BBVA

Colombia Watch

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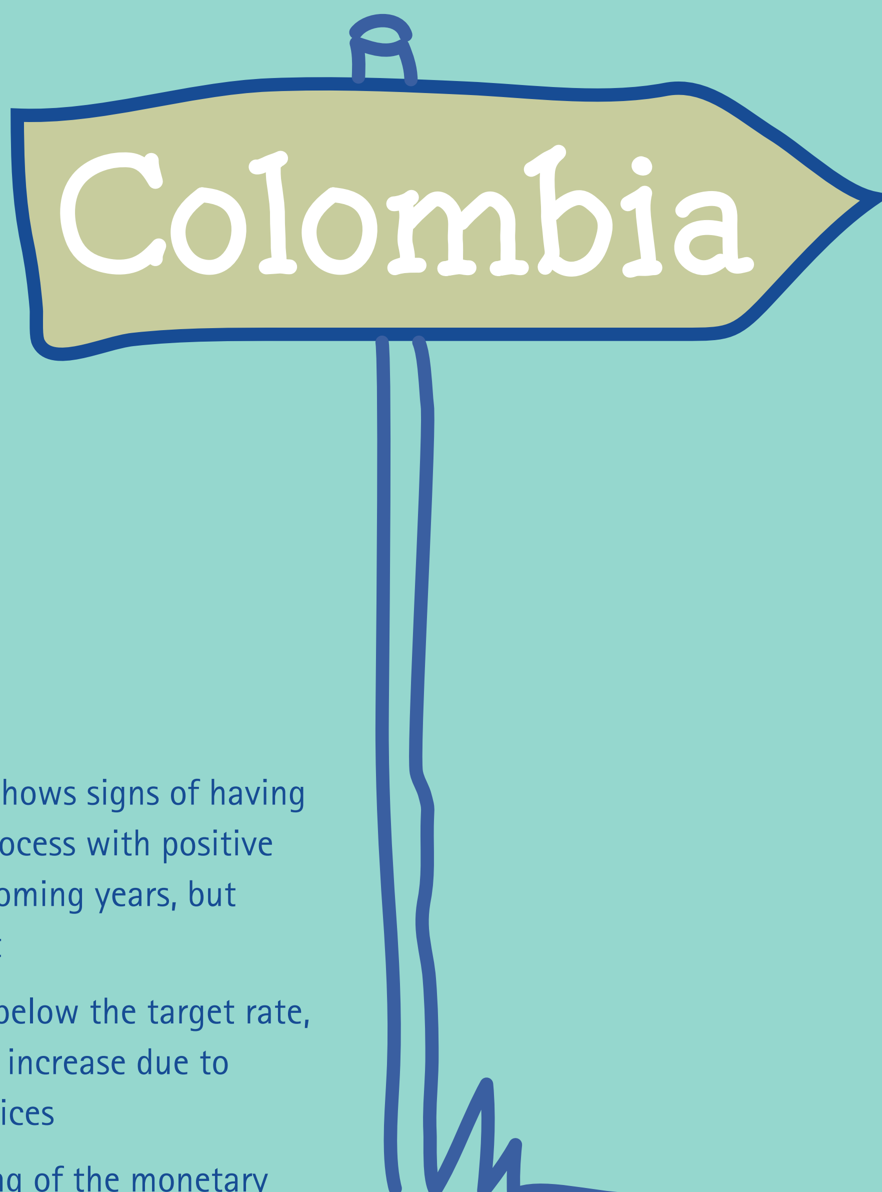
Second Semester 2009



- The Colombian economy shows signs of having started a slow recovery process with positive growth rates during the coming years, but below its potential output
- Inflation will finish 2009 below the target rate, and in 2010 we expect an increase due to higher food and energy prices
- 2010 will see the beginning of the monetary policy normalization process

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Second semester 2009

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Executive Summary

In the second half of 2009 the world economy has begun to give clearer signs of recovery. As stability gradually returns to the financial markets, economic activity is stabilizing in the main developed economies. However, the fundamentals remain weak, and discussion over the coming quarters will be focused on the exit strategy from the current monetary and fiscal stimulus measures.

The Colombian economy has suffered the effects of reduced domestic and external demand, although the increased execution of public works has partly cushioned the fall in economic activity. It would seem that the worst of the crisis has passed, so the economy should grow slightly above zero in 2009. The forecast trend for 2010 involves a slow process of recovery in economic activity, with positive growth but still below potential output.

Inflation continued its sustained fall, reaching its lowest level in 45 years. Lower food prices, stable fuel prices, the appreciation of the currency and the weakness of domestic demand, all explain the major reduction in inflation over 2009. In this context, the Banco de la República (BanRep) has defined its inflation target for 2010 at between 2% and 4%, consistent with the long-term objective. Inflation is expected to end 2009 at under 3%, and in 2010 it should be close to Banco de la República´s upper target limit as a result of the impact of the El Niño phenomenon on food prices.

Access to domestic and external financing has facilitated continued expansion of fiscal policy, despite the drop in tax revenues. The fiscal accounts and increased budget deficit expected for the coming year will be items to watch in the following months.

The good inflation figures, strength of the Colombian peso, weakness of domestic demand and trade restrictions with neighboring countries, all led BanRep to extend its expansive policy during the second half of 2009. It is expected that low rates will be maintained in 2010, with a normalization of monetary policy in the second half of the year.

Despite the slowdown in loan portfolio growth and the mild downturn in quality indicators, the financial system continues to be in good shape. The capital markets have performed positively in the second half of the year, with rises in fixed-income and equity markets.

In short, the Colombian economy has resisted the external shock well. This reflects the built in strengths resulting from the process of economic reforms begun in the 1990s. The institutions and instruments that were set up then and have been implemented subsequently have enabled the country to face up the process of domestic slowdown and external shock, which has been one of the biggest in recent times. This suggests a structural change is taking place in the risk perceptions of Colombia and other countries in the region, thus improving opportunities for attracting capital and new business to the country.

The International Background

Global economic prospects improve…

Since the middle of the year the world economy has been giving clearer signs of recovery. The sensation of free fall prevalent at the end of 2008 and the start of this year has given way to relative stability and, in some cases, moderate growth.

The change in the trend has been favored by the exceptional stimulus measures adopted in most economies. The measures are both monetary (substantial reductions in the intervention rates, massive injections of liquidity and unconventional operations with assets) and fiscal (fiscal stimuli that have boosted sectors such as the automobile industry and have helped temporarily sustain the income and spending of private agents).

… although latent risks of a downturn in the short term continue, above all in the most advanced economies

Nevertheless, the fundamentals of the world economy continue to be fragile and the risks of a downturn therefore persist in the short term. The main risk is a possible premature withdrawal of the stimulus packages, above all in the most advanced economies, and uncertainty over whether private-sector spending can replace public spending as the main driving force of recovery. In developed countries, growth during the expansive phase was boosted by domestic demand, supported by the increase in disposable income and also very high private debt. This will not recur in this new phase of the cycle. The labor market figures will also not contribute to a swift emergence from the crisis, since the rate of job destruction continues to be very high in many economies.

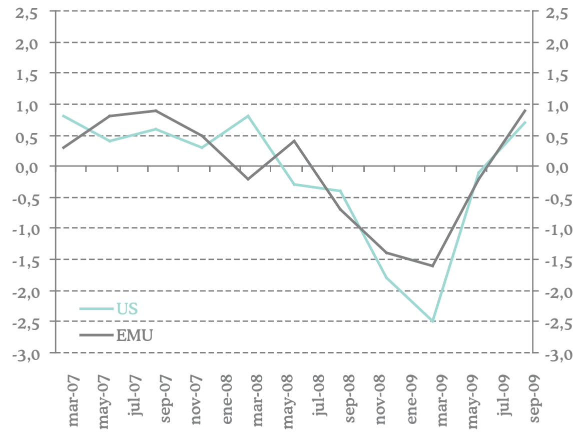
For all these reasons, the biggest challenge now facing economic policy makers is to organize a timely and well-planned withdrawal of the public, fiscal and monetary support programs.

In this situation, the most probable scenario would point to a maintenance of low official rates for an extended period, as it does not appear likely that there will be a significant upturn in inflation, given the high productive capacity available. However, maintenance of the stimuli over time could also have detrimental consequences, since they distort the incentives to take decisions on adjusting balance sheets and question the sustainability of the public accounts in many economies.

It therefore appears probable that central banks will gradually try out possible alternatives to bring their liquidity policies back to normal when the time comes. The evidence from recent weeks shows the importance of communication on the part of the monetary authorities during this phase. They have to separate what is said about the design of the exit strategies from the moment of their application, which should be delayed until the economy gives signs of self-sustained recovery.

