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Colombia Macro Outlook and Policies in the LatAm Context

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Summary



- Currently, Colombia is the LatAm country discussing more structural reforms
- Progressive economic reforms (tax, energy, health, labor, pension, land)
- GDP losing traction, after strong 2022, with moderate prospects for next years
- We expect BanRep to start cutting rates in October, amid gradual decline of inflation
- Commitment to Fiscal Rule is very positive, because it anchors public debt
- Narrowing of current account deficit is reassuring for markets

Latin America - The main themes of 2023



-  • **Brazil:** Dealing with debt sustainability (new Fiscal Rule and forthcoming tax reform)
-  • **Mexico:** Nearshoring of US supply chains to LatAm is lifetime opportunity
-  • **Argentina:** Presidential elections in October and chances of political transition
-  • **Colombia:** By far, the country doing (or debating) more structural economic reforms
-  • **Chile:** Constitutional referendum in December (lessons from Ecuador and Costa Rica)
-  • **Peru:** Hit by multiple shocks (social protests, cyclone, El Niño, Dengue)
-  • **Ecuador:** Risk of undoing reforms implemented during IMF program
-  • **Dominican Republic:** Booming tourism sector with spillovers across the economy
-  • **Guatemala:** Strong macro, but democratic checks-and-balances under scrutiny
-  • **Venezuela:** Economy growing from depressed levels, out of hyperinflation
-  • **Panama:** Robust growth, but issues with pension system and pace of fiscal adjustment
-  • **Uruguay:** Outperforming on environmental, Social and Governance (ESG) matters
-  • **Costa Rica:** Most effective Fiscal Rule in LatAm is inducing credit rating upgrades
-  • **El Salvador:** Bold economic policies (Bitcoin as legal tender, security reform, buybacks)



Colombia GDP: Losing traction, after strong 2022

- **3rd-fastest growing economy in LatAm in 2022**

- Colombia grew 7.3%
- Only surpassed by Panama and Venezuela

- **Negative drivers in 2023**

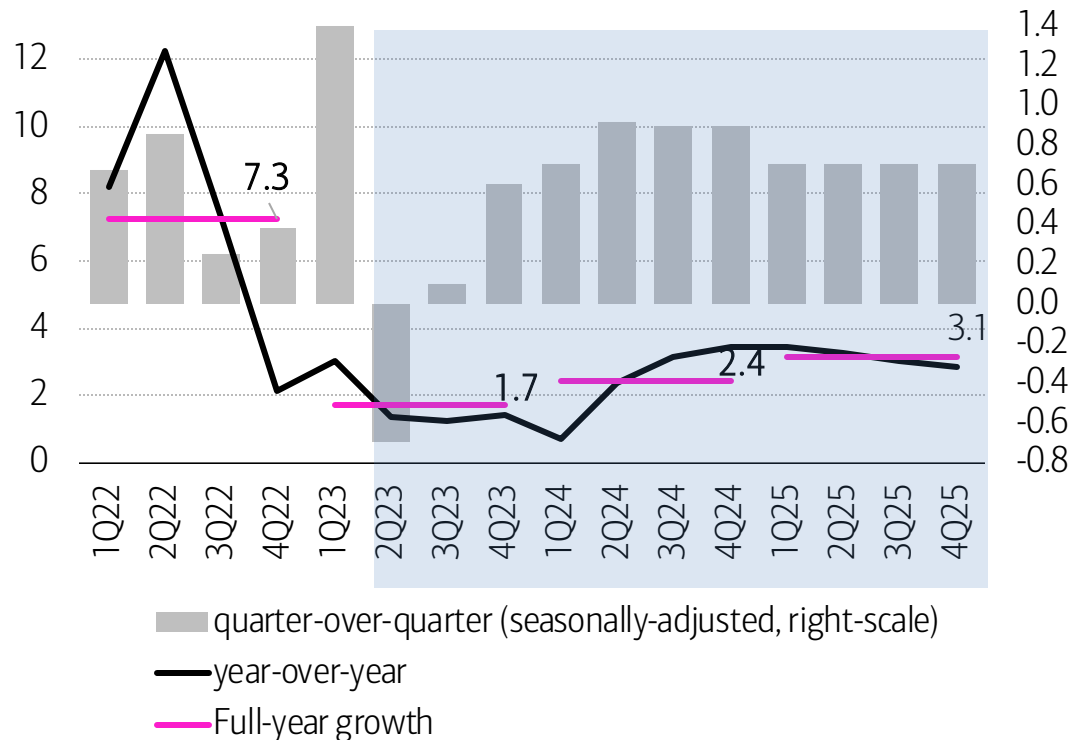
- Two tax reforms kicking-in at same time
- High interest rates
- Other reforms affecting business confidence (energy, pension, labor, land, health)

