3. The economy in 2017: in search of the turning point

Markets: dollar kept in check by a rising crude oil price, assets undecided over the quarter

Over the third quarter, crude came back onto a rising course as a result of some disruptions to the supply from the Middle East and uncertainty caused by one of the heaviest hurricane seasons in the Atlantic Ocean. Even so, in the midst of these dynamics a key role was also played by strengthening demand and the declared intention of several OPEC member countries, including Saudi Arabia, to prolong production cuts. The Brent benchmark crude price thus hit USD52.2/bbl. in the quarter, showing a rise of 2.7% over its Q2 average (Figure 3.1).

In this scenario the COP appreciated markedly over the quarter, from 3038.26 pesos to the dollar at the end of June to 2941.07 at the end of September, with a maximum trading range of 199.47 pesos (Figure 3.2). This trend was overshadowed at the end of the quarter by Federal Reserve announcements of potential tightening of its monetary policy, hiking rates and unwinding its balance sheet in the fourth quarter.

On the capital markets front, the quarter saw mixed trends which reflected both domestic and external uncertainty. On the domestic side, the quarter began with a drop in the price of Colombian treasury bonds that was caused by a blend of: the announcements about the National Government’s medium term fiscal framework, the Fed announcements on scaling back the balance sheet and crude price volatility in June. From these levels there was a strong resurgence in their market price which was then affected once more by Fed announcements from abroad in the latter half of September and upturns in domestic inflation accompanied by a potential pause in the central bank’s cycle of rate cuts.
The mixed trends in the quarter also showed through in the performance of assets; on the one hand, the cost of underwriting Colombian bonds as measured via CDSs came down by 13.89 points, while the rate on Colombian 2024 treasuries rose by 18bp. At the same time, the Colcap share index was up slightly, by 1.7%, on the quarter. In terms of investments, net foreign flows fell back considerably, reaching USD577mn in the quarter as of 15 September, which was substantially less than the level observed in the first half of the year of USD2.357bn (Figure 3.2).

Activity indicators show signs of improving, thus confirming that the economy ought to have bottomed out in 2Q17

Colombia’s economy grew by 1.2% in the first half of 2017. This resulted from a continuation of the gradual yet steady process of economic slowdown which began with the drop in the oil price in 2014. More recently, going into the second half, the economic indicators are showing signs of improvement, which could be associated with a turning point in the decelerating path, and confirm the beginnings of a recovery in activity. Lower inflation and the rate cuts also point in the same direction.

Export and investment figures stand out. In the former case, there has been a notable increase in the monthly average of agro-industrial exports since May. In the case of investment, the positive takeaway can be found in the rise in imports directed at capital goods. This is the import component that has grown the most over the year so far. Moreover, its rate has picked up since midway through the second quarter despite the fact that in the first part of the year this was very heavily driven by aircraft imports, which almost completely faded away from May onward.

The second half of the year should therefore see higher growth than in the first half. The argument in favour of this course of events is supported by the better figures discussed above and also certain base effects which worked in favour of the performance in 3Q17. Here we refer to the lorry strike in July 2016, which frustrated a great deal of the economy’s transactions last year and led to a low basis for comparison relative to this year’s performance.

Nonetheless, we also expect other positive (or less negative) factors to gel which will underpin the coming recovery and mean that fourth quarter growth will also surpass that seen in the first half, in spite of the absence of statistically based factors at year end. These are: execution of the 4G civil engineering work, higher oil prices, investment in the mining and oil industry and the farming and livestock sector, the latter due to recent high growth rates. On top of this, though to a lesser extent, there will be a pick-up in the real estate projects that had been held up by low sales growth prior to implementation in September of the mortgage rate subsidy (although this will not offset the sharp drop in building work up to June).

An additional spur to economic activity has come in the form of public consumption, which grew at 3.4% YoY in the first half. Yet the momentum from this appears to have been transitory and will gradually wear off from late in the year. As we shall see anon in the fiscal section, government budget conditions require it to tighten up on public expenditure in 2018. Moreover, the law on electoral guarantees, which restricts direct contracting by arms of government for a certain number of months prior to elections (from November 2017), could stand in the way of high growth levels under
this heading, despite the fact that government bodies are now showing better control over expenditure restriction periods, and besides the above factors there is also a base effect as a result of a better performance than that recorded in recent years which places a limit on growth capacity in 2018.

