



THE REPORT TO CONGRESS BY
THE BOARD OF DIRECTORS

MARCH 2002

BANCO DE LA REPÚBLICA
(THE CENTRAL BANK)

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*1 April 2002
Bogotá D. C. (Colombia)*

*Honorable Chairman and Members of the
Third Standing Constitutional Committees of
the Senate and House of Representatives
Bogota, Colombia*

Dear Sirs:

Pursuant to Article 5 of Law 31/1992, the Board of Directors of Banco de la República hereby submits to the Congress of the Republic of Colombia a report on the macroeconomic results of the years 2001 and 2002 to date, together with a description of the goals adopted by the Board of Directors for the current year and the prospects for the different macroeconomic variables. The last section of the report provides Congress with information on the composition of international reserves and projections on the financial position of Banco de la República for 2002.

Sincerely,



Miguel Urrutia Montoya
Governor, Banco de la República

INTRODUCTION

The following report, presented to the Colombian Congress, offers a detailed analysis of recent economic performance and the macroeconomic policy implemented in 2001. Annual inflation that year, measured by the consumer price index (CPI), was 7.65%, which is slightly below the target set by the Board of Directors of Banco de la República (BDBR), in conjunction with the government. As to the balance of payments, the current account for 2001 showed a deficit, following equilibrium the year before. This was the result of import growth, a decline in the volume of oil exports, and lower prices for coffee on the international market. In spite of important increases in employment throughout the year, unemployment continued to be the most serious problem in the Colombian economy.

Chapter II of the report contains an analysis of the principal macroeconomic variables in 2001. The past year was a time of slow growth and less momentum compared with 2000. This was associated with the limited growth in demand brought on by external factors such as performance of the world economy and the drop in terms of trade. These factors affected other Latin American countries as well. Lower coffee prices had an important impact on the decline in aggregate demand. Less demand, in turn, was also influenced by domestic factors such as persistent unemployment. In terms of supply, the economy faced several major shocks, including the slowdown in oil and farm production due to violence in the countryside and the onset of retention in the cattle cycle. Guerrilla and paramilitary violence had a negative effect on investment and destroyed infrastructure, forcing public and private funds to be deviated for defense and security, besides prompting a flight of capital and skilled manpower from the country.

As is traditional, the report provides a detailed description of the country's macroeconomic policy with respect to monetary, exchange, financial and fiscal matters. Chapter III explains that macroeconomic policy in 2001 was applied to support maximum economic growth, without jeopardizing the inflation target. The exchange situation saw major changes in 2001. Depreciation of the peso in the first half of the year was followed by revaluation in the second. Even so, the exchange rate was 10.2% higher, on average, than in the year 2000. This upward trend was influenced by important external borrowing in the public sector, not only to finance the fiscal deficit but to guarantee the significant level of borrowing required for 2002.

The main indicators for the financial system continued to improve. Nevertheless, there are still problems, especially in mortgage banking where the portfolio declined throughout 2001. However, capitalization was possible at the end of the year, with the support of Fogafin.

The fiscal deficit is one of the primary concerns with respect to the macroeconomic situation. This has been the case for several years and steps were taken in 2001 to continue to reduce the

deficit. Legislative Act 01 and Law 715 are two examples. Law 617/2000 began to be applied as well. Although these measures will imply fiscal savings, more needs to be done. Due to the persistent deficit in the country's public finances, primarily those of the central government, public borrowing continues to rise, although at a slower pace. And, unless efforts to reduce the deficit continue, it is likely to become a stumbling block to sound, short-term macroeconomic management and to long-term economic growth. The fiscal deficit and sustainability of the public debt are analyzed from this perspective in Chapter IV of the report

The macroeconomic prospects for 2002 with respect to inflation, the balance of payments, economic growth and the fiscal deficit are outlined in Chapter V. Inflation will continue to decline gradually, thanks to carefully implemented monetary policy. Accordingly, the BDBR is confident the target of 6% inflation for 2002 will be met. As to the country's balance of payments, the current account deficit in 2002 is expected to equal 3.1% of gross domestic product (GDP), due to a 1.8% decline in merchandise exports and a 3.9% increase in merchandise imports. On the other hand, weak product growth in 2001, coupled with the difficult international environment, prompted the Ministry of Finance and Public Credit to revise its projections for 2002. New government projections anticipate economic growth between 2.5% and 3.0%. The consolidated deficit in the public sector will be around 2.6% of GDP at year's end, with a variation near 0.7% of GDP compared with the size of the deficit in 2001.

The report ends with a look at the trend in international reserves and the financial position of Banco de la República. Due to low interest rates, Colombia expects less yield on its international reserves this year and a substantial reduction in profits for Banco de la República.

II

RECENT MACROECONOMIC PERFORMANCE

Annual inflation, measured by the CPI, continued to decline gradually throughout 2001. It was 7.65% at year's end, as opposed to the target of 8.0% set by the BDBR for the same period. According to the most recent calculations by the National Bureau of Statistics (DANE), real GDP growth in Colombia was 1.57% in 2001. The larger Latin American economies witnessed a similar phenomenon. According to figures published by the Economic Commission for Latin America (ECLAC), real growth in the region was 0.5%. Some Latin American countries, such as Mexico and Peru, experienced no growth, and Argentina is in the midst of a dramatic economic recession. Calculations point to 2% growth in Brazil and, according to the latest figures from the Central Bank, real GDP in Chile, the Latin American country to grow the most in the last few decades, rose by 2.9%. The preliminary figures on economic performance in all the countries are much lower than those expected a year earlier. As a result, projected GDP growth for 2002 has been revised downward.

The combination of a sharp drop in product growth in countries with economies that are very different from an economic and geographic standpoint suggests that some of the reasons for poor economic performance in 2001 are external. The following are highlights in this respect.

- The major slowdown in the United States economy reduced the demand for goods and services from Latin America and Asia. This had a negative impact on GDP growth in countries

such as Mexico, where 80% of all exports go to the North American market, and in Chile, where more than 30.0% of all exports are destined for the Asian market. In Colombia, the effect on industrial production and certain agricultural goods was especially significant, as sales from these sectors to the United States market have increased substantially in recent years.

- The deterioration in external conditions was evidenced by an almost 3.0% drop in oil prices on the international market compared with the level observed in the last quarter of 2000. The result was a negative impact on national revenue and on the fiscal situation in Venezuela, Mexico, Ecuador and Colombia.
- There was a generalized downturn in commodity prices, mainly because of the international recession. Specific factors in each market also had an influence. International coffee prices have declined sharply compared with average values observed a decade earlier. This is due to coffee production in Brazil and Vietnam, and has negatively affected the economy in Colombia and several Central American countries. The price of copper has also declined, adversely affecting the Chilean economy, and the demand for meat has been reduced the world over. The latter is due to the incidence of cattle diseases and has deepened the economic recession in Argentina.
- In the past, reduced foreign capital inflows displayed anti-cyclical behavior by increasing

when these economies slowed, and vice versa. However, this is no longer the case. According to recent estimates by the International Monetary Fund (IMF), foreign direct investment in Latin America declined in 2001. This was due to the events of September 11, to less demand for the products of multinational companies, and to deterioration in the financial situation of several companies. There has been less portfolio investment and less access to external credit, which has not been offset by lower costs due to the drop in long-term interest rates in the United States economy.

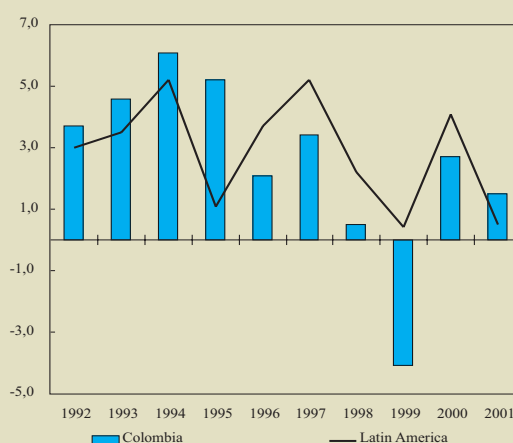
The negative impact of external shocks was magnified in Latin America by internal causes. In Colombia, as will be illustrated later, external shocks coincided with the growing deterioration in law and order, high unemployment, major borrowing in the private sector, a growing public debt, and a strong perception of risk in the financial system. This has weakened the climate for private investment (domestic and foreign) and made it difficult to apply an anti-cyclical fiscal policy. At the same time, households are reluctant to spend and the effectiveness of monetary policy as a mechanism for economic reactivation in the short term has declined. This also explains the low growth in the potential productive capacity of the Colombian economy.

A. ECONOMIC ACTIVITY AND EMPLOYMENT

1. Economic Activity

Real annual GDP growth in Colombia was estimated at 1.57% for 2001, following 2.8% the year before. This is evidence of weakened economic recovery in the wake of the 1999 recession. The situation in Colombia was echoed in other Latin American countries, showing that common external shocks affect the region as a whole (Figure 1).

FIGURE 1
GDP GROWTH RATES
LATIN AMERICA AND COLOMBIA 1992-2001
 (PERCENTAGE)



Note: The figures for 2001 are preliminary.
 Source: ECLAC.

a. Analysis of Demand

External demand was the most dynamic component, with 7.03%¹ annual growth (Figure 1). This aggregate grew more than in 2000, in spite of the slowdown in demand from the United States, which was accentuated by the events of September 11, 2001. According to quarterly export figures, much of the loss caused by those events was recovered in the last quarter of the year, showing the transitory nature of this negative shock. The slowdown in demand in the United States was also offset, in part, by momentum in the Ecuadorian and Venezuelan economies throughout the entire year.

Growth in domestic demand remained low (2.51%) because of slow growth in end consumption (1.45%), which has yet to recover two years after of the worst recession on record for the Colombian economy. However, the pace of government consumption increased due to more public spending in the last two quarters of the year.

¹ When this report went to press, DANE had yet to publish GDP information on demand. Therefore, this analysis is based on projected figures from the Ministry of Finance and Public Credit.

TABLE 1
ANNUAL GDP GROWTH BY DEMAND
(% CHANGE)

	2000 (pr)					2001 (pr)				
	I	II	III	IV	Annual	I	II	III	IV	Annual
Gross domestic product	1,82	3,10	3,39	2,95	2,81	1,72	1,89	1,04	1,62	1,57
Total imports	3,65	6,60	8,80	3,89	5,69	10,91	21,02	13,47	6,02	12,77
Total final supply	2,09	3,60	4,17	3,09	3,24	3,10	4,71	2,92	2,28	3,25
End consumption	1,81	1,19	1,04	0,13	1,03	1,31	1,30	1,00	2,20	1,45
Household	1,90	1,95	1,66	0,67	1,54	1,76	1,51	0,87	2,02	1,54
Non-durables	2,35	1,34	2,28	(0,28)	1,41	0,29	(0,63)	(3,92)	(1,44)	(1,43)
Semi-durables	4,17	7,66	8,51	10,53	7,73	6,53	6,37	6,01	7,18	6,53
Utilities	0,51	1,49	2,22	1,53	1,44	2,51	2,66	2,99	3,21	2,85
Durables	11,95	14,41	6,82	7,51	10,04	7,41	4,39	5,85	9,24	6,76
Government consumption	1,40	(2,08)	(1,63)	(2,21)	(1,15)	(0,70)	0,39	1,58	2,96	1,07
Gross capital formation	1,19	21,81	24,22	15,05	14,93	8,80	15,76	8,42	0,39	8,85
Gross fixed capital formation	(11,00)	(1,11)	3,74	9,17	(0,24)	4,19	11,04	10,81	8,64	8,69
Machinery and equipment	(15,16)	(4,79)	13,69	18,41	1,94	17,42	36,20	19,22	(1,77)	17,05
Transportation equipment	(5,75)	10,14	3,79	0,15	1,89	30,73	33,07	43,27	50,25	38,98
Buildings	(21,03)	(7,42)	7,86	11,17	(3,48)	7,29	10,18	7,95	17,13	10,76
Civil works	(0,56)	3,79	(4,98)	4,21	0,58	(12,70)	(9,69)	0,49	5,31	(4,31)
Subtotal: End internal demand	1,72	3,67	3,89	2,03	2,82	2,37	3,61	2,15	1,94	2,51
Total exports	4,13	3,23	5,65	8,71	5,45	6,96	10,56	6,84	4,01	7,03
Total final demand	2,09	3,60	4,17	3,09	3,24	3,10	4,71	2,92	2,28	3,25

(pr) Preliminary.

Source: DANE (2000-I to 2001-III) and Ministry of Finance and Public Credit (2001-IV and 2001 annual).

Less annual growth in household consumption was the result of a slowdown in the consumption of non-durable goods, specifically food and beverages. The sharp downturn in this respect is a phenomenon observed since late 2000 and contrasts with the healthy pace exhibited by the other components of this variable - especially durables and semi-durables - and with imports of consumer durables (13.5% annual increase).

A consumption pattern of this type is not easy to explain. However, the limited growth in non-durables, which has the most effect on such trends, is the result of several factors. To begin with, the

decline in terms of trade had a negative effect on national revenue, particularly in the coffee sector. Secondly, higher taxes reduced the amount of income available to households. Third, real wages in the formal sector of the economy increased, while those in the informal sector declined, causing a rise in durable consumption and a decline in non-durable consumption. Finally, high unemployment made many families more cautious about consumption, given persistent uncertainty about the future of household income.

As shown in Figure 2, last year's decline in terms of trade for Colombia exceeded the Latin American

average. Due to this factor and to foreign transfers for interest on the debt and remittance of profits to foreign oil companies, income grew less than product and even declined in 2001. This is according to the estimates presented in Figure 3.

The coffee sector was especially hard hit due to the drop in income resulting from lower terms of trade. Despite increased production, the negative

shock originating with international prices had an important impact on producer income and affected domestic coffee prices as well, in spite of the subsidy provided by the national government as of October 2001 (Figure 4).

The tax reform adopted at the end of 2000 increased levies on companies and households, thereby reducing available income. It can be said that one of the primary consequences was a standstill in the private GDP during 2001, as illustrated in Figure 5. The contractionary effect of higher taxes was offset, in part, by increased growth in the public GDP as a result of more spending, particularly towards the end of the year. Nevertheless, this did not lead to a rise in economic activity overall, since the trend in product is closely associated with the trend in private activity. It also shows the fiscal policy was not effective in reactivating the economy.

On the other hand, the substantial increase in the consumption of durables and semi-durables can be explained by their relative decline in price due to

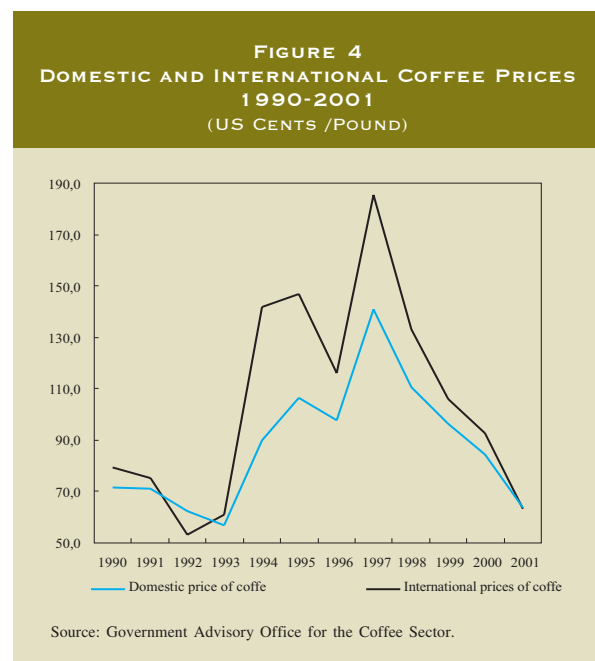
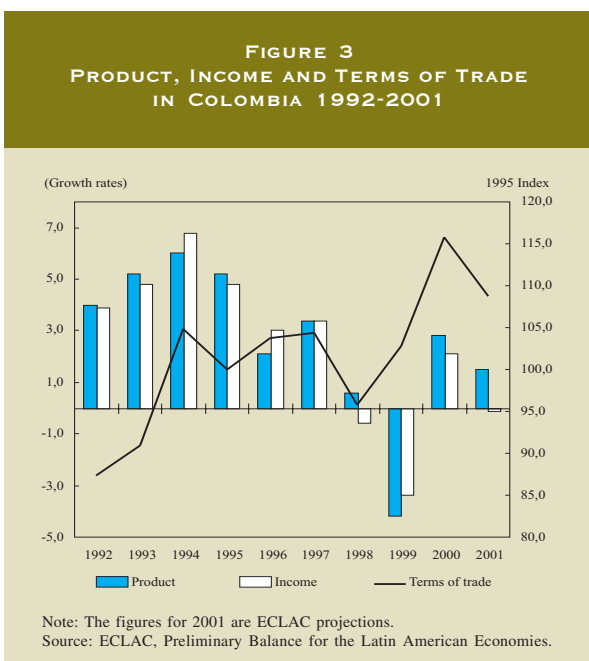
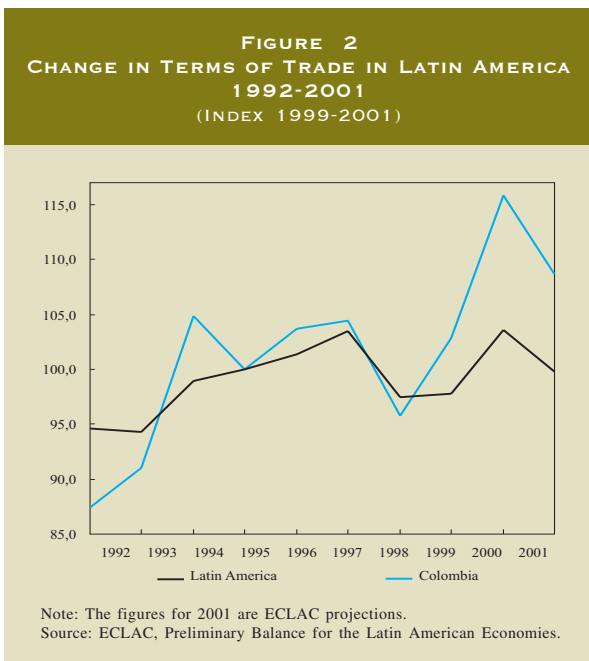
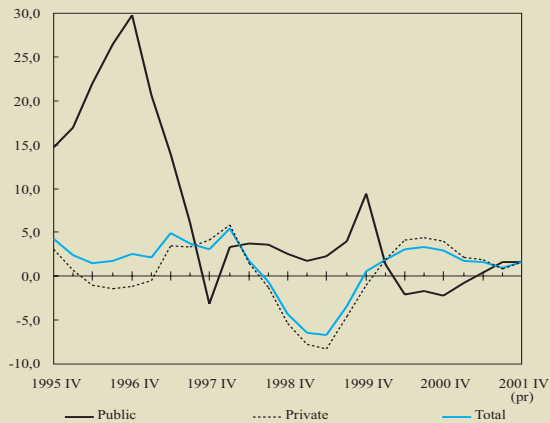
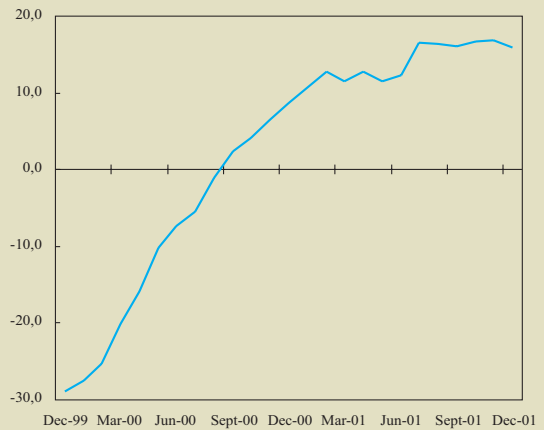


FIGURE 5
GDP GROWTH 1994-2001
 (PERCENTAGE)



(pr) Preliminary.
 Source: DANE, National Department of Planning (DNP) calculations.

FIGURE 6
ANNUAL GROWTH IN IMPORTS OF CONSUMER
GOODS 12-MONTH ACCUMULATION
 (PERCENTAGE)



Source: Import declarations, National Revenue and Customs Authority (DIAN).

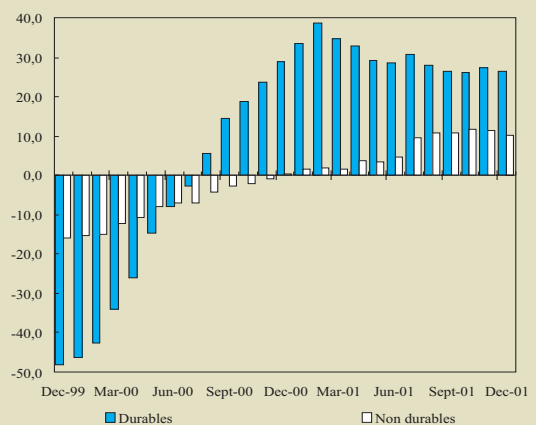
limited devaluation in the exchange rate. Most of these goods are imported or compete with imports from other countries. Consequently, their price depends on the exchange rate. In fact, imports of consumer durables rose sharply during the course of the year (Figures 6 and 7).

There was an increase of 8.69% in the formation of fixed capital during 2001, as opposed to -0.24% in the year 2000. The items registering the highest growth rates were transportation equipment (38.98%) and machinery and equipment (17.05%).

b. Analysis of Demand

A look at the trend in GDP by sectors shows transportation was the most dynamic, with 3.55% growth, due mainly to foreign sales in certain sectors. Construction was the second most dynamic sector, with 3.15% annual growth (Table 2). Several government policies, such as increased spending on subsidies for low-income housing and measures to reduce taxes on home loans, were instrumental in this respect. The number of building permits approved during the year rose by 12.0%, on average, and the momentum of new loans for housing continued (Figures 8 and 9).

FIGURE 7
GROWTH IN IMPORTS OF CONSUMER GOODS
BY TYPE 12-MONTH ACCUMULATION
 (PERCENTAGE)



Source: DANE.

The commercial sector saw low but positive growth rates (2.06%), a sign of continued weak growth in final household consumption. Social, community and personal services also increased (1.44%), thanks to social and health services that depend largely on the trend in public spending.

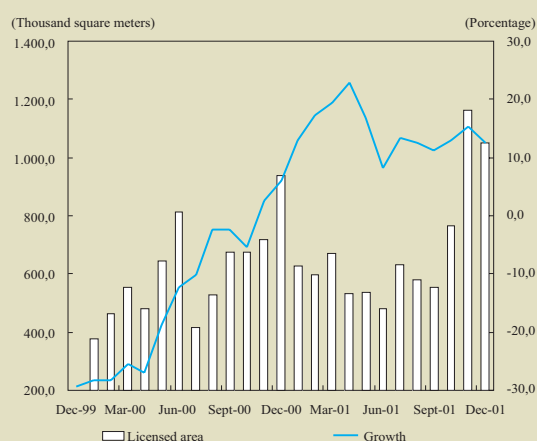
Agriculture and livestock, one of the most dynamic sectors in the year 2000, with 6.24% growth, saw

TABLE 2
QUARTERLY GDP BY SECTOR - DESEASONALIZED SERIES
(ANNUAL % CHANGES)

	2000 (pr)					2001 (pr)				
	I	II	III	IV	Annual	I	II	III	IV	Annual
Agriculture and livestock, forestry, hunting and fishing	2,94	8,99	5,43	7,73	6,24	4,02	0,17	(0,22)	2,08	1,50
Mining and quarrying	(6,30)	(12,76)	(12,48)	(8,62)	(10,04)	(9,54)	(3,50)	0,94	(6,66)	(4,81)
Electricity, gas and water	1,60	(0,24)	(0,67)	1,26	0,48	1,07	2,87	2,71	0,94	1,89
Manufacturing industry	10,08	11,72	11,95	5,28	9,69	2,50	0,88	(3,28)	(2,96)	(0,75)
Construction	(13,84)	(4,78)	0,74	8,60	(2,85)	(3,36)	(0,19)	4,81	10,91	3,15
Commerce, repairs, restaurants and hotels	6,33	12,19	13,11	9,72	10,32	4,02	1,72	0,35	2,24	2,06
Transportation, storage and communication	2,77	3,80	4,82	3,32	3,68	3,19	5,07	2,83	3,13	3,55
Financial establishments, insurance and real estate	(0,42)	0,56	1,32	(1,14)	0,08	0,37	(0,74)	0,37	0,77	0,19
Social, community and personal services	1,43	(0,89)	(1,61)	(2,55)	(0,93)	(0,14)	0,84	2,30	2,74	1,44
Gross domestic product	1,67	3,09	3,41	3,07	2,81	1,72	1,89	1,04	1,67	1,57

(pr) Preliminary.
Source: DANE.

