January 9th, 2024

Colombia Country Report 2024: The Last Mile Is The Longest

Economic Research Team

Colombia achieved one of the most remarkable post-pandemic economic rebounds in Latin America and the universe of emerging countries. However, the evident slowdown in several crucial sectors, such as manufacturing, retail, and construction, demands policy actions and cannot be solely attributed to base effects. The Colombian economy entered an adjustment phase in 2023. This adjustment will continue in 2024. We are optimistic about the outcome, and a year from now, if our projections are accurate, we will be talking about an economy with lower inflation and interest rates, showing signs of an incipient rebound in domestic demand. However, the last kilometer of the current adjustment will be challenging and the longest.

In the first part of 2024, inflation will remain high, and consumers and firms will still face high financial costs. Sectors with higher financial leverage, in a context of still hesitant consumers, will have a tough start to the year. In cycling terms, the first semester of 2024 will be a high mountain prize, at a time when many entrepreneurs and families accumulate several kilometers of financial fatigue. During this last kilometer, the outcome of a significant part of the economic reforms proposed by the Government will be defined.

In this scenario, the international framework will be decisive. A headwind could make this mountain prize even more challenging. In 2023, the global economy managed to avoid a recession. For 2024, the IMF expects global economic growth to be similar to 2023. However, several latent risks that need to be monitored this year.

The Colombian economy would grow less in 2024 than in 2023, consistent with further moderation in consumption, a new contraction in investment, and a less favorable contribution from external accounts. Inflation will continue to decrease but at a slow pace. The Central Bank of Colombia will have room to reduce its benchmark rates to 8% before the end of 2024, but this would not necessarily translate into a proportional relief in financial costs for the private sector. The country risk premium will remain relatively high, limiting the decline in long-term rates because of a higher fiscal uncertainty.

The government must also resist the temptation to derail public finances with the unrealistic goal of rescuing the economy. Colombia exhibits high public spending, similar to pre-pandemic levels, as if the country were experiencing permanent COVID symptoms on the fiscal front. Spending without interest and excluding the fuel subsidy scheduled for 2024 is 19.5% of GDP, very similar to the peak of 20.3% observed during the pandemic. With a fiscal deficit of 4.5% of GDP programmed for next year, exactly at the limit allowed by the Fiscal Rule and one of the highest in the region, financial markets will continue to closely monitor the fiscal issues.

The government will also play a decisive role in the legislative and regulatory agendas. It is challenging to anticipate the outcome of the reforms. The labor reform is unlikely to gain sufficient traction, and health and pension reforms, if approved, may do so with substantial modifications. Physical security is an issue of growing concern for citizens and investment decisions. A similar case occurs with regulatory concerns, where uncertainty in some sectors, such as energy and gas, is hindering investment.

If the external context is favorable and the country manages to overcome many of the challenges in this last kilometer of the adjustment, a year from now we will be talking about a new, calmer, and less demanding stage for the families and businesses. With our hopes and eyes set on that goal, let's advance in this last kilometer.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

January 9th, 2024

Chapter I. Global Outlook: Overcoming The Last Mountain Pass

The global economy had a better-than-expected performance, with worldwide economic growth reaching nearly 3.0%, surpassing previous expectations of 2.7%. This growth was primarily driven by the robust performance of the U.S. economy. The IMF projects a slight deceleration to 2.9% in 2024, due to uncertainties arising from geopolitical conflicts and the risks of a hard landing in the U.S. and the eurozone (Table 1).

The U.S. economy exceeded growth expectations in 2023, leading to upwardly revised projections by the IMF. The labor market demonstrated strength, with record employment and wage data, while the unemployment rate remained historically low at 3.7% in November. The Federal Reserve (Fed) faced the inflationary challenge, maintaining a hawkish stance with high rates for an extended period, prevailing in the face-off with financial markets (Figure 1).

Inflation in the U.S., the primary challenge in the last three years, showed signs of deceleration, favored by the decrease in energy prices. Annual inflation dropped from 9.1% in June 2022 to 3.1% in November 2023, while core inflation decreased to 4.0% from 6.6% in September 2022.

Despite the strong economic performance, events like the regional bank bankruptcies in March and April increased risk aversion, highlighting the vulnerability of the global financial system. Authorities' intervention, such as the Fed opening extraordinary liquidity windows, prevented a systemic crisis. However, it remains one of the risks that will need continued monitoring looking forward.

In the eurozone, after recording high inflation rates in October 2022, the economy showed resilience following the monetary tightening by the European Central Bank (ECB). However,

Table 1. World Economic Outlook Projections 2023 y 2024 - IMF

	2023			2024		
	Est. jul-23 (%)	Est. oct-23 (%)	Var. (p.p.)	Est. jul-23 (%)	Est. oct-23 (%)	Var. (p.p.)
World Output	3.0	3.0	**0.0**	3	2.9	**-0.1**
Advanced Economies	1.5	1.5	**0.0**	1.4	1.4	**0.0**
United States	1.8	2.1	**0.3**	1.0	1.5	**0.5**
Euro Area	0.9	0.7	**-0.2**	1.5	1.2	**-0.3**
Japan	1.4	2.0	**0.6**	1.0	1.0	**0.0**
United Kingdom	0.4	0.5	**0.1**	1.0	0.6	**-0.4**
EM and Developing Economies	4.0	4.0	**0.0**	4.1	4.0	**-0.1**
EM and Developing Asia	5.3	5.2	**-0.1**	5.0	4.8	**-0.2**
China	5.2	5.0	**-0.2**	4.5	4.2	**-0.3**
India	6.1	6.3	**0.2**	6.3	6.3	**0.0**
EM and Developing Europe	1.8	2.4	**0.6**	2.2	2.2	**0.0**
Russia	1.5	2.2	**0.7**	1.3	1.1	**-0.2**
Latam and the Caribbean	1.9	2.3	**0.4**	2.2	2.3	**0.1**
Brasil	2.1	3.1	**1.0**	1.2	1.5	**0.3**
Mexico	2.6	3.2	**0.6**	1.5	2.1	**0.6**

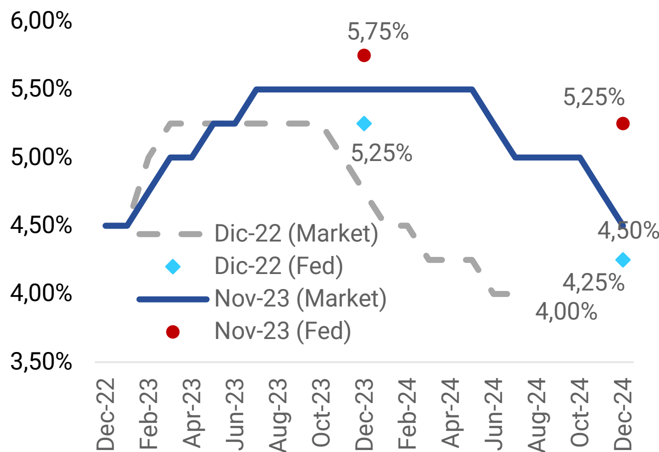
Source: IMF, World Economic Outlook

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

private economic activity was disappointed in the third quarter of 2023, reflecting weakness in the manufacturing sector and signs of cooling in services.

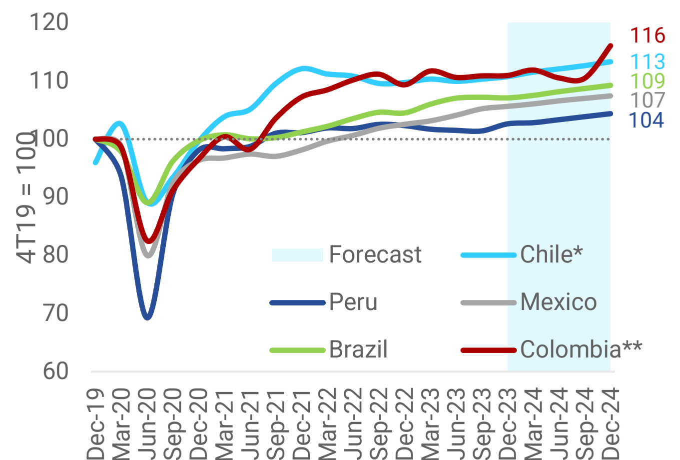
The deterioration of the fiscal outlook in the eurozone, especially in leveraged economies like Belgium, France, Greece, Italy, Portugal, and Spain, poses a threat with debt exceeding 100% of GDP. Both the total and the primary deficit (excluding interest payments) of the general government will be at higher levels in 2023 and 2024 than before the pandemic, and the increase in financial costs will continue to upwardly pressure debt interest payments in the coming years, according to IMF projections.

Figure 1. Expected path of Fed Funds Rate



Source: CME and Fed. Calculations: Corficolombiana

Figure 2. Economic activity recovery in LatAm



Source: *Refinitiv Eikon*, *Latin Focus Consesus Forecast*. Calculations: Corficolombiana
*3T19 = 100 **Corficolombiana forecast.

