

STAND-BY ARRANGEMENT BETWEEN COLOMBIA AND THE INTERNATIONAL MONETARY FUND

- MEMORANDUM OF ECONOMIC POLICIES
 - COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)
-
-



Bogotá, Colombia
December 24, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

The government remains fully committed to promoting faster sustainable and equitable economic growth through the implementation of its economic program for 2003–04, which is being supported by the two-year Stand-By Arrangement (SBA) approved by the Fund in January 2003.

We are requesting the completion of the second review under the program. We are adopting policies that will achieve the program's objectives for the remainder of 2003 and 2004, and are proposing quantitative performance criteria for end-December 2003, end-March and end-June 2004 (with indicative targets for the remainder of 2004) and structural reforms for 2004. These policies are explained in detail in the attached Memorandum of Economic Policies (MEP) and Technical Memorandum of Understanding (TMU). All quantitative performance criteria through September 2003 have been observed, and all but one of the structural reforms have been implemented on schedule. In the area of budget reform, we had planned to submit the bill to reform the Budget Code by end-October 2003, which is a structural performance criterion. However, we have needed more time to ensure that the proposed reform is as strong as possible. We submitted this bill to Congress on December 16, 2003, and on this basis, we are requesting a waiver for the nonobservance of this structural performance criterion. We are also requesting a waiver of the applicability of the performance criteria for end-December 2003.

We are proposing to have two additional reviews under the program, the third to be completed by May 2004 and the fourth by November 2004. In the third review, we will reach understandings on quantitative performance criteria for September and December 2004, while in the fourth review, we will ensure that the program policies remain on track. The government will continue to treat the SBA as precautionary and will maintain a close policy dialogue with the Fund.

Sincerely yours,

/s/

Alberto Carrasquilla
Minister of Finance
and Public Credit

/s/

Miguel Urrutia
General Manager
Bank of the Republic

MEMORANDUM OF ECONOMIC POLICIES

I. INTRODUCTION

1. The government of President Alvaro Uribe took office in August 2002 in the midst of a deteriorating fiscal position, domestic security concerns, and difficulties in accessing international capital markets. The government's program sought to support an increase in real economic growth to 2 percent in 2003 and to over 3 percent in 2004, while continuing to reduce inflation gradually. Net international reserves were expected to rise by about US\$300 million a year. The combined public sector (CPS) deficit was targeted to decline to 2½ percent of GDP in 2003 and 2.1 percent of GDP in 2004 in order to arrest the increase in public debt, which reached 58.4 percent of GDP by end-2002¹, and set public debt in relation to GDP on a downward path. Our policy initiatives also included structural reforms to resolve institutional issues that undermine the sustainability of the fiscal position, to improve the quality of social programs, and to continue to strengthen the financial system.
2. All quantitative performance criteria through end-September 2003 were observed, and all structural reforms, except for the submission of the revised budget code, have proceeded on schedule (Tables 1 and 2). Moreover, the economic outlook is favorable:
 - Real GDP is projected to increase by 2.8 percent, faster than expected, led by increased output in construction, manufacturing, and financial services on the supply side and durable goods consumption and private investment on the demand side.
 - Inflation is likely to decline to close to 6 percent by end year, in line with the program target of 5.9 percent, reflecting in large part the decisions by the Banco de la República to raise its policy interest rate and to conduct foreign exchange intervention. As a result, net international reserves are expected to decline by US\$290 million, in line with the adjusted program target.
 - The external current account deficit is projected to reach 2.2 percent of GDP, somewhat less than expected. Exports have performed well, in spite of the difficulties with Venezuela, because of the real effective exchange rate depreciation since mid-2002 and higher oil and coal exports

¹ Includes debt of the financial public sector, in line with the program definitions.

