International Monetary Fund

Colombia and the IMF

Press Release:
IMF Executive Board Approves US$ 613 million Stand-By Arrangement for Colombia
April 29, 2005

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

April 13, 2005

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
April 13, 2005

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

Dear Mr. de Rato:

The government remains fully committed to promoting faster sustainable and equitable economic growth through the implementation of a strong economic program in 2005 and 2006, which is explained in the attached Memorandum of Economic Policies and Technical Memorandum of Understanding.

We are requesting the Fund's support for this program through a new 18-month Stand-By Arrangement (SBA) in the amount of SDR 405 million (35 percent of quota on an annual basis), with these resources to become available on a quarterly basis. The government will treat the new arrangement as precautionary. We would also like to cancel the SBA that expires on May 14, 2005 simultaneously with the approval of the new program.

We are also requesting completion of the final review under the current Stand-By Arrangement. All quantitative performance criteria at end-2004 have been observed and most structural benchmarks have been met (Tables 1 and 2). In this regard, we are requesting a waiver of the condition for the completion of the fourth review calling for congressional approval of the revised budget code. We will strive to have this legislation approved by Congress by June 2005, which will be a structural performance criterion under the new arrangement. We are also requesting a waiver for the nonobservance of the performance criterion on the nonintroduction of a multiple currency practice, which was created by the subsidies for banana and flower exports introduced in December 2004. The deadline for applying for these subsidies was February 28, 2005. Now no one is eligible for these subsidies.

Sincerely yours,

Alberto Carrasquilla Minister of Finance and Public Credit	Gerardo Hernandez Acting General Manager Banco de la República

Attachments

MEMORANDUM OF ECONOMIC POLICIES

Introduction

1. When it took office in August 2002, this government embarked on a medium-term strategy to foster steady economic growth by reducing the vulnerability of the economy. As a result, real economic growth rose from 1.9 percent in 2002 to 4 percent a year (about 2½ percent a year in per capita terms) in 2003–04. The urban unemployment rate declined from17.6 percent at end-2002 to 15.4 percent at end-2004. Inflation declined from 7 percent during 2002 to 5.5 percent during 2004, as targeted. The external current account deficit fell to about 1 percent of GDP in 2004, aided by high world prices of oil and coal and a recovery in exports to Venezuela. At the same time, net capital inflows picked up sharply to 3.3 percent of GDP in 2004. To reduce the external vulnerability of the economy and to limit the upward pressures on the peso, the Banco de la República made significant purchases of foreign exchange, raising net international reserves to US$13.2 billion (123 percent of short-term debt on a remaining maturity basis).

2. Economic reforms—centered on fiscal discipline—were an essential component of this strategy. Congress approved a number of the government's initiatives to strengthen the medium-term sustainability of the fiscal position, with a view to reducing public debt to less than 45 percent of GDP by 2010. Through revenue enhancements as well as improved administration, tax revenues rose from 19.2 percent of GDP in 2002 to 20.3 percent of GDP in 2004. Pension reforms in December 2002 and May 2003 helped lower the actuarial deficit of the pension system from 207 percent of GDP to 187 percent of GDP. At the same time, the central government continued to exercise expenditure restraint, while local and regional governments—benefiting from several laws adopted earlier this decade that strengthened Colombia's system of decentralization—continued to run moderate surpluses.

3. In 2004, the combined public sector (CPS) deficit experienced an unusually sharp decline to 1.3 percent of GDP, compared with an adjusted program target of 2.1 percent of GDP[1] and a deficit of 3.7 percent of GDP in 2002 (Table 3). The central government (which comprises the central administration, social security and decentralized agencies) performed broadly as expected, registering a deficit of 3.7 percent of GDP. This unusually low CPS deficit in 2004 reflects several temporary factors. Local and regional governments spent considerably less than budgeted, and ran exceptionally large surpluses. Also, the operating surplus of Ecopetrol (the state petroleum enterprise) was unusually high, as the average export price of Colombia's oil rose to US$36 per barrel.This fiscal consolidation, together with the real appreciation of the peso, helped reduce total public debt from 60 percent of

[1] According to the program, the fiscal deficit target for 2004 was reduced by 130 percent of the increase of deposits of the Oil Stabilization Fund (FAEP), which capture part of the windfall arising from higher than expected world oil prices.

GDP at end-2002 to 53 percent of GDP by end-2004.[2] Also public sector deposits rose from about 8 percent of GDP at end-2002 to 10 ½ percent of GDP by end-2004, and public debt net of deposits fell from 52 percent of GDP to 43 percent of GDP in this period.

4. Since August 2002, the government's program to modernize public administration has limited the growth in public spending. These efforts have resulted in the closing of 33 public entities and the restructuring of several others, leading to the elimination of about 27,000 positions. Other important steps include modifying the labor regime of the Social Security Institute (ISS), restructuring the state telecommunications company, public hospitals and health clinics and public electricity companies, and introducing on-line procurement systems.

5. The Banco de la República used its inflation targeting framework effectively in a challenging environment. In 2003, it reduced inflation through increases in its policy interest rate complemented by well-timed and moderate foreign exchange sales designed to calm expectations, following the sharp depreciation of the peso vis-à-vis the U.S. dollar between mid-2002 and early 2003. In 2004, the Banco de la República met its inflation target, while mitigating the strong upward pressures on the peso. The amount of the foreign exchange purchases were consistent with the inflation target.

