

Colombia Economic Outlook

4th Quarter 2017

Colombia Unit

October 2017

Main messages

- 1. Global growth remains robust and includes more regions.** Financial markets still favour emerging economies. +However, global downside risks remain
- 2. The economic slowdown seems to have ended in the second quarter.** In the third quarter, there are signs of recovery to be seen in several sectoral indicators, although growth will remain low for the full year.
- 3. Better external conditions and the ending of internal shocks will allow a more dynamic 2018.** The majority of economic sectors will show higher growth in 2018 than in 2017, however, their aggregate growth rate will still be low, with GDP growth of 2.0%. On the demand side, private domestic spending is recovering
- 4. Inflation showed a significant correction in the course of the year, it is expected that in 2018 it will consolidate around the Central Bank's target.** Food and tradables have contributed to the slowdown observed, it is expected that by 2018 non-tradables will be supporting the reduction in inflation
- 5. In this context, the Banco de la República will be able to provide greater support to the economy with additional rate cuts.** Once inflationary fears have been overcome, the central bank would have room to reduce its policy rate by at least 75 bps, placing it at a level of 4.5% which, given inflationary expectations, would be considered expansive

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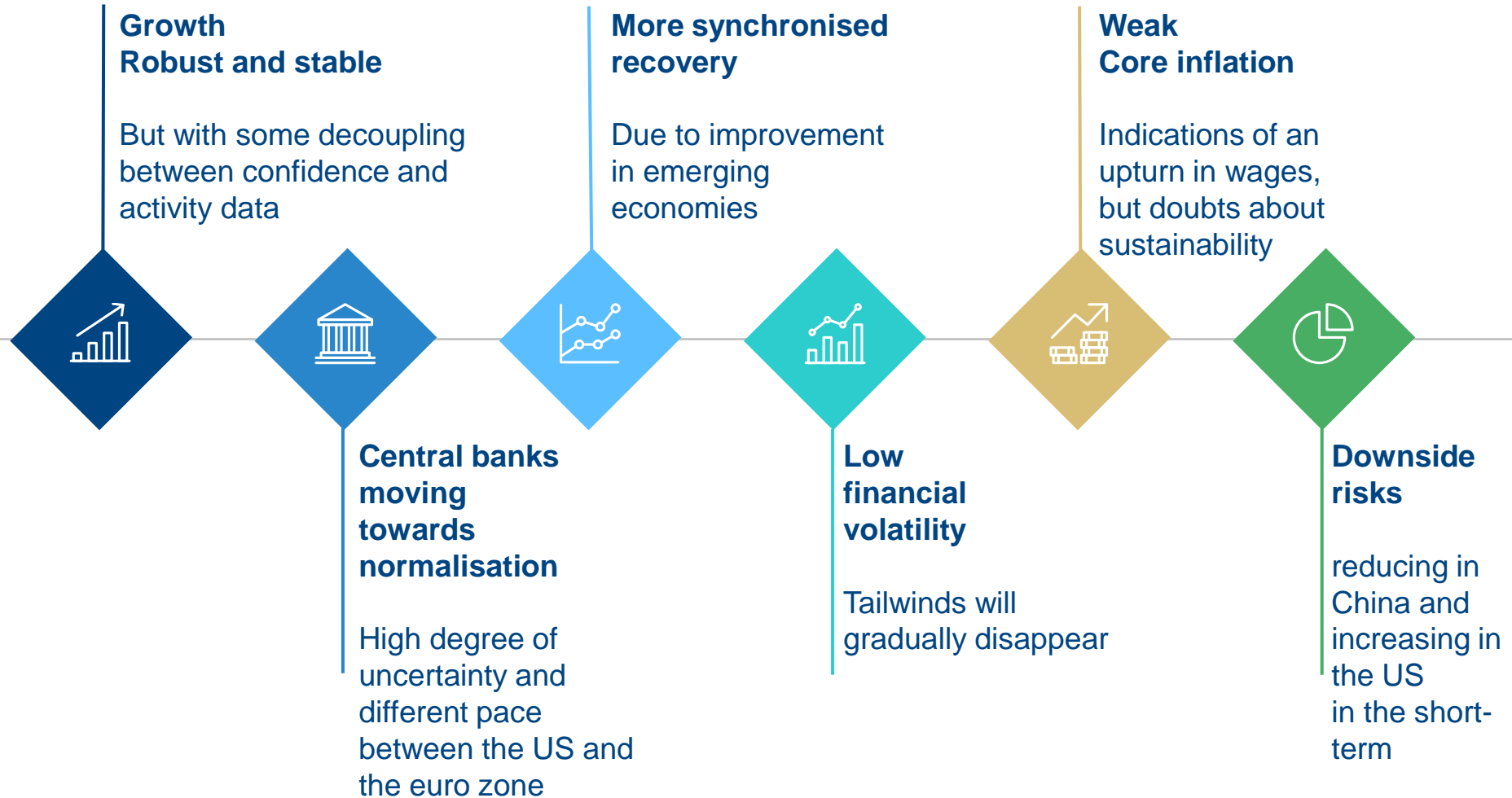
01

GLOBAL

The positive global environment is consolidating, but with downside risks



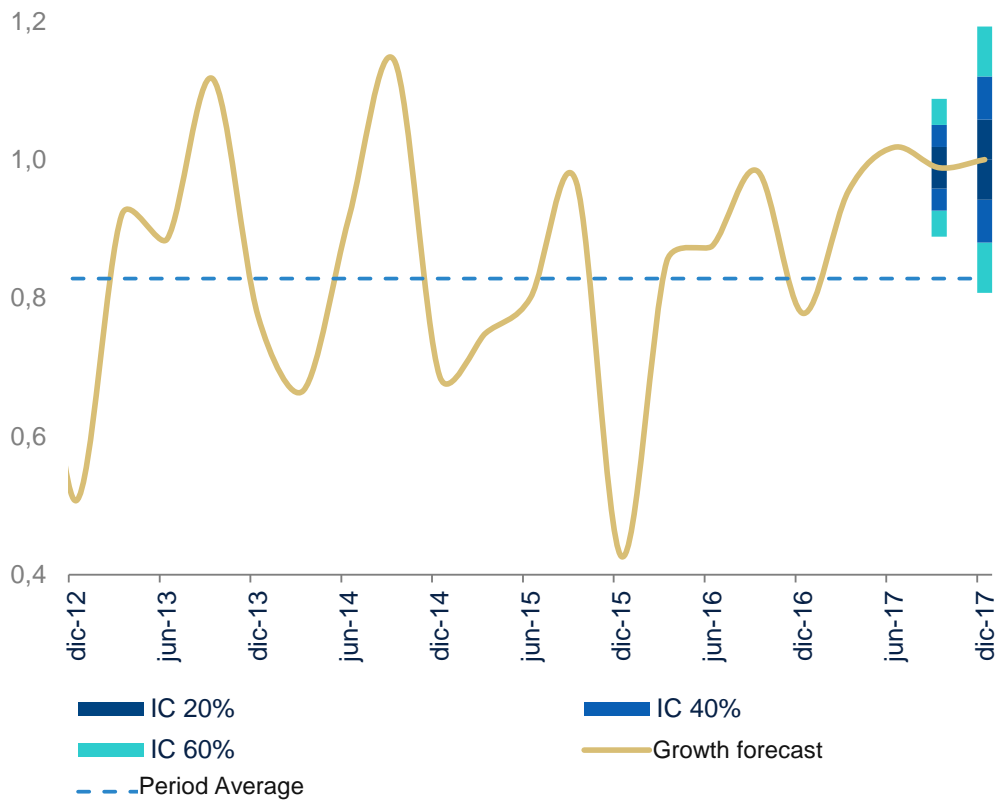
The positive global environment is consolidating



Global growth: robust and stable in 2H17

Growth of world GDP

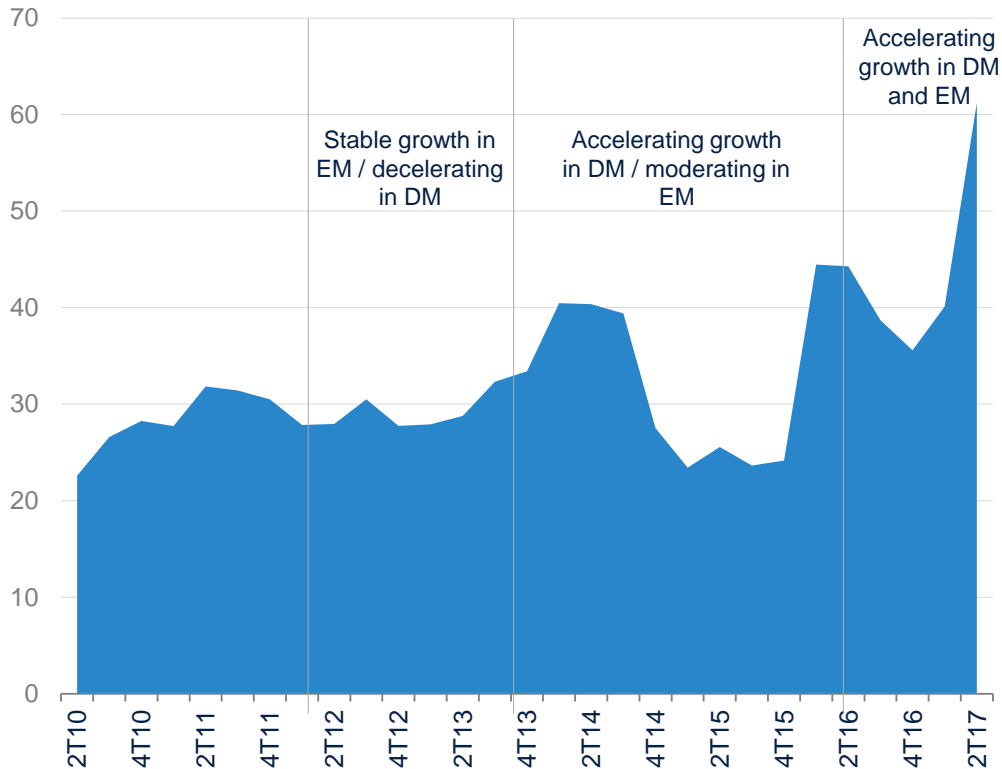
(Forecasts based on BBVA-GAIN (% QoQ))