II. Policies for the Remainder of 2003 and 2004

3. In the national referendum, the government had included a temporary expenditure freeze and additional pension reforms to help place fiscal policy on a sustainable path. In the October 25 vote on the referendum, these two proposals, as well as all other proposals, received 5½ to 6 million votes, an overwhelming majority of the votes cast. Nonetheless, the preliminary results suggest that many of the proposals may not have received the required minimum number of votes. The negative outcome for the expenditure freeze means that—without corrective measures—the CPS deficit would have risen to 3½ percent of GDP in 2003 and to 3.7 percent of GDP in 2004.
4. The government is fully committed to keeping fiscal policy on a sustainable path. Because of this commitment, our program continues to aim at a further pick up in real economic growth to 3.3 percent in 2004, while targeting a further decline in inflation. With more rapid economic growth and the secular decline in oil exports, the external current account deficit is projected to rise to 2.5 percent of GDP, which is expected to be fully financed by net capital inflows.
5. The government intends to limit the CPS deficit to 2.8 percent of GDP in 2003 and to 2.5 percent of GDP in 2004, targets only slightly higher than those envisaged in the original program (Table 1). With these fiscal targets, the primary surplus of the nonfinancial public sector is projected to increase from 0.4 percent of GDP in 2002 to about 2½ percent of GDP in 2004, while public debt is projected to decline to about 56 percent of GDP by end-2004. To compensate for the rejection of the expenditure freeze that had been proposed in the referendum, the government moved quickly to develop a fiscal plan that paid close attention to the need to have all sectors contribute to this effort. This plan includes measures to trim expenditure in 2003 and 2004 and to secure congressional approval of a tax package for 2004 and beyond. The package proposes to:
 - Keep the top income tax rate at 38.5 percent, with a credit for a certain percentage of reinvested profits.
 - Establish a tax of 0.3 percent on individuals' net worth above a certain threshold;
 - Increase the financial transactions tax rate from 0.3 percent to 0.4 percent.
 - Strengthen tax administration by enhancing the authorities' powers to negotiate and settle disputed tax arrears and penalties and increase some penalties for tax evasion.
 - There is no change in the structure of the VAT. However, there will be a rebate of 2 percentage points for credit and debit card transactions, which is intended to improve tax administration.

In 2004, the growth in expenditure will be restrained by redirecting territorial transfers to fund the territorial pension fund (FONPET) and by controlling spending on goods and services and investment.

Table 1
Colombia: Performance Criteria^{1/}

Performance Criteria Dec. 31, 2003	2004				
	Performance Criteria		Indicative Targets		
	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					
Floor	-6,375	-1,200	-1,650	-1,850	-6,100
Outturn					
Margin (+) or shortfall (-)					
Inflation Rate ^{2/} (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					
(In millions of U.S. dollars)					
Net international reserves of the Banco de la República					
Floor	10,540	10,240	10,300	10,400	10,540
Outturn					
Margin (+) or shortfall (-)					
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					
Margin (+) or shortfall (-)					
Change in the outstanding stock of short-term external debt of the public sector					
Ceiling	100	200	200	200	200
Outturn					
Margin (+) or shortfall (-)					

Sources: Ministry of Finance; Banco de la República; 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/ Deviations from the quarterly path for inflation will trigger consultations with the Fund, as set out in the technical memorandum of understanding.

6. In 2004, the CPS deficit will be financed largely from external sources to ensure that the private sector has sufficient financial resources. The government may seek additional commercial external financing for liability management purposes or to pre-finance 2005 financing requirements. The public sector's external borrowing will remain in line with the performance criteria and indicative targets presented in the TMU. Over the next few years, the government intends to increase its reliance on domestic financing to reduce the sensitivity of public debt to external factors.
7. Looking beyond 2004, we intend to continue to strengthen the fiscal position through the term of this government. In line with the recently approved Fiscal Responsibility Law, the government intends to announce by June 2004 that the primary surplus for the nonfinancial public sector will reach 3 percent of GDP for 2005, which will place fiscal policy on a path to reduce public debt to 40–45 percent of GDP by 2010.
8. The Banco de la República will continue to conduct monetary policy within a framework of inflation targeting and a floating exchange rate. Since its inception, this approach has succeeded in reducing inflation, and has benefited from the current institutional arrangement for central bank independence. Looking forward, the Banco de la República has set an inflation target for 2004 of 5.5 percent and it will take the actions necessary to achieve this target. The quarterly path of inflation in 2004 is identified in Table 1. It intends to reduce inflation further to 3.5 to 5.5 percent in 2005, in line with its medium-term objective of lowering inflation to 3 percent. Consistent with the floating exchange rate system, the Banco de la República is targeting no change in its net international reserves.
9. The implementation of the structural reforms will continue to proceed as envisaged in the December 2002 MEP (Table 2), with the following changes:
 - *Reform of the Budget Code.* The revised budget code is designed to strengthen the institutional framework for managing public spending. The government intends to secure congressional approval of the revised code during 2004 and agrees that it will not request completion of the fourth review until the key elements of this reform have been approved. As a first step towards strengthening budgeting procedures, the 2005 budget that is submitted to congress in July 2004 will include a presentation of expenditure according to a more transparent classification framework, as well as a presentation of expenditure according to the existing classification system and this action will be a structural performance criterion.
 - *Pension reform.* In November 2003, the government submitted legislation to address the concerns raised by the constitutional court with regard to the pension reform approved in December 2002. By March 2004, the government will submit to congress constitutional reform to deal with the issues raised in the referendum in relation with special pension regimes. The government will evaluate the situation of people registered as contributors to both the public and private regimes (*multiafiliados*), and the contributions to private funds of those that were not yet eligible to transfer away from the public system will be returned to ISS.

