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COLOMBIA

Staff Report for the 1999 Article IV Consultation

Prepared by the Western Hemisphere and
Policy Development and Review Departments

Approved by Claudio M. Loser and Jesús Seade

December 3, 1999

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EXECUTIVE SUMMARY

Background

- For several decades Colombia achieved significant economic progress with steady and strong economic growth, and good balance in its external accounts. In recent years this performance has given way to slow growth and widening economic imbalances. To a large extent, the deterioration has been the result of unsustainable fiscal policies, external shocks, and a difficulty internal security situation. The weak fiscal policies reflected mainly the introduction earlier in the 1990s of additional expenditure programs and a constitutionally mandated system of revenue transfers to the territorial governments.

- The recessionary trend intensified in late 1998 and real GDP is projected to fall by 3½ percent in 1999. The weak economic activity has helped reduce inflation rapidly and has sharply lowered the external current account deficit. However, the fiscal position deteriorated further in 1999, unemployment rose to record levels, and the financial system is undergoing a period of substantial stress. Following repeated episodes of pressure against the peso, the currency was allowed to float in September 1999.

The program

- The authorities are requesting a three-year extended arrangement aimed at restoring economic growth, reducing inflation further, and achieving a sustainable external position. To attain these objectives, the program calls for strong fiscal consolidation, financial sector restructuring, structural reforms, and a flexible exchange rate policy.

- Specifically, the program seeks to restore real GDP growth to 3 percent in 2000 and near 5 percent by 2002, with inflation declining from 10 to 6 percent. The external current account deficit would rise somewhat in 2000 to 2.4 percent of GDP, but would stabilize subsequently at just over 3 percent of GDP, consistent with maintaining Colombia's external debt (public and private) at 43–44 percent of GDP. Under the floating exchange rate regime the central bank will intervene in the exchange market only to meet the targeted increase in net international reserves (NIR) and to maintain orderly market conditions.

- The fiscal program for 2000 calls for a sharp reduction in the NFPS deficit, to 3.6 percent of GDP from an estimated 6.3 percent in 1999. The improvement is predicated on a tight wage policy; strong tax enforcement; improved control of resources under the fiscal decentralization system; and economic recovery. In 2000 privatization proceeds and increased borrowing from multilateral institutions will contribute a major share of the financing for the fiscal and external current account deficits. Subsequently, it is expected that foreign direct investment will rebound and that the share of traditional market borrowing will increase.

- The structural reform agenda includes measures to strengthen the finances of the territorial governments; streamline the revenue sharing system; reform the pension system; downsize the public sector, mainly through privatization; and reform the tax system.

I. Introduction

1. The discussions for the 1999 Article IV consultation and use of Fund resources under the Extended Fund Facility (EFF) were held at headquarters during three periods from August 15 to October 27.[1] In a letter to the Managing Director dated December 3, 1999 and its attached memorandum of economic policies, the authorities describe the policies they intend to pursue during the period through 2002 and request a three-year extended arrangement in an amount equivalent to SDR 1.957 billion, equal to 84 percent of quota on an annual basis (Appendix I). Colombia has not accepted the obligations under Article VIII, Sections 2, 3, and 4, and maintains multiple currency practices that are subject to Fund approval (Colombia's relations with the Fund are set out in Appendix II).

2. At the conclusion of the last consultation with Colombia on December 8, 1998 (EBM/98/124), Directors stressed the need for rapid action to reduce the imbalances in the economy, address the structural weaknesses in the fiscal area, and deal with emerging problems in the financial system. They noted that the tightening of monetary policy in response to the turmoil in the international financial markets had been appropriate, and expressed support for the decision to adjust the exchange rate band in September 1998. Directors welcomed the achievement of the inflation target in 1998 and underscored the importance of attaining the target on a consistent basis.

II. Background and Recent Developments

3. **For several decades, Colombia achieved significant economic progress, with steady and strong economic growth and good balance in its external accounts**. In recent years this record has given way to slow growth, rising unemployment, and widening external current account deficits, while inflation remained around 20 percent. In the first half of the 1990s Colombia's fiscal position began to deteriorate, mainly owing to the introduction of expenditure programs that were not accommodated by appropriate adjustments in revenue or other expenditures, and fiscal management was made difficult by a revenue sharing system

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[1] The staff team met with the minister of finance, the director of the national planning department, the general manager of the central bank (Banco de la Republica—BR), members of the board of directors of the BR, and other senior officials. Staff members participating in one or more rounds of the discussions comprised Messrs. Gronlie (Head), Terrones, and Gil-Diaz, Mses. Krieger and Honjo (all WHD), Mr. Yamada (FAD), and Mr. Rossi (PDR). Mr. Ize (MAE) participated in the discussions on financial sector restructuring. Ms. Partow of the World Bank participated in most of the discussions. Mr. Bernal and Mr. Junguito, Alternate Executive Directors for Colombia, to October 1, 1999 and from October 1, 1999 respectively, participated in the policy discussions.

that required the central government to transfer an increasing part of its revenue to territorial governments. This put a disproportionate burden on monetary policy, with high interest rates and a real appreciation of the peso contributing to a slowdown in economic activity and the emergence of financial sector distress toward the end of the decade, while the external imbalances continued to widen.

4. **Since the early 1990s Colombia has implemented important reforms** to liberalize its external trade and financial sectors; it has advanced on reducing the public sector's role in key sectors of the economy through significant privatizations, concessions, and private sector participation in the construction and operation of infrastructure facilities; and it has sought to decentralize the public sector by increasing the autonomy of territorial governments.

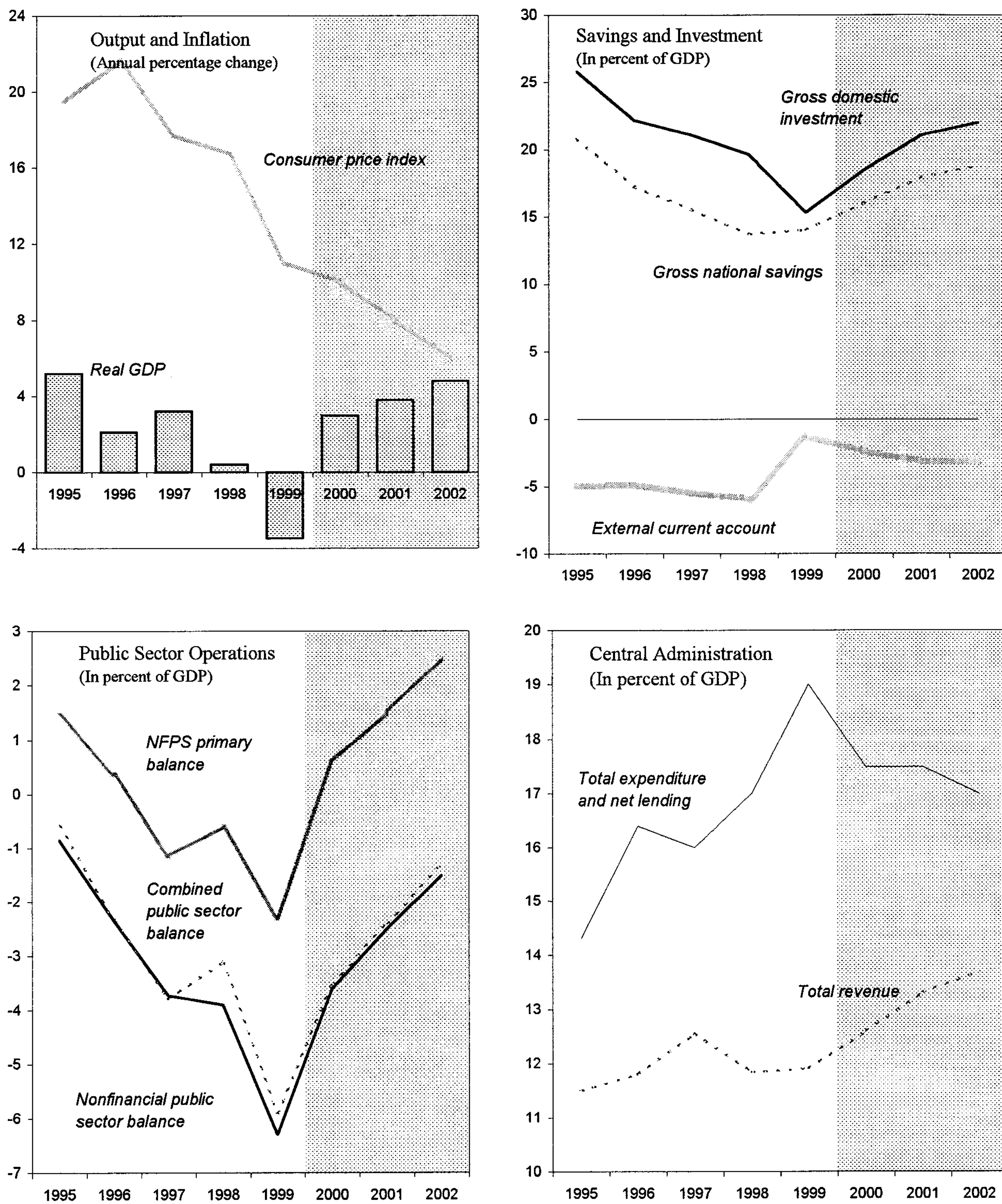
5. **Supported by the introduction of structural reforms, output grew by 5 percent a year during 1992–95,** but it slowed subsequently as the emergence of political uncertainties, further fiscal drift, and the onset of the Asian crisis affected Colombia's economic performance. Faced with a weakening of economic activity, policies were relaxed in 1997, but the recovery was short lived after pressures against the peso started to build toward the end of the year.

6. **Colombia's economy continued to deteriorate in 1998 and real GDP contracted in the second half of the year.** To a large extent, the deterioration was the result of external shocks; the effect of the fiscal imbalances; and a further weakening of confidence related to stepped-up activity by insurgent groups. The turmoil in international financial markets and growing concerns about the sustainability of Colombia's large fiscal and external deficits led to repeated episodes of pressure against the peso despite a tightening of monetary policy that resulted in record-high real interest rates, and in September 1998 the trading band for the peso vis-à-vis the U.S. dollar was depreciated by 9 percent (Figures 1, 2, and 3).

7. **The recession intensified in the first half of 1999 and real GDP is projected to fall by 3.5 percent for the year as a whole** (Table 1). Weak aggregate demand helped reduce the external current account deficit significantly and 12-month inflation has been in single digits since mid-1999, while unemployment rose to a record 20 percent in September from 15 percent a year earlier. Following a decline in real GDP of 6.7 percent (year-on-year) in the first half of 1999, there are signs that the export sector may have begun to recover, helped by the 24 percent real depreciation of the peso during the 12 months to August 1999 (see Figure 2). Agriculture also continues to rebound from the effects of the El Niño weather phenomenon in 1998, and the decline in manufacturing output has slowed.

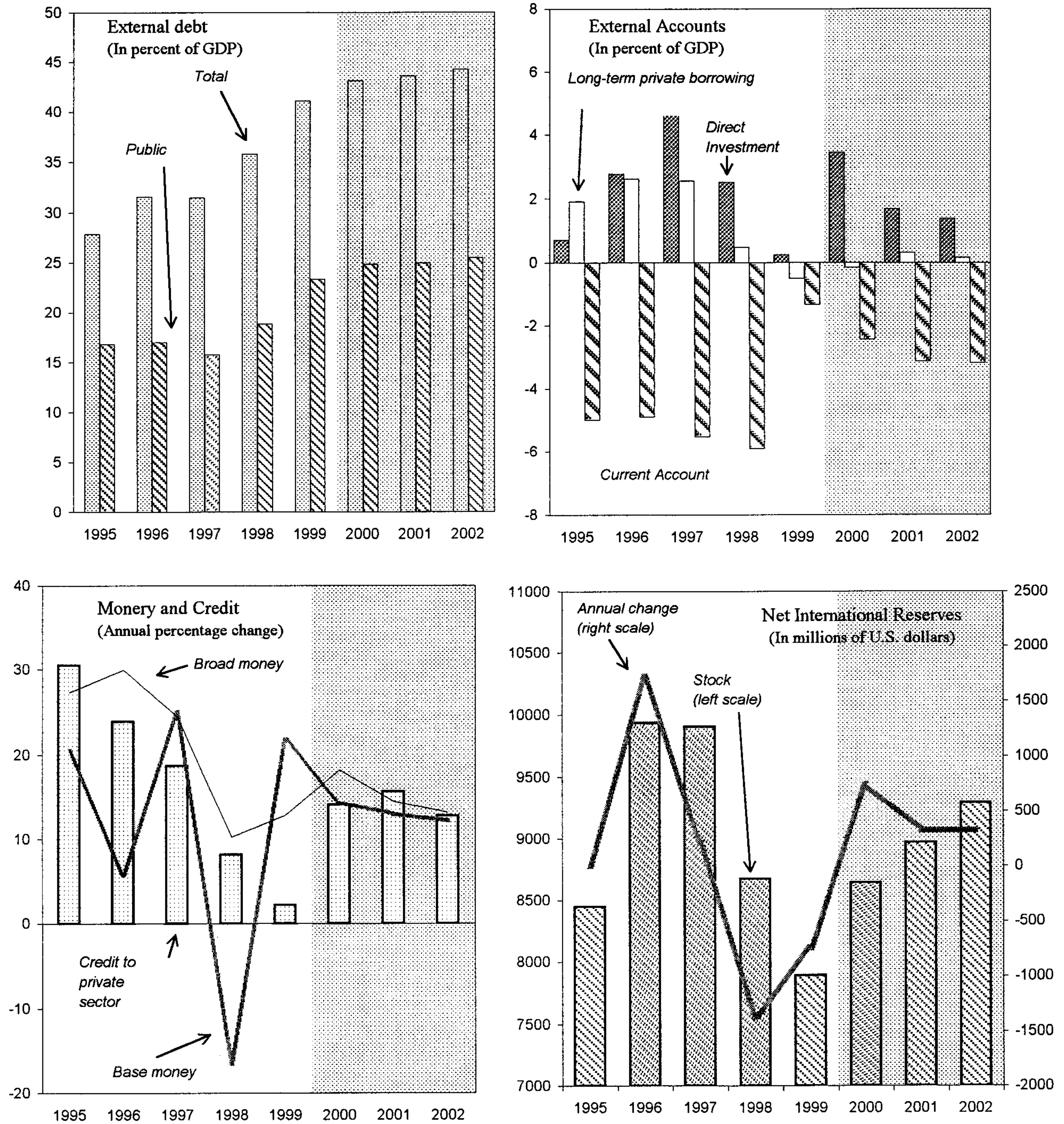
8. The fiscal position deteriorated markedly during the first half of 1999, and the nonfinancial public sector (NFPS) deficit is projected to rise to 6.3 percent of GDP for the year, from 3.9 percent in 1998, due to higher interest payments, large salary increases (awarded when inflation was expected to be much higher than at present), higher pension payments (linked to wages), lower tax collections, and increased capital outlays in response to the earthquake in January 1999 (Table 2). The projected widening of the deficit also reflects

Figure 1. Colombia:
Selected Economic Indicators, 1995-2002



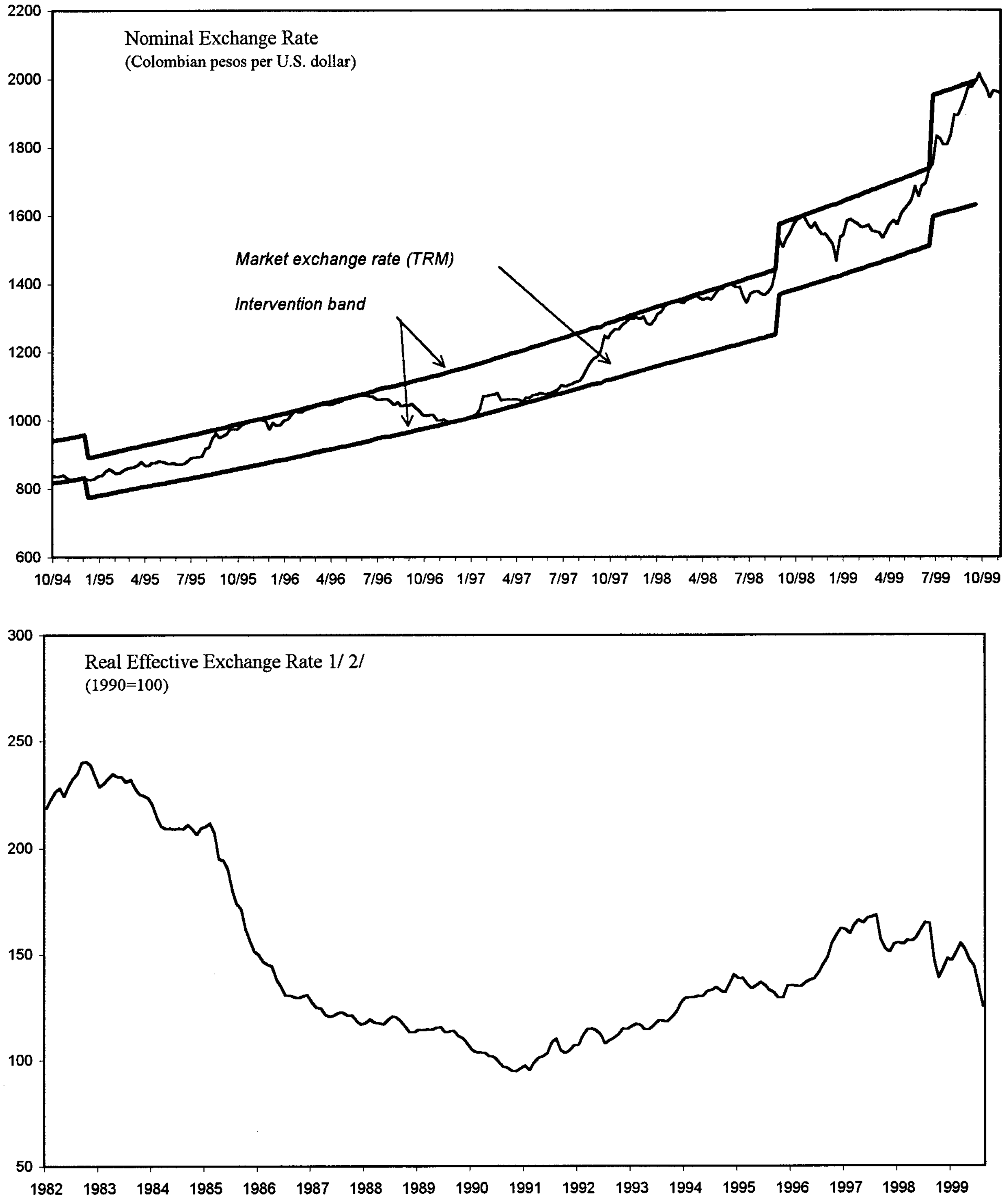
Source: Banco de la Republica

Figure 1. Colombia:
Selected Economic Indicators, 1995-2002



Sources: Colombian authorities; and Fund staff estimates.

