BBVA | RESEARCH

Colombia Economic Outlook

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Global economy: slow recovery with the support of central banks

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Colombia is nearing completion of its adjustment to lower oil prices and its growth will gradually accelerate from 2017 onwards

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Closing date: October 24th

1. Editorial

2016 will be the year when much of the economy's adjustment to lower oil prices will have completed. On the one hand, consumption and investment have undergone a major adjustment this year and for the first time since oil prices fell, domestic demand will grow below total GDP. A good balance between production and spending will continue in the medium term, thanks to the fact that consumption will continue to grow at about the same rate as GDP. In total, we expect the economy to gradually accelerate from growth rates of 2.2% in 2016 to 2.4% in 2017.

On the other hand, the current account deficit, another of the adjustments demanded by the economy, is quickly imporving. Thanks to falling imports and lower profit repatriation, the deficit stood at 4.8% of GDP in the first half of the year. We believe that this deficit will be around 4.4% and 3.8% of GDP in 2016 and 2017, respectively, rates below the 6.5% of GDP that the economy recorded in 2015. The current exchange rate levels will continue to help this external deficit correct itself: in 2017, we expect the Colombian peso to record an average value of COP 3,007, very similar to the 2016 average.

In addition, the public accounts, with the passing of the tax reform, which should occur before the end of this year, will become more sustainable, replacing part of the revenue that the Treasury lost from the oil sector. The redistribution of tax burdens between individuals and businesses, simplifying of taxes, and legal and institutional strengthening to combat tax evasion and avoidance are the pillars of this proposal. In the short term, this reform increases the uncertainty already generated by the victory of the No option in the plebiscite, which will affect some decisions on consumption and investment. However, in the medium term, if most of the proposal is approved, tax revenues that were transitory will become permanent and will have positive effects on the productivity and formalization of the economy.

Inflation, which had been accelerating since late 2014 due to the devaluation and the El Niño phenomenon, peaked in July and has since declined due to these two factors, which, being temporary in nature, are losing momentum. In this context, we believe that this year inflation will end at a rate close to 6.2% and in the second half of next year, it will be around the top of the target range.

Given the rapid decline in inflation and moderate growth in domestic demand, BanRep will be more aggressive in reducing the intervention rate throughout 2017. We believe that the monetary authority could reduce its benchmark rate to 175 basis points, leaving it at 6.0%.

In conclusion, Colombia has weathered the fall in oil prices quite well. The growth of its economy has been higher than those in Latin America, and the correction of its external imbalance has been surprisingly speedy. Inflation will soon be in the target range and the fiscal deficit will continue to moderate without sharp adjustments in spending. Also, the current account deficit will continue to decline and, at a sectoral level, the economy will be more balanced, which will make economic growth more sustainable in the medium term.

2. Latin America: Turning Point

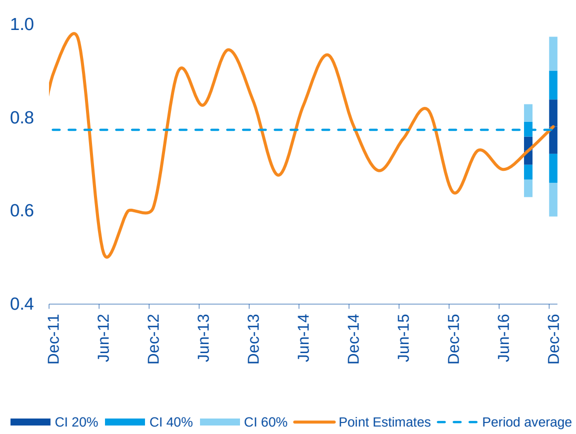
Global scenario: slow recovery with the support of central banks

There has been very little news in the past few months on the performance of the world economy. Financial stresses have remained moderate, while global activity seems to be showing signs of slight improvement (Figure 2.1) following a weak first half-year and some stabilization of international trade. All this with the continued support of the economic authorities, especially the developed countries' central banks. In particular, the US Federal Reserve's more cautious tone confirms a very gradual normalisation of interest rates once the second hike materialises, probably in December.

Meanwhile the emerging economies continue to see inflows of capital driven by the search for yield and low volatility, plus the recovery in oil and other commodity prices. As regards currencies, the US Federal Reserve interest rate hike expected before year-end is favouring the dollar's generalised appreciation.