FIGURE 8
BUILDING PERMITS AND GROWTH
IN THE LAST 12 MONTHS

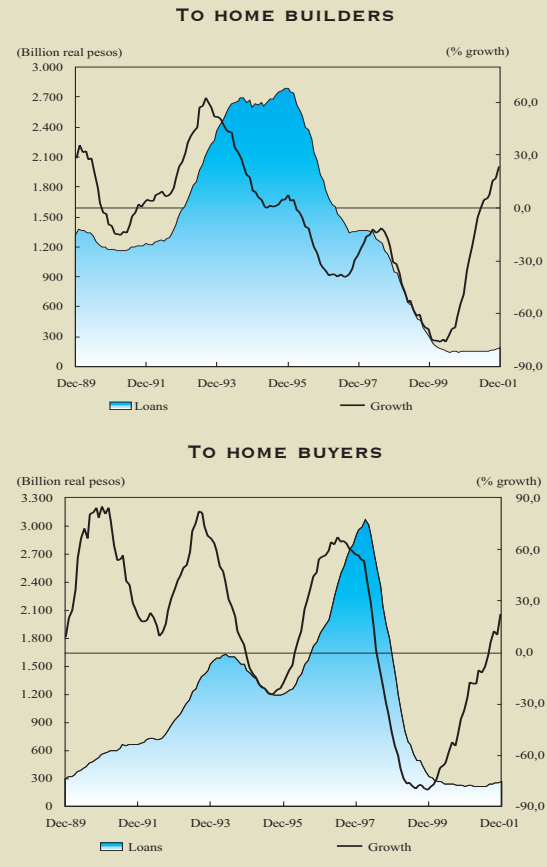


Source: DANE.

a increase of 1.50% in 2001. Due to the start of retention in the cattle cycle, the livestock sector was primarily responsible for this slowdown. Violence in the country's rural areas was also a contributing factor.

Activity in the manufacturing sector slowed by 0.75% compared with 2000. This is a setback from the previous year, when activity increased by 9.69%, and is attributed to factors such as the drop in external demand, the slowdown in orders (particularly from exporting companies), and a possible policy to reduce the accumulation of inventory. In fact, the sectors showing a decline up to September were those directly involved with

FIGURE 9
LOANS GRANTED AND ANNUAL MONTHLY GROWTH



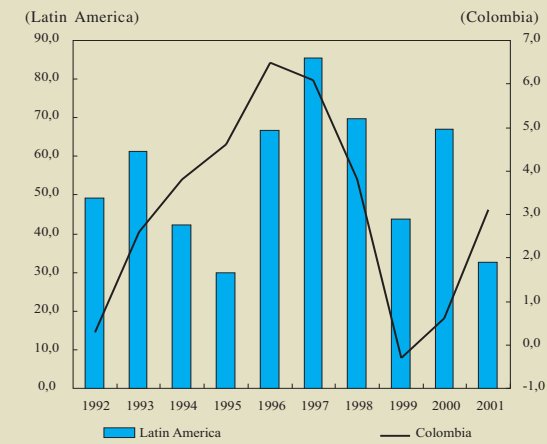
Source: Colombian Savings and Home Loan Institute (ICAV).

exports to the United States or to the domestic market, particularly exports of clothing, metallic goods, and basic and manufactured chemical products. The sectors registering the most growth were those that export products to neighboring countries, such as automobiles, electrical machinery, food, sugar and leather goods.

Mining and quarry exports declined in 2001 (-4.81%) as a result of the slowdown in oil production throughout the year. Terrorist attacks on oil facilities in the first six months prevented Caño Limón from producing at full capacity during several months of the year. Coal production increased somewhat during the first half of the year, but was affected adversely in the second by terrorist attacks on mining companies.

In short, there were a variety of reasons for the decline in growth in Colombia during 2001. Some of them, such as the reduction in terms of trade, affected other Latin American countries as well. The slump in capital inflows to the region was a determining factor in the economic slowdown on the continent. In the case of Colombia, capital inflows increased, primarily those to finance the public sector, giving the country's economic policy an expansionary bias (Figure 10).

FIGURE 10
CAPITAL ACCOUNT BALANCE IN LATIN AMERICA AND COLOMBIA 1992-2001
(US\$ BILLIONS)



Source: ECLAC, Preliminary balance for the Latin American economies, 2001.

Panel 1 contains an analysis of the factors that affect the productive capacity of the economy in the long term and explain the reasons why it is growing less than in the past.

2. Employment

In December 2001, unemployment was 16.4% for the 13 major urban areas, a rate similar to that registered for the same month the year before (Figure 11). This was the result of more demand for jobs (occupation was 55.1% in December or

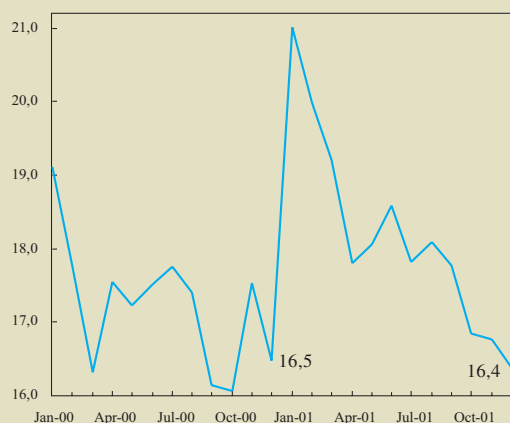
0.6 percentage points more than during the same month in 2000), coupled with an increase in the labor supply (the overall rate of employment was 65.9%; that is, 0.6 percentage points above the rate in December 2000). The national unemployment rate was 13.5%, the lowest during the year.

Growth in employment in the 13 major cities, measured through the so-called continuous home

surveys (ECH), accelerated as of October, reversing the trend observed in the second and third quarters of 2001 (Figure 12).

The decline in unemployment at December 2001 occurred in spite of a renewed downturn in industrial employment. This is according to figures from the monthly manufacturing sample (Figure 13). Therefore, the improvement in employment at December is probably associated with increased productive activity in sectors such as construction, commerce and general services.

FIGURE 11
UNEMPLOYMENT RATE FOR 13 CITIES
NEW METHODOLOGY
(PERCENTAGE)

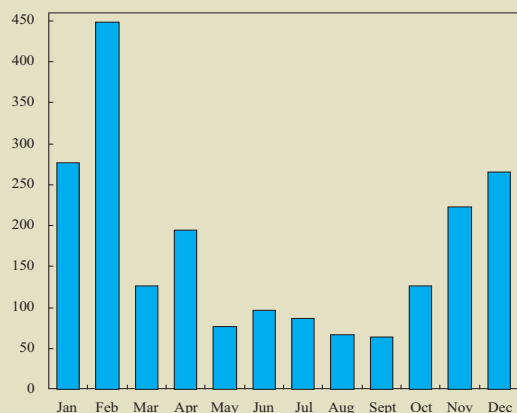


Source: DANE.

B. BALANCE OF PAYMENTS

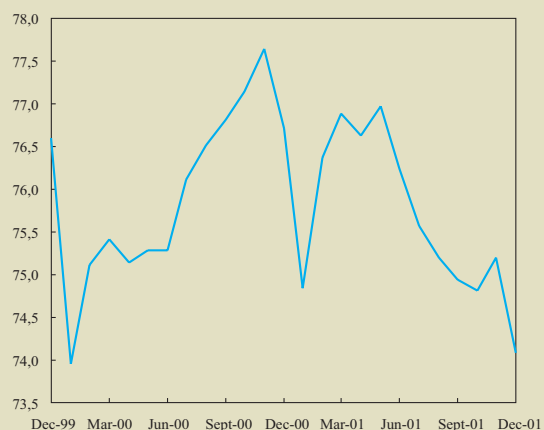
A preliminary estimate of the balance of payments for the 12 months of 2001 shows a current account deficit of US\$2,636 million (m) (2.0% of GDP) and US\$3,507 m in net capital inflows. Gross international reserves accumulated during the year came to US\$1,125 m, with a balance of US\$10,245 m at December (Table 3).

FIGURE 12
ANNUAL GROWTH IN EMPLOYMENT IN THE 13
MAJOR CITIES - 2001
(THOUSANDS OF EMPLOYED)



Source: DANE.

FIGURE 13
TOTAL INDUSTRIAL EMPLOYMENT RATE
(EMPLOYEES - WORKERS)
(PERCENTAGE)



Source: DANE.

TABLE 3
SUMMARY OF COLOMBIA'S BALANCE OF PAYMENTS
2000-2001

	Millions of dollars		% of GDP		Annual Difference 2001-2000
	2000 (pr)	2001 (e)	2000 (pr)	2001 (e)	
I. CURRENT ACCOUNT	394	(1,636)	0.48	(2.01)	(2,030)
Income	18,446	18,191	22.69	22.35	(255)
Disbursements	18,052	19,826	22.20	24.36	1,774
A. Nonfactor goods and services	1,286	(825)	1.58	(1.01)	(2,111)
1. Goods	2,531	494	3.11	0.61	(2,037)
Exports	13,620	12,759	16.75	15.67	(862)
Imports	11,089	12,265	13.64	15.07	1,175
2. Nonfactor services	(1,245)	(1,319)	(1.53)	(1.62)	(75)
Exports	2,069	2,201	2.54	2.70	132
Imports	3,314	3,520	4.08	4.32	207
B. Factor Income	(2,542)	(2,949)	(3.13)	(3.62)	(407)
Income	859	728	1.06	0.89	(131)
Disbursements	3,401	3,677	4.18	4.52	276
C. Current Transfers	1,650	2,139	2.03	2.63	488
Income	1,898	2,503	2.33	3.08	605
Disbursements	248	365	0.31	0.45	116
II. CAPITAL AND FINANCIAL ACCOUNT	517	2,507	0.64	3.08	1,990
A. Financial Account	517	2,507	0.64	3.08	1,990
1. Long-term Financial Flows	2,094	4,823	2.58	5.92	2,729
a. Assets	325	(60)	0.40	(0.07)	(385)
i. Colombian direct investment abroad	325	(60)	0.40	(0.07)	(385)
ii. Loans 1/	0	0	0.00	0.00	0
iii. Leasing	0	0	0.00	0.00	0
iv. Other assets	0	0	0.00	0.00	0
b. Liabilities	2,459	4,798	3.02	5.89	2,339
i. Foreign direct investment in Colombia	2,387	1,979	2.94	2.43	(408)
ii. Loans 1/	273	2,988	0.34	3.67	2,715
Public sector	1,139	2,949	1.40	3.62	1,810
Private sector	(866)	39	(1.07)	0.05	905
iii. Leasing	(202)	(169)	(0.25)	(0.21)	32
Public sector	(32)	(31)	(0.04)	(0.04)	1
Private sector	(169)	(138)	(0.21)	(0.17)	31
iv. Other liabilities	0	0	0.00	0.00	0
Public sector	0	0	0.00	0.00	0
Private sector	0	0	0.00	0.00	0
c. Other long-term financial movement	(40)	(35)	(0.05)	(0.04)	4
2. Short-term Financial Flows	(1,577)	(2,316)	(1.94)	(2.85)	(739)
a. Assets	1,527	3,232	1.88	3.97	1,705
i. Portfolio investments	1,014	3,412	1.25	4.19	2,398
Public sector	100	1,604	0.12	1.97	1,504
Private sector	913	1,808	1.12	2.22	894
ii. Loans 1/	513	(180)	0.63	(0.22)	(694)
Public sector	(65)	(6)	(0.08)	(0.01)	59
Private sector	579	(174)	0.71	(0.21)	(753)
b. Liabilities	(50)	916	(0.06)	1.12	965
i. Portfolio investments	17	(41)	0.02	(0.05)	(58)
Public sector	0	(1)	0.00	(0.00)	(1)
Private sector	17	(40)	0.02	(0.05)	(56)
ii. Loans 1/	(67)	956	(0.08)	1.17	1,023
Public sector	(473)	121	(0.58)	0.15	595
Private sector	406	835	0.50	1.03	429
B. Special Capital Flows	0	0	0.00	0.00	0
III. NET ERRORS AND OMISSIONS	(42)	254	(0.05)	0.31	296
IV. CHANGE IN GROSS INTERNATIONAL RESERVES 2/	870	1,125	1.07	1.38	256
V. GROSS INTERNATIONAL RESERVES	9,006	10,245	11.08	12.59	1,239
VI. NET INTERNATIONAL RESERVES	9,004	10,192	11.08	12.52	1,188
Months merchandise imports	9,7	10,0			
Months goods and services imports	6,1	6,3			
Nominal GDP in US\$ millions	81,298	81,396			
VII. CHANGE IN NET INTERNATIONAL RESERVES	869	1,074	1.07	1.32	205

(p) Provisional.

1/ Includes portfolio investment, direct loans and commercial credit.

2/ According to the balance-of-payments methodology.

Source: Banco de la República.

1. Current Account

The current account deficit rose mainly because the trade balance (non-factory goods and services) dropped from a surplus of US\$1,286 m in 2000 to a deficit of US\$825 m in 2001. The factors responsible for this slump deal with the increase in the dollar value of merchandise imports (US\$1,175 m, which implies an annual increase of 10;6%) and the decline in the dollar value of traditional export products, primarily oil and coffee (US\$1,515 m and US\$305 m, respectively).²

The current account was also affected by factor income, which produced a larger deficit than the year before (US\$407 m) owing to increased remittance of profits on foreign direct investment (US\$352 m). This was offset by more net income from transfers (US\$605 m) related to the increase in remittances from abroad and to donations associated with Plan Colombia.

Table 4 shows the trend in exports by product during 2001. Hydrocarbon exports came to US\$3,055 m. This represents a 33.1% decline and was due to the drop in international prices and export volume. Foreign income from coffee declined by US\$305 m from US\$1,069 m in 2000 to US\$764 m in 2001, also because of a drop in foreign prices and export volume (Table 5). Non-traditional exports rose by 10.3% during the same period, thanks to a 13.0% increase in those of industrial origin, which accounted for 77.6% of all non-traditional exports.

An important factor was the decrease in total exports to the United States and Japan, which fell by 19.5% and 28.4% respectively in comparison with the year 2000. Another significant feature was the growth in non-traditional exports to Venezuela and Ecuador, with respective increases of 33.7% and 52.2% in relation to the previous year (Table 6).

² Not including foreign trade transactions.

The upswing in imports during 2001 originated primarily with the increase in purchases of capital goods. The dollar value of such purchases rose by 30.5% due to a rise in imports of transportation equipment and capital goods for industry. There was a 15.9% increase in imports of consumer goods, while imports of intermediate goods declined by 1.9% (Table 7).

2. Capital Account

The capital and financial account for 2001 showed US\$2,507 m in net revenue, which is US\$1,990 m more than during the same period the year before. This was due mainly to an increase of US\$2,729 m in long-term external flows, offset in part by an additional US\$739 m in short-term capital outflows.

Medium and long-term credit, especially in the public sector, was also a highlight, having increased from US\$1,107 m in 2000 to US\$2,917 m in 2001. This last figure includes US\$1,900 m in foreign bonds placed by the national government as part of 2002 prefunding obtained the year before. Net borrowing in the private sector was negative by US\$99 m, due to repayment of US\$284 m by the financial sector. Borrowing in the rest of the private sector was positive by US\$185 m.

The increase in short-term capital disbursements is explained fundamentally by the behavior of the public sector, especially the national government. The flow of Colombian portfolio investment abroad came to US\$3,412 m; that is, US\$2,398 m more than in the year 2000. This item includes US\$1,138 m in foreign deposits by the National Treasury. Short-term liability flows came to US\$916 m in 2002, or US\$965 m more than in the year 2000. This seems to have been caused by less of a difference between external and internal profitability, thanks to lower foreign interest rates, less-than-expected devaluation of the peso, and increases in credit for import financing.

TABLE 4
EXPORTS, ACCORDING TO PRINCIPAL PRODUCTS AND ECONOMIC SECTORS (PR)
(US\$ MILLIONS, FOB)

	2000	2001	Change	
			Absolute	Relative
Total Exports	13,121.2	12,289.9	(831.3)	(6.3)
Traditional Exports	6,807.5	5,325.3	(1,482.1)	(21.8)
Coffe	1,068.7	764.2	(304.5)	(28.5)
Coal	861.2	1,178.8	317.6	36.9
Ferronickel	211.4	235.2	23.8	11.3
Oil and by-products	4,569.3	3,054.7	(1,514.6)	(33.1)
Gold	0.0	3.3	3.2	6,579.1
Emeralds	96.8	89.2	(7.6)	(7.9)
Non-traditional Exports 1/	6,313.7	6,964.5	650.8	10.3
Agricultural sector	1,350.2	1,347.5	(2.7)	(0.2)
Industrial sector	4,722.2	5,336.9	614.8	13.0
Mining sector	241.3	280.0	38.7	16.1

(pr) Preliminary.

1/ Does not include temporary exports, re-exports and others. Includes balance-of-payments adjustments.

Source: DANE and Banco de la República.

TABLE 5
EXPORT PRICES OF TRADITIONAL PRODUCTS

	Prices		Change %
	2000	2001	
Coffee (US\$/pound, ex-dock)	1.02	0.72	(29.5)
Oil (US\$/barrel)	28.78	23.79	(17.4)
Coal (US\$/ton)	26.73	30.93	15.7
Ferronickel (US\$/pound)	1.76	1.13	(36.0)
Gold (US\$/troy ounce)	279.72	270.02	(3.5)

Source: Banco de la República.

3. Changes in international reserves

The accumulation in gross international reserves came to US\$1,125 m in 2001, thanks to movement in capital and goods and services. This placed the balance at US\$10,245 m, which is equivalent to 10

months of merchandise imports and 6.3 months of goods and services imports. It is also 1.1 times the value of public and private debt amortization during one year. This last indicator has become more important in determining the payment capacity of international reserves. To limit the vulnerability of markets to international flows, it is believed this indicator should at least have a value of one (1.0)³.

C. INFLATION RESULTS AND BASIC TRENDS

The product groups (Table 8 & Figure 15) registering the most favorable trends were housing, clothing and transportation, which showed less of an increase than in the previous year. With a hike of 10.9%, health

³ Bussier & Mulder (1999). "External Vulnerability in Emerging Market Economies: How High Liquidity Can Offset Weak Fundamentals and the Effects of Contagion," International Monetary Fund.

TABLE 6
ANNUAL PERCENTAGE GROWTH IN THE DOLLAR VALUE OF COLOMBIAN EXPORTS
(JANUARY-MARCH 2001)

	United States	Venezuela	Ecuador	Japan	Germany	Mexico	Others	Total
Totals	(19,5)	33,7	52,2	(28,4)	(3,1)	13,6	(4,5)	(6,3)
Non-traditional Exports	0,2	33,8	56,0	(21,0)	2,4	21,3	(3,6)	10,3
Agricultural Sector	(2,6)	73,1	918,5	(12,1)	21,5	34,5	(16,1)	(0,2)
Agricultural Sector	(2,9)	30,8	52,2	(25,2)	(19,6)	21,4	1,0	13,0
Food, beverages and tobacco	22,2	47,4	38,3	(28,6)	(27,5)	85,1	(17,4)	7,5
Yarn and fabric	(0,4)	2,5	22,2	(90,6)	33,2	(19,6)	(3,9)	1,1
Clothing	(1,2)	29,8	105,1	(76,4)	(18,6)	12,4	2,4	9,1
Plastic and rubber products	(19,6)	23,7	7,3	n.a.	2,8	328,1	(6,1)	6,2
Leather and leather goods	(9,4)	(2,0)	198,9	(66,4)	2,7	(13,2)	10,2	4,7
Wood and wood products	5,8	64,6	124,6	(98,9)	(46,1)	46,4	19,9	28,2
Graphic arts and publishing	18,9	37,8	19,9	149,9	40,8	20,6	21,7	25,5
Chemical industry	(26,7)	22,9	15,1	253,7	(50,7)	23,4	9,8	2,8
Non-metallic minerals	13,5	67,1	51,8	(40,0)	(34,9)	16,2	(8,1)	12,6
Common metal industry	6,1	22,9	36,6	68,9	30,0	(1,1)	7,4	13,4
Machinery and equipment	73,8	26,0	44,0	37,4	51,2	43,3	2,0	27,6
Transport material	86,7	40,7	409,3	n.a.	(87,3)	25,1	(14,5)	68,4
Optical, cinema and other apparatus	(3,3)	66,7	106,1	(79,1)	(15,8)	(13,5)	(6,3)	11,7
Other industries	20,5	14,0	21,4	107,3	(31,4)	24,8	(7,4)	8,4
Mining sector 1/	30,1	47,5	545,9	(36,5)	43,1	(26,4)	(49,3)	16,1

n. a. Not applicable.

1/ Does not include emeralds.

Source: Dane and Banco de la República.

TABLE 7
IMPORTS, ACCORDING TO ECONOMIC USE OR DESTINATION (PR)
(US\$ MILLIONS)

	2000	2001	Change	
			Absolute	%
Total Imports	10,783.6	12,009.8	1,226.2	11.4
Consumer Goods	2,034.1	2,356.8	322.7	15.9
Durables	1,323.4	1,457.3	133.9	10.1
Non-durables	710.7	899.5	188.8	26.6
Intermediate Goods	5,454.0	5,352.0	(102.0)	(1.9)
Fuel and lubricants 1/	225.5	173.2	(52.3)	(23.2)
For agriculture	445.1	444.0	(1.1)	(0.3)
For industry	4,783.4	4,734.9	(48.5)	(1.0)
Capital Goods	3,288.1	4,292.2	1,004.1	30.5
Construction material	154.0	168.6	14.6	9.5
For agriculture	22.4	37.9	15.5	69.0
For industry	2,154.1	2,529.6	375.5	17.4
Transport equipment	957.6	1,556.2	598.6	62.5
Unclassified goods	7.4	8.8	1.4	19.2

(pr) Preliminary.

1/ Includes petroleum derivatives and coal.

Source: DANE and DIAN.

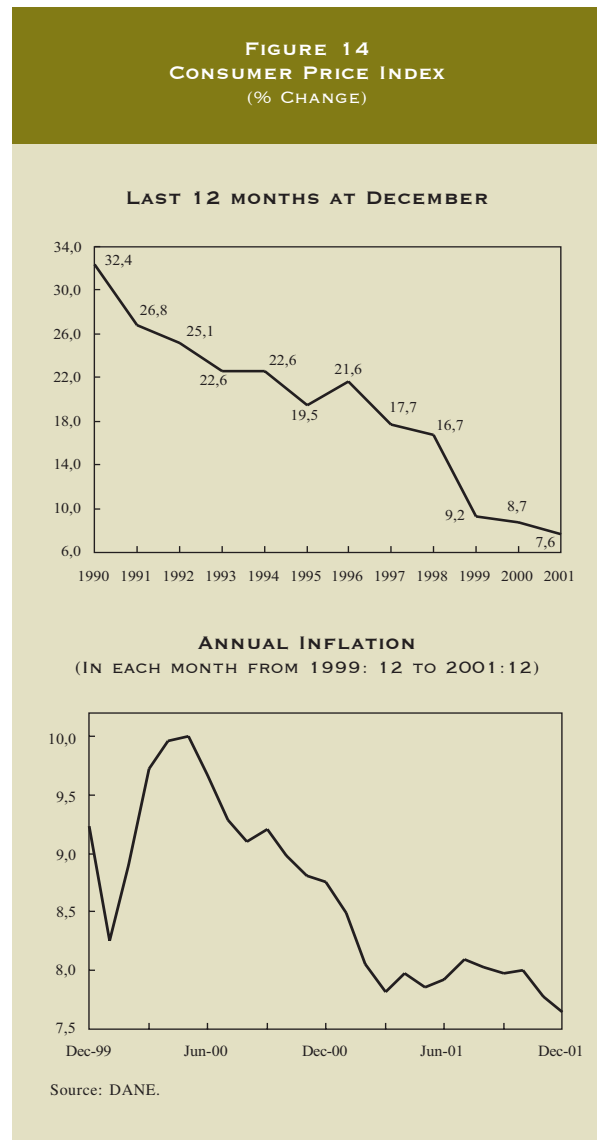
services did the most to increase prices. The 10.5% rise in food prices was the second contributing factor. There were also important increases in public utility rates. Prices for water, sewage and garbage collection, transportation and residential telephone service rose by 15.6% as a whole.

In 2001, the indicators of core inflation, which filter short-term fluctuations in the CPI resulting from temporary phenomena (e.g. droughts), were more favorable than the CPI as a whole. Figure 16 shows three alternative measurements for this type of inflation: the CPI excluding food, the inflation nucleus and the CPI excluding staple foods, fuel and public utilities. The three increased by 6.5%, 7.4% and 6.1%, respectively. As illustrated in Figure 16, these measures definitely declined. By year's end, they were below target inflation for 2001 (8.0%) and below the total CPI inflation rate as well. This seems to indicate the downward trend in CPI inflation will likely continue during 2002.

2. Producer price index

Annual inflation for the producer, measured by changes in the producer price index (PPI), was 6.9% at December 2001, which is 0.7 points below consumer inflation. Producer inflation was 4.1 percentage points less than in December 2000. Annual PPI inflation has declined steadily since May 2001, when it was 11.1%. Moreover, the rate in December 2001 is the lowest for that month since 1970, which is the year this indicator began to be measured (Figure 17).

According to the origin of goods, the producer price index for exports showed a reduction of almost 8.0%, while the same index for imports rose by 4.6%. However, the growth in import prices declined significantly throughout the year because of changes in the exchange rate, on which it depends heavily. Inflation for goods produced and



consumed internally was 7.7% and fell during the year, as did inflation for all the groups under consideration (Table 9).

Mining was the groups to experience the biggest slowdown in price growth, with a drop in inflation from 27.3% at December 2000 to 1.3% in the same month of 2001. Falling international oil prices were responsible for this decline. Prices for producers of industrial goods slowed from an 11.9% rise in December 2000 to only 7.0% at the end of 2001. In contrast, prices in agriculture, forestry and fishing group showed a slight increase in annual growth.

TABLE 8
INFLATION INDICATORS
(ANNUAL PERCENTAGE CHANGE)

	2000	2001			
	Dec.	Mar.	Jun.	Sep.	Dec.
CPI	8,8	7,8	7,9	8,0	7,6
Food	7,4	7,1	8,5	10,6	10,5
Housing	4,9	4,2	3,8	3,8	4,3
Clothing	3,6	3,5	3,7	3,3	2,6
Health	10,3	11,1	10,7	10,8	10,9
Education	9,4	8,2	10,6	10,4	10,2
Culture and recreation	11,7	11,1	11,3	11,2	7,1
Transportation	16,2	15,2	12,9	9,8	8,9
Sundry expenses	15,2	9,3	9,7	8,9	7,6

Source: Banco de la República, Economic Studies Division (SGEE), PPI, CPI and DANE lists.

