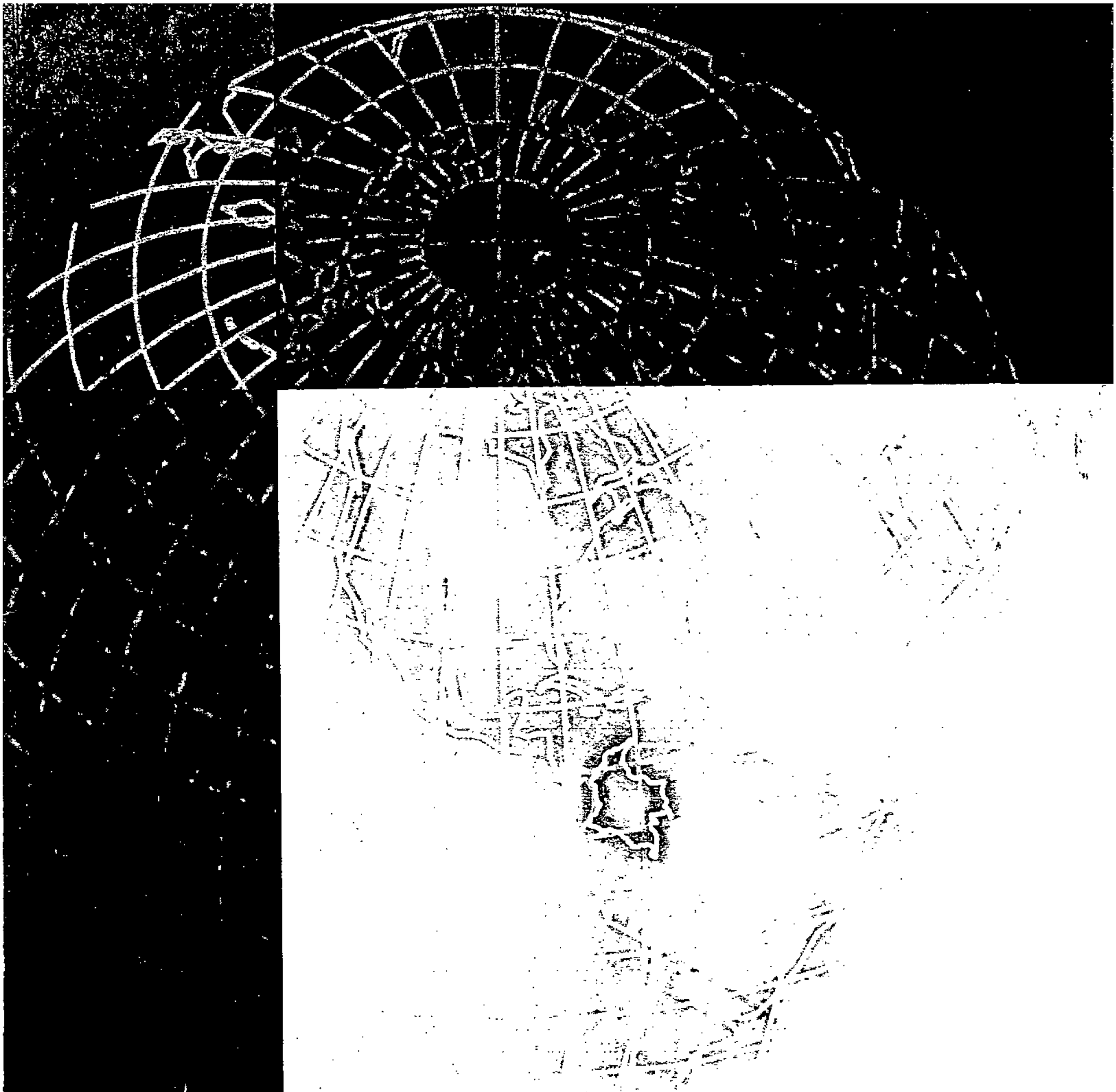

FEDESARROLLO

Café de Colombia

THE COLOMBIAN ECONOMY

RECENT PERFORMANCE AND PERSPECTIVES

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This report on the Colombian Economy was prepared by Fedesarrollo for the Fifth Japan - Colombia Meeting, held in Tokyo in April 2005