Figure 2.1

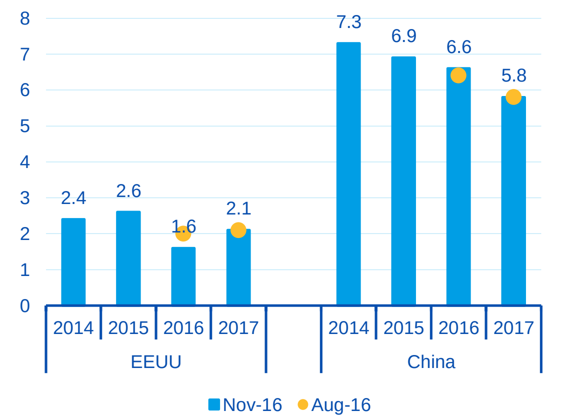
Global GDP, % QoQ. 3Q and 4Q forecasts for 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2.2

GDP growth in the US and China (%)



Source: BBVA Research

Changes in forecasts for the US and China, the two economies with the most influence on Latin America, have gone in opposite directions. The latest US data point to less robust growth in the second half of the year than was foreseen three months ago, following a first half that was already weak, and this leads us to revise our growth forecast for this year downwards by 0.4 pp to 1.6% (Figure 2.2). This is a clear slowdown in activity compared to the average increase of close to 2.5% in the 2014-15 biennium.

The growth composition continues to stoke concerns about medium-term potential, as it continues to show a two-speed economy, with solid private consumption but investment that might fall slightly for 2016 as a whole, after advancing by less than 1% on average in the past five years. Expectations of lower long-term growth potential might be holding back investment decisions, and might in turn feed back into reduced increases in productivity in the future, with a labour market at practically full employment. Even so, we still expect a moderate advance of 2.1% in 2017.

World growth will increase slowly in 2017 relative to 2016

Turning to China, the fiscal and monetary stimulus measures put in place at the beginning of the year to stabilize growth have borne fruit and will allow the short-term growth target set by the authorities to be met, at the expense of building up growing imbalances. We are therefore revising our growth forecast for 2016 upwards to 6.6% (Figure 2.2). Nonetheless, the outlook is still for gradual slowdown to 5.8% in 2017. Moreover, medium-term risks are increasing, especially those of overheating in the real estate sector, financial instability, depreciation of the yuan and capital flight, as well as companies' indebtedness. In the long term, doubts about growth prospects persist given the slow progress of structural reforms in certain key areas, particularly state-owned companies.

In this context, we have revised our global growth forecast slightly downwards, partly in view of the worse-than-expected results of the first half of the year in certain areas, and also in the light of the lower growth foreseen in the USA. In any case, growth will hold at around 3% in 2016, with a slight increase to 3.2% in 2017.

3. The economy is near to finalising adjustments to lower oil prices

Forces encountered in the performance of domestic asset markets

Various factors generating opposing forces have determined the recent behaviour of financial markets in Colombia. On the one hand, pressures for exchange rate devaluation and the decline of domestic assets came from the increasing probability of a US rate hike, in line with our expectation of an increase of 25 basis points in December this year. This pressure, which was not common to all developed markets, was combined with the political uncertainty caused by the surprise negative result of the plebiscite to ratify the peace agreement signed between the Colombian government and the FARC. However, the effect on the markets of the latter factor was very limited and corrections quickly ensued.

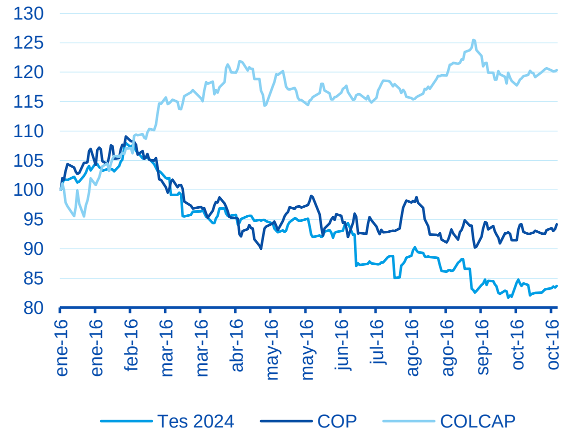
Meanwhile, among the factors that led to exchange rate appreciations and domestic asset valuations are rising oil prices and increased capital flows to Colombia. In the first case, the imbalance in the oil market has been self-correcting and the lower excess of supply, also including the production cuts announced by OPEC, caused an increase in the international price of oil prices at the moment this publication was finalized. In the second case, the trigger was the increase by about 4 percentage points (pp) of the Colombian weighting in the investment grade country index of the investment bank JP Morgan.

