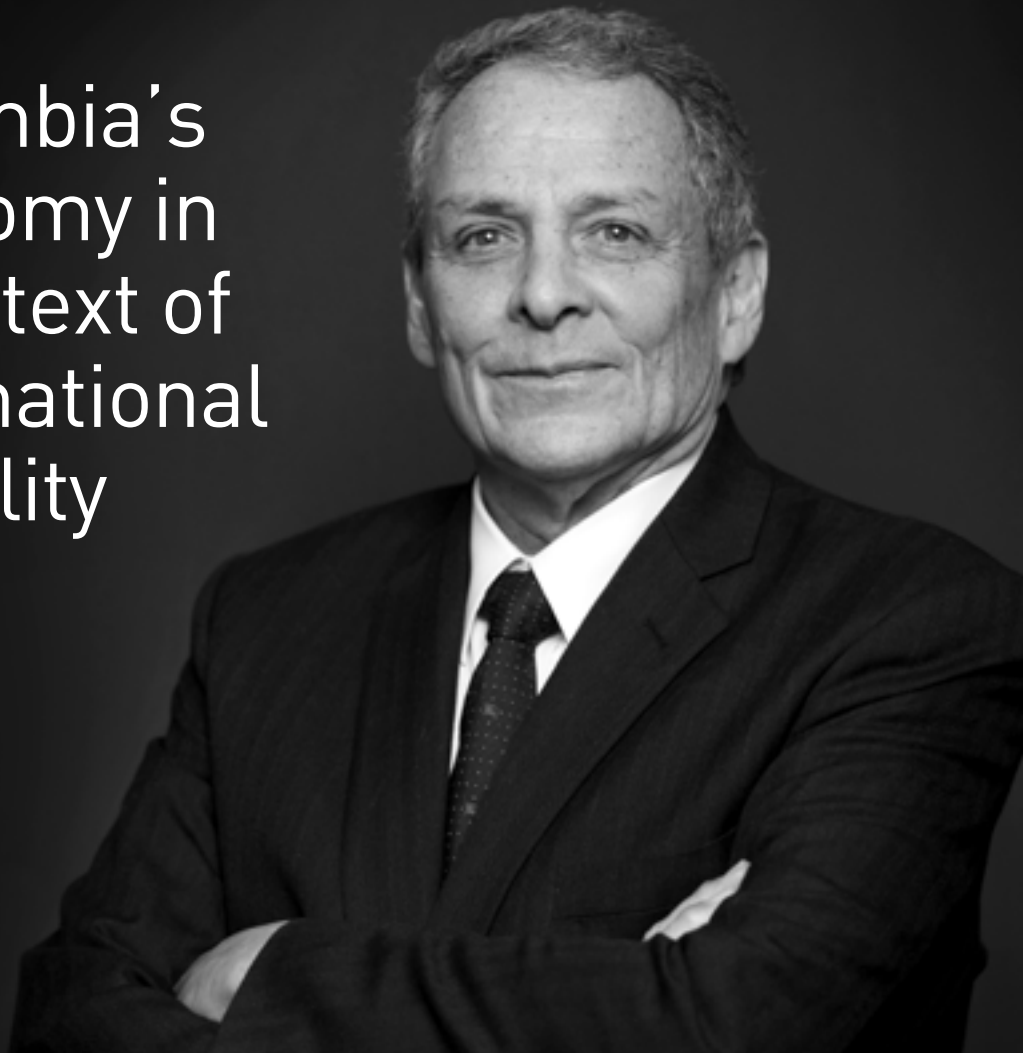


GOVERNOR'S REPORT

BANCO DE LA REPÚBLICA - CENTRAL BANK OF COLOMBIA

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Colombia's Economy in a Context of International Volatility



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Introduction

This edition of the *Governor's Report* presents an assessment of the country's economic situation and its prospects. We argue that the Colombian economy remains stable despite strong international shocks and the recent crises in countries like Argentina and Turkey. However, the country still faces challenges ahead related, for example, to fiscal and external adjustments. The rise in interest rates in developed countries, the volatility in commodity prices and the recent trade war (among others) could have a strong negative impact on the most vulnerable emerging market economies.

1. A More Dynamic Economy

The evolution of recent economic growth is a good starting point for our analysis. According to the figures on gross domestic product (GDP) published by the National Department of Statistics (DANE), the Colombian economy grew at an annual rate of 2.2% in the first quarter of 2018 and 2.8% in the second. These are positive news, not only due to the upturn observed between one quarter and the next one but also because of the relative improvement when compared to the previous year (2.1% and 1.7%, respectively).

These figures should be interpreted with caution, however, since they do not consider adjustments for seasonal factors or for the number of working days in each quarter. Such adjustments are necessary for the growth rates to be comparable over time, as the economy has seasonal variations, and the Easter holiday does not always occur at the same time every year.

