, the situation in which economic policies push in opposing directions will continue, with a monetary policy that will continue to be lax for a long period, and an unnecessarily contractive fiscal policy in the short term. Thus the U.S. public deficit will have fallen without market pressure (unlike in Europe) from 6.8% in 2012 to 4% in 2013, which could mean a drain of 1.3 percentage points of GDP growth in 2013. Moreover, the long-term challenges for the fiscal sustainability of the U.S. economy have not been tackled. In any event, in our baseline scenario, a lower fiscal burden in 2014 and continued recovery should enable growth in the U.S. from our estimate of 1.6% for 2013, to 2.3% in 2014 (Chart 4).

Risks in the forecast: downward bias but a priori with less probability and lower impact

There are fewer risks to the aforementioned baseline scenario. This does not take away the fact that the balance of risks continues to be downward, given that a variety of factors are still in place that could move in this direction. First of all, it is worth mentioning the possibility that the Fed's exit process from QE may be disorderly, giving rise to an excessive increase in interest rates (in the U.S. and in other countries). Financial conditions that are too tight for the rest of the world could abort a global recovery if it is not especially dynamic, particularly in the Eurozone.

Second, it is worth identifying as a risk factor the possible adjustment in growth in China and in other emerging markets. This could be the result of idiosyncratic factors, but also of dilemmas which have to be addressed by domestic policies in a less favorable global financial environment.

Lastly, the resurgence of the euro crisis remains a globally relevant risk. The authorities have to support the positive perception of the markets with decisive progress to strengthen monetary union, in particular banking union. However, there are number of elements which could lead to a shift in perception, ranging from a check in the necessary reforms to unexpected results in the review of bank balance sheets and stress tests of risk scenarios, which are needed for setting up the ECB as the single banking supervisor. Lastly, as has been shown by past experience, disagreements on the definition of policies that strengthen the euro area, in this case bank resolution mechanisms, may produce tensions and volatility in the financial markets.

3. The Colombian economy will grow by 4.1% in 2013 and 4.7% in 2014

Despite the positive surprise in the second quarter, we maintain our growth forecast for 2013

In the second quarter of 2013 the economy grew by an annual 4.2%, with cumulative growth of 3.4% in the first half of the year (compared with 3.1% expected by BBVA Research). Economic activity in the second quarter was boosted by agriculture and construction, with these two sectors growing by an annual 7.6% and 6.4% respectively. Growth was more balanced by sectors, as all the branches of output, except for construction, saw growth increase in the first quarter. In particular, the industrial sector recovered from three consecutive quarters in negative territory, but still at a slow pace (1.2%). Household consumption grew more than GDP (4.4% y/y), with a significant recovery in durable goods (4.5% compared with a fall of 0.9% in 1Q13), probably due to increased transmission of previous rate cuts by the central bank.

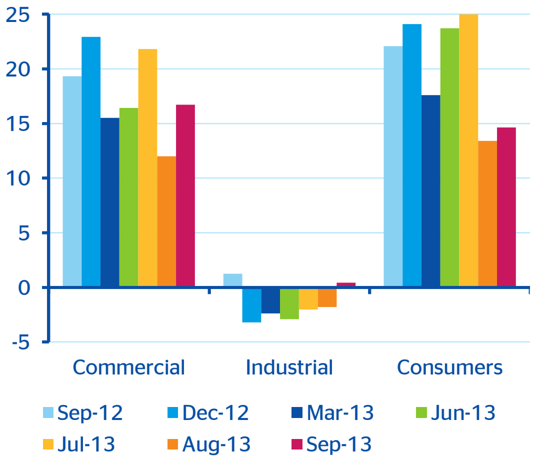
Growth through June led an improvement in the expectations of many economic analysts, who had put GDP growth in 2013 at under 4% in the period, though it did not change our own forecast of 4.1% for the year as a whole. Our interpretation of the good economic performance to June is that it generated a less demanding scenario in terms of economic expansion for the third and fourth quarter, where uncertainty appears greater (particularly in the case of the third quarter).

Advance indicators between July and September show economic growth lower than expected three months earlier, although GDP is still growing at a faster pace than in the first half of the year. Household and business confidence deteriorated significantly in August as a result of social tension, mainly from farmers and coal miners (Chart 5).

This did not have a direct effect on household consumption, as reflected in the good performance of retail sales for the month (annual 6.9%), but there could have been an effect on lower industrial output, which fell by an annual 3.8% in August and accumulated a fall of 2.8% between January and August on the same period a year earlier. However, the negative balance of the industrial sector can also be explained by the lower exports over the year, which declined further in August, affecting above all low-technology manufactured products (Chart 6).

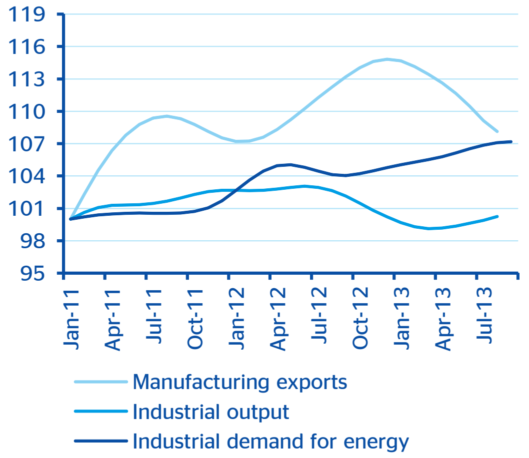
Thus the observed data in the second half of the year suggest that private consumption (and imports of consumer goods) could continue to expand strongly, led by an upturn in durable goods, and that the growth of private investment in machinery and equipment goods, from both industry and the coal sector, could be slower than forecast three months ago. At the same time, the weakness of the manufacturing and coal sectors abroad will lead to growth in exports slowing. To sum up, compared with expectations three months ago, the economy will now grow at an average annual 4.7% in the second half of the year, rather than 5.1%. The new year-on-year growth figure will be achieved despite the limited quarterly growth figures of 0.4% in 3Q and 1.9% in 4Q, thanks to the favorable base effect in the same period in 2012.

Chart 5
Business and household confidence. Net responses



Sep 12 to Jun 13 figures are quarterly averages
Source: Fedesarrollo and BBVA Research

Chart 6
Manufacturing indicators Jan 2011=100



Source: DANE, XM and BBVA Research

We maintain our optimism for 2014

We have maintained the GDP growth forecast for 2014 at 4.7% from our previous Colombia Economic Outlook. This expansion requires a moderate quarterly strength in the four quarters of 2014 (1.0%, 1.4%, 0.3% and 0.8%), equivalent as an average to the mean quarterly growth since 2000. As a result, growth in 2014 will diverge in the first and second half of the year. In the first half of the year growth will be 5.2%, thanks to the favorable statistical base and the steady recovery of GDP components. In the second half of the year growth will increase to 4.1% due to the more demanding base effect and reduced support from public expenditure.

