Colombia Outlook

Economic growth will continue to be spearheaded by investment ahead of expected stabilization in consumer expenditure

Third quarter of 2019

The end of the first half is a good time to discuss our projections for the future, but we also want to take the opportunity to take stock of our recent forecasts. The first major trend that we anticipated last year was economic growth bottoming out in 2017, after which recovery would begin. Although we pointed out that the recovery would be slow, gradual, and orderly. This seems to have been the case, aided by an improved performance from domestic demand, amid a negative contribution from net external demand due to the curbed buoyancy of exports.

The most recent data reflects a gradual recovery. In the second half of 2017, the economy grew 1.4%, while in the two subsequent halves of 2018 GDP growth was 2.5% and 2.7%, in that order. In addition, in the first half of 2019, average growth should also be around 2.7% and accelerate to 3.2% in the second half of this year, according to our forecasts.

Investment will expand in 2019 thanks to the contribution made by civil works and machinery and equipment, while in 2020 investment in housing and non-residential buildings will be vital to the recovery.

One critical factor behind the GDP recovery so far, which we had anticipated, is a better trend from non-construction investment, which we tipped to recover as of late last year. In 2018 this investment grew 2.3%, showing a still incipient and volatile rebound. However, as early as the first quarter of 2019 the growth was 14.6% YoY. Despite this good result, said investment is yet to return to its pre-oil shock levels, having fallen in 2015 and 2016 by 7.7% and 7.3% respectively. In fact, the investment rate (excluding construction) was 10.1% of GDP in 2014 and will be 8.4% of GDP this year.

In the following years, the rate of investment excluding construction will stabilize slightly below this level. That is, it will grow at rates somewhat lower than GDP during 2020 and will then just about outstrip the same, held in check particularly by investment in machinery and equipment. The main reason for the slower growth of the latter investment going forward is the lack of export buoyancy in the economy, given the slower global growth that we will discuss later, and consequently more depressed investment requirements for exporting companies in the medium term.

Civil works also supported the GDP trend at the beginning of this year. The economic-political cycle allowed us to anticipate a good trend from such works in 2019, as regional and local governments traditionally have higher spending capacity in the later years of their mandates. In the first quarter of this year, civil works grew 8.5%, their sharpest increase since the end of 2017, although linked to a favorable base effect, compared to poor performance at the beginning of 2018. For the rest of the year, civil works will remain in positive territory, despite the Electoral

Guarantee Law[1] being in force, although this should not hinder the spending of regional and local institutions quite as much, thanks to their past experience hiring while the law was in effect. However, by 2020 civil works spending will no longer be as decisive, slowing as a result of the same economic-political cycle, with lower spending in the initial years of mayoral and governor mandates.

Regarding the other construction type, linked to housing and non-residential buildings, we had indicated our concerns regarding data from the building census, which pointed to a decline in new buildings and the total number of buildings underway. In fact, in previous reports, we justified our growth estimate for 2019, which at that time was below the market consensus, based on the depressed building sector. Since then, furnished with data from the first quarter and having seen a sharp drop in building works, analyst forecasts have been cut, and our estimate no longer seems so far off the consensus. In 2020 we believe increased housing construction, especially social housing (VIS), and a gradual recovery from higher-value housing and non-residential construction, should help the building sector to start making positive contributions to growth and offset the smaller positive contribution from civil works and investment in machinery and equipment, in addition to the slowdown in end consumption.

Final consumption expenditure will be determined by the future stability of private consumption, conditioned by the labor market, as well as the slowdown in public consumption.

Regarding public consumption, three months ago, we estimated a slowdown of the positive contribution made to GDP compared to the strong growth seen in 2018. The downturn in the first quarter of this year was even more far-reaching than we had expected, although due to transitory reasons that will be reversed. By the end of the first quarter of 2019, the government had not yet established the annual salary growth for public sector employees, while this time last year, the same had already been determined and paid. In what is left of the year the slowdown could be less pronounced depending on the retroactive payment of the wage increase, although we expect the variation at the end of the year will be less than last year. By 2020 public consumption will grow at an even slower rate because of the lower spending associated with the early stages of local government mandates.

