BBVA Research

Colombia Outlook

2Q19

April 2019

Creando Oportunidades

Key Messages

- Global activity has continued moderating, with a particularly weak performance in exports and industrial sectors. A series of factors have contributed to activity weakening, especially:
  i) structural deceleration of the Chinese economy; ii) protectionism; iii) Uncertainty in Europe related to *brexit* and the automotive sector; and iv) the cyclical moderation in the US economy. We expect global growth in 2019 and 2020 of 3.4%. Central Banks will be more cautious in their hiking cycles in this new scenario and will help to reduce global volatility.

- Internal demand, though leading growth in Colombia, will continue showing significant differences within its components. Investment will accelerate thanks to machinery and equipment. Building construction will be limited in 2019, but will accelerate in 2020. Civil Works will be very dynamic in 2019, but not as much in 2020 due to the political cycle of regional governments. On the other hand, private consumption will grow in 2019 and 2020 at similar rates as observed in 2018, given that a weak consumer confidence and the deterioration of the labor market reduce the capacity of consumption acceleration. Finally, public expenditure will progressively decelerate.

- Inflation will remain close to 3,0% in 2019 and 2020. With activity recovering slowly, controlled inflation will allow the Central Bank to delay its interest rate hiking cycle further down in 2019, and achieve its neutral level of 4,75% in early 2020. However, *Banco de la Republica* will remain vigilant of the reasons behind the deterioration of the current account deficit this year, explained more by investment than consumption, and the mid term structural fiscal adjustment needed.

Content

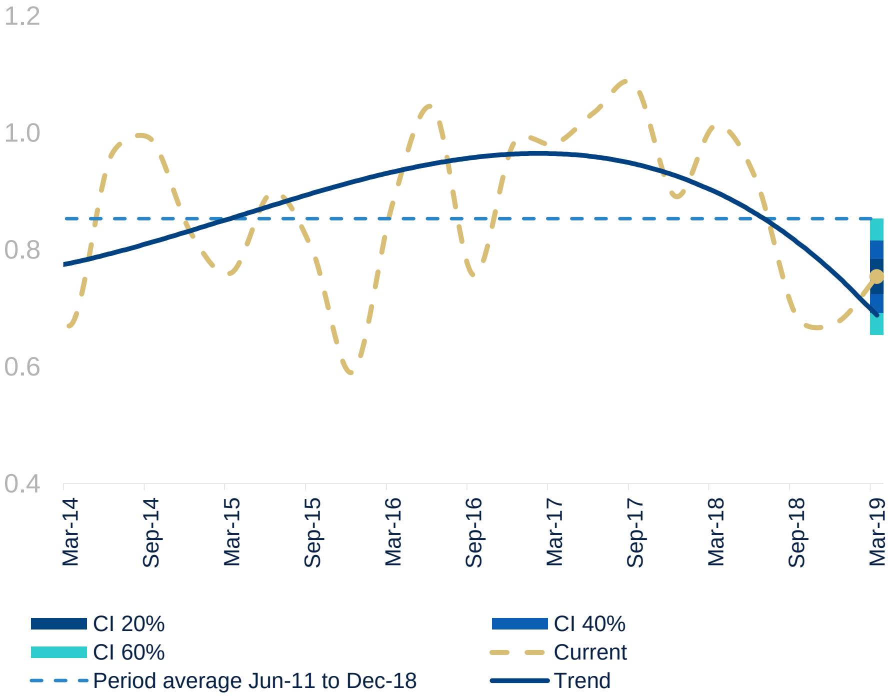
01

Global growth remains weak and monetary policy will be cautious

Global GDP has moderated more than expected

World GDP growth

(Forecasts based on BBVA-GAIN % QoQ)

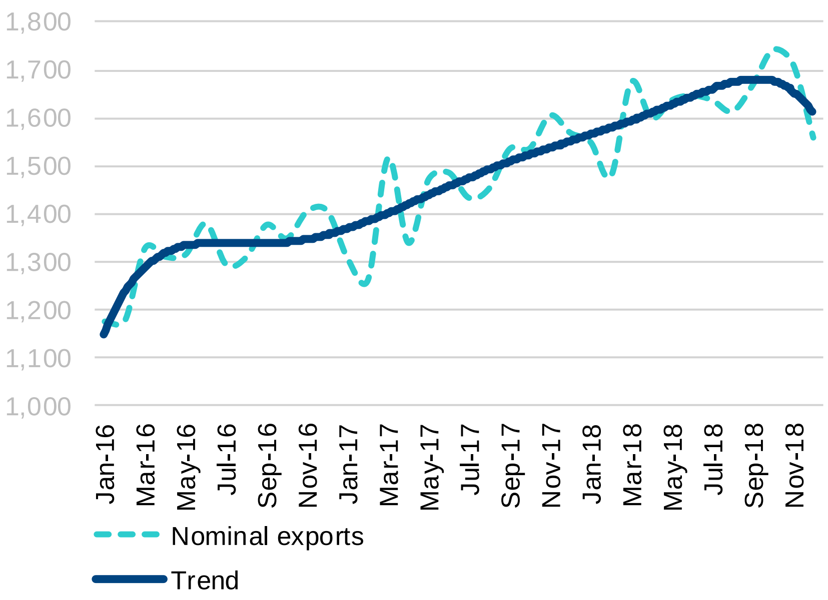


Source: BBVA Research

- Global growth has slowed due to China's structural moderation, high uncertainty in Europe, trade protectionism and the cyclical slowdown in the US
- A slight improvement is possible in the short, but activity will remain less dynamic than in previous years

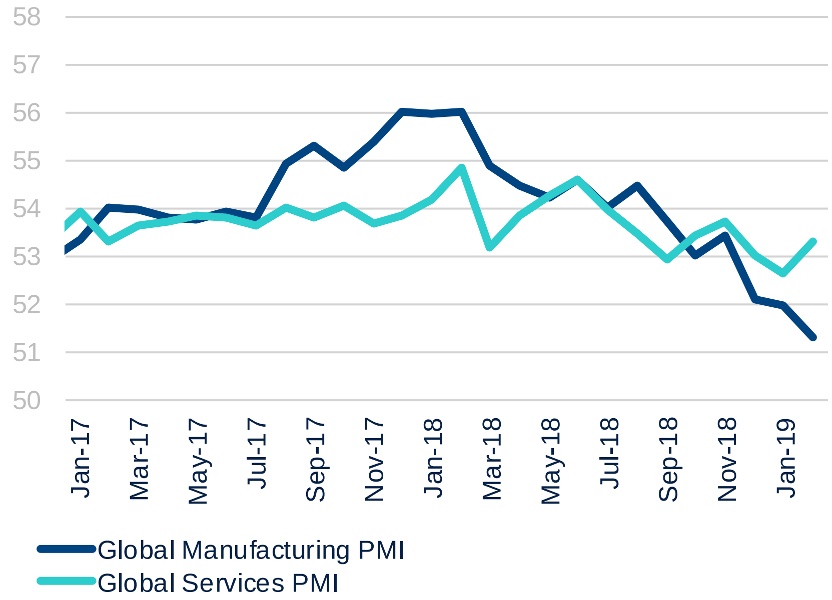
Weak exports and investment, but private consumption remains relatively robust

World Exports
(Thousands of dollars)



Source: BBVA Research based on IMF data

PMIs
(Level)



Source: BBVA Research based on IHS Markit data

Protectionism: US-China trade agreement delayed, as the EU begins to gain prominence as focus of tensions

U.S.