6. The financial system has strengthened. The solvency and profitability of the banking system has recovered, reflecting economic growth, a successful recapitalization scheme, and improved supervision. Nonperforming loans declined to about 4 percent of total loans by end-2004 and are fully covered by provisions. Some of the funds lent for bank recapitalization by the Deposit Insurance Fund (FOGAFIN) have been prepaid. Several smaller banks intervened in 1999 were sold in 2004 and in early 2005. Progress has continued in implementing the risk-based financial supervision, valuation mechanisms have been introduced to unify application of mark-to-market regulations, and actions to combat money laundering have continued.

7. The government's democratic security policy also was an integral part of the strategy. There are many signs—such as a reduction in guerilla attacks, kidnappings, increased road travel and fewer incidents of economic sabotage—that the security situation has improved considerably since 2002. This helped strengthen confidence, which in turn encouraged investment and economic growth.

Economic Program for 2005–06

8. The government's economic strategy will continue to aim at supporting steady economic growth over the medium term, which will help reduce unemployment and poverty

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[2] The IMF definition of public debt differs from data published by the Colombian government, which is net of the public sector's external financial assets.

further. Fiscal consolidation will remain at the center of this strategy, as further declines in the public debt burden will support growth by strengthening confidence and lowering interest rates.

Macroeconomic Framework: Main Elements 2003-10

	2003	2004		Projection			
		Rev. Prog.	Rev.	2005	2006	2007	2010
	(Annual percentage change)						
Real growth	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Inflation 1/	6.5	5.5	5.5	5.0	4.5	3.5	3.0
	(In percent of GDP)						
External current account balance	-1.5	-2.2	-1.0	-2.8	-2.6	-2.7	-2.5
NFPS primary balance 2/	1.7	2.5	2.7	2.7	2.7	2.7	2.7
Combined public sector balance 2/ 3/	-2.7	-2.5	-1.3	-2.5	-2.0	-1.8	-1.4
Total public debt	56.0	52.1	52.9	50.4	49.8	48.2	42.7
Public deposits	8.6	…	10.6	…	…	…	…
	(In billions of U.S. dollars)						
Net international reserves 4/	10.5	10.4	13.2	12.3	12.7	13.1	14.9
	(In U.S. dollars per barrel)						
Crude oil, spot price 5/	28.9	....	37.8	40.5	38.0	36.0	34.0

1/ For 2007 and beyond, inflation projection consistent with achieving medium-term inflation target of 2-4 percent a year
2/ At projected WEO price of oil in 2005-06, adjusted to reflect Colombia export price.
3/ Excludes the effect of the program adjustor for any oil windfall.
4/ 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.

9. For 2005–06, economic policies have been designed to support real GDP growth of 4 percent a year and to reduce inflation to a range of 4½ to 5½ percent during 2005 and to a point target within the range of 3–5 percent in 2006. The external current account deficit is projected to rise to close to 3 percent of GDP in 2005–06, reflecting falling volumes of oil exports, the effect of slower global growth and a return to more normal expansion in exports to Venezuela. Net capital inflows are expected to stay at around 3 percent of GDP in each year. Net international reserves are projected to stay at US$12.2 billion by end-2005 (107 percent of short-term debt on a remaining maturity basis), reflecting the recent purchase by the government of US$1.25 billion to prepay an emergency loan from the Inter-American Development Bank. The quarterly targets for net international reserves (with an adjustor for sales of foreign exchange of up to US$2 billion) are presented in the TMU.

Fiscal policy

10. The medium-term fiscal framework that was presented to Congress in June 2004 (in accordance with the Fiscal Responsibility Law approved in 2003) aims to reduce net public debt to 38 percent of GDP by 2015. It added that the combined public sector would need to raise its primary surplus to 2½ to 3 percent of GDP starting in 2005 to reach this objective.

11. The program fiscal targets are consistent with this framework. These targets assume that spending by local and regional governments will return to normal levels following a sharp and unexpected decline in 2004. In this context, the combined public sector deficit (CPS) will amount to 2.5 percent of GDP in 2005 (Table 3). The central government stands ready to adjust its spending if necessary to achieve the program target, and if spending by local and regional governments turns out lower than expected, there will be scope for enhanced investment in high quality projects by the central government. In 2006, the CPS deficit would decline further to 2.0 percent of GDP. By July 2005, the government will present a 2006 budget to Congress that is consistent with this objective, which will be a structural performance criterion. In 2006, the primary surplus would reach 2.7 percent of GDP, which—together with a reduction of public sector deposits to more normal levels—would lower public debt to below 50 percent of GDP by end-2006.

12. The government needs to ensure that spending stays on a sustainable path, even if world prices of oil reach unusually high levels. The 2005 fiscal target is based on an average export price of Colombia's oil of US$31 per barrel and the underlying average export price of oil in 2006 will be based on an independent estimate of the long-term world price of oil. To ensure that the public sector saves a significant share of any oil windfall, the targets for the CPS deficits for 2005–06 will be adjusted downward as explained in the TMU when the average export price of oil exceeds these baseline prices.

13. The government will seek to continue reducing the vulnerability of the public finances to exchange rate fluctuations. In 2005, it will seek to limit net foreign currency financing to minus 0.3 percent of GDP, in line with the indicative quarterly limits presented in the TMU. The government has also begun to manage its exchange rate risk more actively. It has already issued US$825 million through a global peso-denominated bond, with the investor bearing the exchange risk. It has also begun to conduct forward transactions in foreign exchange. The government will 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. To continue to ensure that these operations are consistent with monetary and exchange rate policy, the government will provide the Banco de la República with 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.

