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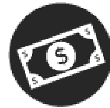
GOVERNOR'S REPORT_

March 2019

This is the fourth edition of a publication by the Governor of the Central Bank of Colombia, addressed to citizens, analysts, and domestic and foreign investors interested in learning about the most recent events in the Colombian economy and their implications for monetary policy decision-making. It is published in Spanish and in English with a Statistical Annex.

INTRODUCTION

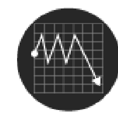
GROWTH


INFLATION

MONETARY POLICY

INTERNATIONAL CONTEXT

PROSPECTS


VULNERABILITIES

ANNEX

INTRODUCTION

Colombia's economy expanded by 2.7% in 2018, gaining momentum after a period of deceleration in which the annual growth rate fell from 4.7% in 2014 to 1.4% in 2017 (**Graph 1**). While growth was still below potential (estimated around 3.3%), the uptick in 2018 suggests the groundwork for Colombia's economic recovery has been laid.

Sound macroeconomic policy aims to cushion dips in economic activity during periods of deceleration and promote it during periods of recovery. That's why it's so important to identify the reasons for Colombia's turnaround in 2018, and identify both the risks and opportunities that may lie ahead.

Graph 1
Real Annual Growth in GDP
(%)

Source: DANE.
Note: GDP seasonally adjusted and corrected for calendar effects (2015 base year).

1. Sources of Growth

Inflation
Monetary Policy
International Context
Prospects
Vulnerabilities

The increase in economic activity seen in 2018 was driven by domestic demand, which grew at an annual rate of 3.8%, well above the 1.2% registered in 2017. Household and public sector consumption provided the basis for this resurgence, alongside a strong rebound in gross capital formation in the second half of the year (**Table 1**)

Table 1
Real Annual GDP Growth, by Type of Expenditure

(annual variation %)

	2017	2018				2018
	Full Year	**QI**	**QII**	**QIII**	**QIV**	**Full Year**
Total Consumption	**2.4**	**3.9**	**4.4**	**3.8**	**3.6**	**3.9**
Household consumption	2.1	3.4	3.9	3.6	3.3	3.5
Non-durable Goods	3.1	4.4	5.2	3.9	3.6	4.2
Semi-durable Goods	0.8	3.0	5.1	5.3	4.4	4.4
Durable goods	-4.3	6.4	8.1	5.3	5.6	6.3
Services	2.7	2.8	2.6	2.4	2.5	2.6
Final public sector consumption	3.8	6.0	5.9	6.2	5.4	5.9

Gross Capital Formation	**-3.2**	**-2.3**	**-1.8**	**8.7**	**9.9**	**3.5**
Gross Fixed capital formation	1.9	-0.9	-2.8	2.9	5.4	1.1
Housing	-1.9	-4.8	-1.0	0.9	5.8	0.0
Other Buildings and structures	4.6	-2.2	-2.6	1.5	9.5	1.5
Machinery and equipment	1.4	8.8	-0.8	0.2	-3.8	1.0
Cultivated biological resources	0.3	-2.7	2.0	7.6	-2.6	0.9
Intellectual property products	2.5	4.0	5.3	4.7	4.1	4.5
Internal Demand	**1.2**	**3.5**	**3.3**	**4.0**	**4.5**	**3.8**
Total Exports	**2.5**	**-0.2**	**0.4**	**1.6**	**3.1**	**1.2**
Total Imports	**1.2**	**0.3**	**8.3**	**7.9**	**15.6**	**8.0**
GROSS DOMESTIC PRODUCT (GDP)	1.4	2.2	2.6	2.9	2.9	2.7

Source: DANE; Calculations by Banco de la República (Central Bank of Colombia).
Note: GDP seasonally adjusted and corrected for calendar effects (2015 base year).

Several factors contributed to the 3.5% expansion in household consumption seen in 2018. First, the effects of an increase in the VAT from 16% to 19%, approved by a 2016 tax reform, began to wane. At the same time, the inflation rate converged to the target rate, and the Central Bank maintained a moderately expansive monetary policy. This policy led to a reduction in interest rates on consumer credit and contributed to a positive spending and loan environment, especially in the second half of the year (**Graph 2**).

