BBVA Research

Colombia
Economic Outlook 3Q19

2019

Creating Opportunities

BBVA Research

01

Global environment: growth will ease, in the midst of stimulus measures and trade tensions

Main messages

Global growth will stabilize at lower levels than in previous years. Additional stimulus measures, particularly of a monetary nature, will offset the effects of increased trade tensions.

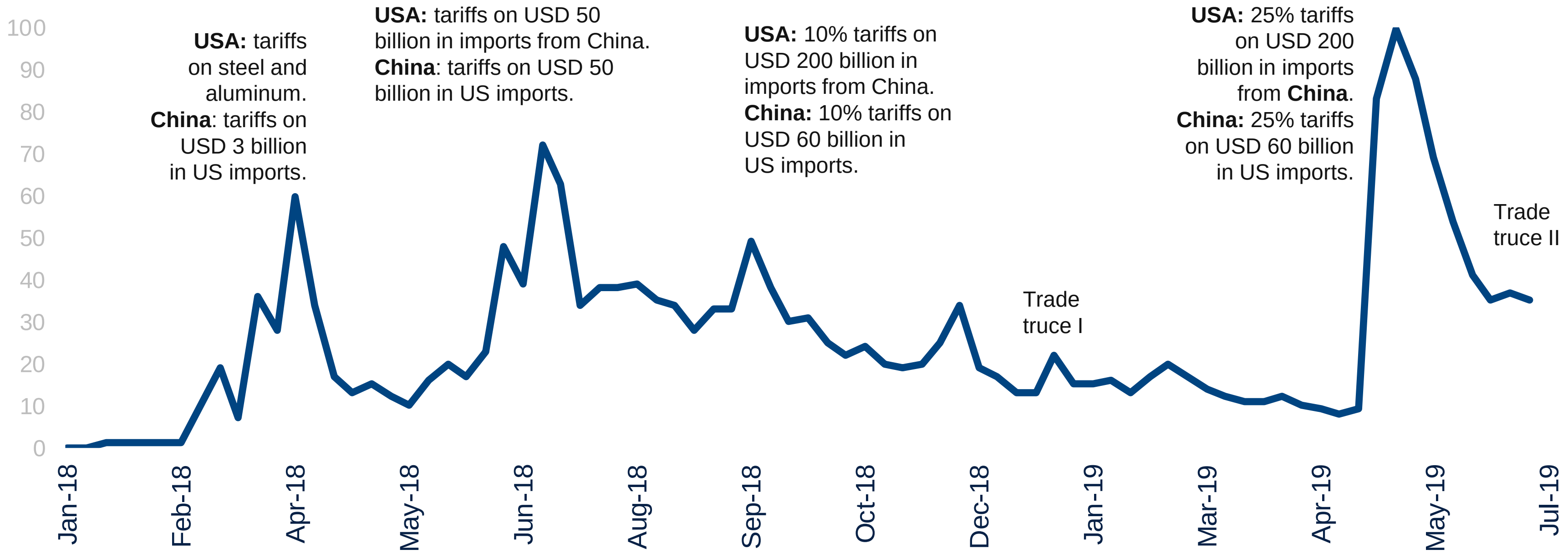
Monetary policy will be more expansive. The Federal Reserve will cut its rates by as much as 75 basis points in the coming quarters, and then keep them stable until 2022. The ECB will reduce its rate by 10 bps in the third quarter of 2019, leaving them unchanged until the end of 2021. La política monetaria será más expansiva.

Global growth will stabilize at 3.3% in 2019 and 2020, down from 3.8% in 2018.

The global environment will be particularly challenging for emerging countries. The new round of accommodative policies may give them some room for manoeuvre, but they will have to face less favourable prospects for commodity markets, as well as the impacts of trade tensions and possibly a moderation of capital flows.

The escalation of protectionism keeps uncertainty high, even after the recent truce between the USA and China

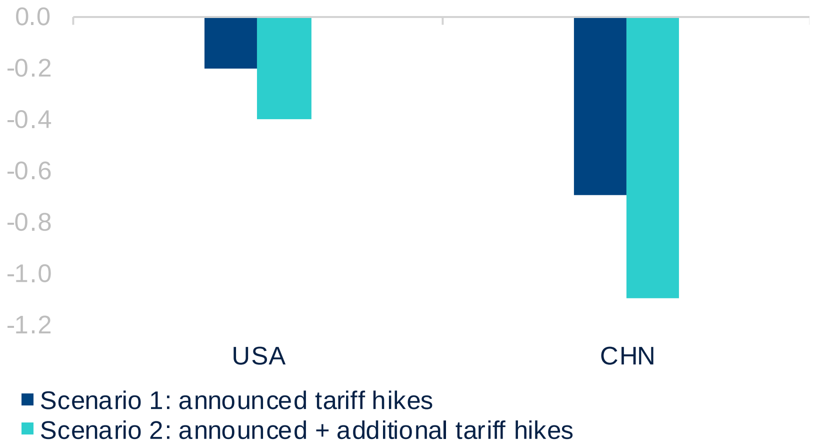
TRADE WAR INDEX: GOOGLE SEARCHES OF THE TERM "TRADE WAR"
(INDEX FROM 0 TO 100)



Source: BBVA Research, Google Trends

Global growth continues on a smooth downward path, despite the rebound in the first quarter

THE GDP LEVEL IMPACT OF TWO TRADE WAR SCENARIOS BETWEEN THE UNITED STATES AND CHINA
(TWO YEARS, PP)

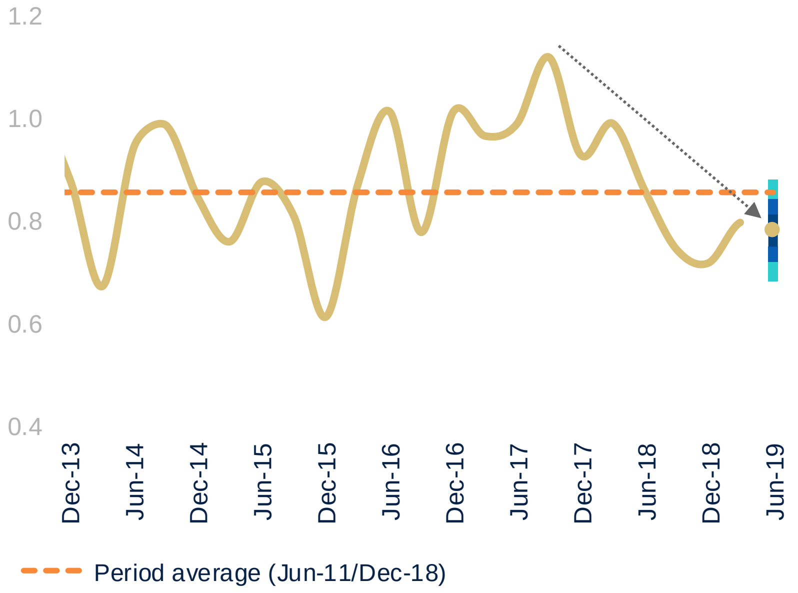


Scenario 1: Measures approved by the US: 25% tariffs on steel, 10% tariffs on aluminum, and 25% tariffs on USD 250 billion in imports from China. China's retaliation: 25% tariffs on USD 110 billion in US imports.
Scenario 2: US measures: measures already approved plus 25% tariffs on all imports from China. China's retaliation: 25% tariffs on USD 130 billion in imports from the US.
Source: BBVA Research

- The trade war causes particularly negative effects for China...
- ... however the US and other countries will also be affected.
- Data shows that trade tensions are already diminishing growth.

Global growth continues on a smooth downward path, despite the rebound in the first quarter

WORLD GDP GROWTH
(FORECASTS BASED ON BBVA-GAIN MODEL, % QoQ)

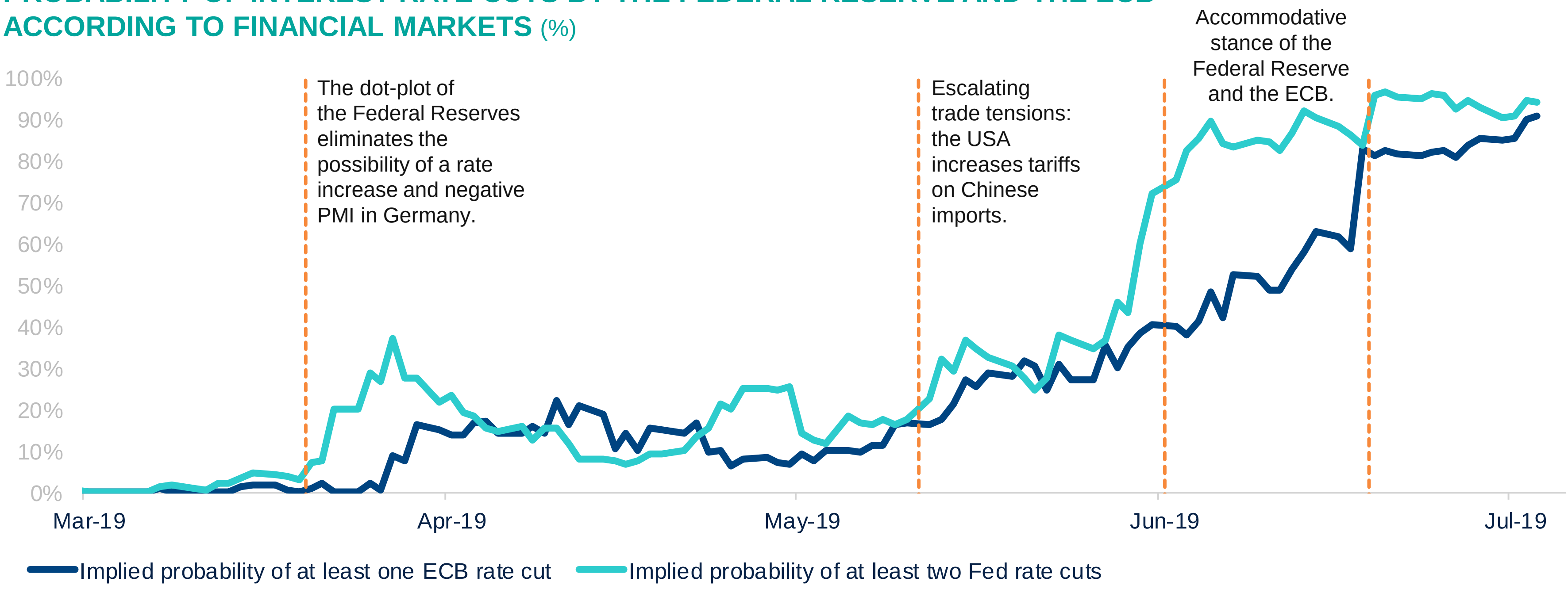


Source: BBVA Research

- Low growth since mid-2018.
- Particularly weak performance in exports and manufacturing.
- Growth in 1Q19 was higher than expected; and no changes are expected for 2Q19.

