BBVA Research

Colombia Outlook
1Q19

January 2019

Creating Opportunities

Key messages

- Global growth will decelerate in 2019 and 2020 respect to our 2018 estimate. The deceleration will be explained by a lower expansion, relative to expected, in the United States, both by the extinction of the fiscal stimulus and the deterioration of commerce
- In Colombia, investment, driven by construction, will be the key to the acceleration of the economy in 2019 and 2020. Private consumption will continue its recovery path. On the contrary, public consumption and exports will have low growth
- Inflation rate will remain within the target range defined by the Central Bank. Prices will favor of lower oil prices, stability of the fx and low demand pressure
- Even though inflation rate will remain stable and within target and growth should be moderate, the Central Bank will increase gradually its policy rate in 2019 and 2020 taking it to its neutral level to reduce structural risks for the Colombian economy
- The main two structural risks are the fiscal deficit and the external deficit. The tax reform increased revenue in 2019 but they are not structural. The fall in oil prices and the subsequent commercial imbalance will increase the current account deficit and will make its financing more difficult

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Content

01

Lower growth in the US reduces global activity

Towards a soft landing in global growth, but with significant uncertainty

World growth deceleration, but still robust

Strong adjustment in global commerce and the industrial sector meanwhile investment and consumption weather a deterioration of confidence indicators

Lower inflation after the fall in oil prices

Less pressure for central banks and greater support for oil importing economies

Hike in financial tensions in developed countries

Strong adjustment in asset prices and portfolio investment outflows, not in emerging economies

Central banks more cautious and patient

Monetary policy normalization will depend on the evolution of the economy and is key to contain market uncertainty

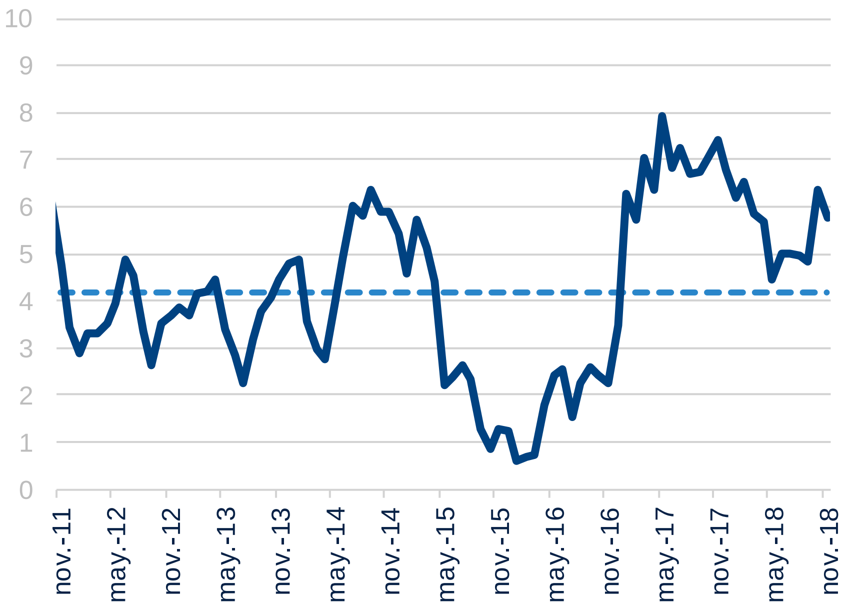
Global risks intensify

Alongside protectionism, risks of a greater deceleration in China and the US and greater uncertainty in Europe rise

Global trade: effect of both increased tariffs and uncertainty on trade negotiations are now more evident

BBVA – Global exports of goods

(% YoY, 3-period moving average, nominal exports)

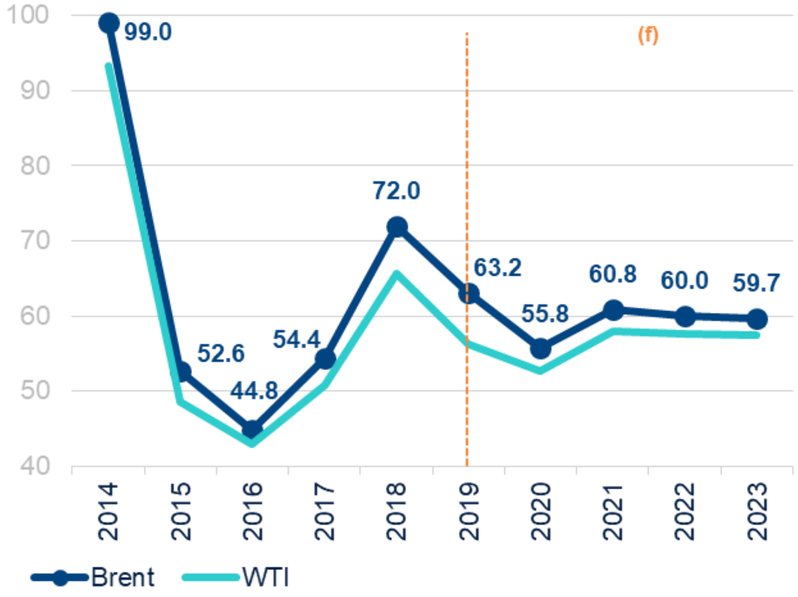


Source: BBVA Research

- World trade has shown strong volatility due to uncertainty about trade disputes
- The recent poor performance of exports in China is partly due to the previous front-loading of exports triggered by the possibility of new tariff increases, but its downward trend is worrying
- The worse-than-expected evolution of exports has also been observed in the rest of Asia and in Germany

Oil prices have fallen significantly and will represent a lower impulse for commodity exporting countries

Oil price
(Dollars per barrel)



