Colombia Economic Outlook

Domestic demand will continue to drive growth in an environment of low interest rates

Second quarter 2019

Colombia's economic growth during 2019 and 2020 will once again be driven by domestic demand. Meanwhile, external demand will remain weak, and may even negatively affect growth, as imports will outstrip exports. Exports will be subject to several constraints: low external demand due to the moderation of global activity, weak global exports and oil prices that are set to fall in the coming quarters. World growth has slowed down more than expected over recent months, increasing fears of an abrupt slowdown in economic activity (Chart 1). In this context, the Fed and the ECB have changed tack and announced new monetary stimulus measures. Similarly, China has implemented additional expansionary policies, both of a fiscal and monetary nature. This reaction by the economic authorities in the world's main economies will encourage a more gentle slowdown in world growth. However, an unforeseen reduction in dynamism in the Chinese economy, a new wave of protectionist measures or the disorderly exit of the UK from the European Union, among other risks, could trigger more negative scenarios.

Global economic activity has slowed, with particularly weak performance in exports and the manufacturing sector.

A series of factors has contributed to the moderation of global activity, especially: (i) the structural slowdown of the Chinese economy, now that it has stopped increasing its debt; (ii) trade protectionism; (iii) in Europe, high levels of uncertainty, as well as some specific and probably temporary events, such as the effects of the new European regulations on emissions in the automotive sector; and (iv) cyclical moderation in the US, in a context in which the effects of the fiscal stimulus are losing their impact. The factors underlying this world slowdown have affected economic activity, mainly in terms of exports and manufacturing. This, for now, is being offset by private consumption, which remains relatively robust, supported by the dynamism of labor markets and limited inflation.

The slowdown in growth has led to an unexpected shift in monetary policy in the US and the Eurozone

The more negative tone of the world economy has generated a certain level of concern, as well as an increase in financial volatility. In this context, and given that inflationary pressures are still quite limited, the Fed and the ECB have reacted, making an about-turn in respect of their communications regarding their assessment of the environment and the expected trajectory of their policies. The US monetary authority has significantly adjusted its tone and strategy toward a more accommodative monetary policy. In this sense, in addition to revealing that it will be "patient" when considering additional interest rate hikes, the Fed has announced that the process of reducing its balance sheet will end sooner than expected. Given its cautiousness and low inflationary pressures, rates can be expected to remain stable, or potentially be reduced, if economic data reveal an increasing weakening of the economy. In any case, there would still be scope for a final increase of 25 bps to 2.75% by the end of 2019, if the slowdown in growth turns out to be gentle and limited.

As for the ECB, the change toward a more expansionary policy has translated into a delay in the expected interest rate hikes and the announcement of a new round of liquidity auctions. In respect of the former, the ECB has postponed its forecast rate hikes from summer 2019 to at least the end of the year. China has also reacted to the growing concern regarding the weakening economy. Specifically, local authorities have confirmed a tax cut, focused on VAT, of 2 percentage points of GDP, as well as an increase in the budget deficit from 2.6% of GDP in 2018 to 2.8% of GDP in 2019. Signs of greater quantitative easing are also evident. In this regard, two additional

cuts of 25 bps in the reference interest rates are forecast, as well as two reductions in the bank reserve requirements in the second and third quarters.

Global growth is forecast to sit at 3.4% in both 2019 and 2020.

New economic stimulus packages will rein in the decrease in world growth. Global GDP, which rose by 3.8% in 2018, is expected to grow by 3.4% in 2019 and 3.4% in 2020 (Chart 1). This gentle deceleration in the world economy is conditional on the US and China reaching a trade agreement in the second quarter, which is essential to reduce uncertainty and prevent further deterioration in international trade. In addition, the exit of the United Kingdom from the European Union (Brexit) must not generate major disruptions in the relationship between the two powers. Finally, the probable reduction of the price of oil going forward, due to less robust demand as well as growing supply in the US, will help to keep inflationary pressures under control, and will give central banks room for maneuver to execute their monetary policy (the price of a barrel of Brent is expected to fall from around 65 dollars during the first quarter of the year, to around 62 and 55 dollars at the end of 2019 and 2020, respectively).