FIGURE 15
ANNUAL CPI INFLATION BY GROUPS
(PERCENTAGE)



Source: DANE, calculations by the Banco de la República.

3. Compliance with target inflation

In the 1990s, the Colombian economy went from moderate to single-digit inflation. Inflation during the last five years has been below the target proposed by Banco de la República, with the exception of 1998 when there was a positive difference of less than one percentage point (Table 10).

Meeting the inflation target is important for several reasons, one being that it increases Banco de la República's credibility. This helps to reduce inflation due to its effect on expectations, and gives the inflation target more of a role as a guide to economic decisions, such as those on prices set by business, wage negotiations and long-term interest rates. The more influence the target has on expectations of inflation, the easier it is for the bank to meet the target. More credibility added to the possibility of achieving higher rates of economic growth in an atmosphere of low inflation.

a. The long-term inflation target

In economic theory, there is no agreement on an appropriate level for long-term inflation. A number of studies show that inflation, in the long run, is inverse to economic growth; that is, the more growth in prices, the less economic activity. Some economists believe that inflation makes it difficult to distinguish between changes in relative prices and those attributed to price levels, thereby distorting resource allocation. From this standpoint, the ideal level of inflation would be zero.

However, other authors say positive but low inflation can facilitate adjustments in relative prices and real wages in markets characterized by nominal rigidity.⁴ It is also defended by those who argue that positive biases in inflation measurement are caused by the appearance of new market-basket

⁴ Akerlof, Dickens & Perry (1996). "Low Inflation or No Inflation: Should the Federal Pursue Complete Price Stability." Policy Brief No. 4, August.

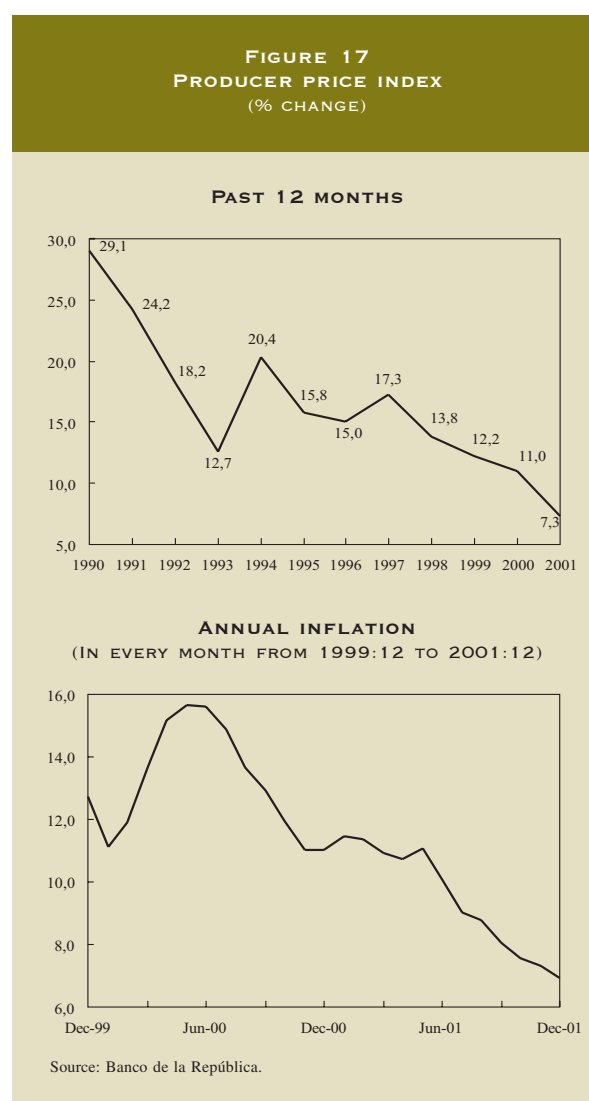
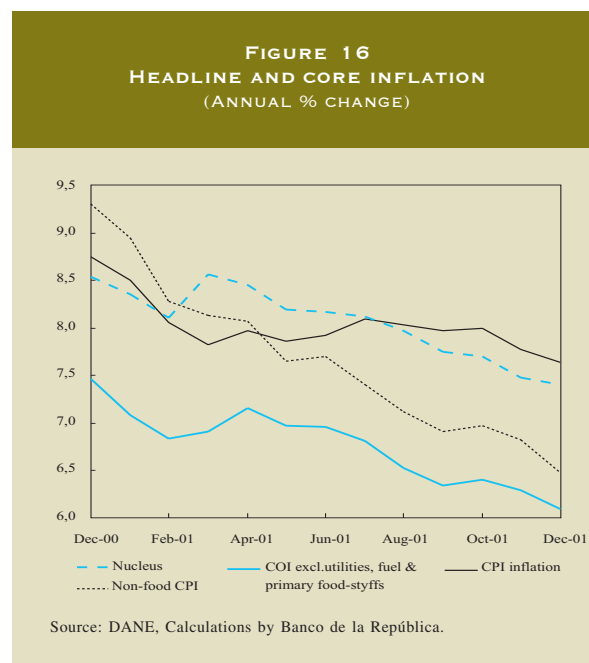


TABLE 9
INFLATION INDICATORS
(ANNUAL % CHANGE)

	2000	2001			
	Dec.	Mar.	Jun.	Sep.	Dec.
PPI	11,0	10,9	10,2	8,0	6,9
By origin					
Produced and consumed	10,6	10,4	11,1	9,1	7,7
Imported	12,5	12,5	7,6	4,8	4,6
Exported	6,4	2,8	(1,7)	(8,0)	(7,9)
By industrial origin (ISIC)					
Farming, forestry and fishing	6,0	4,2	9,8	6,8	7,6
Mining	27,3	27,0	23,5	3,4	(1,3)
Manufacturing industry	11,9	12,4	10,0	8,5	7,0

Source: Banco de la República, SGEE, and DANE PPI and CPI lists.

TABLE 10
INFLATION TARGET AND RESULTS - COLOMBIA
1991-2001
(PERCENTAGE)

Year	Target (a)	Inflation (b)	Difference (a) - (b)
1991	22,0	26,8	(4,8)
1992	22,0	25,1	(3,1)
1993	22,0	22,6	(0,6)
1994	19,0	22,6	(3,6)
1995	18,0	19,5	(1,5)
1996	17,0	21,6	(4,6)
1997	18,0	17,7	0,3
1998	16,0	16,7	(0,7)
1999	15,0	9,2	5,8
2000	10,0	8,8	1,2
2001	8,0	7,6	0,4

Source: Banco de la República and DANE.

products that are not included in the price index quickly enough and by improvements in the quality of products.⁵ Studies on the subject show a positive bias of one to two percent in the measure of inflation in the United States.⁶

Given these considerations, Banco de la República established and publicly announce a long-term

inflation target of 3%. This is low enough not to affect the decisions of economic agents, but high enough to correct biases in inflation measurement and to avoid problems with adjustments in relative prices occasioned by short-term rigidity in some nominal variables.

b. Short-term inflation targets

International experience suggests that the speed at which price growth can be reduced is less with single-digit inflation than with higher rates of inflation. This is illustrated in Table 11, which shows the average speed at which inflation declined in several, selected countries.⁷ Accordingly, the coming years will continue to see a gradual bid for an inflation target near 3%.

⁵ Shapiro, Mathew, D. and David Wilcos (1998), "Causes and Consequences of Imperfections in the Consumer Price Index," NBEF, Macroeconomic Annual, No. 6, pp. 93-142.

⁶ Nakamura, Leonard I. (1996). "Is US Economic Performance Really Bad?" Federal Reserve Bank of Philadelphia, Working Paper, No. 95-21, April.

⁷ The first scenario (moderate inflation) goes from double-digit to single-digit inflation, and the second (single-digit inflation) from single-digit to stationary inflation.

TABLE 11
SPEED OF DISINFLATION BEFORE AND AFTER REACHING A SINGLE DIGIT
(ANNUAL % CHANGE)

Country	Moderate		Single Digit		End Inflation	Average speed of disinflation (moderate)	Average speed of disinflation (single digit)
	Period	Initial Inflation	Period	Intermediate Inflation			
	(a)	(b)	(c)	(d)	(e)	(f)	(g)
Ireland	1981-1983	20,3	1984-1987	8,6	3,1	(5,9)	(1,8)
Israel	1991-1996	19,0	1997-2000	9,0	1,1	(2,0)	(2,6)
Chile	1990-1994	26,0	1995-2000	8,2	3,8	(4,5)	(0,9)
New Zealand	1985-1987	15,4	1988-1991	6,4	1,7	(4,5)	(1,6)
Mexico (*)	1995-1999	52,0	2000	9,0		(10,8)	
Peru (*)	1994-1996	23,7	1997-2000	8,6	3,8	(7,6)	(1,6)
Colombia (*)	1990-1998	32,4	1999-2000	9,2	8,8	(2,9)	(0,5)
Brazil (*)	1995-1996	66,0	1997-2000	6,9	7,0	(59,1)	0,0

(f) = (d) - (b) / (a); (g) = (e) - (d) / (c).

(*) These countries have not reached long-term inflation.

Source: Central banks.

At the end of 2001, Banco de la República established a 4% - 6% range as the inflation target for 2003. The specific target for 2003 will be set at the end of

2002, within this range. It will be based on inflation projections at the time and on the idea of gradually reducing this variable to the long-term target of 3%.

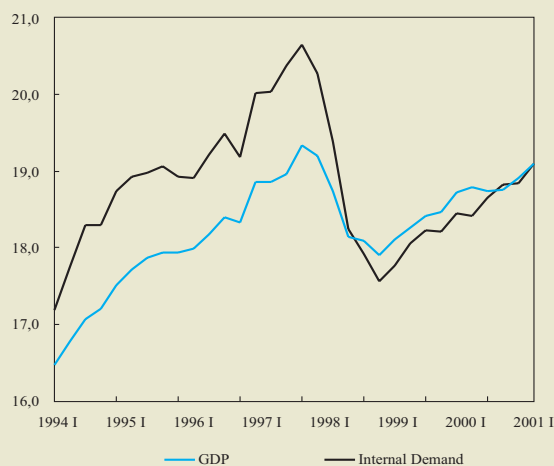
LONG-TERM ECONOMIC GROWTH

The behavior of an economy's productive capacity, or the potential product, is affected by a variety of factors, such as extensive business and household borrowing, violence and all the factors that create uncertainty over economic performance.

In Colombia, domestic demand grew faster than domestic product up until 1999, and less so from then on, until mid-2001 (Figure 1). The first period reflects the huge expansion in consumption, particularly consumption financed with internal and external credit. It was a "financial bubble" that burst because the situation was clearly unsustainable in the medium term. The second period saw a reversal of this trend, when the most dynamic elements of spending were those associated with investment and external demand. Nevertheless, this last factor has lost momentum due to the worldwide recession, especially as of the third quarter of 2001. Product has begun to grow at the same pace as domestic demand, which is recovering slowly from the decline during the recession.

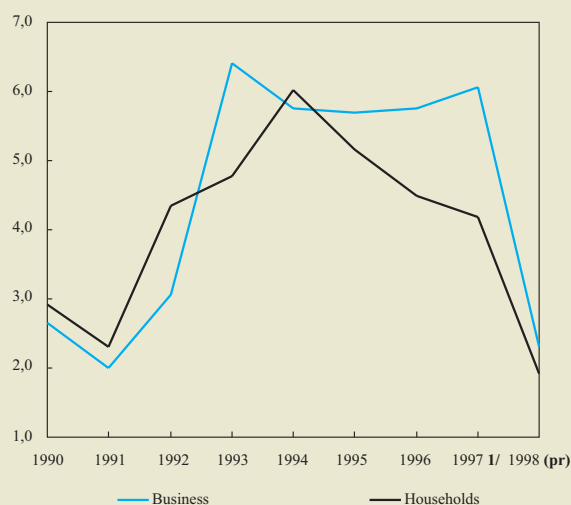
In the wake of excessive borrowing to finance the substantial increase in consumption during the first part of the 1990s, the economy is now trying to restore the financial position of households and businesses. As numerous surveys show, collapse of the "financial bubble" resulted in less demand for credit and a generalized fear of borrowing. Figure 2 reflects the trend in business and household borrowing up to 1998.

FIGURE 1
GDP AND INTERNAL DEMAND
DESEASONALIZED SERIES
 (1994 PESOS - BILLIONS)



Source: DANE.

FIGURE 2
FLOW OF LOANS FROM THE FINANCIAL SECTOR TO
BUSINESS AND HOUSEHOLDS 1990-1998
 (% OF GDP)



(pr) Preliminary.
 Source: Banco de la República, financial accounts.

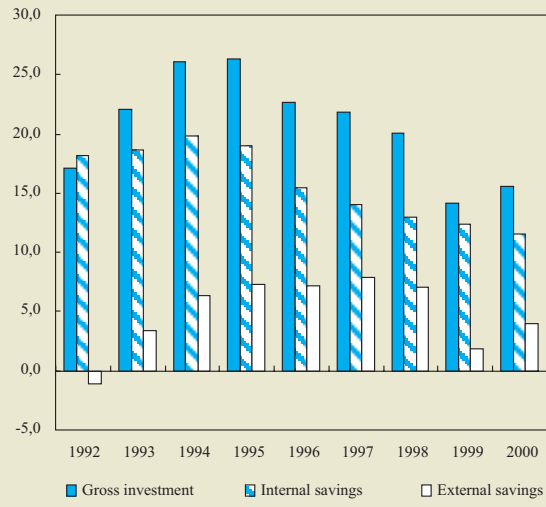
This makes it difficult for the Colombian economy to recover quickly. With households and businesses heavily in debt, consumption and investment are less than under other circumstances. This limits the response of monetary policy.

The violence perpetrated by illegal groups, which has escalated in recent months, is one of the factors that has affected productive capacity. Its impact on production in certain sectors, such as livestock and hydrocarbons, has been particularly serious. The actions of these groups, apart from their direct effect, also indirectly influence the economy's productive capacity by frightening off domestic and foreign investment in all economic activities. The wave of violence has also destroyed facilities that are strategic to national production.

In general, not only violence but all the factors that jeopardize the country's macroeconomic stability or generate uncertainty over how the economy will perform have a negative effect on productive capacity or potential product. These factors influence this variable primarily through insufficient investment to maintain and increase productive capacity. As illustrated in Figure 3, investment as a percentage of GDP has declined since 1995 and now accounts for only 15.6% of product.

In this sense, fiscal imbalance and subsequent public borrowing, both internal and external, are also factors that cause uncertainty about the future of the economy. Moreover, until there is a real solution to the fiscal problem, the state will be unable to invest part of its resources in a series of items that are essential to generating increased economic growth.

FIGURE 3
GROSS INVESTMENT, INTERNAL AND EXTERNAL SAVINGS IN COLOMBIA 1992-2000
 (% OF GDP)



Source: Ministry of Finance and Public Credit.

III

MACROECONOMIC POLICY

A. MONETARY POLICY

According to the last BDBR report to Congress, the Bank's policy is to lower the inflation target, while seeking a recovery in aggregate demand and economic growth.⁸ This involves a strategy that combines elements of the inflation target scheme with reference values for the monetary aggregates. Therefore, monetary policy is decided according to an evaluation of inflationary pressure, inflation projections and the behavior of other macroeconomic variables. Special attention is given to monetary aggregates, and particularly the monetary base.

1. Trend in money-market intervention

To provide adequate liquidity consistent with the demand for liquidity and with efforts to meet inflation targets, the Board of Directors has established an intervention band for interest on open market operations (OMO). Banco de la República offers primary liquidity at these rates, setting quotas for daily auctions of expansion and contraction transactions, which are determined according to how supply and demand for liquidity are expected to behave.

In the course of 2001, the Board of Directors modified the intervention band on seven occasions (Table 12). The biggest adjustment came in August, with a reduction of 100 basis points (bp) in all intervention rates. The other reductions were between 50 and 25 bp. As a whole, these changes reduced the expansion and contraction auction rates by 350 bp. In turn, the maximum and minimum expansion and contraction rates (Lombards) declined by 375 and 225 bp, respectively.

Expansion auctions throughout most of 2001 were held at the minimum expansion rate and only on isolated occasions was the auction closing rate above this floor. Window transactions were sporadic and in marginal amounts (Figure 18). On the other hand, contraction auctions up to September were used in amounts below those offered and at the maximum contraction rates (Figure 19). However, as of October, there were window contraction operations in important amounts. Most of these resources correspond to surplus liquidity in the National Treasury (TGN).

The mechanisms used generally by Banco de la República to supply liquidity have allowed for an extremely stable interbank rate, which has been within the maximum contraction auction rate and the minimum expansion auction rate. (Figure 20).

Year-end Liquidity

Considering the liquidity requirements at year's end, the BDBR agreed to grant permanent liquidity

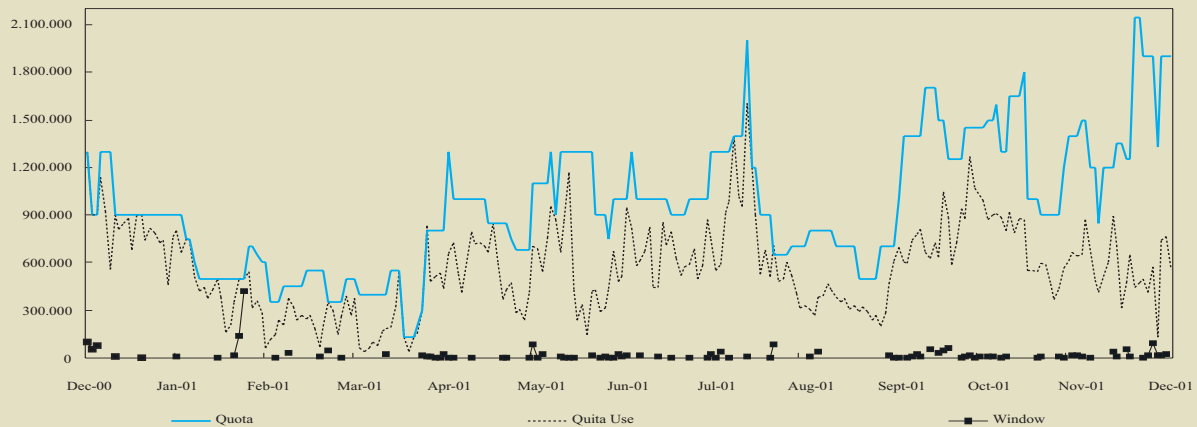
⁸ *Report from the Board of Directors to Congress, July 2001.*

TABLE 12
INTERVENTION RATES - BANCO DE LA REPÚBLICA
(PERCENTAGE)

Effective Date		Contraction Minimum (Lombard)	Contraction Auction Maximum	Expansion Auction Minimum	Expansion Maximum (Lombard)	TIB (Year's end)
From	To					
2-Jan-01	9-Mar-01	8,50	11,00	12,00	16,00	10,80
12-Mar-01	27-Jul-01	8,00	10,50	11,50	15,50	11,25
30-Jul-01	17-Aug-01	8,00	10,00	11,00	15,00	10,30
21-Aug-01	14-Sep-01	7,00	9,00	10,00	14,00	9,64
17-Sep-01	12-Oct-01	7,00	8,50	9,50	13,50	9,20
16-Oct-01	9-Nov-01	6,75	8,25	9,25	13,25	9,30
13-Nov-01	14-Dec-01	6,25	7,75	8,75	12,75	8,43
17-Dec-01	18-Jan-02	6,25	7,50	8,50	12,25	8,21

Source: Banco de la República.

FIGURA 18
LIQUIDITY QUOTAS AND EXPANSION OPERATIONS AT ONE DAY
DAILY OPERATIONS IN 2001
(COL\$ MILLIONS)

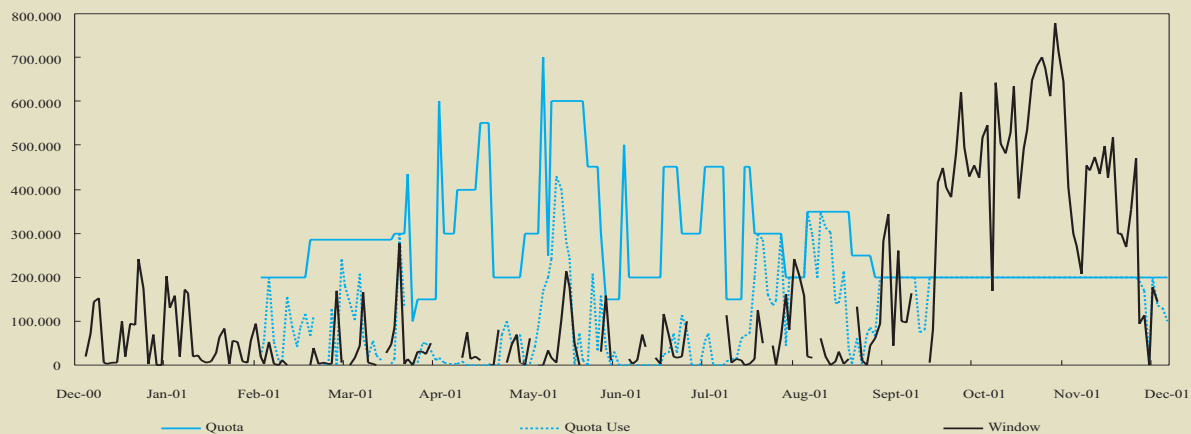


Source: Banco de la República.

through the purchase of international reserves and the definite purchase of public debt securities between September and December 2001. During those months, liquidity rose by Col\$993 billion (b), with Col\$833 b of this amount supplied through the exercise of options to accumulate international reserves and Col\$160 b through the purchase of public debt securities (TES).

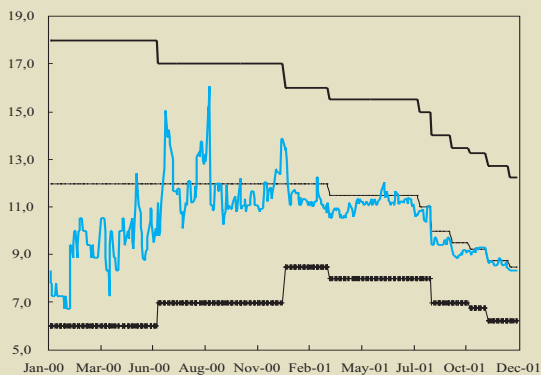
Banco de la República provided temporary liquidity in the last quarter through expansion repo operations at one, 35 and 91 days. Expansion repos offered at one day were requested, on average, for only 66% of the quota defined in the last quarter. In contrast, 91-day repos were requested in their entirety, while only 31.4% of the 35-day quota (Col\$800 b) was used.

FIGURE 19
CONTRACTION OPERATIONS BY WINDOW, QUOTA AND USE OF THE ONE-DAY CONTRACTION AUCTION
DAILY OPERATIONS IN 2001
 (COL\$ MILLIONS)



Source: Banco de la República.

FIGURE 20
INTERBANK AND INTERVENTION RATES
BANCO DE LA REPÚBLICA
 (PERCENTAGE)



Source: Banco de la República.

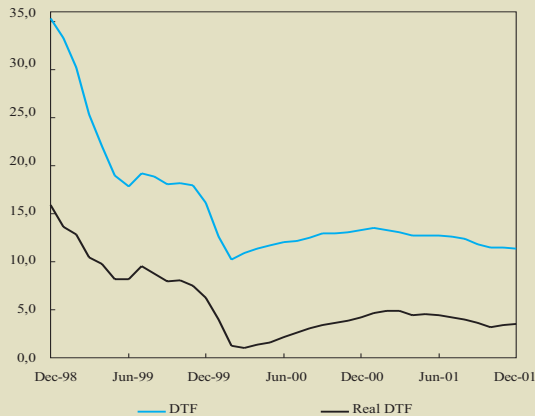
2. Interest rates

The reduction in the intervention rate established by Banco de la República had a direct impact on the decline in the interbank rate and indirectly effected the drop in interest rates on deposits, TES and loans.

In 2001, the nominal time deposit rate (DTF), calculated as the weighted average of interest on 90-day deposits, declined by 1.9 percentage points from 13.3% at December 2000 to 11.4% at December 2001. In real terms, the DTF rate suffered a 0.7 percentage point reduction during the same period, considering the rate of 3.5% at December 2001 (Figure 21). This last situation is explained by a contraction in nominal interest on deposits, which exceeded the downturn in inflation for 2001.

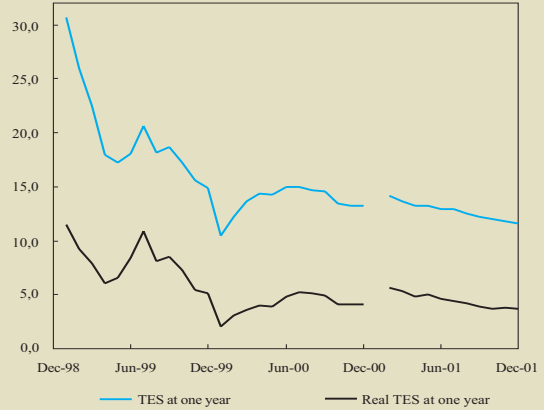
Nominal and real interest on TES, regardless of maturity, also declined. The nominal rate on one-year TES was 11.6% at December and 3.7% in real terms. This represents a decline of 1.6 percentage points, or 0.4 percentage points discounting inflation (Figures 22 and 23). As Figure 23 illustrates, interest on one-year TES was higher than the 360-day CD rate in most months of 2000, which was not the case in 2001. Interest on TES at three and five years declined by 2.6 and 3.1 percentage points, respectively, registering nominal rates of 13.5% and 13.9% at December 2001 (Figure 24).