DANE incorporates these adjustments, with growth series that are comparable both annually and quarterly. *Banco de la República's* staff uses this last series in different reports. **Chart 1** presents the adjusted series. They show that GDP increased 2.6% and 2.5% during the first and second quarters respectively.¹ Those figures are higher than those reported for 2017 (1.4% and 2.2% respectively), and although growth dynamics is not very strong, the trend confirms the diagnosis presented in our *Report to Congress* last July in which we argued there that the economy had finally begun to recover after a long period of adjustment.

¹ Likewise, the growth between consecutive quarters has not been much different (0.9% and 0.6% in the first two quarters of the year).

Chart 1
Real Annual GDP Growth
 (Seasonally adjusted and corrected for calendar effects)



Source: DANE; calculations by *Banco de la República*.

A detailed analysis of GDP figures reveals other interesting facts. On the demand side, total consumption shows progressive improvement, with annual rates that went from 2.2% in 2017 to 2.9% and 3.2% in the first and second quarters of 2018. This dynamism is explained mainly by household consumption² and the greater consumer confidence observed in recent months. It is also associated with the expansion of government consumption (4.9% annual growth in the second quarter) explained by the spending related to the recent election process and the two national censuses performed (population and housing); and also to large expenditures at the local level (**Table 1**).

Investment growth has not been as satisfactory. The negative rates observed in 2017 and 2018 were primarily due to the contraction in the housing sector (-5.4% and -0.7% in each quarter) and in buildings and structures (-5.6% and -3.1%); investment demand has been weak, and there has been a large surplus building during the previous good years. There were also delays in the financing of some infrastructure projects.

² The annual rate of growth in household consumption increased from 1.8% in 2017 to 2.6% in the second quarter of 2018.

Table 1
Real Annual GDP Growth on the Demand Side
 (Seasonally adjusted and corrected for calendar effects)

(Percentage)

	2016	2017				2017	2018	
	Full year	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Full year	I Qtr.	II Qtr.
Total consumption	1.4	1.8	2.3	2.6	2.2	2.2	2.9	3.2
Household consumption	1.4	1.7	1.7	2.0	1.6	1.8	2.0	2.6
Non-durable goods	-0.4	0.5	1.3	3.3	2.9	2.0	2.6	3.1
Semi-durable goods	3.0	-1.7	-3.5	-3.7	-0.5	-2.4	0.6	2.0
Durable goods	-5.9	0.1	1.5	4.7	-3.2	0.7	5.2	1.8
Services	3.0	3.0	2.5	2.0	1.7	2.3	1.7	2.5
Final government consumption	1.8	2.5	4.2	4.8	4.5	4.0	6.4	4.9
Gross fixed capital formation	0.3	-2.6	-1.2	3.7	2.8	0.6	-3.2	0.5
Gross fixed capital formation	-2.7	0.8	6.6	4.4	1.6	3.3	-2.6	-2.5
Housing	-0.2	8.6	7.2	-0.5	-9.5	1.2	-5.4	-0.7
Other buildings and structures	0.0	2.5	1.2	0.5	-3.0	0.3	-5.6	-3.1
Machinery and equipment	-7.9	-5.4	-1.6	2.0	-2.6	-2.0	1.6	0.6
Other cultivated biological resource:	13.1	7.9	-11.1	-5.0	7.1	-0.6	-2.1	1.1
Intellectual property items	-8.9	4.6	14.7	18.7	20.7	14.6	7.2	4.4
Domestic demand (consumption plus investment)	1.2	0.8	1.5	2.9	2.3	1.9	1.6	2.6
Total exports	-1.4	-4.2	2.4	3.4	-4.1	-0.7	-0.3	2.6
Total Imports	-4.0	0.2	4.2	0.0	-3.2	0.3	-1.4	4.8
GROSS DOMESTIC PRODUCT (GDP)	2.0	1.4	2.2	1.8	1.6	1.8	2.6	2.5

Source: DANE; calculations by *Banco de la República*.

Aggregate domestic demand (consumption plus investment) has shown some dynamism, however, with annual growth rates of 1.6% and 2.6% during the first and second quarters of 2018. Consumption has been growing, and also other types of investments as evidenced by imports of capital goods.

Real total exports declined 0.3% in the first quarter but increased 2.6% in the second. There were large increases in mining (32.4%, in USD), particularly in oil and coal, but sales of non-primary goods also grew 14%. Manufacturing exports of chemicals, vehicles, and non-metallic minerals did especially well. Agricultural exports fell 4.9%, with special reductions of coffee and bananas.

Imports also recovered, with a real rise of 4.8% in the second quarter (and 1.4% decline in the first quarter), explained mainly by more purchases of electrical machinery and intermediate goods. Finally, GDP data shows rapid growth in such sectors as professional services, public administration and defense, and agriculture, while construction and mining contracted (**Table 2**).

