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Colombia Outlook

Third Quarter 2017

Colombia Unit

July 2017

Main messages

1. **Global growth is continuing to increase**. This improvement mainly affects **advanced economies and China**. China has also experienced fiscal stimuli. Overall, global risks remain a concern.

2. **Colombia's economy has responded positively to the oil price shock.** Despite a sharp slowdown, the capacity to cushion the cycle and maintain external funding has enabled growth to remain in positive territory.

3. **The economy will recover.** The recovery cycle will be slow, due to limited exogenous sources of growth: we expect GDP to perform below its potential over the coming years.

4. **Economic policy will contribute less to the recovery than in 2009.** In the absence of significant improvement in revenues, compliance with the fiscal rule will mean the Government has a negative impact on growth. Meanwhile, the Central Bank is worrying about inflation persistence

5. **Inflation will continue to fall in 2018.** The marked slowdown in inflation over the last year will pause briefly from August to November, before returning to its downward trend and ending 2018 at 3.2%

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GLOBAL

Stable growth in 2017-18,
but downside risks remain

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Global dynamics remain positive

Global growth driven by China

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Some rebalancing from the USA to Europe

Both macro and political

Low Inflation in developed countries

Wage moderation and correction of commodity prices

Central Banks in developed countries gradually moving towards normalisation

Withdrawal of liquidity and higher interest rates

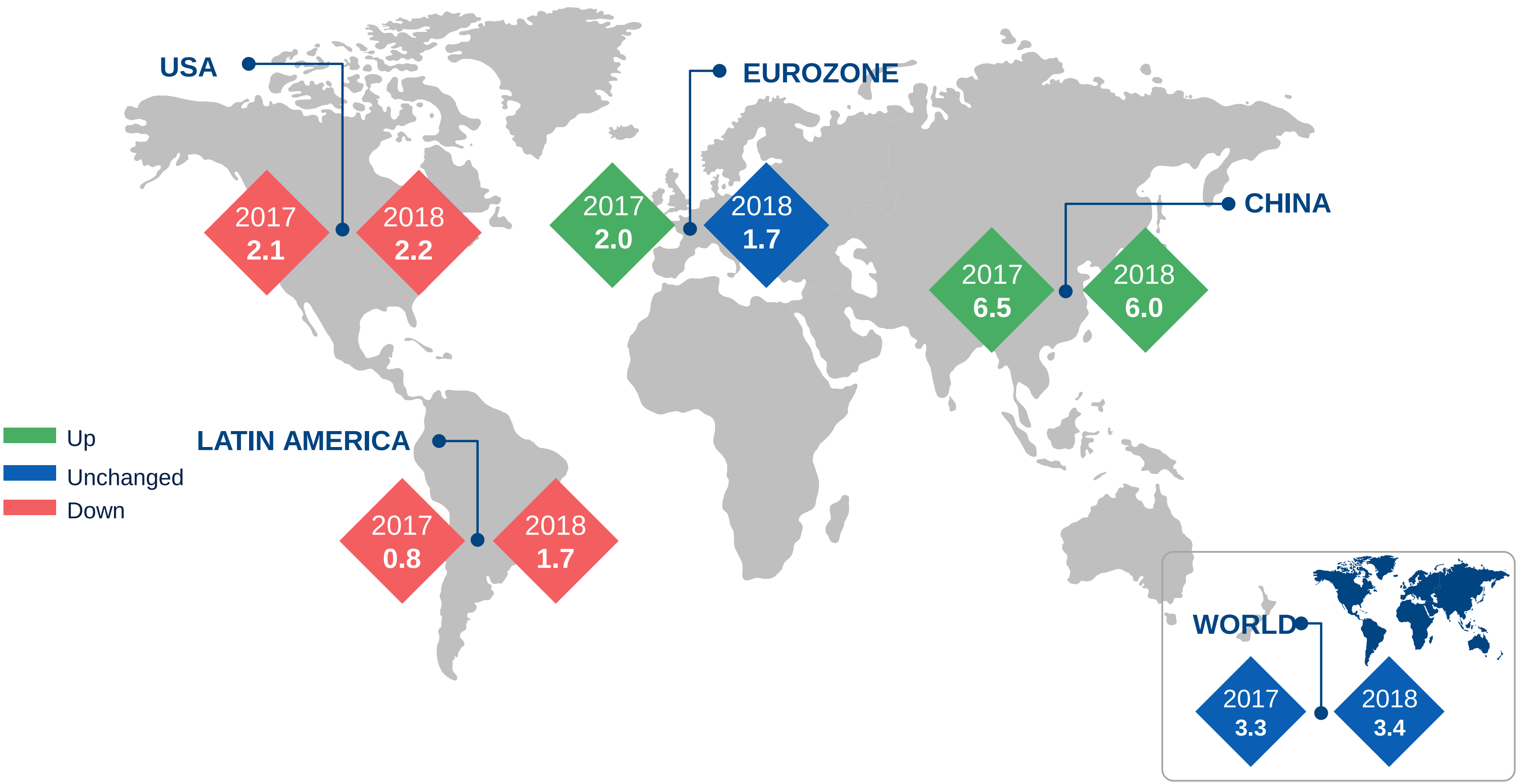
Financial markets remain calm

Low volatility fosters risk taking

Risks

Falling in Europe, but accumulating in China

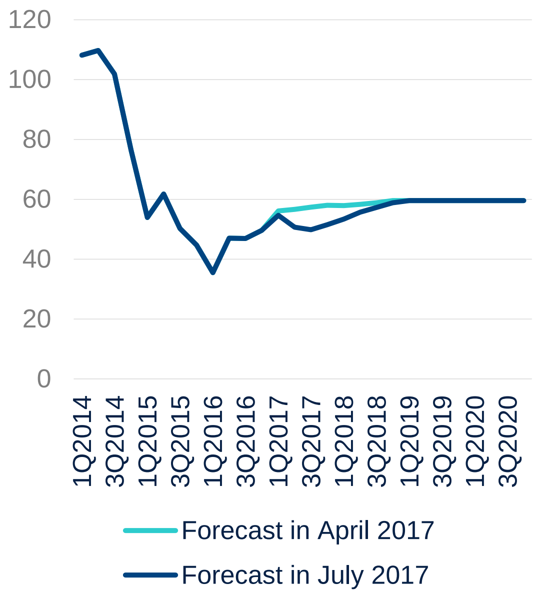
Growth revised up in Europe and China, but down in the USA and Latin America



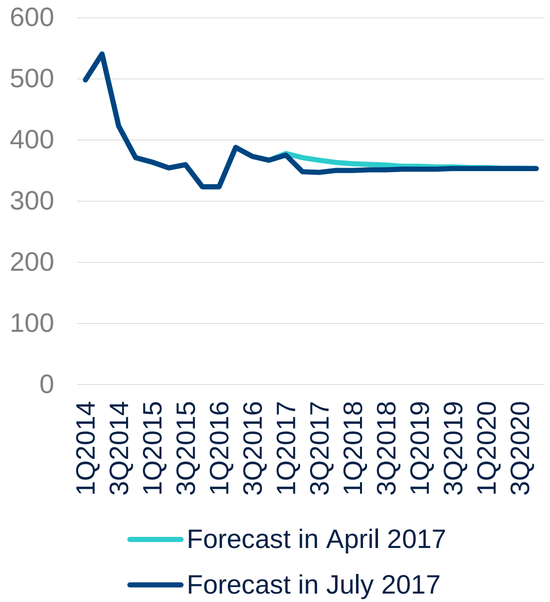
Source: BBVA Research. Latin America comprises: Argentina, Brazil, Chile, Colombia, Mexico, Paraguay, Peru, Uruguay and Venezuela

Adjustment to commodity price forecast for 2017-18, due to concerns about the strength of supply

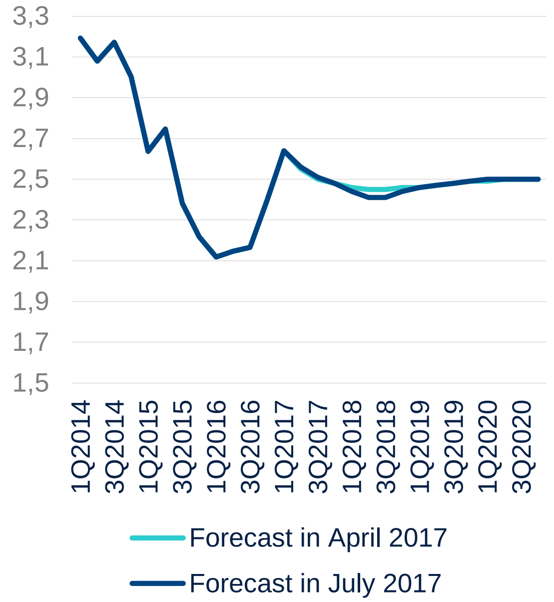
BRENT CRUDE
(US$ per barrel)



SOYBEANS
(US$ per metric ton)



COPPER
(US$ per lb.)



Source: BBVA Research and Bloomberg

Oil price undermined by output levels and stocks. Prices are still expected to remain around US$60 per barrel in the long term, due to falling investment in exploration.

The strength of supply is also affecting short-term soybean and copper prices. No major changes expected in long-term commodity prices.

The main global risks for Latin America centre on US politics and rebalancing in China

1

Lingering uncertainty about **measures approved in the US**, but falling concerns about the risk of protectionism

2

Policy stimulus measures taken to bolster the recent strength of investment in **China** are continuing to accumulate imbalances and financial fragility

3

Political risks are falling in Europe, but some remain with regard to Brexit, the handling of some banking issues and elections in Italy.

4

Risks associated with the **normalisation of monetary policy**, particularly in the USA, due to divergence from market expectations.

