Bogotá, Colombia
February 23, 2001

Mr. Horst Köhler
Managing Director
International Monetary Fund
700 19th Street NW
Washington, D.C. 20431
U.S.A.

Dear Mr. Köhler:

1. In our letter for the first review under the extended arrangement, dated August 22, 2000, we noted that the economic recovery, inflation, and the fiscal consolidation process remained on track to achieve the program objectives for 2000. We also described the positive developments in the external current account, expressed satisfaction with the operations of the exchange market after the peso was floated in 1999, and reported on the improvements in the financial system; but we expressed regret that unemployment remained high. These broad trends have since continued, and we can also report on significant advances in the area of structural reform. In the following we provide a short update of recent economic and financial developments; outline the challenges that remain as Colombia enters the second year of its three-year economic recovery program; and summarize the policy changes that are being introduced to achieve the objectives of the government's program for the next years and for the medium term.

I. Recent Developments

2. Economic conditions improved in 2000 as real GDP recovered from a drop of 4.3 percent in 1999 to a growth of an estimated 3 percent, as projected in the program, based on a strong recovery of exports and some rebound in domestic demand; manufacturing output expanded by more than 10 percent. Inflation ended the year at 8.8 percent, well within the 10 percent target and declined to 8.5 percent in January 2001, but the unemployment rate remains in excess of 19 percent.

3. Policy implementation under the program has progressed well, and all quantitative performance criteria were observed through September 2000, in some cases with sizable margins. Available information for the fourth quarter indicates that the performance criteria for end-December also were observed.

4. Fiscal performance was better than envisaged in 2000, due mainly to higher oil revenues, but also reflecting lower than projected expenditure. The finances of the health system under the social security institute (ISS) and the public pension systems, on the other hand, deteriorated more than envisaged. Despite the strong fiscal position, the public sector's recourse to both external and domestic financing was larger than anticipated because of a need to offset a major shortfall in privatization proceeds.

5. In October of last year, the constitutional court handed down a decision that revoked the wage freeze that was being applied to some 70 percent of central government employees and to the workers in some territorial governments in 2000, requiring that they instead be awarded increases corresponding to the previous year's inflation (9.2 percent, payable before the end of 2000), and that future public wage increases must, at a minimum, compensate for inflation in the preceding year. This raised the NFPS wage bill by about 0.5 percent of GDP in 2000 and absorbed much of the over performance that the government had planned to achieve relative to the fiscal deficit target. Nevertheless, the targeted reduction in the combined public sector deficit to 3.7 percent of GDP, from 5.5 percent of GDP in 1999, is estimated to have been achieved as noted above.

6. Monetary developments over the past year have been characterized by slow growth of the broad aggregate, which has been rising by 3-4 percent year-on-year in recent months, while the public's holdings of government securities have increased sharply. At the same time, there has been a notable shift in the composition of the monetary aggregates toward more liquid instruments as a result of the introduction of the financial transactions tax and low bank deposit rates. The central bank has kept its interest rate structure basically unchanged since June 2000 on the grounds that the current and projected inflation rates are consistent with the program targets. Financial system credit to the private sector declined somewhat over the 12 months to November reflecting the problems faced by the financial sector (especially the mortgage institutions), low collateral prices (mainly real estate), and relatively weak credit demand, as the initial phase of the recovery from the 1998-99 recession was facilitated to a large extent by increased utilization of already installed capacity and financed in part by corporate savings resources. Domestic credit growth, excluding mortgage credit, has started to recover in recent months.

7. The conditions in the financial system have improved over the past year: the average capital adequacy ratio increased from 11 percent in December 1999 to 13.8 percent in November 2000; consumer and commercial lending has started to grow, as noted above, and the average return on assets and equity is less negative. However, indicators of asset quality have not improved significantly, mainly due to the resurgence of arrears on mortgage credits during the last half of 2000, after a substantial reduction in the first half of the year as a result of debt relief operations. A recent ruling by the constitutional court established that interest rates on mortgage loans must be the lowest in the market, to be defined by the central bank. This rate was set at 13.9 percent in September, inducing a reduction in the interest rate for about a quarter of total mortgage loans. Other interest rates are market determined.

