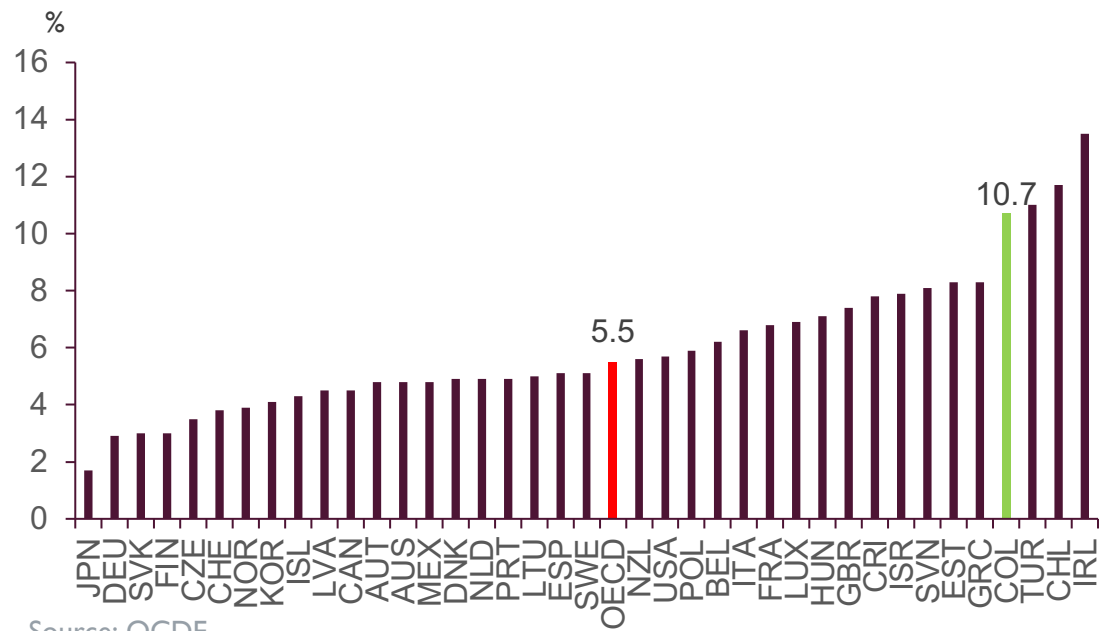

THE COLOMBIAN ECONOMY: HEADING TO A SOFT LANDING OR A FREE FALL?

MAURICIO CÁRDENAS, *COLUMBIA UNIVERSITY*

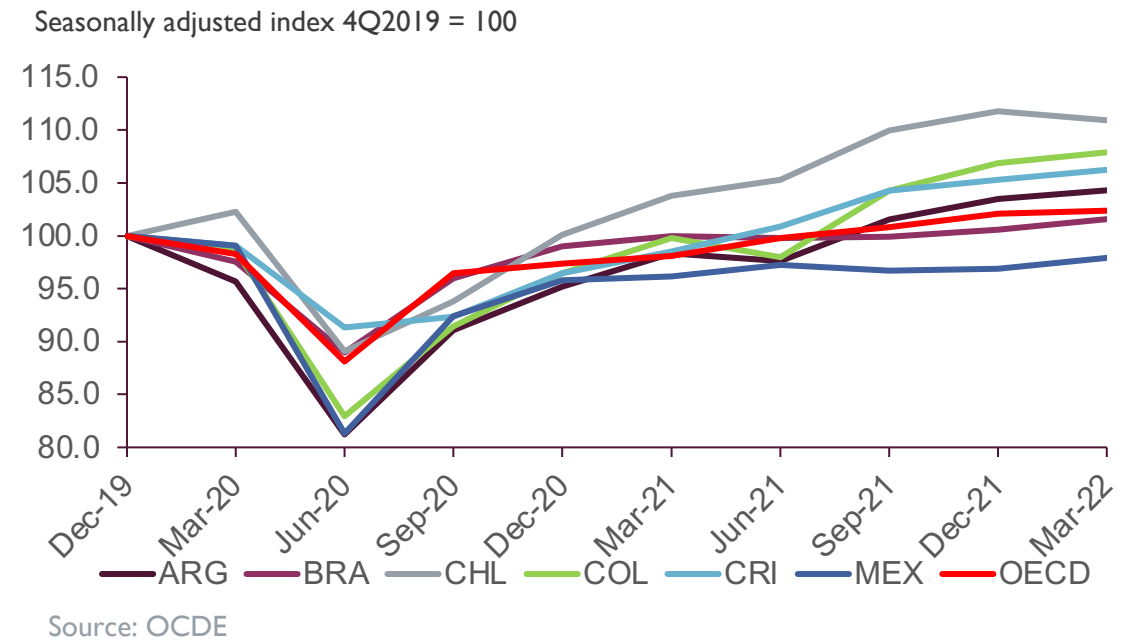
08/23/2022

AN ACCELERATED RECOVERY

One of the fastest economic recoveries of the OECD

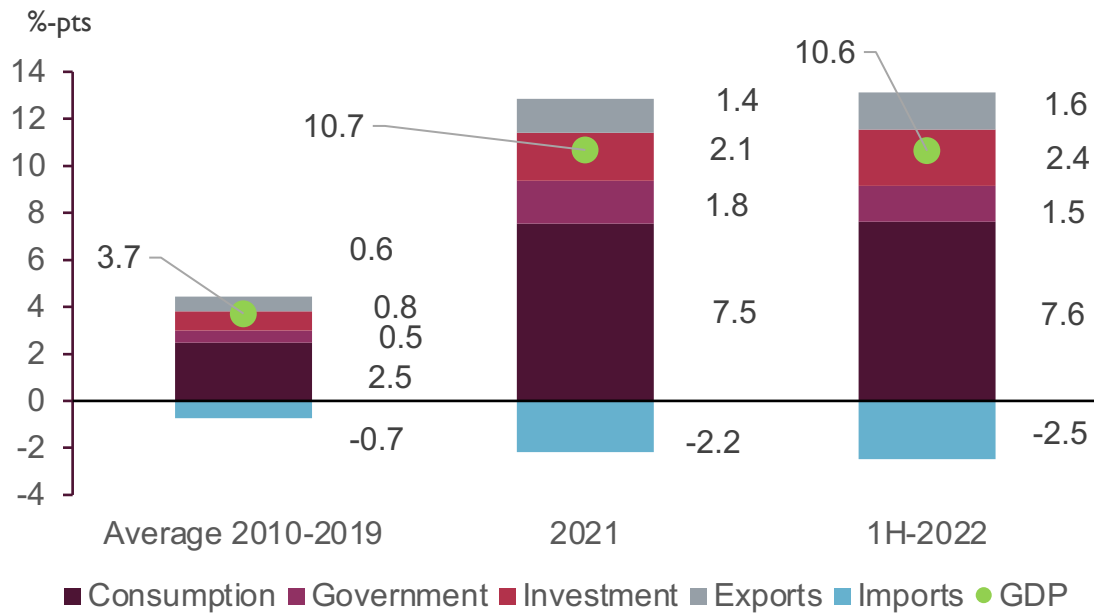


Which surpassed pre-pandemic levels by mid-2021



2021 GROWTH BOLSTERED BY CONSUMPTION

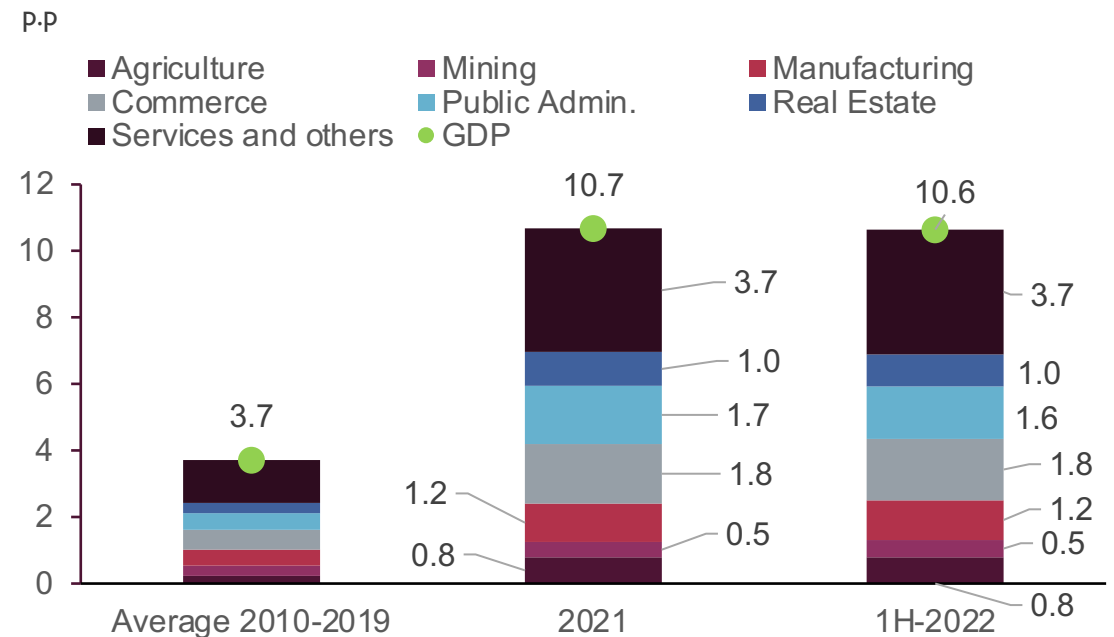
Consumption drive GDP growth, and continues to do so



