ABN·AMRO

Colombia Watch

Group Economics
Emerging Markets Research

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Scope for more growth

- **Duque to succeed president Santos in August**
- **New president inherits an economy that has overcome setbacks…**
- **…and is returning to growth**
- **IMF credit line protects against whims of capital markets**

New president elected

Colombia is set to get a new government in August. Having completed his second term in office, it was time for president Juan Manuel Santos to step down. However, his liberal Partido de la U failed to come up with a credible election candidate. The final round in June was therefore contested between Iván Duque of the centre-right Centro Démocratico and Gustavo Petro of the centre-left Colombia Humana. Petro, who champions nature conservation and is critical about the country's reliance on mineral extraction, lost out against Duque.

Duque is known for his tougher stance on the FARC. But whether the new president can genuinely take a substantially harder line in talks with the Marxist rebels remains to be seen. To get far-reaching measures through parliament, Duque needs to build a majority through the support of other parties, such as the Liberal Party. But they are not keen to play ball. All in all, we think that the peace agreement is likely to remain in force and that the country's political stability and economic development will not be put in jeopardy.

Economy has overcome setbacks…

The new president will inherit an economy that has just recovered from a string of setbacks between 2014 and 2016. The falling price of oil, a crucial export product, caused a deterioration of the terms of trade. And the precarious economic situation in neighbouring Venezuela further undermined the country's foreign trade. Export volume halved in a short space of time and the current account deficit doubled to 6.4% of GDP in 2015. That same year, the peso collapsed, shedding over a third of its value. Despite an increase in the official interest rate to 7.75%, inflation peaked at 9% in 2016. That is three times higher than the central bank's target range of two to four per cent.

… interest rate cuts support business activity

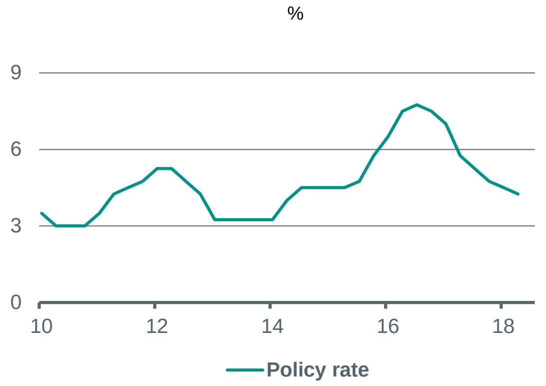
Meanwhile, the central bank has brought inflation back under control. Inflation is just above 3% and no longer distorted by past disturbances. The VAT hike in January 2017 is also dropping out of the inflation figures. The central bank has seized upon the downward inflationary trend to reduce its key interest rate by 350 basis points to 4.25% in a bid to cautiously revive lending.

The steadily improving inflation outlook and the end of the election uncertainties open up scope for further interest rate cuts. Whether the central bank will actually play this card is open to question. In view of the Federal Reserve's monetary tightening and the threat of an international trade war, caution is in order, particularly as the country has become more dependent on foreign investors.

Strong fall in inflation…

Source: Thomson Reuters Datastream

…gives central bank scope to cut interest rates



Source: Thomson Reuters Datastream

Investing in the future…

At their current lower levels, interest rates no longer impede economic activity. With capacity utilisation rates and oil prices both on the rise, more companies are pondering fresh investments. After the sharp depreciation, the peso has stabilised against the US dollar since 2016. The earlier fall in the exchange rate can open up new opportunities for foreign trade, although it often takes some time for a currency depreciation to translate into higher exports.

GDP growth for this year is expected to come to 2.5%, after posting 1.5% last year. The economy is also being driven by consumption. Consumers are becoming more confident in the future as they have more to spend now that inflation is no longer eating into their income.

… by removing structural shortcomings

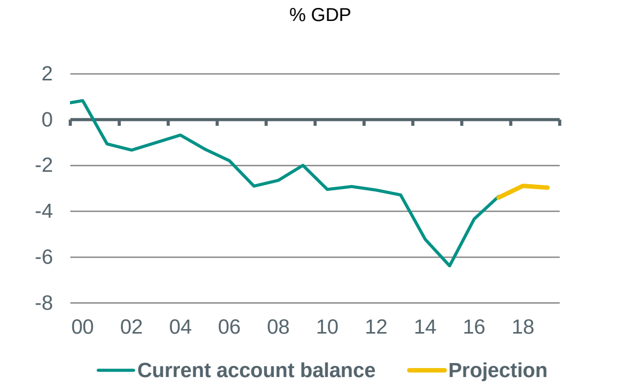
GDP growth of 2.5% is still relatively low for a country like Colombia. Labour and product market reforms could help to accelerate growth. According to the World Economic Forum Index (66th position) and the World Bank's Ease of Doing Business Index (59th position), further improvements are possible in the field of cross-border trade regulation. The rudimentary infrastructure is another serious shortcoming. For this reason, Colombia is working hard to improve the road network while also investing heavily in the construction of a G4 network.