The recovery of private consumption and the boost from civil works will be decisive in 2014

Private consumption will extend its process of recovery to next year thanks to the moderate upturn in food consumption, which will account for 30% of total household spending, and the greater balance of spending on durable goods, whose low 5.0% share of private consumption is compensated by strong growth. We have revised the forecasts in the August Colombia Economic Outlook for private consumption in 2013 and 2014 from 3.5% and 4.1% to 3.9% and 4.4%, respectively.

An essential element in the recovery of durable goods has been (and will continue to be) the increased transmission of the central bank's low interest rates on consumption decisions and their positive effect on credit growth. Since April the annual growth of consumer spending (quarterly moving average to reduce volatility) increased from only 2.5% to an annual 15.5% in August, despite its erratic behavior in the last month due to social protests.

In addition, public expenditure on investment will continue strong in 2014 (7.6%), although less so than forecast in 2013 (9.5%). In these two years, GDP including civil works will be higher than the aggregate figure that excludes this investment, although its contribution will be reduced significantly in the second half of 2014. The lower public expenditure is the result of the start of the new presidential term (2014-2018) and the greater boost given to execution in the period before the elections.

Total investment will also grow above GDP and support it, boosting potential GDP and avoiding excessive demand pressures on inflation. However, we have reduced its figure for 2014, with a slower recovery of output in the industrial sector and a delayed take-up of its excess installed capacity, so there will be fewer incentives to increase investment at the start of 2014 than we thought three months ago. In total, fixed investment will grow 6.3% in 2013 and 7.1% in 2014, implying an upward revision in 2013 and downward in 2014. The upward adjustment is due to an increased balance of investment in construction, while the downward adjustment in 2014 is due to weaker private commercial investment and a higher statistical base affecting civil works.

Finally, exports will slowly recover their strength over 2014, although growth will not be consolidated until 2015. In 2013, exports will grow by an annual 3.7%, under the figure in 2012, because they reflect the lower output volumes of coal and the fall in industrial exports, which cannot be offset by an increased expansion in oil production. In 2014, exports will pick up their annual growth to 5.8%, thanks to the improved industrial output and the easing of some internal bottlenecks affecting mining output this year.

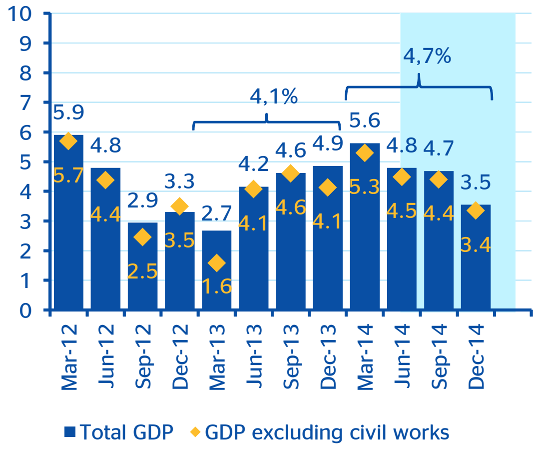
At the end of 2014, and above all in 2015, the positive effects of the free-trade agreements with developed and emerging countries will begin to be clearly felt. In the case of developed countries, greater demand from the United States and Europe is expected due to their improved economic growth. Commodity prices will also remain high due to the good performance in Asia. In the case of emerging countries, a greater rate of penetration of regional exports is possible, mainly to countries making up the Pacific Alliance (see Box 1). This will lead to a change in the recent trend for a greater proportion of traditional goods in the components of exports (oil, coal, coffee and nickel), and leave room for manufactured products to increase their share.

Growth forecasts for 2014 will be achieved despite pressure on public investment

Our scenario expects that starting in 2014 the government will use investment as an adjustment variable to comply with the fiscal rule. This is because of the inflexibility of the fiscal accounts and pressure from expenditure, particularly payment for pensions, which will increase from 3.6% of GDP to 3.8% of GDP from 2013 to 2014. In order to achieve the deficit of 2.3% of GDP imposed by the fiscal rule the central government's investment in 2014 has been cut by 1 pp of GDP on the 2013 figure, from 3% to 2% of GDP (Medium-Term Fiscal Framework in June 2013 –MFMP for Spanish name–).

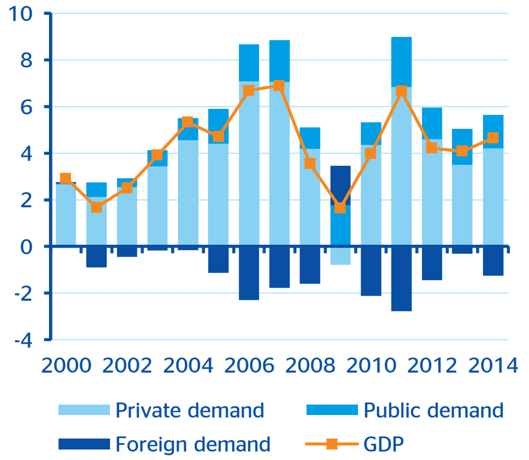
In the case of the transport sector, at the level of national budget (PGN), the commitments established previously and charged to future accounts have been maintained, amounting to COP 5 trillion in 2014. These commitments are focused on the road concessions programs (COP 1.9 trillion), road maintenance and renovation (COP 2.7 trillion) and airport infrastructure (COP 0.3 trillion). At the same time, the national budget finally approved by Congress includes an increase in investment of COP 6.1 trillion, in addition to the COP 40.6 trillion initially budgeted. The expenditure mentioned earlier will be financed mainly from increased tax revenue (COP 3 trillion), if the financial movement tax for 2014 is maintained at "4x1000" or 0.4%).

Chart 7
Total GDP excluding civil works. Annual % change



Source: DANE and BBVA Research

Chart 8
Decomposition of economic growth. Contribution to annual change



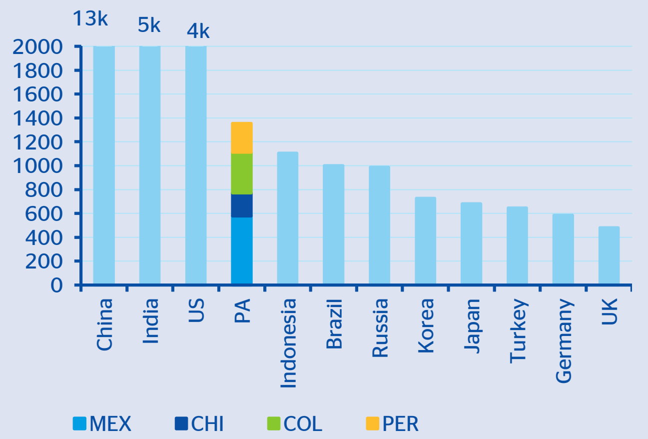
Source: DANE and BBVA Research

Box 1: The Pacific Alliance: the Latin American giant committed to trade and financial integration

The Pacific Alliance (PA) is an ambitious process for economic and trade integration. One of its pillars is the building of an area of close integration through participation and agreement, progressing gradually towards the free movement of goods, services, capital and persons. At present it is made up of Chile, Colombia, Mexico and Peru (Costa Rica and Panama are in the process of joining). It not only aims to extend integration between its members but also with the rest of the world, with particular emphasis on the Asia-Pacific region.

