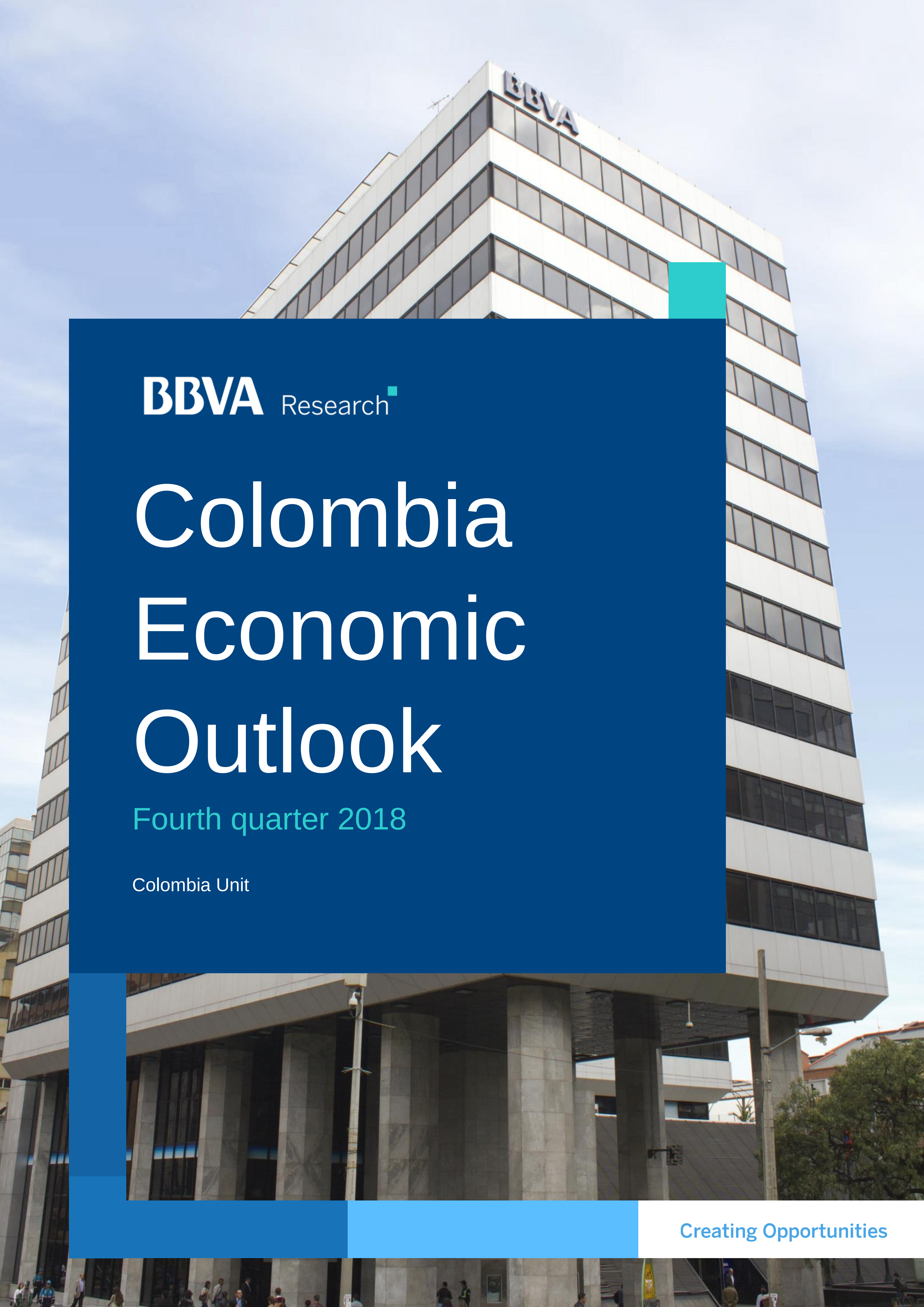


BBVA Research

Colombia Economic Outlook

Fourth quarter 2018

Colombia Unit

Creating Opportunities

Contents

Closing date: **10 October 2018**

1. Editorial

The global economy continues to show positive data, though in an environment of growing uncertainty. Inertia in world growth has continued over the past three months, prolonged by the effect of the fiscal stimulus on the US economy and a certain stability in the Chinese and European economies within a context of slowdown. Nevertheless, the protectionist escalation between the US and China has intensified, while appreciation of the US dollar can be seen in an increase in financial tensions in emerging economies, which, although there is a clear differentiation between countries, has meant a major adjustment in those that are more vulnerable (such as Turkey and Argentina). In this context, both the Federal Reserve (Fed) and the European Central Bank (ECB) continue to make progress in normalising monetary policy, which means a gradual tightening of monetary conditions that will continue to put pressure on emerging economies in the coming quarters.

Amidst this complex panorama for emerging economies, some have managed to overcome the prevailing volatility with less impact on their economies and assets. Among these, the Colombian economy has remained robust, given recent fluctuations. Exchange rates have been somewhat affected, although there has been little impact on other assets, such as sovereign debt and risk premiums, which benefited in part from buoyant crude oil prices as well as the policy of reducing external imbalances in place over recent years, a clear independence of the country's Central Bank and inflation approaching its target.

Throughout 2018, a number of tendencies that we forecast are being confirmed. Firstly, final consumption has recovered as expected. High public expenditure growth levels continue, while there has been an upturn in domestic spending, above all, on services and non-durable goods. Secondly, exports have shown a return to positive levels, recording growth so far this year, which is something that has not been seen over a full year since 2015. This is not only due to the higher prices of raw materials, but also the upturn in non-traditional exports, albeit from somewhat low levels. Thirdly, investment maintained its differing momentum – positive in terms of machinery and equipment, yet negative in the construction sector. Finally, an upturn was noted in imports related to the greater consumption of non-durable goods and partly due to investment. All in all, we expect to see growth of 2.6% in 2018, a similar figure to that forecast at the close of Q2, rising to 3.3% in 2019, approaching the potential growth estimated for the Colombian economy. This acceleration in 2019 will be based on a consolidation of private spending, both in terms of the consumption, which is already showing positive signs of reaction, and of investment in all its facets, including investment in construction, which is going through a tough time this year.

Within this context, inflation will remain stable at around the target level set by the Central Bank, ending 2018 at 3.3% and 2019 at 3.2%. In any event, far from being a threat to monetary policy, it may in fact consolidate the recovery of the economy, with a rise in the benchmark rate, which currently stands at 4.25% to 4.75% in 2019, with most increases seen in the second half of next year. This scenario is also founded on a certain calm with regard to the exchange rate, which will gradually approach its long-term level of 2,900 pesos to the US Dollar.

As far as the fiscal situation is concerned, this panorama has its basis within fiscal rule, something we consider to be possible in 2019 due to higher crude prices, the government's austerity measures and, eventually, the sale of certain minor assets. As for 2020, our forecast at the moment is based on financing through the sale of minor assets or an unobtrusive reform of the decisions taken by private banks, which will not directly involve the Financing Act that the Government has planned to introduce, although no details of this were available at the time of writing.

2. Global economy: Global growth is moderating slightly and risks are intensifying

The global economy continues to show positive data, but in an environment of growing uncertainty. The inertia in world growth has continued in the last three months, prolonged by the effect of the fiscal stimulus on the US economy and certain stability in the Chinese and European economies in a context of deceleration. However, the protectionist escalation between the US and China has intensified, while the appreciation of the US dollar has been reflected in an increase in financial tensions in emerging economies which, although with a clear differentiation between countries, has meant a major adjustment in those that are more vulnerable (such as Turkey and Argentina). In this context, both the Federal Reserve (Fed) and the European Central Bank (ECB) continue to make progress in normalising monetary policy, which means a gradual tightening of monetary conditions that will continue to put pressure on emerging economies in the coming quarters. Despite this, it does not seem that we are facing a systemic crisis in these countries. Faced with a global scenario of relative continuity with a slight slowdown in 2019, the main risk in the short term is still protectionism, the effect of which could be felt in the coming year.

