International Monetary Fund

Colombia and the IMF

Press Release:
IMF Executive Board Completes Second Review of Colombia's Stand-By Arrangement
June 14, 2006

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Colombia: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 23, 2006

The following item is a Letter of Intent of the government of Colombia, which describes the policies that Colombia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Colombia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Bogotá, Colombia
May 23, 2006

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

Dear Mr. de Rato:

In 2005, Colombia's economic performance surpassed expectations, owing to the government's continued prudent economic policies as well as the favorable external environment. Real GDP rose by 5 percent, helping reduce poverty and unemployment. The external current account deficit remained low, while net foreign direct investment rose to the highest level in almost a decade. At the same time, inflation declined to the lowest level in decades. The Fund's support through the 18-month Stand-By Arrangement (SBA) approved in April 2005 has helped provide a transparent policy framework and fortify confidence.

We are requesting the completion of the second review as well as the rephasing of the remaining purchases under this arrangement. All performance criteria at end-December 2005 have been observed, all continuous performance criteria have been observed, and most structural benchmarks have been met (Tables 1 and 2). The attached Memorandum of Economic Policies (MEP)—which supplements our MEP of April 13, 2005 and of September 26, 2005—describes our economic policies and objectives for 2006.

We remain fully committed to exiting from formal Fund support once the current arrangement expires later this year, and we will continue to treat the arrangement as precautionary.

Sincerely yours,

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

Attachments

MEMORANDUM OF ECONOMIC POLICIES

Achievements

1. In 2005, Colombia's economic performance surpassed expectations in many areas. Real GDP rose by 5 percent, contributing to lower unemployment and a decline in the poverty rate to 49 percent (from 57 percent in 2002). Inflation fell to 4.9 percent during the year, with slower increases in prices of both traded and nontraded goods. High world prices of oil, coal and coffee as well as robust growth in nontraditional exports contained the external current account deficit to 1.6 percent of GDP. At the same time, net foreign direct investment reached 4⅓ percent of GDP—the highest level since 1997—reflecting projects mainly in oil, coal, and manufacturing.

2. A strong fiscal policy, together with an accommodative monetary policy, supported growth and smoothed the rate of appreciation of the peso. The combined public sector (CPS) was in balance, compared with a revised program target of a deficit of 1.6 percent of GDP. Strong growth in tax revenues and spending restraint cut the deficit of the central administration to 4.8 percent of GDP. Higher than expected world oil prices, together with the policy of raising domestic fuel prices in real terms, boosted the operating surplus of Ecopetrol to 3.6 percent of GDP, and territorial entities ran a surplus of 1.1 percent of GDP. The primary surplus rose to 4.0 percent of GDP, helping to lower gross public debt to about 47 percent of GDP while public deposits rose to 12 percent of GDP. While meeting the established inflation target, the Banco de la República reduced its policy interest rate to 6 percent (1½ percent in real terms) and intervened in the foreign exchange market to contain the appreciation of the peso vis-à-vis the U.S. dollar to 4½ percent during the year. The structure of public debt improved quite significantly through steps to lengthen the maturity of and broaden the investor base for domestic currency debt and through prepayments of foreign currency debt using in part the foreign exchange purchased from the Banco de la República. With these policies, Colombia's risk premium fell to historic lows, outperforming the average for emerging markets, and domestic bond yields declined significantly.

3. Structural reforms advanced. In June 2005, Congress approved the new securities market law and the pension reform (the third such reform under this government). The government improved its information on the operations of local governments and issued in December a decree to strengthen budgetary procedures. The financial restructuring agency (FOGAFIN) sold Granahorrar—a mortgage bank intervened in 1999—to BBVA. The superintendencies of securities and financial institutions were merged in December to limit the scope for regulatory arbitrage and promote a deeper financial system. In February 2006, the government reached agreement in principle on a free-trade agreement with the United States. The report that evaluates the revenue sharing system will be published in March.

4. The financial system has strengthened. The solvency and profitability of the banking system has recovered, reflecting a pick up in the growth of the loan portfolio in tandem with stronger macroeconomic conditions. Nonperforming loans declined to less than 3 percent of total loans by end-2005 and were more than fully covered by provisions. Furthermore, solvency indicators are now as high as prior to the 1998–99 crisis.

