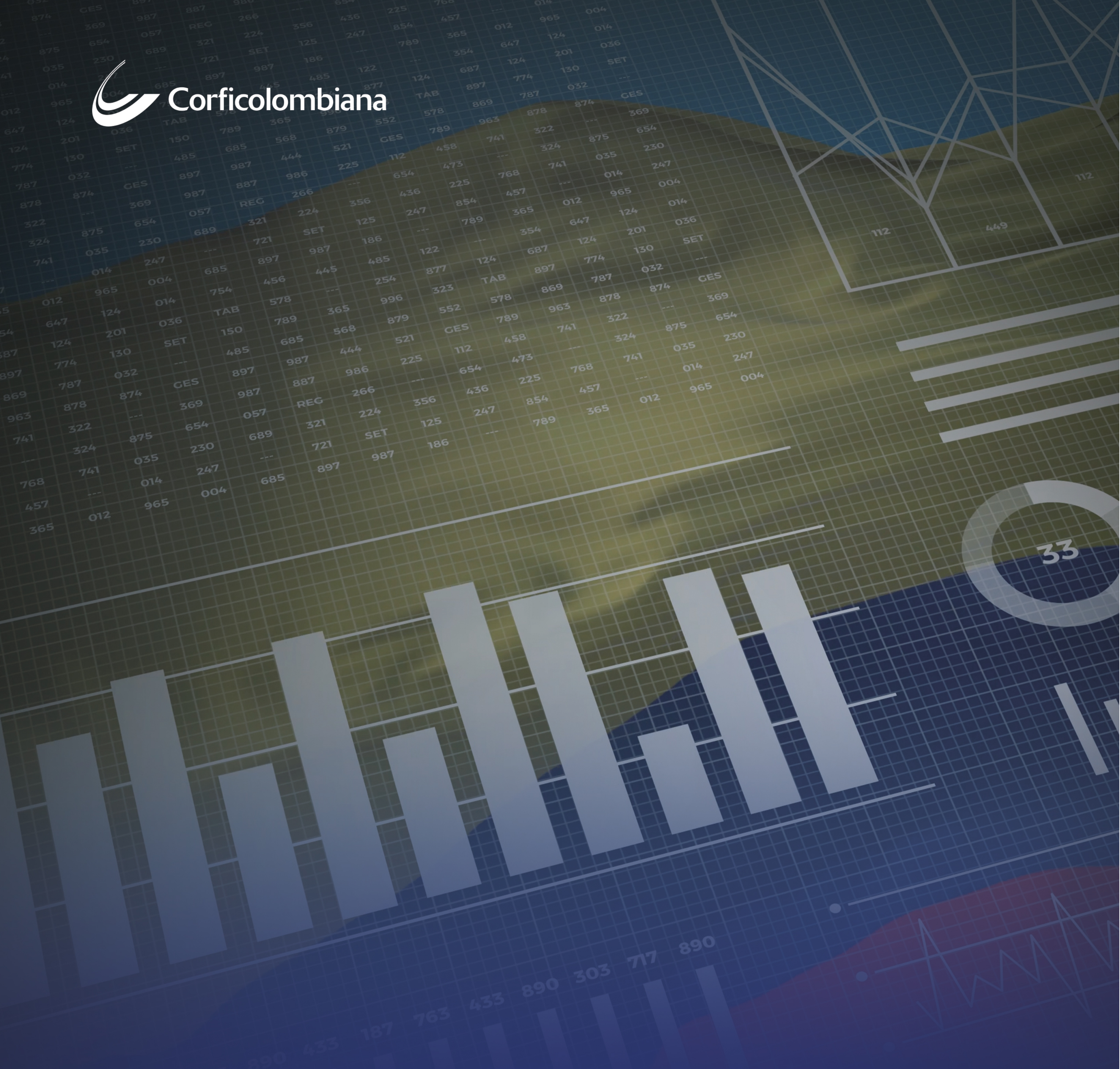

Corficolombiana

Investigaciones Económicas

Special Report

Colombia Country Report
Q1-2021: A dose of optimism

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Colombia 2021: a dose of optimism

