THE WEEKLY **LATAM** ECONOMIC MONITOR

FEBRUARY 18, 2019
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Solid retail sales in Colombia more than offset weak manufacturing activity in Q4; the recovery continues.

The trade balance deteriorated in late 2018; exports are softening and imports are strengthening.

An improving global outlook will help Colombia's external and fiscal accounts; its Achilles' heel.

A Solid End to 2018 for Colombia's Economy; no Threats, for Now

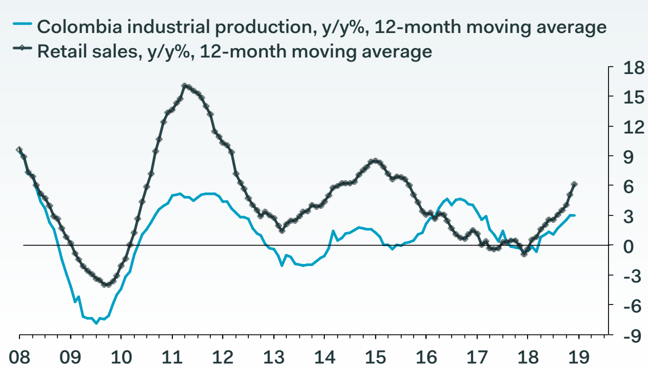
Colombia's December activity reports confirmed that quite strong retail sales last year were less accompanied by local production, which became only a minor driver of the economic recovery, as shown in our first chart. Manufacturing sector activity rose by 2.9% in the year, up from -0.5% in 2017, but retail sales jumped by 6.9% in 2018, from -1.2% in 2017. In the retail sales core measure, which excludes vehicle and fuel sales, the gap between consumption and production is less pronounced; core sales grew by 5.4% in 2018, up from -0.1% in 2017, but the difference is still significant.

We think Q4 GDP grew about 1.0% quarter-on-quarter, pushing the year-over-year rate up to 3.6% the fastest pace since Q3 2015, and up from 2.7% in Q3. Full-year 2018 growth was 2.9%, up from 1.8% in 2017. Looking ahead, household demand should remain healthy over the first half of this year, assuming improving oil prices. Private consumption likely will be the main driver of the economic cycle, once again, consistent with better domestic fundamentals, including low inflation, low interest rates and a resilient credit market. We expect consumer confidence gradually to improve, following the approval of tax reform which will penalise consumers less significantly than initially thought. *Moreover, we expect a modest COP rebound, which will continue to boost consumption of imported goods.*

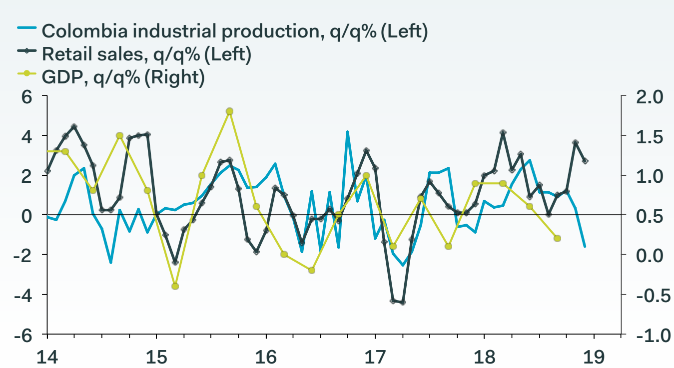
Industrial production, meanwhile, recovered some ground last year, particularly over the first half, but it languished later in Q4, due mainly to weakness in oil refining. Looking ahead, we expect a relatively good 2019 for the industrial sector as a whole. Improving commodity prices, the potential end of the trade war, relatively strong U.S. demand and solid domestic fundamentals will help. The sector's traction will be constrained by a stronger COP, but this will not fully offset other tailwinds, including increasing infrastructure spending on projects that were delayed because of corruption scandals.

Moreover, the recent fiscal reform, which included the exemption of capital goods tax imports and a four percentage point cut to the corporate tax rate, likely boosted capex, offsetting the hit from lower public

MANUFACTURING ACTIVITY WILL IMPROVE THIS YEAR



A GOOD END TO THE YEAR FOR RETAILERS



sector investment over the second half of the year. A resolution of the Venezuelan crisis would also help Colombia's industrial sector, along with the boost from a potential reconstruction effort. We remain cautiously optimistic on this front, but the risk of Mr. Maduro remaining in power is real.

