**International Monetary Fund**

Colombia and the IMF

**Press Release**:
IMF Executive Board Completes First Review Under the Stand-By Arrangement for Colombia
October 24, 2005

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# **Colombia:** Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

September 26, 2005

Bogotá, Colombia
September 26, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

So far in 2005, Colombia's economy has continued to perform well, supported by prudent economic policies as well as a favorable external environment. We appreciate the Fund's support through the 18-month Stand-By Arrangement (SBA) approved in April 2005, which is designed to help preserve the credibility of our economic policies during the upcoming political transition and to provide for a smooth exit from formal Fund support. The government will continue to treat the arrangement as precautionary.

We are requesting the completion of the first review under this arrangement. All quantitative performance criteria at end-June 2005 have been observed and all structural benchmarks have been met (Tables 1 and 2). Moreover, we are strengthening our economic policies in 2005 to lock in the better than expected fiscal performance in the first half of this year. The attached Memorandum of Economic Policies (MEP)—which supplements our MEP of April 13, 2005—describes these policies. Most importantly, the government is now targeting a combined public sector deficit of 1.6 percent of GDP in 2005, well below the original program target of 2.5 percent of GDP. For this reason, we are requesting the modification of the quantitative performance criteria for the combined public sector deficit for end-September and end-December 2005. We are also requesting a waiver for the nonobservance of the performance criterion calling for congressional approval of the revised budget code by June 2005. We remain fully committed to introducing the key elements of this reform and have identified corrective measures in the attached MEP. Finally, since the Board is expected to consider this review in October before the full information for end-September becomes available, we are requesting a waiver of the applicability of the quantitative performance criteria for end-September 2005.

Sincerely yours,

/s/
Alberto Carrasquilla
Minister of Finance
and Public Credit

/s/
José Dario Uribe
General Manager
Banco de la República

Attachments

## MEMORANDUM OF ECONOMIC POLICIES

### Achievements

1. So far this year, the economy has continued to perform very well, surpassing expectations in key areas. Real GDP is growing at a pace of 4 percent a year, supported by improving confidence, strong growth in real investment, and robust growth in exports. Inflation through August fell to 4.9 percent year-on-year, with moderate increases in prices of both traded and nontraded goods. Exports have grown by 37 percent through June, supported not only by high world prices for oil and coal but also by a vigorous expansion in nontraditional exports. Imports have also grown rapidly, led by imports of capital and intermediate goods. At the same time there are clear signs that foreign direct investment is picking up significantly in many sectors, especially oil, coal, and telecommunications. SABMiller—one of the world's leading producers of beverages—purchased Bavaria, a Colombian-owned multinational also specializing in beverages.

2. Fiscal consolidation has moved ahead more rapidly. Through June, the combined public sector (CPS) registered a surplus of 0.8 percent of annual GDP, compared with a program target of a deficit of 0.5 percent of GDP in that period. Net savings have accrued from better-than-expected tax collections, additional revenues from high world oil prices, and lower interest payments resulting from the decline in domestic interest rates. Moreover, territorial governments ran a surplus estimated at 0.7 percent of annual GDP.

3. Structural reforms have advanced. In June 2005, Congress approved the new securities market law and the pension reform (the third such reform under this government). The pension reform cut the actuarial deficit of the pension system by 19 percent of GDP, about two-thirds of the savings sought by the government. However, and in spite of the government's best intentions and effort, the revised budget code was not approved, although—as explained below—we plan corrective actions in this area.

4. The Banco de la República continued to ably manage monetary policy. In the first eight months of the year, it kept its policy interest rate constant at 6.5 percent, while purchasing US$2.8 billion of foreign exchange to restrain the appreciation of the peso. Drawing on the strength of fiscal policy, the government built up its deposits at the central bank by Col$5.5 billion in this period, allowing for full sterilization of the intervention without putting pressure on short-term interest rates. In September, the Banco de la República lowered its policy interest rate by 50 basis points to 6 percent, consistent with the favorable outlook for inflation.

5. The financial system has strengthened. The solvency and profitability of the banking system has recovered, reflecting a recovery in the growth of the loan portfolio in tandem with stronger macroeconomic conditions. Nonperforming loans declined to about 3 percent of total loans by end-June 2005 and are fully covered by provisions. Furthermore, solvency indicators are at the highest level since the 1998–99 crisis.