FIGURE 21
NOMINAL AND REAL INTEREST
ON DEPOSITS (*)
 (PERCENTAGE)



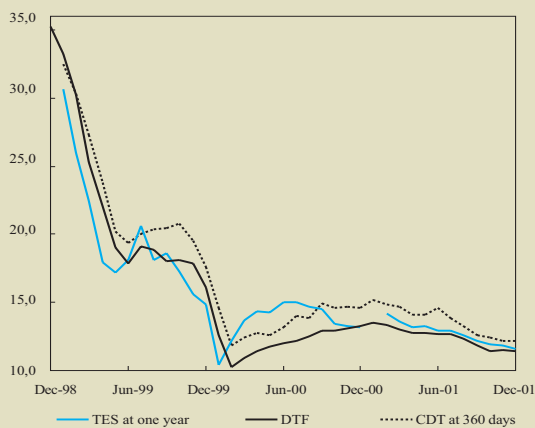
(*) Deflated with the CPI.
 Source: Banco de la República and the Banking Superintendent.

FIGURE 23
NOMINAL AND REAL RATE ON ONE-YEAR TES (*)
 (PERCENTAGE)



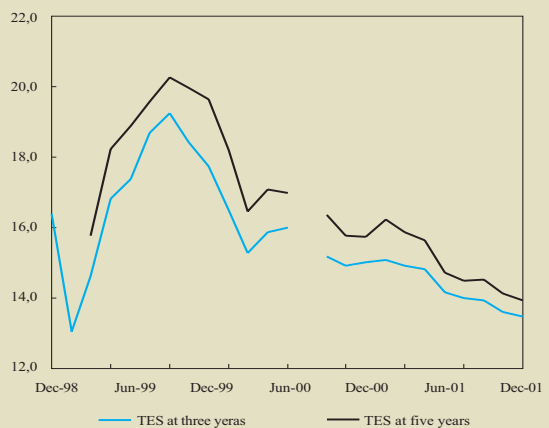
(*) Deflated with the CPI.
 Source: Banco de la República.

FIGURE 22
INTEREST ON ONE-YEAR TES,
DTF AND 360-DAY CD
 (PERCENTAGE)



Source: Banco de la República and the Banking Superintendent.

FIGURE 24
RATE ON THREE AND FIVE-YEAR TES
 (PERCENTAGE)



Source: Banco de la República and the Banking Superintendent.

The lending rate varied, according to the risk for the financial agency. Information on debtor history and current performance, cash flows, payment capacity and collateral to secure the operation are determining factors when evaluating the risk inherent in a loan. Consequently, they affect the lending rate. As a result of risk measurement, the loan market tends to charge higher interest on consumer credit, as opposed to other loans that are

considered less risky, such as those to preferred borrowers or treasury loans.⁹

The rates on all types of credit declined in 2001. At December 2001, the average rate on regular

⁹ A treasury loan is defined as credit extended to preferred customers at less than 30 days to cover short-term liquidity requirements.

and consumer credit was 31.4% and 19.4%, respectively; that is, is 2.1 and 1.0 percentage points lower than during the same month in 2000. On the other hand, preferred and treasury loans, defined as credit to special, creditworthy customers, declined by 4.1 and 2.1 percentage points, respectively, to 14.1% and 13.9% at December 2001 (Figure 25).

3. Monetary aggregates

By the end of 2001, the monetary base came to Col\$11,648 b, with 12.6% average growth and 8.8% growth at the end of the year. This is Col\$68 b above the reference line.¹⁰ On that date, the average 45-month daily moving average of the base was Col\$112 b (1.1%) below the moving average of the reference line, while the 20-month moving average was Col\$95 b (0.9%) below its reference line. At December, the M-3 aggregate registered 7.1% annual growth and 9.7% growth at year's end.

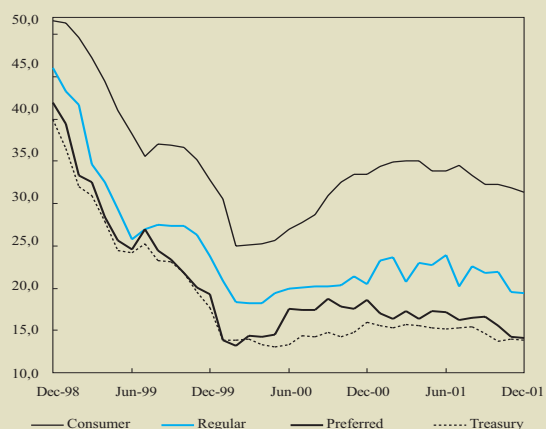
a. Monetary base

As of the reference line adjustment at the end of June and for the remainder of the year, the base registered 20-month and 45-month daily moving averages near the respective base line averages (Figure 26). Cash demand maintained average and year-end growth rates of 21.6% and 14.8%, respectively, while reserve demand grew at an average rate of 5.1% for the year (Figure 27).

In the third quarter, the monetary base registered levels below those defined in the reference line. However, this trend reversed in the last quarter, especially during the final weeks of the year (Figure 28). Growth in the monetary base at the end of the year was due to the sharp increase in the demand for reserves on the part of financial agents and the public's demand for cash. During December, cash in the hands of the public and reserves in the

¹⁰ In comparison, the reference line registered 15.9% average growth and 8.1% year-end growth.

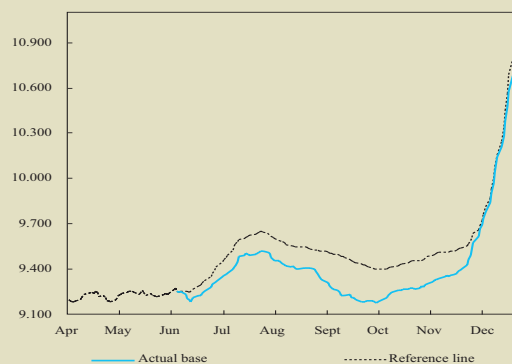
FIGURE 25
INTEREST RATE PER TYPE OF CREDIT
(PERCENTAGE)



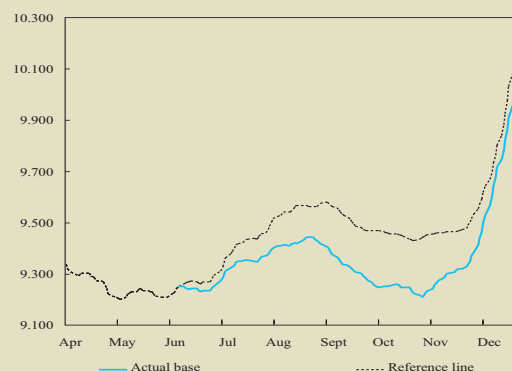
Source: Banco de la República.

FIGURE 26
MONETARY BASE AND REFERENCE LINE, 2001
(COL\$ BILLIONS)

20-MONTH DAILY MOVING AVERAGE



45-MONTH DAILY MOVING AVERAGE



Source: Banco de la República, SGEE.

financial system increased by Col\$1,481 b and Col\$326 b, respectively. As noted earlier, the demand for liquidity at the end of the year was satisfied essentially through foreign currency purchases and repo operations at one, 35 and 90 days.

b. Money supply (M1)

The M1 growth rate throughout 2001 maintained the downward trend observed since November of the

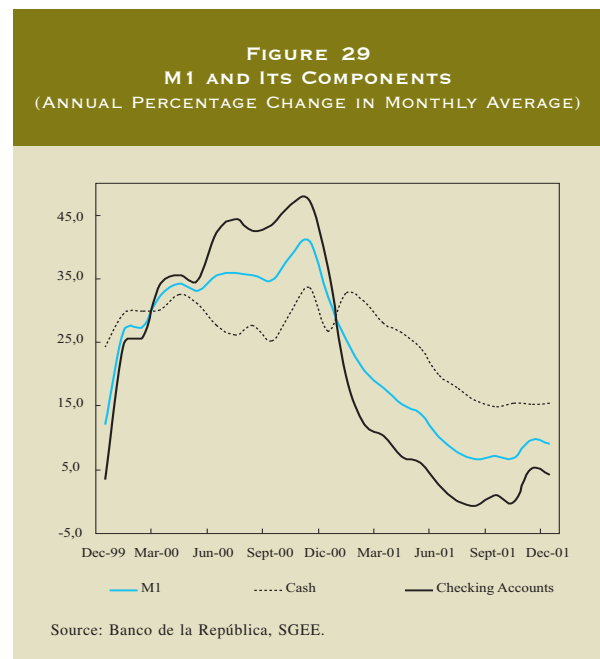
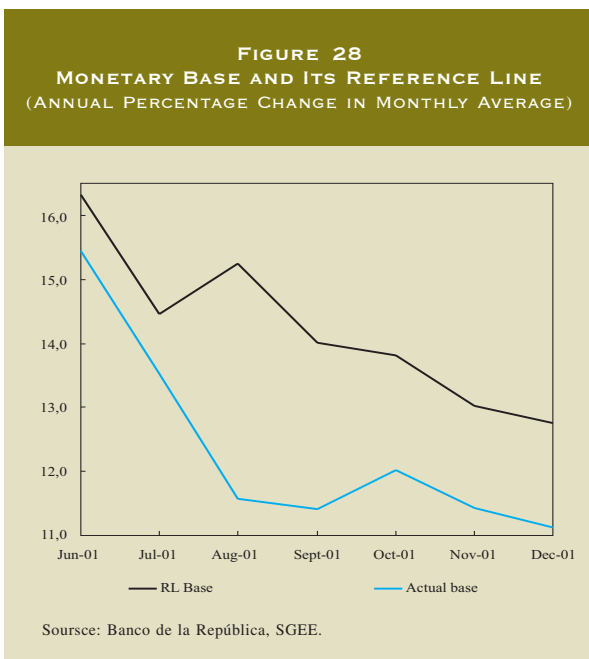
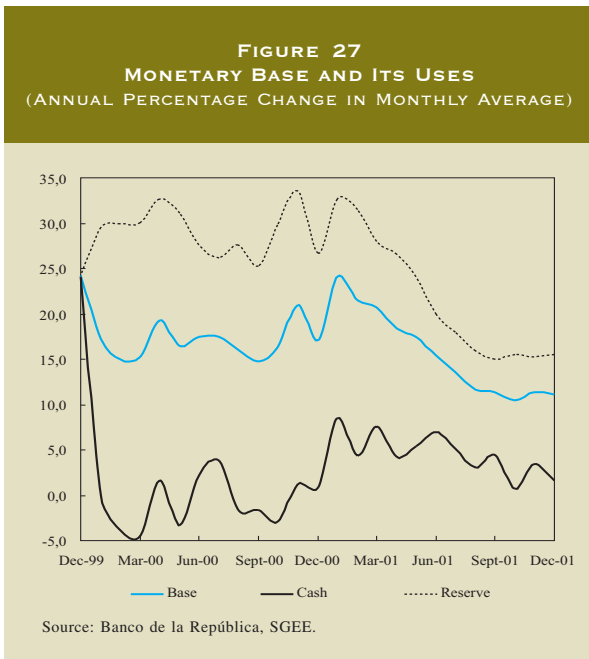
previous year. Growth at year's end was 12.1%, thanks to a 14.8% increase in cash and 10.0% in checking accounts. These rates were substantially less than those registered in 2000: 30.5%, 20.5% and 39.4%, respectively.

The slow momentum in M1 demand is explained largely by the change in the financial transaction tax. In 2000, this levy was charged on transfers between accounts pertaining to the same owner; the result was strong growth in checking accounts. The fact that such transactions became exempt in 2001 led to changes in the public's portfolio towards other liabilities, to the detriment of checking accounts.

The fourth quarter of the year saw a slight increase in M1 growth. This was due to the rise in cash demand, as noted earlier, and to the increase in checking account growth (Figure 29).

C. Broader monetary aggregate (M3)

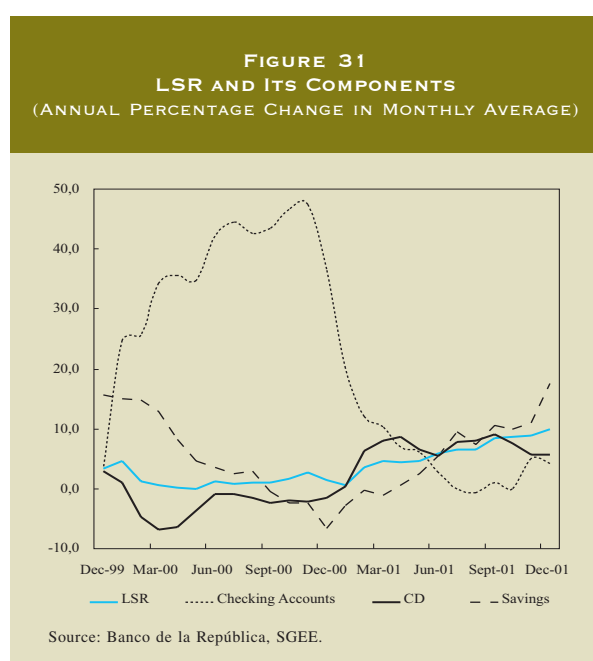
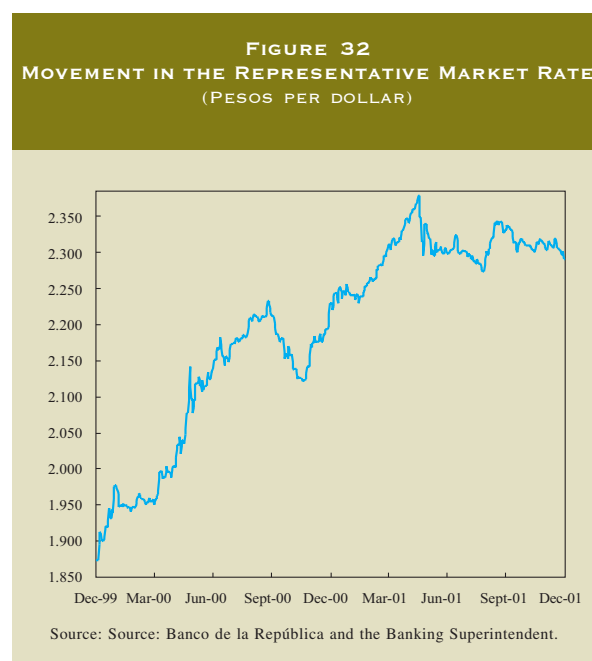
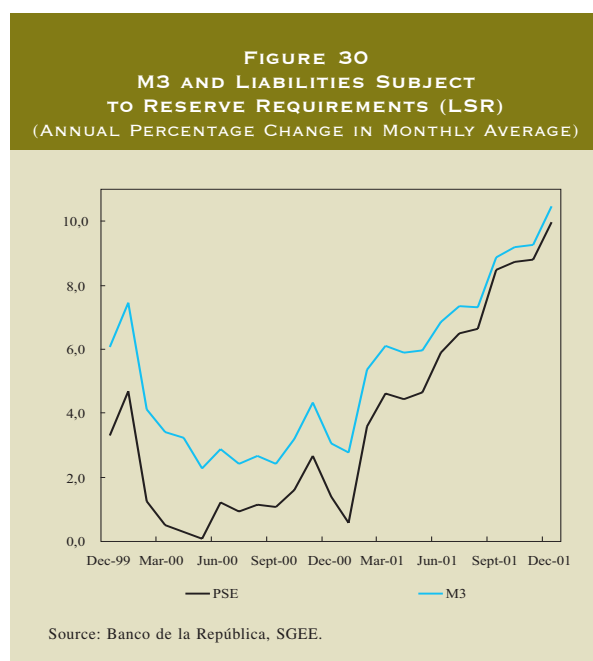
Contrary to the M1 situation, annual growth in the broader monetary aggregate (M3) recovered substantially, from 2.8% at the end of 2000 to 9.7%



on the same date in 2001 (Figure 30). The recovery observed during the year in liabilities subject to reserve requirements (LSR) was due primarily to more growth in checking accounts and in repos with the national treasury. As mentioned earlier, in addition to high growth rates throughout the entire year, the latter increased their share as part of LSR (Figure 31).

B. EXCHANGE MARKET AND EXCHANGE POLICY

The representative market rate (TRM) was Col\$2,291.2 at the end of 2001. This represents 2.8% annual devaluation (Figures 32 and 33). In average terms, the exchange rate rose by Col\$212.4



(10.2%), from Col\$2,087.4 in 2000 to Col\$2,299.8 in 2001. The slowdown in peso depreciation observed in the exchange rate at the end of the period reflects the increased supply of foreign currency during the second half of the year. In 2001, the first half of the year was characterized by a devaluation trend in the nominal exchange rate and the second by strengthening of the peso. Average annual devaluation was 14.8% between January and June 2000, before declining to 6.1% in the second half of the year.

1. Changes in the exchange market

Table 13 contains an estimate of excess foreign currency supply with the principal economic agents in the exchange market during 2001¹¹ (the minus sign denotes net demand). In contrast with 2000, when the productive sector of the economy faced an excess foreign currency demand on the order of US\$174 m, the excess foreign currency supply in 2001 came to US\$77 m, plus the sale of US\$943 m in foreign currency by the national treasury. This surplus was absorbed by Banco de la República through an increase of US\$629 m in its international

reserves, obtained with the purchase of dollars on the market through auctions of foreign currency sale options, and by the financial sector, which increased its own cash position by US\$414 m. Up until June, the national treasury was the only source of net foreign currency supply on the market. This helped to curb the exchange rate increase during the first half of the year. In the second half, the supply of foreign currency came primarily from exchange transactions in the productive sector of the economy. On the other hand, Banco de la República purchased US\$420 m in foreign currency through auctions in the second half of the year; that is, US\$211 m more than in the first six months.

2. Sale of foreign currency to Banco de la República: exercise of sale options

In 2001, Banco de la República auctioned foreign currency sale options to accumulate US\$835 m in international reserves; US\$629.2 m of these options were exercised (Table 14). Although US\$ 180 m less were auctioned in 2001 compared with the previous year, the use of options increased by US\$310.6 m.

The behavior of the exchange market in 2001 and uncertainty over its future at a time of international and local unrest prompted the BDBR to make

¹¹ La suma de las demandas netas de divisas de los distintos agentes económicos es igual a cero en cada período, reflejando el hecho que el mercado cambiario debe estar en equilibrio.

TABLE 13
NET SUPPLY OF FOREIGN CURRENCY FROM THE PRINCIPAL ECONOMIC AGENTS
(US\$ MILLIONS)

	2000			2001		
	Jan.-Jun.	Jul.-Dec.	Total	Jan.-Jun.	Jul.-Dec.	Total
A. Productive sector	(250.5)	76.7	(173.8)	(382.0)	491.4	109.4
B. PPC change - financial sector 1/	219.3	(30.1)	189.2	(237.8)	(176.0)	(413.8)
C. Treasury 2/	117.2	186.0	303.2	829.1	104.5	933.6
D. Banco de la República intervention	(86.0)	(232.6)	(318.6)	(209.3)	(419.9)	(629.2)

1/ Own cash position (PPC)-Banco de la República intervention Banking Superintendent.

2/ Excluding purchase-sale of foreign currency outside the exchange market

Source: Banco de la República.

TABLE 14
AUCTIONS OF SALE OPTIONS TO ACCUMULATE INTERNATIONAL RESERVES
 (US\$ MILLIONS)

Auction Date 1/	Amount		Quota	Premium			Amount Exercised
	Presented	Approved		Minimum	Maximum	Closing	
2000	4.818,8	1.014,9	1.060,0			32.230,0	318,6
2001	3.242,0	834,9	835,0			67.660,0	629,2
2001 Jan.	287,0	100,0	100,0	320,0	4.110,0	1.860,0	80,0
Feb.	405,7	75,0	75,0	212,0	7.100,0	5.560,0	69,3
Mar.	259,4	50,0	50,0	500,0	7.566,0	3.800,0	0,0
Abr.	240,5	50,0	50,0	312,0	5.570,0	3.000,0	0,0
May.	79,0	30,0	30,0	1.290,0	5.560,0	3.510,0	30,0
Jun.	123,0	30,0	30,0	3.960,0	10.000,0	9.550,0	30,0
Jul.	133,5	30,0	30,0	1.500,0	11.560,0	10.200,0	30,0
Aug.	86,5	30,0	30,0	1.000,0	12.500,0	6.000,0	30,0
Sep.	427,0	80,0	80,0	100,0	10.570,0	7.180,0	0,0
Oct.	222,4	100,0	100,0	100,0	11.000,0	5.780,0	100,0
Nov.	530,0	140,0	140,0	100,0	8.210,0	5.210,0	140,0
Dec.	448,0	119,9	120,0	210,0	10.200,0	6.010,0	119,9

1/ Options are auctioned on the last working day of the previous month
 Source: Banco de la República.

several adjustments in the exchange market intervention scheme to control exchange rate volatility. In December 2001, the percentage of exchange rate fluctuation required to activate foreign currency auctions of purchase or sale options was lowered from 5% to 4% of the deviation in the TRM with respect to the moving average of this rate for the last 20 days. The quota on foreign currency purchase and sale options was increased from US\$120 m to US\$180 m. However, Banco de la República has never been obliged to use this device, which was adopted, in practice, in December 1999. There was no change in the option auction mechanism to accumulate international reserves. It is used to exercise foreign currency sale options to the Bank, provided the TRM for the day is below the moving average for the last 20 days.

3. Real exchange rate

The real exchange rate index (RERI) has been used traditionally in Colombia and is based on purchasing power parity. Changes in this index reflect the difference between nominal devaluation of the Colombian peso against the 20 currencies of Colombia's major trading partners and the gap between domestic and foreign inflation. A RERI-PPI is calculated, using the PPI to measure domestic and foreign prices, as is a RERI-CPI, using the CPI.

At December 2001, the RERI-PPI showed 3.3% real annual appreciation and stood at 115.8 (1994=100). Although nominal devaluation of the Colombia peso (5.5%¹² at December 2001) was 2.8 percentage points

¹² Esta cifra corresponde al promedio de diciembre de 2001 frente al promedio del mes de diciembre de 2000.

above that of the country's 20 trading partners, it did not offset the increase of 6.3 percentage points in producer inflation in Colombia compared with the other countries. In fact, due to limited economic growth and the drop in oil prices on the international market in 2001, countries such as the United States, England and Argentina saw wholesale price deflation. The situation with consumer prices was similar. However, there was less of a difference between Colombian and foreign inflation measured by the CPI (3.3 percentage points), Consequently, the RERI -CPI appreciated by just 0.5% and was 117.9 at December 2001 (Figure 34).

C. SITUATION IN THE FINANCIAL SYSTEM

The highlight of performance in the financial system in 2001 was the reduction in losses. This was part of the improvement process initiated after the crisis in 1998 and 1999. Following nearly Col\$1.720 b in accumulated losses at December 2000, the same month in 2001 saw Col\$268 b in profits. However, this figure is still low compared with equity. Non-performing asset and overdue portfolio indicators, other than those for mortgages, also improved.

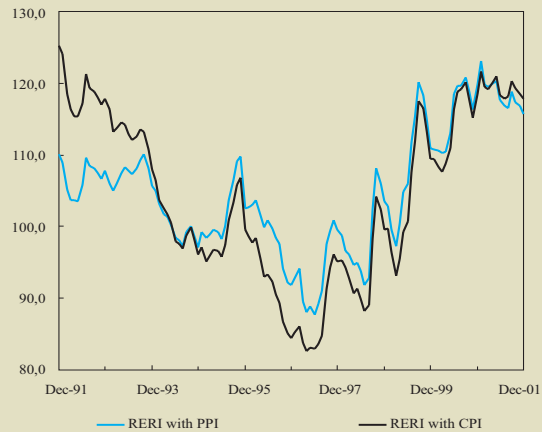
The indicator of solvency in the public financial system quickly deteriorated and the pace of loan portfolio recovery as of early 2001 was insufficient to achieve positive growth rates. Portfolio growth did not turn positive until October, and then only slightly.

1. Solvency⁶

The solvency indicator for the financial system as a whole declined gradually from a high of 14.4% in January 2001 to 13.1% in December (Figure 35).

¹³ Patrimonio técnico / Activos ponderados por riesgo.

FIGURE 34
REAL EXCHANGE RATE INDEX IN COLOMBIA
NON-TRADITIONAL TRADE
 (CPI AND PPP DEFLATED)



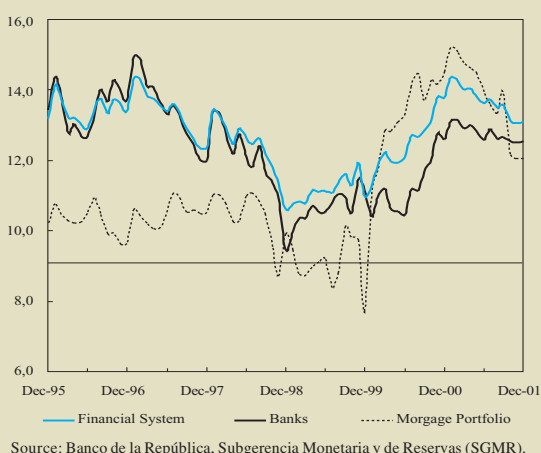
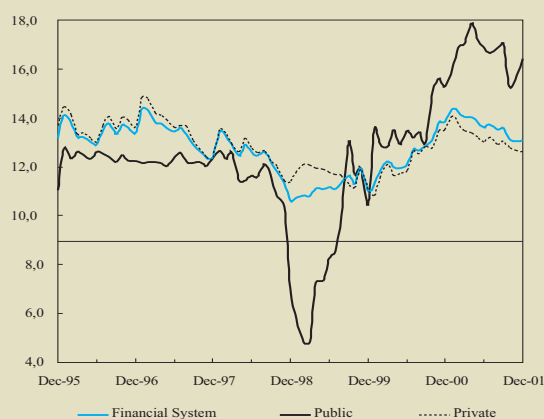
Source: Source: Banco de la República and the Banking Superintendent.

