Colombia Economic Outlook

Colombia will continue to consolidate growth amid considerable headwinds from the foreign sector

Fourth Quarter 2019

Economic growth figures for the first half of the year position Colombia as one of the best-performing economies not only in Latin America but anywhere in the world. However, Colombia's relatively stronger performance is more the result of deteriorating conditions in comparative countries rather than any exceptional development of the Colombian economy, with growth standing at just 3.0% in the first half of the year, 40 bp more than the figure for all of 2018. In fact, Colombia's "stronger momentum" is chiefly due to the decoupling of economic cycles with other countries in the region, particularly with economies with close links to metals compared to economies with close links to hydrocarbons, such as Colombia. While there has been a close correlation between these commodities over the last decade, a time lag of between 12 and 18 months has emerged between the two, with oil-based economies reacting more slowly than those associated with metals. As such, the more positive figures for Colombia may simply be a transitional effect of the decoupling of these economic cycles, and some easing in domestic spending could be expected between 2019 and 2020.

On the other hand, the end of the summer season in the northern hemisphere was shaped by major trade tension between China and the United States, certain key geopolitical issues—including Brexit and the attacks on Saudi Arabian oil facilities—and several monetary relief measures that was judged largely ineffective by the markets (for example the Federal Reserve rate cut). Consequently, as in the second quarter of the year, risk perception was again exacerbated, especially among emerging economies, which were shaken by considerable currency deterioration against the US dollar.

A more negative global climate: trade tensions, political uncertainty, a slowdown in activity and a shift toward more secure financial assets

Tensions between the US and China rose significantly yet again in August following a new bilateral increase in tariffs and the US government officially accusing China of currency manipulation, after the Chinese yuan slipped to its lowest level in over 11 years. Although negotiations have resumed in recent weeks, uncertainty remains high and recent data appears to confirm that growing protectionism and uncertainty are behind the slowdown in global activity. There has been a loss of buoyancy in exports, the manufacturing sector and investment. There are further contributing factors, such as concerns over a no-deal Brexit, the previously mentioned doubts about the effectiveness and scope of monetary policy, the upturn in oil prices following the attack on production facilities in Saudi Arabia and geopolitical tensions in other countries.

In geographical terms, this slowdown is primarily notable in China and the eurozone, but also in the US. Trade tensions are having a particularly negative effect on China, in combination with the structural slowdown of the Chinese economy. In the eurozone, recent negative surprises in terms of growth are also linked to fears of a no-deal Brexit. Finally, in the US, where the slowdown has been more gradual, growth is converging with its potential rate following the waning of the fiscal stimulus applied in 2018.

Given the high level of uncertainty and signs of moderation, and considering that inflation remains generally low, in recent months central banks have announced further monetary easing measures. In the US, the Federal Reserve cut interest rates by 50 bp to a range of between 1.75% to 2.0% as of July. This prompted a stream of similar actions from several central banks around the world. Measures taken in Europe aimed at expanding liquidity were of particular note, including a rate cut (10 bp) and additional stimuli. In China, in addition to actions in the fiscal area and exchange rate depreciation, a 50 bp cut in reserve requirements for banks was announced. Furthermore, official interest rates were cut from 4.35% to 4.20% between July and September.

Although there are growing doubts regarding the ability of monetary policy to further underpin economic activity, at least in the US and Europe, recent measures have helped to keep financial tensions under control. For example, the CBOE Volatility Index (VIX), which had risen at the beginning of August following trade tensions, eased more recently. However, markets remain cautious and sovereign debt yields are holding at particularly low levels in both Europe and the US. While low yields stimulate the search for alternative financial investments, risk aversion remains relatively high on a macroeconomic level, as seen, for example, in the recent weakness of most currencies against the US dollar.

