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DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

COLOMBIA

INVESTMENT SECTOR LOAN

(CO-0035)

LOAN PROPOSAL

SEPTEMBER 1991

GLOSSARY

CERTS	Tax Reimbursement Certificates
COLPUERTOS	Colombia's Ports Administration
CONPES	The National Planning Council
DIMAR	National Maritime and Ports Directorate
DTF	The marginal cost of funds
EAI	The Enterprise for the Americas Initiative
FEN	The National Electric Finance Company
FINDETER	The Municipalities' Finance Company
GDP	Gross National product
IBRD	The World Bank
INCOMEX	Colombia's Institute of External Trade
MIF	The Multilateral Investment Fund
PROEXPO	Colombia's Export Promotion Fund
PSRL	The Public Sector Reform Loan

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I. INTRODUCTION

A. The Setting

1.1 The Colombian economy is going through a period of profound changes. After following for many years an inward-oriented model of economic development, with the distortions that this implies, the authorities have embarked on a reform program to modernize the economy. The new model, contained in what is called the Economic Modernization Program, recognizes Colombia's interdependence with the rest of the world and the need to offer greater economic participation to its people. Most of the economic reforms will make the country much more competitive and attractive to foreign direct investment than it has been in the past.

1.2 Contrary to what has happened in other countries, the Economic Modernization Program did not spring from a protracted and difficult economic crisis but rather from a genuine desire to improve general economic performance and social welfare. Colombia should be recognized, therefore, as one of those few countries undergoing reforms not out of short-term necessity but from a desire to enhance long-term growth potential. The Investment Sector Loan is an appropriate policy tool which the Bank has for participating in the modernization program.

B. Government Efforts and IDB Participation

1.3 The Colombian Government is seeking a society more open to interaction with the rest of the world and based on free private initiative. In order to establish an economy more dynamic, more easily adapted to world trade, more efficient and more even handed, a series of far-reaching structural reforms has been implemented.

1.4 The most significant reforms that have recently taken place are those whose objective is to:

- promote efficiency and competition in the financial sector (Law 45 of 1990);

- simplify the tax system and enhance its equity and efficiency (Law 49 of 1990);

- make the labor market more flexible and facilitate the creation of new job opportunities (Law 50 of 1990);
- improve ports and customs services (Law 1 of 1991).
- open up the foreign trade system (Law 7 of 1991);
- simplify and reduce distortions of the foreign exchange system (Law 9 of 1991); and
- liberalize the domestic and foreign investment regimes (Resolution 49 of 1991);

1.5 In addition to the enactment of the above mentioned legislation, the commitment of the present administration to reform the economy is illustrated by the fact that during development of the proposed Sector Investment Loan:

- dozens of norms and regulations needed to implement the approved laws have already been prepared;
- the new institutions authorized by law to be created have already been established; and
- the tariff reduction goals that were set to be reached by 1994 were accelerated and implemented in August of this year.

1.6 In spite of the breadth and depth of the economic reforms that have taken place, the authorities are aware that there remain administrative, legal, and economic issues that limit the growth of investment in Colombia. To that effect, the Government has begun a process to identify and evaluate the impact of the remaining obstacles to private investment, as well as examine the means by which those obstacles can be removed.

1.7 Through the Public Sector Reform Loan (PSRL) and through the development of the proposed Investment Sector Reform Loan, the Bank has become an active supporter and participant in the process to modernize Colombia's economy. This has been done by engaging the authorities in a policy dialogue where constraints have been properly identified and addressed, and where Bank staff has helped formulate appropriate and realistic solutions.

1.8 In developing the policy structure for this loan, Bank staff worked closely with Colombian authorities to identify additional policy actions that would complement and extend the Government's Economic Modernization Program, and that would be consistent with the aims of an investment sector reform loan. As a result, this Bank operation accelerates the port privatization process over that contemplated in the PSRL. It also defines a comprehensive approach to customs reform, starting with a detailed customs information management scheme. Finally, important policy initiatives in the financial sector were included.

1.9 A determining factor in defining the loan's policy context is that the government's modernization program is still in its early stages. The loan concentrates, therefore, on the main structural issues as they relate to promoting private investment. They include: (i) lower transaction costs for traded goods via reduced tariff charges, port handling fees, and more efficient customs procedures; (ii) transparent trade finance and trade promotion activities; (iii) equality of tréatment of foreign and domestic investment; (iv) improved access by small- and medium-size firms to commercial credit; (v) restructuring and divestment of government-owned banks; and (vi) development of a long-term capital market.

1.10 The proposed loan will also provide the technical assistance necessary for the Government to continue the reform process. The support provided by this loan will help ensure the success of the Government's efforts to establish an economic environment in which Colombians and foreigners alike are no longer prevented by bureaucratic obstacles from taking advantage of the economic opportunities that the country offers.

C. Scope and Rationale

1.11 The proposed Investment Sector Reform Loan supports the ongoing program of the Government of Colombia to modernize its economy and expand economic opportunities through the removal of constraints that impede or hinder private sector participation. The rationale of the loan is that greater participation of private domestic and foreign investors will have a direct impact on the government's efforts to improve economic performance. Private sector participation will be fostered through the adoption of policy changes in the investment, external trade and financial sectors of the economy. Although an impressive amount of policy changes has already taken place, more remains to be done.

1.12 The proposed operation shares many of the objectives sought by the Enterprise for the Americas Initiative (EAI) announced in June 1990. The purpose of the Initiative is to promote concerted action by governments throughout the Caribbean and Latin America region, in the areas of trade liberalization and investment policy reform. Investment reform is predicated on the premise that development efforts will be largely ineffective if regulatory and other obstacles hinder domestic and foreign investment and limit a country's ability to generate new capital and attract old capital flight. The loan will also enable Colombia to participate in bilateral debt reduction programs, and in the Multilateral Investment Fund (MIF) which the Bank will administer.

1.13 Although during the 1980's Colombia avoided the financial crisis of other Latin America and Caribbean countries through consistently effective macroeconomic policy management, its development strategy was basically inward looking, with a high degree of protection from external competition. As the countries of the region began a process of opening

up their own economies to external competition, Colombia could no longer continue with this model. Consequently, beginning in 1990, the Colombian authorities started a process of opening the economy in order to compete effectively in this new environment.

1.14 The challenge facing Colombian authorities today is how to bring about this transformation without losing development momentum within a continued framework of relative social and economic stability. The proposed reform program is an integral part of the authorities' efforts to meet this challenge.

1.15 The proposed loan contributes to this effort in two important ways:

- it provides potential investors (domestic and foreign) a clear signal of the authorities' intention of improving the investment climate;

- it provides an added financial cushion to ensure the non-reversibility of the proposed reforms.

1.16 This policy loan is consistent with the Bank's sector loan program, and the resources are charged against the 25 percent limit on sector lending. The operation is supported by an appropriate macroeconomic framework, as discussed in Section II, and has been developed without co-financing from the World Bank since that institution is not presently programming additional policy loans for the country. However, the policy reforms contained in the loan do complement the basic economic policy objectives of the World Bank's adjustment operations there. Colombia is currently under a normal surveillance program of the Article IV of the IMF.

D. Summary of the Proposed Policy Measures

1.17 Measures that improve the investment regime are:

- simplifying and reducing the number of restrictions in the foreign exchange regime to lower the level of uncertainty;
- reducing labor market rigidities to improve labor utilization;
- eliminating or reducing taxes that have a negative effect on private investment; and
- removing policy and institutional obstacles that inhibit investment.

1.18 Measures to open up the external trade sector and to strengthen its institutions are:

- reorienting the incentives system towards favoring exports and efficient import substitution;
- reducing the number of tariffs and their dispersion across commodities;
- strengthening the main institutions responsible for external trade activities;
- ensuring the financial and administrative autonomy in the ports subsector; and

- building up the institutional and technical capacity of the customs system.

1.19 Measures to make the financial system more competitive and to create adequate financial instruments are:
- strengthening the capacity of the financial sector to mobilize domestic and external resources, and allocate them efficiently at competitive margins;
- making up for and potentially eliminating identified market failures in the access to credit of small entrepreneurs; and
- undertaking reforms that will facilitate the development of long-term capital markets.

E. The Bank's Lending Strategy in Colombia

1.20 IDB strategy in Colombia parallels the two major areas of emphasis of the Government for the period 1990-94. First, opening of the economy to make it more competitive internationally. Second, improving access and coverage for all government services, especially in the social sectors, through a more participatory and decentralized decision-making process.

1.21 The proposed operation is one of two sector loans that form the basis of the Bank's actions in the areas of opening the Colombian economy. The first policy-based sector operation was the Public Sector Reform Loan, which was processed and approved in 1990 for a total of US$305 million. The loan was co-financed by the IBRD in the amount of US$304 million.

1.22 The purpose of the PSRL is to improve the productivity of the public sector by creating incentives for the provision of efficient services, and by ensuring that the sectoral and specific policies and operations of decentralized institutions are consistent with the objectives and macroeconomic goals established for the medium-term. The PSRL complements the objectives of the proposed loan by including institutional actions and reforms to rationalize the organizational and administrative structure of the public sector, promote efficiency, and stimulate competition through private sector development.

1.23 Through the PSRL the Colombian authorities are promoting sectoral reforms for ports, railroads, maritime transportation, low-income housing and agricultural marketing. The specific purpose of those reforms is to eliminate barriers to entry and to develop a regulatory and incentive system based on competitive market mechanisms.

1.24 The Public Sector Reform and the Investment Sector Reform loans are the foundation for approximately one-half of the projects in the proposed pipeline. The policy measures taken in the PSRL will clear the way for important future programs in various sectors. For instance, in the transportation sector, with an intermodal operation geared to export corridors, and in the productive sectors, with credit programs in

agriculture, industry, non-traditional exports, and micro-enterprise. Similarly, in the energy sector, with programs for financial and institutional restructuring of the sector and, later on, a program for substitution of energy sources and privatization of the sector.

1.25 In its pursuit of a more modern, competitive economy, the Government has made clear that the social sectors would receive a higher proportion of its attention and resources. In fact, the Government sees the improvement in social services, in terms of access and quality, as a critical factor in its overall strategy for increased productivity as well as quality of life and social welfare.

1.26 The Bank's lending program for 1991-94 includes projects in the health and education sectors which are geared to improve efficiency and to increase coverage for the most vulnerable segments of the population. At the same time, programs in areas such as job re-training and relocation are also being explored, and it is hoped that such programs could eventually be presented for financing under the EAI which features technical assistance for this type of activity.

1.27 Micro-enterprises and small projects with non-governmental organizations have been the most consistently innovative elements of the Bank's program in the past, and promise to be equally so in the future. The Bank has already approved two global credit programs for micro-enterprises, and is scheduled to begin studying a new one next year.

1.28 In terms of small projects, the list of activities under consideration demonstrates that Colombia and the Bank are at the forefront in the treatment of women's issues, as well as programs for indigenous communities and for the handicapped. The possibilities of success of these efforts should be enhanced by the improvement of economic opportunities that is being sought under the proposed operation.

F. Loan and Program Summary

1. The Application

1.29 By letter, the Minister of Finance and Public Credit requested the Bank to design a sectoral loan to support the development of economic policy measures that will improve the private investment environment. The borrower would be the Republic of Colombia and the executing agency would be the Ministry of Finance and Public Credit.

1.30 In order to coordinate the various policy measures, the Government will create a committee whose members will be drawn from the Ministries of Finance, Development, Public Works and Transports, and from the Department of National Planning. The Committee will be headed by the Minister of Finance.

2. Loan Amount and Tranching

1.31 The proposed loan is for US$200.0 million to be disbursed in two equal tranches in a period of 18 months. There will also be a reimbursable technical cooperation component of US$5.0 million, part of which is directly related to studies necessary for timely execution of policy conditions. Supplementary technical activities will be considered for financing from the Multilateral Investment Fund, when it becomes available.

1.32 First tranche conditions have been fulfilled before presentation to the Board of Executive Directors.

3. Financial Conditions

1.33 The loan uses funds from the Bank Ordinary Capital resources. It has a 20 year amortization period and a five years grace. The interest rate is variable, according to the Bank's current policy. There is a credit fee of 0.75 percent to be charged on undisbursed balances, and a 1 percent inspection and supervision fee applicable to the whole loan amount.

II. FRAME OF REFERENCE

A. Background

2.1 Colombia's closed-economy model achieved satisfactory growth rates through much of the post-World War II period. However, during the 1980s it became clear that the inward development model could not support needed future growth. Thus, average annual GDP growth rates went from 5.1 percent during the 1960s, to 6.0 percent during the 1970s, but then only grew by 3.4 percent per year from 1980 to 1988. Yet Colombian authorities consider an economic growth rate of 5 percent per year to be a necessary condition for reducing unemployment and alleviating poverty.

2.2 Colombia's major source of economic growth has been through incremental inputs of capital and labor. In contrast, the contribution of total factor productivity to economic growth has been relatively small and declining since the 1970s. Unless the economy is able to use its resources more efficiently, future economic growth would be limited.

2.3 Raising total factor productivity is, therefore, an important component of Colombia's development strategy, and includes:

- strengthening public sector functions through better resource management;
- streamlining public investment projects;

- improving the flexibility of the budget allocation mechanism;
- rationally pricing public goods; and
- enhancing private sector productivity through the removal of domestic and external trade restrictions, thus altering the incentive system.

2.4 The present Colombian administration, which came to power in August, 1990, is moving faster and going farther on the economic reforms initiated by the previous administration. In a five-month period, 12 major pieces of legislation affecting all areas of economic activity were enacted.

B. The Economic Modernization Program

2.5 In February of 1990, Colombia's previous administration announced an Economic Modernization Program aimed at improving the efficiency in the allocation and use of the country's resources. The Program consisted of a set of structural reforms and accompanying macroeconomic policies that would increase the rate of economic growth to 5 percent per year, reduce the inflation rate to less than 20 percent per year, and lower the incidence of poverty. The objectives of the Modernization Program are:

- to structurally change the old development model by opening the economy to international markets;
- to improve public sector efficiency as well as to reduce and rationalize its areas of competence; and
- to implement sectoral reforms in order to stimulate economic efficiency and productivity.

2.6 A trade reform program, aimed at increasing the competitiveness of the tradeable goods sector was the centerpiece of the Program. Complementary policies were designed to rationalize the public sector, facilitate domestic resource mobilization, improve the efficiency of transport and port services, and support private sector adjustment to policy reforms. These structural reforms would be underpinned by fiscal, monetary, and exchange rate policies to maintain internal and external balance.

2.7 The current administration not only expressed its commitment to the Economic Modernization Program but decided to accelerate its implementation. Actions were taken or have been proposed in the areas of trade policy, agricultural trade and other agricultural sector policies, the financial sector, the public sector, and labor markets. As a result of these measures, the Bank approved the Public Sector Reform Loan in December of 1990.

C. Recent Economic Performance

2.8 In 1990 most of the attention on the part of Colombia's policy-makers was geared towards the implementation of the new, more liberalized trade

regime, the aim of which was to eliminate quantitative restrictions and reduce import duties. At the same time, legislation was passed enabling other important adjustments considered to be a vital complement to the new trade strategy.

2.9 During 1990, the economy grew at 4.2 percent, a level considered to be achievable without structural reforms. Mining, agriculture and manufacturing were the leading sectors, while commerce and especially construction showed signs of deterioration. From the demand side, exports played a crucial role, as those labelled non-traditional (basically manufacturing and agricultural goods other than coffee) increased 26.7 percent in dollar terms, after having increased 15.6 percent during the previous year.

2.10 The current account of the balance of payments showed a surplus of US$530.0 million (equal to 1.1 percent of GDP), mainly due to a strong surplus in the trade account (equal to 4.2 percent of GDP). The performance of exports was quite impressive. In spite of a 27 percent decline in world prices, coffee export revenues remained unchanged due to the fact that since the international coffee agreement was not being adhered to by the member countries, the excellent quality of Colombian coffee could benefit from increases in its demand. Export revenues from oil and coal reflected the increases registered both in volume as well as in prices. Non-traditional exports grew 24.2 percent and now account for almost 40 percent of total export receipts, with manufactured goods, cut flowers and bananas among the most successful ones.

2.11 The capital account is, to a great extent, the reflection of Colombia's debt strategy, which has been pursued in a consistent manner since 1984 and is geared towards maintaining normal relations with the international financial community. Through successive rollovers, Colombia has kept current with all of its creditors, and has made substantial progress towards solving its financial needs up to 1994. This strategy has been successful thanks to the cooperation of the financial community in general and the Japanese in particular. The latter accounts for 20 percent of Colombia's outstanding debt with commercial banks.

2.12 Inflation, which declined slightly in 1989, showed another upsurge in 1990. The devaluation in real terms, the boost in aggregate demand stemming from a good export performance, and substantial increases in the price of some goods and public services (e.g., utilities and gasoline) brought about a rate of inflation of 32.4 percent.

2.13 During 1990 the stance in terms of fiscal policy was very much in line with what has been characteristic in the past six years; that is, to continue the progressive reduction of the fiscal deficit. As things turned out, and due to the balance of payments surplus, a more stringent fiscal policy was called for.

2.14 As a proportion of GDP, the fiscal deficit was reduced from 1.9 percent in 1989 to less than 1 percent in 1990. Improvement in the public sector

accounts can be explained by a temporary reduction in public investment, which decreased from 7.3 percent of GDP in 1989 to 6.9 percent in 1990.

D. The 1991 Macroeconomic Program and Short-Term Outlook

2.15 Colombia's 1991 economic program is predicated on achieving the following objectives:

- to reduce the annual inflation rate to 22 percent;
- to eliminate the fiscal deficit through increased revenues and controlling expenditures;
- to establish limits to the deficit of public enterprises;
- to put in effect the opening of the agricultural sector during the first quarter of 1991;
- to ensure that the debt service burden is substantially reduced during the next years; and
- to maintain the strong performance of the external sector, expanding the export capacity, and maintaining a satisfactory volume of international reserves.

2.16 As a result of the application of the package of macroeconomic policies, the rate of inflation has slowed down slightly in 1991 but it is still short from the target rate. The Government projects that as a result of the measures adopted during the first semester of 1991, and the determination to maintain strict monetary and fiscal controls, the inflation rate will be below 28 percent by the end of the year. Due to these restrictive policies, as well as to adverse endogenous factors, such as damage to the physical infrastructure caused by terrorist attacks, the Government expects a growth rate of GDP of 2.5 percent or less in 1991.

2.17 The balance of payments surplus has increased rapidly in 1990-91, due mainly to the growth of exports and to large private capital inflows which have helped enlarge the positive current account balance. It should be noted, however, that a significant portion of those capital inflows is the result of a temporary reversal of capital flight due to high market interest rates. There is therefore a danger that if the rates were to fall, there could be an outflow of some of this so-called "hot money".

2.18 Estimates for 1991 show that in spite of lower oil prices, Colombia's current account will still be in surplus. Once again, with a projected growth rate of 24.6 percent, non-traditional exports stand to explain an important part of the country's export success. The capital account is expected to show a significant improvement in 1991. This is to be partly explained by increased disbursements from multilateral institutions, which are interested in providing the financial resources needed to ensure the success of the structural reforms being implemented. Together with developments in the current account, by the end of 1991 Colombia

should hold reserves in excess of the equivalent of 8 months of imports of goods and services.

2.19 The accumulation of international reserves has affected the management of monetary policy. To sterilize in part the impact of the increase in international reserves over the money supply, the monetary authorities have issued certificates in open market operations. Their value has increased from Col$350 billion in July 1990 to Col$1080 billion in July 1991--a significant figure when compared with net international reserves equivalent to Col$3500 billion and money supply M1 of Col$2120 billion at the same date. Issuing these certificates has contributed to an increase in the real level of domestic interest rates up to 16 percent a year. The inflow of external capital, induced by the attractive domestic interest rates, requires in turn further issuing of certificates by the Central Bank.

2.20 The Colombian authorities consider the 1990 inflation rate of 32.4 percent unacceptably high. They have targeted reducing the inflation rate as their first policy objective for 1991. It is towards that end that in 1991 monetary policy has been geared almost exclusively towards reducing inflation. Since the Government intends to maintain the fiscal adjustments introduced in 1990, the public sector's current revenue (as a proportion of GDP) is expected to increase from 35.5 percent in 1990 to 37.1 percent in 1991.

2.21 Despite the transitional increase of open market operations, the projected reduction in the fiscal imbalance is matched by a substantial decline in the domestic financing to the government. In fact, it is expected that in 1991 the public sector will become a net lender in domestic capital markets. This is an important achievement, much in line with the need to provide the private sector with the financing resources that it will be demanding, so as to bring about the technological transformation required to guarantee the success of the private sector in accessing international markets.

III. RATIONALE FOR SECTOR LENDING

3.1 Investment policy loans are designed to facilitate institutional and policy change across sectors to support significant improvements in the private investment environment. As a result, many of the issues tackled in these operations tend to be second generation adjustments. Their multi-focal character makes it difficult or inappropriate to effect such policy reforms by means of the Bank's traditional lending modalities. Such loans do not necessarily assume a critical foreign exchange shortage, as do the Bank's other policy loans. Other important factors to consider are the scope and breadth of policy reforms included in the operation, and the size and structure of the Bank's lending program for the country.

3.2 At present Colombia is experiencing a confortable foreign reserves position due to the high interest rates prevailing in the market. Those rates are, however, of a transitory nature, and if they were to fall, a large portion of those external reserves plus the interest that they have earned, would flow out of the country.

3.3 Investment policy loans are most effective when there is a favorable economic framework in place. Before seeking an expansion of both domestic and foreign investment through this type of loans, there must be some assurance that the economy registers a steady positive growth performance with relative price stability, a realistic exchange rate, an absence of wage indexation mechanisms, and a monetary policy that attains positive but moderate real interest rates.

3.4 The existence of an adequate macroeconomic framework, and the adoption of an inward-oriented development model, enabled the Colombian economy to perform satisfactorily for many years, and remain somewhat insulated from the vagaries of the world economy. However, macroeconomic measures alone proved insufficient to raise productivity and output growth in the long term. There was a need to break away from the old development model and focus on raising efficiency and growth through increased competition.

3.5 Even in a stable economic environment such as the one in Colombia, dismantling an economic model and adopting another is not without problems. The deeper the reforms go, the greater are the risks that social and economic pressures will disrupt the process.

3.6 Although the Government has already taken significant structural measures to reform the economy, a formidable challenge lies ahead. The Colombian authorities must now complete the implementation of the announced structural reforms. This will entail strengthening the institutional capacity, monitoring the supply response of the private sector and identifying remaining barriers to that response, preventing backtracking, and continuing to adopt new, complementary policies. As it will be shown in the rest of this document, it is at this level of the reform process where the Bank will make, through the Investment Sector Loan, its major contribution to the Colombian economy.

IV. THE INVESTMENT SECTOR REFORM PROGRAM

A. Program Objectives

4.1 The objective of this investment sector reform program is to support on-going and future efforts of the Government of Colombia to improve the country's investment environment through the adoption of specific measures, as well as through studies and technical analyses that will lead to either the removal of obstacles or the introduction of measures that facilitate investment decisions. This program will concentrate on

actions on the private investment, external trade and the financial sectors.

4.2 Colombia's leadership has recognized that economic performance within a more competitive international framework will depend on the efficiency of productive investment. As a result, the Government has implemented several measures aimed at eliminating structural obstacles to the development of private investment.

4.3 A highly protected trade regime and a concentrated industrial structure had reduced the motivation of domestic producers to be competitive and innovative. The liberalization of external trade will raise total factor productivity and be an effective instrument to reduce industrial concentration and further raise productivity growth in the private sector. However, for trade liberalization to achieve its desired objectives, the opening-up should be closely coordinated with the removal of remaining distortions in the financial sector.

4.4 The proposed program thus entails conducting studies to identify remaining obstacles to private sector participation, and adopting measures that complement the reforms that are being implemented in the private investment sector itself, as well as in the external trade and financial sectors.

B. Program Elements

4.5 The program concentrates on three sectors, or program elements, that play a major role in the decision that an individual makes to invest. Within each of these sectors the program establishes performance conditionality in those areas that were identified to be major impediments to the participation of the private sector. The three program elements are:

1. the private investment sector itself;
2. the foreign trade sector; and
3. the financial sector.

1. Private Investment

4.6 Under this program element, reform measures in the following areas will have a significant impact on investment decisions of the private sector:

a. the foreign exchange system;

b. the labor market;

c. the tax system; and

d. the foreign investment regime.

4.7 From the 1930s to the 1960s, investment, as a percentage of GDP, grew at rates close to those achieved by countries at a similar stage of development. However, during the last two decades, investment began to grow at significantly lower rates.

