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Colombia Economic Outlook

Investment will be key in consolidating the recovery process and dealing with local and external challenges

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The recovery of the Colombian economy and the behavior of capital markets will face the headwinds of global volatility

Throughout 2018, the performance of the global economy was challenging for emerging-market countries. Initially, when the markets priced into their assessments the likelihood of faster interest rate hikes by the Fed, which had already been forecast by analysts, emerging-market assets depreciated, and the resilience of their economies was put to the test. Capital flows slowed and only some countries, among them Colombia, continued to receive capital, or at least did not suffer significant capital outflows. These countries were able to differentiate themselves positively because they had one or several of the following strengths: a low deficit that was under control, a low or diminishing external deficit, and an increase in their raw material exports, prices of which had been moving upwards until the outset of the fourth quarter of 2018. These positive characteristics, shared by Colombia, together with an end to electoral uncertainty halfway through the year, meant that the effects were not so sharply felt as in other countries, with the risk premium and the yield on treasury debt remaining relatively unscathed, with the impact being felt mainly on the exchange rate.

More recently, however, global volatility has increased again, no longer at the mercy of the position taken by the Fed, but because of uncertainty about global growth capacity and in particular about whether high rates of growth in the United States will continue through 2019 and 2020 (Figure 1). At the same time, raw material prices have weakened, particularly the oil price, and lower average prices for this fuel are forecast for the next few years. This is no minor matter. While the United States is Colombia's biggest trading partner, and its slowdown will delay the recovery of the Latin country's external trade, oil continues to be Colombia's main export product. What is more, oil is a source of economic expansion that goes beyond its production: the investments linked to its exploration, which were starting to pick up in 2018, the demand it creates for services from other sectors, and the fact that it has a major indirect impact on national income.

Deceleration of advanced economies and lower crude prices are the key international challenges to be tackled by the Colombian economy

GDP growth in the United States is estimated to drop from 2.9% in 2018 to 2.5% in 2019 and 2.0% in 2020, with regard to its potential growth rate. The price of oil, which stood at USD 72 a barrel on average in 2018, is expected to average at USD 63 in 2019 and fall to USD 56 in 2020. This represents two negative shocks, both with a lasting effect through 2019 and into 2020, shocks which are already limiting Colombia's capacity for growth, mainly through the external trade channel. The escalation in protectionist measures which affected the United States, China and Europe above all, could have negative impacts on global trade and, as such, on Colombia's export capacity, principally because of the generalized reduction in the volume of trade.

Thus, it will continue to be very important for Colombia to make the most of its regional trade with Latin America, which is characterized by having greater aggregate value and for being more industrialized than the trade it does with other developed regions, where its exports of raw materials are more significant. In fact, during 2018, non-fuel exports to Latin America expanded by 6.0%, while to other countries they fell by 0.3%, showing the region's potential for offsetting the deterioration of other external demand fronts.

The economy will have to overcome local factors if it is to consolidate economic recovery

However, it is not only external factors that are setting a greater challenge to the Colombian economy. There are also some local developments that have affected its future growth expectations and the country's capacity to respond to external shocks.

In the first place, the current account deficit increased in 2018 to an estimated 3.5% of GDP, even though the average price of oil over the year was 32% higher than in 2017, when the deficit had been 3.3% of GDP. The deficit will widen even further in 2019 and 2020, to 4.1% and 3.8% of GDP, respectively, as a result of lower oil prices, the dispatch of dividends abroad and the boost on imports provided by expected higher domestic demand. In this latter factor, the recent, and anticipated, momentum in machinery and equipment investment has been decisive. These types of goods had accelerated since 2017 but were consolidated in 2018. As such, the fact that it was investment more than consumption driving the current account deficit, provides something of a nuance to the consequences of the larger external deficit (Figure 2).

Nevertheless, we should bear in mind that it will not be sufficient to finance the external deficit through direct foreign investment, as in 2017 and 2018, which forced the country to obtain additional financing through indebtedness and/or portfolio capital flows, of about USD 1 billion on average every year (as a reference we should bear in mind that portfolio capital flows in 2018 accounted for USD 1.8 billion). The risks associated with this scenario are currently mitigated by a high balance of international reserves (15% del GDP), the country's flexible borrowing facility with the IMF for USD 11 billion, and the central bank of the Republic's current international reserve purchasing program.

In the second place, since September discussions have been taking place in Colombia about a Finance Act (tax reform) which, while not affecting to a large degree Colombian households' capacity to pay, did push confidence down, a sentiment that could last through the first few months of 2019, exacerbated by the negative effect that a high exchange rate tends to have on confidence. But it was not only confidence that was affected by the debate on taxes. Fiscal revenues in the medium term were also impacted, since the Finance Law only guaranteed higher tax revenues for 2019, of around COP 7.5 trillion, about 50% of what the Government estimates that it needs for 2019.

