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THE BOARD OF DIRECTORS' REPORT  
TO THE CONGRESS OF COLOMBIA

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MARCH DE 2000

BANCO DE LA REPÚBLICA

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*Santafé de Bogotá, D.C., March 27, 2000*

*Honorable Chairmen and Members  
Third Standing Constitutional Committees of  
The Senate and  
The House of Representatives  
Santafé de Bogotá*

*Dear Sirs,*

*Pursuant to Law 31 of 1992, Article 5, the Board of Directors of the Banco de la República hereby presents for consideration by Congress a report on the country's macroeconomic results for 1999 and the current year to date. The report also contains the targets adopted by the Board for 2000, together with forecasts of the different macroeconomic variables. The final section describes the composition of international reserves and provides projections of the Banco de la República's financial situation for the year 2000.*

*Yours truly,*

*Miguel Urrutia Montoya  
Governor*

## INTRODUCTION

Average annual inflation, as measured by the Consumer Price Index, stood at 9.2% in December 1999, 7.5 percentage points down on a year earlier and 5.8 percentage points below the 15% target set by the Banco de la República for 1999. This was the lowest year-end inflation since 1970 and the first one-digit consumer inflation to be reported in 30 years. The lowering of inflation last year was a step forward in the process of inflation control undertaken by the Board of Directors since its creation, pursuant to the Banco de la República's constitutional mandate of bringing about price stabilization as a fundamental task.

In contrast to this satisfactory result, Colombia's gross domestic product registered a record fall of 5.2% in real terms\*. The sharp decline in economic activity was accompanied by a rise in unemployment: 18.1% in December 1999, slightly lower than in September (20.1%) but still one of the highest ever recorded in Colombia.

Thus, the economy registered historical extremes in 1999, in terms of low inflation on the one hand, and deep recession with high unemployment on the other. The considerable loss of drive in economic activity characterized an economy in crisis, with underused productive facilities and almost one fifth of the labour force jobless. Understanding the causes of this crisis is essential to formulating suitable economic policies to overcome it without generating inflationary pressure.

An economic contraction as sharp as Colombia's last year is brought about by a number of immediate and distant causes. In this case, an immediate cause was the international financial crisis of 1998, while the longer-gestating causes included financial fragility, macroeconomic imbalances produced by excessive aggregate demand during some years of the nineties, intensification of the internal armed conflict, and political uncertainty. The July 1999 Report to Congress pointed out as the main causes of the recession: increasing deterioration of public finances, a high current-account deficit, a fall in private saving, and financial fragility. On the basis of that diagnosis, the present Report highlights an adjustment and recovery scheme that is expected to rectify the major internal and external macroeconomic imbalances so as to set the economy on a path of high, sustainable growth.

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\* This estimate does not include DANE's revision-as this Report was going to press-of industrial performance, to the effect that the decline in industrial activity was less than initially estimated, signifying a lower contraction in the economy in 1999 than is reported here.

The policies for stimulating economic recovery need to be considered in close connection with the causes of the recession. The success of the policies clearly depends on their effectiveness in eliminating these causes. It is appropriate therefore to mention once more, albeit briefly, the causes of the recession, so as to establish the context for analyzing the policies for recovery. One point consistently emphasized by previous Reports is the excessive growth in both public and private spending that started in the early nineties. Accelerated public spending led to a public-sector deficit of 3.6% of GDP in 1998, compared with barely 0.5% in 1990, while soaring private spending induced an unprecedented boom in share prices, and a fall in private saving, from 14.1% of GDP in 1990 to 6.1% in 1998, according to the latest figures available.

An economy in which domestic demand outpaces production inevitably ends up generating external imbalances. In Colombia's case such imbalance showed up in the balance-of-payments current account, with the surplus of the early nineties turning into a record deficit of 6.2% of GDP by the first quarter of 1998. The deficit was financed from growth in total external debt, which rose from 27.4% of GDP in 1994 to 36% in 1998, despite implementation of a privatization program. The private sector accounted for most of this borrowing, expanding its share of total foreign debt from 34% to 48% over the same period. An external imbalance of this magnitude makes the economy highly vulnerable to adverse changes in world-market conditions for goods and capital. Colombia's recent experience has been very illustrative in this respect. A worsening of the terms of trade, a drastic fall in capital inflows, and the rising cost of foreign credit caused a loss of confidence among economic agents that might not have proved so sharp if the macroeconomic fundamentals had been in better shape.

Loss of confidence in the viability of Colombia's external position soon led to speculative attacks against the peso, which translated into a fall in international reserves and a strong upward pressure on the exchange rate and domestic interest rate. The rise in interest rates was induced by various kinds of mechanisms. The first was monetary contraction resulting from the fall in international reserves. If the monetary authority had tried to avert this contraction completely through increased primary expansion, the outcome would have been to stimulate further attacks against the peso, leading to a balance-of-payments crisis, as in other countries. The second mechanism was growth in the parity interest rate (a measure of the return economic agents expect to obtain relative to rates abroad) caused by expectations of higher devaluation of the peso. The increase in the parity interest rate was soon reflected in a higher domestic interest rate. The third mechanism was uncertainty about the country's capacity to finance the external imbalance. This led both domestic and foreign investors to demand a higher risk premium to keep their capital in the country, which helped drive up the domestic interest rate.

The complex chain of repercussions that such a situation can produce in an economy can be analyzed by reviewing Colombia's experience. On the external front, a higher exchange rate raised the cost of foreign debt considerably. The private sector was hard hit by this because of its high level of foreign borrowing and poor level of foreign-exchange coverage. On the domestic front, a higher domestic interest rate, combined with over-borrowing by the private sector, led to

slower growth in lending, which, by damping demand, sharply brought down fixed-asset prices, particularly real estate prices, which had risen to artificially high levels in the past. This was reflected in a loss of wealth, reducing the capital base of households, companies and the financial sector. The loss of capital was deepened by costlier debt servicing, which increased the amount owed in pesos.

As a result of the situation described above, the financial sector saw a rapid expansion in bad debts, which showed up, through provisioning, as heavy losses that weakened the sector's capital position, damaged its solvency and enfeebled it even more. Financial intermediaries therefore began to limit their lending. The economy suffered not only from the lack of credit but also from the fall in households' consumption capacity and decline in private-investment capacity resulting from the deterioration in family and enterprise fortunes. This situation ultimately produced an overall contraction in spending, and the outbreak in 1999 of an economic recession propelled by feedback forces and therefore reversible only by means of a consistent, credible and effective economic policy.

This is precisely the central aim of the adjustment and recovery strategy presented in this Report. Productive activity must be revived, but this has to be done in a sustainable manner by preserving the gains obtained so far in other areas. The most important of these gains is undoubtedly reduction of inflation to its lowest level in 30 years. Low inflation brings greater equity and efficiency in resource allocation, which will generate long-term benefits for society as a whole. The second gain to be preserved is reduction of the current-account deficit. This was brought down from 5.3% of GDP at the end of 1998 to 1.5% in 1999 and is expected to remain under 3% for the next few years. A lower current-account deficit ensures the viability of the country's external position, making it less vulnerable to negative external shocks, which have caused the Colombian economy so many setback in the past two years.

The adjustment and recovery strategy required for accomplishing the above aims must have two fundamental characteristics: it must be credible, and macroeconomically consistent. Credibility was fully achieved in the second half of 1999 by designing a macroeconomic program that has been endorsed by the international financial community and establishes precise guidelines for the adjustment effort to be made over the next three years. Macroeconomic consistency is a technical requirement met by designing each one of the program's goals in full knowledge of the economic interrelationships between the different variables.

As described in detail in this Report, the adjustment and recovery strategy deals with the causes of the recession, focusing on three basic areas crucial to the success of the adjustment program, namely: monetary discipline, restructuring of the financial sector, and fiscal consolidation, which requires implementation of the government's agenda of structural reforms. Action on these economic-policy fronts will rectify the fundamental disequilibrium—faster growth in spending than in output—which deepened all through the nineties and ultimately undermined the viability of the country's external position. More specifically, fiscal adjustment will give the private sector greater scope for spending and financing and allow the existing structural imbalances to be corrected

without any sacrifice of the inflation reductions already achieved. Moreover, setting the country's public finances in order will ease the heavy burden monetary policy has been carrying in efforts to bring about macroeconomic stabilization. This will make it easier to keep interest rates at a suitable level for stimulating economic recovery and solving the financial sector's problems.

The adjustment and recovery scheme is presented in Chapter II. Chapter III deals with macroeconomic matters: monetary and credit policy, exchange and balance-of-payments policy, financial policy, and fiscal policy. Inflation results are presented in Chapter IV, with a description of basic trends in inflation. Chapter V discusses major developments in economic activity and unemployment. Chapter VI rounds off the Report with a review of the country's international reserves and the Banco de la República's financial situation.



## ADJUSTMENT AND RECOVERY PLAN

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### A. RATIONALE FOR THE ADJUSTMENT

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To achieve economic growth, price stability and external viability, economic management will have to keep the level and growth rate of aggregate demand in line with the economy's productive capacity and resource base. This requires domestic economic policies designed to ensure consistency with macroeconomic equilibrium. Four broad policy areas can be identified in this connection.

First is *the fiscal dimension of macroeconomic management*. The growing disequilibrium in Colombia's public finances has generated an expansion in aggregate demand that is inconsistent with macroeconomic equilibrium. This has been reflected in a growing current-account deficit in the balance of payments, adversely affecting the country's external position.<sup>1</sup> Correcting this disequilibrium calls for efforts to rationalize spending growth and increase revenues and thereby make the country's public finances viable once more and its external position firmly sustainable. Fiscal results are closely linked to financial developments, especially to the behavior of money and credit markets in the economy. This is because the fiscal balance depends on public borrowing needs, specifically borrowing from the banking and private sector. Consequently, besides improving external viability, the fiscal adjustment will allow greater scope for financing private consumption and investment, stimulating their growth and contributing to economic recovery.

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<sup>1</sup> Reduction of the current-account deficit in the balance of payments in 1999 was largely attributable to a 26.8% fall in imports. In the absence of fiscal adjustment the reduction was produced by a significant contraction in private-sector spending.

A second policy area is *the monetary dimension of macroeconomic management*. This area of the adjustment plan highlights the significant link between expansion of money supply and domestic credit on the one hand, and aggregate spending and income on the other. In other words, it focuses on the fact that a discrepancy between money supply and demand (monetary disequilibrium) is mirrored by a discrepancy between spending and income (goods-market disequilibrium). Accordingly, to maintain a stable relation between spending and income, primary money will need to be expanded in line with the expected path of desired monetary balances in the economy. This is the consideration behind the adjustment plan's emphasis on the range of expansion of net internal credit by the Banco de la República.

*The financial dimension of macroeconomic management* is part of the adjustment plan, because a strong and efficient financial sector is essential to mobilizing domestic savings between sectors that generate a deficit and sectors that generate a surplus in any economy. Intermediation failures caused by the weakness of financial institutions, as in the case of a credit crunch, help to generate recessionary tendencies in economic activity. An adjustment plan designed to produce an economic upturn should therefore contain measures to restructure and consolidate the financial system, if necessary.

In the fourth place, consistency requires that both fiscal and monetary policy be complemented by a suitable strategy for managing external assets and liabilities. This is the *external financing dimension*, covering external debt, foreign investment, and privatizations. The importance of this policy stems from the direct bearing it can have on the balance

between spending and income and on substitutability between external and domestic credit. In essence, a central concern of macroeconomic management is that the total flow of financial resources (domestic and foreign) in the economy should be compatible with a sustainable spending-and-income pattern that keeps aggregate demand from expanding beyond the economy's productive capacity. In an adjustment plan this restriction can appear as explicit ceilings on public external borrowing.

Besides the characteristics described above, such an adjustment plan would require international backing to make it more credible, so that it can generate a climate of confidence both at home, to facilitate implementation of the adjustment policies, and abroad, to increase access to world capital markets.

In July 1999 the government and the Bank's Board of Directors, aware of the need for implementing macroeconomic adjustments regarded as credible in Colombia and abroad, drew up an adjustment plan, subsequently endorsed by the International Monetary Fund through an agreement signed on December 20, 1999. This is one of the most important economic-policy decisions taken by Colombia in recent years. It is therefore considered pertinent to explain in this Report to the Honorable Members of Congress the need for this plan, its main points, and the economic benefits the country may expect to derive from its implementation.

The necessity for this adjustment plan is an inevitable consequence of the macroeconomic imbalances that began to develop in Colombia's economy in the early nineties. Economic literature has shown that countries presenting larger macroeconomic imbalances will inevitably be affected by external shocks. Colombia has not been the exception. In 1998, when the effects of the Asian crisis began to be felt in Latin America, exacerbated later by the Russian foreign-debt moratorium and its repercussions on Brazil's economy, symptoms of contagion appeared in the Colombian economy. One of the first effects of the external crisis was a significant drop in capital inflows,

evidenced by a fall in the balance-of-payments capital account, from US\$7,092 millions (m) in 1997 to US\$4,454m in 1998, and down to a scant US\$462m in 1999. This fall stemmed in part from contraction in international reserves, which fell by US\$1,390m in 1998, and by US\$331m in 1999 (Table 1).

If the Colombian economy had been free from fundamental macroeconomic imbalances such as those described above, the decline in external funding in 1998 and 1999 would probably not have created so many setbacks. Indeed, in both those years international reserves amounted to more than US\$8,000m, equivalent to a little over five months' imports of goods and services. From a historical perspective, this provided more than ample margin for meeting external liabilities. The market, however, did not see it this way. The exchange market began in early 1998 to show growing signs of nervousness, evidenced by strong pressure against the peso.

As explained by the October 1999 Supplementary Report to Congress, the Banco de la República's Board of Directors met the recurrent exchange attacks with a strategy that combined intervention in the exchange market through currency sales, monetary contraction (because of falls in international reserves), and a broadening of the interest-rate intervention band.

TABLE 1  
BALANCE OF PAYMENTS  
AND INTERNATIONAL RESERVES  
(MILLIONS OF DOLLARS)

	1997	1998	1999
Current account	(5,957)	(5,293)	(1,252)
Capital and financial account	7,092	4,454	462
Errors and omissions	(857)	(551)	459
Balance of gross international reserves	9,908	8,740	8,103
Change in reserves 1/	277	(1,390)	(331)

1/ Changes in reserves do not coincide with differences between reserve balances, because the effects of exchange-rate variations between the dollar and other currencies and interest-rate variations are not taken into account.  
Source: Banco de la República.

Subsequently, seeing that the worsening of the terms of trade and tightening of world capital markets had raised the equilibrium exchange rate, the Bank's Board of Directors decided twice to shift the exchange band upwards, in September 1998 and June 1999, announcing at the same time the macroeconomic plan for the following year.

Although this strategy succeeded temporarily in reducing pressure on the peso, its measures were finally seen to have no lasting effect as far as calming the exchange market was concerned. As long as fiscal and external imbalances were to continue to exist, along with financial-market frailty and unequal burdens on monetary and fiscal policies, domestic and foreign capital markets would remain skeptical about the medium-term viability of the Colombian economy's external position. Recurring attacks against the peso showed that the macroeconomic plans, announced at the same time as the exchange-band shifts, had lost credibility because economic performance in 1998 and 1999 differed significantly from what had been forecast.

It became clear in these circumstances that recovery of exchange stability called for a deeper macroeconomic adjustment plan that would, with IMF endorsement, gain greater domestic and international credibility to ensure access to world capital markets. This in turn will make it possible to consolidate the progress already achieved in reducing interest and inflation rates. The plan provides cast-iron assurance of the macroeconomic consistency of commitment goals, and lays down guidelines for adjustments to be made over a three-year period. It also helps to dispel fears about the sustainability of the country's external position by allowing greater access to funds from multilateral banks and offering some US\$2,700m in balance-of-payments support, which the country may disburse, if it deems it necessary, as the established adjustment goals are being met.

The plan's contribution to regaining credibility in macroeconomic management is reflected, in the first place, by the behavior of the exchange rate, which has remained relatively stable since the currency was

allowed to float in September 1999. Thus, Colombia's exchange-rate flotation process has been similar to Brazil's and Chile's, but less volatile thanks to the exchange recovery observed since mid-1997. A second sign of greater credibility is the declining trend in foreign public-debt spreads (Figure 1). Lastly, improved credibility has brought renewed access to external capital markets, making it possible for Colombia to place foreign-debt bonds worth US\$500m in November 1999 and US\$750m in February 2000.

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## B. OBJETIVES AND EXPECTED RESULTS

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The macroeconomic adjustment plan agreed on with the IMF for 1999-2002 essentially aims to: i) set the economy on a path of high, sustainable growth conducive to raising the level of employment; ii) continue the process of reducing inflation; iii) reach a sustainable external position; and iv) reduce poverty. Achieving these aims will depend crucially on: reducing the fiscal deficit; maintaining monetary discipline; following an external financing policy compatible with the adjustment plan; restructuring the financial sector; and continuing to implement the

**FIGURE 1**  
**SPREAD ON EXTERNAL PUBLIC DEBT, 1999**  
 (BASIS POINTS OVER 30-YEAR US TREASURY BONDS)



Source: Banco de la República.

government's planned structural reforms. Each of these objectives and policies is briefly discussed below.

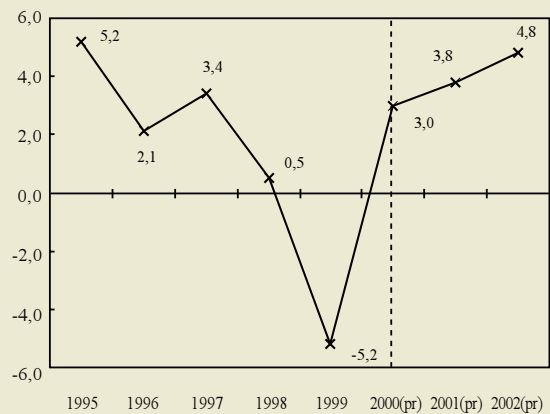
Economic growth began to slow down around the mid-nineties for a wide range of reasons, notably because of the impact of adverse external shocks, the end of the speculative bubble (which caused real-estate prices to plummet), intensification of the domestic armed conflict, political uncertainty, and growing fiscal imbalances (which have laid a heavy burden on monetary and exchange policies). As discussed in Chapter V below, economic results for 1999 were very poor: production shrank by about 5.2% and unemployment went up to 18.1%. The adjustment plan contains policies designed to bring real GDP growth up to 3% in 2000 and raise it to about 4.8% by 2002 (Figures 2).

The macroeconomic policy to be followed under the adjustment plan will allow inflation to be further reduced, down to 6% by the year 2002 (Figure 3). Expected lower inflation will reduce distortions in the economy, make resource allocation more efficient and limit the undesirable redistributive effects of high inflation rates, thereby helping to speed up long-term economic growth and improve the population's welfare.

The current-account deficit widened disturbingly up to 1998, largely because of a growing fiscal disequilibrium and a drastic fall in private saving. Although the deficit narrowed from 5.3% to 1.5% of GDP between 1998 and 1999, driven down, amongst other things, by a 26.8% fall in imports, policies will need to be formulated to prevent an external disequilibrium from recurring when the economy recovers. The adjustment plan envisages a current-account deficit of 2.4% of GDP in 2000 and about 3% in 2001 and 2002 (Figure 4). These levels are considered to be sustainable through medium and long-term financing and a conservatively projected level of direct foreign investment.

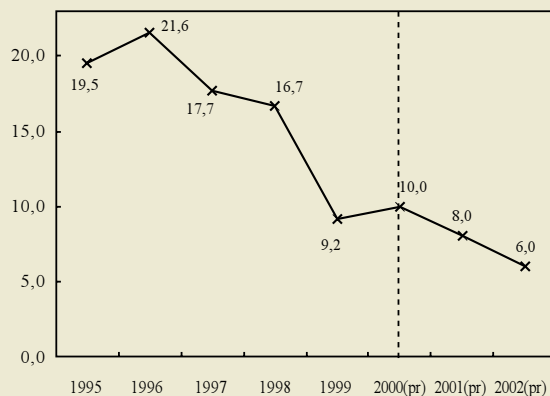
Achieving a sustained economic growth with a decreasing rate of inflation is central to poverty reduction. Programs making up the social safety net

**FIGURE 2**  
ANNUAL GROWTH IN REAL OUTPUT, 1995-2002  
(PERCENTAGE)



(pr) Preliminary projection.  
Source: Finance Ministry, Macroeconomic Policy Directorate, and National Planning Department, Macroeconomic Unit.

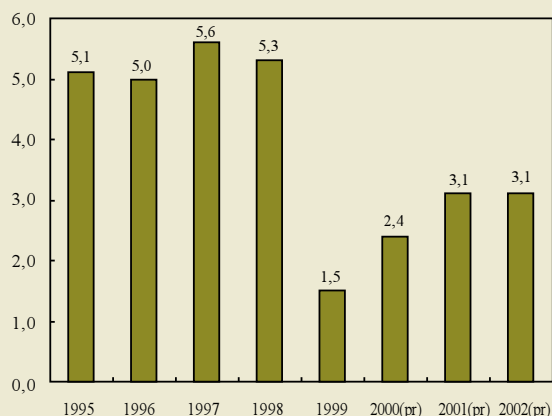
**FIGURE 3**  
ANNUAL INFLATION RATE, 1995-2002  
(PERCENTAGE)



(pr) Preliminary projection.  
Sources: National Statistics Agency (DANE), calculations by the Banco de la República, Economic Studies Division.

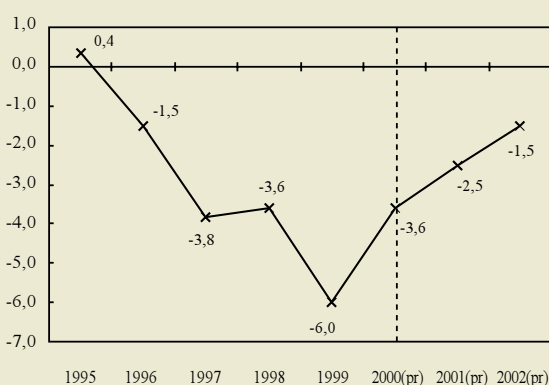
are to be strengthened, with support from multilateral and donor agencies. Such programs are designed to be cost effective and consistent with the fiscal plan. They focus on providing direct assistance to the more vulnerable members of society such as women and children, and making infrastructure investments to stimulate the creation of new job opportunities. Considering these programs, as well as spending on health care and education, the government expects social spending to increase as a share of total spending, over the adjustment period.

**FIGURE 4**  
CURRENT ACCOUNT DEFICIT, 1995-2002  
(AS PERCENTAGE OF GDP)



(pr) Preliminary projection.  
Source: Banco de la República.

**FIGURE 5**  
NONFINANCIAL PUBLIC SECTOR DEFICIT,  
1995-2002, BY IMF METHODOLOGY  
(AS A PERCENTAGE OF GDP)



(pr) Preliminary projection.  
Source: Fiscal Policy Council (CONFIS).

For the adjustment plan to prove successful, it is essential to bring about a substantial, sustainable reduction in the fiscal deficit within the medium term. The plan aims to reduce the nonfinancial public sector deficit from 6.3% of GDP, projected for 1999, to 1.5% in 2002, taking into account the additional spending envisaged for social programs (Figure 5)<sup>2</sup>.

<sup>2</sup> Starting in 1999 the variation in the budget lag has been taken into account in calculating the fiscal deficit.

With the help of economic recovery, the government plans to accomplish the job of fiscal adjustment by introducing a Tax Modernization Law providing for a lowering of the income-tax rate, and containing measures for optimizing tax collection and reducing tax evasion, avoidance and late payment; by continuing the program for strengthening tax administration; by proposing a constitutional reform to modify the system of transfers to local governments; and by devising a law to make the social security system financially sustainable. The planned reduction in the fiscal deficit will allow public debt to be stabilized at 35% of GDP during the plan period. Domestic borrowing by the public sector will be reduced to release funds for an upturn in the private sector. The fiscal program for 1999 and 2000 will be monitored every quarter by means of a cap on the public sector's combined deficit<sup>3</sup>.

Monetary discipline, the second requirement for attaining the proposed objectives, is necessary for meeting the plan's inflation targets. The credibility of macroeconomic policy, lower expectations of inflation, and fiscal austerity will also help in this respect. Fiscal consolidation and restored confidence will help to reduce the burden on monetary policy, so that additional credit funds will be expected to become available for supporting private-sector recovery without pressure on interest rates. Monetary-base growth is still being used as an intermediate policy target in monetary management, and a monetary-base corridor is determined every year for meeting the inflation target. However, the Bank has long been studying a direct inflation-targeting scheme as a framework for its monetary policy. For this purpose it has been working on a basic inflation indicator, more effective procedures for predicting inflation, and analyzing transmission mechanisms for monetary policy.

With the peso allowed to float freely since September 1999, the Colombian economy is expected to be better

<sup>3</sup> For monitoring purposes, the combined public sector includes the nonfinancial public sector, Fogafin, the Banco de la República's quasi-fiscal balance sheet, and annual spending connected with restoration of the financial sector.

able to absorb external shocks, making monetary policy easier to manage. Intervention by the Banco de la República on the exchange front will be limited to keeping order in market conditions, by smoothing short-term movements in the nominal exchange rate, in a manner consistent with the plan's projected net international reserves. The monetary program for 2000 will be monitored by setting quarterly ceilings on net domestic assets and floors for the net international reserves of the Banco de la República.