Table 2
Real Annual GDP Growth on the Supply Side
(Seasonally adjusted and corrected for calendar effects)

(Percentage)

	2016	2017				2017	2018	
	Full year	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	Full year	I Qtr.	II Qtr.
Agriculture, forestry, hunting and fishing	2.2	8.3	7.6	5.3	1.6	5.6	3.5	4.7
Mining and quarrying	-3.0	-7.6	-1.8	-4.9	-2.7	-4.3	-4.1	-5.0
Manufacturing industry	2.8	-1.0	-2.7	-1.5	-2.7	-2.0	0.5	1.7
Electricity, gas and water	0.0	-1.0	1.0	1.6	1.7	0.8	1.2	2.4
Construction	3.0	0.8	-2.5	-4.9	-1.3	-2.0	-7.6	-7.4
Buildings	5.4	-3.3	-3.9	-9.1	-4.9	-5.3	-3.0	-7.6
Civil works	-3.2	6.6	4.9	7.8	10.6	7.5	-7.7	-5.5
Specialized activities for construction	5.3	-3.6	-3.7	-6.3	-3.3	-4.2	-3.6	-9.2
Commerce, repairs, transportation and lodging	1.9	0.5	1.5	1.8	1.0	1.2	2.6	3.3
Information and communications	-0.8	-0.1	0.5	-3.0	2.5	-0.1	1.5	2.5
Financial and insurance activities	6.6	6.7	7.3	6.6	6.9	6.9	6.7	4.0
Real estate activities	3.3	3.2	2.8	2.6	2.5	2.8	2.3	2.1
Professional, scientific and technical activities	-2.3	0.6	3.6	3.6	6.2	3.5	7.1	7.6
Public administration and defense, education and health	3.6	3.9	4.8	4.0	2.7	3.8	6.9	4.8
Artistic, entertainment and recreational activities	5.5	9.1	2.7	1.0	3.0	3.9	1.6	3.1
Subtotal: aggregate value	2.0	1.5	1.9	1.4	1.4	1.5	2.5	2.5
Taxes minus subsidies	1.2	1.0	5.0	6.0	5.4	4.3	5.7	2.6
GROSS DOMESTIC PRODUCT (GDP)	2.0	1.4	2.2	1.8	1.6	1.8	2.6	2.5

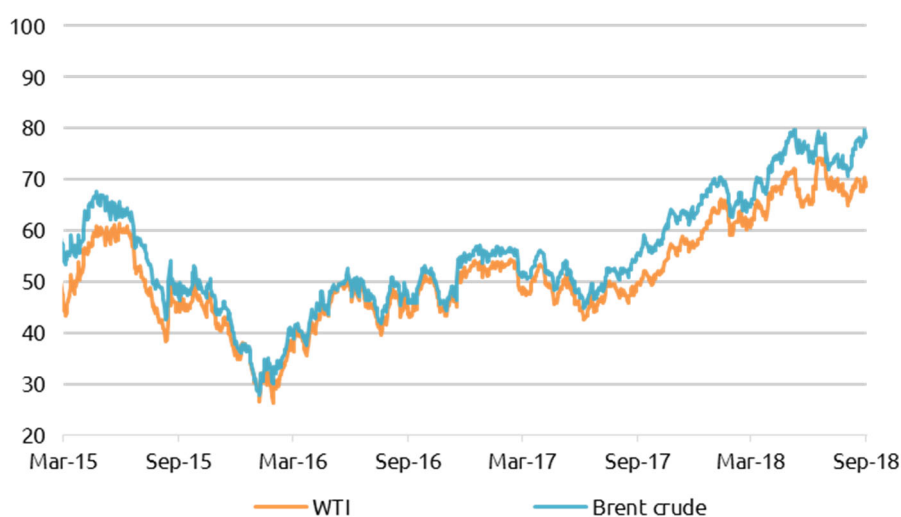
Source: DANE; calculations by *Banco de la República*.

2. Growth Consolidation

Banco de la República, the government, and some multilateral organizations such as the IMF and ECLAC are expecting GDP growth close to 2.7% - 3.0% in 2018, and 3.3% - 3.7% in 2019. The economy still operates below capacity, with potential growth estimated by the Bank's staff at 3.3% - 3.5%. This means the economy has adjusted relatively well to the large shocks suffered in 2014 – 2016 (terms of trade, new VAT taxes and strikes in the transport sector). Oil and coal prices have partially recovered (**Chart 2**), and we expect oil prices of USD 72 and 69 per barrel in 2018 and 2019. Country-risk levels have remained stable (**Chart 3**), and there has been a remarkable improvement in consumer and business confidence (**Charts 4A and 4B**). Lower policy and bank interest rates have helped the economy.