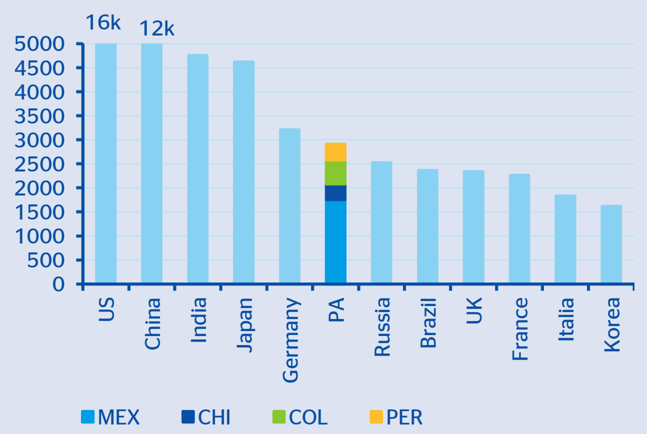
The commitment to integration between these four economies means that it makes increasing sense to see this bloc as a whole, and not as isolated countries. From this perspective, the four countries making up the Alliance represent the sixth biggest world economy, behind Germany but ahead of Russia and Brazil (see Chart 9). More important still, it will be the fourth biggest economy in terms of contribution to world growth in the next ten years, behind China, India and the United States (see Chart 10). It appears clear that the Pacific Alliance (PA) is becoming Latin America's real giant.

Chart 9
The biggest economies in 2012 (USD million adjusted for PPP)



Source: BBVA Research and IMF

Chart 10
Biggest contributions to global growth in the next 10 years (USD million adjusted by PPP)



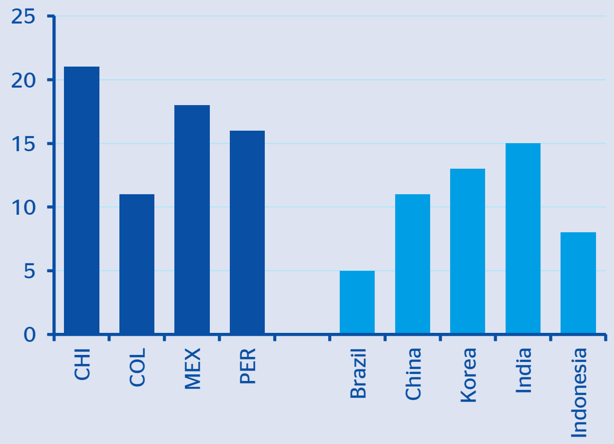
Source: BBVA Research and IMF

But size is not everything. Also important is the type of policies that can be expected from the countries making up the Alliance. Here the PA is also notable for its commitment to integration, not only between its members but also with the global economy. The countries in the Alliance are the emerging markets with the greatest number of free trade agreements signed (see Chart 11); in the case of Peru and Chile this includes agreements with the four main economic areas: the U.S., the European Union, Japan and China. This contrasts with Brazil, for example, which does not have free trade agreements with any of them.

The commitment to trade integration also involves boosting trade flows between the members of the PA. There has been significant progress in this respect, with 92% of the customs tariffs being eliminated completely, and an additional 6.5% due to be eliminated within a very short period. Overall, given the current structure of exports (mainly manufacturing in Mexico, compared with the significant level of commodities in the Andean countries), there is some asymmetry in the potential for increasing the trade of goods within the Alliance. In principle, this should favor Mexico more than the three Andean countries (see Chart 12). Even so, there is a great deal of potential for cooperation, transmission of know-how and investment in the infrastructure and capital market sectors[1].

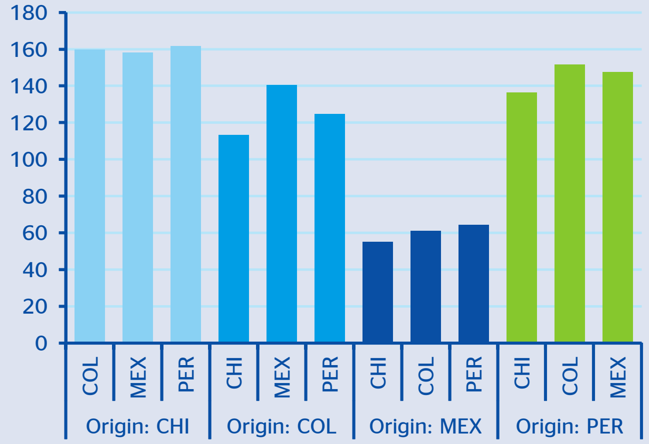
1: For a more detailed analysis of trading links in the Pacific Alliance, see our Economic Watch, August 2012: "New Pacific Alliance Bloc: Mexico and Andeans look towards Asia", available at http://www.bbvaresearch.com/KETD/fbin/mult/120822_EW_EAGLEs_New_Pacific_Alliance_Bloc_tcm348-355823.pdf?ts=25102013

Chart 11
Number of trade agreements signed



Source: BBVA Research and WTO

Chart 12
Index of export potential (0 = very high; 200 = very low)