Resolving the financial sector's problems is an essential condition for promoting a rapid economic upturn. The sector's difficulties are evidenced by an increase in the financial intermediaries' ratio of bad debts to total gross outstanding debt, from 10.8% in December 1998 to 14.2% a year later; by huge losses, amounting to 2,700 billion pesos in 1999; and by a significant deterioration in solvency. With support from Congress, the government and Fogafin (the state deposit-guarantee agency) have been taking numerous measures to deal with the sector's enfeeblement, notably by providing support to insolvent institutions, especially financial cooperatives and public banks, and assistance to mortgagors. Programs have been introduced for recapitalizing private financial institutions with credit support from Fogafin. Steps have been taken to dismantle non-viable public-sector financial institutions, restructure mortgage and cooperative debt, and strengthen banking regulations. Progress in restructuring the financial sector and privatizing public-sector banks is to be monitored by half-yearly reviews under the plan.

External financing policy should be consistent with the aim of balancing income and spending. Colombia's total foreign debt continues to be manageable but has increased significantly in recent

years, from 27.4% of GDP in 1994 to 36% in 1998 and an estimated 42%<sup>4</sup> in 1999. This increase is partly explained by the greater value in pesos of foreign debt, due to devaluation and real contraction in output last year. Under the adjustment plan the authorities will seek to stabilize debt within a range of 43-44% of GDP. Colombia's public foreign debt will be monitored by means of quarterly limits on its net disbursement and the amount of guarantees provided by the public sector for private foreign debt.

Lastly, successful implementation of the structural reforms contemplated in the adjustment plan is crucial to achieving the plan's proposed objectives. With collaboration from Congress, significant headway has already been made in debating the major reforms (Table 2). The reforms will make it possible to create permanent sources of revenue, introduce greater flexibility in public spending, and generate large savings. In contrast to short-term public spending cuts, the reforms will thus be reflected in a permanent, sustainable rehabilitation of the country's public finances. In 1999 several reforms became law, such as the Local-Government Pension Liabilities Fund, the Economic Intervention Law, the Housing Law and the National Budget for the Year 2000, which adapts spending to its financing possibilities. Discussion has advanced on other bills, such as the bill for rationalization of local-government spending, and the bill on games of chance and luck. A number of crucial reforms are awaiting consideration; they include a constitutional amendment modifying the system of transfers to local governments, the tax modernization bill, and reform of Law 100 of 1993.

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<sup>4</sup> Preliminary estimate.

TABLE 2  
LEGISLATIVE AGENDA, 1999-2000

Submission to Congress		House		Senate		Enactment
		Committee	Plenary	Committee	Plenary	
Housing	Oct. 99					Law 546, Dec. 99
2000 budget	Jul. 99					Law 547, Dec. 99
Local-government pension liabilities fund	Aug. 99					Law 549, Dec. 99
Economic intervention	Oct. 99					Law 550, Dec. 99
Rationalization of spending by local-government entities	Nov. 99					
Reorganization of the national lottery system	Aug. 99					
Transfers to territorial-government entities (*)	Nov. 99					
Law 100	Mar. 00					
Tax modernization law	Mar. 00					

(\*) Constitutional amendment.

Source: Finance Ministry.

## SIGNIFICANCE OF FISCAL ADJUSTMENT FOR MONETARY POLICY

When a country's economy moves towards an environment of full capital mobility, economic policy should be designed in the awareness that monetary and exchange instruments must not be made solely responsible for controlling such capital flows. Fiscal policy should play a very important offsetting role in times of sudden capital inflows or outflows. In either case a conservative fiscal policy is needed to minimize the effect of capital flows on the exchange rate or inflation, and allow greater scope for action by monetary policy. Monetary policy usually has to perform the job of exchange control by easing or tightening liquidity, with this movement being reflected in the rate of interest. In times of capital inflows, two types of effects may be produced. If the exchange rate is free floating, the currency will appreciate. In this case a fiscal adjustment could help to moderate the size of the appreciation by reducing pressure on interest rates. But if the exchange rate is fixed, capital inflows will expand the monetary base, forcing the monetary authorities to sterilize the inflow of foreign currency if they wish to preserve the inflation target. In this case, too, a fiscal adjustment would be necessary, for it will help to reduce the size of the sterilization by lessening pressure on interest rates and thereby saving the central bank a large quasi-fiscal cost. Fiscal adjustment is therefore needed in both cases.

In times of capital outflows, fiscal adjustment reduces the level of absorption, averting a possible balance-of-payments crisis and sharp depreciation of the exchange rate. In general, the establishment of a sufficiently flexible fiscal framework should be proposed to accommodate the government's revenues and spending to the situation imposed by capital flows, without overloading monetary instruments with the burden of stabilization policies. One of the mechanisms suggested by theory is to adjust tax rates and reschedule investment spending on projects tied to capital movement. So, in times of capital outflows it is wise to cut public spending on tradable goods. But in times of capital inflows it is best to adjust spending on nontradable goods to reduce inflationary pressures.



## FINAL INFLATION TARGET OR INFLATION TARGETING

For a number of years now monetary policy in Colombia has included several elements of a strategy known as inflation targeting (IT) or «final inflation target.» This strategy has been adopted in several countries, such as New Zealand, Spain, United Kingdom, Canada, Sweden, Australia, Chile and Israel, to bring down persistently high inflation rates and keep them steady at low levels.

In inflation targeting the central bank explicitly announces a final inflation target. The target is set on the basis of the speed of disinflation considered acceptable and feasible by the bank, taking into account the degree of inflationary inertia, credibility, and monetary policy lags. Announcement of the target becomes the channel by which the monetary authority informs the public of its main objective. If the target is credible it may operate as a nominal anchor for agents' inflation expectations and significantly reduce the costs of lowering inflation. In theory, this process should allow the rules governing action by the central bank to become transparent, by making any deviations from forecasts relating to the announced target explicitly guide changes in monetary policy stance<sup>1</sup>.

Since inflation responds with a lag to changes in monetary policy, the central bank should be on the alert for possible changes in inflation forecasts. Any deviations from these forecasts relating to the set target should prompt the bank to use the tools available to it for controlling inflationary pressures. Inflation forecasts are therefore the chief forecasts determining the response function of monetary policy, causing it to become restrictive (expansive) when they run above (below) the fixed target. The monetary authorities also use other types of information in their decision-making (for example, information on external or supply shocks), which enable them to identify the source and duration of inflationary disturbances and hence to guide variations in policy stance.

For inflation targeting to be successful, certain conditions have to be met. They include the need for monetary policy to be conducted with a high degree of independence. Moreover, the monetary authority is required not to subordinate meeting the inflation target to achieving other objectives (employment, exchange rate, etc.), though it will of course take these variable into account in formulating monetary policy. The Colombian constitution of 1991 provides that the Banco de la República shall be independent and shall seek to protect the currency's purchasing power.

Operationally, the following parameters need to be defined in inflation targeting:

- *Price index.* In some countries inflation targets are fixed with respect to price indices that do not include some products with highly volatile prices. Such indices are therefore expected to be a more accurate reflection of demand inflation, that is, the inflation closely related to monetary policy. Colombia has chosen to fix inflation targets in terms of the full Consumer Price Index because it is the index that the public knows and understands best.

- *Inflation-target horizon.* Choosing a horizon depends on the lag with which monetary policy affects inflation. A too short horizon makes it difficult to achieve ambitious targets, resulting in an excessively slow process of disinflation or a situation in which the target merely reflects an inflation forecast rather than a firm commitment by the monetary-policy formulator. Colombia first announced an inflation target for 1991, and since 1992 the Banco de la República is required by law to set annual inflation targets. Until 1997 target announcements were made at the end of the year, for application the following year, but since 1998 they have been made up to 18 months in advance.
- *Type of target.* Inflation targets may be set as exact figures or as ranges. International experience is varied in this respect. But an exact figure is thought to be a better guide for forming expectations, particularly in a low-credibility environment, where a target range may induce economic agents to regard the range's upper limit as the effective target. In Colombia targets are always exact figures.
- *Disinflation speed and targeting.* As pointed out above, the speed of disinflation must take into account the degree of inflationary inertia, credibility, and monetary policy lagging. Inflation targeting in Colombia involves three kinds of technical tasks: i) detailed evaluation of existing short- and medium-term inflationary pressures; ii) making inflation projections by using econometric models, and iii) performing an IMF-style financial programming exercise, in which the consistency of monetary and fiscal policies is evaluated in terms of meeting the inflation target, given certain assumptions about other macroeconomic variables, such as output growth and real exchange rate.
- *Intermediate targets.* In Colombia the final inflation target is set together with an intermediate monetary-base target. A major trend-break in Colombia's inflation in recent years has created some degree of uncertainty about the accuracy of inflation forecasting and knowledge of monetary-policy transmission mechanisms. In this context, a monetary-policy guide is devised by setting an intermediate target for a monetary aggregate possessing two essential characteristics: i) having a stable long-term relation with the final target, and ii) being controllable by the monetary authority. Various assessments by the Banco de la República show the monetary base to be the most suitable aggregate for this purpose. The intermediate monetary-base target is explicitly subordinated to the final inflation target.
- *Monitoring, transparency and signals.* In inflation targeting it is of the utmost importance for monetary policy to be explained to economic agents, because the policy's effectiveness will depend in good measure on its impact on inflation expectations. In Colombia, the Banco de la República's technical team constantly monitors the monetary variables and makes a full monthly evaluation of inflationary pressures, reporting its findings in an «Inflation Report» similar to those produced by other countries with inflation targeting. The report has been published continuously since 1993 and currently includes behavior descriptions of CPI and PPI inflation and of the so-called «basic» or demand inflation, an

assessment of overall supply and demand pressures, a world outlook review, a section on inflation projections, and a general conclusion on the inflation situation. The Banco de la República's Board of Directors makes decisions regarding monetary-policy stance on the basis of the report and the monitoring of monetary variables. Its decisions are published and explained in a quarterly Inflation Report (started in 1998) and in press releases. The Board also publishes its assessment of the economy and monetary-policy outlook in two reports submitted to Congress every year.

In conclusion, several elements of inflation-targeting strategy have been applied in Colombia for some years now. The success of this strategy in Colombia over the next few years will generally depend on two conditions being met. First, it is essential that fiscal-policy objectives should not interfere with monetary-policy decisions, and that public-spending financing should not rely excessively on seignorage. This will be achieved through the fiscal consolidation resulting from the adjustment plan undertaken by the government. Second, a sound financial system is crucially needed to minimize the economy's financial fragility and allow the central bank to concentrate on meeting its inflation targets. Operationally, the Banco de la República may eventually move towards a simpler inflation-targeting scheme than the present one by dispensing with intermediate targets other than actual inflation forecasts. This will require improving its inflation-forecasting capacity and greater knowledge of transmission mechanisms in monetary policy.

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<sup>1</sup> The literature considers two types of IT systems: a strict and a flexible systems. Under the «strict» system the monetary authority focuses all its attention on meeting the announced target, and any deviation from forecast inflation is quickly corrected, regardless of what happens to other variables. In contrast, under «flexible» inflation targeting, the monetary authority takes into account other objectives, such as output stability and the real exchange rate, and if forecast inflation deviates from the established target the authority responds more gradually to move it back to target, trying to keep the affect on other objectives to a minimum.

### III

## MACROECONOMY POLICY

At the beginning of 1999 the monetary and exchange market was operating smoothly, with a declining trend in both nominal and real interest rates and a steady level of international reserves. This behavior was in marked contrast to that of exchange instability and interest-rate volatility observed over much of 1998. The change in market behavior came from confidence placed by economic agents in the macroeconomic program for 1999, unveiled by the Banco de la República's Board of Directors in early September 1998. The policies contained in the program included notably a 15% inflation target for 1999, the shifting of the exchange band upwards by nine points, and a commitment by the government to reduce the consolidated public-sector deficit to 2% of GDP. The climate of stability generated by a credible macroeconomic program was further strengthened by measures designed to deal with the crisis in the financial system; these measures were adopted under the November 1998 Economic Emergency Decree.

Taking advantage of the favorable conditions created by renewed confidence in the country's macroeconomic management, the Bank's Board of Directors began in 1998 to change the profile of macroeconomic policy with the aim of increasing liquidity in the economy and driving interest rates down<sup>5</sup>. From November 1998 the monetary base was back within the corridor after six months of running below the lower limit<sup>6</sup>, while the interbank interest rate as well as the deposit rate (DTF) and lending rate began to

fall gradually and steadily. The nominal exchange rate stopped pushing up against the exchange-band ceiling and was down by the centre of the band in the first quarter of 1999.

Lower interest rates, higher real devaluation, the absence of exchange pressures, the planned fiscal adjustment, and measures supporting the financial system characterized the end of 1998 and beginning of 1999, producing a certain optimism about economic recovery. So, although output had shrunk over the last two quarters of 1998, government projections expected a 2% economic growth for 1999 from a 7.3% growth in exports and a 1.8% rise in private investment<sup>7</sup>.

The design of monetary and exchange policy for 1999 was consistent with the scheme of economic recovery expected by government projections. Since, in the context of fiscal adjustment, demand dynamics was to come from private investment and exports, the economic authorities clearly saw the need for providing sufficient liquidity to reduce the interest rate significantly and keep the floating exchange rate within a range compatible with the inflation target.

However, for reasons discussed all through this Report, the main macroeconomic projections prepared in mid-1998 failed to be met in 1999. The economy did not grow at the expected rate; private investment and consumption declined; the nonfinancial public

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<sup>5</sup> The main measures included reducing legal reserves and introducing a yield on them, gradually reducing the interbank interest rate's intervention band, expanding the limits of REPO operations, and easing access to ordinary and transitory liquidity allocations (see the March 1999 Report to Congress).

<sup>6</sup> In relation to the 20-month daily moving average.

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<sup>7</sup> According to these projections, growth in exports and private investment would be sufficient to offset the fall in public investment (8%) and public-administration consumption (3.3%) resulting from fiscal adjustment, so that the economy would grow by 2% (see CONPES Document 3020, dated December 18, 1998).

sector deficit rose; and inflation ran below the set target. But the main aims of monetary policy were achieved, in that inflation and interest rates were significantly reduced.

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## A. MONETARY AND CREDIT POLICY

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### 1. Main parameters of monetary policy

The monetary-base corridor was defined by the Bank's Board of Directors, in line with macro-economic programming criteria, to allow a 23.6% midpoint expansion by the end of 1999 relative to a year earlier. This growth exceeded the expected 15.3% increase in nominal GDP by 8.3 percentage points. The increased growth allowed in the base was consistent with the monetary authority's intention of increasing the supply of liquidity to the economy and reducing the volatility shown by short-term interest rates in 1998. For the same purpose, an indicative corridor was established for the M3-plus-bonds (M3B) aggregate to provide for a 26.2% midpoint growth relative to its value at the end of 1998. As in the case of the monetary base, the proposed growth in M3B was significantly higher than expected growth in nominal GDP.

As stated in the March 1999 Report to Congress, at the beginning of 1999 a series of measures adopted at the end of 1998 came into effect to increase liquidity and make the interbank interest rate less volatile. First, access was provided to a new form of bridging liquidity support to make it easier for entities to obtain funds. Pursuant to the Statute of the Banco de la República (Law 31 of 1992), from January 1st, 1999 all open-market operations by the Bank were to be made with public debt securities. Accordingly, the Banco de la República stopped issuing securities as a means of controlling the level of liquidity in the economy.

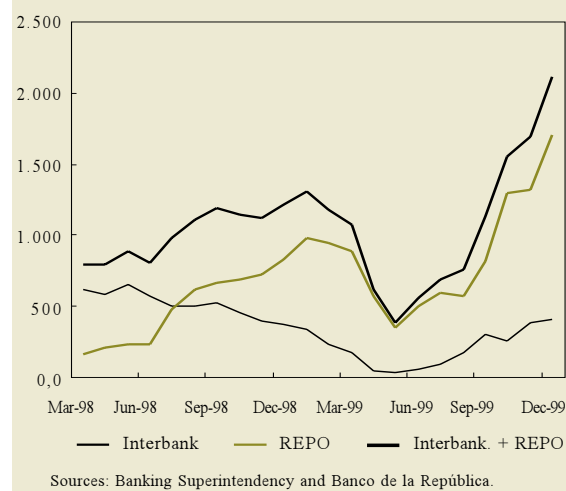
Second, changes were made in the way of calculating the liquidity support provided to the financial system by the Bank as lender of last resort (Resolution 26, 1998). The reference value for the volume of deposits

was to be the average of the three highest deposit days during the last 15 days preceding support, whereas before the reference value was the average of the last 15 days. In this way financial intermediaries were given access to a larger volume of funds.

From February 1999 a longer lag was allowed between the period for which reserve requirements were calculated and the time when the amount was to be deposited by financial entities (Resolution 28, 1998). Thus, more time was allowed for a reliable estimation to be obtained of the reserve required, enabling the financial system and the Bank to have the capacity to respond and preventing sudden shortages of liquidity that make the interbank rate volatile. Moreover, the reserve period was unified by eliminating the scheme that divided financial entities into two groups with different 15-day reserve periods (Resolution 28, 1998). This scheme made it difficult to estimate the system's reserve requirements. Unification has allowed a better estimation of demand for monetary base.

In March 1999, the levy on interbank transactions was unified and raised to two per thousand by the Constitutional Court's decision on the Economic Emergency. As a result, the volume of trading in this market fell from 400 billion pesos a day to 60 billion pesos (Figure 6). Because of this fall, the Bank

**FIGURE 6**  
LIQUIDITY TRANSACTIONS, AVERAGE MONTHLY  
BALANCE MARCH 1998 - DECEMBER 1999  
(BILLIONS OF PESOS)



considerably increased its intervention in the monetary market and succeeded in maintaining the supply of short-term liquidity to financial entities, thereby averting the turmoil the financial system would have suffered from virtual paralysis of the interbank market.

Around mid-1999 further steps were taken to provide easier and more flexible access to funds from the central bank. In early June the ordinary support facility was expanded to offer automatic access to credit institutions suffering shortfalls because of default by another institution (Resolution 9, 1999). They were also allowed to keep ordinary support funds for 90 consecutive days if the discount and rediscount operations were backed by a certain type of eligible securities. For this purpose, a mechanism was devised for prior review of eligible securities, to streamline the delivery of properly guaranteed support funds.

On July 9, Board Resolution 13 expanded and regulated access to bridging support for credit institutions whose mortgages denominated in UPACs (constant purchasing power units) represented more than 15% of their total portfolios. To this end, regulations were made governing the use of contracts for discounting or rediscounting credit securities representing UPAC-denominated mortgage portfolios.

To irrigate the financial system with more liquidity and make sure it was sufficient, the Bank's Board of Directors decided in early August to close the auction window through which the Bank drew funds from the financial system. At the time, such funds were yielding 15%. Access by intermediaries to the limitless contraction window was set to yield 12%. This three-point reduction in the yield on excess liquidity brought to the Bank was intended to prompt financial institutions to offer more credit to the real sector of the economy.

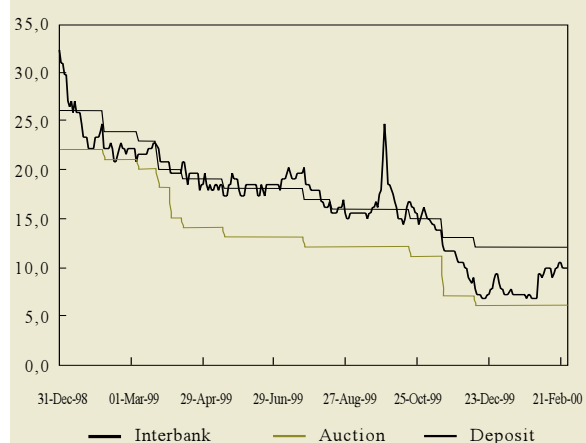
In September, Board Resolution 18 modified existing procedures for granting bridging liquidity support to credit institutions. To simplify and facilitate access to such funds, the distinction between ordinary and

special support was abolished, credit institutions were no longer required to show a fall in deposits to obtain funds from the Bank, and restrictions on these funds were removed.

Besides taking the above measures to increase the supply of liquidity, the Bank made ten consecutive reductions in intervention-band interest rates during 1999. At the beginning of the year, liquidity deposit rates were set at 22%, the limited REPO rate at 26%, and the unlimited REPO auction rate at 33%. At the end of the year these rates stood at 6%, 12% and 18%, respectively. This helped to reduce short-term interest rates systematically and consistently with signs of exchange stability and the notable decline in inflation and inflationary expectations. In addition, as intended by the monetary authority, the interbank rate's volatility was considerably reduced compared with its behavior in 1998 (Figure 7).

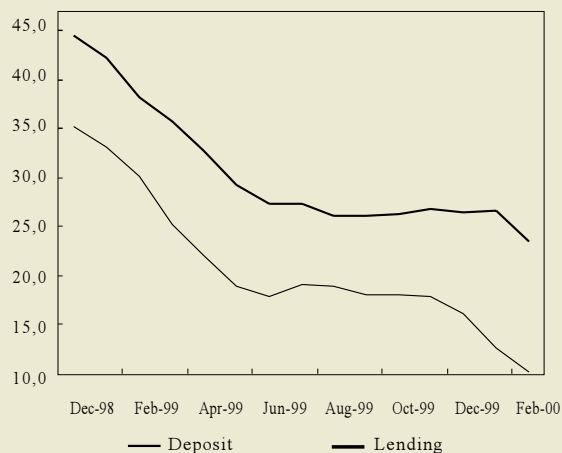
Increased liquidity and lower rates of intervention by the Bank soon translated into lower deposit and lending rates for the longer maturities. Thus, in December 1999 the DTF deposit rate stood at 16.1% and the lending rate at 26.4%, down by 19.2 and 18.1 percentage points respectively—equivalent to 9.7 and 8.6 points in real terms—from a year earlier (Figures 8 and 9). This result marked the achievement of one

**FIGURE 7**  
**INTERBANK RATE AND INTERVENTION BAND,**  
**31 DECEMBER 1998 - 25 FEBRUARY 2000**  
 (PERCENTAGE)



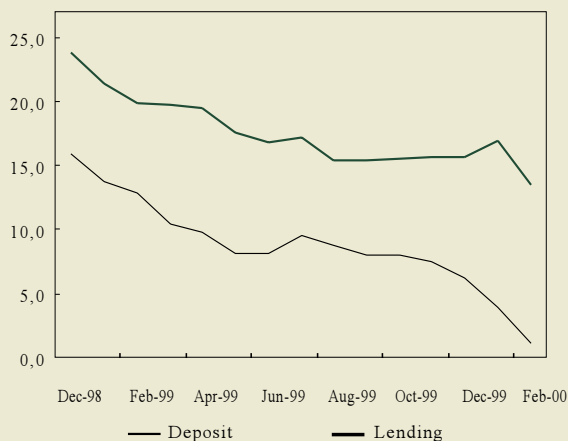
Sources: Banking Superintendency and Banco de la República.

**FIGURE 8**  
**NOMINAL DEPOSIT AND LENDING RATES,**  
**DECEMBER 1998 - FEBRUARY 2000**  
**(PERCENTAGE)**



Sources: Banking Superintendency and Banco de la República.

**FIGURE 9**  
**REAL DEPOSIT AND LENDING RATES, DECEMBER**  
**1998 - FEBRUARY 2000**  
**(PERCENTAGE)**



Sources: Banking Superintendency and Banco de la República.

of the major monetary-policy aims announced at the beginning of the year.

## 2. Monetary aggregates

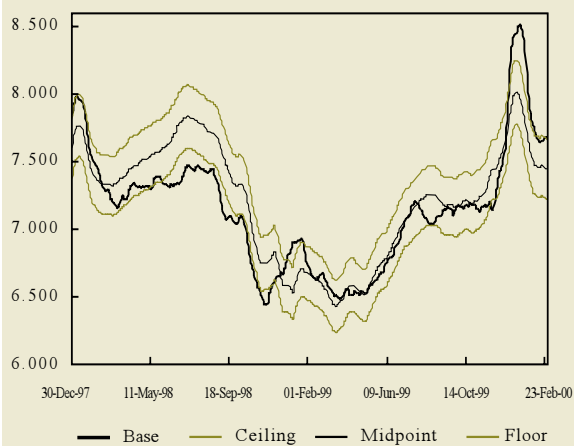
The monetary-policy aim of allowing an adequate supply of liquidity in the economy was reflected in the behavior of monetary aggregates in the ways described below.

### a. Monetary base

For most of 1999 the monetary base remained around the midpoint of the corridor except in August and November, when it stood in the lower half, and in December, when it overshot the upper limit. Concern over the millennium change caused an unusual increase in demand for cash and bank reserves among both the public and the financial system in the last few days of December. As a result, the 20-month daily mobile average of the monetary base ended up 1.9% over the corridor ceiling (Figure 10), and the monetary base itself amounted to 9,737 billion pesos on December 31, 1999, with a 40.6% growth rate for the year as a whole. As was to be expected, however, the expansion was completely reversed in the first few days of January as Y2K fears vanished.

Figure 11 shows how the monetary bases's average monthly balance expanded increasingly faster over 1999, the growth rate rising from -13.5% in December 1998 to 24.2% a year later. It also shows this behavior to have been accounted for by higher annual growth in both cash and bank reserves. The pick-up in cash growth resulted, among other things, from a more effective use of cash by economic agents to avoid paying the two-per-thousand levy on financial transactions, and from a sharp fall in interest rates that reduced the opportunity cost of keeping cash.

**FIGURE 10**  
**MONETARY BASE 20-MONTH DAILY MOVING AVERAGE,**  
**30 DECEMBER 1997 - 28 FEBRUARY 2000**  
**(BILLIONS OF PESOS)**



Source: Banco de la República.