Outlook for 2006

5. The government intends to maintain strong economic policies in 2006 to ensure that the economy continues to perform well. Fiscal policy would continue to aim at reducing public debt to 40 percent of GDP by 2010, and save most of the additional revenues from high world oil prices, while improving the non-oil balance. For 2006, the CPS deficit would be targeted to decline to 1.5 percent of GDP, at a projected export price for Colombian oil of US$47 per barrel (consistent with a WTI price of US$60 per barrel), with a primary surplus of 3.2 percent of GDP. Over the medium term the primary surplus would taper off to 2½ to 3 percent of GDP, as world oil prices (adjusted for inflation) and Ecopetrol's oil production decline gradually. Structural reforms will continue to advance. The government is preparing reforms of the tax code, revenue sharing, and the financial sector, and plans to submit legislation to congress by August 2006, if voters choose to re-elect President Uribe.

6. Based on these policies, the medium term outlook is favorable. The economy is expected to grow by 4½ percent in 2006 and then by 4 percent in 2007 and beyond, consistent with expected growth in the economy's productive capacity. Inflation would decline to the range of 4−5 percent in 2006 and then to 2−4 percent over the medium term. Based on the continued strength of the terms of trade, the external current account deficit is projected to amount to 1.3 percent of GDP, while confidence would sustain strong private capital inflows. Net international reserves are expected to rise to US$15.2 billion by end-2006 (about 150 percent of short-term debt at a remaining maturity), and to rise gradually over the medium term, consistent with maintaining exchange rate flexibility and achieving the inflation targets.

Macroeconomic Framework: Main Elements 2003–11

	2003	2004	2005 Prog.	2005 Est.	Projections 2006	Projections 2007	Projections 2011
Real growth	3.9	4.8	4.0	5.1	4.5	4.0	4.0
Inflation 1/	6.5	5.5	5.0	4.9	4.5	4.0	3.0
(In percent of GDP)							
External current account balance 2/	-1.2	-1.0	-1.0	-1.6	-1.3	-2.6	-2.4
NFPS primary balance 3/	1.5	3.2	3.1	4.0	3.2	2.7	2.7
Combined public sector balance 3/	-2.7	-1.4	-1.6	0.0	-1.5	-1.7	-0.3
Total public debt	54.8	51.9	47.8	47.4	45.9	45.2	39.3
Public deposits	8.7	10.4	…	12.4	…	…	…
(In billions of U.S. dollars)							
Net international reserves 4/	10.5	13.2	15.2	14.7	15.2	15.6	16.9
(In U.S. dollars per barrel)							
Crude oil, spot price 5/	28.9	37.8	54.2	53.4	68.0	71.0	66.0

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

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 2006, adjusted to reflect Colombia export price.
3/ For 2005, average export price of US$47 per barrel. For 2006, assumes a baseline export price of US$47 per barrel.
4/ IMF definition.
5/ WEO petroleum price is average of spot prices for U.K. Brent, Dubai, and West Texas Intermediate.

Fiscal policy

7. For 2006, the primary surplus would amount to 3.2 percent of GDP and would reduce gross public debt to about 44 percent of GDP, with public deposits falling slightly in relation to GDP. The deficit of the central administration would amount to 4.9 percent of GDP, as economic growth and improved tax administration bolster tax receipts, while spending remains under control. This profile for the central administration takes into account the cost of programs to assist certain sectors that might be adversely affected by the free-trade agreement with the United States. Ecopetrol's operating surplus would amount to 3.7 percent of GDP, based on the projected export price and continued declines in the implicit subsidies on sales of regular gasoline and diesel. Territorial entities are expected to run a surplus of slightly more than 1 percent of GDP. The government intends to save a significant share of any windfall if world oil prices were to evolve differently than expected. The end-year deficit target would be adjusted accordingly in the context of the third review under this arrangement. The specific targets for the CPS deficit at end-June and end-September 2006 are presented in Table 1.

8. The government intends to submit a budget for 2007 budget that aims at a CPS deficit of 1.7 percent of GDP and a primary surplus of 2.7 percent of GDP which should allow for a further decline in public debt. The submission of such a budget to congress by end-July 2006 is a structural performance criterion.

