CAPITAL ECONOMICS

LATIN AMERICA ECONOMICS UPDATE

Colombia's imbalanced recovery can't be sustained

- **Colombia's very strong post-pandemic recovery has come at the expense of a build-up of large macroeconomic imbalances and a period of below-trend growth is needed to reduce these vulnerabilities. The longer the adjustment process drags on, the higher the risk that the peso comes under renewed downward pressure. That would prevent inflation from falling back more markedly and force the central bank to keep monetary policy tighter for longer.**
- Last week's Q1 GDP data confirmed that Colombia's post-pandemic recovery has been one of the strongest of any emerging market. The economy was operating above its pre-pandemic trend for the sixth consecutive quarter. (See Chart 1.) **But the flipside of the country's strong recovery has been a build-up of large macroeconomic imbalances**.
- For one thing, the boom in household consumption – we estimate that consumer spending is currently 6% above its pre-pandemic trend – has caused import growth to outpace export growth, despite the boost to Colombia's terms of trade from high oil prices. **The result of this has been a rapidly widening current account deficit – at over 6% of GDP, it is one of the largest deficits of any major EM.**
- The large external shortfall has left Colombia vulnerable to tighter external financing conditions and explains why the peso has come under downward pressure whenever investor risk appetite has soured (most recently following the ousting of market-friendly Finance Minister José Ocampo).
- The falls in the peso, the rapid improvement in the labour market – the decline in the unemployment rate has been sharper than in many other Latin American countries and wage growth is still accelerating – as well as the strength in domestic demand also explain why **Colombia's inflation problem is more severe than elsewhere in the region.** While inflation in most other Latin American economies peaked last year (with the exception of Argentina), the headline rate in Colombia has only just topped out and, at close to 13% y/y, remains high. (See Chart 2.) What's more, core price pressures continued to strengthen in April.
- **In spite of signs that the economy has been overheating and that imbalances are building, policymakers haven't stepped on the brakes hard enough.** Admittedly, the central bank hiked interest rates to a multi-decade high of 13.25% in this cycle. But it was much slower off the mark to raise interest rates than other central banks in the region, such as those in Brazil and Chile.
- **And, more importantly, while the Petro administration has not been fiscally reckless, fiscal policy has not been tightened sufficiently either**. According to the IMF's estimates, the structural budget balance widened for a third consecutive year in 2022 and was well above its pre-pandemic level. This is in stark contrast to Chile – the other Latin American economy that was overheating – where the budget position flipped back into surplus last year, helping to reduce the country's macroeconomic vulnerabilities.
- **The upshot is that Colombia's economy needs a period of tighter policy and weaker growth to address macroeconomic imbalances**. This the key reason why we expect growth to slow to a below-consensus 0.8% this year and 1.5% in 2024. But there's a risk that the adjustment process takes longer than we're currently anticipating. **If that's the case, the likelihood of renewed sharp falls in the peso will grow, causing inflation to remain elevated and forcing the central bank to keep interest rates higher for longer**.

Chart 1: Real GDP (SA, Q4 2019 = 100)

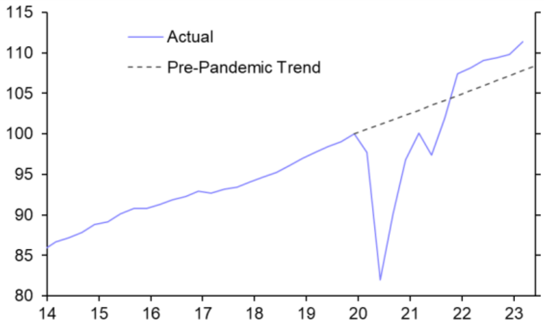
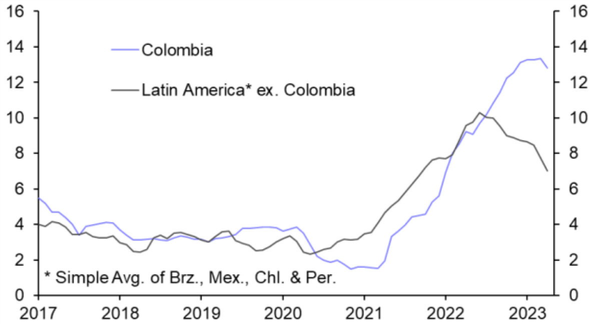


Chart 2: Consumer Prices (% y/y)



Sources: Refinitiv, Capital Economics

Kimberley Sperrfechter, Latin America Economist, kimberley.sperrfechter@capitaleconomics.com

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