Private consumption, meanwhile, will post growth slightly short of the 2018 figure both in 2019 and 2020, representing a similar message to previous editions of this outlook: "private consumption will be unable to accelerate in 2019 and 2020." The basic reasoning behind this statement is labor market deterioration, which was confirmed throughout the year and represented, in our opinion, the primary constraint on private consumption. Besides, the labor market appears to be one of the chief reasons for household confidence remaining negative, in addition to low purchasing intentions for various groups of durable goods and housing.

Employment in the thirteen largest cities grew between November 2017 and early 2019, but at slower rates than prior to the oil shock (before 2014). However, as of March, 2019 jobs were destroyed (on average 100 thousand jobs were destroyed in March-May 2019 in the thirteen largest cities), meaning further deterioration of the labor market. The Electoral Guarantee Law may further weaken employment through to the end of October. Historically, government job creation (community services sector) is low during active months for the Electoral Guarantee Law, followed by a rebound once the period ends. In 2020 job creation will remain weak, with lower levels of unemployment coming only as of the second half of the year. On average, the unemployment rate in 2020 will be slightly below 2019 levels.

1The Electoral Guarantee Law will be in force between June 25 and October 25, 2019. The same was introduced to control public spending during electoral periods. This year, regional and local elections will be held on October 27.

Growth forecasts for 2019 and 2020 will depend on domestic demand

Taking everything in account, we estimate 2019's growth to stand at 3.0%, with said growth holding at the same level in 2020. Domestic demand will be the main support for the stated estimate, as external demand will continue to undermine growth due to the greater buoyancy of imports over exports. Looking at the internal dynamics, while in 2019 end consumption is set to grow faster than investment, with the latter undermined by a deterioration of the building sector, the opposite will be true in 2020: investment growth will outstrip that of consumption. This is because all major investment items are set to grow, and there will be greater performance symmetry between the two.

We expect a long monetary pause shaped by local conditions and the international climate

Global monetary policy is set to be more flexible in response to a global slowdown, leading us to shift our position regarding future actions from the Central Bank of Colombia. Let's look at the international climate shaping the new trends that we are now forecasting.

Global environment marked by trade tensions and the reactions of central banks

In recent months, the rise of protectionism has intensified, and trade tensions have increased. Although the USA and China announced a truce during the last G20 summit that provided an opportunity to resume negotiations, doubts about a final agreement will not go away easily and will continue to slow global growth, as it is has a negative impact on confidence that runs through investment and business expectations. In this context, with inflation remaining low and growth risks very much in place, central banks have changed their positions and seem to be inclined to reduce interest rates again.

This shift by monetary authorities will probably offset the negative effect of increased trade tensions, through a positive impact in demand, which will stabilize global growth, although at lower levels than in previous years. Global growth will stabilize at 3.3% in 2019 and 2020, below the 3.7% seen in 2018.

By geographies, in the US, growth should gradually lose traction, converging with its potential growth rates. Growth is set to stand at 2.5% in 2019 and 2.0% in 2020, following 2.9% in 2018. In order to sustain economic expansion amid the risk of slower growth and low inflation, the Federal Reserve is in a position to start an expansion cycle in 3Q19, reducing its rates by up to 75 bps over the next few quarters, and then keeping them stable until 2022.

In Europe, growth will be more modest owing to weak industry and uncertainties (trade and Brexit). The ECB is therefore expected to strengthen its forward guidance and further reduce deposit rates (-10 bps in 3Q19), leaving these unchanged until the end of 2021. In addition, we expect it to adopt a staggered deposit system and re-implement quantitative easing (QE) measures, but only if the situation worsens. Therefore, the scenario for Europe remains largely unchanged. Following strong data from the first quarter, we have revised growth upward in 2019 (+0.1 pp to +1.1%), while owing to the persistent weakness of the industrial sector and greater uncertainty (trade and Brexit), we have slightly lowered our 2020 forecast (-0.1 pp to +1.2%).

In China, we expect more fiscal stimulus measures (tax cuts and growth of regional government debt) that, along with loan interest rate cuts, bank swaps and specific medium-term credit, as well as other measures, should sustain the country's growth and therefore counter the negative impact of the trade war. These stimulus measures will help GDP to grow by 6.0% in 2019 and 5.8% in 2020, in line with previous forecasts.

The global environment will be particularly challenging for emerging countries. Although the new round of accommodative policies in major global economies may give them some room for maneuver, they face generally less favorable prospects for commodity markets, as well as the fallout from trade tensions and potentially an easing of capital flows.