Downward revision of global growth: uncertainty is set to remain high and countercyclical policies will not prevent a slowdown

Our economic forecasts are based on the key assumption of ongoing tensions between the US and China. A partial trade agreement between the two countries, with mutual concessions, is the most likely outcome, even in the short term. However, it is unlikely that tariffs will return to the levels seen a few months ago and structural and technological conflicts will continue to generate instability all the same. Thus, protectionism and uncertainty are likely to weigh further on global activity, even if, as we expect, the UK's departure from the European Union has no negative impact on the global economy, although the impact on the UK economy, and to a far lesser degree the economies of some eurozone countries, is another matter. With regard to oil prices, despite the heighten tensions in the Middle East following the September attack on the Saudi Arabian oil industry, together with the risk premium associated with what may not be an isolated event, we are assuming that prices will remain under control, declining from around USD 64 per barrel over the remainder of the year to approximately USD 57 by the close of 2020.

Central banks will continue with their accommodating policies, despite the shrinking margin for action and the rising doubts as to the effectiveness of these policies. In particular, in the US we expect the Federal Reserve to slash interest rates by an additional 25 bp in October, while the ECB will likely cut deposit facility rates by -0.10 bp to -0.60%. These exceptionally expansive interest rates could be maintained over an extended period of time, while the risk is that they might be cut even further, especially in the US where there is still some leeway.

Due to this, we have revised downward the growth prospects for the global economy, as well as for the US, China and Europe. Global growth is expected to reach 3.2% in 2019 and 3.1% in 2020, significantly below that recorded in previous years and less than previously expected (3.3% in 2019 and 2020). In the US, following growth of 2.9% in 2018, GDP is set to expand 2.3% in 2019 and 1.8% in 2020 (0.2 pp below what was previously expected in both periods). In China, the rate of GDP expansion is expected to fall from 6.6% in 2018 to 6.0% in 2019 and 5.6% in 2020 (the forecast for this year is therefore unchanged, while that for next year has been lowered by 0.2 pp). Finally, the growth forecast for the eurozone is also unchanged at 1.1% for 2019 but cut by 0.4 pp for 2020 to 0.8%.

Thus, despite lower rates forecast in all three regions, countercyclical policies would help the US and Europe to avoid a recession, which is now more likely than three months ago, and would help China to avert increasing risk and ensure a relatively gentle easing. Notwithstanding this, the risks faced by the global economy are increasingly skewed downward, mainly due to the possibility of a further escalation of trade and political tensions.

At the local level, consumption and investment buoyed activity in the first half of the year. However, traction will be lost over the remainder of 2019 and 2020, leading to slower imports growth

The Colombian economy expanded 3.0% in the first half of 2019, compared to 2.6% for the whole of 2018. This buoyancy was driven by robust trends in domestic demand, both in terms of household consumption, which grew 4.5% in the first half of the year, and an upturn in investment, which accelerated to 4.2% in the same period. External demand had a negative effect on growth, as growth in imports outstripped growth in exports, despite the latter reaching a rate of 3.4% in the first half of the year, which was higher than GDP growth. Over the remainder of the year, domestic demand is expected to abate as a result of tax uncertainty weighing on investment decisions and high exchange rates affecting local purchasing power. Thus, GDP will maintain similar growth over the remainder of 2019, at around 3.0% on average. However, the composition of growth is set to change with private consumption and investment losing prominence, public sector spending playing a larger role and a smaller negative contribution from external demand. Investment should get a fresh boost in 2020, again reaching growth of 4%, but private consumption will slip further to below 4%. Imports are set to suffer a slowdown in 2020, leading to full-year growth of 3.0% but once again with a different composition: a little more investment and a little less consumption and imports.

