Colombia Economic Outlook

4th QUARTER 2017 | Colombia Unit

BBVA | Research

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Closing date: **11 October 2017**

1. Editorial

The world economy is showing robust growth, being driven by better than expected results in China and Europe, and with encouraging readings in the United States. With respect to Latin America, the expected recovery has taken hold, although it is doing so at a slower pace than the global economy. For 2017 we have raised our forecast for world growth to 3.4% and we are maintaining the same reading for 2018. This performance has given free rein to the major central banks in the developed economies to embark on their exit strategies after several years of generous stimuli, yet even so the markets have remained calm over this policy tightening and are still in positive territory with perceived risk on the low side.

The healthy momentum externally has still not shown through in most macro figures for Colombia's economy, partly because the more recent slowdown has mostly been based on domestic factors such as consumer and business confidence rather than on any external pull via exports or capital inflows. Nonetheless, some positive signs of a change in trend are being glimpsed and it seems that the Colombian economy should have bottomed out in the second quarter this year. Part of the economy's encouraging response has been built on an easing of factors which had been restricting private spending, such as high inflation, high interest rates and the tax reform, thereby opening up some breathing space for variables such as investment to recover. Added to this, is the good performance from public consumption.

In 2018 growth will remain modest, at 2%, even though most sectors of the economy will exhibit some degree of acceleration. This across-the-board sector behaviour will be mirrored in a recovery of household spending and additional growth in investment and exports; although in 2018 the government may make a smaller contribution to GDP growth.

Within this setting, in 2018 inflation will converge on the central bank's precise target and by the close in 2017 it will reach a level close to the ceiling of the target range. These factors will allow the central bank to reinitiate its rate cut cycle in 2018 with reductions of at least 75bp. Finally, the exchange rate will remain at around COP3000 to the dollar on average, although it could suffer fits and starts as well as volatility in early 2018 on account of Fed decisions, the oil price and the Colombian election period, after which we will once again see the currency's exchange rate settle and return to its strengthening trend with the rising oil price.

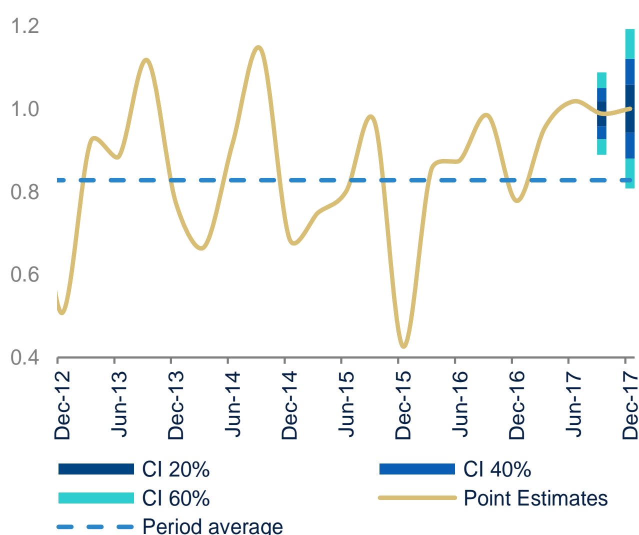
The main risk for the economy will be associated with the process of monetary policy normalisation in the United States, which could prompt some capital migration, exchange rate depreciation and a slight rise in risk premiums, all of which are factors that increase the cost of borrowing. Even though this risk is latent, the market perception of risk is still at a low level. On the domestic front, the risk lies with a potential postponement of the investment and recovery processes, which could be brought about by a decline in confidence.

2. The positive global environment is strengthening

Robust and steady global growth with a more synchronized recovery across areas

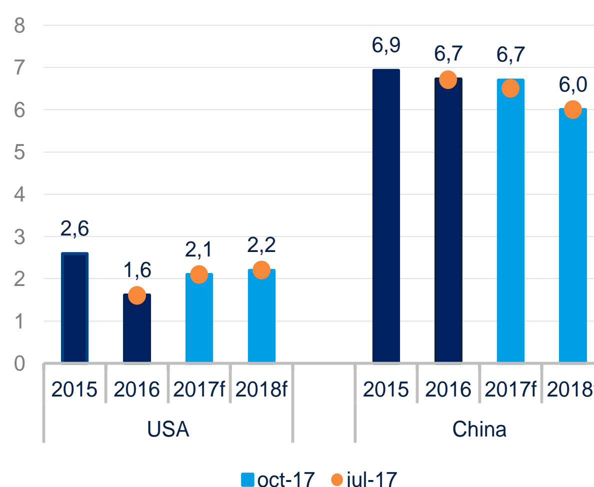
The growth rate of the world economy has stabilised by mid-year at around 1% QoQ, and the available indicators suggest so far that this trend will continue in the second half of the year (Figure 1). This positive dynamic reflects a stronger economic performance in all areas, making the current recovery the most synchronized since the financial crisis of 2008-9.

Figure 1. World GDP growth
(QoQ, %) Forecasts based on BBVA-GAIN



Source: BBVA Research

Figure 2.2 USA and China GDP growth
(annual variation, %)



Source: BBVA Research

This environment of positive and more synchronised growth has thus far been accompanied by moderate levels of inflation, also generalized by areas, despite the abundance of liquidity in the markets, while there are still no clear signs of accumulation of inflationary pressures. This context helps central banks in the emerging economies to have greater room for manoeuvre to continue supporting growth, while it allows the monetary authorities in the advanced economies to remain cautious in normalizing their monetary policies. In an environment where growth remains dynamic and with no downward surprises on inflation, central banks are pressing ahead with the gradual process of withdrawing monetary stimulus. Specifically, we expect a 25 bp hike for official rates of the Fed in December this year and then two further hikes up to 2% in 2018. However, uncertainty about these hikes has increased, not only because inflation is still at low levels, but also because of the changes of several of its members.

Like in the previous quarter, the combination of low volatility, low rates and dollar weakness have drawn a favourable outlook for EMs. Hunt for yield strategies have led to strong inflows towards EMs, particularly in the bond market, as

well as currency strength. In general, the international landscape has been accompanied by relatively complacent financial markets that are not suffering persistently from sources of political or geopolitical stress.

