

## 4. Inertia in growth: towards a slow recovery cycle

The economic slowdown has continued into 2017, with YoY growth of 1.1% in the first quarter, and signs of similar performance in the second quarter.

The shock to the terms of trade has produced a major adjustment to national income, firstly through the oil sector and the government. As the economy adjusted to this new situation, the effect on income spread gradually among private agents, first to companies - through investment - and then to consumers. This has led to growth slowing significantly, to 2.0% in 2016 and 1.1% in the first quarter of 2017. The economy is currently in transition back to recovery, but no powerful drivers of growth are apparent that would foster a rapid adjustment in economic activity. Quite the contrary. We believe that the recovery cycle will be slow, taking an **L** shape, with inertia in the recovery as natural growth in spending and population growth boost activity.

**Table 4.1** GDP demand and supply (%)

	2015	2016	I 2016	II 2016	III 2016	IV 2016	I 2017
<b>GDP</b>	<b>3.1</b>	<b>2.0</b>	<b>2.7</b>	<b>2.5</b>	<b>1.1</b>	<b>1.6</b>	<b>1.1</b>
<b>Demand</b>							
Private consumption	3.2	2.1	2.8	2.1	1.1	2.3	1.1
Public consumption	5.0	1.8	3.9	3.1	0.2	0.2	2.1
Fixed investment	1.8	-3.6	-4.0	-4.0	-3.6	-2.9	-0.7
Exports	1.2	-0.9	0.7	2.1	-3.0	-3.3	-3.6
Imports	1.4	-6.2	-5.8	-3.5	-10.9	-4.3	-0.4
<b>Supply</b>							
Agriculture	2.5	0.5	0.0	0.4	-0.5	2.0	7.7
Mining	0.2	-6.5	-4.6	-6.8	-6.5	-8.3	-9.4
Industry	1.7	3.0	4.3	5.3	1.3	1.0	0.3
Electricity, gas and water	3.0	0.1	2.9	-0.7	-1.4	-0.6	-0.6
Construction	3.7	4.1	5.5	0.7	6.8	3.4	-1.4
Trade, restaurants, hotels	4.6	1.8	2.8	1.9	0.7	1.8	-0.5
Transport and telecommunications	2.6	-0.1	0.9	0.2	-1.4	-0.3	-0.3
Financial and business services	5.1	5.0	4.9	5.4	4.4	5.1	4.4
Social and communal services	3.1	2.2	3.5	3.2	1.3	0.9	2.2
Taxes	0.7	2.2	1.3	4.1	0.4	2.9	2.7

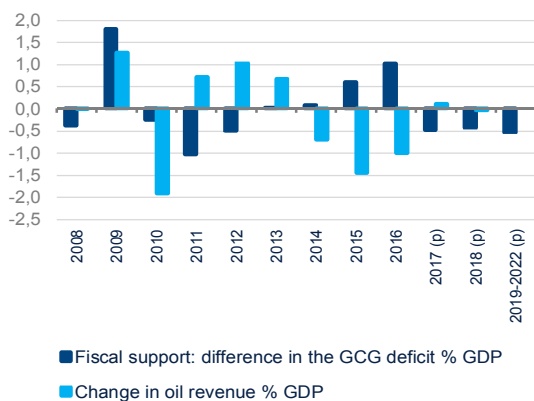
Source: DANE

### Fiscal and monetary policy restrictions on robust stimuli to the economy

Fiscal policy has historically been one of the major sources of short-term growth for economies that have suffered significant slowdowns and see their growth rates threatened. However, this time, the government's hands are tied over fiscal policy. The government has seen the fall in oil prices reduce its revenue from the oil sector from 3.3% of GDP in 2013 to 0.1% in 2016 (excluding royalties). However, while the fiscal deficit increased from 2.3% to 4.0% over

this period as a result of the fiscal rule, this was not sufficient to offset the negative effect of the loss of revenues. In order to meet its commitments and maintain a positive environment for investors, the government also had to cut spending and introduce tax reforms in 2014. The government's impact on growth in this cycle has therefore been negative (Figure 4.1).

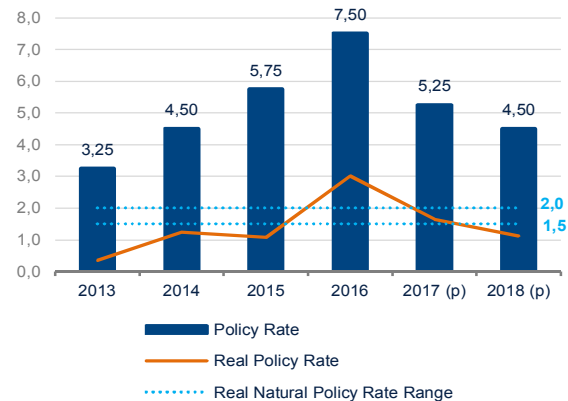
**Figure 4.1** Fiscal contribution and oil revenues (%)