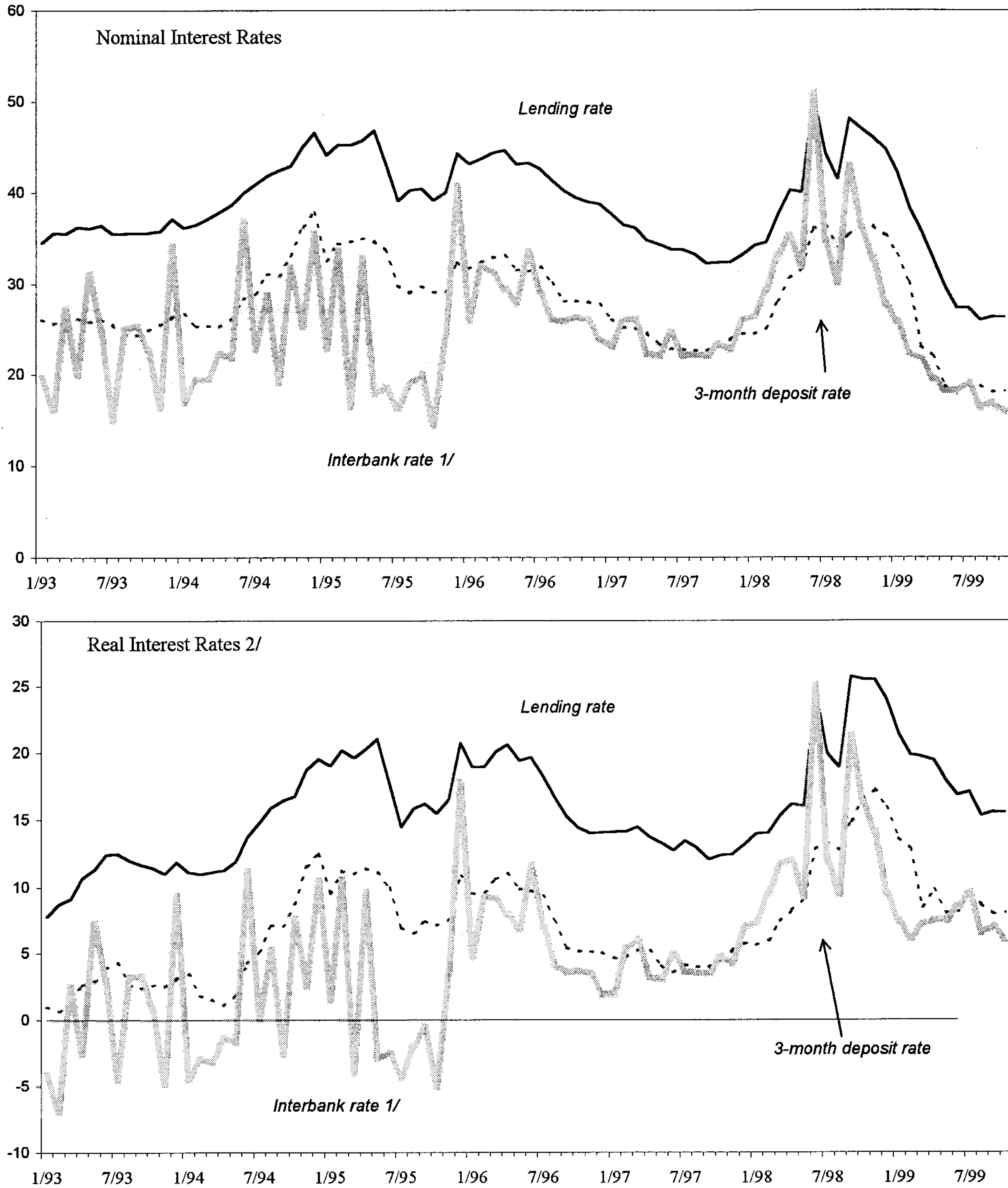
Figure 2. Colombia
Exchange Rate Developments, 1982-99



Sources: IMF Information Notice System; and Banco de la Republica.

1/ Nominal exchange rate through November 12, 1999; real effective exchange rate to August 1999.
2/ IMF trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices; increase means appreciation.

Figure 3. Colombia:
Interest Rates, 1993-October 1999
(In percent per annum)



Source: Banco de la Republica.

1/ Effective rate (monthly average).

2/ Based on the change in the consumer price index over the preceding twelve months.

revenue sharing arrangements that prevent a timely reduction of government transfers when revenue falls below budgeted amounts (Table 3 and Box 1).

9. At the beginning of 1999, the government introduced measures to help deal with the difficult outlook for revenue induced by the weakening of the economy. These included a widening of the base for the value-added tax (VAT), higher fuel taxes, and programs to strengthen tax enforcement.[2] Despite these measures, tax revenue of the NFPS is projected to fall by 0.8 percentage points of GDP in 1999 due to the impact of the recession on tax collections and social security contributions (see Table 2). Nevertheless, the overall revenue position of the NFPS is projected to improve, mainly because of a notable increase in the operating surplus of the state oil company (ECOPETROL), and improvements in the financial positions of the oil stabilization fund and local telephone and water supply (aqueduct) companies.

10. **As inflation fell faster than expected during the first three quarters of 1999, interest rates were reduced** (Table 4 and see Figure 3). Nevertheless, financial sector credit to the private sector fell by 2.5 percent (year-on-year) in September 1999 owing to the recession and the difficulties facing the financial sector. The reduction in interest rates contributed to renewed pressures on the currency, and on June 27 the exchange rate band was again depreciated by 9 percent and widened from 7 to 10 percentage points on each side of the midpoint. Nevertheless, the exchange market remained unsettled as market sentiment continued to be unfavorable in light of uncertainties about the direction of economic policies and the reduction in August/September of Colombia's sovereign debt to below investment grade by two major rating agencies. By mid-September the peso had come under renewed pressure and on September 27 the central bank allowed the peso to float. In the preceding 21 months the central bank's net international reserves (NIR) had fallen by US$2.1 billion, to US$7.6 billion. From the time it was floated until end-November, the peso appreciated by nearly 5 percent against the U.S. dollar.

11. **The Colombian financial system was showing clear signs of distress by late 1998, exacerbated by the turnaround in the economic and financial environment.** The difficulties have been manifested by a rise in nonperforming loans (to 13.2 percent of total loans in September1999 from 9.0 percent a year earlier), large losses, and a significant deterioration in solvency.[3] Recent MAE missions found that the health of the system is worse than reported by the official statistics owing to underprovisioning of nonperforming assets, misclassification of loans, and overvaluation of repossessed assets (see Section III C below).

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[2] The legislation supporting the widening of the VAT base also provided for a reduction of the VAT rate from 16 percent to 15 percent from November 1, 1999.

[3] Three medium-sized credit institutions have been taken over by the authorities, and ten small financial institutions have been closed.

Moreover, only a small number of institutions appear to satisfy the minimum capital adequacy requirements when adjustment is made to reflect the fact that a share of fully performing loans may be rolled over systematically without clear repayment perspectives. Most of the state banks have been undercapitalized or outright insolvent, with a nonperforming loan ratio of 24.0 percent in September 1999, compared with 13.2 percent one year earlier. Credit institutions are generally well hedged against direct foreign exchange risk and have only limited foreign currency denominated liabilities. Nevertheless, they are indirectly exposed to exchange rate risk, as Colombian corporations have large debts denominated in foreign currency.[4]

12. **To head off a system-wide crisis, the government introduced several measures in late 1998 and early 1999, including programs to assist savings and loan institutions, financial cooperatives, and mortgage holders, financed by a new tax of 0.2 percent on financial transactions (excluding interbank transactions). Subsequently, programs were put in place to help recapitalize viable private banks, deal with the problems of the public banks, and, in October, the authorities proposed additional relief for mortgage holders who remain current on their obligations at the end of 1999.** Under the recapitalization plan for private banks, the government, through FOGAFIN (the Colombian insurance fund and bank resolution agency), extends credit lines to the shareholders of troubled institutions. These lines, which are given in the form of FOGAFIN bonds, are used by the shareholders to recapitalize the financial institutions. The largest public bank (Caja Agraria) is in the process of liquidation and has been replaced with a smaller agricultural bank, and a resolution strategy has been adopted for the six remaining state-owned banks (including three that have been taken over by the authorities) based on audits, recapitalization, and subsequent divestment. A financial sector reform law was enacted in June 1999 which, inter alia, strengthens the power of the authorities to deal with troubled banks in a timely manner. The recent proposal submitted to congress provides for the additional mortgage relief to be financed by forced investments in government bonds at below market rates by the financial and the financial services sectors.[5] [6] The cost of the restructuring program for the financial

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[4] Steps have been taken to help restructure corporate sector domestic debt. In June 1999 the authorities introduced special credit lines administered by second-tier state banks. These credit lines are funded with resources that will be provided by multilateral lending institutions and other second-tier banks (during the July–October 1999 period, some Col$200 billion was disbursed out of Col$600 billion available under these credit lines). In July 1999, the superintendency of banks issued regulations to facilitate the restructuring of corporate debt and defined the conditions under which the classification of restructured loans could be upgraded.

[5] The programs introduced by the authorities in response to the difficulties faced by the financial system are summarized in Appendix III.

sector (including the mortgage relief programs) is currently estimated at about 5 percent of GDP in net present value terms.

III. The Program Discussions

13. **To deal with the deteriorating economic and financial situation, the Colombian authorities have formulated an economic program for the period through 2002 that calls for a major policy correction in a medium-term context.**

14. **The program seeks to restore conditions for the resumption of economic growth, the further reduction of inflation, and the achievement of a sustainable external position.** Specifically, it aims at reducing inflation from 10 percent in 2000 to 6 percent in 2002, while real GDP growth is projected to accelerate to 3 percent in 2000 and near 5 percent by 2002. The external current account deficit would widen somewhat to 2.4 percent of GDP in 2000, and then stabilize at around 3 percent of GDP in 2001 and 2002 (Table 5 and see Figure 1).

15. **In the first part of the program period, mainly in 2000, privatization proceeds and increased borrowing from multilateral institutions will contribute a major share of the financing for the external current account deficit.** Subsequently, it is expected that foreign direct investment will rebound to historical levels and that the share of traditional market borrowing will increase.[7] The net international reserves would increase in each year of the program after 1999, with gross reserves remaining at the equivalent of nearly six months of imports of goods and services, one and a half times the level of short-term external debt (by remaining maturity), and about 30 percent of broad money (Table 6 and see Table 5). Under the program, Colombia's external debt would stabilize at 43–44 percent of GDP.

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[6] To provide debt reduction to qualifying mortgage holders, mortgage lending institutions will be given 10-year government bonds as compensation for the reduction of debt. Monthly interest and amortization on these bonds will be financed with the proceeds from forced purchases (to be made over the next 12 months) of other government bonds by all institutions in the financial and financial services sector. The forced bonds will be redeemed after five years in amounts that maintain their real value, i.e., no "real" interest will be paid, and the inflation part of the interest is capitalized until the bonds are redeemed.

[7] Colombia has maintained a deposit requirement on external borrowing since 1993 intended to compensate for the differential between domestic and international interest rates. The terms—the percentage and maturity of the loans subject to the requirement and the length of the deposits—have been eased on several occasions in recent years. The effectiveness of this measure in reducing the amount of capital inflows is not clearly supported by the available evidence, but it may have served to lengthen the maturity of the flows.

16. **Achievement of the program objectives will be sought through fiscal consolidation; structural reforms; financial sector restructuring; and exchange rate flexibility, and would be supported by the depreciation of the peso that has taken place over the past year and a half** (to a level in real effective terms similar to that of the early 1990s when Colombia's external current account was near balance, prior to the onset of petroleum exports on a large scale). These policies also should ease the pressure on interest rates and lend support to the growth and inflation objectives of the program.

A. Fiscal Policy

17. **The fiscal program for 2000 calls for a sharp reduction in the NFPS deficit to 3.6 percent of GDP, and further to 2.5 percent in 2001 and 1.5 percent in 2002 (see Table 2). The deficit of the combined public sector is projected at 3.5 percent of GDP in 2000 (a performance criterion), 2.4 percent of GDP in 2001, and 1.3 percent of GDP in 2002.**[8]

18. **The reduction in the NFPS deficit in 2000 is crucially dependent on a tight wage policy; economic recovery; improved control of resources under the fiscal decentralization system; and continued success of the tax enforcement program**. The further reduction in the NFPS deficit beyond 2000 is predicated on a further widening of the tax base, both at the national and territorial level; continued strict control of non-interest spending; the implementation of structural reforms in the fiscal area; and a sustained recovery in economic activity.

19. **Central to the achievement of the medium-term fiscal objectives** are plans to build up funds to support the pension liabilities of territorial governments, streamline the special pension schemes for teachers and oil workers, and introduce pension reform under the social security system. Also important is a plan to freeze in real terms the amount of revenue transferred to territorial governments (see Box 1). These reforms are being presented to the congress in its July–December 1999 session together with initiatives to restrict the creation of new municipalities and limit the territorial governments' current spending.

20. **The program to strengthen tax administration and tax enforcement will support the fiscal effort**. To this end, the tax administration (DIAN) has been invested with additional powers and authorized to hire 1,000 additional inspectors/agents under a program aimed to reduce collection lags, identify delinquent accounts, collect arrears, and reduce contraband. The program has been successful to date in terms of its collection goals.

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[8] The combined public sector comprises the NFPS (excluding revenue and expenditure related to the financial sector restructuring operations); the net budgetary outlays on financial sector restructuring; the quasi-fiscal balance of the central bank; and the fiscal balance of FOGAFIN.

Box 1. Changes in Transfers to Territorial Governments

Fiscal decentralization in Colombia has been mainly financed by constitutionally mandated revenue sharing arrangements, under which 44.5 percent of the central government's current revenue is presently transferred to territorial governments, up from 36.5 percent in 1993. These transfers have been the largest source of increase in central government outlays during the 1990s.

The *Situado fiscal* and the *Participación municipal* are the main transfer mechanisms of the revenue sharing system. Under the *Situado*, the central government provides transfers to regional governments for education and health, while the *Participación* transfers funds to municipal governments for education, health, and water supply. The 1991 constitution stipulates that neither the *Situado* nor the *Participación* can diminish as a share of central government current revenue from one year to the next, mandating that their combined share be increased to 46.5 percent by 2001. Moreover, in the event of a shortfall in current revenue from budgeted amounts, the transfers cannot be reduced in the same proportion, thus complicating fiscal management. To increase budgetary flexibility, a constitutional amendment was presented to congress in September 1999 aimed at freezing in real terms the transfers under the *Situado* from 2001 and under the *Participación* from 2002, once they reach the maximum rate of 24.5 percent and 22 percent of current government revenue, respectively. This reform requires approval by two successive sessions of congress and could provide fiscal savings of 0.4 percent of GDP in 2001, increasing to 0.8 percent of GDP in 2002.

Mineral royalties, collected mainly from oil and coal production, are distributed two-thirds to the producing regions and the remainder to the National Royalties Fund (NRF). The NRF's resources are earmarked to more than 40 specific sectors and projects. To help strengthen the finances of the territorial governments, the authorities are proposing to channel 10 percent of the NRF to territorial government pension funds.

An important change in the transfer system was the phasing out of the *cofinancing funds* in 1999; these funds (not mandated by law) provided matching grants for territorial government investment projects. The government also allocates resources to regional universities and provides a supplementary education fund to territorial governments. In all, of the central government's current spending of 13.6 percent of GDP in 1998, all but 3.6 percent of GDP was allocated to wages, pensions, interest payments, and the constitutionally mandated revenue sharing arrangements.

21. **A major part of the sharp fiscal adjustment planned for 2000 reflects a reduction in non-interest current spending of the NFPS by 1.7 percent of GDP**. To achieve this, 70 percent of government employees will receive no wage increase, and the rest, including the lowest paid and those with rights to automatic annual adjustments, will receive an average of 4–5 percent. Combined with some staffing reductions, this would reduce the wage bill of the NFPS from 7.5 percent of GDP in 1999 to 7.0 percent of GDP in 2000 (Table 7 and see Table 2). To alleviate the impact of the recession on the most vulnerable groups, the budget also includes additional social safety net programs for 0.3 percent of GDP that will be

continued over the next three years, and will help ensure that the gains in social spending over the past several years will be preserved (Table 8).[9] The new programs include training for youths, additional daycare centers; school lunch programs; and increased enrollment of the elderly in the health insurance system. In addition, there will be a reduction in capital outlays in 2000, by 0.7 percent of GDP, reflecting lower investment by the central government and the state oil company, ECOPETROL (see Tables 2 and 3).[10] At the same time, investment by territorial governments will increase somewhat; in particular, the city of Bogota is using the proceeds from last year's divestment of its electricity company to fund a major public works program.