4.8 The composition of investment also changed. Until 1985, as a percentage of GDP, private investment fell while public investment more than doubled. After 1985, responding to better economic conditions, private investment recovered, but never reached the levels attained in the 1970s.

4.9 In order to raise private investment closer to previously attained levels, there has been a concerted effort to eliminate constraints to private domestic investors and to make domestic investment more attractive. This has been done through a series of reforms aimed at improving the profitability of investment, increasing the supply of domestic savings, and creating the necessary infrastructure so that investors could take advantage of opportunities offered by the world markets.

4.10 In addition to liberalizing the domestic and foreign investment regimes, the Government adopted complementary reform measures designed to facilitate foreign trade, improve resource mobilization, ensure an adequate supply response to trade liberalization, and improve the efficiency and effectiveness of the public sector.

a. The Foreign Exchange System

4.11 Colombia's private sector operated under a foreign exchange regime in which the quantity and the periodic introduction of exchange restrictions had created a difficult environment. Expectations on the availability of foreign exchange and on the rate of exchange were characterized by a high level of uncertainty. This, in turn, negatively affected investment decisions.

4.12 Foreign exchange transactions, and the movement and ownership of capital abroad have been restricted by Decree 444 of 1967. The purpose of the decree was to maintain a stable real exchange rate by means of periodic mini-devaluations and through controlled capital flows in order to prevent speculative or destabilizing movements of capital abroad.

4.13 Decree 444 imposed quantitative controls on foreign exchange markets by making unlawful the private ownership of assets located abroad (except commercial bank positions), and of foreign currency denominated assets. The decree gave the Central Bank (*Banco de la Republica*) monopoly ownership of foreign exchange and gold. These restrictions led to the emergence of parallel foreign exchange markets. Private citizens were

forbidden from contracting debt abroad, and long-term debt financing of investment in machinery and equipment was not always authorized.

4.14 Foreign exchange transactions, repatriation of capital, and the sectors in which multinational enterprises could operate, were regulated by Decree 444, which also restricted the access of foreign investors to domestic credit markets.

4.15 In order to foster private investment, it was necessary to simplify and reduce the number of restrictions in the foreign exchange system. The Colombian authorities recognized this need and through Law 9 of 1991 introduced significant reforms to the foreign exchange regime. The reforms are being made within the system of a unified foreign exchange market with a managed exchange rate.

4.16 Law 9 liberalizes international transactions in goods and services while maintaining control over capital transactions. It simplifies, however, procedures for contracting external debt and the operations of multinational enterprises. In particular, the purpose of the law is to:

- simplify and reduce foreign exchange controls, so that the system can handle the expected larger and more diverse trade flows that will result from the liberalization of the trade regime;
- reduce administrative discretion in the allocation of foreign exchange as much as fiscal, monetary, and exchange rate objectives allow;
- decentralize the foreign exchange regime, linking it more closely with the financial sector;
- remove barriers to export diversification, and permit the growth of competing imports through the simplification of the procedures that regulate international trade operations;
- modernize the financial system by strengthening its relationship with the international banking community and encouraging the use of new financial instruments; and
- permit adequate coordination of monetary, fiscal, and exchange rate policies by maintaining sufficient flexibility in the exchange regime.

4.17 One of the most significant features of the new foreign exchange statute is the decentralization of the administration of foreign exchange transactions. Before enactment of the new legislation, the Central Bank and the Office of Exchange controlled the approval and sale of foreign exchange, and the exchange of export earnings in foreign currency. Law 9 permits the purchase and sale of foreign exchange by authorized financial institutions. These can hold positions up to a maximum limit or time period established by the Government. Once the financial institutions have reached that limit they would be required to clear their net or excess positions with the Central Bank.

4.18 Another important aspect of the reform is that now individuals are permitted to own assets denominated in foreign currency, or assets located abroad when used for international trade transactions and related

to productive activities. For instance, individuals can have, up to certain limits, deposits in foreign banks. Again, up to certain limits, investments abroad by Colombian residents will be approved automatically.

4.19 The new legislation also reduces the administrative requirements related to the import and export of goods and services. Exchange licenses and advanced deposits for imports are eliminated, and import and export procedures now will pass through a single window.

4.20 In addition to the above measures, Law 9 grants equal treatment to the foreign exchange transactions of foreign and domestic firms. It also eliminates the monopoly of the Central Bank on the possession, purchase, and sale of gold. The Central Bank will remain, however, as the sole authorized exporter of gold.

4.21 The Government of Colombia intends to continue liberalizing the foreign exchange market and international capital transactions. Additional liberalization measures will be affected gradually (i.e., successive increases in the limits on the net foreign exchange positions of domestic financial institutions and partial liberalization of the capital account). It is expected, however, that the Central Bank will still intervene in foreign exchange markets to manage the value of the domestic currency, and that controls on external private and public debt will be maintained.

b. The Labor Market

4.22 High non-wage benefits have contributed to the high labor costs in Colombia relative to other developing countries. While labor legislation has not been the only cause of high non-wage benefits, some regulations governing severance payments, in particular the retroactivity of unemployment payments, have been important contributing factors.

4.23 Labor regulations may reduce labor turnover by raising the cost to firms of unjustified labor dismissal. However, the higher costs of separation payments and increases in severance contributions past the tenth year of employment contribute to excess labor turnover and low rates of retention beyond the tenth year.

4.24 The application of labor regulations is limited. This is proven by the large informal labor market and the common use of temporary contracts. As a result, the main objectives of guaranteeing a minimum of rights for workers and ensuring stability of employment, were not being achieved under the existing legislation.

4.25 Labor legislation has been oriented toward job security through penalties and Government controls. A 1986 World Bank Mission and other more recent studies have indicated that the labor regime has acted as an important

barrier to labor mobility and has increased labor costs, thus reducing the international competitiveness of Colombian industry.

4.26 During the last fifty-four years, Colombian labor legislation had been virtually unchanged (except for one reform in 1965). In late 1990, in order to permit more flexibility in labor deployment, and to ensure that current labor regulations did not frustrate the trade and industrial restructuring programs, the Government submitted to Congress proposals to revise the labor code.

4.27 In order to increase market flexibility and facilitate the creation of new job opportunities, the Colombian Congress approved Law 50 on December 12, 1990. The new legislation modifies labor code regulations, social security benefits, and other related institutional aspects in order to increase market flexibility and facilitate the creation of new job opportunities.

4.28 The labor market was made more flexible by introducing changes in the hiring practices. Before the reform, fixed-term appointments could not be for less than a year or more than three years. After the reform, fixed-term appointments can be up to a maximum of three years and renewable.

4.29 To stimulate the creation of employment, more flexibility has also been introduced in the weekly working period. The maximum legal working period during a week remains at 48 hours. However, the new legislation permits that the number of hours worked during a day be up to 10 hours without overtime payment (as long as the weekly maximum of 48 hours is not exceeded during the week).

4.30 Firms working 24 hours a day are authorized to offer a 36-hour working period for workers employed during night shifts or holidays. Firms would pay these workers salaries equivalent to the ones earned by day time employees working the traditional 48 hour period. Previously, workers employed during night shifts or holidays worked 48 hours but were paid overtime and/or holiday premiums which could, in some cases, result in a doubling of their salaries

4.31 Before the labor reform of 1990, dismissal of workers due to no fault of their own, with more than ten years of services, was extremely difficult due to an onerous system of compensations. These compensations included an indemnification ranging from 45 to 615 days of salary (depending upon the years of service), and the right to be reinstated, or alternatively, to claim an extra pension payment (*pension-sancion*). These benefits led frequently to a high turnover ratio as workers were dismissed before reaching the ten-year period of employment.

4.32 With the new legislation, which increases severance payments and eliminates the obligatory rehiring of dismissed employees with more than ten years of service, more flexibility has also been introduced to the

termination procedures for workers who are dismissed due to no fault of their own.

4.33 Remuneration requirements are also now more flexible. The new law introduces a concept of general compensation which comprises wages and fringe benefits, including pensions, for workers earning the equivalent of at least ten minimum salaries. Firms are permitted to negotiate freely the compensation level of the workers who accept this salary regime.

4.34 The Law also revised the procedures to permit, for the next ten years, separate labor contract negotiations with economically distinct units of the same enterprise. Law 50 reduced the number of enterprises for which a review by the Ministry of Labor and Social Security is required prior to collective employee transfer or dismissal; or for reduction or closing of production capacity.

4.35 The Colombian authorities remain committed to reduce labor market rigidities in order to improve labor utilization, increase incomes of the poorer groups, and reduce labor costs.

c. The Tax System

4.36 Throughout the years Colombia's tax legislation has been subjected to a series of reforms. In 1986 a major tax reform legislation was approved. Its aims were to simplify the tax system and to enhance its equity and efficiency.

4.37 The tax system was simplified:

- by unifying personal and corporate income tax rates at a maximum rate of 30 percent to be reached in 1989;
- by eliminating several personal and corporate tax exemptions and deductions; and
- by simplifying the income tax return forms.

4.38 The tax system was made more equitable by making the personal income tax system more progressive. Thus, while the range of personal income tax rates was reduced from 0-49 percent to 0-30 percent, proportionally larger cuts were made for individuals in lower income brackets, including a substantial raise of the maximum nontaxable income. Double taxation of income was eliminated by only taxing partnerships or corporations directly at a rate of 30 percent (as opposed to the previous method of taxing both corporate profits and the distributed earnings or dividends at the personal income tax rates).

4.39 In order to improve the economic efficiency of the tax system, the reform aimed at eliminating fiscal distortions that discourage private savings and investment, and at eliminating the bias against equity financing. The reform allowed individuals to deduct fully the inflation component of

financial income, and provided a timetable for phasing out the taxation of the inflation component of the income of business derived from financial investments. Similarly, the reform also introduced a timetable to phase out the deductibility of the inflation component of business interest costs.

4.40 Additional measures were approved in 1988 to complement the 1986 tax reform. The tax rate on profit remittances abroad was reduced to 25 percent in 1988 and to 20 percent in 1989, and the wealth tax for house owners was abolished on the first Col$10 million of the value of the house.

4.41 Following the above reforms, Colombia's overall tax regime governing income, sales, and consumption taxes was considered relatively neutral in its effect on incentives. There remained, however, some taxes that constrain the growth of private sector investment as well as introduce some inefficiency.

4.42 New tax measures were introduced at the end of 1990. Among these, the income tax was modified to include:

- the exemption of capital gains arising from sales of stock market shares from taxable income;
- the elimination of the requirement of filing income tax declarations for individuals that receive more than 80 percent of their income from fees, commissions, and services up to an income of Col$8 million, and with wealth of less than Col$15 million, as well as for wage earners with incomes of up to Col$12 million and whose wealth is less than Col$15 million; and
- the introduction of a timetable reducing the income tax rates on repatriated profits and dividends from existing foreign investment (either directly or through the participation in a Colombian enterprise) from 20 percent in 1990 to 12 percent by 1996.

4.43 In addition, repatriated profits and dividends from new foreign investment will be subjected to an income tax rate of only 12 percent. Tax payments on repatriated profits and dividends for existing and new foreign investment can be delayed up to ten years provided that these funds are capitalized and after ten years the profits become tax exempt.

4.44 The Government has agreed to effectively implement the new tax legislation. The Government has begun a study on the incidence of taxation on private investment (Summary Terms of Reference is attached as Annex VI). Implementation of an Action Plan based on the study's recommendations will begin before disbursement of the second tranche is authorized.

d. Foreign Investment

4.45 During the last 25 years, foreign investment has played a decreasing role in capital formation. After accounting for about 1.4 percent of GDP during the 1960s, foreign investment's contribution to GDP fell to 0.45 percent in the 1970s, and to even further in the 1980s--0.35 percent.

4.46 As a percentage of GDP, Colombia's foreign investment flows are not only declining but also low in comparison to those of other Latin American countries. This is partly explained by the fact that lack of business competition, due to a highly protected trade regime and a concentrated industrial structure, have provided little incentive to foreign entrepreneurs to invest in Colombia.

4.47 Cumbersome procedures and discriminatory practices have provided additional disincentives. Yet, Colombia needs a higher rate of private foreign investment to alleviate capacity bottlenecks, increase productivity, and thereby sustain strong economic growth and moderate inflationary pressures.

4.48 Aware of the country's need to develop the necessary incentives to attract foreign capital, the Colombian authorities have recently introduced important changes in foreign investment regulations. This was done through Law 9 of 1991 and Resolution 49 of the National Planning Council (CONPES).

4.49 The new foreign investment statute places most regulations governing international investment under one investment code. International investment comprises foreign investments in Colombia and Colombian investment abroad. Under the new statute, foreign direct investment is no longer defined based on the nationality of the investor but rather as capital investment from abroad.

4.50 Resolution 49 introduces the principles of equality, universality, and automaticity:

- equality means that with certain exceptions established in the Constitution and in the Statute, and with the exception of regulations governing profit remittances, domestic and foreign investors will be treated equally;
- universality means that domestic and foreign investors are permitted access to all sectors of the economy, except national defense and hazardous wastes produced outside Colombia;
- automaticity means automatic approval of new investments, except in the above prohibited sectors, or those subject to special regimes that require prior authorization.

4.51 The Colombian authorities have agreed to revise the new International Investment Statute to assess its consistency with the new Andean Pact legislation and with the recently liberalized foreign exchange regime (Summary attached as Annex V). The revision will include the opinions of

the private sector. In addition, the Government has agreed to implement the Action Plan of the foreign investment promotion program (see Annex VIII), and to design a master agreement for foreign investment protection and double taxation. The Government has also concurred with the need to be engaged in negotiations on these issues with at least one of its major trading partners.

2. Foreign Trade

4.52 Under this program element, reform measures in the following areas will have a significant impact on investment decisions of the private sector:

a. tariffs;

b. foreign trade institutions and finance;

c. ports; and

d. customs.

4.53 Colombia's protectionist trade regime has been characterized by the pervasive use of quantitative restrictions. These resulted in a wide disparity of effective protection rates among different producing sectors, and in a bias against export activities. The sector has also been diagnosed to suffer three fundamental problems: the absence of a proper organizational structure, the excessive amount of red tape, and the country's weak participation in the international markets.

4.54 The economic authorities frequently used external sector policies as instruments of macroeconomic management of cycles in agricultural exports. Imports and foreign exchange controls have been alternately tightened or eased to smooth out aggregate expenditure in response to external payments deficits or coffee booms. The instruments of trade policy have included large devaluations, multiple exchange rates, prior deposits, and frequent changes in tariffs, license requirements, and prohibited lists to ration foreign exchange in times of shortages. Liberalizing imports was never considered a primary policy objective, nor an alternative to achieve faster growth rates or to improve the allocation of economic resources. As a result, the direction and speed of previous trade liberalization were principally determined by internal macroeconomic policies and international economic conditions.

4.55 Studies of Colombia's industrial sector reveal that during the past twenty years the sector experienced growth without change and at a high cost. The absence of structural change was manifested by the fact that manufacturing contribution to GDP was relatively constant, growth in non-traditional exports had not been diversified across a wide range of industrial products, and the export orientation of the industrial sector remained low.

4.56 The high cost of industrial sector growth is manifested by the low and often negative rates of growth of total factor productivity. That is, growth has not been the result of a more efficient use of resources but mainly as a result of the expansion in the quantity of resources used (principally capital). A World Bank report on Colombia's industrial sector asserts that the lack of dynamism in the sector was related to the lack of import competition faced by domestic producers, as well as to the imperfectly competitive market structure of Colombian industry.

4.57 Following a series of discussions, Colombia's Government and its private sector agreed on the need to modernize the economy by opening it to international competition. The decision to liberalize the trade regime was based on the evidence that the inward-oriented trade model, while perhaps useful during earlier stages of industrialization, had become counterproductive. Implementation of the trade reform program began in March 1990.

4.58 Under the pre-reform trade regime, prior license requirements or prohibitions (quantitative restrictions) covered 61 percent of a total of 5144 tariff positions, and 82 percent of manufacturing production. In March 1990, 864 tariff positions were transferred from the prior license to the free list, increasing the proportion of freely importable items from 39 percent to 56 percent of the total. Subsequent transfers of items to the free list increased the proportion of freely importable items to 67 percent, and all prohibited items were moved to the prior license list.

4.59 The new Colombian administration began by transferring another 465 tariff positions to the free list, and then completed the elimination of quantitative restrictions for industrial products by transferring all but 3 percent of tariff positions to the free list. The remaining 3 percent correspond to basic agricultural products and their derivatives, and items restricted for health and safety reasons.

4.60 Complementing the above measures, Congress enacted Law 7 in January of 1991. This is an international trade law that defines export promotion instruments, import policy instruments, and changes in the framework of institutions responsible for external trade activities.

4.61 Law 7 affected changes to Colombia's export policy in the following manner:

- PROEXPO, Colombia's export promotion fund is authorized to become an export-import bank;
- mixed or private sector ownership of free trade zones are now permitted;
- the Government is allowed to establish price stabilization funds for export commodities;
- the Government is authorized to modify the Tax Reimbursement Certificates (CERT), although CERT will remain as an instrument of tax reimbursement and selective export promotion; and

- the Colombian Institute of External Trade (INCOMEX) is authorized to establish contracts with exporters fixing CERT rates for certain periods of time.

4.62 Import policy was affected by the new international trade law in the following manner:

- the Government is allowed to establish a variable tariff scheme for agricultural imports;
- the Government is allowed to regulate international transport to facilitate trade, and protect domestic transport companies from illegal trade practices; and
- the establishment of anti-dumping regulations and compensatory duties are authorized.

a. Tariffs

4.63 The large number of tariff rates, as well as the high value and dispersion have been major impediments to the establishment of a free trade regime. Before the 1990 reform of the trade regime, there were 23 tariff rates ranging from 0 percent to 200 percent. The majority of tariff positions (88 percent) had tariff rates less than or equal to 40 percent. The highest tariff rates, 100 and 200 percent, were assigned to motor vehicles.

4.64 The tariff structure exhibited the usual cascading form, with an average tariff of 40 percent for manufactured consumer goods, 20 percent for intermediate goods, and 21 percent for capital goods. Average tariffs were highest for food and beverages, textiles, and, to a lesser extent, wood and paper products. The lowest rates were for mining and petroleum, agricultural products, and chemicals.

4.65 The trade reform program of 1990 reduced the number of tariff rates from 23 to 13, lowered the maximum tariff from 200 to 100 percent, and reduced the average tariff from 27 to 24 percent. In addition, the uniform tariff surcharge, previously set at 18 percent, was reduced to 16 percent.

4.66 Upon taking office, the new Colombian administration began to reduce tariffs, principally on capital goods and other production inputs. In September of 1990, the average tariff decreased from 24 to 22 percent, with the greatest decline in capital goods, whose average tariff fell from 19 to 15 percent. Further reductions were effected on the tariff surcharge, which was lowered from 16 to 13 percent, while tariff exemptions for official imports were eliminated.

4.67 In late 1990, the current administration announced a schedule of tariff reductions to take place until 1994. According to that schedule, between 1991 and 1994, the number of distinct tariff rates was to fall from seven to four, the average tariff was to fall from 24.7 percent to 14.8

percent, and the effective protection rate from 44 percent to 24.8 percent. Tariff surcharges would be reduced to 8 percent, which would result in average nominal protection of 15 percent in 1994.

4.68 In August 1991 the Colombian authorities decided to accelerate the trade reform process and reach the goals set to be achieved by 1994. As a result, effective immediately, there are only four tariff rates, the average tariff is 14.8 percent, the effective protection rate is to be 24.8 percent, and the tariff surcharge is to be at 8 percent. The Government intends to adhere to the present tariff structure.

b. Foreign Trade Institutions and Finance

Institutional Issue

4.69 There are 52 public institutions responsible for either designing and executing external trade policy, or for approving and controlling the activities of importers and exporters. It is not surprising, therefore, that a frequent criticism of trade policy is that trade policy-making is fragmented among many institutions. For instance, export policy-making is shared by the Ministry of Economic Development, the Central Bank, PROEXPO, INCOMEX, the General Department of Tariffs, the Ministry of External relations, and the Ministry of Agriculture, along with the Ministry of Finance and the Department of National Planning, who set the general framework.

4.70 The general impression is that each institution has marched in its own direction, with little coordination, and that high level officials in many of the institutions are involved in making innumerable daily operational decisions, and have little time to spend in developing an overall strategy and coordinating the strategies of their respective institutions.

4.71 With the purpose of integrating in a single entity the different functions performed by the myriad of institutions, the current administration promulgated Law 7 of 1991, whose main institutional reform features are as follows:

- establishment of a Ministry of Foreign Trade, which will include INCOMEX, Customs and Custom's Revolving Fund and DIMAR. The new Ministry will have representation in CONPES and in the Monetary Board;
- a redefinition of the functions of the External Trade Council, whose responsibilities will now include free zones policy and commodity price stabilization fund policy;
- the establishment of a mixed commission to advise on trade policy, composed of members of the External Trade Council and representatives of the private sector;
- institutional changes in the Ministry of Economic Development and in the *Junta de Importaciones*.

4.72 The Government has agreed that before disbursement of the second tranche of this loan is authorized, it will have in place the new institutional setting under which PROEXPO will operate. The new setting will incorporate the recommendations made on the diagnosis of the institutional problems as well as those of the financial study, as discussed below.

Finance Issue

4.73 PROEXPO has in the past been entirely funded by government transfers and earmarked import taxes. With the amount of funds it received it has been able to offer credit at below market interest rates and has expanded into a number of promotional activities.

4.74 In order to move away from directed and subsidized credits, the role and structure of PROEXPO is being modified. PROEXPO will be divided into two entities: a foreign trade bank and an exports promotion bureau. As the new exports promotion bureau, PROEXPO will continue to promote Colombian exports, but will it be funded through user fees and direct transfers from government budget. Hidden subsidies in interest rates and distortions in import taxes will no longer be used to fund these activities.

4.75 Based on the outcome of negotiations with the Colombian financial authorities relating to this Investment Sector Loan, the IDB has helped ensure that PROEXPO (the bank) will be restructured as a competitive financial institution guided by sound economic and financial principles. It has been decided that PROEXPO will operate as a second tier financial institution able to mobilize resources and operate profitably in a competitive environment. In particular, interest rates will be made variable and increased to market levels. PROEXPO is also changing its system for credit allocation from a quota system to one in which credit is based on their borrower's export financing requirements.

4.76 The Government is currently undertaking a study, based on terms of reference developed with the support of the Bank, which will analyze the current financial and institutional situation of PROEXPO.

4.77 The Government has agreed that before disbursement of the second tranche of this loan is authorized, it will have in place the new financial setting under which PROEXPO will operate. The new setting will incorporate the recommendations made on the diagnosis of the institutional problems as well as those of the financial study.

4.78 The strategy of this restructuring program is to be guided by the objectives for PROEXPO:

- operating as a second tier financial institution;
- provide credit guarantees and insurance as needed;

- withdraw from direct short-term lending as other private financial institutions move into this market;
- operate competitively in order to maintain equity in real terms, not depending on fiscal transfers; and
- divest itself of assets which are not related to financial activities.

4.79 PROEXPO is also committed to maintain interest rates at levels which reflect market conditions including the cost of funds, transaction costs, risk premiums and the opportunity cost of capital.

4.80 We should note that the success of the Colombian economic and financial reform program should eventually be marked by the reestablishment of direct access (on a voluntary basis) to international financial and credit markets. At such a time when normal, voluntary trade financing becomes available to the Colombian financial system, the role of PROEXPO will have to be reconsidered. However, until such a time, PROEXPO will fill the important role of channeling important external trade-related resources to the domestic financial sector.

c. Ports

4.81 An insufficient ports infrastructure, and the absence of a regulatory framework to allow competition, has led to high monopoly rents that increase the costs of international transactions.

4.82 In response to this, on January 10, 1991, the Government enacted a law that restructures national ports, making it possible for them to better support external trade. The law establishes the institutional framework for ports, redefines the responsibility of the public sector, and sets norms for private sector participation in port activities.

4.83 The Government also created the Superintendency of Ports, whose responsibility is the planning and supervision of port activities. It abolished COLPUERTOS (the Colombian Ports Administration), whose internal problems were having a negative impact on transport costs.

4.84 The construction, maintenance, and administration of the ports will be transferred to port societies. The responsibility for the provision of port services such as loading and unloading of merchandise, storage, etc., will be given to these port societies. These societies, which will be initially constituted with public capital, will also allow and encourage the eventual participation of private capital.

4.85 The creation of port authorities effectively guarantees the financial and administrative autonomy of the ports and promotes competition among them. It is contemplated that at a later date the State will sell its shares either to private interests or to the regional governments.