Source: Treasury and BBVA Research calculations

Note: the forecasts of the fiscal deficit are by the Treasury; the oil revenue forecasts are from BBVA Research

**Figure 4.2** Monetary policy rate (% end of period)



Source: Central Bank of Colombia and BBVA Research calculations

The government introduced a new tax reform in 2016, enabling it to maintain its spending as a percentage of GDP in 2017 and meets its fiscal rule. However, central government will have to cut its spending in terms of GDP in order to comply with the fiscal rule in 2018. The commission responsible for the fiscal rule has also announced a change to the methodology for calculating the output gap: this involves moving from a non-parametric deficit target imposed by the Fiscal Rule Committee to a deficit limited by the new methodology. Under this, the government can run larger deficits of 3.6% in 2017 (previously 3.3%) and 3.1% in 2018 (previously 2.7%), largely because of the correction to the current account deficit.

The revenues from the tax reform, together with the greater flexibility on the deficit, mean that central government spending can be less restrictive than previously expected, although it must still fall as a percentage of GDP, due to the adjustment of the fiscal deficit from 4.0% in 2016 to 3.6% of GDP in 2017. In the opposite direction, the spending of regional governments - which are in the second year of their term - accelerated in 2017 compared to 2016, providing a boost to growth. Even so, figures for implementation of investment remain low at the moment, whilst spending has rebounded. We expect actual annual growth in public consumption of 2.6% in 2017, exceeding GDP growth. We expect actual annual growth of 1.5% in 2018, supported by regional spending. This is below the average historical growth rate.

The Central Bank has cut its monetary policy rate, but by less than the adjustment in inflation. Whilst the policy rate has been cut by 200 basis points, inflation has corrected by almost 500 basis points: even using measures of expected inflation, the real rate remains above the natural rate (Figure 4.2). The limitations on monetary policy making a more decisive contribution to reigniting the economy are based on fears of possible outbreaks of inflation, due to the inertia or persistence of inflation in the system. However, there are also concerns that the economy may yet require

further structural adjustment towards a balance that is sustainable over time. This adjustment could come through the current account, with an equilibrium deficit of around 2.0%-2.5% (as mentioned by the IMF in its most recent report on Colombia's economy), compared to an actual deficit of 4.4% in 2016 and 6.4% in 2015. Even so, the Bank has released some of the pressure on demand by reducing its interest rate almost continually since December 2016. This effect is starting to be felt in market rates, particularly for the corporate sector. However, growth in lending to companies remains low: quite possibly this is because companies have opted for cheaper liabilities to foster investment or production, rather than increasing debt.

**Box 4.1: Potential GDP and the cycle**

One of the complex arguments about Colombia's economy is the level of its potential GDP. Whenever there is a shock such as the "El Niño", it is usually assumed that the impact will be temporary and that it has no effect on potential GDP. However, we are currently dealing with a permanent supply-side shock - the fall in oil prices. This has happened in an economy that has spent almost a decade pushing investment in the oil sector and leveraging growth through the hydrocarbons.

The major contraction in investment could have cut potential growth to below 3.0% in 2017 and to 3.3% for the five year period, well below the level expected for our economy prior to the shock (around 4.4%). This reduction of around 1.5 percentage points in potential growth (in 2017) reduces the scope for a monetary-policy response, as the difference between actual and potential GDP will not be as large as would be suggested simply by the behaviour of the GDP cycle, as both will slow. The uncertainty about this variable is further increased by the potential impact of recent investment in the hydrocarbons sector, which could reduce the economy's potential growth rate even further, at least during the transition to a new growth path.

## The adverse scenario for consumers is reflected in their confidence

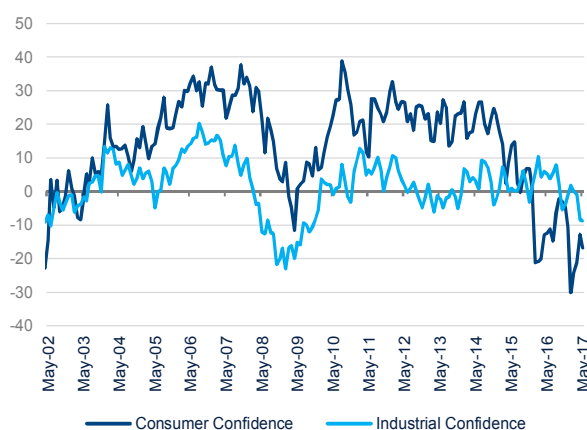
The policy restrictions do not only affect those who formulate them, but also all other economic agents. The Central Bank's increased interest rates to contain expectations of inflation, and this has also had a significant effect on consumers and businesses. It increases the cost of their debts, whilst their purchasing power is being diminished by rising food prices.

