

**Fundación para la Educación Superior y el Desarrollo  
(Fedesarrollo)  
and  
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**THE COLOMBIAN ECONOMY:  
RECENT PERFORMANCE AND PERSPECTIVES**

**A report prepared for the Third Japan – Colombia Economic  
Conference**

**Santafé de Bogotá, Colombia – September , 1997**

## 1. Introduction

This report on the Colombian economy has been prepared by Fedesarrollo for the Third Japan-Colombia Economic Conference, to be held in Tokyo in September 3 - 5, 1997. A previous study was prepared for the second conference held in March, 1995, which gave an overview of the structural characteristics of the Colombian economy, and its recent reforms and performance. Therefore, this report pays special attention to the most recent developments, especially those corresponding to the period 1994-1997. After this brief introduction, the second section of the report examines the recent performance of the Colombian economy and its perspectives. The third section reviews the recent structural reforms undertaken to foster economic growth, while the fourth presents some of the most important investment opportunities that currently offers the Colombian economy. The fifth section is devoted to a brief analysis of the main issues of the presidential election and the top agenda of the next administration.

## 2. Economic Performance and Perspectives

### 2.1 Recent Economic Trends

#### *Growth*

- Economic growth was on average 5% during the 1950-1979 period (with a slight acceleration). However, it slowed drastically during the eighties to 3.8% per year, calling for a change in the development model.
- Structural reforms undertaken in the late 80s and early 90s resulted in an acceleration of growth rates. While the GDP average rate of growth in the 80s was 3.5%, it increased to 4.4% between 1990 and 1995.
- However, this trend was reversed in 1996 by a number of factors, such as the increase in real interest rates, the appreciation of the Colombian currency, Venezuela's economic crisis, and the deepening of the domestic political crisis. Thus, GDP growth dropped to 2.1% in 1996, and is expected to be 2.3% in 1997.

#### *Inflation*

- Inflation rates doubled during the early seventies, moving from a single digit level to an average of 23% since 1970.
- In 1990 inflation peaked (32%), making more evident the need for central bank independence, which was included in the new Constitution of 1991.
- The result in this front has been extremely modest. Inflation in 1996 was 19.5%, 2.5 points above the 17% target for the year. The target for 1997 was set at 18%, however, inflation is expected to reach 19.2% at year-end.

#### *Current Account*

- Colombia has not suffered large current account deficits in the past forty years, with the exception of a few isolated episodes.
- Colombia's foreign trade balance shifted from a relatively large surplus in the early 90s to a situation of increasing deficits (current account deficit in 1995 and 1996 were 5.3%

and 5.6% of GDP, respectively). This reversion is due mainly to a significant increase of Colombian imports since 1993, which resulted from the acceleration of trade liberalization.

The current account deficit for 1997 has been estimated at 4.4% of GDP. However, this deficit is expected to show a decreasing tendency for the next three years.

#### *Investment*

- During the 80s both private and public investment rates declined, so that the total investment rate rapidly deteriorated from 20.5% in 1982 to 15.8 in 1991.
- Since 1991 capital formation rates increased at spectacular rates (total investment averaged a real growth rate of 16.5% between 1990 and 1994, while private investment rates grew 20.4% a year).
- The trend towards the increase of private investment reverted in 1996 as a result of extremely high interest rates, as well as the uncertainty generated by political events. Private investment decreased by 5% in 1996.

#### *Savings*

- Private saving rates were outstandingly stable for 25 years (between 1972 and 1990 private saving fluctuated between 13% and 15% of GDP).
- In 1990 private saving began a process of rapid deterioration that resulted in private savings rates of around 8% in 1993 and 1994. Yet, since 1995 there has been a recovery in private savings.

## **2.2 Economic Policy**

This section reviews the main policies implemented in the 1995-1997 period. We start by discussing monetary and exchange rate policies, which are controlled by the Central Bank. Then we move into fiscal and foreign trade policy, which is in the realm of the Government.

### **2.2.1 Monetary Policy**

During 1994 capital inflows forced exchange rate intervention by the Central Bank, leading to a much higher growth of M1 than initially expected by the monetary authorities. While nominal devaluation was 3.2% in 1994, growth of M1 was 26.3% (or 32.6% on a 12-month average basis). M1 grew above 30% during the first half of 1994, as the Central Bank was reluctant to carry out more active open market operations, trying to avoid generating further pressure on interest rates and exacerbating capital inflows. Beginning in March 1994 the Central Bank tried briefly to control credit by administrative means. However, the control was offset by a more rapid credit growth allowed on the basis of approved loan applications. The credit controls were lifted in early July.

In the second half of 1994, the authorities raised interest rates on open market bills by 8 percentage points and, in an effort to limit the impact of higher domestic interest rates on capital inflows, the Central Bank intensified restrictions on foreign

borrowing. There was some deceleration of monetary aggregates in the second semester of 1994, but by November, growth of M1 continued to exceed the target range.

At the beginning of 1995, the Central Bank announced that it would limit growth of M1 to 24.5%. At the time, the target seemed easily attainable given that capital inflows were expected to decrease due to the Mexican crisis. However, throughout 1995, growth of M1 averaged 14%, below the lower level of the monetary corridor.

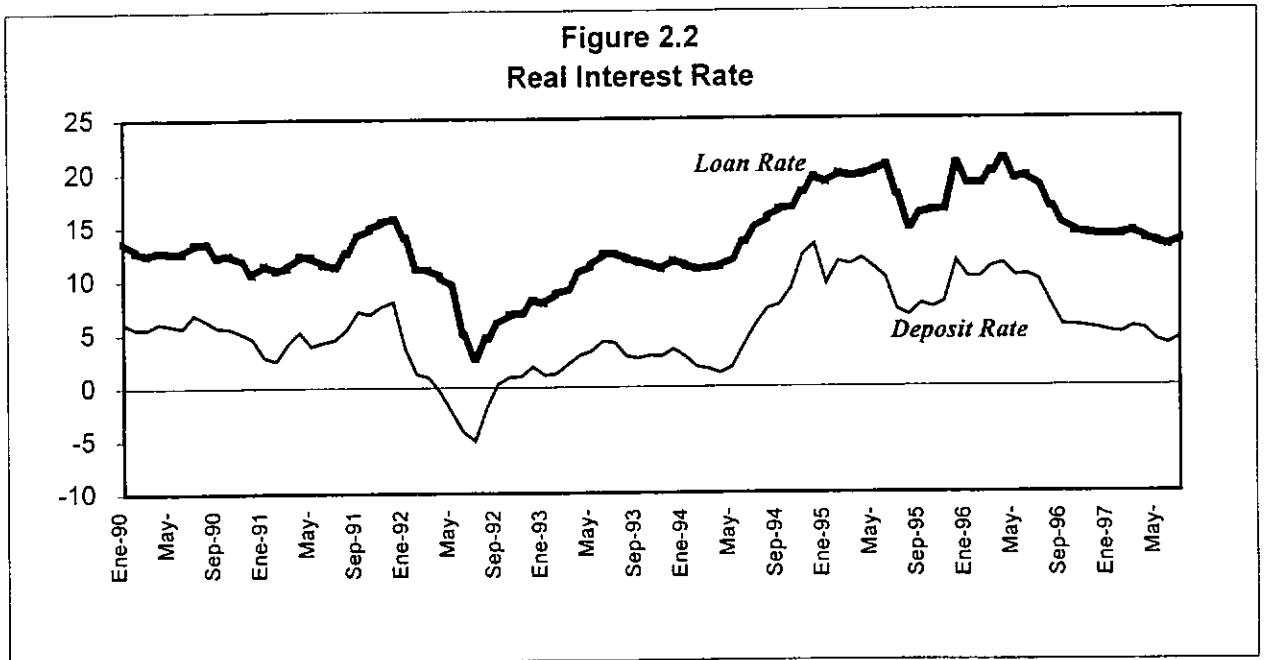
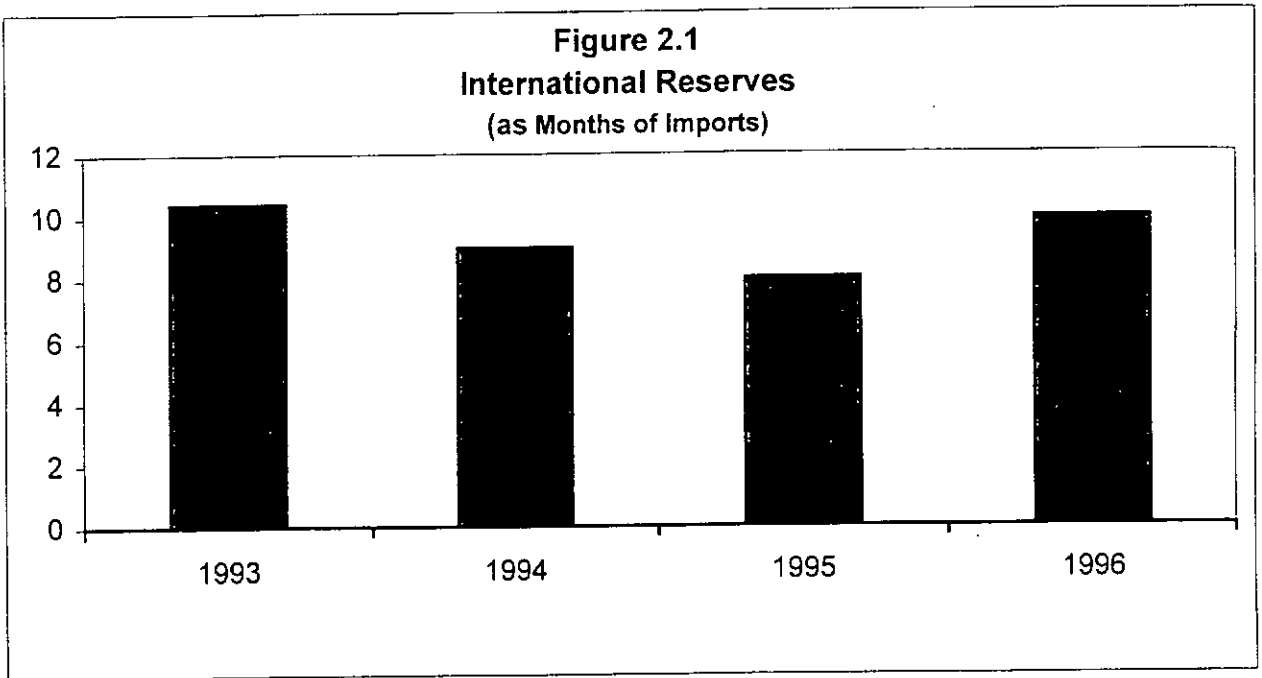
In the first semester of 1996 restrictive monetary policy not only continued, but also was intensified in an effort to offset speculative attacks against the currency derived from the political crisis. Tight monetary policy was made extensive to all monetary aggregates that registered very low growth rates throughout most of the year. However, raising capital inflows during December, which led to the intervention of the Central Bank in the foreign exchange market in order to support the foreign exchange band, resulted in an increase in the foreign exchange reserves level and the annual growth rates of all monetary aggregates (Figure 2.1).

Capital inflows continued throughout 1997. Indeed, by March, annual growth of the monetary base had already exceeded the target set for the year ( $17\% \pm 3$ ). The authorities had to choose between moving the target upward, or allowing the increase in interest rates which would come as a result of the sterilization operations required to force the base back into its target corridor. Since higher interest rates were not a good option under an economic slowdown situation, in May 1997, the Central Bank decided to move the monetary corridor upward by four points ( $21\% \pm 3$ ).

### *Interest rates*

By restricting monetary policy in 1994, the Central Bank aimed at reducing inflation rates, but lower liquidity soon resulted in high interest rates. Deposit rates increased from 25.98% in January 1994 to 38.95% in December of that year, while lending rates went up from 36.40% to 46.56%. This trend persisted throughout the first semester of 1995, and was reversed in June when a ceiling was placed on lending rates. However, the very tight monetary stance which followed after the political events of 1995, and first months of 1996, pushed interest rates upwards again (Figure 2.2).

In 1996 interest rates were further pressured by the Government's very active participation in the domestic market. In fact, all efforts made on the monetary front to contract total spending were more than offset by the overly expansionary fiscal policy adopted by the current administration (according to data published by the National Department of Planning, the size of Colombia's public sector increased from 28.5% of GDP in 1994 to 33.6% of GDP in 1996). Pressure on interest rates ceased in the second semester of 1996, as capital inflows became larger, once the Government increased its share of foreign indebtedness, and capital controls were relaxed. In fact, by July 1997, both lending and deposit rates were 10 percentage points lower than last year's averages.



### 2.2.2 Exchange Rate Policy

In January 1994, the authorities introduced a foreign exchange band system. The midpoint of the band was set at the market rate prevailing at that moment. The width of the band was set at +/- 7%. That year the exchange rate continued to crawl at 11% per year. In the first half of 1994 the exchange rate remained in the middle of the band, but later moved to the lower part, reaching the bottom in late 1994. In December 1994, the Central Bank revalued the band by 7%, making the new central parity equal to the previous lower margin. However, the crawl was increased from 11 to 13.5%.

During the first semester of 1995, hardly anyone believed that the 13.5% target would be attained given the tendency towards the appreciation of the currency of the previous year (nominal devaluation of 3.2%). In fact, interest rates were extremely high, thus stimulating capital inflows, and foreign private indebtedness continued to grow, despite the deposit requirements for loans with maturities below five years. Nominal devaluation in the first six months of 1995, was 5.5%, while inflation reached 10.8% in the six-month period.

During the second semester, however, things changed drastically in the foreign exchange market. The inquiries into the funding sources of the presidential campaign of 1994, and all the political unrest it generated, reversed the 5-year appreciating of the peso. The increasing evidence that drug traffickers had contributed more than 3 million dollars to the campaign of Ernesto Samper generated a political polarization, as well as uncertainty among the economic actors about the outcome of the scandal. Since August 1995 the Colombian currency depreciated amidst higher volatility. The exchange rate was very close to the upper level of the exchange band, requiring the intervention of the Central Bank on several occasions.

Throughout the first semester of 1996 there were growing expectations that as a result of the political crisis, and the pressure on the exchange rate, the Central Bank would be forced to move the exchange band upward. However, starting July 1996, events in the foreign exchange market changed dramatically. Capital inflows increased significantly as the government shifted to foreign indebtedness to finance its growing fiscal deficit, and as controls on private borrowing abroad were loosened. During the second semester of 1996, the exchange rate moved from the upper level of the band to the lower level, resulting in a strong appreciation of the currency. In terms of the real exchange rate, there was a real revaluation as the index decreased from 100 in January (the 1986 level, regarded by many as the 'equilibrium' rate) to 88.6 at year-end 1996. Capital inflows during 1997, as well as the appreciation of the US dollar against the Yen and the German mark had lowered this index to 84.5 by July 1997.

#### *Capital Controls*

In September 1993 the Central Bank adopted a one year 47% (non-remunerated) reserve requirement on all foreign credits with maturities below 18

months<sup>1</sup>. The mechanism was based on certificates issued by the monetary authority, denominated in foreign exchange and redeemable in domestic currency after a 12 month holding period. As pressure toward the appreciation of the currency continued this measure was considered insufficient. The requirement was extended in March 1994 to loans with maturities below 36 months<sup>2</sup>. However, in this case the reserve requirement was set in proportion to the holding period of the deposits at the Central Bank: 93% for 12 month deposits, 64% for 18 month deposits, and 50% for 24 months deposits (regardless of the maturity of the loan). The borrower was given the option to choose the desired holding period. In August 1994, once the new administration took office, the board of the Central Bank extended non-remunerated deposits to all foreign loans of less than 5 years. A decreasing reserve ratio was adopted (140% for loans of less than 1 month; 42.8% for those with maturities between 59 and 60 months) with a holding period identical to the maturity of the loan (although redemptions are allowed with a high discount). However, in all resolutions a large number of exemptions were granted<sup>3</sup>.

However, no matter how restrictive all this might have seemed private sector's medium and long-term indebtedness doubled in 1994. In fact, borrowers were not willing to waste the opportunity of taking advantage of the large interest rate differentials, and therefore moved to longer maturities, eluding the controls.

In March 1996 controls were partially relaxed and maturities over 3 years did not require a deposit. At the same time, commercial banks were allowed to borrow abroad and lend in domestic currency.

As a result of the continued inflow of foreign capital during 1997 the Central Bank has tightened controls on foreign indebtedness twice this year. First, in March when maturities requiring a deposit were extended from 36 to 60 months<sup>4</sup>, and later in May, when the deposit (30%) was extended to all credit operations. This deposit must remain in the Central Bank for a period of eighteen months with no profit gain<sup>5</sup>.

### 2.2.3 Fiscal Policy

Congress approved the development plan of the Samper administration (*El Salto Social*) in June 1995. However, from the beginning the plan appeared as extremely ambitious, especially in relation to social expenditures and infrastructure. If fully carried out, the *Salto Social* was supposed to have led the central government into an aggressive expansion in real expenditures averaging 12.2% over the 1995-98 period, on top of the significant increases in justice and security expenditures under the previous administration. By 1998, central government expenditures would have reached 20.6% of GDP, as compared to 12.9% in 1991. The central government's deficits were expected to

<sup>1</sup> Resolution 21 (1994). Paradoxically, in other aspects this resolution liberalized capital flows. Colombian nationals were allowed to hold financial assets abroad and the issuing of ADR's and GDR's was made more flexible.

<sup>2</sup> Resolution 7 (1994).

<sup>3</sup> Related to import and export financing, capital used in privatizations and concessions, loans contracted by Colombian nationals to finance investments in other countries plus previously registered loans. See Bernal (1995) for details.

<sup>4</sup> Resolution 4 (March, 1997).

<sup>5</sup> Resolution 4 (May, 1997).

widen from 2.7% of GDP in 1995 to 4.0% of GDP in 1998. These figures included the likely proceeds from privatization, and the granting of various concessions. According to the plan, these deficits would be more than offset by surpluses in the other sectors of government such as Ecopetrol, the National Coffee Fund, and the Social Security Institute. As a result, the public sector as a whole was expected to post a surplus of 0.7% of GDP in 1995, and to stay basically in balance between 1996 and 1998. To minimize the impact of the central government's projected deficits on the local capital markets, the Finance Ministry hoped to fund itself by placing bonds with those public-sector entities posting surpluses.

Under this administration the Central Government has run a deficit equivalent to 1.3% of GDP in 1994, 2.6% in 1995, 4.3% in 1996, and an estimated deficit of 4.7% for 1997 (Table 2.1). The deficit of the consolidated public sector accounted for 0.4% of GDP in 1995, and 2.0% in 1996, far away from the surpluses estimated in the plan for these years and the projected balanced accounts thereafter (Table 2.2).

The factors that have led to the deterioration of the fiscal accounts are two-fold. On the one hand, revenues have been lower than estimated, and the privatization process has been slower than expected. On the other, the central government expenditures have increased, partly because of structural factors due to the new Constitution, which have led to an increasing share of transfer payments to municipalities, from 4.9% of GDP in 1991 to 8.9% of GDP in 1996, and the rise in social security transfers. Thus, transfers to local and regional governments will represent 23.1% of total expenditures in 1997 (27.5% in 1998). Interest payments will grow 48.6% in 1997 and 39.3% in 1998.

In fact, the Constitution of 1991 in an effort to de-centralize the administration established that an increase share of current government revenues should go to local and regional governments. These transfers are tied to public investment, particularly in education and health care. However as the central government has been increasing these payments, it has not abandoned its spending attributions. This has led to a situation in which the government continues to spend in projects for which it has no assigned revenue and which should be taken up by municipal governments. A way out of this situation of overspending is an amendment of the Constitution in order to reduce the size of these transfers. However, given that within the next ten months both local and presidential elections will be held, it is very unlikely that the Congress and the administration will have the political willingness to promote such an unpopular measure. In any case, the fiscal situation is not sustainable in the near future, and thus the central government will have to find a way to cut down on spending.



