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

Dear Mr. Köhler:

1. Colombia has continued to make progress under its economic program in a domestic and global environment that has become increasingly difficult. Nevertheless, there has been compliance with the performance criteria established under the program and there has been significant advances on structural reforms. The authorities are committed to continuing the reform effort and to adjusting the fiscal deficit despite the urgent need to increase expenditures to promote the peace effort in the coming year. Significant macroeconomic stabilization has been achieved under the three-year program so far and the exchange rate has shown remarkable stability despite global and regional turmoil, and Colombia's access to the international capital markets is evidence of confidence in the country's economic management. The Fund's involvement with advice and support of the Colombian program has been a key element in the sustained economic recovery effort.

I. Recent Developments

2. The pace of Colombia's economic recovery has slowed in 2001 as both external and domestic factors combined to reduce real GDP growth in the first nine months of the year. To a considerable extent, the slowdown reflected a weakening of both external and domestic demand. In particular, the growth in external markets has weakened, affecting both coffee exports and—most recently—the export of manufactures. Colombia also suffered supply shocks: oil exports were disrupted by sabotage in the first half of the year, and strikes affected economic activity. Inflation has remained in line with the program target of 8 percent for 2001, but the unemployment rate remains high, around 18 percent.

3. Policy implementation under the program has been satisfactory. The quantitative program has evolved as anticipated and a number of significant reforms have been implemented, including the change in the system of revenue sharing with territorial governments. However, some of the structural reforms that were to have been submitted to congress in the first half of this year were delayed, mainly as the government sought to build consensus and mobilize political support for the reforms. Action to implement most of these reforms has since been taken, as described below.

4. The fiscal program has remained on track, despite a shortfall in revenue collections induced by the cyclical downturn, the disruption of oil exports, and some initial delays in implementing the tax package that was approved last year. The revenue shortfall was largely compensated by a reduction in spending, lower-than-projected bank restructuring costs, and larger-than-projected quasi-fiscal profits of the central bank. By allowing for the effect on revenue collections of the cyclical downturn and the temporary reduction in oil exports in the first half of the year, totaling 0.4 percent of GDP, the fiscal deficit for 2001 would meet the indicative target presented at the time of the second program review in March 2001.

5. Colombia has enjoyed successful access to the international capital markets in 2001 even after the events of September 11 in the United States; its sovereign bonds were in strong demand—as reflected in the narrowing of spreads—despite the difficult market conditions faced by some other economies in the region. By mid-May, the government had completed its foreign market-borrowing

program for 2001 through the placement of bonds for US$2.7 billion, of which US$1 billion carried a partial World Bank guarantee. Since then nearly US$1.5 billion in prefinancing of the 2002 market requirements, which total US$2.8 billion, has been obtained, most recently through a bond placement of US$500 million in mid-November. Most of the prefinancing funds will be held abroad until 2002. The government's strategy for the remaining financing needs for next year is to access the markets as early as feasible given the uncertainties surrounding the access for emerging market economies, although the most recent placement is reassuring for Colombia.

6. Monetary trends in the past 18 months have been characterized by the slow growth of deposits and credit. The private sector's financial portfolio is projected to grow by 8 percent in 2001, and broad money would increase by 6.5 percent, up from 1.3 percent in 2000. Outstanding credit to the private sector is projected to rise by 5.5 percent this year when adjusted for loan write-offs and mortgage debt relief, mainly due to strong growth of credit by private commercial banks, while credit by mortgage banks and public banks have continued to decline. Interest rates have declined since the beginning of the year, and the central bank reduced its interest rates on six occasions in 2001 in light of the continued favorable outlook for inflation, the economic slowdown, and declining international interest rates.