What is more, from 2020 onwards, the central government will have to obtain new revenues and/or make new spending adjustments, even larger than those it had to obtain/make before passing the Finance Act. This is due to the special exemptions created under this law that come into effect in 2019 and that will show up in lower tax takings from 2020 onwards (Figure 2). As a result, the credit ratings agencies will be paying close attention to how the fiscal account performs, to the announcements of public spending adjustments for 2019 and to the financing strategy after 2020. With all this, inward investors may set more demanding conditions. On a positive front, during 2019 more portfolio capital is likely to enter the country, concentrated for the most part in the first semester, because of the reduction in the tax rate (from 14% to 5%) on earnings from this external investment, by virtue of the Finance Act, and also because of the lack of electoral uncertainty this year.

In any case, the government will have to make an effort to stick to its compliance with the fiscal rule if it wants to minimize the effects of its fiscal policy on the country's credit rating and the price of assets. It will also have to communicate very clearly how it will close its 2019 and 2020 fiscal years, giving full explanations of how it has calculated the fiscal rule. In particular it should make clear whether it is thinking about the potential space for maneuver in the fiscal rule for special issues, such as the massive migration from Venezuela.

Thirdly, it has not been easy for President Duque to govern: the majorities in Congress, that were perceived to be sufficient by the political parties supporting his second electoral round, were not consolidated during his government's first legislative semester. Thus, of the two major reforms led by the government, the political reform and the judicial reform, the first was postponed and the second was suspended, together with other projects that were shelved or postponed, such as the Telecommunications law. In future, the government will have to reinforce its majorities so that its proposals end up getting approved and/or so that the structural reforms that the country needs can be carried out.

All in all, the external and domestic panorama is fairly stringent for the Colombian economy and will mean that the recovery of GDP, while steady, will be slow and very gradual, with less support from external trade, from public-sector spending, whose growth will progressively slow, and from the oil price. The main sources of growth for 2019 and 2020 will be domestic. Private-sector consumption will continue to be driven by the purchase of durable goods and, later, by spending on services, and will return to growing slightly above GDP in 2019 and 2020. Households will benefit from controlled inflation within the target range, from continued low interest rates and from the gradual improvement in the labor market.

Investment, based around construction, will be key for the acceleration of growth in 2019

Investment will be the principal reason for the acceleration of GDP. It will go from expanding by an annual 1.8% in 2018 to 3.9% in 2019 and 4.8% in 2020. There are several features underpinning this stronger momentum in investment (Figure 3).

Firstly, the growth rate in construction will no longer hover around zero in 2019, after three years (2016-2018) of low figures. Construction will have a new head of steam in 2019 thanks to stronger performance in the social housing segment. Nevertheless, since it is the low aggregate value housing that will expand most, the growth rate in the building sector overall will be sluggish compared to the high rates of nearly double digits, posted by the sector in the previous expansionary part of the cycle, between 2011 and 2015. This time, it will be the high aggregate value housing and non-residential construction (with prices that are even steeper when the space is used for offices and commercial purposes) that will bring in positive results for the sector from 2020 onwards.

Civil building work in 2019 will also be an important stimulus for GDP. Not so much the major infrastructure works in national programs as the execution of local and regional building projects that tend to be prioritized in the final years of mayors' and governors' terms. Afterwards, in 2020, they will slow again because of the low implementation of commencement by local governments. This is because the investment by value (trillions of pesos) of the fourth-generation infrastructure works will be similar to previous years and low in direct public-sector building work, since the year will be one in which the central government's fiscal situation is tight.

Non-construction investment will behave in a similar fashion in 2019 as it did in 2018, before gradually speeding up in 2020. Its performance in 2019 will be determined by two opposing forces. The first, the reduction in VAT payable on fixed assets, as approved in the 2018 Finance Act, could boost investment decision-making. On the other hand, the lower oil price and the deterioration in external conditions experienced by some of our trading partners will lead companies who would otherwise export, to spend less on investment. In the end, these two forces will be similar, canceling one another out, so investment in machinery & equipment will not accelerate in 2019 over the result in 2018 but will maintain an expansion rate that is higher than GDP growth. Then, in 2020, with better performance from Latin America, a progressive closing of the installed business capacity gap and an even stronger recovery of internal demand, Colombian industry will experience a more robust investment process, independently of whether the oil price falls even lower (Figure 3).