In an environment of persistent uncertainty and low inflation, central banks have changed their position and consider additional stimuli

PROBABILITY OF INTEREST RATE CUTS BY THE FEDERAL RESERVE AND THE ECB ACCORDING TO FINANCIAL MARKETS (%)



Source: BBVA Research and Bloomberg

Looking ahead, additional expansionary measures are expected to offset the effect of trade tensions

High trade tensions

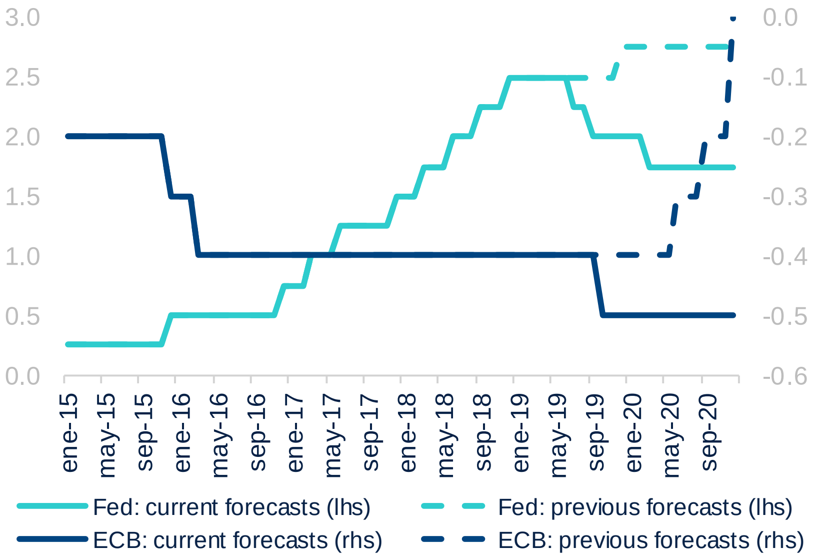
- Protectionism has already caused irreversible damage.
- The strategic rivalry between the US and China will not disappear.
- Uncertainty will continue to weigh on investment decisions.

New stimulus measures

- The Federal Reserve and the ECB: short-term rate cuts.
- China: additional stimuli.
- The new measures will keep financial tensions limited.
- The drop in oil prices.

The counter-cyclical effort will continue to be led by the central banks

THE FEDERAL RESERVE AND THE ECB: INTEREST RATES (%, END OF PERIOD)



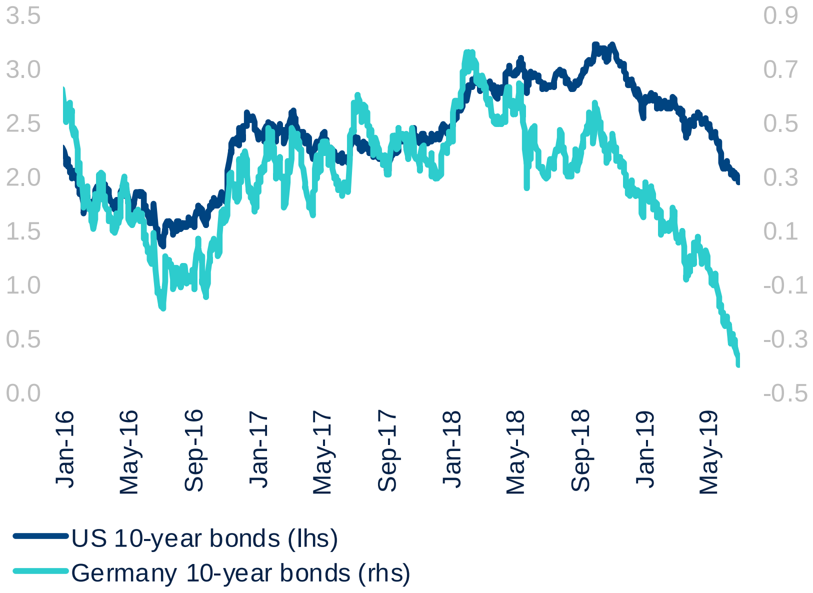
(*) Deposit interest rates in the case of the ECB.
Source: BBVA Research

- The risks to growth and low inflation create a margin **for lower rates for longer periods.**
- **Federal Reserve:** cuts up to 75 bps.
- **ECB, new measures expected:**
  - 10 bps cut from deposit rates in 3T19.
  - staggered deposit system.
  - strengthened forward guidance.
- In **China**, fiscal policy will also play a role in the effort to sustain growth.

In financial markets, there is a strong safe-haven effect

SOVEREIGN DEBT YIELDS

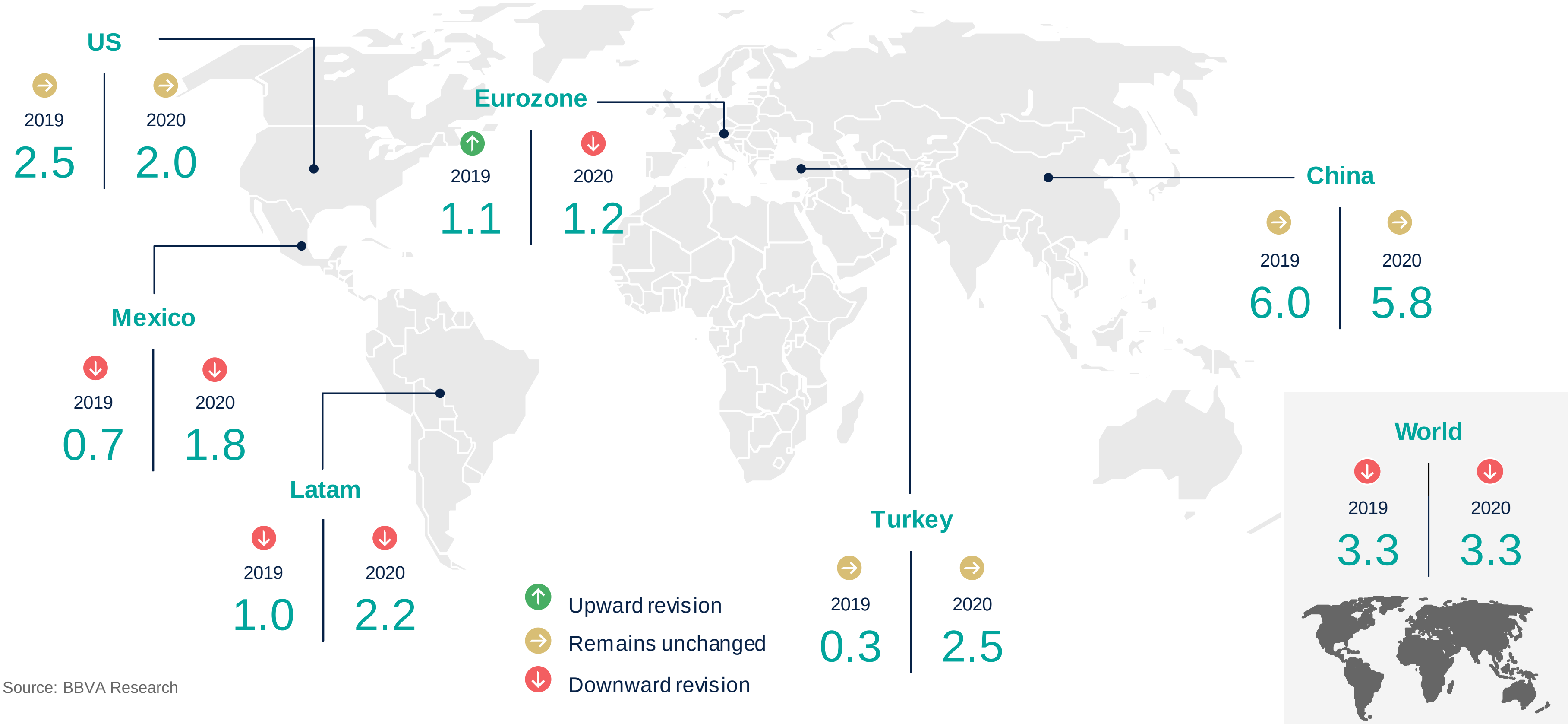
(%)



Source: BBVA Research and Bloomberg

- **Very low sovereign debt yields** due to trade tensions and growth risks.
- The shift of the Federal Reserve and the ECB prompted a **search for profitability and** earnings in the peripheral markets...
- **...without generating a generalized risk appetite.**

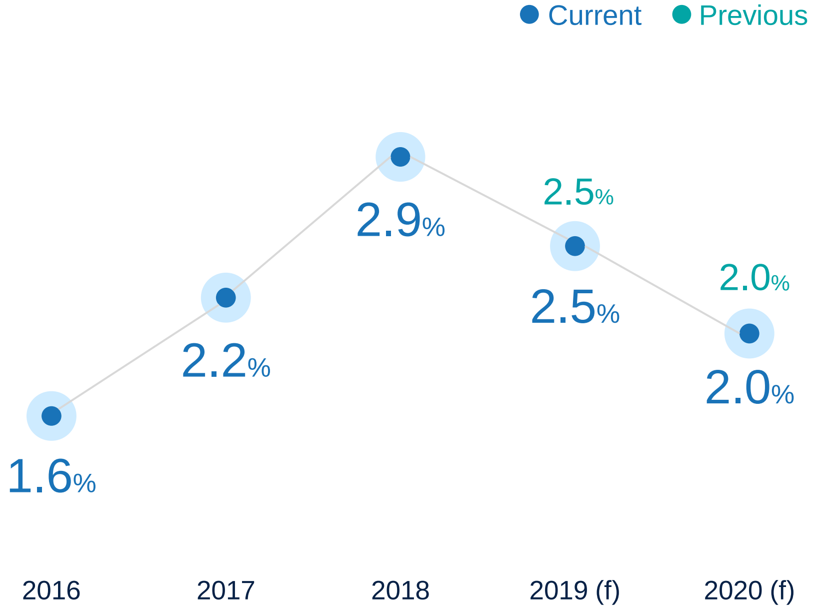
Global growth will stabilize at relatively lower levels



Source: BBVA Research

USA: growth will slow down, with greater support than expected from the Federal Reserve

GDP GROWTH
(%)

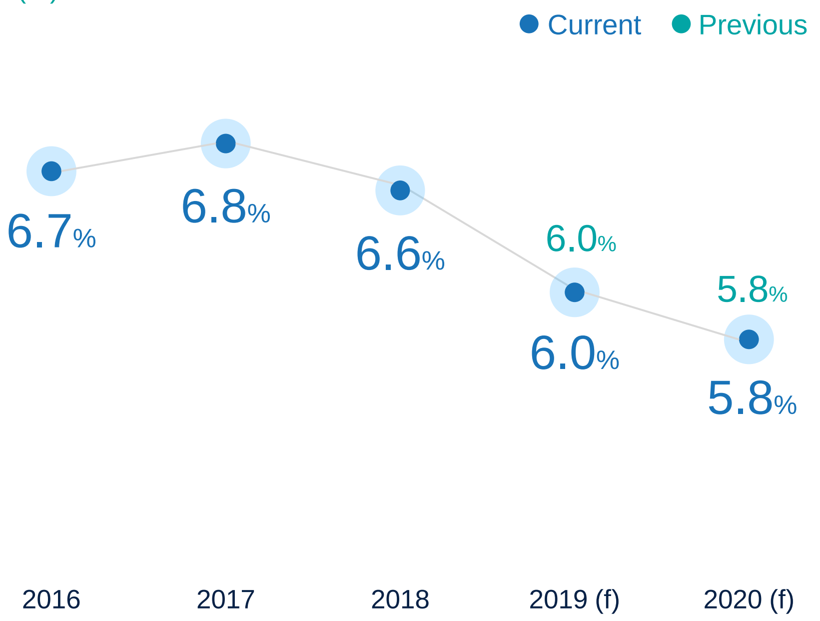


(f) Forecasts.
Source: BBVA Research

- GDP growth will approach potential growth.
- Core inflation will remain below the 2% target.
- The likelihood of recession remains high, skewing risks downward.

