Macro scenario - Colombia

June 11, 2021

Fiscal deterioration takes its toll

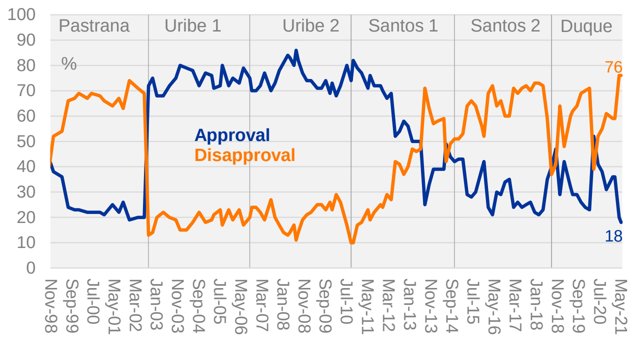
- S&P downgraded Colombia to sub-investment grade as the withdrawal of a tax reform proposal weakened the prospects for a significant fiscal consolidation. A downgrade by Fitch in the coming weeks (also to below investment grade) is possible.
- Enduring social unrest reflects generalized public discontent as poverty rates rise during the ongoing crisis. Political risks will remain high as strained fiscal space would limit room to increase social transfers, while a surging new COVID-19 wave is resulting in record daily deaths. Even so, we are revising our GDP-growth call up by 1.5 pp this year, to 6.5%, as the pace of the recovery during the back-end of last year and in 1Q21 surprised favorably. Supply shocks would see inflation ending the year at 3.7% (2.8% previously). Along with growing fiscal risk, we now expect the central bank to start raising the policy rate before the end of the year.

Intense protests and a rising COVID-19 caseload

Nationwide protests have continued for more than a month. Protestors, initially opposing a tax reform (that sought to widen the income-tax base and increase VAT on certain products), now demand that the government implements measures to tackle rising poverty, police violence, and inequalities in the health and education systems. The protests follow from demonstrations in 4Q19, when thousands took to the streets to demand better wages and additional resources for higher education. The pandemic and one of the longest lockdowns in the region have exacerbated social problems. Poverty in 2020 reached 42.5% of the total population, compared with 35.7% in 2019. Social unrest in some instances has been accompanied by roadblocks and escalating violence, affecting the distribution of fuel and basic goods, especially in the southwestern region of the country. While this is still a key point in the discussions between the government and protestors, most of the distribution channels are now operating normally.

Street confrontations complicate negotiations. President Duque has tried to meet with protesters and has announced that the poorest students would get free higher education from the second half of the year. Additionally, the government presented a job-subsidy scheme, which will cover 25% of the salary of around 0.5 million young people for at least a year. However, the announcements, along with meetings between Duque and civil-society groups (including the National Strike Committee, an alliance of trade unions, and other groups that convened the protests), have not persuaded people to leave the streets. In this context, Duque's political capital is diminishing. The last Invamer poll shows President Duque's approval at 18%, down from 21% in April and a record low for any Colombian president since 1994. The poll also showed support for political parties at just 9%, once more opening the way for an anti-establishment candidate in next year's election. Currently, left wing, and runner-up to Duque, Gustavo Petro is leading the polls.

Diminished political capital



Source: Inavamer

With extensive protest action and limited capacity to enforce strict lockdowns, the health situation has worsened. The current COVID-19 wave has led to record daily cases and deaths. The weekly daily average of new cases neared 25 thousand in early June, compared with the previous peak of around 18 thousand in mid-January. Additionally, the weekly average of daily deaths is over 500, well above the 390 peak in January, and intensive-care unit occupancy rates sit around 96% in the country's main cities.

