BBVA Research

Colombia Economic Outlook 2Q18

Colombia Unit

April 2018

Creando Oportunidades

Key messages

- Global growth remains robust, but uncertainty rises. The fiscal stimulus in the US may extend growth impact in other areas, but protectionist measures imply a risk
- Economic recovery will rely on private activity. Better conditions for investment and household consumption will forge a gradual recovery along 2018 and 2019 on the shoulders of the private sector. For 2018 GDP will grow 2,0% while in 2019 it will grow 3,0%, still below potential GDP growth of about 3,3% in the mid term.
- Inflation inertia breaks in 2018 and inflation converges to the target, 3,1% for the end of 2018. The absence of upward price pressing shocks like the ones seen in the past couple of years, in hand with a still weak demand, allow inflation to adjust to the target within the first semester and core inflation to close 2018 within the target range for the first time after 3 years of not achieving the target. The Central Bank will have space to reduce its policy rate to 4,0% in the second quarter. This to maintain the real policy rate slightly accommodative.
- The current account deficit has reduced significantly, laying a more solid base for economic recovery. The current account deficit for 2018 will be around 2,7% of GDP thanks mainly to oil price recovery, and slightly higher in 2019. On the other hand, fiscal deficit for 2018 will be around 3,1%. For 2019 an active fiscal policy is required to fulfill the fiscal rule objective.
- In the mid term, we expect a potential GDP growth of around 3,3%. Traditional sources of growth are fading, with a high investment rate, higher than the average of the OECD and a diluting demographic bonus, the economy requires a transformation towards productivity growth to achieve a better performance of potential GDP growth and with which to maintain and improve social advances of the past two decades.

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Global context

Robust global growth, but higher uncertainty

01

The pace of global growth continues...

...thanks to the recovery in investment and trade

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Economic policies are extending the cyclical recovery

The US fiscal stimulus could underpin the other areas

03

Greater financial volatility

The unusual environment of low volatility has been left behind

04

Normalisation of the monetary policy of central banks

somewhat faster than expected at the Fed, while the ECB has already taken the first steps

05

Uncertain effect of US protectionist measures

The direct effect of what has already been approved is not very sizable but could herald more aggressive measures

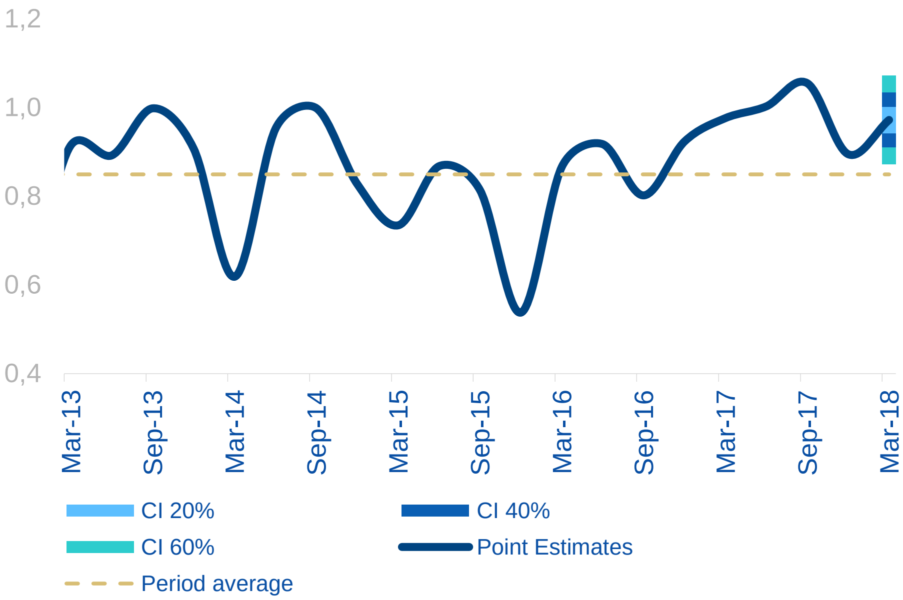
06

Global risks

Greater in the short term due to a possible escalation of protectionist measures

Robust global growth

World GDP growth
(Forecasts based on BBVA-GAIN, % QoQ)

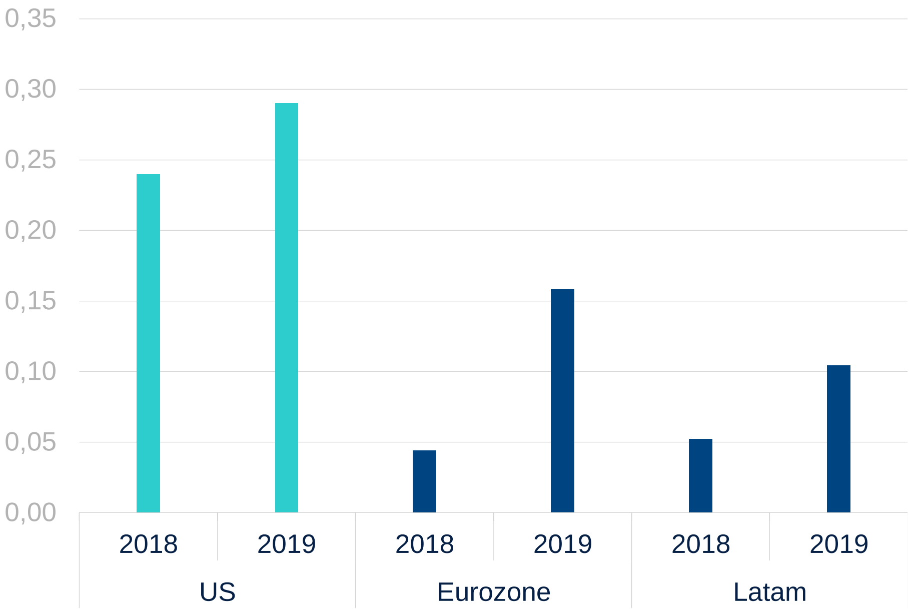


- Global growth is continuing, buoyed by the recovery in investment and trade
- Private consumption is softening, but remains a positive factor for the advanced economies and is gaining momentum in emerging economies
- Confidence indicators remain at high levels, but show signs of dampening

Source: BBVA Research

Higher growth in the US could underpin progress in other areas

Impact of the US fiscal stimulus on growth
(pp)

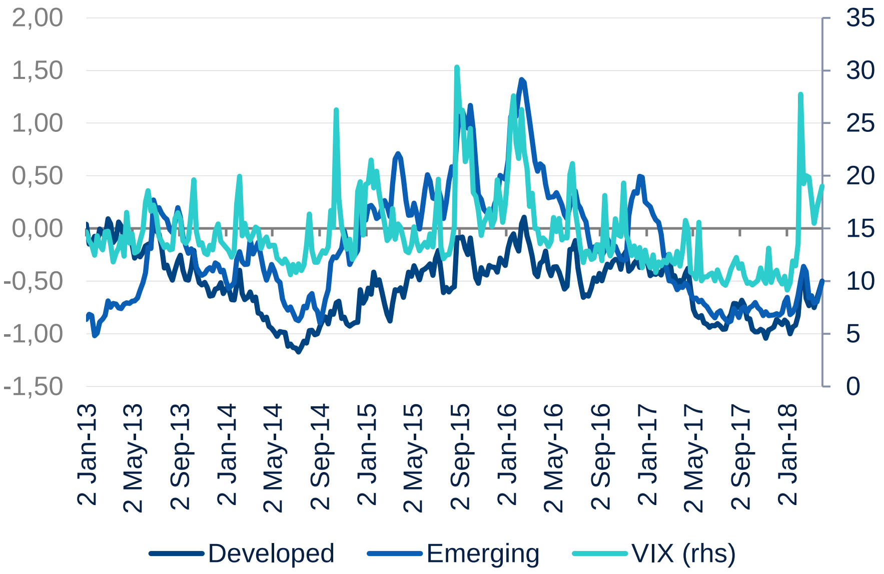


- The most significant effect should be observed in 2019, especially in the euro area
- Such support should offset some headwinds in other areas (political uncertainty in Latin America or increasing global volatility)
- Dollar weakness could diminish the positive impact of the increase in US demand

Source: BBVA Research

Financial stresses are beginning to reflect a less benevolent environment

VIX and BBVA financial tensions indicator
(%)



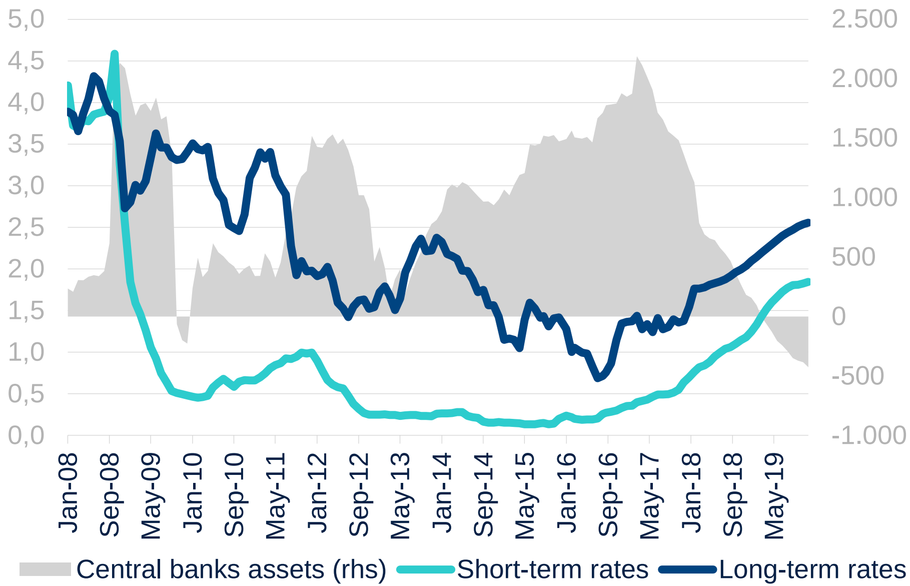
- The fear of an upturn in inflation (United States) and the announcement of protectionist measures has triggered an increase in volatility and correction on stock markets
- The spill-over effect is proving limited, but everything will depend on the persistence of the current shock
- It is unlikely that the markets will be as obliging as regards uncertainty as in 2017