This report was written by a team formed by Mauricio Reina, Cristina Gamboa and Arturo Harker. Editorial assistance was provided by Myriam Consuelo Lozano

FEDESARROLLO
Calle 78 No. 9-91
Tel.: 312 5300 - 530 3717
Fax: 212 6073 A.A. 75074
E-mail: administrator@fedesarrollo.org.co
www.fedesarrollo.org
Bogotá D.C., Colombia

CONTENTS

THE COLOMBIAN ECONOMY

RECENT PERFORMANCE AND PERSPECTIVES

I. INTRODUCTION[1]

After weathering the effects of the recession of 1998-1999, the Colombian economy is now achieving satisfactory growth rates. At the same time, Colombia is positively perceived by the international markets, which recognize an improvement in the local business climate. This document analyzes the origins and prospects of this significant turn of events.

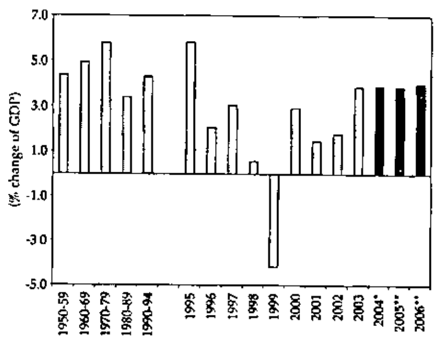
The document is organized as follows. After this brief introduction, Chapter II describes the recent recovery of the Colombian economy, and analyzes key policy stances in the monetary, exchange rate, fiscal and social areas. One of the central factors upholding improved growth rates is the Uribe administration's Democratic Security and Defense Policy, which is discussed in Chapter III. Regarding trade policy, Chapter IV elaborates on the country's significant progress towards an outward-oriented development model, with particular interest given to new integration goals like the negotiation of a Free Trade Area with the United States. Chapter V evaluates the recent developments in infrastructure (electricity, natural gas, water and sanitation, telecommunications and transportation) and the essential role of private sector participation. The last section of this chapter highlights opportunities of interest for foreign investors. Colombia's political prospects, particularly those of the upcoming presidential elections of 2006, are analyzed in Chapter VI. Finally, basic information about Colombia and selected economic indicators for the 2002-2006 period can be found near the end of this document.

[1] This document was financed by the National Federation of Coffee Growers of Colombia, and was written by the following team of Fedesarrollo's economists: Mauricio Reina, Associate Researcher, Cristina Gamboa, Researcher; and Arturo Harker, Research Assistant. The authors wish to thank comments and data support by Ximena Cadena, Juan C. Chaparro, and Carolina Ramírez of Fedesarrollo. The opinions expressed in this document are the sole responsibility of the authors and do not represent the official position of the National Federation of Coffee Growers of Colombia.

II. THE ECONOMIC RECOVERY AND POLICY RESPONSES

The Colombian economy is achieving satisfactory growth results after several years of underperformance caused by the 1998-1999 recession. This chapter discusses this positive outcome and the related public policy actions. To provide a context to analyze current events, the first section examines the main economic developments of the 1990s. Then Colombia's recent economic performance is reviewed (Section II.B). Section II.C discusses the foundations and progress in the monetary and exchange rate policy areas, followed by a similar evaluation of fiscal policy (Section II.D). Finally, we discuss the main challenges and prospects in the social policy area (Section II.E).

Chart II.1
COLOMBIA: ECONOMIC GROWTH
1951-2006**



* Estimate; ** Forecast.
Source: Greco-Banco de la República and Fedesarrollo.

A. The Legacy of the 1990s

In the mid-1990s, Colombia's economic growth began to stall after decades of positive outcomes. Economic growth was on average 4.6% between 1950 and 1989 (see Chart II.1) This expansion rate was maintained between 1990 and 1994 as the economy grew on average 4.3%. However, the average growth rate reached a meager 1.5% for the 1995-1999 period.