The government's need to balance its books through tax reform also affects consumer confidence. The tax reform increased the general VAT rate from 16% to 19%, and reduced some personal income tax allowances. The government's actions - together with a number of negative shocks to households over the last 2 years - have had a significant effect on consumer confidence (Figure 4.3). This has increased precautionary saving and slowed private spending. Growth in household consumption fell from 2.8% YoY in the first half 2016 to 1.1% in the first quarter of 2017 (Table 4.1).

The confidence and spending capacity of households has also been limited by a deteriorating the labour market, although this is heavily concentrated in urban areas, particularly Bogotá, where there have been 7 consecutive months of job losses. The urban unemployment rate reached 10.2% in May 2017, an increase of 1.2 percentage points on 2016 and 2015 (Figure 4.4). The labour market will therefore have a negative effect on future consumption.

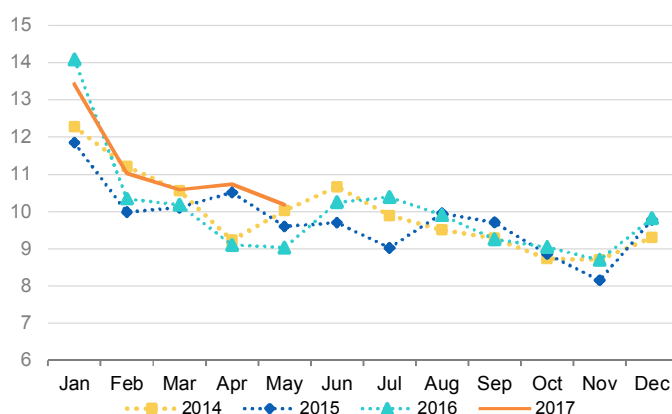
This will partially negate the positive effects of the reduction in interest rates and lower inflation we have started to see in 2017.

**Figure 4.3** Consumer and industrial confidence



Source: Fedesarrollo

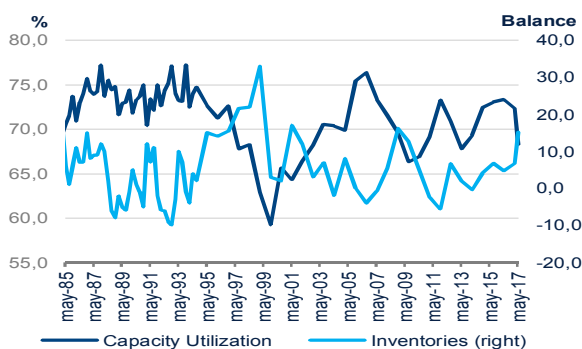
**Figure 4.4** Unemployment rate, 13 cities (%)



Source: DANE

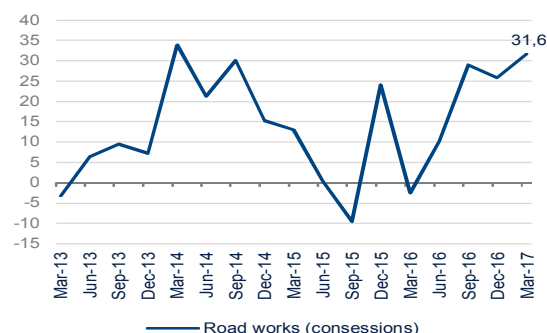
Business confidence has also fallen sharply, as a result of the weakness of the cycle and lack of demand (Figure 4.3). This has led to plans to expand production capacity being postponed, undermining investment. The most recent figures show a fall in utilisation of installed capacity and in increase in stocks and inventories (Figure 4.5). This demonstrates the current weakness of demand, enabling companies to take advantage of current low interest rates to improve their funding costs, rather than expanding production capacity. Figures for investment in the first quarter remain weak, with a YoY contraction of 0.7%: while this is an improvement on the 3.6% contraction in 2016, it is less than expected.

**Figure 4.5** Capacity utilisation (%) and inventories



Source: ANDI

**Figure 4.6** Other civil engineering work—concessions (%)



Source: DANE and BBVA Research calculations

## Short- and medium-term drivers of recovery

One of the main engines of growth - which to date is only firing on one its four cylinders - is the 4G infrastructure programme. As of March, 6 projects had made progress of more than 10%, with some already having achieved almost 30%. This group of projects was responsible for the boost to public investment in the first quarter of 2017, with actual growth of 31.6%. Progress on these projects, together with 2 others for which funding is now in place, will support part of the expansion of GDP in 2017 and 2018. However, there are 3 other cylinders that can be used to power the economy: the 2nd and 3rd waves of the 4G work, and private projects. No new funding has been put in place for these as of the date of this publication and we believe that they could be delayed. We believe that the government's proposed 48.8 trillion peso programme will not be completed to schedule and will overrun. We have decided to extend the period for execution of the programme to the period 2016 to 2022 in our forecasts, with 2019 being the peak year for spending on the programme and its contribution to GDP.