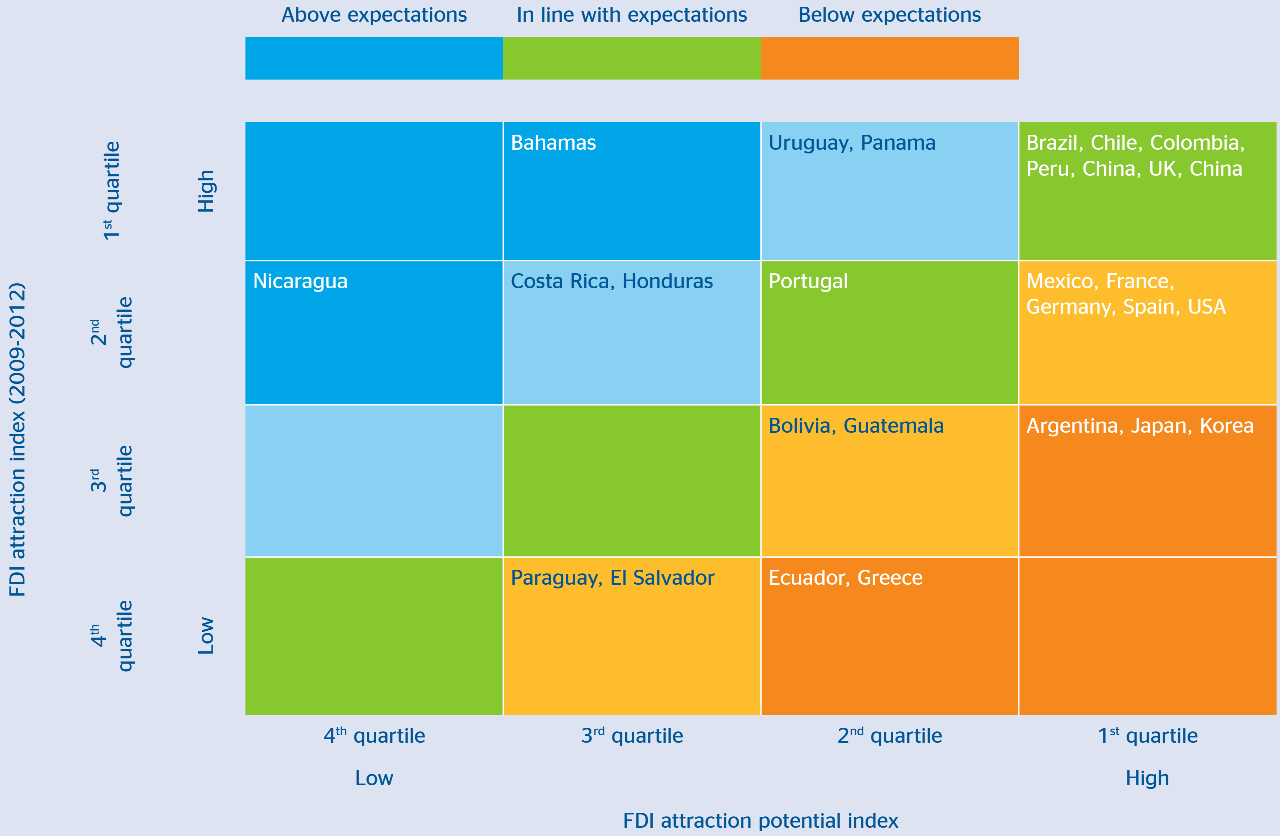
Fuente: BBVA Research y COMTRADE

The PA is also firmly committed to financial openness and integration, both with the rest of the world and between the countries in the alliance. The countries of the PA have been major recipients of direct investment (in absolute terms and in relation to the size of their economies), above all from the U.S. and Europe, but increasingly from Asia as well. Even more importantly, according to UNCTAD, the countries in the PA are in the top 25% of the global ranking of countries with potential to attract FDI. Chart 13 shows that in a comparison of the two dimensions (observed FDI flows and potential for attracting FDI), the Pacific Alliance countries not only have a high potential for attracting FDI flows, but they actually achieve the rates to be expected by this high potential[2], unlike many other countries in the region.[3]

As in the case with trade flows, if we observe the FDI flows within the PA, the first thing to notice is its limited percentage in terms of the total FDI received by the four countries (3% of the total in 2009-2013). Further, they are also strongly concentrated in FDI flows from Chile to Peru and Colombia (Chart 14), probably due to the smaller size of the Chilean economy leading some of its companies to diversify and expand their operations within the region. There is no doubt that the maturity of the pension system in Chile has also enabled capital to be injected into companies with regional expansion policies, particularly in the retail sales and financial sectors. The concentration of FDI flows to Peru and Colombia would be conditioned by their geographical and cultural proximity, which is associated with the lower costs of monitoring and controlling these investments. The foregoing is also reflected in the aggregate figures from 2009 to 2012, when Peru absorbed 42% of intra-PA foreign investment, followed by Colombia with 27% (Chart 15).

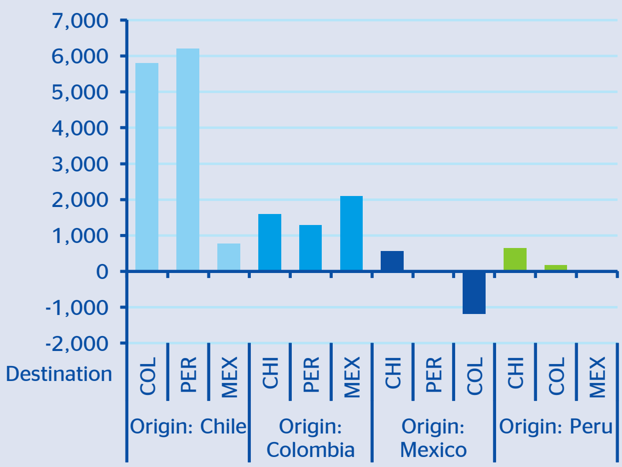
2: Mexico only appears in the second quartile of the world ranking for attracting FDI, but it should be remembered that the non-equity modes of production (NEMs) such as manufacturing under contract or service outsourcing are very significant in Mexico. They do not count as FDI but include many of its advantages, including transfer of know-how and technologies.
3: A more detailed analysis of the potential to attract FDI and FDI flows within the PA can be found in our Economic Watch, November 2013 "Integración financiera en la Alianza del Pacífico", available at http://www.bbvaresearch.com/KETD/fbin/mult/131028_Observatorio_Alianza_Pacifico_tcm346-407163.pdf?ts=1112013

Chart 13
Ranking of Foreign Direct Investment inflows (2009-2012) and potential to attract it (2012)



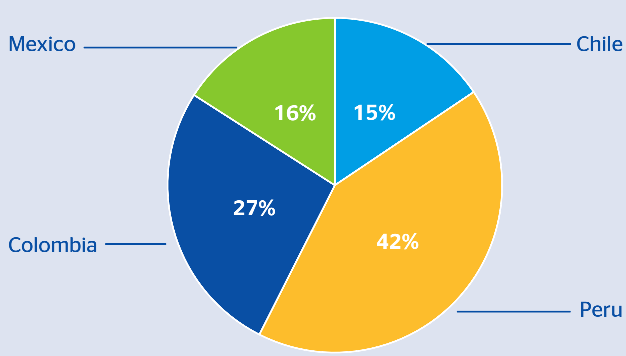
Note: The ranking and distribution by quartiles are based on a total of 177 countries. The table only shows the Latin American countries and some selected countries outside the region.
Source: BBVA Research and UNCTAD

Chart 14
Cumulative intra-PA FDI flows, 2009-2012.
By origin and destination (USD million)



Source: BBVA Research and Central Bank of Chile

Chart 15
Destination of intra-PA FDI.
Cumulative 2009-2012 (% of total)



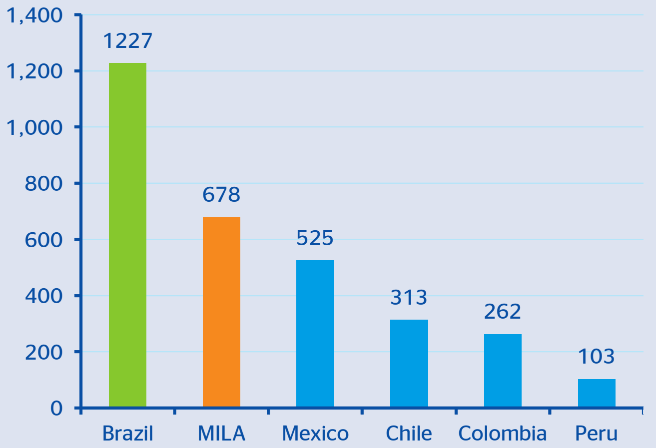
Source: BBVA Research and Central Bank of Chile

It is true that the integration of portfolio flows is still at its early stages, but initiatives such as the integrated Latin American market (MILA), with the full incorporation of Mexico at the start of 2014, have the potential to create a stock market with a capitalization similar to that of Brazil (Chart 16), although with a lower depth and market liquidity. In this context, we expect the cross flows to begin to increase, using and generating synergies toward deeper and more integrated markets, particularly if the process of harmonization, clarification and coordination of the tax treatment by the authorities of each country continues.