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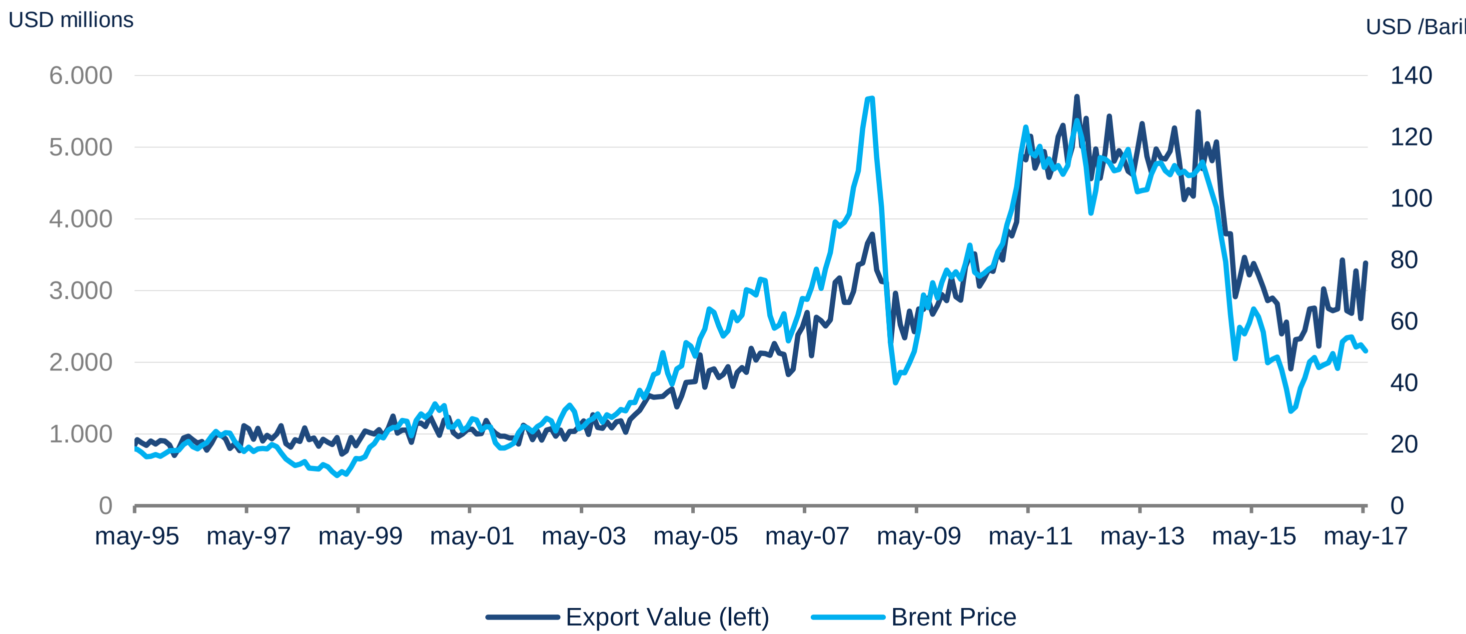
An unprecedented shock

A positive response from the economy, despite the sharp shock

Exports dropped by 48% between 2012 and 2016, the steepest fall since the great depression of 1929 to 1932

Oil price and exports volumes



Events

	1000 day War			Great Depression			International Financial Crisis			Oil Crisis		
Dates	*1898*	*1902*	var %	*1928*	*1932*	var %	*2008*	*2009*	var %	*2012*	*2016*	var %
Values	17	9	**-47%**	130	65	**-50%**	37.625	32.546	**-13%**	60.125	31.394	**-48%**

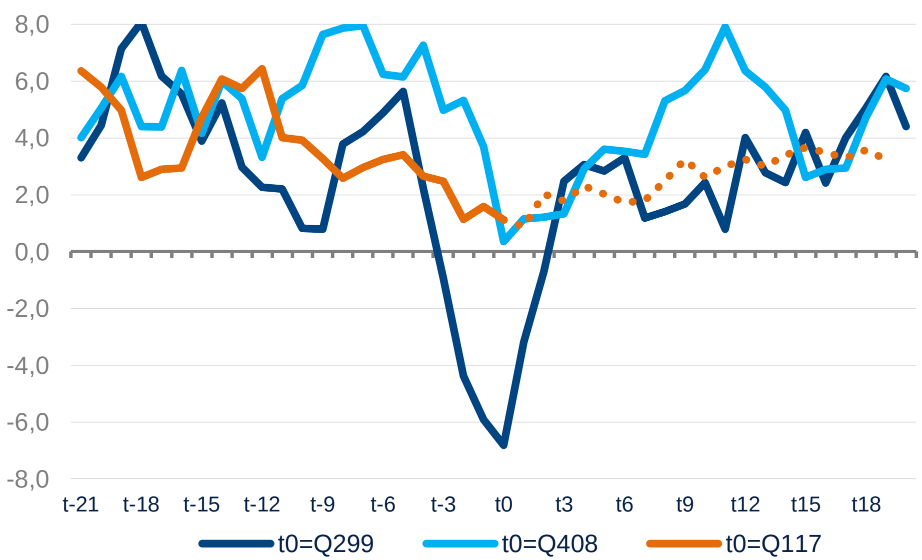
USD milliones

Source: BBVA Research with data from DANE and Bloomberg

The current shock is significant compared to recent precedents

Colombia economic cycle

(%, for t0=1Q17 BBVA forecasts)

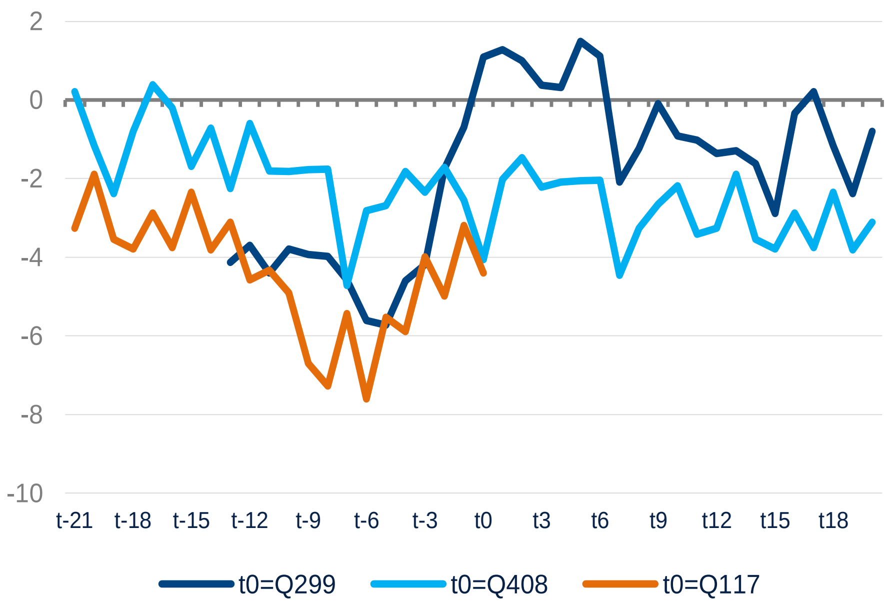


- The current shock is becoming more severe than that of 2009 (international financial crisis). In part this is because emerging economies are not benefiting from the boost from China and oil prices they enjoyed then
- However, it is not like 1999, in principle because external funding and shock absorbers such as the exchange rate have cushioned cyclical impacts today
- Even so, the recovery will be very similar to that of 2000-2003: low growth with a similar slope

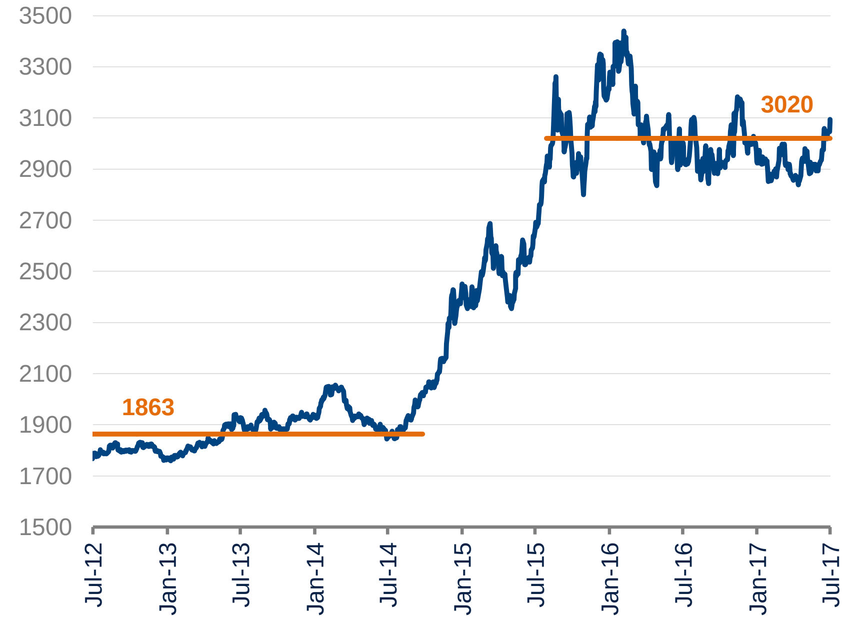
Source: BBVA Research with DANE data

Achieving positive growth after a shock of this scale is virtue of shock absorbers and international credibility

Colombia current account cycle
(% of GDP)



Exchange rate
(Pesos per dollar)

