Colombia Outlook 2Q17

Main messages

1. **World growth continues apace**, accompanied by a certain clarification regarding US policy. Overall. global risk remains a concern.

2. **The Colombian economy will grow slightly faster than it did in 2016.** Growth is expected to increase from 2% in 2016 to 2.1% in 2017 and 2.7% in 2018.

3. **2016 saw a healthy and significant adjustment to the current account.** The current account deficit as a percentage of 2016 GDP stood at 4.4%, around 2% less than in 2015. We expect it will close around 3.3% on average in the next two years.

4. **Inflation shakes off supply-side shocks and ratifies its sharp fall.** After two years of exchange rate pressure and twelve months of the worst of “El Niño” phenomena on record, inflation consolidated its downward trend to stand at 4.7% at the close of the first quarter of 2017.

5. **The Banco de la República has embarked on a downward rate cycle**. With the drop in inflation and the external balance, the Bank will be able to reduce interest rates to 5.5% in 2017.

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GLOBAL

Stronger growth,
but still with significant risks

Positive global momentum

Main trends continue …

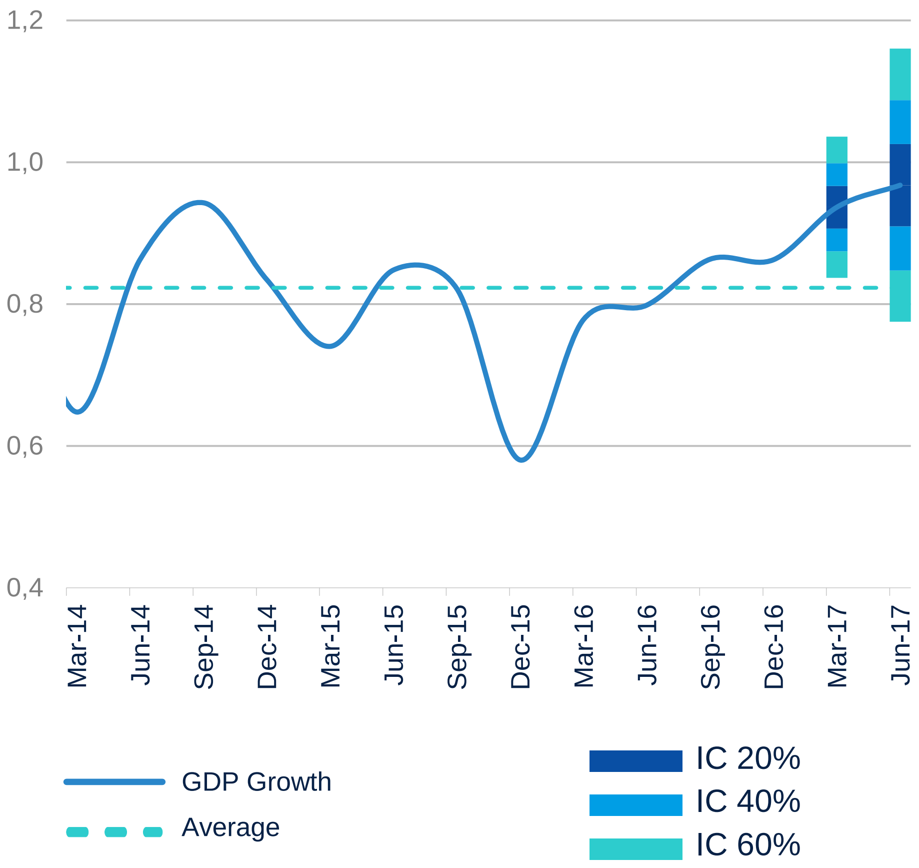
- Recovery of industrial production and trade still underway
- Low volatility in financial markets
- Headline inflation continues to rise in advanced economies, but core inflation remains stable

… and central scenarios become more likely

- A strong stimulus to US economy looks less likely…
- …but so does scenarios with strong protectionism
- Central banks in developed countries lean towards policy normalization

Global growth continues to increase at the beginning of 2017

Global GDP growth
Forecasts based on BBVA-GAIN model (%, qoq)