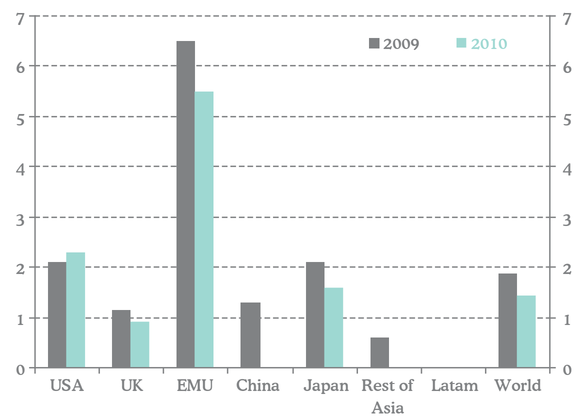
Although the financial tensions have steadily reduced from the maximum levels after the Lehman collapse, the current situation is far from being fully satisfactory. In fact, the levels of tension in the markets

U.S. and EMU: GDP growth
(quarterly % change)



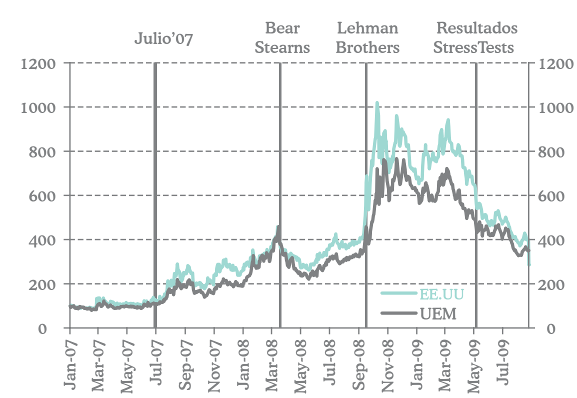
Source: BBVA ERD

Fiscal stimulus packages: Size
(% share of GDP)



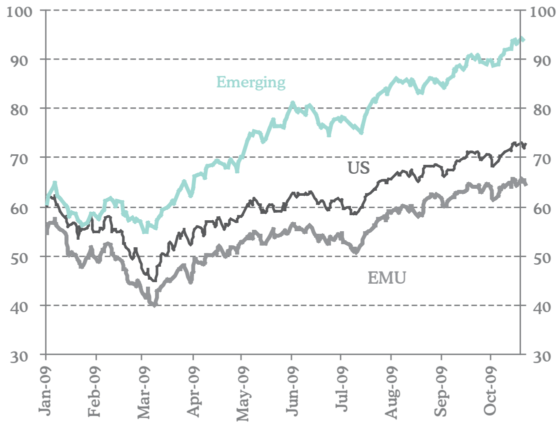
Source: BBVA ERD

Indicator of Financial Tension
(100=January 07)



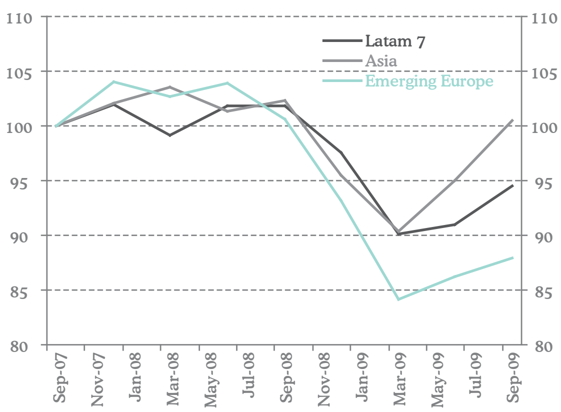
Source: BBVA Research Department
The first standardized principal component of the OIS spread series, implicit U.S. stock market volatility, bank and corporate CDS

Equity markets
(July 2007=100)



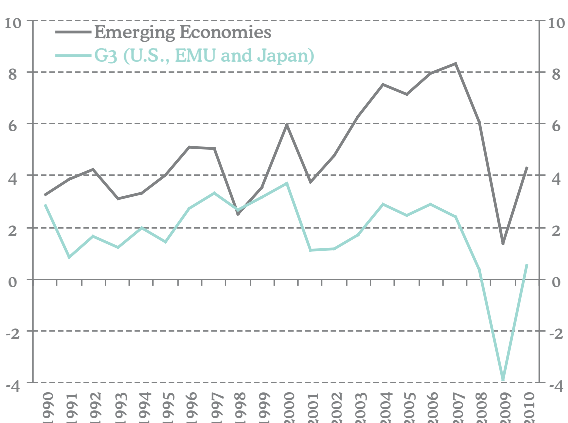
Source: Bloomberg and MSCI

Industrial output
(Index, 2007:3= 100)



Source: Bloomberg

Emerging economies and G3: GDP growth
(year-on-year change)



Source: BBVA ERD

are still a long way from pre-crisis levels. The biggest progress so far has been in the interbank markets. The reduction in risk premiums has also been extraordinarily swift over recent months.

Emerging economies, the new motor of global growth...

Economic recovery is very uneven. In general terms, emerging economies are on a more solid path to recovery than developed ones. This can be explained by a number of factors that set these economies apart and have made it easier for most of them (with the exception of Emerging Europe countries) to cope with more expensive funding markets and the contraction in economic activity and employment. Specifically, these factors include the following: their lower exposure to the financial crisis, above all in its initial stage; the success of the fiscal and monetary stimulus packages implemented after the start of the crisis; the growth in commodity prices in recent months; the modest recovery in world trade after its collapse at the end of 2008; and, perhaps most importantly for stable long-term growth, the earlier efforts made in many of the countries to promote and practice a policy of macroeconomic stability.

Among developed economies, the U.S. appears to be in a better position than Europe. In particular, the fiscal stimulus in the U.S. will have a relatively greater impact on growth over the coming years. In 2010 it is expected to have an impact of 3 percentage points (pp), compared with 1.5 pp in Europe. The most probable scenario for the U.S. economy is moderate growth, as there is no certainty that once the public stimulus ends, the private sector will recover its high level of sustained growth. In addition, questions such as unemployment or the public accounts are still sources of obvious concern.

In Europe, the fiscal stimulus will be comparatively lower in 2010, and vary among the different countries. The recovery in economic activity will also be delayed by the greater rigidity in the European labor market.

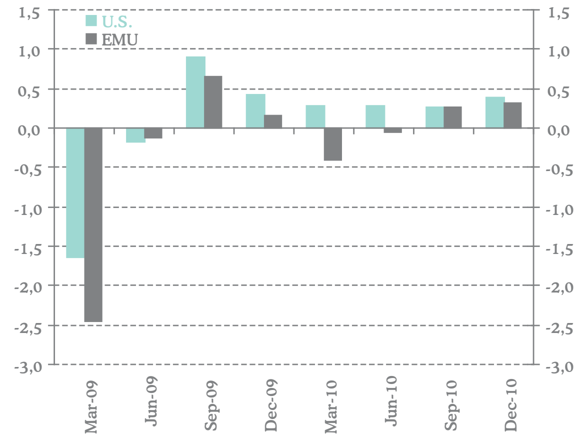
The signs of recovery in activity are already clear in emerging countries, although with some notable variations. China, for example, has already returned to high growth rates, partly as a result of an extremely rapid increase in credit and other stimulus measures. In Latin America, most countries are already showing signs of positive growth in the third quarter. However, there is more risk in the situation of Emerging Europe economies, which are weaker in macroeconomic and financial terms.

Commodity prices recover in this more positive context

Strong demand, above all from China, and the prospects of a recovery in developed countries in 2010, have greatly boosted commodities, which began to recover together with the equity markets. In recent months, the fall in risk aversion and the weakness of the dollar have attracted financial investment to these markets and supported a recovery in prices. This has eased the pressure on public funding felt in some emerging economies at the start of the year, and given additional support to the appreciation of the currencies of countries that are rich in natural resources.

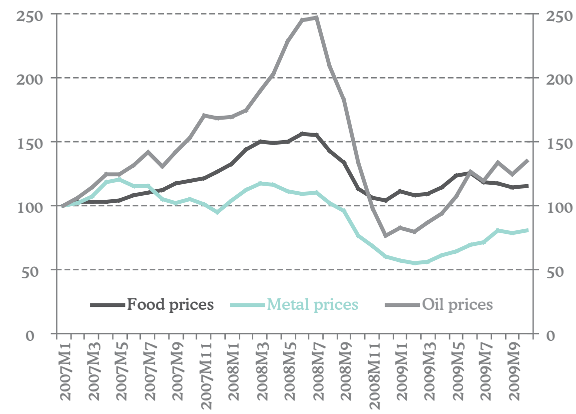
The price prospects for 2010 will depend on synchronizing the recovery of industrial production in developed countries with the normalization of demand from China. As we expect that Chinese demand will return to normal before the recovery in industrial production, we estimate that the fundamentals point to a moderate correction in commodity prices in the coming months, followed by new rises as the recovery in global demand begins to manifest the restrictions on extending supply capacity in the coming years.