Negotiations are still ongoing; the most likely is an agreement in 2Q19

U.S. threatens to increase tariffs on EU vehicles

China

EU toughens stance on China, seen as "economic competitor" and "systemic rival"

European Union

Growth moderation has caused a shift in monetary policy in the US and the Eurozone, and new stimuli in China

Fed

- **Long pause in the rate hike,** but there could be a hike by the end of the year
- **The normalization (reduction) of the balance sheet will end earlier than expected** (September 2019)

BCE

- **Postponement of monetary normalization**
- **Lower interest rates** for longer and additional liquidity

China

- **Additional monetary stimulus:** RRR and lending rate reductions in 2019
- **Increase in public deficit,** to 2.8% of GDP in 2019
- **Tax cuts** (2% of GDP)

Latam and other emerging countries

- There is room for a **more dovish monetary policy**

Action by central banks and an absence of "accidents" would enable global growth to soft-land

More signs of global slowdown

New stimulus policies

Assumption on the evolution of the global outlook: no "accidents"

01
Protectionism
An US-China trade agreement is still likely, despite the delay

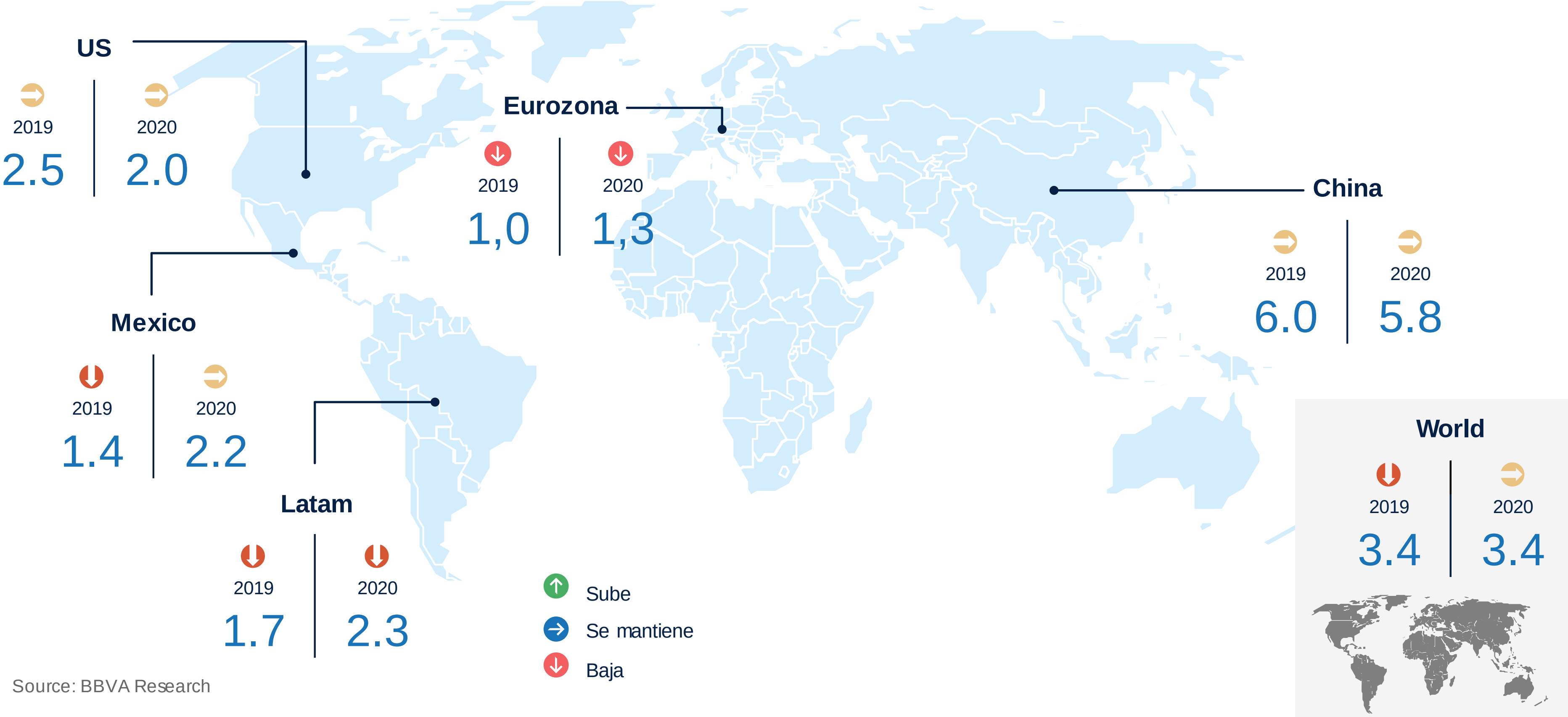
02
***Brexit*:**
Greater uncertainty, for a longer time

03
Financial markets:
volatility constrained by central banks' measures

04
Oil:
Price moderation following the recent upturn

Global growth soft-lands

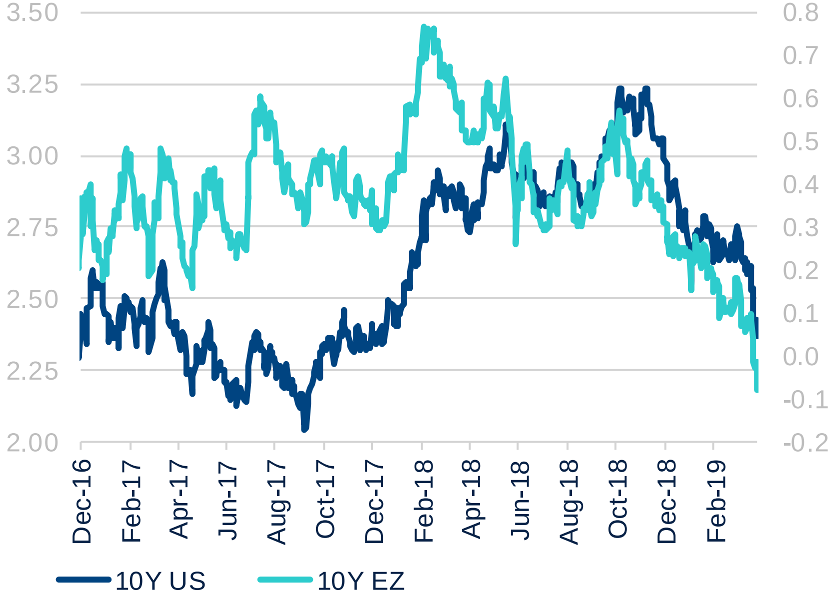
Without "accidents", global growth will decelerate gradually



Source: BBVA Research

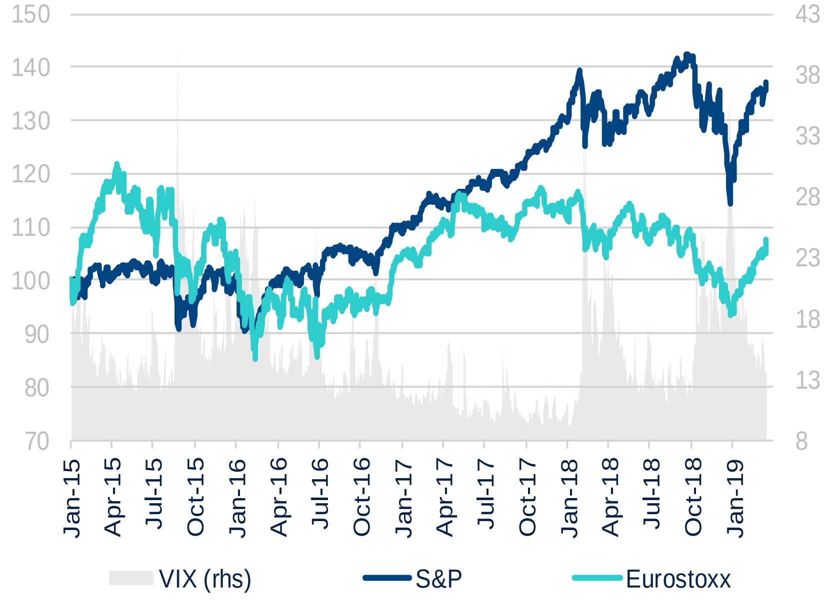
Markets: long-term yields excessively low due to cyclical risk and "safe haven" effect , with volatility limited by central banks' dovish tone