These factors have been offset, creating some stability in valuations of local assets in recent weeks, although strong volatility prevailed in the meantime. Indeed, the rates at the long end of the yield curve have remained relatively stable since September (2024 TES at rates close to 7.0%), the same as the exchange rate (at around 2,930 COP) and the stock index (Figure 3.1). Internal debt bonds (TES) held by foreign investors, meanwhile, reached 23.3% of that issued up to September (Figure 3.2).

Looking forward, progressive correction of the inflation rate will add to the factors pushing towards a recovery at the short end of the yield curve of government debt. Meanwhile, the materialization of the Fed's rate rise and the stability of oil prices determine some devaluations at the long end of the curve and pressure the devaluation of the exchange rate, which will continue until the first few months of 2017.

Figure 3.1

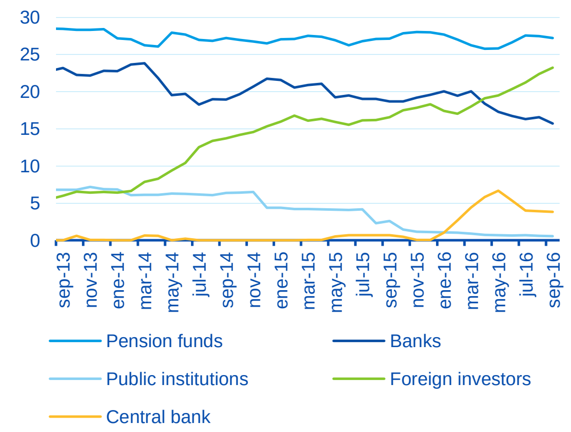
TES 2024, COLCAP stock index and exchange rate (index, Jan-04 = 100)



Source: Bloomberg and BBVA Research

Figure 3.2

TES bonds by holder (%, participation in the total)



Source: Ministry of Finance and BBVA Research

The Colombian economy will continue to expand, although in the short term it will do so at a slower pace

All the most recent economic data, which include the publication of 2Q GDP and some 3Q indicators, show a further slowdown of activity with regard to that initially planned. This lower growth is occurring in all components of domestic demand. On the one hand, private consumption rapidly eased in line with the drop in household confidence, and the slowdown was beyond the drop in spending on durable goods, which came from before, and extended to other product groups.

Moreover, private investment is recovering, as we anticipated, but at a much slower pace than initially estimated. The uncertainty of businessmen in the manufacturing sector (exchange rate, tax reform and socio-political conditions, especially) is preventing the economic signal that an increased use of installed capacity be transformed into greater investment.

The result of the plebiscite, where the Peace Agreement signed between the government and the FARC in early October was not ratified has generated uncertainty which may affect consumption and investment decisions in the remaining months of the year and, if this uncertainty is prolonged, it could also affect such decisions in 2017. This uncertainty is combined with the discussion process on tax reform presented by the Government to Congress on October 19th and will not end before mid-December. Very important and favourable changes in taxation are proposed, such as those to do with the tax burden on companies and the fight against tax evasion. The proposed reform includes an increase in general VAT, an increase in taxes on legal persons of high income, a reduction in the tax burden on companies and several instruments to improve the ability to control tax evasion and bring the country to within international practice in this area.

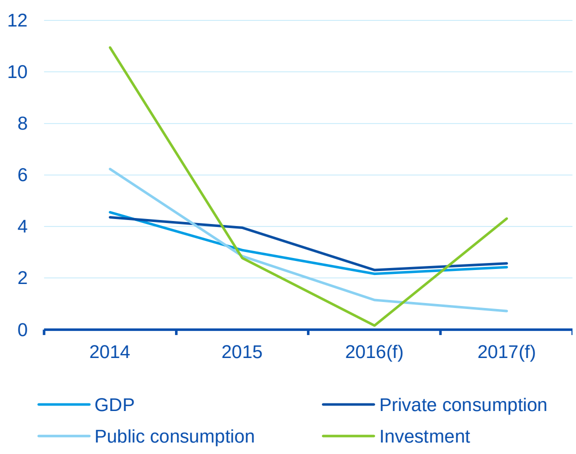
Given the leading indicators published recently, the uncertainties mentioned above together with the tax reform yet to be approved, we believe that the expected growth in the economy in 2016 and 2017 will be lower than we projected three months ago. In total, we estimate a marginal correction to the 2016 growth rate of 2.2%, while for 2017 we expect a moderate acceleration to 2.4% throughout the year, compared with the 3% we had in our previous scenario.