- ◆ Confidence indicators significantly improve and anticipate a more positive outlook than activity indicators
- ◆ Strong growth in world trade and a recovery in the industrial sector that continues
- ◆ Signs of strength in private consumption despite weaker tail winds

More synchronised recovery between the different areas

Growth synchronisation index between developed and emerging economies



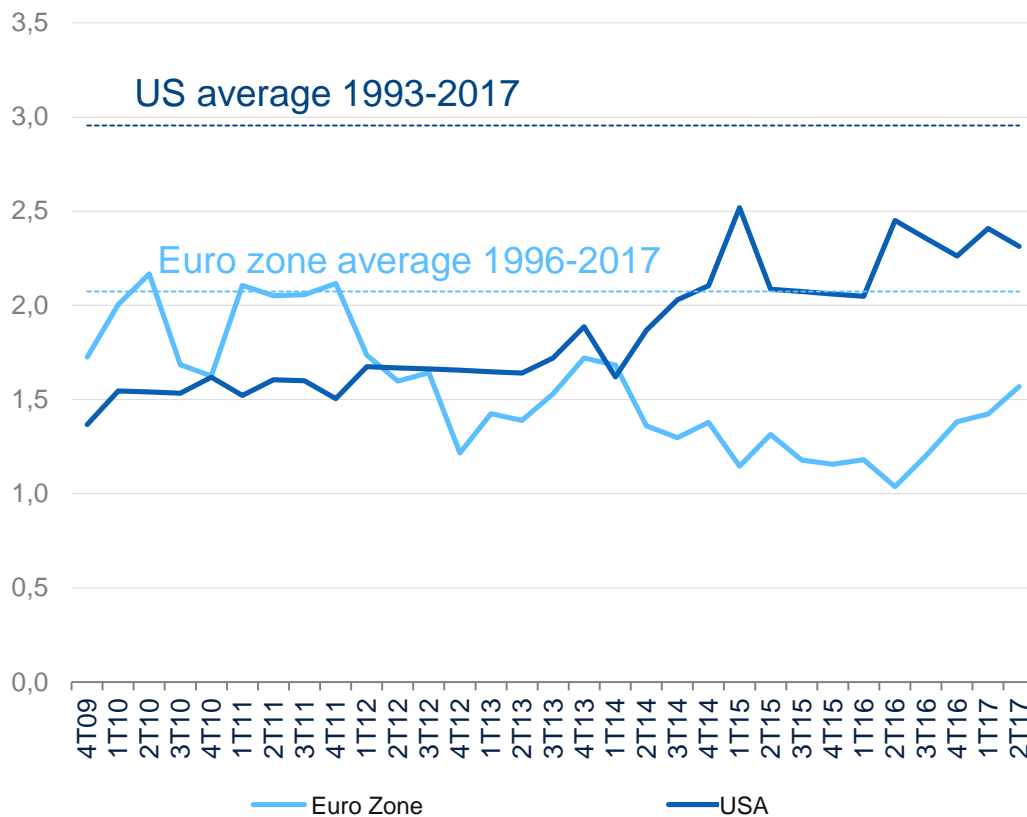
- ◆ Developed:
 - Strong rebound in the US
 - Positive surprise in Europe
- ◆ Emerging:
 - Mild slowdown in China, although less than expected. Continues to support the rest of Asia
 - Recovery in Russia and Brazil, which are no longer holding back world growth
 - Growth is gaining traction in the countries of Latin America
- ◆ Increased support for growth from economic policies

The **synchronisation index** is the product of inverting the standard deviation of quarterly growth observed in countries. The index therefore associates less growth volatility among countries with a higher degree of synchronisation at global level.

Source: National sources, Markit Economics and BBVA Research

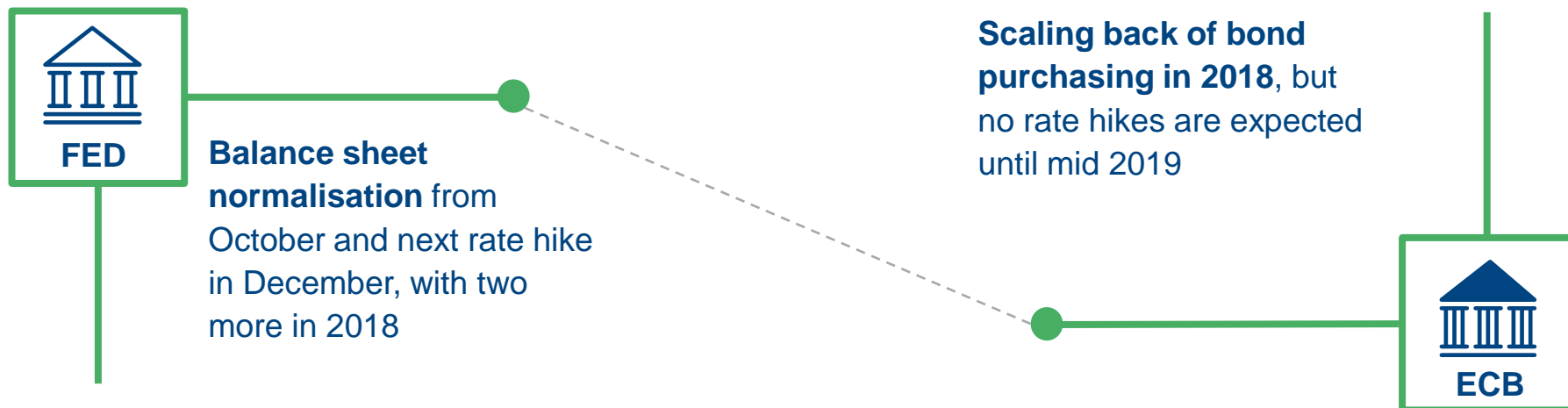
Core inflation shows no warning signs

The US and euro zone: wages
(%, YoY)



- ◆ Despite economic growth and the improvement in the labour market, **core inflation remains at low levels**
- ◆ Doubts about the consolidation of incipient upticks in wages. **Inflationary pressures contained**
- ◆ **Uncertainty** about the determinants of inflation: are changes transitory or permanent?
- ◆ **Caution of central banks**, especially in developed countries. More monetary policy margin in emerging economies

Central banks are moving towards a very gradual normalisation process



High degree of uncertainty:

- In the **United States** due to slowing inflation and the expected change to the FOMC in 2018

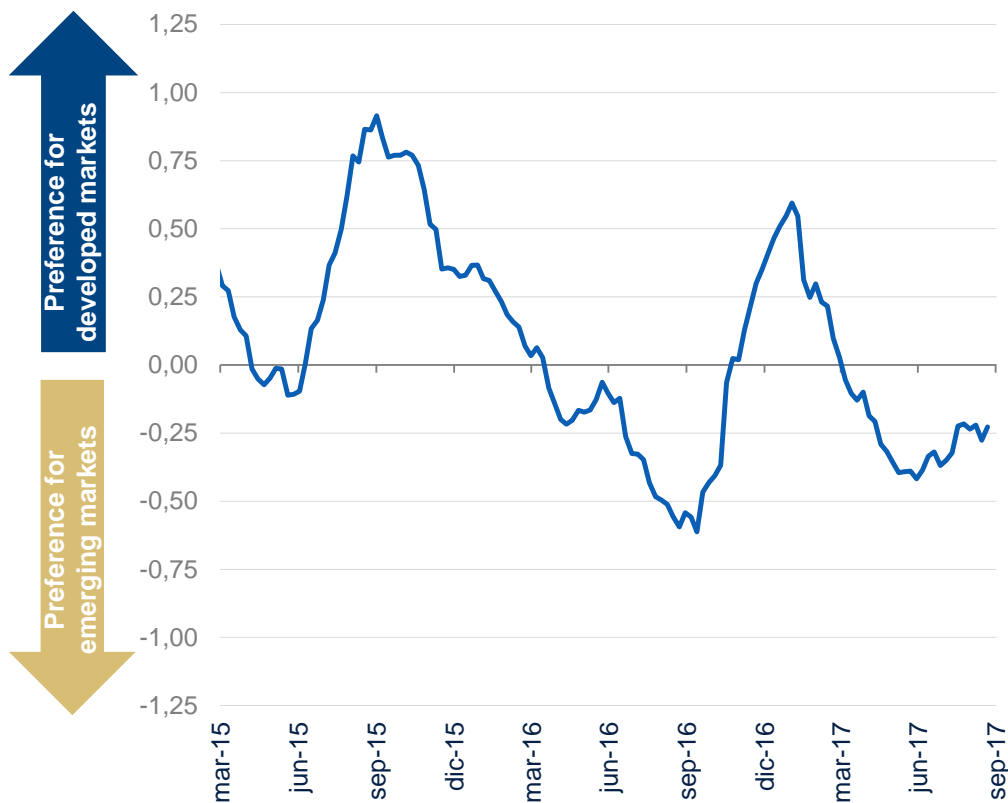


- In the **euro zone**, bias towards more gradual tapering (euro strength) and a delay to the rate hike cycle (low inflation)

