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Colombia Economic Outlook

1st Quarter 2018

Colombia Unit

January 2018

Main messages

1. **World growth shows robustness**. Upward generalized revision in 2018 by areas, trending towards stabilization in 2019. Latin American growth recovers. Growth is revised upwards by 0,1pp in 2018 and remains stable at 2,5% in 2019. Growth is supported mainly by the external sector and investment.

2. **Colombian recovery should consolidate in 2018, specially in the second half.** Lower inflation and interest rates and a more favorable global context support investment in equipment and machinery and household expenditure in durable goods. For 2018 GDP growth would be 2,0% and for 2019 3,0%.

3. **Inflation will continue decelerating in 2018, achieving 3,1% in the year end.** Exchange rate stability and weakness in demand will allow inflation to decelerate in the first semester of 2018 and stabilize around the mid-point of the target range. For 2019 inflation would close slightly below, at 2,8% **The Central Bank will be able to reduce interest rates to 4,0% in the first semester.** Inflation behavior and its consolidation within the target range will allow the Bank to reduce its reference rate in the first semester to maintain the real interest rate stable.

4. **Structural imbalances, both external and fiscal, tend to improve.** The demand adjustment and higher oil prices allow for a reduction in the current account deficit to 3,2% in 2018, meanwhile the fiscal deficit will meet the fiscal rule at 3,1% in 2018. For 2019 the government faces some challenges in the fiscal front with the need to further reduce expenditure and improve revenue to comply with the fiscal rule

Content

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01

GLOBAL

World growth consolidates and the global monetary policy normalization strategy progresses

Global growth consolidates

01 Projections for the U.S., China and Eurozone improve
There is less uncertainty in the short run

02 More positive perspectives for emerging economies
Better global demand and higher commodity prices

03 Greater caution in financial markets
Expectations of less liquidity might reduce flows to emerging economies

04 Central Banks continue progressing towards normalization
Motifs to withdraw stimulus are materializing in the midst of a contained core inflation

05 Global risks
Less significant in the short run; without changes in de mid to long run

Reasons for optimism in the main areas, though with caution

U.S.

Upward growth revision

Improvements in the labor market

Approval of the fiscal reform

Non-disturbing changes in the FED

CHINA

Moderate deceleration

Some reforms underway

Positive conclusions from the

XIX Congress of the CChP

Higher potential growth

EUROZONE

Better growth than expected

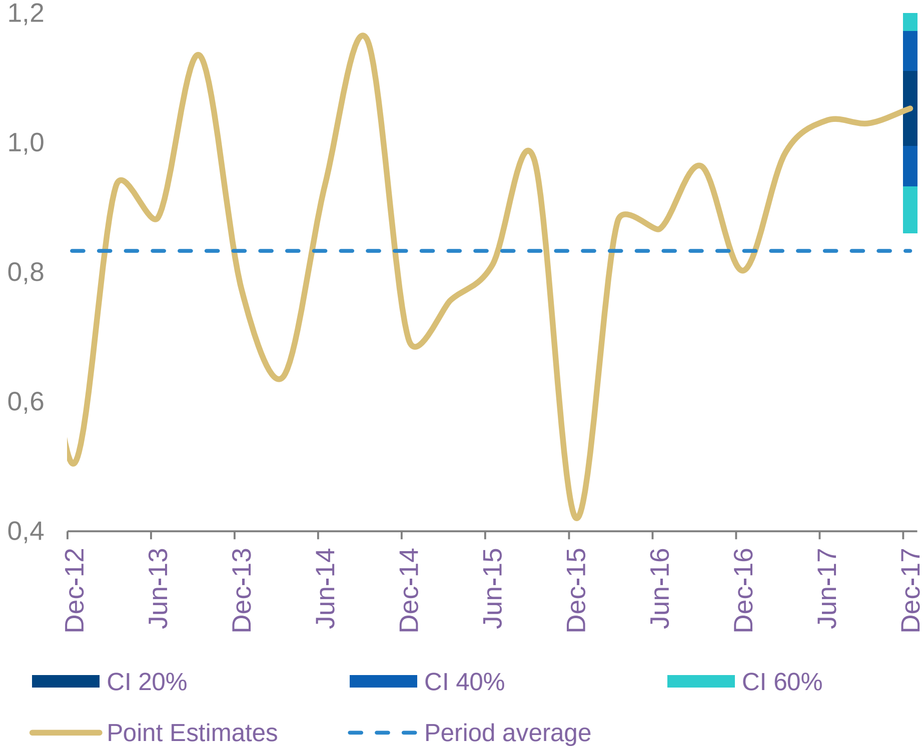
More robust internal demand

Lower political uncertainty

Plans for greater integration

Global growth: robust and sustained

World GDP growth
(Projections based on BBVA-GAIN %, q/q)

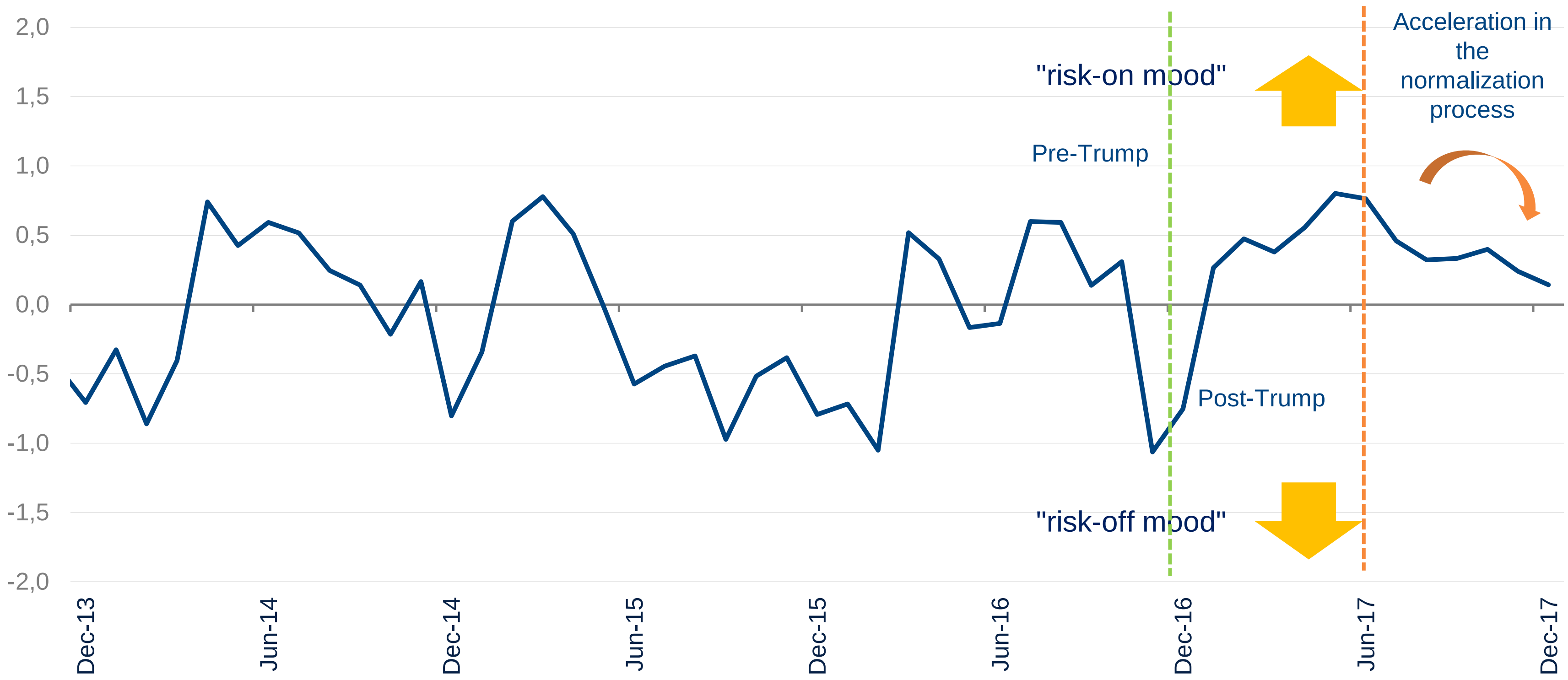


- World growth continues, supported in the recovery of the industrial sector
- Confidence indicators have improved and anticipate continuity in the current scenario
- Private consumption continues to drive growth in advanced economies and gains propulsion in emerging economies