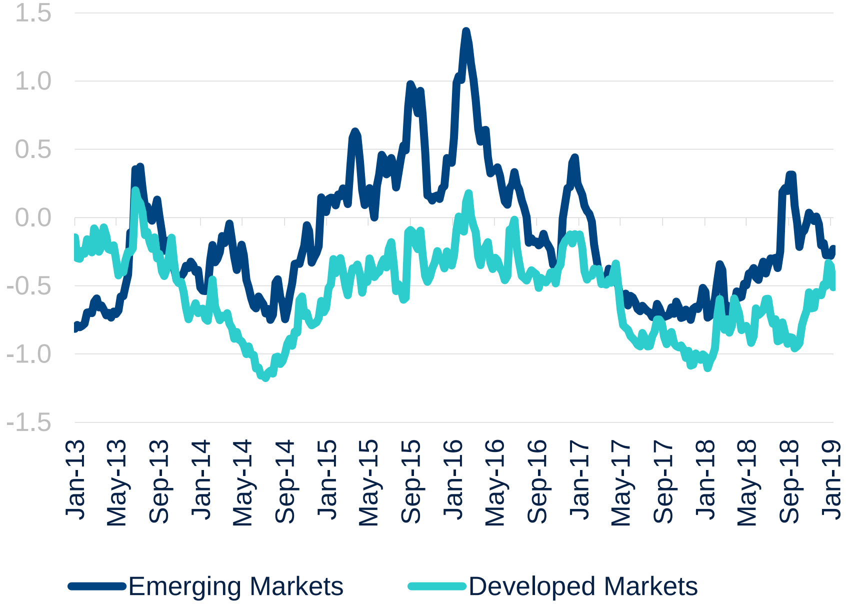
Source: BBVA Research

- Oil prices should rise in the short run in in accordance to the OPEP+ production reduction schedule, the Iranian sanctions and lower production from a country in south America.
- In general, we expect a gradual reduction in oil prices, particularly in 2019 and 2020, due to a slower global demand
- In the long run, we expect oil prices to converge towards a USD 60 a barrel for the Brent type

Recent turmoil in the financial markets due to a risk of a sudden adjustment of global growth

BBVA's Financial Tensions Index

(index)



Source: BBVA Research

01

Developed markets (US) are at the center of the episode, where financial tensions have rebounded sharply

02

EM remained relatively resilient despite the global mood and the fall in oil prices

03

Investors have withdrawn **sizeable outflows from DM**, but EMs have failed to attract new flows

04

The **response of central banks**, particularly the Fed showing higher prudence/patience, has been key to halt tensions

Central Banks are sensible to growing risk scenarios, and the monetary normalization process is slowing

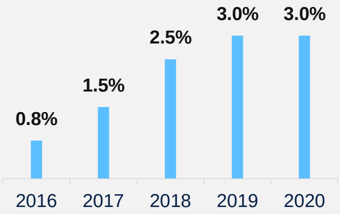
Balance Sheet

Interest Rate

Federal Reserve System

- **Reduction of the balance sheet continues** (550bn dollars in 2019)

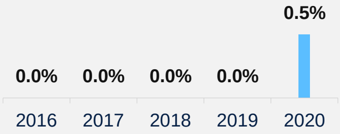
- **A pause in the rate hike cycle is closer** (two rate hikes of 25bp each in 2019)



European Central Bank – Eurosystem

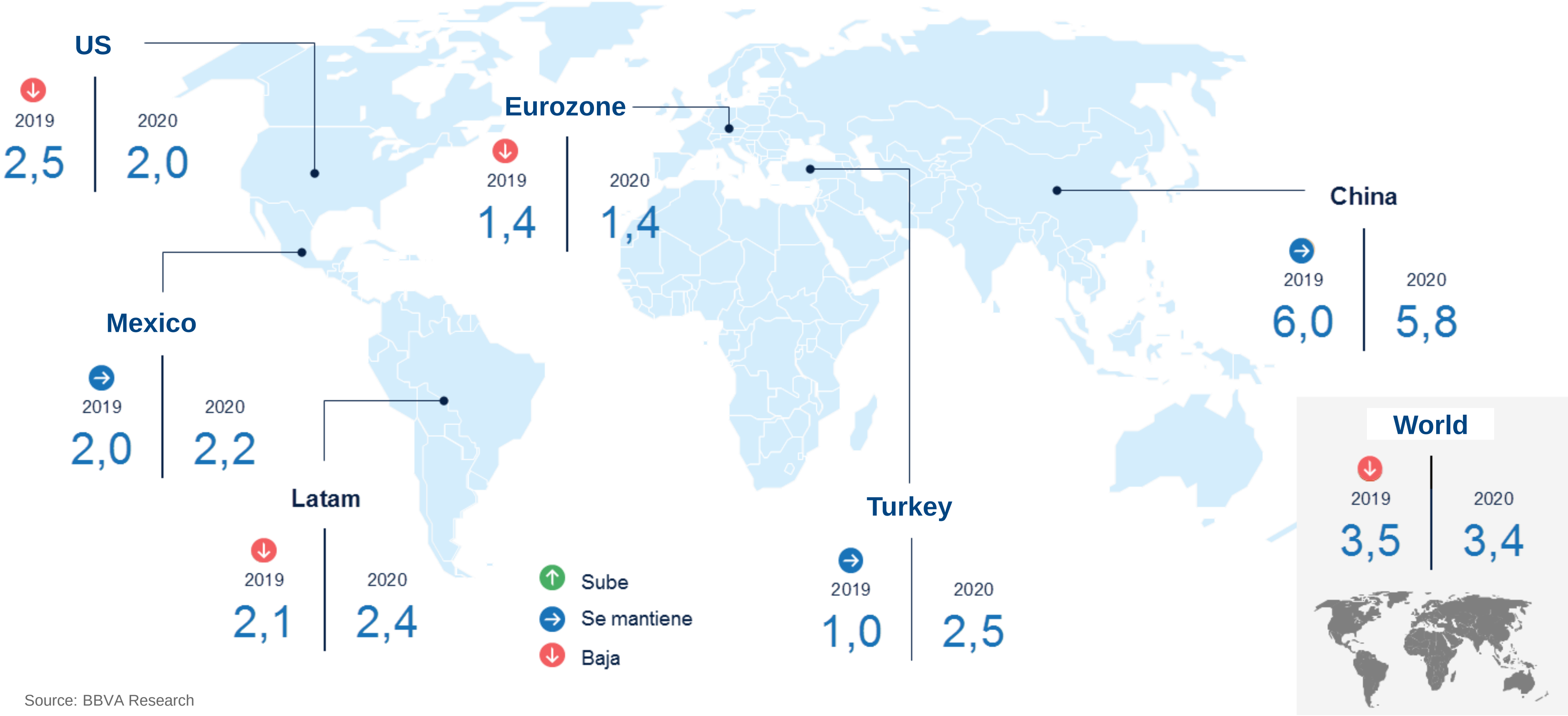
- **QE end** (December of 2018)
- **Total reinvestment of QE** further than the start of the rate hike cycle
- **A very probable new LTRO** before June 2019