A breakdown between the public and private systems shows strong recovery of the first from October 2000 to April 2001, leading to a high of 17.9% and closing in December at 16.4%, which was above the closing figure in 2000. The signal is that, although the public financial system has gained strength in terms of equity, the risk indicator for its productive assets has increased. This has rapidly undermined its solvency indicator. In the private sector, the solvency indicator went from a high of 14.0% in January 2001 to 12.6% in December of the same year (Figure 35). Yet, these indicators are still above the required minimum (9.0%).

2. Profitability

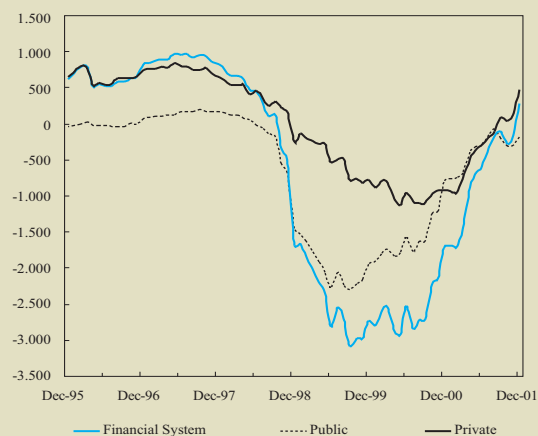
Losses in the Colombian financial system declined considerably during the course of the year. The accumulated income statement for the 12 months ended at December 2001 showed Col\$286 b in profits, following Col\$1,720 b in losses at December 2000. Public institutions reduced their losses from Col\$808 b to Col\$182 b, while private companies reported Col\$468 b in profits following Col\$912 b in losses (Figure 36).

FIGURE 35
SOLVENCY-CREDIT INSTITUTION RATIO
 (PERCENTAGE)



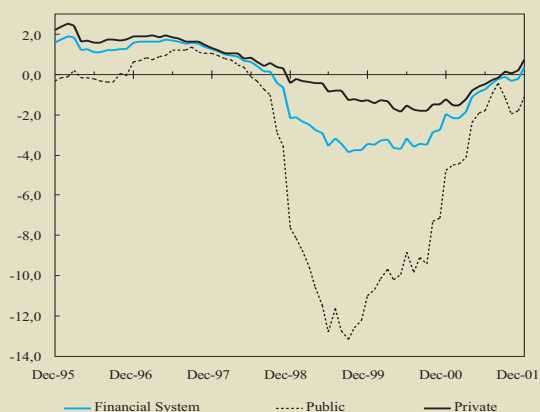
Source: Banco de la República, Subgerencia Monetaria y de Reservas (SGMR).

FIGURE 36
12 MONTHS ACCUMULATED PROFITS IN THE
FINANCIAL SYSTEM
 (COL\$ BILLIONS)



Source: Banco de la República, SGEE.

FIGURE 37
RETURN ON ASSETS
 (PERCENTAGE)



Source: Banco de la República, SGMR.

The increase in the profitability indicator from -2.0% at December 2000 to 0.3% during the same month in 2001 reflects fewer losses in the financial system. This indicator recovered more in the public sector (from -4.8% to -1.1%) than in the private sector (-1.2 to 0.7, Figure 37).¹⁴

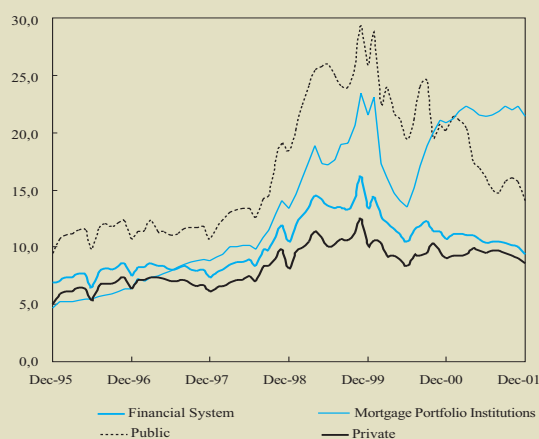
3. Asset quality

The overdue/gross portfolio ratio for the financial system as a whole improved slightly, having declined from 10.7% to 9.3% between December 2000 and December 2001. According to the type of institution, the ratio for private entities was close to 8.5%, while public institutions registered important progress by reducing their ratio from 20.2% to 14.1%. Even so, the high level and upward trend in delinquent mortgage holdings, which increased from 20.8% to 21.4% during the same period, are still a cause for concern (Figure 38).

The ratio of non-performing assets to total assets in the financial system continued to improve, declining from 4.2% in December 2000 to 2.6% during the same month in 2001 (Figure 39).

¹⁴ $(\text{Profits accumulated in the course of the year } (12/n)) / (\text{Total assets})$.

FIGURE 38
OVERDUE/GROSS PORTFOLIO
(PERCENTAGE)



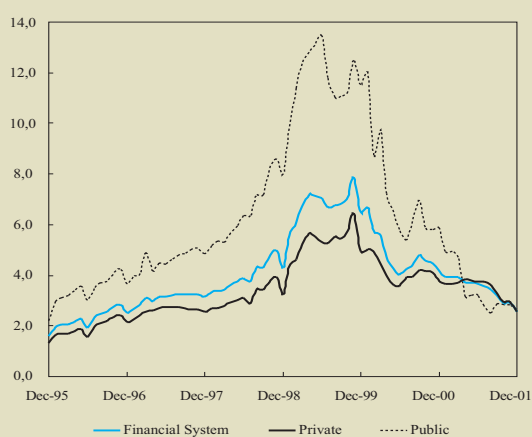
Source Banco de la República, SGMR.

FIGURE 40
EX-ANTE SPREAD BETWEEN LENDING
AND DEPOSIT-TAKING
(PERCENTAGE)



Source: Banco de la República.

FIGURE 39
CHANGES IN NON-PERFORMING ASSETS
(PERCENTAGE)



Source : Banco de la República, SGMR.

4. The lending and deposit spread

The gross spread between lending and deposit rates in the financial system declined appreciably as of November.¹⁵ The spread, including interest on treasury loans, went from 6.6 percentage points in

¹⁵ Measured as the simple difference between the lending rate, weighted by the new amounts of ordinary, commercial, credit card, preferred and treasury credit, and the DTF deposit indicator.

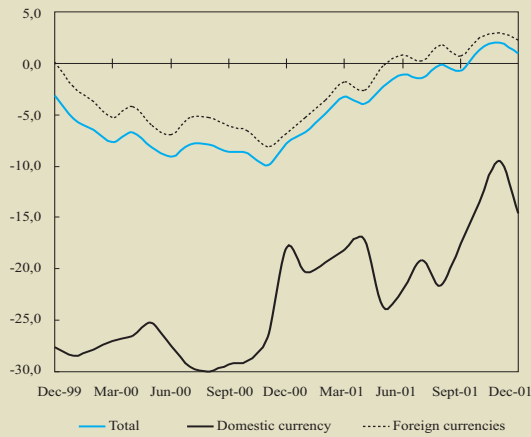
October 2001 to 5.1 in December 2001. A spread assessment excluding interest on treasury loans shows a reduction from 10.4 percentage points in October 2001 to 7.8 in December 2001 (Figure 40). Up until September, the tendency was for the spread to increase and the drop in *ex ante* intermediation spreads obeyed reductions in lending rates other than those for treasury loans (ordinary, consumer, credit card and preferred).

5. Credit in the financial system

According to the latest consolidated monthly balances for the financial system, available at December 2001, the annual increase in gross loans was only 1.0%. This is poor performance. Annual growth was negative up until September, turning positive in the last quarter (Figure 41). Consumer loans were the most dynamic, with 11.2% growth. Mortgage growth remained negative, but the downward trend was reversed. The annual increase in commercial loans, which rose to 6.9% in June 2001, declined to 2.8% (Figure 42).

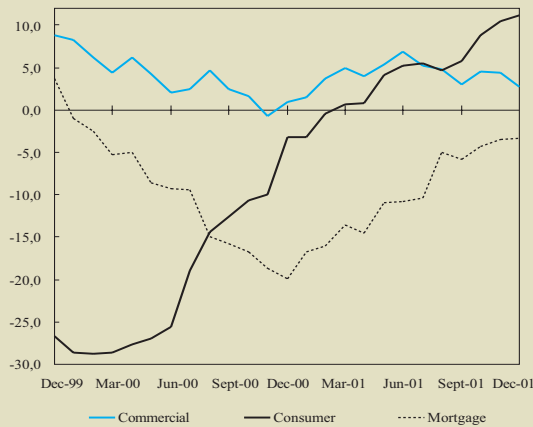
Slow portfolio growth does not appear to be the result of shaky performance in financial savings or restrictions on the supply of primary liquidity.

FIGURE 41
TOTAL NOMINAL GROSS PORTFOLIO
BY TYPE OF CURRENCY
(ANNUAL PERCENTAGE CHANGE)



Source: Banco de la República and the Banking Superintendent.

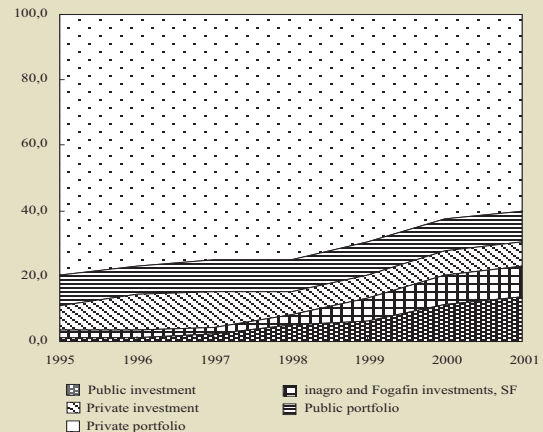
FIGURE 42
NOMINAL GROSS PORTFOLIO
IN DOMESTIC CURRENCY
(ANNUAL PERCENTAGE CHANGE)



Source: Banco de la República and the Banking Superintendent.

As mentioned earlier, M3 growth accelerated throughout the year. For the most part, the additional resources available to the financial system were used to purchase TES, as illustrated by their large share of the sector's financial assets (Figure 43). This factor and limited economic activity, coupled the idea of considerable financial and institutional risk, are the major reasons for the recent trend in credit.

FIGURE 43
FINANCIAL ASSET COMPONENTS
SHARE OF TOTAL ASSETS



Source: Banco de la República and the Banking Superintendent.

D. FISCAL POLICY AND PROGRESS WITH THE ADJUSTMENT PROGRAM

1. Fiscal performance in 2001

The consolidated public sector showed a deficit of Col\$6,097 b at the end of 2001, which is equivalent to 3.3% of annual GDP. The fiscal situation was similar to that of 2000, with a slight decline in non-financial public sector (NFPS) finances (Table 15). The government's initial objective was to achieve a consolidated deficit equal to 2.9% of GDP. The fiscal target was revised in the second half of the year due to the slowdown in economic activity, which affected revenue, and to the increase in certain expenses. The IMF accepted this revision as part of the adjustment program being carried out with that agency.

There was less of a fiscal surplus in the decentralized sector, from both Ecopetrol and the Oil Stabilization and Savings Fund (FAEP). In the case of Ecopetrol, the deteriorating fiscal situation is associated largely with the decline in

TABLE 15
EFFECTIVE OPERATIONS IN THE CONSOLIDATED PUBLIC SECTOR

Item	Col\$ Billions		Percentage of GDP	
	2000	2001 (pr)	2000	2001 (pr)
Electricity	310,0	256,0	0,2	0,1
Emcali	(19,0)	141,0	(0,0)	0,1
EPM	7,0	293,0	0,0	0,2
FAEP	1.622,0	451,0	1,0	0,2
Ecopetrol	1.272,0	779,0	0,7	0,4
Telecom	(32,0)	355,0	(0,0)	0,2
Other entities 1/	325,0	308,0	0,2	0,2
Social security	766,0	1.100,0	0,5	0,6
Regional and local entities	(191,0)	26,0	(0,1)	0,0
National Coffee Fund	(275,0)	(77,0)	(0,2)	(0,0)
1. Subtotal: Decentralized Sector	3.785,0	3.632,0	2,2	1,9
2. National government	(10.082,0)	(10.774,0)	(5,9)	(5,8)
A. Total non-financial public sector (NFPS) (1 + 2)	(6.297,0)	(7.142,0)	(3,7)	(3,8)
B. Banco de la República cash profit and loss	877,0	1.393,0	0,5	0,7
C. Fogafin cash profit and loss	30,0	327,0	0,0	0,2
D. Cost of restructuring the financial sector	(666,0)	(1.268,0)	(0,4)	(0,7)
E. Adjustments	275,0	593,0	(0,2)	(0,3)
F. Total consolidated public sector (A + B + C + D + E)	(5.781,0)	(6.097,0)	(3,4)	(3,3)

(pr) Preliminary.

1/ Includes Carbocol in the year 2000.

Source: National Fiscal Policy Council, CONFIS.

international oil prices and the drop in crude production. The FAEP surplus suffered as a result of Law 633/2000, which allowed territorial entities to use the resources saved in this fund to discharge and prepay the debt with the financial sector.

Central government finances in 2001 showed a deficit of Col\$10,774 b, or 5.8% of GDP. Total revenue increased by 21.2% and tax yields by 26.3% (Table 16). The most important taxes during the period were those on financial transactions, gasoline and income, with respective

increases of 37.1%, 32.8% and 30.8%. The increase in yield from these levies and the domestic VAT is associated with the tax reform approved at the end of previous year, which changed several rates and tax bases.¹⁶ Nevertheless, it is important to remember that government collections were Col\$500 b under the initial target, due to the slowdown in the economy.

¹⁶ In the case of gasoline, the increase in tax revenue is explained by the fact that several special contributions are now entered under this item.

TABLE 16
EFFECTIVE CENTRAL GOVERNMENT OPERATIONS
(COL\$ BILLIONS)

	2000	2001 (pr)	Annual growth 2001/2000
I. Total Revenue (A+B+C+D)	22.680,5	27.489,0	21,2
A. Tax revenue	19.643,8	24.802,2	26,3
Income	7.661,4	10.022,0	30,8
Domestic VAT	5.903,9	6.931,5	17,4
Foreign VAT	2.449,9	3.079,4	25,7
Customs	1.679,6	2.150,1	28,0
Gasoline	833,0	1.106,4	32,8
Financial transactions	1.036,6	1.421,4	37,1
Others	79,4	91,4	15,1
B. Non-tax revenue	482,8	374,9	(22,3)
C. Special funds	430,6	240,5	(44,1)
D. Capital resources	2.123,3	2.071,4	(2,4)
Financial yield	837,2	571,3	(31,8)
Financial surplus	1.152,9	1.320,0	14,5
Others	133,2	180,1	35,2
II. Total Expenditure (A + B + C + D)	32.943,8	39.043,6	18,5
A. Interest	6.630,2	7.497,1	13,1
Domestic	2.256,4	3.114,4	38,0
Foreign	4.373,8	4.382,7	0,2
B. Operating expenses	22.801,8	27.171,9	19,2
Personal services	4.675,0	5.279,6	12,9
General expenses	1.375,1	1.774,3	29,0
Transfers	16.751,7	20.118,0	20,1
C. Investment	2.679,4	2.904,0	8,4
D. Net loan	832,4	1.470,6	76,7
Cash deficit or surplus	(10.263,3)	(11.554,6)	12,6
III. Accrual adjustments	181,3	780,6	330,6
IV. Deficit (-) or surplus (+) (I - II + III) 1/	(10.082,0)	(10.774,0)	6,9
Cost of financial restructuring	666,2	1.267,7	90,3
V. Financing (A + B + C + D)	(10.748,2)	(12.041,7)	12,0
A. Net external credit	3.674,2	8.746,4	138,0
Disbursements	5.730,6	12.589,8	119,7
Amortization	2.056,4	3.843,4	86,9
B. Net internal credit	6.638,0	5.945,9	(10,4)
Disbursements	12.006,0	13.870,9	15,5
Amortization	5.368,0	7.925,0	47,6
C. Banco de la República profits	516,3	1.452,8	181,4
D. Others	(80,3)	(4.103,4)	5.010,1
VI. Deficit as a percentage of GDP	(5,9)	(5,8)	

(pr) Preliminary.

1/ Excluding the cost of financial restructuring.

Source: CONFIS.

There was mayor growth in expenses, with an increase of 18.5% in total payments. For instance, interest on the debt rose by 13.1%, operating expenses by 19.2% and investment by 8.4%. Operating expenses included an increase of 12.9% in personal services, 29.0% in general expenses and 20.1% in transfers. General expenses rose due to the purchase of military equipment. The net loan came to Col\$1,471 b.

The government deficit was financed with credit and earnings transferred from Banco de la República. Net external credit came to Col\$8,746 b, owing to Col\$12,590 b in disbursements and Col\$3,843 b in loan payments. Net internal credit was Col\$5,946 b, with Col\$13,871 b in disbursements and Col\$7,925 b in loan payments. Col\$13,085 b in TES were placed during the year.

The past year was characterized by what can be considered an active fiscal policy. Nevertheless, this was not a constant feature throughout 2001. Tax revenue increased in the early part of the year, with introduction of the tax reform adopted at the end of 2000. This reduced the short-term aggregate demand, as indicated in Chapter II of this report, but facilitated external borrowing. As the year progressed, public spending, particularly by the central government, grew at a fast pace due to financing, especially towards the end of the year.

In 2001, the quarterly trend in national treasury draws shows the chronology of the rise in expenditure. As illustrated in Table 17, draws for operating expenses increased rapidly as the year progressed. In the last quarter, these transfers registered a nominal growth of 28.2%, which is equivalent to 20.5% in real terms. This is explained primarily by the tendency in draws through transfers, which rose by 40.1% during the same

TABLE 17
ANNUAL INCREASE IN DRAWS
FROM THE NATIONAL TREASURY
(PERCENTAGE)

	Quarter - 2001			
	I	II	III	IV
Operating Expenses	12,1	17,8	20,1	28,2
Personal services	22,1	8,1	17,0	2,4
General expenses	54,4	40,1	22,9	18,3
Transfers	5,4	19,5	13,3	40,1
Investment	66,1	86,5	175,3	5,3
External debt	5,8	196,3	3,4	13,0
Internal debt	53,2	23,1	21,7	(37,9)

Source: National Treasury.

three months owing to transfers from the government to the regions in December to pay employee bonuses and other labor costs. The increase in draws for personal services was primarily in the first and third quarters of last year; that is, when public employees received their annual wage increase.

2. Progress in the adjustment program

A series of technical criteria for quarterly assessments were designed as part of the macroeconomic adjustment program agreed on by the government and the IMF. It is based on reduction of the fiscal deficit and a funding policy compatible with this adjustment. These quarterly targets for 2001 were based on: a) net international reserves (NIR); b) inflation measured by the accumulated CPI in the last 12 months; c) the overall balance for the combined public sector and d) net disbursements on the short, medium and long-term external debt in the public sector. As indicated in Table 18, all the targets outlined in the macroeconomic agreement were met during 2001.

TABLE 18
CRITERIA FOR COMPLIANCE WITH THE IMF PROGRAM, 20011/

	March			June		
	IMF Target (a)	Actual (b)	Spread (c)	IMF Target (a)	Actual (b)	Spread (c)
NIR Floor (US\$ millions)	8.900	9.077	177	8.980	9.203	223
Inflation target	8,70	7,81	(0,89)	8,90	7,93	(0,97)
Ceiling on the overall deficit in the consolidated public sector, as of January 1, 2001 (Col\$ billions)	1.000	908	(92)	2.600	2.437	(163)
Ceiling on accumulated, net medium and long-term external public debt disbursement, as of January 1, 2001 (US\$ millions) 2/	460	408	(52)	1.210	684	(526)
Ceiling on accumulated, net short-term external public debt disbursement, as of January 1, 2001 (US\$ millions)	80	0	(80)	80	80	0
	September			December		
	IMF Target 3/ (a)	Actual (b)	Spread (c)	IMF Target 3/ (a)	Actual (b)	Spread (c)
NIR Floor (US\$ millions)	9.060	9.388	328	9.500	9.982	482
Inflation target	8,60	7,97	(0,63)	8,00	7,65	(0,35)
Ceiling on the overall deficit in the consolidated public sector, as of January 1, 2001 (Col\$ billions)	4.150	1.994	(2.156)	6.550	6.097	(453)
Ceiling on accumulated, net medium and long-term external public debt disbursement, as of January 1, 2001 (US\$ millions) 2/	1.745	682	(1.063)	2.680	1.317	(1.363)
Ceiling on accumulated, net short-term public external debt disbursement, as of January 1, 2001 (US\$ millions)	80	80	0	180	80	(100)

(c) = (b) - (a).

1/ The figures have been updated from previous reports.

2/ The figure for net disbursements on the medium and long-term external debt in the public sector exceeded the target. However, the figures included here for each quarter were obtained pursuant to the clause that allows assets accumulated abroad to be deducted from excess external financing with those maturities.

3/ An indicative target and not a criteria to be met.

Source: Banco de la República.

IV

THE PUBLIC DEBT AND FISCAL SUSTAINABILITY

A. THE PUBLIC DEBT SITUATION

In the late 1980s and the early 1990s, the emerging economies received an important supply of foreign credit from the more developed countries, which were experiencing major changes and significant growth in their financial systems. International financial deregulation altered the intermediation business, prompting the consolidation of agents, a major expansion in institutional investors and unprecedented growth of the instruments used in this market. According to estimates contained in a recent study by ECLAC, the number of investment companies, insurance companies and pension funds in the major developed countries increased fourfold during the period between 1987 and 2000.¹⁷ What came to be known in economic literature as the integration and globalization of capital markets was consolidated.

Although the emerging economies played less of a role in this process than the developed countries, these movements implied a considerable increase in their receipt of private capital flows. The aforementioned study shows the participation of emerging economies in these flows increased fivefold between 1987 and 1997 and ninefold in terms of

foreign direct investment (FDI). As a member of this group, Latin America occupied a leading position. Structural reforms and capital market deregulation in most of the Latin American countries set the stage for this influx of capital by providing an environment favorable to increased investment and economic growth. Nevertheless, as of 1998, with the crisis in Russia and Asia, the capital flows that had come to the region left en masse and Latin America's participation in financial flows returned to historic levels.

The foreign capital cycle described above had a role in external public and private borrowing in Latin America during the 1990s and at the beginning of the current decade. Consequently, it is key to understanding the momentum of public financing for the region in the 1990s. However, in an important group of countries, it was the private and not the public sector that increased its level of foreign indebtedness to finance expansion needs. In some cases, the public sector also required capital of this type to finance increased public spending, without having to raise taxes.

In other countries, particularly Colombia, the public sector did not begin to acquire a significant external debt until the latter half of the 1990s. In addition to this capital inflow, the way the 1991 constitution was interpreted led to an increase in public spending equal to more than 10 points of GDP, while the increase in tax yields came to only four points of

¹⁷ R. Studart (2001). "Integración financiera en América Latina," ECLAC, Mimeograph.

GDP. In short, because of more spending and an abundant supply of internal and external credit, Colombia's total public debt grew quickly during the 1990s, at a nominal rate of 29.4% between 1996 and 2001. Presently, the gross debt accounts for 54.2% of GDP, with 27.0% of GDP corresponding to the internal debt and 27.2% to the external debt. In 1995, the proportion was 26.0% of GDP for the total public debt, and 11.8% and 14.2% of GDP for the internal and external debts, respectively. As the debt has increased, so has interest paid on this item. It now accounts for 5.4% of GDP, as opposed to 3.1% at the start of the 1990s.

However, the extent of current borrowing as a share of GDP is not the only problem. The likelihood that borrowing will continue to increase, as long as the financial imbalance and the momentum in public spending continue, is also a cause for concern. In this sense, there are two possible scenarios: 1) the country will maintain access to foreign resources in a highly atypical manner compared with the situation in other Latin American countries, or 2) access to capital markets will be limited and Colombia will be unable to continue to finance its fiscal imbalance with credit. Neither of these two scenarios is trouble free. In the first, the momentum created by public indebtedness implies the risk of creating an unsustainable situation, unless the necessary corrective measures are taken to balance public finances. In the second scenario, the country would have to choose between financing itself internally, with less than favorable consequences for the interest rate and growth, or resorting to an abrupt fiscal adjustment, which could be traumatic in the short-term.