- **Pick-up in 2024 and 2025**

- Lower interest rates
- Lower inflation increasing real wages
- Less uncertainty on reforms
- Cyclical improvement of global economy
- Venezuelan immigration (potential growth)

GDP growth (%)

We expect growth to slow down in 2023, and pick up in next years



Source: Statistics Institute (DANE), BofA Global Research

Colombia fiscal policy: some positive signals



- Positive signal to see government pledging to meet Fiscal Rule targets. Conducive to lower debt ratio
- Colombia near vicinity of what is considered a prudent debt ratio for emerging markets (40%-50% of GDP)
- Having public debt in this vicinity allows operation of fiscal policy under “rules-based approach”. Otherwise credibility issues sabotage the Fiscal Rule (no longer credible to save in goods times to spend in bad times)
- Countries with high public debt lose ability to use fiscal policy because markets will always ask them for fiscal consolidation. Reversal of lending can be quite painful for the economy

Debt stabilizing primary balance (% of GDP)

$$= \text{Public debt/GDP} * [1 / (1 + g + \pi)] * (i - \pi - g) - \text{Monetary base/GDP} * (\pi + g)$$

		Potential GDP growth (%)							
		2.0	2.5	3.0	3.5	4.0	4.5	5.0	
Average interest rate paid on public debt (%)	6.5	0.2	-0.1	-0.3	-0.6	-0.8	-1.1	-1.4	
	6.0	0.0	-0.3	-0.5	-0.8	-1.1	-1.3	-1.6	
	7.5	0.6	0.4	0.1	-0.2	-0.4	-0.7	-0.9	
	8.0	0.9	0.6	0.3	0.1	-0.2	-0.5	-0.7	
	8.5	1.1	0.8	0.5	0.3	0.0	-0.3	-0.5	
	9.0	1.3	1.0	0.7	0.5	0.2	0.0	-0.3	
	9.5	1.5	1.2	1.0	0.7	0.4	0.2	-0.1	
	10.0	1.7	1.4	1.2	0.9	0.6	0.4	0.1	
	13.0	3.0	2.7	2.5	2.2	1.9	1.7	1.4	

Note: “g” is potential GDP growth, “π” is the inflation target, and “i” is the average interest rate paid on public debt
 Source: BofA Global Research, Ministry of Finance (Hacienda)