Our new forecasts lead global growth to accelerate to 3.4% in 2017-18, which implies an upward revision of around 0.2pp this year and an acceleration from 3.2% in 2016. This change is due to higher forecasted growth both for China and Europe in 2017 on account of positive surprises in both regions since Q2. Thus, we expect China to grow by 6.7% and 6% by 2017-18 (Chart 2.2), while Europe would grow by 2.2% and 1.8%. For the United States, we are maintaining our estimate of sustained growth of slightly over 2% within the forecast horizon, while the better progress predicted for the Latam economies is being confirmed. In contrast, growth for the rest of the Asian economies will continue to be robust, although it will feel the effect of the expected slowdown in the Chinese economy in the coming quarters.

The underlying factors supporting the acceleration and stability of global growth will remain present, even though some of them could gradually wear off in the coming quarters. The most immediate will be the normalisation of monetary policy by both the Federal Reserve and the European Central Bank, as it will lead to gradual reduction in global liquidity and less support for capital flows into the emerging economies. In addition, there are still multiple political risks that can influence economic confidence and market behaviour.

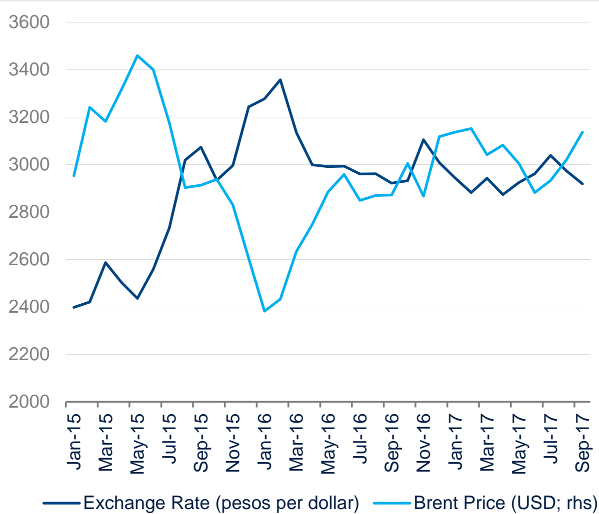
The downside risks to this global scenario that may most affect Latin America remain, on the US side, the unknowns regarding the implementation of the economic policy measures announced, whereas the long period of cyclical expansion together with lax demand-side policies still work in favour of a build-up of financial vulnerabilities that could trigger a recession in the medium term. On the Chinese side, the authorities' strategy and the more gradual slowdown in growth have diminished the risks over the forecast horizon, although they are still rising over the medium term given that debt remains on the rise with some debt service indicators at high levels, while the adjustments by state-owned companies is still being delayed.

3. The economy in 2017: in search of the turning point

Markets: dollar kept in check by a rising crude oil price, assets undecided over the quarter

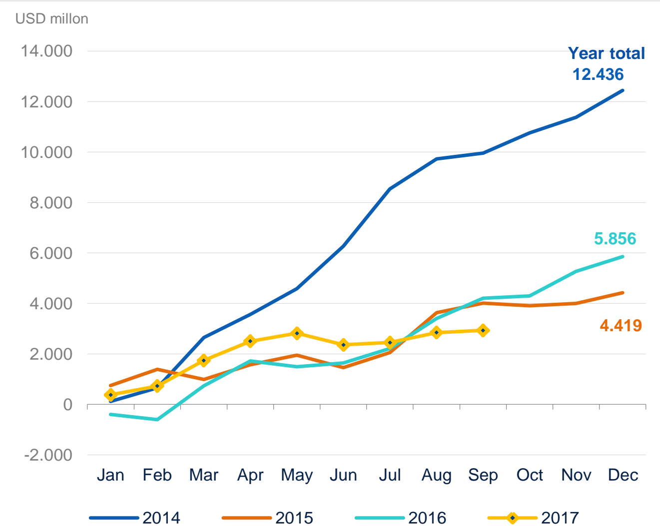
Over the third quarter, crude came back onto a rising course as a result of some disruptions to the supply from the Middle East and uncertainty caused by one of the heaviest hurricane seasons in the Atlantic Ocean. Even so, in the midst of these dynamics a key role was also played by strengthening demand and the declared intention of several OPEC member countries, including Saudi Arabia, to prolong production cuts. The Brent benchmark crude price thus hit USD52.2/bbl. in the quarter, showing a rise of 2.7% over its Q2 average (Figure 3.1).

Figure 3.1 Brent Oil and Exchange Rate



Source: Bloomberg

Figure 3.2 Net Portfolio Capital Flows



Source: Banco de la República de Colombia

In this scenario the COP appreciated markedly over the quarter, from 3038.26 pesos to the dollar at the end of June to 2941.07 at the end of September, with a maximum trading range of 199.47 pesos (Figure 3.2). This trend was overshadowed at the end of the quarter by Federal Reserve announcements of potential tightening of its monetary policy, hiking rates and unwinding its balance sheet in the fourth quarter.

On the capital markets front, the quarter saw mixed trends which reflected both domestic and external uncertainty. On the domestic side, the quarter began with a drop in the price of Colombian treasury bonds that was caused by a blend of: the announcements about the National Government's medium term fiscal framework, the Fed announcements on scaling back the balance sheet and crude price volatility in June. From these levels there was a strong resurgence in their market price which was then affected once more by Fed announcements from abroad in the latter half of September and upturns in domestic inflation accompanied by a potential pause in the central bank's cycle of rate cuts.

The mixed trends in the quarter also showed through in the performance of assets; on the one hand, the cost of underwriting Colombian bonds as measured via CDSs came down by 13.89 points, while the rate on Colombian 2024 treasuries rose by 18bp. At the same time, the Colcap share index was up slightly, by 1.7%, on the quarter. In terms of investments, net foreign flows fell back considerably, reaching USD577mn in the quarter as of 15 September, which was substantially less than the level observed in the first half of the year of USD2.357bn (Figure 3.2).

Activity indicators show signs of improving, thus confirming that the economy ought to have bottomed out in 2Q17

Colombia's economy grew by 1.2% in the first half of 2017. This resulted from a continuation of the gradual yet steady process of economic slowdown which began with the drop in the oil price in 2014. More recently, going into the second half, the economic indicators are showing signs of improvement, which could be associated with a turning point in the decelerating path, and confirm the beginnings of a recovery in activity. Lower inflation and the rate cuts also point in the same direction.