14. In 2005, public revenues are projected to decline slightly to 31 ¼ percent of GDP. Tax revenues will remain broadly stable at close to 21 percent of GDP, reflecting the buoyancy of tax revenues and the success of our tax administration efforts. Also, the government will continue to scale back the subsidies for domestic prices of gasoline and diesel, which cost over 1 percent of GDP in foregone revenue in 2004. This will help offset the revenue impact of the continued decline in Ecopetrol's oil production.

15. Total public expenditure is expected to rise to 33.7 percent of GDP in 2005. The government will restrain the growth in spending on wages and goods and services, but will remain under pressure from rising pension costs. In December 2004, the government granted

export subsidies for exporters of bananas and flowers that hedge their exchange rate risk, with an estimated fiscal cost of less than 0.1 percent of GDP. The eligibility period for this subsidy expired on February 28, 2005. After this date, the government will not grant any further export subsidies but may seek other options to assist the agricultural sector within its budget constraint.

16. The government believes public investment, especially in infrastructure, plays an important role in the growth process. The government will continue to strengthen the quality of investment by increasing the commercial orientation of public enterprises and by relying, where possible, on projects carried out by public-private partnerships (PPPs). The government will complete the valuation of contingent liabilities arising from PPPs by including all past liabilities, in particular those stemming from infrastructure investment, and will present this valuation in the medium-term fiscal framework for the 2006 budget. It will also set up a pilot program to assess the results of a group of completed investment projects, with a view to establishing over time a centralized system for project evaluation.

17. The deficit of the central government—which comprises the central administration, social security and the decentralized agencies—would rise moderately to 4.0 percent of GDP in 2005 and to 4.3 percent of GDP in 2006. Total revenues would remain broadly stable at about 23.0 percent of GDP, while total expenditures would rise slightly in relation to GDP reflecting increased pension payments.

18. For 2005–06, we intend to press ahead with the following structural fiscal reforms (Table 4):

- *Budget code.* Congress is currently considering the reform of the budget code, which seeks to reduce expenditure rigidities by scaling back revenue earmarking (which amounts to 50 percent of tax revenues), budgetary carryovers, and multi-year spending commitments. Building on the fact that the reform was already voted upon favorably at the House committee level, we will make every effort to secure approval of the revised code by June 2005, and this action will be a structural performance criterion. Once approved, we will enact the necessary regulations to implement this reform as quickly as possible and no later than December 2005. We will also strive to continue to reduce remaining expenditure rigidities.

- *Pension reform.* In spite of the steps that have already been taken, the actuarial deficit of the pension system remains very high at almost 190 percent of GDP, partly because the constitutional court ruled against the transition rules that had been approved in December 2002. Also, the pension reserves of ISS were depleted in 2004, placing an extra burden on transfers from the central administration. To continue to press ahead with this reform, in July 2004, the government submitted a constitutional amendment that proposed to eliminate all special pension regimes and the 14th monthly pension payment for new retirees and to set a cap on the maximum pension. These reforms will yield crucial benefits for the long term by reducing the actuarial deficit of the pension system to about 160 percent of GDP. The elimination of the 14th

monthly pension payment for new retirees will yield moderate fiscal savings starting in 2006. The proposed amendment also clarifies the interpretation of acquired rights, a critical element for any future changes to the regime's parameters. The government will press hard to secure congressional approval of its proposed reform by June 2005. The government recognizes that additional reforms will be needed over the medium term to reduce the actuarial deficit further.

- *Privatization.* The government intends to bring Ecogas, which operates the country's natural gas pipelines, to the point of sale in 2005. It will hire an investment bank to begin to prepare to bring 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 the point of sale by June 2006. Together these public enterprises have an estimated value of about 0.8 percent of GDP.

- *Improving information on operations of all levels of government.* 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 policy. By June 2005, the government will review the quality of the information on the local and regional governments provided by the Contaduria. By September 2005, the government will issue the regulations needed to improve the quality of the information reported on the operations of the local and regional governments. The progress in improving the quality of this information will be discussed in the context of the first program review. By December 2005, the government will publish the upgraded information on the operations of all levels of government.

19. After 2006, the public sector will continue to face important challenges in its efforts to reduce public debt further. For this reason, this government will begin to lay the foundation for crucial medium-term reforms, especially in the areas of tax policy, subsidies, and revenue sharing. A more efficient tax system—with a simplified structure of VAT rates and a much broader VAT base and no distortionary taxes such as the financial transactions tax and the bank stamp tax—would support faster economic growth. Since 1991, Colombia has developed an extensive network of subsidies that has helped improved the quality of life for the most vulnerable members of the population, yet poverty remains too high. The government will seek to find more effective ways to target these subsidies to the poor, and there may be some scope to trim the cost of the subsidies that tend to benefit the middle and upper classes. The current mechanism for setting domestic prices of gasoline and diesel creates an implicit subsidy that implies a revenue loss for the public sector, especially Ecopetrol, and the government intends to liberalize domestic fuel prices over the medium term. The mechanism for transferring revenues to local and regional governments presents a potential risk to the finances of the central government, starting in 2009. By December 2005, the government will publish a report that evaluates the current system of sharing revenues with local and regional governments.

Monetary and exchange rate policy

20. The Banco de la República is fully committed to reducing inflation to a range of 4½ to 5½ percent during 2005, within the inflation targeting framework adopted in the late 1990s. In December 2004, in light of evidence that inflationary pressures had eased, the central bank relaxed the stance of monetary policy by reducing its repo interest rate and closing its window for contractionary monetary operations. If necessary to meet the inflation target, the Banco de la República will tighten monetary policy by raising its repo interest rate and re-opening the window for contractionary operations.