**Near-term policy outlook**

6. The government intends to strengthen further the medium-term policy framework to lock in the favorable performance so far this year. The economy is expected to continue growing at an annual rate of 4 percent, while inflation would decline to the range of 2-4 percent over the medium term. Fiscal policy will be able to bring public debt closer to 40 percent of GDP by 2010, as the government plans to tighten the target for the CPS deficit in 2005. Moreover, the outlook for the external sector is now more favorable than envisaged in the program. Benefiting from the strength of the terms of trade and the strong growth in non-oil exports this year, the external current account deficit is now projected to amount to 1 percent of GDP in 2005 and to remain below 2.5 percent of GDP for the rest of the decade. Net international reserves are expected to reach US$15.2 billion by end-2005 (140 percent of short-term debt at a remaining maturity), reflecting the foreign exchange intervention and sales of foreign exchange to the government through August 2005, and to rise gradually over the medium term, consistent with maintaining exchange rate flexibility and the inflation targeting framework.

Macroeconomic Framework: Main Elements 2003-10

| | | | 2005 | | Projections | | |
|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | Prog. | Proj. | 2006 | 2007 | 2010 |
| Real growth | 4.1 | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Inflation 1/ | 6.5 | 5.5 | 5.0 | 5.0 | 4.5 | 4.0 | 3.0 |
| | (In percent of GDP) | | | | | | |
| External current account balance 2/ | -1.5 | -1.0 | -2.8 | -1.0 | -2.3 | -2.5 | -2.5 |
| NFPS primary balance 3/ | 1.7 | 2.7 | 2.7 | 3.1 | 2.7 | 2.7 | 2.7 |
| Combined public sector balance 3/ | -2.7 | -1.3 | -2.5 | -1.6 | -2.0 | -1.7 | -1.0 |
| Total public debt | 56.0 | 52.9 | 50.4 | 48.3 | 46.8 | 46.6 | 39.8 |
| Public deposits | 8.6 | 10.6 | … | … | … | … | … |
| | (In billions of U.S. dollars) | | | | | | |
| Net international reserves 4/ | 10.5 | 13.2 | 12.3 | 15.2 | 15.5 | 15.9 | 17.9 |
| | (In U.S. dollars per barrel) | | | | | | |
| Crude oil, spot price 5/ | 28.9 | 37.8 | 40.5 | 54.2 | 61.8 | 60.0 | 56.5 |

1/ For 2007 and beyond, inflation projection consistent with achieving medium-term inflation target of 2 to 4 percent a year.
2/ At projected WEO price of oil in 2005-06, adjusted to reflect Colombia export price.
3/ For 2005, based on the projected WEO oil price. For 2006, assumes a baseline export price of US$32 per barrel.
4/ IMF Defintion. Takes into account the prepayment of the IDB loan in 2005.
5/ Petroleum price is average of spot prices for UK Brent, Dubai, and West Texas Intermediate.

**Fiscal policy**

7. The government will lower the 2005 target for the CPS deficit to 1.6 percent of GDP (below the original program target of 2.5 percent of GDP), reflecting a decline in the deficit of the central administration of 0.6 percent of GDP to 5.5 percent of GDP. This lower target also takes into account the effects of additional revenues of 0.4 percent of GDP from the higher export price of oil (about US$48 per barrel for 2005), and for this reason, this target will not be adjusted downward for any further increases in the export price of oil. This stronger fiscal position will help reduce the total public debt ratio to close to 48 percent of GDP by end-2005. The revised targets for the CPS deficit at end-September and end-December 2005 are presented in the attached TMU.

8. For 2006, the CPS deficit will amount to 2 percent of GDP, as envisaged, based on an assumed baseline export price of oil of US$32 per barrel. In 2006 total revenues are expected to remain stable in relation to GDP, while interest payments and pension costs will rise slightly as a share of GDP. The government will continue to ensure that spending stays on a sustainable path, even if world oil prices stay exceptionally high. At the time of the second review, we will revisit the target for the CPS deficit in 2006 taking into account several factors, and will continue to save a significant share of any oil price windfall.

9. In 2005, total public revenues are expected to rise to 31.9 percent of GDP, compared with 31.2 percent of GDP envisaged in the program. Reflecting improved tax administration, tax revenues are now projected to rise to over 21 percent of GDP, while Ecopetrol will generate a significant operating surplus. At the same time, the government will not submit a supplemental budget to Congress, which will help limit total public expenditures to 33.4 percent of GDP, somewhat less than expected. The public sector is taking advantage of lower-than-expected interest payments to curtail current expenditure and to allow for more public investment. The deficit of the central government (the central administration, social security and the national decentralized agencies) is projected to decline to 3 percent of GDP in 2005, well below the deficit of 4.1 percent of GDP expected in the program. Territorial governments and local enterprises are expected to register a surplus of 1.1 percent of GDP, as the earlier concerns of a surge in spending by these entities are not likely to materialize this year.

