BBVA Research

Creating Opportunities

Colombia Economic Outlook

First quarter 2020

Colombia meets its potential growth level, driven by an accelerating internal demand

The Colombian economy secured a positive performance in 2019, particularly when compared to other economies in the region. With a growth rate around its potential but still carrying a growth debt from the last few years. This improved performance was possible despite headwinds, both at the local and global levels, which shaped a scenario of significant uncertainty, financial market volatility and a slowdown of global demand that led to sliding oil prices. Looking ahead to 2020, the uncertainties are set to dissipate somewhat but will remain latent, with global growth stabilizing around current levels, a smoother dip in oil prices and a more nurturing scenario for economic growth. Inflation is set to gradually converge towards its target aided by a stabilization in the exchange rate and a slightly expansionary policy stance. For 2021, economic growth consolidation will continue on the back of an improvement of the external demand and a robust investment.

Diminishing uncertainty paves the way for stabilizing global growth

Easing trade tensions between the US and China, as well as the risk of a disorderly Brexit being chased away in the near term (albeit remaining a threat at the end of 2020), have helped to clear up some economic uncertainty. This has paved the way for the economic slowdown to lose momentum and for stabilization of the global economy, despite protectionism continuing to loom over global trade, while the geopolitical and structural risks remain significant. In addition, the prospect of stabilizing global activity growth has been bolstered by resilient activity levels in the US and slightly stronger expansion data than expected in China and the Eurozone.

Likewise, economic policy remains propitious for growth and this should continue to be the case over the coming quarters, at least for the major world economies. Following recent monetary stimulus measures, both the US Federal Reserve and the ECB are expected to hold interest rates at the current low levels for an extended period of time, while China is set to adopt new fiscal and monetary stimulus measures. Greater optimism regarding the global climate has also set a robustly improved tone across financial markets. As a result, following sustained impairment of the global economic outlook during 2019, forecasts are now being lifted slightly for China and the Eurozone, with prospects of mild easing in the US.

2019 was shaped by a global growth slowdown. According to estimates from BBVA Research, the global economy grew 3.2% during the year, the slowest pace since 2009 (between 2010 and 2018 global GDP growth stood at 3.8% on average) and 0.4 percentage points short of the growth observed in 2018. The slower expansion posted during 2019 was to a significant degree due to a structural slowdown affecting the Chinese economy and cyclical easing in the US, particularly as the impact of the fiscal stimuli introduced in 2018 dwindles, compounded by rising protectionism. There was intensifying weakness in terms of investment and exports, in contrast with a relatively solid performance from private consumption, which was backed by the relative resilience of labor markets, low inflation and counter-cyclical policies adopted in major regions.

After growing 3.2% in 2019, the global economy is set to expand 3.2% in 2020 and 3.3% in 2021, less than posted in previous years

Prospects of stabilization are likewise backed by the view that economic policy will continue to support activity in most regions. In particular, amid a climate of limited inflationary pressure, both the Fed and the ECB are expected to keep rates at current levels throughout 2020 and 2021. Although in both cases additional stimulus measures cannot be ruled out in the event of further economic deterioration, while an upside rate adjustment is not out of the question in the US should inflation rise more than anticipated. Fiscal policy, meanwhile, will play a stimulus role in the Eurozone and more so in China, where public investment in infrastructure will be ramped up further than had been expected three months ago. This will come alongside monetary expansion measures from the Chinese central bank, although these may be curbed by the recent, largely temporary, rally in inflation.

Following easing in 2019, the most likely scenario is that global growth will hold at 3.2% in 2020 and gradually gain traction to around 3.3% in 2021. Although the strategic rivalry between the US and China will continue to generate tensions, while other regions may be affected by new protectionist measures, global uncertainty is expected to stand at lower levels than in 2019, allowing the global slowdown to come to an end. These growth forecasts are conditional upon geopolitical tensions being kept in check and other risks threatening the global economy not materializing. Specifically, the BBVA Research scenario assumes that the recent tensions between the US, Iran and Iraq do not have a permanent negative bearing on the global environment. In particular, oil prices are estimated to stabilize at around $61 per barrel over the two-year period, below the average figure recorded in 2019 ($64) and the current price level ($68). This anticipated decline in oil prices would be supported by a gradual improvement in global demand and a projected increase in supply from non-OPEC countries. Similarly, should an escalation of instability in the Middle East drive oil prices up to $70 a barrel and keep them at these levels throughout 2020, global growth over the next biennium could be undermined by between one and two tenths, with Europe being the hardest hit.