Sovereign debt yields
(%)



Source: BBVA Research based on Haver data

Equity indexes and Volatility (VIX)
(Base 100 in Jan-15 and %)

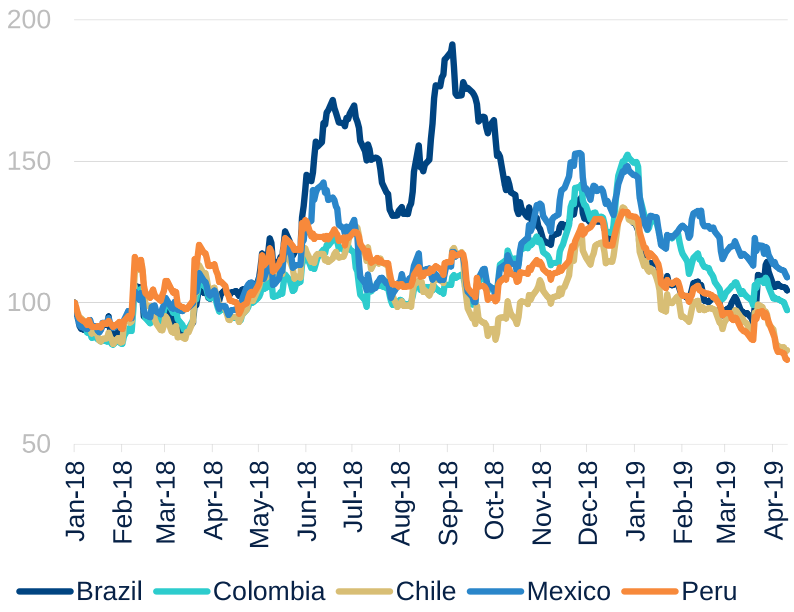


Source: BBVA Research based on Haver data

Volatility reduced in emerging economies, due to a moderation in the expectation of interest rate hikes by CB and higher commodity prices.

CDS in Latam

(Index Jan 2017=100)



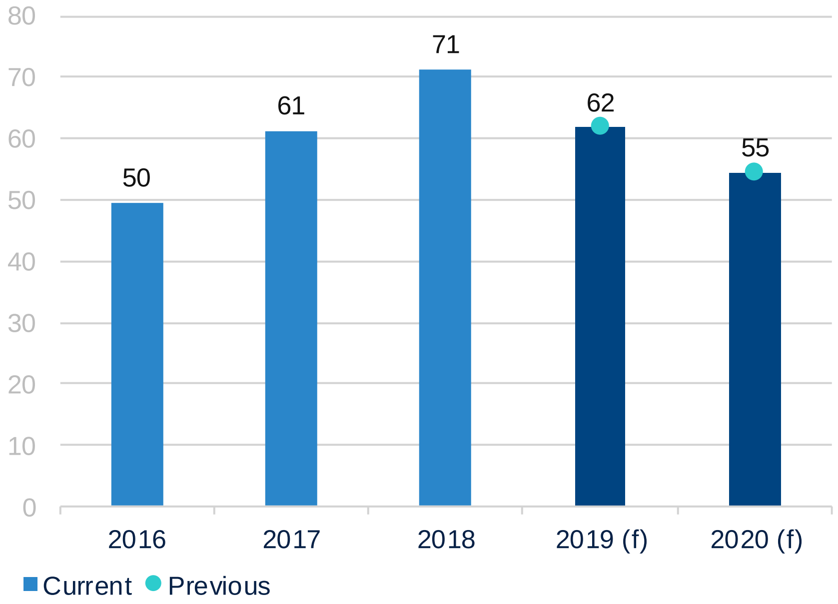
- Risk levels of emerging countries are very heterogeneus since some countries have to solve their internal and external imbalances
- The realization of lower growth forecasts in develop countries and the expected fall in oil prices, could raise risk premium in emerging countries by year end.

Source: BBVA Research with Bloomberg data

Oil markets: as expected, supply adjustments provided support to prices in 1Q19, which will likely move down from now onwards

Brent oil prices

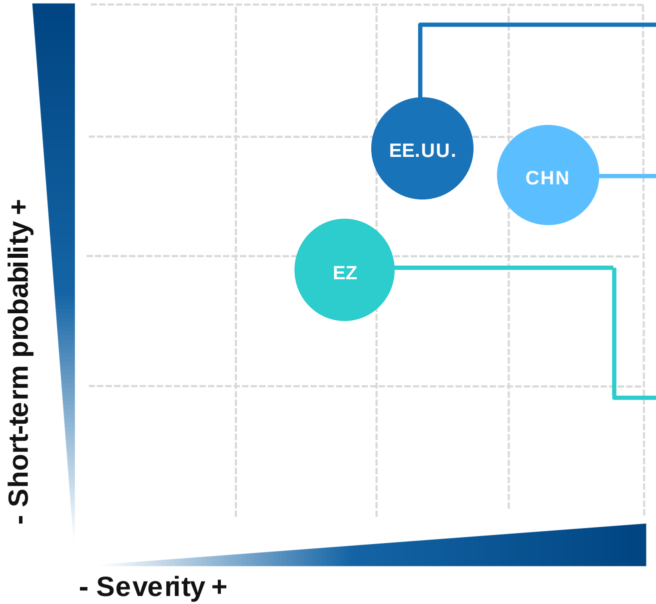
(USD per barrel, end-of-period)



Source: BBVA Research based on Haver data

- Production cuts have driven oil prices up (65 dollars per barrel, on average, in 1Q19)
- We maintain prospects for lower prices in 2H19 and 2020, on slower economic growth and rising US supply
- The lower global demand will also favor a drop in copper prices, although we have revised our forecasts slightly up, mainly due to supply disruptions
- In the case of soybeans, we have revised our forecasts slightly upwards, but we continue to expect prices to recover moving forward

Global risks: increasing fears about a recession in the US and in the Eurozone, in spite of central banks' broader support



Source: BBVA Research

- **Recession: high**
- **Protectionism: high**
- **Fed's exit: significantly lower**

- **Disorderly deleveraging : relatively higher**
- **Protectionism: high**

- **Recession: on the rise**
  - *Brexit*
  - Italy
  - Surge of Eurosceptic forces in the European Parliament
- **Protectionism: on the rise**
- **ECB's exit: significantly lower**

