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January 2003
IMF Country Report No. 03/19

Colombia: 2002 Article IV Consultation and Request for Stand-By Arrangement—Staff Report; Staff Supplement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Colombia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2002 Article IV consultation with Colombia and request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the combined 2002 Article IV consultation and request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **October 25, 2002**, 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 December 6, 2002**. 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 staff supplement of **January 10, 2003** updating information on recent economic developments.

- a Public Information Notice (PIN) and Press Release, **summarizing the views of the Executive Board as expressed during its January 15, 2003, discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

- 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

INTERNATIONAL MONETARY FUND

COLOMBIA

Staff Report for the 2002 Article IV Consultation and Request for 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

December 6, 2002

- The three-year extended arrangement with Colombia expires on December 19, 2002. No purchases were made under that arrangement, and Colombia has no outstanding credit from the Fund. A summary of the developments under the EFF (December 1999–December 2002) are presented in Appendix VIII.

- In a letter to the Managing Director dated December 2, 2002 (Appendix IX), the authorities describe recent economic developments in Colombia, outline the policies they intend to follow in the period through 2004, and request Fund support under a two-year Stand-By Arrangement (SBA) in an amount equivalent to SDR 1,548 million, 100 percent of quota on an annual basis.

- At the conclusion of the last Article IV consultation with Colombia on March 28, 2001 (Country Report No. 01/64), Directors welcomed the authorities' efforts toward fiscal consolidation, financial sector restructuring, and structural reforms, as well as the adoption of an inflation-targeting framework. They considered that the main economic challenges facing the authorities were to put the public finances on a sustainable footing, reduce the high level of unemployment, and continue to strengthen the financial system.

- Colombia intends to accept the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement, and the authorities are currently discussing with Fund staff how the restrictions that remain can be phased out. Provision of statistical information is adequate for surveillance purposes.

- Discussions for the 2002 Article IV consultation and use of Fund resources were held in Bogotá in July, September, and October 2002. The missions met with the president of the republic, the ministers of finance, labor and health, and commerce; the governor and the Board of Directors of the central bank; other high public officials; and representatives of the private sector.

- The staff participating in one or more rounds of the discussions were O. Gronlie (Head), B. Fritz-Krockow, A. Espejo, A. Hajdenberg, O. Mandeng, E. Vesperoni (all WHD), A. Hilaire (PDR), and P. Jacome (Assistant-WHD). J. Márquez-Ruarte participated in the final discussions. The Alternate Executive Directors for Colombia (R. Junguito and R. Steiner) also took part in the policy discussions.

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EXECUTIVE SUMMARY

Background

- The Colombian economy has staged a steady, albeit slow recovery since the 1998–99 crisis. Macroeconomic stabilization was achieved, and robust fiscal and structural policies during most of the period since then have allowed the country to avoid some of the difficulties faced by other economies in the region. This is all the more remarkable since Colombia also has had to contend with a long and costly civil conflict that disrupts economic processes and distorts resource allocation.

- The economic situation worsened in the first half of 2002. Peace negotiations with the guerillas broke down in February, followed by escalating violence. Economic activity has remained sluggish, and the fiscal consolidation went significantly off track. Increased contagion from other countries in the region and rising concerns about fiscal solvency led to increased pressure on the peso from mid-year and a loss of external market access.

Strength of Policies and New Program

- After taking office in August 2002, the new administration of President Uribe took determined action to quicken a resolution of the internal conflict; reverse the fiscal deterioration; and safeguard macroeconomic stability, which had come under threat. At the same time, a two-year economic program was designed, under which the government aims at fiscal consolidation and to put in place critical structural reforms to help lay the basis for strong and sustained growth and a better distribution of income and social services.

- To support its program, the government has requested a two-year Stand-By Arrangement from the Fund. To achieve its objectives, the program calls for tax measures and a freeze on most current expenditures for two years. This would help reduce the fiscal deficit by about 2 percent of GDP during 2003–04. Over the medium term, structural reforms, particularly changes in the pension system and a program to modernize the state, will help solidify the fiscal consolidation and allow the public debt to decline.

- The central bank will continue to cast monetary policy within an inflation targeting framework and a floating exchange rate regime. Inflation has been brought down in recent years, to about 6 percent, but the risks have tilted increasingly towards inflation in recent months amid a sharp depreciation of the peso. The central bank has committed to take action as required to meet its inflation target. The banking system has continued to recover from the 1998–99 crisis, but weaknesses remain, particularly in the mortgage banking sector. The authorities will continue to strengthen banking supervision and seek to divest or liquidate intervened public institutions.

Risks

- The principal risks to the program arise from the internal security situation and some degree of uncertainty regarding the outcome of major legislative initiatives. In order to guard against these risks, the authorities would, if necessary, consider additional revenue or expenditure measures, and have outlined alternative sources of financing in case of shortfalls from the program's financing plan.

I. Background and Recent Economic Developments

1. **In the second half of the 1990s, Colombia's economic performance weakened under the weight of intensified guerilla activity, a worsening fiscal position, and external shocks**[1]. Recessionary forces intensified towards the end of the decade when much of Latin America felt the effects of the Asian and Russian crisis. Real GDP grew by only ½ percent in 1998 and fell by 4½ percent in 1999, while unemployment rose to record levels (Figure 1). The fiscal imbalance widened sharply and the financial system came under stress. With the peso under attack in the exchange markets, the currency was floated in September 1999.

2. **In December 1999, the Fund granted Colombia an extended arrangement in support of a three-year economic program** (see Appendix VIII). Under the program, macroeconomic stability was restored quickly, albeit at lower rates of growth (2.7 percent in 2000 and 1.4 percent in 2001). Consumer price inflation fell from an annual rate of about 20 percent during 1996–98, to 9 percent in 1999 and continued to decline in the following years. The deficit of the combined public sector (CPS) fell from 5½ percent of GDP in 1999 to below 3½ percent in 2000 and 2001. Still, public debt continued to rise and reached the equivalent of over 50 percent of GDP at the end of 2001 (Table 1).

3. **The economic situation turned adverse in the first half of 2002.** Activity remained sluggish as the civil conflict intensified; consumption remained subdued by persistently high private debt levels and uncertainty associated with the continued high unemployment levels. At the same time, fiscal consolidation went significantly off track. The major reasons were: faltering revenue collections related to lower than projected growth; unforeseen security outlays; higher-than-programmed capital spending; unexpected losses on litigation against the state; and cost overruns by the public health service. As the year progressed, the peso came under pressure and sovereign bond spreads widened sharply, reflecting increased contagion from neighboring countries, rising market concerns about fiscal solvency, and political events.

4. **Against the backdrop of political turmoil that followed the breakdown of peace negotiations with the guerrillas in February, congressional elections in March and presidential elections in May gave a strong mandate to Alvaro Uribe.** Mr. Uribe ran on a platform of market-oriented economic policies, social equity, and quick action to resolve the civil conflict.

5. **Faced with a difficult economic situation, the new government moved quickly to forestall an even further deterioration.** It introduced cuts in the budget for 2003, imposed a

[1] For a review of the conflict with guerrilla groups, see Box 1 in "Colombia—Staff Report for the 2001 Article IV Consultation and Second Review Under the Extended Arrangement" (EBS/01/34; March 26, 2001).

one-off wealth tax under emergency legislation, prepared a tax package, and set in motion a structural reform program.[2] Even so, the CPS deficit is projected to rise to 4 percent of GDP in 2002, compared with a target of 2.6 percent under Colombia's extended arrangement (Tables 2, 3, and 4). The deficit is being financed domestically to the tune of 3.1 percent of GDP, significantly higher than in the two preceding years, mainly through bond placements and a small increase in the public sector's floating debt. The public sector debt is projected to reach the equivalent of 55 percent of GDP at the end of 2002.

6. **In recent months, economic activity appears to have recovered somewhat,** but real GDP is projected to rise by just 1.6 percent for the year as a whole. The unemployment rate has fallen slightly to 17 percent since last year, but the decline masks a fall in labor market participation and rising underemployment. Helped by the weakness in domestic demand, inflation has continued its downward trend, although it rose somewhat in October, to 6.4 percent (year-on-year), compared with an end-year target of 6 percent [3] (Figure 2).

7. **Monetary policy has been kept on hold in recent months after having been eased since the first half of 2001.** Short-term interest rates have fallen, led by the central bank's policy rates, which were reduced by 625 bps, to 5.25 percent—below current inflation—over the 12 months to June this year and have remained unchanged since then. The private sector's portfolio of financial assets is projected to grow by about 9 percent in 2002, similar to last year, with the strongest growth continuing to be in the holding of government securities (Table 5). Credit growth remains sluggish, but mortgage lending has increased in 2002 after several years of stagnation or decline (Table 6 and Figure 3). Colombian residents hold negligible amounts of foreign currency deposits in the domestic banking system.

8. **Financial indicators deteriorated considerably in 2002 after midyear, but have since recovered somewhat** (Figures 4 and 5). The Colombian peso depreciated by nearly 20 percent in the third quarter of the year, at the same time that Colombia's EMBI+ spread nearly doubled to 1100 bps. The fall in Colombian bond prices was precipitated by negative alerts posted by ratings agencies as fiscal slippages became evident amid effects of intensified contagion. Increased risk perception also reduced the liquidity of the domestic public debt, particularly at the long end, with the yield on 10-year government notes rising by 5 percentage points to 17.5 percent. The stress in financial markets eased notably in October following indications of increased financing from the IFIs, as well as a more general tightening of the risk premia in emerging markets in the region. By the second half of November, the bond spread had narrowed to below 700 bps.

9. **The recovery of the banking system from the crisis in 1998–99 has continued, but weaknesses remain, particularly in the mortgage banks.** Consistent with

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[2] The wealth tax, earmarked for security spending, is levied at 1.2 percent of net wealth.

[3] Inflation has been lower than the announced target every year since 1997.

recommendations under the Financial System Stability Assessment (FSSA) of December 1999, the authorities have tightened supervision, strengthened loan classification regulations, incorporated market risk for capital adequacy, and adopted strict rules and penalties to secure prompt corrective actions. Reflecting this, capital adequacy has improved while provisioning levels have risen, and the nonperforming loans ratio has fallen for the system as a whole. However, mortgage banks still report 20 percent of loans as overdue (Table 6). Three public sector banks that have been intervened since the 1998–99 crisis remain to be liquidated or privatized. However, supervision and regulation of securities firms have continued to lag behind banking supervision.

10. **The external current account deficit is estimated to fall slightly to 1.7 percent of GDP in 2002.** Exports have weakened further as oil shipments have continued to decline. In addition, the growth of nontraditional exports has stagnated, mainly because of difficulties in the important Venezuelan market, but also reflecting a prolonged period of real appreciation of the peso during 2001 and early this year (see Figure 4). Nonetheless, nontraditional exports have increased in importance in recent years and account for more than 50 percent of merchandise exports; a further boost is expected to follow the exchange rate correction in 2002 and the recent renewal of the Andean Trade Preferences Act by the United States.

11. **Colombia regained access to the financial markets after the crisis of 1998–99, and the public sector financed a large part of its requirements abroad in 2000 and 2001** (Table 7). Foreign direct investment has remained steady at just under US$2 billion per year, well below the level of the mid-1990s, as the oil sector has been affected by guerrilla actions, and investments in the financial sector have been held back by adverse market sentiment towards the region. Nevertheless, the central bank has built up sizeable net international reserves, which now exceed US$10 billion, about 100 percent of external debt service payments in 2003 (see Table 1).

12. **As a share of GDP, Colombia's external debt rose from 40 percent in 1998 to an estimated 53 percent in 2002, entirely because of the depreciation of the peso during the period.** In 2002, the debt is set to increase by 4.7 percentage points of GDP due to the sharp depreciation of the peso, and notwithstanding a reduction of the debt in U.S. dollar terms (Tables 8 and 9 and Figure 6).

13. **As summarized above, Colombia has been able to meet only in part the economic challenges that were identified at the time of the 2001 Article IV consultation.** The strengthening of the financial system has continued, but unemployment remains high and the fiscal position weakened significantly in 2002.

II. Policy Discussions and the Program

14. **The most pressing issue facing Colombia is the difficult and costly civil conflict, which disrupts economic processes and imposes widespread social hardship.** The intensification of the conflict has stretched social spending programs; turned poverty

indicators for the worse; and resulted in an internally displaced population that is one of the largest in the world.

15. **The immediate priority in the economic area is to strengthen macroeconomic policies** to help Colombia regain market access, reduce vulnerability, and avoid disruptive exchange rate fluctuations. The measures taken by the new government to rein in the fiscal imbalances are designed to achieve these objectives and are cast in a wider framework for controlling the civil conflict.

16. **Looking ahead, there is a need to strengthen the economy's growth performance to help deal with the persistent problems of unemployment and poverty.** Colombia also needs to sustain a strong competitive position to face a projected fall in oil production, the possibility that coffee prices will remain low for some time to come, and the prospect that export markets in Venezuela may not recover fully in the near term.

17. **Colombia's public debt has grown rapidly in recent years,** bringing into question the issue of Colombia's longer term fiscal solvency. Left unchecked, the rise in public debt and debt-service obligations could lead to a weakening of budgetary control and pre-empt resources for social programs.

18. **The policy discussions with the authorities focused on the main challenges summarized above and plans to deal with them in the framework of a Fund-supported economic program.** The government has already moved quickly to put its economic program in motion by:

- Introducing cuts in the budget for 2003, which was approved by congress in October 2002.
- Introducing, by emergency decree, a wealth tax to be paid over 2002 and 2003.
- Strengthening tax administration and proposing to congress a package of tax measures, which is expected to be passed in December 2002.
- Introducing legislation to reform the pension system and the labor market, also expected to be passed in December.
- Preparing a nationwide referendum in early 2003 that will deal with important political and economic questions, including a two-year freeze on most public spending.
- Embarking on a multifaceted program to modernize the public sector.

19. **The macroeconomic framework going forward is based on a conservative view of economic recovery and growth** (see following tabulation and Figure 7). Under the program's basic scenario of steady reforms and containment of the civil conflict, real GDP growth is projected to rise modestly to 2 percent in 2003, led by the continued recovery of

the construction sector and an increase in nontraditional exports, and would strengthen to over 3 percent in 2004. Headline inflation would fall to 5.5 percent in 2003, which is consistent with the central bank's target,[4] and decline further to about 4 percent in 2004. Reflecting the external financing constraint and the fiscal adjustment, the (external) current account deficit would narrow to about 1–1½ percent of GDP in 2003–04.

Macroeconomic Framework, 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
Combined public sector deficit (-)	-4.0	-2.5	-2.1
Private sector savings minus investment	2.3	1.7	0.5

A. Fiscal Policy

20. **During the discussions, the authorities underscored their commitment to take the measures needed to ensure public debt sustainability and maintain Colombia's record of servicing its debt.** Accordingly, the program calls for tax reforms and expenditure cuts, supported by key structural measures and administrative improvements in the public sector. On this basis, the combined public sector deficit would be reduced to 2.5 percent of GDP in 2003 and 2.1 percent in 2004, while the primary surplus would rise from a modest amount in 2002 to 2¾ percent of GDP in 2003–04 (Figure 8).

21. **The government aims to achieve a substantial increase in tax revenue in 2003** (Figure 9). The tax strategy is based principally on controlling evasion and broadening the tax base, and only partly on higher tax rates in the short term. Thus, the government has already introduced a wealth tax, and launched a program to control tax evasion through new enforcement measures and stricter penalties. The proposed tax package calls for a temporary surcharge on income taxes in 2003, a broadening of the VAT base—the new items will be taxed at a lower rate—and other measures, as explained in paragraph 16 of the memorandum of economic policies (MEP). These measures would yield 1.6 percent of GDP in 2003, although the total revenue of the nonfinancial public sector (NFPS) would only increase by

[4] This target will be adjusted upward at the time of the first program review to allow for the "first-round" effect of the changes in the VAT that congress is expected to vote in December.

1.3 percent of GDP, because of a fall in the operating surplus of the public enterprises reflecting mainly the continuing decline in oil production.

22. **The major challenge in expenditure policy is to limit the effect of legal and statutory provisions that determine 95 percent of budgetary spending.** To that end, the government is submitting a plan for a two-year freeze on most current primary spending (at the 2002 nominal level) to a nationwide referendum in early 2003; the referendum has the force of constitutional law (see MEP, paragraph 16). The proposed freeze would yield savings of 0.7 percent of GDP in 2003, rising to 1.2 percent of GDP in 2004, and lower the base for a number of expenditure categories to help sustain savings at about 0.5 percent of GDP per year thereafter (see Table 4). A reduction in public investment spending, primarily in the areas of electricity, public transport, and agriculture will complete the fiscal effort in 2003.

23. **In the discussions, the authorities noted that their program was designed to continue the fiscal consolidation process beyond the program period.** Indeed, savings from the planned structural reforms would more than make up for the temporary measures that will be phased out (the spending freeze, the income tax surcharge, and the wealth tax), and keep the fiscal deficit to well below 2 percent of GDP in 2005 and beyond. To safeguard medium-term fiscal consolidation, additional and contingent reforms would be developed, including some that could be implemented during the period of the program. A reform plan will be developed for the public health service, which posted a deficit also in 2002 despite the efforts made in 2001 to reduce its operating costs. Other actions being considered include reducing income tax exemptions and raising the preferential VAT rate in the current tax package from 5 to 8 percent (the general rate is 16 percent).

24. **Given the recent difficulties in accessing the international financial markets, the authorities have sought increased financing from the multilateral lenders,** who are seeking to raise their commitments significantly over the next few years. Nevertheless, the net external financing of the public sector is projected to fall sharply in 2003, to about 0.3 percent of GDP. Domestic financing will account for 2.3 percent of GDP, a level considerably lower than in 2002. Given recent trends in financial savings and sluggish private sector credit demand, the authorities saw little risk of excessive pressure on domestic interest rates or of crowding out the private sector demand for credit.

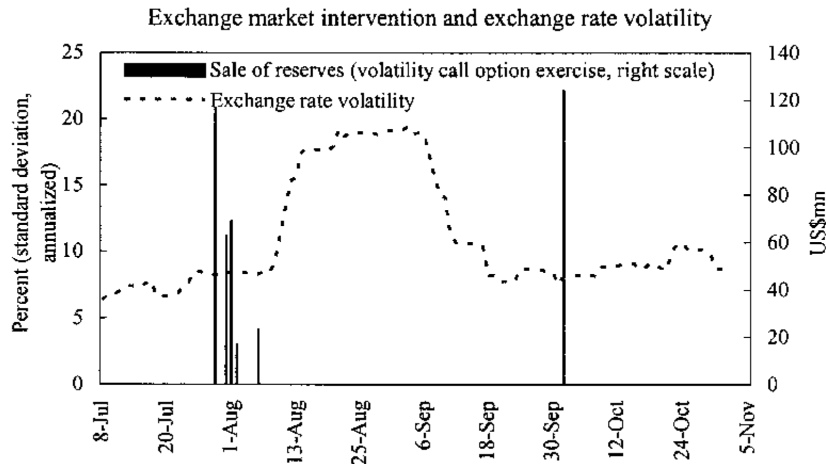
B. Monetary Policy

25. **The central bank will continue to cast monetary policy within a framework of inflation targeting and a floating exchange rate.** Inflation targets are set and announced annually by the bank, and policy statements are communicated through quarterly inflation reports and periodic press releases. The central bank will intervene in the foreign exchange market as necessary to secure orderly market conditions, using its rules-based intervention mechanism (Box).

Box. Use of Options for Foreign Exchange Market Intervention

The Bank of the Republic (BR) in November 1999 introduced a rules-based mechanism for foreign exchange market intervention to control excessive exchange rate volatility. The BR is currently the only central bank to use options in a systematic fashion for exchange market intervention. The main attraction of options is that the central bank is not perceived as targeting a specific exchange rate level and that hedging activities by bearers of options to protect against potential losses incurred by holding an option portfolio should exert a stabilizing impact on the underlying exchange rate.

The BR auctions call (put) options with a maturity of 30 days, giving the bearer the right to buy (sell) dollars from (to) the Bank of the Republic. An auction, in an amount of US$180 million, is triggered whenever the peso is 4 percent more depreciated (appreciated) than its 20-day arithmetic moving average. The calls can be exercised at any time during their life whenever the exchange rate is more than 4 percent depreciated (appreciated) than its 20-day arithmetic moving average. Options to support the currency (volatility call options) were issued for the first time in July 2002 amid mounting pressure against the peso. The auction amount is significant compared with an average daily exchange market volume during the first 6 months of 2002 of about US$300 million.



Preliminary observations suggest that the exercise of call options may not have reduced exchange rate volatility as much as anticipated. This may, at least in part, be attributed to some of the call options' key properties, in particular the exercise style and determination of the exercise price. The options can be exercised shortly after the auction date, thus undermining the need for associated hedging operations. The strike price as a moving average reduces sensitivity to movements in the underlying (low gamma); the 4 percent threshold may also cause the option to quickly become worthless (go deep out-of-the-money) and hence induce reduced hedging needs.

26. **The 2003 monetary program is based on a further reduction in the 12-month CPI inflation to 5.5 percent by the end of the year.** The growth rate for base money is projected to decline and broad money would increase in line with nominal GDP. Bank credit to the private sector is expected to recover only modestly amid continued weak credit demand.

27. **The discussions reviewed the issue of the appropriate level of the central bank's policy rate.** While acknowledging that the central bank's track record of successful

disinflation would lend credibility to the announced inflation target and help guide expectations, the staff team raised the concern that the sharp depreciation of the peso and a recent increase in producer price inflation had tilted the risks toward inflation (see Figure 2). There was also an issue of whether it was prudent for the central bank to maintain a negative real intervention rate in light of the difficult external conditions and the risk that the low rates could fuel a further exchange rate depreciation.

28. **The central bank representatives considered the current policy stance to be satisfactory, albeit with some downside risk.** They stressed that the substantial gap between actual and potential GDP would be a factor dampening inflationary pressures, and noted that other indicators also pointed to an absence of such pressures. Regarding short-term interest rates, the central bank representatives explained that the bank did not subordinate its policy objective to banking system concerns, and assured the staff representatives that it would take action as required to meet its inflation targets.

C. Financial Sector

29. **Under the program, the authorities will continue to strengthen the operating environment of the banking system and foster risk management based on international best practices** (see MEP, paragraph 23). Regulations will be tightened further by increasing capital requirements against market risk, and loan classification and provisioning rules will be updated based on internal risk models of anticipated default probabilities, in line with the New Basel Capital Accord. The authorities will not establish new loan subsidy programs for distressed borrowers and, in compliance with Basel core principles, will reinforce the independence of the superintendency of banks and take steps to provide for the immunity of bank supervisors.

30. **The staff representatives expressed concern that the difficult domestic and external environment may increase credit and market risks, putting pressure on the weaker institutions and slowing the full recovery of the system.** The authorities agreed that banks remain vulnerable, in particular the mortgage banks, and will continue to monitor closely the implementation of new regulations and enforce recovery plans for the weaker banks, and resort to market-based mechanisms if support becomes necessary. The authorities will conclude the sale of intervened public institutions by end-2004 if market conditions permit.

31. **The staff representatives noted that regulation of securities firms and brokerages remains significantly weaker than that of banks.** The authorities shared this view and indicated that there are plans to strengthen supervision and regulation of capital market institutions through the securities commission, and enhance coordination with banking supervision. They expected these plans to be implemented progressively during the program period.

D. External Issues

32. **The program for 2003 is based on conservative assumptions for access to private external capital.** The authorities explained that the government had not been able to tap private external capital markets as successfully in 2002 as last year, but was poised to reenter once conditions became more favorable. In the meantime, their efforts to secure a substantial increase in lower-cost multilateral credit had been successful and disbursements from the World Bank, the Inter-American Development Bank, and the Andean Development Corporation are expected to increase from an estimated US$1.1 billion in 2002 to US$2.7 billion in 2003 to support projects and a wide range of reforms. In view of the increase in multilateral lending and the uncertain outlook, the authorities had drawn up the program for 2003 on conservative rollover assumptions for private external debt. The staff representatives supported this approach, as well as the authorities' intention to continue to improve the conditions for foreign direct investment.

33. **The staff representatives agreed with the authorities that Colombia has been well served by the floating of the peso and its considerable flexibility in responding to shocks.** The staff considered Colombia's exports to be competitive at the current exchange rate, and emphasized the importance of pursuing macroeconomic policies that would prevent an erosion of competitiveness and protect against sharp exchange rate moves that would raise the external debt burden.

34. **The authorities underscored that the upcoming discussions on the Free Trade Area of the Americas (FTAA) was the key focus of Colombian trade policy,** especially given its potential stimulus to foreign investment.[5] They also emphasized the importance of export diversification to reduce the dependence on coffee and petroleum and noted that Colombia's nontraditional exports had shown strong growth since 1999, but had recently faced a weakening of the Venezuelan market. The authorities consider that high tariffs and restrictions imposed by some industrialized countries create significant problems for Colombian exports of textiles and clothing. Sugar and banana exports also face undue restrictions, and they noted that agricultural subsidies in industrial countries pose serious competitive disadvantages for Colombian exports, particularly of rice, cotton, and milk.[6] They welcomed the attention the Fund is paying to issues of market access.

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[5] Colombia has a rank of 2 on the Fund's index of trade restrictiveness, which ranges from 1 (most open) to 10 (most restrictive).

[6] Colombia received a one-year extension by the WTO of its January 1, 2003 deadline to phase out support and subsidies related to exports under its free trade zone system and tax exemptions on capital goods used by exporting companies (Plan Vallejo). In line with a WTO commitment, the subsidy element of the tax certificates for exporters (CERT) is scheduled to be eliminated from the beginning of 2003. In 2002, the expiring restrictions on exports of raw leather and live cattle were not renewed, but Colombia introduced or extended

(continued…)

E. Structural Reforms

Pension reform

35. **In September the government presented to congress its proposal for a second generation reform of the general pension system.** A vote is expected in December.[7] In its proposal the government also requested powers to modify the special (privileged) pension regimes of teachers and the security forces.

36. **The main goal of the pension reform is to reduce the imbalance between benefits and contributions.** Most importantly, new entrants into the system will not give rise to increases in the actuarial deficit. The proposal shortens the transition period stipulated under the 1993 reform, increases the retirement age to 58 and 62 years for women and men in 2009 and to 60 and 65 years in 2018, respectively. The minimum contribution period would increase from 1000 weeks to 1200 in 2009 and to 1300 weeks in 2018. In addition, pension contributions would be increased by 2 percent of salaries and replacement rates would be reduced and made inversely related to the base salary.

37. **The pension system will remain a heavy burden on the public finances for several years to come.** Even after the proposed reform, the actuarial deficit of the public sector's pension system would decrease from about 210 percent of GDP to around 160 percent, while the cash deficit would still widen from 3.1 percent of GDP in 2001 to around 4.5 percent of GDP by 2010. Figure 1 in Appendix VI shows that savings would accrue mainly toward the end of the decade. The staff representatives expressed concern that the slow consolidation of the pension accounts would still leave the system vulnerable. The authorities indicated that additional measures are under consideration that would strengthen the reform. These would be put forward in the 2003 referendum, and include a cap on all new pensions in the public system at 20 times the minimum wage, the alignment of all retirement ages in the public service with that of the general pension system, and a four-year freeze on pensions of high government officials.

Labor market reform

38. **Labor market rigidities and high payroll charges remain obstacles to stronger economic performance.** More than 60 percent of Colombia's labor force works in the informal sector, in part because of high labor costs and inflexibility in the formal labor

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temporary surcharges or import restrictions for a limited range of products. These include a tariff increase on some steel imports, which expired in September, and quantitative restrictions on the importation of rice. In November 2002 the government reduced the tariff on some capital goods.

[7] A fuller description of the pension system and the proposed reform is presented in Appendix VI.

market. At present, payroll charges amount to about 45 percent of the salary, among the highest in Latin America.[8] A second source of high wage costs is the minimum wage, which is adjusted annually by past inflation and is about 60 percent of the average wage in the economy, also high by Latin American standards. Currently, one-third of the labor force in the formal sector earns the minimum wage.

39. **In an effort to deal with some of the labor market problems, the government presented a reform proposal to congress in September 2002.** Under the proposal, labor costs would be lowered by extending daytime working hours and reducing overtime charges and severance payments. Congress is expected to vote on this reform in December 2002.

40. **The staff representatives suggested that the proposed reform would respond only partially to the labor market problems.** In particular, it would not affect the backward indexation of the minimum wage and the high payroll charges. The authorities explained that the adjustment mechanism for the minimum wage has been ordered by the constitutional court. They also felt that the proposed reform would go a long way towards addressing the current problems, noting in particular that the National Planning Department estimates that more than 150,000 new jobs would be created per year as a result of the proposed reform.

Public sector modernization program

41. **The new government has launched a comprehensive plan to modernize the state.** The first step was to put in place a fiscal adjustment program that will set the baseline for the institutional reform. The second step comprises changes in the public sector management system that include the introduction of international best practices for budgetary management and the adoption of a Fiscal Responsibility and Transparency Law. The third provides for changes in the public service career plan, and a reduction of nonmilitary staff. The fourth aims at improving public sector contracting procedures, strengthening the state's capacity to defend its interests in court, and changing the management of the state's assets. Some of these programs will generate savings while others will entail net implementation costs in the short run; all hold the potential to increase productivity and savings over the medium term.

42. **The government requested special powers of congress in August 2002 to initiate these reforms.** Congress is expected to decide on this request in December, but in the meantime the government has taken steps to merge entities, provide incentives to help public workers transfer to the private sector, eliminate the duplication of functions, and strengthen the use of information technologies. However, the bulk of this reform program will be implemented during 2003–06 and will require a large legislative agenda, as set out in the

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[8] The payroll charges are distributed as follows: 13.5 percent for pensions, 12 percent for health coverage, 8.3 percent for severance funds, 2.5 percent for work accidents insurance, and 9 percent for various social and training programs.

technical memorandum of understanding attached to the letter of intent from the authorities (see MEP, paragraphs 17 and 18).[9]

F. Medium-Term Outlook and Capacity to Repay the Fund

43. **The baseline scenario elaborated by the staff for the period through 2010 is based on full and sustained implementation of the program drawn up by the new government.** It adopts the WEO assumptions for key international prices and interest rates. It also takes account of the projected decline in oil production over the next few years and the new government's more cautious assumption for new oil discoveries. Nontraditional exports are projected to grow at an accelerated pace over the next few years, spurred by this year's peso depreciation and the broadening of duty-free access for Colombian industrial exports to the United States. Real GDP growth would recover gradually to 4 percent in the last few years of the decade.