The sharp rise in the average annual rate of demand for reserves is explained by comparing the 1999 reserve rate with the very low rate prevailing in the final quarter of 1998<sup>8</sup>. To correct for this statistical effect, an adjusted monetary base is calculated in which the demand for reserves is estimated by using the current average reserve rate (4.6%). Thus, the evolution of the monetary base may be seen to have been less volatile than is suggested by its actual values, for the adjusted base shows a relatively stable growth rate, which rose from 12.2% in December 1998 to 17.2% a year later (Figure 11). This increase is explained by the growth in liabilities subject to reserve requirements, and by the tendency of many financial institutions to over-reserve because of increased credit risks, falling interest rates, and expected massive withdrawals out of fear of Y2K problems.

#### b. M1 money supply

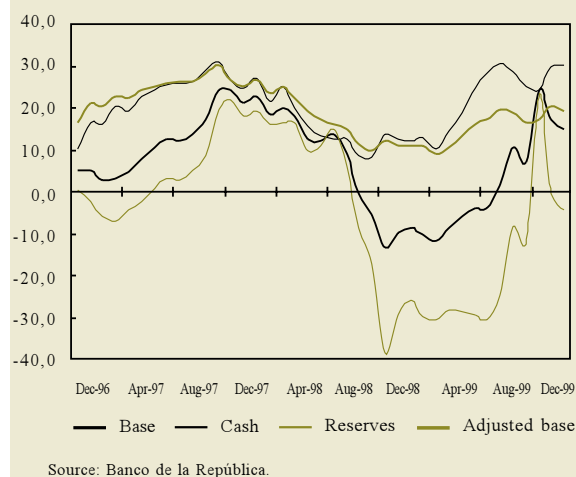
The M1 balance closed at 12,857 billion pesos on December 31, up by 22.1% on a year earlier. The average balance grew by 12.5% between 1998 and 1999. This behavior is explained by faster growth in cash and current accounts. At the end of 1998 current accounts registered an average contraction of -5.3%, but a year later they had expanded by 3.9% and have continued to show recovery over the first few months of 2000 (Figure 12).

#### c. M3-plus-bonds

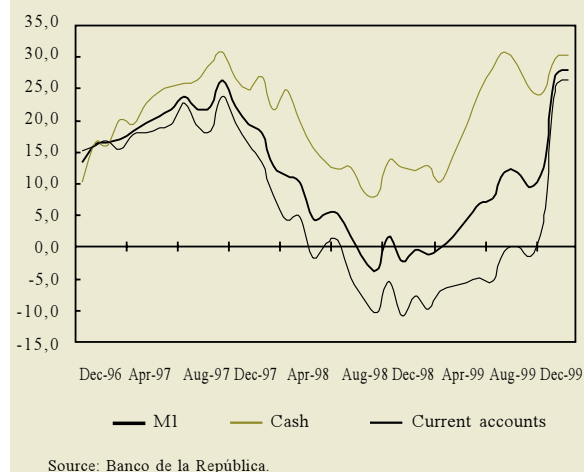
The M3-plus-bonds aggregate, a broader measure of liquidity, amounted to 60,002 billion pesos on December 31, with an annual growth rate of 6.3%. The average M3-plus-bonds balance registered a declining trend, with the annual growth rate slowing from 9.9% in December 1998 to 3.8% in August 1999 and picking up moderately thereafter to finish the year at 5.6%. In real terms M3-plus-bonds contracted, but at an average rate that diminished from -5.8% at the end of 1998 to -3.3% a year later (Figure 13).

<sup>8</sup> In the second half of 1998 the Board made several reductions in the reserve rate applicable to the different types of deposits in the financial system (Resolutions 11, 15 and 19 of 1998). Thus the average reserve rate was reduced from 8.7% at the beginning of 1998 to 4.9% towards the end of the year.

**FIGURE 11**  
**MONETARY BASE AND ITS USES**  
**DECEMBER 1996 - FEBRUARY 2000**  
 (ANNUAL PERCENTAGE GROWTH  
 IN AVERAGE MONTHLY BALANCE)



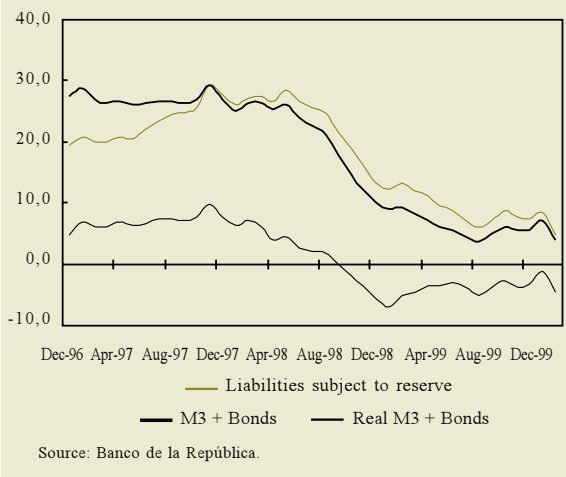
**FIGURE 12**  
**M1 AND ITS COMPONENTS**  
**DECEMBER 1996 - FEBRUARY 2000**  
 (ANNUAL PERCENTAGE CHANGE  
 IN AVERAGE MONTHLY BALANCE)



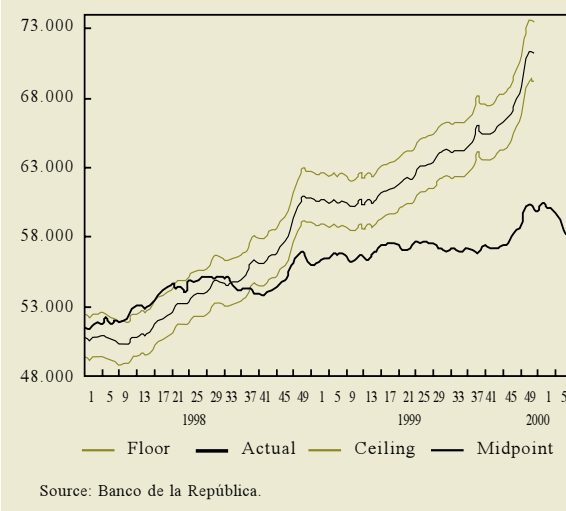
Relative to its indicative corridor, calculated on the assumption of a 2% economic growth and a 15% inflation, M3-plus-bonds stood 15.2% (or 9,102 billion pesos) below the lower limit at the end of 1999 (Figure 14). As pointed out in the July 1999 Report to Congress, the main factors explaining this behavior are the slowdown in economic activity and limited the dynamism in the banking portfolio, which reduced the demand for broad money. This situation was intensified by a private-portfolio change from pesos to dollars to obtain the higher external returns



**FIGURE 13**  
**M3-PLUS-BONDS AND ITS COMPONENTS**  
**DECEMBER 1996 - FEBRUARY 2000**  
 (ANNUAL PERCENTAGE CHANGE  
 IN AVERAGE MONTHLY BALANCE)



**FIGURE 14**  
**M3-PLUS-BONDS WEEKLY INDICATIVE CORRIDOR**  
 (BILLIONS OF PESOS)



associated with greater expectations of devaluation in 1999<sup>9</sup>. Stagnation in M3-plus-bonds was further exacerbated by increased private-sector demand for Treasury paper (TES). Indeed, the balance of TES B securities held by the private sector surged by 29.4% in 1999, outstripping by far the growth rate (7.3%) of liabilities subject to reserve requirements.

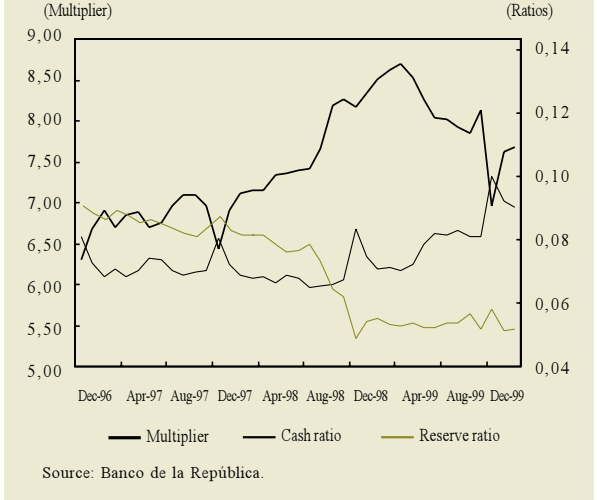
<sup>9</sup> A shift in the private portfolio's composition towards the dollar was reflected in a decrease in net private external indebtedness (debt less external portfolio), which by the third quarter of 1999 had fallen by US\$1,272m relative to the second quarter of 1998.

The discrepancy in 1999 between the behavior of the monetary base (stable around the corridor's midpoint for most of the year, then overshooting the upper limit in December) and that of M3-plus-bonds (much slower growth than expected) showed up as a significant fall in the broad-money multiplier. Between 1998 and 1999 the average monetary multiplier fell from 8.178 to 6.954. This may be explained by a greater demand for cash by the public than for liabilities subject to reserve requirements; a tendency to over-reserve throughout the year; and a faster pace of growth in the balance of TES than in that of liabilities subject to reserve requirements (Figure 15).

**d. Monetary programming for 2000**

The Board has established monetary-policy goals for 2000 consistent with its objectives concerning inflation and a sufficient money supply. Accordingly, growth in the monetary base at the midpoint of the corridor is set to be 14.3% by the end of 2000 relative to a year earlier. This is faster than the 13.7% growth rate planned for nominal GDP, ensuring an abundant supply of liquidity. To accomplish this program, the Board will constantly monitor and evaluate the monetary base, M3-plus-bonds, growth in public and private credit, and actual and projected inflation trends.

**FIGURE 15**  
**M3-PLUS-BONDS MULTIPLIER**  
**DECEMBER 1996 - FEBRUARY 2000**  
 (DICIEMBRE DE 1996-FEBRERO DE 2000)



The projected midpoint monetary-base growth will mean a 22.2% expansion in M3-plus-bonds by the end of 2000 relative to a year earlier, with an 11.5% increase in the cash component and a 23.4% surge in liabilities subject to reserve. Banking reserves will fall by 29.9%<sup>10</sup>, assuming a 4.6% average reserve rate on liabilities subject to reserve; this behavior results from over-reserve at the end of 1999.

### 3. Credit behavior

The net balance of local- and foreign-currency loans provided by the financial system excluding FEN (National Energy Financing Corporation) was 50,433 billion pesos on December 31, showing an annual contraction of -4.0%. The local-currency component decreased by 0.9%, while the foreign-currency balance expressed in pesos diminished by 27.5%, corresponding to a 41.8% fall in dollars. The annual rate of change in the gross local-currency portfolio showed a fall of -1.8% in December, equivalent to -9.8% in real terms (Figures 16 and 17)<sup>11</sup>.

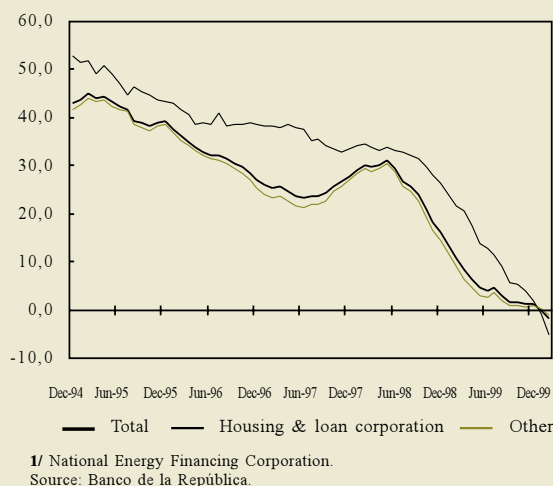
A breakdown of the annual change in the net real portfolio shows that the fall between December 1998 and 1999 in loans by public financial institutions was 14.0 percentage points, much steeper than the 5.7 percentage-point fall in loans by private financial institutions. The corresponding real changes were -21.6% and 9.2%, respectively (Figures 18).

As the above figures suggest, the Colombian economy is going through a credit crunch: a situation in which a break occurs in the channel of credit, partly because the financial system is unwilling to intermediate. This impedes economic recovery, because an upturn depends on expanding household consumption, private-sector investment and exports, and therefore requires an adequate volume of credit as an essential condition.

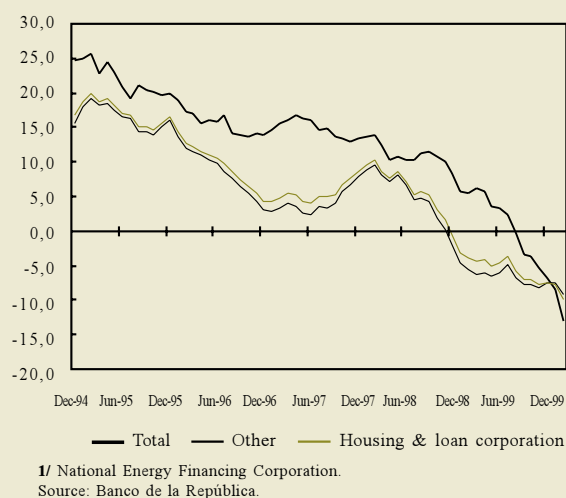
<sup>10</sup> Since the size of this fall is the outcome of over-reserve at the end of 1999, no reduction is projected in reserve ratios.

<sup>11</sup> The gross local-currency loan portfolio is a better indicator of credit disbursements, for it is unaffected by provisions for doubtful debt (which affect the net portfolio) and by exchange-rate variations (which affect the foreign-currency portfolio).

**FIGURE 16**  
GROSS NOMINAL LOCAL-CURRENCY LOANS  
OF FINANCIAL SYSTEM EXCLUDING FEN<sup>1/</sup>  
DECEMBER 1994 - FEBRUARY 2000  
(ANNUAL PERCENTAGE CHANGE  
IN AVERAGE MONTHLY BALANCE)



**FIGURE 17**  
GROSS REAL LOCAL-CURRENCY LOANS  
OF FINANCIAL SYSTEM EXCLUDING FEN<sup>1/</sup>  
DECEMBER 1994 - FEBRUARY 2000  
(ANNUAL PERCENTAGE CHANGE IN AVERAGE MONTHLY  
BALANCE)



The reasons why financial intermediaries have been reluctant to channel credit to the economy were discussed in the July 1999 Report to Congress. In this respect, the diagnosis presented there holds true: this behavior is caused not by monetary constraints but by factors unrelated to monetary policy<sup>12</sup>. The main

<sup>12</sup> As mentioned above, the financial system registered an over-reserve all through 1999 and often returned excess liquidity to the Banco de la República through contraction operations.

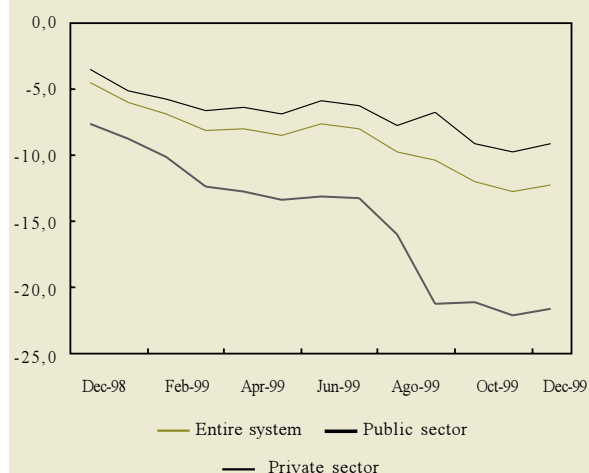
factors are: increased credit risks for financial intermediaries because of the plight of many debtors; deterioration of some financial intermediaries' assets, making them less solvent; and loss of value in security interests, particularly real estate. As for the contraction in demand for credit, it has been a direct result of the economic downturn and of over-borrowing by the private sector throughout the nineties.

The government has taken important steps to deal with this problem. First, it has made headway in debt restructuring. Even before the Economic Intervention Law, discussed below, came into force, the financial system had restructured corporate obligations worth more than 1,300 billion pesos, according to estimates by the Banking Superintendency. Second, the government has put in place mechanisms for facilitating mobilization of funds to the productive sector. In this connection, the capitalization of IFI (Industrial Development Agency) with 300 billion pesos will expand its borrowing capacity by 1,100 billion pesos, which will be lent through direct credits or rediscounting, to reinforce the lines of credit for economic reactivation and debt restructuring. The government will also capitalize the National Guarantee Fund with 100 billion pesos to back, up to 50%, the loans of small and medium-sized companies, including builders of low-income housing. This capitalization will enable the Fund to leverage 1,400 billion pesos in credit guarantees.

The Bank's Board of Directors authorized the transfer to IFI of 130 billion pesos of funds recovered from the BIRF 3321-CO line originally amounting to US\$200m. The transferred funds are to be used for debt restructuring and consolidation of liabilities. This operation was performed under a constitutional exception (Art. 373) allowing the Banco de la República to be the intermediary for external funds intended for the private sector, provided that the Bank takes no part in individual allocations of the loans<sup>13</sup>.

<sup>13</sup> Art. 373 "...The Bank may not establish credit allocations, or provide guarantees in favor of private parties, except in the case of intermediation of foreign credit to be placed through credit institutions, or of bridging liquidity support thereto. ..."

**FIGURE 18**  
TOTAL NET REAL LOCAL-CURRENCY LOANS  
DECEMBER 1998 - DECEMBER 1999  
(ANNUAL PERCENTAGE CHANGE)



Sources: Banking Superintendency and Banco de la República.

Besides the action described above, suitable monetary conditions have been established to stimulate the supply of and demand for credit by providing sufficient liquidity and reducing real interest rates. In particular, lower real interest rates should help to improve the financial system's risk indicators, and thereby to reduce credit risk.

## B. EXCHANGE POLICY AND BALANCE OF PAYMENTS

### 1. Abandonment of the exchange band

In early 1999, though the international environment was in turmoil, the nominal exchange rate came under no great pressure, thus allowing interest rates to continue to fall. As explained above, this was because the 9-point upward shift made in the exchange band on September 2, 1998 was favorably received, and because the 1999 macroeconomic program still inspired confidence. But economic crisis and financial frailty made it very difficult for this exchange calm to last. The economy was in deep recession, unemployment continued to rise, the real prices of assets kept on falling, and access to external funds was more limited and more expensive.

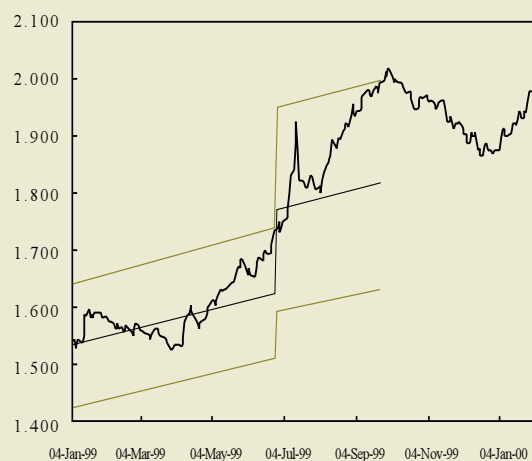
In April the exchange rate began to come under pressure and by June 26 had once more reached the band's ceiling (Figure 19). During the first months of the year the decision was maintained to defend the band as long as it was consistent with the downward trend that interest rates were showing. But a strong recession, limited progress in structure reforms of public finances, privatization delays, and tight world capital markets made it increasingly difficult to maintain an exchange policy of this kind. In a fresh attempt to stabilize the exchange market, the 1999-2000 macroeconomic program was released on June 27 and provided for making the nominal exchange rate more flexible by shifting its corridor by 9 percentage points, reducing its slope and making it broader. But pressure on the peso subsided only briefly. In September the pressure became intense once more, and almost the whole month long the Bank intervened with foreign-exchange sales amounting to US\$479m. On September 25 the Bank's Board of Directors, having reached an agreement in principle with the IMF on an adjustment plan and therewith a commitment from multilateral banks to support the plan, decided to stop defending the exchange band, thus moving to a system of a freely floating nominal exchange rate.

Considering the recurrent attacks against the peso, one might ask why the exchange rate was not left to float earlier. In this connection, the Board's Supplementary Report to Congress, dated October 1999, explains that in a situation of large macroeconomic imbalances, insufficient external funding, uncertainty associated with the world financial crisis, and loss of credibility of the exchange system, such as that prevailing in 1998, it was highly risky to liberate the exchange rate completely. Nevertheless, at the end of September 1999, despite the existence of exchange-attack pressures, the Board decided to free the exchange rate on the basis of a series of conditions that allowed it to foresee a smoother transition to a floating exchange rate system. These conditions included especially an agreement with the IMF guaranteeing a larger commitment on fiscal adjustment, greater access to credit from multilateral banks, and the backing of a balance-of-payments loan of about US\$2,700 m from the IMF on the terms of the agreement.

Other conditions allowing expectations of a shock-free transition to flotation were the reduction of the current-account deficit from around 8% of GDP in the first quarter of 1998 to less than 2% at the end of the first half of 1999; changes made in the band in the past year that came close in practice to a floating regime; a real devaluation of 25 percentage points over the past two years that brought the observed exchange rate closer to its equilibrium level; the strengthening of the financial system through capitalization and debt-restructuring programs; the reduction of both actual inflation and expectations of inflation; and a sufficient level of international reserves for possible interventions capable of discouraging exchange speculation.

The timing of the flotation was right, as the stability of the exchange rate has shown: it has remained below or close to the level it stood at when the band was abandoned (Figure 19). Colombia was not the only Latin American country to float its currency: Chile, Brazil and Ecuador did so too. In the case of Brazil and Ecuador the transition was highly turbulent, with the exchange rates over-reacting strongly.

FIGURE 19  
NOMINAL EXCHANGE RATE  
4 JANUARY 1999-31 JANUARY 2000  
(PEOS TO THE DOLLAR)



Sources: Banking Superintendency and Banco de la República.

## 2. Flotation at work

Monetary strategy continue to be centered essentially on a quantitative inflation target, inflation forecasts, and the monetary-base corridor. This scheme contains all the basic elements of an objective inflation regime such as that adopted by countries that have allowed their exchange rates to float. The main advantage of flotation is that it allows greater control over the monetary base as an intermediate target because, by eliminating the need for intervention in the exchange market through foreign-exchange sales or purchases, it also removes a major sources of volatility in the monetary base.

Even with a floating exchange rate, extreme volatility needs to be avoided because of the perverse effects it could produce on economic stability. The Bank's Board of Directors therefore considered it appropriate to establish standing rules for deciding on Bank intervention under the new system. In particular, it was necessary to define the type of market intervention, its aims, and its operating capacity. For this purpose, the Board has drawn up guidelines for intervention in the exchange market. The aims of intervention are twofold: to accumulate reserves and check excessive volatility in the exchange rate<sup>14</sup>. The mechanisms to be used are transparent and consistent with the prevailing flotation system agreed upon on September 25, and do not seek to defend a particular exchange-rate level.

As regards the mechanism for accumulating reserves, the Board has decided to auction rights to sell foreign currency to the Banco de la República at the market representative rate (TRM), in accordance with the agreement defined with the IMF, which contemplates an accumulation of international reserves for the next few months. Financial institutions operating as intermediaries in the exchange market and the Finance Ministry's Directorate General of Treasury are the entities specified by the Board as being eligible to participate in auctions. Auctions are to be held every month, the specified monthly amount being US\$80m

in the first three months of 2000<sup>15</sup>. The price of rights is to be determined at each auction and the right may be exercised during the month following the auction, provided the TRM exchange rate on the day the right is to be exercised is not less than the moving average of the past 20 working days. Rights may be negotiated among agents eligible to participate in auctions. By these conditions the Banco de la República ensures that dollars shall be purchased only when the market representative rate is lower than its trend. Table 3 reports the operations performed so far under this mechanism, showing that the authorized auction capacity has been allocated in full.

To avoid excessive volatility in the exchange rate, the Board of Directors has agreed that the Bank shall sporadically auction rights to buy or sell foreign currency. Such auctions may only be held when the TRM exchange rate deviates by at least 5% in one day from the moving average of the past 20 working days. Financial institutions operating as intermediaries in the exchange market, and the Finance Ministry's Directorate General of Treasury are again the entities eligible to participate in the auctions. The amount will be US\$120m. The price of rights is to be determined at each auction and the right shall be exercised only during the month following the auction on a day when the TRM exchange rate is 5% below or above its moving average of the past 20 days. Rights may be negotiated among agents eligible to participate in the auctions. No auctions of this kind have been held so far, because the volatilities implicit in the rule have not occurred.

## 3. Balance of payments

### a. Balance-of-payments situation in 1999

According to the Bank's estimates, at the end of 1999 the balance-of-payments current account showed a deficit of US\$1,252m (1.5% of GDP) (Table 4). Exports of goods, including special foreign-trade operations, are estimated to have expanded by 5.4% to US\$12,072m, while imports fell by 26.8%<sup>16</sup> to US\$10,248m, giving a US\$1,824m surplus in the

<sup>14</sup> Volatility refers to the variance of the exchange rate.

<sup>15</sup> The Board decided to make the first auction for US\$200m.

<sup>16</sup> Preliminary estimate.