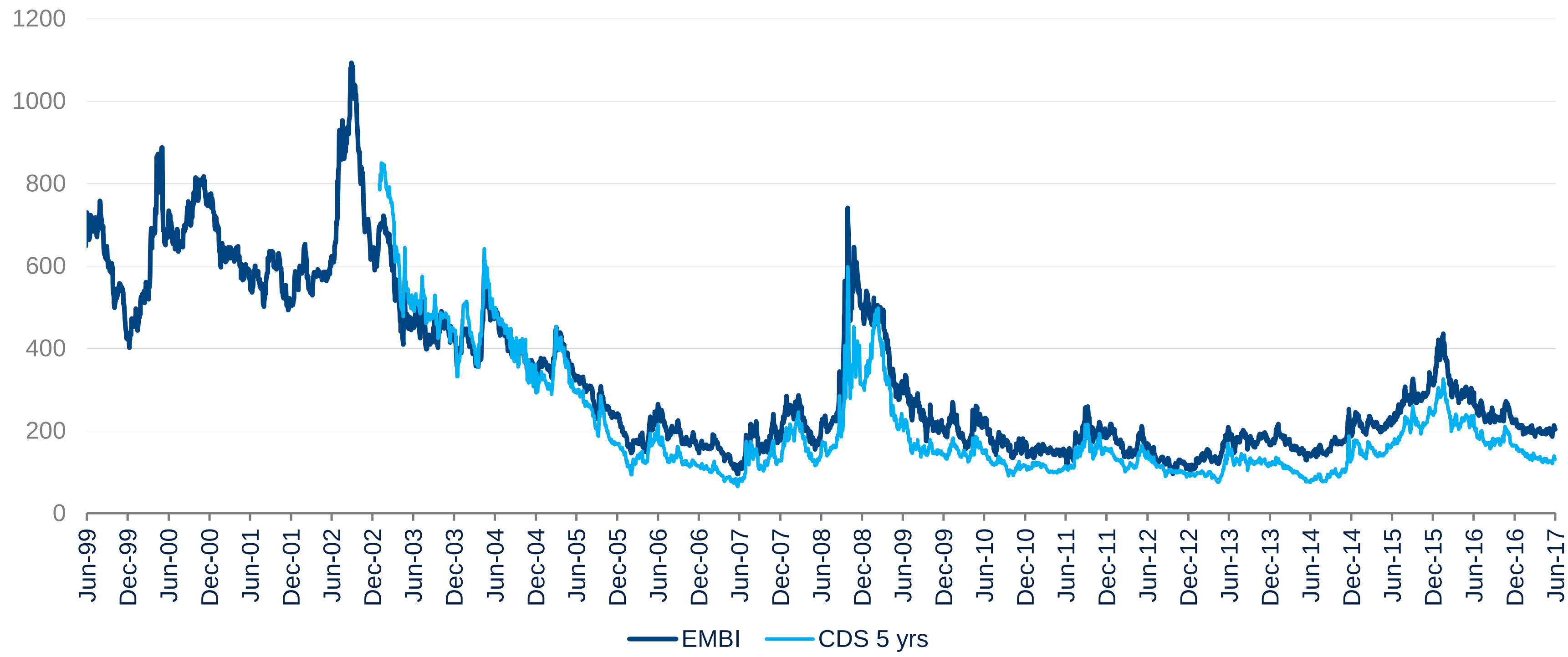


Ample funding for the current account, unlike 1999

Source: BBVA Research based on DANE data: Bloomberg

Unlike 1999, when markets shut, and the major shock in 2009, there have been no significant impacts on risk premiums in the current cycle

Colombia risk premiums
(5Y CDS and EMBI, basis points)



Source: BBVA Research based on Bloomberg data

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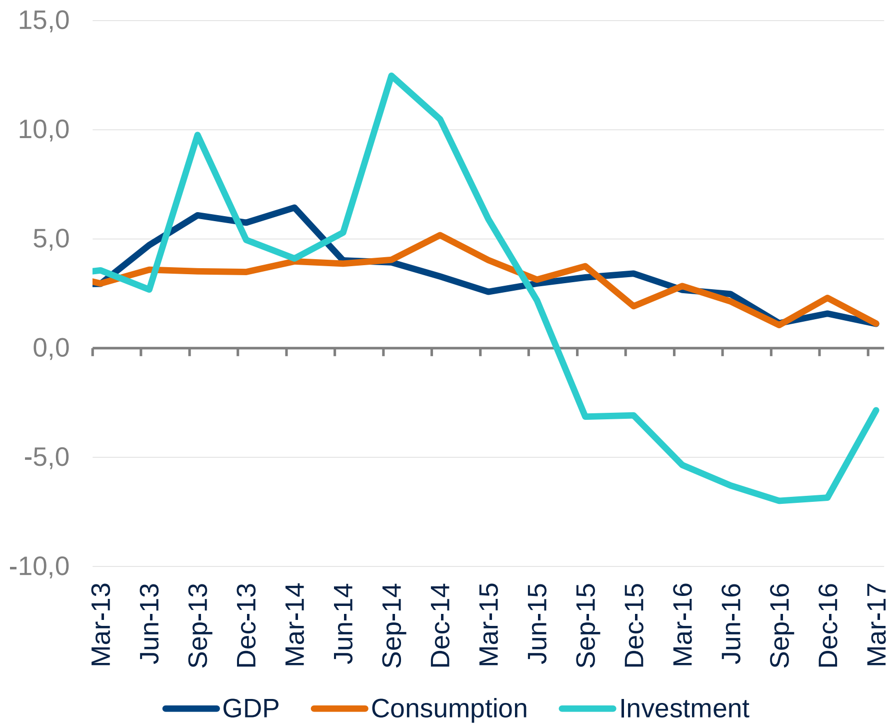
The adjustment was first seen in investment, with private consumption hit hard until 2H16

Private consumption
(% YoY change, annual moving average)



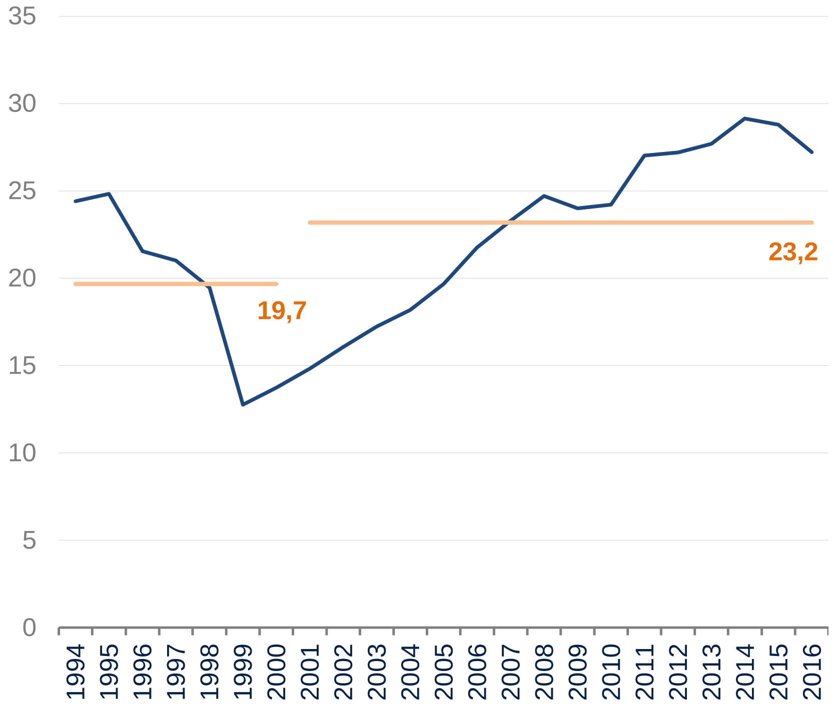
- The shock affected investment directly through two channels: activity and prices (exchange rate). The contraction in spending in the oil and gas sector impacted various economic indicators
- External funding and employment kept private consumption high even up to 2H16. However, accumulating effects (inflation, interest rates and economic slowdown) resulted in a sharp fall in consumer confidence

Source: BBVA Research with DANE data

Despite the scale of the adjustment, the gains in investment continued (high investment rate)

Gross fixed capital formation

(% of GDP, constant prices)



- The investment rate peaked in 2014, driven in particular by the cycle of strong oil prices
- By 2016, the investment rate had fallen by 2 points of GDP - a smaller adjustment than in the '90s, but outstripping 2009
- Part of the investment is very specific to the oil and gas sector, which could limit adaptability to other sources of growth. We should consider a correction in the productivity of such investment, which would be in line with the argument that potential GDP is lower than expected

Source: BBVA Research with DANE data

Slow recovery

Figures for the first quarter of 2017 show the continuing weakness of spending and production

GDP growth: supply and demand

(%)

	2015	2016	I 2016	II 2016	III 2016	IV 2016	I 2017
GDP	**3,1**	**2**	**2,7**	**2,5**	**1,1**	**1,6**	**1,1**
Demand							
Private Consumption	3,2	2,1	2,8	2,1	1,1	2,3	1,1
Public Consumption	5	1,8	3,9	3,1	0,2	0,2	2,1
Fixed Investment	1,8	-3,6	-4	-4	-3,6	-2,9	-0,7
Exports	1,2	-0,9	0,7	2,1	-3	-3,3	-3,6
Imports	1,4	-6,2	-5,8	-3,5	-10,9	-4,3	-0,4
Supply							
Agriculture	2,5	0,5	0	0,4	-0,5	2	7,7
Mining	0,2	-6,5	-4,6	-6,8	-6,5	-8,3	-9,4
Industry	1,7	3	4,3	5,3	1,3	1	0,3
Utilities	3	0,1	2,9	-0,7	-1,4	-0,6	-0,6
Construction	3,7	4,1	5,5	0,7	6,8	3,4	-1,4
Commerce, hotels and restaurants	4,6	1,8	2,8	1,9	0,7	1,8	-0,5
Transport and telecom	2,6	-0,1	0,9	0,2	-1,4	-0,3	-0,3
Financial and business services	5,1	5	4,9	5,4	4,4	5,1	4,4
Social and communal services	3,1	2,2	3,5	3,2	1,3	0,9	2,2
Taxes	0,7	2,2	1,3	4,1	0,4	2,9	2,7

