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Colombia: First Review Under the Stand-By Arrangement, Requests for Modification of Performance Criteria, and Waiver of Nonobservance of Performance Criteria and of Applicability of end-September Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Colombia

In the context of the first review under the Stand-By Arrangement, requests for modification of performance criteria, and a waiver of nonobservance of performance criteria and applicability of end-September performance criteria with Colombia, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Stand-By Arrangement, Requests for Modification of Performance Criteria, and Waiver of Nonobservance of Performance Criteria and of Applicability of end-September Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on September 25, 2005, with the officials of Colombia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 4, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Press Release summarizing the views of the Executive Board as expressed during its October 24, 2005 discussion of the staff report that completed the review.

- a statement by the Executive Director for Colombia.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Colombia*
Memorandum of Economic and Financial Policies by the authorities of Colombia*
Technical Memorandum of Understanding*
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

COLOMBIA

First Review Under the Stand-By Arrangement, Requests for Modification of Performance Criteria, and Waiver of Nonobservance of Performance Criteria and of Applicability of end-September Performance Criteria

Prepared by the Western Hemisphere Department
(In consultation with other Departments)

Approved by José Fajgenbaum and Michael Hadjimichael

October 4, 2005

Current arrangement. The authorities consider continued Fund support important to provide a transparent policy framework during the upcoming political cycle and to allow for a gradual exit from formal Fund support. In April 2005, the Board approved an 18-month SBA in the amount of SDR 405 million (35 percent of quota at an annual rate). The authorities are treating the arrangement as precautionary. Colombia has no outstanding credit to the Fund (Appendix I). Colombia has accepted the obligations of Article VIII, Sections 2, 3, and 4.

In 2005, the economy has been performing well. Real GDP growth and inflation are likely to turn out as envisaged, but with stronger fiscal and external positions. All quantitative performance criteria at end-June 2005 were observed. In June 2005, congress approved the pension reform and the securities market law (structural benchmarks), but not the revised budget code (structural performance criterion). In July 2005, the government submitted a 2006 budget that envisaged a combined public sector (CPS) deficit of 2 percent of GDP (structural performance criterion).

First review. The authorities are requesting completion of the review and a modification of the quantitative performance criteria for the CPS deficit for end-September and end-December 2005 to reduce the 2005 target for CPS deficit to 1.6 percent of GDP, from the original target of 2.5 percent of GDP. They are requesting a waiver of the non-observance of the structural performance criterion on the revised budget code on the basis of several corrective measures, including steps already adopted. The staff supports these requests.

Discussions. A mission visited Bogotá during August 22–September 2, 2005 and met the Minister of Finance, Board of Directors of the Banco de la República, Director of the National Planning Department, and other government officials and private sector representatives. The mission comprised R. Rennhack (Head), R. Garcia-Saltos, O. Hendrick, R. Portillo (all WHD), I. Adenauer (FAD), and S. Reichhold (PDR). Mr. Steiner, Alternate Executive Director for Colombia, participated in all policy discussions.

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EXECUTIVE SUMMARY

Background

The economy is expected to continue to perform well in 2005. Real GDP is expected to grow by 4 percent, with consumer prices rising by 5 percent, as targeted. The external current account deficit is estimated at 1 percent of GDP, compared with 2.8 percent of GDP projected originally. The authorities intend to keep the combined public sector (CPS) deficit to 1.6 percent of GDP, well below the target of 2.5 percent. The central bank remains committed to achieving its inflation target, while continuing to resist the upward pressure on the peso. In June, congress approved the securities market law and the pension reform (both structural benchmarks), but not the revised budget code (a structural performance criterion).

Policy discussions

The authorities intend to strengthen the medium-term framework. Real GDP would continue to rise by 4 percent a year, while inflation would decline to 3 percent by 2010. Public debt is now expected to decline to 40 percent of GDP by 2010 (43 percent of GDP in the program). The external current account deficit would range between 2 and 2 ½ percent of GDP during 2006-2010, less than projected earlier.

The authorities are proposing to modify the fiscal performance criteria for the remainder of 2005, in line with the lower CPS deficit. This better performance reflects gains in tax administration, higher oil revenues, and controlled spending by local and regional governments. For 2006, the program targets a CPS deficit of 2.0 percent of GDP. However, this target will be revisited during the next review.

The authorities continue to make progress on structural reforms. The authorities noted that several important elements of the revised budget code have already been adopted, and they identified corrective measures in the other areas. On this basis, they are requesting a waiver for the non-observance of this performance criterion. They are also taking steps to strengthen public enterprises and domestic fuel pricing policy.

The central bank is continuing to purchase foreign exchange out of a concern for the pace and extent of the appreciation of the peso. The staff noted that this policy had not undermined the achievement of the inflation target but urged the authorities to allow for more exchange rate flexibility, in view of the persistent strength of the external position.

The authorities are continuing to strengthen financial supervision, especially through the merger of two financial superintendencies.

Economic performance under the arrangement has been favorable. Staff supports the authorities' request for completion of the first review, for the modification of the fiscal targets and for waivers.

I. Recent Developments

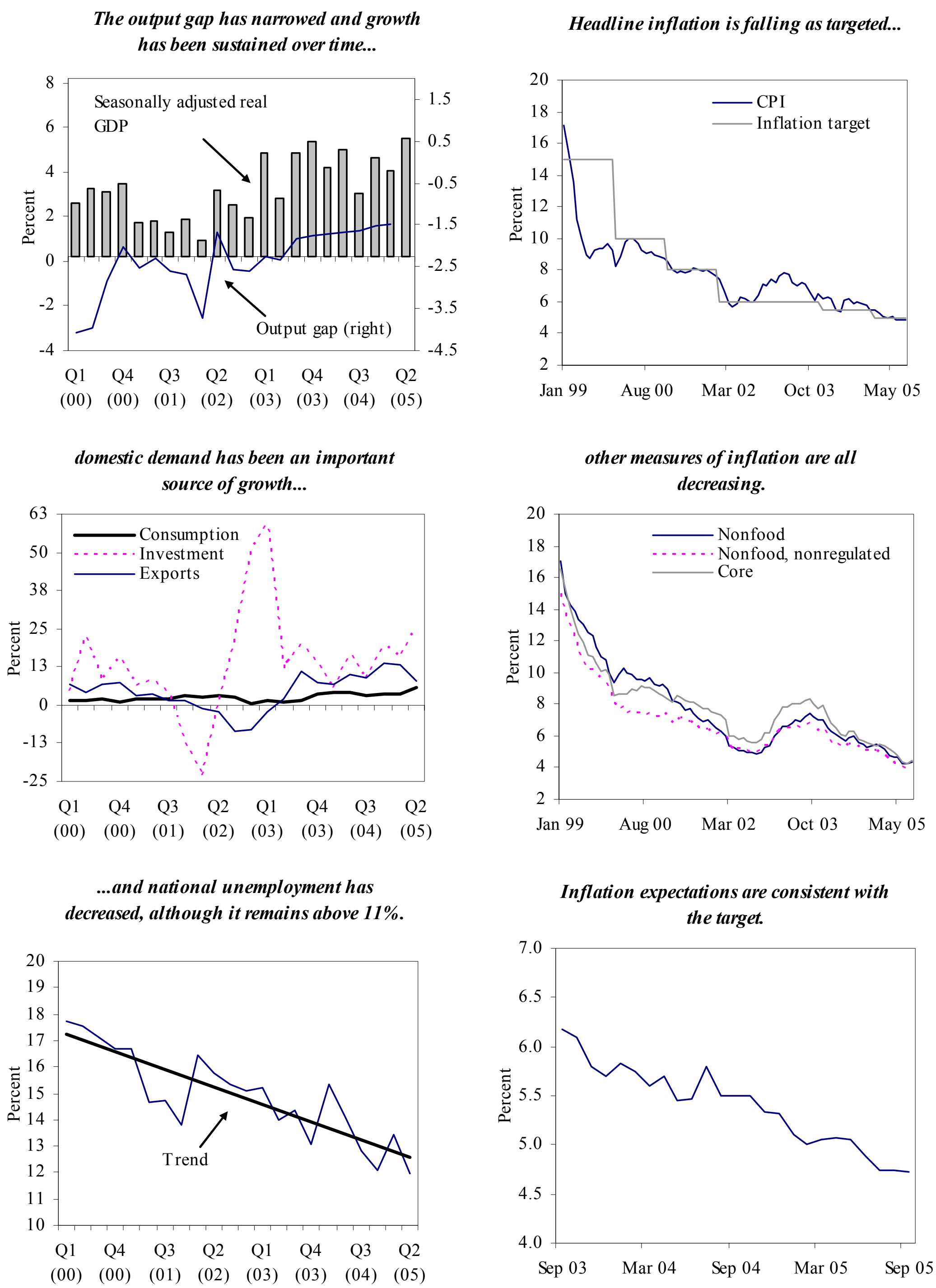
1. **The political situation is calm, as Colombia enters a political transition, with elections in 2006 for Congress (March) and President (May).** President Uribe enjoys approval ratings of 70–80 percent, although his reelection prospects are still unclear. In November 2004, Congress approved a constitutional amendment allowing for re-election of presidents starting in 2006. However, the Attorney General recommended that this amendment be overturned by the Constitutional Court, which is reviewing numerous challenges to this amendment and must decide no later than mid-November. This uncertainty has been limiting the government's room for maneuver in Congress.

2. **The economy is performing well in 2005.** Real GDP is likely to grow by 4 percent, led by strong real growth in investment and exports (Table 1 and Figure 1). The urban unemployment rate fell to13.8 percent in August 2005, compared with 15.0 percent a year earlier. So far this year, inflation has reached historic lows, and is expected to amount to 5 percent during the year, as targeted. Inflation expectations point to continued declines in inflation in 2006. The strength of the peso has trimmed traded goods inflation to below 4 percent year-on-year. Non-fuel, nontraded goods prices have been rising by about 5 percent, while domestic prices of gasoline and diesel (which are regulated) have been rising by about 15 percent on average.

3. **The authorities intend to keep the combined public sector (CPS) deficit to 1.6 percent of GDP in 2005, well below the program target of 2.5 percent of GDP (Tables 2, 3, and 4).** Through June, the CPS registered a surplus of 1.6 percent of semester GDP (the program targeted a deficit of 1 percent of semester GDP), and the authorities intend to preserve part of this margin for the rest of the year. The better fiscal performance, together with the strength of the peso, is projected to reduce public debt to about 48 percent of GDP by end-2005, compared with about 50 percent envisaged in the program.

4. **Progress on structural reforms has been mixed**. In June, Congress approved the securities market law and the pension reform (both structural benchmarks). The new securities markets law aims to strengthen investor protection, improve supervision and regulation of trading companies and develop the necessary market infrastructure. The pension reform will lower the actuarial deficit of the pay-as-you-go (PAYG) pension system by 19 percent of GDP—about two-thirds of the savings sought by the government. However, Congress did not approve the revised budget code—a structural performance criterion for end-June. By end-July, the government submitted to Congress a budget for 2006 that provided for a CPS deficit of 2 percent of GDP (structural performance criterion). Discussions on a possible free-trade agreement between Colombia, Ecuador, Peru and the United States are continuing.

Figure 1. Colombia: Real Sector and Inflation Developments



Sources: Central Bank of Colombia; Department of National Statistics (DANE); and Fund staff estimates and projections.

5. **The Banco de la República remains firmly committed to achieving its inflation target, while resisting upward pressures on the peso vis-à-vis the U.S. dollar.** In the period January–August, the central bank kept its key policy interest rate steady at 6.5 percent, while purchasing US$2.8 billion (Figure 2). The monetary effect of this intervention was fully sterilized through a build up of government deposits in the central bank, helping to limit the growth in monetary base to 19 percent year-on-year through August (Table 5). In September, the central bank lowered its key policy interest rate by 50 basis points to 6 percent and stated that foreign exchange intervention would continue. Through end-August, the peso had appreciated by 3.6 percent vis-à-vis the U.S. dollar year-on-year (4.2 percent in real effective terms).

6. **The overall health of the banking system remained solid through June, with low nonperforming loans and sufficient capital (Table 6).** Through August, bank credit to the private sector grew by more than 9 percent in real terms year-on-year. On July 25, Granahorrar—one of the banks intervened after the 1999 crisis—was offered for sale (a structural benchmark for end-2005). Consistent with Colombian law, the bank was offered first to its employees and certain cooperatives at a minimum price of about Col$400 billion (0.2 percent of GDP). If these groups decline to accept this offer, Granahorrar will be opened to bids from banks and other private investors in late October.

Colombia: Financial Soundness Indicators

(In percent, unless otherwise indicated)

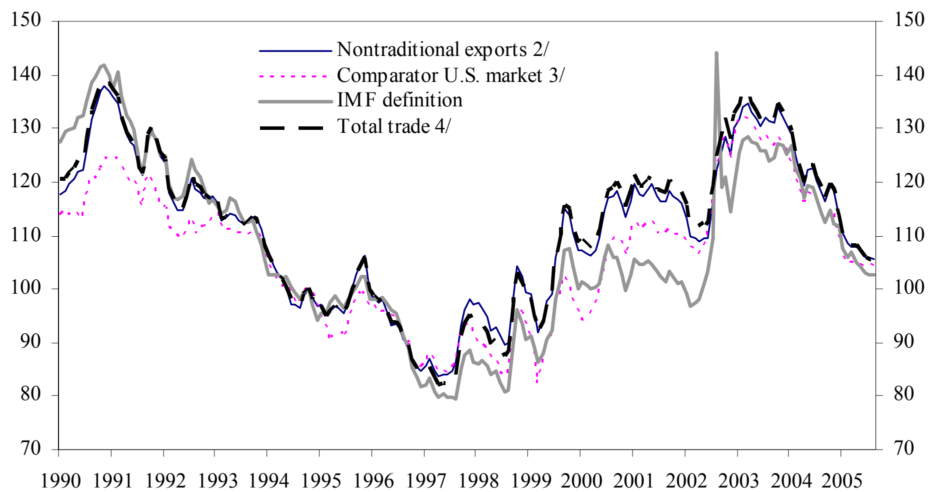
	2000	2002	2004	2005 (June)
Capital adequacy ratios 1/	11.3	11.0	12.1	12.4
Nonperforming loans to total loans 2/	11.0	8.7	3.3	3.2
Provisions to nonperforming loans 2/	56.6	86.5	149.2	142.2
Operating margin to assets	-0.1	2.7	4.1	4.5
Return on average equity	-20.7	9.6	23.3	24.9
Liquid assets to assets	12.9	19.7	20.6	19.7

Sources: Bank Superintendency, and staff estimates.

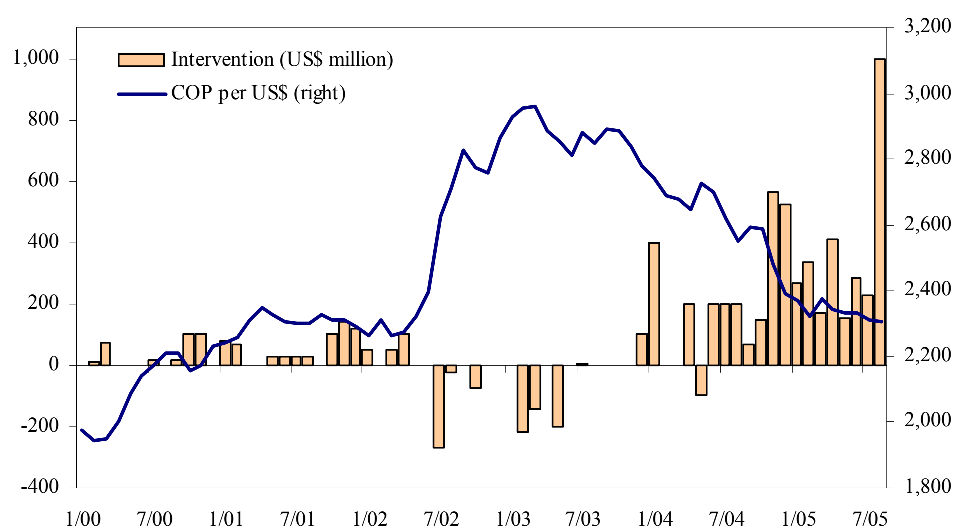
1/ Not risk weighted.
2/ Excludes leases.

Figure 2. Colombia: Exchange Rate Developments

Several real exchange rate measures point to a sustained appreciation of the COP since end-2003.