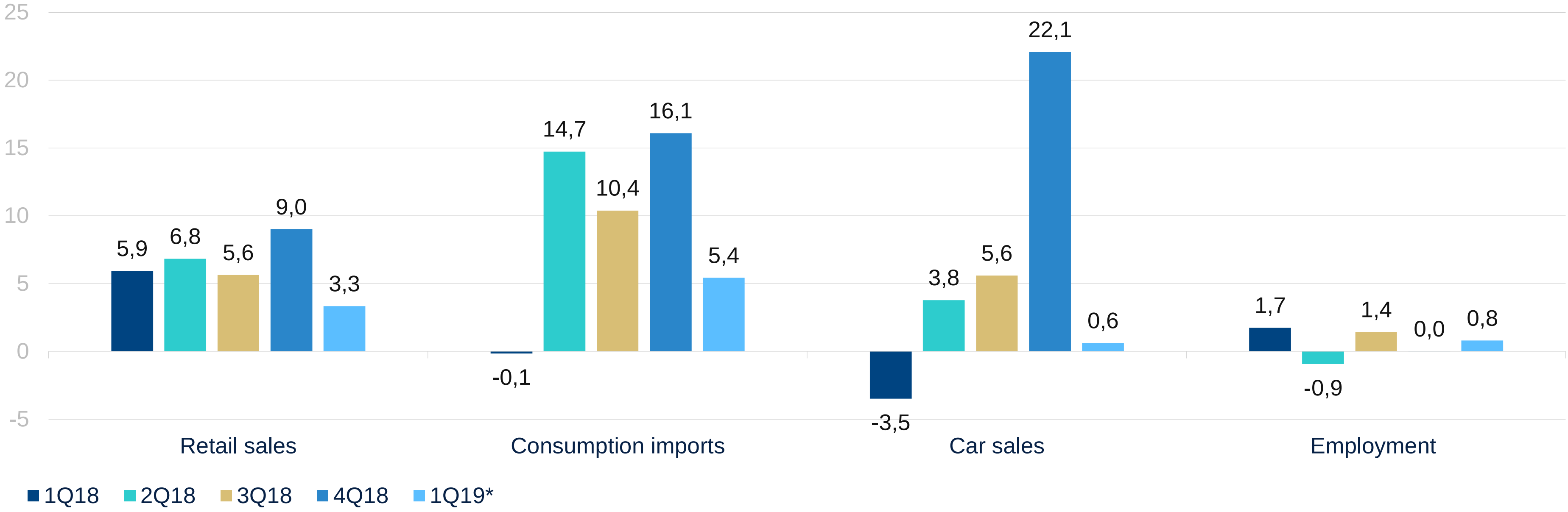
Financial vulnerabilities can amplify the severity of the risks

02

Internal demand boosts economic growth in Colombia

Recent indicators signal that private consumption will grow in 2019 at a similar rate than in 2018

Consumption leading indicators
(Annual variation, %)

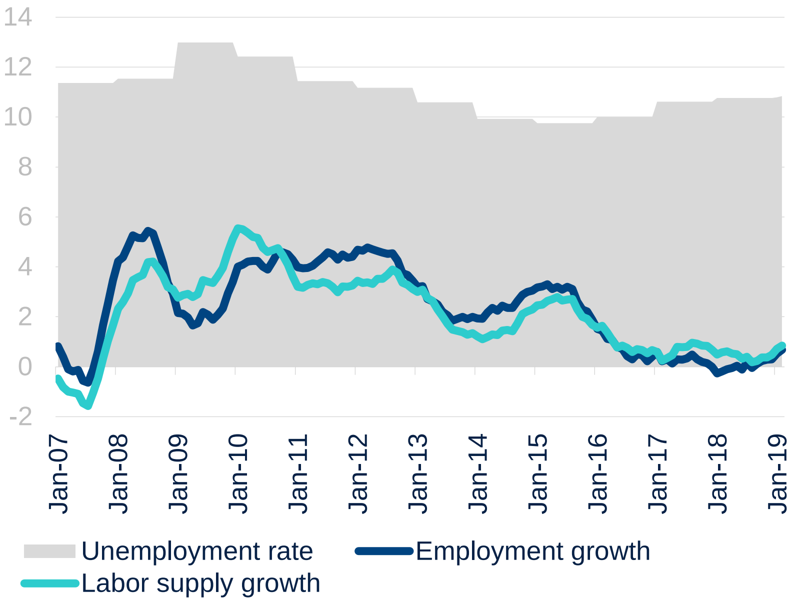


Source: BBVA Research, with DANE, ANDI and Fenalco data. * To January for retail sales and imports. To February for employment. And to March for vehicles

Employment growth, in low levels relative to previous periods, accounts for expected consumption growth stability

Labor market: employment, supply and unemployment

(Annual average. growth %y/y and rate in % of LF)



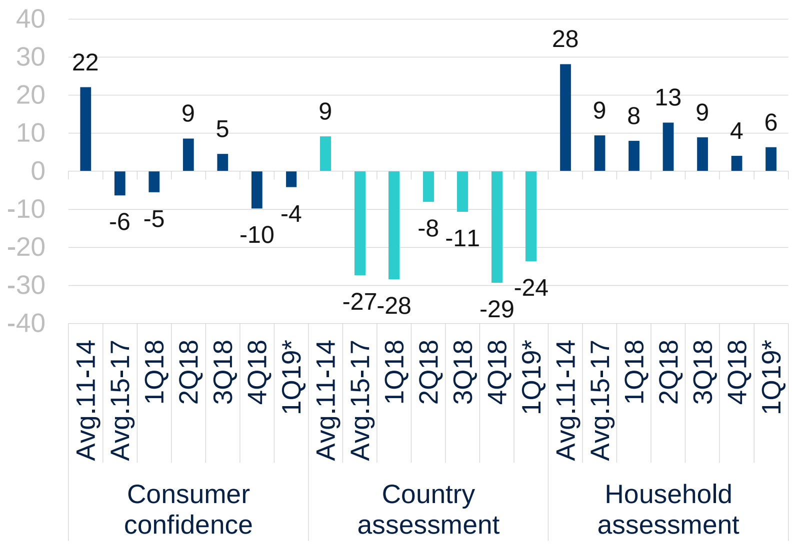
Source: BBVA Research, DANE data

Job creation rate has reduced below the growth of labor supply. As a result, unemployment rate has increased in recent quarters

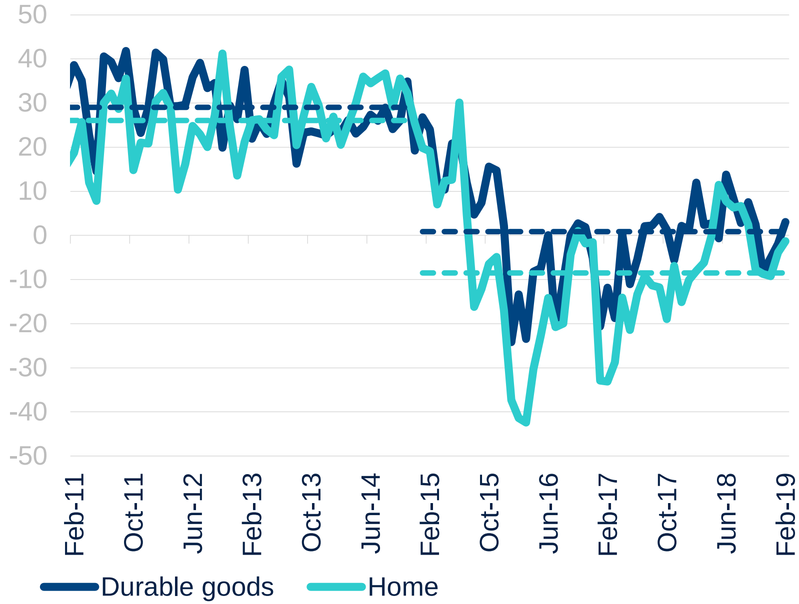
- Lower job creation could stall consumption acceleration

Consumer confidence remains negative due to weak country assesment. But it has been low for a while ¿structural change?

