The Experience on the business and knowledge of the environment we operate in guide our strategic vision.

During 2012, the Colombian banking system had good growth dynamics confirming its soundness

Economic activity in Central America was stable in most economies

Chapter 2

Economy and Banking system in Colombia and Central America

2. Economic Framework

International Context

After a good year start for global economic activity, the second half of 2012 experienced moderate growth to the extent that concerns on the fiscal situation of the Euro Zone remained, the problem of the automatic tax and expenses adjustments (fiscal cliff) of US Government emerged and the international trade stagnated.

The International Monetary Fund estimates that in 2012 the world economy grew 3.2% below the immediately previous year (3.9%). It forecasts a 3.5% growth for 2013, with upgrades of 1.4% and 5.5% for developed and emerging economies, respectively.

World economic growth became moderate as a result of uncertainty in developed countries and lower trade dynamics

Despite the climate shock that temporarily affected food prices at the global level, commodities as a whole ended 2012 with a 3.4% drop, which favored the good behavior of world inflation. With an approximate variation of 3.5%, the 2012 inflation was recorded as one of the lowest in the past few years. According to the IMF, inflation in 2013 would be similar to that of 2012.

With this balance, the world's central banks kept a broad monetary policy. In the United States, the Federal Reserve extended and expanded its monetary stimulus, while in the Euro Zone, the European Central Bank firmly committed to buy sovereign bonds of the countries that accomplish fiscal agreements. These decisions not only provided support to the economic activity but also calmed markets and eased the above-mentioned concerns.

In emerging economies the cutback of interest rates continued and, at the end of the year, somewhat more that two thirds of the countries in this group had rates below those valid a year before. Interest rate increases are foreseen for 2013 in some emerging economies, while developed countries will continue to follow a lenient monetary policy.

Colombia

With a less favorable international context, Colombian economy experienced considerable slow down in the second half of 2012. The most recent information indicates that in the third quarter, the Gross Domestic Product (GDP) had a 2.1% annual growth and it is likely that for the full year the economy has grown around 3.6%. Mining and financial sectors led growth with enhancements close or above 5.0%, while in a second group, transportation, power and social services had an approximate growth of 4.0%. Agriculture continued to experience low growth, but both industry and construction were the sectors that faced the greatest challenges. Industry tackled demand problems, while construction suffered institutional issues and lower execution driven by the Government. Banco de Bogotá forecasts a growth slightly below 4.0%.

Slowdown of Colombian economy focused on construction and industry

Given the lower growth, improvements in the labor market were moderated and jobs creation dropped. In the second half of 2012, unseasoned urban unemployment averaged 11.0%, the same level it had a year before and slightly below the figure during the first semester of the year (11.3%).

As far as prices, inflation surprised at a low and averaged 2.4%, the second lowest level since 1955 after 2009 (2.0%). The drop in inflation was attributed to the reduction in the price of primary foodstuffs and low inflations in regulated tradable goods. By groups, only education and health experienced annual variations above the target range of Banco de la República (Colombian Central Bank) (2.0% -4.0%), while housing and food were within the range and the remaining groups under it.

Basic inflation measurements had a favorable behavior as well, confirming the absence of price pressures, at the same time that inflation expectations remained controlled. Inflation without foodstuffs was 2.4%.

In February 2013, the CPI (Consumer Price Index) showed an annual increase of 1.8% and year to date this index showed a variation of 0.74%.

For 2013, Banco de Bogotá expects an inflation in the lower part of the target range, probably 2.7%.

In the second half of 2012, Banco de la República adopted an expansionary monetary policy taking the intervention rate from 5.25% to 4.25%, after four cut backs of 25 basis points (pbs). The change in the monetary cycle was caused by the convergence of deceleration in economic activity and low inflation. Despite the change towards an expansionist monetary policy, the current broad liquidity in the economy encouraged Banco de la República to implement the monetary control TES, with which it withdrew $2 trillion and plans to continue to withdraw the current liquidity surplus.