Financial markets still favour emerging economies

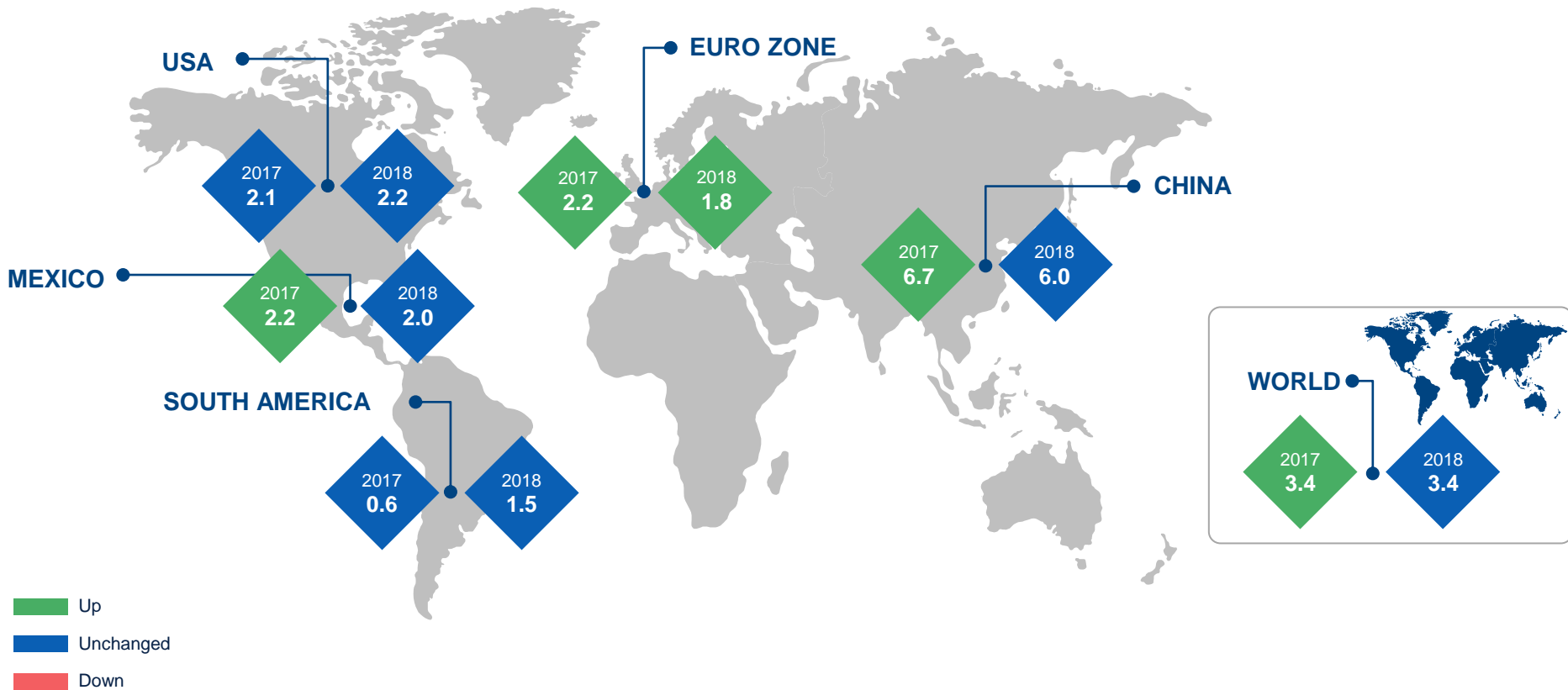
Indicator of regional relocation of assets

(standard deviation from the historical mean)



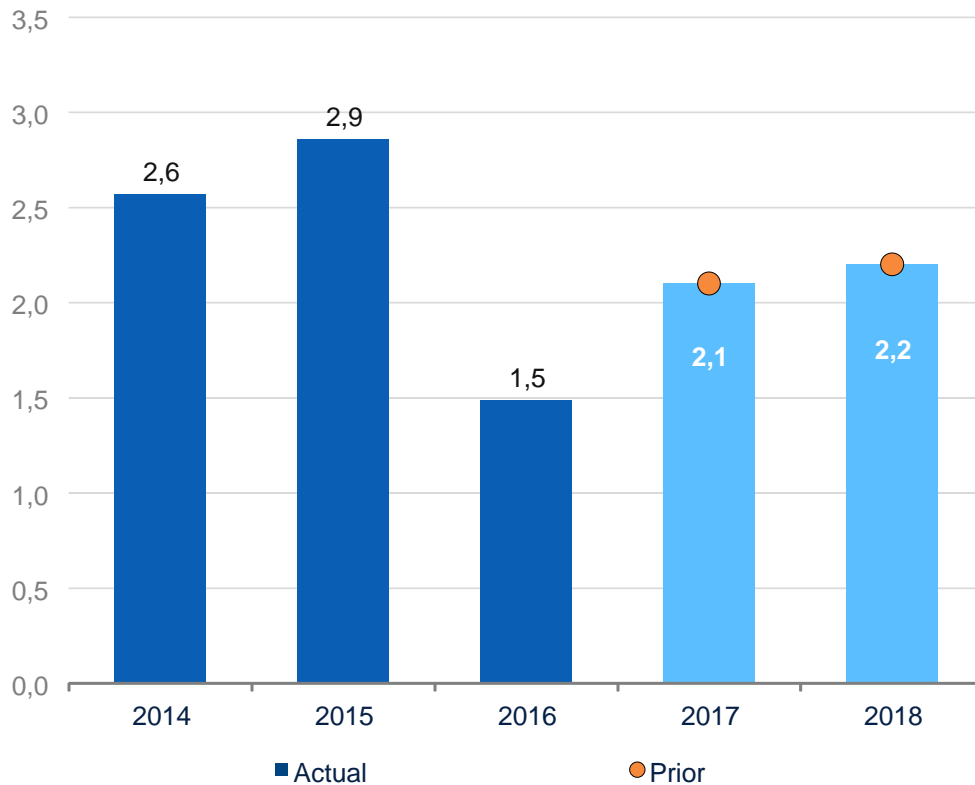
- ◆ Weakness of dollar and low US bond yield boost the quest for profitability, which backs assets of emerging economies
- ◆ Global liquidity will remain high, given the gradual process of normalisation of the Fed and the ECB, although these tailwinds will disappear

Upward revisions of growth for Europe and China. Positive bias in South America



The United States: sustained growth in spite of political uncertainty and natural disasters

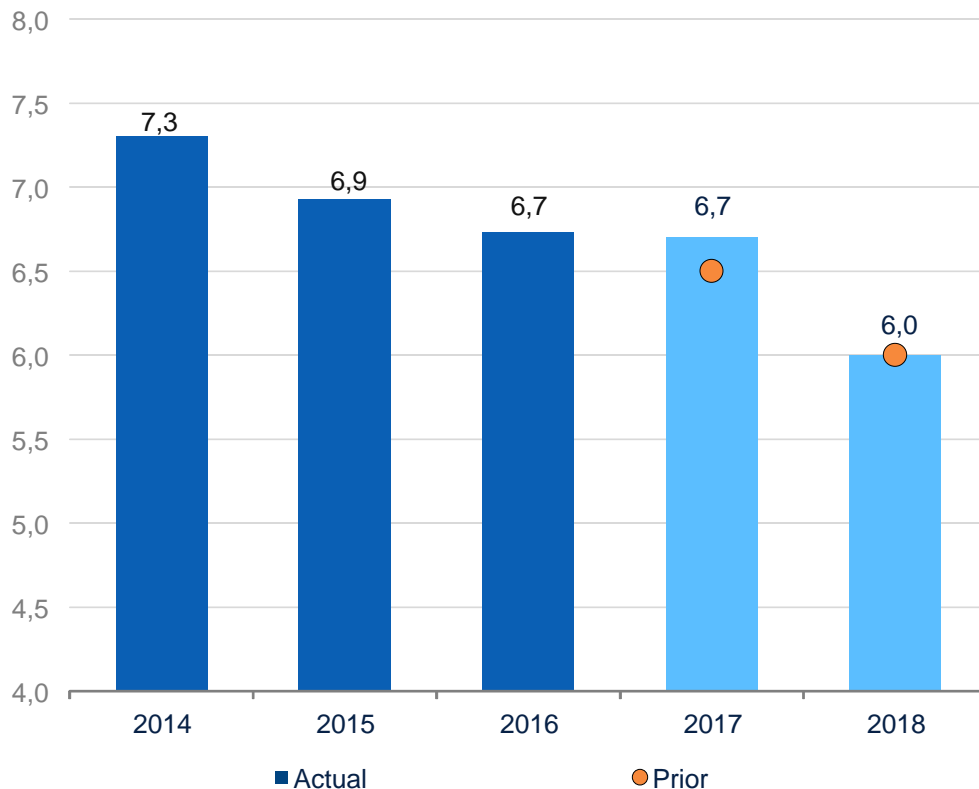
USA: GDP growth
(YoY, %)



- ◆ Hurricanes will have a moderate impact on activity, so we maintain growth forecasts for 2017-2018
- ◆ Among the outstanding issues:
 - A tax reform yet to be clarified
 - Uncertainties about economic policy
 - Certain signs of financial vulnerability
 - And greater geopolitical risks

China: a more promising panorama in the short term

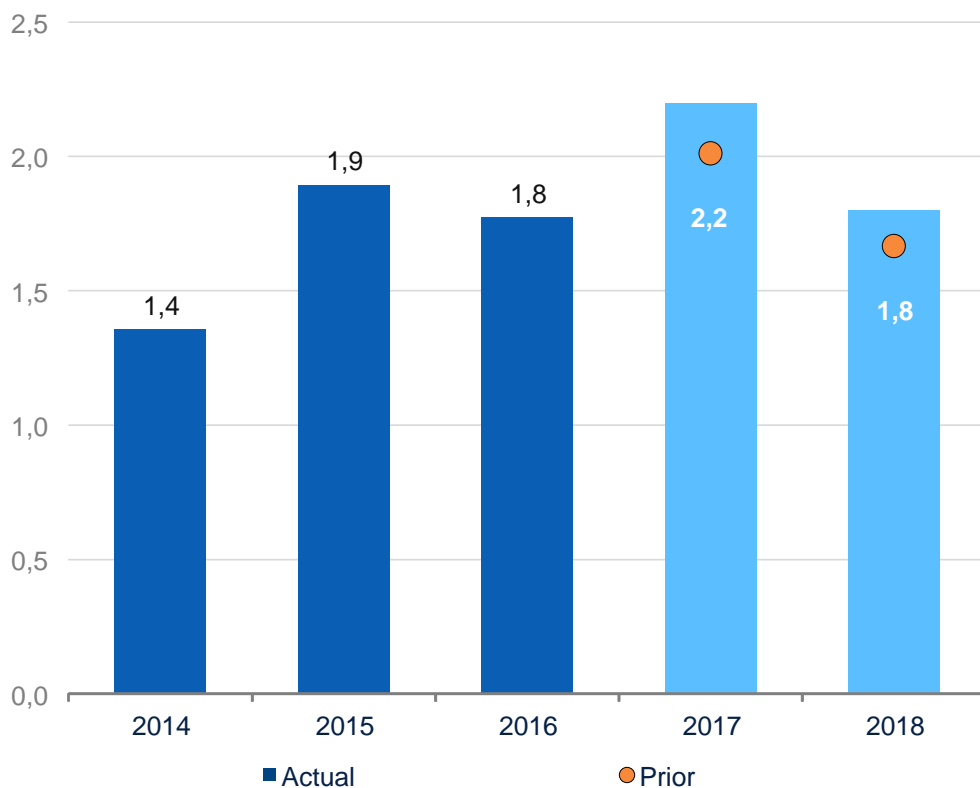
China: GDP growth
(YoY, %)