Source: BBVA Research with DANE data

- Private consumption adjusted significantly from 3Q16, impacted by high inflation and interest rates, and low confidence
- Investment remained in negative territory; however, the positive performance of road building (concessions) was a highlight
- There was wide dispersal on the supply side: a couple of sectors performed strongly, but most recorded slow growth. Of these, agriculture was boosted by weather conditions returning to normal - a transitory effect

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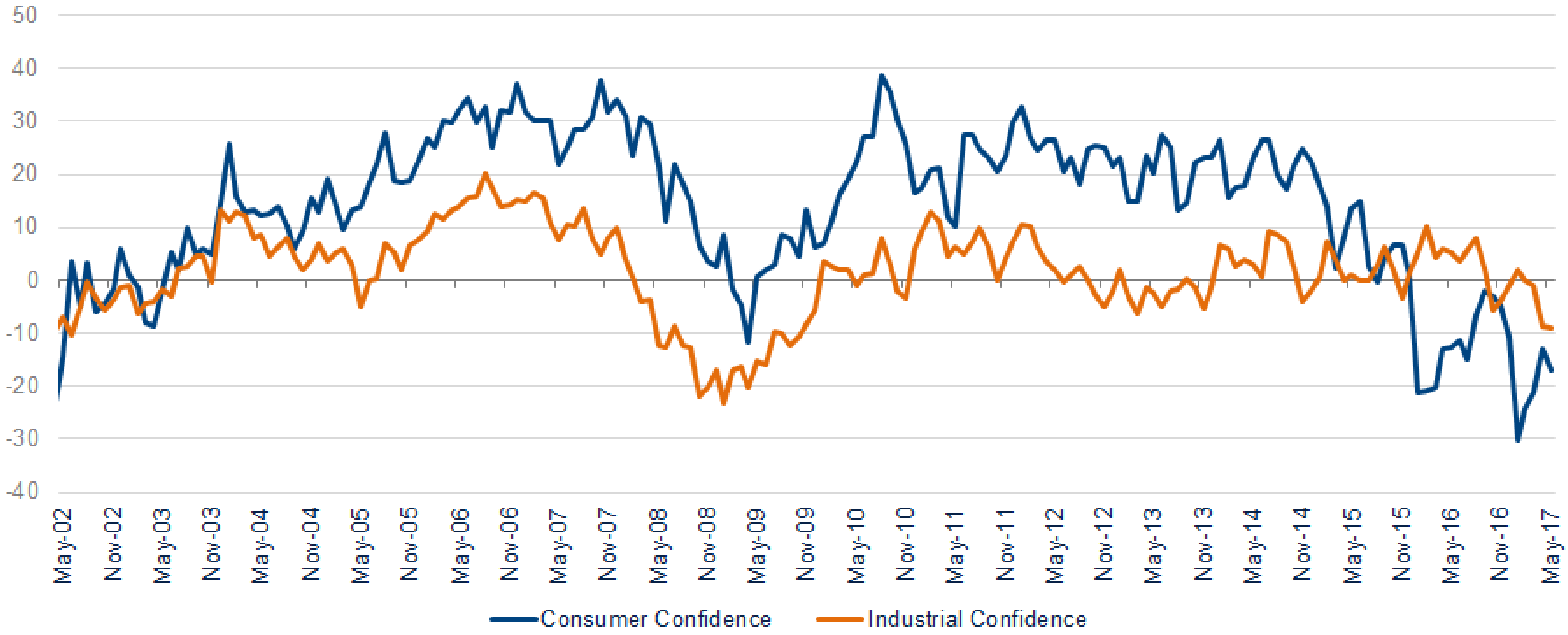
The signs of economic recovery are not yet conclusive

Consumer and industrial confidence
(Balance of confidence)



Source: BBVA Research with Fedesarrollo data

Confidence remains in negative territory, with unexpected falls in the most recent readings

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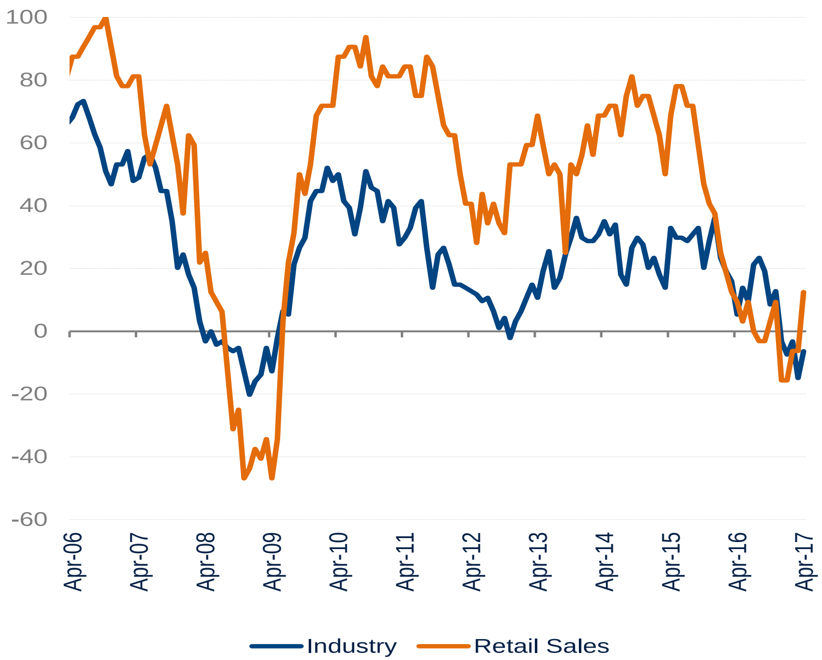
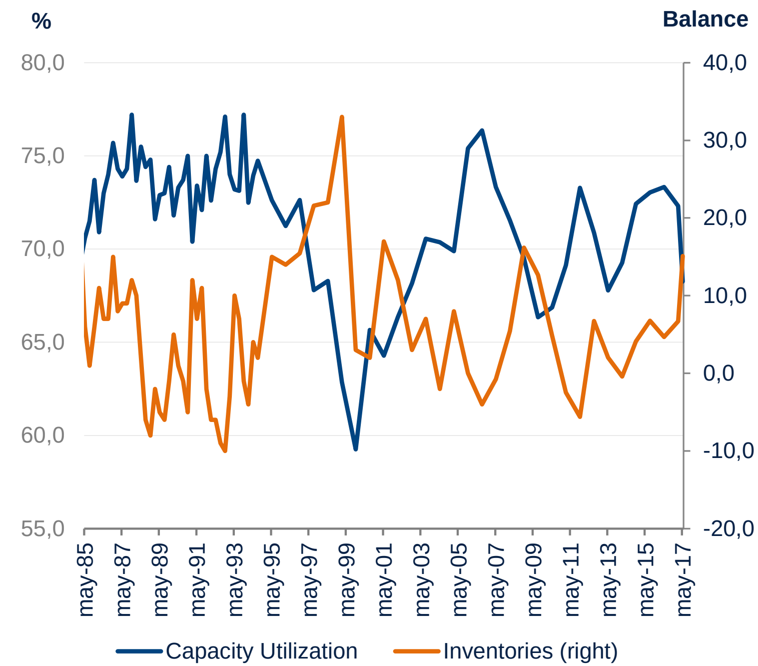
The signs of economic recovery are not yet conclusive

Retail sales and industry sector balance*
(standardised balance)



*Calculated as the number of sub-sectors accelerating minus the number of sub-sectors slowing on a monthly basis. This is then converted into a percentage value compared to the total sub-sectors.

Capacity utilization and inventories

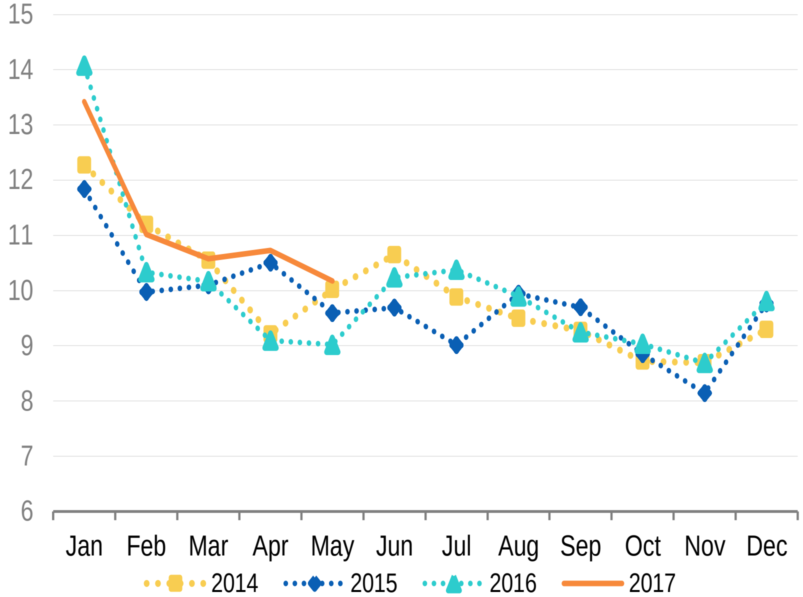


The retail sales and industry sector balance shows signs of recovery, although there are still some signs of weakness. Indicators of inventories and capacity utilization show that demand remains weak

