Colombia Economic Outlook

1st QUARTER OF 2018 | COLOMBIA UNIT

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Closing date: January 10th 2018

1. Editorial

The emerging economies' recovery cycle has consolidated, accompanying the developed economies' strong performance in the past few quarters. This dynamic has been underpinned by an improvement in commodity prices resulting from growth in China driven by domestic policies, improved consumer confidence, and increased consumer spending in the US and Europe. This improved outlook for activity, within a context of still-contained inflation, has opened the door to the normalisation of monetary policy in the US, which raised its base rates three times in 2017, with similar adjustments expected for 2018 together with the Federal Reserve's balance sheet reduction programme which started last October. The reaction of the capital markets has been favourable, incorporating this panorama of orderly and gradual adjustments into its asset valuation, which has led to a flattening of the yield curve for US Treasuries and limited gains on the equities front following the strong boost at the end of 2016.

For the region, strong demand from developed economies and China has translated into a significant improvement in the terms of trade, enabling it to cope with the adjustments to monetary policy without too many upsets in their currency or asset prices, while as the same time providing a new boost to regional activity. In the case of Colombia, this boost allows additional narrowing of the current account deficit to levels consistent with the current cycle, with crude at over US$60 a barrel. At the same time, we anticipate improved performance from the mining and energy sector in 2018, with increased investment and output even though in the medium term, risks persist as to reserves. Meanwhile sectors such as civil engineering, exports and trade will post more positive performances, allowing manufacturing to also see positive growth figures in 2018 and 2019. This being so, we expect the economy to grow by 2% in 2018, more than the 1.5% forecast for 2017. Activity will gradually continue to regain dynamism, as it has done since the second half of 2017. We consequently anticipate a better performance in the second half of 2018 than in the first, with growth consolidating at around 3% for 2019, closer to the Colombian economy's potential growth.

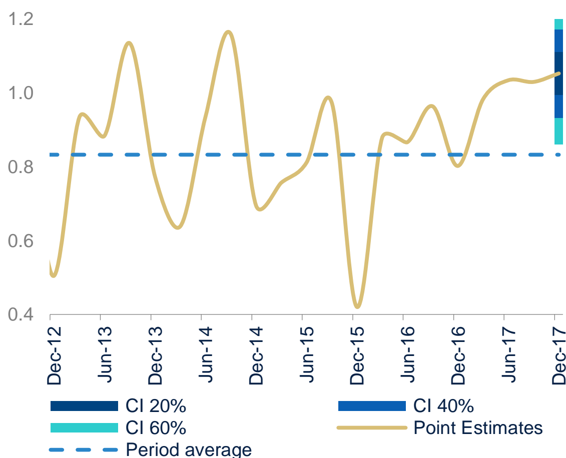
Inflation should remain under control, moving closer to the target in 2018, ending the year at around 3.1% and slightly lower in 2019 (2.8%). This dynamic in prices as a whole with less vulnerability in the current account should allow the central bank to cut its base rate in the first half of 2018 to 4% and hold it at that level for a couple of years. On the currency front, we do not see any obvious tensions in the short term to replicate the events of 2014-2016, although in the first half of the year, as a result of the normalisation of US monetary policy and the Colombian electoral cycle, there could be upward pressure on the exchange rate, although not beyond 3,100 pesos to the dollar. In the second half of the year the currency could appreciate thanks to better oil prices, improved production and the impact this will have on the current account. This being so, we expect an exchange rate of around 3,000 pesos to the dollar, ending the year slightly below this figure.

2. Global growth confirmed

Solid, sustained global growth in 2017

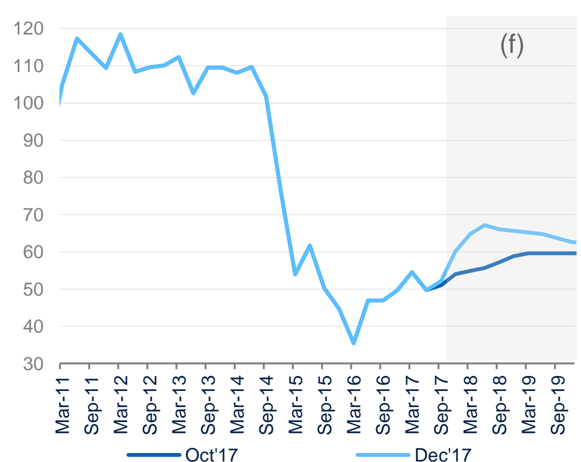
World economic growth consolidated in late 2017 at reasonably solid rates of around 1% QoQ (see Figure 1), reflecting improved results in all major areas and showing signs of continuing in good health over the coming quarters. Support from economic policy, above all in developed economies, eventually had a clear impact on the real economy, with a recovery of investment that gained traction with support in the form of increased demand and an upturn in international trade, factors which have also driven the recovery of the industrial sector. Meanwhile, private consumption continues to perform well in advanced economies, while gaining momentum in emerging economies. Forecasts and market confidence in many such economies have also been favoured by the higher commodity prices (see Figure 2), as well as by financial markets, which continue to encourage the influx of capital. Confidence indicators continue to improve, the result of strong economic performance and reduced short-term risk, with forecasts pointing to an ongoing positive panorama. World growth may increase by 0.4% to 3.7% in 2017, 0.2% more than was forecast three months ago.

Figure 2.1 World GDP growth (QoQ, %)
Forecasts based on BBVA-GAIN



Source: BBVA Research

Figure 2.2 Price of a barrel of Brent crude
Dollars



Source: BBVA Research

Over the past three months, there have been further reasons to remain optimistic in the key areas. Throughout 2017, recovery in the U.S. was accompanied by growth rates that were higher than expected, while the labour market has also continued to strengthen. Tax reforms were finally passed, which may slow cyclical recovery. Nevertheless, they will not have a significant impact in the long-term. Meanwhile, recent Federal Reserve appointments point to an unchanged monetary policy, which should be reflected by a very gradual approach to normalisation. In China, the measures passed by the authorities stabilised the economy while also implementing structural reforms and approving an economic strategy that focuses more on getting fiscal imbalances under control and less on meeting growth

targets. Finally, the Eurozone recorded higher than forecast growth in 2017, backed by an improved economic climate and stronger internal demand which is benefitting from less political uncertainty.

This scenario of increased growth and higher demand was accompanied by subdued inflation, despite the expansionary measures adopted by major central banks and the gradual reduction in idle capacity in developed economies. Doubts nevertheless remain as to whether factors underpinning the weakness of inflation are transitory or permanent, whether globalisation, the flexibility of labour markets, low inflation forecasts or increased productivity lie behind the slower reaction of prices to increased economic activity. Doubts also exist as to whether or not there will continue to be a lack of clear signs of increased inflationary pressure, at least for now. Increased growth and higher oil prices should push inflation up in the short term, facilitating advances in the normalisation of central bank policy in developed economies, while many emerging economies still have room for manoeuvre when it comes to using monetary policy to bolster growth.