Notwithstanding, the heavy intervention in the FOREX market by the central bank. 5/



Sources: Central Bank of Colombia; and Fund staff estimates.

1/ Using CPI.
2/ Using weights from nontraditional exports and imports from 20 trading partners.
3/ Relative to 23 countries that compete with Colombia in the U.S. market.
4/ Relative to the main 20 trading partners.
5/ The negative values of intervention in 2004 correspond to sales of reserves to the central government.

7. **The external sector is also projected to turn out stronger than expected (Table 7)**. The external current account deficit is likely to amount to 1 percent of GDP, well below the program projection of 2.8 percent of GDP. Exports are likely to grow by 20 percent on the back of high world prices of oil, coal, and coffee, as well as rapid growth in nontraditional exports. Imports are expected to rise by 26 percent, reflecting strong investment and the effects of the real appreciation of the peso since end-2003. Net capital inflows are likely to reach 2¾ percent of GDP, owing to strong foreign direct investment in oil, coal, and other sectors. Colombia's risk premium had fallen to about 235 basis points by end-September, broadly in line with decline in the EMBI. The public sector will register a net capital outflow, resulting from the prepayment of external public debt. By end-2005, net international reserves are projected to reach at least US$15.2 billion (140 percent of short-term debt on a remaining maturity basis).

II. Policy Discussions

8. **The authorities want to take advantage of the favorable economic performance to strengthen the macroeconomic policy framework.** In their view, tightening fiscal policy will preserve confidence during the upcoming political transition. This stance will reduce the government's need for net external financing, and ease upward pressures on the peso by helping to sterilize the monetary effects of the foreign exchange intervention. The authorities also recognize that—while the global economic environment is currently very favorable—the economy still faces several external risks, including a possible slowdown in global demand in response to high world oil prices. In this context, the gain in net international reserves since 2003 will safeguard economic performance in the coming years.

9. **The medium-term macroeconomic framework is being strengthened compared with the program (Table 8)**. Real GDP is still projected to grow by 4 percent a year, while inflation would decline to 3 percent by 2010. Public debt is now expected to decline to 40 percent of GDP by 2010 (43 percent of GDP in the program), with less external debt than envisaged. This reflects the faster fiscal consolidation in 2005 as well as the assumption of a stronger peso over the medium term, compared with the program. The external current account deficit is expected to range from 2 percent to 2½ percent of GDP a year in 2006–10, as sustained foreign direct investment supports continued growth in imports. Net international reserves would remain at about 140 percent of short-term debt on a remaining maturity basis.

Macroeconomic Framework: Main Elements

			2005		Projections		
	2003	2004	Prog.	Proj.	2006	2007	2010
Real growth	4.1	4.1	4.0	4.0	4.0	4.0	4.0
Inflation 1/	6.5	5.5	5.0	5.0	4.5	4.0	3.0
	(In percent of GDP)						
External current account balance 2/	-1.5	-1.0	-2.8	-1.0	-2.3	-2.5	-2.5
NFPS primary balance 3/	1.7	2.7	2.7	3.1	2.7	2.7	2.7
Combined public sector balance 3/	-2.7	-1.3	-2.5	-1.6	-2.0	-1.7	-1.0
Total public debt	56.0	52.9	50.4	47.8	46.4	46.6	39.8
Public deposits	8.6	10.6	…	…	…	…	…
	(In billions of U.S. dollars)						
Net international reserves 4/	10.5	13.2	12.3	15.2	15.5	15.9	17.9
	(In U.S. dollars per barrel)						
Crude oil, spot price 5/	28.9	37.8	40.5	54.2	61.8	60.0	56.5

1/ For 2007 and beyond, inflation projection consistent with achieving medium-term inflation target of 2 to 4 percent a year.
2/ At projected WEO price of oil in 2005-06, adjusted to reflect Colombia export price.
3/ For 2005, based on the projected WEO oil price. For 2006, assumes a baseline export price of US$32 per barrel.
4/ IMF Defintion. Takes into account the prepayment of the IDB loan in 2005.
5/ Petroleum price is average of spot prices for UK Brent, Dubai, and West Texas Intermediate.

A. Fiscal Policy

10. **The authorities intend to lower the 2005 target for the CPS deficit to 1.6 percent of GDP.** This reflects mainly a stronger position of the central administration and higher oil revenues than originally envisaged.

- The central administration deficit is expected to be 0.6 percent of GDP less than programmed. The efforts to improve tax administration have begun to yield more revenues than projected (Box 1), and the government decided not to introduce a supplementary budget in 2005.
- Based on the most recent WEO projection for world oil prices,[1] the operating surplus of Ecopetrol is projected to reach 3.5 percent of GDP, compared with 3.1 percent in the program. This gain is equivalent to about half of the country's oil export windfall (Box 2). The authorities preferred to send a clear signal about the stance of fiscal

[1] In August, the WEO projected an average world oil price of US$55 per barrel for 2005, which is consistent with an average Colombian export price of US$48 per barrel for 2005, well above the baseline export price of oil of US$31 per barrel.

policy by basing the revised target on the projected world oil price and dropping the oil adjustor for the remainder of 2005.[2]

- The surplus of local and regional governments and enterprises—which operate independently of the central government—is likely to amount to 1.1 percent of GDP, virtually as envisaged. Earlier concerns about a possible surge in spending have eased, and it appears that the decentralization reforms adopted earlier this decade are paying dividends.

Box 1. Benefits of Fiscal Structural Reforms

Several reforms adopted in recent years appear to be yielding fiscal savings:

- **Tax administration measures.** The authorities have developed an integrated database on taxpayer information that allows DIAN (the tax authority) to compare information reported on tax returns with other sources. All large taxpayers now have to declare their taxes electronically. DIAN now exchanges information with large enterprises and applies sanctions more effectively.

- **Tax reform.** In 2002 and 2003, Congress approved several tax increases, including broadening the base of the VAT, an income tax surcharge and a wealth tax. Some of the measures, such as raising the rate of the financial transactions tax, made the tax system less efficient. Thus, while tax revenues are performing well, there is still a need to improve the structure of taxes.

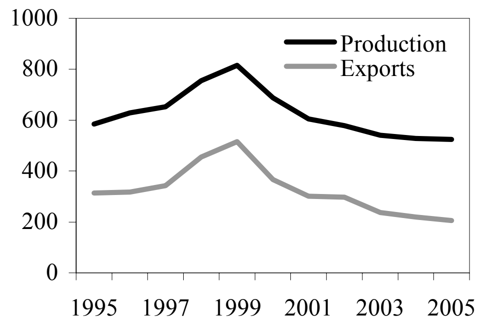
- **Pension reform.** Congress has approved three pension reforms since 2002. In December 2002, the reform included lengthening contribution periods, lowering replacements ratios, and raising contribution rates. In May 2003, congress approved another reform that lowered the actuarial deficit of teachers' pensions. By raising contributions, these reforms helped limit the government's net pension costs to 4 percent of GDP in recent years, even though pension outlays rose. Most recently in June 2005, a further reform phased out most special pension regimes, eliminated the 14th monthly pension payment for new retirees, and shortened the period during which certain workers can retire under the generous pre-1993 benefits.

- **Decentralization reform.** Congress approved early this decade several laws to strengthen territorial finances. Now local and regional governments must adhere to both liquidity and solvency indicators before they can borrow, and have to respect a set of fiscal rules. The intergovernmental transfer system was reformed in 2001, decoupling transfers from central government revenues until 2009. Now all levels of government must announce each year their fiscal targets for the following year, in the context of a public debt sustainability framework. The key remaining issue is to reform the system of transfers to local governments, which reverts to the costly pre-2001 system in 2009.

[2] At the projected WEO price, the program adjustor would have yielded an estimated windfall of 0.2-0.4 percent of GDP, depending on the mix of oil actually exported and royalty payments to territorial governments.

Box. 2 Effect of Oil on the Colombian Economy

Oil Production and Exports
(In thousand of barrels/day)



Net Oil Exports
(In percent of GDP)

	2002	2003	2004	2005
Colombia	**3.8**	**3.9**	**4.0**	**3.8**
Ecuador	7.5	7.4	12.6	13.6
Mexico	2.3	2.9	3.5	4.2
Venezuela	23.2	26.1	29.5	32.9

Sources: Central Bank of Colombia; and WEO.

Oil has been a declining sector since 1999. Over the past 10 years, proven reserves have fallen by 50 percent to 1.5 billion barrels by end-2004, as exploration has not led to the discovery of any new major oil fields. As a result, both production and exports have dropped significantly since 1999. Over the last four years, Colombia's net oil exports have averaged 4 percent of GDP, similar to Mexico and well below the oil export share in Ecuador and Venezuela. Unless there are significant oil discoveries in the coming years, Colombia could become a net oil importer by 2010.

The legal framework for hydrocarbons was modified in 2003 to give a larger role to the private sector. Until then, private firms could only operate in joint ventures with Ecopetrol (the national oil company), who also supervised the oil industry and managed the country's oil reserves. In 2003, the supervision and the reserves management were transferred to a new agency—the National Hydrocarbons Authority (ANH). While Ecopetrol retains monopoly power over the production of petroleum products, it must now compete with private companies for new contracts in oil exploration and production.

The fiscal impact of oil revenues has been diminishing. In 2005, the oil export windfall for the country is estimated at about 1.4 percent of GDP, of which about half goes to Ecopetrol. With these extra resources, Ecopetrol has had to fund its domestic purchases of crude oil for its refinery operation, for which it pays world prices but then sells domestically at less than world market prices. It also has to transfer a share of the additional revenues to local and regional governments.

Oil Export Windfall, 2005
(In percent of GDP)

	Benchmark	Proj. 2005	Windfall
Total oil exports	**2.7**	**4.1**	1.4
Ecopetrol	1.5	2.3	0.8
Private Companies	1.2	1.8	0.7

Source: Staff estimates.

The effect of oil on growth has also declined. The authorities estimated that a 20 percent rise in the world oil price would raise real GDP moderately, perhaps by 0.2–0.3 percent after one year. Staff estimates suggest that for the output effect was larger during the period 1994–2004, when oil played a larger role in the economy.

Domestic prices of gasoline and diesel are regulated, which limits the effect of rising oil prices on inflation. Wholesale and retail prices of these products are adjusted monthly, with a view to bringing them in line with a reference price for crude oil—now US$48 per barrel. The retail prices are broadly in line with U.S. prices, but wholesale prices are below international levels, implicitly costing Ecopetrol about 1¾ percent of GDP in 2005.

Key Fiscal Trends

(In percent of GDP)

	2000	2001	2002	2003	2004	2005 Prog.	2005 Proj.
CPS balance	-3.4	-3.2	-3.7	-2.7	-1.3	-2.5	-1.6
Of which:							
Central Administration	-5.7	-5.7	-6.4	-4.5	-5.4	-6.1	-5.5
Ecopetrol operating surplus	3.0	2.5	2.3	2.9	3.4	3.1	3.5
Local and regional overall balance	0.0	0.3	0.9	0.6	1.6	1.2	1.1

Sources: Colombian authorities; and staff estimates.

11. **Total revenues are projected to reach almost 32 percent of GDP, compared with 31.2 percent in the original program.** Tax revenues are expected to perform well, reflecting increased collections of value-added, trade and property taxes. The operating surplus of public enterprises is projected to rise to 5½ percent of GDP (4.7 percent of GDP projected in the program), partly because of Ecopetrol and additional revenues of the state-owned electric companies. Other non-tax revenues—which consist of many small taxes collected by local and regional governments—are conservatively estimated at 4 percent of GDP.

12. **Total expenditure is expected to amount to 33.4 percent of GDP, slightly less than programmed**. Current spending is projected to turn out below program, mainly because interest payments are much lower than expected. Interest rates on domestic government securities have declined significantly this year, and the peso has remained stronger than expected. These savings will allow the authorities to redirect spending towards public investment. Fixed capital formation is projected to reach 8.6 percent of GDP, compared with 8.1 percent of GDP in the program.

13. **The government will continue to manage its debt well to reduce its exposure to currency risk and to lengthen maturities.** The sharp decline in the government's domestic borrowing costs has allowed it to issue domestic debt at longer maturities and to sharply cut its recourse to external financing. The government has swapped about US$2 billion of foreign currency debt for domestic securities. It recently announced that it will purchase at least US$3 billion to retire more external debt or prefinance needs for 2006, financed by drawing down government deposits or issuing more domestic securities. Based on these efforts, net external financing is projected at minus 1.0 percent of GDP in 2005. The government continues to conduct forward and swap operations to minimize the carrying cost of foreign currency assets. Through August, the government had accumulated a long position for US$562 million in swaps and has kept net forward sales below the limit of US$100 million.

14. **For 2006, the target for the CPS deficit is 2 percent of GDP, in line with the budget currently before Congress**. Revenues are projected to decline to 31.6 percent of

GDP, reflecting a cautious assumption about collections on other non-tax revenues. Tax revenues are projected to rise slightly in relation to GDP, while oil revenues are based on a prudent assumption of an oil export price of US$32 per barrel. Total expenditures would rise to 33.7 percent of GDP, reflecting mostly slightly higher investment as a share of GDP. The staff noted that there may be scope for a significant decline in the target for the CPS deficit, depending on the outturn for 2005. The authorities agreed to revisit this issue in the context of the second review under the program and stressed their intention to continue to save a significant share of any oil price windfall.

B. Structural Fiscal Reforms

Revised budget code

15. **The authorities remain fully committed to reducing budgetary rigidities but considered it fruitless to resubmit the revised budget code in the current political environment**. They noted that the Fiscal Responsibility Law approved in 2004 took care of several important elements proposed in the new code, such as requiring the presentation of a medium-term fiscal framework each June (which also serves as a midyear report to Congress), and establishing limits on multiyear spending commitments. The government intends to reduce the stock of floating debt from 2.2 percent of GDP at end-2004 to about 1 percent of GDP at end-2005. The decision not to present a supplemental budget in 2005 would help prevent a rise in floating debt in 2006. The government will issue a decree by October that implements other aspects of the proposed budget code—including steps to improve classification of expenditure—that do not require new legislation. The authorities also wanted to address the rigidities introduced by revenue earmarking, and some initial steps are included in the decree. In addition, they agreed to prepare by March 2006 draft legislation to limit earmarked revenues not mandated by the Constitution.

Fiscal decentralization

16. **The authorities will continue to strengthen the quality of information on the fiscal operations of local and regional governments.** The authorities are working on reducing the number of data requests from local entities and ensuring the consistency of the information from different sources. They also agreed that a number of major local governments should submit their fiscal projections regularly and more frequently.

Tax reform

17. **The authorities believe a less distortionary tax system will encourage economic growth.** However, they noted that it would be difficult to submit a substantive tax reform in the current political environment and added that on two previous occasions Congress had diluted or rejected the government's tax proposals. They intend to prepare a tax reform that could be presented to the next government. Key elements could include a simplification of the system, a broadening of the VAT and income tax bases, the reduction of the number of VAT rates, and the phasing out of distortionary taxes such as the financial transaction tax.

Public enterprise reform

18. **The authorities are continuing to enhance the commercial orientation of public enterprises.** The government is in the process of selling a majority share in the public telephone company (Telecom) to improve the quality of telecommunications services and to cover the significant pension liability of Telecom. Telmex has expressed some interest and several firms may present bids in the near future. The government also intends to modernize Ecopetrol's refinery—a project expected to cost US$800 million (0.7 percent of GDP)—through a joint venture with a private partner who would retain the majority share. This approach will ease the pressure on the public finances and help ensure that the project is economically efficient. The government plans to open the bidding soon, with a view to finding a private partner by mid-2006. The process of selling several smaller public enterprises, such as Ecogas (the state natural gas distributor), is proceeding.

Domestic fuel pricing

19. **The authorities noted that the success of the joint venture for Ecopetrol's refinery depends in part on modifying the policy for setting domestic fuel prices.** The government will continue to narrow the gap between domestic wholesale prices of diesel and gasoline and their import costs.[3] On October 1, the Minister of Mines announced that these prices will increase faster to bring them in line by 2007 with a reference price of crude of US$48 per barrel, compared with the previous reference price of US$35 per barrel. By 2011, the refinery would receive the import price of gasoline and diesel, and any subsidy of domestic retail prices would appear as a direct cost in the budget. The staff welcomed this step but urged the authorities to bring domestic prices more quickly in line with the reference price, as well as to consider aiming at a higher reference price. It noted that the cost of the implicit subsidy on wholesale prices would amount to about 1¾ percent of GDP in 2005, as in the previous three years.