- **Delay in the rate hike path** due to less favorable global perspectives and higher risks. **Not expected until June 2020**



Source: BBVA Research

General downward revision in growth, with a more evident moderation in developed economies and emerging Asia



Source: BBVA Research

Still soft landing, but more uncertain due to dependence on policies

Worse macro outcomes

Faster slowdown than expected
(Protectionism+China)

Evidence that impact from **US fiscal stimulus** will fade earlier than expected

Higher financial stress

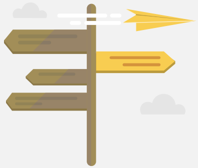
Risks of **global growth hard landing**

Tougher financial conditions

Three key assumptions in our projections:

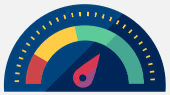
01

Easing US-China trade tensions with no changes in the auto sector



02

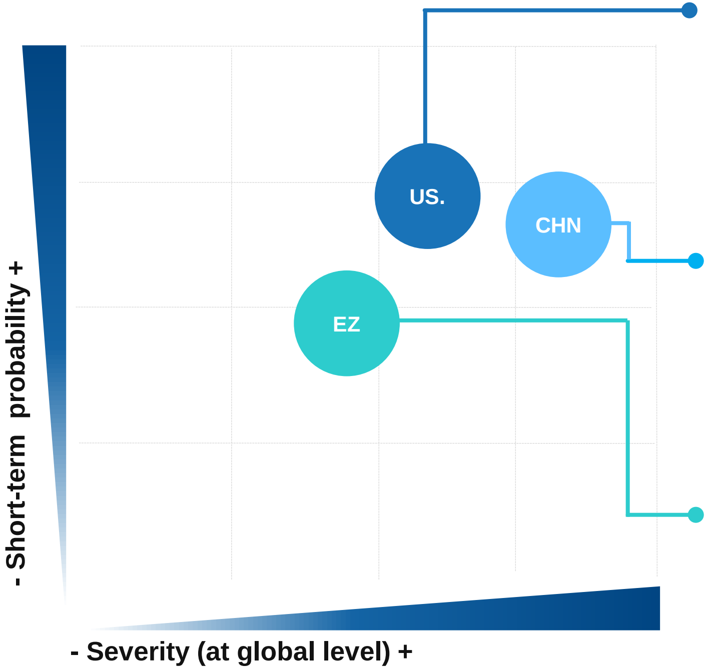
Orderly Brexit



03

Fed and ECB: more dovish and with more room of maneuver

Global risks tilted to the downside: US recession fears, China's debt and trade war are the main sources of concerns



- **Economic recession: increasing** (trade concerns, political controversy -shutdown-, geopolitical issues, credit risk / corporate leverage)
- **Protectionism: high.** Negative spillovers on growth (investment, impact on certain sectors / states) and cost pressures
- **Fed's exit: falling**. Lower risk of overshooting (rates above neutral levels)

- **Disorderly deleveraging: relatively higher**. Growing debt overhang amidst further stimulus and flagging growth (also visible in household expenditure). Monitoring: RMB, corporate defaults, local government debt
- **Protectionism: high**. Big differences remain despite a potential trade deal in March19. Lack of advances in structural issues (intellectual property, FDI, WTO reform)

- **Political concerns: relatively higher**. Lack of advances in integration process on the eve of European Parliament elections
  - ***Brexit***: risk of a cliff-edge Brexit in March19
  - **Italy:** political and policy uncertainty remains. Banking concerns rising
- **Proteccionism:** contained but it could be not discarded (autos)
- **ECB's exit risk:** low. Pending on changes in the Board

