

Colombia Macro Update

EXECUTIVE SUMMARY:

- Growth is gaining momentum, even if we don't expect it to strengthen as much as the government's forecasts suggest. On the rates front, we are fairly in line with consensus, although we see the bottom of the easing cycle a little higher than consensus, but it will depend on fiscal results.
- Even if we see a somewhat challenging political environment for the fiscal adjustment, we only see 30% odds of a downgrade by S&P, and very, very low odds of a loss of investment grade.

MACRO SITUATION

Colombian growth is accelerating, at the same time as rapidly dropping inflation is giving BanRep room to ease rates. The main hurdle for easing is fiscal. We expect growth in Colombia to gradually accelerate over the next couple of years, even if we are a little less constructive than the government's projections. The [FinMin's estimates suggest that potential GDP growth is around 3.7%–3.9% for the next few years](#), a view to which we skew risks to the downside (probably closer to 3.0%–3.5%, which is still very reasonable in the global context, and given the strong drop in Colombia's terms of trade we saw a couple of years back). The good news is that growth should be supported by a couple of structural factors that will gradually play out over the next couple of years, and explain why we see growth accelerating in the coming years. These factors can also help diversify the Colombian economy in the longer term, reducing risks from shocks:

- The [4G road construction program](#) is expected to drive investments of nearly US\$50bn, directed at constructing 7,000 km of roads to improve connectivity in Colombia (5,400 km will come from rounds 1–3). The government's estimates suggest that during its construction, the 4G program could boost growth by 1.5 percentage points. In addition, relatively poor infrastructure is currently one of the main hurdles for the country, with the Executive Survey undertaken by the World Economic Forum showing inadequate infrastructure as the third main obstacle for doing business in the country (after tax rates and corruption).
- The Peace Process: progress on pacifying the country should have a positive impact on growth going forward. Not only will a substantial amount of resources now be re-deployed to more productive objectives (estimates reported by the [Australian Institute of Foreign Affairs suggest that Colombia spent US\\$140bn in the conflict](#), the 7th highest cost of violence as a share of GDP globally), but we will also see important regions of the country now open for investment and, over time, we could see the cost of developing the country's energy assets drop, as attacks on oil infrastructure by FARC rebels disappear. We expect this benefit to be gradual, but meaningful.

CONTACTS

Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174
Scotiabank Economics
eduardo.suarez@scotiabank.com

Chart 1: Colombian growth and inflation are both delivering better news in 2017, with CPI back within BanRep's target, and the economy rebounding.

Colombia: growth and inflation

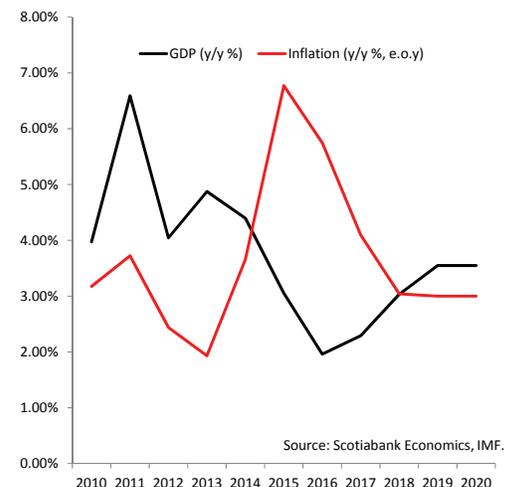
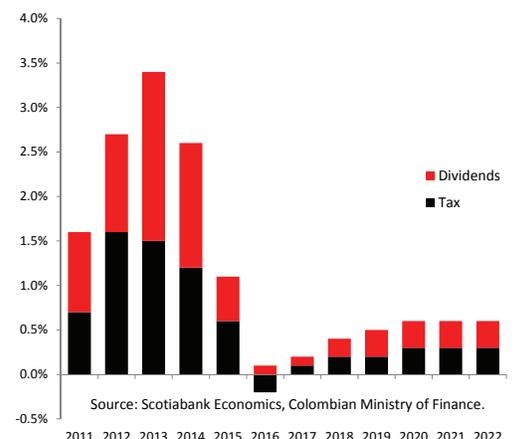


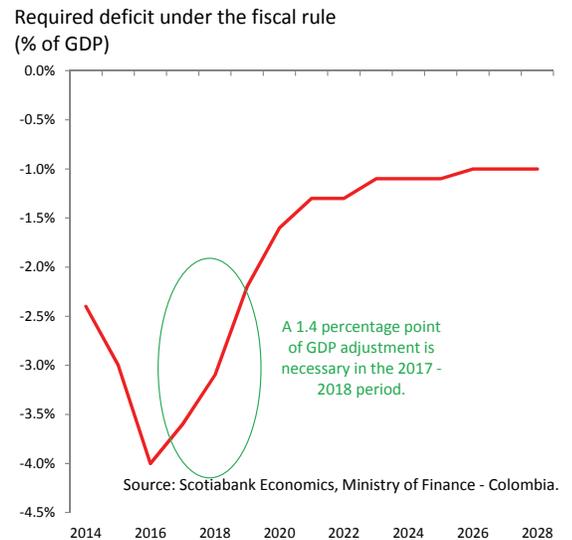
Chart 2: A "collapse" in oil-related revenues put important pressure on Colombia's fiscal position.