In the first part of 2019, household consumption gained significant traction despite a deteriorating labor market. The unemployment rate has been on the rise, especially since the end of 2018, and jobs have been slashed, with the final figure for the month of August standing at 562 thousand jobs nationwide during the previous year and 78 thousand jobs lost in the 13 largest cities during the same period. This is accompanied by other indicators with a strong proven correlation with consumption, such as the Fedesarrollo consumer confidence indicator. Confidence deteriorated gradually throughout the year, dipping to its lowest level for 2019 in September. The decoupling between the traditional fundamentals and the impact on consumption could be explained by some of the following hypotheses: (1) increased spending on non-durable goods and services among the migrant population; (2) stronger leverage growth than explained by fundamentals for spending on durable goods, semi-durable goods and some services; (3) a shift in sales trends due to the low-cost retail phenomenon; (4) a change in household spending patterns; and (5) an improvement in household income (indicated by household surveys but not ratified by production sector surveys). Although we have neither sufficient nor adequate data to test any of these hypotheses, the majority would explain the deviation between the drivers of household spending and the private consumption trend. Going forward, we believe the one-off impact of the five factors mentioned above will gradually dissipate and lead household spending to ease toward levels of 3.8% by 2020, compared to the expected growth of 4.3% this year.

In terms of investment, the upturn in the first half of the year was underpinned by the strong performance of civil works, progress in the 4G rollout, mining-related areas and the political cycle of regional governments coming to an end. It was also supported by investment in machinery and equipment, spurred by increased production activity in industry and mining, and by the incentives provided under the 2018 financing law. This has coincided with strong growth in imports, especially in capital goods, having a short-term negative bearing on GDP growth. Going forward, we may see some changes in the trends of these two investment items. High current and anticipated exchange

rates could curb future investment in machinery and equipment, while the opening of new regional and local governments, due in 2020, is often associated with low spending on civil works. However, the housing construction industry, which has been on a negative footing for a number of periods, has the potential for significant growth in 2020. This is partly due to base effects, but also because the market is moving toward restoring its balance, with supply tipped below demand, meaning we can expect a gradual decline in inventories and the start of new construction work. The robust growth in imports, thanks to investment in machinery and equipment, is set to subside. However, we also anticipate a weak performance in exports on account of slower growth among trading partners, low prices for basic materials that could limit profitability and production, and an inability to make use of the good exchange rate to boost exports of other goods. This is perhaps due to an inability to replace the value chain of imported intermediate goods with local solutions.

Growth in domestic demand in excess of GDP growth caused the current account to fall to a deficit of 4.3% of GDP in the first half of the year. This balance showed a larger deficit than posted in 2017, 3.3% of GDP, following the economic adjustment after a drop in oil prices. The deficit growth was largely due to higher imported investment, which might be considered a sign of greater growth capacity going forward. However, despite the fact that the current account deficit will shrink in 2020, international investors regard this as a weak point of the Colombian economy in terms of structural balances, which has rendered it more sensitive to international shocks in terms of exchange rates. Indeed, the Colombian peso was one of the hardest hit currencies anywhere in the world during the recent cycle of risk aversion. We expect further deficit deterioration over the course of 2019, reaching 4.6% of GDP, a figure that should correct to the still high level of 3.9% of GDP as a result of a slowdown in imports in 2020.

Finally, government spending was relatively low in the first half of the year (2.6% per year), associated with public sector wage increases being postponed, which should be corrected in the next GDP publication, a lower payroll for the military and the active austerity implemented by the Ministry of Finance. As a result, around 40 billion pesos in Treasury deposits were held at the Central Bank of Colombia between June and August. We expect higher spending in the second half of the year, reaching growth of 3.8% for the full year. Despite the upturn in the second half of the year, the full-year figure is set to show slower spending growth compared to 2018 (5.6% annual). We believe fiscal austerity will continue into 2020, with public consumption growing 3.0%, largely supported by the opening of regional governments and the lower spending capacity of these governments. This translates into a fiscal deficit of 2.4% in 2019, lower than the figure authorized under the fiscal rule, followed by a fiscal deficit of 2.2% in 2020, also marginally lower than that required under the fiscal rule. These numbers are underpinned by an unorthodox fiscal year, with asset sales used as a source of current income, debt issuances for specific expenses and a number of relatively optimistic assumptions, particularly in terms of growth. This strategy might develop into a significant risk that could lead to a one-notch downgrade from one of the investment agencies that still rates the country at investment grade. Particularly when combined with a large current account deficit.