China: additional stimulus measures to counter the effects of trade tensions

GDP GROWTH
(%)

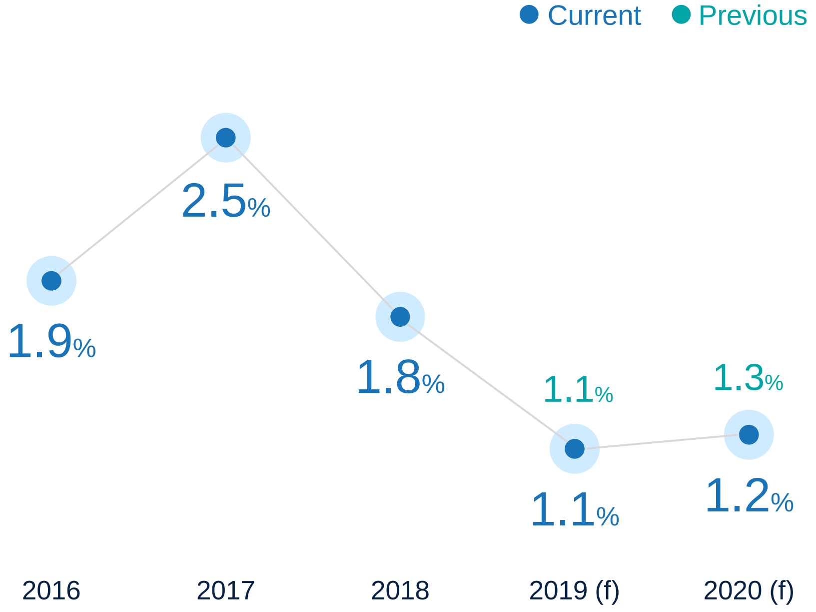


(f) Forecasts.
Source: BBVA Research

- Additional stimulus measures:
  - Debt issuance by regional governments.
  - Focused monetary stimulus.
  - Increase in the public deficit.
- Better prospects for consumption than for exports and investment.
- Risks: sudden slowdown, disorderly deleveraging, and trade war.

Eurozone: more modest growth looking ahead due to industry weakness and uncertainty

GDP GROWTH
(%)

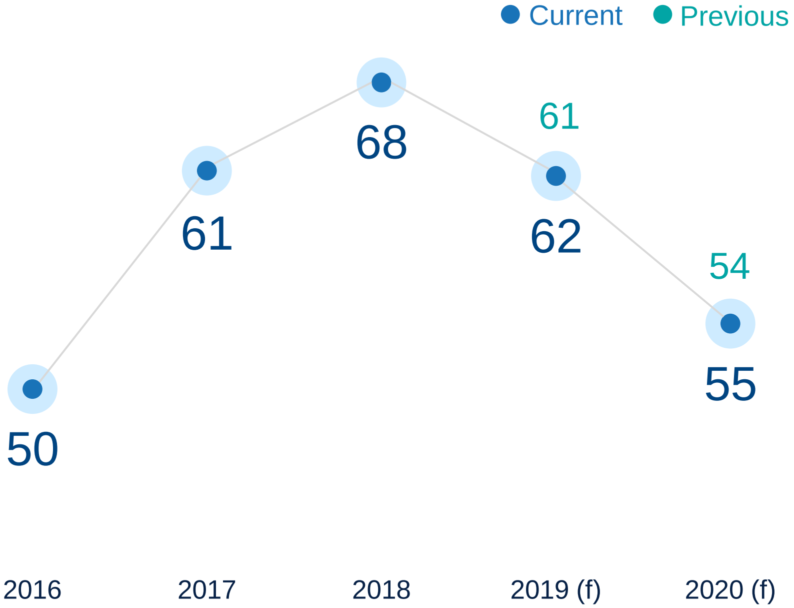


(f) Forecasts.
Source: BBVA Research

- Uncertainty remains high, due to trade issues and Brexit.
- Monetary policy will particularly support domestic demand.
- A somewhat expansive fiscal policy.
- Gradual increase in core inflation.

Declining oil prices will provide some support to the global economy

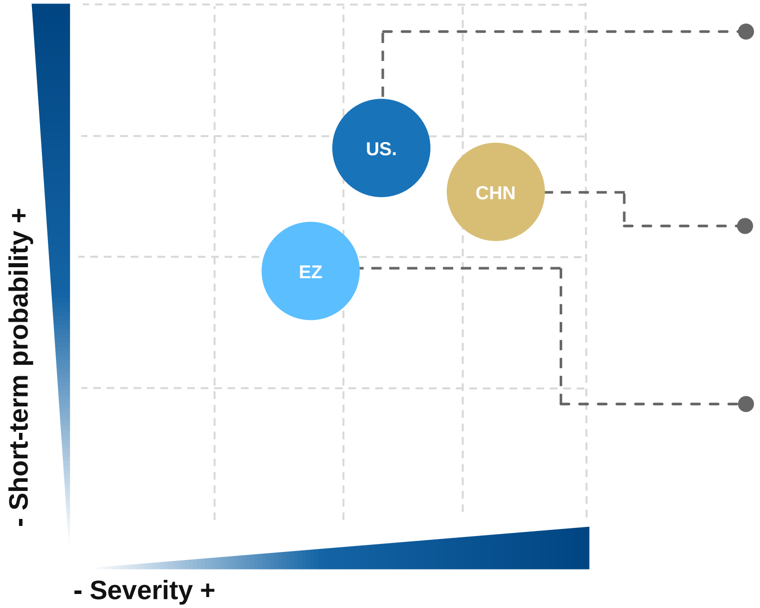
PRICE OF OIL
(DOLLARS PER BARREL)



(f) Forecasts.
Source: BBVA Research

- Crude oil demand will be affected by **weaker global growth**.
- **The increase in production in the US** will help keep prices under control.
- Production cuts by OPEC+ and supply disruptions will support prices.

Global risks: rising on account of the escalation in protectionism, mainly due to the potential impact on China



- Economic downturn: very high
- Protectionism: higher

- Protectionism: higher
- Disorderly deleveraging: relatively greater.

- Growth issues: relatively high
  - Brexit
  - Italy:
- Protectionism: limited, yet still growing.

Source: BBVA Research

Trade war between the US and China: high risk and high probability of non-resolution.
Financial vulnerabilities may increase the severity of risks.

02

The economy will maintain a stable growth path in 2019 and 2020

Main messages

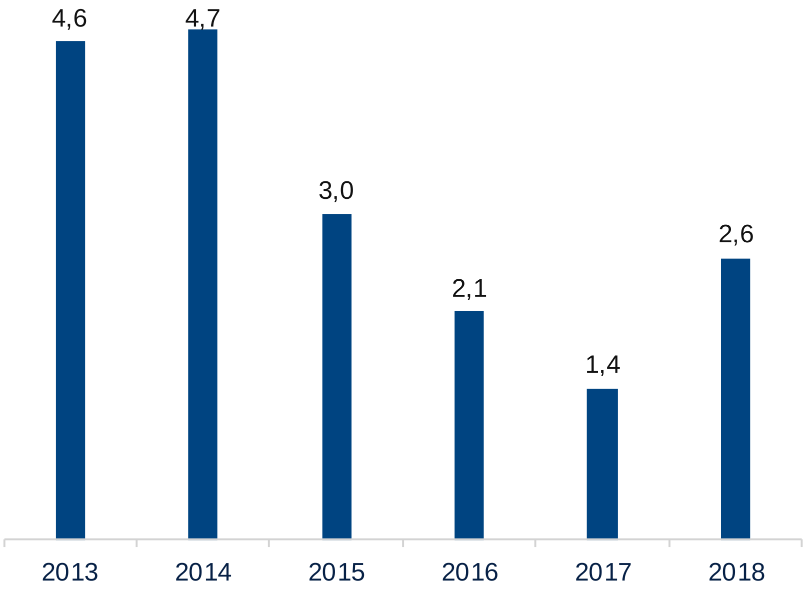
Recent data show a gradual recovery in growth. In the second half of 2017 GDP grew 1.4%, in the two halves of 2018 the variation of GDP was 2.5% and 2.7%, in order. In the first half of 2019, average growth will stand at 2.7% and will accelerate to 3.2% in the second half of this year.

Investment will grow in 2019 thanks to the contribution of civil works and machinery and equipment and in 2020 by the recovery of investment in housing and non-residential buildings. Investment in machinery and equipment will be supported by the improved performance of the manufacturing and oil industries. On the other hand, private consumption will maintain a stable growth rate, limited by the recent deterioration of the labor market and low levels of household confidence.

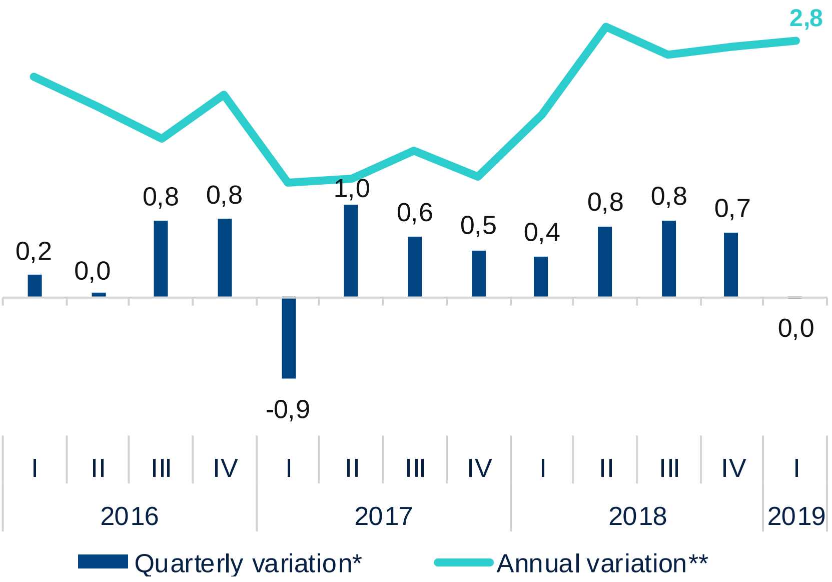
We estimate that 2019 and 2020 growth will be at 3.0%. Domestic demand will be the main support for this estimate.