Employment, meanwhile, continues to rise in the retail sector, but is falling in the manufacturing industry, although it is showing some signs of stabilization. Overall, labour market conditions deteriorated slightly in Q4. These dynamics need to be monitored because a weaker labour market could constrain consumption if the services sector gets weaker, which is not the most likely scenario at this point. The labour market lags the cycle and we expect better news ahead.

More immediately, though, the relatively weak industrial data and recent downside pressures in the labour market indicate that the output gap is far from closing. *This suggests that policymakers will have to keep interest on hold over the next three-to-six months*. Still, we remain upbeat about Colombia's economic outlook, despite recent sluggishness in some indicators. President Duque and his team have a clear vision for the country, so the near-and medium-term outlook remains relatively positive.

The country, however, still faces very deep structural challenges, including the implementation of the peace accord with FARC, compliance with the OECD—particularly over labour laws, the informal sector, and trade issues—the humanitarian crisis in Venezuela and rising cocaine production, which potentially can damage the country's good relationship with the U.S. Most importantly, the government will have to improve both its fiscal and external accounts to avoid a looming sovereign rating downgrade. This is not our base case; stronger economic activity and improving oil prices should help to hold off the rating agencies.

We think the government will achieve the nominal deficit target of 2.4% of GDP this year, but will struggle to comply with its goal over the coming years if it doesn't enact further reforms. The government needs to improve the current weak fiscal framework and implement reforms to increase potential output. Last week, Moody's highlighted the country's rigidities—a low revenue base and inflexible spending structure—and Fitch highlighted the debt increase over the last five years; they are watching closely.

On the external front, meanwhile, data released last week suggested that the current account deficit increased slightly last year, hurt mostly by falling oil prices and stronger domestic demand. The unadjusted trade deficit in December was USD0.6B, slightly better than November's reading, but much bigger than the USD0.5B *surplus* in December 2017. Exports fell 14% year-over-year in December, down from an 8% increase in November, and the underlying trend is falling. Oil exports fell for the first time since mid-2017. Oil prices are showing some signs of recovery, but it is too soon to bet on a protracted rebound. Non-oil exports, particularly coal, are also deteriorating, but we expect better news as the external environment improves.

Imports, meanwhile, are strengthening, climbing by almost 15% year-over-year in December, and the underlying trend is rising rapidly. Consumer goods imports and intermediate goods and raw materials imports are increasing, thanks mainly to the gradual economic recovery last year. Capital goods imports jumped 25% year-over-year in December, boosted by solid transportation equipment. In volume terms, both consumer and capital goods imports rebounded last year, due to the recovery in domestic demand. Imports rose about 11% in 2018, up from 3% in 2017, led by intermediate goods imports, thanks to the gradual industrial recovery.

Overall, the trade deficit widened to USD7.4B in 2018, from USD6.9B in 2017, putting an end to two years of improvement. We expect Colombia's trade deficit to improve slightly this year, to about USD7B, helped by the end of the trade war, a still-competitive currency—despite the rebound that we expect over the coming months—and improving commodity prices. These factors will offset the effect of rising imports driven by improving domestic demand. We expect the current account deficit to increase slightly to about 3.6% of GDP last year, from about 3.3% in 2017. For this year, we expect a current account gap of about 3.5%. The deficit is structural, so it will take more than the end of the trade war to drive a significant improvement of the external accounts.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, February 18

- **No significant data released.**

Tuesday, February 19

- **Peru GDP (Q4)/No specific time**

We think GDP rose **4.9%** year-over-year in Q4, from 2.3% in Q3, marking a solid end to the year. If we are right, this will be a strong report, confirming that the economic recovery gathered momentum in Q4, after a relatively soft Q3. Improving confidence, a solid labour market, the boost from low interest rates and low inflation, and solid investment, have offset the hit from external threats. Falling metals prices are a big threat, but it seems that the trade-war rhetoric is easing. **Consensus: 4.8%.**

- **Colombia Consumer Confidence (1)/No set time**

We look for the confidence index to increase to **-1** in January, from -8.3 in December. **Consensus: -3.3.**

Wednesday, February 20

- **No significant data released.**.