Export and investment figures stand out. In the former case, there has been a notable increase in the monthly average of agro-industrial exports since May. In the case of investment, the positive takeaway can be found in the rise in imports directed at capital goods. This is the import component that has grown the most over the year so far. Moreover, its rate has picked up since midway through the second quarter despite the fact that in the first part of the year this was very heavily driven by aircraft imports, which almost completely faded away from May onward.

The second half of the year should therefore see higher growth than in the first half. The argument in favour of this course of events is supported by the better figures discussed above and also certain base effects which worked in favour of the performance in 3Q17. Here we refer to the lorry strike in July 2016, which frustrated a great deal of the economy's transactions last year and led to a low basis for comparison relative to this year's performance.

Nonetheless, we also expect other positive (or less negative) factors to gel which will underpin the coming recovery and mean that fourth quarter growth will also surpass that seen in the first half, in spite of the absence of statistically based factors at year end. These are: execution of the 4G civil engineering work, higher oil prices, investment in the mining and oil industry and the farming and livestock sector, the latter due to recent high growth rates. On top of this, though to a lesser extent, there will be a pick-up in the real estate projects that had been held up by low sales growth prior to implementation in September of the mortgage rate subsidy (although this will not offset the sharp drop in building work up to June).

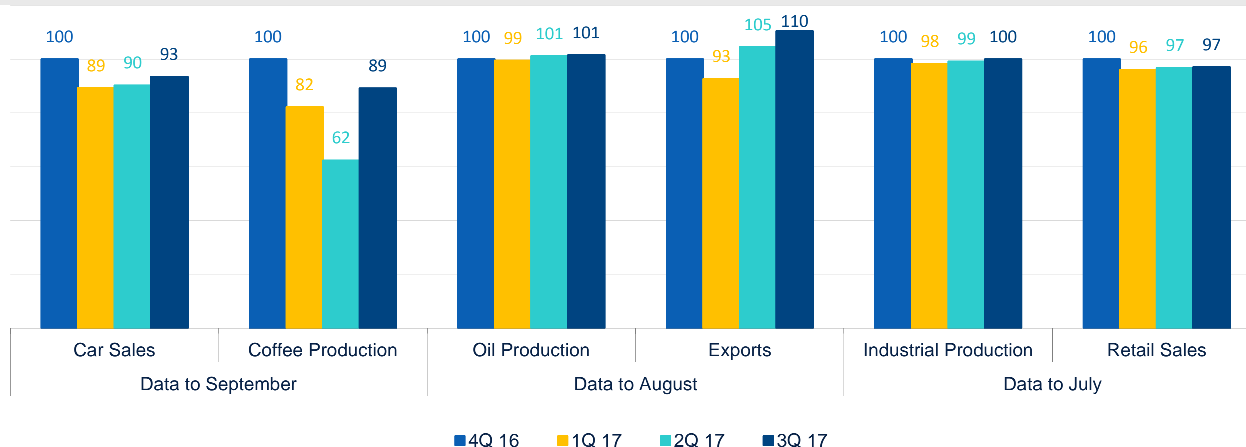
An additional spur to economic activity has come in the form of public consumption, which grew at 3.4% YoY in the first half. Yet the momentum from this appears to have been transitory and will gradually wear off from late in the year. As we shall see anon in the fiscal section, government budget conditions require it to tighten up on public expenditure in 2018. Moreover, the law on electoral guarantees, which restricts direct contracting by arms of government for a certain number of months prior to elections (from November 2017), could stand in the way of high growth levels under

this heading, despite the fact that government bodies are now showing better control over expenditure restriction periods, and besides the above factors there is also a base effect as a result of a better performance than that recorded in recent years which places a limit on growth capacity in 2018.

Nevertheless, the economy's acceleration is being limited by domestic confidence. Consumers are still pessimistic about current and future conditions in the country, even though their perception of household finances has improved (employment, household income, etc.). On the other hand, industrial respondents suggest that order volumes are still low although their inventories are slowly coming down and installed capacity utilisation stands at slightly above the historical average.

We expect GDP growth for 2017 to be 1.5%, which is the lowest rate for Colombia's economy since the oil price fell. This reading has been attained via growth of 1.6% in household consumption and of 1.2% in investment, marking a return to positive territory after two years of contraction with respect to the latter. The great driver will be public consumption, with growth of 3.5%, whereas external demand will not play a decisive role in 2017.

Figure 3.3 Leader Indicators*
4Q.16 = 100



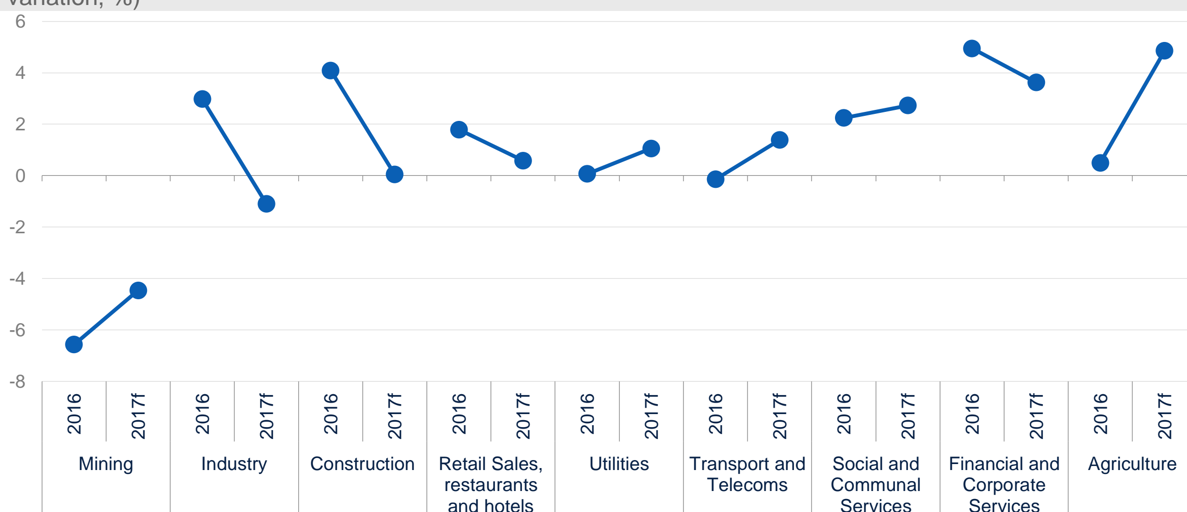
Source: DANE, Fenalco, ANH, Federación Nacional de Cafeteros, BBVA Research

Not many sectors are driving the economy, which betrays the weakness of private demand

The weakness of private demand has had negative consequences on several sectors in the economy. Trade has suffered from the lower consumption level and its growth rate in 2017 will be barely 0.6%. Besides having to cope with frail domestic demand, industry has also been hit by the weakness of Colombia's trading partners and will consequently suffer a contraction of 1.0%. Even so, not all of the manufacturing sectors are in decline: the foods, and chemical products and paper segments are having a very good year thanks to increased agricultural supply and the fact that the demand for these products has not been very badly affected. For its part, despite the gradual upturn in civil project work, which has partly been driven by 4G activity, construction will see zero growth because of the

reduction in building construction. On the other hand, mining will end the year in the red on lower production of both oil and certain ores associated with construction.

