

Colombia: First Review Under the Stand-By Arrangement—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Colombia

In the context of the first review under the Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the first review under the Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **April 11, 2003**, 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 May 27, 2003.** 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 11, 2003 discussion** of the staff report that completed the request and/or review.
- a statement by the Executive Director for Colombia.

The document(s) 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

First Review Under the Stand-By Arrangement

Prepared by the Western Hemisphere and
Policy Development and Review Departments

(In consultation with other Departments)

Approved by Jorge Márquez-Ruarte and Michael T. Hadjimichael

May 27, 2003

Stand-By Arrangement. A two-year arrangement was approved on January 15, 2003 in the amount of SDR 1,548 million (100 percent of quota on an annual basis). The 2002 Article IV consultation was concluded at that time. The authorities are treating the SBA as precautionary. Upon completion of this review, Colombia would be eligible to draw the first three purchases under the arrangement—which total SDR 580.5 million. Colombia has no outstanding credit from the Fund (Appendix I).

Discussions. A staff team held discussions in Bogotá during April 1–9, 2003 and at headquarters on April 11. The team met with the ministers of finance and social protection, the director of the national planning department, the governor and Board of Directors of the Banco de la República, and other senior officials and private sector representatives.

Team. The staff team comprised R. Rennhack (Head), B. Fritz-Krockow, A. Espejo, O. Mandeng, A. Hajdenberg (all WHD) and A. Hilaire (PDR). O. Gronlie (WHD) joined the mission for the first few days. R. Steiner (OED) attended many key meetings.

Safeguards Assessment. A FIN mission that visited Bogotá during the same period determined that the safeguards of the Banco de la República presented few risks, and the authorities agreed to adopt the mission's three recommendations.

Letter of Intent. In the attached letter, the authorities are requesting the completion of the first review, based on policies that fully support the program's macroeconomic framework. This review was intended to: (i) identify the need for additional fiscal measures and additional steps on pension reform following a constitutional referendum that was expected to be approved in February 2003; (ii) adjust the program inflation target for the effects of the VAT increase approved in December 2002; (iii) assess whether the public sector's domestic borrowing was crowding out private credit demand; and (iv) set performance criteria for June and September 2003.

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EXECUTIVE SUMMARY

Under the authorities' program, economic performance has been mostly favorable. Real economic growth appears to be recovering, led by a pick up in domestic demand that outweighed a decline in net exports. Inflation, however, has remained above the program target. The combined public sector deficit declined somewhat more than programmed in the first quarter of 2003, while the Banco de la República has begun to tighten monetary policy. Since late February, the currency has appreciated, responding partly to a sharp decline in the country risk premium.

Risks to the program have diminished but remain significant. While congress has supported the government's legislative agenda and Colombia has regained access to international capital markets, risks arise from the ongoing civil strife, the difficulties in Venezuela, and the delay in the nationwide vote on the referendum.

The program is on track and the authorities have reiterated their full commitment to achieving the main elements of the program's macroeconomic framework. Specifically:

- All performance criteria and the structural benchmarks for end-December 2002 and end-March 2003 have been observed.
- The authorities remain fully committed to reducing the public sector deficit to 2.5 percent of GDP in 2003, as programmed. They have identified contingency measures to safeguard the fiscal position in 2003, if necessary.
- The Banco de la República has reaffirmed its commitment to take the necessary measures to keep inflation under control.
- The authorities are continuing to strengthen prudential regulations and financial supervision, as envisaged.
- Structural reforms remain focused on strengthening fiscal sustainability. The submission of a revised budget code to congress by end-October will be a structural performance criterion. In May 2003, congress approved another pension reform measure that reduced the actuarial deficit of teachers' pensions. The authorities are proposing to reform military pensions by end-July 2003, as a structural benchmark. Other pension reforms are included in the national referendum.

Against this background, the staff supports the authorities' request to complete the first review under the SBA.

I. RECENT DEVELOPMENTS

1. Under the authorities' program (Box 1), economic performance has been mostly favorable (Table 1):

- Real economic growth picked up to 3 percent year-on-year in the first quarter of 2003, compared with annual growth of 1.5 percent in 2002. This growth appeared to be led by domestic demand, as net exports declined in the first quarter. Also, the unemployment rate fell to 15.2 percent in the first quarter, compared with 16.4 percent a year earlier.
- Inflation, however, has remained above the program. Twelve-month CPI inflation rose from 7 percent during 2002 to 7.9 percent in April, compared with a program target of 6.3 percent for June (Figure 1). Core inflation (excluding food prices) picked up as well, rising to 6.6 percent in April.
- The combined public sector (CPS) deficit in 2002 amounted to 3.6 percent of GDP, lower than programmed (Tables 2 and 3). Through March 2003, the CPS deficit declined in line with the program (Memorandum of Economic Policies, Table 1). Central government tax revenue performed well, while current expenditure stayed in line with program owing to a freeze on wages and salaries. Capital budget execution has been somewhat faster than anticipated, reflecting an effort to advance implementation of social expenditure commitments.
- The Banco de la República (BR) has begun to tighten monetary policy, raising its main refinancing rate by 100 basis points in mid-January and by another 100 basis points in late April to 7.25 percent. However, both deposit and lending interest rates in the banking system have been slow to respond to this tightening.
- Broad money has been growing in line with economic activity, accompanied by continued strong growth in narrow money (Table 4). While the financial situation of banks improved in 2002, the growth in credit demand has been sluggish, as borrowers are still trying to reduce their high levels of debt (Table 5). In addition, some mortgage banks are still experiencing significant difficulties.
- The external current account deficit widened to 2 percent of GDP in 2002 and remains high so far in 2003 (Table 6, Figure 2). Events in Venezuela (Colombia's second largest trading partner) have led to a sharp drop in nontraditional exports. Also, capital goods imports have been rising rapidly, in part due to a one-year tax exemption from customs tariffs for capital goods imports adopted in November 2002.
- Since late March, the currency has appreciated by about 2 percent, after depreciating significantly between April 2002 and February 2003. In April 2003, the real effective exchange rate depreciated by about 20 percent (year-on-year). This trend reflects several factors:

Box 1. Key Elements of Authorities' Economic Program

The economic program for 2003–04 seeks to strengthen fiscal policy to ease the public debt burden and to advance structural reforms, with a view to reducing the economy's vulnerability and promoting more rapid economic growth. The specific policies include:

- **Cutting the overall public sector deficit to arrest the rise in total public debt**, which had increased from 30 percent of GDP in 1996 to about 55 percent in 2002.¹
- **Reducing inflation to 5½ percent during 2003** through the central bank's inflation targeting framework coupled with a floating exchange rate.
- **Keeping net international reserves** at about US\$10.5–11 billion (about 100 percent of short-term debt on a remaining maturity basis).
- **Adopting structural reforms** to strengthen the financial position of the general pension system, restructure and downsize the nonfinancial public sector, improve financial supervision, and privatize or liquidate the remaining public banks.

Macroeconomic Framework, Main Elements of Original Program 2002–04

| | 2002 | 2003 | 2004 |
|---|------|------|------|
| (Annual percentage change) | | | |
| Real GDP | 1.6 | 2.0 | 3.3 |
| CPI inflation | 6.0 | 5.5 | 4.0 |
| (In percent of GDP) | | | |
| External current account deficit (-) | -1.7 | -0.8 | -1.6 |
| NFPS primary balance | 0.2 | 2.7 | 2.8 |
| Combined public sector deficit (-) | -4.0 | -2.5 | -2.1 |
| Private sector savings minus investment | 2.3 | 1.7 | 0.5 |
| (In billions of U.S. dollars) | | | |
| Net international reserves | 10.4 | 10.6 | 11.0 |

¹ This deterioration reflected the sizable real depreciation of the peso since 1998 as well as lax fiscal policies.

- Confidence has improved. The EMBI+ Colombia yield spread fell from a peak of about 1,100 basis points in September 2002 to the range of 450–500 basis points by late May, slightly outperforming the spreads for other emerging market countries. The yield curve for government securities has flattened, as short-term interest rates have increased while long-term rates have declined as demand for these securities has increased.
- The government has received more net external financing than envisaged. Taking advantage of favorable market sentiment, the government placed US\$1.25 billion of bonds in international capital markets in the period December 2002–April 2003. In April, the government also drew a disbursement of US\$750 million under an emergency loan from the Inter-American Development Bank.
- In mid-February, the BR announced that it would be prepared to sell up to US\$1 billion through an options mechanism established in late 1999, a move that is in line with the parameters of the program.¹ US\$600 million of options have been sold in February, March, and April, of which US\$145 million have been exercised, and net international reserves declined from US\$10.5 billion at end-December 2002 to US\$10.3 billion by end-March 2003—over 100 percent of short-term debt.²
- The structural benchmarks for end-December 2002 and March 2003 were observed (Memorandum of Economic Policies, Table 2). In December 2002, the government submitted to congress a draft Public Procurement Law (structural benchmark for end-June 2003). In May 2003, congress approved a law that reduced the actuarial deficit of teachers' pensions by about one-fourth (Box 2).

2. **Political uncertainties remain high.** While the civil conflict has intensified in the first months of 2003, President Uribe continues to command strong popular support and congressional backing for the government's key economic reforms. Moreover, several recent incidents, such as the slaying of a provincial governor and a former defense minister, appear to have strengthened public support for the government's strong approach to the security situation. However, the vote on a constitutional referendum—a major initiative of the government that is intended to promote political reforms, approve a two-year expenditure freeze and take additional steps to reform pensions—has been delayed possibly until late 2003 (Box 3).

¹ Under this mechanism, the central bank writes call options that give private agents the right to buy foreign exchange if the daily exchange rate depreciates below the moving average exchange rate for the preceding 20 days.

² The performance criterion on net international reserves was observed on both dates. The performance criterion on net international reserves includes a limited adjuster for foreign exchange intervention. The end-March target was adjusted by US\$145 million.

Box 2. Key Legislative Measures

Pension reform.

- *May 2003.* Congress approved the National Development Plan that included the following provisions for teachers' pensions: (i) raise contribution rates for teachers' pensions and health benefits from 3 percent to 17.5 percent of salaries, with teachers' own contributions rising from 0 percent to 4.4 percent and the government paying the difference; and (ii) place new teachers under the general pension regime, which implies an increase in the retirement age for new teachers to 57 years of age, from 50 years.
- *December 2002.* In December 2002, congress approved a pension reform that lengthened minimum contribution periods, lowered replacement ratios, and raised contribution rates, lowering the actuarial deficit from over 200 percent of GDP to 160 percent of GDP. Because the actuarial imbalance remains high, the program contemplates further reforms in this area. In December 2002, proposals to reform the special pension regimes for teachers and other nonmilitary groups were included in the referendum, while congress gave President Uribe a six-month period to reform the special regime for the military. In addition, the authorities planned to take other steps by end-June that would help reduce the actuarial deficit of teachers' pensions.

Tax reform. In late 2002, several revenue measures were adopted (a one-time wealth tax, an income tax surcharge, and a broadening of the VAT base) that are expected to raise revenues by 1.6 percent of GDP in 2003 and 1.2 percent of GDP in 2004.

Expenditures. Expenditure policy seeks to freeze most current primary spending and reduce capital spending in 2003–04, while the government puts in place a more fundamental budget reform that will make management of expenditure more flexible.¹ At the same time, this policy allows for a sizable increase in military spending. The 2003 budget included a spending freeze that is to be ratified in the nationwide constitutional referendum.

Labor reform. Congress also approved in December 2002 a labor market reform that extended regular daytime working hours, lowered the overtime premium for work on Sundays and holidays, reduced severance payments, and cut nonwage costs for certain employee groups.

¹ Currently legal and statutory provisions determine 95 percent of budgetary spending.

Box 3. The Constitutional Referendum

Purpose

- Introduce political reforms to improve governance.
- Simplify management of public expenditure by altering provisions that earmark revenues, require annual increases in certain types of spending and protect overly generous pension regimes.

Key Economic Reforms

- *Two-year expenditure freeze:*
 - Hold most current primary spending at 2002 level.
 - Freeze would not apply to military expenditure (other than salaries), pension payments to new retirees, and new social security contributions.
 - Expected to yield fiscal savings of 0.7 percent of GDP in 2003 and 1.2 percent of GDP in 2004.
 - The budget law, together with a 2001 constitutional court decision, allow the government to keep most spending at levels consistent with the freeze until the vote on the referendum. Pensions were not frozen.
- *Extend pension reform:*
 - Prohibit special or exempted pension regimes for teachers, military, employees of state-oil company, and other public sector workers starting at end-2007.
 - Prohibit pension-related clauses in labor contracts that differed from the general pension regime.
 - Bar old-age pensions for people below 55 years of age.
 - Cap most public salaries and pensions at the equivalent of 25 minimum wages.
 - These measures would yield fiscal savings over the long term.

Timing

- The SBA program assumed that voters would decide on the referendum in February 2003.
- However, the constitutional court is taking longer than expected to review the constitutionality of the referendum. After the court decision, it may take up to 100 days to arrange the logistics of the vote.
- For these reasons, the vote on the referendum has been delayed, perhaps to late 2003.

II. POLICY DISCUSSIONS

3. **The authorities and the mission agreed that the risks to the program have diminished but remain significant.** When the program was designed, the sources of risk included a worsening of the internal security situation, uncertainty about whether several key economic reforms would be approved, the possibility of no access to international capital markets, and a temporary loss of export markets. Since then, the government's legislative agenda has advanced and Colombia has regained access to international capital markets, as the country risk premium has dropped sharply. However, the ongoing civil strife, the difficulties in Venezuela, and the unclear status of the referendum present risks for the economic outlook.

4. **In this context, the authorities have reiterated their full commitment to achieving the main elements of the program's macroeconomic framework.** They remain confident in the success of the referendum, and noted that President Uribe will begin campaigning actively for it when the vote nears. The main modification to the framework is a higher external current account deficit, which reflects lower nontraditional exports to Venezuela and higher capital goods imports than envisaged. Even with lower net exports, the authorities and the mission reached an understanding to keep the projection for real GDP growth for 2003, in light of the strong indicators for the first quarter. Also the program is now targeting inflation of 5.9 percent for end-2003 to account for the direct effect of the December VAT increase (0.4 percentage point).

Macroeconomic Framework, 2003

| | Program | First Review |
|----------------------------------|---------|-------------------|
| (In percent) | | |
| Real GDP growth | 2.0 | 2.0 |
| Inflation | 5.5 | 5.9 |
| (In percent of GDP) | | |
| Overall public sector deficit | 2.5 | 2.5 |
| Primary balance of NFPS | 2.7 | 2.7 |
| External current account deficit | 0.8 | 2.3 |
| (In billions of U.S. dollars) | | |
| Net international reserves | 10.5 | 10.5 ¹ |

¹ Excludes effects of program adjuster for foreign exchange intervention.

A. Fiscal Policy

5. **The authorities remain fully committed to reducing the CPS deficit to 2½ percent of GDP in 2003, as planned.** They are proposing to convert the indicative fiscal targets for June and September 2003 into performance criteria (Memorandum of Economic Policies, paragraph 6). They noted that the indicative program targets called for a combined public sector deficit of 2 percent of GDP (on an annual basis) through September, providing a significant fiscal tightening. They added that these targets implied tighter-than-expected limits on nonwage spending commitments, because of an additional commitment of one month of teachers' wages (0.3 percent of GDP) in March caused by an accounting change.³ Wage commitments for the year as a whole would remain as approved in the budget, thereby creating a reserve of 0.3 percent of GDP for expenditure commitments for the fourth quarter.

6. **The authorities stressed that they were prepared to take additional measures to safeguard the fiscal position in 2003, if necessary.** If the referendum were unsuccessful or if the vote were postponed to 2004, the government would need to unwind the spending freeze in 2003, potentially widening the overall public sector deficit by 0.7 percent of GDP in 2003. In such a contingency, they are prepared to implement several offsetting measures, including:

- Advancing the increase in the VAT planned for 2005, which is estimated to yield 0.3 percent of GDP a year.
- Issuing a decree to maintain the freeze on general government wages, consistent with a 2001 ruling of the constitutional court—an action that would save 0.3 percent of GDP of spending.
- Scaling back subsidies on gasoline, diesel, and electricity, which currently cost about 0.5 percent of GDP a year.
- As a financing item, issuing long-term bonds on concessional terms mainly to domestic residents, in support of the government's domestic security program.⁴

³ In March the government decided to advance the payment date of teachers' wages by one week. Thus, teachers received their salary for work performed in March on April 2, instead of on April 10. This step required the government to commit to pay the salaries in March, instead of in April, leading to two salary commitments for teachers in March. For the period April–November 2003, the government will commit teachers' salaries late in each month to be paid at the beginning of the following month.

⁴ The program allows for an adjustment of up to 0.5 percent of GDP of the target for the overall public sector deficit (and of the ceiling on disbursements of medium- and long-term external loans) by the amount of any concessional loan disbursements.

7. **The mission concurred with these contingency measures, but noted that their fiscal impact in 2003 could be limited if they were adopted late in the year.** For this reason, it encouraged the government to continue to manage expenditure commitments carefully so as to build a fiscal cushion until the status of the referendum becomes clear.