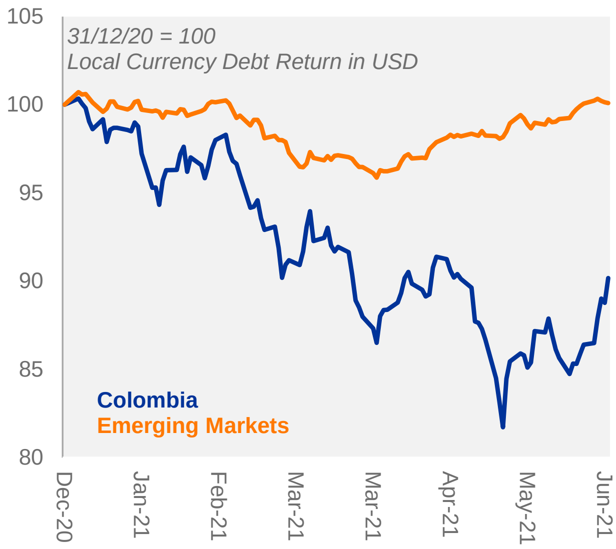
Despite the uncomfortable sanitary situation, the government has decided to loosen mobility restrictions, likely in response to growing fatigue and frustration within the population. The government issued a new decree at the end of May, extending the 'selective isolation' measure, but opening the door for a full reactivation of economic activity. The decree establishes that, from June, all economic and social activities including restaurants and bars could be opened if the city's ICU occupancy sits below 85%. The decision aims to boost economic activity and labor-market recovery, a key factor behind the social unrest. Employment currently sits nearly 9% below levels prior to the pandemic. While progress has been made in the vaccination process, reaching herd immunity is unlikely before the end of the year or early 2022 (only around 7% of the population has completed the course of vaccines).

S&P downgrades Colombia to junk, Fitch likely to follow

S&P downgraded Colombia's sovereign debt rating to BB+, with a stable outlook. The decision comes after the administration was forced to withdraw the structural tax reform from Congress that had aimed to fund the extension of some support measures implemented during the pandemic and to allocate more than 1 pp of GDP to a credible fiscal-consolidation program. In addition, S&P highlighted external vulnerabilities (partly mitigated by adequate access to international markets and credible monetary policy). S&P believes that prospects for substantial structural reforms are low in the near term, given social discontent and the upcoming election cycle in 2022. The stable outlook reflects the expectation of an economic recovery in 2021 and considers there will be an institutional solution to the social recent unrest.

Following the S&P decision, Fitch announced that it will review Colombia's rating in the short term. The rating agency will conduct its periodic mid-year review of Colombia's sovereign credit rating evaluating the impact of protests on short- and medium-term growth. According to the senior director of Fitch, the agency wants to see Colombia's debt levels stabilize and begin to fall. Fitch rates Colombia at BBB- (lowest investment grade) and Moody's still holds Colombia's rating two notches into investment grade (Baa2, negative outlook). The scars of the pandemic and limited political room to implement structural reforms mean that the loss of the investment-grade rating from Fitch is likely.

Colombia debt holders feel the pain



Source: Bloomberg

A new version of the tax reform could be delayed to July. According to statements made by the new Minister of Finance, José Manuel Restrepo, tax reform 2.0 would seek to raise just COP 14 trillion (slightly over 1% of 2022 GDP, versus around 2% originally), without touching the poorest, most vulnerable families or the middle class. The proposal would postpone the benefits for corporations approved in the tax reform of 2019 (of a gradual decline in income-tax rate). Additionally, it would include a wealth tax and higher taxes on people with the highest incomes. The Minister of Finance has stated on several occasions that the government is still seeking consensus, not only on the content of the reform, but also for the moment in which it will be presented, suggesting that it could be delayed to the next legislative sessions, which begin on July 20, and not be considered in the current sessions that conclude on June 20.

Robust activity to start 2021

GDP grew 1.1% yoy in the first quarter of the year, as a gradual recovery unfolded amid a normalization of activities in the quarter. At the margin, activity posted a third consecutive sequential expansion, with most sectors recording gains from 4Q20. The robust showing means GDP is only sitting 0.7% below pre-pandemic levels, at the close of 2019. Improved activity shows the economy is coping better with distancing measures.

On the external front, as internal demand recovers, the current-account deficit widened sharply in 1Q21. A USD 3.6 billion current-account deficit was registered in the first quarter of the year, wider than the USD 2.5 billion recorded one year earlier. In the quarter, FDI into Colombia declined by 21% from last year. Overall, the rolling-four-quarter current-account deficit increased to 3.8% of GDP, from 3.4% of GDP in 2020 (4.5% in 2019).