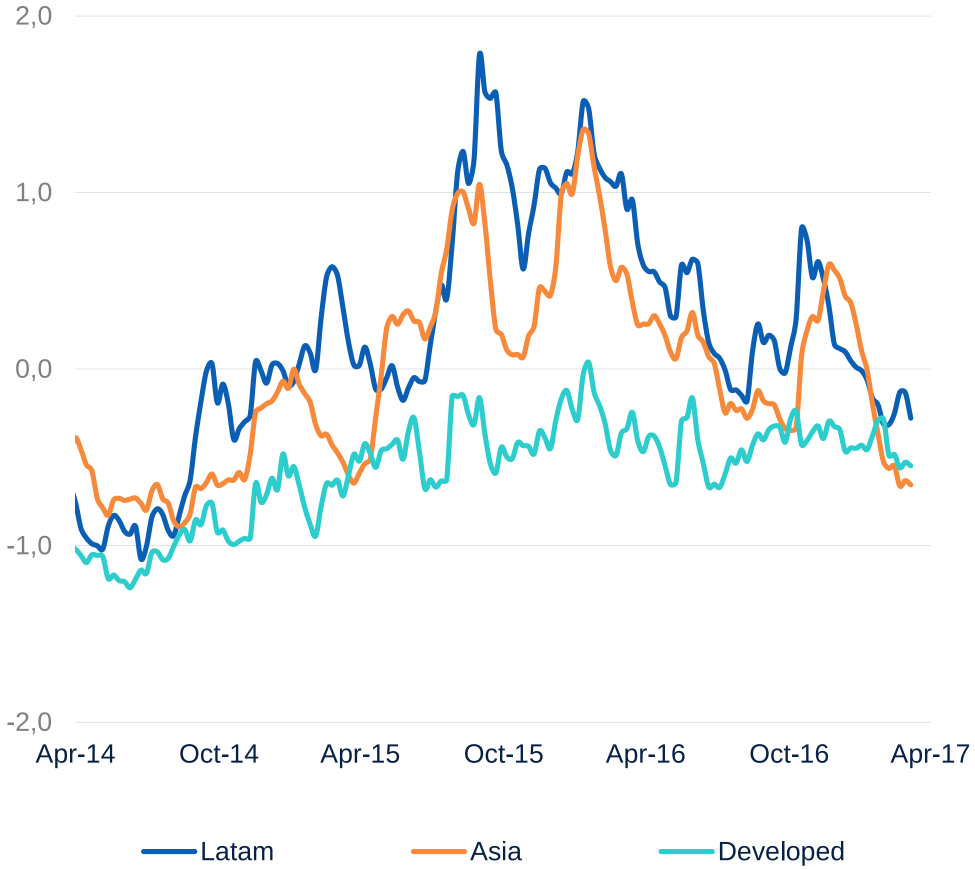


- Confidence indicators remain very high, although hard data still do not capture all the improvement in sentiment
- China and developed economies show signs of strong growth. However, other emerging economies show mixed signals

Source: BBVA Research

Financial stress remains low

BBVA Financial Stress Index
(normalized)



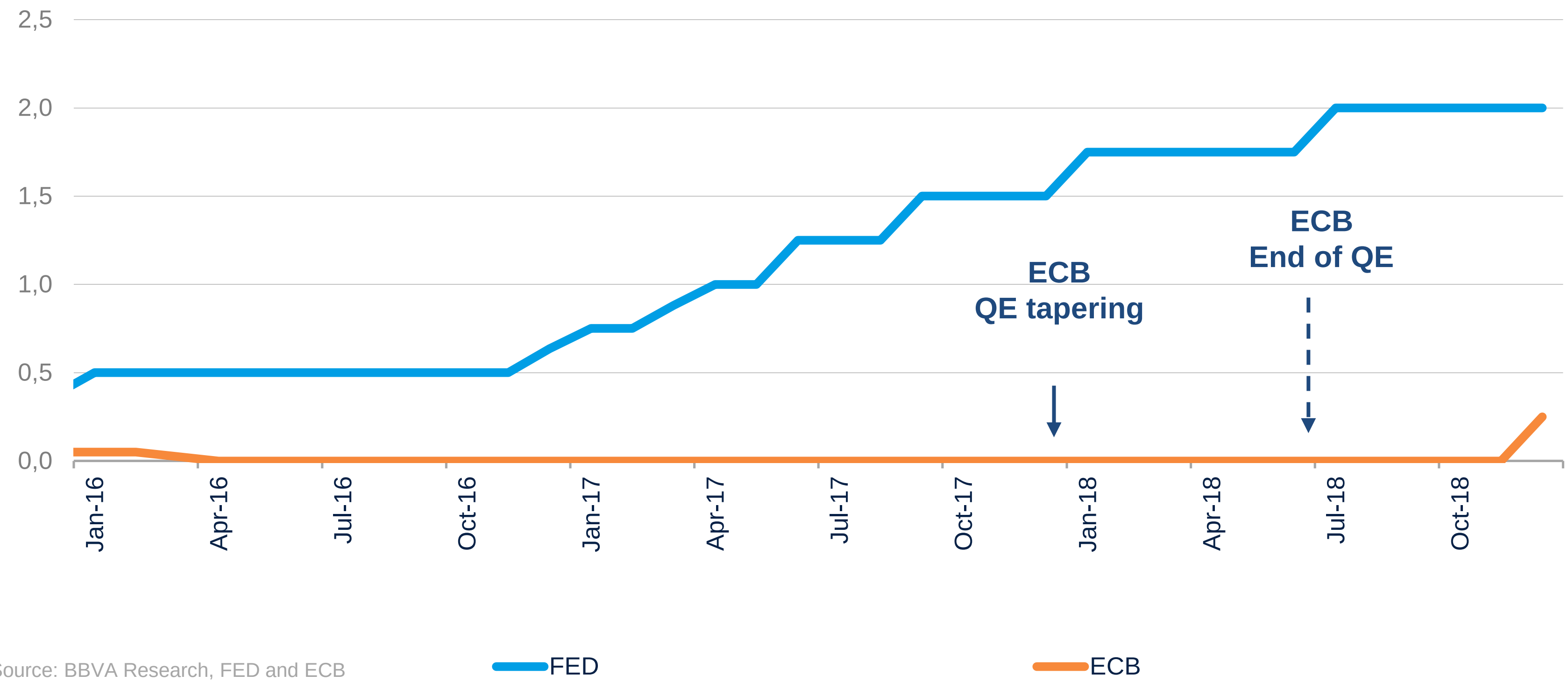
Source: BBVA Research

- Volatility has decreased despite uncertainty about economic policies
- Monetary and fiscal stimulus mask some underlying weakness
- Europe has been the exception, with some increase in sovereign spreads, linked to elections in France and the political outlook for the region as a whole

Central banks on the way to policy normalization

Official interest rates in the US (Fed) and Eurozone (ECB)

(pp)