World growth will tend to stabilise in 2018-19

Our forecasts point to global growth slightly accelerating in 2018-19 by around one basis point to 3.8%, meaning an upward revision of 0.3% on our expectations three months ago. This change has come in response to higher growth forecasts for the U.S, China and the Eurozone in 2018, mainly due to greater economic activity in past quarters, although the economic measures adopted in the two key areas have also had an impact. In particular, we expect the U.S. to grow 2.6% in 2018 (0.4% more than in the previous report) and 2.5% in 2019, supported in the tax reform and better external and domestic fundamentals. For China, we expect a more moderate deceleration (thanks to a better international outlook and to the policy strategies after the XIX Congress of the Communist Party), with a 6.3% growth in 2018 and 6.0% in 2019, from 6.7% in 2017. For the Eurozone we reviewed growth 0.4% upward in 2018, to 2.2%, which would be followed by a 1.8% in 2019, supported in the strength of internal demand and net exports. Finally, in Latin American economies, we expect to see a somewhat stronger recovery this year, due to the upward revision of global demand and higher commodity prices. Despite the foreseeable stability of world growth, we still expect a certain tempering of growth in developed economies in 2019, while in the majority of emerging economies; the recovery will continue to consolidate. There are still a number of political risks that could influence economic confidence and the performance of the markets, albeit to a lesser extent than three months ago.

Risks to this relative benign global scenario still exist, though are smaller than expected three months ago. Political and geopolitical risks standout, this may influence economic confidence and the behaviour of financial markets.

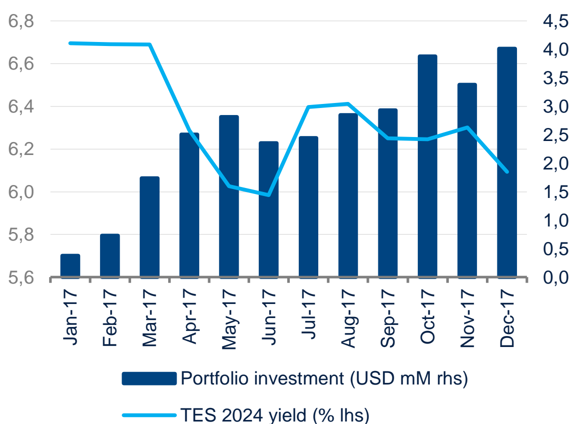
3. A slow recovery cycle in 2018, but with fewer macroeconomic imbalances

2017 saw sustained appetite for assets in emerging economies

Over the course of 2017, emerging markets posted positive performances with generalised gains in assets and currencies. This was the result of an external political context that presented relatively few challenges for the region, against a background of orderly, gradual normalisation of developed economies' monetary policies and rising commodity prices. These factors led to a first half-year of significant currency appreciation and a second half-year of stability with a view very isolated upsets.

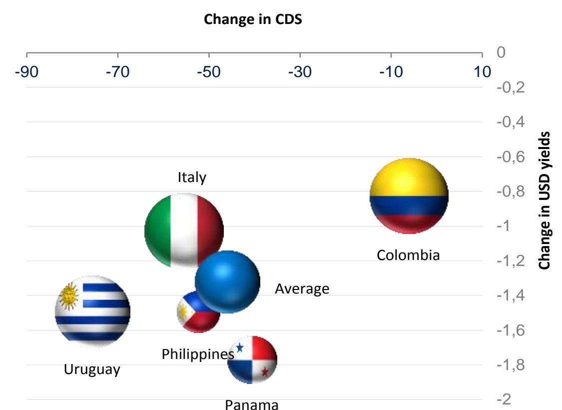
In the case of Colombia, the first half-year revealed considerable foreign appetite for domestic debt, reflected in capital inflows of US$2,357 million, nearly 64% of total inflows for the year, leading the currency to appreciate, peaking at 2,838 pesos to the dollar on 19 April (Figure 3.1). This positive regional performance was accompanied by gains on the Colombian equities market, albeit less than those reported on other similar markets. By the end of June it had gained 8.2%, while the most liquid benchmark of the sovereign debt market had risen by 76 basis points. In contrast, the second half of the year started with a number of upsets, such as the announcement of the US Federal Reserve's normalisation programme, the presentation of a fiscal framework in Colombia with less growth expected and the announcement of the proposed tax reform in the US, all of which factors exerted pressure on the domestic market and in particular the currency, which reached its maximum for the year of 3,093 pesos to the dollar on 10 July.

Figure 3.1 Foreign portfolio investment, TES 2024 yield



Source: BanRep, Bloomberg, BBVA Research

Figure 3.2 CDS and BBB countries USD yields Changes



Source: Bloomberg, BBVA Research
The size of each sphere corresponds to the relative 5Y CDS for each country

The last few months of the year saw a weakening of the correlation between the exchange rate and the price of Brent crude, which reached US$66 a barrel, partly due to advances made on tax reform in the US and the Federal

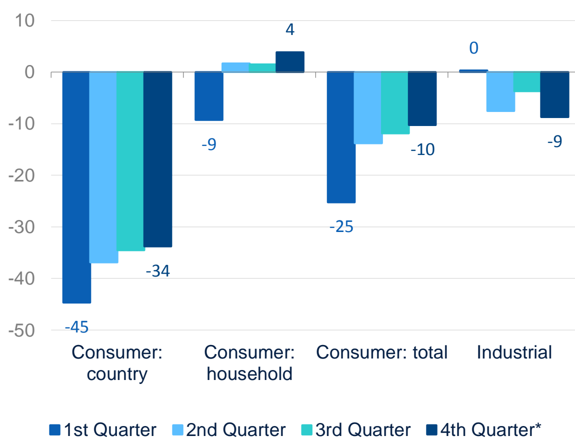
Reserve's final decisions on interest rates. On the domestic front, one factor that accompanied the year-end movements was Standard & Poor's downgrading of Colombia's sovereign debt rating from BBB to BBB-. However, in practical terms the downgrade did not lead to significant movements in domestic assets, given that it had already been largely factored in to both CDS and the return paid in foreign currency for Colombian sovereign debt (Figure 3.2). Additionally, S&P offered a stable outlook, which limits the risk of additional downgrades that could take it below investment grade. However, we feel that the other two major rating agencies might downgrade Colombia's sovereign debt by a notch, although still leaving it at investment grade.

The year ended more positively on the currency markets, with significant new inflows of capital which pushed the exchange rate below levels expected by the analysts. This was reflected in public debt securities, which increased in value over the course of the year, particularly at the short end of the yield curve, thanks to the issuer's rate reductions. However, at year-end the appreciation came more particularly from the long end, despite the deterioration and flattening of the curve for US Treasuries.

