Bogota, Colombia
December 3, 1999
Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
Dear Mr. Camdessus:

1. The attached memorandum describes the economic policies that the Government of Colombia intends to pursue during the period 1999-2002, and sets out the specific objectives and targets for the period through 2000. Under the economic program the authorities will seek to promote sustainable economic growth and increased employment; lower inflation; consolidate progress toward external viability; and reduce poverty. The program's success depends crucially on fiscal consolidation, monetary discipline, financial sector restructuring, and continued implementation of the government's structural reform agenda.

2. Colombia's economic policies have been the subject of continuous and close dialogue with Fund staff and management, and the government hereby requests an extended arrange-ment in support of their program for the three-year period through December 2002 in an amount equivalent to SDR 1.957 billion, corresponding to approximately US$2.7 billion.

3. The Government of Colombia believes that the policies set forth in the attached memorandum are adequate to achieve the objectives of the program, but will take any further measures that may become appropriate for this purpose. During the period of the arrangement, the authorities will consult with the Fund periodically on policy issues and measures in accordance with the Fund's policies on such consultations. The first review under the extended arrangement, covering implementation of the economic program, will be completed by June 30, 2000, at which time the quarterly performance criteria for end-September and end-December 2000 also will be determined. There will be semi-annual reviews with the Fund under each of the three years of the arrangement.
Sincerely yours,

/s/	/s/
Juan Camilo Restrepo Salazar	Miguel Urrutia Montoya
Minister of Finance and Public Credit	General Manager
	Bank of the republic

Colombia—Memorandum of Economic Policies

I. Background

1. **The Colombian economy has had a strong record of economic performance, growing at a pace of 4.5 percent a year on average in the last two decades. However, this progress has, since the mid-1990s, given way to slow growth, rising unemployment, and a widening of the fiscal and external current account deficits.** To a considerable extent, the weaker economic performance has been the result of external shocks; political uncertainty; intensification of the armed internal conflict; and growing fiscal imbalances, which have placed a heavy burden on monetary and exchange rate policies.

2. **The deterioration in Colombia's fiscal situation has resulted largely from the introduction of programs earlier in the 1990s that entailed large increases in public spending.** The authorities also have faced difficulties in fiscal management owing to widespread earmarking of government revenue, and the constitutionally mandated revenue sharing arrangements have not been properly accompanied by a reduction of central government expenditures. Hence, although the fiscal decentralization process has helped in consolidating democracy at the local level, the central government has continued to bear much of its original spending responsibilities, with a significant proportion of its resources being transferred to territorial governments.

3. **Colombia also initiated an important structural reform program in the early/mid-1990s** focused on liberalization of the financial system and external trade, and on increasing the private sector's participation in key economic sectors. An important labor reform was enacted in 1990 and was extended in 1996 to most civil service contracts. To promote private sector participation in key economic sectors, the authorities have given concessions for the construction and operation of infrastructure projects, and major public enterprises in the telecommunications, energy, and mining sectors have been privatized. A private pension system, based on individual capitalization, was created in 1993 as an alternative to the system managed by the social security administration. Reforms also were introduced to encourage foreign direct investment; these have proven successful, including in the petroleum and financial sectors.

4. **The economic situation deteriorated markedly in 1998 and in the first three-quarters of 1999, mainly as a result of a series of external shocks.** Export revenue was reduced by a large drop in commodity prices and by the economic difficulties in some neighboring countries. In addition, the turmoil in international financial markets and growing concerns about the sustainability of Colombia's large fiscal and external deficits resulted in episodes of pressure against the peso, capital outflows, and losses of reserves. In response, the authorities announced an economic package in September 1998 to control public expenditure and allow the foreign exchange rate band to depreciate by 9 percentage points. The measures, and the declaration of an economic emergency to tackle the fragility of the financial sector, stabilized the exchange market and facilitated a decrease in nominal and real interest rates from November 1998.

5. **Real GDP** fell 6.7 percent during the first half of 1999 (compared with a year earlier), following a smaller decline in the preceding six months; real GDP is projected to contract by 3.5 percent in 1999, the first decline in more than three decades. The open unemployment rate rose to 20 percent in September 1999 from 16 percent at the end of 1998. The 12-month inflation rate, however, has declined to one digit from the 22 percent average observed during the last 30 years. A real depreciation of the peso of 24 percent year-on-year to August 1999 has contributed to a sharp increase in nontraditional exports to industrial countries this year, but there has been a marked reduction in exports to Andean Pact countries. The external trade account shifted into surplus in the first eight months of 1999 from a deficit a year earlier, reflecting mainly the effect on imports of the contraction in domestic demand and the significant real depreciation of the peso.