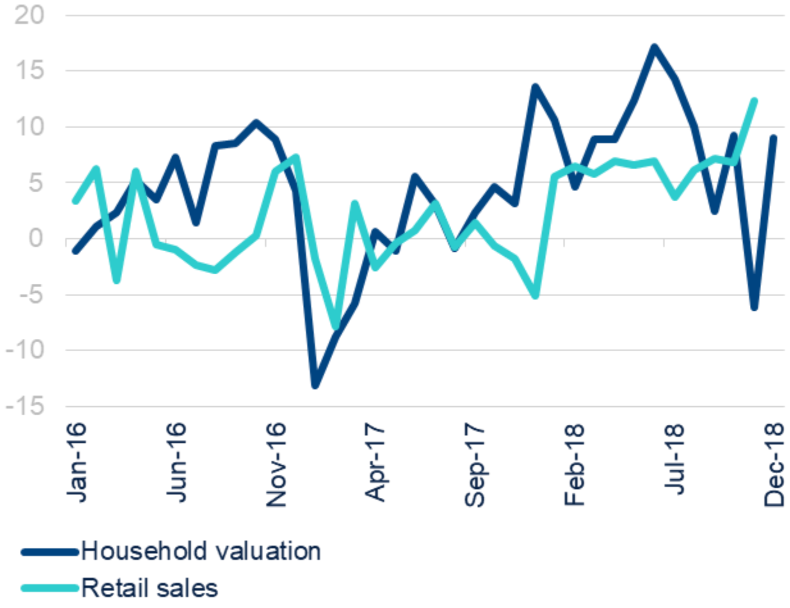
Fuente: BBVA Research

02

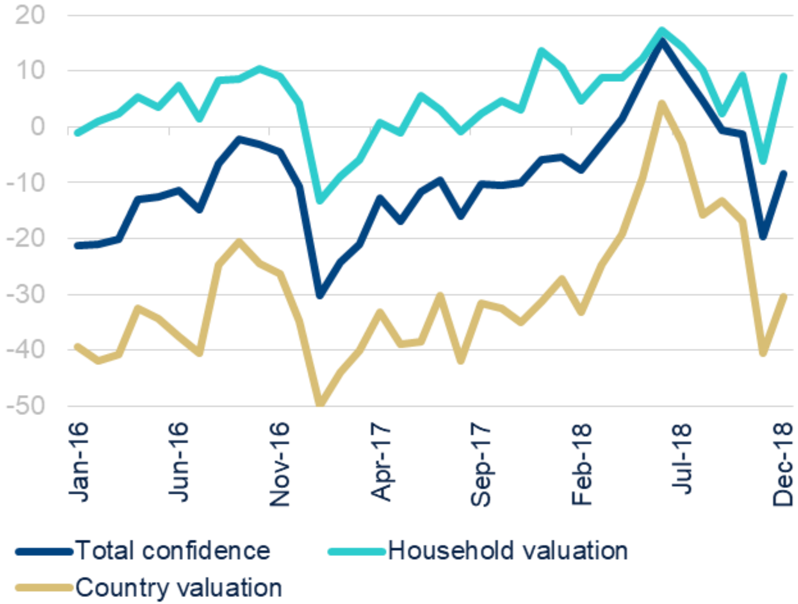
Investment will be the responsible of economic acceleration in Colombia

Fall in consumer confidence has not transmitted to economic results. This happens when deterioration comes from the country component

Household valuation and retail sales
(Answer balance and annual variation, %)



Consumer confidence and components
(Answer balance)

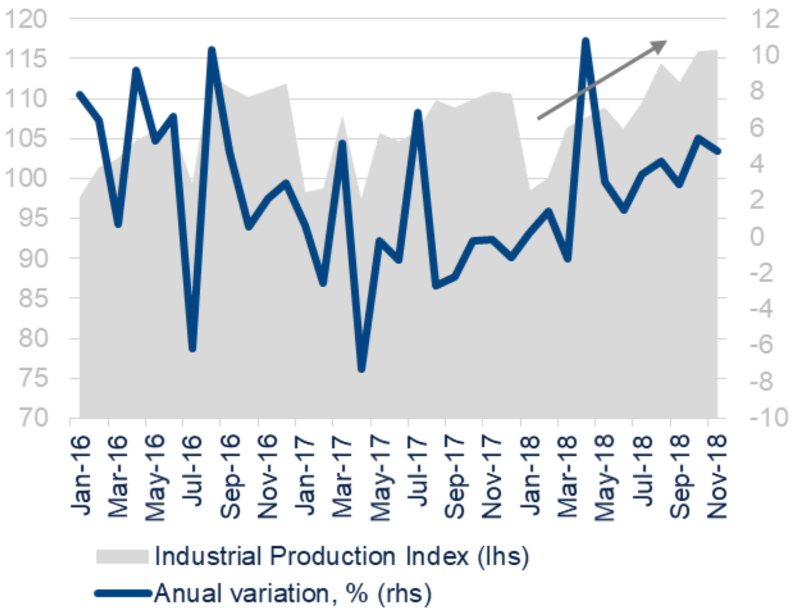


Source: BBVA Research, Fedesarrollo and DANE data

Higher internal demand is boosting the industrial sector, which could have investment capacities in 2019

Industrial Production Index and annual variation

(Index 2014=100 y annual variation, %)



Source: BBVA Research and DANE data

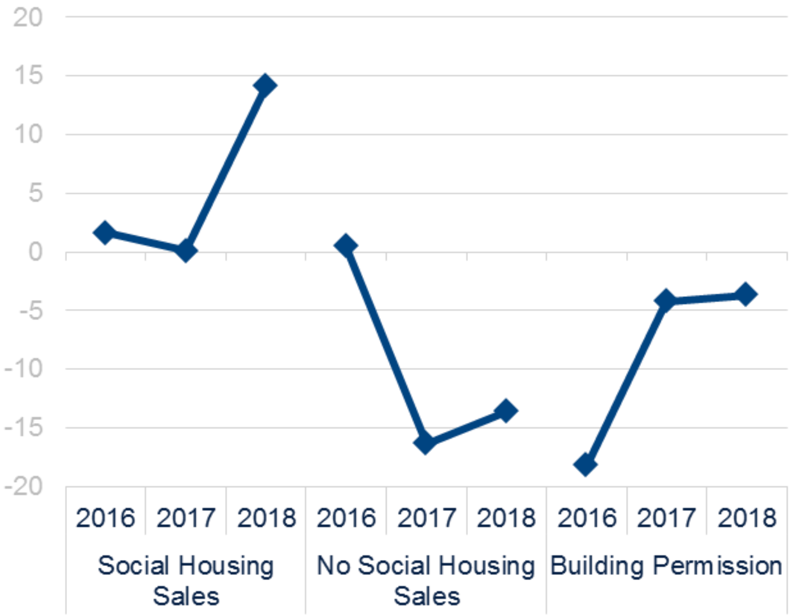
The recovery in internal consumption has raised gradually the capacity utilization