Source: BBVA Research

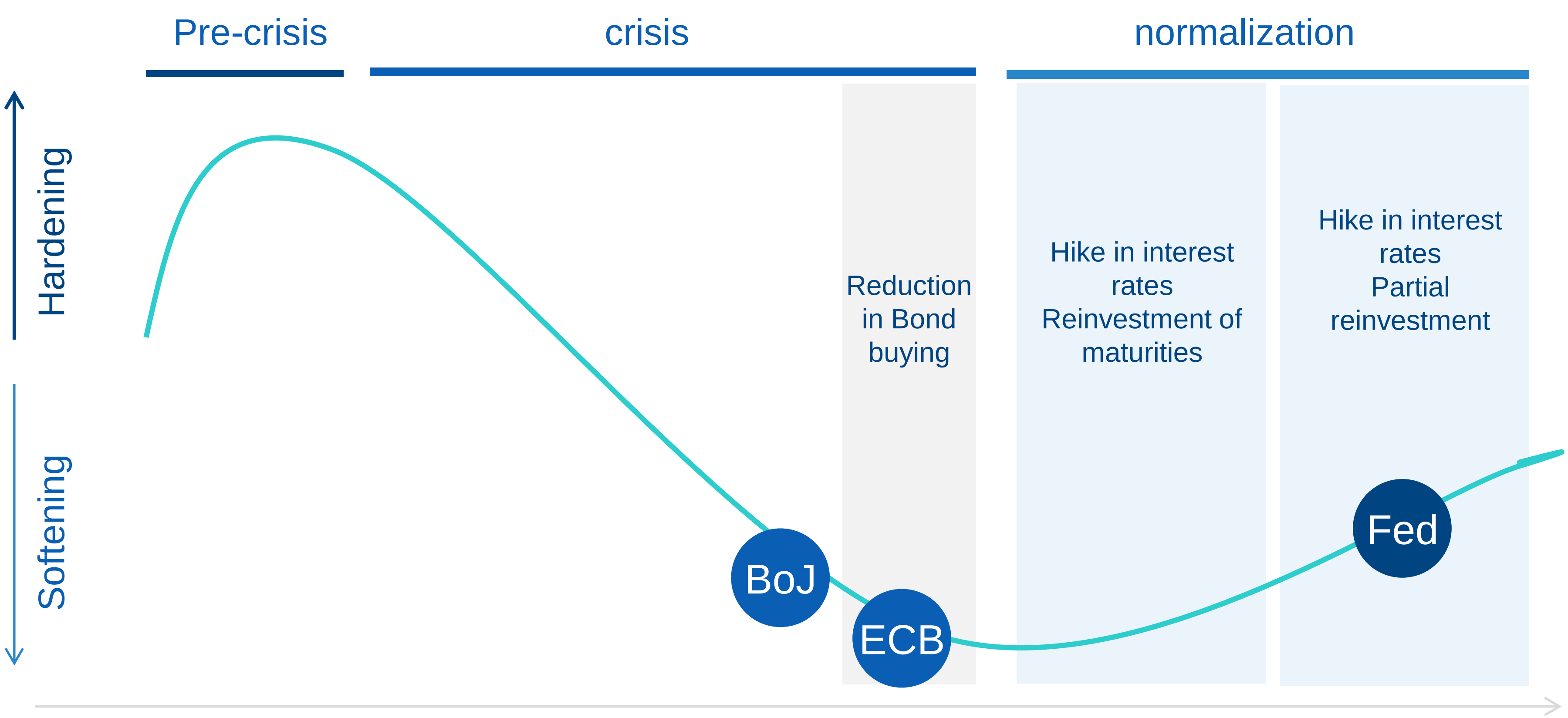
Cautiousness in financial markets, with gradual moderation in flows to emerging economies

Apetite for risk indicator
1st Factor (global), analysis of capital flows EPFR



Source: BBVA Research, EPFR

Non-conventional monetary policies withdrawal



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The Fed accelerates policy normalization meanwhile the BCE moderates

FED

Ongoing interest rate hiking cycle and balance reduction

75bp hikes anticipated for 2018, to 2,25% and reduction of the balance of 500 billion dolars

ECB

QE reduction, but extension until September 2018

No interest hikes before 2019

Objective: gain action margin

Objective: avoid a sudden hike in long term interest rates

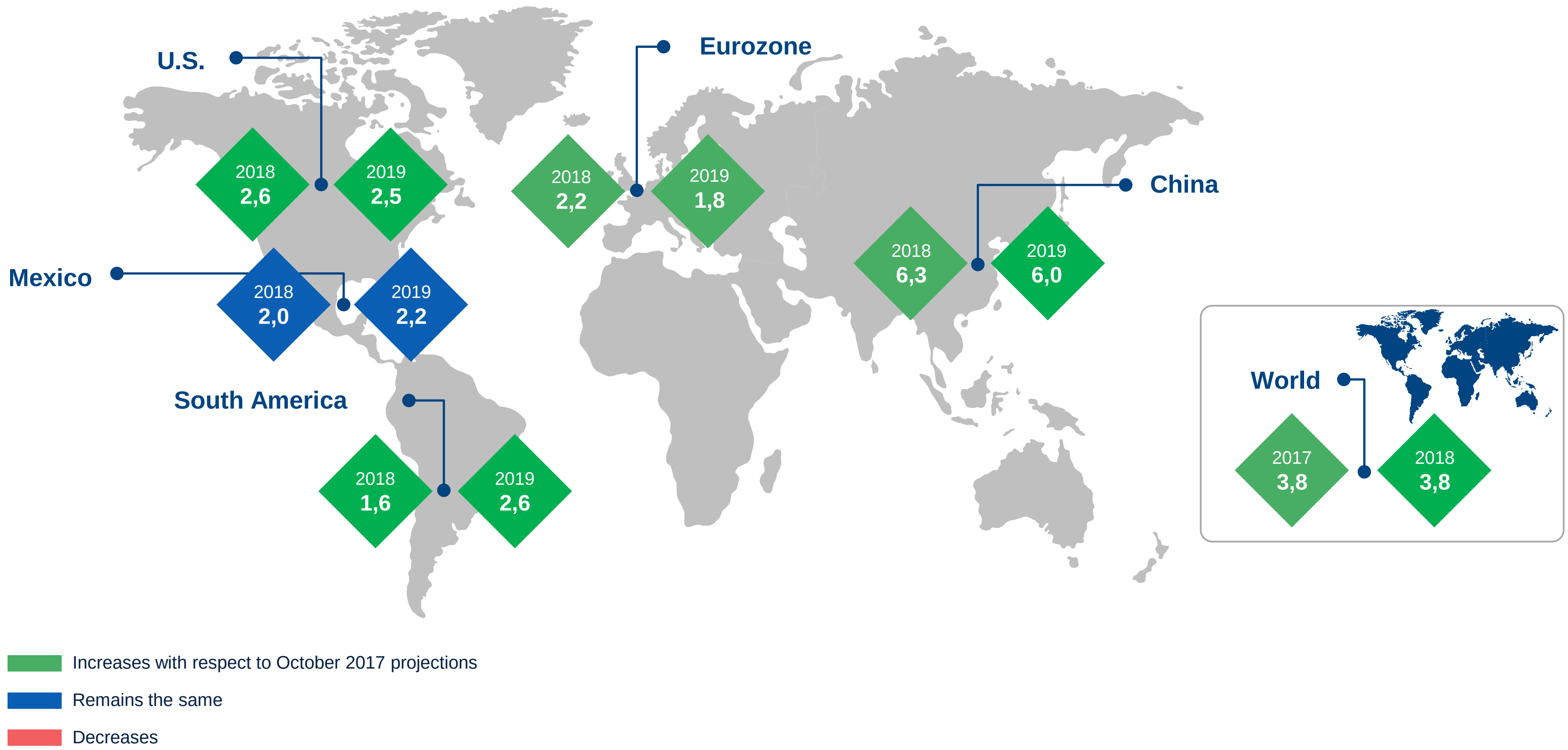
Uncertainty elements:

Political: changes in policy makers (Fed, ECB)

Macro: possible inflation surprises

Markets: long term rates and slope of the curve

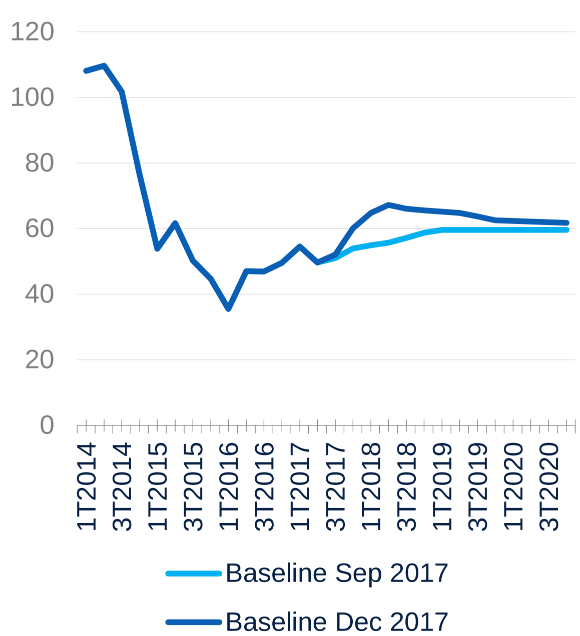
Generalized upward growth revision



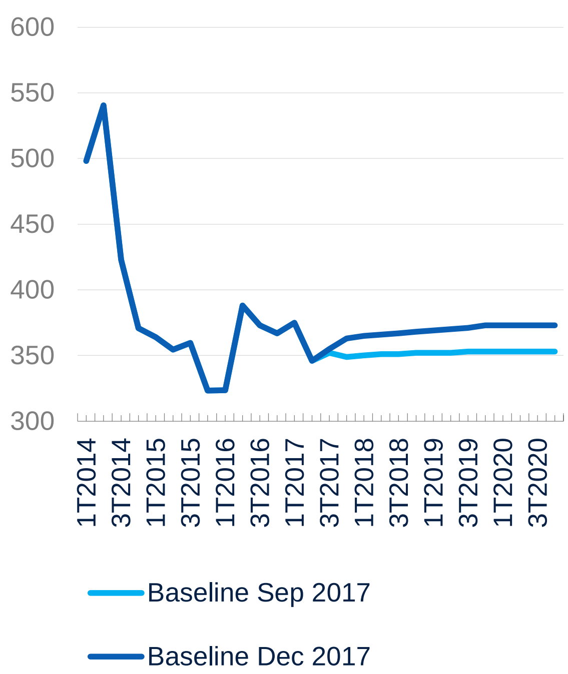
Source: BBVA Research

Higher commodity price forecasts mainly driven by greater world demand.