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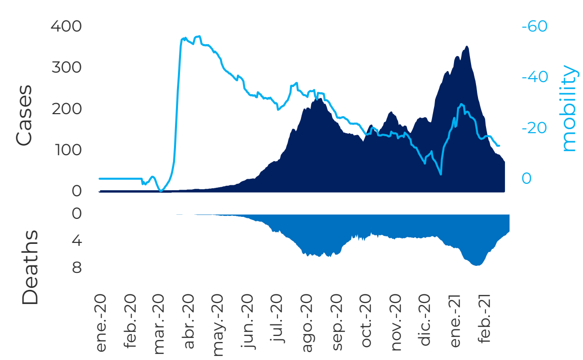
- Despite great uncertainty regarding renewed waves of contagion and the speed of the vaccine rollout, we maintain a constructive view on the country´s growth prospects and expect **the economy to expand 5.3% in 2021**.
- On the supply side, **mining and construction should lead the recovery** with growth rates close to 7% as a result of higher oil prices, record-high home sales that will stimulate housing construction and an ambitious pipeline in civil construction.
- The labor market is likely to remain weak with informal jobs gaining participation as commercial and industrial employment lags and labor-intense activities, such as tourism, are likely to remain sluggish for most of the year. We forecast **an average unemployment rate of 14.6% for 2021**.
- Inflation should reach a record low of 1.4% in March, to start a gradual upward trend in subsequent months towards **2.6% at the end of 2021**.
- Consistent with recovery in economic activity and the normalization in the inflation rate, **we expect the repo rate to remain flat at 1.75%** for the whole year.
- The fiscal outlook remains troublesome. The Government will soon present a tax bill to Congress aimed at increasing revenue by 1.5% of GDP over the medium term. Despite all the risks involved in the political process, **we believe that the Government has the coalition to deliver on the reform**.
- In our baseline scenario, we anticipate **both Fitch and S&P will refrain from downgrading Colombia's investment grade** in 2021.
- **The new legislative period from March to June will be busy** as Congress not only discusses changes to the tax code, but also an eventual modification of the pension and healthcare systems and teleworking regulations.

› *Economic activity*

The beginning of the year started with the wrong foot, when the recovery in economic activity was suddenly put on hold as the second wave of COVID-19 cases reached an even higher peak in December than the one in August. As a response to the surge in cases and deaths, government officials, particularly in the largest cities, imposed renewed restrictions on social mobility. **The new round of lockdowns depressed output and sales in January, luckily, the month of the year with the lowest seasonal economic activity**.

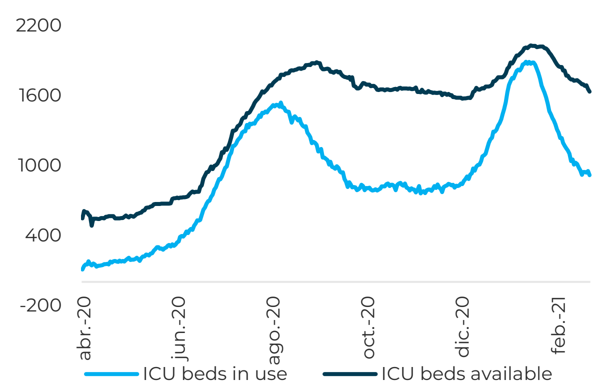
Figure 1. COVID-19 deaths and cases per million and changes in mobility with respect to January 2019



Source: Google, Eikon.

Although we are still waiting for official numbers to paint a picture of economic activity for 1Q2020, real-time and low frequency data show a quick recovery in February and early March. Based on these numbers, we expect real GDP to decline 1.9% yoy in 1Q2021. **The softening in early 2021 is expected to give way to a better momentum of economic activity in 2Q2021**. In fact, the business confidence index, which measures sentiment among business executives in the industrial and commercial sectors, managed to stay on the positive side despite the tumble in activity in January.

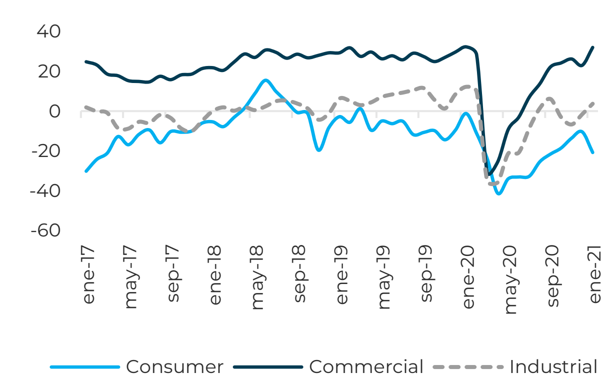
Figure 2. ICU beds available and in use in Bogota



Source: Observatio de Salud de Bogota.

