



# Colombia: Not Just an Oil Play

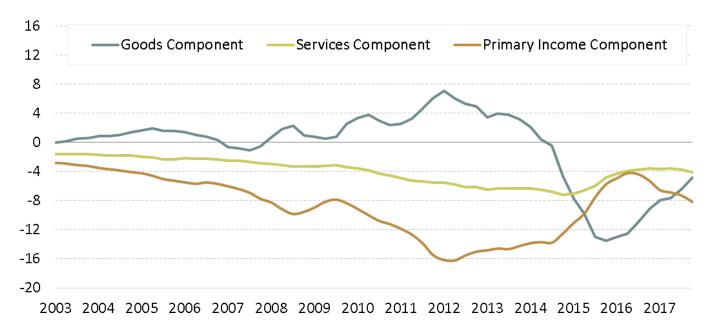
At its peak, energy accounted for 56% of Colombia's exports so it's understandable that the country became known as an energy proxy. However, we think there's a lot more to the Colombian economy than just oil. The country exhibits a resilient and diversified balance of payments picture, has enacted disciplined fiscal adjustments, and managed to bring down inflation from the high single digits. And yes, the energy outlook is also improving.

### Resilient and diversified balance of payments

Following the 2014 oil shock, Colombia's current account (CA) deficit widened to a jaw dropping 7.2% of gross domestic product (GDP). The rebalancing that followed was quite swift and multifaceted. The exchange rate was allowed to adjust from sub 2,000 to 3,400 (a ~70% move) which led to a contraction in import demand of 6 percentage points (ppts) of GDP. The income balance declined by \$9bn as multinationals that invested in Colombia repatriated less profits. The services balance improved as well, led by tourism receipts. Colombian expats took advantage of the improved exchange rate to send more remittances home. The exchange-rate valuation is even boosting non-traditional export sectors such as flowers and food. All in, these factors cut the CA deficit in half to a more sustainable 3.3% of GDP (see Chart 1). The funding of this deficit also improved with new foreign direct investment (FDI) coming in to the tourism, energy, and telecommunications sectors—among others. FDI now fully funds the CA gap.

**Chart 1: Current Account: Select Components** 

Billions of U.S. Dollars, 4 Quarter Sum, As of 12/31/2017



Source: Banco dela Republica/Haver Analytics

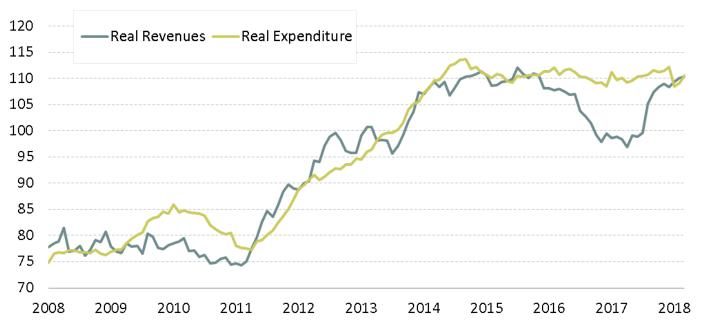
### Baby steps on the fiscal front

Instead of adopting a big-bang approach to fiscal reform, political realities have forced the government to try frequent piecemeal fiscal improvements. This approach has frustrated some in the market who have been waiting for bolder measures, but the progress thus far can't be dismissed. Colombia's fiscal rule is perhaps a bit too flexible for the market's taste serving more as a guideline rather than a binding constraint. Downgrade risks cannot be dismissed if fiscal consolidation is delayed. We tend to be more optimistic. In our view, the main challenge for Colombia's fiscal situation came from the revenue side, as the government went from collecting 3.3% of GDP in oil revenues to near zero. Expenditures in real terms were well contained (see Chart 2).

The authorities are trying to consolidate. Raising the value-added tax (VAT) from 16% to 19% for instance, was something that was not politically popular, but much needed. The next administration should focus on a more broad-based personal income tax approach. It should also be noted that these changes have been paired with a gradual reduction in corporate income taxes from 37% to 33% to incentivize private industry.