U.S. and EMU: GDP growth
(quarterly % change)



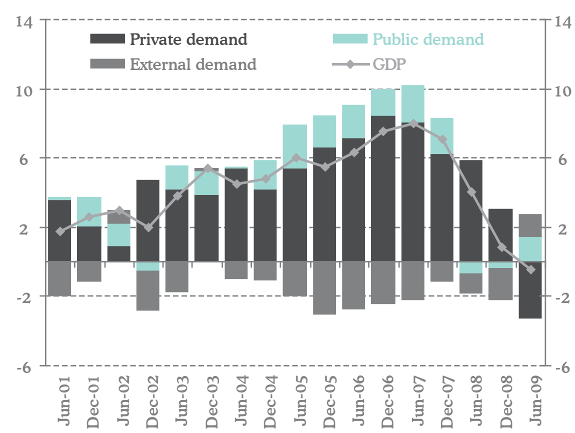
Source: BBVA ERD

Commodity prices
(January 2007=100)



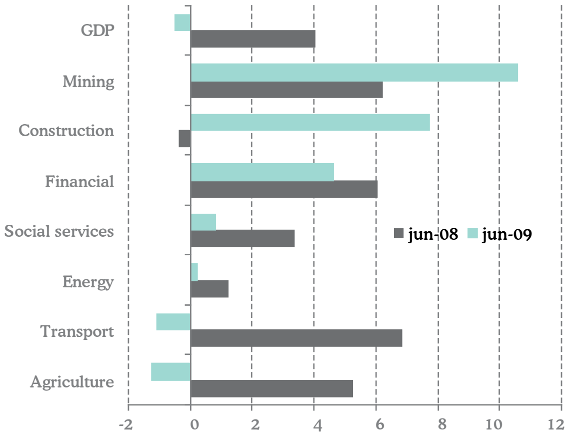
Source: IMF BBVA ERD

Contribution to economic growth
(Half-yearly data, year-on-year % change)



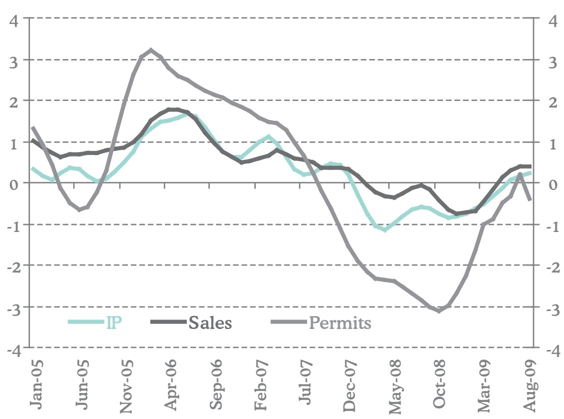
Source: DANE and BBVA ERD calculations BBVA ERD

GDP by branch of economic activity
(half-yearly data, year-on-year % change)



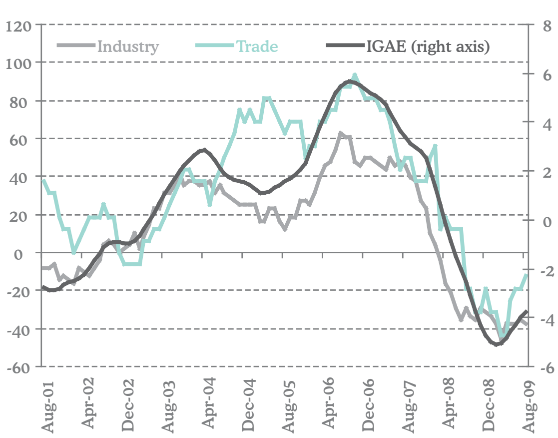
Source: DANE BBVA ERD

Industrial production, retail sales and construction permits
(Seasonally-adjusted series, m/m %)



Source: DANE and BBVA ERD BBVA ERD

Sectoral balance sheet and economic activity index



Fuente: SEE BBVA SEE BBVA

Macroeconomic environment

The impact of the external crisis on private-sector demand was partially compensated by investment in public works in the first half of the year

The external crisis led to a major reduction in global demand and in prices of the main commodities. This caused a dent in the confidence of business and consumers, which was manifested through reduced domestic demand, particularly in private-sector investment, and the negative performance of retail sales and industrial output.

In addition, exports of manufacturing goods to Venezuela fell as a result of the low oil price and a reduced rate of economic activity there. This led to an even greater fall in industrial sales.

GDP fell 0.5% in the first half of the year. Private consumption and investment registered greater falls than GDP between January and June. Consumers delayed their spending due to uncertainty about the labor market. Businesses decided to postpone their investment projects given the high level of economic uncertainty, lower industrial orders and an accumulation of housing stock in the construction sector.

However, access to external and domestic finance allowed real growth in the level of government spending, accompanied by a greater efficiency in the execution of public works, despite the reduction in tax revenues. Between January and June civil engineering works grew by 25.2% y/y, mainly due to the increased progress on port works, construction for mining and roads.

At the same time, the current low inflation outlook has allowed the Banco de la República to change its monetary posture. So far this year it has moved from a restrictive policy, whose basic aim was to control the inflationary outbreaks of previous years, to one that aims to stimulate economic growth and ease the financial burden on households.

Finally, net external demand made a positive contribution to growth in the first half of 2009. The reduction in exports was compensated by the fall in imports, which corresponded to the major adjustment in private-sector demand. During this period the mining and hydrocarbons sector experienced a major improvement in productivity, increased the volume of exports and raised its contribution to GDP, slowing down the fall in the commodities prices.

The worst of the crisis is over and in 2009 the GDP will register slightly positive growth

In the third quarter the results of economic activity still show negative variations in year-on-year terms in industrial production, retail sales and construction permits. However, retail trade and industry have begun a process of inventory reduction, so a future reactivation of demand would mean a relatively rapid upturn in retail sales, industrial orders and imports. Lower interest rates and the incentives for new house purchases introduced by the government in April have also reduced home turnover times and led to a recovery in the granted permits in recent months. Given the characteristic way that construction activity lags behind permits, a recovery in investment in building construction can be expected starting at the end of 2009.

At the same time, the different surveys of confidence point to an upturn in expectations of agents starting in July. If this turnaround in the trend, which points to the start of a recovery, is maintained, there is a possibility of a year-on-year positive variation in the fourth quarter. This would sustain the hypothesis of slight positive growth for 2009 as a whole, despite the expectation of a renewed fall in GDP for 3Q09.

However, there are still some risks for activity in the second semester that could postpone the process of economic recovery. First, the economy is facing new restrictions on trade with Venezuela, in line with those anticipated. These are leading to a steeper fall in industrial commodity exports. At the same time, although civil works are the main source of growth, with positive contributions to GDP over the coming quarters, no year-on-year changes similar to those registered to June can be expected.

For 2009 we expect a slightly positive growth (0.1% y/y), with a contraction in the third quarter similar to that observed between January and June, and with a growth close to 2.0% y/y in the last quarter. This forecast includes stabilization in the progress of civil works, lower industrial exports and an additional adjustment in investment, corresponding to reduced imports. This forecast is also backed by the recent performance of the indicators of economic activity. Both the BBVA Indicator of Activity (IGAE) and the BBVA Sectoral Balance Sheet for industry and commerce show that the process of recovery began at the end of the first half of the year.

The economy will move slowly towards its potential growth over the coming years

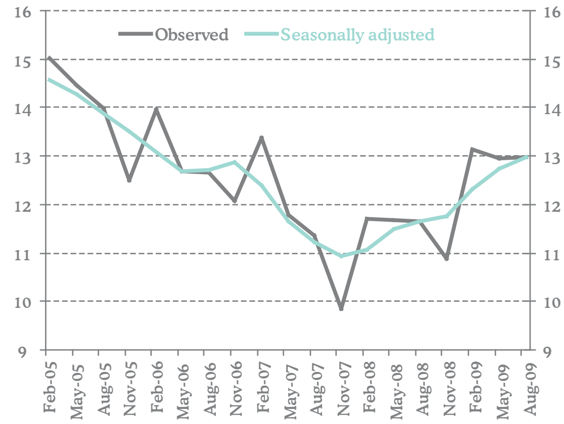
The Colombian economy will take time to recover its growth potential. It is limited by the international scenario, as developed countries are taking time in recovering their growth paths. The consolidation of new markets for industrial exports will take time and determine the weakness of manufacturing activity over the coming months. Thus real exports will only begin to grow in 2011.