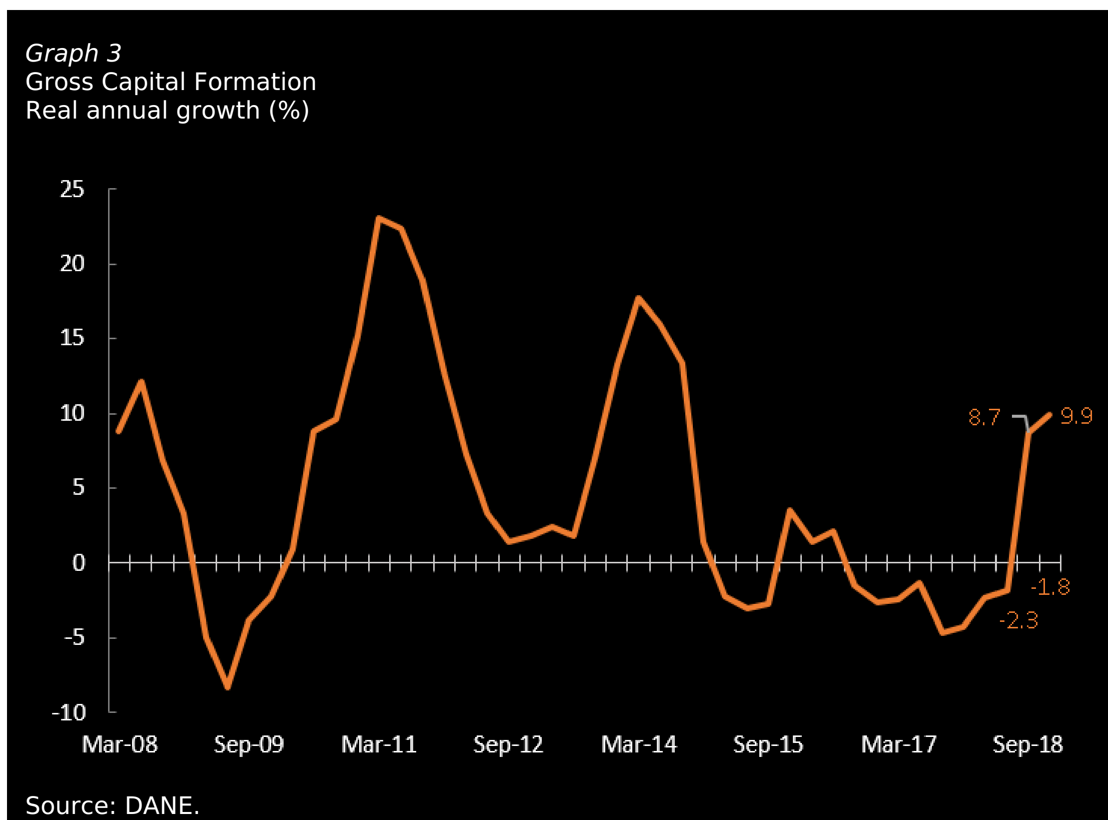
Graph 2
Consumer Loans
Real annual growth (%)

Source: Office of the Financial Superintendent of Colombia (*Superintendencia Financiera de Colombia*).

Public sector consumption increased by 5.9% in 2018, higher than the 3.8% growth registered in 2017. This was in part due to election-season spending and costs associated with a national census.

Gross capital formation grew 3.5% in 2018, although its performance over the course of the year was inconsistent. The first two quarters saw contractions of 2.3% and 1.8%, respectively. These were due primarily to a rough patch in the construction sector, both in home-building and public works, associated with excess housing supply, uncertainty surrounding the election, and administrative and institutional problems that delayed major highway construction projects throughout the country.

Gross capital formation turned around in the second half of the year, however, growing by 8.7% and 9.9% in the third and fourth quarters, respectively (**Graph 3**). This was the result of a reduction in excess housing, progress on the highway projects, and an increase in business confidence once the elections had concluded.



Graph 3
Gross Capital Formation
Real annual growth (%)

Source: DANE.

Acceleration in domestic demand was not fully reflected in economic growth in 2018, as net external demand (exports minus imports) weighed negatively on GDP. Real growth in imports (8.0%) was faster than that of exports (1.2%), with imports of capital goods (11.4%) and raw industrial and agricultural materials (11.5%) proving especially dynamic.

On the supply side, the increase in economic activity in 2018 was reflected in positive growth across all sectors except mining, which saw a slight contraction of 0.8% compared to 2017 (**Table 2**). Strong growth in professional, scientific and technical activities (5.0%) and in public administration and defense, health and education (4.1%) merit special attention. The commercial, repairs, transportation and housing sectors, as well as the information and communications technology sector, all grew at a 3.1% annual rate, higher than in 2017.

Manufacturing also rebounded, growing at 2.0% in 2018 compared to a 1.8% contraction in 2017. Agriculture and livestock grew by 2.0%, less than in 2017 (5.5%), due to lower production in coffee and other crops as a result of adverse weather conditions. Meanwhile, construction saw low but positive growth (0.3%), a contrast to the 2.0% contraction seen in the sector in 2017. Growth in this sector included a noteworthy rebound in public works in the last quarter of the year (7.8%).

Table2
Real Annual GDP Growth by Branch of Economic Activity

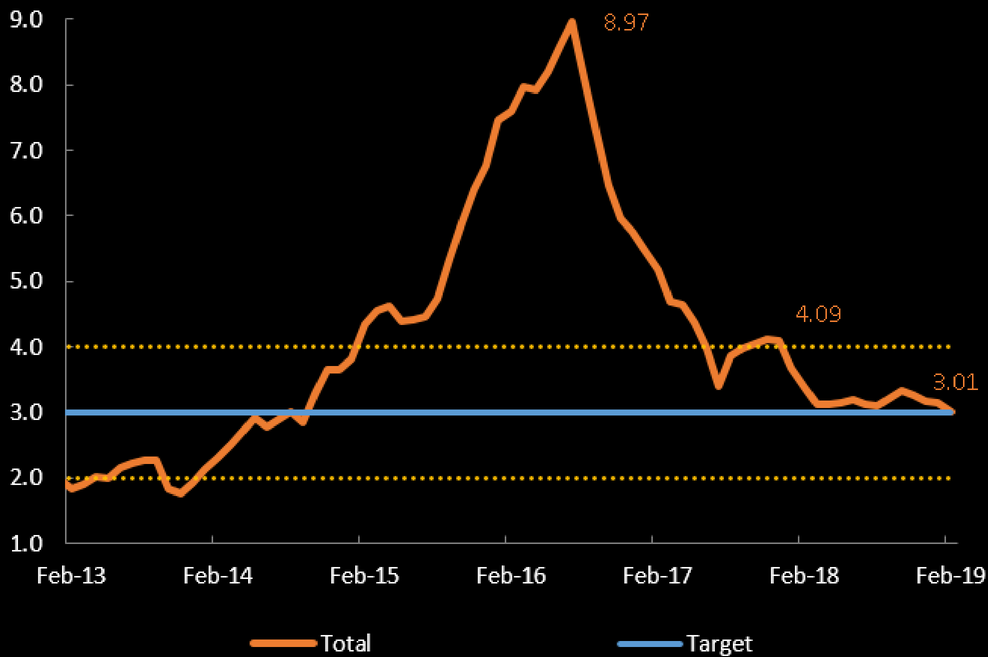
(annual variation %)

