



# FX MARKETS UPDATE

## The Colombian peso looks poised for a rebound

- **As political risks appear to be largely discounted by investors, we expect the Colombian peso to outperform other major EM currencies over the next couple of years.**
- Although the Colombian peso is broadly unchanged against the greenback so far this year, the bigger picture is that since the start of 2022 the peso has fallen ~30% against the dollar and has underperformed all other major currencies (except the Turkish lira). Notably, it has diverged from other major currencies of Latin America over that period. (See Chart 1.)
- **We think two factors are behind the peso's underperformance.** For one, its trade deficit has widened – reaching ~7% of GDP in the second half of last year (see Chart 2) – even as global financial conditions tightened. In our view, this reflects a combination of exceptionally strong import demand and a fall in the price of oil, Colombia's key export. At the same time, investors have grown increasingly concerned about [interventionist policies of President Petro's new administration](#); indeed, the peso's underperformance appears to have started around the time of Petro's election last summer. (See Chart 1 again.)
- **After the currency's sharp fall, we now think the prospects for the peso have brightened for three reasons.**
- **First, we think the current account deficit is likely to continue to narrow over the next few years.** On the export front, we expect the price of oil to remain elevated through 2024 on the back of growing global demand, boosting Colombia's terms of trade and export volumes. The peso remains far below the levels implied by its commodity terms of trade, so we think there is scope for the currency to appreciate steadily if oil remains at or above current prices. (See Chart 3.) And on the import front, despite [Q4 GDP growth in Colombia](#) exceeding expectations, the expenditure breakdown showed there was a sharp contraction in imports, which we expect to continue amid sluggish domestic demand growth.
- **Second, we expect monetary policy to remain restrictive for longer than most analysts anticipate given our view that inflation will remain stubbornly high.** With the third highest carry among major currencies, we suspect the peso's high yield will provide some protection against further depreciation and, in turn, help to bring inflation down.
- **Third, the peso's depreciation over the past few years means that the currency is well below its historical long-term average on a real, trade-weighted basis.** (See Chart 4.) By this measure, the peso is the most undervalued major EM currency. (See Chart 5.) Although valuation is a poor tool for timing turning points in currencies, an extreme value like this suggests to us that the peso is likely to outperform other EM currencies over the next couple of years.
- **Admittedly, political developments in Colombia could deteriorate further and continue to put pressure on the peso,** especially if additional government spending raises concerns about fiscal sustainability. And given its high sensitivity to oil prices and risk sentiment, we suspect the peso, [like other EM currencies](#), will struggle against the US dollar in the near term as major economies enter recession.
- **But to a large extent, these risks appear to be discounted by investors given the elevated risk premia of Colombian assets.** For example, although the dollar bond spread – which tends to fluctuate in line with the peso – is now below its peak, it remains near of the peak it hit during the initial stage of the COVID pandemic. (See Chart 6.) What's more, prior episodes of domestic political concerns that have marked the peaks in EMBI spreads in other Latin American economies over the past few years (e.g., Chile's new constitution) have tended to mark turning points for their respective currencies.
- **Although the currency may remain under pressure over the next quarter or two, we think the peso's low valuation and cyclical sensitivity means that it will outperform most other EM currencies through the end of 2024, appreciating to 4,400/\$ from ~4,850/\$ currently.** See the latest details underpinning our forecast for the peso in our forthcoming *Outlooks* on the *Latin America* and *FX Markets* services.



Chart 1: % Drawdown From Highs Vs USD (Since 1st Jan. 2020)

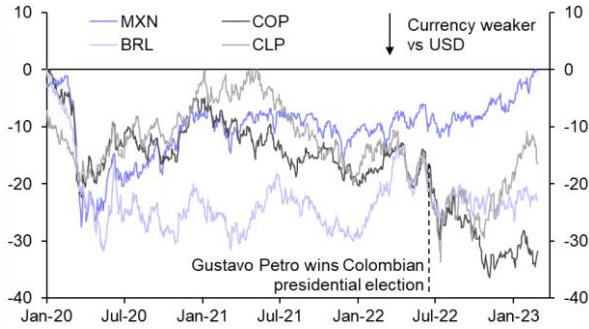


Chart 2: Colombia Trade Balance (3m Sum, % Of GDP)