The economy began its recovery process in 2018 in a slow and very gradual but also orderly manner

GDP
(ANNUAL VARIATION, %)



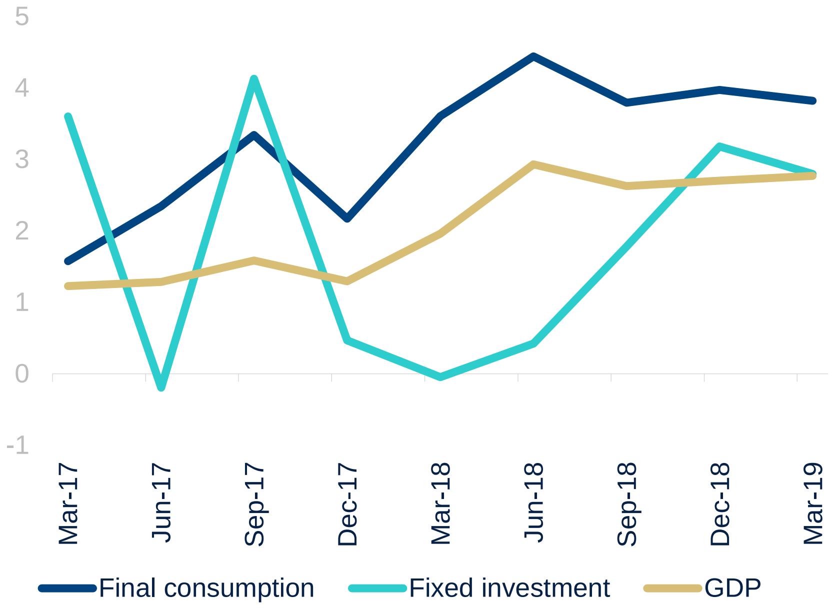
GDP
(INTER-ANNUAL AND INTER-QUARTERLY VARIATION, %)



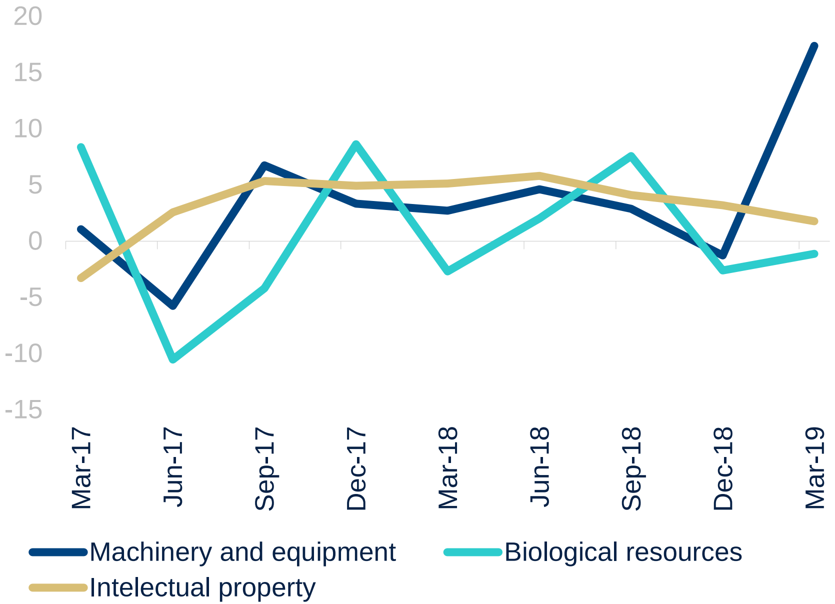
Source: BBVA Research based on DANE data.

Growth was driven more by final consumption than by investment, although the latter is recovering through machinery

FINAL CONSUMPTION, INVESTMENT AND GDP
(ANNUAL VARIATION, %)



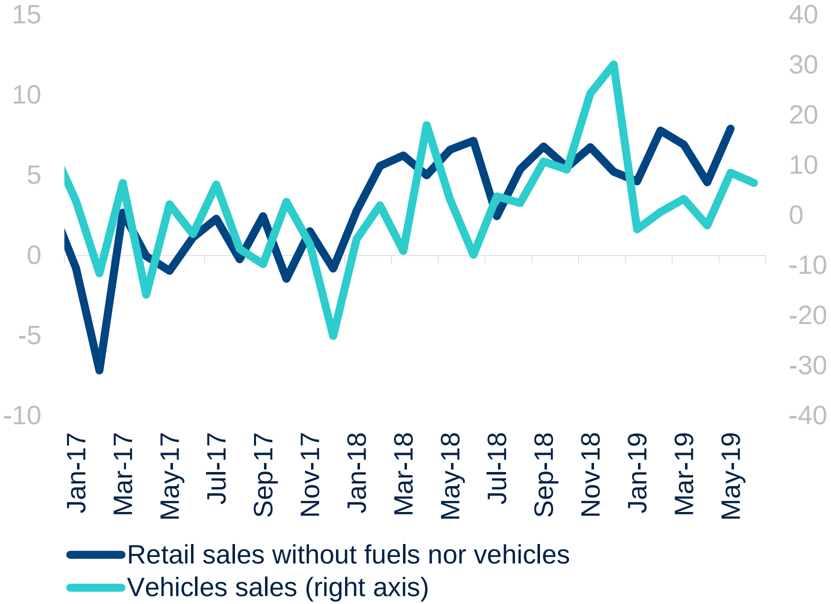
INVESTMENT OTHER THAN CONSTRUCTION
(ANNUAL VARIATION, %)



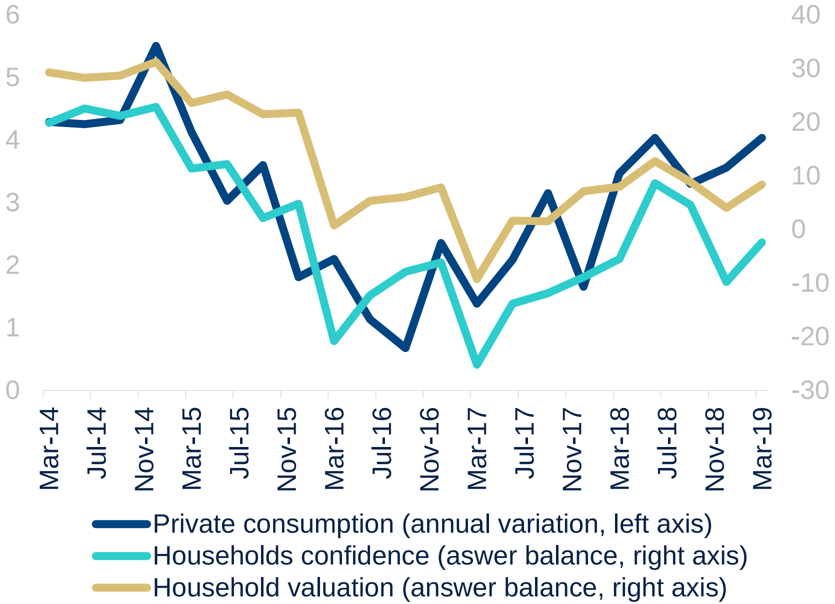
Source: BBVA Research based on DANE data.

Consumption continued to show good leading indicators in the second quarter of 2019, despite weak confidence

RETAIL SALES AND AUTOMOBILE SALES
(ANNUAL VARIATION, %)



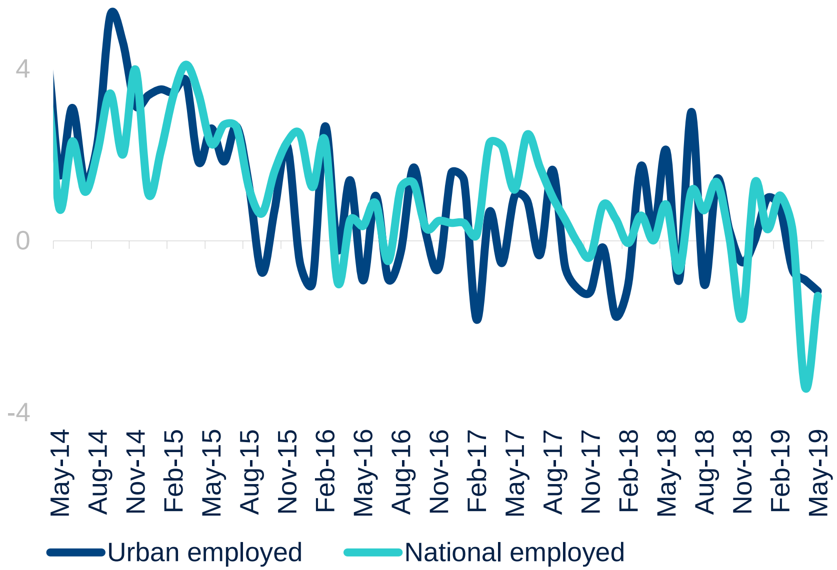
PRIVATE CONSUMPTION AND CONFIDENCE
(ANNUAL VARIATION AND RESPONSE BALANCE, %)



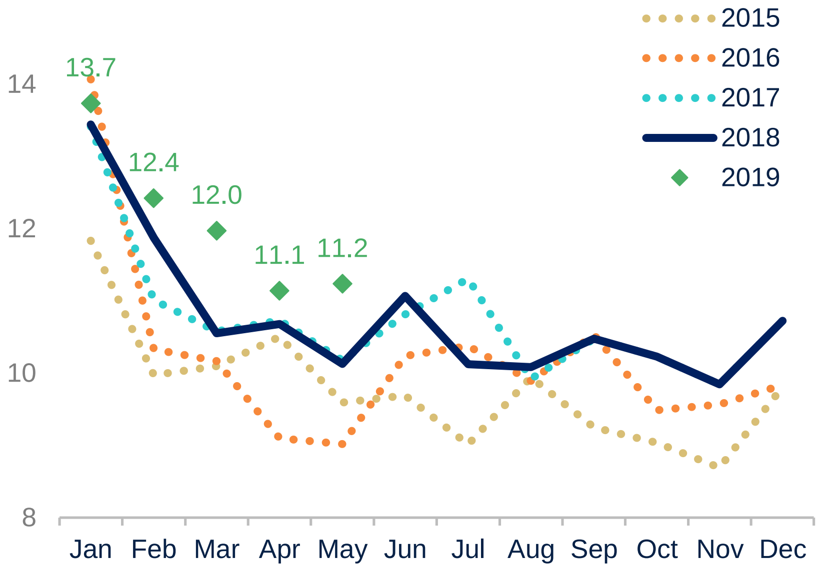
Source: BBVA Research based on data from DANE, Fenalco, and Fedesarrollo

Lower job creation limits the expansion of consumption, although a good number of salaried employment is maintained

JOB CREATION
(ANNUAL VARIATION, %)



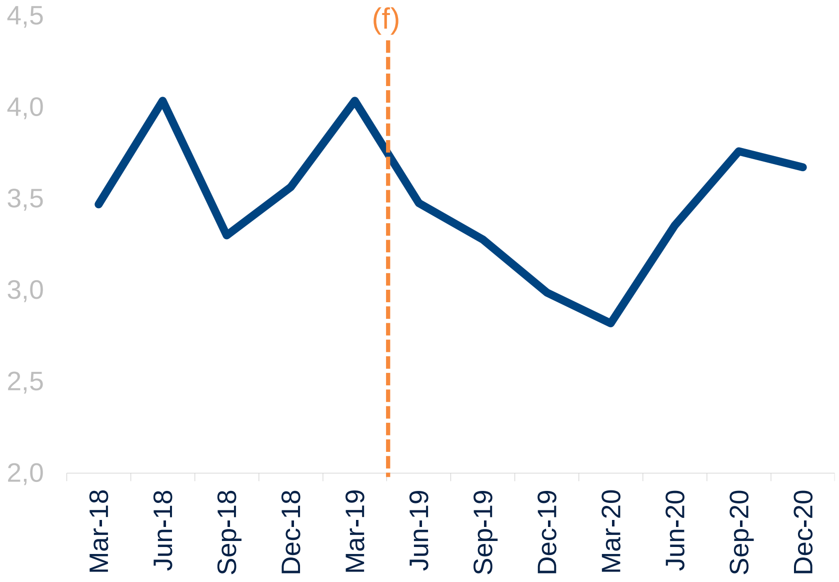
URBAN EMPLOYMENT BY TYPE
(THOUSANDS OF PEOPLE, %)



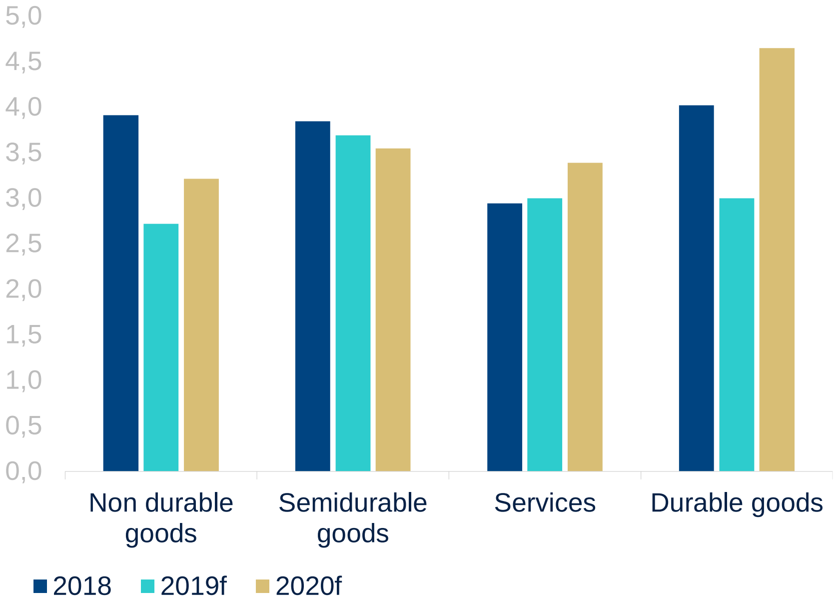
Source: BBVA Research based on DANE data.