Source: BBVA Research with Bloomberg data

Financial conditions will be less accommodative

Global financial conditions*

(% and change in billion dollars)



- In a context in which central banks will be scaling down their balance sheets and interest rates gradually rise...
- ... volatility shocks could be more frequent and persistent
- More cautious positioning by investors

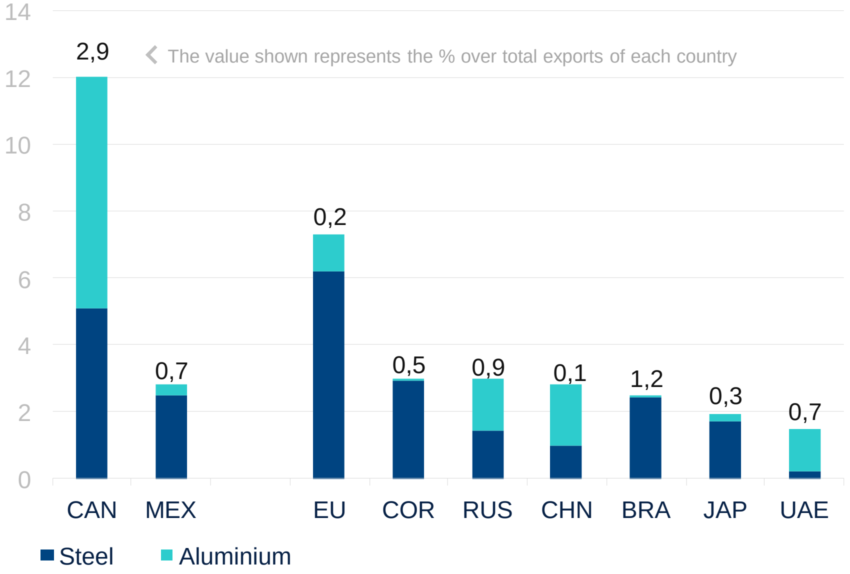
(*) Short and long term interest rates, average yield of German and US bonds over 3 months and 10 years. Includes assets on the balance sheets of the Fed, ECB, BoE and the BoJ

Source: BBVA Research, Fed, ECB, BoE and BoJ

The risk of an escalation of protectionism is prompting uncertainty over the global economy

USA: Imports of steel and aluminium and weight of total exports of each country

(billion USD, % of total exports)

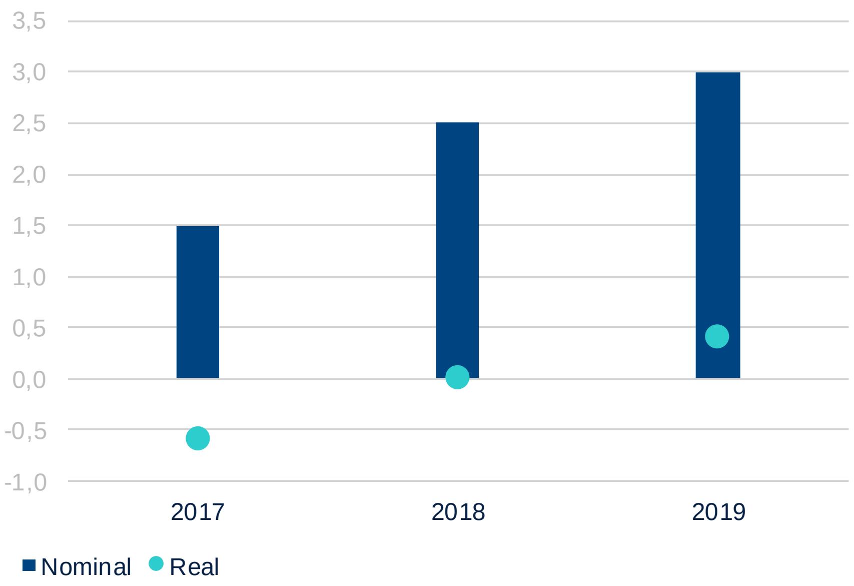


Source: BBVA Research

- Tariffs on US steel and aluminium have a small direct impact:
  - They only represent a small portion of total exports
  - Exemption for many countries until May
  - The greatest adverse impact might come from the indirect effects and the potential reaction of the affected countries
- The mutual tariff hike between the United States and China (25%):
  - These have a bigger impact: 38% of exports to China (3% of the total) and 11% of exports to the US (2% of the total)
  - It may be only the beginning of a major escalation

Fed rate hikes are picking up pace on increased economic dynamism

US: Policy interest rate
(%)



Source: BBVA Research, Fed y BEA

- The Fed will raise rates by 75 basis points more this year and another 50 basis points in 2019
- Monetary conditions will remain loose, with real interest rates

The ECB is making headway in exiting QE without generating tensions

QE

2018 will see the ending of QE

Monthly asset purchases (€30 billion) up to September

Reduction of purchases between September and December

Rates

As we approach the end of the QE, **the focus is shifting to rate hikes**: when they start and at what pace

But **the ECB will remain present in the debt market**: reinvestment upon maturities

The **challenge** for the ECB is to **marshal expectations** about rates (forward guidance)

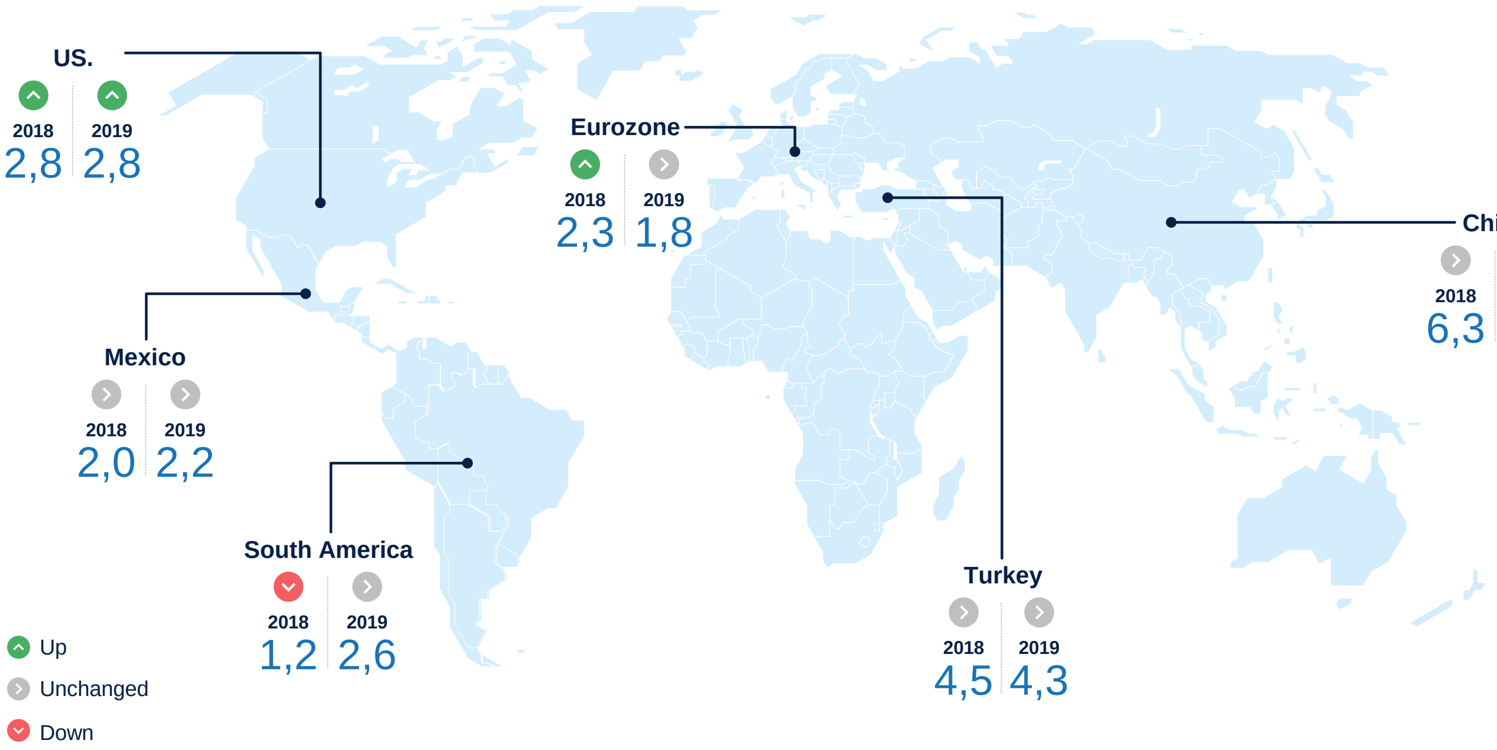
Key elements in the exit from QE:

Rates at the long end and risk premiums

Exchange rate (EUR)

Rate hike expectations

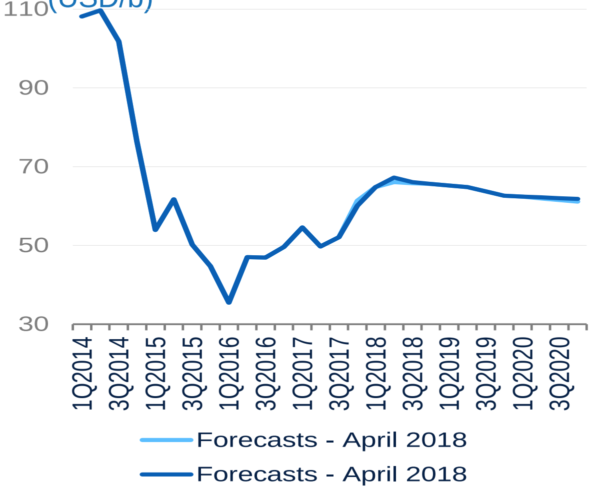
Revised upwards in the USA and downwards in South America