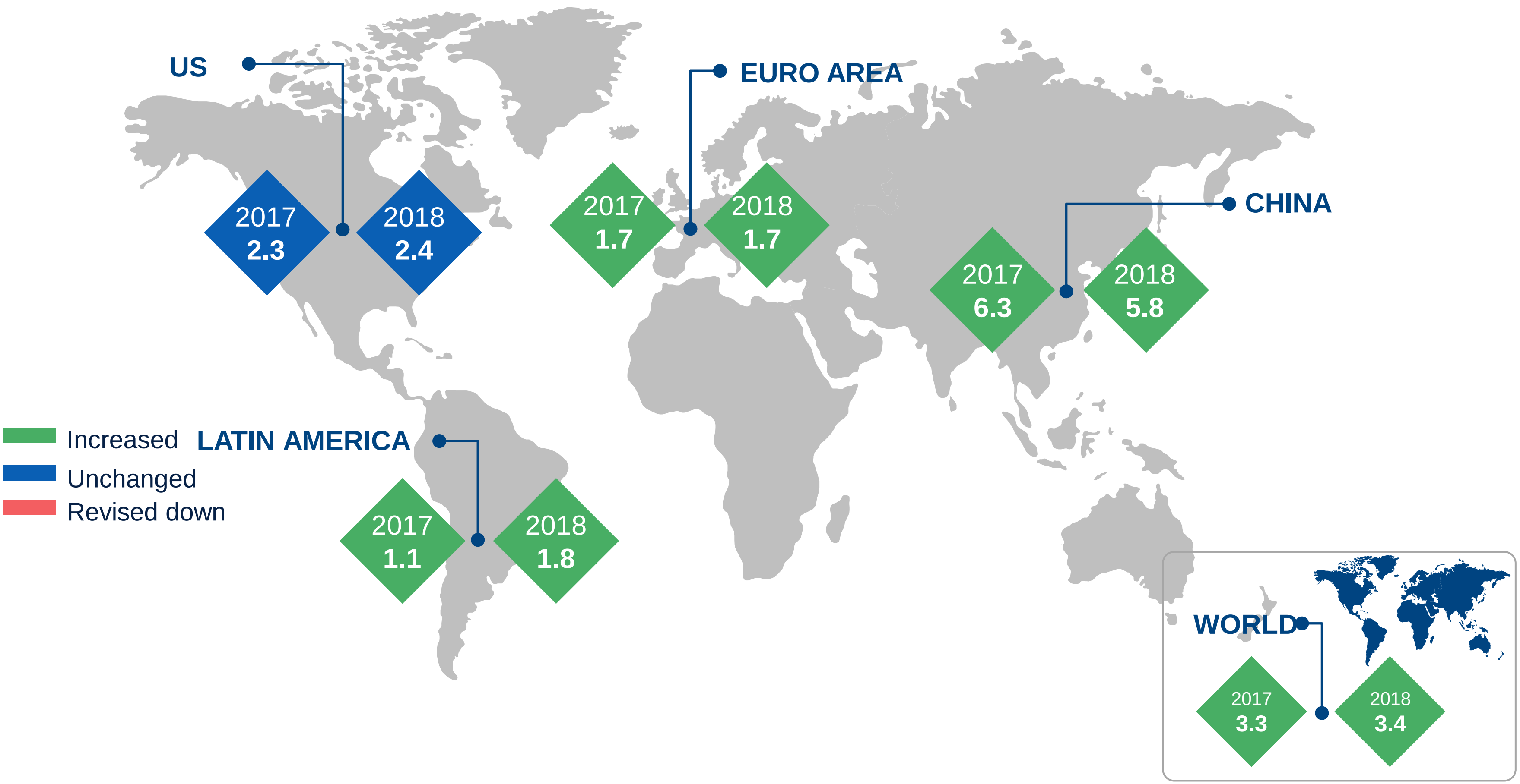


Source: BBVA Research, FED and ECB

Fed continues to increase interest rates, though is still cautious about the economic outlook.

The ECB is to start discussing its exit strategy, but very cautiously.

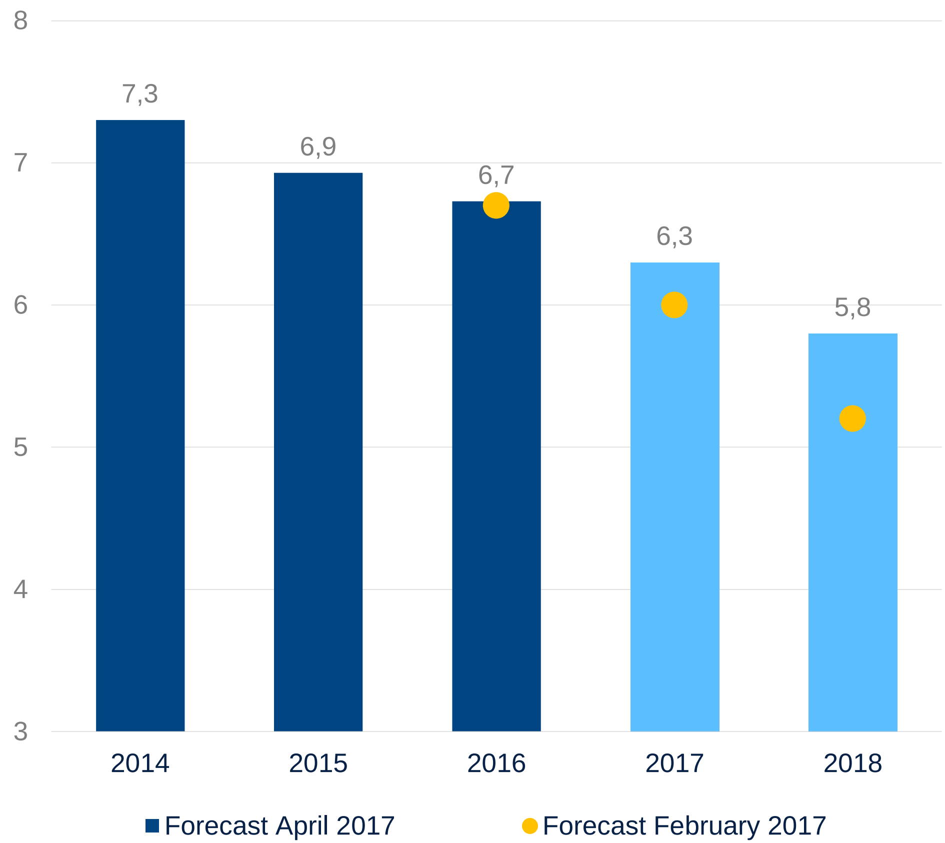
Global growth revised up



Source: BBVA Research. Latin America includes: Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

China: renewed recovery with old engines

China: GDP growth
(%)