What is the economic outlook for the PA in the short term? This is a region with a high growth potential, around 6% in Peru and 5% in Colombia and Chile. In the case of Mexico, the current reform agenda could increase potential growth to around 4%. This means an average potential growth for the PA of close to 4.5% per year, higher than in Brazil and nearly three times the figure expected in developed economies (see Chart 17).

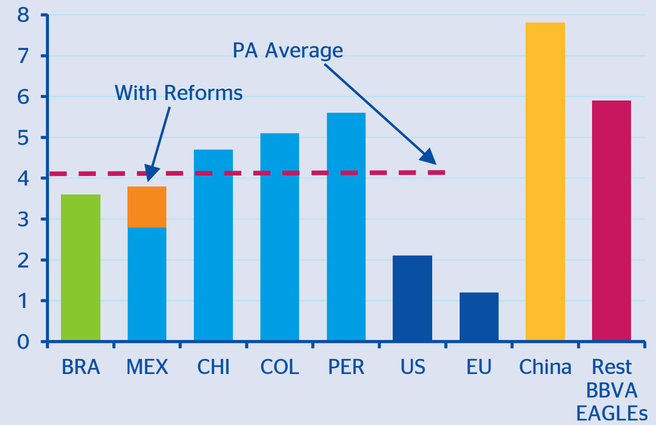
Although the region still has major challenges ahead (high informality, inadequate infrastructures, low quality of education and health), progress has been made in recent years in the right direction. A firm commitment to reform in these areas could increase their high potential growth still further.

Chart 16
Stock-market capitalization, December 2012 (USD million)



Source: BBVA Research and Bloomberg

Chart 17
Potential growth (%)



Source: BBVA Research and COMTRADE

The output gap will close gradually starting in 2014

The output gap moved into negative territory in 2013 and will remain at similar levels in 2014, as the variation see in GDP will equal (though not exceed) the potential, according to our estimates. We expect the gap to be closed completely by the end of 2015, and become slightly positive in 2016. The closure will be slow, starting toward the end of 2014, due to the simultaneous expansion in the investment rate, employment and thus potential GDP growth, which will hit 4.9% in 2015 and 5.1% in 2016.

According to studies on the subject, inflation will begin to put pressure on demand before the closure of the gap, precisely when the trend for expansion of the gap is reversed, in 2014. Thus monetary policy will have to take into account this expected trend in the monetary cycle and respond quickly to demand shocks.

The materialization of some uncertainties will imply a downward bias in our forecast

In this edition of Colombia Economic Outlook we want to highlight three uncertainties that will face the Colombian economy over the coming quarters. These episodes still have a low likelihood of occurring, but they will reduce our growth forecasts for 2014. First, another deterioration in confidence, similar to that seen in the third quarter of 2013, but more lasting, would have a negative impact on consumption and investment decisions in 2014.

Second, if the recovery in the industrial sector does not gain strength and the global environment undermines growth prospects for exports, the recent progress made in employment, the recent recovery in agriculture and the country's fiscal and external accounts could all be negatively affected. In this case, the levels of household and business confidence could also decline.

Finally, given that our forecasts have received a significant boost from civil works, if these are executed deficiently at the end of this year and in 2014 it could prevent the recovery of salaried employment and the progress made in competitiveness derived from new constructions. At the same time, our growth forecast assumes that the first fourth-generation projects enter into execution in the fourth quarter of 2014. Thus a delay in the National Infrastructure Agency schedule could result in a negative bias for the outlook at the end of next year.

4. Inflation will rise steadily in 2014

The CPI has remained under control throughout the year at the bottom of the target 2-4% range (2.05% on average in January-October). Inflation has been kept under control as core inflation indicators have recovered and without significant supply shocks. The devaluation of the interest rate (6.6% in October) has had a limited effect on consumer prices (although in line with our forecast), with a marginal impact on tradable goods and on the import component of producer prices. Equally, the rise in international fuel prices in 3Q13 has not been reflected in gasoline prices, which have varied only to a very limited extent this year (-1.6% YTD through October).

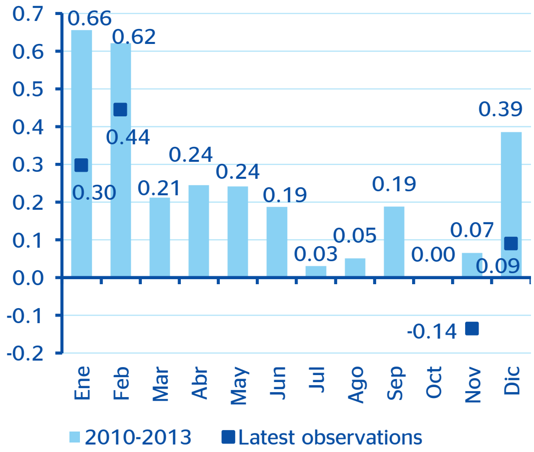
The CPI will be under 3% y/y in the first half of 2014

For the last quarter of the year we expect an increase in inflation to a 2.30% y/y for December 2013, mainly due to a significant base effect (mainly from regulated goods) and a sustained recovery in economic activity. The rise in prices will continue for the first half of the year, supported by low base prices a year ago. As a result, the CPI will end 2014 with a year-on-year rise of 3.25% (Chart 18).

The room for inflationary growth is shown in Chart 19. It presents an average for 2010-2013 for the monthly changes each month of the year and the observed changes at the end of 2012 and in the initial months of 2013. As can be seen, the month-on-month values for the reference period were significantly low compared with the historical average and our forecasts, so inflation is close to the average of its target range (3%) in the first part of the year and marginally higher in September, at 3.2%.