Chart 2
International Price of Oil

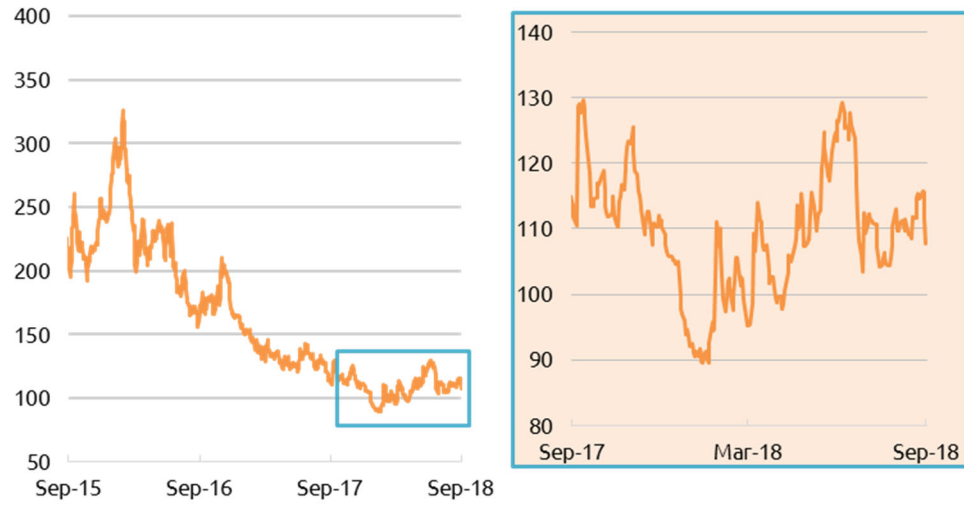
(Dollars per barrel)



Source: Bloomberg.

Chart 3
Five-year Credit Default Swaps (CDS) for Colombia

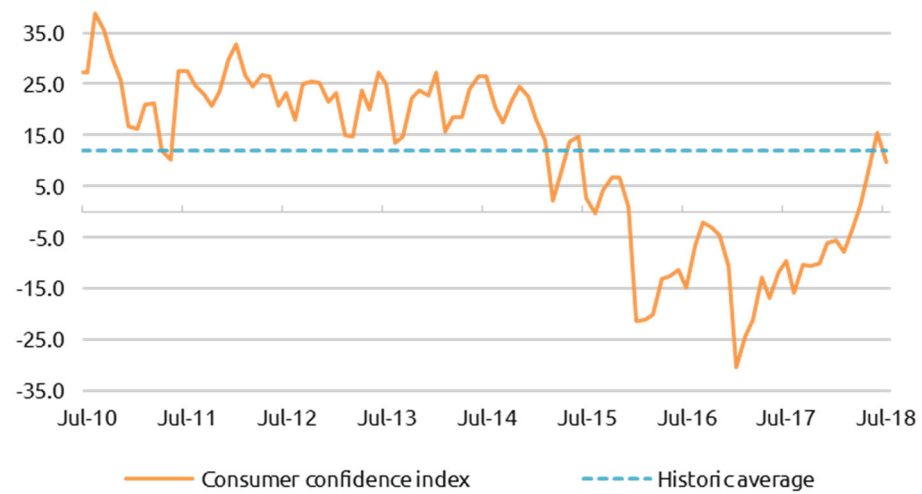
(Basis points)



Source: Bloomberg.

Chart 4A
Consumer Confidence Index

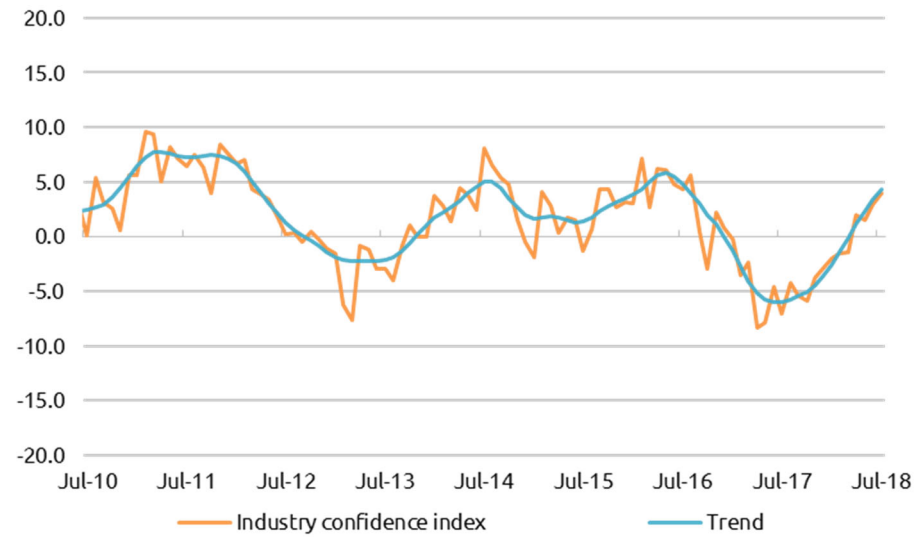
(Balance)



Source: Fedesarrollo.