For the rest of the year, we anticipate a gradual improvement in economic activity supported by stronger business sentiment, a bounce back of consumers spending and a more favorable external backdrop.

Figure 3. Consumer, commercial and industrial confidence indices

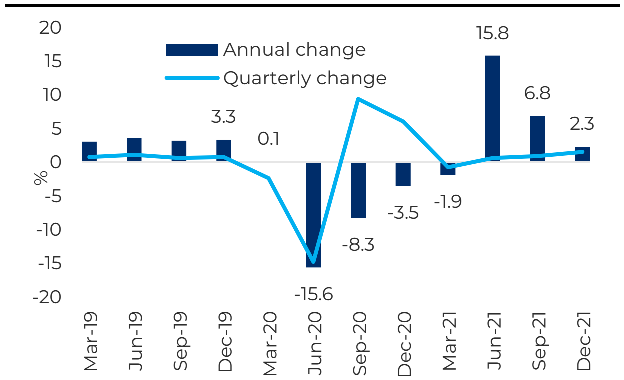


Source: Fedesarrollo

Positive sentiment on the business side coupled with the beginning of the vaccination campaign on February 17th and the large decline in the number of infections during the last few weeks could help to restart business activity. **For 2Q2021 we expect real GDP to jump to 16.2% yoy as a result of a gradual improvement in domestic demand and the low base from last year. Our forecast for the growth rate of 3Q2021 and 4Q2021 on annual basis are 7.8% and 2.4%, respectively.**

Based on this trajectory we expect the GDP growth figure for 2021 to come at 5.3%, which is 50 basis points higher than the 4.8% implied by the carry-over of 4Q2021 into this year. At the moment, our forecast for 2021 is above market-consensus and the Central Bank's 4.5% GDP growth rate projection.

Figure 4. Annual and quarterly growth rate observed and forecast for 2021



Source: Cofricolombiana

Although uncertainty remains elevated, and an eventual third-wave of contagion led by a new variant of COVID-19 could derail our forecasts, **we believe that the balance of risks is now on the upside** given the confluence of three factors: i) a more favorable external backdrop, including oil prices above pre-pandemic levels, ii) positive momentum for economic activity in the construction, agriculture and mining sectors and iii) a bounce back of private consumption.

In addition, although the vaccination campaign is lagging in relation some regional peers like Chile, and it is likely to miss the 70% population target before year's end, the speed of the vaccine rollout should be enough to maintain the ICU load well below the critical levels, avoiding new rounds of lockdowns.

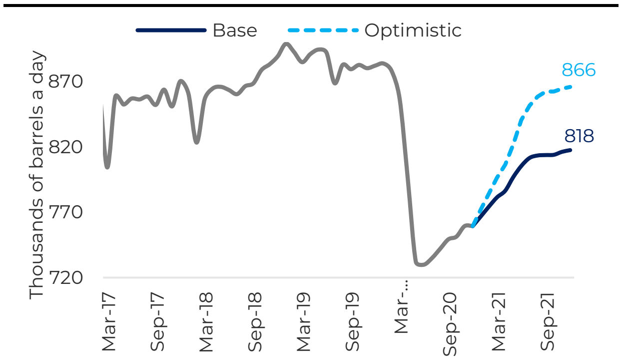
Despite our constructive view for this year, the 5.3% growth rate will be insufficient to match pre-coronavirus economic activity levels in 2021, which we anticipate will be only reached by mid-2022.

› Growth by industry

As in most countries, business activities that heavily rely on physical interaction, such as entertainment or the hospitality industry, have been affected the most by the social-distancing measures.

Going forward we expect a gradual normalization in these sectors and anticipate a stronger recovery in construction and mining.