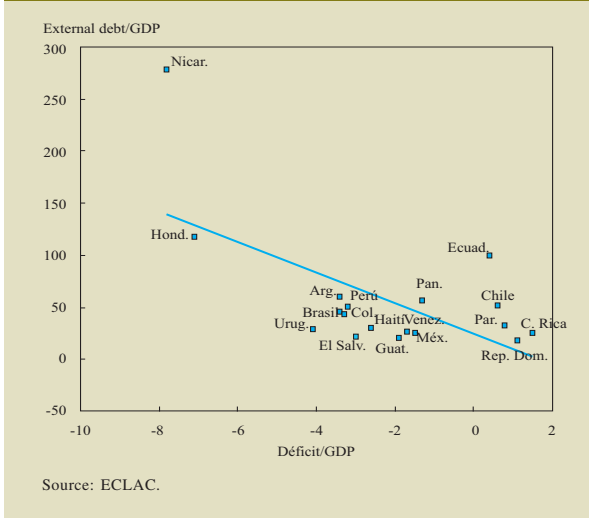
1. Some international comparisons

On the American continent, the public debt/GDP ratio in 2000 was 23.5% in Mexico and 35.0% in the United States. In Argentina, it was 47.0% at

the end of 2001. After devaluation in March 2002, this proportion is expected to be above 100%. The current proportion in Colombia (54.2%) is relatively high compared with the last two countries, but is lower than that of the European countries and Argentina after exchange devaluation. In general, economic literature focused specifically on countries with an exchange crisis in the last five years emphasizes the trend in public borrowing as an important indicator of macroeconomic vulnerability, more so than the extent of borrowing. In the recent Argentinean crisis and the one in Turkey (in 2001), growth of the public debt in the 1990s was a particular sign of imbalances that eventually led to abrupt currency devaluations. In Turkey, the public debt as a percentage of GDP rose from 45.0% to 62.0% during the 1990s. The internal portion rose from 20.0% to 45.0% of GDP, which is more than double. In the case of Argentina, the public debt/GDP ratio increased from 20.7% to 47.0% between 1990 and 2000, while the internal portion quadrupled, climbing from less than 5.0% to 22.0% of GDP.

As there are no statistics on the total public debt for a larger sample of countries similar to Colombia, Figure 44 shows the extent of total external borrowing and the fiscal balance in the non-financial public sector (NFPS) of several Latin American countries as a percentage of GDP in the year 2000. As illustrated, there is a positive connection between levels of borrowing and the fiscal deficit. This suggests the public sector, in the majority of cases, makes the most use of external credit. Some countries, such as Chile and Ecuador, have a large external debt and a fiscal surplus. In these instances, the private sector is more in debt than the public sector. There are also atypical cases such as Paraguay, with a low external debt and a major fiscal account deficit. Nicaragua is the most extreme case.

FIGURE 44
THE EXTERNAL DEBT AND FISCAL DEFICIT AS A
PERCENTAGE OF GDP IN SEVERAL LATIN AMERICAN
COUNTRIES, 2000



Its external debt represents more than 200% of GDP and its fiscal deficit represents more than seven points of GDP.

In the Latin American context, Colombia has a gross external debt/GDP ratio below average (49.0% against 57.0%), but the fiscal deficit in the non-financial public sector exceeds the average for the countries analyzed (3.4% against 2.2% in the year 2000). As illustrated (Figure 44), the situation of both these variables is similar to that of Argentina, Brazil and Peru.

Figure 45 offers a breakdown of the trend in total external borrowing, both public and private, in several Latin American countries. For example, Chile, Argentina and Colombia saw a major increase in their total external debt during the 1990s, while Peru and Mexico registered an increase in the first half of the 1990s, followed by a decline. Moreover, in the first three countries, private indebtedness was fundamental to the trend in external borrowing, especially in Chile. However, this balance has stabilized and even declined in recent years. External public borrowing has also diminished in

Chile, Peru and Mexico, three countries that have undertaken or completed successful fiscal adjustments. In contrast, external public borrowing in Colombia and Argentina is on the rise. This denotes a persistent financial imbalance in the public sector.

2. Development of the public debt in Colombia

a. The external public debt

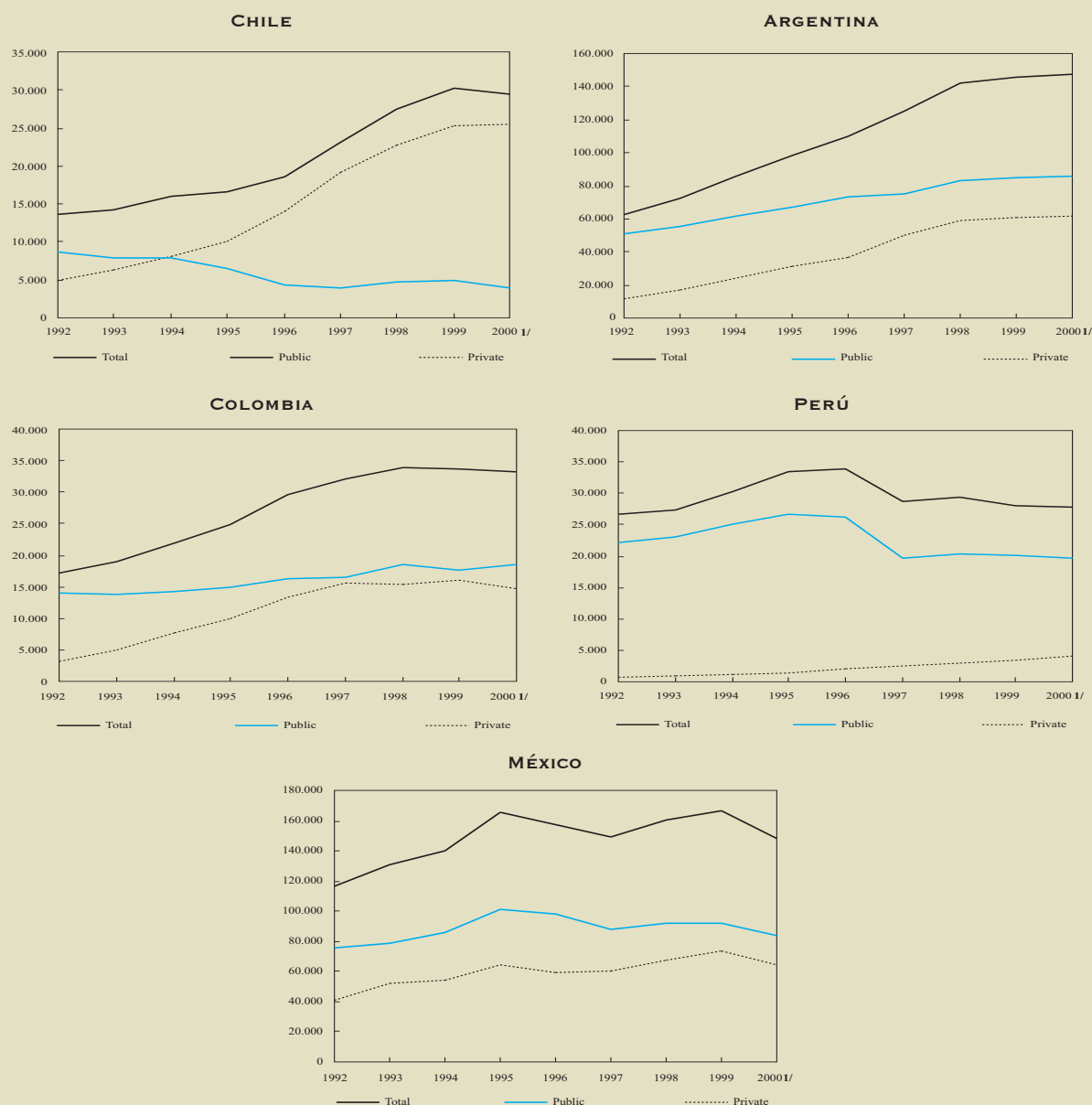
In Colombia, external borrowing by the public sector, as a percentage of GDP, declined from 27.9% to 12.9% between 1990 and 1996 (Figure 46).

Less of an external debt in the first half of the 1990s was the result of an explicit policy to finance the fiscal imbalance with internal revenue. This was also a time of increased taxes, various privatizations, and licensing for cellular telephone service. The proceeds that resulted were used to finance the growing public deficit and even made it possible to pay part of this external debt in advance. Exchange appreciation throughout most of this period also helped to lower the outstanding debt in pesos.

Nevertheless, the economic and financial crisis between 1998 and 2001 brought an abrupt change in the international scene, causing the public sector to rely more on foreign markets to finance the fiscal imbalance. Consequently, the external public debt increased, especially as of 1998. Just as appreciation allowed for a decline in the debt during the previous period, sharp depreciation in the final years of the 1990s was another reason why this balance increased in pesos. The external debt/GDP ratio also rose due to less product growth.

At present, the external debt in the public sector accounts for 60% of the country's total external debt. This proportion has increased in the last five years, inasmuch as the private sector is not borrowing to the extent observed at the start of

FIGURE 45
TOTAL EXTERNAL DEBT, PUBLIC AND PRIVATE, 1992-2000
 (US\$ MILLIONS)



1/ Preliminary figures.
 Source: ECLAC.

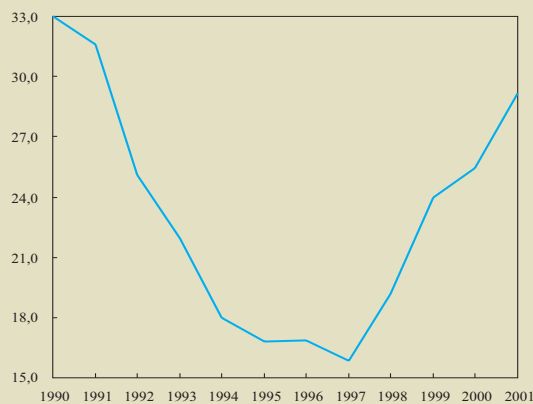
the decade. The external public debt as a percentage of goods and services exports is 151% and 232% as a portion of international reserves.

The increase in external borrowing by the public sector was reflected in interest payments, which accounted for 1.1% of GDP in 1995 and 2.1% in 2001. Although

manageable, this last percentage highlights the urgency of consolidating fiscal adjustment as a way to prevent the debt and interest payments from growing excessively in the years ahead.

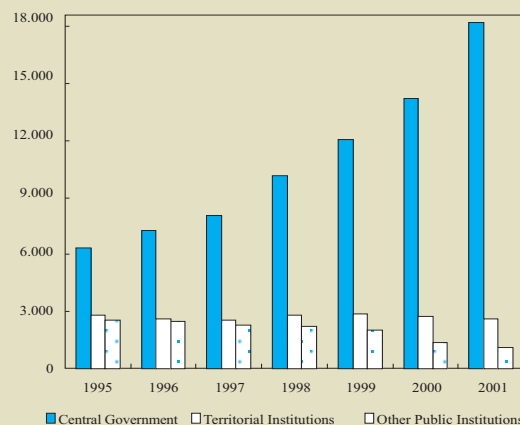
The trend in the external public debt in recent years is attributed largely to central government borrowing,

FIGURE 46
COLOMBIA: EXTERNAL PUBLIC DEBT, 1990-2001
 (PERCENTAGE OF GDP)



Note: To calculate the external debt as a percentage of GDP the balance was converted to Colombian pesos using the exchange rate in effect at the end of the period.
 Source: Banco de la República.

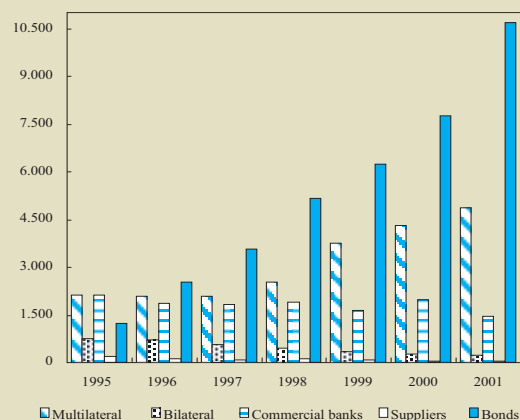
FIGURE 47
EXTERNAL PUBLIC DEBT PER TYPE OF BORROWER, 1995-2001
 (US\$ MILLIONS)



Source: Banco de la República.

which represents 82.3% of the total external debt. Figure 47 shows how the central government external debt practically tripled between 1995 and 2001, with an increase from US\$6,367.0 m to US\$18,188.0 m. Figure 48 shows this process was accompanied by a change in the type of lender. In 1995, multilateral agencies were the principal source of central government credit. As of 1996, bonds placed on the international market became the main source of external credit and accounted for 51% of total external government borrowing at the end of 2001. Borrowing from multilateral banks increased as well, particularly as of 1998. Other sources of financing have become less important in recent years.

FIGURE 48
EXTERNAL DEBT OF THE CENTRAL GOVERNMENT BY TYPE OF LENDER
 (US\$ MILLIONS)



Source: Banco de la República.

Eight percent (80%) of the debt contracted by the central government is in dollars, 15% in euros and 5% in yen. As to the total, 64% is at a fixed rate, 25% at a floating rate and 12% at a semi-floating rate.

Public debt maturity is profiled in Figure 49, which shows an important part of repayment concentrated

in 2002 and 2003. According to the criterion applied by the Public Credit Department at the Finance Ministry, new external borrowing is to be contracted in such a way that repayment does not exceed 15% of the amount outstanding each year. In 2003, repayment will come to US\$2,600 m (3.2% of GDP), which is close to this limit.

In contrast with the central government, the rest of the public sector obtained most of its financing in 2001 from multilateral agencies. Metro Medellín is responsible for the bulk of foreign borrowing in this sector (US\$674 m), followed by Empresas Públicas de Medellín (US\$ 666 m), Central Hidroeléctrica de Urrá (US\$ 296 m), the city of Bogotá (US\$301 m), Ecopetrol (US\$303 m and Emcali (US\$217 m).¹⁸ (Table 19)

b. The internal public debt

Between 1995 and 2001, the internal public debt grew faster than the external public debt. Due to the availability of funds in the economy, in the financial sector and the private sector, and to the devices commonly used to oblige public agencies with a surplus to invest in public debt securities, the central government had a growing supply of internal resources at its disposal. Law 100 of 1993 also contributed to this supply by creating private

pension funds, which have invested a good portion of their resources in public debt securities.

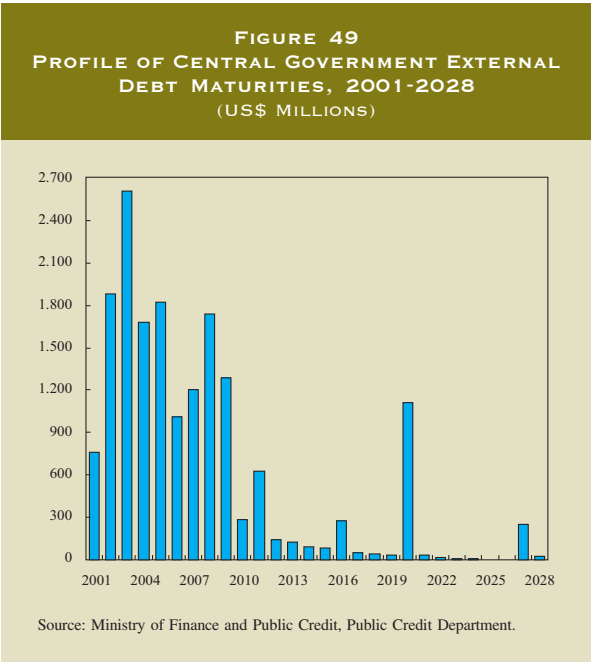
The government used treasury paper (TES) to tap these resources. Capital markets in Colombia and in other developing countries are characteristically flat and illiquid, with a very limited investor base. As a result, the private sector has relied heavily on credit from the financial sector. In this environment, issues of public debt paper became an attractive investment alternative on the domestic capital market.

The market in domestic debt securities is comprised mostly of government bonds. Institutions such as Fogafin and Finagro also issue securities, but they are not as important as treasury bonds. The total stock of TES B came to \$31,300 m at December 2001.

The gross internal debt, represented by TES and other liabilities with the financial system, increased at an average annual rate of 31.4% between 1995 and 2001. During this period, the value of the gross debt as a share of GDP rose from 11.8% to 27.0%. As with the external debt, most internal borrowing in the public sector was done by the central government. In 2001, its share of the internal debt was 82%. Territorial institutions accounted for 11.3% and the other NFPS agencies, 6.0%.

On the other hand, it is important to differentiate between the gross internal debt and the net internal debt. The latter is calculated by deducting the debt contracted between public sector institutions from the gross debt. As seen in Figure 50, the net debt accounted for nearly 65.0% of the gross debt in 2001 and 17.5% of the product.

Unfortunately, there are no statistics on evolution of the gross or net debt in the NFPS during the early 1990s. However, Banco de la República has



¹⁸ Due to the financial difficulties facing Metro de Medellín, Central Hidroeléctrica de Urrá and Emcali, the central government will probably assume these liabilities, which represent US\$1.2 m in total.

TABLE 19
MEDIUM AND LONG-TERM EXTERNAL DEBT BY LENDER AND BORROWER
AMOUNT OUTSTANDING AT SEPTEMBER 2001
 (US\$ MILLIONS)

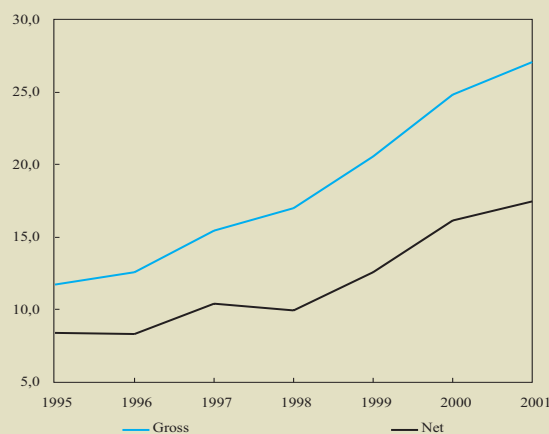
Institutions	Multilateral	Bilateral	Commercial Banks	Suppliers	Bonds	Total
Central government	4,889	210	1,457	41	10,676	17,273
Ecopetrol	0	206	90	7	0	303
Telecom	6	20	49	33	0	108
ISA	279	11	1	0	0	291
Fondo Nacional de Caminos Vecinales	43	3	0	0	0	46
Satena	0	0	0	30	0	30
Instituto de Adecuación de Tierras	12	0	0	0	0	12
ICFES	13	0	0	0	0	13
Fondo Vial Nacional	188	0	0	0	0	188
Federación de Cafeteros	0	0	60	0	0	60
Antioquia	11	4	0	0	0	15
CHEC	0	4	26	0	0	30
CAR - Cundinamarca	35	15	0	0	0	50
Corelca	0	9	20	0	0	29
Urrá	8	0	177	111	0	296
Bogotá, D.C.	72		229	0	0	301
Cartagena	21		0	0	0	21
EAAB	96	39	0	0	0	135
EEEEB	0	11	0	0	0	11
ETB	0	0	102	31	0	133
Emcali	63	117	5	32	0	217
EPM	516	89	59	2	0	666
Metro de Medellín (ETMVA)	0	239	435	0	0	674
Others	15	17	12	25	0	69

Source: Banco de la República.

reconstructed a record of the central government debt, as represented in the most important securities of different types and categories, such as TES B, agricultural bonds, peace bonds and constant-value bonds, among others. Figure 51 shows the change in the government domestic debt in bonds as a percentage of GDP, which increased from 2.7% in 1992 to 20.9% of GDP in 2001.

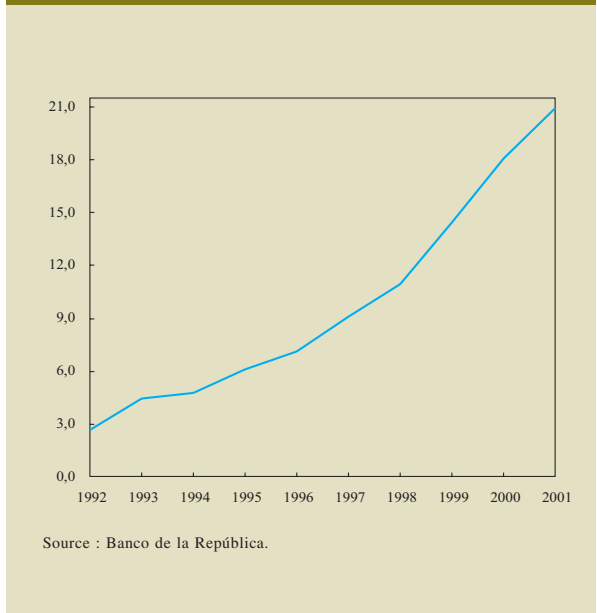
While the central government domestic debt is represented essentially by bonds, the debt of territorial institutions and other NFPS agencies is concentrated largely with commercial banks. In this type of institution, bonds account for a relatively

FIGURE 50
NFPS EXTERNAL DEBT, GROSS AND NET
 (PERCENTAGE OF GDP)



Source: Banco de la República.

FIGURE 51
CENTRAL GOVERNMENT: DOMESTIC DEBT IN BONDS,
1992-2001
 (PERCENTAGE OF GDP)



small share of the total internal debt, although they have gained importance in recent years as a funding device (Figure 52).

According to information reported to Banco de la República, 40.2% of all TES B issued by the national government are held by the financial system, including Fogafin, Banco de la República, trust companies and pension-severance fund managers. The non-financial private sector holds 14.5% of all TES and the public sector 45.2%.

Figure 53 illustrates the profile of central government domestic debt maturities in the years ahead. As can be seen, there is an important concentration of maturities in 2002, 2004, 2006 and 2011. Interest paid on the internal public debt doubled in the last six years. In 1995, such payments accounted for 1% of GDP for the NFPS as opposed to 2.7% in 2001.

FIGURE 52
INTERNAL PUBLIC DEBT BY LENDER, 1995-2001
 (AMOUNT OUTSTANDING IN COL\$ MILLIONS)

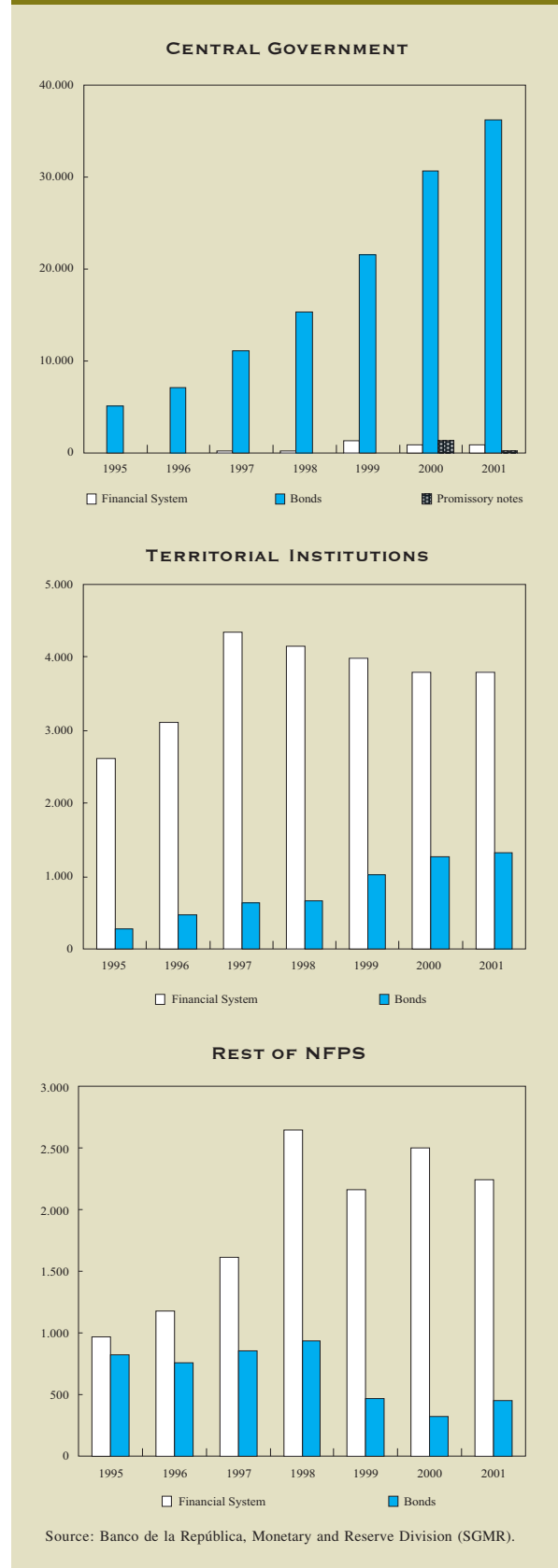
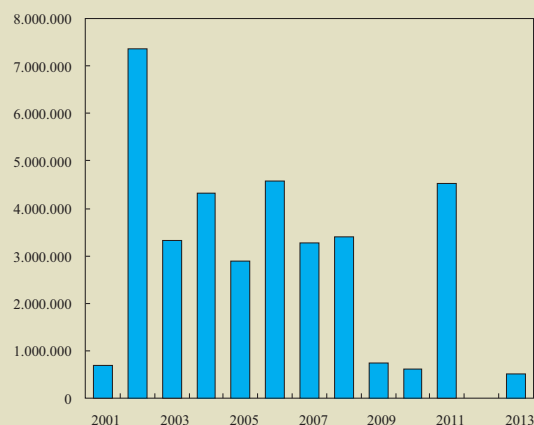


FIGURE 53
PROFILE OF CENTRAL GOVERNMENT DOMESTIC
DEBT MATURITIES
 (COL\$ MILLIONS)



Source: Ministry of Finance and Public Credit, Public Credit Department.

B. SUSTAINABILITY OF THE PUBLIC DEBT

As indicated, public spending in Colombia during the 1990s grew faster than tax revenue, causing the public debt/GDP ratio to increase rapidly. The present debt is large compared with that of other Latin American countries. However, more important than the extent of the debt, which is beginning to cause concern, is its development, which is tied closely to public spending and to distribution of the tax burden, as indicated in a recent study by Posada and Arango (2000).¹⁹

Public borrowing can be seen as a cumulative process whereby the net debt at the end of a particular year is conditional on the debt existing in the previous period, plus the interest on this debt and the primary balance of the current period. The size of the primary balance required to sustain

¹⁹ Posada, Carlos Esteban and Luis Eduardo Arango (2000), "¿Podremos sostener la deuda pública?" Borradores de Economía No. 165, Banco de la República.

the public debt is determined by the debt/GDP ratio, the real GDP growth rate, and the real interest rate at which the public debt was acquired.²⁰

According to economic literature, a long-term primary surplus is necessary for the public debt to be sustainable. However, during the 1990s, the primary balance turned negative for the central government - and also for the NFPS, as of 1999 - when the increase in public spending exceeded the growth in fiscal receipts. Moreover, the GDP growth rate slowed and interest rates increased on several occasions.