10. The government will take additional measures to reduce the vulnerability of the public debt, including to exchange rate fluctuations. In 2005, it will seek to limit net foreign currency financing to minus 0.4 percent of GDP, as targeted in the indicative quarterly limits presented in the TMU. The government has prepaid about US$2 billion of external debt so far this year, and announced a plan to purchase at least US$3 billion from the central bank to retire more external debt. It will finance these purchases through the use of government deposits as well as the issuance of local-currency denominated government securities. The government will continue to refrain from introducing export subsidies to address concerns about the effects of the peso appreciation. The government will continue to provide a transparent accounting of the stock of all its foreign currency derivative transactions and positions, including an estimate of the possible fiscal impact of adverse movements in the

exchange rate, and to give the Banco de la República a schedule of its planned forward operations. The government will limit the stock of its net forward sales of foreign exchange to no more than US$100 million.

11. For 2005–06, we intend to press ahead with the following structural fiscal reforms (Table 2):

- *Budget code.* The government remains committed to adopt the reforms contained in the revised budget code proposal that failed to be approved in Congress. The Fiscal Responsibility Law approved in 2003 already addressed several of the reforms in the budget code, including presenting to Congress medium-term fiscal projections and a midyear report on fiscal policy and establishing limits on multiyear spending commitments. With the planned tightening of fiscal policy and in particular the decision not to introduce a supplemental budget in 2005, the government will be able to reduce the stock of floating debt *(rezago presupuestal)* from 2.2 percent of GDP at end-2004 to 1.1 percent of GDP by end-2006. By October 2005, the government will issue a decree that preserves as many elements of the revised budget code as possible that do not require legislation. This decree will include steps in several areas, including to classify expenditure according to international standards. The decree will also take initial steps to scale back revenue earmarking. By March 2006, the government will prepare draft legislation to limit all earmarked revenues not mandated by the constitution**.** We will work closely with international financial institutions in these areas.

- *Public enterprise reform.* The government is in the process of selling a majority stake in the state telecommunications company (Telecom) to private firms. This operation will yield important benefits by widening access to telephone service at lower costs and by helping to cover the net pension costs of Telecom. The government is also planning to undertake the modernization of the Cartagena refinery (a US$800 million project) in the context of a joint venture, with Ecopetrol to hold a share of up to 49 percent or US$250 million. The process of finding a private partner will be completed by end-June 2006 (structural benchmark). Ecogas, which operates the country's natural gas pipelines, will be brought to the point of sale by end-2005. An investment bank has been hired to prepare several regional electricity firms (Empresa de Energía de Cundinamarca, Electrificadora del Meta, Empresa de Energía de Boyaca, Electrificadora de Santander and Centrales Eléctricas del Norte de Santander SA) to be brought to the point of sale by June 2006.

- *Improving information on operations of all levels of government.* The government has been working on assessing the quality of subnational level information. For such purposes a sample of 70 entities, from all levels of government, has been selected to be monitored in order to verify quality of the data. The objective is to attain high quality information on a quarterly basis. Additionally, the MHCP has adopted a unified format for processing subnational level information in order to guarantee that the data from the Contaduria General de la Nación is correctly translated into fiscal figures. More complete, up-to-date information on the operations of all levels of government will allow for better monitoring of the fiscal position and for better coordination of monetary and fiscal policies. Additionally the MHCP has committed to strengthen its relationship with subnational governments in order to facilitate the information flow and thereby increase transparency and clarity regarding fiscal information at the subnational level. For this purpose, the MHCP will aim at obtaining budget execution information on a quarterly basis as well as the outlook for the remainder of the fiscal year for a sample of 10 large subnational governments. By December 2005, the government will publish the upgraded historical information on the operations of all levels of government.

- *Tax reform* The government remains fully committed to improving the efficiency of the tax system, and is preparing a tax reform that could be introduced by the next government. This reform would simplify the VAT, including by reducing the number of rates, and the income tax and reduce distortionary taxes.