Chart 18

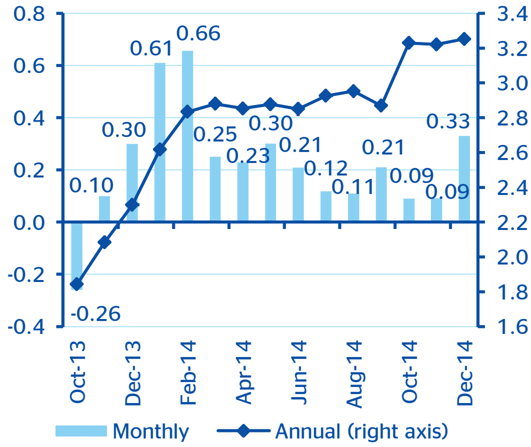
Average month-on-month changes in the CPI between 2010-2013 and more recent changes (%)



Source: DANE and BBVA Research

Chart 19

Expected month-on-month and year-on-year inflation As percentage change



Source: BBVA Research

There should be a significant boost from regulated goods, with readjustments in January and February in many of the inflation-indexed goods and services in December above the rate a year before (2.4% y/y). Equally, the holiday period in December-January will support this trend, and anticipate a stronger private consumption than that observed 12 months previously, reflecting a greater seasonal factor.

After this, inflation will remain at under 3%, without greater extraordinary pressures or foreseeable supply shocks. This would mean that with fewer concerns, the monetary authority would have greater room to normalize domestic monetary conditions.

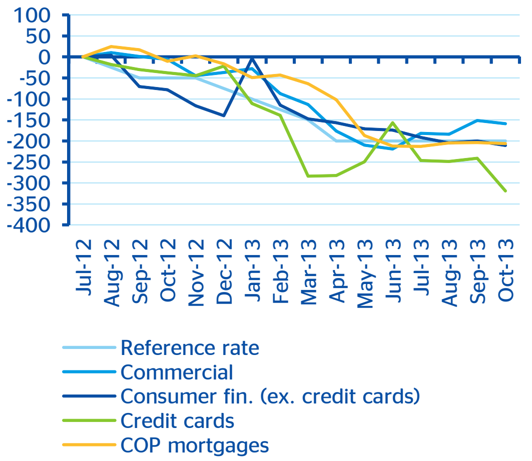
Some factors could speed up the inflationary trend, such as the adjustment of the minimum wage for 2014 and its transmission to consumer prices. In fact, anticipating inflation of 2.30% in 2013 (EoP) and 3.2% in 2014, the rise in the minimum wage would be close to 4.8% (with a typical margin of 1.65% on forecast inflation, see Economic Watch 2011 "We expect a moderate real increase in the minimum wage"). However, it could be higher than this, as it is a pre-election year and in response to the recent signs of social discontent. The risks could be for a high increase, with the resulting consequences on prices and the impact on labor dynamics.

5. We expect a change in the monetary policy stance in the second quarter of 2014

The central bank has maintained an expansive stance throughout the year. During the monetary stimulus period, the interest-rate cuts have been transmitted to the rest of the market interest rates, providing a consistent support for activity. The monetary easing appears to have been used up and is not expected to be extended over the next quarters (see Chart 20), while the cut of 200 bps in the reference rate has already been reflected by similar cuts in bank lending rates, implying a full transmission to economic activity.

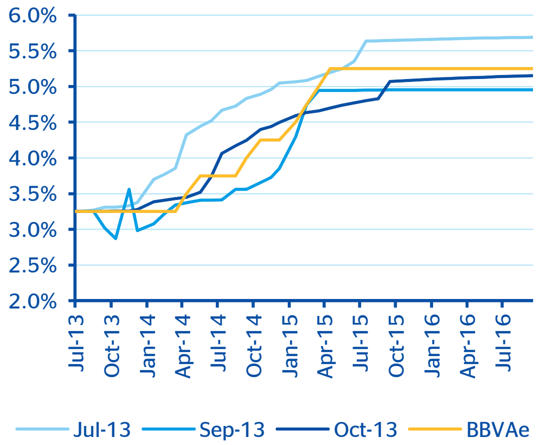
Throughout the year the Bank of the Republic (BanRep) has maintained an expansive tone, suggesting a sustained economic recovery but with the permanent concern for some external risks (lower growth in trading partners and uncertainty with respect to U.S. economic policy), and to a lesser extent local ones. In fact, at the August meeting a minority of members of the Bank pointed to the slow process of recovery, with downward bias that was not anticipated by the market. These fears led to a change in market expectations, which managed to partially anticipate a cut in the rates for the September meeting. With the positive surprise of GDP growth in 2Q13, downward expectations were reversed (see Chart 21) and accompanied by optimistic leading indicators. As a result, the central bank did not act on its August tone and maintained its reference rate in September and October.

Chart 20
Change in the reference rate and in bank lending rates (bps)



Source: Superfinanciera and BBVA Research

Chart 21
Expected trend of the BanRep rate in the IBR swap curve and the BBVAe trend



Source: Bloomberg and BBVA Research

First increase in rates in April 2014 with inflationary normalization and strong recovery in activity

The risk of a cut appears to have eased, so the monetary discussion over the coming months will be about when the central bank will make its first interest-rate rise. Although so far it has not given official signs of being considering the possibility of a rise (and has not suggested one in the short term), market agents have already anticipated a change in the monetary stance in 2014. Market analysts vary in their expectations on the month of the first rise. However, as can be seen in Chart 12, the fixed-income market anticipates that the first increase will be between 1Q14 and 2Q14.

Looking to the future, we maintain the forecast we have held to throughout the year, which anticipates that the first increase in rates will be in April 2014 after the central bank ratifies the positive growth in 4Q13 (published in March) and after the leading indicators for 1Q14 suggest continued economic strength. In April there should also have been a normalization in consumer inflation, with a return to the average of the target range.

The central bank will increase the rate by 100 bps in 2014, reflecting a recovery in economic activity but with a position that is still expansive, given the continuing negative output gap during the year. Monetary conditions will return to normal in 2015, with the closure of the output gap toward the end of the year, at a neutral level of 5.25% (2.25% in real terms), given the external monetary conditions and local activity this year (see Box 2 on the Neutral Interest Rate).

The rate of recovery in confidence could affect the time for changing the monetary stance

If any of the local uncertainties pointed to before are materialized, the Bank could maintain its expansive position for a more extended period of time. The main uncertainty is related to a slow recovery in household confidence. In fact, after the standstill in August, household confidence fell from 25 in July to 13 in August, remaining at 14 in September. Household confidence has a close relationship with private consumption, so a slow recovery in confidence would impose a downward bias to domestic demand and potentially trigger the need for more prolonged monetary support.

Other political factors suggest a prolonged expansive bias, which however we do not consider will be materialized. The presidential elections in May and the intention of continuing with a prolonged expansive position beyond the needs of the economy should not in principle delay the change in the monetary stance.

