Statement by M. Portugal and R. Junguito, Executive Directors for Colombia
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Introduction

The Colombian authorities have asked us to convey their appreciation for the competence and cooperation shown by staff and Management in the discussions of Colombia's Article IV consultation and in the negotiations leading to Colombia's request of an Extended Arrangement. They also wish to express their satisfaction for the timely and fruitful work on the assessment of the financial sector.

Background

For several decades Colombia enjoyed significant economic progress with steady and strong economic growth, and a good balance in its external accounts. Colombia also distinguished itself for being able, even in the difficult 1980s, to maintain a moderate rate of inflation, to grow in a sustained form, and to serve on a timely basis its external debt obligations, without either restructuring or having to request access to IMF resources. In those days, Colombia had a monitoring arrangement with the Fund that facilitated its access to the private capital markets which were then highly closed to Latin American countries. Since the early 1990s Colombia has implemented important structural reforms that, in addition to those mentioned by the staff, included also the establishment of the Banco de la República as an independent central bank, and a significant labor reform.

In recent years, economic performance gave way to slow growth (negative in 1999), increasing unemployment, and economic imbalances, mainly in the fiscal and financial fronts. We coincide with the staff in attributing this deterioration mainly to the internal security situation, to fiscal rigidities, and to the external shocks of the past years. Under such an atypical set of circumstances, the authorities decided to undertake an economic adjustment program based on strong fiscal consolidation, financial sector restructuring, structural reforms, and a flexible exchange rate regime, and to request an extended arrangement with the IMF.

Objectives

The objectives of the program are to restore GDP growth, from a projected decline of 3.5 percent in 1999 to a 3 percent growth rate in 2000, and to achieve a sustainable growth of around 5 percent by the end of the program; to continue the successful process of gradual disinflation, which has allowed to reduce annual inflation from the traditional 20 percent to 30 percent range to less than 10 percent in 1999, and to stabilize the current account deficit at a level of around 3 percent of GDP (1.3 percent in 1999), which implies a substantial adjustment from the more than 5 percent registered in the past few years. The program requires, above all, to reduce the significant consolidated fiscal deficit.

Fiscal Policy

The purpose of the authorities is to reduce the NFPS deficit from a projected level of 6.3 percent of GDP in 1999 to 3.6 percent in 2000 and to 1.5 percent by 2002. It is worth underlying that soon after taking office in August 1998 the Pastrana Administration took steps on the fiscal front—including spending cuts, a widening of the VAT base, increases in fuel taxes, and the introduction of programs to strengthen tax collection and combat tax evasion. Nevertheless, the 1999 deficit worsened as a result of the decline in economic activity and its negative incidence on fiscal revenue. A restrained public wage bill and overall budget, which has already been approved by Congress, together with strong tax enforcement and the recovery in economic activity are the key factors for the achievement of the fiscal target in 2000.

Above all, the fiscal program is a medium-term strategy based on structural reforms that are being submitted to the Colombian Congress. These proposals tackle fundamental issues such as a Constitutional reform for the streamlining of transfers from the central government to the sub-national governments and legal reforms to the pension system, both at the territorial and national levels. It is also the intention of the authorities to propose legislation early next year to broaden the income tax base, and to close existing loopholes in the VAT system, as well as to undertake an ambitious privatization program. An IMF Fiscal Affairs technical assistance mission visited Colombia in November to assess the fiscal structure and make technical recommendations to be taken into account in the legislation to be submitted to Congress. The Memorandum of Economic Policies indicates that if during congressional consideration some of these initiatives are subject to substantial changes in terms of their fiscal outcome, the authorities will adopt additional measures to ensure that program targets are fully met.

With regard to public sector expenditures, it is important to stress that the authorities—considering that improved protection of vulnerable groups is one of the principal policy aims of the Administration—decided to introduce measures to reduce the effects of unemployment, poverty, and political violence within a special program financed mainly from external sources. The Colombian government is committed to continue pursuing the peace process and, to the extent that it moves forward, the authorities intend to frame public investment plans to ensure the rapid reconstruction of the areas most affected by the conflict and to proceed with the resettlement of the population internally displaced. This could require temporarily widening of the NFPS deficit, in which case the Colombian authorities would discuss with the Fund the budgetary changes that might be required.

Monetary and Exchange Rate Policy

The program establishes that monetary policy will aim at attaining inflation targets, and indicates that Colombia's framework for the conduct of monetary policy will use the growth of base money as its intermediate policy target. This was taken into account in the establishment of the NDA ceiling. Open market operations are used to attain the monetary goals and the interest rate is the operational instrument. The central bank has been gradually cutting its intervention interest rates and providing the economy with liquidity consistent with the monetary base targets, and in light of the decline in inflation and the stability of the exchange rate. The most recent cut of 100 basis points established on December 10 brought the central bank's rate structure for the repo, reverse repo, and Lombard rates to 12 percent, 6 percent, and 18 percent respectively. Additionally, the rate for access of the financial sector to the liquidity facility of the central bank was also cut 200 basis points, though it still stands at a penalty rate equivalent to the benchmark 90-day deposit rate plus 500 basis points. Despite successive cuts, real interest rates remain high, as the current twelve-month inflation rate at end-November stood at 9.7 percent.

