# *LatAm Views:* Oil and FX Vulnerability in Colombia

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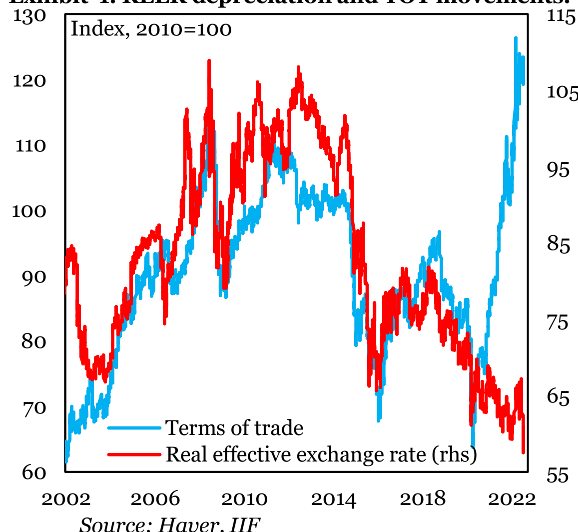
- The Colombian peso has seen a plunge this year amid global and local factors.
- External and fiscal imbalances remain wide despite a windfall from commodity exports.
- Uncertain policy plans of the incoming administration have exacerbated FX pressure.

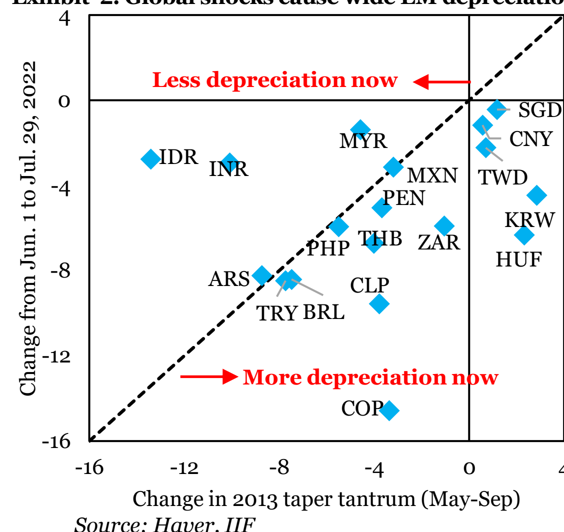
The Colombian peso has seen a plunge since May driven by the dollar strengthening amid fears of global recession, macro fundamentals, and uncertainty over the policy plans of the incoming administration (Exhibit 1). The terms of trade windfall that characterized the first half of 2022 may have started to reverse, and both external and fiscal imbalances remain significant. The current account deficit widened to 6.2% of GDP in Q1, and recent trade data suggests the deficit has eased only modestly. In this ***LatAm Views***, we take stock of Colombia's external and fiscal imbalances and add some perspective based on initial signals of President-elect Gustavo Petro's policy plans (he takes office on August 7). Petro has vowed to halt new oil and gas exploration, aiming to accelerate the energy transition toward renewables, but major investor concerns arise from the pace and timing of the transition, its impact on the external accounts and growth outlook, and prospects for continuation of fiscal adjustment. In a scenario where crude production is based only on existing exploration contracts, we estimate oil exports would fall up to 2 percentage points of GDP per year by 2028, relative to baseline projections, worsening external account dynamics. In this context, we expect currency volatility to continue. While successful efforts so far to create a broad-based government coalition suggest that President-elect Petro would aim at more moderate plans, pressure amid increased social demands could trigger a more forceful policy shift.

**Exhibit 1. REER depreciation and TOT movements.**




*Source: Haver, IIF*

**Exhibit 2. Global shocks cause wide EM depreciation.**




*Source: Haver, IIF*

The Colombian peso has seen a sharp depreciation over the last month. The depreciation partly reflects strengthening of the US dollar worldwide, driven by fears of global recession and aggressive Fed tightening. The spike in commodity prices triggered by the war in Ukraine, which initially fueled currency appreciation in commodity exporters, may be starting to reverse, weighing on countries like Chile, Colombia, and Brazil. Notably, FX losses in Colombia have been an order of magnitude higher than during the 2013 taper tantrum, when abrupt tightening of US monetary conditions fueled EM currency depreciation (Exhibit 2). Preliminary trade data show imports eased in June after several months of increases driven by consumption and investment in machinery and equipment. However, the trade deficit remained wide in Q2 (Exhibit 3). Commodity export volumes have not bounced back meaningfully, stabilizing well below their 2015 peak. We expect gradual deceleration in domestic demand and ongoing recovery in tourism to help narrow the current account deficit in H2, ending at 4.8% of GDP this year, and moderating to near 4.0% in 2023. Robust FDI inflows, particularly non-oil, would largely finance the current account deficit (Exhibit 4). Our capital flows tracker suggests portfolio inflows remain resilient, with net purchases of local currency government bonds through June. Sustained resident capital inflows could be partly offset by higher-than-usual resident outflows, triggered by fears of tax changes and further FX losses. However, persistently wide deficits could become harder to finance under heightened policy strain.