Although consumption will continue to contribute the most to GDP growth. Within consumption, durable goods will accelerate in 2020

PRIVATE CONSUMPTION FORECAST
(ANNUAL VARIATION AND CONTRIBUTION, %)



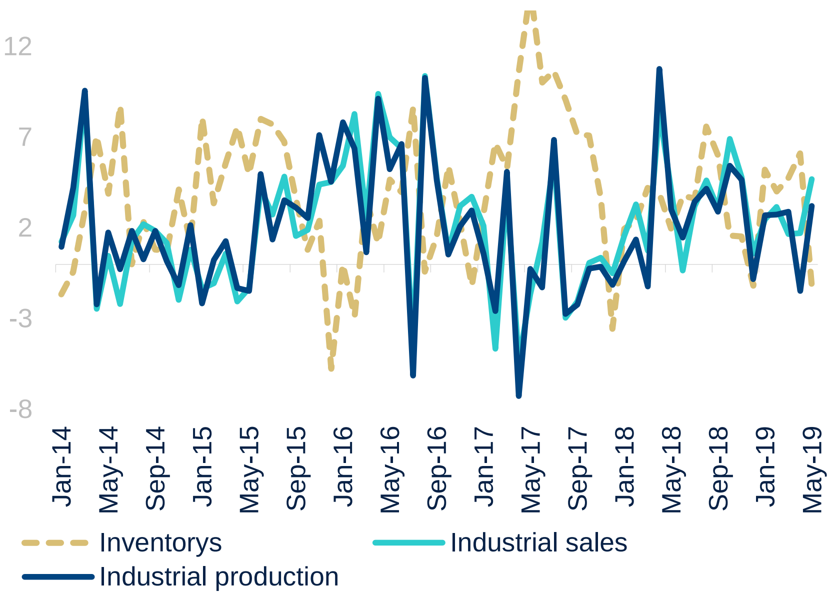
PRIVATE CONSUMPTION BY COMPONENT
(ANNUAL VARIATION, %)



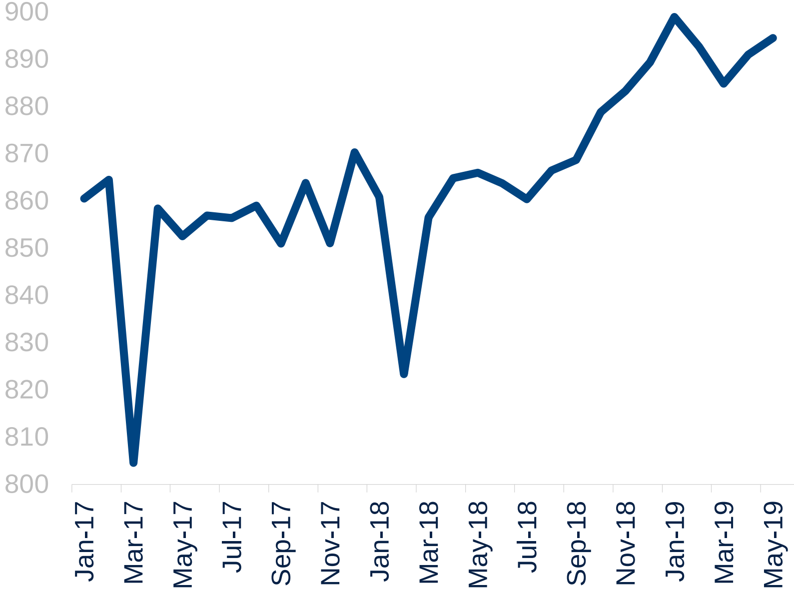
Source: BBVA Research based on DANE data.

On the contrary, the investment path seems to be positive looking ahead, as industrial, oil, and coffee production is growing

INDUSTRIAL PRODUCTION AND INVENTORIES
(ANNUAL VARIATION AND RESPONSE BALANCE, %)



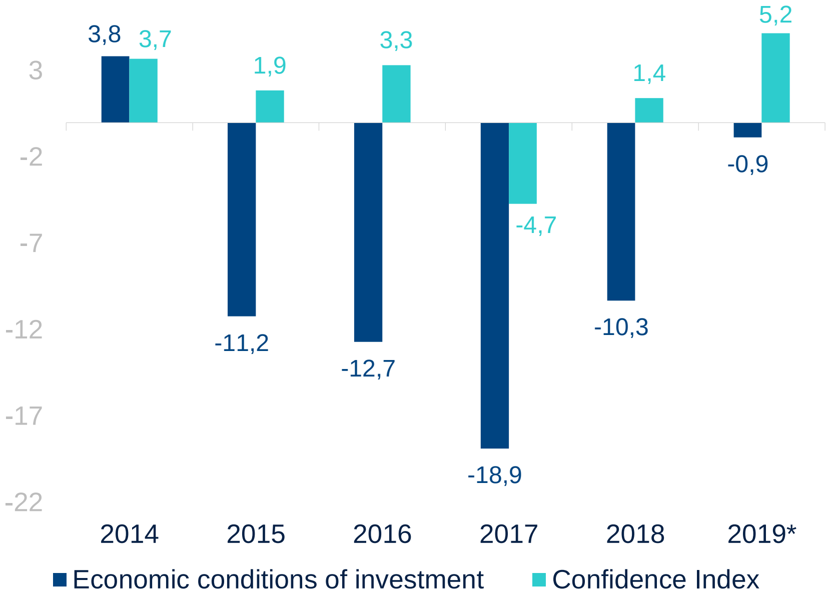
OIL AND COFFEE PRODUCTION
(THOUSANDS OF BARRELS PER DAY AND BAGS PER MONTH, %)



Source: BBVA Research based on DANE data.

Increased use of industry capacity and positive assessment of investment conditions by industry anticipate future investment

INVESTMENT CONDITIONS AND INDUSTRIAL CONFIDENCE (RESPONSE BALANCE, %)

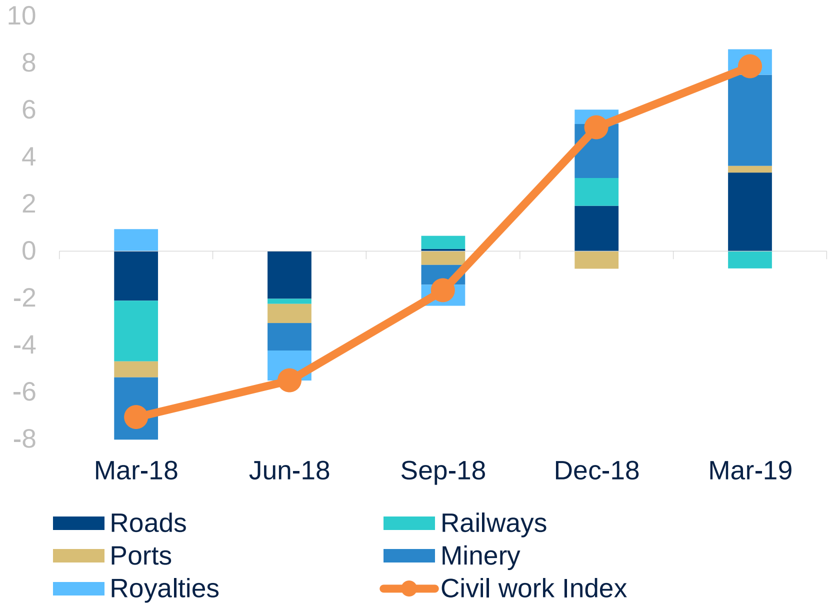


Source: BBVA Research based on Fedesarrollo data

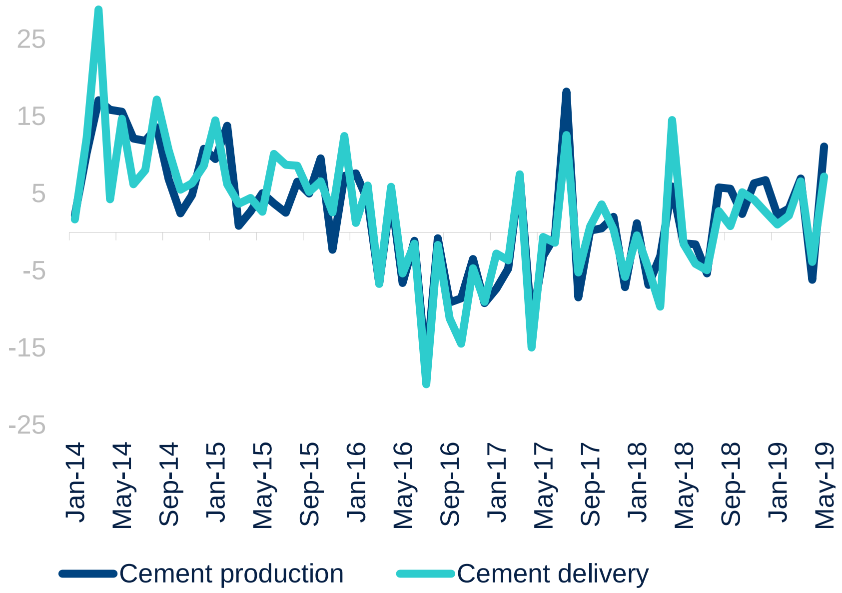
- In addition, imports of capital goods have shown an outstanding dynamic. In the first four months of the year they grew 11.3% annually (vs. 1.9% annually in the same period a year ago).