7. The recovery of the financial system has continued in 2001. After heavy losses in the previous two years, the system recorded moderate profits in the first half of 2001. The capital adequacy ratio of commercial banks (including public banks and mortgage banks) stood at 12.7 percent in August 2001, nearly unchanged from December 2000. At the same time, nonperforming loans fell to 10.9 percent of total loans, reflecting lower delinquencies for consumer and commercial credit. Mortgage portfolios, however, have deteriorated since May 2000, with nonperforming loans hovering around 20 percent of total loans during 2001. In an effort to strengthen the mortgage banks, FOGAFIN, the public deposit insurance agency, recently launched a recapitalization program for mortgage institutions. Under the new program it will extend credit to the owners of these institutions, against appropriate guarantees, to finance the purchase of capitalization bonds issued by Fogafin and subject to a significant equity injection by the owners. The new line of credit for this purpose has already been set up and has been used to facilitate the restructuring of three mortgage banks. Although the government remains committed to the divestment of all public banks, except Banco Agrario, some legal and administrative steps remain that have delayed the sale or liquidation of some.

8. The foreign exchange market has remained orderly since the peso was floated in September 1999. The central bank's foreign exchange auction system is transparent and has been functioning well. After a depreciating trend in the first five months of this year, the peso has remained stable against the U.S. dollar, resulting in a depreciation of 3.6 percent from December 2000 to October 2001. The central bank continues to be committed to the flexible exchange rate regime and to the transparent procedures for foreign exchange interventions that are compatible with the bank's inflation targeting framework for monetary policy.

9. The reduction of oil exports, mainly due to sabotage of the pipelines in the first half of the year and the weakening of coffee prices are projected to cause the external trade surplus to fall to US$0.4 billion in 2001 from US$2.5 billion in 2000. Nontraditional exports would grow by 8 percent despite a weakening of external demand from around the middle of the year. Imports are projected to grow by 12 percent. Transfer receipts have been larger than envisaged (related to grants under the Plan Colombia and larger remittances from Colombians abroad). The foreign financing of the fiscal deficit and the somewhat higher-than-projected private capital inflows so far this year would help accumulate nearly US$800 million in net international reserves (NIR), with the level rising to about US$9,600 million, equivalent to more than 5.5 months of imports of goods and services.

10. As a result of the strong implementation to date of the government's three-year program, the external vulnerability of the Colombian economy is relatively low (the ratio of NIR to external debt-service payments falling due in 2002 exceeds 100 percent). Colombia has continued to enjoy access to external financing with falling bond spreads despite the turbulence in the international capital markets and the financial difficulties faced by some countries in the region, as noted above. The floating of the exchange rate and the fiscal consolidation since 1999 have strengthened the confidence in Colombia's economic management and given the authorities room to maneuver in case of external shocks.

II. The Outlook for 2001 and the Program for 2002

11. During the recent revision of the macroeconomic framework for 2001, the projection of real GDP growth has been reduced to around 2 percent, from the 3.8 percent projected at the beginning of the year; the forecast for consumer price inflation has been maintained at 8 percent, and the NIR accumulation is projected to exceed the program target. The real GDP growth projection for 2002 has been reduced to 3 percent from 4.5 percent, in line with the revisions that have been made for growth in the world economy.

12. In order to tackle the combined effects of the economic slowdown and the persistence of high unemployment, the authorities introduced a set of measures in the last half of 2001 to help stimulate economic growth and generate employment. In particular, the government announced an initiative to make the labor market more flexible. This initiative was taken up by congress, which will continue to discuss this issue in the March-June session of 2002. Other elements in the set of measures include debt relief and temporary price support for the coffee sector, which is suffering from record low prices on the world market; the use of resources in the petroleum stabilization fund to restructure territorial government debt; and new credit lines (funded by the sale of assets by a second-tier public bank) to benefit small- and medium-sized firms at below market-interest rates (the cost of which will be covered with budgetary transfers). The government has also taken steps to accelerate the low-cost housing construction program, and provide additional resources to fund the public health system. These measures to stimulate economic growth have been adopted in a framework of fiscal discipline, within the deficit target discussed below.