- *Domestic fuel pricing*. In the near future, the ministry of mines intends to raise the reference medium-term price of oil from US$35 per barrel to at least US$40 per barrel, with a view to further narrowing the gap between domestic wholesale prices of gasoline and diesel and the cost of importing these products.

**Monetary and exchange rate policy**

12. The Banco de la República remains fully committed to reducing inflation to a range of 4½ to 5½ percent during 2005. Inflation expectations both from surveys to market participants as those implicit in financial instruments continue to be well-anchored. As always the central bank stands ready to take actions as needed to achieve the inflation target. It may continue to intervene in the foreign exchange market to limit the speed and depth of the appreciation of the peso. However, the Banco de la República will continue to attach top priority to achieving its inflation target.

**Financial sector**

13. Colombia is continuing to strengthen financial supervision along the lines presented in our April 2005 MEP. Moreover, FOGAFIN brought Granahorrar to the point of sale in July 2005, ahead of schedule, and began to liquidate the Banco del Estado—a bank that ceased operations with the public in June 2000 but still manages a large portfolio of nonperforming loans. FOGAFIN is working with the Monetary and Financial Systems Department from the Fund to develop a corporate governance framework for the new Granbanco and Banco Agrario. By January 2006, the government will complete the merger of the superintendencies of financial institutions and of securities, which is a crucial step forward to allow for effective consolidated supervision in modern financial markets. The government will request technical assistance from the Monetary and Financial Systems Department to strengthen financial supervision further.

14. Following the approval of the new securities law in June 2005, the government will move quickly to adopt the regulations necessary for the full implementation of the law, so that Colombia's capital markets can start benefiting from the new legal environment. The government is also working with the International Capital Markets Department of the Fund to develop further the use of hedging instruments to strengthen risk management in the financial system.

**Other issues**

15. As envisaged, the second review under this program is to be completed by March 2006 and will focus on reaching detailed understandings on policies for 2006, including specific plans for structural reforms during 2006. The third review (to be completed by September 2006) will concentrate on economic performance in 2006 under the program.

16. The government continues to believe that the policies set forth in this Memorandum of Economic and Financial Policies (MEFP) are adequate to achieve the objectives of its program, and as usual we will maintain a close policy dialogue with the Fund. We stand ready to take additional measures, as necessary, to achieve the objectives of the program. The Fund's management or the authorities can request a consultation on the stance of policies when appropriate.

Table 1. Colombia: Performance Criteria for 2005-2006 Program 1/

| | | 2005 | | | |
|---|---|---|---|---|---|
| | | Indicative | | | |
| | Outturn | Targets | Performance Criteria | | |
| | Dec. 31, 2004 | Mar. 31 | Jun. 30 | Sept. 30 | Dec. 31 |
| **I. Performance Criteria** | | | | | |
| Cumulative flows from beginning of calendar yea | | | | | |
| (In billions of Colombian pesos | | | | | |
| **Overall balance of the combined public sector** | | | | | |
| Ceiling 2/ | … | | | | |
| Original | | -1,485 | -1,393 | -3,403 | -6,890 |
| Modifiec | | … | … | 0 | -4,557 |
| Outturn | -3,447 | -1,509 | 2,244 | … | … |
| Margin (+) or shortfall (-) | … | -24 | 3,637 | … | … |
| Inflation rate 3/ | | | | | |
| (12-month inflation rate) | | | | | |
| **Inflation - Consultation band** | | | | | |
| Upper limit | … | 6.5 | 6.3 | 6.2 | 6.0 |
| Target | … | 5.5 | 5.3 | 5.2 | 5.0 |
| Lower limit | … | 4.5 | 4.3 | 4.2 | 4.0 |
| Outturn | 5.5 | 5.0 | 4.8 | … | ... |
| (In millions of U.S. dollars) | | | | | |
| **Net international reserves of the Banco de la Republica** | | | | | |
| Floor | … | 12,215 | 12,215 | 12,215 | 12,215 |
| Outturn | 13,195 | 12,645 | 13,560 | ... | … |
| Margin (+) or shortfall (-) | … | 430 | 1,345 | … | … |
| **Change in the outstanding stock of short-term external debt of the public sector** | | | | | |
| Ceiling | … | 200 | 200 | 200 | 200 |
| Outturn | … | -145 | -162 | … | … |
| Margin (+) or shortfall (-) | … | 345 | 362 | … | … |
| **II. Indicative Targets** | | | | | |
| Cumulative net disbursement from beginning of calendar yea | | | | | |
| (In millions of U.S. dollars) | | | | | |
| **Net disbursement of foreign currency debt to the public sector** | | | | | |
| Ceiling | ... | 300 | -800 | -650 | -750 |
| Outturn | … | -1,101 | -1,739 | … | … |
| Margin (+) or shortfall (-) | … | 1,401 | 939 | … | … |

Sources: Ministry of Finance; Banco de la Republica; and Fund staff estimate

1/ Definitions of concepts and adjustments to the performance criteria are explained in the technical memorandum of understanding (TMU) attached to IMF Country Report 05/154.