	2017	2018				2018
	Full Year	**QI**	**QII**	**QIII**	**QIV**	**Full Year**
Agriculture, livestock, hunting and fishing	5.5	2.2	3.7	1.3	0.8	2.0
Mines and quarries	-5.7	-3.5	-3.2	2.7	1.0	-0.8
Manufacturing industry	-1.8	0.1	2.5	2.8	2.6	2.0
Electricity, gas and water	2.9	2.9	2.7	2.6	2.7	2.7
Construction	-2.0	-4.3	-5.2	5.3	5.6	0.3
Buildings	-5.2	0.1	-5.6	5.7	3.9	1.0
Public Works	6.5	-3.7	-3.8	-2.9	7.8	-0.6
Specialized construction activities	-4.0	-1.0	-5.7	2.1	1.0	-0.9
Commerce, repairs, transportation and lodging	1.9	3.1	3.2	3.2	3.0	3.1
Information and communications	-0.2	0.6	3.1	5.5	3.2	3.1
Financial activities and insurance	5.4	4.7	3.8	1.6	2.3	3.1
Property activities	3.1	2.2	2.0	1.9	1.8	2.0
Professional, scientific and technical activities	1.3	7.2	6.1	3.4	3.4	5.0
Public and defense activities, health and education	3.5	5.2	4.2	3.5	3.7	4.1
Artistic, educational and recreational activities	2.2	0.7	1.6	0.9	2.5	1.4
Subtotal value added	**1.4**	**2.4**	**2.1**	**2.9**	**2.5**	**2.5**
Taxes minus subsidies	1.1	2.1	3.1	2.6	2.5	2.6
Gross Domestic Product (GDP)	1.4	2.2	2.6	2.9	2.9	2.7

Source: DANE; Calculations by the *Banco de la República* (Central Bank of Colombia).
Note: GDP seasonally adjusted and corrected for calendar effects (2015 base year).

An early drop in the inflation rate on consumer prices in 2018 was followed by an extended period of stability, boosting consumer purchasing power and giving businesses a favorable price outlook for investment decisions. The annual rate closed the year at 3.18%, close to the long-term target of 3.0% and 91 basis points below the 4.09% observed in 2017. This drop was concentrated between January and April, after which the inflation rate remained between 3.1% and 3.3% (**Graph 4**).

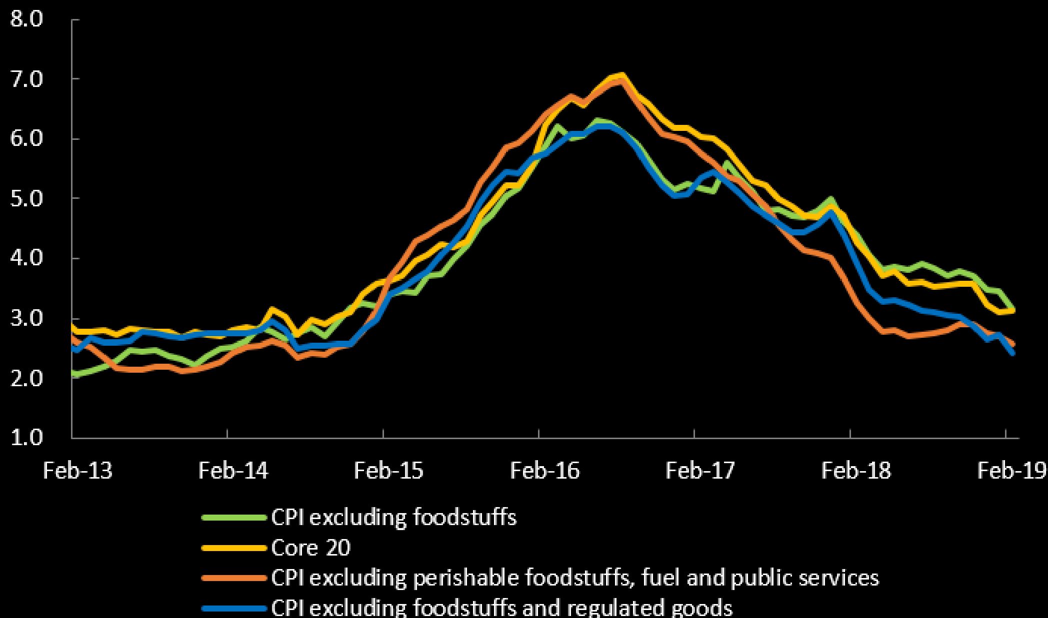
Graph 4
Annual consumer inflation
(%)



Source: DANE and *Banco de la República* (Central Bank of Colombia).

Core inflation also fell significantly, dropping from 4.66% in December 2017 to 3.03% at the end of 2018. This drop was also concentrated in the first quarter, though a significant unanticipated reduction also occurred in December. All core inflation indicators dropped significantly in 2018 (**Graph 5**).