In Latin American economies, Colombia, Brazil, Chile, Mexico, and Peru, the regional synchronization in the economic cycle observed between 2020 and 2022 waned despite all countries exhibiting a more moderate growth pace in 2023 compared to the preceding year. Brazil and Mexico exceeded expectations and are expected to sustain higher-than-potential growth primarily driven by increased investment. In contrast, Chile, Colombia, and Peru experienced negative growth figures during the year, reflecting a significant decline in domestic demand, particularly in investment and consumption (Figure 2).

Outlook 2024: Economic beyond monetary adjustment

In the U.S., we expect both total and core inflation to continue descending in 2024, closing at 2.5% and 2.9%, respectively (Figure 3). The improvement in household purchasing power, derived from falling inflation compared to wage growth, would mitigate the return of inflation to target levels.

The labor market would gradually adjust, supported by high job vacancies, productivity gains, and increased purchasing power. We anticipate a soft landing for the economy, leading the Fed to maintain rates between 5.25%-5.50% in the first half of 2024, with a monetary easing cycle starting in June and accumulating 100 bps cuts in the year.

Risks in the U.S. include consumption affected by higher debt service payments, investment impacted by high-interest rates, and fiscal challenges due to Congress's inability to reach a consensus. Regarding next year's presidential elections, we expect a close contest between Joe Biden and Donald Trump –if the latter ultimately consolidates as the Republican

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

candidate-. A year before the elections, the latest polls suggest that Trump would win in five of the six most decisive states.

In the eurozone, the ECB will likely cut rates before the Fed based on relative economic deterioration, dismantling of energy subsidies, and fiscal challenges. Although the labor market remains robust, fiscal policy and the risk of financial sustainability will continue to be significant challenges in the medium term.

In the geopolitical sphere, conflicts between Israel and Hamas and Ukraine and Russia will threaten energy security in the eurozone, although demonstrated good governmental management until now will mitigate long-term impacts.

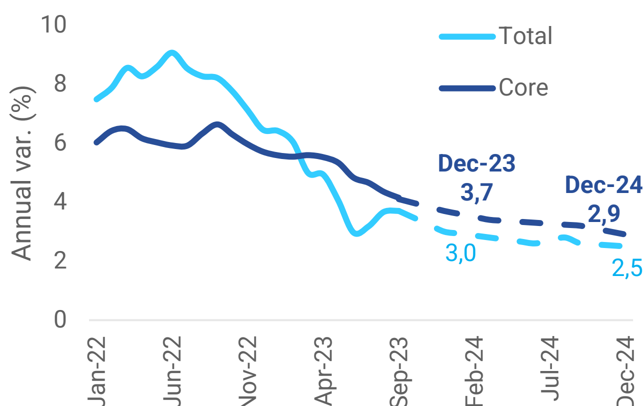
Fiscal policy will be crucial in the eurozone, with expenses related to energy subsidies and high debt, especially in France and Italy. Despite the monetary adjustment, a slight deterioration in the unemployment rate and a slowdown in nominal wages are expected. The ECB would have room to maintain stable rates until early 2Q24.

Overall, we anticipate that the ECB will have sufficient room to keep interest rates stable at their current levels until the beginning of 2Q24. Additionally, we expect the relative strength of the dollar to persist in a context where the U.S. economy would continue to show greater strength compared to other developed economies. Thus, we estimate that the EURUSD exchange rate will have limited space for further appreciation during the first semester, operating for most of the year between 1.02 and 1.09 dollars per euro.

In Latin American economies,we will witness the final phase of the economic cycle adjustment, albeit facing headwinds that may bring this deceleration phase to a close. On a positive note, we anticipate a continued retreat of inflation, converging towards central banks' target ranges, except in Colombia. The increased purchasing power would boost consumption, complemented by ongoing interest rate cuts that favor domestic financial conditions. In addition, a scenario of reduced political uncertainty in the region will bolster business confidence and investment.

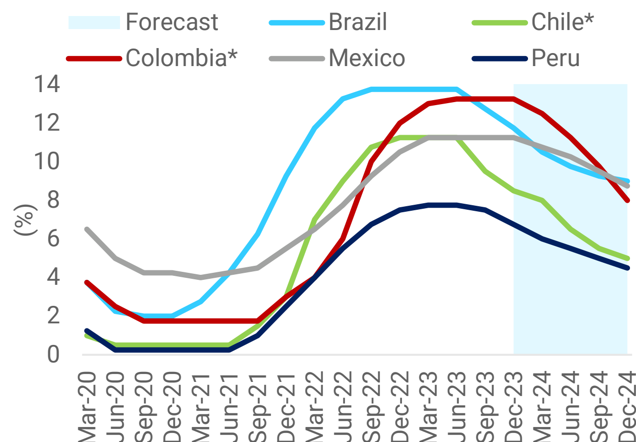
However, external momentum will be constrained, as the deterioration of the two main trading partners, the USA and China, may result in reduced external demand for commodities, given the cooling of the industry, lower investment flows, and a decrease in remittances. On the flip side, the magnitude of the El Niño phenomenon poses an additional risk to economic growth due to its impact on the primary sector's production, mainly in the Andean economies.

Figure 3. Inflation forecast - U.S.



Source: *Refinitiv Eikon*. Forecast: Corficolombiana

Figure 4. Monetary policy rate observed and projected



Source: *Refinitiv Eikon*, Latin Focus Consensus Forecast. *Forecast: Corficolombiana.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

Consequently, the economic slowdown will continue to be a major topic in central bank discussions. As long as inflation continues to decrease, allowing for the anchoring of inflation expectations to policy targets, central banks will persist in monetary normalization in 2024 to support economic recovery. The scenario of monetary easing is subject to risks that may lead to more conservative cuts than anticipated. On one hand, the impact of the El Niño phenomenon is expected to temporarily press food prices during the first semester. Plus, the escalation of geopolitical tensions in Eastern Europe and between Israel and Hamas could elevate oil prices and agricultural input costs. Furthermore, central banks will need to factor in exchange rate sensitivity into their monetary policy response function to prevent significant depreciation of local currencies due to reduced carry trade stimulus (Figure 4).

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

January 9th, 2024

Chapter II. Economic Activity in Colombia: An Endurance Test

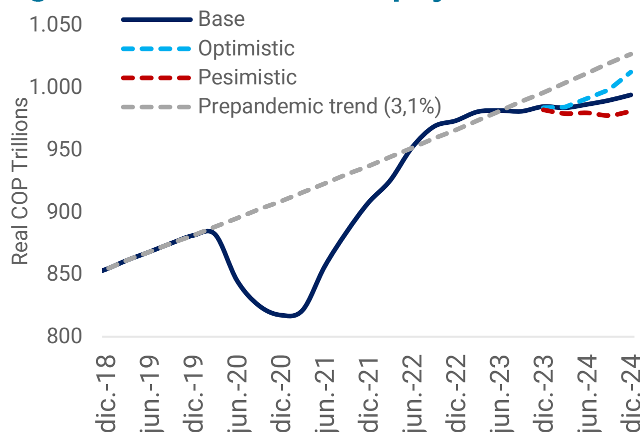
The Colombian economy decelerated its annual growth to 1.0% in the first three quarters of 2023, down from 7.3% in 2022. This deceleration resulted from an adjustment in the demand excesses, particularly in private consumption, coupled with a collapse in investment. Thus, the Gross Capital Formation distanced further from pre-pandemic levels, threatening the country's potential growth.

The adjustment in household consumption focused on durable and semi-durable goods, such as vehicles, appliances, and clothing, in a context where high interest rates and accumulated debt limited families' spending capacity. However, service consumption (restaurants, entertainment, transportation) remained strong. Figures as of November indicated that the economic slowdown was beginning to translate into the labor market, as the unemployment rate began to increase from historic lows. On the other side, fixed investment decreased in machinery and equipment—previously showing positive performance in 2022—and civil works. The latter extended its negative trend due to the absence of new infrastructure projects and low public investment. Additionally, investment in buildings began to reflect the poor performance of housing sales amid adverse conditions such as rising input costs, high interest rates, and bottlenecks in the government's subsidy program.

While the economic deceleration in 2023 was partly a result of the monetary tightening by Banco de la República (BanRep) from September 2021 to April 2023, the increase in the Monetary Policy Rate (MPR) is not the sole cause of the poor performance of gross fixed capital formation (-22.5% year-to-date). Elevated regulatory uncertainty and adverse conditions for private investment in the country also contribute. The absence of decisions on energy regulation matters, erratic infrastructure policies, and confusing adjustments to housing programs, combined with uncertainty about government proposals for labor, pension, and health reforms, make the investment landscape challenging for the private sector. Thus, the anticipated interest rate cuts in the policy rate in 2024 would have a positive but limited impact on economic reactivation, particularly in investment, if the uncertainty factors persist.