4.86 During development of the proposed Investment Sector Loan it became clear that the opening of Colombia's economy and the increased participation of the private sector in external trade activities would require continued improvement in the efficiency of port services. The Colombian authorities accepted the Bank's recommendation to make ports an element of this loan.

4.87 The Government agreed, therefore:
- to select one of Colombia's ports to be used as a pilot project for implementing the privatization program of port activities;
- to establish a pricing mechanism through which the State will charge users for the use of port space; and
- to determine a valuation method for tug boat services, and to define the system by which those activities will be transferred to other operators.

4.88 The Government has agreed that in order to become eligible for disbursement of the second tranche of this loan, it will accelerate the liquidation program of COLPUERTOS. The program will identify the costs of indemnifying dismissed personnel, value existing assets, determine a starting date for its implementation, and establish the mechanism to transfer COLPUERTOs' activities.

4.89 Before the second tranche can be disbursed it will also be required that the Government:
- be implementing the pilot port project;
- be implementing the Action Plan to obtain the active participation of the private sector in port societies;
- have established the pricing mechanism for use of port space; and
- have determined the value of the tug services and begun the process of transferring those services to other operators.

d. Customs

4.90 In the process of opening up the Colombian economy, customs acquires an importance and responsibility for which it is not presently prepared. The disappearance of administrative controls on external trade leaves customs with the responsibility to protect the national economy through the application of tariffs and the valuation of traded merchandise. At the same time, to the extent that tariff reform lowers government income, the efficient collection of customs duties becomes more important.

4.91 During the early development of this sector loan it became clear to Bank staff that in its present state, Colombia's customs cannot support the Government's efforts to increase foreign trade. Customs suffer a number of problems and deficiencies. Some of the most significant are its weak administrative capacity and poor financial management, due to the fact that its personnel, communications, transport, and systems equipment are ill-prepared to meet the new challenge posed by the trade liberalization.

This in turn has contributed to the problem of over- and under-invoicing which has led to significant revenue losses.

4.92 The Government has agreed with the Bank that to properly address these problems, it is first necessary to correct existing weaknesses in the customs' information systems. To that effect, a preliminary study to: (i) identify information systems bottlenecks, and (ii) offer alternatives to solve the problem of over- and under-invoicing of traded merchandise, has been conducted (Terms of Reference attached as Annex VII). Based on the preliminary findings of the study, the Colombian authorities and the Bank have determined that this loan should concentrate in improving the information systems of customs.

4.93 To achieve a more rational allocation of customs responsibilities, the authorities have clearly defined the functions of the General Directorate of Customs, and reached agreement with the Bank on the legal strategy necessary to enforce existing customs norms and regulations.

4.94 Before the second tranche of this loan is disbursed, customs authorities will have designed and implemented an information system for price references and records of international transactions, and adopted procedures to regulate customs claims. A large portion of this project's technical assistance component will be devoted to conduct the studies and implement the measures needed to have an information system that meets the present needs. Once the information bottleneck has been corrected, it will be possible to identify the subsequent institutional changes required to complete the modernization process.

3. The Financial Sector

4.95 Lack of competition and a high level of regulations has led to high costs of intermediation in the financial sector, penalizing both savers and investors. Likewise, there is a lack of financial instruments, especially for channeling long-term resources.

4.96 The Colombian Government has made considerable progress over the last several years in restructuring the financial sector of the economy. With an eye towards increasing competition (and therefore efficiency), and reducing the cost of financial intermediation, many of the restrictions on the activities of financial intermediaries have been reduced and/or eliminated.

4.97 The primary goal of this Investment Sector Loan in the financial sector is the establishment of the basic market conditions and incentives required for properly functioning financial intermediaries. The Colombian Government has already adopted a number of basic reforms relating to the financial sector. During negotiations the Bank has insisted on the need to continue and deepen the reforms undertaken to date. In particular, Bank staff has concentrated its efforts on helping

the government identify risks to the stability of the financial sector and pointed out the important linkages between macroeconomic policies and the health and well-being of the sector. The reforms adopted will form the basis for an ongoing program of development of Colombian financial markets.

4.98 The Government is continuing to take important steps leading to the integration of the Colombian economy within the international economy and is preparing the financial sector to play a role in these integrated markets. Among the specific measures which have been taken, or which are in the process of being taken are:

- the elimination of barriers to entry and exit including eliminating restrictions on foreign ownership of financial intermediaries;
- the partial elimination of directed and subsidized credits (currently limited to low income housing and certain agricultural credits required by law. Under an agreement signed with the World Bank remaining interest rate subsidies are to be eliminated by 1994); and
- a reduction in the artificial segmentation of financial markets among different types of financial intermediaries (including an expansion of powers of most financial intermediaries through the use of financial subsidiaries into brokerage, investment management and other related activities).

4.99 Most of the actions taken are viewed as positive, and over time it is expected that the Government will continue to work in the direction of more open and liberated markets in the financial as well as the non-financial sectors of the economy. Despite this progress, in many ways Colombian financial markets can be characterized by a series of inter-related disequilibria which are placing considerable stress on the financial system as a whole.

4.100 Although significant progress has been made, particularly in terms of the adoption of the philosophical guidelines of market-based economics at senior levels of the government, and the establishment of a general legal framework which both allows and encourages market-based financial reform of the financial sector, considerable work remains to be done in the implementation of the Government's program. While the objectives of the Government remain clear, the means of obtaining these objectives remain elusive. Furthermore, the amount of time which will be required for many of the financial reforms to take effect is uncertain. Thus, while for the purposes of this operation, the basic structure is in place, the IDB will continue working with Colombia's financial sector to help assure that reforms continues along the path currently indicated.

4.101 Colombia's banks and other financial institutions, following years of strict regulation and control by the government are not accustomed to open competition. Innovation is limited both by the lack of competitiveness in the financial system and by some remaining regulatory restrictions on the ability to introduce new products. The small size of the formal financial system, and the high cost of intermediation (due to a combination of high reserve requirements, forced lending in government

directed credits at below market rates, and the traditional cartel-like functioning of the formal financial system) have encouraged a considerable degree of disintermediation by many of the larger, prime credits. Government ownership and/or management of approximately 70 percent (in terms of assets) of the entire financial system along with the past practice of intervening and socializing the costs of any failures in the financial sector have led to a degree of complacency.

4.102 In addition to the above general problems, there are some specific deficiencies in the Colombian financial system. At the current time, due to a temporary marginal reserve requirement of 100 percent (originally instituted as an attempt to control inflation by restraining credit), bank and other financial intermediaries have no incentives to compete for deposits. The banking system's declared marginal cost of funds (DTF) has little relation to market rates (DTF is currently 5-10 percent below the comparable market rate on discounted banker's acceptances) making it very difficult to determine the existence of long-term subsidies in government lending programs which are often based on DTF. This situation should, hopefully, be alleviated as the Government continues to take actions in freeing the banking systems from external constraints such as the 100 percent marginal reserve requirement.

4.103 As noted above, the 100 percent marginal reserve requirement was instituted by Colombian financial authorities as an attempt to restrict credit and thereby control inflation. An unfortunate side-effect of this policy is a substantial increase in the already high cost of financial intermediation. This in turn has led to further disintermediation, increased risk and stress within the financial system.

4.104 Following pressure from a number of fronts (including IDB), the temporary 100 percent marginal reserve requirement was lifted in September 1991. Average reserves were boosted to offset any monetary impact. It is to soon to see the impact of this change. Bank staff remains concerned that the average reserve requirement combined with a portfolio of forced lending (this is being substantially reduced over time, but the banks still bear the impact of the past practice of forced lending at below market rates) leads to very high intermediation costs.

4.105 Rather than fighting inflation the strategy is leading to (i) high real interest rates; (ii) a temporary reversal of capital flight resulting in increased inflationary pressure; and (iii) the need for extensive open market operations to eliminate excess market liquidity. There is a risk that once financial markets normalize, there could be an outflow of capital (including the interest earned on this "hot money"), which could lead to a recession due to a continued credit shortage.

4.106 Other problems in the financial sector are related to the non-existence of long-term financial markets. The long-term debt market is limited, forward markets in foreign exchange and financial instruments which would allow hedging of interest rate risk have not developed due to past restrictions on innovation within the banking system, and perhaps more

importantly on the active role taken by the Government in assuming the majority of foreign exchange and interest rate risk.

4.107 The inability of financial intermediaries to securitize and sell parts of their asset portfolio may restrict their ability to compete effectively in the more open financial markets than are envisioned under the current policy framework. In particular, there is a critical need for the development of a secondary market in Mortgage Backed Securities.

4.108 There exists the potential of a major crisis among the Mortgage Savings Banks (*Corporaciones de Ahorro y Vivienda*). The opening of financial markets may lead to a rapid disintermediation of the short-term funds which these use to fund long-term loans. Although both assets and liabilities are variable (floating with the rate of inflation), the short-term deposits of Mortgage Savings Banks are not currently competitive with other short-term deposits. Even with the existence of a secondary market for mortgage loans (which may help price future loans and eliminate basis risk through improved asset-liability management), the current economic losses created by the mismatch may exceed the capital of many, if not all, of these institutions. This will be the focus of future attention by IDB.

4.109 Finally, long-term sources of capital are limited in Colombia. Regarding this last point, there are complications that arise from both the supply and the demand side. On the supply side, there are few sources of long-term capital in Colombia and institutional investors have played a very marginal role.

4.110 Some steps are being taken to encourage the development of institutional investors. These efforts should be continued. From the point of view of demand, many Colombian firms have traditionally been closely held and those which are publicly traded face very thin markets. Possibly due to the demand for complete control by a small group of owners, disclosure requirements and voluntary information disclosure are inadequate for potential outside investors. Combined with the historical tax preference given to debt financing, few firms have looked to equity markets for financing needs.

4.111 While the tax system has been modified to eliminate the penalty on equity, equity financing remains limited. This should change as the Colombian economy continues to open and firms are forced to expand in order to compete internationally. The possibilities for increase capital market operations exist, but it will take some time before both demand and supply problems are resolved.

4.112 One purpose of the proposed Investment Sector Loan is to assist the Government in addressing these problems. Some of the loan conditions are aimed at a specific restructuring of the current system in order to increase competition, improve regulation and allow markets to function better (a fairly rapid response can be expected). Others are designed to lay the ground work for dealing with other, more deeply rooted problems

where the response time may be slower but the effect of equal importance.

4.113 There are three areas where financial reform is being undertaken: the restructuring and strengthening of the formal financial sector, the restructuring of the financial structure of the import/export sector, and the development of contractual saving markets. In the first two, substantial progress has already been made and the further steps taken under this program will help assure that the reform efforts continue.

4.114 Contractual savings are just beginning to be developed. These initial steps are important in the long term strategy of developing more complete financial markets and in particular developing long-term capital markets. The Bank's long-term strategy is to work with Colombia in order to assist with the development of:

- some limited forward markets in foreign exchange and interest rates (and possibly related derivative markets);
- secondary markets in mortgage-backed securities and other long-term debt instruments; and
- the role of domestic institutional investors through the reform of pension systems.

These latter are long-term proposals, beyond the scope of the present loan, but the groundwork is being laid.

a. Restructuring and Strengthening the Financial Sector

4.115 Legislation enacted by Congress (Law 45, 1990) is designed to reform the financial sector along market lines. In particular, the law encourages competition as the method for increasing efficiency in the economy. Entry and exit barriers have been eliminated in the financial sector and foreign investment in the sector is encouraged through the elimination of ownership restrictions.

4.116 The norms of regulation that lead to an artificial segmentation of financial markets have been eliminated and financial intermediaries are free to convert to the form which they consider best. In addition, efforts are being made to increase the transparency of the financial sector by publishing information regarding the structure and performance of all financial institutions.

4.117 The Government has also been authorized to redefine the role of the public financial sector and has begun the process of strengthening the system of prudential regulation for all financial institutions, both public and private. The Basel agreements on bank supervision relating to minimum capitalization standards have been adopted.

4.118 The Government is committed to ensure that public and private financial institutions receive identical regulatory treatment and is attempting to privatize the traditional public financial institutions. In particular, the regulations applied to public owned and managed banks will be

enforceable by the financial authorities and they will be enforced without discrimination vis-a-vis private banks. Until their unique situations can be resolved, this requirement will not extend to two government sponsored development institutions: FEN and FINDETER.

4.119 FEN and FINDETER operate to support, respectively, development in the energy sector and development of the municipal infrastructure. As such they work somewhat outside of the traditional financial sector. The government is currently seeking a long-term solution which will allow the restructuring (and recapitalization as necessary) of their operations. Because of the important development roles and overall importance in some segments of Colombian financial markets, a political consensus on the form and degree of restructuring has not yet been reached.

4.120 In order to extricate the Government from direct involvement in the financial sector, a privatization effort has begun. Two institutions already have been offered for sale, three more will quickly follow. An action plan regarding bringing each institution to a point of sale will be developed and initiated for all other government owned and managed financial institutions. Additionally, the government-owned shares of *Banco Ganadero* and the non-financial assets of *Caja Agraria* will be presented for sale.

4.121 As a set of complementary actions, the Government has approved the necessary norms, decrees and resolutions necessary to reduce targeted interest rate subsidies. These will be limited to low income housing and small agricultural producers, whose impact on the financial system is insignificant (subsidized credit to low-income housing accounts for 3.8 percent of total credit, and credit to small agricultural producers accounts for less than 5 percent of total agricultural credit). At the same time, directed credits will be reduced, and the Government will begin the phasing out of existing forced lending practices (except those required by law, again for low income housing and small agriculture as defined in the Policy Letter).

4.122 It is also of interest to note that the new Constitution has redefined the role of the Central Bank giving it greater independence and precise functions in monetary management.

b. Contractual Savings

4.123 Contractual savings have played a minimal role in financing domestic investment. The investment activities of some potential participants in this market, pension funds and insurance companies have been controlled by the government. Both private and public pension funds have been significantly underfunded. The current funds are experiencing liquidity problems and if not restructured will face solvency problems within a few years. Insurance rates have been controlled and a substantial percentage of investments have been directed to government sponsored industrial development projects at below market interest rates.

4.124 The only true long-term market in Colombia is in mortgage lending. *Corporaciones de Ahorro y Vivienda* have been able to capture short terms funds paying a spread over the rate of inflation and lending these funds, again at a (higher) spread over the rate of inflation for long term mortgages. While both rates are floating above that same base (rate of inflation) the resulting mismatch is potentially dangerous. As the economy opens, these short-term deposits will have to compete with other financial instruments. Spreads may increase leading to a squeeze on profitability. There is already evidence that more loans are being channelled to more profitable, but riskier real estate development projects as an attempt to maintain profitability.

4.125 One of the first steps in the development of longer-term capital markets is the development of contractual savings programs. Colombia has initiated the development by creating a legal and regulatory structure for the private administration of severance funds (*Fondos de Cesantia*). All new employees will be covered by this program, and incentives are being set up to encourage voluntary coverage by other employees.

4.126 Many of the labor market distortions and adverse incentives related the to structure of the old program have been eliminated, and more important, from the perspective of contractual savings, a professionally managed fund is being created. Five private fund administrators have been approved by the Superintendency of Banks. In exchange for the management fee earned on these funds, the administrators will provide capital to cover losses through fraud and mismanagement.

4.127 A limited guarantee of the funds will also be provided by the *Fondo de Garantias*. The amount of funds that will be available in these severance funds may be somewhat limited at first, but they provide an important precedent for long-term investment and will be useful for developing prudent regulations and supervisory practices.

4.128 The insurance industry is also being reformed along market lines. The rates charged by both life and property-liability insurers have been freed to market rates. In addition, the choice of reinsurance arrangements have been liberated. Competition in terms of both price and quality of services is increasing. While insurers have not yet begun to invest in long term capital markets to a significant degree, there is an important potential source of funds.

4.129 Regulations governing the formation of *Fondos de Inversion* (mutual funds) and *Fondos Mutuos* (employer sponsored tax-deferred savings programs) have been developed and some funds are currently being formed to take advantage of market opportunities.

4.130 Possibly the most important underdeveloped source of contractual savings is the use of pension savings in Colombia. The current status of the pension system is not fully known, but significant problems exist. The private sector fund is insufficient (past funding has been set at too low a level and the fund is technically insolvent). There are an estimated

1,200 separate funds covering various groups of public sector employees, and the status of these funds is unknown. The Government has committed as part of this operation to ascertain the true financial situation of the funds. They will also develop concrete alternatives for restructuring and strengthening these programs and assure that programs are managed prudently. The Government will also propose to the Congress a law authorizing reform of the pension system. This is a major first step to pension reform as well as an important stage in the creation of long-term capital markets.

V. THE PROGRAM, THE PROJECT, FINANCING AND EXECUTION

A. Borrower and Program Financing

5.1 The Government of the Republic of Colombia, as borrower, has designated the Ministry of Finance and Public Credit as the executing agency. The loan will be guaranteed by the Colombian Government.

5.2 The proposed operation will be a quick disbursing loan of US$200 million to be disbursed in two equal tranches. There will also be a reimbursable technical cooperation component of US$ 5 million, part of which is directly related to studies necessary for timely execution of policy conditions.

B. Use of Resources

5.3 The disbursement of the proposed loan would finance the cost of eligible imports, subject to documentary evidence that they have been paid for and that the goods have entered into the country. Eligible imports would be determined according to a negative list, i.e., the customary limitations excluding the financing of military equipment, luxury consumer goods, and hazardous materials as defined in Appendix III.

C. Execution of the Project

5.4 The Ministry of Finance and Public Credit will be responsible for maintaining loan accounts, for preparing and submitting withdrawal applications, and for maintaining all records pertaining to the program's execution.

1. Procurement Procedures

5.5 International public bidding will be followed for public and private sector purchases in excess of US$ 5 million. For lesser amounts, procurement by the public sector shall be done in accordance with the procedures established in local legislation insofar as such legislation is not inconsistent with the Bank's procurement policy. For private sector procurement below US$ 5 million, purchases should be made following established commercial practices. Procurement shall be subject to the procedures that are indicated in Appendix V of this loan proposal.

2. Reimbursement of Procurement

5.6 Within the context of the Bank's existing policies, the resources of the financing may be used to compensate the country for foreign exchange expenses incurred on goods imported within six months prior to signature of the loan contract, provided that the requirements laid down by the Bank in this operation have been complied with and that they do not exceed 50 percent of the aggregate amount of the loan.

3. Audit and Control

5.7 Disbursements from the proposed loan would be made on the basis of a summary from the Ministry of Finance and Public Credit detailing individual import transactions in each relevant period, together with a certification of payments of the amounts involved, and of their eligibility under the proposed loan. Such statements will itemize transactions during each period and would provide evidence establishing that eligibility conditions have been complied with.

5.8 The borrower shall submit to the Bank after disbursement of each tranche, and not later than 90 days, a report which substantiates, according to terms of reference satisfactory to the Bank, that the goods for which disbursement requests have been submitted were eligible for reimbursement using the resources of the financing.

5.9 The Bank will reserve the right to conduct ex-post supervision of the various stages and documents of each procurement relating to the project. For this purpose, the borrower undertakes to provide the Bank with whatever documentation the Bank may request regarding the procurement to be reviewed. As well, the Bank will reserve the right not to make disbursements for goods that have been purchased other than in accordance with the requirements laid down in this operation.

5.10 The statements of account of the imports financed with the resources of the loan throughout the execution of the project, shall be submitted to

the Bank annually, dully audited by the Contraloria General de la Republica, within 90 days after the close of each fiscal year subject of auditing (Appendix II).

4. Inspection and Supervision

5.11 The Bank will establish inspection procedures that it considers necessary to ensure satisfactory execution of the program. To this end, the borrower and the guarantor will cooperate in providing the assistance needed to accomplish this purpose. The sum of US$ 2.0 million from the proceeds of the financing will be credited to the general accounts of the Bank to meet inspection and supervision expenses.

5.12 The guarantor, the borrower, and the Bank will hold periodic meetings, at the request of any one of the parties, to exchange views on the progress achieved in implementing the program, the consistency between the economic policy framework and the program, and the fulfillment of the conditions established for disbursement of each tranche. For this purpose, the guarantor and the borrower will furnish, prior to each meeting, a report containing the details the Bank requests on the advance of the program and the fulfillment of the obligations (Appendix II).

5. Ex-Post Evaluation

5.13 The ex-post evaluation will be conducted between six and 12 months after disbursement of the last tranche is authorized. Bank staff will take part in the analysis, for the purpose of making the study as complete as possible. It is expected that focus will be placed on the evaluation of the process of the execution of the loan, including in the analysis the fulfillment of the agreed policies. The ex-post evaluation will also look at the immediate impact of the measures taken. The specific details for the evaluation will be determined with the participation of the Bank's Operation Evaluation Office (OEO).

6. Policy Statement

5.14 During negotiations, the Government and the Bank agreed on the final text of the Government's Letter of Development Policy and on the timetable for the introduction of the policy reforms. The Policy Letter describes a program of actions, objectives and policies designed to support ongoing and future efforts of the Government of Colombia to improve the country's investment environment.

7. Negotiations and Tranche Release Conditions

5.15 During negotiations, the Colombian authorities and the Bank agreed on the tranche release conditions that are presented in the Policy Matrix Annex. The conditions are related directly to the main objectives of the program.

a. First Tranche Conditions

5.16 To simplify and reduce the number of restrictions in the foreign exchange system, the Government has adopted a foreign exchange regime which:

- facilitates foreign exchange transactions by reducing the costs and the uncertainty of availability of foreign exchange; and
- provides a larger and more direct role for financial institutions in the foreign exchange market.

5.17 To reduce labor market rigidities, the Government has approved labor legislation that:

- reduces the value and uncertainty of labor costs by eliminating retroactive obligations of employers;
- fosters the development of institutional savings (severance funds); and
- takes into account economic factors to justify dismissals.

5.18 To eliminate or reduce taxes that have a negative impact on private sector investment, the Government has approved tax legislation that:

- eliminates taxes on dividends and windfall profits;
- reduces the remittances tax for new investments from 20 percent to 12 percent; and
- encourages foreign investment in capital funds.

In addition, the Government has begun a study on the incidence of taxation on private investment.

5.19 To remove policy and institutional obstacles that limit the role of foreign investors in the economic process, the Government has approved an International Investment Statute that:

- ensures equal treatment to both national and foreign investors;
- allows the free entry of foreign investors to most sectors of the economy; and
- liberalizes and guarantees the foreign exchange rights of foreign investors.

In addition, the Government has presented the Action Plan of the foreign investment promotion program.

5.20 To bring about a greater outward orientation of the economy, the Government has approved external trade legislation that commits the country to a system of free trade, giving particular attention to:

- the elimination of quantitative restrictions to imports;

- the elimination of the state monopoly on imports of agricultural products;
- the introduction of countervailing and anti-dumping duties; and
- the creation of an institutional framework to promote foreign trade.

5.21 To reduce the number, value, and dispersion of tariff rates, the Government is implementing a trade reform in which a tariff reduction and dispersion program has been designed and is being implemented. The program has achieved the following:
- average tariff rates have been reduced from about 40 percent to 14.8 percent;
- the number of tariff levels has been reduced from 20 to 4;
- the level of import surcharge has been reduced from 18 percent to 8 percent; and
- a flexible tariff system for agricultural products has been put into operation.

5.22 To develop a clear, simple, and stable institutional setting for international trade, the Government has approved the legislation required to:
- empower the Government to create a Ministry of Foreign Trade; and
- unify the decision-making process in a Trade Council, under the direction of the President.

In addition, the Government has completed a diagnosis of the problems that affect the institutional setting of foreign trade procedures.

5.23 To transform Colombia's export promotion fund (PROEXPO) into an international bank, the Government has approved the legislation required to do so. In addition, the Government has:
- eliminated the earmarked tax on c.i.f. imports allocated to PROEXPO by Law 75 of 1986;
- discontinued reimbursement by PROEXPO of tax rebates;
- increased interest rates and instituted variable interest rates for PROEXPO credit; and
- changed the allocation of PROEXPO credit for working capital from a quota system to a system based on borrowers' exports financing requirements.

The Government has also have begun a study, based on terms of reference developed by PROEXPO with the support of the Bank, to analyze the current financial and institutional situation, and recommend alternatives for the reorganization of the institution.

5.24 To ensure the financial and administrative autonomy of Colombia's ports, and to promote competition between them, the Government continues to implement the ports reform legislation that:
- authorizes the administrative restructuring of the ports system;
- authorizes the liquidation of COLPUERTOS;
- contemplates private sector participation in the construction, maintenance, and administration of ports, either directly or in joint ventures with the government; and

- authorizes the creation of a Superintendency of Ports, as the single, independent regulatory authority.