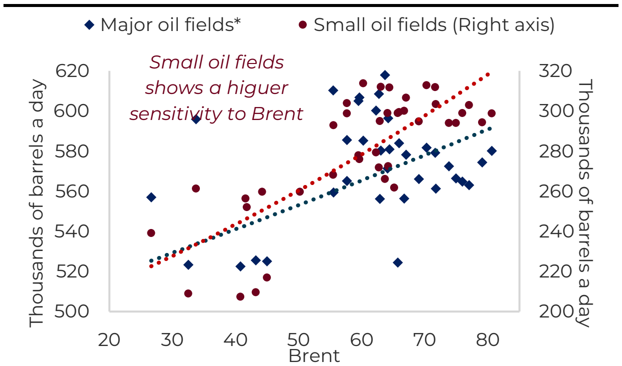
Figure 5. Oil production (observed and forecast)



Source: Corficolombiana

New housing construction is likely to rebound as a result of a new building cycle driven by record-high home sales during 2H2020. Home sales have been

Figure 6. Oil production by field and Brent

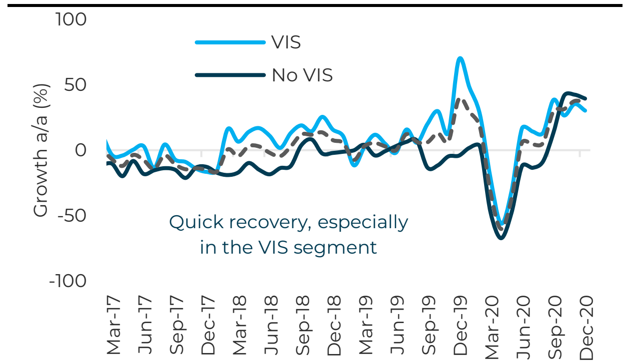


**Major oil fields account 70% of the total national supply. Source: ANH, Corficolombiana*

supported by the 200.000 subsidies granted last year by the Government through different programs such as "Mi Casa Ya" that helped sales, in particular in the social-interest-housing (VIS) segment.

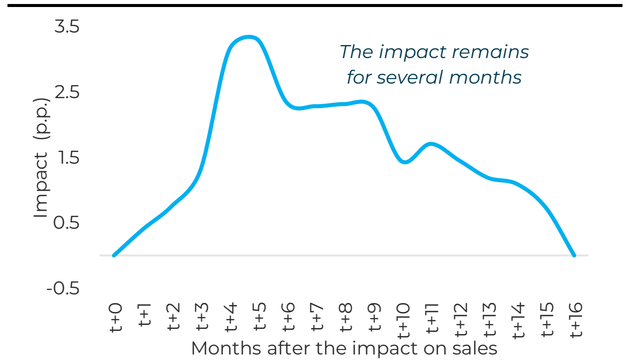
Our estimates show that a positive shock to home sales have a lag effect on the construction of new units up to 16 months, with a 5-month peak. **Based on these calculations we anticipate an expansion in housing construction of 6.5% yoy in 2021, after a decline of 27% in 2020.**

Figure 7. New home sales by segment



**Major oil fields produce 70% of the total national supply. Source: ANH, Corficolombiana*

Figure 8. Impulse-response of home sales on new housing construction



Source: Corficolombiana

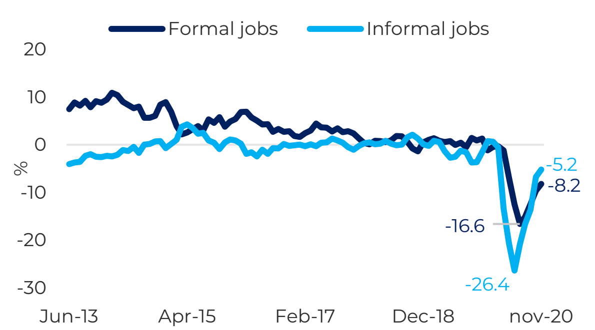
In addition to the rebound in housing, we expect a recovery of the growth rate of investment in civil construction to 7% in 2021 from the decline of 13% in 2020, thanks to the confluence of several programs that include the continuity of the 4G roads, the start of the first wave of 5G projects and the beginning of the preliminary construction work needed for the Bogota Metro.