Nevertheless, the economy’s acceleration is being limited by domestic confidence. Consumers are still pessimistic about current and future conditions in the country, even though their perception of household finances has improved (employment, household income, etc.). On the other hand, industrial respondents suggest that order volumes are still low although their inventories are slowly coming down and installed capacity utilisation stands at slightly above the historical average.

We expect GDP growth for 2017 to be 1.5%, which is the lowest rate for Colombia’s economy since the oil price fell. This reading has been attained via growth of 1.6% in household consumption and of 1.2% in investment, marking a return to positive territory after two years of contraction with respect to the latter. The great driver will be public consumption, with growth of 3.5%, whereas external demand will not play a decisive role in 2017.

Not many sectors are driving the economy, which betrays the weakness of private demand

The weakness of private demand has had negative consequences on several sectors in the economy. Trade has suffered from the lower consumption level and its growth rate in 2017 will be barely 0.6%. Besides having to cope with frail domestic demand, industry has also been hit by the weakness of Colombia’s trading partners and will consequently suffer a contraction of 1.0%. Even so, not all of the manufacturing sectors are in decline: the foods, and chemical products and paper segments are having a very good year thanks to increased agricultural supply and the fact that the demand for these products has not been very badly affected. For its part, despite the gradual upturn in civil project work, which has partly been driven by 4G activity, construction will see zero growth because of the
reduction in building construction. On the other hand, mining will end the year in the red on lower production of both oil and certain ores associated with construction.

On the positive side we can point to the growth rate of nearly 5% which agriculture will show, fuelled by higher production of coffee and a broad array of crops, which have benefited from more normal weather and the stimulus from prices which Colombia experienced last year. Finally, social services will perform positively, achieving growth of almost 3.0%.

Inflation is closing in on the target level thanks to foods and tradable goods, although this is still pending improvements for non-tradables.

The news on the inflation front remains encouraging as regards the foods and tradable goods segment. Agricultural output is still on the rise thanks to benign weather and the high prices recorded last year. On the other hand, the stability of the exchange rate has allowed the cost of imported products to stabilise, thus taking some of the wind out of the sails of tradable goods inflation. As a result of this, foods and tradable goods inflation has come down by roughly 11 and 4 percentage points, respectively and contributed to headline inflation falling back to the 4% level as this publication goes to print.

Thanks to the slowdown for tradables and weak demand in the economy, core inflation has also dropped. Its fall has been slower than that of headline inflation though, given that inflation for the non-tradable segment has held relatively stable at a rate of about 5.2% throughout this year; the high degree of persistency exhibited by this indicator is still a cause for concern for certain members of the board at the central bank, causing them to entertain doubts about the speed at which headline inflation will hit the 3% target, which is a factor that played a significant role in the central
bank’s decision to hold the reference rate stable in September. Given this context, we still expect headline inflation to end the year at a rate in the region of 4.2%, while core inflation should stand at approximately 4.7%.

The central bank is likely to stick to its current policy until it receives indications of further relief with respect to inflation

Over the year the central bank has steadily cut its reference rate by 225 basis points since February and 250 bp since rates peaked, from December 2016. This policy adjustment was largely in response to the slowdown in inflation and expectations with respect to it, as well as weak economic activity. Nonetheless, certain inflation components that are still on the high side, such as non-tradable goods, could lead the central bank to ask itself whether this is due to indexation and inflation persistence, in which case its effect should be transitory and pave the way for it to make further rate adjustments, or whether, on the contrary, the fact that non-tradable goods inflation (that which most closely follows demand) has not fallen back reflects lower excess production capacity and a narrower GDP gap, with the result that a bigger policy rate cut could once again revive inflation.

Given this straight choice, the central bank chose to leave the policy rate unchanged at its September meeting and, in the context of rising inflation up to the end of the year, we take the view that it will prefer to hold its stance unchanged as it waits to confirm (very possibly in early 2018) whether high core and non-tradable goods inflation is wearing off as the effect of inflation persistence fades or whether the pressure from this is persevering on account of a narrower than expected GDP gap.
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