The Central Bank of Colombia will keep interest rates stable

In this context, the Central Bank of Colombia may also alter its stance on monetary policy. It would no longer face external upside pressure, as monetary policy should be more flexible in developed countries, enough to initiate a period of interest rate hikes. At the same time, the growth rate we expect in 2019 and 2020 does not indicate excessive demand-side pressure or a rapid narrowing of the output gap. This should allow the Central Bank ample room to keep interest rates stable for a long time, holding unchanged in the 2019-2020 period at least, but possibly through to 2022, as we expect for the Fed. Potentially we may see the most extended monetary pause in the target inflation strategy period. This is a significant shift in our position, as we had thought the Central Bank might increase its rates by 50 basis points by the end of 2019 and in 2020.

Inflation and structural deficits will remain on the radar of the Colombian Central Bank

The long monetary pause that we expect from the Central Bank will depend on inflation standing close to the target in 2019 and 2020, but it is clear that the performance of the same will be a determining factor in terms of policy change. This year food will continue to drive up inflation due to the low 2018 comparison base when the prices of many foods declined. However, its also because of the climate effect and bottlenecks in the transport of such goods via some routes in the country. At the same time, tradable goods inflation increased through to May due to exchange rate devaluation in late 2018 and early 2019, but we do not expect additional effects of any considerable magnitude going forward thanks to the recent exchange rate stability. The upside inflation effects of food prices and the devaluation will be offset, but only partially, over the rest of the year by lower inflation in regulated goods. The remaining non-tradable goods will also continue to show low inflation levels.

In 2020 food prices will decline until midway through the year and move inflation to below 3.0%. Food price growth will then accelerate, while the remaining inflation will hold at stable rates. In total, we expect inflation of 3.3% at the close of 2019 and 3.2% by the end of 2020, data that although close to the Central Bank’s target (3.0%) does not match it. Even in July, inflation could show its highest record, standing at 3.7%, a level that will be studied closely by the Central Bank for its interest rate decisions going forward and to discuss the persistency or not of this inflation levels. These inflation levels are similar to those estimated three months ago, although we revised up our 2019 inflation by three tenths due to the higher impact from food inflation.

Another issue that will be on the Central Bank's radar is the sustained high current account deficit, in line with rising imports of capital goods. This trend, which we had anticipated a few months ago, began to be confirmed in the first quarter, with the deficit standing at 4.6% of GDP. We project that the current account deficit in 2019 could stand at 4.4% of GDP, and while financing is very likely to be complete, it may be less concentrated in direct foreign investment and more dependent on portfolio investment and external debt, thanks to lower external interest rates. As a result, the 2020 deficit would stand at 3.8% of GDP. This improved figure would be due to the slowdown in investment in machinery and equipment, mostly imported, as a result of slower global growth, which affects investments at exporting companies, and the one-time boost (with no additional effects in 2020) to investment decisions had by reimbursement of VAT on capital goods as of 2019. Current account deficits will continue to gradually decline, albeit to levels still above 3.4% of GDP.

In this scenario, the exchange rate may appreciate slightly until September, as of when there could be some devaluation through to the end of the year, standing a very close to current levels (COP 3186 at year-end). This trend would be due to the seasonality of Colombian markets and sustained risk aversion globally, which should be offset initially by market expectations of Fed interest rate cuts. Subsequently, in 2020 the exchange rate will continue to depreciate throughout the year due to declining oil prices (to 55 dollars per brent barrel) and global tensions remaining in place. It will end the year at 3226 pesos per dollar.

Fiscal issues will remain on everyone's radar during the coming years.

Despite the publication in mid-June of the Medium-Term Fiscal Framework (MFMP in its Spanish acronym), doubts were not dispelled regarding revenue trends, and therefore the deficit in both the short and medium terms. At the market level, the MFMP was well received and may have partially contributed to recent domestic sovereign debt bond rate appreciation, as well as to the entry of external capital flows. However, it was not received with the same enthusiasm elsewhere, including by us, as it left persistent doubts concerning the country's fiscal consolidation.

In the short term, the national government committed in the MFMP to securing a lower fiscal deficit than permitted by the Fiscal Rules Committee. While this is a laudable target, we believe it will be difficult to achieve due to the need to sell government-owned assets in the short term, as well as the proposed accounting changes for the latter. Similarly, because it expects to have a value of fiscal revenue in 2020 similar to that of 2019 despite the lower tariffs, exemptions, and discounts that occurred in that year and were approved in the 2018 tax reform.

