Economic Outlook

Colombia

Third Quarter 2012
Economic Analysis

- **Global growth will recover steadily in 2013** as European and U.S. authorities reduce existing uncertainty.
- **In 2012 and 2013, the Colombian economy will grow by 4.1% and 4.4%,** respectively, a moderate slowdown after its strength in 2011.
- **The central bank will maintain a slightly expansive stance in 2012 and 2013.** An improvement in the execution capacity of public investment is expected to boost activity.
- **In a more adverse external scenario, Colombia will face a significant adjustment in domestic demand,** though this will be limited by the healthy situation of the private sector and the activation of policy buffers.

Index

Closing date: August 10, 2012

1. Summary

The global growth forecast has been revised slightly downward to 3.4% in 2012 and 3.7% in 2013. This revision is based on the financial tensions in Europe and the slowdown that has been somewhat more intense than expected three months ago, especially in the largest emerging markets such as China, India and Brazil. This global scenario presupposes that the necessary political agreements will be reached for making progress in the institutional development of the European monetary union and also for avoiding the automatic fiscal adjustment in the U.S.

In Colombia, in response to more sluggish external markets, the economy moderated its growth compared with the strength in 2011, emphasized by a low level of execution of public works in the first quarter of 2012.

We expect the Colombian economy to grow by 4.1% in 2012 and 4.4% in 2013, as a result of some improved prospects for global growth and oil prices, combined with internal factors related to the lower execution of public works and the weaker performance of the main leading indicators in the first half of the year.

The high levels of household and corporate confidence suggest we can anticipate growth of household consumption in 2012 in line with GDP, while private investment will increase by over 9%. At the same time, foreign demand will continue to take away from growth, consistent with a more uncertain global situation that will return to normal slowly over the last quarter of the year.

The improvement in the rate of execution of public investment in the second half of 2012 and 2013 will speed up growth next year. Expectations on public works are optimistic to the extent that significant institutional changes have been made that suggest a better execution of public investment, taking advantage of the current availability of resources from higher tax revenues and increased royalties.

Combined with the moderation of risks derived from credit growth for financial stability, stable inflation led to the start of a new cycle of monetary policy easing, in line with the actions by other central banks in the region and other emerging countries, and demonstrating a firm determination by the Central Bank to counter the slowdown in the economy and respond to the consequences of external turbulence. We expect at least one additional interest-rate cut before the end of the year.

A deeper and more prolonged recession in the euro zone, with a contagion effect to the United States and other developed economies, would have considerable effects on global commodity values, external capital flows and domestic confidence in Colombia. In this scenario, it will be essential to maintain the boost to growth from mining and energy, based on a long-term investment structure that is a feature of the sector, and to increase execution of public investment. In this way, the external shock can be coped with and its negative effects on domestic demand limited. It is also true that the present starting-point of a easily financed current-account deficit and a flexible exchange rate reduces the risk of an abrupt fall in private expenditure.

2. External environment: a slowdown that may deepen unless decisive economic policy action is taken

Global growth will improve only if key economic policy measures re fully implemented in time. Some of them have already been approved but others are still under consideration

After the deterioration in global economic conditions in the first part of 2012, our current scenario that still envisages a slight economic rebound in 2013 is very dependent on economic-policy issues. Our global GDP growth forecast stands at around 3.5% in 2012-13, but relies on the assumption that several policy measures are implemented around the world. Some of them have already been brought into force but need appropriate implementation; others have been announced but not introduced yet; and, finally, some key measures still have yet to be passed. Policy measures must avoid a financial mess in Europe, an automatic fiscal adjustment in the US in 2013, and help reach higher growth rates in emerging economies. However, if economic policies fail to achieve their goals, the slowdown now in place since 2011 is likely to intensify in 2012 and 2013. That could leave 2013 global GDP growth at its slowest pace in 30 years (except for the 2009 recession).

At a summit in June, the eurozone leaders reached agreements in the right direction to reinforce the currency union: single bank supervision in the euro area, far-reaching plans covering banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms that have been approved to ensure financial stability in the eurozone (i.e., EFSF&ESM) must be used in their full capabilities as soon as possible to avoid a financial "accident.[1]"This is the only way to make sure that those economies currently struggling to access financial markets have the chance to implement fiscal-consolidation plans and structural reforms. This should include the involvement of the ECB.

In the US, there must be an agreement to prevent that automatic spending-cut measures and the expiration of tax cuts come into force at the beginning of 2013. This "fiscal cliff" would not solve long-term sustainability of the country's public finances and, if all measures materialized, they would push the US economy back into recession in 2013. As the presidential campaign makes any kind of agreement difficult until the election, the surrounding uncertainty over the outcome of this process is likely to play a key role in shaping the economic and financial outlook as we move towards the end of the year.

Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand so that the effects of the external slowdown are mitigated. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and, on the other hand, flows related to a new round of quantitative easing the US Fed is likely to embark on.