Source: DANE

Note: Data for 1H22 is compared with 1H21

Commerce, Public Administration, and services contributed the most

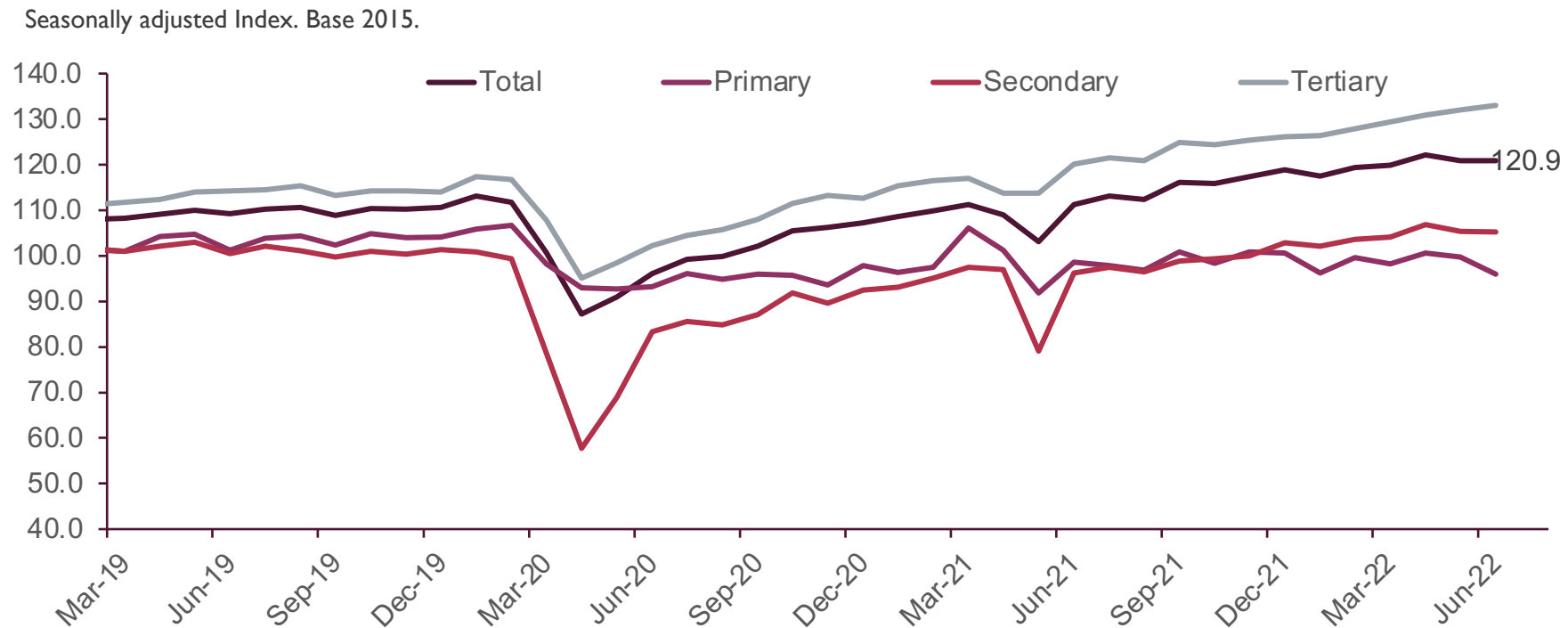


Source: DANE

Note: Data for 1H22 is compared with 1H21

ECONOMIC ACTIVITY CONTINUES TO RISE

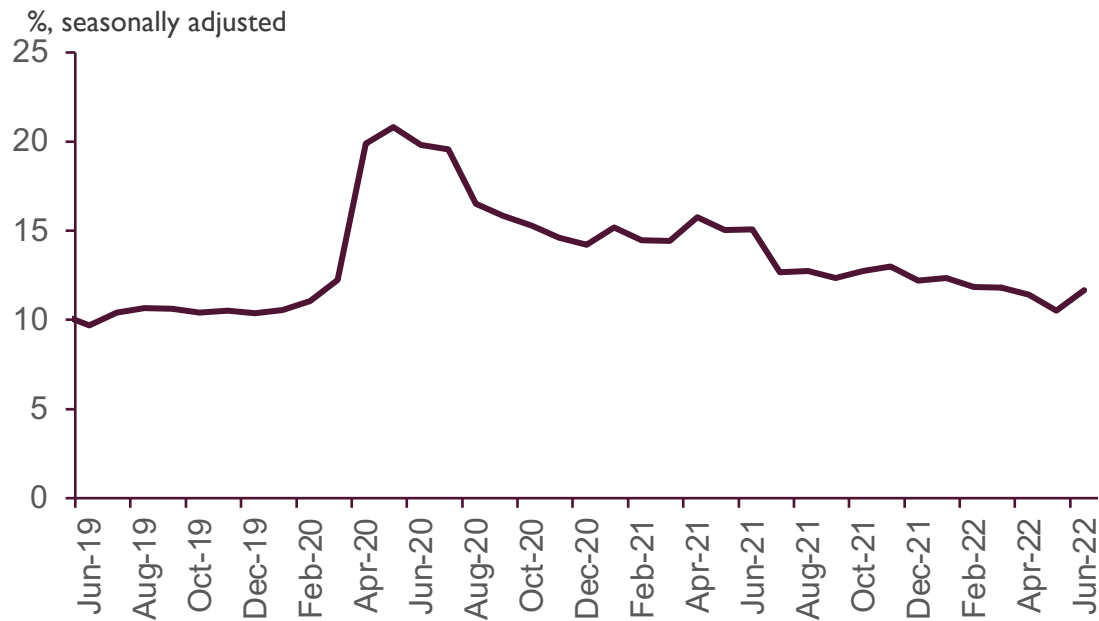
Tertiary sector leads the recovery in the economic activity index ISE