In turn, the mining sector will be supported by the recovery in oil production to 818k barrels per day in 2021. In particular, our analysis suggests that the recovery of small oilfields, which account for 70% of the total national supply and which contributed to more than 50% of the fall in 2020, would be accelerated by their greater sensitivity to changes in oil prices. Accordingly, a rally in the Brent benchmark to an average of $ 61 per barrel for 2021 is consistent with an increase in crude production of 2.4% for the year.

› *Labor markets*

Despite the expected rebound in domestic demand the labor market is likely to remain weak. The latest job market numbers for January show that the number of people employed fell by 1.6 million in annual terms, which represents a variation of -7.3% yoy. As expected, 80% of the increase in the unemployed people nationwide in January was concentrated in urban areas.

Figure 9. Annual change in employment (yoy % change)



Source: DANE and Corficolombiana

The unemployment rate in the 13 main cities showed a greater deterioration than the nation-wide rate, reaching 19.5% in January 2021 compared to 12.9% in January 2020, an increase of 6.6 percentage points. Bogota and Medellin were the most affected cities, with unemployment rates that reached 21.6% and 18.4%, which represents annual increases of 9.5 and 6.5 percentage points, respectively.

At the sectoral level, two-thirds of the fall in jobs is explained by three activities: industry, entertainment, and hotels and restaurants. In contrast, commerce and construction have continued to post job gains, with an increase in their payroll number for January of 44k and 32k in annual terms.

Looking forward we anticipate a mild improvement in labor markets, with a decline of the average rate of unemployment to 14.6% in 2021 from 16.1% in 2020. Job creation will continue sluggish despite the pickup in economic activity, as most of the recovery in the labor market has been slanted towards informal jobs.

› *Inflation and monetary policy*

Annual inflation has continued its downward trajectory falling from its peak of 3.86% in March 2020, to 1.61% in December, the lowest figure since 1955, and to the latest print of 1.56% in February. The decline in consumer prices has been mainly driven by negative variations in rents, education and food, as a result of weak demand, and in regulated prices, such as utilities, gas and telecommunications.

The February inflation figure of 0.64% mom was above market consensus and it signals that the decline in annual inflation is likely coming to an end. We expect 12-month inflation to reach a minimum of 1.4% in March, owing to base effects, and to then exhibit a gradual upward trend in the upcoming months as most of the price cuts of regulated prices start to wane.

In line with our CPI estimates we see a flat repo rate for the rest of the year. The latest inflation print and the better-than-expected high frequency data of the last few weeks, including the substantial decline in COVID-19 cases, should help to make the case for steady rates in the upcoming meeting on March 26th.

None of the recent changes of the board, including the new Governor, Mr. Villar, and the three new members, Mr. Villamizar, Mrs. Taboada and the soon-to-be appointed, Mr. Jaramillo, should change the current policy stance. We will update our priors, however, about their policy preferences during the next few months. We believe that Mr. Villar is slightly more dovish than his predecessor Mr. Echarravia, but that Mr. Villar is unlikely to push for rates cuts at this juncture. From the other three new members, Mr.

Jaramillo seems to be the most hawkish, giving his professional record.

Due to this backdrop, we expect little action in terms of monetary policy for the remainder of the year. However, the Central Bank could be prompted to act in the secondary market if the current repricing of long-term bonds in the US turned out to be disruptive for local markets or if Colombia's sovereign rating were to be downgraded, which could trigger capital outflows and put pressure on local rates. None of these events are part of our baseline scenario, but they cannot be entirely rule out at the moment.

› *Fiscal policy*

The government recently updated its 2021 financing plan and its fiscal accounts for 2020 and 2021. The fiscal deficit of 7.8% of GDP in 2020 was lower than the 8.2% announced last year and within the range of our 7.9% forecast. Part of the additional spending aimed to mitigate the effects of the pandemic was deferred to 2021, so the announced larger deficit of 8.6% for 2021 it is not entirely surprising, as it in some way reflects a reshuffle of spending over time. Nevertheless, the headline deficit number came above market expectations and it was not completely well received by the local markets.

The 2021 fiscal accounts, unlike previous years, are based on what could be considered relatively cautious assumptions: a 5% GDP growth rate and an average Brent price for the year of USD 53. In addition, the Government marked COP 12 trillion or 1.2% of GDP as a source of revenue from the sale of its stake on ISA to Ecopetrol, an operation that we believe could raise COP14 trillion or 1.4% of GDP. The fiscal accounts include 3.1% of GDP from discretionary public investment, a much larger figure than expected, that could overstate the capacity of the Government to execute spending programs.