Failure to dovetail sovereignty transfer with debt mutualisation at the rhythm that markets demand drags the euro crisis out

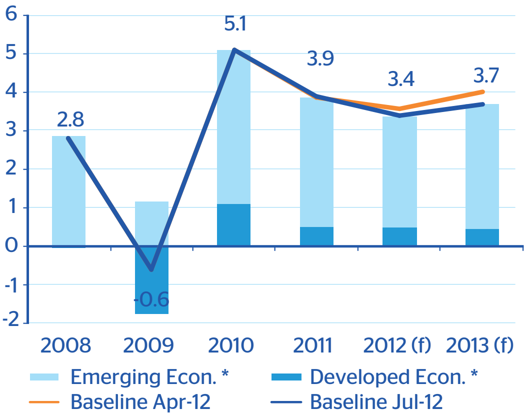
The main uncertainty over the current economic scenario is whether the efforts that the eurozone countries will have to make to reinforce its governance will be preceded by a further deterioration in its financial situation. If this were the case, we think that it will produce massive interventions from EU mechanisms to eventually assure the financial stability of the eurozone. The decisions already taken, if implemented forcefully could suffice but that requires that the measures approved at the end of June are implemented quickly. Those measures aimed to eliminate the risk emerging from the sovereign-banking feedback loop in Spain and to stabilise financial markets across the

1: The financial "accident" could take various forms, including for example the lack of demand for sovereign-bond issuances of peripheral economies.

eurozone with the active use of the EFSF and later on of the ESM actively purchasing bonds in the primary and secondary market. Recent policy measures in Spain to reign in the deficit together with the strongly supportive stance by the President of the ECB are helping to ease tensions.

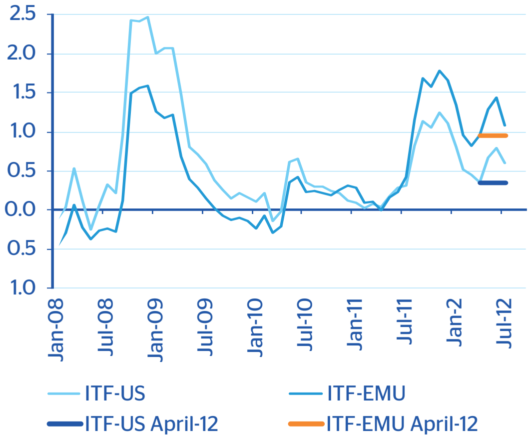
All in all we have revised downwards our previous forecast (released three months ago) due to continued financial stress stemming from the euro area crisis and ongoing deterioration in global economic confidence. This scenario implies a period of stagnation in the eurozone in 2012- 13. Despite this revision, in our view, the balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries. If that were to happen, then the risk of a recession in Europe in 2013 would be relevant, especially in countries such as Spain and Italy.

Chart 1
Global GDP growth (%) to pick up in 2013



Source: BBVA Research

Chart 2
Financial stress indicator, BBVA Research



Source: BBVA Research

Eurozone countries have to solve the liquidity squeeze on some markets. Those constraints are a consequence of market participants assigning some chance that a euro break-up may occur. Euro countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms of reduction of imbalances at the rhythm that markets demand. As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the zone. A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break up. However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures are lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualisation). That will also happen as for the fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. If the challenges ahead are met satisfactorily, global growth could gradually gain traction during 2H12.

In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of a high financial stress coming from the euro area. As for Asia, growth in the first half of the year slowed in China by more than expected. In line with the weaker global outlook, we have accordingly revised down our projections for 2012-13. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup in China, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. However, there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

3. The Colombian economy is slowing, but domestic demand remains resilient

Growth in the first quarter was limited by the major drop in investment in public works

In the first quarter of 2012 the low execution of public works became one of the main factors slowing down the economy. In fact, excluding public works, GDP and domestic demand grew by respective annual 5.5% and 7.0%, above the figure of 4.7% and 6.1% for total GDP and domestic demand. Exports also reduced their rate of growth over the quarter from an annual 16.2% in the fourth quarter of 2011 to 6.3% in March, in response to more sluggish external markets and some domestic bottlenecks in the production and transport of oil and coffee.

More moderate foreign demand also affected the performance of the manufacturing sector and agriculture. As a result, these two sectors, together with construction, were those with the lowest growth rates in the first quarter. In fact, in recent months industries less exposed to international trade or markets in the region, such as iron and steel and food, have outperformed sectors that trade more with the United States and Europe, such as textiles and leather. The direct result is a lower growth of investment in capital goods for the rest of 2012.

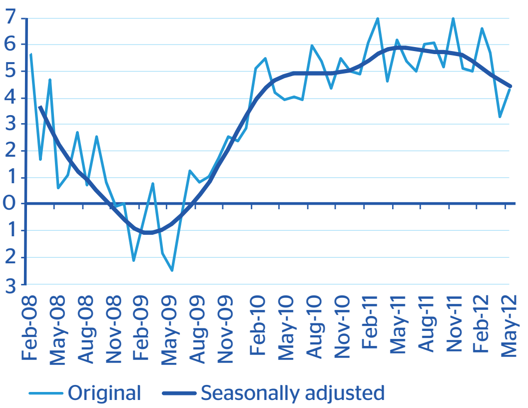
Economic slowdown due to less favorable external conditions is being passed on in part to domestic demand

Recent leading indicators show a continued economic slowdown, not only in the external variables, but also in the performance of local demand (see Chart 3). On the external front exports growth has slowed. In fact, in 2011 foreign sales increased by an annual 43%, but in May the rate had dropped to 13.5%. The dip is a result of the rapid slowdown in mining and energy from 57% in December to 15.5% year-to-date (May). This performance extended to industrial goods, whose exports grew by 18.1% in 2011, while YTD to May they were only up by an annual 5.5%.