The exchange rate has therefore acted as the economy's shock absorber, maintaining a mild effect on inflation and an absence of policy action

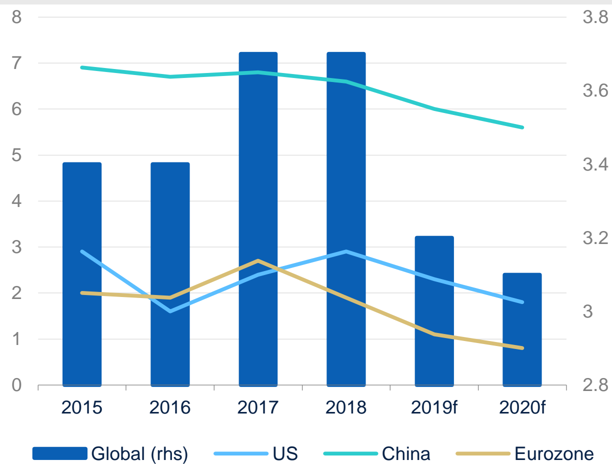
The challenging external scenario, combined with a large current account deficit, created an environment conducive to sharp exchange rate depreciation over the course of the year, especially in the months of April and May, and subsequently in August and September. In September the exchange rate even reached a new record peak of 3,503 pesos per dollar. Movements in recent months have moved away from the fundamentals that have traditionally shaped exchange rate fluctuations, such as country risk, which is close to its lowest level, and oil, with a Brent barrel price of USD 62 this year; figures that do not justify the current exchange rate. At the same time, Colombian debt held in dollars is performing well, on a similar level to US bonds, and while local debt rates are no

longer rising, they have sustained the levels reached prior to the escalation of risk events, indicating an absence of credit risk or intrinsic risk for the economy. Going forward, we expect local markets to remain shaped by global risk that is benefiting from an economy with a considerable current account deficit, despite this being generated by capital goods imports and being largely financed by foreign direct investment during the year. Thus, we expect the dollar to close at around 3,388 pesos, with an average for the full year of 3,278 pesos per dollar. Looking ahead to 2020, we do not anticipate any changes to the risk scenario. There will be some further deterioration in oil prices, but with stronger local growth that will help curb depreciation of the exchange rate, which is set to close 2020 at 3,370 with an average for the full year of 3,380 (average depreciation of 3.1% compared to 2019). We do not believe this exchange rate represents a new normal, but we do expect a somewhat more gradual correction than usual given that the external scenario will remain strained in the medium term.

Exchange rates have had a minor impact on inflation and an additional effect may still be in store, considering that the various pass-through mechanisms create a 4-month transmission lag. As such, although some transfers were observed in September, this has not exceeded 160 basis points on total tradable inflation and would account for some 50 bp in total inflation amid a twelve-month depreciation of slightly more than 10%, in line with our pass-through estimates. We expect the tradable inflation group to remain strained for some months until annual depreciation begins to ease toward the end of the year. That said, the most recent major impact on total inflation has been a sharp surge in food prices. Initially, this was driven by a significant reduction in crops to avert risks associated with a potential "El Niño" event, which ended up being less severe than anticipated. It was also linked to a considerable demand for food outside of the home and purchases in border areas. These factors led to food price inflation of up to 5.6% in September from levels below the 3.0% target a year ago. Food inflation is expected to slow gradually over the remainder of the year and early next year, with price inflation moving close to the target by mid-2020. We thus expect inflation to stand at around 3.8% by year-end 2019 and 3.3% by the end of 2020.