For 2017, investment will remain the main support, both that from civil works, although with a smaller contribution than expected before, like that carried out by the manufacturing and mining industries. Regarding investment not directed at civil works, basic effects that favoured its sluggishness during 2016, the gradual recovery in raw materials prices and the continued good results in the industry will help determine growth rates for investment that are above total GDP growth. Advances in civil works, including the beginnings of Fourth Generation infrastructural works, will remain one of the engines of growth. However, we believe that their effect in 2017 will be less than estimated three months ago because of the perceived delay.

Private consumption will grow marginally more in 2017 compared to 2016 (2.6% annually vs. 2.3%) (Figure 3.3). Increases in VAT and increases in taxes on high-income individuals should be approved in the tax reform, the higher expected rate of unemployment and the validity period for monetary policy interest rates, which are higher than the neutral rate throughout most of the year, will limit household consumption.

Figure 3.3

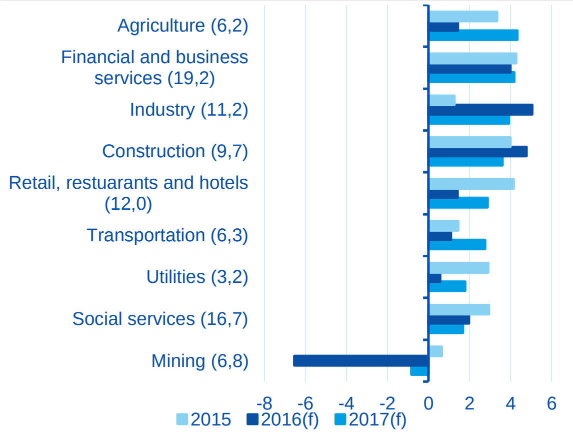
GDP growth, demand side (%, YOY)



Source: DANE and BBVA Research

Figure 3.4

GDP growth, supply side (%, YOY)



Source: DANE and BBVA Research

By sector, agriculture, along with the construction and industry sectors will grow faster than the economy-wide average in 2017 (Figure 3.4). Agriculture, fuelled by 2016's high prices and the normalization of the climate, will increase output at rates close to 4%. Construction, driven by 4G infrastructure projects and low and middle-price housing, will grow by about 3.5%. Industrial production, supported by increased external demand and its own increase in installed capacity will grow by more than 3.5%. Tourism will continue its winning streak, taking advantage of security gains and the weak exchange rate. On the other hand, mining will continue in the doldrums due to the lower production in oil that we expect next year.

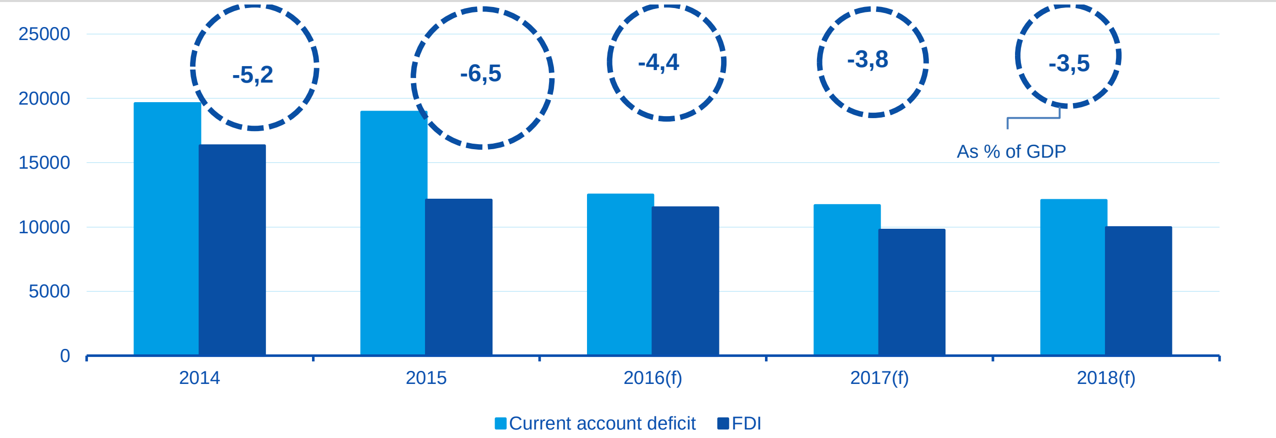
In the medium and long term, the economy will accelerate gradually, reaching growth rates of around 4% in 2019. After this year, the internal rate of expansion will stabilise at slightly higher figures (one or two tenths above).