Consumer confidence
(Balance of answers)



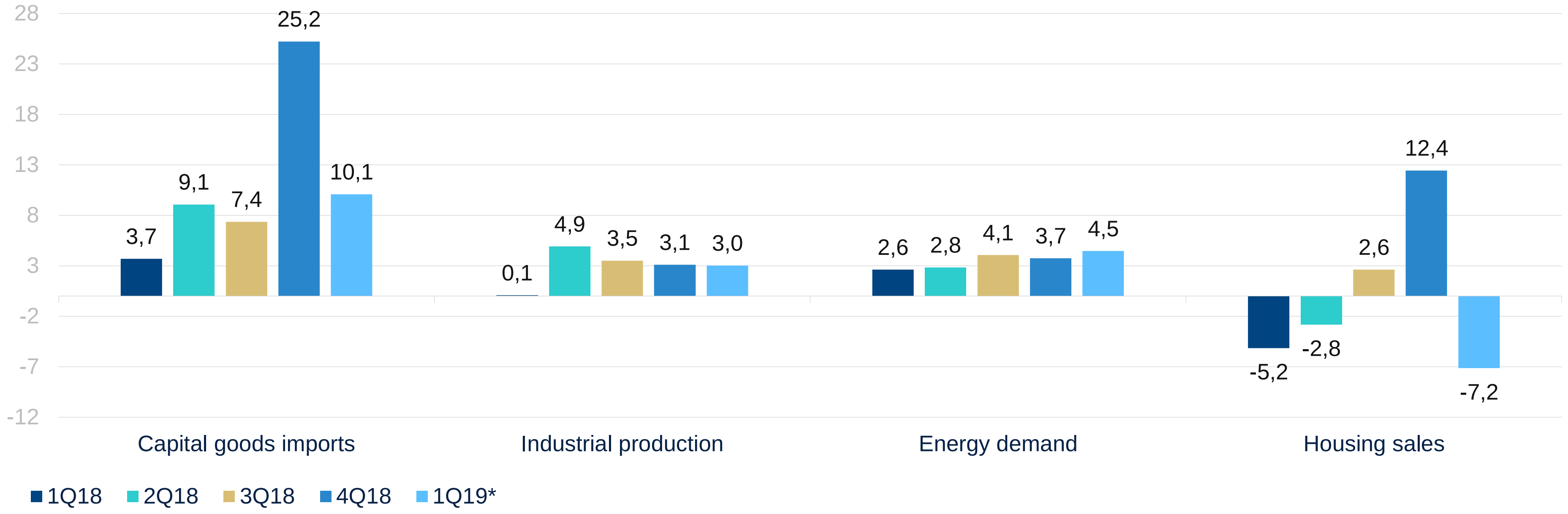
Propensity to by durable goods and homes
(Balance of answers)



Source: BBVA Research, Fedesarrollo data

On the other hand, leading indicators related to investment in machinery and equipment show a favorable dynamic

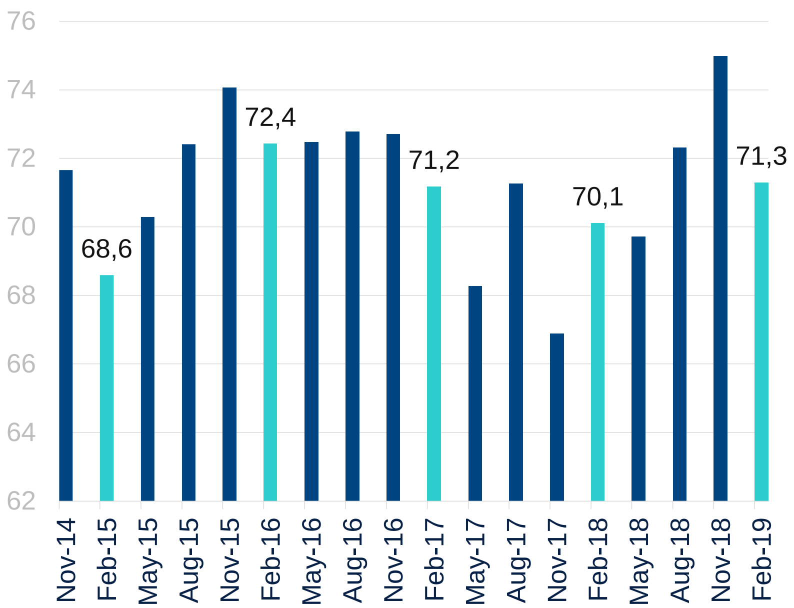
Investment leading indicators
(Annual variation, %)



Source: BBVA Research, DANE, XM and La Galería Inmobiliaria data. * Imports and industrial production as of January. Energy demand in February. House sales to March

In addition, capacity utilization in the industry is at high levels respect to its recent average

Capacity utilization in the industry
(% of total)



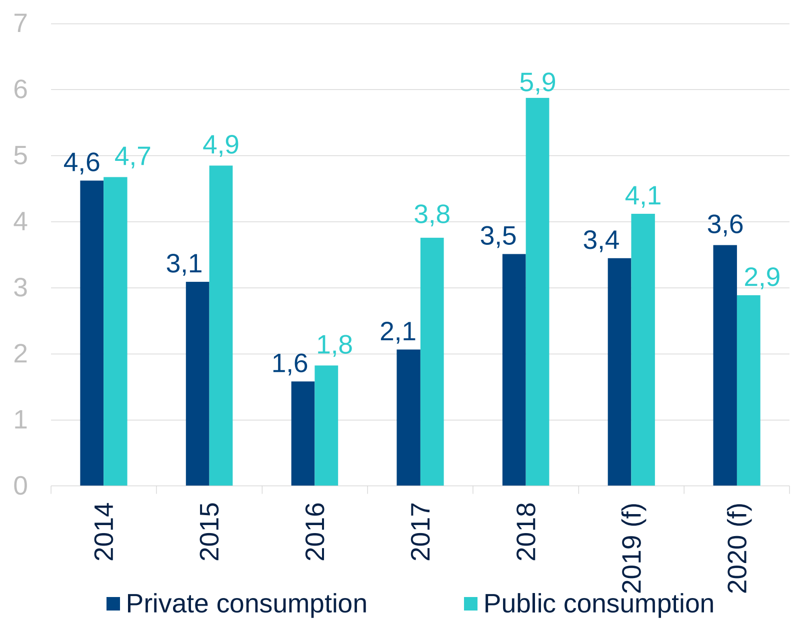
The increase in use of installed capacity is associated with higher investment needs to respond to the observed increase in internal demand

- In addition, higher oil prices are an incentive to investment in the oil sector
- And, the VAT deduction to investment goods approved in the Financing Law should also push for stronger investment

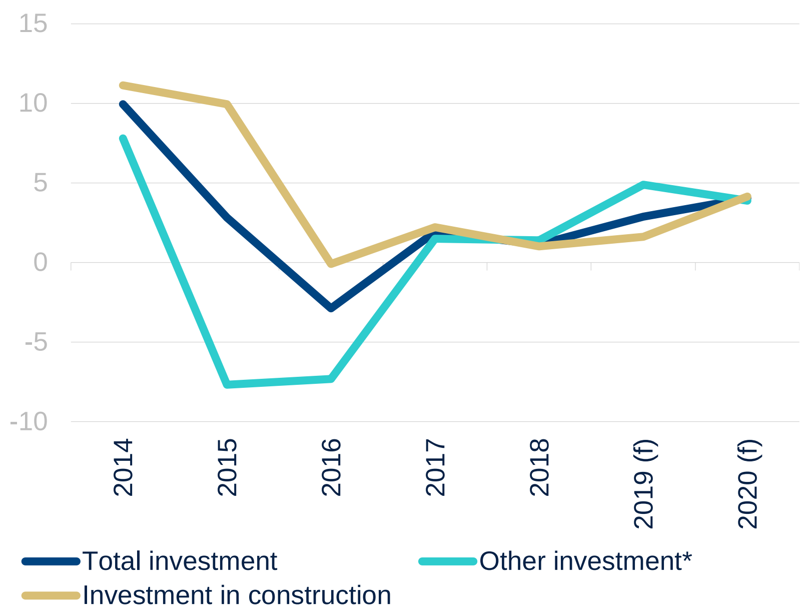
Source: BBVA Research, Fedesarrollo data

Private consumption will boost total consumption from the end of 2019 and investment in machinery and equipment total investment