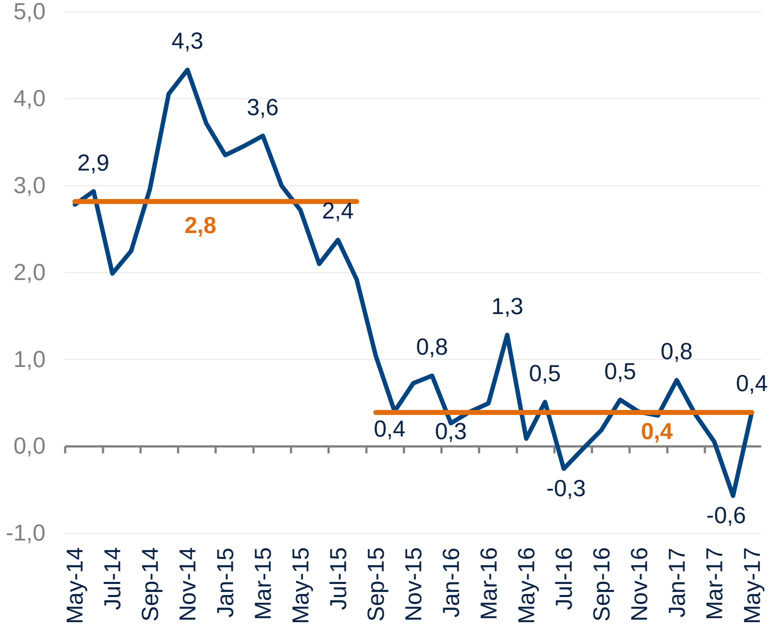
Source: BBVA Research with DANE and ANDI data

Signs of deterioration in the labour market are starting to appear

Unemployment rate
(% of EAP, 13 cities)



Employment growth rate
(%, quarterly data, 13 cities)

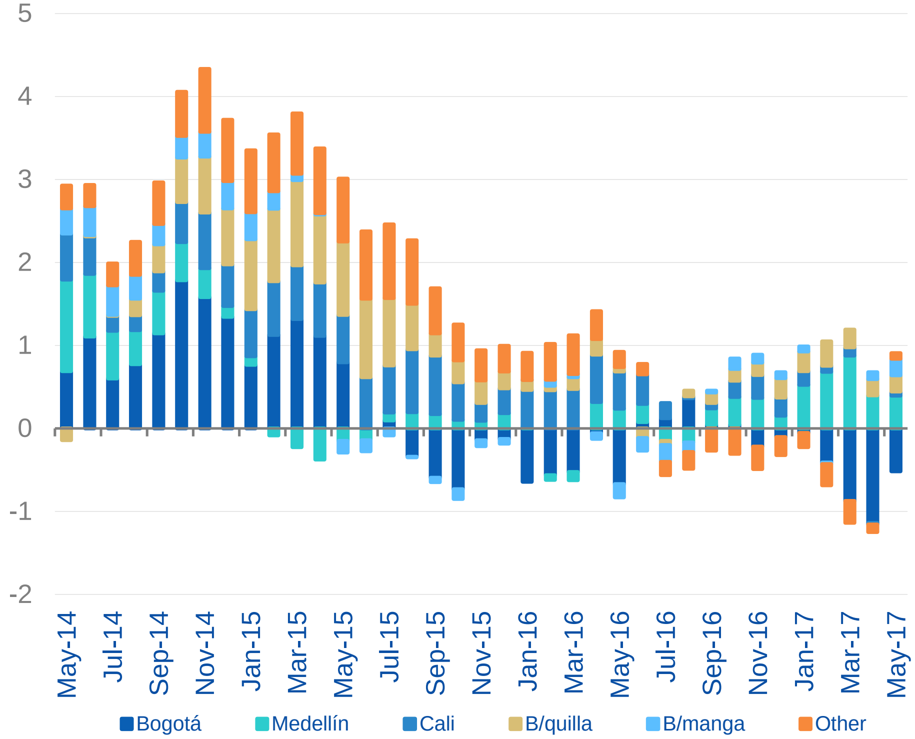


The 2017 unemployment rate is higher than 2016. Job creation is continuing to weaken

Source: BBVA Research based on DANE data

Marked regional differences in labour market results

Employment growth rate
(%, quarterly)



- Bogotá is leading the destruction of jobs, with 7 consecutive months of job losses and weakness since mid-2015
- Medellín is offsetting some of this, especially so far in 2017, but this is insufficient
- Labour market results closely resemble regional consumer confidence results: Bogotá is bringing up the rear in terms of confidence and job losses, with Medellín and Barranquilla reporting higher confidence and job creation

Source: BBVA Research based on DANE data

Restrictions on fiscal and monetary policy

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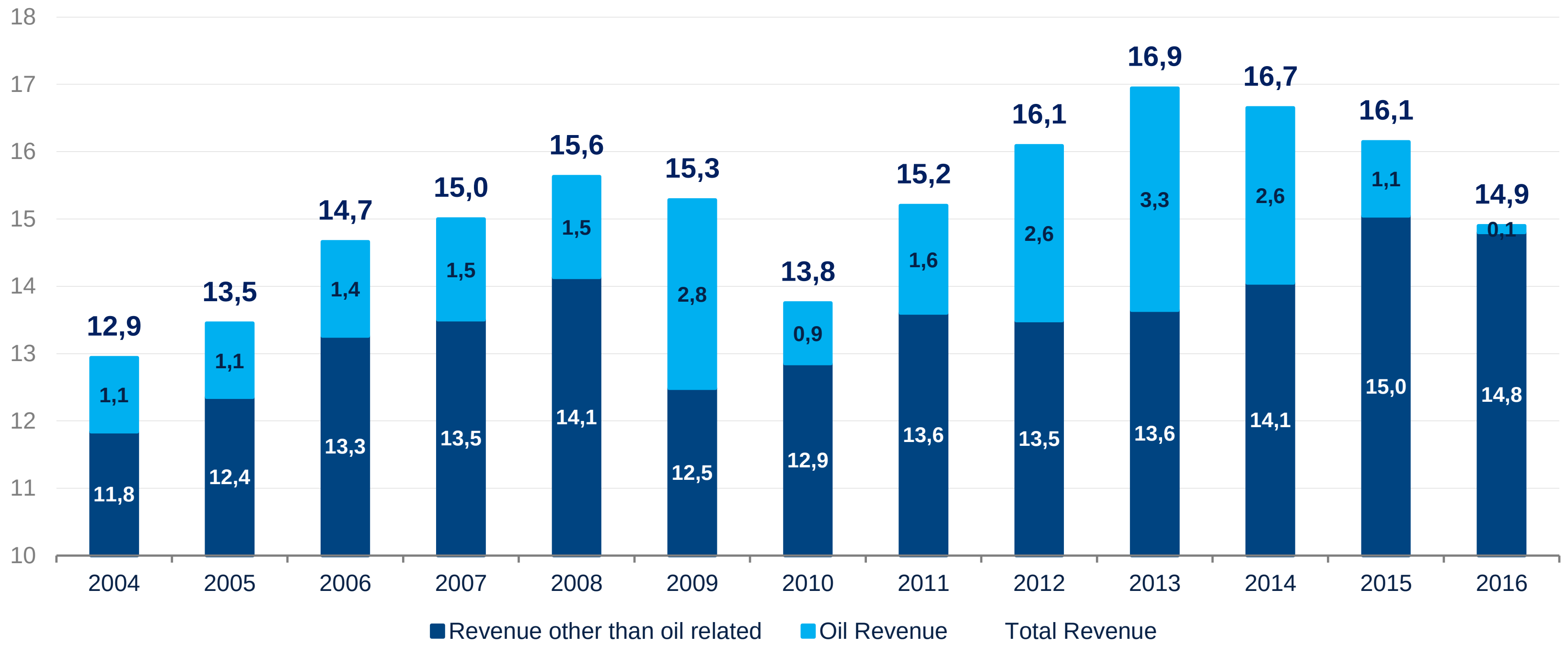
The government has suffered a sharp fall in oil revenues, which have not been offset by other sources

Government revenues

(% GDP)



There is a lag in the effect of falling oil prices. This was seen in 2010 and from 2015

