

International Commentary — May 27, 2022

Colombia's Turn to Lean Left?

Summary

In mid-2020, we identified rising populism and support for populist-style political candidates to be a long-term theme that emerged from COVID. Latin America has been a region where this theme has materialized, and with Colombians heading to the polls this weekend, opinion polls suggest Colombia may be on the verge of electing their own populist president. As of the latest polling data, the populist and left-leaning Gustavo Petro is leading opinion polls; however, a Petro win is far from guaranteed as opposition candidates have demonstrated strong momentum in recent weeks. In this report, we lay out each of the main candidates' top policy proposals and gauge potential market reactions to the outcome of the first-round vote.

While we believe a Petro victory would represent a sea change in Colombian politics, a Rodolfo Hernandez administration could place Colombia's public finance position on a worsening trajectory and ultimately push Colombia's sovereign credit rating further into non-investment grade territory. In the lead-up to the election, local financial markets have been calm. But, we worry a scenario where Petro meets Hernandez in a runoff vote could unsettle financial markets and put sovereign debt and the peso under pressure as the risk of deteriorating fundamentals would rise and be a focus of market participants. Long term, a divided Colombian congress should keep many of the more radical policy proposals from being implemented, although policy paralysis and precarious public finances should keep Colombia in non-investment grade rating territory.

Economist(s)

Brendan McKenna

International Economist | Wells Fargo Economics
Brendan.Mckenna@wellsfargo.com | 212-214-5637

Populism Has Been Popular in Latin America

Latin America has arguably been the region most affected by the significant events of recent years. Regional economies experienced some of the sharpest activity declines during the depths of the pandemic, while a select few have yet to reach pre-pandemic nominal GDP levels. Inflation across Latin America has also been persistently high and has reduced purchasing power for households across the region. Many of the larger and more systemically important countries, such as Brazil, Chile, Colombia, Mexico, Peru and Argentina, are experiencing above-target price growth with little indication inflationary pressures have peaked. In response, central banks across Latin America are looking to raise interest rates into restrictive territory purely in an effort to contain inflation. Restrictive policy rates raises the probability that most Latam countries could fall into recession within the next 12 months. Needless to say, the economic prospects for Latin America are less than stellar. With economies struggling to gather momentum and the cost of living soaring, civilian protests and demonstrations have erupted across the region. These demonstrations started in 2020 during the rise of COVID and in response to lockdowns, intensified in 2021 during times of high inflation, and are ongoing in 2022 as price growth has yet to subside and poverty levels rise.

In our 2020 midyear outlook, **we identified renewed support for populism and populist leaders as one of the long-term themes likely to emerge from COVID.** Without question, Latin America has been a region to fit this theme and embrace populism during the COVID era. In 2021, Peru and Chile elected populist leaders with relatively unorthodox policy platforms. Both Castillo of Peru and Boric of Chile were elected under the promise of more government intervention, fiscal support for low-income households as well as creating more protectionist-style economies. In Brazil, Lula da Silva, the wildly popular former president known for lifting millions of Brazilian households out of poverty through social spending programs, is campaigning on a similar platform and leading opinion polls ahead of this year's election. And in Colombia, well known politician Gustavo Petro, has been able to rally support for his progressive policy platform. Petro also wants to increase social spending through fiscal support programs and is seeking to essentially upend Colombia's current economic model. While Brazil's election and political developments in Peru and Chile are certainly important and will be influential over the economic path of each country, Colombia's election is approaching and could result in an even further shift left in Latin American politics.

Colombia Election Primer. Who's Who?

The Colombian presidential election could be significant and represent a sea change in local politics. Most of Latin America has, at one point, elected a far-left leaning politician; however, Colombia has so far avoided that trend. Instead, Colombia has opted for more centrist candidates. Presidents have come from both sides of the political aisle, but none have looked to completely upend Colombia's economic model. On May 29, Colombians will head to the polls to vote in the first round of the election. **The first-round election outcome could indicate Colombia is pushing back on centrist candidate policy platforms and is ready to adopt a left-leaning policy agenda.**

