Colombia Watch

Trip notes: fiscal risks looming

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Key takeaways

- We visited Bogota and returned with the impression that fiscal risks are worse than we thought.
- Fiscal situation poses risks for COP (and inflation), prevents faster monetary easing, and creates a headwind for activity.
- We remain Marketweight on Colombia's EXD bonds. We receive 5y IBR. Long BRL/COP

Trip summary: fiscal risks seem worse than we thought

We spent two days in Bogota, meeting with policymakers, politicians, independent experts, and business associations. Except for the government, there appears to be consensus that the fiscal rule law was violated in 2024 for the first time since its inception (in 2011). The fiscal battle for 2025 is uphill, which poses risks for the exchange rate (and inflation), forces the central bank to go slower on monetary easing, and slows activity.

Taking stock of what happened in 2024

The 2025 Financing Plan (official fiscal update) brought bad news for the market in February, with unprecedented arguments ("bad luck and policy mistakes") to bend the fiscal rule law. The Ministry of Finance announced that in 2024 the fiscal deficit was 6.8% of GDP, much higher than in 2023 (4.3% of GDP) and the deficit they previously "estimated" to be consistent with the fiscal rule law for 2024 (5.6% of GDP).

Fiscal rule law is losing its meaning

We say "estimated" because the fiscal rule target is defined for a non-observed variable called the "structural primary balance excluding one-off transactions", which must consider three main adjustments (economic cycle, oil cycle, and one-off transactions) to trace back the observed fiscal deficit. Adjusting the economic and oil cycles is standard for economists. But defining "one-off transactions" is proving to be subjective and serves as an excuse for high fiscal deficits.

"Bad luck" is now considered a one-off transaction

The government estimates COP 32tn (1.9% of GDP) of "one-off transactions" for 2024. The bulk of the COP 32tn comes from a "non-anticipated decline in tax revenues" (COP 26tn, 1.5% of GDP). Colombia had never experienced a decline in tax revenues during a year in which GDP growth was positive, which is why they consider this highly atypical event as a "one off transaction". Our interpretation is that – in other words – "back luck" now qualifies as a "one off transaction".

And "policy mistakes" too

Also, within the item of "non-anticipated decline in tax revenues", the government cites a decree passed by former Finance Minister Jose Antonio Ocampo in February 2023 that substantially increased anticipated income tax payments and monthly withholding, shifting tax collection from 2024 to 2023. Thus, one could say "policy mistakes" now also fit the government's definition of "one-off transaction".

CARF says 2025 budget is off by 2.6% of GDP

The Autonomous Fiscal Council (CARF) says compliance with the fiscal rule law in 2025 will require an adjustment of COP 46tn (2.6% of GDP). Their projection was accurate in 2024, so it's worth paying attention of what they are saying now. In their view, it's more an expenditure than a revenue problem. Expenditures in 2024 were 4.7pp of GDP higher than in 2019 (and even 0.3pp higher than in the pandemic year). Revenues barely increased by 0.4pp of GDP from 2019 to 2024 after three tax reforms.

The "budget reserves" (expenditure lags) issue

In Colombia, fiscal expenditures have four stages: appropriations, commitments, obligations, and payments. Expenditures are accrued/recorded as part of the fiscal balance once they reach the "obligation" stage. "Budget reserves" are defined as commitments that didn't reach the obligation stage in their fiscal year. They are a backlog of lagged expenditures that can materialize later.

3x "budget reserves" is like operating with more leverage

CARF notes "budget reserves" have more than tripled, reaching COP 51tn (3.2% of GDP) compared to COP 16tn in 2021 (normal levels). This abnormally large backlog of expenditure commitments is a fiscal risk for 2025. However, we think "budget reserves" as one of the measures to narrow the fiscal deficit will increase further in 2025, rather than decrease, This is tantamount to kicking the can down the road. From the government's perspective, it's like operating with more leverage against its suppliers.

"Budget reserves" levels in contravention of Budget law

The current level of "budget reserves" (COP 51tn) are more than double the legal ceiling determined by the Statutory Budget Law (around COP 20tn). The legal limit is the addition of 2% of current expenditures and 15% of capex. To attack the root cause of the problem, the government would need to deliver deep budget cuts. Yet they argue it's not viable for them to cut rigid expenditures (health, education, pension, transfers to local governments) because they are protected by Constitutional mandates that have a higher-ranking order than the Statutory Budget Law.