The main cause of the slowdown in domestic demand is the reduction in private consumption, which we partly anticipated in our earlier analyses. The expected end of the expansive phase of the consumption of durable goods, both by the statistical effect of high levels in 2011 and by the gradual removal of the monetary stimulus through the first half of 2012, was not offset by an equivalent upturn in consumption of non-durable goods. Services are the main source of the rise in private consumption, as shown by the indicators of hotel occupancy and purchases through travel agencies.

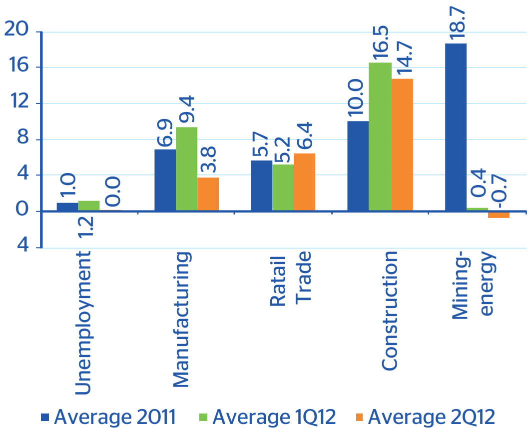
Until the first quarter of 2012 the gradual reduction in unemployment supported the expansion of private consumption. However, slowing rate of employment growth over recent months, which could extend until the end of the year, would limit this stimulus by affecting household confidence. In fact, in June the confidence surveys by Fedesarrollo showed a marginal increase in consumer concerns about losing their jobs. The reduced rate of job creation in the economy is directly related to the lower increase in labor demand in the manufacturing and mining and energy sector. The good results in the construction sector have not been enough to offset this trend (Chart 4).

Chart 3
General index of economic activity. Principal components of leading indicators



Source: BBVA Research

Chart 4
Fall in unemployment and increase in employment by sector. Percentage points and annual change



*The fall in unemployment is in percentage points, the increase in employment is given as annual change.
Source: DANE and BBVA Research

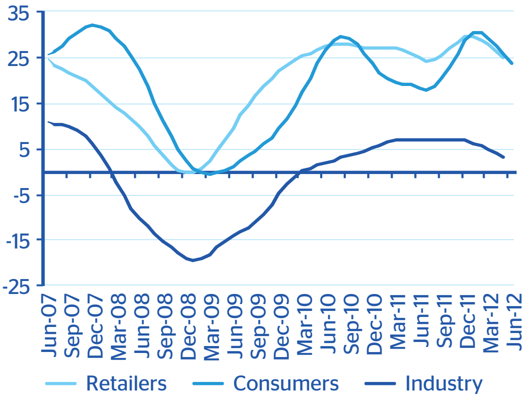
Even so, business and household confidence remains high, although the trend has been in recent months, particularly in the case of the manufacturing sector. Representatives of the industry point to an increase in inventories and a fall in orders, which could be the result of a reduction of foreign demand. However, they continue optimistic about production over the upcoming months. Equally, retailers warn about a fall in sales, but their expectations remain high (see Chart 5).

We expect the economy to grow by 4.1% in 2012 and 4.4% in 2013

As a response to the signs of a slowdown in the economy, we have revised down GDP growth for this year and next (see Chart 6). The revision of the forecast from an annual 5% to 4.1% this year is a response to the lower prospects for global growth and oil prices. Domestic demand will also be down due to lower execution of public works and the weaker performance of the main leading indicators in the first half of the year. In this situation household consumption in 2012 will grow in line with GDP, while private investment will expand at over 9%. Overall, domestic demand will contribute 5.1 percentage points (pp) to growth, while foreign demand will reduce it by 1.0 pp, in line with a more uncertain global situation that will return to normal steadily over the last quarter of the year.

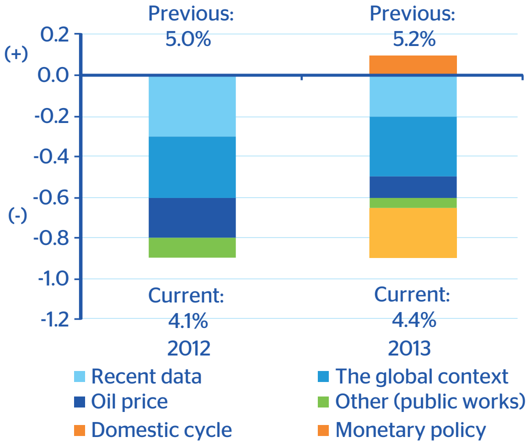
The improvement in the rate of execution of public investment the rest of 2012 and 2013 will speed up growth next year. The institutional change in the sector and new legislation make us relatively optimistic on this point (see Box 1). In addition, moderate growth among the country's main trading partners, the slow recovery of oil prices and the extension of weak growth in some industrial sectors until next year are all factors that lead to a downward revision of forecast growth for 2013 to 4.4%.