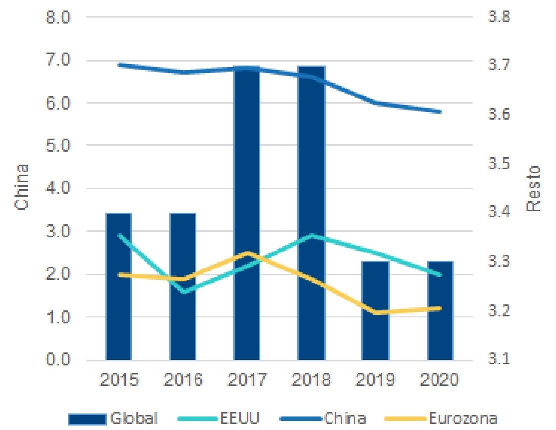
In terms of asset sales, disposal plans will have to be very flexible, which represents a challenge for the public apparatus. On the accounting side, the government treats revenues from asset sales as the current capital income and not a source of financing, multilateral agencies do not endorse this approach. For example, in the Article IV Consultation with Colombia of April 2019, the IMF excludes expected privatization income from the deficit calculation, taking it as a source of financing rather than current income. The IMF, therefore, estimated a deficit for 2019 of 3.0% of GDP, compared to 2.4% of GDP expected by the government for the same year. Additionally, the government comes to the questionable figure of financing current expenditure through asset sales, which may give a sense of tranquility in the short term, but widens the uncertainty in the medium term for not being structural income.

To reach the 2.4% of GDP deficit mark in 2019 (compared to 2.7% allowed under the fiscal rule), the MFMP includes a 10% annual increase in expenditure compared to 2018 (from COP 180 billion to COP 198 billion and reaching 19% of GDP compared to 18.4% in the previous year), asset sales worth COP 6 billion (0.6% of GDP) and revenues of COP173 billion (16.6% of GDP).

For 2020 the government forecasts a deficit of 2.2% of GDP (2.3% of GDP according to the fiscal rule), with an annual spending reduction of 0.3 pp of the GDP with respect to 2019, to position itself at 18.7% of the GDP. The government is expecting a relatively stable revenue (16.5% of the GDP), including new asset sales for a total of COP 6 billion (0.6% of the GDP), in addition to the Central Bank utilities as source of current financing. Nevertheless, for 2020, the doubt remains regarding the possibility of sales of proposed assets, as well as the stability of tax revenues expected by the government. Even including the assets sale, our assumptions see us forecast revenues that are lower by about 0.7 pp of GDP (some COP 7 billion), requiring a strategy shift to secure the deficit. Part of this difference in income may be explained by our less optimistic macro scenario, as well as lower estimated efficiency gains in terms of tax collection than the government envisages.

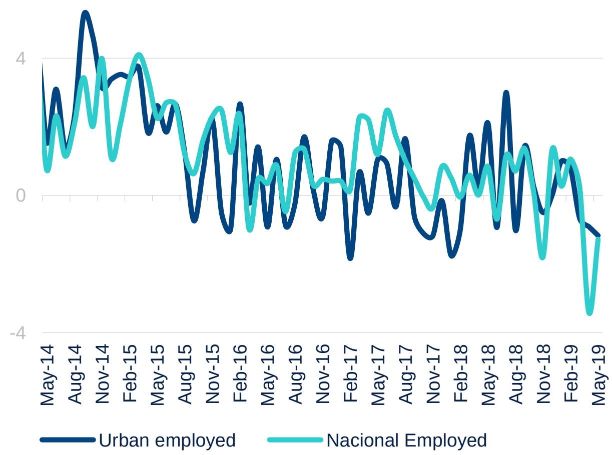
In the medium term, the MFMP points to fiscal consolidation achieved via a significant spending adjustment between 2019 and 2030, driving the required deficit reduction and offsetting the decline in revenues. In order to reduce spending, the government will seek to improve subsidy targeting, pay high-cost liabilities, and shape a more efficient Inland Revenue system. Besides, interest payments will be reduced as a result of lower debt. The drop in revenues between 2019 and 2030 would be due to income from asset sales not being permanent and disappearing once the sales plan is finalized. The MFMP is unambitious, keeping tax revenues stable, with the latter continuing to account for less than 15% of GDP by 2030. Nonetheless, the expected deficit by the government will stand above the defined one by the Fiscal Rules Committee between 2022 and 2029.