As mentioned, **senator Gustavo Petro represents the far-left populist candidate of the type that Colombia has not elected so far.** Petro has a controversial background and political history and is widely viewed as a polarizing figure across Colombia. For context, at a young age Petro joined the 19th of April Movement (M-19), a guerilla revolutionary organization formed to protest the alleged fraudulent presidential election of 1970. M-19 was not as large as other guerilla groups in Colombia, but was widely viewed as violent and Petro's involvement in M-19 ultimately landed him in prison. Following a demobilization of M-19, Petro along with former M-19 members founded a political party and was eventually elected to Colombia's Chamber of Representatives to represent the capital city of Bogota. During his time in Chamber, Petro vehemently opposed the presidential administration of Alvaro Uribe and raised corruption allegations against Uribe. Following a failed, but better-than-expected, presidential campaign in 2010, Petro became mayor of Bogota where he had success implementing liberal policies, a shift from Bogota's history of operating under more conservative policies. After another unsuccessful attempt at the presidency in 2018, Petro has been a member of Congress where he has prompted controversy by supporting and encouraging violent nationwide protests in response to proposed tax hikes from the Ivan Duque administration in 2021.

As far as proposals, **Petro has campaigned on an unorthodox policy mix, which has the potential to disrupt Colombia's economy, worsen public finances and harm sovereign creditworthiness.** His platform consists of eliminating oil exploration and energy exports, uprooting Colombia's capitalist economic model in favor of more government intervention and social program spending, introducing

more progressive taxation, and increasing import tariffs in an effort to protect employment opportunities for Colombian citizens and residents. Eliminating oil exploration and exports would have a very severe, negative impact on Colombia's economy. Oil exports account for over 30% of total exports and contribute a sizable percentage of overall output. Completely eradicating energy exports from the economy would significantly reduce Colombia's growth prospects, result in a deteriorating public finances and would likely send Colombia's economy into a deep and prolonged recession. While eliminating oil production is very unlikely, Petro has a better chance of passing social spending measures and tax reform. Increased social spending could raise debt levels and widen the fiscal deficit, although a more progressive tax structure and increased corporate tax rates could offset social spending plans. On balance, Petro's proposed policies are seen as less business-friendly and could create a more uncertain environment for corporations operating in Colombia. These uncertainties could reduce longer-term investment into the country, which could also weigh on future growth prospects.

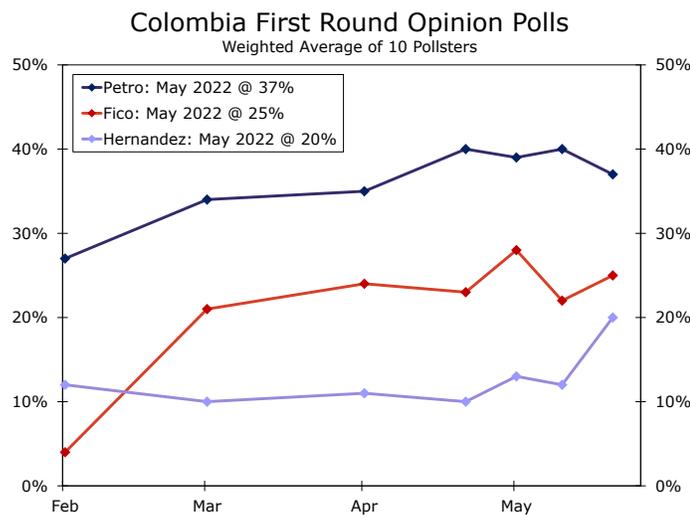
Petro's main challengers include a center-right candidate, Federico "Fico" Gutierrez, and another populist candidate in Rodolfo Hernandez. **"Fico", the former mayor of Medellin, is the policy continuity and most market-friendly candidate.** At the core of his policy agenda is prudent fiscal spending, maintaining existing social welfare programs, reducing the government debt burden and regaining Colombia's investment grade sovereign credit rating. Fico's policy proposals are also focused on strengthening trade relationships with Latin American economies, boosting business competition and encouraging hydrocarbon exploration and production. In our view, Fico's policy agenda would place Colombia's public finance position on an improving trajectory and reduce political risk across the country, while at the same time making Colombia an attractive foreign direct investment destination. While a return to an investment grade credit rating may be a stretch as of now, a Fico administration likely provides Colombia with the best opportunity to regain investment grade status.