Chart 4B
Industry Confidence Index
(Seasonally adjusted series and trend)

(Balance)



Source: Fedesarrollo.

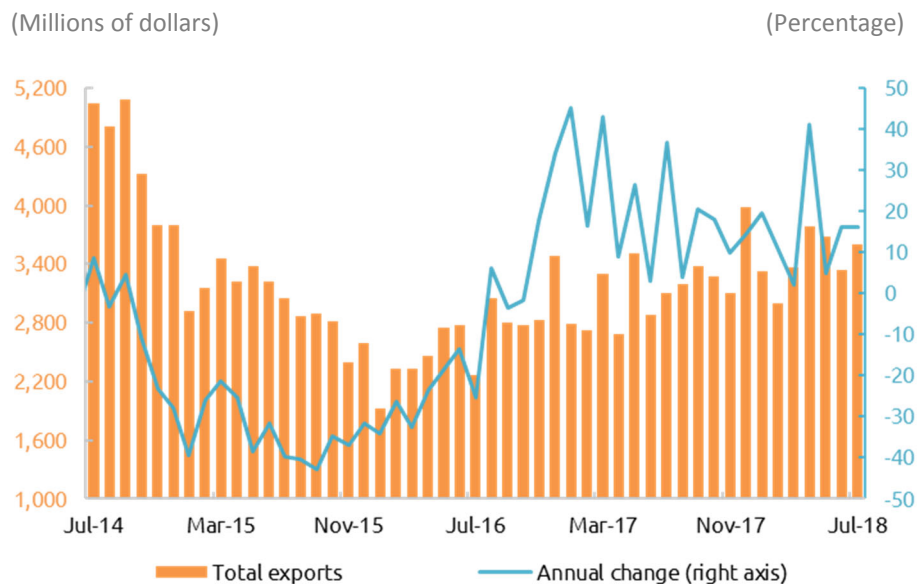
3. The International Economy and the Recent Recovery

There are positive growth projections for the United States, the euro area, China and (less) for Japan and Latin America, with the world economy probably growing at rates close to 3.5% in 2018 and 2019. These are good news for the Colombian economy; international oil prices will probably remain high, and foreign demand will stimulate trade and exports.

The strengthening of foreign demand and the improvement in terms of trade stimulate trade and exports. The total value of exports (in dollars) registered an annual growth rate of 16.2% up to July 2018 (**Chart 5**), due to the increase in exports of goods with mining origin (32.4%), particularly oil and coal. Between January and July, total exports rose by 14.9%, those of mining origin were up by 21.0%, and those comprised in the category “all others” increased by 12.3%, among which external sales of chemical products, automotive vehicles, and non-metallic minerals were a high point. Agricultural exports, however, fell by 4.9% during this period, due to the lower value of exports of coffee and bananas.

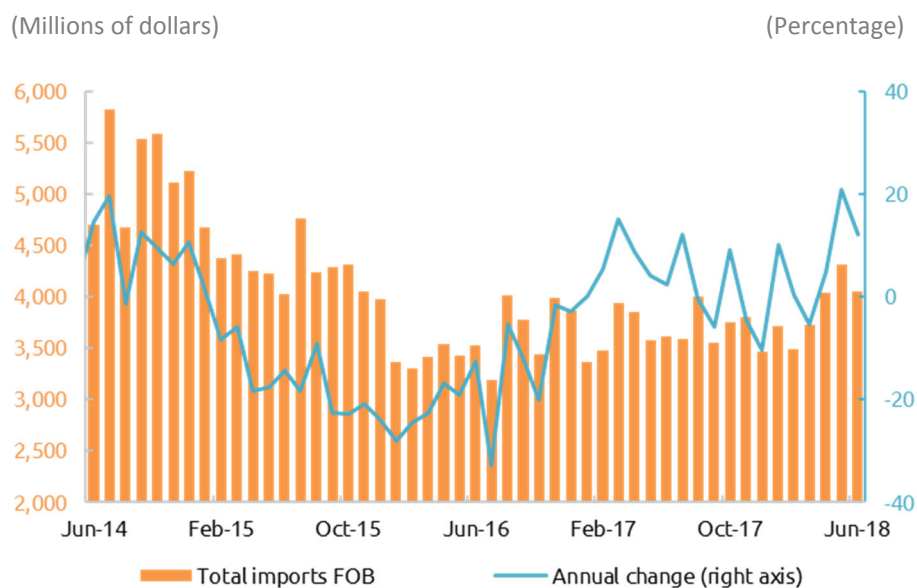
The total value of imports in June was up by 11.9% compared to the same month in 2017 (**Chart 6**), while imports’ growth during the first six months of the year was 7.0%. External purchases of raw materials destined for industry were especially important, having increased by 17.1% in June, and 12.9% annually during the first half of the year. Imports of capital goods have risen as well, especially for industry, having grown 10.9% annually during the first six months of the year.