Slight moderation in global growth in the second half of 2018 and lower synchronisation

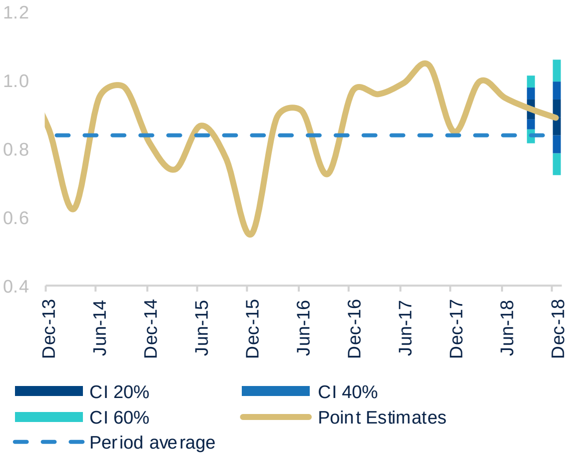
Data available up to September suggest that **global growth would have again slowed down in the third quarter of the year** (BBVA-GAIN: 0.92% QoQ after 0.95% in 2Q18) (see Figure 2.1) and **regional differences would have intensified**. The strength of the US economy contrasts with the moderation in China and the eurozone and, above all, with the significant adjustments observed in the emerging economies most vulnerable to the increase in financial tensions.

The **growth of the industrial sector is very moderate** and still does not recover from the poor performance at the beginning of the year. This behaviour **seems more to reflect the worsening outlook for domestic demand in emerging countries than the solid improvement in global trade** up to August, with the good export performance of Asia-Pacific countries being particularly noteworthy. However, it is still early for the trade data to reflect the possible negative effects of the protectionist escalation that has developed in recent months between the US and China; on the contrary, they may have been positively affected by the advancement of some trade exchanges in the face of the threat of new tariff increases.

Confidence indicators up to August also point to a gradual moderation in global growth, **although they remain at high levels**. The deterioration in confidence in the manufacturing sector is due to worsening employment expectations and foreign orders, affected by uncertainty about trade relations and the need for some emerging economies to reduce their external deficit levels and thus affect some advanced economies, mainly Germany and Japan. Expectations about the evolution of the services sector have also deteriorated, although they remain well above the historical average, partly supported by the strength of domestic demand in developed economies. In particular, retail sales suggest that the downward trend in household spending in recent months has come to a halt and continues to grow at a relatively robust pace, so **consumption will likely continue to support global growth**.

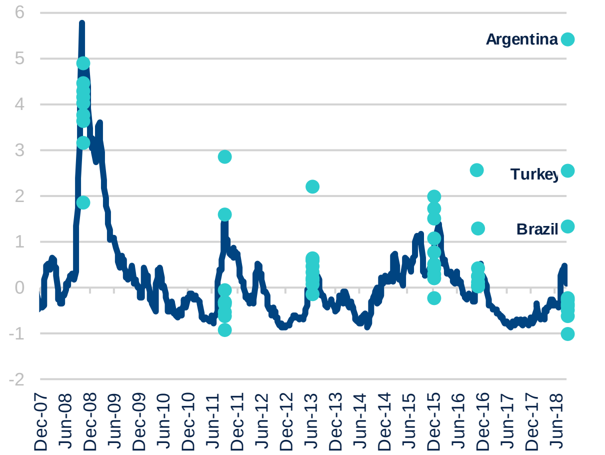
With regard to price trends, **the rise in inflation before the summer has moderated** more recently due to the evolution of commodity prices. **Core inflation remains contained**, but is expected to rise gradually as a result of robust domestic demand in advanced economies and the translation of currency depreciations to prices in emerging economies.

Figure 2.1 World GDP growth
(QoQ, %)



Source: BBVA Research

Figure 2.2 BBVA index of financial tensions for emerging economies



Source: BBVA Research

The normalisation of monetary policy, together with increased uncertainty, will keep on adding pressure on emerging economies

Despite confirming the signs of global economic moderation in the last quarter, **global inertia remains positive, especially in developed economies, and reinforces the** ongoing **normalisation process** of the main central banks in the coming quarters, which will further affect **financial conditions in emerging markets**. In this environment, the feeling of risk aversion among investors has continued for another quarter, **particularly affecting the most vulnerable emerging countries** (those with the greatest external financing needs and high foreign currency indebtedness) (see Figure 2.2), while developed countries continued to benefit from an environment generally free of financial tensions.

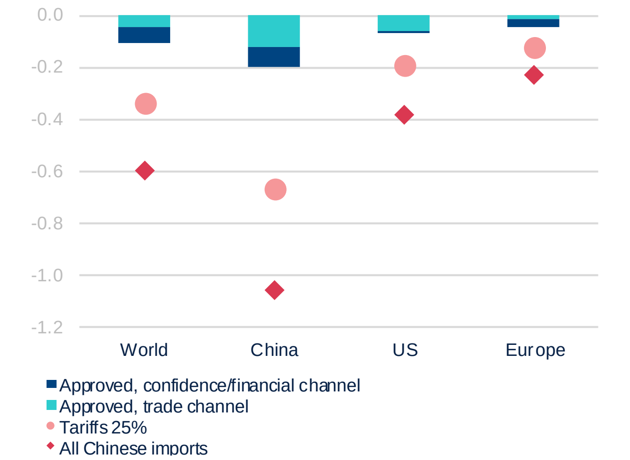
In this context, **Argentina and Turkey suffered in particular**, and their currencies depreciated by 30% and 24%, respectively, while their risk premia increased markedly. However, **tensions eased after monetary and fiscal measures were taken.** On the other hand, trade tensions continue, but with limited effects so far on markets during the quarter, which has been helped by the fact that **China has so far stabilised its currency and curbed the slowdown in growth** through economic policy stimuli. The other focus in the markets has been **Europe,** and for a twofold reason. Firstly, the **risk linked to Italy** increased during the summer and following the government's fiscal proposal - which deviates from the path marked by Europe - with the consequent extension of the Italian risk premium (up to 300 basis points), but with a very limited contagion in the other peripheral countries. Secondly, the ***impasse* at which the *Brexit*** negotiations are stuck has increased the likelihood of a non-deal exit from the EU.

The **tightening of global financing conditions will most likely continue over the forecast horizon**. On the one hand, **the Fed goes on with the normalisation of its monetary policy.** After the cumulative increase in its intervention rate of 75 basis points so far this year (currently at 2.25%), we expect a **rise of more than 25 basis points to 2.5% by the end of this year and to 3.25% by the end of 2019**. Concerning **the ECB, it has reaffirmed and begun its exit strategy** (see below). Coupled with this, **the upward pressure on the dollar against major currencies** has been maintained, driven by the flight to quality and an increasingly favourable interest rate differential.

Uncertainty about protectionist escalation remains high. Although trade tensions between the U.S. and some areas have eased for the time being, the agreement with Mexico and Canada has yet to be ratified and negotiations on the automotive sector with Europe will be reopened after the US mid-term elections in November. Meanwhile, **some of the US protectionist threats towards China have already materialised**, with their respective countermeasures by the Asian country. The US has approved a 10% tariff increase for Chinese imports worth US$200 billion, in addition to the US$50 billion worth of Chinese products with 25% tariffs. China, on the other hand, has reacted by increasing its tariffs to 10% for US imports worth US$60 billion dollars, in addition to the increase of tariffs up to 25% on products worth US$50 billion dollars. **The impact on GDP of these measures** (see Figure 2.3), together with those already approved for steel and aluminium imports, **through the trade channel is limited** (around 0.1% of GDP for China). However, to this direct impact, **other indirect effects** (lower confidence among economic agents, impact on financial markets) could **also be added**, especially for China and emerging economies. These are difficult to estimate but could additionally subtract around 0.1 pp from growth.