2/ The indicative ceiling for March 2005 has been adjusted downward by Col$121 billion and the performance criterion for June 2005 has been adjusted downward by Col$121 billion, in accordance with the adjustor explained the TMU attached to IMF Country Report 05/154.

3/ Deviations from the quarterly path for inflation will trigger consultations with the Fund, as set out in the TMU.

Table 2. Colombia: Structural Conditionality Under the 2005-2006 Program SBA[1]

| | Prior Action | Status |
|---|---|---|
| | Issue circular that requires banks to treat the annexes pertaining to their operations with the nonfinancial public sector as part of their reports on their balance sheets. | Done. |
| | **Structural Performance Criteria** | |
| **June 30, 2005** | Congressional approval of the changes to the Budget Code. The revision will (a) adopt a budget classification according to international standards that fits into the context of Colombia's legal framework; (b) require that the annual budget law include information on tax expenditures, quasifiscal activities, subsidies, contingent fiscal liabilities, medium-term fiscal projections, and a fiscal sustainability analysis; (c) establish a mid-year budget report to Congress; (d) gradually phase out most revenue earmarking not mandated by the constitution by subjecting these earmarking provisions to explicit sunset provisions; (e) limit the budget carry over by eliminating the "reserva presupuestal"; and (f) limit the power of the government to make spending commitments for future years on projects not authorized under the Development Plan. | Not observed. Several of these issues have been addressed in the context of the Fiscal Responsibility Law approved in 2003. The authorities are reducing the budget carry over, and will begin to limit revenue earmarking in the context of a decree and draft legislation. |
| **July, 31 2005** | Submission to Congress of 2006 budget consistent with combined public sector deficit of 2.0 percent of GDP in 2006. | Done. |
| | **Structural Benchmarks** | |
| **June 30, 2005** | Congressional approval of a constitutional amendment to eliminate special pension regimes, end 14th monthly pension and cap maximum pension at no more than 25 minimum salaries.<br><br>Congressional approval of new securities law. | Done.<br><br>Done. |
| **September 30, 2005** | Issue the regulations needed to improve the quality of information reported for the operations of local and regional governments. | |
| **October 31, 2005** | *Issue decree that adopts as many elements of the revised budget code as possible, including a requirement to present expenditure according to an international classification system.* | |
| **December 31, 2005** | Publish a report evaluating the current system of sharing revenue among the different levels of government.<br><br>Bring Granahorrar to the point of sale. | <br><br>Done. |
| **March 30, 2006** | *Prepare draft law on revenue earmarking not mandated by the constitution.* | |
| **June 30, 2006** | *Complete issuance of all regulations needed to fully implement the securities market law approved in June 2005.*<br><br>*Complete process of finding private investor for joint venture to modernize the Cartagena refinery.* | |

[1] New measures presented in italics.

## COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This Technical Memorandum of Understanding (TMU) is a supplement to the TMU dated April 13, 2005.

## I. FISCAL TARGETS

### A. Performance Criterion on the Overall Deficit of the Combined Public Sector[1]

2. The quarterly targets for September and December 2005 for the overall balance of the **combined public sector (CPS)** will be modified as follows:

| | Ceiling (In Billions of Colombian Pesos) |
|---|---|
| Overall deficit of the combined public sector | |
| From January 1, 2005 to: | |
| March 31, 2005 (indicative target) | 1,606 |
| June 30, 2005 (original performance criterion) | 1,514 |
| September 30, 2005 (modified performance criterion) | 0 |
| December 31, 2005 (modified performance criterion) | 4,557 |

[1] As indicated in the April 2005 TMU, measured by the net financing.

### Adjustment

3. The fiscal targets for 2005 and 2006 will no longer be subject to an adjustor for a windfall arising from higher world oil prices. The issue of how to handle the effects of higher world oil prices in 2006 will be revisited at the time of the second review.