Figure 1. **GLOBAL GROWTH AND PRINCIPAL COUNTRIES** (%)



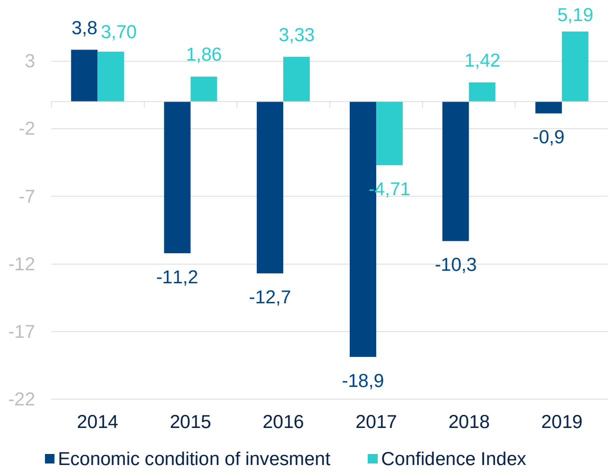
Source: BBVA Research

Figure 2. **EMPLOYED CREATION (ANNUAL VARIATION, %)**



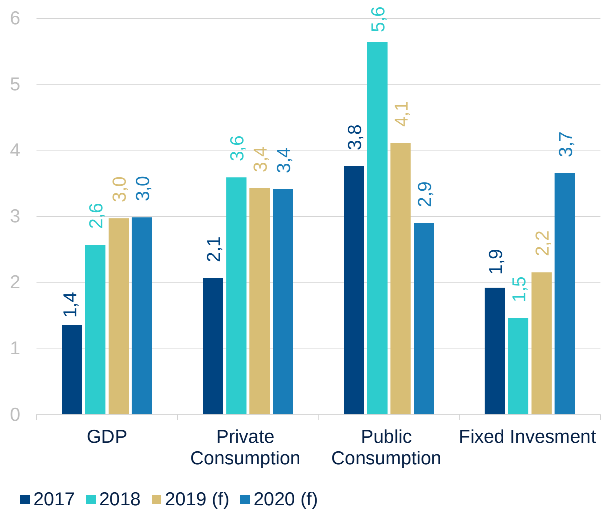
Source: BBVA Research based on DANE data

Figure 3. **INVESTMENT CONDITIONS AND INDUSTRIAL CONFIDENCE** (ANSWER BALANCE, %)



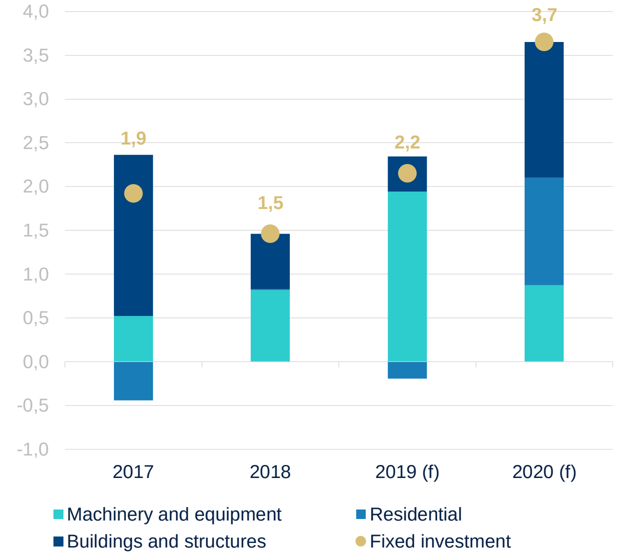
Source: BBVA Research based on Fedesarrollo data