- ◆ Slight upward revision of growth in 2017 due to better performance in 1H17
- ◆ Slowdown in 2018 due to less supportive economic policies and currency appreciation.
- ◆ Uncertainty about the decisions to be taken at the Communist Party Congress
- ◆ In the long term, risks remain, although financial vulnerabilities have improved somewhat thanks to regulatory measures

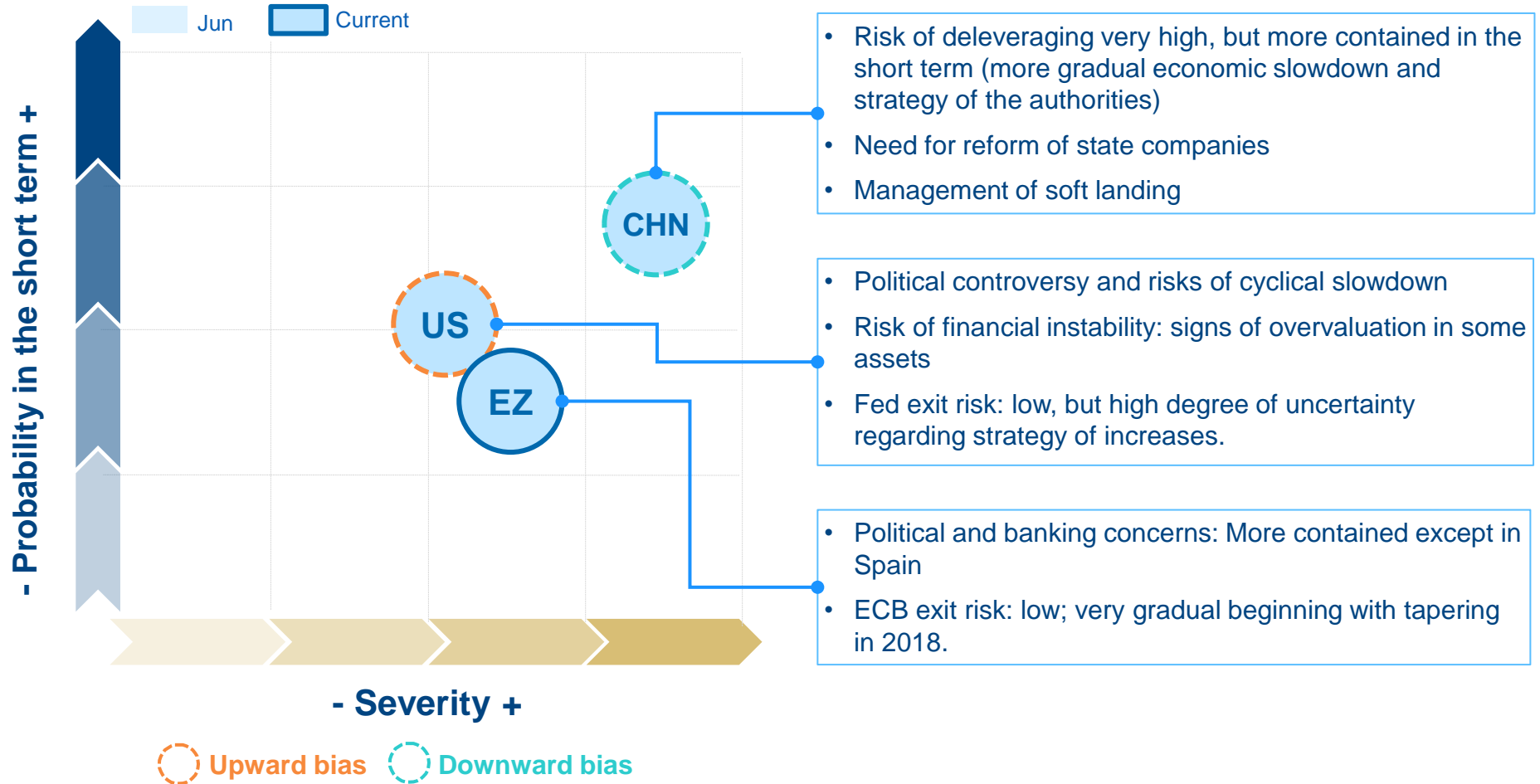
Euro zone: increased growth due to strong domestic demand

Euro zone: GDP growth
(YoY, %)



- ◆ Better consumption and investment behaviour, with a limited impact of the appreciation of the euro.
- ◆ Very gradual increase in inflation towards the ECB target
- ◆ The normalisation of monetary policy will allow it to continue to support growth
- ◆ Political and banking risks continue (Spain, Italy, support for the European project, Brexit, although they are more contained)

Global Risks: rebalancing from China to the US in the short term



**Other risks: Geopolitical (North Korea); Protectionism (China, US)

02

2017: breakeven point

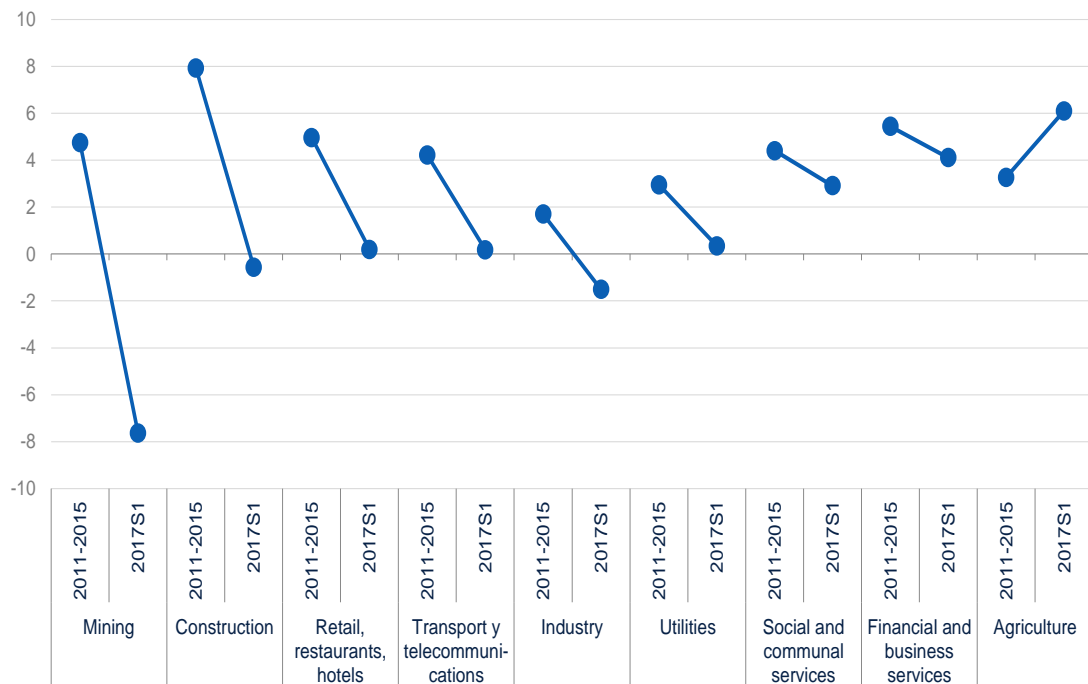
There is evidence that the lowest point of activity may have been left behind in the second quarter of 2017



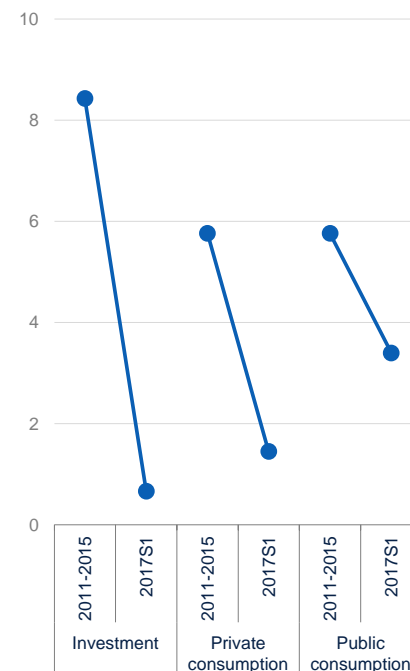
In the first half-year, the economy did not present a good picture

GDP growth in 2017H1 compared with average growth in 2011-2015

GDP supply-side (%)

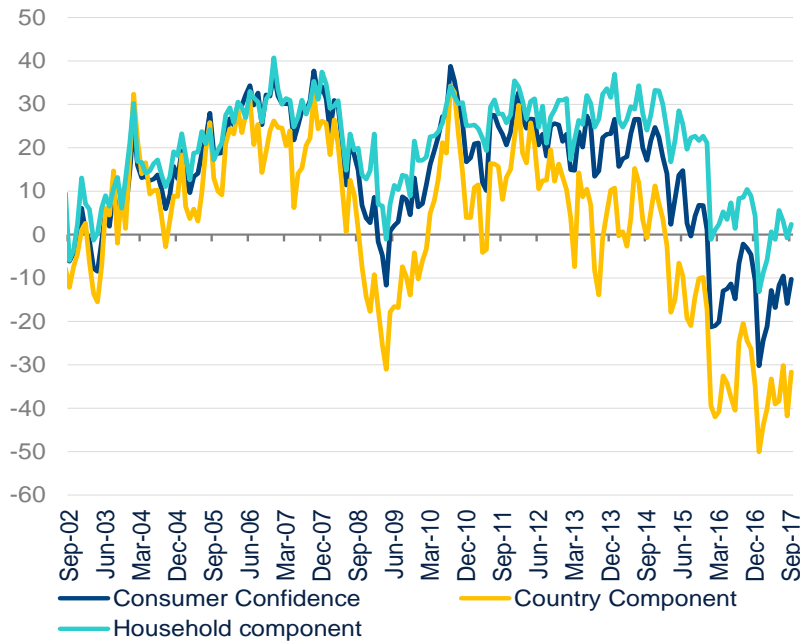


GDP demand-side (%)