5.25 To promote private sector participation in ports activities, the Government has:
- agreed to select one of Colombia's ports as a pilot project for implementing the privatization program of port activities;
- agreed to establish a pricing mechanism through which the State will charge for the use of port space;
- designed a specific plan to obtain the active participation of the private sector in the port societies, including alternatives for financing private sector investments; and
- determined a valuation method for tug boat services, and defined the system by which those activities will be transferred to other operators.

5.26 To strengthen the institutional and technical capabilities of customs, the Government has:
- agreed on the terms of reference of a study that will identify customs' information bottlenecks, and offer alternatives to solve the problem of properly valuing traded merchandise;
- defined the functions of the General Directorate of Customs; and
- agreed on the legal strategy to enforce customs norms and regulations.

5.27 To strengthen the capacity of the financial sector to (i) mobilize resources and allocate them efficiently at competitive margins; (ii) make up for and potentially eliminate identified market failures in the access to credit of small entrepreneurs; and (iii) undertake the reforms that will facilitate the development of long-term capital markets, the Government has approved the legislation required to reform the financial sector. The principal elements of the legislation are to:
- promote competition and efficiency in the financial sector;
- promote the participation of foreign investment in financial institutions by eliminating all restrictions to ownership;
- eliminate norms or regulations that lead to artificial segmentation of markets;
- eliminate barriers to entry and to exit, and allow reconversion of existing institutions;
- authorize the Government to redefine the role of the public financial sector;
- increase transparency in information systems (monthly publication of financial indicators institutional performance); and
- strengthen the prudential regulation system, applicable to private and publicly owned institutions.

5.28 To improve Colombia's financial system, the Government has also approved the necessary norms, decrees, and resolutions that will enable taking the following complementary actions:
- substantial reduction and targeting of interest rate subsidies (limited to small agricultural producers and low-income housing);

- privatization of official financial institutions;
- interest rates reflecting market conditions (non-administered rates based on average bank deposit rates) in more than 90 percent of the financial market;
- to have begun phasing out of existing forced-lending practices, except as required by law (low income housing and small farmers); and
- reduction of directed credit.

5.29 In addition, to improve the level of prudential regulation, the Government has made the commitment that publicly owned and managed banks and financial institutions will be subject to enforceable regulation without discrimination vis-a-vis private sector banks and financial institutions until their unique situation can be resolved.

5.30 To assist in the development of long-term domestic capital markets that will adequately span the set of investment opportunities, the Government has developed regulations governing the establishment of severance funds such as:

- the creation of an actual fund (required for new employees, effective January 1, 1991, and voluntary for other employees);
- reducing incentives for labor market distortions;
- reducing opportunities for fraud; and
- setting up incentives (favorable tax treatment for earnings on fund's internal build-up) to encourage participation among voluntary participants.

In addition, the Government has presented to the Bank preliminary terms and conditions for a study of the existing pension systems and restructuring alternatives.

5.31 To assure that instruments of contractual savings are given maximum flexibility for assisting in leading to the proper allocation of scarce economic resources, the Government has agreed that the management of these funds will be regulated by the Superintendent of Banks and Financial Institutions.

5.32 To deepen economic markets and thereby increase the overall domestic savings rate, the Government has agreed that investors in these funds will be protected against fraud and mismanagement by:

- capital provided by fund administrators; and
- limited guarantees by the *Fondo de Garantias e Instituciones Financieras*.

5.33 To develop the regulatory framework and economic conditions conducive to the development of properly structured and funded long-term contractual savings instruments, the Government has agreed that the rates charged by life insurers have been freed to market rates and that regulation of life insurance will be based on solvency.

5.34 Providing finance to assist Colombia in its reform efforts only makes sense if the Government has a strong macroeconomic program in place. The loan requires, therefore, that the Government have a short- and medium-

term macroeconomic program to reduce inflation and accelerate growth. It is a condition for loan effectiveness that the Government's macroeconomic policy performance be satisfactory to the Bank.

b. **Second Tranche Conditions**

5.35 To ensure that private investors operate in an environment in which foreign exchange uncertainties are significantly reduced, the Government will maintain and improve the foreign exchange system.

5.36 To continue to enhance labor utilization, increase incomes of the poorer groups, and reduce labor costs, the Government will maintain the measures adopted in the new labor legislation.

5.37 To ensure that the tax system does not play a constraining role in the growth of private sector investment, the Government will continue to implement the new tax legislation. The Government will also have initiated implementation of the Action Plan based on the recommendations made by the study of the incidence of taxation on private investment.

5.38 To ascertain that cumbersome procedures and discriminatory practices no longer hinder foreign investment, the Government, through CONPES, will review the International Investment Statute to assess its consistency with the new Andean Pact legislation, and with the liberalized foreign exchange regime, taking into consideration the opinions of the private sector. In addition, the Government will:

- be implementing the Action Plan of the foreign investment promotion study;
- have designed a master agreement for foreign investment protection and prevention of double taxation; and
- be engaged in negotiations with at least one major trading partner.

5.39 To ensure the non-reemergence of a protected trade regime, the Government will adhere to the principles of the trade liberalization program.

5.40 To ensure that there is no longer a multitude of agencies and procedures regulating foreign trade activities, the Government will have in place the new institutional setting under which PROEXPO will operate. The new setting will have taken into consideration the recommendations made on the institutional diagnostic study and the financial study.

5.41 To ensure that PROEXPO, as an international trade bank operating in a market oriented setting, is able to mobilize resources and be profitable in a competitive environment, the Government will ensure that PROEXPO is functioning guided by the following principles:

- operates as a second tier financial institution;
- divests itself from its non-financial related assets;
- banking and promotion activities are to be differentiated in accounting and administrative terms;

- manages banking activities in accordance with commercial principles and the protection of base capital;
- limits its participation from short-term lending as other private financial institutions move into the market;
- designs mechanisms that will help solve the problems of securities and insurance; and
- maintains interest rates at levels which reflect market conditions including the cost of funds, transaction costs, risk premiums, and the opportunity cost of capital.

5.42 To ensure the financial and administrative autonomy of Colombia's ports, and to promote competition between them, the Government will:

- have accelerated the liquidation program for COLPUERTOS. The program will identify the costs of indemnifying dismissed personnel, value the existing assets, determine the starting date for its implementation, and establish the mechanism to transfer COLPUERTOS' activities;
- have initiated implementation of the pilot port project;
- have established the pricing mechanism through which the state will charge for the use of port space;
- be implementing the Plan to obtain the active participation of the private sector in the port societies; and
- have determined the value of tug boat services, and have begun the process of transferring those services.

5.43 To ensure that the institutional and technical capabilities of customs are being strengthened, the Government will:

- have designed and implemented an information system for price references and records of international transactions; and
- have adopted the procedures to regulate customs claims.

5.44 To ensure the continuing opening and transparency of the financial sector, the Government will show that:

- public and private financial institutions have incorporated in their strategy the regulations and practices of the disposition of Law 45 of 1990;
- has begun the process of privatization of the traditionally public financial institutions;
- has begun the process of privatization of *Banco Cafetero* and *Caja Agraria*. Action plans will be developed to eventually bring these institutions to a point of total or partial sale;
- has presented for sale all remaining shares of Banco Ganadero; and
- has presented for sale the non-financial assets of Caja Agraria.

In addition, the Government, together with the Bank, will have undertaken an analysis of the barriers that limit the access of small- and medium-sized enterprises to credit and other banking services. Based on the analysis, the Government will have prepared an Action Plan to correct those barriers.

5.45 To ensure the Government's commitment to the development of long-term domestic capital markets that will adequately span the set of investment opportunities, the authorities will have agreed to have completed the study which will:

- ascertain the true financial situation of existing pension programs, both for private and public sector employees;
- present concrete alternatives to restructure and strengthen existing programs, including proposals on adequate funding and funding levels; and
- demonstrate the actuarial soundness of proposed systems.

The Government will present to the Bank a summary of the findings and an Action Plan based on the results of the study. In addition, the government will have proposed a law to Congress authorizing the reform and restructure of Colombian pension systems.

5.46 To ensure that instruments of contractual savings are given maximum flexibility for assisting in and leading to the proper allocation of scarce economic resources, the Government will have given assurances that pension funds will be subject to prudential regulation and adequate supervision.

5.47 To ensure the commitment to deepening economic markets, the Government will propose to Congress a reform of Colombia's pension system.

5.48 It is also a condition for second tranche release that the Government's macroeconomic policy performance be satisfactory to the Bank.

D. Benefits and Risks

5.49 As has been stated in previous sections of this document, analyses based on economic growth accounting show that growing inputs of capital have been the major source of economic growth in Colombia since 1950. By contrast, the contribution of total factor productivity to economic growth has been relatively small and has been declining since the mid-1970s, becoming negative from 1981-1989.

5.50 Declining growth rates indicate that the inefficient use of resources has become a major constraint to economic growth. If improving total factor productivity means producing more output with the same or fewer inputs, and a more efficient allocation and better use of resources, it is only through improvements in productivity growth that Colombia will be able to reach and sustain the level of economic growth necessary to reduce unemployment and alleviate poverty.

5.51 Seeking to promote greater private investment flows and better utilization of resources will stimulate productivity, economic growth and employment. The policy measures supported by this program will improve the efficiency in the economy, which will make a major contribution in reversing the secular decline of total factor productivity. The

prospects for vigorous and sustained economic growth in the 1990s and beyond would not take place without changes in the economic development model that this loan supports.

5.52 The productivity of the private sector in Colombia has been hampered by the highly protected trade regime and a highly concentrated industrial structure. These factors reduce the motivation of domestic industries to be competitive and innovative. The productive efficiency of the private sector, which is the leading sector of the economy (producing 85 percent of the nation's output), will be increased by stimulating more competition among producers. Given that this program encourages more competition in different sectors of the economy, and the liberalization of external trade, it contributes to increasing the productive efficiency of the private sector.

5.53 The main risk to this program rests on the economic authorities' ability and determination to maintain consistency between macroeconomic objectives, particularly the targeted reduction in inflation, and trade reform objectives. Careful management of the real exchange rate, as well as tight fiscal and monetary control, will be key to the simultaneous achievement of trade liberalization and inflation objectives. It is clear that the success of the Economic Modernization Program and of this loan is dependent on the Government's ability to keep inflation under control.

E. Distributional Impact

5.54 The primary goal of this program is to raise Colombia's economic growth rates to the levels that are necessary to reduce unemployment and alleviate poverty. To the extent that this sector investment operation achieves its objectives, it will, therefore, have a positive impact on the standard of living of the poor.

5.55 It is a well known fact that ownership of production assets plays a crucial role in getting people onto what are called "income escalators". If the poor are given greater opportunities to have access to productive assets, their primary claims will be raised. By supporting measures that make the Colombian economy more open and transparent, thus enabling individuals to take advantage of the economic opportunities that the country offers, the loan will directly contribute to increased income opportunities. Greater income opportunities will, in turn, raise standards of living and alleviate poverty.

5.56 By helping reduce market distortions the proposed Investment Sector Loan will also increase the primary claims of Colombia's poor. Reductions of labor market rigidities will increase the poor's return on their labor, and to the extent that they hold some assets, the program's measures will increase the return on their assets.

5.57 Workers will directly benefit by the employment opportunities brought about by the new labor legislation, which eliminates the need for employers to resort to temporary work contracts to avoid the onerous requirements imposed on permanent work contracts in the past. As a result of this, Colombia's labor force will have more stable employment, without the danger of being terminated when approaching ten years of service.

F. Environmental Impact

5.58 No significant environmental impact is expected as a result of the actions included in this program. The Bank's Environmental Committee approved the classification II proposed for this program.

VI. RECOMMENDATION

6.1 In view of the foregoing, the proposed program is considered to comply with the Bank's Charter and with the Seventh Replenishment Agreement. It is therefore recommended that the loan be approved by the Board of Executive Directors, and to this end the following normative documents are submitted for consideration:

- Proposed Resolution (Appendix I);
- Recommendations (Appendix II);
- Description of the program (Appendix III: Annex A to the Loan Contract);
- Proposed Resolution, Technical Cooperation (Appendix IV); and
- Procurement Procedure for Sector Adjustment Operations (Appendix V: Annex B to the loan contract).
- Selection and Contracting of Consulting Firms and/or Individual Experts (Appendix VI: Annex C).

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

LICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE S
NT			
Exchange System:			
odic introduction nge restrictions an environment in e level of nty negatively investment s.	To simplify and reduce the number of restrictions in the foreign exchange system, thus allowing private investors to operate in an economy in which the level of uncertainty is reduced.	Has adopted a new foreign exchange system which: - facilitates foreign exchange transactions by reducing the costs and the uncertainty of availability of foreign exchange; and - provides a larger and more direct role for financial institutions in the foreign exchange market.	Maintain libe
r Market:			
e labor regulations tributed to ly high labor hich are a tive to productive nt.	To reduce labor market rigidities in order to improve labor utilization, increase incomes of the poorer groups, and reduce labor costs.	Has approved labor legislation that: - reduces the value and uncertainty of labor costs by eliminating retroactive obligations of employers; - fosters the development of institutional savings (severance funds); and - takes into account economic factors to justify dismissals	Maintain obje labor legisla
em:			
main some taxes y a constraining the growth of sector investment.	The elimination or reduction of taxes that have a negative impact on private sector investment.	Has approved tax legislation that: (i) eliminates taxes on dividends and windfall profits; (ii) reduces the remittances tax for new investments from 20 percent to 12 percent; and (iii) encourages foreign investment in capital funds	Maintain obje tax legislati
		Has begun a study on the incidence of taxation on private investment.	To have begun of an Action the study's r

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

LICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE SE
Investment			
me procedures and natory practices tributed to foreign nt flows which, as tion of GDP, and in on to other Latin countries, are low experienced a g trend.	The removal of policy and institutional obstacles that limit the role of foreign investors in the economic process.	Has approved an International Investment Statue (IIS) that: - ensures equal treatment to both national and foreign investors; - allows the free entry of foreign investors to most sectors of the economy; and - liberalizes and guarantees the foreign exchange rights of foreign investors.	CONPES will re assess its con the new Andea legislation, liberalized fo regime taking consideration the private se
		Has presented the Action Plan of the foreign investment promotion program.	To be implemen Plan of the fo investment pro
			To have desig agreement for investment pro prevention of taxation, and negotiations one major trad

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

LICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE SE
TRADE			
tence of a d external trade as reduced total roductivity, d economic ation, and ly impacted on nt opportunities.	To bring about a greater outward orientation of the economy by reorienting the incentives system towards favoring exports and efficient import substitution.	Has approved external trade legislation that commits the country to a system of free trade, giving particular attention to: - the elimination of quantitative restrictions to imports; - the elimination of the state monopoly on imports of agricultural products; - the introduction of countervailing and antidumping duties and - the creation of an institutional framework to promote foreign trade.	Maintain obje trade liberal
e number of tariff s well as the high d dispersion are nts to the hment of a free gime.	To reduce the number, value and dispersion of tariff rates.	Is implementing a trade reform in which a tariff reduction and dispersion program has been designed and is being implemented. The program will have achieved the following: - average tariff rates have been reduced from about 40 percent to 14.8 percent; - the number of tariff levels has been reduced from 20 to 4; - the level of import surcharge has been reduced from 18 percent to 8 percent; and - have designed and put in operation a flexible tariff system for agricultural products.	Adhere to the program of ta

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

ICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE SE
Trade Finance and ions:			
onal Issue:			
sts a dispersion es and procedures of supervising, ng and financing rade activities	To develop a clear, simple, and stable institutional setting which will minimize the cost of administrative intervention and which will effectively support the participation of Colombia's productive sectors in the international markets. The institutional setting includes a Trade Council, a Ministry of International Trade, an international trade bank, and a specialized trade promotion agency.	Has approved the legislation required to: - empower the government to create a Ministry of Foreign Trade; and - unify the decision-making process in a Trade Council, under the direction of the President.	To have in pla new institutio which will inc recommendation diagnostic of that affect th setting of for procedures.
		Has completed a diagnosis of the problems that affect the institutional setting of foreign trade procedures.	
Issue:			
Colombia's export fund, offered below market rates, was funded by t transfers and import taxes, and sed money in arkets.	To transform PROEXPO into an international trade bank, which will operate in a market oriented setting, able to mobilize resources and operate profitably in a competitive environment. To identify and compensate for market failures concerning finance of international trade related activities.	Has approved the legislation required to: - transform PROEXPO into an international trade bank; - eliminate the earmarked tax on c.i.f. imports allocated to PROEXPO by law 75 of 1986; - discontinue reimbursement by PROEXPO OF TAX rebates; - increase interest rates and institute variable interest rates for PROEXPO credit; and - change the allocation of PROEXPO credit for working capital from a quota system to a system based on borrower's exports financing requirements.	
		Has begun a study, based on terms of reference developed by PROEXPO with the support of the Bank, to analyze the current financial and institutional situation and recommend alternatives for the reorganization of the institution.	To have in pla new financial will include t recommendation completed stud

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

ICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES: ALREADY TAKEN	POLICY MEASURES: BEFORE SE
ssue (continued)			To have develo term strategy guided by the objectives: - operates financial - divests it non-financ - banking a activitie tiated in administr - banking a managed i with comm principle - limited p from shor - designed will help problems; - maintains at levels the cost funds, tr risk prem opportuni capital. Maintain inte market condit include, amon cost of funds, costs, risk p opportunity c

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

ICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE SE
icient ports cture and the f a regulatory to allow on, has led to poly rents that the costs of onal transactions.	To ensure the financial and administrative autonomy of Colombia's ports, and to promote competition between them.	Continue implementing the ports reform legislation that: - authorizes the administrative restructuring of the ports system; - authorizes the liquidation of Colpuertos; - contemplates private sector participation in the construction, maintenance, and administration of ports, either directly or in joint-ventures with the government; and - authorizes the creation of the Superintendency of Ports, as the single, independent regulatory authority.	To accelerate program for Co program will i costs of indem dismissed pers existing asset starting date implementation the mechanism Colpuertos' ac
		Has agreed to select one of Colombia's ports as a pilot project for implementing the privatization program of port activities.	To have initia implementation port project.
		Has agreed to establish a pricing mechanism through which the state will charge for the use of port space.	To have establi pricing mechan
		Has designed an specific plan to obtain the active participation of the private sector in the port societies, including alternatives for financing private sector investments.	To be implement in a manner ac Bank.
		Has determined a valuation method for tug boat services, and defined the system by which those activities will be transferred to other operators.	To have determ of the service process of tra
ms system has been strative barrier al trade. A myriad tions has led to ncies, creating ty and higher users. In over-and-under- has led to nt revenue losses.	To strengthen customs's institutional and technical capabilities.	Has reached agreement on the need to carry on, and on the Terms of Reference of a study that will identify customs' information bottlenecks, and offer alternatives to solve the problem of properly valuing traded merchandise.	To have design implemented an system for pri and records of transactions.
		Has defined the functions of the General Directorate of Customs.	To have adopte regulate custo
		Has reached agreement on the legal strategy to enforce customs normas and regulations.	

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

LICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE S
L SECTOR			
competition and a el of regulations to high costs of iation in the l sector, ng both savers and s. Likewise, there k of financial nts, specially for ng long term s.	Enact the reforms that will allow: - the strengthening of the capacity of the financial sector to mobilize domestic and external resources and allocate them efficiently at competitive margins; - making up for and potentially eliminating identified market failures in the access to credit of small entrepreneurs; and - undertaking the reforms in the financial sector that wil facilitate the development of long-term capital markets in Colombia.	Has approved the legislation required to reform the financial sector. The principal elements of the legislation are to: - promote competition and efficiency in the financial sector; - promote participation of foreign investment in financial institutions by eliminating all restrictions to ownership; - eliminate norms of regulations that lead to artificial segmentation of markets. - eliminate barriers to entry and to exit, and allow reconversion of existent institutions; - authorize the government to redefine the role of the public financial sector; - increase transparency in information systems (monthly publication of financial indicators institution performance); and - strengthen the prudential regulation system, applicable to private and publicly owned institutions (the Basil agreement was taken as a minimum standard reference to structure the new system.	Public and pr institutions incorporated statutes regu practices for of Law 45 of The financial will begin th privatization Cafetero and action plan w and initiated bring these i point of tota sale. The governmen for sale all of Banco Gana The governmen for sale the assets of Caj

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

ICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE SE
CTOR (continued)		Has approved the necessary norms, decrees, and resolutions that will enable taking the following complementary actions: - substantial reduction and targeting of interest rate subsidies (limited to small agricultural producers and low income housing); - privatization of Official Financial Institutions (2 banks have been offered for sale, three more will follow); - Interest rates reflecting market conditions (non-administered rates based on average bank deposit rates) in more than 90% of the financial market; - to have begun phasing out of existing forced-lending practices, except as required by law (low income housing and small agriculture), as detailed in the Policy Letter; and - reduction of directed credit. To improve the level of Prudential Regulation, the Government has, in this project's Policy Letter, made the committment that publicly owned and managed banks and financial institutions will be subject to enforceable regulation without discrimination vis-a-vis private sector banks and financial institutions. Until their unique situation can be resolved, this requirement will not extend to FEN and FINDETER.	The Minister c together with undertake an a barriers that which limit th small and medi enterprises to other banking on the results analysis, an a be agreed to h overcome these

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

LICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE SE
ual Savings			
ual Savings have minimal role in g domestic nt.	Assist in the development of long-term domestic capital markets that will adequately span the set of investment opportunities.	Developed regulations governing the establishment of severance funds such as: - An actual fund will be created (required for new employees, effective 1/1/91, voluntary for other employees). - Incentives for distortions in labor markets will be reduced. - Opportunities for fraud will be reduced. - Incentives (favorable tax treatment for earnings on fund's internal build-up) will be set up to encourage participation among voluntary participants. Presented to the Bank preliminary terms and conditions for study of existing pension systems and restructuring alternatives.	To have compl which will: - Ascertain financial existing (both for public se - Present c alternati restructu strengthe programs proposals funding a levels. - Demonstra soundness systems. Present to the of findings a based on the above study.
for Contractual have been rized by tion and have been d to housing and nt sponsored al development .	Assure that instruments of contractual savings are given maximum flexibility for assisting in and leading to the proper allocation of scarce economic resources.	The management of these funds is regulated by the Superintendent of Banks and Financial Institutions.	Assure that p will be subje regulation an supervision.
ilities associated y contractual rograms (pension rance funds in ar) have not been pported by nding assets.	Deepen economic markets and thereby increase overall domestic savings rate.	Participants (investors) in these funds are protected against fraud and mismanagement by: a) Capital provided by fund administrators b) Limited guarantee by Fondo de Garantias e Instituciones Financieras.	Propose to Co authorizing t undertake ref pension syste
regulation has not ducive to the ent of long-term instruments.	Development or regulatory framework and economic conditions conducive to the development of properly structured and funded long-term contractual savings instruments.	The rates charged by Life Insurers (another potential source of long terms contractual savings) have been freed to market rates and regulation of life insurance will be based in solvency.	

COLOMBIA: INVESTMENT SECTOR LOAN
Policy Matrix

.ICY ISSUE	POLICY OBJECTIVE	POLICY MEASURES	
		ALREADY TAKEN	BEFORE S
C FRAMEWORK	Reduce inflation and stimulate growth.	Has in place a short- and medium-term macroeconomic program to reduce inflation and accelerate growth.	A macroeconom performance s the Bank.

Santa Fe de Bogota, D.C.

September 23, 1991

Mr. Enrique Iglesias
President
Inter-American Development Bank
1300 New York Avenue, N.W.
Washington, D.C. 20577
U.S.A.

Dear Mr. Iglesias:

The Government of the Republic of Colombia wishes to request a sector loan from the Inter-American Development Bank in support of the development and refinement of a series of laws and regulations intended to improve the domestic climate and conditions for investment, and thus facilitate the growing participation of the private sector in national economic activity. The support being sought would be a natural continuation of previous operations with the Bank, including the loan in support of public sector reform now under way, in which clear criteria were established defining public and private activity.

The Government's development strategy seeks an aggressive opening in the areas of economic and social matters and in decentralization, within the context of prudent macroeconomic management.

In the economic sphere, conditions have been created to permit free trade in goods, establish equal treatment for local and foreign investment, set up a competitive and efficient financial sector, restructure sectors fundamental to external trade, such as ports, and reorganize foreign trade institutions, streamlining procedures and administrative involvement and modernizing infrastructure in support of international trade negotiations.

On the social front, government action has focused on education and health, seeking maximum coverage and placing special emphasis on areas such as higher education and scientific research. Further progress will be made in decentralization by consolidating the financial and execution capacities of the regions. Our country has received support from the IDB in all these areas, and hopes to continue to do so in the years to come.