8. The foreign exchange market has remained orderly since the peso was floated in September 1999, and the central bank's foreign exchange auction system is transparent and has been functioning well. After experiencing a depreciating trend since April that reflected political events and increasing difficulties in executing the government's privatization program, the peso was relatively stable in the last few months of 2000 and so far this year.

9. The external current account is estimated to have posted a surplus of 0.2 percent of GDP in 2000, after a 0.1 percent of GDP deficit in 1999; the trade surplus rose to 3.0 percent of GDP from 2.1 percent of GDP a year earlier. Boosted by higher oil prices and a more

competitive exchange rate, Colombian exports grew by nearly 15 percent (in U.S. dollar terms) in 2000, with petroleum exports rising by 31 percent and nontraditional exports by nearly 15 percent, while coffee exports fell. The capital account was in near balance as net repayments of debt by the financial sector and the nonfinancial private sector were compensated by net loan inflows to the nonfinancial public sector. Net international reserves rose by US$707 million (US$252 million more than called for in the program), thus remaining at more than six months of imports of goods and services. About US$319 million was accumulated through the auction system.

10. The privatization program fell short of the ambitious expectations in 2000, mainly due to security-related problems that developed during the year and affected the electric power sector. The large coal mining company, CARBOCOL, was sold in October. As a result, the proceeds from privatization were 0.4 percent of GDP in 2000, well below the amount expected. The sale of ISAGEN (an electricity generating company) was postponed due to legal problems, which have since been largely resolved. The government will seek to sell ISAGEN in 2001, but is not including it in its financing plan for this year. Another setback to the privatization program was the withdrawal by the city of Bogotá of the sale of its telephone company, due to a lack of investor interest.

II. The Program for 2001

A. Macroeconomic Policies

11. Under the program for 2001, the projection for real GDP growth has been maintained at 3.8-4.0 percent and the targets for consumer price inflation and NIR accumulation have been kept at 8 percent and US$326 million, respectively, in line with the three-year program drawn up in 1999.

12. In order to ensure that medium-term fiscal sustainability is achieved, the authorities in October of last year decided to strengthen the tax package that had been submitted to congress in mid-year. Following deliberations in congress, a package was approved in December 2000 that will yield about 1.9 percent of GDP annually, substantially more than envisaged in the program. The approved tax package is based on an increase in the VAT rate from 15 to 16 percent; an increase in the presumptive income tax rate from 5 percent to 6 percent of net assets; the introduction of a financial transactions tax of 0.3 percent to replace one at 0.2 percent that expired at the end of 2000; and a customs service charge of 1.2 percent. In addition, the tax package establishes temporary tax incentives for the repatriation of capital.

13. For 2001 the government projects that NFPS revenue will exceed the earlier program projection by 0.6 percent of GDP mainly because of the recently approved tax package. Despite the 0.6 percent of GDP increase in the wage bill from the level projected when the three-year program was drawn up, the financial deterioration of the social security system, and the maintenance of public investment at about the previously programmed level, the deficit of the NFPS will be 2.6 percent of GDP, very close to the indicative target of 2.5 percent of GDP established earlier. The deficit of the combined public sector will be 2.8

percent of GDP due to the higher than projected fiscal costs of financial sector restructuring.

14. The considerable effort that the government is making toward fiscal consolidation is evidenced by the strengthening of the primary balance of the NFPS when oil-related revenue and the operations of the public health and pension systems are excluded. This balance improved by 3.1 percent of GDP in 2000 and will be strengthened by another 2.0 percent of GDP in 2001. The authorities are committed to saving excess oil sector revenue relative to the program projection in 2001, through a downward adjustment of the ceiling on the combined public sector deficit, as set out in the attached Technical Memorandum of Understanding (TMU). The proportion of the excess than can be saved is determined by a number of factors, mainly the earmarking restrictions on the use of these revenues. The authorities intend to review the overall fiscal target with the Fund should economic growth fall below the projection. Any shortfall in oil revenue or any other fiscal slippages will be dealt with through additional revenue or expenditure measures in order to ensure that the deficit remains within the limit.