In the US, growth will continue to lose momentum gradually, moving toward potential interest rates. In particular, US GDP is estimated to grow by 2.5% in 2019 and by 2.0% in 2020, down from 2.9% in 2018. Although the growth forecasts for the country remain unchanged, we are facing a downward trend and the risk of recession continues to be significant, given the possibility of a greater slowdown in investment, financial vulnerability and the more negative tone in the global environment, among other factors.

In Europe the downturn in activity, mainly in exports and in the industrial sector, has continued longer than expected. In addition, uncertainty remains high about the outcome of Brexit, and with regard to the US threat to increase tariffs on vehicles produced in the region. **In this context, growth forecasts for the Eurozone have been revised downward, from 1.4% to 1.0% in 2019, and from 1.4% to 1.3% in 2020.** These forecasts are bearish.

With respect to China, it is expected that the trade agreement with the US will materialize and that recent stimulus measures will shore up domestic demand, which would allow GDP to grow by 6.0% in 2019 and 5.8% in 2020, in line with previous forecasts. These more expansionary policies reduce the risk of a sharper drop in growth, but at the cost of hindering the reduction of the country’s structural problems, such as its high leverage levels.

The greater slowdown in world growth will bring about additional difficulties for the economies of emerging countries. The more accommodating policies of the main economies could also reduce the pressures on the emerging currency and money markets. In a nutshell, both in the main developed and emerging economies, the slowdown in growth will tend to reduce the pressures on inflation even more. This will be further helped by the expected drop in oil prices.

Interest rates throughout the world will rise more slowly, but capital flows to emerging countries will still be limited and heterogeneous.

This environment of lower interest rates (Chart 2) will not necessarily lead to higher capital flows to emerging economies. Investors will be more selective as to the levels of risk they want to assume in the emerging world, and the fiscal and external performance of countries will be a very important factor in their decisions. For this year, we estimate that there will be net inflows of portfolio capital to Colombia, but they could be slightly below the level reported in 2018. For this reason, the exchange rate is likely to remain between 3130 and 3170 this year, ending the year at 3150 — close to the lows of the previous range in the middle of the year. During 2020, the exchange rate will remain above 3100 throughout the first half of the year, before slowing to 3020 at the end of the year (Chart 3).

There are two opposing forces that will determine the relative stability of the exchange rate. On the one hand, the low interest rates in the developed world will support currency appreciation, not only because of their direct effect, but also because of the reduction in long-term bond yields in developed countries (Chart 2). On the other hand, the more demanding capital flows toward emerging countries and a level of global volatility that is set to remain close to current levels, increasing at the end of the year due to the materialization of lower global growth, will prevent such an appreciation.

In addition, there is a factor unique to Colombia that will also push up the exchange rate and partially offset the effect of lower global interest rates. This factor is the high current account deficit, which could stand at 4.3% of GDP in 2019 and is likely to fall to 4.0% of GDP in 2020 (Chart 4). The upward pressure on the exchange rate through this channel will be kept in check by the capacity of the Colombian economy to finance the external deficit — 88% through foreign direct investment and the remaining 12% through public and private debt, and portfolio inflows.

The current account deficit will increase during 2019 and 2020 from the 3.8% of GDP recorded in 2018, mainly due to the fall in exports. External shipments will be reduced due to lower oil prices and the inability of non-traditional shipments to make up the difference. Imports will also remain strong as the Colombian economy will base its growth on domestic demand, with a significant imported component in terms of investment, consumption and raw materials from industrial sectors. The external deficit will be 4.3% of GDP in 2019 and 4.0% of GDP in 2020. In real terms, these percentages will translate to financing needs equivalent to 14 billion dollars in each of the two years, up from the 12.7 billion of financing required in 2018 (Chart 4).

Although domestic demand will drive Colombia's growth, there will be huge disparities between its segments.