In the months elapsed during 2013, Banco de la República has reduced twice its intervention rate to 3.75%. For the week of March 4 to 10, DTF was 4.78%.

In the second half of the year, the exchange rate stabilized averaging $1,804, slightly above the average of the first semester ($1,794). This trend partly resulted from a reduction in dollar flows[1], particularly from Direct Foreign Investment and special operations of the government sector, including those of Ecopetrol (the stated-owned oil company). In the first case, the flows of the first and second semester were US$9,329 million and US$7,355 million, while in the second case they reached US$7,513 million and US$5,496 million, respectively.

The average exchange rate in February 2013 was $1,791 and devaluated 1.2% per month.

Furthermore, Banco de la República increased exchange intervention with purchases amounting to US$2,884 million compared to US$1,960 million in the first semester. Likewise, the National Government intervened repeatedly in the exchange market in a verbal and discretionary manner, buying US$307 million for budget purposes and US$820 million for the Savings and Stabilization Fund (FAE).

[1] Information based on the Exchange Balance at the closing of 2012. The Balance of Payments information is not available to date.

Economic Environment in Central America

The regional inflationary pace had at the end of 2012 an increasing trend due to volatility in international commodity prices. At the end of 2012, inflation averaged 4.23%. Nicaragua was the country with the highest price increase (6.6%), while El Salvador experienced the lowest variation (0.8%).

Since the end of 2011 and during 2012, the pace of economic activity, measured by Monthly Index on Economic Activity (IMAE cycle trend), slowed down in most countries, mainly in Costa Rica, Honduras and Nicaragua. However, in November 2012, economic activity showed certain stability in most of the economies, with the exception of Panama which experienced a relative reduction in its growth pace.

The exchange rate in the various countries was stable during 2012. Both Costa Rica and Guatemala have kept international reserves levels above US$6.6 billion which enables them to use resources in case they have to defend the exchange rate as they are countries with more flexible exchange regimes.

Fiscal deficit continues to be one of the biggest concerns in the region. Forecasts for 2012 estimate a deterioration in the deficit of Costa Rica (-4.5%), El Salvador (-2.5%), Nicaragua (-0.4%) and Panama (-3.9%). These figures evidence that fiscal reforms are urgent and public spending should be contained.

The regional economic growth continues to be threatened by external factors. However, there was considerable recovery during the third quarter of 2012, mainly because of export increases, investment reactivation and private consumption (SECM-CA, 2012). Real growth forecast range for 2012 increased from 3.0-3.4% to 3.1-3.4%.

The main current and forecast macroeconomic indicators for December 2012 are shown below:

	Real GDP (annual variation)		Current Account/GDP		Central Government Operational Balance[1] / GDP	
	2011	2012*	2011	2012	2011	2012
Costa Rica	4.2	4.8	-5.3	-5.4*	-4.1	-4.5*
El Salvador	1.5	1.3	-5.3	-2.9*	-2.2	-2.5*
Guatemala	3.9	2.9-3.3	-3.1	-3.3	-2.8	-2.1*
Honduras	3.6	3.0-4.0	-8.6	-8.8*	-4.6	-3.7
Nicaragua	5.1	4.0	-14.0	-16.7*	0.5	-0.4
Panama**	10.6	8.5	-12.6	-12.6	-3.6	-3.9

*Revised forecasts. 1/ Donations Included
Source: SECMCA (January 2013).
**CEFSA (October 2012)

Indicators December 2012	Guatemala	El Salvador	Honduras	Nicaragua	Costa Rica	Panama
Reserves (US$Bn)	6,694	3,141	2,571	1,692	6,857	N/A
Inflation (Annual Var.)	3.45%	0.78%	5.39%	6.60%	4.55%	4.63%
Exchange Rate (Annual Var.)	1.17%	N/A	4.78%	4.57%	-0.65%	N/A
IMAE (Nov-12)	3.83%	1.85%	4.22%	4.57%	3.00%	8.55%

Source: Central Banks and Statistics Bureaus

Colombian Banking System

Figures confirm the soundness of the Colombian Banking System

During 2012, the Colombian Banking System experienced a good growth dynamic, which enabled it to maintain an increasing trend in assets and profits. Particularly, the assets of the system ended at $337.6 trillion (14.1% annual growth) while profits ended at $6.6 trillion (13.0% annual growth).