Chart 5
Total Exports of Goods (FOB, in dollars)



Source: DANE. Calculations by *Banco de la República*.

Chart 6
Total Imports of Goods (FOB, in dollars)



Source: DANE. Calculations by *Banco de la República*.

This expansion in the trade of goods is consistent with a current account deficit registered in 2017 (3.4% of GDP). Although the deficit will continue to be

financed by foreign direct investment (FDI), these flows will decrease, partially because of the large fines imposed on the communication sector last year.³ Close to 30% of FDI flows will go into the mining sector, but the other 70% will mainly go into communication, transport and manufacturing. Foreign loans contracted by the public sector will increase, but portfolio capital flows (i.e purchases of TES) will probably be lower.

³ Discounting the base effect would show an increase in FDI, driven by investments destined for both the mining-energy sector and “all others”. Nearly 30% of FDI in recent years went to the mining sector (oil and mining, and quarries), while the remaining 70% was for “all others”, mainly transportation, communications and manufacturing.

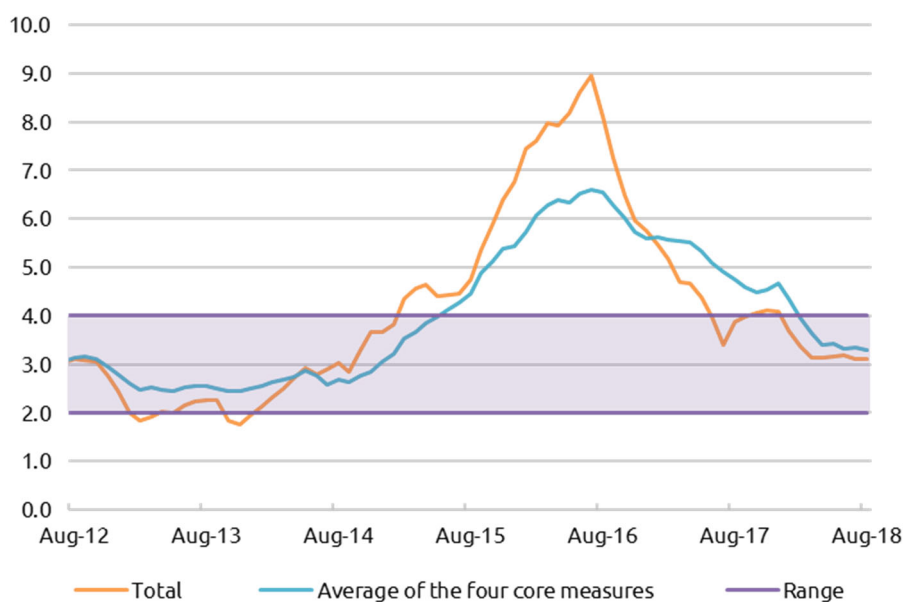
4. Inflation: Close to Our 3.0% Target

Annual inflation decreased from 4.09% in December, 2017 to 3.10% in August, 2018, very close to our 3.0% target. Core inflation (average of four indicators) fell from 4.66% in December 2017 to 3.31% in August (Chart 7).

Chart 7

Total Consumer Inflation and Core Inflation

(percentage)



Source: DANE; calculations by *Banco de la República*.

Inflation expectations have been stable, but still slightly above our long term target of 3.0%, and also above actual inflation. This means markets anticipate a slight inflation upturn during the rest of 2018, maybe coming from food prices,

fuel, or the exchange rate. Our surveys among financial analysts show inflation expectations at 3.20% and 3.32% for 2018 (December) and 2019.⁴ In this environment, the Board has kept policy rates at 4.25% since April.

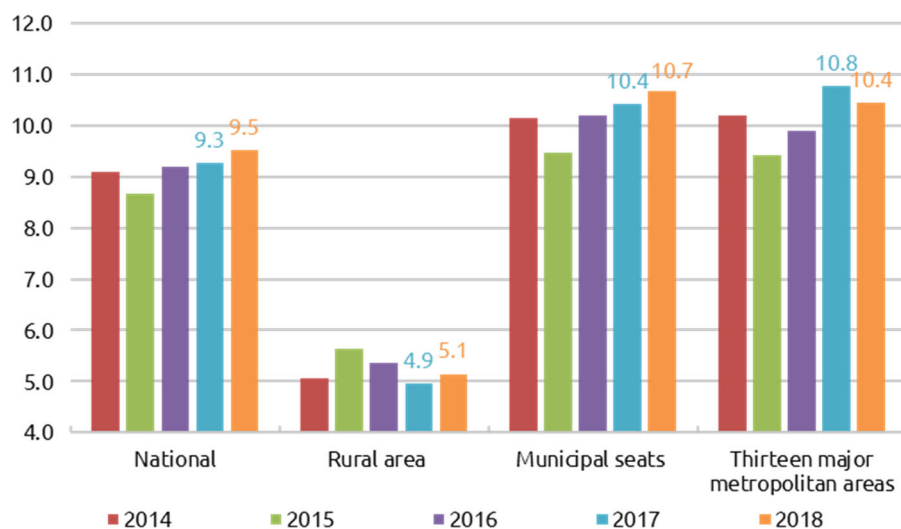
⁴ The amount of inflation implicit in public debt securities, which is extracted from peso-denominated TES and the UVR, was 2.95%, 3.06% and 3.25% in August at 2, 3 and 5 years, respectively.