Although Colombia's fiscal outlook remains challenging, the fiscal accounts for this year could reveal that the Ministry of Finance prefers to start the discussion of the upcoming tax bill with a larger headline deficit number. In our view, the final print of this year's fiscal deficit will be close to 8% of GDP. Both the headline number and the larger investment account could be part of a strategy to persuade Congress to approve the fiscal reforms.

In turn, the financing plan reflects the balancing act of funding an historical record-high deficit. The updated numbers added COP 10 trillion in funding from external sources and almost COP 20 trillion from local funding.

Table 1. Central Government Accounts as % of GDP

	2019	2020	2021
Total revenue	16.2	15.2	15.8
Tax revenue	14.0	13.0	13.5
Non-tax revenue	0.1	0.2	0.1
Fonds	0.1	0.1	0.1
Capital revenue	1.9	1.9	2.1
Ecopetrol	1.1	0.7	0.1
Central Bank	0.2	0.7	0.6
Others	0.3	0.3	0.2
Total expenditure	18.7	23.0	24.4
Interests	2.9	2.8	3.4
Spending	1.,8	20.2	21.1
COVID-19 emergency	0.0	1.7	1.7
FNG capitalization	0.0	0.1	0.1
Total Balance	-2.5	-7.8	-8.6
Primary Balance	0.4	-4.9	-5.3

Source: Ministerio de Hacienda and Corficolombiana

External sources in the new 2021 accounts participate with USD 10.1 billion, almost double of what was initially announced in the Medium-Term Fiscal Framework (MFMP) of last year. Although it is unclear how much of the foreign funding will be through issuance of external debt, it was hinted that it will be slanted towards market issuance. Multilateral funding will be less abundant in 2021 for middle-income countries like Colombia, and we don´t expect the Government to tap the Flexible Credit Line (FCL) with the IMF again.

Given that the Government already placed USD 2.3 billion of foreign-denominated debt at the beginning of the year, tapping external markets for the remaining needs of USD 7.3billion will be challenging, in particular, in the current volatile environment. Thus, we anticipate that the Ministry of Finance will delay a good fraction of the external issuance to 2H2021, in the hopes that market conditions improve, and the approval of the tax reform helps to dissipate some of the concerns regarding the country's sovereign rating.

Table 2. Financing Plan (COP trillion)

	2020	2021	
		MFMP	Update
Sources	137.1	104.9	132.1
Disbursements	116.2	64.2	90.5
External	59.1	24.4	35.2
Domestic	57.1	39.9	58.7
TES Auctions	36.0	32.0	42.0
Initial cash hold.	20.8	22.1	32.7
Other sources	21.1	18.6	9.0
Uses	137.1	104.9	132.1
Deficit	77.7	57.8	94.7
Amortizations	11.2	29.2	18.7
External debt	6.4	14.5	10.4
Domestic	4.9	14.7	8.3
Final cash hold.	32.7	9.8	10.2

Source: Ministerio de Hacienda and Corficolombiana

The financing plan also includes TES issuance of $ 42 trillion, which although it is the largest in nominal terms in the country's history, it is lower than what we anticipated. The market also speculated about a higher local issuance in the days before the announcement, so the number was received as relatively good news. However, the financing plan also includes COP 9 trillion from other sources, a sort of black box, which includes the placement of TES to public entities, use of sitting cash in the hands of local and regional public entities, and issuance of short-term bonds, the so-called TCOs. **Under the assumption that 60% of the other sources come from the placement of short-term debt, the overall pressure of the financing needs on the domestic market is around $47 billion, much in line with our original estimate**.

Of the overall $42 trillion of TES issuance, $2 trillion will be in the form of "green TES" bonds, which are expected to be issued from July onwards. The bond references for the regular auction schedule includes fixed-income TES-B due in 2027, 2036 and 2050 and inflation-linked UVR maturing in 2029, 2037, 2049. The amount of the biweekly auction in UVR was increased to COP 350 billion from the previous COP 300 billion, which could bring the amount to total CO 1.5 trillion in addition, compared to the previous schedule.