8. **The government has been more successful than expected in securing external financing, thus helping to relieve domestic crowding out.** The program assumed that the government would not have access to private international capital markets and that net external financing would amount to 0.3 percent of GDP in 2003, well below historical levels and leading to a domestic borrowing requirement of 2.2 percent of GDP. In the event, the government has been able to tap private international capital markets, and disbursements from multilateral lenders are on track to reach US\$2.7 billion, as envisaged in the program. The World Bank and the Inter-American Development Bank (IDB) are providing the bulk of these disbursements to support reforms to public administration, budgeting procedures, pensions and the public health system (Appendices II and III). As a result, net external financing in 2003 is now expected to reach 2.1 percent of GDP, cutting the public sector's domestic financing requirement to 0.4 percent of GDP. At the end of 2003, total public debt would amount to about 55 percent of GDP, while public external debt would reach about one-third of GDP, somewhat more than envisaged.

B. Monetary Policy

9. **The Banco de la República reaffirmed its commitment to take the necessary measures to keep inflation under control** (Memorandum of Economic Policies, paragraph 8). The authorities noted that the increases in the main refinancing rate in January and April were based on a forward-looking assessment of inflation. In their view, supply factors and the sharp depreciation of the peso in 2002 explained much of the recent upswing in inflation. Indeed, capacity utilization had been low, suggesting the absence of demand pressures. The central bank intends to maintain its official inflation target of 5½ percent during 2003 as a signal of its commitment to reduce inflation. For program purposes, as envisaged, the authorities proposed to raise the performance criteria for inflation in June and September 2003 and the indicative target for December 2003 by 0.4 percentage point, in line with the direct effect of the VAT increase approved in December 2002. On this basis, the program target for inflation for end 2003 would be 5.9 percent.

10. **The mission emphasized the need to preserve the consistency between the policy stance and the announced target.** It suggested that a further tightening of monetary conditions would probably be required in order to bring inflation close to the target, regardless of the source of inflation (Figure 3). The steady rise in core inflation indicated that price pressures could be extending to nontradable goods. The central bank's main refinancing rate remained negative in real terms, and base money and M1 had been growing rapidly, both of which circumstances ultimately could exert pressures on the exchange rate and raise inflationary expectations. The authorities attributed the rapid growth in the liquid forms of money to increases in bank transactions cost that have raised the demand for cash.

11. **The authorities considered that the foreign exchange intervention through the options mechanism had limited the effect of speculative pressures on the exchange rate,** which also had the secondary benefit of easing inflationary pressures. The mission took the view that it would be best to support this intervention with a stronger monetary policy; otherwise foreign exchange market conditions could remain susceptible to undue volatility.

C. Financial Sector

12. **While the health of the banking system has improved since 1999, the authorities are continuing to strengthen prudential regulations and financial supervision, as envisaged:**

- To strengthen the immunity of the superintendency of banks, a legal defense fund for supervisors was approved by congress in January 2003, and the government intends to present legislation that allows for full budgetary autonomy of the superintendency of banks by end-2003.
- In January 2003, regulatory capital requirements were increased as expected in account for market risk.
- All banks were scheduled to adopt by June 2003 loan classification and dynamic provisioning based on internal models, which would make Colombia the first country to apply this new approach. The authorities noted, however, that more time will be needed to put this complex measure in place, but expect all banks to have implemented the new system by 2004.
- The authorities will also enhance supervision of securities firms and monitor full implementation of harmonized capital and provisioning standards between banks and securities firms. The securities commission is in the process of adopting a strict separation between supervision and regulation and is introducing enhanced rules on disclosure, minimum “fit and proper” rules, and stricter compliance controls for securities firms.
- As of end-2002, mortgage banks had nonperforming loans of 19 percent of total loans and low provisioning levels, mainly reflecting significant difficulties in some of these institutions. The bank superintendent will continue to closely monitor those banks that are operating under restructuring plans.

D. External Sector Outlook

13. **The external current account deficit is now projected to widen to 2.3 percent of GDP in 2003, compared with a deficit of 0.8 percent of GDP envisaged in the program.** Nontraditional exports are now estimated to decline by 2½ percent in U.S. dollar terms in 2003—instead of increasing by over 13 percent—largely because of the difficulties in Venezuela. At the same time, merchandise imports are expected to fall by 1 percent in 2003,

less than expected. On the positive side, the data on family remittances from 2001 onwards have been revised upward significantly, offsetting part of the fall in the trade surplus.

14. **At the same time, net capital inflows are also projected to reach 2.3 percent of GDP**, reflecting the public sector's better access to external financing. By contrast, net private capital inflows are now projected to be less than anticipated in the program, owing mainly to more foreign direct investment by Colombian enterprises in Perú and elsewhere in the region. On this basis, the overall balance of payments in 2003 is projected to be in equilibrium, compared with a moderate surplus envisaged in the program.⁵

15. **The medium-term outlook remains favorable (Table 7).** In the baseline scenario, the external current account deficit is projected to decline gradually to less than 2 percent of GDP by 2006, in line with the outlook presented in the original program, assuming that exports to Venezuela recover gradually and provided the authorities maintain a strong fiscal policy (Figure 4). Both total external debt and total public debt are projected to fall to around 40 percent of GDP by 2010, broadly as envisaged in the program.

16. **Colombia's external debt profile over the medium term remains sensitive to the effect of different assumptions (Table 8).** Currency fluctuations have a significant impact, with a hypothetical 30 percent permanent real exchange rate depreciation (appreciation) leading to external debt of 50 (30) percent of GDP by 2010. If interest rates were to rise by 300–400 basis points in 2003–04 compared to the baseline, total external debt would rise to 42 percent of GDP by 2010. The profile of the CPS deficit through 2010 is projected to remain as envisaged in the program, and the conclusions of the analysis of the sustainability of public debt presented in EBS/02/210 remain valid.

17. **Colombia would be able to fully make repayments to the Fund, if it were to decide to make all the purchases under the arrangement.** Fund credit would peak at only 3.0 percent of GDP in 2004, if all available resources were purchased as scheduled. Repurchases and charges would peak at 5.5 percent of exports of goods and nonfactor services in 2007 (Table 9).

18. **The authorities are moving forward towards fully accepting the obligations of Article VIII, Sections 2 (a), 3, and 4 by the end of the SBA.** Colombia and China have agreed to eliminate by end-June 2003 their bilateral payments arrangement, which featured a relatively long settlement period and constitutes an exchange restriction subject to the Fund's

⁵ The projected overall of payments is consistent with achieving the program target for net international reserves, adjusted for the effect of the central bank's foreign exchange intervention through March 2003.

jurisdiction. The authorities are developing a timetable to eliminate the few remaining restrictions that will be incorporated into the program during subsequent reviews.⁶

E. Structural Issues

19. **Structural reforms remain focused on strengthening fiscal sustainability.** The authorities intend to meet the program's structural conditions, with the following changes:

- **Teachers' pensions** (Memorandum of Economic Policies, paragraph 9). The program set a structural benchmark to reform the special pension regimes of the teachers by end-June 2003 to achieve a reduction in their actuarial deficit of about one-fourth (the reduction achieved by the December 2002 reform). This action was to be converted into a structural performance criterion for end-June 2003 at the time of the first review, following the referendum. The law approved by congress in May 2003 observed this structural benchmark for teachers. An additional strengthening of teachers' pensions will come from the elimination of the special pension regimes for existing teachers starting in 2008, which is part of the referendum and will take place automatically once the referendum is approved.
- **Military pensions** (Memorandum of Economic Policies, paragraph 9). The program included a reform of these pensions as a structural benchmark for end-June that was to be converted into a structural performance criterion at the time of the first review. The authorities noted that congress left military pensions out of the referendum and instead granted special powers to President Uribe through end-July 2003 to reform this regime by decree. The government intends to issue a decree that makes this regime more equitable, most likely by broadening the contribution base as well as redistributing pension benefits more equitably among the different ranks. This action will be a structural benchmark for end-July 2003.
- **Special pension regimes of other public groups.** The program also set a structural benchmark for end-June to reform the special pension regimes for other public sector groups, which refers mainly to employees of the state petroleum company (Ecopetrol). The mission supported the authorities' view that it was necessary to wait for the approval of the referendum, which includes the proposal to eliminate these special regimes and is the only way to take this action for these regimes.
- **Budget reform** (Memorandum of Economic Policies, paragraph 9). The authorities have been developing a fundamental budget reform that makes expenditure management more flexible by eliminating budgetary carry-overs, regulating the use of future commitments, decreasing entitlements, and limiting earmarking of revenues.

⁶ These restrictions consist of multiple currency practices that result from a 7 percent tax on profit remittances and a 3 percent tax on foreign exchange receipts from personal services to nonresidents and other transfers, export tax credit certificates, and as well as restrictions resulting from a special foreign exchange regime for the hydrocarbons sector.

An FAD technical assistance mission visited Colombia in March 2003 and developed recommendations to strengthen the draft Budget Code that was to be submitted to congress by June 2003 as a structural benchmark. The authorities are proposing to make this action a structural performance criterion for end-October 2003, which will allow for more time to incorporate FAD's recommendations.

- **Public health system** (Memorandum of Economic Policies, paragraph 9). The government has begun to implement the CONPES plan to strengthen the financial position of the health service unit of ISS and is negotiating a loan from the IDB aimed at making public hospitals financially viable by 2007. The authorities noted that these efforts might generate upfront fiscal costs by restructuring public health clinics and hospitals but then remove a significant drain on the public finances over the medium term. It was envisaged to consider during subsequent program reviews the effect these plans might have on the target for the CPS deficit.

III. PROGRAM MONITORING

20. **All performance criteria and the structural benchmarks for end-December 2002 and end-March 2003 have been observed.** The inflation outturn for March falls within the program's band of plus or minus 2 percentage points, and the authorities sent a letter to Fund staff explaining the reasons behind the high inflation and their policy response, as envisaged under the program in the event of significant deviations from the target. Upon Board approval of this review, an amount of SDR 193.5 million will be made available for completion of the first review and observance of the end-December 2002 performance criteria. Another SDR 193.5 million will also become available for observance of the end-March 2003 performance criteria. In total, the authorities would be eligible for a cumulative purchase of SDR 580.5 million, including the amount made available upon Board approval (Table 10).

21. **The program conditionality is being amended at this review as follows:**

- The indicative program targets for the overall public sector deficit and net international reserves would be converted into performance criteria.
- The performance criterion on net disbursements of short-term external debt of the public sector for end-June and end-September 2003 would be lower than the indicative program targets, in light of the smaller-than-anticipated need for this type of financing.
- The performance criteria for net disbursements of medium- and long-term external public debt for end-June 2003 and end-September 2003 would be set at levels higher than the indicative program targets to reflect the country's better than envisaged access to external financing.

- The performance criterion on inflation for June 2003 and September 2003 is 0.4 percentage point above the indicative program targets to account for the direct effect of the VAT increase approved in December 2002.
- One new structural performance criterion is being proposed, namely the submission of the draft budget code to congress by end-October 2003. This action was originally a structural benchmark to be completed by end-June 2003.
- In line with the recommendations of the safeguards assessment, the Banco de la República intends to fully adopt International Accounting Standards (as long as these do not conflict with established domestic accounting regulations and law) and to adopt as a more permanent feature the requirement for an annual external audit conducted by a firm with international experience.
- The second review under the program is to be completed by November 2003, compared with August 2003 as envisaged.⁷ This review will focus on assessing whether measures are needed to keep fiscal policy in 2003 in line with the program, and will propose performance criteria for December 2003. It will also consider the full program for 2004, set performance criteria for March and June 2004, and propose a schedule of reviews in 2004. The amounts of purchases under the SBA are proposed to stay the same, with slight changes in the conditions and the availability date for the fourth purchase under the arrangement.

IV. STAFF APPRAISAL

22. **The government of President Uribe has shown strong ownership of its economic program for 2003–04, which aims to promote more rapid economic growth and improve social conditions.** Economic developments under the program have been mostly favorable. The risks to the program have diminished but remain significant, as the outcome of the referendum is unclear, trade with Venezuela has been disrupted, and the domestic security situation remains tense. For this reason, the authorities have prepared contingency measures to safeguard the program from the effect of these risks.

23. **The authorities intend to reduce the fiscal deficit in 2003 as planned, which is a crucial step in bringing the public debt situation back under control.** They are proposing to convert the program's indicative targets for June and September into performance criteria, which will result in a significant fiscal tightening through September. Nonetheless, the uncertainty about the referendum poses a risk to fiscal policy in 2003 and beyond. To address

⁷ In EBS/02/210, there is an inconsistency about the timing of reviews in 2003. The Stand-By Arrangement (Appendix IX) established semi-annual reviews, while the staff report and the memorandum of economic policies referred to quarterly reviews in 2003. In this situation, the arrangement prevails.

this, the authorities are committed to safeguarding fiscal policy—if necessary—and are studying the feasibility of the contingency measures identified in their December 2002 Memorandum of Economic Policies and additional measures. These measures will help, but they may have little effect on the fiscal deficit in 2003 if adopted late in the year. For this reason, it would be prudent to maintain a margin in expenditure commitments during the year until there is greater clarity on the referendum.

24. The central bank has reaffirmed its commitment to its inflation target but faces significant challenges amid mounting price pressures. While the central bank tightened monetary policy in January and April 2003, its main refinancing rate remains negative in real terms, which may keep inflationary expectations relatively high, and price pressures may be extending to nontradables. For these reasons, the central bank needs to take more decisive action to bring inflation close to the target. Foreign exchange intervention has helped limit the effects of speculative pressures on the exchange rate, which may also ease inflationary pressures. However, this intervention should not substitute for monetary policy and instead should be regarded as a complement to an appropriate interest rate policy.

25. The authorities have made significant progress in improving the health of the banking system in recent years. They are to be commended for continuing to strengthen prudential requirements and raising capital standards for banks. Bank supervision would also be strengthened by granting budgetary autonomy to the superintendency. While the legal defense fund for supervisors is a positive step, it still falls short of best international practices. Progress was also made on harmonizing regulatory standards and supervision between securities firms and banks, which should help minimize regulatory arbitrage between market segments. It will be important for the authorities to continue to closely monitor the mortgage banks, some of which are still experiencing significant difficulties.

26. While the outlook for the external current account deficit in 2003 has shifted, the medium-term outlook remains favorable, provided the authorities maintain a strong fiscal position and continue to advance structural reforms. Moreover, the sizable real exchange rate depreciation since mid-2002 will improve the competitiveness of exports, especially of nontraditional goods, in the next few years, and continued exchange rate flexibility will help the external sector adjust to shifts in world markets. Colombia's recent return to the international capital markets signals increased confidence in the country's economic prospects, as well as more favorable market sentiment for emerging markets in general. Nonetheless, market perceptions can reverse quickly, especially if economic policies weaken.

27. Structural reforms are proceeding broadly as envisaged. The pension reform measures of December 2002 and May 2003 will reduce the financial imbalances in the pension system. However, the actuarial deficit of the general pension system remains high, and the elimination of the special pension regimes proposed in the referendum is an important additional step. The new budget code that is being developed is essential to allow for the flexible expenditure management needed to keep the overall public sector deficit under control. The staff welcomes the authorities' decision to make submission of this legislation by end-October 2003 a structural performance criterion, which will increase the

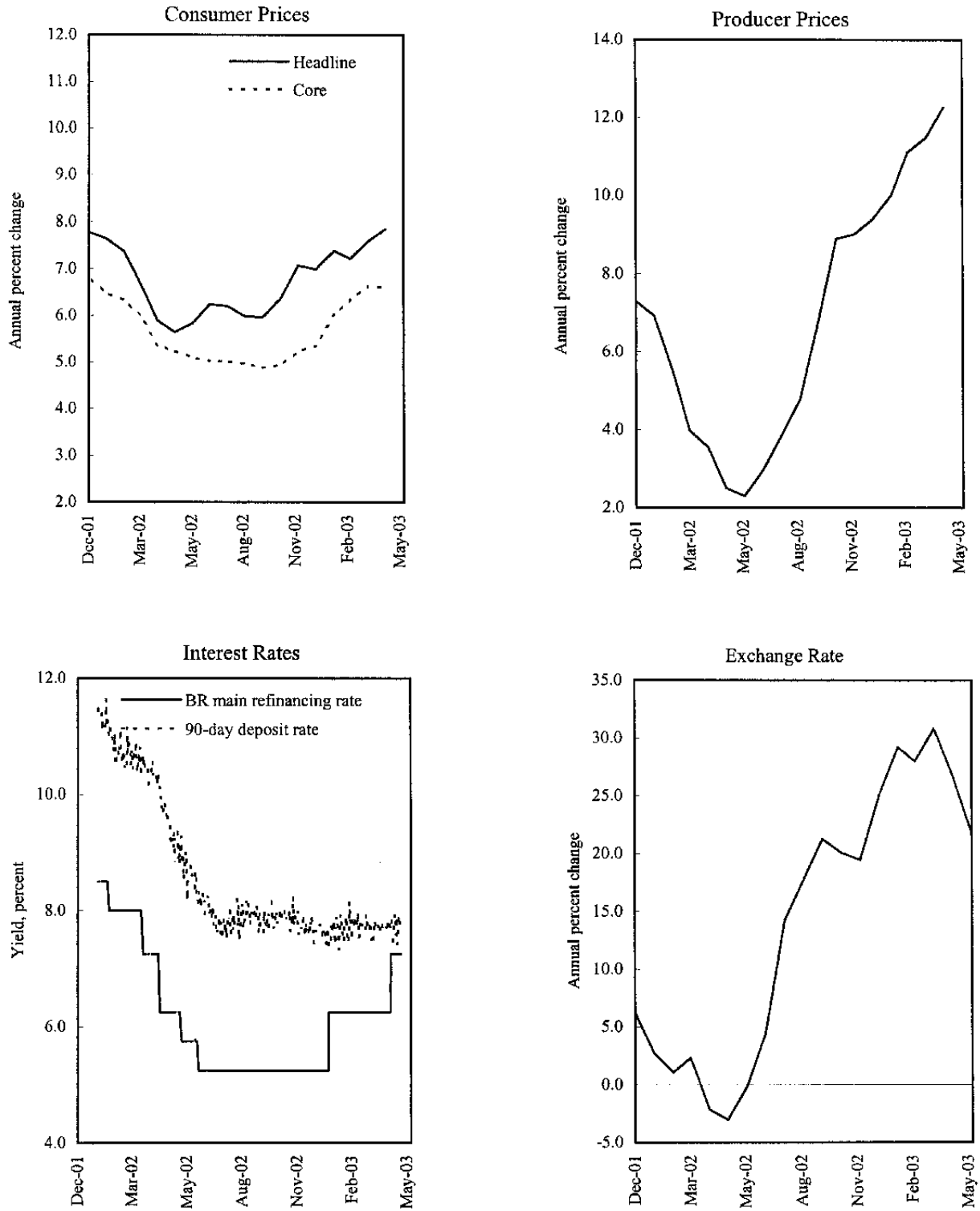
likelihood that the new budget code will take effect by mid-2004 and in time for the 2005 budget. The authorities are moving forward with plans to strengthen the financial position of the ISS health system and of public hospitals. However, it will be important for these plans to result in clear fiscal savings over the medium term.