On the other hand, **a Hernandez term would likely place public finances on a worsening trajectory and push the sovereign credit rating deeper into non-investment grade status.** Hernandez is not a formal politician, but rather a Colombian businessman who built a fortune operating a construction company. Hernandez has campaigned on the ideology of reducing tax rates, adopting a lower VAT rate and establishing a universal basic pension for retirees. At the same time, Hernandez's agenda includes renegotiating free trade agreements, protecting Colombian manufacturing jobs from being shipped overseas, while at the same time encouraging investment into Colombia, reducing barriers to entry and eliminating red tape for new business initiatives. In our view, Hernandez's policy proposals would likely widen Colombia's fiscal deficit and raise the overall government debt burden. Tax cuts and a universal basic pension would likely result in less tax revenues, and in turn, higher borrowing needs and an even more elevated debt burden. According to Hernandez, his administration would also eliminate government corruption, and his policy platform would be financed by revenues previously lost to fiscal slippage and corruption. In a Hernandez administration, restoring an investment grade credit rating may be very difficult. Should Hernandez move forward with his proposals, we expect external credit rating agencies could downgrade their Colombia sovereign rating as political risk rises and as Colombia's public finance position worsens.

Petro Plus Who? Election Scenario Analysis

While Petro's policy agenda is unorthodox, especially in Colombia, voters seem to be responding to his proposals. As of the latest polling data, Petro is in the lead and is likely to capture the most votes in the first round. Assuming poll data accurately reflect voter intentions, Petro could capture 37% of first-round votes ([Figure 1](#)). Polls indicate Petro has a 12 percentage point lead over Fico, who may receive 25% of votes. And while Hernandez is currently third with polls suggesting he could receive just 20% of the vote, momentum behind his campaign is building and the trajectory of voting intentions for Hernandez has risen sharply in recent weeks. However, in Colombia, a candidate must win at least 50% of first-round votes in order to be declared the winner. If we take opinion polls at face value, a new president will not be declared after the first round of voting, and **a second-round runoff will most likely be needed to determine a winner.** Assuming a runoff is indeed needed, the two candidates that receive the most first-round votes will square off June 19 in a second round of voting.

Figure 1



Source: AS/COA and Wells Fargo Economics

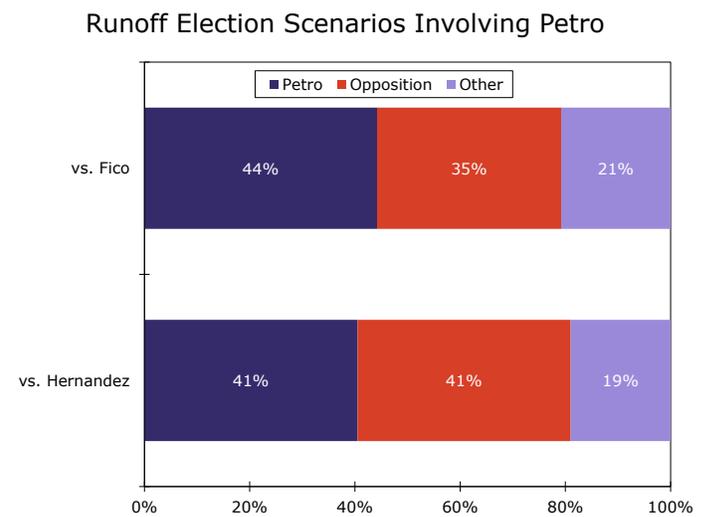
In our view, polls accurately reflect, but may still underestimate, the sizable support for Petro's candidacy, and we believe Petro will make it to the June runoff. Who will join Petro in the second round is still a toss up, especially given the recent jump in support for Hernandez. In our view, Hernandez's rise creates more uncertainty around the election, and could result in elevated local financial market volatility over the course of the election cycle, given Hernandez's populist policy platform. But given the range of outcomes, we offer a scenario analysis for how Colombian asset prices could respond in each situation. While we expect a runoff, the first round vote can still result in large swings in Colombian asset prices. **Market participants' base case scenario is for Petro and Fico to meet in the second round, with Petro winning the first round by a double-digit margin.** In our view, this scenario is not fully priced by financial markets, and should this scenario materialize, we would expect a modest rise in sovereign bond yields and a contained depreciation of the Colombian peso. Runoff scenario polls suggest Petro would beat Fico by a wide margin in second-round voting (Figure 2), so this first-round outcome may actually clear some of the uncertainty around the election. In our view, **the Colombian peso would likely hover around current levels, but not weaken beyond the psychologically important COP4000 level.**