Table 2.1  
*Central Government Fiscal Situation*  
 % of GDP

	1990	1991	1992	1993	1994	1995	1996	1997
Fiscal Revenues	10.3	12.1	12.7	14.1	13.7	13.2	13.3	13.5
Current Expenditures	9.0	9.4	10.1	12.1	12.7	13.5	15.1	15.5
Personal Expenditures	1.9	2.2	2.4	2.8	2.9	2.9	3.0	3.0
General Expenditures	0.9	0.8	0.7	1.0	1.1	1.0	1.0	1.2
Transfers	4.9	4.9	5.8	7.0	7.4	8.0	9.0	9.0
Debt Service	1.3	1.4	1.2	1.4	1.4	1.6	2.2	2.4
Primary Balance	1.3	2.8	2.6	2.0	1.0	-0.3	-1.8	-2.1
Investment	2.0	2.3	2.4	2.3	2.3	2.3	2.5	2.7
Surplus (Déficit)	-0.7	0.5	0.2	-0.3	-1.3	-2.6	-4.3	-4.7

Source: Banco de La Republica, National Planning Department (DNP)

Table 2.2  
*Non-Financial Public Sector*  
*Surplus (Déficit) as a % of GDP*

	1995	1996	1997
Power Sector	0.5	-0.1	-0.2
Ecopetrol	-0.1	-0.3	-0.4
Carbocol	0.0	0.0	0.0
Telecom	-0.2	0.1	0.0
Medellín Metro	-0.2	-0.1	-0.1
Social Security	2.2	2.3	0.3
National Coffee Fu	-0.3	0.1	-0.2
Central Governmen	-2.4	-3.7	-4.7
Other	0.2	-0.1	0.2
<b>Total</b>	<b>-0.4</b>	<b>-2.0</b>	<b>-3.8</b>

Source: CONFIS

According to the latest official projections (June 17, 1997) the deficit at the Central Government's level will be 4.8% of GDP in 1997 and 4.2% of GDP in 1998, while the consolidated deficits (after privatization) are estimated at 2.4% of GDP for both years. These deficits are not only extremely high but are difficult to finance. If the Government does not take measures to adjust its fiscal accounts or if the deficit is larger than expected, either the exchange rate will have to appreciate even further, or credit to the private sector will have to be reduced, or a higher inflation level will have to be accommodated.

The problem will be even worse in 1998 since, as oil exports increase, the government will have to reduce foreign indebtedness to reduce pressure on the exchange rate.

### ***2.3 Economic Performance***

Colombian economic growth was high in 1994 and 1995, 5.7% and 5.3%, respectively, but it dropped to 2.1% in 1996 (Figure 2.3). Despite the reduction in growth during 1996, mining and services (mainly government and personal services) continued to play a key role within the economy. Agriculture, industry and construction experienced slowdowns.

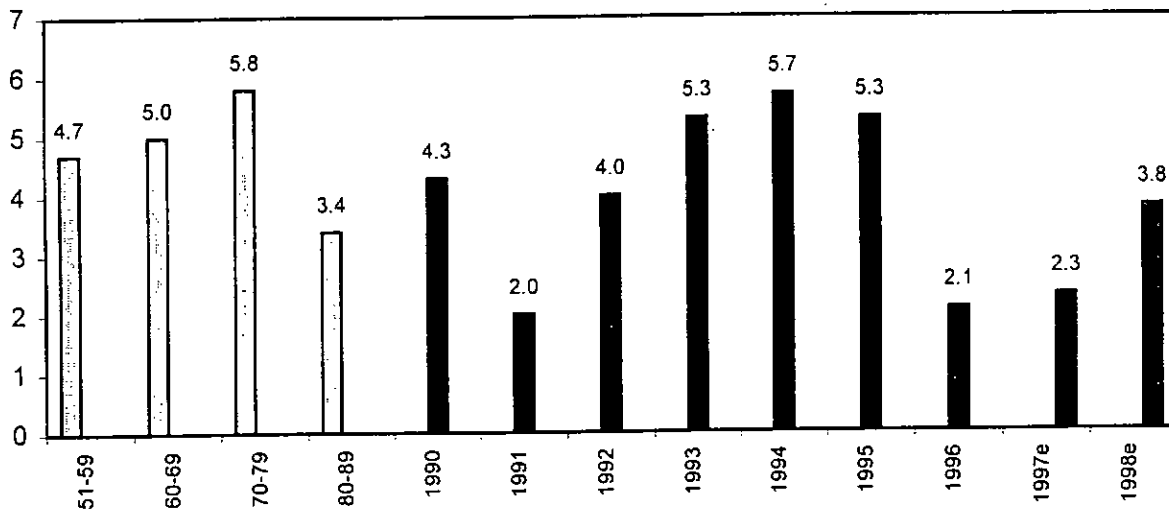
Aggregate demand fell during 1996, with a sharp decline in the growth rate of consumption, which decreased from 5.9% in 1995 to 3.3% in 1996. Private consumption increased by 1.7%, while public consumption grew 10.4%. Notwithstanding, the worst performance during 1996 came from private investment, which decreased by 22.6% as compared to an increase of 13.9% in the previous year.

Economic growth was negative both in the last quarter of 1996 (-0.1%), and first of 1997 (-1.1%). Although the figures for the second quarter of 1997 are positive, poor performance in the manufacturing sector, as well as in oil production and construction was the characteristic during the first semester. Some recovery is expected for the second semester, resulting from expected increases both in the production of coffee and oil.

#### ***Industry***

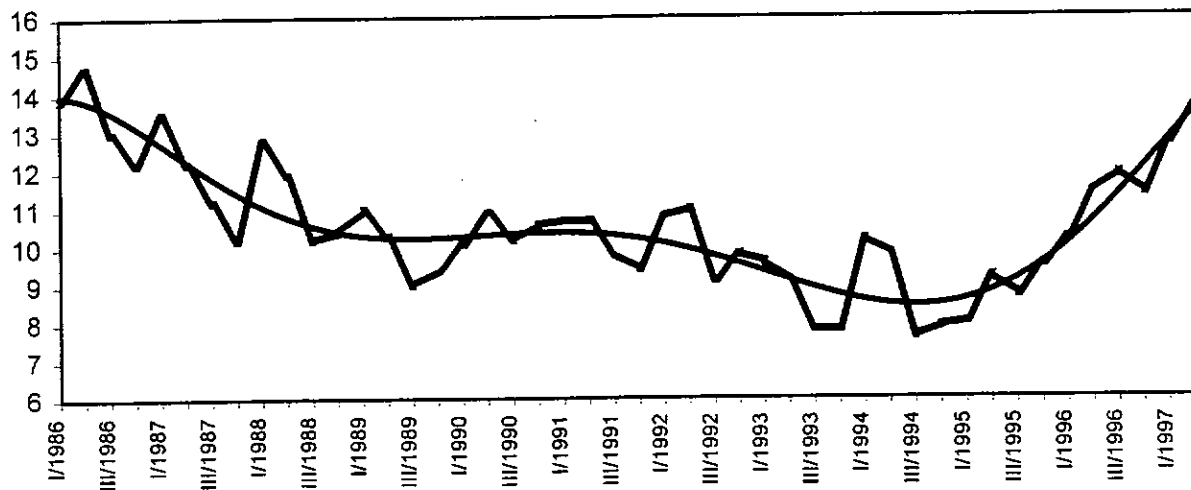
Due to a weakened domestic demand, and political uncertainty, manufacturing production decelerated in 1995 and 1996. Industrial growth fell from 4.4% in 1994 to 3.5% in 1995, and decreased by 3.9% in 1996. Last year's tendency has continued throughout 1997, with industrial activity contracting by 3.3% in the January-May period.

**Figure 2.3  
Economic Growth**



Source: Dane and Fedesarrollo

**Figure 2.4  
Unemployment Rate**



### *Retail sales*

Retail sales which registered historically high growth rates in the 1992-94 period, slowed down in 1995, and experienced negative growth in 1996 (-2.7%). High interest rates, low demand, as well as credit restrictions derived from a much tighter monetary stance since 1994, account for most of the deceleration in this sector. In 1996, the worst performance in the retail sector came from car sales, which dropped by 21.8% during the year.

So far this year, retail sales have had some recovery, observing a growth rate of 3.2% in the January-April period.

### *Construction*

The construction sector as a whole (housing, and both private and public works) increased by 5.3% during 1995, and by 0.3% in 1996. However, performance varied according to the type of construction. Activity in the home-building sector, for example, after having experienced excellent growth rates in the 1992-1994 period, decreased by 3% in 1995, and by 22% in 1996. Although deceleration in this cyclical sector was expected, high interest rates, lower consumer demand, as well as increasing political and economic uncertainty accelerated the slowdown.

### *Mining*

Growth of the mining sector in 1995 was 17.8%, given to the expansion of the oil sector, which grew 30%. During 1995, average oil production was 584,858 barrels per day (0.96% of total world production), allowing for an increase of 64.3% in oil exports. In 1996, the mining sector grew by 7.6%, as production of coal and oil increased by 12.5% and 12.4%, respectively that year.

### *Coffee*

Coffee production fell by 18.5% in 1996. The drop took place mainly in the last quarter when production decreased from 5.4 million bags in this three months of 1995 to 3.7 million in 1996, which in terms of coffee producers' income meant a decrease of 22% in this quarter. Due to the high incidence of coffee income on domestic demand, the decrease of the last quarter of 1996 severely affected economic activity during that period.

High international prices of coffee in the first semester of 1997, which were transferred almost entirely to the coffee producers, are expected to have some effect on this year's production, which is estimated at 12 million bags, 6.8% over last year's production.

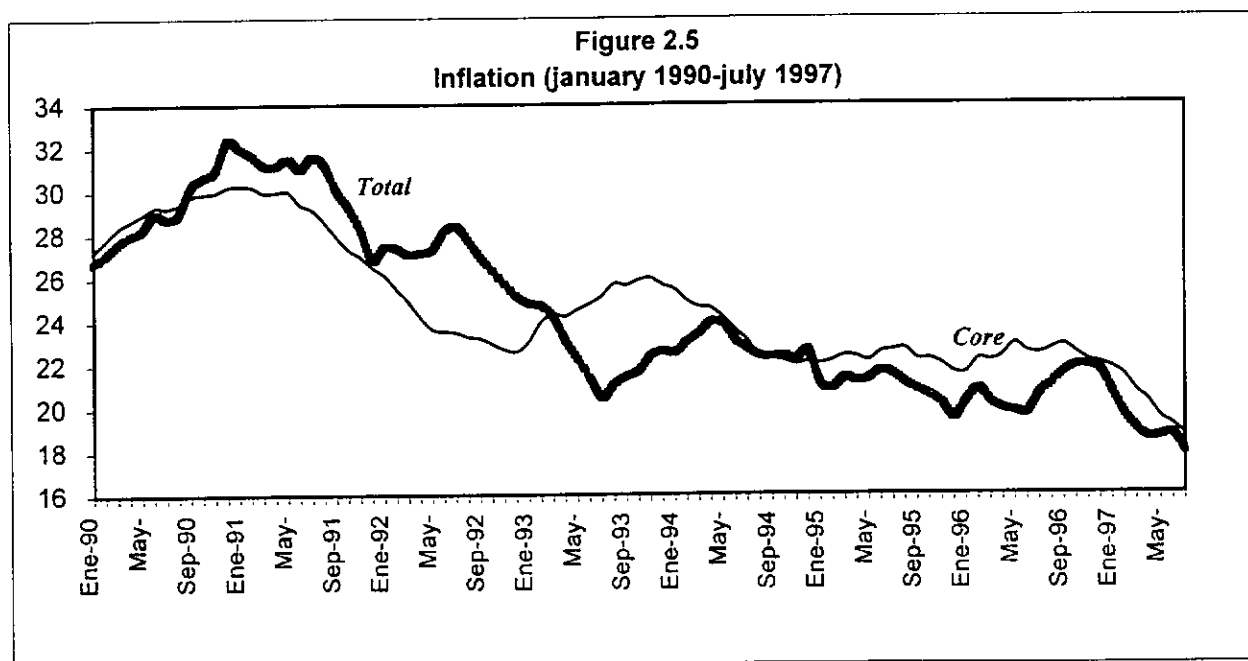
## **2.4 Employment**

The slowdown in economic activity during 1996, especially in construction and retail sales, both sectors that generate a great number of jobs, affected employment's performance during the year. Employment decreased by 1.8% in 1996. By December 1996, the unemployment rate had reached 11.5%, the highest for this month in the nineties (figure 2.4).

In March 1997, consistent with the slowdown in economic activity in the first quarter of 1997, the unemployment rate went up to 12.7%, also the highest for this month in the nineties. By June 1997, unemployment had reached 13.7%, and is expected to increase further this year.

## 2.5 Inflation

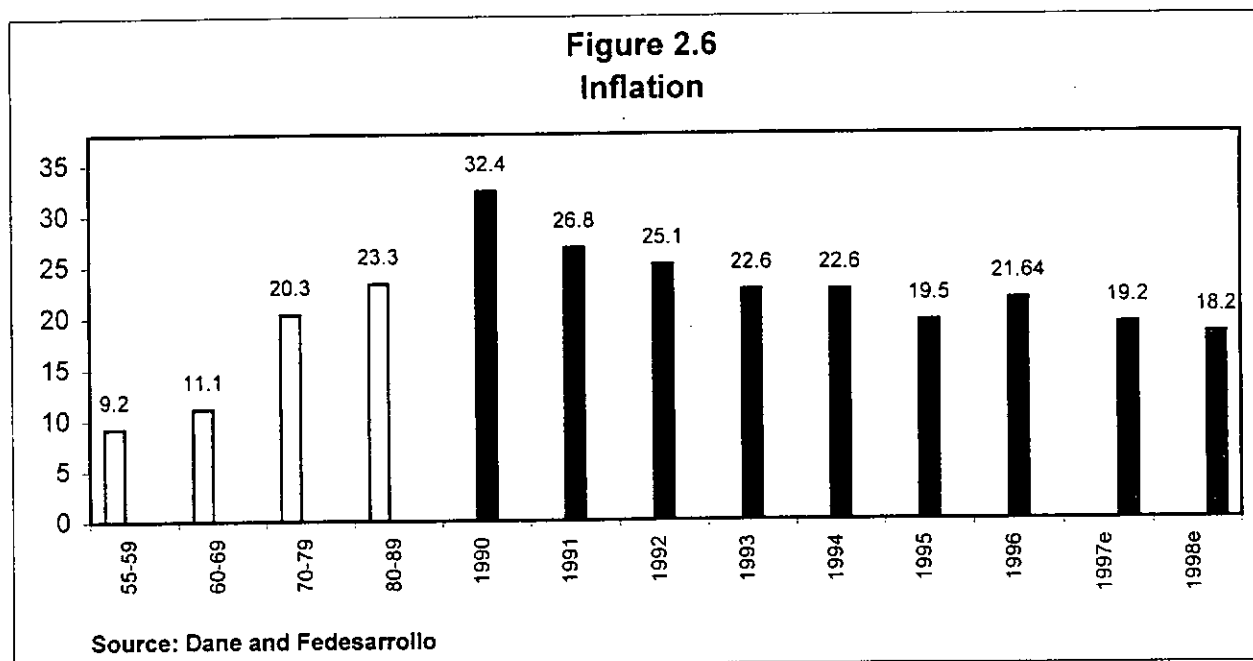
The fight against inflation in Colombia has been a difficult one, basically because of the presence of inertial factors linked to the widespread indexation of the economy, and more recently to a rapid increase in public spending. Thus, inflation has been entrenched between a 20-32% range since 1974. From 1980 to 1993, average inflation in Colombia was 24.3%, peaking in 1990 (32.4%). It has gradually subsided since then, falling to 22.6% in 1993 and 1994 (Figure 2.5). In December 1994, the government launched a Mexican style tripartite price and wage pact, known as the *Pacto Social*, aimed at reducing inflation to 18% in 1995, by dismantling the main mechanisms of price indexation and reducing inflation expectations. Under the *Pacto*, labor unions agreed to accept a minimum wage increase of 20.5% in 1995 roughly equal to expected inflation plus likely productivity gains. Industry agreed to increase prices by 18% over the year, as did the government for most public sector prices, except gasoline, natural gas, and long-distance telephone rates, which would rise by less than 18%.



In 1995 the inflation rate was 19.5%, 3.1 points lower than a year before, but still higher than the 18% target set by the Central Bank for the year. A breakdown of

the CPI shows that the *Pacto* was useful for avoiding an over-increase in the tariffs of public services, and perhaps in the prices of some manufacturing goods, but not for eliminating the indexation of the economy. The prices of some services, such as education, housing and health care had remarkable increases during the year, 25.8%, 23.13% and 21.6%, respectively. The main contribution to the three-point reduction in the inflation rate came from foodstuffs (2.2), and public services (0.9). However, the latter was achieved at the cost of delaying a long due increase in tariffs of public services, which off course was made in 1996, affecting the inflation results for that year. The *Pacto Social* was renewed in December 1995. The inflation target set for 1996 was 17%.

From the beginning, the task of lowering inflation further in 1996 was not seen as an easy one. Prices in 1996 were pressured by the lagged effect of the easing of credit conditions in 1995, the faster depreciation of the peso, the one-time effects of the tax reform, the need to catch up adjustments in public tariffs, and a possible recovery of food prices. In fact, inflation in 1996 was 21.6%, 4.6 points above the 17% target (Figure 2.6). The increase in the prices of most administered goods and services made the 17% target unattainable. Education and public services (mainly electricity) increased by 51.3% and 34.1%, respectively, contributing with 4.5 points to inflation. In December 1996, the bases for a new Pact for 1997 were set. However, because of the continued changes in economic policies since January 1997, and the uncertainty it caused, the pact was not signed.



## ***2.6 External accounts***

Following the *apertura* in 1991, Colombia's current account moved from a surplus of 5.1% of GDP in 1991 to a deficit equal to 5.6% of GDP in 1996. However, a surge in direct investments and long-term capital inflows have allowed for an expansion in international reserves from US\$4.2 billion in 1990 to a historic high of US\$10 billion in 1996.

While import growth was strong in 1995 (17%) reflecting the strength in investment, it dropped to -1.1% in 1996 as a result of the slowdown in economic activity that year (table 2.3). Exports increased by 16.5% and 4.2% in 1995 and 1996, respectively (table 2.4). The downfall in exports in the past year came mainly from industrial exports which decreased by 1.3%, because of competitive pressures, and a poor economic performance in Venezuela, which is Colombia's second most important market after the USA.

For 1997 and 1998 the current account deficit has been estimated at US\$4.4 bn and US\$4.2, respectively, due to a stronger trade balance as well as a larger service deficit (table 2.5). While the projected current account deficit numbers are unquestionably large, foreign direct investment and other long-term capital, especially in 1997 (table 2.6) will largely finance them. Large-scale investment projects in oil, electricity, and other infrastructure projects are expected to result in net foreign direct investment of US\$3.2 billion in 1997 and US\$1.8 billion in 1998. Most of the investment projects are already under way, and there is little risk that foreign capital of this sort will not take place.

The country's external accounts are not expected to change dramatically over the next several years, although certain recent trends should begin to reverse. Starting next year, foreign direct investment will most likely fall, and so will the current account deficit. Hence, net credits may stay around US\$2.4 billion in order to maintain international reserves at a comfortable level, above US\$5 billion. External debt ratios (public plus private sector) are expected to remain stable at very manageable levels over the period: gross external debt should remain at about 30% of GDP, while debt service is expected to remain at about 30% of exports.

## ***2.7 Economic projections***

Fedesarrollo's projection of economic growth for 1997 is 2.3%. Growth will be just slightly higher than in 1996 mainly due to increasing oil exports and large expenditures by the government. The main presumption is that continued political and economic uncertainty will have a negative impact on the investment climate. Therefore, in 1997 the main constraint for economic growth will come from private investment, which we have assumed will decrease by 5.1% relative to 1996.

**Table 2.3**  
**IMPORTS**  
*US\$ Billions*

	1993	1994	1995	1996	1997
Consumer Goods	1.7	2.2	2.5	2.4	2.8
Intermediate Goods	3.8	4.4	5.7	6.0	6.3
Capital Goods	3.6	4.5	4.8	4.4	4.6
<b>TOTAL</b>	<b>9.1</b>	<b>11.0</b>	<b>12.9</b>	<b>12.8</b>	<b>13.7</b>

Source: Bank of Republic and DNP

**Table 2.4**  
**EXPORTS**  
*US\$ Billions*

	1993	1994	1995	1996	1997
Oil	1.3	1.3	2.2	2.9	2.8
Coffee	1.1	2.0	1.8	1.6	2.4
Mining	1.4	1.4	1.5	1.5	1.6
Non-Traditional	3.6	4.0	4.7	4.7	4.9
<b>TOTAL</b>	<b>7.4</b>	<b>8.7</b>	<b>10.2</b>	<b>10.7</b>	<b>11.7</b>

Source: Bank of Republic.



