# Colombia

## In search of a second wind

*Colombia is coming off a four year macroeconomic adjustment, orchestrated by a large terms of trade shock following the end of the commodity super cycle in 2014. Colombia made a number of policy adjustments to deal with the shock and since 2017, the economy has largely corrected allowing the current account balance to narrow, the fiscal balance to improve and inflation to converge towards the target. However, the intensification of the Venezuelan migrant crisis is challenging fiscal accounts. President Duque's pledge to make adjustments to the 2016 peace agreement represents a source of risk to the security environment. Meanwhile, the economic slowdown has bottomed out in 2018. Growth is set to accelerate in 2019 but will remain modest.*

### Cyclical pickup in growth

In 2018, the economy's growth rate accelerated (+2.7% y/y) after decelerating continuously between 2014 (+4.7% y/y) and 2017 (+1.4% y/y)—its lowest level since the global financial crisis. Meanwhile, the upward adjustment to the minimum salary, the effects of el Niño weather phenomenon and FX pass through did not materialize into increased inflationary pressures as the CPI surprised to the downside (+3.2% y/y at end 2018), allowing the policy rate to remain unchanged since April 2018 at 4.25%. GDP growth was driven by solid private consumption growth (+3.9% y/y) which benefited from decelerating inflation, rising real wages, improving consumer sentiment (through H12018), and lower real interest rates. After dipping in negative territory in 2017, gross investment bounced back in 2018 (+3.5% y/y) driven by strong inventory accumulation. It accelerated strongly post elections on the back of an uptick in commodity prices, a greater availability of credit, a rebound in property investment and a recovery in construction. However, the consumer led demand recovery resulted in a sharp acceleration in imports (+8 y/y). Meanwhile, exports experienced a deceleration (+1.2% y/y from +2.5% in 2017) resulting in net exports acting as a significant drag on yearly growth.

Looking forward, the economy is set to gain speed (+3.5% in 2019 and 3.3% in 2020) but will remain below historical trend growth (+4.3%, over period 2000-17). The main sources of growth will be domestic. Household spending should benefit from increased bank lending and a gradual improvement in the labor market. Congress' decision to reject the government's proposal to broaden the VAT base should also support households' purchasing power. Lower corporate tax rates, recovering oil prices as well as the strong projected capital expenditure by Ecopetrol should, in the meantime, back an acceleration in investment. Government spending is set to moderate owing to a tight fiscal situation. Sentiment indicators though show a hesitant start to the year. Manufacturing PMI showed a print below 50 for the third consecutive month in March and consumer sentiment - while on a broadly increasing trend since November - remained in pessimistic territory in February.

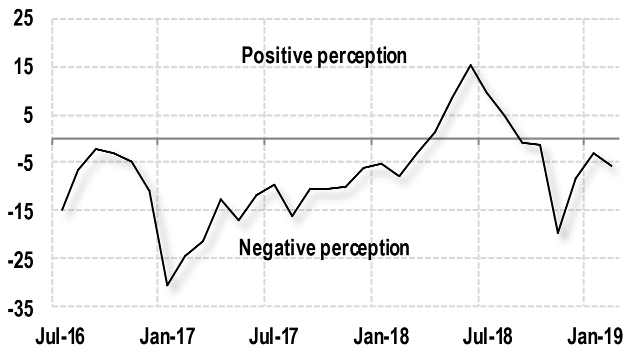
In the medium term, Colombia's growth outlook remains supported by a sound policy framework (credible inflation targeting regime, fiscal rule, active public debt management, and exchange rate flexibility). Colombia's invitation to OECD membership in May 2018 also testifies to its efforts towards structural reforms along several policy areas (labour, governance, trade, industry). Nonetheless important challenges remain in order to raise the economy's growth prospects, most notably large infrastructure gaps (in roads and ports), high commodity dependence, lagging economic diversification with dwindling competitiveness in manufacturing, elevated levels of job informality, as well as still high levels of drug related violence and organized crime.

**1- Forecasts**

| | 2017 | 2018e | 2019e | 2020e |
|---|---|---|---|---|
| Real GDP growth (%) | 1.4 | 2.7 | 3.5 | 3.3 |
| Inflation (CPI, year average, %) | 4.3 | 3.2 | 3.2 | 3.6 |
| Fiscal balance / GDP (%) | -3.6 | -3.1 | -2.4 | -2.6 |
| Gross public debt / GDP (%) | 46.6 | 46.1 | 44.1 | 45.7 |
| Current account balance / GDP (%) | -3.4 | -3.8 | -4.0 | -3.8 |
| External debt / GDP (%) | 40.3 | 41.9 | 42.6 | 43.5 |
| Forex reserves (USD bn) | 47 | 48 | 48 | 49 |
| Forex reserves, in months of imports | 10.1 | 9.2 | 10.0 | 10.0 |
| Exchange rate USD/COP (year end) | 2952 | 2958 | 3021 | 2922 |

*e: estimates and forecasts BNP Paribas Group Economic Research*

**2- Consumer confidence index (points)**




*Source: Fedesarollo, BNP Paribas*

### Fiscal challenges linger amid new tax reform

Colombia's fiscal accounts are expected to face mounting pressures despite recently passing a sixth tax reform in 10 years. The reform[1]