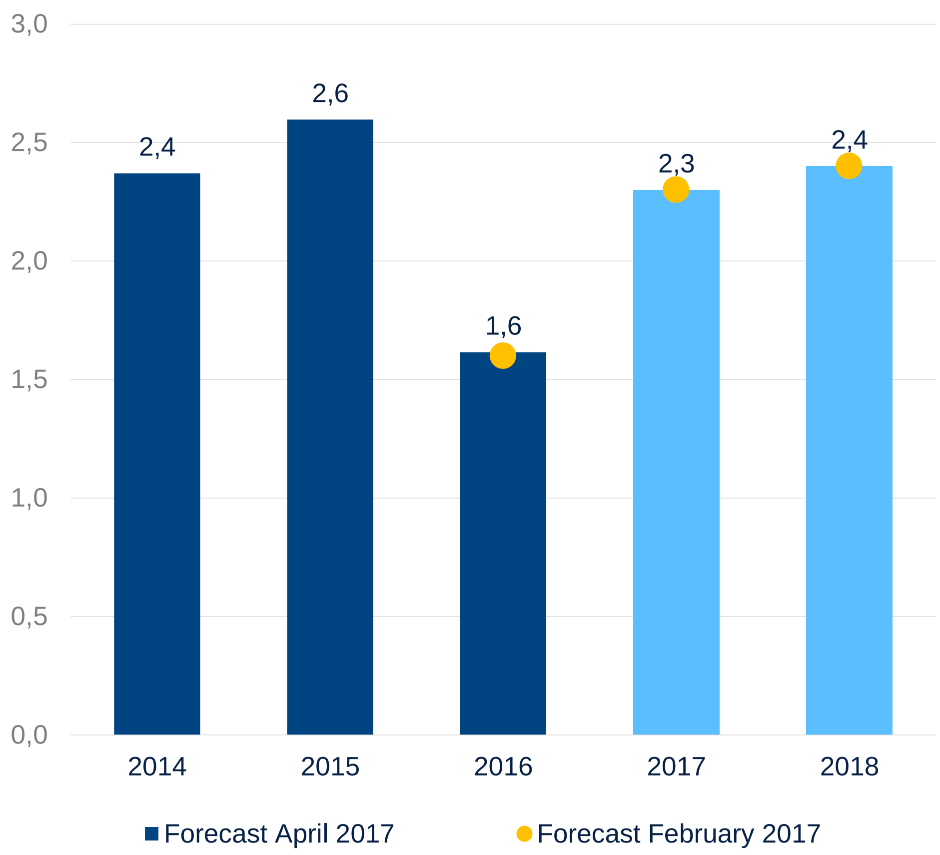
Source: BBVA Research and CEIC

- We revised up our growth forecasts for 2017-18, due to incoming data and a fiscal impulse. Gradual deceleration underway

- But medium-term risks are still significant:
  - Rebalancing of growth towards services and consumption has stalled
  - Policy missteps could lead to a disorderly deleveraging

US: diminished prospects of a pro-growth fiscal impulse

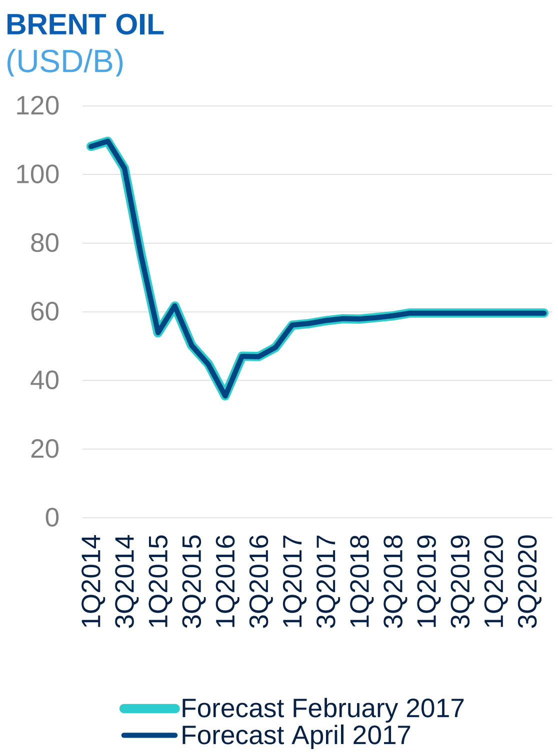
US: GDP growth
(%)

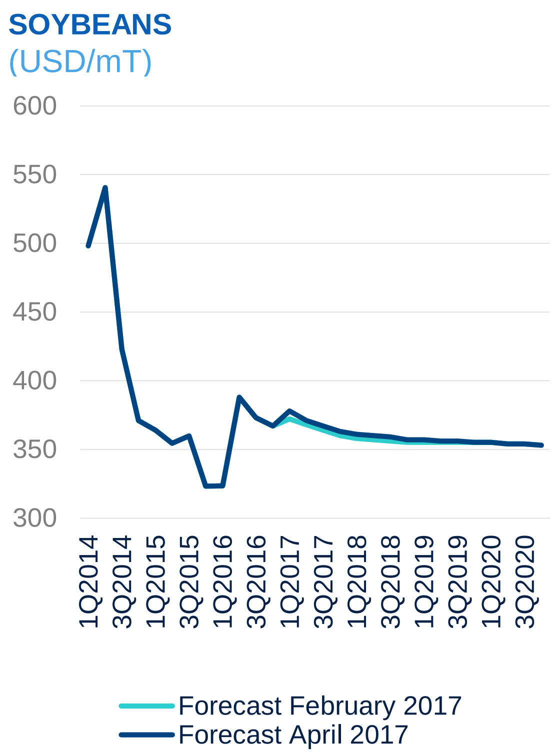


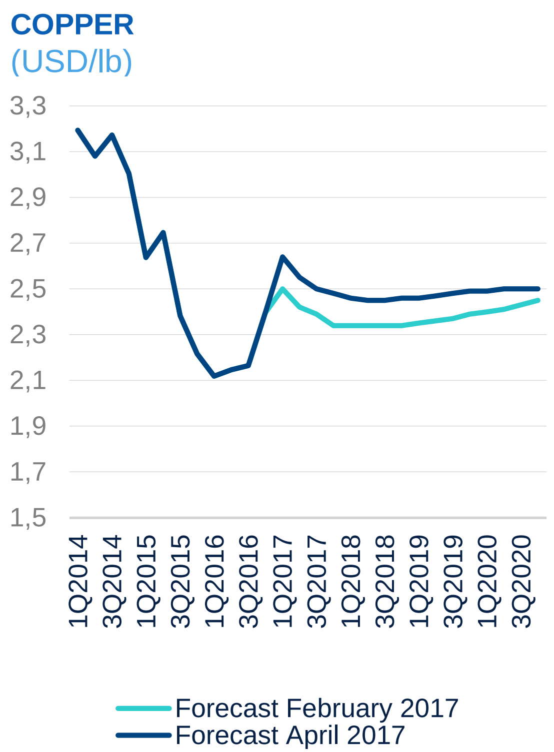
Source: BBVA Research and BEA

- Growth increases in 2017 given pick up in investment. However, private consumption is expected to slow down
- Risks stemming from economic policy continue despite a softer tone in the last months