Economic Activity: not until the second half of 2018 will we see GDP accelerate to its potential growth

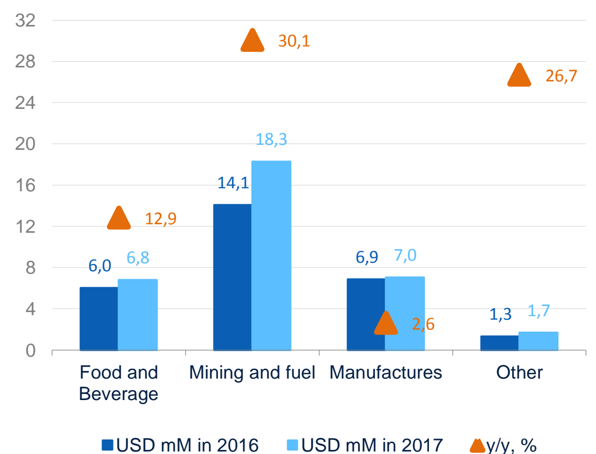
Growth for 2017 stood at approximately 1.5%. Growth in activity in the fourth quarter of last year was lower than that posted between July and September due to the lack of a base effect (which there had been for Q3 due to the transport strike in 2016), low growth in coffee production and continuing losses in the construction sector. Confidence also continued to be weak for longer than expected, leading to a weak recovery in consumption and investment, which will persist until early 2018.

Figure 3.3 Consumer and Industrial confidence
Balance



Source: Fedesarrollo
* Data to November

Figure 3.4 Total exports and by sector
Accumulated data to November



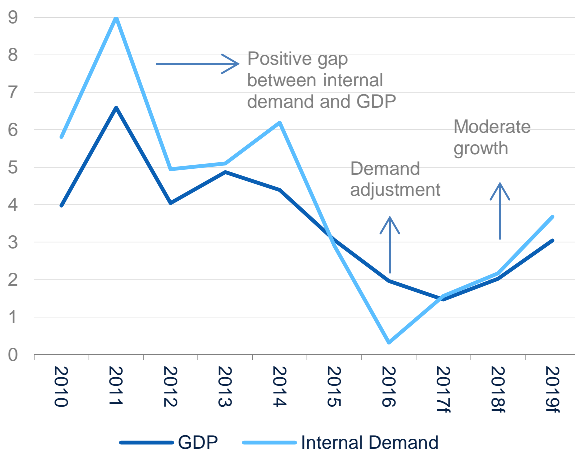
Source: DANE, BBVA Research

Nonetheless, we expect a continuation of the gradual recovery in private investment (other than in construction) and non-traditional exports. Manufacturing confidence will limit the recovery of investment, although sectors such as civil

engineering and petroleum were showing positive signs at the end of 2017, consolidating in 2018 and 2019. In contrast, construction was weak and will pose more negative figures at the beginning of 2018, preventing any marked acceleration of investment. Exports reacted positively to the improvement in international demand and the favourable exchange rate. The best performing sectors were in agro-industry, and improvements are expected in the mining sector, with the recovery in oil production and prices.

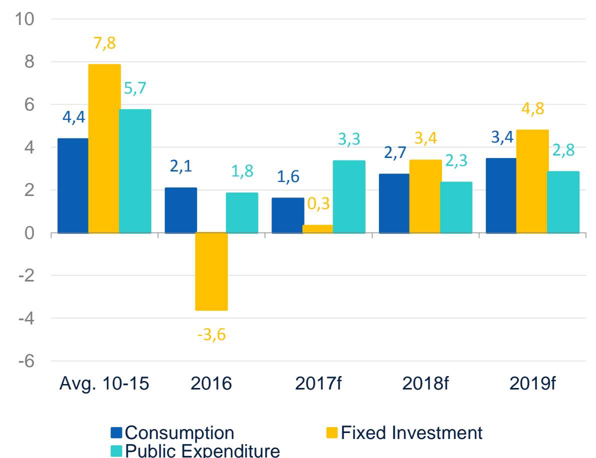
Unlike 2015 and 2016 when it grew less, total domestic demand grew by slightly more than GDP for the full year 2017, driven mainly by public consumption, with a gradual recovery in non-residential investment. Public expenditure was very noteworthy, offsetting the additional slowdown in private demand during the past year.

Figure 3.5 GDP and internal demand
Annual growth, %



Source: DANE, BBVA Research

Figure 3.6 Consumption, investment and public expenditure
Annual growth, %



Source: DANE, BBVA Research

In 2018, GDP growth will be higher than that estimated for 2017. Several factors continue to support this forecast. Firstly, the lower interest rates, not only the lagged effects of the previous year's reductions, but also further cuts that will take place in interest rates this year. Secondly, the fall in inflation and the wage increases tied to the legal minimum wage will ensure improvements in' real household income this year. Real income will also be helped by the recovery in oil prices and its positive effect on national income through the improved terms of trade. Thirdly, the improved global environment, and, in particular, that of our trading partners, will have a positive effect on exports, which have been showing an improved dynamic since mid-2017. Last but not least, investment will regain a positive dynamic thanks to the continuation of the fourth generation infrastructure and to the acceleration driven by the recovery in mining and manufacturing and regional governments' budget execution in their third year in office.

In 2018 (and 2019), the momentum of public spending will not be as significant as it was in 2017. In fact in 2019 it will grow by less than GDP for the first time in three years. Although regional and municipal authorities will increase execution of their budgets as their terms of office advance, and in line with the country's characteristic economic and political cycles, the central government will have to pursue an austere approach to spending in order to comply with the "fiscal rule" (maximum deficit levels as % of GDP).

As a result, we expect GDP growth of 2% in 2018. In terms of the various components of domestic demand, private consumption (65% of GDP) will accelerate from a growth rate of 1.6% in 2017 to one of 2.7% in 2018, while fixed investment will go from a growth rate of just 0.3% in 2017 to 3.4% this year. Nonetheless, the economy will expand at two different speeds in 2018. In the first half of the year, GDP will grow at a very similar rate to the average for 2017. However, in the second half, the acceleration will be greater, especially towards year-end. Indeed in the last quarter of the year GDP will grow by almost 3%. The end of electoral uncertainty, at mid-year, will be definitive for the more marked recovery in domestic confidence and private demand, especially via the investment component.

Growth in 2018 will be constrained by the behaviour of the construction sector, which we believe will contract further this year, albeit by much less than in 2017. Thanks to lower interest rates and increased global growth, part of the forecast improvement in consumption, investment and exports will be negated by the deterioration in the construction sector, whose performance we have revised downwards in view of the latest leading indicators.

Economic recovery will continue in 2019. Both private consumption and fixed investment will show further acceleration. The low interest rates will continue to boost domestic demand. The labour market will perform better, improving household incomes. Residential construction will start to grow again, and a new cycle of expansion of non-residential construction (shops and offices) will start once current stocks are reduced (estimated for mid-2019). Use of installed manufacturing capacity will remain above the historical average, leading to more investment decisions by the Colombian business community. Finally, this being the last year of the regional and local governments, budget execution in these jurisdictions will be significantly greater than in their first two years of office. In particular, spending on royalties for construction of infrastructure is bound to be more dynamic that year.

Our GDP growth forecast for 2019 is 3%. This will largely be driven by growth in fixed investment of 4.8%. Private consumption will benefit from a new cycle of expansion in consumer durables, which is characteristic of periods of low interest rates accompanied by the improving real household income, which we expect to see in 2019. Finally, external trade will continue to drive growth, thanks to the improved relative performance of our major trading partners in the region and of the developed economies.