6. **The health of the financial sector has deteriorated markedly since end-1996, particularly affecting the financial cooperatives and the public banks, as existing weaknesses in supervision have been exacerbated by the worsening in the economic environment.** The difficulties have been manifested in a rise in the share of nonperforming loans of financial intermediaries from 9.0 percent a year earlier to 13.2 percent in September 1999 (down from 14.1 percent in May); large losses, particularly in public banks, financial cooperatives, and savings and loans institutions; and a significant deterioration in solvency. Three medium-sized credit institutions have been taken over by the authorities, and ten small institutions have been closed. Although all groups of financial intermediaries have weakened, the most serious difficulties have been faced by the publicly owned banks, which account for 20 percent of the deposits of the banking system, and which also have been affected by poor management. The specialized mortgage institutions were affected by interest rates increases in 1998 and a reduction in asset values. Most of the publicly owned banks have been deeply undercapitalized or outright insolvent, with a nonperforming loan ratio of 24 percent in September 1999, compared with 13.2 percent a year earlier.

7. **Soon after taking office in August 1998, the Pastrana administration took steps to respond to the impending economic and financial difficulties;** these included spending cuts, a widening of the VAT base, increased fuel taxes, and the introduction of programs to strengthen tax collections and combat tax evasion and contraband. In November 1998, an economic emergency was declared under which a 0.2 percent tax was introduced on financial transactions to help fund programs to provide relief for mortgage holders and strengthen public banks and financial cooperatives. More recently, and mainly in the context of the national development plan (1999-2002) that was approved in May 1999, progress was made toward addressing structural problems under the fiscal decentralization system (mainly by increasing the efficiency of education spending); reducing revenue earmarking; and providing better incentives for private investment in the oil and minerals sector.

8. **These measures notwithstanding, the fiscal position weakened in 1999 due mainly to the economic recession that adversely affected fiscal revenues, but also reflecting the need for increased spending that arose after the earthquake in the main coffee producing region in January**. The nonfinancial public sector (NFPS) deficit is projected to increase to more than 6 percent of GDP in 1999 from less than 4 percent of GDP in each of the two preceding years.1 The external current account deficit, on the other hand, is projected to fall to 1.3 percent of GDP in 1999 from 5.9 percent of GDP in 1998, with the trade balance shifting from a deficit of 2.6 percent of GDP in 1998 to a surplus of 2.9 percent of GDP in 1999. The capital account surplus also would decline sharply, and as a result the net international reserves are expected to fall by more than US$700 million in 1999.

9. **Exchange market pressures re-emerged in June 1999, following a period of relative calm that had facilitated a substantial easing of monetary policy and a decline in real interest rates**. On June 27 the authorities announced the inflation target and the monetary base growth for 2000; at the same time, the band was again depreciated by 9 percent, and this time it was widened, from 7 to 10 percent on each side of the mid-point.

II. Macroeconomic and Financial Policies

10. **The government's policies for the medium term aim at setting the economy on a strong and sustainable path of economic growth with declining inflation that will expand employment opportunities and promote higher living standards for all Colombians**. Reflecting these objectives, the program for 1999-2002 is centered on fiscal consolidation, financial sector restructuring, exchange rate flexibility, and continued implementation of the structural reform agenda. The pursuit of sustained economic growth is central to the government's efforts to reduce poverty, and to further support this goal the social safety net programs are being enhanced with the support of multilateral agencies and donors.

11. **Improved protection of vulnerable groups is one of the principal policy aims of this administration**, and in light of the more difficult economic circumstances and the rise in unemployment in the past few years, the government has decided to introduce new and strengthen existing programs to reduce the effect of unemployment, poverty, and political violence. The programs have been designed to be cost effective and are consistent with the fiscal program, and focus on direct assistance to the most vulnerable members of society, such as women and children, and on investment in infrastructure as a temporary tool for creating employment. Taking these programs, as well as expenditure on health and education into account, the share of social spending in total government expenditure will increase over the program period.

12. Consistent with the aims and objectives of the government's program, **the economic plan for 1999-2002 seeks to restore real GDP growth in 2000 to 3 percent and raise it to near 5 percent by 2002, while lowering inflation from 10 percent to 6 percent.** The external current account deficit, which is projected to decline to about 1.3 percent of GDP in 1999, would widen to 2.4 percent of GDP in 2000 and remain slightly above 3 percent of GDP in 2001 and 2002. These deficits can be sustained by medium- and long-term external financing and foreign direct investment which has been conservatively projected under the program. On this basis, Colombia's external debt would stabilize at about 43-44 percent of GDP. Net international reserves are expected to remain above five months of imports of goods and nonfactor services and about one-and-a-half times the country's short-term external debt (including longer-term debt falling due within one year) over the program period.

13. **The Colombian authorities expect that domestic investment and national savings will be strengthened as a result of the restructuring of the financial sector and the fiscal consolidation**. Due to the present excess capacity in the economy, the program targets for economic growth in 2000 can be attained without a major increase in investment in that year, but total investment is expected to increase significantly in the last two years of the program to reach 22 percent of GDP by 2002. Private investment is expected to double to nearly 15 percent of GDP and national savings is projected to rise from 15 percent of GDP in 1999 to 19 percent of GDP in 2002, returning both indicators to their historical averages.