28. **The authorities are developing a timetable to meet the obligations of Article VIII.** The decision to terminate the bilateral payments agreement with China by end-June 2003 is a positive step. In the upcoming program reviews, it would be useful to incorporate a clear schedule for phasing out the remaining restrictions.

29. **With regard to the safeguards assessment,** the staff welcomes the strengthening of the central bank's internal control framework and recommends continued progress towards adopting international accounting standards.

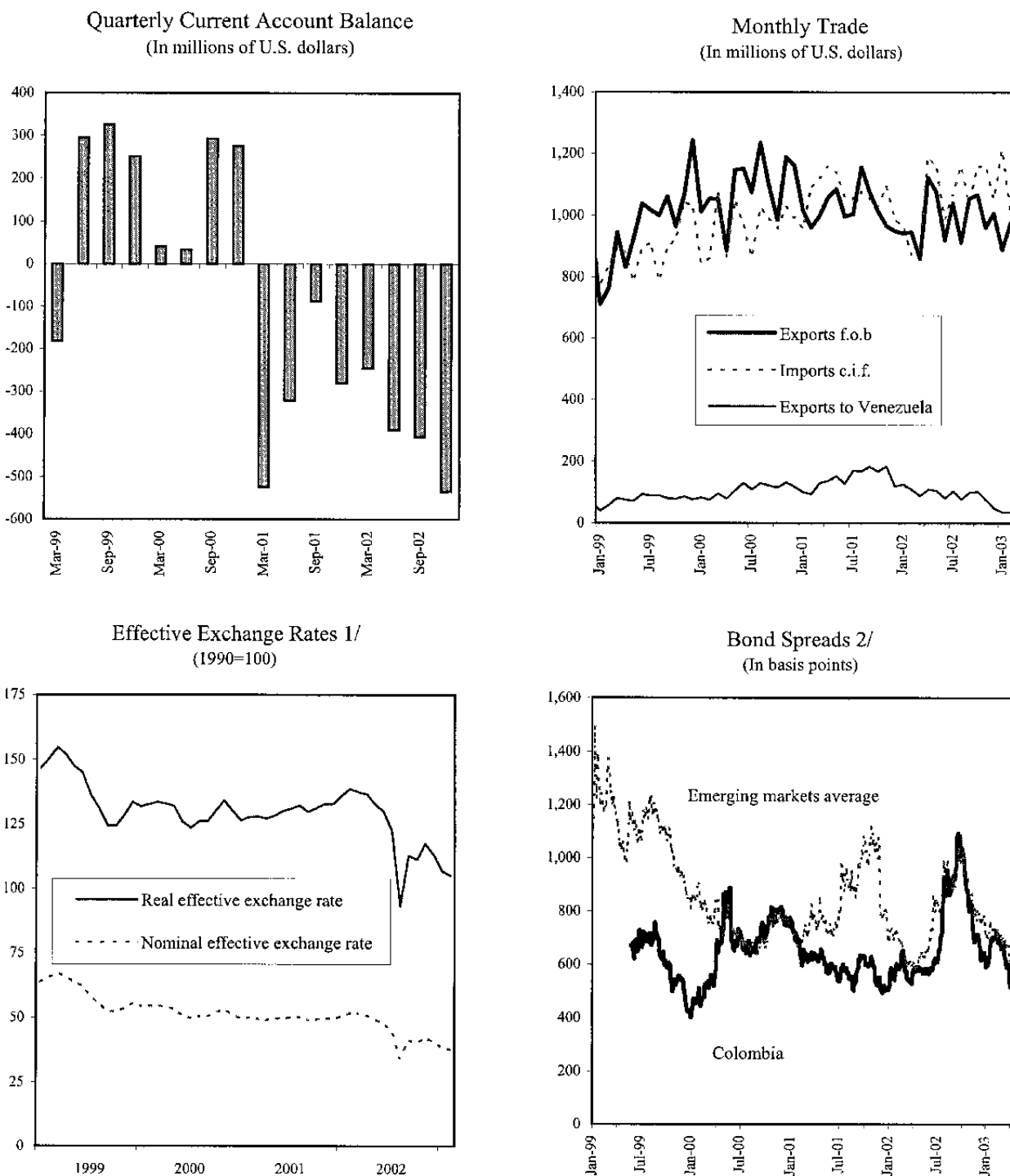
30. **In summary,** so far in 2003, fiscal policy has performed somewhat better than expected, the Banco de la República has tightened monetary policy, and structural reforms advanced. While the risks to the program remain significant, the authorities have reiterated their firm commitment to achieving the objectives of the program, especially with regard to strengthening fiscal policy. On this basis, the staff recommends completion of the first review under the Stand-By Arrangement.

Figure 1. Colombia: Inflation, Interest Rates, and Exchange Rate



Source: Banco de la República.

Figure 2. Colombia: Balance of Payments



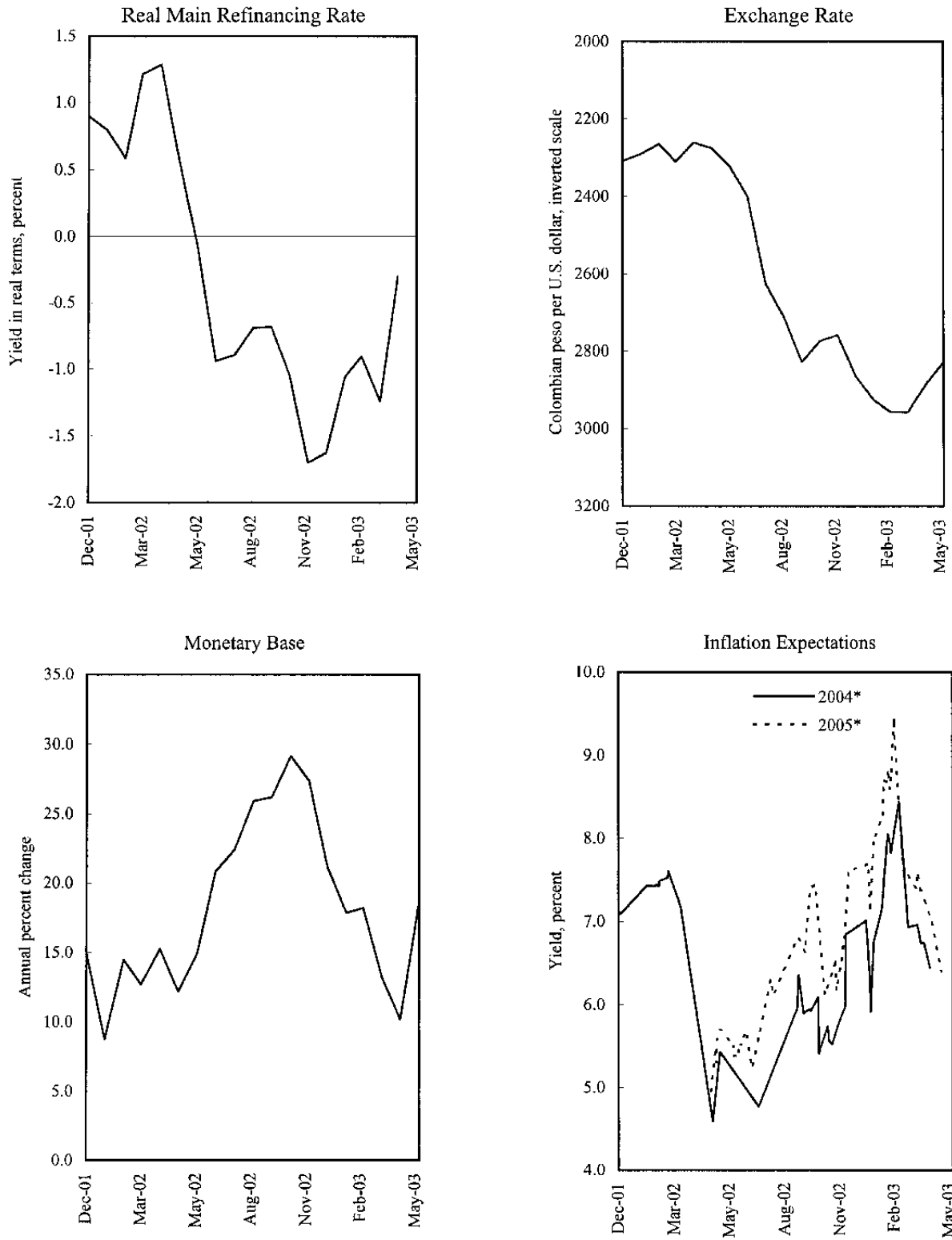
Sources: J.P. Morgan; Banco de la Republica; Information Notice System.

1/ An increase (decrease) indicates appreciation (depreciation).

2/ JP Morgan's EMBI+ measure of bond spread over US Treasuries of comparable maturity.

EMBI+ index and spread are not available for Colombia prior to May 1999.

Figure 3. Colombia: Monetary and Expectations Indicators



* Difference between par bond and inflation indexed-bond in percent of similar maturity.

Source: Banco de la Republica; Staff estimates.

Figure 4. Colombia: Comparison of Medium-Term Outlook, Program and First Review
(In percent of GDP)