All in all, the outlook remains one of a smooth slowdown in the US toward growth rates close to the potential level. This is the case even amid a likely heightening of political noise in the lead up to the presidential elections in November 2020 and despite the risk of recession, although said risk has eased in recent months. In China, the pace of economic growth will continue to slacken, albeit less sharply than previously expected, in part due to the agreement with the US and improved prospects for future relations between the two economies, as well as the decision to ramp up use of fiscal policy as a means of stimulating activity. Finally, growth prospects over the next two years for the Eurozone have marginally improved thanks to the declining risk of a disorderly Brexit.

For Colombia, 2019 was a year of contrasts and significant uncertainty, amid consolidation of economic growth

The Colombian economy saw domestic demand gain considerable traction throughout 2019, both in terms of private consumption and investment. During this time, however, GDP growth accelerated at a slower pace, revealing a significant gap between domestic demand and local supply. The latter had to be offset via a significant ramping up of imports, meaning a negative contribution from foreign demand to economic dynamics. In addition, the country faced a complex foreign context, with greater financial market uncertainty and weak demand for its exports.

Thus, we estimate that the economy grew 3.2% in 2019, with domestic demand expanding 4.6%. Such a significant spread between the two figures has not been observed since 2014, standing as a clear signal of the road toward recovery that the economy has secured following the oil price decline. However, at the same time, it is a clear signal of the current account imbalance, which became considerably more evident in 2019. We estimate a figure of -4.6% of GDP. Nevertheless, despite positive progress for overall activity based on a range of indicators, there remain concerns regarding the composition of economic activity, particularly in terms of household expenditure and household financial circumstances.

Private consumption stood at the epicenter of the contrasts witnessed in 2019, showing significant progress and growth of around 4.8% for the full year, amid a scenario of weak consumer sentiment and a rapidly deteriorating labor market. However, there are certain aspects that reconcile these differences, including short-term factors such as significant immigration, strong growth in remittances, growth in consumer lending and a real minimum wage hike. In contrast, investment has moved more in line with economic fundamentals, securing an expansion of 4.1% thanks chiefly to increased expenditure on machinery, equipment and civil works. These factors were driven by robust confidence among industrialists, greater use of installed capacity, tax benefits enshrined in the 2018[1] Financing Law, and increased regional public investment during the final year of local government legislatures. Not all components of investment marched in the same direction during 2019, with non-civil works construction, particularly housing, faring poorly.

The sharp growth in domestic demand had its reflection in considerable expansion of imports, reaching real growth of close to 9.0%, while the weak foreign scenario and certain supply factors in the agricultural and mining industries led to sluggish exports growth, posting expansion of close to 2.6% in 2019. The result was a deteriorating trade balance, which combined with a considerable slackening in earnings to undermine the foreign balance, reaching a current account deficit of -4.6% in 2019, from -3.8% in 2018 and -3.3% in 2017. We should note that there are some mitigating factors behind this significant current account deficit. First of all, the deficit has been financed chiefly using direct foreign investment, which is more stable. And second, a proportion of the trade balance impairment in 2019 was caused by rapid growth in imports associated with investment, which should ultimately lead to stronger GDP and help partially redress the imbalance.

A look into the labor market

The labor market was significantly weakened in 2019, caused by a prolonged period of low activity that had largely not affected employment during the preceding years. Job creation has been depressed in recent years, gradually leading to the destruction of employment. The rural regions are largely responsible for this situation, with agricultural jobs particularly affected. However, nor is the scenario particularly promising in the major cities. While jobs are being created in cities, the trend remains in very embryonic stages and job creation looks set to hold at low levels for a prolonged period. A higher number of salary earners stands out as a positive factor amid all the bad news, but once again the levels are significantly lower than observed in similar periods of domestic demand growth.