22. **Total revenue of the NFPS would rise only marginally, to 27.5 percent of GDP in 2000, as most of the increase in tax revenue, from 16.5 percent of GDP in 1999 to 18.1 percent of GDP,** would be offset by the elimination from the public sector accounts of the operating surpluses of privatized public enterprises. The projected increase in tax revenue is closely related to the success of the tax enforcement program and the recovery in economic activity and imports.[11] The projection also takes account of the reduction in the VAT rate noted earlier and a fall in income tax receipts that reflect lower earnings in the 1999 recession year (see Table 3). In response to the staff's suggestions that the VAT rate reduction be postponed and that the financial transactions tax be phased out, the authorities noted that the lowering of the VAT rate was an integral part of the tax package that provided for the extension of the VAT base at the beginning of the year, and expressed strong reluctance to phasing out the financial transactions tax over the program period, explaining that there was broad political support for this tax and suggesting that any distorsionary effect would be minimal, given the low rate.

23. The net fiscal cost of the financial sector restructuring operation borne by the combined public sector is expected to be near zero in 1999, supported by the income from the financial transactions tax. The net cost would rise to 0.5 percent of GDP

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[9] Social spending has increased from 3.6 percent of GDP at the beginning of the decade to the range of 7.6–7.9 percent of GDP in recent years.

[10] The privatization of public enterprises also reduces investment in the accounts of the public sector.

[11] The tax revenue projection also reflects the inclusion of the financial transactions tax as NFPS revenue. During 1999 this tax, which would yield 0.6 percent of GDP, was earmarked to support mortgage holders, construction firms, and housing finance institutions as part of the program that was initiated in late 1998 to deal with the difficulties faced by the housing finance sector. This support was accounted for as part of the combined public sector, and not the NFPS, in 1999 but the authorities have decided to extend this tax through 2002, including to help defray the NFPS' costs of reconstruction after the January 1999 earthquake.

in 2000 and remain at 0.2–0.3 percent of GDP in 2001 and 2002, based on the assumption that 60 percent of the loans extended by FOGAFIN to recapitalize viable private banks will be fully serviced and that the costs of the recapitalization of public banks and the new mortgage relief program do not exceed the projected amounts (see Table 2).

24. **In the discussions, the staff pointed to the risks** facing the fiscal plan because of the need for timely congressional approval of the proposed measures, the possibility of a slower than expected economic recovery, and higher than projected costs of the financial sector restructuring plan. The authorities noted that there is broad political agreement on the need for fiscal adjustment and reform, as evidenced by the recent approval of the tight budget for 2000. They added that fiscal savings of 0.1–0.2 percent of GDP a year from the proposed reforms of social security and the special pensions are not included in the baseline projection of the fiscal accounts through 2002, providing a margin under the program, but they underscored their commitment to taking appropriate action, as needed, to ensure that any deviation from the projected path is corrected.

25. **Nearly the full amount of the combined public sector deficit would be financed by privatization proceeds in 2000, consistent with the authorities' financing strategy**. However, as external debt matures, they plan bond placements in external markets of 0.6 percent of GDP in 2000, while multilateral institutions would provide disbursements of 2.6 percent of GDP, following several years during which Colombia has reduced its multilateral debt. On this basis, the domestic debt of the public sector would decline by 0.5 percent of GDP, with the public sector's total debt (excluding financial sector recapitalization bonds) remaining about unchanged at 34 percent of GDP in 2000. In response to the staff's concerns about the risks arising from the heavy reliance on privatization proceeds to finance the program, the authorities explained that the amounts were conservatively estimated and that most projects (mainly in the mining and electricity sectors) were well advanced; nevertheless, because some projects could be delayed, particularly the divestment of public banks, the program for 2000 provides for partial compensation through additional external borrowing.

B. Monetary and External Sector Policies

26. **Monetary policy will be guided by the inflation objective for 2000;** the central bank will manage liquidity mainly through open market operations with a view to staying within the program limits for its net domestic assets. The monetary program is based on a growth of 14.3 percent for base money, which is about in line with the projected growth of nominal GDP and consistent with an increase in the stock of financial system credit to the private sector of some 14 percent (see Table 4). The income velocity of broad money is projected to fall by 3 percent in 2000, to 2.6.

27. **In light of the program's fiscal adjustment and the expected strengthening of confidence, the burden on monetary policy would ease in 2000 and beyond**. In the meantime, inflationary pressures remain relatively subdued, and with the peso having

appreciated somewhat against the U.S. dollar since it was floated, the central bank has proceeded with steps to relax monetary policy. Thus, in October the central bank lowered reserve requirements from 5.2 percent on average to 4.6 percent and cut its interest rate structure by 100 basis points, followed by further cuts of 200–400 basis points in November.[12] In response to the staff's caution against a rapid relaxation of monetary policy, the authorities noted that the central bank was mainly adjusting its own interest rates to the market, and that a lowering of the rate structure was clearly indicated by the fall in inflation. While they saw the lowering of interest rates as a welcome opportunity to support the reactivation of the economy and strengthen the financial system, they noted that the stance of monetary policy would be adjusted as needed to achieve the objectives of the program.

28. **To better ensure that monetary policy is consistent with its inflation objectives, the central bank is seeking to move to a direct inflation-targeting framework**. To assist in this effort, the Fund (MAE) helped organize a seminar with international experts for central bank officials in Colombia in November 1999. Given the instability of economic and financial structures in Colombia in the recent past, the central bank does not expect to be able to put a direct inflation-targeting framework into operation until after 2000.

29. **The authorities have indicated that the central bank has not intervened in the exchange market since the peso was floated,** and have adopted the policy that it will only intervene—according to a clearly defined set of rules—to accumulate the planned increase in net international reserves and to maintain orderly market conditions.[13]

30. **In the area of trade policy, the staff encouraged the authorities not to increase the aggregate level of protection, and the authorities explained that Colombia will continue to pursue a liberal trade regime and to implement policies that are consistent with WTO agreements and principles.** They also noted that Colombia will eliminate performance requirements in the automotive and agricultural sectors by end-1999, implement agreements on customs valuation and intellectual property from January 1, 2000, and continue

[12] The most recent cuts brought the central bank's rate structure, the repo, reverse repo, and Lombard rates to 13 percent, 7 percent, and 19 percent, respectively.

[13] On November 19, 1999, the central bank made public the rules that will govern its interventions in the foreign exchange market. With a view to meeting the reserve targets of the program, monthly auctions will be held of rights to sell foreign exchange to the central bank (US$200 million for December 1999 and US$80 million per month subsequently). Moreover, to maintain orderly market conditions, the central bank will from time to time auction off rights to buy or sell US$120 million; these auctions will be held when the exchange rate deviates by more than 5 percent from the moving average of the previous 20 business days. In both auctions, the rights will be fully tradable and must be exercised within a month of the auction.

work on the harmonization of price bands in the context of the Andean Community. The authorities had originally planned to lower the subsidy rate on the tax credit certificates for exporters (CERTs) in 1999 in order to meet the agreement with the WTO on the elimination of the subsidy component by end-2002 and transform the CERT system into a tax-drawback system; however, in the discussions, they explained that while they intend to meet the end-2002 deadline, they would keep the rate unchanged for the time being given the uncertain environment for exports (Box 2).

Box 2. Colombia Trade Regime

Since it joined the WTO in 1995, Colombia's trade policy has been defined by its WTO obligations as well as its regional and bilateral commercial agreements. The average nominal tariff came down to 11.6 percent in 1999 from 44.6 percent in 1990, and effective protection decreased from 59 percent in 1990 to 20.5 percent in 1999. Also, tariff dispersion has been reduced from 23 different rates to 4, whereas quantitative restrictions have been eliminated. As of end-1998, Colombia scored 2 on the Fund's 10-point scale for classifying the restrictiveness of trade regimes. (A higher score indicates a more restrictive trade regime.)

Colombia has availed itself of the special temporary provisions under the WTO agreement, including the use of official, rather than reference prices, in calculating tariffs in particular sectors (shoes, cars, and textiles). Import restrictions include: (i) the use of official prices for customs valuation purposes; (ii) exceptions to the Andean Pact Common External Tariff (CET) in various sectors, ranging from the agricultural to the automotive sector, with tariff rates reaching 35 percent (automotive sector); and (iii) variable import levies in the agricultural sector. Nontariff barriers include licensing requirements and domestic absorption requirements in the agricultural sector. With regard to export-stimulating measures, exporters of nontraditional products are entitled to receive CERTs at 2.5, 4, and 5 percent of the domestic value added, depending on the product and country of destination, on surrendering export proceeds in the foreign exchange market.

31. **The authorities confirmed their commitment to taking the necessary action to accept the obligations of the Fund's Article VIII, Sections 2, 3, and 4 during the period of the program**. In the meantime, Colombia continues to avail itself of the transitional provisions of Article XIV and maintains multiple currency practices subject to approval under Article VIII, resulting from the tax on the remittance of profits for direct investment in Colombia and the withholding tax on inflow of foreign exchange from personal services and transfers, as well as the issuance of CERTs. The retention of these practices has not been approved by the Fund.

C. Financial Sector Restructuring

32. **The Colombian financial system is undergoing a period of substantial stress, as noted previously,** with the situation of the publicly-owned banks (including the recently intervened banks) being the most difficult. All public banks have been recapitalized, their management has been strengthened, and under the program the authorities have undertaken to

divest fully their ownership of these institutions over the period to the end of 2001, during which they expect that the market for such assets will recover from its current depressed state.

33. **While the savings and loans institutions (CAVs)** report compliance with the minimum capital adequacy requirements, their solvency is questionable in view of the sharp deterioration of their portfolio, the overvaluation of their real assets, and the limited provisioning for their nonperforming assets. Due to the sharp deterioration in the servicing of mortgage loans, these institutions are deeply exposed to credit risk. As already noted, they are being supported trough the mortgage relief plans introduced by the authorities. Moreover, the framework law submitted to congress in October 1999 provides that all CAVs be converted into banks within one year, which would help diversify their portfolio. The authorities expect that the CAVs will be absorbed by existing banking groups.

34. **The banking reform law adopted in June 1999 strengthens the supervisory authorities' procedures to deal with troubled institutions** and, under the program, the authorities will expedite the issuance of implementing regulations for this law, particularly with regard to the timing of intervention and adoption of corrective regimes. In addition, to address the issue of low provisioning of nonperforming assets by most financial institutions, the supervisory authorities have issued regulations that call for a gradual increase in provisions to international levels by the end of the program period.[14]

35. **In the discussions, the staff noted that the strategy followed by the authorities to deal with financial sector issues is broadly adequate,** but that its success is conditional on a rapid improvement in macroeconomic conditions; that the projected fiscal cost assumes substantial success in recovering initial outlays (through divestment of public banks, asset sales, and loan repayments); and it also assumes that there is no significant further deterioration in financial sector conditions. The fact that the state participates in the recapitalization of private banks through lending rather than by taking a direct stake in the banks, exposes it to downside risks without allowing it to benefit from the upside potential; this asymmetry also could raise the potential cost of the recapitalization plan. The authorities noted that the fiscal cost projection incorporates a margin for nonrecovery of costs and that the recapitalization loans are being guaranteed with the shareholders' stake in the institutions and with additional collateral, and that participating institutions will be monitored by FOGAFIN in situ.

D. Structural Reforms

36. **Important on the structural reform agenda under the program are measures to strengthen the finances of the territorial governments and streamline the fiscal**

[14] Provisioning as a share of nonperforming assets was 35 percent in March 1999.

decentralization system. This agenda was advanced in May 1999 by the approval of the development plan for 1999–2002. More recently, in October 1999 the government introduced legislation to help deal with the underfunding of territorial government pensions by constituting pension funds, which would be built up at a rate of 0.7 percent of GDP a year on average from 2000 (see Table 7); resources under the revenue sharing system also would be set aside for this purpose, as would a part of the income of the national royalties' fund. The territorial pension funds also will receive resources from a national lottery that is being organized, proceeds from privatizations, and earmarked resources from some national and territorial taxes.

37. **The pension reform of 1993 introduced a number of measures to strengthen the finances of the social security institute's (ISS) pay-as-you-go pension regime, and opened the way for the establishment of fully funded pensions based on private capitalization funds.** A second round of social security pension reform is being introduced in congress in December 1999 to address the projected decline in the annual surplus of the ISS' pension regime. This would be achieved mainly by raising the retirement age by five years, extending the time it takes to generate a pension by five years, and lengthening the income period on which pension benefits are calculated. These changes will be introduced gradually, and in the same legislation the authorities are proposing to lower the income tax exemption for pensions from 50 to 20 times the minimum wage. Moreover, action is being taken to strengthen the financial position of the special pensions for teachers and public sector oil workers by constituting reserves or by bringing the benefits more in line with the general regime of the ISS. The fiscal savings from the pension reforms will begin to accrue during the program period, and will increase subsequently as the transition to the new system is completed.

38. **Under the revenue sharing system, transfers to territorial governments are slated to rise annually as a share of current government revenue until 2001, and the system itself imposes considerable inflexibility on fiscal management, as noted in Box 1.** In an effort to deal with the most pressing problems of the revenue sharing system, in September 1999 the government proposed a constitutional amendment to freeze the transfers in real terms from 2001. (Constitutional amendments must be approved in two consecutive sessions of congress, and final approval is expected late next year.) Other measures to better control the use of resources under the revenue sharing system are included in legislation that has been introduced to restrict the establishment of new regional universities and halt the creation of additional municipalities. Creation of new municipalities has been relatively simple until now, adding to the burdens on the revenue sharing system. The authorities also have been taking more direct control over the operations of territorial governments that are facing debt-servicing problems.

39. **To help territorial governments deal with the freezing in real terms of transfers** and the reduced contribution of spendable funds from the national royalties fund and other sources, the government introduced legislation in September 1999 to curtail the current expenditures of territorial governments and increase the transparency of their financial

operations. Reliance by territorial governments on annually rising revenue transfers from the central government has led to considerable laxity in the enforcement of territorial taxes. It is expected that the reforms affecting the territorial government finances will lead to stronger tax enforcement at the territorial level, and to help in this effort the government will introduce legislation by early 2001 to provide territorial governments with increased fiscal autonomy, including additional taxing powers.

40. **The government also is taking action to reduce the size of the public sector**, mainly through privatization of major public enterprises in the electricity, banking, and mining sectors in 2000, with additional privatizations and concessions in the telecommunications sector slated for 2001. It also intends to divest completely its ownership in the remaining public sector banks (except one), as noted above. The privatizations are projected to yield nearly US$3 billion in 2000 and US$0.6 billion in 2001. In light of the considerable privatizations that have already taken place during the 1990s, the potential for further divestment of large public enterprises is limited. Regarding the institutions that will remain in the public domain, the authorities intend to consolidate some and downsize others (mainly public banks, second-tier banks, smaller agencies, as well as some ministries), while achieving additional staffing reductions gradually by not fully replacing staff that leave the public service.

41. **While successive tax reforms have served to streamline Colombia's tax system since the 1980s, distortions remain**, as exemplified by the financial sector transactions tax, the multiple VAT rates, and an "implicit VAT" on imports of VAT-exempt items.[15] In an effort to eliminate these and other distortions, help in the implementation of the tax measures called for under the program, and make recommendations for further action to strengthen the tax system, an FAD technical assistance mission visited Colombia in November 1999. In its first assessment, the mission noted that Colombia's tax structure has deteriorated in recent years with a significant erosion of the tax base through increasing incentives and exemptions. The mission recommended possible immediate measures, including a widening of the tax base through the elimination of various exemptions, and a simplification of the VAT structure to a single rate. With the mission's technical recommendations as input, the government will propose legislation early next year to broaden the base of the income tax and reduce exemptions under the VAT, as envisaged under the program.

42. **Following changes in the foreign investment regime earlier in the 1990s, foreign direct investment (FDI) in Colombia increased sharply**, including in the petroleum sector, and in recent years in the financial sector. To help spur a reversal of the decline in such investment that has taken place during the current recession and to further encourage FDI in Colombia, steps were taken earlier in 1999 to improve the terms that govern investments in

[15] Since domestic producers of VAT-exempt items pay VAT on their inputs, while importers of such items pay no VAT, the "implicit VAT" is levied to offset the cost difference (with elaborate calculations of the equivalent tax rates, item by item).

the oil sector by lowering royalty payments and scaling back the role played by ECOPETROL in its partnerships with private operators; legislation also was passed to strengthen the assurances of fair compensation in cases of public expropriations; and the authorities will seek to phase out the tax on profit remittances (7 percent) over the period of the program.

43. **Labor market reforms were introduced in the early and mid-1990s**, including to make hiring procedures more flexible and reduce barriers to dismissals. Nevertheless, the efficiency of Colombia's labor market remains hampered by a lack of flexibility and high payroll taxes (at 46 percent, including to finance worker training programs, social assistance, and family subsidies). The staff encouraged the authorities to continue the reform effort in this area, and while they recognize that there is room for further reform, they consider that the recent increase in unemployment, which they ascribe to the deep recession, can best be tackled at present through stronger macroeconomic policies and by the well targeted programs that have been introduced to provide tax incentives for new employment creation, by payroll tax deductions for company-specific training programs, and with labor intensive public work projects. The authorities' efforts to reduce the incidence of backward-looking wage indexation were given a setback in November 1999 when the constitutional court ruled that the minimum wage should be set so as to compensate for past inflation.

IV. MEDIUM-TERM OUTLOOK AND CAPACITY TO REPAY THE FUND

44. **The baseline economic scenario for the five years through 2004 elaborated by the staff and outlined below is based on full implementation of the policies under the Fund supported program for 2000–2002** and a continuation of the same policy-thrust in the subsequent years (Table 9). It also takes account of a notable decline in oil exports after existing fields reach peak production in 1999, so that oil exports will decrease from 507,000 bpd in 2000 to 340,000 bpd in 2004, with oil prices decreasing by about US$1 per barrel over the period. Coffee prices are projected to increase by 10 percent (Table 10).[16]

45. **On this basis, the NFPS deficit would decline to 1 percent of GDP in 2004**, mainly as the structural reforms introduced during the program period yield increased fiscal savings. The lower deficits would be fully financed by external resources, with the public sector's total debt declining from 34 percent of GDP in 1999 to less than 32 percent of GDP by 2004. In the discussions, the authorities were confident that such a fiscal adjustment profile could be achieved and that it would help provide ample domestic credit resources for the private sector as economic growth recovers. The external current account deficit is projected to be 3.4–3.5 percent of GDP in the two years following the program period (see Table 9), which would be financeable through foreign direct investments and long-term debt. Total external debt

[16] Oil and coffee price projections reflect end-July WEO projections.