Source: DANE

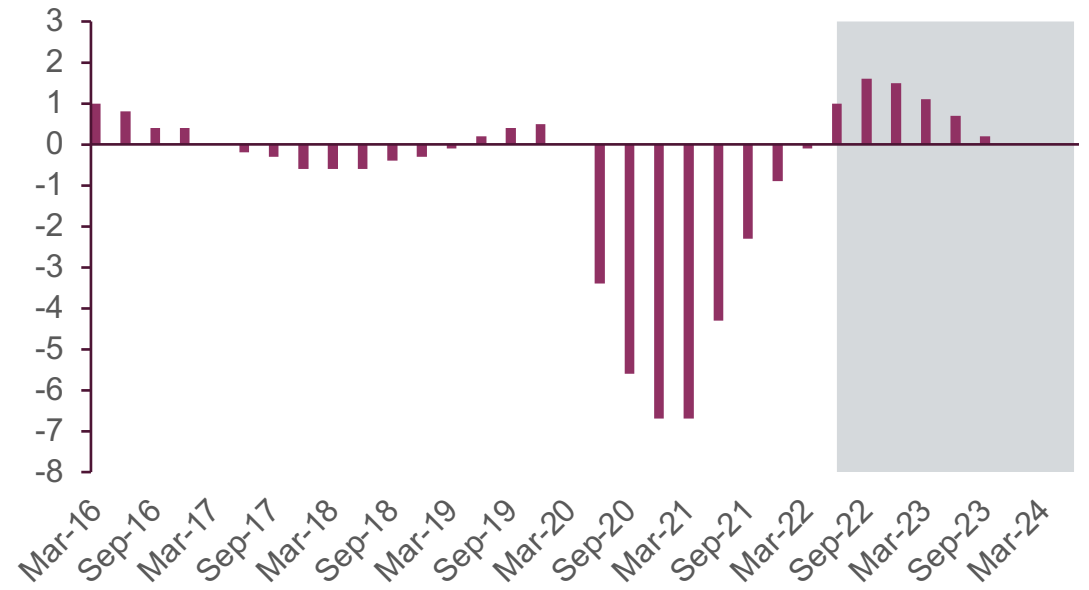
THE OUTPUT GAP IS CLOSING

Unemployment is in the double-digits, but similar to pre-pandemic levels



Source: DANE

Economic activity approaches potential GDP

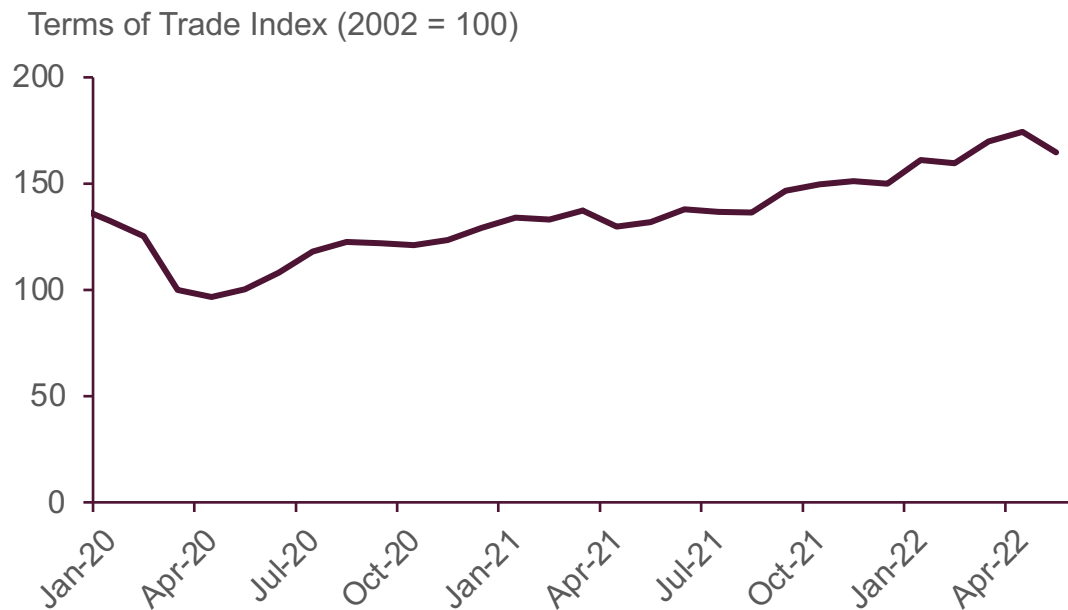


Source: BanRep's Monetary Policy report, July 2022

Note: Shaded area represents BanRep's forecast

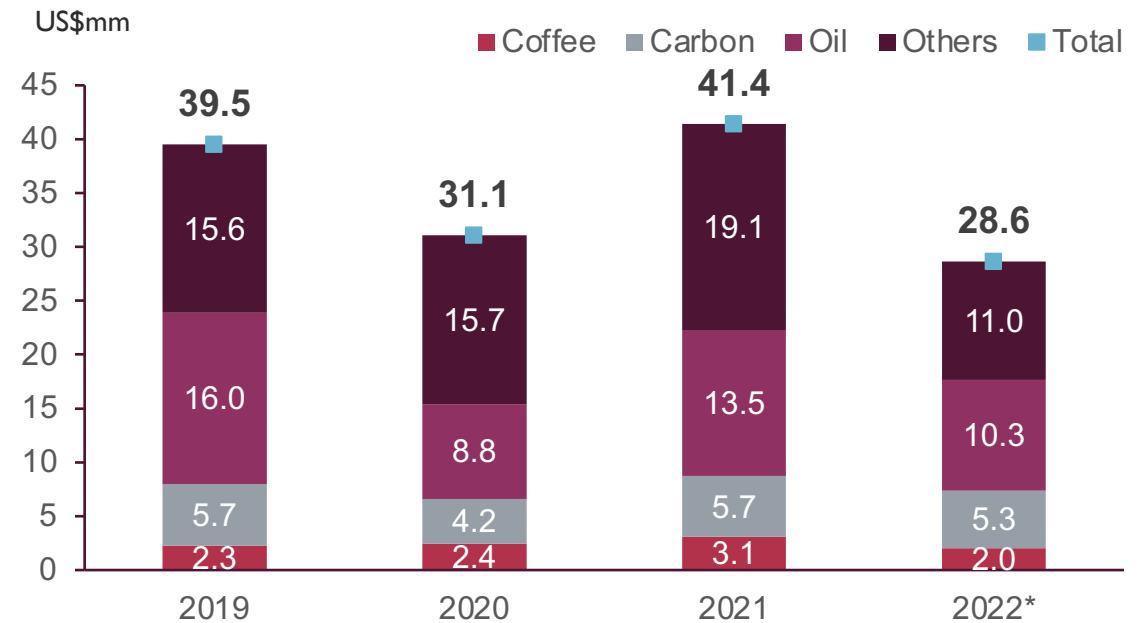
A REASON BEHIND THE BOOM: RISING EXPORTS

Terms of Trade have increased by 70% since the pandemic shock



Source: BanRep

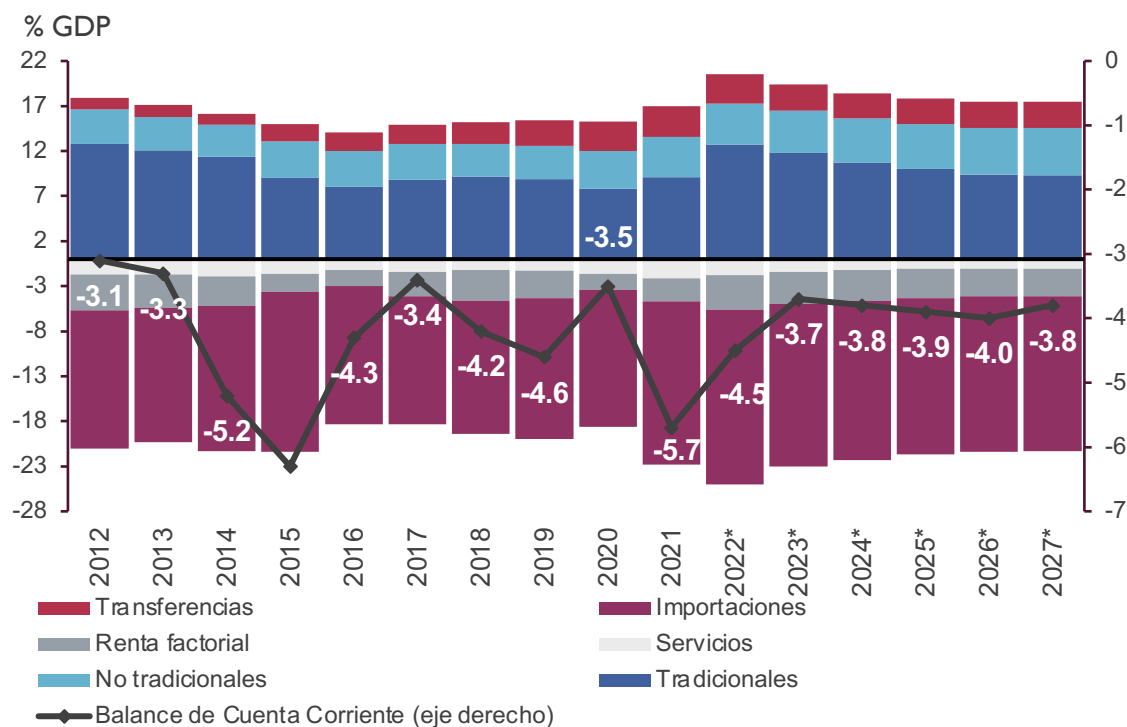
In 2022, export values will be 40% greater than in 2021



Source: BanRep y DANE
*Year to date until June 2022

CURRENT ACCOUNT DEFICIT REMAINS A PROBLEM

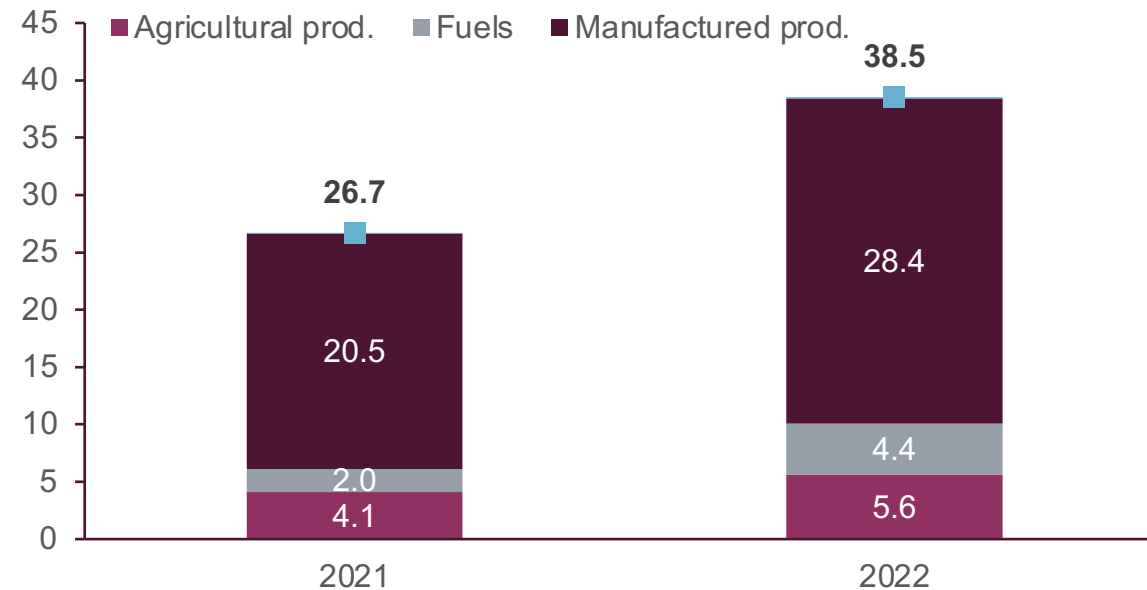
Current Account deficit is becoming a latent risk



Source: Marco Fiscal de Mediano Plazo de 2022 (MinHacienda), Banco de la República.
Cálculos DGPM - MHCP.
*Cifras proyectadas