Colombian Government's oil related revenues (% of GDP)



On the inflation front, as well as on policy rate moves by BanRep, the consensus is in line with the central bank's own estimates according to comments by Governor Echavarría. Based on the latest survey by BanRep (August), consensus looks for the central bank to cut rates to 5.25% in the upcoming meeting, and then once more at the start of next year (to 5.00%). By summer of next year, consensus looks for the policy rate to bottom at 4.50%. We don't necessarily disagree with that view, but have not yet penciled in easing beyond 5.25% until we see the fiscal adjustment materialize, and we have more clarity on the election front for 2018 (for the time being, we are sticking with 5.25% as the end of the easing cycle, but see risks to our call clearly to the downside). As my colleague Joe Kogan stated a couple of months ago *"IMF calculations show a wider range of estimates for the neutral rate—between 0.6% and 3.1%, depending on the method used. The uncertainty is magnified by the fact that the neutral rate is believed to be dynamic, and is estimated today to be far below what we might have expected ten years ago. Second, there exists significant concern that inflation will not be 3%, especially if the Central Bank continues to cut rates. Note that if the neutral rate were 2% and inflation were 3.5% (which is the Bloomberg forecast for 2018) [and consensus from the latest BanRep survey], then monetary policy would no longer be contractionary."* We think the fiscal stance will be critical to determining where real rates can end up.

Chart 3: There's a relatively large 1.4 percentage point of GDP fiscal adjustment that is necessary for 2017–2018 under the fiscal rule.



The current account issue (the deficit got as wide as 6.4% of GDP in 2015), has corrected a lot faster than we, or the FinMin, anticipated, with the deficit for 2017 expected to close somewhere in the 3.5%–4.0% of GDP range for the year (probably closer to 3.5%). The narrower deficit has come despite the rally in the COP, which is up around 7% since the start of 2016. A big part of the narrower deficit comes from improved oil prices, but we have also seen a relatively sharp deceleration in Colombian domestic demand.

PUBLIC FINANCES AND CREDIT RATINGS

Although the fiscal position in Colombia has stabilized recently, there are still some concerns lingering among market participants on whether planned adjustments will be possible heading into an election year, at a time when the government's political position is weakened by corruption scandals and the President's low popularity (around 25%). Oil-related revenues have fallen from around 3.3% of GDP in 2013 to an expected 0.3% in 2018. The re-composition of income, away from volatile oil, is positive, but delivering the necessary adjustment will be tough.

One of our concerns on the fiscal front, is that the longer-term projections that Colombia's government has for potential growth look a little optimistic (as [we mentioned earlier, the government expects potential growth to be around 3.7%–3.9%, and the FinMin's actual growth projections put growth in the 3.5%–4.5% range between 2018 and 2023](#)), which [could impact the assumptions made under the fiscal rule](#). According to the rule, the government can undertake fiscal expansion when the economy is growing at least 2 percentage points below potential—which is a fiscal risk if potential GDP estimates are too optimistic. Another big question on Colombia's public finances is that projects undertaken under a PPP framework are not accounted as part of public debt, and the present value of spending under the 4G infrastructure program is 4.6% of GDP according to the IMF, and the government also guarantees toll revenues received by the project—which adds an additional layer of uncertainty.

Colombia's credit ratings are currently: Moody's Baa2 (stable), Fitch BBB (Stable), and S&P BBB (Negative). Although a downgrade by S&P is possible if the fiscal results are not delivered (I'd put the odds of a downgrade at 30%), we don't expect the market impact of that move would be a major event, as a loss of investment grade looks unlikely (we see very low odds of a 2 notch move). Overall, we would describe Colombia's fiscal position as sound, if unspectacular.

2018 PRESIDENTIAL ELECTIONS

Colombia is holding Presidential Elections in 2018, with the new president taking office in August in 2018. The election is scheduled to be held in May, and the race remains wide open. With the Odebrecht investigations spreading, corruption is increasingly likely to be a major factor in next year's race, in which we still don't know who the candidates will be. Some names that have been discussed include the following, but the list is still much wider:

- German Vargas Lleras: until recently President Santos' VP.
- From Centro Democratico (the party of former President Uribe): Carlos Holmes, and Ivan Duque, among others.
- Partido Liberal: Juan Fernando Cristo (Interior Minister) or Humberto de la Calle (Peace Negotiator).
- Other potential candidates include former Bogota Mayor Gustavo Petro, or Clara Lopez.

The [latest poll by Polimetrica, shows a tie at the lead between Petro and Vargas Lleras.](#)

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.