(public and private) is projected to rise somewhat to 44 percent of GDP in 2002 and then remain at about that level through 2004 (Table 11).

46. **The medium-term scenario depends closely on the baseline assumptions for oil prices, international interest rates (LIBOR), and real GDP growth**. A lower oil price by US$1 per barrel would leave the external current account deficit an average of 0.2 percent of GDP a year higher through 2004 than in the baseline scenario. A LIBOR rate of 1 percent higher than the baseline throughout the period would leave the external current account deficit higher by more than 0.1 percent of GDP a year. These deviations would impact the NFPS deficit somewhat less, but slower real GDP growth by 1 percentage point a year would raise the overall deficit in 2004 to 1.8 percent of GDP, from 1 percent of GDP in the baseline scenario.

47. **Under the baseline scenario the indicators of external vulnerability are maintained at satisfactory levels.** Gross international reserves would stay close to the equivalent of six months of imports until 2002 and decrease slightly thereafter and remain in excess of one and a half times total short-term debt (by remaining maturity) and near 30 percent of broad money throughout the period (see Table 6). These indicators are comparable with other countries in the region with Fund-supported programs.

V. Performance Criteria, Access, and Reviews

48. **As specified in the attached technical memorandum (see Appendix I), the program will be monitored through quarterly performance criteria** on the overall deficit of the combined public sector; the net domestic assets (NDA) and the net international reserves (NIR) of the central bank; the increase in medium- and long-term debt and the outstanding amount of short-term external debt of the public sector; and the issuance of guarantees by the public sector for private external debt. There are adjustors on the performance criteria for the NIR and the NDA in case of shortfalls or excesses in the disbursement of external financing, including privatizations; on the external debt ceiling for shortfalls in privatization proceeds; and on the NIR and NDA to facilitate exchange market intervention for the purpose of maintaining orderly market conditions. The program also contains **structural benchmarks** that will be subject to semi-annual reviews. There would be **five equal purchases under the first year of the arrangement**, the first upon approval, and the subsequent ones will be based on the observance of the quantitative performance criteria for end-December 1999, end-March 2000, end-June 2000, and end-September 2000. The end-June purchase also is contingent upon the completion of the first review under the extended arrangement, at which time the quantitative performance criteria for September and December 2000 will be set. There will be **semi-annual reviews** under each of the three years of the arrangement. The authorities have indicated that **the memorandum of economic and financial policies as well as the technical memorandum will be published**.

VI. Statistical Issues

49. **Colombia provides adequate data for Fund surveillance**, and although there have been inconsistencies in the public finance data, recent improvements in coverage and in the coordination between agencies producing fiscal data would allow timely monitoring of the program. Ongoing technical assistance from STA following a multisector statistics mission in late 1997 would further help to strengthen the quality of economic data. The authorities have indicated that they would welcome Fund assistance in strengthening their monitoring system for Colombia's external debt (see also Appendix IV.)

VII. Other Issues

50. The gains made in the area of **poverty reduction** in Colombia over the 30-year period through the mid-1990s have eroded significantly in the past two years, due to the economic downturn and the intensification of the internal conflict. The number of persons internally displaced by the conflict and needing public assistance is estimated to have risen sharply to 0.6–1.0 million, putting great pressure on public and private resources at a time when attention also is being paid to the reconstruction after the earthquake that affected the coffee producing region in early 1999. In an effort to help alleviate the impact of the present difficulties, the government has identified the segments of the population that have been hit the hardest, and has initiated new programs (summarized in Section III A above) and enlisted external support, including from the World Bank, for its efforts.[17]

51. In response to increasing insurgent activity in recent years **security outlays** (police and military, of which the police accounts for somewhat less than half) have risen from 2.5 percent of GDP in 1994 to 3.2 percent of GDP in 1998. Under the program the government projects a modest decline in spending on security to 2.8 percent of GDP in 2002. This is mainly attributable to restraint on wages which account for 75 percent of such spending.[18]

52. **Economic and financial policies in Colombia are conducted in a transparent and nondiscriminatory manner** based on procedures and institutions that establish accountability. The country has a number of control institutions, and legislation and regulations in the economic and financial areas are often reviewed, and sometimes overturned, by the courts. All public expenditures, both at the central and local government levels, pass through official

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[17] The World Bank identifies poverty reduction as a principal objective of its work in Colombia in the Country Assistance Strategy (CAS) paper that was discussed by the Bank's Executive Board in November.

[18] Not included in the budgetary outlays are external grants-in-kind and technical assistance of a security related nature to help with anti-narcotics operations.

budgets (except in the case of some external grants of a security related nature used in drug interdiction), and government purchases and sales (including privatizations) are subject to open bidding. Colombia has for many years tolerated contraband imports sold by small traders in certain locations (*sanandresitos*), and while the recent program by DIAN to control contraband trade can be expected to reduce its scope, some informal tolerance of this trade is likely to continue. The central bank's foreign exchange market intervention policy has been made public. The Government of Colombia has for a number of years pursued an active policy against money laundering, and has established a special information and analysis unit under the ministry of finance to coordinate the effort; all financial institutions are required to report certain transactions, consistent with international standards and practices.

53. **Recognizing the problems created by corruption,** the government has named a presidential council to oversee its anti-corruption strategy. The World Bank has been requested to assist in this effort, and legislation has been passed to assign greater individual accountability to public servants. The World Bank's involvement would be channeled through its Public Financial Management Project and would include programs in tax administration and public procurement, which are areas thought to be susceptible to corruption.

54. The authorities report that **major computer systems** have been found to be Y2K compliant, including those affecting electricity generation, water supply, and domestic telephone service. Less progress has been made in the health sector. Invoicing systems are thought to be lagging in terms of compliance. The banking system also has been found to be well prepared and the central bank has set up a special facility to meet increases in the demand for cash that may be associated with the year 2000 problem.

55. Spending on **environmental protection** has been financed mainly by the central government, regional autonomous entities (*Corporaciones Autónomas Regionales—CAR*),[19] and earmarked resources from the national royalty fund (at least of 20 percent of the fund's resources). Total spending on environmental protection increased from 0.2 percent of GDP in 1994 to 0.3 percent of GDP in 1999. In addition, transfers under the revenue sharing system finance local water supply projects. To further enhance protection and conservation of the environment, the authorities have sought to obtain grants from bilateral donors and the World Bank Global Environment Facility, with an active involvement of local NGOs. In the wake of January 1999 earthquake, a part of the resources for environmental projects was reallocated to support the reconstruction.

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[19] The CARs receive resources from taxes on vehicles and property, transfers from enterprises in the electricity sector, fees on the use of forests and water, various licenses, and penalty fees.

VIII. STAFF APPRAISAL

56. **After decades of sound economic management, reflected in a solid record of economic growth, albeit with moderately high inflation, policies have weakened in recent years**, and Colombia has experienced large macroeconomic imbalances, aggravated by external shocks and a difficult internal security situation. To deal with these imbalances the government has elaborated a wide ranging set of macroeconomic and structural policy measures in a medium-term context and is seeking international support for its efforts, including through a three-year extended arrangement from the Fund.

57. **The principal economic policy challenge facing Colombia is to reestablish internal and external balance on a sustainable basis as a means of restoring a strong growth performance while reducing poverty**. The economic program designed to achieve these objectives is based on fiscal consolidation, structural reform, financial sector restructuring, and exchange rate flexibility. Achievement of the program's targets and objectives requires flexibility and timely policy adaptations as the economic and financial environment changes. To this end, the government would need to ensure that a broad consensus is maintained for its policies and its legislative agenda. Encouraging in this regard is the recent approval of the government's budget for 2000, which calls for a sharp restraint on expenditure while seeking to preserve social spending.

58. **When fully implemented, the authorities' fiscal adjustment plan should bring the deficit to a level that can be sustained over the medium term, as reflected in the stabilization and eventual decline of public sector debt. Beyond the program period, fiscal consolidation would continue as the transition to the new pension regimes is pursued**. At the same time, there remains scope for additional strengthening of the tax system through measures aimed at widening the base and reducing distortions. A broadening of the tax base combined with continued efforts to strengthen tax enforcement would make room for a reduction in tax rates. The taxes that have been placed on the already distressed financial sector should be phased out and replaced with more broad-based sources of revenue.

59. **The authorities' plans to deal with the underfunded pension liabilities of public pension systems** are clearly in order. The proposed actions should provide relief to the public finances for several years to come.

60. **Fiscal decentralization has served to bring democratic institutions and decisions closer to the grass-roots level, and there is broad consensus on its desirability**. Since taking office, the present administration has introduced some measures to make the system more efficient, and under the program major reforms are being introduced to control the amount of transfers under revenue sharing, enhance the efficiency of their use, and define better the spending responsibilities of different levels of government. The tightening of controls on territorial governments with debt-servicing problems also promises to contribute to the reduction of pressures on the public finances.

61. **The reforms of the fiscal decentralization system and the territorial government finances will, over time, reduce the territorial governments' dependence on transfers from the central government and other sources**. This would require that tax administration and tax enforcement at the territorial government level be strengthened and that the territorial tax reform be introduced in the congress and approved expeditiously.

62. **The policy to downsize the public sector through privatization and by inviting the private sector to build and operate infrastructure projects is making a contribution to addressing Colombia's current fiscal difficulties and holds out the promise of establishing a more efficient private-based economy**. Under this policy valuable assets are being sold to help finance the fiscal deficits as these are being reduced; this makes it all the more important to achieve a significant and permanent fiscal consolidation.

63. **The floating of the peso** and the central bank's decision to minimize intervention in the foreign exchange market were clearly appropriate in the circumstances. The flexible exchange system will help Colombia better manage the short-term effects of external shocks. While subdued inflationary pressures and a strengthening of the peso in the period since it was floated have provided the central bank with some margin for lowering its interest rates, caution is needed in pursuing a substantial further relaxation of monetary policy before the fiscal adjustment takes hold.

64. **The financial system restructuring strategy is sound**, though its success depends on rapid improvements in macroeconomic conditions to prevent that its fiscal costs rise beyond current estimates. The authorities are fully aware of the risks involved in the strategy and have taken action to limit them, but continued vigilance will be required in the coming months. In particular, the savings and loan institutions are likely to remain weak for some time, and the successive rounds of debt relief for mortgage holders, and the measures to encourage corporate debt restructuring, have potentially important moral hazard implications. To avoid undermining payments discipline, the authorities should hold firm on not providing further debt relief to delinquent debtors.

65. **As regards public banks**, the strategy of delaying their divestment until market conditions improve appears reasonable, but it could result in further operating losses and additional deterioration of their assets if the banks are not properly managed during the transition. To ensure a smooth transition for the public banks, tight management arrangements that limit political interference will be essential.

66. **A strengthening of supervisory practices will be required** to ensure that banks which do not participate in the recapitalization program, and hence were not subjected to the special audits, correctly reflect their true financial situation in their balance sheets. Especially strong vigilance will be needed to limit the risks taken by the recapitalized banks. In addition, regulations should be issued and vigorously enforced to fully implement the recent amendments to the banking law, including a system of automatic triggers for early corrective actions to deal with problem banks.

67. **Multiple currency practices** result from taxes on profit remittances from direct investment in Colombia and on foreign exchange earnings from personal services and transfers, and the use of an export subsidy directly linked to the surrender of exchange proceeds (CERTs). The authorities should replace CERTs with a tax drawback system and eliminate taxes on profit remittances as soon as possible to allow Colombia to accept the obligations under Article VIII of the Fund's Articles of Agreement by the end of the program period. In the absence of a specific timetable for the removal of these practices and in view of the discriminatory nature of the CERTs, staff do not recommend their approval.

68. **Colombia's provision of economic statistics to the Fund** is generally satisfactory and adequate for surveillance and for formulating and monitoring the program. The staff would encourage the authorities to continue their efforts to improve economic databases, and welcome their intention to continue working with Fund staff in this area.

69. **The staff is of the view that the authorities' program reflects a courageous and comprehensive effort, consistent with progress toward fiscal and external viability, while advancing structural reforms**. A strengthening of domestic confidence and the secured flow of resources from official and private institutions abroad should help consolidate the process. Clearly, there are risks to the program in the form of a slower than expected economic recovery, with its attendant fiscal consequences; uncertainties with regard to the timing and the outcome of the current peace negotiations; uncertainties about the political support for the reform agenda; the heavy reliance on privatizations to finance the fiscal deficit in 2000; and the difficulties facing the financial sector. The authorities recognize these risks, and their strong commitment to their program gives confidence that they will take prompt corrective action as needed. The program presented by the authorities represents a significant strengthening of macroeconomic policies and has a clear focus on structural reforms to be implemented over several years, and in view of this the staff supports Colombia's request for a three-year extended arrangement. The high access under the EFF is sought by the authorities and supported by staff as Colombia remains vulnerable to adverse external shocks due to the continued fragility of the financial system and the internal security situation.

70. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

IX. PROPOSED DECISION

The following decision, which can be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

1. Colombia has requested an Extended Arrangement for the period from December 20, 1999 to December 19, 2002 for an amount equivalent to SDR 1.957 billion.

2. The Fund approves the Extended Arrangement attached to EBS/99/218.

3. The Fund waives the limitation in Article V, Section 3 (b) (iii).

Table 1. Colombia: Selected Economic and Financial Indicators

	1995	1996	1997	Prel. 1998	Program 1999	2000	2001	2002
	(Percentage changes, unless otherwise indicated)							
National income and prices								
Real GDP	5.2	2.1	3.2	0.4	-3.5	3.0	3.8	4.8
GDP deflator	18.9	16.9	17.0	16.7	11.6	11.5	8.8	7.0
Consumer prices (average)	20.9	20.8	18.5	18.7	11.3	11.2	8.8	7.0
Consumer prices (end of period)	19.5	21.6	17.7	16.7	11.0	10.0	8.0	6.0
External sector (on the basis of U.S. dollars)								
Exports (f.o.b.)	16.2	4.0	10.1	-5.8	8.9	9.2	1.1	5.2
Imports (f.o.b.)	16.5	-0.6	12.8	-5.2	-29.8	20.2	4.2	3.9
Export volume	2.5	-2.3	6.6	5.4	5.1	6.0	2.2	4.1
Import volume	8.0	2.0	21.7	-1.4	-28.9	18.4	2.5	1.7
Terms of trade (deterioration -)	5.1	9.2	11.4	-7.0	5.0	1.5	-2.7	-1.1
Nominal exchange rate 1/ (depreciation -)	-10.4	-13.6	-10.0	-25.1	...	...	...	...
Real effective exchange rate 1/2/ (depreciation -)	-3.5	10.4	-3.2	-4.5	...	...	...	...
Central administration								
Revenue	23.9	23.0	27.9	9.8	9.2	20.7	19.2	16.2
Expenditure	38.0	36.0	18.5	24.3	20.4	5.7	12.6	9.0
Money and credit 3/								
Broad money	27.3	30.0	24.5	10.3	12.8	18.2	14.4	13.1
Private sector credit	30.5	23.9	18.7	8.2	2.2	14.1	15.7	12.8
Income velocity of money	3.3	2.8	3.0	2.9	2.7	2.6	2.6	2.6
Interest rate (90-day time deposits) 1/								
Nominal	32.4	27.8	23.9	33.9	...	...	...	...
Real	10.8	5.0	5.3	14.7	...	...	...	...
Broad money (as ratio to net international reserves)	3.4	3.6	3.5	3.9	3.7	3.6	3.5	3.5
	(In percent of GDP)							
Central administration balance 4/	-2.8	-4.5	-3.5	-5.2	-7.1	-5.0	-4.2	-3.2
Public sector savings 4/	8.2	6.3	5.8	4.8	2.7	4.4	5.1	5.6
Nonfinancial public sector balance 4/	-0.8	-2.4	-3.7	-3.9	-6.3	-3.6	-2.5	-1.5
Combined public sector balance 4/	-0.6	-2.3	-3.8	-3.1	-5.9	-3.5	-2.4	-1.3
Foreign financing	1.2	0.9	0.6	1.9	1.4	0.4	1.3	1.0
Domestic financing 5/ 6/	0.6	0.8	1.8	1.0	3.8	-0.5	0.6	0.5
Privatization	0.1	0.8	1.3	0.1	0.7	3.5	0.5	-0.2
Public sector debt	26.3	24.6	24.2	27.5	34.2	34.1	33.8	34.0
Gross domestic investment	25.8	22.2	21.0	19.6	15.3	18.4	21.0	22.0
Gross national savings 5/	20.8	17.3	15.5	13.7	14.0	16.0	17.9	18.8
Current account (deficit -)	-5.0	-4.9	-5.5	-5.9	-1.3	-2.4	-3.1	-3.2
External debt 7/	27.9	31.6	31.5	35.8	41.1	43.1	43.6	44.3
Of which: Public sector 7/	16.9	17.0	15.8	18.9	23.3	24.8	25.0	25.5
Total short-term external debt to reserves 8/	49.9	49.9	47.8	52.7	72.0	57.2	66.4	58.4
	(In percent of exports of goods, services and income)							
External debt service 7/	22.9	21.7	24.0	23.2	22.6	21.1	27.4	27.5
Of which: Public sector	13.2	17.5	21.3	25.2	27.4	27.8	30.2	30.5
Interest payments 7/	8.7	7.9	8.4	8.4	8.9	9.3	10.4	10.4
Of which: Public sector	5.7	7.1	8.7	9.4	8.0	7.1	6.9	6.9
	(In millions of U.S. dollars)							
Overall balance of payments	1	1,722	211	-1,374	-750	744	326	323
Gross official reserves	8,447	9,938	9,908	8,741	8,215	9,458	9,784	10,107
Gross official reserves (in months of imports of goods and services)	5.5	6.2	5.5	5.0	5.8	5.9	5.8	5.8

Sources: Colombian authorities; and Fund staff estimates and projections.