15. In order to secure adequate credit resources for the private sector to sustain the ongoing economic recovery and prevent any excessive upward pressure on domestic interest rates, the authorities will make every effort to limit the access to domestic financial savings by the combined public sector in 2001. To this end, the government has already made considerable progress in securing foreign financing, with the equivalent of US$920 million in Eurobond issues between November 2000 and January 2001 and the arrangement of a guarantee by the World Bank for a leveraged bond placement of US$1.2 billion scheduled for early March 2001. Most of the remaining financing need will be covered by disbursements from multilateral institutions. With this external financing plan, the program provides for the net use of domestic credit by the combined public sector of 0.4 percent of GDP in 2001, a sharp reduction compared with 2000, when the comparable number was 1.5 percent of GDP.

16. Based on present policies, the NFPS deficit for 2002 is projected to be 1.8 percent of GDP given current forecasts for economic growth, while the balance for the combined public sector will amount to 1.7 percent of GDP. The increase in wages ordered by the constitutional court in 2000 (which will raise expenditures in 2002 by 0.5 percent of GDP); the growing deficit of the social security system; and the decline in oil production, account for the increase in the expected deficit from the indicative target established in 1999 when the three-year program was first drawn up. The targets for 2002 reflect the continuation of the adjustment effort, as the non-oil, nonsocial security primary balance of the NFPS will improve by another 1.5 percent of GDP in 2002, for a total of 6.6 percent of GDP over the three years of the program.

17. The peace discussions with the insurgent groups may contemplate the implementation of partial peace agreements, which may require a temporary increase in the NFPS deficit in order to ensure their adequate implementation. While the government expects that progress on the peace front will strengthen the underlying fiscal position, the authorities will discuss with the Fund any budgetary changes that may be required should the need arise.

18. We also want to bring you up to date on the progress in implementing the government's "Plan Colombia," which integrates its strategies for combating drug trafficking and addressing the difficult security situation while dealing with the social fall-out from these problems. The United States' contribution to the plan—about US$1.1 billion over three years-will be provided largely in the form of grants. The European Union and other countries are expected to contribute a similar amount, in the form of grants and concessional loans. Any disbursements of concessional loans will be accommodated under the program through adjustors on the limits for the fiscal deficit and the external public debt. In addition, it is expected that the Inter-American Development Bank will provide a loan for development projects in the conflict zone under the plan. To the extent such support is provided, the ceiling on the combined public sector deficit will be raised by the amount disbursed under this loan, up to a total of US$150 million in 2001. The Colombian government's contribution to the plan—some two-thirds of the total—is being provided through a re-orientation of resources within the fiscal program.

19. Last year the central bank continued to take steps to make inflation targeting the nominal anchor of its monetary policy. Consequently, Colombia's monetary policy framework for 2001 is being based on a scheme for inflation targeting. The new framework is transparent and provides a clear signal to the markets of the central bank's determination to continue to achieve the program's inflation objective. Together with Fund staff the authorities have developed performance criteria for inflation. These include consultations with the Fund about inflation control policies if current inflation were to deviate significantly from the projected quarterly path, as set out in the attached TMU. The program also incorporates a quarterly floor for the central bank's net international reserves which will rise by US$326 million in 2001 to reach US$9,145 million by the end of December 2001.

B. Structural Reforms

20. In July 2000, President Pastrana appointed a member of the Liberal party to the ministry of finance in an effort to broaden the political support for the economic program of the government. This has strengthened governability and has been decisive in advancing reforms through congress. At the same time, the government initiated roundtable discussions with the political opposition, the territorial governments, the business community, the unions, and others on the most important structural reforms. This broad dialogue on issues that affect large segments of the population has been useful, and the views expressed in these fora are being reflected in the structural reform proposals that are being presented to congress. The government wishes to reiterate its commitment to structural reforms and has continued to strengthen the structural agenda and keep it moving forward.