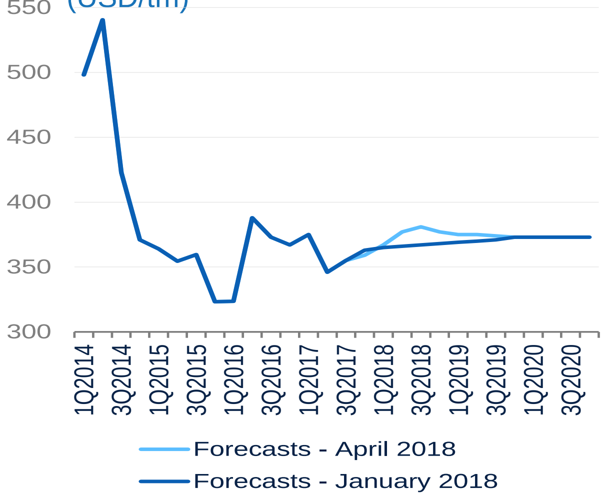
Source: BBVA Research

Commodity prices continue to move upwards, mainly supported by demand factors

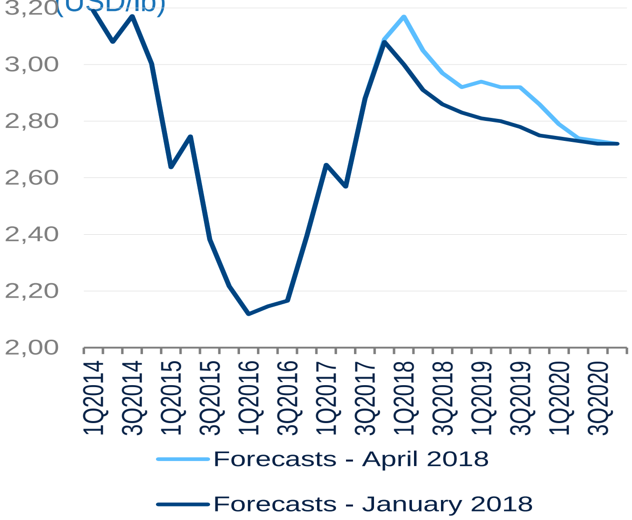
Brent oil
(USD/b)



Soybean
(USD/tm)



Copper
(USD/lb)

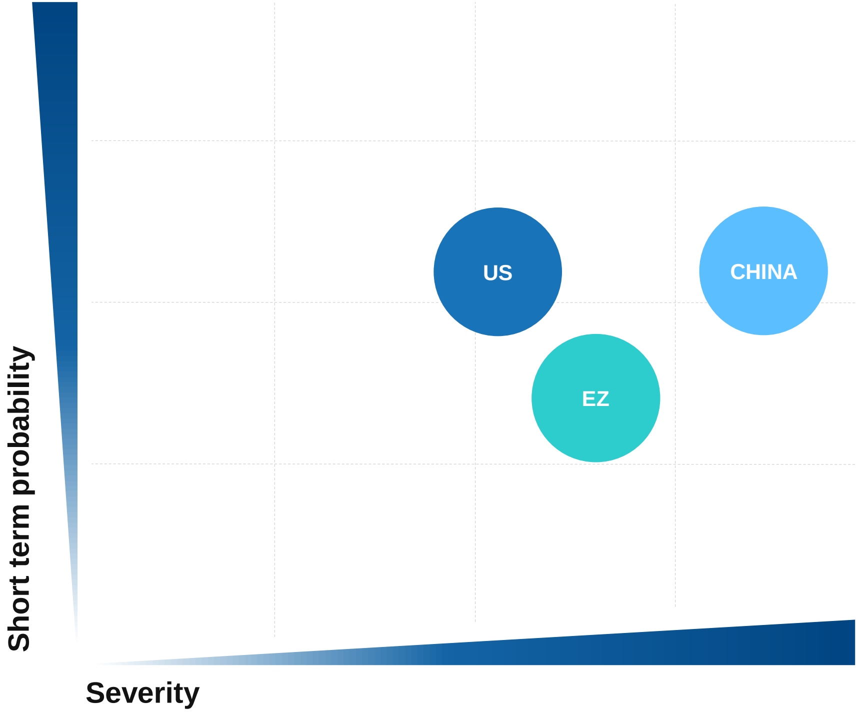


Source: BBVA Research and Bloomberg

The oil price converged recently to a range between 60 and 65 dollars per barrel. Global growth will support the price of the crude, but the expected increase in production will likely support of the price to USD 60 / b in the medium term

We continue to anticipate copper price to adjust downward as speculative positions decline. Soybean prices will continue to increase due to the effects of the drought in the producing areas of South America

Global risks: Growing in the short term and with a focus on the US.



Source: BBVA Research

CHINA

- Containment of risks associated with high leverage in the short term and the economic slowdown
- Potential negative effect of increased protectionism

USA

- Recent announcements increase the risk of protectionism
- Political controversy is still high, despite the fiscal stimuli
- Signs of over-valuation of certain financial assets
- Risks associated with the Fed exit (aggressive rate hikes in the face of a temporary spike in inflation) and its impact on the bond market

EUROZONE

- Increased political uncertainty after the elections in Italy
  - Italy: uncertainty about the formation of the new government. Risk of a policy that hinders the European project
  - Brexit: doubts about future trading relations
- Management of the normalisation of monetary policy

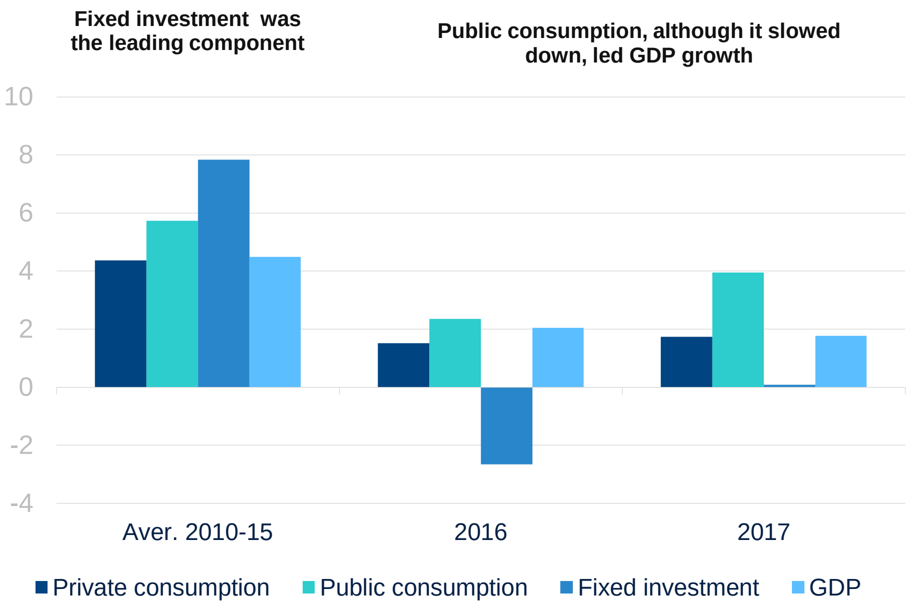
02

Recovery based on the private sector

In 2017, the economy grew 1,8% helped by a strong public expenditure

GDP Components (withouth external demand)

(Annual variation, %)



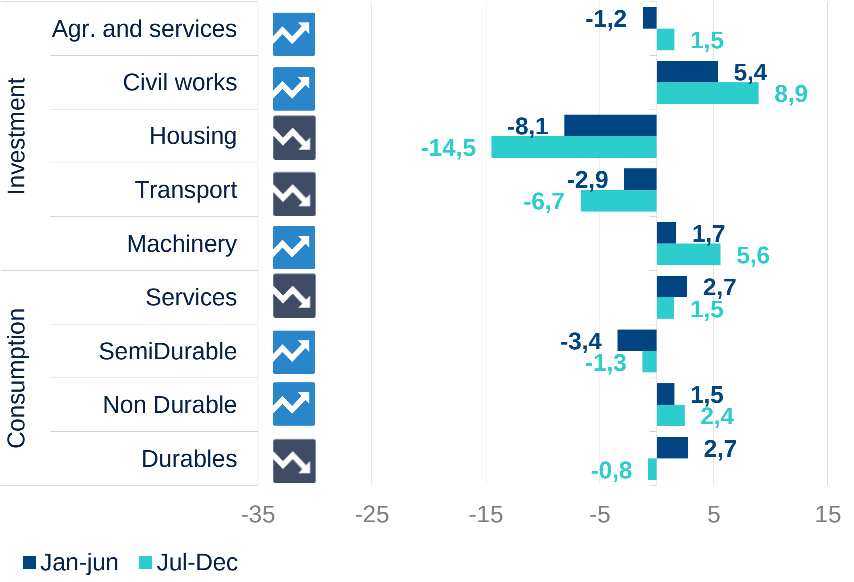
- In the first part of this decade, investment supported GDP growth. In the past couple of years, after the oil price shock, investment has reduced its contribution to growth…
- … allowing, for 2016 and 2017, public expenditure to contribute more to growth

Source: BBVA Research with DANE data

At the end of 2017, some components of the private demand start to show a better behavior

Investment and consumption components (in GDP)

(Annual variation of the semester, %)



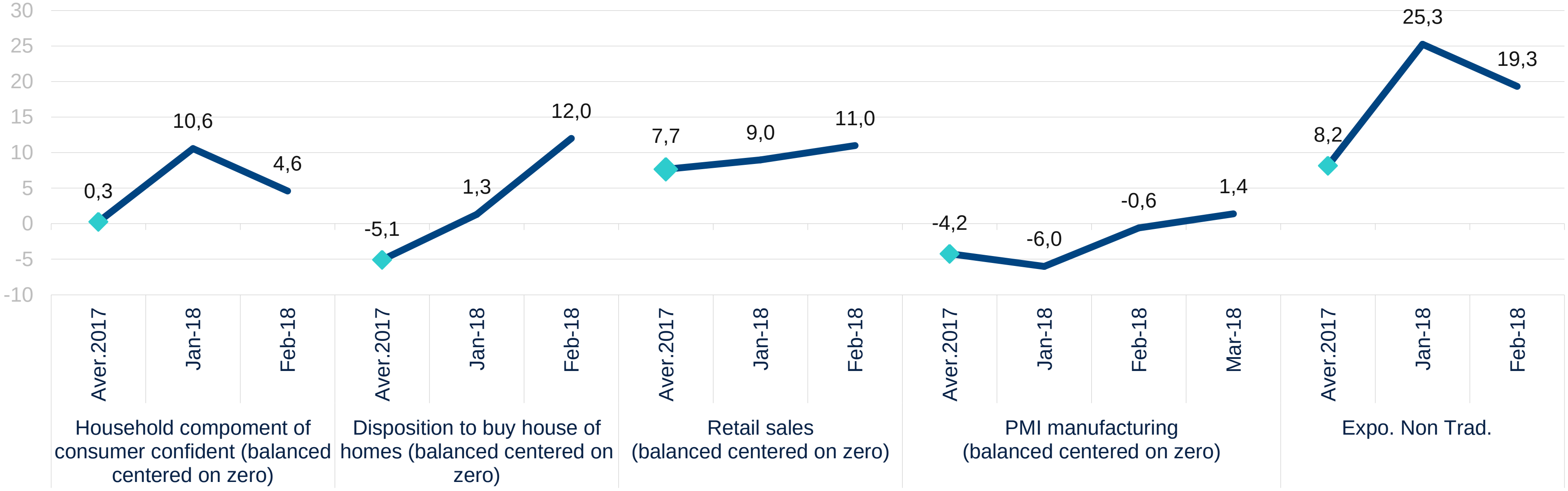
- Expenditure in machinery accelerated, this probably relates to an expected increase in demand
- Households increased first their expenditure in basic goods (non-durable and semi-durable goods), which is characteristically of recovery cycles where other types of consumption tend to react with a lag