Graph 5
Core inflation indicators
(%)



Source: DANE; Calculations by *Banco de la República* (Central Bank of Colombia).

A close look at the consumer price index suggests that last year's decline was driven by the non-food basket, where inflation fell from 5.01% at the end of 2017 to 3.48% at the end of 2018. Of the three components included in this basket – tradable, non-tradable and regulated goods – only the latter failed to contribute to the drop in inflation, increasing from 5.86% to 6.37% between 2017 and 2018. This was due to a rise in electricity and other public utility rates.

Inflation on tradable goods (which depends primarily on international prices and exchange rates) registered a significant drop, falling from 3.79% in 2017 to 1.09% at the end of 2018. This contrasts with significant increases registered in previous years, and is due in part to the end of upward pressures that had resulted from an increase in the VAT and other indirect taxes. A devaluation in the final months of the year did not affect prices of tradable goods, perhaps because the market judged it to be temporary. Strong competition and the ease of substitution in key sectors, like telephone services and air travel, may have also been a factor of the low pass-through.

Inflation on non-tradable goods also fell, dropping from 5.49% in 2017 to 3.79% in 2018. This is significant, as inflation on non-tradable goods had proven resistant prior to 2017. All items in this category showed reductions in the inflation rate between 2017 and 2018, with an especially strong showing in rentals (from 4.28% to 3.42%); products affected by the exchange rate (from 5.72% to 3.29%); indexed items (from 6.96% to 5.43%) and "all others" subgroup (from 10.88% to -0.42 %).

Annual inflation in foodstuffs increased moderately, from 1.92% in 2017 to 2.43% in 2018, partly as a result of a very low base of comparison in 2017 following the El Niño weather pattern the year before. By the end of 2018 we began to see an increase in prices on perishable foods, in part as a consequence of another, this time more moderate El Niño phenomenon.

In February 2019 the annual consumer inflation rate was 3.01%. Colombia hasn't enjoyed a rate that close to the target rate of 3% since September 2014. Multiple factors contributed to this positive showing.[1] First, inflation on non-food items fell significantly, from 3.48% in December to 3.14% in February. A similar pattern occurred for the average of the four indicators used to measure core inflation, which fell from 3.03% to 2.81%. It's worth noting that inflation on tradable goods (not including food or regulated items) continued to fall through December (from 1.09% to 0.80% annually), confirming our belief that there is not a lagged transfer of depreciation on the exchange rate to prices.

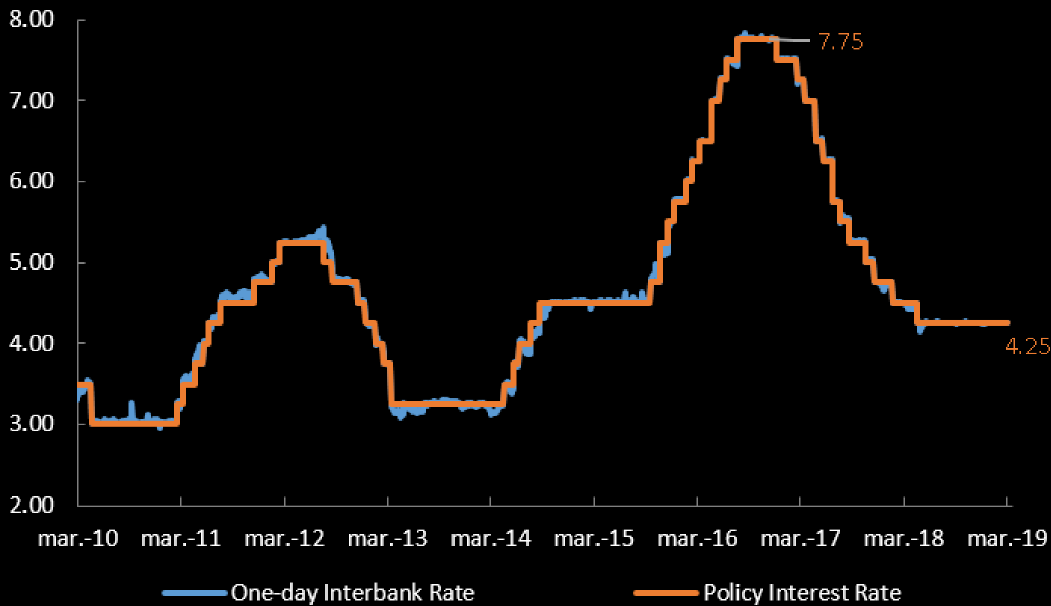
Annual inflation of non-tradable goods fell from 3.79% at the end of 2018 to 3.38% in February, and inflation of regulated goods dropped from 6.37% to 5.72% over the same period, thanks to a reduction in energy rates. Finally, annual inflation on foodstuffs rose from 2.43% in December to 2.84% in February; the slight increase could be the result of an El Niño phenomenon that was less severe than expected.

In surveys taken in January and February of this year, financial analysts set inflation expectations for 2019 at close to 3.5% and 3.4%, respectively. The most recent survey, taken in mid-March, showed a reduction in those expectations to 3.23%. This revision took into account data from February that showed some inflationary risks present at the beginning of the year (including a 6% increase in the minimum wage, negative effects on prices as a result of devaluation, high inflation on regulated goods, and negative impacts from the El Niño weather pattern) did not materialize. The expectation of lower inflation is another important factor in favor of price stability.

1/ DANE introduced a new basket index for consumer prices in 2019. Nevertheless, to facilitate comparison to 2018, here we refer to the previous classification.