Meanwhile, although the unemployment rate has climbed, it has done so less dramatically than job creation figures might indicate. This was due to a simultaneous and significant decline in the economically active population, a phenomenon not usually witnessed at times of economic weakness. More so when the Colombian economy is facing the strongest immigration flows in its history. It may therefore be inferred that households at the national level are facing a tougher scenario than the unemployment data suggest. While the impact has been mitigated by extraordinary sources of funds, such as remittances, the labor market

1: The country's Constitutional Court declared that the Financing Law was unenforceable on procedural grounds from January 1, 2020. In its ruling, the court maintained the rights and duties enshrined in the Law during 2019.

looks set to deteriorate further in the early stages of 2020, and the consequences for the economy may be felt more strongly than has been the case to date.

We believe the turning point in this scenario will come with the reactivation of those sectors that generate significant demand for labor, such as non-civil works construction and the agricultural industry. This is likely to result in similar average unemployment rates in 2019 and 2020, albeit concealing a relative improvement in the second half of 2020 compared to the first half.

A healthier balance of economic activity is expected in 2020, despite growth standing close to 2019 levels

Growth in 2020 is set to hold at 3.2%, matching the 2019 figure. However, there are likely to be considerable differences in the composition of growth, rendering 2020 a more upbeat year for the Colombian economy. The main distinction is the anticipated investment trend, with growth of 5.0%, stronger than 2019, while also growing faster than consumption for the first time since 2014. Taking center stage in 2020 will be non-civil works construction, which is set to reverse from contraction to growth of 5.5%. This expansion will mainly be driven by social housing, thanks to a series of policies aimed at securing funding for the industry over several years. However, an improved performance is also anticipated in mid-price and high-value housing, driven by shrinking supply and stabilizing demand. This should see a reduction in the housing inventories that had impeded the industry. In turn, the scrapping of a 2% consumer tax on transactions of high-value properties as part of the 2019 tax reforms should help to relieve pressure on this segment. The other components (machinery and equipment and civil works) will continue to expand, albeit at a more moderate rate than in 2019.

Looking at household consumption, we expect the growth rate to slacken from 4.8% in 2019 to 4.3% in 2020. Although consumption will continue to grow faster than GDP, this easing should relieve the current pressure currently exerted on macroeconomic balances, such as the current account balance and savings. Those aspects that drove an acceleration in consumption during 2019 will remain in place during 2020, albeit having a waning impact, such as immigration, household leverage and remittance income, etc. Meanwhile, the accumulated impairment of the labor market, which to date has failed to curb household spending trends due to the absorption capacity of consumption, is set to have a more significant impact in 2020.

Overall, domestic demand will continue to spearhead growth in 2020, standing at 3.8%, but the shift in the investment balance toward non-civil works construction relative to machinery and equipment, combined with easing household spending, should see imports post more moderate growth of 4.8%. Exports, meanwhile, will remain affected by the foreign sector scenario. Global demand is set to remain weak in 2020, while certain additional impacts on some commodity prices are set to curb the country's foreign sales, leading to weak growth of 1.2% in real exports. Thus, a faster slowdown in imports compared to exports should have a positive impact on the trade balance, with a gradual correction of the current account deficit, reaching 4.3% in 2020. The foreign deficit is expected to ease gradually due to an anticipated dip in oil prices to $61 per Brent barrel on average, down from $64 per Brent barrel in 2019. Economic growth is set to accelerate slightly in 2021 to 3.5%. This should help to continue the gradual narrowing of the output gap. Additionally, this would represent the fastest growth since 2014, while standing above the estimated long-term growth rate of 3.3% for the first time. Activity should remain driven by domestic demand, despite further easing anticipated in consumption, and a somewhat marginal and transitory slackening in investment, with both expanding faster than GDP. Looking at the foreign sector, there have been initial signs of a gradual recovery in real exports, although these will continue to expand more slowly than GDP and imports. The latter will allow an improvement in the external balance for 2021 with an expected current account deficit of 3.9% of GDP.

Global uncertainty and the imbalances affecting the Colombian economy are set to exert pressure on the exchange rate in Colombia, partially affecting inflation

The complex foreign situation, which became more acute during the year, triggered considerable strengthening of the US dollar globally. Within the region, this strengthening combined with the deteriorating political and social circumstances, meant that several currencies plunged to record lows, including the Colombian peso. The volatility affecting the Colombian currency was likewise associated with a considerable current account deficit and certain measures that exerted pressure on currency demand in the local market. As a result, the average exchange rate in 2019 reached 3281 pesos per dollar, the highest on record, while peaking at 3522.5 pesos per dollar. Despite this, the fundamentals that are most closely associated with currency trends were positive, with an average oil price in the second half of 2019 of $64 per Brent barrel and an EMBI that did not exceed 200 points during the same period, standing close to its recent minimum values. Together with the recent slackening of foreign risks, particularly those associated with trade conflicts, this saw the exchange rate ease significantly by year-end, with prospects of appreciation in the first quarter of the year.