_Source: BBVA Research with DANE data

Some leading indicatores show a recovery in private expenditure in 2018

Private expenditure leading indicators

(Balance and annual variation, %)

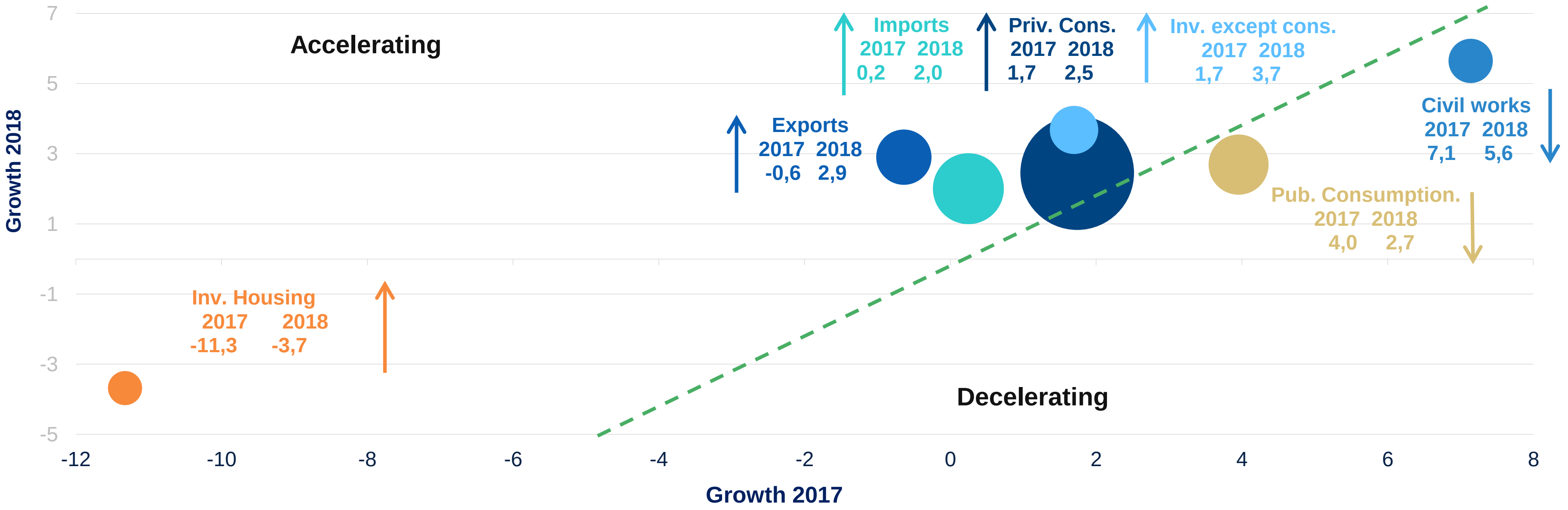


Source: BBVA Research with Fedesarrollo, Fenalco, Markit and DANE data

Hence, we expect an acceleration in private expenditure in 2018

Expected growth by components of the demand

(Numbers below each year in each component correspond to the annual growth. Size of the circle indicates weight in GDP)

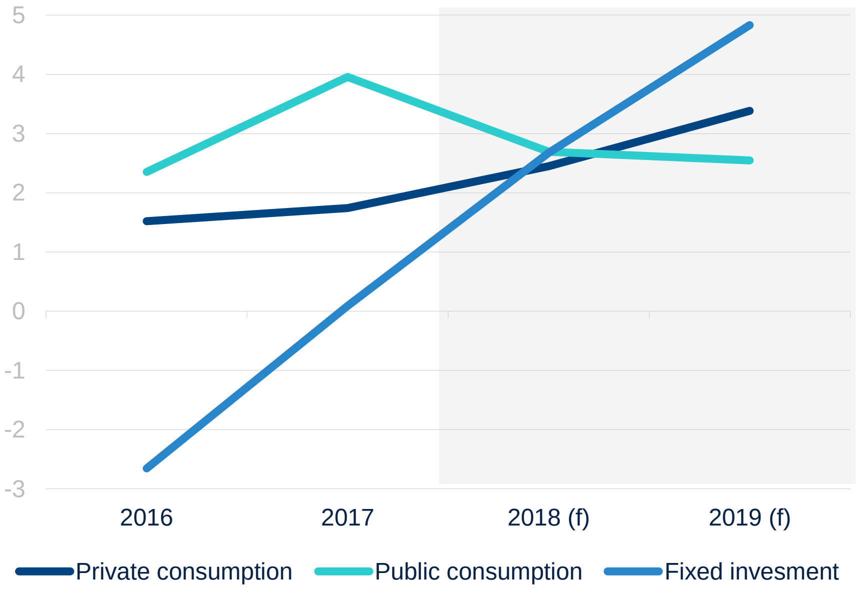


Source: Forecast BBVA Research and observed data DANE. *Priv.Cons = Private consumption. Pub.Consumption. = Public consumption.

…which will continue in 2019 thanks to a significant acceleration in investment and durable goods consumption

Investment and Consumption

(Annual variation, %)



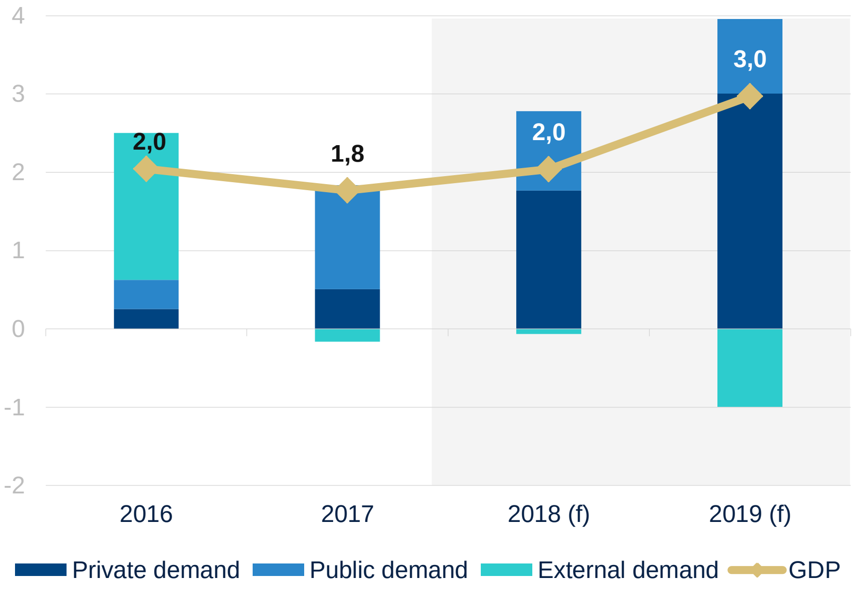
(f) Forecast
Source : Forecast BBVA Research and observed DANE data

- The return to positive growth in the housing sector will be very important to propell general activity and investment.
- Private consumption will continue to accelerate in 2019 from the good behavior in durable goods given positive financial condiciones as low inflation and low interest rates and from de services sector

Private demand will gain momentum in GDP growth in 2018 and 2019

Growth contribution by demand components

(Contribution to annual variation of GDP, %)



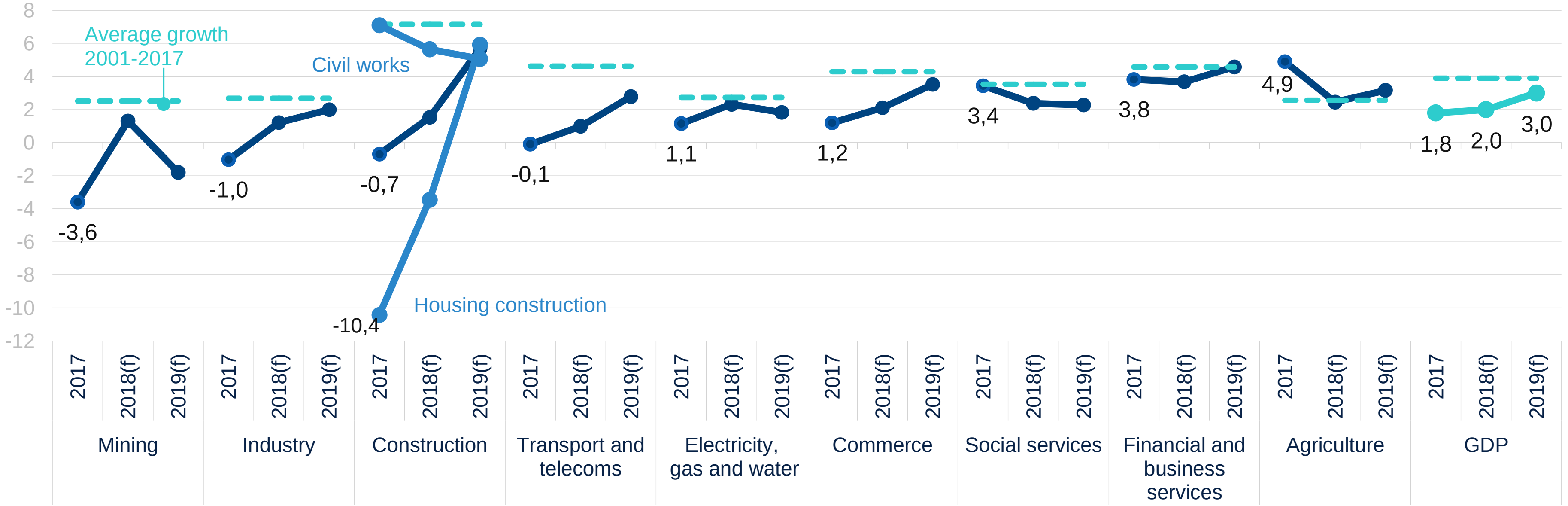
(f) Previsión
Source : Forecast BBVA Research and observed DANE data