We maintain our view of gradual convergence of commodity prices to their long-run equilibrium levels







Source: BBVA Research and Bloomberg

Oil prices will continue to get support from OPEC production agreement, as well as increase in demand. Copper prices will benefit from stronger demand and also supply disruptions.

No significant changes in our view for long-term commodity prices. Forecasts mostly unchanged for oil and soybeans relative to February.

Global risks most relevant for Latin America are related to US policies and rebalancing in China

1

Lingering **uncertainty about economic policies** to be implemented in US, especially trade policies

2

Policy stimulus in China to support investment could delay and slow down reforms to reduce structural imbalances

3

Elections in France and Italy in (the unlikely) case that Eurosceptic platforms prevail

4

Risks stemming from **monetary policy normalization**, especially in the US

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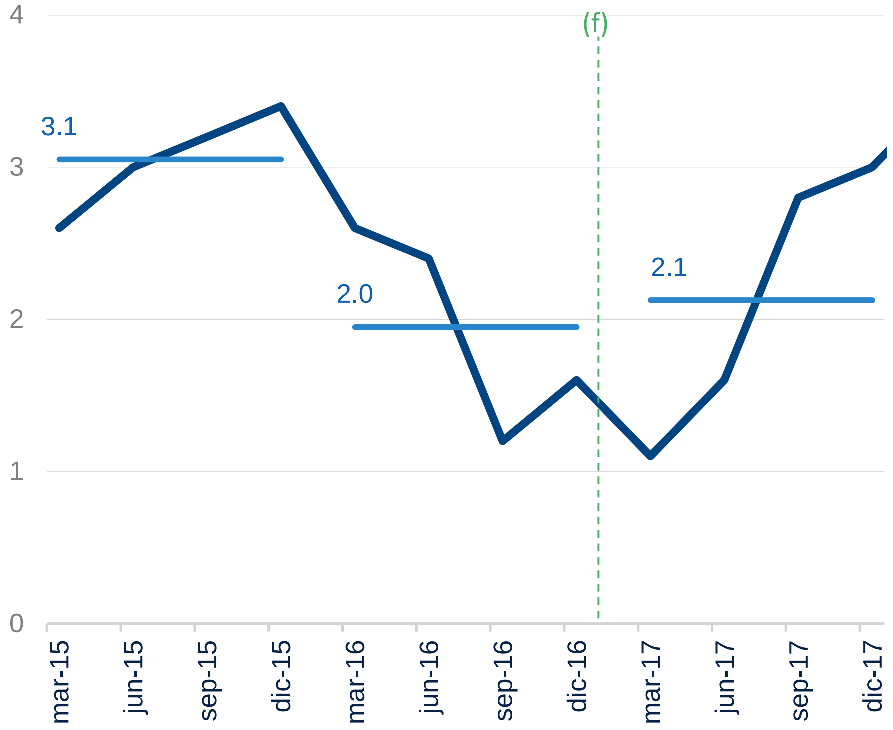
Colombia

Sowing the future

2017 growth will be slightly higher than that seen in 2016

GDP growth Colombia
(% variation YoY)

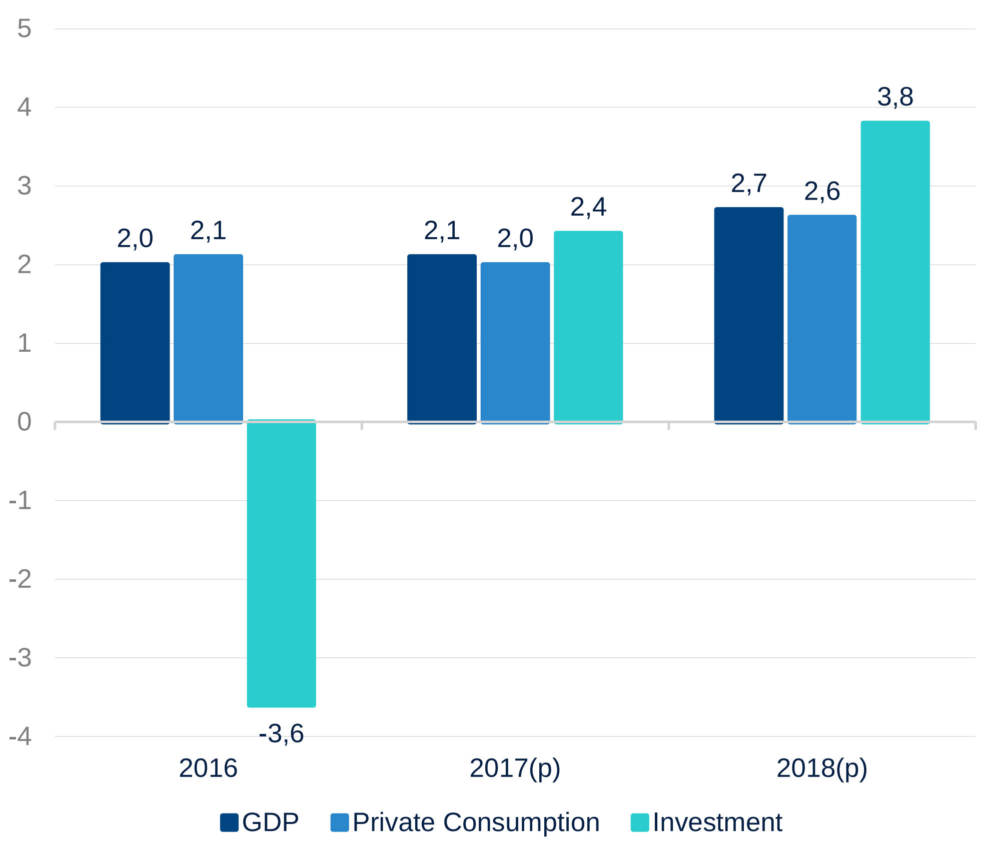


Source: DANE and BBVA Research

- We expect improved investment performance in 2017, due to public works and private industry, agriculture and mining investment programmes.
- Available leading indicators show a weak start to the year. However, we expect to see recovery in the second half of this year