Looking ahead to 2020, while foreign risks have waned, these remain in place and look set to exert sustained pressure on exchange rates, combining with a still sizable current account deficit and additional oil price declines. We therefore expect an average exchange rate of 3271 pesos per dollar in 2020, very similar to 2019 levels (0.3% appreciation). However, the trend should look favorable in the first quarter and then gradually deteriorate in the second and third quarters, as a result of declining oil prices, which we expect to bottom out in the third quarter of the year. The gradual economic recovery, driven by moderation of the current account deficit and adjustments to ensure normalization of monetary policy, should see the exchange rate return to an appreciating trend in 2021, with an average rate of 3231 pesos per dollar and appreciation of 1.2%.

Inflation gained traction in 2019, rising from 3.2% to 3.8%. This shift was driven chiefly by two factors. First, sharply rallying food inflation during the year, largely due to climate effects, but also the impact of exchange rate depreciation on imports of food or food with significant import components. This initial factor accounted for 63 bps of increased inflation. Second, tradable goods inflation stripping out food and regulated items, which accelerated from 1.1% to 2.3%, explaining 30 bps of the total inflation increase. In this case, exchange rates had a smaller impact on prices than in the past, with an additional transfer effect potentially set to be felt in early 2020. Annual inflation is expected to remain high this year, close to the top end of the target range through to March, to subsequently decline to 3.4% at year-end. The risks facing inflation in 2020 include a sharper transfer of exchange rate depreciation to inflation, a stronger persistence effect than expected due to the minimum wage rising faster than anticipated inflation and adjustments for productivity (see chart xx), as well as specific effects on certain goods and services where demand is more robust due to expanding household consumption. In 2021 inflation is expected to converge with the inflation target, ending the year at 3.2%.

In this economic context, the Colombian central bank has left policy rates stable for 20 months, the longest such period since the introduction of target inflation as part of monetary policy implementation. In general terms, the central bank has indicated that it has weighed up the conflicting factors and consequently left rates at stable levels. The factors conducive to a rate hike include rallying inflation, exchange rate depreciation and a large current account deficit. While those factors advocating for a rate cut include a deteriorating labor market and a still negative output gap. This scenario is unlikely to change significantly in 2020; as inflation and depreciation ease, the output gap should narrow further while labor market conditions are set to improve. We therefore believe that the central bank will lift interest rates by 25 bps in the first quarter of 2021, while it would only bring forward this movement should one of the risks to inflation mentioned in the above section materialize. The policy rate would end 2021 at 4.75%, with a second adjustment in the second half of the year, thus reaching its long-term level.

The country should meet its short-term fiscal targets thanks to extraordinary revenue, while structural challenges remain

The 2019 fiscal deficit is set to stand at 2.4% of GDP, below the maximum figure allowed by the fiscal rule committee (2.7% of GDP, which was lifted 0.5 pp due to the burden to the state of attending to the immigrant population). The 2018 Financing Law had a limited bearing in securing this target, with lower revenue attributable to the measure than had been expected. This was offset by taxation associated with upbeat consumption and import trends, as well as the distribution of strong Ecopetrol earnings, among other factors.

The key events of 2019 on the fiscal front included a ruling from the Constitutional Court declaring the Financing Law unenforceable on procedural grounds. This meant that urgent tax reforms had to be processed (Growth Law) to allow the majority of the regulations enshrined in the Financing Law to be enacted, this time without the procedural shortcomings. However, this all happened at a complex political and social juncture, leading the government to include several additional measures, some of them social in nature and carrying significant tax costs, which were not offset in terms of revenue in order to limit their impact on public finances.