C. Monetary and Exchange Rate Policy

20. **The Banco de la República explained that the recent cut in the policy interest rate was consistent with reaching the inflation objective.** The technical analysis suggested that consumer prices would rise by 5 percent, or perhaps less, during 2005. They noted that the seasonal rise in the demand for liquidity in the fourth quarter could be met as the government drew down its deposits, also for seasonal reasons. However, they stressed their readiness to conduct open market operations, if necessary, to absorb any excess liquidity.

21. **The central bank intends to continue its purchases of foreign exchange out of a concern about the pace and depth of the appreciation of the peso.** The authorities

[3] The retail price of gasoline is broadly the same as, while diesel is about 40 percent cheaper than, the retail prices of these products in the United States. The difference between retail and wholesale prices reflects taxes and distribution margins.

commented that a stronger peso would begin to weaken the competitiveness of exports, especially in sectors where the workers could shift to illicit activity. While most exports were performing well this year, they noted that these pressures on the peso would not necessarily persist. In particular, the trend decline in oil production would probably cut oil exports sharply over the next few years, creating pressure for a weaker peso. The authorities added that the build up of net international reserves would cushion the effects of adverse shocks in the future. Furthermore, use of these additional reserves to cut the public sector's external debt would limit the public sector's exposure to currency risk.

22. **The staff expressed some concern about sustained foreign exchange intervention**. It agreed that intervention had not yet generated price pressures, and acknowledged that several other inflation-targeting countries in the region also had been intervening their foreign exchange markets. However, several factors—the improved confidence, the prospect of continued high world oil and coal prices, the strength of nontraditional exports, and the considerable growth in remittances in recent years—pointed to a lasting strength in the external sector that could continue to put upward pressure on the peso. In this regard, staff questioned whether continued foreign exchange intervention would remain a viable policy for a prolonged period, especially if it were to attract even more capital inflows. It emphasized that more exchange rate flexibility would help the economy adjust to the stronger external position with less inflationary pressures and lower fiscal costs.

D. Financial Sector

23. **The authorities will continue to strengthen the financial sector.** They intend to prepare by June 2006 the regulations necessary for the full implementation of the new securities market law (structural benchmark). They expect the process of selling Granahorrar to proceed smoothly and began to liquidate the Banco del Estado—a bank that no longer takes deposits or makes loans but still manages a stock of nonperforming loans. The Monetary and Financial Affairs Department (MFD) is providing technical assistance in the design of a governance framework for Banco Agrario and the newly-formed Granbanco.[4] The authorities are continuing to make progress in advancing the implementation of the risk-based approach for capital adequacy in line with the Basle II capital guidelines. They plan to merge the superintendencies of financial institutions and of securities in early 2006, which will allow for more effective consolidated supervision. The authorities intend to request technical assistance from MFD to help strengthen financial supervision further.

III. Medium-Term Outlook

24. **Colombia's medium-term outlook is favorable, with the prospect of expanding investment, sustained growth and declining inflation.** If recent trends continue, investment is expected to reach 22 percent of GDP by 2010. The authorities agreed that this outlook for

[4] This bank is carrying out the sound operations of the restructured Bancafé.

investment could imply faster economic growth, but preferred to retain the prudent assumption of 4 percent annual growth in real GDP. The medium-term framework also cautiously assumes that national savings stays below 20 percent of GDP through 2010, resulting in an external current account deficit ranging from 2 to 2½ percent a year during 2006–10. Economic policies would remain strong, as the government would sustain a primary surplus of 2.7 percent of GDP and the central bank would gradually lower inflation to its target of 2–4 percent a year. The government would continue to undertake fiscal structural reforms and to strengthen financial supervision further.

25. **Under these assumptions, the outlook for the sustainability of public and external debt is more favorable than envisaged in the program (Tables 9 and 10).** Public debt is now expected to decline to about 40 percent of GDP by 2010, while total external debt would fall to 28 percent of GDP. The prepayment of external debt has begun to reduce the vulnerability to currency depreciation. Now a 30 percent nominal depreciation of the peso is estimated to raise public debt by 8 percent of GDP, compared with 10 percent of GDP envisaged in the program. Staff also estimated that a sharp and permanent decline in the world price of oil would lead to a moderate rise in public debt compared with the baseline. This is consistent with the diminishing effect of world oil prices on the fiscal accounts.

Public Debt: Baseline and Alternative Scenarios

(In percent of GDP)

	Prel.	Projections			
	2004	2005	2006	2007	2010
Baseline	**52.7**	**47.8**	**46.4**	**46.6**	**39.8**
Alternative					
Primary balance falls by one-half standard deviation from 2006 through 2010	52.7	47.8	47.2	48.2	44.0
Real GDP growth falls by one-half standard deviation from 2006 through 2010	52.7	47.8	47.4	49.1	48.8
One time 30 percent real depreciation in 2006	52.7	47.8	54.2	54.8	48.7
Oil Prices fall by two standard deviations (US$23.04) from 2006 through 2010	52.7	47.8	47.7	48.5	43.0

Sources: Fund staff estimates and projections.

IV. Program Modalities and Risks

26. **The authorities are requesting the completion of the first review under the arrangement.** All quantitative performance criteria at end-June 2005 were observed with ample margins, and a similar outturn is expected for end-September 2005 as well. All structural benchmarks were met. The authorities are requesting a modification of the performance criteria for the CPS deficit for end-September and end-December 2005, in line with the downward revision of the CPS deficit for 2005. They are also requesting waivers

for: (i) the nonobservance of the structural performance criterion on congressional approval of the revised budget code; and (ii) the applicability of the quantitative performance criteria for the CPS deficit and the limit on net short term external public debt for end-September, because information on these policies for this date will not be available by the time of the Board meeting. The staff supports these requests.

27. **The access under the arrangement remains appropriate (Table 11).** Upon completion of the first review, Colombia would be eligible to purchase SDR 235.8 million (30.5 percent of quota), and the remaining four purchases would amount to SDR 42.3 million each (Table 12). The authorities are treating the arrangement as precautionary.

28. **Quarterly performance criteria will continue to apply to the same policy variables as in the original program.** The modified targets for the CPS deficit for end-September and end-December 2005 will no longer be subject to an adjustor for an oil price windfall. The remaining semi-annual program reviews are to be completed by March 2006 and September 2006.

29. **Structural conditionality.** Structural benchmarks include (i) the issuance of regulations to improve the quality of information reported by local and regional governments; (ii) the issuance of a decree to adopt a number of elements of the revised budget code as possible; (iii) the publication of a report that evaluates the current system of revenue sharing; (iv) the preparation of a draft law on revenue earmarking; (v) the completion of the issuance of all the regulations necessary for the full implementation of the securities market law; and (vi) the completion of the process of finding a private investor for the joint venture to modernize the Cartagena refinery. Further structural benchmarks and performance criteria for 2006, if necessary, would be introduced at the time of the second review.

30. **Colombia would be able to repay the Fund, if all purchases were made under the proposed arrangement** (Table 13). Fund credit would be equivalent to 0.4 percent of GDP in 2006. Debt service to the Fund would peak at 1.0 percent of exports of goods and nonfactor services in 2010.

31. **The economy is becoming less vulnerable, although some risks remain.** Public debt is sensitive to exchange rate fluctuations and other shocks. In the run up to the 2006 elections, pressures for increased public spending could mount or the security situation could become more difficult. Alternatively, the external environment could worsen, especially if a surge in world oil prices slows the growth in the global economy.

V. Staff Appraisal

32. **The authorities' determination to pursue strong policies is allowing the economy to benefit from a favorable global economic environment.** Supported by high world commodity prices, real GDP is likely to rise by 4 percent for the third consecutive year, leading to further declines in unemployment. Confidence is continuing to improve, aided by sustained declines in public debt and low inflation. This in turn encourages investment both

domestically as well as from abroad. Moreover, exports of commodities as well as nontraditional products continue to grow rapidly, resulting in a low external current account deficit. In this situation, the key policy challenge is to manage this favorable position with a view to strengthening economic performance further.

33. **The authorities' decision to advance fiscal consolidation in 2005 provides several crucial benefits.** It sends a strong signal that spending will remain under control during the upcoming political transition**.** It also eases upward pressures on the peso by reducing the need for net external financing and by helping to sterilize foreign exchange intervention without affecting domestic interest rates. The staff supports the decision to drop the oil windfall adjustor for the remainder of 2005 because the revised target already incorporates a realistic outlook for the impact on revenue of the world price of oil for this year. It will be crucial to advance fiscal consolidation in 2006 by keeping the CPS deficit (at the baseline export price of oil) below 2 percent of GDP. Moreover, a significant share of any oil windfall will need to be saved.

34. **There has been progress on several structural issues, although it will be important to sustain the pace of reform.** The pension reform is an important step towards putting the pension system on a sounder footing, but another round of reform is probably unavoidable to further reduce the actuarial deficit of the system. The new securities law will help deepen local capital markets further. The authorities remain committed to scaling back budgetary rigidities. Several elements of the revised budget code have already been implemented and the government has developed sensible measures to address the other key aspects of the budget code, including initial steps to address revenue earmarking. While these steps are welcome, a revised budget code would provide a more sustainable and comprehensive framework to strengthen expenditure management, and the staff would encourage the authorities to resubmit the revised budget code. It will also be important to follow through with the preparation of draft legislation on revenue earmarking. The government is continuing to improve the quality of information on the fiscal operations of local and regional governments, and the staff would encourage the authorities to establish an intergovernmental working group to share information on budgetary execution and prospects. The government is committed to introducing a substantive tax reform, but sees little political room for such a reform until the change in government. The public enterprise reforms should help limit potential fiscal risks over the medium term, while improving the efficiency of key sectors. The authorities plan to raise domestic prices of gasoline and diesel at a faster pace. However, the implicit subsidy remains large and the staff urges the authorities to takes steps to eliminate this subsidy over the next few years.

35. **The Banco de la República is continuing to conduct monetary policy well in a challenging environment**. Interest rate policy has been managed cautiously, and the government has helped control liquidity growth by building up deposits at the central bank. In this context, the efforts to stem the appreciation of the peso have not undermined the achievement of the inflation target. However, the staff would favor less foreign exchange intervention, especially to avoid inducing one-way bets. It would urge the authorities to consider whether intervention on the recent scale can be sustained for a prolonged period.

The authorities' intention to use excess net international reserves to prepay the public sector's external debt is welcome but this approach has its limits. By substituting external for domestic debt, the public sector does reduce its exposure to currency risk. But it also transfers market and fiscal risk to domestic residents who hold the domestic public debt. For this reason, it would be crucial to aim at even stronger fiscal consolidation.

36. **The authorities are continuing to strengthen the financial system.** The staff welcomes the progress achieved in bringing Granahorrar to the point of sale, the decision to liquidate Banco del Estado, and the commitment to establish a governance framework for Granbanco and Banco Agrario. The upcoming merger of the superintendencies of securities and financial institutions should help improve financial supervision, and the staff welcomes the authorities' interest in receiving technical assistance in this area.

37. **Colombia's medium-term economic prospects are favorable**. The country appears poised to enjoy a period of sustained growth, with declining inflation and a strong external position. Of course it will be essential to maintain strong economic policies. While the fiscal outlook through 2006 is positive, numerous challenges to fiscal sustainability—such as pensions, transfers to territorial entities and a distortive tax system—are on the horizon, and the process of structural fiscal reform must resume as soon as politically feasible. In this regard, the staff encourages the authorities to prepare reforms that could be considered by the next government.

38. **Economic performance under the arrangement has been favorable.** Macroeconomic performance is better than envisaged, and the authorities have wisely decided to lock in the strong fiscal outturn in the first half of 2005. Moreover they have developed corrective measures to address the issues contained in the revised budget code. On this basis, the staff supports the authorities' requests for completion of the review, the modification of the fiscal performance criteria and the waiver for the non-observance of the structural performance criterion on the revised budget code.

Table 1. Colombia: Selected Economic and Financial Indicators

	2001	2002	2003	Prel. 2004	2005 Prog.	2005 Proj.	Proj. 2006
(Percentage changes, unless otherwise indicated)							
National income and prices							
Real GDP	1.5	1.9	4.1	4.1	4.0	4.0	4.0
GDP deflator	6.2	6.5	8.2	7.1	5.3	5.2	4.8
Consumer prices (average)	8.0	6.3	7.1	5.9	5.2	5.2	4.7
Consumer prices (end of period)	7.6	7.0	6.5	5.5	5.0	5.0	4.5
External sector (on the basis of US$)							
Exports (f.o.b.)	-6.4	-4.1	12.3	24.7	-0.1	20.3	5.1
Imports (f.o.b.)	10.6	-1.6	9.8	19.8	15.7	26.0	12.1
Export volume	0.9	-4.4	3.5	9.1	0.7	4.8	1.8
Import volume	12.3	-1.1	2.2	13.7	16.9	13.2	12.0
Terms of trade (deterioration -)	-5.9	0.7	1.0	8.6	0.2	3.2	3.2
Real effective exchange rate (depreciation -)	1.5	-17.4	-5.2	11.4	…	…	…
Central administration							
Revenue	20.8	10.1	13.9	16.0	10.1	12.5	11.1
Expenditure	16.7	12.6	6.8	17.4	13.2	11.8	12.1
Money and credit 1/							
Broad money	7.2	2.8	9.7	16.5	11.1	17.1	9.3
Credit to the private sector	1.7	4.0	9.2	12.0	14.6	17.4	16.0
Interest rate (90-day time deposits; percent per year)							
Nominal	11.5	7.7	7.9	7.7	…	…	…
Real	3.6	0.7	1.4	2.2	…	…	…
(In percent of GDP)							
Central administration balance	**-5.7**	**-6.4**	**-4.5**	**-5.4**	**-6.1**	**-5.5**	**-5.8**
Nonfinancial public sector balance	-3.5	-4.2	-3.2	-1.7	-2.5	-1.4	-2.0
NFPS primary balance	**1.5**	**0.4**	**1.7**	**3.1**	**2.7**	**3.0**	**2.7**
Public sector balance	**-3.2**	**-3.7**	**-2.7**	**-1.3**	**-2.5**	**-1.6**	**-2.0**
Foreign financing	2.3	0.6	1.0	-0.3	-0.5	-1.0	0.6
Domestic financing 2/	0.9	3.1	1.8	1.7	3.0	2.6	1.4
Privatization	0.0	-0.1	-0.1	0.0	-0.1	-0.1	0.0
Public debt 3/4/	**51.8**	**60.2**	**55.9**	**52.7**	**50.4**	**47.8**	**46.4**
Gross domestic investment 5/	14.3	15.4	18.2	18.8	15.3	19.4	19.6
Gross national savings	12.9	13.8	17.0	17.8	12.5	18.3	17.3
Current account (deficit -)	-1.3	-1.6	-1.2	-1.0	-2.8	-1.0	-2.3
External debt	47.5	52.3	45.9	36.8	35.9	31.2	28.7
Of which : public sector	28.5	31.9	29.6	24.0	22.7	20.3	19.4
NIR in percent of short-term debt	98.4	106.1	119.5	109.3	110.5	139.4	149.4
(In percent of exports of goods, services, and income)							
External debt service	50.2	64.0	55.9	37.1	52.1	45.1	32.0
Of which : public sector	28.2	37.0	33.0	18.3	30.9	29.6	17.1
Interest payments	16.3	16.8	14.8	11.7	14.5	11.3	11.0
Of which : public sector	10.4	11.3	10.5	8.4	10.3	8.2	8.1
(In millions of U.S. dollars)							
Overall balance of payments	1,217	138	-184	2,541	-855	1,941	364
Net official reserves 4/	9,982	10,507	10,524	13,195	12,340	15,156	15,520
Net official reserves (in months of imports of goods and services)	7.8	7.6	6.4	6.5	6.5	6.8	6.7

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

1/ All annual changes in foreign currency stocks valued at constant exchange rate.
2/ Includes the quasi-fiscal balance of Banco de la Republica, sales of assets, phone licenses, and statistical discrepancy.
3/ Includes bonds issued to recapitalize financial institutions.
4/ Program definition. Assumes no purchases under the current SBA arrangement. Includes valuation changes.
5/ In mid-2005, the investment data were revised upward starting in 2003.