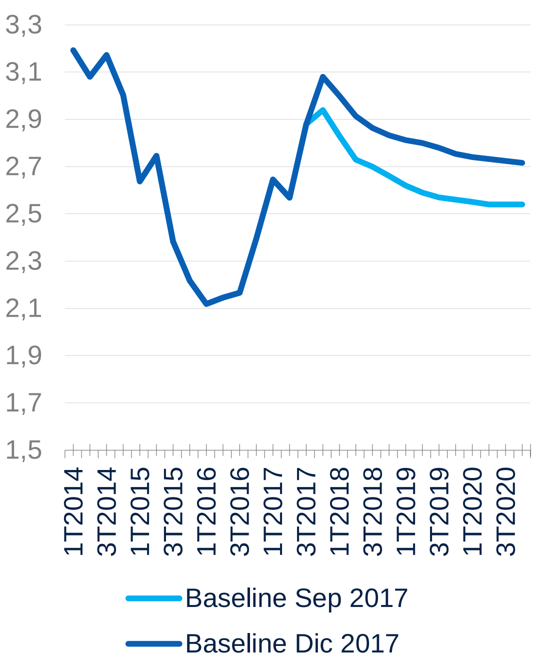
OIL BRENT
(USD/B)



SOY
(USD/mt)



COPPER
(USD/lb)



Source: BBVA Research and Bloomberg

Oil price reflects a greater demand but also some supply factors, geopolitical risks and a correction of inventories. We continue to anticipate a long term price of USD 60 per Brent barrel due to higher competition

Copper price increased significantly by greater demand and the pressure of financial factors. The later should increase gradually looking forward

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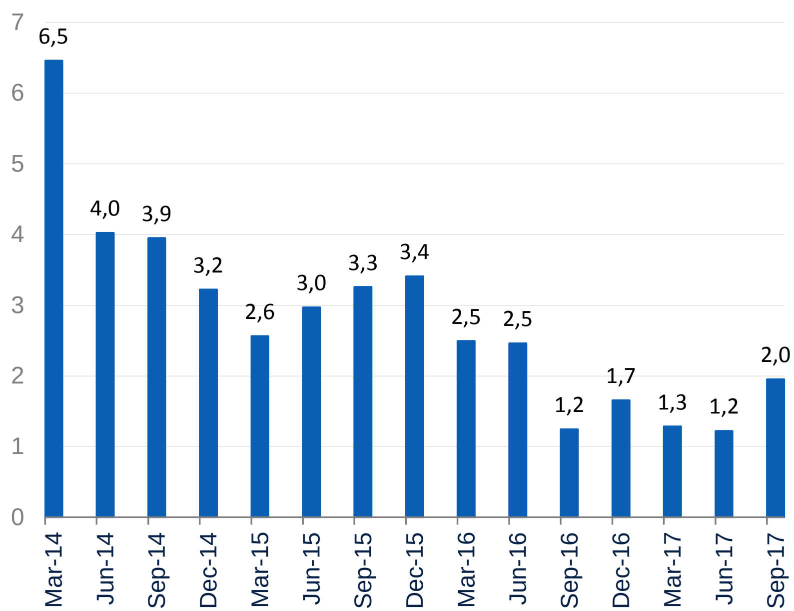
02

Ordered but slow recovery

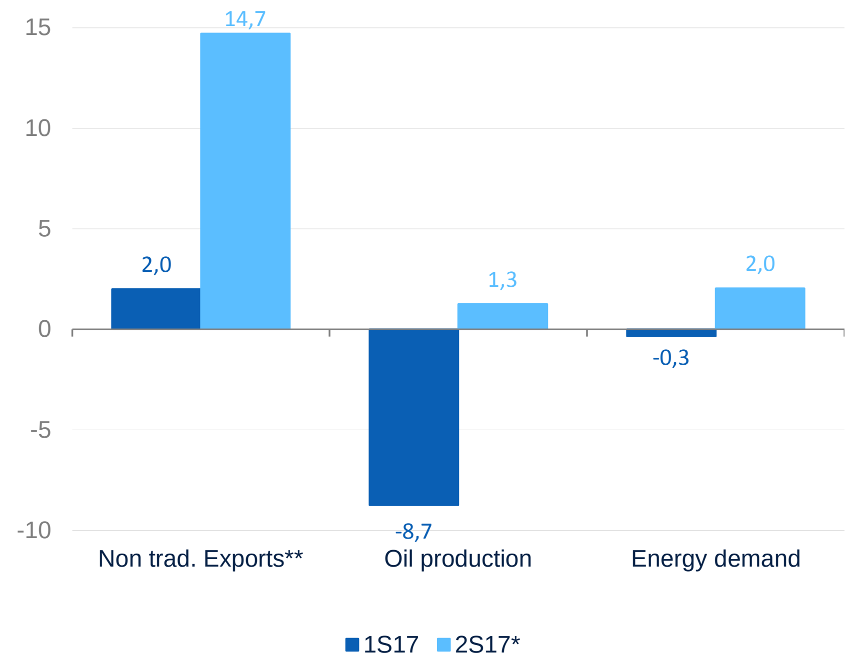
GDP will grow 2,0% in 2018 and 3,0% in 2019

Growth touched bottom in the second quarter of 2017, achieving an inflection point

GDP annual growth
(%)



Selected leader indicators
(%)



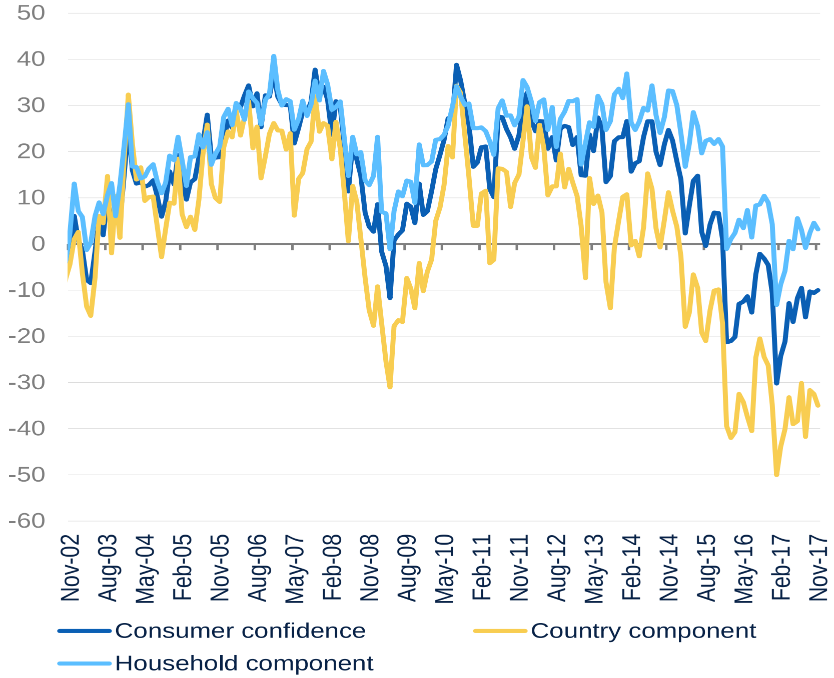
* Exports and energy demand with data to November
** Does not include gold and emeralds

The improvement in most economic sectors in the second semester was shadowed by a poor behavior in the construction sector (residential)

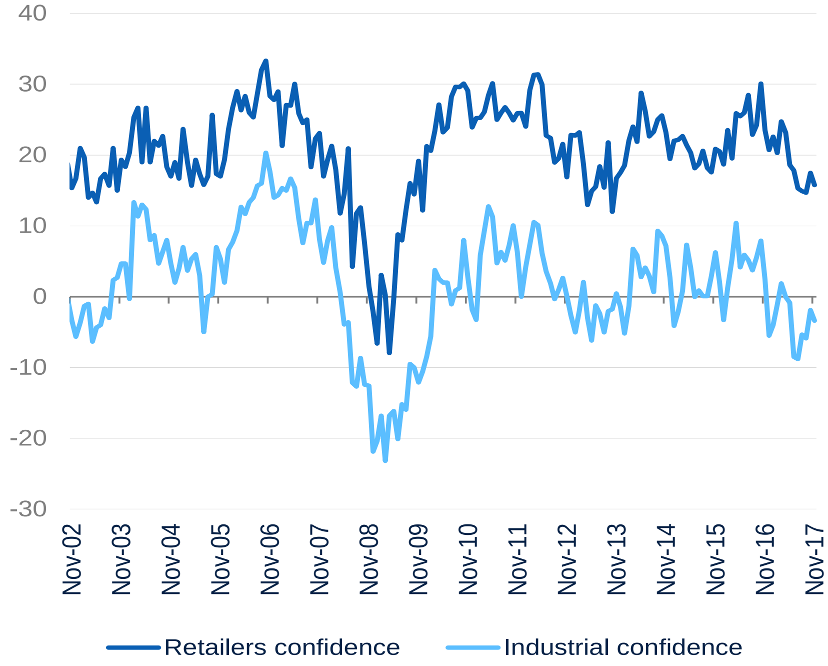
Source: BBVA Research with data from DANE, XM and ANH

In part, the slow recovery is associated to the weakness in confidence indicators

Consumer confidence
(Balance)