44. **On these assumptions, the combined public sector deficit would decline to below 1 percent of GDP towards the end of the decade.** The fiscal adjustment would provide for a gradual shift in the current excess of private savings over investment, to a deficit of 1.5 percent of GDP, while maintaining the external current account deficit in the range of 2.0 to 2.5 percent of GDP (Table 10).

45. **On this basis Colombia's external debt would decline by nearly 15 percentage points of GDP to below 40 percent by the end of the decade.** The public debt (domestic and external) would fall from 55 percent of GDP to below 45 percent of GDP over the same period, and public debt-service payments, which peaked at 50 percent of nonfinancial public sector revenue in 2001 would fall to 38½ percent in 2004 and decline further over the medium term.

46. **Under the baseline scenario, the indicators of external vulnerability would continue to improve** (Table 11). Colombia's net international reserves would remain about unchanged at the equivalent of 8–9 months of imports of goods and services.

47. **Colombia's external debt-to-GDP-ratio is sensitive to exchange rate shocks, as evidenced this year, and to deviations from the growth and interest rate assumptions.**[10] Sensitivity analysis of the external debt was performed using the standard tests under the Fund debt sustainability framework.[11] The exercise shows that a 30 percent nominal

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[9] A further description of the public sector modernization program is provided in Appendix V.

[10] See Appendix VII for a detailed review of public debt sustainability.

[11] In the Fund's standard sensitivity tests, shocks are defined as the variables' average value plus or minus two standard deviations calculated over the period 1992–2001.

depreciation of the peso in 2003 would raise the external debt ratio by about 10 percent of GDP above the baseline. If the economy would contract annually by about 3 percent in 2003 and 2004, the external debt would increase by 7 percent of GDP by 2010. Finally, a 3–4 percent higher interest rate than in the baseline in 2003 and 2004 would increase the external debt ratio by 4 percent of GDP in 2010.

48. **With no credit currently outstanding to the Fund, the purchases under the program will impose a manageable repayment burden on Colombia.** If all available resources are purchased as scheduled, outstanding Fund credit will peak at 2.8 percent of GDP in 2004. Repurchases and charges would peak at 4.4 percent of exports of goods and nonfactor services in 2006 (Table 12).

G. Risks

49. **The principal risks to the program arise from the internal security situation and uncertainty with regard to the outcome of the major legislative initiatives.** The program provides for an increase in military spending of 0.3 percent of GDP in 2002 and 0.6 percent in 2003 to around 4.2 percent of GDP. In addition, the authorities have indicated that the one-off tax on net wealth (earmarked for security spending) is now projected to yield more than anticipated and that measures on the VAT and the income tax currently under consideration for the post-program period could be brought forward to help finance any unanticipated increase in military spending. They also would consider mandatory bond purchases to help finance higher security outlays (see MEP, paragraph 20).

50. **Regarding the legislative initiatives, passage of the tax package and support for the spending freeze in next year's referendum are critical for the 2003 program, and the pension and the public sector modernization programs are key to strengthening the public finances over the medium term.** The authorities would be prepared to take additional tax and spending reduction measures to safeguard the program if the fiscal yield of the proposed tax legislation or next year's referendum is less than expected.

51. **There is also a risk that financial market access will remain difficult for a prolonged period, adversely affecting the private sector.** To guard against this risk, the program has been designed on the basis of conservative rollover rates for private debt. The public sector's external financing plan is not dependent on the private markets (Table 13). A significant shift to domestic credit by the private sector could put pressure on the domestic market, particularly since the public sector's domestic borrowing requirement will remain large, although substantially reduced from 2002 (see Table 2). In the event of a public sector financing shortfall, the authorities will consider using resources in the petroleum stabilization fund on a temporary basis. Only in the event of a major exogenous shock, and only if the program remains on track, would central bank financing be considered (see MEP, paragraph 19).

52. **Other risks include a temporary loss of export markets, as has occurred for nontraditional exports to Venezuela, or a marked deterioration in the terms of trade.**

Colombia's floating exchange rate offers some protection against these risks, and the broadening of duty-free access for nontraditional exports to the U.S. market holds the potential for strengthening the external current account relative to the program baseline. The consequences of an exchange rate shock are set out in the previous section; and while the banking system remains largely protected against such shocks with a well balanced position in foreign currency, it remains exposed through its clients.

H. Performance Criteria, Access, and Reviews

53. **Program performance will be monitored by quarterly performance criteria and quarterly reviews.** As specified in the technical memorandum attached to the letter from the Colombian authorities (Appendix IX), the program for 2003 will be monitored by quarterly performance criteria on the overall deficit of the combined public sector; the net international reserves (NIR) of the central bank; the net disbursement of external public debt; and by the issuance of guarantees by the public sector for private external debt. There will be quarterly program reviews and special reviews with the Fund if the inflation rate deviates significantly from its quarterly targets or if there is a rapid loss of net international reserves by the central bank (Table 14). There is an adjustor for the performance criterion on the NIR to allow limited exchange market interventions to help maintain orderly market conditions.

54. **Compliance with the program's structural benchmarks will be assessed under the quarterly program reviews** (Table 15). At the first review, before end-March 2003, the quantitative performance criteria for June and September 2003 will be set. This review will focus on a number of issues, inter alia, the need for additional fiscal measures that may become necessary in light of the congressional decisions in December on the tax package and the general pension reform, and the outcome of the referendum in early 2003. In addition, detailed understandings will be reached on the reform of the special pension regimes, and the structural benchmark for June 2003 related to these regimes will be converted to a structural performance criterion. In view of the government's strong ownership of the program and the evolving plans in the area of pension reform, including the likelihood that additional pension reform measures will be included in the referendum, the staff agreed with the authorities to define a structural performance criterion on specific elements of the pension reform only at the time of the first review, after the congressional decisions and the outcome of the referendum are known. Performance criteria for December 2003 and March 2004 and the full program for 2004 will be developed at the time of the September 2003 review, at which time the frequency of reviews in 2004 also will be determined.

55. **The program involves access at 100 percent of quota per year, for a total of SDR 1,548 million over the period of the arrangement.** In the staff's view, the proposed access is justified by Colombia's potentially large financing needs in light of the difficult and volatile situation in the international financial markets, and the speed and magnitude with which capital account problems can be transmitted to emerging market economies; by the strength of the policies; and by the broad political support and ownership of the program. The program is precautionary in nature in that the staff understands that the authorities do not intend to draw on the Fund resources unless the external financing needs exceed the current

projection (see Table 13). The first purchase, for SDR 193.5 million, would be available upon Executive Board approval of the program, and four purchases would be available in 2003, as set out in Table 16. The authorities plan to publish the letter of intent and the attached memorandum of economic policy and technical memorandum of understanding, and have indicated that they also want the staff report and a PIN to be published.

III. Other Issues

56. **Statistical information provided to the Fund is generally adequate.** Colombia subscribes to the Special Data Dissemination Standard, and is in compliance with the standard. However, the timeliness of the fiscal data and the accuracy of revenue and expenditure data for the noncentral public sector needs to be improved to enhance the monitoring of economic developments.

57. **Under the proposed SBA Colombia will be subject to the full safeguards assessment, which would be completed by the first program review.** Under the EFF, Colombia was subject to the transitional procedure. At that time the central bank's financial statements were not independently audited using the criteria of International Standards on Auditing (ISA), but the bank has since appointed an external auditing firm that will issue its opinion together with the bank's financial statement for 2002. Any recommendations resulting from the full assessment would be incorporated into the program at the time of the first review.

58. **Colombia has a comprehensive set of laws to combat money laundering, and responded to the first round of AML/CFT questionnaires issued by the Fund** (see MEP, paragraph 24). Colombia's laws criminalize financing of terrorism and provide for the freezing and confiscation of assets related to such activity. The laws cover a wide range of financial institutions, including banks, insurance companies, securities firms, and other intermediaries, and enlist participation of a large number of regulatory and other agencies and industry associations. A financial intelligence unit (UIAF) was established in 1999, which has emerged as one of the leading agencies in financial intelligence by international standards. The UN Convention Against Transnational Organized Crime and the UN Convention for the Suppression of the Financing of Terrorism remain to be ratified, and the pertinent laws and regulations remain to be extended to dealers of precious stones and metals.

59. **Since the 1998–99 economic crisis, the authorities have sought to improve the transparency of the public finances.** Initiatives have included the establishment of an integrated financial management information system for the central administration (SIIF) and an information system for territorial entities (FOSIT); a website with broad information on government activities, legal data, and procurement; and the implementation of a fiscal restructuring program for territorial governments. As part of this effort, the authorities requested an assessment of fiscal transparency under the Fund's Report on Standards and Codes (ROSC). An FAD mission visited Bogotá in March 2002 to assess Colombia's compliance with the standard. The mission made recommendations regarding budgetary

procedure and practices; quasi-fiscal activities and contingent liabilities; the excessive internal and external controls at all levels of government; the complexity of tax laws; exemptions to procurement procedures; and the lack of official information on medium-term fiscal projections and debt sustainability. The authorities welcomed the recommendations, several of which have been incorporated in the program to modernize the state.

60. **While Colombia has taken important steps to liberalize its exchange system since 1991, it has not yet accepted the obligations of Article VIII, Sections 2(a), 3, and 4 of the Fund's Articles of Agreement.** The authorities have stated their intention to accept these obligations and eliminate the exchange restrictions that remain (see MEP, paragraph 24). A mission from MAE and LEG that visited Bogotá in July 2002 concluded that the remaining restrictions arise from a tax benefit for exporters linked to the surrender of foreign exchange (CERT, see above), the long settlement period under a bilateral payments agreement with China, and a special foreign exchange regime for the hydrocarbons sector. There is also a 7 percent tax on profit remittances, which the authorities have indicated that they are not prepared to phase out at this point.

IV. Staff Appraisal

61. **The Colombian economy has staged a steady, albeit slow recovery since the 1998–99 crisis.** Macroeconomic stabilization has been achieved, and robust fiscal and structural policies during most of the period since then have allowed the country to avoid some of the difficulties faced by several other countries in the region. This is all the more remarkable since Colombia has had to contend with a long and costly internal conflict.

62. **Economic performance and the fiscal position came under stress again in 2002, at a time of turbulence in international financial markets and intensification of the internal conflict.** Regretfully, no serious attempt was made by the previous administration to reverse the fiscal slippages, leading to pressures on the peso and a loss of access to the international financial markets. This was unfortunate, since restoration of market confidence can be a lengthy process. The new government has taken rapid and determined action since August to quicken a resolution of the internal conflict, reverse the fiscal deterioration, and safeguard macroeconomic stability. Building on this, it is putting in place an economic program for the next two years designed to reinforce macroeconomic policies and reduce vulnerabilities by strengthening control over the public debt dynamics and undertaking structural reforms to help foster economic growth and enhance social services.

63. **The government's fiscal program contains measures to reduce the fiscal deficit sharply in 2003–04.** Although the program provides for the fiscal consolidation to continue over the medium term, the staff welcomes the additional plans that are under consideration to make the medium-term profile more robust. Together, these steps would help provide for a lasting improvement in the public finances and better secure the sustainability of Colombia's public debt .

64. **The fiscal program for 2003 is fully financed from the domestic market and the multilateral agencies.** In order to avoid undue pressure on domestic interest rates and a crowding out of the private sector, it is important to ensure that the conditions are met for disbursements under the higher lending commitments of the multilateral lending institutions, thereby reducing the public sector's recourse to domestic credit in 2003 as envisaged in the program.

65. **The central bank needs to stand ready to take early and decisive action to forestall the emergence of inflationary expectations and protect the inflation targets.** The bank rightly enjoys a high degree of credibility after having presided over a period of significant disinflation. At the same time, it should be recognized that, in spite of the large unused capacity in the economy, the recent exchange market pressures have increased the risk of higher inflation.

66. **Significant progress has been achieved in strengthening the banking system, but continued vigilance is warranted.** Particularly welcome is the authorities' commitment to refrain from introducing new subsidy programs for distressed borrowers, given the importance of strengthening the payment culture to help reactivate credit.

67. **The government has proposed a well-conceived reform of the general pension system and intends to move quickly to set new parameters for the special (privileged) pension regimes of teachers and other groups.** Pension reform is long overdue, and the government's proposal is intended to make the system more equitable and help to secure pension payments to future retirees on a fiscally sound basis. Also essential are the government's plans to modernize the state and introduce greater flexibility in public spending, reforms that will allow the budget to better serve the changing social and economic needs of Colombians.

68. **The steps that are being proposed to make the labor market more flexible are welcome.** However, the government's proposal may not go far enough as it does not address the backward indexation of the minimum wage or the high payroll charges, both of which tend to exclude workers from the formal sector and thus from appropriate pension and health benefits. More flexible labor market policies would help spur economic growth and fiscal consolidation, and support the achievement of the government's social equity objectives.

69. **Colombia's floating exchange rate regime, with limited and rules-based intervention by the central bank, is appropriate and offers the country flexibility in responding to shocks.** Colombian exports are competitive at the current exchange rate, and the outlook for nontraditional exports is good, which is key to offset the decline in oil exports. The staff recognizes the advances that have been made in liberalizing Colombia's trade regime and will encourage the authorities to phase out the remaining import restrictions.

70. **Colombia is urged to accept the obligations of Article VIII of the Fund's Articles of Agreement as soon as possible**, and eliminate the few exchange restrictions that remain.

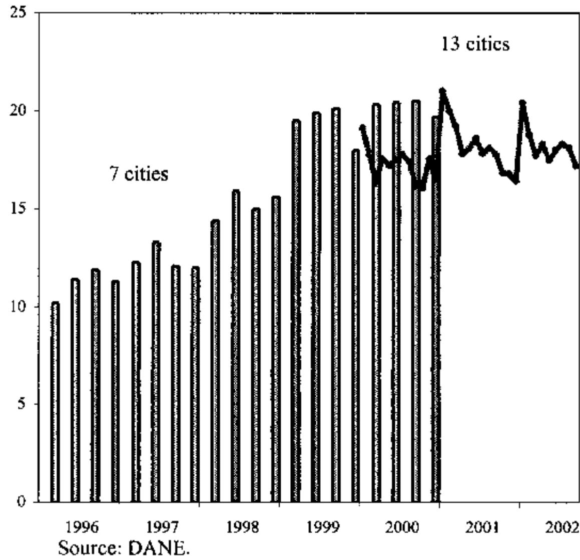
Since there is no timetable for removing the restrictions, the staff does not recommend their approval.

71. **The staff supports the authorities' request for a two-year Stand-By Arrangement.** Faced with an adverse domestic security situation and a difficult external environment, the Colombian authorities have drawn up a program that is robust and realistic, and enjoys strong political support. Important steps are being taken to face the challenges posed by the financial deterioration of the public pension and health systems, and the program calls for initiatives to chart the course for further fiscal improvements over the medium term. The program faces significant risks, but in light of the broad and strong ownership and the authorities efforts to develop contingency plans, the staff recommends approval of Colombia's request for a two-year Stand-By Arrangement.

72. It is expected that the next Article IV consultation with Colombia will be held on a 24-month cycle, subject to the provision of the decision on consultation cycles approved on July 15, 2002.

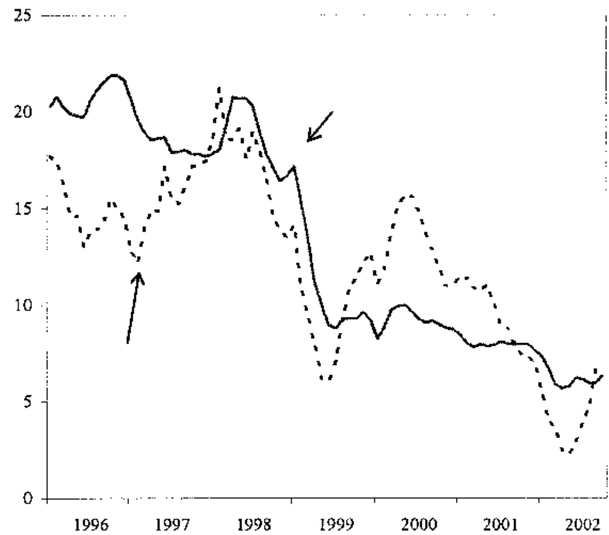
Macroeconomic Indicators: Background

Figure 1. Unemployment Rate 1/
(Percent of labor force)



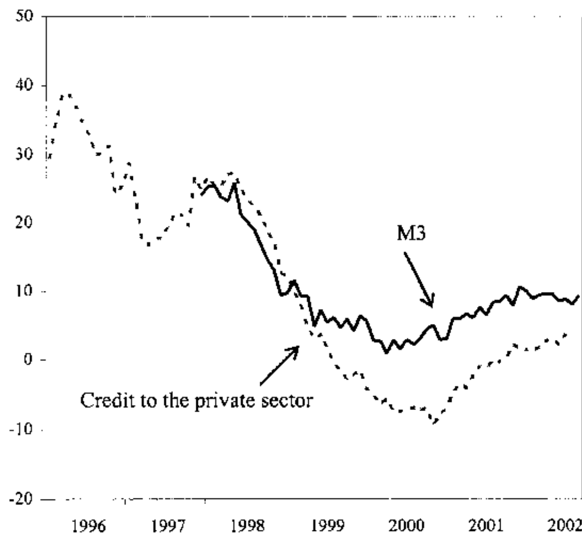
Source: DANE.
1/ Because of differences in methodology, the two series are not directly comparable.

Figure 2. Annual Inflation
(12-month percentage change)



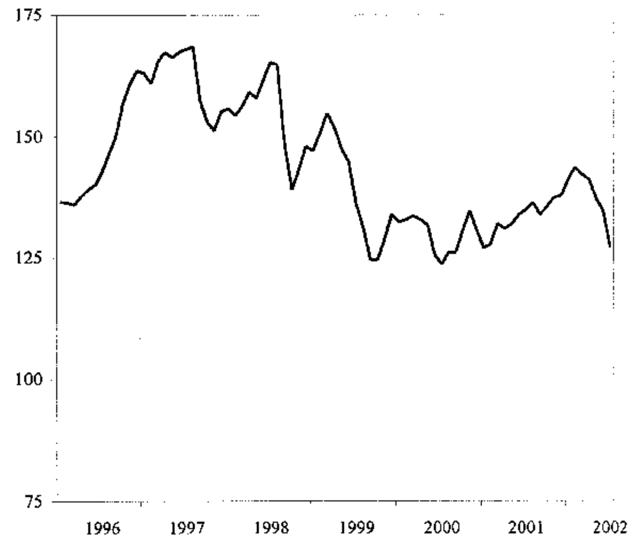
Sources: Banco de la República; and Fund staff estimates.

Figure 3. Growth of Money and Credit
(12-month percentage change)



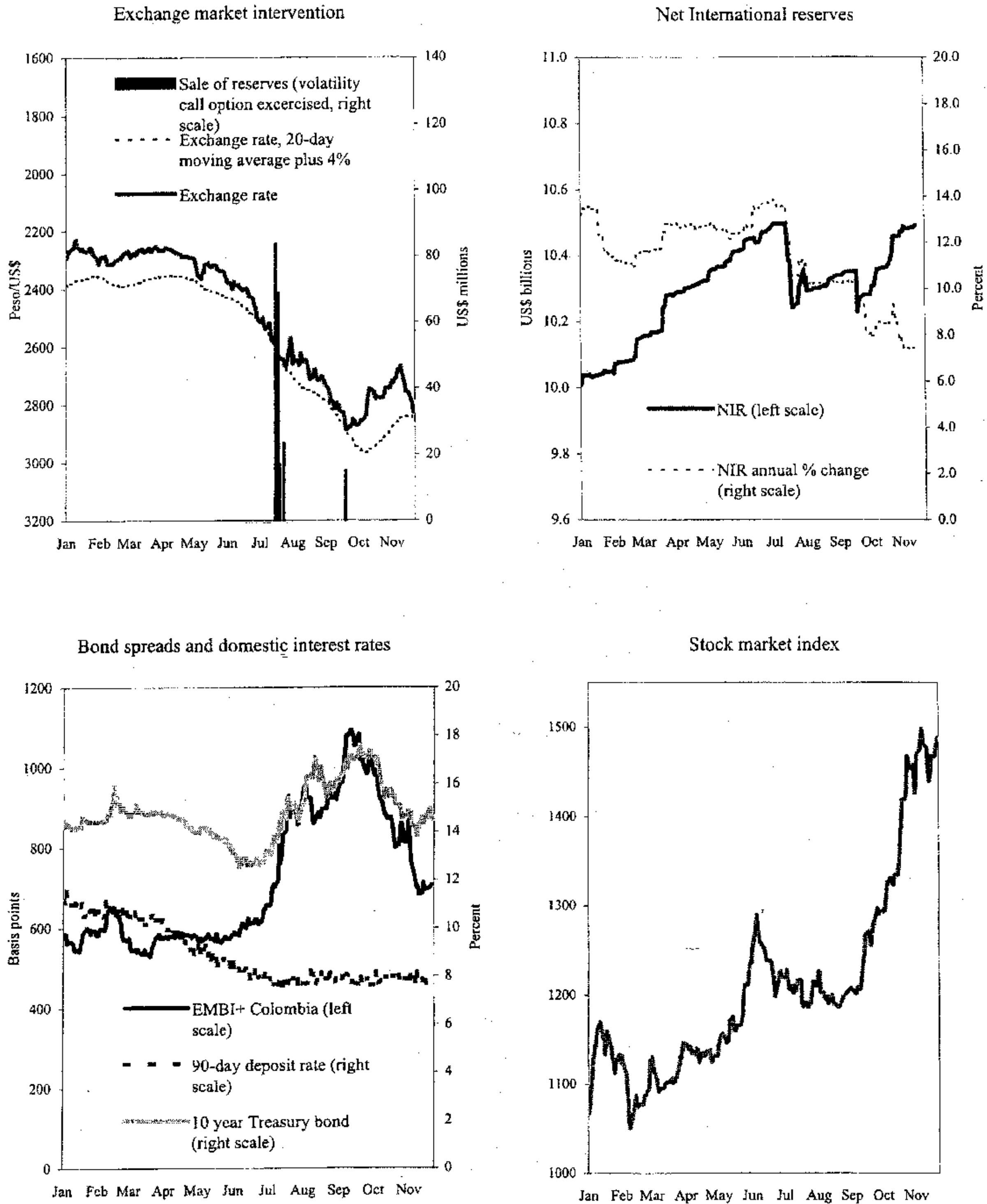
Source: Banco de la República.

Figure 4. Real Effective Exchange Rate 1/
(1990=100)



Source: Information Notice System.
1/ An increase (decrease) indicates appreciation (depreciation).

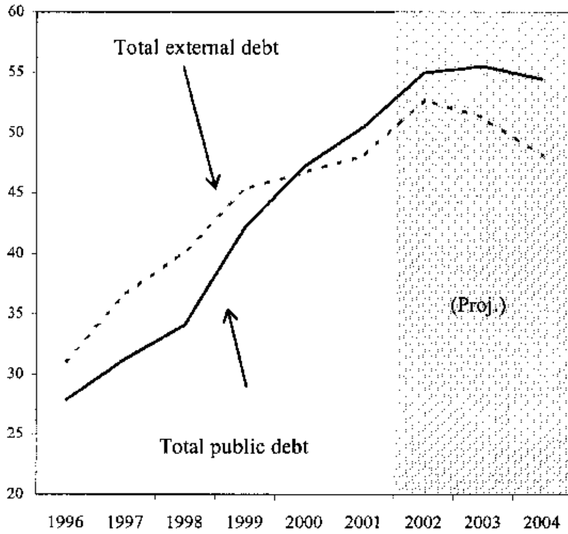
Figure 5. Selected Financial Indicators, 2002



Sources: Banco de la Republica; JP Morgan.

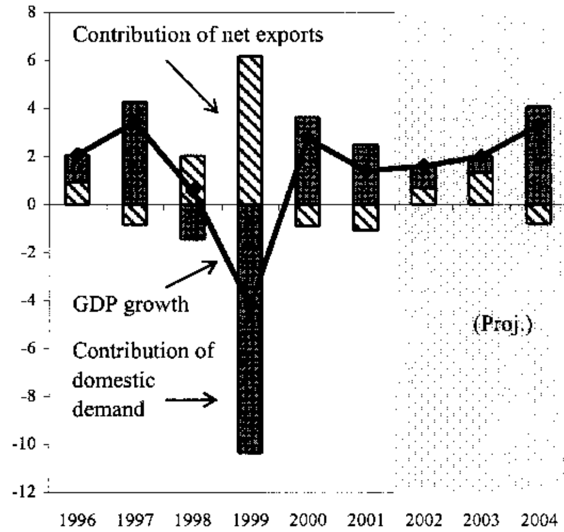
Macroeconomic Indicators: Program

Figure 6. Debt
(In percent of GDP)



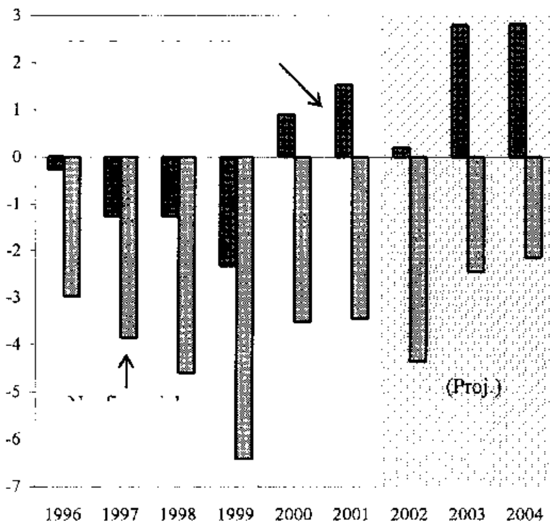
Sources: Banco de la República; and Fund staff estimates.

Figure 7. Real GDP Growth and Its Components
(Annual change as percentage of GDP)



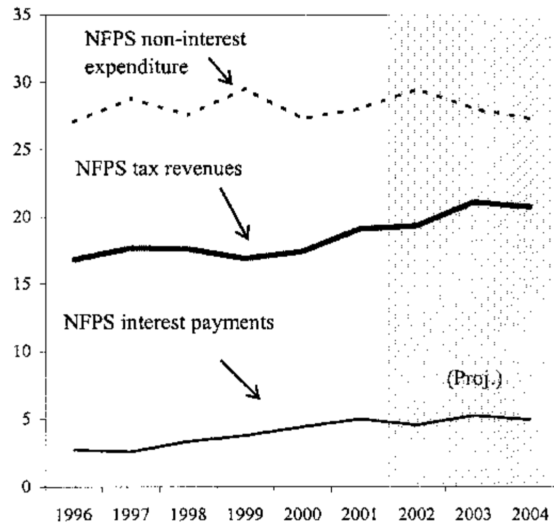
Source: DANE; and Fund staff estimates.

Figure 8. Fiscal Balance
(In percent of GDP)



Source: Ministry of Finance; and Fund staff estimates and projections.

Figure 9. Tax Revenue and Expenditure
(In percent of GDP)



Source: Ministry of Finance; and Fund staff estimates and projections.

Table 1. Colombia: Selected Economic and Financial Indicators

	1998	1999	2000	2001	Prog. 2002	2003	2004
(Percentage changes, unless otherwise indicated)							
National income and prices							
Real GDP	0.6	-4.2	2.7	1.4	1.6	2.0	3.3
GDP deflator	14.8	12.6	11.6	7.6	5.7	5.5	4.5
Consumer prices (average) 1/	18.7	10.9	9.2	8.0	5.7	5.6	4.3
Consumer prices (end of period) 1/	16.7	9.2	8.7	7.6	6.0	5.5	4.0
External sector (on the basis of U.S. dollars)							
Exports (f.o.b.)	-4.8	4.9	13.2	-6.2	-1.1	4.9	2.4
Imports (f.o.b.)	-5.3	-26.3	8.1	10.6	-4.5	-4.5	7.1
Export volume	7.7	0.9	2.5	1.7	-3.2	5.1	2.6
Import volume	-2.1	-22.4	7.4	13.5	-4.5	-7.3	4.7
Terms of trade (deterioration -)	-8.7	9.4	9.7	-5.3	2.2	-3.1	-2.4
Nominal exchange rate to U.S. dollar (depreciation -) 2/	-16.1	-17.7	-15.9	-2.7	...	...	...
Real effective exchange rate (depreciation -) 3/	-4.6	-9.5	-2.4	5.5	...	...	...
Central administration							
Revenue	9.8	8.1	25.7	20.8	9.2	15.9	4.1
Expenditure 4/	25.4	20.5	11.9	17.3	12.2	3.3	2.0
Money and credit 5/							
M3 6/7/	7.8	6.9	3.6	9.3	5.0	7.4	7.0
Credit to the private sector 8/	...	2.9	1.3	2.7	5.2	6.2	7.5
Interest rate (90-day time deposits; percent per year)							
Nominal	34.3	15.8	13.4	11.5	...	...	...
Real	15.1	6.0	4.2	3.6	...	...	...
(In percent of GDP)							
Central administration balance 4/	-5.4	-7.4	-5.8	-5.8	-6.5	-4.5	-3.9
Nonfinancial public sector savings 4/	4.7	3.9	4.6	2.5	4.2	4.7	5.2
Nonfinancial public sector balance 4/	-4.6	-6.4	-3.5	-3.5	-4.4	-2.5	-2.2
Combined public sector balance 4/	-3.8	-5.5	-3.4	-3.2	-4.0	-2.5	-2.1
Foreign financing	1.8	1.1	1.6	2.3	1.0	0.3	0.5
Domestic financing 9/	1.9	3.7	1.4	0.9	3.1	2.3	1.6
Privatization	0.1	0.7	0.3	0.0	-0.1	-0.1	-0.1
Public debt 10/	34.1	42.2	47.2	50.5	55.0	55.5	54.3
Gross domestic investment	19.7	12.9	13.4	14.7	13.8	13.0	14.0
Gross national savings	14.4	13.3	13.8	12.8	12.1	12.2	12.4
Current account (deficit -)	-5.3	0.6	0.5	-1.9	-1.7	-0.8	-1.6
External debt 11/	40.2	45.3	46.7	48.1	52.7	51.3	48.2
Of which: public sector 11/	20.8	25.0	26.4	28.4	31.3	31.3	30.1
Total short-term external debt to NIR 12/	101.8	106.1	90.2	100.9	97.9	90.8	90.8
(In percent of exports of goods, services, and income)							
External debt service	48.7	50.7	50.0	49.7	59.2	52.6	49.3
Of which: public sector	23.2	23.0	22.1	28.6	34.1	31.9	29.9
Interest payments	18.0	17.2	16.2	16.5	16.4	16.4	16.1
Of which: public sector	8.6	8.8	9.3	10.6	11.3	11.4	11.3
(In millions of U.S. dollars)							
Overall balance of payments	-1,388	-319	870	1,218	171	243	350
Gross official reserves 13/	8,740	8,103	9,006	10,245	10,680	10,923	11,272
Gross official reserves (in months of imports of goods and services) 13/	7.8	6.8	6.8	8.0	8.6	8.3	8.3

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

1/ The 2003 rate to be adjusted to take account of first round effects of changes in VAT.