21. The government recently announced a restructuring and downsizing plan for the public sector to strengthen the ongoing effort to increase efficiency and minimize duplications both at the central and territorial government levels. Action will be taken by executive order to merge, close, or downsize a number of entities. The authorities estimate that the savings from the new restructuring and downsizing plan for the central government will amount to some 0.2 percent of GDP annually, but severance payments are likely to reduce

the savings in the first year. This program is in addition to the considerable action that has been taken in the past few years to streamline the operations and reduce the size of the central and territorial governments and to privatize or liquidate public enterprises and banks.

22. Considerable progress has been made over the past few years to streamline the operations and reduce the size of territorial governments under the direction of the ministry of finance (Dirección de Apoyo Fiscal—DAF). Additional actions were taken last year to introduce systems designed to help control public spending and strengthen the public finances at the territorial level. Law 617 ("Ley de Saneamiento Fiscal de las Entidades Territoriales"), passed in October 2000, strengthens the control of spending at the territorial government level; limits territorial government current spending and introduces restrictions on the creation of new municipalities, allowing only those capable of generating sufficient own revenues. It also provides for a debt-restructuring scheme that involves support from the central government for those local governments that enter into fiscal adjustment programs monitored by the DAF. Additionally, in December, congress voted the first round of the constitutional amendment required to change the system of revenue transfers to the territorial governments ("Acto Legislativo"). While the change in the transfer system will itself help control overall public spending, it will be complemented by a reform of the law (Ley 60) that determines the distribution of transfers and assigns the responsibilities of municipalities and departments regarding the management of health and education, in order to strengthen the control over the use of these resources. In the health sector, with funding provided by the IDB, the government is also implementing a restructuring plan for public hospitals.

23. The constitutional reform of territorial transfers also includes a provision to limit the growth of central government expenditure, intended to secure a parallel effort to that established for territorial governments. This introduces a key fiscal rule in the constitution. The final element of the strategy to strengthen the control over public spending is the presentation to congress in 2001 of a fiscal responsibility law that complements the actions taken under "Ley 617" and the "Acto Legislativo." In drafting this law, the authorities have consulted with the Fund (FAD) on technical issues. The government supports the principles underlying the Code of Fiscal Transparency endorsed by the Fund, and will begin to assess Colombia's compliance with the code.

24. Regarding the plan to provide territorial governments with increased fiscal autonomy, the government has made progress in drafting a law, which will be presented to congress when it reconvenes in March 2001, as provided in the program. In addition to strengthening the territorial tax administrations, the main provisions of the proposed law are to simplify the regulations and procedures for regional taxes, such as those on liquor, tobacco, property, and the turnover tax ("industria y comercio"), providing the regional administrations with a transparent framework for applying and collecting existing taxes. A recent advance in this direction was the approval by congress in September of a law that increases the proceeds from lotteries and helps strengthen the finances of the health sector.

25. The authorities are drawing up plans to reform the public health system under the social security institute (ISS), which is facing a difficult financial position as a result of rapidly rising costs and stagnating revenues. Operational deficits of around 0.3 percent of GDP appeared in 1999 and the system's deficit was projected to widen further in 2001 and 2002. In response, the authorities are at present considering different options for a reform with the view to securing a sustainable financial position of the ISS's health related operations. The government will put into effect a reform plan by end-June 2001.