Net Loans experienced a significant annual growth of 15.6%, in commercial and consumption segments the growth was 13.5% and 17.6%, respectively. Such growth was attained through an adequate risk management: the loan quality was 2.8% and the non performing loan coverage was 162.5%. On the other hand, total investments were $63.2 trillion, with an annual growth of 12.0%.

Furthermore, deposits increased 18.0% and added up $223.6 trillion, being Term Deposits the most dynamic with a 31.5% growth.

Equity ended 2012 at $47 trillion, $7.5 trillion more than the previous year.

The good dynamics of the sector allowed Net Profits to go up to $6.6 trillion in December, 13.0% more than the previous year with regard to financial indicators, in December, average ROA was 2.1% and ROE was 15.1%. In general, while profitability indictors show a slight moderation, the Profits and Equity level confirm the system's soundness.

Market Share of Banco de Bogotá in the Colombian Banking System

Up to December 2012, the Bank's operation in Colombia increased its market share in Assets, Net Loans, Deposits and Net Profits.

Market Share						
2011		2012				Variation
Dec		Mar	Jun	Sep	Dec	Annual Absolute
14,6%	Assets	14,8%	14,9%	15,2%	14,7%	0,1
19,0%	Investments	18,9%	18,3%	19,2%	18,4%	-0,6
9,7%	Debt Securities	10,3%	10,2%	10,9%	10,0%	0,2
60,2%	Equity Securities	59,0%	57,2%	57,8%	54,0%	-6,3
13,4%	**Gross Loans**	**13,5%**	**13,5%**	**13,6%**	**13,5%**	**0,1**
13,6%	Net Loans	13,7%	13,7%	13,8%	13,7%	0,1
17,6%	Commercial Loans	17,9%	17,9%	18,0%	17,8%	0,2
8,9%	Consumer Loans	9,0%	9,0%	9,1%	9,2%	0,3
4,4%	Microcredit Loans	4,3%	4,1%	3,8%	3,8%	-0,5
0,1%	Mortgage Loans	0,1%	0,2%	0,3%	0,6%	0,5
14,8%	**Deposits**	**15,3%**	**15,3%**	**16,0%**	**15,1%**	**0,3**
19,7%	Current Accounts	22,1%	22,0%	23,6%	19,5%	-0,2
13,1%	Saving Accounts	13,2%	13,5%	14,2%	14,7%	1,6
15,9%	Term Deposits	16,4%	15,8%	15,8%	14,4%	-1,5
19,1%	Net Income from Commissions	18,7%	19,3%	19,5%	19,4%	0,2
20,5%	Equity	19,8%	19,5%	19,8%	20,0%	-0,5
19,0%	**Net Profit**	**15,3%**	**18,1%**	**19,2%**	**20,6%**	**1,6**

Source: Financial Superintendency of Colombia

Central American Banking System

Banco de Bogotá beyond borders

BAC Credomatic in the Central American Financial Market

In the last few years, the Central American financial system has strengthened through greater loan placement and a stable funding at low cost. This has helped banks to remain immune to the widespread financial crisis and generate greater profitability levels. As far as Honduras and Nicaragua, this behavior has mitigated their weaknesses on operational levels.

In the years after the world crisis, an increasing trend of further credit in local markets has been observed, especially in terms of consumption and mortgage loans. Loan quality indices reflect such growth along with conservative risk levels where results of the Costa Rican banks stand out.