Debt sustainability should be calculated on a medium-term basis and not from one year to the next. However, substituting the gross debt/GDP ratio, which is 54.2%, and considering that real economic growth was approximately 2.0% in 2001 and average weighted interest rates on the public debt are around 7.2% in real terms, the primary surplus should be 2.7% of GDP if the public debt is to be sustainable (Table 20). If the net debt/GDP ratio (44.7%) is included in the equation, a primary surplus of 2.3% would be required for the debt to be sustainable at a rate of 2.0% economic growth. If economic growth in the longer term increases to a real rate of 4.0%, less of a primary surplus would be required (around 1.4% of GDP).

Generally speaking, the positive primary balance required to sustain the debt declines by 0.5% of GDP with each additional point in real economic growth. It also declines by the same proportion

²⁰ The primary deficit is defined as follows:
 Primary deficit = Debt/GDP * ((g-r)/(1 + g))
 Where,
 Primary deficit: primary deficit (or surplus, when there is a minus sign (-))
 g: real GDP growth rate
 r: weighted average of real interest rates charged on the public debt.

with each point less in the real interest rate. In contrast, a 10-point rise in public borrowing requires an increase in the primary balance equal to 0.7% of GDP. If pension liabilities in the non-financial public sector are added to the equation, the required primary surplus would be higher than the levels presented here.

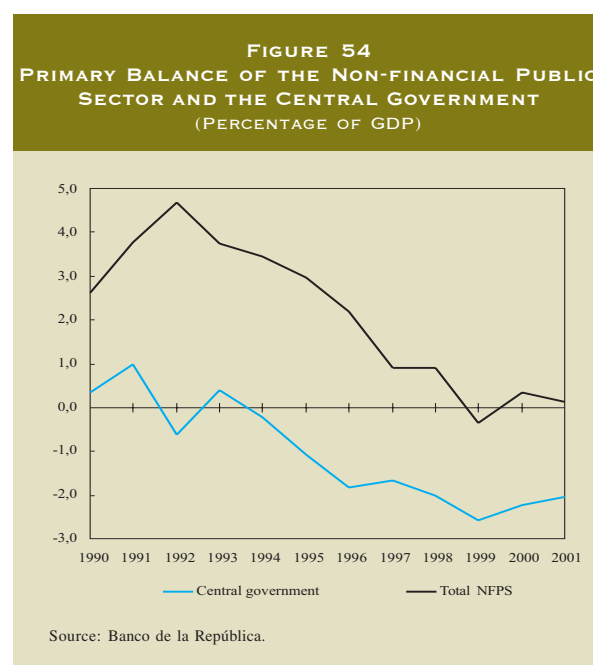
In short, the simplest calculations of public debt sustainability indicate a major effort will be

required of the Colombian state in the years ahead if its accounts are to generate the primary surpluses needed to prevent the public debt from becoming unsustainable. The extent of these surplus will depend on the course of economic growth. If long-term growth is around 3.0%, as models estimated by Banco de la República and the National Department of Planning (DNP) appear to indicate, the necessary surplus would be around 2.0% of GDP. However, this will be difficult, in spite of the equilibrium observed in the primary balance during the last two years (Figure 54).

TABLE 20
PRIMARY SURPLUS NEEDED
FOR DEBT SUSTAINABILITY AT DIFFERENT REAL
GROWTH AND INTEREST RATES
(PERCENTAGE)

GDP Growth	Interest Rates	Gross debt/GDP 54,2	Net debt/GDP 44,7
1,0	7,15	3,30	2,72
2,0		2,74	2,26
3,0		2,18	1,80
4,0		1,64	1,35
1,0	6,15	2,76	2,28
2,0		2,21	1,82
3,0		1,66	1,37
4,0		1,12	0,92
1,0	5,15	2,23	1,84
2,0		1,67	1,38
3,0		1,13	0,93
4,0		0,60	0,49

Source: Calculations based on Posada and Arango, 2000. The outstanding net and gross debt as a percentage of GDP based on statistics compiled by Banco de la República.



THE PUBLIC DEBT PROBLEM IN THE EIGHTIES

In the early 1980s, Colombia suffered an economic slowdown at a time when international financial markets had become inaccessible due to external debt problems in a number of Latin American countries. The public debt in Colombia had been growing since 1978, mainly because of more investment spending in the electrical sector. This was reflected in the extent of borrowing. While the deficit in the non-financial public sector went from 0.1% of GDP in 1978 to 5.1% in 1982, the outstanding balance on the external public debt increased from 10.7% of GDP in the first of these years to 13.4% in the second. In contrast, the balance on the government domestic debt declined from 1.8% of GDP in 1978 to 1.4% in 1982. Essentially, the reduced importance of domestic borrowing during the early 1980s reflects the limited development of capital markets, which made it difficult for the government and other public institutions to adopt a regular policy for the issue and sale of domestic debt securities.

The situation on the exchange market, which had been deteriorating since the late 1970s, worsened as of 1981 when the balance of payments showed a current account deficit equivalent to 4.1% of GDP, after several years of surplus. At the start, the current account setback had no major economic repercussions, due to the increase in foreign borrowing by the public sector and the sizable stock of international reserves accumulated during the coffee boom in the mid-1970s. However, with the closure of external credit markets in 1982, the current account deficit led to a major loss of international reserves in Colombia.

The country's economic problems worsened in 1982-1983, when international financial markets were virtually closed. Even so, external borrowing in the public sector continued to grow and amounted to 15.2% of GDP at the end of 1983. As of that year, domestic credit began to gain importance as a source of deficit financing, especially with the issue of new government debt securities known as national savings bonds (TAN) and with monetary financing extended to the national government by Banco de la República.

In 1984, adoption of a severe adjustment program was considered necessary to stabilize public finances, restore external equilibrium and regain access to international financial markets. Accordingly, between 1984 and 1985, an import surtax was implemented, certain tax exemptions were eliminated, public utility rates were raised, wage increases were controlled, and the exchange policy was characterized by rapid devaluation of the peso. These measures were part of a monitoring agreement with the International Monetary Fund.

Although certain sectors of the economy were affected by these fiscal and exchange adjustments, the program as a whole was successful. In 1986, the economy showed clear signs of recovery, with more than 5.0% real growth in GDP, a current account surplus, and a fiscal situation that was almost balanced. The recovery in the economy was also the result of an improvement in the price of coffee on the international market, particularly due to its favorable impact on export

value and the finances of the National Coffee Fund. Compliance with the goals of the adjustment program brought renewed access to international financial markets. The so-called Jumbo Loan for US\$ 1 b was disbursed between 1985 and 1986.

At the end of the 1980s, the focus of economic policy was on consolidating the adjustment process and restoring normal relations with the international banking community. Both the fiscal deficit and the current account of the balance of payments stayed within the limits outlined in the government's program, and Colombia again had access to new foreign credit. The Concorde Loan for US\$1,060 m was disbursed between 1987 and 1988, followed by the Challenger Loan for US\$1.7 b between 1989 and 1990. Renewed access to credit markets was reflected in the extent of external borrowing by the public sector, which increased from 23.6% of GDP in 1985 to 30.0% in 1989.

THE MACROECONOMIC OUTLOOK FOR 2002

The outlook for the principal macroeconomic variables in 2002 (inflation, the balance of payments, growth and the fiscal deficit) is discussed in this section. Given the decline in inflation observed in recent years and the country's monetary policy, the BDBR is reasonably confident the inflation target of 6.0% for the current year will be met and inflation will stay within the 4.0% to 6.0% range in 2003. The current account deficit is expected to be 3.1% of GDP, due to slow export growth and more imports. There are signs that domestic product will again grow at a more accelerated pace, somewhere between 2.5% and 3.0% by the end of the year, according to government forecasts. The deficit in the consolidated public sector should be around 2.6% of GDP at year's end, which would imply an adjustment close to 0.8% of GDP in relation to the size of the deficit in 2001.

A. THE OUTLOOK FOR INFLATION

According to projection models estimated by Banco de la República, the target of 6.0% inflation in 2002 will likely be met. This outlook is based on the behavior of core inflation indicators, which averaged below 7% in the last six months of 2001 and in January and February 2002. Moreover, low price adjustments on important market-basket items such as rental and clothing, coupled with forecasts

for harvests and the weather in the months ahead, allow for a certain degree of optimism about how this variable will behave. If inflation in 2002 does not exceed 6%, the rate in 2003 will probably be within the range established by the BDBR as the target for that year.

Even so, it is important to keep an eye on developments that could have a negative effect on these trends. The weather poses the most risk. For example, El Niño can be an important phenomenon, particularly in the second half of the year. The trend in meat prices and those for meat by-products and substitutes will have to be followed closely, as they can exert upward pressure on consumer prices. This is because of their importance to the market basket and the current restriction on supply due to retention in the cattle cycle, which is characteristic of this market. Potato prices could increase as a result of less planting in response to low prices in the second half of 2001.

Aggravation of the internal conflict could have a negative impact on inflation by creating supply problems in some parts of the country. It could also affect certain public utility rates, if companies are forced to transfer the cost of repairing facilities damaged by terrorists to the consumer.²²

²² The measures adopted by Venezuela consist of applying reference prices to textile and clothing imports. These prices operates like a tariff when export products are priced below the reference rate. Therefore, it is difficult to gauge their impact on current exports to Venezuela, which include nearly US\$100 m in products of this type.

B. THE OUTLOOK FOR ECONOMIC GROWTH

The outlook is for stronger economic growth in 2002 than in 2001. According to government projections, the economy should grow by 2.5% to 3.0%. This is consistent with 6% target inflation, with continued low international prices for coffee, oil prices below those of the previous year, and with less growth in non-traditional exports, owing to the decline in external conditions caused by a fragile international environment.

A look at the behavior of the various sectors of the economy provides a clearer idea of what to expect during the rest of the year (Table 21). The agriculture and livestock sector should grow moderately, although slightly more than in 2001. This is attributed to the mediocre performance of foreign markets and modest real devaluation. The production of certain principal export products, such as flowers and coffee, is expected to suffer as a result of the aforementioned factors.

The mining sector will continue to see less oil production, owing to the natural decline in oil deposits and the likelihood of more terrorist attacks on oil facilities. This will be offset, in part, by increased coal production. Accordingly, real activity in the sector is expected to decline again, by -0.6%.

Industry may recover somewhat, as demonstrated by several indicators of expectations for the sector. However, this will depend on the recovery in domestic consumption. The domestic market is essential, as exports will not be very active, due to the recent slowdown in the US economy and less growth in other neighboring markets such as Ecuador and Venezuela.

TABLE 21
GDP BY MAJOR AREA OF ACTIVITY
(REAL PERCENTAGE INCREASES)

Sector	2001	2002 (proj.)
Agriculture, livestock, forestry, hunting and fishing	1,0	2,7
Mining and quarrying	(3,3)	(0,6)
Electricity, gas and water	2,3	1,4
Manufacturing industry	0,5	2,4
Constructoin	1,1	4,8
Commerce, restaurants and hotels	2,4	3,1
Transportation and communications	2,3	3,2
Financial sector and services for companies	0,8	1,4
Social, community and personal services	1,0	0,6
Subtotal: value added	1,4	2,3
Gross domestic product	1,5	2,5

(Proj.) Projected.

Source: DNP, 2001 Macroeconomic Balance and 2001 Perspectives. Conpes document 3251, December 21, 2001.

Devaluation of the bolívar and less economic growth in Venezuela could have a negative effect on growth in certain sectors and on the Colombian economy in general. According to models estimated by Banco de la República, the decline in Colombian sales would be somewhere between US\$250 m and US\$600 m, from US\$1,737.9 m in 2001. This would imply 0.2 to 0.7 percentage points less economic growth in 2002. Essentially, Venezuelan devaluation would be harmful to Colombia by jeopardizing the industries that produce goods for export to Venezuela, particularly vehicles and automobile parts, textiles and clothing. The latter will also be hurt by import restrictions adopted recently in the neighboring country.²³ These industries reported negative growth in 2001 and may behave similarly this year, despite some optimism about the behavior of the US economy

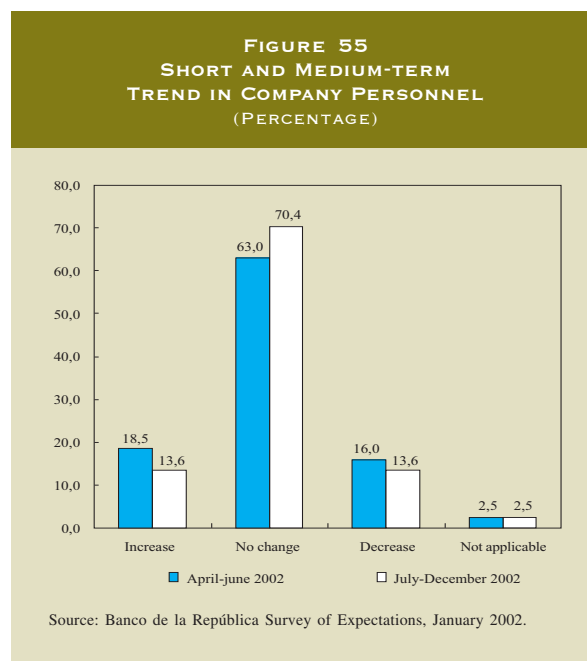
and the approval of Andean trade preferences, which would have a positive impact. Both factors could improve the outlook for these industries in the US market. Ecuador will also see less economic growth. However, no appreciable slowdown in sales to the Ecuadorian market is anticipated, as exchange conditions are still favorable for Colombia.

The recovery in home construction is expected to continue. In 2002, the government will maintain its policies to this effect, which include subsidies for low-income housing and tax benefits for mortgage holders. Investment in civil works is expected to be less favorable. This will slow recovery of the sector as a whole. However, the outlook is for a much higher rate of growth than in previous years (4.8%).

C. THE OUTLOOK FOR EMPLOYMENT

A Banco de la República survey of expectations in January showed an improvement in the way economic agents view the future of the economy (Figure 55). In fact, 16.0% of those surveyed plan cutbacks in personnel during the next three to six months, which is less than the proportion registered in the October survey (27.9%). The percentage of those who plan to reduce personnel in the next six to 12 months (13.6%) is also less than in the October survey (20.3%).

²³ The measures adopted by Venezuela consist of applying reference prices to textile and clothing imports. These prices operate like a tariff when export products are priced below the reference rate. Therefore, it is difficult to gauge their impact on current exports to Venezuela, which include nearly US\$100 m in products of this type.



D. THE OUTLOOK FOR THE BALANCE OF PAYMENTS

The latest projection on the balance of payments (Table 22) shows a current account deficit of US\$2,616 m for 2002, which is equivalent to 3.1% of GDP. US\$3,035 m in anticipated capital receipts (3.6% of GDP) will be used to finance this deficit.

The current account estimate for the balance of payments points to an annual reduction of 1.6% in merchandise exports, due to an annual decline of 26.8% in oil exports.²⁴ The annual increase in merchandise imports is estimated at 3.9% and includes US\$570 m in imports scheduled as part of Plan Colombia.²⁵ Without this last item, the increase in the value of imports in 2001 comes to 4.1%.

²⁴ Includes special commercial transactions.

²⁵ *Ibid.*

TABLE 22
SUMMARY OF COLOMBIA'S BALANCE OF PAYMENTS
(US\$ MILLIONS)

	US\$ Millions			As a % of GDP		
	2000 (pr)	2001 (e)	2002 (proy.)	2000 (pr)	2001 (e)	2002 (proy.)
I. CURRENT ACCOUNT	394	(1,636)	(2,616)	0.48	(2.01)	(3.08)
Income	18,446	18,191	17,864	22.69	22.35	21.06
Disbursements	18,052	19,826	20,480	22.20	24.36	24.15
A. Nonfactor goods and services	1,286	(825)	(1,474)	1.58	(1.01)	(1.74)
1. Goods	2,531	494	(183)	3.11	0.61	(0.22)
Exports	13,620	12,759	12,554	16.75	15.67	14.80
Imports	11,089	12,265	12,737	13.64	15.07	15.02
2. Nonfactor Services	(1,245)	(1,319)	(1,291)	(1.53)	(1.62)	(1.52)
Exports	2,069	2,201	2,233	2.54	2.70	2.63
Imports	3,314	3,520	3,524	4.08	4.32	4.16
B. Factor Income	(2,542)	(2,949)	(3,231)	(3.13)	(3.62)	(3.81)
Income	859	728	615	1.06	0.89	0.73
Disbursements	3,401	3,677	3,847	4.18	4.52	4.54
C. Current Transfers	1,650	2,139	2,090	2.03	2.63	2.46
Income	1,898	2,503	2,462	2.33	3.08	2.90
Disbursements	248	365	372	0.31	0.45	0.44
II. CAPITAL AND FINANCIAL ACCOUNT	517	2,507	3,035	0.64	3.08	3.58
A. Financial Account	517	2,507	3,035	0.64	3.08	3.58
1. Long-term Financial Flows	2,094	4,823	2,136	2.58	5.92	2.52
a. Assets	325	(60)	200	0.40	(0.07)	0.24
i. Colombian direct investment abroad	325	(60)	200	0.40	(0.07)	0.24
ii. Loans 1/	0	0	0	0.00	0.00	0.00
iii. Leasing	0	0	0	0.00	0.00	0.00
iv. Other assets	0	0	0	0.00	0.00	0.00
b. Liabilities	2,459	4,798	2,371	3.02	5.89	2.80
i. Foreign direct investment in Colombia	2,387	1,979	2,624	2.94	2.43	3.09
ii. Loans 1/	273	2,988	(322)	0.34	3.67	(0.38)
Public sector	1,139	2,949	576	1.40	3.62	0.68
Private sector	(866)	39	(898)	(1.07)	0.05	(1.06)
iii. Leasing	(202)	(169)	69	(0.25)	(0.21)	0.08
Public sector	(32)	(31)	86	(0.04)	(0.04)	0.10
Private sector	(169)	(138)	(17)	(0.21)	(0.17)	(0.02)
iv. Other liabilities	0	0	0	0.00	0.00	0.00
Public sector	0	0	0	0.00	0.00	0.00
Private sector	0	0	0	0.00	0.00	0.00
c. Other long-term financial movement	(40)	(35)	(35)	(0.05)	(0.04)	(0.04)
2. Short-term Financial Flows	(1,577)	(2,316)	900	(1.94)	(2.85)	1.06
a. Assets	1,527	3,232	(882)	1.88	3.97	(1.04)
i. Portfolio investments	1,014	3,412	(956)	1.25	4.19	(1.13)
Public sector	100	1,604	(2,030)	0.12	1.97	(2.39)
Private sector	913	1,808	1,074	1.12	2.22	1.27
ii. Loans 1/	513	(180)	74	0.63	(0.22)	0.09
Public sector	(65)	(6)	0	(0.08)	(0.01)	0.00
Private sector	579	(174)	74	0.71	(0.21)	0.09
b. Liabilities	(50)	916	18	(0.06)	1.12	0.02
i. Portfolio investments	17	(41)	0	0.02	(0.05)	0.00
Public sector	0	(1)	0	0.00	(0.00)	0.00
Private sector	17	(40)	0	0.02	(0.05)	0.00
ii. Loans 1/	(67)	956	18	(0.08)	1.17	0.02
Public sector	(473)	121	(80)	(0.58)	0.15	(0.09)
Private sector	406	835	98	0.50	1.03	0.12
B. Special Capital Flows	0	0	0	0.00	0.00	0.00
III. NET ERRORS AND OMISSIONS	(42)	254	0	(0.05)	0.31	0.00
IV. CHANGE IN GROSS INTERNATIONAL RESERVES 2/	870	1,125	420	1.07	1.38	0.49
V. GROSS INTERNATIONAL RESERVES	9,006	10,245	10,483	11.08	12.59	12.36
VI. NET INTERNATIONAL RESERVES	9,004	10,192	10,430	11.08	12.52	12.30
Months merchandise imports	10	10	10			
Months goods and services imports	6	6	6			
Nominal GDP in millions of dollars	81,298	81,396	84,810			
VII. CHANGE IN NET INTERNATIONAL RESERVES	869	1,074	420	1.07	1.32	0.49

(pr.) Preliminary.

(e) Estimated.

(proj.) Projected.

2002 assumptions: Export prices: Coffee - US\$0.7/pound (Exdock), oil -US\$18.4/barrel and growth in merchandise imports - 3.9% (4.1% without Plan Colombia).

1/ Includes portfolio investment, direct loans and commercial credit.

2/ According to the balance-of-payments methodology.

Source: Banco de la República.

The projection for the capital and financial account contemplates a sizable reduction in long-term flows from US\$4,823 m in 2001 to US\$2,136 m in 2002. As to short-term flows, an influx of US\$900 m is expected, as opposed to an outflow of US\$2,316 m in 2001. The behavior of these long and short-term flows is due largely to the fact that the government prefinanced US\$1,900 m in 2001, which will be liquidated in 2002 for external debt service. As a result, net long-term external financing for the public sector in 2002 would be almost US\$2,250 m less than in 2001. This projection also considers the reduction in the consolidated public sector deficit, which is analyzed in the following section. Being close to 0.7% of GDP, it will imply less of a requirement for external credit in the public sector. The projection for the same item in the private sector is highly conservative and points to US\$898 m in net payments.²⁶

As a result of the foregoing, the country would accumulate US\$420 m in gross international reserves during 2002, for a balance of US\$10,483 m at the end of December. This is equivalent to 9.9 months merchandise imports and 6.3 months total goods and services imports.

D. THE FISCAL OUTLOOK FOR 2002

The CONFIS projection for 2002 points to a consolidated fiscal deficit equal to 2.6% of GDP, or 0.7% of GDP less than the amount observed in 2001. As shown in Table 23, fiscal deficit reduction in 2002 will depend on the fiscal effort of the

²⁶ Leasing not included.

NFPS, since the cost of restructuring the financial sector, estimated at 0.5% of GDP, will be offset by the surplus from Banco de la República and Fogafin. According to official estimates, a reduction in the amount of the central government deficit equal to 1.1% of GDP will be required to achieve the fiscal goal.

Central government finances will register a deficit equivalent to 4.7% of GDP, thanks to substantially less growth in expenditure (Table 24). Compared with the year before, the increase in this item is expected to decline from 18.5% to 3.6%. This is equivalent to a reduction in real terms, provided the inflation projections are borne out. As to income, the expectation is for tax yields to grow by 9.5% and non-tax revenue to decline by 21.8%. Revenue from income tax and domestic VAT will rise by 14.0% and 9.0%, respectively. Gasoline tax revenue is expected to decline by 0.2% due to the lower rate stipulated in Law 681 of 2001. Capital earnings, which are comprised mainly of financial yields and surpluses from state-owned companies and establishments at national level, will expand by only 1.7% due to fewer profits transferred from Ecopetrol.

The estimate, by expenditure item, points to an increase of 18.3% in interest, 7.0% in operating expenses and 1.3% in the net loan. Operating expenses include 0.4% growth in personal services and 9.2% in transfers. There will be a major change in general expenditure, which is expected to increase by 1.7% in nominal terms. Investment payments will decline by approximately 65.4% to somewhere around Col\$1 b. In any case, meeting the deficit target will depend on cutbacks in the budget for spending. The net loan is projected at Col\$1,489 b, with Col\$500 b earmarked for the Social Security Institute (ISS), Col\$417 b for Corelca and Col\$250 b for Metro de Medellín.

TABLE 23
DEFICIT IN EFFECTIVE OPERATIONS
OF THE CONSOLIDATED PUBLIC SECTOR
DEFICIT

Item	Billions of Pesos		Percentage of GDP	
	2001 (pr)	2002 (proj.)	2001(pr)	2002 (proj.)
Electricity	256,0	386,0	0,1	0,2
Emcali	141,0	80,0	0,1	0,0
EPM	293,0	460,0	0,2	0,2
FAEP	451,0	(814,0)	0,2	(0,4)
Ecopetrol	779,0	984,0	0,4	0,5
Telecom	355,0	124,0	0,2	0,1
Other Entities	308,0	762,0	0,2	0,4
Social Security	1.100,0	899,0	0,6	0,4
Regional and Local Entities	26,0	1.243,0	0,0	0,6
National Coffee Fund	(77,0)	(64,0)	(0,0)	(0,0)
1. Sub-total Decentralized Sector	3.632,0	4.060,0	1,9	2,0
2. National Government	(10.774,0)	(9.687,0)	(5,8)	(4,7)
A. Total non-financial public sector (NFPS) (1+2)	(7.142,0)	(5.627,0)	(3,8)	(2,7)
B. Cash losses and profits				
Banco de la República	1.393,0	879,0	0,7	0,4
C. Cash losses and profits Fogafin	327,0	256,0	0,2	0,1
D. Cost of restructuring the financial sector	(1.268,0)	(969,0)	(0,7)	(0,5)
E. Adjustments	593,0	0,0	(0,3)	0,0
F. Total Consolidated Public Sector (A + B + C + D + E)	(6.097,0)	(5.461,0)	(3,3)	(2,6)

(pr) Preliminary
(proj.) Projection.
Source: Confis.