Another key priority is to bring the large informal sector into the formal economy. In recent years, considerable progress has been made through the implementation of income tax cuts and educational improvements. Colombia should now also seek to diversify its export package and build trading relations with even more countries to make the economy less vulnerable. Finally, security remains a concern. Despite substantial improvements since the 1990s, drugs production and the associated crime and corruption remain rife.

Improved public finances...

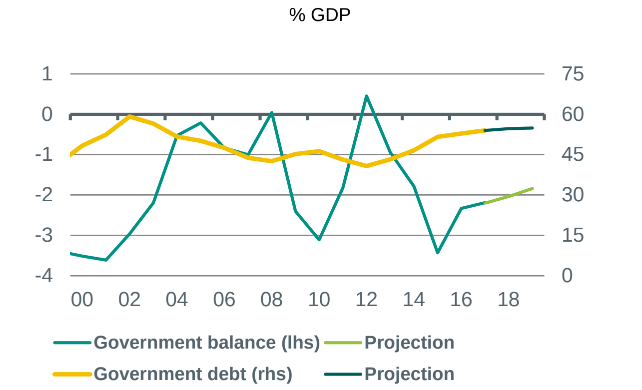
In recent years, the government was confronted with a decline in both oil and tax revenues. In the period from 2012 to 2017, the government debt ran up from 41% to 54% of GDP. In response to the deterioration of the already weak public finances, the government decided to cut spending and implement tax reforms. The VAT rate was raised, the number of income tax relief items was reduced, and measures were taken to clamp down on tax evasion.

Improvement of both the current account balance…



Source: Thomson Reuters Datastream

…and public finances



Source: Thomson Reuters Datastream

Thanks to these measures, the budget deficit is coming down. The rising revenue from oil is also helping matters. The recent surge in the oil price has boosted the profits of Ecopatrol, the state-controlled oil producer that was forced to slash costs when oil prices were low. The budget deficit for this year is expected to come to 2% of GDP, significantly lower than the 3.4% in 2015.

…reinforce national resilience

Thanks to the improved fiscal balance, plus the prospect of higher oil revenues (for now at least), Duque is in a position to meet his election pledges. He wants to reduce corporate taxes. This plan, which enjoys broad political support, is to be partly funded with public spending cuts.

In 2011, a law was adopted stipulating that the structural budget deficit should be no more than 1% of GDP at the end of 2021. This statutory objective will demand sacrifices. The IMF has advised the government to reduce public spending by 0.6% of GDP and to save any oil revenue windfalls. In this way, the public debt can be reduced to 40% of GDP in 2023. A lower debt will make it easier to withstand future economic shocks.

Short-term financing is a vulnerability

Healthy current account financing can make a further contribution to economic stability. The current account deficit has shrunk from 6.4% in 2015 to 3.4% in 2017. As a result, the deficit is once again largely covered by long-term direct investments. However, in the years that the deficit spiralled upwards, the financial gap was bridged with short-term loans and investments.

Due to this temporary shift in the current account deficit financing, a quarter of the total foreign debt, which is roughly the same size as the GDP, is now financed with short-term investments. This makes Colombia vulnerable to the whims of the international capital markets. In this light, the extension of the IMF credit line is a most welcome development. This flexible credit should provide the country with an ample cushion to withstand any shocks that might occur.

Key forecasts for the economy of Colombia

	2015	2016	2017e	2018e	2019e
GDP (% yoy)	3,1	2,0	1,8	2,5	3,0
CPI inflation (% yoy)	5,0	7,5	4,3	3,5	4,5
Budget balance (% GDP)	-3,4	-2,3	-2,2	-2,0	-2,0
Government debt (% GDP)	52	53	54	55	55
Current account (% GDP)	-6,4	-4,3	-3,4	-3,0	-3,0
Gross fixed investment (% GDP)	26,4	24,6	22,9	22,8	22,9
Gross national savings (% GDP)	20,3	20,4	20,0	20,4	20,3
USD/COP (eop)	3149	3001	2984	3100	3101
EUR/COP (eop)	3421	3165	3582	3565	3876

Economic growth, budget balance, current account balance for 2018 and 19 are rounded figures
Source: EIU, ABN AMRO Group Economics