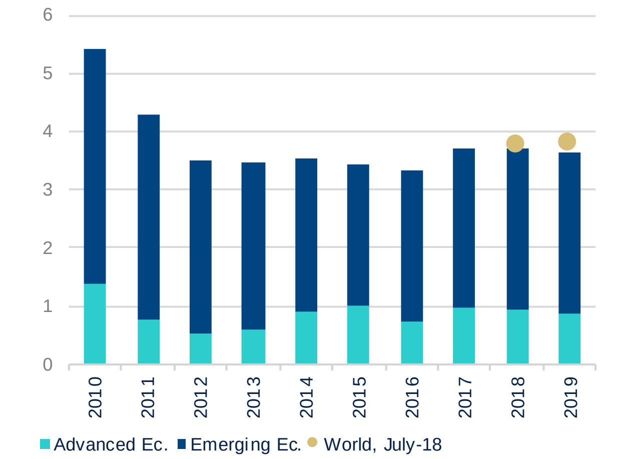
Negotiations with China are likely to resume by the end of the year, and if they do not meet US demands (particularly on intellectual property rights), **the 10% tariff approved in September could rise to 25% from January 2019 on**. In this scenario, and assuming that China reacts with the same rise, **the impact on growth would already be much more significant**, possibly subtracting around 0.7 pp from the growth of the Chinese economy and 0.2 pp from that of the US (and thus -0.3 pp from world GDP and around -0.1 pp from Europe's). While the Chinese authorities are willing to implement policies to support growth, a trade war affecting all their trade exchanges could derail the global recovery.

Figure 2.3 Effect on GDP growth due to US tariff hikes and the response of other countries (2018-19, pp)



Source: BBVA Research

Figure 2.4 Forecasts of world GDP growth (% YoY)



Source: BBVA Research

The ECB has reaffirmed its exit strategy and does not anticipate any rate increases until the second half of 2019

In line with expectations, at the two meetings held during the summer period the ECB reiterated that **the asset purchase programme** (APA) **will conclude in December** this year, given the progress towards a sustained adjustment of the inflation path, while keeping **intact the anchoring of interest rate expectations**.

The ECB made it clear that the bond purchase programme will continue to be activated until the end of the year at a monthly pace of €15 billion between October and December, when net asset purchases will end. With regard to interest rates, the monetary authority is maintaining the reference rate at 0% and the deposit rate at -0.40%, but reiterated that the reference rates will remain unchanged until at least summer 2019. Against this backdrop, with no change in the direction of monetary policy, our expectation of the **first rise in interest rates remains unchanged, with a first rise in the deposit rate in September (+15 bps) and the official reference rate (+25 bps) in December 2019**.

With the end of the asset purchase programme in sight, the focus in the **coming months will be on how the policy of reinvestment of the principal of securities acquired under the PPP purchase programme will be implemented and when and at what pace interest rates will rise**. So far, the ECB seems to be satisfied with market expectations (discounting a first rate hike in October 2019), and does not seem to be in a hurry to make any change in its forward guidance, although in the first part of 2019 we expect it to start giving clues about its interest rate *guidance*.

The downward revision of growth in emerging economies explains the expected moderation of global growth in 2019

The global growth forecast for 2018 has been revised downwards 0.1pp, both for 2018 and 2019, to 3.7% and 3.6%, respectively (see Figure 2.4), since we now expect the slight moderation in the second half of the year to further settle ahead. This slowdown in global activity is **mainly explained by the slower progress expected from some emerging economies**, especially those with greater vulnerabilities in a context of tighter global financial conditions.

In the US, the increase in consumption and the strength of investment keep providing support for the forecast of 2.8% growth in 2018-19. The strength of private consumption is still underpinned by the dynamism of the labour market and higher wage growth, which reinforces optimism in households. Regarding investment, it continues to benefit from favourable financial conditions and rising oil prices. Nevertheless, the acceleration of the economy in the second quarter seems transitory after the strong momentum of the foreign sector, and some moderation is expected in the coming quarters due to the appreciation of the dollar. In this context, the strength of domestic demand, partly driven by a more expansionary fiscal policy, and the rebound in oil prices have accelerated inflation so far this year, but it is already moderating, while core inflation remains stable at around 2%.

In China, the authorities are implementing more accommodative policies to try to curb the slowdown in domestic demand and counteract the rise of protectionism. The good performance of the economy in the first half of the year leads us to revise the GDP growth forecast slightly upwards by 0.2 pp to 6.5% in 2018, although the data observed so far show **clearer signs that progress is moderating**. On the fiscal side, tax reductions are being carried out, both for workers and companies, and the increase in infrastructure investment is being favoured. On the monetary policy side, the main measures are aimed at encouraging banks to extend credit to small and medium-sized enterprises and at stabilising the exchange rate. With all this, **the forecast of 6% growth for 2019 remains unchanged**.

In the euro zone, strong domestic demand and accommodative policies (both monetary and fiscal) **could compensate for increased uncertainty and moderation in global demand**. After the slowdown observed in the first quarter, growth seems to have stabilised so far this year, **maintaining the GDP growth forecast at 2% in 2018 and 1.7% in 2019**, although we now expect greater support from private consumption, underpinned by the improvement in the labour market, and investment, driven by favourable financial conditions and the absorption of the idle capacity of economies. The depreciation of the euro since the second quarter of this year, in conjunction with still-dynamic world trade, will continue to support exports, although it will not prevent a smaller contribution of external demand due to the dynamism of imports linked to investment. In this context, rising inflation has responded to the strong increase in energy prices, and should therefore moderate in the coming months if oil prices are maintained, while core inflation will increase only gradually, especially in 2019.

Protectionism and the Fed's exit strategy are still the most relevant risks on the forecasting horizon, while political uncertainty increases in Europe

The global scenario continues to be subject to mostly negative risks. On the one hand, the risk of a trade war remains unabated and could worsen after the November elections in the US, especially with China, but negotiations with the EU and Japan will also be reopened, mainly with threats involving the interests of important sectors in these regions, such as the automobile sector. While the direct impact of the measures would be limited, the risk of a trade war **could act as a drag on confidence, increase risk aversion in the markets and curb global flows of direct investment**, with the consequent impact on global growth potential. In addition, the escalation of oil price (due to the sanctions on Iran) is also a risk to be taken into account due to its potential asymmetrical impact by country.

On the other hand, in a more volatile financial environment and with a tightening of global financial conditions, **increased financial tensions in emerging economies could intensify**, especially in the most vulnerable countries, **and have an amplifying effect on global risks**. The combination of increased protectionism and accelerated normalisation of US monetary policy together with a possible slowdown in the global economy could lift the perception of risk in emerging financial markets, raising the likelihood of a halt in capital flows. In this context, the risk of an abrupt adjustment of the Chinese economy remains, as some measures to respond to a slowdown in demand and the effects of protectionist measures imposed by the US could limit or delay the process of deleveraging and restructuring its economy.

Lastly, **political risks in Europe have also intensified**. In Italy, the expected increase in the deficit could raise doubts about the sustainability of its public accounts, which could further raise the risk premium of the economy and lead to a potential resurgence of financial tensions in peripheral bond markets. And we cannot rule out a possible UK exit from the EU without a deal.