13. The combined public sector deficit in 2001 will be 3.3 percent of GDP, compared with 2.9 percent of GDP in the program. This widening reflects mainly the effect on revenue collections of the cyclical downturn and the impact of the sabotage against oil pipelines. The larger-than-programmed expenditures related to the peace process, the support for the coffee sector, and higher health and social security outlays, have been accommodated by spending compression in other areas, higher quasi-fiscal profits of the central bank, and lower costs of the bank restructuring program (mainly due to lower domestic interest rates).

14. On this basis, the NFPS' primary surplus will continue to improve in 2001, to 1.1 percent of GDP from 0.9 percent of GDP in 2000. At the same time, the primary fiscal balance, when the oil sector and the operations of the public health (ISS) and pension systems are excluded, improved by 3.3 percent of GDP in 2000 and will be strengthened by another 2 percent of GDP in 2001. This illustrates the fiscal consolidation effort to date under Colombia's three-year recovery program.

15. In order to prevent a crowding-out of the private sector from the domestic credit market and avoid upward pressure on interest rates, the public sector has kept its use of domestic credit resources to a minimum so far this year, and the combined public sector deficit is being financed mainly with external resources, (the net use of domestic credit will amount to 0.1 percent of GDP in

2001, compared with 1.3 percent of GDP last year). In June of this year the government swapped domestic debt amounting to Col$5.6 trillion (US$2.4 billion) falling due in 2001-05 with securities of longer maturities in order to smooth the amortization profile. This voluntary operation extended the average maturity of the domestic debt from 3.5 to 4.5 years and reduced amortization payments by 22 percent in 2001 and 34 percent in 2002 at a marginal increase in costs.

16. The combined public sector deficit is projected to be 2.3 percent of GDP in 2002, compared with the 1.9 percent indicated at the time of the second program review, with the increase reflecting the negative impact on revenue of two consecutive years of lower-than-projected economic growth. The target reflects a continuation of the adjustment effort and is consistent with a strengthening of the primary balance by 1.3 percent of GDP. The improvement of this balance over the three years of the government's recovery program supported by the EFF would amount to 5.1 percent of GDP. The primary deficit excluding oil and social security accounts will improve by 1 percentage point of GDP in 2002 for a total adjustment of 6.3 percent of GDP between 1999 and 2002.

17. In addition, Colombia will need to spend some 0.3 percent of GDP in 2002 to further the ongoing peace process in the context of the implementation of the "Plan Colombia," which sets out the government's strategy for settling the internal conflict, curbing the production of and trafficking in illicit drugs, and dealing with the social consequences of these problems. The additional spending reflects the government's intensified efforts in these areas. The continuation of the peace process will strengthen the underlying economic position of the country in the medium term, but requires a temporary increase in spending in order to ensure its adequate implementation. The additional expenditures will be used for social investment in the conflict zones, strengthening the capability of the armed forces, and reinforcing narco-traffic control activities. Since the establishment of the three-year economic recovery program in 1999 the Colombian authorities have explained to the public and to the Fund that a need might arise to strengthen the peace process with targeted expenditure programs. After taking into account these expenditures, the combined public sector deficit will amount to 2.6 percent of GDP in 2002.

18. The government expects that this deficit will be financed mainly through medium- and long-term external resources from multilateral lenders and the private financial markets. As noted, the government has already made considerable progress in prefinancing its 2002 needs. The authorities will continue to make every effort to limit the access to domestic financial savings by the public sector in order to secure adequate domestic credit resources for the private sector to support the economic recovery. If during the first half of 2002 there is a shortfall in the programmed external financing, the government will postpone nonpriority expenditures and will use most of its available external portfolio resources to attend to payments before increasing its access to the domestic financial market. This policy response will be subject to special focus at the time of the subsequent program review, scheduled for September 15, 2002. If Colombia's access to external markets were to become difficult towards the middle of the year, the government will assess the need to cut postponed expenditures. If it is concluded that the difficulties to access international financial markets would remain for the rest of the year, the government would modify its expenditures plans as needed in the context of the review mentioned above. Also, if revenue were to fall short of projections in the first two quarters of 2002, the government will take expenditure measures in order to meet the corresponding fiscal deficit targets.