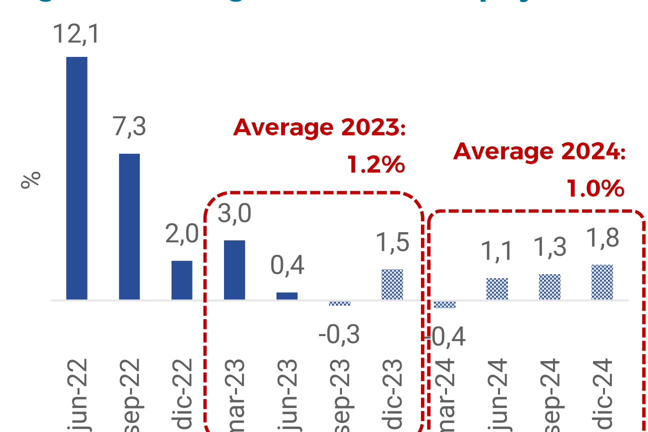
Although the fiscal position was more expansionary than anticipated, the spending mechanisms were atypical, and execution progressed slowly and in components different from the social transfers proposed during the presidential campaign. Public spending expanded by 1.1% year-to-date, driven by concentrated progress in the first semester.

Figure 5. Annualized GDP and projected scenarios



Source: DANE. Forecasts of Corficolombiana.

Figure 6. Annual growth of GDP and projections



Source: DANE. Forecasts of Corficolombiana.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

Import figures mirrored the domestic demand decline: imports accumulated a real decline in pesos close to 30% by August. Two-thirds of the contraction was explained by the manufacturing sector, especially inputs for chemicals and pharmaceuticals production and industrial capital goods. These components, along with the lower importation of transport equipment and intermediate goods for agriculture, explained 74% of the retreat, thereby explaining part of the collapse in investment and inventory deaccumulation.

Thus, the trade balance contributed positively to growth for the first time since 2017 (excluding the 2020 recession), in line with the weakness of domestic demand, evident in the 15% contraction in imports measured by national accounts. The import dynamic was complemented by a positive export performance in Colombian pesos, with a growth of 3.6% in the context of currency depreciation and favorable terms of trade, especially for traditional goods sells.

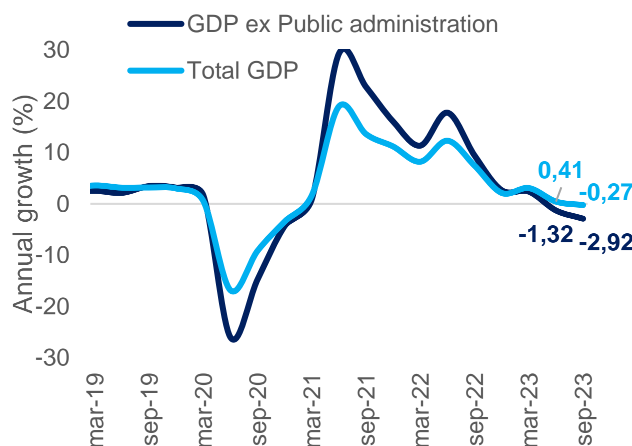
For the last quarter of the year, we anticipate an annual GDP growth of 1.5%, whose rebound from the -0.3% in 3Q23 would be primarily explained by a low statistical base (Figure 6). Although the consumption adjustment has been orderly and has prevented the accumulation of macro imbalances at the credit level, the decline in investment and the moderate progress in diversifying the export basket raise concerns for medium-term prospects. While public spending does not reveal an outstanding dynamic from the demand perspective, fiscal figures and the outlook from the supply side reveal that the deceleration has been mitigated by the expansion of the state's size (Figure 7).

Outlook 2024: An Endurance Test

We anticipate that the Colombian economy will register a lower growth in 2024 (1.0%) than in 2023 (1.2%), consistent with a mild moderation in consumption, a continued contraction in investment, and a less favorable contribution from external accounts (Figure 6). Annual growth would only surpass 1.5% until the last quarter of 2024. Although financial conditions will be less stringent in 2024, the deterioration of the labor market will constraint household consumption, while investment will remain below its pre-pandemic level in an environment of regulatory uncertainty and high cost of capital.

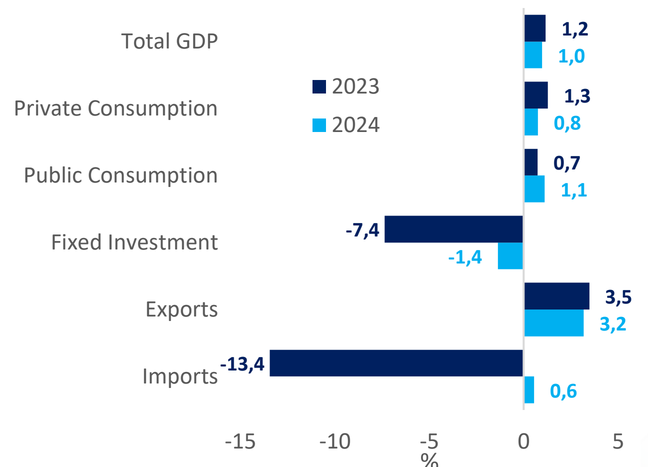
In past deceleration cycles, the labor market (source of two-thirds of household income) reflected productive deterioration between 1 and 7 months later, with an average lag of 3 months. We expect the significant GDP deceleration in 2023 to translate in a slower pace of job creation during the first half of 2024 and in an increase of the unemployment rate to 11.0%

Figure 7. Annualized GDP and projected scenarios



Source: DANE. Calculations of Corficolombiana.

Figure 8. Forecasts of GDP growth - Demand side



Source: DANE. Forecasts of Corficolombiana.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

from 10.2% in 2023. Remittances will partially mitigate household income. There will also be a mild contraction in monetary transfers and, as the interest rate cuts progress and the household deleveraging process advances, a gradual recovery in credit issuance. Additionally, the loss of household purchasing power will moderate in a deflationary context. One factor that could partially mitigate the deceleration, especially for vulnerable households, is a potential improvement in the execution of social transfers. Thus, we estimate that consumption will grow by 0.8% in 2024, lower than the projected 1.3% for 2023.

The investment outlook remains uncertain despite expecting monetary policy to be less restrictive. Specifically, we forecast a contraction of 1.4% in fixed investment in 2024, after falling by 7.4% in 2023, as the determinants of the deterioration in risk appetite continue to be unfavorable (Figure 8). From a sectoral perspective, investment associated with other structures and buildings—related to civil works—will partially reactivate after contracting to levels not seen since 2008 (excluding the pandemic). The start of construction on roads, 5G projects, the execution of the Bogotá metro, and tertiary roadways, within a framework of reduced construction costs will promote a better performance of this sector. Meanwhile, the residential building component will continue affected by the collapse in new home sales. Furthermore, stagnation in mining and quarrying investment is likely to continue, given the significant regulatory uncertainty.

In comparative terms, Colombia will have the highest consumption levels (relatively acyclical) relative to the LatAm economies, but investment will remain lagging. In this sense, the share of investment in GDP will continue its declining trend that started in 2022, compromising the capacity for short- and medium-term expansion.

Public spending would experience a counter-cyclical acceleration, with government consumption growth increasing from 0.7% in 2023 to 1.1% in 2024. Finally, concerning external accounts, we foresee a stagnation in imports, with growth of only 0.6%, in line with a tepid recovery following the significant 13.4% contraction in 2023. Regarding exports, we project similar growth to this year, at 3.2% in 2024, slightly lower than the estimated 3.5% for 2023 (Figure 8). Export perspective results from a relatively constant mining extraction, favorable terms of trade, and a gradual improvement in the non-traditional segment in line with increased exports to Venezuela.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

January 9th, 2024

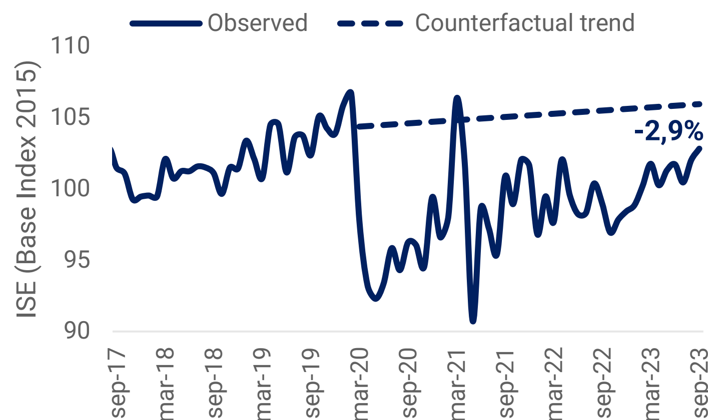
Chapter III. Sectoral Analysis 2023-2024

During 2023, sectoral performance heterogeneity led to two main conclusions. Firstly, an economic slowdown has emerged due to a loss of dynamism in the industry, construction (secondary), and services (tertiary) sectors. In contrast, the mining and agricultural (primary) sectors have shown a higher growth rate during 2023, although they still lag behind prepandemic trend levels.