Chart 5
Business and household confidence. As net answers



Source: Fedesarrollo and BBVA Research

Chart 6
Determinants of the change in the growth forecast. In percentage points



Source: BBVA Research

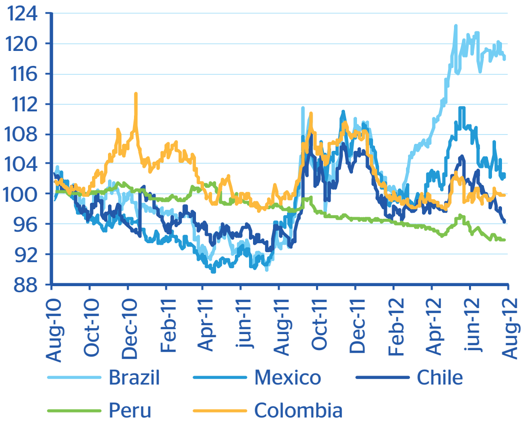
A lower current-account deficit in the medium term will continue to be financed with long-term flows

The new growth forecasts imply a stable current-account deficit for 2012 with respect to the 2011 figure. It is expected to fall over the coming years. For 2012 and 2013 we expect a deficit of 3.0% and 2.4% of GDP respectively. Its downward trend will be extended over the coming years to a level of around 2% of GDP in the medium term. This behavior is coherent with growth in 2012 and 2013 being under the economy's potential, in a context of oil prices at above their historical average, although below their historical peaks. The financing of the current account will continue to be focused on long-term funds, mainly from foreign direct investment, which on July data exceeded the levels for 2011. At the same time, Colombian investment abroad will be below the amount recorded in 2011. As a result, there will be a big surplus in the capital account over the coming years.

The Colombian peso will remain relatively stable in the second half of the year compared with the first

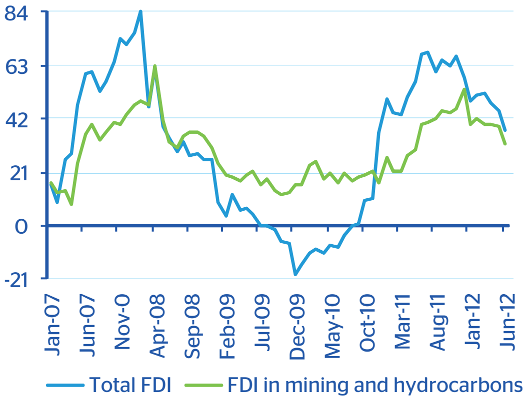
In the first few months of the year, with abundant global liquidity and favorable export prices, the exchange rate strengthened significantly. This led to the renewal in February of the daily purchase program by the central bank, with the aim of moderating the speed of the rise. More recently, the local currency has been affected by volatility in global markets, and additional gains in the exchange rate have been limited (see Chart 7). The Colombian peso has managed to be relatively stable and resist the effects of external turbulence, mainly due to the continuity of the foreign direct investment inflows, as shown by the most recent exchange-rate balance sheet figures (see Chart 8). In addition, the factors supporting the local currency are still in place, as despite the recent deterioration, the terms of trade continue at high levels. As well as this, there are investment opportunities associated with the growing interest in the mining-energy sector and the continued expansion of domestic demand. In line with the above, and taking into account the more expansive monetary policy stance, we expect that the Colombian peso will remain relatively stable with respect to its current level for the rest of 2012, and recover its upward trend next year (see Tables 1 and 2). In any event, the behavior of the local currency will remain firmly dependent on the financial tensions related to the fiscal crisis in Europe. This situation could generate a strong depreciation in the case of a sudden movement in the levels of global risk aversion.

Chart 7
Colombia and LatAm exchange rates (14/09/10=100)



Source: Bank of the Republic and BBVA Research

Chart 8
Foreign Direct Investment (12-month total, annual % change)



Source: Bank of the Republic and BBVA Research

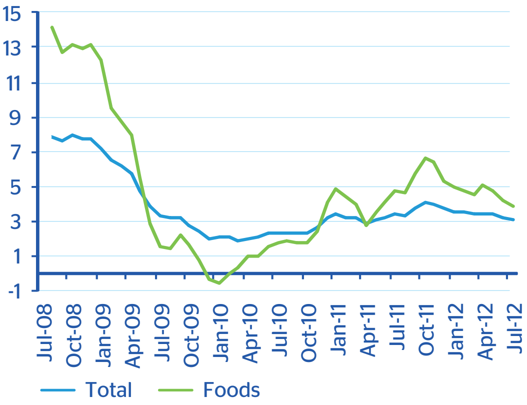
4. The Central Bank will use the room it has available to extend its expansive stance

Inflation moderates more than expected as price rises of basic goods slow

Inflation has shown a clear tendency to slow over recent months. This has led to improved expectations, which are anchored at the Central Bank's target range. In July, the annual increase in prices stood at 3.0%, compared with a rate of 3.7% at the end of 2011 (see Chart 9). This can be explained mainly by the slowdown in the prices of regulated goods and services and the moderation of prices of foods as a result of the return to normal of weather conditions at a local level. Equally, the core inflation indicators suggest demand pressure has been contained, with relative stability in recent months (see Chart 10). The downward review in our oil price forecast, together with the lower than expected figures so far this year and the expected moderation in the growth of domestic demand, all lead us to reduce our inflation forecast from 3.4% to 3.0% in 2012 and from 3.3% to 3.2% in 2013.