2/ End of period.

3/ End of period. Based on the Information Notice System.

4/ Includes floating debt defined as unpaid bills plus outstanding budgetary commitments.

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

6/ Currency in circulation plus deposit liabilities of the banking system to the public and private sectors.

7/ End-of-period.

8/ Data for 1999-2002 have been adjusted for loan write-offs from the mortgage debt reduction and bank restructuring programs.

9/ Includes the quasi-fiscal balance of Banco de la Republica, sales of assets, phone licenses, and statistical discrepancy.

10/ Includes bonds issued to recapitalize financial institutions and assumes no purchases from the Fund.

11/ Ratio to GDP calculated using end of period exchange rate.

12/ Short term debt is defined by remaining maturity.

13/ Not including purchases from the Fund under the Stand-By Arrangement.

Table 2. Colombia: Operations of the Combined Public Sector

(In percent of GDP)

					Prog.		
	1998	1999	2000	2001	2002	2003	2004
Total revenue	**26.9**	**27.4**	**28.2**	**29.3**	**29.5**	**30.7**	**29.9**
Current revenue	**26.9**	**27.4**	**28.2**	**29.3**	**29.5**	**30.7**	**29.9**
Tax revenue 1/	17.6	16.9	17.4	19.1	19.3	21.1	20.9
Nontax revenue	9.3	10.5	10.8	10.2	10.2	9.6	8.9
Property income	0.9	1.0	1.0	1.3	0.9	0.8	0.8
Operating surplus of public enterprises	3.3	4.0	4.2	4.2	4.6	4.4	3.7
Of which: Ecopetrol	1.7	2.4	3.0	2.5	2.8	2.5	1.9
Other 2/	5.1	5.5	5.5	4.7	4.7	4.3	4.4
Total expenditure and net lending 1/	**30.9**	**33.3**	**31.7**	**33.0**	**33.9**	**33.2**	**32.0**
Current expenditure	**22.9**	**24.5**	**23.7**	**24.7**	**25.6**	**25.9**	**24.8**
Wages and salaries	7.1	7.7	7.3	7.5	7.6	7.2	6.5
Goods and services 3/	3.5	3.7	3.3	3.5	3.7	3.3	3.1
Interest	3.3	3.8	4.4	5.0	4.6	5.2	5.0
External	1.1	1.4	1.6	2.2	2.2	2.5	2.3
Domestic	2.2	2.3	2.8	2.7	2.4	2.8	2.6
Transfers to private sector	8.6	9.2	9.1	9.7	10.0	10.3	10.2
Of which: from social security	5.0	5.5	5.6	6.4	6.8	7.1	7.1
Other 4/	0.4	0.2	-0.3	-0.9	0.0	-0.1	0.0
Capital expenditure	**8.0**	**8.7**	**8.0**	**8.2**	**8.2**	**7.1**	**7.2**
Fixed capital formation 4/	7.8	8.6	7.8	8.1	8.1	7.1	7.2
Transfers	0.1	0.1	0.1	0.1	0.1	0.0	0.1
Net lending	0.0	0.1	0.0	0.1	0.1	0.1	0.0
Statistical discrepancy 5/	-0.6	-0.5	0.0	0.3	0.0	0.0	0.0
Nonfinancial public sector balance	**-4.6**	**-6.4**	**-3.5**	**-3.5**	**-4.4**	**-2.5**	**-2.2**
Quasi-fiscal balance (BR cash profits)	0.8	0.4	0.5	0.7	0.6	0.4	0.4
Fogafin balance	...	0.5	0.0	0.2	0.2	0.1	0.3
Net cost of financial restructuring 6/	...	0.0	-0.4	-0.7	-0.5	-0.5	-0.6
Overall balance	**-3.8**	**-5.5**	**-3.4**	**-3.2**	**-4.0**	**-2.5**	**-2.1**
Overall financing	**3.8**	**5.5**	**3.4**	**3.2**	**4.0**	**2.5**	**2.1**
Foreign, net	1.8	1.1	1.6	2.3	1.0	0.3	0.5
Of which							
Changes in assets held abroad (-increase)	0.1	-0.9	0.0	-1.8	2.6	0.4	0.4
Domestic, net	1.9	3.7	1.4	0.9	3.1	2.3	1.7
Banking system	1.3	2.2	-0.3	-1.2	0.5	0.5	0.5
Bonds	0.2	0.9	2.3	2.8	2.3	1.9	1.2
Change in floating debt and accrual adjustments 7/	0.4	0.6	-0.6	-0.7	0.3	-0.1	0.0
Privatization (including concessions) 8/	0.1	0.7	0.3	0.0	-0.1	-0.1	-0.1
Memorandum items:							
NFPS saving	4.0	2.9	4.5	4.5	3.9	4.7	5.1
NFPS primary balance	-1.3	-2.6	0.9	1.5	0.2	2.7	2.8
Public sector gross borrowing requirements	7.9	11.3	8.6	12.8	12.0	10.7	8.6
Of which: domestic borrowing requirement	4.3	7.4	4.5	7.6	6.9	6.0	4.2
Debt service (as percentage of CPS revenues)	27.5	35.1	34.1	49.7	42.5	43.9	38.5
Petrolem stabilization fund (change in deposits)	0.1	0.4	0.9	0.2	-0.2	-0.2	-0.3
Military expenditure	3.2	3.2	3.2	3.3	3.6	4.2	4.2

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

1/ Excludes proceeds of financial transaction tax from revenue in 1999.
2/ Includes local fees, penalties, and other revenues.
3/ From year 2000 includes changes in the unpaid bills of Instituto del Seguro Social.
4/ Includes change in the budget carryover of the central administration and in the unpaid bills of selected nonfinancial public enterpri
5/ Comprises residual differences between items above and below the line.
6/ Transfer to Caja Agraria in 1999, interest payments on public banks restructuring bonds and mortgage debt relief related costs.
7/ Includes central administration, nonfinancial public enterprises and the Instituto del Seguro Social.
8/ Includes nonrecurrent fees from telecommunications licensing.

Table 3. Colombia: Operations of the Central Administration

(In percent of GDP)

	1998	1999	2000	2001	Prog. 2002	2003	2004
Total revenue	**12.0**	**12.0**	**13.1**	**14.5**	**14.8**	**15.9**	**15.4**
Current revenue	**12.0**	**12.0**	**13.1**	**14.5**	**14.8**	**15.9**	**15.4**
Tax revenue 1/	10.6	10.0	11.3	13.1	13.3	14.6	14.1
Net income tax and profits	4.3	4.2	4.3	5.3	5.7	6.1	5.8
Goods and services	5.0	4.9	5.3	5.9	5.8	6.6	6.4
Value-added tax	4.6	4.4	4.9	5.3	5.3	6.1	5.9
Gasoline tax	0.5	0.5	0.5	0.6	0.5	0.5	0.5
International trade	1.2	0.9	1.0	1.1	1.0	1.0	1.1
Financial transaction tax	0.0	0.0	0.6	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
Nontax revenue and transfers	1.4	1.9	1.8	1.5	1.5	1.4	1.3
Property income	0.3	0.3	0.5	0.3	0.3	0.1	0.3
Other	1.1	1.6	1.3	1.2	1.2	1.3	1.0
Total expenditure and net lending	**17.4**	**19.4**	**18.9**	**20.3**	**21.3**	**20.4**	**19.3**
Current expenditure	**13.9**	**15.0**	**15.4**	**15.8**	**17.2**	**17.1**	**16.3**
Wages and salaries	2.7	2.9	2.9	3.0	3.0	2.8	2.2
Goods and services	1.4	1.3	1.3	1.5	1.8	1.5	1.4
Interest	1.9	2.1	3.0	3.5	3.4	4.2	4.3
External	0.7	1.0	1.2	1.6	1.8	2.0	2.1
Domestic	1.2	1.1	1.8	1.9	1.6	2.2	2.2
Other expenditure 2/	0.4	0.2	-0.1	-0.9	0.0	-0.1	0.0
Current transfers 3/	7.5	8.5	8.3	8.6	9.0	8.8	8.4
Capital expenditure	**3.2**	**3.8**	**3.1**	**3.8**	**3.3**	**2.7**	**2.6**
Fixed capital formation 2/	1.1	1.6	1.0	1.3	1.3	0.9	0.9
Capital transfers	2.0	2.3	2.1	2.5	2.0	1.8	1.7
Net lending	**0.2**	**0.5**	**0.5**	**0.8**	**0.8**	**0.6**	**0.4**
Overall balance	**-5.4**	**-7.4**	**-5.8**	**-5.8**	**-6.5**	**-4.5**	**-3.9**
Memorandum items:							
Primary balance	-3.5	-5.3	-2.8	-2.3	-3.1	-0.3	0.3
Transfers to local governments	4.3	5.0	4.7	5.3	5.0	5.3	5.3

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

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

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

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

Table 4. Colombia: Impact of Proposed Fiscal Measures

(In percent of GDP)

	Effect	2002	2003	2004
A. Total fiscal measures (B-C)		**0.2**	**1.9**	**2.2**
B. Total revenue measures (B1+B2+B3)		**0.5**	**1.8**	**1.5**
B1. Central administration revenue measures 1/		**0.5**	**1.5**	**1.1**
1. Tax on net assets 2/	Temporary	0.5	0.5	
2. Income tax credit (local taxes); yields in 2005	Temporary			
3. Surcharge in income tax rate	Temporary		0.2	0.1
4. Inventories adjustment according to inflation rate	Permanent			0.1
5. VAT extension at 5 percent	Permanent		0.6	0.6
6. Changes in special VAT rates (from 10 to 16 percent)	Permanent		0.1	0.1
7. VAT tax credit on capital goods	Temporary			-0.1
8. Financial transaction tax	Permanent		0.1	0.1
9. Penalties against tax evasion	Permanent		0.1	0.2
B2. Territorial entities revenue measures 1/			**0.1**	**0.1**
10. Territorial Entities tax modifications	Permanent		0.1	0.1
B3. Pension reform 1/			**0.1**	**0.2**
11. Pension reform	Permanent		0.1	0.2
C. Expenditure measures (decrease -)		**0.3**	**-0.1**	**-0.7**
12. Military expenditure	Permanent	0.3	0.6	0.6
13. Capital expenditure (Territorial entities) 3/	Permanent		0.1	0.1
14. Expenditure freezing 4/	Temporary		-0.7	-1.2
15. Downsizing of the state 5/	Permanent		-0.1	-0.2

Sources: DIAN and CONFIS estimates.

1/ Bills submitted to congress in September 2002.
2/ Approved; Presidential Decree 1838.
3/ Will be implemented if modifications to territorial taxes are approved by congress.
4/ To be approved by a national referendum (early 2003).
5/ Most of the required bills will be submitted to congress in 2003.

Table 5. Colombia: Monetary Indicators

	1998	1999	2000	2001	Proj. 2002	2003	2004
(In billions of Colombian pesos, unless otherwise stated)							
Central bank							
Net international reserves 1/	13,001	14,941	19,470	23,320	29,607	32,725	34,821
In billions of US$	8.7	8.1	9.0	10.2	10.4	10.6	11.0
Net domestic assets	-6,078	-5,202	-8,760	-11,672	-15,978	-18,320	-19,264
Net credit to public sector	700	2,161	2,427	1,631	1,666	1,548	1,368
Net credit to financial system	847	1,645	1,496	700	1,209	901	1,264
Other	-7,625	-9,008	-12,682	-14,003	-18,853	-20,768	-21,895
Monetary base	6,923	9,740	10,710	11,648	13,628	14,405	15,557
Of which: currency in circulation	4,603	6,037	7,276	8,349	9,769	10,326	11,152
Banking system							
Net foreign assets 1/	5,001	7,597	13,455	18,303	23,237	25,684	27,329
billions of US$	3.2	4.1	6.0	8.0	8.1	8.3	8.6
Net domestic assets	45,140	46,754	41,532	39,855	37,848	39,942	42,907
Net credit to public sector	5,251	8,444	11,846	12,704	14,660	16,406	18,261
Credit to private sector	51,602	50,576	46,707	47,659	48,868	52,829	57,945
Other net	-11,713	-12,266	-17,021	-20,509	-25,680	-29,294	-33,299
Broad money 2/	50,142	54,351	54,987	58,157	61,085	65,626	70,236
(Annual percentage change)							
Credit to public sector, net	293.6	60.8	40.3	7.2	15.4	11.9	11.3
Credit to private sector	12.8	-2.0	-7.6	2.0	2.5	8.1	9.7
Currency	12.2	31.1	20.5	14.8	17.0	5.7	8.0
Monetary base	-16.5	40.7	10.0	8.8	17.0	5.7	8.0
M3 3/	7.8	6.9	3.6	9.3	5.0	7.4	7.0
(In percent of GDP)							
Credit to public sector, net	3.7	5.6	6.8	6.7	7.2	7.5	7.7
Credit to private sector	36.7	33.4	26.9	25.1	24.0	24.1	24.5
Currency	3.3	4.0	4.2	4.4	4.8	4.7	4.7
Monetary base	4.9	6.4	6.2	6.1	6.7	6.6	6.6
M3 3/	40.3	40.0	36.1	36.2	35.4	35.3	35.0
(In billions of Colombian pesos, unless otherwise stated)							
Memorandum items:							
Central bank inflation target (percent) 4/	16.0	15.0	10.0	8.0	6.0	5.5	...
Consumer price inflation (percent)	16.7	9.2	8.8	7.6	6.0	5.5	4.5
Producer price inflation (percent)	13.8	12.7	11.0	6.9	6.9	5.8	5.0
Exchange rate (annual percent change) 5/	19.2	21.5	19.0	2.8	21.5	...	...
Financial system 6/							
Net assets in foreign currency 7/	329	-387	-445	371	924	...	...
In billions of US$	0.2	-0.2	-0.2	0.2	0.4	...	...
In percent of GDP	0.2	-0.3	-0.3	0.2	0.5	...	...
Foreign currency assets to total assets (percent) 6/	14.7	10.9	8.9	8.1	9.4	...	...
Foreign currency credit to total credit (percent) 6/	18.5	15.2	13.1	11.0	11.3	...	...
Foreign currency deposits to total deposits (percent) 6/	0.4	0.5	0.4	0.5	0.5	...	...
M3/NIR	4.4	4.1	3.2	2.9	2.4	2.4	2.4
Adjusted credit to the private sector 8/	56,806	58,454	59,213	60,794	63,973	67,934	73,049
Annual percent change	...	2.9	1.3	2.7	5.2	6.2	7.5
Percent of GDP	40.4	38.6	34.1	32.1	31.4	31.0	30.9
Total private sector portfolio 9/	58,520	63,574	67,554	73,932	80,599	88,423	95,550
Percent of GDP	41.7	41.9	38.9	39.0	39.6	40.4	40.4

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

1/ Assets on and liabilities to nonresident entities.
2/ Currency in circulation plus deposit liabilities to the private sector.
3/ Currency in circulation plus deposit liabilities to the public and private sectors.
4/ 2003 target will be adjusted in line with first round effects of planned VAT reform.
5/ For 2002, through end-November 2002, vis-à-vis U.S. dollar.
6/ Deposit taking institutions plus specialist financial institutions excluding the central bank. Through August 2002.
7/ Regulation limits net foreign liabilities to 5 percent and net foreign assets to 20 percent of regulatory capital.
8/ Observed credit to the private sector plus loan writeoffs and debt relief for mortgage loans.
9/ Broad money plus direct holdings of public sector debt and stocks.

Table 6. Colombia: Banking System Indicators

	1998	1999	2000	2001	2002 1/
(In millions of Colombian pesos, unless otherwise indicated)					
Total system 2/					
Assets	79,395	80,046	82,027	86,318	86,218
Investment portfolio	9,388	12,066	17,181	22,251	22,976
Loan portfolio	51,040	48,469	45,046	45,135	44,734
Of which: nonperforming loans	5,688	6,919	5,290	4,877	4,662
Capital	8,402	8,823	9,182	9,627	9,722
Operational margin 3/	-29	-1,366	-269	1,420	1,586
Net results	-1,613	-2,599	-1,511	417	905
(Annual percent change)					
Assets	7.2	0.8	2.5	5.2	4.4
Loan portfolio	7.8	-5.0	-7.1	0.2	-1.3
(In percent)					
Financial ratios					
Total system 2/					
Net interest margin to assets	4.1	3.0	3.4	2.9	3.2
Gross interest margin to assets	8.6	7.9	7.8	7.9	8.5
Operational margin to assets 3/	0.0	-1.7	-0.3	1.6	2.8
Return on equity	-19.2	-29.5	-16.5	4.3	14.0
Cash to assets	6.3	7.2	6.7	6.2	6.6
Investment portfolio to total assets	11.8	15.1	20.9	25.8	26.6
Nonperforming loans to total loans 4/	10.7	13.6	11.0	10.0	9.6
Loan-loss provisions to nonperforming loans	37.9	36.8	54.5	73.9	80.7
Capital to assets 5/	10.6	11.0	11.2	11.2	11.3
Mortgage banks					
Net interest margin to assets	4.6	4.1	5.0	3.2	3.3
Return on equity	-18.7	-17.3	-16.6	-0.5	11.3
Cash to assets	3.0	5.2	5.6	6.0	7.2
Investment portfolio to total assets	4.1	10.3	21.7	24.4	26.6
Nonperforming loans to total loans 4/	14.8	22.2	20.2	19.4	20.0
Loan-loss provisions to nonperforming loans	12.4	21.1	27.5	46.2	49.3
Capital to assets 5/	7.7	7.7	7.7	7.9	7.7
(In percent of private sector investment portfolio, unless otherwise indicated)					
Memorandum items:					
Private sector investment portfolio (percent of GDP)	15.1	19.0	23.2	28.2	33.3
Banks	44.3	41.8	42.6	41.5	36.1
Insurance companies	10.8	9.0	6.5	6.8	6.2
Mutual funds	2.8	3.5	3.0	3.1	2.5
Pension funds	23.9	27.6	28.6	29.4	26.9
Investment funds	18.2	18.1	19.4	19.1	28.3

Sources: Superintendencia Bancaria; and Fund staff estimates.

1/ Data to August 2002. To June 2002 for private sector investment portfolio.
2/ Excluding credit unions and public sector special institutions.
3/ Gross interest margin plus net provisions and administrative cost before depreciation and amortization.
4/ Nonperforming based on past-due period (30 days).
5/ Not risk weighted.

Table 7. Colombia: Summary Balance of Payments, 1998-2004

	1998	1999	2000	2001	Prog. 2002	2003	2004
	(In millions of U.S. dollars)						
Current account balance	**-5,225**	**510**	**424**	**-1,539**	**-1,409**	**-593**	**-1,207**
Trade balance	-2,450	1,775	2,531	510	919	2,074	1,602
Exports, f.o.b.	11,480	12,037	13,620	12,777	12,635	13,261	13,585
Coffee	1,893	1,324	1,069	764	745	805	978
Petroleum products	2,329	3,757	4,569	3,285	3,276	2,871	1,999
Nontraditional	5,420	5,279	6,201	6,613	6,639	7,536	8,259
Other	1,838	1,678	1,782	2,115	1,975	2,048	2,349
Imports, f.o.b.	13,930	10,262	11,090	12,267	11,717	11,186	11,983
Services (net)	-1,463	-1,205	-1,262	-1,383	-1,403	-1,488	-1,495
Income (net)	-1,758	-1,514	-2,514	-2,751	-2,887	-3,091	-2,900
Interest (net)	-1,761	-1,839	-1,885	-1,893	-1,968	-2,119	-1,827
Of which: public sector	-631	-809	-925	-1,109	-1,261	-1,489	-1,409
Other Income (net)	3	324	-629	-857	-919	-972	-1,072
Current transfers (net)	446	1,455	1,669	2,085	1,962	1,912	1,586
Capital and financial account balance	**3,725**	**-613**	**349**	**2,595**	**1,580**	**836**	**1,556**
Public sector (net)	1,453	625	575	1,449	741	247	423
Nonfinancial public sector	1,784	958	1,374	1,919	881	401	436
Medium- and long-term (net)	2,008	1,967	1,642	3,471	-1,233	295	200
Disbursements	3,607	3,690	3,205	5,751	2,042	3,353	3,181
Amortization	1,599	1,723	1,563	2,280	3,275	3,058	2,980
Other long-term flows	-15	-23	-40	-35	0	0	0
Short term 1/	-210	-986	-228	-1,518	2,114	106	236
Of which: change in assets	65	-861	-122	-1,540	1,917	306	236
Financial public sector	-331	-334	-799	-470	-139	-154	-13
Private sector (net)	2,272	-1,238	-226	1,146	838	589	1,133
Nonfinancial private sector (net)	3,019	-112	111	1,200	744	563	1,034
Direct investment	2,033	1,336	1,905	2,386	1,864	1,733	1,896
Of which: privatization	511	0	465	0	0	0	0
Leasing finance	532	226	-196	-169	-213	-146	-90
Long-term loans	285	-270	-346	247	-1,653	-616	-406
Short term 2/	170	-1,404	-1,252	-1,264	747	-407	-366
Financial private sector (net)	-748	-1,126	-337	-53	95	25	99
Net errors and omissions	**112**	**-216**	**97**	**162**	**0**	**0**	**0**
Changes in NIR	**-1,388**	**-319**	**870**	**1,218**	**171**	**243**	**350**
	(In percent of GDP)						
Current account balance	-5.3	0.6	0.5	-1.9	-1.7	-0.8	-1.6
	(In months of imports of goods and services)						
Gross international reserves 3/	7.8	6.8	6.8	8.0	8.6	8.3	8.3

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

1/ Includes movements of short-term assets owned by the public sector abroad.
2/ Includes net portfolio investment.
3/ Not including purchases from the Fund under the standby arrangement.

Table 8. Colombia: External Debt and Debt Service

	1998	1999	2000	2001	Proj. 2002
	(In millions of U.S. dollars)				
Total debt outstanding	36,606	36,667	36,398	39,781	37,552
Medium- and long-term 1/	32,644	33,653	33,502	36,043	32,742
Short term	3,961	3,014	2,897	3,737	4,810
Public sector debt outstanding	18,964	20,200	20,590	23,459	22,256
Medium- and long-term 1/	17,988	19,528	20,391	23,139	21,813
Short term	976	672	199	320	443
Private sector debt outstanding	17,642	16,466	15,808	16,322	15,296
Medium- and long-term 1/	14,656	14,125	13,110	12,905	10,929
Short term	2,985	2,341	2,698	3,417	4,367
Leasing	2,672	2,907	2,706	2,537	2,316
Public sector	240	91	86	86	78
Private sector	2,432	2,816	2,620	2,451	2,238
Total debt service	6,975	7,483	8,272	7,826	9,125
Public sector	3,321	3,395	3,648	4,494	5,253
Amortization 2/	2,096	2,091	2,115	2,823	3,513
Interest	1,225	1,304	1,533	1,671	1,740
Private sector	3,655	4,088	4,624	3,331	3,872
Amortization	2,309	2,848	3,472	2,405	3,090
Interest	1,346	1,240	1,152	926	782
	(In percent of GDP) 3/				
Total debt	40.2	45.3	46.7	48.1	52.8
Public sector	20.8	25.0	26.4	28.4	31.3
Private sector	19.4	20.4	20.3	19.7	21.5
	(In percent of exports of goods, services, and income)				
Total debt stock	255.7	248.3	220.2	252.9	245.1
Total debt service	48.7	50.7	50.0	49.7	59.2
Public sector 2/	23.2	23.0	22.1	28.6	34.1
Private sector	25.5	27.7	28.0	21.2	25.1
Interest	18.0	17.2	16.2	16.5	16.4
Public sector	8.6	8.8	9.3	10.6	11.3
Private sector	9.4	8.4	7.0	5.9	5.1
Amortization 2/	30.8	33.5	33.8	33.2	42.8
Reserves to short-term external debt 4/	1.0	0.9	1.1	1.0	1.0

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

1/ Includes leasing.
2/ In 2002, part of the increase in amortizations reflects a swap ($596 million) of external for domestic debt.
3/ Calculated using end of period exchange rates
4/ Short-term debt by remaining maturity.

Table 9. Colombia: Public Sector Debt

	1997	1998	1999	2000	2001	Proj. 2002
	(In percent of GDP)					
Total outstanding debt 1/	**31.5**	**34.1**	**42.2**	**47.2**	**50.5**	**55.0**
Domestic debt	13.5	13.2	17.2	20.8	22.1	23.7
External debt	18.0	20.8	25.0	26.4	28.4	31.3
Nonfinancial public sector debt	**27.3**	**29.8**	**37.2**	**42.3**	**45.8**	**50.2**
Domestic debt	12.8	12.2	15.5	18.2	19.0	20.6
External debt	14.6	17.6	21.7	24.1	26.8	29.5
Financial public sector debt	**4.2**	**4.2**	**5.1**	**4.9**	**4.7**	**4.8**
Domestic debt	0.8	1.0	1.8	2.6	3.1	3.1
External debt	3.4	3.2	3.3	2.3	1.6	1.7
	(In billions of Colombian pesos)					
Total public sector debt	**38,325**	**47,856**	**63,972**	**82,028**	**95,666**	**111,750**
Domestic debt 1/	**16,478**	**18,612**	**26,122**	**36,130**	**41,917**	**48,165**
Nonfinancial public sector	15,527	17,194	23,433	31,611	36,016	41,957
Central government	8,103	8,806	15,778	23,700	28,129	...
Territorial entities	4,964	4,800	5,016	5,089	5,298	...
Other public sector	2,459	3,588	2,639	2,822	2,589	...
Financial public sector	951	1,418	2,689	4,519	5,901	6,208
External debt	**21,847**	**29,245**	**37,850**	**45,899**	**53,749**	**63,585**
Nonfinancial public sector	17,743	24,722	32,883	41,922	50,777	60,117
Medium and long term	17,317	24,156	32,572	41,866	50,649	59,594
Central government	10,428	15,674	22,538	31,935	41,672	...
Territorial entities	3,330	4,318	5,355	6,159	6,115	...
Other public sector	2,999	3,399	3,839	3,016	2,342	...
Leasing and titularizations	561	765	839	756	520	...
Short term	426	566	311	56	128	523
Financial public sector	4,105	4,523	4,967	3,977	2,972	3,468
Medium and long term	3,318	3,584	4,019	3,589	2,367	2,726
Short term	786	939	948	388	605	743
	(In millions of U.S. dollars)					
External debt	**16,889**	**18,964**	**20,200**	**20,590**	**23,459**	**22,256**
Nonfinancial public sector	13,716	16,031	17,549	18,806	22,162	21,042
Medium and long term	13,387	15,664	17,383	18,781	22,106	20,859
Central government	8,061	10,164	12,028	14,326	18,188	...
Territorial entities	2,574	2,800	2,858	2,763	2,669	...
Other public sector	2,318	2,204	2,049	1,353	1,022	...
Leasing and titularizations	434	496	448	339	227	...
Short term	329	367	166	25	56	183
Financial public sector	3,173	2,933	2,651	1,784	1,297	1,214
Medium and long term	2,565	2,324	2,145	1,610	1,033	954
Short term	608	609	506	174	264	260

Source: Banco de la República: Estadísticas sobre Deuda Pública; and CONFIS.

1/ Excludes debt held by other public sector entities.

Table 10. Colombia: Medium-Term Outlook

(Baseline Scenario)

	2001	2002	2003	2004	2005	Proj. 2006	2007	2008	2009	2010
I. Output and Prices										
(Annual percentage changes)										
Real GDP	1.4	1.6	2.0	3.3	3.7	3.9	4.0	4.0	4.0	4.0
Consumer prices										
End of period	7.6	6.0	5.5	4.0	4.0	3.0	3.0	3.0	3.0	3.0
Period average	8.0	5.7	5.6	4.3	4.0	3.0	3.0	3.0	3.0	3.0
(In percent of GDP, unless indicated otherwise)										
II. Saving and Investment										
Gross national saving	**12.8**	**12.1**	**12.2**	**12.4**	**12.8**	**13.0**	**13.0**	**13.8**	**14.8**	**15.7**
Private sector	7.8	7.9	7.5	7.2	6.9	6.9	7.3	7.7	7.9	8.3
Public sector	5.0	4.2	4.7	5.2	5.8	6.1	5.7	6.1	6.9	7.5
Gross domestic investment	**14.7**	**13.8**	**13.0**	**14.0**	**14.6**	**14.8**	**15.3**	**16.3**	**17.0**	**17.5**
Private sector	6.5	5.6	5.9	6.8	7.4	7.6	8.0	9.0	9.6	9.9
Public sector capital expenditure	8.2	8.2	7.1	7.2	7.2	7.2	7.3	7.3	7.4	7.6
External current account balance	**-1.9**	**-1.7**	**-0.8**	**-1.6**	**-1.8**	**-1.8**	**-2.3**	**-2.5**	**-2.2**	**-1.8**
Private sector	1.3	2.3	1.7	0.5	-0.5	-0.7	-0.7	-1.3	-1.7	-1.6
Public sector	-3.2	-4.0	-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	29.3	29.5	30.7	29.8	30.1	30.0	29.2	29.2	29.3	29.3
Expenditure	33.0	33.9	33.2	32.0	31.6	31.2	30.9	30.5	30.0	29.7
Current expenditure	24.7	25.6	26.0	24.8	24.4	24.0	23.6	23.2	22.6	22.1
Capital expenditure	8.2	8.2	7.1	7.2	7.2	7.2	7.3	7.3	7.4	7.6
Primary balance	1.2	0.2	2.7	2.8	4.0	4.1	3.4	3.6	4.1	4.1
Overall balance	-3.5	-4.4	-2.5	-2.2	-1.5	-1.2	-1.7	-1.4	-0.7	-0.4
Combined public sector balance	**-3.2**	**-4.0**	**-2.5**	**-2.1**	**-1.4**	**-1.1**	**-1.6**	**-1.2**	**-0.5**	**-0.2**
External financing	2.3	0.9	0.3	0.6	1.0	0.7	1.2	1.0	0.3	0.1
Domestic financing	0.9	3.2	2.2	1.5	0.4	0.4	0.4	0.2	0.2	0.1
Privatization	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IV. Balance of Payments										
External current account balance	**-1.9**	**-1.7**	**-0.8**	**-1.6**	**-1.8**	**-1.8**	**-2.3**	**-2.5**	**-2.2**	**-1.8**
Of which										
Trade balance	0.6	1.3	2.9	2.2	1.8	1.9	1.9	1.7	2.0	2.3
Exports	15.4	17.7	18.7	18.3	18.1	18.0	18.1	17.9	17.9	17.8
Imports	14.8	16.5	15.8	16.1	16.3	16.1	16.1	16.2	15.8	15.5
Capital and financial account balance	3.1	2.0	1.2	2.0	3.2	2.9	3.4	3.3	2.6	2.3
Public sector	2.3	0.9	0.3	0.6	1.0	0.7	1.2	1.0	0.3	0.1
Private sector	0.8	1.0	0.9	1.5	2.3	2.1	2.2	2.2	2.3	2.2
Overall balance	1.5	0.2	0.3	0.5	1.4	1.1	1.2	0.7	0.5	0.5
V. Debt										
Total external debt 1/	**48.1**	**52.7**	**51.3**	**48.2**	**46.7**	**44.9**	**43.6**	**42.2**	**40.2**	**38.1**
Public debt 1/	28.4	31.3	31.3	30.1	29.6	28.7	28.3	27.7	26.5	25.1
Private debt 1/	19.7	21.5	20.0	18.1	17.2	16.2	15.3	14.5	13.7	13.0
Total public debt 1/	**50.5**	**55.0**	**55.5**	**54.3**	**52.6**	**50.6**	**49.2**	**47.5**	**45.1**	**42.6**
Domestic debt 1/	22.1	23.7	24.2	24.2	23.0	22.0	20.9	19.8	18.7	17.5
External debt 1/	28.4	31.3	31.3	30.1	29.6	28.7	28.3	27.7	26.5	25.1

Sources: Colombian authorities; and Fund staff estimates.