- In 2017 the contribution by the public sector prevailed in explaining GDP growth. In 2018 and 2019 the tide will shift and private demand will lead in explaining GDP growth.
- The recovery in private demand will imply a higher growth of imports, which will in turn make external demand contribute in 2019 negatively to GDP growth

On a sector level, growth will accelerate in most sectors in 2018 and 2019, though below the average of the past two decades

Growth forecast for supply side GDP

(Annual variation, %)



Source: BBVA Research with DANE data

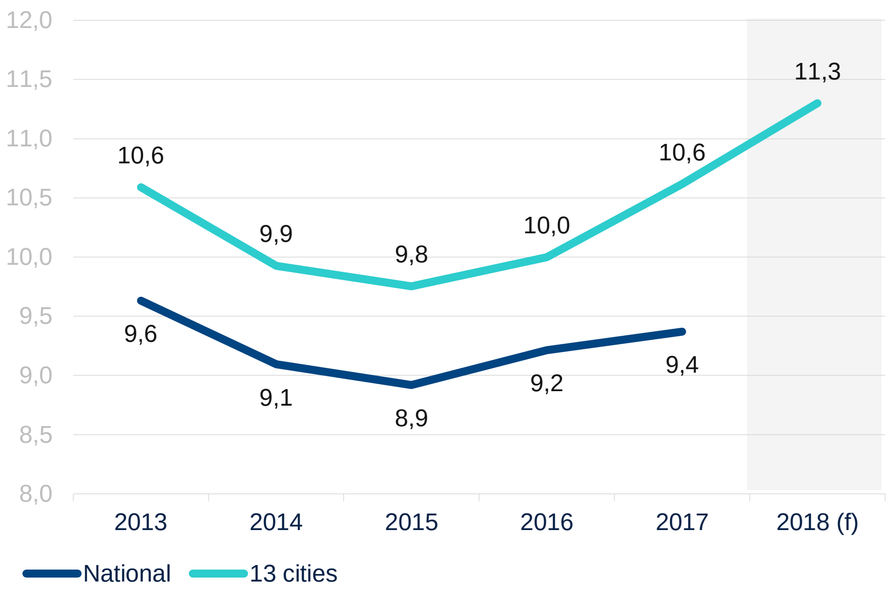
Unemployment will continue to increase in 2018 in the main 13 cities.

Empoloyment creation
(thousands of jobs, % of total)

	13 cities	10 cities	Small cities	Rural	Total
Agriculture	**-4** (-2%)	**1** (0,4%)	**24** (11%)	**138** (61%)	**159** (70%)
Industry	**-20** (-9%)	**9** (4%)	**57** (25%)	**40** (18%)	**86** (38%)
Real estate activities	**55** (24%)	**4** (2%)	**33** (14%)	**-7** (-3%)	**85** (37%)
Transport	**18** (8%)	**1** (0,3%)	**27** (12%)	**-16** (-7%)	**29** (13%)
Construction	**2** (1%)	**-2** (-1%)	**-19** (-8%)	**-9** (-4%)	**-28** (-12%)
Commerce, hotels y restaurants	**-51** (-22%)	**3** (1%)	**5** (2%)	**-56** (-25%)	**-98** (-43%)
Others	**-2** (-1%)	**10** (4%)	**-7** (-3%)	**-8** (-3%)	**-7** (-3%)
Total	**-2** (-1%)	**25** (11%)	**121** (53%)	**82** (36%)	**226** (100%)

Source: BBVA Research wuth DANE data

Unemployment rate
(%, year average)



(f) Previsión

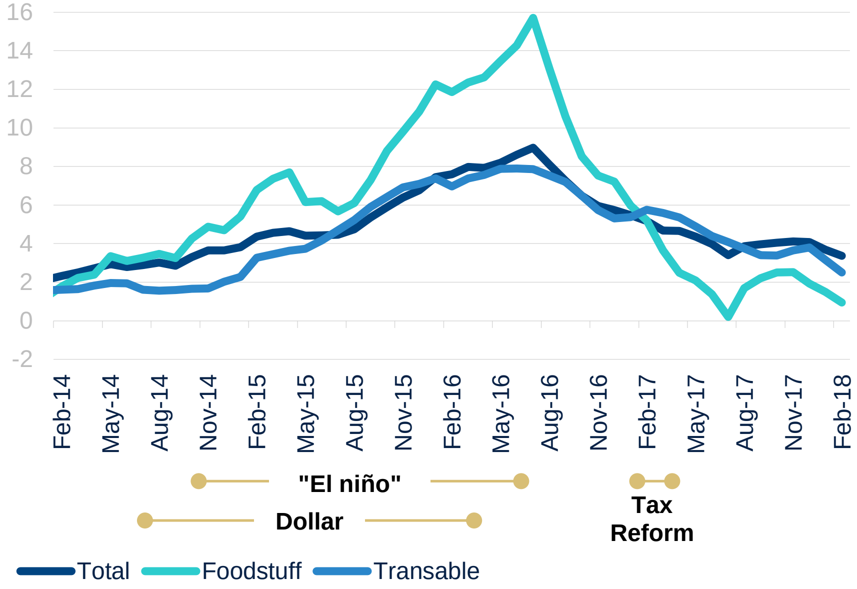
03

Controlled inflation and low interest rates

The shocks of the exchange rate, climate and tax reform that affected inflation have diluted

Total, foodstuffs and tradable goods inflation

(Annual variations, %)

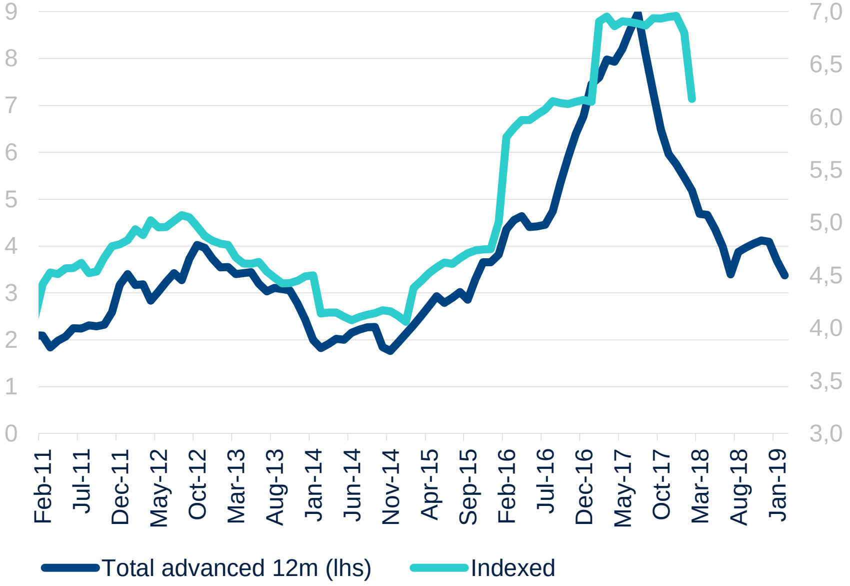


- 2015 to 2017 supply side shocks on inflation have diluted, nonetheless, some items maintain a high inflation due to the price inertia, rising the average
- This items respond with a lag to headline inflation, which should imply that inflation will continue descending in the next couple of months, specially core inflation

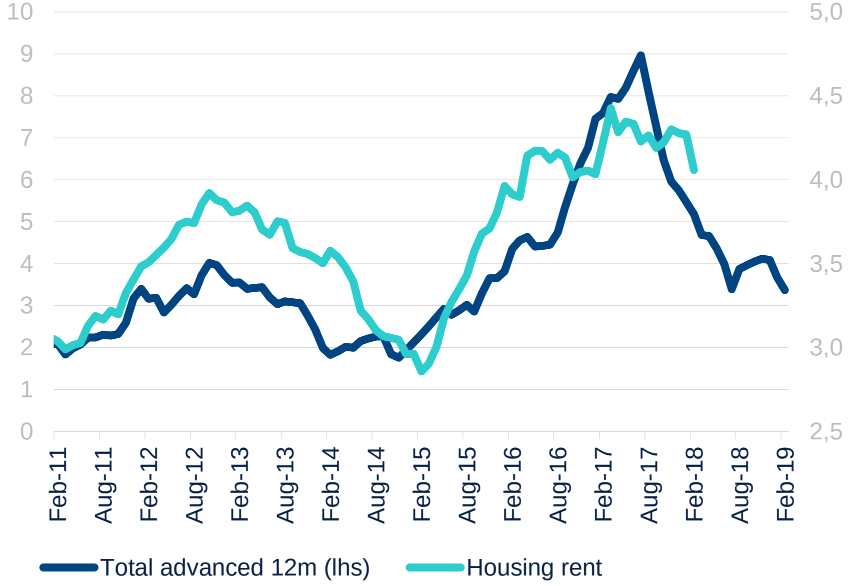
Source: BBVA Research with DANE and BanRep data

Items with high inertial component start to react to headline inflation deceleration

Total and indexed* inflation
(Annual variation, %)



Total and housing* inflation
(Annual variation, %)