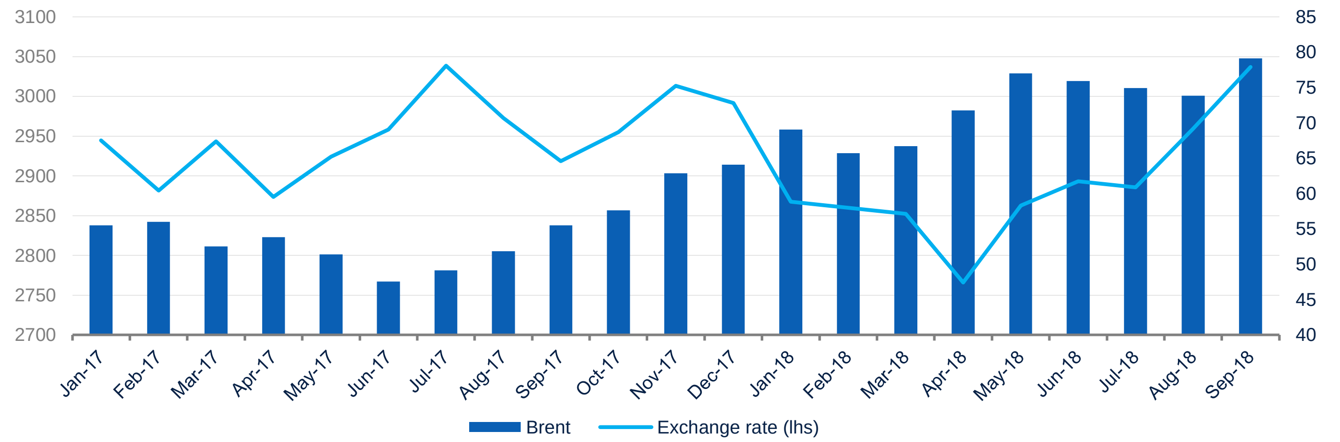
3. Colombia will consolidate its recovery in 2019, boosted by investment and within a challenging international panorama

Colombia sets itself apart from other emerging countries

Since May, the expectations of an accelerated adjustment of international liquidity, along with higher oil prices, have potentially put pressure on inflation, while strong activity in the US has led to an increase in market volatility, especially in emerging economies. Within such a context, it has been those economies that have tackled the strictest short-term credit conditions that have seen the harshest negative capital flows. This can be seen in a significant and accelerated depreciation of interest rates, a sharp fall in their stock market assets and a major hit on risk premiums and interest rates.

However, amidst this difficult panorama, a number of emerging economies have managed to sail through these troubled waters, suffering less impact than others and recording a positive differentiation on markets and with investors. Among these, the Colombian economy has remained robust, given recent fluctuations. With a certain impact on exchange rates, Colombia closed the gaps on its peers through an accumulated appreciation at the start of the year supported by crude oil prices, although barely or not at all in other assets. In April 2016 the exchange rate hit its yearly low point of 2,706 pesos to Dollar, while on 6 September it recorded a high of 3,100 pesos/USD.

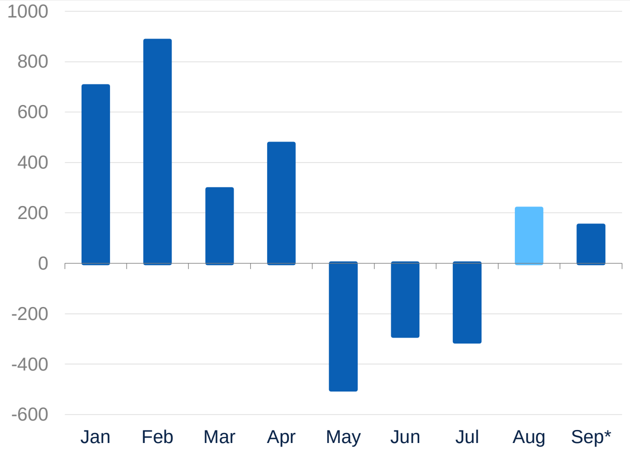
Figure 3.1 Exchange rate and Brent price (Pesos per dollar, USD per barrel)



Source:: BBVA Research with data from Bloomberg and Banco de la República

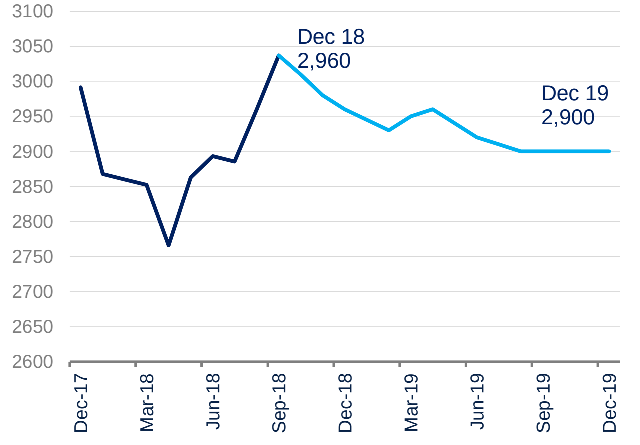
Apart from the impact on the exchange rate, few channels on local asset markets were affected by this turbulence, especially in the most recent month of August. The sovereign curve between 31 July and the third week of August showed marginal movement of less than 8.3 bps, while in the same period there were net portfolio investor inflows (476 million USD). However, we should highlight the net outflows of investors between May and July (797 million USD), possibly more motivated by the downcycle of Central Bank rates than by the risks represented among emerging markets. On the stock market, the net effect is difficult to plot, as there has been a sell-off of key securities due to a rebalancing on the part of international investors outside the context of a crisis event, which has also led to an important valuation of crude-related assets due to their current high price. Nonetheless, perhaps the variable that gives us the clearest picture is that of country risk, which has remained relatively stable in recent months, indicating that the impact has been low and especially tied to the exchange market.

Figure 3.2 Net portfolio investment inflows
(USD millions, *Data as of the 28th of September)



Source: BBVA Research with dafa from Banco de la República

Figure 3.3 Exchange rate (pesrspective)
(pesos per dollar)



Source: BBVA Reserach projections and data from Banco de la República

Given such a context, it is important to outline the factors that have meant that this volatility on emerging markets has had little impact on the Colombian economy. Firstly, it is important to note the reduction of around 3% in the current account deficit in recent years. This has ensured a moderation in terms of domestic spending, allowing for a more sustainable economic expansion. Here we should add that the financing of the deficit has focused – perhaps excessively so – on direct foreign investment within a context in which portfolio investors have continued to come in, which is a sign of their confidence in the country's economic and financial health. Secondly, other institutional factors have had an influence, such as an objective inflation model that tests the independence of the Central Bank maintaining inflation under control through policies that may be regarded as unpopular in times of economic frailty.

Despite this, we should not ignore the importance of the threat, or the effects that it may have on Colombia's economy. The country should therefore not lower its guard. At present, foreign holdings of sovereign debt in Colombia represent close to 25% of the total, which is something that may lead to instability within a scenario of lesser appetite for assets in the country. Given this context, we can also appreciate the watchful eye of the ratings agencies and their possible warnings of Colombia's sovereign grade, which tend toward a negative outlook in the case of the three main services. For this reason, the strategy of including new reserves issued recently by the Central Bank is a positive step toward having more instruments with which to confront any new sign of volatility. In this scenario, we have revised our short-term exchange rate forecasts upward to a close of 2,960 pesos to the dollar in 2018, 80 pesos higher than the previous estimate. In terms of momentum, we feel that in the coming months we may see less stress in emerging economies, leading to new investment and allowing exchange-rate appreciation, albeit limited due to the Central Bank's purchase of reserves. Over the rest of 2018 and 2019, the rate hike announced by the Fed will keep the exchange rate stable to the close of 2018. Only in the second half of 2019 do we expect to see any appreciation in Colombia's currency as it approaches its long-term rate of 2,900 pesos to the dollar.

2019 will see a consolidation in the recovery of economic growth, especially as far as investment is concerned

Throughout 2018, a number of tendencies that we forecast are being confirmed. Firstly, final consumption has recovered as expected. High public expenditure growth levels continue, while there has been an upturn in domestic spending, above all, on services and non-durable goods. Secondly, exports have shown a return to positive levels, recording growth so far this year, which is something that has not been seen over a full year since 2015. This is not only due to the higher prices of raw materials, but also the upturn in non-traditional exports, albeit from somewhat low levels. Thirdly, investment maintained its differing momentum – positive in terms of machinery and equipment, yet negative in the construction sector. Finally, an upturn was noted in imports related to the greater consumption of non-durable goods and partly due to investment.

