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Colombia: Third Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance of Performance Criterion—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Colombia

In the context of the third review under the Stand-By Arrangement and request for a waiver of nonobservance of a performance criterion with Colombia, the following documents have been released and are included in this package:

- the staff report for the third review under the Stand-By Arrangement and request for waiver of nonobservance of a performance criterion, prepared by a staff team of the IMF, following discussions that ended on **April 25, 2004,** with the officials of Colombia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 15, 2004**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Press Release summarizing the **views of the Executive Board as expressed during its June 30, 2004 discussion** of the staff report that completed the review and request.

- a statement by the Executive Director for Colombia.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Colombia*
Memorandum of Economic and Financial Policies by the authorities of Colombia*
Technical Memorandum of Understanding

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

COLOMBIA

Third Review Under the Stand-By Arrangement and Request for a Waiver of Nonobservance of Performance Criterion

Prepared by the Western Hemisphere Department
(In consultation with other Departments)

Approved by José Fajgenbaum and Michael T. Hadjimichael

June 15, 2004

Stand-By Arrangement. A two-year arrangement was approved on January 15, 2003 in the amount of SDR 1,548 (100 percent of quota on an annual basis). All quantitative performance criteria and all but one of the structural benchmarks through March 2004 have been met. The authorities are treating the SBA as precautionary. The second review was completed in January 2004. Colombia has no outstanding credit from the Fund (Appendix I).

Letter of Intent. The authorities are requesting: (i) the completion of the third review on the basis of the proposed policies; and (ii) a waiver for the nonobservance of the continuous performance criterion on the introduction of multiple currency practices. The staff supports the authorities' requests. Upon completion of this review, Colombia would be eligible to draw a total of SDR 1,161 million.

Discussions. A staff team held discussions in Bogotá during April 12–23 and at headquarters on April 24–25. The team met with Mr. Alberto Carrasquilla (Minister of Finance), Mr. Miguel Urrutia (General Manager of the Banco de la República), the Board of Directors of the Banco de la República, Mr. Santiago Montenegro (Director of the National Planning Department), Mr. Jorge Pinzón (Superintendent of Financial Institutions), other senior government officials and representatives of the private sector. The staff team comprised R. Rennhack (Head), A. Espejo, H. Hirschhofer, I. de Carvalho (all WHD) and J. Wiegand (PDR). Mr. Cayazzo (MFD) and Mr. Acevedo (MFD-consultant) joined the mission for the period April 13–20. R. Steiner (OED) attended all meetings.

Relations with World Bank and IDB. The World Bank supports the government's efforts to pursue fiscal reforms, strengthen the financial sector, adopt labor and social sector reform and to improve environmental management (Appendix II). The Inter-American Development Bank (IDB) seeks to help lay the foundation for stronger growth, foster social progress and improve governance and modernize the public sector. The IDB is working with the government to develop a poverty reduction strategy paper (Appendix III).

Contents Page

Executive Summary 3

I. Recent Developments 4

II. Policy Discussions 8
A. Fiscal Policy 10
B. Structural Fiscal Reforms 13
C. Monetary and Exchange Rate Policy....17
D. Financial Sector Policy 18
E. External Sector Policy 19

III. Program Modalities and Risks 19

IV. Staff Appraisal 21

Tables
1. Selected Economic and Financial Indicators 23
4. Operations of the Central Administration....26
5. Monetary Indicators 27
6. Banking System Indicators 28
8. External Debt Sustainability Framework, 2003-2010....30
9. Public Sector Debt Sustainability Framework, 2002-2010....31
11. Schedule of Purchases Under the SBA, 2003-2004....33
12. Indicators of Capacity to Repay the Fund, 2004-09....34

Figures
1. Financial Market Indicators 7
2. Banking System Indicators 9

Boxes
1. Foreign Exchange Intervention....6
2. The State Electricity Transmission Enterprise (ISA)....12
3. Public and External Debt Sustainability 14
4. Fiscal Decentralization....16

Appendices
I. Fund Relations....35
II. World Bank Relations 38
III. Relations with the Inter-American Development Bank 40
IV. Letter of Intent 42

EXECUTIVE SUMMARY

Under the authorities' program, economic performance has improved considerably. Real GDP rose by 3.7 percent in 2003 and 3.8 percent in the first quarter of 2004, while inflation fell to 5.4 percent year-on-year in May, lower than expected. Solid export growth, together with improved confidence, has strengthened the external position.

Economic policies remain sound. Fiscal policy is on track, and almost all structural reforms continue to advance. The authorities have been concerned that the strengthening of the peso since 2003 could weaken export growth. The central bank has intervened in the foreign exchange market, and the authorities have considered whether to introduce capital controls. The health of the banking system continues to improve, although mortgage lending is a concern.

The macroeconomic outlook for 2004 is more favorable than envisaged. Real GDP is expected to grow by 4 percent (3.3 percent in the program). The program continues to target inflation of 5.5 percent during the year and set a floor of US$10.5 billion for net international reserves. The external account deficit for 2004 is projected at 2.2 percent of GDP.

Fiscal policy will remain on a sustainable path. The combined public sector (CPS) deficit is targeted to decline to 2½ percent of GDP, as envisaged. The authorities are proposing to include a small upward adjustor to allow for additional public investment financed with privatization proceeds. They would also like to remove a small, commercially-run public enterprise from the program definition of the public sector. For 2005, the authorities are proposing to include the submission to Congress of a budget that provides for a CPS deficit of 2 to 2½ percent of GDP as a structural performance criterion for end-July 2004.

The authorities will continue to advance the planned structural reforms to the budget code, pensions and fiscal decentralization. Other areas of reform include tax administration, public procurement practices, and the financial system.

Nevertheless, risks to the program remain. The political agenda is being dominated by President Uribe's campaign for a constitutional amendment to allow for the re-election of presidents starting in the next elections in May 2006, and this could divert attention away from key fiscal reforms. The overall security situation is still fragile, despite recent improvements. The medium-term fiscal position remains vulnerable to a rapid increase in international interest rates and sharp currency depreciation.

The staff supports the authorities' request to complete the third review. It supports their request for a waiver for the nonobservance of the performance criterion on the introduction of multiple currency practices (see paragraph 29).

I. Recent Developments

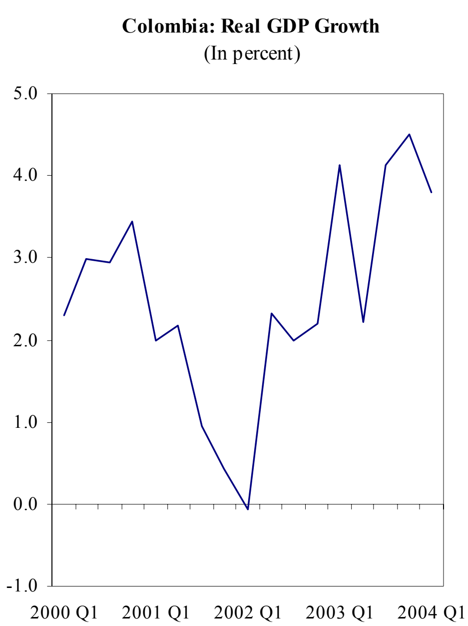
1. **The authorities designed their 2003–04 program to promote a recovery from the recession that began in 1998 and to reduce the vulnerability to external shocks**. They have raised the public sector's primary surplus to ease the burden of public debt (almost 59 percent of GDP at end-2002), adopted tax, pension and other fiscal reforms to strengthen medium-term fiscal sustainability, and have improved financial supervision.

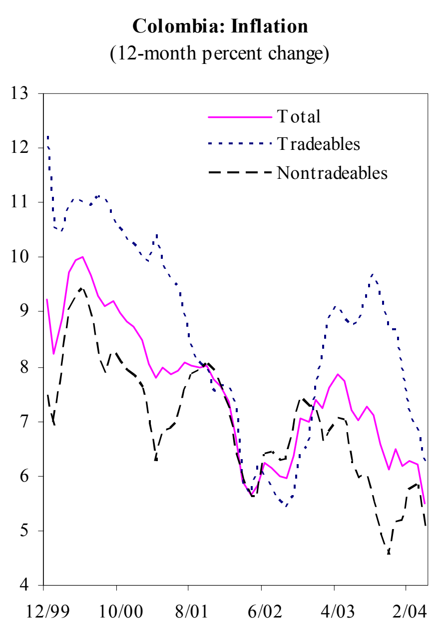
2. **Under this program, economic performance has improved considerably, diminishing the risks to the outlook:**

- In 2003, real economic growth more than doubled to 3.7 percent, from 1.6 percent in 2002, fueled by an increase in real investment of almost 20 percent (Table 1). In the first quarter of 2004, real GDP rose by an estimated 3.8 percent year-on-year, led by output gains in retail sales, construction and industrial production.

- The urban unemployment rate fell to 16.2 percent in March 2004, compared with 17.8 percent a year earlier.

- Inflation declined to 5.4 percent in May 2004, below the program target for June 2004 and down from 6.5 percent at end-2003 (Table 1, Memorandum of Economic Policies). This trend reflects, in part, the 12 percent appreciation of the peso vis-à-vis the U.S. dollar from April 2003 to mid-April 2004.





- Solid export growth, together with improved confidence, has strengthened the external position (Table 2). In 2003, the external current account deficit reached 1.8 percent of GDP. Exports rose by 10 percent, benefiting from high commodity prices and the sizable real effective depreciation of the peso between mid-2002 and early 2003. Also family remittances from abroad rose by over 20 percent, reaching 4 percent of GDP. Net international reserves increased slightly to US$10.5 billion at end-2003, equivalent to about 120 percent of short-term debt on a remaining maturity basis. In the first quarter of 2004, strong growth in traditional exports, led by oil and coal, helped total exports grow by 10 percent year-on-year, while imports rose by about 8 percent year-on-year.

3. **Fiscal policy is beginning to ease the burden of public debt.** In 2003, the combined public sector (CPS) deficit declined from 3.7 percent of GDP in 2002 to 2.7 percent of GDP, slightly less than programmed, with the primary surplus reaching 1.7 percent of GDP (Tables 3 and 4). Total public debt declined to 56.2 percent of GDP at end-2003. Total revenues rose to 31 percent of GDP, largely because of higher nontax revenues. In particular the operating surplus of the state petroleum enterprise (Ecopetrol) improved, as domestic prices on gasoline and diesel fuel were raised by over 20 percent.[1] However, tax revenues increased by less than expected, partly because the VAT increase approved in December 2002 was implemented later than expected. Total expenditures reached almost 34 percent of GDP, reflecting higher investment commitments by public enterprises, especially in oil exploration by Ecopetrol and expansion of the distribution network of the energy enterprise of Medellin (EPM).

4. **Fiscal policy stayed on track in the first quarter of 2004**. In this period, the CPS deficit was 1.3 percent of quarterly GDP, below the program target. Central government tax revenue grew 7.6 percent year-on-year through March, as projected, reflecting higher income tax and VAT collections. The central government's spending increased by 3.5 percent, reflecting restraint of investment commitments.

5. **Almost all structural fiscal reforms have continued (Table 2, Memorandum of Economic Policies)**. In March, Congress began to consider the draft reform of the budget code, which was submitted in December 2003, while the government initiated discussions with ad hoc congressional committees about a constitutional amendment on pension reform. The efforts to modernize the public sector are progressing, with the closure of 29 public entities, the elimination of 14,000 employment positions, and the adoption of stronger hiring procedures for public employees. However, the modifications to Law 80 to strengthen public

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[1] Ecopetrol administers domestic prices of gasoline and diesel fuel and intends to raise them gradually to a level consistent with a long-term petroleum price of US$27 per barrel.

procurement have not been approved (a structural benchmark for December 2003), and need to be resubmitted to Congress.

6. **Through mid-April 2004, the government and the central bank tried to slow the appreciation of the peso, because of concerns about export growth (Table 5)**. The Banco de la República has purchased US$600 million through its option-based intervention mechanism, bringing net international reserves to US$11.2 billion at end-April (125 percent of short-term debt on a remaining maturity basis) (Box 1). The government purchased US$130 million in the forward market in February. The central bank decided—in view of the trends in inflation—to reduce its policy interest rate in February and March by a total 50 basis points to 6.75 percent. In March President Uribe asked for a study of whether to introduce controls on capital inflows to limit upward pressure on the peso.

Box 1. Foreign Exchange Intervention

- In November 1999 the Banco de la Republica announced that it would conduct foreign exchange intervention through options-based mechanisms.

- The central bank auctions call (put) options with a maturity of 30 days, giving the bearer the right to buy (sell) U.S. dollars from (to) the central bank. The call (put) options may be exercised when the spot rate is more depreciated (appreciated) than its arithmetic moving average for the previous 20 days.

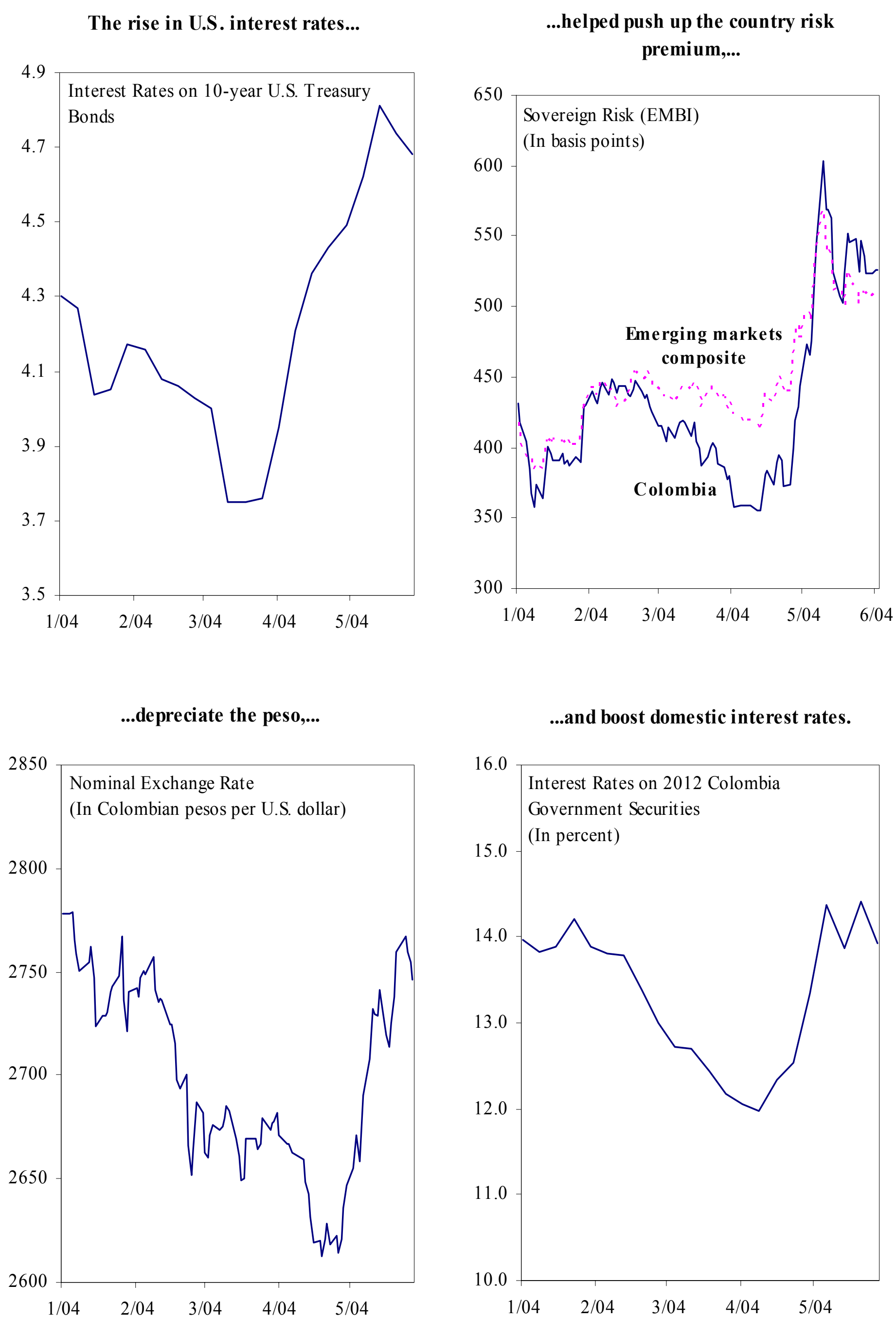
- The central bank relies on two rules:

  - Accumulation/Decumulation of Reserves: The central bank may announce auctions of options to gain or lose net international reserves for periods and amounts determined by central bank. The interventions in 2003 and 2004 were under this rule.

  - Control of exchange rate volatility: An auction—in the amount of US$180 million—of call (put) options is triggered automatically whenever the peso is 4 percent more depreciated (appreciated) than its 20-day moving average. This rule has been used twice—in July and October 2002.

7. **However, domestic financial conditions have turned around, with the shift in expectations about interest rates in the United States (Figure 1)**. Since mid-April, market pressures have raised the country risk premium broadly in line with the increases experienced by other emerging markets countries. As a result, the interest rate on government securities rose and the peso depreciated vis-á-vis the U.S. dollar. Nonetheless, on May 31, the central bank auctioned US$200 million of put options to purchase foreign exchange.

Figure 1. Colombia: Financial Market Indicators



Sources: Central Bank of Colombia; U.S. Federal Reserves; Bloomberg; and JP Morgan.