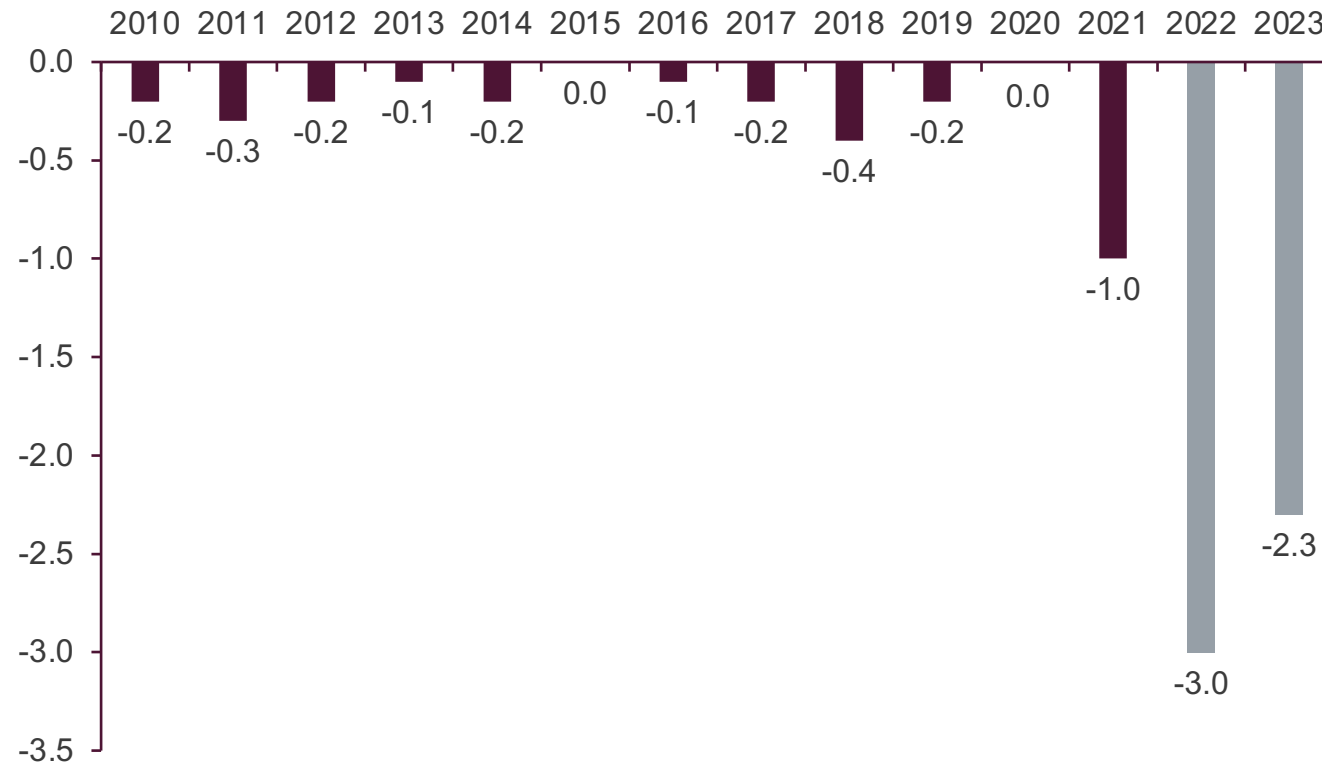
Imports are outpacing exports

CIF Imports according to product type
Rolling sum Jan-Jun (US\$ M)



Source: DANE

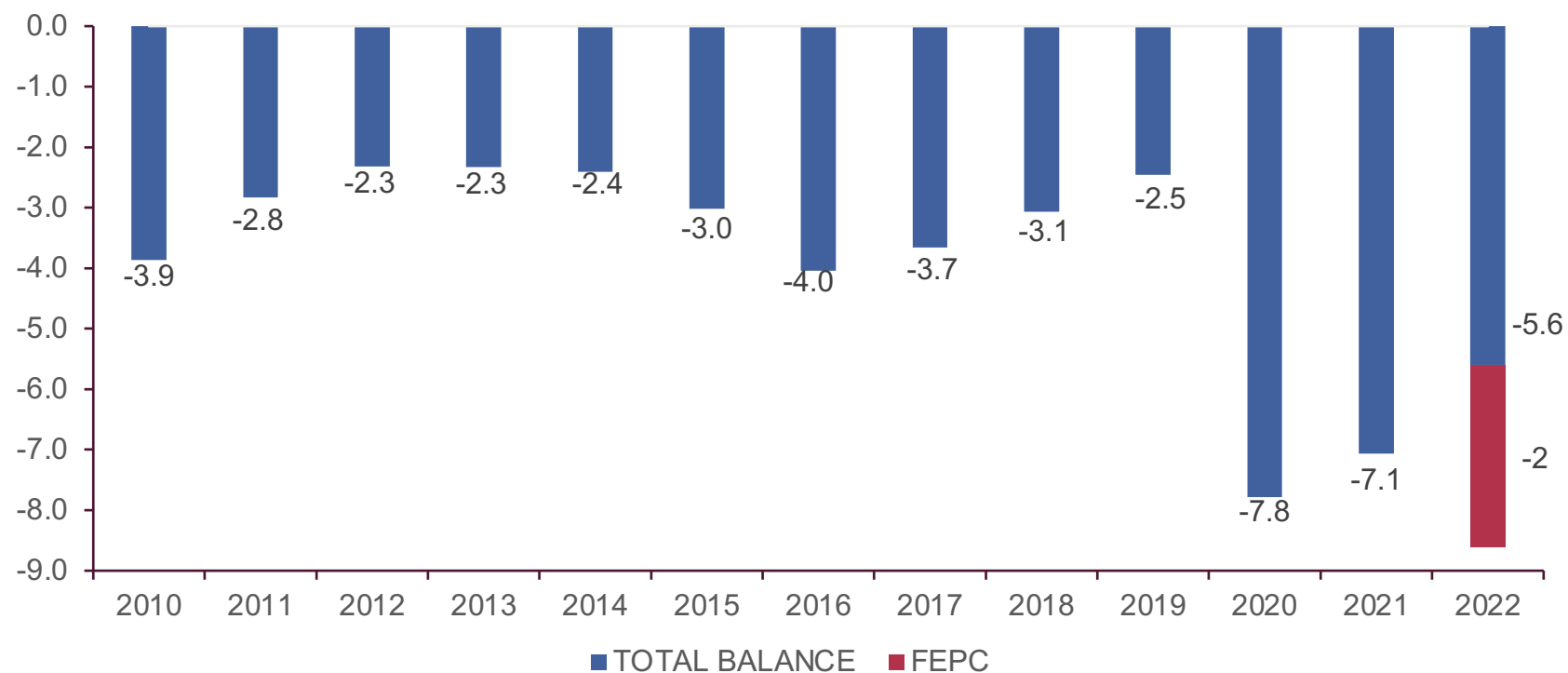
THE BOOM IS ALSO EXPLAINED BY THE EXPANSIONARY FISCAL POLICY: FISCAL DEFICIT CAUSED BY FUEL SUBSIDIES (% of GDP)



Source: MHCP y proyecciones CARF para 2022 y 2023

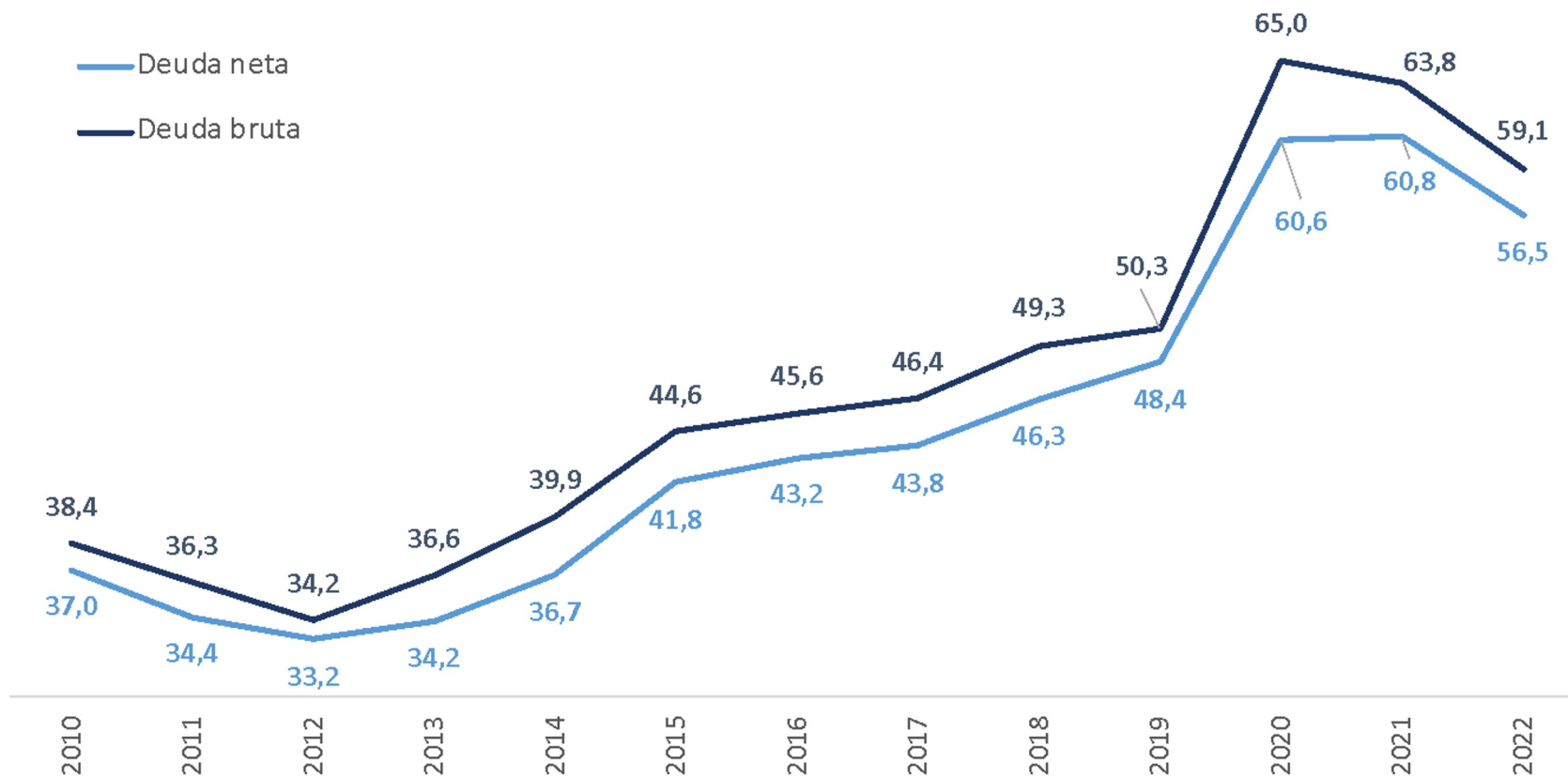
CENTRAL GOVERNMENT FISCAL BALANCE

(% of GDP)