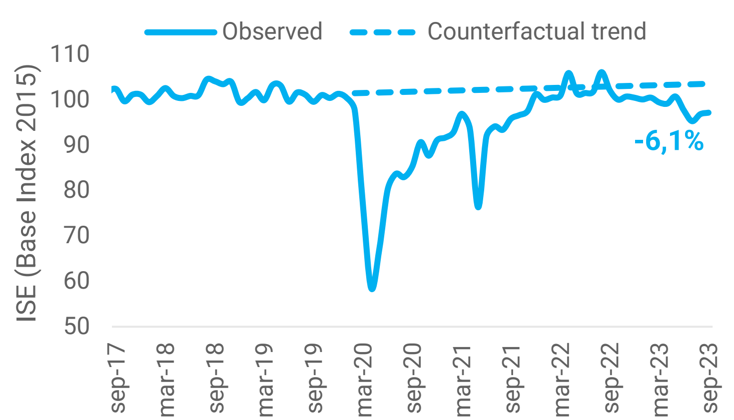
The secondary sector (construction and industry) reached the GDP pre-pandemic trend in 2022, but its activity has been weakening throughout this year, falling by 3.8% (2022: +9.4%). Meanwhile, the tertiary sector (services) has exhibited a slower growth rate, gradually converging to the pre-pandemic trend by registering an expansion of 1.8% in 2023 (2022: 8.2%). In contrast, the primary sector (mining and agriculture) has accelerated (2.4% vs. 2022: -0.2%), but its recovery from the pre-pandemic trajectory is insufficient.

Figure 9. Economic Tracking Indicator (ISE) Gap Versus Pre-pandemic Trend by Sector

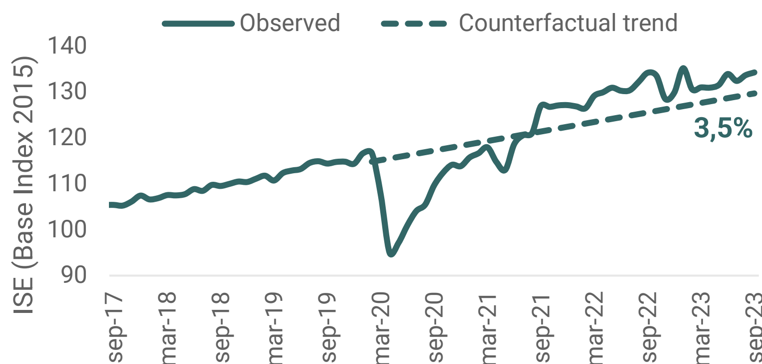
A. Primary sector



B. Secondary Sector



C. Tertiary sector



*For pre-pandemic trend growth we used the average progress from 2015 to 2019.
Calculations: Corficolombiana.
Source: DANE.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

January 9th, 2024

The construction, industry, and services sectors have undergone a noticeable deceleration resulting from higher interest rates, persistent inflation, and a deterioration in household confidence in consumption.

In the secondary sector, activity levels have deviated from the trajectory exhibited before 2020. As of September 2023, they were 6.1% below the trend levels expected in the absence of the COVID-19 crisis. We anticipate that construction and industry will continue to be in contractive territory due to setbacks in the real estate sector, especially in the residential segment, weak growth in civil works, and weakened manufacturing production.

We expect the real estate sector activity to further deteriorate in 2024, with GDP reduction of 4.7% due to the lingering effects of high input costs, elevated interest rates, and a decrease in housing policy stimulus. Although costs will continue to converge to lower levels, we predict they will close 2023 at 6.0% YoY and register an average 5.5% YoY increase in 2024. Interest rates will continue to pressure financial costs for builders, as slow inflation convergence will maintain the Central Bank of Colombia's contractionary stance.

Moreover, we are expecting a trend change in civil works in 2024 when the sector will grow by 1.5% (2023: -14.0% in GDP), driven by the start of seven 5G projects, a highly planned execution of tertiary roads by the National Government, and the budgeted CAPEX for the First Line of the Bogotá Metro and the Medellín Metro. However, project execution delays, increased cost pressures due to additional external shocks, and higher-than-anticipated interest rates for a longer represent downside risks to our estimate.

We project a decline of -3.3% in the industrial GDP. We expect weakness in household spending to continue supporting contractions in the production of food and beverages. On the metallurgical production side, anticipated drops in buildings and civil works suggest steel and iron production decreases. Finally, stagnation in crude production will dampen the dynamism of the oil refining sector.

The services sectors have also exhausted their momentum and moderated their growth rate. After a strong impetus in 2021 and 2022, services growth rate exceeded expectations and, by September, was 3.5% above the trend level. Recent deceleration has responded to a convergence of the sectors' long-term growth. While household service consumption has been the most resilient during 2023, we anticipate a moderation for 2024 in response to deteriorated macroeconomic conditions.

For the retail and wholesale trade sector, we project a contraction of 2.4% (2023: -2.5%) due to a foreseeable deterioration in the labor market and a slowdown in private consumption. Higher unemployment rates will reinforce the adjustment in durable and semi-durable goods spending.

In the hotel and tourism sector, we foresee a slight annual contraction of 0.5% (2023: -2.5%), in line with the lagged effect of monetary policy on employment and the peso's appreciation against the dollar, directly affecting expected international travelers. However, more persistent inflationary pressures than expected and a slower reduction in interest rates pose downside risks to our forecast.

In the financial sector, we anticipate a GDP growth rate of 1.5%, consistent with a credit portfolio that will continue to be in negative territory. We expect the portfolio to transition from a YoY decline of 4.0% in December 2023 to a retreat of 0.4% in December 2024 in real terms. While we anticipate ongoing negative consumer spending (-3.4% real YoY), the mortgage portfolio will end next year with a 0.9% YoY increase.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

We expect a slight expansion in the energy sector in 2024 according to lower electricity demand in the regulated and non-regulated markets. Thus, EGA's GDP will register a growth of 1.3% in 2024, well below the long-term average growth of 2.6% (2006-2019). In terms of prices, we highlight that inflationary risks derived from the El Niño Phenomenon will persist in the first part of 2024, with upwards risks depending on the duration and intensity of the shock.

In contrast, the mining and agricultural (primary) sectors have shown a higher growth rate during 2023, shifting from a decline of -0.2% in 2022 to an advance of 2.0% in 2023. Compared to the prepandemic trend, these sectors are 2.9% below, mainly due to decreased coal and crude production from 2019. Although we expect the primary sectors to remain growing in 2024, their progress will still be insufficient to close the gap with potential growth.

Specifically, we estimate a slight deceleration towards growth of 1.0% in 2024 (2023: 1.2%) in agriculture. The stabilization of production input costs favors the sector's recovery, but a high intensity but short Niño phenomenon explains our projection. We anticipate coffee production will recover while agricultural and livestock production will stabilize. However, a more intense or prolonged El Niño than expected and an unexpected increase in production costs pose downside risks to our 2024 growth forecast.

Additionally, for 2024, we anticipate a stagnation in the mining activity consistent with a slight growth of 0.3%. Firstly, international oil and coal prices will fall slightly as global demand deteriorates due to high-interest rates. The CAPEX of oil companies will be insufficient to offset the natural decline of older fields that contribute the most to the national total supply.
In this scenario, we anticipate that crude production will average 772 thousand barrels per day in 2024, and coal production will reach 13.1 million quarterly tons. While oil companies will sustain production near current levels in the short term, supported by their commitments and investment and production plans, the institutional and national energy policy landscape continues to be a setback for long-term perspectives.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

January 9th, 2024

Chapter IV. Inflation and Monetary Policy: A long road to the goal

In 2023, annual inflation decreased from 13.1% to 10.1%. More than 100% of this decrease originated from the food component due to the correction of the supply shock in 2022. Meanwhile, the inflation of goods was the second most deflationary force in the year, contributing 97 basis points to deflation in the year, in line with household spending weakness. In contrast, the contributions of services and regulated components to total inflation increased compared to the end of 2022. In the case of services, indexing to a high level of inflation and the minimum wage was significant. In the case of regulated components, the government introduced measures to reduce the fiscal cost of subsidies in the Fuel Price Stabilization Fund. These measures increased fuel prices.