Figure 4. **CONSUMPTION, INVESTMENT AND GDP (ANNUAL VARIATION, %)**



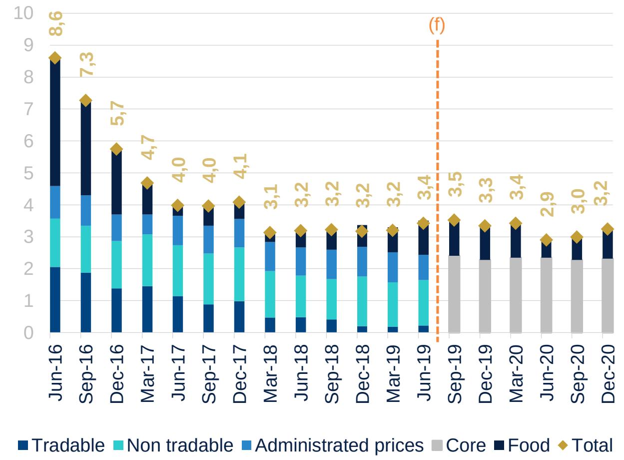
Source: Source: BBVA Research based on DANE data.

Figure 5. **INVESTMENT CONTRIBUTIONS (ANNUAL VARIATION AND CONTRIBUTION, %)**



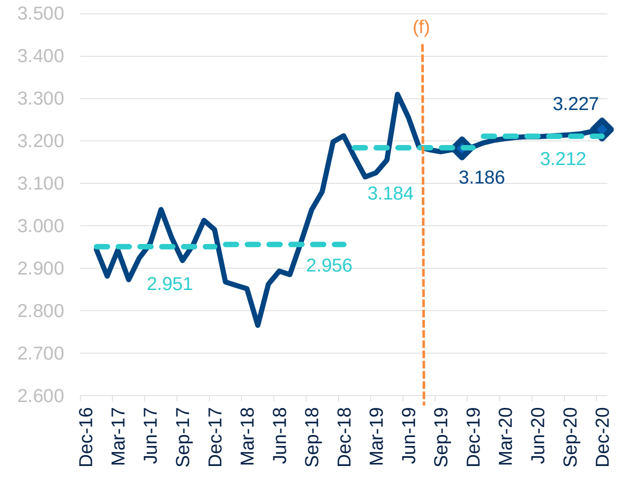
Source: BBVA Research based on DANE data

Figure 6. **INFLATION BY TYPE AND TOTAL (ANNUAL VARIATION AND CONTRIBUTION BY GROUP, %)**



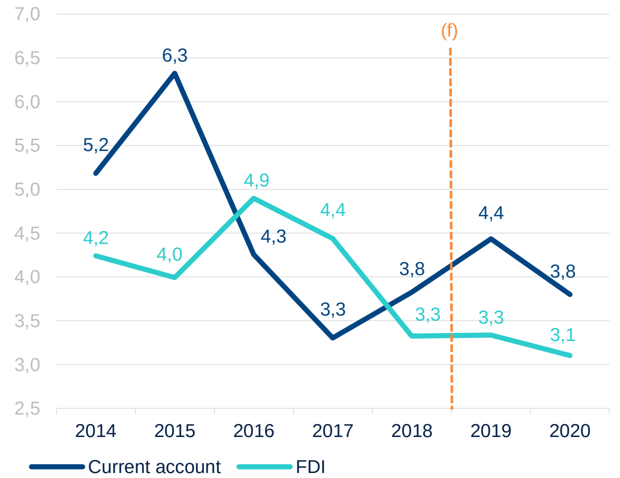
Source: : BBVA Research base on DANE data. *Includes regulated, tradable, and non-tradable in the projection period