2019 will see these trends change. Private consumption will continue to speed up, although spending on non-durable goods will take on greater importance, something which is typical at times when interest rates are low, when the dollar is stable and available revenues increase, all factors we shall see in the coming year. This does not rule out a scenario in which the consumption of services continues to be one of the greatest areas of household expenditure. In fact, we expect to see its performance continue to improve. In fact, the share of the family consumption basket represented by spending on tourism, hotels, restaurants and education continues to increase (see Figure 3.4).

Public consumption will cease to grow at a faster rate than gross domestic product, slowing to parity with GDP. Public expenditure will be driven by the greater role of regional and local government, which is characteristic of recent years and will continue to be in 2019.

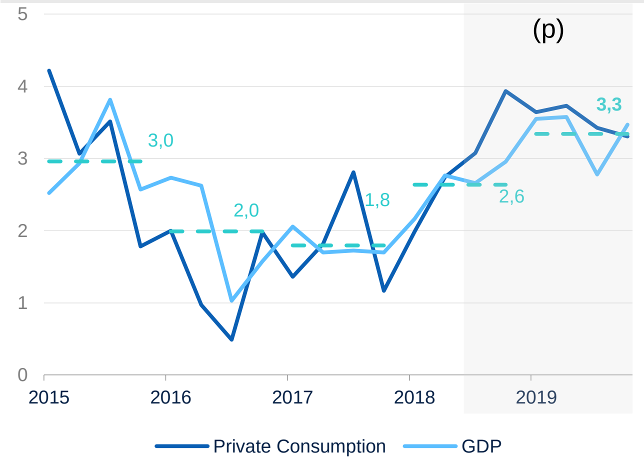
There will be a turning point in investment in construction by the end of the year, as a number of leading indicators forecast: sales of housing in large cities recovering, inventories stabilising with a slight downward tendency, with a large number of projects having sold 70% of the units on offer before work has begun, to which an upturn in the economy will contribute.

A little later, toward the second half of 2019, we will start to see growth in the non-residential construction sector, albeit slow, with a positive momentum limited to port logistics and industrial plant projects. The final year of government and municipal departments will also see more spending on infrastructure, in part due to higher royalties. On the other hand, the building of offices and commercial premises will continue to record slight falls, thus plots may see delays in price adjustment due to oversupply to late 2019 – early 2020.

The rest of investment, stemming from expenditure on transport machinery and equipment, will continue to speed up, accompanying the improved results from industrial production, in terms of agricultural activity and the price of raw materials. In total, investment in 2019 will record its highest level of growth since 2014. This growth will accelerate even further in 2020, with non-residential construction showing the greatest upturn (see Figure 3.5). Investment will rise from 22.1% of GDP to 22.5% in 2019, a level which is still below the maximum recorded in 2014 (23.4% of GDP).

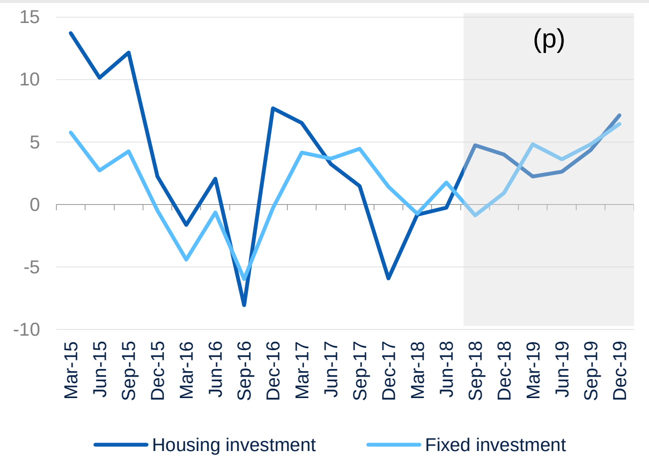
As a result, in 2019, GDP growth will stand at 3.3% YoY, rising from 2.6% in 2018. The following year, for the first time since 2014, GDP growth will exceed 3%, slightly higher than the economy's potential level of growth. In other words, 2018 will be the final year in which the negative GDP gap widens (see Figure 3.4).

Figure 3.4 GDP and private consumption
(annual variation without seasonal adjustment, %)



Source: BBVA Research projections with DANE data

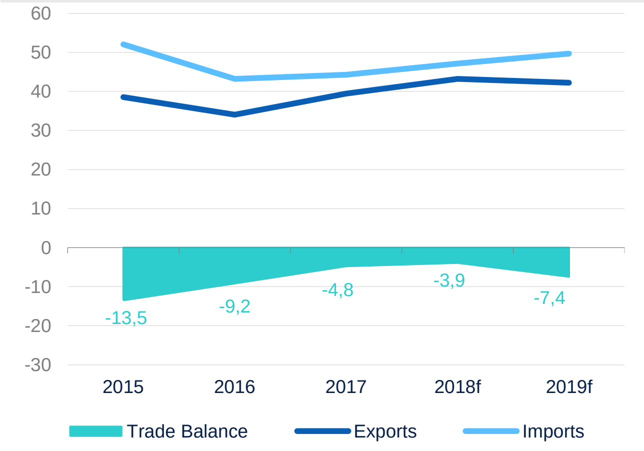
Figure 3.5 Housing investment and total fixed investment
(annual variation without seasonal adjustment, %)



Source: BBVA Research projections with DANE data

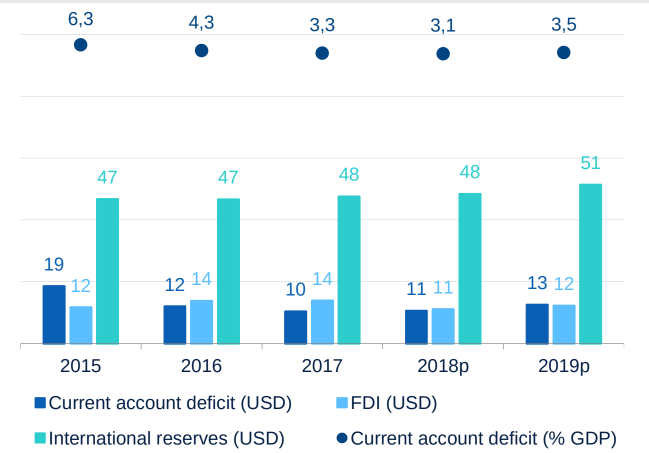
The economy's faster growth will be a challenge to Colombia's foreign accounts. Imports will be marked by greater domestic demand, above all, due to the make-up of consumption and investment. In the case of the former, there will be an upturn in the sales of durable goods. As far as the latter is concerned, we shall see a further acceleration in the rate of investment in machinery and equipment. The two areas will have a marked tendency toward imports, putting pressure on the country's trade deficit. This is even more pertinent when we consider that total exports will fall in 2019 with respect to their 2018 dollar value, as we expect to see oil prices and production fall by 1.4% and 1.8% respectively, a drop that will not be offset by the 7.1% increase in non-traditional exports. In fact, the latter will increase from representing 37% of total exports in 2018 to a level of 41% in 2018.

Figure 3.6 Exports, imports and trade balance
(USD billion)



Source: BBVA Research projection with data from Banco de la República

Figure 3.7 Current account and foreign direct investment
(billion USD dollars –USD- and as % of GDP for the current account)



Source: BBVA Research projection with data from Banco de la República

Pressure on the external deficit will also come in the form of outgoing dividends, as the most significant profits for foreign mining and energy companies working in Colombia this year will become the largest dividend remittances send back to their parent companies in 2019. The growth of outgoing remittances leaving Colombia will help to offset part of this capital outflow as a result of the better working conditions in developed countries.