Table 2. Colombia: Operations of the Combined Public Sector

(In percent of GDP)

	2001	2002	2003	2004	2005 SBA	2005 Proj.	2006 SBA	2006 Proj
Total revenue	**29.6**	**29.6**	**30.7**	**31.5**	**31.2**	**31.9**	**31.3**	**31.6**
Current revenue	**29.6**	**29.6**	**30.7**	**31.5**	**31.2**	**31.9**	**31.3**	**31.6**
Tax revenue	19.2	19.2	19.5	20.3	20.5	21.2	20.5	21.3
Nontax revenue	10.4	10.4	11.3	11.2	10.8	10.6	10.8	10.3
Financial income	1.3	0.9	1.1	1.0	1.0	1.1	1.0	1.1
Operating surplus of public enterprises	4.2	4.0	4.6	4.8	4.7	5.5	4.7	4.9
Of which : Ecopetrol 1/	2.5	2.3	2.9	3.4	3.1	3.5	3.0	3.3
Other	4.8	5.4	5.6	5.4	5.1	4.0	5.1	4.4
Total expenditure and net lending 2/	**33.3**	**33.8**	**33.6**	**32.9**	**33.7**	**33.4**	**33.4**	**33.7**
Current expenditure	**24.9**	**25.5**	**25.2**	**25.3**	**26.2**	**25.3**	**25.8**	**25.9**
Wages and salaries	7.5	7.5	7.4	6.8	6.8	6.9	6.8	6.8
Goods and services 3/	3.5	3.4	3.3	3.3	3.7	3.6	3.5	3.7
Interest	5.0	4.5	4.9	4.5	5.1	4.5	4.7	4.8
External	2.3	2.1	2.2	1.8	2.0	1.6	1.8	1.5
Domestic	2.8	2.4	2.7	2.7	3.2	2.9	2.9	3.3
Transfers to private sector	9.8	9.7	9.8	10.3	11.0	10.8	10.8	10.7
Of which: from social security	6.5	6.7	6.9	7.1	7.5	7.5	7.6	7.6
Other 4/	-0.9	0.2	-0.1	0.4	-0.4	-0.4	0.0	0.0
Capital expenditure	**8.3**	**8.1**	**8.5**	**7.7**	**7.5**	**8.1**	**7.5**	**7.7**
Fixed capital formacition (cash basis)	8.0	7.9	8.4	7.2	8.1	8.6	7.4	7.7
Other (including floating debt) 4/	0.2	0.0	0.0	0.4	-0.7	-0.5	0.0	0.0
Transfers	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Net lending	**0.1**	**0.1**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Statistical discrepancy	0.2	-0.1	-0.3	-0.3	0.0	0.1	0.0	0.0
Nonfinancial public sector balance	**-3.5**	**-4.2**	**-3.2**	**-1.7**	**-2.5**	**-1.4**	**-2.1**	**-2.0**
Quasi-fiscal balance (BR cash profits)	0.7	0.8	0.6	0.5	0.2	0.1	0.2	0.2
Fogafin balance	0.2	0.3	0.3	0.3	0.2	0.1	0.2	0.1
Net cost of financial restructuring 5/	-0.7	-0.6	-0.4	-0.4	-0.4	-0.5	-0.2	-0.3
Overall balance	**-3.2**	**-3.7**	**-2.7**	**-1.3**	**-2.5**	**-1.6**	**-2.0**	**-2.0**
Overall financing	**3.2**	**3.7**	**2.7**	**1.3**	**2.5**	**1.6**	**2.0**	**2.0**
Foreign, net	2.3	0.6	1.0	-0.3	-0.5	-1.0	0.5	0.6
Of which								
Changes in assets held abroad (-increase)	-1.9	1.9	-0.7	-1.0	0.1	-0.1	1.1	-1.0
Domestic, net	0.9	3.1	1.8	1.7	3.0	2.6	1.5	1.4
Financial system 6/	-1.1	-1.4	-0.6	0.3	1.2	1.2	-0.1	-0.5
Bonds 7/	2.8	3.9	2.5	2.1	2.3	2.1	1.8	1.8
Change in floating debt and accrual adjustments	-0.7	0.7	-0.2	0.7	-0.9	-0.8	0.0	0.0
Privatization (including concessions) 8/	0.0	-0.1	-0.1	0.0	-0.1	-0.1	0.0	0.0
Memorandum items								
NFPS savings	4.7	4.1	5.6	6.3	5.0	6.6	6.3	6.3
NFPS primary balance	1.5	0.4	1.7	3.1	2.7	3.0	2.7	2.7
NFPS non-oil balance	-5.3	-5.9	-5.2	-3.5	-4.2	-3.5	-3.9	-4.1
NFPS non-oil primary balance	-2.1	-1.4	-0.3	0.9	0.9	1.0	0.8	0.7

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

1/ Includes higher domestic and diesel prices announced by the authorities.

2/ Expenditure reported on commitments basis.

3/ From year 2000 includes the unpaid bills of the Social Security Institute (ISS).

4/ Includes adjustments to put spending on commitment basis and the change in unpaid bills of selected nonfinancial public enterprises.

5/ Interest payments on public banks restructuring bonds and mortgage debt relief related costs.

6/ Includes changes in public sector loans and deposits in the financial system.

7/ Includes changes in holdings of public securities by banks and nonbanks.

8/ Includes nonrecurrent fees from telecommunications licensing.

Table 3. Colombia: Operations of the Central Administration

(In percent of GDP)

	2001	2002	2003	2004	2005 Proj.	2005 Prog.	2006 Proj.	2006 Prog.
Total revenue	**14.7**	**15.0**	**13.4**	**15.6**	**16.0**	**15.7**	**16.3**	**15.7**
Current revenue	**14.7**	**15.0**	**13.4**	**15.6**	**16.0**	**15.7**	**16.3**	**15.7**
Tax revenue 1/	13.2	13.4	12.2	14.3	14.9	14.3	15.1	14.5
Net income tax and profits	5.3	5.3	4.6	6.1	6.1	5.9	6.1	6.1
Goods and services	5.9	5.8	5.5	6.2	6.6	6.2	6.8	6.3
Value-added tax	5.3	5.3	5.1	5.8	6.1	5.8	6.3	5.9
Gasoline tax	0.6	0.5	0.4	0.4	0.5	0.4	0.4	0.4
International trade	1.1	1.0	0.8	0.9	1.0	0.9	1.0	0.8
Financial transaction tax	0.8	0.7	0.6	0.9	0.9	0.8	0.9	0.8
Stamp and other taxes	0.0	0.7	0.7	0.2	0.4	0.5	0.4	0.4
Nontax revenue	1.5	1.6	1.2	1.3	1.1	1.3	1.2	1.2
Property income	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Other	1.2	1.3	1.0	1.1	0.9	1.2	1.0	1.0
Total expenditure and net lending	**20.4**	**21.4**	**17.9**	**21.0**	**21.5**	**21.8**	**22.1**	**21.9**
Current expenditure	**15.8**	**18.2**	**14.8**	**17.6**	**18.2**	**19.0**	**18.9**	**18.9**
Wages and salaries	3.0	3.0	2.6	2.8	2.8	2.8	2.7	2.8
Goods and services	1.5	1.5	1.3	1.4	1.5	1.5	1.6	1.5
Interest	3.5	3.5	3.5	3.8	3.9	4.6	4.6	4.4
External	1.6	1.7	1.6	1.6	1.4	1.8	1.5	1.7
Domestic	1.9	1.7	1.9	2.2	2.5	2.8	3.0	2.7
Other expenditure 2/	-0.9	0.7	-0.5	0.5	-0.4	-0.4	0.0	0.0
Current transfers 3/	8.6	9.5	7.8	9.1	10.4	10.5	10.2	10.1
Capital expenditure	**3.8**	**2.5**	**2.8**	**3.3**	**3.0**	**2.7**	**3.1**	**2.8**
Fixed capital formation 2/	1.3	1.3	1.0	1.4	1.1	0.7	1.1	0.8
Capital transfers	2.5	1.2	1.7	1.9	2.0	2.0	2.0	2.0
Net lending	**0.8**	**0.6**	**0.3**	**0.1**	**0.2**	**0.1**	**0.1**	**0.2**
Overall balance	**-5.7**	**-6.4**	**-4.5**	**-5.4**	**-5.5**	**-6.1**	**-5.8**	**-6.2**
Memorandum item								
Primary balance	**-2.2**	**-2.9**	**-1.0**	**-1.7**	**-1.5**	**-1.5**	**-1.2**	**-1.7**

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

1/ Excludes proceeds of financial transaction tax in 1999 from revenue and expenditure.
2/ Includes change in the budget carryover. A negative number corrects for current cash payments of expenditures incurred in previous periods.
3/ Includes interest payments to the rest of the nonfinancial public sector.

Table 4. Colombia: Public Debt and Deposits

(In percent of GDP)

	2001	2002	2003	Prel. 2004	June 2005
Total outstanding gross debt 1/	**51.8**	**60.2**	**55.9**	**52.7**	**47.5**
Domestic debt	23.2	28.3	26.3	28.7	28.0
External debt	28.5	31.9	29.6	24.0	19.5
Nonfinancial public sector gross debt	**47.0**	**55.2**	**52.0**	**49.5**	**44.6**
Domestic debt	20.1	24.9	23.4	26.2	25.6
External debt	26.9	30.3	28.6	23.3	19.0
Financial public sector gross debt	**4.7**	**5.1**	**3.9**	**3.3**	**2.9**
Domestic debt	3.1	3.4	3.0	2.5	2.4
External debt	1.6	1.6	1.0	0.7	0.5
Total public sector deposits	**9.3**	**8.2**	**8.6**	**10.3**	**11.2**
Domestic	4.4	4.8	4.8	6.4	8.4
Foreign	4.9	3.4	3.7	3.9	2.8
Nonfinancial public sector deposits	**9.3**	**8.2**	**8.6**	**10.0**	**10.6**
Domestic	4.4	4.8	4.8	6.4	8.4
Foreign	4.9	3.4	3.7	3.5	2.2
Financial public sector deposits	**0.0**	**0.0**	**0.0**	**0.3**	**0.6**
Domestic	0.0	0.0	0.0	0.0	0.0
Foreign	0.0	0.0	0.0	0.3	0.6
Total outstanding net debt 1/	**42.4**	**52.0**	**47.3**	**42.4**	**36.3**
Domestic debt	18.8	23.5	21.5	22.3	19.6
External debt	23.6	28.5	25.8	20.1	16.6
Nonfinancial public sector net debt	**37.7**	**47.0**	**43.4**	**39.5**	**34.0**
Domestic debt	15.7	20.1	18.5	19.7	**17.2**
External debt	22.1	26.9	24.8	19.7	**16.8**
Financial public sector net debt	**4.7**	**5.1**	**3.9**	**2.9**	**2.3**
Domestic debt	3.1	3.4	3.0	2.5	**2.4**
External debt	1.6	1.6	1.0	0.4	**-0.1**
Memorandum items					
Floating debt	1.7	2.0	1.5	2.2	2.7
GDP (billions of Col$)	188,559	204,530	230,467	256,862	281,015

Sources: Colombian authorities; and Fund staff estimates.

1/ Includes floating debt.

Table 5 . Colombia: Monetary Indicators

	2001	2002	2003	2004	2005 Prog.	2005 Proj.
(Billions of Colombian pesos, unless otherwise stated)						
Central bank						
Net international reserves 1/	23,027	29,576	29,544	31,533	31,682	34,888
billions of US$	10.0	10.5	10.5	13.2	12.3	15.2
Net domestic assets	-11,379	-15,471	-12,929	-12,273	-9,316	-11,680
Net credit to public sector	1,716	2,097	2,866	-199	3,938	-1,205
TES	2,016	2,363	3,193	975	4,074	3,846
Other, including deposits and REPOs	-300	-267	-327	-1,174	-136	-5,051
Net credit to financial system	1,927	3,198	4,673	3,512	4,428	3,827
Other	-15,022	-20,766	-20,469	-15,586	-17,682	-14,301
Monetary base	11,648	14,105	16,615	19,260	22,366	23,209
Currency in circulation	8,349	9,993	11,953	13,799	15,371	16,742
Banking system reserves	3,298	4,111	4,662	5,461	6,996	6,467
Banking system						
Net foreign assets	21,499	27,012	28,714	29,150	28,050	30,542
billions of US$	9.3	9.6	10.3	12.2	10.9	13.3
Net domestic assets	37,448	33,582	37,779	48,294	57,537	60,140
Net credit to public sector	11,465	13,021	14,277	13,968	18,370	14,354
Credit to private sector	46,049	47,891	52,287	58,582	67,218	68,762
Other net	-20,066	-27,329	-28,785	-24,256	-28,051	-22,976
Broad money 2/	58,946	60,594	66,493	77,444	85,587	90,682
(Annual percentage change)						
Credit to public sector, net	4.6	13.6	9.7	-2.2	37.7	2.8
Credit to private sector	1.7	4.0	9.2	12.0	14.6	17.4
Currency	14.8	19.7	19.6	15.5	11.4	21.3
Monetary base	8.8	21.1	17.8	15.9	16.1	20.5
Broad money 2/	7.2	2.8	9.7	16.5	11.1	17.1
(Percent of GDP)						
Credit to public sector, net	6.1	6.4	6.2	5.4	6.6	5.1
Credit to private sector	24.4	23.4	22.7	22.8	24.0	24.5
Currency	4.4	4.9	5.2	5.4	5.5	6.0
Monetary base	6.2	6.9	7.2	7.5	8.0	8.3
Broad money	31.3	29.6	28.9	30.2	30.5	32.3
(Annual percentage change)						
Central bank inflation target	8.0	6.0	5.9	5.5	4.5-5.5	4.5-5.5
Consumer price index	7.6	7.0	6.5	5.5	5.0	5.0
Exchange rate (+ depreciation)	2.8	25.0	-3.0	-14.0	...	...

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

1/ Assets on and liabilities to nonresident entities.
2/ Currency in circulation plus deposit liabilities of the private sector.

Table 6. Colombia: Banking System Indicators 1/

(In percent)

	2001	2002	2003	2004	2005 2/
Capital adequacy ratio (with market risk) 3/	13.0	12.6	13.1	13.8	14.2
Regulatory Tier I capital to risk weighted assets	9.3	9.7	10.5	11.0	11.6
Capital to assets	11.2	11.0	11.5	12.1	11.9
Nonperforming loans net of provisions to capital	5.6	1.1	-3.8	-11.0	-9.8
Nonperforming loans to total loans 4/5/	10.2	9.2	6.8	2.6	2.0
Classified loans 5/	18.1	16.0	12.1	6.4	5.1
Specific provisions to classified loans and leases	37.5	43.0	47.6	54.6	55.3
Sectoral distribution of loans to total loans 5/					
commercial	58.4	61.9	62.8	67.2	60.6
consumer	15.6	15.6	18.0	20.7	19.7
housing	26.0	21.7	18.1	11.4	9.0
Return on average equity	1.1	9.6	17.0	23.3	19.9
Return on average assets	0.1	1.1	1.9	2.7	2.4
Interest margin to gross income	32.7	35.5	37.4	39.4	38.5
Noninterest expenses to gross income	85.6	80.7	69.8	61.1	52.9
Personnel expenses to noninterest income	37.3	38.3	38.4	41.4	42.4
Liquid assets to total assets 6/	16.5	19.7	18.7	20.6	20.5
Liquid assets to short-term liabilities 7/	25.2	30.2	29.0	31.2	30.5
Customer deposits to total (noninterbank) loans	136.1	136.1	136.0	133.7	130.2

Sources: Superintendencia Bancaria; IFS; and Fund staff estimates.

1/ Excluding credit unions and public sector special institutions (IOE).
2/ Data to March 2005. Returns are annualized as necessary.
3/ Market risks requirements, effective only as of 2001, are weighted 60% until 2003, 80% in 2003, and 100% thereafter.
4/ Loans past-due 90 days or more (120 days or more in the case of mortgages).
5/ Loan data includes leases as of 2004.
6/ Liquid assets include cash, deposits in other financial institutions and interbank repos, and securities held for trading.
7/ Customer deposits used as proxy for short-term liabilities.