Colombia's mid-1990s slowdown occurred in the following context. Throughout the past decade the country experienced significant capital inflows, an asset price bubble (1993-1997) and a commodity export boom, which translated into a real appreciation of the peso (Colombia's currency). Additionally, the enactment of a new political Constitution in 1991 created important expenditure rigidities that ended up promoting overspending by the fiscal authorities. As a result, the current and fiscal accounts moved into deficits and foreign borrowing increased markedly (both public and private).

The Asian, Russian and Brazilian crises, which meant dealing with increased macro volatility, as well as the synchronized global economic slowdown, exacerbated the already fragile situation. As a legacy of the late 1990s, Colombia experienced several years of undeperformance at the beginning of the new millennium.

To deal with this situation, the Colombian government has been implementing a series of policies and structural reforms to redirect the economy towards a sustainable growth path (see section, II.C, II.D and II.E). As a result, the economy's growth rate has been picking up to 3.8% for the past two years, in sharp contrast to the 1.5% and 1.8% rates observed in 2001 and 2002, respectively. Additionally, the private sector has successfully continued to adjust in the aftermath of the recession of 1998-1999, and private savings and investment rates are improving.

After several years of underperformance, the economy is now achieving satisfactory growth rates of nearly 4%. This growth pace could be replicated in 2005 and 2006.

B. Recent Macroeconomic Performance

Colombia's macroeconomic performance has clearly improved and the economy is now achieving satisfactory growth results (3.8% in 2003 and a similar figure estimated for 2004), a situation that quite possibly will be maintained in 2005 and 2006. Three main factors explain the recent recovery:

- The security policy implemented by the Alvaro Uribe's administration (2002-2006) has markedly improved investors' confidence.[2]
- The strong recovery of the construction sector after a profound crisis in the late 1990s.
- The robust external accounts' position due to increased global economic growth, foreign capital flows and Colombian workers' remittances. Also, Colombian foreign sales to Venezuela have fully recovered after the latter's recession of 2002-2003.

The positive externalities of the security policy on the investment climate could expand further if the Uribe administration continues succeeding in this area.

The positive externalities of the security policy on the investment climate could expand further if the Uribe administration succeeds in capturing the heads of the guerrillas and in current appeasing efforts with the paramilitaries. The second factor's effect on growth may show a diminishing tendency, as recent construction activity seems to have fulfilled demand. Finally, the favorable external environment could be expected to continue in the medium-term, particularly if international interest rates rise slowly and, in general, global imbalances are gradually corrected. As robust external demand holds, high commodity prices (Table II.1) and a still undervalued peso will likely uphold strong export growth, including foreign sales to Venezuela.[3]

External accounts could remain robust if international interest rates rise slowly and global imbalances are gradually corrected.

[2] Chapter III discusses the security policy of the Uribe administration.

[3] Venezuela is Colombia's third main trading partner, with near 10% share of total exports.

Table II.1
INTERNATIONAL COMMODITY PRICES 2002-2004,
YEAR AVERAGES

Year average	2002	2003	2004
Petroleum (US$/barrel, West Texas Intermediate)	26.12	31.11	41.44
Coal (US$/mt)	27.06	27.84	54.70
Coffee (US cents/pound)	65.26	67.31	84.15
Gold (US$/troy ounce)	310	363.50	409.20
Nickel (US$/mt)	6,772	9,629	13,823

Source: World Bank-DECPG and ICO. Mt = metric tons.

Supporting this outlook, it should be stressed that Colombia's links with global trade are set to improve, as the country negotiates new preferential trade agreements. Colombia is currently negotiating a Free Trade Agreement (FTA) with the United States -its main trading partner- which could enter into force as early as 2006 and could have a significant positive impact in terms of economic growth (see Chapter IV).