In the medium term, from 2020 on, GDP growth will be above the country’s potential, albeit only by a narrow margin. This will very slowly close the negative output gap built up by the economy until then, both in the period of slowdown and in the slow recovery up to 2019. However, GDP growth rates will be below the average of the past 20 years until at least 2022, driving home the fact that the oil shock heralded a new stage in the country’s growth.

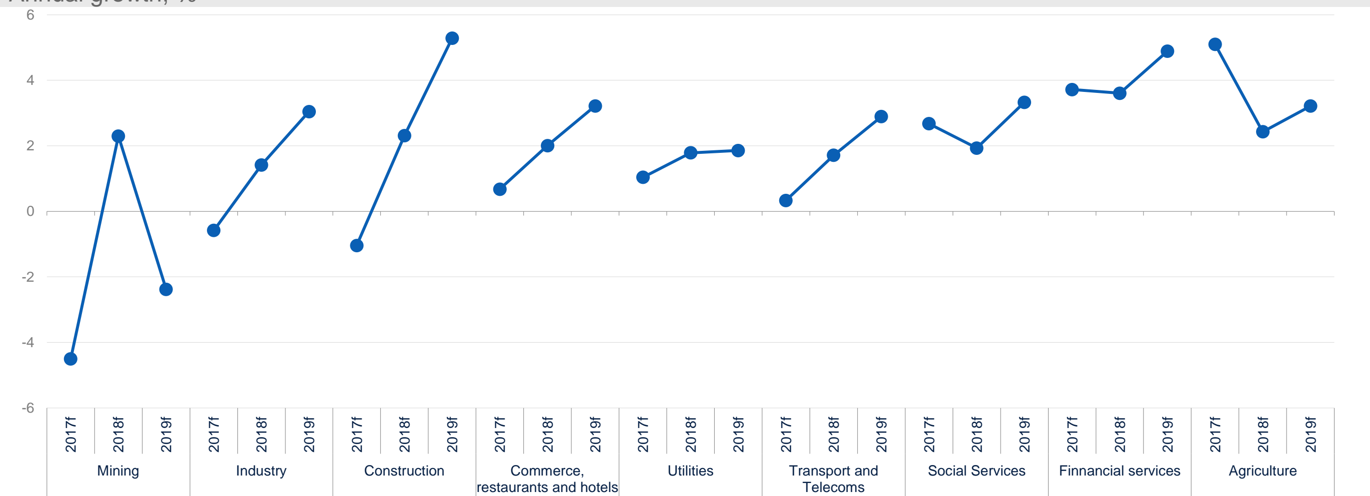
Production by sector: recovery will take on a more uniform aspect as we move into 2018-2019

At sector level we see an upturn in almost all sectors. We would highlight the mining sector, where positive surprises in oil production together with our upward revision of prices have led us to increase the short-term production forecasts: in total we believe that this sector’s growth will go from a negative 4.5% in 2017 to a positive 2.3% in 2018 (Figure 3.7). Despite this, the sector faces difficulties in the medium term, deriving from the low level of cumulative

investment to date and the public consultation processes, which create legal instability and increase the risks to investment in and expansion of the sector. Accordingly we expect the sector to post another fall in production of 2.4% in 2019.

The recovery of consumption in 2018 and 2019 will have positive effects on several sectors. Growth in manufacturing will accelerate in these two years, helped moreover by increased external demand, although its acceleration will be rather timid, with growth of 1.4% in 2018. Retail sales and restaurant and tourism services will also pick up, with growth rates gradually accelerating to 3% in 2019.

Figure 3.7 Supply side GDP
Annual growth, %



Source: DANE, BBVA Research

Construction will return to the top at sector level in terms of growth in 2019 as a result of advances in civil engineering works: with the peak in contribution to GDP coming from the 4G works and the advancement of works in the mining sector, but also favoured by the advance in residential and non-residential (commercial) construction, which will reverse the contracting trend of previous years. Finally the agriculture and livestock sector will maintain a greater rate of growth than its historical average, although more timid than that seen in 2017. Part of the reduced dynamic expected for 2018 is associated with the downward correction seen in prices of several products in the past 18 months, discouraging the growing of these products.

Box 1

The construction sector:

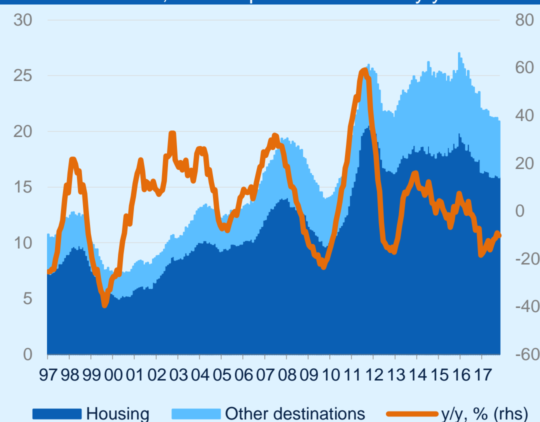
Weak leading indicators point to contraction in 2018 and recovery being delayed until 2019

Based on what we have observed in 2017 and expectations for 2018, the construction sector will detract from growth, even more than initially anticipated. In fact, one of the reasons for maintaining our GDP growth forecast for 2018 at 2% despite the lower interest rates and increased global growth is the deterioration in the leading indicators of the residential and non-residential construction sectors.

adjustment to housing prices. The first and third factors together determined households' reduced purchasing capacity. Despite the fact that the supply of housing continues to grow, prices continue to grow at very close to the rate of inflation, which has led to slower stock rotation.

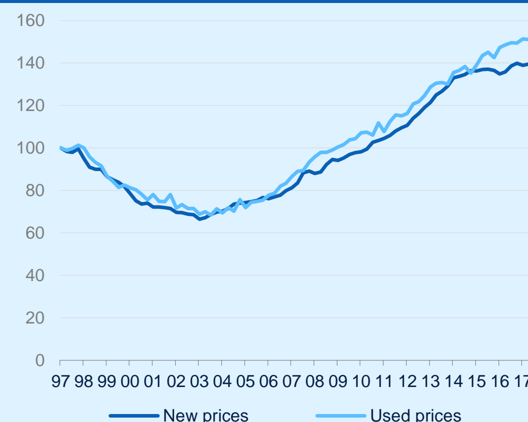
On this point, sharp fall in sales and production in the sector, we might ask ourselves *whether they will continue to fall.* And the answer, although less negative, is not so optimistic – yes, but not by so much and not for much longer.