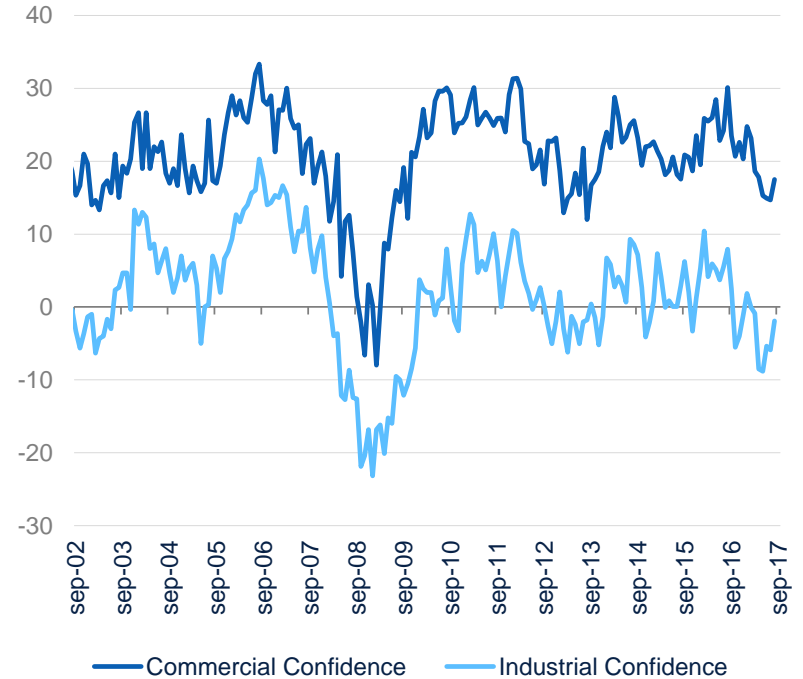


Based on weakened confidence indicators

Consumer Confidence (Balance)



Industrial and Trader Confidence (Balance)



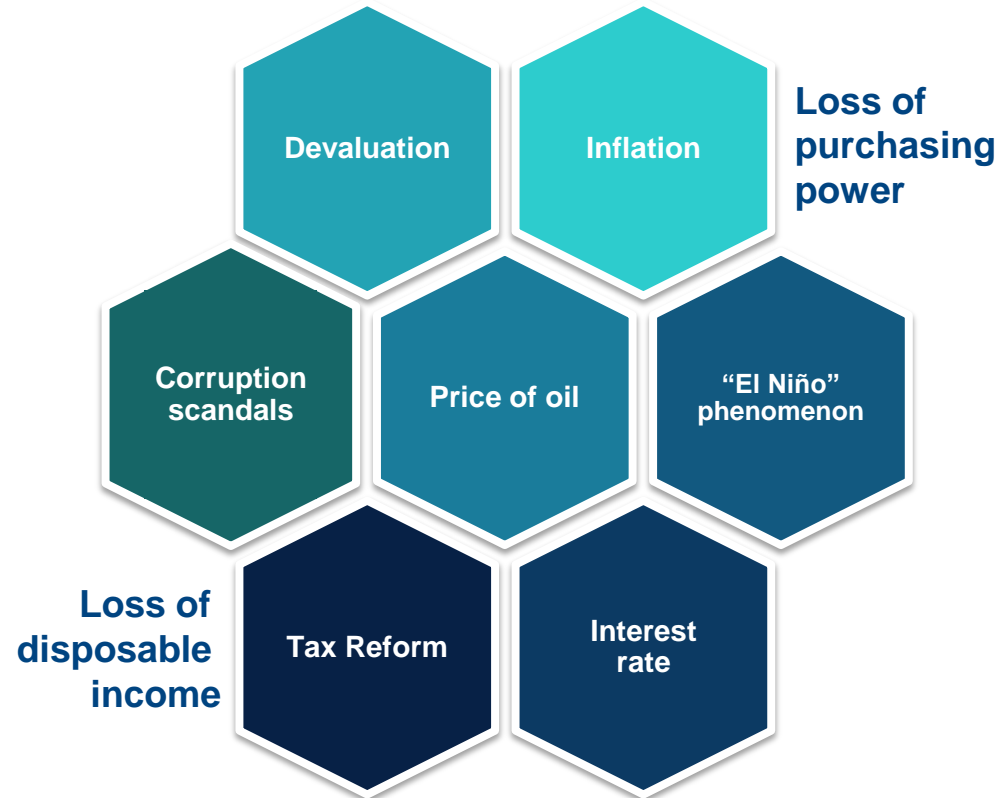
Source: BBVA Research with data from DANE and Bloomberg

While there has been some recent improvement in indicators, their levels for the first half are low relative to their historical records

To a large extent, this is the product of important forces that decimated activity

The Colombian economy simultaneously faced five negative forces, apart from the drop in oil prices:













- ◆ **Devaluation**, which led to an increase in the structure of costs and in imported goods
- ◆ **"El Niño" phenomenon**, which produced food price increases and affected agricultural supplies
- ◆ **Inflation**: the sharp rise in inflation led to a fall in households' purchasing power
- ◆ **Interest rates**: the rise in inflation led to a marked increase in the policy rate.
- ◆ **Tax reform**: the need to replace revenues prompted a tax reform which raised VAT, making consumption more expensive



There are some signs that show a better dynamism in the third quarter compared with the first half of the year

Leading indicators*

(change in 3Q17 relative to each reference)

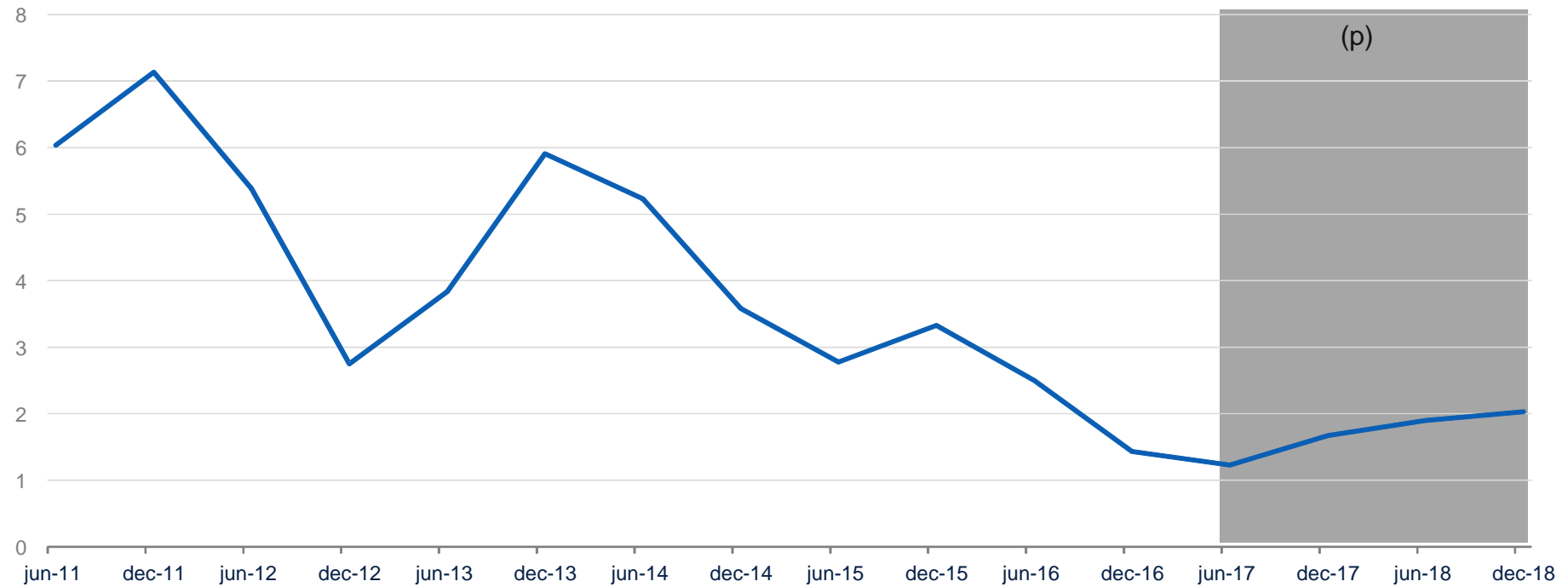
	With respect to 1H17	With respect to 3Q16			With respect to 1H17	With respect to 3Q16	
Energy Demand	4.5	2.2		Industrial confidence*			
Concrete	-1.8	-10.7		Consumer confidence*			
Licences	6.8	-3.0		Non-traditional exports	6.9	13.9	
Cement	5.0	3.3		Vehicle Sales	1.0	-4.1	
Coffee	23.4	17.1		Industry	1.6	1.3	
Oil	1.1	1.7		Retail trade	0.4	1.3	

* Demand data for energy, coffee and oil correspond to the whole quarter, the rest of the variables correspond to the average for July and August.

The second half of the year will see better GDP growth

Growth of half-yearly GDP

(% variation YoY)