Domestic demand will grow above GDP during 2019 and 2020. Public consumption, and investment in machinery and equipment and civil works will be the main drivers of domestic demand. Public consumption will continue to be driven by the increase in employment (and the total wage bill) in regional and decentralized entities and by the maintenance of central government spending thanks to the relaxation of the fiscal rule approved in March. However, public spending will enter a slow deceleration process that will cause its growth to fall below the GDP rate from the end of 2019. In other words, the surge in public spending will be concentrated in the first half of 2019, but the increase will be sufficient to ensure that its growth exceeds GDP for the whole of 2019, despite the slowdown at the end.

Investment other than property will also grow above GDP, not only in 2019, but also in 2020, when investment in property will also help strengthen investment. Several signs point to this good performance. Firstly, the manufacturing industry is showing signs of a gradual recovery that has been accompanied by increased use of installed capacity, to the extent that new investments may be necessary to respond to increases in demand. Secondly, imports of capital goods continue to grow at double-digit rates, although they benefited from a one-off boost at the end of 2018, when aircraft were imported from the European Union. Thirdly, investments are expected from the oil sector, given that the current and expected price of crude oil is generating profits, and investments are needed to maintain similar oil production in the coming years. Finally, civil works will increase during this year thanks to the completion of regional and local governments, which is usually associated with increased spending, primarily on infrastructure.

Investment in property (other than social housing) will begin in 2020 because, given the low number of works in progress in 2019, there will be less space for the completion of the works. In fact, the number of works in progress fell 15% in 2018, from 30 million square meters under construction in December 2017 to 25 million in December 2018. In addition, the number of construction permits registered at the beginning of the year do not indicate any change in the amount of new medium-value and high-value housing or non-residential buildings being built. Later, the gradual reduction in building stock, which will be exhausted between 2021 and 2022, will require the initiation of

new projects from 2020 to be completed in 2021-22. Therefore, in 2020, the building sector is likely to bounce back and make a significant contribution to GDP.

On the other hand, private consumption should remain very close to its figures of 2018 and does not seem to have the capacity for additional acceleration, as there are certain advance data that do not show any signs of increase in household spending capacity. Among these data, the most relevant variable of all is employment. Job creation has fallen significantly in recent months, while the unemployment rate has risen as it outstripped by the increase in labor supply. Also relevant is the continuing negative household confidence figures and the reduction in the rate of satisfaction with household finances (to very close to zero), a variable that has recently been closely related to household spending decisions. Finally, during this year, the figures for the consumption of durable goods (including cars) may be a little more modest, and may even register a year-on-year fall at the end of the year.

In summary, we are keeping our GDP growth forecast for Colombia at 3.0% in 2019 and 3.3% in 2020. Compared to our previous forecast, this estimate contains a reduction in expected investment in construction that is offset by a little more slack in fiscal spending. The growth trajectory of private consumption, investment other than construction and external demand remains quite similar to what was estimated three months ago (Chart 5).

The monetary policy stance in Colombia will also be more cautious.

There are several points to analyze in terms of monetary policy, in terms of its role in defining interest rate decisions. The first is inflation, which is behaving well and stands at around 3.0%, which is the main target rate set by the Banco de la República. In addition, the expectations for the end of the year are also built around this target, because, among other things, it is expected that exchange rate volatility will remain within a narrow range, which will keep the tradable goods prices and their decreasing inflation under control throughout the year. In addition, with the devaluation seen at the end of 2018 and the beginning of 2019 and its lack of impact on prices, it is evident that the impact of exchange rates on prices seems to have reduced in the country. Similarly, the increase in the minimum wage, which exceeded the expected inflation for this year, did not have a noticeable impact on the behavior of core inflation, since wage pressures did not seem to translate into higher producer sales prices. In part, this almost imperceptible impact of wages on prices can be explained by the increase in the unemployment rate, which likely reduced recruitment bottlenecks for employers.

To compensate for the downward pressure of inflation, food costs will accelerate price variation, due to the low statistical base for 2018, when prices were in very low, and the difficulty in repeating this behavior during this year. In addition, during the first quarter there was a slight reduction in rain in Colombia, which, together with the announcements of the return of El Niño (which has already ended and was neither as long nor as intense as expected) and the sowing restriction that this implied owing to the fear that seeds would be destroyed, will cause a reduction in the coming harvests. Finally, we still have to wait to see if the indigenous strike in the southwest of the country had any impact on prices. As of March, no effect had been observed.