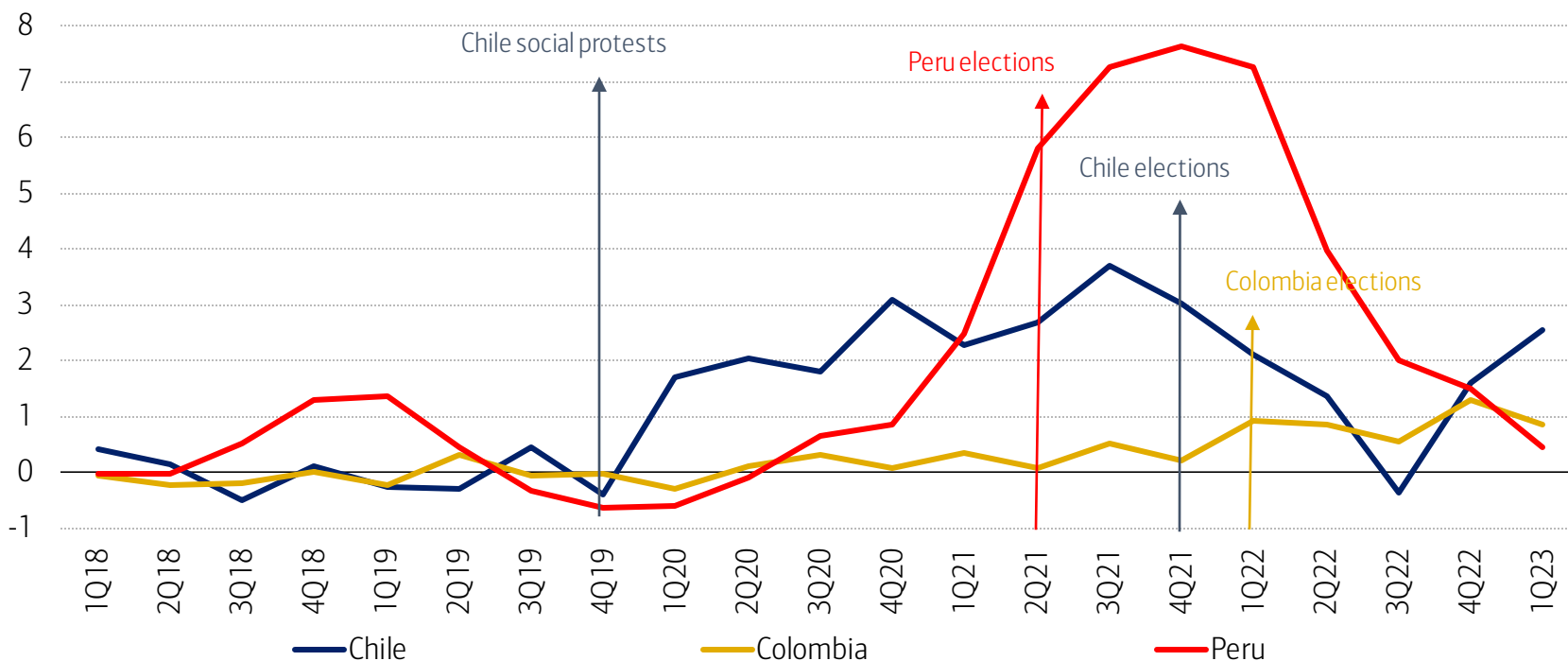
Colombia balance of payments: incoming data is reassuring



- Current account deficit is narrowing substantially, driven by the contraction of food imports.
- Seasonally-adjusted current account deficit was 4% of GDP in 1Q2023, compared to 6.9% in 3Q2022
- FDI is large. Net FDI increased to 4% of GDP in rolling 4 quarters ended in 1Q2023, from 3.9% in 2022
- Cash outflows from households and non-financial firms are small compared to cases of Chile and Peru

Outflows of currency & deposits from households and non-financial corporations (rolling 4 quarters, % of GDP)

In 2022, BoP data shows households and non-financial corporates sent US\$ 4.4bn (1.5% of GDP) out of Colombia