At the same time, growth in the unemployment rate and the deterioration in employment quality will limit the recovery of private consumption. The greater number of employed people registered by the official statistical office DANE during the year was based on the creation of unsalaried jobs. This has a negative effect in household disposable income. Thus until 2010 consumption will post positive, though low, rates of growth once the interest rates of the Banco de la República are passed on to the market and the financial burden of households is reduced further.

Private investment will complete its adjustment in 2009 and begin a new upward cycle towards the end of 2010, when we expect increased growth in construction and stabilization in industry, thus allowing improvement in spending on housing investment and on machinery and capital goods. However, a return to the levels of investment registered in the first half of 2008 will only be achieved towards the end of 2011.

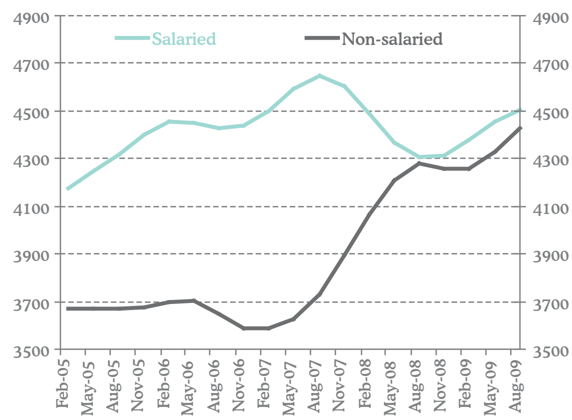
Investment in civil works will remain at high levels for the three coming years thanks to the continuing projects in mass public transport and energy and transport infrastructure. However, there will not be room for

Urban unemployment rate
(Rolling quarter, %)



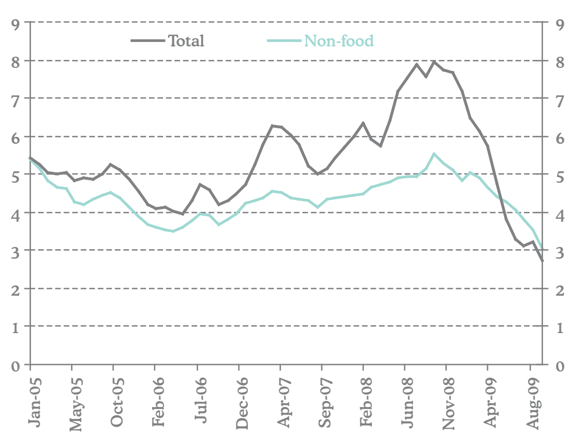
Source: DANE BBVA ERD

Salaried and non-salaried employment
(In thousands, seasonally-adjusted)



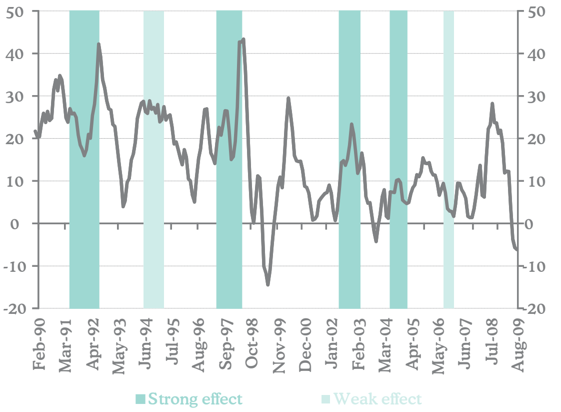
Fuente: DANE BBVA ERD

Inflation



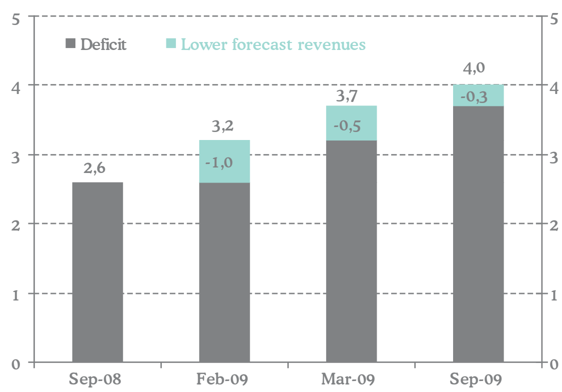
Source: Banco de la República BBVA ERD

Food inflation and the El Niño phenomenon
(%)



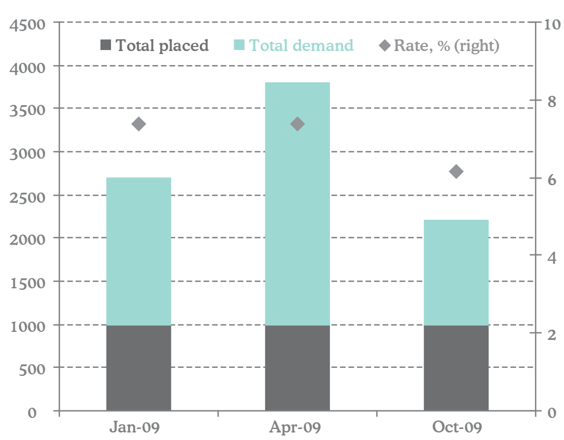
Source: DANE and BBVA ERD BBVA ERD

Central government financial plan 2009
(% of GDP)



* Revenues fell in 2009 by 1.0% of GDP, but this was compensated by a postponed spending of 0.5% of GDP.
Source: Ministry of Finance BBVA ERD

Government bond issues
(millions of dollars)



Source: Ministry of Finance BBVA ERD

civil works to contribute significant year-on-year growth from 2010.

To sum up, we expect a slow recovery in the economy over the coming years, with growth rates in 2010 and 2011 under potential (2.4% and 3.5% respectively), and a return to the long-term trend at the end of 2012 (4.5% y/y).

Throughout the year inflation fell more than expected

In 2009 inflation slowed sharply to its lowest level in 45 years. This is mainly due to the fall in domestic demand, the improved performance of food prices and stability in prices of regulated goods. The favorable climatic conditions early in the year pushed prices of perishable goods down, while trade restrictions with Venezuela increased the local supply of meat products. The central government's policy on fuel prices, that did not allow all the reduction in international crude oil prices to be passed on, has maintained them stable despite their recent upturn.

The indicators of core inflation have registered significant reductions in the second half of the year, although smaller than that for total inflation. This fall can in part be explained by a reduction of inflation in non-tradable goods and increased pressure on inflation of tradable goods as a result of the appreciation of the peso.

The expected and observed performance of inflation so far this year suggests that inflation will be under the lower limit of the target range at the end of 2009.

Inflation for 2010 higher than in 2009

The Banco de la República set the target range for inflation at between 2% and 4%, equivalent to its long-term target. The inflation target set is demanding and aims to take advantage of the favorable price environment in 2009 to anchor inflationary expectations at around the long-term level. The favorable climatic factors in 2009 will not be repeated in 2010, and the confirmation of the climatic effect known as the El Niño phenomenon is a major source of uncertainty that could put upward pressure on food prices. In addition, the increase in international oil prices and low fiscal flexibility mean that gasoline prices are sure to increase and lead rising inflation in regulated goods in 2010.

However, the slow recovery expected in the economy will maintain the output gap in 2010, thus lowering the inflationary pressures of demand. In addition to the above, the expected performance of the exchange rate does not suggest there will be significant upward pressure in the prices of tradable goods.

The main risk factor for inflation forecasts is the intensity of the El Niño phenomenon and its impact on food prices.

Improved access to external finance has allowed the government to undertake a slightly expansive policy

Last September the government increased its fiscal deficit forecast for 2009 to 4.0% of GDP from the previous 3.7%. This decision assumed lower economic growth, a reduction in tax revenues and the maintenance of the same levels of spending planned since January 2009. However, it is likely that given the additional reduction in external tax revenues the deficit may be slightly higher at the end of the year. Revenues as a percentage of GDP will stabilize at similar levels to 2008 (15.7%), and spending will increase around 1.7% of GDP, particularly due to increased transfers to regions and to pensions. At the same time, although total investment fell marginally, it was focused on three specific sectors: infrastructure, social support and stimuli to the productive sector.

In addition, central government's inability to carry out the privatizations planned for 2009 increased its financing needs and led to its seeking new funds of COP 4,4 trillions to compensate for the greater expected deficit and the lower entry of funds through privatizations. As a result, the target for domestic securities issues increased and the final cash position in pesos fell.