8. **The health of the banking system continues to improve (Figure 2 and Table 6).** Favorable interest margins, capital gains on holdings of government securities and the economic recovery have boosted profitability, strengthened capital adequacy ratios, and helped trim nonperforming loans. However, concerns remain about mortgage lending, which still has a high share of nonperforming loans. In February, the financial restructuring agency (FOGAFIN) auctioned a 55 percent ownership stake in Bancafé (a structural benchmark for December 2003), but there were no bids.[2]

9. **The issue of presidential re-election is dominating the political agenda.** President Uribe remains extremely popular, owing to the improved security situation and the sound performance of the economy. He has begun to campaign actively for a constitutional amendment to allow for the re-election of presidents starting in the next elections in May 2006. While the amendment enjoys strong popular support, President Uribe will probably have to reach compromises with the political opposition to gain the support of Congress, which is responsible for approving constitutional amendments.

II. Policy Discussions

10. **The macroeconomic framework for 2004 is more favorable than envisaged.** Real GDP is projected to rise by 4 percent in 2004 (3.3 percent in the previous review), based on the outturn in 2003 as well as faster than expected growth in Colombia's major trading partners. With oil exports equivalent to over 4 percent of GDP, Colombia's growth and external position will benefit from the recent increase in world oil prices. The program continues to target a decline in inflation to 5½ percent, as domestic gasoline and diesel fuel prices are expected rise slightly faster than targeted inflation in 2004. The program also retains the floor of US$10.5 billion for net international reserves, although reserves are projected to reach US$11.2 billion by end-2004. The external current account deficit is projected to rise to 2.2 percent of GDP, slightly less than in the program. Colombia is well positioned to handle the prospect of a gradual rise in interest rates in the United States, provided it continues to implement strong policies. The main policy challenges are to sustain the pace of structural fiscal reforms—which are crucial to reduce public debt to below 45 percent of GDP by 2010—keep monetary policy focused on lowering inflation, and continue to strengthen the financial system.

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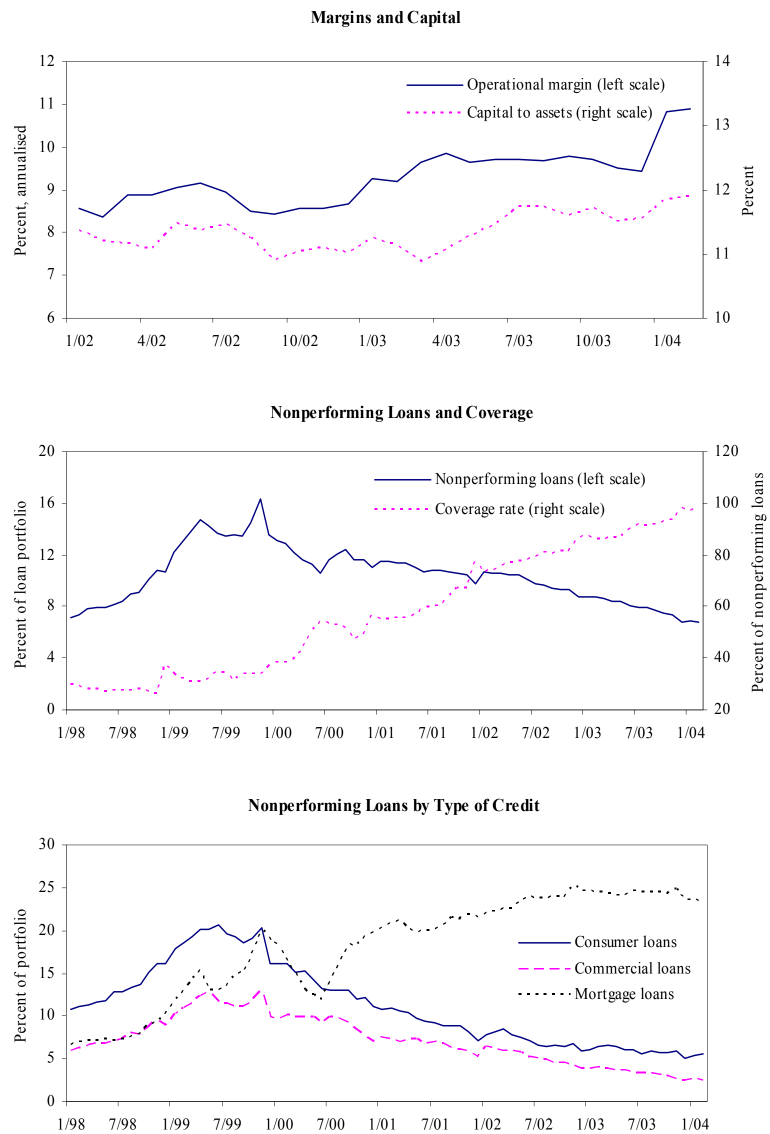
[2] Bancafé is Colombia's third largest bank, accounting for 6 percent of banking system assets and was intervened in 1999.

Figure 2. Colombia: Banking System Indicators



Sources: Superintendency of Financial Institutions; and Fedesarollo.

Macroeconomic Framework: Main Elements 2003-10

	2003		2004		Proj.		
	Prog.	Est.	Prog.	Rev.	2005	2007	2010
	(Annual percentage change)						
Real GDP	2.8	3.7	3.3	4.0	4.0	4.0	4.0
CPI (end of period)	6.2	6.5	5.5	5.5	4.5	3.0	3.0
	(In percent of GDP)						
External current account deficit (-)	-2.2	-1.8	-2.5	-2.2	-2.7	-2.8	-2.5
NFPS primary balance	2.0	1.7	2.4	2.5	2.5-3.0	3.0	2.5
Combined public sector deficit (-)	-2.8	-2.7	-2.5	-2.5	2.0-2.5	-1.6	-1.3
Total public debt	56.3	56.2	56.2	52.1	50.3	47.4	43.2
	(In billions of U.S. dollars)						
Net international reserves	10.4	10.5	10.5	10.5	11.6	12.0	13.1

A. Fiscal Policy

11. **In 2004, fiscal policy will remain on a sustainable path.** The program will continue to aim at reducing the CPS deficit to 2.5 percent of GDP by raising the primary surplus to 2.5 percent of GDP. Total revenues of the public sector are expected to remain unchanged at about 31 percent of GDP. Tax revenues are projected to rise to 20 percent of GDP, reflecting the tax package approved in December 2003[3] and an increase in social security contributions approved in May 2003. At the same time, the operating surplus of Ecopetrol is projected to decrease by 0.3 percent of GDP because of the secular decline in oil production. Total expenditures are expected to decline to about 33½ percent of GDP. Current spending is projected to rise to 26½ percent of GDP, reflecting mandated floors for increases in public sector wages[4] and an increase in net pension costs of 0.6 percent of GDP. Investment is

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[3] The tax package kept the top income tax rate at 38.5 percent, maintained the wealth tax of 0.3 percent, and raised the financial transactions tax rate from 0.3 percent to 0.4 percent. Congress also approved a 2 percent rebate on the VAT for credit and debit card transactions that takes effect in 2004 and an income tax credit of up to 30 percent of reinvested profits that will affect revenues starting in 2005.

[4] In November 2003, the constitutional court required that public wages above two minimum wages had to rise by at least half of the previous year's inflation rate. Wages below two minimum wages had already been required to rise by at least the full rate of inflation.

expected to decline by about 1½ percent of GDP, reflecting cuts by the central government and Ecopetrol.

12. **The 2004 fiscal target will incorporate a small upward adjustor to allow for more public investment that is contingent on privatization (Memorandum of Economic Policies, paragraph 4).** The authorities stressed the need to carry out some additional public investment, drawing on projects already approved by Congress in the May 2003 National Development Plan—a four-year investment plan approved in the first year of each government. These projects would be financed through the sale of the government's shares in the state natural gas enterprise (ECOGAS) and 20 percent of the shares of the electricity distribution company (ISA). The authorities agreed on the importance of avoiding permanent increases in spending financed with temporary revenues. For this reason, the upward adjustor would be limited to no more than 0.3 percent of GDP, and would take effect only if privatization proceeds materialized and would aim to support additional investment spending.

13. **Public debt is expected to fall to about 52 percent of GDP by end-2004 (56 percent of GDP projected in the previous review).** Net public borrowing will amount to 2.5 percent of GDP, with external financing of 1.7 percent of GDP, including planned disbursements of US$1.2 billion from multilateral lenders and US$0.5 billion from an international bond issue that has already been placed.[5] The authorities are aiming to raise the share of domestic debt to 60 percent of total public debt by 2010, from 46 percent in 2003, with a view to limiting the effect of exchange rate fluctuations on debt and debt service. The staff suggested that the government rely more on domestic financing in 2004, as market conditions permit. The authorities agreed but wanted to tap domestic markets carefully, which reacted quickly to the prospect of higher interest rates in the United States.

14. **The program proposes to remove one public enterprise—the state electricity distribution enterprise (ISA)—from the definition of the public sector (Box 2) (Memorandum of Economic Policies, paragraph 7).** After evaluating Colombia's major public enterprises, the staff and the authorities agreed that ISA qualified as a commercially-run enterprise, according to preliminary criteria discussed by the Board in April 2004 to measure the degree of commercial orientation. ISA has a significant share of private ownership and an American Depository Receipt (ADR) program on the New York Stock Exchange and it protects the rights of minority shareholders in major decisions.

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[5] The US$500 million bond was issued with a collective action clause.

Box 2. The State Electricity Transmission Enterprise (ISA)

ISA is a multinational company. In Colombia ISA owns 80 percent and operates all of the national transmission network and administers the wholesale energy market. It owns 50 percent and 25 percent of the transmission networks in Peru and Bolivia, respectively.

Private investors own a significant equity share. As of March 2004, private investors owned 28 percent, the central government owned 60 percent, and other public enterprises held the other 12 percent. In March 2004, ISA established an ADR program to sell shares on the New York Stock Exchange, and in May the government announced that it reduce its ownership stake to 40 percent by end-2004.

Rights of minority shareholders are well protected. Major financial decisions must be approved by a special majority of shareholders (60 to 65 percent). At any time, 20 percent of the shareholders may call a general shareholders meeting, which can decide on any major changes to the structure or terms and conditions of the share capital. Dividends must be paid in line with transparent rules.

ISA has an arms-length relationship with the government in its operations. ISA is subject to the same tax regime and labor laws as the private sector, and receives no government subsidies or transfers. Its operations are governed by a code of good governance adopted by ISA's executive board, a code of ethics, transparent procurement guidelines, and a clear auditing system, with annual outside audits. A public regulatory commission sets the prices for transmission services, allowing for the costs of replacing infrastructure and of administration, operation and maintenance. Prices for other services are free from regulation.

The financial condition of ISA is sound. Since 1997, ISA has been securing all of its financing without the guarantee of the central government. Its credit rating is AAA on its local currency debt (Duff & Phelps) and equivalent to the sovereign credit rating (currently BB-) on its foreign currency debt (S&P). Its operations have been balanced for the past several years and it has a low level of debt.

	2000	2001	2002	2003	Proj. 2004
(As percent of GDP)					
Overall balance	0.05	0.03	0.04	0.09	-0.01
Operating surplus	0.19	0.21	0.20	0.21	0.21
Total debt	0.57	0.47	0.44	0.34	0.27
Domestic	0.21	0.12	0.13	0.08	0.07
External	0.36	0.35	0.31	0.26	0.21

Sources: Ministry of Finance and Banco de la República.

The program fiscal targets would be left unchanged, as ISA's overall balance and operating surplus are very low in relation to GDP. Colombia is participating in the Fund's pilot program to explore whether it will be possible to allow for a more flexible treatment of public investment. In this context, the staff and the authorities will be evaluating the degree of commercial orientation of Colombia's other major public enterprises.

15. **In June 2004, the authorities will announce their fiscal objectives for 2005, as required under the Fiscal Responsibility Law (Memorandum of Economic Policies, paragraph 6)**. They intend to announce that the public sector's primary surplus will reach 2½ to 3 percent of GDP, with the CPS deficit ranging from 2 to 2½ percent of GDP. This target is consistent with the goal of reducing total public debt gradually to below 45 percent of GDP by 2010 (Box 3). At the time of the discussions, the revenue and expenditure projections for 2005 were very preliminary, and it appeared that measures would be required to reach this target. The staff asked whether the investment tax credit approved in December 2003 would weaken revenues in 2005. The authorities believed that this tax credit would only have a limited effect, and felt confident that they would find the expenditure measures needed to reach the fiscal target. For this reason, they are proposing to include, as a structural performance criterion for end-July 2004, the submission to Congress of a budget for 2005 that is consistent with this announcement. The staff indicated that a fiscal target of close to 2 percent of GDP in 2005 would still allow for some additional public investment financed with privatization proceeds, while keeping the CPS deficit below 2½ percent of GDP.

B. Structural Fiscal Reforms

16. **The authorities will continue to advance the planned structural reforms (Memorandum of Economic Policies, paragraph 16)**:

- *Reform of the budget code*: The authorities were cautiously optimistic that Congress would approve this code during 2004, which is a condition for completion of the fourth review. The revised code will require the adoption of international standards for budget classification, establish provisions for phasing out most nonconstitutional earmarked tax revenues while restricting new earmarking, limit the carry over of spending from one year to the next, and restrict the government's power to make multi-period spending commitments.

Box 3. Public and External Debt Sustainability

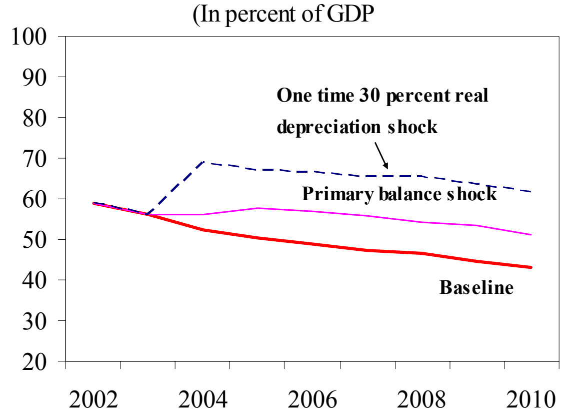
The baseline scenario is based on cautious assumptions. These include a moderate real depreciation of the peso in 2005–08, a gradual increase in international interest rates, and a steady decline in the country risk premium from current levels.

Baseline Scenario: Key Assumptions

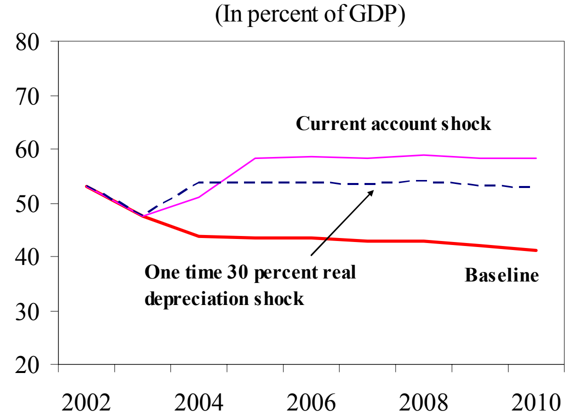
	2004	2005	2006	2007	2008	2009	2010
			(In percent)				
Real GDP growth	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Inflation	5.5	4.5	3.5	3.0	3.0	3.0	3.0
Real peso depreciation (-)	0.5	-2.8	-1.1	-0.7	-2.5	0.7	0.6
LIBOR	1.6	4.3	5.5	5.5	5.5	5.5	5.5
			(In basis points)				
Country risk premium	540	490	440	420	415	400	390

Colombia's public and external debt profile are sustainable, provided policies remain strong (Table 7). Total public debt would decline steadily to below 45 percent of GDP by 2010, while total external debt would fall to slightly more than 40 percent of GDP. This outlook assumes that the authorities can sustain a primary fiscal surplus of 2½ to 3 percent of GDP a year starting in 2005 and that the flexible exchange rate regime help keep the external current account deficit in the range of 2½ to 3 percent of GDP. Investment is assumed to rise to about 19 percent of GDP to help sustain real GDP growth of 4 percent.

Public Debt
(In percent of GDP



External Debt
(In percent of GDP)



There are risks to this outlook (Tables 8 and 9). In the event of a sharp one-time real depreciation of the currency, or if the public sector's primary surplus were to stay at historical levels, public debt would remain high. Similar shocks would also prevent an improvement in the external debt profile.

Source: Fund staff projections.

- *Pension reform*. Further action in this area will yield long-term fiscal benefits by reducing the actuarial deficit of the pension system from its current level of 150 percent of GDP.[6] By end-July 2004, the authorities intend to submit to Congress a constitutional reform that would eliminate all special pension regimes (except for military personnel), cap the maximum pension at the equivalent of 25 minimum wages, and eliminate the 14th monthly pension payments and set the minimum pension at the minimum wage. This action is a new structural benchmark.

- *Strengthening fiscal decentralization*. A recent FAD technical assistance mission visited Bogota in May 2004 (Box 4). The economic policy cabinet (CONPES) is to publish a plan to strengthen decentralization by September 2004.

- *Statistical data on public sector financing*. An interagency committee will develop a plan by June 2004 to improve the quality of the reporting of the financing of the public sector. This plan is to be implemented by December 2004, which is a new structural benchmark.

- *Public procurement*. The authorities intend to resubmit to Congress the modifications to Law 80, which are designed to improve the management of government contracts, by December 2004. This is a modified structural benchmark.

17. **To help safeguard revenues, the program includes a new structural benchmark to improve tax administration (Memorandum of Economic Policies, paragraph 9)**. The staff noted that tax revenues should have performed better in 2003 in view of the faster than expected real economic growth[7] and recommended that tax evasion be subject to stiffer penalties. The authorities explained that—apart from some technical problems with projecting VAT revenues—tax revenues performed well in 2003 and that Congress has, on several occasions, rejected stronger penalties. Nonetheless, they agreed to include a structural benchmark for September 2004 to adopt measures to centralize and unify tax payer information on VAT and income tax payments, close businesses that evade paying taxes, and report persons with tax arrears to credit bureaus. Also, they are also developing a computerized information system to improve monitoring of tax compliance.