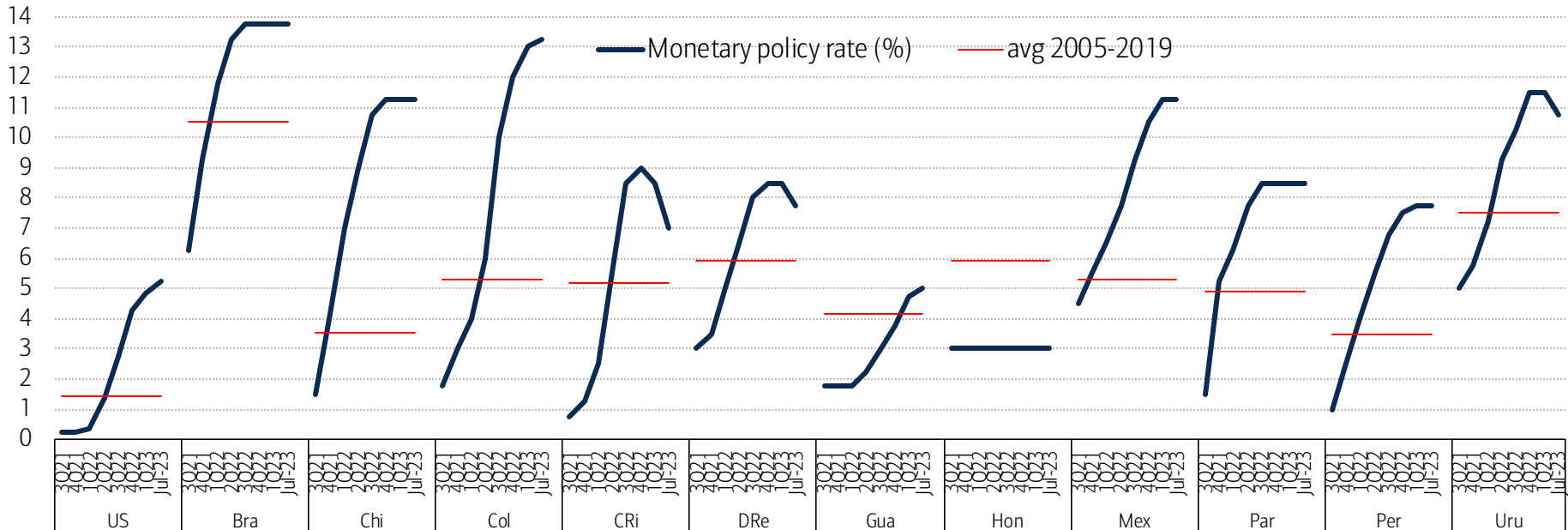
Colombia monetary policy: We expect rate cuts starting in Q4



- BanRep’s June press conference: change from “Delphic” to “Odyssean” (stronger) guidance.
- *“Decrease of inflation and inflation expectations create space for reducing the nominal rate”*
- BanRep believes current level of real interest rate (equal to nominal rate minus inflation) is contractionary enough to bring inflation back to the 3% target. Starting in October, we believe BanRep will partly offset increases in the real rate that are passive (driven by lower inflation)

Monetary cycles across inflation-targeting countries of Latin America and the US (from 3Q2021 to July 2023)

Only three central banks in the region have initiated their easing cycles



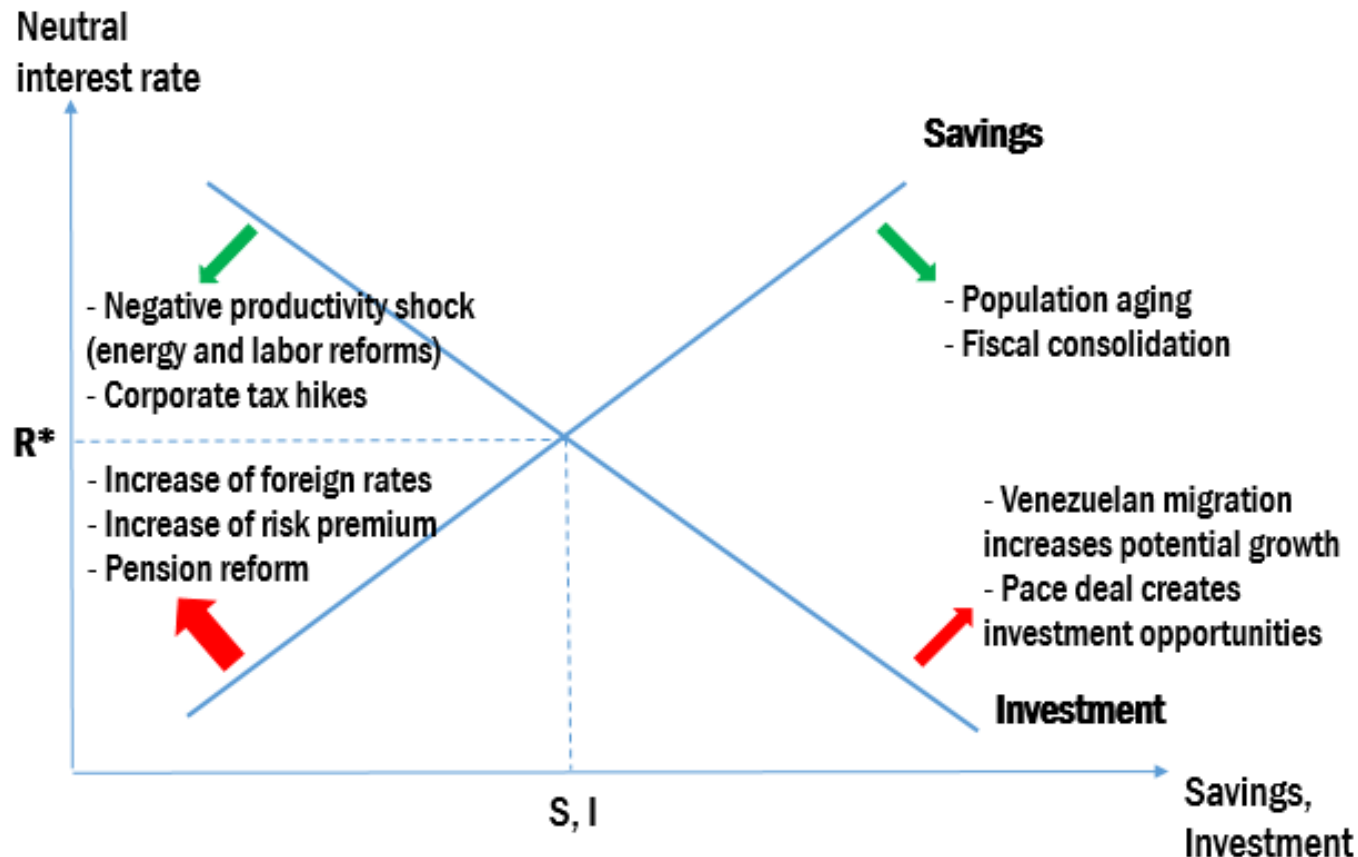
Colombia monetary policy: Rate cuts starting in October