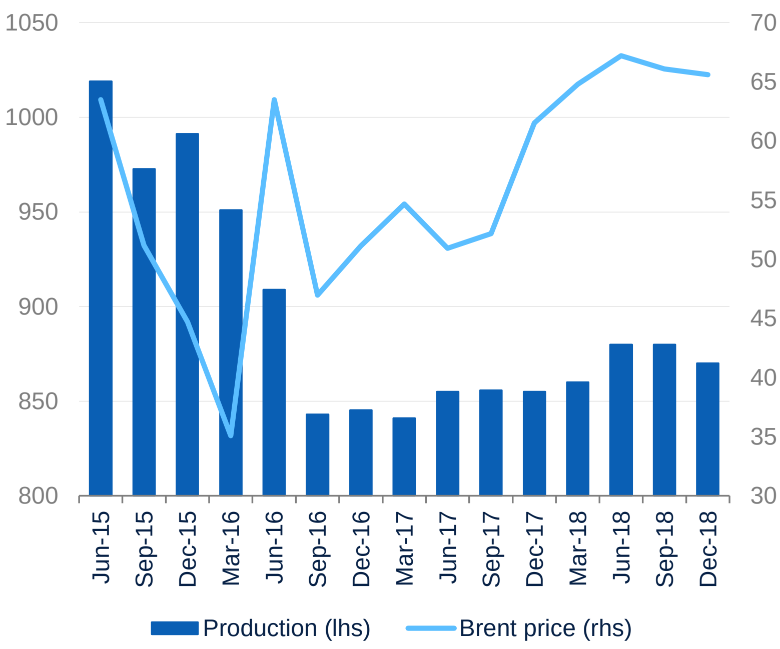
Industrial and retailers confidence
(Balance)



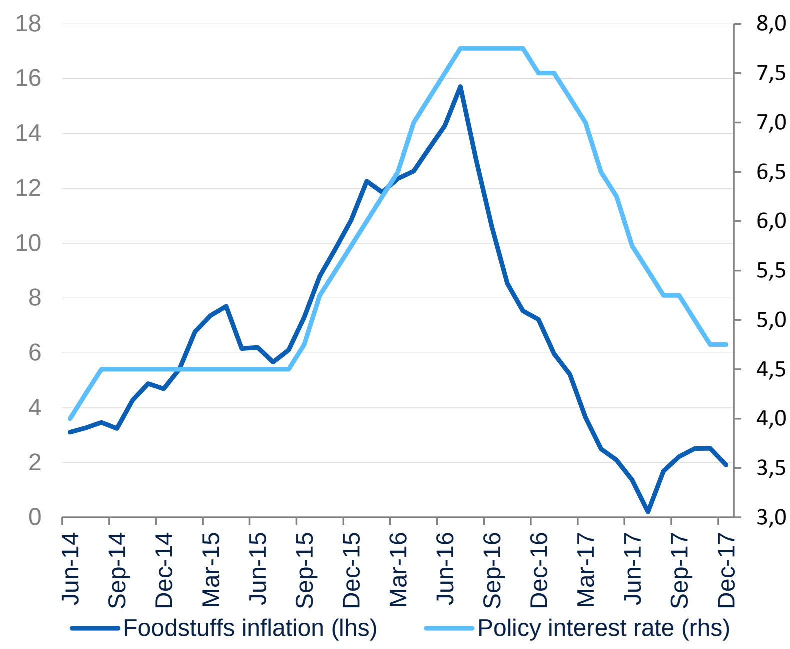
Source: BBVA Research with data from Fedesarrollo

Though, some factors start to provide a positive impulse to growth

Price and oil production
(Barrels, USD/barrel Brent)



Foodstuffs annual inflation and policy interest rates
(annual %)

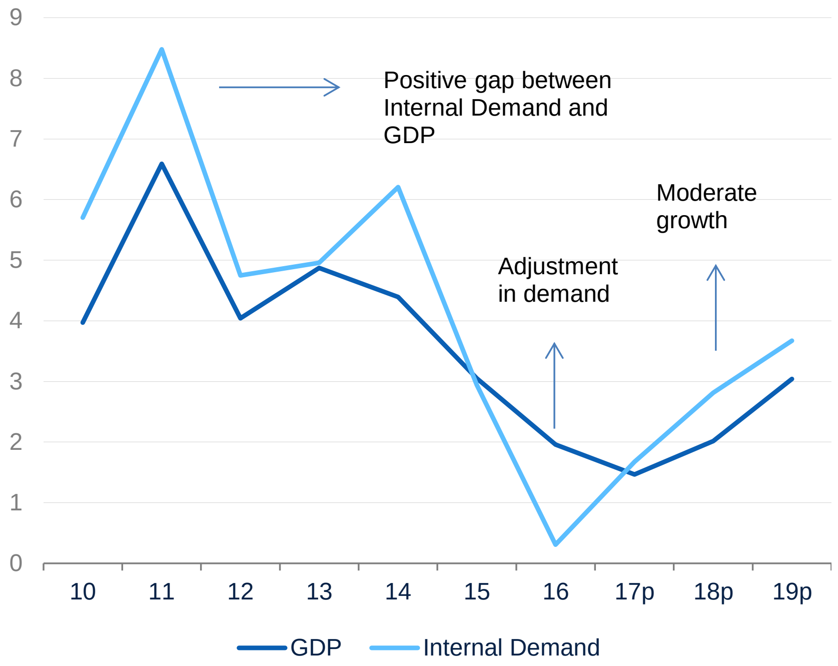


Lower foodstuffs inflation improves household expenditure capacity meanwhile lower interest rates give an incentive to both household and companies expenditure

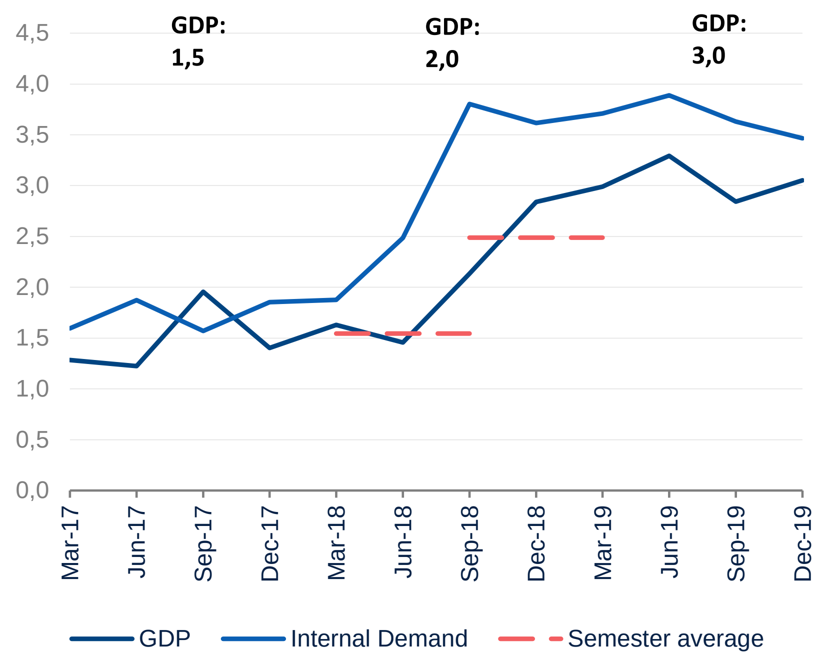
Source: BBVA Research with data from ANH, Bloomberg, DANE and BanRep

Therefore, we expect a consolidation in economic growth in 2018, particularly in the second semester and 2019

GDP and internal demand (activity cycles)
(%)



GDP and internal demand (forecast)
(%)

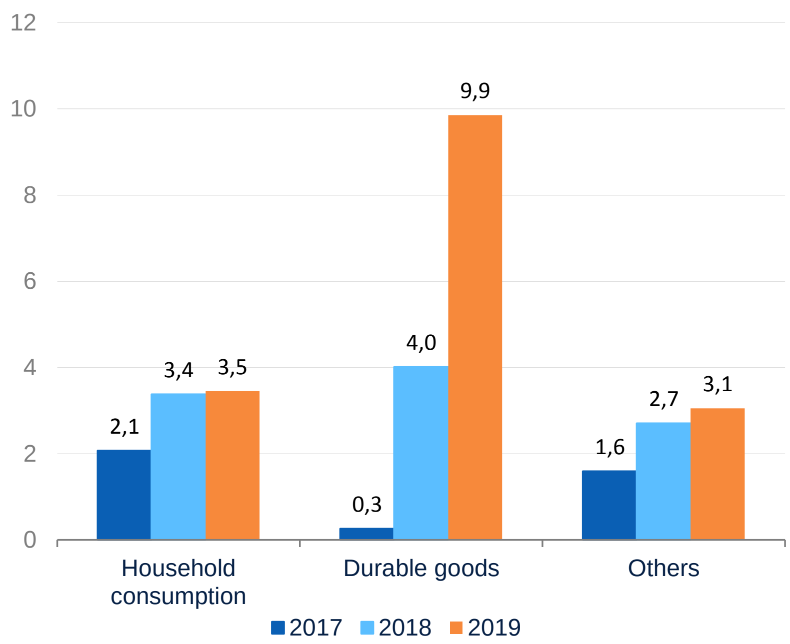


Growth acceleration is possible after a period of adjustment in household and companies balances