Figure **3.4** Supply side GDP Growth (2016-2017f)
(annual variation, %)



Source: DANE, BBVA Research

On the positive side we can point to the growth rate of nearly 5% which agriculture will show, fuelled by higher production of coffee and a broad array of crops, which have benefited from more normal weather and the stimulus from prices which Colombia experienced last year. Finally, social services will perform positively, achieving growth of almost 3.0%.

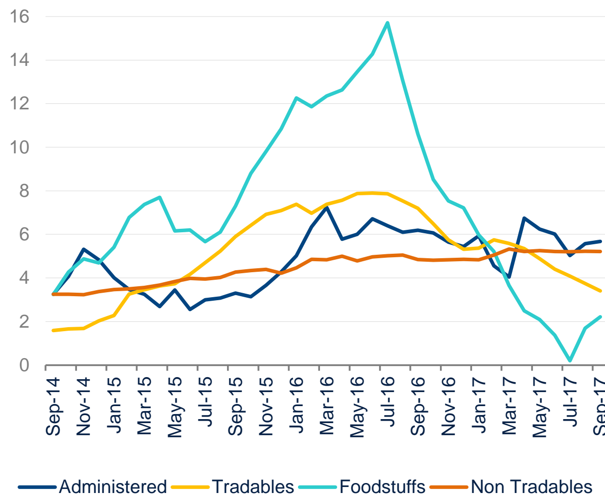
Inflation is closing in on the target level thanks to foods and tradable goods, although this is still pending improvements for non-tradables.

The news on the inflation front remains encouraging as regards the foods and tradable goods segment. Agricultural output is still on the rise thanks to benign weather and the high prices recorded last year. On the other hand, the stability of the exchange rate has allowed the cost of imported products to stabilise, thus taking some of the wind out of the sails of tradable goods inflation. As a result of this, foods and tradable goods inflation has come down by roughly 11 and 4 percentage points, respectively and contributed to headline inflation falling back to the 4% level as this publication goes to print.

Thanks to the slowdown for tradables and weak demand in the economy, core inflation has also dropped. Its fall has been slower than that of headline inflation though, given that inflation for the non-tradable segment has held relatively stable at a rate of about 5.2% throughout this year; the high degree of persistency exhibited by this indicator is still a cause for concern for certain members of the board at the central bank, causing them to entertain doubts about the speed at which headline inflation will hit the 3% target, which is a factor that played a significant role in the central

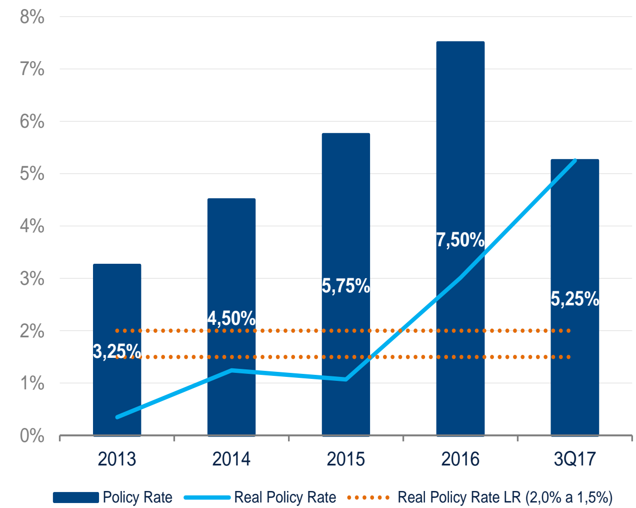
bank's decision to hold the reference rate stable in September. Given this context, we still expect headline inflation to end the year at a rate in the region of 4.2%, while core inflation should stand at approximately 4.7%.

Figure 3.5 Inflation, main groups
(annual variation, %)



Source: DANE

Figure 3.6 Nominal and Real Policy Rate
(end of period, %)



Source: Banco de la República de Colombia, BBVA Research

The central bank is likely to stick to its current policy until it receives indications of further relief with respect to inflation

Over the year the central bank has steadily cut its reference rate by 225 basis points since February and 250 bp since rates peaked, from December 2016. This policy adjustment was largely in response to the slowdown in inflation and expectations with respect to it, as well as weak economic activity. Nonetheless, certain inflation components that are still on the high side, such as non-tradable goods, could lead the central bank to ask itself whether this is due to indexation and inflation persistence, in which case its effect should be transitory and pave the way for it to make further rate adjustments, or whether, on the contrary, the fact that non-tradable goods inflation (that which most closely follows demand) has not fallen back reflects lower excess production capacity and a narrower GDP gap, with the result that a bigger policy rate cut could once again revive inflation.

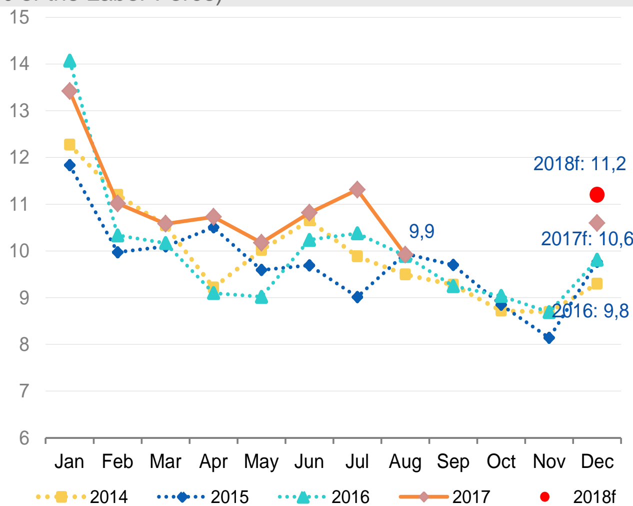
Given this straight choice, the central bank chose to leave the policy rate unchanged at its September meeting and, in the context of rising inflation up to the end of the year, we take the view that it will prefer to hold its stance unchanged as it waits to confirm (very possibly in early 2018) whether high core and non-tradable goods inflation is wearing off as the effect of inflation persistence fades or whether the pressure from this is persevering on account of a narrower than expected GDP gap.