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[6] The reforms of December 2002 and May 2003 lowered the actuarial deficit from over 200 percent of GDP.

[7] When the program was designed in late 2002, the revenue projection for 2003 assumed real economic growth of 1.5 percent.

Box 4. Fiscal Decentralization

Overview

Colombia's fiscal decentralization—established in the 1991 constitution—was designed to improve the efficiency of public spending, especially on health and education. In principle, it shifted expenditure responsibility to local and regional governments, financed by revenue sharing from the central government and efforts to increase reliance on local taxes.

However, there are several difficulties. The allocation of expenditure responsibilities among the different levels of government is unclear, leading to duplication of spending. The revenue sharing, which reached 5.8 percent of GDP in 2003, discourages tax collection by both the local and the central governments. Transfers from the central government are subject to extensive earmarking, making it difficult for subnational governments to manage spending flexibly. While teachers are national employees, they are managed by municipalities. There may be rising contingent liabilities, especially for transport and energy projects.

FAD recommendations

- **Strengthen the institutions.** It would be useful to (i) create a central authority to coordinate all decentralization issues; (ii) establish congressional committees to develop the legal agenda to strengthen decentralization; and (iii) strengthen information, control and audit systems across subnational governments.

- **Improve local revenues.** While the distribution of revenue bases across levels of government is broadly adequate, departmental excise tax rate structures should be simplified. Muncipal turnover taxes should be reformed. The national register of property values should be updated by the central government.

- **Simplify revenue sharing.** Initially, the earmarking of transfers should be modified to allow for much greater spending flexibility within each of the three main spending categories (health, education and other). It would also be useful to keep transfers independent from the level of national revenues.

- **Strengthen macroeconomic coordination.** Governments of the largest departments and municipalities should be required to prepare three-year macroeconomic frameworks to establish binding fiscal targets that are consistent with the objective for the overall public sector deficit.

18. **Steps to make the tax structure more efficient are planned for 2005**. The authorities agreed that Colombia's tax system includes several distortions, such as the many rates and exemptions of the VAT, and relies on a number of temporary taxes. They felt that next year would offer a better opportunity to adopt legislation that would simplify the tax structure and could replace the temporary taxes with permanent revenues. The staff encouraged the authorities to at least introduce this type of legislation in 2004—well before the campaign for the 2006 election begins—to reduce distortions and help sustain revenues and lower the CPS deficit as planned in 2005.

C. Monetary and Exchange Rate Policy

19. **The Banco de la República remains fully committed to reducing inflation to 5½ percent in 2004, as targeted (Memorandum of Economic Policies, paragraph 10).** The central bank has also announced that it intends to keep inflation within a range of 3½ to 5½ percent in 2005. The authorities commented that monetary policy would remain focused on achieving the inflation target, regardless of developments in the foreign exchange market. The staff noted that the central bank's long-term inflation forecast pointed to the need for monetary tightening starting this year to reduce inflation further in 2005 and over the medium term.

20. **The Banco de la República is strengthening its inflation targeting framework**. The staff noted that the central bank's inflation reports had become more transparent by giving more emphasis on a forward looking analysis of inflation. Supported by the Fund's Monetary and Financial Systems Department (MFD), experts from the Czech National Bank visited Bogotá in May 2004 to provide advice on creating a general equilibrium model and improving the forecasting and policy analysis system. The authorities plan to hire an outside expert to undertake a comprehensive review of the inflation targeting framework.

21. **The authorities explained that they would not undertake foreign exchange intervention that would jeopardize the inflation target (Memorandum of Economic Policies, paragraph 11)**. The volume of the intervention operations has been chosen to avoid creating inflationary pressures. They added that the options-based intervention rules are designed to slow the rate of change of the peso while letting the market determine its level.[8] The staff urged the authorities to avoid sustained and large foreign exchange purchases, which could add to inflationary pressures and create the impression that the intervention was intended to influence the level of the peso.

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[8] The options are exercised depending on the movements of market determined exchange rates. Also, by using the 20-day moving average as the strike price, it is more difficult for the intervention to resist sustained market trends.

22. **The debate about whether to introduce controls on capital inflows appears to have subsided since mid-April**. Based on their study, the Ministry of Finance and the Banco de la República noted that these controls could entail some costs, such as restricting credit to medium- and small-enterprises, while yielding few benefits. The staff agreed with this view and added that such a measure could also weaken the credibility of economic policies.

D. Financial Sector Policy

23. **The authorities are continuing to strengthen financial supervision (Memorandum of Economic Policies, paragraph 13).** They are working with banks to develop internal risk models that will be used to determine capital adequacy and provisioning requirements, in line with the Basle II capital adequacy guidelines. These new models will be phased in gradually, after an adequate track record has been established. In addition, consolidated supervision of financial conglomerates, including the operations of their off-shore and nonbank affiliates, is being strengthened.

24. **Most mortgage banks have strengthened their financial position.** They have diversified into commercial and consumer lending and benefited from a pick up in housing prices associated with the economic recovery. Nonetheless, the stock of mortgage lending has stagnated as both borrowers and banks remain wary of this type of lending, partly because of the large overhang of nonperforming mortgages. Also these loans are subject to a number of legal and regulatory impediments, such as a ceiling on the real mortgage interest rate and long delays in completing mortgage foreclosures. The financial superintendency continues to monitor a few banks with significant amounts of mortgages through restructuring plans that—if necessary—require increases in provisioning and capital.

25. **The government remains fully committed to divest the financial institutions intervened in 1999 (Memorandum of Economic Policies, paragraph 14)**. The staff and the authorities agreed that the difficulties in selling Bancafé stemmed mainly from the bank's sizable pension liabilities and high and rigid labor costs.[9] As a new structural benchmark, the financial restructuring agency (FOGAFIN) intends to restructure Bancafé by end-2004 by placing the labor-related liabilities into a "bad bank" and putting the assets and deposits into a "good bank," which would be sold in early 2005. As a new structural benchmark, the authorities agreed to announce by end-2004 the auction of Granahorrar—which is profitable and well-managed—with a view to selling it in early 2005.[10] This is a slight delay with

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[9] About half of the bank's employees cannot be fired, and labor costs per employee in the acquiring bank would rise to the level of these costs in Bancafé.

[10] Granahorrar is the 11th largest bank in Colombia, accounting for about 3½ percent of the banking system's assets.

respect to the program, which envisaged bringing Granahorrar to the point of sale by September 2004.

E. External Sector Policy

26. **On June 1, the authorities sent a letter to the Managing Director communicating their acceptance of the obligations of Article VIII**. Staff plan to send to the Board a paper on this issue that explains—inter alia—the authorities' plans to modify the regime for hydrocarbons exporters by December 2004 and eliminate the tax on outward foreign exchange remittances by December 2005.[11]

27. **The trade regime is being liberalized further.**[12] Colombia, together with Ecuador and Peru, has started negotiations on a free-trade agreement with the United States, which will cover a wide range of issues including intellectual property and market access. The negotiations are expected to conclude by early 2005.

III. Program Modalities and Risks

28. All performance criteria and all but one of the structural benchmarks through end-March 2004 have been observed. Access under the arrangement remains appropriate (Table 10). Upon completion of the third review, an amount of SDR 387 million will be made available, and the authorities will be eligible for a cumulative purchase of SDR 1,161 million under the arrangement (Table 11). The amount of purchases and the availability dates for the remaining purchases under the SBA would stay the same.

29. **Program conditionality is being amended at this review as follows**:

- The indicative targets for September and December 2004 for the combined public sector deficit, inflation, net international reserves, net disbursements of short-term external debt and of medium- and long-term external debt by the public sector are being converted into performance criteria.

- An adjustor, up to a specified amount, is being incorporated into the performance criteria for the combined public sector deficit for September and December 2004 to allow for additional public investment, provided the government receives higher-than-expected privatization proceeds.

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[11] In 2003, the authorities eliminated the bilateral payments agreement with China and the tax on inward foreign exchange remittances. The rate on the export subsidy certificate is set at zero, which is consistent with WTO guidelines.

[12] Colombia has a rating of 2 on the Fund's index of trade restrictiveness.

- The electricity distribution enterprise (ISA) will be removed from the program definition of the public sector starting in July 2004. There is no need to adjust the program fiscal targets for this step.

- The authorities are proposing to add to the structural performance criterion for July 31, 2004 a commitment to submit a budget law for 2005 that provides for a CPS deficit of 2 to 2½ percent of GDP. The criterion will continue to require that the 2005 budget law include a presentation of expenditure according to a standard international classification system.

- The authorities are adding structural benchmarks to: (i) initiate a congressional discussion of a constitutional amendment for pension reform by July 31, 2004; (ii) improve tax administration by September 2004; (iii) restructure Bancafé by December 2004; (iv) announce an auction for Granahorrar by December 2004; (v) implement the plan to improve the reporting of the financing of the public sector by December 2004; and (vi) resubmit to Congress the modifications of Law 80 by December 2004.

- The authorities are requesting a waiver for the nonobservance of the continuous performance criterion on the introduction of multiple currency practices. This practice was introduced unintentionally on February 12, 2004 in the regulation that authorized the government to purchase foreign exchange in the forward market. It allowed the government to transact at an exchange rate that could potentially differ from the market spot exchange rate by more than 2 percent. On April 16, the government issued a regulation stating that it would ensure that the exchange rate used in its transactions would not deviate by more than 2 percent from the prevailing spot market exchange rate.

- The authorities are proposing that the Board complete the fourth review under the arrangement by December 2004, one month later than envisaged. Conditions for completing the review include congressional approval of the revised budget code and a budget for 2005 that provides for a CPS deficit of 2 to 2½ percent of GDP.

30. **Colombia would be able to repay the Fund, if all purchases were made under this arrangement**. Fund credit would be equivalent to 2.5 percent of GDP in 2004. Debt service would peak at 6.1 percent of exports of goods and nonfactor services in 2008 (Table 12). However, the authorities intend to continue to treat the arrangement as precautionary.

31. **Risks to the program remain significant**. The political focus on the issue of presidential reelection could divert attention away from the key structural fiscal reforms or create pressures for additional public spending. The security situation has improved, but remains fragile. While Colombia is well positioned to manage a gradual increase in interest rates in the United States, rapid increases in the yield on long-term U.S. government bonds

could drive up the Colombian government's borrowing costs and complicate the fiscal outlook.

IV. Staff Appraisal

32. **Colombia's strong policy track record under the program is bolstering confidence and contributing to the economic recovery.** In 2004, real economic growth is expected to reach 4 percent, inflation to continue to decline, and the external sector to remain strong. This outlook is benefiting from faster than expected growth in Colombia's trading partners as well as the rise in world oil prices. A gradual rise in interest rates in the United States should be manageable, provided the policy mix continues to be strong. In this context, the main policy challenge for 2004 is to take advantage of this good economic performance to press ahead with the reforms that are crucial to sustain the economic recovery.

33. **The authorities are strongly committed to keep fiscal policy in 2004 and 2005 on a path to reduce public debt to below 45 percent of GDP by 2010.** The authorities continue to target a decline in the CPS deficit to 2½ percent of GDP in 2004 as envisaged in the program, with a small adjustor to allow for additional investment projects that are financed with nondebt creating flows. They have also agreed to submit a budget for 2005 that provides for a CPS deficit of 2 to 2½ percent of GDP. The staff supports the authorities' proposal to remove ISA from the program definition of the public sector. ISA has many characteristics of a commercially-run enterprise, including meeting the requirements for issuing ADRs.

34. **However, fiscal policy should be managed carefully, in view of the risks that may arise from higher interest rates, a depreciation of the peso or other factors.** There is little room for policy slippages that would bring the primary surplus below the range of 2½ to 3 percent of GDP in 2005 and beyond. Against this background, the staff supports the authorities' goal of raising the share of domestic public debt and encourages the authorities to try to rely on more domestic financing in 2004 and 2005.

35. **It is important to press ahead with the structural fiscal reforms envisaged in the program.** These reforms will allow for more flexibility in managing current expenditures and enable the government to limit the CPS deficit without having to trim investment. The staff notes that the authorities are cautiously optimistic that Congress will approve the revised budget code this year, as this would allow the budget for 2006 to be prepared under the new code. Steady increases in net pension costs also complicate expenditure management, and it is important to adopt pension reform this year to begin to ease this burden. With regard to strengthening the system of fiscal decentralization, the recommendations of the recent FAD technical assistance mission provide useful inputs to CONPES.

36. **Furthermore, the level of public revenues—already above 30 percent of GDP—needs to be protected.** The staff welcomes the steps to improve tax administration and encourages the authorities to continue to press for the approval of stronger penalties for tax

evasion. The staff urges the authorities to introduce this year legislation that would make the tax structure more efficient and protect the level of revenues in 2005, given the possible revenue loss arising from the investment tax credit, and help lower the CPS deficit as planned. Such a reform would enhance the effectiveness of tax administration. It is unclear whether the political appetite for tax reform legislation will improve as the May 2006 elections approach.

37. **The Banco de la República continues to succeed in lowering inflation.** It has been managing monetary policy well in a complicated environment, with unanticipated shifts in the exchange rate. The staff supports the central bank's technical analysis which points to the need for a gradual monetary tightening to continue to reduce inflation in 2005 and beyond. The staff believes the flexible exchange rate system has served Colombia well, contributing to a strong export performance in 2003 and so far in 2004. The staff has cautioned against sustained intervention that would raise questions about the degree of exchange rate flexibility and—in the event of foreign exchange purchases—can weaken the credibility of the inflation targeting framework. The staff concurs with the Ministry of Finance and the Banco de la República that capital controls would yield few, if any, benefits, while carrying some costs, especially by possibly weakening confidence in Colombia's economic policies.

38. **The health of the financial system continues to improve**. However, mortgage lending is being affected by the overhang of nonperforming mortgages and legal and regulatory obstacles. The staff welcomes the authorities' interest in receiving technical assistance in developing recommendations for improving housing finance. The staff urges the authorities to follow through with the sale of Bancafé and Granahorrar, which will virtually eliminate the government holdings of distressed banks.

39. **The staff welcomes the authorities' acceptance of the obligations of Article VIII**. They have already removed several restrictions and plan to eliminate the remaining restrictions.

40. **The staff supports the authorities' request for the completion of the third review.** The authorities are determined to strengthen fiscal policy in 2004 and 2005, and are advancing the structural fiscal reforms envisaged in the program. Monetary policy is reducing inflation and financial supervision continues to improve. The staff supports the authorities' request for a waiver of the nonobservance of the continuous performance criterion on the introduction of a multiple currency practice.

Table 1. Colombia: Selected Economic and Financial Indicators

	2000	2001	2002	2003 Prog.	2003 Prel.	Prog. 2004	Proj. 2005
(Percentage changes, unless otherwise indicated)							
National income and prices							
Real GDP	2.9	1.4	1.6	2.8	3.7	4.0	4.0
GDP deflator	12.1	6.0	6.5	7.6	6.6	5.9	5.0
Consumer prices (average)	9.2	8.0	6.3	7.0	7.1	6.0	5.0
Consumer prices (end of period)	8.7	7.6	7.0	6.2	6.5	5.5	4.5
External sector (on the basis of U.S. dollars)							
Exports (f.o.b.)	13.1	-6.2	-3.7	6.8	9.9	11.2	-2.3
Imports (f.o.b.)	8.1	10.6	-1.6	8.4	9.8	15.1	3.3
Export volume	0.4	1.1	-4.0	-2.1	0.7	2.9	1.0
Import volume	8.0	9.7	-1.6	1.2	1.3	7.6	1.5
Terms of trade (deterioration -)	12.6	-8.0	0.3	1.9	0.6	1.1	-5.0
Real effective exchange rate (depreciation -)	-6.9	-0.5	-13.8	…	-3.8	…	…
Central administration							
Revenue	25.7	20.8	10.1	12.8	13.9	10.0	6.0
Expenditure 1/	11.9	16.7	12.6	9.5	6.8	10.7	11.7
Money and credit 2/							
Broad money	1.5	6.4	5.3	9.3	9.9	10.2	10.2
Credit to the private sector 3/	-8.6	1.7	5.1	11.0	9.5	11.5	8.5
Interest rate (90-day time deposits; percent per year)							
Nominal	13.4	11.5	7.7	…	7.6	…	…
Real	4.2	3.6	0.7	…	1.1	…	…
(In percent of GDP)							
Central administration balance 1/	-5.7	-5.7	-6.5	-5.2	-5.4	-5.6	-6.5
Nonfinancial public sector balance 1/	-3.5	-3.5	-4.2	-3.1	-3.2	-2.5	-2.0
NFPS primary balance 1/	0.9	1.5	0.4	2.0	1.7	2.5	3.1
Public sector balance 1/	-3.4	-3.2	-3.7	-2.8	-2.7	-2.5	-2.0
Foreign financing	1.6	2.3	0.6	1.9	1.0	1.7	0.9
Domestic financing 4/	1.2	0.9	3.1	1.0	1.8	0.9	1.1
Privatization	0.5	0.0	-0.1	-0.1	-0.1	0.1	0.0
Public debt 5/	45.1	49.6	58.8	56.3	56.2	52.1	50.3
Gross domestic investment	13.7	15.1	14.8	16.3	15.5	15.5	15.8
Gross national savings	14.5	13.6	13.0	14.1	13.7	13.4	13.1
Current account (deficit -)	0.8	-1.6	-1.9	-2.2	-1.8	-2.2	-2.7
External debt 6/	46.1	47.7	53.0	48.2	47.6	43.7	43.6
Of which : public sector 6/	26.3	28.6	32.3	30.2	30.6	28.6	28.4
NIR in percent of short-term debt	111.5	98.4	106.1	...	121.3	124.4	115.6
(In percent of exports of goods, services, and income)							
External debt service 6/	50.1	50.2	64.0	60.6	55.7	47.7	50.7
Of which : public sector	21.7	28.2	37.0	33.0	33.8	23.8	28.2
Interest payments 6/	15.9	16.3	16.8	16.3	15.2	15.9	16.9
Of which : public sector	8.9	10.4	11.3	11.4	10.8	11.2	12.2
(In millions of U.S. dollars)							
Overall balance of payments	870	1,217	138	-289	-184	712	180
Net official reserves 7/	8,800	9,982	10,507	10,424	10,524	11,408	11,588
Net official reserves (in months of imports of goods and services)	6.8	8.0	7.9	7.2	7.7	7.2	7.2

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

1/ Includes floating debt defined as unpaid bills plus outstanding budgetary commitments.
2/ All annual changes in foreign currency stocks valued at constant exchange rate.
3/ The figures for 1999-2002 have been adjusted for loan write-offs resulting from the mortgage debt reduction and bank restructuring programs.
4/ Includes the quasi-fiscal balance of Banco de la Republica, sales of assets, phone licenses, and statistical discrepancy.
5/ Includes bonds issued to recapitalize financial institutions.
6/ Includes short-term debt.
7/ Program definition. Assumes no purchases under the current SBA arrangement. Includes valuation changes.