Figure 7. **EXCHANGE RATE FORECAST (MONTHLY AND ANNUAL AVERAGE VALUE, PESOS PER DOLLAR)**



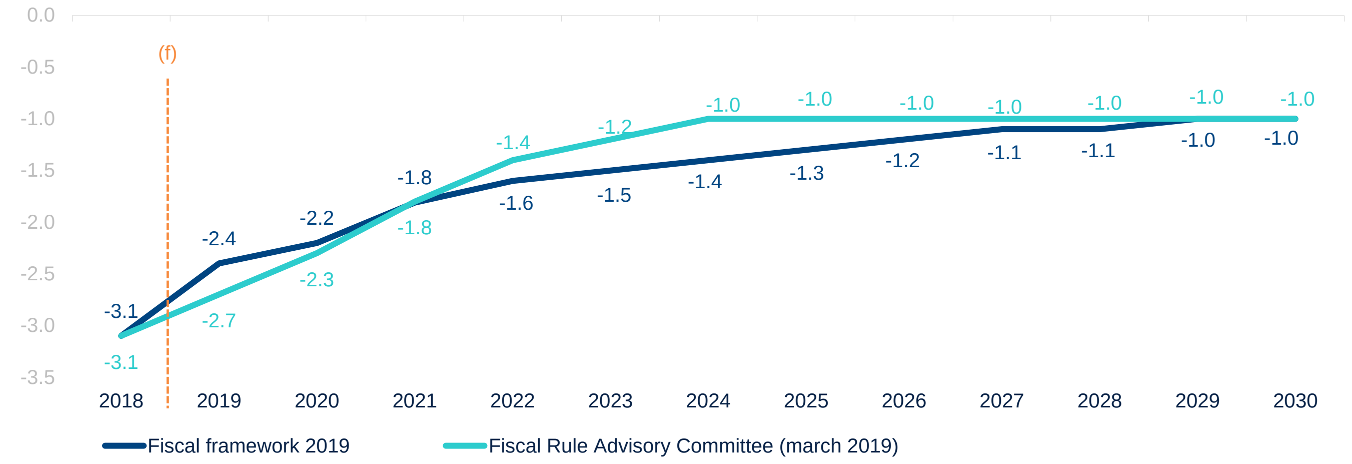
Source: BBVA Research forecast and calculation with Banco de la República data

Figure 8. **EXCHANGE RATE FORECAST (MONTHLY AND ANNUAL AVERAGE VALUE, PESOS PER DOLLAR)**



Source: Source: BBVA Research forecast and calculation with Banco de la República data

Figure 9. **CENTRAL NATIONAL GOVERNMENT FISCAL DEFICIT (% OF GDP)**



Source: BBVA Research with data from the Ministry of Finance in the 2019 Medium-Term Fiscal Framework and Act 11 of March 2019 of the Committee of Experts on Fiscal Rule

Tables

Table 1. **MACROECONOMIC FORECAST**

	2016	2017	2018	2019f	2020f
GDP (% y/y)	3,0	2,1	1,4	2,6	3,0
Private consumption (% y/y)	3,1	1,6	2,1	3,6	3,4
Public consumption (% y/y)	4,9	1,8	3,8	5,6	4,1
Fixed investment (% y/y)	2,8	-2,9	1,9	1,5	2,2
Inflation (% y/y, eop)	6,8	5,8	4,1	3,2	3,3
Inflation (% y/y, average)	5,0	7,5	4,3	3,2	3,4
Exchange rate (eop)	3.149	3.001	2.984	3.250	3.186
Devaluation (%, eop)	31,6	-4,7	-0,5	8,9	-1,9
Exchange rate (average)	2.742	3.055	2.951	2.956	3.184
Devaluation (%, eop)	37.0	11,4	-3,4	0,2	7,7
Policy interest rate (%, eop)	5,75	7,50	4,75	4,25	4,25
Term Deposit Rate (%, eop)	5,2	6,9	5,3	4,5	4,5
Fiscal balance Central National Government (% GDP)	-3,0	-4,0	-3,6	-3,1	-2,4
Current account (% GDP)	-6,3	-4,3	-3,3	-3,8	-4,4
Unemployment urban rate (%, eop)	9,8	9,8	9,8	10,7	11,0

Source: Central Bank, DANE y BBVA Research

Table 2. **MACROECONOMIC FORECAST**

	GDP (% y/y)	Inflation (% y/y, eop)	Exchange rate (vs. USD, eop)	Policy interest rate (%, eop)
Q1 16	2,4	8,0	3.022	6,50
Q2 16	2,1	8,6	2.916	7,50
Q3 16	1,7	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	1,3	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	2,0	3,1	2.780	4,50
Q2 18	2,9	3,2	2.931	4,25
Q3 18	2,6	3,2	2.972	4,25
Q4 18	2,7	3,2	3.250	4,25
Q1 19	2,8	3,2	3.175	4,25
Q2 19	2,7	3,4	3.206	4,25
Q3 19	3,1	3,5	3.175	4,25
Q4 19	3,3	3,3	3.186	4,25
Q1 20	3,0	3,4	3.206	4,25
Q2 20	2,6	2,9	3.210	4,25
Q3 20	3,2	3,0	3.215	4,25
Q4 20	3,1	3,2	3.227	4,25

Source: Central bank, DANE y BBVA Research

Table 3. **GDP** (ANNUAL AVERAGE, %)