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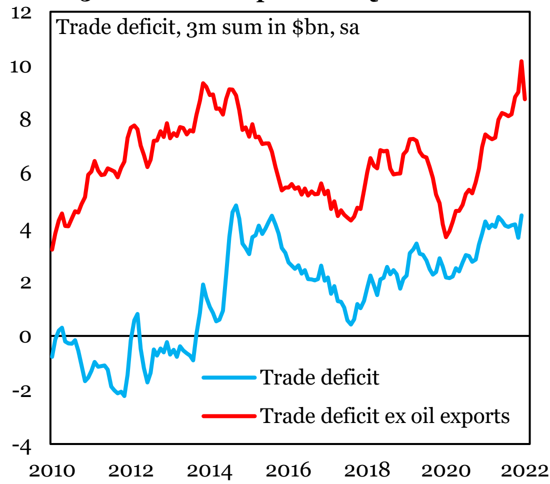
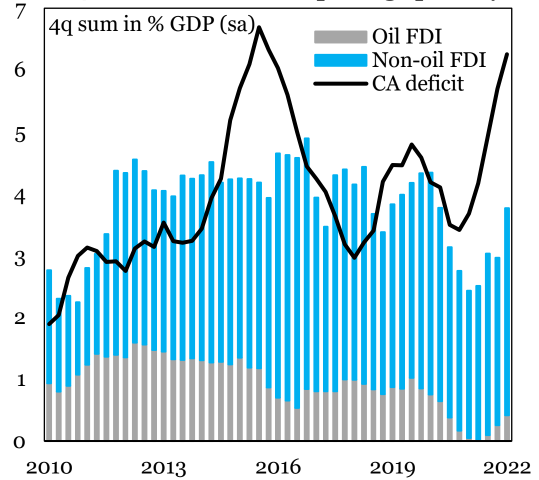
**Exhibit 3. Trade deficits persist in Q2 data.**




*Source: Haver, IIF; Trade deficit up to May 2022.*

**Exhibit 4. FDI in the oil sector picking up slowly.**

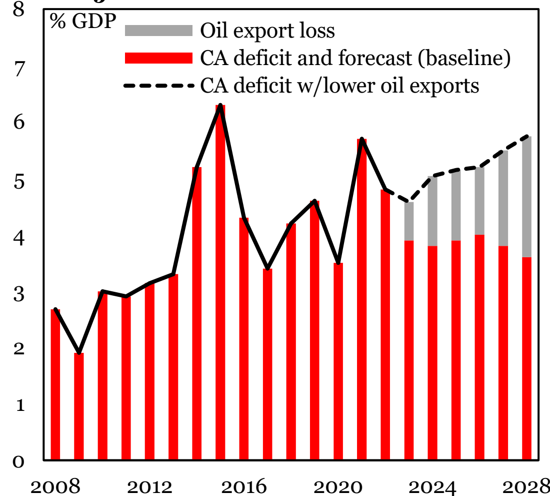



*Source: Haver, IIF*

In a scenario where the government halts new oil and gas exploration and determines to ban fracking, crude oil production would decline at a strong pace from already-low levels. The country would move from exporting about 4.2% of GDP in crude and oil derivatives a year to becoming a net oil importer by 2028, earlier than projected based on proven reserves and gains from new exploration. In this context, we estimate oil export losses relative to the base scenario of 0.7% of GDP in 2023, 1.2% in 2024-26 and 2.0% onwards, pressuring external accounts (Exhibit 5). While domestic demand would weaken, historical experience suggests that import compression and the reaction of non-oil exports to real depreciation would be insufficient to achieve meaningful external adjustment. Partially easing concerns, Petro's pick for Finance Minister, José Antonio Ocampo, has signaled that the energy transition would proceed gradually to allow time for policies to spur export diversification.

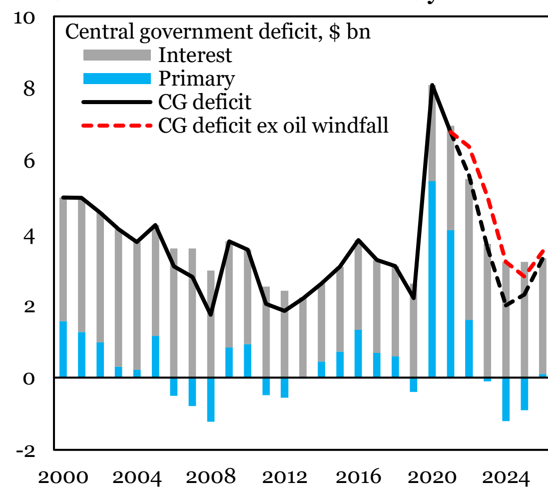
Fiscal strains continue to weigh on sentiment despite an improved outlook. According to the 2022 Medium-Term Fiscal Framework, the deficit was lower than expected last year (7.1% of GDP) driven by the growth rebound and reduced tax evasion. The fiscal imbalance is likely to narrow to 5.6% of GDP this year, below 6.2% projected previously, easing to 3.6% in 2023 and 2.0% in 2024 (Exhibit 6). While the higher revenue could be temporary, spending is set to remain above 2019 levels. New spending commitments include higher central government transfers to sub-national administrations and gradual repayment of the shortfall in the oil price stabilization fund, which could reach 3% of GDP by year-end. In this context, an ambitious tax reform to finance a large spending package (above 10% of GDP) will be a major test for the incoming administration. Overall, external constraints, checks and balances, and consolidation of political alliances will likely lead President-elect Petro to pursue more moderate plans. However, more forceful policy changes are still feasible, partly given the commitment with energy transition goals, and the risk of increased tensions with the more left-leaning sectors pressuring to implement an ambitious social agenda.

**Exhibit 5. Wider deficits in the absence of new oil.**




*Source: Haver, ANH, IIF*

**Exhibit 6. Lower fiscal deficits driven by oil windfall.**




*Source: Haver, 2022 MTFF, IIF*

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