Final consumption: private and public
(Annual variation, %)



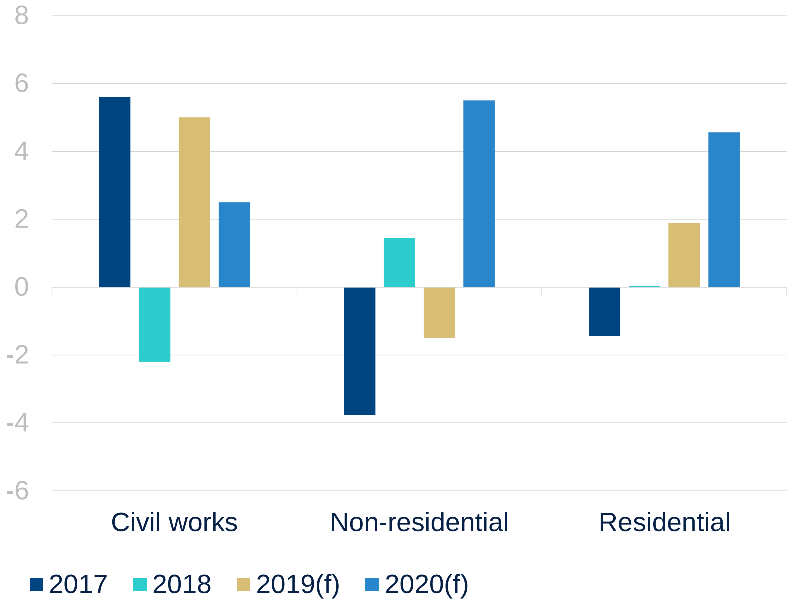
Total investment
(Annual variation, %)



Source: BBVA Research, DANE data

Construction investment will have a heterogeneous behavior within its components, improving notoriously in 2020

Construction investment by components
(Annual variation, %)



Source: BBVA Research, DANE data

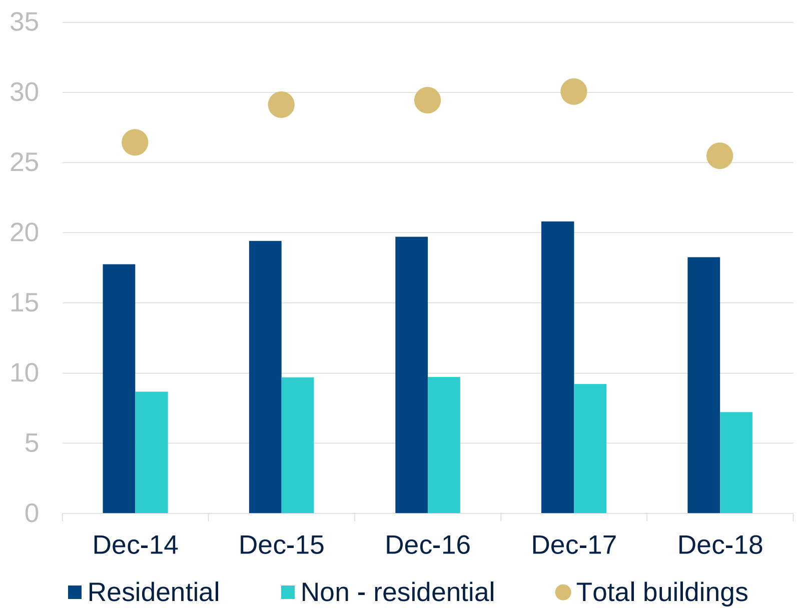
In 2019, residential construction and civil works will grow. Non residential construction will contract

- Residential construction will be boosted by social interest housing, which represents 65.8% of units sold and 37.6% of the value of those sales. In 2014 this percentages where 61.7% and 29.1%, respectably
- Civil works will grow this year due to the boost by regional governments in their last year in office. In 2020, they should decelerate by the effect of the political cycle as well
- Non residential construction will contract this year because building starts and buildings in process have fallen this year. In 2020 they should return to positive numbers given the expected inventory reduction, to be eliminated completely by 2021

Negative contribution by non residential construction is driven by a fall in work in process since the end of last year

Construction under process

(Million of sq. meters, end of year)



Between December 2017 and 2018, work in process fell by 15%. Given this, construction culmination will be limited this year by the reduction of sq. meters in process

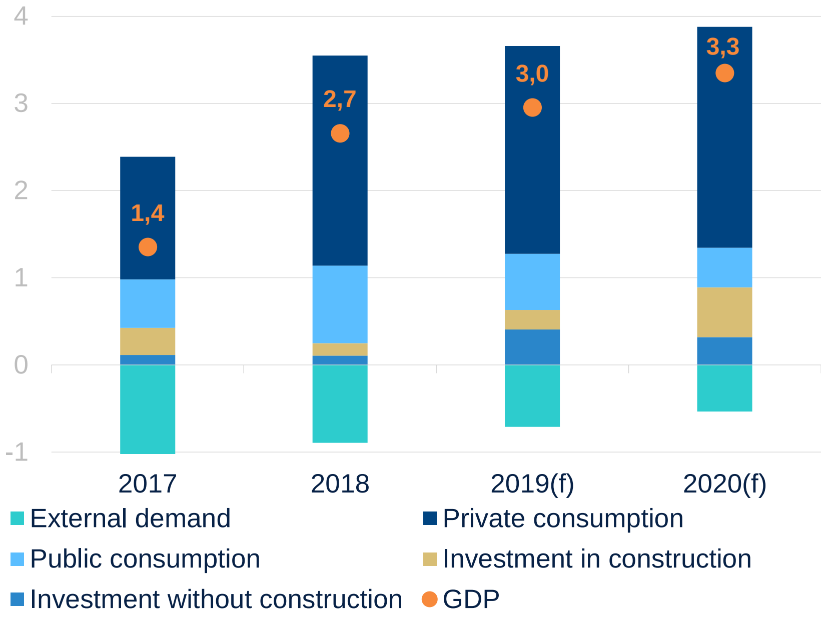
In particular, residential work in process fell by 12% and non residential fell by 22%

Source: BBVA Research, DANE data

Total investment will increase its contribution to growth. While public expenditure will reduce it slowly

GDP Growth and contributions

(Annual variation, contribution to the growth rate, %)



Private consumption remains as the most relevant component in GDP, more for its contribution than for its dynamics, despite the expected acceleration of Investment

- In 2020, investment will contribute with a point of growth, highest contribution since 2014
- External demand, will continue to reduce growth, given that the expected dynamic of imports is higher than the expected behavior of imports