Table 2. Colombia: Summary Balance of Payments, 2000-2005

				2003		2004		Proj.
	2000	2001	2002	Prog.	Est.	Prog.	Rev. Prog.	2005
	(In millions of U.S. dollars)							
Current account balance	**641**	**-1,272**	**-1,497**	**-1,677**	**-1,417**	**-2,017**	**-1,978**	**-2,506**
Trade balance	2,531	503	225	44	265	-382	-222	-1,072
Exports, f.o.b.	13,620	12,772	12,302	13,139	13,523	13,649	15,039	14,698
Coffee	1,069	764	772	847	806	942	913	983
Petroleum products	4,569	3,285	3,275	3,635	3,383	3,001	3,991	3,119
Non-traditional	6,200	6,613	6,287	6,250	6,083	6,953	6,560	6,975
Other	1,782	2,110	1,968	2,408	3,251	2,754	3,575	3,621
Imports, f.o.b.	11,090	12,269	12,077	13,095	13,258	14,031	15,260	15,770
Services (net)	-1,276	-1,425	-1,459	-1,474	-1,499	-1,517	-1,632	-1,604
Income (net)	-2,286	-2,615	-2,848	-3,019	-3,361	-2,933	-3,423	-3,104
Interest (net)	-1,663	-1,738	-1,905	-2,094	-1,982	-2,014	-2,282	-2,025
Of which : public sector	-889	-1,087	-1,262	-1,445	-1,448	-1,428	-1,660	-1,652
Other Income (net)	-623	-877	-944	-925	-1,379	-919	-1,141	-1,079
Current transfers (net)	1,673	2,265	2,585	2,773	3,178	2,815	3,299	3,275
Financial account balance	**80**	**2,479**	**1,310**	**1,175**	**829**	**2,017**	**2,690**	**2,686**
Public sector (net)	458	1,446	370	1,041	457	1,356	1,450	823
Nonfinancial public sector	1,258	1,916	494	1,394	785	1,710	1,513	836
Medium- and long-term (net)	1,663	3,464	-1,091	1,055	1,478	1,399	748	713
Disbursements	3,238	5,743	2,469	4,212	4,915	3,346	2,723	3,236
Amortization	1,575	2,280	3,560	3,157	3,438	1,947	1,975	2,522
Other long-term flows	-40	-35	-30	-26	-30	-26	-26	-26
Short term 1/	-365	-1,512	1,615	365	-663	337	792	149
Of which : change in public assets	-259	-1,534	1,566	460	-570	337	792	149
Financial public sector	-800	-470	-124	-353	-328	-355	-63	-13
Private sector (net)	-378	1,032	939	134	372	661	1,240	1,863
Nonfinancial private sector (net)	28	1,017	1,414	118	531	405	1,063	1,719
Direct investment	2,069	2,509	1,258	991	837	1,182	1,265	1,346
Of which : Privatization	465	0	0	0	0	0	0	0
Leasing finance	-109	-211	-160	-404	-311	-315	-278	-184
Long-term loans	-479	126	-970	-796	-675	-322	-243	83
Short term 2/	-1,453	-1,406	1,285	328	680	-141	319	474
Financial private sector (net)	-406	15	-475	17	-159	256	176	143
Net errors and omissions	**148**	**10**	**325**	**213**	**405**	**0**	**0**	**0**
Changes in GIR 3/	**870**	**1,217**	**138**	**-289**	**-184**	**0**	**712**	**180**
Changes in NIR, program definition 3/	**687**	**1,182**	**525**	**-205**	**17**	**0**	**883**	**180**
	(In percent of GDP)							
Current account balance	0.8	-1.6	-1.9	-2.2	-1.8	-2.5	-2.2	-2.7
	(In months of imports of goods and services)							
Gross international reserves 4/	6.8	8.0	7.9	7.2	6.8	7.1	7.2	6.8

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

1/ Includes movements of short-term assets owned by the public sector abroad.
2/ Includes net portfolio investment.
3/ Does not include valuation changes of reserves denominated in other currencies than US dollars.
4/ Not including Fund purchases under the standby arrangement.

Table 3. Colombia: Operations of the Combined Public Sector

(In percent of GDP)

				2003		2004		Proj.
	2000	2001	2002	Prog.	Est.	Prog.	Rev. Prog.	2005
Total revenue	**28.0**	**29.6**	**29.6**	**30.3**	**31.2**	**30.1**	**31.1**	**31.0**
Current revenue	**28.0**	**29.6**	**29.6**	**30.3**	**31.2**	**30.1**	**31.1**	**31.0**
Tax revenue	17.3	19.2	19.2	19.9	19.7	20.1	20.0	19.9
Nontax revenue	10.7	10.4	10.4	10.4	11.5	10.0	11.1	11.1
Property income	1.0	1.3	0.9	1.2	1.1	0.9	1.0	1.2
Operating surplus of public enterprises	4.2	4.2	4.0	4.7	4.6	4.4	4.2	4.2
Of which : Ecopetrol	3.0	2.5	2.3	3.0	2.9	2.7	2.6	2.4
Other	5.5	4.8	5.4	4.5	5.7	4.7	5.9	5.7
Total expenditure and net lending 1/	**31.5**	**33.3**	**33.8**	**33.4**	**34.1**	**32.7**	**33.6**	**33.0**
Current expenditure	**23.6**	**24.9**	**25.5**	**25.4**	**25.5**	**25.3**	**26.4**	**25.8**
Wages and salaries	7.2	7.5	7.5	7.4	7.5	7.4	7.5	7.2
Goods and services 2/	3.3	3.5	3.4	3.6	3.3	3.4	3.4	3.4
Interest	4.4	5.0	4.5	5.1	4.9	5.0	5.0	5.1
External	1.6	2.3	2.1	2.3	2.2	2.2	2.0	2.0
Domestic	2.8	2.8	2.4	2.8	2.7	2.8	3.0	3.1
Transfers to private sector	9.0	9.8	9.7	10.3	10.0	10.5	10.9	10.6
Of which: from social security	5.5	6.5	6.7	6.9	7.0	7.2	7.7	7.7
Other 3/	-0.3	-0.9	0.2	-1.0	-0.1	-1.0	-0.4	-0.5
Capital expenditure	**7.9**	**8.3**	**8.1**	**7.9**	**8.6**	**7.4**	**7.2**	**7.2**
Fixed capital formation 3/	7.8	8.2	7.9	7.8	8.5	7.3	7.1	7.2
Transfers	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.0
Net lending	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Statistical discrepancy	0.0	0.2	-0.1	-0.1	-0.3	0.0	0.0	0.0
Nonfinancial public sector balance	**-3.5**	**-3.5**	**-4.2**	**-3.1**	**-3.2**	**-2.6**	**-2.5**	**2.0**
Quasi-fiscal balance (BR cash profits)	0.5	0.7	0.8	0.6	0.6	0.3	0.3	0.3
Fogafin balance	0.0	0.2	0.3	0.2	0.3	0.2	0.1	0.1
Net cost of financial restructuring 4/	-0.4	-0.7	-0.6	-0.4	-0.4	-0.4	-0.4	-0.4
Overall balance	**-3.4**	**-3.2**	**-3.7**	**-2.8**	**-2.7**	**-2.5**	**-2.5**	**-2.0**
Additional investment projects 5/							**-0.3**	**0.0**
Overall financing	**3.4**	**3.2**	**3.7**	**2.8**	**2.7**	**2.5**	**2.8**	**2.0**
Foreign, net	1.6	2.3	0.6	1.9	1.0	1.6	1.7	0.9
Of which								
Changes in assets held abroad (-increase)	-0.1	-1.9	1.9	0.6	-0.8	0.3	0.9	0.2
Domestic, net	1.2	0.9	3.1	1.0	1.8	0.9	0.8	1.1
Financial system 6/	-0.5	-1.1	-1.4	-0.6	-0.6	-1.0	0.5	0.7
Bonds 7/	2.3	2.8	3.9	2.6	2.6	1.7	1.0	1.1
Change in floating debt and accrual adjustments	-0.6	-0.7	0.7	-1.0	-0.2	0.2	-0.7	-0.7
Privatization (including concessions) 8/	0.5	0.0	-0.1	-0.1	-0.1	-0.1	0.3	0.0
Memorandum items								
NFPS savings	4.4	4.7	4.1	4.7	5.7	4.8	4.6	5.2
NFPS primary balance	0.9	1.5	0.4	2.0	1.7	2.4	2.2	3.1
Oil stabilization fund (deposits in FAEP)	0.9	0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.2
Military expenditure	3.2	3.4	3.8	4.5	4.5	4.8	4.8	4.8

Sources: Ministry of Finance; Banco de la República; and Fund staff estimates.

1/ Expenditure reported on commitments basis.
2/ From year 2000 includes the unpaid bills of the Social Security Institute (ISS).
3/ Includes adjustments to put spending on commitment basis and the change in unpaid bills of selected nonfinancial public enterprises.
4/ Interest payments on public banks restructuring bonds and mortgage debt relief related costs.
5/ These projects will be implemented only if privatizations proceeds materialize.
6/ Includes changes in public sector loans and deposits in the financial system.
7/ Includes changes in holdings of public securities by banks and nonbanks.
8/ Includes nonrecurrent fees from telecommunications licensing.

Table 4. Colombia: Operations of the Central Administration

(In percent of GDP)

				2003		2004		Proj.
	2000	2001	2002	Prog.	Est.	Prog.	Rev. Prog.	2005
Total revenue	**13.0**	**14.7**	**15.0**	**15.5**	**15.4**	**15.7**	**15.4**	**15.0**
Current revenue	**13.0**	**14.7**	**15.0**	**15.5**	**15.4**	**15.7**	**15.4**	**15.0**
Tax revenue	11.2	13.2	13.4	14.0	14.1	14.2	14.0	13.9
Net income tax and profits	4.3	5.3	5.3	5.8	6.0	5.9	5.7	5.6
Goods and services	5.3	5.9	5.8	6.5	6.3	6.4	6.7	6.7
Value-added tax	4.8	5.3	5.3	6.0	5.9	5.9	6.2	6.2
Gasoline tax	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5
International trade	1.0	1.1	1.0	1.0	1.0	1.0	0.9	0.9
Financial transaction tax	0.6	0.8	0.7	0.7	0.7	0.9	0.7	0.7
Stamp and other taxes	0.0	0.0	0.7	0.0	0.0	0.0	0.0	0.0
Nontax revenue and transfers	1.8	1.5	1.6	1.5	1.4	1.5	1.4	1.0
Property income	0.5	0.3	0.3	0.4	0.2	0.3	0.3	0.3
Other	1.3	1.2	1.3	1.1	1.1	1.2	1.1	0.8
Total expenditure and net lending	**18.8**	**20.4**	**21.4**	**20.7**	**20.9**	**20.5**	**21.0**	**21.5**
Current expenditure	**15.3**	**15.8**	**18.2**	**17.4**	**17.4**	**17.9**	**18.2**	**18.5**
Wages and salaries	2.9	3.0	3.0	2.9	3.0	3.0	3.1	2.9
Goods and services	1.3	1.5	1.5	1.9	1.5	2.1	1.6	1.5
Interest	3.0	3.5	3.5	4.1	4.0	4.3	4.3	4.5
External	1.2	1.6	1.7	2.0	1.9	2.0	1.8	1.8
Domestic	1.8	1.9	1.7	2.2	2.1	2.4	2.6	2.6
Other expenditure 1/	-0.1	-0.9	0.7	-1.0	-0.1	-1.0	-0.3	-0.5
Current transfers 2/	8.2	8.6	9.5	9.4	9.0	9.5	9.5	10.0
Capital expenditure	**3.0**	**3.8**	**2.5**	**2.8**	**3.0**	**2.3**	**2.5**	**2.7**
Fixed capital formation 1/	1.0	1.3	1.3	0.9	1.1	0.4	0.5	0.9
Capital transfers	2.1	2.5	1.2	1.9	2.0	1.9	2.0	1.9
Net lending	**0.5**	**0.8**	**0.6**	**0.5**	**0.4**	**0.3**	**0.3**	**0.2**
Overall balance	**-5.7**	**-5.7**	**-6.4**	**-5.2**	**-5.4**	**-4.8**	**-5.6**	**-6.5**
Memorandum item								
Primary balance	-2.7	-2.2	-2.9	-1.1	-1.4	-0.5	-1.3	-2.0

Sources: Ministry of Finance; Banco de la República; and Fund staff estimates.

1/ Includes change in the budget carryover. A negative number corrects for current cash payments of expenditures incurred in previou periods.

2/ Includes interest payment to the rest of the nonfinancial public sector.

Table 5. Colombia: Monetary Indicators 1/

	2000	2001	2002	2003 Prog.	2003 Est.	2004 Prog.	2004 Rev. Prog.	Proj. 2005
(Billions of Colombian pesos, unless otherwise stated)								
Central bank								
Net international reserves 2/	19,470	23,320	30,301	30,545	29,544	32,342	31,260	33,563
billions of US$	9.0	10.2	10.5	10.5	10.5	10.5	11.2	11.4
Net domestic assets	-8,760	-11,672	-16,194	-14,167	-13,102	-14,988	-12,679	-13,273
Net credit to public sector	2,790	1,641	2,403	2,704	3,074	2,424	3,628	3,398
TES	2,361	1,752	2,675	...	3,471	...	4,022	3,328
Other, including deposits and REPOs	429	-111	-272	...	-397	...	-394	70
Net credit to financial system	2,695	2,006	3,230	5,351	4,721	5,031	3,674	4,975
Other	-14,245	-15,319	-21,826	-22,222	-20,897	-22,443	-19,981	-21,646
Monetary base	10,710	11,648	14,107	16,378	16,442	17,354	18,581	20,290
Currency in circulation	7,276	8,349	9,993	11,546	11,953	12,728	13,737	15,001
Banking system reserves	3,434	3,298	4,114	...	4,489	...	4,844	5,289
Banking system								
Net foreign assets 2/	13,455	18,303	24,649	27,809	28,720	29,601	30,084	31,977
billions of US$	6.0	8.0	8.6	9.6	10	9.6	10.8	10.9
Net domestic assets	41,532	40,550	37,352	39,958	39,375	45,105	44,942	50,701
Net credit to public sector	8,031	8,006	10,641	11,066	11,270	10,827	10,786	12,128
Credit to private sector	45,261	46,049	48,379	53,725	52,968	59,554	59,064	64,098
Other net	-11,761	-13,505	-21,669	-24,833	-24,863	-25,276	-24,909	-25,525
Broad money 3/	54,987	58,853	62,001	67,767	68,095	74,706	75,026	82,678
(Annual percentage change)								
Credit to public sector, net	-2.6	-0.3	32.9	4.0	5.9	-2.2	-4.3	12.4
Credit to private sector	-8.6	1.7	5.1	11.0	9.5	10.8	11.5	8.5
Currency	20.5	14.8	19.7	15.5	19.6	10.2	14.9	9.2
Monetary base	10.0	8.8	21.1	16.1	16.5	6.0	13.0	9.2
Broad money 3/	1.2	7.0	5.3	9.3	9.9	10.2	10.2	10.2
(Percent of GDP)								
Credit to public sector, net	4.6	4.3	5.3	4.9	5.0	4.4	4.4	4.5
Credit to private sector	25.9	24.5	23.9	24.0	23.7	24.3	24.0	23.9
Currency	4.2	4.4	4.9	5.1	5.4	5.2	5.6	5.6
Monetary base	6.1	6.2	7.0	7.3	7.4	7.1	7.6	7.6
Broad money 3/	31.4	31.3	30.6	30.2	30.5	30.5	30.5	30.8
(Annual percentage change)								
Central bank inflation target 4/	10.0	8.0	6.0	5.9	5.9	5.5	5.5	4.5
Consumer price index	8.8	7.6	7.0	6.2	6.5	...	...	...
Exchange rate (+ depreciation)	19.0	2.8	25.0	1.2	-3.0	...	...	...
(In billions of Colombian pesos, unless otherwise stated)								
Financial system 5/								
Net assets in foreign currency 6/	-445	373	650	...	326	...	...	...
billions of US$	-0.2	0.2	0.2	...	0.1	...	...	...
percent of GDP	-0.3	0.2	0.3	...	0.1	...	...	...
Foreign currency assets to total assets (percent) 6/	8.9	8.2	8.7	...	5.8	...	...	...
Foreign currency credit to total credit (percent) 6/	13.1	11.0	11.6	...	7.5	...	...	...
Foreign currency deposits to total deposits (percent) 6/	0.4	0.5	0.4	...	0.5	...	...	...
Memorandum item								
Broad money/net international reserves	2.9	2.6	2.1	2.3	2.3	2.3	2.4	2.4

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

1/ Historic data series were revised during 2003.
2/ Assets on and liabilities to nonresident entities. Net international reserves include liabilities in foreign currency to resident entities. Exclude valuation effect.
3/ Currency in circulation plus deposit liabilities of the private sector.
4/ 2003 target was revised upward by 0.4 percentage points in account of the first round effect of the VAT reform.
5/ Banking system excluding the central bank.
6/ Regulation limits net foreign liabilities to 5 percent and net foreign assets to 20 percent of regulatory capital.