On the other hand, should Fico maintain enough support to narrow the gap between himself and Petro, or even overtake Petro, we would expect Colombian asset prices to rally. As mentioned, Fico represents the most market- and business-friendly candidate. Policy continuity should help Colombia retain its investor-friendly status, while an expectation for an improved sovereign credit rating should attract capital back toward Colombia. **In a scenario where Fico outperforms, we would expect the peso to test COP3800 in the short term.**

A worst-case scenario for Colombian asset prices, in particular sovereign debt and the peso, entails Hernandez's momentum carrying him into the runoff against Petro. In this scenario, a populist-style candidate looking to make drastic changes to Colombia's policymaking framework and economic model gets elected. We believe there would be a "sticker shock" effect in this outcome, and financial markets could reprice Colombian assets for more elevated political risk and a deterioration in economic fundamentals going forward. While there is political risk priced into Colombian bond yields and the currency at this point, this scenario is far from fully reflected in local financial markets. Opinion polls are essentially tied in a Petro-Hernandez runoff, which likely means politically driven uncertainty could linger over Colombian markets over the course of the election cycle. **Should Petro and Hernandez meet in the runoff, we expect Colombian yields to spike higher and for the USD/COP exchange rate to test COP4100 in the short term,** implying around a 5.5% Colombian peso depreciation from current levels.

Our scenario analysis only mentions short-term bond and currency market reactions as we are not convinced the 2022 election will result in actual long-term policy changes in Colombia. A few months ago, Colombia hosted congressional elections, which yielded a fractured legislature and no majority for

Figure 2



Source: AS/COA, CNC and Wells Fargo Economics

any political party or alliance. **Against a divided legislature, we believe whoever is elected will face challenges to implementing the more radical or politically decisive policies they campaigned on.** In Petro's case, we believe eliminating oil production and immediately diversifying Colombia's economy away from hydrocarbons is extremely unlikely. For Hernandez, we envision hurdles to implementing a basic universal pension system. With that said, over the medium to longer term we forecast a weaker Colombian peso; however, we believe external factors such as uninspiring global growth prospects and a hawkish Federal Reserve are more likely to be the primary drivers of peso weakness. **Sporadic bouts of peso volatility could come from local political risk factors, but given a divided Colombian congress, we believe political risk may not have a long-term influence over the Colombian peso.** We do, however, believe a Petro or Hernandez administration could be a hurdle to Colombia recovering an investment-grade sovereign credit rating. Political paralysis likely means that little, or possibly no, reforms to improve creditworthiness can be achieved, while both candidates are likely to leave public finances in worse shape. In that sense, we believe the risk of another sovereign credit rating downgrade is more likely than an upgrade at this point.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Mark Vitner	Senior Economist	704-410-3277	Mark.Vitner@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	704-410-1437	Sara.Cotsakis@wellsfargo.com
Jessica Guo	Economic Analyst	704-410-4405	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures

This report is produced by the Economics Group of Wells Fargo Bank, N.A. ("WFBNA"). This report is not a product of Wells Fargo Global Research and the information contained in this report is not financial research. This report should not be copied, distributed, published or reproduced, in whole or in part. WFBNA distributes this report directly and through affiliates including, but not limited to, Wells Fargo Securities, LLC, Wells Fargo & Company, Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Europe S.A., Wells Fargo Securities Canada, Ltd., Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC is registered with the Commodity Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. WFBNA is registered with the Commodity Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this report.

This publication has been prepared for informational purposes only and is not intended as a recommendation offer or solicitation with respect to the purchase or sale of any security or other financial product nor does it constitute professional advice. The information in this report has been obtained or derived from sources believed by WFBNA to be reliable, but has not been independently verified by WFBNA, may not be current, and WFBNA has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of the report. The views and opinions expressed in this report are not necessarily those of WFBNA and may differ from the views and opinions of other departments or divisions of WFBNA and its affiliates. WFBNA is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report, neither WFBNA nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this report and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. WFBNA is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company. © 2022 Wells Fargo Bank, N.A.

Important Information for Non-U.S. Recipients

For recipients in the United Kingdom, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority ("FCA"). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 ("the Act"), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. For recipients in the EFTA, this report is distributed by WFSIL. For recipients in the EU, it is distributed by Wells Fargo Securities Europe S.A. ("WFSE"). WFSE is a French incorporated investment firm authorized and regulated by the Autorité de contrôle prudentiel et de résolution and the Autorité des marchés financiers. WFSE does not deal with retail clients as defined in the Directive 2014/65/EU ("MiFID2"). This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED - MAY LOSE VALUE - NO BANK GUARANTEE