**TABLE 3**  
**PUT-OPTION AUCTIONS**  
**FOR ACCUMULATING INTERNATIONAL RESERVES**

	Auction date			
	30 Nov-99	27 Dec-99	27 Jan-00	28 Feb-00
	(Millions of dollars)			
Amount presented	924.50	430.20	204.00	368.00
Amount approved	200.00	80.00	80.00	80.00
Allocation	200.00	80.00	80.00	80.00
Amount exercised	200.00	0.00	12.00	
	(Pesos / thousands of dollars)			
Minimum premium	3.00	210.00	10.00	130.00
Maximum premium	8,000.00	8,100.00	3,020.00	4,100.00
Cut-off premium	4,000.00	4,500.00	210.00	1,600.00

Source: Banco de la República, Monetary and Reserves Department.

goods balance. The nonfactor-services account<sup>17</sup> showed a deficit of US\$1,415m and the factor income account a deficit of US\$2,542m, because of increased interest, dividend and profit-remittance payments relative to income.

Goods exports expanded by 6.3% owing to the growth in oil and by-product exports from high world crude prices. There was also a pick-up in exports of emeralds and ferronickel (Table 5). But coffee, non-monetary gold, coal and non-traditional exports declined in 1999. The decline in non-traditional exports was associated with lower world commodity prices and slower growth in neighboring economies. Table 6 shows that recession in Venezuela and Ecuador reduced Colombia's exports to these countries in 18.8% and 44.6%, respectively. In contrast, non-traditional exports to the United States surged by 22.7% thanks to the notable vigor of the US economy. In 1999 exports of goods as a share of GDP reached 13.7%, up from the 10.9% average for 1994-1998 but still below the 15.1% level of the early nineties. So, the aim of making the economy strong in exports has yet to be accomplished.

<sup>17</sup> Includes transport, travel and other services different from factor income.

Goods imports fell by 26.8%, driven down by a strong contraction in domestic demand, and an increase in the real exchange rate that raised the relative price of imported goods over domestic ones. The biggest drop was in imports of capital goods, which shrank by 34.3%. This behavior was closely associated with a 56.4% contraction in private investment during 1999.

The capital and financial account showed a net inflow of US\$462m, vastly lower than the US\$4,454m registered in 1998. In particular, net long-term inflow amounted to US\$1,633m, considerably less than the US\$4,465m balance in 1998. This was due to a fall in both privatization revenues and net long-term borrowing. Short-term capital movements produced a net outflow of US\$1,171m, resulting from a US\$721m decrease in net foreign portfolio investments and credit for Colombia and a US\$450m increase in foreign portfolio investments made by Colombians.

Gross international reserves held by the Banco de la República were reduced by US\$331m, the net result of a sale of reserves by the Bank amounting to

**TABLE 4**  
**COLOMBIA'S BALANCE OF PAYMENTS - SUMMARIZED**

	Millions of dollars			As percentage of GDP		
	1998	1999 (pr)	2000 (proj.)	1998	1999 (pr)	2000 (proj.)
<b>I. CURRENT ACCOUNT</b>	(5,292.8)	(1,251.5)	(1,373.2)	(5.33)	(1.48)	(1.61)
Income	15,040.5	15,866.8	17,659.5	15.14	18.73	20.71
Expenditure	20,333.4	17,118.3	19,032.7	20.46	20.21	22.32
<b>A. Nonfactor goods &amp; services</b>	(4,009.9)	409.6	1,244.7	(4.04)	0.48	1.46
Income	13,521.3	13,993.7	15,933.9	13.61	16.52	18.68
Outlays	17,531.3	13,584.1	14,689.2	17.64	16.03	17.22
1. Goods	(2,549.6)	1,824.2	2,785.7	(2.57)	2.15	3.27
Income	11,456.0	12,072.4	13,957.2	11.53	14.25	16.36
Expenditure	14,005.6	10,248.2	11,171.5	14.10	12.10	13.10
2. Nonfactor services	(1,460.3)	(1,414.6)	(1,541.1)	(1.47)	(1.67)	(1.81)
Income	2,065.3	1,921.3	1,976.6	2.08	2.27	2.32
Expenditure	3,525.6	3,335.9	3,517.7	3.55	3.94	4.12
<b>B. Factor income</b>	(1,728.7)	(2,542.2)	(3,264.2)	(1.74)	(3.00)	(3.83)
Income	909.3	804.7	886.4	0.92	0.95	1.04
Expenditure	2,638.0	3,346.9	4,150.7	2.66	3.95	4.87
<b>C. Transfers</b>	445.8	881.1	646.3	0.45	1.04	0.76
Income	609.9	1,068.3	839.2	0.61	1.26	0.98
Expenditure	164.1	187.2	192.9	0.17	0.22	0.23
<b>II. CAPITAL &amp; FINANCIAL ACCOUNT</b>	4,454.0	461.6	2,009.4	4.48	0.54	2.36
<b>A. Financial account</b>	4,454.0	461.6	2,009.4	4.48	0.54	2.36
1. Long-term financial flows	4,465.4	1,633.1	3,677.6	4.49	1.93	4.31
a. Assets	543.8	90.0	300.0	0.55	0.11	0.35
i. Colombian direct investment abroad	528.8	90.0	300.0	0.53	0.11	0.35
ii. Loans 1/	15.0	0.0	0.0	0.02	0.00	0.00
iii. Leasing	0.0	0.0	0.0	0.00	0.00	0.00
iv. Other assets	0.0	0.0	0.0	0.00	0.00	0.00
b. Liabilities	5,023.7	1,737.6	3,992.1	5.06	2.05	4.68
i. Direct foreign investment in Colombia	2,907.3	867.3	2,464.0	2.93	1.02	2.89
ii. Loans 1/	1,768.8	780.7	1,296.3	1.78	0.92	1.52
iii. Financial leasing	347.6	89.5	231.9	0.35	0.11	0.27
iv. Other liabilities	0.0	0.0	0.0	0.00	0.00	0.00
c. Other long-term financial movements	(14.5)	(14.5)	(14.5)	(0.01)	(0.02)	(0.02)
2. Short-term financial flows	(11.5)	(1,171.4)	(1,668.3)	(0.01)	(1.38)	(1.96)
a. Assets	(395.8)	450.3	1,487.4	(0.40)	0.53	1.74
i. Portfolio investment	(659.0)	478.3	1,384.6	(0.66)	0.56	1.62
ii. Loans 1/	263.2	(28.0)	102.7	0.26	(0.03)	0.12
b. Liabilities	(407.3)	(721.1)	(180.9)	(0.41)	(0.85)	(0.21)
i. Portfolio investment	(264.9)	(26.9)	0.0	(0.27)	(0.03)	0.00
ii. Loans 1/	(142.4)	(694.2)	(180.9)	(0.14)	(0.82)	(0.21)
<b>B. Special capital flows</b>	0.0	0.0	0.0	0.00	0.00	0.00
<b>III. NET ERRORS AND OMISSIONS</b>	(551.2)	459.3	0.0	(0.55)	0.54	0.00
<b>IV. CHANGE IN GROSS INTERNATIONAL RESERVES 2/</b>	(1,390.1)	(330.5)	636.1	(1.40)	(0.39)	0.75
<b>V. BALANCE OF GROSS INTERNATIONAL RESERVES</b>	8,740.5	8,103.4	8,739.5	8.80	9.57	10.25
<b>VI. BALANCE OF NET INTERNATIONAL RESERVES</b>	8,739.9	8,102.1	8,738.3	8.80	9.56	10.25
Months of goods imports	7.5	9.5	9.4			
Months of goods & services imports	5.2	5.7	5.6			
Nominal GDP in millions of dollars	99,357.6	84,718.0	85,288.3			
<b>VII. CHANGE IN NET INTERNATIONAL RESERVES</b>	(1,387.8)	(330.5)	636.1	(1.40)	(0.39)	0.75

**Assumptions.** Export prices: coffee US\$1.03/lb; oil US\$23/barrel; growth in goods imports 9.1%.

**(pr)** Preliminary estimate

**(proj)** Projection

1/ Includes portfolio investment, direct loans and commercial credit.

2/ According to Balance-of-Payments methodology.

Source: Banco de la República.



**TABLE 5**  
**GOODS EXPORTS**  
**(MILLIONS OF DOLLARS)**

	1998	1999	Percentage change
<b>TOTAL</b>	10,906	11,595	6.3
Coffee	1,893	1,324	(30.1)
Oil and by-products	2,329	3,754	61.2
Coal	936	848	(9.4)
Ferronickel	120	154	28.8
Emeralds	83	108	29.8
Non-monetary gold	104	77	(25.8)
Non-traditional exports	5,442	5,330	(2.1)

Sources: DANE and Banco de la República.

**TABLE 6**  
**NON-TRADITIONAL EXPORTS, BY DESTINATION**  
**(MILLIONS OF DOLLARS)**

	1998	1999	Percentage change
United States	1,525.4	1,871.2	22.7
Venezuela	1,121.3	910.0	(18.8)
Ecuador	582.6	322.9	(44.6)
Europe and Japan	744.6	683.7	(8.2)
Other	771.7	783.1	1.5
<b>Total</b>	<b>4,745.7</b>	<b>4,570.8</b>	<b>(3.7)</b>

Sources: DANE and Banco de la República.

US\$735m, partially offset by yields on reserves totalling US\$404m. At the end of 1999 the balance of gross international reserves stood at US\$8,103m, equivalent to 9.5 months of goods imports and 5.7 months of payments for goods and services.

#### **b. Balance-of-payments projections for 2000**

The current-account deficit is presently projected to run to US\$1,373m in 2000, or 1.6% of GDP, much the same level as in 1999. It will be financed from net capital income projected at US\$2,009m (2.4% of GDP), accounted for by US\$3,678m in net long-term

capital inflows, partially offset by US\$1,668m in short-term capital outflows.

The resulting increase in net international reserves will be US\$636m. This estimation does not take into account either disbursements from the Latin American Reserve Fund, or a greater access being perhaps provided to multilateral-bank credit because of greater confidence in the macroeconomic adjustment that is under way. Moreover, the stability expected in the balance-of-payments situation has made it unnecessary to disburse the funds offered by the IMF in support of the adjustment plan, but they continue to provide strong backing to ensure this stability.

### C. FINANCIAL POLICY

The Introduction to this Report has shown how an economic recession as severe as Colombia's in 1999 would stem from a combination of immediate causes, such as the 1998 world financial crisis, and long-standing causes operating over a whole decade. The latter included macroeconomic imbalances resulting from several years of much faster growth in domestic spending than in revenues, and the financial sector's increasing frailty since 1994. This section first deals with recent developments in the financial sector, then describes measures designed for its recovery, and ends by discussing some of the early results of these measures.

Apart from the climate of stability created by the macroeconomic program released in September 1998, measures were adopted to strengthen the financial sector under the Economic Emergency decreed in the following November. Under this decree, mechanisms were to be created to resolve critical situations in financial and cooperative institutions, and relieve the financial burden on home-loan debtors<sup>18</sup>. Both the macroeconomic program and the decree sought to provide scope for recovery of the financial sector in 1999.

<sup>18</sup> Legislative Decree 2331 dated November 16, 1998.

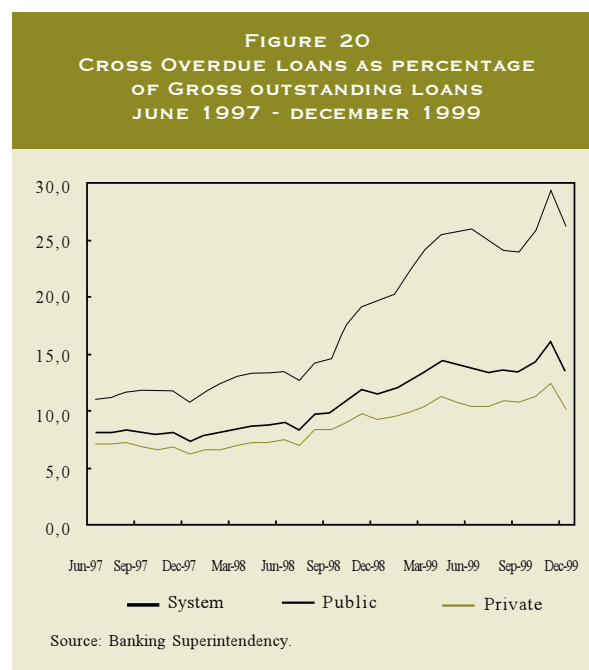


New measures were obviously needed to supply financial institutions with liquidity and drive interest rates down. These measures have already been discussed in this Chapter's section on monetary policy. Further laws were to be needed in 1999 for restructuring banking and corporate debt, solving the mortgage debtors' crisis, and modernizing financial statutes. The new laws on housing, economic intervention and financial reform embody the main thrusts of the legal framework put in place for rehabilitation of the financial sector. This section discusses the new laws, and official decisions in support of the financial sector, after reviewing and putting into perspective the evolution of some financial indicators.

## 1. Evolution of financial-institution indicators

### a. Deterioration of the loan portfolio

As the financial crisis deepened, non performing loans began to grow as a proportion of gross outstanding debt. This proportion rose sharply in the final quarter of 1998 and continued to do so over the first half of 1999, before flattening out at around 13.5% (double the level barely two years ago) and displaying a downward drift<sup>19</sup>. As Figure 20 shows, public-sector institutions fared the worst, with a 25% average rise in non performing loans over the past six months, whereas rise for private institutions at the end of 1999 was 10%, the same as a year earlier. A similar contrast may be observed by comparing domestic and foreign banks. In effect, since the crisis started, foreign banks have been able to keep their non performing loans stable at around 8% of the total. Domestic banks managed to do so at similar levels until the end of 1997, when their non-performing



loans began to represent an increasing proportion of gross outstanding loans, reaching 15% by the end of 1999.

The evolution of non performing loans is attended by the creation of provisions. In the mid-nineties the ratio of provisions to bad debts was 30%. The crisis caused growth in bad loans outpace expansion in provisions, so that from 1997 to 1998 the ratio dropped to 25%. In 1999 a boost in provisions raised them to one third of bad debts by the second half of the year. Before the crisis, public banks used to maintain much the same provisioning ratio as private banks. But with the outbreak of the crisis the latter raised their ratio while the former lagged clearly behind. In 1999, however, both public and private banks increased their provisioning to 33% of bad debt. The contrast between domestic and foreign banks is noteworthy. Up to 1996 both used to set aside provisions to cover 30% of non performing loans. From then on foreign banks continually increased their ratio, so that by the end of 1998 it was 40% and a year later 63%, double the domestic banks' provisioning.

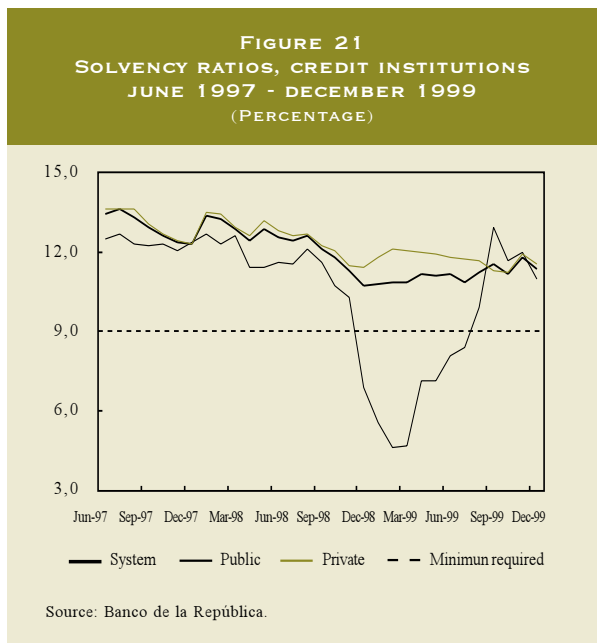
Property received in payment represented no more than 0.5% of the financial system's assets in the mid-nineties. But their ratio increased steadily from then

<sup>19</sup> Evolution of the non performing loans indicator over the second half of 1999 was clearly affected by operations designed to purge the loan portfolio of Banco Uconal. The indicator's drop in July stemmed from an attempt by Banco del Estado and Banco Uconal, in the process of merging, to create an autonomous capital and transfer their overdue loans to it. This is why the system's bad loans decreased. Failure to carry out this operation caused the two banks' bad loans to be registered again as usual, producing the last rise in November. The indicator's fall in December reflected Banco del Estado's rehabilitation arranged by Fogafin in that month. The fall in the private banks' indicator, also in December, reflected Megabanco's rehabilitation, also led by Fogafin.

on, to over 2.5% by mid-1999. For public banks property received in payment exceeded 3.5% of assets, far above the 2.2% it represented for private banks. Since then, however, the ratio for the system as a whole has tended to decline, down to 2.1% by the end of last year, and even lower (1.1%) for private banks.

The marked improvement in this indicator is one outcome of the decisions taken to clean up and capitalize banks, through Fogafin, by removing unproductive assets, such as property received in payment, from balance sheets and replacing them with productive assets. The strategies devised to provide credit to private banks and capitalize public ones are discussed below.

To sum up, non performing loans grew apace in the first half of 1999, as did property received in payment. Their trends over the second half, however, seem to suggest that deterioration of banking assets may have bottomed out and that a number of recovery factors may have already begun to come into play. These factor would include the policy measures described below.



<sup>20</sup> The solvency indicator is the relation between technical capital and assets weighted by the level of risk.

### b. Solvency of financial intermediaries

In the second half of the nineties the solvency ratio<sup>20</sup> fell continually, from a record high of 13.4% at the end of 1996 down to 10.7% by the end of 1998. In 1999 it improved steadily, reaching 11.2% by the end of the year. Figure 21 shows how the pick-up in the private banks' solvency was overshadowed by the collapse of the public banks' capital accounts. A drastic adjustment of asset values kept the public banks' solvency ratio well below international standards over the first eight months of the year<sup>21</sup>.

### c. Financial system's capital and returns

The financial institutions' capital grew consistently up to the end of 1997. Over the following year and a half the real value of their capital fell by 28%. In the last months of 1999 the capital account improved with the capitalizations of public-sector banks. The capital collapse was centered on domestic banks, while the capital base of foreign banks remained practically constant in terms of real value during the second half of the decade.

Despite the downturn in the economic cycle since 1996, financial institutions managed to show positive real earnings up to the first half of 1998. Thereafter these results fell sharply, mainly because of the free fall in the public banks' earnings. Not until the second half of 1999 did earnings stop falling and, though they are still negative, better results are beginning to emerge. The foreign banks' real earnings became slightly negative from the end of 1998.

Trends in earnings were very closely linked to movements in returns on assets. The financial institutions' low nominal rates of return (barely 1.6% in 1996-1997) became negative from mid-1998 for the entire system and for both domestic and foreign banks.

As a whole, the above indicators show how deterioration of the banks' balance sheets grew considerably

<sup>21</sup> The steepest falls in the solvency indicator occurred between September 1998 and February 1999: in Bancafé from 14.5% to 1.4%, BCH from 9.01% to 0%, and Banestado from 7.8% to 0%.

worse from mid-1998 to mid-1999. But trend changes are also discernible and may have been propelled by a variety of policy measures. The financial problems of public-sector banks were largely responsible for movements in the overall indices.

## **2. Measures**

A whole range of measures were adopted in 1999 to restore the financial sector to health, by providing relief to mortgage debtors, creating instruments for the capitalization of banks, and reforming financial-sector laws and regulations. Fogafin (Financial Institutions' Guarantee Fund, a state agency) has played a leading role in financing the initiatives discussed below, by issuing securities. Just in providing relief to debtors, credit to private banks, and support to public ones, it has committed funds amounting to some 4,400 billion pesos, about 3% of GDP.

### **a. Relief for mortgage debtors**

Under the Economic Emergency Decree of November 1998, as supplemented by other legal provisions, lines of credit were established to finance both relief for mortgage debtors (whether up to date or in arrears), and losses incurred by financial institutions in accepting real offered estate by way of payment. The relief provided amounted to 850 billion pesos, of which 60% went to finance reductions in interest payments for up-to-date debtors, 20% to provide relief to debtors in arrears, and 20% to finance the difference between the value of individual debts and that of property given in payment and thereby cancel the debts. Some 85% of the relief provided was financed through Fogafin bonds and 15% from proceeds of the two-per-thousand levy, which will translate into future budget expenditures.

### **b. Bank recapitalizations**

The Constitutional Court's decision on the November 1998 Economic Emergency limited extraordinary measures to the financial public sector, the cooperative sector, and relief for home-mortgage debtors. By the end of the first quarter of 1999, it was clear to the economic authorities that financial activity was showing worse signs of deterioration than when the

Economic Emergency was decreed. It was at this point that a government strategy was set in motion to remove unproductive assets from the balance sheets of financial institutions and encourage their capitalization.

Guided by such criteria as minimizing interventions in or nationalizations of financial entities, averting moral risk and not favoring the entities' owners, and with the aim of protecting the public's deposits, Fogafin recommended that a line of credit be established for rehabilitating credit institutions by two means: capitalization, and sale of unproductive assets. Under this scheme shareholders were to bear part of the losses incurred but still not counted as such by the institutions. In practice, the institutions were to adjust their capital values to bring them closer to their true level, which might be negative. In this case, provided that the institutions were deemed to have a viable future, the shareholders were to capitalize them to the point of raising their capital at least to the value of zero.

Upon creation of the credit line, it was established that eligible beneficiaries should, above all, rehabilitate their balance sheets by reducing the technical capital. The shareholders of entities whose rehabilitated capital turned out negative were required to subscribe for a sufficient number of shares to raise the capital at least to zero, and further required to pay up at least 50% of the shares' value at the time of subscription. Fogafin offered to give the shareholders six-month bridge loans for this purpose. The remaining 50% was to be paid up within a year. Subsequently, to restore the solvency ratio to the level of 10%, Fogafin's line of credit came to finance up to 90% of the capital funds required, for periods of three to six years<sup>22</sup>.

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<sup>22</sup> The complete scheme as laid down in Fogafin Resolution 006 required banks not only to undertake the necessary clean-up operations to raise previously purged capital to zero and the solvency level to 10%, but also to sign a performance agreement containing agreed goals to ensure their solvency and ability to repay the long-term credit.

**TABLE 7**  
**BANKS, FOGAFIN LOANS TO PRIVATE**  
**AT DECEMBER 1999**  
(BILLIONS OF PESOS)

Capitalized Entities	Capitalization required	Loans from Fogafin			Solvency (%)	
		Total	Short-term	Long-term	June 1999	January 2000
Banco Unión	32,7	27,3	1,8	25,5	11,4	10,0
Banco Superior	69,0	52,2	7,0	45,2	4,6	5,8
Banco Colpatría	269,6	212,1	38,1	174,0	10,1	6,0
Coltefinanciera CFC	39,7	28,4	9,1	19,3	9,0	9,9
Interbanco	58,6	43,2	1,0	42,2	9,9	10,2
Multifinanciera	4,8	2,9	0,0	2,9	12,7	11,7
Banco de Crédito	75,0	60,0	0,0	60,0	10,2	9,3
Corporación Financiera del Norte	47,7	19,8	0,0	19,8	10,4	9,1
Megabanco (*)	662,0	478,2	171,0	307,2	9,0	10,5
<b>Total</b>	<b>1.259,1</b>	<b>924,1</b>	<b>228,0</b>	<b>696,1</b>	<b>9,4</b>	<b>8,4</b>

(\*) Of the 662 billion pesos, 192 billion pesos had been disbursed to Coopdesarrollo from proceeds of the financial-transaction levy before it assigned its assets and liabilities to Megabanco. Unlike loans to other private financial entities, the bridge loan to Coopdesarrollo shareholders was granted for a period of 12 months, not six months.

Sources: Fogafin and Banking Superintendency.

Although the capital-restoration strategy applied to both private and public banks, the aid program for the latter imposed additional conditions: public banks were to place their unproductive assets in designated

institutions to be sold, to restructure their administrations, and finally to be privatized, except for the Banco Agrario. Fogafin's agenda includes putting Granahorrar up for sale in the second half of this year, and sale of Bancafé by the first half of 2001. Banestado is scheduled to be reduced in size in the first half of this year.

**TABLE 8**  
**FOGAFIN FUNDS PROVIDED TO PUBLIC BANKS,**  
**AT FEBRUARY 2000**  
(BILLIONS OF PESOS)

Entity	Funding required	Funds provided by Fogafin	Solvency (%)	
			June 1999	January 2000
BCH	1.590,0	1.254,0	0,0	8,0(*)
Granahorrar	600,0	272,0	16,6	27,6
Bancafé	1.530,0	600,0	6,3	13,2
Estado	1.290,0	1.240,0	17,9	16,4
Banco Agrario	150,0	150,0	n.a.	8,8
FES	90,0	n.a.	n.a.	n.a.
<b>Total</b>	<b>5.250,0</b>	<b>3.516,0</b>	<b>6,5</b>	<b>13,2</b>

(\*) To December 1999.

n.a. Not available.

Sources: Fogafin and Banking Superintendency.

Table 7 shows the use of Fogafin credits by private banks, and Table 8 the amounts of funds provided by Fogafin to public banks. In the private sector, only 9 out of a total of 82 financial entities availed themselves of capitalization credit, and half the capitalization required was for a cooperative bank (Megabanco). The total requirements of these private entities amounted to no more than 30% of the urgent capitalization needs originally budgeted for private banks by Fogafin. Private users of Fogafin credits have yet to show an improvement in their solvency

<sup>23</sup> Fogafin's capitalization facility for private banks expired at the end of 1999. Fogafin Resolution 011 of 1999 provided that institutions availing themselves of the support program in 1999 might obtain a second loan in the first six months of 2000.

ratios, but the one-year period allowed them for raising their solvency ratios to at least 10% has not expired yet<sup>23</sup>.

The capitalization scheme for private banks provided no subsidies or relief for shareholders, because all loans were made at market rates and secured by appropriate guarantees.