Financing for the deficit of the national government will originate largely with domestic credit, use of the National Treasury portfolio, and profits transferred by Banco de la República. Net external borrowing will amount to Col\$877 b, owing to Col\$5,978 b in disbursements and Col\$5,101 b in amortization. New domestic borrowing will amount to Col\$3,253 b, as a result of Col\$11,298 b in disbursements and Col\$8,045 b in amortization. TES placement is estimated at Col\$10,898 b, with Col\$6,330 b corresponding to obligatory or agreed investments and Col\$4,568 b to auctions.

As to the decentralized sector, official projections show a major setback in the fiscal standing of the

NFPS, seeing that resources will be disaccumulated this year so the regions can serve their debts with the financial sector. The National Coffee Fund (FNC) will continue to show a deficit because of low international prices for coffee, even in spite of government subsidies to ensure its operation.

It is also important to mention the fiscal adjustment process being undertaken by the national government to lower the consolidated deficit to levels compatible with macroeconomic stability. Recent years have witnessed adjustments in the tax system and a series of reforms to curb the growth in public spending. For example, Law 617 of 2000 established regional fiscal rehabilitation

TABLE 24
EFFECTIVE CENTRAL GOVERNMENT OPERATIONS
(COL\$ BILLIONS)

	2001 (pr)	2002 (proj.)	Annual Growth 2002/2001
I. Total Revenue (A + B + C + D)	27.489,0	29.892,0	8,7
A. Tax revenue	24.802,2	27.161,0	9,5
Income tax	10.022,0	11.421,0	14,0
Domestic VAT	6.931,5	7.552,0	9,0
External VAT	3.079,4	3.182,0	3,3
Customs	2.150,1	2.286,0	6,3
Gasoline tax	1.106,4	1.104,0	(0,2)
Tax on financial transactions	1.421,4	1.519,0	6,9
Others	91,4	97,0	6,1
B. Non-tax revenue	374,9	293,0	(21,8)
C. Special funds	240,5	331,0	37,6
D. Capital resources	2.071,4	2.107,0	1,7
Financial yields	571,3	902,0	57,9
Financial surpluses	1.320,0	1.076,0	(18,5)
Others	180,1	118,0	(34,5)
II. Total Expenditure (A + B + C + D)	39.043,6	40.438,0	3,6
A. Interest	7.497,1	8.870,0	18,3
External	3.114,4	3.838,0	23,2
Internal	4.382,7	5.032,0	14,8
B. Operating Costs	27.171,9	29.074,0	7,0
Personal services	5.279,6	5.299,0	0,4
General expenses	1.774,3	1.804,0	1,7
Transfers	20.118,0	21.971,0	9,2
C. Investment	2.904,0	1.005,0	(65,4)
D. Net loan	1.470,6	1.489,0	1,3
Cash deficit or surplus	(11.554,6)	(10.546,0)	(8,7)
III. Adjustments	780,6	859,0	10,0
IV. Deficit (-) or surplus (+) (I - II + III) 1/	(10.774,0)	(9.687,0)	(10,1)
Cost of financial restructuring	1.267,7	969,0	(23,6)
V. Financing (A + B + C + D)	(12.041,7)	(10.656,0)	(11,5)
A. Net external credit	8.746,4	877,0	(90,0)
Disbursements	12.589,8	5.978,0	(52,5)
Amortization	3.843,4	5.101,0	32,7
B. Net domestic credit	5.945,9	3.253,0	(45,3)
Disbursements	13.879,9	11.298,0	(18,5)
Amortization	7.925,0	8.045,0	1,5
C. Banco de la República earnings	1.452,8	1.022,0	(29,7)
D. Others	(4.103,4)	5.504,0	(234,1)
VI. Deficit as a Percentage of GDP	(5,8)	(4,7)	

(pr) Preliminary.

(proj.) Projections.

1/ Excluding the cost of restructuring the financial sector.

Source: CONFIS.

mechanisms and Legislative Act 1 of 2000 modified the system of territorial transfers, separating the amount earmarked for health, education and other municipal responsibilities from the behavior of current national revenue. Law 715 of 2001 was approved to complement Legislative Act 1 of 2000 by regulating the way resources from territorial revenue sharing are calculated, distributed and used. It also defines the responsibilities of each level of government with respect to health and education.

To distribute funds transferred from the nation to the regions, the new law initially establishes a deduction equivalent to 4.0% of the annual value of revenue sharing, which is distributed among the National Pension Fund for Territorial Agencies (FONPET), the Indian reservations, municipalities along the Magdalena River, and district and municipal food programs for schools throughout the country. The remaining 96.0% is then divided into three types of revenue sharing: the first is used specifically for education, the second specifically for health, and the third to finance general expenses, including those for water and basic sanitation. The resources allocated to each of these types of revenue sharing correspond, in order, to 58.5%, 24.5% and 17.0% of the amount of the net shares of the 4.0% deduction.

Changing the system of transfers will help to reorganize the health and education sectors in a way that allows government resources to be allocated more efficiently, thereby improving the quality and coverage of such services. From a fiscal standpoint, the reform generates no important savings in the short term. A recent study by the CONFIS Advisory Office estimates the savings to the government would amount to barely 0.1% of GDP in 2002.

Although these reforms have curbed spending, there are still a number of fiscal risks associated with government pension liabilities that may threaten fiscal stability in the years ahead. In this respect, it is urgent that Congress consider the pension reform bill presented by the government at the end of last year. Generally speaking, it proposes a gradual increase in pension-fund contributions, tightens the requirements for retirement age, disability and survivors, and modifies the formula used to calculate the monthly pension. Congress shall determine if the proposal would result in a financially viable social security system for pensions, or if new adjustments are needed in the number of weeks contributed to the system, the retirement age and the size of monthly pensions. The government, Congress and the labor unions will also have to address the issue of special pension schemes, which must move gradually in the direction of the general scheme.

VI

INTERNATIONAL RESERVES AND THE FINANCIAL POSITION OF BANCO DE LA REPÚBLICA

A. INTERNATIONAL RESERVES

1. The International Reserve Balance

Colombia had US\$10,191.8 m in net international reserves at December 2001. This represents an annual increase of US\$1,187.7 m.²⁷ The bulk (91.4%) correspond to the international reserve investment portfolio (US\$9,317.0 m), US\$6,236.3 m of which are managed directly by Banco de la República and US\$3,080.7 m by external financial entities. The remainder is distributed as follows: US\$648.0 m in the country's reserve position with the International Monetary Fund and the Latin American Reserve Fund (FLAR), US\$137.1 m in special drawing rights (SDR), US\$112.8 m in gold, Andean pesos and positive balances from international agreements, and US\$30.3 m in demand deposits and cash. Short-term external liabilities at December 2001 came to US\$53.3 m (Table 25).²⁸

2. Criteria for Managing International Reserves

Security, liquidity and profitability, in that order, are the three criteria established by Banco de la República for the management of international reserves. Accordingly, in 2001, the bank continued

its policy of appointing international financial institutions to manage part of the country's international reserves. These organizations are subject to a rigorous selection process based on their experience in the business, the size of the funds they manage, and the extent of their capability for management and risk control. They have improved the profitability of international reserves through specialized management, and have supported development of the bank's own internal capacity for management.²⁹

In keeping with the criteria adopted by Banco de la República for managing international reserves and to ensure the country's external liabilities are met, reserves are invested in financial assets with a broad secondary market. A portion are kept as working capital to guarantee their immediate availability.

Banco de la República directly managed a portfolio of US\$6,236.3 m (66.9% of the total), including US\$535.3 m in working capital. The other 33.1% (US\$3,080.7 m) was managed by Barclays Global Investors, Morgan Investment Management and Goldman Sachs Asset Management.

During 2001, the yield on the portion of Colombia's international reserves managed by Barclays Global Investors was 5.89%, as opposed to

²⁷ Equal to total international reserves, or gross reserves, minus Banco de la República short-term external liabilities. The latter are comprised of sight liabilities in foreign currency with non-resident agents.

²⁸ FAEP resources deposited by foreign banks in Banco de República accounts.

²⁹ A number of central banks use similar delegation schemes to allow first-rate institutions to manage a portion of their external assets. This enables them to benefit from the specialized expertise these firms have to offer. In Latin America, this scheme is used by countries such as Argentina, Brazil and Chile.

TABLE 25
PRINCIPAL COMPONENTS OF INTERNATIONAL RESERVES
(US\$ MILLIONS)

Description	December 1999	Share %	December 2000	Share %	December 2001	Share %
Cash	91.2	1.1	30.0	0.3	30.3	0.3
Vault	90.2	1.1	28.5	0.3	29.9	0.3
Demand deposits	1.0	0.0	1.5	0.0	0.5	0.0
Investments	7,122.0	87.9	8,083.2	89.8	9,317.0	91.4
Managed directly	4,395.9	54.3	5,173.0	57.5	6,236.3	61.2
Delegated management	2,726.1	33.7	2,910.2	32.3	3,080.7	30.2
Gold	95.4	1.2	89.4	1.0	90.6	0.9
Vault	0.0	0.0	0.0	0.0	0.0	0.0
Custody	95.4	1.2	89.4	1.0	90.6	0.9
International Monetary Fund	523.0	6.5	508.1	5.6	495.9	4.9
Special drawing rights	131.2	1.6	135.7	1.5	137.1	1.3
Reserve position	391.8	4.8	372.4	4.1	358.9	3.5
Latin American Reserve Fund	270.0	3.3	285.8	3.2	309.1	3.0
Contributions	250.0	3.1	265.8	3.0	289.1	2.8
Andean pesos	20.0	0.2	20.0	0.2	20.0	0.2
International Agreements	1.8	0.0	9.7	0.1	2.2	0.0
Total Gross Reserves	8,103.4	100.0	9,006.1	100.0	10,245.1	100.5
Short-term Liabilities	2.3	0.0	2.0	0.0	53.3	0.5
International agreements	0.0	0.0	0.0	0.0	0.0	0.0
Foreign banks	0.0	0.0	0.0	0.0	50.0	0.5
Latin American Reserve Fund	0.0	0.0	0.0	0.0	0.0	0.0
Amounts payable for investment purchase	0.3	0.0	0.0	0.0	0.0	0.0
Liability accrual and appraisal	2.0	0.0	2.0	0.0	3.3	0.0
Total Net Reserves	8,101.1	100.0	9,004.1	100.0	10,191.8	100.0

Source: Banco de la República.

5.85% on the portion managed by JP Morgan Investment Management and 5.79% on the portion delegated to Goldman Sachs Asset Management. These percentages compare favorably with the yield of 5.30% on the reference portfolio, which is used to measure the performance of these asset managers and to evaluate direct management by the bank itself.³⁰ International asset managers are able to obtain higher

yields than those on the reference portfolio, seeing that a portion their portfolio is invested in specialized management assets different from those of the index used as a reference by the Banco de la República.

The currency distribution of the portfolio is in keeping with the management criteria mentioned earlier and with the country's external liabilities. At December 2001, this distribution was as follows: 82.8% in US dollars, 13.4% in euros, 3.0% in Japanese yen and 0.8% in other currencies.³¹ Although this investment

³⁰ The reference portfolio is comprised of assets denominated in US dollars (80%), euros (15%) and yen (5%). These assets are invested in a combination of money market instruments at three months (25%) and one to five-year government bonds (75%), with two years average duration for the portfolio as a whole.

³¹ Such as Canadian dollars, Swedish kronors and pounds sterling.

policy occasionally results in unexpected earnings or disbursements due to changes in the exchange rates for different currencies vis-à-vis the dollar, it does allow for a balance between international reserves and the make-up of the country's external payments.

The investment portfolio, including the portion managed directly by the bank and that managed by other institutions, is invested primarily in securities issued by sovereign governments (72.2%) and a lesser portion in banking institutions (27.8%). The credit risk on these investments is distributed to ensure security in the way international reserves are managed. Risk distribution at December 2001, according to the ratings assigned by specialized agencies, was as follows: 80.0% AAA, 7.5% AA, 6.6% AA-, 5.7% AA + and 0.2% A+.³²

In 2001, Banco de la República obtained US\$477.4 m in net yield on the investment portfolio of reserves. This was the result of US\$539.4 m in cash revenue and -US\$62 m in losses recorded as accrual and appraisal of international reserves at market prices. As to accrual, US\$4.3 m in earnings were obtained, while the appraisal loss came to US\$66.3 m, primarily because the euro depreciated sharply against the dollar in the first half of the year.³³

B. FINANCIAL POSITION

1. Results in 2001

Banco de la República reported Col\$31,874.5 b in total assets, with an annual increase of Col\$2,725.2

b or 9.3% (Table 26). The variation is explained mainly by: a) an increase of Col\$3,945.2 b in international reserves, derived from an accumulation of reserves and devaluation of the peso against the dollar; b) a positive variation in other assets (Col\$ 528.7 b), primarily due to appreciation in the value of artistic and cultural works (Col\$397.9 b)³⁴ and in the value of the representative portfolio of pension resources (Col\$88.6 b); c) an increase in the value of contributions with international organizations (Col\$213.7 b), due to an adjustment occasioned by growth in the peso-dollar exchange rate; and d) a rise in accounts receivable (Col\$30.0 b). These increases were offset, in part, by: a) the decline in investments (Col\$1.192.3 b) (TES B redemptions and maturity of bonds to capitalize public banking); b) less demand for repos and temporary liquidity support on the part of the financial system (Col\$617.6 b); and c) the decline in the loan portfolio balance (Col\$182.2 b), basically due to portfolio repurchase by Banco Granahorrar.

The Bank showed Col\$15,288.6 b in liabilities and Col\$16.585.9 b in equity, with respective annual increases of Col\$1,467.1 b and Col\$1,258.2 b. The growth in liabilities is explained primarily by: a) an expansion of Col\$937.5 b (8.8%) in the monetary base; b) an increase of Col\$166.9 b in other deposits³⁵; and c) more financial system investment in reverse repos (Col\$140.9 b). The change in equity originated with the peso-dollar exchange adjustment in international reserves (Col\$1,069.7 b) and with the entry offsetting the property appraisal (Col\$417.4 b).

Banco de la República earned Col\$1,223.8 b in profits in 2001 (Table 27) as a result of Col\$1,857.4

³² Standard & Poors, Moody's and IBCA.

³³ The euro devaluted 9.5% against the dollar during the first half of 2001 and revaluated 6.13% between July and December.

³⁴ This year, Banco de la República appraised its art collection for the first time. The purpose in doing so was to reflect its value in the institution's surplus equity. This appraisal implies no expenditure or investment during the period; that is, it has no effect on the Bank's income statement.

³⁵ Current account deposits other than the banking reserve.

TABLE 26
GENERAL BALANCE SHEET - BANCO DE LA REPÚBLICA
(COL\$ BILLIONS)

	December, 2000		December, 2001	
	Balance	Share %	Balance	Share %
Assets	29.149,2	100,0	31.874,5	100,0
Gross international reserves	19.689,2	67,5	23.634,5	74,1
Contributions with international organizations	2.268,6	7,8	2.482,3	7,8
Investments	3.248,7	11,1	2.056,0	6,5
Consolidated public debt	308,8	1,1	240,3	0,8
Public securities in keeping with monetary regulations	2.398,0	8,2	1.730,2	5,4
Public bank bonds and others	541,8	1,9	85,4	0,3
Loan portfolio	323,9	1,1	141,7	0,4
National government-public sector	3,7	0,0	3,4	0,0
Banks	6,0	0,0	3,5	0,0
Financial corporations	154,1	0,5	132,9	0,4
Savings & loan associations	160,1	0,5		
Other loans			1,9	0,0
Repurchase Agreements - Temporary liquidity support	1.729,0	5,9	1.111,4	3,5
Accounts receivable	64,3	0,2	94,3	0,3
Other net assets	1.825,6	6,3	2.354,3	7,4
Liabilities and Net Worth	29.149,2	100,0	31.874,5	100,0
Liabilities	13.821,5	47,4	15.288,6	48,0
Foreign currency liabilities affecting international reserves	4,3	0,0	123,0	0,4
Monetary base	10.710,4	36,7	11.647,9	36,5
Notes in circulation	8.698,6	29,8	9.990,8	31,3
Treasury coins	344,2	1,2	357,7	1,1
Bank reserve requirement deposits	1.362,8	4,7	1.118,5	3,5
Current account deposits rest of financial sector	304,9	1,0	180,9	0,6
Other deposits	77,5	0,3	244,5	0,8
National government - National Treasury	253,7	0,9	97,9	0,3
International agency liabilities	1.853,8	6,4	1.980,2	6,2
External credit liabilities	207,6	0,7	183,9	0,6
Securities regulating domestic and exchange liquidity	28,7	0,1	162,7	0,5
Reverse repos	20,9	0,1	161,8	0,5
Exchange certificates	0,8	0,0	0,0	0,0
Foreign currency funding certificates & Dep. Res. 5/97 J.D.	6,9	0,0	0,8	0,0
Others	0,1	0,0	0,1	0,0
Accounts payable	31,4	0,1	40,9	0,1
Other liabilities	654,1	2,2	807,6	2,5
Total Net Worth	15.327,7	52,6	16.585,9	52,0
Capital	12,7	0,0	12,7	0,0
Reserves	345,9	1,2	321,2	1,0
Capital surplus	13.094,6	44,9	14.172,1	44,5
Special exchange account liquidation	453,5	1,6	453,5	1,4
Exchange adjustment: 1993 and thereafter & surplus	12.619,7	43,3	13.689,3	42,9
Others	21,4	0,1	29,3	0,1
Property appreciation (art works, cultural property and real estate)	438,7	1,5	856,1	2,7
Results	1.435,9	4,9	1.223,8	3,8
Current year profits/losses	1.435,9	4,9	1.223,8	3,8

Source: Banco de la República.

TABLE 27
INCOME STATEMENT - BANCO DE LA REPÚBLICA, 2000-2002
(COL\$ BILLONES)

	Performance		Actual annual % change	Projection for 2002	Estimated annual % change
	2000	2001			
I. Total Income	2.090,8	1.857,4	(11,2)	890,8	(52,0)
1. Operating Income	2.055,8	1.839,6	(10,5)	885,3	(51,9)
Interest and yield	1.733,9	1.602,4	(7,6)	634,6	(60,4)
Net international reserves	1.086,1	1.104,0	1,6	405,3	(63,3)
External credit lines	21,7	12,3	(43,2)	9,6	(22,1)
TES "A" appreciation at market prices	46,4	37,0	(20,2)	24,3	(34,2)
TES appreciation through monetary expansion transactions	311,0	297,8	(4,2)	170,5	(42,8)
Appreciation public bank capitalization bonds	48,2	39,6	(18,0)	0,0	(100,0)
Temporary purchase of securities and quotas	147,3	66,0	(55,2)	20,0	(69,7)
Others	73,2	45,6	(37,7)	4,9	(89,3)
Commissions	77,3	96,2	24,4	95,6	(0,6)
Banking services and trusts	65,4	85,8	31,3	86,8	1,1
Foreign currency management	11,0	10,3	(6,5)	8,8	(14,4)
Others	0,9	0,1	(93,9)	0,0	(100,0)
Exchange difference	170,0	56,8	(66,6)	112,2	97,7
Issue of coins and precious metals	2,8	0,8	(71,9)	40,4	4.958,3
Securities redeemed in advance	22,5	0,7	(96,7)	0,0	(100,0)
Others	49,3	82,8	67,8	2,5	(97,0)
2. Non-operational Income	35,0	17,8	(49,0)	5,5	(69,1)
II. Total Disbursements	654,9	633,6	(3,3)	689,9	8,9
1. Operating disbursements	642,2	610,1	(5,0)	687,1	12,6
Interest and yield	219,1	208,7	(4,8)	177,4	(15,0)
Deposit accounts	125,5	180,4	43,7	127,8	(29,2)
Temporary sale of securities	71,4	18,3	(74,3)	39,6	115,8
External credit lines and exchangeable securities	22,2	9,9	(55,3)	10,1	1,6
Commissions and fees	17,8	16,6	(6,4)	10,5	(36,8)
Exchange difference	77,4	31,4	(59,4)	57,6	83,3
International organizations	27,1	5,0	(81,5)	16,5	230,0
External credit lines	34,7	12,8	(63,1)	22,4	74,7
Others	15,5	13,6	(12,4)	18,7	37,4
Cost of currency issue	17,7	27,2	53,5	59,4	118,5
Personnel expenses	150,6	152,8	1,5	164,2	7,4
Retirement pensions	52,5	62,9	19,7	95,8	52,4
General expenses	48,8	52,6	7,9	58,6	11,3
Taxes	2,0	2,9	45,5	4,7	61,6
Insurance	4,1	5,3	29,8	7,9	48,4
Cultural expenses	6,0	5,7	(5,7)	6,2	8,9
Provisions, depreciation and amortization	31,7	34,5	8,8	36,1	4,6
Other operating expenses	14,5	9,5	(34,7)	8,8	(7,1)
2. Non-operational disbursements	12,7	23,5	84,9	2,8	(88,1)
III. Fiscal Year profit/loss, including depreciation	1.435,9	1.223,8	(14,8)	200,9	(83,6)

Source: Banco de la República.

b in income and Col\$633.6 b in disbursements. The following are highlights: a) Col\$1,104.0 b in yield on international reserves, which is equivalent to US\$477.4 m; b) Col\$297.8 b in appreciation in TES acquired through monetary expansion transactions; c) Col\$96.2 b in commissions from banking and trust services; d) Col\$82.8 b in other operational income due mainly to the reduction in provisions constituted in other periods; and e) Col\$66.0 b in interest from the temporary purchase of repos and liquidity quotas.

Total disbursements declined by 3.2%. The following were the most important aspects in this respect: Col\$180.4 b in remuneration on deposit accounts, Col\$152.8 b in personnel expenses, Col\$62.9 b in pension costs and Col\$52.6 b in general expenses³⁶ During 2001, personnel expenses increased by just 1.5% in nominal terms. This amounts to a reduction of more than six percentage points in real terms. There was virtually no real growth in general expenses (0.2%), thanks to policies to trim spending.

2. Constitution of reserves and profit distribution

Pursuant to the bylaws of Banco de la República, the BDBR agreed to distribute Col\$1.233.4 b in the current year, originating with profits earned in 2001 (Col\$1,223.8 b) and use of part of the reserves accumulated to protect assets (Col\$9.6 b).³⁷ This distribution will include: a) Col\$1,225.9 b for the national government and b) Col\$7.5 b for net investments in property for cultural activity (Table 28).

³⁶ These include public utilities, janitorial service, surveillance, maintenance and repairs, currency transport, stationary, information activities, etc.

³⁷ The reduction in this reserve obeys the decline in the net cash balance in coins from their production cost.

TABLE 28
2001 PROFIT DISTRIBUTION AND USE OF BANCO DE
REPÚBLICA RESERVES
(COL\$ BILLIONS)

Resources for distribution	1.233,4
2001 profits	1.223,8
Use of reserves	
for asset protection	9,6
Allocation	1.233,4
National government	1.225,9
Net investment	
in cultural property	7,5

Source: Banco de la República.

Pursuant to the same statutes, the BDBR decided there was no need to establish a monetary stabilization and exchange reserve, as no losses are anticipated for the next two years. The reserve for currency fluctuation was also considered adequate, given the possible risk of future loss, and the BDBR decided to keep the respective balance of at Col\$100.3 b. As in 2001, there were no losses on daily foreign currency purchase and sale. Consequently, the BDBR did not change the exchange yield reserve.

3. Income and expenditure projected for 2002

The projection for the current year is Col\$890.8 b in income and Col\$689.9 b in disbursements, which would result in a profit of Col\$200.9 b. Interest and yield on international reserves and the TES portfolio acquired by Banco de la República would be the main source of income: Col\$405.3 b and Col\$170.5 b, respectively. The projection for 2002, compared with the year before, indicates a reduction of Col\$826,0 b in these earnings as a whole. The lower yield on TES (Col\$127.3 b) is explained primarily by the decline in their balance. On the other hand, the reduction in yield on international reserves - projected at around Col\$698.7 b - is explained by two factors: first, lower interest rates on the international market,

which reduce the regular yield on reserves, and second, the expectation that interest rates will rise during the current year, which would devalue the reserve portfolio valued at market prices, negatively affecting its yield. In addition, the yield calculated on international reserves does not include the possible impact of a change in the exchange rates for the currencies in the reserve portfolio.³⁸ Therefore, the amount is subject to uncertainty over the future of exchange rates for the dollar against the euro and the yen.

Banco de la República anticipates Col\$689.9 b in disbursements. This represents an increase of 8.9%. The following are the main items: Col\$177.4 b paid

³⁸ The yield on international reserves was calculated with information available up to January 31, 2002. Therefore, it includes the change in exchange rates during the first month of the year.

for interest and yield, including Col\$127.8 b in remuneration on deposits; Col\$164.2 b for personnel expenses, with 7.4% nominal growth³⁹; Col\$95.8 b in net disbursements for pension costs⁴⁰; Col\$58.6 b for general expenses, with a projected increase of 11.3%; Col\$59.4 b for the cost of currency issue; Col\$57.6 b for exchange differences, due to an increase in the peso value of liabilities in foreign currency, and Col\$36.1 b for provisions and depreciation.

³⁹ This projection takes into account the collective bargaining agreement now in force, which contemplates a wage increase equal to the inflation target, plus two percentage points.

⁴⁰ The projection implies a nominal increase of 6.3% during the year in expenses incurred by Banco de la República to pay retirement pensions and to update the reserve according to the actuarial calculation. This percentage is practically the same as the target for inflation. However, given the way interest rates are expected to behave, the yield on the portfolio of actuarial liability investments is expected to decline by 13.3%. The combination of these two projections explains the projected 52.4% increase in net pension costs.

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