A. Fiscal Policy

14. **To achieve a substantial and sustainable reduction in the fiscal deficit over the medium term, the government has designed the set of reforms described below. Some of these have already been submitted to congress and others will follow according to the schedule presented in the attached technical memorandum. In the event that during congressional consideration, some of these initiatives register substantial changes in terms of their expected fiscal outcomes or there are other slippages in the program, the authorities will take alternative measures to assure that the program targets are fully met**.

15. **The fiscal outlook for the period of the program depends crucially on the implementation of structural reforms in the public sector, the success of the ongoing program to strengthen tax enforcement, the recovery of economic activity, and the potential fiscal costs of financial sector restructuring.** There is little scope for reducing the projected fiscal deficit in 1999, considering that measures were already adopted earlier this year and that the central government has limited control in the short term over the use of public sector resources, owing to earmarking restrictions and the revenue sharing arrangements.

16. **For the medium term, the fiscal plan envisages a sharp reduction in the NFPS deficit, to 3.6 percent of GDP in 2000, 2.5 percent of GDP in 2001, and 1.5 percent of GDP in 2002, after taking account of additional social safety net expenditures**. Helped by a recovery in economic activity, this fiscal adjustment will be achieved by widening the tax base further; pursuing the program to strengthen tax enforcement; curbing public sector non-interest spending; gaining better control of resources under the fiscal decentralization system (including through a constitutional reform); strengthening the public sector pension systems; streamlining territorial government

operations; and limiting the replacement of newly pensioned employees. More specifically, the notable fiscal adjustment programmed for 2000 will be achieved mainly through a sharp reduction in central government non-interest spending, including a tight wage policy, pension reforms, and the strengthened tax enforcement program.

17. **Tax evasion in Colombia is high by international standards**. Legislation approved in December 1998 has permitted the government to introduce a comprehensive program to strengthen tax administration and enforcement. In particular, supported by a new service of 1,000 agents and invested with additional powers, the tax administration (DIAN) has been performing ahead of a month-by-month plan to raise tax collections under special programs to reduce contraband, shorten collection lags, collect tax arrears, control VAT and income tax evasion, and simplify tax programs for small businesses. At the same time, the VAT base was widened to generate revenues that would more than compensate for the planned VAT rate reduction (from 16 to 15 percent) in November 1999, also approved by congress in December 1998.

18. **In February 2000, an income tax reform will be presented to congress** aimed at reducing exempted sources of income. At the same time, changes will be introduced to close existing "loopholes" in the VAT system. These measures will be targeted to yield 0.6 percent of GDP per year in 2001 and an additional 0.2 percent of GDP starting in 2002. The government also will extend the financial transactions tax to 2002 and additional revenue will be obtained by a reorganization of the national lottery system. The government is also introducing in the present legislative session (July-December 1999) a series of structural reforms to help control public spending. Noteworthy among these are reforms of the public pensions and social security sector, steps to streamline the fiscal decentralization system, and action to modify operational expenditures of territorial entities. Further details on structural reforms are provided in Section E below.

19. **To help attain its fiscal objectives, the central government will exercise strict control over its non-interest expenditures**, which are projected to decrease from 16.7 percent of GDP in 1999 to 14.8 percent of GDP in 2000, and further to 14.3 percent of GDP in 2002. To achieve this, while at the same time accommodating increased spending on social services for the most vulnerable groups, the government will present budgets consistent with its expenditure reduction plans. Included in the fiscal targets is a special program under the heading of the social emergency fund. The outlays of this fund have been set at 0.3 percent of GDP annually until 2002; funding for this program is expected to come mainly from external sources, as noted above.

20. **More important in the efforts to control public spending over the medium term is legislation (a constitutional amendment) that was presented to congress in September 1999 aimed at maintaining constant in real terms the amount of funds to be transferred to territorial governments under the revenue sharing arrangements.** This reform, which requires approval by two successive sessions of congress, is expected to take effect from July 2001 and provide fiscal savings of 0.4 percent of GDP in 2001, rising to 0.8 percent of GDP in 2002.

21. **The government is committed to continue pursuing the peace process**. To the extent the process moves forward, the authorities intend to frame their public investment plans in order to insure rapid reconstruction of the areas most affected by the conflict and proceed with resettlement of the large number of persons who have been internally displaced. The corresponding outlays will be financed with peace bonds subscribed by businesses and the higher income groups and by contributions from the international community. While a peace settlement is expected to reduce the need for security outlays in the future, the authorities may need to widen the NFPS deficit temporarily, compared with the baseline targets of the program, in order to ensure adequate implementation of a peace agreement. The Colombian authorities would discuss budgetary changes that might be required in this regard.