The Central Bank's board of directors began gradually reducing interest rates in December 2016, lowering the policy rate from a peak of 7.75% to 4.75% by the end of 2017. In sessions in January and April 2018, the board made two more cuts of 25 basis points each, to 4.25%; interest rates have remained at this slightly expansionary level ever since. In sum, the Bank cut the policy rate by 350 basis points between December 2016 and April 2018, and in March marked 11 months without any alterations (**Graph 6**). The one-day interbank rate has also remained very close to the policy rate.

Graph 6
Policy Interest Rate and One-day Interbank Rate
(%)

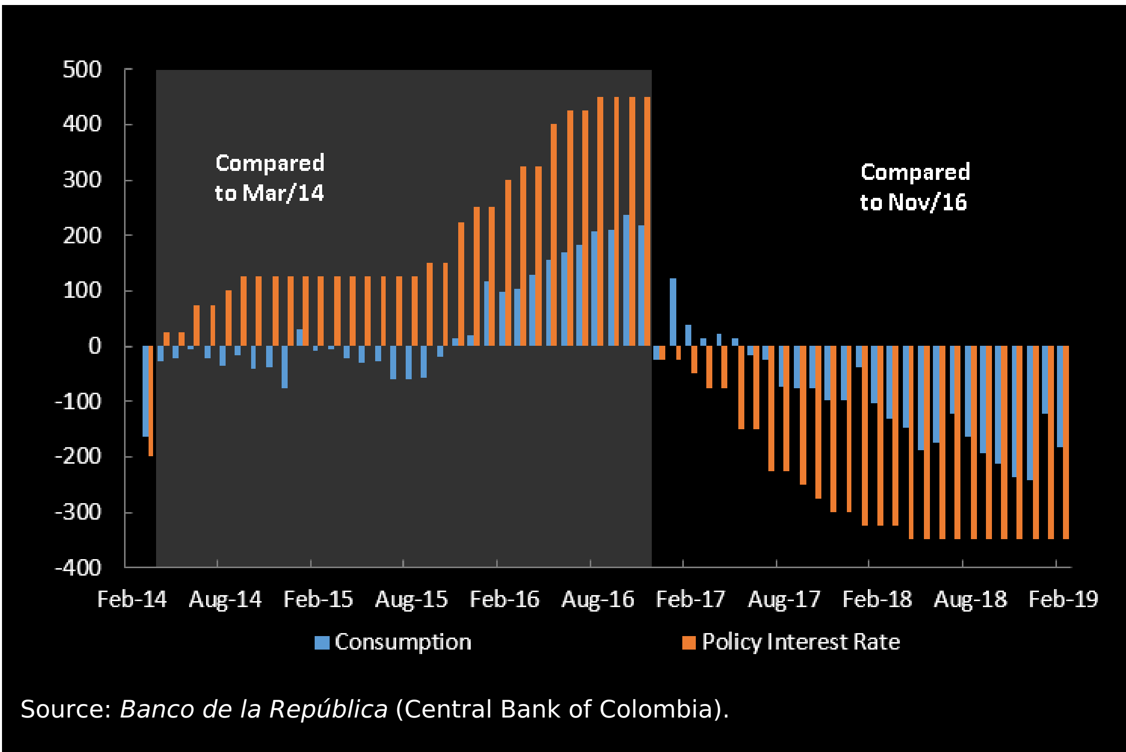


Source: *Banco de la República* (Central Bank of Colombia).

A significant portion of this accumulation of cuts was reflected in market interest rates in 2018. Rates on consumer credit dropped across all classes by 160 basis points over the course of the year, after previously having shown resistance to changes in the policy rate (**Graph 7**)[2]. After a small seasonal increase in January, consumer rates began to fall again in February 2019. Interest rates for both commercial credit and housing continued to drop in 2018 as well.

2/ There has been some backsliding in the policy rate's transmission on interest rates for consumer credit, but this appears to be seasonal in nature.

Graph 7
Policy Rate and Interest Rates on Consumer Credit
Accumulated variation (basis points)



Source: *Banco de la República* (Central Bank of Colombia).

	4. International Context	🏠	Growth Inflation Monetary Policy	Prospects Vulnerabilities

The world economy grew by 3.7% in 2018, according to the most recent estimates from the International Monetary Fund (IMF)[3]. Global growth was led by positive momentum in the U.S. economy, which grew by 2.9% as a result of fiscal stimulus and an increase in private consumption, as well as by growth in China (6.6%). Latin America and the Caribbean grew by just 1.1%, making it one of the slowest-growing regions in 2018.

The strong performance of the world economy in 2018 contributed to the beginning of economic recovery in Colombia in the form of improved terms of trade (**Graph 8**). This, in turn, was made possible by a rebound in the price of oil, which lasted through the first week of October, when the Brent crude benchmark reached a peak of $85 per barrel (**Graph 9**). As a result, Colombia's accumulated crude oil exports grew between January and October at an annual rate of 28.9%.

In 2018 total exports grew at an annual rate of 10.4% and crude oil exports by 24.1%. During the first 10 months of the year, total exports grew at an annual rate of 14.0%, driven by increased demand from Colombia's trade partners and by a relatively high exchange rate. That dynamic began to cool in the last quarter of 2018, due to a decrease in the price of crude and the prospect of lower global economic growth in 2019.

The remainder of Colombia's exports grew by 6.3%. Manufacturing exports performed particularly well, growing by 8.0% in 2018. Other exports (excluding agricultural products) like food, beverages, tobacco and chemical products grew at an annual rate of 8.2%.