4. Who will fire up the engines in 2018?

Without the spectres of inflation, currency depreciation, taxes and high interest rates, private spending should improve

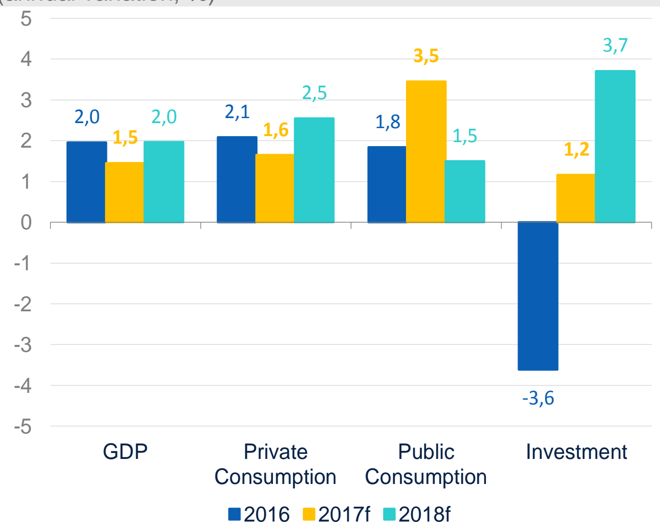
Inflation will open 2018 with a sharply downward correction. The base effects brought about by the 2017 tax reform, together with the downward adjustment that will be exhibited by certain indexed services such as leases and certain education costs, will bring about a sudden drop in inflation to 3.0% in the second quarter of the year. Thanks largely to the decline in inflation and the stability of the exchange rate over the past year, the central bank has managed to lower rates considerably in 2017, which could continue into 2018. This cut will be the prelude to the continued recovery of private consumption. Nonetheless, despite the positive news on the inflation front, consumption growth will be limited by developments in the labour market, where we expect results to be slightly worse than those in 2017, given the prolonged slowdown which the economy has experienced. Indeed, although the economic slowdown began in 2014, the increase in the unemployment rate has only been noticeable since mid 2016. The deterioration in urban unemployment has carried on over 2017 so far. We forecast an even greater worsening in 2018, since, although the economy is starting to revive, the lagged effects on unemployment are persisting. We estimate an unemployment rate for 13 cities of 11.2% at the end of 2018, which is above the estimated closing figure for 2017 of 10.6%.

Figure **4.1** Urban Unemployment Rate
(% of the Labor Force)



Source: DANE, BBVA Research

Figure **4.2** Demand side Expected GDP Growth
(annual variation, %)



Source: DANE, BBVA Research

Investment will forge ahead with the recovery process it embarked on in mid 2017, especially its privately sourced part: manufacturing industry, agriculture, building construction and the mining and oil sector. Exchange rate stability will allow a steady investment process, based to a high percentage on imported goods, which will be attributable to a

better showing by household consumption and better installed capacity utilisation in industry. On top of this, execution of fourth generation civil engineering work on infrastructure will continue to make a positive contribution.

In 2018 real exports will grow ahead of GDP for the first time since 2013. The recovery will be driven by higher global growth, notably in Latam and, to a lesser extent, in the United States. The bulk of demand from Colombia's partners in Latin America is for agro-industrial products, which will shore up the ongoing manufacturing sector recovery.

Nonetheless, net external demand will continue to make a negative contribution to GDP growth, since imports (machinery and equipment investment goods, raw materials and consumer durables) will see slightly greater growth than exports, and mainly because the weight of imports is larger than that of exports within GDP.

Sector differences will start to boost investment, with infrastructure and oil leading the way

The sectors which were hit by low domestic demand will begin to show a livelier pattern in 2018. The trade sector will grow at a rate of 2.8%, with the restaurants and hotels industry growing at over 3.0%, which will be one of the future drivers of the economy. Industry will also be stimulated by higher external demand that will be especially exploited by the chemicals industry and grow at a rate of 1.8%. This sector will also be boosted by the revival of building construction, which will produce favourable results for other sectors such as metallurgy and building materials manufacturing. Durable and semi-durable goods manufacturing (furniture and vehicles) will also be rekindled, although this will be at a slow pace on account of the only gradual recovery we foresee in the consumption of such goods.

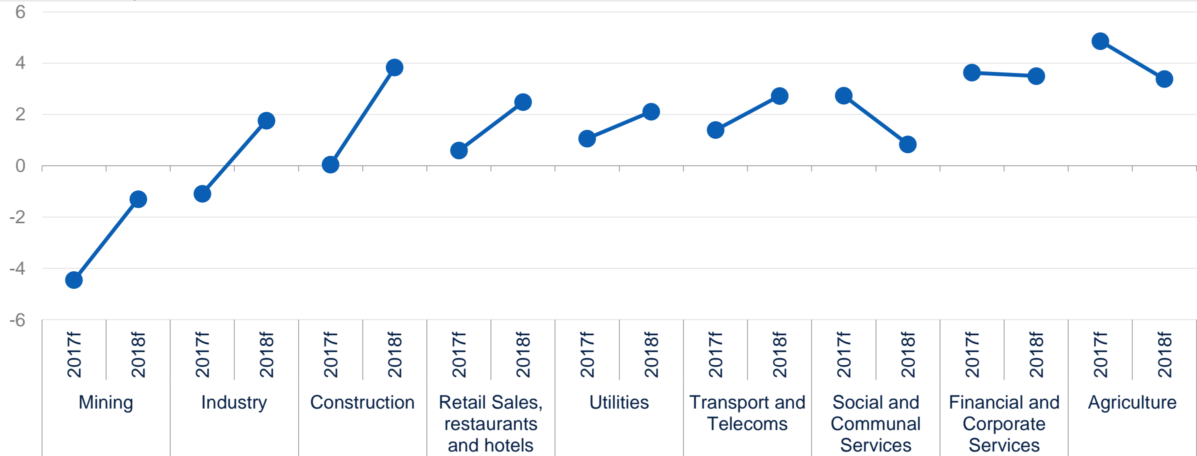
Construction will be the stand-out driver of the economy in 2018. The construction of public works will continue to grow via the execution of fourth generation projects. This will be accompanied by a recovery of the building construction sector, which, after suffering a 5.8% contraction in 2017, will grow at a rate of 3.7%, spearheaded by the residential sector, which will benefit from subsidies for purchases of new homes that do not exceed 435 monthly minimum wages (320 million in 2017).