Figure B1.1
Construction permits
12 month acum., mil of square meters and y/y%



Source: DANE, BBVA Research

Figure B1.2
Housing prices (new and used)
March 1997 = 100



Source: DANE, BanRep, BBVA Research

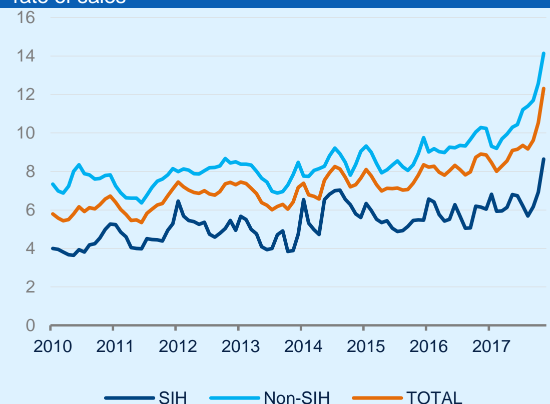
The performance of the construction sector fell back one quarter after another in 2017 [Graph R1, sector performance]. There seem to be three explanations for the slowdown in the sector: the fall in national revenue due to lower oil prices, the fact that inclination to buy homes has remained at negative levels and the inadequate or non-existent

Several leading indicators for the sector point to this behaviour. In the first place, project launches fell by 20% and new building starts by 4.4% in the twelve months to October 2017 (Camacol figures). According to DANE, the national statistics department, in the same period, the number of building permits fell by 9.1%, the fall being sharper in permits

for non-residential purposes (13.4%) such as shops and offices. Consequently the number of buildings under construction fell in the third quarter, since the lower number of new permits did not offset the accumulation of new starts in the past.

These indicators allow us to forecast construction performance over the following seven to twelve months. This means that only from the third quarter of 2018, and maybe even later, will we be able to start to see some recovery in the sector, providing that the indicators at the end of 2017 and beginning of 2018 show some improvement. The recovery will have several driving factors. Firstly, the interest rate cuts have improved household's financial situation, and this, together with the expected increase in their real income will allow the increase in housing prices to be offset and secondly, the government's public policy will maintain interest rate subsidies for mortgage loans for homes costing up to 320 million pesos until 2019. Added to this are the subsidies for lower cost housing such as the 'Mi Casa Ya' family housing subsidy and the VIS housing interest rate subsidy. Thirdly place, the recovery in oil prices in particular, and the improved behaviour of anticipated investment generally, could allow a better business dynamic that would help to reduce the over-supply of non-residential property.

Figure B1.3
Inventory rotation
Number of months to sell the current supply at the current rate of sales



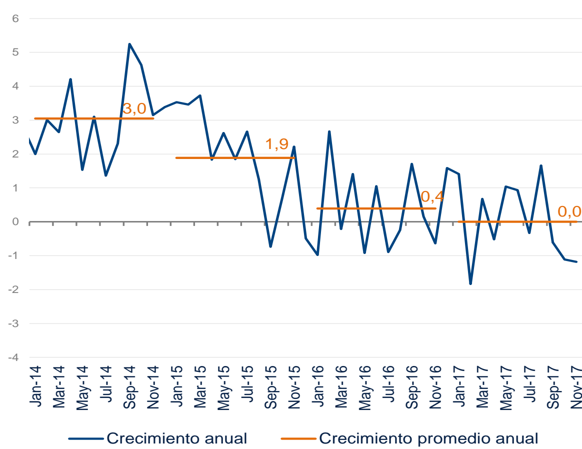
Source: Cmacol, BBVA Research

In short, we expect a fall of 2.7% in the construction sector in 2018, coming on top of the fall of more than 11% that it experienced last year. Later, in 2019, the sector will return to positive figures, with growth of 5.5%, becoming once again one of the key sectors for GDP growth.

Labour Market: weak performance expected as a result of the lag with economic activity

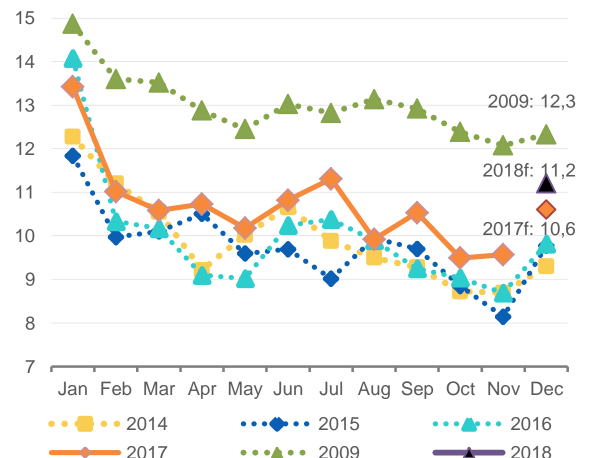
The labour market has been gradually deteriorating since the fall in oil prices. Job creation in the 13 cities has deteriorated year after year, with the average growth in the number of people in work going from 3.4% to zero YTD November 2017 (Figure 3.8). Despite this, the urban unemployment rate did not start to deteriorate until mid-2016, when the number of entrants to the workforce started to grow by more than the number of people in work. According to our calculations, the unemployment rate will continue to deteriorate in 2018, since economic activity will remain weak or some time, below the threshold from which we estimate that there could be an improvement in unemployment (2.5% GDP growth, according to an estimate of Okun's law with data from the past decade).

Figure 3.8 Job creation (13 cities)
Annual growth, %



Source: DANE, BBVA Research

Figure 3.9 13 Cities unemployment rate
% of the working force



Source: DANE, BBVA Research

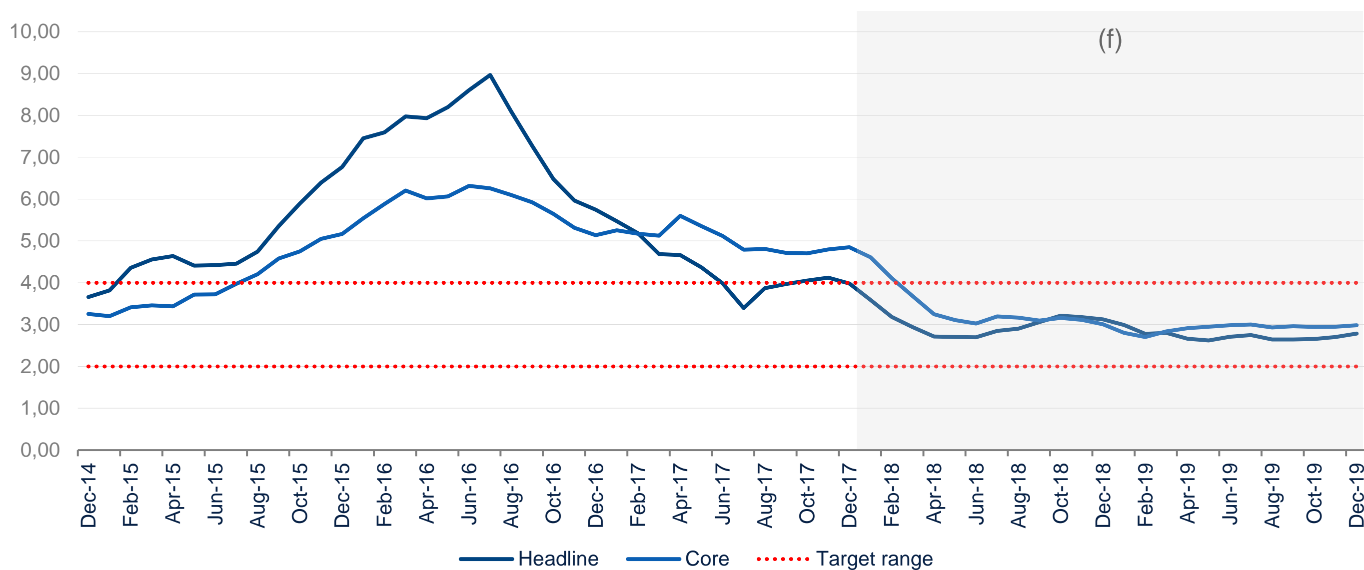
We therefore project a higher unemployment rate in 2018 than in 2017, closing 2018 at 11.2% as against 10.6% for 2017 (Figure 3.9). Despite the deterioration it should be pointed out that the unemployment rate in 2018, when it will be at its highest, will be well below that of other periods of slowdown (in 2009 the unemployment rate was 13%). The resilience of unemployment may be partly due to the past few years' achievements in getting people out of the informal and into the formal labour market. In 2019 we will start to see some relief in the labour market, but the adjustment will be gradual.