Table 6. Colombia: Banking System Indicators

	2000	2001	2002	2003	2004 1/
(In millions of Colombian pesos, unless otherwise stated)					
Total system 2/					
Assets	80,390	84,244	89,185	97,311	100,083
Investment portfolio	17,165	22,163	25,070	28,946	31,576
Loan portfolio	44,301	44,098	46,436	49,620	49,872
Of which					
Nonperforming loans	5,211	4,640	4,386	3,602	3,610
Capital	9,101	9,417	9,824	11,164	11,797
Operational margin 3/	-174	1,558	2,393	3,439	1,311
Net results	-1,574	506	1,349	2,399	1,090
(Annual percent change)					
Assets	0.4	4.8	5.9	9.1	10.5
Loan portfolio	2.5	9.0	5.3	8.0	8.1
Of which					
Nonperforming loans	-24.7	-11.0	-5.5	-17.9	-17.8
(Percent)					
Financial ratios					
Total system 2/					
Capital adequacy ratio (with market risk)	12.4	12.4	12.0	12.6	12.6
Regulatory Tier I capital to risk weighted assets	8.4	8.8	9.1	10.0	10.6
Nonperforming loans net of provision to capital	24.8	11.1	6.0	5.3	-0.3
Net interest margin to assets	3.5	3.0	3.3	3.8	4.1
Gross interest margin to assets	8.3	8.4	8.7	9.4	11.1
Operational margin to assets 3/	-0.2	1.8	2.7	3.5	5.2
Gross interest margin to gross income	42.1	43.2	41.2	51.7	55.7
Noninterest expenses to gross income	19.4	21.6	35.2	26.0	22.8
Return on equity	-17.3	5.4	13.7	21.5	37.0
Return on assets	-2.0	0.6	1.5	2.5	4.4
Cash to assets	6.7	6.2	6.3	6.6	6.3
Cash to deposits	10.7	9.5	9.7	10.2	9.8
Investment portfolio to total assets	21.4	26.3	28.1	29.7	31.5
Nonperforming loans to total loans 4/	11.0	9.7	8.7	6.8	6.7
Loan-loss provisions to nonperforming loans	56.6	77.5	86.5	83.5	100.9
Capital to assets 5/	11.3	11.2	11.0	11.5	11.8
Net open position in foreign exchange to capital	4.9	-4.0	-6.6	-2.9	0.0

Sources: Superintendencia Bancaria; and Fund staff estimates.

1/ Data to March 2004.
2/ Excluding credit unions and public sector special institutions (IOE).
3/ Gross interest margin plus net provisions and administrative cost before depreciation and amortisation.
4/ Nonperforming based on past-due period (30 days).
5/ Not risk weighted.

Table 7. Colombia: External Debt Sustainability Framework - Baseline Scenario

	2002	2003	2004	2005	2006	2007	2008	2009	2010
				I. Output and Prices					
				(Annual percentage changes)					
Real GDP	1.6	3.7	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Consumer prices (end of period)	7.0	6.5	5.5	4.5	3.5	3.0	3.0	3.0	3.0
				(In percent of GDP, unless indicated otherwise)					
				II. Saving and Investment					
Gross national saving	**13.0**	**13.7**	**13.4**	**13.8**	**13.4**	**14.7**	**15.4**	**16.0**	**16.3**
Private sector	9.0	8.0	8.7	8.6	8.1	9.5	9.9	10.4	10.6
Public sector	4.0	5.7	4.7	5.2	5.3	5.2	5.5	5.6	5.7
Gross domestic investment	**14.8**	**15.5**	**15.5**	**16.5**	**16.4**	**17.5**	**17.9**	**18.5**	**18.8**
Private sector	7.2	7.0	8.1	9.3	9.5	10.8	11.0	11.5	11.8
Public sector capital expenditure	7.6	8.6	7.5	7.2	6.9	6.7	6.9	7.0	7.0
External current account balance	**-1.9**	**-1.8**	**-2.2**	**-2.7**	**-3.0**	**-2.8**	**-2.5**	**-2.5**	**-2.5**
Private sector	1.8	1.1	0.6	-0.7	-1.4	-1.3	-1.1	-1.1	-1.2
Public sector	-3.7	-2.9	-2.8	-2.0	-1.6	-1.5	-1.4	-1.4	-1.3
				III. Nonfinancial and Consolidated Public Sector					
Nonfinancial public sector									
Revenue	29.6	31.2	31.1	31.0	30.3	29.7	29.4	29.6	29.5
Expenditure	33.8	34.1	33.6	33.0	31.9	31.3	30.8	31.0	30.9
Current expenditure	25.5	25.5	26.4	25.8	25.0	24.6	23.9	24.0	23.9
Capital expenditure	8.1	8.6	7.2	7.2	6.9	6.7	6.9	7.0	7.0
Primary balance	0.4	1.7	2.2	3.1	2.9	3.0	2.7	2.6	2.5
Nonfinancial public sector balance	-4.2	-3.2	-2.5	-2.0	-1.7	-1.6	-1.4	-1.4	-1.4
Combined public sector balance	-3.7	-2.7	-2.8	-2.0	-1.6	-1.6	-1.4	-1.4	-1.3
External financing	0.6	1.0	1.7	0.9	1.0	0.6	0.1	0.2	0.0
Domestic financing	3.1	1.8	0.8	1.1	0.6	1.0	1.3	1.2	1.4
Privatization	-0.1	-0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
				IV. Financial System					
Velocity (GDP / broad money)	3.3	3.3	3.3	3.2	3.2	3.2	3.2	3.2	3.2
Real growth in private sector credit	-1.2	2.2	5.2	3.4	6.9	7.3	6.2	7.7	8.1
				V. Balance of Payments					
External current account balance	**-1.9**	**-1.8**	**-2.2**	**-2.7**	**-3.0**	**-2.8**	**-2.5**	**-2.5**	**-2.5**
Of which: Trade balance	0.3	0.3	-0.2	-1.1	-1.8	-1.8	-1.5	-1.5	-1.4
Exports	15.3	17.4	16.6	15.8	15.4	15.7	16.4	16.6	16.9
Imports	15.0	17.1	16.8	16.9	17.2	17.5	17.9	18.1	18.4
Capital and financial account balance	**1.6**	**1.1**	**3.0**	**2.9**	**3.3**	**3.1**	**2.8**	**2.8**	**2.8**
Public sector	0.5	0.6	1.6	0.9	1.0	0.6	0.1	0.2	0.0
Private sector	1.2	0.5	1.4	2.0	2.2	2.5	2.7	2.6	2.8
Overall balance	**0.2**	**-0.2**	**0.8**	**0.2**	**0.2**	**0.3**	**0.3**	**0.3**	**0.3**
				VI. Debt					
Total external debt	**53.0**	**47.6**	**43.7**	**43.6**	**43.4**	**42.8**	**42.9**	**41.9**	**41.4**
Public debt	32.3	30.6	28.6	28.4	27.9	26.9	26.1	24.5	23.0
Private debt	20.7	17.0	15.1	15.2	15.5	15.9	16.8	17.4	18.4
Total public debt	**58.8**	**56.2**	**52.1**	**50.3**	**48.8**	**47.4**	**46.5**	**44.8**	**43.2**
Domestic debt	26.5	25.6	23.6	21.9	20.9	20.5	20.4	20.2	20.3
External debt	32.3	30.6	28.6	28.4	27.9	26.9	26.1	24.5	23.0

Sources: Colombian authorities; and Fund staff estimates.

Table 8. Colombia: External Debt Sustainability Framework, 2003-2010

(In percent of GDP, unless otherwise indicated)

		Projections						
	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Medium-Term Projections								
External debt	**47.6**	**43.7**	**43.6**	**43.4**	**42.8**	**42.9**	**41.9**	**41.4**
Change in external debt	-5.4	-3.9	-0.1	-0.2	-0.6	0.1	-1.0	-0.5
Identified external debt-creating flows	-5.1	-3.5	-1.3	-0.9	-1.2	-0.9	-1.3	-0.9
Current account deficit, excluding interest payments	-1.2	-0.6	-0.5	-0.6	-1.1	-1.3	-1.2	-1.1
Net nondebt creating capital inflows (negative)	-1.0	-1.4	-1.5	-1.1	-1.3	-1.2	-1.0	-0.7
Automatic debt dynamics 1/	-2.8	-1.5	0.6	0.8	1.2	1.6	0.9	0.9
Residual, including change in gross foreign assets	-0.3	-0.4	1.2	0.7	0.6	1.0	0.3	0.4
Key macroeconomic and external assumptions								
Real GDP growth (in percent)	3.7	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Nominal exchange rate appreciation (US$ value of local currency, change in percent)	3.1	-0.1	-5.4	-2.3	-1.3	-3.2	0.0	-0.3
GDP deflator in US$ (change in percent)	9.9	5.7	-0.6	1.5	1.9	-0.3	3.0	2.7
Nominal external interest rate (in percent) 2/	6.5	6.7	7.6	8.8	9.5	9.3	9.4	9.2
Growth of exports (US$ terms, in percent)	8.2	10.6	-1.8	1.7	8.0	7.1	7.9	8.4
Growth of imports (US$ terms, in percent)	13.8	17.7	4.3	7.7	8.2	5.8	9.5	8.9
II. Stress Tests for External Debt Ratio								
Real GDP growth, nominal interest rate, dollar deflator, noninterest current account, and nondebt inflows are at historical average in 2004-10	47.6	45.5	43.7	42.2	40.8	39.4	37.9	36.3
Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005	47.6	44.5	44.9	44.7	44.2	44.3	43.4	42.9
Real GDP growth is at historical average minus two standard deviations in 2004 and 2005	47.6	47.2	50.7	50.6	50.3	50.6	49.8	49.4
Noninterest current account is at historical average minus two standard deviations in 2004 and 2005	47.6	51.1	58.4	58.5	58.3	59.0	58.3	58.1
Combination of 2-4 using one standard deviation shocks	47.6	50.5	56.9	56.9	56.7	57.3	56.6	56.4
One time 30 percent nominal depreciation in 2004	47.6	53.7	53.7	53.7	53.4	53.8	53.1	52.8

Statistics for key variables	Average 1991-2003	Standard Deviation	Average 2004-10	Standard Deviation
Current account deficit, excluding interest payments	-0.1	3.1	-0.9	0.3
Net non-debt creating capital inflows	2.2	1.1	1.2	0.3
Nominal external interest rate (in percent)	7.3	0.7	8.6	1.1
Real GDP growth (in percent)	2.7	2.7	4.0	0.0

Source: Fund staff projections.

1/ Depends on external interest rates, domestic GDP deflator, real GDP growth, exchange rate changes, and the share of domestic currency-denominated debt in total external debt.

2/ Nominal effective interest rate on all external debt.

Table 9. Colombia: Public Sector Debt Sustainability Framework, 2002-2010

(In percent of GDP, unless otherwise indicated)

	Prel.	Projections						
	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Medium-Term Projections								
Public sector debt 1/	**56.2**	**52.1**	**50.3**	**48.8**	**47.4**	**46.5**	**44.8**	**43.2**
Of which : foreign-currency denominated	30.9	28.4	27.6	27.5	27.1	26.4	25.1	23.7
Change in public sector debt	-2.6	-4.0	-1.8	-1.6	-1.4	-0.9	-1.7	-1.6
Identified debt-creating flows (4+7+12)	-3.7	-2.3	-0.8	-1.4	-1.4	-0.8	-1.7	-1.5
Primary deficit	-2.0	-2.2	-3.1	-2.9	-3.0	-2.7	-2.6	-2.5
Revenue and grants	31.2	31.1	31.0	30.3	29.7	29.4	29.6	29.5
Primary (noninterest) expenditure	29.2	28.9	27.9	27.3	26.7	26.7	27.0	27.0
Automatic debt dynamics 2/	-1.6	0.0	2.3	1.5	1.6	1.9	0.9	1.0
Contribution from interest rate/growth differential 3/	-0.7	-0.1	0.7	0.8	1.3	1.0	0.9	0.9
Of which contribution from real interest rate	1.3	2.0	2.6	2.7	3.1	2.8	2.6	2.6
Of which contribution from real GDP growth	-2.0	-2.0	-1.9	-1.9	-1.8	-1.8	-1.7	-1.7
Contribution from exchange rate depreciation 4/	-1.0	0.0	1.6	0.7	0.4	0.9	0.0	0.1
Other identified debt-creating flows	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	1.1	-1.7	-1.0	-0.1	0.0	-0.1	0.0	0.0
Public sector debt-to-revenue ratio 1/	180.2	167.4	162.5	161.1	159.6	158.1	151.4	146.6
Key macroeconomic and fiscal assumptions								
Real GDP growth (in percent)	3.7	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 5/	9.3	10.0	10.7	9.9	10.1	9.4	9.2	9.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.7	4.1	5.7	6.0	6.9	6.4	6.2	6.2
Nominal appreciation (increase in US dollar value of local currency, in percent)	3.1	-0.1	-5.4	-2.3	-1.3	-3.2	0.0	-0.3
Inflation rate (GDP deflator, in percent)	6.6	5.9	5.0	3.9	3.3	3.0	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	3.4	3.2	0.2	2.1	1.4	3.9	5.4	4.0
II. Stress Tests for Public Debt Ratio								
1. Historical average real growth, real interest rate, and primary balance	56.2	53.3	52.9	52.4	51.8	51.6	50.6	49.6
2. Real interest rate shock (two standard deviation)	56.2	56.9	60.8	59.4	58.0	57.2	55.0	52.8
3. Real GDP growth shock (two standandard deviation	56.2	55.5	55.0	54.3	53.0	51.4	50.4	48.3
4. Primary balance shock (two standard deviation)	56.2	56.3	57.6	57.0	55.8	54.3	53.3	51.2
5. Combination of 2-4 using one standard deviation shocks	56.2	59.3	64.6	63.4	62.2	61.1	58.6	56.3
6. One time 30 percent real depreciation in 2004 6/	56.2	68.7	67.0	66.4	65.5	65.1	63.3	61.4

Statistics for Key Variables (past 12 years)	Historical Average	Standard Deviation	Average 2003-10
Primary deficit	-0.8	1.7	-2.7
Real GDP growth (in percent)	2.7	2.7	4.0
Nominal interest rate (in percent) 5/	17.1	5.6	9.8
Real interest rate (in percent)	2.1	5.7	5.9
Inflation rate (GDP deflator, in percent)	15.0	6.6	3.9
Revenue to GDP ratio	27.5	1.9	30.1

1/ For nonfinancial public sector. Based on gross debt.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Derived as nominal interest expenditure divided by previous period debt stock.

6/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 10. Colombia: External Financing Requirements and Sources, 2000-2005

(In millions of U.S. dollars)

	2000	2001	2002	2003	2004 Prog.	2004 Rev. Prog.	Proj. 2005
1. Gross financing requirements	8,896	10,382	11,779	11,137	10,795	11,390	11,880
External current account deficit	-641	1,272	1,497	1,417	2,017	1,978	2,506
Debt amortization	8,667	7,893	10,144	9,903	8,778	8,700	9,195
Medium- and long-term debt	5,727	5,379	7,022	6,411	4,966	5,240	5,505
Public sector	2,127	2,823	3,820	3,648	2,034	2,075	2,608
Private sector	3,601	2,556	3,202	2,763	2,931	3,165	2,897
Short-term debt 1/	2,940	2,514	3,122	3,492	3,812	3,460	3,690
Public sector	672	199	320	429	172	226	226
Private sector	2,267	2,315	2,802	3,063	3,641	3,233	3,464
Gross reserves accumulation	870	1,217	138	-184	0	712	180
2. Available financing	8,896	10,382	11,779	11,137	10,795	11,390	11,880
Foreign direct investment (net)	2,069	2,509	1,258	837	1,182	1,265	1,346
Medium- and long-term debt disbursements	5,645	7,884	4,189	6,361	5,324	5,022	5,718
Public sector	3,238	5,743	2,469	4,915	3,346	2,723	3,236
of which : multilaterals	...	...	856	2404	1,160	1,215	1,847
Private sector	2,407	2,141	1,720	1,446	1,978	2,299	2,482
Public sector use of external assets	-259	-1,534	1,566	-570	337	792	149
Short-term debt 2/	2,514	3,122	3,492	3,460	4,079	3,690	3,711
Public sector	199	320	429	226	172	226	226
Private sector	2,315	2,802	3,063	3,233	3,907	3,464	3,485
Other capital flows (net) 3/	-1,074	-1,599	1,274	1,050	-128	621	956
Exceptional financing and arrears	0	0	0	0	0	0	0
of which: IMF 4/	0	0	0	0	0	0	0
3. Financing gap	0	0	0	0	0	0	0
Memorandum items (in stocks)							
Gross international reserves	9,006	10,245	10,844	10,674	10,527	11,356	11,536
Net international reserves (traditional concept) 5/	9,004	10,192	10,841	10,670	10,522	11,352	11,532
Net international reserves (program definition) 6/	8,800	9,982	10,507	10,524	10,424	11,408	11,588

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

1/ Original maturity of less than 1 year. Stock at the end of the previous period.
2/ Original maturity of less than 1 year. Stock at the end of the current period.
3/ Includes all other net financial flows, and errors and omissions.
4/ Assumes no purchases under the Stand-by Arrangement.
5/ The traditional balance of payments concept of net international reserves, which excludes central bank short-term foreign liabilities and liabilities to the Fund.
6/ In contrast to the traditional concept, foreign currency liabilities of the central bank to residents are excluded (among other things). A complete definition is given in the Technical Memorandum of Understanding.