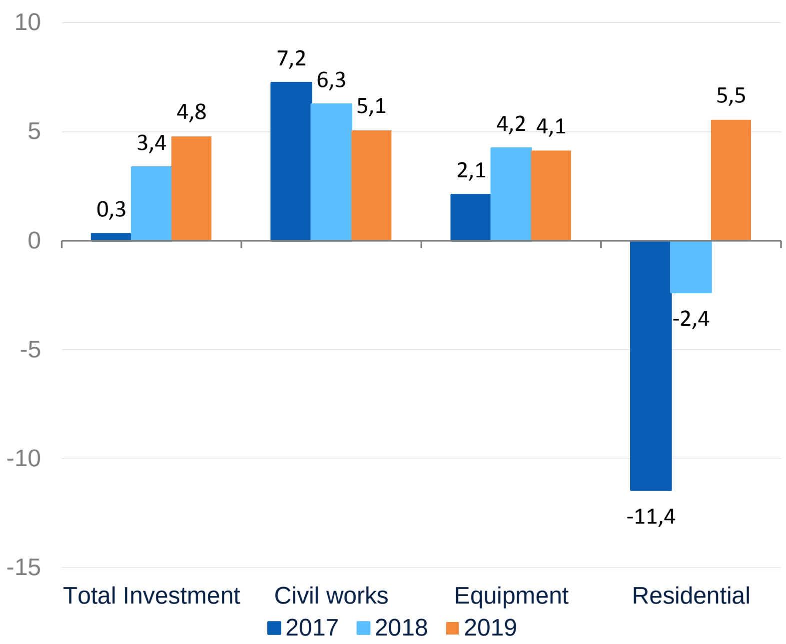
Source: BBVA Research with data from DANE

On the demand side, non-residential investment and household consumption will contribute to GDP acceleration

Household consumption
(annual growth, %)



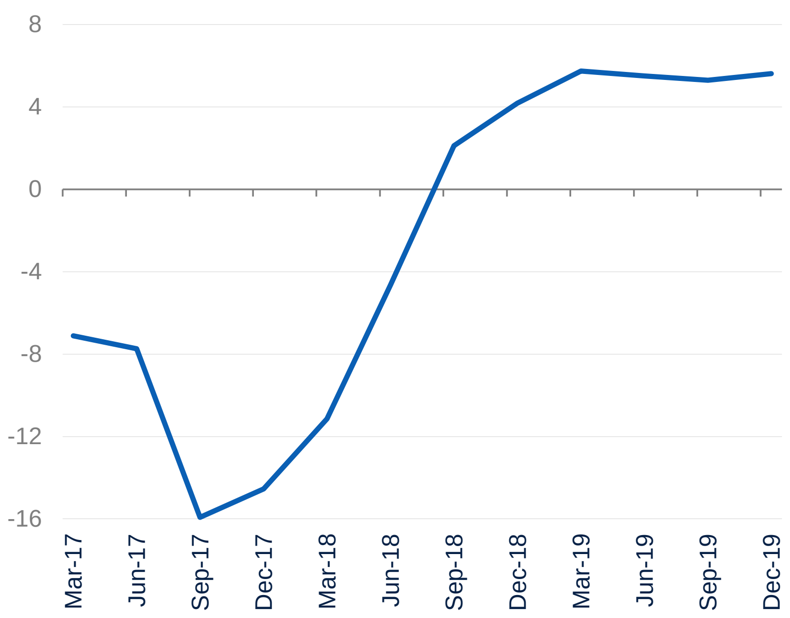
Investment
(annual growth, %)



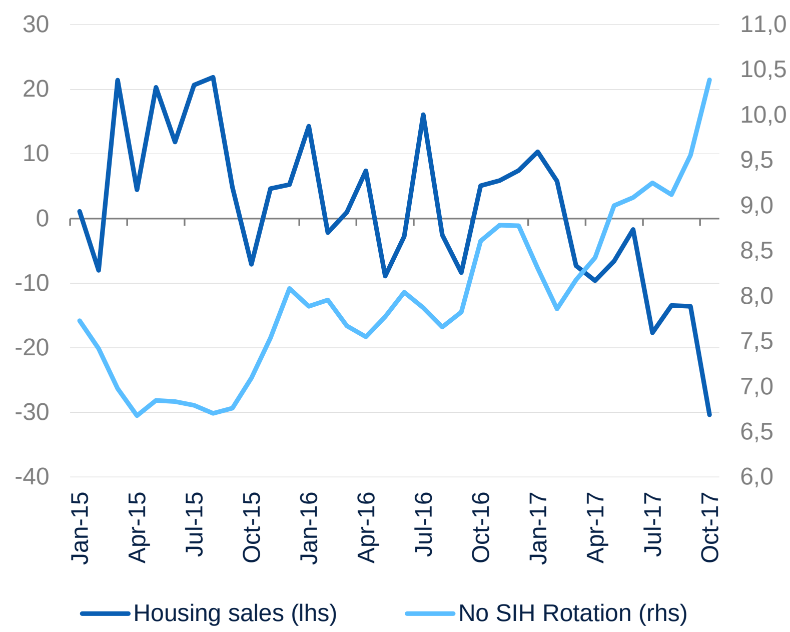
Source: BBVA Research with data from DANE

Weak growth in the residential construction sector shadows over the positive effect of higher oil prices and better global dynamic

Residential sector GDP
(Annual growth, %)



Housing sales and rotation index
(Annual growth (%) and number of months to sell a house)

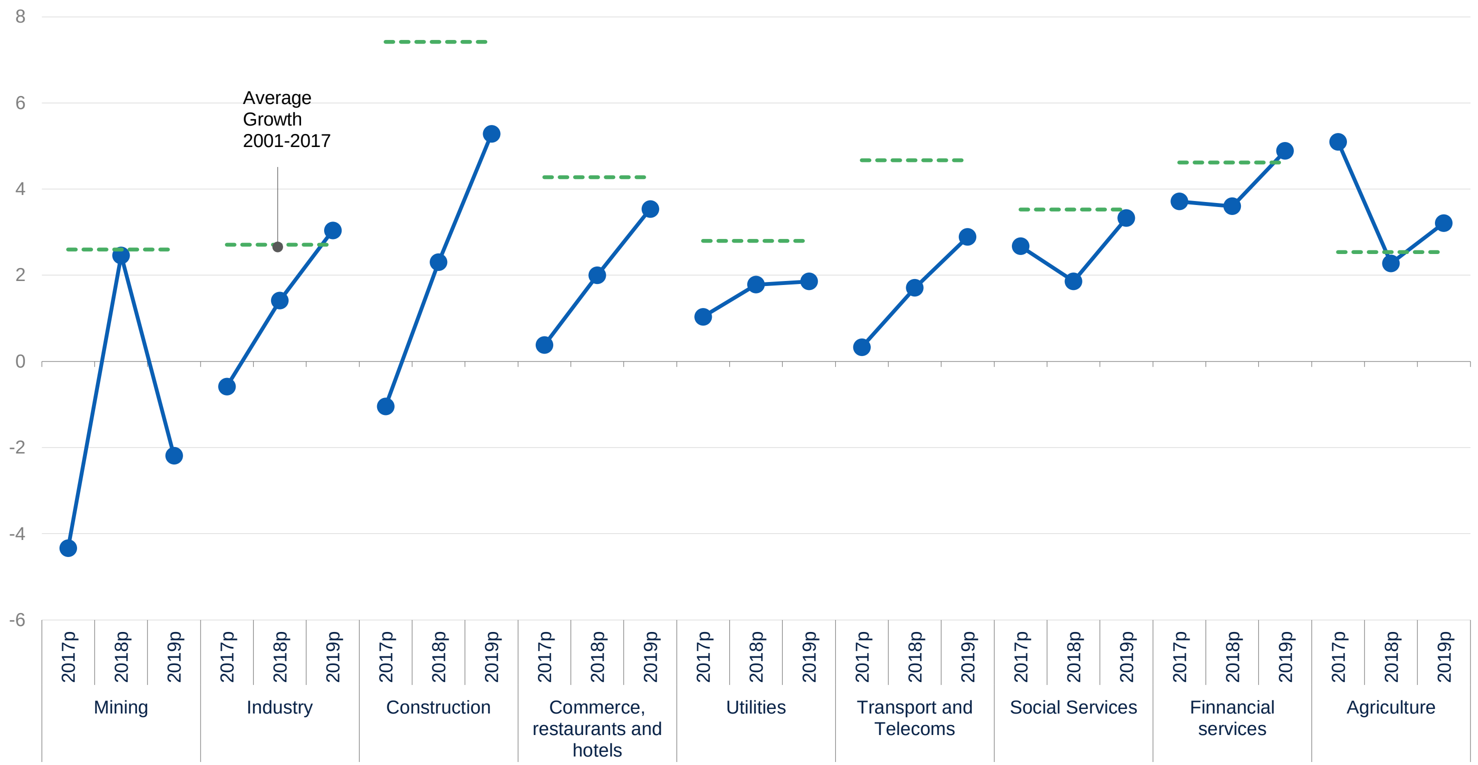


Some recovery of residential construction will be seen in the second semester of 2018, other commercial and office constructions will take longer to recover

Source: BBVA Research with data from DANE and Camacol

On the supply side, most sectors show evidence of a slow recovery

GDP by sectors growth forecast
(Annual growth %)



Agriculture stabilizes slightly above its historic average, while mining 2018 recovery fades in 2019