Table 7. Colombia: Balance of Payments, 2001-2006

	2001	2002	2003	2004	2005 Prog.	2005 Proj.	Proj. 2006
	(In millions of U.S. dollars)						
Current account balance	**-1,085**	**-1,332**	**-969**	**-952**	**-3,150**	**-1,263**	**-3,044**
Trade balance	579	239	567	1,368	-1,500	739	-617
Exports, f.o.b.	12,848	12,316	13,825	17,246	16,905	20,744	21,803
Coffee	764	772	809	949	1,129	1,460	1,409
Petroleum products	3,285	3,275	3,383	4,180	3,795	4,987	5,904
Nontraditional	6,613	6,287	6,250	8,223	7,789	9,539	9,540
Other	2,186	1,982	3,382	3,894	4,192	4,758	4,950
Imports, f.o.b.	12,269	12,077	13,258	15,878	18,405	20,004	22,421
Services (net)	-1,404	-1,427	-1,423	-1,773	-1,785	-1,817	-1,996
Income (net)	-2,615	-2,848	-3,446	-4,193	-3,669	-3,984	-4,470
Interest (net)	-1,738	-1,905	-2,001	-2,009	-2,026	-1,766	-1,746
Of which : public sector	-1,087	-1,262	-1,452	-1,483	-1,555	-1,371	-1,377
Other Income (net)	-877	-944	-1,445	-2,184	-1,643	-2,218	-2,724
Current transfers (net)	2,354	2,704	3,333	3,647	3,804	3,799	4,040
Financial account balance	**2,465**	**1,249**	**737**	**3,483**	**2,295**	**3,204**	**3,408**
Public sector (net)	1,442	318	369	11	-515	-1,157	604
Nonfinancial public sector	1,905	474	665	382	-481	-1,088	839
Medium- and long-term (net)	3,462	-1,093	1,457	912	-613	-840	1,837
Disbursements	5,743	2,469	4,915	2,890	3,145	4,138	3,762
Amortization	2,281	3,561	3,459	1,977	3,759	4,978	1,925
Other long-term flows	-35	-30	-30	-51	-29	-29	-29
Short term 1/	-1,522	1,597	-762	-479	161	-219	-969
Of which : change in public assets	-1,534	1,567	-582	-727	161	-101	-969
Financial public sector	-463	-156	-296	-371	-35	-69	-234
Private sector (net)	1,023	931	368	3,472	2,811	4,361	2,803
Nonfinancial private sector (net)	1,054	1,105	809	2,936	2,392	4,015	2,501
Direct investment	2,509	1,258	863	2,862	2,343	3,280	2,938
Of which : Privatization	0	0	0	0	0	0	0
Leasing finance	-211	-160	-319	-66	-214	-60	-123
Long-term loans	126	-970	-726	-1,474	337	-903	-656
Short term 2/	-1,369	976	990	1,614	-75	1,698	342
Financial private sector (net)	-31	-174	-441	536	418	346	302
Net errors and omissions	**-163**	**222**	**48**	**10**	**0**	**0**	**0**
Changes in GIR 3/	**1,217**	**138**	**-184**	**2,541**	**-855**	**1,941**	**364**
Changes in NIR, program definition 3/	**1,182**	**525**	**17**	**2,672**	**-855**	**1,960**	**364**
	(In percent of GDP)						
Current account balance	-1.3	-1.6	-1.2	-1.0	-2.8	-1.0	-2.3
	(In months of imports of goods and services)						
Gross international reserves 4/	8.0	7.8	6.6	6.7	6.5	6.8	6.7

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

1/ Includes movements of short-term assets owned by the public sector abroad.
2/ Includes net portfolio investment.
3/ Does not include valuation changes of reserves denominated in other currencies than U.S. dollars.
4/ Not including Fund purchases under the Stand-By Arrangement.

Table 8 . Colombia: Medium-Term Outlook

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Output and Prices										
(Annual percentage changes)										
Real GDP	1.5	1.9	4.1	4.1	4.0	4.0	4.0	4.0	4.0	4.0
Consumer prices										
End of period	7.6	7.0	6.5	5.5	5.0	4.5	4.0	3.5	3.0	3.0
(In percent of GDP, unless indicated otherwise)										
II. Saving and Investment										
Gross national savings	12.9	13.8	17.0	17.8	18.3	17.3	17.7	18.7	19.2	19.5
Private sector	7.9	9.8	11.4	11.4	11.8	11.6	11.0	11.7	11.9	11.8
Public sector	5.0	3.9	5.7	6.4	6.5	5.7	6.8	7.0	7.3	7.7
Gross domestic investment	14.3	15.4	18.2	18.8	19.4	19.6	20.2	20.9	21.5	22.0
Private sector	6.0	7.9	9.9	11.1	11.3	11.8	11.9	12.6	13.2	13.7
Public sector capital expenditure	8.2	7.5	8.3	7.7	8.1	7.7	8.3	8.3	8.4	8.4
External current account balance	-1.3	-1.6	-1.2	-1.0	-1.0	-2.3	-2.5	-2.2	-2.3	-2.5
III. Nonfinancial and Consolidated Public Sector										
Nonfinancial public sector										
Revenue	29.5	29.3	30.2	31.5	31.9	31.6	31.2	30.8	30.8	30.7
Expenditure	33.2	33.4	33.0	32.9	33.4	33.7	32.9	32.4	32.1	31.7
Current expenditure	24.9	25.8	24.7	25.3	25.3	25.9	24.5	24.1	23.8	23.3
Capital expenditure	8.2	7.5	8.3	7.7	8.1	7.7	8.3	8.3	8.4	8.4
Primary balance	1.3	0.5	1.9	3.1	3.0	2.7	2.7	2.7	2.7	2.7
Overall balance	-3.5	-4.1	-3.1	-1.7	-1.4	-2.0	-1.6	-1.6	-1.3	-1.0
Combined public sector balance	-3.2	-3.6	-2.6	-1.3	-1.6	-2.0	-1.6	-1.4	-1.0	-0.6
External financing	2.3	0.6	1.0	-0.3	-1.0	0.7	0.4	0.2	0.3	0.4
Domestic financing	0.9	3.1	1.7	1.7	2.6	1.4	1.2	1.2	0.8	0.3
IV. Financial System										
Velocity (GDP / broad money)	3.2	3.4	3.5	3.3	3.1	3.1	3.2	3.2	3.2	3.2
Real growth in private sector credit	-5.8	-2.2	1.9	5.8	11.5	10.7	4.0	4.0	4.0	4.0
V. Balance of Payments										
External current account balance	-1.3	-1.6	-1.2	-1.0	-1.0	-2.3	-2.5	-2.2	-2.3	-2.5
Trade balance	0.7	0.3	0.7	1.4	0.6	-0.5	-0.8	-0.7	-0.9	-1.7
Exports	15.7	15.1	17.3	17.6	17.2	16.1	16.3	16.8	17.0	16.8
Imports	15.0	14.8	16.5	16.2	16.6	16.6	17.1	17.6	18.0	18.5
Capital and financial account balance	3.0	1.5	0.9	3.6	2.7	2.5	2.7	2.6	2.8	2.9
Public sector	1.8	0.4	0.5	0.0	-1.0	0.4	0.4	0.3	0.3	0.4
Private sector	1.2	1.1	0.5	3.6	3.6	2.1	2.3	2.4	2.4	2.5
Overall balance	1.5	0.2	-0.2	2.6	1.6	0.3	0.3	0.4	0.4	0.4
VI. Debt										
Total external debt	47.5	52.3	45.9	36.8	31.2	28.7	30.2	29.2	28.5	27.7
Public debt	28.5	31.9	29.6	24.0	20.3	19.4	21.0	20.5	20.1	19.5
Private debt	19.0	20.4	16.3	12.8	10.9	9.4	9.2	8.6	8.4	8.2
Total public debt	51.8	60.2	55.9	52.7	47.8	46.4	46.6	44.6	42.4	39.8
Domestic debt	23.2	28.3	26.3	28.7	27.6	27.0	25.6	24.1	22.3	20.2
External debt	28.5	31.9	29.6	24.0	20.3	19.4	21.0	20.5	20.1	19.5
Memorandum items										
Nominal GDP (billions of Col$)	188,559	204,530	230,467	256,862	281,015	306,345	332,583	357,426	383,395	409,631
Risk Premium	602	645	430	400	300	300	300	300	300	300
US LIBOR	3.7	1.9	1.2	1.8	3.6	4.5	4.6	4.7	4.7	4.7
Crude oil, spot price	24.3	25.0	28.9	37.8	54.2	61.8	60.0	58.0	57.3	56.5

Sources: Colombian authorities; and Fund staff estimates.

Table 9. External Debt Sustainability Framework, 2001-2010
(In percent of GDP, unless otherwise indicated)

	Actual						Projections						
	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
							I. Baseline Projections						**Debt-stabilizing non-interest current account 1/**
1 **External debt**	47.5	52.3	45.9	36.8			**31.2**	**28.7**	**30.2**	**29.2**	**28.5**	**27.7**	**-1.7**
2 Change in external debt	1.5	4.8	-6.4	-9.1			-5.7	-2.4	1.4	-1.0	-0.7	-0.8	
3 Identified external debt-creating flows (4+8+9)	-3.9	7.4	-7.2	-12.2			-6.0	-3.1	0.2	-1.6	-1.3	-1.3	
4 Current account deficit, excluding interest payments	-2.1	-1.6	-1.7	-1.4			-1.2	0.3	0.4	0.1	0.3	0.5	
5 Deficit in balance of goods and services	1.0	1.7	1.0	0.4			0.9	1.9	2.3	2.3	2.5	3.3	
6 Exports	18.3	19.9	19.0	18.1			19.0	17.9	18.2	18.7	18.9	18.6	
7 Imports	19.3	21.5	20.0	18.5			19.9	19.8	20.5	21.0	21.4	21.9	
8 Net non-debt creating capital inflows (negative)	-3.0	-1.8	-1.0	-2.7			-2.7	-2.2	-2.2	-2.3	-2.3	-2.4	
9 Automatic debt dynamics 2/	1.2	10.8	-4.4	-8.2			-2.2	-1.2	1.9	0.6	0.7	0.7	
10 Contribution from nominal interest rate	3.4	3.5	2.9	2.3			2.2	2.0	2.0	2.1	2.0	2.0	
11 Contribution from real GDP growth	-0.6	-1.1	-1.9	-1.5			-1.3	-1.1	-1.1	-1.1	-1.1	-1.1	
12 Contribution from price and exchange rate changes 3/	-1.5	8.3	-5.4	-9.0			-3.1	-2.1	1.1	-0.4	-0.2	-0.2	
13 Residual, incl. change in gross foreign assets (2-3) 4/	5.3	-2.6	0.7	3.2			0.4	0.7	1.2	0.6	0.6	0.5	
External debt-to-exports ratio (in percent)	260.1	263.3	242.1	203.1			164.0	160.8	165.9	155.5	150.5	148.7	
Gross external financing need (in billions of US dollars) 5/	8.9	11.5	11.0	11.4			15.0	14.9	14.9	15.9	16.9	18.3	
in percent of GDP	10.9	16.1	13.2	10.6			12.3	11.0	10.9	11.1	11.2	11.6	
Key Macroeconomic Assumptions					10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	1.5	1.9	4.1	4.1	2.2	2.6	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-2.7	-20.0	3.1	16.3	-9.3	12.5	3.8	2.3	-7.8	-2.1	-2.4	-1.8	-2.3
GDP deflator in US dollars (change in percent)	3.4	-14.9	11.6	24.5	1.4	12.5	9.2	7.2	-3.7	1.2	0.7	0.8	1.3
Nominal external interest rate (in percent)	7.7	6.4	6.5	6.4	7.1	0.7	6.8	7.1	7.1	7.3	7.2	7.4	7.2
Growth of exports (US dollar terms, in percent)	-4.6	-5.7	10.9	23.9	6.6	9.8	19.1	4.8	1.9	8.6	5.7	3.4	4.9
Growth of imports (US dollar terms, in percent)	10.2	-3.1	7.9	19.9	9.0	38.4	22.1	10.9	3.6	8.2	6.6	7.4	7.3
Current account balance, excluding interest payments	2.1	1.6	1.7	1.4	0.3	2.9	1.2	-0.3	-0.4	-0.1	-0.3	-0.5	-0.3
Net non-debt creating capital inflows	3.0	1.8	1.0	2.7	2.4	1.1	2.7	2.2	2.2	2.3	2.3	2.4	2.3
							II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 1/**
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2006-10 6/							**31.2**	**30.3**	**29.8**	**28.7**	**27.6**	**26.3**	**-1.5**
B. Bound Tests													
B1. Nominal interest rate is at baseline plus one-half standard deviation							**31.2**	**28.8**	**30.3**	**29.4**	**28.9**	**28.2**	**-1.6**
B2. Real GDP growth is at baseline minus one-half standard deviations							**31.2**	**29.1**	**30.9**	**30.3**	**29.9**	**29.5**	**-1.5**
B3. Non-interest current account is at baseline minus one-half standard deviations							**31.2**	**30.2**	**33.2**	**33.7**	**34.6**	**35.5**	**-1.5**
B4. Combination of B1-B3 using 1/4 standard deviation shocks							**31.2**	**29.7**	**32.2**	**32.2**	**32.5**	**32.8**	**-1.4**
B5. One time 30 percent real depreciation in 2006							**31.2**	**39.8**	**41.6**	**40.1**	**39.1**	**37.8**	**-2.4**

1/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

2/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ The implied change in other key variables under this scenario is discussed in the text.

Table 10. Public Sector Debt Sustainability Framework, 2001-2010
(In percent of GDP, unless otherwise indicated)

	Actual						Projection						
	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
							I. Baseline Projections						**Debt-stabilizing primary balance 1/**
1 **Public sector debt 2/**	51.8	60.2	55.9	52.7			**47.8**	**46.4**	**46.6**	**44.6**	**42.4**	**39.8**	**1.3**
o/w foreign-currency denominated	28.5	31.9	29.6	24.0			20.3	19.4	21.0	20.5	20.1	19.5	
2 Change in public sector debt	4.0	8.5	-4.3	-3.2			-4.9	-1.4	0.2	-2.0	-2.2	-2.6	
3 Identified debt-creating flows (4+7+12)	0.9	7.1	-4.8	-8.3			-3.8	-2.3	-0.4	-1.2	-1.2	-1.3	
4 Primary deficit	-1.3	-0.5	-1.9	-3.1			-3.0	-2.7	-2.7	-2.7	-2.7	-2.7	
5 Revenue and grants	29.5	29.3	30.2	31.5			31.9	31.6	31.2	30.8	30.8	30.7	
6 Primary (noninterest) expenditure	28.2	28.9	28.3	28.5			28.9	28.9	28.5	28.2	28.2	28.0	
7 Automatic debt dynamics 3/	2.3	7.5	-2.9	-5.2			-0.9	0.4	2.3	1.4	1.5	1.3	
8 Contribution from interest rate/growth differential 4/	1.6	0.4	-2.0	-1.3			0.0	0.8	0.7	1.0	0.9	0.9	
9 Of which contribution from real interest rate	2.2	1.3	0.2	0.8			1.9	2.6	2.4	2.7	2.6	2.5	
10 Of which contribution from real GDP growth	-0.7	-0.9	-2.2	-2.1			-1.9	-1.8	-1.7	-1.7	-1.7	-1.6	
11 Contribution from exchange rate depreciation 5/	0.7	7.1	-0.9	-4.0			-0.9	-0.4	1.6	0.4	0.5	0.4	
12 Other identified debt-creating flows	0.0	0.1	0.1	0.0			0.1	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.1	0.1	0.0			0.1	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3)	3.1	1.3	0.5	5.1			-1.1	0.9	0.6	-0.8	-1.0	-1.3	
Public sector debt-to-revenue ratio 2/	175.4	205.3	185.2	167.2			150.1	146.7	149.3	144.7	137.5	129.4	
Gross financing need 6/	6.3	8.4	7.5	3.6			6.1	4.4	3.6	3.4	3.2	2.8	
in billions of U.S. dollars	5.1	6.8	6.0	3.5			7.3	6.0	4.9	4.8	4.8	4.4	
Key Macroeconomic and Fiscal Assumptions					10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	1.5	1.9	4.1	4.1	2.2	2.6	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Average nominal interest rate on public debt (in percent) 7/	11.3	9.4	8.9	8.9	11.1	1.6	9.4	10.9	10.2	9.7	9.5	9.2	9.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.1	2.9	0.7	1.8	-0.9	4.1	4.2	6.1	5.8	6.4	6.4	6.5	6.2
Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.7	-20.0	3.1	16.3	-9.3	12.5	3.8	2.3	-7.8	-2.1	-2.4	-1.8	-2.3
Inflation rate (GDP deflator, in percent)	6.2	6.4	8.2	7.1	12.0	4.8	5.2	4.8	4.4	3.3	3.1	2.7	3.7
Growth of real primary spending (deflated by GDP deflator, in percent)	5.5	4.5	1.8	4.9	4.8	6.6	5.5	4.0	2.7	2.7	4.0	3.5	3.4
Primary deficit	-1.3	-0.5	-1.9	-3.1	-0.5	1.6	-3.0	-2.7	-2.7	-2.7	-2.7	-2.7	-2.7
							II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 1/**
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2006-10 8/							**47.8**	**46.5**	**46.8**	**44.5**	**42.1**	**39.4**	**-0.8**
A2. No policy change (constant primary balance) in 2006-10							**47.8**	**44.1**	**43.9**	**41.3**	**38.6**	**35.6**	**1.2**
B. Bound Tests													
B1. Real interest rate is at baseline plus one standard deviations							**47.8**	**47.3**	**48.5**	**47.5**	**46.3**	**44.7**	**2.3**
B2. Real GDP growth is at baseline minus one-half standard deviation							**47.8**	**47.4**	**49.1**	**48.8**	**48.8**	**48.8**	**2.2**
B3. Primary balance is at baseline minus one-half standard deviation							**47.8**	**47.2**	**48.2**	**47.0**	**45.7**	**44.0**	**1.4**
B4. Combination of B1-B3 using one-quarter standard deviation shocks							**47.8**	**47.5**	**49.0**	**48.3**	**47.3**	**46.0**	**2.2**
B5. One time 30 percent real depreciation in 2006 9/							**47.8**	**54.2**	**54.8**	**53.0**	**51.1**	**48.7**	**1.6**
B6. 10 percent of GDP increase in other debt-creating flows in 2006							**47.8**	**56.4**	**57.1**	**55.4**	**53.6**	**51.3**	**1.7**