In summary, core inflation will decrease throughout the year, while food inflation will increase, leaving total inflation very stable at around 3.0%. In 2020, inflation will remain at 3%, or close to that level, until August, when it will increase slightly to 3.2%. It will end 2020 at this level, due to the impact of food inflation which, after falling until the middle of the year, will accelerate again. Core inflation, on the other hand, will remain below 3% from May 2019 to May 2020, after which it will gradually return to a rate of 3%.

The Central Bank's second point of analysis is growth, which, as we saw above, will continue to accelerate very gradually, more due to investment than consumption. This GDP composition reduces the inflationary pressures involved in accelerating domestic demand. Nevertheless, the Bank will analyze the performance of public consumption and the balance sheet, since the recent decisions of the fiscal rule, the announcement of high levels of privatization in 2019 (not just in 2020 as we had forecast) and the greater payment of profits from Ecopetrol to

the government due to the extraordinary increase in the distributed percentage, made public spending more flexible and will cause it to slow down less quickly, as we mentioned before.

The fiscal deficit allowed by the fiscal rule is now 2.7% of GDP for 2019 (previously 2.4%) and 2.3% of GDP for 2020 (previously 2.2%). With this larger deficit, the government intends to cover the basic expenses of Venezuelan immigrants, without having to reduce current public spending aimed at ensuring the normal functioning of the social security and education services in particular. Despite this larger deficit, the decreasing pace of public debt will continue. However, from 2020 onwards, the reduction required in the deficit and the fall in tax revenue, due to the corporation tax breaks approved in the Financing Law of 2018, will necessitate additional measures to obtain new income.

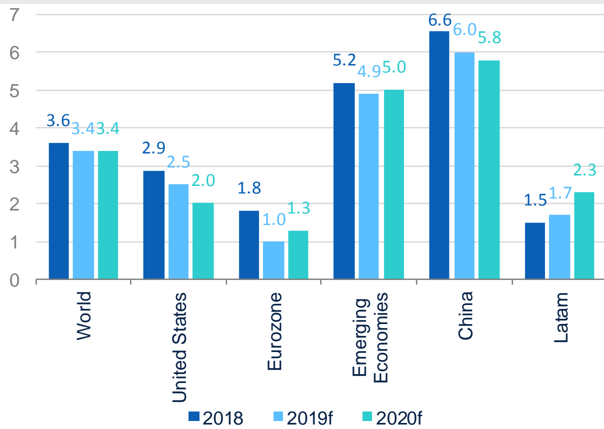
These new sources of income are likely to come from surpluses from the privatization of public assets and withdrawals from some public funds, because the government has said it will not introduce new tax reforms in its four-year term, although it is clear that asset sales would finance current expenditure. We believe that the solution to the fiscal shortfalls from 2020 onwards should be more structural in nature. Confidence in the prudent management of public finances requires a structural strategy, which should be presented in the medium-term fiscal framework by June 15.

The third topic of analysis is the external context. In this respect, world interest rates will be more relaxed, although capital flows may remain demanding in respect of emerging countries. Colombia requires these flows to finance its current account deficit. This deficit reduces (increases) the pressure on monetary policy as long as it is driven more (less) by investment and less (more) by consumption.

Thus, the stage seems to be set for the Central Bank to maintain its interest rate, without increases, for longer. The next upward movement is not likely to occur before the fourth quarter of 2019. And it is likely to be 25 basis points, ending the year at 4.50%. In addition, the long-term interest rate is now closer to 4.75%, not 5% as we estimated before, thanks to the lower upward pressure exerted by the lower long-term rates in developed countries. The Central Bank will only increase the rate by another 25 basis points in the first quarter of 2020 to reach the long-term rate of 4.75% (Chart 6).