According to calculations by BBVA ERD, the budget deficit of the central government will increase in 2010 to 4.5% of GDP, with a reduction of 1.6% of GDP in current revenues compared with 2009. Spending will fall by 1.0% of GDP thanks to the elimination of the subsidy on fuels and the reduction on funds spent on the "democratic security" program. Despite this, the government expects to maintain the level of investment as a percentage of GDP.

The fiscal deficit forecasts suggest greater financing needs for the government

If these results are realized, the government will have new financing needs that are not included in the current issue targets. If it is to maintain the current spending level without modifications, the final cash position in pesos for 2009 will probably be reduced again (by about COP 1 trillion), the issuance targets will increase in 2010 (by at least COP 2 trillion) and swap transactions will be used to extend the debt maturities of shorter-term securities. Despite this, domestic and external liquidity conditions will allow greater government demand for funds.

In order to consolidate the fiscal accounts and anticipate one of the major uncertainties in the Colombian economy over the coming years, the government has made a preliminary announcement that it will begin to design a fiscal policy rule.

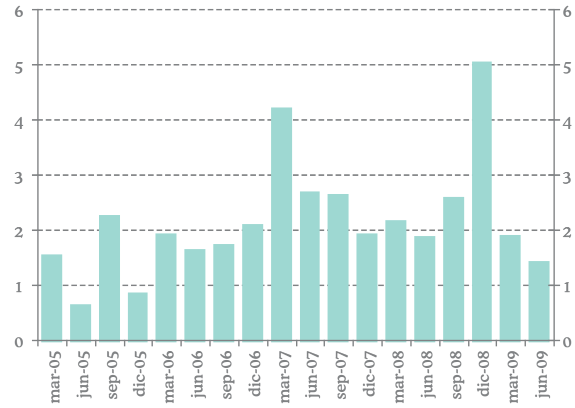
The adjustment in domestic demand has been reflected in a lower current account deficit

In the first half of the year the current account deficit was 1.6% of GDP, below the figure registered a year earlier (2.0% GDP). This adjustment can be explained by a less negative balance in factor income, as a result of slower domestic economic activity and its effect on the results of foreign companies.

The performance of exports provided a positive surprise up to June, particularly as a result of sales of primary goods to Venezuela and the major growth in volumes of exported oil. Imports were affected by reduced consumption of durable goods, the fall in industrial production and a reduction in private investment. All these items showed considerable falls, in line with forecasts.

The financing of the economy continued to be based on long-term flows. Foreign direct investment fell by 9.1% y/y, but established itself

Current-account deficit
(% of GDP)



Source: Banco de la República BBVA ERD

Balance of payments
(% of GDP)

	2007	2008	1H09
Current account	-2,8	-2,8	-1,6
Goods balance sheet	-0,3	0,4	1
Exports	14,1	15,2	14,5
Imports	14,5	14,9	13,7
Special operations	0,1	0,1	0,2
Services	-1,3	-1,3	-1
Factor income	-3,8	-4,2	-3,9
Current transfers	2,5	2,3	2,2
Financial account	5	3,9	1,8
Long term	5,5	4,1	3,9
FDI	4,4	4,4	4,6
Short term	-0,5	-0,2	-2,1
Gross international reserves	10,1	9,9	10,7

Source: Banco de la República BBVA ERD

FOB exports
(Composition and destination, year-on-year change)

	2007	2008	2009*
Traditional	20,3	40,8	-22,6
Oil	15,6	66,9	-33,5
Other	25,7	13,1	-4,2
Non-traditional	25,5	11,6	-13,4
Venezuela	93,1	14,3	-17,9
Ecuador	3	16,5	-17,4
United States	-4,7	10,7	-6
European Union	28,6	12,1	-20,8
Other	12,5	8	-10,8
Total	23	25,5	-18,5

* This year to September
Source: DANE BBVA ERD

as the second biggest capital inflow in historical terms, only below that of the first half of 2008. Corporate issues abroad by Colombian companies were also successful. Thus unlike previous crises, the country guaranteed external savings, allowing it to continue financing its excess spending. Lower private flows were more than compensated by capital inflows to the public sector, even though there was some pressure on the appreciation of the peso.

A slowdown in the fall in exports and a stabilization in the level of imports is expected in the second half of the year

Available data anticipate a moderate increase in the current account deficit in the second half of the year. Remittances from workers have decreased further in recent months, and exports of primary and intermediate goods to Venezuela stagnated in the third quarter and were no longer a support for non-traditional sales.
For 2009, the current account deficit is expected to be at 2.4% of GDP, as the second half of the year will see a deficit of around 3.0%, implying greater external financing needs in the capital account. However, the improved performance of foreign investment and easy access by private companies and the government to the capital markets will allow the foreign imbalance to be funded easily. The current account deficit is expected to be under 2.0% in 2010, with an additional reduction in dividends sent abroad, improved trade terms and a weak recovery in imports.

Rates year/year %	9-Mar	9-Jun	Sep 09*	Dec 09*	Mar 10*	Jun 10*	Sep 10*	Dec 10*	2008	2009*	2010*
Final consumption	-0,3	-0,3	-0,6	-0,2	1,1	1,8	2,2	1,7	2,3	-0,4	1,7
Private consumption	-0,5	-0,7	-0,7	-0,7	0,5	1,9	2,4	1,8	2,5	-0,7	1,6
Public spending	0,3	0,9	0,0	1,6	3,3	1,4	1,4	1,4	1,3	0,7	1,9
Gross investment	-3,7	-7,3	-11,3	-4,2	0,7	2,7	7,9	11,3	7,7	-6,7	5,6
Domestic demand	-1,1	-2,1	-3,3	-1,2	1,0	2,0	3,5	3,9	3,6	-1,9	2,6
Exports	2,0	-5,7	-6,3	-11,0	-12,0	-4,0	-1,9	-1,9	6,9	-5,3	-5,1
Imports	-1,5	-9,7	-14,3	-17,3	-10,9	-2,5	2,0	6,1	9,8	-10,8	-1,6
GDP	-0,4	-0,5	-0,6	1,9	2,0	2,1	3,0	2,4	2,4	0,1	2,4

* BBVA ERD forecast
Source: DANE and BBVA ERD

SEE BBVA

Monetary and Exchange Rate Policy

The Banco de la República surprised the market with additional cuts in the policy rate in the second half of the year

The good performance of inflation, weakness of domestic demand, the impact of trade restrictions in neighboring countries and the appreciation of the peso were the combined reasons behind the additional interest rate cuts by BanRep in the second half of 2009. The BanRep´s Board decided to extend the expansive monetary policy stance by cutting policy rates in its July, September and November meetings. It also announced measures to increase liquidity on a permanent basis through the purchase of up to COP 3 trillion in Colombian Treasury securities (TES) and dollars during the remainder of 2009.

The cuts in the Banco de la República policy rate continued to be passed through on quicker and greater proportion than on previous occasions. Interest rates in the second half of the year showed additional falls that were greater than those in interest rates for the public debt securities and new deposits. The biggest fall was in interest rates for consumer credit and the "usury rate" interest limit. The forecast is that the process of passing on the rates will be complete in the first half of 2010.

The Banco de la República will maintain interest rates low throughout 2010

Monetary policy for 2010 will be defined in accordance with the inflation target set by BanRep and the slow recovery expected in economic activity. BanRep is expected to start a process of normalizing monetary policy in the second half of 2010 in order to anchor inflationary expectations in 2011 and 2012, but maintain them low.

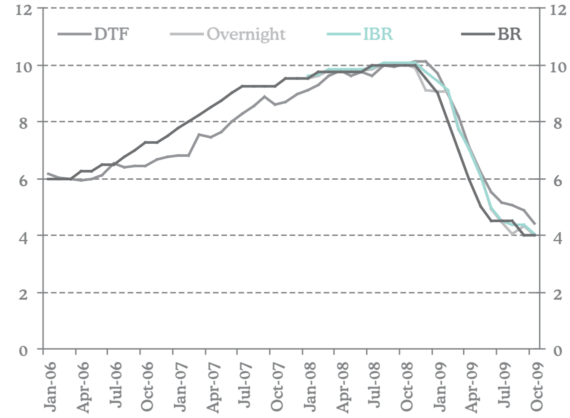
As commented above, the balance of risks puts an upward bias on the inflation forecast for 2010, and in this scenario BanRep may speed up the process of normalizing monetary policy.