Thursday, February 21

- **D: Brazil IBGE Inflation IPCA-15 (2)/9:00 Local**

The index likely rose **0.3%** unadjusted month-to-month, due mainly to higher school tuition fees—normal at this time of the year—and food prices. Other key components likely fell marginally or rose only at a modest pace. In year-over-year terms, inflation probably fell to **3.7%** from 3.8% in January. If we are right, this will be a good inflation report, underscoring that pressures are well under control. We expect inflation to remain close to its current rate this year. Upward pressures driven by an improving labour market and stronger economic growth will be offset by a still-ample output gap and a favourable base effect. Moreover, favourable inertia/indexation and expectations subdued will help contain inflation. **Consensus: 3.8%.**

Friday, February 22

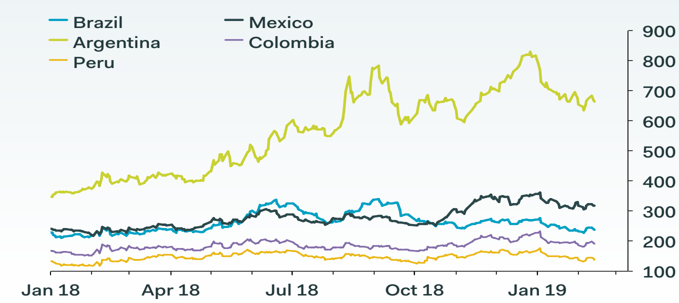
- **Mexico Bi-Weekly Inflation CPI (2/15)/8:00 Local**

Mexico's CPI likely was **unchanged** month-to-month in the first part of January, due mostly to higher energy tariffs, offset by falling food prices. On a year-over-year basis, we expect the headline rate to fall to **4.0%**, from 4.2% in January. Core prices likely increased 0.2%. We think the headline inflation rate will continue to fall towards 3.6% over the first half of the year. Favourable base effects, the relatively stable MXN, and modest demand-related pressures will help to bring inflation down over the next three-to-six months. The gradual fall in inflation likely will push inflation expectations lower, allowing policymakers to ease their hawkish bias. Threats remain, however, as the MXN likely will come under temporary pressure in Q2 due to risks associated with the USMCA ratification process and AMLO's policies, which are still an unknown factor. We believe that AMLO is now settling into a more pragmatic policymaking mode, but risks remain. **Consensus: Headline 4.1%.**

PANTHEON'S LATAM FINANCIAL CONDITIONS DASHBOARD

	Currency			Benchmark Stock index		
	Value	Week, %	YTD, %	Value	Week, %	YTD, %
Argentina	38.60	-2.0	-2.4	37,470	2.2	23.7
Brazil	3.70	0.8	4.9	97,526	2.3	11.0
Chile	663.9	-0.7	4.5	5,400	0.4	5.8
Colombia	3,134	-0.6	3.8	12,099	1.7	8.6
Mexico	19.25	-0.9	2.1	42,989	-0.4	3.2
Peru	3.33	-0.1	1.3	20,391	0.4	5.4
Venezuela	--	--	--	5,057	-8.5	215.0

INDEX EMBIG SPREAD LATAM HISTORY



PANTHEON'S ECONOMIC FORECASTS

	Real GDP, y/y%		Inflation, Avg.		Interest rate, Q4	
	2018	2019	2018	2019	2018	2019
Argentina	-2.4	-0.4	33.8	35.0	59.25	30.00
Brazil	1.4	2.4	3.7	3.7	6.50	6.50
Chile	4.0	3.4	2.4	2.8	2.75	3.50
Colombia	2.9	3.1	3.2	3.2	4.25	4.75
Mexico	2.0	2.0	4.9	4.2	8.25	8.00
Peru	3.9	4.2	1.3	2.5	2.75	3.25
Venezuela	-17.0	-20.0	1.3M	25M	--	--

COMMODITY PRICES (JANUARY 1, 2017 = 100)

PANTHEON'S FINANCIAL FORECASTS

	Currency			Benchmark Stock index		
	Q1F	Q2F	Q3F	Q1F	Q2F	Q3F
Argentina	38.5	39.1	39.8	32,100	32,900	33,100
Brazil	3.79	3.67	3.65	88,100	89,200	89,500
Chile	680	676	672	5,120	5,240	5,480
Colombia	3,130	3,080	3,010	1,320	1,480	1,510
Mexico	19.5	19.2	19.0	42,310	43,500	44,300
Peru	3.34	3.28	3.25	20,050	21,200	22,500
Venezuela	--	--	--	--	--	