The country's macroeconomic management has been balanced and consistent, with the result that today Colombia has a competitive real exchange rate and appropriate and consistent fiscal and external balances. The current administration has continued to apply this philosophy, with greater emphasis on reducing inflation in the short term. In addition, it has introduced structural reforms which, in combination with the measures to be taken under the present operation, will contribute to accelerate economic growth. Income per capita is expected to rise between two and three percent per annum throughout the decade.

Our dialogue with the Bank during the process of preparing this operation has been a fruitful one, and many of the structural and related measures have already been adopted.

This administration intends to uphold the reforms adopted, refining and adjusting them on the basis of experience and subsequent analysis. This operation will contribute to the process in the following specific areas: private investment, foreign trade, and the financial sector.

Before providing a detailed outline of the actions in support of this operation, we would like to place them, in terms of direction and scope, within the context of recent economic developments, operations with the Bank, and structural reform programs.

Background

In 1984 the Colombian Government undertook a program of economic reform which has been stepped up under the current administration. Under the stabilization phase, completed in 1986, external and fiscal balances were restored to levels traditionally considered acceptable. Simultaneously, monetary policy was oriented toward ensuring adequate price stability by confining growth in the money supply to anticipated nominal growth in gross domestic product.

In spite of the success of the stabilization measures, in recent years, recurring signs of slowing growth in productivity and a gradual rise in inflation have confirmed concerns about the long-term viability of the economic strategy that the country was following.

It became evident that it was necessary to reformulate the country's development strategy, abandoning the gradual application of structural reforms and revitalize private investment. In the process the following constraints were identified: the narrowness of the domestic market, the fragility of the financial system, a weak infrastructure to support international trade, impediments to foreign investment, the unfair treatment to international financial inflows, and the lack of exactitude in defining the areas of participation of the public and private sectors.

From a very beginning, this Administration has responded rapidly and coherently in its efforts to eliminate the above mentioned impediments. It is worth mentioning the legislative package approved by Congress during the second half of 1990.

It is appropriate to mention the following laws:

- Law 49 of 1990 on tax measures;
- Law 45 of 1990 on financial reform;
- Law 9 of 1991 on foreign exchange;
- Law 51 of 1991 on domestic debt;
- Law 7 of 1991 on international trade;
- Law 1 of 1991 on ports; and
- Law 50 of 1990 on labor reform.

The Government deems indispensable the support of the IDB in the process of revitalize private investment, specifically in the areas mentioned below.

Defining the Areas of Activity of the Public and Private Sectors

The Government has assignment the highest priority to rationalize State's activities through a process of specialization of functions to ensure an adequate increase in public sector productivity and to support and clear the field for private initiative in the production and distribution of goods and services.

Steps have been taken in this direction, with the support of the IDB and the World Bank, in connection with a public sector adjustment loan.

At the same time as this frees up resources for use in social investments and related infrastructure, it will contribute to reducing the size and scope of public-sector activity, thereby enhancing its efficiency.

Size of the Domestic Market

In an effort to protect national industry, an overdiversified productive base was developed that had difficulties competing internationally, with the result that growth potential was curtailed drastically.

Given the unequivocal need to internationalize the economy, a program was undertaken to rationalize the protection given to the domestic market, including the elimination of almost all quantitative restrictions on imports. Approximately three percent of all tariff items were exempted for reasons of security and to combat drug trafficking. The tariff structure has been streamlined to four levels:

- the first, at 0 percent, applies to inputs, raw materials, intermediate goods and capital goods not produced domestically, and goods likely to be smuggled, such as electrical appliances, tobacco and liquor;

- the second and third, at 5 and 10 percent, respectively, apply to inputs, raw materials, intermediate goods and capital goods that are produced domestically; and

- the fourth, at 15 percent, applies to consumer goods.

With this measure Colombia achieves a trade regime that is modern and equal to the most advanced ones in the region, thus facilitating the process of integration that is taking place.

Private Investment

The package of reforms adopted by the current administration in its first year seeks to promote a broad recovery of private investment. Generally speaking, the reforms are intended to: (i) eliminate uncertainties in the economic environment; (ii) broaden access to markets, inputs and technology; (iii) promote competition in all sectors; (iv) upgrade transportation and communications infrastructure; (v) substantially reduce price distortions, tariffs, and taxes; and (vi) contribute to expanded and more highly specialized training of human capital.

The new foreign exchange statute issued in July 1991, which has as a base what is established in Law 9/91, is intended to allay uncertainty concerning access to foreign exchange and reduce transaction costs typical of such operations. A foreign exchange market was created with the requirement that all transactions with the exterior be channeled through financial institutions, which will be the only ones to have direct operations with Banco de la República. This will not only contribute to strengthening and modernizing the financial system, but users will be able to benefit from new financial services facilitating international trade. The statute will be refined in the future as this new market develops, always with a view to ensuring streamlined and transparent operations.

Under the labor legislation previously in force, there was uncertainty about the calculation of effective wages and limited worker mobility. The new legislation eliminates the uncertainty by specifying how monetary obligations between employer and employee are calculated and providing quick methods for doing so, such as "comprehensive" wages for higher pay levels. Special treatment is provided for companies adversely affected by the liberalization process, thus facilitating their reconversion and/or relocation. Finally, the new labor legislation constitutes a first step toward strengthening institutional savings, by promoting the creation and operation of severance funds with tax incentives.

Since the 1986 tax reform, successive administrations have been sensitive to the effect of taxes on investment, the development of capital markets, and the capitalization of companies. The current one has made even more progress, by eliminating taxes on dividends and windfall profits, reducing the tax on foreign remittances for new investments from 20 to 12 percent, and facilitating the creation of investment funds to attract venture capital abroad. However, given the importance attributed to the effect of taxes on investment, particularly internationally, a study on taxes and private investment will be undertaken shortly with the cooperation of the IMF in order to develop an action plan to be carried out in 1992.

Foreign Investment

Regulations on foreign investment have been completely revamped, so that today such investment is treated in a manner similar to domestic investment, can be made in any sector of the economy, and enjoys broad assurances as to remittance rights.

It is the government's intention to make progress in promoting foreign investment next year, for which purpose:

- the foreign investment statute will be reviewed to reflect the views of the private sector and ensure consistency with the new Andean Pact agreements and the new foreign exchange statute;

- consideration will be given to creating an institution to promote foreign investment with private-sector participation; and

- a standard agreement on investment and taxes will be drawn up to serve as a basis for bilateral negotiations of a selective nature, with a view to protecting foreign investment and preventing double taxation.

It is the Government's intention to negotiate in the near future an agreement of this type with at least one of Colombia's major trading partners.

International Trade

The Government has made rapid progress on the international trade front by eliminating the vast majority of quantitative restrictions and making the tariff the principal instrument of trade policy. The average tariff was reduced recently from 24.7 to 14.8 percent, and effective protection from 44 to 26.2 percent.

The government is aware that administrative restrictions continue to exist, however, and that many institutions and agencies continue to affect the movement of goods. For this reason it will undertake a review of foreign trade sector regulations and implement an action plan to adjust them in the second half of this year and the first half of the next, using the authority granted under Law 7 of 1991 on foreign trade. Among the matters to be decided before year-end in this connection is the conversion of PROEXPO into an independent, self-supporting institution, and the exercise of the powers granted to the President of the Republic to create the Ministry of Foreign Trade.

In preparation for the redefinition of PROEXPO, the government recently eliminated the institution's role in reimbursing export taxes, and consequently the import surcharge transfer it received. The surcharge

will become a tariff effective January 1, 1992, and eliminates its specific destination. As a result, it will no longer be a tied revenue.

It is expected that PROEXPO will be operating in accordance with its new structure no later than January 1992, according to the following principles:

- to operate as a second-tier institution;

- to gradually divest itself of nonfinancial investments;

- to keep its banking and promotional activities separate;

- to conform its banking operations to commercial practices and the protection of its capital base;

- maintain interest rates at levels which reflect market conditions and include the marginal cost of funds, intermediation costs, and risk premiums, and other factors that may be deemed relevant;

- to diminish its participation in the short-term market as private-sector participation increases; and

- to come up with ways of solving problems with guarantees and insurance in the sector.

Concurrently, the customs reform will continue, in particular the implementation of a system of international reference prices to be used in merchandise valuation, tax assessment and any cases of arbitration that may arise in the import process. The program to streamline customs procedures will enter into effect in the first half of 1992.

The Congress approved Law 1 of 1991 on port reform, for which regulations are now being drafted. The principal features of the port modernization to be introduced are as follows:

- rate system regulations that will allow the various port activities to function efficiently;

- the formulation of a methodology to determine compensation to the State for the use of beaches and lowtide areas by port companies;

- the elaboration of a legal framework covering the creation of port societies. Satisfactory progress will be made in the implementation of a plan to obtain the active participation of the private sector;

- development of the program for liquidation of COLPUERTOS, including staff compensation and the valuation of tangible

assets, with a view to creating new port companies, as established by law. The time frame provided by the law for liquidation of COLPUERTOS and creation of port companies is three years from the date of issue.

In addition, a complete program will be developed to privatize services in a port to be selected, which will be used as a pilot project. The implementation of this pilot plan will begin in the first half of 1992.

The Financial Sector

The Government proposes to create conditions to encourage domestic and foreign competition within the financial sector in order to narrow intermediation spreads, thus benefiting savings as well as investment. In support of this proposal, the Colombian Congress has passed financial reform legislation (Law 45 of 1990), for which regulations have been issued, in particular the Financial System Fundamental Law.

This set of regulations promotes greater competition within an effective regulatory system. The regulatory system that governs both public and private organizations has as its minimum frame of reference the standards set forth in the Basel Agreement. In order to encourage competition, the government has lifted restrictions on foreign investment in the sector and eliminated barriers that encouraged artificial segmentation, thus facilitating the conversion of financial institutions and the entry of new investors.

In order to ensure a stable framework for the activities of private financial organizations, and to avoid preferential treatment, the government is now performing a review of each one of the financial organizations in the public sector in order to design specific action programs conforming to the following criteria:

- public and private financial organizations are to be accorded equal treatment in terms of both supervision and control;

- steps will be taken to make it viable to place all or part of public-sector entities on the market;

- the strategy includes having second-tier institutions, preferably channelling foreign resources, with the exception of FEN and FINDETER, the former in energy and the latter in territorial decentralization.

Action plans have already been drawn up for Caja Agraria and Banco Ganadero, to be implemented beginning in the first half of next year. Plans call for putting up for sale, in 1992, all Banco Ganadero shares still held by the government and all nonfinancial assets of Caja Agraria.

The Government is confident that reforms concerning interest rates, competitiveness and mandatory investments will contribute to eliminating such existing flaws as restricted access to credit by small and medium-sized producers, the lack of medium and long-term financial markets and limited services to complement the economic liberalization. Studies will be done to assess the expediency of introducing additional regulations or legislation, but always within the general direction of financial reform. To address the issues that limit access of small and medium enterprises to credit and other banking services, we will develop a joint action plan with the IDB that will take into consideration the recommendations of the pertinent studies.

Institutional Savings

Several factors have contributed to holding down institutional savings in Colombia, and the size of the markets for shares and bonds traditionally fuelled by such savings has been affected as a result. Under the legislation passed, the government gained approval to give special tax treatment to companies managing severance funds. It was not possible, however, to make progress on a wider framework. The government intends to pursue its review of existing forms of institutional savings and design a system of incentives that would enable workers to augment their savings and channel them into productive activities and capital markets. The measures will be placed before the Congress in the form of draft legislation.

Macroeconomic Stability

It will continue to be a priority of this administration to maintain stable macroeconomic conditions. Particular attention will be paid to lowering inflation, maintaining a competitive exchange rate and ensuring equilibrium between fiscal and exchange balances.

Executing Agency

The supervision and monitoring of the reform program will be the responsibility of the Ministry of Finance and Public Credit as executing unit. A committee will be created to coordinate policy, chaired by the Minister of Finance and with representatives of the Ministries of Development and Public Works and Transport, and the National Planning Department.

Yours truly,

Rudolf Hommes
Minister of Finance and Public Credit

Basic Socioeconomic Data of Colombia

General

Total Population (Millions of Inhabitants, 1990)	32.9
Rural Population (Percentage)	29.7
Land Area (1,000 de Km2)	1,141.7
Population per Km2	28.8
Birth Rate per 1,000 Inhabitants (1985-90)	27.4
(Average 1985-90) (Percentage)	2.0
Gross Domestic Product per Capita (1990) 1/	1,304
Death Rate per 1,000 Inhabitants (1985-90)	6.1
Infant Mortality Rate per 1,000 Live Birth (1985-90)	39.7
Physicians per 10,000 Inhabitants (1988)	8.8
Hospital Beds per 1,000 Inhabitants (1987)	1.5
Literacy Rate (1990) (Percentage)	86.7
Registration Rate (Percentage) 2/ (1990)	
Primary	84.0
Secondary	46.0
Official Exchange Rate:	
December 31, 1990 (Pesos per Dollar)	568.73
Energy Consumption per Capita (1987) (Kwh)	938
Low Income Level per Inhabitant	
December 1990 (Pesos)	372,820

Economically Active Population by Sectors (1985)	Thousands	Percentage
Total	7,664	100.0
Agriculture and Fishing	2,629	34.3
Mining	69	0.9
Manufacturing	1,357	17.7
Construction	360	4.7
Commerce, Finance and Insurance	1,218	15.9
Services	1,487	19.4
Others	544	7.1

Labor Indexes:

	Anual Average (Percentage)									
Year	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Unemployment	8.1 a/	9.0 a/	11.5 a/	13.3 a/	13.8 a/	13.6 a/	11.8 a/	11.3 b/	10.0 b/	10.5 b/
Real Wages (deflated by the CPI, 1980=100)										
Manufacturing 3/	102.4	106.1	112.2	119.2	116.8	121.4	120.9	120.3	122.6	123.2
Agriculture 4/	97.6	94.8	95.2	91.9	92.5	98.7	101.2	106.3	107.1	112.4
Legal Minimum	99.3	103.7	108.2	113.7	110.0	114.7	113.5	110.7	111.7	109.0

1/ 1990 dollars.
2/ Total registration/population by eligible age group.
3/ Without the coffee husking process.
4/ Without foodstuff.
a/ Four principal cities.
b/ Seven principal cities.

Source: Departamento Administrativo Nacional de Estadísticas (DANE) y Departamento Nacional de Planeación (DNP).

tional Accounts	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
oss Domestic Product Billions of rrent Pesos)	1,579.1	1,982.8	2,497.3	3,054.1	3,856.6	4,965.9	6,788.0	8,824.4	11,731.3	15,189.6	20,519.4
oss Domestic Investment Millions of 1975 Pesos)	525,765	537,736	542,836	551,380	569,855	587,561	621,781	655,164	681,791	703,823	730,874

	Composition Percentages (Current Prices)							Real Annual Growth Rate (Percentag				
P by Type of Expenditure	1980	1985	1986	1987	1988	1989	1990	1985	1986	1987	1988	1989
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	3.1	5.8	5.4	4.1	3.2
Consumption	80.3	79.7	75.2	76.0	75.6	75.3	74.5	2.2	3.0	4.0	4.5	2.4
Exports	19.1	19.0	18.0	20.0	22.0	20.5	20.6	-9.6	4.4	9.2	8.0	-6.0
Fixed Investment	16.8	17.5	17.7	17.4	19.5	19.0	18.5	-5.2	7.6	0.8	10.9	-0.9
Private	9.8	8.4	9.2	10.2	12.0	11.8	11.7	-6.2	16.7	13.7	-1.9	3.4
Public	7.0	9.2	8.5	7.3	7.5	7.2	6.8	-4.3	-0.6	-13.0	28.9	-5.6
Change in Stocks	2.3	1.5	0.3	2.6	2.5	1.4	2.1	-39.0	-29.6	141.5	-10.8	-47.7
Exports	16.2	13.8	18.8	16.9	16.3	17.9	18.9	14.4	20.7	7.8	0.3	9.1
Imports	15.6	12.5	12.0	12.9	13.9	13.6	14.0	-6.6	4.1	5.3	6.6	-5.0
By de Origen												
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	3.1	5.8	5.4	4.1	3.2
Agriculture	19.4	17.0	17.5	18.1	16.7	16.2	16.4	1.6	3.4	6.4	2.8	4.5
Mining	2.3	4.2	4.9	6.5	6.2	7.5	7.8	38.0	62.1	24.1	4.5	12.9
Manufacturing	23.3	21.4	22.5	20.3	21.2	20.6	20.9	3.0	5.9	6.2	1.9	2.9
Construction	4.7	6.9	6.6	5.6	6.6	6.6	6.0	8.6	4.9	-10.0	13.2	0.4
Commerce	13.3	14.1	13.6	14.1	14.4	14.2	14.0	1.8	3.6	4.4	5.0	1.1
Transportation	8.9	8.2	7.8	8.1	8.3	8.3	8.3	1.0	1.0	3.3	3.4	3.6
Government	7.7	8.5	8.1	8.1	7.9	8.2	8.5	4.3	6.1	7.1	7.0	3.8
Financial Services	6.7	6.1	5.9	6.1	6.6	6.9	6.8	0.2	5.3	6.2	12.4	6.8
Other Services	13.8	13.7	13.3	13.2	12.1	11.6	11.3	3.0	5.6	3.1	0.2	-1.6

ce: DANE.

3. External Trade	(Millions of Dollars)							Composition (Percentages)						
	1980	1985	1986	1987	1988	1989	1990	1980	1985	1986	1987	1988	1989	199
Exports of Goods (FOB)	4,296	3,782	5,467	5,409	5,439	6,082	7,140	100.0	100.0	100.0	100.0	100.0	100.0	100.
Tradicional Goods	2,628	2,657	4,059	3,743	3,506	3,919	4,400	61.2	70.3	74.2	69.2	64.5	64.4	61.
Coffee	2,208	1,702	2,988	1,651	1,641	1,524	1,415	51.4	45.0	54.7	30.5	30.2	25.1	19.
Petroleum	100	409	463	1,369	987	1,399	1,935	2.3	10.8	8.5	25.3	18.1	23.0	27.
Coal	10	126	201	263	306	453	539	0.2	3.3	3.7	4.9	5.6	7.4	7.
Ironickel	0	55	48	76	161	178	137	0.0	1.5	0.9	1.4	3.0	2.9	1.
Other	310	365	359	385	413	366	374	7.2	9.7	6.6	7.1	7.6	6.0	5.
Non Tradicional Goods	1,668	1,125	1,408	1,666	1,933	2,163	2,740	38.8	29.7	25.8	30.8	35.5	35.6	38.
Banana	94	156	200	210	252	253	314	2.2	4.1	3.7	3.9	4.6	4.2	4.
Flowers	97	132	149	145	190	217	227	2.3	3.5	2.7	2.7	3.5	3.6	3.
Sugar	192	43	44	19	61	94	124	4.5	1.1	0.8	0.4	1.1	1.5	1.
Clothing	137	63	95	128	226	298	382	3.2	1.7	1.7	2.4	4.2	4.9	5.
Imports of Goods (CIF)	4,283	3,673	3,409	3,794	4,515	4,558	5,102	100.0	100.0	100.0	100.0	100.0	100.0	100.
Capital Goods	1,456	1,165	1,245	1,381	1,587	1,595	1,910	34.0	31.7	36.5	36.4	35.2	35.0	37.
Consumption Goods	570	345	380	488	515	470	522	13.3	9.4	11.1	12.9	11.4	10.3	10.
Intermediate Goods	1,727	1,697	1,654	1,823	2,266	2,282	2,361	40.3	46.2	48.5	48.1	50.2	50.1	46.
Fuel	530	466	130	101	148	210	310	12.4	12.7	3.8	2.7	3.3	4.6	6.

Sources: DANE. Banco de la República and DNP.

Millions of Dollars

ance of Payments	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
rent Account Balance	104.0	-1,722.0	-2,885.0	-2,826.0	-2,088.0	-1,586.0	463.0	-20.6	-215.7	-193.4
rade Balance	13.0	-1,333.0	-2,076.0	-1,317.0	-404.0	109.0	1,922.0	1,460.9	827.3	1,474.0
Exports of Goods FOB	4,296.0	3,397.0	3,282.0	3,147.0	3,623.0	3,782.0	5,331.0	5,254.0	5,342.6	6,031.8
Imports of Goods FOB	4,283.0	4,730.0	5,358.0	4,464.0	4,027.0	3,673.0	3,409.0	3,793.5	4,515.3	4,557.8
et Services Balance	-74.0	-631.0	-978.0	-1,673.0	-1,983.0	-2,156.0	-2,244.0	-2,482.4	-2,006.5	-2,565.6
(Interests)	-627.0	-937.0	-1,147.0	-1,011.0	-1,178.0	-1,293.0	-1,315.0	-1,341.4	-1,397.7	-1,587.9
ransfers	165.0	242.0	169.0	164.0	299.0	461.0	785.0	1,000.9	963.5	898.2
ital Account Balance (net)	945.0	2,040.0	2,231.0	1,436.0	944.0	2,220.0	1,079.0	-14.8	938.3	373.4
ong Term	815.0	1,641.0	1,616.0	1,528.0	1,822.0	2,350.0	2,629.0	184.9	833.4	653.4
(Direct Investment)	51.0	228.0	337.0	514.0	561.0	1,016.0	562.0	287.1	158.4	547.1
hort Term	130.0	399.0	615.0	-92.0	-878.0	-130.0	-1,550.0	-199.7	104.9	-280.0
ancing Item	24.0	24.0	0.0	-67.0	20.0	-39.0	51.0	90.0	-70.4	152.3
ors and Omissions	169.0	-98.0	-48.0	-266.0	-137.0	-311.0	-129.0	-82.4	-292.3	-275.2
nges in Reserves - Increase)	-1,242.0	-244.0	702.0	1,723.0	1,261.0	-284.0	-1,464.0	27.8	-360.0	-57.1

DNP and Banco de la República.

	As Percentages of GDP														
	Central Government								Non Financial Public Sector						
blic Finances	1980	1984	1985	1986	1987	1988	1989	1990	1980	1984	1985	1986	1987	1988	198
rrent Revenue	11.5	10.2	9.0	9.7	10.6	10.3	10.1	10.2	16.8	19.2	22.2	26.6	24.7	23.6	22.
x Revenue	10.4	10.1	8.6	9.0	9.6	9.4	9.2	9.2	12.4	12.4	13.7	15.1	14.8	14.5	14.
rrent Expenditure	9.3	11.6	8.7	8.3	8.7	9.0	9.3	8.9	13.0	15.9	13.5	15.4	16.2	16.8	17.
rrent Savings	2.2	-1.4	0.3	1.3	1.9	1.3	0.8	1.3	3.7	3.3	8.7	11.2	8.5	6.8	5.
pital Expenditure	3.7	3.5	3.0	2.7	2.4	2.7	2.4	2.2	6.3	10.1	13.3	11.3	9.9	9.0	7.
ficit (-)	-1.5	-4.9	-2.7	-1.3	-0.5	-1.4	-1.6	-0.9	-2.6	-6.8	-4.5	-0.1	-1.4	-2.2	-1.
nancing															
Domestic						0.5	1.1	0.9	0.5	4.9	0.5	-3.5	1.3	0.2	1.
Foreign						1.0	0.6	0.0	2.1	1.9	4.0	3.6	0.2	2.0	0.

s: DNP and Banco de la República.

	Billions of Pesos							Annual Growth Rate				
al Financial System	1980	1985	1986	1987	1988	1989	1990	1985	1986	1987	1988	1989
ternational Reserves	212.8	99.8	516.2	642.5	1,006.1	1,312.4	1,974.1					
ic Credit	473.2	2,265.2	2,507.7	3,312.7	4,269.5	5,793.0	7,263.9	26.9	10.7	32.1	28.9	35.7
ic Sector	23.5	439.1	267.5	440.7	551.5	718.7	799.0	6.0	-39.1	64.7	25.1	30.3
ral Government	29.0	437.7	403.5	483.4	477.7	565.3	625.6					
of Public Sector	-5.5	1.4	-136.0	-42.8	73.8	153.4	173.4					
ate Sector	482.0	1,837.9	2,320.0	3,103.8	4,058.0	5,485.2	7,079.7	24.0	26.2	33.8	30.7	35.2
Supply M1	216.7	642.2	784.5	1,048.3	1,318.5	1,696.6	2,141.0	28.2	22.2	33.6	25.8	28.7
Money	250.6	1,126.0	1,467.7	1,854.0	2,246.0	2,611.9	3,455.2	37.8	30.3	26.3	21.1	16.3
Supply M2	467.3	1,768.1	2,252.1	2,902.2	3,564.5	4,308.5	5,596.2	34.1	27.4	28.9	22.8	20.9

	As Percentage of GDP						
	1980	1985	1986	1987	1988	1989	1990
ternational Reserves	13.5	2.0	7.6	7.3	8.6	8.6	9.6
ic Credit	30.0	45.6	36.9	37.5	36.4	38.1	35.4
ic Sector	1.5	8.8	3.9	5.0	4.7	4.7	3.9
ral Government	1.8	8.8	5.9	5.5	4.1	3.7	3.0
of Public Sector	-0.3	0.0	-2.0	-0.5	0.6	1.0	0.8
ate Sector	30.5	37.0	34.2	35.2	34.6	36.1	34.5
Supply M1	13.7	12.9	11.6	11.9	11.2	11.2	10.4
Money	15.9	22.7	21.6	21.0	19.1	17.2	16.8
Supply M2	29.6	35.6	33.2	32.9	30.4	28.4	27.3

Banco de la República.