21. The Banco de la República remains committed to a flexible exchange rate regime, which is helpful for the economy to adjust to shifts in external conditions. Since 2004, the exchange rate regime could be characterized as a managed float, as the central bank stepped up its intervention 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

22. Colombia is pioneering a new risk-based approach to credit risk regulation and supervision. Banks are making good progress in developing models for their risk assessment, which will be used to determine capital adequacy and provisioning requirements in accordance with the Basle II capital principles. The new capital and provisioning standards will be implemented gradually over the next several years. In this context, the government will ensure that the Superintendency of Financial Institutions will have sufficient resources to hire the qualified technical staff that it needs to implement this new system.

23. The quality of the mortgage loan portfolio is improving gradually as the economy and housing prices recover further. Some banks with significant amounts of mortgages will continue to operate under restructuring, which—if necessary—could call for increases in provisioning and capital.

24. The Superintendency of Financial Institutions will advance in designing the framework for consolidated supervision of financial conglomerates. The government is in the process of unifying the supervisory framework of financial institutions, currently under responsibility of the Superintendency of Financial Institutions and the Superintendency of Securities. This will allow for a more effective monitoring of the financial system and limit the possibilities for regulatory arbitrage.

25. The government has made important strides in resolving the situation of the distressed banks following the crisis of 1999. Since then, FOGAFIN (Financial Institution Guarantee Fund) has spent considerable effort in liquidating six of these banks, merging two and selling another four. Last year, the auction of Banco Aliadas earned 1.7 times the bank's book value. The government remains fully committed to divesting the financial institutions that were intervened in 1999 and remain under the control of FOGAFIN. To this end, it has begun the privatization process of Granahorrar which will be brought to the point of sale by December 2005 (a structural benchmark). Regarding Bancafé, after the failed privatization process

implemented in early 2004, the government initiated a thorough restructuring program with the aim of improving the bank´s efficiency and bringing performance indicators in line with its private sector peers. Under this program, the bank closed 40 of its 278 branches in 2004, reduced staff from 4,100 to 3,550 and cut operating expenses substantially. In March 2005, the staff was reduced further to 3,200 and a process of restructuring began to lower labor costs further, with a view to eventually bringing this institution to the point of sale. In the meantime, the government wants to ensure that the new Bancafé and the other public bank—Banco Agrario—will continue to be managed efficiently. Therefore, the government will establish by September 2005 a corporate governance framework for the new Bancafé and Banco Agrario. In this regard, the authorities have requested technical assistance from the Monetary and Financial Systems Department from the Fund.

26. The government will seek congressional approval of the new securities law by June 2005. This law will help modernize local capital markets by clarifying the principle of finality in securities trading, reducing counter-party risk in securities transactions, and facilitating the establishment of centralized clearing and settlement systems for both exchange rate and fixed income derivatives markets.

27. The government will continue to foster the development of hedging instruments to strengthen risk management in the financial system. For this purpose, we will request technical assistance from the Fund to establish the road map for developing hedging instruments.

Other Issues

28. This program would have semi-annual reviews, which would be completed by September 2005, March 2006, and September 2006. The first review will evaluate the progress under the program so far, and will look at the pace of spending by local and regional governments. The second review will focus on reaching detailed understandings on policies for 2006, including specific plans for structural reforms during 2006. The third review will concentrate on economic performance in 2006 under the program.

29. The government believes 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 Under 2003-2004 Program 1/

	Performance Criteria Dec. 31, 2003	2004 Performance Criteria Mar. 31	Jun. 30	Sept. 30	Dec. 31
	Cumulative flows from beginning of calendar year (In billions of Colombian pesos)				
Overall balance of the combined public sector					
Ceiling 2/	-6,375	-1,178	-1,460	-1,462	-5,394
Outturn	-6,225	-956	-64	1,713	-3,447
Margin (+) or shortfall (-)	150	222	1,396	3,175	1,947
	Inflation rate 3/ (12-month inflation rate)				
Inflation - Consultation band					
Upper limit	7.9	8.0	8.0	7.7	7.5
Target	5.9	6.0	6.0	5.7	5.5
Lower limit	3.9	4.0	4.0	3.7	3.5
Outturn	6.5	6.2	6.1	6.0	5.5
	(In millions of U.S. dollars)				
Net international reserves of the Banco de la Republica					
Floor 4/	10,202	9,902	10,300	10,400	10,540
Outturn	10,524	11,019	11,379	11,929	13,197
Margin (+) or shortfall (-)	322	1,117	1,079	1,529	2,657
	Cumulative net disbursement from beginning of calendar year (In millions of U.S. dollars)				
Net disbursement of medium- and long-term external debt by the public sector					
Ceiling	1,850	800	1,300	1,750	1,800
Outturn	716	26	-237	-735	-289
Margin (+) or shortfall (-)	1,134	774	1,537	2,485	2,089
Change in the outstanding stock of short-term external debt of the public sector					
Ceiling	100	200	200	200	200
Outturn	-274	-81	-65	102	167
Margin (+) or shortfall (-)	374	281	265	98	33

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 attached to the staff report for Colombia's request for a Stand-by Arrangement (EBS/02/210).

2/ The ceiling has been adjusted downward by 130 percent of the gross deposits to the Petroleum Stabilization Fund. This adjustment is Col$22.1 billion in March, Col$189.97 billion in June, and Col$387.6 billion in September, and Col$705.6 billion in December.

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

4/ Floor for December 2003 and March 2004 adjusted downward by US$338 million, the accumulated foreign exchange sales through the options intervention mechanism.