19. The monetary framework based on inflation targeting that was adopted by the central bank in 2000 has been functioning well. The framework is transparent and the central bank's quarterly inflation reports are made public to provide a clear signal of the central bank's determination to achieve the program's inflation objectives. Within the context of the program, the central bank has

set targets for inflation and the authorities undertake to consult with the Fund (the Executive Board) on inflation control policies if inflation were to deviate significantly from the projected quarterly path, as set out in the attached Technical Memorandum of Understanding (TMU). Information up to November provides assurances that the 8 percent inflation target established for 2001 will be achieved, and the central bank has reaffirmed its inflation target of 6 percent for 2002, thereby continuing the process of lowering inflation towards international levels. The current central bank assessment of inflation for 2002 indicates the possibility of a temporary increase in the prices of food items due to weather related disruptions of a temporary nature, which would not require corrective action on the part of the central bank.

III. Structural reforms

20. The government's structural reform agenda includes ambitious measures to increase economic efficiency, stimulate economic growth, and foster social progress. To this end, a large number of reforms have been introduced so far under the three-year program, starting with the floating of the peso at its inception in 1999. Other important reforms have been introduced through the adoption of an inflation targeting framework for monetary policy; the restructuring of the financial sector; two revenue enhancing tax packages; the establishment of funds to support territorial government pensions; privatization/liquidation of public enterprises and banks; action to deepen domestic financial markets and develop longer-term financial instruments for the private sector; and elimination of the remaining capital account restrictions. Since the second program review in March this year, additional action has been taken to strengthen the control of public finances at all levels of government, mainly through a constitutional reform of the system of transfers (revenue sharing) to the territorial governments and the submission to congress of a proposal to increase territorial government revenue. The central government, in conjunction with the territorial governments, has also been implementing the territorial fiscal adjustment law (Law 617), which is expected to generate permanent fiscal savings, improve the debt profile of territorial entities while preventing the emergence of unfunded contingent liabilities, and reinforce the administrative capacity of local governments. The government also has submitted to congress a proposal to improve the control and allocation of the revenue sharing funds, particularly by strengthening the control of education and health expenditures (reform of Law 60). The proposal for a second-generation pension reform will be presented to congress in December, and a reform that will strengthen the finances of the health service of the Social Security Institute was initiated in July. Also since the last program review, steps have been taken to improve the instruments and procedures used to address and facilitate the restructuring needs of the mortgage banks; and a new legal framework for the capital market is being established.

21. Since early in its mandate and with technical advice from the World Bank, the government has been developing a pension reform that aims to reduce its long-term actuarial deficit and bolster the financial position of the public pension systems, which would otherwise require significant fiscal support over the next decade. The government's draft pension reform has been submitted for analysis and comments to a commission of representatives from the industrial associations, labor unions, congress, and the presidential candidates, before it is presented to congress. The main elements of the government's reform proposal are: a) an increase of up to 2 percentage points in payroll contributions (1 point initially and 0.25 points yearly from 2005 to 2008); b) increased retirement ages (from 60 to 63 years for men and from 55 to 58 for women in 2014 and then to 65 and 60 years, respectively for men and women in 2020); c) an increase, beginning in 2014, in the minimum number of weeks of contributions required for a pension (from 1,000 at present to 1,250 by 2020, increasing by 35 weeks per year); d) making higher-income pensions subject to income taxes; e) establishing a cap for new pensions equivalent to 20 minimum wages; and f) requiring new public employees to enroll in the public pension system. The government expects that the final

approval of the reform will take place in the first half of 2002. The fiscal savings of the pension reform amount to 2.2 percent of GDP during the period to 2010, and the net present value of the pension liabilities to 2050 will be reduced from 206 percent of GDP to 159 percent of GDP. In addition, a reform of the special (privileged) pension regimes will be developed by a group of experts that has been entrusted to present recommendations for their reform by March 2002, which would be added to the reform of the general pension system. The government expects that the reform of the special regimes will make the pension system more equitable and reduce the actuarial deficit further while adding to the medium-term fiscal savings.