9. The government will continue to reduce the vulnerability of public debt, including to exchange rate fluctuations. In 2006, it will seek to limit net foreign currency financing to about 0.2 percent of GDP, as targeted in the indicative quarterly limits presented in the TMU. The government recently agreed to prepay US$0.6 billion of foreign currency debt, financed with the proceeds from re-opening the global peso bond introduced in 2004 as well as a drawdown of the government's foreign currency deposits. The global peso bond can now be traded in local financial markets, which will enhance its appeal. The government will continue to seek opportunities to prepay other foreign currency obligations when conditions are favorable and will continue to prudently manage its forward foreign exchange operations, as discussed with Fund staff previously.

10. The government is preparing several comprehensive fiscal reforms that it would submit to congress by August 2006 as indicated in Table 2, if President Uribe wins re-election. These reforms include:

- *Tax reform.* The government is developing a proposal for a revenue-neutral reform that would simplify the current system, in particular by reducing tax rates, and enlarging the tax base. The government would seek to reduce the number of VAT rates and lower income tax rates, while cutting exemptions and deductions. The government intends to implement its already announced plan to phase out the effects of the financial transaction tax (currently at 0.4 percent) and the tax of 1.5 percent on medium- and long-term bank loans, which discourage financial intermediation and tilt lending towards shorter maturities. This reform would be supplemented by the ongoing successful efforts to strengthen tax administration.

- *Revenue sharing.* Starting in 2009, the revenue sharing arrangement is scheduled to return to the pre-2001 system, which required central administration transfers to territorial entities to rise in line with the growth in current revenues of the central administration. This shift would undermine the sustainability of the central administration's finances. For this reason, the government will submit to congress a constitutional amendment that in broad terms would seek to make the current transitory arrangement permanent.

- *Revenue earmarking*. In the context of the 2007 budget, we will analyze earmarked revenues not mandated by the Constitution and then propose steps to phase out those that no longer serve their original purpose.

11. We will continue to take other measures to strengthen public sector finances and intend to press ahead with the on-going process of public enterprise reform. The system of setting domestic prices of regular gasoline and diesel will be strengthened. In 2005, this system led to an implicit subsidy of 1.7 percent of GDP, which weakens Ecopetrol's capacity to invest and operate increasingly on a commercial basis. The current reference medium-term price of oil is US$48.50 per barrel and the ministry of mines intends to close the gap between domestic wholesale prices of gasoline and diesel and this reference price by end 2007. Over the next few years, domestic prices will be liberalized, and any remaining subsidies would appear as an explicit expenditure item.

Monetary and exchange rate policy

12. The Banco de la República attaches top priority to achieving the inflation target. It is fully committed to reduce inflation to a range of 4 to 5 percent during 2006. Inflation expectations both from surveys of market participants and those implicit in financial instruments continue to be well-anchored. The central bank may also continue to intervene in the foreign exchange market, as long as it does not compromise the inflation target.

Financial sector

13. The government is taking the steps needed to make the new unified financial superintendency fully operational. We intend to submit to congress by August 2006 a law that gives this agency political independence and grants legal immunity to supervisors for their official acts. The new superintendency is about to issue new regulations on the computation of market risk, and we have requested technical assistance from MFD to improve the measurement of credit and interest rate risk. The superintendency also plans to develop a detailed reporting system of the financial derivative positions of financial intermediaries. The regulations required to implement the securities market law approved in 2005 will be issued by June, 2006.

14. An investment bank is currently reviewing options for the business strategy of Granbanco, which was created out of the restructuring of Bancafé. In June 2006, the government will open a second-tier bank to provide special credit lines to banks to support micro-lending. This bank will not put any pressure on the public finances, as it will remain relatively small, will not incur any losses and will compete on a level playing field with private banks. In line with the recommendations of MFD, the government will strengthen the governance of public banks, including Banco Agrario and the new second-tier bank.

15. The government is developing, with assistance from the World Bank, several financial sector reforms to deepen domestic capital markets. These proposals will be discussed at a conference in May, 2006. Areas for reforms under study include assessing the convenience of implementing a multifunctional banking system, strengthening creditor rights, removing impediments to the development of an annuities market, and strengthening consolidated supervision.

Other issues

16. We request that the last two purchases under the arrangement be rephased into a single final purchase in an amount equivalent to SDR 84.60 millions to become available upon completion of the third review. This review will be completed by mid-October 2006

and will be based on end-June 2006 performance criteria, and on the relevant structural and continuous performance criteria.