1/ Ratio calculated using the end-of-period exchange rate.

Table 11. Colombia: Indicators of External Vulnerability

(In percent of GDP, unless otherwise indicated)

	1998	1999	2000	Prel. 2001	Latest Obs.	Date of Obs.	Proj. 2002	2003	2004
Financial indicators									
Public sector debt (domestic and external) 1/	34.1	42.2	47.2	50.5	52.2	Jun-02	55.0	55.5	54.3
Broad money (percent change, 12-month basis)	10.2	8.4	1.2	5.8	2.8	Jul-02	5.0	7.4	7.0
Private sector credit (percent change, 12-month basis)	12.8	-2.0	-7.6	2.0	3.6	Jul-02	2.5	8.1	9.7
90-day time deposit rate	34.6	15.5	13.1	11.3	7.9	Sep-02	...	...	...
90-day time deposit rate (real)	15.3	5.7	4.0	3.4	1.8	Oct-02	...	...	...
External indicators									
Exports (percent change, 12-month basis in U.S. dollars)	-4.8	4.9	13.2	-6.2	-5.0	Sep-02	-1.1	4.9	2.4
Imports (percent change, 12-month basis in U.S. dollars)	-5.3	-26.3	8.1	10.6	-4.4	Aug-02	-4.5	-4.5	7.1
Terms of trade (percent change, 12-month basis)	-8.7	9.4	9.7	-5.3	...	2001	2.2	-3.1	-2.4
Non-oil terms of trade (percent change, 12-month basis)	-1.4	-2.6	-6.3	-1.7	...	2001	0.3	-0.7	0.2
Current account balance	-5.3	0.6	0.5	-1.9	-3.7	Jan-Jun,02	-1.7	-0.8	-1.6
Capital and financial account balance	3.8	-0.7	0.4	3.1	-2.3	Jan-Jun,02	2.0	1.1	2.0
Of which									
Inward short-term portfolio investment (debt securities, etc.)	0.3	-2.0	-1.2	-4.2	-4.4	Jan-Jun,02	1.8	0.5	0.0
Other investment (loans, trade credits, etc.)	-0.4	-1.3	-1.0	1.0	12.4	Jan-Jun,02	0.9	-0.9	-0.1
Inward foreign direct investment and long-term flows	3.8	2.7	2.6	6.4	-5.8	Jan-Jun,02	-1.5	1.6	2.1
Gross official reserves (billions of U.S. dollars)	8.7	8.1	9.0	10.2	10.7	Nov 20, 02	10.7	10.9	11.3
Central bank short-term foreign liabilities (millions of U.S. dollars)	0.7	1.4	1.9	52.9	2.5	Nov 20, 02	2.6	2.6	2.6
Short-term net foreign assets of the banking system (billions of U.S. dollars)	3.2	4.1	6.0	8.0	7.6	Jul-02	8.1	8.3	8.6
Official reserves in months of imports of goods and services 2/	7.8	6.8	6.8	8.0	8.4	Oct 2, 02	8.6	8.3	8.3
Broad money to reserves	3.7	3.6	2.7	2.5	2.2	Jul-02	2.0	2.0	2.0
Total short-term external debt to reserves 3/	101.8	106.1	90.2	100.9	97.0	Jun, 02	97.9	90.8	90.8
Total external debt 1/	40.2	45.3	46.7	48.1	42.2	Jun, 02	52.7	51.3	48.2
Of which									
Public sector debt 1/	20.8	25.0	26.4	28.4	26.1	Jun, 02	31.3	31.3	30.1
Total external debt to exports of goods, services, and income (percent)	255.7	248.3	220.2	252.9	232.2	Jun, 02	245.1	229.9	218.8
External interest payments to exports of goods, services, and income (percent)	18.0	17.2	16.2	16.5	18.2	Jan-Jun,02	16.4	16.4	16.1
External amortization payments to exports of goods, services, and income (percent)	30.8	33.5	33.8	33.2	50.9	Jan-Jun,02	42.8	36.2	33.3
Exchange rate (per U.S. dollar, end of period)	1,542	1,874	2,229	2,291	2,666	Nov 22, 02	...	...	...
Real effective exchange rate appreciation (+) (end of period) 4/	-4.6	-9.4	-2.4	5.5	-7.7	July, 02	...	...	...
Financial market indicators									
Stock market index 5/	1,086	998	713	1,070	1,493	Nov 21, 02	...	...	...
Foreign currency debt rating 6/	BBB-	BB+	BB	BB	BB	Nov 25, 02	...	...	...
Spread of benchmark bonds (basis points, end of period) 7/	...	423	755	514	686	Nov 25, 02	...	...	...

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

1/ Ratio calculated using end-of-period exchange rates.
2/ Not including purchases under the Stand-By Arrangement.
3/ Short-term debt is defined by its remaining maturity.
4/ Latest observation refers to percentage change from December 2001. Source INS.
5/ The index was changed in July 2001, so that the later numbers are not strictly comparable to earlier figures.
6/ Standard & Poors.
7/ J. P. Morgan Emerging Market Bond Index (EMBI+).

Table 12. Colombia: Indicators of Capacity to Repay the Fund, 2001-07 1/

	2001	2002	2003	2004	2005	2006	2007
Fund repurchases and charges							
In millions of SDRs	0.0	1.0	15.0	34.1	273.1	566.2	561.1
In millions of U.S. dollars	0.0	1.3	19.9	45.3	363.9	754.8	748.2
In percent of exports of goods and NFS	0.0	0.0	0.1	0.3	2.2	4.4	4.1
In percent of GDP	0.0	0.0	0.0	0.1	0.5	0.9	0.9
In percent of quota	0.0	0.1	1.9	4.4	35.3	73.2	72.5
In percent of overall debt service	0.0	0.0	0.2	0.5	4.1	8.3	8.2
In percent of gross foreign reserves	0.0	0.0	0.2	0.3	2.7	5.8	5.9
Fund credit outstanding							
In millions of SDRs	0.0	193.5	774.0	1,548.0	1,318.2	786.1	241.9
In millions of U.S. dollars	0.0	255.9	1,025.9	2,058.4	1,756.3	1,047.9	322.5
In percent of exports of goods and NFS	0.0	1.7	6.7	13.0	10.7	6.1	1.8
In percent of GDP	0.0	0.4	1.4	2.8	2.2	1.3	0.4
In percent of quota	0.0	25.0	100.0	200.0	170.3	101.6	31.3
In percent of overall debt service	0.0	2.8	12.2	24.8	19.9	11.5	3.5
In percent of gross foreign reserves	0.0	2.3	8.6	15.4	13.1	8.0	2.5
(In millions of U.S. dollars, unless otherwise indicated)							
Memorandum items:							
Exports of goods and NFS	14,971	14,812	15,427	15,806	16,429	17,238	18,250
Quota (millions of SDRs)	774	774	774	774	774	774	774
GDP	82,720	71,220	70,943	74,348	78,214	82,838	87,821
U.S. dollar per SDR (WEO projection)	1.257	1.323	1.326	1.330	1.332	1.333	1.333
Public sector external debt	23,459	22,512	23,224	24,443	24,887	24,797	25,154
Overall external debt service	7,826	9,126	8,438	8,293	8,809	9,121	9,130
Overall external debt	39,781	37,808	37,425	37,881	38,321	38,217	38,581
Gross foreign reserves	10,245	10,935	11,949	13,331	13,389	13,053	12,712

Source: Fund staff estimates.

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

Table 13. Colombia: External Financing Requirements and Sources

(In millions of U.S. dollars)

	1998	1999	2000	2001	Projections 2002	2003	2004
1. Gross financing requirements	**12,891**	**7,754**	**9,080**	**10,903**	**12,185**	**11,438**	**11,472**
External current account deficit	5,225	-510	-424	1,539	1,409	593	1,207
Debt amortization	**8,834**	**8,900**	**8,601**	**8,125**	**10,341**	**10,602**	**9,916**
Medium- and long-term debt	4,404	4,939	5,588	5,228	6,603	5,792	5,562
Public sector	2,096	2,091	2,115	2,823	3,513	3,279	3,111
Private sector	2,309	2,848	3,472	2,405	3,090	2,512	2,451
Short-term debt 1/	4,430	3,961	3,014	2,897	3,737	4,810	4,353
Public sector	936	976	672	199	320	443	243
Private sector	3,493	2,985	2,341	2,698	3,417	4,367	4,110
Gross reserves accumulation	-1,168	-636	903	1,239	434	243	350
2. Available financing	**12,891**	**7,754**	**9,080**	**10,903**	**12,185**	**11,438**	**11,472**
Foreign direct investment (net)	2,033	1,336	1,905	2,386	1,864	1,733	1,896
Medium- and long-term debt disbursements	**5,839**	**5,519**	**5,533**	**7,912**	**3,096**	**4,929**	**4,937**
Public sector	3,607	3,690	3,205	5,751	2,042	3,353	3,181
Of which:							
Multilaterals	...	...	...	...	1,108	2,724	1,698
Andean Development Corporation	...	...	...	...	313	350	375
Inter-American Development Bank	...	...	...	...	324	1,353	627
World Bank	...	...	...	...	471	1,021	696
Private sector	2,232	1,829	2,328	2,161	1,054	1,575	1,757
Public sector use of external assets 2/	65	-861	-122	-1,540	1,917	306	236
Short-term debt 3/	**3,961**	**3,014**	**2,897**	**3,737**	**4,810**	**4,353**	**4,518**
Public sector	976	672	199	320	443	243	243
Private sector	2,985	2,341	2,698	3,417	4,367	4,110	4,275
Other capital flows (net) 4/	993	-1,254	-1,132	-1,593	498	117	-116
Exceptional financing and arrears	0	0	0	0	0	0	0
Of which: IMF 5/	0	0	0	0	0	0	0
3. Financing gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum items (in stocks):							
Gross international reserves	8,740	8,103	9,006	10,245	10,680	10,923	11,272
Net international reserves (traditional concept) 6/	8,739	8,102	9,004	10,192	10,677	10,920	11,270
Net international reserves (program definition) 7/	...	8,113	8,800	9,982	10,300	10,543	10,893

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

1/ Original maturity of less than 1 year. Stock at the end of the previous period.

2/ In the balance of payments (Table 7), changes in assets abroad are included in short-term flows.

3/ Original maturity of less than 1 year. Stock at the end of the current period.

4/ Includes all other net financial flows, and errors and omissions.

5/ Assumes no purchases under the Stand-by Arrangement.

6/ The traditional balance of payments concept of net international reserves, which excludes central bank short-term foreign liabilities and liabilities to the Fund.

7/ Differs from the traditional concept since, among other things, foreign currency liabilities of the central bank to residents are excluded. See technical memorandum of understanding for a complete definition.

Table 14. Colombia: Performance Criteria 1/

	2002	2003			
			Indicative		
	Dec. 31	Mar. 31	Jun. 30	Sept. 30	Dec. 31
	Cumulative flows from beginning of calendar year (In billions of Colombian pesos)				
Overall balance of the combined public sector					
Floor	-8,350	-1,590	-3,240	-3,315	-5,490
	Inflation rate 2/ (12-month inflation rate)				
Inflation target					
Ceiling	6.0	6.1	5.9	5.7	5.5
	(In millions of U.S. dollars)				
Net international reserves of the Banco de la Republica					
Floor	10,300	10,360	10,420	10,480	10,540
	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	1,050	1,050	950
Change in the outstanding stock of short-term external debt of the public sector					
Ceiling	375	300	300	300	-180

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

1/ Definitions of concepts and adjustments to the performance criteria are explained in the technical memorandum of understanding.

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

Table 15. Colombia: Structural Benchmarks Under the SBA

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.
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.
June 30, 2003	Congressional approval of the Fiscal Responsibility Law. Introduction to congress of changes to the Budget Code (Ley Orgánica del Presupuesto). 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 regimes for teachers, the military, and other groups that will reduce the actuarial deficit of these regimes and raise additional cash savings. The actuarial deficit of the regime for the teachers will be reduced at least in a proportion similar to that proposed by the government for the general regime.
December 31, 2003	Congressional approval of the changes to the Budget Code. CONPES to finalize a plan to streamline the management of government property (*activos fisicos del Estado*) under which an assets 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. Divestiture of Bancafe.
March 31, 2004	Completion of a CONPES document to strengthen the government's legal defense service (*defensa jurídica del Estado*) 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 government's legal defence services (*defensa jurídica del Estado*). Restructure and bring Granahorrar to the point of sale.

Table 16. Colombia Schedule of Purchases Under the SBA 2002-04

	Amount (in millions of SDR)	Conditions
	193.50	Board approval
February 15, 2003	193.50	Observance of end-December 2002 performance criteria and completion of first review.
May 15, 2003	193.50	Observance of end-March 2003 performance criteria.
August 15, 2003	96.80	Observance of end-June 2003 performance criteria and completion of second review.
November 15, 2003	96.70	Observance of end-September 2003 performance criteria.
February 15, 2004	193.50	Observance of end-December 2003 performance criteria and completion of third review.
May 15, 2004	193.50	Observance of end-March 2004 performance criteria.
August 15, 2004	193.50	Observance of end-June 2004 performance criteria and completion of fourth review.
November 15, 2004	193.50	Observance of end-September 2004 performance criteria.

Source: Fund staff estimates.

Table 17. Colombia: Social Indicators

	1978	1988	1995	1999
Income per capita in U.S. dollars	881	1,297	2,562	2,212
Income share highest 20 percent/ lowest 20 percent	17.2	17.6	17.2	20.2
Average years of schooling , persons older than 18	6.2	7.7	8.4	8.9
Homicides (per 100,000 pop.) 1/	26	62	65	59
(In percent of relevant population)				
Poverty rate	80	65	60	64
Extreme poverty rate	45	29	21	23
Illiteracy rate (12 years or older)	5.3	3.3	2.8	2.6
Complete primary school (ages 12 to 17)	67.0	78.7	77.7	89.8
Complete high school (ages 18 to 22)	21.6	35.3	48.7	59.2
Child labor				
Ages 12 to 16	12	11.5	9.9	9.5
Ages 12 to 14	5.8	5.0	5.2	3.7
Access to public utilities				
Electricity 2/	63	99	100	99
Water	63	97	98	99
Telephone	NA	62	71	84
Sewerage	51	95	96	97

Source: Carlos Eduardo Velez. Poverty Report, The World Bank, 2002.

1/ 1999 figure refers to 1998.
2/ 1978 figure refers to 1974.

COLOMBIA: FUND RELATIONS

(As of October 31, 2002)

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	111.85	97.88

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	Dec. 20, 1999	Dec. 19, 2002	1,957.00	0.00

VI. Projected Obligations to Fund: None

VII. Safeguards Assessments:

Under the EFF arrangement that is expiring on December 19, 2002, Colombia was subject to the transitional procedures governing safeguards assessment. The staff found that the central bank's financial statements were not independently audited by auditors external to the central bank, using the criteria of International Standards on Auditing (ISA). At the staff's recommendation the bank appointed an external auditing firm that will issue an opinion to be published with its annual financial statement for 2002.

Under the proposed SBA Colombia will be subject to a full safeguards assessment. It is expected that the assessment will be completed by the first review. The central bank will provide TRE documentation to allow an off-site assessment (stage one). After this assessment, if necessary, a mission from TRE will visit Colombia to perform an on-site assessment (stage two). Any recommendations resulting from the assessment would be incorporated into the program at the time of the first review.

VIII. Exchange Rate Arrangement:

In January 1994, the Banco de la Republica (BR) adopted a managed float of the exchange rate vis-à-vis the U.S. dollar within a 14 percentage point band. The midpoint of the band was devalued by 9 percent in September 1998. In June 1999, the midpoint of the band was again devalued by 9 percent, the width increased to 20 percent points, and the slope reduced from 13 percent to 10 percent per year. Finally, in September 1999 the BR eliminated the band, floating the peso. Multiple currency practices that result from taxes on profit remittances from direct investment in Colombia and on foreign exchange earnings from personal services and transfers, and export tax credit certificates (CERTs) have not been approved under Article VIII. In April 2000, the BR reduced to zero the deposit requirement on external loans. At end-October 2001, the exchange rate was Col$2,773.7 per U.S. dollar.

IX. Last Article IV consultation:

The 2001 Article IV consultation was concluded by the Executive Board on March 28, 2001. The second review under the Extended Arrangement was completed by the Executive Board on March 28, 2001, and the third review was completed on January 25, 2002.

X. FSAP participation:

A joint IMF-World Bank mission visited Colombia in April, June, and July 1999 to conduct an assessment of the vulnerabilities of the financial system and propose the implementation of relevant financial standards. The Executive Board discussed the Financial Sector Assessment Program (FSAP) report (FO/DIS/99/172) at the time of the approval of the Extended Fund Facility (December 20, 1999).

XI. Recent Technical Assistance:

Dept.	Purpose	Time of Delivery
MAE	Financial sector stability assessment (FSSA)	May 1999
STA	Advice on government finance statistics	August 1999
STA	Advice on banking statistics	October 1999
FAD	Advice on tax policy	November 1999
FAD	Advice on tax administration	December 1999
FAD	Follow-up on customs administration	February 2000
MAE	Advice on the deposit insurance system	March 2000
STA	Advice on national accounts statistics	March 2000

FAD	Advice on the measurement of the deficit of the nonfinancial public sector	May 2000
FAD	Follow-up on customs administration	June 2000
STA	Advice on money and banking statistics	September 2000
MAE	Advice on banking restructuring issues	September 2000
MAE	Advice on banking supervision and regulation	December 2000
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

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: RELATIONS WITH THE WORLD BANK GROUP

(As of October 31, 2002)

I. BACKGROUND

The range of programs supported by the World Bank has encompassed various sectors: economic policy, water supply and sewerage, social protection, urban development, rural development, education, public sector governance, financial sector, private sector development, and environment. Between the 1997 and 2000 fiscal years, Colombia made average net repayments to the World Bank of US$64.5 million a year. Over the past two fiscal years (FY 2001 and FY 2002) the Bank made average net disbursements to Colombia of US$82.4 annually.

II. OBJECTIVES

The overriding objective of the World Bank's assistance program for Colombia is to support the government's efforts to achieve economic development and poverty reduction as a necessary, albeit not a sufficient, condition for peace. Finding the path to sustainable economic development will be an important foundation upon which Colombia will build national reconciliation and lasting peace. The Bank's strategy will support the following three areas: (a) achieving fast and sustainable growth; (b) sharing the fruits of growth; and (c) building a government of quality.

III. LENDING

The Colombia Country Assistance Strategy (CAS) progress report that was approved by the Bank's Executive Board on November 18, 1999, proposed a "high-case" lending program of an average of US$433 million for fiscal years 1998–2001. A new CAS is expected to be discussed by the Bank's Executive Board in January 2003. Commitments in FY 2001 amounted to US$185.5 million, while in 2002 they were US$482 million. Recently approved loans include a Social Sector Adjustment Loan (US$155 million), a Rural Productive Partnerships Project (US$32 million), a Structural Fiscal Adjustment Loan (US$400 million), and a Water Sector Reform Assistance Project (US$40 million), as well as smaller loans in the areas of judicial reform, and peace and development in FY 2001. A policy-based guarantee of a sovereign bond issue, using resources from the Financial Sector Adjustment Loan, was approved, and assisted the Government of Colombia in obtaining resource of US$1 billion from international capital markets. A Fiscal Reform Loan, a Programmatic Public Sector Reform, a Second Social Sector Adjustment Loan, and investment projects in the urban development and education sectors are under preparation for FY 2003.

IV. NONLENDING SERVICES (NLS)

The Bank prepared policy notes that were discussed with the Uribe administration in August 2002, spanning a wide range of sectors. They will be published in December 2002. Also, the Bank is undertaking analytical work to assist the government in identifying social sector efficiency. Additional studies deal with tax administration, public debt management, public expenditures, and a country financial accountability assessment. A comprehensive analysis of the labor market is also underway.

V. WORLD BANK TECHNICAL ASSISTANCE (TA)

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

VI. IFC

IFC's portfolio for Colombia stood at $339 million as of June 30, 2002, for a total of 16 projects, of which $188 million consisted of loans. IFC focuses on improving access to financing, particularly through the development of the domestic financial and capital markets; facilitating the investment supply response through support for the 'core' of the private sector; helping the private sector demonstrate tangible benefits of reform (e.g., infrastructure, housing finance, low income and small and medium enterprise/microfinance); and strengthening the natural resource sectors. In pursuing these objectives, IFC also focuses on activities that help improve the quality of growth—access to investment financing for underserved segments of the population, environmentally and socially sustainable business practices, and corporate governance.

VII. MIGA

Colombia became a full member of MIGA on November 30, 1995. As of September 30, 2002, MIGA's gross exposure in Colombia amounts to US$62.4 million, for a guarantee in the infrastructure sector. MIGA is currently analyzing other guarantees to support primarily infrastructure projects in the country.

Prepared by World Bank staff. Questions may be addressed to Ms. Connie Luff, Senior Country Officer, at (202) 458-5155.

Colombia: Financial Relations with the World Bank Group

(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed
I. IBRD Operations (active, as of October 31, 2002)			
Loans fully disbursed 1/	**8207.4**	**8207.4**	**0.0**
Current operations	**1253.2**	**667.0**	**554.6**
Economic policy	400.0	340.0	60.0
Education	67.2	33.4	33.8
Environment	5.0	1.4	3.6
Financial sector	15.0	7.4	2.1
Private sector development	12.5	8.9	3.6
Public sector governance	40.5	2.0	38.4
Rural sector	88.0	49.5	38.5
Social development	5.0	2.2	2.8
Social protection	255.0	42.9	212.1
Urban development	95.0	46.2	22.8
Water supply and sanitation	270.0	133.1	136.9
Total	**9460.5**	**8874.4**	**554.6**
Repayments		7906.8	
Total disbursed and outstanding		967.6	

II. IFC Operations (as of June 30, 2002)

	Loans	Equity (+Quasi)	Partici-pation	Total
Total commitments 1/	188.4	118.5	32.0	338.9
Total undisbursed	173.3	71.2	10. 7	255.2

III. IBRD Loan Transactions, per fiscal year (July 1–June 30)

	1997	1998	1999	2000	2001	2002
Disbursements	152.0	172.2	237.5	471.0	263.8	368.9
Repayments	379.8	394.3	238.8	278.1	225.1	242.9
Net disbursements	-227.8	-221.6	-1.4	192.8	38.8	126.0

Source: World Bank.

[1] Net of cancellations.
[2] Includes exchange rate adjustments and loans sold to and repaid by third parties.

COLOMBIA: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of October 28, 2002)

I. BACKGROUND AND OBJECTIVES

In August 1999, the IADB Board of Directors approved the Bank's strategy for Colombia for the period 1999–2001. The Bank and the Colombian government agreed on the following priority areas: (i) support the peace process by facilitating a national dialogue; (ii) help reduce poverty and inequality by increasing investment in human capital and easing access to basic social services; (iii) deepen the decentralization process by strengthening the power of civil society at local and regional levels; (iv) modernize the public sector by reforming public institutions and improving public finances; and (v) promote sustainable growth. At the beginning of 2002, this strategy was reconfirmed and its operational program was updated for the political transition period of 2002.

Currently, a new strategy for the period 2003–06 is being prepared. It will be presented for consideration of the Board of Directors by the first quarter of 2003.

II. LENDING

As of October 28, 2002, the IADB was executing 33 loans for an amount equivalent to US$2,223 million. These loans include projects to support the modernization reform process, the private sector, technical assistance and investment projects in the agricultural sector, transportation, water supply and sewerage, management of natural resources, and social development.

COLOMBIA: FINANCIAL RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of October 28, 2002)

I. IDB OPERATIONS

(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed amounts
Agricultural and rural development	116.5	63.5	53.0
Public sector management	496.8	238.4	258.4
Education	26.0	4.7	21.3
Population, health, etc. *(social investment)*	1,103.9	559.0	544.9
Transportation	100.0	87.8	12.2
Urban development	28.5	17.1	11.4
Water supply and sewerage	94.2	21.5	72.7
Natural resource management	156.0	139.9	16.1
Energy	1.9	1.9	0.0
Multisector	100.0	96.0	4.0
Total	**2,223.8**	**1,229.8**	**994.0**

II. IDB LOAN TRANSACTIONS

(In millions of U.S. dollars)

	1996	1997	1998	1999	2000	2001	2002
Gross disbursement	262.7	271.6	412.9	952.4	241.2	778.2	525.4
Amortization	458.6	575.0	366.9	441.8	447.7	417.2	857.4
Net disbursements	-195.9	-303.4	46.0	510.6	-206.5	361.0	-332.0

Source: IADB.

COLOMBIA: STATISTICAL ISSUES

The data provided by the authorities are generally adequate for surveillance, although the timeliness of public sector financial data needs to be improved. Colombia has subscribed to and is in observance of the Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB).

Real sector

The National Department of Statistics (DANE) is responsible for the compilation of the national accounts, though the Banco de la República (BR) compiles the financial accounts for this system of macroeconomic data. In 1999, the DANE revised the national accounts data by moving the base year from 1970 to 1994, improving the trade data by incorporating transactions in the free trade zones, and including part of the illegal activities in the national accounts.

Government finance statistics

The ministry of finance is responsible for the compilation on public revenue, expenditure, and financing data. The need for a comprehensive and timely monitoring of non financial public data under the EFF prompted efforts to reconcile above-the-line data, on revenue and expenditure, with financing data. While significant progress has been made, there is still a need to improve the timeliness and coverage of aggregate data, develop timely and reliable data on local government finances, and improve monitoring of floating debts by gradually extending the coverage from the central government to other public sector entities.

Although monthly data are reported for publication in IFS, annual data have not been reported for publication in the *2002 GFS Yearbook*. The last year reported was 1999.

Financial sector statistics

The BR is in charge of compiling and distributing data regarding the financial sector of Colombia, while the Superintendence of Banks and the Superintendence of Securities compile and distribute data in their respective areas. Fund technical assistance missions in the past have placed special emphasis on issues of data quality, interagency cooperation, and procedures to ensure data consistency data.

Balance of payments and external debt

The BR is in charge of compiling and distributing balance of payments data. Quarterly balance of payments data is produced since 1994, and the BR adopted the BPM5 standard in 1998. Balance of payment statistics have been extended to cover transactions in the free trade zones and improved surveys, particularly in the service sector, have enhanced coverage and consistency. Capital account data are now based on actual disbursement rather than registers. Issues remaining include the improvement in the cooperation between BR and DANE to

improve data compilation. It is also recommended that monthly data on public sector short-term external debt should be improved, and the calculation of interest payments for the private sector debt should be refined.

The BR compiles and disseminates data on international investment statistics and Data Template on International Reserves and Foreign Currency Liquidity.

Colombia: Core Statistical Indicators
(As of November 22, 2002)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Government Balance 1/	GDP GNP	External Debt
Date of latest observation	10/30/02	10/24/02	10/24/02	9/30/02	10/17/01	10/31/02	Oct. 2002	Sep. 2002	June 2002	Aug. 2002	June 2002	June 2002
Date received	10/31/02	10/31/02	10/31/02	10/15/02	10/31/02	10/31/02	11/12/02	11/12/02	Oct. 2002	Oct. 2002	Oct. 2002	Sept. 2002
Frequency of data	Daily	Daily	Daily	Monthly	Daily	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of reporting	Weekly	Weekly	Weekly	Monthly	Weekly	Weekly	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Quarterly
Data source 2/	BR	BR	BR	BR	BR	BR	DANE	BR/DANE	BR	CONFIS	DANE/DNP	BR
Mode of reporting	Fax/E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	Fax/E-mail	E-mail
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of Publication	Daily	Weekly	Weekly	Monthly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Quarterly

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

COLOMBIA: PUBLIC SECTOR MODERNIZATION PROGRAM

The public sector modernization program will help redefine the role and the size of the state in the economy by changing the government's own management systems, improving budgetary practices, strengthening the civil service career plan and streamlining the public sector wage bill, improving public sector contracting, and strengthening the legal defense of the state. Most of these programs require modification of the corresponding legal framework and administrative changes.