We forecast fiscal deficit narrowing to 6% of GDP in 2025

We expect the central government's deficit to narrow to 6% of GDP from 6.8% last year. This is above the Ministry of Finance projection of 5.1% of GDP, which is supposed to be consistent with the fiscal rule target. We assume an active scenario in which the government delivers budget cuts (flexible expenditures in the budget are around 2% of GDP according to CARF) and runs larger "budget reserves" (to postpone the accounting of expenditures).

Drivers of GDP growth should more than offset fiscal drag

The fiscal impulse should turn from positive to negative between 2024 and 2025, assuming the government does deliver some fiscal consolidation. Domestic demand would be suppressed by fiscal cuts in the short term. Nevertheless, we expect this drag to be more than offset by lower inflation (increasing real wages), lower interest rates, worker remittances (US deportation fear factor à la Central America), and stronger business sentiment (in the run-up to the May 2026 presidential elections). We forecast GDP growth of 2.6% for 2025 (from 1.7% last year) and 2.8% for 2026.

Monetary policy: pause in March, cut in April

We change our view for the next Central Bank (BanRep) decision to take place on 31 March to a pause (from a 25bp rate cut). Two upward inflation surprises (January and February) following the previous meeting will be hard to ignore. Moreover, the last figure on retail sales came in a lot stronger than expected. And bad news on the fiscal situation is another consideration that warrants cautiousness from board members. We expect March's decision to be split (4 vs. 3). Nevertheless, we still have high conviction that BanRep will reach a terminal rate of 7% (by mid-2026). Even some board members from the hawkish camp hope to resume rate cuts later this year. BanRep doesn't view the latest inflation data as terrible (because core inflation is falling). They consider the current monetary stance as “highly contractionary”.

Politics: public consultation, reforms, and elections

Given strong signals from the Senate that they will reject the health and labor reforms and an impeding Constitutional Court ruling that may repeal the pension reform (by May), the government proposes public consultation to defend these three reforms. Political analysts think the public consultation will fail because the voter threshold is too high (require minimum participation of 13.5mn people whereas President Petro won the 2022 election with 11mn votes). Meanwhile, presidential election polls indicate Vicky Davila consistently at the top of voter preferences.

Vicky Davila’s libertarian/conservative economic proposals

Davila has libertarian economic proposals, such as a downsizing the government, boosting oil & gas production, and slashing taxes. Her tax plan is called “10-10-10”: 10% flat corporate income tax (from 35% currently); 10% personal income tax (from 39% highest marginal rate); and 10% sales tax (from a 19% value-added tax). The plan is market friendly, but difficult to implement. Mexico tried a flat tax more than 10 years ago (called “IETU”) but then cancelled it. Also, we think VAT is superior to sales tax because it prevents “cascading” and provides more traceability to tackle evasion.

Exhibit 1: Summary of BofA’s macroeconomic forecasts for Colombia

The fiscal deficit will likely remain elevated in coming years

COLOMBIA	2017	2018	2019	2020	2021	2022	2023	2024	2025F	2026F
Nominal GDP (US$ bn)	312	334	323	271	314	346	369	418	413	430
GDP growth (%)	1.4	2.6	3.2	-7.2	10.8	7.3	0.7	1.7	2.6	2.8
Inflation (%, end-of-period)	4.1	3.2	3.8	1.6	5.6	13.1	9.3	5.2	4.3	3.4
Exchange rate (USDCOP, end-of-period)	2,984	3,250	3,277	3,430	4,080	4,853	3855	4406	4,550	4,500
Monetary policy rate (%)	4.75	4.25	4.25	1.75	3.00	12.00	13.00	9.50	8.00	7.00
Central government primary balance (% of GDP)	-0.8	-0.3	0.4	-5.0	-3.6	-1.0	-0.3	-2.4	-1.7	-1.1
Central government overall balance (% of GDP)	-3.7	-3.1	-2.5	-7.8	-7.0	-5.3	-4.3	-6.8	-6.0	-5.4
Central government gross debt (% of GDP)	46.4	49.3	50.3	65.0	63.0	60.8	56.7	62.3	63.9	64.8
Current account balance (% of GDP)	-3.2	-4.2	-4.6	-3.4	-5.6	-6.0	-2.2	-1.8	-2.1	-2.3