Box 2: The neutral interest rate in Colombia

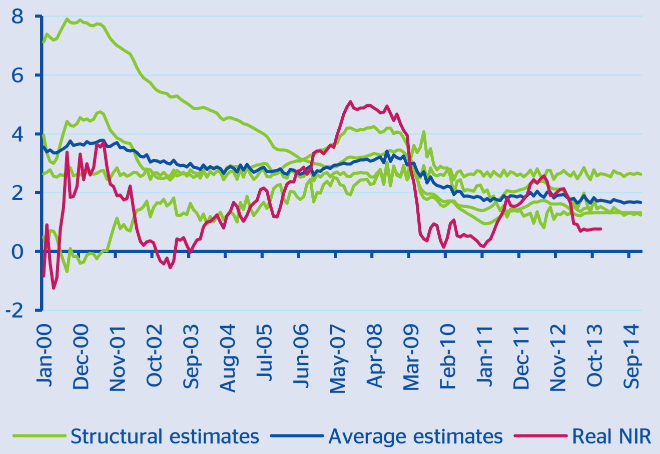
The neutral interest rate (NIR) refers to the reference rate consistent with a closed output gap and full use of the factors of production (Yellen, 2005). Thus the Bank of the Republic in its target inflation mandate defines the reference rate and compares it with the NIR to establish its monetary policy.

The NIR is a non-observable variable that changes over time, and must be estimated regularly to determine the level of monetary expansion or contraction. It depends on external and local conditions, some of which cannot be forecast. In particular, the NIR depends positively on international interest rates, local risk premiums and expectations of devaluation (due to interest-rate parity in small economies that are open to capital). It is contingent to medium-term turbulence that may alter the output gap and that requires a change in the interest rate to achieve full employment (Yellen, 2005); and on the capacity for monetary transmission to general interest rates in the economy (e.g. macroprudential controls that affect the credit channel of monetary policy).

In general terms there are two methodologies for estimating the NIR, one static and the other variable over time. This exercise refers five estimates, all of them variable over time. The first is a SI model, which focuses on the balance between demand and aggregate supply. The second model is a common stochastic trend (CST), which is based on the SI model, although it assumes a shared trend between the short-term and long-term interest rates, whose spread is explained by a term premium. Two variations of these models were also made: for the SI model the trend and cycle factor was decomposed from the NIT, while for the CST the behavior of the output gap was assumed as endogenous. Finally, the model for uncovered interest rate parity (UIRP) was estimated. The detailed description of the models and estimates can be found in Economic Watch "Tasa Neutra en Colombia", pending publication.

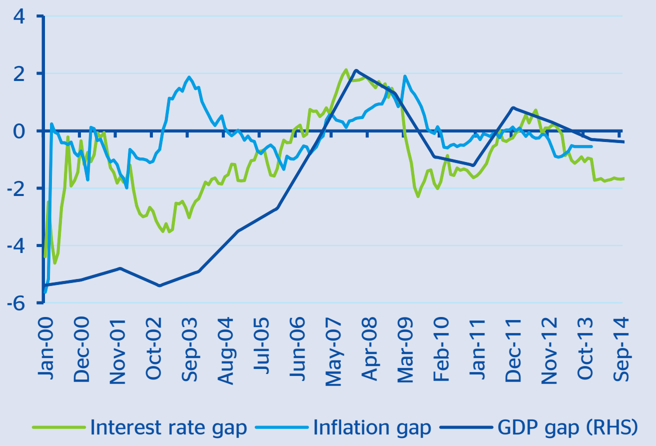
The NIR has been estimated from January 2000 to September 2013 (Chart 22). As can be seen, the NIR has steadily fallen from average levels of a real 3.5% in 2000 to 2.65% in 2009, and 1.9% in 2012-2013. The moderation in the neutral rate can be explained by the structural reduction in risk premiums, which were high above all in 2009 with the reduction in the local EMBI and the subsequent level of sovereign debt investment. Equally, the lower level of 2013 would be explained by low international interest rates (FED and QE3), which due to arguments of local interest-rate parity with international rates sustain a lower neutral rate in Colombia compared with the rate previously observed with relation to international currency relaxation.

Chart 22
Estimates of NIR, average of estimates and real reference rate



Source: Banco de la República and BBVA Research

Chart 23
Inflation gap (against target), output gap and reference rate gap



Source: Banco de la República, DANE and BBVA Research

The results estimated for May 2012 average out at a real 2.16%, with a dispersion by methodologies of between a real 1.35% and 2.81% (Table 1). The average is slightly below the result of Magud et al. (2012), which estimates the NIR at a real 2.3% (with results between 1.6% and 4.4%). For September 2013, the estimated average is a real 1.9%, with results of between 1.31% and 2.9%, suggesting a currently expansive position by the central bank, with a policy rate in the same month of a real 1%. The expansive stance is consistent with a negative output gap, following the recent moderation of activity (Chart 23).

In the future, the trend of the NIR will be for an increase to levels higher than now (1.9%), although lower than those observed in 2009 (2.6%) before sovereign debt received investment grade rating. With the gradual close of the output gap and fundamentally with the start of international monetary normalization in 2015 (increase of Fed rates), the neutral rate should be close to 2.25% (Table 1). This also takes into account structurally lower risk premiums than those observed in 2000-2008. This level is in line with BBVA Research forecasts, which anticipate a neutral long-term rate of a nominal 5.25%, with a long-term inflationary level of 3.0%.

Table 1
Estimated neutral interest rate (%, real)

Date	Magud and Tsounta (2012)	IS model	IS model*	CST model	CST model*	UIRP	Total average
May-12	2.25%	2.81%	1.35%	1.68%	2.34%	2.62%	2.16%
Sep-13	-	2.44%	1.33%	1.31%	1.49%	2.90%	1.90%
Dec-15	-	2.63%	1.25%	1.32%	1.49%	4.56%	2.25%

Source: BBVA Research

6. Moderate impact in Colombia from the return of global liquidity to equilibrium levels

Capital flows into Colombia continued strong in recent months, after a marginal reduction in the weeks following the Fed's announcement of an expected reduction in quantitative easing. Between May 24 and October 18 net portfolio capital flows amounted to USD 1,117 million, with entries (by non-residents) of USD 2,078 million and outflows (by residents) of USD 962 million. Since September these net flows have picked up pace from an average USD 66 million to USD 107 million weekly. One of the results is that TES held by foreigners increased from 5.6% of the total at the end of April 2013 to 6.0% now. At the same time FDI recorded in the foreign exchange balance, also at the close of October 18, was USD 13,474 million, above the USD 5,716 million cumulative figure through the third week of May.

When the lower level of bond purchases by the Fed becomes a reality, we could once more experience an increase in volatility in net capital flows and a reduction in net weekly entries. However, markets anticipated some of the nervousness in recent months and thus there will be less pressure on Colombia's foreign-exchange balance once there is less global liquidity. In other words, temporary new reductions in flows are not ruled out, but they could be minor or at most similar to those recorded previously.