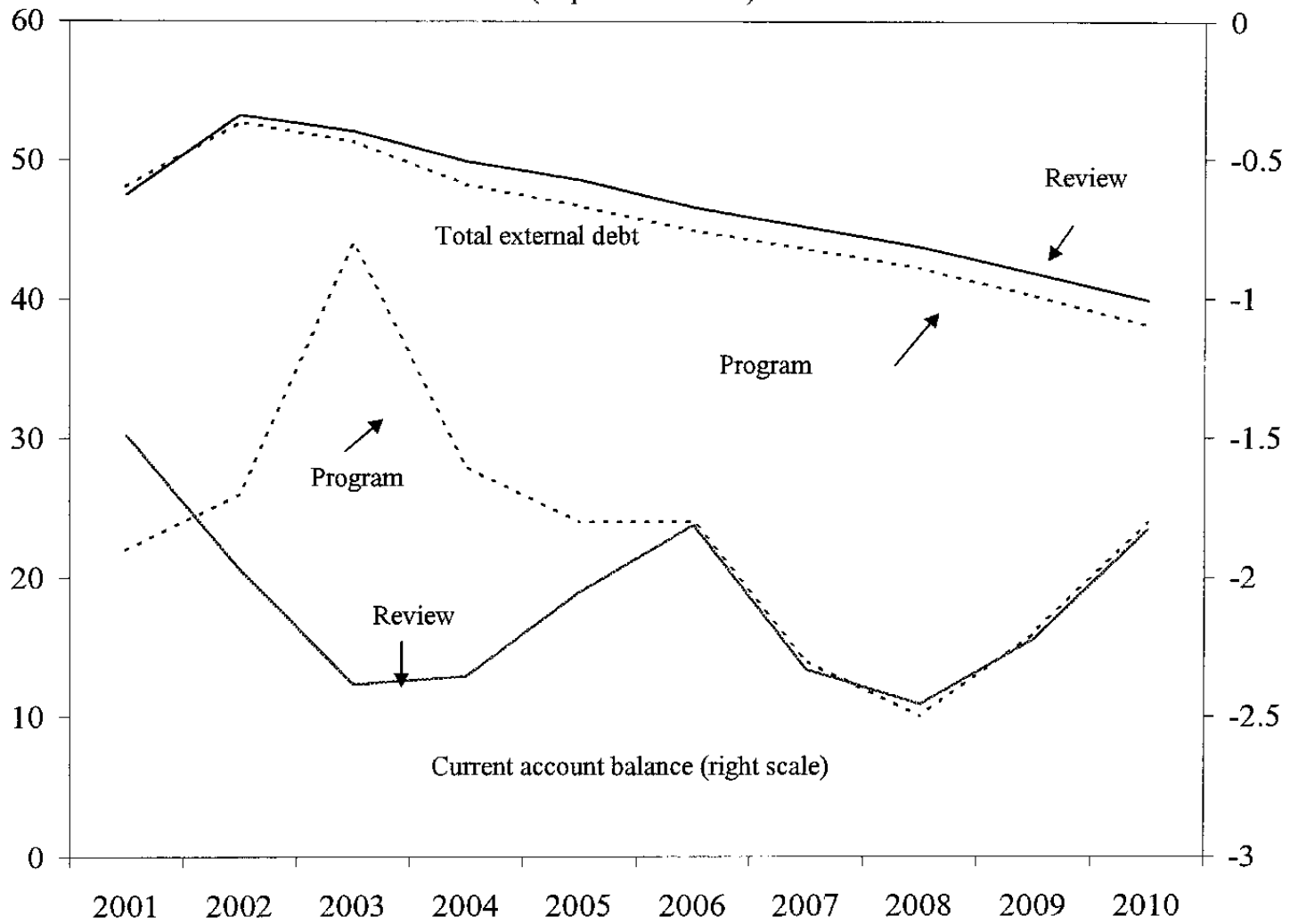


Table 1. Colombia: Selected Economic and Financial Indicators

| | 1998 | 1999 | 2000 | 2001 | Prel. 2002 | 2003 | | Prog. 2004 |
|---|--------|-------|-------|--------|---------------|--------|--------|---------------|
| | | | | | | Prog. | Rev. | |
| (Percentage changes, unless otherwise indicated) | | | | | | | | |
| National income and prices | | | | | | | | |
| Real GDP | 0.6 | -4.2 | 2.9 | 1.4 | 1.5 | 2.0 | 2.0 | 3.3 |
| GDP deflator | 14.8 | 12.6 | 12.1 | 6.0 | 6.0 | 5.5 | 7.4 | 5.0 |
| Consumer prices (average) | 18.7 | 10.9 | 9.2 | 8.0 | 6.3 | 5.6 | 6.9 | 5.3 |
| Consumer prices (end of period) | 16.7 | 9.2 | 8.7 | 7.6 | 7.0 | 5.5 | 5.9 | 5.0 |
| External sector (on the basis of U.S. dollars) | | | | | | | | |
| Exports (f.o.b.) | -4.8 | 4.9 | 13.2 | -6.1 | -3.8 | 4.9 | -1.4 | 4.9 |
| Imports (f.o.b.) | -5.3 | -26.3 | 8.1 | 10.6 | -1.6 | -4.5 | -0.9 | 4.7 |
| Export volume | 6.0 | 1.4 | 1.2 | 1.4 | -5.4 | 5.1 | -5.6 | 8.0 |
| Import volume | -1.9 | -22.4 | 7.7 | 12.4 | -1.6 | -7.3 | -5.9 | -1.3 |
| Terms of trade (deterioration -) | -7.1 | 8.8 | 11.5 | -6.0 | 1.8 | -3.1 | -0.9 | -8.4 |
| Real effective exchange rate (depreciation -) | -2.2 | -6.4 | 1.4 | 2.4 | -15.9 | ... | ... | ... |
| Central administration | | | | | | | | |
| Revenue | 9.8 | 8.1 | 25.7 | 20.8 | 10.1 | 15.9 | 14.8 | 4.1 |
| Expenditure 1/ | 24.5 | 20.0 | 11.9 | 16.7 | 12.6 | 4.5 | 3.4 | 2.0 |
| Money and credit 2/ | | | | | | | | |
| Broad money | 10.2 | 8.4 | 1.2 | 5.8 | 1.9 | 7.4 | 7.4 | 7.0 |
| Credit to the private sector 3/ | 12.8 | -2.0 | -7.6 | 2.0 | 6.7 | 8.1 | 8.1 | 9.7 |
| Interest rate (90-day time deposits; percent per year) | | | | | | | | |
| Nominal | 34.3 | 15.8 | 13.4 | 11.5 | 7.7 | ... | ... | ... |
| Real | 15.1 | 6.0 | 4.2 | 3.6 | 0.7 | ... | ... | ... |
| (In percent of GDP) | | | | | | | | |
| Central administration balance 1/ | -5.5 | -7.4 | -5.7 | -5.7 | -6.3 | -4.5 | -4.4 | -3.9 |
| Nonfinancial public sector savings 1/ | 4.0 | 2.9 | 4.4 | 4.7 | 4.1 | 4.7 | 4.6 | 5.0 |
| Nonfinancial public sector balance 1/ | -4.6 | -6.4 | -3.5 | -3.5 | -4.2 | -2.4 | -2.5 | -2.2 |
| Combined public sector balance 1/ | -3.8 | -5.5 | -3.4 | -3.2 | -3.6 | -2.5 | -2.5 | -2.1 |
| Foreign financing | 1.8 | 1.1 | 1.6 | 2.3 | 0.6 | 0.3 | 2.1 | 0.9 |
| Domestic financing 4/ | 1.9 | 3.7 | 1.2 | 0.9 | 3.1 | 2.3 | 0.5 | 1.2 |
| Privatization | 0.1 | 0.7 | 0.5 | 0.0 | -0.1 | -0.1 | -0.1 | -0.1 |
| Public debt 5/6/ | 34.1 | 42.2 | 47.2 | 50.5 | 55.9 | 55.5 | 54.9 | 53.5 |
| Gross domestic investment | 19.7 | 12.9 | 13.7 | 15.1 | 14.8 | 13.0 | 15.0 | 15.2 |
| Gross national savings | 14.8 | 13.7 | 14.5 | 13.7 | 12.8 | 12.2 | 12.7 | 12.8 |
| Current account (deficit -) | -4.9 | 0.8 | 0.8 | -1.5 | -2.0 | -0.8 | -2.3 | -2.4 |
| External debt 7/ | 40.3 | 45.4 | 45.9 | 47.5 | 53.2 | 51.3 | 52.0 | 49.9 |
| Of which: public sector 7/ | 20.8 | 25.0 | 26.2 | 28.6 | 32.2 | 31.3 | 32.6 | 31.6 |
| Total short-term external debt to reserves | 103.1 | 107.0 | 87.6 | 98.0 | 90.7 | 90.8 | 75.1 | 76.5 |
| (In percent of exports of goods, services, and income) | | | | | | | | |
| External debt service 7/ | 49.6 | 50.6 | 50.1 | 50.1 | 64.0 | 52.6 | 60.3 | 47.8 |
| Of which: Public sector | 22.7 | 22.5 | 21.7 | 28.2 | 37.1 | 31.9 | 34.7 | 26.3 |
| Interest payments 7/ | 17.9 | 16.8 | 15.9 | 16.2 | 16.9 | 16.4 | 17.2 | 16.9 |
| Of which: Public sector | 8.2 | 8.5 | 8.9 | 10.4 | 11.3 | 11.4 | 12.2 | 11.9 |
| (In millions of U.S. dollars) | | | | | | | | |
| Overall balance of payments | -1,390 | -315 | 870 | 1,217 | 138 | 243 | -2 | 295 |
| Gross official reserves 6/ | 8,740 | 8,103 | 9,006 | 10,245 | 10,844 | 10,923 | 10,787 | 11,082 |
| Gross official reserves (in months of imports of goods and services) | 7.8 | 6.7 | 6.8 | 8.0 | 8.5 | 8.3 | 8.1 | 8.3 |

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/ Assuming no purchases under the current SBA arrangement.

7/ Includes short-term debt.

Table 2. Colombia: Operations of the Combined Public Sector
(In percent of GDP)

| | 1998 | 1999 | 2000 | 2001 | Prel. 2002 | 2003 | | Prog. 2004 |
|---|-------------|-------------|-------------|-------------|---------------|-------------|-------------|---------------|
| | | | | | | Prog. | Rev. 1/ | |
| Total revenue | 26.9 | 27.4 | 28.0 | 29.6 | 29.6 | 30.7 | 30.3 | 29.3 |
| Current revenue | 26.9 | 27.4 | 28.0 | 29.6 | 29.6 | 30.7 | 30.3 | 29.3 |
| Tax revenue 2/ | 17.6 | 16.9 | 17.3 | 19.2 | 19.2 | 21.1 | 20.8 | 20.6 |
| Nontax revenue | 9.3 | 10.5 | 10.7 | 10.4 | 10.4 | 9.6 | 9.4 | 8.8 |
| Property income | 0.9 | 1.0 | 1.0 | 1.3 | 0.9 | 0.8 | 0.9 | 0.8 |
| Operating surplus of public enterprises | 3.3 | 4.0 | 4.2 | 4.2 | 4.0 | 4.4 | 4.4 | 3.7 |
| <i>Of which: Ecopetrol</i> | 1.7 | 2.4 | 3.0 | 2.5 | 2.3 | 2.5 | 2.5 | 1.8 |
| Other | 5.1 | 5.5 | 5.5 | 4.8 | 5.4 | 4.3 | 4.1 | 4.3 |
| Total expenditure and net lending 2/ | 30.9 | 33.3 | 31.5 | 33.3 | 33.7 | 33.2 | 32.8 | 31.5 |
| Current expenditure | 22.9 | 24.5 | 23.6 | 24.9 | 25.5 | 25.9 | 25.6 | 24.4 |
| Wages and salaries | 7.1 | 7.7 | 7.2 | 7.5 | 7.5 | 7.2 | 7.1 | 6.4 |
| Goods and services 3/ | 3.5 | 3.7 | 3.3 | 3.5 | 3.4 | 3.3 | 3.2 | 3.1 |
| Interest | 3.3 | 3.8 | 4.4 | 5.0 | 4.5 | 5.2 | 5.2 | 4.9 |
| External | 1.1 | 1.4 | 1.6 | 2.3 | 2.1 | 2.5 | 2.4 | 2.3 |
| Domestic | 2.2 | 2.3 | 2.8 | 2.8 | 2.4 | 2.8 | 2.8 | 2.6 |
| Transfers to private sector | 8.6 | 9.2 | 9.0 | 9.8 | 9.7 | 10.3 | 10.2 | 10.0 |
| <i>Of which: from social security</i> | 5.0 | 5.5 | 5.5 | 6.5 | 6.7 | 7.1 | 7.0 | 7.0 |
| Other 4/ | 0.4 | 0.2 | -0.3 | -0.9 | 0.2 | -0.1 | -0.1 | 0.0 |
| Capital expenditure | 8.0 | 8.7 | 7.9 | 8.3 | 8.1 | 7.1 | 7.1 | 7.1 |
| Fixed capital formation 4/ | 7.8 | 8.6 | 7.8 | 8.2 | 7.9 | 7.1 | 7.1 | 7.0 |
| Transfers | 0.1 | 0.1 | 0.1 | 0.1 | 0.2 | 0.0 | 0.0 | 0.1 |
| Net lending | 0.0 | 0.1 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 |
| Statistical discrepancy | -0.6 | -0.5 | 0.0 | 0.2 | -0.1 | 0.0 | 0.0 | 0.0 |
| Nonfinancial public sector balance | -4.6 | -6.4 | -3.5 | -3.5 | -4.2 | -2.5 | -2.5 | -2.2 |
| Quasi-fiscal balance (BR cash profits) | 0.8 | 0.4 | 0.5 | 0.7 | 0.8 | 0.4 | 0.4 | 0.3 |
| Fogafin balance | ... | 0.5 | 0.0 | 0.2 | 0.3 | 0.1 | 0.1 | 0.3 |
| Net cost of financial restructuring 5/ | ... | 0.0 | -0.4 | -0.7 | -0.6 | -0.5 | -0.5 | -0.6 |
| Overall balance | -3.8 | -5.5 | -3.4 | -3.2 | -3.6 | -2.5 | -2.5 | -2.1 |
| Overall financing | 3.8 | 5.5 | 3.4 | 3.2 | 3.6 | 2.5 | 2.5 | 2.1 |
| Foreign, net | 1.8 | 1.1 | 1.6 | 2.3 | 0.6 | 0.3 | 2.1 | 0.9 |
| <i>Of which</i> | | | | | | | | |
| Changes in assets held abroad (-increase) | 0.1 | -1.0 | -0.1 | -1.9 | 1.9 | 0.4 | 0.9 | 0.3 |
| Domestic, net | 1.9 | 3.7 | 1.2 | 0.9 | 3.1 | 2.3 | 0.5 | 1.2 |
| Financial system 6/ | 1.2 | 2.2 | -0.5 | -1.1 | -1.4 | 0.4 | -1.4 | 0.0 |
| Bonds 7/ | 0.2 | 0.9 | 2.3 | 2.8 | 3.9 | 1.9 | 1.9 | 1.2 |
| Change in floating debt and accrual adjustments | 0.4 | 0.6 | -0.6 | -0.7 | 0.7 | -0.1 | -0.1 | 0.0 |
| Privatization (including concessions) 8/ | 0.1 | 0.7 | 0.5 | 0.0 | -0.1 | -0.1 | -0.1 | -0.1 |
| Memorandum items: | | | | | | | | |
| NFPS savings | 4.0 | 2.9 | 4.4 | 4.7 | 4.1 | 4.7 | 4.6 | 5.0 |
| NFPS primary balance | -1.3 | -2.6 | 0.9 | 1.5 | 0.4 | 2.7 | 2.7 | 2.7 |
| Oil stabilization fund (deposits in FAEP) | 0.1 | 0.4 | 0.9 | 0.2 | -0.2 | -0.2 | -0.2 | -0.3 |
| Military expenditure | 3.2 | 3.2 | 3.2 | 3.3 | 3.6 | 4.2 | 4.2 | 4.2 |

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

1/ SBA fiscal figures at Board approval in January 2003. Fiscal targets in nominal pesos remain unchanged. A revision of the nominal GDP projection for 2003 resulted in lower GDP ratios.

2/ Excludes proceeds of financial transaction tax from revenue in 1999.

3/ From year 2000 includes the unpaid bills of the Social Security Institute (ISS).

4/ Includes change in the budget carry-over of the central administration and in the unpaid bills of selected nonfinancial public enterprises.

5/ Interest payments on public banks restructuring bonds and mortgage debt relief related costs.

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 3. Colombia: Operations of the Central Administration

(In percent of GDP)

| | 1998 | 1999 | 2000 | 2001 | Prel. 2002 | 2003 | | Prog. 2004 |
|--|-------------|-------------|-------------|-------------|---------------|-------------|-------------|---------------|
| | | | | | | Prog. | Rev. 1/ | |
| Total revenue | 12.0 | 12.0 | 13.0 | 14.7 | 15.0 | 15.9 | 15.7 | 15.1 |
| Current revenue | 12.0 | 12.0 | 13.0 | 14.7 | 15.0 | 15.9 | 15.7 | 15.1 |
| Tax revenue 2/ | 10.6 | 10.0 | 11.2 | 13.2 | 13.4 | 14.6 | 14.4 | 13.8 |
| Net income tax and profits | 4.3 | 4.2 | 4.3 | 5.3 | 5.9 | 6.1 | 6.1 | 5.7 |
| Goods and services | 5.0 | 4.9 | 5.3 | 5.9 | 5.7 | 6.6 | 6.5 | 6.3 |
| Value-added tax | 4.6 | 4.4 | 4.8 | 5.3 | 5.3 | 6.1 | 6.0 | 5.8 |
| Gasoline tax | 0.5 | 0.5 | 0.5 | 0.6 | 0.5 | 0.5 | 0.5 | 0.5 |
| International trade | 1.2 | 0.9 | 1.0 | 1.1 | 1.0 | 1.0 | 1.0 | 1.1 |
| Financial transaction tax | 0.0 | 0.0 | 0.6 | 0.8 | 0.7 | 0.7 | 0.7 | 0.7 |
| Stamp and other taxes | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Nontax revenue and transfers | 1.4 | 1.9 | 1.8 | 1.5 | 1.6 | 1.4 | 1.4 | 1.3 |
| Property income | 0.3 | 0.3 | 0.5 | 0.3 | 0.3 | 0.1 | 0.2 | 0.3 |
| Other | 1.1 | 1.6 | 1.3 | 1.2 | 1.3 | 1.3 | 1.1 | 1.0 |
| Total expenditure and net lending | 17.4 | 19.4 | 18.8 | 20.4 | 21.4 | 20.4 | 20.2 | 19.0 |
| Current expenditure | 14.1 | 15.0 | 15.3 | 15.8 | 17.6 | 17.1 | 16.9 | 16.0 |
| Wages and salaries | 2.7 | 2.9 | 2.9 | 3.0 | 3.0 | 2.8 | 2.7 | 2.2 |
| Goods and services | 1.4 | 1.3 | 1.3 | 1.5 | 1.6 | 1.5 | 1.4 | 1.4 |
| Interest | 1.9 | 2.1 | 3.0 | 3.5 | 3.5 | 4.2 | 4.1 | 4.2 |
| External | 0.7 | 1.0 | 1.2 | 1.6 | 1.7 | 2.0 | 2.0 | 2.0 |
| Domestic | 1.2 | 1.1 | 1.8 | 1.9 | 1.7 | 2.2 | 2.1 | 2.2 |
| Other expenditure 3/ | 0.6 | 0.2 | -0.1 | -0.9 | 0.6 | -0.1 | -0.1 | 0.0 |
| Current transfers 4/ | 7.5 | 8.5 | 8.2 | 8.6 | 8.9 | 8.8 | 8.7 | 8.3 |
| Capital expenditure | 3.1 | 3.8 | 3.0 | 3.8 | 3.1 | 2.7 | 2.7 | 2.6 |
| Fixed capital formation 3/ | 1.1 | 1.6 | 1.0 | 1.3 | 1.3 | 0.9 | 0.9 | 0.9 |
| Capital transfers | 2.0 | 2.3 | 2.1 | 2.5 | 1.8 | 1.8 | 1.8 | 1.7 |
| Net lending | 0.2 | 0.5 | 0.5 | 0.8 | 0.6 | 0.6 | 0.6 | 0.4 |
| Overall balance | -5.5 | -7.4 | -5.7 | -5.7 | -6.3 | -4.4 | -4.4 | -3.9 |
| Memorandum items: | | | | | | | | |
| Primary Balance | -3.5 | -5.3 | -2.7 | -2.2 | -2.9 | -0.3 | -0.3 | 0.3 |
| Transfers to local governments | 4.3 | 5.0 | 4.6 | 5.4 | 5.1 | 5.3 | 5.2 | 5.2 |

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

1/ SBA fiscal figures at Board approval in January 2003. Fiscal targets in nominal pesos remain unchanged. A revision of the nominal GDP projection for 2003 resulted in lower GDP ratios.