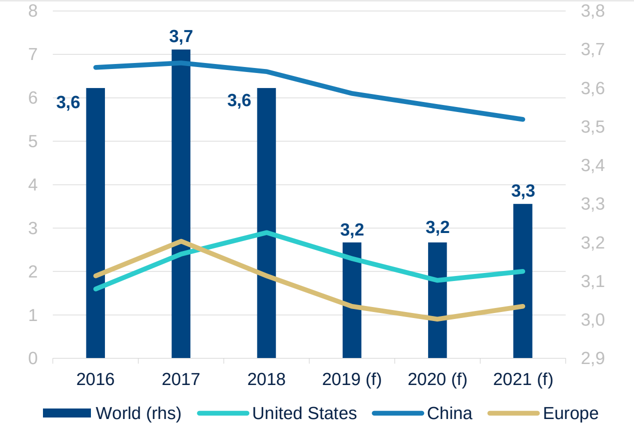
Despite this, we believe that the fiscal deficit in 2020 will stand very close to the maximum level allowed under the fiscal rule, of 2.3% of GDP. This is due to a series of unanticipated revenues, including exceptional earnings for the central bank in 2019 due to the rising value of its international reserves portfolio and extraordinary Ecopetrol dividend payments from a reserve held by the company. New accounting practices adopted by the government should likewise drive progress toward achieving the target. As in 2019, these will permit the transfer of expenditure that must be included on the balance sheet, seeing it directly covered by debt, without affecting the deficit but driving up the debt.

Securing the fiscal deficit target in 2021 presents a tougher challenge. On the one hand, the fiscal deficit target is more demanding, at 1.8% of GDP. While on the other hand, there is less leeway to ramp up revenue and cut expenditure. On the revenue side, just as with the 2019 tax reform, the 2018 Financing Law came at a significant fiscal cost, cutting taxes on corporate earnings and allowing VAT deductions on the purchase of fixed productive assets, as well as on industry and commerce taxes (ICA). In turn, there are fresh fiscal burdens, such as the gradual dismantling of a proportion of contributions to low-income pensioner health care, a lower presumptive income rate in 2020, VAT compensations for vulnerable groups, a first job salary deduction for the youth population and the scrapping of a consumer tax on purchases of high-value properties. This difference, compounded by the new reforms, means a strategy to improve revenue or cut expenditure is required, both of which face significant challenges due to the current political and social scenario. Another potential strategy is to sell off assets, which looks implicit in the medium-term fiscal framework. However, the funds raised would be transitory, with structural measures again required to shore up the balance sheet.

Lower levels of uncertainty in early 2020 are no guarantee that volatility will not return to the global and local economies

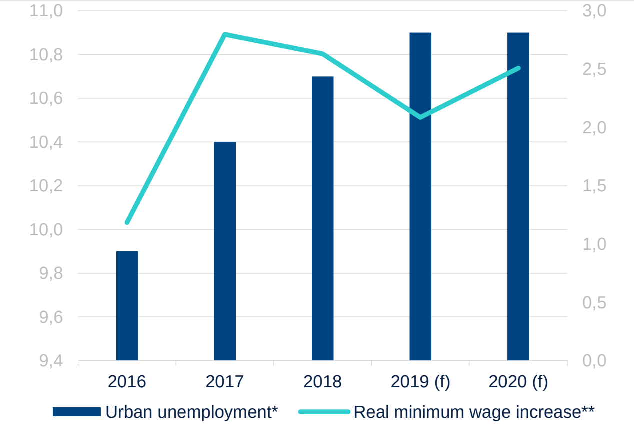
The scenario in early 2020 is less adverse than last year, particularly the second half of 2019. However, none of the external factors that created the difficulties have been fully resolved. We therefore see persistent risk of a more volatile global and local economy in 2020. This will be compounded by the elections in the United States, which are certain to shape global trends and could have economic, political and social consequences. At the local level, these factors tend to affect exchange rate trends, which in our forecasts remain high, albeit with volatility largely reined in. Disruptive factors in the foreign scenario could exacerbate this volatility, particularly as the country maintains a sizable current account deficit and still significant dependence on currencies as a result of the hydrocarbon industry. At the local level, the risks remain varied. First, looking at the social factors, the protests in late 2019 set out significant policy challenges for the current national government and the newly formed regional and local governments. Understanding the phenomenon and providing solutions that do not compromise fiscal responsibility will undoubtedly be a major challenge looking forward. Second, further fiscal adjustments are required in 2021. However, to achieve them a revenue and expenditure debate will need to get underway in 2020, amid a less complacent social climate and following two consecutive tax reforms, which may pose a real difficulty. Finally, the labor market and inflation have positioned the central bank and the government at a challenging crossroads. On the one hand, the labor market has been evidently deteriorating and is yet to show signs of improvement, meaning factors such as the real minimum wage being lifted faster than productivity and the slow pace at which production has reacted in Colombia could prevent improvements on this front. On the other hand, the same increase in the real minimum wage faster than productivity may trigger price adjustments that make it difficult for the central bank to achieve its inflation targets. As has become customary in recent years, the risks are significant. This partly reveals the vulnerability facing the economy amid a very sluggish economic recovery, underpinned more by rising domestic household spending than by the real growth of productive capacity and competitiveness in foreign markets.