Inflation: In 2018, both headline and core inflation will move towards the target, slowing markedly in the first half of 2018

News on inflation will continue to be positive in 2018. We expect the fall in inflation that we have been seeing since mid-2016 to continue during much of this year. The base effect created by the three percentage point increase in VAT in 2017, which affected the dynamic of prices in the first few months of that year, will mean that inflation has a strong correction in these first few months of 2018. Added to this is the relative stability of the exchange rate (compared with

that observed between 2014 and 2016), which should limit the effect of tradable goods on inflation and support its move towards the inflation target. The 5.9% increase in the legal minimum wage, considerably in excess of observed and expected inflation, may have a negative effect on inflation, especially given its relevance in several services and goods that are adjusted with that indicator and goods and services with a high labour cost component in their production.

Figure 3.10 Headline and core inflation
% (y/y)



Source: DANE, BBVA Research

Overall we estimate that inflation will quickly approach 3% in the first half of the year and that price increases will not move far from that rate by year end, posting 3.1% in December 2018 (Figure 3.10). In 2019, given that the economy will still be growing at below its potential, the pace of inflation will have additional room in which to slow, ending the year at close to 2.7%.

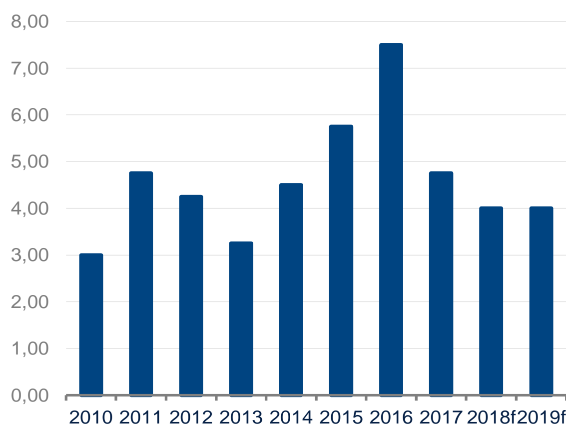
Interest rates: The central bank will have room to reduce interest rates to adjust the lower inflation expected

Over the course of 2017, the central bank cut its base rate by 2.75% (Figure 3.11) to 4.75% from 7.50% at the beginning of the year (3% since the start of the rate-cutting cycle in December 2016). This significant reduction in the interest rate was possible thanks to a marked and to some extent unexpected downturn in inflation as a whole and the improved performance of the external balance of the economy. These factors allowed the central bank to adopt a more aggressive tone in favour of growth and calmed certain fears that had been expressed during the year by the governing council about the persistence and inertia of inflation.

This argument less rooted in risks and more inclined to support the economic cycle, together with our expectations of still low but slowly recovering growth, allows us to anticipate bigger interest rate cuts in 2018. In particular, and due to

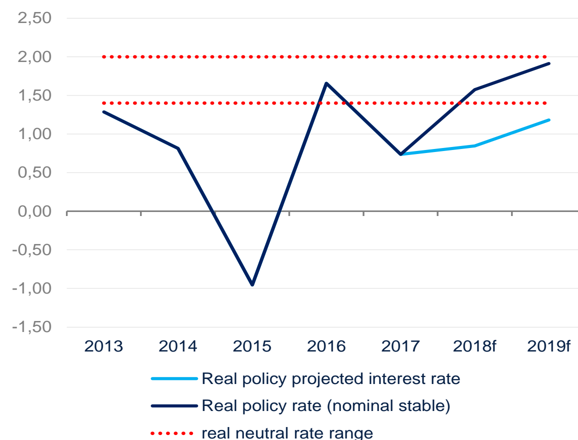
the sharp decline we anticipate in headline inflation in the first few months of 2018 (with a marked correction of core inflation), we consider that the base rate could reach 4% in the first half of the year, with the real rate remaining similar to its current level (Figure 3.12).

Figure 3.11 Monetary policy rate
%, End of period



Source: BanRep, BBVA Research

Figure 3.12 Real monetary policy rate
%, End of period



Source: BanRep, DANE, BBVA Research
Uses observed inflation until 2017.For 2018 and 2019 we assume an stable nominal interest rate of 4,75%

As mentioned in the section on economic activity, if we consider that growth will recover gradually until it marginally exceeds potential growth after 2019, this implies that the estimated output gap will not start to close until after 2019 and only slowly even then. This being so, we consider that the central bank will hold interest rates low for a considerable time, always providing the external panorama and the macroeconomic balances allow it to do so.

We should highlight the fact that the central bank made a significant adjustment to its calendar of monetary policy meetings, going from twelve meetings on interest rates to only eight in the year (although if necessary the bank could use the other four policy meetings or call an extraordinary meeting in order to make policy adjustments). The meetings in which policy decisions will initially be taken will be those of the first and last month of each quarter, in other words, January and March in the first quarter and April and June in the second. In the intermediate meetings the inflation report will be presented. This change involves a slower cycle of rate adjustment than previously anticipated.

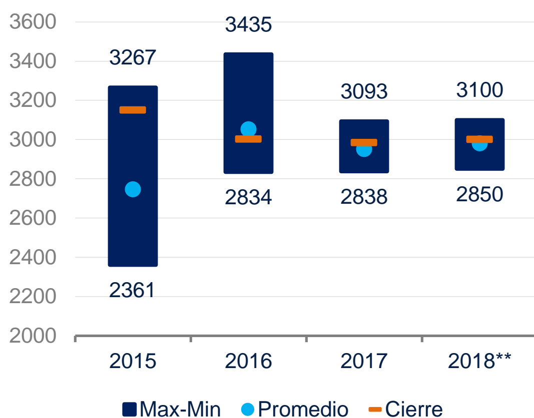
Exchange rate: A stable trend is being maintained within a panorama marked by strong factors

Over the course of the past few years, two forces have made themselves particularly felt, largely determining the behaviour of Colombia's exchange rate: the policy of monetary normalisation in the US and the price of oil. To a large extent, in the years when both forces tended to act in tandem, the currency showed a marked depreciation, but since 2016 these pressures have gone their separate ways. The policy of normalisation continues, at a slightly greater speed than previously expected by the markets, but still slowly compared with other historical references. On the other hand, the price of crude has reversed its trend and a slightly faster than anticipated recovery is consolidating,

supported by positive global growth global, the lack of investment in the sector and certain geopolitical factors. As a result the exchange rate, although volatile, has significantly reduced its range of deviation and has shaken off the tendency to depreciate that we saw in previous years.