Table 2. Colombia: Structural Performance Criteria and Benchmarks Under 2003-2004 Program

	Structural Performance Criteria	Status
October 31, 2003	Submitting to Congress a revision of the Budget Code (Ley Orgánica del Presupuesto). This revision will give the ministry of finance greater control over the expenditure level and budget execution with the purpose of achieving more transparency and higher budgetary flexibility. Specific measures will include (a) the adoption of budget classification according to international standards that fits into the context of Colombia's legal framework; (b) a requirement to include in the annual budget law information on tax expenditures, quasifiscal activities, subsidies, contingent fiscal liabilities, medium-term fiscal projections, and a fiscal sustainability analysis; (c) the establishment of a midyear budget report to Congress.	Was structural performance criterion for end-October 2003. Done Dec.16, 2003. Waiver approved.
July 31, 2004	The 2005 budget submitted to Congress will provide for a CPS deficit of 2 to 2½ percent of GDP and will include a presentation of expenditure according to a standard international classification system.	Done.
Prior to completion of fourth review	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 midyear 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 met.
	Structural Benchmarks	
December 31, 2002	Issuance of a decree to eliminate existing vacancies in the public service with immediate effect, and also to close vacancies created by retiring staff.	Done October 2002.
March 31, 2003	Approval by CONPES (Consejo Nacional de Política Económica y Social) of the Social Security Institute's financial sustainability plan for its health service. The plan will clearly identify the fiscal effect of each of its elements and be consistent with eliminating the deficit of the ISS health system by 2007.	Done March 2003.
June 30, 2003	Congressional approval of the Fiscal Responsibility Law.	Done June 2003.
	Presentation to Congress of a revision of Law 80 to improve management of government contracts. The objective is to curb corruption in government procurement, improve transparency in public contracting, promote e-procurement, and design and implement a standard methodology specifying bidding terms and conditions for typical contracts.	Done with a delay in July 2002.
	Implementation of a reform of the special pension regime for teachers that reduces the actuarial deficit of the regime for teachers at least in a proportion similar to that proposed by the government for the special regime.	Done in May 2003.
July 31, 2003	Implement reform of special pension regime for the military that will make the regime more equitable.	Done July 2003.
December 31, 2003	CONPES to finalize a plan to streamline the management of government property under which an asset management unit will be set up to define and implement a management plan based on consolidated inventories and develop a program for inventory assessment.	Done October 2003.
	Congressional approval of the modifications of Law 80 to improve management of government contracts.	Not met.
	Bring Bancafé to point of sale.	Done with a delay in February 2004. No bids received.

Structural Benchmarks		
March 31, 2004	Completion of a CONPES document to strengthen the government's legal defense service to take effect by 2005.	Done November 2003.
June 30, 2004	The government will issue a plan to improve the statistical reporting system for the financing of the nonfinancial public sector deficit.	Done.
	A financial evaluation of ISS health will be undertaken, in order to determine whether additional actions beyond those established in Decree 1750 of June 2003 are required.	Done.
July 31, 2004	Submit to Congress a constitutional amendment to eliminate special pension regimes, end 14th monthly pension and cap maximum pension at no more than 25 minimum salaries.	Done.
September 30, 2004	Full implementation of CONPES plan to eliminate the deficit of the ISS health system by 2007.	Done.
	Implementation of the plan to strengthen the governments' legal defense services.	Done.
	CONPES will publish a strategy for strengthening the current system of fiscal decentralization.	Not met. By December 2005 government will publish study that evaluates revenue sharing system.
	Adoption of the following measures to improve tax administration: (i) establish an integrated taxpayers' current account, which records all of a taxpayer's payments in a single account; (ii) begin to close enterprises that evade taxes; and (iii) begin to report persons with tax arrears to credit bureaus.	Done.
December 31, 2004	FOGAFIN will announce auction for Granahorrar.	December 2005.
	Restructuring of Bancafé will be completed.	Done with delay in March 2005.
	Implement plan to improve reporting of financing of public sector.	Done with delay. Prior action for new program adopted in March 2005.
	Resubmit to Congress the modifications to Law 80 to improve management of government contracts.	Done.

Table 3. Colombia: Performance Criteria for 2005-2006 Program 1/

		2005			
	Outturn	Indicative 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/	…	-1,606	-1,514	-3,403	-6,890
Outturn	-3,447	…	…	…	…
Margin (+) or shortfall (-)	…	…	…	…	…
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	…	…	...
(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	…	…	…	…
Margin (+) or shortfall (-)	…	…	…	…	…
Change in the outstanding stock of short-term external debt of the public sector					
Ceiling	…	200	200	200	200
Outturn	…	…	…	…	…
Margin (+) or shortfall (-)	…	…	…	…	…
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	…	…	…	…	…
Margin (+) or shortfall (-)	…	…	…	…	…

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 the staff report for Colombia's request for a Stand-by Arrangement (EBS/05/---).

2/ The ceiling for December 2004 has been adjusted downward by Col$994 billion, 130 percent of the gross deposits to the Petroleum Stabilization Fund during 2004.

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

Table 4. Colombia: Structural Conditionality Under the 2005-2006 Program SBA

	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.	Approval was a condition for completion of final review under previous program.
July, 31 2005	Submission to Congress of 2006 budget consistent with combined public sector deficit of 2.0 percent of GDP in 2006.	
	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.	
September 30, 2005	Issue the regulations needed to improve the quality of information reported for the operations of local and regional governments.	
December 31, 2005	Publish a report evaluating the current system of sharing revenue among the different levels of government. Issue regulations to implement the revised budget code. Bring Granahorrar to the point of sale.	
March 30, 2006		
June 30, 2006		

COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This Technical Memorandum of Understanding (TMU) presents the concepts, specific performance criteria, and the format for periodic reporting to the Fund, as well as the assumptions that apply under the program supported by the stand-by arrangement.