	2016	2017	2018	2019f	2020f
USA	1,6	2,2	2,9	2,5	2,0
Eurozone	1,9	2,5	1,9	1,1	1,2
Germany	2,2	2,5	1,5	0,8	1,2
France	1,0	2,4	1,7	1,3	1,5
Italy	1,2	1,8	0,7	0,0	0,4
Spain	3,2	3,0	2,6	2,3	1,9
United Kingdom	1,8	1,8	1,4	1,1	1,2
Latam*	-0,2	1,8	1,5	1,0	2,2
Mexico	2,6	2,4	2,0	0,7	1,8
Brazil	-3,3	1,1	1,1	0,9	1,8
Eagles**	5,3	5,4	5,2	4,7	4,9
Turkey	3,2	7,4	2,6	0,3	2,5
Pacific Asia	5,6	5,6	5,6	5,3	5,1
Japan	0,6	1,9	0,8	0,7	0,4
China	6,7	6,8	6,6	6,0	5,8
Asia (ex. China)	4,7	4,6	4,7	4,6	4,4
World	3,4	3,7	3,7	3,3	3,3

* Argentina, Brazil, Chile, Colombia, Mexico, Peru y Venezuela.
** Bangladesh, Brasil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Maxico, Nigeria, Pakistan, Russia, Turkey y Vietnam.
Close date of forecast:: 12 de julio de 2019.
Source: BBVA Research

Table 4. **INFLATION** (ANNUAL AVERAGE, %)

	2016	2017	2018	2019f	2020f
USA	1,3	2,1	2,4	1,8	2,0
Eurozone	0,2	1,5	1,8	1,3	1,5
Germany	0,4	1,7	1,9	1,4	1,6
France	0,3	1,2	2,1	1,3	1,5
Italy	-0,1	1,3	1,2	0,9	1,2
Spain	-0,2	2,0	1,7	1,1	1,4
United Kingdom	0,7	2,7	2,5	1,8	1,8
Latam*	9,8	6,7	7,1	8,3	6,8
Mexico	2,8	6,0	4,9	4,0	3,7
Brazil	8,8	3,5	3,7	3,8	4,8
Eagles**	4,4	4,0	4,7	4,9	4,6
Turkey	7,8	11,1	16,3	16,5	13,7
Pacific Asia	2,3	2,0	2,3	2,4	2,7
Japan	-0,1	0,5	1,0	0,9	1,3
China	2,1	1,5	1,9	2,3	2,5
Asia (ex. China)	2,5	2,4	2,7	2,6	2,9
World	3,2	3,3	3,8	3,8	3,6

* Argentina, Brazil, Chile, Colombia, Mexico, Peru y Venezuela.
** Bangladesh, Brasil, China, Egypt, Philippines, India, Indonesia, Iran, Malaysia, Maxico, Nigeria, Pakistán, Russia, Turkey y Vietnam.
Close date of forecast: 12 de julio de 2019.
Source: BBVA Research

Table 5. **INTEREST RATE OF PUBLIC DEBT TO 10 YEARS** (ANNUAL AVERAGE, %)

	2016	2017	2018	2019f	2020f
	1,84	2,33	2,91	2,30	1,73
	0,13	0,37	0,46	-0,14	-0,16

Close date of forecast: 12 de julio de 2019.
Source: BBVA Research

USA
G

Table 6. **EXCHANGE RATE** (ANNUAL AVERAGE)

	2016	2017	2018	2019f	2020f
	0,90	0,89	0,85	0,88	0,84
	1,11	1,13	1,18	1,14	1,19
	1,35	1,29	1,33	1,30	1,43
	108,82	112,20	110,47	110,65	110,08
	6,64	6,76	6,61	6,72	6,71

EUR-USD
USD-EUR
USD-GBP
JPY-USD
CNY-USD

Close date of forecast: 12 de julio de 2019.
Source: BBVA Research

Table 7. **OFFICIAL EXCHANGE RATE** (END OF PERIOD, %)

	2015	2016	2017	2018f	2019f
	0,75	1,50	2,50	2,00	1,75
	0,00	0,00	0,00	0,00	0,00
	4,35	4,35	4,35	3,85	3,85

USA
Eurozone
China

Close date of forecast: 12 de julio de 2019.
Source: BBVA Research

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