22. Action has been taken to reverse the financial deterioration of the Social Security Institute's (ISS) health service. To this end, a wide-ranging restructuring plan has been adopted and is being implemented. The main elements of the plan include an unprecedented renegotiation of the collective bargaining agreement with the health workers completed in October 2001, which reduces wage and pension benefits; a set of measures to streamline the operations of the ISS; and the restructuring of the ISS's debt. It has been decided to reduce ISS costs further through a more equitable distribution of the financial burden related to high-cost illnesses among health insurance providers. Also, the superintendency of health recently lifted the sanction that prevented the ISS from increasing the number of its affiliates; this will allow the ISS to increase its income and contribute further to the reduction of its deficit. These reforms involve significant savings that will reduce the health system's cash deficit by 0.2 percent of GDP per year from 2002, and eliminate its operating deficit by 2005.

23. The reform of the system of revenue transfers to the territorial governments that was adopted through a constitutional amendment in June, will be complemented by the modification of Law 60. The proposed changes in this law, submitted to congress in September, will improve the efficiency in the use of revenue sharing funds and strengthen the control over the use of these resources. In the area of education, the proposed reform establishes clear definitions of the responsibilities between regional and municipal governments for providing education services; distributes resources based on the number of students rather than teachers; incorporates performance indicators for learning; and establishes limits on current spending. The government will set up a special regulatory commission to monitor the performance indicators and determine the technical parameters of the new system, such as the average cost per student, optimal student to teacher ratio, etc. In the area of health, the roles of each jurisdiction are being clarified; a number of intermediary institutions will be eliminated; and performance-based indicators also will be established. While this law is not expected to generate fiscal savings, it will contribute to significant efficiency gains that will allow for a widening of coverage in the provision of these services.

24. The government has named a Public Revenue Commission to address the distortions and rigidities that hamper fiscal efficiency in Colombia. The commission, which includes three foreign experts, has been entrusted to study the Colombian tax system and propose comprehensive measures to deal with the distortions in the revenue system, and the problems stemming from the widespread earmarking of public resources at both the national and local level. The commission also has been asked to suggest further measures to ensure that medium-term sustainability of the public finances is achieved. The commission began its work last July and will issue its final recommendations by August 2002.

25. The territorial tax reform proposal, which was presented to congress in September, is intended to increase the fiscal autonomy at the territorial government level and strengthen tax administration by simplifying regulations and payment procedures. It would appear that this proposal will not be supported by congress in the forthcoming electoral period, and the government will ask the Public

Revenue Commission to review the proposal with a view to including it among its recommendations to the next government.

26. To ensure the permanence of the reforms described above, the government will submit to congress in the first half of 2002 a proposal for a fiscal responsibility law. The main elements of the law will include fiscal rules to ensure that the annual fiscal deficits are consistent with the stabilization of the public debt and procedures for casting the budget within a multiannual financial plan will be established. The proposal will call for periodic reports to congress and evaluations of compliance with the objectives of the law. It also will provide for a further strengthening of the regulations that limit the access to credit of territorial governments.