1/ End of period.

2/ Based on the Information Notice System.

3/ All annual changes in foreign currency stocks valued at constant exchange rate.

4/ Excluding privatization proceeds.

5/ Includes the balance of the quasi-fiscal operations of Banco de la Republica.

6/ Includes residual differences between items above and below the line, as well as sales of assets and extension of phone licenses.

7/ Includes short-term debt.

8/ Short-term debt is defined by its remaining maturity from 1999 onwards.

Table 2. Colombia: Operations of the Combined Public Sector

(In percent of GDP)

				Prel.	Program			
	1995	1996	1997	1998	1999	2000	2001	2002
Total revenue	**25.4**	**27.0**	**27.4**	**26.5**	**27.3**	**27.5**	**27.5**	**27.6**
Current revenue	25.4	27.0	27.4	26.5	27.3	27.5	27.5	27.6
Tax revenue 1/	16.1	16.8	17.7	17.3	16.5	18.1	19.3	19.8
Nontax revenue	9.3	10.1	9.8	9.1	10.8	9.4	8.2	7.9
Operating surplus of public enterprises	4.3	4.7	3.7	3.3	4.0	4.0	3.5	3.2
Other 2/	5.0	5.4	6.0	5.9	6.7	5.4	4.7	4.6
Total expenditure and net lending	**26.2**	**29.3**	**31.2**	**30.3**	**33.6**	**31.1**	**30.0**	**29.2**
Current expenditure	18.3	20.6	21.6	22.4	24.7	23.2	22.6	22.2
Wages and salaries	5.9	6.6	6.7	7.0	7.5	7.0	6.5	6.2
Goods and services	3.1	3.5	3.7	3.4	3.4	3.0	2.9	2.8
Interest	2.3	2.7	2.6	3.3	4.0	4.2	4.0	4.0
Transfers	6.7	7.7	7.9	8.4	9.6	9.0	9.1	9.1
Other 3/	0.3	0.2	0.8	0.2	0.1	0.0	0.0	0.0
Capital expenditure	8.0	8.6	9.6	7.9	8.6	7.9	7.5	7.0
Fixed capital formation	7.9	8.4	9.1	7.8	8.4	7.7	7.3	6.9
Transfers	0.1	0.2	0.4	0.1	0.2	0.1	0.1	0.1
Net lending 1/	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0
Nonfinancial public sector balance	**-0.8**	**-2.4**	**-3.7**	**-3.9**	**-6.3**	**-3.6**	**-2.5**	**-1.5**
Quasi-fiscal balance of the central bank	0.3	0.0	-0.1	0.8	0.4	0.5	0.5	0.4
Net cost of financial sector restructuring 4/	--	--	--	--	0.0	-0.5	-0.3	-0.2
Fogafin balance	...	...	...	...	0.3	-0.2	0.1	0.1
Net budgetary cost	...	...	...	...	-0.2	-0.2	-0.4	-0.3
Combined public sector balance	**-0.6**	**-2.3**	**-3.8**	**-3.1**	**-5.9**	**-3.5**	**-2.4**	**-1.3**
Statistical discrepancy 5/	-1.3	-0.2	0.1	0.1	0.0	0.0	0.0	0.0
Financing	**1.8**	**2.5**	**3.7**	**3.0**	**5.9**	**3.5**	**2.4**	**1.3**
Foreign	1.2	0.9	0.6	1.9	1.4	0.4	1.3	1.0
Of which								
Change in government reserves (increase -)	1.0	-0.4	-0.6	0.1	-0.6	-1.3	0.4	0.1
Domestic	0.6	0.8	1.8	1.0	3.8	-0.5	0.6	0.5
Privatization proceeds 6/	0.1	0.8	1.3	0.1	0.7	3.5	0.5	-0.2
Memorandum items:								
Security expenditure 7/	2.5	2.8	3.3	3.2	3.2	3.0	2.9	2.8
Public sector savings	7.4	6.3	5.8	4.8	2.7	4.4	5.1	5.6
NFPS primary balance	1.5	0.4	-1.1	-0.6	-2.3	0.6	1.5	2.5
Public sector final demand 8/	17.1	18.6	20.2	18.3	19.4	17.7	16.8	15.9
Consolidated fiscal balance, official definition 9/	-0.3	-1.7	-2.8	-3.4	-4.6	-3.8	-2.7	-1.7

Sources: Ministry of Finance and Public Credit; Banco de la Republica; and Fund staff estimates.

1/ Excludes proceeds of financial transaction tax in 1999 from revenue and expenditure.

2/ Includes local fees, penalties, and oil stabilization fund.

3/ Includes expenditure on an accrual basis not included in other outlays.

4/ Transfer to Caja Agraria in 1999, interest payments on public banks restructuring bonds and mortgage debt relief related costs.

5/ Includes residual differences between items above and below the line.

6/ Includes nonrecurrent fees from telecommunications licensing.

7/ Includes army and police wages and purchases of goods and services.

8/ General govenrment expenditure less transfers to households and interest payments, plus investment by public enterprises.

9/ National definition for the nonfinancial public sector. Includes transfers of central bank profits from previous years, proceeds from long term licenses, future oil sales, and Fogafin resources maintained in central government. Excludes unrecorded local government expenditure, increase in floating debt expenditure and net lending.

Table 3. Colombia: Operations of the Central Administration

(In percent of GDP)

	1995	1996	1997	Prel. 1998	Program 1999	2000	2001	2002
Total revenue	**11.5**	**11.9**	**12.6**	**11.8**	**11.9**	**12.6**	**13.3**	**13.7**
Current revenue	11.5	11.8	12.6	11.8	11.9	12.6	13.3	13.7
Tax revenue 1/	9.7	10.1	10.8	10.4	10.1	11.0	11.9	12.4
Net income and profits	4.0	3.8	4.4	4.3	4.2	4.0	4.4	4.5
Goods and services	4.6	5.3	5.3	4.9	4.9	5.2	5.6	6.0
Value-added tax	4.1	4.7	4.8	4.5	4.4	4.6	5.0	5.4
Gasoline tax	0.6	0.6	0.5	0.5	0.5	0.6	0.7	0.7
International trade	1.0	0.9	1.0	1.2	0.9	1.2	1.2	1.3
Financial transaction tax	0.0	0.0	0.0	0.0	0.0	0.6	0.6	0.6
Stamp and other taxes	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Nontax revenue and transfers	1.8	1.7	1.8	1.4	1.9	1.6	1.4	1.4
Property income	0.2	0.3	0.3	0.3	0.2	0.3	0.3	0.3
Other	1.7	1.4	1.5	1.1	1.7	1.3	1.1	1.1
Total expenditure and net lending	**14.3**	**16.4**	**16.0**	**17.0**	**19.0**	**17.5**	**17.5**	**17.0**
Current expenditure	10.6	11.8	12.2	13.6	15.1	14.4	14.3	13.8
Wages and salaries	2.4	2.5	2.5	2.7	2.9	2.7	2.6	2.5
Goods and services	1.2	1.3	1.6	1.4	1.3	1.1	1.1	1.1
Interest	0.7	1.1	1.2	1.9	2.3	2.7	2.6	2.7
External	0.6	0.5	0.6	0.7	1.0	1.1	1.2	1.2
Domestic	0.1	0.6	0.6	1.2	1.3	1.6	1.4	1.5
Other expenditure 2/	0.3	0.2	0.1	0.2	0.1	0.0	0.0	0.0
Current transfers 3/	6.0	6.7	6.8	7.4	8.5	7.9	8.0	7.5
Capital expenditure	3.5	4.1	3.6	3.2	3.4	2.9	2.9	3.0
Fixed capital formation, cash basis	1.4	1.6	1.8	1.1	0.7	0.9	0.7	0.7
Capital transfers	1.6	2.1	2.2	2.0	2.3	2.0	2.3	2.3
Net lending 1/	**0.2**	**0.4**	**0.2**	**0.2**	**0.5**	**0.2**	**0.2**	**0.2**
Overall balance	**-2.8**	**-4.5**	**-3.5**	**-5.2**	**-7.1**	**-5.0**	**-4.2**	**-3.2**
Memorandum items:								
Current transfers to territorial governments	3.3	4.0	4.0	4.3	4.6	4.3	4.2	4.1
Current account balance	0.9	0.0	0.3	-1.8	-3.1	-1.8	-1.1	-0.1

Source: Ministry of Finance and Public Credit.

1/ Excludes proceeds of financial transaction tax in 1999 from revenue and expenditure.

2/ Expenditure on an accrual basis not included in other outlays.

3/ Includes interest payments to the rest of the nonfinancial public sector.

Table 4. Colombia: Summary Accounts of the Financial System

	1995	1996	1997	Prel. 1998	Program 1999	2000	2001	2002
	(Annual percentage changes) 1/							
	I. Financial System 2/							
Net foreign assets	**-0.2**	**6.8**	**-0.8**	**-2.7**	**-2.0**	**2.1**	**0.1**	**-0.1**
Net domestic assets	**25.5**	**25.0**	**23.0**	**12.9**	**14.6**	**16.1**	**14.3**	**13.2**
Credit to public sector (net)	-0.8	1.2	-0.3	7.1	8.2	4.6	5.0	3.6
Quasi-fiscal deficit (surplus -)	-1.3	0.0	0.2	-2.4	-1.2	-1.7	-1.4	-1.2
Credit to private sector	34.9	28.4	20.9	8.9	2.4	13.6	14.6	12.1
Other (net)	-7.2	-4.5	2.1	-0.8	5.2	-0.4	-4.0	-1.3
Liabilities to private sector	**25.4**	**31.8**	**22.2**	**10.2**	**12.6**	**18.2**	**14.4**	**13.1**
	II. Banco de la Republica (BR) 3/							
Net international reserves	**13.8**	**50.4**	**-0.3**	**-34.2**	**-21.5**	**18.1**	**7.0**	**6.1**
Net domestic assets	**6.7**	**-44.7**	**25.3**	**17.7**	**43.2**	**-3.8**	**6.0**	**6.0**
Credit to public sector (net)	7.8	1.4	-2.8	5.6	15.2	0.4	-4.8	-1.9
Credit to financial system	12.7	-11.9	10.4	7.0	13.0	-0.7	10.1	6.6
Credit to private sector (net) 4/	6.3	-7.1	14.4	7.2	2.7	-0.3	-0.3	-0.3
Other (net)	-20.1	-27.0	3.4	-2.2	12.4	-3.3	1.0	1.7
Monetary base	**20.5**	**5.7**	**25.0**	**-16.6**	**21.7**	**14.3**	**12.9**	**12.1**
Memorandum items:								
	(Flows in millions of U.S. dollars)							
Net official international reserves 5/	351.1	1,540.7	-9.3	-1,382.7	-725.0	744.3	326.2	323.5
	(Annual percentage changes in nominal terms)							
Broad money 6/	27.3	30.0	24.5	10.3	12.8	18.2	14.4	13.1
Money (M1)	18.4	15.8	20.6	1.7	1.2	16.3	13.7	12.6
Quasi-money and other	30.1	34.1	25.4	12.3	15.4	18.6	14.6	13.2
Private sector credit	30.5	23.9	18.7	8.2	2.2	14.1	15.7	12.8
Base money	20.5	5.7	25.0	-16.6	21.7	14.3	12.9	12.1
	(Annual percentage changes in real terms)							
Broad money 6/	6.5	6.9	5.7	-5.5	1.6	7.5	4.0	2.9
Money (M1)	-0.9	-4.8	2.4	-12.8	-8.8	5.7	3.3	2.4
Quasi-money and other	8.9	10.3	6.6	-3.7	3.9	7.8	4.2	2.9
Private sector credit	9.2	1.9	0.9	-7.2	-7.9	3.7	5.2	2.5
Base money	0.8	-13.0	6.2	-28.5	9.7	3.9	2.7	1.9
	(Nominal GDP/broad money)							
Velocity of broad money	3.3	2.8	3.0	2.9	2.7	2.6	2.6	2.6
	(Interest rates) 7/							
90-day deposit rates								
Nominal	32.4	27.8	23.9	34.6	17.5	...	...	...
Real	10.8	5.0	5.3	15.3	7.5	...	...	...
Lending rates								
Nominal	44.2	38.7	33.2	44.6	26.2	...	...	...
Real	20.7	14.1	13.2	23.9	15.4	...	...	...

Sources: Banco de la Republica; and Fund staff estimates.

1/ All annual changes in foreign currency stocks valued at a constant exchange rate.

2/ Changes in relation to private sector liabilities at the beginning of the period. Rates of growth of money and quasi-money are with respect to themselves.

3/ Changes in relation to monetary base at the beginning of period.

4/ Corresponds mainly to the sum of the stock of open market bills and exchange certificate

5/ The NIR are equal to the BoP concept of NIR excluding *causaciones* (accrued, but unpaid, interest on reserve assets).

6/ Includes M3 plus bonds issued by financial institutions.

7/ End of period annual rates. The 1999 interest rates correspond to September.

Table 5. Colombia: Summary Balance of Payments

	1995	1996	1997	Prel. 1998	Program 1999	2000	2001	2002
	(In millions of U.S. dollars)							
Current account	**-4,623**	**-4,758**	**-5,892**	**-5,909**	**-1,159**	**-2,087**	**-2,724**	**-2,798**
Trade balance	-2,638	-2,143	-2,714	-2,647	2,542	1,696	1,339	1,573
Exports, f.o.b.	10,528	10,948	12,057	11,362	12,377	13,519	13,662	14,376
Coffee	1,832	1,577	2,259	1,891	1,409	1,516	1,547	1,578
Petroleum products	2,185	2,895	2,707	2,298	3,673	3,649	2,865	2,286
Other	6,511	6,477	7,091	7,172	7,296	8,355	9,250	10,512
Imports, f.o.b.	13,166	13,091	14,771	14,008	9,836	11,823	12,323	12,803
Services (net)	-1,126	-1,132	-1,447	-1,393	-1,628	-1,658	-1,675	-1,759
Income (net)	-1,616	-2,103	-2,371	-2,350	-2,618.2	-2,630.9	-2,904.4	-3,138.8
Interest	-1,250	-1,446	-1,775	-1,714	-1,827	-1,786	-1,911	-2,055
Other services	-367	-657	-596	-635	-791	-845	-993	-1,084
Current transfers (net)	758	618	640	480	545	506	517	527
Capital and financial account	**4,684**	**6,715**	**6,699**	**4,743**	**332**	**2,831**	**3,050**	**3,122**
Financial account	4,684	6,715	6,699	4,743	332	2,831	3,050	3,122
Medium-and-long term	2,775	7,185	8,439	4,595	1,585	4,574	2,296	2,111
Direct investment 1/	712	2,795	4,892	2,509	249	3,460	1,682	1,375
Of which: Privatization	0	443	2,998	513	0	2,785	650	0
Other than oil sector excl. privatization	561	1,562	1,513	1,983	1,150	1,601	1,706	1,904
Long-term loans	1,730	4,113	3,169	1,753	1,223	961	505	675
Public sector	84	1,578	877	1,538	1,807	1,222	265	555
Private sector	1,646	2,534	2,292	215	-584	-261	240	120
Others	333	278	378	333	113	154	109	60
Leasing loans	333	278	401	348	127	168	123	75
Others	0	0	-23	-15	-15	-15	-15	-15
Short-term	1,909	-470	-1,740	148	-1,253	-1,743	753	1,011
Portofolio investment	559	-294	-446	536	-450	-1,634	882	1,218
Of which: Privatization 2/			-1,308	0	0	-450	450	0
Other investment 3/	1,350	-176	-1,294	-388	-804	-109	-129	-206
Net errors and omissions	**-60**	**-235**	**-596**	**-208**	**78**	**0**	**0**	**0**
Changes in NIR	**1**	**1,722**	**211**	**-1,374**	**-750**	**744**	**326**	**323**
	(In percent of GDP)							
Current account balance	-5.0	-4.9	-5.5	-5.9	-1.3	-2.4	-3.1	-3.2
Changes in net reserve assets	0.0	1.8	0.2	-1.4	-0.5	1.7	1.3	1.3
	(In months of imports of goods and services)							
Gross international reserves	5.5	6.2	5.5	5.0	5.8	5.9	5.8	5.8

Sources: Banco de la Republica; and Fund staff estimates and projections.

1/ Net of capital remittance of the oil sector. In 1999, this includes US$-475 million as a result of the decapitalization of EEB.
2/ Consists of movements in deposits held abroad in response to privatization receipts.
3/ Includes trade credits, short-term borrowing, and deposits held by the Colombian residents in current account abroad net of interest payments of deposits held by nonresidents in Colombia.