Source: BBVA Research with data from DANE

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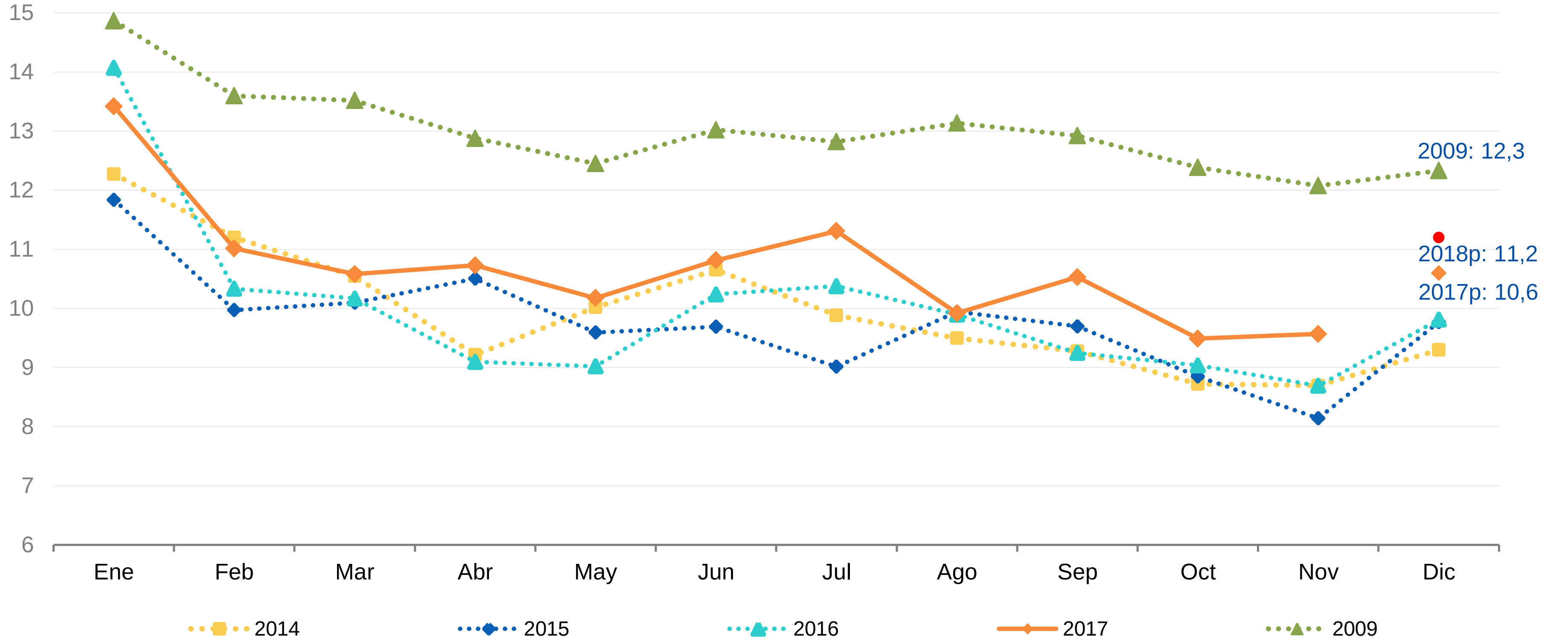
GDP's slow recovery will continue to have a negative impact in the labor market

Unemployment rate for 13 cities
(% of the labor force)



We expect the unemployment rate to deteriorate further in 2018, to 11,2% given a weak job creation

Source: BBVA Research with data from DANE

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03

Controlled inflation and monetary stimulus

Inflation will converge within the target range after three years of missed targets. With this achievement, the Central Bank will have some space to lower interest rates further

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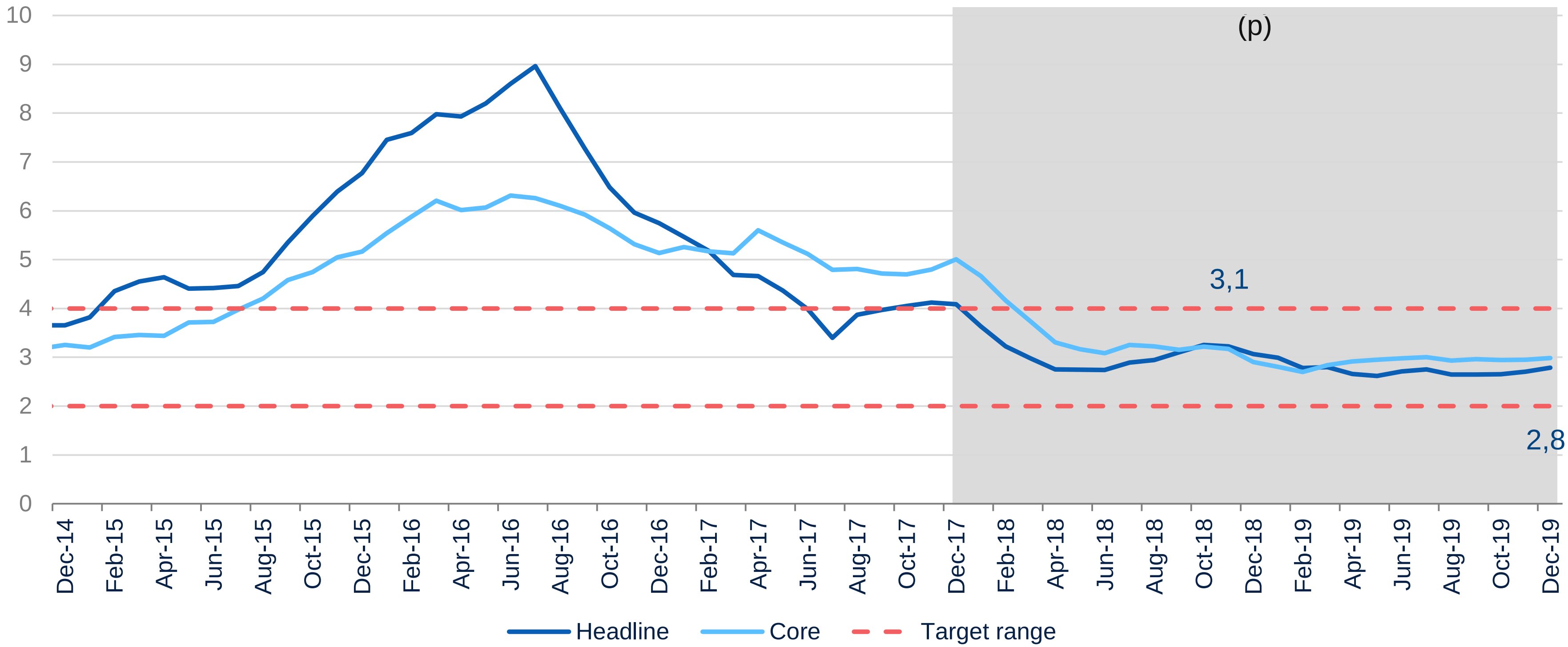
Inflation will converge swiftly towards the mid point of the target range, stabilizing around this level in de mid term

Inflation
(Annual variation, %)

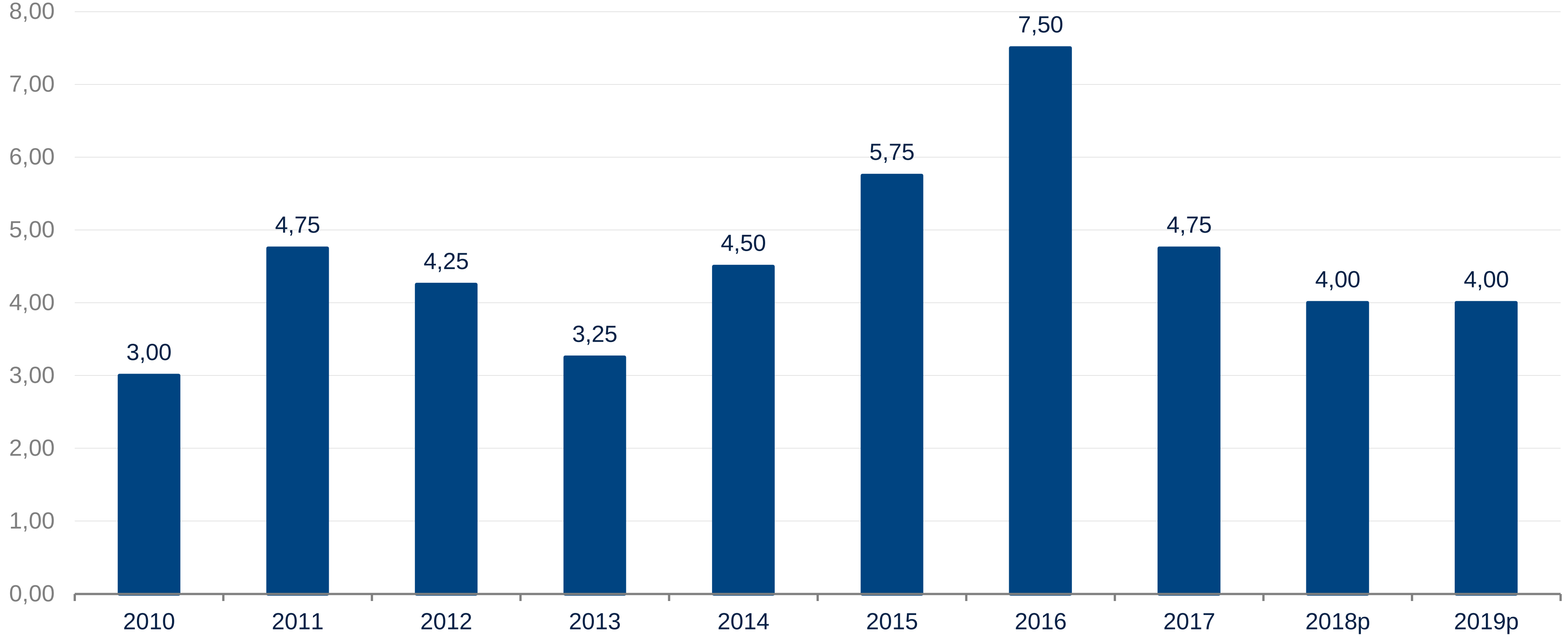


Weak demand and a stable exchange rate will continue playing an important role in de deceleration of the inflation