27. While the financial sector is recovering from the crisis of the past few years, as noted above, the authorities are continuing their efforts to strengthen Colombia's financial system. In particular, in September the government proposed to congress a modification of the banking law to allow the implementation of closed-bank resolution procedures for problem banks and to modify the legal framework for the asset management company (CISA). The adoption of closed-bank resolution mechanisms will help minimize the use of public resources and strengthen the stability of the financial sector during times of stress. The proposed legal framework for CISA will facilitate the sale of the foreclosed assets acquired from the public banks. In addition, the efforts to privatize or liquidate all public banks, except Banco Agrario, have been advancing but recent market events, as well as legal and administrative issues, have delayed the plans. The process of taking Bancafé to the point of sale will be completed by end-2001 and it will be offered for sale when market conditions permit. Progress on the privatization or closure of Granahorrar is being made but its final resolution is subject to the coming into effect of the revisions of the banking law. In the case of Banestado, its commercial activities have been severely curtailed but the bank cannot be sold or liquidated until pending legal issues are resolved.

IV. The Medium Term and Other Issues

28. The authorities have reviewed the medium-term outlook for Colombia's public finances, external debt, and the balance of payments. The projections reflect a conservative scenario in which productivity gains, unemployment, the investment rate, and GDP growth return gradually to their historical levels. As a result of the extensive fiscal adjustment measures and the structural reforms that have been implemented so far, the growth of public sector debt is projected to moderate significantly from the rapid increases in the late 1990s, when the debt rose from 26.7 percent of GDP in 1997 to 42.6 percent of GDP in 2000. At the same time, the external current account deficit would be reduced from 5.4 percent of GDP on average during 1997-98, to 2.9 percent of GDP on average in the period to 2010. The authorities recognize that the fiscal adjustment and the structural reforms being pursued in 2001 and 2002 will not be sufficient to stabilize the public debt at 44-46 percent, as is desirable. To achieve this, it will be necessary to continue Colombia's fiscal consolidation efforts beyond the three years of the EFF-supported program and put in place a combination of measures that permanently reduce the fiscal deficit by around 1 percent of GDP relative to the current projection. It should also be noted that this medium-term scenario does not take into consideration the positive impact on the economy that additional progress in the peace process would bring about.

29. In the area of trade policy, the government has developed a plan to reduce the dispersion of tariffs in the context of harmonization of tariffs within the Andean Group, and to convert the export tax certificates (CERTs) into a simple duty drawback instrument. The export subsidy components of the Plan Vallejo (mainly a subsidy on imports of materials and capital goods used in export industries) and the free trade zones have been notified to the WTO and will be eliminated according

to agreements with the WTO. In September and October, the 1.2 percent customs service charge and the implicit value-added tax on some imports were eliminated. Temporary safeguard measures in the form of tariffs and quantitative restrictions currently exist on three products, but they will be lifted by 2003.

30. The Colombian government gives special emphasis to transparency issues. As noted above, Colombia has subscribed to the Special Data Dissemination Standard (SDDS) and took part in the FSAP pilot project. The government has also decided to undertake the fiscal transparency module; it has advanced on the self-assessment and has requested a technical mission from the Fund to discuss the assessment and complete the module.

31. Colombia has strengthened legislation regarding control and prevention of money laundering since 1992 for all financial intermediaries subject to the vigilance of the Banking Superintendency and has adopted legislation consistent with the 40 recommendations suggested by the Financial Action Task Force. In particular, Colombia is presently strengthening the "know your client" obligations in line with the "Customer due diligence for banks" issued by the Bank for International Settlements early this year. Colombia is also reviewing the mechanisms for control and interdiction of funds transferred for the purpose of terrorist activities, particularly those resulting from drug related operations. An Information and Financial Intelligence Unit was established in late 1990s as part of the country's integrated system to fight money laundering. Its main function is to detect funds originating from narcotics operations, arms trade, extortion, and corruption, among others.

32. The authorities have noted the Executive Board's decision on safeguards assessment and have explained to the Fund staff the legal framework that underpins the current audit system of the central bank. The present system has been working well and has served to safeguard the resources of the central bank. Nonetheless, the authorities commit to establishing an external audit mechanism according to International Standards on Auditing and to publish the audit opinion together with the central bank's annual financial statements beginning with the financial year 2002.