In contrast to what has occurred with private banks, the capitalizations required by public banks, amounting today to over 5,500 billion pesos, have exceeded the 3,300 billion pesos originally budgeted by Fogafin. When the Fogafin credit scheme was proposed, it was estimated that private banks would cost more to be financially rehabilitated than public banks. Six months into implementation of the scheme, the financial imbalances of public institutions are emerging more fully. At the end of 1999, funding extended to public banks through Fogafin bonds barely met half their capitalization needs. The shortage was partially covered in February when new capitalizations were extended to BCH (state mortgage bank) and Granahorrar. Thus, the amount provided by Fogafin reached 3,516 billion pesos, or 67% of the capitalization required in February of this year.

A variety of factors could explain why private banks made little use of the Fogafin's credit line. One such factor would be the provisioning required for slow-performing loans (such as Category C or D loans), which was far higher than the rate imposed by the Banking Superintendency. Institutions that did not use the credit line, which expired on December 31, have to be capitalized by their partners or by issuing shares. Some major institutions have, in fact, launched share issues since the beginning of the year to strengthen their capital capacity.

The Banco de la República has recently acquired Fogafin securities worth 498.8 billion pesos, to facilitate the government's program for restructuring and rehabilitating public banks, including the recent dismantling of BCH's operations. Such securities, known as 'Fogafin Securities - Public Banks', were issued in 1999 and are to be repur-

chased by Fogafin within the next 20 months. The measure has had important repercussions on the interbank market. Since some public banks, particularly BCH, were having difficulty in obtaining access to the interbank market, the REPO lending rates were registering considerable variations, unjustified by liquidity conditions in the economy. Purchase of the those securities by the Banco de la República has provided public banks with a major source of constant liquidity.

The capitalization required by entities that did not make use of Fogafin credit may be estimated at 2,500 billion pesos. Entities specializing in mortgage loans account for 57% of this amount, domestic private banks for 26%, financial corporations and commercial financing companies for 12%, and foreign banks for the remaining 5%<sup>24</sup>. So, despite private banks' major efforts at rehabilitation with support from Fogafin, their partners still face considerable capitalization requirements.

The strategies devised to rehabilitate and capitalize private and public banks are not risk-free. For private banks, the risk is that their shareholders may be unable to repay the loans, in which case the guarantees expressed in bank shares would have to be called in. For public banks, the risk remains of a new capital deterioration occurring before they are sold or dismantled, despite the official efforts that have been made to capitalize them.

A financial crisis, if left unremedied, can unleash devastating effects on economic activity. The measures discussed above are intended to put financial institutions back on a sound footing in terms of capital and the capacity for credit intermediation, and also to protect the public's savings. They have present and future fiscal implications. The potential fiscal

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<sup>24</sup> Required capitalization was roughly estimated by applying the terms of Fogafin Resolution 006 to those private entities that did not make use of Fogafin's capitalization credit. Thus, estimates were made of the 100% provisions required to be set aside on the following items : i) category C loans, except for mortgage loans, and loans classified as category D or E; ii) property received in payment; iii) accounts receivable; and iv) amortization of goodwill and prepaid expenses. Calculations were made on balances at the end of 1999.

costs of the strategies supporting the financial sector are described in the next few paragraphs.

The credit line for capitalizing private banks is not expected to generate fiscal costs, because the debt service of the bonds will be covered by the return on loans extended to shareholders. Some comments are in order about support to public banks. Two bond issues were launched in 1999 to recapitalize them, the first for 3,000 billion pesos and the second for 1,200 billion pesos. In both cases, the debt service will be included in future budgets. Moreover, the strategy has required 600 billion pesos, financed from the proceeds of the levy on financial transactions. Fogafin has estimated that the present value of these support operations would be around 3,000 billion pesos.

A major component of the fiscal cost associated with the public-bank crisis was the liquidation of the Caja Agraria, estimated to have cost 2,700 billion pesos, in terms of present value.

Lastly, to support the rehabilitation of cooperative banks Fogafin extended loans amounting to 200 billion pesos, from the proceeds of the financial-transactions levy.

In all, in terms of present value, the fiscal cost of the strategies supporting the financial sector may amount, so far, to some 5,500 billion pesos, or 3.7% of estimated GDP for 1999<sup>25</sup>.

### c. Changes in financial-sector laws and regulations

In 1999 several changes were made in laws and regulations governing the financial system. They are expected to have major repercussions in both the short and long run. The main measures were adopted under Banking Superintendency Circular 039 of 1999, and Laws 510, 546 and 550 of 1999.

#### 1) Banking Superintendency Circular 039

Circular 039 of 1999 amended the Superintendency's Basic Accounting and Financial Circular as regards assessment of credit portfolios. It created a transitory regime whereby, for a period of six months, excep-

<sup>25</sup> Information on the expected fiscal costs of support operations has been taken from Fogafin reports. *Informe de gestión, 1999*, Santafé de Bogotá, March 2000.

tional measures would apply for restructuring corporate debt. Circular 039 provided, among other things, that: financial entities would condone default interest; grace periods could be established for payment of interest (up to one year) and repayment of capital (up to three years); interest rates on restructured loans would be freely set by agreement between banks and companies; and maturities of restructured loans should not be more than seven years. To attract commercial banks, a direct line of credit was to be created in IFI (state Industrial Development Agency) for the sum of 300 billion pesos, to cover any liquidity shortages in banks that are involved in restructuring processes.

Table 9 shows the number and value of restructurings arranged by a sample of financial entities. The total value of the sample's 347 restructurings came to 1,300 billion pesos, or 18% of the financial system's bad loans at the end of 1999<sup>26</sup>.

**TABLE 9**  
**EXTRAORDINARY RESTRUCTURINGS**  
**OF CREDIT INSTITUTIONS**  
(BANKING SUPERINTENDENCY CIRCULAR 039/99)

	No. of Restructurings	Millions of pesos
Banco de Bogotá	70	184.361
Bancolombia	41	148.785
Colpatria (Multicolor)	11	26.259
Bancafé	17	49.568
Ganadero	15	91.800
Banco Santander	8	61.000
Banco de Occidente	38	53.820
Banco Popular	16	75.923
Davivienda	1	874
<b>Subtotal de bancos</b>	<b>217</b>	<b>692.770</b>
Corfinsura	42	188.000
Corficolombiana	54	121.600
Corfivalle	16	160.326
IFI	18	143.071
<b>Subtotal other entities</b>	<b>130</b>	<b>612.997</b>
<b>Total for sample</b>	<b>347</b>	<b>1.305.767</b>

Source: Banking Superintendency, *Boletín de prensa*, February 2000.

<sup>26</sup> Since the commercial loan portfolio of the sample entities represents 72.5% of the total at the end of 1999, the Banking Superintendency has estimated that the total cost of restructurings at the end of 1999 would have been of the order 1,800 billion pesos. Banking Superintendency, *Boletín de prensa*, Santafé de Bogotá, February 1999.

The restructurings constitute a market solution to the serious bad-loan problem, and a means of re-establishing normal relations between debtors and creditors. The relative success of Banking Superintendency Circular 039 bodes well for the Economic Intervention Law, discussed below. In contrast, IFI's direct line of credit, designed as a liquidity safety net in support of restructurings, seems to have been less successful: between July 1999 and January of this year loans totalled only 1,137m pesos out of an available amount of 300 billion pesos.

### 2) *Financial Reform Law (510 of 1999)*

Law 510 has raised the minimum capital requirements for creating and operating financial institutions and requires them to be adjusted every year according to the consumer price index. It has also broadened the banks' range of operations by allowing them to securitize mortgage loans. It has done away with the division of commercial financing companies into traditional companies and those specializing in leasing. Lastly, the law has extended the grounds on which a regulated entity may be taken over, and lays down more flexible conditions for intervention in an entity.

### 3) *Housing and Mortgage Funding Law (546 of 1999)*

#### a) Features of the new system

i. Individual long-term home loans are to be expressed in Real Value Units (Unidad de Valor Real - UVR), which will vary in line with inflation. But credit institutions and other entities such as the National Savings Fund, cooperatives and employee funds may extend such loans in pesos (Articles 1 and 17).

ii. Under the old system savings and loan associations (Corporaciones de Ahorro y Vivienda - CAV) could choose to become banks under certain conditions. Under the new regime they are obliged to become banks and have three years to make the necessary adjustments.

iii. The interest rate shall be fixed for the life of the loan. It shall be calculated on the basis of the UVR and payable in arrears. There shall be no capitalization of interest (Article 17).

iv. The loan period shall be between 5 and 30 years; formerly it was 15 years for home buyers (Article 17).

v. Mortgagors may prepay their debt at any time (Article 17). In the past this was a matter of dispute, which the Constitutional Court resolved in favor of debtors in 1998.

vi. Amortization schemes require express approval from the Banking Superintendency (Article 17). The multiplicity of options (amortization by super-small installments, by small installments, etc.) formerly offered by the CAV to their clients are no longer admissible. The Banking Superintendency reckons the CAV were using 84 amortization schemes. Once the Housing Law was passed, the Superintendency established two alternatives: in one the installment, including capital and interest, will be fixed in UVRs; in the other the installment, including capital but not interest, will be fixed in UVRs.

vii. The law expressly deals with low-income housing. The aim is to earmark a portion of mortgage loans, recalling a practice of past decades. For five years after the law's entry into force, credit institutions are required to assign at least 25% of the increase in their gross housing portfolios to the construction or improvement of low-income housing (Chapter VI, particularly Article 28).

#### b) New rules for debtors

i. All obligations expressed in UPACs are to be expressed in terms of UVRs. The law provides up-to-date debtors with relief in the form of a direct contribution towards the outstanding principal of the loan. Each mortgage institution shall determine the value of the relief by working out the difference between the balance of the debt at December 31, 1999 and the balance resulting from calculating the loan on the basis of UVRs from January 11, 1993 (Articles 38 and 41).

ii. Facilities are provided for buying back housing given up as payment in kind. Such facilities did not

exist before. To appreciate this point, bear in mind that the value of property received in payment by the CAV increased by 93% from 1998 to 1999. In the case of the state mortgage bank, BCH, the increase was 110%<sup>27</sup>. The law now stipulates that if the property given up in payment has not yet been sold, the institution that received it may offer it on lease to the former owner and sign a repurchase option agreement with him for a period of up to three years. If the property has already been sold, the mortgage institution may offer another property on the same terms.

iii. Repurchase of a property through the above procedure creates obligations for the beneficiary, notably: he must live in it for up to three years, paying a rent equal to 0.8% of the property's assessed market value; he must adhere to a program for saving an amount equal to 30% of the property's value; these savings gives him the right to receive from the government a peso for every peso saved, up to 15% of the property's value, and will go towards the price of buying back the home (Article 46).

iv. Up-to-date debtors receiving relief undertake to remain up to date, otherwise they forfeit the contribution. In effect, debtors are required not to be more than 12 months in arrears to ensure the contribution referred to above (Article 41).

#### c) Mortgage loans and the capital market

i. The law authorizes the creation of a new financial asset, a Mortgage Bond, to be used exclusively for financing long-term housing projects. Investments in these bonds will enjoy tax benefits, provided they are made for periods of at least five years (Articles 9 and 16).

ii. To finance the contributions towards outstanding individual debts, the law has created negotiable, ten-year Debt Reducing Instruments (TRDs), to be issued by the government, the principal payable in a single amount at maturity or, fiscal conditions permitting, earlier (Article 44).

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<sup>27</sup> Property received in payment amounted to 2.2% of the assets of the CAVs by November 1999, and 4.9% in the case of BCH.

iii. The TRDs are to be purchased in the primary market by financial institutions (not just credit entities), by way of compulsory investment. The investment will be calculated on the credit entities' liabilities to the public, and will be made for a period of six years, in an amount representing 0.68% a year of such liabilities (Article 45).

iv. The law contemplates the creation of a Mortgage Stabilization Reserve Fund, to be administered by the Banco de la República, to provide cover against the risk of a differential arising between the rate of interest and the rate of inflation (Article 48). The Bank may offer such cover only for the balance of the individual home-loan portfolio at end of 1999 (roughly 8% of GDP).

v. An interesting aspect of the new law for the future of the capital market is securitization of the mortgage portfolio (Article 21). The government may, directly or through Fogafin, take stakes in securitizing companies (Article 15). The former CAVs and other mortgage institutions are very likely to invest in setting up a mortgage securitizing company. Moreover, certain international organizations such as the International Finance Corporation may be interested in investing in this kind of company together with the Colombian private sector. If this securitization-company project, or other such projects offering economies of scale, prove successful, they will benefit the capital market and may provide a market alternative to issuing Debt Reducing Instruments.

#### 4) *Economic Intervention Law (550 of 1999)*

##### a) Why have an intervention law?

A major reason for making the law was the need to resolve the breakdown in credit relations by contractual, not judicial, means. The bill's statement of reasons acknowledged that last year's steep fall in credit came from deteriorating relations between debtors and creditors:

"... the financial system had to cope with deterioration in the quality of its portfolio by increasing its provisions considerably. It was obliged to receive much payment in kind and practically to stop giving new credit because of a declining customer-risk perception."



The law is essentially intended to create a favorable framework for corporate restructuring. This is the meaning the laws gives to the term «economic intervention.» This is a similar issue to Chapter 11 reform in the United States, which sought to establish a contractual, not judicial, framework for better understanding between businessmen and bankers. The aim is to design a valid scheme for addressing not occasional individual difficulties but collective problems likely to have a devastating impact on the economy<sup>28</sup>.

b) Changes introduced by the intervention law

i. The existing *judicial* procedure for arrangement with creditors is *suspended* (for five years) and replaced by a system for forging agreements between debtors and creditors under the guidance of the Banking Superintendency.

ii. The entrepreneur's vote is replaced by that of the internal creditors, defined as the company partners, whose say in decision-making will depend on the relative magnitude of the company's assets compared with external claims. This loosens the veto power of entrepreneurs (with a decision-making power equal to that of all the creditors together), traditionally regarded as an obstacle to any possible agreements. The intervention law thus provides solutions.

iii. The law stipulates that, except as regards payroll and pension commitments, contractual preferences may be defined in the negotiations. This gives greater flexibility to the claims preference system, which traditionally work against agreements because it was generally oriented towards liquidating the assets.

### 3. Summary and conclusions

The balance sheets banks' deteriorated considerably from mid-1998 to mid-1999. The Economic Emergency decreed in November 1998 and a variety of measures adopted over 1999 have sought together to restore liquidity to the financial system, strengthen banks' capital base, lighten the financial burden of mortgage debtors, and revitalize relations between debtors and creditors.

In 1999 state intervention in the financial sector was guided by such criteria as nationalizing as few entities as possible, averting the so-called moral risk, not favoring the partners of credit institutions, and protecting the public's savings. Various indicators suggest that the measures may be protecting the financial system from further deterioration it might otherwise have suffered.

Some private banks that needed credit for capitalization have probably already obtained support from Fogafin. Others are being capitalized by their own partners or by issuing shares in domestic or foreign markets. The authorities expect that any further capitalizations still needed will come from shareholders.

The progress made in corporate restructurings under Banking Superintendency Circular 039 of 1999 augurs well for normalizing relations between debtors and creditors, and sets a good precedent for enforcement of the Economic Intervention Law recently passed by Congress.

The financial sector's full recovery is not achieved just by capitalizing banks and providing relief to its most affected components. The credit crunch will tend to continue as long as company balance sheets show no signs of recovery and the legal framework lacks the flexibility required in critical times. The experience of several countries that have recently gone through similar situations suggests that support and bail-out measures are not enough. Bank portfolios will start showing normal growth rates again when the banks, with their newly restored solvency ratios, can perceive a sustained revival in corporate business and can rely on laws and regulations remaining stable in future.

A great many measures were adopted in 1999 to put the financial sector back on a sound footing. Prominent among these was a new law on housing and long-term mortgage funding. For measures as far-reaching as this new law to be successful, it is essential that the legal framework underpinning savers and investors' predictions should remain stable.

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<sup>28</sup> J. Stiglitz and J. Miller, *Bankruptcy Protection Against Macroeconomic Shocks: The case for a 'super Chapter 11'*, World Bank, 1999.

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## D. FISCAL POLICY

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The fiscal situation presented here has been assessed by IMF methodology, which differs in important ways from the cash-basis methodology traditionally employed. The advantage in using the new methodology is that the central government's fiscal balance is measured on an accrual basis (including the full budget lag), taking into account the statements of results of the Banco de la República and Fogafin. Thus a more accurate measure is obtained of public-sector deficit (see Box).

### 1. Fiscal policy in 1999

At the end of 1999 the consolidated public sector showed a deficit of 5.1% of GDP, and the nonfinancial public sector a deficit of 6.0%<sup>29</sup>. Although the government had initially intended to reduce the size of the consolidated deficit, especially through a tax reform and the introduction of a financial-transaction levy, several unexpected factors prevented it from obtaining a better fiscal result. Such factors included a downturn in the economy, an earthquake in the coffee-growing region, and crisis in the financial sector. This fiscal performance was consistent with the terms of the IMF agreement, which contemplated a deterioration in public finances in 1999, to be corrected by the plan (Table 10).

Official estimates put the central government's deficit at 7.6% of GDP<sup>30</sup>, an increase of 2.3% of GDP on the figure for 1998. One feature of the government's fiscal performance is the low level of tax receipts, associated with the decrease in both output and the

value of imports. In all, tax receipts grew by only 8.4%, despite larger revenues resulting from the tax reform passed at the end of 1998 and the introduction of a two-per-thousand levy on bank withdrawals. Revenues were low from both internal taxes and import taxes. Income tax and internal VAT registered nominal growths of 4.9% and 17.2%, while customs taxes and external VAT shrank by 16.6% and 18.3% respectively. Unlike tax revenues, the central government's non-tax income surged by 50.3%, thanks to transfers of financial surpluses from national-level public companies and establishments (Table 11).

As regards outlays, according to government estimates interest payments grew by 22.9% and operating costs by 24.1%, while investment decreased by 1.1%. Under operating costs, general expenditures shrank by 1.5%, but personal services and transfers expanded by 15.7% and 29.3% respectively. The expansion in transfers payments was connected with transfers to the departments and districts (*situado fiscal*) to municipalities and pensions, which grew by 36.3%, 26.7% and 19.8%, respectively. It is important to point out that the surge in *situado fiscal* outlays is connected with the 1999 budget's overestimation of current-income growth (the basis for determining the size of appropriations for local-government transfers). It is also connected with the legal impossibility of making cuts in this spending item upon detecting slow growth in tax revenues. Consequently, the relevant adjustment in *situado fiscal* outlays will not be reflected in government operations until 2000, and then as a result of a negative reassessment in the government's income budget. Higher growth in the *situado fiscal* made it possible to reduce the resource needs of the Educational Credit Fund, which normally supplements payments to teachers financed from the *situado fiscal*. So, the *situado fiscal* and the Fund, taken together, reported a 23% growth in 1999.

The government's deficit was mostly financed from domestic and foreign loans, because of postponement

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<sup>29</sup> Measuring the deficit on the basis of sources of financing gives an imbalance of 5.3% of GDP for the consolidated public sector and of 6.3% for the nonfinancial public sector. Because of differences in coverage, these figures show a statistical discrepancy of 0.2% and 0.3% of GDP, respectively, compared with the corresponding figures in Table 10, which were measured on basis of the income and expenditures of the different public entities.

<sup>30</sup> As explained in the Box below, the central government's deficit of 7.6% of GDP, as measured by the new methodology, is equivalent to a deficit of 6.0% by the cash-basis methodology previously used. The main differences consist in not counting the Banco de la República's profits (0.8% of GDP) as government income, and including the change in the budget lag, in an amount equivalent to 0.6% of GDP.

TABLE 10  
CONSOLIDATED PUBLIC-SECTOR DEFICIT

Percentage of GDP	Entity/sector		Billions of pesos	
	1998	1999 (pr)	1998	1999 (pr)
Electricity	(797,0)	(437,0)	(0,6)	(0,3)
Carbocol (coal company)	117,0	266,0	0,1	0,2
F.A.E.P. (oil stabilization fund)	155,0	533,0	0,1	0,4
Ecopetrol	130,0	933,0	0,1	0,6
Telecom	206,0	(70,0)	0,1	(0,0)
Other entities	(82,0)	160,0	(0,1)	0,1
Social security	2.381,0	1.517,0	1,7	1,0
Regional & local entities	(40,0)	(524,0)	(0,0)	(0,4)
National Coffee Fund	(37,0)	(43,0)	(0,0)	(0,0)
<b>1. Subtotal decentralized sector</b>	<b>2.033,0</b>	<b>2.335,0</b>	<b>1,4</b>	<b>1,6</b>
<b>2. National government</b>	<b>(7.441,8)</b>	<b>(11.338,5)</b>	<b>(5,3)</b>	<b>(7,6)</b>
A. Total nonfinancial public sector (1 + 2) 1/	(5.408,8)	(9.003,5)	(3,8)	(6,0)
B. Banco de la República's cash profit or loss	1.108,0	608,0	0,8	0,4
C. Fogafin cash profit or loss	n.a.	828,0	n.a.	0,6
D. Financial sector restructuring costs	0,0	(10,0)	0,0	(0,0)
<b>E. Total consolidated public sector (A + B + C + D)</b>	<b>(4.300,8)</b>	<b>(7.577,5)</b>	<b>(3,0)</b>	<b>(5,1)</b>

(pr) Preliminary estimate

n.a. Not available

1/ These estimates include the change in the central government's budget lag.

Source: CONFIS.

of the privatizations program to the year 2000. Net foreign borrowing rose to 3,244 billion pesos, and net domestic debt to 5,713 billion pesos. The domestic-debt instruments used by the government were the TES treasury paper (totalling 11,933 billion pesos) and Security and Peace Bonds (totalling 207 billion pesos). Increased borrowing raised the central government's total debt from 21.9% of GDP in 1998 to 29.5% in 1999. As indicated in discussing the evolution of total foreign debt, this increase too is explained by higher devaluation and contraction of GDP in 1999.

The other sectors and entities of the nonfinancial public sector reported a fiscal surplus of 1.6% of GDP, attributable in part to Ecopetrol's satisfactory financial performance, thanks to higher world crude prices and larger export volumes. The fiscal performance of the rest of the public sector was also

affected by the deterioration in social-security finances caused by the economic downturn, the loss of members to private funds, and the transfer of some 800 billion pesos from Cajanal (social security entity for government employees) to the central government.

## 2. Fiscal outlook for 2000

All studies point to the need for a sustained fiscal adjustment, which will start to be implemented this year. The adjustment involves carrying out a series of reforms, including a new tax reform, creating a Local-Government Pension Liabilities Fund<sup>31</sup>, setting limits to local governments' operating expenditures, redefining the mechanism used for calculating transfers (*situación fiscal* and current-income allocations to municipalities), and modifying the social-security regime as regards pensions. In this

<sup>31</sup> This Fund was created by Law 549 dated December 28, 1999.

**TABLE 11**  
**CENTRAL GOVERNMENT**  
(BILLIONS OF PESOS)

	1998	1999 (pr)	Annual growth
<b>I. Total revenues (A + B)</b>	16.775,0	18.997,4	13,2
A. Tax revenues	14.825,4	16.066,6	8,4
Income tax	6.109,2	6.409,5	4,9
Internal VAT	4.038,0	4.734,3	17,2
External VAT	2.368,5	1.935,1	(18,3)
Customs	1.646,6	1.372,6	(16,6)
Gasoline	641,8	706,5	10,1
Other 1/	21,3	908,6	4.165,7
B. Nontax and other revenues	1.949,6	2.930,8	50,3
<b>II. Total expenditures (A + B + C + D)</b>	23.820,8	29.404,6	23,4
A. Interest	4.089,6	5.025,5	22,9
External	1.194,6	1.559,2	30,5
Internal	2.895,0	3.466,3	19,7
B. Operating costs	17.122,0	21.254,6	24,1
Personal services	3.547,9	4.106,2	15,7
General expenditures	1.315,3	1.295,6	(1,5)
Transfers	12.258,8	15.852,8	29,3
To departments & districts (situado fiscal)	3.300,8	4.499,7	36,3
Educational Credit Fund	694,2	425,6	(38,7)
To municipalities	2.480,3	3.141,6	26,7
Pensions	2.556,6	3.063,4	19,8
Financial sector	0,0	920,6	n.a.
Other	3.226,9	3.801,9	17,8
C. Investment	2.280,4	2.254,7	(1,1)
D. Net loans	328,8	869,8	164,5
<b>III. Budget lag</b>	396,0	931,3	135,2
<b>IV. Deficit or surplus (+) (I - II - III)</b>	(7.441,8)	(11.338,5)	52,4
<b>V. Financing (A + B + C)</b>	7.441,8	11.338,5	52,4
A. Net external credit	2.701,3	3.244,0	20,1
Disbursements	3.699,9	5.102,0	37,9
Repayments	998,6	1.858,0	86,1
B. Net domestic credit	3.997,0	5.713,0	42,9
Disbursements	7.709,2	12.003,0	55,7
Repayments	3.712,2	6.290,0	69,4
C. Other	743,5	2.381,5	220,3
<b>VI. Deficit as percentage of GDP</b>	(5,3)	(7,6)	44,8

(pr) Preliminary estimates.

n.a. Not applicable.

1/ Includes the 2/1000 withdrawal levy.

Source: CONFIS.

connection it is to be noted that, according to preliminary official projections, the nonfinancial public sector deficit will run to 3.6% of GDP for 2000.