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

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

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

Table 4. Colombia: Monetary Indicators

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | | Prog. 2004 |
|---|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | | | | | | Prog. | Rev. | |
| (In billions of Colombian pesos, unless otherwise indicated) | | | | | | | | |
| Central bank | | | | | | | | |
| Net international reserves 1/ billions of US\$ | 13,001 8.7 | 14,941 8.1 | 19,470 9.0 | 23,320 10.2 | 30,301 10.5 | 32,725 10.6 | 32,404 10.5 | 34,201 10.8 |
| Net domestic assets | -1,817 | -5,202 | -8,760 | -11,672 | -16,194 | -18,320 | -17,493 | -18,098 |
| Net credit to public sector | 700 | 2,161 | 2,427 | 1,631 | 2,101 | 1,548 | 1,548 | 1,368 |
| Net credit to financial system | 847 | 1,645 | 1,496 | 700 | 1,452 | 901 | 901 | 1,264 |
| Other | -3,363 | -9,008 | -12,682 | -14,003 | -19,746 | -20,768 | -19,941 | -20,730 |
| Monetary base | 6,923 | 9,740 | 10,710 | 11,648 | 14,107 | 14,405 | 14,912 | 16,104 |
| Of which: currency in circulation | 4,603 | 6,037 | 7,276 | 8,349 | 9,993 | 10,326 | 10,563 | 11,408 |
| Banking system | | | | | | | | |
| Net foreign assets | 5,001 | 7,597 | 13,455 | 18,303 | 23,338 | 25,684 | 25,684 | 27,108 |
| billions of US\$ | 3.2 | 4.1 | 6.0 | 8.0 | 8.1 | 8.3 | 8.3 | 8.5 |
| Net domestic assets | 45,140 | 46,754 | 41,532 | 39,855 | 35,897 | 39,942 | 37,959 | 40,983 |
| Net credit to public sector | 5,251 | 8,444 | 11,846 | 12,704 | 15,856 | 16,406 | 16,674 | 18,385 |
| Credit to private sector | 51,602 | 50,576 | 46,707 | 47,659 | 50,858 | 52,829 | 54,987 | 60,329 |
| Other net | -11,713 | -12,266 | -17,021 | -20,509 | -30,818 | -29,294 | -33,703 | -37,731 |
| Broad money | 50,142 | 54,351 | 54,987 | 58,157 | 59,234 | 65,626 | 63,643 | 68,092 |
| (Annual percentage change) | | | | | | | | |
| Credit to public sector, net | 293.6 | 60.8 | 40.3 | 7.2 | 24.8 | 11.9 | 5.2 | 10.3 |
| Credit to private sector | 12.8 | -2.0 | -7.6 | 2.0 | 6.7 | 8.1 | 8.1 | 9.7 |
| Currency | 12.2 | 31.1 | 20.5 | 14.8 | 19.7 | 5.7 | 5.7 | 8.0 |
| Monetary base | -16.5 | 40.7 | 10.0 | 8.8 | 21.1 | 5.7 | 5.7 | 8.0 |
| Broad money | 10.2 | 8.4 | 1.2 | 5.8 | 1.9 | 7.4 | 7.4 | 7.0 |
| (In percent of GDP) | | | | | | | | |
| Credit to public sector, net | 3.7 | 5.6 | 6.8 | 6.8 | 7.8 | 7.5 | 7.5 | 7.7 |
| Credit to private sector | 36.7 | 33.4 | 26.7 | 25.4 | 25.2 | 24.1 | 24.8 | 25.1 |
| Currency | 3.3 | 4.0 | 4.2 | 4.4 | 4.9 | 4.7 | 4.8 | 4.7 |
| Monetary base | 4.9 | 6.4 | 6.1 | 6.2 | 7.0 | 6.6 | 6.7 | 6.7 |
| Broad money | 35.7 | 35.9 | 31.4 | 30.9 | 29.3 | 30.7 | 28.7 | 28.3 |
| (In billions of Colombian pesos, unless otherwise indicated) | | | | | | | | |
| Memorandum items: | | | | | | | | |
| Central bank inflation target (percent) 2/ | 16.0 | 15.0 | 10.0 | 8.0 | 6.0 | 5.5 | 5.9 | ... |
| Consumer price inflation (percent) | 16.7 | 9.2 | 8.8 | 7.6 | 7.0 | 5.5 | 5.9 | 5.0 |
| Producer price inflation (percent) | 13.8 | 12.7 | 11.0 | 6.9 | 9.4 | 5.8 | 5.8 | 5.0 |
| Exchange rate (annual percent change) | 19.2 | 21.5 | 19.0 | 2.8 | 25.0 | ... | ... | ... |
| Financial system 3/ | | | | | | | | |
| Net assets in foreign currency 4/ billions of US\$ | 329 0.2 | -387 -0.2 | -445 -0.2 | 371 0.2 | 660 0.2 | ... | ... | ... |
| percent of GDP | 0.2 | -0.3 | -0.3 | 0.2 | 0.3 | ... | ... | ... |
| Foreign currency assets to total assets (percent) 5/ | 14.7 | 10.9 | 8.9 | 8.1 | 8.7 | ... | ... | ... |
| Foreign currency credit to total credit (percent) 5/ | 18.5 | 15.2 | 13.1 | 11.0 | 11.6 | ... | ... | ... |
| Foreign currency deposits to total deposits (percent) 5/ | 0.4 | 0.5 | 0.4 | 0.5 | 0.4 | ... | ... | ... |
| M3/NIR | 6.5 | 4.1 | 3.2 | 2.9 | 2.4 | 2.4 | 2.5 | 2.5 |
| Adjusted credit to the private sector 5/ annual percent change | 56,806 ... | 58,454 2.9 | 59,213 1.3 | 60,794 2.7 | 65,963 8.5 | 67,934 6.2 | 70,092 6.3 | 75,434 7.6 |
| percent of GDP | 40.4 | 38.6 | 33.9 | 32.3 | 32.6 | 31.0 | 31.6 | 31.4 |
| Total private sector portfolio 6/ percent of GDP | 58,520 41.7 | 63,574 41.9 | 67,554 38.6 | 73,932 39.3 | 78,748 38.9 | 88,423 40.4 | 86,440 39.0 | 93,406 38.9 |

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

1/ Net international reserves include liabilities in foreign currency to resident entities.

2/ 2003 target was revised upward by 0.4 percentage points in account of the first round effect of the VAT reform.

3/ Banking system excluding the central bank.

4/ Regulation limits net foreign liabilities to 5 percent and net foreign assets to 20 percent of regulatory capital.

5/ Observed credit to the private sector plus loan write-offs and debt relief for mortgage loans.

6/ Broad money plus direct holdings of public sector debt, stocks, and assets arising from privatizations.

Table 5. Colombia: Banking System Indicators

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|--------|--------|--------|--------|--------|
| (In millions of Colombian pesos, unless otherwise indicated) | | | | | |
| Total system 1/ | | | | | |
| Assets | 79,395 | 80,046 | 80,390 | 84,244 | 89,325 |
| Investment portfolio | 9,388 | 12,066 | 17,165 | 22,163 | 25,102 |
| Loan portfolio | 51,040 | 48,469 | 44,301 | 44,098 | 46,456 |
| <i>Of which</i> : nonperforming loans | 5,688 | 6,919 | 5,211 | 4,640 | 4,524 |
| Capital | 8,402 | 8,823 | 9,101 | 9,417 | 9,979 |
| Operational margin 2/ | -29 | -1,366 | -174 | 1,558 | 2,530 |
| Net results | -1,613 | -2,599 | -1,574 | 506 | 1,513 |
| (Annual percentage change) | | | | | |
| Assets | 7.2 | 0.8 | 0.4 | 4.8 | 6.0 |
| Loan portfolio | 7.8 | -5.0 | -8.6 | -0.5 | 5.3 |
| (In percent) | | | | | |
| Financial ratios | | | | | |
| Total system 1/ | | | | | |
| Net interest margin to assets | 4.1 | 3.0 | 3.5 | 3.0 | 3.3 |
| Gross interest margin to assets | 8.6 | 7.9 | 8.3 | 8.4 | 8.7 |
| Operational margin to assets 2/ | 0.0 | -1.7 | -0.2 | 1.8 | 2.8 |
| Return on equity | -19.2 | -29.5 | -17.3 | 5.4 | 15.2 |
| Cash to assets | 6.3 | 7.2 | 6.7 | 6.2 | 6.3 |
| Investment portfolio to total assets | 11.8 | 15.1 | 21.4 | 26.3 | 28.1 |
| Nonperforming loans to total loans 3/ | 10.7 | 13.6 | 11.0 | 9.7 | 9.0 |
| Loan-loss provisions to nonperforming loans | 37.9 | 36.8 | 56.6 | 77.5 | 83.5 |
| Capital to assets 4/ | 10.6 | 11.0 | 11.3 | 11.2 | 11.2 |
| Mortgage banks | | | | | |
| Net interest margin to assets | 4.6 | 4.1 | 5.0 | 3.2 | 3.7 |
| Return on equity | -18.7 | -17.3 | -16.6 | -0.5 | 11.6 |
| Cash to assets | 3.0 | 5.2 | 5.6 | 6.0 | 6.3 |
| Investment portfolio to total assets | 4.1 | 10.3 | 21.7 | 24.4 | 28.5 |
| Nonperforming loans to total loans 3/ | 14.8 | 22.2 | 20.2 | 19.4 | 19.1 |
| Loan-loss provisions to nonperforming loans | 12.4 | 21.1 | 27.5 | 46.2 | 52.4 |
| Capital to assets 4/ | 7.7 | 7.7 | 7.7 | 7.9 | 7.9 |
| (In percent of private sector investment portfolio, unless otherwise indicated) | | | | | |
| Memorandum items: | | | | | |
| Capital adequacy banks excl. mortgage banks 5/ | ... | ... | 12.2 | 12.4 | 12.7 |
| Capital adequacy mortgage banks 5/ | ... | ... | 13.1 | 13.6 | 13.6 |
| Private sector investment portfolio (percent of GDP) | 15.1 | 19.0 | 23.0 | 28.4 | 37.8 |
| Banks | 44.3 | 41.8 | 42.6 | 41.5 | 32.8 |
| Insurance companies | 10.8 | 9.0 | 6.5 | 6.8 | 5.6 |
| Mutual funds | 2.8 | 3.5 | 3.0 | 19.1 | 31.0 |
| Pension funds | 23.9 | 27.6 | 28.6 | 29.4 | 28.1 |
| Investment funds | 18.2 | 18.1 | 19.4 | 3.1 | 2.6 |

Sources: Superintendencia Bancaria; and Fund staff estimates.

1/ Excluding credit unions and public sector special institutions (IOE).

2/ Gross interest margin plus net provisions and administrative cost before depreciation and amortization.

3/ Nonperforming based on past-due period (30 days).

4/ Not risk weighted.

5/ Risk weighted.

Table 6. Colombia: Summary Balance of Payments, 1998-2004

| | 1998 | 1999 | 2000 | 2001 | Prel. 2002 | 2003 | | Prog. 2004 |
|--|---------------|-------------|------------|---------------|---------------|-------------|---------------|---------------|
| | | | | | | Prog. | Rev. | |
| (In millions of U.S. dollars) | | | | | | | | |
| Current account balance | -4,843 | 689 | 641 | -1,215 | -1,579 | -593 | -1,753 | -1,832 |
| Trade balance | -2,450 | 1,775 | 2,531 | 520 | 228 | 2,074 | 159 | 190 |
| Exports, f.o.b. | 11,480 | 12,037 | 13,620 | 12,787 | 12,304 | 13,261 | 12,129 | 12,719 |
| Coffee | 1,893 | 1,324 | 1,069 | 764 | 772 | 805 | 777 | 881 |
| Petroleum products | 2,329 | 3,757 | 4,570 | 3,285 | 3,275 | 2,871 | 3,265 | 2,502 |
| Nontraditional | 5,420 | 5,279 | 6,201 | 6,613 | 6,291 | 7,536 | 6,133 | 7,037 |
| Other | 1,838 | 1,678 | 1,782 | 2,125 | 1,966 | 2,049 | 1,953 | 2,299 |
| Imports, f.o.b. | 13,930 | 10,262 | 11,090 | 12,267 | 12,076 | 11,187 | 11,971 | 12,529 |
| Services (net) | -1,461 | -1,204 | -1,273 | -1,419 | -1,453 | -1,488 | -1,451 | -1,493 |
| Income (net) | -1,683 | -1,337 | -2,286 | -2,607 | -2,729 | -3,091 | -2,777 | -2,778 |
| Interest (net) | -1,686 | -1,661 | -1,663 | -1,738 | -1,906 | -2,119 | -1,960 | -1,918 |
| <i>Of which</i> : public sector | -562 | -759 | -888 | -1,086 | -1,264 | -1,489 | -1,380 | -1,456 |
| Other Income (net) | 3 | 324 | -623 | -870 | -824 | -972 | -816 | -860 |
| Current transfers (net) | 750 | 1,455 | 1,669 | 2,292 | 2,377 | 1,912 | 2,316 | 2,248 |
| Financial account balance | 3,314 | -611 | -79 | 2,405 | 1,172 | 836 | 1,751 | 2,128 |
| Public sector (net) | 1,587 | 902 | 457 | 1,443 | 358 | 247 | 1,316 | 723 |
| Nonfinancial public sector | 1,920 | 1,235 | 1,256 | 1,913 | 482 | 401 | 1,543 | 736 |
| Medium- and long-term (net) | 1,937 | 1,995 | 1,663 | 3,466 | -1,098 | 295 | 884 | 500 |
| Disbursements | 3,515 | 3,719 | 3,238 | 5,746 | 2,462 | 3,353 | 3,953 | 2,618 |
| Amortization | 1,578 | 1,724 | 1,575 | 2,280 | 3,560 | 3,058 | 3,069 | 2,118 |
| Other long-term flows | -15 | -23 | -40 | -35 | -30 | 0 | 0 | 0 |
| Short term | -3 | -736 | -367 | -1,518 | 1,610 | 106 | 659 | 236 |
| <i>Of which</i> : change in assets | 270 | -611 | -261 | -1,540 | 1,558 | 306 | 659 | 236 |
| Financial public sector | -333 | -334 | -799 | -470 | -124 | -154 | -227 | -13 |
| Private sector (net) | 1,727 | -1,513 | -537 | 962 | 814 | 589 | 435 | 1,404 |
| Nonfinancial private sector (net) | 2,604 | -128 | -130 | 1,020 | 1,193 | 564 | 526 | 1,262 |
| Direct investment | 2,033 | 1,336 | 1,911 | 2,505 | 1,251 | 1,733 | 1,474 | 1,519 |
| <i>Of which</i> : Privatization | 511 | 0 | 465 | 0 | 0 | 0 | 0 | 0 |
| Leasing finance | 604 | 208 | -109 | -211 | -241 | -146 | -142 | -88 |
| Long-term loans | 452 | -193 | -479 | 126 | -1,021 | -616 | -636 | 0 |
| Short term 1/ | -484 | -1,479 | -1,454 | -1,401 | 1,204 | -407 | -169 | -169 |
| Financial private sector (net) | -877 | -1,385 | -406 | -57 | -379 | 25 | -91 | 142 |
| Net errors and omissions | 139 | -393 | 308 | 27 | 545 | 0 | 0 | 0 |
| Changes in NIR | -1,390 | -315 | 870 | 1,217 | 138 | 243 | -2 | 295 |
| (In percent of GDP) | | | | | | | | |
| Current account balance | -4.9 | 0.8 | 0.8 | -1.5 | -2.0 | -0.8 | -2.3 | -2.4 |
| (In months of imports of goods and services) | | | | | | | | |
| Gross international reserves | 7.8 | 6.7 | 6.8 | 8.0 | 8.5 | 8.3 | 8.1 | 8.3 |

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

1/ Includes net portfolio investment.

Table 7. Colombia: External Sustainability Framework - Baseline Scenario

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| I. Output and Prices | | | | | | | | | |
| (Annual percentage changes) | | | | | | | | | |
| Real GDP | 1.5 | 2.0 | 3.3 | 3.7 | 3.9 | 4.0 | 4.0 | 4.0 | 4.0 |
| Consumer prices | | | | | | | | | |
| End-of-period | 7.0 | 5.9 | 5.0 | 4.0 | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Period average | 6.3 | 6.9 | 5.3 | 4.0 | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| (In percent of GDP, unless otherwise indicated) | | | | | | | | | |
| II. Saving and Investment | | | | | | | | | |
| Gross national saving | 12.8 | 12.6 | 12.8 | 12.2 | 13.0 | 13.0 | 13.8 | 14.8 | 15.7 |
| Private sector | 8.4 | 8.0 | 7.8 | 6.4 | 6.9 | 7.2 | 7.8 | 7.9 | 8.2 |
| Public sector | 4.4 | 4.6 | 5.1 | 5.8 | 6.1 | 5.7 | 6.1 | 6.9 | 7.5 |
| Gross domestic investment | 14.8 | 15.0 | 15.2 | 14.3 | 14.8 | 15.3 | 16.3 | 17.0 | 17.5 |
| Private sector | 6.7 | 7.9 | 8.1 | 7.1 | 7.6 | 8.0 | 9.0 | 9.6 | 9.9 |
| Public sector capital expenditure | 8.1 | 7.1 | 7.1 | 7.2 | 7.2 | 7.3 | 7.3 | 7.4 | 7.6 |
| External current account balance | -2.0 | -2.4 | -2.4 | -2.1 | -1.8 | -2.3 | -2.5 | -2.2 | -1.8 |
| Private sector | 1.7 | 0.1 | -0.3 | -0.7 | -0.7 | -0.8 | -1.2 | -1.7 | -1.7 |
| Public sector | -3.6 | -2.5 | -2.1 | -1.4 | -1.1 | -1.6 | -1.2 | -0.5 | -0.2 |
| III. Nonfinancial and Consolidated Public Sector | | | | | | | | | |
| Nonfinancial public sector | | | | | | | | | |
| Revenue | 29.6 | 30.3 | 29.3 | 30.6 | 30.9 | 30.5 | 30.7 | 30.9 | 31.0 |
| Expenditure | 33.7 | 32.8 | 31.5 | 32.0 | 32.5 | 32.2 | 32.0 | 31.5 | 31.3 |
| Current expenditure | 25.5 | 25.6 | 24.4 | 24.8 | 25.3 | 24.9 | 24.7 | 24.1 | 23.7 |
| Capital expenditure | 8.1 | 7.1 | 7.1 | 7.2 | 7.2 | 7.3 | 7.3 | 7.4 | 7.6 |
| Primary balance | 0.4 | 2.7 | 2.7 | 4.1 | 4.1 | 3.4 | 3.6 | 4.1 | 4.1 |
| Overall balance | -4.2 | -2.5 | -2.2 | -1.3 | -1.7 | -1.7 | -1.4 | -0.6 | -0.3 |
| Combined public sector balance | -3.6 | -2.5 | -2.1 | -1.4 | -1.1 | -1.6 | -1.2 | -0.5 | -0.2 |
| External financing | 0.4 | 1.8 | 0.9 | 1.0 | 0.6 | 1.1 | 1.0 | 0.3 | 0.1 |
| Domestic financing | 3.3 | 0.7 | 1.2 | 0.4 | 0.5 | 0.5 | 0.3 | 0.2 | 0.1 |
| Privatization | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| IV. Balance of Payments | | | | | | | | | |
| External current account balance | -2.0 | -2.4 | -2.4 | -2.1 | -1.8 | -2.3 | -2.5 | -2.2 | -1.8 |
| <i>Of which</i> | | | | | | | | | |
| Trade balance | 0.3 | 0.2 | 0.3 | 0.9 | 1.6 | 1.2 | 1.0 | 1.2 | 1.5 |
| Exports | 17.4 | 16.9 | 16.8 | 17.1 | 17.4 | 16.7 | 16.3 | 16.2 | 16.7 |
| Imports | 17.1 | 16.7 | 16.6 | 16.3 | 15.9 | 15.6 | 15.3 | 15.0 | 15.1 |
| Capital and financial account balance | 1.5 | 2.4 | 2.7 | 3.0 | 2.6 | 3.2 | 3.3 | 2.9 | 2.6 |
| Public sector | 0.4 | 1.8 | 0.9 | 1.0 | 0.6 | 1.1 | 1.0 | 0.3 | 0.1 |
| Private sector | 1.0 | 0.6 | 1.8 | 2.0 | 2.0 | 2.0 | 2.3 | 2.6 | 2.5 |
| Overall balance | 0.2 | 0.0 | 0.4 | 1.0 | 0.8 | 0.8 | 0.8 | 0.6 | 0.8 |
| V. Debt | | | | | | | | | |
| Total external debt | 53.2 | 52.0 | 49.9 | 48.6 | 46.6 | 45.2 | 43.7 | 41.8 | 39.9 |
| Public debt | 31.9 | 32.5 | 31.5 | 30.9 | 29.8 | 29.3 | 28.6 | 27.3 | 25.8 |
| Private debt | 21.4 | 19.6 | 18.4 | 17.6 | 16.7 | 15.9 | 15.2 | 14.6 | 14.1 |
| Total public debt | 55.9 | 54.9 | 53.5 | 51.9 | 50.0 | 48.6 | 47.0 | 44.7 | 42.2 |
| Domestic debt | 24.1 | 22.4 | 22.1 | 21.0 | 20.2 | 19.4 | 18.4 | 17.4 | 16.4 |
| External debt | 31.9 | 32.5 | 31.5 | 30.9 | 29.8 | 29.3 | 28.6 | 27.3 | 25.8 |

Sources: Colombian authorities; and Fund staff estimates.