› *Fiscal reform*

There is a great deal of anticipation regarding what could be the final proposal of the Government to Congress to change the tax code. In the upcoming days the Government will receive the final report from the Commission appointed to study the tax system and its loopholes. It goes without saying that if the Government does not present a tax reform or if the bill gets watered down so the additional fiscal revenue gets below 1% of GDP, Colombia will lose its investment grade.

The Ministry of Finance seems committed enough to get a tax bill approved by Congress that gets at least 1.5% of GDP of additional revenue in the medium term. This could imply that the bill will have a gradual positive effect on revenue.

Although, there has been a lot of speculation about the specifics of the proposal, we anticipate that the Government will try to 1) lower the threshold at which individuals need to pay income taxes, 2) postpone the reduction in the corporate income tax rate which under the previous reform was set to decline to 30% in 2022 and onwards from 31% this year and 32% in 2019, 3) reverse the tax deduction of 50% for the local-paid industry and commerce tax (ICA), 4) extend the wealth tax while lowering the wealth threshold and making tariff progressives, 5) reduce the list of goods that are excluded or exempt from VAT and 5) extend the social transfers program of *Ingreso Solidario*, so as to make it permanent.

This last point could be the "carrot" that helps the revenue-raising ideas, which are obviously unpopular, politically viable. In addition, the Government could try to amend some of the structural issues of the pension system, by proposing a transition towards a unique system of retirement savings, in which the pay-as-you-go public systems slowly and gradually fades.

Any reform to the pension system could face as much political resistance as changes to the VAT. We conjecture that the government will try to overshoot its goal of additional revenue to leave enough room to negotiate a bill that end secures a minimum of 1.5% of GDP in additional fiscal revenue.

Members of Congress could be reluctant to approve unpopular tax hikes, but the Ministry of Finance has sent a clear message that without a tax reform the country will face higher interest rates and that with the fiscal deficit of 8.6% of GDP this year, spending programs could be in jeopardy in 2022, an election year, without a credible fiscal adjustment plan.

In addition, the Ministry of Finance will propose a new fiscal rule that could be put in place in 2023. The new rule is likely to have a higher long-term target for the debt-to-GDP and it is most likely to include a dual mandate in which both deficits and debt limits are included.

› *External accounts*

The current account deficit decreased to 3.3% of GDP, or USD 9 billion, in 2020 from 4.4% in 2019 – US 14.2 billion. During the first three quarters of 2020, the fall in the profits of non-resident companies, with direct investment in the country, and a smaller trade deficit, resulting from a sharp decline in domestic demand, helped to narrow the current account deficit.

In fact, the decline in the repatriation of profits of non-resident companies accounted for 90% of the USD 5 billion current account reduction in 2020, proving to be an important automatic stabilizer of the economy. The contraction in the repatriation of utilities was particularly large in the oil sector and financial and business services as well as in transport and communications.

In turn, the trade deficit for goods declined by USD 532 million, as imports fell more than exports as a result of weak domestic demand. It is worth noting that imports showed a rebound in 4Q20 that prevented a greater adjustment of the trade deficit for the whole year. In line with the recovery of the economy, purchases of imported capital goods for industry, transportation equipment and durable consumer goods substantially reduced their falls in the last quarter of 2020. In contrast, exports had a more moderate recovery, especially oil and coal exports, which exhibited a slower rebound. For December, oil exports registered a significant drop of 40.1% yoy while coal declined 30.9% yoy.

Although the adjustment in the external imbalance reduced financing needs, net capital inflows were above 3.0% of GDP in 2020. The sources of external financing changed as the sharp decline in FDI was offset by the increase in foreign portfolio investment, through the issuance of long-term debt securities in international markets and loans of multilaterals to address the coronavirus emergency, in particular the Flexible Credit Line of the IMF by USD 5.3 billion.

We expect a widening of the current account deficit for this year to 3.8% of GDP, although there is still uncertainty about the evolution of the trade deficit and the speed of recovery of the income factor payments, as the economy bounces back. Regarding the financing of the current account deficit, we anticipate a gradual rebound in FDI, in line with the strong growth of 260% qoq it exhibited in 4Q20. Thus, FDI is likely to resume as the main source of external financing in 2021, reaching 3.6% of GDP.

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