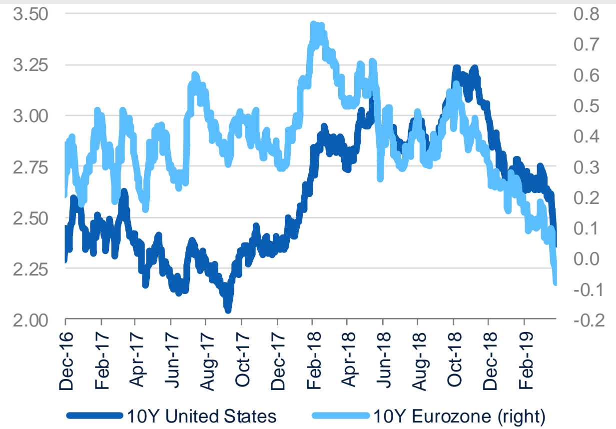
In conclusion, the growth of the Colombian economy will accelerate gradually, led by investment other than property in 2019 and also by the latter from 2020 onwards, in an environment of controlled inflation rates and greater flexibility in the monetary policy to postpone its increases and to slightly reduce its long-term rate. The most important challenges will be the reduction of public accounts from 2020 and the reduction closure of the current account deficit to make it more sustainable and affordable. In addition, the external environment will be challenging.

Chart 1 Global growth
(Annual change, %)



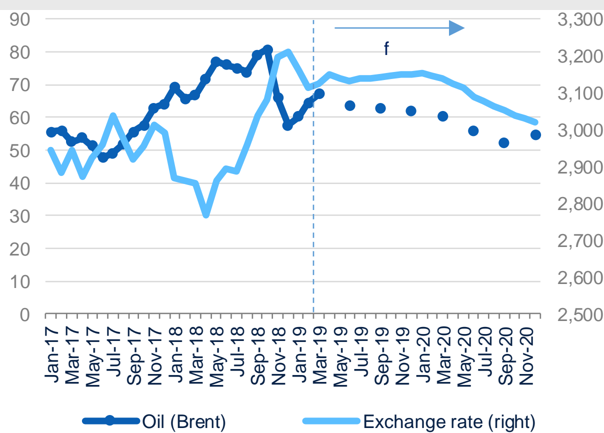
Source: BBVA Research

Chart 2 Long-term interest rate in developed countries
(%)



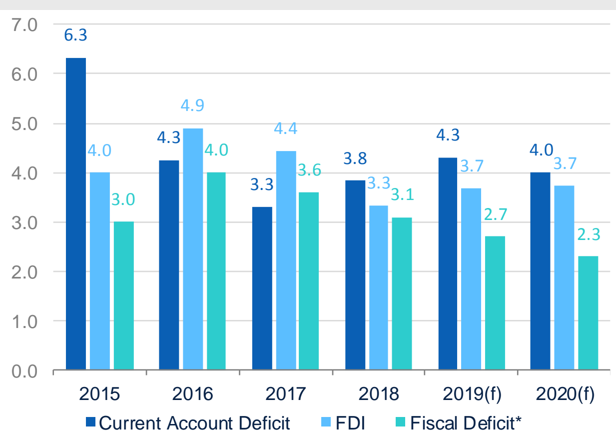
Source: BBVA Research based on Bloomberg data

Chart 3 Exchange rate and oil price
(Pesos per dollar and dollars per barrel of Brent)



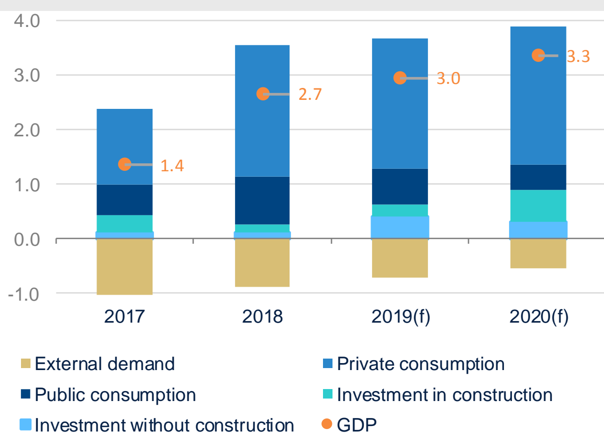
Source: BBVA Research based on data from Banco de la República and the Ministry of Finance *Central National Government

Chart 4 Fiscal and external deficit and Foreign Direct Inv.
(Annual change and contribution to annual change, %)