The closure of the current account deficit is gaining speed

The growth expected for 2016 and 2017 implies a limited increase in imported goods, in line with the low momentum of domestic demand. The positive effect of this composition of growth will be a faster closure of the trade deficit and the current account. This year, the current account deficit could end up at 4.4% of GDP and in 2017 could be further adjusted to 3.8% of GDP. As a result, this year's financing needs will be lower than capital inflows, albeit by a narrow margin, allowing for a contained accumulation of international reserves. Over the next year, funding will also suffice, but the share of foreign direct investment (FDI) in the flow of resources will be lower. In fact, while FDI this year will cover 92% of the deficit in the current account, next year this figure will be reduced to 84% (Figure 3.5).

Figure 3.5

Current account deficit and foreign direct investment (millions of USD)



(f): forecast.
Source: Banco de la República and BBVA Research

Food prices speed up the bringing of inflation within the target range

Inflation has begun to recede rapidly in recent months thanks to the sharp decline in food prices, which was expected after the end of El Niño. Indeed, food prices fell on average by 5% between July and September, helping total inflation finish the third quarter at a rate of 7.3% YoY, the lowest in 2016. In the coming months, we expect food inflation to continue receding, though at a slower pace than we saw in recent months.

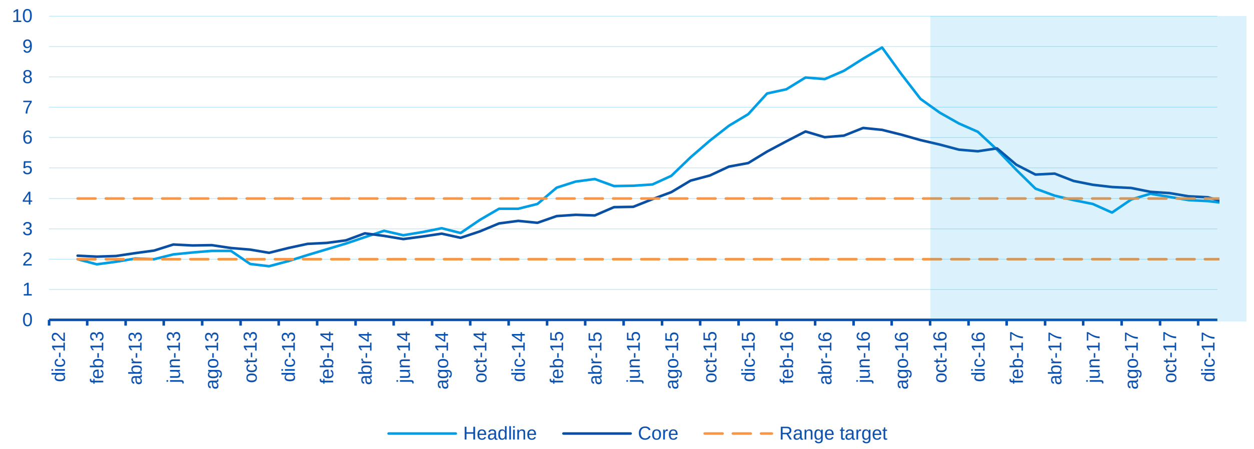
As a result of improved weather, hydroelectric generation of electricity gained in share of total output, allowing for a significant reduction in energy prices on the stock market. The price per kWh in the third quarter (COP 159) fell by 64% over the average of the first half (COP 445). These lower prices will reduce the payment made by households for energy rates in the coming months, becoming another factor that ensures that inflation will continue to slow down.

The stability of the exchange rate in recent months has also contributed, albeit to a lesser extent, to the moderation of inflation. In 3Q16 the exchange rate stood at COP 2,946, 6% below the average level recorded during 1H16. This appreciation in the exchange rate has helped tradable inflation begin decreasing from growth rates of 7.9% YoY by mid-year, to a rate of 7.2% in September. The price of gas, where about 40% of its rate is indexed to the performance of the dollar, has also benefited from this appreciation: between July and September rates for this service went down from growth rates of 20% to rates of 10% YoY.

Non-food inflation, thanks to falling tradable inflation and to the slowdown in consumption, also seems to be following a downward path. In this context, we believe that total and core inflation will continue to decline in the coming months. The observed rapid adjustment in food prices leads us to reduce our inflation forecast for the end of 2016 from 6.9% to 6.2%. This downward adjustment will result in a lower inflationary inertia in 2017 (via the adjustment of wages and prices for some services, such as leases), which together with the lower growth we expect for this year, means a downward adjustment in our forecast for 2017. In total, we expect inflation to be at the top of the BanRep target range in 2H17, and end the year at a rate of 3.9% (Figure 3.6).