Investment will be supported by the good performance of civil works, which will continue to be positive judging by cement figures

CIVIL WORKS INDEX BY TYPE
(ANNUAL VARIATION AND CONTRIBUTION, %)



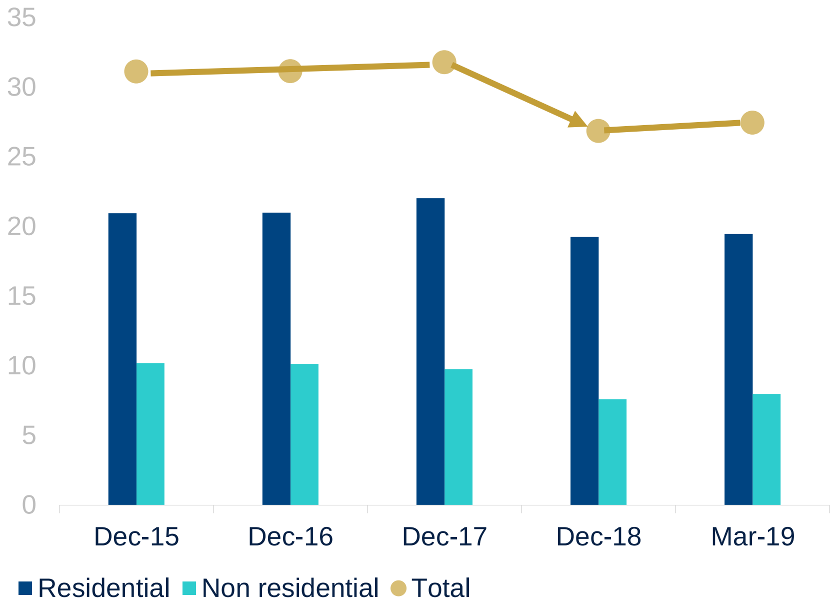
CEMENT PRODUCTION AND DISPATCHES
(ANNUAL VARIATION, %)



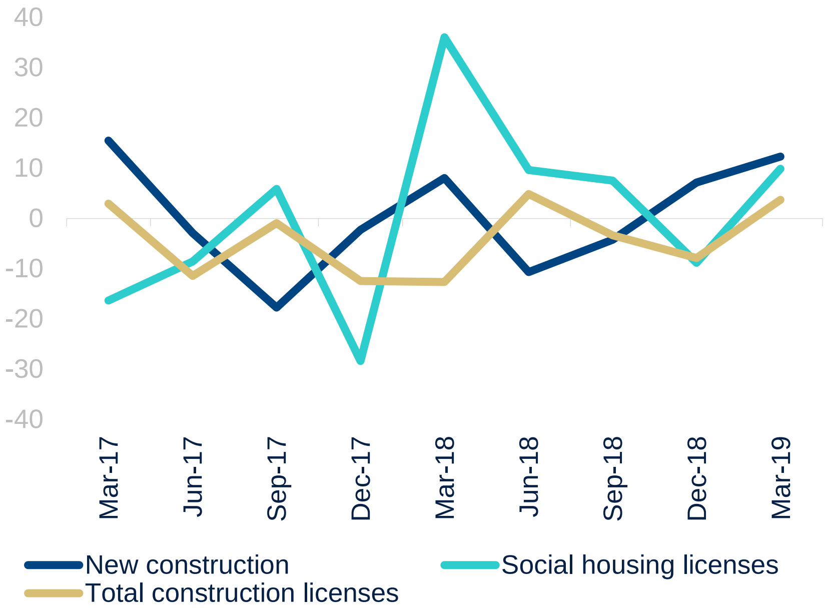
Source: BBVA Research based on DANE data.

On the contrary, buildings will contribute positive to the GDP in 2020, The recent upturn in licenses will take time to materialize

BUILDING WORKS IN PROCESS
(MILLION SQUARE METERS, %)



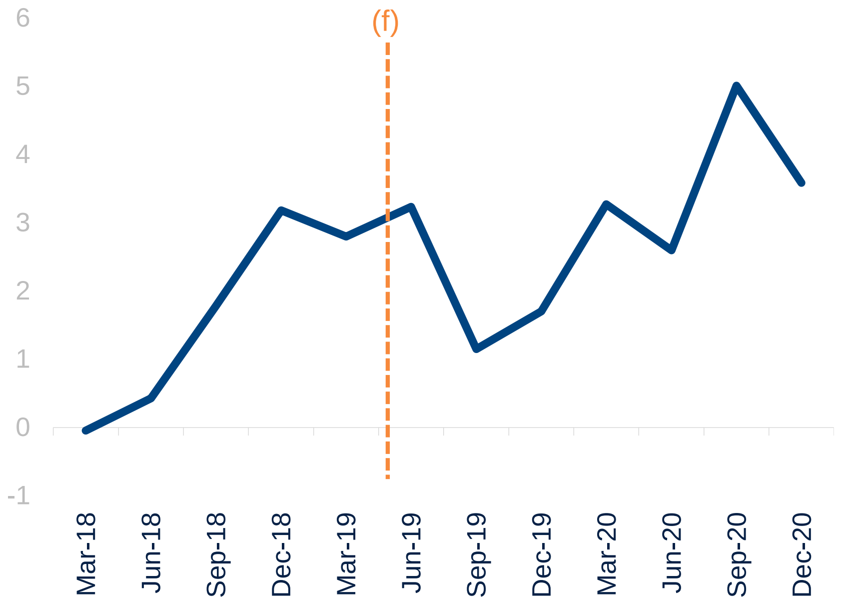
NEW WORKS AND HOUSING LICENSES
(ANNUAL VARIATION, %)



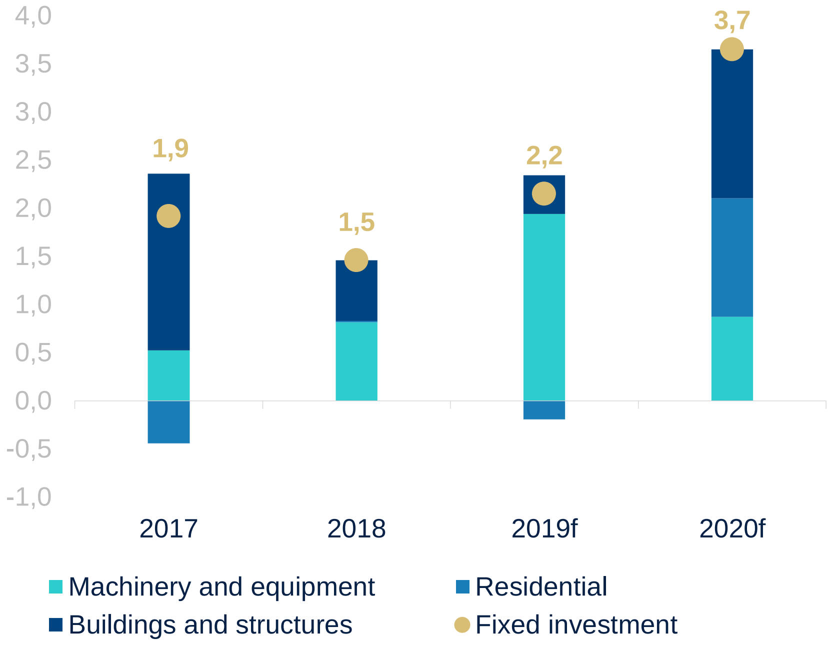
Source: BBVA Research based on DANE data.

Investment: good growth in machinery and equipment this year and in buildings in 2020. Construction investment is 62% of the total

INVESTMENT
(ANNUAL VARIATION, %)



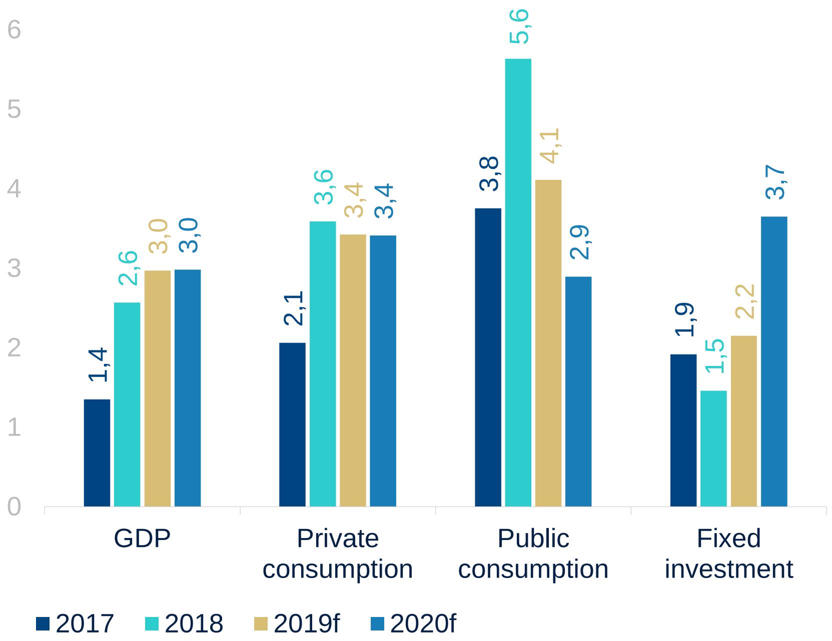
INVESTMENT CONTRIBUTIONS
(ANNUAL VARIATION AND CONTRIBUTION, %)



Source: BBVA Research based on DANE data.

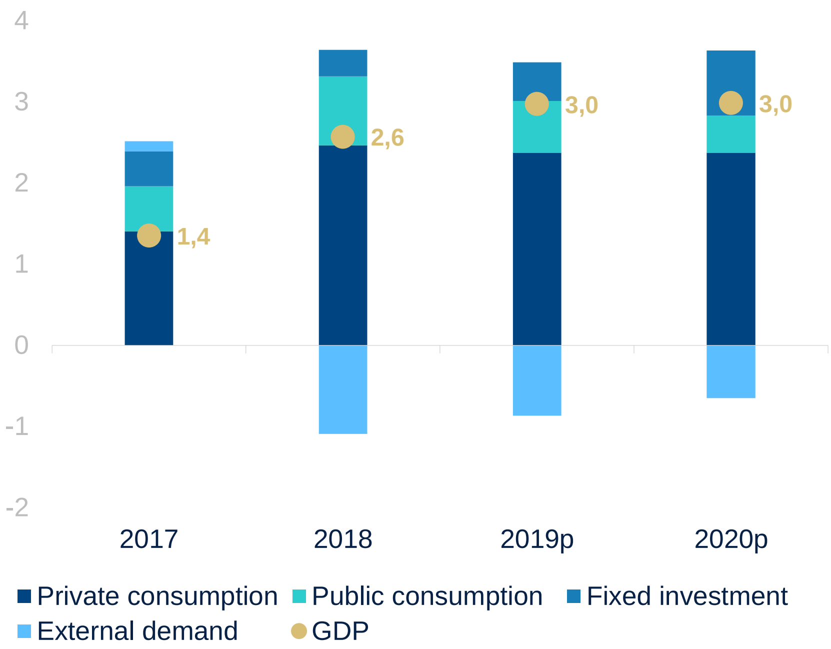
Thus, growth projection is based on the stability of private consumption, the slowdown of public consumption, and investment accelerating

CONSUMPTION, INVESTMENT AND GDP
(ANNUAL VARIATION, %)



Source: BBVA Research based on DANE data.

CONTRIBUTIONS TO GDP GROWTH
(ANNUAL VARIATION AND CONTRIBUTION, %)



Growth up to 2020, although slowly recovering, will also have a better sectorial balance sheet

Will accelerate

- Construction
- Entertainment
- Agriculture
- Financial services
- Taxes
- Industry
- Trade

Will remain stable

- Public services
- Real estate services
- Telecommunications
- Professional services

Will slow down

- Government
- Mines

03

The Banco de la República will keep its interest rates stable for a long time

Main messages

Central Bank will keep its interest rates stable for a long time, leaving them unchanged in the 2019-2020 horizon, at least, but we must not rule out that it will be until 2022 as we expect for the FED.