[1] The reform which introduced new measures to increase tax collection was principally marked by tax incentives for the corporate sector to help promote private investment, one of President Duque's main campaign goals. Alongside a reduction in the VAT for capital goods, the corporate income tax will be cut by 1 pp annually to

failed to tackle a number of structural fiscal ailments, namely rigid spending (~85% of spending is mandatory), high dependency on oil and most importantly lift long term revenue intake (tax revenues as share of GDP have stagnated since 2011 at ~14%). In fact, congressional bargaining resulted in the reform projecting only half as much revenue as expected in the original bill (~0.7% of GDP). Moreover, the concurrent lowering of the corporate tax rate should result in an estimated 1% of GDP loss in revenues annually. This is coming at a time where pressures on public finances are mounting due to the fiscal impact of the Venezuelan migrant crisis (estimated at +0.5% of GDP annually). In April, this has led the fiscal rule committee to adjust the fiscal deficit targets for 2019 and 2020 to 2.7% and 2.3% of GDP. Given the shortfall in revenues, public borrowing requirements will increase but should be easily covered thanks to strong appetite for Colombian debt both from domestic lenders and foreign investors (as evidenced by relatively low sovereign risk premia on external debt with 5 year CDS at 107 bps in April).

## Slowing investment flows

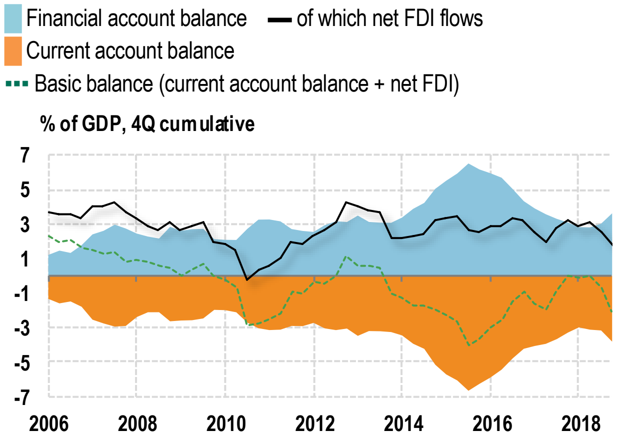
Colombia's current account deficit narrowed through 2017, adjusting relatively rapidly since deteriorating strongly in 2015 (-6.4% of GDP). Strong import growth in 2018 partly reversed the trend as the CAD widened to 3.8% of GDP. The continued recovery in domestic demand coupled to a slowing global economy should come at the expense of a rising CAD in 2019.

In 2018, net FDIs failed to cover the CAD owing in part to inward FDIs slowing to their lowest level since 2010 (~USD 11bn vs USD 14.5bn on average over period 2011-17). The external financing shortfall was covered by new debt commitments in the form of loans predominantly contracted by the private sector. The rising levels of external debt (42% of GDP in 2018 vs 27% in 2014) underscores an increased vulnerability to tightening external financing conditions. Colombia also remains vulnerable to a sell-off resulting from shifts in investors' sentiment. The stock of portfolio liabilities held by non-resident has increased by 14% on average since 2012 (~24 of GDP in 2018). Non-resident holdings of local currency sovereign bonds are sizeable (at ~25%) and foreign investors also represent more than 1/3 of total market traded volumes in the local stock market. In 2018, portfolio inflows slowed down significantly (USD 349 mn vs USD 7.8bn in 2017) resulting in net outflows by non-residents of USD 1.2bn. In the local stock market, foreign investors were net sellers for the first time in 7 years.

The authorities have recently taken steps to mitigate exposure to a sudden stop in external financing. In September 2018, the Central Bank announced a programme to accumulate reserves through the sale of put options—a course of action it had already resorted to in the past. Colombia also has a precautionary Flexible Credit Line (USD 11.4 bn, 3.3% of GDP) in place with the IMF through 2020. Colombia's external liquidity position remains comfortable (representing ~ 9 months of imports and covering close to 2/3 of the stock of portfolio investment). Above all, the flexibility of the exchange rate will remain Colombia's first line of defence against external shocks. Meanwhile, the fate of external accounts will stay largely tied to oil prices (oil represents ~40% of exports, and attract over 1/3 of FDI).

30% by 2022 from 33% in 2019. The reform also catered to foreign investors by cutting tax withholdings for offshore sovereign bond investors from 14% to 5%.

**3- Balance of payments**




*Source: Central Bank of Colombia, BNP Paribas*

## Headwinds on the political front

President Duque has faced multiple headwinds since stepping into office in August 2018. His government's difficult relationship with Congress required a significant watering down of his ambitious tax reform bill. Student protests over education spending, popular resistance over his proposals to cut gas and energy subsidies and the fallout from the corruption scandal with Brazilian construction firm Odebrecht also hurt his approval ratings. Meanwhile, drug trafficking and crime have been on the rise. The number of coca plantations has also surged since 2013 and illegal armed groups and drug gangs have continued to fight over former FARC territories. The intensification of the political crisis in Venezuela and the large inflow of migrants have also been a source of tensions on society and public services. The violent attack perpetrated by the Ejercito de Liberacion National (ELN) in January against a police academy in Bogota (killing over 20 office cadets) has meanwhile fueled concerns about a possible deterioration in the security environment at a time where President Duque is revisiting the legislation implementing the peace accord with the FARC[2]. While the move to revisit the peace deal is in line with President Duque's campaign promises, and echoes widespread popular discontent over certain provisions of the 2016 agreement, altering the agreement creates a risk that demobilized combatants might once again take up arms. President Duque's pledge to focus on structural reforms to boost GDP growth above 4% may be contingent on his ability to first safeguard peace.

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[2] President Duque announced in March a partial veto of a law governing the transitional justice system, the so-called Special Jurisdiction for Peace (JEP) on the grounds that the terms of the JEP are too lenient.