I. BILL TO MODERNIZE THE STATE

The Uribe administration initiated the modernization effort by taking actions to downsize the state shortly after assuming office. In August 2002, the government requested that congress grant the administration special powers to merge ministries and other public entities, create incentives for public sector workers to return to the private sector, eliminate the duplication of functions, and strengthen the use of information technologies in the public sector.

II. THE BUDGET LAW AND EXPENDITURE RIGIDITIES

Constitutional provisions and other legislation impose a rigid expenditure structure that significantly reduces the effectiveness of the budget as a management tool, and indeed as an economic policy instrument. The precommitted outlays include transfers to territorial governments for health and education, transfers to public universities and decentralized agencies with budgetary autonomy, and the wage bill for military and judicial personnel (83 percent of the total government wage bill). Other outlays are also inflexible, some because they entail earmarking of revenues (e.g., oil and mineral royalties). All in all, 95 percent of the budget is precommitted, leaving the government with effective control only over the expenditure of some goods and services payments and a small part of the public investment program (5 percent of the total budget, or 1.6 percent of GDP).

Modifying the Budget Law to help increase expenditure flexibility will improve fiscal management, and ensure consistency between annual spending plans and the medium-term fiscal objectives to be set out in the Fiscal Responsibility and Transparency Law, which is currently before congress. The budget reform will improve fiscal information by replacing an outdated classification system for government expenditure with one that is compatible with the international classification standard. In addition, the reform would allow the treasury to improve its cash management by establishing a unity of government accounts.

III. REFORM OF THE CIVIL SERVICE LAW

While the current Civil Service Law requires that jobs in the public sector be filled after open competition, the authorities want to change the system to ensure more transparent and competitive practices and provide appropriate incentives. One aspect of this is to eliminate any conflict of interest between the National Civil Service Commission and the Executive Branch, which oversees the commission.

The plan also calls for eliminating all current vacancies and reducing personnel by attrition. The authorities estimate that this plan is more cost effective than laying off workers and incurring severance costs. Under the plan, the staffing of the nonmilitary public sector would be reduced by 10–12 percent over a four-year period, and a new career plan will be implemented. This reform requires modifications of the Civil Service Law 448 (1998) and the granting by congress of the request for special powers to merge public entities.

IV. Reform of the Public Sector Contracting Law

Law 80 establishes generally accepted principles of transparency and disclosure for the process of securing contracts to provide goods and services to the public sector, and Colombia has a public registry of bidders. In addition, the General Comptroller's Office maintains an online information system for monitoring government contracting, which helps compare prices paid by public entities with market prices. However, there are some circumstances in which public entities do not need to follow the established contracting procedures. These include transactions related to real estate, technological goods and services, national defense and security hardware, "minor purchases," and goods and services associated with national disaster. The authorities intend to modify the law to simplify the contracting process, reduce the numerous exemptions to established procedures, and set new rules for evaluating leasing contracts.

V. Strengthening the Legal Defense of the State

Litigation against the state has increased sharply in recent years, with considerable losses for the state (0.2 percent of GDP in 2002). In addition, the state's ability to mount an effective defense has been eroded by high turnover of qualified legal staff. A lack of coordination between public entities on legal issues results in poor information, a duplication of efforts, and inefficient planning of cases. The Department of National Planning estimates that strengthening the public sector's legal defense would generate significant savings and is taking steps to do this by merging legal units, improving the career prospects for government lawyers, and providing incentives for successful management of legal disputes.

VI. The Fiscal Transparency and Responsibility Law

The Fiscal Transparency and Responsibility Law currently before congress will strengthen existing and establish new fiscal rules for national and territorial governments. A key objective of this reform is to establish annual primary balance targets for each level of government consistent with a preannounced path for the public finances over the medium term. Other rules include limits on budgetary carryovers (*rezago presupuestal*) and the establishment of debt rules for territorial governments. Though its focus is on fiscal transparency and consistency with macroeconomic objectives, the law will provide a framework that will support the modernization and downsizing of the state.

COLOMBIA: PENSION REFORM

I. BACKGROUND

In December 2002 the Colombian congress will decide on a second generation pension reform to modify the pension system established by Law 100 of 1993. At present the system is a heavy burden on the public finances; the proposed reform seeks to strengthen its finances and reduce the inequalities embedded in the system.

In 2001 the implicit pension liabilities[1] (IPL) stood at about 210 percent of GDP; the operational deficit of the public pension system was 3.1 percent of GDP and was projected to increase to 5.5 percent by 2010. The reform is expected to reduce the IPL to about 160 percent of GDP; it will be phased in gradually with annual savings rising progressively to 1 percent of GDP in 2010 as the transition to the new rules takes effect.

Prior to the 1993 reform, Colombia had a pay-as-you-go (PAYG) defined benefit pension system consisting of a large number of coexisting pension plans: three systems for government employees comprising 56 national and 991 regional funds, several decentralized and public enterprise funds; and a mandatory pension scheme for private sector employees administered by the Social Security Institute (*Instituto de Seguro Social, ISS*). There were also pension plans administered by insurance companies for voluntary pension supplements subscribed to by private and public sector workers and by private firms.

The old system varied widely between different regimes, and in general suffered from serious imbalances that rendered the system unsustainable: benefits were too high and contributions too low. Retirement ages were 60 for men and 55 for women in the ISS system, five years more than in the public sector schemes. Pensions for private sector workers were granted with as little as 500 weeks of contributions and were defined relative to average nominal wages two years before retirement with a replacement ratio ranging from 75 for most public sector employees to 45–90 for private sector workers, depending on the salary base and period of contribution. Some special regimes provided pensions with replacement ratios above 100 percent. Contributions for public sector employees were generally zero while for ISS affiliates contributions were 6.5 percent of wages.

II. THE 1993 REFORM

The 1993 reform created a fully funded defined contribution (DC) pension system as an alternative to the publicly administered system. This system is privately administered and competes with the ISS for affiliates. The law envisaged that all the insolvent public pension

[1] The implicit pension liabilities are the present value of future net obligations for retirement pensions.

funds would be closed; the others would remain open to pay pensions but would not be allowed to accept new affiliations. Pension payments from the closed funds would be taken over by a centralized entity (FOPEP) and by specialized regional entities. A fund to finance future pensions (FONPET) for territorial government employees was created in 1999. However, three public pension schemes were not included in the reform: those of the security services (military and police), the teachers, and the state oil company (Ecopetrol), about 45 percent of public employees.

By the early 1990s the deficit of the old pension system was already increasing rapidly. However, despite the significant changes introduced in 1993 the system remained unbalanced and it soon became evident that further reforms would be needed. The failure to equilibrate the system better at that time reflected political difficulties in approving a more ambitious reform. The pension contributions for the ISS and the private systems were raised initially to 8 percent and subsequently to 13.5 percent of salaries; the minimum contribution period was increased to 1,000 weeks, for which the replacement ratio was set at 65 percent; the salary base was computed as the average of the last 10 years prior to retirement; and the retirement age was increased to 62 and 57 years for men and women respectively. The new parameters would be applied only to affiliates retiring in 2014 or later.

Law 100 made affiliation with one of the two regimes mandatory for public employees and private sector workers, and voluntary for independent workers. Switching back and forth between regimes was allowed every three years. Male workers older than 40 and female workers older than 35 had to stay in the former system, while younger workers could choose between the two regimes. Affiliates with the insolvent public funds could choose between joining the private scheme or the ISS.

Currently, the contributions of people who choose the private system are directed to individual pension accounts managed by six pension fund administrators (AFPs) that compete for the administration of these funds.[2] Both the AFPs and the ISS are regulated by the Superintendency of Banks. The law regulates the portfolio of the AFP by type of investment.

When switching to the private system affiliates of the ISS receive recognition bonds issued by the government to compensate them for the pension contributions already

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[2] In August 2002 the AFPs had 4.6 million affiliates, of which 2.2 million were making regular contributions. The value of the managed funds was US$5.2 billion. The average real rate of return since inception of the system was 7.3 percent, larger than the 2.25 percent rate required by the law. To date the AFPs have granted only around 10,000 pensions. Fifty percent of their portfolio consists of government debt, 22 percent of financial institutions' bonds, and 20 percent of debt from institutions not regulated by the Superintendency of Banks. Twenty four percent of the portfolio is denominated in U.S. dollars.

made. The value of the bond is calculated as the present value of pension entitlements accumulated under the public system. This bond is deposited in the AFP and accrues interest while the holder remains active. When the person retires, the bond is redeemed and the proceeds, together with the funds accumulated in the private account, can be used in three different ways: to buy an annuity from an insurance company; to start a series of phased withdrawals; or a combination of the two. The bond can be redeemed earlier if the holder opts for early retirement, receives a disability pension or dies, in which case a survival pension is assigned to the spouse. Early retirement is possible if the balance in the individual account is enough to finance a pension of at least 110 percent of the minimum wage. By October 2002 the equivalent of US$22 billion of recognition bonds had been issued.

The 1993 reform also created a solidarity pension fund to subsidize the contributions of workers who are incapable of making the entire contribution. This fund is financed by an additional 1 percent contribution by workers earning more than four minimum wages.

Law 100 went a long way towards addressing the fiscal imbalances and the inequities inherent in the previous regime. Nonetheless, a reduced but persistent disequilibrium between contributions and benefits remained, and—as it turned out—was aggravated by the larger than anticipated transfers of affiliates to the AFPs (only 10 percent of entrants to the labor force have opted for the PAYG system in the last four years). Furthermore, the existence of exempted regimes prolongs a subsidy to privileged groups that imposes a large fiscal cost.

III. The Proposed Reform

The current pension reform strategy has two components: (i) the proposal to be voted by congress in December to reform the general pension regime regulated by Law 100, including a request for special powers for the administration to modify the privileged regimes; and (ii) pension issues to be decided in the referendum early next year.

The attached table lists the main elements of the current proposal to modify the general pension system and presents a comparison with the existing regime. Some of the changes are the following: retirement ages for both men and women and the minimum contribution period will increase in 2009 and again in 2018; contribution rates will rise by 2 percentage points, a new formula to compute the replacement ratio will be introduced, and the base salary will be averaged over a longer period. The new parameters are devised to balance the system in the long run, e.g., new entrants will not increase the IPL. Short-term fiscal savings are realized through an increase in contributions and a reduction of management fees charged by AFPs. The latter saving will be used to finance the minimum pension guarantee, currently under government responsibility. The benefits of the other elements of the reform accrue after a transition period when the changes take effect. A limitation on switching between the public and private regimes will help improve the finances of the ISS by reducing arbitrage practices and administration costs. Introducing a Unified Registry of Contributors (URC) for all social security programs seeks to reduce fraudulent behavior and enhance the efficiency of the system.

The proposal also establishes guidelines to modify the regimes excluded by Law 100, and seeks special powers to change them. The teachers' pension plan will remain open but the government has indicated that it will seek to align this plan more closely with the general regime. The proposed law increases the teachers' pension contributions from 3 percent to 18 percent of salaries and also requires the pension contributions of new uniformed personnel of the security forces to be computed over a broader salary base, including nonwage items hitherto excluded, and the pensions of civilian personnel will be aligned with those of other public servants. Only the changes to the teachers' regime are expected to generate savings; the proposal for the security forces is mainly designed to make their pension system more equitable. The proposed law incorporates new employees of Ecopetrol into the general pension system but the implementation of the new rules is contingent upon a change in the company's collective bargaining agreement. More specific features of the reform for these regimes are not yet defined.

Other issues related to pensions will be addressed by the national referendum scheduled for early next year. The referendum will seek to cap new pensions of public servants at 20 minimum salaries, equalize their retirement age with that of the general pensions system, and freeze for two years all pensions under public responsibility and for four years those of high government officials. In addition, the revenue transfers from the central to the territorial governments that cannot be spent because of the proposed expenditure freeze, will be allocated to the FONPET and the teachers' and health sector's pension funds.

Several of the key elements of the reform have been subject to intense public discussion, and in congress alternatives are being considered, among them: deferring the change in retirement age until 2014 as established in Law 100; a more gradual increase in the minimum number of weeks required for a pension; a reduction in other wage deductions[3] compensated by increased pension contributions to pre-fund pension liabilities and different approaches to deal with the exempted regimes.

The existing pension system poses a serious problem for Colombia's fiscal accounts and for the public sector's ability to honor its future pension obligations. Failure to implement a substantial reduction of the pension system deficits would require additional fiscal adjustment. Sustaining large pension deficits also has negative social implications: the scarcely 20 percent of the population with access to pensions would continue to receive large subsidies from the rest of society to the extent general public resources are used to subsidize pensions. With the poverty rate in Colombia at 65 percent and unemployment at 17 percent resources needed for other social objectives would be tied up in subsidizing a pension system that benefits a small proportion of the population.

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[3] Payroll deductions of 9 percent of wages (*cargas parafiscales*) are used to finance family welfare, worker training and private institutions for social development.

Figure 1. Total Deficit of Public Pension System

(In percent of GDP)

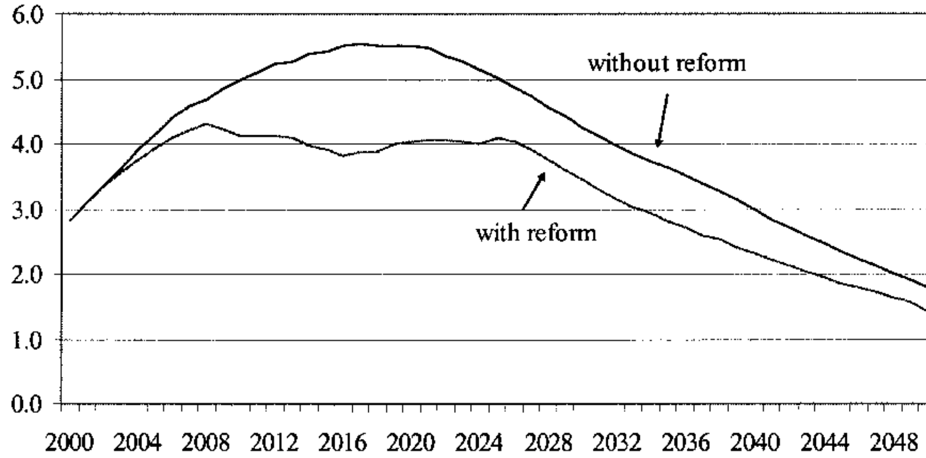


Figure 2. Operational Deficit of Public Pension Regimes

(In percent of GDP)

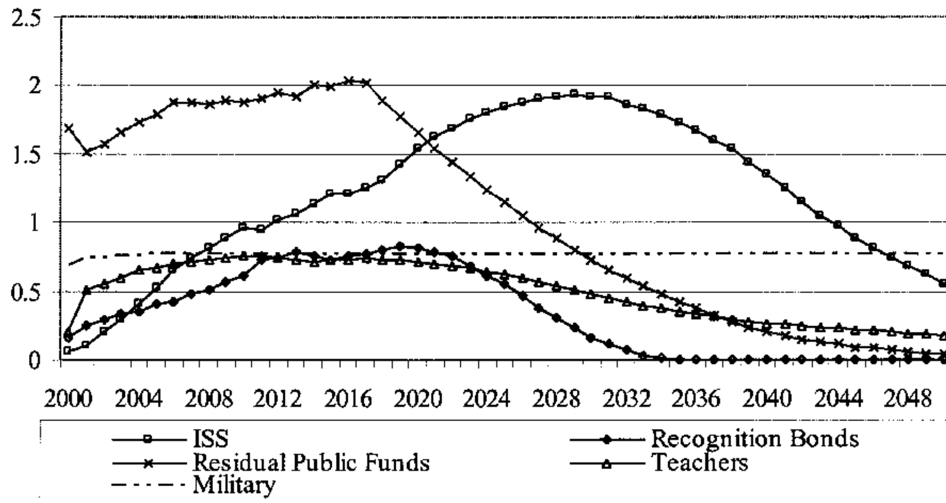


Table 1. Main Elements of the Pension Reform

	Current system (Law 100)	**Proposed reform**
Contribution rates	13.5%	Increases to 14.5% in 2004 and 15.5% in 2005
Use of contributions	10% for pension payments and personal accounts 3.5% for administrative costs, disability and survival pensions, and insurance costs	11% for pension payments and personal accounts 3% for administrative costs, disability and survival pensions, and insurance costs 1.5% for minimum pension guarantee
Additional contributions	1% for those earning more than 4 minimum salaries	1% for those earning more than 4 minimum salaries and another 1% for those earning more than 20 minimum salaries (for Solidarity Pension Fund)
Pensionable age	55 for women and 60 for men Beginning 2014, increases to 57 and 62	Increases to 58 years for women and 62 for men in 2009, and to 62 and 65 in 2018
Contribution weeks to be eligible for a pension	1000	Increases to 1200 in 2009 and to 1300 in 2018
Pension in terms of base salary	Minimum: 65% Maximum: 85%	Minimum: 55.5% Maximum: 80%
Maximum pension in terms of minimum salaries	"Could" be limited to 20 minimum salaries	20 minimum salaries
Base salary	Average income over the last 10 years. Minimum: 1 minimum salary. Maximum: 20 minimum salaries	Average income over the last 20 years Minimum: 1 minimum salary Maximum: 20 minimum salaries for those in the system already, 25 for new entrants
Replacement ratio	1000 weeks: 65%. 1000–1200 weeks: 2% more for every 50 weeks. 1200–1400 weeks: 3% more for every 50 weeks up to 85%	From 2009: 1200 weeks: 65% to 55.5%, inversely related to the base salary. 1200–1500 weeks: 1% more for every 50 weeks. 1500–1800 weeks: 1.5% more for every 50 weeks Starting in 2018:

		1300–1800 weeks: 1.5% more for every 50 weeks.
Solidarity Pension Fund	To subsidize pension contributions for those earning less than 1 minimum salary	To provide subsidies to indigents subject to budget availability and to subsidize pension contributions for those earning less than 1 minimum salary
Financing of Solidarity Pension Fund	50% of the 1% surcharge for those earning more than 4 minimum salaries	50% of the 1% surcharge for those earning more than 4 minimum salaries plus the 1% surcharge for those earning more than 20 minimum salaries
Minimum pension	1 minimum salary	1 minimum salary. Needs at least 1150 weeks, increasing to 1200 weeks in 2009 and 1300 in 2018
Minimum pension guarantee in the private regime	Unfunded. Guaranteed by the government	Funded from affiliates' contributions
Centralized registry	No	Will be established to avoid multiple pensions
Movement between regimes	Unlimited every 3 years	Once every 5 years. Not allowed during last 10 years before pension

Colombia: Public Debt Sustainability

I. Background

The public debt in Colombia has increased sharply after the economic crisis in 1998–99, when the economy experienced the worst recession since the 1930s and the public debt ratio increased by 8 percentage points of GDP due to a widening of the fiscal deficit and a sharp fall in the external value of the peso. Although substantial fiscal adjustment was implemented in 2000 and 2001, the debt ratio has risen by an additional 13 percent of GDP since the crisis, much of it due to the fiscal slippage and the depreciation of the peso in 2002. As a result, Colombia's public debt increased from 34 percent of GDP in 1998 to 55 percent of GDP at the end of 2002 (Table 1). More than 50 percent of the increase in the public debt during this period was due to the devaluation of the peso.

Fiscal slippages and low economic growth have raised concerns this year about the sustainability of Colombia's public debt, as reflected in pressure against the peso and a sharp widening of the spread on Colombian sovereign bonds. The following sections present medium term projections of the public debt (2003–10) based on the government's adjustment program, and a sensitivity analysis to examine the impact of changes in key macroeconomic variables on the debt level.

II. Baseline Scenario

The main assumptions under the baseline scenario (see Table 1) are:

- *GDP growth rate:* A moderate recovery of real GDP growth to 2 percent in 2003 (from 1.6 percent in 2002), and a gradual increase during the period 2004–07, with the growth rate stabilizing at 4 percent thereafter.

- *Inflation rate:* A gradual convergence to international levels.

- *Interest rates:* An increase in LIBOR over the medium term consistent with the latest WEO projection, and stable interest rates for domestic debt. The sovereign spread on Colombian debt would fall somewhat over the medium term, as the fiscal consolidation proceeds and output recovers.

Table 1. Colombia: Baseline Scenario

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Output and Prices															
(Annual percentage changes)															
Real GDP	2.1	3.4	0.6	-4.2	2.7	1.4	1.6	2.0	3.3	3.7	3.9	4.0	4.0	4.0	4.0
Consumer prices															
End of period	21.6	17.7	16.7	9.2	8.7	7.6	6.0	5.5	4.0	4.0	3.0	3.0	3.0	3.0	3.0
Period average	20.8	18.5	18.7	10.9	9.2	8.0	5.7	5.6	4.3	4.0	3.0	3.0	3.0	3.0	3.0
Exchange rate (+ depreciation)															
Nominal eop	...	28.7	19.2	21.5	19.0	2.8	24.7	8.0	3.0	2.0	1.0	1.0	1.0	1.0	1.0
Real eop	...	5.1	4.6	9.5	2.4	-5.5	17.3	5.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
(In percent, period average)															
Interest rate															
External debt	...	7.2	7.3	7.4	7.2	9.3	8.4	8.4	9.7	9.6	10.1	10.1	10.1	10.1	10.0
Domestic debt	...	17.0	19.1	19.0	18.9	14.4	11.4	12.7	12.4	12.3	11.9	12.0	11.9	11.9	11.9
(In percent of GDP, unless otherwise indicated)															
II. Public Sector															
Nonfinancial public sector															
Primary balance	-0.1	-1.4	-0.7	-2.2	0.9	1.2	0.2	2.7	2.8	4.0	4.1	3.4	3.6	4.1	4.1
Overall balance	-3.0	-3.9	-4.6	-6.4	-3.5	-3.5	-4.4	-2.5	-2.2	-1.5	-1.2	-1.7	-1.4	-0.7	-0.4
Combined public sector balance	-3.0	-3.9	-3.8	-5.5	-3.4	-3.2	-4.0	-2.5	-2.1	-1.4	-1.1	-1.6	-1.2	-0.5	-0.2
III. Public Debt															
Total public debt	27.8	31.2	34.1	42.2	47.2	50.5	55.0	55.5	54.3	52.6	50.6	49.2	47.5	45.1	42.6
Domestic debt	11.4	13.3	13.2	17.2	20.8	22.1	23.7	24.2	24.2	23.0	22.0	20.9	19.8	18.7	17.5
External debt	16.5	18.0	20.8	25.0	26.4	28.4	31.3	31.3	30.1	29.6	28.7	28.3	27.7	26.5	25.1

Sources: Colombian authorities; and Fund staff estimates.

- *Public sector deficit:* A fiscal effort that brings the primary surplus of the consolidated public sector from 0.2 percent of GDP in 2002 to an average of about 3.5 percent of GDP during 2003–10, consistent with the government's program for 2003–04.[1]

[1] Total revenue would remain unchanged in terms of GDP between 2002 and 2010, with tax revenue increasing by about 2 percent of GDP, offsetting a decline in oil revenue. Total expenditure would be reduced by more than 4 percent of GDP.

- *Exchange rate:* A moderate depreciation of the real exchange rate in 2003, followed by a broadly stable real rate during the rest of the decade.
- *Oil output:* The baseline incorporates conservative medium term projections, as explained in the main text of the staff report.

Under these assumptions, the public debt ratio would peak in 2003 at 55.5 percent of GDP, and fall in 2004 for the first time in eight years (see Table 1). Although the baseline scenario shows an increase in the primary surplus in 2003, the real exchange rate assumption keeps the debt ratio rising somewhat. Further fiscal adjustment in 2004 and the stabilization of the real exchange rate results in the reduction of the debt ratio.

The public debt would converge to about 45 percent of GDP towards the end of the decade. This is mainly due to the tight fiscal policies that raises the primary surplus. Moreover, towards the end of the decade, the increased savings from the pension reform, lower interest payments, and higher real GDP growth accelerate the debt reduction, with the debt ratio falling by more than 4 percentage points of GDP over 2009–10.

III. Sensitivity Analysis

A sensitivity analysis was carried out following the standard sensitivity tests developed by the Fund (Table 2). According to the analysis, the public debt is particularly sensitive to exchange rate shocks; a real depreciation of about 30 percent relative to the baseline would raise the debt to 70 percent of GDP in 2003, before declining to 62 percent of GDP in 2010. Weaker output performance than in the baseline also would have an impact. If real GDP falls by about 3 percent during 2003 and 2004 (instead of growing by about 2–3 percent as assumed in the baseline), the debt would increase to about 10 percent of GDP above the baseline in 2010. The analysis also shows that an interest rate increase or a deterioration of the primary balance during 2003–04 would keep the debt ratio above 55 percent by the end of the decade.[2]

[2] The debt sustainability framework is described in SM/02/166. In the Fund's standard sensitivity tests, the shocks are defined as the variables' average value plus or minus two standard deviations calculated over the period 1992–2001.

Table 2. Colombia: Sensitivity Analysis
Temporary and Permanent Changes in the Macroeconomic Scenario Under Baseline Fiscal Policies

(In percent of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Standard Sensitivity Tests for Public Debt Ratio									
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007	55.0	50.6	45.4	40.9	36.3	32.1	28.3	24.8	21.6
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004	55.0	60.7	64.9	63.6	62.0	61.0	59.8	58.0	56.0
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	55.0	58.8	61.8	60.4	58.7	57.6	56.3	54.3	52.2
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004	55.0	61.1	65.8	64.5	63.0	62.1	60.9	59.1	57.2
5. Combination of 2-4 using one standard deviation shocks	55.0	59.9	63.9	62.6	61.0	60.0	58.7	56.8	54.8
6. One time 30 percent real depreciation in 2003 7/	55.0	70.6	69.9	68.8	67.5	66.7	65.7	64.2	62.4
7. 10 percent of GDP increase in other debt-creating flows in 2003	55.0	65.5	64.7	63.4	61.8	60.8	59.6	57.8	55.8
Memorandum items: 1/									
Primary balance (average)	0.7								
Primary balance (standard deviation)	1.8								
Nominal interest rate (average)	11.6								
Nominal interest rate (standard deviation)	0.9								
Real interest rate (average)	-7.6								
Real interest rate (standard deviation)	11.0								
Real GDP growth (average)	2.6								
Real GDP growth (standard deviation)	3.0								
II. Permanent Changes in Macroeconomic Scenario									
Total public debt if,									
Interest rate is 1% higher than in baseline after 2002	55.0	56.1	55.4	54.3	52.8	52.0	50.9	49.2	47.3
GDP growth is 1% lower than in baseline after 2002	55.0	56.1	55.5	54.4	53.0	52.2	51.2	49.5	47.7
1% real depreciation in relation to baseline after 2002	55.0	55.9	55.1	53.7	52.1	51.0	49.7	47.8	45.6

1/ These are used to calculate the shocks to the variables in the baseline scenario. Averages and standard deviations calculated for the period 1992-2001.

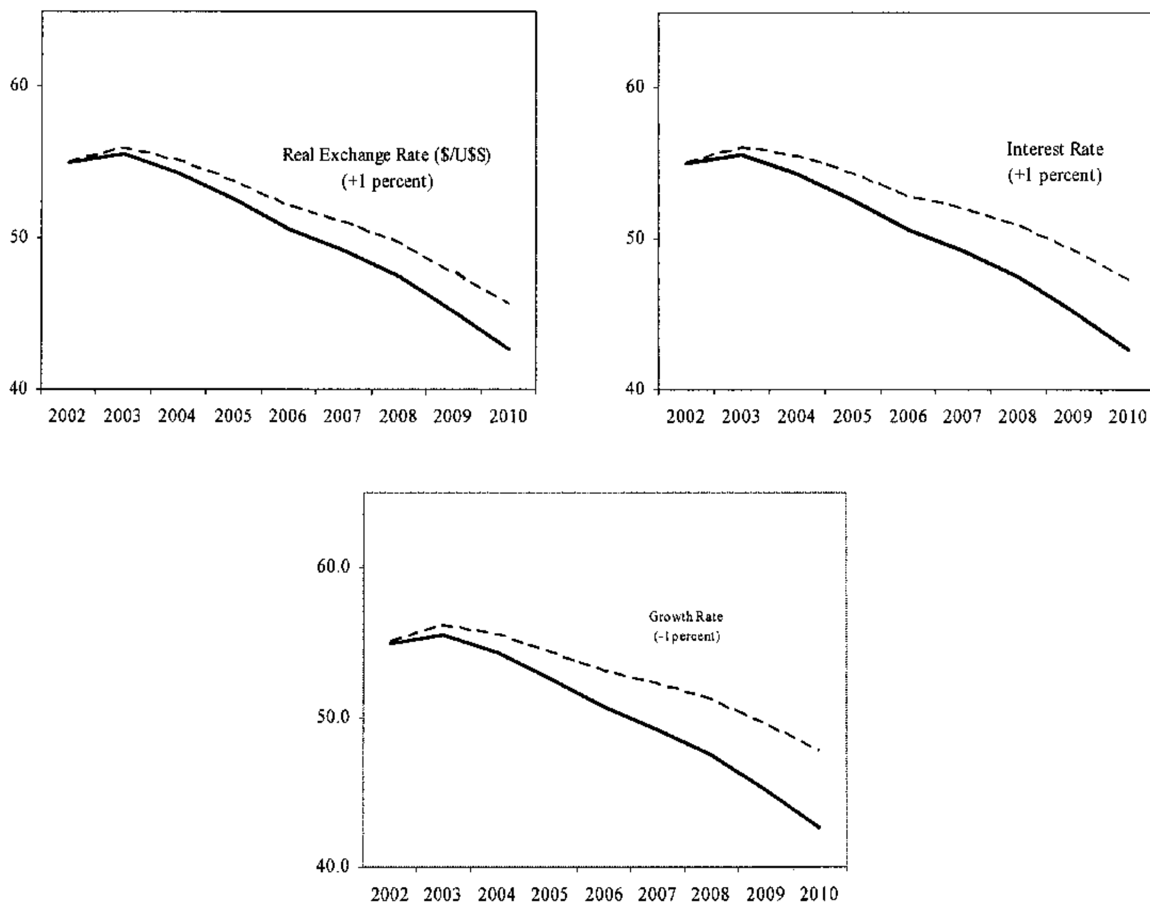
A second set of sensitivity analysis focuses on how marginal changes in the macroeconomic environment will affect the debt profile.[3] The exercise assumes that,

[3] The rationale behind this exercise is twofold. First, as the Fund's standard sensitivity tests perform partial equilibrium analysis (in most cases, analyzing the effect of shocks to one variable while leaving others unchanged), introducing large shocks may be misleading, because the assumption that other variables remain unchanged may be unrealistic. To avoid this problem, the sensitivity tests presented here analyze "marginal" changes. Second, while
(continued)

although key macroeconomic variables change (the exchange rate, interest rates, or the growth performance), the fiscal deficit is reduced as envisaged in the baseline. Approximately, a one percent real depreciation of the peso per year (in relation to the baseline) would increase the debt stock by 0.4 percent of GDP in 2003, and add 3 percentage points to the baseline ratio by 2010. Similarly, for each percentage point interest rates exceed the baseline, the debt stock would increase by more than 0.5 percent of GDP in 2003 and about 5 percent of GDP by 2010. A lower annual growth rate by 1 percentage point would have about the same effect as the increase in interest rates. In sum, this analysis suggests that small permanent deviations of key macroeconomic variables would each leave the debt at just below 50 percent of GDP at the end of the decade (see Table 2 and Figure 1).