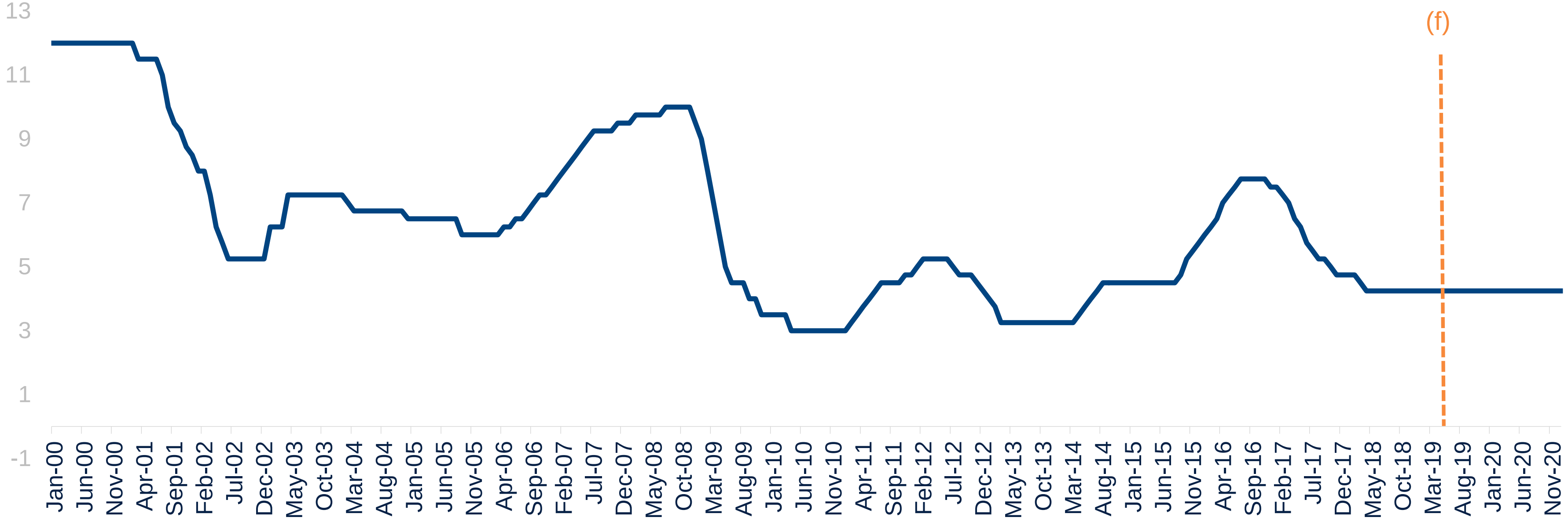
The more flexible global monetary policy, the presence of moderate growth rates in Colombia and controlled inflation close to target of Central bank will allow the Central Bank to maintain its stable interest rate.

We expect inflation stands at 3.3% by the end of 2019 and 3.2% by the end of 2020, figures that, although close to the central goal of the Banco de la República (3.0%), do not coincide exactly with that goal.

One issue that will be on the Central Bank's radar is the persistence of high current account deficits, in line with increased imports of capital goods. Our projection is that in 2019 the current account deficit could reach 4.4% of GDP. Then, in 2020, the deficit will be at 3.8% of GDP.

The Central Bank policy rate is expected to remain stable, in line with the slow recovery demonstrated by the Colombian economy

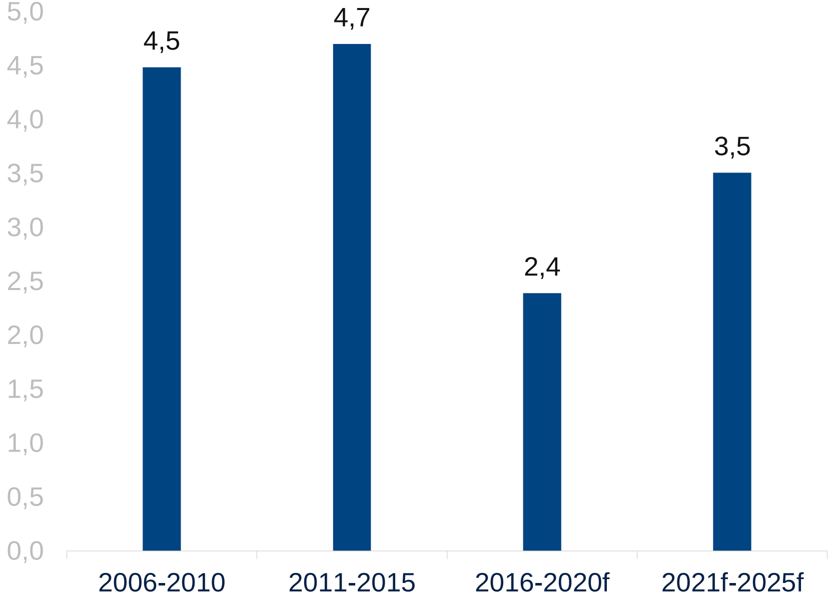
CENTRAL BANK POLICY RATE
(E.A., %)



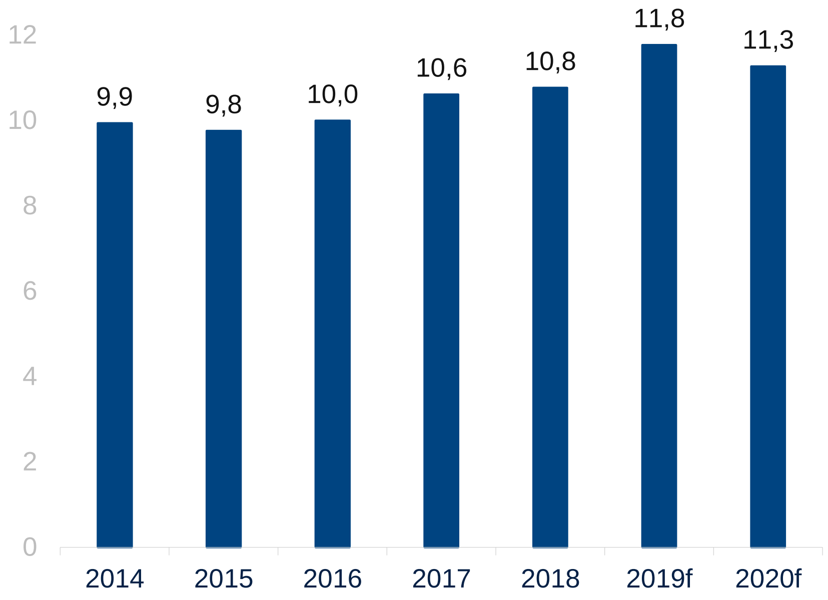
Source: BBVA Research based on data from Banco de la República

The growth of the economy will not involve great pressure from demand or an accelerated closing of the output or employment gap

MEDIUM-TERM GDP GROWTH
(AVERAGE ANNUAL VARIATION, %)



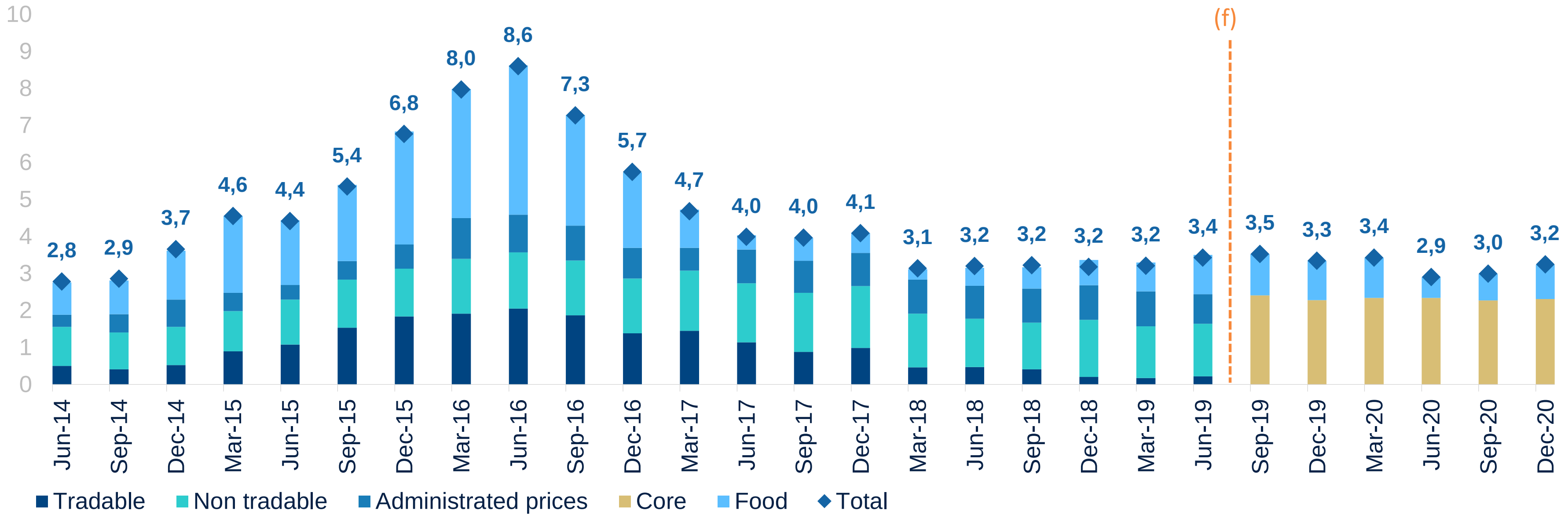
URBAN UNEMPLOYMENT RATE
(ANNUAL AVERAGE, %)



Source: BBVA Research projections based on DANE data

Inflation, although on an upward trend due to food, along with core inflation, will be close to the midpoint of BanRep's goal

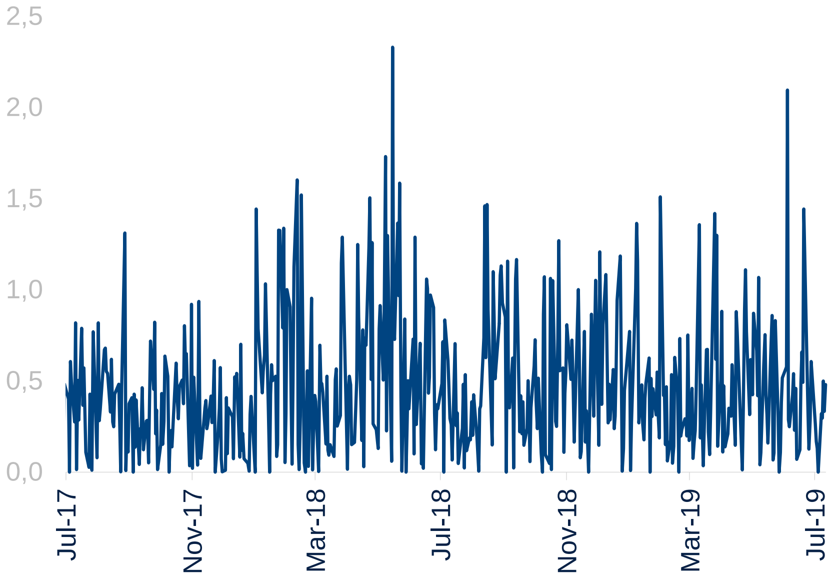
INFLATION BY TYPE AND TOTAL
(ANNUAL VARIATION AND CONTRIBUTION BY GROUP, %)