Figure 3.6

Headline and core inflation (%, YoY)



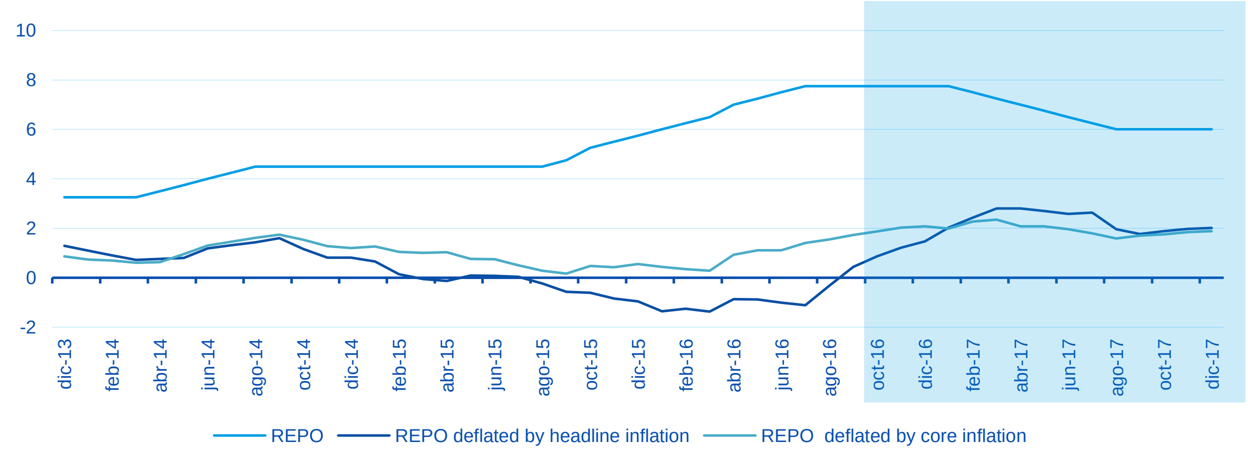
(f): forecast.
Source: Banco de la República and BBVA Research

Monetary policy will have more room for reductions

The downward adjustments in our forecasts for growth and inflation open the possibility for BanRep to be more aggressive in reducing its intervention rate throughout 2017. In this context, we believe that the monetary authority could make cuts in its intervention rate by up to 175 basis points, leaving it at 6.0%. Thus, discounting the inflation rate of 2H17, the real intervention rate would be at levels close to 2% (Figure 3.7).

Figure 3.7

Central bank intervention rate (%)



Source: Banco de la República and BBVA Research

Tax reform will increase taxes more gradually

Last October 18th, the Government sent its tax reform bill to Congress. This is a structural reform that increases collection, rebalances the tax burden from corporations to individuals, and simplifies and increases taxes bases. It also replaces temporary taxes for permanent ones, fights tax evasion and promotes formalization.

According to the Government, the reform increases non-oil fiscal revenue by an amount of 0.8% of GDP in 2017, a figure that will rise gradually in the following years and to which must be added the effects of increased revenues because of the formalization of the economy (Figure 3.8).

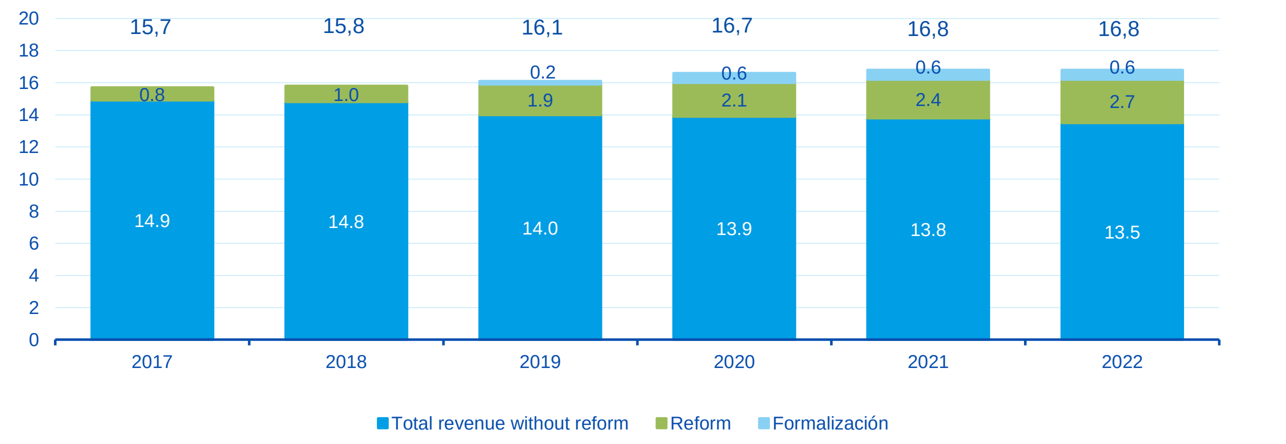
Regarding indirect taxes, the reform increases rates and marginally modifies the basket of goods. The proposed legislation seeks to increase the rate of general VAT from 16% to 19%, from 2017 and the list of goods that are VAT exempt or excluded remains virtually unchanged.