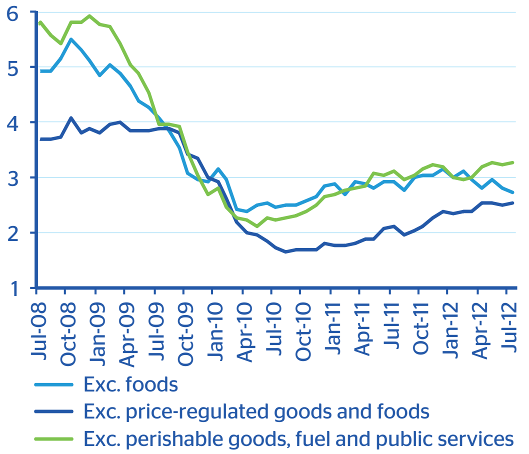
In addition, inflationary risks and possible financial imbalances linked to excessive credit growth have been moderating, in line with expectations. This can be mainly explained by a weaker commercial portfolio, and also by the reduced stimulus from consumer finance, which has fallen off from a real annual growth of 24% at the start of 2012 to under 20% in May. In addition, recent surveys reveal an increase in bank requirements for granting loans. We therefore expect that credit will continue to moderate to more sustainable rates of growth.

Chart 9
Total and food inflation (annual % change)



Source: DANE and BBVA Research

Chart 10
Core inflation indicators (annual % change)



Source: DANE and BBVA Research

Thus the main upward risk for the inflation forecast for 2012-2013 comes from possible pressure on food prices. This is the result of the recent upturn in international prices of some foodstuffs caused by supply problems linked to the major drought in the United States and lower production by other major producers. There is also a greater chance that the El Niño phenomenon will occur at the start of 2013. This would affect crop productivity, with delayed effects on food prices in the country. The impact of this phenomenon would be temporary in nature, depending on how it effects inflationary expectations. It would be determined by the intensity of the climate event, although it is not expected to be as big as on previous occasions.

Monetary policy turns to an expansive stance and gives a strong signal supporting the economy

With the increase in global financial tension, the Central Bank has chosen to change its monetary stance and reduced its reference interest rate by 25 bps in July. Despite some uncertainty regarding the imminence of this measure due to recent political problems, the movement was in line with expectations. It sent a clear signal of support to economic activity, given the risks from the external environment and the signs of a greater than expected moderation in domestic demand.

The direction of monetary policy proved the flexibility of the monetary instrument in responding to changes in the economic situation. At the same time, it was able to send a signal of caution with respect to the strength of credit and possible pressure in asset markets, against the background of interest rates that are under their average historical levels. Nevertheless, the recent moderation of these risks, mainly reflected in the positive inflation figures, generated the room needed to start a new cycle of monetary policy easing, in line with what other central banks in the region and in other emerging countries have done.

In addition, in its reasoning, the Central Bank would have considered the situation of some sectors of the economy, mainly manufacturing and agriculture. They are more exposed to foreign trade and have been hit more strongly by the slowdown abroad. In addition, they have been affected by specific factors that have led to lower than expected growth that is under the figure for the rest of the economy. The Ministry of Finance has announced its interest in implementing measures to tackle the slowdown in these sectors of the economy, partly to offset the effects of the stronger exchange rate. As an addition to these measures, the Central Bank and the sectors involved have suggested extending the Central Bank's intervention in the foreign-exchange market, although so far no consensus has been reached between the members of its governing board in terms of the need to combat the strengthening of the peso given the current global situation.

We consider that the discussion on improvements to the competitiveness of specific sectors of industry and agriculture should go beyond the subjects of foreign-exchange intervention designed by the Ministry of Finance as part of the measures aimed at supporting specific sectors. The discussion should focus on how to increase the competitiveness of these sectors as the economy opens up to international markets while maintaining more expensive labor costs and low levels of infrastructure and logistical capacity. For the good of macroeconomic stability and the country's position with respect to the international rating agencies and multilateral agencies, the discussion about the competitiveness of sectors of the economy has to be separated from the recent discussion about the optimum level of international reserves.

The Central Bank will make at least one additional cut to its policy rate this year

With the latest reduction of the policy rate to 5.0%, and given that at the same meeting of the Central Bank some board members voted for a more aggressive cut to boost the economy, we expect a more expansive monetary policy over the coming months. The most recent statement by the Central Bank suggests a firm determination to counter the economic slowdown and respond to the turbulence abroad. This suggests we can expect at least one additional cut to the interest rate, which should close the year at 4.75%. This expansive monetary policy stance will be maintained until the second half of 2013, when we expect stronger growth in the midst of a global recovery. In any event, we consider that the monetary authority will continue to watch closely the debt crisis in Europe, as well as the risks of greater contagion to the Colombian economy, which depends in part on the recovery of public investment and the resolution of the temporary factors that have slowed some sectors of the economy. The reduction in inflationary expectations and pressures will help maintain a capacity for swift response if any additional adjustments in the interest rate are required.