Chart 2: Real Revenues and Expenditures

Index: 2013 = 100, As of 03/31/2018



Source: Haver Analytics

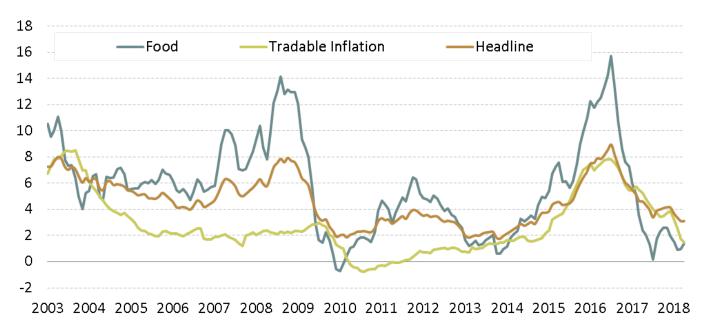
## Central bank surprising, but succeeding

Banco Central de la Republica (BanRep) has gotten a bad rap for being somewhat unpredictable. Unlike other central banks that take pains to make sure they telegraph their moves to markets well ahead of the meeting, BanRep has taken a course of action different than market consensus at 10 meetings since 2015. The communication strategy should certainly be improved, but BanRep should get credit for delivering on its 2-4% inflation target band.

The last few years have been challenging and have forced a data dependent, flexible approach by the bank. The peso's devaluation in 2014-16 pushed tradables inflation above 8%. Concurrently, adverse weather conditions led to a surge in food inflation (Chart 3). BanRep responded by hiking rates to 7.75% amidst a growth downturn. The strategy worked and BanRep was able to ease rates repeatedly in 2017 as disinflationary conditions took hold. Inflation expectations—which had also spiked—are now back within the target band as well.

### Chart 3: Consumer Price Index

Annual Percent Change, As of 04/30/2018



Source: Haver Analytics

### Oil outlook is improving as well

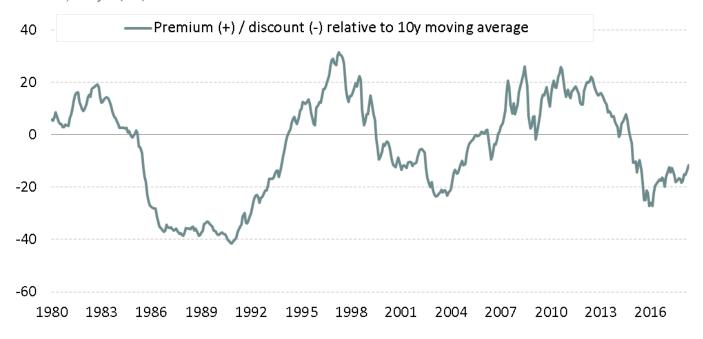
We started this post by stating that Colombia was more than just an oil play, but we can't just ignore energy dynamics either. Things are looking better on this front as well. After 2014, the majority state-owned oil company was forced to cut its dividend and retrench on capex in order to bring down leverage. The strategy has worked with gross debt to EBITDA down to 1.9x at the end of 2017 from 2.8x in 2015. The crisis also forced a more austere cost structure with cash breakevens—inclusive of capex and dividends—now down to \$45 from \$100 in 2014. The company has now resumed paying dividends, most of which will flow into government coffers. Most importantly, for the first time in years, crude production and the reserve outlook are improving as well.

## Colombia is not out the woods yet

The next president who will be elected on May 27 must tackle fiscal reform with vigor. This will occur at the same time as society deals with the challenge of integrating former guerrilla members after the historic peace process as well as assisting Venezuelan refugees crossing the border. BanRep needs to improve its communication strategy and avoid confusing the market as often as it has. All in, however, information risk is turning decidedly positive. Price risks remain low considering ex-ante real rates over 3% in local-currency sovereign bonds and a real effective exchange rate 11% cheaper than its 10-year moving average (see Chart 4).

Chart 4: REER Premium (+) / Discount (-) Relative to 10 Year Moving Average

Percent, As of 04/30/2018



Source: Haver Analytics

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