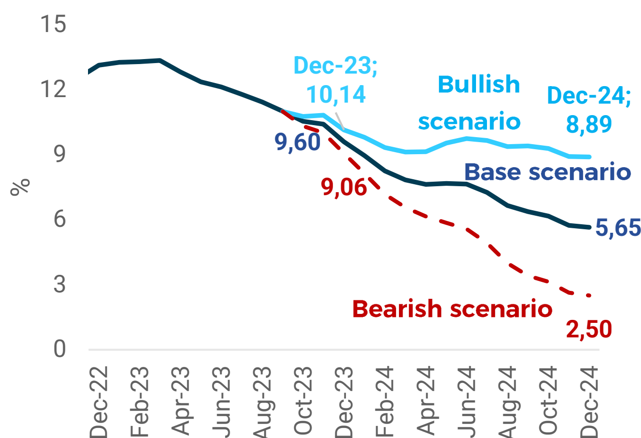
For 2024, we expect disinflation to consolidate in the services and regulated components. In addition, less pressure from goods and food would help to achieve an inflation downward trend. In our baseline scenario, inflation would close at 5.7% in 2024 (Figures 10 and 11). Services and regulated components would be the most common sources of upward pressure.

In 2024, energy prices will be decisive for goods and regulated services inflation, considering the adjustment determined by the government for fuel and the impact of the El Niño phenomenon on electricity and gas tariffs. We anticipate that gasoline prices will incorporate additional increases to $15,000 and $15,500 per gallon in the first half of the year.

The CPI for goods will continue to reflect a weaker demand. The deflationary trend will be reinforced by the lagged effect of the exchange rate depreciation in the second half of 2023. Finally, food will continue the disinflationary process, temporarily interrupted in 2Q24 by a negative statistical base. Despite being pressured in 1Q24 by the El Niño effect on perishable food supply, we expect a quick correction (Figure 11).

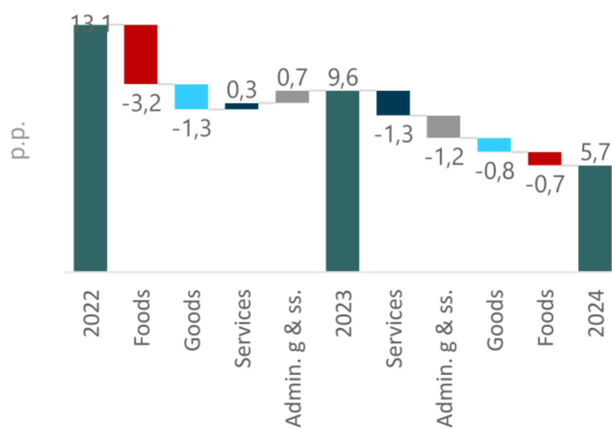
The strong inflationary inertia adversely affected inflation expectations at 1 and 2 years. The unanchoring of expectations led BanRep to continue its cycle of increases until April, raising the rate by 125 basis points in the first four months of the year, and bringing the intervention rate to 13.25%, the highest nominal level since the inflation target regime operates in Colombia.

Figure 10. Inflation and projected scenarios



Source: DANE. Calculations Corficolombiana

Figure 11. Changes in the contribution to inflation by component



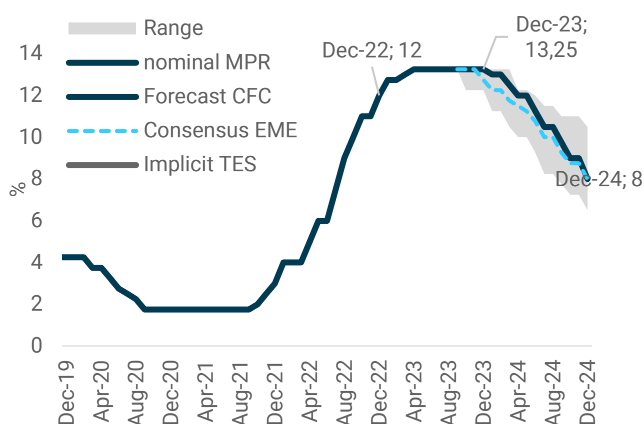
Source: DANE. Calculations Corficolombiana

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

We anticipate that the BanRep Board will extend the normalization process throughout 2024 and the beginning of 2025. The real interest rate has become increasingly contractionary, and excess demand on installed capacity measured by the output gap has decreased (Figure 13). Thus, in the December 2023 meeting, the BanRep Board began the Monetary Policy Rate adjustment with a 25 bps cut to 13,0%. We expect the magnitude of rate cuts to maintain at 25 bps in January and then to accelerate progressively during the year. The monetary policy rate would decrease by 500 bps during 2024, to 8.0% (Figure 12).

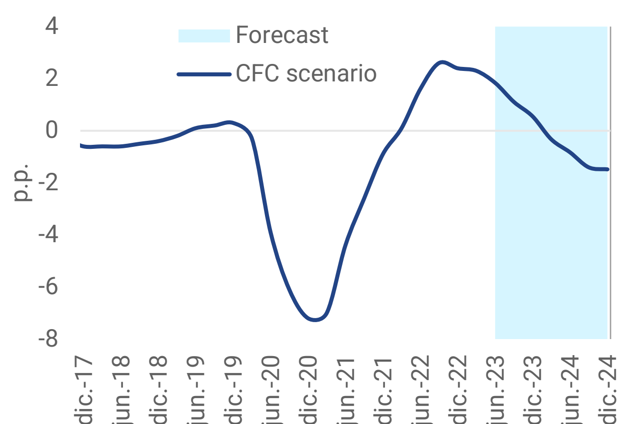
The monetary cycle occurs in a context where i) inflation will be in single digits and maintain a downward trend; ii) inflation expectations at one and two years will anchor to BanRep's target range; iii) the output gap will turn negative from the first half of the year; and iv) in the U.S., the Fed will begin cutting its interest rate from June (Figure 13).

Figure 12. Monetary policy rate



Source: DANE. Calculations Corficolombiana

Figure 13. Output gap



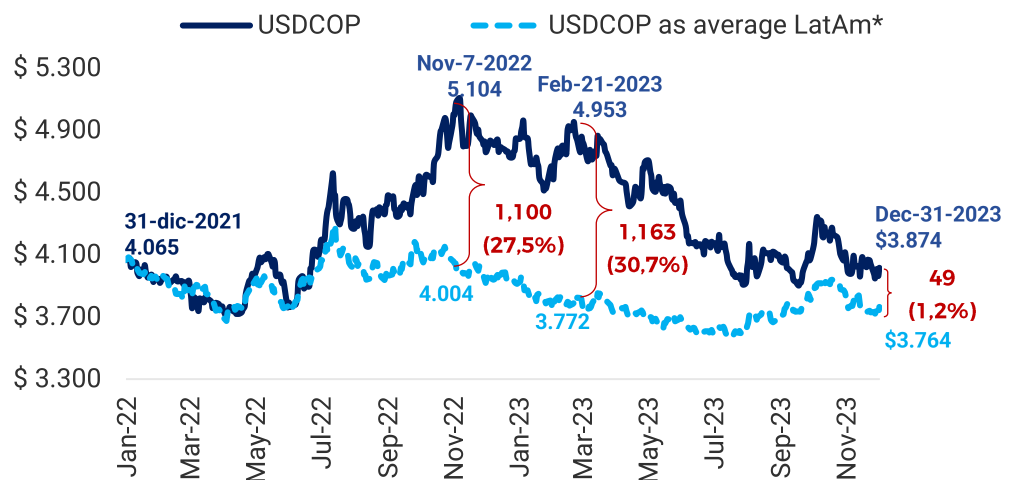
Source: DANE. Calculations Corficolombiana

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

Chapter V. Exchange Market and External Accounts

In 2023, the Colombian peso experienced a significant appreciation against the dollar, outperforming other Latin American currencies. The peso strength reduced the exchange rate differential that had emerged in the second half of 2022 following a change in government in Colombia (Figure 14). Additionally, the country successfully adjusted its current account deficit, projecting a decrease to 3.5% of GDP from the previous year's 6.2%. These adjustments mitigated macroeconomic vulnerability, although maintaining this pace in 2024 may be challenging. Colombia is poised to continue having one of the highest current account imbalances in the region, making it vulnerable to external shocks, especially given the monetary tightening in the U.S. The volatility in the Colombian exchange rate could increase due to fiscal deterioration in 2024.

Figure 14. USDCOP observed exchange vs. counterfactual (average LatAm*)



*Source: Refinitiv Eikon. Calculations: Corficolombiana. *Includes USDBRL, USDCLP; USDMXN and USDPEN*

2023 Balance: Colombia Back in the LatAm League

Despite low inflation in the Western world, the dollar maintained its global strength in 2023. Factors such as the hawkish language of the Federal Reserve (Fed) and the economic resilience of the U.S. contributed to this. Although Latin American currencies initially benefited from interest rate hikes, some, like the Brazilian real and the Chilean peso, saw their gains mitigated with the onset of interest rate cuts. In Colombia, institutional safeguards moderated concerns about proposed economic reforms and contributed to closing the gap that opened in 2022. Various factors, such as demand for future dollars, banking regulation, foreign exchange inflows, and budget execution, affected liquidity conditions and contributed to the dollar fall against the Colombian peso in the first half of 2023.