Table 2
Colombia: Structural Performance Criteria and Benchmarks Under the SBA^{1/}

Structural Performance Criteria		
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 mid-year budget report to congress.	Was structural performance criterion for end-October 2003. <i>Done Dec.16, 2003.</i> <i>Waiver requested.</i>
July 31, 2004	<i>The 2005 budget submitted to congress will include a presentation of expenditure according to a standard international classification system.</i>	
Prior to completion of fourth review.	<i>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) eliminate most revenue earmarking not mandated by the constitution; (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.</i>	Was structural benchmark to be completed by end-2003.
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 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.	Congress approved law in May 2003.
Julio 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.	
	Bring Bancafé to point of sale.	
March 31, 2004	Completion of a CONPES document to strengthen the government's legal defense service to take effect by 2005.	<i>Done November 2003.</i>

Structural Benchmarks

June 30, 2004	<i>The government will issue a plan to improve the statistical reporting system for the financing of the nonfinancial public sector deficit.</i>
	<i>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.</i>
September 30, 2004	Full implementation of CONPES plan to eliminate the deficit of the ISS health system by 2007.
	Implementation of the plan to strengthen the governments' legal defense services.
	Restructure and bring Granahorrar to the point of sale.
	<i>CONPES will approve a strategy for strengthening the current system of fiscal decentralization.</i>

¹New or revised measures or dates are presented in italics.

- *Strengthening fiscal decentralization.* The government has requested technical assistance from the Fund's Fiscal Affairs Department to prepare a report on the system of fiscal decentralization, with a view to developing options for reform. CONPES will prepare a report by September 2004 that presents a strategy for increasing the effectiveness of the current system.
 - *Statistical data on public sector financing.* The government will publish a document by June 2004 to recommend a statistical reporting system of the public sector financing with the objective of obtaining monthly estimates of the below-the-line fiscal deficit with a minimum reasonable delay.
 - *Improving transparency of inflation targeting framework.* The Banco de la Republica will continue to improve the communication of its inflation targeting framework, with a view to helping markets develop a medium-term focus on inflation.
10. The government is prepared to accept the obligations under Article VIII of the Fund's Articles of Agreement. The bilateral payments arrangement with China was eliminated in June 2003, and the rate on the CERTs (the system of export subsidies) has been set at zero for several years, in line with Colombia's obligations to the WTO. The tax on inward remittances has been removed in the context of the tax legislation approved in December 2003. The government intends to eliminate the taxes on outward remittances by 2005. The central bank is undertaking conversations with Fund staff in order to identify whether the foreign exchange regime for hydrocarbons exporters gives rise to an exchange restriction.
11. The Banco de la República now requires its annual external audit to be conducted by an auditing firm with international experience and exposure, as recommended by the safeguards assessment.

COLOMBIA—TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

1. This memorandum sets out specific performance criteria for December 31, 2003 and March 31, 2004, and the structural performance criteria and structural benchmarks for the remaining period of the program. This TMU supplements the TMU of December 2, 2002, which presents all the definitions of the variables used to monitor performance under the program.

I. FISCAL TARGETS

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

	Ceiling (In billions of Colombian pesos)
Overall deficit of the combined public sector from January 1, 2003 to December 31, 2003 (performance criterion)	-6,375
Overall deficit of the combined public sector from January 1, 2004 to:	
March 31, 2004 (performance criterion)	-1,200
June 30, 2004 (performance criterion)	-1,650
September 30, 2004 (indicative target)	-1,850
December 31, 2004 (indicative target)	-6,100

2. The overall balance of the **combined public sector** (CPS) will remain as defined in the TMU of December 2, 2002 with the following change. With regard to Caja Agraria, the CPS deficit will include the severance payments and interest costs of closing Caja Agraria.