Table 2.5  
*Current Account*  
*US\$ Billions*

	1993	1994	1995	1996	1997
Exports	7.4	8.7	10.2	10.7	11.7
Imports	9.1	11.0	12.9	12.8	13.7
Trade Balance	-1.7	-2.3	-2.7	-2.1	-2.0
Service Balance	-1.7	-1.8	-2.4	-3.2	-3.3
Transfers	1.1	0.9	0.7	0.5	0.5
Current Account	-2.3	-3.3	-4.4	-4.8	-4.7

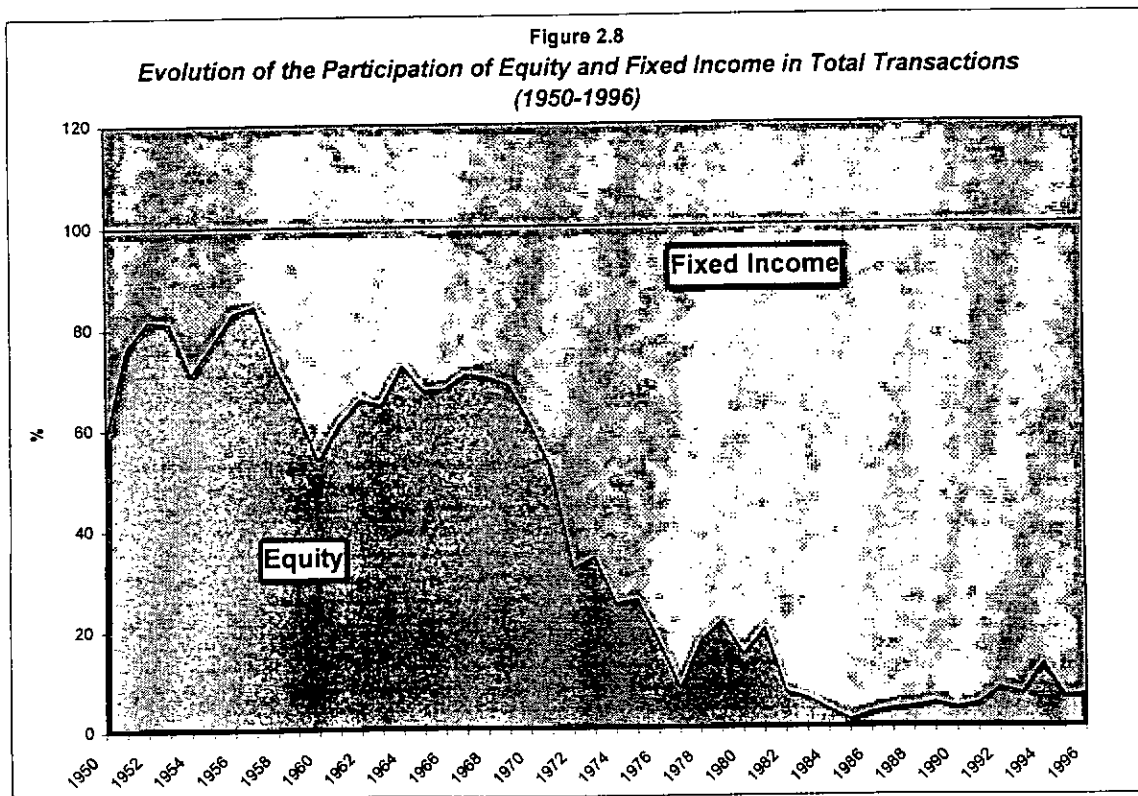
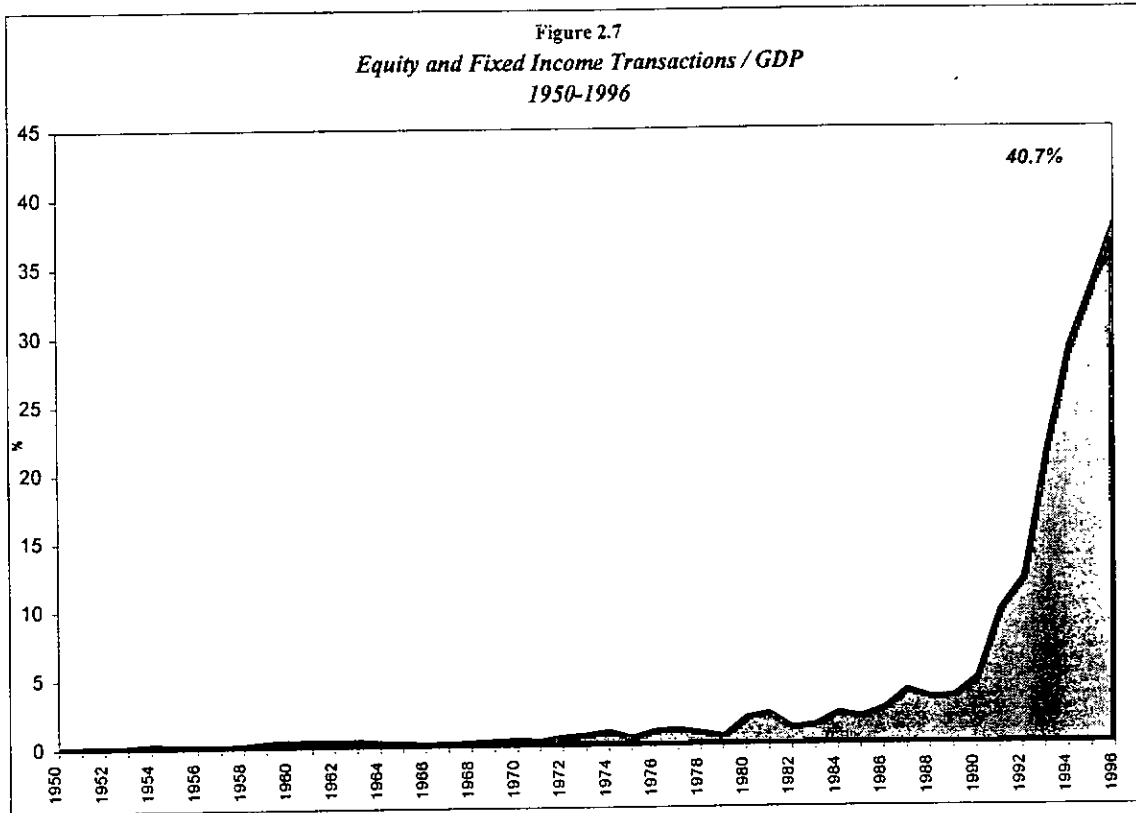
Source: Bank of Republic.

Table 2.6  
*How is the Current Account Deficit Financed*  
*US\$ Billions*

	1993	1994	1995	1996	1997
Current Account	-2.3	-3.3	-4.4	-4.8	-4.7
Direct Investment	0.9	1.7	1.9	3.4	3.9
Private Debt	0.8	2.3	2.0	2.6	1.0
Public Debt	-0.1	-0.2	0.1	-0.1	0.4
Short-Term Capital	1.2	-0.9	1.4	-0.8	-1.0
Change in reserves	0.2	0.2	0.4	1.5	1.0
Reserves	7.9	8.1	8.5	9.9	10.9

Source: Bank of Republic

For 1998, economic growth has been estimated at 3.8%, and at 3% without oil. Private investment is expected to recover in 1998 as infrastructure projects advance, and construction starts a new cycle. Total exports will increase by 10.3% as oil fields



will reach their peak levels of production by 1998 after the completion of the pipeline and the extraction facilities.

## **2.8 Capital Markets**

Colombia's capital markets have traditionally been structured around financial intermediaries as a consequence of the prevailing regulation. Regulation did not place the right incentives for the development of a large stock and bond market. Additionally, it did not encourage firms to obtain capital directly by placing bonds or equity in the capital markets. Consequently, at the end of eighties, economic authorities decided to direct their efforts towards the development of these markets through the implementation of a series of reforms.

### **2.8.1 Opening Up the Colombian Capital Market**

Before 1986 Colombia's regulatory framework prevented the adequate development of the capital markets. The government directed the allocation of credit and placed strict control over the interest rate. The central bank was structured as a development bank since 1951. Hence, a significant proportion of the demand for capital was satisfied by development credits granted by the central bank and not through the capital markets. This stimulated the formation of economic consortia that established close links between the financial and industrial sectors in order to have easy access to the resources offered by the central bank. Additionally, in 1953, a tax reform was approved which offered advantages for indebtedness and placed higher taxes on corporate firms. Consequently, the activity within the capital market was barely 1% of GDP (see figure 2.7).

As a result of the unsatisfactory activity economic authorities decided to put forward a series of reforms in order to stimulate the markets. The tax burden of corporate firms was gradually reduced to the levels of incorporated firms ('86), nominal interest deductions were eliminated ('86), and capital gains taxation on the sale of stocks was eliminated as well ('89). Some structural reforms that affect the capital markets were also enacted. In 1990 the economic authorities approved a series of reforms that increased the number of agents that can participate in the markets. The labor reform created trust and severance funds ('90), and the social security reform gave birth to pension funds ('93). Additionally, financial intermediaries can participate in the organization of securities' houses and direct foreign investment was liberalized.

As a consequence of the reforms and the availability of new instruments like preferred stocks, equity funds, and asset securitization, the activity within the market has increased since 1990. Total transactions in equity and fixed income rose from 2.5% in 1980 to 40.7% of GDP in 1996 (figure 2.7). However, the level of participation of stocks in the market has decreased (figure 2.8). In a recent evaluation of the capital market done by Fedesarrollo with the support of the Ministry of Finance<sup>6</sup>, firms stated that they do not turn to the capital market for resources because

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<sup>6</sup> Mision de Estudios del Mercado de Capitales(1996)

they fear loss of control of the company. Another important reason is that firms apprehend the possibility of the participation of illegal capital within their companies. Indicators on market capitalization, number of listed companies and foreign investment show the same trend. Market capitalization increased from US\$2.0 billion in 1990 - about 4.5% of GDP - to US\$16.4 billion in 1996 - 18.5% of GDP (figure 2.9)<sup>7</sup>. The number of listed companies grew from 211 in 1990 to 289 in 1996 (figure 2.10). However, average annual growth in the number of listed companies is still weak, 6.4%, if compared to other emerging economies.<sup>8</sup> Foreign investment in the Colombian capital market has also increased. Figure 2.11 shows that the number of funds has increased from 19 in July 1992 to 181 in January of 1997, and their portfolio increased from US\$19 million to US\$1028 million.

The stock market suffered a setback in 1996 because its performance was not isolated from changes in economic activity and the political environment<sup>9</sup>. During the first semester of 1996, stock prices were very low as a consequence of low corporate earnings, high interest rates and political uncertainty<sup>10</sup>. Things changed during the second semester due to expectations of lower interest rates which triggered heavy trading and brought an increase in stock prices. Total value traded in the Bogotá Stock Exchange, which accounts for 66.2% of total capital market transactions, increased by 36.7% as compared to 1995. The Bogota Stock Exchange Index - IBB - grew by 11.8%, but due to inflation it declined by 8% in real terms (figure 2.12). The IBB in dollars grew 9.8% because the currency only depreciated by 1.8% on a year to year basis.<sup>11</sup> Unfortunately, market concentration measured as the 10 most traded shares as a percentage of total value grew in 1996, reversing the trend that had been started since 1992. Levels of concentration in 1996 were similar to those registered in 1992 (figure 2.13).

Although during the second semester total value traded in the Bogota Stock Exchange increased, it could have been more dynamic if all of the privatizations in 1996 had been done through the capital market. Unfortunately, not all of them were undertaken through the stock market. However, the ones that did occur within the market had an important influence. Three companies were privatized in 1996 that represented transactions for US\$ 364 million.<sup>12</sup>

<sup>7</sup> Fact Book, Bolsa de Bogotá (1997).

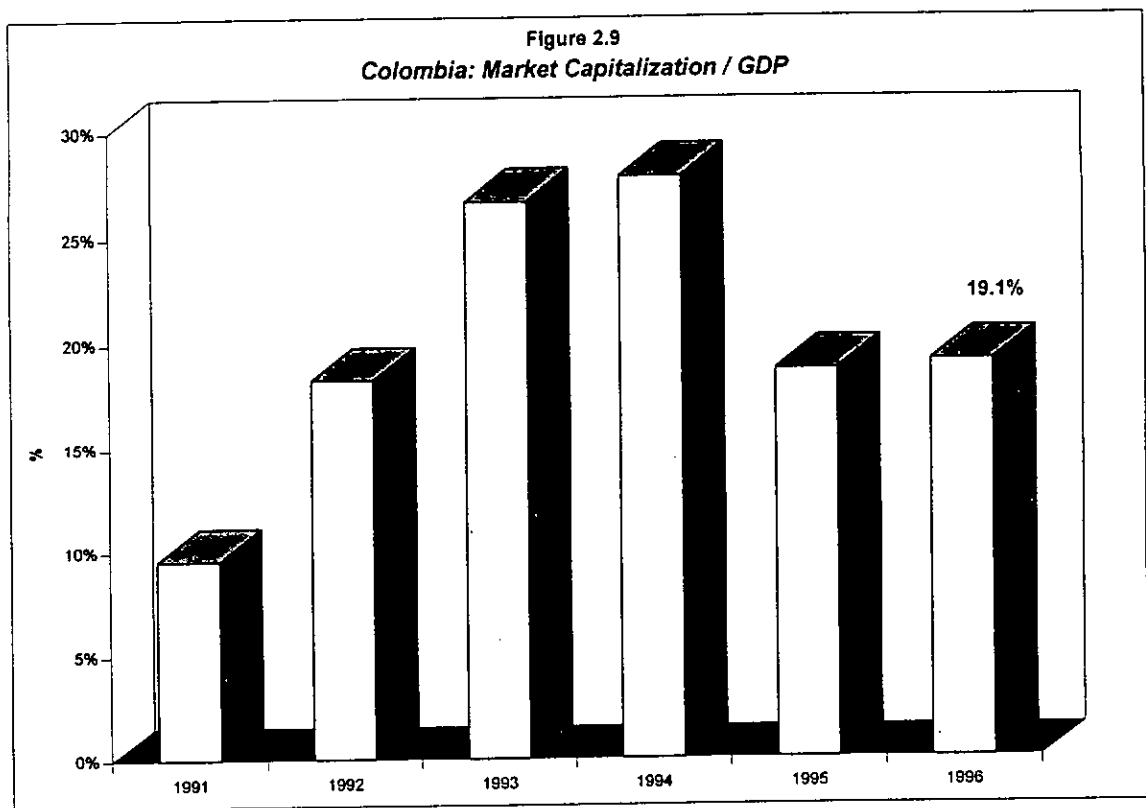
<sup>8</sup> For example, Indonesia had an average annual growth in the number of issuers between 1990 and 1994 of 35.7% and Turkey 34.1%. Fact Book, Bolsa de Bogotá (1997) pg.7.

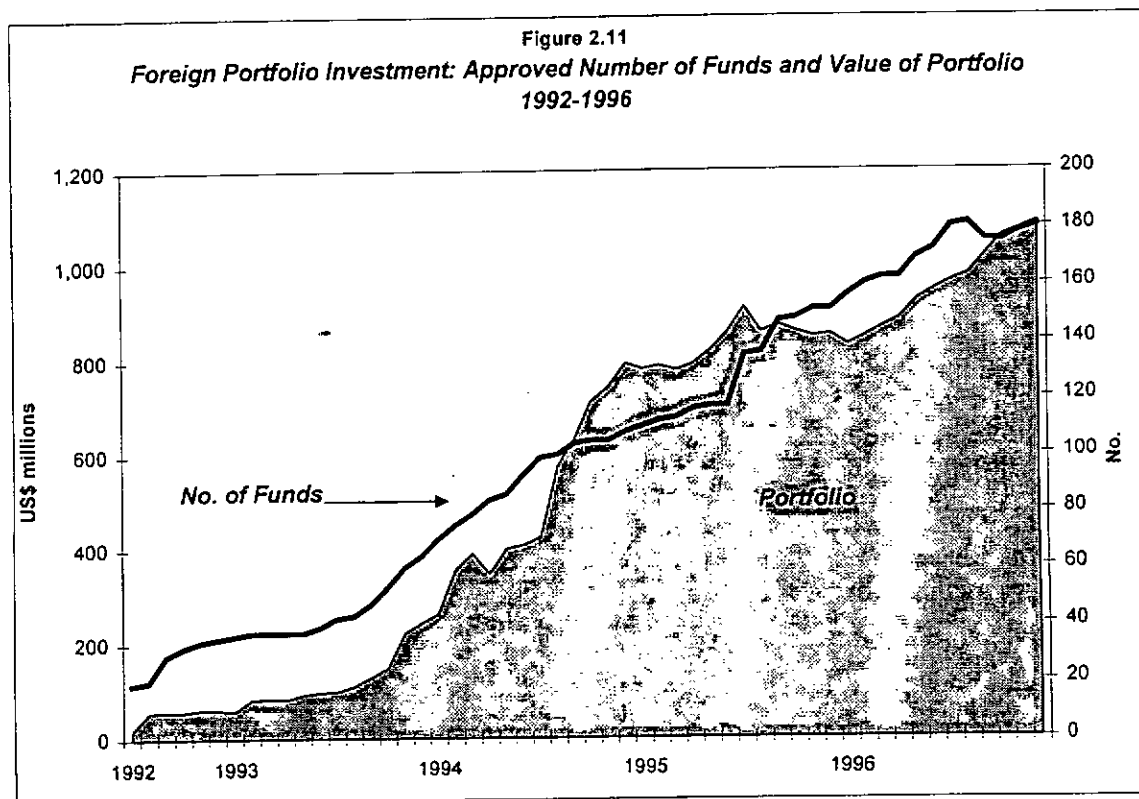
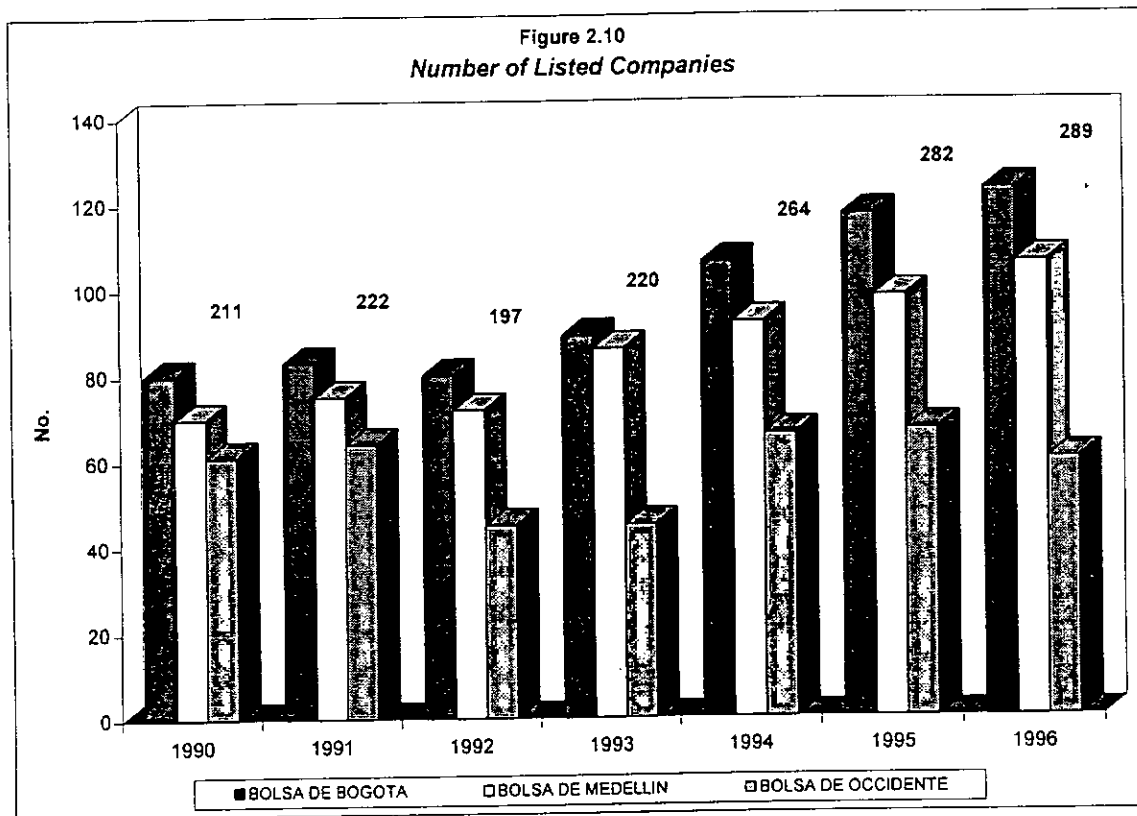
<sup>9</sup> See the corresponding sections for a detailed analysis of Colombia's economic and political situation.