Causes of peso appreciation in the first half of 2023:

Expectations about the exchange rate: At the beginning of the year, exchange rate expectations deteriorated due to the strong depreciation of the peso in the second half of 2022. With the change in government and the global strength of the dollar, the USDCOP exceeded $5,000 in early November 2022, leading to an increase in long positions to hedge

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

real-sector operations in 2023 and increase the foreign currency position of foreign exchange market intermediaries.

Banking regulation: New regulations on liquidity indices created a relative scarcity of the local currency, encouraging banking entities to capture resources for the longer term

Foreign exchange inflows: A significant influx of foreign exchange for tax payments and dividend distribution, especially from the oil sector, contributed to the depreciation of the exchange rate in the first half of 2023.

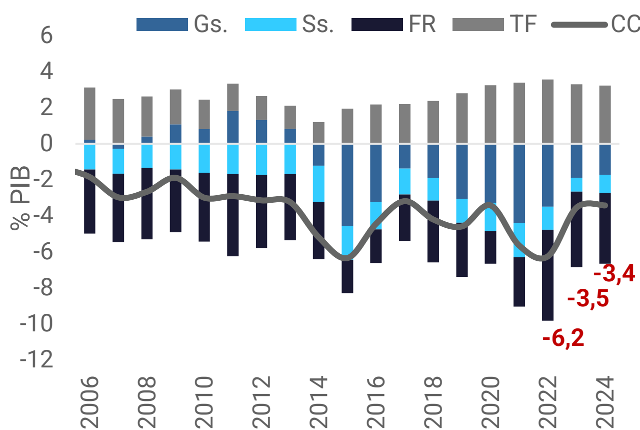
Remunerated deposits of the National Treasury: They increased considerably, responding to lower budget execution and the expiration of the contract for the administration of resources from the Territorial Pension Fund (Fonpet).

Correction of the current account deficit: The lower outflow of dollars due to imports adjustment contributed to consolidating the peso appreciation.

Outlook 2024: Challenges in the Exchange Rate

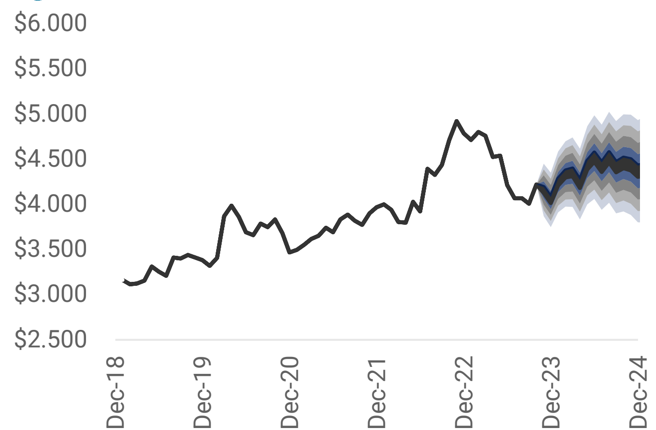
A slight dollar depreciation is anticipated in 2024, supported by the US's strong economic performance and the consequent capital attraction. In Latin America, an interest rate cut will mitigate the FX gains of 2023. Colombia will face challenges in maintaining stability in its external accounts and exchange rate in 2024, adapting to global and local dynamics while managing potential risks. The Banco de la República would perform a cycle of interest rate cuts during the year, while the current account deficit will reduce to 3.4% of GDP (Figure 15), moderating the appreciative pressures on the Colombian peso. In this context, we estimate that the exchange rate will close in 2023 at levels close to $4,050, and then take an upward path to $4,400 by the end of 2024 (Figure 16).

Figure 15. Current Account Balance



Source: BanRep. Calculations and forecast: Corficolombiana.
Gs.: Goods; Ss.: Services; FR: Factors revenue; TF: Transfers; CC: Current account.

Figure 16. USDCOP forecast



Source: BanRep. Forecast: Corficolombiana.

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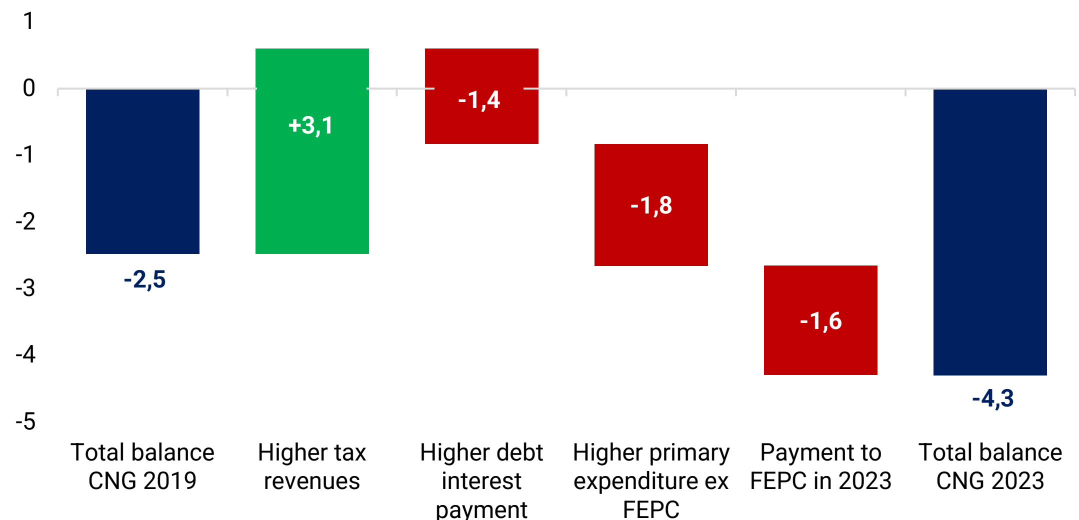
Chapter VI. Fiscal Accounts: A Growing Source of Risks

Colombia continued its fiscal adjustment process in 2023. The pandemic-induced shock increased the Central National Government (CNG) deficit from 2.5% of GDP in 2019 to 7.8% in 2020, and its gross debt to GDP ratio rose to a historic peak of 65% from 50% in 2019. Subsequently, Colombia underwent two tax reforms. The first one took place under Iván Duque administration (Social Investment Law, 2021), and the other one under Gustavo Petro (Equality and Social Justice Law, 2022). The reforms contributed to a more than three-points of GDP increase in CNG revenues (Figure 17).

Nevertheless, the tax burden on the private sector fell short of reducing the fiscal imbalance to its pre-pandemic level, because the government expenditure expanded by almost five percentage points of GDP over the last four years to a record high of 23.6% in 2023. Less than 30% of the rise in CNG expenditures stemmed from increased debt interest payments (1.4% of GDP). Around 71% resulted from augmented primary spending (3.5% of GDP), including payments to the Fuel Price Stabilization Fund (FEPC, by its acronym in Spanish). The government's last updated projections (Medium-Term Fiscal Framework – MTFF of June 2023) indicate the fiscal deficit to decrease to 4.3% of GDP in 2023 from 5.3% in 2022, remaining significantly above the 2019 level (Figure 17).

Figure 17. Change in Central National Government (CNG) Fiscal Balance 2019-2023 (% of GDP)



Source: Ministry of Finance. Calculations: Corficolombiana

The 2023 fiscal figures were better than expected as tax collection maintained a robust performance despite the economic slowdown, and government spending did not align with initial projections. However, the state of public finances in 2024 demands particular attention:

i) The government anticipates additional revenue of $28 trillion (1.7% of GDP) from legal settlements and the DIAN's fight against evasion. We consider this goal to be very optimistic.

ii) Economic deceleration has led to a diminished trajectory of tax revenues since the second half of 2023.

iii) The Constitutional Court declared unconstitutional the ban established in the 2022 tax reform, preventing extractive sector companies from deducting royalty payments from the

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

income tax base. The Court decision implies a loss of $6.6 trillion for the government in 2024 (0.4% of GDP), with $3.2 trillion corresponding to refunds for overpayment in 2023.

iv) The complex financial state of the healthcare system and certain energy distribution companies may pose contingencies next year, resulting in additional fiscal costs.

The government's strategy to cut the 2024 General National Budget (GNB) –approved at $502.6 trillion (18.9% higher than 2023)– is yet to be defined. The 2024 Budget is underfunded, and the government will have to shorten its planed social investment or to cut the workforce in some state entities. Another option for the government is to present a Financing Law in early 2024, citing the deficit caused by the Constitutional Court's ruling. However, success in this strategy is unlikely due to the executive's limited political capital. We anticipate that local financial assets will be particularly sensitive to events that pose doubt on Colombia's fiscal discipline. The country's risk premium will remain high, surpassing that of peer economies in Latin America.