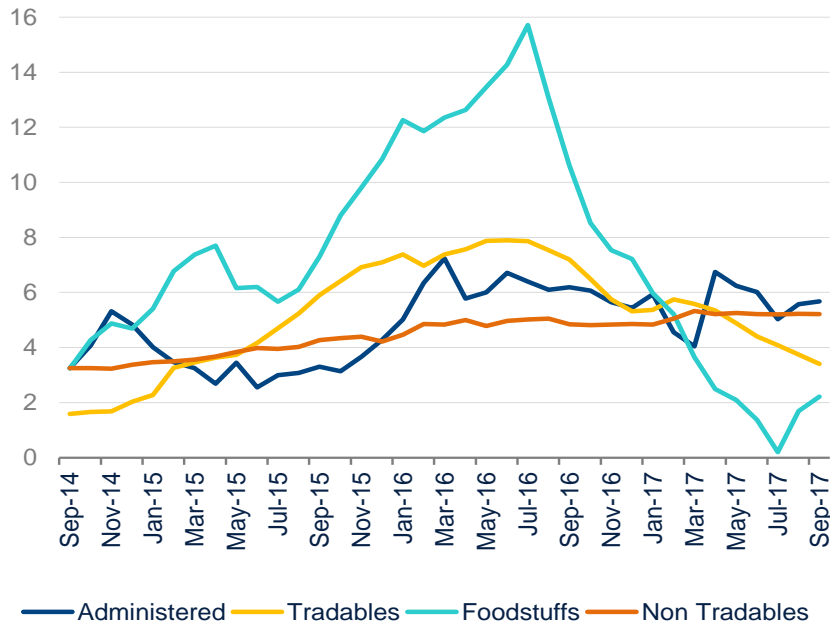


Source: BBVA Research based on DANE data

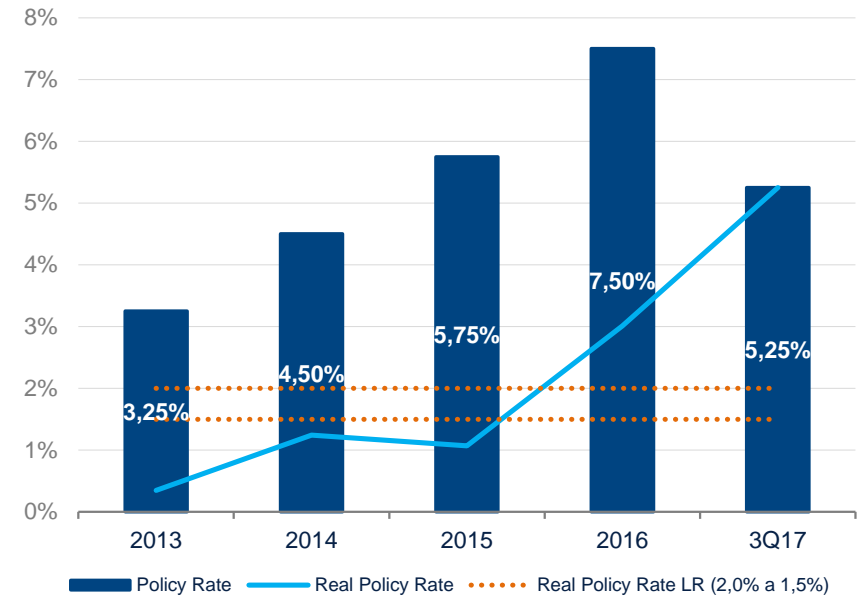
A slow recovery of the economy is consolidated, this will continue in a similar fashion in 2018

In this context, inflation eased off throughout the year and the Central Bank was able to reduce its reference rate

Inflation, total, food and basic (YoY change, %)



Monetary policy rate (year-end)



* One-year inflation expectations are used to calculate the actual rate

Source: BBVA Research based on data from DANE and Banco de la República de Colombia

These lower figures have helped remove friction from the economy allowing a gradual recovery of confidence and spending

03

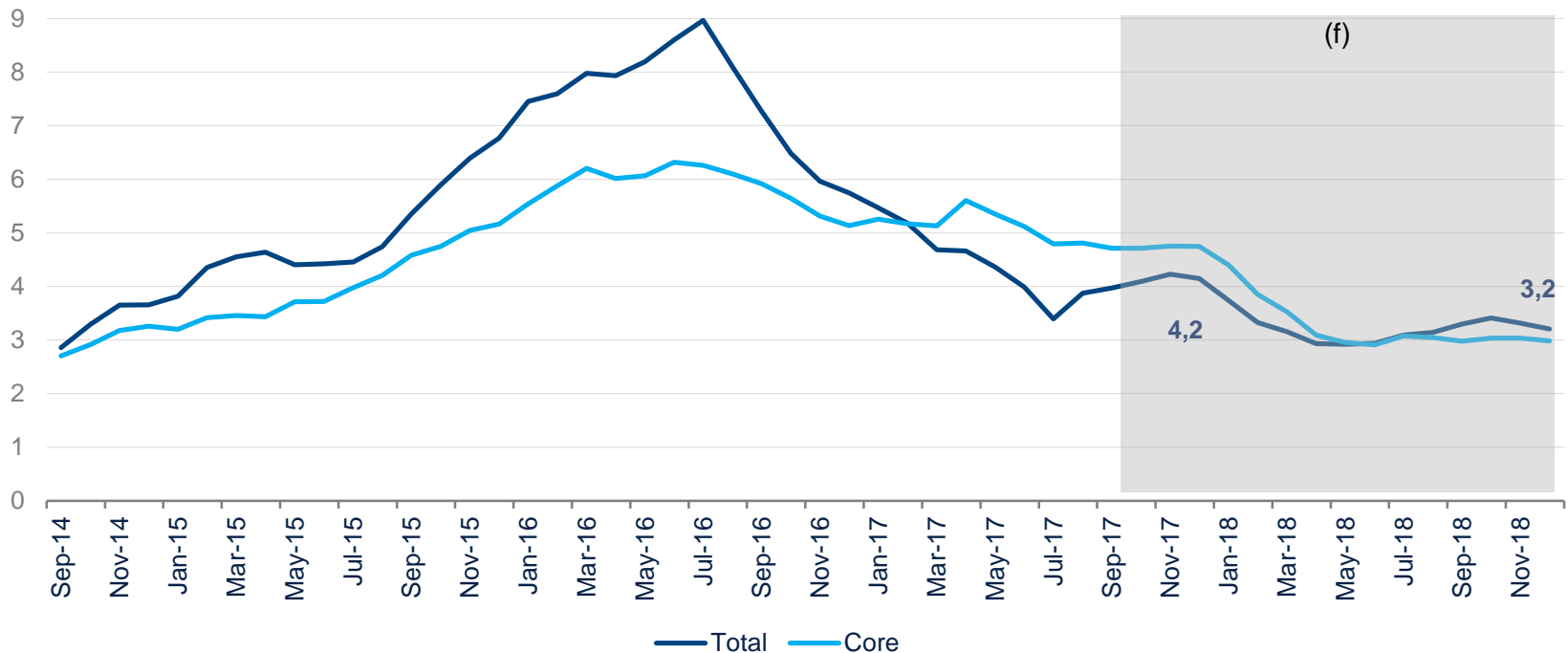
Drivers of growth in 2018

Domestic demand is accelerating thanks to lower inflation and interest rates, boosting various sectors



After overcoming supply shocks and the adjustment to VAT, inflation will rapidly approach 3%

Inflation (YoY change, %)



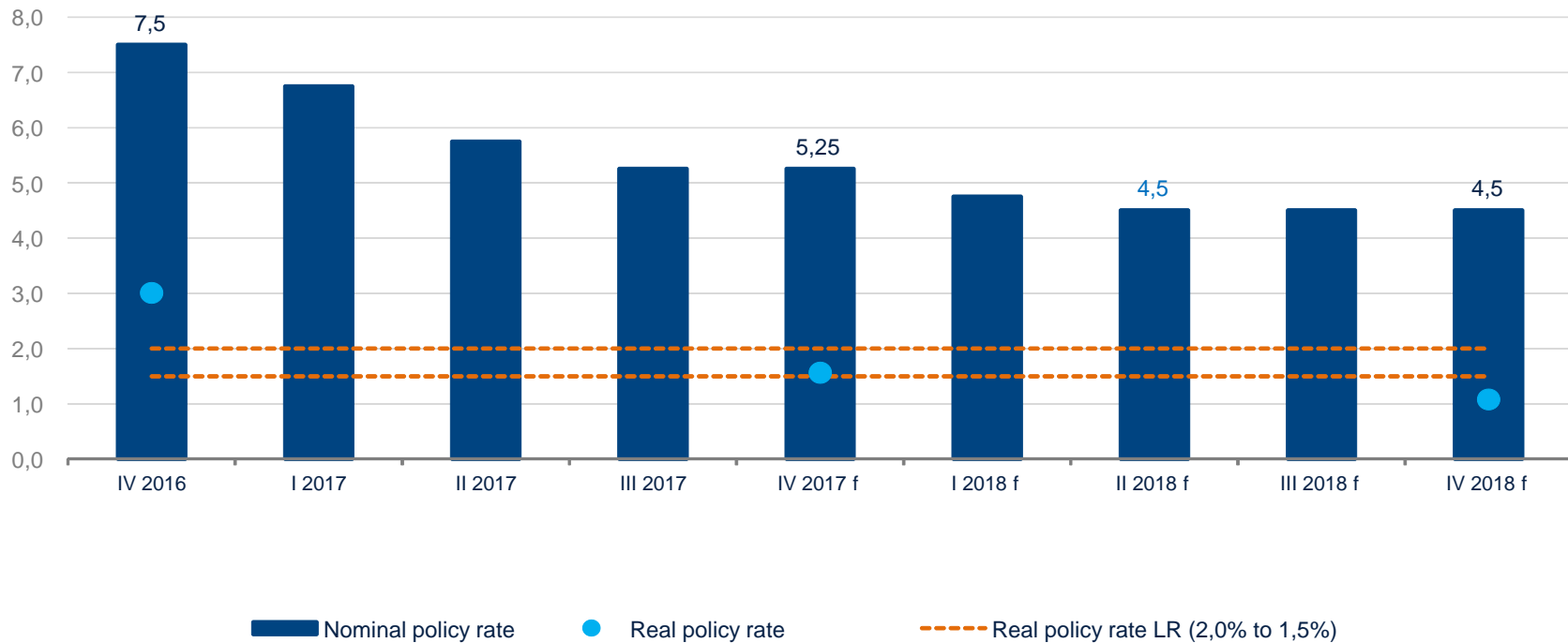
Source: BBVA Research with DANE data

Taking into account that much of the inflation shock came from food, this downward adjustment helps to improve household purchasing power

With this, the Central Bank could reduce its policy rate and provide greater stimulus to the economy

Monetary policy rate

(e.a., %)



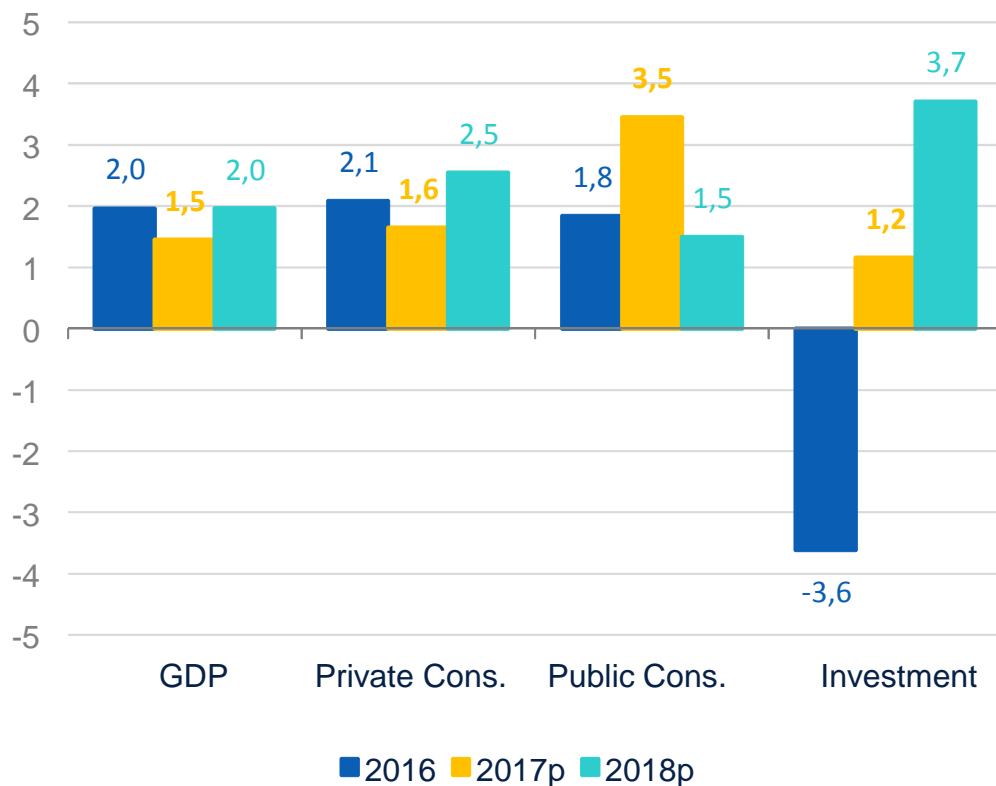
Source: BBVA Research based on data from Banco de la República de Colombia