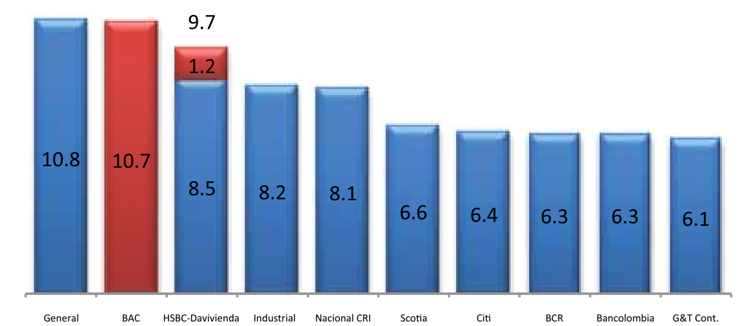
Furthermore, the growth of the system has been coupled by an update of local regulations, seeking more transparent and better guaranty systems for investors. In the past year, the case of Guatemala was relevant as a result of the approval of the Banking and Financial Holdings Law Amendment, which enhanced its management risk.

BAC Credomatic, as one of the main conglomerates of the region strengthened its leadership position in the Central American financial market. ■

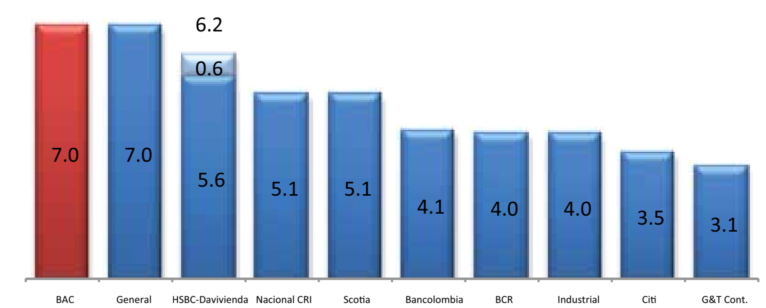
BAC
Credomatic strengthened its leadership position

Regional Market Share in December 2012

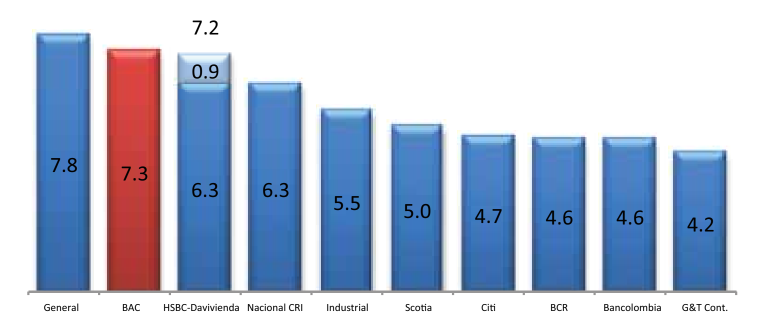
Assets US$Bn



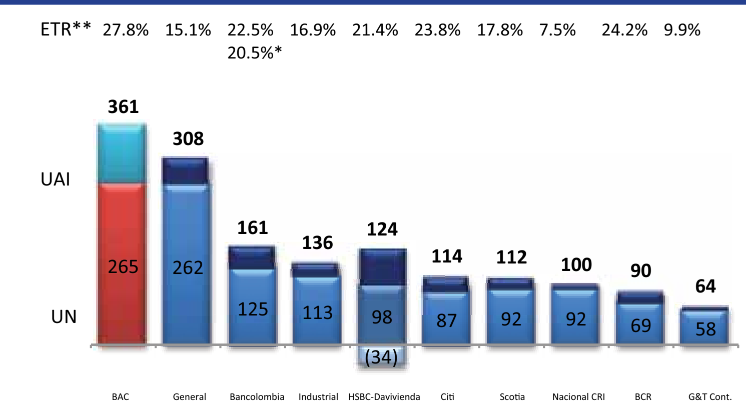
Net Loans US$Bn



Deposits US$Bn



Net Profits and Profit before Taxes US$MM



**Tax rate on profits

* 20.5% corresponds to the tax rate of financial statements 4T12 for Agromercantil. 22.5% corresponds to Banco Agricola's tax rate.