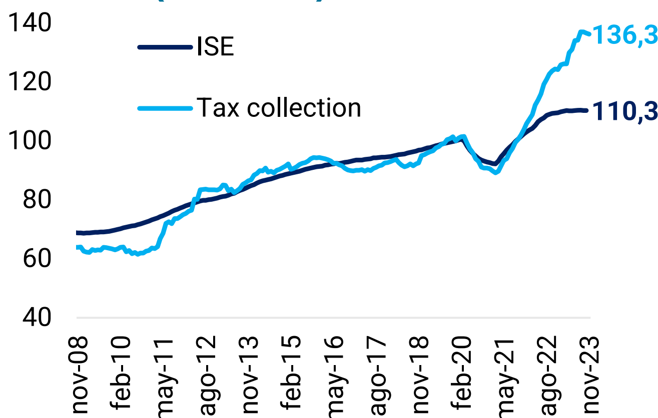
Good Fiscal News in 2023

The fiscal accounts for 2023 will outperform the official projections in the MTFF. Although government revenues would fall below the target, expenditures would lag even more, resulting in a lower fiscal imbalance than initially projected.

The cumulative tax collection until November grew at an annual rate of 23.4%. This growth was propelled by a 44.0% increase in income tax, reflecting the effects of the tax reforms in 2021 and 2022. However, external taxes experienced an annual decline of 13.4% due to the weak dynamics of imports, while Value Added Tax (VAT) and the Financial Transactions Tax started to incorporate the weakening of domestic demand. Consequently, up to November, income tax and domestic VAT contributed 19.9 and 4.5 percentage points to the total increase in tax revenues, while external taxes subtracted 2.8 percentage points.

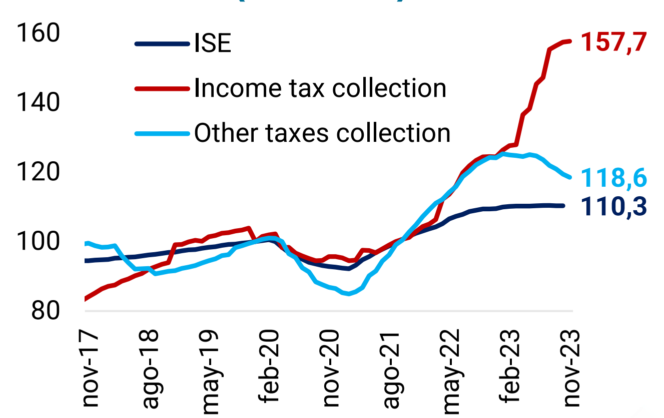
The noteworthy increase in tax revenues in 2023 contrasts with the weakness in the Colombian economy over the past year. The Economic Activity Index (ISE by its acronym in Spanish) stagnated since the second half of 2022, significantly deviating from the upward trend in tax collection and marking an unusually high gap, vastly superior to what has been observed in the last decade (Figure 18). This discrepancy reflects income tax driving total revenue upwards, thanks to the tax reforms of 2021 and 2022, while other taxes incorporate the lower dynamism of the economy during 2023 (Figure 19).

Figure 18. Economic activity (ISE) vs Real Tax Collection (2019 = 100)



Source: DANE and DIAN. Calculations Corficolombiana.

Figure 19. ISE vs Real Income Tax and other taxes collection (2019 = 100)

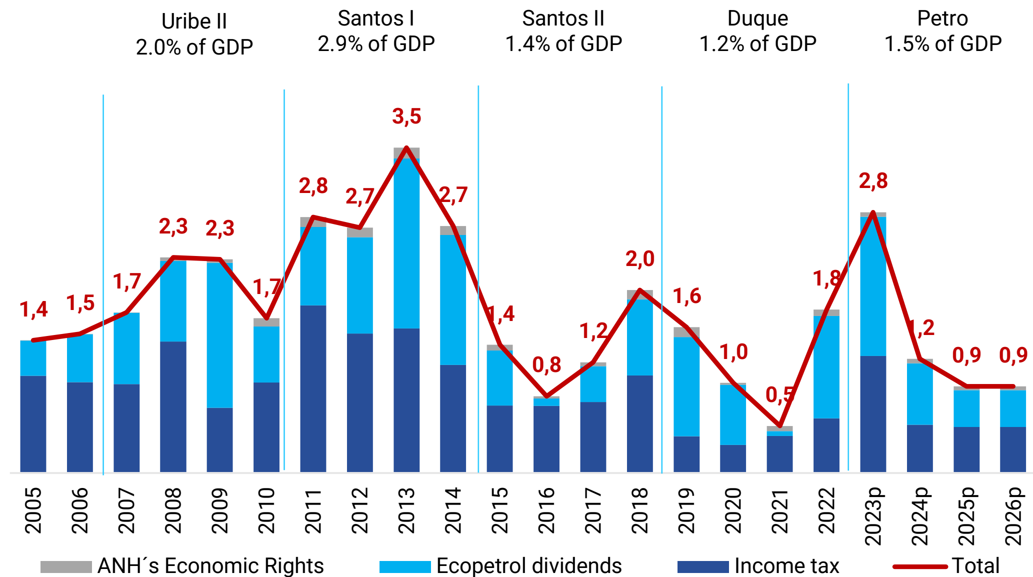


Source: DANE and DIAN. Calculations Corficolombiana

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

The 2023 favorable fiscal figures are also a result of extraordinary fiscal contribution from the oil sector. The excellent financial results of Ecopetrol and other oil companies in 2022 and the increase in the tax burden on extractive activities derived of the 2022 tax reform, boosted an extraordinary performance of revenues for the government. Through income taxes, dividends from Ecopetrol, and economic rights paid to the National Hydrocarbons Agency (ANH), hydrocarbons sector contributions amounted to 2.8% of GDP in 2023, approximately $45.6 trillion, their highest level in the last decade (Figure 20).

Figure 20. Contribution of Oil & Gas Sector to Government Revenues (% of GDP)



Source: Ministry of Finance, Ecopetrol. Calculations: Corficolombiana

The low budget execution also contributed to getting better-than-expected figures in public finance in 2023. Between January and September, the primary spending of the CNG reached 13.3% of GDP, while the average from 2020 to 2022 was 13.8% of GDP. Assuming that in the last quarter of 2023, primary spending progresses at a similar pace to the previous three years average, the CNG total spending would be $369.5 trillion or 22.8% of GDP, below the 23.6% of GDP projected in MTFF.

As a result, we estimate that the CNG deficit will be 4.1% of GDP in 2023, which is 0.2 percentage points lower than the MTFF projected. Our calculations contain the payment to the FEPC of approximately $26.3 trillion in 2023 (1.6% of GDP), which reduces the contingent liability associated with fuel price subsidies. One of the achievements of the Petro government so far has been the decision to reduce the FEPC deficit, through increases in gasoline prices. Supposing the gap between local gasoline and the international ones will close in early 2024 and that increases in diesel prices will be very gradual or may not materialize at all, we estimate the 2024 FEPC deficit to be between $8 and $16 trillion.

Outlook 2024: Growing Fiscal Challenges

Despite the positive fiscal news in 2023, there are significant risks for this year associated with low economic growth and its impact on government revenues, the challenge of meeting ambitious revenue targets, the substantial increase in projected spending in the 2024 Budget,

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

and the fiscal cost of crises in the healthcare and energy markets. The situation of Colombian public finances demands special attention in 2024.

Firstly, the additional revenues expected by the government from litigation and the Tax Administration (DIAN) fight against evasion amount to a combined $28 trillion (1.7% of GDP). This figure appears overly optimistic. If these do not materialize, it would jeopardize compliance with the fiscal rule. Moreover, the economic slowdown will traduce in a reduced dynamism of tax revenues since the second half of 2023, and it is likely that this situation will deepen next year. Additionally, the mid-November ruling by the Constitutional Court declaring unconstitutional the prohibition established in the 2022 tax reform, preventing extractive sector companies from deducting royalty payments from the income tax base, poses further challenges: the government will forego $6.6 trillion next year (0.4% of GDP). Moreover, the complex financial situation of the healthcare system and some energy distribution companies may lead to contingencies next year, incurring additional fiscal costs.

As a result of the prior considerations, the CNG total revenues would be 1.3 percentage points of GDP lower than MTFF anticipated. Our base scenario assumes half of the additional revenues expected from litigation and evasion efforts and the adjustment of 0.4% of GDP due to the Constitutional Court's ruling on royalty deductibility. Additionally, we foresee CNG expenses to be a 1.5% of GDP lower than MTFF outlined. This adjustment would not necessarily have to come through a budget cut but can materialize as a low execution throughout the year, as observed in 2023. In fact, entities with low execution in 2023 are likely to face a reduction in their allocated budget for 2024. Thus, the CNG deficit would be 4.4% of GDP in 2024, 0.1 percentage points lower than anticipated in the MTFF.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

January 9th, 2024

Chapter VII. Sovereign Fixed Income: A Steeper Slope

Overview 2023: Two sides of the same coin

A year ago, we warned that debt markets behavior in 2023 would depend mainly on the U.S. Federal Reserve's (Fed) interest rate adjustment (see "Debt market: Risks and opportunities for TES in 2023" in Annual Report – December 1, 2022). In 2023, we saw evidence of tension between the Fed's hawkish monetary stance and the behavior of the financial markets. The volatility in U.S. Treasuries was high throughout the year, especially during August, September, and October, driving declines in global fixed-income markets. At the end of November, developed markets (DM) government bond completed three consecutive years of declines, while a few emerging markets (EM) posted gains on their 10-year fixed-rate bond in local currency.