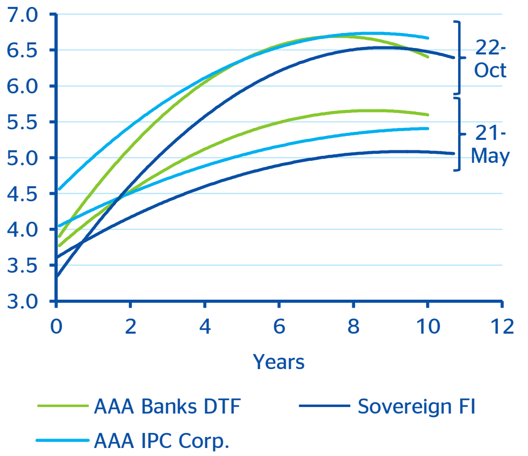
This is what happened in 2011 when the second round of the Fed's expansion ended. On that occasion, capital flows responded with net outflows of an average of USD 46 million per week between March and May, before the completion of the round in June. The flows then stabilized, without the announcement of a new quantitative expansion (which finally occurred starting in September) and there were average net inflows of USD 39 million per week between June and July.

In addition, the performance of capital flows largely determined the behavior of markets in Colombia. The financial and debt market reacted to the upcoming liquidity moderation. The clearest response was seen in the public and private debt market, with general peaks in the yield curves (Chart 24). The peso sovereign debt curve peaked by 186 basis points (bps) between May and June. After this, the curve gradually corrected, but maintained an increase of 130 bps in the 10-year bond rates between May and October. Similarly, the 5-year bonds issued by the banking sector increased by 90 bps between May and October, while the corporate 5-year bonds reacted most, with a change of 180 bps in the same period, reflecting more expensive borrowing conditions.

As a result, the holders of government bonds accumulated losses of COP 10 trillion between May and June, with a subsequent correction of COP 5.4 trillion following the adjustment in the sovereign curve in the U.S. and the bias for prolonged maintenance of the Fed's monetary stimulus. Equally, the private sector temporarily postponed the rate of corporate emissions, which in May exceeded those of 2012 by COP 1 trillion, but through October they amounted to COP 1 trillion, below the figure recorded for the same month of 2012.

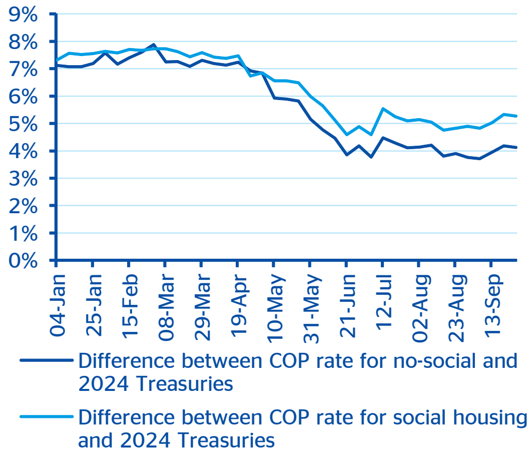
The more expensive debt in the capital markets has not been passed on to bank lending. Lending rates in the medium and long term have remained at very similar levels to those observed in June-July, with the spread on 10-year sovereign bonds narrower than at the start of the year. This is the case with mortgage lending (Chart 25) and commercial lending of over 5 years.

Chart 24
Sovereign, financial and corporate bond yield curve (%)*



For the financial sector, uses the DTF curve of AAA banks; for corporates, the CPI curve of the real AAA sector
Source: BVC and BBVA Research

Chart 25
Spread entre tasas de crédito hipotecario y TES 2024



Source: Superfinanciera and BBVA Research

Low vulnerability depends on the origin of the foreign deficit and type of finance

The current-account deficit of the Colombian economy has remained stable at around 3% of GDP in 2010. The main pressure factor on the deficit have been the dividends sent abroad by mining companies, which have been partially offset by greater exports of goods and services.

The high rates of investment in the economy, combined with the low capacity for savings in the country, appear to be the structural reason for this persistent deficit. In fact, the investment rate increased from 24.2% of GDP in 2010 to 28.4% now, while the capacity for private saving has barely risen and the fiscal deficit has fallen by just over 1 percentage point. At the same time, private consumption has not increased its share of GDP, nor has public expenditure. This means that external finance has been used to extend the country's production capacity, without having a direct influence on the greater current expenditure of households and the government.

In other words, Colombia's current-account deficit appears to have an intertemporal ratio, which reduces the risk of its unsustainability in the medium term and locates it at close to its structural level. This is the result of the greater production capacity of the economy and the resulting greater saving rate in the future to offset the current deficit.

There does not appear to be any greater uncertainty with respect to finance, given the increased importance of long-term flows in the financial account. FDI covers 117% of the current-account deficit, while the other components (loans and portfolio) only account for 33%. By definition, when the current account is tied to long-term flows such as FDI, it has fewer risks of the kind arising from international interest rates due to greater risk aversion or lower international liquidity. Quite the reverse, given that investment projects (mining and others) are permanent by nature, with long-lasting execution times, the resources remain in the country for a prudent time. At the same time, the new foreign investment resources (or at least a good part of them) are backed by the continuity of the country's mining and energy expansion and infrastructure projects.

7. Tables

Table 2
Macroeconomic forecast annual

	2011	2012	2013	2014
GDP (y/y %)	6.6	4.2	4.1	4.7
Private Consumption (y/y %)	5.9	4.7	3.9	4.4
Public Consumption (y/y %)	5.1	3.6	4.6	4.8
Fixed Investment (y/y %)	18.7	7.6	6.3	7.1
Inflation (y/y % EoP)	3.7	2.4	2.3	3.3
Exchange Rate (vs. USD, EoP)	1934	1794	1895	1900
Interest Rate (%, EoP)	4.75	4.25	3.25	4.25
Fiscal Balance (% GDP)	-2.9	-2.3	-2.5	-2.3
Current Account (% GDP)	-2.9	-3.3	-3.1	-2.9

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

Table 3
Macroeconomic Forecast Quarterly

	GDP (y/y %)	Inflation (y/y %, EoP)	Exchange Rate (vs. USD, EoP)	REPO rate (%, EoP)
1Q11	5.6	3.2	1884	3.50
2Q11	6.5	3.2	1783	4.25
3Q11	8.0	3.7	1836	4.50
4Q11	6.5	3.7	1934	4.75
1Q12	5.9	3.4	1766	5.25
2Q12	4.8	3.2	1793	5.25
3Q12	2.9	3.1	1803	4.75
4Q12	3.3	2.4	1794	4.25
1Q13	2.7	1.9	1810	3.25
2Q13	4.2	2.2	1910	3.25
3Q13	4.6	2.3	1919	3.25
4Q13	4.9	2.3	1895	3.25
1Q14	5.6	2.9	1920	3.25
2Q14	4.8	2.9	1890	3.75
3Q14	4.7	2.9	1875	4.00
4Q14	3.5	3.3	1900	4.25

Source: DANE, BanRep and BBVA Research Colombia

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