1. *Investment Recovery, Booming Exports and Weak Consumer Spending* [4]

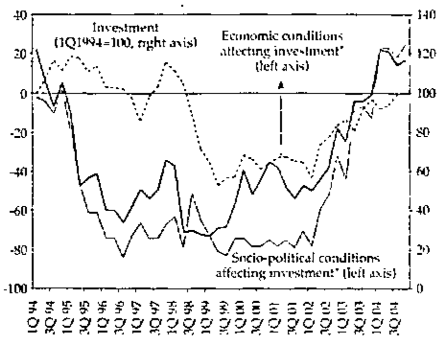
The Uribe administration has kept up campaign promises of improving domestic security by strengthening the country's armed forces. Significantly, the encouraging results of this policy, which are discussed in Chapter III, have had a positive influence on the investment climate. Fedesarrollo's business survey shows that investment conditions, both economic and socio-political, have recovered to historical highs since late 2002 (Chart II.2).

Therefore, total investment is improving, reaching 17.7% of GDP in 2003, while private investment represented 9.4 percentage points of GDP that year. In the meantime, the tight fiscal situation has kept public investment from surpassing 5.8% of GDP (Chart II.3). Chart II.4 confirms that investment has been a key growth engine since 2002, increasing at an annual rate of 21.7% in 2003. Investment is expected to rise 9.5% in 2004.[5]

[4] All percentage changes presented in this section, as well as in sections II.B.2 and II.B.3, are expressed in real terms, based on data in pesos of 1994.

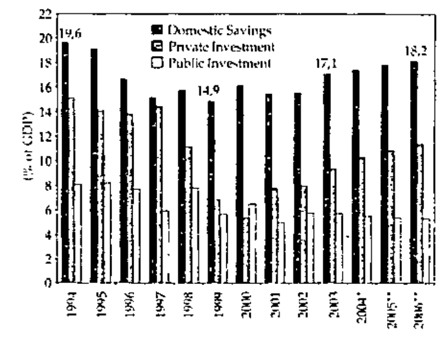
[5] At the time of writing this document, official GDP figures for 2004 had not been released. Therefore, the mentioned 2004 GDP data correspond to Fedesarrollo's own estimates.

Chart II.2
COLOMBIA: INVESTMENT CONDITIONS*
AND PRIVATE INVESTMENT
(Index 1Q1994=100), 1994-2004



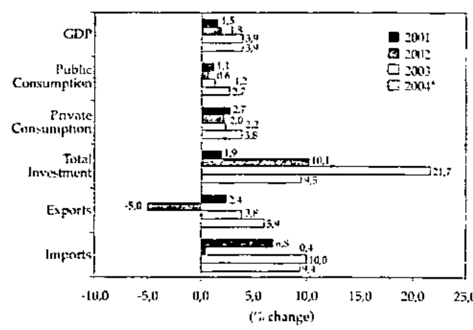
* Increasing index value = better conditions.
Source: Fedesarrollo's calculations with DANE and Fedesarrollo Industrial Business Survey.

Chart II.3
DOMESTIC SAVINGS AND INVESTMENT
(Private and Public), 1994-2006**



* Estimate; ** Forecast.
Source: DANE and Fedesarrollo.

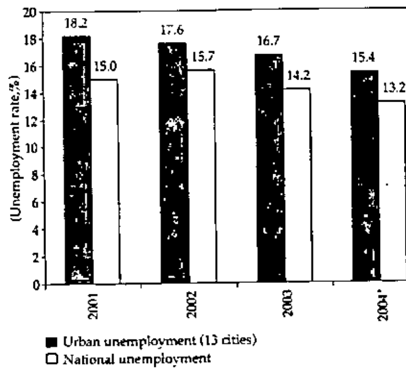
Chart II.4
GDP GROWTH BY AGGREGATE DEMAND,
2002-2004*



* Estimate.
Source: DANE and Fedesarrollo.