The central bank does not yet have a rate that can be considered expansive, it has taken the handbrake off the economy, which allows a more comfortable reaction

For 2018, we expect slightly higher growth than that observed in 2017

GDP growth: demand

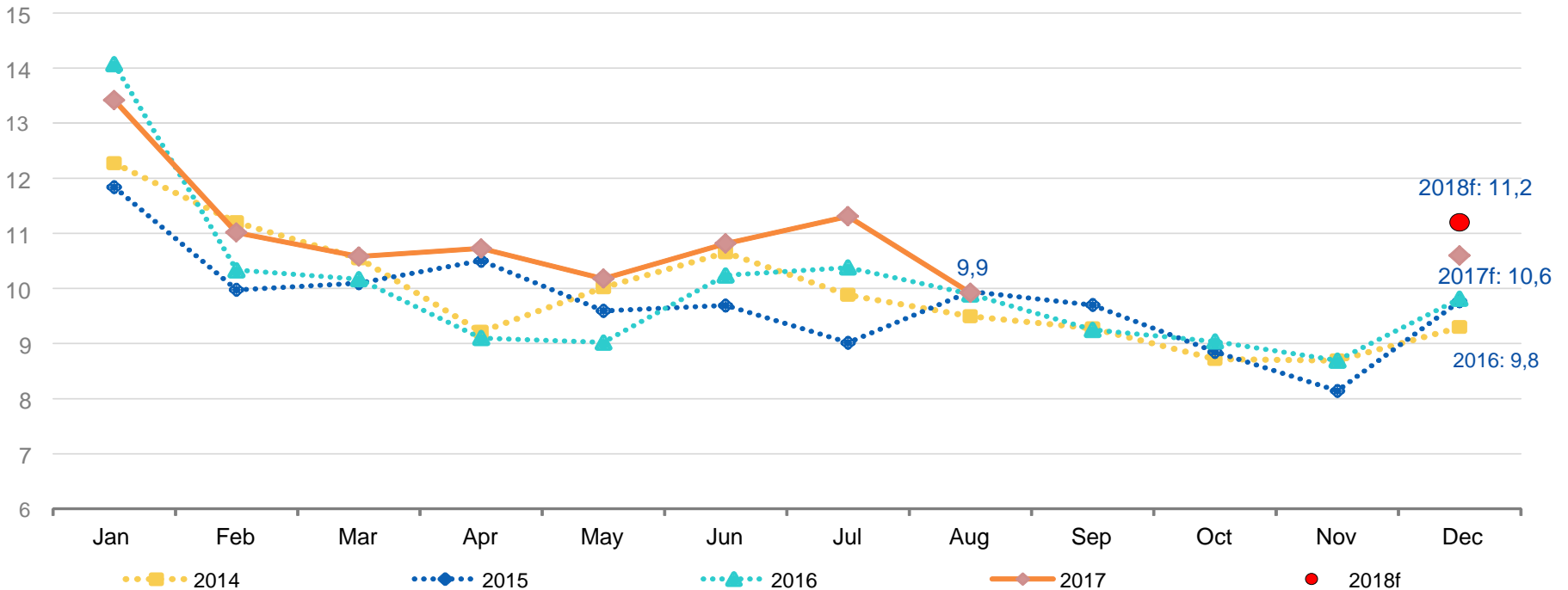
(YoY change, %)



- ◆ Household spending will benefit from lower interest rates and lower inflation
- ◆ Investment is showing great advances thanks to the civil works and the mining-energy projects
- ◆ Public consumption will present a slowdown due to the law of guarantees, the beginning of a new government and the need for austerity measures to comply with the fiscal rule

The deterioration in urban unemployment will limit the acceleration in household spending

Unemployment rate in 13 cities (% of EAP)



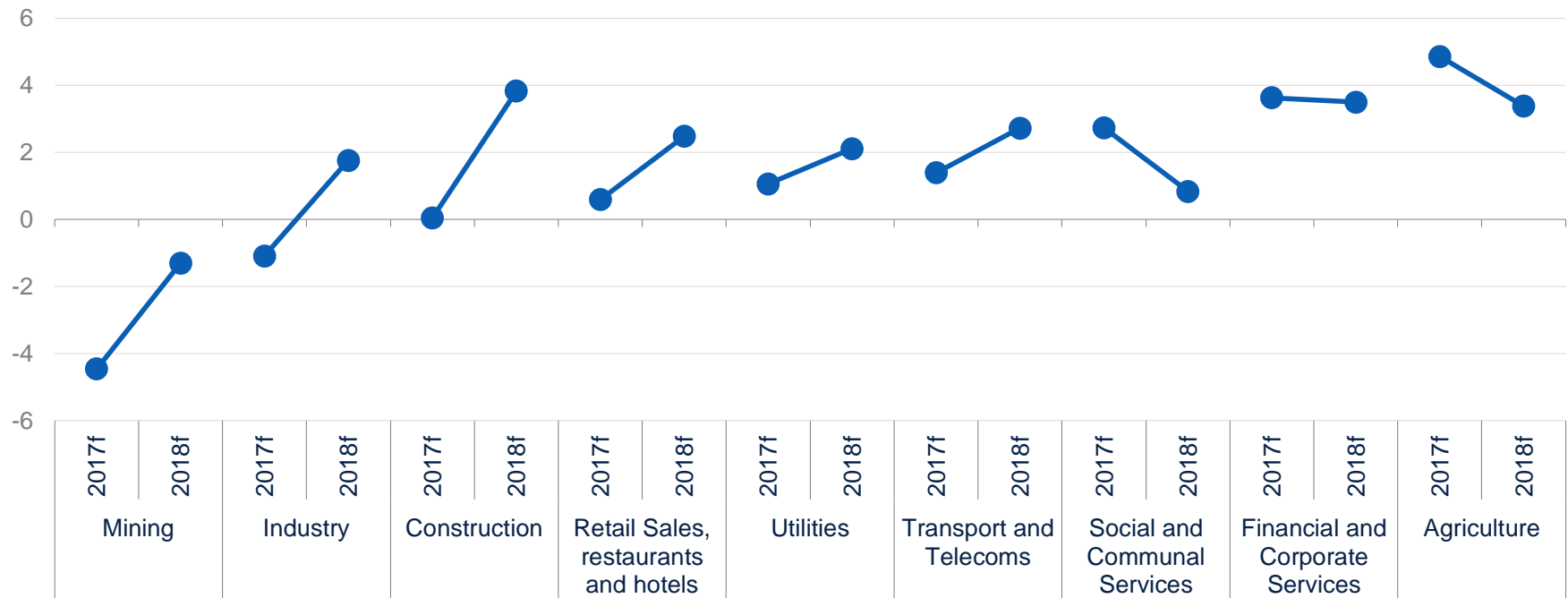
Source: BBVA Research with DANE data

Unemployment usually lags behind the economic cycle, so some deterioration in the labour market can still be expected

This improved aggregate dynamic will be reflected in a recovery in the dynamic of most sectors

GDP growth: supply

(YoY change, %)



Source: BBVA Research with DANE data

The acceleration is evident in construction and industry, while social and communal services show lower performance. The farming sector, despite its slowdown continues to grow at its historical average

04

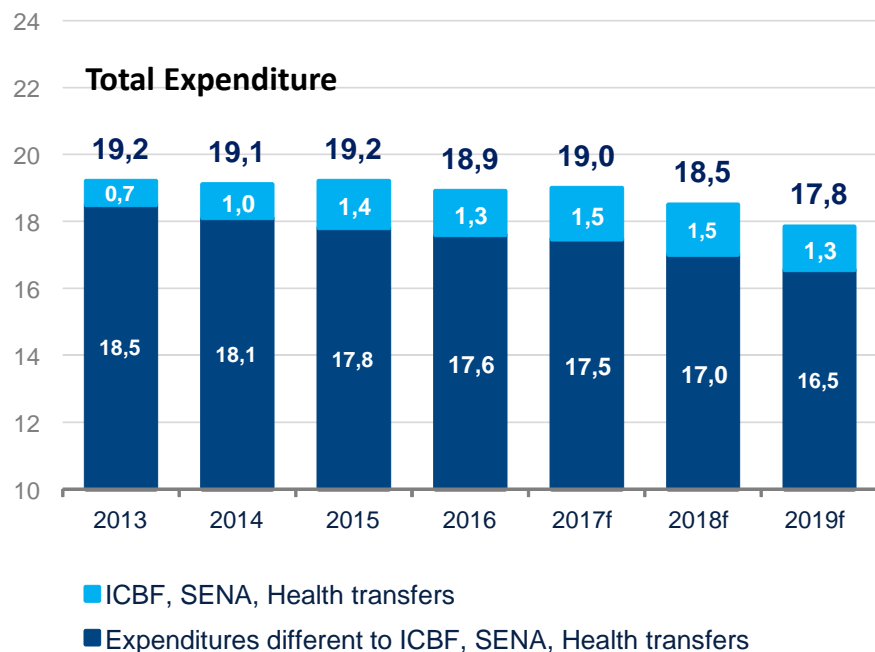
Macroeconomic Balances

Despite the progress that has been observed in the macroeconomic balances, there is still an important task to be done to reduce the vulnerability of the economy