I. FISCAL TARGETS

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

	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 (performance criterion)	1,514
September 30, 2005 (performance criterion)	3,403
December 31, 2005 (performance criterion)	6,890

[1] As measured by the net financing defined in the text below. The combined public sector is defined in the text below.

2. The overall balance of the **combined public sector (CPS)** is defined as the sum of the overall balances of the nonfinancial public sector (NFPS), the operating cash result (quasi-fiscal balance) of the Banco de la República (BR), the overall balance of the Fondo de Garantías de Instituciones Financieras (FOGAFIN), and the net fiscal costs borne by the central administration and the rest of the NFPS related to financial sector restructuring. The NFPS consists of the general government and the public enterprises. The general government includes the central government and the territorial governments. The central government includes the central administration, the social security system; and the national decentralized agencies. The net fiscal costs borne by the central administration and the rest of the NFPS related to financial sector restructuring (not part of the NFPS balance) are defined to include interest payments and amortization of the bonds used to compensate financial entities for the mortgage debt reductions approved by the Congress in December 1999, the interest payments on the bonds used to recapitalize public banks, the costs of closing Caja Agraria, and any additional fiscal charges (including interest costs) related to the recapitalization, restructuring, liquidation, and privatization of financial entities.

The Combined Public Sector

CPS	=	NFPS[1] + FOGAFIN + quasi-fiscal BR + net fiscal costs borne by the NFPS related to bank restructuring
NFPS	=	general government (GG) + public enterprises (PE)
GG	=	central government (CG) + territorial governments (TG)
CG	=	central administration (CA)+ social security (SS) + national decentralized agencies (DA)
TG	=	territorial governments + territorial decentralized agencies

[1] Excludes net fiscal costs borne by NFPS related to bank restructuring.

3. For any given calendar quarter, the overall **CPS balance** is measured, in Colombian pesos, as the sum of: (i) its net domestic financing; (ii) its net external financing; and (iii) privatization proceeds, as defined below.

4. The **CPS net domestic financing** comprises (i) the change in its net credit from the financial system, excluding bonded debt; (ii) net proceeds from the placement, with the domestic financial system and other private sector residents, of bonds (issued or guaranteed by any CPS entity) denominated in domestic or foreign currency or indexed to any foreign currency, excluding any valuation changes; (iii) the change in the budget carryover (*rezago presupuestario,* which includes *cuentas por pagar* and *reservas de apropiación*) of the central administration; and changes in the floating debt (*cuentas por pagar*) of the social security system (*Instituto de Seguro Social, Cajanal, and Caprecom*) and main public enterprises: Ecopetrol, Telecom, the national electricity companies, and the national coffee fund; (iv) the change in the amount of public funds administered by *Fiduciarias*; and (v) the operating cash result of the BR. Any capitalization of interest on new issues of government bonds after September 1, 1999 and the accrual of the inflationary component of indexed bonds will be included—on a quarterly basis—as interest expenditure for the purpose of measuring the CPS deficit.

5. The **financial system** comprises the banking sector, mortgage banks, finance corporations (*corporaciones financieras*), FEN, IFI, finance and leasing companies (*compañías de financiamiento comercial*), Bancoldex, Finagro, and Findeter. The banking sector comprises the BR and the commercial banks.

6. The **CPS net external financing** is defined as the sum of (i) disbursements of grants and project and nonproject loans, including securitization (*titularización*) of public sector export receipts; (ii) proceeds from bonds issues to nonresidents (issued or guaranteed by any CPS entity) denominated in domestic or foreign currency or indexed to any foreign currency; (iii) the net changes in short-term external debt including prepayment of exports; and (iv) any change in arrears on external interest payments; minus (v) net increase in the financial assets held abroad by the CPS; (vi) cash payments of principal on current maturities for bonds and loans; (vii) cash payment to settle any external arrears; (viii) any prepayment of external debt; and (ix) the value of any new leasing contracts entered into by the public sector during

the program period, which is defined as the present value at the commercial interest reference rate (CIRR) (at the inception of the lease) of all lease payments expected to be made during the period of the lease contract excluding those that cover the operation, repair, or maintenance of the property.

7. **Privatization** proceeds are defined as the cash payments received by the CPS from the sale of the government's ownership stake in enterprises. Nonrecurrent fees (e.g., prepayments) received by the CPS for concessions to operate public services, such as in the telecommunications sector, are treated as privatization proceeds. For purposes of the program, such fees will be accounted for over the concession period, distributed in equal quarterly amounts. Proceeds from the the sales of the government's shares in public enterprises will be considered as privatization. To the extent that the purchasers of public enterprises assume their debts, the net financing used by these enterprises during the program period until their sale will be deducted from the net financing of the CPS; if the CPS assumes the debt, the net financing used by the enterprise during the program period before the sale will remain outstanding as part of the financing of the CPS.

8. The **joint operation** between TELECOM and a resident firm, which is a subsidiary of a foreign company, will be registered in the fiscal accounts on an accrual basis. The operation involves the acquisition by TELECOM from a resident firm of fixed assets (represented by installed telephone lines) financed by a loan from the resident firm that will accrue interest. The breakdown of the debt service between amortization and interest payments, to be accrued in the fiscal accounts, will be determined by the internal rate of return corresponding to the cash payments to be made during the period of the joint agreement.