Investment in 2017 will cease to shrink, while consumer spending maintains its pace

GDP, investment and consumer spending
(% variation YoY)

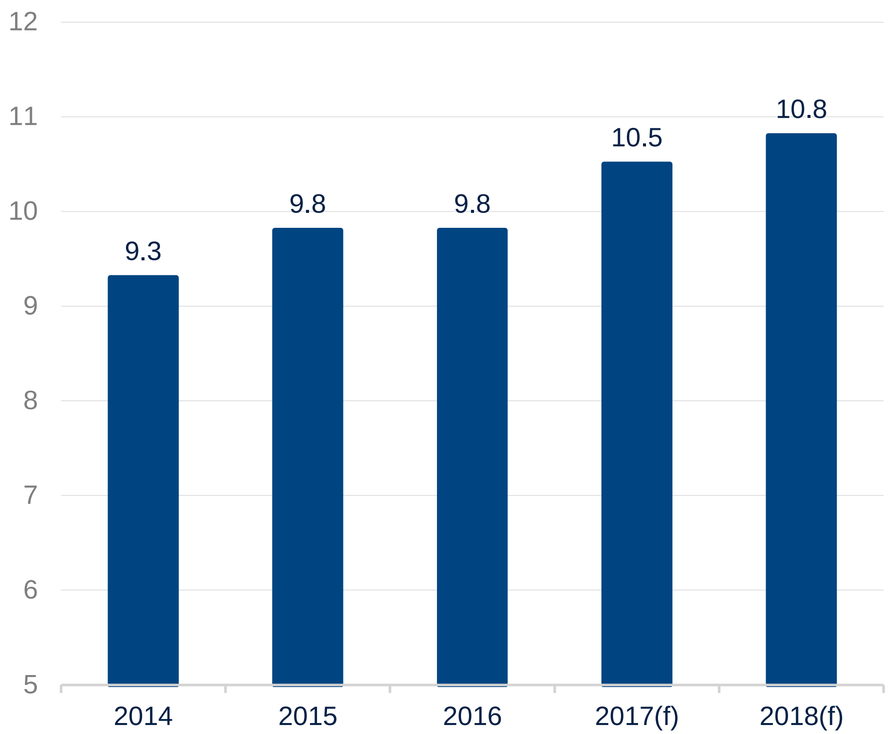


Source: DANE and BBVA Research

- Lower inflation and interest rates and greater relative confidence will see higher consumer spending from the second half of 2017 and especially in 2018.
- The investment rate will rise again between 2017 and 2018, as a result of adjusting at a faster rate than aggregate GDP.

The economic slowdown is affecting the labour market with a lag

Unemployment rate in 13 cities
(%, end of period)



- Higher unemployment rate is expected going forward on the prolonged deceleration. Though not at the levels of previous deceleration cycles as 2009 of 13%

- The consumer spending dynamic will be affected by the deterioration in the labour market, especially in 2017.

Source: DANE and BBVA Research

Agriculture and construction will lead growth in 2017

- Agriculture will benefit from better weather in 2017
- Mid-level housing, 4G and improved local governments budget execution will continue to bolster the construction sector.
- Industry will have a regular year due to weak demand
- Mining will continue its weak growth

GDP growth by sector
(% variation YoY)

Sector	2016	2017(f)	2018(f)
Agriculture	0.5	3.5	2.7
Construction	4.1	3.4	4.4
Financial and Corporate Services	5.0	3.2	4.1
Government and Social Services	2.2	1.9	2.6
Utilities	0.1	1.7	2.6
Industry	3.0	1.6	2.3
Oil and Mining	-6.5	1.6	-2.2
Retail, Restaurants and Hotel Industry	1.8	1.5	3.2
Transportation	-0.1	1.4	2.9
Total	**2.0**	**2.1**	**2.7**