3/ World Economic Outlook Update, January 2019. A Weakening Global Expansion. https://www.imf.org/en/Publications/WEO/Issues/2019/01/11/weo-update-january-2019

Graph 8
Terms of Trade Index
(2005=100)

Source: *Banco de la República* (Central Bank of Colombia).

Graph 9
Brent Crude Oil Prices
(Dollars per Barrel)

Source: Bloomberg.

	5. Prospects for 2019		Growth Inflation Monetary Policy	International Context Vulnerabilities

Recovery in 2018 has laid the groundwork for continued acceleration in economic growth in 2019. This year we estimate GDP to expand by close to 3.5%, well above the 2% the IMF projects for Latin America as a whole. Our forecast envisions internal demand strengthening at a faster rate than in 2018, in part thanks to the positive impact of 2018 Financing Law on business investment.[4]

There is also room to expect growth in public works as financing closes for projects included in the 4G highway program, and as regional governments increase spending in their last year in office. Financing for infrastructure projects via royalty payments, as called for in the National Development Plan, will also give an added boost to territorial investment.

We also foresee positive trends in household consumption observed in 2018[5] continuing in 2019, with improved prospects for sectors such as construction, commerce and industry.

Finally, the Bank's technical team predicts inflation to remain between 3.0% and 3.2% for the rest of the year. This forecast does not include the effects of the El Niño weather pattern, which dissipated without putting pressure on food prices. On the other hand, we foresee inflation on items excluding foodstuffs and regulated goods continuing to converge with the 3.0% target, in the context of an output gap that remains in negative territory. The only product class that will continue experiencing inflationary pressure is regulated goods, which may continue to register annual price variations above 4.0% annually.

4/ Businesses can now deduct VAT paid for the acquisition of capital goods from their revenue taxes, and deduct 50% of the tax on industry and commerce; the general income tax rate for businesses will drop to 33% in 2019, 32% in 2020, 31% in 2021 and 30% in 2022.

5/In January 2019, Fedesarrollo's consumer confidence index (CCI) showed an increase November and December of last year, and is now approaching positive territory thanks to a boost in consumer expectations. The survey also revealed an increase of consumer spending intentions on housing, automobiles and durable goods. A historical decomposition analysis of the CCI conducted by a technical team at the Bank suggests that non-fundamental negative shocks that affected confidence at the end of last year are now dissipating.

Colombia’s economic outlook for 2019 looks promising. The economy will move toward equilibrium, in the sense that economic growth will get close to its potential, and inflation will wind up near the target rate. This future is not free from risks, however – both from abroad and from within.

A. External Risks

Toward the end of 2018, an increase in perceived risk in the world economy was reflected in volatility and declines in international stock markets. International liquidity conditions look likely to remain on track, however, following recent announcements from the Federal Reserve of the United States (FED) signaling a slowdown on interest rate hikes. Those announcements have broadly helped pacify markets, reducing risk premiums and leading to the recovery of some stock indices. In emerging markets like Colombia, this has helped the currency rebound after a significant depreciation in the last quarter of 2018.

Despite this recovered sense of calm, the global economy continues to face significant risks related to increases on tariffs between China and the U.S., which could limit international growth and result in a decline in the volume of global trade. Other factors that could weaken the global appetite for risk even further are high levels of debt in the United States, China and other advanced and emerging economies; the prospect of a “no-deal” departure of the United Kingdom from the EU; and a deceleration in the Chinese economy that exceeds expectations.

In mid-January, the IMF revised downward its projections for global economic growth, to 3.5% in 2019 and 3.6% in 2020, 0.2 and 0.1 percentage points below their projections from October. For Latin America, the IMF estimates that economic activity will continue to recover (2.0% in 2019 and 2.5% in 2020).