Supply disruptions from protests mean food prices are pressuring inflation indices. Consumer prices gained 1.00% from April (0.32% fall one year before). The overwhelming contributor to the monthly price gain was the 5.37% increase in food and non-alcoholic beverages component, contributing 88 bps to the monthly CPI increase. The food-price acceleration and the low base of comparison mean annual inflation increased to 3.30% from 1.95% in April, moving beyond the central bank's 3% target. Core inflation, excluding food and energy prices, is significantly lower at 1.89% (from 1.54% in April), remaining below the 2%-4% range around the inflation target.

Higher growth, inflation and policy rates

We now expect the Colombian economy to bounce back with growth of 6.5% this year (5.0% growth in our previous scenario), after contracting 6.8% in 2020. The stronger-than-expected statistical carryover at the start of the year would mitigate the impact on 2021 growth from the reactivation of distancing measures and protest events during 2Q21. Additionally, the significant monetary stimulus still in place and favorable terms of trade would support the recovery. However, for 2022 we now expect activity to grow 3.0%, a moderation from our previously expected 3.5%, affected by a higher base of comparison along with uncertainty around the fiscal scenario and the presidential election.

A swifter internal demand recovery and increased income deficit would offset the positive effect on exports of high terms of trade and a global demand recovery. Hence, we now expect the CAD for this year to reach 3.9% of GDP (from 3.4% of GDP previously). In this context, and considering the likelihood of further downgrades, we now forecast COP at 3,700 per dollar by the end of both 2021 and 2022 (previously COP 3,600 and 3,700 per dollar, respectively).

Recent negotiations with the strike committee have seen blockades lifted, which should result in some unwinding of recent food-price pressures in coming months. Nevertheless, significant upside surprises in recent months and a consolidated reopening of the economy would likely result in inflation ending the year at 3.7% (+90 bps from our last report; 1.61% in 2020).

Higher-than-expected activity growth, along with Colombia's large fiscal and external imbalances and rising inflationary pressures (which could de-anchor medium-term inflation expectations), increases the odds that the central bank begins the normalization cycle later this year. We now expect the policy rate at 2.0% by the end of 2021, as the central bank starts a hiking cycle by the end of this year (with a 25-bp rate hike). The still fragile labor market likely prevents an earlier and swifter tightening of monetary policy. For 2022 we continue to expect the reference rate at 3.5% by year-end.

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Colombia | Forecasts and Data

	2016	2017	2018	2019	2020	2021F		2022F	
						Current	Last Month	Current	Last Month
Economic Activity									
Real GDP growth - %	2.1	1.4	2.6	3.3	-6.8	**6.5**	5.0	**3.0**	3.5
Nominal GDP - USD bn	282	311	334	323	272	**301**	305	**315**	317
Population (millions)	48.7	49.3	49.8	50.4	50.9	**51.4**	51.4	**51.8**	51.8
Per Capita GDP - USD	5,791	6,308	6,704	6,417	5,335	**5,865**	5,926	**6,084**	6,108
Unemployment Rate - year avg	9.2	9.4	9.7	10.5	16.1	**14.0**	14.0	**11.0**	11.0
Inflation									
CPI - %	5.8	4.1	3.2	3.8	1.6	**3.7**	2.8	**2.8**	3.0
Interest Rate									
Monetary Policy Rate - eop - %	7.50	4.75	4.25	4.25	1.75	**2.00**	1.75	**3.50**	3.50
Balance of Payments									
COP / USD - eop	3002	2,932	3,254	3,287	3,428	**3,700**	3,600	**3,700**	3,700
Trade Balance - USD bn	-11.1	-6.0	-7.0	-10.8	-10.1	**-8.5**	-8.0	**-7.0**	-6.0
Current Account - % GDP	-4.5	-3.5	-4.1	-4.5	-3.4	**-3.9**	-3.4	**-4.0**	-3.6
Foreign Direct Investment - % GDP	4.9	4.4	3.5	4.4	2.8	**3.7**	3.7	**4.4**	4.4
International Reserves - USD bn	46.7	47.6	48.4	53.2	59.0	**61.5**	61.5	**61.5**	61.5
Public Finances									
Nominal Central Govt Balance - % GDP	-4.0	-3.6	-3.1	-2.5	-7.8	**-8.6**	-8.6	**-4.0**	-4.0
Central Govt Gross Public Debt - % GDP	45.6	46.4	49.3	50.2	64.8	**67.2**	67.4	**66.3**	66.4

Source: IMF, Bloomberg, Dane, Banrep, Haver and Itaú

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