- Textiles, leather, cement, metals, furniture, machinery services have the highest capacity utilization
- The tax discount on fixed asset investments approved in the most recent financing law also helps to consolidate investment
- The industry is leading the demand of energy. Its average growth in the second semester of 2018 (3.9%) was the highest since 2014 for a six month period

Investment will also be supported by stronger construction in social housing. Other buildings will accelerate in 2020

Housing sales and building permits*

(annual variation, %)



Source: BBVA Research, La Galería Inmobiliaria and DANE data. *Information available until october

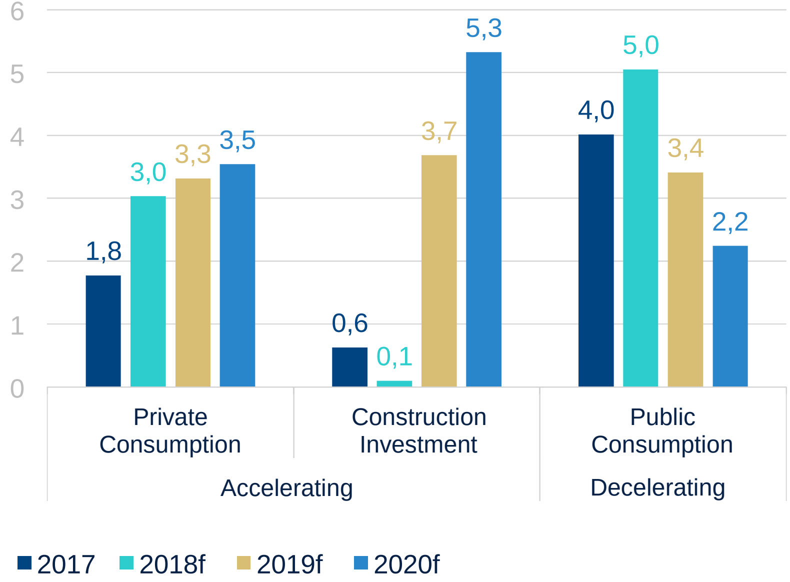
Social housing sales accelerated significantly in 2018, this in turn should accelerate construction activity in 2019 in this type of housing

- High and middle value housing sales continue in negative territory. Their recovery, in hand with a better behavior in non housing construction, will start at the end of 2019 and, mostly, in 2020

Private consumption and construction investment will determine the acceleration of economic activity in 2019 and 2020…

Consumption and investment

(Annual variation, %)



Source: BBVA Research forecast and observed DANE data

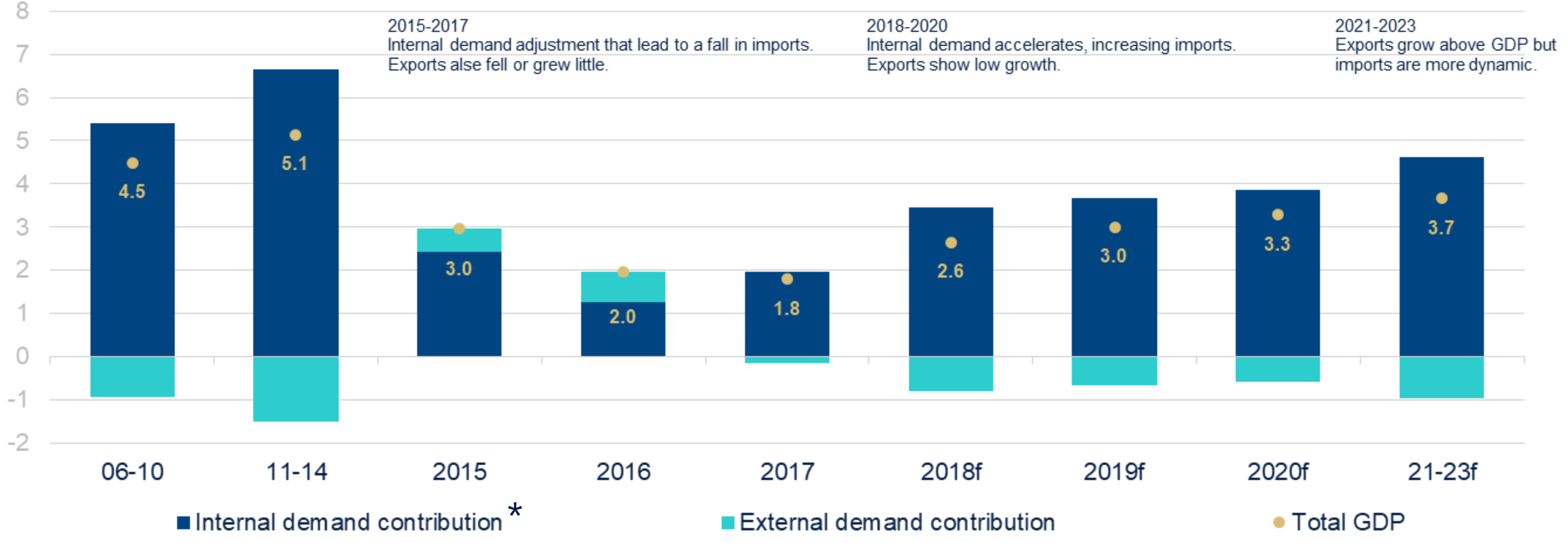
…public consumption will decelerate while investment other than construction should stabilize at a similar rate as in 2018