Finally, we expect to see the current account deficit, which this year stands at 3.1% of GDP rise to 3.5% in 2019. Financing will not be easy, although 100% of the deficit will be covered by direct foreign investment, limiting the need for further capital flows leading to greater volatility. The Central Bank has also announced a plan to stockpile international reserves until 2020, which may help to keep Colombia's foreign indicators positive, despite the increase in imports.

The sectors bearing the brunt of the growth slowdown are construction and services

With the upturn that we have seen in certain construction sector indicators in 2018 (shrinking housing inventories), and given the fact that 2019 will be the final year for local government mandates, we feel that construction will be the leading sector in 2019. In total, we hold the view that the sector will grow by almost 5%, leaving behind the bad results of 2017 (-2%) and 2018E (-3.8%) (see Figure 10, Table 1).

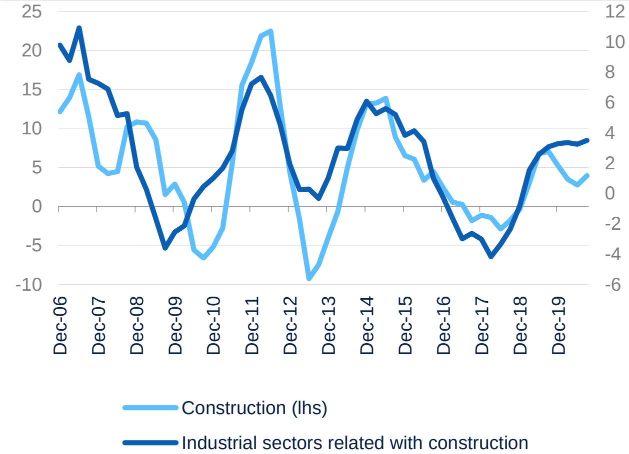
Following the building industry, we still see the business sector, services which will benefit from industrial recovery and the consumer sector, which will grow 4.7% in 2019, a figure below the 5.4% that we estimated for 2018 (the sector has expanded less due to the slowdown in public expenditure). Other services which will experience an acceleration in 2019 are entertainment (up 4.3%), trade, transport and restaurants (the sector as a whole will grow by 3.8% with the hotel and restaurant segment by 4.3%) and telecommunications (set to rise by 3.7% and 3,9% in 2019 and 2010), a sector that is traditionally highly pro-cyclical across its activities (see Table 1).

Industry will grow in a more balanced fashion. In this sector, the activities related to building (the manufacture of metal and non-metal products and the chemical and plastics industries) which lagged behind due to the sector's poor performance, will begin to perform better in 2019 and 2020 (see Figure 1). Other industries, especially food and drink, will continue to record positive results thanks to improved domestic demand. In total, we believe that the industry will show a gradual growth of 2.8% and 3.5% in 2018 and 2019.

Finally, the mining and oil sector will continue to show weak growth. We will see a temporary upturn in 2019 with higher coal production, in comparison to the low production in 2018, when it was affected by rain. Oil production will stay flat due to the investment levels in the sector in general being insufficient to increase production going forward (see Figure 10). Growth in the metal mining sector will be sluggish due to the legal instability caused by popular consultations. Finally, the mining and quarrying sector will recover, due to greater construction activity.

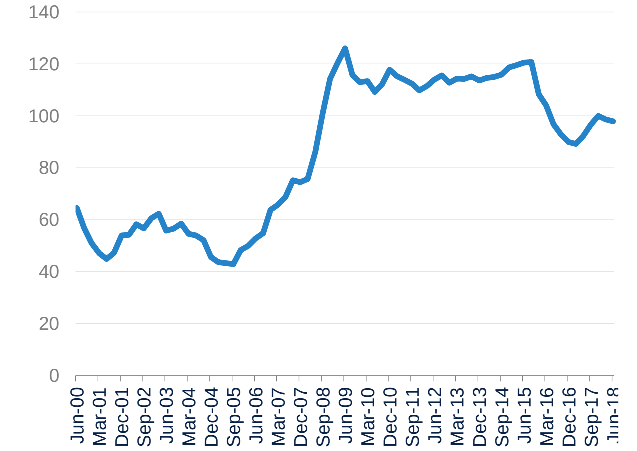
In conclusion, the economy's growth will be more balanced moving forward, with the service sector making an important contribution. The negative contribution of mining, whose growth from mid-2014 to late-2018 was -3%, is left behind (looking ahead, the sector will show mildly positive growth). We could say the same about the construction of buildings, where the adjustment process has concluded. We have started to see positive figures since the beginning of the year (bearing in mind that the sector fell by an average of 4% in 2017 and 2018). Within this context, we can see a GDP that will gradually begin to pick up speed as we move forward.

Figure 3.8 Construction and some industrial sectors'* growth (4 quarter moving average)



* Chemical industry, rubber and plastic, non-metallic minerals, basic metallurgic.
Source: BBVA Research projections with data from DANE

Figure 3.9 Civil works investment in mining and oil (index, 2017 = 100)



Source: BBVA Research with data from DANE

Table 3.1 GDP growth by sectors (annual variation, %)

	2017	2018p	2019p	2020p
Agriculture	5,7	4,0	3,7	3,3
Mining	-4,3	-2,6	1,3	-0,2
Industry	-1,9	2,1	2,8	3,5
Utilities	0,8	2,1	2,3	2,4
Construction	-2,0	-3,8	5,5	4,9
Buildings	*-5,3*	*-2,9*	*6,1*	*5,8*
Civil works	*6,4*	*-4,5*	*6,7*	*5,5*
Trade, transport, housing	1,2	3,5	3,8	4,4
Telecommunications	-0,1	2,5	3,7	3,9
Financial activities	6,9	4,1	5,5	6,1
Real Estate activities	2,8	2,2	2,8	3,0
Professional activities	3,4	5,4	4,7	4,5
Government	3,8	4,6	3,1	3,7
Entertainment	3,9	3,1	4,3	5,5
GDP	**1,8**	**2,6**	**3,3**	**3,7**

Source: BBVA Research projections with data from DANE. p: projections

As we go forward we will see recovery continue, with a gradual closing of the output gap

From 2020 to 2022, the Colombian economy will continue to close its output gap, with sustainable growth above its potential level. The average growth rate for the period will be 3.8%, driven by investment (5.7%) and private consumption (4.1%). Meanwhile, average public expenditure growth may be below that of GDP.

Sectoral results will be more balanced, as the recovery of agro-industrial exports from 2019 onward will boost the growth of associated tradable goods sectors. However, the gradually fall in oil prices to their long-term levels ($60 dollars per barrel of Brent) will mean that the mining and energy sectors will continue to record weak growth. Lastly, the trend toward ongoing improvement in the labour market and household income will continue to bolster expenditure on services, benefiting the tourism, hotel and restaurant and education sectors, among others.

Fiscal uncertainty may delay investment and consumer decisions

We expect to see fiscal deficit as a percentage of GDP gradually falls from 3.1% in 2018 to 2.4% y 22% in 2019 and 2020 respectively, in line with the fiscal rule. Such a scenario presumes extra revenue of 0.5% of GDP in 2019 and 1% of GDP in 2020, as well as a stringent reduction in expenditure as reflected in medium-term forecasts presented by the government in July this year. Based on the government's calculations, expenditure will drop from 19.1% of GDP in 2017 to 18.2% in 2018, 18% in 2019 and 17.9% in 2020 – a cutback of 1.2% of GDP in three years.

Given the difficulty in cutting expenditures, it seems that the government will have to meet its fiscal targets through higher revenue rather than by reducing spending. This is suggested by budget increases in operations and investment totalling 14 trillion pesos presented by the current government in its 2019 General National Budget, with debt amortisation reduced by the same sum. Even so, the Budget, set at 258.9 trillion pesos (an increase of 10.9% on 2018), ensures compliance with the fiscal rule (as provided for in 2011's Act 1473), as the process by which it was passed by Congress demands the presentation of a Financing Act as a consequence of the extra revenue. According to the initial plan, these measures will represent a cost of 14 trillion pesos in order to leave fiscal deficit targets unchanged.