Table 8. Colombia: External Debt Sustainability Framework, 2002-2010

(In percent of GDP, unless otherwise indicated)

| | 2002 | Projections | | | | | | | |
|--|-------------|----------------|-------------|------------------|-------------|----------------|-------------|------------------|-------------|
| | | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
| I. Baseline Medium-Term Projections | | | | | | | | | |
| External debt | 53.2 | 52.0 | 49.9 | 48.6 | 46.6 | 45.2 | 43.7 | 41.8 | 39.9 |
| Change in external debt | 5.7 | -1.2 | -2.2 | -1.3 | -2.0 | -1.4 | -1.5 | -1.9 | -1.9 |
| Identified external debt-creating flows | 3.2 | -2.4 | -3.1 | -3.1 | -3.1 | -2.4 | -2.5 | -2.8 | -3.0 |
| Current account deficit, excluding interest payments | -1.3 | -1.1 | -1.4 | -1.9 | -2.5 | -1.7 | -1.5 | -1.5 | -1.7 |
| Net nondebt creating capital inflows (negative) | -1.8 | -2.1 | -2.0 | -1.9 | -2.0 | -2.0 | -2.2 | -2.4 | -2.3 |
| Automatic debt dynamics 1/ | 6.3 | 0.7 | 0.3 | 0.8 | 1.4 | 1.2 | 1.2 | 1.1 | 1.0 |
| Residual, including change in gross foreign assets | 2.5 | 1.2 | 1.0 | 1.7 | 1.1 | 1.1 | 1.0 | 0.9 | 1.0 |
| Key macroeconomic and external assumptions | | | | | | | | | |
| Real GDP growth (in percent) | 1.5 | 2.0 | 3.3 | 3.7 | 3.9 | 4.0 | 4.0 | 4.0 | 4.0 |
| Nominal exchange rate appreciation (US\$ value of local currency, change in percent) | -20.0 | -7.2 | -2.9 | -2.0 | -1.0 | -1.0 | -1.0 | -1.0 | -1.0 |
| GDP deflator in US\$ (change in percent) | -15.2 | -0.3 | 2.2 | 1.9 | 1.9 | 1.9 | 1.9 | 1.9 | 1.9 |
| Nominal external interest rate (in percent) 2/ | 6.5 | 6.7 | 7.7 | 8.6 | 9.6 | 9.4 | 9.4 | 9.3 | 9.2 |
| Growth of exports (US\$ terms, in percent) | -5.4 | -1.2 | 4.5 | 8.0 | 7.2 | 2.0 | 3.0 | 4.8 | 8.5 |
| Growth of imports (US\$ terms, in percent) | 1.2 | -1.3 | 5.5 | 3.2 | 3.4 | 4.0 | 4.0 | 4.0 | 7.1 |
| II. Stress Tests for External Debt Ratio | | | | | | | | | |
| Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2010 | 53.2 | 49.3 | 46.3 | 44.4 | 42.1 | 39.8 | 37.6 | 35.3 | 33.2 |
| Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004 | 53.2 | 53.0 | 51.3 | 50.0 | 48.1 | 46.7 | 45.3 | 43.5 | 41.6 |
| Real GDP growth is at historical average minus two standard deviations in 2003 and 2004 | 53.2 | 55.0 | 56.6 | 55.4 | 53.6 | 52.4 | 51.2 | 49.4 | 47.7 |
| Noninterest current account is at historical average minus two standard deviations in 2003 and 2004 | 53.2 | 59.8 | 65.7 | 64.6 | 63.1 | 62.2 | 61.2 | 59.7 | 58.2 |
| Combination of 2-4 using one standard deviation shocks | 53.2 | 58.5 | 63.5 | 62.4 | 60.8 | 59.8 | 58.7 | 57.2 | 55.6 |
| One time 30 percent nominal depreciation in 2003 | 53.2 | 61.7 | 59.6 | 58.5 | 56.8 | 55.7 | 54.5 | 52.9 | 51.2 |
| Statistics for key historical and projected variables | | Average | | Standard | | Average | | Standard | |
| | | 1991-01 | | Deviation | | 2002-10 | | Deviation | |
| Current account deficit, excluding interest payments | | 0.1 | | 3.3 | | -1.6 | | 0.4 | |
| Net non-debt creating capital inflows | | 2.3 | | 1.0 | | 2.1 | | 0.2 | |
| Nominal external interest rate (in percent) | | 7.5 | | 0.6 | | 8.5 | | 1.2 | |
| Real GDP growth (in percent) | | 2.7 | | 3.0 | | 3.4 | | 1.0 | |

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: Indicators of Capacity to Repay the Fund, 2002-2008 1/

| | Projections | | | | | | |
|--|-------------|---------|---------|---------|---------|--------|--------|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
| Fund repurchases and charges | | | | | | | |
| In millions of SDRs | 0.0 | 9.5 | 28.0 | 168.5 | 561.4 | 655.5 | 244.9 |
| In millions of U.S. dollars | 0.0 | 13.1 | 38.6 | 232.3 | 774.6 | 904.1 | 337.8 |
| In percent of exports of goods and NFS | 0.0 | 0.1 | 0.3 | 1.5 | 4.9 | 5.5 | 2.0 |
| In percent of GDP | 0.0 | 0.0 | 0.1 | 0.3 | 0.9 | 1.0 | 0.4 |
| In percent of quota | 0.0 | 1.2 | 3.6 | 21.8 | 72.5 | 84.7 | 31.6 |
| In percent of overall debt service | 0.0 | 0.1 | 0.5 | 2.9 | 9.0 | 10.1 | 3.8 |
| In percent of gross foreign reserves | 0.0 | 0.1 | 0.3 | 1.7 | 5.9 | 7.2 | 2.7 |
| Fund credit outstanding | | | | | | | |
| In millions of SDRs | 0.0 | 774.0 | 1,548.0 | 1,415.0 | 882.8 | 241.9 | 0.0 |
| In millions of U.S. dollars | 0.0 | 1,066.6 | 2,132.0 | 1,951.0 | 1,218.1 | 333.6 | 0.0 |
| In percent of exports of goods and NFS | 0.0 | 7.6 | 14.6 | 12.9 | 7.7 | 2.0 | 0.0 |
| In percent of GDP | 0.0 | 1.5 | 2.8 | 2.5 | 1.4 | 0.4 | 0.0 |
| In percent of quota | 0.0 | 100.0 | 200.0 | 182.8 | 114.1 | 31.3 | 0.0 |
| In percent of overall debt service | 0.0 | 12.1 | 28.8 | 24.4 | 14.2 | 3.7 | 0.0 |
| In percent of gross foreign reserves | 0.0 | 9.0 | 16.1 | 14.6 | 9.4 | 2.7 | 0.0 |
| (In millions of U.S. dollars unless otherwise indicated) | | | | | | | |
| Memorandum items: | | | | | | | |
| Exports of goods and NFS | 14,152 | 13,986 | 14,615 | 15,129 | 15,836 | 16,468 | 17,293 |
| Quota (millions of SDRs) | 774 | 774 | 774 | 774 | 774 | 774 | 774 |
| GDP | 70,588 | 72,907 | 75,601 | 79,532 | 84,234 | 89,301 | 94,671 |
| U.S. dollar per SDR (WEO projection) | 1.360 | 1.378 | 1.377 | 1.379 | 1.380 | 1.379 | 1.379 |
| Public sector external debt | 22,758 | 24,482 | 26,034 | 26,071 | 25,525 | 24,876 | 24,815 |
| Overall external debt service | 9,493 | 8,848 | 7,407 | 7,987 | 8,579 | 8,958 | 8,826 |
| Overall external debt | 36,964 | 37,780 | 39,362 | 39,375 | 38,991 | 38,615 | 38,867 |
| Gross foreign reserves | 10,844 | 11,853 | 13,214 | 13,388 | 13,021 | 12,514 | 12,570 |

Source: Fund staff estimates.

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

Table 10. Colombia: Schedule of Purchases Under the SBA, 2002-2004

| Date | Amount | | Conditions |
|-------------------|-----------------------|-----------------------|--|
| | (In millions of SDR) | (In percent of quota) | |
| | 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. |
| 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.

COLOMBIA: FUND RELATIONS

(As of April 30, 2003)

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 | 112.36 | 98.33 |

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 |

VI. Projected Obligations to Fund: None

VII. Safeguards Assessments:

Under the safeguards policy, Colombia is 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. 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 also intends to adopt as a more permanent feature the requirement for an annual external audit conducted by an external audit firm, with international experience and exposure.

VIII. Exchange Rate Arrangement:

In September 1999 the Banco de la Republica eliminated the exchange rate band, and floated the peso. Multiple currency practices still exist arising from taxes on profit remittances from direct investment in Colombia and on foreign exchange earnings from personal services and transfers, and export tax credit certificates (CERTs). In April 2000, the BR reduced to zero the deposit requirement on external loans. On April 23 2003, the exchange rate was Col\$ 2,916.03 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 |
|--------------|---|-------------------------|
| STA | Advice on national accounts statistics | March 2001 |
| FAD | Follow-up on customs administration | May 2001 |
| STA | Regional visit on data template | September 2001 |
| FAD | ROSC Assessment | March 2002 |
| MAE/LEG | Assessment of exchange restrictions | July 2002 |
| MAE | Assesment of the banking system | September 2002 |
| STA | Follow-up on government finance statistics | November 2002 |
| FAD | Technical assistance on public expenditure management | March 2003 |

XII. Resident Representative: None.

XIII. Fourth Amendment: Colombia has not yet accepted the Amendment to the Articles of Agreement; a legal review (by the constitutional court) remains.

COLOMBIA: WORLD BANK RELATIONS

Partnership in Colombia's Development Strategy

The government's strategy contains a broad social, political and economic agenda. At the core of this program is the administration's National Development Plan 2003–06 for economic and social reform, particularly in the areas of pensions, labor, tax and the modernization of the public administration. The National Development Plan, recently approved by Congress, 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.

World Bank Group Strategy

The WBG's strategy seeks to support Colombia's quest for development in three essential areas: (a) achieving fast and sustainable growth; (b) sharing the fruits of growth; and, (c) building efficient, accountable, and transparent governance. The WBG's lending program focuses on operations that would: (a) have the most tangible impact on poverty alleviation and help Colombia meet the Millennium Development Goals; (b) restore macro-stability and sustainable growth while protecting the poor; (c) incorporate the lessons learned from previous Bank operations, and (d) pilot innovative interventions with important demonstration effects.

The CAS, considered by the Bank's Executive Board on January 16, 2003, envisages a maximum lending program for IBRD of about US\$3.3 billion for the remainder of FY03 to FY06. About half of the lending program would consist of fast-disbursing operations to support the government's comprehensive reform program. IFC's increased activity will accompany IBRD's enhanced assistance, supporting private sector firms—large and small—and catalyzing a private-sector supply response. IFC's primary choice of instruments will be structuring and investments (loans, equity and credit enhancement) for individual transactions, supplemented by noninvestment activities in private institution strengthening and the investment climate.

Achieving Fast and Sustainable Growth

With regard to the macroeconomic framework, the main objective of the IBRD's strategy is to support Colombia's continued fiscal adjustment, including the quality of the adjustment. To support this, the IBRD, in close collaboration with the IMF, is preparing a series of loans to support fiscal adjustment, including reforming the tax system, strengthening the tax administration, implementing a fiscal responsibility law and reforming the public sector. An assessment on public debt management will be carried out to identify institutional needs, assist the government to design a program to address those needs, and develop a comprehensive public debt strategy. The IBRD is also processing a program of financial sector adjustment operations to address the remaining agenda for reform in the financial sector to help promote the development of a well-functioning financial system that can provide adequate services to all segments of the productive sector and the population at large.

The WBG is also supporting a broad program of initiatives in the infrastructure sector and private sector development. Specific IBRD lending operations covering water supply, wastewater and sanitation management, national urban transportation and urban upgrading

strategy are envisaged for FY03–06. The WBG’s overall strategy for private sector development is to foster an improved business environment, removing the impediments currently constraining the achievement of the full potential of the private sector. World Bank’s assistance to the government in the area of rural development builds upon a rich history of successful projects (e.g., Magdalena Medio Regional Development, Rural Education, Earthquake Recovery, Peasant Enterprise Zones projects) targeted towards strengthening local leadership and nongovernmental organizations in rural areas.

The WBG will help promote mainstreaming of the environment and natural resources management. Emerging international carbon markets offer opportunities to capture value-added from environmental assets, such as production of certified emission reductions from new renewable energy investments as well as carbon sequestration and storage via land use, land use change and forestry activities.

Sharing the Fruits of Growth

The IBRD is providing support for the Government’s strategy to face the challenges of enhancing equity in coverage, quality and efficiency in the education sector, within an environment characterized by the need to reinforce the process of decentralization and efforts to reduce internal conflict and violence. In the health sector, further reforms are necessary to create a financially sustainable system that provides incentives for greater efficiency. Bank support for the reform effort is initially focusing on policy dialogue and actions being promoted under ongoing and proposed adjustment operations. To help Colombia protect its most vulnerable and meet the target of reducing the proportion of people living in extreme poverty, the WBG is providing support to promote a major revamping of the country’s social protection system. The WBG’s strategy also contains a series of activities in relation to the indigenous and Afro-Colombian populations and the internally displaced population.

Building Efficient, Accountable and Transparent Governance

The WBG will help the Colombian government to broaden the scope of Colombia’s anticorruption program. Furthermore, the Bank will continue its support in areas that are critical for improving transparency and accountability in the public sector, such as procurement, budgeting and financial management, tax administration, and improved information systems. The WBG will also continue to support the judicial authorities’ efforts to improve Court services delivery. The objective of the project is to improve the timeliness, quality and productivity of the Judiciary’s conflict resolution system.

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, including reforming the tax system, strengthening tax administration, implementing a fiscal responsibility law, and reforming the public sector.* The main macroeconomic task of the new administration is to carry out fiscal adjustment and put public debt on a sustainable path. The WBG is supporting the country in the development of a comprehensive public debt strategy, to better manage the risks of the debt portfolio and reduce vulnerabilities. It is also providing assistance to enhance the transparency and

accountability of the public sector, by improving procurement arrangements, budgeting processes and financial management systems.

- *Reform of the pension and social security systems.* Reform of the pension system remains incomplete and poses a major contingent liability to the fiscal accounts. The consolidated pension system for public sector workers is technically insolvent, and the annual fiscal transfers required to cover its cash deficit is equivalent to the total health budget. This is a worrisome position for a country that is still demographically young and whose pension system only covers one third of the labor force. Contribution rates are already too high and discourage participation in the formal labor market. Until a transfer of all workers from the public pension system to the private sector can be achieved, further reforms should focus on a reduction of the benefits package and reform of the currently exempted regimes. The WBG is helping Colombia, in close coordination with the IMF, to address the remaining agenda for reform of the pension and social security systems.
- *Foster financial sector and capital market developments.* Reforms are needed to address critical governance and regulatory issues related to entities participating in the capital and debt markets, consolidation of state controlled second-tier banking entities, and regulation for bank resolution, bad-asset disposition and the insurance sector. Therefore, building on the financial sector reforms put in place during 1999-2001, a second round of financial sector reforms are being implemented with IBRD support. The WBG is working in close partnership with the IMF in supporting the development of Colombia's financial sector and capital markets.
- *Broaden and deepen the scope of Colombia's anticorruption program.* Corruption is widely considered to be one of the most serious development challenges. Surveys have indicated that although corrupt practices in transactions such as tax payments or the processing of permits are relatively infrequent relative to regional standards, a more systemic but less visible form of state capture permeates many areas of government involvement. Although previous Colombian administrations have clearly identified corruption as a main issue, the problem has not been faced in practice. The WBG is taking the leadership in supporting Colombia's anticorruption program, in close coordination with the IMF and other development institutions.
- *Combat money laundering.* The World Bank has been supporting the strengthening of the legal and regulatory framework applicable to financial institutions, including the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime. The Ministry of Finance and Banking Superintendency (SB) have strengthened the AML/CFT system over the last two years, including the establishment of a monitoring unit to detect money laundering and white collar crime. A Programmatic Financial Sector Adjustment Loan has been prepared using the updated assessment of the country's financial sector vulnerabilities, including those in the AML/CFT regime provided by the FSAP program (in which Colombia participated in 1999) conducted jointly with the IMF. Under the Programmatic Financial Sector Adjustment Loan, the IBRD is supporting a financial sector reform that through the SB's issuance of new procedural regulations strengthens the special anti-money laundering information intelligence unit.