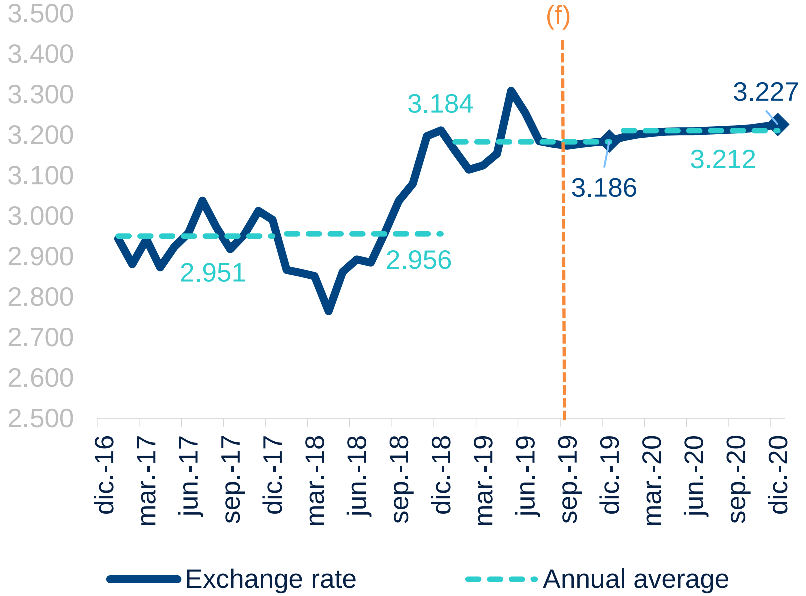
Source: BBVA Research base on DANE data. *Includes regulated, tradable, and non-tradable in the projection period

Tradable inflation will perform better as the exchange rate will move within a narrow range in the coming months

OBSERVED EXCHANGE RATE VOLATILITY
(ABSOLUTE VALUE OF DAILY VARIATION)



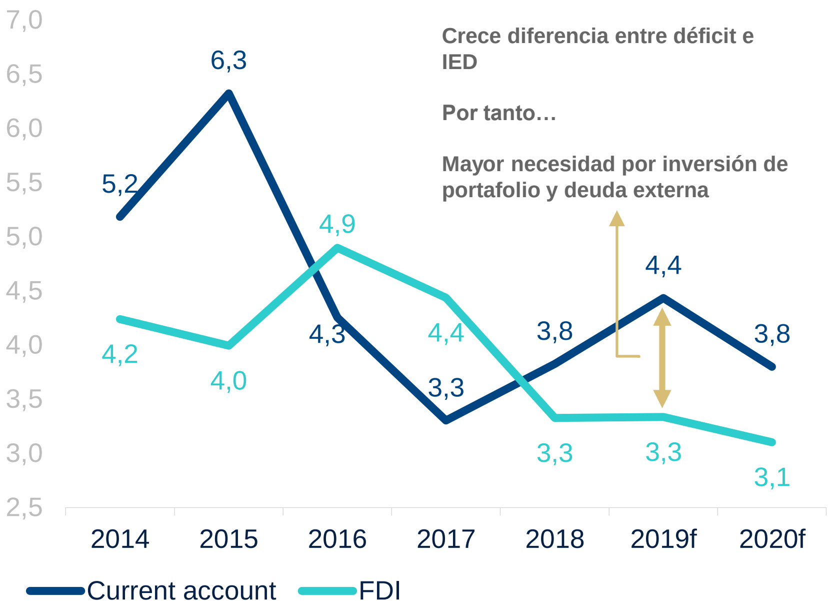
EXCHANGE RATE FORECAST
(MONTHLY AND ANNUAL AVERAGE VALUE, PESOS PER DOLLAR)



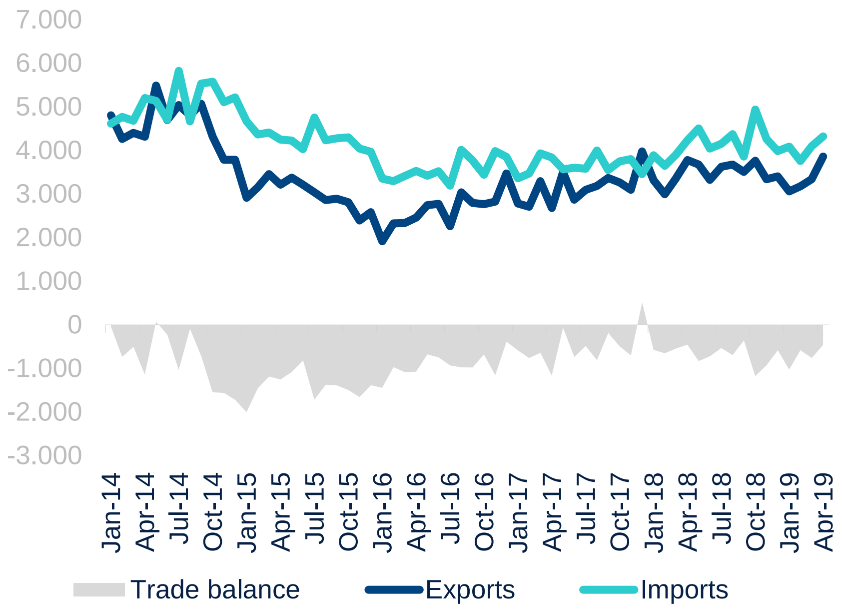
Source: BBVA Research forecasts and calculations with Banco de la República data

BanRep's limiting factor in reducing interest rates will be the high current account deficit level and the trade deficit

CURRENT ACCOUNT DEFICIT AND FOREIGN DIRECT INVESTMENT (% OF GDP)



FOREIGN TRADE (MILLIONS IN USD)



Source: BBVA Research forecasts and calculations with Banco de la República data

In addition, meeting fiscal targets in 2019-2021 depends drastically on the success of the asset sales plan that was laid out

CENTRAL NATIONAL GOVERNMENT 2018-2021 BALANCE SHEET
(% OF GDP)

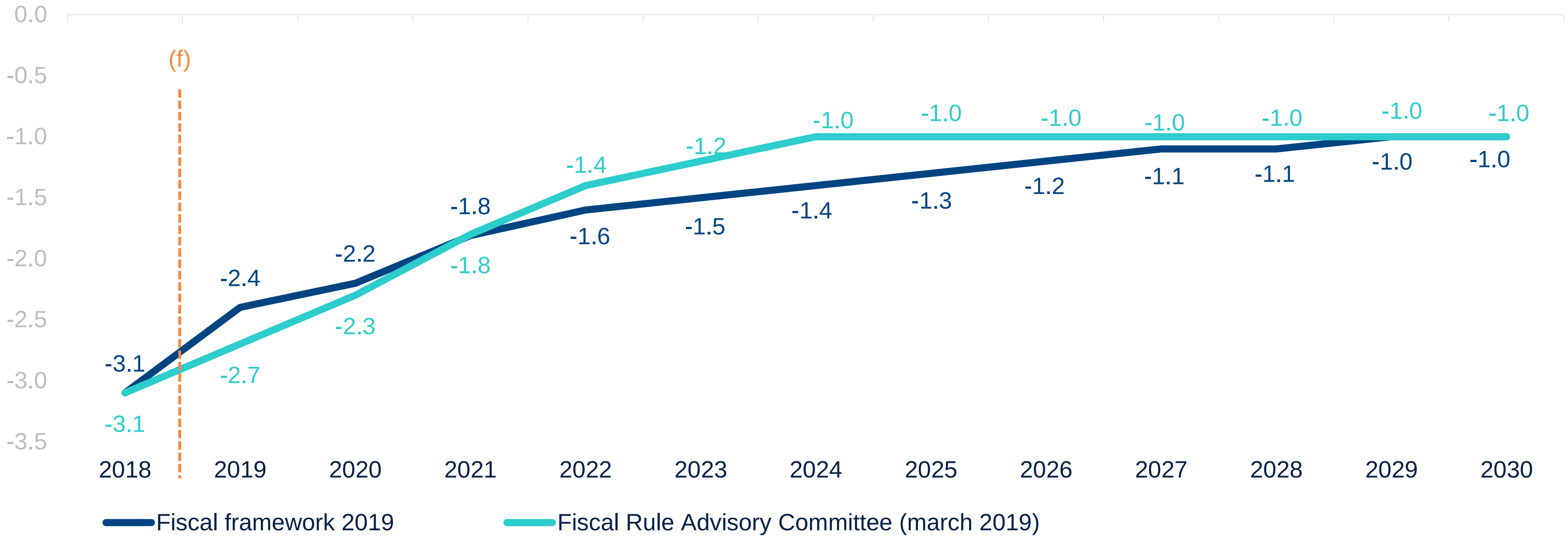
	Government scenario				
	2018	2019f	2020f	2021f	
Total income	15.3	16.6	16.5	16.5	
Tax income	13.9	14.3	14.2	14.3	
Non tax income	1.5	2.3	2.3	2.3	Includes asset sales
Total expenditure	18.4	19.0	18.7	18.4	
Deficit	-3.1	-2.4	-2.2	-1.8	
Government debt (%GDP)	50.6	51.5	49.9	48.3	

- The achievement of a deficit of 2.4% of the GDP in 2019 requires, in addition to the revenue from the 2018 tax reform, that COP 6 billion worth of assets are sold, as government expenditure has increased by 10% with respect to 2018 expenditure.
- In 2020, the government will also have asset sales of 0.8 p.p. of the GDP. However, it will have to overcome the dilution of revenue from the 2018 tax reform in light of the exemptions and discounts it laid out.

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

Similarly, a reduction in the medium-term deficit depends on the government generating new revenue and/or significantly reducing spending

FISCAL DEFICIT OF THE CENTRAL NATIONAL GOVERNMENT
(% 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

Principal macroeconomic variables

TABLE A1. MACROECONOMIC FORECAST

	2015	2016	2017	2018	2019f	2020f
GDP (% y/y)	3,0	2,1	1,4	2,6	3,0	3,0
Private consumption (% y/y)	3,1	1,6	2,1	3,6	3,4	3,4
Public consumption (% y/y)	4,9	1,8	3,8	5,6	4,1	2,9
Fixed investment (% y/y)	2,8	-2,9	1,9	1,5	2,2	3,7
Inflation (% y/y, eop)	6,8	5,8	4,1	3,2	3,3	3,2
Inflation (% y/y, average)	5,0	7,5	4,3	3,2	3,4	3,1
Exchange rate (eop)	3.149	3.001	2.984	3.250	3.186	3.227
Devaluation (%, eop)	31,6	-4,7	-0,5	8,9	-1,9	1,3
Exchange rate (average)	2.742	3.055	2.951	2.956	3.184	3.212
Devaluation (%, eop)	37.0	11,4	-3,4	0,2	7,7	0,8
Policy interest rate (%, eop)	5,75	7,50	4,75	4,25	4,25	4,25
Tasa DTF (%, eop)	5,2	6,9	5,3	4,5	4,5	4,5
Fiscal balance Central National Government (% GDP)	-3,0	-4,0	-3,6	-3,1	-2,4	-2,2
Current account (% GDP)	-6,3	-4,3	-3,3	-3,8	-4,4	-3,8
Unemployment urban rate (%, eop)	9,8	9,8	9,8	10,7	11,0	10,7

(*) Contribution to GDP growth. (f) Forecast.
Source: BBVA Research

Principal macroeconomic variables

TABLE A2. 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

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