Table 11. Colombia: Schedule of Purchases Under the SBA, 2003-2004

Date	Amount (In millions of SDR)	Amount (In percent of quota)	Conditions
January 15, 2003	193.50	25.0	Board approval.
February 15, 2003	193.50	25.0	Completion of first review and observance of end-December 2002 performance criteria.
May 15, 2003	193.50	25.0	Observance of end-March 2003 performance criteria.
July 31, 2003	96.80	12.5	Observance of end-June 2003 performance criteria.
November 15, 2003	96.70	12.5	Observance of end-September 2003 performance criteria and completion of second review.
February 15, 2004	193.50	25.0	Observance of end-December 2003 performance criteria.
May 15, 2004	193.50	25.0	Observance of end-March 2004 performance criteria and completion of third review.
August 15, 2004	193.50	25.0	Observance of end-June 2004 performance criteria and end-July 2004 structural performance criterion.
November 15, 2004	193.50	25.0	Observance of end-September 2004 performance criteria and completion of fourth review.
Total	**1,548.00**	**200.0**	

Source: Fund staff estimates.

Table 12. Colombia: Indicators of Capacity to Repay the Fund, 2004-09 1/

	2004	2005	2006	2007	2008	2009
Fund repurchases and charges						
In millions of SDRs	21	41	42	356	802	467
In millions of U.S. dollars	31	61	62	527	1190	693
In percent of exports of goods and NFS	0.2	0.4	0.4	2.9	6.1	3.3
In percent of GDP	0.0	0.1	0.1	0.5	1.1	0.6
In percent of quota	2.7	5.3	5.4	45.9	103.6	60.3
In percent of overall debt service	0.3	0.5	0.5	3.8	7.9	4.3
In percent of gross foreign reserves	0.2	0.4	0.4	3.8	9.1	5.4
Fund credit outstanding						
In millions of SDRs	1,548	1,548	1,548	1,234	460	0
In millions of U.S. dollars	2,282	2,285	2,292	1,830	682	0
In percent of exports of goods and NFS	13.5	13.7	13.6	10.0	3.5	0.0
In percent of GDP	2.5	2.4	2.4	1.8	0.6	0.0
In percent of quota	200.0	200.0	200.0	159.4	59.4	0.0
In percent of overall debt service	19.4	19.4	17.8	13.2	4.6	0.0
In percent of gross foreign reserves	16.7	16.5	16.3	13.1	5.2	0.0
(In millions of U.S. dollars; unless otherwise stated)						
Memorandum items						
Exports of goods and NFS	16,938	16,631	16,914	18,262	19,560	21,100
Quota (millions of SDRs)	774	774	774	774	774	774
GDP	90,830	93,275	96,898	103,264	106,507	113,960
U.S. dollar per SDR (WEO projection)	1.474	1.476	1.481	1.483	1.485	1.485
Public sector external debt	25,246	25,919	26,902	27,492	27,626	27,846
Overall external debt service	11,772	11,780	12,888	13,853	14,974	15,953
Overall external debt	38,592	39,782	41,823	43,713	45,430	47,557
Gross foreign reserves	13,636	13,818	14,062	13,929	13,127	12,807

Source: Fund staff estimates.

1/ Projections assume that all upcoming scheduled purchases under the Stand-By Arrangement are made.

COLOMBIA: FUND RELATIONS

(As of April 30, 2004)

I. Membership Status:

Joined: December 27, 1945
Status: Article XIV

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	774.00	100.00
Fund holdings of currency	488.20	63.08
Reserve position in Fund	285.80	36.93

III. SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	114.27	100.00
Holdings	113.41	99.25

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
SBA	Jan. 15, 2003	Jan. 14, 2005	1,548.00	0.00
EFF	Dec. 20, 1999	Dec. 19, 2002	1,957.00	0.00

VI. Projected Obligations to Fund (in SDR Million):

			Forthcoming		
Type	**2004**	**20005**	**2006**	**2007**	**2008**
Principal	0	0	0	0	0
Charges/Interest	0.02	0.02	0.02	0.02	0.02
Total	0.02	0.02	0.02	0.02	0.02

VII. Safeguards Assessments:

Under the safeguards policy, Colombia was subject to a safeguards assessment with respect to its current Stand-By Arrangement with the Fund. Staff concluded a safeguards assessment mission on April 10, 2003 and the final report was approved by management on May 14, 2003. The assessment noted no significant vulnerabilities. The Banco de la República already has a strong financial control environment and complies with most of the International Accounting Standards (IAS). The BRC intends to fully adopt IAS to the extent that these do not conflict with established accounting regulations and the law. The Banco de la República adopted as a permanent feature the requirement that annual external audits be conducted by external audit firms with international experience and exposure.

VIII. Exchange Rate Arrangement:

In September 1999 the Banco de la República eliminated its exchange rate band, and floated the peso. The authorities have accepted the obligations of Article VIII and will present to the Board their plans to remove taxes on outward profit remittances and modify the special regime for hydrocarbon sector. At end-April 2004, the exchange rate was Col$2,647 per U.S. dollar.

IX. Last Article IV consultation:

The 2002 Article IV consultation was concluded by the Executive Board on January 15, 2003. A two-year Stand-By Arrangement with Colombia was approved by the Executive Board on January 15, 2003.

X. FSAP participation:

The Executive Board discussed the Financial Sector Stability Assessment (FSSA) (FO/DIS/99/172) when it approved the Extended Fund Facility (December 20, 1999).

XI. Recent Technical Assistance:

Dept.	**Purpose**	**Time of Delivery**
FAD	Follow-up on customs administration	May 2001
STA	Regional visit on data template	September 2001
FAD	ROSC Assessment	March 2002
MFD/LEG	Assessment of exchange restrictions	July 2002
MFD	Assessment of the banking system	September 2002
STA	Follow-up on government finance statistics	November 2002

Dept.	**Purpose**	**Time of Delivery**
FAD	Advice on the reform of the budget code	March 2003
FAD	Follow-up on the reform of the budget code	November 2003
MFD	Assessment of mortgage banks	April 2004
MFD	Inflation forecast under inflation target framework	May 2004
FAD	Assessment of fiscal decentralization	May 2004

XII. Resident Representative: None.

XIII. Fourth Amendment: Colombia has accepted this amendment.

COLOMBIA: WORLD BANK RELATIONS[1]

The World Bank and Colombia's Development Strategy

Colombia's National Development Plan is built on four pillars: (i) provide security to all Colombians; (ii) foster sustainable economic growth and employment generation under macroeconomic and price stability; (iii) build a more equitable society; and (iv) increase the transparency and efficiency of the State. The World Bank Group's (WBG's) strategy seeks to support Colombia's quest for development and peace. The Country Assistance Strategy (CAS) envisages a maximum lending program for IBRD of about US$1.8 billion for the remainder of FY 2004 to FY 2006. Between 50–60 percent of the lending program would consist of fast-disbursing operations.

The World Bank Program for FY 2004–06

In 2004, the IBRD will continue the preparation of a series of adjustment loans to support fiscal adjustment, financial sector adjustment, the labor and social sector reform, and environmental management. It will have an investment operation to support the peace and development efforts. The WBG will also support an anticorruption program and a broad program of initiatives in the infrastructure sector, covering water supply, wastewater and sanitation management, national urban transportation and an urban upgrading strategy. IFC will focus on supporting new forms of public-private partnership. MIGA will focus on the provision of political risk guarantees for private sector investments; hands-on technical assistance for investment promotion intermediaries; and the dissemination of information on investment opportunities in Colombia.

The IBRD would also provide support for the government's strategy to enhance equity in coverage, quality and efficiency in the education sector, and hospital restructuring in the health sector. In rural development, the World Bank will support the development of an institutional platform to enable the transition to a more competitive environment, as well as enhancing the knowledge and innovation system for competitiveness.

Bank-Fund Collaboration in Specific Areas

The WBG is helping Colombia implement its reform agenda in the following areas of Bank-Fund collaboration:

- Fiscal adjustment, notably reforming the tax system, strengthening tax administration, implementing a fiscal responsibility law, and reforming the public sector.

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[1] Prepared by World Bank staff. Questions may be addressed to Ms. Keta Ruiz, Senior Country Officer, at (202) 473-0137 or kruiz@worldbank.org.

- Reform of the pension and social security systems.
- Foster financial sector and capital market developments.
- Broaden and deepen the scope of Colombia's anticorruption program.
- Combat money laundering.

Operations Portfolio (IBRD/IDA and grants)
As of March 8, 2004
(In millions of U.S. dollars)

Closed Projects	**157**
Active Projects	**18**
IBRD/IDA *	
Total Disbursed (Active)	365.1
Of which has been repaid	31.1
Total Disbursed (Closed)	9,532.8
Of which has been repaid	8,159.9
Total Disbursed (Active + Closed)	9,897.9
Of which has been repaid	8,191.0
Total Undisbursed (Active)	620.6
Total Undisbursed (Closed)	3.6
Total Undisbursed (Active + Closed)	624.2

Loan Information (IBRD)
As of March 8, 2004
(In millions of U.S. dollars)

Fiscal Year*	2001	2002	2003	2004
Total disbursements	264	369	948	443
Repayment amount	225	243	223	128
Net disbursements	39	126	725	315

* Fiscal Year: July 1–June 30.

IFC Operations
As of September 30, 2003
(In millions of U.S. dollars)

	Loans	Equity (+Quasi)	Participation	Total
Total commitments	170.7	172.6	166.6	509.9
Total undisbursed	49.9	8.3	7.1	65.3

COLOMBIA: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK[1]

(As of April 30, 2004)

I. BACKGROUND AND OBJECTIVES

In September 2003, the IADB Board of Directors approved the Bank's strategy for Colombia for the period 2003–2006. The strategy identifies three overarching objectives that constitute the frame of reference for Bank activities: (i) lay the foundations for economic revival and jump-starting growth; (ii) foster social progress and make sure society's most vulnerable are protected; and (iii) strengthen governance and further modernization of the State.

To **reinvigorate the economy** the Bank will: (i) foster competitiveness and (ii) support agricultural development and natural resources management. **To foster social progress and ensure that society's most vulnerable are protected**, the Bank will improve: (i) social protection systems, to leave low-income groups less vulnerable, and (ii) the coverage, quality, and efficiency of essential social services. To strengthen **governance and modernization of the State,** the Bank will support: (i) national public sector reform, (ii) local management capacity building, (iii) initiatives to foster transparency and combat corruption, and (iv) judicial branch reform.

From the Bank's standpoint, two constraints for the strategy's viability are the country's fiscal deficit and the armed conflict. Both constraints have implications for the size of the lending program, the mix of lending and nonlending products, and prospects for achieving the strategy objectives.

II. LENDING

As of April 30, 2004 the country's portfolio consists of 27 loans an amount equivalent to US$1,408 million. These resources are distributed among 26 investment loans (US$1,008 million) and a policy-based loan (US$400,0 million). In addition, the country portfolio with Colombia includes 38 non-reimbursable technical cooperation (US$25,6 million) and four small projects (US$1.46 million). Through the Multilateral Investment Fund (MIF), which finances private sector investment projects, Colombia has 22 nonreimbursable operations (US$21.5 million).

In 2003 five loans for US$1,886.03 million were approved. These operations include a social emergency program (US$ 1.25 billion). According with the last Programming Mission Report on November 2003, the Bank would approve in 2004 eight investment loans by

[1] Prepared by IADB staff. Questions may be addressed to Mr. Javier León, Country Officer, at (202) 623-1769 or javierl@iadb.org.

US$ 407.3 million and a policy-based loan to support the reform of public services. The lending program for 2004 will support the government strategy in areas such as rural household, vaccination, transport, public services, environmental investment, privatization, and national public sector reform.

FINANCIAL RELATIONS
(As of April 30, 2004)

I. IDB Operations
(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed amounts
Agricultural and rural development	71.2	55.2	16.0
Modernization of State	89.5	49.2	40.3
Social Investment	825.2	515.9	309.3
Education	26.0	8.5	17.5
Health	110.0	29.2	80.8
Sanitation	49.4	26.5	22.9
Natural resource management	36.9	27.2	9.7
Urban development and household	178.5	26.8	151.7
Transportation	21.7	7.3	14.4
Grand total	**1,408.4**	**745.8**	**662.6**

II. IDB Loan Transactions
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001	2002	2003	2004*
Gross disbursement	271.6	412.9	952.4	241.2	785.3	151.8	2,011.7	292.7
Amortization, interest and contributions	579.2	369.1	445.8	473.2	408.2	819.4	1,017.5	660.5
Net cash flow	-307.6	43.8	506.6	-232.0	377.1	-667.6	994.5	-367.8

(*) projections

Source: IADB.

Bogotá, Colombia
June 15, 2004

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

Dear Mr. de Rato:

The government remains fully committed to promoting faster sustainable and equitable economic growth through the implementation of its economic program for 2004, which is being supported by the two-year Stand-By Arrangement (SBA) approved by the Fund in January 2003.

We are requesting completion of the third review under the program. We are continuing to implement policies that will achieve the program's objectives for 2004. All quantitative performance criteria for end-December 2003 and end-March 2004 have been observed. All but one of the structural reforms are proceeding as scheduled. We are proposing to convert the quantitative indicative targets for end-September and end-December 2004 into performance criteria. We intend to advance the structural reforms already included in the program according to the schedule presented in the previous memorandum of economic policies. Moreover, we are adding structural benchmarks in the areas of reforming pensions, improving tax administration and divesting banks still controlled by the public sector. These policies are explained in detail in the attached Memorandum of Economic Policies (MEP) and Technical Memorandum of Understanding (TMU). We are also requesting a waiver for the nonobservance of the continuous performance criterion on the introduction of a multiple currency practice, as this was removed on April 16, 2004.

We are proposing that the Fund's Board conduct the fourth review by December 2004. Conditions for completing the fourth review are congressional approval of the revised budget code, as envisaged, and of a budget for 2005 that provides for a combined public sector deficit of 2 to 2½ percent of GDP. As usual, we will maintain a close policy dialogue with the Fund and stand ready to take additional measures, as necessary, to achieve the objectives of the program, and the government will continue to treat the arrangement as precautionary.

Sincerely yours,

/s/	/s/
Alberto Carrasquilla Minister of Finance and Public Credit	Miguel Urrutia General Manager Bank of the Republic

Attachments

Memorandum of Economic Policies

Introduction

1. The government's economic reform program, which is anchored by fiscal discipline, is already bearing fruit. In 2003, real economic growth more than doubled to 3.7 percent from 1.6 percent in 2002, and the unemployment rate declined to 14.1 percent by December. Inflation fell from 7 percent during 2002 to 6.5 percent during 2003, but was somewhat above the program target of 5.9 percent partly because of unexpectedly high food prices in December (Table 1). The external current account deficit held steady at 1.8 percent of GDP in 2003, as exports performed well and family remittances from abroad rose by over 20 percent. Net international reserves increased slightly, compared with a targeted decline of about US$200 million.

2. This favorable economic outturn reflects the strengthening of policies implemented starting in August 2002. The combined public sector (CPS) deficit declined from 3.7 percent of GDP in 2002 to 2.7 percent of GDP in 2003, in line with the program target, with the primary surplus rising from 0.4 percent of GDP in 2002 to 1.7 percent of GDP in 2003. As a result, total public debt (including the financial public sector) declined to 56.2 percent of GDP from 58.8 percent of GDP at end-2002. The Banco de la República slowed inflation by raising its policy interest rate by 200 basis points in early 2003. All structural reforms proceeded on schedule, except for minor delays in submitting the draft reform of the budget code to congress and in bringing Bancafé to the point of sale. Also, Congress has not yet approved the new public procurement law, which was to be approved by December 2003 as a structural benchmark. The overall health of the banking system improved, as nonperforming loans declined and profitability and capital adequacy strengthened.

Economic policies for 2004

3. The government intends to sustain the momentum of economic reforms, which are crucial to ensure that economic performance continues to improve and sustain growth. Economic policies in 2004 aim to support an increase in real economic growth to 4 percent, while inflation is targeted to decline to 5½ percent. The external current account deficit is projected at 2.2 percent of GDP, and net international reserves are likely to rise by US$0.7 billion. These are broadly in line with the program's original macroeconomic framework.

Macroeconomic Framework: Main Elements

	2003		2004	
	Prog.	Est.	Prog.	Rev.
(Annual percentage change)				
Real GDP	2.8	3.7	3.3	4.0
CPI (end of period)	6.2	6.5	5.5	5.5
(In percent of GDP)				
External current account deficit (-)	-2.2	-1.8	-2.5	-2.2
NFPS primary balance	2.0	1.7	2.4	2.5
Combined public sector deficit (-)	-2.8	-2.7	-2.5	-2.5
Total public debt	56.3	56.2	56.2	52.1
(In billions of U.S. dollars)				
Net international reserves	10.4	10.5	10.5	10.5

Fiscal policy

4. Fiscal policy in 2004 is designed to reduce the CPS deficit further to 2.5 percent of GDP, as envisaged in the program, by raising the primary surplus to 2.5 percent of GDP. Total public revenues are projected to amount to about 31 percent of GDP, reflecting in part higher tax revenues resulting from the tax package approved in December 2003. Nontax revenues are expected to decline to 11 percent of GDP, as the operating surplus of Ecopetrol decreases. Total expenditure commitments are expected to rise to COL$82.8 trillion (about 33.7 percent of GDP), with current spending rising to 26.5 percent of GDP, reflecting higher military spending and additional pension payments caused by a faster than expected pace of retirement. Commitments of capital expenditure are projected to decline to 7.2 percent of GDP. The target for the CPS deficit will be adjusted upwards by an amount of up to 0.3 percent of GDP (COL$725 billion) to allow for the implementation of additional investment projects already included in the National Development Plan and will be contingent on the realization of proceeds of the sales of the government's shares in some public enterprises. With this adjustor, the government will strive to raise public investment to 7.5 percent of GDP. Details of this adjustor are presented in the attached TMU.