26. Colombia initiated a second-generation reform of its pension system last year with the establishment of funds to help finance territorial government pension liabilities, and the authorities are currently in the process of introducing a fundamental and broad based pension reform. The earlier pension reform, in 1993, established a dual system of fully funded private capitalization funds and the pensions provided by the ISS with guaranteed benefits on a pay-as-you-go basis. At the same time, most of the numerous pension plans in the public sector stopped accepting new affiliates and will be closed after a transition period. Over the past 1-1½ years the public pension plans and the ISS pension system have come under increasing pressure as evidenced by a marked slowdown of their cash-flows that reflects the rise in unemployment, a stronger than anticipated transfer of existing contributors and new affiliates to the private capitalization funds, as well as overly generous benefits and inadequate control procedures in many of the public plans. The World Bank is assisting the government in the evaluation of alternatives for a fundamental and long lasting pension reform. The government intends to present a reform plan to congress in the first half of 2001, whose major principles will include a dual system; establishment of greater equity among different pension systems; and the achievement of short- and long-term financial sustainability of the public sector's pension obligations.

27. The ongoing economic recovery will reduce unemployment gradually from its current level, and to speed up the process the government has sought to encourage the use of provisions in existing legislation that allow individual firms and employees to enter into voluntary contracts under collective bargaining agreements that may differ from ordinary regulations. The government also is implementing a strategy to reduce the transitory and structural components of unemployment through programs to create short-term jobs and provide incentives for increased school attendance, complemented by longer-term strategies to align the workers' skills with the requirements of the productive sector, through training and education.

28. Despite the difficulties faced by Colombia to implement its privatization plan in 2000, the authorities are determined to pursue efforts to put the plan back on track. The government is not relying on privatization proceeds to help finance the fiscal deficit in 2001 as noted above, but will nonetheless seek to privatize the enterprises that had been offered for sale in 2000 in order to improve Colombia's debt profile and reduce financing costs, and will in any event sell or liquidate the state banks (except Banco Agrario) by the end of 2001, as called for under the program.

29. In dealing with a resurgence of the difficulties faced by the savings and loans associations (CAVs), the authorities recognize the need to strengthen further their capital base and assure their efficient restructuring in order to facilitate the recovery of the housing

industry. The strategy adopted for the CAVs consists of introducing rigorous capitalization and restructuring plans to be monitored by the banking superintendency with clear targets and a credible set of actions to be taken by the authorities should those targets not be met. Simultaneously, FOGAFIN, the securities and banking superintendencies, the central bank, and the ministry of finance are developing a full-fledged package of measures to facilitate the restructuring process and the development of capital market instruments for long-term mortgage financing. The annual fiscal cost of the additional assistance to the mortgage finance sector is estimated to be small and has been incorporated within the fiscal program.

30. Recent developments suggest that the private banks which have received support from FOGAFIN have improved their performance, although some of them remain weak. Conditional on the implementation of a restructuring plan, the authorities stand ready to assist potentially viable institutions that may need support. The remaining state banks are being prepared for privatization or a process of gradual asset shrinking and final closure, as noted above. The clean-up of their portfolios and additional capitalization in preparation for their sale or liquidation by end-2001 is progressing, with the additional costs having been incorporated in the fiscal program.

31. The pending regulations to implement the provisions of the 1999 financial sector reform law was a benchmark for June 2000 under the program. At that time it was decided not to issue the decree on early warning indicators in the form originally proposed because it was considered inadvisable under the prevailing circumstances. Instead, the authorities in December issued regulations in a more general form that allowed the superintendency of banks to intervene promptly and efficiently when entities fail to comply with minimum solvency, liquidity, and management indicators. With regard to prudential regulations, the authorities recognize the need to strengthen the current provisioning rules and expect to reach international standards by the end of 2002, as envisaged in the program.

32. In order to deal in a comprehensive manner with the distortions and rigidities in the Colombian fiscal system, which limit the scope and application of fiscal policy, reduce competitiveness, and hinder economic development, the government has created a technical commission, headed by a highly reputed international expert. The commission has been entrusted to study, quantify, and propose measures to deal with the prevailing distortions in the revenue system, and the earmarking of public resources, as well as to review budgeting and expenditure control procedures. The commission will issue its final report by May 2002.