17. 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 2006 1/

		2006			
		Indicative	Performance	Indicative	
	Outturn	Targets	Criteria	Targets	
	Dec. 31, 2005	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	-4,557	-1,657	-1,383	-1,995	-4,711
Outturn	-24	…	…	…	…
Margin (+) or shortfall (-)	4,533	…	…	…	…
		Inflation rate 3/ (12-month inflation rate)			
Inflation - Consultation band					
Upper limit	6.0	5.8	**5.1**	**5.1**	…
Target	5.0	4.8	4.1	4.1	4.5
Lower limit	4.0	3.8	3.1	3.1	…
Outturn	4.9	4.1	…	…	…
		(In millions of U.S. dollars)			
Net international reserves of the Banco de la Republica					
Floor	12,215	12,215	12,215	12,215	12,215
Outturn	14,721	15,011	...	...	...
Margin (+) or shortfall (-)	2,506	2,796	…	…	…
Change in the outstanding stock of short-term external debt of the public sector					
Ceiling	200	100	100	100	100
Outturn	-92	…	…	…	…
Margin (+) or shortfall (-)	292	…	…	…	…
		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	-750	-400	-100	100	200
Outturn	-2,835	…	…	…	…
Margin (+) or shortfall (-)	2,085	…	…	…	…

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 IMF Country Report No. 05/154 and IMF Country Report No. 05/392.

2/ 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 2005−06 Program SBA[1]

	Prior Action for Approval of Arrangement	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 have reduced the budgetary carry over and issued a decree in December 2005.
July, 31 2005	Submission to Congress of 2006 budget consistent with combined public sector deficit of 2.0 percent of GDP in 2006.	Done.
July 31, 2006	*Submission to Congress of 2007 budget consistent with CPS deficit of 1.7 percent of GDP.*	
	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.	Revised information without having to issue regulations.
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.	Done in December 2005.
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.	Prepared in February 2006 but not yet published. Done in October 2005.
March 30, 2006	Prepare draft law on revenue earmarking not mandated by the constitution.	To be done by June 2006.
June 30, 2006	Complete issuance of the *key* 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.	
August 31, 2006	*Submit tax reform to Congress .* *Submit revenue sharing reform to Congress.* *Submit to Congress law to strengthen independence of financial superintendency .*	

[1] New measures presented in italics.

COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This Technical Memorandum of Understanding (TMU) is a supplement to the TMUs dated April 13, 2005 and September 26, 2005.

2. For all bond issuance beginning in 2006, any premium or discount resulting from a difference between the market rate of interest and the coupon rate of interest will be amortized over the remaining maturity of the bond. The amount of the premium or discount will be calculated as the difference between the gross issuance proceeds and the face value of the bond, minus interest accumulated since the date of the last coupon payment (if any). The resulting premium (discount) will be added to (subtracted from) a reserve account ("reserva en caja"). Shares of these premia (discounts) will be recorded as reductions in (additions to) interest expenses in the period during which coupon payments occur, and this will be matched by reductions in (additions to) the reserve account. The reserve account will be recorded as a financing item.

3. Debt management and debt buyback operations will not change the amortization profile of premiums or discounts generated at issuance, which will continue to be amortized according to the procedure established in paragraph 2.

4. Any premium or discount resulting from debt management operations undertaken in 2006 and beyond will be amortized according to the procedure in paragraph 2. For bonds that have been retired, any premium or discount will be amortized over the period corresponding to the original maturity of the bond. For newly issued bonds in an exchange or swap, the premium or discount will be amortized over its lifetime.

5. For June 2006, the target for inflation and the associated upper and lower limits that trigger consultations with the Fund (Executive Board), as specified in Section V of the TMU dated April 13, 2005 (Inflation Consultation Band), shall be as specified in table 1 of the MEP (attachment 1).

6. For June 2006, the floor for Net International Reserves and the associated decline that triggers consultations with the Fund (Executive Board), as specified in Section VI.A of the TMU dated April 13, 2005 shall be as specified in table 1 of the MEP (attachment 1). The floor for Net International Reserves will no longer be adjusted downward by up to US$2 billion for foreign exchange sales.