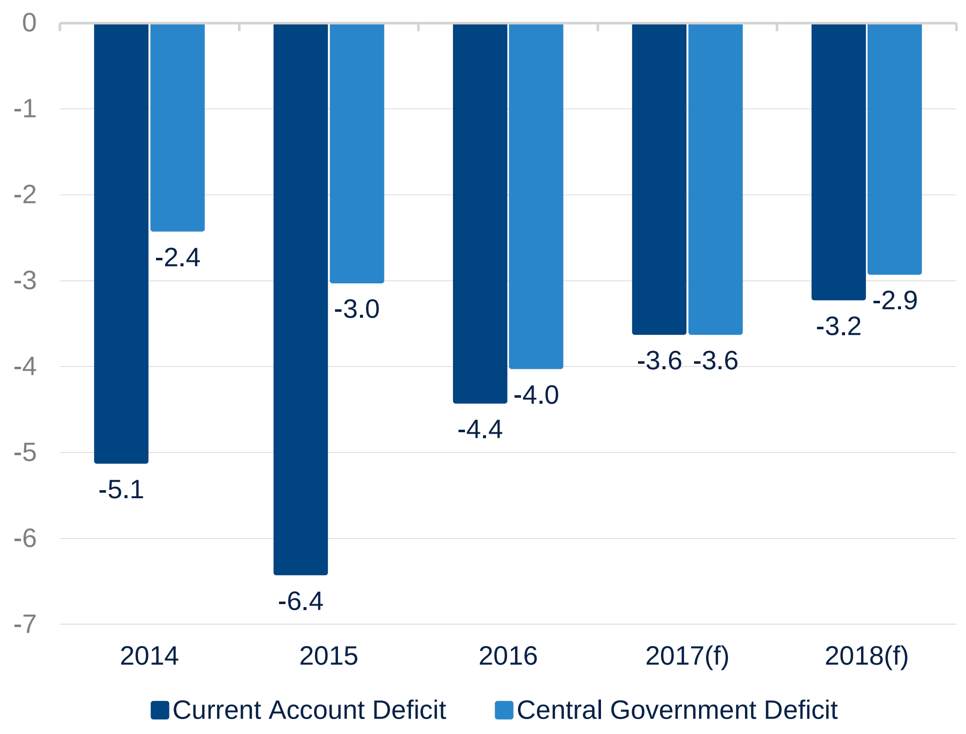
Source: DANE and BBVA Research

Economic risk in Colombia has fallen

- The 2% adjustment in 2016 of the current account will favour long term growth. The considerable current account deficit caused pressure to maintain monetary policy rates high, limited the government's room for manoeuvre and created a sensation of vulnerability in the private sector.

- Tax reform will improve the sustainability of public finances. Between 2014 and 2016, the government made an important adjustment in expenditure.

Fiscal and current account deficit
(% of GDP)

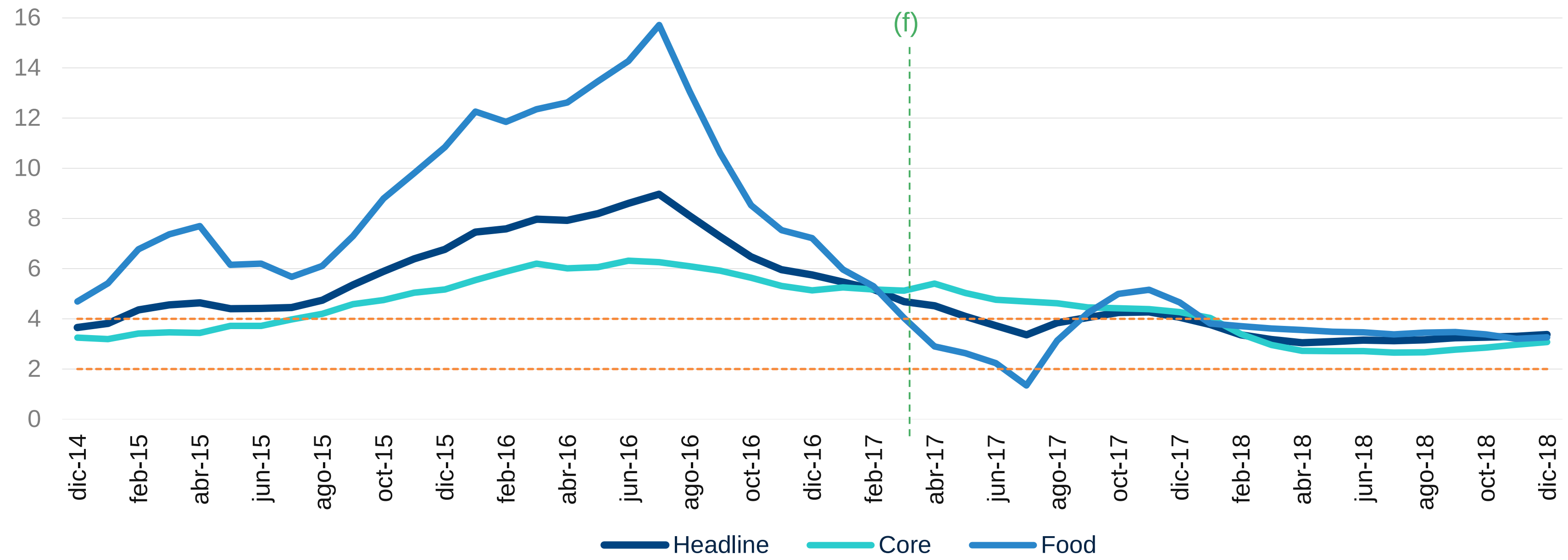


Source: Banco de la República, DANE, the Ministry of Finance and BBVA Research

In this context, inflation has slowed down significantly. We expect that at the end of 2017 the annual rate will be 4.1%

Headline, core and food inflation

(% variation YoY)



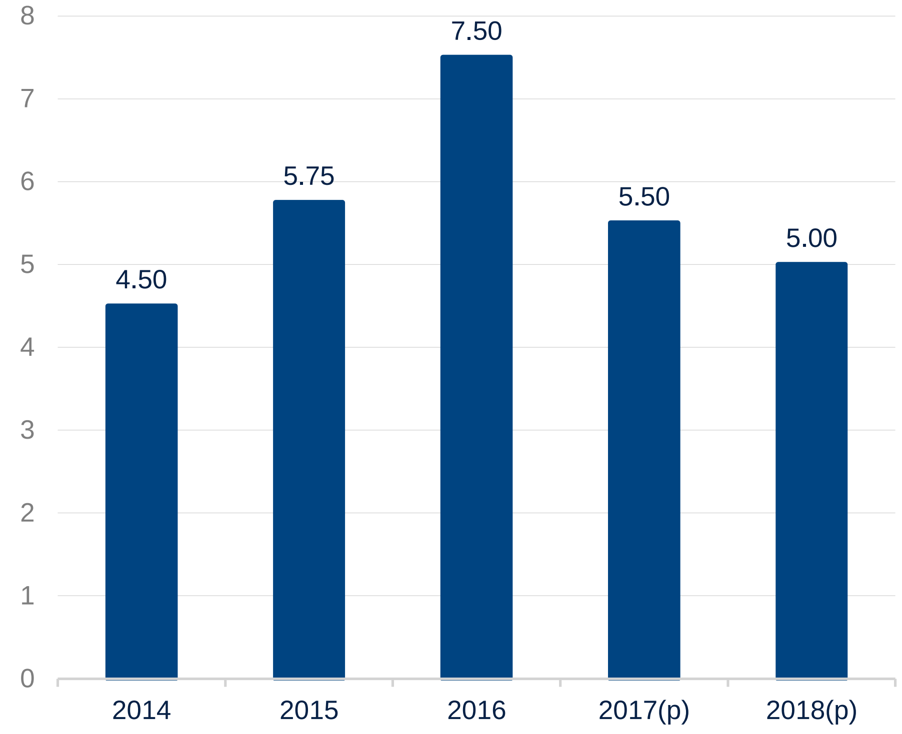
Source: DANE and BBVA Research

Foodstuff prices will continue to fall in 2017 due to greater agricultural supply. Exchange rate stability will help to keep the price of imported goods down.