Source: MHCP y CARF

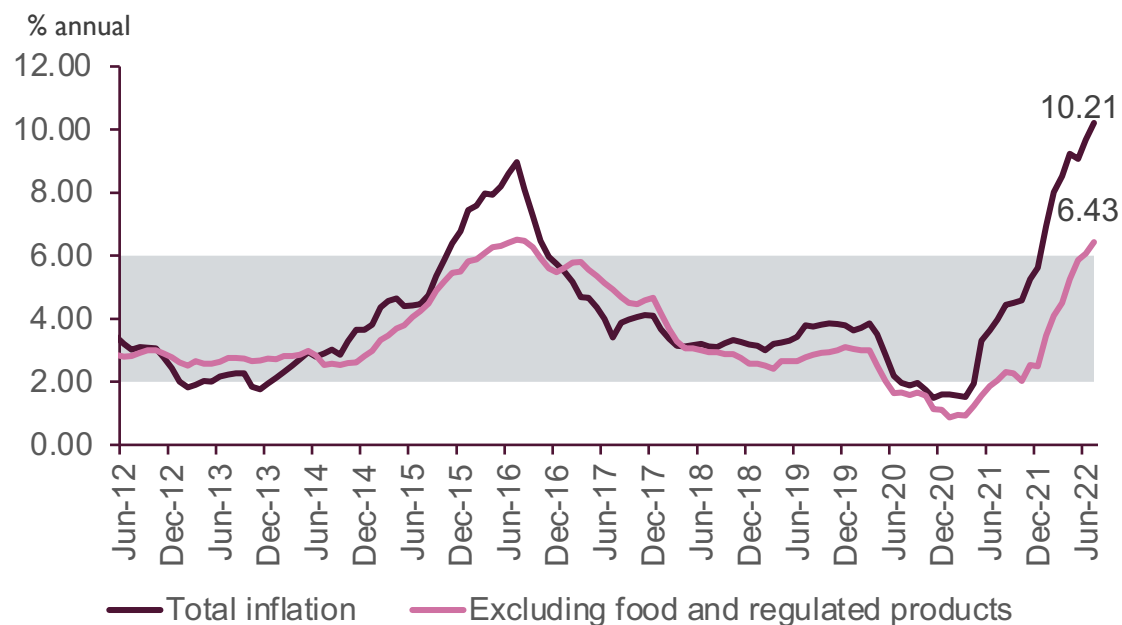
CENTRAL GOVERNMENT DEBT WITHOUT FULL EFFECT OF FUEL POLICIES (% GDP)



Source: MHCP

HIGH AND PERSISTENT INFLATION

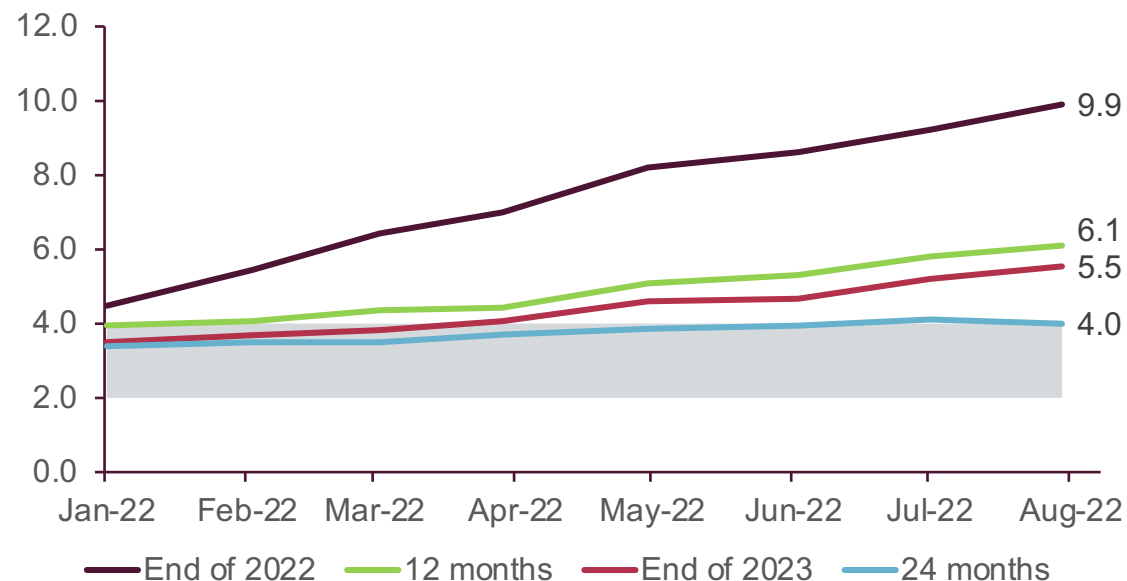
Total and core inflation are still over the target range



Source: DANE, BanRep

Note: Shaded area represents BanRep's target range

And inflation expectations continue to rise



Source: Encuesta de Expectativas económicas de BanRep, Junio de 2022

Note: Shaded area represents BanRep's target range

IT IS LIKELY THAT THE CENTRAL BANK WILL INCREASE INTEREST RATES FURTHER

Markets expect policy rate to reach 10% in late 2022, but could be more



After increasing the rate by 150 bp on July 29, 2022 (6-1 vote)

The Central Bank's last meeting minutes reveal the following:

Limited excess capacity

Risk of inflation expectations de-anchoring

Inflationary effects of the COP devaluation

Credit growth remains high

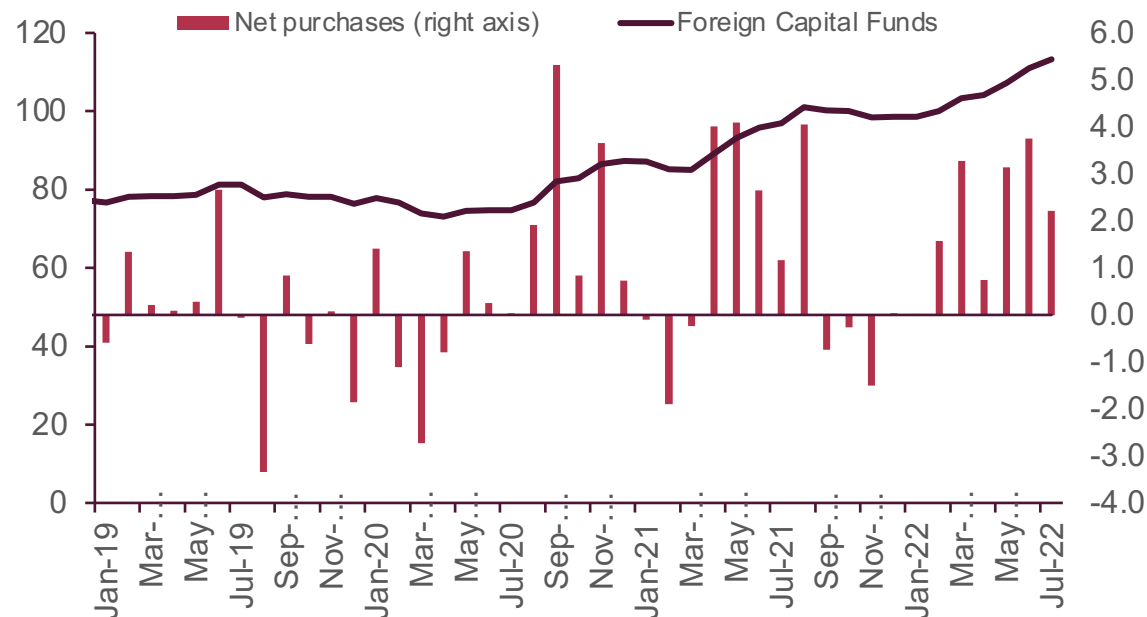
Source: Encuesta de Expectativas económicas de BanRep, Agosto de 2022