Agriculture will see continued growth in 2018. Coffee production will hit a record figure of 15 million sacks, beating 2017 production by 10%. The growth rate for certain crops such as rice and other cereals will dampen a bit following the high harvest levels experienced in 2016. This is due to the correction in the price of some of this produce. The goods that will perform to a similar or even better level are those which are exported, such as flowers, bananas and certain fruits such as cocoa beans and avocados, as well as the livestock sector, particularly cattle-raising, boosted by rising meat prices. Given this situation, we expect agriculture to grow at a rate of 3.4%, becoming established as one of the most dynamic sectors in the economy.

Mining will see a marginal fall of 0.7% given that in our scenario oil production will carry on falling in 2018 and 2019 as a result of low investment between 2015 and 2016 as well as the hangover from low oil prices. That said, it is worth

noting that its negative contribution to the economy's growth will diminish after the fall of 6.6% in 2017 and of 5.1% which we estimate for 2017. Although production will not rise, investment will, which will add a little more sparkle to the numbers for public works.

Figure 4.3 Supply side GDP Growth (2017p-2018p)
(annual variation, %)



Source: DANE, BBVA Research

The real exchange rate has enabled an adjustment in terms of competitiveness, although this is less than is implied in the nominal exchange rate

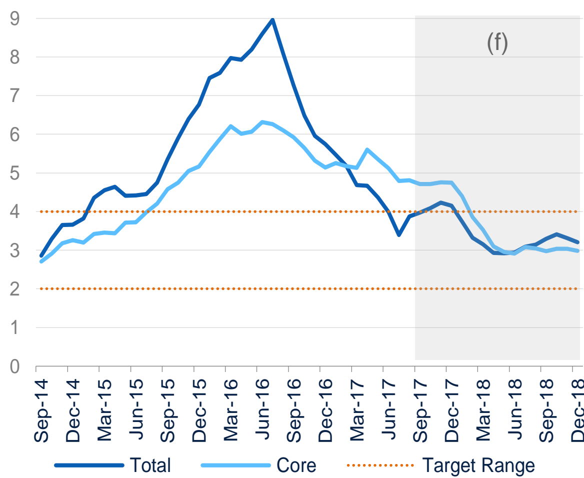
The real exchange rate on the date of this publication has depreciated by 30% since mid 2014, while in the same period the nominal rate has done so by 65%. Based on this, the stimulus for exports did not match the extent of the nominal currency depreciation, among other things because Colombia's inflation for the same period was above that of its key trading partners. Nonetheless the real price appreciation was in fact profitable in the import substitution process, above all in certain consumer sectors. On the other hand, raw materials and capital goods sectors did not see such significant substitution because a high proportion of the structure of domestic production still depends on imports.

The positive effects of the gain in competitiveness have been slow in making themselves apparent on the export side, although certain non-traditional products already show improvements and the frontier for non-conventional exportable products is expected to expand in 2018, especially those from within agriculture and to some extent industry. Even so, adjustment for a system that is used to an extended cycle of appreciation via the substitution of production with commercialisation takes time to re-establish sales channels, trade and production, which are phases that seem to be excelling themselves according to the figures observed. This dynamic has also played a significant role in trends in activity on a regional level, with a better than average performance in exporting zones such as in the west and north of the country.

Monetary policy could make a contribution to activity in 2018

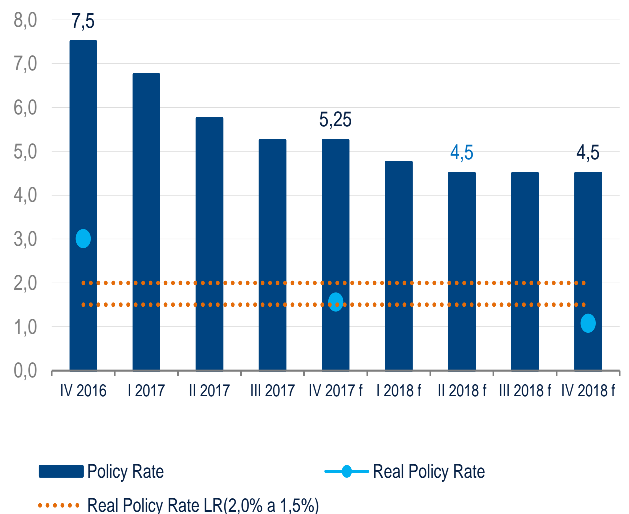
In 2018, particularly early on in the year, upward core inflation pressure is expected to have abated, confirming that its high reading throughout 2017 was to a large extent due to inflation persistence and the effects of tax reform on VAT. The lower inflation pressure and the still weak reaction from economic activity could open up the way for a new series of rate cuts that could take the rate below neutral territory. We think that in the first half there will be room to see a cut of at least 75bp in the rate, taking it to 4.5%.

Figure 4.4 Total and Core Inflation
(annual variation, %)



Source: DANE, BBVA Research

Figure 4.5 Nominal and Real Policy Interest Rate
(End of period,. %)



Source: Banco de la República, BBVA Research

The real rate based on expectations 24 months out from the most recent survey by the central bank (3.36%) ought to be 1.1%, below the range which we assume for the natural real rate of interest: from 1.4% to 2.0%. This would therefore be mildly expansionary and contribute to the economy's performance in late 2018 and especially in 2019.

GDP will thus manage to pick up marginally in 2018 compared to 2017, growing by 2.0%, which is still low on the chart of growth rate readings

For 2018 we expect growth of 2.0%, which is a higher figure than that estimated for 2017 (1.5%). All the demand-side components except public consumption will see higher growth than the rates they recorded in 2017. Monetary policy transmission will be key in the process of consumption and investment recovery.