<sup>10</sup> Fact Book, Bolsa de Bogotá (1997) pg. 11

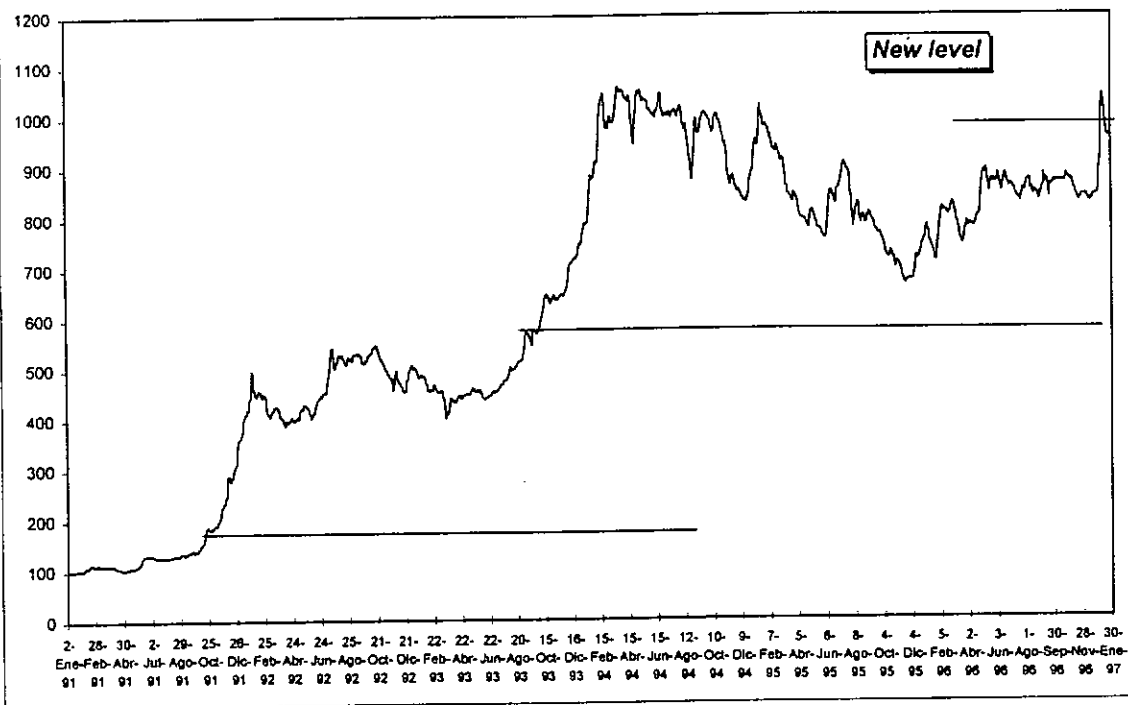
<sup>11</sup> Ibid. pg. 12

<sup>12</sup> The companies privatized were Promigas, Terpel Bucaramanga, and Banco Popular. Ibid. pg.12

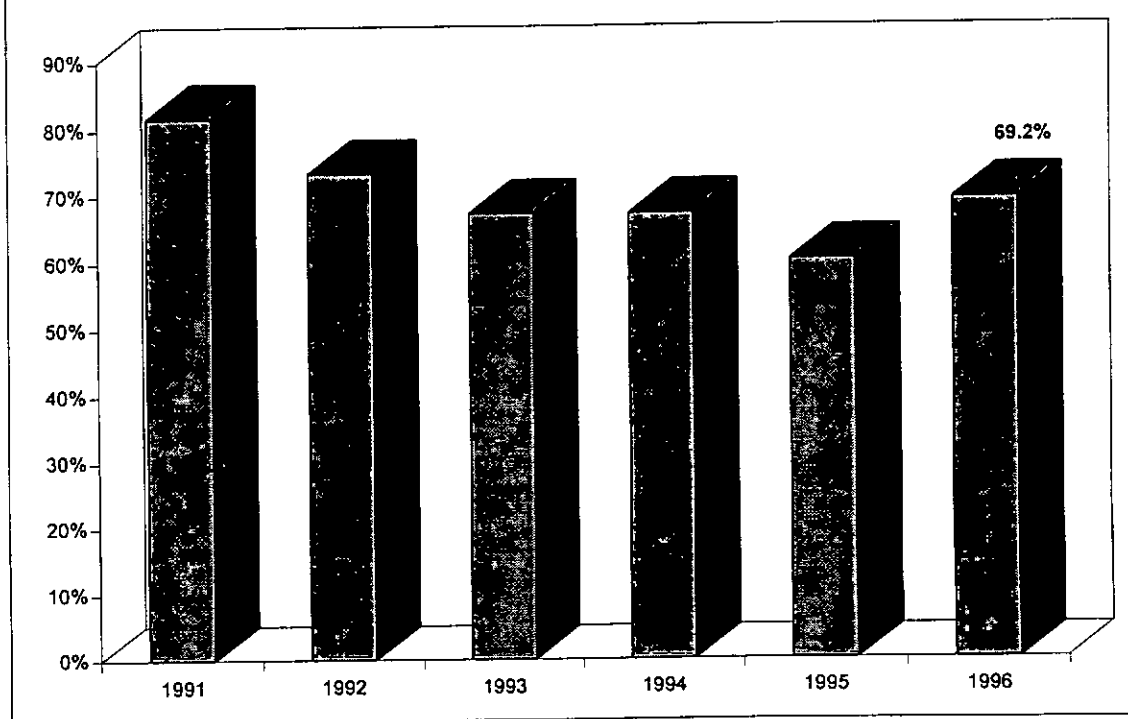




**Figure 2.12**  
**Bogota Stock Exchange Index - IBB**  
**1991-1997**



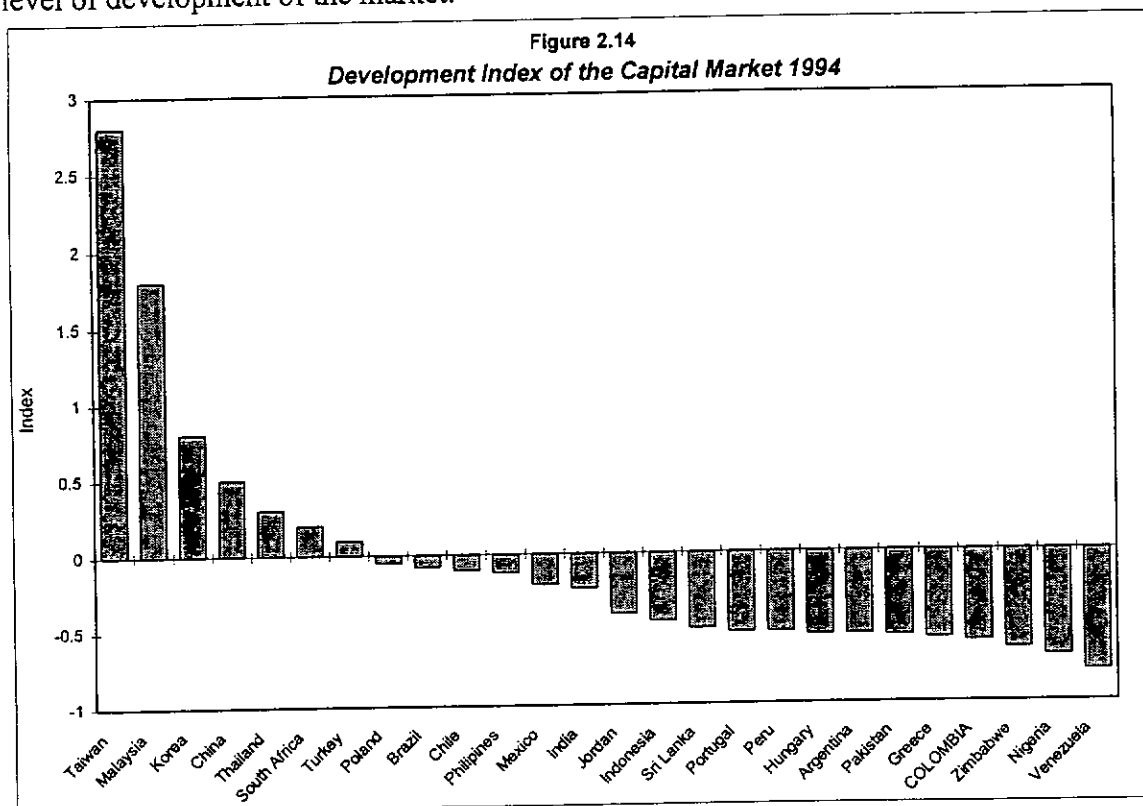
**Figure 2.13**  
**Market Concentration: 10 Most Traded Shares / Total Value Traded**



### 2.8.2 The Way Ahead

Expectations on the performance of the stock exchange for 1997 are optimistic. Interest rates are expected to decline further, following the trend that began in 1996. Large flows of foreign currency are foreseen, mainly due to expectations of a further appreciation of the Colombian peso. Additionally, it seems that this year authorities will be able to achieve the planned inflation rate of 18%, making equity more appealing. Lastly, economic activity is expected to recover this year, hence, corporate earnings are expected to rise. It seems that this year the IBB index is setting at a higher and less volatile trend (see figure 2.13).

Despite of the growth that the capital market accomplished in the beginning of the decade, Colombia's capital market is still underdeveloped. Figure 2.14 shows an index of the development of the capital market for 26 emerging economies in 1994<sup>13</sup>. The Colombian capital market appears as the fourth less developed according to the index. Consequently, there is still a lot to be done in order to accomplish a proper level of development of the market.



Although the expected results of the Colombian capital market are optimistic, they are subject to upcoming political changes, economical performance, and the

<sup>13</sup> For details on how this index was constructed see Mision del Mercado de Capitales (1996).



progress achieved in solving the different social tensions within the country<sup>14</sup>. In May 1998, presidential elections are going to be held. Consequently, it is expected that the political uncertainties that have permeated the economy during the last 3 years could clear up. Despite the uncertainty of Colombia's situation, foreign investment in the capital markets grew 80% from 1993 to 1996. Consequently if things clear up, it can be expected that foreign investors will increase their trust in Colombia's economy, and therefore a larger amount of foreign investment could be expected. Additionally, the government is solving the problems that have delayed the privatization program in infrastructure<sup>15</sup>. Once these problems are solved, it is expected that many international investors will participate in the process of privatizations, generating an additional inflow of capital within the market.

## ***2.9 Drug Trafficking***

Colombia has traditionally been pointed out as a country with an economy strongly influenced by drug trafficking. Many international observers have claimed that most of Colombia's economic growth is due to the increase in aggregate demand associated to drug revenues. However, recent studies have shown that the revenues from drug trafficking are smaller than what they are believed to be, and, moreover, that they have been dropping in the past few years, and that they have had a negative on the economy.

Since the mid-80's, a number of efforts have been made to determine the real size of Colombia's illegal drug activity. Several studies have attempted to estimate the revenues that the Colombian economy receives from illegal drug exports<sup>16</sup>. However, this is not an easy task given the illegal nature of drug trafficking. Analysts have used alternative methods to obtain reliable data<sup>17</sup>. Estimates start in US\$500 million a year and go up to US\$4,600 million a year for the period 1987-1991 (Table 2.7).

### **2.9.1 The Size of the Drug Economy in Colombia**

In a recent study, Roberto Steiner<sup>18</sup> shows that the amount of foreign exchange received by the Colombian economy from illegal exports of drugs has fallen since 1989, as a percentage of GDP and as a percentage of total exports (figure 2.15). While in 1989 drug revenues represented 6.5% of GDP and 42.8% of total exports, in 1995 revenues represented 3.5% of GDP and 23.7% of total exports (Table 2.8)<sup>19</sup>. This trend is not surprising if we take into account that international pressure on Colombia to strengthen the control on drug trafficking has increased substantially

<sup>14</sup> See the corresponding sections for more information on the developments of these areas.

<sup>15</sup> See the section on Infrastructure for detailed information.

<sup>16</sup> Some of the studies are the ones done by S. Kalmanovitz, H.J. Gomez, E. Sarmiento all in 1990, O'Byrne and Reina in 1993, H.J. Gómez and M. Santa Maria in 1994, and R. Rocha in 1995.

<sup>17</sup> Methods include testing for consistency with macroeconomic accounting and contrasting statistical series.

<sup>18</sup> Roberto Steiner is a Colombian researcher who is currently Associate Researcher in Fedesarrollo.

<sup>19</sup> Steiner reports a series since 1980, but, it is most reliable starting in 1987 because a unified method is used to construct it since that date.

in the past few years, and that Colombian authorities have taken effective measures in

**Table 2.7**  
**Estimates of Revenues Obtained of Exporting Illegal Drugs**  
(US\$ Million annual average)

	GSM <sup>1</sup>	Kalmanovitz <sup>2</sup>	O'Byrne y Reina <sup>4</sup>	Rocha <sup>5</sup>		Steiner <sup>6</sup>
				min.	max.	
76-80		2328				
81-82	3033	4090				1977
83-86	1614	4201	2602	1005	3664	2511
87-91	735	4042	3099	517	4668	2071
92-94				705	3393	2462

Source: Steiner (1996)

order to dismantle the drug cartels. Nevertheless, revenues from drug trafficking have represented considerable amounts of foreign exchange flows into the country. In 1989 drug revenues were 42.8% of total exports and 6.5% of GDP.

Such large amounts of illegal foreign exchange are introduced in the domestic economy through several mechanisms. Steiner examines the different conduits that could be used to introduce the illegal money and determines which are most probably used.

Drug traffickers may introduce illegal foreign currency in the Colombian economy through the legal market, which until 1991 was served exclusively by the central bank, or through the black market. Drug traffickers have traditionally preferred to use the legal market because the rate at which currency is exchanged by the central bank is usually higher than the one available in the black market.

Consequently, the balance of payments serves as a good indicator to approximate the inflows of currency that have entered through Colombia's legal foreign currency market. Figure 2.16 shows the evolution of three different components of the balance of payments: private transfers, trips and airfares, and other non-financial services. Since they are all services that are easy to counterfeit, because they do not have a real balancing entry that can be monitored to control the declared inflows, it is important to follow the evolution of these three components of the balance of payments. The last two series show a very stable evolution but private transfers have grown excessively since 1984. Moreover, Colombian revenues of private transfers, as a percentage of GDP, seem particularly high compared to those of similar economies (Table 2.9). Most surprising is that in 1970-74 they only represented 0.1% of GDP, while in 1990-94 they represented 3.2%.

Through the use of different statistical methods the author finds strong evidence pointing out that the use of private transfers to justify revenues was a mechanism frequently used to introduce illegal drug money. It seems that traffickers were able to introduce US\$600 million annually in 1985-89, US\$1,173 million in 1990-92 and US\$ 822 million in 1993-94<sup>20</sup>. Comparing these figures with the estimated revenues

<sup>20</sup> Steiner(1997) explains thoroughly how this data was achieved.

that entered Colombia since 1980 until 1995 (Table 2.9) they only represent about half of the foreign currency inflow associated to drug trafficking. Hence, it is likely that the rest of the illegal resources entered the economy through the black market.

The resources entering through the black market have been used by Colombians who travel abroad and are willing to pay for a lower exchange rate, and by smugglers who trade with illegal imports. The author finds strong evidence suggesting that considerable resources are used to smuggle goods from Panama and the Antilles. Illegal imports of various products, from the Zona de Colon in Panama, are estimated to be US\$1,000 million per year, and illegal imports of cigarettes are estimated at approximately US\$ 450 million per year<sup>21</sup>.

Nevertheless, it should not be ignored that drug activity has generated employment. Yet, that employment is both informal and volatile. Drug cartels employ large amounts of security forces to protect themselves, their families and their properties. They also train and employ "sicarios" (hired assassins) to perform occasional jobs.

The volatility of this type of employment can be illustrated by observing the evolution of employment in Cali and Medellin, cities where the biggest cartels centered their activities. In these two cities the rate of unemployment recently rose to unprecedented levels after the cartels were dismantled. In the case of Medellin, this occurred at the beginning of the decade. Medellin's unemployment rate was 4.5 percentage points above the national aggregate in 1992 reaching levels of 15.2% (see figures 2.17 and 2.18). Currently, Cali's unemployment rate is 18.8%, 5 points above the aggregate level.

### **2.9.2 Effects of Drug Trafficking on the Colombian Economy**

Inflows of illegal revenues have affected the Colombian economy. However, many analysts state that the effect has been far from positive. Illegal drug revenues have generated inflation, real appreciation of the currency, smuggling of goods, an inflow of sumptuary imports, distortions in relative prices and high levels of violence and corruption. The central bank has been forced to intervene in the exchange market in order to support the exchange rate. Additionally, an important proportion of illegal revenues have been used to smuggle goods into the country. Consequently, local manufacturers have to compete against illegal imports that do not pay tariffs or taxes. Moreover, it seems that illegal revenues are invested in urban and rural real estate (45%), in cattle ranches (20%), in retail trade (15%), construction (10%), and in other services and recreation (10%)<sup>22</sup>. The construction in the early nineties, which was partly induced by drug money, resulted in an oversupply of luxury housing, which elevated the relative prices of real estate and generated distortions within the economy.

<sup>21</sup> Steiner(1997) explains thoroughly how this data was achieved.

<sup>22</sup> Gómez, H.J. (1990)

Therefore, the perception that drug activities have been beneficial for the Colombian economy has been revised. Drug revenues have generated inflation and appreciated the currency. Moreover, distortions in relative prices have emerged due to the particularities of the demand associated to drug revenues. The levels of corruption and violence have grown in the last decade, and these have direct effects over the performance of the economy. As it is mentioned in the section on public security, it is realistic to expect that the problems related to drug trafficking will continue to decrease. Hence, the negative consequences of drug trafficking on the economy will disappear. However, if the successful campaign against the cartels comes to a halt the distortions will continue affecting the economy.

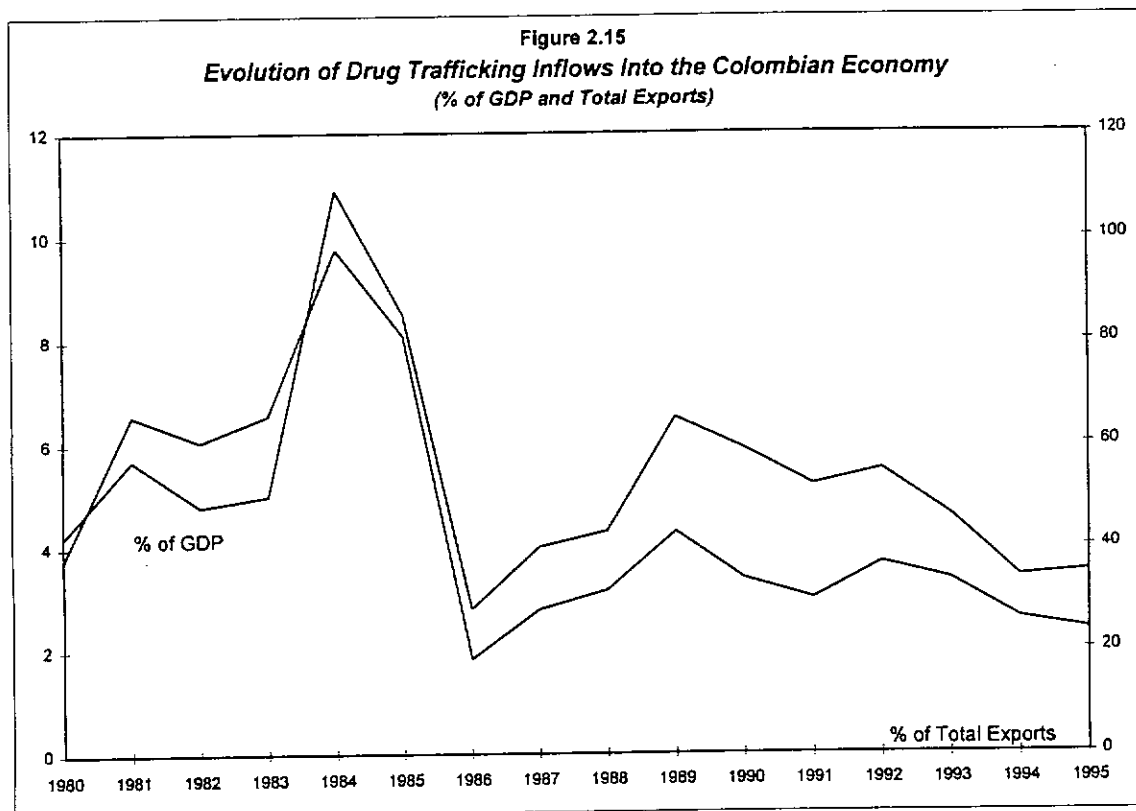
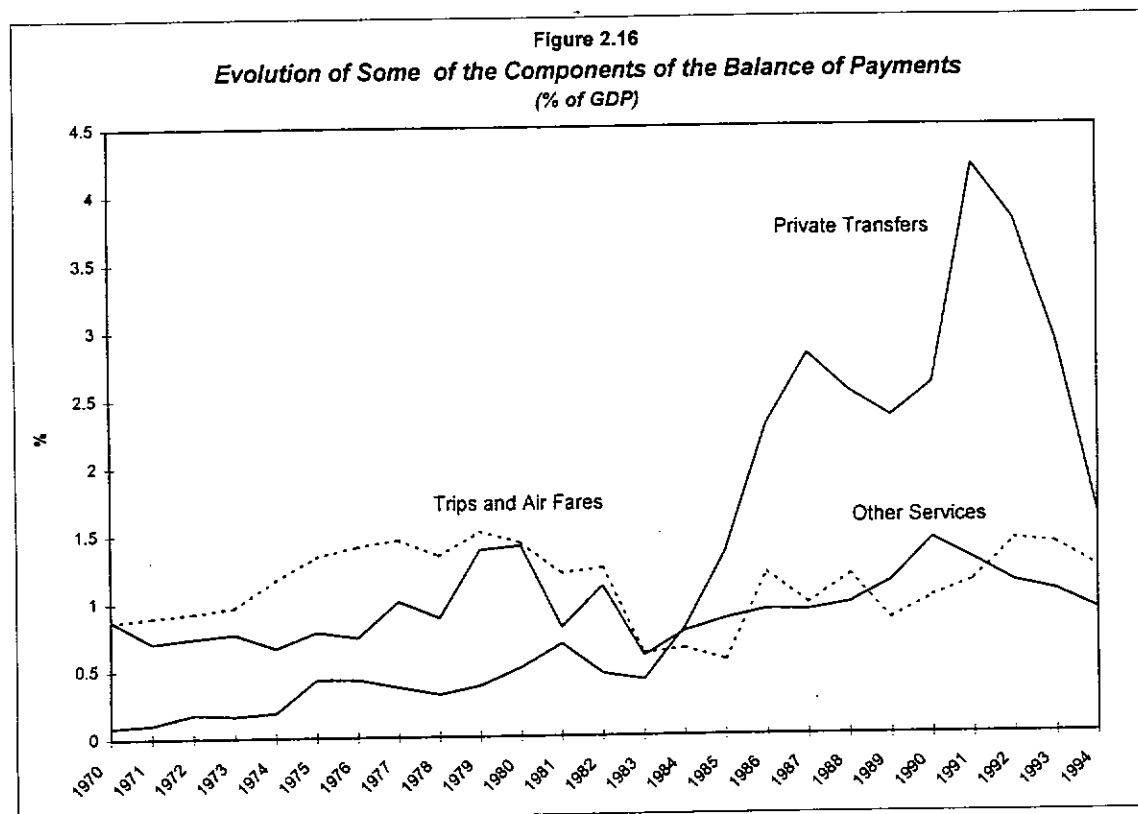