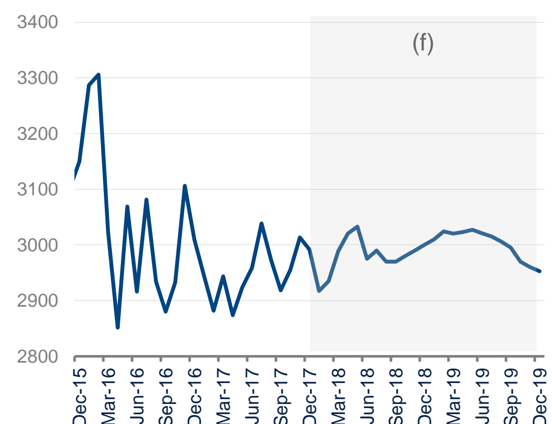
For 2018 we expect the policy of monetary normalisation to continue, with three rate hikes and a gradual reduction of the US Federal Reserve's balance sheet together with a more limited injection of resources from Europe. Its transmission path to the exchange rate would be through portfolio investment flows, which could be reduced in 2018 in favour of other emerging economies with better returns or in favour of developed economies with better growth prospects. Apart from this, the price of Brent crude has risen above US$65 a barrel for the first time in two years. For 2018, we expect this level to hold, which implies a significant improvement in the return for every barrel exported, and added to this is the improvement in production, factors that will contribute to an additional reduction in the current account deficit. This reduced balance to be financed will allow an additional structural adjustment in the exchange rate towards a slight appreciation.

Figure 3.13 Exchange rate (range of operation)
Pesos for a dollar



Source: Bloomberg, BBVA Research.
**: The range is not a formal forecasts

Figure 3.14 Exchange rate (path)
Pesos for a dollar



Source: Bloomberg, BBVA Research

For these reasons, we consider that the exchange rate will continue to drift without a clear trend in 2018. In the early part of the year, appetite for emerging market assets and a calm panorama could imply stability at a level close to 2,900 pesos to the dollar, but this stability would fracture in the second quarter as a result of the electoral cycle and the Federal Reserve's first rate hike. In the second half, we expect to see some calm once the electoral uncertainty has past. However, in the latter part of the year, especially from September on, we could see a renewed depreciation of the peso, closing at around 3,000 to the dollar, a trend that might continue in the first half of 2019 before resuming its appreciating trend and reaching its long-term level of 2,900 pesos to the dollar (Figure 3.14).

The main risk on the currency front is of greater sensitivity of capital flows to the monetary policy adjustments in the US, which so far have only partly affected returns on emerging market assets, particularly those of Colombia. This risk could materialise in a context of increased speed of monetary normalisation, which might be caused by higher growth

than that anticipated by the Federal Reserve, or an uptick in inflation, or greater investor sensitivity to policy adjustments. In this case, the first threat would be the reduced inflow of portfolio investments, which in the third quarter of 2017 represented 28% of the financing of the current account. A second level of this threat might put the capital already positioned in the Colombian market at risk. With US$20 billion in foreign investment in the domestic public debt market, a scenario in which these assets are sold, with a deteriorating exchange rate and valuation of domestic debt, could lead to further depreciation.

Macroeconomic balances: significant advances in the external balance and challenges in the fiscal balance

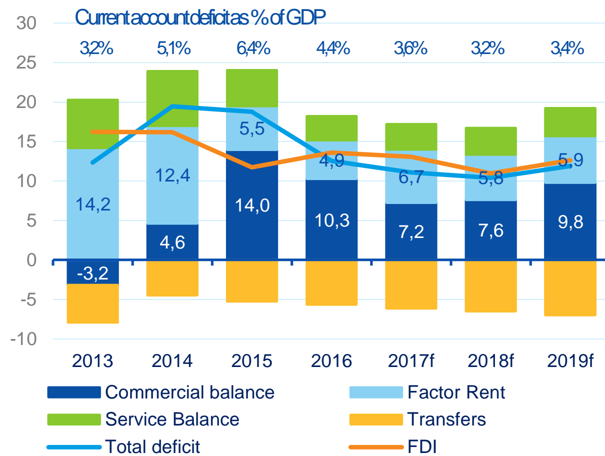
The current account deficit will have ended 2017 at around 3.6% of GDP. This represents a significant reduction in the external deficit from the 4.4% of GDP seen in 2016. Despite the fact that in the first quarter of 2017 the deficit stood at 4.9% of GDP, data for the subsequent quarters were very favourable for the external balance, both because of the fall in imports and due to the recovery in oil prices in the last part of the year. Furthermore, oil production, which had been falling regularly since 2015, recently stabilised.

These trends in oil prices and production will extend into 2018, when the contribution from fuel exports will be greater as a proportion of total exports (36% compared to 31% in 2017). There will also be an additional recovery of non-traditional exports and workers' remittances from abroad, both of which will benefit from greater growth of our main trading partners and the countries where Colombian emigrants work. Nonetheless, imports, driven by increased domestic demand, will also grow in 2018, as will the repatriation of dividends from foreign companies with a presence in Colombia, limiting the improvement in the external balance implied by the improved result of exports and remittances.

For 2018, we estimate that the external deficit will continue to fall to 3.2% of GDP (US$10.4 billion), returning to 3.4% of GDP in 2019 (Figure 3.15). For 2019, we expect a fall in oil production, given the low volumes of investment in exploration that prevailed in 2015-2017 and the implications for proven reserves, and a fall in oil prices to an average of US$60 per barrel of Brent crude (from US$66 in 2018). There will also be an additional recovery in imports, which will accompany the acceleration of domestic demand and the strengthening of the peso.

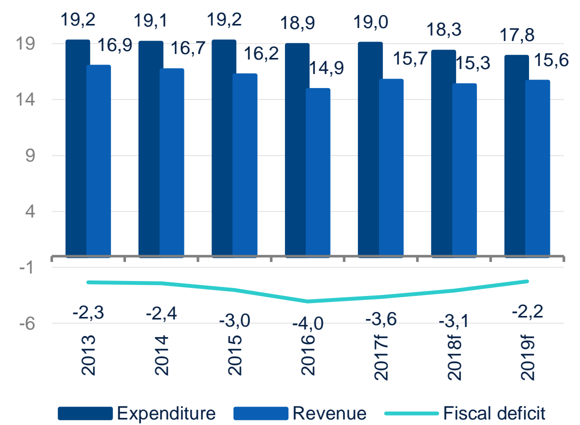
The financing of the current account will continue to be concentrated in foreign direct investment. We do not expect any significant build-up of foreign reserves. This means that external financing will be tight and that any upward bias in the current account deficit will materialise only if external liquidity conditions become more expansive.