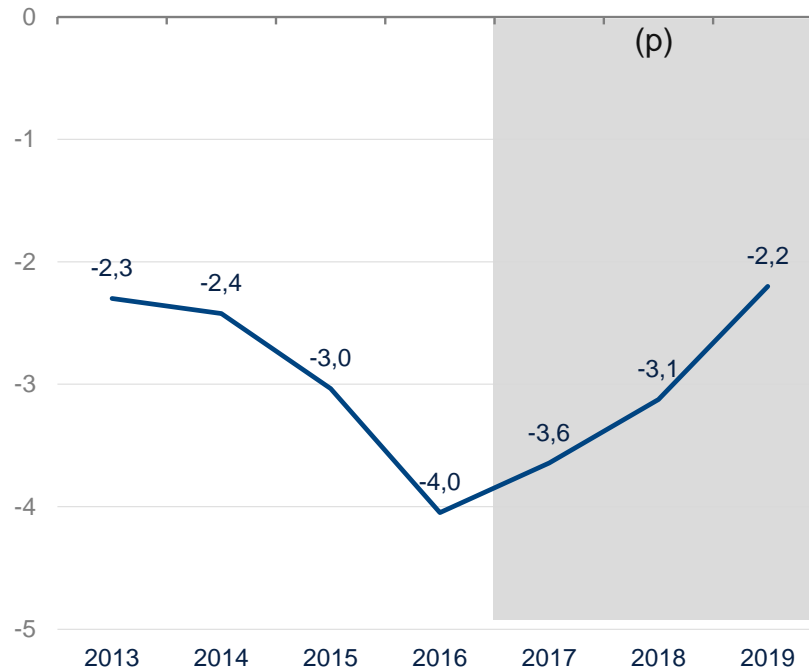


The path of reducing government spending to comply with the fiscal rule is demanding

Central National Government Expenditure (% of GDP)

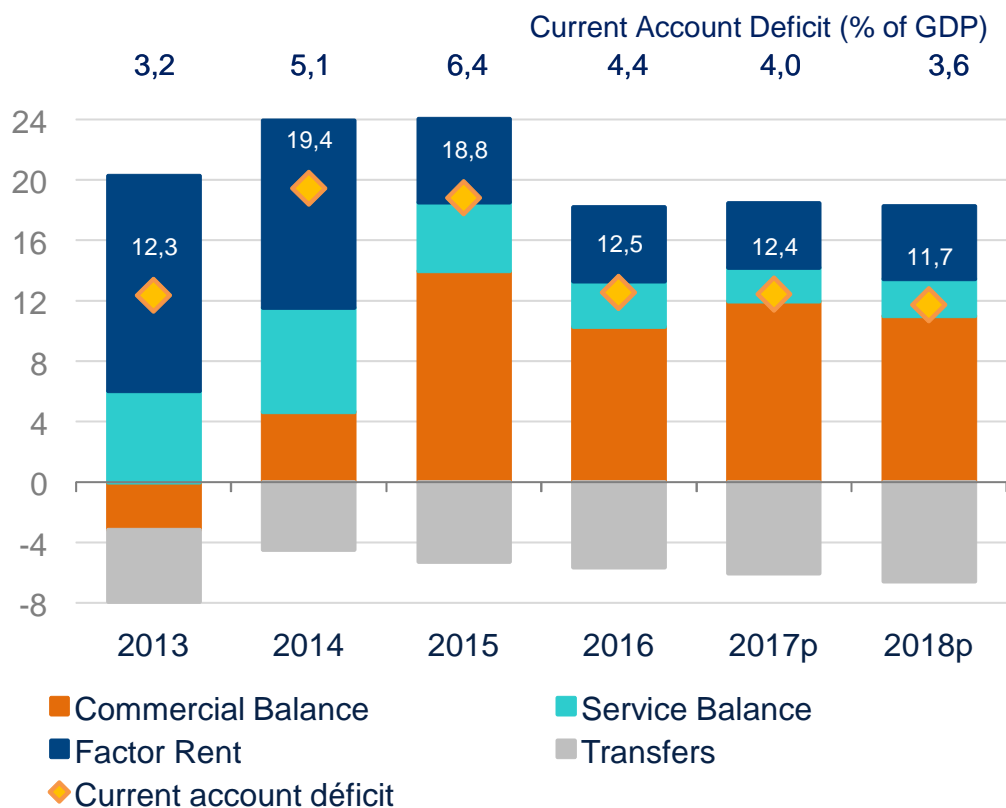


Fiscal Deficit (% of GDP)



Private adjustment has been more appropriate, evidenced by a moderation in the current account

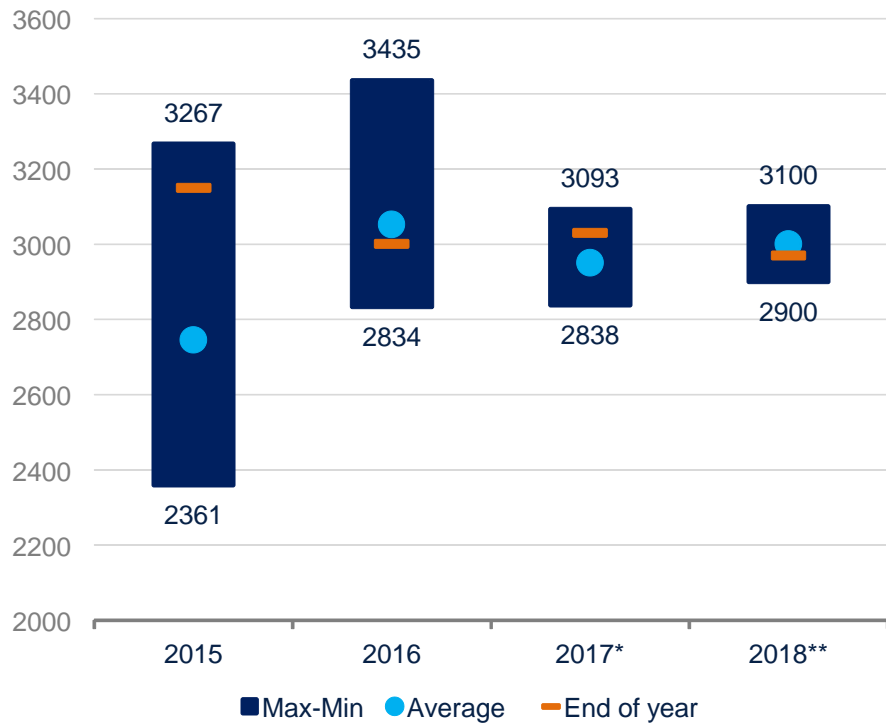
Current account % GDP (US\$ billions)



- ◆ The slowdown in **domestic demand** between 2015 and 2016 allowed a significant **adjustment in the current account deficit**
- ◆ However, its adjustment must continue to achieve a level that is **sustainable** in the medium term.
- ◆ We expect the **adjustment** in the future to be **more moderate** than that observed in 2016 as a result of the **recovery in spending**

Factors playing a significant role in reducing the expected volatility in the exchange rate

Exchange Rate Pesos per dollar



* With data to 11 October (BBVA forecasting)

** BBVA forecasting, simulations of ranges are not necessarily forecasts

- ◆ The exchange rate responds mainly to the perception of risk in the Colombian economy, therefore, maintaining a moderate current account deficit reduces the volatility of the exchange rate
- ◆ We expect an average exchange rate in 2017 of 2,960 pesos and a slightly more depreciated one in 2018 of 3,000 on average
- ◆ At the same time, we expect a lower exchange rate operating range in 2017 and 2018 than in 2015 and 2016 when the current account deficit was considerably high

Main messages

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- 2. The economic slowdown seems to have ended in the second quarter.** In the third quarter, there are signs of recovery to be seen in several sectoral indicators, although growth will remain low for the full year.
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This report has been produced by the **Colombia Unit**

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ANNEX:



Main macroeconomic variables

Table A1 Macroeconomic Forecasts

	2013	2014	2015	2016	2017	2018
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	2,5
Public consumption (YoY, %)	9,2	4,7	5,0	1,8	3,5	1,5
Fixed investment (YoY, %)	6,8	9,8	1,8	-3,6	1,2	3,7
Inflation (% YoY, eop)	1,9	3,7	6,8	5,7	4,2	3,2
Inflation (% YoY, average)	2,0	2,9	5,0	7,5	4,3	3,2
Exchange rate (eop)	1.927	2.392	3.149	3.001	3.030	2.970
Devaluation (% eop)	9,0	24,1	31,6	-4,7	1,0	-2,0
Exchange rate (average)	1.869	2.001	2.742	3.055	2.944	3.000
Devaluation (% average)	3,9	7,1	37,0	11,4	-3,6	1,9
BanRep interest rate (% eop)	3,25	4,50	5,75	7,50	5,25	4,50
Deposit interest rate (% eop)	4,1	4,3	5,2	6,9	5,5	4,8
Fiscal balance (% 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	-4,0	-3,6
Unemployment rate (% eop)	9,7	9,3	9,8	9,8	10,6	11,2

Main macroeconomic variables

Table A.2 Quarterly Macroeconomic Forecasts

	GDP (%, YoY)	Inflation (%YoY, eop)	Exchange rate (vs. USD, eop)	BanRep rate (%, eop)
Q1 14	6,5	2,5	1.965	3,25
Q2 14	4,0	2,8	1.881	4,00
Q3 14	3,9	2,8	2.028	4,50
Q4 14	3,2	3,7	2.392	4,50
Q1 15	2,6	4,6	2.576	4,50
Q2 15	3,0	4,4	2.585	4,50
Q3 15	3,2	5,4	3.122	4,75
Q4 15	3,4	6,8	3.149	5,75
Q1 16	2,5	8,0	3.022	6,50
Q2 16	2,5	8,6	2.916	7,50
Q3 16	1,2	7,3	2.880	7,75
Q4 16	1,6	5,7	3.001	7,50
Q1 17	1,2	4,7	2.880	7,00
Q2 17	1,3	4,0	3.038	5,75
Q3 17	1,6	4,0	2.938	5,25
Q4 17	1,7	4,2	3.030	5,25
Q1 18	2,1	3,5	3.015	4,75
Q2 18	1,7	3,2	3.000	4,50
Q3 18	2,0	3,3	2.985	4,50
Q4 18	2,0	3,2	2.970	4,50

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