1/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.
2/ General government gross debt.
3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 11. Colombia: External Financing Requirements and Sources, 2001-2006

(In millions of U.S. dollars)

				Est.	Proj.	
	2001	2002	2003	2004	2005	2006
1. Gross financing requirements	10,197	11,616	10,957	12,299	16,458	14,276
External current account deficit	1,085	1,332	969	952	1,263	3,044
Debt amortization	7,894	10,146	10,173	8,806	13,255	10,869
Medium- and long-term debt	5,380	7,023	6,681	5,440	7,913	5,160
Public sector	2,824	3,821	3,670	2,122	5,023	2,212
Private sector	2,556	3,202	3,011	3,318	2,890	2,947
Short-term debt 1/	2,514	3,122	3,492	3,365	5,341	5,709
Public sector	199	320	429	224	391	245
Private sector	2,315	2,802	3,063	3,141	4,951	5,464
Gross reserves accumulation	1,217	138	-184	2,541	1,941	364
2. Available financing	10,197	11,616	10,957	12,299	16,458	14,276
Foreign direct investment (net)	2,509	1,258	863	2,862	3,280	2,938
Medium- and long-term debt disbursements	7,904	4,239	6,485	4,382	5,608	5,498
Public sector	5,763	2,518	4,934	2,905	4,141	3,815
Private sector	2,141	1,720	1,551	1,477	1,468	1,683
Public sector use of external assets	-1,534	1,567	-582	-727	-101	-969
Short-term debt 2/	3,122	3,492	3,365	5,341	5,709	5,966
Public sector	320	429	224	391	245	245
Private sector	2,802	3,063	3,141	4,951	5,464	5,720
Other capital flows (net) 3/	-1,804	1,061	826	441	1,962	844
Exceptional financing and arrears	0	0	0	0	0	0
Of which: IMF 4/	0	0	0	0	0	0
3. Financing gap	0	0	0	0	0	0
Memorandum items (in stocks)						
Gross international reserves	10,245	10,844	10,921	13,540	15,328	15,692
Net international reserves (traditional concept) 5/	10,192	10,841	10,916	13,536	15,323	15,686
Net international reserves (program definition) 6/	9,982	10,507	10,524	13,197	15,156	15,520

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

1/ Original maturity of less than 1 year. Stock at the end of the previous period.
2/ Original maturity of less than 1 year. Stock at the end of the current period.
3/ Includes all other net financial flows, and errors and omissions.
4/ Assumes no purchases under the Stand-by Arrangement.
5/ The traditional balance of payments concept of net international reserves, which excludes central bank short term foreign liabilities and liabilities to the Fund.
6/ In contrast to the traditional concept, foreign currency liabilities of the central bank to residents are excluded (among other things). A complete definition is given in the Technical Memorandum of Understanding (attachement II of IMF Country Report 03/181).

Table 12. Colombia: Schedule of Purchases Under the SBA, 2005-2006

Date	Amount (In millions of SDR)	Amount (In percent of quota)	Conditions
May 2, 2005	193.50	25.0	Board approval.
September 15, 2005	42.30	5.5	Observance of end-June 2005 performance criteria and completion of first review.
December 15, 2005	42.30	5.5	Observance of end-September 2005 performance criteria.
March 15, 2006	42.30	5.5	Observance of end-December 2005 performance criteria and completion of second review.
June 15, 2006	42.30	5.5	Observance of end-March 2006 performance criteria.
September 15, 2006	42.30	5.5	Observance of end-June 2006 performance criteria and completion of third review.
Total	**405.00**	**52.3**	

Source: Fund staff estimates.

Table 13. Colombia: Indicators of Capacity to Repay the Fund, 2005-10 1/

	2005	2006	2007	2008	2009	2010
Fund repurchases and charges						
In millions of SDRs	1.6	13.2	15.8	15.9	184.4	209.0
In millions of U.S. dollars	2.4	19.2	23.1	23.1	269.0	304.7
In percent of exports of goods and NFS	0.0	0.1	0.1	0.1	0.9	1.0
In percent of GDP	0.0	0.0	0.0	0.0	0.2	0.2
In percent of quota	0.2	1.7	2.0	2.0	23.8	27.0
In percent of overall debt service	0.0	0.1	0.2	0.1	1.7	1.8
In percent of gross foreign reserves	0.0	0.1	0.1	0.1	1.5	1.7
Fund credit outstanding						
In millions of SDRs	278.1	405.0	405.0	405.0	234.2	31.7
In millions of U.S. dollars	411.7	589.5	590.2	590.8	341.7	46.3
In percent of exports of goods and NFS	1.8	2.4	2.4	2.2	1.2	0.2
In percent of GDP	0.3	0.4	0.4	0.4	0.2	0.0
In percent of quota	35.9	52.3	52.3	52.3	30.3	4.1
In percent of overall debt service	2.6	4.1	4.2	3.8	2.1	0.3
In percent of gross foreign reserves	2.6	3.6	3.5	3.4	1.9	0.3
(In millions of U.S. dollars; unless otherwise stated)						
Memorandum items						
Exports of goods and NFS	23,204	24,309	24,775	26,900	28,422	29,377
Quota (millions of SDRs)	774	774	774	774	774	774
GDP	120,754	135,276	136,218	144,308	151,245	158,389
U.S. dollar per SDR (WEO projection)	1.481	1.456	1.457	1.459	1.459	1.458
Public sector external debt	24,751	26,354	28,616	29,477	30,227	30,776
Overall external debt service	16,020	14,358	14,045	15,452	16,157	17,340
Overall external debt	39,625	41,092	43,537	44,577	45,551	46,306
Gross foreign reserves	15,774	16,315	16,693	17,331	17,740	18,128

Source: Fund staff estimates.

1/ Projections assume that scheduled purchases under the proposed Stand-By Arrangement are made.

COLOMBIA: FUND RELATIONS

(As of September 30, 2005)

I. Membership Status:
Joined: December 27, 1945
Status: Article VIII

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	774.00	100.00
Fund holdings of currency	488.20	63.08
Reserve position in Fund	285.80	36.93

III. SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	114.27	100.00
Holdings	117.60	102.91

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
SBA	May 2, 2005	Nov. 2, 2006	405.00	0.00
SBA	Jan. 15, 2003	April 14, 2005	1,548.00	0.00
EFF	Dec. 20, 1999	Dec. 19, 2002	1,957.00	0.00

VI. Projected Obligations to Fund (in SDR Million):

			Forthcoming		
Type	**20005**	**2006**	**2007**	**2008**	**2009**
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.01	0.01	0.01	0.01	0.01
Total	0.01	0.01	0.01	0.01	0.01

VII. Safeguards Assessments:

An updated safeguards assessment of the Banco de la República (BRC) with respect to the new Stand-By Arrangement approved on May 2, 2005 is substantially completed and revealed no new material vulnerabilities in the BRC's safeguards framework.

VIII. Exchange Rate Arrangement:

In September 1999 the Banco de la República floated the peso. The authorities accepted the obligations of Article VIII in August 2004. At end-August 2005, the exchange rate was Col$2,304 per U.S. dollar.

IX. Last Article IV Consultation:

The 2005 Article IV consultation was concluded on April 29, 2005.

X. FSAP Participation:

The Executive Board discussed the Financial Sector Stability Assessment update (FSSA) in April, 2005.

XI. Statistics: Colombia subscribes to the SDDS. A ROSC mission visited Bogotá in September 2005.

XII. Recent Technical Assistance:

Dept.	**Purpose**	**Time of Delivery**
FAD	Advice on the reform of the budget code	March 2003
FAD	Follow-up on the reform of the budget code	November 2003
MFD	Inflation forecast under inflation target framework	May 2004
FAD	Assessment of fiscal decentralization	May 2004
STA	National Income Accounts	June 2005

XIII. Resident Representative: None.

XIV. Fourth Amendment: Colombia has accepted this amendment.

COLOMBIA: WORLD BANK RELATIONS[1]

The World Bank and Colombia's Development Strategy

Colombia's National Development Plan is built on four pillars: (i) provide security to all Colombians; (ii) foster sustainable economic growth and employment generation under macroeconomic and price stability; (iii) build a more equitable society; and (iv) increase the transparency and efficiency of the State. The World Bank Group's (WBG's) strategy seeks to support Colombia's quest for development and peace. The Country Assistance Strategy (CAS) for Colombia was discussed by the Bank's Board in January 2003 and since then Colombia has received about US$2 billion in loans, of which nearly 60 percent consists of fast-disbursing operations. A CAS Progress Report in being prepared for fall 2005.

The World Bank Program for FY 2005–06

In line with the CAS, since June 2004, the IBRD has continued the preparation of adjustment loans to support fiscal adjustment, financial sector adjustment, the labor and social sector reform, and environmental management. Labor and social sector reforms are being supported by a development policy loan and a technical assistance loan that aims to improve knowledge, develop effective instruments, and strengthening ability to carry out such reforms. The environment development policy loan is being complemented by a technical assistance loan to support the inclusion of environmental and social policies in government programs and to strengthen the capacity of the major relevant institutions.

The WBG's International Bank for Reconstruction and Development (IBRD) will also support a program in the infrastructure sector, and a program to increase the business productivity and efficiency. In particular, in the water sector the IBRD will support a project in the Guajira region. The Bank's support for the Government of Colombia's program for promoting greater business productivity would consist of a three-phased programmatic development policy lending operation. The first phase focuses on making improvements in the regulatory framework; and improving access to financial services for micro, small and medium enterprises. The WBG's International Finance Corporation (IFC) focuses on supporting new forms of public-private partnerships, while the Multilateral Investment Guarantee Agency (MIGA) focuses on the provision of political risk guarantees for private sector investments; hands-on technical assistance for investment promotion intermediaries; and the dissemination of information on investment opportunities in Colombia.

[1] Prepared by World Bank staff. Questions may be addressed to Ms. Keta Ruiz, Senior Country Officer, at (202) 473-0137 or kruiz@worldbank.org.

Bank-Fund Collaboration in Specific Areas

The WBG is helping Colombia implement its reform agenda in the following areas of Bank-Fund collaboration:

- Assisting fiscal reforms, notably reforming the tax system, strengthening tax administration, implementing a fiscal responsibility law, and reforming the public sector.
- Reforming the pension and social security systems.
- Fostering financial sector and capital market developments.
- Broadening and deepening the scope of Colombia's anticorruption program.
- Combating money laundering.

Operations Portfolio (IBRD/IDA and grants)
As of September 9, 2005
(In millions of U.S. dollars)

Closed Projects	**165**
Active Projects	**20**
IBRD/IDA *	
Total Disbursed (Active)	239.51
Of which has been repaid	3.70
Total Disbursed (Closed)	10,295.08
Of which has been repaid	8,535.45
Total Disbursed (Active + Closed)	10,534.59
Of which has been repaid	8,539.15
Total Undisbursed (Active)	1,109.65
Total Undisbursed (Closed)	0.0
Total Undisbursed (Active + Closed)	1,109.65

Loan Information (IBRD)
As of September 9, 2005
(In millions of U.S. dollars)

Fiscal Year (July 1-June 30)	2001	2002	2003	2004	2005
Total disbursements	264	369	948	491	567
Repayment amount	225	243	223	205	254
Net disbursements	39	126	725	286	313

IFC Operations
As of June 30, 2005
(In millions of U.S. dollars)

	Loans	**Equity (+Quasi)**	**Participation**	**Total**
Total commitments	264.7	118.3	115.9	498.9
Total undisbursed	24.3	84.6	0.0	108.9

COLOMBIA: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK[1]

(As of August 31, 2005)

I. Background and Objectives

In September 2003, the IADB Board of Directors approved the Bank's strategy for Colombia for the period 2003–2006. The strategy identifies three overarching objectives: (i) lay the foundations for economic revival and jump-starting growth; (ii) foster social progress and make sure society's most vulnerable are protected; and (iii) strengthen governance and further modernization of the State. These objectives constitute the framework for the Bank activities in Colombia.

To help **reinvigorate the economy** the Bank is working to foster competitiveness and will support agricultural development and natural resources management. **To foster social progress and ensure that society's most vulnerable are protected**, Bank's actions will improve social protection systems and will promote the coverage, quality, and efficiency of essential social services. In the **governance and modernization of the State** area the Bank will support national public sector reforms and local governments management capacity building, moreover, the Bank will promote initiatives to foster transparency and combat corruption, and will support judicial branch reforms.

From the Bank's standpoint, the implementation of the strategy is constrained by the country's fiscal deficit and security issues. Both constraints have implications for the size of the lending program, the mix of lending and non-lending products, and the prospects for achieving the strategy objectives.

The Bank is initialing the process of preparation of a new country Strategy for Colombia that will cover the period 2007–2010.

II. LENDING

As of August 31, 2005 the country's portfolio consists of 25 loans an amount equivalent to US$1,549 million. These resources are distributed among 24 investment loans (US$949 million) and one policy-based loans (US$600 million). In addition, the country portfolio with Colombia includes 44 non-reimbursable technical cooperation (US$25,7 million). Through the Multilateral Investment Fund (MIF), which finances private sector investment projects, Colombia has 30 non-reimbursable operations (US$28.3 million). The IIC has 7 active projects totaling US$71 millions, and the Private Sector has active two operations totaling US$20 million.

[1] Prepared by IADB staff. Questions may be addressed to Mr. Kim Staking, Country Economist, at (202) 623-3003 or kims@iadb.org.

In 2004 six loans for US$737 million were approved. These operations include policy-based loans to support the Public Utilities Reform (US$600 million). In 2005, the Bank has approved one loan for US$ 107 million and estimates the approval of five additional investment loans totaling US$ 514 million (in the areas of transportation, health, education, citizens security, energy and agriculture).

COLOMBIA: FINANCIAL RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK
(As of August 31, 2005)

I. IDB OPERATIONS
(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed amounts
Agricultural and rural development	14.5	9.6	4.9
Modernization of State	674.3	240.0	434.3
Social Investment	418.2	238.9	179.3
Education	26.0	16.1	9.9
Health	110.0	62.6	47.4
Sanitation	49.4	32.9	16.5
Natural resource management	55.4	31.9	23.5
Urban development and household	180.0	36.0	144.0
Transportation	21.7	14.9	6.8
Grand total	**1,549.5**	**682.9**	**866.6**

II. IDB LOAN TRANSACTIONS
(In millions of U.S. dollars)

	1999	2000	2001	2002	2003	2004	2005*	2006*
Gross disbursement	952.4	241.2	785.3	151.8	2,011.7	329.6	590.4	668.6
Amortization, interest and contributions	445.8	473.2	408.2	819.4	1,017.5	661.3	1,790.6	463.7
Net cash flow	506.6	-232.0	377.1	-667.6	994.2	-331.7	-1,200.2	204.9

(*) Projections. Note: 2005 included prepayment of Emergency Loan (US$1,250 million) issued in 2003.
Source: IADB.