22. The authorities are confident that the fiscal adjustment described above provides a solid base for the program, with front-loaded reforms that support the fiscal effort. However, some time will be needed for all the structural reforms to take effect and yield fiscal savings. In the meantime,

proceeds from privatization will be used to secure appropriate financing of the fiscal deficit. On this basis, and with the programmed decline in the deficit, the public sector debt (domestic and external) will stabilize at 35 percent of GDP over the program period and decline somewhat thereafter. The decline in the public sector's use of domestic financing during the program will help provide resources for a recovery of activity in the private sector.

23. The fiscal program for 1999 and 2000 will be monitored on a quarterly basis through a ceiling on the combined public sector deficit, as set out in Section I.A of the annexed technical memorandum.

B. Monetary and Exchange Rate Policies

24. **Monetary policy will aim at attaining the inflation target of the program**. Estimates of the demand for financial assets, which take into account the sizeable demonetization observed since end-1997, have been used in framing the monetary program. With fiscal consolidation and a reestablishment of confidence, the burden on monetary policy would ease, and the authorities expect that additional credit resources would be available to help support the reactivation of private sector activity without undue pressure on interest rates, while providing for an increase in net international reserves over the period.

25. **Colombia's framework for the conduct of monetary policy uses the growth of base money as its intermediate policy target**. Open market operations are used to attain the monetary goals and the interest rate is the operational instrument. The monetary base corridor is set annually to support the inflation target and may be modified if projected inflation departs from the target and/or if the velocity of circulation of base money changes significantly. The central bank is taking steps toward adopting direct inflation targeting as a framework for its monetary policy, and for that purpose it is working on an effective forecasting procedure. Until such a framework can be put in place, base money growth will remain the guide for the central bank's disinflation policy.

26. In Colombia, the exchange rate policy has been conducted through an exchange rate band system since 1994. This system of bands has served the country well, but it came under increasing pressure in 1998 and 1999 as Colombia felt the effect of deteriorating terms of trade and turmoil in international financial markets and the imbalances in the economy continued to widen. In response, the Banco de la Republica tightened monetary policy, devalued the midpoint of the band on two occasions (each by 9 percent), and widened the band once, as noted above. Together with a sharp reduction in inflation, these moves and the movement of the nominal exchange rate within the band have resulted in a depreciation of the peso in real terms that has served to restore Colombia's competitive position in international markets. Against this background, and with the strong fiscal adjustment called for in the economic program for 1999-2000, the central bank at the end of September 1999 eliminated the band and allowed the peso to float freely. The central bank expects that allowing the market to set the rate for the peso will enable the Colombian economy to better absorb external shocks and facilitate the conduct of monetary policy, as well as reduce speculation against the currency, while allowing the central bank to continue its disinflation policy. Under the floating exchange rate regime, intervention by the Banco de la Republica in the foreign exchange market will be limited to maintaining orderly market conditions by smoothing short-term movements in the nominal exchange rate consistent with the program projections for the net international reserves.

27. The monetary program for 1999 and 2000 will be monitored by quarterly ceilings on the net domestic assets and floors on the net international reserves of the Banco de la República, as set out in Sections II.A and III.A of the annexed technical memorandum.

C. Financial Sector Restructuring and Policies

28. **The government has taken several important steps to deal with the weakening of the financial sector**. In November 1998 an emergency decree was issued that provided for liquidity support to solvent institutions, and for assistance from the government to mortgage debtors, financial cooperatives, and public banks; the latter was funded in part by resources from the

financial transactions tax. Subsequently, a program was introduced to recapitalize viable private financial institutions whose current shareholders have limited resources available for recapitalization. Under this plan, shareholders will bring banks' net worth back to zero (if negative) and banks will be recapitalized to required levels with medium-term credit from the financial system guarantee fund, Fogafin, for up to 80 percent (guaranteed with their stake in the institution and other collateral, so that 133 percent of the loan is covered) and a minimum 20 percent contribution by shareholders. A part of the latter can be financed by a six-month credit from Fogafin against easily marketable collateral. So far five banks have been recapitalized under this plan.

29. **Following the recent liquidation of the Caja Agraria (a large public sector bank with an extensive branch network) and its replacement with the smaller and more tightly controlled Banco Agrario, the authorities are committed to disinvest fully from all remaining public sector banks during the period 2000 to 2001**. In the meantime, the authorities have established tight controls over the operations of these banks. The financial sector resolution strategy also calls for a major strengthening of banking supervision, including more intense on-site inspections, and for the superintendency of banks to take steps to bring the level of provisioning by financial institutions gradually to international standards by the end of 2002. In July 1999, congress enacted a financial sector reform law that, inter alia, strengthens the power of the supervisory authorities to deal with troubled banks in a timely manner and to increase the minimum capital requirements, among other measures. The regulations required for implementation of most of these measures will be issued by the supervisory authorities by June 30, 2000.