9. Adjustment

(i) The quarterly ceilings on the combined public sector deficit will be adjusted upward (larger deficit), and the indicative target on net disbursements of public sector foreign currency and foreign currency indexed debt (see below) will be adjusted upward by the value of the grant element of any concessional loan disbursements or the full value of grants up to a maximum of 0.5 percent of GDP or US$500 million for 2005 as a whole, in support of the government's projects related to post-conflict, which include support for refugees ("*desplazados*") and programs to reincorporate former insurgents ("*reinsertados*") into civilian life. The program does not envisage any concessional financing for this purpose. A loan will be considered concessional if it has at least a 35 percent grant element at the time of loan approval using the commercial interest reference rate (CIRR) as discount rate. The value grant element of the loan will equal the grant element in percentage terms multiplied by the total value of the disbursements in U.S. dollars during the period.

(ii) The cumulative quarterly ceilings on the combined public sector deficit will be adjusted downward by the net oil export revenues in excess of the baseline set out in the table below, net of additional royalties relative to the baseline and net of the net financial costs of export coverage. Net oil export revenues are defined to include proceeds from exports of crude oil and petroleum derivatives minus the value of domestic purchases and imports of crude oil. The net financial costs of export hedging apply to oil sold as part of one-year contracts, and refers to the difference between the contractual price and the actual spot price. The baseline for net oil export revenues and royalties are specified in U.S. dollars, but all amounts in this adjustor will be valued in pesos at the following average exchange rates: Col$2,596 per U.S. dollar for the first quarter of 2005; Col$2,620 per U.S. dollar for the second quarter of 2005; Col$2,643 pesos per U.S. dollar for the third quarter of 2005; and Col$2,668 per U.S. dollar for the fourth quarter of 2005. All adjustments will be made within a quarter, which means that the ceiling on the cumulative CPS deficit in a quarter will be adjusted downward by the amount of the windfall in the same quarter. There will be no upward adjustment to the ceiling on the CPS deficit.

Baseline Assumption for Oil Windfall

	Net export revenue (In millions of U.S. dollars)	Royalties (In millions of U.S. dollars)
From January 1, 2005 to March 31, 2005	321.4	221.5
From January 1, 2005 to June 30, 2005	603.2	436.4
From January 1, 2005 to September 30, 2005	926.0	635.9
From January 1, 2005 to December 31, 2005	1287.0	831.9

10. **Exchange rate conversion.** (i) For the CPS balance, all revenue, expenditure and financing items denominated in foreign currency will be converted into Colombian pesos at the average exchange rate prevailing in the month when the transaction took place.

II. Monetary Targets

11. Reflecting the BR's inflation targeting framework for monetary policy, quarterly targets for 2005 have been established for the 12-month rate of consumer price inflation, measured by the *Indice de precios al consumidor* (IPC) compiled by the *Departamento Administrativo Nacional de Estadisticas* (DANE). The authorities will complete consultations with the Fund (Executive Board) on the proposed policy response before requesting purchases from the Fund in the event that the observed year-on-year rate of inflation at the end of each quarter were to deviate from the programmed quarterly baseline target by 1 percentage point or more, as set out in the table below. The BR will provide Fund staff with monthly information and analysis of inflationary developments including inflation forecasts, and keep the staff informed of all policy actions taken to achieve the inflation objectives of the program.

Performance Criterion on Inflation[1]	
	Inflation (12-Month Percentage Change)
March 31, 2005 (indicative target)	5.5
June 30, 2005 (performance criterion)	5.3
September 30, 2005 (performance criterion)	5.2
December 31, 2005 (performance criterions)	5.0

[1] These performance criteria trigger consultations with the Fund, as noted above.

III. EXTERNAL TARGETS

A. Performance Criterion on NIR of the BR

	Target[1] (In Millions of U.S. Dollars)
Outstanding stock as of:	
March 31, 2005 (indicative target)	12,215
June 30, 2005 (performance criterion)	12,215
September 30, 2005 (performance criterion)	12,215
December 31, 2005 (performance criterion)[3]	12,215

[1] These performance criteria are explained in Table 1 of the TMU. NIR is defined in paragraph 13.

12. The **NIR** of the BR (*reservas de caja*) are equal to the U.S. dollar value of gross foreign reserves of the BR minus gross foreign reserve liabilities.

13. **Gross foreign reserves** of the BR comprise (i) gold; (ii) holdings of SDRs; (iii) the reserve positions in the FLAR and the Fund; and (iv) all foreign currency-denominated claims of the BR on nonresident entities excluding accrued, but unpaid, interest on reserve assets and valuations. Gross foreign reserves exclude capital participation in international financial institutions (including Corporación Andina de Fomento (CAF), IDB, IBRD, IDA, BCIE, and the Caribbean Development Bank), the holdings of nonconvertible currencies, and holdings of precious metals other than gold. The *pesos andinos* are considered to be part of Colombia’s gross foreign reserves.

14. **Gross foreign reserve liabilities** of the BR are defined as the sum of (i) all foreign currency-denominated liabilities of the BR with an original maturity of one year or less excluding accrued, but unpaid, interest on liabilities (*causaciones*); (ii) liabilities to the Fund,

(iii) any position in derivatives that represent a claim on gross foreign reserves; (iv) any purchases from the Latin American Reserve Fund (FLAR); (v) any increase in medium- and long-term external debt of the BR over and above US$2.6 million, which is the level of the outstanding debt on December 31, 2004; and (vi) any foreign currency liabilities of the BR to residents, including financial institutions.