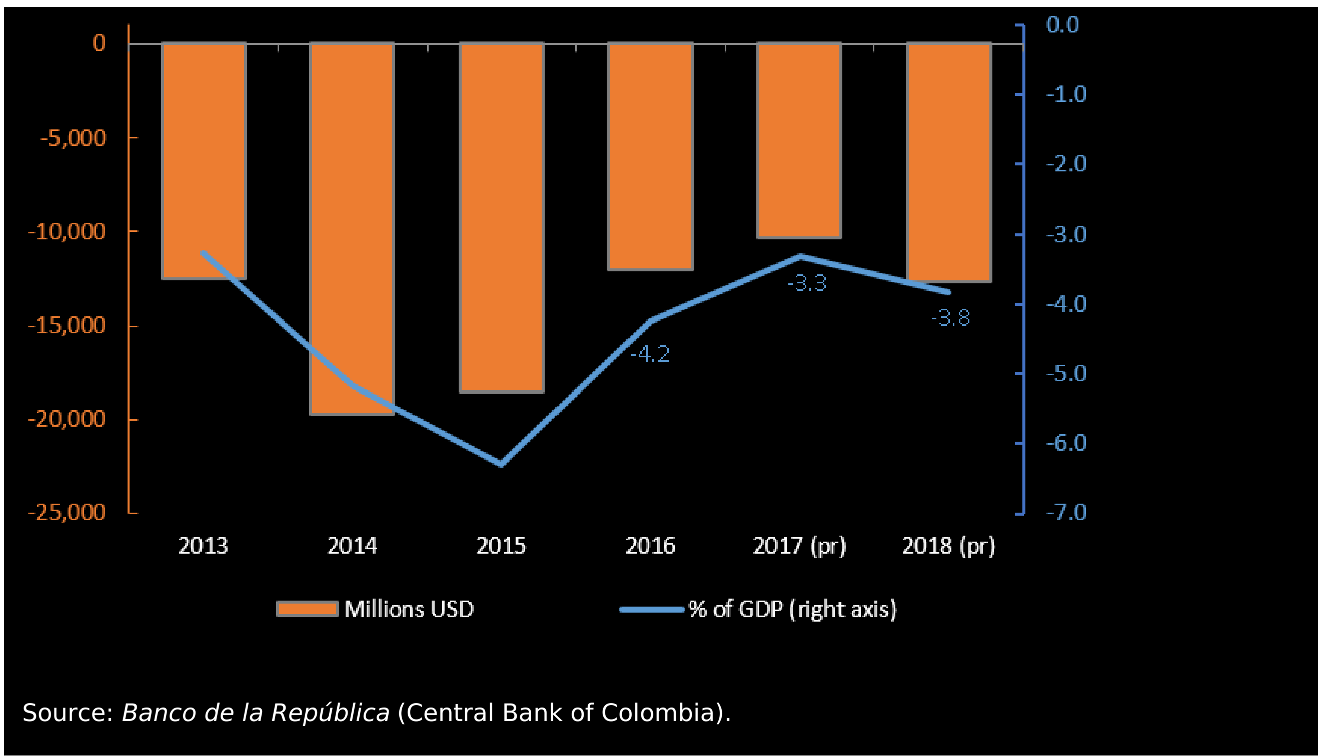
But if the negative outcomes mentioned above come to fruition, they could translate to slower growth in the demand for Colombian exports, a decrease in the price of crude and other raw materials, and an increase in sovereign risk premiums. This could put downward pressure on the exchange rate, which, if translated to prices on tradable goods and imported raw materials, would produce inflationary cost pressures and lower levels of aggregate demand. This scenario could be partially mitigated by more lax international financial conditions, which would encourage increased foreign capital flows to the country.

B. The Current Account

The current account on Colombia’s balance of payments fell drastically in response to the oil shock of 2014, increasing from a deficit of 3.3% of GDP in 2013 to 6.3% of GDP in 2015. This increase in Colombia’s external imbalance was driven by a reduction in the value of exports at the time. In 2016 and 2017, the external imbalance was corrected considerably, with the current account deficit falling to 4.2% and 3.3% of GDP, respectively. That correction came about initially from a significant reduction in imports and the remission of utilities abroad by international oil companies. However, the makeup of that adjustment changed in 2017, when exports rebounded and other external revenues outpaced the increase in imports.

This process eventually stalled, and even reversed course in 2018, as the current account deficit reached 3.8% of GDP, 0.5 percentage points above levels from a year before (**Graph 10**). This backslide was the result of an acceleration in imports, primarily in raw materials and capital goods, and a slump in export growth. Earnings transferred abroad from businesses with foreign direct investment (FDI) into the country also increased.

Graph 10
Current Account Deficit
(Millions USD) (% of GDP)



Source: *Banco de la República* (Central Bank of Colombia).

The technical team at the Bank forecasts the current account deficit to continue to grow, reaching a level slightly over 4.0% of GDP at the end of 2019 due to lower prices for Colombian coal and crude oil, as well as a moderation in the growth of exports of industrial goods (in the context of a global economic slowdown). Imports will continue to grow in 2019, though at a slower rate than in 2018. This is consistent with an environment in which internal demand grows more than GDP.

A current account deficit, if it can be financed, need not be cause for alarm. For Colombia, the news in that regard is positive: FDI has been stable at around $11 billion for several years, and revenues from foreign portfolio investments, which in 2018 totaled $349 million (0.1% of GDP) could hold steady in 2019.

In the medium term a lower current account deficit would be advantageous, ideally to a level between 2.5% and 3.0% of GDP, which is considered sustainable by the technical team at the Bank. For that to happen, Colombia would need more dynamic growth and a diversification of its exports. Simply reducing imports wouldn't do, as the country needs to continue to import raw materials and capital goods to consolidate its recovery.

From a macroeconomic perspective, Colombia's external imbalance could be reduced if national savings were to outpace investment. That, in turn, would require an improved fiscal environment and a pension reform that encouraged young people to save for their later years.