The deficit in the central government's finances is projected to be 6.6% of GDP for 2000, down by 1.0% of GDP from its level in 1999. Income projections show a 17.4% growth in tax receipts and a 4.6% decrease in non-tax revenues, this decrease arising largely from the transfer of financial surpluses by public entities. The central administration's outlays will show growths of 30.8% in interest payments, 4.5% in operating expenditures, and 21.1% in investment. Under operating expenditures, personal services will grow by 8.5% and general expenditures shrink by 3.1%. Transfers will increase by only 4.1%, largely because of adjustment of the *situación fiscal* to reflect the fall in current income over 1999. As regards financing, there will be a net external borrowing of 2,555.5 billion pesos, a net domestic borrowing of 3,544.2 billion pesos, and 2,121.8 billion pesos from privatizations. The privatization plan includes the sale of Carbocol (coal), and ISA and Isagen (energy companies).

The rest of the nonfinancial public sector is forecast to show a surplus of 3.0% of GDP, up by 1.4% of GDP on 1999. The creation of the Local-Government Pension Liabilities Fund is noteworthy; it will allow the social-security sector to maintain the level of surplus registered in 1999. Ecopetrol's situation may improve relative to 1999 if world crude prices remain high.

The government succeeded in moving major reforms through Congress in 1999. Some of these, such as the Financial Law, the Housing Law and the Economic Intervention Law, were devised to resolve problems in the financial and credit sector. Others, such as the laws approving an austere national budget for this year and the creation of a Local-Government Pension Liabilities Funds, have made it possible to start setting the country's public finances in order.

But the most substantive part of the structural reforms is to be debated during the first session of the legislature this year. The government's constitutional reform bill, intended to moderate and improve the use of transfers to local governments, is the most important reform for putting the country's public finances into shape. In particular, a new arrangement for local-government transfers that allows a more balanced and flexible management of the budget will be the first step towards regaining the «investment grade» rating Colombia recently. Mexico's example is illustrative in this connection: its fiscal reorganization, curbing of inflation, and dynamic trade under NAFTA have just raised it to the desirable status of an «investment grade» country.

Congress will also be considering a pension-reform bill for addressing serious problems in social-security finances. By lowering benefits, improving collection systems, and treating people more equally (through future elimination of preferential systems), the financial position of society as a whole will be improved, making it possible to meet responsibly the enormous pension obligations that are increasingly becoming due.

Lastly, the government has put before Congress a tax modernization bill seeking to reduce income-tax rates, make the financial-transaction levy a permanent tax (except on transactions in the interbank and currency markets), and create a new tax regime for small and medium taxpayers in place of the present income-tax and VAT system

National and foreign analysts, private and multilateral banks, the government, Congress, the Banco de la República and public opinion are all aware that the country's economic fate will depend on the outcome of the present legislature, not so much because of its immediate bearing on the adjustment plan, but because the reforms discussed above touch on the deeper structural problems besetting the country for a decade.

**TABLE 12**  
**CENTRAL GOVERNMENT, PROJECTIONS FOR 2000**  
 (BILLIONS OF PESOS)

	Amount	Growth 2000-1999
<b>I. Total revenues (A + B)</b>	21.656,5	14,0
A. Tax revenues	18.861,6	17,4
Income tax	7.343,9	14,6
Internal VAT	5.197,3	9,8
External VAT	2.618,4	35,3
Customs	1.798,8	31,1
Gasoline	875,8	24,0
Other 1/	1.027,4	13,1
B. Nontax and other revenues	2.794,9	(4,6)
<b>II. Total expenditures(A + B + C + D)</b>	32.469,1	10,4
A. Interest	6.574,9	30,8
B. Operating costs	22.207,1	4,5
Personal services	4.453,8	8,5
General expenditures	1.255,9	(3,1)
Transfers	16.497,4	4,1
To departments & districts (situado fiscal)	4.197,4	(6,7)
Educational Credit Fund	820,1	92,7
To municipalities	3.374,8	7,4
Pensions	4.216,2	37,6
Financial sector	10,8	(98,8)
Pensions	3.878,1	2,0
C. Investment	2.730,2	21,1
D. Net loans	956,9	10,0
<b>III. Budget lag</b>	685,9	(26,4)
<b>IV. Deficit or surplus (I - II - III)</b>	(11.498,5)	1,4
<b>V. Financing (A + B + C)</b>	11.498,5	1,4
A. Net external credit	2.555,5	(21,2)
B. Net domestic credit	3.544,2	(38,0)
C. Other	5.398,8	126,7
<b>VI. Deficit as percentage of GDP</b>	(6,6)	(12,7)

Includes the 2/1000 withdrawal levy.  
 Source: CONFIS.

## NEW METHODOLOGY FOR CALCULATING THE CONSOLIDATED PUBLIC SECTOR DEFICIT

Since the mid-eighties the nonfinancial public sector's fiscal balance has been prepared on a cash basis, an accounting method using the cash movements in the income and expenditures of the government and public entities. Although this type of accounting has been very useful in macroeconomic programming, it poses some problems. By focusing exclusively on cash movements it fails to take into account operations affecting the fiscal balance, such as an increase in accounts payable. In other cases, it books under a single fiscal year income generated by operations covering several years, such as license fees for concessions lasting for several years, or payments for instruments issued on future oil production.

To solve these problems the government and the IMF have been working for some time on designing a methodology that values operations on an accrual basis and makes a broader measurement of public-sector deficit. The new method of measuring the fiscal balance makes it possible to reckon the consolidated public sector deficit or surplus by aggregating the fiscal balance of the nonfinancial public sector, the cash profit and loss statements of the Banco de la República and Fogafin, and the cost associated with restructuring the financial system.

Operations on an accrual basis refers to accounting movements that also affect the fiscal balance, though lacking the corresponding cash movements. In particular, to reflect fiscal pressures more accurately, the new official calculation includes changes in the budget lag, which is made up of the central government's accounts payable and budget reserves. Moreover, accrual accounting does not include the cash income from oil securitization or telecommunications concessions but books instead only the amount of the equal annual portions of such operations. The subsidy to mortgage debtors, recently created by the Housing Law, is distributed over the repayment period of their debt. The costs of restructuring the financial system are also included. Lastly, a part of the government's financial-transaction levy is transferred from central-government accounts to Fogafin's balance sheet. By excluding some income and including changes in the budget lag, the new methodology tends to give a higher fiscal deficit than that obtained by cash-basis accounting, as the following table shows for 1999.

**CONSOLIDATED PUBLIC SECTOR DEFICIT, 1999  
CALCULATED BY THE NEW METHODOLOGY**

	<b>Billions of pesos</b>	<b>Percentage of GDP</b>
A. Central government, by old methodology	(8.889,3)	(6,0)
Concessions	(140,0)	(0,1)
Banco de la República profits	(1.244,0)	(0,8)
Annual portions of concessions	238,1	0,2
Other	(372,0)	(0,2)
Change in budget lag	(931,3)	(0,6)
B. Central government, by new methodology	(11.338,5)	(7,6)
C. Rest of public sector, by old methodology	2.548,0	1,7
Crude-oil securitization	(277,0)	(0,2)
Private TV channel concessions	(95,0)	(0,1)
Annual portion of crude-oil securitization	179,0	0,1
Other	(20,0)	0,0
D. Rest of public sector, by new methodology	2.335,0	1,6
E. Nonfinancial public sector deficit, by old methodology (A + C)	(6.341,3)	(4,3)
F. Nonfinancial public sector deficit, by new methodology (B + D)	(9.003,5)	(6,0)
1. Banco de la República cash profit or loss	608,0	0,4
2. Fogafin cash profit or loss	828,0	0,6
3. Financial restructuring costs	(10,0)	0,0
G. Adjustments (1 + 2 + 3)	1.426,0	1,0
H. Consolidated public sector deficit (F + G)	(7.577,5)	(5,1)

Source: CONFIS (Fiscal Policy Council).



## IV

### INFLATION RESULTS AND BASIC TRENDS

Annual consumer inflation stood at 9.2% in December 1999, down by 7.5 percentage points on a year earlier and well below the 15% target set by the Banco de la República for 1999. This was the lowest year-end inflation since 1970 and the first time in 30 years that consumer inflation was down to one digit.

Last year's inflation reduction should allow a deepening of the process of inflation control undertaken by the Board from its creation, pursuant to the Bank's constitutional mandate of bringing about price stabilization as a fundamental task. The monetary authority's efforts have succeeded in lowering inflation gradually and almost without a break over the past eight years, from the moderate to high rates of the late eighties and early nineties (25%-30%) to what may be considered a low rate (under 10%), much closer to inflation in developed countries enjoying a high degree of economic stability.

The reductions in inflation have been largely the result of a monetary policy explicitly intended to control excess liquidity in the economy by regulating the pace of monetary growth. Economic literature and international experience point to a strong link between the behavior of monetary aggregates and inflation in the long run. In many economies, accelerating inflation has usually been accompanied by lax monetary policies that have been reflected in faster money growth. Conversely, policies to curb inflation only work to the extent that they are accompanied by a slowing of monetary expansion.

The Colombian economy has been no exception in this respect. The lowering of inflation over the nineties went hand in hand with slower growth in the different monetary aggregates. Besides this, a factor that helped

to reduce inflation more than expected in 1999 was the depth of the recession. In times of recession, when income is below its potential level, lower inflationary pressures may be expected because economic agents moderate their price adjustments in view of falling demand and low utilization of installed capacity. Sectors with highly income-elastic demand tend to be the most affected, having to make minimal price adjustments to avert any further decline in sales. In Colombia, this was the case of many manufactured goods such as clothing and electrical appliances, whose consumption can be postponed without undue difficulty, and of many non-essential services such as those connected with culture and recreation.

Another factor that helped to reduce inflation was the satisfactory behavior of agricultural supply, thanks to favorable rainfalls in 1999 and high prices in 1998. In 1999, the prices of most farm products included in the CPI basket rose more slowly than usual, particularly in the first half of the year. As a result, the first two quarters were free of the inflationary pressures usually caused by this group of goods at the beginning of the year, which impeded inflation-reduction in the following months.

Both the recession and agricultural supply explain how inflation in 1999 came to run below the target set by the Bank. But they could not have reduced inflation by themselves, as recent economic history has shown on numerous occasions in Colombia and other Latin-American countries. Indeed, the region has often seen strong economic contraction accompanied by high inflation, notably in Argentina, Brazil and Peru during the eighties (Table 13). In Colombia inflation accelerated in 1991, although the country was in a moderate economic downturn. Today, Venezuela and

**TABLE 13**  
INFLATION AND GROWTH IN ARGENTINA,  
BRAZIL AND PERU

Average rates	Argentina		Brazil		Peru	
	1970-1979	1980-1989	1970-1979	1980-1989	1970-1979	1980-1989
<b>GDP growth</b>	2,9	(0,5)	8,5	2,3	3,9	0,1
<b>Annual inflation</b>	132,9	565,7	30,6	327,4	26,5	481,3

Sources: ABN-AMRO and WEFA Group.

Ecuador are going through deep recessions without gaining anything thereby in their fight against high inflation (Table 14).

So, although the recession helped to slow Colombia's inflation last year, it did so thanks to the economic program being pursued to ensure macroeconomic stability in the medium term. A prudent monetary policy adopted under this program allowed the monetary base to grow at a rate consistent with the strategy of greater price stability.

The steady decline in inflation since 1992 has also made the task of reducing it easier by making the Bank's targets more credible and hence more likely to be taken into account by economic agents in their expectations of future inflation. Thus, the gradual targeting of inflation at increasingly lower levels has

reduced inflationary expectations. During the last year, all of these factors have helped start the defusing several of the firmly entrenched indexation mechanisms that have existed in Colombia for three decades and have rendered inflation strongly inertial, which makes their dismantling very costly.

The existence of a policy designed to adjust macroeconomic imbalances also neutralized the inflationary effects usually produced by a nominal devaluation such as last year's in the Colombian economy. Two conditions are required for a nominal devaluation not to translate into higher inflation. First, the nominal devaluation should occur when the real exchange rate is overvalued; this allows the exchange rate to move to its long-term equilibrium position. Second, monetary policy should dampen the expectations of higher inflation that are usually aroused by a strong nominal devaluation. If both conditions had not been met in 1999, it would have been very difficult to bring inflation down, and the economy might have found itself again in the same straits as in 1990-1991, when higher devaluation accelerated inflation without permanently raising the equilibrium real exchange rate. Or the economy could have gone into a dangerous devaluation-inflation circle, such as the circle some neighboring economies are now caught in.

**TABLE 14**  
INFLATION AND GROWTH IN ECUADOR, VENEZUELA AND COLOMBIA, 1999

	Ecuador		Venezuela		Colombia	
	Annual growth in quarterly GDP	Annual inflation	Annual growth in quarterly GDP	Annual inflation	Annual growth in quarterly GDP	Annual inflation
<b>1999 I</b>	(4,4)	50,4	(9,3)	30,7	(5,7)	13,5
<b>II</b>	(6,6)	47,2	(8,9)	30,0	(7,2)	9,0
<b>III</b>	(7,1)	53,4	(5,9)	29,2	(4,6)	9,3
<b>IV</b>	(11,1)	60,7	(4,5)	28,5	(3,1)	9,2

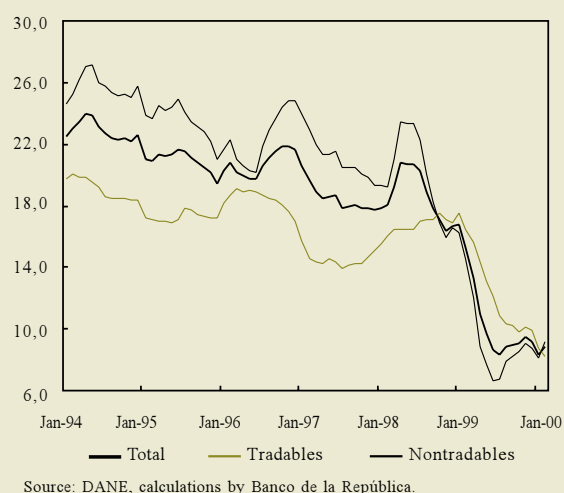
Sources: Bloomberg and Banco de la República.

## A. CONSUMER PRICE INDEX

Last year's steep fall in inflation was concentrated in the first half of the year, while in the second half inflation levelled out at under 10% (Figure 22). By December 1999 all the major CPI groups registered slower growth than in December 1998 (Table 15), but four developments were essentially responsible for the big reduction in 1999. First, the growth in food prices slowed considerably in the first half of the year. In June 1999 food prices registered barely a 0.3% growth rate and, though they rose sharply in the second half of the year, their year-end growth, at 7.5%, was lower than overall CPI inflation. Second, housing, which weighs heavily in the CPI basket, decreased gradually in price over the year, ending up in December with a 5.8% annual growth rate. Clothing and amusement in the third place, and culture and recreation in the fourth, presented satisfactory price behaviors that drove inflation down in 1999. In December their annual price growths were 3.1% and 2.4% respectively.

The other CPI groups also helped to reduce inflation although their annual growth rates in December were higher than overall inflation. This was the case of

**FIGURE 22**  
CPI INFLATION, TRADABLE AND NONTRADABLE ITEMS  
JANUARY 1994 - FEBRUARY 2000  
(ANNUAL PERCENTAGE CHANGE)



education, with an annual price rise of 12.4% in December, which however compared very favorably with its 18.6% growth rate at the end of 1998. The groups displaying the fastest price rises in 1999 were health care (15.1%), others expenditures (16.1%), and transport (18.7%).

Analysis of inflation by sector shows that the reduction was achieved despite large variations in relative prices over the year, which accounted for price rises

**TABLE 15**  
CONSUMER PRICE INDEX  
(PERCENTAGE CHANGE)

	First half			Second half			Annual		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>CPI</b>	11,3	14,1	6,5	5,8	2,3	2,5	17,7	16,7	9,2
Food	9,0	21,7	5,6	6,8	(5,0)	7,3	16,4	15,7	7,5
Housing	10,7	9,1	4,2	6,2	6,8	2,7	17,6	16,6	5,8
Clothing	5,5	4,5	2,1	3,7	3,1	1,6	9,4	7,8	3,1
Health care	16,6	15,4	11,0	4,2	4,5	6,0	21,5	20,6	15,1
Education	19,7	16,2	10,6	2,5	2,0	7,1	22,8	18,6	12,4
Leisure	n.a.	n.a.	5,4	n.a.	n.a.	1,0	n.a.	n.a.	2,4
Transport	15,2	14,2	11,0	5,3	5,2	11,8	21,3	20,2	18,7
Other	10,4	10,6	11,2	7,0	8,7	11,1	18,2	20,2	16,1

n.a.: Not available

Source: DANE, calculations by Banco de la República.

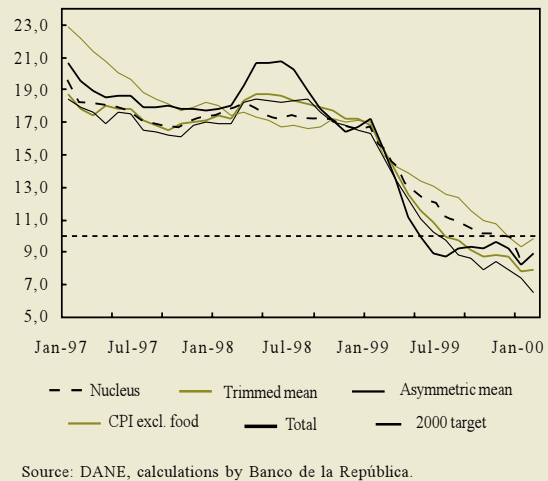
in very specific goods. Thus, higher gasoline prices caused big price increases in the transport sector. Similarly, extension of the value-added tax to several basic products at the beginning of 1999 produced the fast price growth of sundry expenditures. Lastly, the gradual phasing out of consumer subsidies for utilities translated into above-average-inflation increases in water and energy charges.

The price behavior of CPI goods, as reviewed under an alternate classification, shows that devaluation did not greatly affect annual inflation. This can be appreciated from the price behavior of tradable goods (Figure 22). At the end of 1999 inflation in tradable goods (9.9%) was not much higher than inflation in nontradables (8.7%), especially in view of the size of the devaluation: about 22% for the year. The better performance shown by nontradables (flexible, indexed and cyclical items) in the first half of the year was largely accounted for by the satisfactory price behavior of flexible goods (unprocessed farm produce, excluding meat and dairy products), and to a lesser extent by that of cyclical goods (meat and dairy produce). Inflation in indexed items (consisting mostly of services) declined gradually over the year as overall inflation slowed, as was to be expected for items of this kind.

The reduction in CPI inflation showed up also as a decline in the different core-inflation indicators calculated by the Banco de la República, namely: CPI excluding food, nucleus, mean, and asymmetric mean<sup>32</sup>. These indicators measure inflation of monetary origin (that is, inflation vulnerable to action by the monetary authority) and disregard supply-driven price changes. They should therefore provide better measures of demand inflation than CPI inflation does. As shown in Figure 23, all these indicators displayed a declining trend over the whole year, even during the second half, when CPI inflation levelled out. As a result, by December two of the four core-inflation indicators (the mean and asymmetric mean) registered growth rates lower than CPI inflation.

<sup>32</sup> Definitions of these indicators are given on Chapter IV of the March 1999 Report to Congress.

FIGURE 23  
CORE INFLATION INDICATORS  
JANUARY 1997 - FEBRUARY 2000  
(ANNUAL PERCENTAGE CHANGE)



## B. PRODUCER PRICE INDEX

Inflation measured by the Producer Price Index (PPI) displayed an irregular behavior in 1999, compared with the declining trend of CPI inflation. During the first half of the year annual PPI inflation fell steeply to 6.1%, its lowest level since 1970, but reversed this trend in the second half. By December 1999 annual producer inflation was running at 12.7%, barely 0.8 percentage points lower than a year earlier.

The sharp drop in producer inflation in the first half of 1999 was made possible by very slow price growth in agricultural goods over the whole period and by declining fuel prices up to March. In April fuel prices began to climb steeply, driven by rising world crude prices and a faster nominal devaluation that put strong inflationary pressure on the PPI basket. In the second half of 1999 inflationary pressure from rising fuel prices remained steady, whereas pressure from nominal devaluation intensified, as evidenced by accelerating price growth in imported goods. All these factors led to an upturn in PPI inflation. Pressure from devaluation tended to disappear towards the end of the year but was replaced by pressures originated in agricultural prices.

By origin, exported goods showed the biggest annual increase (26.7%) in December, followed by imported goods (16.1%), and domestically produced and consumed goods (11.6%) (Table 16). By ISIC economic origin, mining registered the largest growth rate (31.1%), followed by manufacturing (12.7%), and farming (11.7).

According to recent studies, there is no close correlation between the Producer and Consumer Price Indices<sup>33</sup>. This is because the PPI does not include services such as education, health care and recreation,

which do figure in the CPI. And the CPI does not include raw materials and capital goods, only final consumer goods. Consequently, the only way of finding a relation between the two indices is to compare PPI consumption with the CPI excluding services.

### C. OUTLOOK FOR 2000

In 1999 a major break was achieved in Colombia's inflation. The lowering of inflation to one-digit levels was attended by a significant reduction in inflation expectations, as suggested by several developments. Pay increases for 2000 were negotiated at about 10% for many workers. The minimum wage, covering a high percentage of the country's labor force, was adjusted by 10%. By the end of 1999, nominal interest rates for both deposits and loans had reached

TABLE 16  
PRODUCER PRICE INDEX  
(PERCENTAGE CHANGE)

	First half			Second half			Annual		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>PPI</b>	12,2	12,2	4,9	4,7	1,1	7,5	17,5	13,5	12,7
<b>By economic use or destination</b>									
Intermediate consumption	14,1	9,6	4,1	2,3	2,4	8,0	16,6	12,2	12,4
Final consumption	10,9	17,4	5,6	7,6	(2,0)	6,5	19,3	15,2	12,4
Capital formation	6,5	7,7	5,5	6,5	6,3	9,8	13,3	14,5	15,8
Construction materials	9,6	3,4	7,3	7,1	8,7	6,5	17,5	12,4	14,3
<b>By origin</b>									
Domestically produced and consumed goods	13,2	13,1	4,9	4,0	0,4	6,3	17,7	13,6	11,6
Imports	4,7	5,6	4,5	10,7	6,6	11,1	15,9	12,6	16,1
Exports 1/	27,1	(0,4)	7,7	7,4	4,6	17,7	36,5	4,3	26,7
<b>By ISIC industrial origin</b>									
Agriculture, forestry & fishing	23,7	21,3	3,6	(0,4)	(9,3)	7,8	23,3	10,0	11,7
Mining	(4,3)	(9,6)	25,2	10,2	1,6	4,8	5,5	(8,2)	31,1
Manufacturing	8,6	9,5	4,9	6,6	5,4	7,4	15,8	15,5	12,7

1/ Total IPP does not include exported goods; it is calculated as the weighted sum of domestically produced and consumed goods and imported goods.  
Source: Banco de la República.

historical lows, which were consistent with a 10% annual inflation though not with previous years' inflation rates of about 15% or 20%. The nominal interest rate is the sum of the real interest rate and agents' inflation expectations. So, a large drop in the nominal interest rate in the context of a steep fall in inflation, such as occurred in Colombia last year, is largely the outcome of the public's lower expectations of inflation. In fact, the Banco de la República's expectations surveys in 1999 revealed a gradual decrease in inflation expectations. They also found that in December 1999 annual inflation was expected to run at 10.4% by December 2000 (Figure 24).

Several developments allow optimism about price performance in 2000, promising an inflation similar to last year's or lower. In the first place, the fact that inflation expectations have dropped to 10% or so clears the way for annual inflation to stand at around this level in 2000. As suggested by international experience, to lower inflation it is necessary to lower inflation expectations among the public, for this is the way to deactivate the price-indexing mechanisms that make high inflation a permanent phenomenon. In Colombia, price changes in traditionally indexed sectors such as housing, education and services in general, have slowed, indicating that indexation weakened in 1999, and that the 10% inflation target

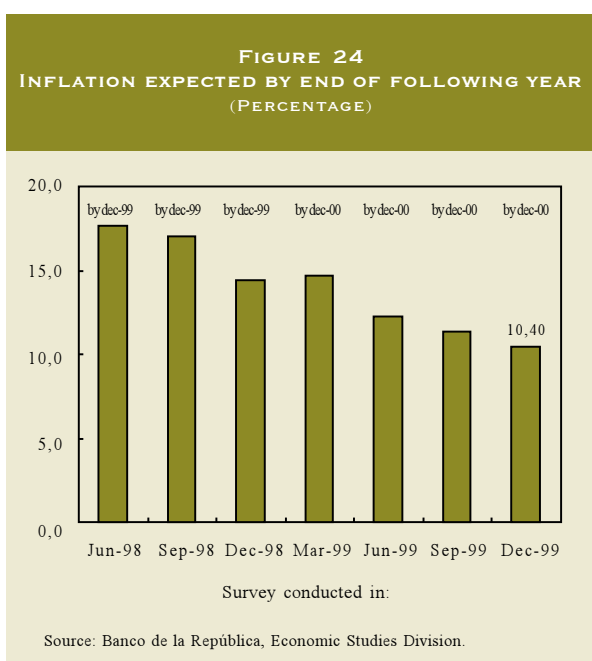
for 2000 has already been taken into account in many wage agreements and much pricing.

In the second place, since unused installed capacity is amply available in almost every economic sector and production is well below potential levels, there is sufficient room for the upturn in demand not to trigger inflationary pressures during the first stages of economic recovery.