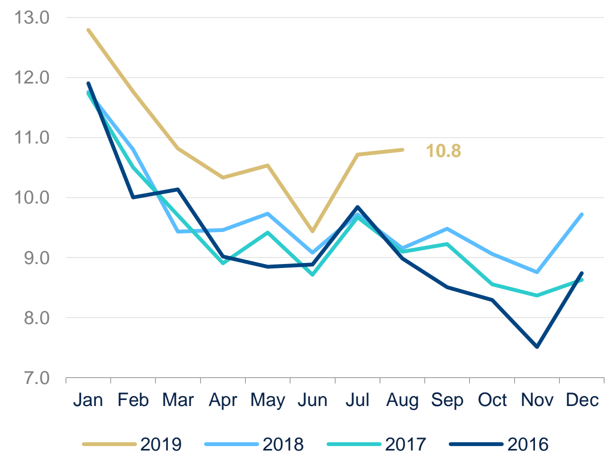
In this context, the issuer will face a rather unclear scenario shaped by the following factors: i) rising exchange rates that stand at peak levels, to date only partially affecting consumer inflation; ii) inflation at the top end of the target range, largely due to a food shock; iii) a current account deficit that complicates macroeconomic adjustment; iv) an output gap that remains on negative ground; v) a more lax external environment allowing for an easing of intervention rates in various countries; and vi) a drop in Federal Reserve rates. We therefore expect the Central Bank of Colombia to leave rates unchanged at the current rate of 4.25%. It should be noted that this level is expansionary. Considering the current level of inflation and the level forecast over the next 12 months, a real rate of under 1.0% is anticipated. However, the rate may remain stable until early 2021, when a small increase may be considered to bring rates to neutral levels.

Figure 1. **GLOBAL GROWTH AND MAIN COUNTRIES** (ANNUAL CHANGE, %)



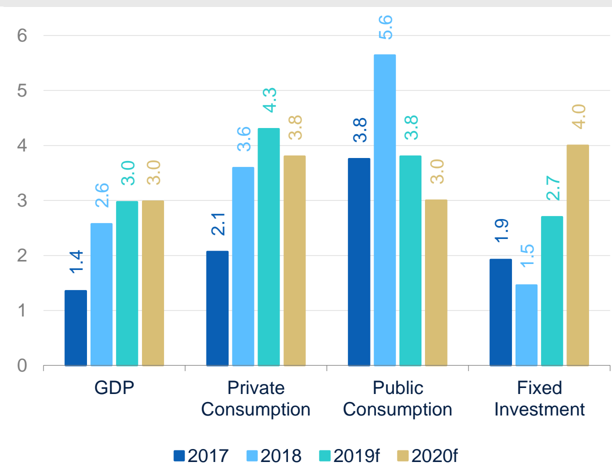
Source: BBVA Research

Figure 2. **TOTAL NATIONAL UNEMPLOYMENT** (% EAP)



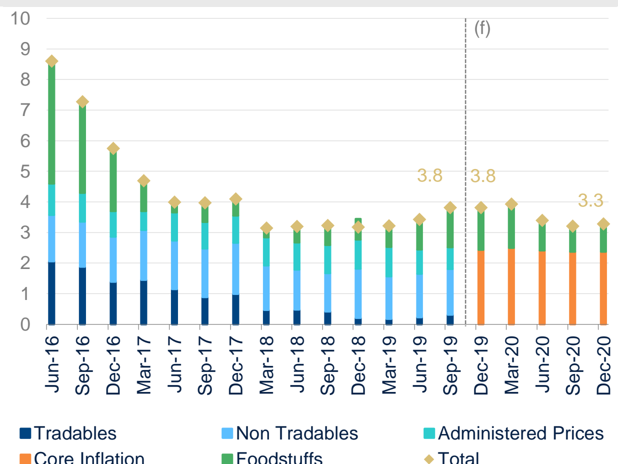
Source: BBVA Research based on DANE data.

Figure 3. **GDP AND DOMESTIC DEMAND** (ANNUAL CHANGE, %)



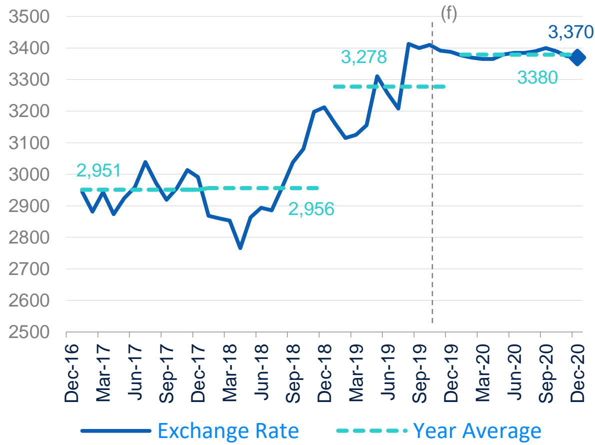
Source: BBVA Research based on DANE data.