From a historical perspective, in the last 70 years of activity records, only on nine occasions has annual growth of less than or equal to 2% been noted. Of these, three have occurred consecutively in this post oil shock period. This confirms that the scenario which the economy faces is different from what was seen in previous periods and in particular implies the challenge of understanding a slow recovery and how the economy adjusts to this cycle.

A reading such as that anticipated for 2017 and 2018 shows that it is healthier to grow only a little but on a solid base than to do so rapidly yet in short-lived fashion. Part of the reason why growth will be low in this cycle is because we are pulling out of a strong income effect and the economy must rescale to its proper level by looking to moderate private spending so as to be able to bring down the current account deficit to a sustainable level and also to temper government expenditure to take the fiscal deficit to its long term target balance. Drawing up such targets for macroeconomic stability means recognising that demand will not be as vigorous in the short term because deleveraging processes are underway, which in this case are necessary to being able to lay the foundations for more prosperous and sustainable growth in the future.

Nevertheless, understanding that private spending will represent only a limited driver for growth does not imply that greater efforts should not be called for on the supply side as well as for a more robust dynamic. On the contrary, all possible efforts should focus on defining, promoting and fuelling the sectors that can accompany the next growth cycle, those that can replace or accompany the oil sector.

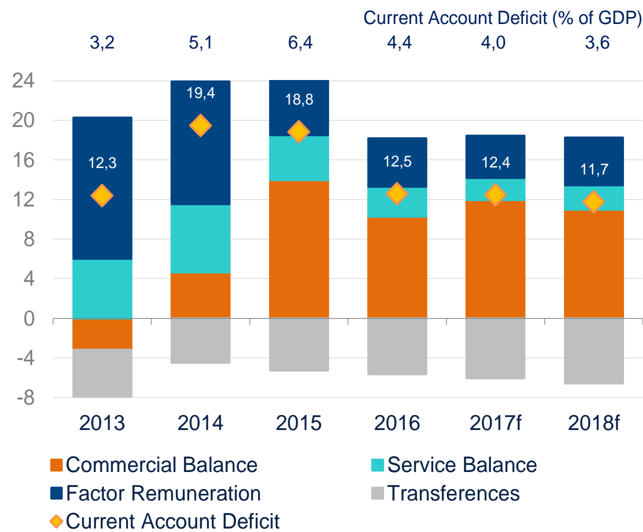
The current account deficit is trending towards acceptable though as yet not ideal levels

The current account deficit will be 4.0% and 3.6% of GDP in 2017 and 2018 respectively. These levels are still high in terms of Colombia's history and are demanding in terms of funding from abroad, in a setting in which interest rates in the developed countries are beginning to rise and the expansionary policies of the Fed and the ECB are starting to be gradually cut down or scaled back.

The trade deficit will continue to be the component showing the biggest shortfall in the balance of payments. It will go up to 3.9% and 3.4% of GDP in 2017 and 2018 respectively. On the other hand, the factor income account (which includes the sending of dividends abroad) has narrowed (with the odd bout of volatility) very sharply towards a smaller deficit. The factor income deficit will remain stable at low levels because oil and coal exports will not experience growth of note in the upcoming years. On the positive side, remittances will keep on growing, in line with the brighter performances by labour markets in the developed world.

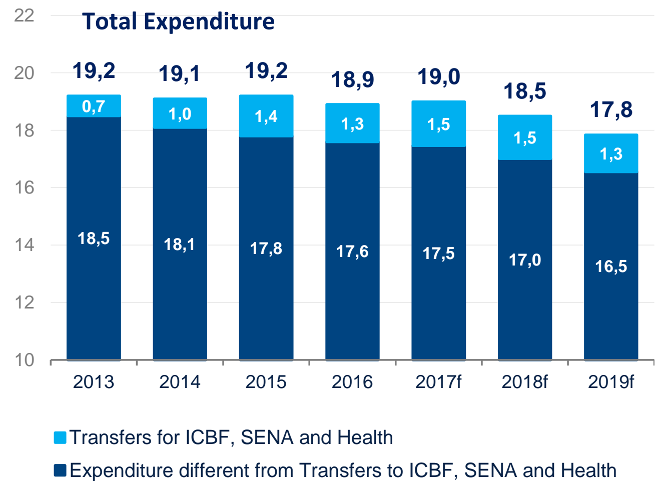
The financing of the current account will be a close thing, with almost no surplus of capital from abroad relative to the current account borrowing requirement. This will limit additional international reserve accumulation in the next few years. The bulk of the financing comes from foreign direct investment, which reduces the financing risks associated with lower portfolio capital inflows for 2017 and 2018 (which is what we actually expect).

Figure 4.6 Current Account Deficit (% of GDP)



Source: Banco de la República, BBVA Research

Figure 4.7 Central Government Expenditure (% of GDP)



Source: Ministerio de Hacienda, BBVA Research

Government policies must be directed at revenue improvements and cutting back on expenditure in line with the fiscal target

The government has managed to satisfy the fiscal rule ever since it was implemented by making considerable efforts to substitute income via the 2014 and 2016 tax reforms and by cutting back on expenditure over 2015 and 2016 (as a percentage of GDP). The fiscal rule imposes a requirement to have brought down the central government's fiscal deficit down by half a point in 2018, from 3.6% to 3.1% of GDP. To meet this target the Ministry of Finance brought a 2018 Budget bill before the lower house which consisted of reducing central government expenditure by half a point of GDP, from 19.0% to 18.5% of GDP.

As we note above, the central government's intended austerity is mirrored in our forecast that Colombia's national government will contribute less to GDP in 2018 than in 2017. This lower contribution will only be partly offset by a further increase (with respect to 2017) in spending by regional and local governments which are entering their third year in office.

With more of a medium term outlook the national government will have little room for manoeuvre to implement a fiscal stimulus and, on top of this, in certain cases such as that of 2018, it will provide less of a boost to the economy than it managed to give over the year in 2017. In 2019 the additional adjustment of over half a percentage point which the fiscal rule requires will once again prevent fiscal policy from making a positive contribution to growth. To achieve this reduction target both in 2019 and going forward calls for an effort to cut expenditure as a percentage of GDP or to increase revenues. We are waiting to receive the proposals from the Expenditure Committee which might outline

some strategies for lightening the State's burden in a structural sense. There is nevertheless uncertainty over the role of fiscal policy in medium term recovery and the adjustment requirements that compliance with the fiscal rule entails.