However, there is considerable uncertainty regarding the amount that the Financing Act will bring in, as well as concern about its sources. These serious doubts may extend to the next legislative session (March-June 2019), the maximum period provided for by law in which to enact such legislation.

Among the possible measures that the Financing Act may provide for in order to increase revenue is the privatisation of national assets, the extension of the VAT or income tax base, the combining of tax brackets and an increase in the tax rate payable by those with very high incomes. However, it will seek to reduce the tax burden on companies through a reduction of the business tax rate and VAT rebates on the purchase of capital goods (rather than the current discount system).

These latter measures may have a positive effect on investment as long as they do not overly affect the capacity for growth in domestic demand through the taxation of individuals. The uncertainty that reigns regarding such proposals is considerable and could initially affect household confidence or later delay investment or consumer decisions, depending on the type of financing that the Congress and Senate approve.

If they opt for a financing with a low tax burden and instead choose to sell off state assets (i.e. privatisation), the effect on domestic demand will be minor, limited to a short-term loss of confidence due to doubts about the reforms. However, if direct personal taxation is increased, with an extension of the tax base, the income subject to tax, with greater rates applicable to those with the highest incomes or a combination of these measures, the effect on confidence will manifest itself more slowly in lower consumer spending, although with a low impact in the short term and broadly spread over the next seven quarters (i.e. to September 2020). Finally, if financing has a greater impact on VAT revenue, probably by increasing the products on which purchase tax is payable, the initial effect on confidence will be swiftly seen in lower consumption in the first six months of 2019.

Our base growth scenario for 2019 (an annual variation of 3.3%) is founded on the first two revenue-raising possibilities, where the real impact on domestic demand is either very low or spread out over time. In the event of the third option being adopted, the extension of the VAT tax base will put a negative slant on our growth forecasts.

Inflation will be very close to target levels by late 2019, albeit with fluctuations throughout the year

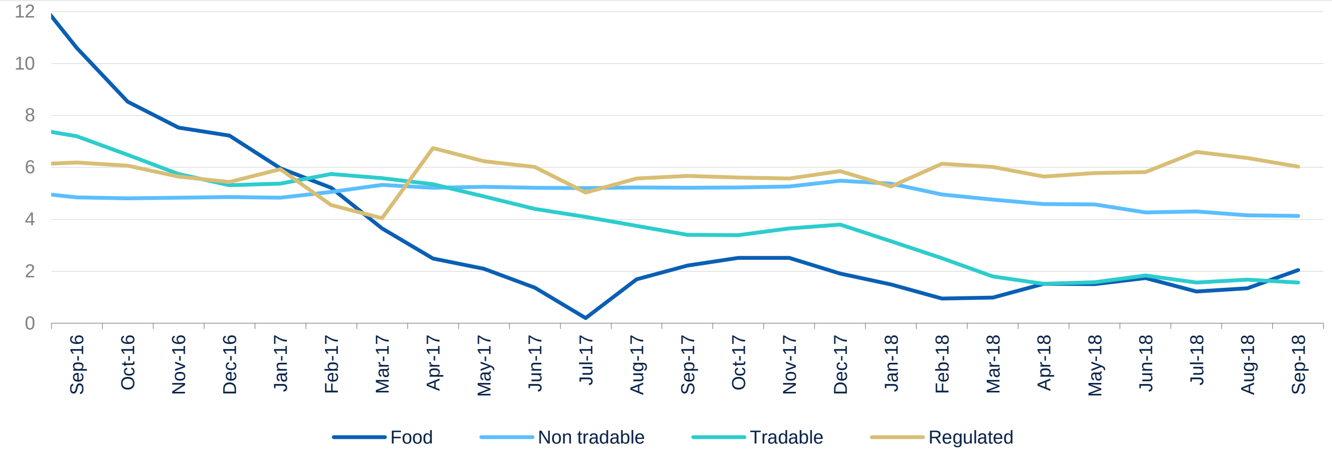
The rate of inflation for 2018 will close the year slightly above 3%, lower than the 4.1% we saw at the end of 2017. Between December 2017 and September this year, the majority of inflationary components slowed: non-tradable goods inflation dropped to 4.1% from 5.5% while tradable goods inflation fell from 3.8% to 1.6% (see Figure 11). Meanwhile, food price inflation has increased very little, standing at below 2% for the year. The only group to buck this downward inflationary trend was regulated goods, where inflation rose from 5.9% to 6.2%, mainly due to energy inflation climbing from 2.1% to 7.7% as a result of higher fuel costs.

In the first months of 2019, the inflation rate will fall further, temporarily dropping below 3%. The downward inertia affecting certain components, such as rents and leases, educational services and health, will be key to keeping price rises at around 3%. The recent devaluation of the exchange rate will have very short-term effects, without macroeconomic risk to companies. We are of the view that the exchange-rate trend that we expect to see in 2019 (very stable on average compared to 2018) will help to ensure that the tradable goods inflation remains below 3%.

Regulated goods inflation will slow down from late 2018 onward. The percentage increase in fuel prices in 2019 should be lower than we saw in 2018, given the fall in Brent crude prices that we expect to see in 2019. Furthermore, electrical energy costs should also come down as a result of the ending of measures which increased the restriction charge for 36 months from late 2015 onward introduced by the regulator to compensate for costs incurred in generating energy from liquids during the El Niño phenomenon. Within this context, we feel that inflation may close 2019 at around 3.2%.

Our forecast has a high degree of uncertainty: as well as not knowing (i) which changes Colombia's National Administrative Department of Statistics (DANE) will make to the basket of goods used to measure the RPI in the coming months and (ii) which changes will be introduced to VAT rates that the government is structuring as part of its Financing Act, there is also some risk that these may affect our inflation predictions. On the one hand, there is a probability that there will be an El Niño phenomenon beginning late this year, which might extend to mid-2019, with negative consequences on food price inflation. On the other hand, a greater-than-expected depreciation of the exchange rate may affect our forecasts for tradable goods inflation. These two risks, should they materialise, may increase inflation in 2019, and depending on its impact on expectations, they could also affect the interest rate trends in our main scenario.

Figure 3.10 Inflation by main groups (annual variation, %)



Source: BBVA Research with data from DANE

A change of monetary posture will gradually be underway in the second half of 2019

Within a panorama of controlled inflation, at around 0.5% from the target range and with activity showing signs of recovery, albeit slow, the Central Bank will maintain its benchmark rate at 4.25% until mid-2019. To a large extent, this is due to the current balance between internal forces, which are in favour of monetary support in order to consolidate recovery, and external forces, which are in favour of not altering the current capital flow balance. We forecast that the Central Bank will make its first upward adjustment to the rate in the second half of 2019 (July) when economic growth consolidates above 3% and we begin to see the output gap close. At the same time, given the moderate pace of recovery, the Central Bank will gradually take the rate toward its neutral level, with a second increase before the end of 2019, closing the year at 4.75%, with a final adjustment made to the cycle in the last quarter of 2020, leaving the rate at 5%, its neutral level.

As for the risk balance that the Central Bank has to deal with, fiscal or external disruptions may affect the estimated interest-rate adjustment trend. In principal, an unstable, hostile external environment with regard to emerging economies, without positive differentiation for those economies with better fundamentals, may result in an upward rate adjustment with a view to containing affected inflation expectations given a potential depreciation of the exchange rate. Similarly, an incomplete fiscal adjustment, which may lead ratings agencies to consider reducing Colombia's credit rating, may result in a similar scenario to the one mentioned previously. There is also a risk here of a fiscal reform that once again hits consumer confidence, hindering – albeit partially – the spending recovery, delaying the closing of the output gap and any rate rises.

