I

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.

* This estimate does not include DANE's revision-as this Report was going to pressæof 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 disequilibriumæfaster growth in spending than in outputæ, 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.