Source: BBVA Research with data from the Ministry of Finance

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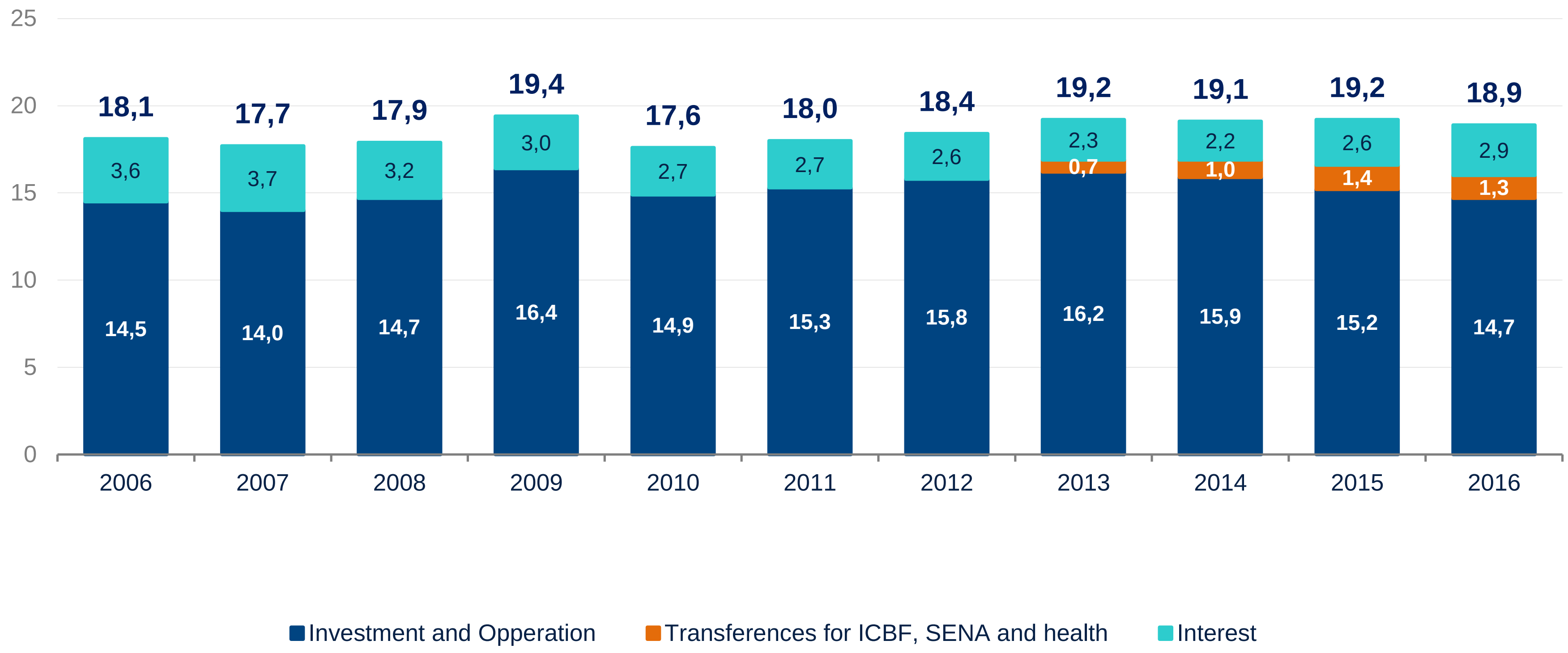
Part of the adjustment has come from lower spending, but interest and charges stemming from the 2012 reform have decimated this effort

National government spending

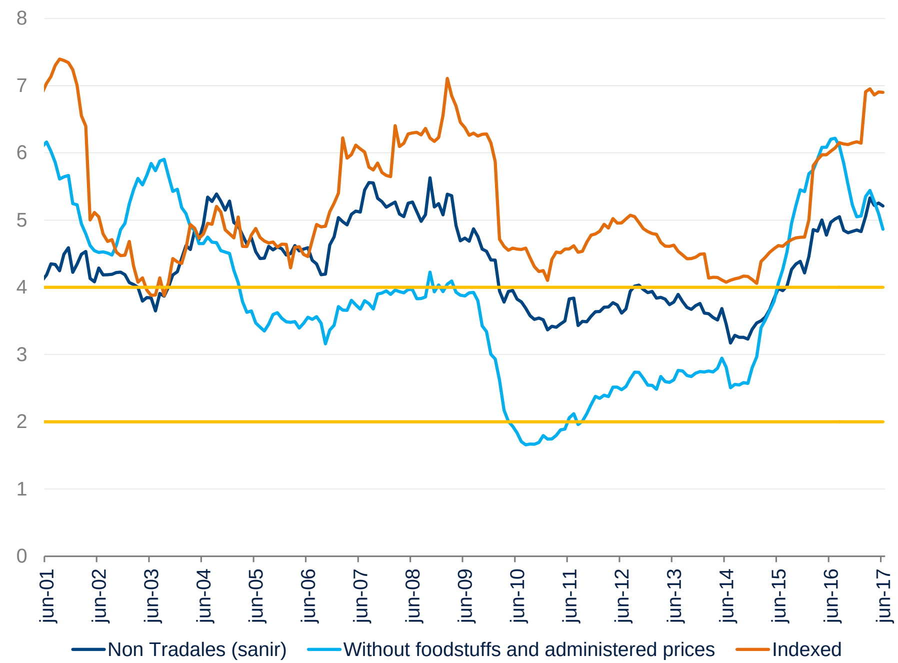
(% GDP)



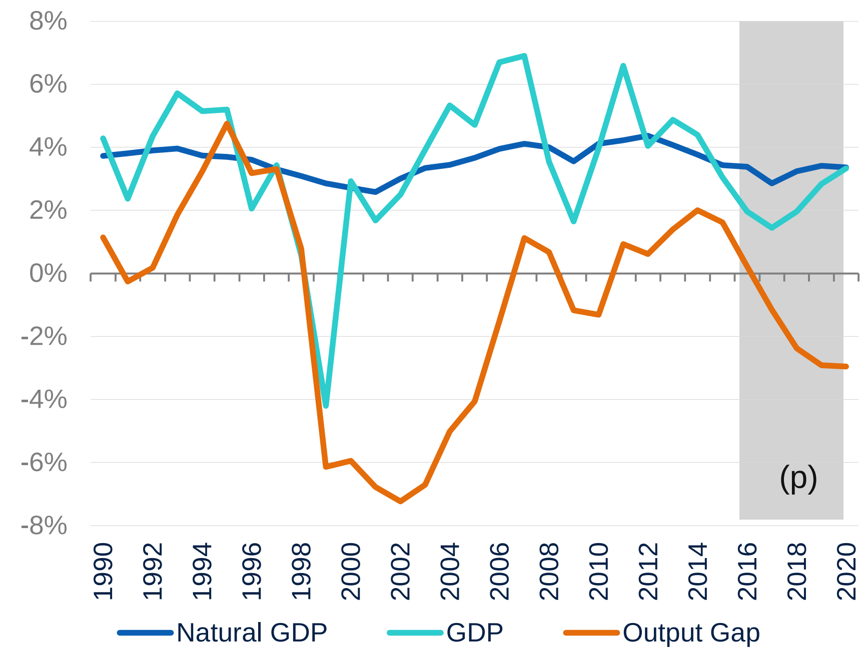
Source: BBVA Research with data from the Ministry of Finance (MFMP)

The Central Bank is facing a difficult dilemma of a slowing economy with inflationary risks

Inflation, non tradables
(%)



Potential and observed GDP and output gap

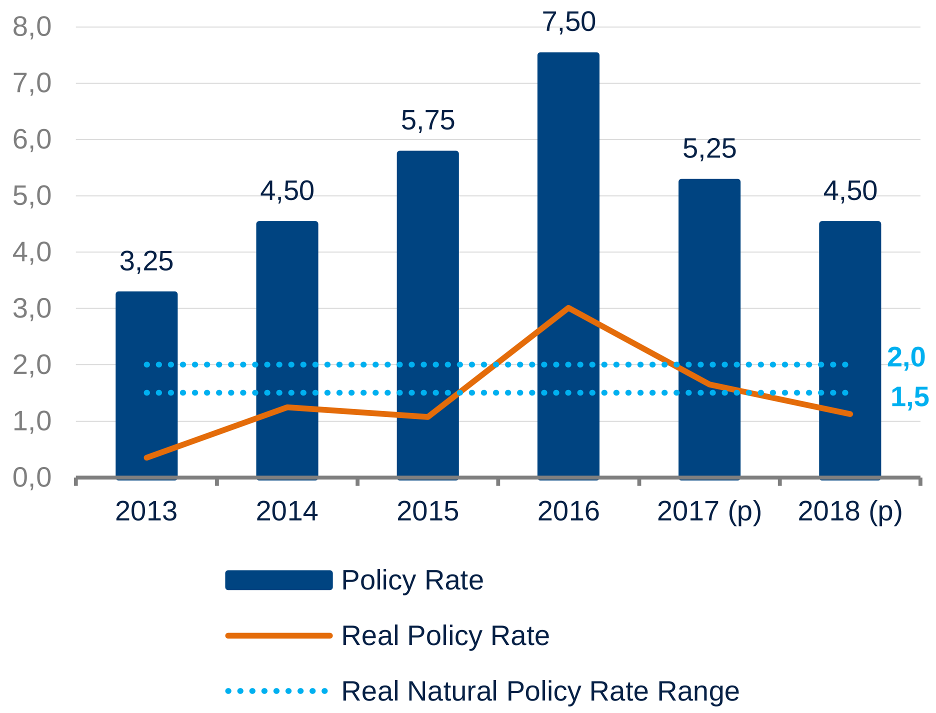


Part of the shock will be permanent, reducing observed and potential GDP, and limiting the Central Bank's scope for action

Source: BBVA Research based on DANE data

The Central Bank has adjusted its rates by 200 bp, but could have scope for a further 125 bp in 2H17 and 2018