7. Prices (Annual Growth Rate)	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Consumer Prices											
December to December	25.9	26.5	24.0	16.6	18.3	22.5	20.9	24.0	28.1	26.1	32.4
Annual Average	26.5	27.5	24.5	19.7	16.2	24.0	18.9	23.3	28.1	25.9	29.1
Wholesale. Annual Average	24.2	24.1	25.7	21.7	18.3	24.9	22.0	24.9	28.3	28.2	26.6
Implicit GDP Deflator	27.6	22.8	24.8	20.4	22.2	24.9	29.2	23.4	27.8	25.4	30.1

Source: Dane and Banco de la República.

8. External Debt	1982	1983	1984	1985	1986	1987	1988	1989	1990
	Outstanding Balance Year-End (Millions of Dollars)								
Long Term Debt	7,182	8,152	9,171	11,141	13,765	15,352	15,384	15,272	15,715
Public Debt	5,990	6,874	7,734	9,573	12,181	13,828	13,846	14,000	14,587
Multilateral Institutions	1,880	2,155	2,333	3,408	4,561	5,773	5,612	5,651	6,022
(IDB)	546	654	768	1,010	1,299	1,660	1,703	1,839	2,139
Governments	1,148	1,346	1,469	1,891	2,279	2,527	2,512	2,379	2,707
Private Banks	2,566	2,893	3,258	3,406	4,284	3,979	4,256	4,149	3,911
Others	395	480	673	870	1,056	1,549	1,465	1,822	1,947
Private Debt	1,192	1,278	1,437	1,568	1,585	1,524	1,538	1,272	1,128
Short Term Debt	3,124	3,260	2,868	3,099	1,597	1,654	1,609	1,614	1,850
Total Debt	10,306	11,412	12,039	14,240	15,362	17,006	16,993	16,886	17,571
External Debt Service	1,490	1,598	1,617	1,981	2,268	2,680	3,100	3,719	3,652
Interests	1,092	984	935	1,227	1,147	1,268	1,375	1,568	1,509
Amortizations	398	614	682	754	1,121	1,412	1,725	2,151	2,143
Long Term Public Debt	875	913	1,085	1,416	1,848	2,388	2,762	2,905	3,143
Interests	571	520	545	766	879	1,115	1,135	1,197	1,297
Amortizations	304	393	540	650	969	1,273	1,627	1,708	1,840
Long Term Private Debt	228	326	217	206	251	208	177	630	509
Interests	134	105	75	102	99	69	79	187	212
Amortizations	94	221	142	104	152	139	98	443	297
Interests on Short Term Debt	387	359	315	359	169	84	161	184	

Sources: World Bank and Banco de la República.

9. IDB Loans (Approved through December 31, 1990)	Millions of Dollars	Percentage
Total	4,474.2	100.0
Ordinary Capital	3,714.2	83.0
Fund for Special Operations	695.6	15.6
Social Progress Trust Fund	49.0	1.1
Other Funds	15.3	0.3
By Sector	4,474.2	100.0
Agriculture and Fishing	461.9	10.3
Industry and Mining	320.9	7.2
Transportation and Communications	311.2	7.0
Energy	2,028.6	45.3
Education. Science and Technology	154.6	3.5
Urban development	339.0	7.6
Public Health and Environment	504.4	11.3
Preinvestment	34.6	0.8
Others	359.0	8.0
Disbursement	3,192.5	71.4

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TECHNICAL COOPERATION
PLAN OF OPERATIONS
(September 5, 1991)

COUNTRY:	Colombia
PROJECT NAME:	Investment Sector Reform Loan
PROJECT NUMBER:	CO-0035
EXECUTING AGENCY:	Ministry of Finance and Public Credit
BENEFICIARY:	The Government of the Republic of Colombia
FINANCING PLAN:	
BANK:	US$ 5.0 million
LOCAL:	0.5 million
TOTAL:	US$ 5.5 million
TERMS:	Reimbursable
DISBURSEMENT:	36 months from date of Agreement.

I. Background

1.1 The Investment Sector Reform Loan to which this Technical Cooperation is parallel, is an operation whose main goal is to remove obstacles that constrain the growth of the private sector. The loan covers policy actions in three main areas: the investment regime, the foreign trade sector, and the financial sector. The proposed loan contains, therefore, policy actions that have a direct impact on the country's investment climate.

1.2 This technical assistance is designed to support the Government's Economic Modernization Program and the Investment Sector Reform Loan through studies, the preparation of action plans and training to ensure full compliance with the second tranche conditions described in the Loan Proposal.

1.3 The technical assistance will be provided in the areas of labor markets, foreign investment, trade institutions and trade finance, ports, customs, and the financial sector.

II. Objectives

2.1 The principal objective of this technical cooperation is to support ongoing and future efforts of the Government of Colombia to improve the country's investment environment. This is to be done through the preparation of a variety of studies, technical analyses and counsel that will lead to either the removal of obstacles or the introduction of measures that facilitate investment decisions. Therefore, this operation will contribute to achieve the goals indicated in the Loan document.

2.2 This technical cooperation will concentrate its activities on the areas of private investment, external trade, and finance.

III. Project Description

3.1 Compliance with second tranche conditionality will require to have the technical expertise necessary to conduct the agreed upon studies, prepare and complete the action plans to implement the studies' recommendations, and offer the training needed to build up the technical capability of Colombian staff. If the Sector Investment Loan is to meet its objectives, the Executing Agency must have at its disposal the funds necessary to obtain those services. Following is a list, under each of the elements of the program, of the specific areas in which consulting services are required.

3.2 Investment Sector

Labor Markets

- Labor utilization and labor costs reduction.

Foreign Investment

- Assessment of consistency of the International Investment Statute with the new Andean Pact legislation, and with the new foreign exchange regime.
- Foreign Investment Promotion Program and its implementation.
- Foreign investment protection and prevention of double taxation.

3.3 Foreign Trade Sector

Foreign Trade Institutions and Finance

- PROEXPO's medium-term institutional strategy.
- PROEXPO's medium-term financial strategy.

Ports

- Colpuerto's liquidation program.
- Pilot port privatization project.
- Pricing use of port space.
- Valuation of tug boat services.

Customs

- Comparative analysis of proposed information systems.
- Tailored information system.
- Hardware and software requirements.
- Inter-office network of Customs Services.
- Implementation of critical information systems solutions.
- Consolidation of present various and disparate information systems and operations for valuation, classification and data collection.
- Customs control system to reduce the opportunities for fraud and corruption.
- Administrative support systems.
- Implementation of critical information systems solutions.
- Assess the Informatica organization.
- Definition of development environment and implementation of a programmer's workbench.
- Interface standards for large importer processing and integration.
- Integration of information exchange between ports and customs.
- Integration of the customs information with other government agencies.
- Supervision and coordination of the independent consulting efforts.

3.4 The Financial Sector

- Barriers limiting access of small enterprises to credit and other banking services.
- Establishment of long term credit instruments.
- Foreign exchange markets in Colombia.
- Long-term housing finance.

- Macroeconomic policies and incentives towards increased risk taking of financial institutions.
- Training on above areas.
- Pension systems.
- Contractual savings programs.
- Colombia's Stock Exchange.
- Venture capital in Colombia.

IV. PROJECT EXECUTION

4.1 The proposed T.C. will be executed by the Ministry of Finance and Public Credit. Given the topics to be covered, and methodologies to be applied in each study, carrying out its various components will require teams of experts with diverse qualifications: economists, lawyers, financial analysts, investment experts, systems and organizational experts, etc,.

4.2 These services will be provided by professional consultant firms that will be selected and contracted by the executing agency in accordance with the Bank's procedures for contracting consulting firms. The Project executing agency will verify that all consultants involved will be working in Colombia at the agreed time and for the agreed period. The Ministry of Finance will also have general overall responsibility for the in-country performance of the consultants.

4.3 The execution of the proposed T.C. will demand the utmost cooperation of the local counterpart and top level of authorities of the Ministry of Finance. This will be particularly vital to secure access to experts for the preparation of background information, and to assure the smooth functioning of the international team of experts.

4.4 Detailed Terms of Reference and budgets for each study group will be prepared. A draft version of the Terms of Reference is attached to the present Plan of Operations. The Project Team will review and approve these with the Executing Agency.

V. MONITORING

5.1 Thirty days after completing their respective contracts, the Consultant firms will present to the Executing Agency and the Bank a report detailing the nature of the services

provided and summarizing the results of the work done in each of the study's components.

5.2 Once the studies are finished, the Colombian authorities and the Bank will undertake the publication of the relevant results. It is expected that the results of these studies will be of interest to other governments in the region as well as to policy makers and investors.

VI. COSTS AND FINANCING

6.1 The total cost of the T.C. program is estimated to be US$ 5,500,000.00 of which US$ 5,000,000.00 will be Bank financing on a reimbursable basis. The Government administrative and logistical support provided as counterpart is estimated to be US$ 500,000.00.

6.2 The Bank's contribution will be disbursed in US dollars. Disbursements will be made according to the usual procedures prescribed by the Bank. A summary of the budget is presented below. A fully detailed budget is attached to this Plan of Operations.

	In U.S. Dollars		
	BANK	GOC	TOTAL
1.Professional Services Firms	4,822,500	-	4,822,500
A. Private Investment	490,000	-	490,000
-The labor market	150,000	-	150,000
-Foreign Investment	340,000	-	340,000
B. Foreign Trade Sector	2,350,000	-	2,350,000
-Institutions and finance	170,000	-	170,000
-Ports	170,000	-	170,000
-Customs	2,010,000	-	2,010,000
C. Financial Sector	1,982,500	-	1,982,500
-Credit and Banking	497,500	-	497,500
-Financial Markets	620,000	-	620,000
-Contractual Savings Ins.	620,000	-	620,000
-Housing Finance Markets	245,000	-	245,000
6.0 General Support	-	480,000	480,000
7.0 Publications	-	20,000	20,000
98. Contingencies	177,500	-	177,500
Total	5,000,000	500,000	5,500,000

VII. RECOMMENDATIONS

7.1 In order to assure the successful implementation of the reform objectives which this technical cooperation supports, the Executing Agency will have initiated the technical cooperation activities within 12 months of contract signature. It is expected, however, that most of the consultants will be hired within six months of contract signature.

VIII. RESPONSIBILITY WITHIN THE BANK

8.2 The basic and technical responsibilities are with the Plans and Programs Department, Sector Lending and Policy Division (DPL/POL).

PROPOSED TERMS OF REFERENCE FOR SELECTED STUDIES
TO BE CONDUCTED WITH TECHNICAL COOPERATION RESOURCES

Following are the draft terms of reference for a selection of the principal studies to be conducted with Program resources.

Private Investment

A. The Labor Market

A team of labor economists and lawyers, with national and international experience will assist the government in further efforts to improve labor utilization and reduce labor costs.

B. Foreign Investment

A team of international lawyers and investment experts, with proven experience in investment codes will be required to conduct an in-depth evaluation of the new International Investment Statute to assess its consistency with the new Andean Pact legislation, and with the new foreign exchange regime. The consultants will seek comments from the private sector in Colombia and in those countries that are Colombia's main sources of private investment funds.

If the evaluation of the International Investment Statute is negative, a different team of experts will be needed to assist in redrafting a statute that is consistent with Colombia's economic liberalization program.

An expert in foreign investment promotion programs will review the program's Action Plan and assist in its implementation.

An expert with proven experience in investment protection and double taxation issues will help design a master agreement for foreign investment protection and prevention of double taxation.

Foreign Trade

It is envisioned that to achieve the purpose of some of the components of the Foreign Trade program element described on

the Loan document, technical assistance in the amount of US$ 2.3 million is needed. At present, the following consulting services required have been identified:

A. Foreign Trade Institutions and Finance

A team of experts with proven experience in institutional issues of international trade banks will assist PROEXPO in carrying forward its medium-term institutional strategy. Emerging institutional problems will be addressed during implementation of the strategy.

A team of experts with proven experience in financial issues of international trade banks will assist PROEXPO in carrying forward its medium-term financial strategy. Emerging financial problems will be addressed during implementation of the strategy.

B. Ports

An expert with proven experience in privatization of port services will assist in the liquidation program for Colpuertos, and in designing the pilot project for implementing the privatization of a port that is to be selected. Additional technical cooperation is expected to arise during this process.

An expert with proven experience in pricing port services will assist in establishing the pricing mechanism through which the state will charge for the use of port space. The consultant will also assist in determining the value of tug boat services and in transferring those services to other operators.

C. Customs

Experts with proven experience in providing information systems related services will conduct a comparative analysis of the suitability of SIDUNEA (U.N.), the Private Sector Large Importers Initiative, and the existing Customs Information Systems. Based on that analysis, the consultants will identify the most appropriate system(s) to meet Customs' needs.

If the comparative analysis reveals that no system fully meets customs' information needs, experts will be needed to develop a tailored information system.

Experts with proven experience in providing information systems related services will study and assess the hardware and software requirements to support the implementation of the selected Customs Information System.

Experts with proven experience in providing information systems related services will identify and design the inter-office network of Customs Services, including an assessment of the architecture and capacity of the inter-office network to support the reliable exchange of data collected at the designated Customs' offices.

Experts with proven experience in implementing critical information systems solutions will coordinate the hardware, software and telecommunications implementation of the selected inter-office network of Customs Services.

Experts with proven experience in providing information systems related services will help consolidate the present various and disparate information systems and operations for valuation, classification and data collection into a common integrated system.

Experts with proven experience in providing information systems related services will help develop a procedural customs control system to reduce the opportunities for fraud and corruption by limiting the individuals' flexibility and discretion in critical areas.

Experts with proven experience in providing information systems related services will help define and design customs' administrative support systems designed to improve operational efficiency, streamline the exchange of information and assist in evaluating staff performance.

Experts with proven experience in implementing critical information systems solutions will help implement the designed customs' administrative support system.

Experts with proven experience in providing information systems related services will help assess the Informatica organization (i.e, define organization structure, assure proper roles and functions are supported, etc.) to improve efficiency and reduce the risk involved in ongoing systems development and operational support.

Experts with proven experience in providing information systems related services will help define a development environment and implement a programmer's workbench, which includes defining the methodology, identifying the proper tools and providing training to the Informatica staff to

establish a consistent, modern and efficient approach to information systems development.

Experts with proven experience in providing information systems related services will help evaluate and define interface standards for large importer processing and integration with the proposed Informatica system to ensure proper controls, ownership and an arms-length relationship designed to protect the integrity of the data collection effort.

Experts with proven experience in providing information systems related services will help integrate the information exchange between ports and customs, defining the requirements, the procedural steps and implement the information system to eliminate points of duplicative data entry, thereby improving efficiency and the reliability of the data for statistical and operational purposes.

Experts with proven experience in providing information systems related services will help integrate the customs information with other government agencies; including INCOMEX and the Ministry of Finance for the exchange of data, thereby improving efficiency and the reliability of the data for statistical and operational purposes.

Experts with proven experience in providing information systems related services will help supervise and coordinate the independent consulting efforts of such groups as UNCTAD, World Bank, Konsultorias Ltds., and Grupo Tecnico to ensure a coordinated, consistent and singular approach is being pursued.

The Financial Sector

It is envisioned that to achieve the purpose of some of the components of the Financial Sector program (including Contractual savings) element described on the Loan document, technical assistance in the amount of US$ 1.9 million is needed. At present, the following consulting services required have been identified:

Experts with proven experience in credit markets directed towards small and medium scale enterprises who will assist in the study of barriers that currently exist which may limit the access of such enterprises to credit and other banking services.

Experts with proven experience in developing country credit markets who can assist in the establishment of long term credit instruments.

Experts in the development and operation of foreign exchange (especially forward foreign exchange) markets who will examine the potential and pitfalls of foreign exchange markets in Colombia.

A team of experts in the development and operation of interest rate markets (for fixed an floating rate instruments as well as interest rate derivatives) who will examine the potential and pitfalls of developing such markets in Colombia.

A team of experts will examine the long-term housing finance markets to determine the impact of asset-liability mismatch and resulting disintermediation risk. They will also aid the government's efforts in creating a market in mortgage-based securities.

An expert in the relationship between financial markets and macroeconomic policy (fiscal and monetary) who will assist the government in understanding the effect of macroeconomic policies on the incentives towards increased risk taking of financial institutions.

The teams described in above will also be used to provide training in their respective areas both to financial regulators and to financial institutions.

An expert in the design of contractual savings instruments who can assist the government in the development of pension systems and other forms of institutional savings taking into account the fiscal and tributary impact of various alternatives.

A team of experts with proven experience in developing information systems and related services for contractual savings programs that will improve efficiency, safeguard information and reduce risk.

A team of experts will evaluate the regulation of the Colombia Stock Exchange and its capacity to handle the increased demands expected under the current privatization program. The study will include the identification of constraints and bottlenecks and recommend actions to be taken.

A team of experts will undertake a study of the potential role of venture capital in Colombia and, if appropriate, suggest methods to support the development of venture capital funds.

DETAILED TERMS OF REFERENCE

Detailed Terms of Reference and updated budgets for each study group will be prepared by the Executing Agency in consultation with the Bank's Project Team..

DETAILED BUDGET

		(IN US$)		
		IDB	LOCAL	TOTAL
1.	Professional Services Firms	4.822.500	-	4.822.500
	Private Investment			
	A. The labor market	150.000	-	150.000
	1.1 Fees			
	(a) Salaries	52,000	-	52,000
	- Economist (labor utilization) (4m x US$6,500)	26,000	-	26,000
	- Lawyer (labor related legislation) (4m x US$6,500)	26,000	-	26,000
	(b) Contracting and employment (2 x US$10.000)	20.000	-	20,000
	(c) Overhead (150% times salary costs) (52,000 x 150)	78,000	-	78,000
	B. Foreign Investment	340.000	-	340.000
	1.1 Fees			
	(a) Salaries	120,000	-	120,000
	- Lawyer (International Investment Statutes and Codes) (4m x US$7,500)	30,000	-	30,000
	- Investment Expert (Foreign Exchange Regime) (4m x US$7,500)	30,000	-	30,000
	- Economist (Foreign Investment Program and Promotion) (4m x US$7,500)	30,000	-	30,000
	- Economist (Investment Protection and Taxation) (4m x US$7,500)	30,000	-	30,000
	(b) Contracting and employment (4 x US$10.000)	40.000	-	40,000
	(c) Overhead (150% times salary costs) (120,000 x 150)	180,000	-	180,000

Foreign Trade Sector

A. Foreign Trade Institutions and Finance	170.000	-	170.000
1.1 Fees			
(a) Salaries	60,000	-	60,000
- Financial Expert (Medium-term strategy) (4m x US$7,500)	30,000	-	30,000
- Institutional Analyst (Medium-term strategy) (4m x US$7,500)	30,000	-	30,000
(b) Contracting and employment (2 x US$10.000)	20.000	-	20,000
(c) Overhead (150% times salary costs) (60,000 x 150)	90,000	-	90,000
B. Ports	170.000	-	170.000
1.1 Fees			
(a) Salaries	60,000	-	60,000
- Economist (Privatization ports services) (4m x US$7,500)	30,000	-	30,000
- Economist (Pricing ports services) (4m x US$7,500)	30,000	-	30,000
(b) Contracting and employment (2 x US$10.000)	20.000	-	20,000
(c) Overhead (150% times salary costs) (60,000 x 150)	90,000	-	90,000
C. Customs	2.010.000	-	2.010.000
1.1 Fees			
(a) Salaries	780,000	-	780,000
- Technical Director (Senior expert customs systems) (20m x US$7,500)	150,000	-	150,000
- System Analysts (18m x US$7,000 x 2)	252,000	-	252,000
- Expert in Technical Support, Teleprocessing and security) (18m x US$7,000)	126,000	-	126,000
- Expert in Procedural Customs Control Systems (18m x US$7.000)	126,000	-	126,000

-	Expert in Administrative Support Systems (18m x US$7,000)	126,000	-	126,000
(b)	Contracting and employment (6 x US$10.000)	60.000	-	60,000
(c)	Overhead (150% times salary costs) (780,000 x 150)	1,170,000	-	1,170,000

<u>The Financial Sector</u>

A. Credit and Banking Services		<u>497,500</u>	-	<u>497,500</u>
1.1	Fees			
(a)	Salaries	183,000	-	183,000
-	Coordinator (Senior expert in credit and Banking services) (6m x US$8.000)	48,000	-	48,000
-	Economist (Expert in credit to medium scale enterprises) (6m x US$7,500)	45,000	-	45,000
-	Financial Analyst (Long term credit instruments) (6m x US$7,500)	45,000	-	45,000
-	Economist (Expert in credit policy) (6m x US$7,500)	45,000	-	45,000
(b)	Contracting and employment (4 x US$10.000)	40.000	-	40,000
(c)	Overhead (150% times salary costs) (183,000 x 150)	274,500	-	274,500

B. Financial Markets and Macroeconomic Policy		<u>620,000</u>	-	<u>620,000</u>
1.1	Fees			
(a)	Salaries	228,000	-	228,000
-	Coordinator (Senior expert in public and financial policies) (6m x US$8.000)	48,000	-	48,000
-	Macroeconomist (Financial intermediation) (6m x US$7,500)	45,000	-	45,000
-	Investment Expert (Regulation of Stock Exchange and Privatization Programs) (6m x US$7,500)	45,000	-	45,000
-	Investment Expert (Development of Venture Capital Funds) (6m x US$7,500)	45,000	-	45,000

-	International Economics Expert (Potential pitfalls of Foreign exchange markets) (6m x US$7,500)	45,000	-	45,000
(b)	Contracting and employment (5 x US$10.000)	50.000	-	50,000
(c)	Overhead (150% times salary costs) (228,000 x 150)	342,000	-	342,000
C.	Contractual Savings Instruments	620.000	-	620.000
1.1	Fees			
(a)	Salaries	228,000	-	228,000
-	Coordinator (Senior expert in contractual savings instruments) (6m x US$8.000)	48,000	-	48,000
-	Economist (Development of Pension Systems Programs) (6m x US$7,500)	45,000	-	45,000
-	Economist (Impact of institutional savings mechanisms on fiscal and tributary policies) (6m x US$7,500)	45,000	-	45,000
-	2 System Analysts (Development of information systems for contractual savings programs) (6m x US$7,500 x 2)	90,000	-	90,000
(b)	Contracting and employment (5 x US$10.000)	50.000	-	50,000
(c)	Overhead (150% times salary costs) (228,000 x 150)	342,000	-	342,000
D.	Housing Finance Markets	245.000	-	245.000
1.1	Fees			
(a)	Salaries	86,000	-	86,000
-	Coordinator (Senior expert long-term housing financial markets) (4m x US$7,500)	30,000	-	30,000
-	Financial Expert (Market in mortgage-based securities) (4m x US$7,000)	28,000	-	28,000
-	Financial Expert (Disintermediation risks on long-run housing financial markets) (4m x US$7,000)	28,000	-	28,000
(b)	Contracting and employment (3 x US$10.000)	30.000	-	30,000

(c) Overhead (150% times salary costs) (86,000 x 150)	129,000	-	129,000
6.0 General Support	-	480,000	480,000
6.1 Premises			
6.1.2 Renting (Offices in Santa Fe de Bogota) (7 Offices x 36m x US$1,000)	-	252,000	252,000
6.3 Equipment			
6.3.2 Rent			
- Informatic Equipment	-	50,000	50,000
- Telecommunications Equipment	-	10,000	10,000
6.5 Computer Services	-	24,000	24,000
6.6 Support Personnel			
6.6.4 Temporary Secretaries (36m x US$400 x 10)	-	144,000	144,000
7.0 Publications	-	20,000	20,000
98 Contingencies	177,500	-	177,500
TOTAL	5,000,000	500,000	5,500,000

The International Investment Statute

Summary

The recognition that foreign investment is important, together with the will to liberalize the economy, guided the reform on foreign investment incorporated in Resolution 49/91 of the National Economic and Social Policy Council, CONPES.