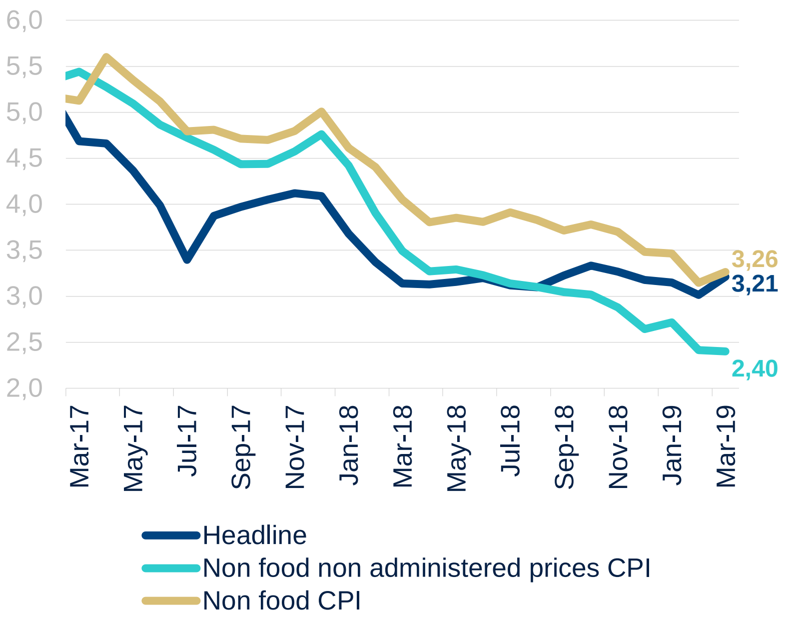
Source: BBVA Research, DANE data

03

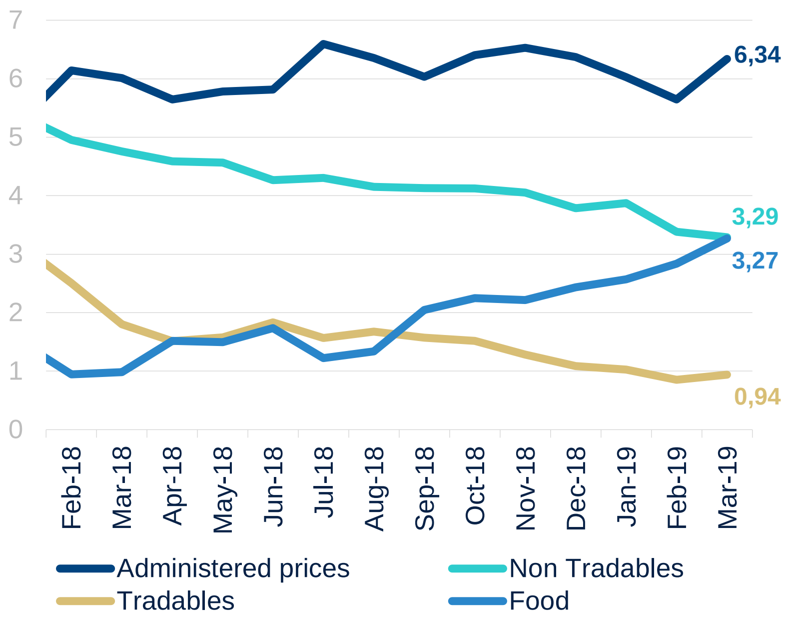
Slow recovery and low inflation delay interest rate move for Banco de la Republica

Headline inflation will be close to the 3.0% Central Bank target, despite the recent upward pressure in administered and food prices

Headline and core inflation
(Annual variation, %)



Inflation by type of expenditure
(Annual variation, %)

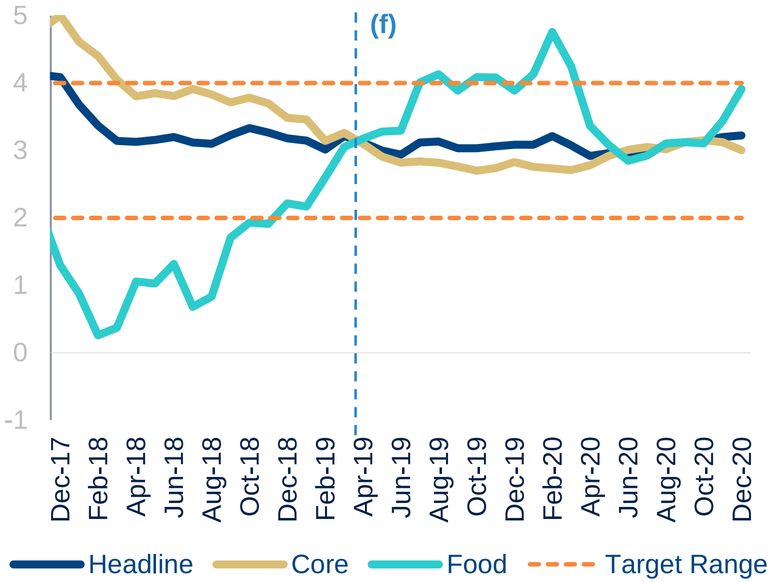


Source: BBVA Research, DANE data

Food prices continue to pressure this years result, but core inflation will continue reducing allowing for headline inflation to end at 3,0%

Headline and core inflation

(Annual variation, %)



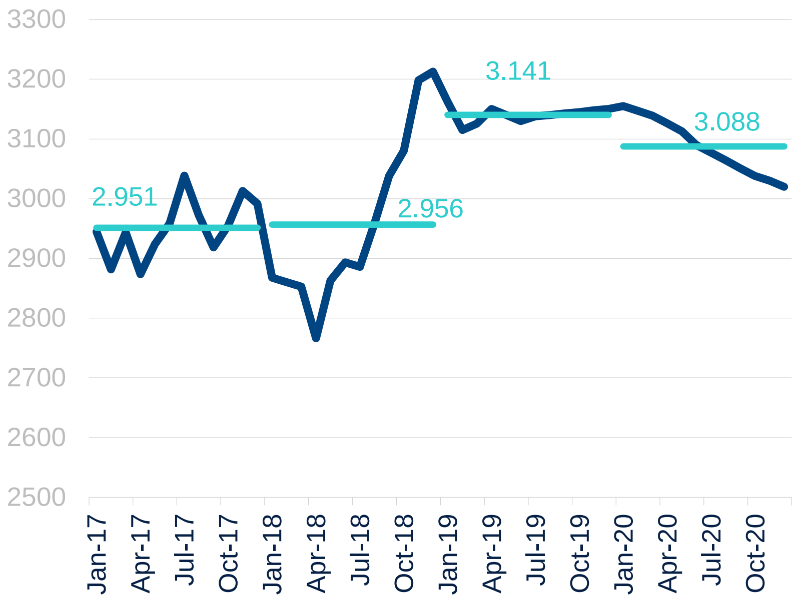
Source: BBVA Research, DANE data

Shocks revived by inflation at the beginning of the year seem transitory and are already moderating

- In the first quarter, food inflation accelerated marginally by the decisions of reducing crops to prevent the effects of “el Niño” and by energy costs driven by a reduction in the levels of water reservoirs
- We believe this shocks are transitory and inflation will return to its previous trend soon

The exchange rate within a relatively narrow range will help to reduce transmission effects on inflation in 2019 and 2020

Exchange rate
(pesos per dollar)



* Corresponds to year-end data.
Source: BBVA Research projections and Banrep data

The exchange rate will face opposing forces that will restrain its net upward and downward movements (though maintaining significant volatility) within a narrow range

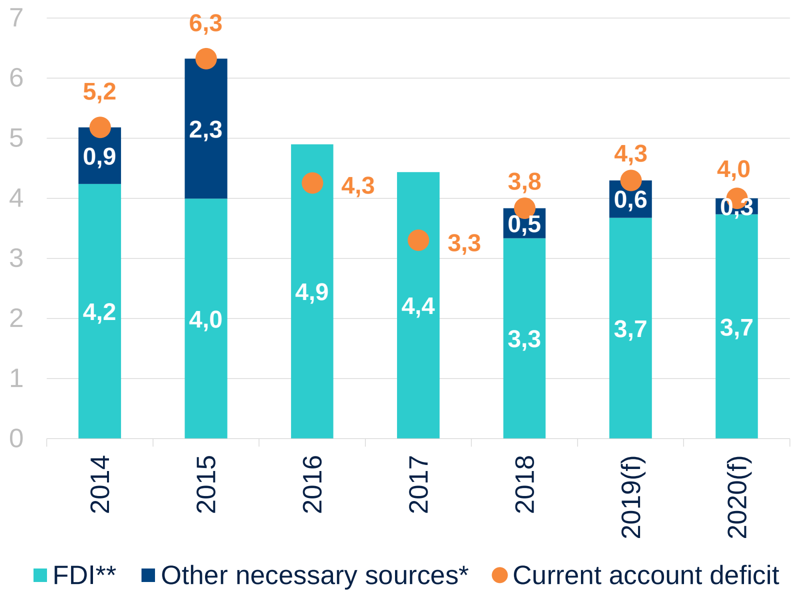
- Brent oil prices, though high currently, will reduce gradually to USD62 per barrel at the end of 2019 and to USD55 per barrel in 2020. This will be a factor that pushes the exchange rate upward, and that also explains part of the deterioration of the external balance