C. The Medium Term and Other Issues

33. Together with Fund staff, the authorities have reviewed the medium-term outlook for Colombia's public finances, external debt, and the balance of payments. As a result of the fiscal adjustment measures and the structural reforms adopted and envisaged during the three years of the program, the public sector debt will stabilize around the current level of 40 percent of GDP by 2010. This would be the result of a stable central government debt, a reduction of the rest of the nonfinancial public sector debt, and an increase in social security debt. It should be noted that the pension reform will have its most significant impact on public debt beyond the projection period. The improvement in public sector

finances will allow the private sector greater access to domestic and foreign financing, eliminating the crowding out observed since 1999 and without increasing Colombia's total debt (public and private) over the medium term. We would like to note that this medium-term scenario does not take into consideration the potential impact on the economy that progress in the peace process could bring about. In any case, the medium-term outlook will be reassessed at the time of the next review of the program.

34. In the area of trade policy, the government has implemented the majority of the measures mentioned in the 1999 Article IV consultation. These include the elimination of performance requirements in the automotive sector; the implementation of WTO agreements on customs valuation and intellectual property rights, and the elimination of the subsidy component of CERTs. In addition, the government is developing a plan to reduce the dispersion of tariffs in the context of the Andean Group, and converting the CERTs into a simple duty drawback instrument. The export subsidy components of the Plan Vallejo and the free trade zones have been notified to the WTO and will be eliminated according to agreements with the WTO.

35. The authorities reiterate their commitment to accept the obligations of the Fund's Article VIII, Sections 2, 3, and 4, by end-September 2002, and to help achieve this the remaining multiple currency practices will be eliminated. Also, congress is expected to finalize the process for acceptance of the proposed Fourth Amendment of the Fund's Articles of Agreement shortly after it reconvenes in March.

36. The Colombian authorities reaffirm their policy commitments under the program supported by the extended arrangement approved by the Fund in December 1999, request completion of the second review thereunder, and intend to conduct the third review with the Fund by June 30, 2001. That review will focus on the implementation of the fiscal program, and, in particular, on the adequacy of the main structural reforms—particularly the pension system reform—to help promote fiscal sustainability over the medium term.

Sincerely yours

/s/	/s/
Juan Manuel Santos Minister of Finance and Public Credit	Miguel Urrutia General Manager Bank of the Republic

Colombia—Technical Memorandum of Understanding

1. This memorandum sets out the definition of concepts, specific performance criteria for March 31 and June 30, 2001, the structural benchmarks for the remaining period of the program, and the assumptions that apply under the second year of the program supported by the extended arrangement.

I. Fiscal Targets

A. Performance Criterion on the Overall Deficit of the

Combined Public Sector 1

	Ceiling [2] (In billions of Colombian pesos)
Overall deficit of the combined public sector from January 1, 2001 to:	
March 31, 2001(performance criterion) [3]	1,000
June 30, 2001 (performance criterion)	2,600
September 30, 2001 (indicative target) [4]	4,150
December 31, 2001 (indicative target) [4]	5,650

[1] As measured by the net financing requirement defined in the text below. Combined public sector defined in the text below.
[2] Minimum cumulative balance of the combined public sector.
[3] The overall balance of the combined public sector in the first calendar quarter of 2001 will in any case accrue expenditure of at least Col$650 billion (and Col$970 billion through the first two quarters) on account of public bank restructuring and mortgage plan expenditure under Law 546.
[4] To be specified as performance criterion at the time of the program review scheduled for June 30, 2001.

2. The overall balance of the **combined public sector** (PS) 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, the territorial governments, and the social security system; the central government includes the central administration and the national decentralized agencies as indicated below. 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

PS = 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) + social security
CG = central administration + national decentralized agencies
TG = territorial government + territorial decentralized agencies

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

3. For any given calendar quarter, the overall **PS 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. Items denominated in foreign currency will be converted into Colombian pesos at the actual exchange rate of each transaction.

4. The **PS net domestic financing** comprises (i) the change in its net credit from the financial system, excluding bonded debt; (ii) the change in its bonded debt (including domestic bonds denominated in or indexed to foreign currencies) excluding any valuation changes; (iii) the change in the budget carry-over (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 (ISA, ISAGEN, and the national electricity distributors), 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 PS deficit.