Table 6. Colombia: Indicators of External Vulnerability

(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	Projection 2000	2001	2002
Financial indicators						
Public sector debt	24.2	27.5	34.2	34.1	33.8	34.0
Broad money (percent change, 12-month basis)	24.5	10.3	12.8	18.2	14.4	13.1
Private sector credit (percent change, 12-month basis)	25.6	11.9	5.9	14.1	15.7	12.8
90-day time deposit rate (as of September 1999)	23.9	34.6	17.5	...	...	...
90-day time deposit rate (real) (as of September 1999)	5.3	15.3	7.5	...	...	...
External indicators						
Exports (percent change, 12-month basis in U.S. dollars)	10.1	-5.8	8.9	9.2	1.1	5.2
Imports (percent change, 12-month basis in U.S. dollars)	12.8	-5.2	-29.8	20.2	4.2	3.9
Terms of trade (percent change, 12-month basis)	11.4	-7.0	5.0	1.5	-2.7	-1.1
Current account balance	-5.5	-5.9	-1.3	-2.4	-3.1	-3.2
Capital and financial account balance	6.3	4.7	0.4	3.3	3.4	3.4
Of which						
Inward short-term portfolio investment (debt securities, etc.)	-0.4	0.5	-0.5	-1.9	0.9	1.3
Other investment (loans, trade credits, etc.)	-0.9	-0.1	-0.8	0.1	0.0	-0.2
Inward foreign direct investment and long-term flows	7.6	4.3	1.7	5.1	2.5	2.3
Gross official reserves (in U.S. dollars)	9,908	8,741	8,215	9,458	9,784	10,107
Central bank short-term foreign liabilities (in U.S. dollars) 1/	-2.4	0.7	334.3	832.4	832.4	832.3
Short-term net foreign assets of the financial sector (in U.S. dollars)	6,128	5,536	5,051	5,642	5,672	5,629
Official reserves in months of imports of goods and services	5.5	5.0	5.8	5.9	5.8	5.8
Broad money to reserves	3.6	3.8	3.5	3.3	3.2	3.2
Total short-term external debt to reserves 2/	47.8	52.7	72.0	57.2	66.4	58.4
Total external debt 3/	31.5	35.8	41.1	43.1	43.6	44.3
Of which						
Public sector debt	15.8	18.9	23.3	24.8	25.0	25.5
Total external debt to exports of goods, services, and income	222.2	248.8	236.3	223.0	224.8	221.1
External interest payments to exports of goods, services, and income	21.3	25.2	27.4	27.8	30.2	30.5
External amortization payments to exports of goods, services, and income	17.1	17.7	16.9	16.4	17.3	17.3
Exchange rate (per U.S. dollar, period average) (end-October)	1,140	1,426	1,737	...	...	...
Real effective exchange rate appreciation (+) (12-month basis) 4/	-3.2	-4.5	-15.4	...	...	...
Financial market indicators 5/						
Stock market index (end-October)	1,417	1,086	916	...	...	...
Foreign currency debt rating 5/	BBB-	BBB-	BB+	...	...	...
Spread of benchmark bonds (basis points, end of period) 6/ (end-September)	298	641	650	...	...	...

Sources: Ministry of Finance and Public Credit; Banco de la Republica; and Fund staff estimates and projections.

1/ The increase shown for September 1998 reflects a reporting change that takes account of operations with a foreign financial institution. The net international reserves remain unaffected.

2/ Short-term debt is defined by its remaining maturity from 1999 onwards.

3/ There is a data break in 1996 which includes data on the private sector financial debt stock previously not available.

4/ Source: INS. For 1999, the reference month is August.

5/ Standard & Poors.

6/ Consists of spread on US$750 million global ten-year note issued in February 1997 at a spread of 130 basis points.

Table 7. Colombia: Impact of Selected Fiscal Measures

(In percent of GDP)

	Proposal to Congress	Impact of measures		
		2000	2001	2002
Total		**1.7**	**3.5**	**3.7**
Revenue measures		**0.6**	**1.2**	**1.6**
1. National tax reform	By March 31, 2000	--	0.6	0.8
VAT loopholes and widening of income tax base				
2. Territorial tax reform	By March 31, 2001	--	--	0.2
3. Financial transaction tax	Effective from November, 1999. To be extended until 2002	0.6	0.6	0.6
Expenditure measures		**1.1**	**2.3**	**2.1**
1. Creation of the territorial government pension funds	By December 31, 1999	0.5	1.1	0.7
2. Constitutional reform on transfers	By December 31, 1999	--	0.4	0.8
Situado Fiscal	Requires two consecutive	--	0.4	0.4
Participacion Municipal	approvals by congress	--	--	0.4
3. Measures to curtail the current expenditures of local governments (Law 136)	By December 31, 1999	0.08	0.12	0.11
Departments		0.05	0.06	0.05
Local governments		0.02	0.06	0.06
4. Other measures introduced by National Development Plan	Approved	0.08	0.12	0.14
Elimination of retroactividty in severance bonds (territorial)		0.08	0.08	0.09
Collective wage agreement		--	0.03	0.05
5. Pension reform (Law 100)	By December 31, 1999	--	0.1	0.1
6. Wage policies	Approved	0.50	0.50	0.30

Sources: Ministry of Finance; and Fund staff estimates.

Table 8. Colombia: Social Spending

	1990	1991	1992	1993	1994	1995	1996	1997	1998	Projections			
										1999	2000	2001	2002
	(In billions of Colombian pesos)												
Total social spending	**845**	**1,292**	**1,836**	**2,665**	**3,698**	**5,185**	**7,702**	**9,498**	**11,251**	**11,936**	**13,813**	**15,461**	**16,637**
Health	**202**	**331**	**468**	**816**	**1,055**	**1,702**	**2,592**	**3,030**	**3,610**	**4,056**	**4,409**	**4,944**	**5,343**
Central government 1/	35	100	127	298	357	617	1,041	1,225	1,474	1,394	1,584	1,733	1,915
Territorial governments 2/	167	231	341	518	698	1,085	1,551	1,805	2,136	2,662	2,825	3,211	3,428
Departments	128	168	246	367	476	573	808	876	981	1,312	1,259	1,375	1,458
Municipalities	39	64	96	151	222	512	743	929	1,155	1,350	1,567	1,836	1,970
Education	**551**	**768**	**1,087**	**1,500**	**2,183**	**2,803**	**4,213**	**5,353**	**6,373**	**6,422**	**7,211**	**8,034**	**8,540**
Central government 3/	201	285	360	469	705	998	1,559	2,181	2,675	1,929	2,516	2,794	2,964
Territorial governments 2/	350	483	726	1,031	1,478	1,804	2,654	3,172	3,698	4,492	4,694	5,240	5,576
Departments	295	391	580	801	1,158	1,382	1,910	2,162	2,457	3,105	3,063	3,333	3,554
Municipalities	56	92	146	231	320	422	744	1,010	1,241	1,388	1,631	1,908	2,022
ICBF 4/	**92**	**122**	**186**	**233**	**297**	**437**	**586**	**735**	**851**	**976**	**1,112**	**1,265**	**1,396**
Central government 5/	88	116	175	217	276	398	526	655	745	853	963	1,079	1,199
Municipalities	4	7	11	16	21	38	61	80	105	123	149	185	197
SENA 6/	--	**71**	**95**	**116**	**163**	**244**	**311**	**379**	**418**	**482**	**554**	**621**	**689**
Social safety net program	--	--	--	--	--	--	--	--	--	--	**529**	**597**	**669**
	(In percent of GDP)												
Total social spending	3.6	4.2	4.7	5.2	5.5	6.1	7.6	7.8	7.9	7.8	7.8	7.8	7.5
Of which: Funded by the central government 7/	3.4	4.1	4.5	4.8	5.0	5.5	6.6	6.8	6.8	6.6	6.7	6.7	6.4
Education	0.9	1.1	1.2	1.6	1.6	2.0	2.6	2.5	2.5	2.6	2.5	2.5	2.4
Health	2.3	2.5	2.8	2.9	3.2	3.3	4.2	4.4	4.5	4.2	4.1	4.0	3.8
Other	0.4	0.6	0.7	0.7	0.7	0.8	0.9	0.9	0.9	1.0	1.2	1.2	1.2

1/ Includes transfers (pensions, severance payments, contributions to health funds and subsidies) and investments.

2/ Includes expenditures funded by constitutionally mandated transfers from the central government (*Situado Fiscal* for departments and *Participacion Municipal* for municipalities)

3/ Includes transfers (pensions, severance payments, contribution to education funds and subsidies to public universities), goods and services and investments.

4/ Welfare services agency.

5/ Includes transfers and investments related to maintenance of the agency.

6/ Provides training for youth entering the labor force and unemployed workers.

7/ Including direct expenditures by the central government and constitutionally mandated transfers.

Table 9. Colombia: Medium-Term Macroeconomic Outlook

	1997	1998	Projection 1999	2000	2001	2002	2003	2004
I. Output, Prices, and Trade								
(Annual percentage change)								
Real GDP	**3.2**	**0.4**	**-3.5**	**3.0**	**3.8**	**4.8**	**4.5**	**4.5**
Oil sector	2.7	18.0	10.3	-4.4	-11.9	-10.3	-18.0	-6.2
Non-oil sector	3.3	-0.4	-4.3	3.5	4.7	5.5	5.4	4.9
Consumer prices								
End of period	17.7	16.7	11.0	10.0	8.0	6.0	5.0	4.0
Period average	18.5	18.7	11.3	11.2	8.8	7.0	5.0	4.0
Terms of trade (deterioration -)	**11.4**	**-7.0**	**5.0**	**1.5**	**-2.7**	**-1.1**	**0.2**	**0.2**
Exports of goods and nonfactor services	**7.9**	**-5.3**	**6.2**	**8.7**	**1.2**	**4.8**	**7.7**	**8.3**
Of which								
Crude oil (1,000 bpd)	5.4	32.9	17.0	-4.9	-16.0	-20.3	-7.8	8.6
Imports of goods and nonfactor services	**11.7**	**-4.8**	**-23.5**	**15.9**	**3.6**	**3.7**	**7.5**	**7.7**
Domestic demand	**3.8**	**-1.4**	**-8.4**	**3.3**	**3.4**	**4.1**	**4.5**	**3.8**
(In percent of GDP)								
II. Nonfinancial Public Sector								
Public sector revenue	**27.4**	**26.5**	**27.3**	**27.5**	**27.5**	**27.6**	**26.9**	**26.7**
Public sector expenditure	**31.2**	**30.3**	**33.6**	**31.1**	**30.0**	**29.2**	**28.2**	**27.7**
Of which								
Fixed capital formation	9.1	7.8	8.4	7.7	7.3	6.9	6.8	6.8
Primary balance	**-1.1**	**-0.6**	**-2.3**	**0.6**	**1.5**	**2.5**	**2.4**	**2.4**
Overall balance	**-3.7**	**-3.9**	**-6.3**	**-3.6**	**-2.5**	**-1.5**	**-1.3**	**-1.0**
III. Saving and Investment								
Gross national saving	**15.5**	**13.7**	**14.0**	**16.0**	**17.9**	**18.8**	**18.4**	**18.6**
Private sector	9.7	8.9	11.3	11.6	12.8	13.1	12.6	12.4
Public sector 1/	5.8	4.8	2.7	4.4	5.1	5.6	5.9	6.3
External saving	**-5.5**	**-5.9**	**-1.3**	**-2.4**	**-3.1**	**-3.2**	**-3.5**	**-3.4**
Gross domestic investment	**21.0**	**19.6**	**15.3**	**18.4**	**21.0**	**22.0**	**21.9**	**22.0**
Private sector	11.5	11.7	6.7	10.5	13.6	15.0	15.0	15.1
Public sector	9.6	7.9	8.6	7.9	7.5	7.0	6.9	6.9

Sources: Colombian authorities; and Fund staff estimates and projections.

1/ Includes the balance of the quasi-fiscal operations of the Banco de la Republica.

Table 10. Colombia: Merchandise Trade Projections

	1997	Prel. 1998	Projection 1999	2000	2001	2002	2003	2004
	(In millions of U.S. dollars, unless otherwise indicated)							
Total exports	12,057	11,362	12,377	13,519	13,662	14,376	15,574	16,981
Value (percent change)	10.1	-5.8	8.9	9.2	1.1	5.2	8.3	9.0
Volume, percent change	6.6	5.4	5.1	6.0	2.2	4.1	6.2	7.3
Unit value, percent change	3.3	-10.6	3.7	3.0	-1.1	1.0	2.0	1.7
Coffee	2,259	1,891	1,409	1,516	1,547	1,578	1,609	1,640
Value (percent change)	43.3	-16.3	-25.5	7.6	2.0	2.0	2.0	1.9
Volume (million bags)	10.3	10.6	9.9	10.6	10.6	10.6	10.6	10.6
Unit value, f.o.b. (US$/lb)	1.7	1.3	1.1	1.1	1.1	1.1	1.1	1.2
Percentage of total exports	18.7	16.6	11.4	11.2	11.3	11.0	10.3	9.7
Petroleum products	2,707	2,298	3,673	3,649	2,865	2,286	2,330	2,514
Value (percent change)	-4.1	-11.8	55.0	2.3	-21.9	-21.5	-7.3	10.0
Percentage of total exports	22.5	20.2	29.7	27.0	21.0	15.9	15.0	14.8
Crude oil	2,338	2,063	3,198	3,271	2,556	2,006	1,860	2,045
Volume (1,000 bpd)	343	456	533	507	426	340	313	340
Unit value (US$/bbl)	18.7	12.7	16.4	17.6	16.4	16.2	16.3	16.5
Refined petroleum products	370	236	475	377	310	279	471	468
Coal	886	934	1,009	1,232	1,203	1,225	1,263	1,605
Nonmonetary gold	183	92	92	92	92	92	92	92
Nickel	161	118	126	126	126	126	126	126
Emerald	141	83	83	83	83	83	83	83
Others (Free trade zone)	528	548	588	636	643	674	721	785
Nontraditional exports	5,192	5,399	5,399	6,187	7,103	8,313	9,350	10,138
Value (percent change)	11.5	4.0	0.0	14.6	14.8	17.0	12.5	8.4
Percentage of total exports	43.1	47.5	43.6	45.8	52.0	57.8	60.0	59.7
Total imports, f.o.b	14,771	14,008	9,836	11,823	12,323	12,803	13,902	15,095
Value (percent change)	12.8	-5.2	-29.8	20.2	4.2	3.9	8.6	8.6

Sources: DANE; Banco de la Republica; and Fund staff estimates.

Table 11. Colombia: External Debt and Debt-Service Projections

	1997	1998	1999	2000	2001	2002	2003	2004
			Projection					
	(In millions of U.S. dollars)							
Total debt outstanding	33,575	35,794	35,859	37,075	37,954	38,950	41,482	43,933
Medium- and long-term 1/	28,840	31,185	32,164	33,293	33,922	34,672	36,833	38,894
Short term	4,734	4,609	3,695	3,782	4,032	4,278	4,649	5,039
Public sector debt outstanding	16,820	18,840	20,359	21,338	21,738	22,420	23,813	25,025
Medium- and long-term 1/	15,916	17,972	19,466	20,758	21,084	21,692	23,012	24,150
Short term	904	867	893	581	654	728	802	875
Private sector debt outstanding	16,755	16,954	15,500	15,737	16,215	16,530	17,669	18,908
Medium- and long-term 1/	12,924	13,212	12,698	12,535	12,837	12,980	13,822	14,745
Short term	3,831	3,742	2,802	3,202	3,378	3,550	3,847	4,163
Total debt service	6,841	6,961	7,589	8,141	9,712	10,209	9,934	9,777
Public sector	3,625	3,334	3,434	3,514	4,620	4,840	5,046	4,638
Amortization	2,359	2,133	2,084	1,966	2,869	3,001	2,939	2,514
Interest	1,266	1,201	1,350	1,548	1,751	1,838	2,107	2,124
Private sector	3,216	3,627	4,155	4,626	5,092	5,369	4,888	5,139
Amortization	1,897	2,277	2,934	3,445	3,920	4,160	3,532	3,737
Interest	1,319	1,350	1,221	1,181	1,172	1,210	1,357	1,402
	(In percent of GDP)							
Total debt	31.5	35.8	41.1	43.1	43.6	44.3	44.2	43.8
Public sector	15.8	18.9	23.3	24.8	25.0	25.5	25.4	25.0
Private sector	15.7	17.0	17.8	18.3	18.6	18.8	18.8	18.9
	(In percent of exports of goods, services, and income)							
Total debt stock	222.2	248.8	236.3	223.0	224.8	221.1	219.7	215.5
Total debt service	45.3	48.4	50.0	49.0	57.5	58.0	52.6	48.0
Public sector	24.0	23.2	22.6	21.1	27.4	27.5	26.7	22.8
Private sector	21.3	25.2	27.4	27.8	30.2	30.5	25.9	25.2

Sources: Banco de la Republica; and Fund staff projections.

1/ Includes leasing.

COLOMBIA: FUND RELATIONS
(As of October 31, 1999)

I. Membership Status:
Joined: 12/27/45
Status: Article XIV

II	General Resources Account	SDR Million	Percent of Quota
	Quota	774.00	100.0
	Fund holdings of currency	488.20	63.1
	Reserve position in Fund	285.80	36.9

III.	SDR Department:	SDR Million	Percent Allocation
	Net cumulative allocation	114.27	100.0
	Holdings	95.11	83.2

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Rate Arrangement:

In January 1994, the Banco de la Republica (BR) adopted a managed float of the exchange rate vis-à-vis the U.S. dollar within a 14 percentage point band. In May 1997, to limit foreign capital inflows further, the nonremunerated deposit requirement (in pesos) for 18 months at the BR was extended to cover external loans of all maturities, except for loans to finance imports of capital goods, and trade credits with a maturity of six months or less. In September 1998, the authorities reduced the deposit requirement from 25 percent to10 percent, and the period was lowered from 12 months to 6-month duration. Multiple currency practices that result from taxes on profit remittances from direct investment in Colombia and on foreign exchange earnings from personal services and transfers, and export tax credit certificates (CERTs) have not been approved under Article VIII. June 1999, the BR depreciated the exchange rate band by 9 percent, widened it from 14 to 20 percentage points, and reduced its slope from 13 to 10 percent. In September 1999 the BR eliminated the band, floating the peso. At end-October 1999, the BR's selling exchange rate was Col$1,965.4 per U.S. dollar.

VIII. Last Article IV consultation and recent contacts:

The 1998 Article IV consultation was concluded by the Executive Board on December 9, 1998 (SM/98/249). A staff visit took place in April and May 1999 followed by program discussions at headquarters from August to October.