5. Improvements in the fiscal balance, but there is still some way to go on the structural front

Improvements in the fiscal balance: a combination of increased revenues and efficiency

The fiscal figures have continued their consolidation begun in 2010. The administrative improvements in the collection of taxes, the elimination of some tax deductions starting in 2011 and the strength of domestic demand, have all helped to continue the fall in the fiscal imbalance. Tax revenues from domestic activity (excluding oil and imports) grew between 2010 and 2012 by 1.3% of GDP, leading to a similar reduction in the size of the country's fiscal deficit. Similarly, the process of exchange-rate strengthening has resulted in lower interest payments for the most recent debt issues, which in turn has reduced pressure on the central government's fiscal deficit.

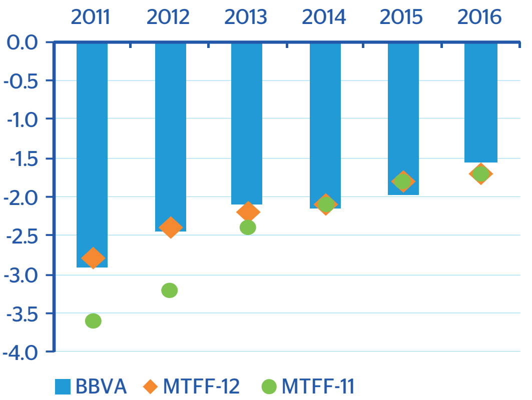
For these reasons, we estimate that central government will end 2012 with a fiscal deficit of 2.5% of GDP. This will be reduced to 2.1% in 2013 thanks to less pressure from expenditure on transfers (see Chart 11). The reduced fiscal pressure made it easier for the government to postpone the sale of 10% of the state-owned oil company Ecopetrol, which is not a fundamental part of fiscal consolidation in the medium term. In the future fiscal consolidation will give Colombia room to activate a countercyclical policy if there is further deterioration in the foreign scenario (see Section 6).

Postponement of the tax reform with lower fiscal impact, but with effects on the structural design in the medium term

Medium-term fiscal consolidation is independent of the structural reforms announced earlier by the government. The tax reform, which aims to eliminate some tax benefits and increase equality in taxation, has been postponed temporarily by the government. It is not clear whether it will be presented before the end of the year. Although the aim of the reform is not to achieve greater fiscal consolidation, the target of the reforms is a structural weakness in the Colombian economy. The national budget's structure means that government expenditure is inflexible, and makes it difficult for the government in power at any time to meet its requirements swiftly. In addition, the structure of consumption taxes and the many tax deductions on income tax (see Chart 12) make the tax system regressive in nature.

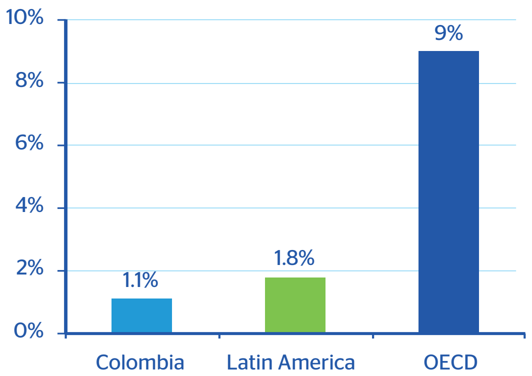
Some sovereign rating agencies have highlighted the need for a more flexible tax system, and even conditioned their revision of Colombia's sovereign debt rating on factors including more flexibility in the national budget. Thus while the delay in the tax reform does not affect the fall in the central government deficit in the long term, its postponement will delay the objective of having a fairer and more transparent tax system and could put on hold any additional improvement in the ratings.

Chart 11
Central government fiscal deficit (% GDP)



Note: MTFF = Medium-Term Fiscal Framework 2011, 2012.
Source: Ministry of Finance and BBVA Research

Chart 12
Personal income tax revenues (% GDP, 2010)



Source: Jorratt (2010) and World Bank

The 2013 budget maintains growth in investment expenditure, with a priority for defense and housing

The national budget for 2013, which was presented to Congress for debate recently, is a reflection of the move toward central government fiscal consolidation. With a moderate increase of 9.4% y/y excluding debt payments (0.1% of GDP), the budget maintains a similar distribution in spending on the main sectors, where defense, education and social protection are the items with the biggest share of expenditure. Investment— the most flexible budget component, increased by 0.2% of GDP mainly aimed at the defense and housing sectors. Defense received resources from wealth tax, while housing benefited from the government's aim of providing a boost to homes for people on low incomes. Equally, there has been an increase in resources for the reconstruction of infrastructure damaged by the extreme winter weather.

The housing sector has increased its investment expenditure by 53% compared with 2012, and raised its total share of the budget to 5%. This increase is to pay for three areas: the program launched in 2012 to provide subsidies for the whole value of homes for 100,000 families in urban areas; maintenance of the programs subsidizing interest rates; and investment in the improvement of the urban water supply.