Source: BofA Global Research, Statistics Agency (DANE), Central Bank (BanRep), Ministry of Finance (Hacienda)

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EXD Strategy: Remain Marketweight

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We maintain our Marketweight recommendation on Colombia’s external bonds (EXD). We acknowledge wide valuations (Colombia is one of the sovereigns that trades widest to its ratings in LatAm), but we think it is a crowded trade and the story lacks significant potential short-term positive catalysts. Overall, we think it is too soon to trade the 2026 elections, which are more than one year away. We are worried about the precedent that the government set with non-compliance with the fiscal rule in 2024, as it generates doubt about fiscal discipline in a pre-election year. That said, the proximity of the election could make investors more willing to overlook another year of weak fiscal performance as the final 2025 figures would only be released in early 2026.

LDM Strategy: Still value in rates

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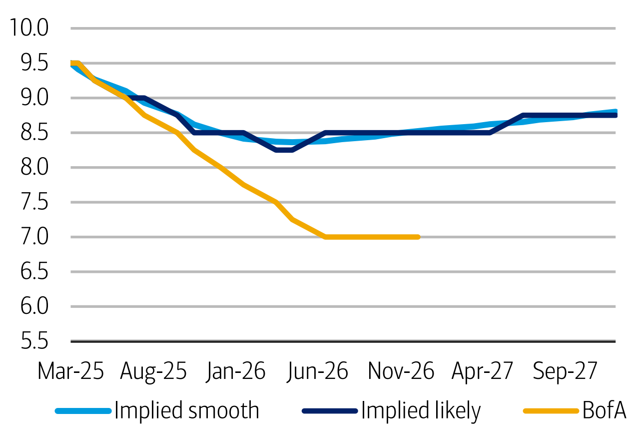
Despite the change in our call to a slower easing cycle, we continue to believe there is meaningful value in Colombian rates. The steady pace of monetary policy easing should, in our view, translate into a deeper easing cycle, as a cautious approach should allow a more sustainable anchoring of inflation expectations. Our call continues to be for a 7.0% terminal rate, which sharply contrasts with the 8.50% market-implied terminal rate (see Exhibit 2). We therefore continue to like risk-reward of receiving 5y IBR (current: 8.43, see report Receive 5y IBR amid underpriced easing cycle). Given the significant fiscal challenges ahead, we prefer to position in the belly rather than the back end of the curve. Risks are further pressure in core rates, a reacceleration in inflation, and a de-anchoring of inflation expectations in Colombia.

In FX, we continue to believe that the Colombian peso (COP) has outperformed beyond what would be consistent with fundamentals. We think year-to-date performance can be largely attributed to the high carry, as COP continues to be overvalued in our fair value models. Yet, we believe that risk-reward of carry strategies in such an uncertain global environment is not attractive. As a result, we continue to like to fade recent COP strength and like risk-reward of being long BRL/COP (current: 716, see report Buy BRL/COP). We are also convinced that COP is underpricing fiscal risks. Risks to the trade are a worsening of the fiscal outlook in Brazil or a dovish shift in Brazil.

Exhibit 2: Market-implied policy rate vs. BofA (%)
We think the market is underpricing the easing cycle in Colombia



Source: BofA Global Research, Bloomberg

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Valuation & risk

Colombia (COLOM)

We are Marketweight on Colombia's external bonds. Colombia trades cheap to its ratings, but we think valuations are fair given incomplete fiscal adjustment and pipeline of external debt issuance.

Downside risks to bonds are non-compliance with fiscal rule or proposals to amend it, larger than expected fiscal slippage, low growth, credit rating downgrades.

Upside risks to bonds are moderation of reforms, backtracking on the ban on new oil exploration contract, faster growth, higher oil prices.

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Colombia / COLOM

Sovereign	Date[R1]	Action	Recommendation
Colombia / COLOM	28-Feb-2022		Overweight
	31-May-2022	Downgrade	Marketweight
	28-Nov-2022	Upgrade	Overweight
	15-Feb-2024	Downgrade	Marketweight
	21-May-2024	Downgrade	Underweight
	20-Jun-2024	Upgrade	Marketweight

Table reflects credit opinion history as of previous business day's close. ^First date of recommendation within last 36 months. The investment opinion system is contained at the end of the report under the heading "BofA Global Research Credit Opinion Key."[R1]

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