In addition, the government has announced the relaunch of its Frech programme of interest-rate subsidies for house purchases: 2.5 percentage points for mortgages on homes of up to 320 million pesos (previously 250 million pesos). This programme, together with the initiative by most commercial banks to cut their mortgage interest rates, should boost the construction sector. There will be an initial phase during which current inventories will be run down: once this has completed, new projects will start to be developed in 2018 and 2019. Whilst the effects of this programme will be felt in the medium term, previous versions of this programme have had considerable impact on the growth of the sector and the labour market.

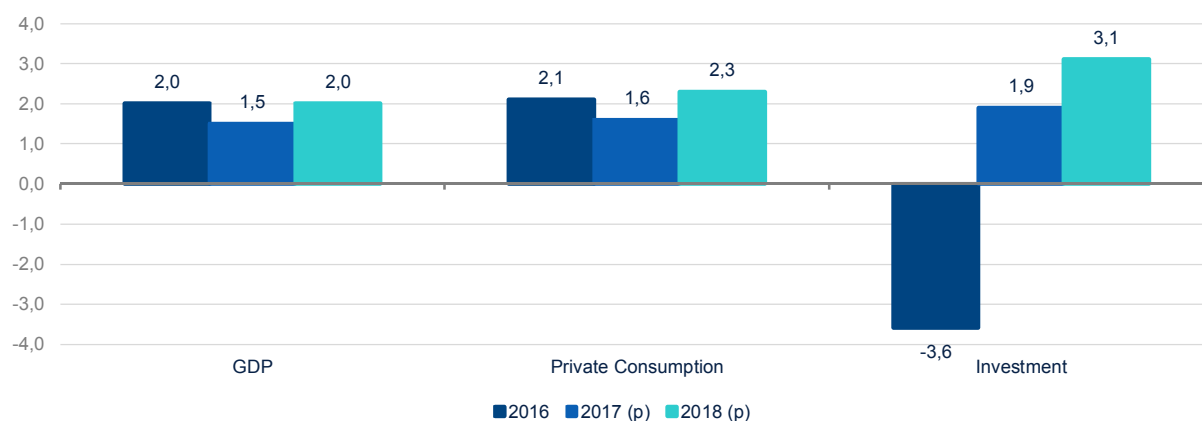
With the recent recovery in oil prices to between USD 45 and USD 55 per barrel (Brent), Colombia's oil sector has changed its attitude to investment in both extraction and exploration. A number of companies have announced increased investment, which they will start to roll out in 2017. However, no major changes have yet been seen in imported capital goods or investment in the sector's infrastructure. This should be noticed in the second half of the year, possibly after the government legislates for the special tax conditions for the sector, in addition to the VAT discount for capital goods included in the tax reform. These special measures include: VAT discounts for off-shore exploration; a yet-to-be-defined percentage of costs incurred in successful explorations; and the possibility to discount depreciation of intangible assets required for successful exploration projects. As can be seen, these tax incentives seek to foster successful exploration and investment in this field.

Finally, exports are one of the sectors we expect to perform most strongly, particularly in 2018, taking advantage of the exchange rate becoming consolidated in a more stable range at significantly more competitive levels, with gains in relative competitiveness from depreciation of the real exchange rate against our trading partners. We expect exports to grow by 0.4% in 2017. This is slow, due to a number of ad hoc supply factors affecting the oil sector and some agricultural products, but we expect it to pick up to 3.1% in 2018. The gradual recovery in domestic demand, particularly from investment, will lead to stronger performance by imports. However, this will still be much weaker than seen so far this century. We expect 0.3% growth in 2017, and 3.6% growth in 2018. With export demand performing in this way, we expect a slower improvement in the current account, with estimated deficits of 3.9% in 2017 and 3.5% in 2018.

## Waiting on a slow recovery cycle

We expect 1.5% GDP growth in 2017, and 2.0% in 2018 (Figure 4.7). Our low expectations for growth are based on delays in the reanimation of investment and household spending, and a prolongation of adverse consumer- and business-confidence cycles. Thus, we expect gradual improvements in investment, from a 3.6% contraction in 2016, to growth of 1.9% in 2017 and 3.1% in 2018. Public investment will play an important role in this uniformly positive performance, through the 4G projects, a recovery in housing investment in 2018 and a gradual return to growth in investment in equipment. We expect 1.6% growth in household consumption in 2017, with the recovery slightly outperforming GDP growth in 2018, at 2.3%. The balance points to the floor of the slowdown in consumption being hit in 2017, but the recovery will be drawn out.

**Figure 4.7** Projections of GDP growth, private consumption and investment (%)



Source: DANE and BBVA Research