Finally, current monetary policy has allowed for credit profiling, which has improved momentum with regard to the past-due portfolio, slowing impairment and favouring portfolio quality variables, preventing them from worsening further. A hurried adjustment of interest rates, as might be seen in scenarios of external volatility, may end up creating a negative environment for portfolio recovery. This phenomenon takes on a special dimension in the case of the commercial portfolio, which, despite very favourable interest rates over a long period of time, has barely reacted, even shrinking in real terms.

4. A faster recovery of the Colombian economy will depend on improved productivity

From 2004 to 2014, the Colombian economy experienced high oil prices and accelerated world growth, ensuring a significant revenue flow. This allowed the consolidation of a cycle of investment in different production sectors, resulting in notable social progress. The investment rate rose to 29.1% of GDP in 2014, driving the growth of the economy and increasing its potential level. Furthermore, 6 million people were taken out of poverty, increasing the percentage of the middle classes from 14.7% to 28.5% and increasing the average monthly income from 5.5 million pesos to 9.5 million pesos (both figures based on constant pesos in 2017).

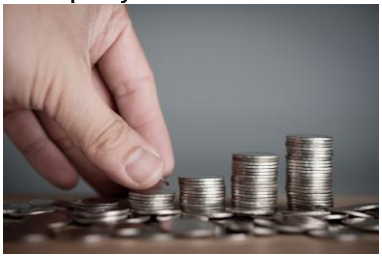
Looking to the future, the challenge to maintain investment profits and social progress is even greater. This is due to a lesser impact from the oil sector, the lower fuel prices of late and expected for the future and the lack of an alternative to oil as far as its export role is concerned, government revenues and the drive toward investment in the country, the end of the demographic dividend, less favourable credit conditions and a more moderate panorama in terms of global growth potential. Further policies are therefore needed to ensure that, in a more complex environment, a higher level of growth can be maintained, creating opportunities for a new scenario. The new paradigm will be characterised by the following: a higher exchange rate, greater sectoral uniformity without the clear dominance of one production branch, a more dynamic non-oil tradable goods sector, less flexible fiscal policies and a more digitalised world with faster, more accessible technological progress. All of this requires a change toward a domestic production offering greater added value.

The path to follow is one of improving Colombia's productivity and competitiveness. These factors cut across the whole spectrum of economic activity and are the basis for business development through overall economic progress. A panorama in which there is less friction, little public and private uncertainty and a state that is committed to improving infrastructures, logistics and regulation may result in higher productivity, the viability of the country's companies, the strengthening of the labour market in terms of reliability and knowledge and greater encouragement in the setting up of new businesses. The most productive countries pay higher wages, have more free time, offer higher returns on investment and show a greater capacity for innovation. Meanwhile, the most competitive are able to reduce transaction costs, penetrate foreign markets, reduce time spent on marketing and facilitate the creation of new businesses. This allows them to expand trade beyond their borders and diversify exports.

Certain specific sectoral measures will also be needed to roll out across-the-board policies that ensure higher productivity and greater competitiveness. Here, the development of value chains could be effective, including activities that are key to the country, which can be characterised by their high added value and their role as promoters of social inclusion and as nexuses for other sectors of the economy. In our judgement, these sectors are agro-industry and services (tourism and real estate, among others). Finally, the document is made up of three parts. The first of these is the introduction, we then look at cross-cutting factors before finally including the specific proposals for each sector.

Following this, is a summary of the five common central themes, along with diagnosis and lines of action to strengthen them and ensure a positive impact on productivity in Colombia.

Table 4.1. Diagnosis and lines of action designed to increase productivity in Colombia

	Diagnosis:	Lines of action
The digital environment 	Market penetration of digital products is high. However, their use could be more productive. Currently, only 10% of those with Internet access use it to purchase goods and services, 10% use e-banking and 9% use it for government transactions. In contrast, 79% use the Internet to access social media.	• Consolidate the design and monitoring of digital policies • Establish digital standards • Move toward a 100% digital state • Implement clear policies that promote digital initiatives • Reduce access costs
Education 	Out of the 72 countries assessed in PISA testing, Colombia came 57th in science, 61st in maths and 54th in reading. Despite the fact that Colombia's expenditure on education as a percentage of total public spending is higher than the OECD average, when it is evaluated in per capita terms, it is the lowest by a significant margin.	• Evaluation of and incentives for teachers • The strengthening of low-status subjects and the single shift system • The development of skills to create digital projects • Technological research • Ensuring universal bilingualism and introducing the formal certification of tourism services • Incentives for the education of young people
Fiscal policy 	Colombia's collection rates are low in comparison to those in other OECD countries and those in the region. There is an emphasis on collecting from companies (83%), though with few contributor companies. Personal income tax is concentrated on 1.8 million contributors.	• Introducing modern transport and energy systems that are more economical, cleaner and multi-modal • Developing international trade logistics and urban centres • Integrating outlying areas through multi-modal networks and social infrastructure • Implementing an integrated, green urban public transport system
Infrastructure 	Colombia has 4.2 kilometres of paved road per thousand inhabitants, one of the lowest in the region. The cost per kilometre and per ton transported on the road network in Colombia was $0.21 in 2016, higher than most other countries in the region. According to the *World Economic Forum*, Colombia occupies the 87th place in terms of infrastructure, the 110th in roads and the 88th in health and primary school education among a total of 137 assessed economies.	• Establishing tax-income parameters using reliable models (objective taxation) • Extending and demanding the use of electronic invoicing • Simplifying people's interaction with the government • Eliminating contributions to compensation funds as part of the payroll • Easing transit between subsidised and contributory health centres • Eliminating health contributions from formal employees (<2SMLV)
Formalisation 	According to the National Planning Department (DNP), around 75% of companies are not registered on the Single Tax Register (RUT) or the Single Business & Social Register (RUES). Non-compliance is even higher in the case of ensuring that employees are affiliated to the social security system, health standards and tax declaration and payment. Half of Colombia's employees are classified as "informal", and only 30% are affiliated to the social security system.	• Increasing tax collection by giving greater powers to the National Tax and Customs Office (DIAN), dismantling the tax exemption system and extending tax bases, offering efficiency incentives to local tax collectors • Reducing company tax (once improved collection has been ensured) • Simplifying municipal and departmental taxes • Implementing mechanisms which ensure flexibility and which target public spending • Parametric pension reform: removing the differences between systems • Ensuring regulatory clarity and stability with a focus on competence and efficiency • Speeding up legal proceedings

Source: BBVA Research

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5. Tables with forecasts

	2014	2015	2016	2017	2018	2019
GDP (% y/y)	4,7	3,0	2,0	1,8	2,6	3,3
Private Consumption(% y/y)	4,6	3,1	1,4	1,8	3,0	3,5
Public Consumption (% y/y)	4,7	4,9	1,8	4,0	4,8	3,4
Investment (% y/y)	9,9	2,8	-2,7	3,3	0,3	5,0
Inflation (% y/y, eop)	3,7	6,8	5,7	4,1	3,3	3,2
Inflation (% y/y, average)	2,9	5,0	7,5	4,3	3,3	3,2
Exchange Rate (eop)	2.392	3.149	3.001	2,984	2.960	2.900
Devaluation (%, eop)	24,2	31,6	-4,7	-0,6	-0,8	2,0
Exchange Rate (average)	2.001	2.742	3.055	2.951	2.911	2.921
Devaluation (%, eop)	7,1	37.0	11,4	-3,4	-1,4	0,3
Policy Rate(%, eop)	4,50	5,75	7,50	4,75	4,25	4,75
DTF Rate (%, eop)	4,3	5,2	6,9	5,3	4,5	4,8
Fiscal Balance (% GDP)	-2,4	-3,0	-4,0	-3,6	-3,1	-2,4
Current account (% GDP)	-5,2	-6,5	-4,4	-3,3	-3,1	-3,5
Unemployment urban rate (%, eop)	9,3	9,8	9,8	9,8	9,8	9,6

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