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ECONOMICS: LATIN AMERICA PERSPECTIVES

COLOMBIA: MANY POLICY CHALLENGES

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A decline in Colombia's terms of trade has helped slow the pace of growth and widen the country's current account deficit and fiscal imbalances. If oil prices don't rebound, more currency depreciation or additional adjustments will soon be needed.

CENTRAL BANK IN A TIGHT SPOT

Despite rising inflation, Banco de la República (BANREP), Colombia's central bank, held its target interest rate at 4.5% this week—where it has stood since last August (*Display 1*). The central bank argues that the spike in headline inflation—it's been on the rise since late 2013 and is above the top of the bank's official target range—is a temporary reaction to a food price shock. Some pass-through from currency depreciation has also contributed in recent months. But different measures of expected inflation are fairly well anchored at 3.5% or lower.

The inflation spike has been occurring while the economy has been slowing, a process that became more evident after Colombia's external terms of trade began to fall during the third quarter of last year. That is making the design and implementation of monetary policy more challenging.

Gross domestic product (GDP) expanded at an average annual pace of 5.2% during President Juan Manuel Santos's first term in office, but it's slowed to 3.2% in the past two quarters, and chances are that it will slow more over the rest of the year (*Display 2*).

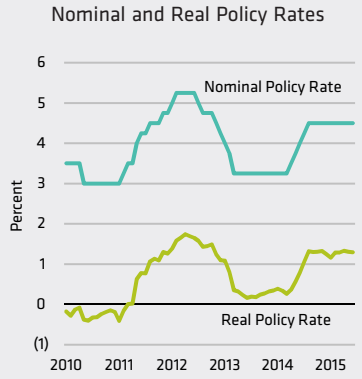
BANREP has correctly indicated that the slowdown is the result of an adjustment to less favorable external conditions, which will negatively impact national income. In other words, Colombia is moving toward a lower rate of potential growth. That means the country's output gap may be less negative than initially thought when the growth deceleration started.

Given these circumstances, BANREP has maintained a fairly conservative stance. Policymakers likely concluded that peso depreciation is helping to relax financial conditions, reducing the urgency to cut the policy rate.

That said, we believe the central bank will keep a close watch on economic activity data. If activity declines more sharply, we can't rule out a cut to the reference rate over the next few months. The window for making the move, however, may be small. That's because the US Federal Reserve could raise rates as soon as September. Looser policy in Colombia just as the Fed starts to tighten isn't likely.

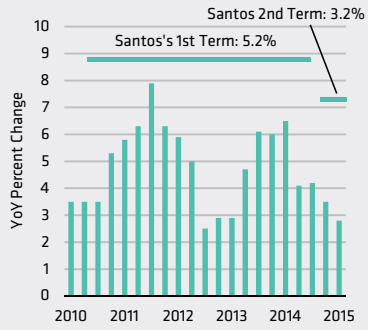
All in all, we don't expect BANREP to cut the policy rate unless current inflation falls below 4%. Even if that happens, we'd expect any easing cycle to be a moderate one.

Display 1
Is There Room to Cut Rates?



Through June 25, 2015
Source: Banco de la República AB

Display 2
Ongoing Deceleration



As of June 25, 2015
Source: Banco de la República, AB

WIDER IMBALANCES

The terms of trade shock that prompted the growth deceleration has caused Colombia's external and internal imbalances to widen. On the external front, the drop in export values occurred much more quickly than a contraction in imports, giving rise to an increase in the current account deficit, which is expected to hover around 6% of GDP this year (*Display 3*). BANREP has cited this imbalance as a risk to financial stability.

The currency has weakened significantly both in nominal and real terms. Combined with softer growth, this should gradually moderate the demand for imports. But without a rebound in oil prices, the overall adjustment in the current account is likely to be small. That means Colombia will require larger external financing over the near term.

The official financing plan for next year calls for US$6 billion worth of foreign financing, half of which would come from multilateral sources. That represents a 20% increase relative to 2014 and 2015 levels. With global interest rates expected to increase once the Fed makes its first move, this larger amount of foreign financing must be monitored closely.

The slowdown has also affected fiscal revenues. Spending, meanwhile, has not adjusted at the same pace. Consequently, the fiscal imbalance has also edged up. Last year, the central government deficit was equivalent to 2.4% of GDP, but a surplus in decentralized entities reduced the overall public sector imbalance to 1.8% (*Display 4*).

The central government deficit is expected to reach 3.0% this year and 3.6% in 2016, with the overall imbalance remaining around 2.4%. According to official projections, the public sector will remain in deficit until 2019.

These higher deficit figures are still within the parameters of the fiscal rules of the government and will be financed by a larger amount of Colombian treasury bills, or TES, in domestic auctions.

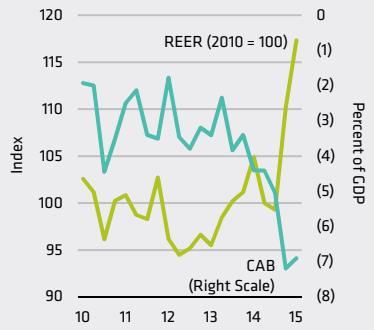
But if the economy slows further, more fiscal tightening will be needed. Last month, President Santos said a tax reform was not urgently needed. But we suspect that fiscal policy adjustments will have to be implemented sooner rather than later, so discussion of the tax reform issue may heat up again soon.

MORE FISCAL ADJUSTMENT

Despite the slowdown, Colombia is still growing more quickly than the Latin American average. Prospects for a peace agreement with the FARC guerrillas could unleash important productivity gains over the medium term. However, they pose an additional fiscal challenge for the near term—over and above those caused by slower growth.

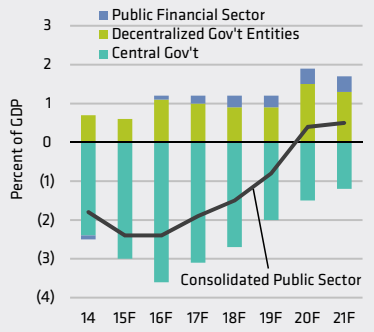
With local elections and the final stretch of the FARC talks on the calendar, we suspect tax reform will probably have to wait until 2016. In the meantime, the twin deficits will likely widen (unless oil prices increase), and the currency will remain Colombia's main adjustment valve. ■

Display 3
Deterioration of External Balance Despite Depreciation



Through June 25, 2015
Source: Banco de la República, AB

Display 4
Challenging Fiscal Outlook



As of June 25, 2015
Source: Ministry of Finance and Public Credit of Colombia, AB