Figure 4. **INFLATION AND COMPONENTS** (ANNUAL CHANGE AND CONTRIBUTION, %)



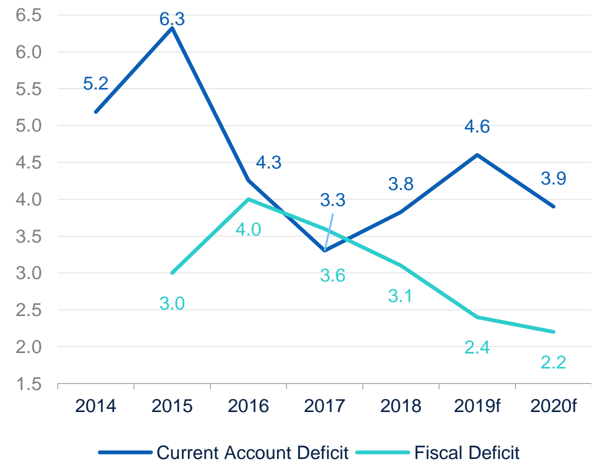
Source: BBVA Research based on DANE data.

Figure 5. **EXCHANGE RATE** (MONTHLY AND ANNUAL AVERAGE DATA, PESO AND DOLLAR)



Source: BBVA Research based on BanRep data

Figure 6. **CURRENT ACCOUNT DEFICIT FISCAL DEFICIT** (% OF GDP)



Source: BBVA Research based on BanRep and Treasury data

Tables

Table 1. **MACROECONOMIC FORECAST**

	2016	2017	2018	2019f	2020f
GDP (% y/y)	2.1	1.4	2.6	3.0	3.0
Private consumption (% y/y)	1.6	2.1	3.6	4.3	3.8
Public consumption (% y/y)	1.8	3.8	5.6	3.8	3.0
Fixed investment (% y/y)	-2.9	1.9	1.5	2.7	4.0
Inflation (% y/y. eop)	5.7	4.1	3.2	3.8	3.3
Inflation (% y/y. average)	7.5	4.3	3.2	3.5	3.5
Exchange rate (eop)	3,001	2,984	3,250	3,388	3,370
Devaluation (%. eop)	-4.7	-0.6	8.9	4.2	-0.5
Exchange rate (average)	3,055	2,951	2,956	3,278	3,380
Devaluation (%. eop)	11.4	-3.4	0.2	10.9	3.1
Policy interest rate (%. eop)	7.50	4.75	4.25	4.25	4.25
Term Deposit Rate (%. eop)	6.9	5.3	4.5	4.5	4.5
Fiscal balance Central National Government (% GDP)	-4.0	-3.6	-3.1	-2.4	-2.2
Current account (% GDP)	-4.3	-3.3	-3.8	-4.6	-3.9
Unemployment urban rate (%. eop)	9.8	9.8	10.7	11.1	10.4

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	2.3	8.0	3,022	6.50
Q2 16	2.0	8.6	2,916	7.50
Q3 16	1.7	7.3	2,880	7.75
Q4 16	2.3	5.7	3,001	7.50
Q1 17	1.4	4.7	2,880	7.00
Q2 17	1.3	4.0	3,038	5.75
Q3 17	1.5	4.0	2,937	5.25
Q4 17	1.2	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	3.1	3.2	3,175	4.25
Q2 19	3.0	3.4	3,206	4.25
Q3 19	2.8	3.8	3,462	4.25
Q4 19	3.3	3.8	3,388	4.25
Q1 20	2.9	3.9	3,365	4.25
Q2 20	3.1	3.4	3,385	4.25
Q3 20	2.1	3.2	3,400	4.25
Q4 20	2.8	3.3	3,370	4.25

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