Consolidation of recovery is expected to have a minimal impact on inflation, for an economic program is being followed that seeks to ensure elimination of macroeconomic imbalances in the medium term and allow the composition of spending to be altered in favor of the private sector. Moreover, the macroeconomic program contains monetary goals consistent with a 10% inflation target, which in turn allows total spending to be planned in accordance with the country's level of potential income.

The above is predicted to occur despite the inflationary pressures likely to arise in 2000 from an expected increase in gasoline prices and a rise in relative food prices, especially over the first half of the year. Gasoline prices will go up because of higher world crude prices and the effects of the peso's devaluation in 1999, which are partially transferred to 2000 by the Ministry of Mines and Energy's calculation formula. Food prices exhibited a highly satisfactory behavior for several months in 1999, thanks to abundant rainfall. But previous years' low prices tended to reduce the area and care of crops under cultivation, thereby affecting supply and pushing up prices. Something of this phenomenon began to be discerned at the end of 1999 and is likely to gather force in the first six months of 2000.

Nevertheless, projections made at the beginning of this year point to an inflation range of 8% to 10% for 2000, as indicated in the Bank's Inflation Report published in January. Various forecasting models developed by the Bank are used for making inflation projections covering time horizons of a month to two years. The Bank's basic models are all of a statistical nature and may be divided in two types: time-series



models, and structural models (see Box). The reason for using various models with different methodologies is that it makes it possible to evaluate a wider range of factors considered capable, by economic theory, of producing a strong impact on prices and affecting future inflation trends. Thus, each model focuses on the different transmission channels of monetary policy, projecting inflation from different but complementary theoretical perspectives.

Lastly, low inflation and the expectations of stability it generates among agents have the very important effect of stimulating development and deepening the capital market, by making it possible to predict future interest-rate levels with some degree of certainty. In

his posthumous book, *Power and Prosperity*, Mancur Olson points out that all countries of the world manage to develop acceptable markets for goods paid for in cash or with short-term credit. But only rich countries having the necessary institutions and, above all, the ability to keep inflation at bay have managed to deepen markets for long-term productive or financial assets, such as shares, mortgages, bonds and hedge derivatives; this is what makes the great difference between prosperous and poor countries<sup>34</sup>.

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<sup>34</sup> “To realize all the gains from trade, then, there has to be a legal system and political order that enforces contracts, protects property rights, carries out mortgage agreements, provides for limited liability corporations, and facilitates a lasting and widely used capital market that makes the investments and loans more liquid than they would otherwise be. These arrangements must also be expected to last for some time”. Mancur Olson, *Power and Prosperity*, Basic Books, New York, 2000, p. 185.

## INFLATION FORECASTING MODELS

As monetary tools take time to affect price behavior, it is of the utmost importance for a central bank to have inflation projections covering different time horizons. Only if the monetary authority can foresee future inflation changes in good time, will it be able to take the necessary corrective measures to make sure that inflation targets are met.

Aware of the above, the Banco de la República has developed several forecasting models for making inflation projections with time horizons ranging from a month to two years. The Bank's basic models are all statistical models, falling in two types: time-series models, and structural models. The reason for using several models with different methodologies is that it makes it possible to evaluate a wider range of factors considered capable, by economic theory, of producing a strong impact on prices and affecting future inflation trends. Accordingly, each model focuses on the various transmission channels of monetary policy, projecting inflation from different but complementary theoretical perspectives.

All the *time-series models* use monthly series and produce monthly forecasts of inflation. The Bank employs two basic time-series models: the ARIMA Model and the Nonlinear Model.

- *The ARIMA (Autoregressive Integrated Moving Average) Model* is a conventional autoregressive model that projects inflation from the historic behavior of the price series. In addition to lagged inflation, the model uses dummy variables to catch point shocks on prices that are not easily explained by the history of the series. The features of this model tend to make it attach greater importance to the inertial components of inflation, limiting its capacity for foreseeing structural breaks in inflation. As a result its forecasting capacity is greater for short time horizons (six months or less) than for long ones. The specification currently used by the Bank gives considerable weight to price lags of a few months, so that changes in one month's inflation results tend to affect projections quickly.
- *The Nonlinear or Smooth Transition Regression Model (STR)* can be regarded as the nonlinear generalization of an ARIMA-type model. In this sense, STR is an autoregressive model but is capable of incorporating explanatory variables other than lagged inflation. The STR model estimated by the Bank uses, besides lagged inflation, the M1 monetary aggregate, providing an idea of how changes in monetary aggregates are transmitted to inflation. In all nonlinear models, explanatory variables are grouped in two components: a linear and a nonlinear component. In the model estimated by the Bank, lagged inflation and M1 are present in both components. The weight of the linear factor in the inflation forecast is variable and depends on lagged inflation. This feature of the STR model allows it to determine structural changes in the inflation series, and thus gives it an ample forecasting capacity for long time horizons. The STR model has been particularly accurate in predicting part of the large drop in Colombian inflation last year.



*Structural models* are multiple linear regression models that project inflation by exploiting the different relations existing between nominal, real and price variables, as predicted by economic theory. All structural models work with quarterly series and are used to make quarterly forecasts in horizons ranging from one quarter to two years. The main models and their characteristics are as follows:

- *Phillips Curve*. This model uses as independent variables, in addition to lagged inflation, a product-gap estimation,<sup>1</sup> a price index for imported goods, and a switching variable that picks up the likelihood of actual inflation being high and highly variable. This model tries to capture situations in which excessive demand growth causes inflationary pressures to appear. This happens when actual production exceeds potential production. The model also allows inflation to respond to supply shocks transmitted through the prices of imported goods. Lastly, the model takes into account possible changes in inflation expectations, through the switching variable. It has usually had a good forecasting capacity for long horizons.
- *The «Scandinavian» model* determines inflation by the growth in wages and by the difference between nominal devaluation and inflation in the previous quarter. It takes into account supply conditions in the economy by incorporating two very important aspects of pricing, namely, labor costs and real devaluation.
- *The relative food price model* attempts to capture the inflation effects of the most common supply shock in Colombia: food-price shocks. The frequency and magnitude of these shocks is due to the great weight of food (29%) in Colombia's CPI basket and its highly volatile prices. Besides using relative food prices as an independent variable, the model also checks for demand shocks by using an estimation of monetary supply and the product gap.
- *The monetary model (or Model P\*)* is a reduced form of a more complicated multi-equational model. It possesses several elements of a modern version of the quantitative theory of money, which assumes a slow adjustment of prices to unexpected changes in the money supply. The main idea is that when a monetary shock occurs prices do not respond immediately but react with a lag. This means that the rate of inflation remains unchanged for a time after the shock, before reacting. When it does react, the inflation rate outstrips the pace of money growth until the long-term equilibrium relation between the money supply and prices is restored. Thus, the model incorporates deviation by the money supply from its long-term path, as an explanatory variables. In addition to this variable, the model also controls for the product gap, interest rate and lagged inflation.

<sup>1</sup> The product gap is the difference between the actual and potential growth rates of GDP, the potential rate being the pace at which production can grow in the long run without generating inflationary pressure.

## ECONOMIC ACTIVITY AND EMPLOYMENT

### A. THE SITUATION IN 1999

#### 1. Economic activity

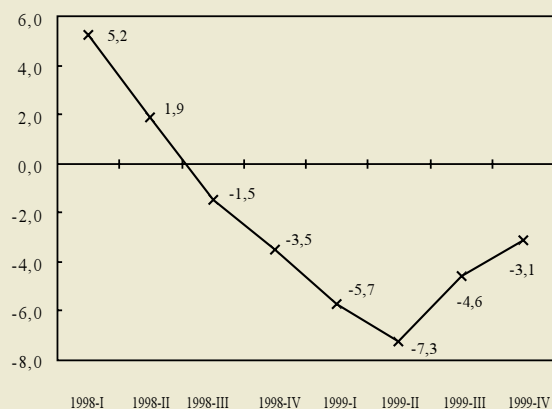
Preliminary estimates indicate that the value of GDP at constant prices fell by 5.2% in 1999. The economy showed contractions of -5.7% in the first quarter of 1999, -7.3% in the second, -4.6% in the third, and an estimated -3.1% in the final quarter (Figure 25).

In 1999 construction continued to be the most affected sector (-20.8%), followed by manufacturing (-16.2%)<sup>35</sup>, commerce (-7.9%), and the financial sector (including housing rents, -6.2%). Every sector of the economy contracted, except for mining and quarrying, which expanded by 5.4%, and communal, social and personal services, which grew by 2.6% (Table 17). Buoyancy in mining and quarrying came mostly from oil and coal production largely intended for export, and in communal services from the expansion in public administration services. The farming sector's shrinkage (-2.2%) was mainly caused by a sharp fall (-19.2%) in coffee production.

Domestic demand weakened considerably (-10.3%) as a result of falls in total consumption (-4.6%) and total investment (-35.5%). The decrease in total investment resulted in turn from steep declines in gross fixed-capital formation (-35.3%) and in inventory change (-39.3%). Increased consumption

<sup>35</sup> As this Report was going to press, a correction by DANE gave a lower decline in manufacturing than the figure reported here. Specifically, the monthly manufacturing survey has re-estimated the contraction at -13.5% for 1999 as a whole in December. The lower decline in industrial activity will be reflected in a smaller economic contraction for 1999.

FIGURE 25  
GROSS DOMESTIC PRODUCT  
(ANNUAL PERCENTAGE CHANGE IN QUARTERLY GROWTH)



Sources: Finance Ministry, and National Planning Department.

in the public sector (3.3%) did not offset the decrease in household consumption (-7.0%). Private investment fell by about 56.4%, public investment by 7.2%. Gross capital formation in the private sector plunged by 57.5%, but declined by only 6.6% in the public sector (Figure 18).

Demand behavior in consumption and investment was a main cause of the downturn in construction, manufacturing, commerce, transport and financial services because sales in these sectors are mainly directed to the domestic market.

The Board's July 1999 Report to Congress discussed in detail the main causes of the recession that began in 1998 and continued through 1999. Broadly speaking, the recession was initially produced by a strong contraction in aggregate demand and by the world financial crisis.

**TABLE 17**  
**GROSS DOMESTIC PRODUCT, BY SECTOR**  
(QUARTERLY GROWTH RELATIVE TO SAME QUARTER A YEAR EARLIER)

Economic Sector	1999				
	I	II	III	IV	Total
Agriculture and livestock, forestry, hunting & fishing	1,0	(5,4)	(3,1)	(1,3)	(2,2)
Mining and quarrying	12,2	8,4	3,9	(1,8)	5,4
Electricity, gas & water	(5,5)	(5,1)	(2,8)	(1,6)	(3,8)
Manufacturing	(18,3)	(17,3)	(12,4)	(16,4)	(16,2)
Construction	(19,7)	(27,5)	(19,5)	(15,6)	(20,8)
Commerce, repairs, restaurants & hotels	(9,0)	(10,7)	(7,8)	(3,8)	(7,9)
Transport, storage & communication	(3,8)	(3,7)	(1,6)	1,2	(2,0)
Financial, insurance, real-estate & bus. serv. entities	(7,8)	(7,9)	(7,6)	(1,3)	(6,2)
Social, communal and personal services	1,6	2,8	2,9	3,1	2,6
<b>Gross Domestic Product</b>	(5,7)	(7,2)	(4,6)	(3,1)	(5,2)

Source: Finance Ministry, Macroeconomic Policy Directorate, on quarterly GDP data from DANE.

**TABLE 18**  
**GROSS DOMESTIC PRODUCT, BY TYPE OF EXPENDITURE**  
(1994 = 100)  
(PERCENTAGE CHANGE)

	1998 (e)	1999 (e)
Total consumption	0,8	(4,6)
Household consumption	1,2	(7,0)
Public services consumption	(0,7)	3,3
Gross fixed capital formation	(9,9)	(35,3)
Private	(1,7)	(57,5)
Public	(18,7)	(6,6)
Change in stocks	(10,4)	(39,3)
<b>Domestic demand</b>	(1,4)	(10,3)
Exports	7,5	4,5
Imports	(3,4)	(22,4)
<b>Gross Domestic Product</b>	0,5	(5,2)

(e) Estimates

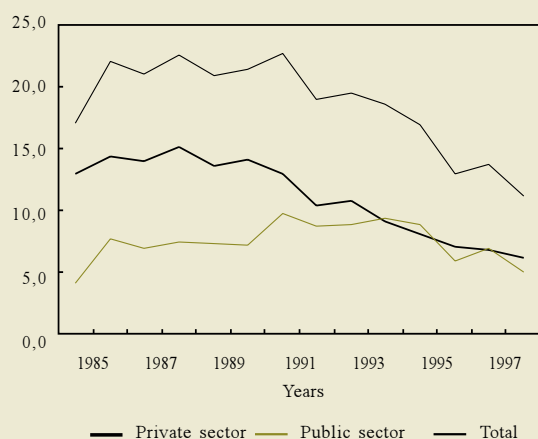
Sources: Finance Ministry, Macroeconomic Policy Directorate.

From the early nineties overspending was rife in both the public and private sectors in Colombia. This disequilibrium was evidenced by a downward trend in domestic saving over those years, which in turn helped to weaken private investment (Figure 26). Overspending, financed from foreign and domestic credit, led to extraordinary growth in real-estate prices and thus to over-expansion in the construction sector.<sup>36</sup> This expansion was not sustainable; it caused the quality of the financial system's portfolio to deteriorate, and the system reacted by sharply cutting lending, with the result that the recession deepened.<sup>37</sup> Besides over-borrowing by the private sector, there was uncertainty in the mortgage market about the

<sup>36</sup> Real estate has traditionally been the main asset for the private sector.

<sup>37</sup> Modern macroeconomic theory includes rigorous analyses of economic cycles exacerbated by borrowing processes and speculative bubbles in asset markets. "The Financial Accelerator in a Quantitative Business Cycle Framework", Chapter 21 of *Handbook of Macroeconomics*, Elsevier Science, 1999.

**FIGURE 26**  
DOMESTIC SAVING, 1985-1998 (e)  
(AS PERCENTAGE OF GDP)



(e) Estimated.  
Source: National Planning Department.

legal standing of home-financing schemes based on UPACs (constant purchasing power units), which prevented any attempt at recovery in the construction sector that might have been fostered by the significant decline in interest rates. This uncertainty continues to impede the sector's recovery.

The world crisis also contributed to deepening and prolonging the recession in 1999 by its negative effects on neighboring countries, the terms of trade, and the conditions and availability of foreign credit. In particular, the prices of Colombia's chief exports fell, except for the price of oil, which started to rise in March and by December was higher than in 1998.

Foreign credit became more expensive and capital inflows declined because of the Russian debt moratorium. Depression in neighboring economies greatly damaged our export markets. In Ecuador the economy contracted by 7.3%, and in Venezuela by 6.2%. Larger economies of the region also slowed in growth, for example, Argentina by 3.3%, and Chile by 0.5% (Table 19). Moreover, the international crisis steepened the fall in foreign investment by more than 70%, though this decline was undoubtedly also caused by the lack of security in the country.

## 2. Employment and wages

According to DANE, in December 1999 the unemployment rate (the ratio of the unemployed to the economically active population) for the seven major metropolitan areas was 18.1% (Table 20), the highest ever recorded in Colombia. Figures for September show an unemployment rate of 23.3% for women, 17.2% for men, and 45.6% for young people (15-19 years old, male and female).

By city, Medellín, Cali and Manizales reported the highest unemployment rates, over 20%. In Bucaramanga, Bogotá and Pasto the rate was between 17% and 18%. Only in Barranquilla was unemployment below 15%, apparently because of public-works projects, and because a significant number of the jobless have moved to the informal sector.

In December 1999, the overall participation rate (economically active population / total population), the usual indicator of labor supply, was 63.8% in the seven metropolitan areas. As this figure is higher than the 62.7% registered in 1998, the rise in unemployment from 1998 to 1999 may validly be considered due in part to increased labor supply (Table 22). Besides, the employment rate decreased up to the second half of 1999 and by December, at

**TABLE 19**  
ECONOMIC GROWTH IN SOME  
LATIN AMERICAN COUNTRIES

Country	1998	1999 (e)
Argentina	4,2	(3,3)
Brazil	0,2	0,5
Chile	3,3	(0,5)
<b>Colombia</b>	<b>0,4</b>	<b>(5,2)</b>
Ecuador	0,2	(7,3)
Peru	1,5	2,6
Venezuela	(0,4)	(6,2)

(e) Estimates  
Sources: ABN-AMRO and WEFA Group.

**TABLE 20**  
**TOTAL UNEMPLOYMENT RATE,**  
**SEVEN LARGEST CITIES**  
 (AVERAGE QUARTERLY PERCENTAGE)

Quarter		Unemployment rate
1997	I	12,3
	II	13,3
	III	12,1
	IV	12,0
1998	I	14,4
	II	15,9
	III	15,0
	IV	15,6
1999	I	19,5
	II	19,9
	III	20,1
	IV	18,1

Source: DANE, National Household Surveys.

52.2%, it was still lower than the rate (52.9%) registered in the same period of 1998 (Table 23).

Some signs of recovery began to appear on the labor front in the final quarter of 1999. The unemployment rate, having risen from 19.5% in March to 19.9% in June and up to 20.1% in September, dropped to 18.1% in December. And, as shown in the December 1999 Inflation Report on the basis of seasonally adjusted figures, unemployment in the seven biggest cities fell from 20.3% to 19.2% between September and December.

Lower inflation in 1999 made it possible for negotiated pay rises to be fixed at lower rates than in previous years. For example, in the manufacturing sector, where pay rises tend to be above average, the average nominal pay increase in the past 12 months was 16.0%, lower for wage earners (14.6%) than for employees (17.6%) (Figure 27). This did not, however, translate into deterioration of real wages, despite an over-supply of labor. On the contrary, the reduction in inflation, no doubt

**TABLE 21**  
**UNEMPLOYMENT RATE, BY CITY**  
 (AVERAGE QUARTERLY PERCENTAGE)

Quarter	Barranquilla	Bucaramanga	Bogotá	Manizales	Medellín	Cali	Pasto	
1997	I	12,8	12,7	8,5	13,8	16,3	17,2	14,9
	II	11,4	11,5	11,4	12,0	15,3	18,4	15,1
	III	12,1	9,6	9,9	12,1	13,8	17,0	15,8
	IV	10,6	11,4	10,6	11,9	12,4	16,6	14,2
1998	I	13,0	14,5	12,7	14,5	16,3	17,9	14,5
	II	13,0	15,9	14,8	16,6	16,7	19,7	17,0
	III	11,6	14,0	13,3	17,4	15,8	20,6	16,6
	IV	10,4	15,0	15,3	16,5	15,8	19,6	16,1
1999	I	16,7	19,6	18,0	21,1	23,1	21,2	18,6
	II	16,3	21,1	19,1	21,3	21,7	21,5	19,2
	III	16,5	18,7	19,3	20,8	22,4	21,9	21,0
	IV	14,5	17,4	17,1	21,1	20,1	20,7	18,4

Source: DANE, National Household Surveys.

**TABLE 22**  
OVERALL PARTICIPATION RATE, SEVEN CITIES  
(PERCENTAGE)

Quarter		Overall participation rate
1997	I	58,3
	II	59,9
	III	59,9
	IV	61,5
1998	I	62,3
	II	62,7
	III	61,0
	IV	62,7
1999	I	62,3
	II	62,9
	III	63,3
	IV	63,8

Source: DANE, National Household Surveys.

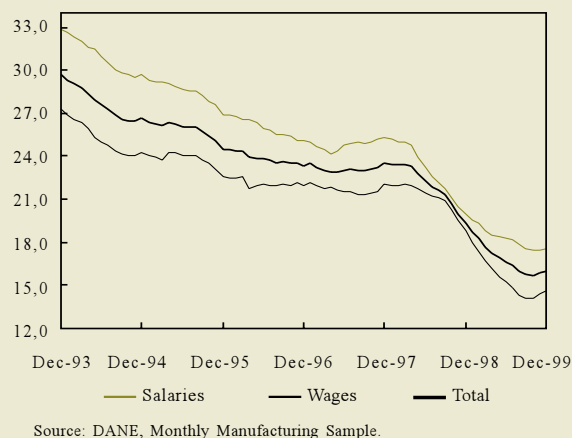
**TABLE 23**  
EMPLOYMENT RATE, SEVEN CITIES  
(PERCENTAGE)

Quarter		Employment rate
1997	I	51,2
	II	51,9
	III	52,9
	IV	54,1
1998	I	53,3
	II	52,8
	III	51,8
	IV	52,9
1999	I	50,1
	II	50,4
	III	50,6
	IV	52,2

Source: DANE, National Household Surveys.

unexpected by a considerable number of employers and workers, brought additional real pay increases. This probably accounts for the 4.5% annual growth over the past 12 months in average real industrial pay (Figure 28). The increase in labor costs resulting from this situation reduces competitiveness in tradable sectors, which may make it difficult to bring unemployment down.

**FIGURE 27**  
NOMINAL AVERAGE INDUSTRIAL PAY  
IN PAST 12 MONTHS  
DECEMBER 1993 - DECEMBER 1999  
(ANNUAL PERCENTAGE CHANGES)



Source: DANE, Monthly Manufacturing Sample.

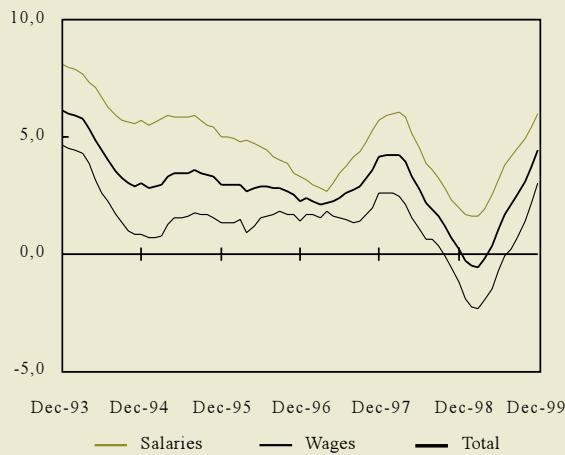
## B. OUTLOOK FOR 2000

As stated earlier, one of the main economic-policy objectives of the macroeconomic adjustment plan endorsed by the IMF is to set Colombia on a path of constant growth that stimulates employment and reduces poverty, while keeping inflation low. Its policies are designed to accomplish fiscal consolidation, implement structural reforms, reactivate priority sectors, keep the exchange rate flexible, and restructure the financial system. It is expected that as a result of these policies domestic investment and saving will reach the levels required for a sustainable upturn in the economy, which is projected to grow by 3% in 2000.

Progress has already been made in this respect. On the macroeconomic front, inflation has fallen to one-digit levels, the current-account deficit in the balance of payments has been reduced to some US\$1,250m<sup>38</sup>, and interest rates have decreased significantly. In particular, total exports are expected to grow by about 15.7% in 2000 and nontradables by 7.7%, helping to drive up real income over the year.

<sup>38</sup> Equivalent to 1.5% of GDP in 1999.

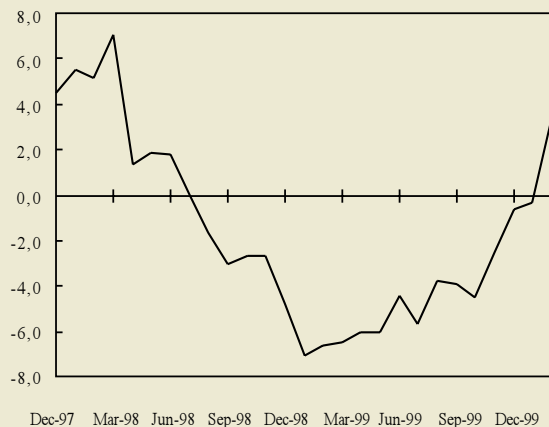
**FIGURE 28**  
**REAL AVERAGE INDUSTRIAL PAY IN PAST 12 MONTHS**  
**DECEMBER 1993 - DECEMBER 1999**  
 (ANNUAL PERCENTAGE CHANGE)



Source: DANE, Monthly Manufacturing Sample.

Recent statistics point to a turnaround in the real sector. For example, data on electricity demand—a variable with a strong bearing on economic activity that was on a downward trend—indicate that it may be rebounding. Energy consumption grew by 3.4% in February relative to the same month in 1999, its first positive annual growth since June 1998 (Figure 29). Signs of continued recovery are also being shown by credit-card sales: in January, monthly nominal sales expanded by 8% relative to January

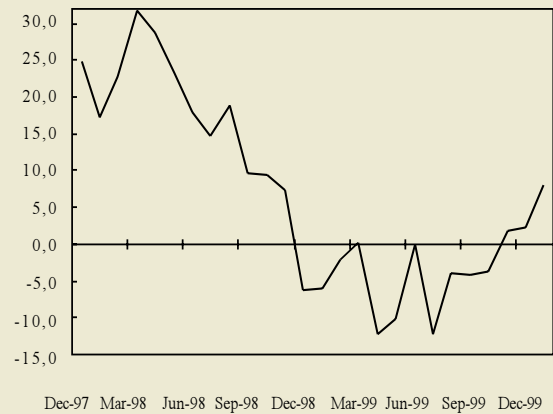
**FIGURE 29**  
**MONTHLY ENERGY CONSUMPTION**  
**DECEMBER 1997 - FEBRUARY 2000**  
 (ANNUAL PERCENTAGE CHANGE)



Sources: ISA and DANE.