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

6. The PS **net external financing** is defined as the sum of (i) disbursements of project and nonproject loans, including securitization (titularización) of export receipts; (ii) proceeds from bond issues abroad; (iii) the net changes in short-term external debt including pre-payment of exports; and (iv) any change in arrears on external interest payments; minus (v) net increase in the financial assets held abroad by the PS; (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, is 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. The local currency amounts of the net external financing transactions are calculated at the actual exchange rate of each transaction.

7. **Privatization** proceeds are defined as the cash payments received by the PS, converted to Colombian pesos at the actual market exchange rate of each transaction. Nonrecurrent fees (e.g., prepayments) received by the PS 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 decapitalization of public enterprises will be considered as privatization. To the extent 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 PS; if the PS 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 PS.

8. **Adjustments**

(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 will be adjusted upward (see below) by the full amount of any concessional loan disbursements in support of the "Plan Colombia." 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 (Fund staff will provide data for the CIRR if required).

(ii) It is expected that the Inter-American Development Bank will provide a loan for development projects in the conflict zone under the "Plan Colombia." To the extent such support is provided, the quarterly ceilings on the **combined public sector** deficit will be raised by the amount disbursed, up to the equivalent to US$150 million in 2001.

(iii) The cumulative quarterly ceilings on the combined public sector deficit will be adjusted downward by 130 percent of the revenue of the petroleum stabilization fund (FAEP), as currently defined in the law, in excess of the baseline set out in Table 1.

II. Monetary Targets

9. Reflecting the BR's inflation targeting approach to monetary policy, quarterly targets for 2001 have been established for the 12-month rate of consumer price inflation, measured by the IPC compiled by DANE. The authorities will complete consultations with the Fund (Executive Board) on the proposed policy response before requesting purchases from the Fund in the exceptional event that the observed quarterly inflation were to deviate by 2 percentage points or more from the quarterly baseline set out in the table below.1 In the event that the actual inflation deviates significantly from the programmed target (within the 2 percent 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.

	Actual December 2000	Projected [1]					
		Mar. 31 2001	Jun. 30 2001	Sep. 30 2001	Dec. 31 2001		
Inflation target			8.75	8.7	8.9	8.6	8.0

[1] The consultation mechanism enters into effect starting with March 2001.

III. External Targets

A. Performance Criterion on NIR of the BR

	Target [1] (In millions of U.S. dollars)
Outstanding stock as of:	

December 31, 2000 (actual)	8,822
March 31, 2001 (performance criterion)	8,900
June 30, 2001 (performance criterion)	8,980
September 30, 2001 (indicative target) [2]	9,060
December 31, 2001 (indicative target) [2]	9,145

[1] Minimum level of NIR of the BR. NIR as defined in Section II below.
[2] Performance criterion to be specified at the time of the program review scheduled for June 30, 2001.

10. The **NIR** of the BR (reservas de caja) are equal to the balance of payments concept of net international reserves, and therefore exclude causaciones (accrued, but unpaid, interest on reserve assets and liabilities); and are the U.S. dollar value of gross foreign reserves of the BR minus gross reserve liabilities. The net reserves are accounted for at the U.S. dollar value at the time of acquisition.

11. **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. Gross foreign reserves exclude capital participation in international financial institutions (including Corporación Andina de Fomento (CAF), IDB, IBRD, IDA, 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**. Gross 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, (ii) liabilities to the Fund, (iii) any net position on foreign exchange derivatives, including forward (futures) contracts, with both residents and nonresidents undertaken directly by the BR or by other financial institutions on behalf of the BR, (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$94.9 million, which is the level of the outstanding debt on December 31, 2000, and (vi) any foreign currency deposits in the BR by residents, including financial institutions. Options to sell foreign exchange to the central bank acquired by financial institutions and the treasury at the monthly auctions to build the central bank's reserves and to buy or sell foreign exchange to stabilize the exchange rate will be added to reserves when they are exercised.

