

## CAPITAL MARKET DYNAMICS

**Foreign Exchange** ► The primary factors shaping the value of the Colombian peso (COP) remain the following: 1) crude oil prices, 2) the degree of global risk aversion towards emerging markets, and 3) the prospects of monetary policy normalization in the USA with the ensuing impact on the value of the USD vis-à-vis its major peer currencies. Of utmost relevance, the COP remains strongly influenced by the direction of energy prices; indeed, the sharp increase in the benchmark WTI price (up 25% since mid-November) was a supporting factor for the COP in the recent past months.

**Sovereign Debt & Credit Ratings** ► There has been a sharp increase in global risk appetite (with an ensuing boost into high-yielding assets) in the wake of the presidential elections in the USA. In this regard, Colombia was a net beneficiary of the escalating volatility affecting Mexican debt assets. As per the US Federal (Fed) Reserve, market pricing implies a benign increase in the administered monetary policy rate in the months to come, alleviating potential fears of disruptive contagion waves in the hemisphere. With the exception of Standard and Poor's, which maintains a "negative" outlook on its "BBB" credit rating for Colombia, the rest of international agencies view the country's ratings in "stable" outlook territory. Progress on the fiscal front will be a key determinant of future ratings revisions.

## ECONOMIC OUTLOOK

**Growth** ► The Colombian economy is still performing below its potential. The ongoing correction of the twin (fiscal and current account) deficits is being accompanied by a slower pace of economic activity. Following an expansion of 1.6% y/y, real GDP increased by just 2% in 2016. Looking ahead, a similar rate of economic growth is projected for this year. The necessary fiscal adjustment under way is at the core of the reduction in economic activity with lower contribution from government spending. Weak employment conditions (jobless rate at 11.7% in Jan-2017) have also eroded consumer confidence during this period of macroeconomic adjustment. Long-term private-sector investment plans may also be delayed ahead of the elections in 2018.

**Inflation & Monetary Context** ► The central bank has adopted a pro-growth monetary stance. A clear disinflation process has been in place since August 2016, with the rate of consumer price inflation reaching 5.2% y/y in February, down from 9% y/y in July 2016. Lower currency market volatility in the context of recovering terms of trade and food price adjustments reinforced this phase of price stabilization over the past few months. The central bank, which maintains its 3% ± 1% inflation target, reacted in an orthodox manner by adopting a gradual monetary easing bias at a time when economic activity shows persistent evidence of deceleration. The central bank reference rate has been reduced by 50 basis points (bps) to 7.25% over the past three months.

**Fiscal & Current Account Balance** ► The structural fiscal adjustment remains a key macroeconomic priority. The Colombian economy is making firm advancements in tackling the structural rigidities which led the general government deficit to increase from 2.3% to 4.0% of GDP over the past three years. The combined effect of depleted oil-linked revenue (from 3.3% of GDP to virtually nil) and rising debt service costs (2.9% of GDP) triggered a swift tax reform which received congressional approval at the end of 2016. Looking ahead, this structural reform aims at increasing non-oil revenue by 1.4% of GDP and reducing government expenditures by 0.8% of GDP over the next five years. Meanwhile, the external adjustment continues to be facilitated by economic deceleration and terms of trade gains which reduced the current account deficit to near 4.5% of GDP.

## INSTITUTIONAL FRAMEWORK & POLITICAL ENVIRONMENT

**Governance** ► The electoral cycle will be the dominant issue shaping the political context in the next 12 months. Congressional elections, scheduled for March 2018, will be followed by presidential elections two months later. Colombia remains a strategic economic partner and military ally of the USA. As such, the administration of President Santos will keep the diplomatic support of the Trump administration through direct and indirect (IMF assistance) means. As per regional integration with peer economies, the four-member Pacific Alliance initiative will help Colombia implement a trade diversification strategy in the hemisphere. At times, trade, migration and security issues connected with the escalating Venezuelan crisis might provoke situations of bilateral friction.

**Financial Sector** ► The banking sector remains well capitalized and rigorously supervised. Domestic credit activity remains tied to the economic and business cycles. In this regard, mortgage financing is expanding at 15% y/y rate over the past few months. Meanwhile, the Colombian government remains strictly dedicated to broadening the local-currency bond market, providing an alternative source of financing for the local corporate sector and portfolio investment opportunities for foreign investors.

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