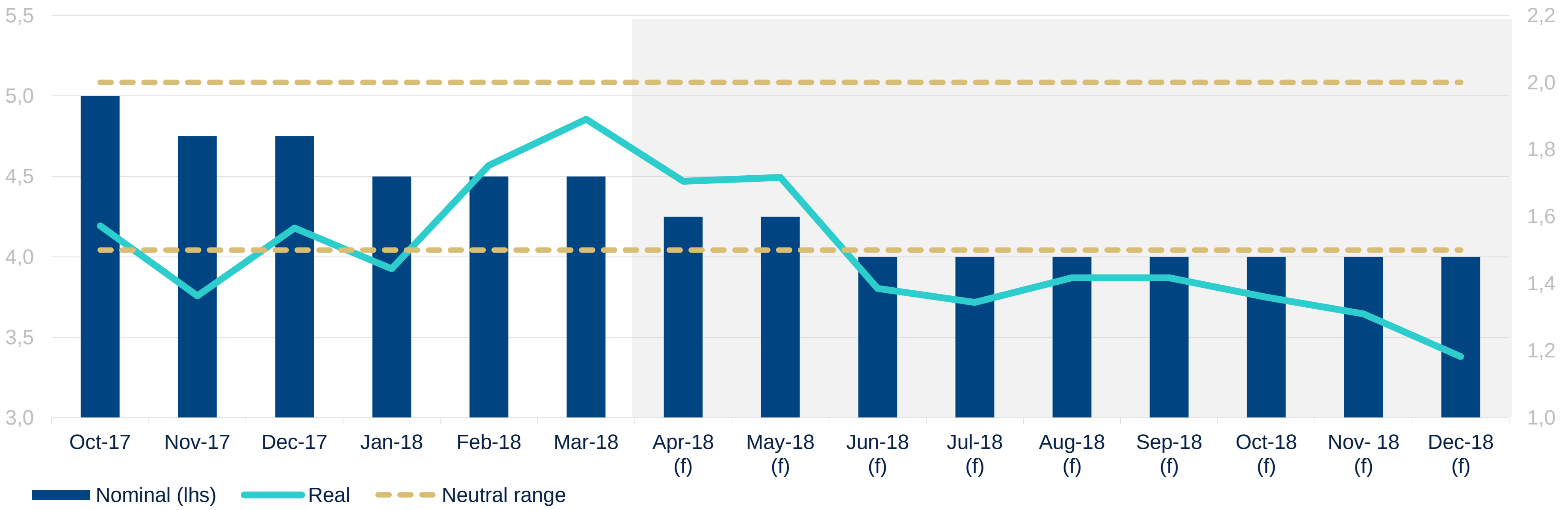


(*) Indexed account for 8,1% of CPI basket and include some services as education and health. Housing accounts for 18,6% of total CPI basket.
Source: BBVA Research with DANE data

Current real interest rate is within the nuetral range and a reduction in nominal rates is required in order to have an accommodative stance

Nominal and real policy rates

(%, real rate is calculated with 12 month proyected inflation by BBVA)



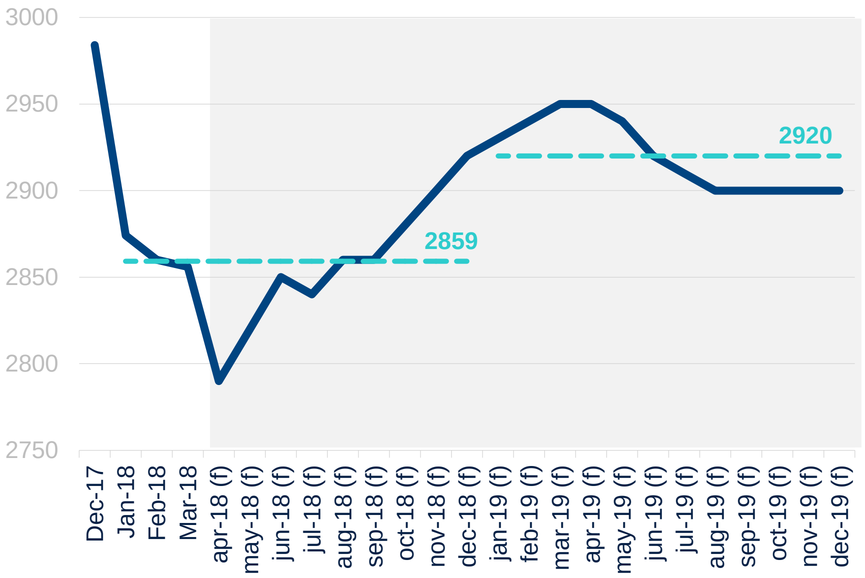
(f) Forecast

Source: BBVA Research with DANE and BanRep data

In the exchange rate front, apetite for local assets and high oil prices have appreciated the Colombian peso

Exchange rate

(Pesos per dollar)



(f) Forecast
Source: BBVA Research with DANE data

- High oil prices and a gradual adjusment in global monetary policy maintain an apetite for local assets, which has led to a significant year to date appreciation of the Colombian peso
- We expect a contained depretiation of the exchange rate for the rest of the year product of the monetary policy normalization in the US and a moderate correction in oil

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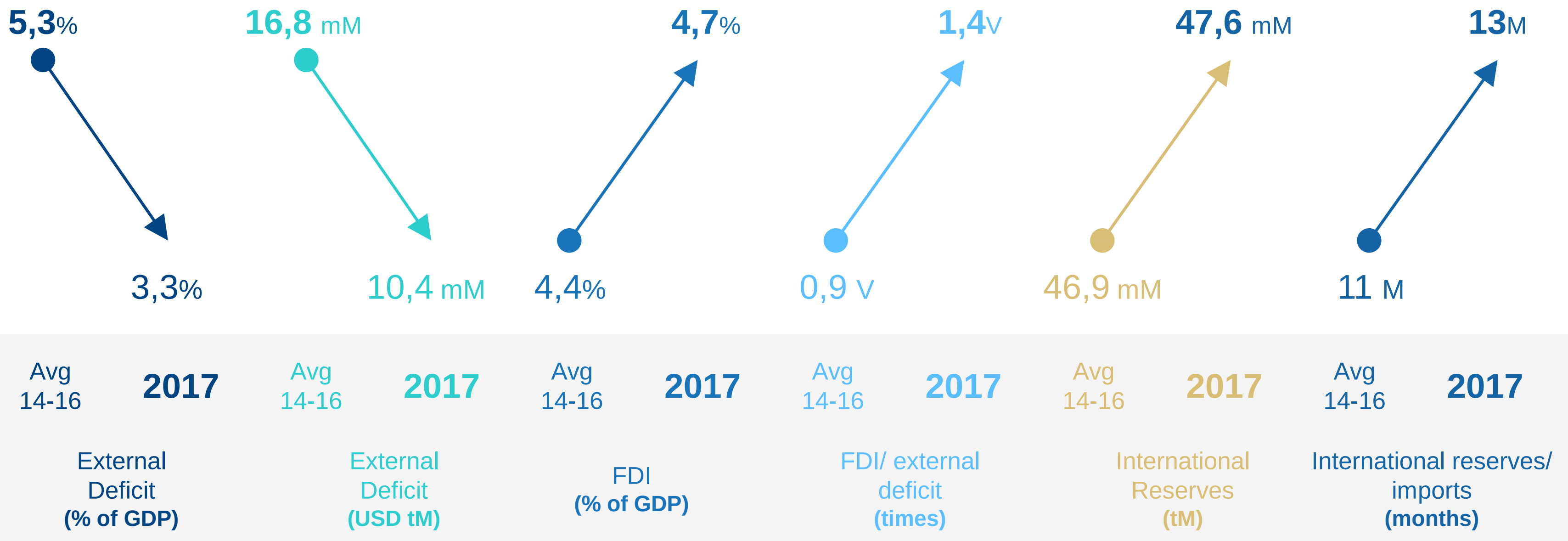
04

Improving macroeconomic balances

2017: a year in which the extarnal deficit and its financing consolidate their improvment

Principal external indicators

(% of GDP, USD thousand million, times and months)

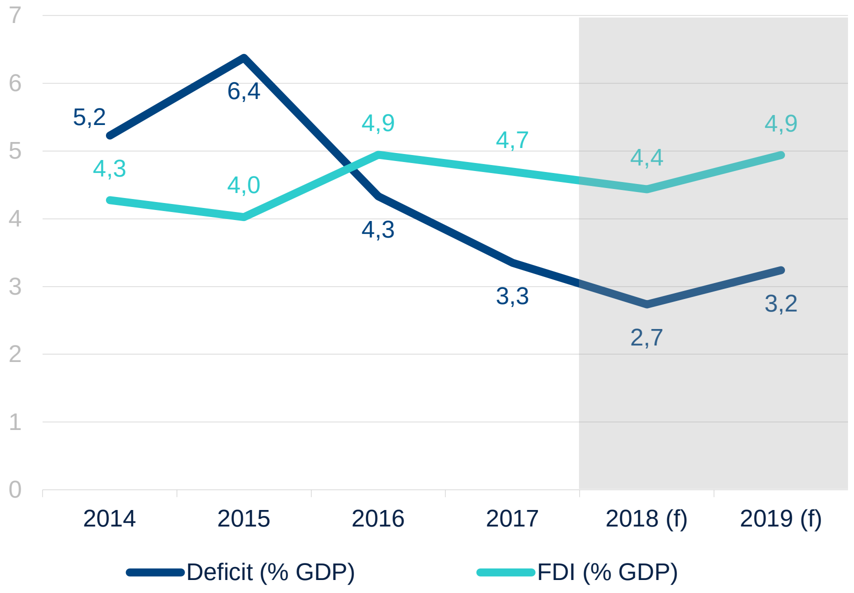


Fuente: BBVA Research with Banco de la República data

In 2018 and 2019, current account deficit will be controlled and its structural financing will be wider

External deficit and Foreign direct investment

(% of GDP)