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



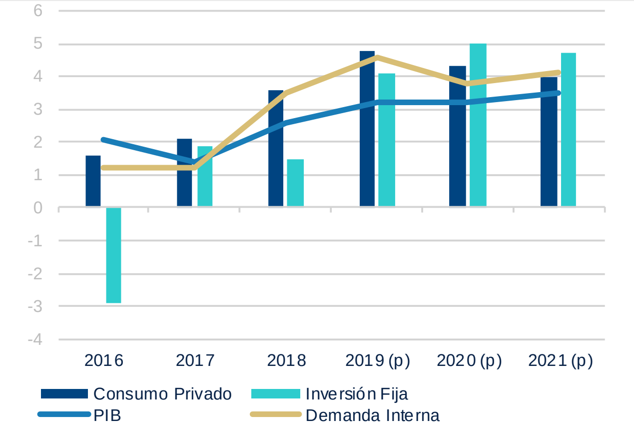
Source: BBVA Research

Figure 2. **COLOMBIA: UNEMPLOYMENT AND REAL MINIMUM WAGE INCREASE** (% EAP, ANNUAL CHANGE, %)



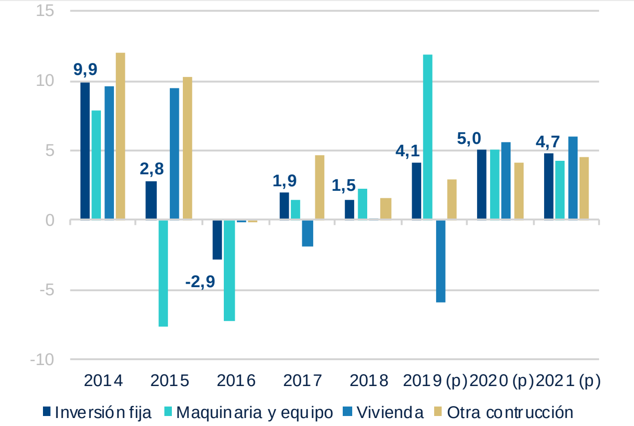
Source: BBVA Research with DANE data and Presidency of the Republic
* Average of end of quarter unemployment rates
** Nominal wage deflated by current inflation

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



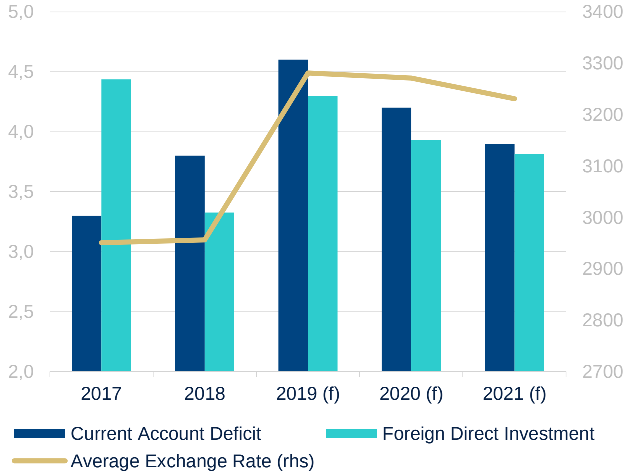
Source: BBVA Research with DANE data

Figure 4. **INVESTMENT COMPONENTS** (ANNUAL CHANGE, %)