Note: La tasa esperada es la respuesta mediana

RISK: DECREASED INTERNATIONAL APPETITE FOR EMERGING MARKET DEBT

Although Colombia is still attracting foreign capital

Portfolio of TES belonging to foreign investors.
COP\$ Bn



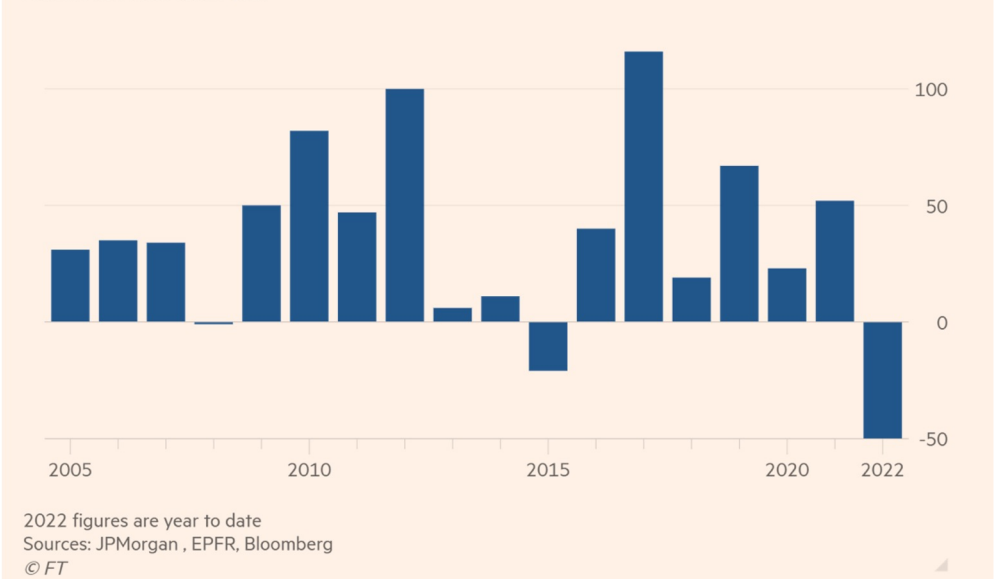
Source: IRC, MinHacienda

Note: Datos con fecha de corte 31 de julio de 2022

Less appetite for EM sovereign debt

Investors ditch emerging market bonds

Annual net fund flows \$bn

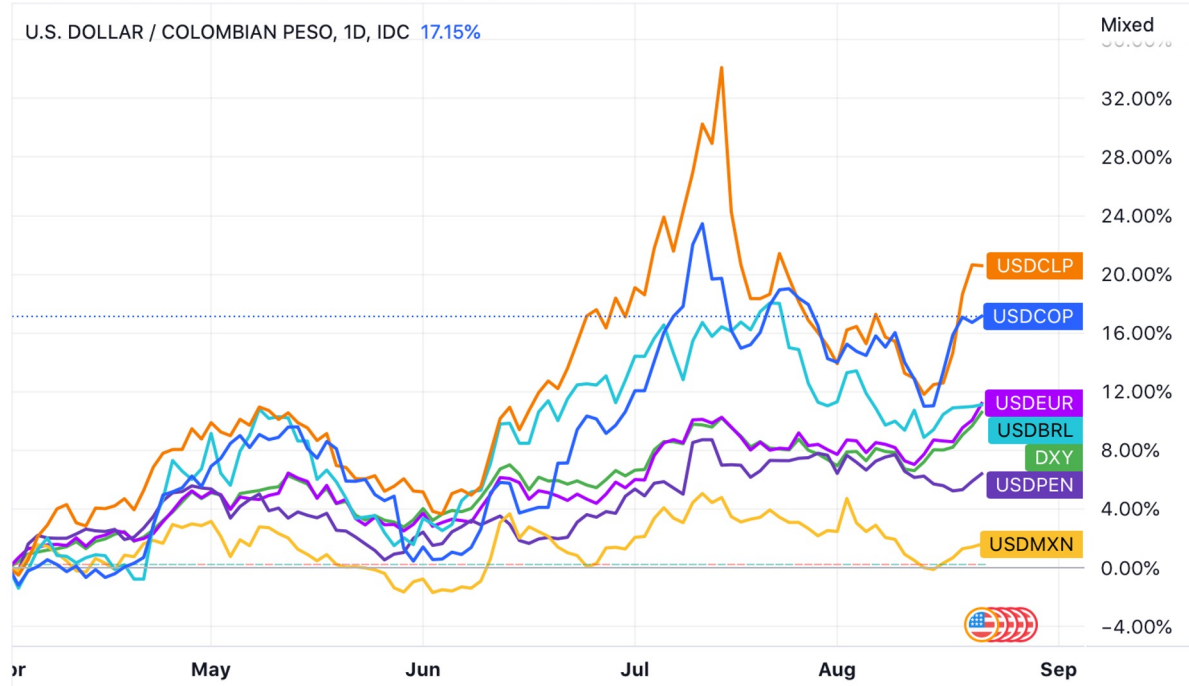


2022 figures are year to date
Sources: JPMorgan, EPFR, Bloomberg
© FT

WITHOUT FISCAL ADJUSTMENT THE EXCHANGE RATE AND THE SPREADS ARE SET TO INCREASE

COP depreciation is above peers

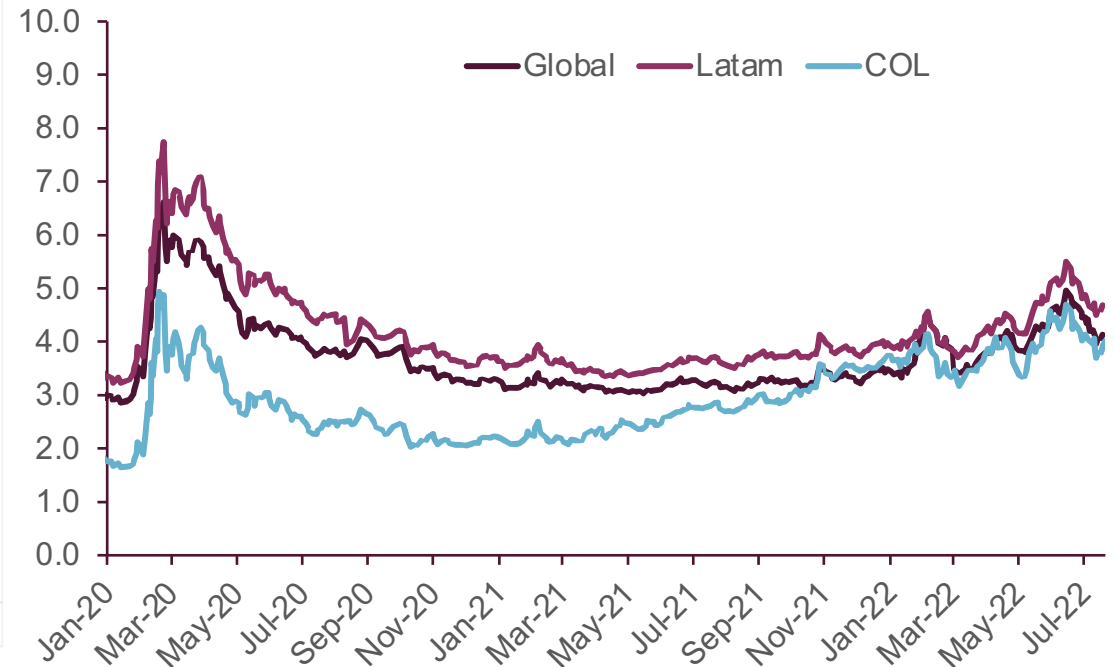
enriquesanzp published on TradingView.com, Aug 22, 2022 15:43 UTC



TradingView

Colombia's country risk is on the rise

EMBI Global Index, pp



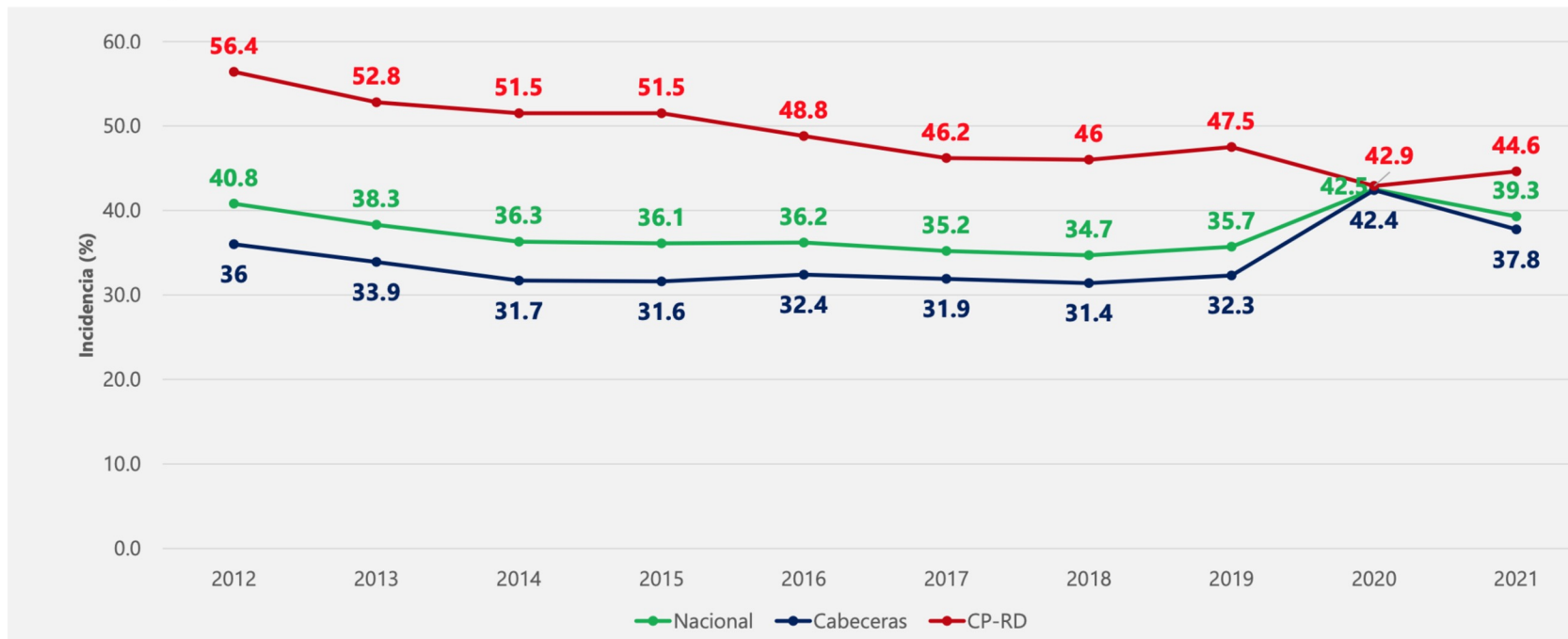
Source: Invenómica, J.P. Morgan

Note: Up to 19th of August, 2022

POVERTY RATES ARE STILL HIGH WITH RESPECT TO PRE-PANDEMIC LEVELS

In 2022 there are two opposing forces: higher inflation and lower unemployment. Which prevails?