C. Public Finances

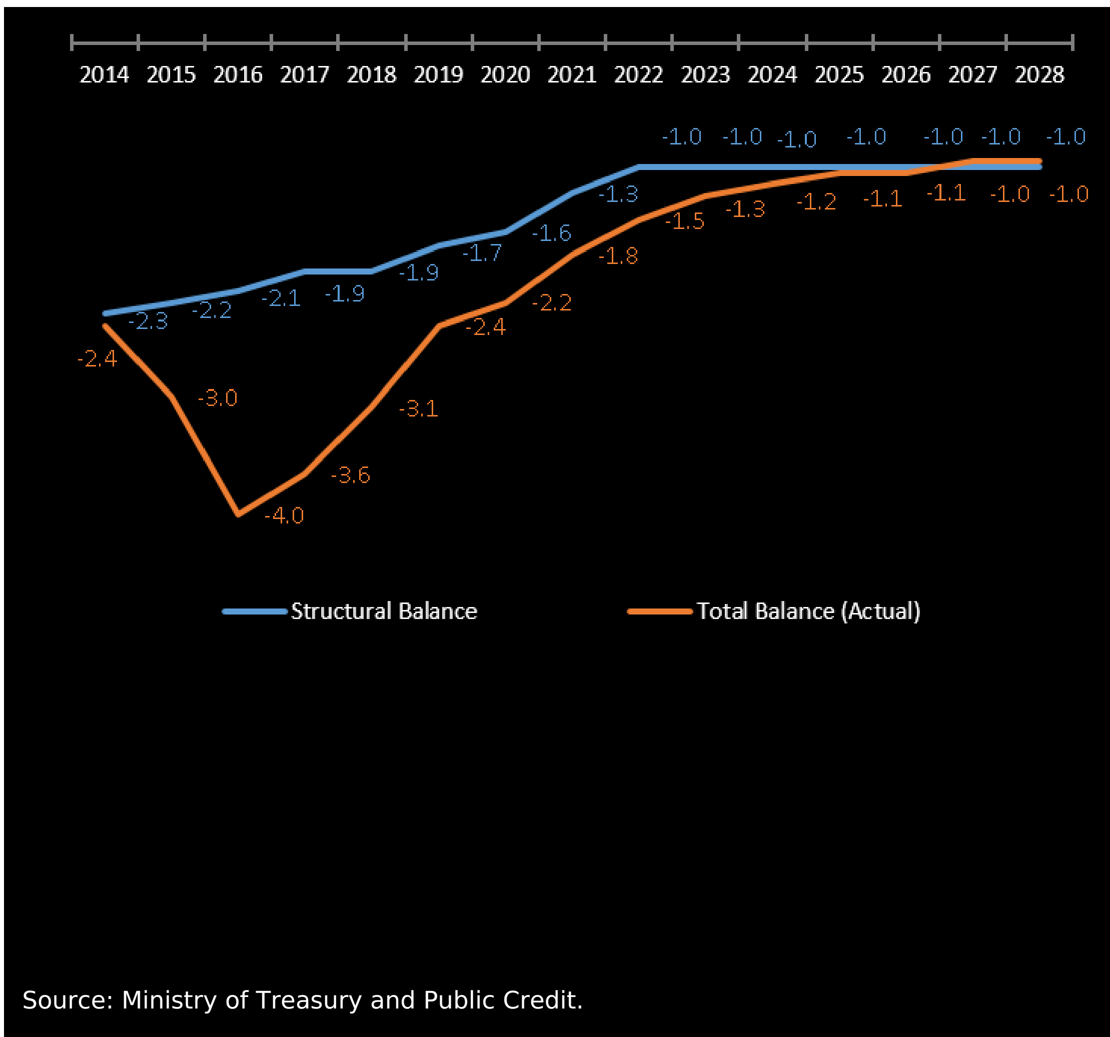
Colombia's Fiscal Rule[6] requires the national government to gradually reduce the structural fiscal deficit until reaching a level of -1.0% of GDP or less by 2022. Since the rule has been in effect, it has enabled a reduction in the structural deficit from -2.3% of GDP in 2014 to -1.9% of GDP in 2018.

The rule takes into account economic cycles and the behavior of oil prices to determine the ideal fiscal balance for a given year, thereby promoting counter-cyclical financial management. In other words, the rule calls for increasing the total deficit above the structural deficit when GDP growth is below potential and/or when the price of crude is below its long-term level, and vice versa.

The fiscal rule has been fundamental to maintaining market confidence in Colombia's public finances and in helping the country keep its investment grade. A Consultative Committee, established by the law, sets a policy guideline for managing the total deficit in a way that is compatible with overall structural deficit goals. In compliance with that guideline, the government reduced the deficit from -4.0% of GDP in 2016 to -3.1% of GDP in 2018. In 2019 the government will be required to reduce the deficit to -2.4% of GDP, until reaching -1.4% of GDP in 2022, equivalent to a structural deficit of -1.0% of GDP (**Graph 11**).

6/ Law 1473 approved in 2011.

Graph 11
Fiscal Deficit Guideline
(% of GDP)



Source: Ministry of Treasury and Public Credit.

The recent Financing Law introduced new challenges to complying with the fiscal rule. While changes in the tax code should stimulate investment and economic growth, after 2019 their effects will not be strong enough to compensate for the expected fall in revenues.

The corporate tax benefits included in the reform can be summed up in three measures: (i) a reduction in the overall income tax from 33% in 2019 to 32% in 2020, 31% in 2021 and 30% in 2022; (ii) an allowance for businesses to discount VAT paid on expenditures for capital goods, as well as 50% of the industry and commerce tax, from their income taxes; and (iii) a reduction in the presumptive revenue percentage to 1.5% in 2019 and 2020 and 0% in 2021.

The Financing Law also introduced measures to increase the tax take, but they will likely fail to compensate for the corresponding fall in revenues after 2019. These included a multi-phase VAT system for beer and carbonated drinks; a national tax on consumer sales of property valued over 918.4 million pesos; an increase in the income tax for high-income individuals and a transitional patrimony tax for individuals and foreign associations; a temporary surcharge on the income tax for entities in the financial sector; and increases in the rate for payment on taxes on dividends for individuals.

The net effect of these measures will increase tax revenues to close to 7.9 trillion pesos in 2019, allowing the government to comply with the fiscal rule by reducing the total deficit from 3.1% of GDP to 2.4% of GDP in 2019. Nevertheless, the majority of analysts believe that additional resources will be required in following years.

Starting in 2020, various corporate tax benefits will take effect, with a net negative impact on tax revenues that could range from 0.3% to 0.6% of GDP. To continue meeting the guidelines for the total deficit set out by the fiscal rule, the national government will need to make a significant adjustment in its public finances of between 0.5% and 1.1% of GDP.