Table 2.8  
Colombia's Total Revenues from Drug Trafficking 1/  
(US\$ Millions)

	Cocaine	Heroin	Marihuana	Total	As % of	
					GDP	Total Exports
1980	1386			1386	4.2	37.6
1981	1933		137	2070	5.7	65.6
1982	1819		65	1884	4.8	60.5
1983	1868		79	1947	5.0	65.6
1984	4093		79	4172	10.9	97.6
1985	2933		20	2953	8.5	80.9
1986	939		34	973	2.8	18.3
1987	1311		152	1463	4.0	27.8
1988	1395		290	1685	4.3	31.5
1989	2485		94	2579	6.5	42.8
1990	2341		48	2389	5.9	33.7
1991	1400	756	83	2239	5.2	29.8
1992	1822	756	89	2667	5.5	36.7
1994	1176	756	329	2261	3.4	25.9
1995	1446	756	333	2535	3.5	23.7
1980-85				2402	6.5	68.0
1986-90				1818	4.7	30.8
1991-93				2464	5.1	33.3
1994-95				2398	3.5	24.8

1/The revenues reported in this table are not the total revenues generated from the activity of drug trafficking, but the estimates of the amount of foreign currency that enters Colombia derived from the exports of illegal drugs. Other revenues may never enter the country.



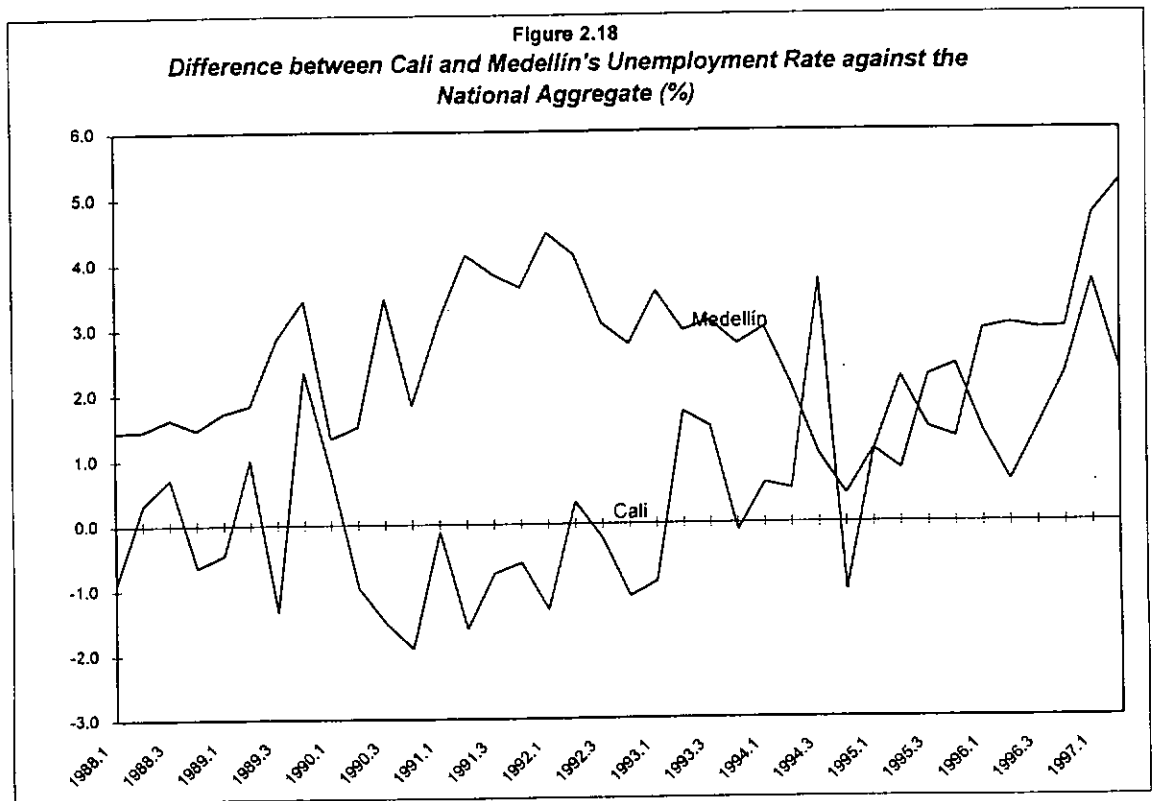
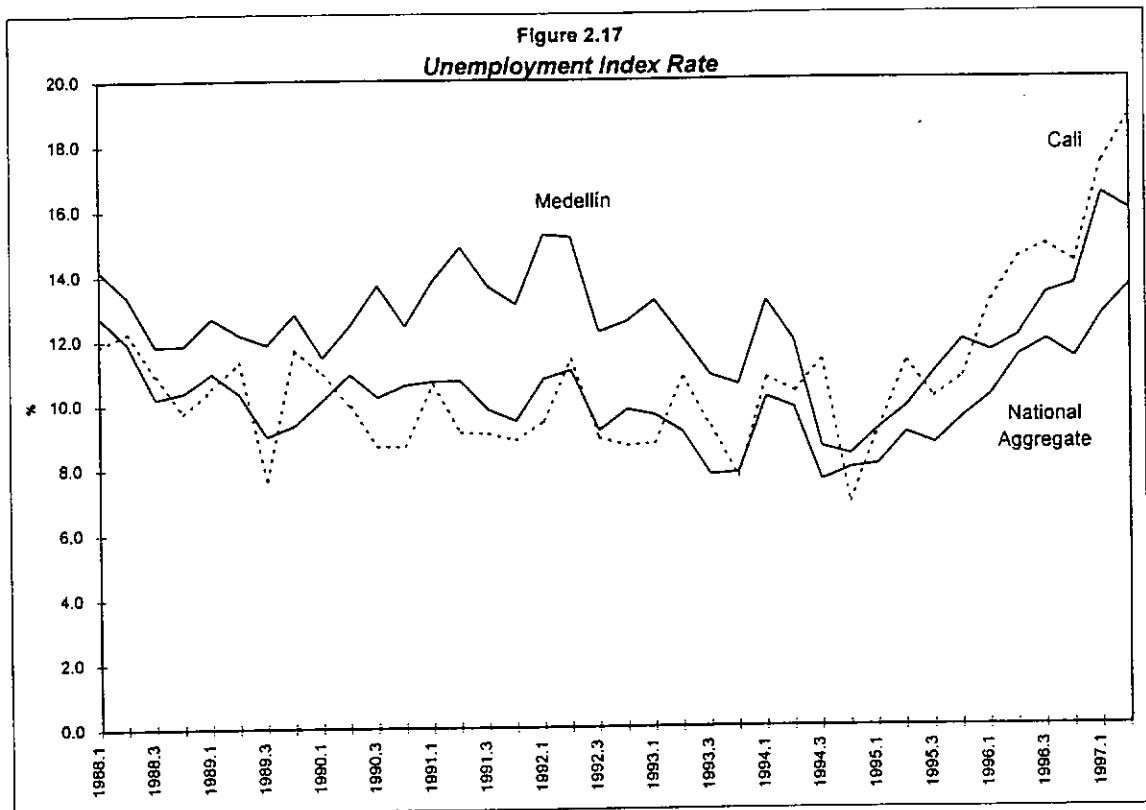
**Table 2.9**  
*Revenues of Private Transfers as Percentage of GDP*

	1970-74	1975-79	1980-84	1985-89	1990-94
Argentina	0.3	0.1	0.1	0	0.4
Bolivia	0.3	0.3	0.8	0.5	0.5
Brazil	0.1	0.1	0.1	0.1	0.4
Chile	0	0.4	0.4	0.5	0.1
<b>Colombia</b>	<b>0.1</b>	<b>0.4</b>	<b>0.6</b>	<b>2.4</b>	<b>3.2</b>
Ecuador	0.4	0.1			
El Salvador	1.3	1.5	2.2	4	9.5
Mexico	0.1	0.1	0.6	1.1	1
Paraguay	0.4	0.1	0.1	0.6	1.1
Peru <sup>a</sup>	0.1	0			0.5
Turkey	4.5	2.7	4	2.8	2.1
Uruguay <sup>b</sup>	0	0	0		0.2

a 1990-94 is only 1994

b 1980-84 is only 1981-1982 and 1990-94 is only 1993-94

Source: Steiner (1997)



### 3. Structural Strategies to Foster Economic Growth

As it has been mentioned, in the late 80s and early 90s the Colombian authorities undertook a number of structural reforms aimed at fostering the competitiveness and the productivity of the economy. This section provides a general overview of the recent evolution of the most important reforms, specifically those related to Trade Policy, Infrastructure, Health, Education, and the struggle against Criminality.

#### 3.1 Colombia's Trade Policy

Since the late 80s Colombia started an aggressive process aimed to guarantee its proper insertion in the global economy. Through the so called process of *apertura*, the government both drastically reduced the barriers that existed on foreign trade and fostered a process of negotiations oriented to strengthen the commercial ties between Colombia and its neighbor countries. Though there was some uncertainty about a reversal of the *apertura*, the current administration has maintained most of the reforms. Yet, the internationalization process of the Colombian economy has virtually come to a halt and is currently facing strong dilemmas.

##### 3.1.1 The opening of the economy (Apertura)

In the early 90s the economic authorities took severe measures to reduce the protection level of the Colombian economy. Import permits and quotas were eliminated. Likewise the average tariff on imports was reduced from 44% in 1989 to 12% in 1993. Thus the effective rate of protection of the economy dropped from 45% in 1990 to 21% in 1993. Reforms also led to a change in the institutional framework of foreign trade. A Ministry of Foreign trade was created to coordinate all the aspects of trade policy, including those related to international negotiations and export promotion.

Meanwhile the authorities undertook an aggressive *integration* strategy aimed to liberalize Colombian trade with the neighbor countries. In January, 1992, tariffs between Colombia and Venezuela were completely eliminated, while those with Ecuador and Bolivia disappeared nine months later. In 1994 a liberalization process of most of the bilateral trade between Colombia and Chile started, while in mid 1994 a similar agreement with Mexico was signed (The Group of Three Agreement). According to these agreements most of the trade between Colombia and Chile will be liberalized before the turn of the century, while the same will happen in the case of Mexico by 2.005. Colombia also enjoys unilateral preferential treatment provided by the United States and the European Union, as cooperation in the fight against drugs, which cover most of the Colombian exports to those markets until 2.001 and 2.004, respectively.

##### 3.1.2 Recent Trade Policy

The authorities under the presidency of Ernesto Samper continued the integration efforts initiated in the previous administration. On the one hand, by late 1994 Colombia, Venezuela and Ecuador negotiated an Andean Common External Tariff, which was implemented in January, 1995. This instrument allowed the Andean



countries to achieve the long-awaited purpose of an Andean Custom Union, which though still shows some exceptions, is currently more consolidated than that of Mercosur. Secondly, in December 1994, the contacts between that block and the Andean Group started, which led to the formal negotiations that are currently taking place between both custom unions. Additionally, notwithstanding the foreign exchange crisis that arised in Mexico by the end of 1994, in January 1995, the Group of Three Agreement liberalization process began. Finally, in March 1996, Colombia hosted and played a central role in the II Trade Ministers of the Americas Summit, a crucial step in the way towards an Americas Free Trade Areas (AFTA), that will be negotiated by 2.005.

The activity shown by the trade policy in the first part of the Samper Administration came to a halt by early 1996, when the authorities gave slight signals oriented towards protectionism. Though the announcements that the Andean Common External Tariff and the Group of Three Agreement would be revised ended up vanishing, the protectionist movements led to a temporary increase of 3 points import tariffs in early 1997, which has been already phased out. Notwithstanding 1996 and early 1997 ended up being a period of uncertainty about the future of Colombia's trade policy, recently the authorities have restated a strong commitment with liberalization and further integration processes.

### **3.1.3 Current Challenges of Trade Policy**

Colombia's trade policy has to deal with challenges at three levels: (i) multilateral negotiations, (ii) hemispheric and regional negotiations, and (iii) domestic macroeconomic consistency.

At the multilateral level it is worth mentioning that Colombia played an active role in the negotiation of the Uruguay Round, which allowed the country to be a full-right member of the World Trade Organization (WTO). Colombia seeks to maintain an active participation in that organization, not only because of the outstanding achievements the WTO has reached in critical trade areas, but also because the multilateral forum is the right one to solve bilateral disputes.

Consistent with its multilateral rights and duties, Colombia is expected to have an active participation in both regional and hemispheric negotiations. At the regional level the authorities shall aim to strengthen the Andean Community Market -which has become as important for Colombian exports as the U.S. market, leaving aside oil and coffee exports- as well as to successfully finishing the negotiation between this community and Mercosur. Though it is clear that this last objective is the right step to be taken in the internationalization process of the Colombian economy, the authorities have to be careful as to prevent this negotiation to generate (i) a loss of the Andean Community unity, (ii) a damage to the Colombian industry -given the asymmetry that exists between the Colombian and the Mercosur's economies-, and (iii) a subordination of the Andean Community negotiators to those of the Mercosur in the negotiation towards the AFTA.

An official commitment exists among the presidents of 34 American countries, by which they agree that the negotiations towards an AFTA must be finished by 2.005. Though the creation of a free trade area in the Americas represents a strong competitiveness challenge for the Colombian industrial production, it is clear

that such an area is the best option to foster economic development in all American countries. While the various existing free trade agreements have been beneficial for the exports of the Latin American countries involved in them, they are still partial in nature, thus generating significant trade deviation and inefficient resources allocation. Under these circumstances the Colombian authorities must take an eventual AFTA as a given. Therefore, Colombia has to maintain an active participation in these negotiations, aimed to preserve the national interest both in commercial and in economic terms.

For Colombia the purpose of negotiating an agreement between the Andean Community and the Mercosur, and that of achieving an AFTA in the medium run, are still compatible with the objective of getting to the North American Free Trade Area (NAFTA). The United States is the most important commercial partner of Colombia, accounting for almost 40% of the Colombian trade. As it was mentioned above, Colombian exports enter the U.S. market under unilateral preferential conditions through the Generalized System of Preferences (GSP) and the Andean Trade Preferential Act (ATPA). Yet, the instability of these mechanisms, given their unilateral nature, makes it necessary for the Colombian government to search a stable access to the North American market.

Though Colombia was very well positioned under the Gaviria Administration to reach this purpose, the internal political crisis has deteriorated the bilateral relations between Washington and Bogotá. The scandal about the drug financing of Samper's campaign subordinated the bilateral agenda to the drug trafficking issues. In 1995 the Colombian government got a 'conditional certification' from the State Department, while in 1996 and 1997 it was simply 'decertified'. The certification process is a unilateral practice of the U.S. government by which The White House annually evaluates the cooperation of foreign countries in the fight against drug trafficking. Though a 'decertification' opens the possibility for The White House to impose economic sanctions on Colombia, up to the present the U.S. government has not used such an instrument, and it is extremely unlikely that it will use it.

Though the deterioration of the relations between Washington and Bogotá has limited in the short term the options for Colombia to undertake a free trade negotiation with either NAFTA or the U.S., the bilateral relations are expected to significantly improve in the near future (see section on The Road Ahead, below). The significant results achieved by the current administration in the fight against drug traffickers, both with the inauguration of a new government in 1998, provide the conditions for such an improvement.

At the domestic level the authorities face the challenge to undertake a macroeconomic policy which is consistent with the objective of further fostering the internationalization of the Colombian economy. As it was mentioned in another section of this report, the Colombian currency has suffered a severe real appreciation throughout the 90s, due mainly to significant capital inflows generated by both an increasing budget deficit and the booming oil exports. Since the appreciation of the currency has become a crucial macroeconomic topic, it is expected that the administration that will take office in August, 1997, will have the fiscal adjustment at the top of its agenda. As it is discussed in the section related to political matters in this report, whether the new administration can deal with this adjustment will depend

on both its orientation and the magnitude of the political support it gets in the presidential election.

### 3.1.4 Colombia's privileged trade position in Latin America

Few Latin American countries can export under preferential conditions to the U.S., the European Union, most of the Andean countries, Chile and Mexico. As it was mentioned before, preferences by the U.S. are provided under the ATPA and last until 2.001, while those by the E.U. last until 2.004. Regional preferences are due to the regional integration negotiations mentioned above. All these preferences cover around 80% of Colombian export items, which means that almost 50% of world's market provide preferential access to most Colombian products.

These preferences are complemented by the existence of special regulations for *zonas francas* (duty free production zones) in Colombia, whose production for export is income tax exempt. Under this regulations, four top-level industrial parks for exports are being developed. Additionally, law provided special tax exemptions for the states of Cauca and Huila, given the tragedy generated in those regions by the overflowing of River Páez. These exemptions include duty free import of capital goods, duty free import of raw materials for the production of goods to be consumed within the Colombian territory, and total or partial income tax exemption.

All these circumstances make Colombia one of the best options in Latin America to undertake foreign investment projects. (For specific investment opportunities, see relevant section in this report.)

## 3.2 Infrastructure

Colombia's infrastructure is lagged behind if compared with international standards. Table 3.1 presents some international indicators of railroads, roads, telephones and electricity for 1970, 1980 and 1990. Colombia's situation is below average every year for all the indicators. Even when compared with other Latin American countries with similar levels of development, Colombia under performs in every area except telephone lines per capita. Thus, substantial amounts of investment in infrastructure are required. Taking into account that the government cannot provide the resources to undertake these projects due to fiscal constraint, since 1990 private participation in projects within the sector has been encouraged. As it is mentioned below, the results of this participation have not been satisfactory because of structural problems, the government is taking the necessary measures to correct these problems.