33. The authorities reiterate their commitment to accept the obligations of the Fund's Article VIII, Sections 2, 3, and 4, by the time of the review scheduled for September 2002, and to help achieve this the remaining multiple currency practices will be eliminated. Also, congress has accepted the proposed Fourth Amendment of the Fund's Articles of Agreement and only the final approval by the constitutional court is pending.

34. The Colombian authorities reaffirm their policy commitments under the program supported by the extended arrangement approved by the Fund in December 1999, and request completion of the third review thereunder. At the same time, the authorities request a waiver for the minor technical excess over the end-June 2001 ceiling on the deficit of the combined public sector. In light of the delay in concluding the discussions for the third program review, no performance criteria were set for September and December 2001; the authorities request that the amount of purchases corresponding to observance of the performance criteria for those dates be made available in 2002. In light of the delay in completing the third review of the program, the authorities also propose that the date for the fourth review be changed from February 15, 2002 to September 15, 2002.

Sincerely yours,

/s/	/s/
Juan Manuel Santos Minister of Finance And Public Credit	Miguel Urrutia General Manager Bank of the Republic

Attachment

Colombia—Technical Memorandum of Understanding

1. This memorandum sets out the definition of concepts, specific performance criteria for March 31 and June 30, 2002, and the structural benchmarks for the remaining period of the program, as well as the assumptions that apply under the program supported by the extended arrangement.

I. Fiscal Targets

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

	Ceiling[2] (In billions of Colombian pesos)
Overall deficit of the combined public sector from January 1, 2001 to December 31, 2001 (indicative)	6,550
Overall deficit of the combined public sector from January 1, 2002 to:	
March 31, 2002 (performance criterion)	950
June 30, 2002 (performance criterion)	2,100
September 30, 2002 (indicative)[3]	2,700

[1]As measured by the net financing defined in the text below. The combined public sector is defined in the text below.
[2] Maximum cumulative deficit of the combined public sector. The ceilings for the quarters in 2002 are based on an annual deficit of Col$5,356 billion.
[3]To be specified as performance criterion at the time of the program review scheduled for September 15, 2002.

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. Items denominated in foreign currency will be converted into Colombian pesos at the actual exchange rate of each transaction.

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 pre-payment 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. The local

currency amounts of the net external financing transactions are calculated at the actual exchange rate of each transaction.

7. **Privatization** proceeds are defined as the cash payments received by the PS, converted to Colombian pesos at the actual market exchange rate of each transaction. 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 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 in support of the "Plan Colombia." 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 (Fund staff will provide data for the CIRR if required).

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

II. Monetary Targets

10. Reflecting the BR's inflation targeting approach to monetary policy, quarterly targets for 2002 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 exceptional event that the observed quarterly inflation were to deviate by 2 percentage points or more from the quarterly baseline set out in the table below.[1] 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.

	Actual	Indicative	Projected[1]		
	September 2001	Dec. 31 2001	Mar. 31 2002	June 30 2002	Sept. 30 2002
Inflation target	8.0	8.0	7.8	7.2	6.7

[1]The projected path for inflation is based on the central bank's annual inflation target of 6 percent for December 2002.

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, 2001 (actual)	9,388
December 31, 2001 (indicative)	9,500
March 31, 2002 (performance criterion)	9,580
June 30, 2002 (performance criterion)	9,660
September 30, 2002 (indicative)[2]	9,740

[1]Minimum quarterly levels of NIR of the BR based on a projected annual accumulation for 2002 of US$323 million. NIR is defined in Paragraph 10.
[2]Performance criterion to be specified at the time of the program review scheduled for September 15, 2002.

11. The **NIR** of the BR (reservas de caja) are equal to the balance of payments concept of net international reserves excluding accrued, but unpaid, interest on reserve assets and liabilities (causaciones); and are the U.S. dollar value of gross foreign reserves of the BR minus gross reserve liabilities. The net reserves are accounted for at the U.S. dollar value at the time of acquisition.