12. Adjustments

(i) The quarterly NIR targets may be adjusted downward by up to US$250 million, as necessary, to help secure orderly foreign currency market conditions consistent with the present rules of the central bank's foreign exchange auctions.

B. Performance Criterion on the Net Disbursement of Medium- and Long-Term External Debt of the Public Sector 1 2 3

	Ceiling (In millions of U.S. dollars)
Cumulative net disbursement of external debt by the public sector from January 1, 2001 to:	
March 31, 2001 (performance criterion)	460
June 30, 2001 (performance criterion)	1,210
September 30, 2001 (indicative target) [4]	1,745
December 31, 2001 (indicative target) [4]	2,680

[1] The public sector includes the PS as defined above and the financial public sector, including second-tier banks.
[2] To the extent that the combined public sector in any calendar quarter increases its net disbursements over and above the ceilings established in this table in the international financial markets to prefinance its future requirements, this amount will not be counted under the ceiling to the extent that the proceeds are being held abroad.
[3] 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).
[4] Performance criterion to be specified at the time of the program review scheduled for June 30, 2001

13. This ceiling applies to the net disbursement (gross disbursement minus amortization/redemptions) of debt of the public sector (financial and nonfinancial) of nonconcessional external debt of maturity of over one year. The changes in the external debt will be valued in U.S. dollars at the exchange rate prevailing at the time of each transaction.

14. Adjustments

(i) The ceilings on the net disbursement of medium- and long-term external debt of the public sector will be adjusted upward to the extent of any disbursements under the loan described in paragraph 8 (ii) above.

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

C. Performance Criterion on Change in the Outstanding Stock 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, 2001 to:

March 31, 2001 (performance criterion)	80
June 30, 2001 (performance criterion)	80
September 30, 2001 (indicative target) [2]	80
December 31, 2001 (indicative target) [2]	80

[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.
[2] Performance criterion to be specified at the time of the program review scheduled for June 30, 2001.

IV. Structural Benchmark

16**. To be completed by March 31, 2001**

- Present to congress a proposal on territorial tax reform, granting more fiscal autonomy to territorial governments (territorial tax reform).
- Present to congress Acto Legislativo on territorial transfers for last reading.
- Government ministries will present to cabinet their plans for restructuring/downsizing of the ministries and their dependent entities.
- Design a legal framework for CISA (assets management company) to facilitate sale of assets.

17. **To be completed by June 30, 2001**

- Put into effect a reform of the health system under the social security institute.
- Present to congress a proposal for a second generation pension reform (modifying Law 100 of 1993).
- Revise investment norms applicable to private pension funds to help stimulate the development of longer term capital markets.
- Introduce legislation (revision of Law 60 regarding public education and health) to strengthen control over the public finances and resource allocation (to complement Acto Legislativo).

- Approve regulatory framework for mortgage-backed securities.

- Develop framework to facilitate the purchase and assumption of assets and liabilities of financial institutions.

18. **To be completed by September 30, 2001**

- Introduce a draft fiscal responsibility law in congress.

19. **To be completed by December 31, 2001**

- Full disinvestment or closure of the remaining public banks, excluding Banco Agrario.

20. **To be completed by June 30, 2002**

- Final report of the commission on public finances.

21. **To be completed by September 30, 2002**

- Complete the process of bringing provisioning standards of the financial institutions to international levels.

- Latest date for accepting the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

Table 1. Colombia: Baseline Assumptions for Oil Stabilization Fund Revenue (FAEP)
(Cumulative from January 1, 2001)

	Mar. 2001	Jun. 2001	Sep. 2001	Dec. 2001
(In millions of U.S. dollars)				
Revenue of FAEP	119	193	239	287

[1] The BR also will provide Fund staff with monthly information and analysis of inflationary developments and forecasts, as agreed, and keep the staff appraised of all policy actions taken to achieve the inflation objectives of the program.