### 3.2.1 Private Participation Mechanisms

Private participation can be accomplished through one of the following mechanisms:

Type of Mechanism	Description
(1) Grants	The contractor transfers the right to render, operate or exploit a public service or the right to construct, exploit or maintain a public work, with financial duties and risks assumed by the grantee, under

	the supervision of the grantor.
(a) Granting the construction of a public work	The government contracts a private company to construct and operate a project for a predetermined period of time. During that time, the company carries out the necessary investments for the construction and the maintenance of the project. The company recovers the investments through the collection of tariffs.
(b) BOT (build operate, and transfer)	The company finances, builds, and operates the project. The operation of the project generates revenues that cover investment and operational costs. On a predetermined date the company transfers the property to the nation.
(c) BOO (build and operate)	These projects are promoted by the public sector but the private sector is responsible of the construction and Operation of the project.
(d) BLT (Build, lease and transfer)	This is the same concept as BOT but financing is achieved through leasing.
(e) Grant to provide a service	The grantor confers the right to provide a service through the use of a contract or a license issued by the appropriate authority.
(2) Direct provision of the services	The grantor hires a private company for the operation of a part or the totality of a project. This applies for projects of water provision, television, cellular communications, local communications, generation of electricity, and distribution of electricity to households.
(3) Association with public sector companies.	Public sector companies can join private companies to provide public services. One type of association is joint-ventures.
(4) Acquisition of public companies	Private investors may participate in infrastructure projects by buying a part or the totality of public participation in companies that provide services.
(5) Managing public assets in specific companies	Public institutions contract a private company to manage the assets of the public sector in companies that provide public services.

More information on the nature of private participation schemes is specified in detail in a document issued by the National Planning Department<sup>1</sup>. In that document risks<sup>2</sup> are assigned between the participating parts, the compensation system is defined, responsibilities are determined, financial aspects are specified, and macroeconomic features are taken into account.

<sup>1</sup> CONPES Document No. 2775, April 1995

<sup>2</sup> Construction, commercial, unforeseen, regulatory, environmental and other risks.

**Table 3.1**  
**Some Selected Indicators of International Developments in Infrastructure**

	Railroads (kms. of railways per million inhabitants)			Roads (kms. of paved roads per million inhabitants)			Telephones (# of local lines per million inhabitant)			Electricity (installed MW per million inhabitants)		
	1970	1980	1990	1970	1980	1990	1975	1980	1990	1970	1980	1990
Bolivia	815	597	473	219	250	242	NA	25494	25134	62	88	100
Chile	871	565	607	780	881	834	32407	32571	65296	225	264	310
Colombia	156	110	62	224	320	310	41246	51591	87486	97	163	270
Ecuador	164	119	91	481	528	597	25018	27945	46331	50	138	157
Egypt	128	114	97	304	310	279	9727	11083	32760	132	88	224
Germany	425	364	539	5310	5960	6393	180633	262250	386463	612	1055	1286
Japan	280	190	194	1457	4375	6334	308848	341880	441625	659	1230	1578
Mexico	464	285	348	809	950	1085	29927	36583	70845	139	241	387
Peru	169	121	116	368	364	348	16754	18598	26193	127	185	200
Spain	491	419	487	2802	4018	6121	143780	192558	321602	530	782	1104
Turkey	226	184	156	538	802	815	19238	29289	123380	65	115	292
United States	1615	1265	823	22859	22696	NA	383392	413959	547048	1757	2767	3111
Venezuela	28	19	25	1697	1523	1477	45638	57224	83971	299	564	1048
<i>Avg. (-Col.)</i>	<i>471</i>	<i>354</i>	<i>330</i>	<i>3135</i>	<i>3555</i>	<i>2230</i>	<i>108669</i>	<i>120786</i>	<i>180887</i>	<i>388</i>	<i>626</i>	<i>816</i>
<i>Avg. Latin American Countries (-Col.)</i>	<i>419</i>	<i>284</i>	<i>277</i>	<i>726</i>	<i>749</i>	<i>764</i>	<i>29949</i>	<i>33069</i>	<i>52962</i>	<i>150</i>	<i>247</i>	<i>367</i>

Source: Cardenas, Escobar and Gutierrez (1996)

### 3.2.2 Private Participation, 1995-1998

Private participation in infrastructure became a priority objective for the Colombian State in the 90s. The policy intended to foster this participation has maintained total continuity during the last two administrations, and is expected to remain stable. Table 3.2 reports planned public and private investment in infrastructure for 1995-1998, corresponding to the current administration. It is noteworthy that private participation represents 42% of programmed investment--gas distribution being the area where participation is the highest.

During 1995 15.7% of the total planned investments for 1995-1998 were completed. This was mainly due to the poor performance of private investment in transportation. Nevertheless, the private sector accomplished 34% of planned investments in ports. Therefore, the productivity indices of Colombian ports increased from 500 tons of merchandise mobilized daily in 1990 to 2.700 tons per day in 1995. If measured as the number of days that the ships spend unloading, it also fell from 10 days needed in 1990 to 2 days in 1995.<sup>3</sup>

In contrast, in 1995 the performance of public and private investments in the energy sector was satisfactory, specially in oil and coal sectors. It is worth mentioning the accomplishment of public investment in gas distribution that was 30% of total planned investments that year. Developments in this area are very important because Colombia has not taken advantage of the gas reserves it possesses. Consequently, households and firms have not been able to take full advantage from this inexpensive energy source.

Notwithstanding the poor performance in the previous year, in 1996 considerable progress was made in investment within the sector; 21% of planned investment for the period (1995-98) was brought about. Private and public investment was high in electricity (32% and 35% respectively), but it remained low in transportation although significant progress was made with respect to the previous year, specially by the private sector.<sup>4</sup>

### 3.2.3 Solving the Problems

Private participation in infrastructure projects faced some limitations in the past years, mainly because the regulatory system had to be tested in order to be adjusted. Problems have emerged specifically in the granting of warrantees, the acquisition of the necessary properties, financing, project structures and payment of service tariffs. The authorities have been taking the right measures to overcome these limitations.

The warrantees granted by the government are equivalent to 20% of the total costs of the projects in which the private sector has participated. These contingent liabilities may produce, in the near future, important fiscal instability within the institutions that confer the warrantees. In addition, in the projects in which they may become operative the necessary liquid resources may not be available, which can jeopardize the financial stability of the project. Hence, the government designed a

<sup>3</sup> pg. 126 Presidencia de la República y Planeacion Nacional(1996)

<sup>4</sup> In 1995 the private sector only invested 3.7% of total planned investments versus 9.2% in 1996.

**Table 3.2**  
**Estimated Public and Private Investment in Infrastructure 1995-1998**  
 (million US\$)

Sector	Planned 1995-1998				Accomplished in 1995						Accomplished in 1996						
	Public Amount	%	Private Amount	%	Total Value	Public Amount	% acc	Private Amount	% acc	Total Value Amount	% acc	Public Amount	% acc	Private Amount	% acc	Total Value Amount	% acc
TRANSPORTATION	6,248	66.8	3,108	33.2	9,356	1,052	16.8	114	3.7	1,165	12.5	1,122	18.0	169	5.4	1,291	13.8
Roads	5,303	70.4	2,227	29.6	7,530	807	15.2	87	3.9	894	11.9	728	13.7	122	5.5	851	11.3
Railways	345	52.8	309	47.2	654	116	33.6	0	0.0	116	17.7	n.a	n.a	n.a	n.a	n.a	n.a
Ports	95	54.9	78	45.1	173	17	18.0	27	34.0	44	25.2	n.a	n.a	32	40.5	n.a	n.a
Airports	200	52.6	178	47.4	376	82	41.1	0	0.0	82	21.9	n.a	n.a	15	8.2	n.a	n.a
Rivers	108	78.9	32	23.1	140	20	18.4	0	0.0	20	14.1	n.a	n.a	n.a	n.a	n.a	n.a
Urban	199	41.3	283	58.7	482	1	0.5	0	0.0	1	0.2	n.a	n.a	n.a	n.a	n.a	n.a
ENERGY	7,675	46.6	8,787	53.4	16,472	1,452	18.9	1,504	17.1	2,956	17.9	2,300	30.0	2,178	24.8	4,477	27.2
Oil	3,017	35.6	5,448	64.4	8,465	763	25.3	829	17.1	1,693	20.0	688	22.8	1,174	21.5	1,862	22.0
Gas	358	16.1	1,871	83.9	2,229	108	30.2	285	15.2	393	17.6	109	30.3	422	22.6	531	23.8
Electricity	4,113	77	1,230	23	5,343	872	21.2	144	11.7	1,018	19.0	1,452	35.3	396	32.2	1,848	34.6
Coal	109	55.1	89	44.9	199	32	29.2	121	135.3	153	76.9	36	32.7	n.a	n.a	n.a	n.a
Mining	78	33.1	158	66.9	236	11	13.8	25	16.0	36	15.2	15	19.7	n.a	n.a	n.a	n.a
TELECOMMUNICATIONS	2,783	63.4	1,610	36.6	4,393	589	21.2	378	23.5	967	22.0	552	19.8	347	21.6	899	20.5
DRINKING WATER	2,052	95.5	96	4.5	2,149	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
<b>TOTAL</b>	<b>18,759</b>	<b>58</b>	<b>13,610</b>	<b>42</b>	<b>32,369</b>	<b>5,088</b>	<b>27.1</b>	<b>1,996</b>	<b>14.7</b>	<b>5,088</b>	<b>15.7</b>	<b>3,993</b>	<b>21.3</b>	<b>2,694</b>	<b>19.8</b>	<b>6,686</b>	<b>20.7</b>

Source: National Planning Department

warranty fund in which the necessary contingencies for each project would be transferred to the fund<sup>5</sup>.

In some cases, there has been uncertainty on the acquisition of the required resources to adequately develop infrastructure projects. Usually, this has implied a rise in costs and delays in the execution of the projects. The government has the necessary tools to obtain the properties, consequently, it must be its responsibility to provide them and deliver them at the agreed date.

Private investors have faced problems obtaining financing for their planned investments. Financing has been available from commercial banks and local and international capital markets. Local commercial banks offer expensive resources in terms of interest rates and maturity, and Colombia's capital market has not proven to be a good source<sup>6</sup>. Therefore, the Ministry of Finance, the National Department of Planning and Bancoldex<sup>7</sup>, are designing different financial tools to support private investment in infrastructure<sup>8</sup>.

Another source of problems has arisen from the preliminary studies of the design and structure of the projects. The main delay has been caused by poor estimations of the time required to adequately develop these studies.<sup>9</sup> Because of this, the government adjusted the original timetable of the developments of private participation, taking into account the time needed to produce the studies<sup>10</sup>. Closely related to this have been the problems related to the payment of service tariffs. The lack of market research to determine disposition to pay by the consumers, the social impact of the different levels of tariffs, and the optimal level of tariffs, have implied that at times the government has had to give additional contributions to the private firms in order to guarantee proper returns on investments.

It is worth mentioning that several institutional advances have been made in order to facilitate private participation within the sector. A committee of private participation in infrastructure was created in May 1995, whose main objectives are to coordinate and direct the different approaches to private participation in infrastructure within the different institutions of the government. Likewise, management of the program of private participation was centralized in the "Gerencia del Programa de Participación Privada en Infraestructura Física", which is intended to promote private participation in the sector by divulging all the necessary information. Finally, the government has hired several firms to develop studies in order to optimize the legal and regulatory structure to simplify private participation.

In some sectors there have also been important institutional improvements in the design of private participation. An example of these advancements are the elaboration of studies on the design of the different roads, the definition of the

<sup>5</sup> At present, the law for the creation of the Warranty Fund is being discussed in Congress.

<sup>6</sup> See the section on Capital Markets.

<sup>7</sup> Bancoldex, is a bank specialized in providing trade finance. It is 99% owned by the state.

<sup>8</sup> Partial results of an investigation done by the Ministry of Finance and the National Department of Planning on the possible tools to be used and their benefits are available from Documento CONPES No.2928, June 11 1997, pg.33.

<sup>9</sup> For example, studies on construction designs, environmental evaluations, financial and legal structure of the project, etc.

<sup>10</sup> The revised timetable is published in Documento CONPES No. 2852, June 26 1996.



mechanism through which private firms can participate in telecommunications, and the delineation of service tariffs for the generation of electricity<sup>11</sup>.

Although private participation in infrastructure in Colombia has had a slow start, the experience acquired in the last few years has allowed the government to take the necessary actions in order to facilitate participation. Moreover, the government wants to encourage private participation within the sector. Consequently, the mentioned aspects permit us to believe that in the following years participation of private firms within the sector will prove to be successful.

### ***3.3 Health ,Education and Criminality***

Since the beginning of the decade public expenditure in the social sectors has increased as a percentage of GDP. At the beginning of the 90's the government of Colombia spent less, as a percentage of GDP, in the social sector than average spending of most Latin American countries (Table 3.3). Average spending in the social sector in 1990-1991 for some Latin American countries was 10.5% of GDP, while Colombia spent 9.2% in those years. In contrast, in 1994-1995 average spending in the social sector in Latin America was 12.4%, while Colombia's spending was above average at 14.2%. The greater amounts of resources directed to health and education have increased significantly the coverage rate of the two sectors. However, sometimes the increases in coverage rate come coupled with better services.

#### **3.3.1 Education**

Colombia has made significant progress in the last few decades. Illiteracy rate fell from 38% in 1951 to 11% in 1993. Unfortunately in the rural area this rate remains high. Although it has fallen from 49.7% in 1951 to 22.8% in 1993, still almost a quarter of the rural population is illiterate (Table 3.4). Other indicators such as coverage rate of schooling at all levels, and the years of schooling have grown steadily since the beginning of the decade. Recently, Law 60 of 1993 introduced reforms within the system in order to transfer the responsibility of spending in education to the regional governments. It is important to proceed with caution in the decentralization process because evidence points out that the biggest problem of the Colombian educational system is not the amount of resources, but the quality of the education, and the efficiency when spending.

The global performance of Colombia in terms of education has been satisfactory in the last decade. The coverage rate in all levels of education has increased significantly, specially in middle and high school where the coverage rate passed from 48% in 1982 to 61% in 1996 (figures 3.1-3.3). The years of schooling received, have also increased from 7.5 years in 1982 to 9 years in 1996 (figure 3.4). However, although there have been increases in coverage rate and years of schooling it is important to take into account other aspects as the quality of the education, equity within regions and social strata, efficiency within the system, and the evolution of the technical capacity of the educated labor force.

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<sup>11</sup> For more information on the specific advances within each sector see Documento CONPES No. 2852, July 26, 1996.

**Table 3.3**  
**Social Spending as a Percentage of GDP in Some Latin American Countries**  
**(1990-1991, 1994-1995)**

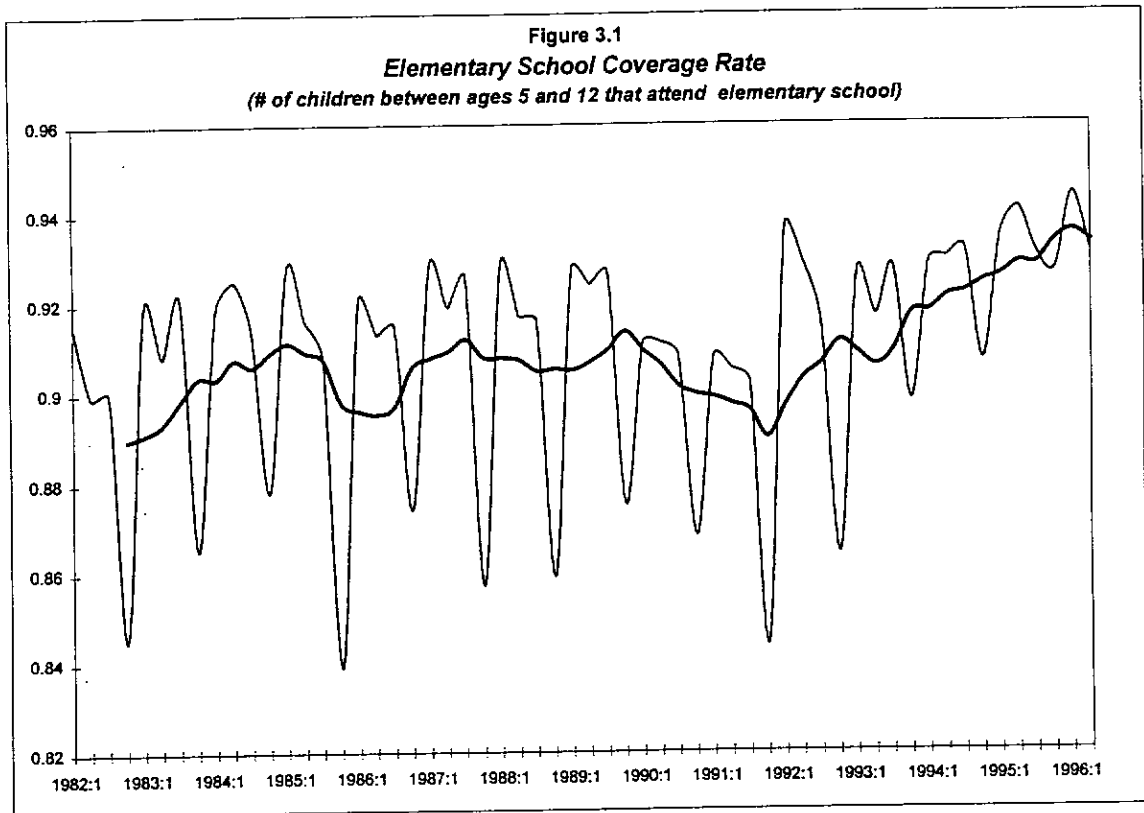
Country	1990-1991 Position (%GDP)		1994-1995 Position (%GDP)	
Uruguay	18.9	2	23.6	1
Costa Rica	19.8	1	20.8	2
Panama	17.1	3	20.0	3
Argentina	17.1	4	18.3	4
<b>Colombia</b>	<b>9.2</b>	<b>8</b>	<b>14.6</b>	<b>5</b>
Chile	13.1	5	13.4	6
Mexico	8.4	9	13.1	7
Brazil	11.6	6	11.2	8
Nicaragua	10.8	7	10.6	9
Ecuador	7.8	10	10.4	10
Honduras	7.8	11	7.6	11
Paraguay	2.6	15	6.6	12
Bolivia	4.6	13	6.3	13
El Salvador	5.5	12	5.3	14
Guatemala	3.3	14	3.7	15
<b>Average</b>	<b>10.5</b>		<b>12.4</b>	