There is uncertainty about what the official position of the Central Bank will be in 2010 with respect to the exchange rate. BBVA ERD considers that there is a chance that the Central Bank will be an active player and accumulate reserves if pressure on the appreciation of the peso continues. In this situation the Bank would once more be presented with the dilemma of whether to concentrate exclusively on its main objective of price control or try to ease the strength of the Colombian peso.

The Colombian peso has appreciated strongly over recent months due to a combination of external and idiosyncratic factors

The devaluation process of the first half of 2009 was turned around in the second half of the year as a result of a general weakness of the dollar at a global level. In the case of Colombia, this new trend has been amplified by the constant monetization by the National Treasury and some public and private companies. External conditions have led investors to seek investment destinations with a high return, thus

Market rates
(anual, %)



Source: Banco de la República BBVA ERD

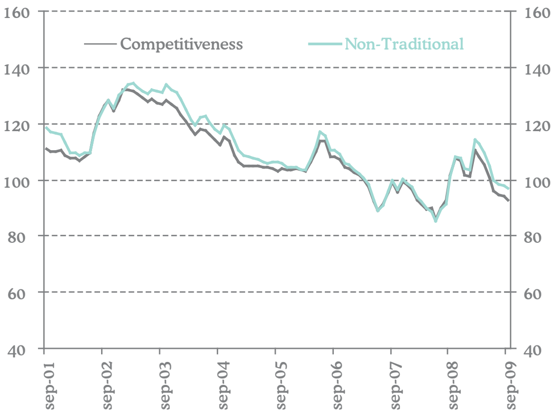
Exchange Rate
(Peso-Dollar)

Source: Banco de la República BBVA ERD

EMBI

Source: JP Morgan BBVA ERD

Real exchange rate index
(Deflated by CPI, 1994 base)



Source: Banco de la República BBVA ERD

weakening the U.S. currency. The major reduction in risk premiums and the strong performance of equity markets in emerging countries show that these kinds of economies have been one of the preferred destinations for investors. This has led to a general appreciation in their currencies.

For 2010 we expect a very slight appreciation of the Colombian peso that will continue in the medium term, given the chance of greater weakening of the dollar at a global level, a higher than expected increase in international commodity prices, increased investment flows to emerging economies and greater financing needs for the government, which will oblige it once more to tap international markets.

Financial sector

Falling economic activity has been reflected in weaker demand in all types of lending. Equally, favorable liquidity conditions and interest rates have boosted issuance of corporate bonds, which have acted as a substitute for commercial lending.

The equity market has posted major rises due to the recovery in commodity prices and improved results of companies at a local level. The fixed-income market also continues to rise, boosted by low inflation rates and additional cuts in the interest rates by the Banco de la República.

The credit portfolio will reactivate slowly in line with economic activity

The slowdown in the credit portfolio in the second half of the year has sharpened, although it is still within expectations, as a result of the deleveraging process of the economy throughout the year. As confirmed by the Banco de la República's Credit Survey, the main determinants of lending activity so far this year continue to be lower household and corporate demand for loans and stricter requirements by financial institutions in granting new loans. The greater rate of corporate issuance has also meant that some companies are restructuring their liabilities and reducing their exposure to bank loans. In addition, disbursements in the consumer loan portfolio showed stability so far this year and an average of 20% growth in the commercial portfolio. This can be explained by much shorter corporate financing terms and lower demand for loans by households.

Falling interest rates could reactivate the demand for loans

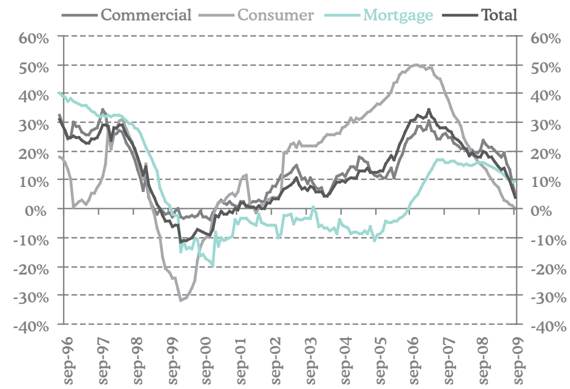
Given the macroeconomic outlook, it is likely that lending activity will begin a slow process of reactivation in the initial quarters of 2010. Similarly, the growth in the financial burden of households slowed in the first half of 2009, and with lower interest rates this trend is expected to extend into 2010.

Growth in the non performing loans portfolio slows

Despite the fact that the traditional quality indicator remains high, it is important to highlighting the slowdown in the growth of the delinquent portfolio. The non performing loans consumer portfolio, nearly half of the total delinquent portfolio, began 2009 with year-on-year growth of close to 40%. The September data revealed year-on-year growth of below 10%. The trend is similar, although less marked, for other types of lending.

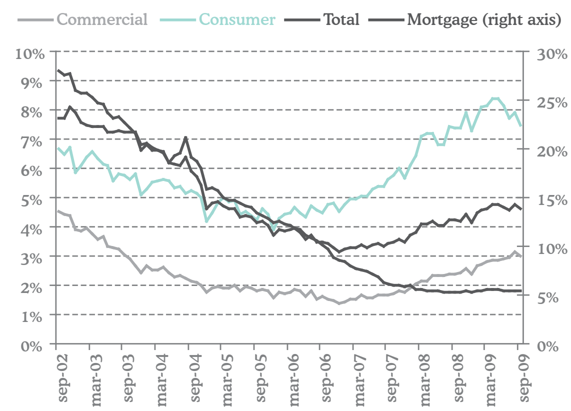
Provisions remain high and the traditional coverage indicator is above 100%. The highest coverage indicator rate is in the commercial portfolio, followed by the consumer portfolio, where in the first three months of the year provisions increased by 13% and 11% respectively. Since June 2007 Colombia has been implementing a system of countercyclical provisions (See Box 1), which obliges the system to accumulate extra provisions during a period of greatest credit expansion and thus reduce the impact on the balance sheets when the portfolio quality deteriorates.

Total loan portfolio
(year-on-year growth)



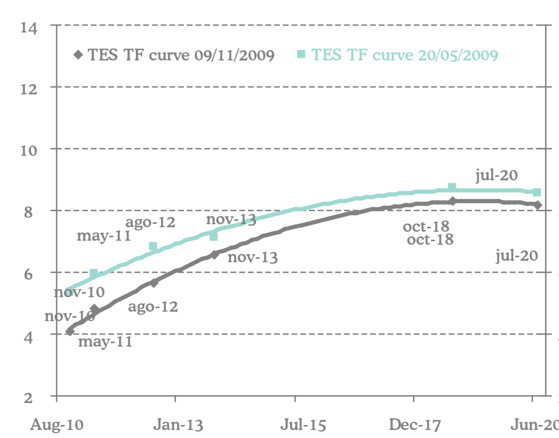
Source: Superfinanciera BBVA ERD

Non performing loans
(percentage of total)



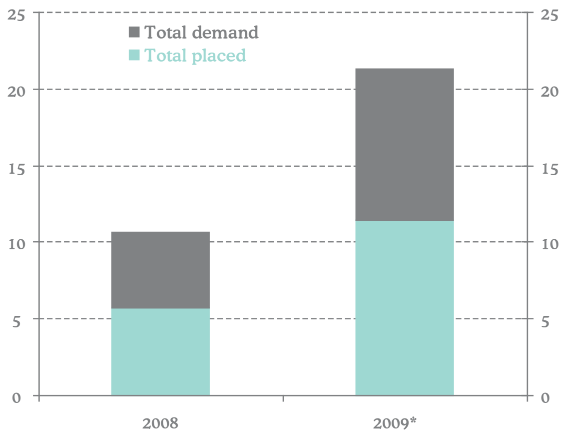
Source: Superfinanciera BBVA ERD

Yield curve fixed-income TES
(anual interest rate)



Source: Bloomberg, Banco de la República BBVA ERD

Issuance of domestic corporate bonds
(Trillions of pesos)



Source: BVC * YTD. BBVA ERD

The local capital market presents favorable results

The public fixed-income market continued to perform well in the second half of the year, and although the reduction in the interest rates of debt securities has slowed, there were additional price rises favoring short and medium-term securities above the long-term. In addition to the above, the favorable liquidity conditions in the economy have been used by companies with access to capital markets to find finance through the issuance of bonds.

The Colombian equity market has posted returns of close to 50% in the first 10 months of the year, and corporate results have supported this rise. In 2010 structural changes are expected in the regulations that could have a positive impact on the equity market. The first of these changes is related to the possibility that international corporations may be allowed to be listed on the local market. The second change is the project under review for a possible integration between the stock markets of Peru, Chile and Colombia. The third is the implementation of a multifund scheme for the pension portfolios. This has been approved in the financial reform program.