IX. Recent Technical Assistance:

Dept.	Purpose	Time of Delivery
FAD	Advise on local government taxation and transfers	January 1995
MAE	Advise on monetary programming and central bank Intervention procedures	March 1995
FAD	Advise on local government indebtedness	June 1995
LEG/MAE	Legal and accounting aspects of currency issue	November 1995
MAE	Advise on interbank and public debt markets	May 1996
MAE	Advise on financial sector reform	July 1997
STA	Multisector mission	November 1997
FAD	Advise on customs administration	November 1997
FAD	Advise on tax administration	February 1998
STA	Advise on national accounts statistics	March 1998
STA	Advise on government finance statistics	May 1998
MAE	Financial sector stability assessment (FSSA)	May 1999
STA	Advise on banking statistics	October 1999
FAD	Advise on tax policy	November 1999
FAD	Advice on tax administration	December 1999

X. Resident Representative: None

Colombia: Schedule of Purchases Under the Extended Fund Facility 1999-2002

Date	Amount (In millions of SDRs)	Conditions
December 1999	150.5	Board approval
February 15, 2000	150.5	Observance of end-December 1999 performance criteria
May 15, 2000	150.5	Observance of end-March 2000 performance criteria
August 15, 2000	150.5	Observance of end-June 2000 performance criteria and completion of first review
November 15, 2000	150.5	Observance of end-September 2000 performance criteria
February 15, 2001	150.5	Observance of end-December 2000 performance criteria and completion of second review
May 15, 2001	150.5	Observance of end-March 2001 performance criteria
August 15, 2001	150.5	Observance of end-June 2001 performance criteria and completion of third review
November 15, 2001	150.5	Observance of end-September 2001 performance criteria
February 15, 2002	150.5	Observance of end-December 2001 performance criteria and completion of fourth review
May 15, 2002	150.5	Observance of end-March 2002 performance criteria
August 15, 2002	150.5	Observance of end-June 2002 performance criteria and completion of fifth review
November 15, 2002	150.5	Observance of end-September 2002 performance criteria

Colombia: Projected Payments to the Fund as at October 31, 1999

(In millions of SDRs)

	Overdue	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Beyond	Total
Obligations from existing drawings													
1. Principal													
a. Repurchases	0	0	0	0	0	0	0	0	0	0	0	0	0
b. ESAF/SAF repayments	0	0	0	0	0	0	0	0	0	0	0	0	0
2. Charges and interest 1/													
a. on Fund credit	0	0	0	0	0	0	0	0	0	0	0	0	0
b. on use of SDRs	0	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	7.4
Total obligations 2/	0	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	7.4
(percent of quota)	0	0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1
Obligations from prospective drawings													
1. Principal													
a. Repurchases	0	0	0	0	0	0	50.2	150.5	250.8	326.1	326.1	852.8	1956.5
b. ESAF/SAF repayments	0	0	0	0	0	0	0	0	0	0	0	0	0
2. Charges and interest 1/													
a. on Fund credit	0	0.8	17.9	44.6	70.8	84.9	84.8	81.1	73.1	60.8	46.7	61.1	626.6
b. on use of SDRs	0	0	0	0	0	0	0	0	0	0	0	0	0
Total obligations 2/	0	0.8	17.9	44.6	70.8	84.9	135	231.6	324	386.9	372.8	914	2583.1
(percent of quota)	0	0.1	2.3	5.8	9.1	11	17.4	29.9	41.9	50	48.2	118.1	333.7
Cumulative (existing and prospective)													
1. Principal													
a. Repurchases	0	0	0	0	0	0	50.2	150.5	250.8	326.1	326.1	852.8	1956.5
b. ESAF/SAF repayments	0	0	0	0	0	0	0	0	0	0	0	0	0
2. Charges and interest 1/		1.0	18.6	45.3	71.5	85.6	85.5	81.8	73.8	61.5	47.4	61.8	634.0
a. on Fund credit	0	0.8	17.9	44.6	70.8	84.9	84.8	81.1	73.1	60.8	46.7	61.1	626.6
b. on use of SDRs	0	0.2	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	7.4
Total obligations 2/	0	0.9	18.6	45.3	71.5	85.6	135.7	232.3	324.7	387.7	373.5	914.7	2590.5
(percent of quota)	0	0.1	2.4	5.9	9.2	11.1	17.5	30	41.9	50.1	48.3	118.2	334.7

1/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for SAF, ESAF, and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.

2/ Overdue obligations (if applicable) will be settled in full at close of business November 1, 1999.

COLOMBIA: FINANCIAL SYSTEM DIFFICULTIES—THE POLICY RESPONSE

1. **Debtor relief programs**. The government has launched three debtor relief programs, in November 1998, March 1999, and October 1999. The November 1998 package included: (i) refinancing at preferential interest rates to homeowners whose outstanding balance on indexed housing loans went up more than 20 percent in nominal terms over the course of the previous year; (ii) refinancing for housing borrowers who had arrears for three months or less on their mortgage obligation; and (iii) mortgage payment relief for low income homeowners who lost their jobs. The March 1999 program contained: (i) a reduction of interest rates (by 3 to 5 percentage points) for mortgage loans that were current and whose interest rates were above the (UPAC)[1] monetary correction plus 10 percentage points; and (ii) credit subsidies for mortgage loan payments in arrears prior to May 31, 1999. Faced with prospects of numerous legal actions by debtors against mortgage institutions, the authorities launched yet another mortgage debt relief program in October 1999 within a comprehensive draft framework law for the mortgage sector. The October 1999 plan offers a 12 percent average debt relief on mortgage obligations outstanding on December 31, 1999 by recalculating these obligations (starting in June 1988) with a new inflation index, the UVR, based on the past average three-month inflation rate. To (partially) offset the reduction of their mortgage claims, financial institutions are offered long-term treasury obligations at below market rates (UVR + 4 percent per year). In turn, to allow the treasury to redeem these obligations, all financial institutions are subjected to compulsory investment requirements in treasury bonds (TDR-bonds) earning UVR. The November 1998 plan covered around 9 percent of all mortgages at a cost of Col$230 billion. The March 1999 plan covered around 65 percent of all mortgages at a cost of Col$340 billion. The October 1999 plan is expected to cover all mortgages (except those in arrears) at a cost of Col$1,600 billion.

2. **Public banks**. In June 1999, the largest public bank (Caja Agraria) entered a process of liquidation and a new smaller agricultural bank (Banco Agrario) was created with the productive assets and deposits of Caja Agraria. The purpose of Banco Agrario is to provide credit to small farmers and financial services to remote areas of the country. In addition, the government plans to restructure and divest all the other public banks. Nonperforming assets will be transferred to public asset management companies. Within this strategy, a large fraction of the assets and liabilities of BCH, which faces severe liquidity difficulties, were transferred to Granahorrar. Banco del Estado and Uconal may be merged and restructured as a single entity before being sold. However, the first divestment on the agenda (that of BCH and Granahorrar) is not expected to occur before mid-2000. The total amount of public funds committed to resolve the financial distress of public banks could reach US$4.2 billion, or 5.0 percent of GDP. This includes the injection of new funds into the banks as subordinated debt and equity capital, and the assumption of some of their contingent debts. However, assuming that the public institutions can be sold at 1.2 times their book value and that 20 percent of the value of nonperforming assets will be recovered, this cost could be reduced to about 2 percent of GDP.

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[1] *Unidad de poder adquisitivo constante*—an indexing unit.

3. **Recapitalization plan for viable private institutions**. In May 1999, the government announced a recapitalization plan under which the government extends, through FOGAFIN, credit lines to the shareholders of troubled institutions. These lines, which are given in the form of FOGAFIN bonds, are used by the shareholders to recapitalize the financial institutions. The credit line cannot exceed 80 percent of the funds needed to bring the capital of the institution to 10 percent and must be repaid in three to seven years, with a one-year initial grace period on the payment of interest. Shareholders must bring the institution's capital back to zero and provide at least 20 percent of the total recapitalization funds. The interest rate charged on the loan is DTF (90-day fixed term deposit rate) + 2 percent during the first three years and DTF + 3 percent during the last four years. The loan is guaranteed with the shareholder's stake in the institution and additional collateral so that at least 133 percent of the loan is covered. These lines of credit are funded with bonds issued by FOGAFIN and consequently do not imply cash disbursements for the government. The participating institutions are required to sign a set of covenants with FOGAFIN, that will be monitored by a representative of FOGAFIN in situ. To benefit from the plan, financial institutions must initially write-off impaired assets. As of September 1999, eleven financial institutions, including five banks, three finance corporations, and three financial credit corporations had requested access to the recapitalization lines, and three banks (Colpatria, Union, and Superior) had already been recapitalized. The total recapitalization funds (for deals concluded and in process) amounted to Col$500 billion, of which Col$350 billion were provided by FOGAFIN.

4. **Provisioning of bad assets.** In July 1999, the superintendency of banks (SBC) issued a number of regulations to raise the level of provisioning of bad assets to international standards within three years. These included: (i) a provisioning of one percent on total loans, to be established during a period of three years (starting in July 1999); (ii) a reduction (starting in July 2000) in the value of collateral that can be deducted from provisioning requirements, and a shortening of the deadlines for further progressive reductions in the value of this collateral; (iii) the elimination (starting in July 2000) of automatic revaluations of collateral, based on a price index; (iv) the elimination (starting in July 2000) of the authorization to reverse provisions after a bank has received collateral in payment for a loan; and (v) starting in January 2002, the value of collateral in the form of machines or equipment will no longer be deductible from provisioning requirements.

5. **Corporate restructuring**. In July 1999, the SBC also issued regulations to facilitate the restructuring of corporate debt. These regulations defined conditions under which the classification of a restructured loan could be upgraded. Specially favorable treatment is granted to loan restructurings undertaken before end-December 1999. In such cases, provisions can be fully reversed when: (i) the loan can be classified in category A; or (ii) the debtor has paid back part of the principal of the loan; or (iii) the debtor has honored the interest rate obligations of the loan for at least two consecutive periods. To further encourage banks to restructure short-term loans into longer-term obligations, the authorities have also set aside public financing resources to provide medium-term to long-term loans to those banks engaging into restructuring operations.

6. **New financial sector law**. The new law was passed by congress in June 1999. Its main provisions are: (i) an increase in minimum capital for all types of financial institutions; (ii) the strengthening of procedures for the timely detection of troubled institutions and the introduction of automatic "prompt corrective actions" by the SBC; (iii) the introduction of time limits for different procedures undertaken by the SBC such as: the decision on whether to liquidate or close an institution (two months); the intervention without liquidation (one year); and the liquidation of an institution (four years); (iv) the tightening of clauses under which a financial institution may be intervened; (v) increased flexibility in the design of some financial transactions; and (vi) new powers to FOGAFIN to expedite mergers and acquisitions, purchase assets from and make loans to financial institutions, and promote securitization.

7. **Lending of last resort facilities**. To provide liquid resources to those financial institutions that have suffered deposit withdrawals, the central bank has increased the amount of REPO transactions and eased access to the rediscount facility. In addition, it has streamlined its longer-term liquidity support facilities to expedite access to these facilities and ensure that the funds are available in time to limit settlement risk in the check clearing house.

Colombia: Statistical Issues

1. A multisector statistics mission from STA visited Colombia in November 1997 and made extensive recommendations to improve the quality and timeliness of Colombia's data. Since then visits by STA staff have provided follow-up technical assistance. The data provided by the authorities to the Fund are generally adequate for surveillance; recent coordination among compiling agencies have served to reduce or eliminate significant gaps in some source data that compromised the usefulness of the public finance data. Colombia has subscribed to the Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB).

Real sector

2. The National Department of Statistics (DANE) is responsible for quarterly data, while the Banco de la Republica (BR) compiles the financial accounts. In 1999, the DANE revised the national accounts data by introducing a new base year, 1994, for annual national income accounts in constant prices (the previous base year was 1970); improved the trade data by incorporating transactions in the free trade zones; and included part of the illegal activities in the national accounts.

Government finance statistics

3. In an effort to reconcile above-the-line data on revenue and expenditure with financing data, and as a by-product of this process produce more complete, reliable, and timely data on the financing of the nonfinancial sector, the government has prepared a new and more comprehensive methodology to monitor and report public finance data. It is expected that the new methodology will become the standard basis for the ongoing monitoring of fiscal developments under the Fund-supported program.

4. Additional improvements are needed to:

- develop timely and reliable data on local government finances, (revenue and expenditure), reconciling data compiled by the budget office with the national accounting office fiscal data reports; and

- improve monitoring of floating debts by gradually extending the coverage from the central government to include main public enterprises.

Financial sector statistics

5. An October 1999 money and banking statistics follow-up mission collaborated with the BR in improving the sectorization of the balance sheet of the central bank based on the new plan of accounts. The mission recommended that the secorization of the analytical accounts for the other depository corporations be improved. This could be done in the short term through the use of additional information to be reported by these institutions. In the medium term, the change of the unified plan of accounts was recommended to incorporate

economic criteria, such as residency and subsector of the domestic economy for identifying the counterpart of the transaction.

Balance of payments and external debt

6. Since late 1994, the BR has been developing quarterly balance of payments data and, more recently, it adopted BPM5 as recommended by the 1997 STA mission. The new balance of payment statistics extended the coverage of the trade account by including transactions in the free trade zones, improved the current surveys, particularly of the service sector, to enhance coverage and consistency in the methodology; and improved the capital account data based on actual disbursement rather than registers. However, several issues still remain:

- the process of data compilation should be improved by enhancing coordination between the BR and DANE; and

- external debt data should be improved by obtaining monthly figures on public sector short-term external debt, and by refining the calculation of interest payments for the private sector debt.

Colombia: Core Statistical Indicators
as of November 17, 1999

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP GNP	External Debt
Date of latest observation	10/99	10/13/99	10/99	9/30/99	10/1/99	10/99	Sep. 1999	Aug. 1999	1999 Q2	Sep. 1999	1999 Q2	1999 Q2
Date received	11/1/99	10/15/99	11/11/99	10/15/99	10/15/99	10/16/99	Oct. 1999	Sept. 1999	Oct. 1999	Aug. 1999	Sep. 1999	Sep. 1999
Frequency of data	Daily	Daily	Daily	Monthly	Weekly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Daily	Weekly	Weekly	Monthly	Weekly	Daily	Monthly	Monthly	When requested	When requested	When requested	When requested
Source of data 2/	BR	BR	BR	BR	BR	BR	BR	BR/DANE	BR	CONFIS	DANE/DNP	BR
Mode of Reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	Fax/E-mail	E-mail
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of Publication	Daily	Daily	Daily	Monthly	Weekly	Daily	Monthly	Monthly	Quarterly	--	Quarterly	Quarterly

1/ Central administration.
2/ BR = Banco de la Republica; DANE = National Department of Statistics; DNP = National Department of Planning; CONFIS = Consejo Superior de Politica Fiscal.

COLOMBIA: RELATIONS WITH THE WORLD BANK GROUP

I. BACKGROUND

1. Since 1993 Colombia has made average net repayments to the World Bank of US$280 million a year. The range of programs has encompassed various sectors: agriculture, health, education, transportation, water supply and sewerage, public sector management, and urban development. The World Bank continues to support programs in these sectors.

II. OBJECTIVES

2. The overriding objective of the World Bank's assistance program for Colombia continues to be the support of the government's efforts in pursuing poverty reduction, social development, and sustainable growth. These objectives are to be achieved by interventions in six strategic areas: (i) peace and development; (ii) rural development; (iii) human capital; (iv) public sector responsiveness and efficiency; (v) infrastructure services; and, (vi) sustainable development.

III. LENDING

3. The Colombia Country Assistance Strategy (CAS) progress report that was considered by the Bank's Executive Board on November 18, 1999, proposes a "high case" lending program of an average of US$433 million for fiscal years 1998–2001. Lending in FY 1999 amounted to US$142 million, including the Toll Road Concession (US$137.0 million) and Youth Development (US$5.0 million) loans. So far in FY2000, the Bank has approved an investment (Cartagena Water and Sewerage) loan of US$85 million an adjustment operation in the amount of US$500 million, to support a financial sector restructuring operation in concert with the IADB. Also under preparation, for FY 2000 is a Social Safety Net loan of US$250 million to support the strengthening and expansion of the social safety net in Colombia.

IV. NONLENDING SERVICES (NLS)

4. The Bank is now preparing, jointly with the government, AAAs (Analytical and Advisory Activities) on a number of topics to strengthen its policy dialogue and as the analytical underpinning of forthcoming operations. Also, the Bank is undertaking analytical work to assist the government in identifying the groups that are suffering the most from the economic recession, as well as those who will bear the brunt of fiscal austerity measures. Additional studies deal with regional trade integration, corruption, and emissions of greenhouse gases.

5. As part of the Bank's analytical work on peace and development, three studies were commissioned: (i) on the international experience of post conflict reconstruction that could be relevant to Colombia; (ii) on the various forms of violence and their impact on social capital; and (iii) on the structural determinants of conflict in Colombia.

V. WORLD BANK TECHNICAL ASSISTANCE (TA)

6. The World Bank is active in securing grants from various sources, including bilateral donors to support project preparation, economic and sector work, supervision and implementation issues.

VI. IFC

7. IFC investment in Colombia increased markedly in FY99 to US$85 million. IFC's strategy is to extend its assistance to the Colombian private sector with a continued focus on: (i) financial markets; (ii) infrastructure; and (iii) selective direct investments in manufacturing and services.

VII. MIGA

8. Colombia became a full member of MIGA on November 30, 1995. As of June 30, 1999, MIGA's exposure in Colombia amounts to US$155 million, of which 63 percent is in infrastructure, 23 percent in mining, and 15 percent in the financial sector, for a total of five Contracts of Guarantee.