For corporations, the taxation scheme is simplified, the tax base goes up, while tariffs decrease very significantly from next year. The new rates would leave Colombia much closer to its counterparts in the Pacific Alliance. Additionally, in order to promote investment, there is a proposed full refund of VAT paid on the purchase of capital goods. For individuals, the tax base increases and the tax regime is simplified.

A central aspect of the reform is the fight against tax evasion and avoidance by strengthening tax administration and by categorizing tax evasion as a criminal offence. In addition, the reform introduces new rules for Non-Profit Institutions in order to control their evasion. The reform also includes international information exchange schemes and forces the disclosure of aggressive tax planning in accordance with OECD guidelines. A very valuable aspect of the reform is that it promotes formality by (i) maintaining the exemption of part of the payroll taxes of employer for workers with salaries of less than ten minimum wages, (ii) introducing the single tax (“Monotax”) and (iii) discouraging the use of cash.

Figure 3.8

Central government revenue with and without reform (% of GDP)



Source: Ministerio de Hacienda and BBVA Research

There is a lot of uncertainty about the articles that will finally be approved. In Congress and at regional forums, the reform is being discussed and it is likely that some changes might be introduced in the process.

We believe the National Government will achieve a reform that will give more room to his spending path compared to the one presented in its budget for 2017. Government public debt will be at around 43.8% of GDP at the end of the year (it was 45.1% of GDP in 2015).

The volatility of the exchange rate will continue

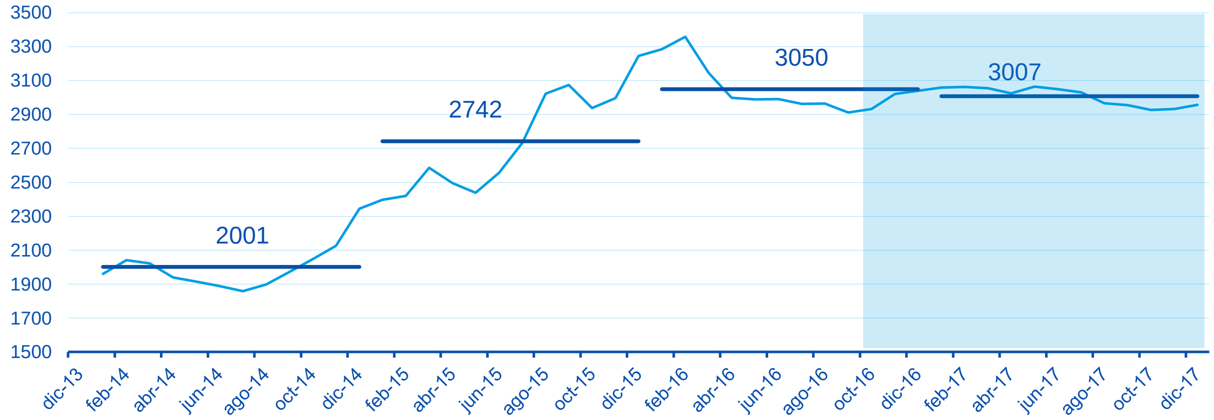
The exchange rate will continue a process of significant volatility in the coming months and during 2017. This is all due to the possible change in monetary stance by the Fed, volatility in oil prices, prospects of lower income portfolio capital and uncertainty about the final approved text regarding tax reform. It is also due to the closure of new peace negotiations with the FARC guerrillas, who are trying to include in the agreements the requests of groups of citizens who voted for the non-ratification of the agreements.

An additional factor of volatility are international credit rating agencies that are attentive to the tax reform approved by Congress to assess and consider if they maintain the current rating and negative outlook or consider to step it down. The Colombian economy has several positive factors in this rating evaluation process and two can be highlighted here: the rapid and forceful closure of the balance of payments current account deficit at 7.7% in the third quarter of 2015, when it peaked at 3.8% of estimated GDP for 2017. The other factor to note is that despite the magnitude of the shock to the mining and oil sector, the economy managed to maintain positive growth rates and the adjustment seems to have bottomed out in 2016.