5. This fiscal stance is expected to reduce total public debt to about 52 percent of GDP by end-2004. In 2004, the government plans to rely on domestic financing equivalent to 0.8 percent of GDP and if the sale of government shares proceeds as expected, financing from privatization proceeds will amount to at least 0.3 percent of GDP. External financing is expected to be equivalent to 1.7 percent of GDP, including disbursements of US$1.2 billion from multilateral lenders and US$0.5 billion from bonds already placed in international markets. The government intends to purchase US$500 million of net international reserves

from the Banco de la República (at the representative market exchange rate) to allow the government to scale back its external borrowing. The government may seek additional commercial external financing for liability management purposes or to pre-finance 2005 financing requirements. Over the medium term, the government intends to reduce the public sector's vulnerability to exchange rate fluctuations by raising peso-denominated public debt to 60 percent of total public debt by 2010 (46 percent at end-2003).

6. Over the medium term, the government remains committed to continue strengthening the fiscal position to reduce public debt to less than 45 percent of GDP by 2010. For this reason, the government will announce in mid-June 2004—as required by the new Fiscal Responsibility Law—that it intends to present to congress a budget for 2005 that is consistent with raising the public sector's primary surplus to 2½ to 3 percent of GDP and lowering the CPS deficit to 2 to 2½ percent of GDP. Moreover, as a structural performance criterion, by July 31, 2004 the government will submit a budget for 2005 that provides for a CPS deficit of 2 to 2½ percent of GDP.

7. It has been agreed to remove the electricity distribution enterprise (ISA) from the definition of the public sector starting in July 2004, on the grounds that it operates like a commercially-run enterprise. ISA has significant private ownership and has a sound governance structure that gives private shareholders a strong voice in major decisions affecting the enterprise. It has a high degree of managerial independence, does not benefit from any special financial treatment from the government, and is profitable and creditworthy. Also, in March 2004, ISA established a program to sell American Depository Receipts on the New York Stock Exchange, after having complied with the relevant reporting requirements of the United States' Securities and Exchange Commission. The government will work with Fund staff to develop a system for evaluating the commercial orientation of Colombia's other public enterprises and to continue to monitor ISA's operations. In addition, Colombia will participate in a pilot program designed to explore ways to allow for more public infrastructure investment, while ensuring proper accounting of public sector liabilities and within the constraints imposed by public debt sustainability.

Structural fiscal reforms

8. Over the next few years, it will be crucial to adopt reforms to moderate the growth in public spending, while sustaining revenues at current levels and making the tax structure more efficient. For this reason the government will continue to advance the reforms according to the schedule already envisaged in the program (Table 2):

- *Reform of the budget code*: In mid-December 2003, the government submitted to congress a draft reform that aims to make expenditure management more flexible. The government intends to secure congressional approval of this law during 2004, which is a condition for completing the fourth review. As a preliminary step, the 2005 budget to be submitted to congress will include a presentation of expenditure according to a standard international classification system, which is a structural performance criterion.

- *Pension reform*: In 2004, the government's net pension costs are projected to rise by 0.6 percent of GDP, and the public social security system will exhaust its reserves. Even after the reforms of December 2002 and May 2003, the actuarial deficit of the country's pension system remains high at 150 percent of GDP. Therefore additional reforms are needed. In March the government began to discuss with political parties a constitutional amendment that eliminates special pension regimes starting in 2008, ends the practice of paying a 14th monthly pension each year and caps the maximum pension at no more than 25 minimum salaries. In July, the government plans to submit this amendment to Congress, which must be approved by two consecutive sessions of Congress.

- *Strengthening fiscal decentralization*: A recent FAD technical assistance mission provided useful recommendations to strengthen Colombia's system of fiscal decentralization. By September 2004, the economic policy cabinet (CONPES) will publish a plan to strengthen the current system of decentralization.

- *Statistical data on public sector financing*. By June 2004, the government will develop a plan for a statistical reporting system of financing of the CPS deficit with the objective of obtaining monthly estimates of the below–the-line fiscal deficit with a minimum reasonable delay. This plan will be implemented by December 2004.

- *Public procurement*: By December 2004, the government will resubmit to Congress the modifications to Law 80.

9. The government will make every effort to safeguard the current level of tax revenue over the medium term. By September 2004, the government will require the unification of tax accounts, the implementation of the plan to close businesses that evade taxes, and to begin reporting taxpayers in arrears to credit bureaus. During 2005, the government will submit to Congress legislation designed to make the tax structure more efficient and, if necessary, to help offset the revenue loss from the end of the temporary tax measures approved in December 2003.

Monetary and exchange rate policy

10. The Banco de la República is committed to taking the actions necessary to lower inflation to 5.5 percent during 2004, within the range of 5–6 percent. It has announced an inflation target of 3½ to 5½ percent for 2005, in line with its medium-term objective of lowering inflation to 3 percent. The Banco de la República's analysis suggests that short-term inflationary trends are favorable, reflecting in part an increase in the demand for Colombian financial assets that has contributed to the appreciation of the peso earlier this year. In this

context, the Banco de la República has reduced its policy interest rate by a total of 50 basis points so far this year.

11. The Banco de la República will maintain the flexible exchange rate system, which includes the options based mechanisms for foreign exchange intervention in place since 1999. The central bank has purchased about US$760 million so far this year, while letting the level of the currency reflect market forces. It has announced that it is prepared to purchase an additional amount of up to US$340 million through July. These operations are fully consistent with achieving the inflation target for 2004 and do not represent interference with the flexible exchange rate system. The effect on base money will be partially sterilized through the sale of the central bank's government securities.

12. We appreciate the recent technical assistance provided by the Fund's Monetary and Financial Systems Department and the Czech National Bank in strengthening our technical forecasting models of inflation and to further improve the operation of the inflation targeting framework.

Financial sector

13. The government will continue to strengthen financial supervision. Banks are making good progress in developing internal risk assessment models that are to be used to determine adequate levels of capital and provisioning in accordance with the Basle II capital standard, and the new provisioning and capital standards will be implemented gradually over the next few years. The superintendency of financial institutions will draft guidelines to strengthen consolidated supervision further. The quality of the mortgage loan portfolio is improving gradually, as the economy and housing prices recover further. Some banks with significant amounts of mortgages will continue to operate under restructuring plans, which—if necessary—could call for increases in provisioning and capital.

14. The government remains fully committed to divesting the financial institutions intervened in 1999. FOGAFIN will complete the sale of the government's stake in two small financial institutions during 2004. Following the unsuccessful sale of Bancafé, in which there were no bidders in the February 2004 auction, FOGAFIN will restructure Bancafé by end-2004, with a view to selling it in early 2005. FOGAFIN will announce by end-2004 an auction for Granahorrar, which would take place in early 2005.

Other issues

15. We have sent a letter to the Managing Director dated June 1, 2004 communicating Colombia's acceptance of the obligations of Article VIII under the Fund's Articles of Agreement. In the near future, a document will be sent to the Fund that inter alia confirms our plans to modify the regime for hydrocarbons exporters by December 2004 and to eliminate the tax on outward foreign exchange remittances by December 2005.

Table 1. Colombia: Performance Criteria 1/

		2004			
	Dec. 31, 2003	Mar. 31	Jun. 30	Sept. 30	Dec. 31
Cumulative flows from beginning of calendar year (In billions of Colombian pesos)					
Overall balance of the combined public sector					
Floor	-6,375	-1,200	-1,650	-1,850	-6,100
Outturn	-6,093	-824			
Margin (+) or shortfall (-)	282	376			
Inflation rate 2/ (12-month inflation rate)					
Inflation - Consultation band					
Upper limit	7.9	8.0	8.0	7.7	7.5
Target	5.9	6.0	6.0	5.7	5.5
Lower limit	3.9	4.0	4.0	3.7	3.5
Outturn	6.5	6.3			
(In millions of U.S. dollars)					
Net international reserves of the Banco de la Republica					
Floor 3/	10,301	10,240	10,300	10,400	10,540
Outturn	10,523	11,019			
Margin (+) or shortfall (-)	222	779			
Cumulative net disbursement from beginning of calendar year (In millions of U.S. dollars)					
Net disbursement of medium- and long-term external debt by the public sector					
Ceiling	1,850	800	1,300	1,750	1,800
Outturn	716	54			
Margin (+) or shortfall (-)	1,134	746			
Change in the outstanding stock of short-term external debt of the public sector					
Ceiling	100	200	200	200	200
Outturn	-274	-81			
Margin (+) or shortfall (-)	374	281			

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

1/ Definitions of concepts and adjustments to the performance criteria are explained in the technical memorandum of understanding attached to the Country Report 03/19.

2/ Deviations from the quarterly path for inflation will trigger consultations with the Fund, as set out in the technical memorandum of understanding (TMU).

3/ Floor has been adjusted as explained in the TMU. In the event that the Banco de la República purchases foreign exchange beyond the US$700 million operation announced in March 2004, the staff of the Banco de la Republica will send—after the intervention is announced—a letter to Fund staff explaining how the intervention is consistent with the inflation target.

Table 2. Colombia: Structural Performance Criteria and Benchmarks Under the SBA[1]

	Structural Performance Criteria	Status
October 31, 2003	Submitting to Congress a revision of the Budget Code (Ley Orgánica del Presupuesto). This revision will give the Ministry of Finance greater control over the expenditure level and budget execution with the purpose of achieving more transparency and higher budgetary flexibility. Specific measures will include (a) the adoption of budget classification according to international standards that fits into the context of Colombia's legal framework; (b) a requirement to include in the annual budget law information on tax expenditures, quasifiscal activities, subsidies, contingent fiscal liabilities, medium-term fiscal projections, and a fiscal sustainability analysis; (c) the establishment of a mid-year budget report to Congress.	Was structural performance criterion for end-October 2003. Done Dec.16, 2003. Waiver approved.
July 31, 2004	The 2005 budget submitted to Congress *will provide for a CPS deficit of 2 to 2½ percent of GDP and will* include a presentation of expenditure according to a standard international classification system.	
Prior to completion of fourth review	Congressional approval of the changes to the Budget Code. The revision will (a) adopt a budget classification according to international standards that fits into the context of Colombia's legal framework; (b) require that the annual budget law include information on tax expenditures, quasifiscal activities, subsidies, contingent fiscal liabilities, medium-term fiscal projections, and a fiscal sustainability analysis; (c) establish a midyear budget report to Congress; (d) gradually phase out most revenue earmarking not mandated by the constitution by subjecting these earmarking provisions to explicit sunset provisions; (e) limit the budget carry over by eliminating the "reserva presupuestal"; and (f) limit the power of the government to make spending commitments for future years on projects not authorized under the Development Plan.	Was structural benchmark to be completed by end-2003.
	Structural Benchmarks	
December 31, 2002	Issuance of a decree to eliminate existing vacancies in the public service with immediate effect, and also to close vacancies created by retiring staff.	Done October 2002.
March 31, 2003	Approval by CONPES (Consejo Nacional de Política Económica y Social) of the Social Security Institute's financial sustainability plan for its health service. The plan will clearly identify the fiscal effect of each of its elements and be consistent with eliminating the deficit of the ISS health system by 2007.	Done March 2003.
June 30, 2003	Congressional approval of the Fiscal Responsibility Law. Presentation to Congress of a revision of Law 80 to improve management of government contracts. The objective is to curb corruption in government procurement, improve transparency in public contracting, promote e-procurement, and design and implement a standard methodology specifying bidding terms and conditions for typical contracts. Implementation of a reform of the special pension regime for teachers that reduces the actuarial deficit of the regime for teachers at least in a proportion similar to that proposed by the government for the special regime.	Done June 2003. Done July 2002. Congress approved law in May 2003.
July 31, 2003	Implement reform of special pension regime for the military that will make the regime more equitable.	Done July 2003.
December 31, 2003	CONPES to finalize a plan to streamline the management of government property under which an asset management unit will be set up to define and implement a management plan based on consolidated inventories and develop a program for inventory assessment.	Done October 2003.

	Congressional approval of the modifications of Law 80 to improve management of government contracts. Bring Bancafé to point of sale.	Not yet approved. Done in February 2004. No bids received.
	Structural Benchmarks	
March 31, 2004	Completion of a CONPES document to strengthen the government's legal defense service to take effect by 2005.	Done November 2003.
June 30, 2004	The government will issue a plan to improve the statistical reporting system for the financing of the nonfinancial public sector deficit. A financial evaluation of ISS health will be undertaken, in order to determine whether additional actions beyond those established in Decree 1750 of June 2003 are required.	
July 31, 2004	*Submit to Congress a constitutional amendment to eliminate special pension regimes, end 14th monthly pension and cap maximum pension at no more than 25 minimum salaries*	
September 30, 2004	Full implementation of CONPES plan to eliminate the deficit of the ISS health system by 2007. Implementation of the plan to strengthen the governments' legal defense services. Bring Granahorrar to point of sale CONPES will publish a strategy for strengthening the current system of fiscal decentralization. *Adoption of the following measures to improve tax administration: (i) establish an integrated taxpayers' current account, which records all of a taxpayer's payments in a single account; (ii) begin to close enterprises that evade taxes; and (iii) begin to report persons with tax arrears to credit bureaus.*	Benchmark moved to December 31, 2004.
December 31, 2004	*FOGAFIN will announce auction for Granahorrar* *Restructuring of Bancafé will be completed.* *Implement plan to improve reporting of financing of public sector* *Resubmit to Congress the modifications to Law 80 to improve management of government contracts*	*Moved from December 31, 2003*

[1] New or revised measures or dates are presented in italics.

COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

1. This memorandum sets out specific performance criteria for the remainder of 2004 and the structural performance criteria and structural benchmarks for the remaining period of the program. This TMU supplements the TMU of December 24, 2003, which presents all the definitions of the variables used to monitor performance under the program.

I. Fiscal Targets

A. Performance Criterion on the Overall Deficit of the Combined Public Sector

	Ceiling (In billions of Colombian pesos)
Overall deficit of the combined public sector from January 1, 2003 to December 31, 2003	-6,375
Overall deficit of the combined public sector from January 1, 2004 to:	
March 31, 2004	-1,200
June 30, 2004	-1,650
September 30, 2004	-1,850
December 31, 2004	-6,100

The overall balance of the combined public sector (CPS) will remain as defined in the TMU of December 24, 2003. Starting in July 2004, the accounts of ISA will be removed from the accounts of the public sector for the reasons identified in the Memorandum of Economic Policies.

2. **Adjustment**

(i) The quarterly ceilings on the combined public sector deficit will be adjusted upward (larger deficit), and the ceiling on net disbursements of medium- and long-term external debt of the public sector (see below) will be adjusted upward by the full amount of any concessional loan disbursements, up to a maximum of 0.4 percent of GDP or US$360 million for 2004 as a whole, that are in support of the military expenditure component of the government's domestic security program "Seguridad Democrática." A loan will be considered concessional if it has at least a 35 percent grant element at the time of loan approval using the commercial interest reference rate (CIRR) as discount rate.

(ii) The cumulative quarterly ceiling on the combined public sector deficit for September and December 2004 will be adjusted upward up to a maximum of Col$725 billion (0.3 percent of GDP) for the purpose of making commitments for public investment projects already included in the National Development Plan. This adjustor is contingent on the realization of privatization proceeds from sales of the government's equity participation in some public enterprises. In the original program projections, there were no projected privatization proceeds. The asset sales envisaged for the year 2004, as part of the privatization scheme, include primarily the sale of the public natural gas enterprise (ECOGAS) and 20 percent of the shares of the electricity distribution company (ISA). All privatization proceeds are to be recorded as a financing item.

(iii) The cumulative quarterly ceilings on the combined public sector deficit will be adjusted downward by 130 percent of the revenue (gross deposits) of the petroleum stabilization fund (FAEP), as currently defined in the law, in excess of the baseline set out in the table below.

B. Baseline Assumption for Oil Stabilization Fund Revenue (FAEP)

	Revenue (In millions of U.S. dollars)
From January 1, 2003 to December 31, 2003	0
From January 1, 2004 to March 31, 2004	0
From January 1, 2004 to June 30, 2004	0
From January 1, 2004 to September 30, 2004	0
From January 1, 2004 to December 31, 2004	0

II. Monetary Targets

3. Reflecting the BR's inflation targeting framework for monetary policy, quarterly targets for 2004 have been established for the 12-month rate of consumer price inflation, measured by the *Indice de precios al consumidor* (IPC) compiled by the *Departamento Administrativo Nacional de Estadisticas* (DANE). The authorities will complete consultations with the Fund (Executive Board) on the proposed policy response before requesting purchases from the Fund in the event that the observed quarterly inflation were to deviate from the programmed quarterly baseline target by 2 percentage points or more, as set out in the table below. In the event that the actual inflation deviates significantly from the programmed target within the 2 percentage points margin in any calendar quarter, the BR staff will report to the IMF staff on the reasons for the deviation and the policy response adopted, if any. The BR will provide Fund staff with monthly information and analysis of inflationary developments and forecasts, and keep the staff informed of all policy actions taken to achieve the inflation objectives of the program.