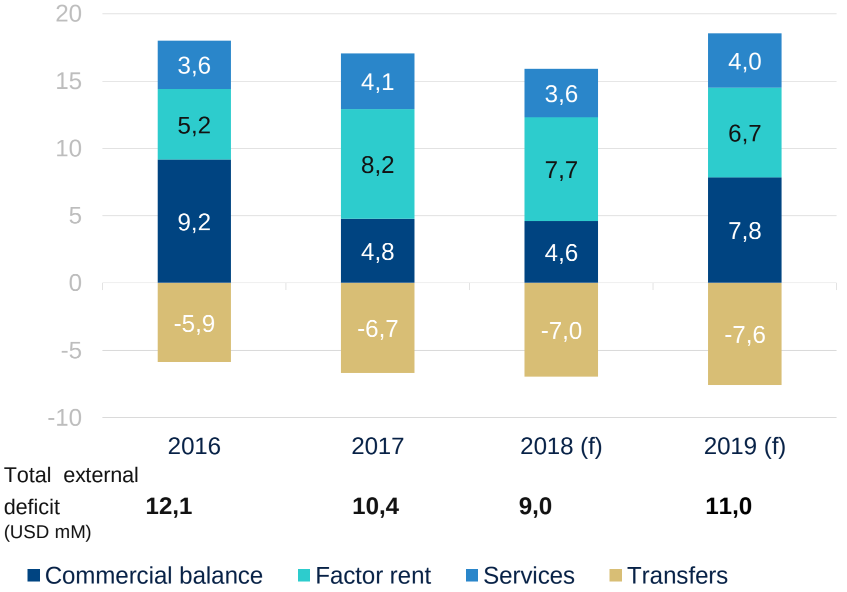
- In 2018 and 2019, the current account deficit will be covered in 1,6 and 1,5 times by Foreign direct investment
- This will help to compensate possible lower portfolio inflows for the second half of 2018
- FDI, in thousands of millions of dollars, will be similar to the observed for 2017

Source: BBVA Research with Banco de la Repúblicva data

In 2019 the commercial balance will be the main source of the external deficit given the expected rebound in imports

External deficit components

(USD Thousand of millions, Transferences is a possitive account)



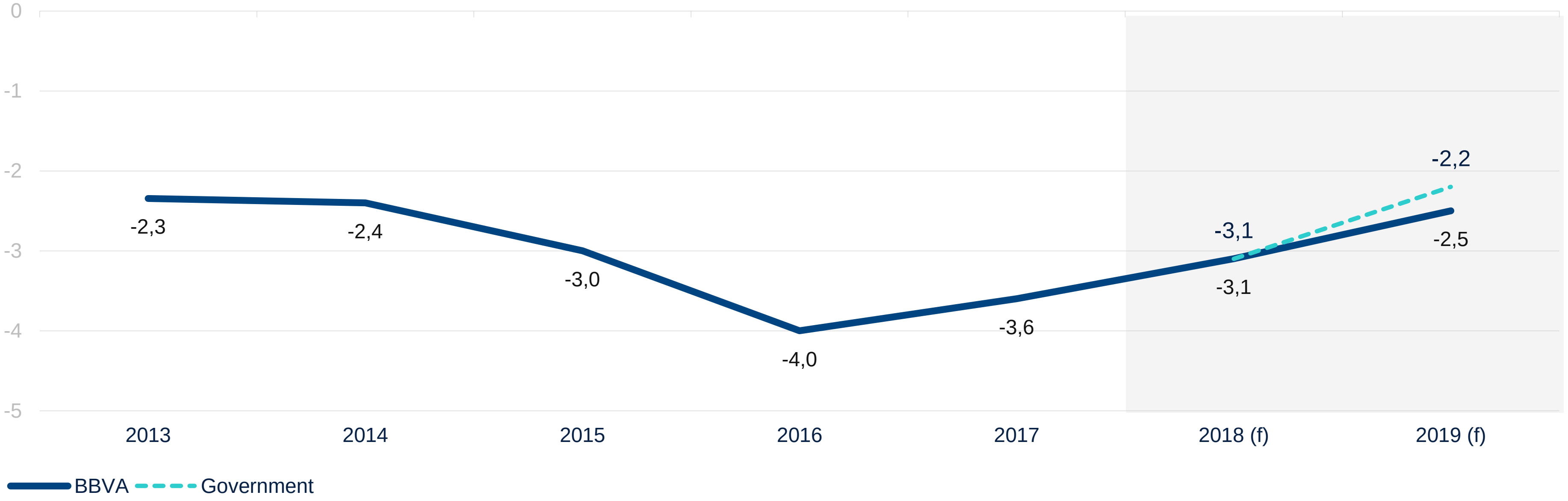
(f) Forecast
Source: BBVA Research with BanRep data

- In 2019, the external deficit, though at low levels, will rise due to a lower oil price and production and to de acceleration in internal demand and the subsequent impulse in imports
- Factor payments (net dividends transferred from local (foreign) capital abroad (home)) will reduce its deficit thanks to the better world context

After the recent peak reached in 2016, the fiscal deficit is adjusting gradually

National Government deficit

(% of GDP)



(f) Forecast
Source: BBVA Research with Minhacienda data

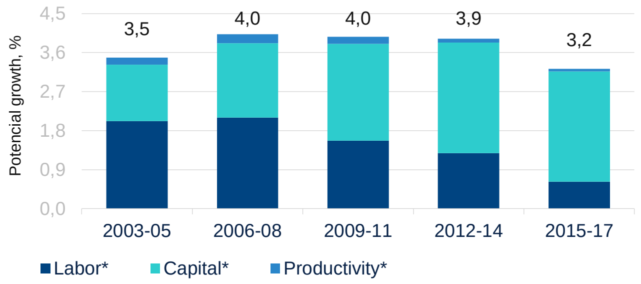
05

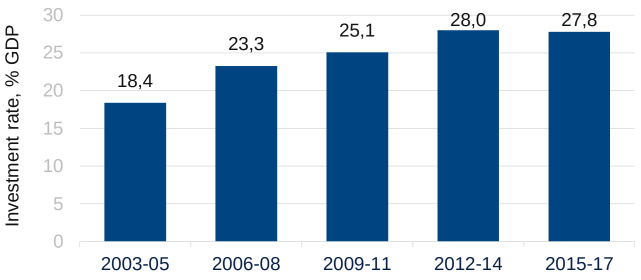
Mid term growth

Colombia has exploited in a significant way the traditional factors of production: capital and labor

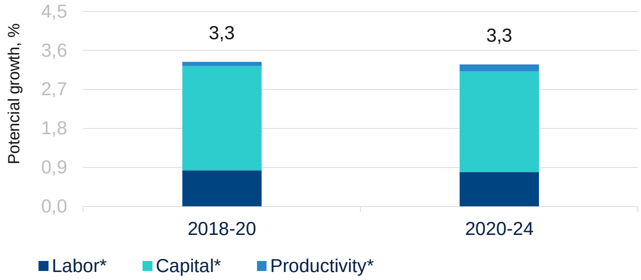
Potencial GDP growth and investment rate in Colombia

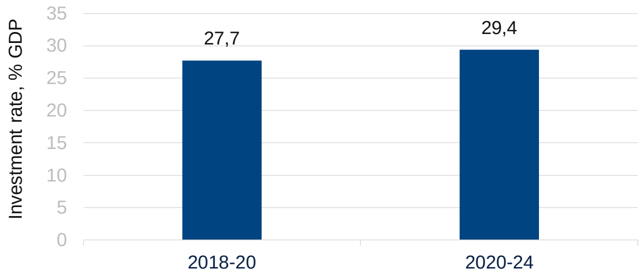
Historic





Forecast





More productivity Is requiered

Traditional factors are Not enough

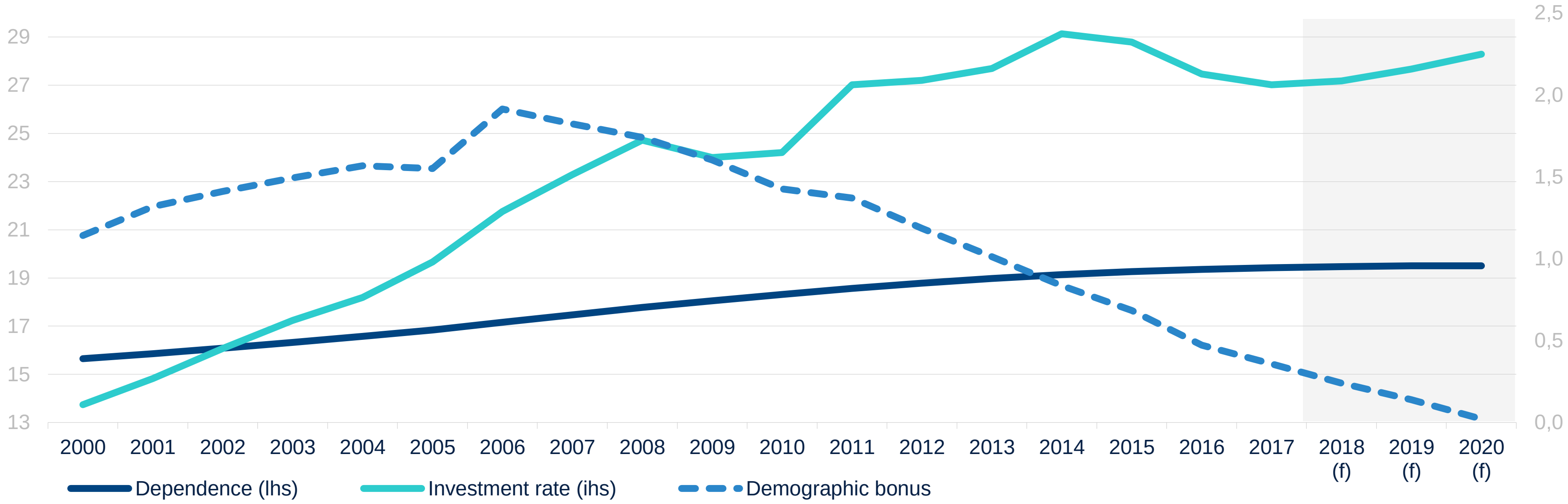
The space for investment growth is limited

(*) Contribution to potential GDP growth by production factor
Source: BBVA Research. With DANE data

We are entering a cycle of lower contribution by the demographic bonus and rate of investment as sources of GDP growth

Investment rate and dependency index

(investment rate: I/GDP; dependence: active to non active people; demographic bonus and its variation)