30. **The government intends to move quickly to resolve the remaining problems in the financial sector, which is key to its efforts to foster a speedy recovery of economic** activity. In this context legislation was introduced to congress in October to provide additional relief to the mortgage sector through a program of debt reduction which will be financed by forced investments of bonds by the financial system, the insurance industry, and others. The cost of the resolution package for private, public, and cooperative institutions is currently estimated in net present value terms at the equivalent of 4-6 percent of GDP, including the relief program for mortgage debtors and the present value of the contingent liabilities to former employees (mainly pensions) of the Caja Agraria. About 60 percent of the total cost is accounted for by the need to recapitalize public banks. The fiscal program includes the net carrying cost to the central government of the financial sector restructuring operations.

31. Progress on implementing the financial sector restructuring strategy and privatizing public banks will be monitored at the semi-annual reviews of the program, the first scheduled for completion by June 30, 2000.

32. The government also has taken steps to help restructure corporate sector debt. To this end, in June 1999 the government announced special lines of credit administered by the Instituto de Fomento Industrial and the Banco de Comercio Exterior de Colombia, both of which are second-tier state run institutions. These resources will be provided by multilateral lending institutions and other second-tier banks. In addition, the government in October introduced legislation to facilitate voluntary debt restructuring agreements.

D. External Sector Policies

33. **As noted above, the external current account deficit** is projected at 2.4 percent of GDP in 2000 and slightly above 3 percent of GDP in 2001 and 2002, predicated on a continued strong recovery in nontraditional exports and moderate import growth, supported by a real depreciation of the peso by 24 percent over the last 12 months and further gains in competitiveness during 2000-2002 based on additional fiscal consolidation and structural reform. The current account projection also takes account of a decline in oil exports after existing fields reach peak production in 1999. While the authorities have introduced reforms to reverse the prospective decline in oil production, the present outlook suggests that oil exports could decline by one-third from 1999 to 2002.

34. **The government remains committed to a liberal trade regime** and to act in accordance with WTO principles. In this regard, agricultural sector protection and import tariff dispersion will be set in accordance with Andean Pact rules and will meet the deadlines set by the agreement with the WTO. The subsidy component of the export credit certificates (CERTs) will be eliminated according to the schedule agreed with the WTO. The government intends to seek deeper integration both within the Andean Pact and outside the region, in particular with ALCA and MERCOSUR. From January 2001 Colombia will start phasing out the remaining exchange restrictions subject to Fund approval and will accept the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement before the end of 2002.

35. **Colombia's external debt remains manageable, but it has risen significantly in recent years**, from 32 percent of GDP in 1997 to 41 percent of GDP in 1999. Under the program, it would stabilize at about 43-44 percent of GDP. Given the recent volatility of short-term capital flows and the fragile state of the financial system, the central bank has intensified its monitoring of such flows, including the availability of external credit lines to the financial system. The deposit requirement on external borrowing established by the central bank Board of Directors has been reduced sharply in recent years and will continue to reflect the differential between domestic and international interest rates. The deposit requirement does not seek to restrict capital inflows but, rather, to avoid the vulnerability risks involved in a large build-up of short-term external debt.

36. Colombia's external public debt will be monitored through quarterly limits on the net disbursement of such debt and the amount of guarantees provided by the public sector for private external debt, as set out in the annexed technical memorandum, Sections III. B and C.

E. Structural Reforms

37. **Considerable progress has already been achieved on structural reform over the past year.** A tax reform was enacted in December 1998, as noted previously; the central government's cofinancing funds (which provide matching grants for territorial government projects) have been eliminated; the pervasive system of revenue earmarking (including the earmarking provisions of the value-added tax receipts) is being reduced and made more flexible; and gasoline price setting has been liberalized.

38. **A number of additional reforms are being introduced in the July-December 1999 legislative session**. The government has already proposed to congress legislation to streamline the fiscal decentralization system through the creation of a territorial pension fund, and to strengthen the finances of territorial governments by limiting their current expenditures. As noted above, among the reforms already presented to congress is also a constitutional amendment which would change the current system of transfers to territorial entities from a fixed proportion of current government revenue to amounts that will remain constant in real terms. The government intends for the new system of transfers to take effect in 2001 in the case of transfers to departments and in 2002 in the case of transfers to municipalities.

39. **Moreover, in the July to December 1999 session of congress the government is presenting proposals for a comprehensive reform of pension systems in Colombia.** This project includes a second generation reform of the social security system, and actions to bring the special pension schemes more in line with the pension provisions of the general social security system. The major fiscal effect of these reforms will be felt when the transition to the new social security regime has been completed by year 2010, generating about 0.5 percent of GDP savings on a permanent basis.

40. **As noted above, the government will submit to congress in early 2000 a tax** reform that seeks to broaden the base of the income tax and close loopholes in the VAT, and extend the financial transactions tax to 2002. Subsequently, the government also will propose to congress a reform which would grant additional fiscal autonomy to territorial government that could yield an additional 0.2 percent of GDP.