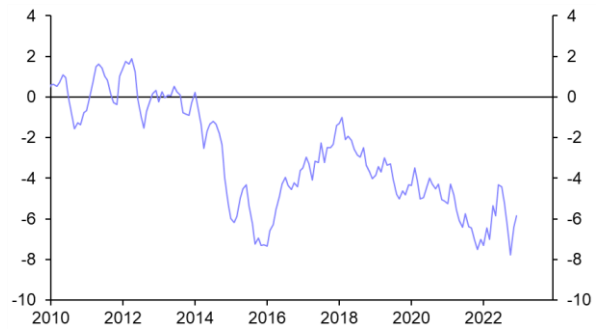


Chart 3: COP Commodity Terms Of Trade (CToT) Index (2010 = 100) & BIS Broad COP REER Index (2020 = 100)

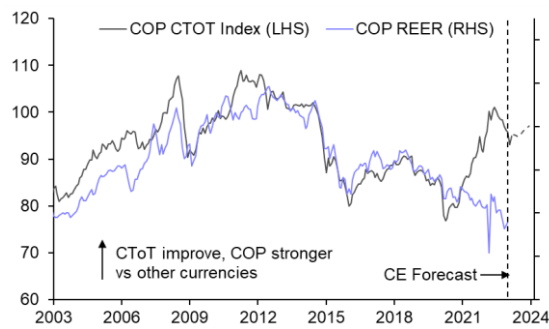


Chart 4: % Deviation From 7-Yr Average BIS Broad COP Real Effective Exchange Rate (REER)

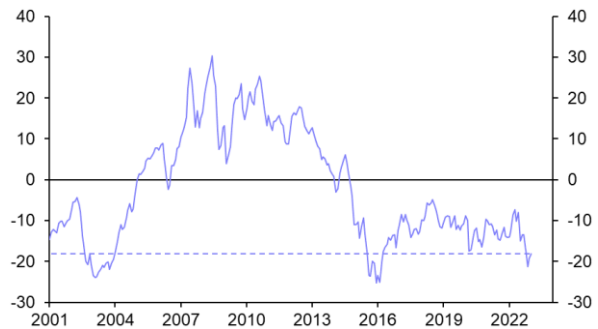


Chart 5: Valuation Percentile From CE Real Equilibrium Estimate (Based On Real Effective Exchange Rate)

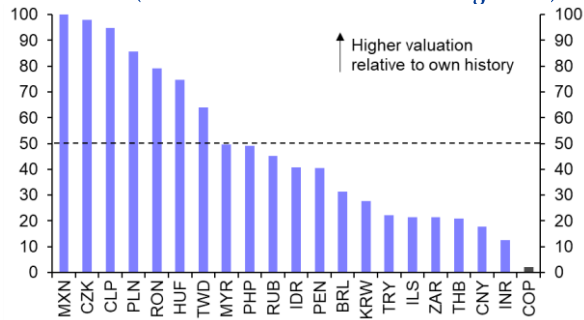
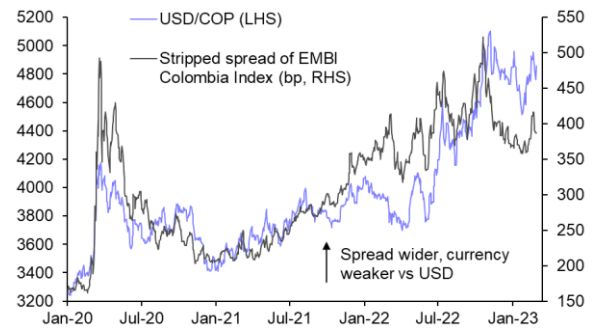


Chart 6: USD/COP & Stripped Spread Of JP Morgan EMBI Colombia Index



Sources: Refinitiv, Capital Economics



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