5. The Labor Market

The unemployment rate is higher in Colombia than in most other Latin American countries but has remained relatively stable during the last year. The national rate was 9.5% in May-July of 2018, slightly higher than in the same quarter of 2017 (9.3%). And the rate for the thirteen major metropolitan areas declined from 10.8% to 10.4% between those two periods. Unemployment in rural areas saw a moderate increase from 4.9% to 5.1 % (**Chart 8**).

Chart 8
Unemployment Rate
(May-July moving quarter)

(Percentage)



Source: DANE (GEIH).

Job losses at the national level were explained by agriculture, real estate and transport; and in the mayor thirteen metropolitan areas, by real estate, business, construction, and transport. Both salaried and non-salaried employment increased.

6. Volatility and Vulnerabilities

Colombian growth is coming back, overcoming some of the strongest external shocks in recent history, but the international economy has become very volatile and uncertain. Further adjustment is needed: the economy has yet to reach its potential growth, inflation and inflation expectations must converge towards the 3.0% target, and the current account and fiscal deficits still need further reductions. International capital will punish those countries with significant vulnerabilities.

Our projections suggest the current account deficit will be close to 3.2% of GDP this year, and also in 2019, a relatively large number when compared to other countries in the region and abroad. Further adjustment is needed here.

Government public debt increased from 34.6% of GDP in 2013 to 43.1% in 2018, mainly due to the devaluation of the exchange rate and higher interest rates; not much to the behavior of the primary deficit. Government oil revenues decreased 3.0% of GDP between 2013 and 2017 and further fiscal adjustment is needed in order to comply with the so called fiscal rule: the fiscal deficit has to decrease from 3.1% of GDP in 2018 to 2.4% and 2.2% in 2019 and 2020 (the structural deficit from 1.9% in 2018 to 1.7% and 1.6% in 2019 and 2020).

The financial system remains strong. The recent increase in non-performing loans is mainly explained by poor past GDP growth, and large provisions accumulated during the previous years. The stress tests designed by the bank's technical staff show satisfactory results.

What are the main sources of international volatility? Tariff wars, oil price volatility, and the so called normalization of the FED policy.

The first source of volatility is related to the recent tariff war. The decisions by the United States government to impose tariffs on imports from China, Turkey, Japan and European countries and the response of the latter with similar policies, poses great threats to world trade and growth in advanced and emerging economies. The United States government's decision to make the trade deficit the center of economic policy could lead to new contradictions. Thus, the increase in public spending and the reduction in taxes in a situation of large fiscal deficits will produce greater current account imbalances and additional tariffs.

A second important source is the volatility of oil prices. How the international oil prices evolve will depend, among other factors, on the decisions on production taken by the Organization of Petroleum Exporting Countries (OPEC) and by other large producers, as well as on global demand. Oil and other raw materials could drop. The recent trade war could also affect oil prices markedly.

The third source of volatility could come from the so-called normalization of monetary policy in the United States and other advanced economies. The US Federal Reserve (the Fed) has raised policy rates twice this year, and they could reach a level close to 3% in 2019. An even larger impact will come from the reduction in the Fed's balance sheet. The European Central Bank (ECB) has also announced an important reduction in its balance sheet, although it seems it will leave interest rates unchanged for the time being. The normalization of monetary policy in developed countries is just beginning and it will possibly generate some capital outflows and exchange rate devaluations in emerging markets.

Some countries with large vulnerabilities like Turkey and Argentina, and (less so) South Africa and Brazil have already been hit. They have experienced episodes of sharp depreciations in their currencies and increases in the cost of international financing (**Charts 9 and 10**). **Chart 9** shows the evolution of the exchange rate between the end of 2017 and September 2018 (December 2017 = 100). It has remained very stable in Colombia during the whole period.

The exchange rate has shown large increases (i.e. devaluations) since April 2018 in Argentina (to 212 at the end of the period), Turkey (181 in mid-August 2018, and 165 at the end); it reached values of 124 and 116 in Brazil and Russia.

The so-called credit default swaps (CDS), a proxy for risk, have remained very stable in Colombia during the entire period, but rose to 349 in Turkey at the beginning of September (and then fell to 255); and reached levels of 183 and 138 in Brazil and Russia in September of 2018 (**Chart 10**).