- Durable goods and expenditure in services will lead the acceleration in private consumption
- There is not much space for public consumption to repeat its high growth rates of 2017 and 2018 given the fiscal austerity needed and its impact on the public wage mass
- Mining and exporting sectors, driven by external conditions, could limit their investment in 2019 and 2020

GDP will gradually accelerate, on the back of private consumption and investment, with a low contribution from the external and public sectors

Total GDP and demand contribution

(annual variation, %)

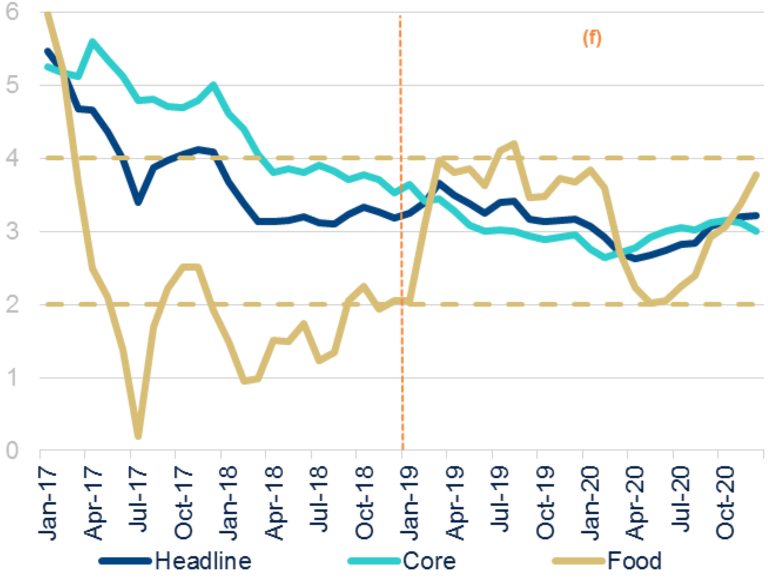


Source: BBVA Research forecast and observed DANE data. *Includes statistical discrepancy

Core inflation should continue descending in 2019. Headline inflation could have a short run hike by foodstuffs and fx pass-through

Headline, food and core inflation

(Annual variation, %)

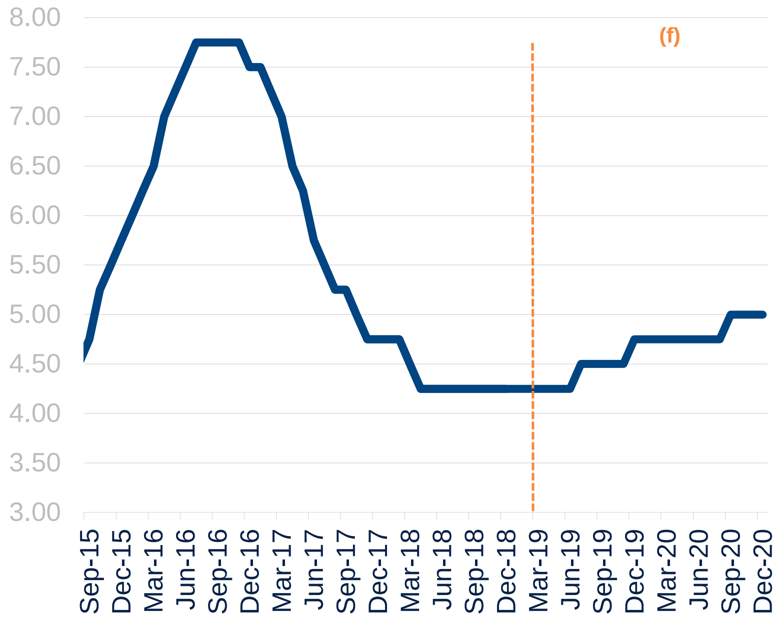


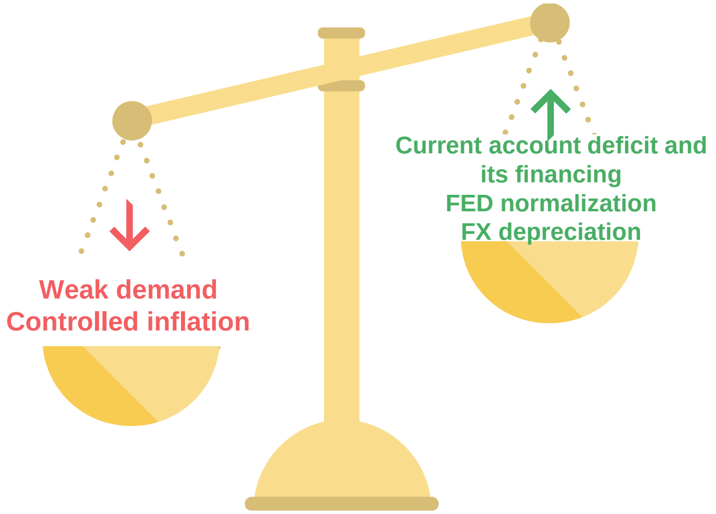
Source: BBVA Research and DANE data

- Nonetheless, there might be some downward bias in the first months of 2019: The “El Niño” phenomenon seems to be shorter and weaker with less impact on crops, at the same time, the new CPI basket will have foodstuffs weighs reduced; additionally the fx pass-through could be smaller than estimated
- Headline inflation could reach a peak of 3,7% in march, but would decelerate towards a 3,2% for the year end

BanRep will gradually raise its policy rate in 2019 in 50 basic points (bp) (25bp in July and 25bp in December)

Policy rate
(%)





The gradual recovery of the economy in a context of controlled inflation allows the Central Bank to hike rates gradually towards its natural rate