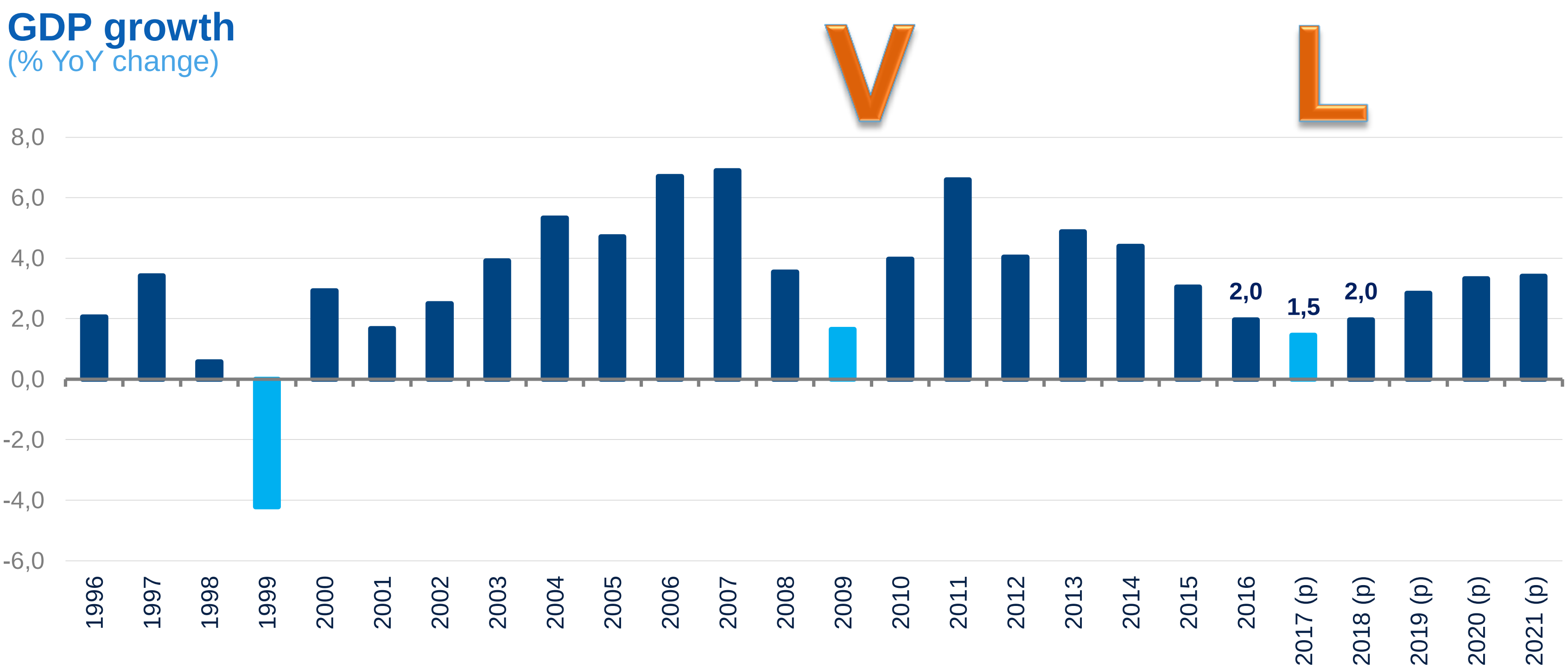
Policy interest rate
(%)



- The Central Bank's recent statements show greater concern about growth. For this reason, it reduced its policy rate by 50 bp at its most recent meeting, and could reduce it by a further 50 bp at its coming meetings
- This would put the rate in neutral territory, enabling the Central Bank to take a breather, taking advantage of an uncomfortable time of increasing inflation to assess the impact on expectations (August to November)
- In 2018 it would have room for further cuts of 75 bp to 4.5%. This would be limited by expectations becoming detached or inflation not falling back significantly at the start of the year

Source: BBVA Research based on Banrep data

Based on the factors mentioned, we expect a slow recovery in economic activity



Source: BBVA Research with DANE data

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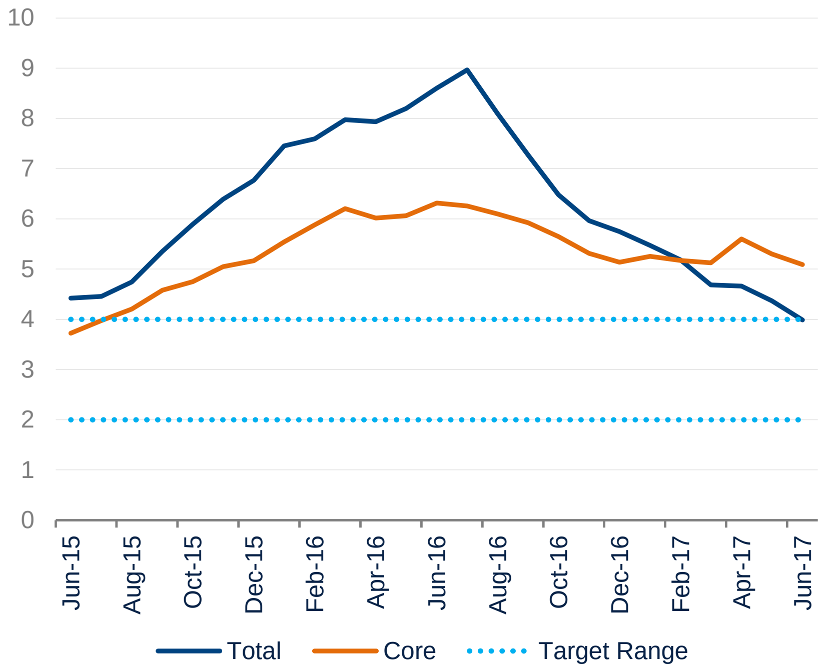
Inflation and exchange rate

After the storm, the calm

Inflation has fallen back over the year, as a result of normalisation of the 2016 supply-side shocks

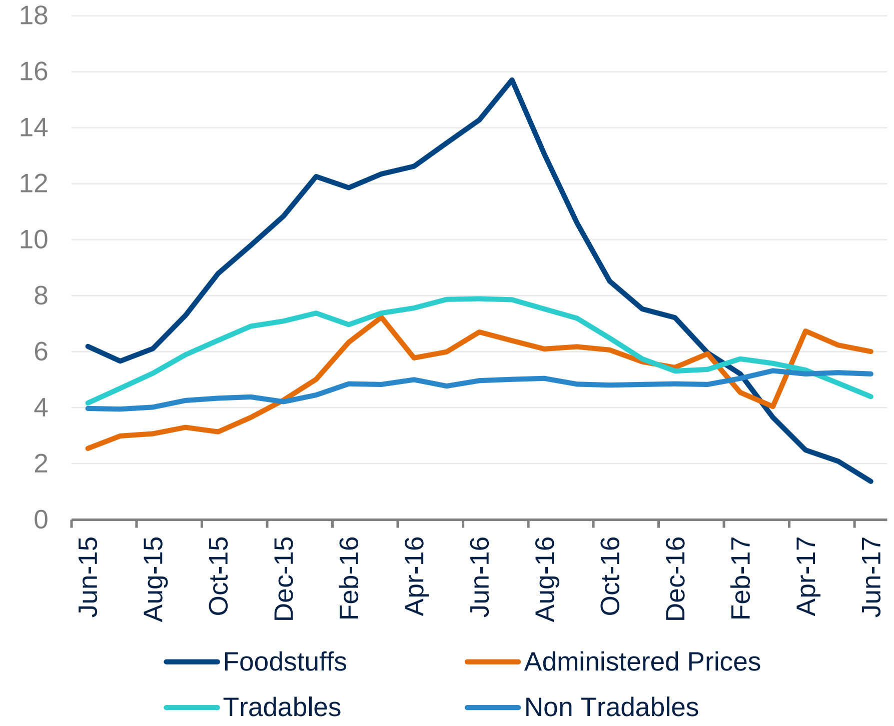
Total inflation and without food

(% YoY change)



Inflation by components

(% YoY change)



Source: BBVA Research with DANE data

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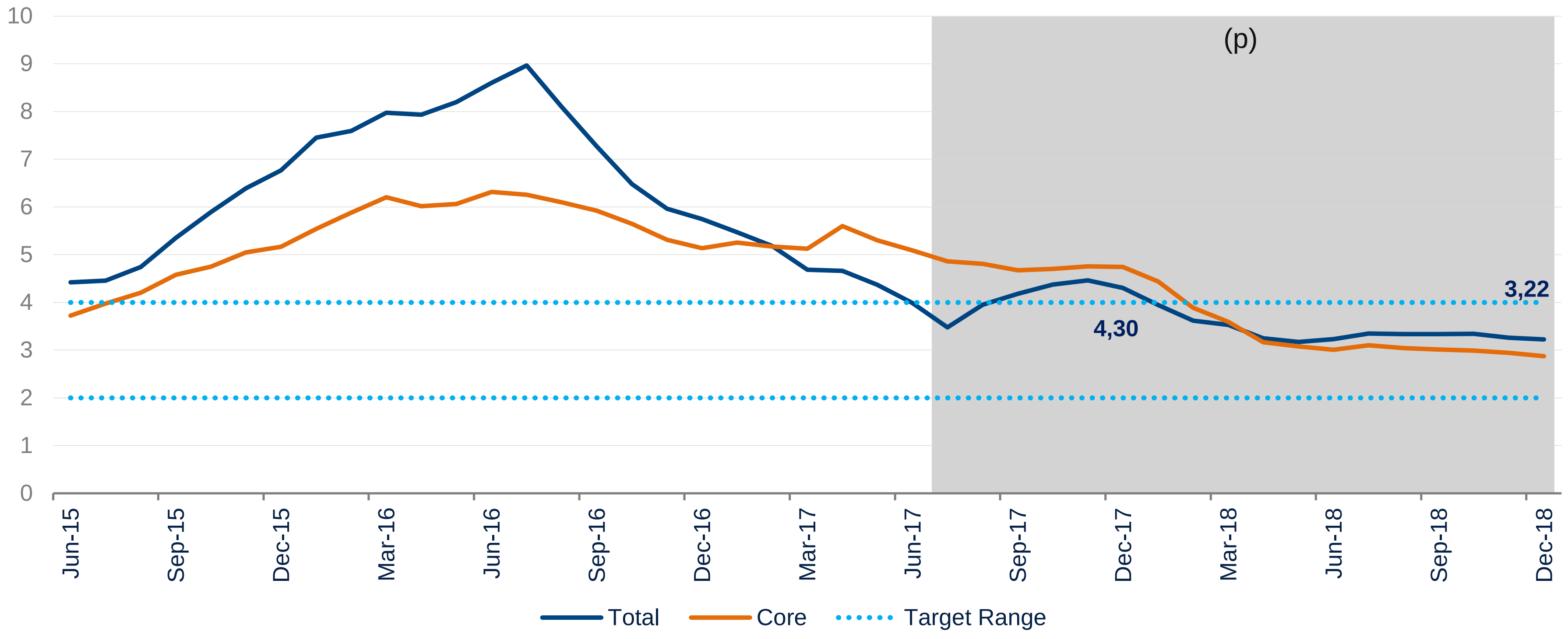
We expect a rebound in inflation between August and November due to base effects: inflation of 3.2% in 2018