Figure 1. Public Debt Sensitivity Analysis

(In percent of GDP)

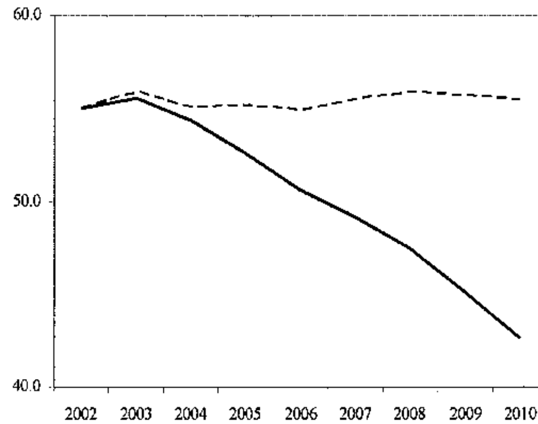


standard Fund sensitivity tests emphasize situations where large shocks are tested, this exercise focuses on permanent, but small deteriorations in key macroeconomic variables, not associated with a crisis at any point in time.

The third sensitivity analysis examines cases in which a deterioration of the macroeconomic environment may coincide with a weakening of the fiscal program. In this test the real exchange rate is more depreciated than in the baseline by about 1 percent per year, the interest rate is permanently 100 basis points above the baseline, the real GDP growth rate is 1 percent lower per year, and the primary surplus is permanently weaker than in the baseline by 0.5 percent of GDP. On these assumptions, the overall fiscal position would weaken more than the primary balance,[4] and the public debt ratio increases to 56 percent of GDP in 2003 and stays about that level through 2010, instead of falling from 55 percent of GDP to 42 percent over those years, as in the baseline scenario (Figure 2 and Table 3).

Figure 2. Effect on Debt of a Worsening Fiscal and Macroeconomic Scenario

(In percent of GDP)



[4] By 2010, the overall fiscal deficit would be 2.8 percent of GDP higher than in the baseline.

Table 3. Colombia: Sensitivity Analysis
Low Growth Macroeconomic Framework 1/

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Output and Prices															
(Annual percentage changes)															
Real GDP	2.1	3.4	0.6	-4.2	2.7	1.4	1.6	1.0	2.3	2.7	2.9	3.0	3.0	3.0	3.0
Consumer prices															
End of period	21.6	17.7	16.7	9.2	8.7	7.6	6.0	6.0	5.0	4.0	3.5	3.5	3.5	3.5	3.5
Period average	20.8	18.5	18.7	10.9	9.2	8.0	5.7	5.0	4.4	4.0	3.5	3.5	3.5	3.5	3.5
Exchange rate (+ depreciation)															
Nominal eop	...	28.7	19.2	21.5	19.0	2.8	24.7	9.2	4.1	3.1	2.5	2.6	2.6	2.6	2.6
Real eop	...	5.1	4.6	9.5	2.4	-5.5	17.3	6.4	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Interest rate															
External debt	...	7.2	7.3	7.4	7.2	9.3	8.4	9.4	11.1	11.0	11.6	11.6	11.6	11.6	11.6
Domestic debt	...	17.0	19.1	19.0	18.9	14.4	11.4	13.7	14.5	13.6	13.7	13.8	13.8	13.7	13.7
(In percent of GDP, unless otherwise indicated)															
II. Public Sector															
Nonfinancial public sector															
Primary balance	-0.1	-1.4	-0.7	-2.2	0.9	1.5	0.2	2.3	2.3	3.5	3.5	2.9	3.1	3.6	3.6
Overall balance	-3.0	-3.9	-4.6	-6.4	-3.5	-3.5	-4.4	-3.0	-2.7	-3.0	-2.7	-3.5	-3.4	-3.0	-3.0
Combined public sector balance	-3.0	-3.9	-3.8	-5.5	-3.4	-3.2	-4.0	-2.9	-2.7	-2.7	-2.6	-3.4	-3.5	-3.1	-3.2
III. Public Debt															
Total public debt	27.8	31.2	34.1	42.2	47.2	50.5	55.0	55.8	55.1	55.1	54.9	55.4	55.8	55.7	55.5
Domestic debt	11.4	13.3	13.2	17.2	20.8	22.1	23.7	24.3	24.4	24.7	25.0	25.6	26.2	27.0	27.9
External debt	16.5	18.0	20.8	25.0	26.4	28.4	31.3	31.6	30.7	30.4	29.9	29.9	29.6	28.7	27.6

Sources: Colombian authorities; and Fund staff estimates.

1/ As described in Section III of the appendix.

IV. Conclusions

If fully implemented, the government's program will halt the rise in public debt in 2003, reverse it in 2004, and substantially reduce it over the medium term. However, changes in the macroeconomic environment would impact the debt projection, and the public debt is particularly sensitive to movements in the exchange and interest rates, variations in the growth performance, and a deviation from the baseline for fiscal consolidation.

Small permanent deviations of some key macroeconomic variables could each leave the public debt at around 50 percent of GDP by the end of the decade, even if the government maintains the tight fiscal stance projected in the baseline.

Under a plausible scenario of simultaneously unfavorable macroeconomic developments and a moderate weakening of the fiscal accounts the debt could stabilize at about 55 percent of GDP for the rest of the decade.

The effect on the debt ratio of large exchange rate shocks of a magnitude somewhat higher than has occurred in Colombia in recent years highlights the challenges faced by the Colombian authorities, not only with regard to fiscal consolidation and economic growth, but also highlights the importance of pursuing policies that help avoid volatility of the exchange and interest rates.

COLOMBIA: THE EFF: DECEMBER 1999–DECEMBER 2002

I. BACKGROUND

For several decades Colombia achieved significant economic progress with steady and strong economic growth, and good balance in its external accounts. In the last half of the 1990s this performance gave way to slow growth and widening economic imbalances. To a considerable extent, the deterioration was the result of lax fiscal policies, aggravated by external shocks and intensified guerilla activity. The fiscal deterioration reflected mainly the introduction earlier in the 1990s of new expenditure programs, including a constitutionally mandated system of yearly increases in revenue transfers to the territorial governments.

The recessionary trend intensified in 1998 as Colombia and much of Latin America felt the repercussions of the Asian and Russian crisis, and in 1999 real GDP fell by 4.5 percent, the fiscal position deteriorated sharply, unemployment rose to record levels, and the financial system faced substantial stress. Following repeated episodes of attacks against the peso, the currency was floated in September 1999.

II. THE PROGRAM

To deal with the deteriorating situation, the authorities formulated a 3-year economic program that called for a significant policy correction, designed to restore external sustainability, lower inflation to international levels, and lay the basis for the resumption of economic growth. To help achieve this, the program called for reducing the fiscal deficit (combined public sector) from nearly 6 percent of GDP in 1999 to 1.3 percent of GDP in 2002. Tax reforms and an ambitious structural agenda would underpin the fiscal effort and promote economic efficiency, and action was taken to restructure and recapitalize the weaker banks. The multilateral lenders would increase their support, and the fiscal program also would be financed through privatization of a large number of public enterprises. Among the structural reforms, the most important was a reform of the system of revenue transfers to territorial governments; a pension reform; a broadening of the tax base; divestment of public enterprises and banks; and restructuring of the financial system through recapitalization and by bringing prudential norms to international standards (in large measure, the blueprint for this was based on the FSSA/FSAP exercise conducted in 1999). Subsequently, the authorities added plans to strengthen the public health system, introduce a fiscal responsibility law, and deal with budget inflexibility.

The program was monitored through quarterly quantitative performance criteria, primarily on the public sector deficit, net disbursements of public sector external debt, and the central bank's net international reserves. With the introduction of inflation targeting in 2001, the performance criterion on the net domestic assets of the central bank was replaced by an agreement to focus monetary conditionality on the quarterly path for inflation. Until the first half of 2002, Colombia met the quantitative performance criteria, with a notable overperformance in the buildup of international reserves. The attached

Tables 1 and 2 show the evolution of the main quantitative performance criteria and compliance with the structural guideposts of the program.

III. Achievements and Shortfalls

Colombia quickly achieved macroeconomic stabilization under its program, as confidence in economic management improved and the country regained access to international financial markets. The floating of the peso and the rules-based mechanism for central bank intervention helped stabilize the foreign exchange market. Fiscal consolidation advanced until early in 2002, albeit at a more moderate pace than initially planned, as the deficit targets were relaxed in light of slower-than-projected economic growth, increased security requirements, and—at one point—higher-than-expected fiscal costs of the otherwise successful restructuring program for the financial sector. The fiscal consolidation was in large measure based on tax increases, as government spending remained inflexible. The tax packages provided for only a modest broadening of the base of the VAT and income taxes; much of the revenue effort relied on a financial transactions tax which was introduced in 1999 and raised to 0.3 percent in 2001. Inflation was reduced as projected, with the central bank gaining credibility for having reduced inflation for five consecutive years (through 2002), helped by economic growth that remained well below potential.

On the structural front, a constitutional change was approved in 2001 that de-linked the transfers to territorial governments from the central government's revenue, but congress added a provision for the transfers to grow by about 2 percent per year in real terms for 2002–05 and 2.5 percent for 2006–08. Pension reform remained an unfulfilled commitment during the period of the EFF arrangement; the authorities did not move forcefully on this technically complex and politically controversial issue, other than to set up and begin capitalizing the pension fund for the territorial governments. The privatization program fell well short of its initial objectives, mainly because of guerilla sabotage against the electricity sector and a lack of investor interest in credit institutions caused by the financial turbulence that hit Latin America during this period. Although it was never a commitment under the program, action was not taken to make the labor market more flexible and reduce payroll taxes, which would have improved the prospects for reducing unemployment from its persistently high level.

A substantial amount of financing was available under the EFF, SDR 2 billion (253 percent of quota). However, with a great deal of success in macroeconomic stabilization and in rebuilding the official international reserves, the authorities chose not to use the Fund resources—in that sense, the arrangement turned out to be precautionary, with financing available in the event it was needed.

Table 1. Colombia: EFF Summary

	1999	2000	2001	Proj. 2002
Combined public sector deficit (in percent of GDP)				
Programmed				
In 1999	5.9	3.5	2.4	1.3
Including all revisions (through January 2002)	5.9	3.6	3.3	2.6
Outcome	5.5	3.4	3.2	4.0
Real GDP growth (in percent)				
Programmed in 1999	-3.5	3.0	3.8	4.8
Outcome	-4.2	2.7	1.4	1.6
CPI inflation; end of period (in percent)				
Programmed in 1999	11.0	10.0	8.0	6.0
Outcome	9.2	8.7	7.6	6.0
Net international reserves (in millions of U.S. dollars)				
Programmed in 1999	-750	744	326	323
Outcome	-319	870	1,218	318
Debt (in percent of GDP)				
Total external, programmed in 1999	41.1	43.1	43.6	44.3
Outcome	45.3	46.7	48.1	52.8
Total public, programmed in 1999	34.2	34.1	33.8	34.0
Outcome[2]	42.2	47.2	50.5	55.0

[1] Data for 2002 outcome correspond to the most recent projections.
[2] Include bonds issued to recapitalize public banks.

Table 2. Colombia: Performance Criterion and Structural Benchmarks Under the EFF

	Performance Criterion	Status
By April 15, 2002	The government will make public reform plans for the special pension regimes (exceptuados, not under collective bargaining agreements) that will reduce the actuarial deficit of these regimes taken as a whole in a proportion similar to that proposed by the government for the general regime, and raise additional cash savings.	Postponed. Incorporated under proposed SBA.
	Structural Benchmarks	
By December 31, 1999	Present to congress a proposal for a second generation pension reform (modifying Law 100 of 1993).	Postponed to December 2000.
	Present to congress a proposal for the creation of the territorial government pension funds.	Done. Approved by congress in December 1999.
	Present to congress for first reading a constitutional reform which delinks transfers to territorial governments from current income of the central government.	Done. Reform proposal somewhat different than envisaged in program. First of two approvals in December 2000.
	Present to congress a proposal for the fiscal strengthening of territorial governments by means of limiting their current expenditures.	Done. Approved by congress in October 2000.
	Present to congress a proposal to organize lottery activities to help boost public revenue.	Done. Approved by congress in December 2000.
By March 31, 2000	Present to congress a proposal for widening the base of the income tax, tackling "loopholes" in the VAT (national tax reform). The reform of the income tax/VAT will be designed to yield a total of 0.6 percent of GDP per year on an annual basis starting in 2001 with additional 0.2 percent of GDP in 2002.	Done. Proposal different from that envisaged in program. Approved by congress in December 2000.
By June 30, 2000	Regulations issued to implement the provisions of the financial reform law enacted in July 1999.	Done. Executive decree on early warning indicators was issued in December 2000.
By September 30, 2000	Present to congress the 2001 budget consistent with a nonfinancial public sector deficit of at most 2.5 percent of GDP.	Done. Approved by congress in October 2000.
By December 31, 2000	Present to congress a draft fiscal responsibility law.	Postponed to September 2001.

	Present to congress a proposal for a second generation pension reform (modifying Law 100 of 1993).	Postponed to June 2001.
By March 31, 2001	Present to congress a proposal on territorial tax policy, granting more fiscal autonomy to territorial governments (territorial tax reform).	Done. Presented to congress in September 2001.
	Present to congress for last reading a constitutional reform which delinks transfers to territorial governments from current income of the central government.	Done. Congress approved the reform (second of two approvals) in June 2001, with changes taking effect in January 2002.
	Government ministries to present to cabinet their plans for restructuring/downsizing of the ministries and their dependent entities.	Replaced by Law 617 and DAF programs.
	Design a legal framework for CISA (asset management company) to facilitate sale of foreclosed assets.	Done. Legislation introduced in congress in October 2001.
By June 30, 2001	Put into effect a reform of the health system under the social security institute.	Initiated in June and completed in December 2001.
	Present to congress a proposal for a second generation pension reform (modifying Law 100 of 1993).	Postponed to December 2001.
	Revise investment norms applicable to private pension funds to help stimulate the development of longer term capital markets.	Done.
	Introduce legislation (revision of Law 60 regarding public education and health) to strengthen control over the public finances and resource allocation.	Done. Law approved in December 2001.
	Approve regulatory framework for mortgage-backed securities.	Done.
	Develop framework to facilitate the purchase and assumption of assets and liabilities of financial institutions.	Done.
By September 30, 2001	Present to congress a draft fiscal responsibility law.	Postponed. Presented to congress in June 2002.
By December 31, 2001	Submit all legal issues to permit decisions by courts or tribunals with a view to liquidating or divesting all remaining public banks, except Banco Agrario; and bring those that are be divested to the point of sale.	Postponed to June 30, 2002.
	Invite bids for at least one public bank.	Postponed to June 30, 2002.

	Present to congress a proposal for a second generation pension reform (modifying Law 100 of 1993). Final decision on the remaining elements in the plan to reduce the deficit of the health system under the social security institute.	Done. Resubmitted by new government in September 2002. Done.
By June 30, 2002	Final report of the public revenue commission to be made public. Introduce reform of special (privileged) pension regimes, if required by presenting legislation to congress. Invite bids for the sale of at least one public bank. Submit all legal issues to permit decisions by courts or tribunals with a view to liquidating or divesting all remaining public banks except Banco Agrario, and bring those that are to be divested to the point of sale. Present to congress a draft fiscal responsibility law.	Postponed. Main report issued in August 2002. Postponed. Incorporated in the request for an SBA. Postponed until market interest improves. Done. Done.
By program review scheduled for September 15, 2002	Complete the process of bringing provisioning standards of the financial institutions to international levels. Latest date for accepting the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement. Final report of the Public Revenue commission to be made public.	Done/Ongoing. Not done. Authorities have expressed intention to accept and are in discussions with MAE/LEG. Main report issued in August 2002. Uncertain when supporting studies will be finalized.

Bogotá, Colombia
December 2, 2002

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

Dear Mr. Köhler:

1. The attached Memorandum of Economic Policy (MEP) and Technical Memorandum of Understanding (TMU) describe the economic policies and objectives for 2003 and 2004 of the new Government of Colombia, headed by President Uribe Velez, in support of which we request a Stand-By Arrangement (SBA) for a period of 24 months from December 2002 in the amount of SDR 1,548 million. We also request the cancellation of Colombia's Extended Fund Facility Arrangement that is scheduled to expire on December 19, 2002, if the SBA is approved before that date.

2. The program for 2003 and 2004 is designed to reinforce macroeconomic policies and reduce vulnerabilities at a time when the external environment has become increasingly difficult and Colombia faces the challenges of fostering higher economic growth, providing enhanced social services, and strengthening domestic security. The government believes that its economic program and the policies described in the memorandum will promote growth and improve opportunities for all Colombians. In a comprehensive manner, the new administration's program enhances fiscal revenue; curtails spending; tackles corruption; supports the economic recovery; and aims at promoting a better distribution of income, social services, and opportunities.

3. With the implementation of the policies outlined in the attached MEP, the government will seek to ensure that the program and its objectives are fully achieved. If the need arises, the government will stand ready to take additional measures. During the period of the arrangement, the Colombian authorities will maintain a close policy dialogue with the Fund.

Sincerely yours,

/s/	/s/
Roberto Junguito Minister of Finance and Public Credit	Miguel Urrutia General Manager Bank of the Republic

Annexes (2)

Colombia—Memorandum of Economic Policy

I. Background

1. Colombia has achieved considerable macroeconomic stabilization since the crisis of 1998–99, despite an increasingly difficult security situation and an often adverse external environment. Fiscal consolidation has advanced, structural reforms have been put in place, inflation has been reduced, and the banking system has been restructured. Up to earlier this year, these achievements had given the country good access to international financial markets and helped stabilize the currency.

2. This year, however, the country has been subject to contagion from other countries in the region, and from midyear the peso came under pressure in the foreign exchange markets. As in most other countries in the region, the sovereign bond spreads widened sharply. This situation was aggravated by the widening of the fiscal imbalance and the difficult domestic security situation.

3. Faced with these challenges, the new government moved quickly after taking office in August to rein in the fiscal imbalances. First, it proposed and congress approved budget cuts for 2003. The result was an austere budget in which noninterest expenditure increased by less than expected inflation. In addition, it levied a one-off tax on net wealth, and in September presented to congress a package of tax measures and key structural reforms. The government also has begun to implement a program to reduce and restructure the public administration, and has advanced on a reform plan for the public finances. Moreover, the government has secured congressional approval of an initiative to submit to a nationwide referendum early next year a number of political and economic measures.

4. The government is determined to strengthen internal security, which is vital for the recovery of confidence in the economy. This objective will not be pursued at the expense of macroeconomic stability, as demonstrated by the imposition of the wealth tax, which will yield about 1 percent of GDP to help finance the additional security needs in 2002 and 2003. Through fiscal consolidation the government intends to gain firm control over the public debt dynamics and reduce the economy's exposure to shocks, thus helping to foster economic growth, employment, and social equity. The Fund's support will be essential by providing comfort to the markets, helping the administration to implement needed policy adjustments and reforms, and by providing additional resources.

5. There will be quarterly reviews with the Fund during 2003. The first review, scheduled for completion before end-March 2003, will focus on (a) the outcome of proposals put forward by the government both to the congress and in the referendum and will assess the need for any additional measures to ensure that the fiscal target is attained; (b) the use of domestic credit by the public sector, the quarterly path for inflation consistent with the annual inflation target established by the central bank board; and (c) reaching detailed understandings on the changes in the special (privileged) pension regimes for teachers and

other groups. Based on these understandings, the relevant structural benchmarks for end-June 2003 will be converted into a structural performance criterion for end-June. The second review is scheduled for June 2003, the third review for September, at which time the frequency of reviews in 2004 also will be decided, and the fourth review for December.

6. The government will provide the Fund the information necessary to monitor implementation of the program, as well as other data that may be needed to adequately follow economic and financial developments. The Colombian government expects technical assistance from the Fund and the World Bank to improve its fiscal information system. During the period of the arrangement, and as needed, the authorities will consult with the Fund on policy issues and program implementation.

II. Recent Economic Developments and the Outcome for 2002

7. Real output grew by about 1.5 percent in 2001 and is expected to grow by slightly more in 2002, as suggested by recent indicators. Nationwide unemployment, however, remains near 16 percent.

8. Fiscal performance improved markedly between 1999 and 2001, but the public sector finances weakened this year. When the present administration took office in August 2002, the deficit of the combined public sector risked rising to nearly twice the EFF target of 2.6 percent of GDP. The fiscal slippage reflected a revenue shortfall on account of lower-than-expected economic growth and spending commitments made by the previous administration. In an effort to control the problem, particularly the unfinanced military expenditure, immediately after taking office the new government levied a temporary tax on net wealth by emergency decree. The deficit is currently projected to be 4.0 percent of GDP.

9. Net debt (i.e., excluding treasury notes held by public sector entities) of the nonfinancial public sector increased from the equivalent of 38.8 percent of GDP in 1999 to an estimated 50.7 percent of GDP in 2002, partly because of this year's sharp depreciation of the peso. Domestic debt represents about half of total public debt, and only 4 percent of the total domestic debt is indexed to the U.S. dollar. Colombia has continued to lengthen the average maturity of its internal debt, and has successfully pursued a strategy of extending the maturities of its external debt and reducing the exposure to exchange rate risk, most recently through a swap operation in June this year.

10. Monetary policy is cast within a framework of inflation targeting. Inflation is expected to decline to 6 percent this year, in line with the central bank's target, completing four years of compliance with the announced targets. The recent depreciation of the peso has had an impact on producer prices, but has not to date had a notable effect on CPI inflation. The central bank's monetary policy stance has remained largely unchanged since the first half of 2002, but the bank has intervened in the foreign exchange market by a small amount to support the peso, using its rules-based intervention mechanism.

11. The monetary base grew at a yearly rate of 26.2 percent through September 2002, reflecting an increase in the demand for currency, while broad money increased by

9.0 percent. Bank credit to the private sector increased in 2001 after falling for two consecutive years, and is growing slightly more this year. The lack of a stronger recovery of private sector credit is due mainly to weak demand.

12. The banking system has continued its recovery since the crisis of 1999, but weaknesses remain, particularly among the mortgage banks. The banks' operating environment has been strengthened significantly with the adoption of tighter regulations for loan-loss provisions, loan classification and capital adequacy, consistent with international best practices. Supervision has improved markedly with the continuing implementation of recovery plans for weak institutions, closer coordination between the supervisory authorities, and adoption of regulations for prompt corrective action. Support mechanisms have been firmly established by the central bank and the bank restructuring agency (FOGAFIN). FOGAFIN also has designed mechanisms to strengthen the capital base of financial institutions.

13. Despite the slowdown of the world economy and the volatility of private capital markets, Colombia's net international reserves (NIR) position has remained strong, covering more than 100 percent of external debt falling due within the next 12 months. The current account deficit is expected to remain unchanged at about 1.8 percent of GDP this year. However, conditions in international capital markets deteriorated sharply in 2002, leading to a fall in public and private capital inflows that will nonetheless finance the current account deficit and provide for a small accumulation of reserves. For the most part, the foreign financing is taking the form of direct investment and medium- and long-term borrowing by the public sector. Colombia's total external debt is projected to increase from 48.1 percent of GDP in 2001 to about 53 percent in 2002, due to the recent sharp depreciation of the peso and the slow growth.

III. The Program for 2003

14. The government's program will allow Colombia to retake the fiscal consolidation path in 2003 through robust and durable policies that will ensure sustainability of the public debt. Fiscal action and a strong structural agenda will ensure that these objectives are attained within a framework of continued macroeconomic stability supported by prudent monetary policies and a further strengthening of the financial system. We understand that the Fund's Executive Board would consider Colombia's request for an SBA by about December 20, 2002, by which time important elements of the government's reform program will have advanced, including the approval by congress of the proposed tax and pension reforms.

15. The macroeconomic framework for the program is based on real economic growth of between 2.0 and 2.5 percent and inflation in the range of 5 to 6 percent in 2003. The current account deficit is projected to narrow to 0.8 percent of GDP, reflecting some rebound in nontraditional exports and also, in part, more difficult access to external financing. Notwithstanding the smaller current account imbalance, the planned fiscal adjustment will allow the excess of private savings over investment to decline and ease the constraint on private sector activity.

16. A strengthening of the public finances is a central element of the program, designed to reduce the combined public sector deficit from 4.0 percent of GDP in 2002 to 2.5 percent of GDP in 2003, and to continue the consolidation process in subsequent years. The adjustment in 2003 will be achieved mainly through the revenue and expenditure measures summarized in this paragraph, which will more than offset increasing security spending and interest payments and a decline in the operating surplus of the public enterprises related to a further fall in oil production. The combined public sector deficit in 2003 will be adjusted upward to the extent any new external financing on concessional terms becomes available, up to a maximum of 0.5 percent of GDP for the year as a whole, to strengthen the security effort and the consolidation of peace as set out in the attached Technical Memorandum of Understanding (TMU), which also establishes the quarterly limits on the fiscal deficit in 2003. The reduction of the overall deficit will raise the primary surplus of the nonfinancial public sector to 3 percent of GDP next year, from 0.7 percent of GDP in 2002. The main fiscal actions contemplated under the program are:

- *Tax measures:* Following the introduction of the wealth tax in August 2002, in September the government sent to congress a tax package that would raise the special VAT rate of 10 percent, applicable to some products, to the standard rate of 16 percent; and provide for an expansion of the VAT base. The items that would be added to the base, including some basic foodstuffs, would be taxed at 5 percent. The tax bill includes a one-year surcharge on all income taxes, a lowering by half of the deduction of territorial taxes from the income base, and a cap on the generalized exemption for higher income individuals. Finally, the government's tax program calls for a major advance in controlling tax evasion through new enforcement measures and stricter penalties, and closes loopholes in the financial transactions tax. At the territorial level, the reform proposes to simplify the tax on alcoholic beverages, and increases the surcharge on gasoline. The increase in tax collections as a result of these measures will be 1.6 percent of GDP in 2003, falling to 1.2 percent in 2004 after payments on the wealth tax ends.

- *Expenditure freeze:* The government has proposed to freeze a large part of the public sector's current primary spending for the next two years at the 2002 level in nominal terms. The lowest salary and pension scales will be exempted, as will military spending, which will increase by 0.3 percent of GDP in 2002 and 0.6 percent of GDP in 2003, when it will reach 4.2 percent of GDP and is currently not projected to increase further in 2004. This measure will be voted in a nationwide referendum in early 2003, and is expected to generate savings of 0.7 percent of GDP in 2003 and additional 0.5 percent of GDP in 2004. Savings at the territorial government level related to the freeze will be allocated to the territorial government pension fund (FONPET) and other public pension funds to strengthen their finances. The freeze will lower the base for a number of expenditure categories, thus sustaining annual savings at about 0.5 percent of GDP in subsequent years.

17. Comprehensive and far-reaching structural reforms and additional fiscal action will complement these measures to achieve the targeted improvement in the public finances during the program period and over the medium term:

- *Second-generation pension reform:* In September 2002, the government introduced to congress a comprehensive reform of the general pension system, designed to better equilibrate contributions and benefits, and also requested powers for the government to strengthen the finances of the special (privileged) pension regimes of teachers and the military. The draft proposal that the government submitted to congress would raise contribution rates by 2 percentage points and increase the retirement ages to 58 and 62 years for women and men, respectively, in 2009, and to 62 and 65 years in 2018. In addition, the minimum contribution period would be increased in two stages from 1,000 weeks to 1,300 weeks in 2018. Moreover, in the referendum the government will propose to cap all new pensions under public responsibility at the equivalent of 20 minimum wages, and require the same age and contribution period for all affiliates. Without incorporating the effects of eliminating the special regimes, the rest of the reform will reduce the net present value of the public sector's pension liabilities from 210 to 158 percent of GDP and will generate fiscal savings that rise from 0.1 percent of GDP in 2003 to 1.0 percent in 2010, as the transition to the new regime takes effect.

- *Restructuring and downsizing the state:* Since taking office the government has initiated action to streamline the central government administration through mergers of ministries, closure of unnecessary institutions and offices, eliminating employee benefits in excess of the norm at the territorial government level, and suppressing vacancies at the Social Security Institute. These actions are part of a multiyear plan that is being developed to restructure and reduce the administrative apparatus of the state. The plan also includes a civil service reform under which the government's nonmilitary staff positions will be reduced gradually over four years, mainly through the closing of existing vacancies and attrition, ultimately reducing the nonmilitary staff positions by around 10 percent from the present level. An effective system of incentives will be established for public servants calling for performance-based hiring and compensation schemes. The plan also introduces changes in the management of the government's physical assets, new control systems to reduce fraudulent access to government benefit programs, new systems to control fraud in government contracting, a strengthening of the state's legal defense services, and others. The authorities expect savings from these measures to rise from 0.1 percent of GDP in 2003 to 0.6 percent of GDP in 2005.

- The government is working with congress to develop approaches to secure fiscal consolidation in 2005 and beyond. In this regard, the government is considering to propose an increase in the VAT rate—as needed—from 5 to 8 percent for the new items added to the VAT tax base and to phase out exemptions to the income tax.

18. The government already has taken steps in planning additional measures to address issues of accountability, transparency, and flexibility of the public finances. The agenda for these reforms is set out in the TMU.

- *Improving fiscal transparency and enforcing fiscal targets:* The government expects that its proposed fiscal responsibility and transparency law will be approved in early 2003. The law would provide a rules-based framework for fiscal policy, and calls for the government to establish and announce primary surplus targets for ten years for the nonfinancial public sector to ensure that fiscal developments are consistent with public debt sustainability. The law provides for clear financial accountability.