3. Adjustment

- (i) The quarterly ceilings on the combined public sector deficit will be adjusted upward (larger deficit), and the ceiling on net disbursements of medium- and long-term external debt of the public sector (see below) will be adjusted upward by the full amount of any concessional loan disbursements beyond what is currently envisaged under the program, up to a maximum of 0.5 percent of GDP or US\$400 million for 2004 as a whole, in support of the government's domestic security program "Seguridad Democrática." 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.

- (ii) The cumulative quarterly ceilings on the combined public sector deficit will be adjusted downward by 130 percent of the revenue (gross deposits) of the petroleum stabilization fund (FAEP), as currently defined in the law, in excess of the baseline set out in the table below.

B. Baseline Assumption for Oil Stabilization Fund Revenue (FAEP)

	Revenue (In millions of U.S. dollars)
From January 1, 2004 to March 31, 2004	0
From January 1, 2004 to June 30, 2004	0
From January 1, 2004 to September 30, 2004	0
From January 1, 2004 to December 31, 2004	0

II. MONETARY TARGETS

4. Reflecting the BR's inflation targeting framework for monetary policy, quarterly targets for 2003 and 2004 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 Estadísticas* (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 quarterly inflation were to deviate from the programmed quarterly baseline target by 2 percentage points or more, as set out in the table below. In the event that the actual inflation deviates significantly from the programmed target within the 2 percentage points margin in any calendar quarter, the BR staff will report to the IMF staff on the reasons for the deviation and the policy response adopted, if any. The BR will provide Fund staff with monthly information and analysis of inflationary developments and forecasts, and keep the staff informed of all policy actions taken to achieve the inflation objectives of the program.

A. Performance Criterion on Inflation^{1/}

	Inflation (12-Month Percentage Change)
December 31, 2003 (performance criterion)	5.9
March 31, 2004 (performance criterion)	6.0
June 30, 2004 (performance criterion)	6.0
September 30, 2004 (indicative target)	5.7
December 31, 2004 (indicative target)	5.5

^{1/} These performance criteria trigger consultations with the Fund, as noted above.

III. EXTERNAL TARGETS

A. Performance Criterion on NIR of the BR^{1/}

	Target (In millions of U.S. dollars)
Outstanding stock as of:	
December 31, 2003 (performance criterion)	10,540
March 31, 2003 (performance criterion)	10,240
June 30, 2003 (performance criterion)	10,300
September 30, 2003 (indicative target)	10,400
December 31, 2003 (indicative target)	10,540

^{1/}These performance criteria and indicative targets are explained in the Annex to the TMU.

- 5. Adjustment.** The quarterly NIR targets may be adjusted downward by up to a cumulative amount of US\$2.0 billion in 2003 and 2004 of foreign exchange sales to help secure orderly foreign currency market conditions in the event of exogenous disturbances in the foreign currency market and consistent with transparent rules used by the central bank for foreign exchange intervention. In the event that NIR declines by US\$1.0 billion during any 30-day period, the authorities will complete consultations with the Fund (Executive Board) on the proposed policy response before requesting purchases from the Fund.

B. Performance Criterion on the Net Disbursement of Medium- and Long-Term External Debt of the Public Sector^{1/}

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of external debt by the public sector from January 1, 2003 to December 31, 2003 (performance criterion)	1,850
Cumulative net disbursement of external debt by the public sector from January 1, 2004 to:	
March 31, 2004 (performance criterion)	800
June 30, 2004 (performance criterion)	1,300
September 30, 2004 (indicative target)	1,750
December 31, 2004 (indicative target)	1,800

^{1/} These performance criteria and indicative targets are explained in the Annex to the TMU.

C. Performance Criterion on Net Disbursement of Short-Term External Debt of the Public Sector^{1/}

	Ceiling (In millions of U.S. dollars)
<hr/>	
Cumulative net disbursement of short-term external debt of the public sector from January 1, 2003 to December 31, 2003 (performance criterion)	100
Cumulative net disbursement of short-term external debt of the public sector from January 1, 2004 to:	
March 31, 2004 (performance criterion)	200
June 30, 2004 (performance criterion)	200
September 30, 2004 (indicative target)	200
December 31, 2004 (indicative target)	200
<hr/>	
^{1/} These performance criteria and indicative targets are explained in the Annex to the TMU.	

IV. STRUCTURAL PERFORMANCE CRITERIA

6. These are described in the Table 2 of the Memorandum of Economic Policies.