With respect to infrastructure, the budget includes growth of 12.8% (0.06% of GDP). The items receiving most resources are the reconstruction works following the extreme winter weather in 2011 and the continued investment on roads. Despite its growth, infrastructure has reduced its share of GDP, so any boost in 2013 depends on a better execution rather than an increase in state funds.

Box 1. The role of public works in economic growth

Investment in public works has increased its share of GDP and domestic demand steadily from 4.7% and 4.2% respectively in 2000 to 6.8% and 6.2% now. The steepest growth in this item was in the period between 2005 and 2009, with an annual average rate of 11.4%. In fact, in 2009 investment and public consumption were key in guaranteeing a positive growth rate for the economy. If we exclude public works and the government's current expenditure, GDP in 2009 would have recorded a contraction of 0.1% instead of a growth of 1.7%. GDP not excluding public works would have grown only 0.9%, half of the total GDP actually recorded.

However, this positive performance has been interrupted in recent years, with a fall of 2.0% in 2010 and a lower than expected upturn of 6.7% in 2011, despite being boosted by the low statistical base the previous year. In 2012 investment in public works was key to the moderation in GDP growth in the first quarter, with annual fall of 8.1% reinforcing the process of slowdown. Given this situation, the recent debate has focused on the capacity for executing public investment. This is because the national budget itself and the territorial agencies both suggest there are extensive resources available for public investment.

In methodological terms there has been discussion on the quality of the figures, due to the way in which the indicator of investment in public works is measured: it is accounted for using the payments made by official entities and other companies to the contractors, but not necessarily taking into account the progress made in the works.

Chart 13

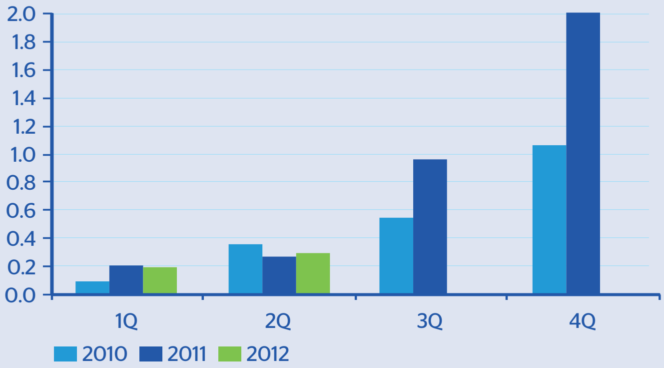
Quarterly payments by the central government for infrastructure works (June 2012 COP, trillion)

Source: Ministry of Finance and BBVA Research

To June execution of the investment payments was only 19.8% of that planned for the time. This figure is significantly lower than the payments made in the other operating items, which is closer to 50%. For the infrastructure sector, the payments made in the first quarter of 2012 by central government were lower than a year earlier (see Chart 13). In addition, the change in the system of bidding for road projects takes away incentives for the government to provide cash advances to concessionaires. This explains part of the moderation in public works in 1Q12, despite the start of major road infrastructure works for COP 3.6 trillion. However, for the second quarter of 2012 the figures for execution show a better situation than that in the same quarter in 2011.

Chart 14

Quarterly payments by the municipalities of Bogota, Cali, Medellin and Barranquilla on infrastructure works (June 2012 COP, trillion)



Source: Contraduría General de la Nación and BBVA Research

With respect to local governments, the modification of the royalties system and the early period in office of the local administrations, have led to limited execution at the start of the year. In addition to the moderation in 1Q12 in the national government's infrastructure expenditure, the local governments (represented in Chart 14 by the four main capital cities) reduced the value of their investment compared with the figures for 1Q11. For 2Q12 the situation is similar to that for 2Q11, so the sector will be mainly boosted by the progress made in this area by central government.

Our growth forecasts assume a swift recovery in public works starting in the second quarter of the year, in line with the positive data for fiscal execution and other leading indicators. For example, cement deliveries to constructors and contractors, the government and concrete producers have increased by an annual 39%, 23% and 16%, respectively, this year through June. This reflects the high level of activity in construction, both in buildings and public works. GDP excluding public works in the second half of 2012 and in 2013 will grow by an annual 3.7% and 4.0% respectively, below the expected total annual GDP growth of 4.1% and 4.4%.

To sum up, the recent indicators of fiscal spending on investment and cement deliveries show strength in the construction sector. The increased uncertainty arises from the execution of resources, rather than their availability. Thus an idiosyncratic risk in our growth forecasts arises from the lower capacity of national and regional entities to organize tenders, launch projects and pay contractors for infrastructure projects currently planned, which would result in a historically high level of investment if they were to be implemented.

6. Good buffers against deterioration in the global situation, but the impact will be substantial

The main risk for the Colombian economy is a more pronounced deterioration in the global situation

A deeper and more prolonged recession in the euro zone, with a contagion effect to the United States and other developed economies, would have considerable effects on global commodity values, external capital flows and domestic confidence in Colombia. In this scenario, in order to overcome the external shock and limit negative effects on domestic demand, it will be essential to maintain the boost provided by mining and energy to growth, as was observed in recent years, through a long-term investment structure that is a feature of the sector. Greater execution of public investment is also key. The private sector's experience with global crises in the past has allowed consumers and investors to maintain moderate levels of spending in extreme situations, as happened in 2008 and 2009, thus reducing the probability of drastic adjustments to domestic demand. Even so, we have to be alert to the performance of domestic demand in the coming months, given that there are already signs of a slight deterioration in local confidence, mainly explained by the response to the global uncertainty.