Figure 3.15 Current account (by components)
USD billions



Source: BanRep, BBVA Research

Figure 3.16 Expenditure and income path of the Central Government
% of GDP



Source: Minhacienda
Note: in 2017 Government created a reserve with resources from the arbitration payment by telecoms for 0,3% of GDP, without it the 2017 fiscal deficit would be 3,3% and not 3,6% of GDP

As regards the balance of the public sector, the central government deficit for 2017 and 2018 will be 3.6% and 3.1% of GDP respectively (Figure 3.16), in line with the fiscal rule. For 2017, the accounts published in the Financial Plan update at the close of 2017 show that tax revenues will be less than the levels forecast by the government (at $126.6 billion, compared with the $130.4 billion in the Medium Term Fiscal Framework, up by 7.9% on 2016), although the shortfall will be more than offset by the increase in non-tax revenues, which will go from the expected 1.1% of GDP to 1.9% of GDP. The additional revenue is explained by the compensation paid to the government by telecommunications companies pursuant to an arbitration award, and increased capital revenues. However, it is necessary to point out that 2017 non-tax revenues (other than oil-related), at 1.3% of GDP (not including the arbitration award of 0.5% of GDP) were more than the average of 0.9% of GDP observed over the past ten years.

For 2018, the government expects to collect $135.5 billion of tax, 7% more than in 2017. This figure includes a lower expectation of economic growth than the average for last year (2.7% as against 3%). In order to comply with the fiscal rule, which requires a deficit of not more than 3.1% of GDP, the government must achieve a level of expenditure of 18.3% of GDP compared with 19% in 2017. This means a significant adjustment from the peak of 19.2% in 2013. This adjustment represents a reduction in investment to 1.4% of GDP in 2018 from 3.3% in 2013 (its highest point in recent years) and to 2% in 2017. We should highlight the fact that although operating expenditure between 2013 and 2018 will have increased by 0.4% of GDP, this increase is less than the payments for health insurance and to the ICBF (Colombian Family Welfare Institute) and SENA (National Vocational Training Agency) that the government assumed and which were previously funded by employer contributions (the increase in the charge for these taxes would be 0.8% of GDP between 2013 and 2018). This shows a considerable effort on the part of the government to adjust its spending.

In 2019, the expenditure contained in the government's fiscal accounts consistent with the fiscal rule (fiscal deficit of 2.2% of GDP) will be 17.8% of GDP, half a percentage point less than in 2018, with revenues standing at 15.6% of GDP, higher than the 15.3% of 2018. Compliance with the rule depends largely on a policy decision to make further cuts in government spending, which has already been reduced, and to increase revenues by means of a more demanding approach to taxes. This challenge will fall to the new government, which will have to establish an action plan in its first few months in office. In line with this, the Expenditure Commission has recently issued a statement stressing the problems of inflexible public spending in Colombia, to combat which it says efforts must focus on greater efficiency, effectiveness and fairness in spending.

Main risks for 2018

Among the idiosyncratic factors most relevant to current economic performance is the downward spiral in both consumer and business confidence. The prolongation of consumers' and businesses' pessimistic state of mind will be the main risk to economic activity in 2018, since it has led to slow growth in household spending, concentrated especially in non-durables and basic necessities, while the slow demand has had a paralysing effect on production, with inventories built up at the beginning of the year being cleared and very low use of installed capacity. To a large extent the posited recovery of the economy relies on the second half of the year being driven by increased household spending and investment in certain sectors, particularly mining and civil engineering. Factors such as corruption, the electoral cycle, the performance of the economy and labour market risk could increase this perception of uncertainty and pessimism by households and businesses, having a negative impact on the recovery.

Another factor that has created an atmosphere of uncertainty in Colombia and the region is the corruption scandal around the public and infrastructure works associated with the Odebrecht case. Although there has been considerable progress with the judicial processes and in identifying and holding to account those responsible, a pall of uncertainty still hangs over the infrastructure projects that represented a significant part of the region's economic recovery foreseen for the coming years. In the case of Colombia, one of the most pertinent factors of this partly-materialised risk is the delay in the process of contracting and closing the financing of the 4G works. Although progress has been made on this front and we have taken into account a positive contribution to activity from these works in the next few years, the risk of renewed paralysis in the sector cannot be ruled out and could have an impact on economic performance.

4. Forecasts

Table 4.1 Annual macroeconomic forecasts

	2014	2015	2016	2017	2018	2019
GDP (YoY, %)	4.4	3.1	2.0	1.5	2.0	3.0
Private consumption (YoY, %)	4.3	3.2	2.1	1.6	2.7	3.4
Public consumption (YoY, %)	4.7	5.0	1.8	3.3	2.3	2.8
Fixed investment (YoY, %)	9.8	1.8	-3.6	0.3	3.4	4.8
Inflation (%, YoY, eop)	3.7	6.8	5.7	4.3	3.2	2.8
Inflation (%, YoY, average)	2.9	5.0	7.5	4.3	3.0	2.7
Exchange rate (eop)	2,392	3,149	3,001	2,984	3,000	2,953
Devaluation (%, eop)	24.1	31.6	-4.7	-0.6	0.5	-1.6
Exchange rate (average)	2,001	2,742	3,055	2,951	2,981	3,002
Devaluation (%, average)	7.1	37.0	11.4	-3.4	1.0	0.7
BanRep interest rate (%, eop)	4.50	5.75	7.50	4.75	4.00	4.00
Deposit interest rate (%, eop)	4.3	5.2	6.9	5.3	4.4	4.4
Fiscal nalance (% of GDP)	-2.4	-3.0	-4.0	-3.6	-3.1	-2.5
Current account balance (% of GDP)	-5.2	-6.5	-4.4	-3.6	-3.2	-3.4
Unemployment rate (%, eop)	9.3	9.8	9.8	10.6	11.2	11.0

Source: Banco de la República. DANE and BBVA Research

Table 4.2 Quarterly macroeconomic forecasts

	GDP (%, YoY)	Inflation (%YoY, eop)	Exchange rate (vs. USD, eop)	BanRep rate (%, eop)
Q1 15	2.6	4.6	2.576	4.50
Q2 15	3.0	4.4	2.585	4.50
Q3 15	3.3	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	1.7	5.7	3.001	7.50
Q1 17	1.3	4.7	2.880	7.00
Q2 17	1.2	4.0	3.038	6.25
Q3 17	2.0	4.0	2.937	5.25
Q4 17	1.4	4.1	2.984	4.75
Q1 18	1.6	3.0	2.989	4.50
Q2 18	1.5	2.7	2.975	4.00
Q3 18	2.1	3.1	2.970	4.00
Q4 18	2.8	3.1	3.020	4.00
Q1 19	3.0	2.8	3.021	4.00
Q2 19	3.3	2.7	3.000	4.00
Q3 19	2.8	2.6	2.995	4.00
Q4 19	3.1	2.8	2.953	4.00

Source: Banco de la República, DANE and BBVA Research

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