**COLOMBIA: RELATIONS WITH THE
INTER-AMERICAN DEVELOPMENT BANK**

(As of January 31, 2003)

I. BACKGROUND AND OBJECTIVES

In August 1999, the IADB Board of Directors approved the Bank's strategy for Colombia for the period 1999–2002. The Bank and Colombian government agreed on the following priority areas: (i) support the peace process by facilitating the national dialogue; (ii) help to reduce poverty and inequality by increasing investment in human capital and easing access to basic social services and productive resources; (iii) deepen the decentralization process by strengthening subnational entities; (iv) modernize the public sector by reforming public institutions and improving public finances; and (v) promote sustainable growth.

Currently, a new strategy for the period 2003–06 is under preparation. It will be submitted to the Board of Directors by April 2003. The Bank has identified three priorities for Bank's assistance to Colombia in the next four years: (i) laying the bases for resumption of dynamic growth, (ii) promoting social development and implementing measures to mitigate poverty and protect vulnerable groups; and (iii) supporting state reform and improving governance.

II. LENDING

As of January 31, 2003, the IADB is executing 29 loans for an amount equivalent to US\$1.1 billion. These loans include projects to support the modernization reform and decentralization process, private sector, technical assistance and investments projects in the agricultural sector, transportation, water supply and sewerage, management of natural resource, and social development.

According with the last Programming Mission Report on December 2002, the Bank would approve in 2003 nine operations by US\$2.0 billion. These operations include a social emergency program (US\$1.2 billion), and a sector program to fiscal sustainability (US\$400 million). The other operations will support the government strategy in areas such as social household, public hospitals, water and sanitation, privatization and integration and trade.

**COLOMBIA: FINANCIAL RELATIONS WITH THE
INTER-AMERICAN DEVELOPMENT BANK**

(As of January 31, 2003)

I. IDB OPERATIONS

(In millions of U.S. dollars)

| | Commitments | Disbursements | Undisbursed amounts |
|--|----------------|---------------|------------------------|
| Agricultural and rural development | 95.5 | 47.8 | 47.7 |
| Public sector management | 96.8 | 43.5 | 53.3 |
| Social Investment | 444.6 | 130.7 | 313.8 |
| Water supply and sewerage and infrastructure | 288.1 | 213.7 | 74.4 |
| Natural resource management | 100.8 | 86.1 | 14.7 |
| Multi sector | 100.0 | 97.0 | 3.0 |
| Grand total | 1,125.7 | 618.8 | 507.0 |

II. IDB LOAN TRANSACTIONS

(In millions of U.S. dollars)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003(*) |
|---|---------------|---------------|-------------|--------------|---------------|--------------|---------------|--------------|
| Gross disbursement | 262.7 | 271.6 | 412.9 | 952.4 | 241.2 | 785.3 | 151.8 | 1,530.2 |
| Amortization, interest and contributions | 467.2 | 579.2 | 369.1 | 445.8 | 473.2 | 408.2 | 819.4 | 1013.9 |
| Net cash flow | -204.5 | -307.6 | 43.8 | 506.6 | -232.0 | 377.1 | -667.6 | 516.3 |

(*) projections

Source: IADB.

Bogotá Colombia
May 23, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

The government remains fully committed to its economic program for 2003–04, which is being supported by the Stand-By Arrangement (SBA) approved by the Fund in January 2003. In the attached Memorandum of Economic Policies (MEP) and Technical Memorandum of Understanding (TMU), we explain the policies we are implementing to ensure that we achieve the program's objectives for 2003. On this basis, we are requesting completion of the first review under the SBA. The second review under the SBA is expected to be completed by November 2003. In the context of this review, we will assess the need for any additional measures to ensure that the fiscal target for 2003 is attained. We will also present our program for 2004, and agree on the schedule and frequency of reviews for 2004. The government will continue to maintain a close policy dialogue with the Fund, and if the need arises, the government stands ready to take additional measures.

Sincerely yours,

/s/

Roberto Junguito
Minister of Finance
and Public Credit

/s/

Miguel Urrutia
General Manager
Bank of the Republic

Attachments

COLOMBIA—MEMORANDUM OF ECONOMIC POLICIES

I. BACKGROUND

1. During the second half of 2002, the government developed an economic program for 2003–04 that is designed to promote more rapid economic growth by strengthening domestic security, improving the fiscal position so as to ease the public debt burden, and advancing structural reforms. The government remains committed to reducing the overall public sector deficit from 3.6 percent of GDP in 2002 to 2.5 percent of GDP in 2003 and 2.1 percent of GDP in 2004. This fiscal stance will halt the rapid increase in public debt, which reached about 52 percent of GDP at end-2002,¹ and set the stage for its reduction in subsequent years. At the same time, the fiscal framework makes room for real increases in social spending of 8 percent in 2003 and 3 percent in 2004. In addition, the Banco de la República intends to reduce inflation, while maintaining net international reserves at comfortable levels.

2. Structural reforms aim to make the fiscal position sustainable and to strengthen further the financial system. Congress already approved in December 2002 several bold reforms under the program that strengthen tax revenues, reduce the actuarial deficit of the pension system, and diminish transaction costs in the financial system. It has also given the executive special powers to streamline the public sector. Congress also approved a labor market reform that makes it easier for Colombians to gain employment in the formal sector. In May 2003, a comprehensive reform of the teachers' pension system was approved by congress in the context of the National Development Plan. Several other fiscal measures have been included in a nationwide referendum, namely a two-year freeze on many components of public expenditure and the elimination of all nonmilitary special pension regimes (*regímenes exceptuados y especiales*) that fall outside of the general pension regime. The government is confident that the referendum enjoys popular support and will be approved, most likely later in 2003. A legal review of the referendum by the Constitutional Court is still pending.

3. This program rapidly gained the support from the international community. In mid-January 2003, the International Monetary Fund approved a two-year Stand-By Arrangement that makes available about US\$2.1 billion of resources. The World Bank and the Inter-American Development Bank (IDB) are also backing the government's policies, and we expect these institutions to disburse over US\$2.5 billion in 2003.

II. RECENT DEVELOPMENTS

4. Under the program, economic performance has been favorable, although inflation is a concern:

¹ At end-2002, public debt amounted to 55 percent of GDP according to the IMF definition, which includes the financial public sector.

- For 2002, the overall public sector deficit was limited to 3.6 percent of GDP, lower than the deficit of 4.0 percent of GDP that had been expected. However, inflation reached 7 percent during 2002, slightly above the Banco de la República's target of 6 percent.
- All performance criteria and the structural benchmarks for end-December 2002 and end-March 2003 were observed (Tables 1 and 2).
- Construction, manufacturing, energy consumption, loans disbursed by the financial sector and other indicators point to a recovery in economic growth.
- The overall public sector deficit remains under control, as the central government's tax revenues are performing well, while its expenditures are rising as anticipated.
- The government returned to international capital markets by issuing US\$1.25 billion in bonds between December 2002 and April 2003, completing the public sector's external financing program for 2003. Colombia's EMBI+ yield spread fell from about 700 basis points in mid-February to about 425 basis points in mid-May.
- The Banco de la República has remained focused on reducing inflationary pressures. In mid-January and late April its key intervention interest rate was increased by a total of 200 basis points. However, inflation through April stayed high at 7.85 percent year-on-year, reflecting in part the lagged effect of the sizable currency depreciation in 2002, the behavior of food prices, the impact of VAT reform, and other "supply" shocks. The inflation rate through April falls within the program's consultation band of plus or minus 2 percentage points. The Banco de la República has informed Fund staff on the reasons behind the inflation performance and its policy response.
- The foreign exchange intervention that began in mid-February has been held within the program. Even though the Banco de la República has held auctions of one-month call options for US\$200 million each at the end of February, March, and April, only US\$145 million have been exercised through mid-May in a clear sign that stability in the foreign exchange market has been restored.

III. PROGRAM FOR 2003

5. The government remains fully committed to its economic program. Real GDP is projected to grow by 2 percent in 2003, while inflation is expected to decline. The external current account deficit is estimated to increase to 2.3 percent of GDP (instead of narrowing to 0.8 percent of GDP as originally envisioned), partly because of lower exports to Venezuela and higher imports of capital goods. Nevertheless, net capital inflows, especially to the public sector, are expected to be sufficient to allow the Banco de la República to meet its objective for net international reserves at end-2003. The performance criteria for net international reserves for June and September 2003 are presented in the attached technical memorandum of understanding (TMU) and are in line with the original program.

6. The overall public sector deficit will decline to 2½ percent of GDP in 2003, as planned. The performance criteria on the overall public sector deficit for June and September 2003 are presented in the attached TMU and are the same as the indicative targets presented in the December 2002 memorandum of economic policies. While fiscal policy faces some risks, the government is committed to achieving the fiscal target for 2003. For this reason it is studying the feasibility of several contingency measures that would safeguard fiscal policy were these risks to materialize. These measures include a rationalization of subsidies on gasoline, diesel, and electricity, a careful management of expenditure commitments in 2003, spending cuts, and bringing forward increases in current revenues scheduled for 2005. The spending cuts would be partly achieved through a decree that would freeze most central government wages. The government may also consider the possibility of issuing long-term bonds on concessional terms.

7. The composition of financing of the overall public sector deficit in 2003 will be prudent and consistent with a recovery of private credit demand. Net public external financing is now expected to amount to over 2 percent of GDP in 2003, compared with 0.3 percent of GDP originally envisaged in the program. The performance criteria on external borrowing for June and September are presented in the attached TMU and reflect this additional financing. As a result, net public domestic borrowing is projected to decline from 3 percent of GDP in 2002 to 0.5 percent of GDP in 2003. If market opportunities arise, the government may seek additional commercial external financing in anticipation of 2004 financing requirements or for liability management purposes.

8. Monetary policy will continue to be conducted within a framework of inflation targeting and a floating exchange rate. As envisaged in the December 2002 memorandum of economic policies, the target path for inflation is being revised upward by 0.4 percentage points to account for the first round effect of the VAT reform approved in December 2002. The Banco de la República remains committed to making the necessary policy adjustments to keep inflation within the targeted range.

9. The government is carrying out the structural reforms explained in the December 2002 memorandum of economic policies (see Table 2):

- **Pension reform.** While the December 2002 pension reform represented a crucial step forward, the government intends to reduce the actuarial deficit of the pension system even further. As envisaged in the program, the referendum includes a proposal that requires all pension regimes to conform to the rules of the general pension system by 2008, which will effectively eliminate all nonmilitary special pension regimes (*regímenes exceptuados y especiales*). Moreover, the reform to teachers' pensions approved in May 2003 brings all new teachers under the general pension regime (which includes raising the retirement age for new teachers) and increases pension contributions of all teachers. This reform reduces the actuarial deficit of the teachers' pension system by one-fourth. The government also plans to take other steps on pension reform that are described in the attached table on structural benchmarks.

- **Public sector modernization.** Drawing on the recommendations of the Fiscal Transparency Report on Standard and Codes (ROSC) the government has developed several draft laws, in many cases with technical advice from the Fund, the World Bank, and others, designed to make expenditure management more flexible and to enhance the efficiency and transparency of the public sector. The process of securing congressional approval of these laws is proceeding as we had envisaged in the program. However, the government plans to submit the draft budget code to congress by October, instead of by June as originally planned, in order to incorporate the recommendations of IMF technical assistance. This measure is a structural performance criterion. The government will continue to trim its expenditure by reducing its workforce gradually through an attrition process that includes explicit mechanisms to protect the most vulnerable groups.

 - **Financial sector.** The financial position of the banking system has continued to improve, as banks' profitability, capital, and provisioning strengthened in 2002. The establishment of loan-loss provisions according to Basel 2 will be phased in during 2003 and 2004, somewhat later than originally expected, because of the complexity of this new approach. The government adopted provisions for the legal defense of supervisors in January 2003 and will present legislation to allow full budgetary autonomy of the superintendency of banks by end-2003. The banking superintendency will continue to enforce the restructuring plans for weak banks.

 - **Public health system.** As envisaged in the program, CONPES (the national social and economic policy council) approved in March 2003 a plan to put the finances of the health service of ISS (the Social Security Institute) on a sustainable footing. The government will begin to carry out this plan before end-June 2003, with a view to fully implementing it by September 2004 as envisaged in the program. The government is developing a new proposal to make the public hospital network financially viable by 2007, with support of a loan that is being discussed with the IDB. The fiscal implications of restructuring the ISS health service and the public hospitals will be considered during subsequent reviews of the Fund-supported program.
10. The government is preparing a timetable to remove remaining exchange restrictions in connection with its acceptance of the obligations under Article VIII under the Fund's Articles of Agreement. To that end, the Banco de la República recently reached agreement with China to eliminate the bilateral payments agreement between these two countries on June 30, 2003. Specific dates for beginning to phase out the remaining restrictions will be established during subsequent program reviews.
11. The safeguards assessment was very favorable, calling for few recommended adjustments to the accounting practices of the Banco de la República. The Banco de la República already has a strong financial control environment and complies with most of the International Accounting Standards (IAS). However with a view to enhancing international transparency, it 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 also intends to

adopt as a more permanent feature the requirement for an annual external audit conducted by an external audit firm, with international experience and exposure.

Table 1. Colombia: Performance Criteria 1/

| | Performance Criteria Dec. 31, 2002 | 2003 | | | Indic. Target Dec. 31 |
|--|--|----------------------|---------|----------|--------------------------|
| | | Performance Criteria | | | |
| | | Mar. 31 | Jun. 30 | Sept. 30 | |
| Cumulative flows from beginning of calendar year (In billions of Colombian pesos) | | | | | |
| Overall balance of the combined public sector | | | | | |
| Floor | -8,350 | -1,590 | -3,240 | -3,315 | -5,490 |
| Outturn | -7,371 | -1,121 | ... | ... | ... |
| Margin (+) or shortfall (-) | 979 | 469 | ... | ... | ... |
| Inflation rate 2/ (12-month inflation rate) | | | | | |
| Inflation - Consultation band | | | | | |
| Upper limit | 8.0 | 8.1 | 8.3 | 8.1 | 7.9 |
| Target | 6.0 | 6.1 | 6.3 | 6.1 | 5.9 |
| Lower limit | 4.0 | 4.1 | 4.3 | 4.1 | 3.9 |
| Outturn | 7.0 | 7.6 | ... | ... | ... |
| (In millions of U.S. dollars) | | | | | |
| Net international reserves of the Banco de la Republica | | | | | |
| Floor | 10,300 | 10,215 3/ | 10,420 | 10,480 | 10,540 |
| Outturn | 10,507 | 10,316 | ... | ... | ... |
| Margin (+) or shortfall (-) | 207 | 100 | ... | ... | ... |
| 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 | 1,100 | 650 | 1,250 | 1,850 | 1,850 |
| Outturn | 274 | 296 | ... | ... | ... |
| Margin (+) or shortfall (-) | 826 | 354 | ... | ... | ... |
| Change in the outstanding stock of short-term external debt of the public sector | | | | | |
| Ceiling | 375 | 300 | 200 | 200 | 100 |
| Outturn | 195 | 3 | ... | ... | ... |
| Margin (+) or shortfall (-) | 180 | 297 | ... | ... | ... |

Sources: Ministry of Finance; Banco de la República; 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 staff report for Colombia's request for a Stand-By Arrangement (EBS/02/210).

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

3/ The target for March has been adjusted by US\$144.6 millions to account for the effect of foreign exchange intervention.

Table 2. Colombia: Structural Performance Criteria and Benchmarks Under the SBA¹

| Structural Performance Criterion | | |
|---|---|---|
| <i>September 30, 2003</i> | <i>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.</i> | Originally was structural benchmark for end-June 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 15, 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 31, 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 December 3, 2002 Congress approved law in May 2003. |
| <i>July 31, 2003</i> | <i>Implement reform of special pension regime for the military that will make the regime more equitable.</i> | Originally envisaged for end-June 2003. |
| December 31, 2003 | Congressional approval of the changes to the Budget Code. 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. Congressional approval of the modifications of Law 80 to improve management of government contracts. | |

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

| Structural Performance Criterion | | |
|---|---|--|
| | Divestiture of Bancafé. | |
| March 31, 2004 | Completion of a CONPES document to strengthen the government's legal defense service to take effect by 2005. The document will identify available data, establish case typologies, design and implement a national policy, and centralize the legal defense of the state. | |
| 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. Restructure and bring Granahorrar to the point of sale. | |

COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

1. This memorandum sets out specific performance criteria for June 30, 2003 and September 30, 2003, and the structural performance criteria and structural benchmarks for the remaining period of the program. This TMU supplements the TMU of December 2, 2002, 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 Sector¹

| | Ceiling (In billions of Colombian pesos) |
|--|---|
| Overall deficit of the combined public sector from January 1, 2002 to December 31, 2002 (performance criterion) | 8,350 |
| Overall deficit of the combined public sector from January 1, 2003 to: | |
| March 31, 2003 (performance criterion) | 1,590 |
| June 30, 2003 (performance criterion) | 3,240 |
| September 30, 2003 (performance criterion) | 3,315 |
| December 31, 2003 (indicative target) ¹ | 5,490 |

¹ Performance criteria to be specified at the time of the program review scheduled for November 2003.