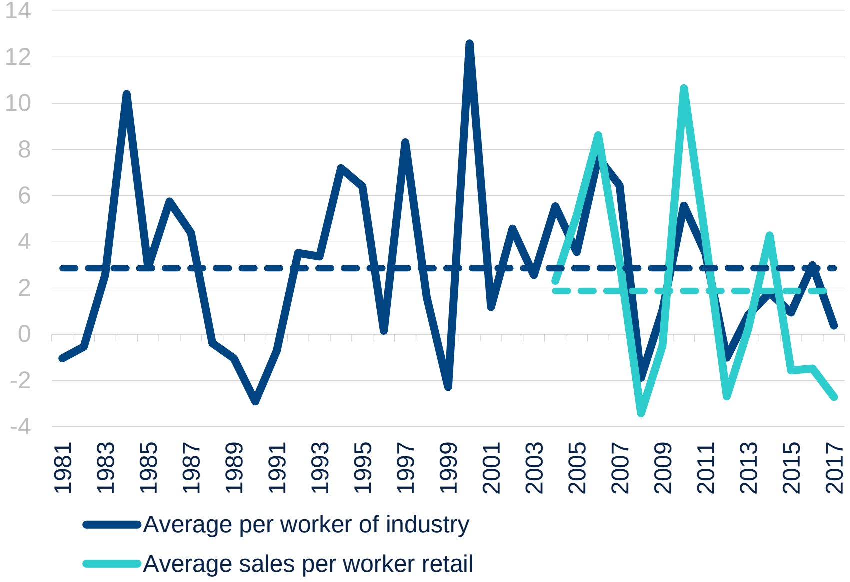


(f) Forecast
Source: BBVA Research with OCDE and DANE data

Productivity, measured as the proxy of product per worker, has been stable in the past 30 years

Industrial production and retail sales per worker

(Production index (sales) / employment index)



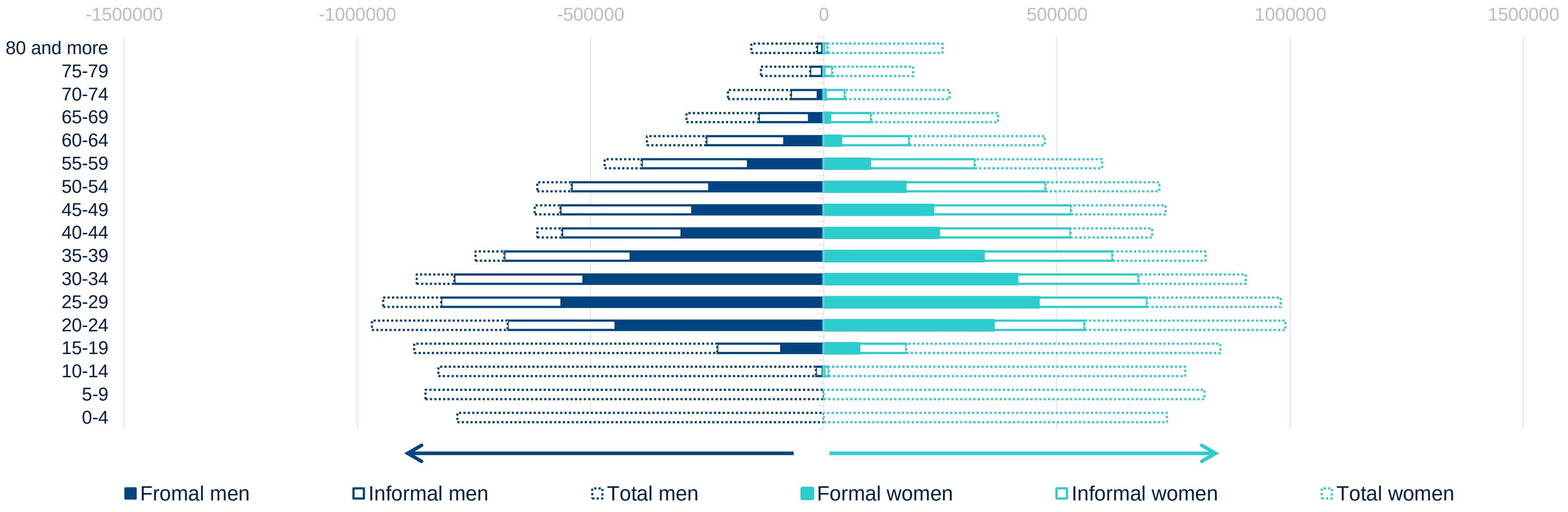
- Productivity in Colombia has had little gowth in the last 30 years, or even none according to some metrics (like producto by worker)
- In the current scenario, of greater difficulty to increase investment and the decay of the demographic bonus, a higher growth in productivity is requiered to increase GDP growth

Source: BBVA Research with DANE data

A path that may influence productivity growth is the reduction of labor and entreprenual informality

Total, informal and formal population

(13 cities, 2016)

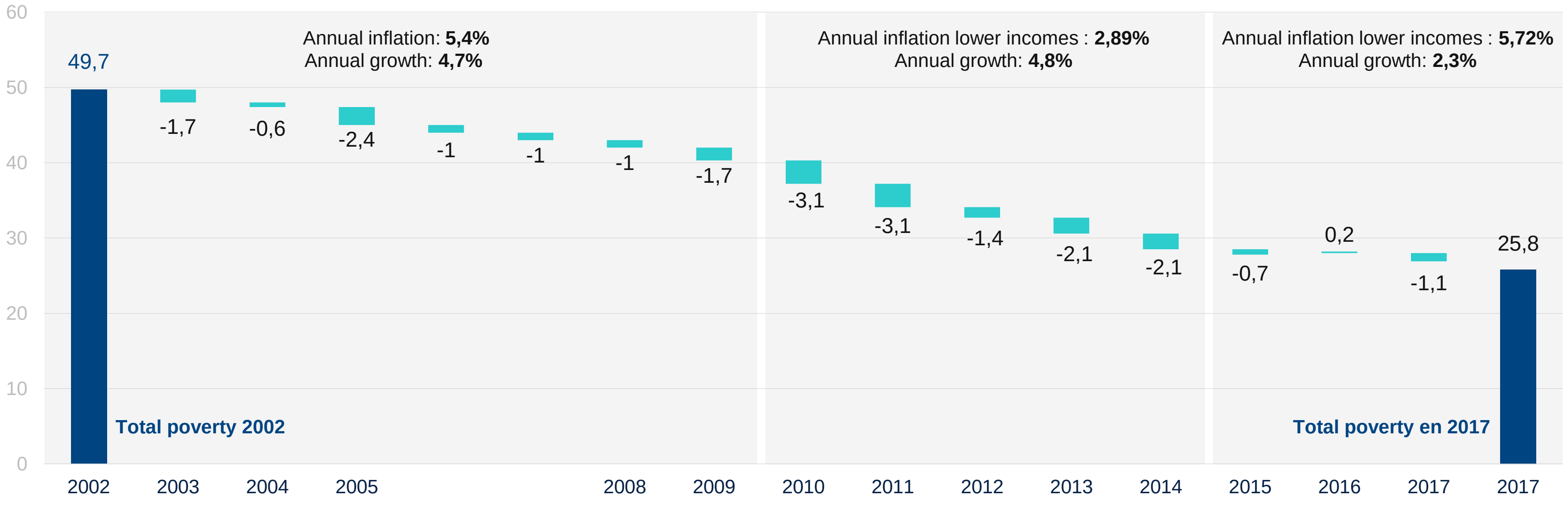


Source: DANE, integrated household survey

¿Why should we grow more? To continue and avoid setbacks in the diverse social indicators

Poverty indicator

(% population, annual change)



Source: DANE, integrated household survey

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Colombia Economic Outlook

2Q18

Colombia Unit

April 2018

Creando Oportunidades

Macroeconomic variables

TableA1. Macroeconomic forecasts

	2014	2015	2016	2017	2018	2019
GDP (YoY, %)	4.4	3.1	2.0	1.8	2.0	3.0
Private consumption (YoY, %)	4.3	3.2	1.5	1.7	2.5	3.4
Public consumption (YoY, %)	4.7	5.0	2.4	4.0	2.7	2.5
Fixed investment (YoY, %)	9.8	1.8	-2.7	0.1	2.7	4.8
Inflation (%, YoY, eop)	3.7	6.8	5.7	4.1	3.1	2.8
Inflation (%, YoY, average)	2.9	5.0	7.5	4.3	3.1	2.7
Exchange rate (eop)	2,392	3,149	3,001	2,984	2,920	2,900
Devaluation (%, eop)	24.2	31.6	-4.7	-0.6	-2.1	-0.7
Exchange rate (average)	2,001	2,742	3,055	2,951	2,858	2,920
Devaluation (%, average)	7.1	37.0	11.4	-3.4	-3.2	2.2
BanRep interest rate (%, eop)	4.50	5.75	7.50	4.75	4.00	4.00
Deposit interest rate (%, eop)	4.3	5.2	6.9	5.3	4.4	4.4
Fiscal nalance (% of GDP)	-2.4	-3.0	-4.0	-3.6	-3.1	-2.5
Current account balance (% of GDP)	-5.2	-6.5	-4.4	-3.3	-2.7	-3.2
Unemployment rate (%, eop)	9.3	9.8	9.8	9.8	10.8	10.6

Macroeconomic variables

Table A2. Quaterly macroeconomic forecasts

	GDP (%, YoY)	Inflation (%YoY, eop)	Exchange rate (vs. USD, eop)	BanRep rate (%, eop)
Q1 15	2.6	4.6	2,576	4.50
Q2 15	3.0	4.4	2,585	4.50
Q3 15	3.2	5.4	3,122	4.75
Q4 15	3.4	6.8	3,149	5.75
Q1 16	2.5	8.0	3,022	6.50
Q2 16	2.2	8.6	2,916	7.50
Q3 16	1.5	7.3	2,880	7.75
Q4 16	1.8	5.7	3,001	7.50
Q1 17	1.5	4.7	2,880	7.00
Q2 17	1.7	4.0	3,038	6.25
Q3 17	2.3	4.0	2,937	5.25
Q4 17	1.6	4.1	2,984	4.75
Q1 18	1.8	3.1	2,780	4.50
Q2 18	1.7	2.8	2,850	4.00
Q3 18	2.1	3.1	2,860	4.00
Q4 18	2.7	3.1	2,920	4.00
Q1 19	3.1	2.7	2,950	4.00
Q2 19	3.1	2.7	2,920	4.00
Q3 19	2.8	2.6	2,900	4.00

This report has been produced by the **Colombia Unit**

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Creando Oportunidades

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