41. **Colombia's privatization program, which has been ongoing since the early 1990s, will gain momentum during the first year of the program** as several major enterprises are expected to be sold. In order to allow time for all the structural reforms described above to take effect and yield the expected fiscal savings; the government will rely on the privatization proceeds to help finance the fiscal program in 2000 and to a lesser extent in 2001. In accordance with decisions that have already been taken, the government expects that by the end of 2000 large companies in the electricity distribution sector will have been privatized and that the sale of a major mining company (Carbocol) will have been concluded. As part of the financial sector restructuring, the remaining public banks, except Banco Agrario, will be offered for sale to the private sector. In the telecommunications sector, the government already has opened up significantly access to the private sector, and long-distance tariffs have dropped considerably.

42. Colombia has over the last several years made **considerable progress in expanding private sector participation in the provision of infrastructure services**. Concessions for new projects in road and railroad construction and operation, as well as existing airport facilities, are being auctioned off to the private sector. In the oil sector, the government recently has introduced a more flexible system of royalties and permitted increased private sector participation. By improving the incentives for oil exploration, it is expected that the country will continue to be an oil exporter in the longer term.

43. To strengthen the **foreign investment regime**, the government already has taken steps to improve the terms that govern investments in the oil and mineral sectors, as just noted. To further boost private investment, a constitutional amendment was approved in the first half of 1999, which strengthens the assurances of fair compensation in cases of public expropriations. These measures are expected to contribute to a recovery in foreign direct investment over the program period.

44. **Colombia adopted a comprehensive labor reform in 1990 that substantially increased the flexibility of the labor market.** However, the recent deep recession and the remaining rigidities in the labor market have contributed to Colombia's high level of unemployment. With a view to reducing the level of unemployment, the government has introduced a series of short-term measures, including labor-intensive maintenance projects, and provided tax incentives for employment creation.

45. Progress in the implementation of the structural reform agenda will be monitored at the semi-annual reviews of the program. In particular, the first review, scheduled for completion by end-June 2000, will focus on progress on the government's legislative agenda and privatization program.

F. Social and Other Policies

46. **Under the strengthened programs in the social area**, labor-intensive projects for maintenance of roads and railroads have been initiated, much of which in the area affected by the January 1999 earthquake. In addition, with the purpose of building housing for the poorest and

creating jobs, a housing plan financed jointly by the central and municipal governments and coordinated by NGOs is being launched. A similar scheme will be used to maintain and improve schools. The social housing program would reduce the present shortage of 1.2 million units by 500 thousand units over the next four years, mostly in urban areas. The provision of potable water and safe sewerage are important elements of this administration's efforts in the area of public health, and the plans call for increasing services of water and sewerage to 3.4 million of people over the next four years.

47. **The government is determined to pursue an active policy against money laundering**, including through international collaboration. Since 1998, a Special Information and Analysis Unit has been active in collecting, organizing and analyzing information about financial transactions that could be linked to illicit activities, and has promoted initiatives to control money laundering. The role of this Unit has been strengthened by the approval of law 526 by congress in August 1999. Existing regulations on the reporting of suspicious transactions and transactors are consistent with international standards.

G. Disclosure of Economic and Financial Information and Program Monitoring

48. **The Government of Colombia acknowledges the importance of timely publication of economic and financial data.** The Bank of the Republic and the superintendency of banks already place a large amount of regular data on their internet websites, as does the ministry of finance and the national planning agency. Since 1996, Colombia has participated in the SDDS initiative. A multisector mission from the Fund's Statistics Department visited Colombia in late 1997 and subsequent follow-up missions have provided assistance to the authorities' ongoing efforts to strengthen the production of statistical information.

49. The Government of Colombia will provide the IMF with the information needed to monitor the implementation of the program as well as other information that may be needed to monitor adequately economic and financial developments in Colombia.

Colombia-Technical Memorandum

I. Fiscal Targets

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

	Floor[2] (In billions of Col$)
Overall balance of the combined public sector, from January 1, 1999 to:	
December 31, 1999 (performance criterion)	-9,150
March 31, 2000 (performance criterion)	-11,550
June 30, 2000 (performance criterion)	-13,300
September 30, 2000 (indicative target)[3]	-14,400
December 31, 2000 (indicative target)[3]	-15,300

[1]As measured by the net financing requirement defined below. Combined public sector as defined below.
[2]Minimum cumulative balance of the combined public sector.
[3]Performance criterion to be specified at the time of the mid-term review of the first year arrangement.

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 Fondo de Garantías de Instituciones Financieras (FOGAFIN), and the net fiscal costs borne by the central government 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 Combined Public Sector

PS	=	NFPS[1] + FOGAFIN + quasi-fiscal BR + net fiscal costs borne by the CG 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 CG related to bank restructuring.

3. For any given calendar quarter, the overall **PS balance** is measured, in Col$, as the sum of: (i) its net domestic financing, (ii) its net external financing, and (iii) privatization proceeds, as defined below. Items denominated in foreign currency will be converted into pesos at the actual exchange rate of Col$/US$.