- We expect the monetary policy rate at 12.75%, 9%, and 6% by year-end 2023, 2024, and 2025
- At the end of the cycle, interest rates in Colombia will likely be higher than in the pre-pandemic period because of both domestic and external reasons

Forces shaping neutral rate in Colombia, negative shift of savings should dominate

Neutral interest rate is fundamentally pinned down by the balance of savings and investment



Colombia monetary policy: Risk of cutting rates too early



- Trade-off: short-term benefit (support economic activity) vs. long-term cost (risk of damaging the monetary transmission channels)
- Discretionary optimization could keep inflation expectations de-anchored for a longer time
- If inflation expectations are de-anchored, monetary policy is less powerful
- Interest rate channel. More difficult to cut rates without fanning inflation
- Expectations channel. Long-term rates are 3 times more powerful than short-term rates to stimulate spending (*“21st Century Monetary Policy”, Bernanke, 2023*). Long rates are influenced by expectations/credibility
- Credit channel. Banks from countries with inflation instability tend to provide loans with shorter periods
- Exchange rate channel. Higher inflation undermines competitiveness

Colombia forecasts



Summary of macroeconomic forecasts for Colombia

We expect broadly stable macroeconomic conditions for the coming years

	2017	2018	2019	2020	2021	2022	2023F	2024F	2025F
GDP growth (%)	1.4	2.6	3.2	-7.3	11.0	7.3	1.7	2.4	3.1
Inflation (% end-of-period)	4.1	3.2	3.8	1.6	5.6	13.1	9.0	5.7	3.5
Exchange rate (USDCOP, end-of-period)	2,984	3,250	3,277	3,433	4,080	4,853	4,500	4,750	4,900
Monetary policy rate (%)	4.75	4.25	4.25	1.75	3.00	12.00	12.75	9.00	6.00
Central government primary balance (% of GDP)	-0.8	-0.3	0.4	-4.9	-3.6	-1.1	0.2	0.0	0.3
Central government overall balance (% of GDP)	-3.7	-3.1	-2.5	-7.8	-7.0	-5.3	-4.2	-4.4	-3.6
Central government gross debt (% of GDP)	46.4	49.3	50.3	65.1	63.0	61.1	57.7	57.6	57.3
Current account balance (% of GDP)	-3.2	-4.2	-4.6	-3.4	-5.6	-6.2	-4.0	-3.3	-3.2

Source: Statistics Institute (DANE), Central Bank (BanRep), Ministry of Finance (Hacienda), Bloomberg, BofA Global Research

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