Bearing these considerations in mind, we expect GDP growth for 2019 and 2020 to come in at 3.0% and 3.3%, respectively. It will be slightly higher than the figure for 2018, which we estimate at between 2.6% and 2.7%. In the medium term, the growth rate will continue to accelerate gradually, posting at around 4% by 2023 (Figure 4).

The central bank will gradually increase interest rates in 2019 and 2020 in a framework of controlled inflation and activity in recovery

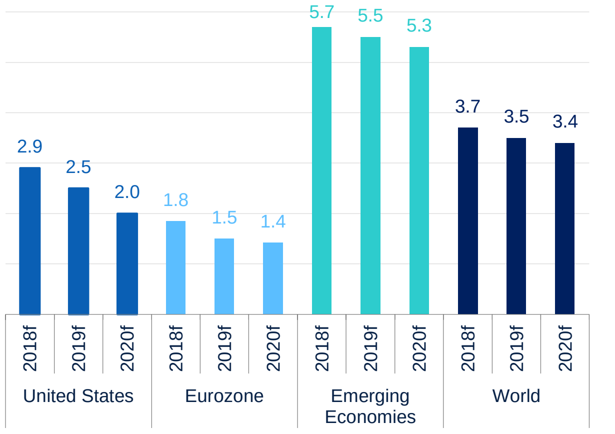
Since the expected rates of growth are not very high, these will not put significant pressure on prices. That is, we expect inflation to stay very close to the bank of the Republic’s central target (3.0%) at the end of 2019 and in 2020, even though in the first semester of 2019 there may be temporary higher rates edging it close to 4%. Between January and June 2019, the presence of the El Niño phenomenon, although moderate, will influence droughts and poorer crop harvests, raising prices and putting pressure on consumer inflation (Figure 5). The lagged effects of the increases in the exchange rate at the end of 2018 could prevent the prices of tradable goods from continuing to correct to the downside and might even imply a small trend to the upside on these prices in the short term.

Nevertheless, this effect will gradually fade as a result of the behavior we anticipate from the exchange rate (Figure 6). Firstly, the average devaluation of the exchange rate over 2019 will be 6.2% compared to 2018. Later, in 2020, it will appreciate by an average of 1.6%. Secondly, compared to the levels at the end of 2018, average exchange rates in 2019 and 2020 will be lower. That is, whereas at the end of 2018 it was USD 1/COP 3,250, the rate will be 3,137 and 3,088, on average, in 2019 and 2020.Thirdly, lower fuel prices will partly offset the pressure coming from the exchange rate, not only from final selling prices (among them, gas), but also because of the reduction in supply costs and, as a result, of the producer price indicator. Therefore, once these transitory shocks have passed, inflation will slowly return to 3.2% by the end of 2019. In 2020, after a first semester characterized by low inflation, under 3%, due to a high statistical base effect, inflation too will end up at 3.2% (Figure 5).

Even though inflation will be under control, and although these inflation shocks will be transitory and economic activity will enjoy a gradual recovery, the central bank’s role will not be an easy one (Figure 5). The fiscal and external deficits, the increase in the external interest rates and the slower portfolio capital flow to emerging-market countries during recent months and expected for 2019 and 2020, are factors that will force the central bank to be cautious. Applying this caution, the bank will raise its interest rate twice in 2019, both times in the second semester and by 25 base points each time. By the end of 2019, the rate will be 4.75%. After this, at the end of 2020, the rate will be 5.0%, which, compared with inflation of 3.2% at the end of that year, will mean a real rate of 1.8%, inside its neutral band (the band that neither restricts nor stimulates economic activity, which we estimate at between 1.5% and 2.0%).

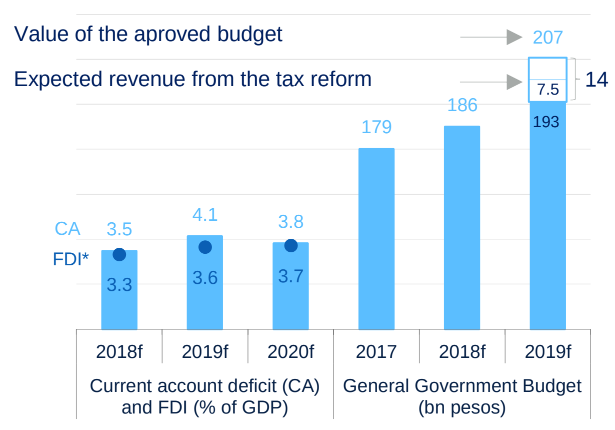
We should bear in mind that only a reduction in the economic deficits, together with more favorable external liquidity conditions than those we expect in our base scenario, would give the central bank enough space to have a stability policy for its interest rates. In other words, expected economic growth, while just reaching its potential in 2020 and as such causing a negative gap in GDP until 2023 at least, is not the only consideration to be taken into account during monetary policy debates. Other factors for discussion are just as important as GDP because they guarantee greater structural stability for the economy, a capacity for growth in the long term and reduce the vulnerabilities to which the economy is currently exposed.