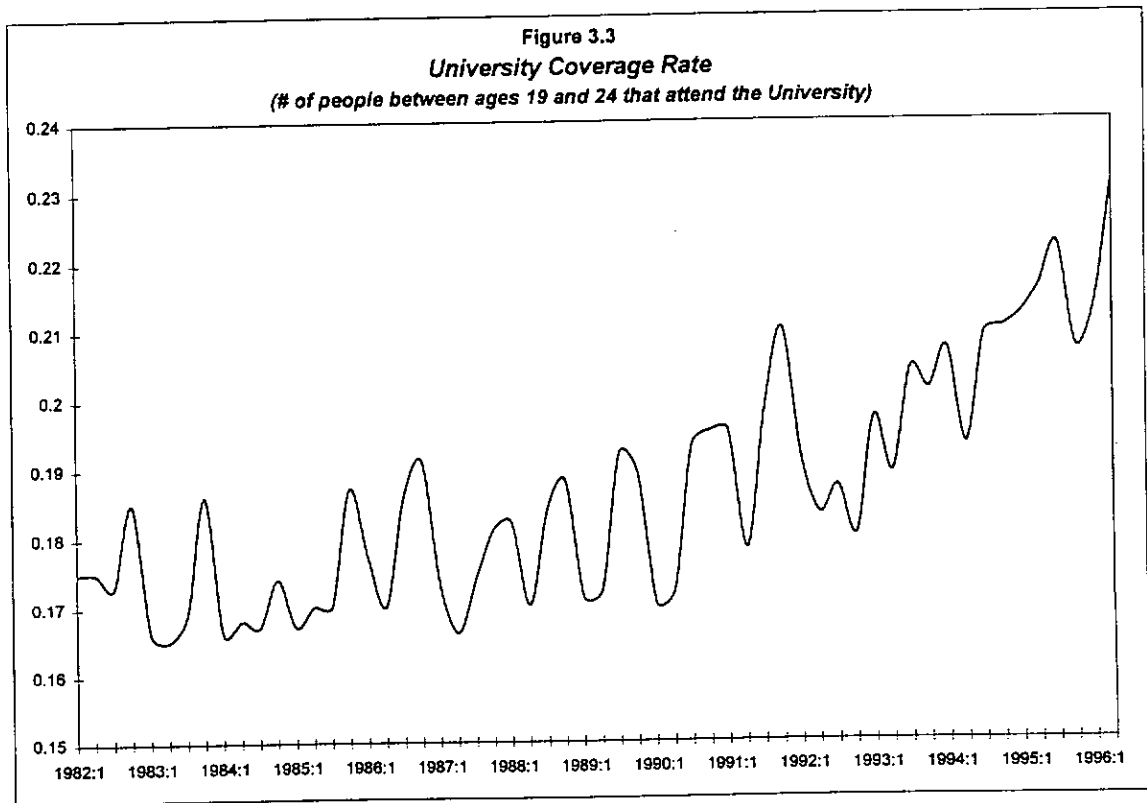
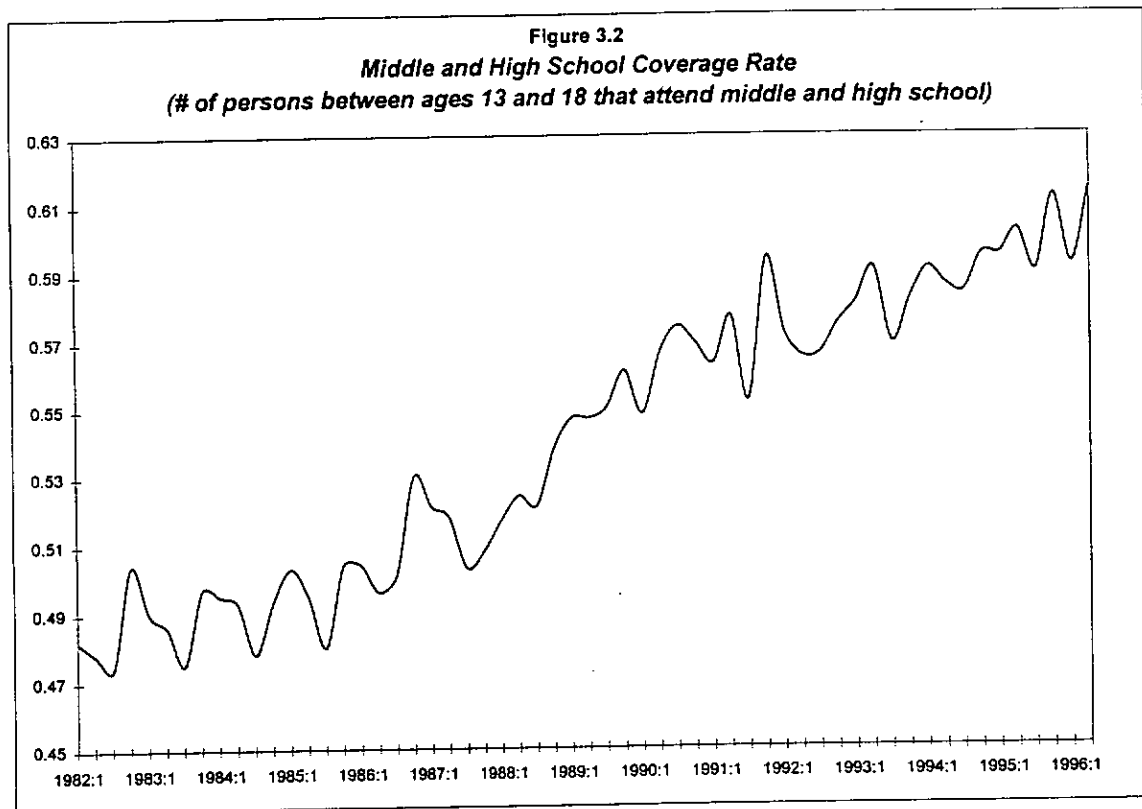
Source: CEPAL, Panorama Social de América Latina, 1996

**Table 3.4**  
**Illiteracy Rate of the Population Above 15 years old (1951-1993)**

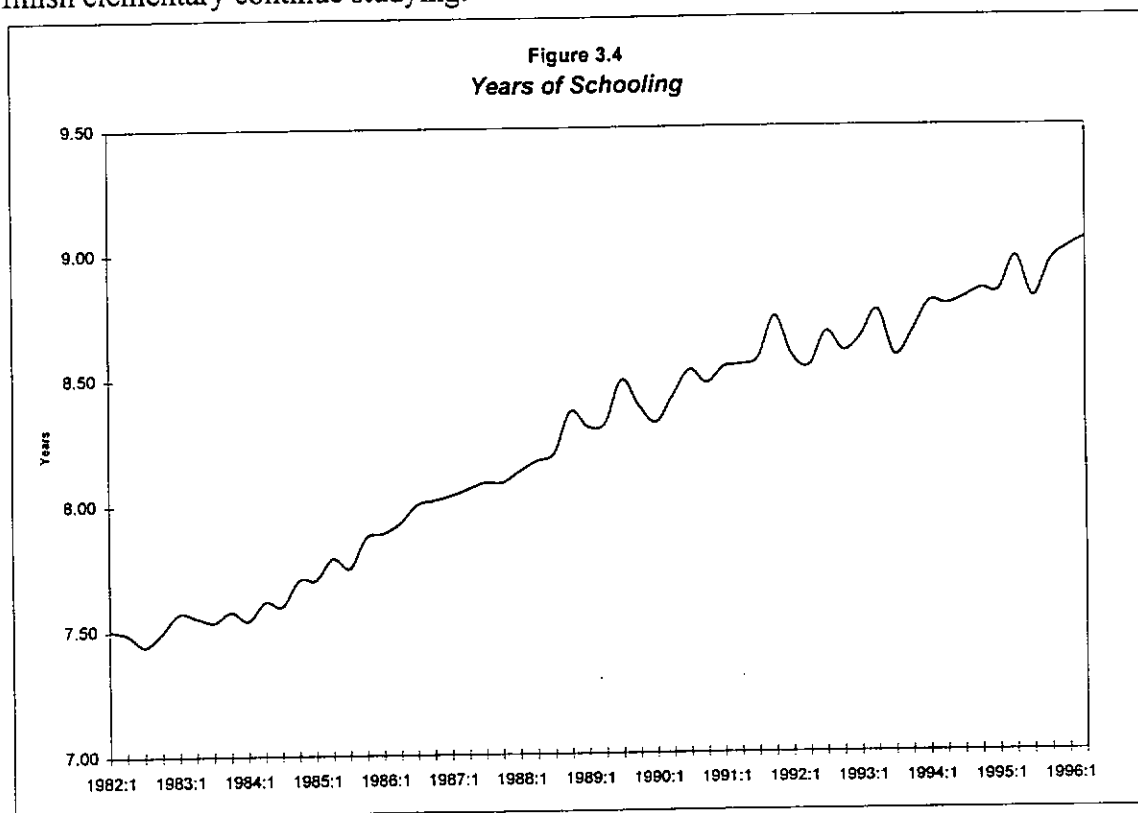
	Total	Metropolitan Area	Rural Area
1951	37.7	21.1	49.7
1964	27.1	15	41.3
1973	18.5	10.5	32.7
1978	16.8	9.6	31.7
1985	13.6	8.4	26.1
1993	11.1	6.6	22.8

Source: Coyuntura Social, November 1995



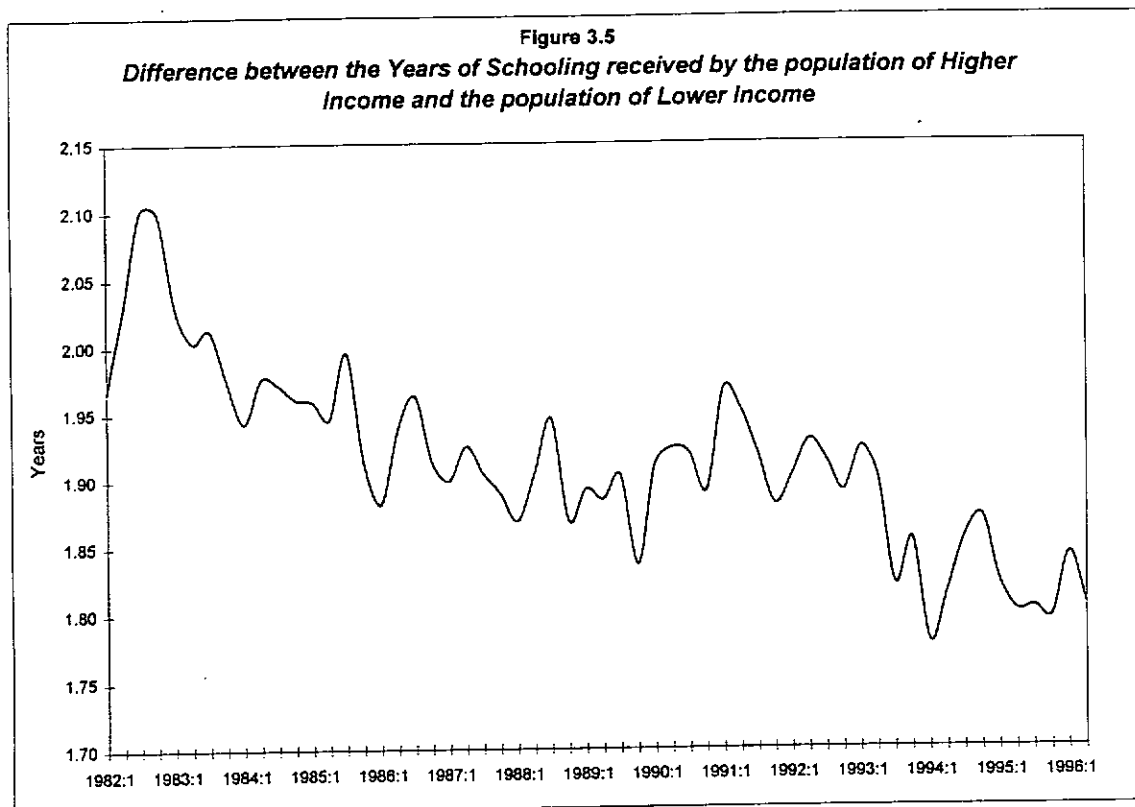


Though important advances have been made in the coverage rates of education, there still are some differences between regions. Some states like Antioquia and Valle, show a coverage rate of 70% while other regions like Choco or Amazonas only show a coverage rate of 50%<sup>12</sup>. Indicators on the quality of the education also display important differences between regions. The number of students who continue studying beyond elementary is 466 for every 1,000 children in Bogota, while in Choco it is only 282. At the national level, only 60% of the students that finish elementary continue studying.



There are also important differences in the coverage rate and years of schooling amongst different levels of income. The difference is especially notorious at the university level. While in 1996, 40% of the people between ages 19 and 24 attended the university, in the lowest level of income only 13.5% did. In terms of years of schooling, figure 3.5 shows the number of extra years of schooling that the people of higher incomes receive. Although the difference in years of education is smaller, members of the strata with highest income still get 1.8 more years of education.

<sup>12</sup> C.G. Molina and C.A. Herrán (1995)



The system of education is also experiencing problems in the supply of necessary programs of higher education. A study by Fedesarrollo reveals that the institutions that provide higher education are not adjusting their curricula to the requirements of the economy. New technical skills are needed within the manufacturing sector and few institutions are providing the necessary training. In Colombia 41% of the available programs of higher education are oriented towards the areas of economics and management, 26% towards engineering, and 11% towards the arts. Hence, although the Colombian economy is demanding new technical capacities the institutions are not adjusting their programs towards the areas of engineering.<sup>13</sup>

As a response to the lack of supply of programs in the areas of engineering, the government and the private sector joined forces. In 1990, law 29 was passed to formalize the collaboration in research and development between the government and the private sector, and it also created centers of technological development. In 1996, already 16 of these centers were operating in sectors such as footwear, plastic, and metallurgic. Within this program, the government invested US170 million in 1996 in research and development.

<sup>13</sup> J.M. Rojas and C. Vallejo (1996)

### 3.3.2 Health

Before the reform of the Colombian social security system in 1993, the system of national health had many problems within its structure. In 1992 58% of the population of lower incomes was not served by the system mainly because the patient had to assume an important proportion of the costs of the treatment. Additionally, membership in the social security public system assisted only one fifth of the population, people of middle and high incomes, with a stable job in the formal urban sector<sup>1</sup>. Consequently, authorities enacted a reform at the beginning of the decade that in the past few years has shown important advances.

The reform brought about in 1993 changed the entire system of social security. In the health sector it opened the possibility of private participation in areas that had only been served by the public sector. Also, additional resources were given to the sector because mandatory contributions grew from 7% to 12% of wages. Likewise, a system of subsidies for the population of lower incomes was designed. One percentage point of the contributions made by the workers from their salaries is directed to a Solidarity Fund. Additionally, as in the case of education, responsibilities in the management of resources and services were transferred to the regional governments. As a consequence of the reform, a system of competition between agents was introduced into the health system in order to improve efficiency, and the population of lower incomes was given the opportunity to access the health system.

The results of the reform have been satisfactory, although private participation has been more dynamic in the management of the resources than in the provision of the service. Private participation can be done through EPS which are institutions that collect and manage the contributions to the system, or through IPS, institutions that provide health services. At the end of 1995, 25 EPS were operating and 19 of them were privately operated. In order to encourage private participation in IPS, the government is designing financial instruments to promote private participation.

The results in coverage rate have also been satisfactory. The law that gave birth to the reform started operating in 1995, and after two years half of the population of the country has been insured. In the case of the population of lower incomes that are eligible for subsidies, 5.9 million people have enrolled, which is 49% of the target for the period 1994-1998. On the other hand, the number of people that contribute to the system has grown more than 100% passing from 6.6 million contributors before the reforms to 13.4 million contributors.

Although the reforms have been successful in the growth of the number of people who contribute to the system, the process of decentralization of resources has not made mayor advances. The resources that used to be managed by the states, have not been transferred adequately to the corresponding territorial entities. Hence, those resources have not been transformed yet into subsidies to the demand of health services. Consequently the whole purpose of converting the system from one that subsidizes the supply to one that gives subsidies to the demand has been delayed.

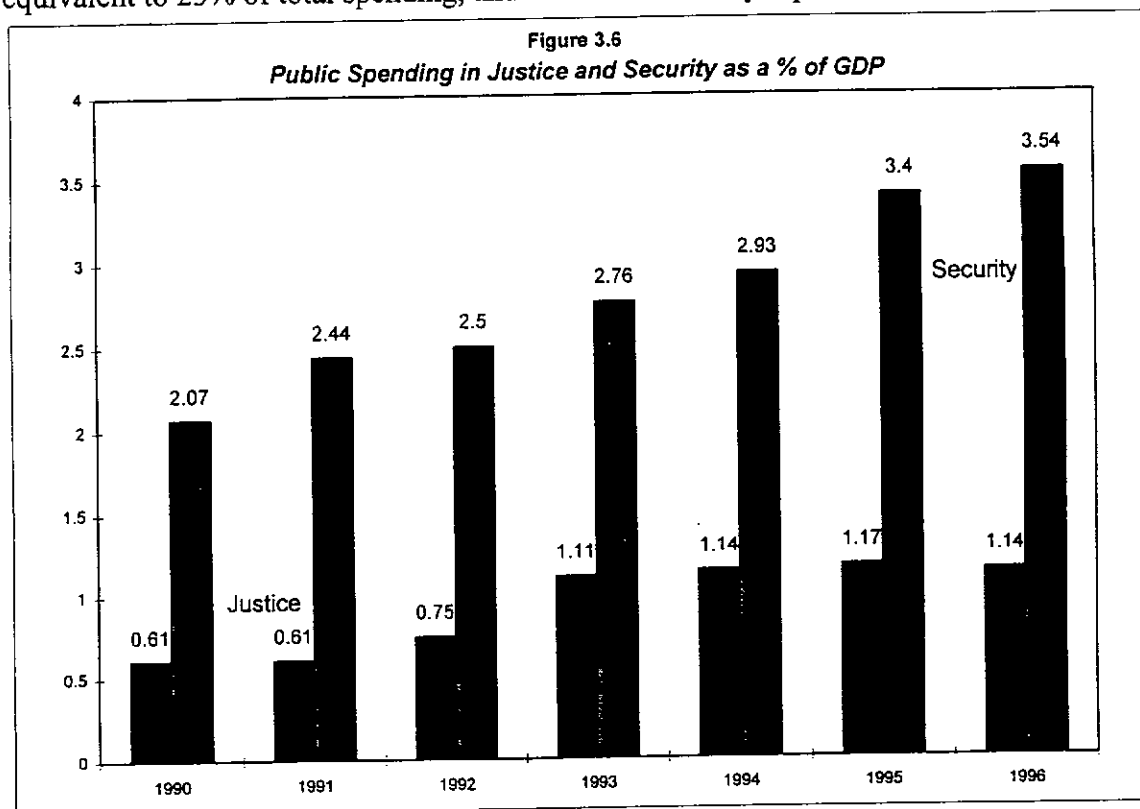
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<sup>1</sup> J. A. Ocampo (1996)

### 3.3.3 Criminology

Reduction of violence and criminality rates is a top priority for Colombian authorities. It is clear that if the country has been able to maintain a good economic performance in the second half of the century, notwithstanding violence and criminality, Colombia's productivity and competitiveness would boost if those conditions are improved.

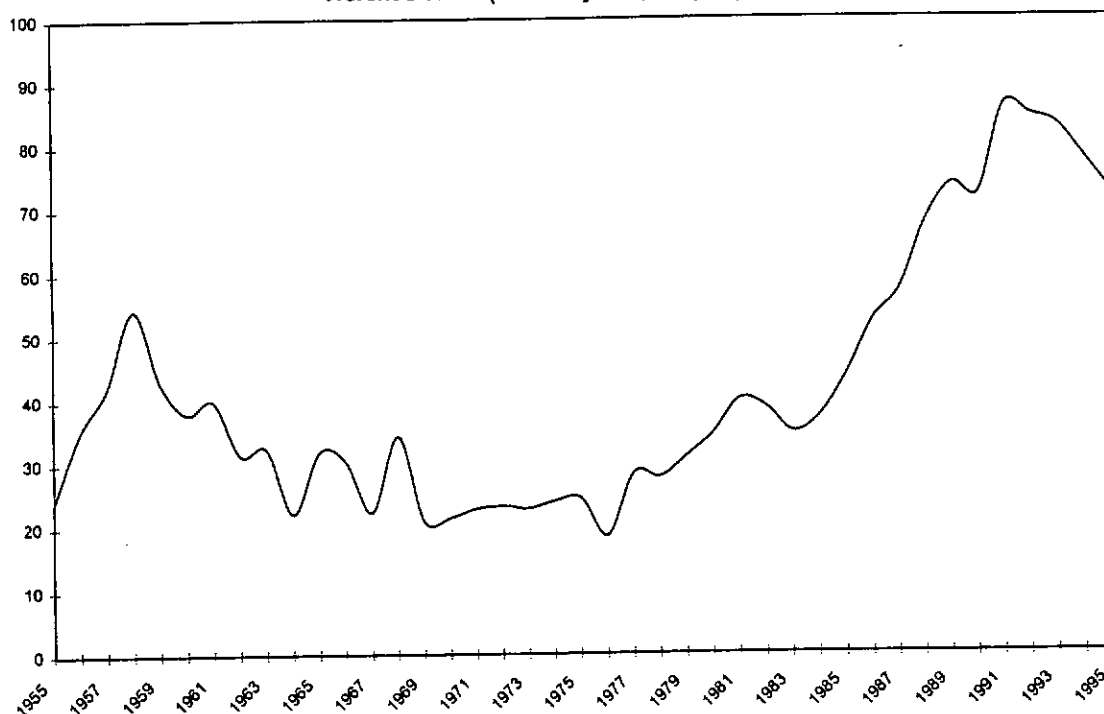
Thus, throughout the 90s the authorities have increased the public expenditure in both Security and Justice, while policy adjustments to increase its efficiency have been introduced. Figure 3.6 shows the evolution of public spending in these two areas. Spending in Justice increased from 0.61% of GDP in 1990 to 1.14% in 1996, while spending in security raised from 2.07% in 1990 to 3.54% in 1996. However, although public spending has grown as a percentage of GDP it has decreased as a percentage of total public spending. In the 50's, spending in justice and security was equivalent to 23% of total spending, and this decade it only represents 16%.



The availability of more resources for these sectors in this decade has had a positive impact in the reduction of the number of violent deaths in the country. Figure 3.7 shows that since 1991 violent deaths fell from 86 for every 100,000 people to 72 in 1995. These indicators are expected to keep on falling in the near future, given the successful fight against drug trafficking undertaken by this government, and the possibility that the next administration could start peace negotiations with the guerrilla groups.



Figure 3.7  
Violent Deaths (for every 100,000 people)



## 4. Investment Opportunities

This section presents the most relevant features of the sectors of the Colombian economy that present the mayor investment opportunities. Specific projects are mentioned for some sectors. In the others, a brief description of the capacity and recent evolution of the sector are brought up.

### 4.1 Infrastructure

In the early 90's the Colombian government began a process of modernization of infrastructure with the participation of the private sector. The section on Infrastructure of this report discusses extensively the mechanisms and recent developments of this participation. In the near future there are opportunities of private participation in roads, railroads, airports, electricity, gas, and water provision.