Resolution 49 incorporates the so-called "International Investment Law" and contains reforms designed to improve flows of foreign capital. The Resolution lays down the principles for foreign investment, modes of investment and exchange rights.

The International Investment Statute was developed based on three fundamental principles which are: equal treatment for domestic and foreign investors, universality and automaticity.

The principle of equal treatment requires that neither the law nor the practice shall discriminate against foreign investment, except for limitations established in the Resolution itself. The limitations refer only to the transfer of resources abroad, i.e., exchange rights applying to foreign investment and taxation related to remittances. In all other aspects foreign investments and domestic investments receive exactly the same treatment.

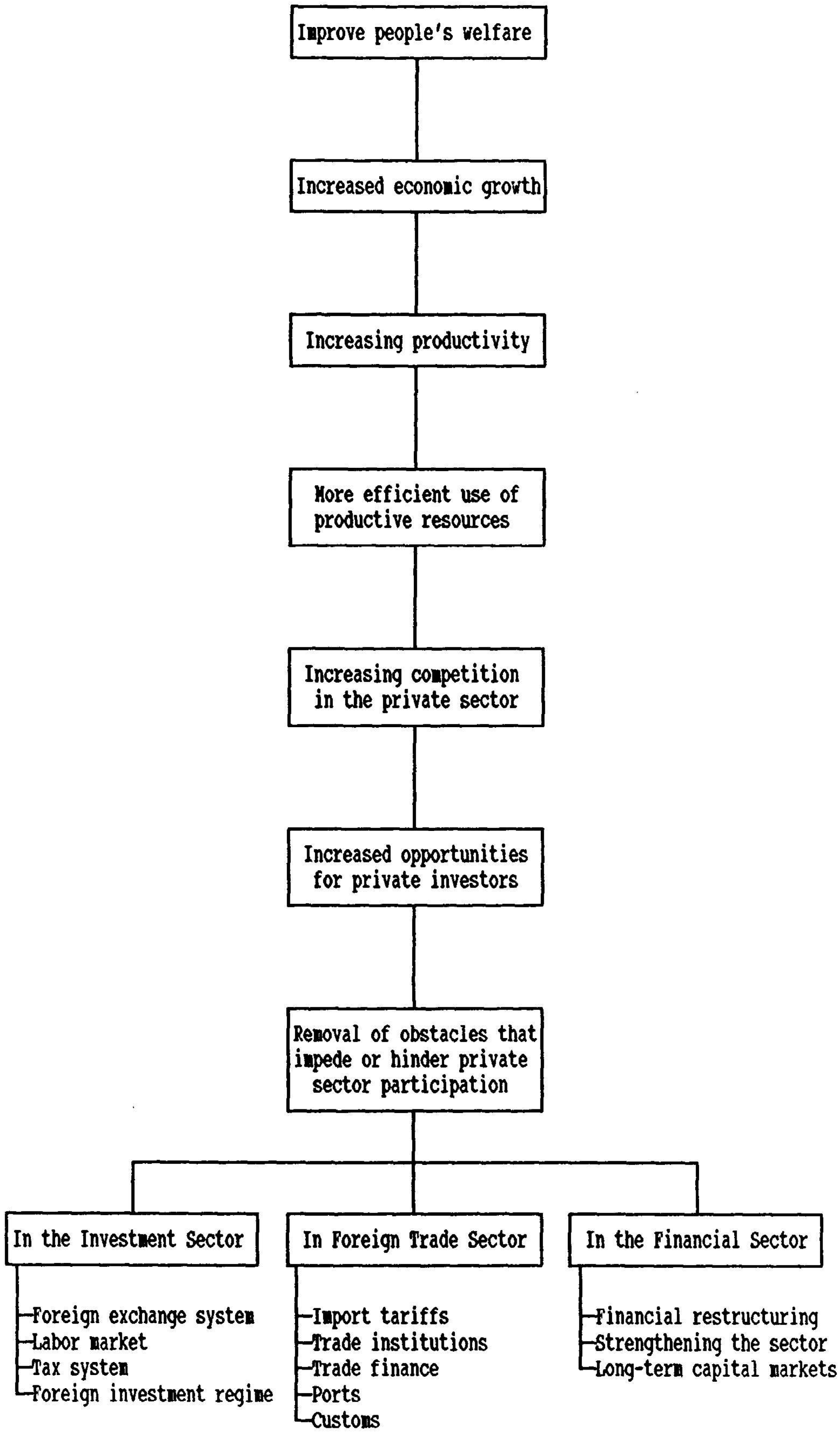
The second principle, universality, means that foreign investors can now invest in all sectors of the economy. Again, the Resolution provides for limitations, notably activities related to security and national defence and the processing and disposal of toxic, hazardous or radioactive waste not produced in Colombia. In both cases, foreign investment is banned.

Finally, the principle of automaticity is intended to bear out the concept of equal treatment and administrative efficiency. Foreign investment is now automatically approved, thus the previous authorization procedures have been abolished. The State does reserve the right by exception to evaluate and authorize foreign investment when addressed to the supply of public services or ventures insured for non-commercial risks.

In addition, there are special regulations for the financial and insurance sector, and energy and mining. For instance, companies investing in oil and natural gas are subject to special regulations on the following: (i) they are not required to sell the proceeds of exports to the Central Bank; (ii) they cannot purchase currency to remit payments for imports, service debt or any other current obligations, nor to remit profits or reimburse capital; and (iii) with prior approval from the Ministry of Mines and Energy, the Monetary Board may permit currency to be obtained to import crude oil and oil products, if it is shown that the currency obtained on domestic sales and exports are insufficient to cover the value of the importation.

Companies investing in refining, transport and distribution of oil and natural gas, and in related services, are subject to the general regulations on foreign investment with respect to obtaining currency to remit profits for up to 100 percent of the registered investment. For foreign investments in exploration, transformation and development of coal, the investor may remit the profits for each accounting period corresponding to the appropriate percentage of capital, together with cash generated by the project up to the total of foreign registered capital.

COLOMBIA: INVESTMENT SECTOR LOAN
Loan Objectives - Means to Attain Them



Colombia's Customs Information System Study

Terms of Reference

The firm will conduct an assessment of Colombia's present automated customs information system. To that effect, the consultants will:

1. travel to the U.S. ports of baltimore and New Orleans to assess the merits of the currently used information system in U.S. ports, and their applicability to the Colombian experience.

2. travel to Bogota and to the ports of Cartagena and Barranquilla in Colombia to:

    a. discuss with customs information officials to get a view of the present information system;

    b. discuss with customs-users to determine the type of information that is required in their decision-making process; and

    c. determine how the information is collected at the ports and how it is transmitted to the decision-making officials.

3. based on the information collected in Colombia, identify present constraints and suggest next steps to improve the system.

The firm will present the results of the above in a final report that is to be sent to the IDB no later than 60 days after the initiation of the assignment.

Foreign Investment Promotion Program

Action Plan Summary

First Year

Build a small staff that is bilingual or multilingual. Establish an office to assist foreign investors. Make known the existence of the organization by placing advertisements at the airport, by providing documentation to Colombian embassies, and maintaining good relations with investors already in Colombia.

All the promotion of the organization should make it clear that the goal of the organization is to be of help, not to provide another level of bureaucracy through which the investor must pass.

Although business with new investors will undoubtedly be quite slow at the outset, the organization should stand ready to provide assistance to investors. In some cases, its most useful role will be simply to explain procedures to would-be investors. In other cases, it can actually provide officials to accompany would-be investors to visit firms already in Colombia, and to introduce the investor to the relevant government agencies. Any such activities should be carefully recorded, and they should be followed up by communication with the prospective investors to find out whether other assistance is needed, or why the investor has not proceeded, if that is the case.

In this first year the new agency will demonstrate to existing investors the usefulness of the organization in solving problems that are of concern to foreign firms in Colombia, as well as try to influence policy so that it will be more attractive to firms considering investing in Colombia.

The staff should institute meetings with current investors to learn what they consider to be major barriers to foreign investment in Colombia, and to learn of problems faced by current investors where the new organization can be of assistance.

The new organization should choose a small number of problems where it might have influence in the government. It should prepare position papers on these issues, and contact the relevant ministries or agencies to try to induce the desirable changes in policy or procedures.

Effort should be spent on developing the organization in this first year. This includes selecting personnel, sending some on training programs, establishing a control and reporting system, and setting up the internal organization.

Help should be sought from inside a successful organization to cover some of the practical details. Perhaps the best source of help, and a willing source, is the Irish Industrial Development Authority.

In addition, the new organization can seek funding from external sources. USAID and the UNDP are good candidates to provide support.

Finally, the organization can begin the process of seeking out industries to target for limited investment generating activities. Probably the best way to do this at the outset is to learn more about the foreign firms that have recently invested in Colombia for export. This will probably require people from the promotion organization actually to visit the operations of the foreign investors, to determine exactly what they are doing, how the business works, why the firms came to Colombia, and what the prospects are for more such firms.

Second Year

If the study of existing export firms suggest that there are more firms in those or similar industries that could be attracted to Colombia, then the investment promotion organization should establish, on an experimental basis, an office abroad to seek out such investors. The office should be located in a country that offers the best prospects of the investors being targeted.

The agency should not devote resources to wide-scale image building until the country has re-established security.

The agency should, however, continue to improve its service activities, and its efforts to serve as a point for the development of policy toward foreign investment.

Study of Incidence of Taxation on Private Investment

Summary Terms of Reference

The objective of the study is to assess to what extent Colombia's present tax structure impacts on private investment decisions.

To that effect, the consultants will:

1. provide a detailed identification and discussion of all the taxes that a national or foreign investor has to pay.

2. provide a detailed discussion of the administrative procedures that a national or foreign investor must follow to meet its tax obligations.

3. compare Colombia's tax system with the tax regimes of countries such as Brazil, Chile, Mexico, South Korea, Indonesia, Malaysia and Thailand.

4. elicit information and comments from the national and foreign business community.

5. suggest alternatives to correct or solve the problem of tax disincentives.

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Appendix I

PROPOSED RESOLUTION [1/]

COLOMBIA. LOAN /OC-CO TO THE REPUBLIC OF COLOMBIA
(Sector Investment Program)

The Board of Executives Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized in the name and on the behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Colombia, as Borrower, for the purpose of granting it a loan to cooperate in the execution of: (a) a sector investment program, whose general framework, objectives, policies and actions, as well as the Borrower's obligation to comply therewith, are set forth in the Policy Letter sent by the Borrower to the Bank on September 23, 1991, all of which, together, are hereinafter referred to as the "Program"; and (b) a project for the importation of eligible goods, hereinafter referred to as the "Project". This financing shall be subject substantially to the following conditions:

1. Amount and Currencies: Up to US$200,000,000, or its equivalent in other currencies, except that of Colombia, which are part of the ordinary capital resources of the Bank, to pay for goods and services acquired through international competition, originating in the member countries of the Bank and for such other purposes as may be specified in the loan contract. Payments of amortization and interest shall be made in the currency or currencies specified by the Bank, in a quantity equivalent to the corresponding amount owed, calculated in units of account in terms of dollars of the United States of America, in accordance with provisions to be included in the loan contract.

2. Source of Funds: The ordinary capital resources of the Bank.

3. Guarantee: The general responsibility of the Borrower.

4. Credit Fee: 0.75% per annum on the undisbursed portion of the financing, commencing to accrue 60 days after the date of the loan

[1/] The provisions contained in this Appendix I and in Appendices II, III and IV shall be final only when the board of Executive Directors has approved the loan proposal.

contract and payable in dollars of the United States of America on the same dates as the interest.

5. Amortization: The Borrower shall amortize the loan in a period of 20 years from the date of the loan contract, by means of semiannual, consecutive and, insofar as possible, equal installments. The first installment shall be paid sixty six months after the date of the loan contract.

6. Interest: The Borrower shall pay interest semiannually on the daily outstanding balances of the loan. The first payment shall be made six months after the date of the loan contract. The Bank shall determine the rates of interest to be applied during the life of the loan, in accordance with the lending rate policy of the Bank.

7. Disbursement: The term for disbursement of the financing shall expire 18 months after the effective date of the contract. The financing shall be disbursed in two trenches, each one in the amount of up to US$100.000.000 or its equivalent in other currencies that are part of the ordinary capital resources of the Bank.

8. Special Conditions:

(a) The Borrower shall utilize the resources of the loan in the Project and the execution of the Program shall be carried out by: (i) the Ministry of Finance and Public Credit, hereinafter referred to as the "MHCP" or "Executing Agency", with respect to the execution of the Program; and (ii) the Banco de la República, hereinafter "BR", with regard to the presentation of documents and other activities in connection with the use of the resources during execution of the project. The Borrower agrees to ensure that the MHCP and the BR shall execute the Program and the Project according to the provisions of the loan contract. If modifications in the legal provisions or the basic regulations concerning the Borrower, the Executing Agency or the BR are approved which, in the opinion of the Bank, may substantially affect the Program or Project; or if the Borrower make changes to its macroeconomic policy or its policies for the sectors affected by the Program, that are inconsistent with the Program, the Bank shall have the right to require the Borrower, the Executing Agency and the BR to provide explanatory and detailed information in order to determine whether such modification or modifications have or may eventually have, a substantially adverse impact on the execution of the Program or the Project. Only after hearing and assessing the information and clarifications provided, may the Bank take such measures as it deems appropriate, in accordance with provisions to be set forth in the loan contract.

(b) Disbursement under the first and second tranche of the financing shall be subject to the Bank's satisfaction with:

(i) the progress made by the Borrower in the execution of the Program and of the related actions agreed upon; and (ii) the consistency between the macroeconomic policies and program of Colombia and the Program. To this end, the Borrower and the Bank shall meet to exchange views, at the initiative of either party, at least once every six months, on a date and at a place agreed upon. For this purpose, the Borrower undertakes to deliver to the Bank for its review and comments, prior to each meeting, a report, in such details as the Bank may reasonably require on fulfillment of the obligations mentioned in subparagraphs (i) and (ii) above. The Borrower shall submit semiannual reports, to demonstrate that the consistency referred to in subparagraph (ii) above is being maintained.

(c) The Bank shall only authorize the initiation of disbursements under the second tranche of the financing once the following conditions have been fulfilled:

(i) following the review referred to in Clause 8 (b) above, it is satisfied with: (1) the progress made by the Borrower in implementing the Program; (2) the form and substance in which the actions described in Clause 8(c) have been carried out; and (3) the consistency between the macroeconomic policy and program of Colombia and the Program; and

(ii) the Borrower has demonstrated, to the satisfaction of the Bank, that:

(1) it has initiated the implementation of an action plan based on the recommendations of the study on the incidence of taxation on private investment;

(2) the National Economic and Social Policy Council (CONPES) has reviewed the Foreign Investment Statute in order to ensure its consistency with the new Andean Pact Agreements and with the dispositions of the new foreign exchange regime, and taking in consideration observations of the private sector;

(3) satisfactory progress has been made in implementation of the Action Plan of the Foreign Investment Promotion Program;

(4) a standard agreement on foreign investment has been drawn up, wherein the mechanisms for the protection of foreign investment and for the prevention of dual taxation have been established, and the terms of such agreement have been negotiated with at least one of the countries with

which Colombia has substantial international trade;

(5) the new institutional structure of the Export Promotion Fund (PROEXPO) is operating, in accordance with the following guidelines:

(aa) that it operate as a second-tier institution;

(bb) that it gradually sell its non-financial investment holdings;

(cc) that it distinguish, countable and administratively, the banking and promotional activities;

(dd) that it conduct its banking operation in accordance with commercial principles and protection of its capital structure;

(ee) that it limit participation in the short-term credit market to the extent that private sector participation increases; and

(ff) that it design mechanisms to help solve the problems of guarantee and insurance in the sector.

(gg) that it maintain interest rates of loans granted with its own resources, at levels which reflect market conditions, the marginal cost of funds, transactions costs, and the risk levels and other factors which could be considered relevant.

(6) satisfactory progress has been made in the implementation of the program of port reform, pursuant to which:

(aa) the rate system for the operation of the various port activities has been implemented;

(bb) the methodology to determine the compensation payable to the State by establishments engaged in port operations for the use of public property has been agreed to; and

(cc) the legal framework providing for the organization of establishments engaged in port operations has been defined; and satisfactory progress has been made in the implementation of the plan to achieve active private sector participation in such establishments.

(7) satisfactory progress has been made in connection with the program for liquidation of the "Empresa Puertos de Colombia" (COLPUERTOS), to which end the following things have been established:

(aa) the compensating cost of the personnel to be dismissed;

(bb) the value of the company's assets;

(cc) the mechanisms for the transfer of the activities of COLPUERTOS; and

(dd) the schedule for implementation of the program.

(8) the implementation of the pilot project for Privatization of Port Activities Program has begun;

(9) satisfactory progress of the customs reform program has continued, for which:

(aa) an international price information system has been designed and instituted for use as a reference base for appraising the value of merchandise, for paying taxes and for settling any claims that may arise in the importation process;

(bb) a program for simplification of customs procedures has been set in operation; and

(cc) a procedure for making customs complaints has been established.

(10) the privatization process of the "Banco Ganadero" and the "Caja Agraria" has begun for which action plans have been elaborated and being implemented with the purpose to adequate those institutions to be eventually partially or totally sold.

(11) the stock shares of the Banco Ganadero that still belong to the Borrower and the non-financial

assets of the Caja Agraria have been offered for sale;

(12) a study to analyze the obstacles that restrict the access of small and medium-size companies to credit and other banking services has been concluded, with the purpose of agreeing with the Bank a plan of action to overcome those obstacles;

(13) the studies to assess the current financial situation of the retirement programs for employees in the public and private sectors has been completed, and an action plan has been drawn up, in accordance with the recommendations, for the reorganization and enhancement of current retirement programs;

(14) relevant measures have been adopted so that pension funds may be supervised by the Superintendencia Bancaria; and

(15) a proposed law has been presented to the Congress to authorize the government to reform the retirement system of the public and private employees;

(d) resources of the financing may be used to compensate the Borrower for foreign currencies expenses incurred in the acquisition of imported goods within the six months prior to the date of the loan contract, provided that requirements substantially similar to those of this resolution and of the loan contract have been fulfilled and that the amount does not exceed the equivalent of US$100,000,000.

(e) in order to utilize the resources of the financing in the acquisition of goods by either the public or private sectors, the system of international public bidding shall have been followed in each case in which the value of such acquisitions exceeds the equivalent of US$5,000,000. For lower amounts, public sector procurement shall have been carried out according to the normal procedures established by local law to the extent that they do not conflict with the Bank's procurement policies, and private sector procurement shall have been carried out following the established commercial practices applicable to the goods in question. The procurement shall be subject to the procedures to be set forth in an annex to the loan contract.

(f) the Borrower and the Bank have agreed that the substantial content of the policy letter of September 23, 1991, from the Borrower to the Bank, describing the plan of action, objectives and policies designed to achieve the objectives of the Program and which states the Borrower's commitment to the execution of

the Program and to the maintenance of macroeconomic policies described in such letter, is an integral part of the Program, for the purposes of Clause 8(b) of this Resolution.

(g) the Bank shall establish such inspection procedures at it deems necessary to assure the satisfactory development of the Program and execution of the Project, and the Borrower shall extend all cooperation which is required for the most effective accomplishment of this purpose. From the amount of the financing the sum of US$2,000,000 shall be allocated for credit to the general income accounts of the Bank to meet expenses of general inspection and supervision.

RECOMMENDATIONS:

A. It is recommended that the following conditions, to be fulfilled to the satisfaction of the Bank, be included in the loan contract in addition to the condition set forth in the proposed resolution:

1. The Borrower agrees to submit to the Bank, through the Executing Unit, with each disbursment request, a report containing such data that will enable the Bank to ascertain that the goods on which the disbursement request is based are eligible for financing under the loan. The Bank may request any additional information that may reasonably be required to carry out such verification, and the Borrower and the Executing Agency shall undertake to present it no later than 60 days after the date of the request.

2. Disbursements may not be made with the resources of the financing for the following:

   (a) imports of goods included in the categories or subcategories of the United Nations Standard International Trade Classification (SITC) as set forth in paragraph V of Appendix III;

   (b) expenses in Colombian pesos or for goods originating in Colombia;

   (c) imports of goods procured by contract or purchase order, the value of which is less than the equivalent of US$10,000;

   (d) imports of goods that have medium- or long-term financing in foreign currency;

   (e) imports of luxury goods;

   (f) imports of arms; and

   (g) imports of goods for the use of the armed forces.

3. The statements of account of the imports financed with the resources of the loan throughout the execution of the project, shall be submitted to the Bank annually, dully audited by the Contraloría General de la República, within 90 days after the close of each fiscal year the subject of auditing.

4. Technical Cooperation Agreement No. ATR/OC-   -CO shall be signed on the same date as the loan contract.

B. The loan contract shall include annexes substantially similar to Appendix III (the Program and the Project) and Appendix V (Procurement Procedure).

ANNEX A

THE PROGRAM AND THE PROJECT

I. Purpose of the Program

1.01 The object of the Program is to support the actions taken by the Government of Colombia to improve the country's foreign investment environment through the adoption of specific measures, as well as through studies and technical analysis that will lead to either the removal of obstacles or the introduction of measures that facilitate investment decisions. This Program will concentrate on actions on the private investment, external trade and the financial sectors.

II. The Project

2.01 The Project consists of the importation of eligible goods by the public and private sectors in Colombia, in accordance with the eligibility criteria for such goods set forth in Recommendation A.2 of Appendix II.

III. Financing

3.01 The Bank shall finance up to the equivalent of US$ 200,000,000 in foreign exchange to be drawn up on the ordinary capital resources. The resources shall be fast-disbursing and shall be disbursed in two trenches of up to the equivalent of US$100,000,000 each.

IV. Utilization of Resources

4.01 The loan proceeds shall be used to: (a) reimburse 100% of the foreign exchange cost of eligible imports, up to the equivalent of US$198,000,000; and (b) cover the cost of general inspection and supervision, up to the equivalent of US$2,000,000.

V. Negative List

5.01 The goods referred to in Recommendation 2 (a), of Appendix II, are those included in the following groups or subgroups of the United Nations Standard International Trade Classification (SITC),[1] including any

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[1] See the United Nations Standard International Trade Classification, revision 3 (SITC, Rev. 3), published by the United Nations in Statistical Papers, Series M, No. 34/Rev. 3 (1986)

amendment that may be made to such groups and subgroups of which the Bank shall advise the Borrower:

Groups	Subgroups	Description of Item
112		Alcoholic beverages
121		Tobacco, unmanufactured; Tobacco refuse;
122		Tobacco, manufactured (whether or not containing tobacco substitutes);
525		Radioactive and associated materials;
667		Pearls, precious and semiprecious stones, worked or unworked;
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), non-irradiated for nuclear reactors;
897	897.3	Jewelry of gold, silver, or platinum group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems);
971		Gold, nonmonetary (excluding gold ores and concentrates)

VI. <u>Procurement</u>

6.01 The procurement of eligible imported goods shall have carried out in a manner that allows the free competition of goods originating in the member countries of the Bank. Accordingly, no conditions shall be imposed in the acquisition procedures or bidding conditions that might limit or restrict the offer of goods from those countries.

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Appendix IV

PROPOSED RESOLUTION

COLOMBIA. REIMBURSABLE TECHNICAL COOPERATION FOR THE STUDIES UNDER THE SECTOR INVESTMENT PROGRAM

The Board of Executive Directors

RESOLVES:

1. That the President of the Bank, or such representative as he shall designate, is authorized in the name and on the behalf of the Bank, to enter into such agreement or agreements as may be necessary with the Government of the Republic of Colombia, and to adopt other relevant measures as may be pertinent for the execution of the plan of operations referred to in Annex IV of Document No.   , for the preparation of studies regarded as essential for the execution of the Sector Investment Program.

2. That up to the sum of US$5,000,000 or its equivalent, is authorized for the purpose of this resolution, chargeable to the ordinary capital of the Bank.

3. That the above mentioned amount is to be provided on a reimbursable basis, and in accordance with conditions set forth in Annex IV of document No. _______ which shall be included in the loan contract.

TENDER PROCEDURES FOR SECTOR ADJUSTMENT OPERATIONS

(Sector Investment Program)

I. APPLICABILITY

1.01 This procedure shall govern all procurement of eligible goods connected with the "Project," whether carried out by the public or private sector. Procurement shall only be for goods imported from member countries of the Bank, as stipulated in paragraph 2.01(b).