4. The PS **net domestic financing** comprises (i) the change in its net credits from the financial system excluding bonded debt; (ii) the change in its bonded debt (including domestic bonds denominated in or indexed to foreign currencies) net of valuation changes; (iii) the operating cash result of the BR; (iv) the change in the floating debt (cuentas por pagar) of the central administration (from March 2000 the floating debt of the principal public enterprises also will be reported and included); (v) public funds administered by Fiduciarias; and (vi) any additional domestic financing operations by FOGAFIN. Any capitalization of interest on new issues of government bonds will be included as expenditure for the purpose of measuring the PS deficit.

5. The **financial system** comprises the banking sector, saving and loan institutions (corporaciones de ahorro y vivienda), finance corporations (corporaciones financieras), FEN, IFI, finance and leasing companies (compañias de financiamento comercial), Bancoldex, Finagro, and Findeter. The banking sector includes the BR, the commercial banks, and BCH.

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

7. **Privatization** proceeds are defined as the cash payments received by the PS, converted to Col$ at the actual market exchange rate of each transaction. Nonrecurrent fees for concessions of 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 amount. Proceeds from 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.

II. Monetary Targets

A. Performance Criterion on Net Domestic Assets (NDA) of the BR

	Ceiling[1] (In billions of Col$)
Outstanding stock of net domestic assets as of:	
September 30, 1999 (actual)	-8,642
December 31, 1999 (performance criterion	-7,650
March 31, 2000 (performance criterion)	-8,950
June 30, 2000 (performance criterion)	-9,050
September 30, 2000 (indicative target)[2]	-8,740
December 31, 2000 (indicative target)[2]	-7,980

[1]Maximum level of end-of period outstanding stock of net domestic assets in the BR. This level has been calculated as the difference between the upper band of the central bank's monetary base corridor and the floor of the NIR established in Section III below.
[2]Performance criterion to be specified at the time of the mid-term review of the first year arrangement.

8. The **NDA** of the BR are defined as the difference between the monetary base and the net international reserves (NIR) of the BR, valued in Col$ at an accounting exchange rate. The monetary base consists of currency in circulation, including cash-in-vaults at financial institutions, and the sight deposits of the financial system at the BR.

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

10. Gross foreign reserves of the BR comprise (i) gold, (ii) holdings of SDRs, (iii) the net position in the FLAR, and (iv) all foreign currency-denominated claims of the BR. Gross foreign assets exclude participation in international financial institutions (including Corporación Andina de Fomento (CAF), IDB, IBRD, IDA, and the Caribbean and Development Bank), the holdings of nonconvertible currencies, and holdings of precious metals other than gold. **Gross reserve liabilities** of the BR are defined as the sum of (i) all foreign currency-denominated liabilities of the BR with original maturity of one year or less, (ii) liabilities to the Fund, (iii) any net position on foreign exchange derivatives 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$125 million, which is the level of the outstanding debt on October 1, 1999, and (vi) any foreign currency deposits in the BR by residents, including financial institutions. Options to sell foreign exchange to the central bank acquired by financial institutions and the treasury at the monthly auctions to build the central bank's reserves (mecanismo para acumular reservas internacionales) will be added to reserves when they are exercised.

11. The BR and Fund staff foresee the possibility that the demand for currency may increase beyond projected levels toward the end of 1999 as a result of perceived uncertainty about computer problems that may affect financial transactions from January 1, 2000. Such increase may give rise to non-observance of the performance criteria established for December 31, 1999, particularly on

the net domestic assets of the BR. In such an event, the Fund would be asked to consider a technical waiver of the non-observance after Fund staff has reviewed developments with the Colombian authorities.

12. **Adjustments**. Adjustments to the ceiling on the NDA of the BR are described in Section III (13) below.

III. External Targets
A. Performance Criterion on Net Domestic Assets (NDA) of the BR

	Target[1] (In millions of U.S. dollars)
Outstanding stock as of	
September 30, 1999 (actual)	7,850
December 31, 1999 (performance criterion)	7,850
March 31, 2000 (performance criterion)	8,150
June 30, 2000 (performance criterion)	8,350
September 30, 2000 (indicative target)[2]	8,250
December 31, 2000 (indicative target)[2]	8,570

[1]Minimum level of NIR of the BR. NIR as defined in Section II above.
[2]Performance criterion to be specified at the time of the mid-term review of the first year arrangement.