12. **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. Gross foreign reserves exclude capital participation in international financial institutions (including Corporación Andina de Fomento (CAF), IDB, IBRD, IDA, 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. **Gross 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; (ii) liabilities to the Fund, (iii) any net position on foreign exchange derivatives, including forward (futures) contracts, with both residents and nonresidents undertaken directly by the BR or by other financial institutions on behalf of the BR; (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$ 88.8 million, which is the level of the

outstanding debt on August 31, 2001; and (vi) any foreign currency deposits in the BR by residents, including financial institutions. Options to sell foreign exchange to the central bank will be added to reserve assets in the net international reserves when they are exercised. The face value of outstanding options to buy foreign exchange from the central bank will be treated as a reserve liability and thus subtracted from the net international reserves.

13. **Adjustment**

(i) The quarterly NIR targets may be adjusted downward by up to US$1.5 billion (about US$650 million above the cumulative overperformance to September 2001 relative to the NIR targets since December 1999), as necessary, to help secure orderly foreign currency market conditions consistent with transparent rules of the central bank's foreign exchange interventions within its inflation targeting monetary framework.

B. Performance Criterion on the Net Disbursement of Medium- and Long-Term External Debt of the Public Sector1 2

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of external debt by the public sector from January 1, 2001 to December 31, 2001 (indicative)	2,680[3]
Cumulative net disbursement of external debt by the public sector from January 1, 2002 to:	
March 31, 2002 (performance criterion)	1,100
June 30, 2002 (performance criterion)	1,800
September 30, 2002 (indicative target)[4]	2,400

[1]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. The quarterly targets for 2002 are based on a total net disbursement of medium- and long-term external debt (including the use of public sector external assets) of US$ 2,573 million during that year.
[2]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).
[3] It is expected that the first tranches of the fast-disbursing loans to be considered by the Board of the World Bank and the Inter-American Development Bank in late December 2001 (US$200 million and US$173 million, respectively) will be disbursed in early 2002. For purposes of the program, these loans will be accounted for in 2001.
[4] Performance criterion to be specified at the time of the program review scheduled for September 15, 2002

14. 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. The changes in the external debt will be valued in U.S. dollars at the exchange rate prevailing at the time of each transaction.

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

C. Performance Criterion on Change in the Outstanding Stock of Short-Term External Debt of the Public Sector1

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of short-term external debt of the public sector from January 1, 2001 to:	
September 30, 2001 (actual)	80
December 31, 2001 (indicative)	180
March 31, 2002 (performance criterion)	180
June 30, 2001 (performance criterion)	180
September 30, 2002 (indicative)[2]	80

[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.
[2]Performance criterion to be specified at the time of the program review scheduled for September 15, 2002

IV. Structural Performance Criterion

16. 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.

V. Structural Benchmarks

17. **To be completed by December 31, 2001:**

- 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 ISS health system.
- Bring to the point of sale at least one public bank through a finding and a decision by the council of ministers that the bank is free of encumbrances and is ready to be offered for sale.

18. **To be completed by June 30, 2002:**

- Introduce reform of special pension regimes referred to above and consistent with the above requirements, 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.

- Introduce a draft fiscal responsibility law in congress.

19. **To be completed by Program Review Scheduled for September 15, 2002**:

- Final report of the Public Revenue commission to be made public.

- 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.

Table. Colombia: Baseline Assumptions for Oil Stabilization Fund Revenue (FAEP)

	Dec.	Proj. 2002[2]		
	2001[1]	Mar.	Jun.	Sep.
	(In millions of U.S. dollars)			
Revenue of FAEP	287	50	50	50

[1]Cumulative since January 1, 2001.
[2] Cumulative since January 1, 2002.

[1]The BR also will provide Fund staff with monthly information and analysis of inflationary developments and forecasts, as agreed, and keep the staff informed of all policy actions taken to achieve the inflation objectives of the program.