We believe that the peso, in this context, would close 2016 at levels close to 3,040 COP, and is expected to peak next February (Figure 3.9). In 2H17, the exchange rate will appreciate against the average for 1H17, finishing the year at a level around 2,957 COP. On average, 2017 will have a COP which has appreciated slightly more than the levels registered in 2016. However, its appreciation (-1.4%) will be lower than we estimated in our previous publication (-6.0%).

Figure 3.9

Exchange rate (COP/1USD, yearly and monthly averages)



Source: Banco de la República and BBVA Research

Downward risks to growth

The recovery of global growth is still fragile. The probability that the US will slow to below current rates or that China will have a hard landing because of the transition in its economy, is not zero, but it is still low. If this were to happen, the Colombian economy would grow less because improvements in exports, which we would expect to consolidate from late 2017, would not materialise. External financing of the current account could also be affected and lead to a further tightening of domestic demand, limiting the recovery of private investment.

In addition, of domestic origin, the main risks facing the economy are adopting a more limited tax reform in terms of collection and structural improvements to the system, prolonging the uncertainty of the peace process and/or a new escalation of the internal conflict. These risks would have an effect on public investment and, therefore, growth observed in 2017 and expectations in the medium and long term. For example, the minor construction of secondary and tertiary roads, ports, sewers and other infrastructure financed through the public budget will affect the country's productivity going forward. Indirectly, a possible deterioration in confidence regarding the realisation of any of these risks can affect investment and private consumption next year.

4. Forecasts

Table 4.1

Macroeconomic Forecasts

	2012	2013	2014	2015	2016	2017
GDP (YoY. %)	4,0	4,9	4,4	3,1	2,2	2,4
Private consumption (YoY, %)	4,4	3,4	4,2	3,9	2,3	2,6
Public consumption (YoY, %)	6,3	9,2	4,7	2,8	1,1	0,7
Fixed investment (YoY, %)	4,7	6,8	9,7	2,8	0,2	4,3
Inflation (% YoY. eop)	2,4	-1,9	3.7	6,8	6,2	3,9
Inflation (% YoY. average)	3,2	2,0	3,7	5,0	7,6	4,2
Exchange rate (eop)	1.768	1.927	2.392	3.149	3.040	2.957
Devaluation (%. eop)	-9,0	9,0	24,1	31,6	-3,4	-2,7
Exchange rate (average)	1.798	1.867	2.001	2.742	3.050	3.007
Devaluation (%. average)	-2,7	3,8	7,2	37,0	11,2	-1,4
BanRep interest rate (%. eop)	4,3	3,3	4,5	5,8	7,8	6,0
FTD interest rate (%. eop	5,2	4,1	4,3	5,2	7,5	6,2
Unemployment rate (%. eop)	10,2	9,7	9,3	9,8	10,3	10,9
Fiscal balance (% of GDP)	-2,3	-2,3	-2,4	-3,0	-3,9	-3,3
Current account deficit (% of GDP)	-3,0	-3,2	-5,2	-6,5	-4,4	-3,8

Forecast closing date: October 28th.
Source: DANE, Banco de la República, Ministerio de Hacienda and BBVA Research

Table 4.2

Macroeconomic Forecasts

	GDP (%, YoY)	Inflation (%, YoY, eop)	Exchange rete (COP/1USD, eop)	BanRep REPO rate (%, eop)
Q1 14	6,4	2,5	1.965	3,25
Q2 14	4,0	2,8	1.881	4,00
Q3 14	3,9	2,9	2.028	4,50
Q4 14	3,3	3,7	2.392	4,50
Q1 15	2,7	4,6	2.576	4,50
Q2 15	3,1	4,4	2.585	4,50
Q3 15	3,1	5,4	3.122	4,75
Q4 15	3,4	6,8	3.149	5,75
Q1 16	2,5	8,0	3.022	6,50
Q2 16	2,0	8,6	2.916	7,50
Q3 16	1,9	7,3	2.880	7,75
Q4 16	2,2	6,2	3.040	7,75
Q1 17	1,9	4,3	3.055	7,25
Q2 17	2,1	3,8	3.050	6,50
Q3 17	3,2	4,2	2.955	6,00
Q4 17	2,4	3,9	2.957	6,00

Forecast closing date: October 28th.
Source: DANE, Banco de la República, Ministerio de Hacienda and BBVA Research