Our forecasting models project that in this more adverse scenario for the Colombian economy, it will continue to post positive growth rates of over 3% on average in the period 2012-2014, with growth in 2013 above that recorded during the Lehman Brothers crisis, despite the expected recession in Europe and the United States.

An easily financed current account deficit and a flexible exchange rate reduce the risks of an abrupt fall in private expenditure. Among the buffers needed to deal with a more adverse global scenario will be the capacity to adjust the exchange rate through depreciation to help moderate the effects of lower foreign demand on the export sector; and an adequate foreign position such as a flexible credit line with the International Monetary Fund for USD 6 billion, which will allow the government to deal with any sudden shortage of finance in the global markets. As in the previous episode of turbulence in 2008-2009, exchange-rate flexibility will allow the Central Bank to prioritize stimulation of domestic demand through an additional reduction in interest rates, although its margin will be reduced. The central government deficit for 2012 will be similar to that before the episode of turbulence abroad, so it will have the fiscal room to deal with a contraction in local economic activity.

Healthy household and corporate balance sheets will allow an orderly adjustment to be made

The debt burden of households increased in 2011, but moderated in the last month of the year. The cost of debt servicing as a proportion of household income stood at 15.2% (Bank of the Republic, 2012), with a slight increase between 2010 and 2011 for mortgage lending and consumer finance. Nevertheless, this level is lower than that at the end of the 1990s. On the question of mortgages, the debt burden of mortgage lending accounts for only 2% of household income. Combined with the low rate of mortgage lending (4% of GDP) this means we can rule out the possibility of contagion to the mortgage or financial sector, and expect the financial accounts of consumers to be stable in case of an adverse scenario.

The private sector has reduced its foreign-currency debt compared with the levels at the start of 2000s, when it was recovering from the domestic crisis. Private-sector foreign debt stands at 10% of GDP, compared with 16% in 1999, while the debt of the corporate sector is half that of 1999. Thus the private sector's exposure to external turbulence or possible restrictions in external finance has been reduced.

7. Tables

Table 1
Macroeconomic forecasts annual

	2010	2011	2012	2013
GDP (y/y %)	4.0	5.9	4.1	4.4
Private consumption (y/y %)	5.0	6.5	4.1	4.5
Public consumption (y/y %)	5.5	2.6	3.3	3.5
Fixed investment (y/y %)	4.6	16.7	7.7	6.8
Inflation (y/y %, EoP)	3.2	3.7	3.0	3.2
Exchange Rate (vs. USD, EoP)	1926	1934	1800	1810
Interest rate (%, EoP)	3.00	4.75	4.75	5.25
Fiscal balance (% GDP)	-3.9	-2.9	-2.5	-2.1
Current account (% GDP)	-3.1	-3.0	-3.0	-2.4

Source: DANE, Ministry of Finance, Superfinanciera, BanRep, and BBVA Research

Table 2
Quarterly Macroeconomic Forecasts

	GDP (y/y %)	Inflation (y/y %, EoP)	Exchange Rate (vs. USD, EoP)	REPO rate (%, EoP)
1Q11	5.0	3.2	1884	3.50
2Q11	5.1	3.2	1783	4.25
3Q11	7.5	3.7	1836	4.50
4Q11	6.1	3.7	1934	4.75
1Q12	4.7	3.4	1766	5.25
2Q12	3.9	3.2	1793	5.25
3Q12	3.6	3.0	1780	4.75
4Q12	4.1	3.0	1800	4.75
1Q13	4.1	3.0	1760	4.75
2Q13	4.3	3.0	1730	4.75
3Q13	4.6	3.1	1750	5.25
4Q13	4.8	3.2	1810	5.25

Source: DANE, Superfinanciera, BanRep, and BBVA Research

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.

This report has been produced by the Colombia Unit:

Chief Economist for Colombia
Juana Téllez
juana.tellez@bbva.com

María Paola Figueroa
mariapaola.figueroa@bbva.com

Mauricio Hernández
mauricio.hernandez@bbva.com

Maria Claudia Llanes
maria.llanes@bbva.com

Julio César Suárez
julio.suarezl@bbva.com

Interns:

Juan Felipe Duarte
juanfelipe.duarte@bbva.com

Mariajosé Argote

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Alejandro Puente
apuente@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo.lopez@bbva.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macroeconomic Analysis Mexico
Julián Cubero (i)
juan.cubero@bbva.bancomer.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spian
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@grupobbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Global Areas:

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Global Equity
Ana Munera
ana.munera@grupobbva.com

Global Credit
Javier Serna
javier.serna@bbvauk.com

Global Interest Rates, FX and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Contact details:

BBVA Research Colombia
Carrera 9 No 72-21 Piso 10
Bogotá, Colombia
Tel: 3471600 ext 11448
E-mail: bbvaresearch_colombia@bbva.com