- *Strengthening the budgetary process and enhancing budget flexibility:* The government intends to submit to congress in 2003 a reform of the budget law that seeks to establish a budgetary process and a classification system that are consistent with international standards. Also, a very high proportion of the government's spending is determined by statutory obligations, legislation, or constitutional law, sometimes under revenue earmarking provisions. This rigidity makes the budget an inefficient instrument of policy, and hinders a timely redirection of resources as priorities change. In a major effort to restore the budget as an efficient and flexible instrument for implementing national priorities, the reform of the budgetary system will include proposals to rescind a large number of the legal bindings on budgetary spending. The government has requested technical assistance from the Fund and the World Bank in this area.

19. The financing of the fiscal program will be based on an appropriate combination of domestic and external sources:

- *Domestic borrowing:* The public sector's net borrowing will be consistent with maintaining adequate access of the private sector to domestic credit and is projected to decline from 3.1 percent of GDP in 2002 to 2.3 percent of GDP in 2003 and 1.7 percent of GDP in 2004. This will help spur economic recovery and avoid excessive upward pressure on domestic interest rates. Of the total financing need, the appropriate level of domestic borrowing will be assessed as part of the quarterly reviews. The government will not request financing from the central bank, unless major exogenous events were to severely restrict other financing, and in that case only if the program is advancing successfully.

- *External financing:* The government has already secured the public sector's external financing program for 2003. The multilateral lenders are increasing their commitments to Colombia significantly, to about US$8,000 million over the next three years, of which US$2,600 million would be disbursed in 2003. In addition, in 2003 the government is seeking a bond placement for US$800 million, supported, if necessary, by a partial guarantee from the IDB. If the external market conditions become adverse and this operation cannot be completed, the IDB has indicated that Colombia may augment its access to the emergency window. With these and other

lending operations the fiscal program is fully financed, and no additional access to the international financial markets is contemplated in 2003. However, commercial borrowing may be sought in anticipation of 2004 financing requirements if market opportunities arise. In any event, the public sector, including the financial public sector, will limit its net external borrowing to US$950 million in 2003, as specified in the TMU. The government would deposit any net external borrowing in excess of this amount in its accounts abroad to be utilized for financing of the 2004 budget.

20. The government recognizes a number of risks that may threaten the full implementation of its program, such as an unanticipated increase in security spending, insufficient support for the government's economic initiatives, including those in next year's referendum, and volatility in the external markets. Thus, the government has identified contingency measures designed to safeguard the program against such events. These include additional tax measures and spending cuts, particularly bringing forward the measures discussed in paragraph 17 (third bullet point) above. In the case of financing shortfalls, the government will consider temporary use of resources in the Petroleum Stabilization Fund, whose current balance is nearly 1.5 percent of GDP. With regard to security spending, initial returns indicate that the wealth tax earmarked for this purpose is yielding more than anticipated. If these additional resources plus the fiscal contingency measures just mentioned were not sufficient to finance unanticipated military spending increases, the government would consider the possibility of issuing long-term bonds on concessional terms.

21. Monetary policy will continue to be conducted within a framework of inflation targeting with a floating exchange rate. The inflation target for 2003 has been set as a range of 5 to 6 percent (with a point target for Colombian legal purposes at 5.5 percent) with a long-run target of 3 percent. The programmed increase in VAT is expected to have a transient upward effect on headline inflation during 2003. The central bank has established a quarterly trajectory for headline inflation, consistent with its annual target and will review with the Fund any major divergence from the trajectory as set out in the TMU. Reflecting its inflation targeting strategy, the central bank will stand ready to take appropriate actions to keep future inflation on target.

22. External viability of the program will be established by targeting a quarterly floor for the central bank's net international reserves (NIR), which for program purposes will rise by US$318 million in 2002 and US$243 million in 2003 to reach US$10,543 million at end-December 2003. The accumulation in 2003 reflects the projected income on the international reserves, and is consistent with no net exchange market intervention by the central bank under the floating regime for the peso. However, the baseline targets may be adjusted downwards to allow interventions called for to control destabilizing exchange rate fluctuations, as set out in the attached TMU. In case of a cumulative decline in NIR in excess of US$1,000 million during any rolling 30-day period, consultations will be held with the Fund on how the loss of reserves can be controlled, as explained in the attached TMU.

23. The government will continue its efforts to strengthen the banking system:

- *Regulation:* Capital requirements against market risk were put in place in January 2002 and will be increased to 80 percent in 2003. Rules on credit risk management have been strengthened in line with best international practices, and by June 2003 all banks will adopt loan classification and dynamic provisioning based on internal models.

- *Supervision:* Banks' implementation of new regulations and their exposure to market risk will continue to be closely monitored and recovery plans for weak banks will be strictly enforced. In line with the Basel core principles, the government intends to strengthen the independence of the superintendency of banks and also take steps to establish immunity for bank supervisors through action that will be initiated in 2003.

- *Capital markets:* Supervision and regulation of capital market institutions will be fortified through the securities commission (Superintendencia de Valores) and coordination with banking supervision enhanced.

- *Bank restructuring:* The government will continue to pursue bank resolution through market-based mechanisms and will not establish new subsidy programs for borrowers. The divestment or liquidation of intervened institutions will be completed by end-2004, to the extent market conditions permit for those slated to be privatized.

24. Business and labor market conditions will be enhanced by policy action in the areas of labor market reform, and the trade regime.

- *Labor reform and nonwage costs*: The government has submitted revisions of the labor law to congress in order to encourage the expansion of employment. The proposal that the government submitted to congress should reduce labor costs by extending daytime working hours and reducing overtime charges and severance payments. These steps should reduce unemployment significantly and bring labor back into the formal sector of the economy, thus gaining access to pension benefits and better health services.

- *Article VIII:* Colombia intends to accept the obligations under Article VIII of the Fund's Articles of Agreement and the authorities are discussing with Fund staff a timetable for phasing out the few restrictions on current account convertibility that remain.

- *Trade regime:* The Government of Colombia is committed to maintaining an open trade regime. Recently the system of export tax certificates (CERTS) was ended, and the tariff on some capital goods were eliminated. Moreover, the government has proposed to congress that the implicit VAT, applicable to some imports, be eliminated. The government recognizes the need for continued diversification of Colombia's exports, especially in view of the weak coffee prices and the continuing

decline in oil production. Nontraditional exports have increased in importance in recent years to over 50 percent of total exports. They are expected to receive a further boost following the renewal and expansion of the Andean Trade Preferences Act in 2002, which widens significantly the duty free access of Colombian exports to the United States.

- *Money Laundering and Anti-Terrorism Financing:* Colombia is committed to remaining at the forefront of best practices against money laundering and the financing of terrorism. Financial regulations incorporate the principles of know-your-customer, reporting suspicious transactions to the Financial Intelligence Unit, adopting codes of conduct, and implementing the Integrated System for the Prevention of Money Laundering. Colombian law severely penalizes money laundering, the financing of terrorism, and the management of assets related to terrorist activities. Forfeiture of assets linked to drug trafficking and terrorist activities has been expedited under the emergency legislation adopted by the new administration shortly after taking office. The South American Financial Action Task Force evaluated Colombia's AML-CFT efforts in 2001 and 2002; the results were very satisfactory. The Colombian authorities have made public the lists of terrorists issued by the UN Security Council and require financial institutions to report any transactions with the listed persons and institutions. Recently, Colombia completed the IMF questionnaire on AML-CFT, and stands ready to respond to any recommendations that may be forthcoming as a result.

- *Safeguards Assessment:* In line with the Executive Board's decision on safeguards assessment, the authorities, under the interim provision, have introduced an external auditing mechanism consistent with International Standards on Auditing, and will publish the audit opinion together with the central bank's annual financial statements beginning with the financial year 2002. The full safeguards assessment will be completed by the first program review.

IV. Further on the Program for 2004 and the Medium Term

25. Fiscal consolidation will continue in 2004 and over the medium term, building on the fiscal measures and structural reforms already described. Economic conditions are expected to improve in 2004. Real GDP growth is expected to increase to above 3 percent, accompanied by a widening of the external current account deficit to 1.5–2.0 percent of GDP. The wider deficit would be financed by direct investment, continued strong multilateral support, and access to external financial markets. Monetary policy will be geared to supporting a moderate further decline in inflation within a framework of inflation targeting and a floating exchange rate.

26. The public sector deficit will be reduced to 2.1 percent of GDP in 2004, supported by the measures outlined above and any additional action that may be required. This will reduce the nonfinancial public sector's debt to 50.1 percent of GDP. The full program for 2004 will be developed at the review scheduled for September 2003.

27. The government is committed to prudent debt management policies and will reduce the nonfinancial public debt as a percent of GDP during the period of its mandate; moreover, it will pursue policies that will permit a further reduction of the public debt-to-GDP ratio during the rest of the decade. The government expects that steady debt reduction, continued improvement in the indicators of economic vulnerability, and strong economic management, will boost confidence and allow Colombia's credit rating to improve, and the cost of its borrowing to fall.

28. Since 1999 Colombia has reduced the economic imbalances that threatened to thwart economic growth and social progress. Inflation has been reduced, competitiveness and financial stability have been restored. However, recently, the economy has underperformed, and the progress on poverty alleviation has been unsatisfactory. With security and economic recovery its highest priorities, the new administration is fully committed to pursuing the fiscal consolidation and structural reforms required to bring about the changes needed to allow all Colombians to benefit from the opportunities that a revitalized economy will create.

COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the definition of concepts, specific performance criteria for December 31, 2002 and March 31, 2003, and the structural benchmarks for the remaining period of the program, as well as the assumptions that apply under the program supported by the stand-by arrangement.

I. FISCAL TARGETS

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

	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 (indicative)[2]	3,240
September 30, 2003 (indicative)[2]	3,315
December 31, 2003 (indicative)[3]	5,490

[1] As measured by the net financing defined in the text below. The combined public sector is defined in the text below.
[2] Performance criteria to be specified at the time of the program review scheduled for March 2003.
[3] Performance criteria to be specified at the time of the program review scheduled for September 2003.

2. The overall balance of the **combined public sector** (PS) is defined as the sum of the overall balances of the nonfinancial public sector (NFPS), the operating cash result (quasi-fiscal balance) of the Banco de la República (BR), the overall balance of the Fondo de Garantías de Instituciones Financieras (FOGAFIN), and the net fiscal costs borne by the central administration and the rest of the NFPS related to financial sector restructuring. The **NFPS** consists of the general government and the public enterprises; the general government includes the central government, the territorial governments, and the social security system; the central government includes the central administration and the national decentralized agencies as indicated below. The net fiscal costs borne by the central administration and the rest of the NFPS related to financial sector restructuring (not part of the NFPS balance) are defined to include interest payments and amortization of the bonds used to compensate financial entities for the mortgage debt reductions approved by the congress in December 1999, the interest payments on the bonds used to recapitalize public banks, the costs of

closing Caja Agraria, and any additional fiscal charges (including interest costs) related to the recapitalization, restructuring, liquidation, and privatization of financial entities.

The Combined Public Sector

PS	=	NFPS[1] + FOGAFIN + quasi-fiscal BR + net fiscal costs borne by the NFPS related to bank restructuring
NFPS	=	general government (GG) + public enterprises (PE)
GG	=	central government (CG) + territorial governments (TG) + social security
CG	=	central administration + national decentralized agencies
TG	=	territorial government + territorial decentralized agencies

[1] Excludes net fiscal costs borne by NFPS related to bank restructuring.

3. For any given calendar quarter, the overall **PS balance** is measured, in Colombian pesos, as the sum of: (i) its net domestic financing; (ii) its net external financing; and (iii) privatization proceeds, as defined below.

4. The **PS net domestic financing** comprises (i) the change in its net credit from the financial system, excluding bonded debt; (ii) the change in its bonded debt (including domestic bonds denominated in or indexed to foreign currencies) excluding any valuation changes; (iii) the change in the budget carryover (*rezago presupuestario,* which includes *cuentas por pagar* and *reservas de apropiación*) of the central administration and changes in the floating debt (*cuentas por pagar*) of the social security system (*Instituto de Seguro Social, Cajanal, and Caprecom*) and main public enterprises: Ecopetrol, Telecom, the national electricity companies (ISA, ISAGEN, and the national electricity distributors), and the national coffee fund; (iv) the change in the amount of public funds administered by *Fiduciarias*; and (v) the operating cash result of the BR. Any capitalization of interest on new issues of government bonds after September 1, 1999 and the accrual of the inflationary component of indexed bonds will be included—on a quarterly basis—as interest expenditure for the purpose of measuring the PS deficit.

5. The **financial system** comprises the banking sector, mortgage banks, finance corporations (*corporaciones financieras*), FEN, IFI, finance and leasing companies (*compañías de financiamiento comercial*), Bancoldex, Finagro, and Findeter. The banking sector comprises the BR and the commercial banks.

6. The PS **net external financing** is defined as the sum of (i) disbursements of project and nonproject loans, including securitization (*titularización*) of export receipts; (ii) proceeds from bond issues abroad; (iii) the net changes in short-term external debt including prepayment of exports; and (iv) any change in arrears on external interest payments; minus (v) net increase in the financial assets held abroad by the PS; (vi) cash payments of principal on current maturities for bonds and loans; (vii) cash payment to settle any external arrears; (viii) any prepayment of external debt; and (ix) the value of any new leasing contracts

entered into by the public sector during the program period, which is defined as the present value at the commercial interest reference rate (CIRR) (at the inception of the lease) of all lease payments expected to be made during the period of the lease contract excluding those that cover the operation, repair, or maintenance of the property.

7. **Privatization** proceeds are defined as the cash payments received by the PS. Nonrecurrent fees (e.g., prepayments) received by the PS for concessions to operate public services, such as in the telecommunications sector, are treated as privatization proceeds. For purposes of the program, such fees will be accounted for over the concession period, distributed in equal quarterly amounts. Proceeds from the decapitalization of public enterprises will be considered as privatization. To the extent that the purchasers of public enterprises assume their debts, the net financing used by these enterprises during the program period until their sale will be deducted from the net financing of the PS; if the PS assumes the debt, the net financing used by the enterprise during the program period before the sale will remain outstanding as part of the financing of the PS.

8. The **joint operation** between TELECOM and a resident firm, which is a subsidiary of a foreign company, will be registered in the fiscal accounts on an accrual basis. The operation involves the acquisition by TELECOM from a resident firm of fixed assets (represented by installed telephone lines) financed by a loan from the resident firm that will accrue interest. The breakdown of the debt service between amortization and interest payments, to be accrued in the fiscal accounts, will be determined by the internal rate of return corresponding to the cash payments to be made during the period of the joint agreement.

9. **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, 2002 to December 31, 2002	0
From January 1, 2002 to March 31, 2003	0
From January 1, 2002 to June 30, 2003	0
From January 1, 2002 to September 30, 2003	0
From January 1, 2002 to December 31, 2003	0

10. **Exchange rate conversion.** (i) For the PS balance, items denominated in foreign currency will be converted into Colombian pesos at the actual exchange rate of each transaction; (ii) for the net external financing of the PS, the local currency amounts of the net external financing transactions are calculated at the actual exchange rate of each transaction; (iii) privatization proceeds are converted to Colombian pesos at the actual market exchange rate of each transaction.

II. Monetary Targets

11. 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 Estadisticas* (DANE). The authorities will complete consultations with the Fund (Executive Board) on the proposed policy response before requesting purchases from the Fund in the event that the observed quarterly inflation were to deviate from the programmed quarterly baseline target by 2 percentage points or more, as set out in the table below. In the event that the actual inflation deviates significantly from the programmed target within the 2 percentage point 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.

12. **Adjustment.** The inflation path could be adjusted by the direct effect of the VAT reform on the current consumer basket used to calculate the inflation target. For the first review scheduled for March 2003, the inflation path could be revised to take into account the VAT reform.

Performance Criterion on Inflation[1]

	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 (indicative)[2]	5.9
September 30, 2003 (indicative)[2]	5.7
December 31, 2003 (indicative)[3]	5.5

[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 March 2003.
[3] Performance criteria to be specified at the time of the program review scheduled for September 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 indicative)[2]	10,420
September 30, 2003 (indicative)[2]	10,480
December 31, 2003 (indicative)[3]	10,540

[1] Minimum quarterly levels of NIR of the BR based on a projected annual accumulation for 2002 of US$318 million. NIR is defined in paragraph 13.
[2] Performance criteria to be specified at the time of the program review scheduled for March 2003.
[3] Performance criteria to be specified at the time of the program review scheduled for September 2003.

13. The **NIR** of the BR (*reservas de caja*) are equal to the U.S. dollar value of gross foreign reserves of the BR minus gross foreign reserve liabilities.

14. **Gross foreign reserves** of the BR comprise (i) gold; (ii) holdings of SDRs; (iii) the reserve positions in the FLAR and the Fund; and (iv) all foreign currency-denominated claims of the BR on nonresident entities excluding accrued, but unpaid, interest on reserve assets and valuations. Gross foreign reserves exclude capital participation in international

financial institutions (including Corporación Andina de Fomento (CAF), IDB, IBRD, IDA, BCIE, and the Caribbean Development Bank), the holdings of nonconvertible currencies, and holdings of precious metals other than gold. The *pesos andinos* are considered to be part of Colombia's gross foreign reserves.

15. **Gross foreign reserve liabilities** of the BR are defined as the sum of (i) all foreign currency-denominated liabilities of the BR with an original maturity of one year or less excluding accrued, but unpaid, interest on liabilities (*causaciones*); (ii) liabilities to the Fund, (iii) any position in derivatives that represent a claim on gross foreign reserves; (iv) any purchases from the Latin American Reserve Fund (FLAR); (v) any increase in medium- and long-term external debt of the BR over and above US$77.5 million, which is the level of the outstanding debt on September 30, 2002; and (vi) any foreign currency liabilities of the BR to residents, including financial institutions.

16. **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[1]

	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 (indicative)[2]	1,050
September 30, 2003 (indicative)[2]	1,050
December 31, 2003 (indicative)[3]	950

[1] Medium- and long-term external debt comprise debt with an original maturity of more than one year. The public sector includes the PS as defined above and the financial public sector, including second-tier banks. In calculating compliance with the ceiling, the use/accumulation of the public sector's assets held abroad will raise/lower net disbursements. Debt is defined in point 9 of the Guidelines on Performance Criteria with respect to foreign debt (Executive Board Decision No. 12274–00/85, August 24, 2000).

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

[3] Performance criteria to be specified at the time of the program review scheduled for September 2003.

17. This ceiling applies to the net disbursement (gross disbursement minus amortization/redemptions) of debt of the public sector (financial and nonfinancial) of nonconcessional external debt of maturity of over one year.

18. **Guarantees.** The government will maintain the policy of not guaranteeing private sector external debt.

19. **Exchange rate conversion.** (i) changes in the external debt will be valued in U.S. dollars at the exchange rate prevailing at the time of each transaction; (ii) the net international reserves are accounted for at the U.S. dollar value at the time of acquisition; (iii) all references of external debt to GDP are calculated at the end-period exchange rate over annual GDP.

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

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of short-term external debt of the public sector from January 1, 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 (indicative)[2]	300
September 30, 2003 (indicative)[2]	300
December 31, 2003 (indicative)[3]	-180

[1] Short-term debt defined as all debt with an original maturity of one year or less, excluding normal trade financing. Public sector includes the PS as defined above and the financial public sector except transactions that affect the reserve liabilities of the BR. The term "debt" has the meaning set forth in point 9 of the Guidelines on Performance Criteria with respect to Foreign Debt (Decision No. 12274-00/85, August 24, 2000).

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

[3] Performance criteria to be specified at the time of the program review scheduled for September 2003.

IV. Structural Benchmarks

20. **To be completed by 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, as set out in paragraph 17 of the MEP.

21. **To be completed by 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.

22. **To be completed by June 30, 2003:**

- Congressional approval of the Fiscal Responsibility Law (paragraph 18 of the MEP).

- Introduction to congress of changes to the Budget Code (Ley Orgánica del Presupuesto) (paragraph 18 of the MEP).

- 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 (paragraph 17 of the MEP).

- Implementation of a reform of the special pension regimes for teachers, the military, and other groups that will reduce the actuarial deficit of these regimes and raise additional cash savings. The actuarial deficit of the regime for the teachers will be reduced at least in a proportion similar to that proposed by the government for the general regime.

23. **To be completed by December 31, 2003:**

- Congressional approval of the changes to the Budget Code (paragraph 18 of the MEP).

- CONPES to finalize a plan to streamline the management of government property (*activos físicos del Estado*) under which an assets management unit will be set up to define and implement a management plan based on consolidated inventories and develop a program for inventory assessment (paragraph 17 of the MEP).

- Congressional approval of the modifications of Law 80 to improve management of government contracts (paragraph 17 of the MEP).

- Divestiture of Bancafe (paragraph 23 of the MEP).

24. **To be completed by March 31, 2004:**

- Completion of a CONPES document to strengthen the government's legal defense service (*defensa jurídica del Estado*) 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 (paragraph 17 of the MEP).

25. **To be completed by 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 government's legal defence services (*defensa jurídica del Estado*) (paragraph 17 of the MEP).
- Restructure and bring Granahorrar to the point of sale (paragraph 23 of the MEP).

INTERNATIONAL MONETARY FUND

COLOMBIA

Staff Report for the 2002 Article IV Consultation and Request for Stand-By Arrangement

Supplementary Information

Prepared by Western Hemisphere Department
(In consultation with the Policy Development and Review, Fiscal Affairs, and Legal Departments)

Approved by Anoop Singh and Michael T. Hadjimichael

January 10, 2003

1. The following information has been received on economic developments and key program policies since the staff report for the 2002 Article IV Consultation and Request for Stand-By Arrangement (EBS/02/210) was issued.

Economic and market developments

2. **Recent financial market data point to improved risk perception and lower volatility.** Exchange rate volatility abated during December but the peso depreciated somewhat, ending the year at Col$2,865 to the U.S. dollar, a 25 percent year-on-year depreciation. Colombian risk spreads have continued to fall, to just under 600 basis points over U.S. treasuries in early January from nearly 1100 bps in September of last year. The government issued a US$500 million global bond in early December, taking advantage of the improving market conditions. Domestic financial markets were stable in December, while the stock market continued to perform strongly; the stock market index ended the year up 52 percent (21 percent in U.S. dollar terms).

3. **Consumer price inflation has increased somewhat in recent months but remains under control.** Inflation rose to 7.0 percent in December (y-o-y) from 6.0 percent in September, due mainly to domestic food price increases and the peso depreciation. The proposed program target for December was 6 percent, but the outcome is well within the 2 percentage points margin that would trigger consultations with the Fund under the program.

4. **Other key program targets.** Net international reserves increased in 2002 to US$10.5 billion, exceeding the floor proposed under the program for end-December. December data for other performance variables are not yet available. With regard to the structural benchmark established for December 31, 2002, all existing vacancies in the public

service (a total of 8,916 posts) have been eliminated,[1] as have all vacancies that will result from retirements during the period to 2006.[2]

Approval of key legislation in December 2002

5. **On December 20, congress approved a strong tax package focused on changes in the income tax and the VAT** as described in the staff report and in line with the staff's discussions with the authorities. The income tax rate will be subject to a temporary surcharge of 10 percent in 2003 (corresponding to 3.5 percentage points for the highest bracket), to be replaced by a permanent increase of half that amount from 2004. Income tax exemptions will be reduced during the period to 2006 and income tax deductions for taxes paid to territorial governments have been reduced by 20 percent. A large number of previously exempted or excluded goods and services will be subject to the VAT at 7 percent from 2003, rising to 10 percent in 2005, and nearly all other exempted and excluded goods and services will be taxed at 2 percent from 2005 onwards. As a result of these changes and because of adjustments in other VAT rates, the rate dispersion under the VAT will increase in 2003. The congress also approved legislation to close loopholes in the financial transactions tax and provide more severe fines for smuggling. Consideration of stricter penalties for tax evasion was deferred until a reform of the criminal code is taken up by congress later this year.

6. **The tax package would yield more revenue than envisaged from 2004.** Preliminary estimates by the authorities indicate that tax collections would increase by about 1 percent of GDP in 2003 as a result of the tax package (slightly less than projected under the program), rising to 1.2 percent of GDP in 2004 (somewhat higher than projected) and to 1.7 percent of GDP by 2005 (0.4 percent of GDP higher). The additional revenue yield reflects mainly the VAT measures that have been scheduled for 2005, the lowering of income tax exemptions and deductions, and the decision to raise the income tax rate permanently. The approved income tax measures are stronger than those in the government's original proposal, and the tax package puts in place VAT measures in 2005 that are similar to those the government would have considered for introduction in the future, should the need arise.[3]

7. **Congress also passed important pension reform legislation,** broadly as outlined in the staff report. Consistent with the government's proposal for the general pension regime, the reform provides for a gradual increase in the rate of pension contributions during 2004–06 by 2 percentage points, a reduction in the replacement ratio, and a gradual increase in the contribution period from 1,000 weeks at present to 1,300 weeks by 2015. The fiscal effect of

[1] Presidential Directive #13.

[2] Law 790, signed by the president on December 27, 2002.

[3] See Memorandum of Economic Policy (MEP), paragraph 17 (third bullet), and the staff report, paragraph 23 (EBS/02/210).

these changes, together with a requirement that public employees remain in the public pension system for three years after the adoption of the reform, is broadly in line with the program projection. However, congress did not approve the government's proposal to increase the retirement age in 2009, leaving the change for 2014 as established under the 1993 pension reform. As envisaged under the program, the law grants special powers to the president—for a six-month period—to reform the special pension regime of the security forces, but it provides that separate legislation will be needed to change the special regime for teachers. The fiscal savings from the pension reform until 2009 will differ little from the amounts projected under the program, provided the special pension regimes are modified as indicated by the government.

8. **On December 19, congress approved the issues to be taken up in the national referendum scheduled for early 2003.** As regards the pension regime, the referendum will propose that all pensions paid by the public sector be subject to a general ceiling of 25 minimum wages and that all special pensions be abolished in 2007.[4] The referendum also seeks approval for most public expenditure to be fixed at their 2002 level for two years, the elimination of some regional institutions, and the allocation of some mineral royalties to the territorial government pension fund. Political reform issues in the referendum include several proposals to prevent the misuse of public resources, reduce the size of congress, make public the votes cast in congress and other elected bodies, and set a minimum threshold for representation of political parties in congress. The constitutional court has 120 days from mid-January to review the referendum, but is expected to reach a conclusion earlier. It had been anticipated that the referendum would take place in February, but it now appears that it would be held somewhat later. The text of the referendum is consistent with the staff's discussions for the program.

9. **Congress also approved a labor market reform and measures to strengthen further the financial sector, while granting powers to the president to streamline the public administration.** The labor market reform extends the limits on the regular work day, reduces wage-premia for work on Sundays and holidays, lowers severance payments, and provides alleviation of nonwage costs for certain employee groups. The financial sector legislation provides additional resolution mechanisms for distressed institutions and defines a comprehensive sanctions catalogue for failure to implement prompt corrective measures. Finally, the president was granted special powers to proceed with streamlining the public administration by closing and merging public entities, eliminating vacancies, etc. These actions are consistent with assumptions under the program.

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[4] The program had called for this ceiling to be set at 20 minimum wages. The fiscal impact of the difference is minor.

Other issues

10. **The direct impact on consumer prices of the VAT reform is estimated to be about 0.4 percentage points in 2003.** At the time of the first program review the inflation target for 2003 will be adjusted accordingly, as specified in the Technical Memorandum of Understanding (TMU) attached to the MEP. The government has set the minimum wage to increase by 7.4 percent for 2003, in excess of targeted inflation.

I. Staff Appraisal

11. **The recent developments do not change the thrust of the staff appraisal.** Overall, the recent legislations increase comprehensiveness of the government's economic program and the probability of its success.

12. **The staff strongly welcomes the tax reform that has been approved,** particularly the measures designed to strengthen the revenue base in 2005 and beyond. The complexity of the VAT reform still poses a challenge for tax administration, and the staff recommends that the government take steps to reduce the dispersion of VAT rates to help facilitate collections and reduce economic distortions.

13. **The staff also welcomes the approval of the pension reform,** and urges the authorities to take action in the first half of 2003—as envisaged in the program—to define and put in place the reform of the special pension regimes. By not providing for an accelerated increase in the retirement age, the finances of the pension system would be somewhat weaker towards the end of the present decade than anticipated earlier. While the strength of the tax reform is likely to offset the impact on the overall fiscal profile, the staff urges the authorities to revisit the issue of the retirement age in the near future.

14. **The staff also welcomes the labor market reform.** The recent legislation advances labor market flexibility, and staff urges the authorities to continue to pursue reforms that can help reduce Colombia's unemployment problem.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/09
FOR IMMEDIATE RELEASE
January 23, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Colombia

On January 15, 2003 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Colombia.[1]

Background

The Colombian economy has staged a steady, albeit slow recovery since the 1998-99 crisis. Macroeconomic stabilization has been achieved, and robust fiscal and structural policies during most of the period since then have allowed the country to avoid some of the difficulties faced by other economies in the region. This is all the more remarkable since Colombia also has had to contend with a costly internal conflict that disrupts economic processes and distorts resource allocation.

However, the economic situation worsened in the first half of 2002. Peace negotiations with the guerillas broke down in February, after which violence escalated. Economic activity has remained sluggish, and the fiscal consolidation has gone off track. Exacerbated by increased contagion from other countries in the region, concerns about fiscal solvency led to increased pressure on the peso from mid-year and a loss of external market access.

After taking office in August 2002, a new administration took determined action to quicken a resolution of the internal conflict, reverse the fiscal deterioration, and safeguard macroeconomic stability, which had come under threat. At the same time, a two-year

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

economic program has been designed, under which the government aims to achieve fiscal consolidation and effect critical structural reforms, so as to lay the basis for strong and sustained growth and a better distribution of income and social services.

Executive Board Assessment

Directors commended the new government's swift and comprehensive action to face a difficult domestic and external situation. A deterioration in the domestic security situation last year, together with the turbulence in international financial markets and a weakening of the public finances, had exerted pressure on the peso and had resulted in a temporary loss of market access. Directors strongly welcomed the new government's rapid and determined actions to reverse the fiscal slippages and safeguard macroeconomic stability, advance institutional and economic reforms, and accelerate resolution of the internal conflict. In particular, Directors were encouraged by the measures already taken, and the strong domestic ownership in support of further reforms, that will allow Colombia to lastingly improve its debt dynamics and prospects for growth and employment. They saw Colombia's recent return to the capital markets as a recognition of the improved economic policies and the reform momentum created by the government.