Source: BBVA Research and Banco de la República data

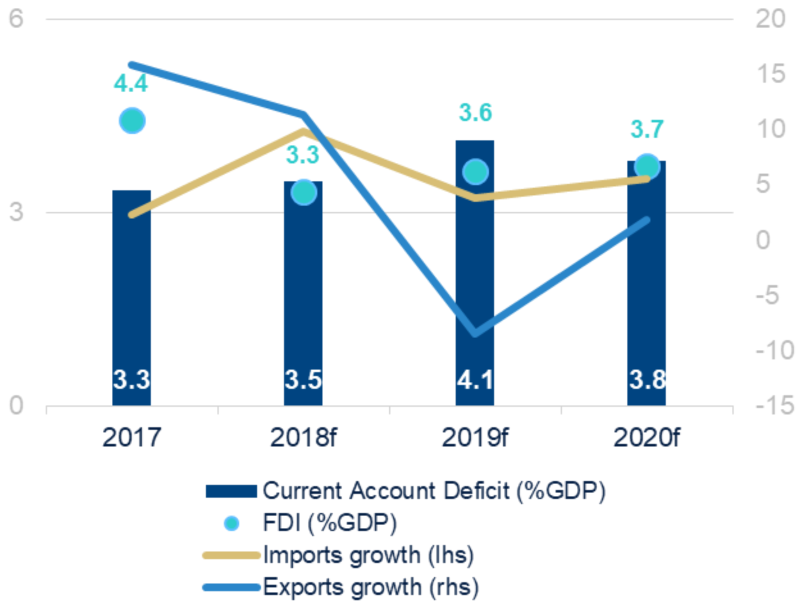
03

External investment will be selective in a more uncertain global context

For 2019 and 2020 the external deficit should stand around 4,0% explained by low exporting activity and growth in imports

Current account deficit and its financing

(% of GDP and annual variation ,%)



Imports will continue to be boosted by internal demand, particularly investment

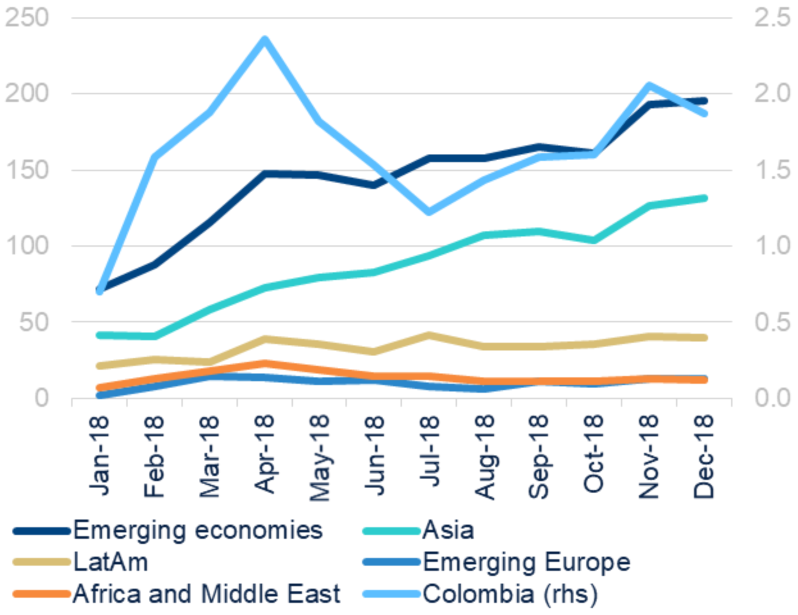
- The good behavior in labor markets for developed economies and Chile will help remittances to remain at a good level
- Dividend payments abroad will reduce their pressure on the current account deficit
- In 2019, FDI will not be enough to finance, by itself, the current account deficit and there will be need of other sources of financing such as debt or portfolio investments

Source: BBVA Research forecast and observed Banco de la República data

The absence of electoral uncertainty and the tax measures should favor capital flows to Colombia this year

Portfolio capital flows

(Annual accumulated, thousand million dollars)



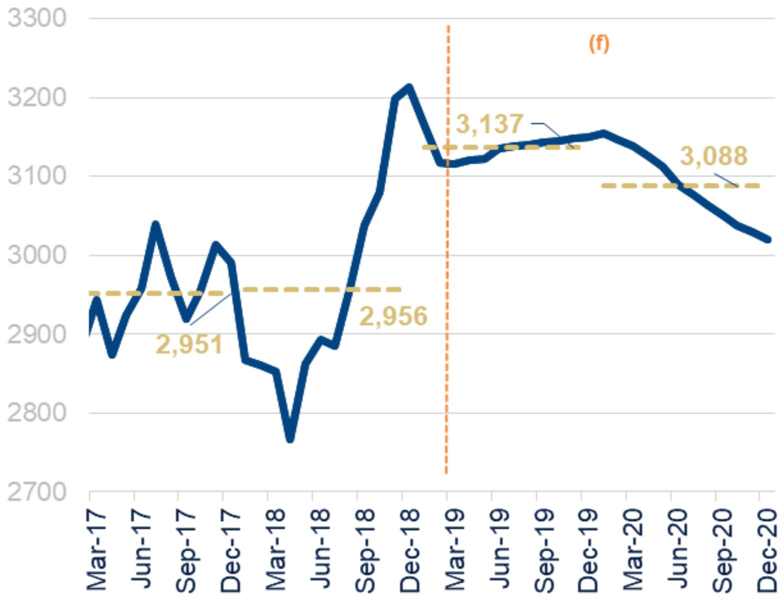
Sorce: BBVA Research with IIF data and Exchange balance of Banco de la República

- Global context in 2019, characterized by an elevated volatility, could restrain capital flows towards risky assets. Nonetheless, we believe capital inflows to Colombia for this year should be similar to those of 2018
- Fiscal conditions and the rating of our sovereign debt could generate some volatility during the year in capital inflows

In turn, we expect the exchange rate to remained stressed in levels above 3100 pesos…

Exchange rate

(Pesos per dollar, annual average in dotted line)