Source: BBVA Research with data from DANE and BanRep

The Central Bank, in a scenario of lower inflation and more favorable external balances, will reduce interest rates to 4,0%

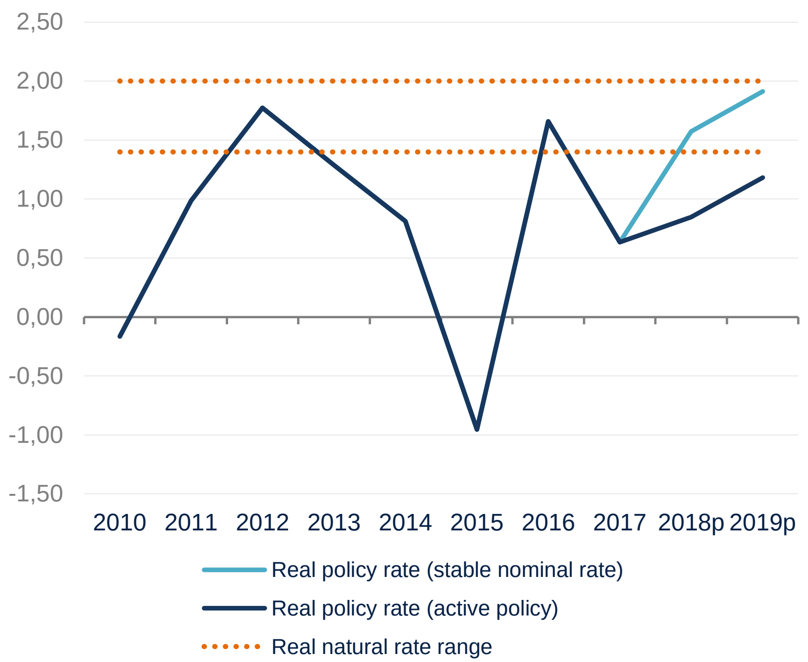
Policy rate
(En of period rate)



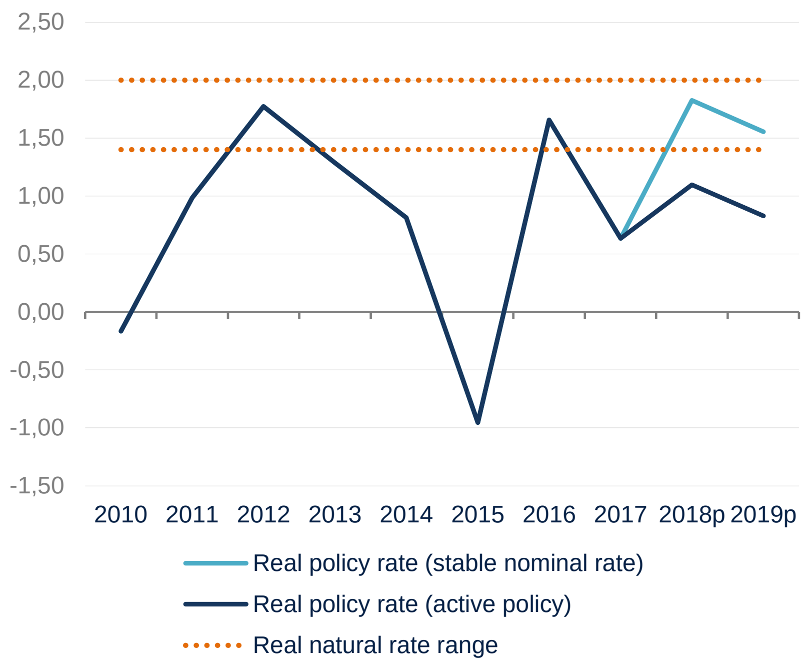
Source: BBVA Research with data from BanRep

A great deal of the response by the Bank will be to neutralize the descent of inflation and its effects on real rates

Policy rate with BBVA data
(e.a., %)



Policy rate with BanRep data
(e.a., %)



The significant decent in inflation, both core and headline, creates a pressure on the Central Bank to reduce interest rates to avoid reducing its current monetary stimulus

Fuente: BBVA Research con datos BanRep y DANE

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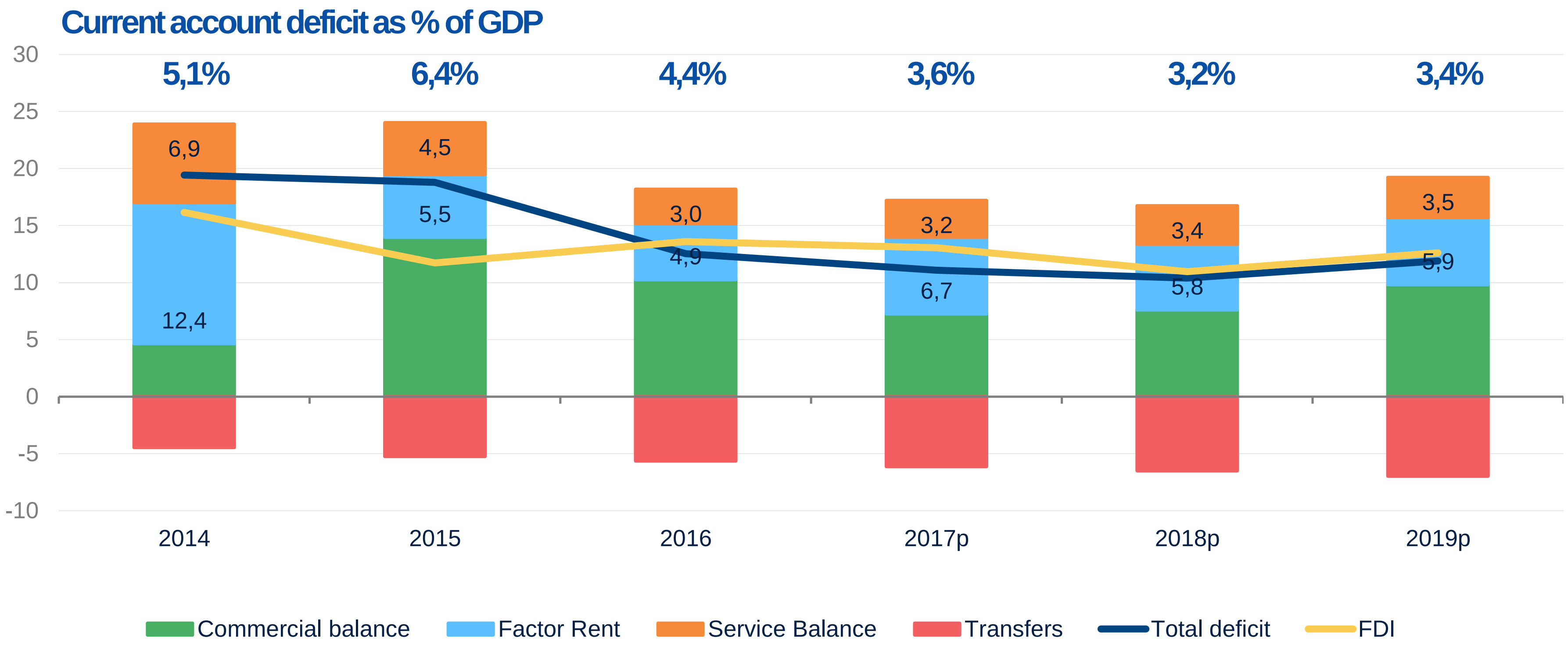
04

Macroeconomic Imbalances

The current account deficit has been favored by a higher oil price and better exports. The fiscal balance faces some challenges in 2019

The adjustment in demand and the higher oil prices allow a positive adjustment in the current account deficit

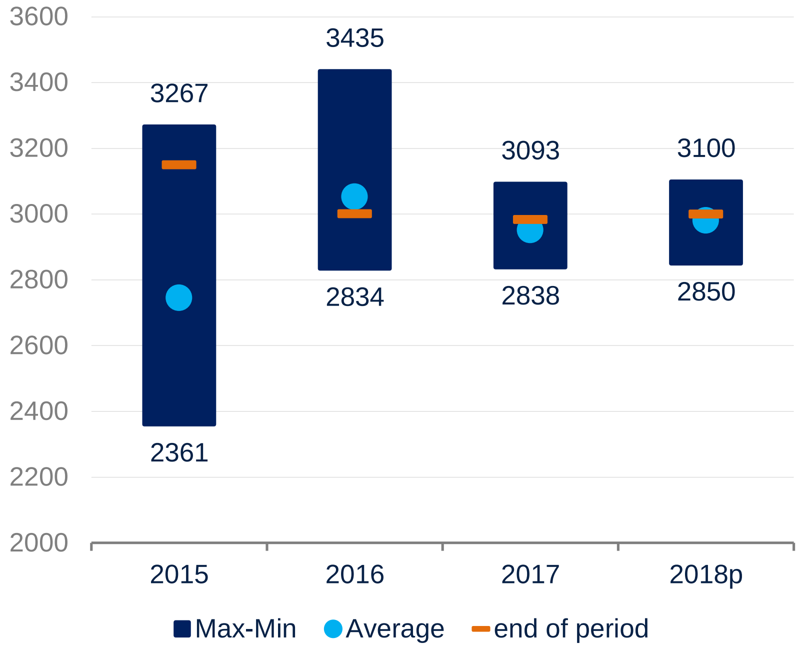
Current account
(USD billons)