Incidencia de pobreza monetaria
Principales dominios (2012-2021)



Fuente: DANE. Gran Encuesta Integrada de Hogares GEIH 2012-2021.
2020 – 2021: Match GEIH – RRAA Ayudas institucionales y PILA (MinSalud)

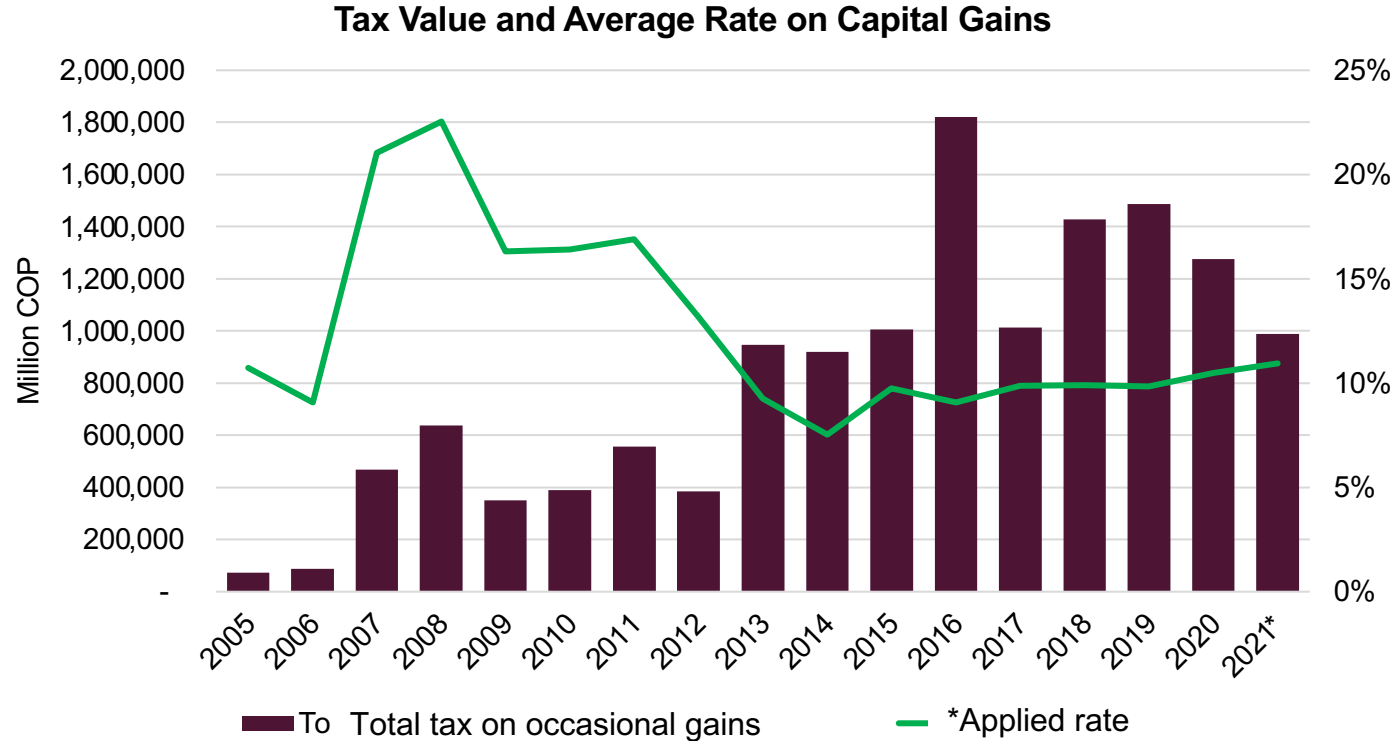
Tax Reform. Some measures correct aspects that were criticized in the 2018-2021 reforms		Comments
Days without VAT	Eliminates "Days without VAT", which were established in 2020	The balance of the "Days without VAT" policy is not positive
Discounts for "ICA" payments	Eliminates 50% discount derived from the payment for the ICA tax. Proposes 100% of the tax will be deductible as expense but not discounted.	Corrects a measure that has high fiscal costs
"Mega-Investment" special tax regime	Abolishes articles 235-3 and 235-4 of the current tax statute, eliminating the special regime for taxpayers that make new investments within the Colombian territory with a value above COP 1.1 bn, and that generate at least 400 jobs.	"Legal stability" contracts are costly and unnecessary
Categories of exempt-income	Modifying article 235-2 of the current tax regime, the following activities and enterprises become taxable: firms of "orange economy", investments directed to increase agricultural productivity, incomes associated to social housing, new forest plantations, river transportation services, literary creations and cinematography.	Reverts some exempt income categories
"Zonas Económicas y Sociales Especiales" (ZESE)	Abolishes the regime that offers special benefits for the "special economic and social zones" (ZESEs) of La Guajira, Norte de Santander, Arauca, Barrancabermeja and Buenaventura – established through the Law 1995 of 2019 (PND 2018-2022) -.	Costly and with no strong impact

Measures to Strengthen Preexisting Initiatives	Comments	
<p>“Simple” tax regime</p>	<p>Modifies the rates for some income ranges and includes a new group of activities, such as “Education and activities related human health services and social assistance”</p>	<p>Makes the Simplified Regime more attractive</p>
<p>Limitation of tax exemptions for natural persons</p>	<ul style="list-style-type: none"> • Reduces maximum deductions and tax-exempt incomes from COP 191M to COP 46M. • Introduces tax on pensions in excess of COP 68M.) • 25% of the total employment income is tax-exempt, up to COP 30M per year. Currently, the exemption of 25% is applicable for employment incomes up to COP 118M. 	<p>Strongly reduces the amount of tax-exempt income for individuals</p>
<p>Taxes on individuals: dividends</p>	<p>Residents: Currently, dividends below COP 11M are not taxed. Marginal rate is 10%. Proposal to raise the exempt portion to XXX and include dividends in the so-called “cédula general”. Therefore, dividends could be subject to a progressive rate between 0-39%. Non-residents: The reform increases the current rate from 10% to 20%.</p>	<p>The increase in the applicable rate to dividend-derived income is excessive</p>
<p>Taxes on businesses: dividends</p>	<p>Increases taxes on dividends obtained by legal persons and foreign entities, that do not have their main legal address in Colombia, from 10% to 20%.</p>	

Measures to Strengthen Preexisting Initiatives		Comments
Wealth tax	<p>Proposes to reintroduce, permanently, the wealth tax for individuals for net worth in excess of COP 2,700M with a marginal rate of 0.5% per year for net worth under COP 4,600M, and a rate of 1.0% on higher values.</p> <p>The wealth tax existed until 2021 for new worth above COP 5,000 M.</p>	Keeps a tax that has existed since 2002, although it makes it permanent.
Carbon tax	Modifies the national carbon tax, including the domestic consumption of coal at a rate of COP 52,215 per ton (equivalent to US\$5 per ton of CO2).	Extends carbon tax to coal but keeps exemption of natural gas

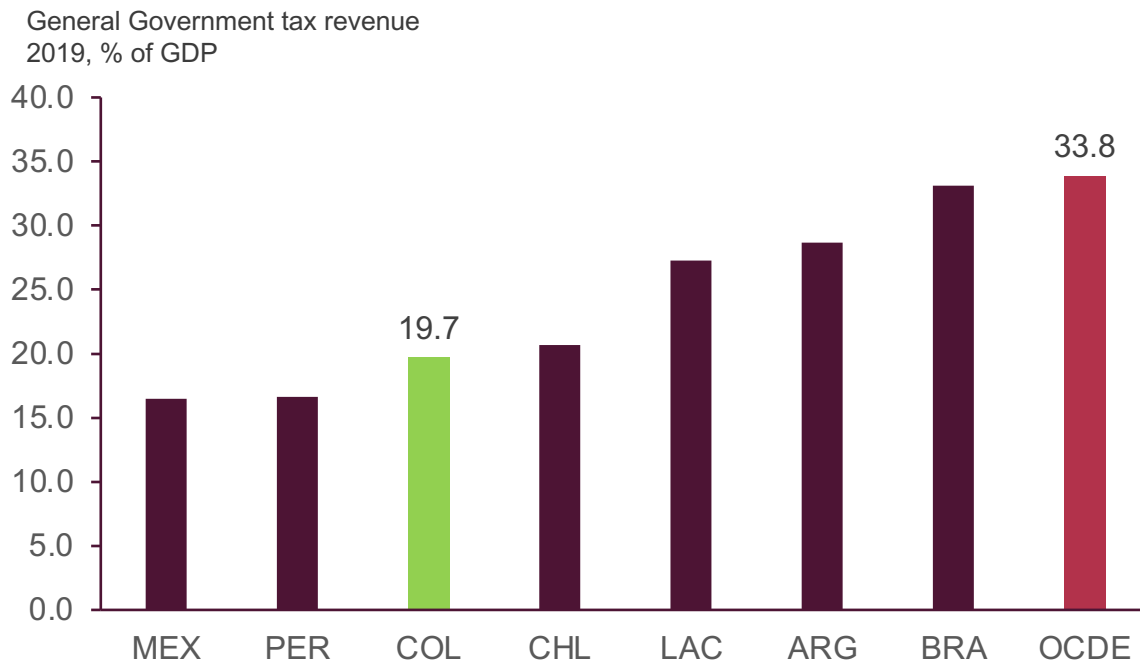
New taxes: Taxation of Extractive Industries	Comments	
<p>Taxes on exports</p>	<p>Creates a new tax on exports of oil, crude, coal and gold. The rate will be 10% of total export value in USD (FOB), paid monthly, when prices are above certain thresholds (oil USD\$48 per barrel, coal USD\$ 87 per ton, Gold USD\$400 per ounce).</p> <p>In the months in which the average observed monthly price of the ton of coal (Newcastle), the oil barrel (WTI) or the ounce of gold (Troy) is equal or lower than the threshold price, the tax will not be applicable for the corresponding product.</p>	<p>It should exclude gold, given the conditions of informality and marginalization of such sector.</p>
<p>Non-deductibility for extractive industry royalties</p>	<p>With the reform, royalties derived from mining and oil-producing activities will not be deductible for purposes of establishing taxable income for income taxes and complementary ones.</p>	<p>It is a discussion that extends over many years, with little consensus.</p>