13. **Adjustments**

(a) The quarterly NIR targets may be adjusted downward by US$500 million, as necessary, to help secure orderly currency market operations after the September 1999 floating of the peso. The amount of any overperformance on the adjusted NIR target for December 31, 1999, up to US$500 million, can be carried forward into 2000 as follows: the adjusted NIR target for March will be subject to an additional downward adjustment of one-half of the overperformance; the adjusted target for June of one-quarter of the overperfor-mance; and the adjusted target for September of one-eight of the overperformance. In case of such adjustments to the NIR, the NDA ceiling established above in Section II.A will be raised using the following marginal adjustments:

Loss of NIR Relative to Baseline (In US$ million)	Marginal Increase of NDA Ceilings[1] (In percent of observed NIR loss)
Between 0 and 200	100 percent
Between 200 and 300	90 percent
Between 300 and 400	80 percent
Between 400 and 500	70 percent
More than 500	60 percent

[1]These refer to the marginal adjustment of the NDA ceiling for each successive US$100 million loss of NIR relative to the baseline. For example, a loss of US$300 million relative to the baseline would imply an upward adjustment of the NDA ceiling by the equivalent in Col$ of US$290 million.

(b) In case there is a shortfall from the amount of net external financing of the combined public sector programmed for 2000 (the sum of privatization proceeds and changes in external debt, as defined in Section I, paragraphs 6 and 7 above and shown in the attached Table 1), the quarterly targets for the NIR in 2000 will be subject to a further downward adjustment of any shortfall up to a cumulative US$600 million through March, and up to a cumulativeUS$900 million for the rest of the year. The ceilings on the NDA of the BR will be raised by the equivalent in Col$ of any downward adjustments in the NIR targets.

(c) In the case of an excess in the amount of net external financing of the combined public sector with respect to the baseline (Table 1), the quarterly targets for NIR will be adjusted upward by the full amount of the excess less US$50 million (such excess could be avoided by increasing the public sector's assets abroad, as indicated in paragraph 6 (viii) above). The ceiling on the NDA of the BR will be lowered by the equivalent in Col$ of any such adjustment in the NIR target.

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

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

	Ceiling[1] (In millions of U.S. dollars)
Cumulative net disbursement of external debt by the public sector from January 1, 1999 to	
December 31, 1999 (performance criterion)	2,450
March 31, 2000 (performance criterion)	2,600
June 30, 2000 (performance criterion)	2,750
September 30, 2000 (indicative target)[2]	2,850
December 31, 2000 (indicative target)[2]	3,200

[1]The public sector includes the PS as defined above and the financial public sector, including second-tier banks.
[2] Performance criterion to be specified at the time of the mid-term review of the first year arrangement.

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. Adjustments. To the extent there is a shortfall in privatization proceeds relative to the program baseline shown in the attached Table 1, the ceiling will be adjusted upward by 50 percent of the shortfall.

16. 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[1] (In millions of U.S. dollars)
Cumulative net disbursement of short-term external debt of the public Sector from January 1, 1999 to:	
December 31, 1999 (performance criterion)	382
March 31, 2000 (performance criterion)	70
June 30, 2000 (performance criterion)	70
September 30, 2000 (indicative target)[2]	70
December 31, 2000 (indicative target)[2]	70

[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 mid-term review of the first year arrangement.

III. Structural Benchmarks

17. **To be completed by December 31, 1999**

• Present to congress a proposal for a second generation social security reform. (Modifying Law 100 of 1993).

- Present to congress a proposal for the creation of the territorial government pension funds.
- Present to congress a constitutional reform which delinks transfers to territorial governments from current income of the central government.
- Present to congress a proposal for the fiscal strengthening of territorial entities by means of limiting their current expenditures.
- Present to congress a proposal that organizes lottery activities to help boost public revenue.

18. **To be completed 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

19. **To be completed by June 30, 2000**

- Regulations issued to implement the provisions of the financial reform law enacted in July 1999.

20. **To be completed by March 31, 2001**

- Present to congress a proposal on territorial tax policy, granting more fiscal autonomy to territorial governments (territorial tax reform).

21. **To be completed by December 31, 2001**

Full disinvestment from all remaining public banks, excluding Banco Agrario.

22. **To be completed by September 30, 2002**

Complete 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 1. Colombia: Baseline Assumptions for Net External Financing of Combined Public Sector

	Mar. 2000	Jun. 2000	Sep. 2000	Dec. 2000
	(In millions of U.S. dollars)			
Net external financing of combined public sector (cumulative in 2000)[1]	**1,217.61**	**2,086.93**	**2,452.01**	**3,197.17**
Cumulative privatization proceeds	385	1,265	2,235	2,785
Cumulative net external financing of the combined public sector[2,3]	832.607	821.928	217.013	412.172

[1]Includes only external sources.
[2]Including concession revenues.
[3]For purposes of the program the net external financing for the first quarter of 2000 includes the US$500 million of prefinancing obtained in November 1999 that is being held abroad until the first quarter of 2000.

[1]There are some basic differences between the methodology of the IMF and the Colombian authorities in fiscal accounting, mainly related to the treatment of central bank profits and the inclusion by the IMF of net lending and floating debt in the measurement of the fiscal deficit. Thus, in the Colombian methodology, the nonfinancial public sector deficit would be 4.6 percent of GDP in 1999.