Furthermore, as the staff report indicates, to better ensure that monetary policy is consistent with the inflation target, the central bank is moving to a direct inflation targeting framework, and it is envisaged that the framework will be fully adopted during the course of the program. In terms of readiness for the transition, the main prerequisite for a successful adoption of inflation targeting is that it should only be undertaken when inflation control has gained credibility—which is Colombia's case—given that inflation is at one-digit levels, and that inflation targets were met in the past two years and will be met in 1999 according to current projections.

Colombia has advanced significantly towards inflation targeting considering that since 1991 the legislation established the obligation for the newly-independent central bank to set an explicit annual inflation target, and mandated that monetary policy be guided to that end. The Board of Directors of the Colombian central bank decides on interest rate adjustments on the basis of its monetary targets and inflation projections discussed in the framework of monthly inflation reports. The IMF-sponsored seminar held in November in Cartagena allowed the staff to study in more detail the Colombian case, and helped the authorities to define the issues and steps that must be taken to adopt the targeting framework.

From 1994 to September 1999, exchange rate policy was conducted through a sliding exchange rate band system, managed in a flexible way both in terms of widening the band and depreciating its central parity whenever the economy felt the effects of deteriorating terms of trade and of turmoil in international financial markets. Together with the significant reduction in inflation, the movement of the nominal exchange rate within the band helped restore Colombia's competitive position in international markets. With the strong fiscal adjustment included in the authorities' economic program and the prospective financial support by the IMF, at the end of September 1999, the Central Bank Board eliminated the band and allowed the peso to float freely. The central bank expects that the floating regime will better enable the economy to absorb external shocks, facilitate the conduct of monetary policy, and reduce speculation against the currency.

On November 19, the Central Bank Board made public the rules that will govern its intervention in the foreign exchange market. To meet the reserve targets of the program, it adopted a system of monthly auctions. In early December, the central bank auctioned rights to sell foreign exchange to the central bank in the amount of US$200 million; and US$80 million rights per month are to be auctioned subsequently. Further, to maintain orderly market conditions, the central bank established the possibility to auction off rights to buy or sell US$120 million, when the exchange rate deviates substantially from the moving average of the previous 20 business days. The Colombian authorities consider that the launching of the new floating exchange regime was very successful to the extent that, without intervention, the nominal exchange rate remained stable (if anything, it appreciated) in the weeks following the adoption of the free-floating regime. Furthermore, the December auction was over subscribed.

Financial Sector Policy

As discussed at length in the Financial Sector Stability Assessment document, the Colombian financial system evidenced signs of distress by late 1998 manifested in a rise of non-performing loans, large losses and a significant deterioration in solvency and liquidity, particularly among public banks, private savings and loans institutions and some cooperative financial intermediaries. To deal with the weakening financial sector situation, the Government issued, in November 1998, an emergency decree that provided for liquidity assistance and established a financial transactions tax. Subsequently, the Government introduced a program to recapitalize viable private financial institutions and proceeded to liquidate the largest public sector bank (Caja Agraria) and replaced it with a smaller and more tightly controlled public institution. The Government has expressed its intention to privatize all remaining public sector banks. It has also proceeded to establish debtor relief programs for homeowners and is in the process of facilitating the restructuring of corporate debt. Success in addressing these difficulties hinges upon a rapid improvement in macro-economic conditions, a strengthening of bank supervision, and sound management of public banks until they are privatized. The financial sector loans from the World Bank and Inter-American Development Bank recently approved are supporting Colombia’s financial sector strategy.

Conclusions

The Colombian authorities appreciate the staff’s view that the program reflects a courageous and comprehensive effort, consistent with progress toward fiscal and external viability while advancing on structural reforms, and that its financial sector strategy has been found to be sound. They also agree with the staff view that a strengthening of domestic confidence and the secure flow of resources from official and private institutions abroad should help to consolidate the process. The Colombian authorities agree that there are risks in terms of a slower-than-projected economic recovery, and that there are uncertainties regarding the political support of the reform agenda. However, they are confident that the Colombian Congress will respond positively, as has been its tradition, to the need of adopting structural reforms, and that the economic program will rapidly translate into economic recovery. The Board’s approval of Colombia’s request for a three-year Extended Arrangement is, in the view of my authorities, a crucial aspect for the credibility of the program.