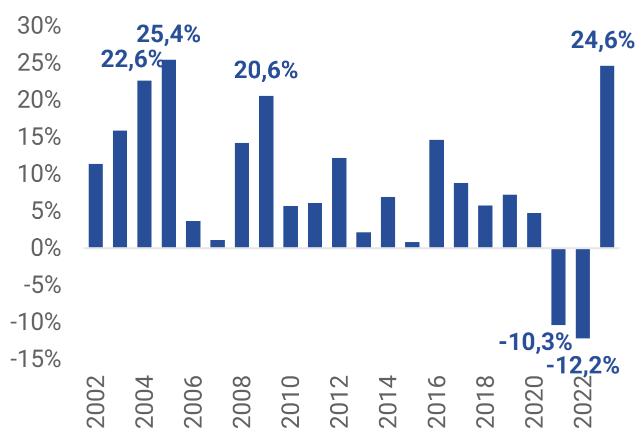
Colombia was one of the countries that maintained a positive result this year at the close of this report, despite the sharp losses recorded in September that were not enough to erase the gains achieved in the first half of the year. So far in 2023 until November, the 10-year TES had appreciated by 232 basis points (bp), the yield curve of fixed-rate TES had fallen by an average of 237 bp, and our Corficolombiana Public Debt Index® (IDP, by its acronym in Spanish) registered a positive variation of 24.6%, the second-best result in its history (Figure 21).

In this way, debt markets behavior in 2023 had two faces. The first brought positive returns, mainly in EM, after the steep losses in 2021 and 2022. Furthermore, Colombia suffered an additional punishment associated with idiosyncratic risks due to the government change, which was largely closed during 2023 (see "Balance of the first half of 2023 in the exchange rate, TES, and risk premium: returning to the LatAm league?" in Special Report – July 5, 2023). The second side was driven by the 10-year US Treasury, which reached a sixteen-year high in both its nominal and real rates (see "Is it time for fixed income?" in Weekly Report – October 23, 2023).

Colombia's risk premium discounts lower credit rating

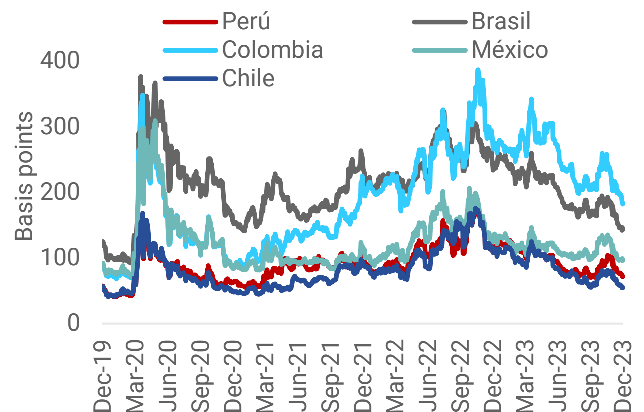
Colombia's country risk premium, measured through the 5-year Credit Default Swap (CDS), showed a correction during 2023 but remained the highest in the region, outperforming Brazil, despite Brazil's credit rating is two notches lower than Colombia (BB- vs Colombia's BB+). However, a lower level on Colombia's CDS in 2023 was due to (i) the wide interest rate

Figure 21. Corficolombiana Public Debt Index® (IDP), year to date



Source: Corficolombiana. *Data until end of November

Figure 22. 5-year Latam's Credit Default Swap (CDS)



Source: Refinitiv Eikon.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

differential concerning the U.S.; (ii) higher oil prices; (iii) current account deficit adjustment; and iv) the partial correction of Colombia's punishment relative to other countries in the region (Figure 22).

However, Colombia's risk premium remains higher than its peers in the region, reflecting the uncertainty in the macroeconomic outlook for the coming years: i) structural slowdown in growth to lower rates than before the pandemic; ii) doubts about fiscal discipline in 2024, due to a possibility to fail the rule target; and (iii) uncertainty about the fiscal impact and economic growth of the pension, health, and labor reforms. At the time of writing, it was unclear whether these reforms would advance in Congress and what changes they would make. The truth is that there exists a high probability that one of the rating agencies will cut Colombia's sovereign outlook rating from "stable" to "negative" in 2024.

Outlook 2024: all roads lead to steepness

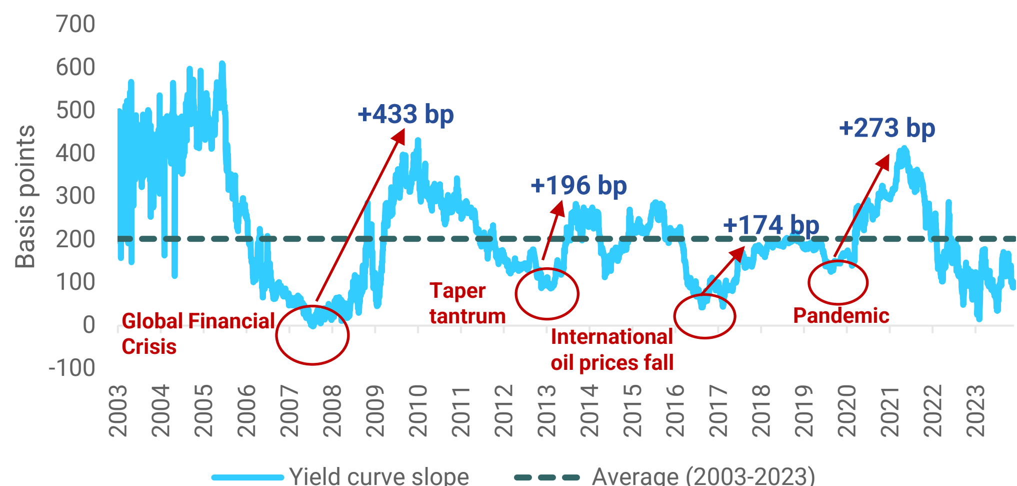
After three years of high volatility, we expect a steeper TES yield curve in 2024, with potential benefits in the front end associated with BanRep's interest rate cuts and upward pressures in the middle and long legs derived from fiscal uncertainty and its effect on the country's risk premium. Changes on the TES yield curve will occur in a context where the Fed would begin to lower its interest rate at the end of the first half of the year, which would boost the earnings on the global fixed-income markets.

Given the uncertainty about the adjustment process of the US economy, we consider two scenarios. First, the Fed continues its stance of higher for longer rates until macroeconomic indicators (inflation, economic growth, unemployment rate) allow it to initiate a gradual easing at the end of the first half of the year. The other one, contemplate a hard landing scenario in the U.S., in which the Fed would anticipate the interest rate cut cycle and do it more aggressively. In both cases, we expect the U.S. Treasury will benefit from its treatment as risk-free asset and would cause steeper sovereign yield curves.

Colombian's higher for longer scenario?

At the end of 2023, BanRep started the monetary easing cycle, which will be slow at first and will accelerate throughout 2024. The monetary cycle will be a restriction in the steepening of

Figure 23. TES yield curve slope (2-year less 10-year yield rate)



Source: Precia and Corficolombiana.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

the TES yield curve, which would be slow in the first months of 2024 and faster beyond the second quarter.

Our expectation of a steepening scenario on the TES curve in 2024 depends on how previous monetary easing processes in Colombia increase the slope. Moreover, on those previous episodes, BanRep cut its interest rate by different magnitudes, driving average declines of 208 bp on 2-year TES and 65 bp on 10-year TES. In these circumstances, the slope of the curve between 2 and 10 years increased by an average of 269 bp, from 67 to 336 bp (Figure 23).

Finally, our baseline scenario for the TES in 2024 anticipates a steepening of the curve in a context in which the Fed would begin to lower its interest rate in the first half of the year and BanRep would be cautious in its monetary easing process during the first quarter and would be more aggressive afterward. In addition, we expect the public finance situation will distress the local debt market. Our projection for the end of 2024 calls: the 2-year TES rate will be between 8.2% and 8.7%, and the 10-year TES rate will be between 10.1% and 10.6%, for a steepening of approximately 190 bps. However, a hard landing event in the U.S. would sharpen the steepening of the TES curve to levels between 280 and 350 bps.

VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

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VIGILADO SUPERINTENDENCIA FINANCIERA DE COLOMBIA

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