A. Performance Criterion on Inflation[1]

	Inflation (12-Month Percentage Change)
December 31, 2003	5.9
March 31, 2004	6.0
June 30, 2004	6.0
September 30, 2004	5.7
December 31, 2004	5.5

[1] These performance criteria trigger consultations with the Fund, as noted above.

III. External Targets

A. Performance Criterion on NIR of the BR[1]

	Target (In millions of U.S. dollars)
Outstanding stock as of:	
December 31, 2003	10,540
March 31, 2004	10,240
June 30, 2004	10,300
September 30, 2004	10,400
December 31, 2004	10,540

[1] These performance criteria are explained in Table 1 of the TMU.

4. **Adjustment.** The quarterly NIR targets may be adjusted downward by up to US$2.0 billion for the cumulative net foreign exchange sales in 2003–04 to help secure orderly foreign currency market conditions in the event of exogenous disturbances in the foreign currency market and consistent with transparent rules used by the central bank for foreign exchange intervention. If these net sales become negative, i.e., there are net foreign exchange purchases, the NIR targets will not be adjusted upwards. The details of this adjustment are presented in Table 2 of the TMU. In the event that NIR declines by US$1.0 billion during any 30-day period, the authorities will complete consultations with the Fund (Executive Board) on the proposed policy response before requesting purchases from the Fund. In the event that the BR announces additional foreign exchange purchases beyond the US$700 million operation announced in March 2004, the staff of the BR will send a

letter—after the announcement of the new intervention—to the Fund staff explaining the consistency of this intervention with the inflation target for 2004 and 2005.

B. Performance Criterion on the Net Disbursement of Medium- and Long-Term External Debt of the Public Sector[1]

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of external debt by the public sector from January 1, 2003 to December 31, 2003	1,850
Cumulative net disbursement of external debt by the public sector from January 1, 2004 to:	
March 31, 2004	800
June 30, 2004	1,300
September 30, 2004	1,750
December 31, 2004	1,800

[1] These performance criteria are explained in Annex 2 to the TMU.

C. Performance Criterion on Net Disbursement of Short-Term External Debt of the Public Sector[1]

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of short-term external debt of the public sector from January 1, 2003 to December 31, 2003	100
Cumulative net disbursement of short-term external debt of the public sector from January 1, 2004 to:	
March 31, 2004	200
June 30, 2004	200
September 30, 2004	200
December 31, 2004	200

[1]These performance criteria are explained in Annex 2 to the TMU.

IV. Structural Performance Criteria

5. These are described in the Table 2 of the Memorandum of Economic Policies.

Table 1. Colombia: External Program Targets, 2004

(In millions of U.S. dollars, cumulative from the beginning of the year)

	March		Revised Projections		
	Proj.	Actual	Jun.	Sep.	Dec.
1. Net accumulation of long-term external debt 1/					
Target	***800***	***800***	***1,300***	***1,750***	***1,800***
Outcome	**433**	**54**	**654**	**1,539**	**1,477**
Net long-term financing	606	-246	348	832	685
Nonfinancial public sector	593	-206	388	882	748
Disbursements	1,366	630	1,523	2,361	2,723
Central government	1,250	594	1,341	1,872	1,995
Decentralized entities	116	36	182	489	727
Amortization	773	836	1,135	1,479	1,975
Central government	636	635	840	1,069	1,371
Decentralized entities	137	201	295	410	604
Financial public sector	13	-39	-40	-50	-63
Disbursements	34	5	28	28	37
Amortization	21	44	68	78	100
Net change in foreign currency assets	-173	300	306	707	792
Nonfinancial public sector	146	300	306	707	792
Central government	82	486	393	660	626
Decentralized entities	64	-186	-87	47	166
Financial public sector	-319	0	0	0	0
Memorandum items					
Net accumumulation of long-term external debt by					
The central government	696	445	894	1,464	1,250
Decentralized entities	43	-351	-200	125	289
The financial public sector	-306	-39	-40	-50	-63
2. Net accumulation of short-term external debt 1/					
Target	***200***	***200***	***200***	***200***	***200***
Outcome	**0**	**-81**	**0**	**0**	**0**
Net short-term financing	0	-81	0	0	0
Nonfinancial public sector (net)	0	5	0	0	0
Central government	0	0	0	0	0
Decentralized entities	0	5	0	0	0
Financial public sector (net)	0	-86	0	0	0
Net change in dollar assets held by foreigners	0	0	0	0	0
3. Stock of net reserves (IMF defitition) 2/					
Unadjusted target	***10,240***	***10,240***	***10,300***	***10,400***	***10,540***
Change in reserve target due to forex intervention	*0*	*0*	*0*	*0*	*0*
Adjusted target	***10,240***	***10,240***	***10,300***	***10,400***	***10,540***
Outcome	**10,172**	**11,019**	**11,535**	**11,560**	**11,408**
Gross reserves	10,275	10,968	11,484	11,509	11,356
Short-term liabilities (trad. definition)	5	2	2	2	2
Short-term liabilities (IMF definition)	102	-51	-51	-51	-51

1/ Ceiling.
2/ Floor.

Table 2. Colombia: Adjustments to Performance Criteria on Net International Reserves

	Performance Criteria	2003				2004			
		Performance Criteria				Performance Criteria		Indicative Targets	
	Dec. 31, 2002	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Mar. 31	Jun. 30	Sept. 30	Dec. 31
Net international reserves of the Banco de la Republica									
Floor	10,300	10,360	10,420	10,480	10,540	10,240	10,300	10,400	10,540
Adjustments for exercised options		145	345	339	239	0	0	0	0
Put options				-6	-106	-706			
Call options		145	345	345	345	345			
Adjusted floor		10,215	10,076	10,141	10,301	10,240	10,300	10,400	10,540
Outturn	10,507	10,316	10,210	10,330	10,523	11,019			
Margin (+) or shortfall (-)	207	100	134	189	222	779			
Adjusted floor (beginning of period)		10,360	10,275	10,136	10,201	10,001	10,300		
Minimum adjusted Floor		8,360	8,420	8,480	8,540	8,240	8,300		

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under Stand-By Arrangement for Colombia and Approves US$284 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Colombia's performance under a two-year, SDR 1.5 billion (about US$2.3 billion) Stand-By Arrangement approved on January 15, 2003 (see Press Release No. 03/04). Completion of the review enables the release of SDR 193.5 million (about US$284 million), which would bring the total amount available under the arrangement to SDR 1.16 billion (about US$1.70 billion).

In completing the review, the Executive Board approved Colombia's request for a waiver of non-observance of a performance criterion.

Following the Executive Board's discussion of Colombia's economic performance, Agustín Carstens, Deputy Managing Director and Acting Chair, said:

"Colombia's strong policy track record is bolstering confidence and contributing to the economic recovery. In 2004, real GDP growth is projected to rise strongly, inflation to continue to decline, and the external sector to remain strong. Colombia is well placed to adjust to a gradual rise in interest rates in the United States, provided that economic policies continue to be strong. The main policy challenge for 2004 is to take advantage of the cyclical upturn in activity to press ahead with reforms that are crucial to sustain the economic recovery.

"Demand policies are set to remain prudent. The authorities are strongly committed to keeping fiscal policy on a path to reduce public debt over the medium term. The combined public sector deficit is targeted to decline in 2004, with some room to accommodate additional investment financed by nondebt-creating flows. The government intends to submit to Congress a budget for 2005 that provides for a combined public sector deficit of 2.4 percent of GDP. Monetary policy will remain directed at reducing inflation further, in the context of the inflation-targeting framework and a flexible exchange rate policy, while efforts will continue to strengthen the financial system, and improve supervision.

"Structural reforms are also set to advance further. The government intends to secure congressional approval of the revised budget code during 2004, which would allow the 2006 budget to be prepared under the new code. Tax administration is to be strengthened further, and a constitutional amendment on pension reform is to be submitted to Congress in July 2004. By September 2004, the economic policy cabinet will develop a plan to strengthen the current system of fiscal decentralization. Colombia has accepted the obligations of Article VIII, and the authorities plan to phase out the few remaining exchange restrictions in the next few years.

"These reforms, together with prudent macroeconomic policies, should lay a solid foundation for sustained growth and financial stability over the medium term, while also reducing poverty and improving social indicators," Mr. Carstens said.

Statement by Roberto Steiner, Alternate Executive Director for Colombia
June 30, 2004

1. On behalf of my authorities, I would like to thank staff for constructive discussions during the third review. Like staff, my authorities believe that performance has considerably improved and that the main challenges are to sustain the pace of fiscal reforms, maintain monetary policy focused on reducing inflation, and continue to strengthen the financial system.

2. **Economic developments have been positive and program implementation strong**. GDP growth is hovering around 4 percent, its private component by more than 5 percent; employment is increasing, with high-quality jobs in the export sector leading the way and unemployment, though high, is declining; inflation is on target; NIR have reached a comfortable level; the current account deficit is modest; and the fiscal deficit and debt burden continue to decline, while safeguarding social expenditure. All quantitative and structural PCs have been met, and the benchmark that was missed–on the procurement law—has been moved to end-2004.

Fiscal policy

3. **Although public debt is still high, it declined in 2003 and is expected to continue declining under the baseline scenario**. The DSA suggests that the debt to GDP ratio remains stable or declines under all stress tests, except for a rather modest increase under a 30 percent real depreciation in 2004. This extreme case seems highly unlikely for a country that, if anything, has recently observed pressures towards a strengthening of its currency.

4. **Strong program implementation has allowed for improvements in the currency composition of debt**. Reflecting the strong demand for peso-denominated assets, recent issues of TES have been three times oversubscribed. In April, the government announced a slight change in its financial program, increasing recourse to the domestic market. Central government domestic debt has increased from 46 to 54 percent of total debt between 2000 and March 2004, and domestic debt linked to the exchange rate is less than 2 percent of total debt.

5. **The authorities are committed to maintaining the current level of tax revenue**. Several reasons –including sunset clauses on some taxes introduced in 2003 and a decline in customs revenue as a result of a free-trade agreement with the United States— make tax reform in 2005 all but inevitable. The authorities see no urgency for a change in the tax code this year. While there is agreement with staff that, revenue considerations aside, the tax code can be improved along several dimensions –including broadening bases and reducing rate dispersion— it has been decided that a comprehensive reform in 2005 is preferable to less ambitious reforms every year. Yearly reforms are politically costly and disliked by the private sector, always eager for more stable rules of the game.

6. **Efforts at reducing the fiscal deficit and debt burden will be centered on controlling expenditure rather than on increasing the tax burden**. To that end, important reforms have been introduced and more will soon be implemented. As required by the 2003 Fiscal Responsibility Law, on June 14 the government announced its medium-term fiscal framework, including a 2.4 percent of GDP CPS deficit for 2005, consistent with a further decline in the debt burden. Before the end of July, the government will submit to Congress the 2005 budget, which the FRL requires to be fully consistent with the announced target.

7. **Before the legislative recess in mid-June, the government obtained Congressional approval at the committee level of the reform to the budget code**. Final approval is expected to occur in the second semester, and the government has agreed not to request completion of the fourth review until such approval is obtained. The reform provides the government with much needed expenditure flexibility, limits the carry over of spending, and restricts the government's ability to make multi-year spending commitments.

8. **Though progress has been achieved on pension reform, more needs to be done**. In 2002, some parameters of the general regime were modified and in 2003 significant changes were introduced to the regime applicable to teachers. As a result, the actuarial deficit of the public system declined by 25 percent. A new benchmark has been introduced to the program, and by July 31 the government will submit to Congress a constitutional amendment that eliminates special regimes, ends the practice of paying a 14th monthly pension, caps pensions and establishes at the constitutional level the concept that all pension regimes have to be sustainable. This reform, seeking to obtain through the legislature what was not possible in last year's referendum, should become law in 2005.

9. **Following reforms in 2001 and 2002, the fiscal decentralization scheme established in 1991 is in need of further improvements**. The recommendations from FAD summarized in Box 4 seem to be a good starting point as they highlight key issues, including the need to improve local revenues and to more clearly allocate expenditure responsibilities.

Monetary and exchange rate policy

10. **At end-May, inflation stood at 5.4 percent, in line with the 5 - 6 percent target for 2004**. During the first four months of the year, the peso strengthened somewhat, and this allowed for a 50 bps reduction in interest rates. Through its options-based intervention rules, the central bank has purchased $800 million during 2004. This intervention, which has been partially sterilized, has not jeopardized the inflation target.

11. **Looking towards the medium term, the central bank announced an inflation target range of 3 ½ - 5 ½ percent for 2005, a gradual reduction consistent with the goal of stabilizing inflation in the 1 - 4 percent range**. Convergence to the steady state will be facilitated by further strengthening the inflation-targeting framework. To that effect, the central bank has received valuable technical advice on modeling issues from the Czech National Bank and plans to hire a renowned expert to undertake a comprehensive review of the framework.

12. **Colombia has recently accepted the obligations of Article VIII under the Fund's Articles of Agreement**. Also, the Ministry of Finance undertook a comprehensive study on the topic of controls on short-term capital inflows. The study concluded that at this stage the costs associated with these controls surpass their expected benefits.

Financial system

13. **The financial system continues to improve. In the context of higher credit to the private sector, capital is growing, non-performing loans are falling and loan-loss provisions have doubled in five years and now surpass 100 percent**. Problems in a few mortgage banks persist, but are contained. The first auction within a market-based strategy for dealing with bad mortgage debt took place in June. Close supervision and the on-going recovery of the housing market should further alleviate the situation. Some impediments to a better functioning of the financial system –including caps on interest rates on low-income mortgages and limits on bank's ability to foreclose properties of distressed borrowers— result from decisions by the Constitutional Court and cannot be contested by the government.

14. **In 1999, Colombia was one of the first countries to undertake an FSAP. The authorities and Bank/Fund staff have agreed on a follow-up, scheduled for September**. The recommendations of the previous exercise proved very valuable, and expectations are high regarding the planned update, which *inter alia* will look at ways to improve consolidated supervision, assess readiness to adopt Basel II, take stock of developments in the mortgage market, and perform an in-depth analysis of the insurance sector.

15. **The government is committed to divesting itself from the institutions it had intervened during the crisis of the late 1990s**. Within the next few months it will sell its stake in two small banks, and before the end of the year it will finalize the restructuring and announce auctions of the two large banks (Bancafé and Granahorrar). In January, there were no bids for Bancafé, given its sizable labor-related liabilities. The government has acknowledged that the bank cannot be sold as is, and has stated its willingness to remove the labor liabilities and sell only the assets and deposits, if necessary. While this strategy would have minor adverse fiscal implications, it may represent the only realistic option at this stage.

Other structural issues

16. **Significant progress has been made in negotiating a free trade agreement with the United States**. It is now expected that it will be in place sometime in 2005. Although benefits in terms of enhanced market access, additional FDI and better and more stable rules of the game could be significant, the government has been very prudent and has not factored-in any trade-related growth enhancement into its medium-term outlook.

17. **Since taking office in 2002, the administration has devoted significant attention to streamlining the government and reforming state institutions**. Since August 2002, the number of central government institutions has declined from 302 to 276. Of those remaining, 141 have been restructured, well ahead of schedule. In the same period, over 17,000 jobs (9.2 percent of the total) have been eliminated, and an additional 5,400 will be eliminated

before 2006. This effort has yielded fiscal savings of COP$362 billion (0.15 percent of GDP). Important progress has also been made in the programs to improve IT in government institutions, including in procurement through the Internet; in enhancing the government's legal defense services; and in improving the business environment by reducing procedures and formalities.

18. **Colombia is participating in the pilot program on public investment**. The government is proposing to remove the state electricity transmission company (ISA) from the public sector accounts given that it conforms to the criteria set out in Public Investment and Fiscal Policy, March 12, 2004 (www.imf.org). The authorities look forward to the exclusion of other public companies, once it is established that they too conform to the stringent criteria. There is also significant interest in discussing with staff from the IFIs issues related to PPPs and to infrastructure projects financed by the MDBs, as Colombia could soon start facing severe bottlenecks in terms of public infrastructure provision and maintenance, particularly in the area of highways.

Risks

19. **On risks to the program, we appreciate the views of the staff and would like to offer some additional thoughts. We fully agree that Colombia is well positioned to cope with a gradual rise in US interest rates**. Since markets appear to have orderly priced-in a modest rise in US interest rates, the main downside risk for Colombia would be that the actual hike in US rates is in fact not gradual, a risk that seems improbable at this stage.

20. **Staff and some market analysts have expressed the view that by focusing on promoting presidential reelection, the government could divert attention from structural reforms.** It is worth noting that in the legislature that recently ended, the government garnered support for the constitutional amendment that would allow reelection of a President, while also moving forward in its reform agenda and obtaining approval of a reform to the penal code that could pave the way for guerrilla and paramilitaries to turn themselves in. The two economic reforms that the government had committed to during this period –amending the budget code and the pension regime— advanced considerably, the first with recent approval at the Lower House, the second through political negotiations outside of Congress. Legislation to reform pensions will be submitted to Congress in July.

21. **Although Colombia's security situation is a matter of concern, it has improved considerably in the last 18 months**. Terrorist attacks and kidnappings have been subsiding at a pace that has surprised even the most optimistic observers and there are reasons to be confident with the continued success of the democratic security strategy, a program that commands significant popular and political support. At the heart of the economic recovery lies a sharp pick-up in private investment and this has as much to do with a credible macroeconomic program as with an improved security situation. The latest surveys undertaken by one of the country's most prestigious think-tanks puts the expectations index – by manufacturer's, consumer's and retail distributor's-- at their highest level in six years.