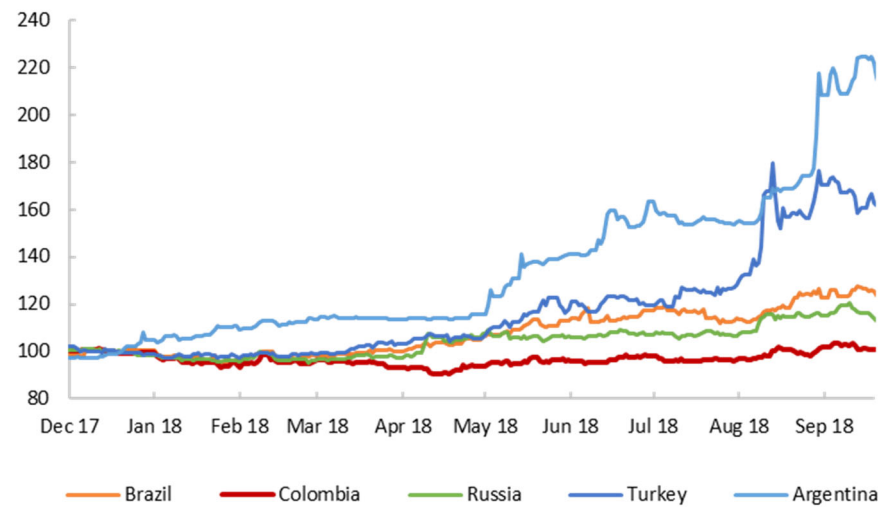
Some of the four countries mentioned present high inflation rates, have central banks with reduced autonomy, and do not float their exchange rates. The recent diplomatic tension between the United States and Turkey have made things more difficult for this last country.

Average inflation rates have been close to 31% in Argentina in 2015-2018, 16% in Turkey, 5% in South Africa and 4.5% in Brazil. President Erdoğan has controlled central bank appointments (and decisions), and President Macri of Argentina, ordered the central bank to change its target; the Central Bank of Brazil does not have full constitutional autonomy.

Chart 9

Nominal Exchange Rate

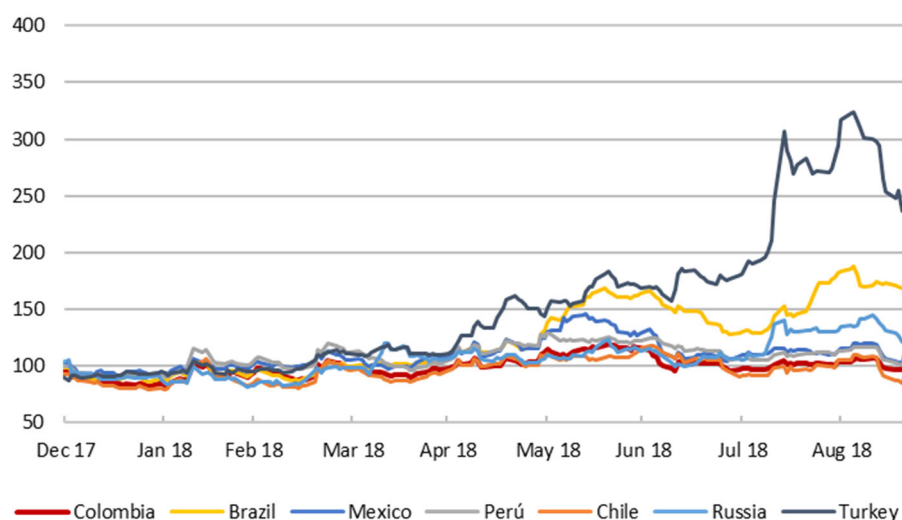
(Base 100 = December 2017)



Source: Bloomberg.

Chart 10
Five-year Credit Default Swaps (CDS)

(Base 100 = December 2017)



Source: Bloomberg.

These economies present other important macroeconomic imbalances. They have large current account deficits (5.9% of GDP in Turkey and 4.7% in Argentina; 3.3% in Colombia), and high fiscal deficits (7% of GDP in Brazil and 5.7% in Argentina; 2.2% in Colombia⁵). They also present high levels of public debt (83% of GDP in Brazil and 53.3% in Argentina for 2016-2018; 33.4% in Colombia⁶).

The relative stability observed so far in Colombia can also be explained by the level of our international reserves, which easily covers the amortization of the external debt and the current account deficit, and represents more than ten months of imports. Furthermore, Colombia has access to a flexible credit line (FCL) with the IMF for USD 11,400 million, which was renewed in June. We decided to buy additional international reserves some days ago to further strengthen our international position.

⁵ The non-financial public sector deficit forecast for 2018.

⁶ The net debt in the non-financial public sector.

Conclusions

Colombia's economy has adjusted well to the strong international shocks witnessed in recent years. There is increasing GDP growth, inflation is near the target, the level of the exchange rate has been relatively stable, and the financial system is solid. But we must complete the adjustment if we want to deal successfully with potential future shocks in a very uncertain world. The international adjustment is just beginning and capital flows will punish those countries that present large vulnerabilities.