Directors supported the authorities' plan to reduce the fiscal deficit sharply in 2003–04 and welcomed their commitment to take the measures needed to ensure public debt sustainability. In particular, they welcomed the recent passage of tax reform that will help underpin the lower deficit, as well as the effort to mobilize broad public support for spending measures. While the program provides for fiscal consolidation to continue over the medium term, it will, nevertheless, remain important that the authorities stand ready to take additional measures, as needed, to address risks that could affect the public finances, including those from security-related spending. Directors welcomed the government's commitment and preparedness to take action in this regard. Looking ahead, they saw a need for further efforts to strengthen the tax base. This would include a reduction in the dispersion of VAT-rates, while, over the medium-term, efforts should aim at alleviating the need to resort to ad-hoc measures, such as the financial transaction tax.

Directors supported the authorities' decision to finance the fiscal program for 2003 entirely from the domestic market and from increased borrowing from multilateral lenders. They underscored the importance of advancing the structural reforms that will help secure this multilateral financing. Directors also noted the efforts underway to reduce the vulnerability of Colombia's debt structure. Going forward, it will remain important to continue to implement policies aimed at reducing the vulnerability of the public debt to shocks, which will require, in addition to fiscal consolidation, the pursuit of sound policies that help avoid volatility of exchange and interest rates. A few Directors encouraged the authorities to introduce collective action clauses in sovereign bond contracts.

Directors were encouraged by the authorities' commitment to wide-ranging structural reforms, which will be key to underpin the fiscal consolidation effort over the medium term. They welcomed the recent approval in congress of the reform of the general pension system, and

looked forward to the next step, which will include reform of the special pension regimes. They also highlighted the importance of reforms to put the health system on a sound financial footing. Directors supported the high priority assigned by the new administration to modernizing and streamlining the state and introducing greater flexibility in public spending. They looked forward to sustained implementation of reform plans in these areas, building on the ongoing initiatives to close existing vacancies and reduce staffing through attrition, and the impending adoption of a Fiscal Responsibility and Transparency Law.

Turning to monetary policy, Directors commended the central bank for the high credibility that it has established after having presided over a period of significant disinflation. They noted that the continued skilful management of the inflation targeting framework in the period ahead will need to balance carefully the risk that the recent peso depreciation may fuel higher inflation against the still large unused capacity in the economy. In this regard, Directors recommended that the authorities should be ready to act promptly to signs that inflationary expectations could become embedded. Some Directors expressed concern that the central bank's policy rate is negative in real terms.

Directors welcomed the significant progress achieved in strengthening the banking system, including the recent legislation to further strengthen the safeguards, and the authorities' commitment to refrain from introducing new subsidy programs for distressed borrowers. They recommended continued vigilance in the period ahead, especially with respect to the mortgage institutions, and encouraged the authorities to strengthen the regulation of securities firms and brokerages. Directors commended the authorities for their exemplary and comprehensive efforts to combat money laundering and the financing of terrorism, and encouraged continued efforts against terrorist assets.

Directors emphasized that increased labor market flexibility will be key to address Colombia's high unemployment and support the government's social equity objectives. While welcoming the recent reform of the labor code, they encouraged the authorities to continue to work toward addressing remaining problems, in particular the backward indexation of the minimum wage and the high payroll charges, which tend to exclude workers from the formal sector.

Directors considered that Colombia's floating exchange rate regime was appropriate and had helped strengthen the country's ability to respond to shocks, and that Colombia's increasingly diversified exports are competitive at the current exchange rate. They commended the authorities for progress in liberalizing the trade regime and encouraged them to phase out remaining import restrictions. A number of Directors underscored the improved export prospects that Colombia would gain from faster trade liberalization by its trading partners.

Directors encouraged the authorities to accept the obligations of Article VIII of the Fund's Articles of Agreement as soon as possible, and eliminate the few remaining exchange restrictions.

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

Colombia: Selected Economic Indicators

	1998	1999	2000	Prel. 2001	Proj. 2002
(Annual percentage change, unless otherwise indicated)					
National income and prices					
Real GDP	0.6	-4.2	2.7	1.4	1.6
Consumer prices (end of period)	16.7	9.2	8.7	7.6	7.0
Nominal exchange rate 1/ (depreciation -)	-16.1	-17.7	-15.9	-2.7	...
Real effective exchange rate 1/2/ (depreciation -)	-4.6	-9.5	-2.4	5.5	...
Money and credit 3/					
Broad money	7.8	6.9	3.6	9.3	5.0
Private sector credit	12.8	-2.0	-7.6	2.0	2.5
Real interest rate (90-day time deposits; percent/year)	15.1	6.0	4.2	3.6	...
(In percent of GDP, unless otherwise indicated)					
External sector					
Current account	-5.3	0.6	0.5	-1.9	-1.7
External debt	40.5	45.3	46.7	48.1	52.7
Of which: public sector 1/	20.8	25.0	26.4	28.4	31.3
Gross official reserves (in months of imports of goods and services)	7.8	6.8	6.8	8.0	8.6
Savings and investment					
Gross domestic investment	19.7	12.9	13.4	14.7	13.8
Gross national savings	14.4	13.3	13.8	12.5	12.0
Public finances					
Combined public sector balance 4/	-3.8	-5.5	-3.4	-3.2	-4.0
Nonfinancial public sector balance 4/	-4.6	-6.4	-3.5	-3.5	-4.4
Central government balance 4/	-5.4	-7.4	-5.8	-5.8	-6.5
Public sector debt 5/	34.1	42.2	47.2	50.5	55.0

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

1/ End of period.

2/ Based on Information Notice System.

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

4/ Excluding privatization proceeds.

5/ Coverage differs from data published by authorities by including debt of the financial public sector.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 03/04
FOR IMMEDIATE RELEASE
January 15, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves a US$2.1 Billion Stand-By Credit for Colombia

The International Monetary Fund (IMF) today approved a two-year SDR 1.5 billion (about US$2.1 billion) Stand-By Arrangement for Colombia in support of its economic program through 2004. The approval opens the way for the immediate release of SDR 193.5 million (about US$264 million). Colombian authorities intend to treat the stand-by credit as precautionary.

Following the Executive Board's discussion on Colombia, Horst Köhler, Managing Director and Chairman, said:

"Confronted with a difficult domestic security situation and a challenging external environment, the new government of Colombia has embarked on a strong reform program. The Executive Board commends the government's rapid and determined action to address the fiscal pressures, which emerged in 2002, and to develop a comprehensive strategy for stability, growth, and improved social equity. The strong ownership of the program and the broad political consensus on the need for reforms have generated a momentum of change that will help to successfully address the challenges ahead and secure a robust recovery of Colombia's economy and employment outlook.

"The government's program, supported by a two-year precautionary Stand-By Arrangement, aims at strengthening macroeconomic and structural policies. In particular, public debt dynamics will be improved by significantly reducing the fiscal deficit over 2003–04 and continuing the fiscal consolidation over the medium term.

"Key components of the program include the tax, pension, and labor market reforms that were recently passed by congress, as well as measures to streamline the public administration and improve its productivity. In addition, continued vigilance by the central bank will help control inflationary pressures.

"The Executive Board is encouraged by the authorities' firm commitment to lasting improvement of the security situation. This, together with a sustained implementation of the reform measures, including those envisaged in the national referendum, will be key to achieving the program's objective of laying the basis for a durable recovery," Mr. Köhler said.

Program summary

After staging a steady recovery from the 1998-99 crisis, the economic situation in Colombia worsened in the first half of 2002. Peace negotiations with the guerrillas broke down in February, followed by escalating violence. Economic activity remained sluggish, consumption was subdued by uncertainty associated with high unemployment levels, and exports weakened as a result of the world economic slowdown and low international coffee prices. At the same time, fiscal consolidation went off track, due in part to an increase in military expenditure.

The government of President Álvaro Uribe, who took office in August 2002, moved quickly to halt the fiscal deterioration by introducing cuts in the budget for 2003, imposing a one-off wealth tax under emergency legislation, preparing a tax package, and setting in motion a structural reform agenda. In recent months, economic activity has recovered somewhat, but real GDP is projected to rise only modestly for the year as a whole.

The government's economic program, which is supported by the IMF stand-by arrangement, aims at achieving fiscal consolidation and putting in place structural reforms that lay the basis for sustained growth and better income distribution. On the **fiscal front**, the authorities intend to take the measures needed to ensure public debt sustainability and maintain Colombia's record of servicing its debt. Accordingly, the program calls for increases in tax revenue and expenditure cuts, supported by key structural reforms and administrative improvements in the public sector. The government aims to achieve a substantial increase in tax revenue in 2003, based principally on a wealth tax, an income tax surcharge, and a broadening of the VAT tax base. The measures would yield 1.6 percent of GDP in 2003. Further savings will be achieved through a reduction in public spending. Overall, the combined public sector deficit would be reduced to 2.5 percent of GDP in 2003 and 2.1 percent in 2004 from an estimated 4 percent in 2002. Net external financing of the public sector is projected to fall from 1 percent in 2002 to about 0.3 percent of GDP in 2003, while domestic financing is projected to fall from 3.1 percent of GDP in 2002 to 2.3 percent.

The **monetary policy** will continue to be cast within a framework of inflation targeting. The program is based on a reduction of inflation from 7 percent in 2002 to around 5.5 percent in 2003 and to 4 percent in 2004. Also, the authorities will continue to strengthen the operating environment of the banking system and foster risk management based on international best practices.

As part of the **structural reform** agenda, the government intends to move forward in the implementation of the pension and labor market reforms approved by congress in late 2002, and plans to reform the special pension regimes. The government will also continue the modernization program for the public sector, reform the budget code, and improve the finances of the health services of the Social Security Institute.

Colombia is an original member of the IMF; its quota is SDR 774 million (about US$1.1 billion); and it has no outstanding use of IMF credit.

Colombia: Selected Economic Indicators

	1998	1999	2000	Prel. 2001	Proj. 2002
(Annual percentage change, unless otherwise indicated)					
National income and prices					
Real GDP	0.6	-4.2	2.7	1.4	1.6
Consumer prices (end of period)	16.7	9.2	8.7	7.6	7.0
Nominal exchange rate 1/ (depreciation -)	-16.1	-17.7	-15.9	-2.7	...
Real effective exchange rate 1/2/ (depreciation -)	-4.6	-9.5	-2.4	5.5	...
Money and credit 3/					
Broad money	7.8	6.9	3.6	9.3	5.0
Private sector credit	12.8	-2.0	-7.6	2.0	2.5
Real interest rate (90-day time deposits; percent/year)	15.1	6.0	4.2	3.6	...
(In percent of GDP, unless otherwise indicated)					
External sector					
Current account	-5.3	0.6	0.5	-1.9	-1.7
External debt	40.5	45.3	46.7	48.1	52.7
Of which: public sector 1/	20.8	25.0	26.4	28.4	31.3
Gross official reserves (in months of imports of goods and services)	7.8	6.8	6.8	8.0	8.6
Savings and investment					
Gross domestic investment	19.7	12.9	13.4	14.7	13.8
Gross national savings	14.4	13.3	13.8	12.5	12.0
Public finances					
Combined public sector balance 4/	-3.8	-5.5	-3.4	-3.2	-4.0
Nonfinancial public sector balance 4/	-4.6	-6.4	-3.5	-3.5	-4.4
Central government balance 4/	-5.4	-7.4	-5.8	-5.8	-6.5
Public sector debt	34.1	42.2	47.2	50.5	55.0

Sources: Colombian authorities; and IMF staff estimates and projections.
1/ End of period.
2/ Based on Information Notice System.
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4/ Excluding privatization proceeds.

Statement by Murilo Portugal, Executive Director for Colombia and Roberto Steiner, Alternate Executive Director January 15, 2003

1. On behalf of the Colombian authorities we would like to express our gratitude to staff and Management for their continued support to the efforts of the Colombian government and people. Staff has produced a well-balanced report that makes a fair assessment of the recent evolution of the Colombian economy and of the main challenges ahead.

2. After decades of prudent macroeconomic management and moderate but steady growth, severe economic imbalances emerged in Colombia towards the second half of the 1990's. In 1999, GDP contracted by 4.2 percent and the combined public sector deficit reached 5.5 percent of GDP. Late that year, an agreement was reached with the Fund on a three-year Extended Fund Facility (EFF) program that has recently lapsed. Under the program there was significant improvement in the fiscal accounts, major structural reforms were undertaken, and access to international capital markets remained adequate. Although the program remained on track until mid 2002, no purchases were made.

3. A combination of domestic and foreign shocks in recent years have maintained growth below potential, with increasing unemployment and weak fiscal revenue. On the domestic front, guerrilla movements and paramilitary organizations remained active and derailed the peace process initiated by the previous administration. Their threats and attacks have displaced thousands of people from the rural areas, hindered investment, affected oil production and forced the government to increase military expenditure. Regarding external events, the price of coffee reached historically low levels, trade with some neighboring countries fell as their economies underperformed and, last year, foreign private financing to Colombia was affected by developments in the region.

4. Following the third review under the EFF program in early 2002, Colombia agreed to a reduction in the combined public sector deficit from 3.2 percent of GDP in 2001 to 2.6 percent in 2002, an inflation target of 6 percent, and important structural reforms – including submitting to Congress draft legislation for a major overhaul of the public pension system. These commitments were meant to complement the achievements of 2000 and 2001, which included an increase in the primary fiscal balance, a reduction in inflation, a significant strengthening of the banking system, and reforms in the revenue sharing system. The deterioration in the domestic security situation, the foreign shocks, and the congressional and presidential elections prevented the outgoing administration from maintaining in 2002 the excellent track record of the first two years of the EFF. By mid-year it became evident that growth would not reach 2 percent, that the combined public sector deficit, if unchecked, would be twice as large as the 2.6 percent of GDP target and that the reform of the pension system would have to be undertaken by the new administration.

Priorities of the New Administration

5. In March 2002, Colombians elected a new Congress and in May a new president. Contrary to precedent, the president was elected on the first ballot. The new administration has a clear and strong mandate especially on four critical issues: restoring democratic

security, advancing political reform, reforming the state and fostering growth through prudent economic management. On all fronts the government has moved swiftly, and markets have reacted very favorably, as witnessed by a sovereign bond placement in December and the recent decline in spreads.

6. Following the terrorist attack on the Presidential Palace on Inauguration Day (August 7), the new administration issued emergency decrees that were later deemed constitutional by the highest Court. Among other issues, the decrees established a once-and-for-all 1.2 percent tax on net wealth, to be paid in four installments in 2002 and 2003, in order to finance military expenditure. The new administration's commitment to strengthening democratic security without jeopardizing the fiscal accounts was well-received by Colombians, many of whom pre-paid the wealth tax in the first installment.

7. On Inauguration Day the President submitted to Congress a proposal for a nation-wide referendum, which was sanctioned by Congress in December. It is now being reviewed by the Constitutional Court, and is expected to be voted in May, 2003. It has two main components. First, it reforms Colombia's political institutions by, among other measures, reducing the size of Congress, mandating nominal voting in Congress, changing the way members are elected, the manner in which political parties are organized and how Congress is administered. These reforms are aimed at making Congress more accountable, removing incentives for corruption and pork-barrel politics, and streamlining the relationship between the executive and the legislative. Second, the referendum has an important economic component, described in more detail below, related to a two-year freeze on government expenditure and the elimination of all privileged regimes within the pension system.

8. The new administration is convinced that a prudent macroeconomic policy, an ambitious reform agenda and enhanced internal security are necessary in order to fulfill its commitment to improve economic conditions of all Colombians. While slow growth has maintained unemployment at historically high levels and has reversed many of the previous gains in terms of poverty reduction and income distribution, the new administration has not been tempted to offer promises of a quick fix through non-market policies. On the contrary, it is requesting a two-year Stand-By Arrangement with the Fund that aims at further reducing the fiscal deficit and the debt burden, bringing inflation closer to the level of developed countries, making the labor market more flexible, diminishing the actuarial deficit of the pension system, and re-defining the way in which the government operates. The authorities believe that a program with the Fund will be instrumental in facilitating financing from the World Bank and the Inter-American Development Bank, securing access to private capital markets and maintaining focus on a structural reform agenda over which there is considerable domestic ownership. Under the EFF these broad conditions were fulfilled, and Colombia never saw the need to disburse the resources it was entitled to by having complied with all the performance criteria and benchmarks.

Fiscal Policy and Debt Sustainability

9. While significant progress was made during the first two years under the EFF, by mid-2002 there was a distinct possibility that the consolidated public sector deficit would surpass 5 percent of GDP. Reducing the deficit while enhancing the military budget became

the most important task for the new administration, which moved swiftly on several fronts. It secured Congressional approval of a budget for 2003 in which non-interest expenditure will rise by less than expected inflation. Through emergency legislation it introduced a once-and-for-all 1.2 percent tax on net wealth that now is projected to yield 1.2 percent of GDP, 0.2 percentage points more than originally anticipated. Congress passed the administration's proposal for a tax reform that considerably broadens the VAT tax base in 2003 and makes the VAT universal from 2005, albeit at a lower rate for basic foodstuffs and some services. The reform also includes a 10 percent surcharge on income taxes in 2003 and a 5 percent permanent increase from 2004, reduces income tax deductions on wages from 30 to 25 percent with a limit of COP$4 million per month, eliminates all other exemptions on income taxes and, starting in 2004, reduces from 100 to 80 percent the proportion of local taxes that can be deducted from national taxes. In all, the reform should yield 1.6 percent of GDP in 2003, 1.2 percent in 2004 after the wealth tax is no longer in effect, 1.7 percent in 2005 when all goods and services will be subjected to the VAT and 1.9 percent in 2006 and thereafter when the full reform of the income tax is phased in.

10. In an effort to overcome the severe inflexibilities that plague Colombia's budget, the government included in the referendum to be voted in May a petition to freeze for two years (at its 2002 level in nominal terms) all public expenditure other than transfers to territorial governments, debt-service payments and wages and pensions below two minimum legal wages. If approved, this will imply fiscal savings of 0.7 percent of GDP in 2003, an additional 0.6 percent in 2004, and important savings thereafter. Since public sector wages will be frozen but transfers to territorial governments not, and given that the bulk of transfers are ear-marked for wages in the health and education sector, the transfers made but not spent would be allocated to the territorial governments' pension fund. These tax and expenditure reforms should reduce the combined public sector deficit from an estimated 4 percent of GDP in 2002 to 2.5 percent in 2003 and to 2.1 percent in 2004. The primary surplus of the non-financial public sector should increase from 0.3 percent of GDP in 2002 to 2.8 percent in 2003 and 3.3 percent in 2004. In case the expenditure freeze is not approved in the referendum, the government stands ready to propose to Congress an additional increase in taxes and further reductions in expenditure.

11. While staff correctly highlights important downside risks, upside risks should not be under-estimated. In particular, for 2003 the fiscal projections assume GDP growth of 1.5 percent. Of the 19 analysts consulted for the Latin Focus Consensus Forecast, 13 have Colombia's 2003 growth at 2 percent or more. Recent evidence supports some moderate optimism. The administration's security strategy already has begun to pay off. In the August-October period, toll collections in real terms were up 3 percent year-on-year and hotel occupancy in October was 4.5 percent higher than a year ago. Although GDP growth for the first three quarters was up only 1.59 percent year-on-year, in the third quarter alone the annual improvement was 1.91 percent. Moreover, household consumption grew 2.51 percent year-on-year in real terms during the third quarter while investment did so by over 10 percent (with gross fixed capital formation growing by 6.42 percent). Unfortunately, exports were down 4.56 percent. Capacity utilization in October reached 76.1 percent, the highest level in two years. Energy demand was 4.3 percent higher in November than a year ago and construction licenses up 33 percent in the year to October. Business and consumer surveys also lend support to moderate optimism. While key trading partners are expected to continue

under-performing, our authorities believe that GDP growth in 2003 will probably surpass 2 percent, but have accepted staff's prudent suggestion of estimating tax collections based on a rate of growth of only 1.5 percent and of running debt sustainability analysis assuming a slight weakening of the real exchange rate in 2003, although a strengthening of the peso is a distinct possibility.

12. In spite of the good fiscal performance for most of the period of the EFF, Colombia's debt dynamics continued to deteriorate. It should be noted that the increase in the public debt to GDP ratio in 2002 is entirely explained by the depreciation of the peso. While the Colombian authorities are concerned about the recent increase in public debt, they believe certain positive characteristics of this debt ought to be highlighted. On the one hand, slightly more than half of the public debt has been issued domestically, and there are plans to increase this ratio to 58 percent by 2006. Second, 70 percent of domestic debt has been issued in pesos, only 27 percent is indexed to inflation and barely 3 percent is in foreign currency. Finally, only 14 percent of total public debt is due in 2003 and 10 percent in 2004, with the remainder falling due in 2005 and beyond.

13. Our authorities see no need to commit to a reduction of the debt-to-GDP ratio of the magnitude that emerges in staff's baseline scenario, from 55 percent in 2002 to 42.6 percent in 2010, with a primary surplus of around 4 percent of GDP. Technical work undertaken at Colombia's Ministry of Finance suggests that with GDP growth at 4 percent, a stable real exchange rate, and a stable real interest on foreign debt, a primary surplus of 2.5 percent of GDP would bring the debt-to-GDP ratio down to a manageable level of 47 percent by 2010. On the other hand, our authorities believe that reforms already implemented and those that are anticipated under the SBA should allow for lower interest rates than those considered by staff in the baseline scenario. We envision a positive market reaction to the Fund-supported program of Colombia's new administration, and expect a decline in spreads on Colombian debt to compensate any increase in US interest rates. This past December a sovereign bond for $500 million was successfully placed in the market, and spreads on sovereign debt (EMBI+ Col), which stood at 1096 basis points in September 2002, are currently around 600.

Monetary and Exchange Rate Policy

14. Since 2000 Colombia adopted an inflation target framework in the context of a floating exchange rate regime in which central bank intervention in the F/X market is undertaken using pre-determined rules. For the first time in five years, the inflation target was not met in 2002. CPI inflation started to deviate from target in October, and by year's end the 6 percent target was surpassed, with inflation closing at 7 percent. Although the weakening of the peso during 2002 (when the peso depreciated by 25 percent against the US dollar) is part of the explanation, the bulk of the problem lies in supply shocks to basic foodstuffs. Potatoes, the most important staple in the CPI basket, experienced a price increase of 90 percent in 2002. In sharp contrast, non-food inflation was 5.35 percent. While the central bank stands ready to take the necessary actions to meet the 5 to 6 percent inflation target for 2003, it believes that these types of supply shocks are self-corrective, with bumper crops of key staples likely in 2003.

15. In setting the 2003 inflation target, the authorities and staff have agreed not to be unrealistically ambitious, particularly given the once-and-for-all effect on inflation stemming from recent changes to the VAT. The target for this year has been set at 5 to 6 percent, and at 3.5 to 5.5 percent for 2004.

16. Contrary to staff, our authorities believe that the rules-based mechanism for intervention in the F/X market has worked remarkably well, although they acknowledge that this is a learning process. Staff claims that the intervention mechanism has reduced volatility much less than expected, reaching this conclusion by estimating the standard deviation of the daily percentage change in the exchange rate. However, the mechanism is not designed to reduce that particular definition of volatility, but rather to counteract a significant (4 percent or more) deviation of the exchange rate from its 20 day-moving average. The exercise of an option that in one day eliminates the entire deviation is deemed completely successful by our authorities, even though it would abruptly increase staff's definition of volatility.

17. Colombia enjoys a comfortable level of international reserves. At US$10.8 billion, net international reserves represent over 100 percent of external debt falling due within the next year. This strong position should be maintained in the future, as the rather small expected current account deficit (1.2 percent of GDP in 2003 and 1.5 percent in 2004) should be financed with FDI, net disbursements from multilateral institutions and adequate access to private capital markets.

18. Under the SBA that is being requested, the Colombian authorities are committed to accepting the obligations under Article VIII of the Fund's Articles of Agreement. While the authorities welcome the Funds technical assistance report on compliance with Article VIII and share most of its conclusions, they do not believe that the exchange regime applicable to the oil sector constitutes a restriction on current account convertibility. This regime is voluntary and is maintained at the request of foreign oil companies as a way to facilitate oil exploration.

The Financial Sector

19. In the context of the economic contraction of 1999, Colombia's financial sector went through a period of severe turmoil. The prompt intervention of the authorities prevented a full-fledged financial crisis. While some problems persist, particularly in the mortgage banks, financial institutions are well capitalized, the level of non-performing loans has declined and provisioning has increased significantly. Though credit to the private sector continues to be sluggish, in 2002 some recovery was observed. In the year to November, consumer and commercial nominal credit were growing 8.8 percent and 9.6 percent, respectively.

20. Showing no signs of complacency, Congress recently approved a reform of the financial sector which tackles a broad range of issues. First, the process by which the supervisory agency can impose sanctions was streamlined and its scope of action broadened. Second, corporate governance is being enhanced and the process of intervening distressed institutions revamped, allowing for assets and liabilities to be transferred to sound institutions, and making costly liquidations unnecessary. Finally, banks are now allowed to be involved in additional activities, including leasing in the housing sector.

Reform of the Pension System

21. Although Colombia introduced private fully funded pension funds in 1993, it maintained a public pay-as-you-go system, and several pension regimes in the public sector were exempted from the reform. The 1993 reform established that key parameters of the pension system –including contributions, contribution period, retirement age and benefits—would have to be gradually changed, starting in 2014. In the late 1990's it became evident that the transition period would have to be shortened and the exempted regimes would need to be changed or eliminated if the public pension system was to remain solvent. The reform of the pension system became an important element of the EFF program. Unfortunately, vested interests proved insurmountable for the previous administration, whose well-intentioned reform efforts did not advance significantly in Congress.

22. The new administration intends to introduce a broad reform of the pension system, and has already achieved significant progress in this regard. In August, it submitted to Congress a reform proposal that was approved in late December. Key elements of the reform include increasing contribution rates from 13.5 percent in 2002 to 14.5 percent in 2004 and to 15.5 percent in 2006; reducing the replacement ratio from 65-85 percent of the average wage of the last 10 years to 65 percent, a percentage that declines with income, with a guaranteed minimum pension of 100 percent of the minimum wage; making pension system affiliations mandatory for independent workers by disallowing affiliations to health services providers for those not affiliated to a pension fund; and requiring public workers to remain in the public system for at least three years. The hiking of the contribution period from 1000 weeks to 1050 weeks in 2005 and by 25 weeks per year thereafter, until reaching 1300 weeks in 2015, to a certain extent compensates for the fact that the proposed changes to the retirement age were not supported by Congress, and will only increase in 2014 as established under the 1993 reform, from 60 and 55 years to 62 and 57 for men and women, respectively. In addition to reducing the actuarial deficit of the public pension system by around 50 percentage points of GDP, the recently approved reform should generate cash savings of around 0.3 percent of GDP in 2004, gradually increasing to around 2 percent of GDP in 2010.

23. In addition, the government has made pension reform an integral part of the referendum that is to be voted in May. One provision in the referendum caps the value of all public sector pensions at 25 times the minimum wage. More importantly, another provision eliminates in 2007 all exempted and privileged regimes. If this provision in the referendum is not supported, the government will introduce separate legislation for the exempted regimes. And regardless of the outcome of the referendum, this year the government will propose to Congress a reform to the pension regime applicable to teachers.

Reform of the State

24. The new administration has assigned a high priority to issues regarding the size, functions and operational aspects of state institutions. Important fiscal savings and a more efficient and accountable public administration should emerge in the medium term. Last December the government obtained from Congress broad powers that allow the President to suppress or merge administrative departments and to reassign functions among central government institutions. Key signals, including the closure of three Ministries and several

diplomatic legations, had been announced before the President was inaugurated. And soon after taking office, the new government eliminated around 9,000 vacancies in 35 institutions. During its term in office, the new administration expects to deliver on a 10 percent decline in non-military central government positions.

25. The reform of the state goes well beyond eliminating civil service positions. Meritocratic hiring through a transparent process has been initiated with a pilot program in two Superintendencies and in the Social Security Institute. In December, the government submitted to Congress a reform of procurement procedures that should reduce corruption, enhance transparency and yield fiscal savings. Other initiatives include a centralized office in charge of addressing legal challenges against the state, which could save tax payers as much as 0.2 percent of GDP per year in lost litigation.

Towards a More Flexible Labor Market

26. Notwithstanding the important steps taken in the early 1990's to make the labor market more flexible, Colombia's labor laws continue to act as an impediment for job creation in the formal sector. As a result, unemployment is extremely high and employment in the informal sector acts as a buffer, albeit one in which health and pension benefits are lacking. Non-wage labor costs currently represent just under 50 percent of the wage bill.

27. In December 2002, Congress approved a reform of the labor code. Key provisions include the redefinition of normal working hours. Previously, the working day extended from 8 a.m. to 6 p.m., with overtime paid outside of this schedule. The working week went from Monday through Friday with overtime paid on Saturdays and double overtime on Sundays. These schedules did not conform to structural changes in the economy, particularly the growth in the services sector. With the reform, the working day now extends from 6am to 10pm and the working week from Monday through Saturday. The reform recently approved also implies a reduction in the costs incurred by businesses if they lay-off personnel who had served for more than 10 years.

28. Additional elements of the reform geared towards enhancing employment include allowing firms to hire students from public training programs and pay them less than the minimum wage and incurring no non-wage costs, while they remain as students.

Other Issues

29. Being one of the countries most adversely affected by the relentless acts of terrorists financed with the proceeds from drug-trafficking, Colombia has a long tradition of being at the forefront of the fight against money laundering and the financing of terrorism. It established a Financial Intelligence Unit in 1999, and has received high marks in two evaluations undertaken by the South American chapter of FTAF. It has made public the UN Security Council lists of terrorists and requires financial institutions to report transactions with listed persons and institutions. Under emergency legislation following a terrorist rampage on Inauguration Day in 2002, forfeiture of assets linked to drug trafficking and terrorist activities has been expedited. In addition, Colombia completed the IMF

questionnaire on AML-CFT and is prepared to respond to recommendations that may be forthcoming as a result.

30. Following the Executive Board's decision on safeguards assessments, the central bank has introduced an external auditing mechanism consistent with international auditing standards, and will publish the audit opinion together with the central bank's financial statements starting with financial year 2002.

31. Being fully supportive of the Fund's policy of enhancing transparency, Colombia once again is interested in having the staff report, the supplement, the Letter of Intent, the TMU and this Buff placed in the web and published.