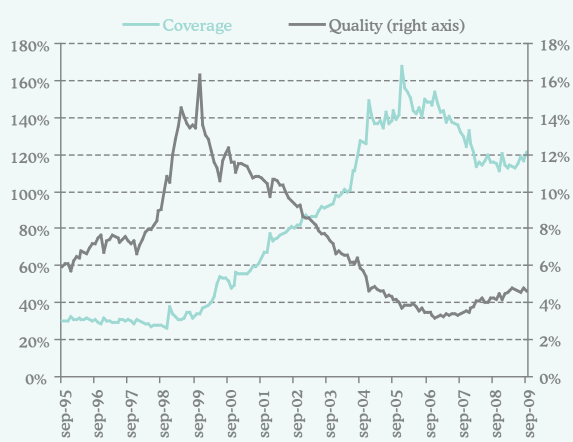
A new scheme for accumulating provisions

Manuel Rey Ayala

At the end of the 1990s Colombia lived through a situation that was similar to those in developed countries in recent years: a strong recession amplified by weakness in the financial sector. As a result of this crisis, the country made a significant change in the regulations governing the financial system with the aim of preventing a repeat of this scenario. The change aimed to make the financial sector sounder and reduce its procyclical character through the adoption of risk models.

Starting in June 2007 the credit institutions began to implement credit risk models known as SARC (system for administering credit risk). Initially SARC was implemented for the corporate portfolio, and then in June 2008 for the consumer portfolio. These two types of credit represent nearly 90% of the total portfolio of credit institutions. The model proposed by the regulator and adopted by the financial institutions modified the form in which the entities accumulate provisions to cover credit risk. SARC includes a countercyclical component in accumulating provisions to ensure that greater reserves were established in economic and credit booms to compensate the provisions that will have to be made once an economic slowdown occurs and credit quality deteriorates.

Portfolio indicators in Colombia



Source: Superfinanciera BBVA ERD

The model of provision accumulation set up is clear about the way in which provisions are accumulated. Under this scheme, not only is the possibility of non-performance under current economic conditions taken into account (the cyclical component), but also the possibility of losses as a result of a change in the economic cycle (countercyclical component).

However, there is great uncertainty regarding the form in which these provisions are disaccumulated. Because of this, and due to the change in the economic cycle, the Financial Superintendency changed the system for accumulating provisions by External Circular 035 of 2009. This will have to be implemented by April 2010 at the latest.

The main difference between the proposed new scheme and the previous one is that the determination of the phase is presented specifically for each financial institution and not in an aggregate form for the system as a whole. Under this new scheme individual financial factors in each credit institution are taken into account to determine whether it is in a phase of accumulation or disaccumulation. Specifically, four indicators are used that measure deterioration in credit quality, efficiency in the recovery of the delinquent portfolio, financial stability and portfolio growth.

The new mechanism presents a number of advantages over that currently in use, as it makes it easier to identify at which phase of the cycle each bank is. Thus it is not necessary to wait for the regulator to declare the change in the cycle based on the behavior of aggregate variables, which would send a signal of a general weakness in the financial sector.

According to Carvajal and Chaparro (2009), the new scheme uses the concept of countercyclicality in a stronger way than the current one. This means that in the accumulating phase, provisions will increase more than under the previous model, while in the disaccumulation phase total provisions will grow at a lower rate than in the current system.

Colombia made significant advances in the regulation of the financial system by the adoption of credit risk models and specifically with the implementation of the countercyclical provision system. External Circular 035 of 2009 presents a further advance in the correct direction to maintain the soundness of the financial system and guarantee its stability at times of deteriorating credit quality.

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Infrastructure and economic growth: the role of public works

Mauricio Hernández Monsalve

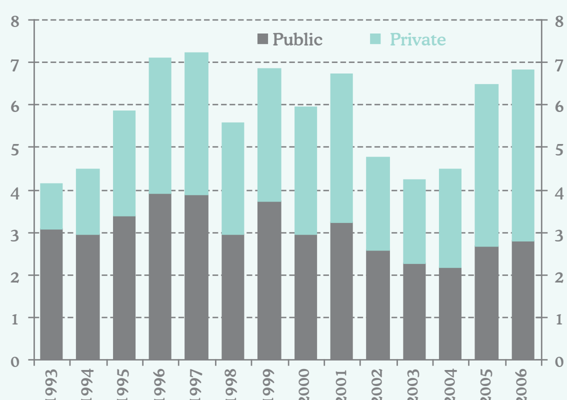
Endogenous growth models have given a special position to the role of infrastructure as a mechanism for achieving improved levels of income and closing the development gap between countries. The argument of these theories is based on the fact that greater total capital assets will generate positive externalities for other productive activities and allow for growth in the aggregate level of productivity.

In particular, this type of externality has been modeled using a production function that includes a variable for public goods (for example, infrastructure works) funded by the government through tax revenues. The results indicate that in the long term the per capita GDP grows at the same rate as per capita public spending, thanks to the effect that public investment has on the growth of total capital. In other words, government policy plays a key role in achieving greater potential growth rates by improving the levels of productivity in the country.

In this respect, Straub (2008) studies the empirical results of 64 recent papers that have investigated the connection between growth and infrastructure. Some dispersion in the results of the studies was noted, but in general they show that public investment in public works show more significant improvements in terms of growth and productivity in developing countries. In developed countries there are greater expulsion effects on private sector activity that partially counteract the positive effects of public investment.

Infrastructure investment in Colombia

(% of GDP)



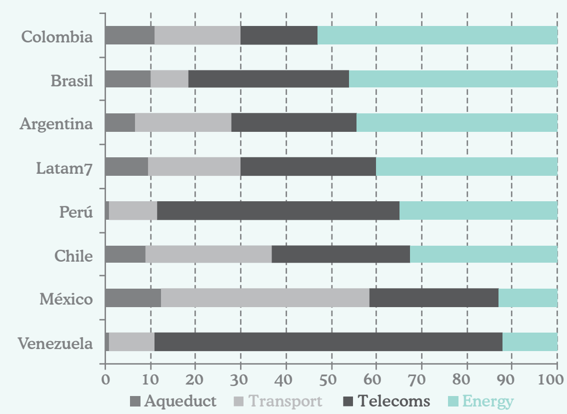
Source: DNP, BBVA ERD calculations BBVA ERD

In line with this trend of research, in Colombia Sánchez (1993) demonstrated that public investment has not been neutral. Initially, a permanent increase in public investment generates an expulsion effect on private investment, but in the long term private investment will begin to increase. Equally, if the investment is in core infrastructure (roads, aqueducts, energy, among others), there is no initial expulsion effect.

Perdomo (2005) also evaluated the impact of transport infrastructure on growth in the country. He determined that if public investment was increased permanently by 1% of GDP, in 100 years real GDP would be 120% higher than without this measure.

However, the assessment made by the World Bank (2004) on the current state of infrastructure in Colombia concluded that there lags behind its peers significantly in the question of roads, communications and energy. It also pointed out that the strategic position of Colombia as a link between Central and South America, represents an unrivaled opportunity to make progress in roads and ports towards regional integration. Thus with the aim of promoting greater economic growth, the report recommends focusing public investment on national access roads, making more efficient use of regional and local resources, reactivating private funding and revising the regulations that have a direct impact on competitiveness.

Investment in infrastructure (% of total)



Source: World Bank (2004) BBVA ERD

This debate has been intensified recently in the country, and focused on two basic points: first, the entry of private pension funds into the financing of major infrastructure works needed by the country as a form of linking private capital to challenges at a national level; and second, the aim of greater economic openness signaled by the signing of a number of free-trade treaties requires a fully interconnected national road, port and airport system, with the ports and airports also being structurally reformed to improve their performance.

In the case of pension funds, the current regulations have to be improved in terms of legal guarantees on private investments and financially viable projects have to be structured to link pension funds through the securities market. With regard to improving the transport system, the internal agenda has been able to progress towards establishing concessions for ports and airports and progress has also been made in improving some roads of a local nature. But there is still a clear delay in terms of surfacing and dual carriageways of national importance. This limits the country's international competitiveness.

Main road infrastructure works in Colombia

		Public contribution (COP trillions 2008)	Estimated term	Kms.
Transversal de las Américas highway	Caribbean coast	1,9	3 años	646
	Urabá - Córdoba	4,3	6 años	1.151
Bogota – Villavicencio freeway		1,8	8 años	45
Mountain freeway		2,0	10 años	900
Ruta del sol highway		3,4	14 años	1.071
Cordillera Central crossing		0,7	6 años	47

Source: DNP and INCO SEE BBVA

In response, the government has currently moved forward three road infrastructure projects with a 10-year horizon. These will be partly financed using the country's current resources, and if there is not sufficient fiscal room, with the sale of 10% of ECOPETROL. The works in question are the cross-continent Traversal de las Américas highway, the dual carriageway between Bogota and Villavicencio and the Mountain freeway system. Studies are also being completed on defining the Ruta del Sol project, and work on the tunnel for the road has already been moved forward.