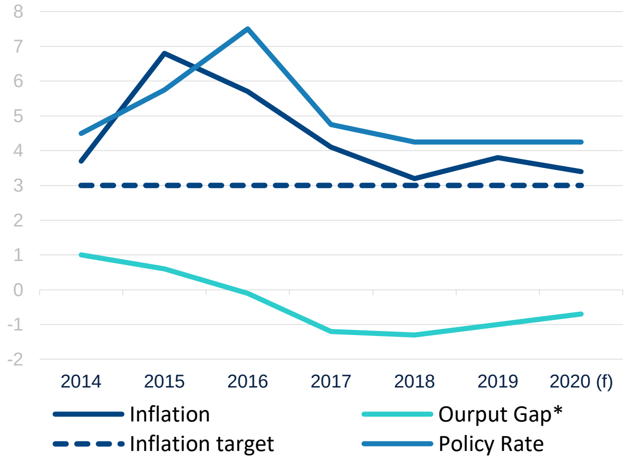
Source: BBVA Research with DANE data

Figure 5. **EXCHANGE RATE AND CURRENT ACCOUNT** (AVERAGE ANNUAL DATA, % OF GDP AND PESOS PER DOLLAR)



Source: BBVA Research with BanRep data

Figure 6. **INFLATION, GDP GAP AND POLICY RATE** (ANNUAL CHANGE AND E.A., %)



Source: BBVA Research with BanRep and DANE data
* GDP gap corresponds to the relative difference between observed and potential GDP, taken from the Central Bank of Colombia Monetary Policy Report

Tables

Table 1, **MACROECONOMIC FORECASTS FOR COLOMBIA**

	2017	2018	2019	2020	2021
GDP (% YoY)	1,4	2,6	3,2	3,2	3,5
Private consumption (% YoY)	2,1	3,6	4,8	4,3	4,0
Public expenditure (% YoY)	3,8	5,6	3,8	3,8	3,3
Fixed investment (% YoY)	1,9	1,5	4,1	5,0	4,7
Inflation (% YoY, eop)	4,1	3,2	3,8	3,4	3,2
Inflation (% YoY, average)	4,3	3,2	3,5	3,5	3,3
Exchange rate (eop)	2.984	3.250	3.277	3.340	3.220
Devaluation (%, eop)	-0,6	8,9	0,8	1,9	-3,6
Exchange rate (average)	2.951	2.956	3.281	3.271	3.231
Devaluation (%, eop)	-3,4	0,2	11,0	-0,3	-1,2
BanRep rate (%, eop)	4,75	4,25	4,25	4,25	4,75
DTF rate (%, eop)	5,3	4,5	4,4	4,5	4,9
CNG fiscal balance (% GDP)	-3,6	-3,1	-2,4	-2,2	-1,8
Current account (% GDP)	-3,3	-3,8	-4,6	-4,2	-3,9
Urban unemployment rate (%, eop)	9,8	10,7	10,8	10,7	10,5

Source: Central Bank of Colombia, DANE and BBVA Research forecasts

Table 2, **QUARTERLY MACROECONOMIC FORECASTS**

	GDP (% YoY)	Inflation (% YoY, eop)	Exchange rate (vs. USD, eop)	BanRep rate (%, eop)
T1 17	1,4	4,7	2.880	7,00
T2 17	1,3	4,0	3.038	5,75
T3 17	1,5	4,0	2.937	5,25
T4 17	1,2	4,1	2.984	4,75
T1 18	2,0	3,1	2.780	4,50
T2 18	2,9	3,2	2.931	4,25
T3 18	2,6	3,2	2.972	4,25
T4 18	2,7	3,2	3.250	4,25
T1 19	3,1	3,2	3.175	4,25
T2 19	3,0	3,4	3.206	4,25
T3 19	3,3	3,8	3.462	4,25
T4 19	3,5	3,8	3.277	4.25
T1 20	3,6	4,0	3.200	4.25
T2 20	2,9	3,4	3.240	4.25
T3 20	2,9	3,3	3.320	4.25
T4 20	3,4	3,4	3.340	4.25
T1 21	3,8	3,4	3.210	4.50
T2 21	2,6	3,2	3.215	4.50
T3 21	4,1	3,2	3.240	4.50
T4 21	3,6	3,2	3.220	4.75

Source: Central Bank of Colombia, DANE and BBVA Research forecasts (in gray)

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