Source: BBVA Research with data from BanRep

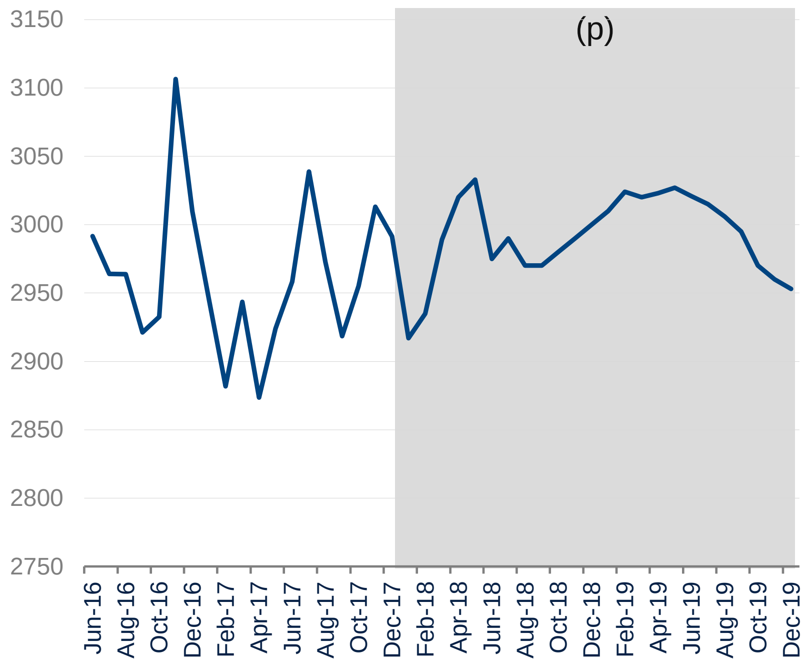
The better external balance and higher oil price help maintain the exchange rate with a reduced volatility

Exchange rate
Pesos for a dollar



P: BBVA projections, range simulations are not necessarily a forecast

Exchange rate: expected trajectory
Pesos for a dollar



Source: BBVA Research with data from Bloomberg

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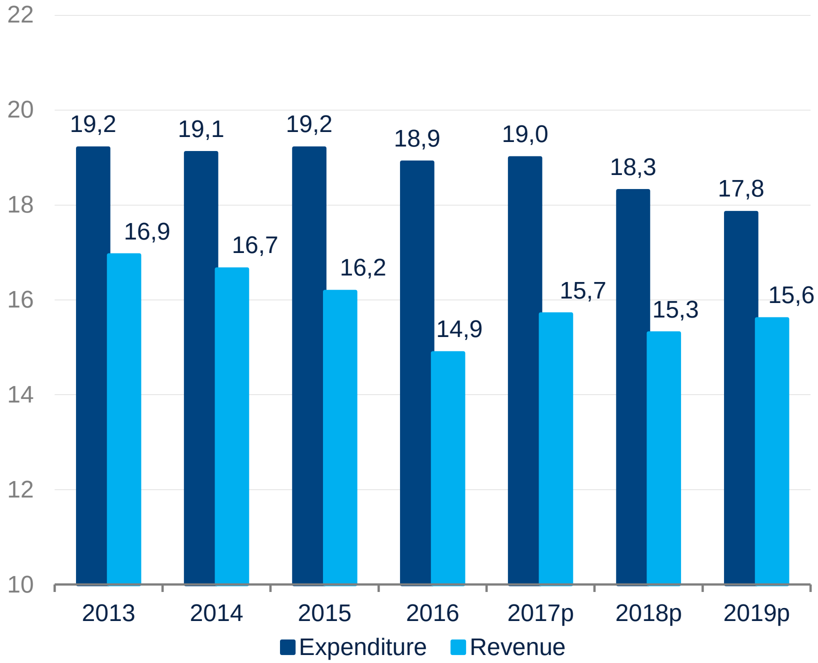
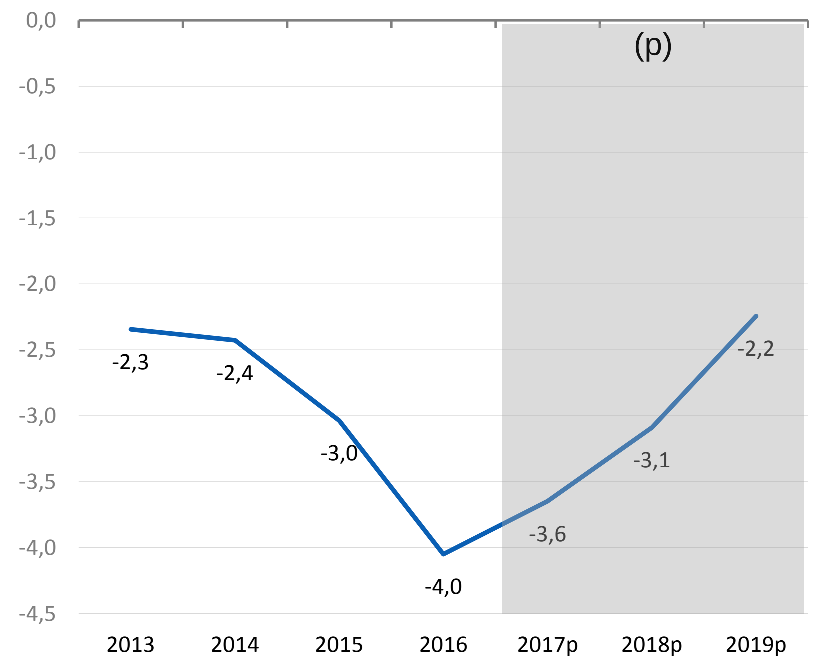
Fiscal deficit trajectory required by the fiscal rule implies an important reduction in expenditure and an improvement in revenue

Expenditure and revenue of the Central Government
(% of GDP)



Fiscal balance
(% of GDP)



The fiscal rule will be met in 2017 and 2018, despite lower than expected tax collections. For 2019 the pressure is greater and will require an active administration by the government

Source: BBVA Research with data from the Ministry of Finance and government projections

Main messages

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3. **Inflation will continue decelerating in 2018, achieving 3,1% in the year end.** Exchange rate stability and weakness in demand will allow inflation to decelerate in the first semester of 2018 and stabilize around the mid-point of the target range. For 2019 inflation would close slightly below, at 2,8% **The Central Bank will be able to reduce interest rates to 4,0% in the first semester.** Inflation behavior and its consolidation within the target range will allow the Bank to reduce its reference rate in the first semester to maintain the real interest rate stable.

4. **Structural imbalances, both external and fiscal, tend to improve.** The demand adjustment and higher oil prices allow for a reduction in the current account deficit to 3,2% in 2018, meanwhile the fiscal deficit will meet the fiscal rule at 3,1% in 2018. For 2019 the government faces some challenges in the fiscal front with the need to further reduce expenditure and improve revenue to comply with the fiscal rule

This report has been produced by the **Colombia Unit**

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ANNEX:

Main macroeconomic variables

Table A1 Macroeconomic Forecasts

	2014	2015	2016	2017	2018	2019
GDP (YoY, %)	4.4	3.1	2.0	1.5	2.0	3.0
Private consumption (YoY, %)	4.3	3.2	2.1	1.6	2.7	3.4
Public consumption (YoY, %)	4.7	5.0	1.8	3.3	2.3	2.8
Fixed investment (YoY, %)	9.8	1.8	-3.6	0.3	3.4	4.8
Inflation (%, YoY, eop)	3.7	6.8	5.7	4.3	3.2	2.8
Inflation (%, YoY, average)	2.9	5.0	7.5	4.3	3.0	2.7
Exchange rate (eop)	2,392	3,149	3,001	2,984	3,000	2,953
Devaluation (%, eop)	24.1	31.6	-4.7	-0.6	0.5	-1.6
Exchange rate (average)	2,001	2,742	3,055	2,951	2,981	3,002
Devaluation (%, average)	7.1	37.0	11.4	-3.4	1.0	0.7
BanRep interest rate (%, eop)	4.50	5.75	7.50	4.75	4.00	4.00
Deposit interest rate (%, eop)	4.3	5.2	6.9	5.3	4.4	4.4
Fiscal nalance (% of GDP)	-2.4	-3.0	-4.0	-3.6	-3.1	-2.5
Current account balance (% of GDP)	-5.2	-6.5	-4.4	-3.6	-3.2	-3.4
Unemployment rate (%, eop)	9.3	9.8	9.8	10.6	11.2	11.0

Main macroeconomic variables

Table A.2 Quarterly Macroeconomic Forecasts

	GDP (%, YoY)	Inflation (%YoY, eop)	Exchange rate (vs. USD, eop)	BanRep rate (%, eop)
Q1 15	2.6	4.6	2.576	4.50
Q2 15	3.0	4.4	2.585	4.50
Q3 15	3.3	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	1.7	5.7	3.001	7.50
Q1 17	1.3	4.7	2.880	7.00
Q2 17	1.2	4.0	3.038	6.25
Q3 17	2.0	4.0	2.937	5.25
Q4 17	1.4	4.1	2.984	4.75
Q1 18	1.6	3.0	2.989	4.50
Q2 18	1.5	2.7	2.975	4.00
Q3 18	2.1	3.1	2.970	4.00
Q4 18	2.8	3.1	3.020	4.00
Q1 19	3.0	2.8	3.021	4.00
Q2 19	3.3	2.7	3.000	4.00
Q3 19	2.8	2.6	2.995	4.00
Q4 19	3.1	2.8	2.953	4.00

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