Colombia: Financial Relations with the World Bank Group

(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursements	Undisbursed Amounts
	I. IBRD operations (as of October 15, 1999)		
Loans fully disbursed 1/	**6,910.7**	**6,910.7**	**0.0**
Current operations	**1,112.1**	**535.7**	**576.4**
Agricultural and rural development	56.0	17.3	38.7
Public sector management	12.5	1.1	11.4
Education	142.2	42.7	99.5
Population, health, and nutrition	50.0	21.6	28.4
Transportation	202.1	59.7	142.4
Urban development	155.0	69.6	85.4
Water supply and sewerage	145.0	60.1	84.9
Natural resource management	39.0	21.7	17.3
Power	260.3	213.5	46.9
Financial sector	45.0	27.7	17.3
Multi-sector	5.0	0.7	4.3
Total	**8,022.8**	**7,403.4**	**576.4**
Repayments 2/		5,677.1	
Total disbursed and outstanding		1,726.3	

II. IFC Operations (as of May 31, 1999)

	Loans	**Equity (+Quasi)**	**Partici-pation**	**Total**
Total commitments 3/	89.7	20.7	42.8	153.2
Total undisbursed	18.1	3.7	0.0	21.8

III. IBRD Loan Transactions (as of July 31, 1999)

	1994	**1995**	**1996**	**1997**	**1998**	**1999**
Disbursements	305.4	323.9	192.8	152.0	172.2	237.5
Repayments	912.8	536.9	344.5	379.8	394.3	238.8
Net disbursements	-607.3	-212.3	-151.7	-227.8	-221.6	-1.4

Source: World Bank.

1/ Includes one IDA credit.
2/ Includes repayment to third parties.
3/ After cancellations, terminations, exchange adjustments, repayments, writeoffs, and sales.

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IMF Concludes Article IV Consultation with Colombia

On December 20, 1999 the Executive Board concluded the Article IV consultation with Colombia,[1] and approved a three-year extended arrangement in an amount equivalent to SDR 1.957 billion (for further details, see press release number 99/63).

Background

For several decades, Colombia achieved significant economic progress with steady and strong economic growth and good balance in its external accounts. In recent years this performance has given way to slow growth and widening economic imbalances. To a considerable extent, the deterioration has been the result of unsustainable fiscal policies, external shocks, and a difficult internal security situation. The weak fiscal policies reflected the introduction earlier in the 1990s of new expenditure programs and a constitutionally mandated system of revenue transfers to the territorial governments. After taking office in August 1998, the Pastrana administration took several measures in an effort to address the difficult fiscal situation; these included spending cuts, a widening of the VAT base, higher fuel taxes, and stronger tax enforcement. Despite these measures, the nonfinancial public sector deficit rose to about 4 percent of GDP and the current account deficit widened to near 6 percent of GDP. The financial sector was beginning to show clear signs of distress by late 1998.

The recession intensified in 1999; the unemployment rate rose to a record 20 percent in September, while inflation fell to 9½ percent (from nearly 18 percent a year earlier) and the current account deficit came down sharply. The fiscal position deteriorated markedly during the first half of 1999, largely as a result of weak tax collections and higher outlays on interests, wages, and pensions. As market sentiment toward Colombia remained unfavorable, the peso came under repeated pressure, and on September 27, the central bank allowed the currency to float.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

To head off a system-wide crisis in the financial sector, the government has introduced several measures since late 1998, including programs to assist savings and loans institutions, financial cooperatives, and mortgage holders; recapitalize viable private banks; and deal with the serious problems of the public banks through restructuring, recapitalization, and eventual divestment.

Executive Board Assessment

Directors noted that, after several decades of sound economic management and strong economic growth, Colombia's economic and financial situation had deteriorated in recent years. Directors observed that the weak performance resulted mainly from growing fiscal imbalances, adverse external shocks, and a difficult internal security situation. They commended the authorities for the corrective fiscal and financial sector restructuring measures taken recently to begin to address the situation, and endorsed Colombia's medium-term economic program.

Directors emphasized that substantial fiscal consolidation, the implementation of the financial sector restructuring plan, the pursuit of the flexible exchange rate, and the acceleration of other key structural reforms will be critical in helping to restore the strong economic growth necessary to promote employment and alleviate poverty.

Directors welcomed the authorities' ambitious medium-term fiscal consolidation plan. They emphasized the importance of a strong commitment to tax reform and tax enforcement, and observed that efforts under way to improve tax collection and strengthen tax administration—combined with measures aimed at broadening the value-added tax and income-tax bases—should help to achieve the fiscal objectives of the program.

Several Directors expressed concern about the distortionary nature of the financial transactions tax, and encouraged the authorities to phase it out as the revenue situation improves. They recommended that territorial government tax reform be enacted expeditiously to enforce reforms of the revenue-sharing system. Directors supported the authorities' intention to exercise firm control over non-interest expenditure, while protecting the gains in social spending that have been achieved in recent years.

Directors welcomed the program's emphasis on streamlining Colombia's system of fiscal decentralization, as well as the plans to help deal with the underfunded liabilities of the public pension systems. The efforts to strengthen control over the finances of territorial governments with debt servicing problems were also welcomed.

Directors considered that the authorities' decision to float the peso was appropriate, and supported their intention to follow a transparent foreign exchange market intervention policy so as to further contribute to a recovery of confidence. They were generally supportive of the reduction in central bank interest rates over the past few months, in light of the easing of inflationary pressures, but recommended that caution be exercised with regard to further steps in that direction until confidence is restored and until such steps can be supported by a stronger fiscal position.

Most Directors considered that inflation targeting could provide a transparent and credible framework for guiding monetary policy in Colombia, and encouraged the authorities to proceed with the implementation of such a framework. Some Directors noted, however, the need to ensure that the necessary preconditions for such a framework to be successful are in place before its adoption. In this regard, some Directors emphasized the need to ensure the operational independence of the central bank.

Directors commended the authorities for their prompt action to strengthen the financial system as it came under increasing stress. They noted that the financial system restructuring strategy was sound, but that important challenges remain in executing the strategy for the public banks, the mortgage sector, and the recapitalization program for private banks, adding that close vigilance is warranted in the period ahead. Directors welcomed the amendments to the banking law that were adopted earlier this year, but noted that a strengthening of supervisory practices will be required. They emphasized the need for tight control over the operations of public banks in the period until they have been divested.

With regard to other structural reforms, Directors endorsed the authorities' plan and policies in the areas of privatization, foreign direct investment, and private sector involvement in infrastructure projects, which hold out the promise of creating a more efficient private-based economy. A few Directors noted that labor market reform was not being vigorously pursued at this time, and urged the authorities to keep this issue on the agenda to help provide further impetus to the recovery.

Directors pointed to the challenges and risks facing the authorities' economic program, including the unsettled security situation, the possibility of a slower-than-expected recovery in economic growth, and the difficulties that might arise in securing political support for the government's reform agenda, as well as the program's heavy reliance on privatization proceeds. In this regard, Directors were encouraged by the political support evidenced by the passage of the tight budget for 2000, and by the authorities' intention to adopt additional measures, if needed, to ensure that their economic objectives remain achievable.

Directors welcomed the authorities' decision to take the necessary steps to accept the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement by the end of the Extended Arrangement, and encouraged them to proceed quickly to achieve this.

Directors also noted that the provision of data to the Fund was adequate for surveillance and welcomed the authorities' intention to continue working with the Fund staff to improve the economic databases.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Colombia: Selected Economic Indicators

	1995	1996	1997	Prel. 1998	Proj. 1999
(Annual percentage change, unless otherwise indicated)					
National income and prices					
Real GDP	5.2	2.1	3.2	0.4	-3.5
Consumer prices (end of period)	19.5	21.6	17.7	16.7	11.0
Nominal exchange rate 1/ (depreciation -)	-10.4	-13.6	-10.0	-25.1	...
Real effective exchange rate 1/2/ (depreciation -)	-3.5	10.4	-3.2	-4.5	...
Money and credit 3/					
Base money	20.5	5.7	25.0	-16.6	21.7
Broad money	27.3	30.0	24.5	10.3	12.8
Private sector credit	30.5	23.9	18.7	8.2	2.2
Broad money (as ratio to net international reserves)	3.4	3.6	3.5	3.9	3.7
(In percent of GDP, unless otherwise indicated)					
External sector					
Current account	-5.0	-4.9	-5.5	-5.9	-1.3
Capital and financial account balance	5.1	6.9	6.3	4.7	0.4
External debt	27.9	31.6	31.5	35.8	41.1
Gross official reserves (in months of imports of goods and services)	5.5	6.2	5.5	5.0	5.8
Savings and investment					
Gross domestic investment	25.8	22.2	21.0	19.6	15.3
Gross national savings	20.8	17.3	15.5	13.7	14.0
Public finances					
Combined public sector balance 4/	-0.6	-2.3	-3.8	-3.1	-5.9
Nonfinancial public sector balance 4/	-0.8	-2.4	-3.7	-3.9	-6.3
Nonfinancial public primary balance	1.5	0.4	-1.1	-0.6	-2.3
Public sector debt	26.3	24.6	24.2	27.5	34.2

Sources: Colombian authorities; and Fund staff estimates and projections.

1/ End of period.

2/ Based on Information Notice System.

3/ All annual changes in foreign currency stocks valued at constant exchange rate.

4/ Excluding privatization proceeds.

Statement by M. Portugal and R. Junguito, Executive Directors
for Colombia
December 20, 1999

Introduction

The Colombian authorities have asked us to convey their appreciation for the competence and cooperation shown by staff and Management in the discussions of Colombia's Article IV consultation and in the negotiations leading to Colombia's request of an Extended Arrangement. They also wish to express their satisfaction for the timely and fruitful work on the assessment of the financial sector.

Background

For several decades Colombia enjoyed significant economic progress with steady and strong economic growth, and a good balance in its external accounts. Colombia also distinguished itself for being able, even in the difficult 1980s, to maintain a moderate rate of inflation, to grow in a sustained form, and to serve on a timely basis its external debt obligations, without either restructuring or having to request access to IMF resources. In those days, Colombia had a monitoring arrangement with the Fund that facilitated its access to the private capital markets which were then highly closed to Latin American countries. Since the early 1990s Colombia has implemented important structural reforms that, in addition to those mentioned by the staff, included also the establishment of the Banco de la República as an independent central bank, and a significant labor reform.

In recent years, economic performance gave way to slow growth (negative in 1999), increasing unemployment, and economic imbalances, mainly in the fiscal and financial fronts. We coincide with the staff in attributing this deterioration mainly to the internal security situation, to fiscal rigidities, and to the external shocks of the past years. Under such an atypical set of circumstances, the authorities decided to undertake an economic adjustment program based on strong fiscal consolidation, financial sector restructuring, structural reforms, and a flexible exchange rate regime, and to request an extended arrangement with the IMF.

Objectives

The objectives of the program are to restore GDP growth, from a projected decline of 3.5 percent in 1999 to a 3 percent growth rate in 2000, and to achieve a sustainable growth of around 5 percent by the end of the program; to continue the successful process of gradual disinflation, which has allowed to reduce annual inflation from the traditional 20 percent to 30 percent range to less than 10 percent in 1999, and to stabilize the current account deficit at a level of around 3 percent of GDP (1.3 percent in 1999), which implies a substantial

adjustment from the more than 5 percent registered in the past few years. The program requires, above all, to reduce the significant consolidated fiscal deficit.

Fiscal Policy

The purpose of the authorities is to reduce the NFPS deficit from a projected level of 6.3 percent of GDP in 1999 to 3.6 percent in 2000 and to 1.5 percent by 2002. It is worth underlying that soon after taking office in August 1998 the Pastrana Administration took steps on the fiscal front—including spending cuts, a widening of the VAT base, increases in fuel taxes, and the introduction of programs to strengthen tax collection and combat tax evasion. Nevertheless, the 1999 deficit worsened as a result of the decline in economic activity and its negative incidence on fiscal revenue. A restrained public wage bill and overall budget, which has already been approved by Congress, together with strong tax enforcement and the recovery in economic activity are the key factors for the achievement of the fiscal target in 2000.

Above all, the fiscal program is a medium-term strategy based on structural reforms that are being submitted to the Colombian Congress. These proposals tackle fundamental issues such as a Constitutional reform for the streamlining of transfers from the central government to the sub-national governments and legal reforms to the pension system, both at the territorial and national levels. It is also the intention of the authorities to propose legislation early next year to broaden the income tax base, and to close existing loopholes in the VAT system, as well as to undertake an ambitious privatization program. An IMF Fiscal Affairs technical assistance mission visited Colombia in November to assess the fiscal structure and make technical recommendations to be taken into account in the legislation to be submitted to Congress. The Memorandum of Economic Policies indicates that if during congressional consideration some of these initiatives are subject to substantial changes in terms of their fiscal outcome, the authorities will adopt additional measures to ensure that program targets are fully met.

With regard to public sector expenditures, it is important to stress that the authorities—considering that improved protection of vulnerable groups is one of the principal policy aims of the Administration—decided to introduce measures to reduce the effects of unemployment, poverty, and political violence within a special program financed mainly from external sources. The Colombian government is committed to continue pursuing the peace process and, to the extent that it moves forward, the authorities intend to frame public investment plans to ensure the rapid reconstruction of the areas most affected by the conflict and to proceed with the resettlement of the population internally displaced. This could require temporarily widening of the NFPS deficit, in which case the Colombian authorities would discuss with the Fund the budgetary changes that might be required.

Monetary and Exchange Rate Policy

The program establishes that monetary policy will aim at attaining inflation targets, and indicates that Colombia's framework for the conduct of monetary policy will use the growth of base money as its intermediate policy target. This was taken into account in the

establishment of the NDA ceiling. Open market operations are used to attain the monetary goals and the interest rate is the operational instrument. The central bank has been gradually cutting its intervention interest rates and providing the economy with liquidity consistent with the monetary base targets, and in light of the decline in inflation and the stability of the exchange rate. The most recent cut of 100 basis points established on December 10 brought the central bank's rate structure for the repo, reverse repo, and Lombard rates to 12 percent, 6 percent, and 18 percent respectively. Additionally, the rate for access of the financial sector to the liquidity facility of the central bank was also cut 200 basis points, though it still stands at a penalty rate equivalent to the benchmark 90-day deposit rate plus 500 basis points. Despite successive cuts, real interest rates remain high, as the current twelve-month inflation rate at end-November stood at 9.7 percent.

Furthermore, as the staff report indicates, to better ensure that monetary policy is consistent with the inflation target, the central bank is moving to a direct inflation targeting framework, and it is envisaged that the framework will be fully adopted during the course of the program. In terms of readiness for the transition, the main prerequisite for a successful adoption of inflation targeting is that it should only be undertaken when inflation control has gained credibility—which is Colombia's case—given that inflation is at one-digit levels, and that inflation targets were met in the past two years and will be met in 1999 according to current projections.

Colombia has advanced significantly towards inflation targeting considering that since 1991 the legislation established the obligation for the newly-independent central bank to set an explicit annual inflation target, and mandated that monetary policy be guided to that end. The Board of Directors of the Colombian central bank decides on interest rate adjustments on the basis of its monetary targets and inflation projections discussed in the framework of monthly inflation reports. The IMF-sponsored seminar held in November in Cartagena allowed the staff to study in more detail the Colombian case, and helped the authorities to define the issues and steps that must be taken to adopt the targeting framework.

From 1994 to September 1999, exchange rate policy was conducted through a sliding exchange rate band system, managed in a flexible way both in terms of widening the band and depreciating its central parity whenever the economy felt the effects of deteriorating terms of trade and of turmoil in international financial markets. Together with the significant reduction in inflation, the movement of the nominal exchange rate within the band helped restore Colombia's competitive position in international markets. With the strong fiscal adjustment included in the authorities' economic program and the prospective financial support by the IMF, at the end of September 1999, the Central Bank Board eliminated the band and allowed the peso to float freely. The central bank expects that the floating regime will better enable the economy to absorb external shocks, facilitate the conduct of monetary policy, and reduce speculation against the currency.

On November 19, the Central Bank Board made public the rules that will govern its intervention in the foreign exchange market. To meet the reserve targets of the program, it adopted a system of monthly auctions. In early December, the central bank auctioned rights

to sell foreign exchange to the central bank in the amount of US$200 million; and US$80 million rights per month are to be auctioned subsequently. Further, to maintain orderly market conditions, the central bank established the possibility to auction off rights to buy or sell US$120 million, when the exchange rate deviates substantially from the moving average of the previous 20 business days. The Colombian authorities consider that the launching of the new floating exchange regime was very successful to the extent that, without intervention, the nominal exchange rate remained stable (if anything, it appreciated) in the weeks following the adoption of the free-floating regime. Furthermore, the December auction was over subscribed.

Financial Sector Policy

As discussed at length in the Financial Sector Stability Assessment document, the Colombian financial system evidenced signs of distress by late 1998 manifested in a rise of non-performing loans, large losses and a significant deterioration in solvency and liquidity, particularly among public banks, private savings and loans institutions and some cooperative financial intermediaries. To deal with the weakening financial sector situation, the Government issued, in November 1998, an emergency decree that provided for liquidity assistance and established a financial transactions tax. Subsequently, the Government introduced a program to recapitalize viable private financial institutions and proceeded to liquidate the largest public sector bank (Caja Agraria) and replaced it with a smaller and more tightly controlled public institution. The Government has expressed its intention to privatize all remaining public sector banks. It has also proceeded to establish debtor relief programs for homeowners and is in the process of facilitating the restructuring of corporate debt. Success in addressing these difficulties hinges upon a rapid improvement in macro-economic conditions, a strengthening of bank supervision, and sound management of public banks until they are privatized. The financial sector loans from the World Bank and Inter-American Development Bank recently approved are supporting Colombia's financial sector strategy.

Conclusions

The Colombian authorities appreciate the staff's view that the program reflects a courageous and comprehensive effort, consistent with progress toward fiscal and external viability while advancing on structural reforms, and that its financial sector strategy has been found to be sound. They also agree with the staff view that a strengthening of domestic confidence and the secure flow of resources from official and private institutions abroad should help to consolidate the process. The Colombian authorities agree that there are risks in terms of a slower-than-projected economic recovery, and that there are uncertainties regarding the political support of the reform agenda. However, they are confident that the Colombian Congress will respond positively, as has been its tradition, to the need of adopting structural reforms, and that the economic program will rapidly translate into economic recovery. The Board's approval of Colombia's request for a three-year Extended Arrangement is, in the view of my authorities, a crucial aspect for the credibility of the program.