II. PUBLIC SECTOR PROCUREMENT AMOUNT ABOVE THRESHOLD

2.01 The procurement of goods carried out by public sector entities [1] (hereinafter referred to as "tendering entity") in amounts greater than the equivalent of US$5 million, must comply with the following requirements in order to be eligible for disbursements under the sector adjustment programs:

(a) International public bidding

The system of international public bidding shall be used. The procedures and specific requirements for the bidding shall permit the unrestricted competition of bidders from the member countries of the Bank. Consequently, no conditions that would limit or restrict the offer of goods or the participation of bidders from such countries may be imposed.

(b) Origin of goods

Only imported goods from member countries of the Bank will be eligible. The origin of a good shall be:

(i) the country in which the material and/or equipment has been mined, grown, produced, manufactured or processed; and

(ii) the country in which, through manufacturing, processing or assembly, another commercially recognized article results which differs substantially in its basic characteristics from any of its imported components. The nationality or

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[1]This sector includes enterprises or other institutions in which state participation is greater than 50% of the capital.

country of origin of the firm producing or selling the goods or equipment shall not be considered in determining the origin of such goods.

(c) Notices of the call to bid and invitations to bid

Calls to bid published in the press must specify, at a minimum, the following information:

(i) exact description of the goods for which the call for bids is being held;

(ii) the office or place, date and time at which the bidding documents, including the bidding guidelines, plans, specifications, and draft contracts may be obtained;

(iii) the office where the bids are to be delivered and the authority responsible for their approval and award; and

(iv) the place, date and time at which the bids will be opened in the presence of the bidders or their representatives.

(d) Publicity

The call for bids shall be:

(i) published in at least one of the most widely circulated newspapers in the country on at least three separate occasions. There must be a space of at least three calendar days between each of the three public notices; and

(ii) published in a journal or specialized newspaper with wide international circulation; or in the United Nations journal entitled Development Business; or distributed to the embassies of the member countries. To that effect, the tendering entity shall deliver copies of the invitation to bid on the same date as the invitation is delivered to the national newspapers for publication. If there are no embassies, it shall be delivered to the respective consulates.

(e) Clarity of the documents

The bidding documents prepared by the tendering entity must be coherent and comprehensive. Particular care must be taken to ensure that the goods to be supplied are described with sufficient clarity and in sufficient detail. The cost of such documents must be reasonable.

(f) Free access to the tendering entity

The tendering entity shall be available, once the bidding documents have been collected by bidders and up to the time the bids are opened, to answer questions or clarify the bid documents for bidders. These inquiries shall be answered promptly by the tendering entity, and clarifications, if any, made available to other interested parties.

(g) Standards of quality

If particular standards with which equipment or materials must comply are cited, the specifications should state that goods meeting other authoritative standards, which ensure an equal or higher quality than the standards mentioned, will also be accepted.

(h) Specifications for equipment: brand names

Descriptions contained in specifications should not prescribe brand names, catalog numbers or types of equipment of a specific manufacturer unless it has been determined that this is necessary to ensure inclusion of certain essential design, performance or construction features. In such a case the reference should be followed by the words "or equivalent," and a measure to determine the "equivalence" included. The specifications should permit offers of alternate equipment, articles or materials which would have similar characteristics and provide equal performance and quality to those specified. In special cases with previous approval of the Bank, specifications may require that a proprietary item be supplied.

(i) Currency Clause

The bidding documents should state the currency to be used in payment.

(j) Bid bonds

Bid bonds or other tender guarantees, if any, should not be set so high [2] or their validity stretched out over long periods, as to discourage suitable bidders from tendering. Bid bonds shall be returned as follows:

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[2]Some bidding practices limit the amount of the bid bonds (tender guarantees) to 1% of the price of the contract. Others recommend that the agencies calling for bids set a fixed price in cash for all bidders instead of requiring the bidder to base his guarantee on a given percentage of the value of his bid. This is to avoid undue publicity of the price of each tender prior to the opening of the bids, should the amount of the guarantee or bid bond become public knowledge.

(i) to the winning party once the contract is executed;

(ii) to the second- and third-place bidders within a term of no more than three months from the date of the award or upon execution of the contract, if the latter occurs prior to such deadline. Nevertheless, if such bidders indicate lack of interest, the bond shall be returned within five days following the award;

(iii) to other bidders within five days following the award.

(k) Deadlines for submission of bids

The deadline for submitting bids shall not be less than 45 calendar days from the date of the last publication of the invitation to bid or the date of availability of bidding documents, whichever is later.

(l) Confidentiality of bids

The officers in charge of receiving the envelopes containing bid registration forms shall verify that such envelopes are delivered properly sealed. These envelopes shall be kept in a safe place until the date set for their opening. Once opened, no copies shall be taken of these documents. Except as may be required by law, information relating to the examination, tabulation, clarification and evaluation of bids and recommendations concerning awards, may only be communicated to officials of the tendering entity officially concerned with the respective bidding procedures, after the public opening of bids and before the announcement of the award of contract to the successful bidder.

(m) Modification or extension of the bidding documents

Any modification or extension of the bidding guidelines, specifications, or the filing date must be communicated to all interested parties who are in possession of the bidding documents. In the event that such modification or extension is substantial, in the opinion of the tendering entity, there must be an interval of at least 30 calendar days between the date of notice to interested parties and the date bids are opened.

(n) Consultations should not modify the bidding documents

Consultations on the interpretation of bidding documents addressed to the tendering entity by interested parties may not be used to modify or expand the bidding guidelines and specifications. Consultations and replies thereto shall in no case cause a suspension of the term for presentation of bids.

(o) Opening of bids

Offers shall be submitted in writing in sealed envelopes. They must be signed by the legal representatives of the bidders and comply with the prerequisites set forth in the bidding documents. They shall be opened in public on the scheduled date and hour. Representatives of the bidders may attend the bid opening and shall be entitled to inspect the bids. Bids received after the filing date shall be returned unopened. The names of the bidders, the price of each bid, the term and amount of guarantees, and any substantial change submitted separately, before the deadline but after the principal bid is submitted, shall be read aloud. All of the above shall be recorded in the proceedings, which shall be signed by the representative of the tendering entity and by any bidders present who so desire.

(p) Clarification of bids

The tendering entity may request clarifications from the bidders with respect to their tenders. Clarifications requested or given shall not alter the essence of the offer or its price, nor shall they violate the principal bidder equality.

(q) Analysis and comparison of bids

(i) Purpose

Bids shall be analyzed and evaluated to determine whether they comply with the terms and conditions stipulated in the bidding documents, and the value of each bid shall be fixed for the purpose of awarding the winning bid.

(ii) Lowest evaluated bid

In addition to the bid price adjusted to correct arithmetical errors, the tendering entity may also consider other relevant factors in determining the lowest bid.

(iii) These factors should be expressed in monetary terms or, as a minimum, given a relative weight according to criteria specified in the bidding documents. No criteria may be used in bid evaluation that are not set forth in the bidding documents. The amount of escalation for price adjustments, if any, included in the bids should not be taken into consideration.

(iv) The currency or currencies in which the price offered in each bid would be paid if that bid were accepted, should be valued in terms of a single currency selected by the tendering entity for comparison of all bids and stated in the bidding documents. The rates of exchange to be used in such valuation should be the selling rates published by an

official source, and applicable to similar transactions on the day bids are opened or at such later date (30 or 60 days after bid opening) as shall be specified in the call for bids.

(v) Regional margin of preference

The following regional margin of preference may be applied in the comparison of bids:

Where suppliers of a country (other than the country of the borrower) that is a party to an integration agreement, [3] to which the country of the borrower is also a party, participate in such bidding, such suppliers of goods are entitled to a regional margin of preference utilizing the following criteria:

(1) Goods shall be considered to be of regional origin if they originate in countries that are parties to an integration agreement to which the borrower is also a party and comply with the standards governing origin and other matters relating to trade liberalization programs established in the respective agreements;

(2) The value added is not less than that stipulated for the national margin of preference; and

(3) In comparing foreign offers the borrower may add to the price offered for goods originating in countries not parties to the respective integration agreement, either 15% or the difference between the import duty applicable to such goods when they originate in countries not parties to the integration agreement and that which is applicable to those goods when they originate in countries which are parties to the agreement, whichever is lower.

(vi) Rejection of bids

The tendering entity shall reject all bids where no bids meet the intent of the specifications, or where there is evidence of lack of competition and/or collusion. The tendering entity may reject all bids if the low bids exceed

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[3]For purposes of this provision, the Bank recognizes the following regional or subregional integration agreements: (i) Central American Common Market; (ii) Caribbean Community; (iii) Cartagena Agreement; and (iv) Latin American Integration Association. If the country where the borrower is located has signed more than one integration agreement, either the subregional margin of preference or the regional margin of preference may apply depending on the country of origin of the article to be procured.

the official estimate by an amount sufficient to provide reasonable justification for such action. In such cases, new bids should be requested from at least all who where invited to submit bids in the first instance and a reasonable amount of time should be allowed for the submission of the new bids. In the absence of a 100% performance bond, individual bids may be rejected in cases where the particular bid is so much lower than the official estimate that it is reasonable to conclude that the bidder will not be able to complete the works or supply the product within the specified time at the price offered.

(vii) Bid evaluation report

The tendering entity shall prepare a detailed report on the analysis and comparison of bids, describing precisely the reasons for selection of the lowest evaluated bid.

(r) Award of contract

The award shall be made to the bidder whose responsive bid has been determined to be the lowest evaluated bid.

(s) Notification of award and signature of the contract

The tendering entity shall notify all bidders of the award at the addresses they have provided within three working days after the date of the award. The contract to be signed shall not modify the winning bid or the terms and conditions stipulated in the bidding documents.

(t) Modification of the award

If for any reason the winning bidder does not sign the contract within the period set for that purpose, the tendering entity may award it, without a new invitation to bid, to the next lowest responsive bidder.

(u) Bidding declared null and void

The tendering entity may, on reasonable grounds, declare the bidding null and void.

(v) Effects of the declaration

Once the bidding is declared null and void, the tendering entity shall issue a second invitation to bid following the provisions set forth in this procedure. If the second bidding is declared null and void, the tendering entity shall establish the procedure to be followed for the procurement involved.

(w) Due process

This procurement procedure must guarantee the legal protection of bidders, establishing the right of administrative and judicial review.

III. PUBLIC SECTOR PROCUREMENT AMOUNTS BELOW THRESHOLD

3.01 The procurement of goods carried out by the public sector in amounts less than the equivalent of US$5 million, must comply with the following requirements in order to be eligible for disbursement under sector adjustment programs:

(a) It must be carried out in accordance with the procedures prescribed under local law.

(b) When such procedures require public bidding, the latter must be acceptable to the Bank, and must therefore satisfy the general principles and provide the guarantees established under Chapter II of this Procedure.

IV. PRIVATE SECTOR PROCUREMENT

4.01 In order to be eligible for disbursement, the procurement of goods by the private sector:

(a) for contracts whose amounts are above US$5,000,000, public international bidding shall be required pursuant to the terms specified in Section 2.01 of these procedures; and

(b) for contracts whose amounts are less than US$5,000,000, purchases shall be made following established commercial practices.

V. SUPERVISION BY THE BANK

5.01 The Bank reserves the right to conduct ex post supervision of the different stages and documents of each procurement connected with the Project, after the contract has been signed with the respective winning bidder. For this purpose, the borrower agrees to provide the Bank with all the documentation it may require regarding the procurement to be supervised. The Bank reserves the right not to make disbursements for goods which have been procured without complying with the regulations prescribed in this Procedure.

VI. REIMBURSABLE IMPORTS

6.01 In order to be eligible for disbursement under the project, all procurement of goods must:

(a) have been carried out according to the regulations of this Procedure; and

(b) have been carried out for goods not included in the categories of goods whose import the borrower and the Bank have agreed to exclude from the financing, as stipulated in Annex A of this Contract.

ANNEX C

SELECTION AND CONTRACTING OF CONSULTING FIRMS AND/OR INDIVIDUAL EXPERTS

In the selection and contracting of consulting firms, specialized institutions and/or individual experts (hereinafter referred to without distinction as "Consultants") necessary for the execution of the Programme, the following shall be applicable:

I. DEFINITIONS

The following definitions are established:

1.01 A consulting firm is any legally constituted association, composed primarily of professional personnel, for the purpose of offering consulting services, technical advice, expert opinions, and professional services of other kinds.

1.02 A specialized institution is a non-profit organization such as a university, foundation, autonomous or semiautonomous organization or an international organization which offer consulting services. For the purpose of this Annex, the same rules shall apply to specialized institutions as to consulting firms.

1.03 An individual expert is any professional or technician specialized in some form of science, art or craft.

II. CONFLICTS OF INTEREST

2.01 The resources of the Bank shall not be used to contract Consultants from the country of the Borrower if: (i) they are part of the regular or temporary staff of the State or of the institution which receives the Financing, or if such institutions are to be the beneficiaries of the services to be provided by the experts; or (ii) they have pertained to such entities within the six months prior to one of the following dates: (a) that of the presentation of the application; or (b) that of the selection of the individual expert, unless the Bank agrees to reduce that period.

2.02 A fully-qualified professional services firm which is a subsidiary or affiliate of a construction contractor, equipment supplier or holding company normally will be considered acceptable only if it agrees in writing to limit its role to the provision of professional consulting services and agrees in the contract to disqualify itself and its associates from any construction work, material or equipment supply or financial participation in the same Programme.

III. ELIGIBILITY AND NATIONALITY REQUIREMENTS

3.01 The Borrower shall not establish in the implementation of the procedures set forth in this Annex, provisions or conditions which may restrict or impede the participation of Consultants from member countries of the Bank.

3.02 Only Consultants who are nationals of countries that are members of the Bank may be contracted. To determine the nationality of a consulting firm the following criteria shall be considered:

(a) The country in which the firm is duly established or legally organized.

(b) The country in which the firm maintains its principal place of business.

(c) The nationality of any firms or the citizenship or the bona fide residency of individuals possessing ownership, with the right to participate in profits, of more than 50% of the consulting firm, as established by the certification of a duly authorized officer of such firm.

(d) The existence of arrangements whereby a substantial portion of the profits or other tangible benefits of the firm accrues to firms or individuals of a given nationality.

(e) A determination by the Bank that the firm constitutes an integral part of the economy of a country, as evidenced by bona fide residency in the country of a substantial portion of the executive, professional and technical personnel of the firm, and that the firm has available in the country the operating equipment or other elements necessary to provide the services to be contracted.

3.03 The nationality requirements established by the Bank shall also be applicable to firms proposed to provide part of the respective services in joint venture with or under sub-contract to a qualified consulting firm which itself meets the nationality requirements.

3.04 The nationality of an individual expert shall be established by means of the individual's passport or other official document of identity. The Bank, however, may allow exceptions to this rule in those cases in which the individual expert, not being eligible by reason of nationality: (i) has established his domicile in an eligible country, is legally entitled to work there (as other than an international civil servant) and has no known intention of returning to his country of origin in the immediate future; or (ii) has established permanent domicile in an eligible country and has resided therein for at least five years.

IV. PROFESSIONAL QUALIFICATIONS

4.01 An analysis of the professional qualifications of a consulting firm for a specific project will take cognizance of the firm's: (i) experience and that of its principals in providing successful consulting services for

projects of a comparable size, complexity and technical specialty as those of the task involved; (ii) assigned number of professionally qualified personnel; (iii) previous experience in the region and in foreign areas; (iv) language capability; (v) financial capacity; (vi) present work load; (vii) ability to organize sufficient personnel to do the work within the required time; (viii) high ethical and professional reputation, and (ix) position being completely free from any potential conflict of interest.

V. PROCEDURES FOR SELECTION AND CONTRACTING

A. Selection and Contracting of Consulting Firms

5.01 In the selection and contracting of consulting firms:

(a) Prior to the selection of the firm, the Borrower shall submit the following for the agreement of the Bank:

(i) The procedure to be used in the selection and contracting of the firm, including:

(A) the role of the Executing Agency Staff or the Selection Committee designated to:

1. review and approve documents;
2. select a short list of firms;
3. determine the order of merit of the short listed firms; and
4. approve the firm finally selected.

The entity contracting the Consultants shall furnish the Bank with the names and positions of the people it chooses to participate in the preselection and selection processes.

(B) the specific points system to be used in preselecting the firms. This system shall include, as a minimum, the following aspects:

1. general background of the firm;
2. similar work done;
3. prior experience in the country where services are to be rendered, or in similar countries;
4. general knowledge of local language; and
5. the utilization of local consultants.

(C) the specific point system to be used as selection criteria. This system shall include at least the following factors:

1. qualifications and experience of personnel to be assigned;
2. evaluation methodology (where applicable);
3. proposed method of implementation;
4. execution schedule;
5. language proficiency; and

6. management support systems to assure quality control during execution of the consulting services (regular reports, budget controls, etc.).

(D) the specific local laws, taxation requirements and procedures which may be relevant to the selection and contracting of the consultant firm.

(E) if it is estimated that the cost of the services will exceed two hundred thousand United States dollars (US$200,000) or its equivalent, calculated in accordance with the provision of Article 3.05(a) of the General Conditions, the selection and contracting shall be advertised in the Development Business of the United Nations and in the national press. These announcements should state the intention of contracting professional consulting services along with a brief description of the services required and inviting interested firms and consortia to apply and to furnish detailed information regarding their technical ability, prior experience with similar work, etc. within 30 days of the date of publication. This announcement should also advise interested firms and consortia of the requirement of maintaining an updated DACON registration form with the Bank and of submitting a copy of this form to the contracting entity with their statement of interest. A copy of the announcements shall be sent to each embassy of the member countries of the Bank accredited in the country. Clippings of these advertisements shall be sent to the Bank specifying the date and the name of the publication in which they have appeared;

(ii) The terms of reference (specifications) describing the work to be done by the firm, together with an estimate of the cost; and

(iii) A list of at least three and no more than six firms from which proposals for the work would be invited.

(b) Once the Bank has approved the foregoing requirements, the approved firms shall be invited to present proposals in conformity with the procedures and terms of reference approved. The approved firms shall be informed regarding the specific selection procedure and evaluation criteria adopted, specific local laws, taxation requirements and procedures relevant to the selection of consulting firms as well as the names of the other firms invited to present proposals.

(c) In the invitations to present proposals the use of one or the other of the following procedures shall be specified, as appropriate:

(i) If the first procedure is utilized, a single sealed envelope including only the technical proposal, without a price quotation, shall be used. The Borrower shall examine the proposals received and establish their order of merit. If the

complexity of the case so requires, the Borrower may resort, with the prior approval of the Bank and at its own expense, to the use of consulting services to review the proposals and provide technical and expert advice in establishing the order of merit.

Once an order of merit has been established among the firms, the firm listed as first shall be invited to negotiate a contract. During these negotiations the details of the terms of reference shall be reviewed completely to assure full and mutual understanding with the firm; the contractual and legal requirements of the agreement shall be reviewed; and finally, detailed costs shall be developed. If agreement cannot be reached with the firm on the terms of the contract, it shall be notified in writing that its proposal has been rejected and negotiations shall be initiated with the second firm and so on until a satisfactory agreement has been reached;

(ii) If the second procedure is utilized, two sealed envelopes shall be used for presenting proposals, the first containing the technical proposal exclusive of costs and the second containing the proposed costs for the services.

The Borrower shall analyze the technical proposal and establish their order of merit. Contract negotiations shall commence with the firm offering the best technical proposal. The second envelope presented by this firm shall be opened in the presence of one or more of its representatives and shall be utilized in the contract negotiations. All the second envelopes presented by the other firms shall remain sealed and, if an agreement is reached with the first firm, they shall be returned unopened to the respective firms. If an agreement on the terms of the contract is not reached with the first firm, it shall be notified in writing of its rejection and negotiations shall be initiated with the second firm and so on until a satisfactory agreement is reached.

(iii) Inability to agree on detailed costs or compensation for services or a judgment on the part of the Borrower that such costs or compensation are inappropriate or excessive, shall be sufficient cause for the rejection of the proposal and for the initiation of negotiations with the firm which follows in the order of merit. Once a firm has been rejected it shall not be recalled for further negotiations on such contract.

(d) Before initiating negotiations with a firm based on the order of merit, the Borrower shall provide the Bank with a copy of the report summarizing the evaluation of technical proposals submitted by the short listed firms identified in Section 5.01(a)(iii) of this Annex.

(e) The final draft of the contract negotiated with the consulting firm shall be submitted for the approval of the Bank by the Borrower before the contract is signed. A true copy of the text, as signed, shall be promptly sent to the Bank.

B. Selection and Contracting of Individual Experts

5.02 In the case of the selection and contracting of individual experts:

(a) Before the selection of the experts, the Borrower shall submit the following for the consideration of the Bank:

(i) The selection procedure;

(ii) the terms of reference (specifications) and the schedule of the services to be performed in the respective study;

(iii) the names of the experts tentatively selected, setting forth in detail their nationality, domicile, background, professional experience and knowledge of languages; and

(iv) the form of contract to be used in retaining the experts.

(b) Once the Borrower and the Bank have approved the foregoing requirements, the Borrower shall proceed to contract the experts. The contract to be entered into with each of them shall be consistent with the form of contract which the Bank and the Borrower shall have agreed upon. A true copy of the signed text of each contract shall be sent promptly to the Bank.

5.03 Notwithstanding paragraphs 5.01 and 5.02 above and at the request of the Borrower, the Bank may assist in the selection and contracting of the Consultants as well as in drafting the pertinent contracts. It is understood however, that the final negotiation and signing of such contracts, under terms and conditions acceptable to the Bank, shall be the sole responsibility of the Borrower and that the Bank assumes no commitment on this matter.

VI. CURRENCIES OF PAYMENT TO CONSULTANTS

6.01 The following provisions are established with respect to the currencies with which the Consultants shall be paid:

(a) Payments to Consulting Firms: Contracts entered into with consulting firms shall reflect one of the following formulations, as the case may be:

(i) If the consulting firm is domiciled in the country in which it is to perform the services, its compensation shall be paid exclusively in the currency of that country, except for expenses incurred in foreign exchange for foreign travel or per diem expenses abroad which shall be reimbursed in dollars, or its equivalent in other currencies that form part of the Financing, except that of the country wherein the study is made;

(ii) if the consulting firm is not domiciled in the country in which it is to perform the services, the highest possible

percentage of its compensation shall be paid in the currency of such country and the rest in dollars or the equivalent in other currencies that form part of the Financing, except that of such country, with the understanding that the part corresponding to per diem expenses shall be paid in the currency of the country or countries in which the respective services are to be performed. In the event that the percentage to be paid in the currency of the country in which the services are to be performed is less than 30% of the total compensation of the consulting firm, a complete and detailed justification shall be submitted to the Bank for its examination and comments;

(iii) in the case of a consortium composed of firms domiciled in the respective country and firms not domiciled therein, the part of the compensation which corresponds to each of the members shall be paid in accordance with paragraphs (i) and (ii) above, as pertinent; and

(iv) the provisions of Article 3.05(a) of the General Conditions shall apply with respect to the rate of exchange.

(b) Payments to Individual Experts:

(i) If the expert is domiciled in the country in which his/her services are to be performed, his/her honoraria shall be paid exclusively in the currency of that country;

(ii) if the expert is not domiciled in the country in which his/her services are to be performed and is hired to work for less than six months, his/her honoraria and per diem shall be paid totally in United States of America dollars;

(iii) if the expert is not domiciled in the country in which his/her services are to be performed and is hired to work six or more months, his/her honoraria and post adjustment shall be paid in the following manner: (1) 40% in the currency of that country; and (2) 60% in United States of America dollars. Per diem, installation and change of residence allowances and withholding of compensation when applicable, shall also be paid in United States of America dollars;

(iv) fixed lump sum compensation for services, including honoraria, transportation tickets and per diem, may be paid in United States dollars; and

(v) the provisions of Article 3.05(a) of the General Conditions shall apply with respect to the rate of exchange.

VII. RECOMMENDATIONS OF CONSULTANTS

7.01 It is understood that the opinions and recommendations of the Consultants obligate neither the Borrower nor the Bank, and that they reserve the

right to put forward such observations or exceptions as they deem appropriate.

VIII. SCOPE OF COMMITMENT OF THE BANK

8.01 It is agreed that the Bank assumes no commitment to finance all or part of any programme or project which, directly or indirectly, might result from the services performed by the Consultants.

IX. SPECIAL CONDITIONS AND REQUIREMENTS

9.01 The final payment for services to the Consultants shall be contingent upon prior acceptance by the Borrower and the Bank of the Consultant's final report. Such payment shall consist of not less than 10% of the total amount to be paid to the Consultants in the accordance with their respective contracts.