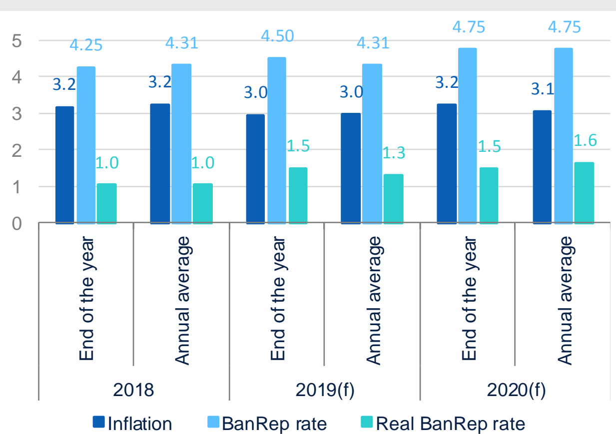
Source: BBVA Research based on DANE data. *Includes statistical discrepancy

Chart 5 Change in GDP and contribution by segment
(Annual change and contribution to annual change, %)



Source: BBVA Research and DANE actual data

Chart 6 Inflation and the monetary policy rate
(Annual change and E.A., %)



Source: BBVA Research and actual data from the Banco de la República

Table 1 Macroeconomic Forecasts

	2015	2016	2017	2018	2019	2020
GDP (% YoY)	3.0	2.1	1.4	2.7	3.0	3.3
Private consumption (% YoY)	3.1	1.6	2.1	3.5	3.4	3.6
Public consumption (% YoY)	4.9	1.8	3.8	5.9	4.1	2.9
Investment (% YoY)	2.8	-2.9	1.9	1.1	2.9	4.0
Inflation (YoY %, eop)	6.8	5.7	4.1	3.2	3.0	3.2
Inflation (% YoY, average)	5.0	7.5	4.3	3.2	3.0	3.1
Exchange rate (eop)	3,149	3,001	2,984	3,250	3,150	3,020
Devaluation (%, eop)	31.6	-4.7	-0.3	7.3	-1.9	-4.1
Exchange rate (average)	2,742	3,055	2,951	2,956	3,141	3,088
Devaluation (%, eop)	37.0	11.4	-3.4	0.2	6.1	-1.6
BanRep Rate (%, eop)	5.75	7.50	4.75	4.25	4.50	4.75
DTF rate (%, eop)	5.2	6.9	5.3	4.5	4.7	5.0
CNG Fiscal Balance (% GDP)	-3.0	-4.0	-3.6	-3.1	-2.7	-2.3
Current account (% GDP)	-6.5	-4.4	-3.3	-3.8	-4.3	-4.0
Urban unemployment rate (%, eop)	9.8	9.8	9.8	10.7	10.6	10.5

Source: Banco de la República, DANE and BBVA Research

Table 2 Quarterly macroeconomic forecasts

	GDP (% YoY)	Inflation (YoY %, eop)	Exchange rate (vs. USD, eop)	BanRep Rate (%, eop)
Q1 16	2.4	8.0	3,022	6.50
Q2 16	2.0	8.6	2,916	7.50
Q3 16	1.8	7.3	2,880	7.75
Q4 16	2.2	5.7	3,001	7.50
Q1 17	1.2	4.7	2,880	7.00
Q2 17	1.4	4.0	3,038	5.75
Q3 17	1.6	4.0	2,937	5.25
Q4 17	1.3	4.1	2,984	4.75
Q1 18	2.1	3.1	2,780	4.50
Q2 18	2.9	3.2	2,931	4.25
Q3 18	2.7	3.2	2,972	4.25
Q4 18	2.8	3.2	3,250	4.25
Q1 19	3.0	3.2	3,175	4.25
Q2 19	2.7	2.8	3,130	4.25
Q3 19	2.9	2.9	3,143	4.25
Q4 19	3.1	3.0	3,150	4.50
Q1 20	3.2	3.0	3,139	4.75
Q2 20	3.2	3.0	3,090	4.75
Q3 20	3.4	3.1	3,051	4.75
Q4 20	3.6	3.2	3,020	4.75

Source: Banco de la República, DANE and BBVA Research

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