Bogotá, Colombia

September 26, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

So far in 2005, Colombia's economy has continued to perform well, supported by prudent economic policies as well as a favorable external environment. We appreciate the Fund's support through the 18-month Stand-By Arrangement (SBA) approved in April 2005, which is designed to help preserve the credibility of our economic policies during the upcoming political transition and to provide for a smooth exit from formal Fund support. The government will continue to treat the arrangement as precautionary.

We are requesting the completion of the first review under this arrangement. All quantitative performance criteria at end-June 2005 have been observed and all structural benchmarks have been met (Tables 1 and 2). Moreover, we are strengthening our economic policies in 2005 to lock in the better than expected fiscal performance in the first half of this year. The attached Memorandum of Economic Policies (MEP)—which supplements our MEP of April 13, 2005—describes these policies. Most importantly, the government is now targeting a combined public sector deficit of 1.6 percent of GDP in 2005, well below the original program target of 2.5 percent of GDP. For this reason, we are requesting the modification of the quantitative performance criteria for the combined public sector deficit for end-September and end-December 2005. We are also requesting a waiver for the nonobservance of the performance criterion calling for congressional approval of the revised budget code by June 2005. We remain fully committed to introducing the key elements of this reform and have identified corrective measures in the attached MEP. Finally, since the Board is expected to consider this review in October before the full information for end-September becomes available, we are requesting a waiver of the applicability of the quantitative performance criteria for end-September 2005.

Sincerely yours,

/s/	/s/
Alberto Carrasquilla Minister of Finance and Public Credit	José Dario Uribe General Manager Banco de la República

Attachments

MEMORANDUM OF ECONOMIC POLICIES

Achievements

1. So far this year, the economy has continued to perform very well, surpassing expectations in key areas. Real GDP is growing at a pace of 4 percent a year, supported by improving confidence, strong growth in real investment, and robust growth in exports. Inflation through August fell to 4.9 percent year-on-year, with moderate increases in prices of both traded and nontraded goods. Exports have grown by 37 percent through June, supported not only by high world prices for oil and coal but also by a vigorous expansion in nontraditional exports. Imports have also grown rapidly, led by imports of capital and intermediate goods. At the same time there are clear signs that foreign direct investment is picking up significantly in many sectors, especially oil, coal, and telecommunications. SABMiller—one of the world's leading producers of beverages—purchased Bavaria, a Colombian-owned multinational also specializing in beverages.

2. Fiscal consolidation has moved ahead more rapidly. Through June, the combined public sector (CPS) registered a surplus of 0.8 percent of annual GDP, compared with a program target of a deficit of 0.5 percent of GDP in that period. Net savings have accrued from better-than-expected tax collections, additional revenues from high world oil prices, and lower interest payments resulting from the decline in domestic interest rates. Moreover, territorial governments ran a surplus estimated at 0.7 percent of annual GDP.

3. Structural reforms have advanced. In June 2005, Congress approved the new securities market law and the pension reform (the third such reform under this government). The pension reform cut the actuarial deficit of the pension system by 19 percent of GDP, about two-thirds of the savings sought by the government. However, and in spite of the government's best intentions and effort, the revised budget code was not approved, although—as explained below—we plan corrective actions in this area.

4. The Banco de la República continued to ably manage monetary policy. In the first eight months of the year, it kept its policy interest rate constant at 6.5 percent, while purchasing US$2.8 billion of foreign exchange to restrain the appreciation of the peso. Drawing on the strength of fiscal policy, the government built up its deposits at the central bank by Col$5.5 billion in this period, allowing for full sterilization of the intervention without putting pressure on short-term interest rates. In September, the Banco de la República lowered its policy interest rate by 50 basis points to 6 percent, consistent with the favorable outlook for inflation.

5. The financial system has strengthened. The solvency and profitability of the banking system has recovered, reflecting a recovery in the growth of the loan portfolio in tandem with stronger macroeconomic conditions. Nonperforming loans declined to about 3 percent of total loans by end-June 2005 and are fully covered by provisions. Furthermore, solvency indicators are at the highest level since the 1998–99 crisis.

Near-term policy outlook

6. The government intends to strengthen further the medium-term policy framework to lock in the favorable performance so far this year. The economy is expected to continue growing at an annual rate of 4 percent, while inflation would decline to the range of 2-4 percent over the medium term. Fiscal policy will be able to bring public debt closer to 40 percent of GDP by 2010, as the government plans to tighten the target for the CPS deficit in 2005. Moreover, the outlook for the external sector is now more favorable than envisaged in the program. Benefiting from the strength of the terms of trade and the strong growth in non-oil exports this year, the external current account deficit is now projected to amount to 1 percent of GDP in 2005 and to remain below 2.5 percent of GDP for the rest of the decade. Net international reserves are expected to reach US$15.2 billion by end-2005 (140 percent of short-term debt at a remaining maturity), reflecting the foreign exchange intervention and sales of foreign exchange to the government through August 2005, and to rise gradually over the medium term, consistent with maintaining exchange rate flexibility and the inflation targeting framework.

Macroeconomic Framework: Main Elements 2003-10

			2005		Projections		
	2003	2004	Prog.	Proj.	2006	2007	2010
Real growth	4.1	4.1	4.0	4.0	4.0	4.0	4.0
Inflation 1/	6.5	5.5	5.0	5.0	4.5	4.0	3.0
	(In percent of GDP)						
External current account balance 2/	-1.5	-1.0	-2.8	-1.0	-2.3	-2.5	-2.5
NFPS primary balance 3/	1.7	2.7	2.7	3.1	2.7	2.7	2.7
Combined public sector balance 3/	-2.7	-1.3	-2.5	-1.6	-2.0	-1.7	-1.0
Total public debt	56.0	52.9	50.4	48.3	46.8	46.6	39.8
Public deposits	8.6	10.6	…	…	…	…	…
	(In billions of U.S. dollars)						
Net international reserves 4/	10.5	13.2	12.3	15.2	15.5	15.9	17.9
	(In U.S. dollars per barrel)						
Crude oil, spot price 5/	28.9	37.8	40.5	54.2	61.8	60.0	56.5

1/ For 2007 and beyond, inflation projection consistent with achieving medium-term inflation target of 2 to 4 percent a year.
2/ At projected WEO price of oil in 2005-06, adjusted to reflect Colombia export price.
3/ For 2005, based on the projected WEO oil price. For 2006, assumes a baseline export price of US$32 per barrel.
4/ IMF Defintion. Takes into account the prepayment of the IDB loan in 2005.
5/ Petroleum price is average of spot prices for UK Brent, Dubai, and West Texas Intermediate.

Fiscal policy

7. The government will lower the 2005 target for the CPS deficit to 1.6 percent of GDP (below the original program target of 2.5 percent of GDP), reflecting a decline in the deficit of the central administration of 0.6 percent of GDP to 5.5 percent of GDP. This lower target also takes into account the effects of additional revenues of 0.4 percent of GDP from the higher export price of oil (about US$48 per barrel for 2005), and for this reason, this target will not be adjusted downward for any further increases in the export price of oil. This stronger fiscal position will help reduce the total public debt ratio to close to 48 percent of GDP by end-2005. The revised targets for the CPS deficit at end-September and end-December 2005 are presented in the attached TMU.

8. For 2006, the CPS deficit will amount to 2 percent of GDP, as envisaged, based on an assumed baseline export price of oil of US$32 per barrel. In 2006 total revenues are expected to remain stable in relation to GDP, while interest payments and pension costs will rise slightly as a share of GDP. The government will continue to ensure that spending stays on a sustainable path, even if world oil prices stay exceptionally high. At the time of the second review, we will revisit the target for the CPS deficit in 2006 taking into account several factors, and will continue to save a significant share of any oil price windfall.

9. In 2005, total public revenues are expected to rise to 31.9 percent of GDP, compared with 31.2 percent of GDP envisaged in the program. Reflecting improved tax administration, tax revenues are now projected to rise to over 21 percent of GDP, while Ecopetrol will generate a significant operating surplus. At the same time, the government will not submit a supplemental budget to Congress, which will help limit total public expenditures to 33.4 percent of GDP, somewhat less than expected. The public sector is taking advantage of lower-than-expected interest payments to curtail current expenditure and to allow for more public investment. The deficit of the central government (the central administration, social security and the national decentralized agencies) is projected to decline to 3 percent of GDP in 2005, well below the deficit of 4.1 percent of GDP expected in the program. Territorial governments and local enterprises are expected to register a surplus of 1.1 percent of GDP, as the earlier concerns of a surge in spending by these entities are not likely to materialize this year.

10. The government will take additional measures to reduce the vulnerability of the public debt, including to exchange rate fluctuations. In 2005, it will seek to limit net foreign currency financing to minus 0.4 percent of GDP, as targeted in the indicative quarterly limits presented in the TMU. The government has prepaid about US$2 billion of external debt so far this year, and announced a plan to purchase at least US$3 billion from the central bank to retire more external debt. It will finance these purchases through the use of government deposits as well as the issuance of local-currency denominated government securities. The government will continue to refrain from introducing export subsidies to address concerns about the effects of the peso appreciation. The government will continue to provide a transparent accounting of the stock of all its foreign currency derivative transactions and positions, including an estimate of the possible fiscal impact of adverse movements in the

exchange rate, and to give the Banco de la República a schedule of its planned forward operations. The government will limit the stock of its net forward sales of foreign exchange to no more than US$100 million.

11. For 2005–06, we intend to press ahead with the following structural fiscal reforms (Table 2):

- *Budget code.* The government remains committed to adopt the reforms contained in the revised budget code proposal that failed to be approved in Congress. The Fiscal Responsibility Law approved in 2003 already addressed several of the reforms in the budget code, including presenting to Congress medium-term fiscal projections and a midyear report on fiscal policy and establishing limits on multiyear spending commitments. With the planned tightening of fiscal policy and in particular the decision not to introduce a supplemental budget in 2005, the government will be able to reduce the stock of floating debt *(rezago presupuestal)* from 2.2 percent of GDP at end-2004 to 1.1 percent of GDP by end-2006. By October 2005, the government will issue a decree that preserves as many elements of the revised budget code as possible that do not require legislation. This decree will include steps in several areas, including to classify expenditure according to international standards. The decree will also take initial steps to scale back revenue earmarking. By March 2006, the government will prepare draft legislation to limit all earmarked revenues not mandated by the constitution**.** We will work closely with international financial institutions in these areas.

- *Public enterprise reform.* The government is in the process of selling a majority stake in the state telecommunications company (Telecom) to private firms. This operation will yield important benefits by widening access to telephone service at lower costs and by helping to cover the net pension costs of Telecom. The government is also planning to undertake the modernization of the Cartagena refinery (a US$800 million project) in the context of a joint venture, with Ecopetrol to hold a share of up to 49 percent or US$250 million. The process of finding a private partner will be completed by end-June 2006 (structural benchmark). Ecogas, which operates the country's natural gas pipelines, will be brought to the point of sale by end-2005. An investment bank has been hired to prepare several regional electricity firms (Empresa de Energía de Cundinamarca, Electrificadora del Meta, Empresa de Energía de Boyaca, Electrificadora de Santander and Centrales Eléctricas del Norte de Santander SA) to be brought to the point of sale by June 2006.

- *Improving information on operations of all levels of government.* The government has been working on assessing the quality of subnational level information. For such purposes a sample of 70 entities, from all levels of government, has been selected to be monitored in order to verify quality of the data. The objective is to attain high quality information on a quarterly basis. Additionally, the MHCP has adopted a unified format for processing subnational level information in order to guarantee that the data from the Contaduria General de la Nación is correctly translated into fiscal figures. More complete, up-to-date information on the operations of all levels of government will allow for better monitoring of the fiscal position and for better coordination of monetary and fiscal policies. Additionally the MHCP has committed to strengthen its relationship with subnational governments in order to facilitate the information flow and thereby increase transparency and clarity regarding fiscal information at the subnational level. For this purpose, the MHCP will aim at obtaining budget execution information on a quarterly basis as well as the outlook for the remainder of the fiscal year for a sample of 10 large subnational governments. By December 2005, the government will publish the upgraded historical information on the operations of all levels of government.

- *Tax reform* The government remains fully committed to improving the efficiency of the tax system, and is preparing a tax reform that could be introduced by the next government. This reform would simplify the VAT, including by reducing the number of rates, and the income tax and reduce distortionary taxes.

- *Domestic fuel pricing*. In the near future, the ministry of mines intends to raise the reference medium-term price of oil from US$35 per barrel to at least US$40 per barrel, with a view to further narrowing the gap between domestic wholesale prices of gasoline and diesel and the cost of importing these products.

Monetary and exchange rate policy

12. The Banco de la República remains fully committed to reducing inflation to a range of 4½ to 5½ percent during 2005. Inflation expectations both from surveys to market participants as those implicit in financial instruments continue to be well-anchored. As always the central bank stands ready to take actions as needed to achieve the inflation target. It may continue to intervene in the foreign exchange market to limit the speed and depth of the appreciation of the peso. However, the Banco de la República will continue to attach top priority to achieving its inflation target.

Financial sector

13. Colombia is continuing to strengthen financial supervision along the lines presented in our April 2005 MEP. Moreover, FOGAFIN brought Granahorrar to the point of sale in July 2005, ahead of schedule, and began to liquidate the Banco del Estado—a bank that ceased operations with the public in June 2000 but still manages a large portfolio of nonperforming loans. FOGAFIN is working with the Monetary and Financial Systems Department from the Fund to develop a corporate governance framework for the new Granbanco and Banco Agrario. By January 2006, the government will complete the merger of the superintendencies of financial institutions and of securities, which is a crucial step forward to allow for effective consolidated supervision in modern financial markets. The government will request technical assistance from the Monetary and Financial Systems Department to strengthen financial supervision further.

14. Following the approval of the new securities law in June 2005, the government will move quickly to adopt the regulations necessary for the full implementation of the law, so that Colombia's capital markets can start benefiting from the new legal environment. The government is also working with the International Capital Markets Department of the Fund to develop further the use of hedging instruments to strengthen risk management in the financial system.

Other issues

15. As envisaged, the second review under this program is to be completed by March 2006 and will focus on reaching detailed understandings on policies for 2006, including specific plans for structural reforms during 2006. The third review (to be completed by September 2006) will concentrate on economic performance in 2006 under the program.

16. The government continues to believe that the policies set forth in this Memorandum of Economic and Financial Policies (MEFP) are adequate to achieve the objectives of its program, and as usual we will maintain a close policy dialogue with the Fund. We stand ready to take additional measures, as necessary, to achieve the objectives of the program. The Fund's management or the authorities can request a consultation on the stance of policies when appropriate.

Table 1. Colombia: Performance Criteria for 2005-2006 Program 1/

		2005			
		Indicative			
	Outturn	Targets	Performance Criteria		
	Dec. 31, 2004	Mar. 31	Jun. 30	Sept. 30	Dec. 31
I. Performance Criteria					
Cumulative flows from beginning of calendar year (In billions of Colombian pesos)					
Overall balance of the combined public sector					
Ceiling 2/	…				
Original		-1,485	-1,393	-3,403	-6,890
Modified		…	…	0	-4,557
Outturn	-3,447	-1,509	2,244	…	…
Margin (+) or shortfall (-)	…	-24	3,637	…	…
Inflation rate 3/ (12-month inflation rate)					
Inflation - Consultation band					
Upper limit	…	6.5	6.3	6.2	6.0
Target	…	5.5	5.3	5.2	5.0
Lower limit	…	4.5	4.3	4.2	4.0
Outturn	5.5	5.0	4.8	…	...
(In millions of U.S. dollars)					
Net international reserves of the Banco de la Republica					
Floor	…	12,215	12,215	12,215	12,215
Outturn	13,195	12,645	13,560 ...		…
Margin (+) or shortfall (-)	…	430	1,345	…	…
Change in the outstanding stock of short-term external debt of the public sector					
Ceiling	…	200	200	200	200
Outturn	…	-145	-162	…	…
Margin (+) or shortfall (-)	…	345	362	…	…
II. Indicative Targets					
Cumulative net disbursement from beginning of calendar year (In millions of U.S. dollars)					
Net disbursement of foreign currency debt to the public sector					
Ceiling	...	300	-800	-650	-750
Outturn	…	-1,101	-1,739	…	…
Margin (+) or shortfall (-)	…	1,401	939	…	…

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

1/ Definitions of concepts and adjustments to the performance criteria are explained in the technical memorandum of understanding (TMU) attached to EBS/05/63.