We expect to see inflation end 2017 and 2018 at a annual rate of 4.1% and 3.4%, respectively.

The Banco de la República has the path clear to reduce rates

End-of-period monetary policy rate
(%)



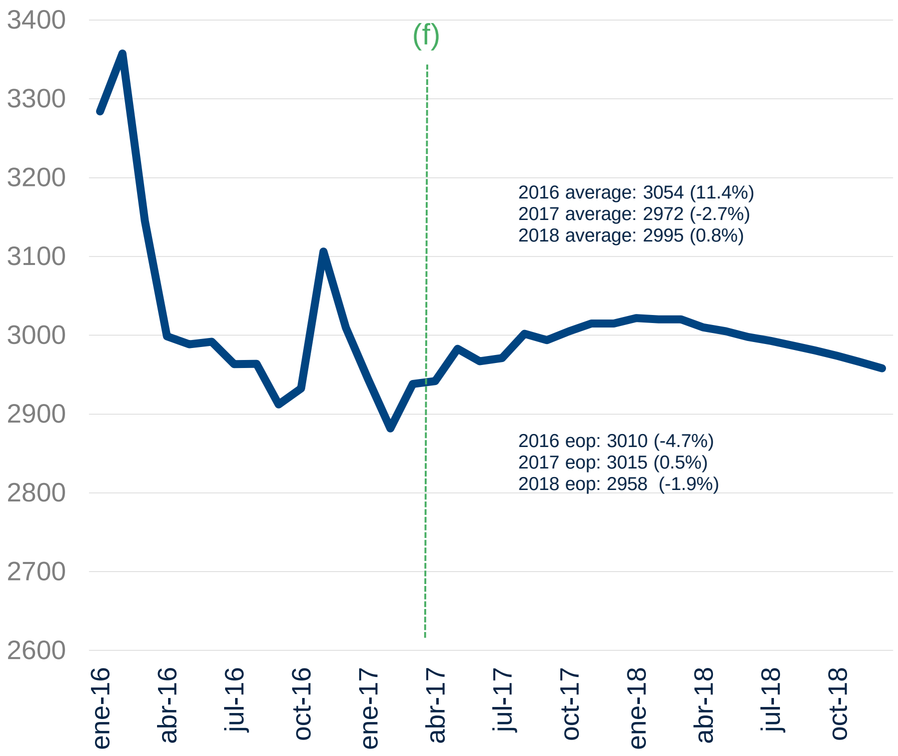
Source: Banco de la República and BBVA Research

- The reduction of the external imbalance risk and inflation allow the Bank to begin a downward rate cycle. We estimate that in 2017 the policy rate will reach 5.5%, then take a brief break before starting 2018 with rate reductions to 5%.
- In the decision balance of the Bank's Board, once inflation expectations approach the target of 3,0%, economic activity will play a more relevant role .

Given the Colombian economy's lower level of external vulnerability, the exchange rate will stay relatively stable

Exchange rate

(Pesos per dollar)



- With the correction of the current account deficit, external vulnerability will decrease, as will the economy's external financing needs. This suggests less pressure on the exchange rate.
- Within a positive context for oil prices and external stability, the peso should appreciate in 2017 compared to 2016, stabilizing slightly below 3,000 pesos to the dollar.
- It should not be forgotten that the US Federal Reserve will make two adjustments to interest rates before year end, according to our forecasts. This will put upward pressure on the exchange rate in the second half of the year.

Source: Banco de la República and BBVA Research

The main risk to economic growth comes from internal affairs

1

Additional delays to the public and private investment decisions which may have an impact on short- and medium-term growth

2

Imbalances in the Chinese economy may cause a hard landing to its growth with **important repercussions to commodity prices**

3

Risk associated with the **normalisation of monetary policy**, especially in the US, which may affect capital flows, and as a result, the exchange rate and the space that BanRep has to reduce rates

4

Uncertainties that are still associated with **measures passed in the USA**, especially in a commercial context, **affecting export performance**

Main messages

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ANNEX

Summary of Baseline Scenario

	2013	2014	2015	2016	2017(f)	2018(f)
GDP (YoY, %)	4.9	4.4	3.1	2.0	2.1	2.7
Private consumption (YoY, %)	3.4	4.3	3.2	2.1	2.0	2.6
Public consumption (YoY, %)	9.2	4.7	4.0	1.8	1.8	2.1
Fixed investment (YoY, %)	6.8	9.8	1.8	-3.6	2.4	3.8
Inflation (% YoY, eop)	1.9	3.7	6.8	5.7	4.1	3.4
Inflation (% YoY, average)	2.0	2.9	5.0	7.5	4.3	3.3
Exchange rate (eop)	1.927	2.392	3.149	3.001	3.015	2.958
Devaluation (%, eop)	9.0	24.1	31.6	-4.7	0.1	-1.4
Exchange rate (average)	1.869	2.001	2.742	3.054	2.972	2.994
Devaluation (%, average)	3.9	7.1	37.0	11.4	-2.7	0.8
BanRep interest rate (%, eop)	3.25	4.50	5.75	5.75	5.50	5.00
Deposit interest rate (%, eop)	4.1	4.3	5.2	6.9	5.7	5.3
Fiscal Balance (% GDP)	-2.3	-2.4	-3.0	-4.0	-3.6	-2.9
Current Account Balance (% GDP)	-3.2	-5.2	-6.5	-4.4	-3.6	-3.2
Unemployment rate (%, eop)	9.7	9.3	9.8	9.8	10.5	10.8

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