#### 4.1.1 Roads

During the next three years 11 projects should be developed in road infrastructure. The projects amount for an investment of US\$4093 million in the construction of 552 km and the restoration of additional 1,819 km more. The following are the road projects in which private capital may participate.

<b>Project</b>	<b>Const</b>	<b>Restore</b>	<b>Total Cost*</b>	<b>Auction</b>	
	<i>Km</i>	<i>Km</i>	<i>US\$ mill</i>	<i>Opens</i>	<i>Closes</i>
Malla Vial del Valle	136	180	400	Aug/97	Nov/97
Barrancabermeja- Bmanga - San Gil	28	227	150	Oct/97	Feb/98
Briceño -Tunja- Sogamoso	n.a.	168	400	Jan/98	May/98
Via Alternativa Buenaventura	56	0	245	Apr/98	Sep/98
Bosa-Chusacá-Girardot	75	122	420	June/98	Nov/98
Cruce Cordillera Central	n.a.	81	1,320	Oct/98	Apr/99
Avenida Cundinamarca	47	n.a.	430	Nov/97	Apr/98
Cartagena- Turbaco- Carreto- Sincelejo	65	170	138	n.a	n.a
Pereira- La Paila- Armenia- Calarcá	115	156	180	n.a	n.a
Bucaramanga- Yé de Ciénaga- Santa Marta	0	530	280	n.a	n.a
Briceño- Zipa- Chiquin- Barbosa- Chiquin- Villa de Leyva- Tunja	30	185	130	n.a	n.a
<b>TOTAL</b>	<b>552</b>	<b>1819</b>	<b>4,093</b>		

\*Some of these projects include public participation in total costs. For information on the exact amounts of private participation in each project, contact the Gerencia de Participación Privada en Infraestructura in the National Department of Planning.  
Source: National Department of Planning, CONPES Document No. 2928

#### 4.1.2 Railroads

In 1995, 1125 thousand tons of freight were transported through Colombian railroads, 988 thousand on the Atlantic network and 140 thousand on the Pacific network. This meant an increase in 58% with respect to the freight transported the previous year. According to research done by the National Department of Planning, in the year 2000 transported freight will be between 8.7 and 12.7 million tons in the Atlantic network, and between 2.1 and 2.2 million tons in the Pacific network. Private Participation is expected in both networks coupled with public participation in sectors where private investment is not profitable. The following are feasible projects in which private capitals can participate.

<b>Project</b>	<b>Restore</b> <i>Km</i>	<b>Total Cost*</b> <i>US\$ mill</i>	<b>Auction</b>	
			<i>Opens</i>	<i>Closes</i>
Red Atlántica			Jan/97	July/97
Bogotá-Puerto Salgar-Puerto Berrío- Santa Marta	972	n.a.		
Puerto Berrío- Medellin	187	n.a.		
Bogotá-Lenguazaque	110	n.a.		
Bogotá-Belencito	262	n.a.		
Red Pacífica			Jan/98	March/98
Medellin-Buenaventura	650	n.a.		
<b>TOTAL</b>	<b>2181</b>	<b>605</b>		

\*Some of these projects include public participation in total costs. For information on the exact amounts of private participation in each project, contact the Gerencia de Participación Privada en Infraestructura in the National Department of Planning.  
Source: National Department of Planning, CONPES Document No. 2928

#### 4.1.3 Airports

Within the objectives of participation of the private sector in infrastructure lies the transfer of the management of Colombia's 5 biggest airports in Cali, Medellin, Bogota, Cartagena and Barranquilla to the private sector. The participating firms must have a corporate structure and an international airport operator must own at least 30% of the stocks of the firm. The management of the airport is transferred to the private operator for a period of 15 years. In 1996 the airport in Cartagena was handed to a private manager in exchange of a compensation of US\$24 million, and in February of 1997, Barranquilla's airport was handed over for US\$9 million. The three biggest airports are still to be transferred to private management in the next years.

<b>Project</b>	<b>Auction</b> <i>Opens</i>
Aeropuerto Internacional de Cali- Alfonso Bonilla	Nov/97
Aeropuerto Internacional de Medellin- J.M. Córdova	June/98
Aeropuerto Internacional El Dorado- Bogotá	Aug/98

#### 4.1.4 Electricity

An important goal of the Generation Expansion Plan that began in 1994, is to increase the component of thermal electricity from the current 24% generated with

thermal power to 40% in the year 2000 and 60% in 2010. Hence, 733 MW of hydro power and 3,230 MW of thermal power are to be added between 1996 and the year 2000, 55% of which will be allowed to private sector participation. At the distribution level there is also a lot to be done. Currently, there is an overloading of the existing networks that cause substantial energy losses. The following are the projects of generation and distribution that will be offered in the next few years.

<b>Project</b>	<b>Capacity</b> <i>MW</i>	<b>Type</b>	<b>Auction</b>	
			<i>Opens</i>	<i>Closes</i>
<b>Generation</b>				
Termocentro	200	Gas-fired		
Termocesar	300	Coal	Aug/97	Dec/97
<b>Distribution</b>				
Corelca	1300		Sep/97	Feb/98
Choco-Cauca-Nariño	53		Nov/97	Mar/98
Electrificadora Tolima		del	Aug/97	Nov/97
Electrificadora Quindio		del	Aug/97	Nov/97

#### 4.1.5 Gas

Colombia has begun to use intensively gas as an energy source. It has become a priority for the government to encourage the use of gas due to reserves found in the Cusiana, Opón, and Volcanera fields. Between 1990 and 1995 gas production grew 1.9%, while in 1995 it grew 6.4% as compared to 1994. However, for the development of the gas sector important amounts of investment in infrastructure for production and distribution are needed. The government wants to encourage the use of gas specially in households given that it is a relatively cheap energy source. Consequently two projects are being offered for the distribution of gas to households. The private investor has to construct and operate the necessary infrastructure to supply gas exclusively in predetermined zones. The following are the projects being offered with the dates established for participation.

<b>Project</b>	<b>Auction</b>	
	<i>Opens</i>	<i>Closes</i>
Distribucion Areas Exclusivas Tolima	February / 97	April / 97
Distribucion Areas Exclusivas Cundinamarca - Boyaca	Nov / 97	Mar / 98

#### 4.1.6 Water Treatment and Provision

Private participation in water treatment and provision started in 1994 with a US\$ 8 million project in Cartagena. The following are the cities where participation in water provision and treatment by private capitals has been approved.

<b>Project</b>	<b>Total Cost</b> <i>US\$ Million</i>	<b>Auction</b> <i>Opens</i>
Monteria	114	II Semester 1997
Bucaramanga	180	II Semester 1998
Santa Marta	90	I Semester 1998
San Andres	27	I Semester 1998

## 4.2 Mining

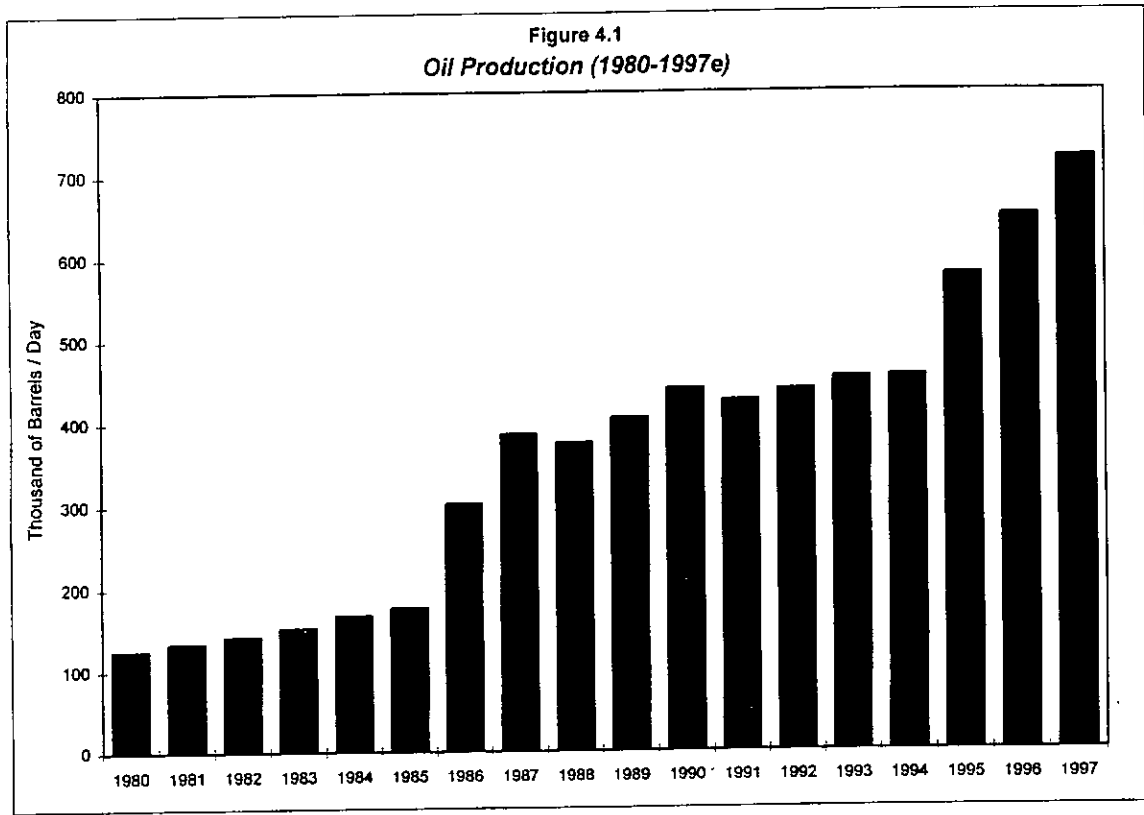
The participation of the mining sector in Colombia's economy has grown from 3.7% of GDP in 1994, to 4.5% in 1996. That year the sector grew 7.6%, oil production grew 7.2%, natural gas 6.1%, and coal 12.0%.

### 4.2.1 Oil

Colombia's oil industry has been very dynamic since the mid 80's and is expected to maintain that trend in the middle run. (figure 4.1). With 2,900 million barrels of reserves, Colombia currently occupies the fourth place in Latin America after Venezuela, Mexico, and Brazil. The country occupies the fifth place in production in Latin America with a production of 720 thousand barrels per day. Colombia has 13 sedimentary basins which comprise 887,000 km, seven of which are under commercial production. Potential reserves account for 24 million barrels.

Ecopetrol, the state owned company, assumes 50% of development costs, pays 50% of incurred costs and shares the operation expenses in proportion to production. The new association contracts have the advantage of a direct contract system delivered on a first come first served basis, a quick negotiation system, and a distribution of costs in agreement with the project profitability. In 1990 there were 40 association contracts prevailing and 100 associations are expected in 1997. Foreign Investment in the oil sector represents 30% of total foreign direct investment.

However, exploratory activity has decreased in the last years, and it is essential that the activity continues because Colombia could become an oil importer in the year 2005. Up to the present, 80% of Colombian territory has not been explored.



Colombia's government is encouraging private participation in the modernization of the oil refineries in Cartagena and Barrancabermeja. Developments in Barrancabermeja require investments for US\$ 580 million between the year 2000 and 2002, while Cartagena's project estimated value is US\$350 million and is expected to be completed by the year 2000. Colombia currently imports 25 kdbc of gasoline to satisfy internal demand, which shows the need to develop the capacity to refine oil in the country.

#### **4.2.2 Coal**

Colombia is the fourth coal exporter in the world. The country has reserves equivalent to 6.700 million metric tones. In 1995 the value of coal exports was US\$595 million, which implied a growth of 7.7% as compared to the previous year. The growth was due to a greater demand by the European Union - 65% of total exports were oriented to the European market last year.

### **4.3 Manufacturing**

The opening of the Colombian economy, which began in 1989, triggered an increase in productivity and an industrial conversion. In the first 3 years of the decade, productivity increased by 2.2%. However, as it is explained in the section devoted to the economic performance in this study, in 1995 the manufacturing industry grew 3.4%, 1.5 points below 1994.

#### **4.3.1 Food and Beverages**

In the beginning of the decade the productivity of the food and beverage sector increased 2.7%. In 1995 the processed food sector grew 9,2%, almost 6 percentage points above the aggregate of the manufacturing sector, and 7% more than the growth registered in 1994. The greater dynamism in 1995 is partially due to a renewal of 51.5% of employed machinery in 1992 and 1993.

Foreign investment in the sector was US\$160.000 million in 1995, representing 12.1% of total foreign investment in manufacturing.

#### **4.3.2 Textile**

Colombia's textile industry is the second largest in Latin America after Brazil. The industry contributed with 5% of the growth of industrial GDP in 1995. National consumption of textiles has grown permanently since 1991, and in 1995 it was 800 million square meters.

In 1995 textile exports grew 50% for a total of US\$204 million. Fifty percent of total exports go to the Andean Community Countries, 16% to the United States and 10% to the European Union.

#### **4.3.3 Iron and Steel Works, Capital Goods and Metallurgical Industry.**

Between 1985 and 1992, the metallurgical industry's value added grew 6.7%, employment grew 1.5% and exports 19.4%. The sectors contribution to GDP growth was 13.4% in 1995. That same year, US\$101 million were exported, which

represented a decrease of 34% as compared to the previous year, when car manufacturing was particularly dynamic. The exports of capital goods grew 18% in 1995, totaling US\$264 million.

#### ***4.4 Agriculture and Agricultural Industry***

Colombia has an agricultural potential of 14,274,000 hectares, which represents 12% of national territory. Approximately 5,320,000 hectares of land are devoted to agriculture, 1,000,000 of which are devoted to coffee growth.

In 1996 the agricultural sector grew 0.21% compared to 1995, year in which it grew 5.2%. Sugar production grew 4%, African palm production 5.5% and orange production 26.4%. The fruit juice sector is expected to grow 15% a year in the next few years, and external demand is expected to grow 5% every year.

##### **4.4.1 Bananas**

Bananas are cultivated in the Caribbean coast of Colombia. The country is the third producer worldwide with 43,900 hectares. Exports are directed primarily to the European Union and the United States. Colombia is also the biggest exporter of green plantain.

In 1996 the production of bananas grew 5.3% with sales of US\$ 500 million. Sales to the European Union grew 20%.

##### **4.4.2 Flowers**

Colombia is the world's second flower exporter after Holland. The country's exports account for 10% of total world exports. More than 50 varieties are grown, being the pompon, carnation and rose the most popular. 92% of the production is grown in the area surrounding Santa Fe de Bogota, while the remaining 8% is produced in Antioquia and Valle. In 1996 flower exports raised to US\$509.2 million, experiencing a rate of growth of 17%. The United States imports 80% of Colombia's production while the European Union 14%.

##### **4.4.3 Fishing**

Colombia has coasts both on the Pacific and Atlantic ocean. Ocean fishing represents 64%. In 1995 69,000 tons of fish were produced, compared to 56,000 in 1994. Colombia's most important exports are tuna and shrimp.

#### ***4.5 Financial Sector***

The Colombian financial sector is going through a drastic transformation due to the entrance of important foreign investors last Two Spanish private banks bought a portion of the Ganadero and Comercial Antioqueño banks. It is expected that the entrance of these investors within the financial sector will create more competition, more efficiency, and greater dynamism within the sector.

The Stock Market's expected recovery represents a very attractive opportunity for foreign investment. According to international analysts most of Colombian stocks are currently below their market value, due to the political crisis and the economic



slowdown. Given that these circumstances shall be overcome under the next administration a number of stock investment options are worth considering.<sup>2</sup>

## 5. The road ahead

### 5.1 Presidential elections

The successor of Ernesto Samper will be elected in May, 1998, and will get to the presidency three months later. Up to the present, there are five candidates who seem to have strong support of the voters.

- **Horacio Serpa**, former Minister of Internal Affairs and the most powerful figure of President Samper's cabinet. It is very likely that Serpa will win the internal election of the liberal party, thus getting its official support.
- **Alfonso Valdivieso**, liberal, former General Prosecutor who accused Samper before the House of Representatives. Though Valdivieso will run as a non-party candidate, he seems to have the implicit support of the members of the liberal party who have taken distance from the current administration.
- **Andrés Pastrana**, conservative, who lost the past election to Samper by a very small margin, and who is likely to get the official support of the Conservative Party.
- **Noemí Sanín**, has a conservative origin, but will run as a non-party candidate.
- **Antanas Mockus**, former mayor of Bogotá. Mockus, a former university professor and an eccentric character, is favored by the voters who are tired of traditional politics.

The two candidates who get the highest voting in the May election will go to a second round three weeks later. According to the polls it seems to be a fact that one of them will be Serpa, while the other one is still uncertain.

### 5.2 The main issues of the debate

The new president of Colombia will have to deal with a number of key political issues, in order to guarantee a solid ground for a strong and stable economic recovery. Among them, the most important issues seem to be the search of internal peace, the continuation of the struggle against drug trafficking, and the strengthening of the relations with the U.S. A politically strong government will be able to have significant accomplishments in those three areas, which will strengthen political and economic confidence, thus opening the way for a fiscal adjustment, a real depreciation of the currency, the continuation of the reform agenda, and sustained economic growth.

#### 5.2.1 Guerrillas and paramilitary groups

Colombian guerrillas are the oldest in Latin America. Though the leftist armed groups have been present in the Colombian life for almost four decades, they have

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<sup>2</sup> Santander Investment, July 1997.

dramatically strengthened since the mid 1980s, not only in terms of their number, but also because of their expanding presence in the country. Thus the solution of the internal war has become a priority for the Colombian political system in order to maintain the stability of the institutions, as well as a solid ground for the economic and social development.

Given the limitations that the Colombian army has shown to defeat the guerrillas, the authorities have tried to use dialogue as a solution to the conflict. Up to the present peace negotiations have had limited success, but to several observers they have to be part of a more global strategy.

The current administration has also tried dialogue as a way out of the conflict. Since the very beginning of his administration Samper announced a new strategy for peace, which involved the search of further economic growth and income redistribution, the promotion of agreements to preserve human rights, and the proposal of negotiations with the guerrillas. Though initially all the armed groups responded in a positive way to the possibility of negotiating, there has been an escalation of the conflict. While the guerrillas have increased their presence in the rural areas, paramilitary groups have also expanded. These anti-guerrillas armed groups emerged in the early 1980s, as a result of the efforts of some regional actors - specially drug traffickers and big landowners- to contain the influence of the guerrillas.

The climate for dialogue has slightly improved in the past few weeks. The key political actors have supported the government's proposal to promote negotiations. However, the FARC representatives have said that, as a prerequisite for starting negotiations, they demand some conditions which are virtually impossible to meet in the short run, like the de-mobilization of paramilitary groups and an agrarian reform to redistribute lands.

The search of internal peace has been a key issue of the current presidential debate. Proposals to deal with the conflict are at the top of the agenda of the various candidates, and the most relevant political actors agree that dialogue is a key component of a comprehensive solution to the problem. Whoever the next president will be, it is clear that peace will be a priority for the next government, and that there will be the political support to achieve it .

### **5.2.2. The fight against drug trafficking**

After the campaign scandal exploded, the struggle against drug trafficking was severely tightened. The Colombian government started a huge offensive against the Cali cartel and put the top drug lords in jail in 1995. Additionally the administration promoted a couple of new laws, that were passed by the Congress, which allow the executive to confiscate illegal lands and real state properties, and which drastically increase the sentences for drug traffickers. Besides that, the Colombian Senate is currently discussing a project that would reestablish the extradition of Colombian citizens to foreign countries, a possibility that had disappeared with the Constitutional Reform of 1991.

The next administration will face the challenge of maintaining the struggle against drug trafficking. All the conditions are given for this struggle to be successful:

the new administration will have the required legal instruments, the support of both national and international community, and a closer relation with the U.S.

### **5.2.3. The strengthening of the relations between Colombia and the United States**

Several factors show that the ground is set for a gradual improvement of the bilateral relations between Colombia and the U.S. On the one hand, the results of the Colombian government offensive on drug traffickers are evident. The Samper administration has put in jail the top leaders of the Cali Cartel, an objective that a few years ago seemed almost impossible to reach. On the second hand, the Administration, both with the Congress, have developed the legal instruments required to effectively fight drug trafficking in the future. The laws that allow the confiscation of illegal assets and the increase of sentences for drug traffickers will be effective instruments for this purpose. Though it is not clear yet whether the Congress will pass the constitutional reform that allow the extradition of Colombians to foreign countries, the debate on this issue has gone much farther than it was expected three years ago. Finally, the inauguration of a new administration in Colombia in August 1998, will certainly mean a new impulse for the bilateral relation.

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