Figure 1 Global growth
(Annual variation, %)



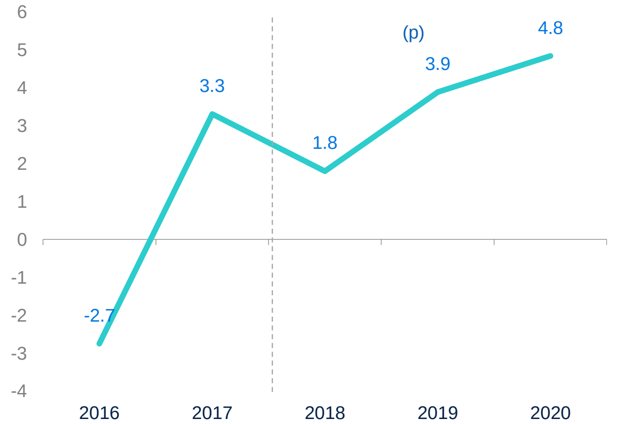
Source: BBVA Research

Figure 2 External balance and Government budget
(% of GDP and billion pesos)



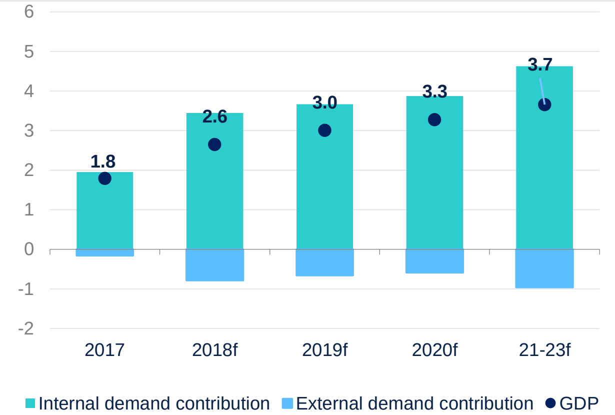
Source: BBVA Research. *Foreign direct investment (% of GDP)

Figure 3 Fixed total Investment
(Annual variation, %)



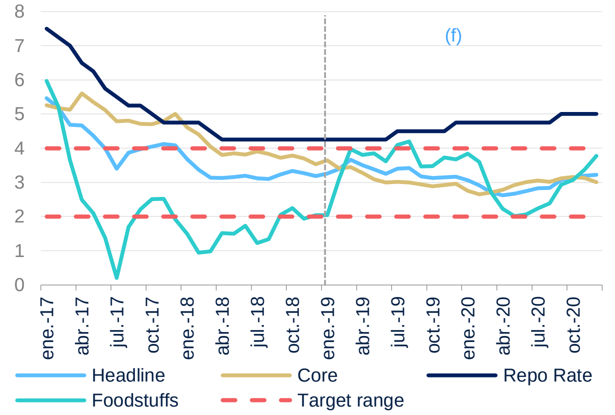
Source: BBVA Research with DANE data

Figure 4 GDP and contribution by demand type
(Annual variation, %)



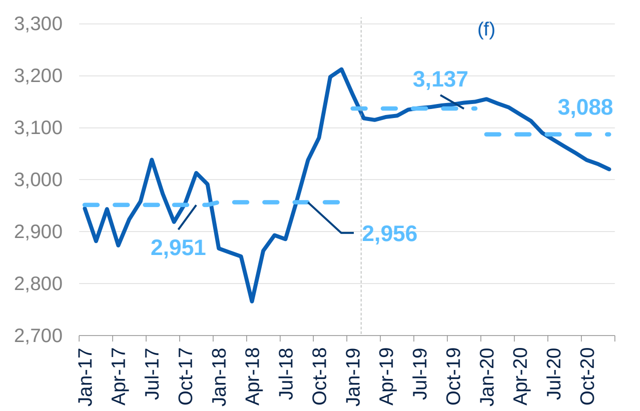
Source: BBVA Research with DANE data, includes statistical discrepancy

Figure 5 Inflation and repo interest rate
(Annual variation, effective annual rate, %)



Source: BBVA Research and DANE and BanRep data

Figure 6 Exchange rate
(Pesos per dollar)



Source: BBVA Research and BanRep data

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Table 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

Source: Banco de la República, DANE and BBVA Research

Table Macroeconomic forecast quarterly

	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

Source: Banco de la República, DANE and BBVA Research

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