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 beyond what is currently envisaged under the program, up to a maximum of 0.5 percent of GDP or US\$360 million for 2003 as a whole, in support 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 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.

Baseline Assumption for Oil Stabilization Fund Revenue (FAEP)

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

II. MONETARY TARGETS

3. Reflecting the BR’s inflation targeting framework for monetary policy, quarterly targets for 2002 and 2003 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 Estadísticas* (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.

4. **Adjustment.** The inflation targets for June, September, and December 2003 have been adjusted upward by the direct effect of the VAT reform estimated at 0.4 percentage point.

Performance Criterion on Inflation¹

| | Inflation (12-Month Percentage Change) |
|--|---|
| September 30, 2002 (actual) | 5.9 |
| December 31, 2002 (performance criterion) | 6.0 |
| March 31, 2003 (performance criterion) | 6.1 |
| June 30, 2003 (performance criterion) | 6.3 |
| September 30, 2003 (performance criterion) | 6.1 |
| December 31, 2003 (indicative target) ² | 5.9 |

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

² Performance criteria to be specified at the time of the program review scheduled for November 2003.

III. EXTERNAL TARGETS

A. Performance Criterion on NIR of the BR

| | Target ¹ (In millions of U.S. dollars) |
|--|--|
| Outstanding stock as of: | |
| September 30, 2002 (actual) | 10,352 |
| December 31, 2002 (performance criterion) | 10,300 |
| March 31, 2003 (performance criterion) | 10,360 |
| June 30, 2003 (performance criterion) | 10,420 |
| September 30, 2003 (performance criterion) | 10,480 |
| December 31, 2003 (indicative target) ² | 10,540 |

¹ Minimum quarterly levels of NIR of the BR based on a projected annual accumulation for 2002 of US\$318 million.

² Performance criteria to be specified at the time of the program review scheduled for November 2003.

5. **Adjustment.** The quarterly NIR targets may be adjusted downward by up to US\$2.0 billion to help secure orderly foreign currency market conditions consistent with transparent rules used by the central bank for foreign exchange intervention. 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.

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

| | Ceiling (In millions of U.S. dollars) |
|---|--|
| Cumulative net disbursement of external debt by the public sector from January 1, 2002 to December 31, 2002 (performance criterion) | 1,100 |
| Cumulative net disbursement of external debt by the public sector from January 1, 2003 to: | |
| March 31, 2003 (performance criterion) | 650 |
| June 30, 2003 (performance criterion) | 1,250 |
| September 30, 2003 (performance criterion) | 1,850 |
| December 31, 2003 (indicative target) ¹ | 1,850 |

¹ Performance criteria to be specified at the time of the program review scheduled for November 2003.

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

| | Ceiling (In millions of U.S. dollars) |
|--|--|
| Cumulative net disbursement of short-term external debt of the public sector from January 1, 2002 to December 31, 2002 (performance criterion) | 375 |
| Cumulative net disbursement of short-term external debt of the public sector from January 1, 2003 to: | |
| March 31, 2003 (performance criterion) | 300 |
| June 30, 2003 (performance criterion) | 200 |
| September 30, 2003 (performance criterion) | 200 |
| December 31, 2003 (indicative) ¹ | 100 |

¹ Performance criteria to be specified at the time of the program review scheduled for June 2003.

IV. STRUCTURAL PERFORMANCE CRITERIA

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



Press Release No. 03/83
FOR IMMEDIATE RELEASE
June 11, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review of Colombia's Stand-By Arrangement, Approves US\$274 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Colombia's performance under a two-year, SDR 1.5 billion (about US\$2.1 billion) Stand-By Arrangement, which was approved on January 15, 2003 (see [Press Release No. 03/04](#)). The completion of this review enables the release of SDR 193.5 million (about US\$274 million) to Colombia, bringing the total amount available to SDR 580.5 million (about US\$822 million). So far the country has not made any drawings under the arrangement.

Following the Executive Board review of Colombia, Anne Krueger, First Deputy Managing Director and Acting Chair, said:

“The government of Colombia is carrying out a strong economic reform program aimed at encouraging faster economic growth and improving social equity. In particular, the government's program focuses on bringing the overall public sector deficit down through a wide range of initiatives, including several important structural measures such as tax, pension, and labor reforms. A lower fiscal deficit is essential to reduce gradually the public debt burden, which in turn will ease pressures on interest rates and stimulate growth.

“The government is to be commended for its strong commitment to economic reform. All performance criteria and structural benchmarks for end-2002 and end-March 2003 have been observed. This strong policy implementation has already helped to improve economic performance. The economy showed signs of recovery in the first quarter of 2003, with a slight decline in unemployment and renewed access to international capital markets.

“For 2003, the government is committed to reducing the overall public sector deficit to 2 ½ percent of GDP, and is prepared to implement contingency measures if necessary, to achieve this target. At the same time, the government intends to continue with key structural reforms, including further steps to strengthen expenditure management and modernize public administration. The central bank already raised its main refinancing rate by 200 basis points so far this year and is committed to taking further measures as necessary to control inflationary pressures.

“Colombia’s economic reform program has helped reduce the risks to the economic outlook. Nonetheless, the authorities will need to sustain the implementation of the program in order to lay the basis for a durable recovery,” Ms. Krueger stated.

**Statement by Murilo Portugal, Executive Director for Colombia
and Roberto Steiner, Alternate Executive Director
June 11, 2003**

On behalf of our authorities we would like to thank staff for a well-balanced report that acknowledges that recent developments in Colombia have been mostly favorable, recognizes that concerns surrounding certain structural reforms have been dissipated, and warns about remaining risks. The two-year SBA program is fully on-track, as all quantitative performance criteria and structural benchmarks have been met in a timely manner.

Economic Growth

The Colombian economy has been performing relatively well since the last quarter of 2002. While GDP grew only 1.5 percent in 2002, it increased 2 percent (yoy) during the fourth quarter, and preliminary estimates suggest that it grew by close to 3.8 percent (yoy) in the first quarter of 2003. Even though it is still too early to believe that Colombia is moving to a higher growth plateau, the 2 percent growth envisioned under the program for 2003 seems very plausible. Several indicators support this claim, including the fact that in March capacity utilization reached 73.8 percent, up from 69.6 percent a year ago, while in April energy consumption was up 3.7 percent (yoy). In addition, financial sector credit to the private sector is picking up and the real exchange rate has reached a historical peak of depreciation.

In 2002, growth was constrained by the evolution of net exports. While private consumption increased 2.2 percent, and total fixed capital formation was up 5.2 percent, exports contracted and imports remained flat. Preliminary data for 2003 indicate that domestic demand continues to perform in an acceptable manner, while net exports are still declining. Since exports are no longer contracting, the dominant factor in the evolution of net exports is a surge in imports, a reflection of expanded domestic activity and of a one-year custom tariff exemption for capital goods. During the first two months of 2003 imports were up 21.3 percent (yoy), with capital goods increasing 55 percent and intermediate goods 10.9 percent. For the first quarter exports were up 6.5 percent (yoy), with traditional exports (coffee and oil) increasing 12.8 percent (yoy) and non-traditional exports improving 1.4 percent (yoy).

The pick-up in economic activity has brought about some improvement in labor market indicators. In April, unemployment reached 17.9 percent in 13 metropolitan areas, down from 18.3 percent one year ago. Our authorities are confident that the consolidation of the recovery and the recently enacted labor reform should produce a further decline in unemployment during the year. However, bringing unemployment back to single digit levels will require much higher and sustained rates of economic growth.

The External Environment

Recently, Colombia successfully accessed international capital markets. This has been the result of implementing a credible economic framework, in the context of a liquid financial market. Two operations in December, 2002 and January, 2003 have covered the public sector's external financial needs for 2003, and a liability management operation was recently completed. If markets remain supportive, operations to partially pre-finance 2004 and to further improve the debt profile might be undertaken in the coming months. Looking into 2004, the Ministry of Finance is considering the possibility of including CAC's in new bond issues, given the favorable outcome of recent issuances by other emerging markets.

While capital markets have been supportive, global economic activity has not. The effects of the slowdown in mature markets have been compounded by the contraction in Venezuela, Colombia's second largest trading partner. Notwithstanding a significant weakening of the peso, total exports are expected to decline 1.4 percent in 2003. Exports to Venezuela are contracting 66 percent (yoy as of March), this on top of a dismal performance in 2002. We believe the program incorporates a realistic assessment of the effects from the contraction in Venezuela, since the 2 percent GDP growth projection assumes that exports to that country will contract 40 percent. As a result of the recovery in domestic demand and in imports, the current account deficit should widen to 2.3 percent of GDP in 2003. Given the adequate level of foreign financing, this higher deficit should not exert undue pressure on the exchange rate.

Fiscal Policy

The fiscal stance has continued to improve. Expenditure has been kept under control while revenue has been enhanced, thanks to the tax package introduced in 2002 and due to the relatively good recent economic performance. The government is committed to achieving a 2.5 percent of GDP fiscal deficit in 2003, and is prepared to undertake the necessary measures to compensate for events that might compromise that target, including a delay in approving the referendum (see below). To further consolidate macroeconomic stability and reduce the debt burden, the authorities will strive to achieve a 2.1 percent of GDP deficit in 2004. Fiscal consolidation will not be undertaken at the expense of social expenditure. Based to a great extent on financial support from the World Bank and the IDB, social spending is expected to increase 8 percent in real terms in 2003, and an additional 3 percent in 2004.

The public debt burden is expected to decline consistently starting in 2003, reaching 42 percent of GDP in 2010 (in the case of the debt definition that includes the financial public sector). Even though this ratio is admittedly high, two issues are worth mentioning. First, the medium-term scenario is based on cautious assumptions regarding key variables, including GDP growth and the real exchange rate path. Second, though the level of debt might still be high, it is still the case that a welcome change in trend is being achieved, as the debt burden continuously increased between 1995 and 2002. The domestic debt market has also improved in recent months. In the secondary market (ex post) real interest rates on

10-year bonds issued in pesos declined from 11.4 percent in October to 7.6 percent at the end of May. These results are particularly relevant given the fact that around half of public debt has been issued locally, mostly in pesos.

Monetary and Exchange Rate Policy

In 2002, and for the first time in five years, inflation, at 7 percent, surpassed the target (6 percent). For 2003 the central bank established a target range of 5 – 6 percent, which allows for the accommodation of the first round effects of the hike in the VAT rate, estimated at 0.4 percent. For program purposes the point target is now 5.9 percent. During this year, inflation has remained above target, as a result of supply shocks to key foodstuffs and the pass-through to prices of the weakening of the exchange rate during the second half of 2002. In May, annual headline CPI inflation was 7.7 percent, while inflation without foodstuffs reached 6.9 percent.

The central bank has taken prompt action in order to meet its inflation target, and has duly informed staff, as established in the SBA. Intervention rates were hiked 100 basis points in January and in April, and are now positive in real terms when corrected by non-food inflation. In addition, one-month call options undertaken in February, March, and April have restored stability in the foreign exchange market. In fact, the peso recently appreciated somewhat. The central bank remains fully committed to its inflation target, and in the context of a flexible exchange rate regime stands ready to introduce policy changes if warranted.

Financial Sector

Colombia's financial sector has strengthened in the last three years, following a critical period in the late 1990's. The recent improvement is occurring in the context of an increase in credit to the private sector. Following a period in which a large portion of bank assets was held in the form of investments, particularly government securities, loans are now increasing in real terms (almost 2 percent yoy in April, compared to an 8 percent decline a year ago). With loans increasing and their quality improving, banks are making important profits. Non-performing loans have diminished substantially, and now stand at 8.4 percent for the entire financial system, 4.2 percent for non-mortgage banks. Provisions for non-performing loans increased from 76.7 percent in April, 2002 to 86.3 percent in April, 2003. While the financial sector crisis has been surpassed, problems persist in a few mortgage banks, and the authorities remain vigilant so that those problems are contained and resolved.

In an attempt to improve financial supervision, the government has been undertaking several reforms. First, a legal defense fund for supervisors was recently approved by Congress. Other measures, including steps towards enhancing budgetary autonomy for the superintendency, are expected to be implemented later in the year. Second, loan classification and dynamic provisioning based on bank's internal models should be in place by 2004. Finally, the government is committed to divesting itself from two large banks.

Structural Reforms

Colombia has advanced in the reform process since a new administration was inaugurated last August. These efforts come on top of progress achieved during 1999-2002 in the context of the EFF. Congress approved a tax reform that expanded the VAT tax base and introduced a temporary surcharge on income taxes. Key parameters of the general pension regime were revised, including hikes in contribution rates and contribution time and a rationalization of benefits. This reform implies a significant reduction in the actuarial deficit of the public pension fund, which is still high. A labor reform was also approved, enhancing labor market flexibility.

Following a concerted effort with government and teachers, Congress recently approved an overhaul of the teacher's pension regime. The reform, which calls for an increase in contributions for all teachers and raises retirement age for new ones, reduces the actuarial deficit of the teachers' pension fund by around 25 percent. The elimination of all other special pension regimes is part of the referendum that is expected to be approved later in 2003. Other reforms underway include approval of a Fiscal Responsibility Law, changes to the procurement law, and the implementation of a plan making the Social Security Institute's health service system viable by 2007. The Institute's management has developed a reform plan that is currently being discussed with labor. Looking ahead, the reform agenda includes amendments to the budget code (now a structural PC), changes that would make the pension regime for the military more equitable, and additional aspects of the government's program to reform the State. In designing the changes to the budget code, our authorities will be aided by the excellent technical assistance report recently produced by staff from FAD and WHD.

The Referendum

In 2002, the government received congressional approval to undertake a referendum covering a broad range of political and economic issues. It is being reviewed by the Constitutional Court. When the SBA program was approved in January, our authorities believed that the referendum would be approved during the first quarter. Unfortunately, at this stage it is unlikely that the vote will take place before the fourth quarter. While there is ample popular support for the referendum, staff is correct in stating that there are risks involved regarding the precise date when the vote will occur.

The two key economic provisions in the referendum are a temporary expenditure freeze and an overhaul of all privileged pension regimes. It calls for all central government expenditure --except transfers to territorial entities (TE's), pensions and debt service -- to be kept at its 2002 nominal level during 2003 and 2004. Since most transfers received by TE's are used to pay wages, which will be frozen, transfers received and not spend will go to the TE pension fund. The referendum mandates that all privileged pension regimes must be terminated by 2008, at which time a cap on benefits will become operative. The referendum should provide fiscal savings of 0.7 percent of GDP in 2003 and 1.2 percent of GDP in 2004.

If the referendum is not voted in 2003, the government has in place a strategy that takes care of half of the problem and has identified measures to compensate for the rest. Wages above two times the minimum wage were frozen earlier in the year. If the referendum is not voted, that freeze would be maintained by decree, assuring fiscal savings of 0.3 percent of GDP. To compensate for the additional 0.4 percent of GDP, the government is studying options such as reducing subsidies (on gasoline and electricity), bringing forward increases in revenue scheduled for 2005 or, as a last resort, issuing long-term concessional bonds (in which case the program contemplates an adjustor to the deficit target of up to 0.5 percent of GDP).

Non-Economic Risk Factors

The enhancement of democratic security is a cornerstone of the new Colombian government. Our authorities strongly believe that increased security is not only a requirement in order to improve the daily lives of millions of Colombians; it is also a critical support of its economic program. Though estimates vary, there is ample evidence that guerrilla activity deters growth in a meaningful way, maybe by as much as 2 percentage points per year. Given its aim of enhancing security without compromising macroeconomic stability, upon coming to office the government introduced a tax on net worth, proceeds of which have been allocated to the security effort. The return on this tax has surpassed expectations, an indication that Colombians support the security strategy, and are willing to pay for it. Military expenditure increased 0.3 percent of GDP in 2002 and is expected to increase an additional 0.6 percent this year. At this stage, no additional increases are expected for 2004 and beyond.

While staff is correct in suggesting that political uncertainties remain high, our authorities do not believe there is evidence that the civil conflict has intensified in 2003. Recently, the military has been successful in its efforts against the guerrillas, and, as expected, there has been some terrorist backlash. The unfortunate consequences of these isolated actions do not deter from the fact that the vast majority of Colombians now feel much safer. As a result, people have, among other things, resumed traveling within their own country. As of March, hotel occupancy rates were up 10 percent (yoy), and traffic in national highways during the first four months of the year up 10.5 percent (yoy). Furthermore, investment by residents is evolving favorably, with gross capital formation increasing 5.2 percent in 2002. Our authorities strongly believe that the economic benefits stemming from enhanced security far outweigh any potential costs arising from isolated acts of terrorism.

Other Issues

Our authorities would like to thank staff for the recent Safeguard Assessment, which calls for a few adjustments to the central bank's accounting practices. To the extent that they do not conflict with established regulations, the central bank intends to fully adopt IAS and will make the annual external audit by an internationally reputed external audit firm a permanent feature. Likewise, the government remains committed to removing the few remaining restrictions in connection with its acceptance of the obligations under Article VIII of the Funds Articles of Agreement. To that end, Banco de la Republica has recently agreed to terminate the bilateral payments agreement with China.

The authorities continue to treat the SBA arrangement as precautionary and, as a result, no disbursements have been made. As is customary, the authorities consent to the publication of the staff report, including the MEP and the TMU. In finalizing, we would like to thank staff and Management for their continued support and advice on the program for Colombia.