- At the same time, lower expected interest rates and volatility in developed countries, due to more cautious central banks, will cushion part of the preceding effect

In a context of moderate growth and low inflation, the economy will experience a higher external deficit

Current account deficit and its financing

(% of GDP. With no additional financing resources to accumulate IR***)



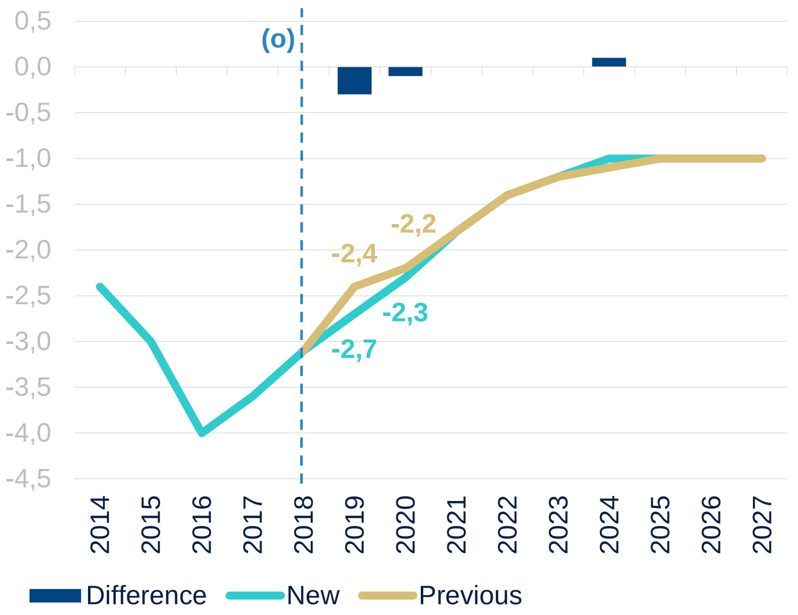
Source BBVA Research with Banrep data. *Portfolio investment and debt flows, mainly;**Foreign direct investment; *** International reserves

The deterioration of the external deficit will be explained more by investment than consumption, even though in the latter, one ought to be vigilant of the fiscal consolidation and consequently on public expenditure. The external financing will be also relevant

- If the external deficit (external financing) is used more for investment, as in 2019 and 2020, rather than what happened in 2018, boosted by consumption, the Central Bank may be less worrisome of such deficit
- On the other hand, between 2014-2015 and 2018-2020 foreign direct investment will not be enough to fully finance the external deficit and some alternative resources are needed, such as capital of debt inflows. This fact in a more complex financial world may lead to a source of risks that should be monitored

Despite recent fiscal decisions, a structural plan for the mid term is still needed

Central Government fiscal deficit (fiscal rule)
(% of GDP)



The fiscal rule committee, when flexibilizing the deficit path, allowed a marginal increase of 0,4pp of GDP in two years. This did not represent a change in the debt path, even though an active policy to increase revenue (asset sales) is needed this year and in 2020

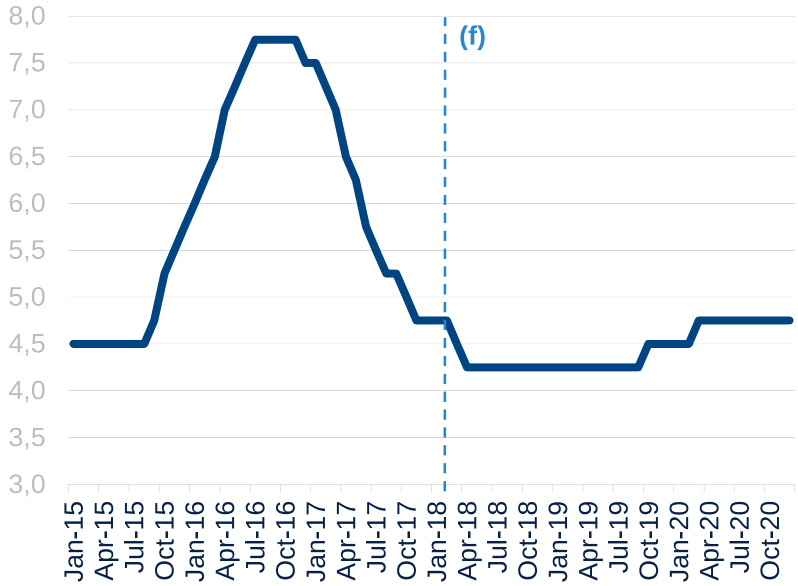
- The Fiscal Mid Term plan is probably the key tool to understand the governments structural plan
- From 2020 on, the corporate benefits approved by the Financing Law of 2018, will stress revenue for the government again

Source BBVA Research and data from the Tax Rule Advisory Committee (Minutes 11 of 2019)

With low inflation, weak demand and a deteriorating external imbalance (investment driven), BanRep can wait until year end to hike rates

BanRep policy interest rate

(%)



Source: BBVA Research and Banrep data

In addition, lower interest rates in the world, credit growth around nominal GDP growth and low pressure by internal demand will allow the neutral interest rate to stand at 4.75%

- In this context the Central Bank could increase its rate 25bp in the fourth quarter of 2019, with a downward bias towards remaining stable for the whole year. For 2020 we expect a new increase of 25bp, reaching 4.75%

Key Messages

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- Inflation will remain close to 3,0% in 2019 and 2020. With activity recovering slowly, controlled inflation will allow the Central Bank to delay its interest rate hiking cycle further down in 2019, and achieve its neutral level of 4,75% in early 2020. However, BanRep will remain vigilant of the reasons behind the deterioration of the current account deficit this year, explained more by investment than consumption, and the mid term structural fiscal adjustment needed.

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2Q19

April 2019

Creando Oportunidades

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Colombia Outlook

2Q19 (Annex)

April 2019

Creando Oportunidades

Main macroeconomic variables

Tabla A1. Macroeconomic forecast

	2015	2016	2017	2018	2019	2020
GDP (% y/y)	3,0	2,1	1,4	2,7	3,0	3,3
Private consumption (% y/y)	3,1	1,6	2,1	3,5	3,4	3,6
Public consumption (% y/y)	4,9	1,8	3,8	5,9	4,1	2,9
Fixed investment (% y/y)	2,8	-2,9	1,9	1,1	2,9	4,0
Inflation (% y/y, eoy)	6,8	5,7	4,1	3,2	3,0	3,2
Inflation (% y/y, average)	5,0	7,5	4,3	3,2	3,0	3,1
Exchange rate (eoy)	3.149	3.001	2.984	3.250	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	3.141	3.088
Devaluation (%, eoy)	37.0	11,4	-3,4	0,2	6,1	-1,6
Politcy Rate (%, eoy)	5,75	7,50	4,75	4,25	4,50	4,75
DTF rate (%, eoy)	5,2	6,9	5,3	4,5	4,7	5,
Fiscal Balance (% GPD)	-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 (%, eoy)	9,8	9,8	9,8	10,7	10,6	10,5

Main macroeconomic variables

Tabla A2. Quarterly macroeconomic forecast

	GDP (% y/y)	Inflation (% y/y, eoy)	Exchange rate (vs. USD, eoy)	Policy Rate (%, eoy)
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

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