The Ruta del Sol will link the center of the country with the ports on the Caribbean, through which 60% of foreign cargo is transported. The cross-continental highway will interconnect the ports located on the north coast and, in turn, these ports to the Colombian borders with Panama and Venezuela. The tunnel will reduce transport time to the port of Buenaventura, through which nearly 40% of exports are moved. Finally, the mountain freeway system and the Villavicencio road will communicate Antioquia and Los Llanos with these port routes and complete the road connections with the main industrial zones in the country.

The impact on economic growth of these works has to be measured from two perspectives: first, that upon completion they will reduce logistical costs for foreign trade operations and represent an easing of the cost structure for companies; and second, that the investment levels that their execution involve will stimulate economic growth during this period. Nevertheless, the final impact on growth will fundamentally depend on public and private investment volumes, which will form a part of these initiatives.

The following analysis can be used to measure this. The government has proposed maintaining the ratio between investment (not including the "democratic security" anti-terrorist program and fuel subsidies) and the GDP constant over coming years. This would involve an equivalent increase in GDP in the resources allocated to infrastructure in the national budget. This objective already takes into account the previous projects that have been considered strategic by the National Planning Department and partially executed by regional and local governments. Thus spending on infrastructure should grow at an average of 3.75% over the following ten years. This is equal to the average economic growth for the period (according to BBVA ERD GPD forecasts).

The government's commitment in the long term is to maintain high investment levels so that these positive anticipated effects for current projects will not revert over time. This will allow the country to achieve sustained growth in potential GDP and close the gap in physical infrastructure with other economies in the region of a similar or slightly higher level of development.

This is the direction that will be taken by public investment policy if the fiscal rule currently proposed by the government is implemented. The windfalls from booms in commodity prices will be the sources of funds for continuing with infrastructure works, even at times of lower tax revenues, and will also serve as a countercyclical strategy at times of lower economic growth.

Finally, as the World Bank warns, the country should also begin to simplify the regulatory framework that oversees the use of public funds on priority infrastructure works. At the same time, means should be introduced so that the government and private initiative can formulate investment plans swiftly and effectively at times when the economy needs it most. Regulations should also allow the use of the growing volume of pension fund resources in the country to finance future works.

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Statistics and forecasts

Colombia

Economic Research Department		2007	2008	2009	2010
ACTIVITY					
Real GDP (y/y %)		7,5	2,4	0,1	2,4
Consumption		6,9	2,3	-0,4	1,7
Private consumption		7,6	2,5	-0,7	1,6
Public spending		4,5	1,3	0,7	1,9
Gross Capital Formation		13,7	7,7	-6,7	5,6
Domestic demand (contribution to growth)		9,2	3,9	-2,1	2,8
Exports		11,4	6,9	-5,3	-5,1
Imports		13,9	9,8	-10,8	-1,6
External demand (contribution to growth)		-1,7	-1,5	2,2	-0,5
LABOR MARKET					
Employment*	% y/y	6,2	1,4	0,9	2,9
Unemployment rate (% active population)		9,8	10,7	13,0	14,0
EXTERNAL SECTOR					
Current account balance	% GDP	-2,8	-2,8	-2,4	-1,6
Primary fiscal balance	% GDP	1,0	0,9	-0,7	-1,2
PRICES					
CPI, %	Average	5,5	7,0	4,3	4,1
CPI, %	(EoP)	5,7	7,7	2,4	3,8
EXCHANGE RATE					
Exchange rate (against USD), average)	Average	2078,35	1966,26	2143,5	2034,4
Exchange rate (against USD, end of period)	(EoP)	2014,76	2243,59	2020,3	2070,1
INTEREST RATES					
Official rate (REPO)	Average	8,9	9,8	5,3	3,7
Official rate (REPO)	(EoP)	9,5	9,5	3,5	4,25
DTF	Average	8,0	9,7	6,2	3,9
DTF	(EoP)	9,0	10,1	4,1	4,2

BBVA Economic Research Department

* Urban: 13 cities

The International Context

Commodities (end of period)							
	2008	2009	2010		2008	2009	2010
Brent (USD/barrel)	45,6	60,6	68,3	Soy (USD/t.)	343	368	339
Copper (USD/t.)	3070	5732	3969	Maize (USD/t.)	144	130	136
				Wheat (USD/t.)	216	168	160

	Real GDP (%)				Inflation (end of year, %)*			
	2007	2008	2009	2010	2007	2008	2009	2010
U.S.	2,1	0,4	-2,5	1,5	2,9	3,8	-0,7	1,1
EMU	2,7	0,6	-3,8	0,2	2,1	3,3	0,3	0,8
Japan	2,3	-0,7	-5,3	1,1	0,5	1	-1,5	-0,3
China	13	9	8,3	9,3	4,8	5,9	-1,1	1,2
Latin America								
Argentina	8,7	5,7	-2,5	2,6	8,5	7,2	7,5	10
Brazil	5,7	5,1	0	4,7	4,5	5,9	4,2	4,6
Chile	4,7	3,2	-1,2	4,1	7,8	7,1	-0,7	2,5
Colombia	7,5	2,4	0,1	2,4	5,7	7,7	2,4	3,8
Mexico	3,3	1,4	-7,2	3,1	3,8	6,5	4	5,2
Peru	8,9	9,8	1,1	4,3	3,9	6,7	0,6	2,1
Venezuela	8,4	4,9	-2,1	-0,5	18,7	31,3	29,3	35,1
LATAM [1]	5,7	4	-2,6	3,5	5,8	8,1	5,6	7,1
LATAM excluding Mexico	6,7	4,9	-0,6	3,6	6,7	8,6	6	7,7

* U.S. and EMU inflation: average for the period

	Public Sector Balance (% of GDP)				Current Account Balance (% of GDP)			
	2007	2008	2009	2010	2007	2008	2009	2010
U.S.	-1,2	-3,2	-9,9	-9,5	-5,2	-4,9	-2,6	-2
EMU	-0,6	-2	-6,6	-7,2	0,1	-1,1	-0,8	-0,3
Japan	-0,4	-0,5	-0,9	-1	-4,9	3,2	2,1	2,1
China	0,7	-0,4	-3,8	-4,4	11	9,8	5,3	4,7
Latin America								
Argentina [2]	1,1	1,4	-2	-0,4	2,9	2,2	2,8	2,5
Brazil	-2,8	-2	-3,5	-2,6	0,1	-1,8	-1	-2,2
Chile [2]	9,9	4,9	-3,9	-1,9	4,4	-2	2,7	1,9
Colombia	-2,7	-2,3	-4,2	-4,5	-2,8	-2,8	-2,4	-1,6
Mexico	-1,1	-2,1	-3	-3,7	-0,8	-1,4	-1	-1,5
Peru	3,1	2,1	-1,8	-1,1	1,1	-3,3	-1,3	-2
Venezuela [2]	4,5	-0,2	-4,6	-6,3	9	13,1	1,4	2,5
LATAM [1]	-0,6	-1,1	-3,3	-3	0,8	-0,4	-0,4	-1
LATAM excluding Mexico	-0,1	-0,5	-3,4	-2,7	1,4	-0,1	-0,1	-0,6

[1] Average of the 7 countries listed; [2] Central Government

	Exchange rate (against $, end of period)				Official Interest Rate (end of period %)			
	2007	2008	2009	2010	2007	2008	2009	2010
U.S.					4,3	0,5	0,1	0,1
EMU ($/€)	1,5	1,3	1,4	1,3	4	2,5	1	1
Japan (yen/$)	113	96,1	98	100,9				
China (CNY/$)	7,6	7	6,8	6,8	7,47	5,31	5,31	6,12
Latin America								
Argentina	3,1	3,4	3,9	4,3	13,52	19,08	13,5	14,03
Brazil	1,8	2,3	1,7	1,62	11,25	13,75	8,75	10,25
Chile	499	649	560	564	6	8,25	0,5	3
Colombia	2015	2244	2020	2070	9,5	9,5	3,5	4,25
Mexico	10,9	13	13,2	12,7	7,5	8,25	4,5	4,5
Peru	2,98	3,11	2,9	2,95	5	6,5	1,25	2
Venezuela	2,2	2,2	2,2	2,2	11,4	16,2	15,2	13,8

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