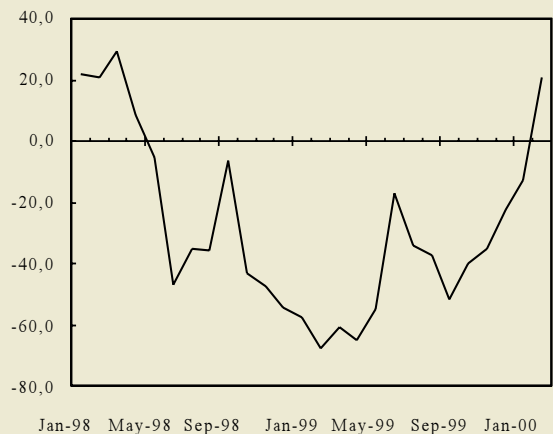
1999, their fastest growth since October 1998 and third consecutive monthly expansion (Figure 30). Car sales, too, recovered strongly in February: sales of domestic and imported cars were up by 20.7% on a year earlier, making February 2000 their first month of positive annual growth since April 1998 (Figure 31). Lastly, retail sales have been improving as well. The Real Retail Sales Index grew by 4.2% in December 1999, having reached its first positive growth in November after a series of falls starting in April 1998 (Figure 32).

**FIGURE 30**  
**CREDIT-CARD SALES**  
**DECEMBER 1997 - JANUARY 2000**  
 (ANNUAL PERCENTAGE CHANGE)



Source: VISA, Colombia.

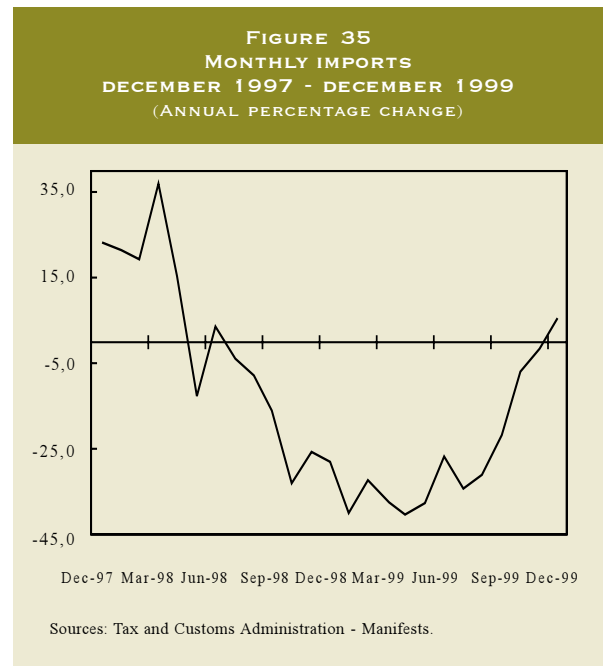
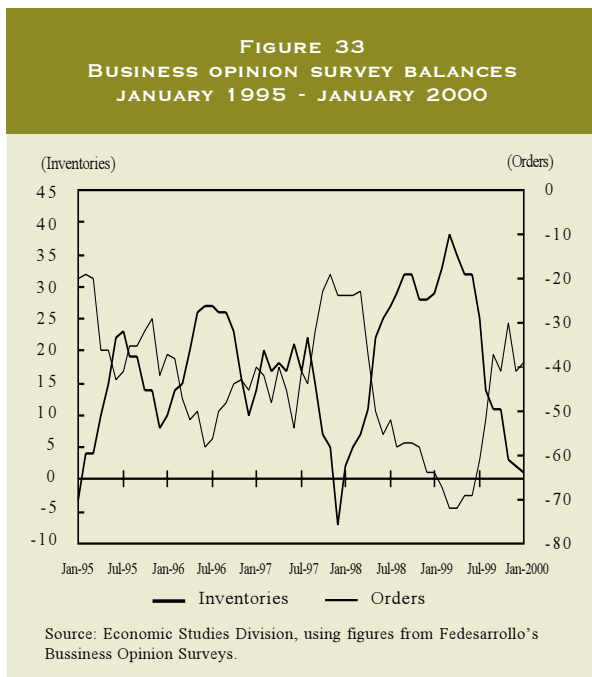
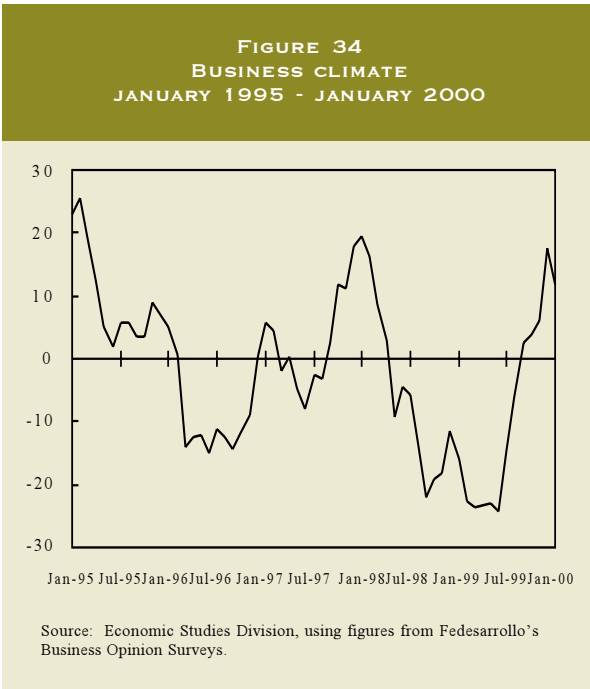
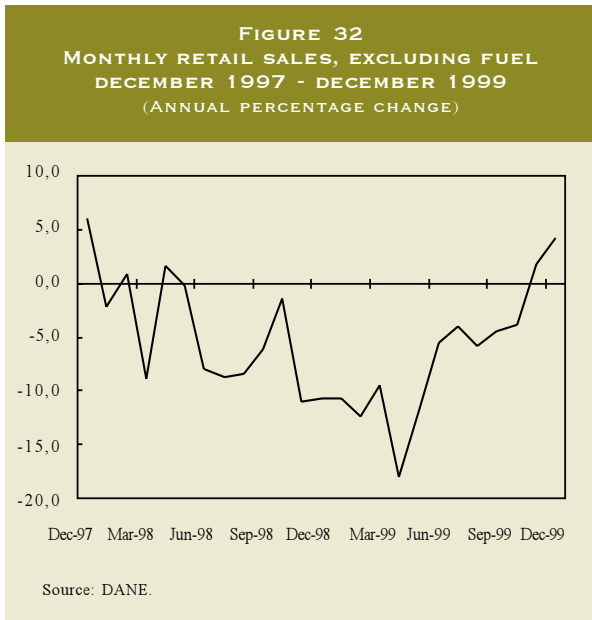
**FIGURE 31**  
**TOTAL CARD SALES**  
**JANUARY 1998 - FEBRUARY 2000**  
 (ANNUAL PERCENTAGE CHANGE)



Sources: National Planning Department and Colmotores.

Fedesarrollo's Business Opinion Survey of January shows that developments favorable to industrial reactivation continued to be at work during the first month of this year. Businessmen reported a continued decline in inventories, and a slight pick-up in orders relative to December (Figure 33). Their expectations about the economy in the short and long run, as measured by their opinion of the business climate, are much higher than in mid-1999 (Figure 34).

Lastly, imports too appear to be recovering: in December they grew (by 5.5%) for the first time since the middle of 1998 (Figure 35). An important aspect of this growth is that it was largely produced by imports of intermediate and capital goods for industry.





## VI

# INTERNATIONAL RESERVES AND FINANCIAL SITUATION OF THE BANCO DE LA REPÚBLICA

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### A. INTERNAL RESERVES

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#### 1. Reserve balance

In December 1999 net international reserves<sup>39</sup> amounted to US\$8,102m, down by US\$638m on a year earlier. The reserves consist mostly of financial investments worth \$7,122m, in foreign deposits and securities. The other components are the reserve position in the IMF and the Latin American Reserve Fund, US\$641.8m; Special Drawing Rights (SDRs), US\$131.2m; and gold, cash items, Andean pesos, and the positive balances of international agreements, US\$208.4m. Short-term liabilities totalled US\$1.4m. (Figure 24).

#### 2. Administration criteria

Colombia's international reserves are administered by the Banco de la República, on the criteria of security, liquidity and profitability. In accordance with these criteria and to ensure discharge of the country's foreign payment obligations, the reserves are invested in foreign assets having an ample secondary market, and a part is kept as working capital to guarantee immediate availability. The successful delegation of part of the reserves' investment portfolio to high-level international financial institutions has led the Bank to entrust the administration of an additional part of the investment portfolio to Goldman Sachs Asset Management.

Thus, of the total financial investments (including the working capital), the Bank itself manages a portfolio of US\$4,395.9m (61.7% of the total), while

the remaining 38.3%, amounting to US\$2,726.1m, is managed by the specialized firms Barclays Global Investors, Morgan Investment Management, and Goldman Sachs Asset Management.

The portfolio's currency distribution, which needs to be consistent with the country's foreign operations, was as follows on December 30, 1999: 82.9% in US dollars, 12.7% in euros, 4.0% in Japanese yen, and 0.4% in other currencies<sup>40</sup>. Although this policy sometimes produces vast capital inflows or outflows due to exchange-rate variations in the different currencies against the dollar, it makes for a balance between international reserves and the composition of external payments.

#### 3. Portfolio security, liquidity and profitability

The investment portfolio, under both direct and delegated management, is placed in sovereign government paper (78%) and in banking and business institutions (22%). The breakdown of the investments' credit risk, according to gradings by credit-rating agencies<sup>41</sup>, is as follows: 79% AAA, 6% AA+, 10% AA, 4% AA-, and the remaining 1% in A+.

To ensure the immediate availability of foreign currencies, the working capital on December 30, 1999 came to US\$913.4m, in highly liquid financial assets. The amount of working capital at any given time is determined on the basis of the average monthly payment for imports of merchandise according to the consolidated exchange balance<sup>42</sup>.

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<sup>39</sup> Net reserves are equal to total or gross reserves, less Banco de la República's short-term external liabilities, consisting of sight liabilities in foreign currencies.

<sup>40</sup> Such as Swedish kronor and sterling.

<sup>41</sup> Standard & Poor's, Moody's and IBCA.

<sup>42</sup> It includes transactions registered in the exchange market and in clearing accounts abroad.

In 1999 the Banco de la República's gains from the return on reserve investments came to US\$100m, resulting from revenues of US\$316m and outlays of US\$216m. These gains were less than the previous year's by US\$525m, essentially because of the dollar's revaluation against the currencies in which the reserves are invested, falling bond-market prices due to interest-rate movements, and a US\$637.8m reduction in international reserves in 1999<sup>43</sup>.

#### 4. SDR movements and reserve position in the IMF

In 1999 the Bank carried out certain operations with the IMF that altered the composition of the country's international reserves and affected the «Contributions in international agencies» item<sup>44</sup>. On the one hand, Colombia increased its quota in the IMF by 212.7 million SDRs, equivalent to US\$305.3m<sup>45</sup>. As required by normal procedure, 75% of the contribution was made in Colombian pesos and 25% in SDRs. The peso amount was entered as an asset of the Bank under «Contributions in international agencies». The SDR portion was paid for with the Bank's SDR holdings, so that the country's overall IMF position constituting international reserves remained unchanged<sup>46</sup>.

On the other hand, at the Fund's request, Colombia made net sales worth US\$248m from its SDR holdings to Mexico, Korea, Argentina, Cyprus and Moldavia. These sales reduced the country's reserve position in SDRs in the Fund (Table 24). But Colombia compensated in full for this reduction with a larger domestic-currency share of its IMF quota, thereby increasing the «Contributions in international agencies» item.

<sup>43</sup> This amount includes changes in the reserve balance stemming from the dollar's movements against other currencies and variations in international interest rates.

<sup>44</sup> Contributions made to the IMF in pesos are counted as Assets of the Bank, under the item «Contributions in international agencies», but do not constitute international reserves.

<sup>45</sup> An IMF member state's quota determines its share of the Fund's resources, its voting power, its access to financial services, and its right to take part in the allocation of Special Drawing Rights.

<sup>46</sup> Total reserves held in the Fund are divided in SDR holdings and reserve position in the Fund. As a result of the operation in question, the country's SDR holdings were decreased but its IMF reserve position was increased by an equal amount, keeping its overall position in the IMF unaltered.

The end result of the above operations was to increase the country's overall position in the Fund by US\$229m<sup>47</sup>, as follows: a) a US\$477m increase<sup>48</sup> in the peso position, and b) and a reduction equivalent to US\$248m<sup>49</sup> in the SDR position.

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## B. FINANCIAL SITUATION

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### 1. 1999 results

The Bank's assets amounted to 24,529.5 billion pesos, up by 6,412.0 billion pesos (35.4%) on a year earlier (Table 25). This increase was accounted for by: a) an increase of 1,963.7 billion pesos in international reserves, due to the peso's devaluation against the dollar; b) 1,752.2 billion pesos in increased liquidity provided to the financial system through REPO operations and bridging liquidity support; c) an increase of 1,452.7 billion pesos in investments, through purchase of TES (Treasury paper) to meet part of the demand for liquidity; and d) an increase of 1,092.4 billion pesos in contributions held in international agencies, consisting of an adjustment for the rise in the peso-dollar exchange rate (200 billion pesos), the compensation for SDR sales (464 billion pesos) and the increase in the country's local-currency IMF quota (429 billion pesos), as explained above.

Liabilities rose by 4,023.6 billion pesos to 12,770.4 billion, and capital by 2,388.4 billion pesos to 11,759.0 billion pesos. The rise in liabilities was accounted for by: a) an increase of 2,816.4 billion pesos in the monetary base, largely associated with a higher year-end demand for liquidity owing to the millennium bug; b) the increase in the peso value of obligations to international agencies, due to the peso's devaluation and to the passive compensation for the SDR sales

<sup>47</sup> Equivalent to the 75% local-currency portion of the new contribution worth US\$305.3m.

<sup>48</sup> This amount is the sum of the new contribution's 75% pesos portion (US\$229m) and the compensation for the SDR sales (US\$248m).

<sup>49</sup> The amount of the SDR sales.

**TABLE 24**  
INTERNATIONAL RESERVES, BY MAJOR COMPONENTS 1/  
(MILLIONS OF DOLLARS)

Components	December 1998 1/	Share %	June 1999 (p)	Share %	December 1999 (p)	Share %
<b>Cash</b>	80.5	0.9	35.6	0.4	91.2	1.1
Vault cash	79.9	0.9	34.9	0.4	90.2	1.1
Sight deposits	0.6	0.0	0.7	0.0	1.0	0.0
<b>Investments</b>	7,524.1	86.1	7,400.9	88.2	7,122.0	87.9
Directly managed	5,300.5	60.6	5,208.0	62.1	4,395.9	54.3
Delegated management	2,223.6	25.4	2,192.9	26.1	2,726.1	33.6
<b>Gold</b>	103.0	1.2	93.4	1.1	95.4	1.2
In vault	1.2	0.0	0.9	0.0	0.0	0.0
Custody	101.8	1.2	92.5	1.1	95.4	1.2
<b>International Monetary Fund</b>	771.3	8.8	604.4	7.2	523.0	6.5
Special Drawing Rights	196.4	2.2	123.5	1.5	131.2	1.6
Reserve position	574.9	6.6	480.9	5.7	391.8	4.8
<b>Latin American Reserve Fund</b>	255.0	2.9	255.0	3.0	270.0	3.3
Contributions	235.0	2.7	235.0	2.8	250.0	3.1
Andean pesos	20.0	0.2	20.0	0.2	20.0	0.2
<b>International agreements</b>	6.5	0.1	3.6	0.0	1.8	0.0
<b>Total gross reserves</b>	8,740.5	100.0	8,392.9	100.0	8,103.4	100.0
<b>Short-term liabilities</b>	0.7	0.0	1.0	0.0	1.4	0.0
International agencies	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding balance int'l. agreements	0.0	0.0	0.0	0.0	0.0	0.0
Outstanding payment orders	0.7	0.0	1.0	0.0	1.4	0.0
Short-term deposits of the Treasury	0.0	0.0	0.0	0.0	0.0	0.0
Short-term deposits of other entities	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total net reserves</b>	8,739.8	100.0	8,391.9	100.0	8,102.0	100.0

(p) Provisional estimates.

1/ Restated figures. The methodology for computing international reserves was modified as of January 1999 to bring it into line with the IMF's Balance of Payments Manual. The definition of short-term liabilities was restricted to under-one-year obligations to non-residents, so that the Banco de la República's obligations to the Treasury and other entities are no longer considered short-term liabilities. Likewise the liabilities to international agencies such as the Inter-American Development Bank and the Caribbean Development Bank were excluded, because they are considered to be long-term obligations. Investment accounts payable have been reclassified under assets but with the opposite sign. And the outstanding balance of restructured agreements with Cuba and Honduras, US\$55.7m, was deducted from the Net Valuation and Provision item.

Source: Banco de la República.

and increase in the IMF local-currency quota. The rise in capital came from the peso-dollar exchange adjustment in international reserves, and from the reserves created in 1999 to cover currency fluctuations and exchange movements.

The Bank's accrued profits in 1999 came to 507.8 billion pesos (Table 26), down by 988.7 billion pesos

on the year before, mostly because of a fall of 892.7 billion pesos in yields on international reserves. As mentioned earlier, this steep fall in yields resulted from the reserve portfolio's loss of value, caused by devaluation of European currencies against the dollar, by lower market prices of bonds in the portfolio, and by the decrease in reserve levels.

TABLE 25  
BANCO DE LA REPÚBLICA BALANCE SHEET, 1998-1999  
(BILLIONS OF PESOS)

	December 1998		December 1999	
	Balance	Share %	Balance	Share %
<b>Assets</b>	18.117,6	100,0	24.529,5	100,0
Gross international reserves	13.206,8	72,9	15.170,5	61,8
Contributions to internat'l agencies	967,2	5,3	2.059,6	8,4
Investments	942,8	5,2	2.395,5	9,8
Consolidated public-sector debt	453,8	2,5	390,0	1,6
Public-sector securities for liquidity regulation	489,0	2,7	2.005,5	8,2
Private sector	0,0	0,0	0,0	0,0
Loan portfolio	455,2	2,5	379,8	1,5
National Government	4,7	0,0	4,0	0,0
Commercial banks	31,4	0,2	24,8	0,1
Finance corporations	76,4	0,4	66,0	0,3
Savings and loans corporations	308,8	1,7	284,9	1,2
Rest of financial system	33,9	0,2	0,1	0,0
Repurchase agreements & access to the Discount window	1.140,1	6,3	2.892,3	11,8
Accounts receivable	34,5	0,2	55,8	0,2
Other net assets	1.370,9	7,6	1.576,0	6,4
<b>Liabilities and net worth</b>	18.117,6	100,0	24.529,5	100,0
<b>Liabilities</b>	8.746,8	48,3	12.770,4	52,1
Foreign-currency liabilities affecting int'l. reserves	1,1	0,0	4,3	0,0
Monetary base	6.923,1	38,2	9.739,6	39,7
Notes in circulation	5.623,0	31,0	7.457,6	30,4
Coins	317,1	1,8	319,4	1,3
Banks' reserve requirement deposits	880,5	4,9	1.648,7	6,7
Current acct. deposits rest of financial sector	102,5	0,6	313,9	1,3
Other deposits	133,7	0,7	142,7	0,6
Treasury	70,7	0,4	83,4	0,3
International agency obligations	759,9	4,2	1.779,9	7,3
External credit liabilities	198,7	1,1	218,0	0,9
Securities for regulating domestic and foreign exchange liquidity	149,5	0,8	147,4	0,6
Reverse REPOs & central-bank securities	25,8	0,1	46,1	0,2
Exchange certificates	0,5	0,0	0,7	0,0
Foreign-currency funding certs. & Board Res. 5/97 Dep.	120,0	0,7	100,6	0,4
Other	3,2	0,0	0,0	0,0
Accounts payable	31,7	0,2	38,7	0,2
Other liabilities	478,3	2,6	616,4	2,5
<b>Total net worth</b>	9.370,7	51,7	11.759,1	47,9
Capital	12,7	0,1	12,7	0,1
Reserves	114,4	0,6	360,1	1,5
Capital surplus	7.492,3	41,4	10.557,7	43,0
Liquidation of Special Exchange Account	453,5	2,5	453,5	1,8
Exchange adjustment since 1993 and surplus	7.029,3	38,8	10.088,2	41,1
Other	9,6	0,1	16,0	0,1
Valuations	254,8	1,4	320,9	1,3
Results	1.496,5	8,3	507,8	2,1
Profit or loss from the previous year	0,0	0,0	0,0	0,0
Profit or loss for fiscal year	1.496,5	8,3	507,8	2,1

Source: Banco de la República.

**TABLE 26**  
**BANCO DE LA REPÚBLICA INCOME STATEMENT, 1998-1999**  
 (BILLIONS OF PESOS)

	1998	1999	
	Observed	Projected	Observed
<b>I. Total income</b>	2.105,7	1.101,0	1.219,6
1. Operating income	2.097,2	1.094,5	1.200,8
Interest and yields	1.428,3	756,5	878,0
Net international reserves	1.079,8	155,7	187,1
External credit lines	23,7	18,3	14,1
TES "A" & "B" valued at market prices	52,9	131,7	166,8
Valuation of TES purchased for liquidity regulation	45,8	95,6	189,3
Transitory purchase of securities & access to discount window	190,7	236,1	201,5
Other	35,5	119,1	119,2
Commissions	47,8	55,1	58,3
Banking services	40,2	44,7	50,2
Foreign currency purchase & sale	7,3	10,2	7,5
Other	0,2	0,2	0,5
Exchange differences	110,4	207,9	164,5
Coin issuance & precious metals	177,1	1,8	7,4
Redemption of securities in advance	227,1	67,4	73,2
Other	106,5	5,8	19,4
2. Non-operating income	8,5	6,5	18,8
<b>II. Total outlays</b>	609,3	826,6	711,9
1. Operating outlays	608,8	825,8	706,8
Interest and yields	56,2	251,1	243,7
On Central-Bank securities	19,2		
On Bank Reserve	25,8	197,7	194,9
On Transitory sale of securities		36,4	32,5
On External lines credit & exchangeable securities	11,2	17,0	16,3
Commissions and fees	4,6	24,3	20,1
Exchange differences	76,1	144,8	97,3
International agencies	21,5	52,7	29,7
External lines	42,5	59,3	45,6
Other	12,1	32,8	22,0
Cost of issuing Bills & coins	48,8	24,5	28,6
Personnel costs	124,5	145,7	142,5
Pensions	120,3	130,5	56,5
Other	178,2	104,9	118,1
2. Non-operating outlays	0,5	0,7	5,1
<b>III. Fiscal year's profit or loss including depreciation 1/</b>	1.496,5	274,4	507,8

1/ Corresponds to accrued profits.

Source: Banco de la República.

## 2. Reserve accumulation and profit distribution

Pursuant to the Bank's bylaws, the Board has decided to distribute 723.5 billion pesos this year, being the sum of 507.7 billion pesos generated in profits in fiscal year 1999 and 215.8 billion pesos from the reserves accumulated to cover currency fluctuations. The 723.5 billion pesos will be distributed as follows: a) 183.3 billion pesos as an asset-protection reserve<sup>50</sup>; b) 18.3 billion to the reserve for exchange movements; c) 5.6 billion pesos as net investment in goods for cultural activity; and d) the remaining 516.3 billion pesos for the government (Table 27). As a result, the currency-fluctuation reserves will be reduced to 100.3 billion pesos, while the exchange-movement reserve will stand at 62 billion and the asset-protection reserve at 183.3 billion. Under the Housing Law (No. 546 dated December 23, 1999), the government is required to create a Mortgage Stabilization Reserve Fund and allocate 150 billion pesos to it from the Banco de la República's profits for 1999.

## 3. Income and outlay projections for 2000

Income is projected to run to 1,504.5 billion pesos in 2000 and outlays to 744.9 billion, giving 759.6 billion in profits. Income will consist mostly of interest revenue and yields, totalling 1,292.2 billion pesos, notably yields of 799.3 billion pesos on international reserves and 261.4 billion on treasury paper TES bought by the Bank in its open-market operations. It is to be noted that yield income from international

<sup>50</sup> This reserve is equal to the balance of minted coins in vault, amounting to 211.8 billion pesos, less the cost of producing it, 28.5 billion pesos.

TABLE 27  
BANCO DE LA REPÚBLICA DISTRIBUTION OF 1999  
PROFITS AND USE OF RESERVES  
(BILLIONS OF PESOS)

<b>I. Funds to be distributed</b>	723,5
a. 1999 profits	507,7
b. Reduction of reserves due to currency-fluctuation	215,8
<b>II. Allocation</b>	723,5
a. Government	516,3
b. Asset-protection reserves	183,3
c. Reserves for the Exchange Foud	18,3
d. Net investment in cultural-activity	5,6

Source: Banco de la República

reserves does not include the possible effects of any interest or exchange rate changes of the reserve portfolio's currencies. Consequently, income projection is subject to uncertainties about the behavior of these variables.

Outlays are projected at 744.9 billion pesos, up by 4.6% on the amount executed in 1999. The largest outlays will be 225.3 billion pesos in interest payments (mainly the return on reserves required on savings accounts and CDs); 161.0 billion pesos in personnel costs; and 159.0 billion for others expenses. An item included under others expenses is the cost of bringing to Colombia work donated by the painter and sculptor Fernando Botero: 60.2 billion pesos, of which 32.8 billion pesos will be for customs duties and 26.3 billion for VAT, giving a total of 59.1 billion pesos in taxes.

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