15. **The government's exposure in derivative markets.** The ministry of finance and public credit will publish on a weekly basis the gross and net operations in futures, forwards and other derivative contracts (involving the Colombian *peso*, vis-à-vis a foreign currency) as well as its cash position in foreign exchange.

16. **Adjustment.** The quarterly NIR targets may be adjusted downward by up to US$2.0 billion in the event of central bank for foreign exchange intervention. In the event that NIR declines by US$1.0 billion during any 30-day period through foreign exchange intervention, the authorities will complete consultations with the Fund (Executive Board) on the proposed policy response before requesting purchases from the Fund.

B. Indicative target on the Net Disbursement of Public Sector Foreign Currency Debt[1]

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of public sector foreign currency debt sector from January 1, 2005 to:	
March 31, 2005	300
June 30, 2005	-800
September 30, 2005	-650
December 31, 2005	-750

[1] The public sector includes the CPS as defined above and the financial public sector, including second-tier banks. In calculating compliance with the ceiling, the reduction/accumulation of the public sector's U.S. dollar assets in both spot and derivative markets will raise/lower net disbursements. Debt is defined in point 9 of the Guidelines on Performance Criteria with respect to foreign debt (Executive Board Decision No. 12274–00/85, August 24, 2000).

17. This ceiling applies to the net disbursement (gross disbursement minus amortization/redemptions) of foreign currency and foreign currency indexed public sector (financial and nonfinancial) debt. It does not apply to debt in foreign currency that is indexed to the peso.

18. **Guarantees.** The government will maintain the policy of not guaranteeing private sector external debt.

19. **Exchange rate conversion.** (i) changes in the foreign currency debt will be valued in U.S. dollars at the exchange rate of that currency with respect to the U.S. dollar prevailing at the time of each transaction; (ii) the net international reserves at end-2004 are valued at

cross-exchange rates prevailing at end-2004 and reserves held in interest-bearing securities are valued at market prices prevailing at end-2004; any accumulation of reserves after end-2004 will be accounted for at the U.S. dollar value at the time of acquisition; (iii) all references of foreign currency debt to GDP in relation to GDP are calculated at the end-period exchange rate of the Colombian peso with respect to the U.S. dollar.

C. Performance Criterion on Net Disbursement of Short-Term External Debt of the Public Sector[1]

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of short-term external debt of the public sector from January 1, 2004 to December 31, 2004 (performance criterion)	13
Cumulative net disbursement of short-term external debt of the public sector from January 1, 2005 to:	
March 31, 2005 (indicative target)	200
June 30, 2005 (performance criterion)	200
September 30, 2005 (performance criterion)	200
December 31, 2005 (performance criterion)	200

[1] Short-term debt defined as all debt with an original maturity of one year or less, excluding normal trade financing. Public sector includes the PS as defined above and the financial public sector except transactions that affect the reserve liabilities of the BR. The term “debt” has the meaning set forth in point 9 of the Guidelines on Performance Criteria with respect to Foreign Debt (Decision No. 12274-00/85, August 24, 2000).

IV. Reporting Under The Program

The regular reporting will include the following:

Monthly reporting

(i) Financial sector

(a) Monthly inflation report (within 15 days following presentation to the Board of Directors of the Banco de la Republica)

(b) Banco de la República intervention in the foreign exchange market in the preceding month (within 15 days).

(ii) Fiscal sector (within 6 weeks)

(a) Net borrowing of the central administration.

(b) Cash operations of the treasury (which includes floating debt).

(c) Operations of the Central Administration including transfers.

Quarterly reporting

(i) Performance criteria: Definitive information on the observance of the program targets not later than 7 weeks after the end of the quarter.

(ii) Fiscal Net Borrowing on the combined public sector deficit, distinguishing between external financing, domestic financing, the financial system, and privatization receipts, not later than 7 weeks after the end of the quarter. This will include data on privatization revenue, which will include gross receipts, costs of privatization and the resulting cash receipts received by the treasury and the assumption of debts by the government in connection with the privatization.

Colombia: Quantitative Indicator on Net Public Financing in Foreign Currency or Indexed to Foreign Currency

(In millions of U.S. dollars, cumulative from the beginning of the year)

		Q1		Q2		Q3		Q4	
		Proj.	Actual	*Proj.*	Actual	*Proj.*	Actual	Proj.	Actual
	Net accumulation foreign currency debt	**-245**		**-1057**		**-816**		**-937**	
+	Net foreign currency financing	639		-864		-465		-695	
	Non-financial public sector	644		-844		-444		-662	
	Disbursements	1006		1537		2311		3080	
	Amortization	362		2381		2755		3742	
	Financial public sector	-5		-20		-21		-33	
	Disbursements	1		1		3		4	
	Amortization	6		21		24		37	
+	Disbursements in Colombian pesos indexed to foreign currency	0		0		0		0	
	Non-financial public sector	0		0		0		0	
	Financial public sector	0		0		0		0	
-	Disbursements in foreign currency indexed to the Colombian peso	450		450		450		450	
	Non-financial public sector	450		450		450		450	
	Financial public sector	0		0		0		0	
-	Net accumulation of foreign currency assets in spot markets	314		-257		-99		-1458	
	Non-financial public sector	314		-257		-99		-1458	
	Financial public sector	0		0		0		0	
-	Net accumulation of foreign currency assets in derivative markets	120		0		0		0	
	Non-financial public sector	120		0		0		0	
	Financial public sector	0		0		0		0	
	Program target (ceiling)	**300**		**-800**		**-650**		**-750**	
	Margin	***545***		***257***		***166***		***187***	