Capital gains	Comments
<p>Currently, there is a single 10% rate for taxes on capital gains for all tax payers. The reform proposes:</p> <ul style="list-style-type: none"> • Include capital gains in the “cédula general” for individuals, which taxes income at rates in the range between 0-39%, depending on total income. • For national and foreign businesses, and for non-resident individuals, the rate rises from 10% to 30%. 	<p>The proposed rate will trigger high evasion, again.</p>



A TAX REFORM IN THE HORIZON : ON THE RIGHT PATH OR INSUFFICIENT TO SOLVE CURRENT ISSUES?

Comparatively, Colombia has a low fiscal revenue

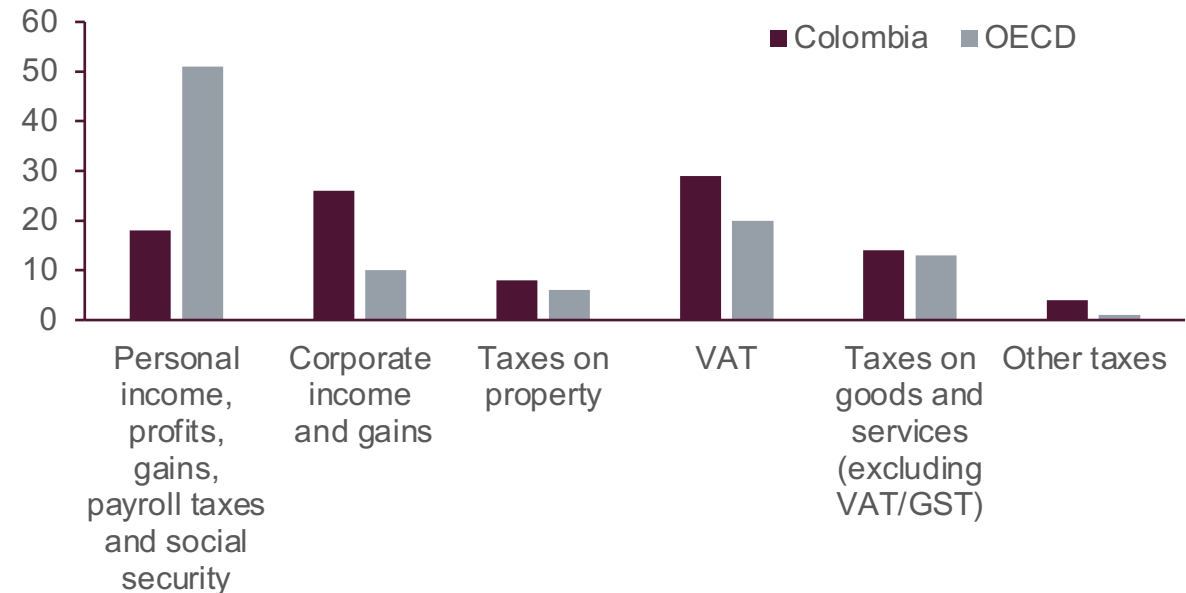


Source: OCDE

Note: LAC is a simple average between ARG, BRA, CHL, COL, CRI, MEX, PER.

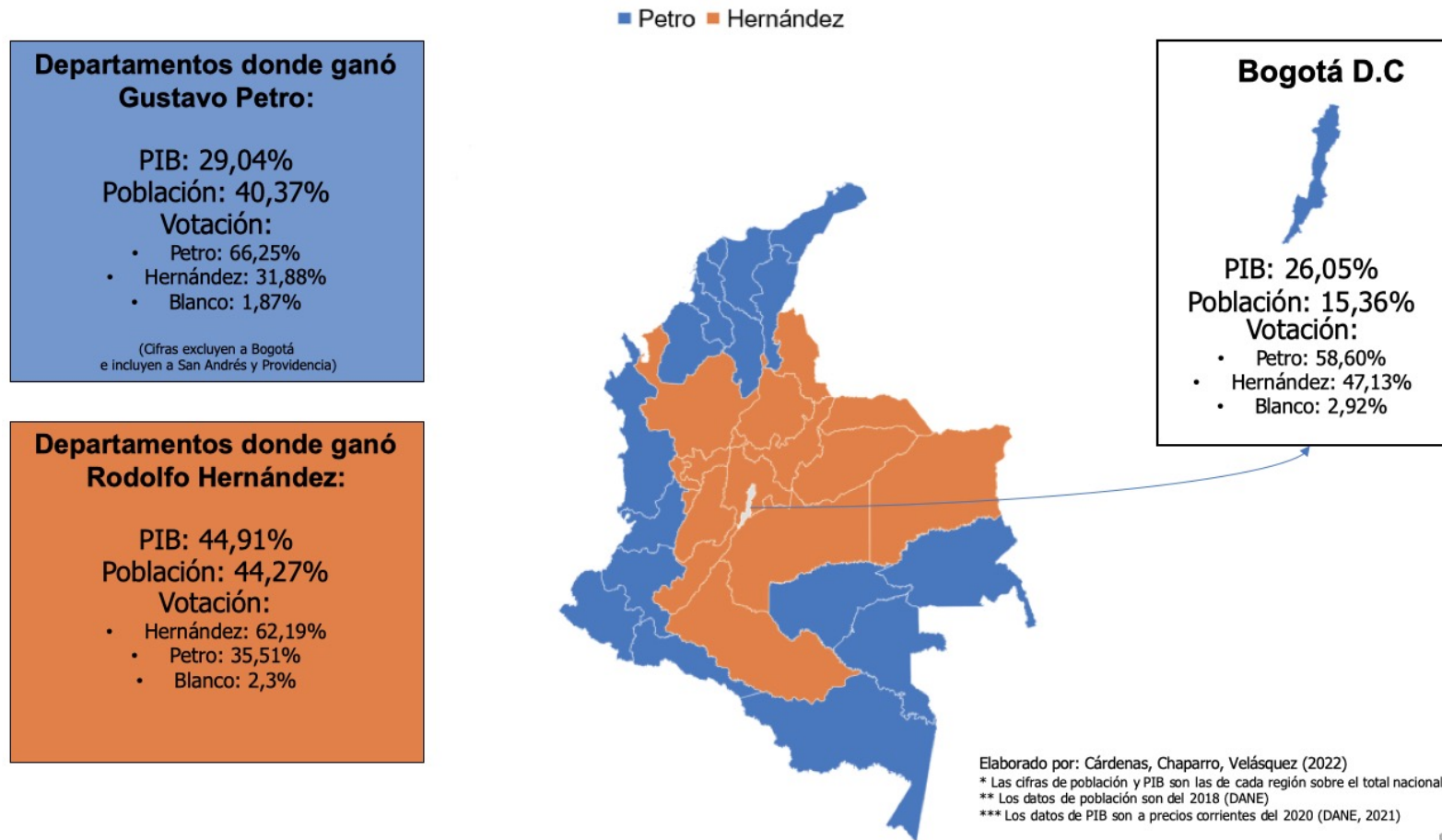
With an unbalanced tax base compared with and OECD average

% of total tax revenues, 2018



Source: OECD Colombia 2022 Economic Review

PRESIDENTIAL ELECTIONS: A *DIVIDED* NATION



SCENARIOS FOR 2023

	SOFT LANDING	FREE FALL
Fiscal Policy	Adjustment, following the fiscal rule	Deficit is maintained at 5-7% of GDP
Monetary Policy	Interest rate reaches 10-11%	Interest rate rises above 11%
Capital Flows	Inflows persist	Outflows begin
Exchange Rate	Stable (COP 4,000 – 4,300)	Devaluation (COP 4,400 – 4,800)
Economic Growth 2023	1-2%	Negative

THE RESULTS OF 2023 WILL BE CRUCIAL FOR 2024-2026

If 2023 is	From 2024 onwards, economic and political scenarios can be very different:	
	ECONOMIC 2024-26	POLITICAL 2024-26
SOFT LANDING	<ul style="list-style-type: none"> • Rising economic forecasts • Trust from markets and investors • Lower interest rates and inflation 	<ul style="list-style-type: none"> • Negotiated pro-equity reforms • Decreases in poverty and inequality
FREE FALL	<ul style="list-style-type: none"> • Necessity of a severe adjustment plan <ul style="list-style-type: none"> • Slow recovery • High interest rates and devaluation <ul style="list-style-type: none"> • Low private investment 	<ul style="list-style-type: none"> • Radicalization: government v. opposition <ul style="list-style-type: none"> • Search for “guilty parties” • Constitutional setbacks (Central Bank, private property, Constitutional Court, reelection)

THE COLOMBIAN ECONOMY: HEADING TO A SOFT LANDING OR A FREE FALL?

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08/23/2022