Total inflation and without food

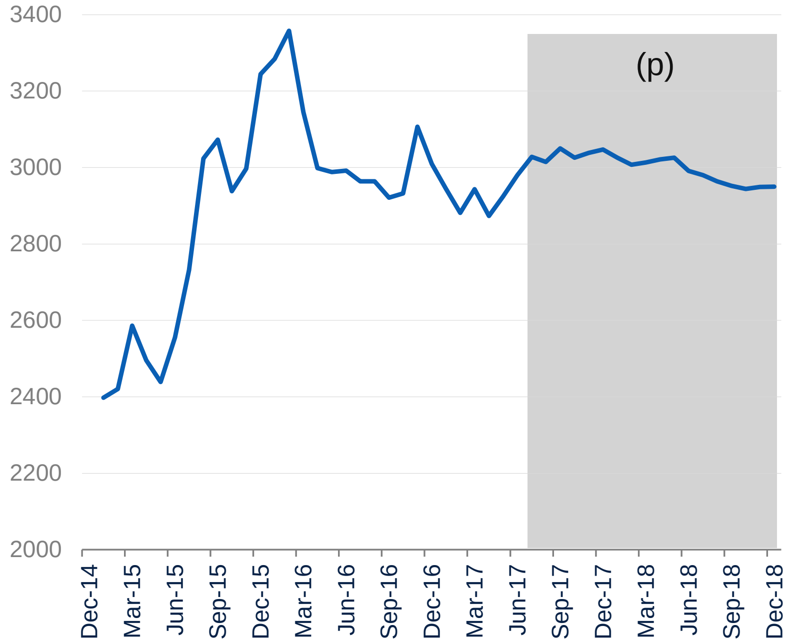
(% YoY change)



Source: BBVA Research with DANE data

The stability of inflation has been accompanied by a moderation in exchange rate volatility

Exchange rate
(% YoY change)



- The fall in oil prices over the last quarter fostered exchange rate depreciation. We expect these conditions to continue over the third quarter, with the exchange rate moderating at year end
- Here at BBVA we expect the oil price to converge on USD 59/Brent barrel. This would imply future upward pressure on the currency. Our long-term estimate of the currency is therefore 2900 pesos to the dollar beyond 2019
- US monetary policy has been another unique factor, prompting the devaluation over the year. It will be important to keep an eye on the behaviour of the exchange rate when the Federal Reserve starts running down its balance sheet

Source: BBVA Research based on Bloomberg data

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Structural balances

Reducing the vulnerability of the economy

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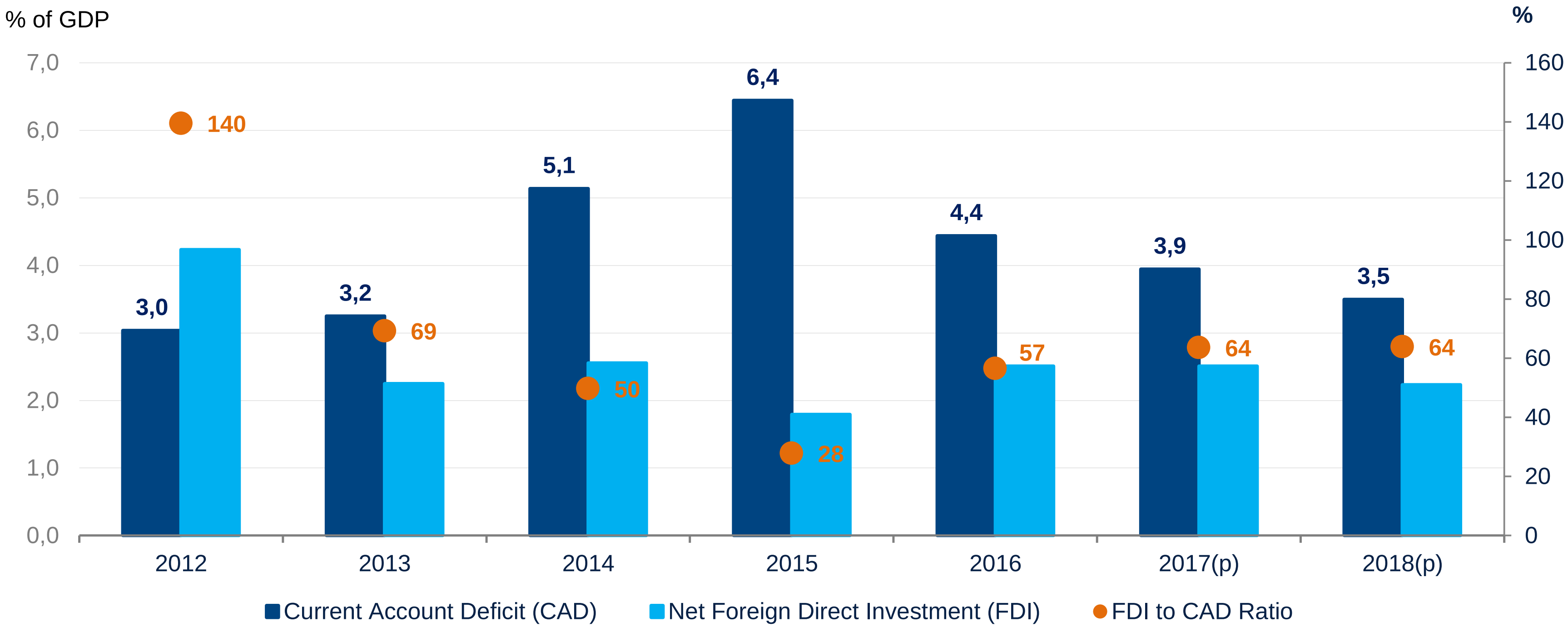
The reduction in the current account deficit will be smaller than in 2016 in 2017 and 2018, but we will keep working on this

Current Account
(% YoY change)



Improved composition of funding compared to 2015, reducing the vulnerability of the Colombian economy

Source: BBVA Research based on Banrep data

Main messages

1. **Global growth is continuing to increase**. This improvement mainly affects **advanced economies and China**. China has also experienced fiscal stimuli. Overall, global risks remain a concern.

2. **Colombia's economy has responded positively to the oil price shock.** Despite a sharp slowdown, the capacity to cushion the cycle and maintain external funding has enabled growth to remain in positive territory.

3. **The economy will recover** The recovery cycle will be slow, due to limited exogenous sources of growth: we expect GDP to perform below its potential over the coming years.

4. **Economic policy will contribute less to the recovery than in 2009.** In the absence of significant improvements in revenues, compliance with the fiscal rule will mean the Government has a negative impact on growth. Meanwhile, the Central Bank is worrying about inflation

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ANNEX:

Main macroeconomic variables

Annual macroeconomic forecasts

	2013	2014	2015	2016	2017(f)	2018(f)
GDP (YoY, %)	4.9	4.4	3.1	2.0	1.5	2.0
Private consumption (YoY, %)	3.4	4.3	3.2	2.1	1.6	2.3
Public consumption (YoY, %)	9.2	4.7	5.0	1.8	2.6	1.5
Fixed investment (YoY, %)	6.8	9.8	1.8	-3.6	1.9	3.1
Inflation (% YoY, eop)	1.9	3.7	6.8	5.7	4.3	3.2
Inflation (% YoY, average)	2.0	2.9	5.0	7.5	4.4	3.4
Exchange rate (eop)	1,927	2,392	3,149	3,001	3,047	2,950
Devaluation (%, eop)	9.0	24.1	31.6	-4.7	1.5	-1.4
Exchange rate (average)	1,869	2,001	2,742	3,055	2,977	2,985
Devaluation (%, average)	3.9	7.1	37.0	11.4	-2.5	0.3
BanRep interest rate (%, eop)	3.25	4.50	5.75	5.75	5.25	4.50
Deposit interest rate (%, eop)	4.1	4.3	5.2	6.9	5.3	4.8
Fiscal nalance (% GDP)	-2.3	-2.4	-3.0	-4.0	-3.6	-3.1
Current account balance (% GDP)	-3.2	-5.2	-6.5	-4.4	-3.9	-3.5
Unemployment rate (%, eop)	9.7	9.3	9.8	9.8	10.6	11.2

Source: Banco de la República, DANE and BBVA Research

Main macroeconomic variables

Tabla 7.2 Previsiones Macroeconómicas Trimestrales

	PIB (% a/a)	Inflación (% a/a, fdp)	Tipo de cambio (vs. USD, fdp)	Tasa BanRep (%, fdp)
T1 14	6,4	2,5	1.965	3,25
T2 14	4,0	2,8	1.881	4,00
T3 14	3,9	2,8	2.028	4,50
T4 14	3,3	3,7	2.392	4,50
T1 15	2,6	4,6	2.576	4,50
T2 15	3,0	4,4	2.585	4,50
T3 15	3,2	5,4	3.122	4,75
T4 15	3,4	6,8	3.149	5,75
T1 16	2,7	8,0	3.022	6,50
T2 16	2,5	8,6	2.916	7,50
T3 16	1,1	7,3	2.880	7,75
T4 16	1,6	5,7	3.001	7,50
T1 17	1,1	4,7	2.880	7,00
T2 17	0,9	4,0	3.038	5,75
T3 17	2,0	4,2	3.050	5,25
T4 17	1,8	4,3	3.047	5,25
T1 18	2,3	3,5	3.013	4,75
T2 18	2,0	3,2	2.991	4,50
T3 18	1,7	3,3	2.952	4,50
T4 18	1,8	3,2	2.950	4,50

Fuente: Banco de la República, DANE y BBVA Research

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