2/ The indicative ceiling for March 2005 has been adjusted downward by Col$121 billion and the performance criterion for June 2005 has been adjusted downward by Col$121 billion, in accordance with the adjustor explained the TMU attached to IMF Country Report 05/154.

3/ Deviations from the quarterly path for inflation will trigger consultations with the Fund, as set out in the TMU.

Table 2. Colombia: Structural Conditionality Under the 2005-2006 Program SBA[1]

	Prior Action	Status
	Issue circular that requires banks to treat the annexes pertaining to their operations with the nonfinancial public sector as part of their reports on their balance sheets.	Done.
	Structural Performance Criteria	
June 30, 2005	Congressional approval of the changes to the Budget Code. The revision will (a) adopt a budget classification according to international standards that fits into the context of Colombia's legal framework; (b) require that the annual budget law include information on tax expenditures, quasifiscal activities, subsidies, contingent fiscal liabilities, medium-term fiscal projections, and a fiscal sustainability analysis; (c) establish a mid-year budget report to Congress; (d) gradually phase out most revenue earmarking not mandated by the constitution by subjecting these earmarking provisions to explicit sunset provisions; (e) limit the budget carry over by eliminating the "reserva presupuestal"; and (f) limit the power of the government to make spending commitments for future years on projects not authorized under the Development Plan.	Not observed. Several of these issues have been addressed in the context of the Fiscal Responsibility Law approved in 2003. The authorities are reducing the budget carry over, and will begin to limit revenue earmarking in the context of a decree and draft legislation.
July, 31 2005	Submission to Congress of 2006 budget consistent with combined public sector deficit of 2.0 percent of GDP in 2006.	Done.
	Structural Benchmarks	
June 30, 2005	Congressional approval of a constitutional amendment to eliminate special pension regimes, end 14th monthly pension and cap maximum pension at no more than 25 minimum salaries. Congressional approval of new securities law.	Done. Done.
September 30, 2005	Issue the regulations needed to improve the quality of information reported for the operations of local and regional governments.	
October 31, 2005	*Issue decree that adopts as many elements of the revised budget code as possible, including a requirement to present expenditure according to an international classification system.*	
December 31, 2005	Publish a report evaluating the current system of sharing revenue among the different levels of government. Bring Granahorrar to the point of sale.	 Done.
March 30, 2006	*Prepare draft law on revenue earmarking not mandated by the constitution.*	
June 30, 2006	*Complete issuance of all regulations needed to fully implement the securities market law approved in June 2005.* *Complete process of finding private investor for joint venture to modernize the Cartagena refinery.*	

[1] New measures presented in italics.

COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This Technical Memorandum of Understanding (TMU) is a supplement to the TMU dated April 13, 2005.

I. FISCAL TARGETS

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

2. The quarterly targets for September and December 2005 for the overall balance of the **combined public sector (CPS)** will be modified as follows:

	Ceiling (In Billions of Colombian Pesos)
Overall deficit of the combined public sector	
From January 1, 2005 to:	
March 31, 2005 (indicative target)	1,606
June 30, 2005 (original performance criterion)	1,514
September 30, 2005 (modified performance criterion)	0
December 31, 2005 (modified performance criterion)	4,557

[1] As indicated in the April 2005 TMU, measured by the net financing.

Adjustment

3. The fiscal targets for 2005 and 2006 will no longer be subject to an adjustor for a windfall arising from higher world oil prices. The issue of how to handle the effects of higher world oil prices in 2006 will be revisited at the time of the second review.

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FOR IMMEDIATE RELEASE
October 24, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under the Stand-By Arrangement for Colombia

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Colombia's performance under an 18-month SDR 405 million (about US$ 583.8 million) Stand-By Arrangement approved on April 29, 2005 (see Press Release No. 05/95). The Board has also approved a modification of performance criteria in order to lower the combined public sector deficit target, and granted a waiver for the nonobservance of the end June 2005 structural performance criterion on congressional approval of changes to the budget code on the basis of several corrective measures, including steps already adopted. The Board also granted waivers of applicability for the end-September 2005 quantitative performance criteria on the combined public sector deficit and on the net disbursement of short-term external debt of the public sector.

Completion of this review makes an amount equivalent to SDR 42.3 million (about US$ 61.0 million) immediately available to Colombia, in addition to SDR 193.5 million (about US$ 278.9 million) made available initially upon the program's approval. However, the authorities continue to treat the arrangement as precautionary, and do not intend to draw on the credit available.

Following the Executive Board's discussion of Colombia, Ms. Anne O. Krueger, First Deputy Managing Director and Acting Chair, made the following statement:

"The authorities' strong economic policies are allowing the economy to benefit from the favorable global economic environment. In 2005, real GDP is expected to rise by 4 percent, reducing unemployment further, while inflation will remain at its lowest level in decades. The external sector has strengthened, benefiting from high world commodity prices, robust growth in nontraditional exports, and strong inflows of foreign direct investment. The government has lowered the 2005 target for the combined public sector deficit to below the original target, from 2.5 to 1.6 percent of GDP. This improvement in the fiscal position results from gains in tax administration, as well as continued control over spending and the effect of higher oil prices. Monetary policy continues to aim at achieving the inflation target, in the context of a managed float exchange rate policy.

"The economic outlook for 2006 is favorable, with good prospects for sustained growth and declining inflation. Fiscal policy is set to remain prudent, with a combined public sector deficit of no more than 2 percent of GDP. Moreover, the authorities also intend to save most of any oil price windfall accruing to the public sector, which will help keep the public debt on a declining path.

"Structural reforms are continuing to advance. The pension reform and the Securities Market Law were approved. The authorities have already adopted several key elements of the revised budget code that had been before Congress, and intend to implement as many of the remaining elements as possible through executive action. Financial supervision will continue to strengthen. The government intends to build political support for additional key medium-term reforms, such as strengthening tax policy, improving the system of revenue sharing, and reducing the extent of revenue earmarking.

"These policies will help lay the foundation for continued growth over the medium term and for a smooth exit by Colombia from financial support from the Fund," Ms. Krueger said.

Statement by Roberto Steiner, Alternate Executive Director for Colombia

On behalf of my authorities, I would like to thank staff and Management for their continued support of Colombia. Timely implementation of the precautionary SBA should allow for exit from Fund support upon program expiration in late 2006.

Recent macroeconomic developments

The Colombian economy continues to perform well. In the second quarter, GDP growth was 5.3 percent y-o-y, surpassing expectations. The expansion continues to be broad based, with household consumption increasing 6 percent, investment 25 percent and exports 8 percent. During the first semester growth reached 4.6 percent, making it very likely that the projection of 4 percent for 2005 will be achieved. Unemployment has declined to 11.8 percent, compared to the 16 percent prevailing when the current administration took office in 2002.

The central bank's strategy of reducing inflation towards the 2 to 4 percent range remains on track. Notwithstanding a yearly increase of 8.8 percent in "administered prices" – namely gasoline and utilities –, at end-September 12-month accumulated inflation was 5 percent, the mid-point target for end 2005. Expectations remain well-anchored and the central bank's forecasting models suggest that inflation 18 months ahead is consistent with the envisioned target. The central bank is fully committed to meeting its inflation target and is willing to undertake a variety of measures – i.e. re-opening its contractionary window, hiking its policy interest rate, or discontinuing its foreign exchange market intervention – in case expectations deviate from announced targets.

Domestic and external factors continue to coalesce to exert upward pressure on the peso. On the domestic front, a strong and credible macro framework and improved security are delivering strong net capital inflows, including historically high levels of FDI. Externally, the situation remains favorable, with improved terms of trade and ample availability of foreign financing. Notwithstanding the $1.7 billion increase in reserves in the year to September – including interest received and net of sales to the government of $2 billion– the peso has appreciated by 4.2 percent against the dollar since end-2004. This appreciation comes on top of a 14 percent appreciation in 2004. Since end-2002, the real effective exchange rate has strengthened by 19 percent. Most of the monetary effect of NIR accumulation has been sterilized. In a context of strengthened confidence and increased demand for peso-denominated assets, it has been feasible to re-build the NIR position and ameliorate the *pace* of appreciation, while not observing any pick-up in inflation expectations in spite of the relatively strong growth of monetary aggregates.

Fiscal results have been better than expected, and the government has tightened the 2005 target to lock in this over-performance. Improved tax administration has delivered impressive results. There is now in place an integrated information system that facilitates comparison of tax returns with other sources. Large taxpayers can now file returns electronically – and this will become mandatory for some fifty thousand taxpayers in 2006. In addition, the surge in imports, particularly of capital goods, has brought about an increase in trade-related taxes. With regard to expenditure, a stronger peso and the strength of the local bond market have produced a decline in interest payments, and these results have been complemented with the solid performance of regional governments, which are again delivering a surplus. Reforms undertaken during the last five years – including strict limits on borrowing, adherence to rules akin to a fiscal responsibility law, and a decoupling of transfers from current revenue – continue to produce positive results. The government has decided not to introduce a supplementary budget in 2005, thereby removing a potential source of vulnerability, namely pressures for increased spending in the run up to the elections.

In spite of Colombia being an oil exporter, high prices have had only a limited effect on the fiscal position. A number of factors account for this result. First, the quality of the oil mix is worsening as lighter-grade reserves are gradually depleted. As a result, the export price for crude declined from 92 percent of the WTI reference price in 2003 to 83 percent in 2004. Second, although the international reference price used to set domestic fuel prices is updated often, it has not kept pace with world prices. It has recently been decided that the reference price will continue increasing, until it reaches $48.45 per barrel in 2007. Since the state-run oil company has to pay international prices for the fuel it refines for local consumption, at the margin the oil windfall is to a certain extent a transfer from Ecopetrol to local distributors and consumers. Other beneficiaries of high prices are local governments through royalties and Ecopetrol's almost fully-funded pension system. While the government remains committed to further rationalizing subsidies, it is unrealistic to think of a complete pass-through of world prices to consumers. It is worth noting that the 2006 budget is based on a price of $32 per barrel for the Colombia mix, or around $38 per barrel of WTI.

Staff suggests the possibility of revisiting the indicative fiscal deficit target established for 2006 during the next review. Recent improvements in the fiscal position are indeed clear and have permanent components. Hence, several policy options emerge. One, of course, is to increase the targeted primary surplus beyond 2.7 percent of GDP. My authorities welcome the invitation to discuss this option, but would like to note that, as the staff report shows, the debt burden has been declining faster than anticipated in the medium-term fiscal framework. Under reasonable assumptions, with a primary surplus of 2.7 percent of GDP the debt burden will continue on a declining trend. Tightening the fiscal stance further is a call to favor retiring debt at a faster pace above other alternative uses, including enhancing infrastructure, improving security, or reducing the tax burden from the most distortionary taxes, all of which have an important bearing on long-run growth and debt dynamics as well.

Colombia has made good use of the benign external environment. Not only has the fiscal position been stronger than anticipated and, therefore, the pace of debt-burden reduction faster, but also the currency composition and maturity of debt has improved markedly, further contributing to reducing vulnerabilities. A recent detailed description and positive evaluation of Colombia's debt management operations, which my authorities appreciated, appeared in the September 28 edition of ICM's *Global Markets Monitor*.

The banking sector remains strong. While credit to the private sector is growing at a solid pace of 5 percent in real terms, profitability has returned to pre-1999 crisis levels, non-performing loans are around 3 percent, and their coverage surpasses 140 percent. Supervision continues to be strengthened and, to facilitate consolidated supervision, the merger of the banking and the securities supervisory agencies should be completed by January 2006.

Structural reforms

Since the program was approved in April, progress has been made on several fronts. In June, Congress approved, with modifications, the pension reform proposed by the government, including phasing out special regimes, eliminating the 14th monthly payment for new retirees, and shortening by 3 ½ years the transition contemplated in the 1993 reform. This reform and those undertaken in 2003 have reduced the actuarial deficit of the public system by 40 percent of GDP. Staff notes that the deficit is still high and that another reform is probably unavoidable. In my authorities' view, except for the retirement age requirement (57 years for women, 62 for men), other parameters – notably time and rate of contribution and benefits – are now at appropriate levels. Opinion surveys show that, unfortunately, the one parameter change to which the public opposes the most is, precisely, an increase in retirement age.

Although Colombia has a well-developed banking sector and a reasonably deep bond market, few companies finance themselves through equity issuance. To address some of the problems hindering the development of the equity market, Congress approved a Securities Law and the government is in the process of making it operational. The law enhances protection of minority shareholder rights, broadens the supervisory agency's scope of action, and makes it easier to impose sanctions. Specifically, it creates an integrated information system, regulates compensation and payment systems for securities and creates a counter-party risk bureau.

In the banking sector, there has been progress on several fronts. Banco del Estado, a publicly-owned bank requiring a large capitalization and subject to huge legal contingencies, and thereby unable to raise deposits or originate loans, is being liquidated. Granahorrar was brought to the point of sale ahead of schedule. Following established procedures, it was first offered to its employees, who on July 22 purchased 1.2 percent of its stock. Five local banks – including subsidiaries of two Spanish institutions – are undertaking a due diligence of Granahorrar, which is expected to become private by the end of the month. The government is committed to improving corporate governance at the two remaining public banks. To that effect, it recently received technical assistance from MFD. Recommendations from staff include establishing adequate procedures for selection of the CEO and Directors, better assessing the risks involved in joint operations with the public second-tier bank specializing in agriculture, and being mindful of Granbanco's exposure to the sovereign.

Unfortunately, Congress did not approve a reform of the budget code, a structural PC for which a waiver is being requested. It should be noted, however, that many of the provisions in the proposed reform have been adopted in other laws or by decree, including limiting multi-year spending commitments and presenting a medium-term fiscal framework. Following last night's approval of the 2006 budget, a decree will soon be issued to address other aspects of the failed reform, including improving expenditure classification. One key aspect of the failed budget code that cannot be addressed in any meaningful way by decree relates to revenue earmarking, since most of it originates in a law. The government has agreed to prepare a draft law to deal with earmarking not mandated by the Constitution, for consideration by the next administration. My authorities are not willing to take on board staff's suggestion to resubmit the revised budget code as they believe this would be pointless in light of the revealed preferences in the current Congress.

The government recognizes that Colombia does not have a particularly good tax code. Some taxes are quite distortionary; the income tax rate is high and applied to a narrow, albeit expanding, base; and several rates are applied to narrow VAT bases. Previous efforts to broaden the VAT base were over-turned by the Constitutional Court. While the overall tax burden seems adequate by comparative standards, the tax code does not fare well in terms of efficiency, perhaps not even in terms of equity. The tax code is the equilibrium of a complex political process in which the goals of different interest groups have prevailed over the interests of society as a whole. The government that takes office in August 2006 may have the opportunity to persuade Congress to provide Colombia with a much improved tax code.

Significant progress notwithstanding, Colombia's decentralization scheme is a potential source of vulnerability. Prior to 2001, transfers to territorial entities were a fixed proportion of central government current revenue. Since the latter increases broadly in line with nominal GDP, the transfer scheme implied that, as long as real GDP grew faster than the population, in per capita terms transfers were on an explosive path. To better align transfers with expenditure needs at the regional level, in 2001 it was established that transfers would increase with inflation plus 2-2.5 percentage points. That change, unfortunately, has a sunset clause that mandates a return to the previous system after 2009. The government is aware of the adverse fiscal implications of such a move and has initiated public discussions on the matter. It has agreed to include as a structural benchmark the publication of a report evaluating the current regime governing revenue sharing.

The authorities are working to enhance efficiency at several entities in which the government has a stake. First, there is a well-crafted plan to upgrade the Cartagena refinery. The project, in which Ecopetrol will have a minority share, is worth around $800 million. A private partner should be identified before June 2006. Second, the government has announced its plan to divest itself of the state telecommunications company. While a tentative agreement reached with Mexico's Telmex had to be withdrawn, Telmex and several of its competitors continue to express interest in the project. Finally, several regional electricity companies and a major gas distributor should be brought to the point of sale in the coming months.