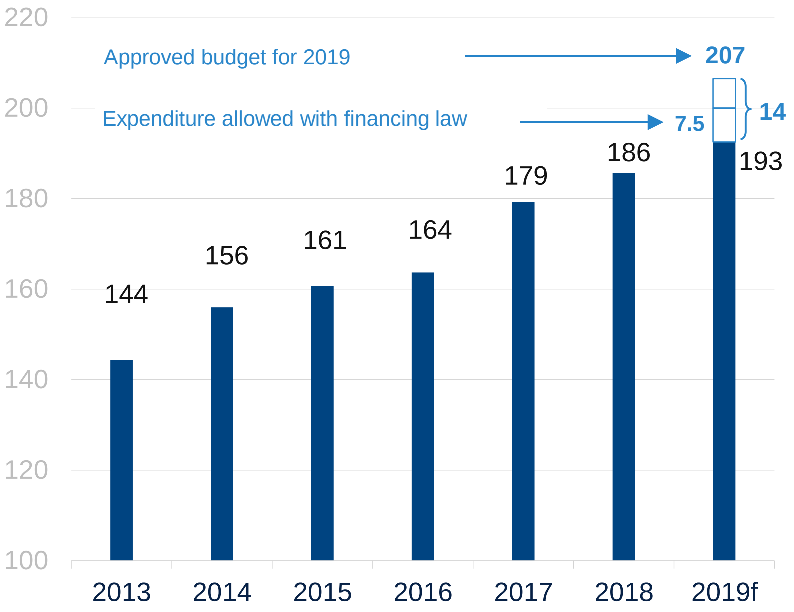


Source: BBVA Research with Banco de la República data

- …given that we expect oil prices to maintain low for the next years and global context should continue with a high volatility
- The steep fall of oil prices in the fourth quarter of 2018 and the hike in global risk aversion accounted for a significant depreciation in the exchange rate
- In the long run, we expect a moderation in the exchange rate thanks to a gradual recovery in oil prices and the end of the monetary policy normalization cycle in the FED

In the fiscal front, the financing law (tax reform) did not contribute with a structural hike in revenue in the mid term

Central Government Budget*
(Billon of pesos)



- The fiscal rule in 2020 is more demanding. Additional resources or an adjustment in expenditure are necessary to continue complying with the fiscal rule

Source: BBVA Research and Ministerio de Hacienda data. *Does not include debt service.

04

Some structural reforms that Colombia needs

There is also need to advance in some important structural reforms

01

Reform the tax code to incentivize productivity and formalization

02

Agricultural reform to incentivize a productive use of the land and define appropriate property rights

03

Empower the judicial system to make it more agile and credible

04

Improve the social security system financing and coverage

05

Promote regulation that promotes the strengthening in the financial system

06

Promote digital transformation with an improvement of the low and high value payment systems

Key messages

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Colombia Outlook

1Q19 (Annex)

January 2019

Creating Opportunities

Main macroeconomic variables

Table A1. Macroeconomic forecast

	2015	2016	2017	2018	2019	2020
GDP (% y/y)	3.0	2.0	1.8	2.6	3.0	3.3
Private consumption(% y/y)	3.1	1.4	1.8	3.0	3.3	3.5
Public consumption (% y/y)	4.9	1.8	4.0	5.0	3.4	2.2
Fixed investment (% y/y)	2.8	-2.7	3.3	1.8	3.9	4.8
Inflation (% y/y, eoy)	6.8	5.7	4.1	3.2	3.2	3.2
Inflation (% y/y, average)	5.0	7.5	4.3	3.3	3.3	2.9
Exchange rate (eoy)	3,149	3,001	2,984	3,212	3,150	3,020
Devaluation (%, eoy)	31.6	-4.7	-0.3	7.3	-1.9	-4.1
Exchange rate (average)	2,742	3,055	2,951	2,956	3,137	3,088
Devaluation (%, eoy)	37.0	11.4	-3.4	0.2	6.1	-1.6
Policy Rate (%, eoy)	5.75	7.50	4.75	4.25	4.75	5.00
DTF rate (%, eoy)	5.2	6.9	5.3	4.5	4.7	5.2
Fiscal Balance (% GDP)	-3.0	-4.0	-3.6	-3.1	-2.4	-2.2
Current Account (% GDP)	-6.5	-4.4	-3.3	-3.5	-4.1	-3.8
Urban Unemployment Rate (%, eoy)	9,8	9.8	9.8	9.9	9.7	9.5

Main macroeconomic variables

Table A2. Quarterly macroeconomic forecast

	GDP (% y/y)	Inflation (% y/y, eoy)	Exchange rate (vs. USD, eoy)	Policy Rate (%, eoy)
Q1 16	2.9	8.0	3,022	6.50
Q2 16	2.6	8.6	2,916	7.50
Q3 16	1.0	7.3	2,880	7.75
Q4 16	1.5	5.7	3,001	7.50
Q1 17	1.9	4.7	2,880	7.00
Q2 17	1.7	4.0	3,038	6.25
Q3 17	1.7	4.0	2,937	5.25
Q4 17	1.8	4.1	2,984	4.75
Q1 18	2.2	3.1	2,780	4.50
Q2 18	2.8	3.2	2,931	4.25
Q3 18	2.7	3.2	2,972	4.25
Q4 18	2.9	3.2	3,250	4.25
Q1 19	2.7	3.7	3,115	4.25
Q2 19	2.7	3.3	3,135	4.25
Q3 19	2.6	3.2	3,143	4.50
Q4 19	3.9	3.2	3,150	4.75
Q1 20	4.0	2.7	3,139	4.75
Q2 20	3.2	2.7	3,090	4.75
Q3 20	3.1	3.1	3,051	5.00
Q4 20	3.0	3.2	3,020	5.00

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