The trend for the exchange rate will continue to be dominated by the struggle between the crude oil price and Fed normalisation, and forex volatility could have a domestic source

The third quarter of 2017 turned into a synthesis of expectations for 2018 in terms of how the currency and capital flows performed. In principle the exchange rate should tend to settle at slightly over 3000 pesos in the first part of the year, reaching levels of around 3030 to 3050 pesos to the dollar. This should be initially on the back of the process of monetary policy normalisation in the United States, which ought to be accompanied by a mild dip in the oil price, the correlation here being historically strong.

Despite this, volatility in the first half of the year will probably also stem from the election process as well as the tussle between the Fed and Brent. It is nothing new for a bit of tension to emerge in certain financial variables in the run-up to a presidential election, especially with respect to the exchange rate, and this has occurred in Colombia in the past, as it also does in other parts of the world. The second half of 2018 should be accompanied by a more settled setting on the domestic front, with an election outcome that we think will stick to the central theme as regards managing the economy and bring a potential expected rise in the crude oil price. The peso exchange rate should therefore start to strengthen again, freeing up the pressure that has been building up since late 2017 and it should return to below 3000 pesos to the dollar, closing at around 2970 in 2018 and possibly converging in the medium term on a level of 2900 pesos to the dollar.

5. Chief risks for 2018

A return of investor appetite to the developed economies could have a significant impact on the emerging economies

Against a backdrop of a recovery for activity globally and proposals (still in draft form) of a more competitive tax policy that is company-friendly in the United States, the case can be made for a tightening of monetary policy that is faster than that anticipated by the markets and certain analysts. Thus the continuation of rate hikes as part of a gradual strategy to scale back the Federal Reserve's balance sheet is starting to build up pressure on the substantial capital inflows into emerging economies which have arrived from developed economies. Although in the central scenario we expect there to be no disorderly adjustment of interest rates or schizophrenic flows seeking out safe-haven or liquid assets, this scenario cannot be ruled out and represents our chief external risk to the Colombian economy's performance.

The main strand to this is that a considerable rise in rates along the sovereign curve in the United States could lead to a similar adjustment in emerging markets, among which Colombia has been a major host to investors, who have 25.7% of sovereign bond holdings. Thus an outflow of such funds, or even the absence of inflows of them, could put pressure on the financing for the current account and consequently on how the COP performs. This scenario of transitory depreciation and a downturn in confidence will have an impact on inflation and limit future decisions on cutting rates by the central bank in Colombia, and lead to costlier debt servicing, which will give rise to more pressure on the public finances. The effect on activity in this context is a little trickier to determine. The exchange rate depreciation could work to the export sector's advantage and would fall within a context of better external demand. Meanwhile the inflation effect and the subsequent rise in rates could limit gains from the point of view of consumers and investment.

Among the idiosyncratic risks we continue to include a crisis of confidence spiral as one, which could end up bringing about a scenario of weaker activity, without significant upticks in household spending and investment decisions by companies in 2018-2019.

Aside from this risk, along with what we have observed as a transversal risk for Latin America, there is also a substantial risk of delays to regional investment processes. In Colombia's case these derive from the regional factor in common that is associated with the Odebrecht corruption scandal, though the risk is not only confined to this. This could also be linked to the election process and the potential for there to be a government outside the realm of the *status quo*, or for difficulty in funding the 4G infrastructure projects on which is leveraged a major portion of economic revival.

6. Tables with forecasts

Table 6.1 Macroeconomic forecasts (annual data)

	2013	2014	2015	2016	2017	2018
GDP (YoY, %)	4,9	4,4	3,1	2,0	1,5	2,0
Private consumption (YoY, %)	3,4	4,3	3,2	2,1	1,6	2,5
Public consumption (YoY, %)	9,2	4,7	5,0	1,8	3,5	1,5
Fixed investment (YoY, %)	6,8	9,8	1,8	-3,6	1,2	3,7
Inflation (% YoY, eop)	1,9	3,7	6,8	5,7	4,2	3,2
Inflation (% YoY, average)	2,0	2,9	5,0	7,5	4,3	3,2
Exchange rate (eop)	1.927	2.392	3.149	3.001	3.030	2.970
Devaluation (%, eop)	9,0	24,1	31,6	-4,7	1,0	-2,0
Exchange rate (average)	1.869	2.001	2.742	3.055	2.944	3.000
Devaluation (%, average)	3,9	7,1	37.0	11,4	-3,6	1,9
BanRep interest rate (%, eop)	3,25	4,50	5,75	7,50	5,25	4,50
Deposit interest rate (%, eop)	4,1	4,3	5,2	6,9	5,5	4,8
Fiscal balance (% GDP)	-2,3	-2,4	-3,0	-4,0	-3,6	-3,1
Current account balance (% GDP)	-3,2	-5,2	-6,5	-4,4	-4,0	-3,6
Unemployment rate (%, eop)	9,7	9,3	9,8	9,8	10,6	11,2

Source: Banco de la República, DANE y BBVA Research

Table 6.2 Macroeconomic forecasts (quarterly data)

	GDP (%, YoY)	Inflation (%YoY, eop)	Exchange rate (vs. USD, eop)	BanRep rate (%, eop)
Q1 14	6,5	2,5	1.965	3,25
Q2 14	4,0	2,8	1.881	4,00
Q3 14	3,9	2,8	2.028	4,50
Q4 14	3,2	3,7	2.392	4,50
Q1 15	2,6	4,6	2.576	4,50
Q2 15	3,0	4,4	2.585	4,50
Q3 15	3,2	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	2,5	8,6	2.916	7,50
Q3 16	1,2	7,3	2.880	7,75
Q4 16	1,6	5,7	3.001	7,50
Q1 17	1,2	4,7	2.880	7,00
Q2 17	1,3	4,0	3.038	5,75
Q3 17	1,6	4,0	2.938	5,25
Q4 17	1,7	4,2	3.030	5,25
Q1 18	2,1	3,5	3.015	4,75
Q2 18	1,7	3,2	3.000	4,50
Q3 18	2,0	3,3	2.985	4,50
Q4 18	2,0	3,2	2.970	4,50

Source: Banco de la República, DANE y BBVA Research

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