Colombia's export recovery can be traced to 2003, when foreign sales increased at an annual rate of 2.8% (see Chart II.4) In 2004 export expansion is expected to be stronger, at a 5.9% annual rate. The coal and oil prices surge in international markets has driven this outcome, along with the recovery of sales to the Venezuelan market and improved non-commodity exports to the US market (chiefly clothing and chemicals, see Section IV.E). A competitive real exchange rate has also supported export recovery and stronger economic growth (even though the nominal exchange rate has been appreciating against the US dollar since the last quarter of 2003, see Section II.C).

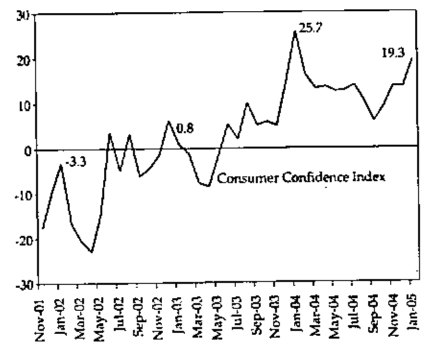
Chart II.5A
UNEMPLOYMENT RATE: 2001-2004*



* Forecast.
Source: DANE and Fedesarrollo.

Chart II. 4 also shows that consumer spending has not been as vigorous as investment and exports. As a matter of fact, consumer spending has not recovered from the late 1990s crisis. Although the unemployment rate has declined steadily during the past three years, it remains high (15.5% in the urban areas in 2004) which may be dampening domestic consumer confidence (see Chart II.5A and 5B). Fedesarrollo's consumer confidence index shows a flat trend for 2004. Thus, it may be necessary to achieve significant unemployment reduction for private consumption levels to rebound in the near future.

Chart II.5B
CONSUMER CONFIDENCE
(Nov-2001/Jan-2005)



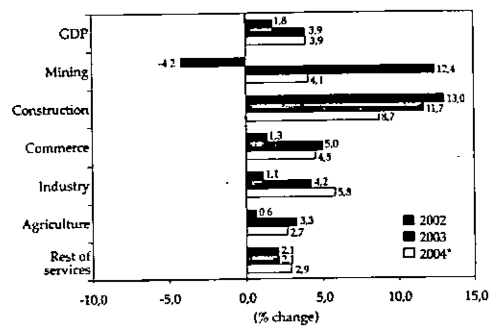
Source: Fedesarrollo consumer confidence survey.

2. *Economic Sectors*

Construction

Construction activity in Colombia has been recovering from a severe crisis in the 1990s. Its current expansion has been very dynamic (see Chart II.6) and has been mainly oriented to the satisfaction of repressed housing demand from the top social tiers. In spite of recent progress, the construction sector's rests at 5% of GDP, below its 7.5% peak registered in 1994 (see Table II.2).

Chart II.6
GDP GROWTH BY SECTORS, 2002-2004*



* Estimate.
Source: DANE and Fedesarrollo.

Currently, the construction's sector growth rate shows a receding tendency (Chart II.6) It is worth noting that the construction sector is composed of dwellings (78% share of construction sector activity) and civil engineering constructions (22%). The sector's expansion rate is falling, first, because supply is catching up with demand in high social tiers. Secondly, the construction of dwellings directed to the lower social strata (or *social housing sector*, as identified by Colombians) has been recently underperforming. Social housing construction activity has greatly depended on the availability of government credit subsidies in the past few years, which

Table II.2
ECONOMIC SECTORS PERCENTAGE SHARE IN TOTAL GDP, 1994 AND 2003

Sectors	1994 (%)	2003 (%)
Agriculture	14.8	13.9
Coffee	2.0	1.7
Mining	3.5	4.6
Industry	14.9	14.4
Services*	66.8	67.1
Construction	7.4	4.9
Commerce	12.5	10.8
Rest of services	39.2	44.9
Taxes minus subsidies*	7.7	6.5

* Includes government services (taxes minus subsidies).
Source: Fedesarrollo with DANE data.

Construction activity is recovering from a severe crisis. The sector should regain its importance in GDP as social housing and civil engineering-related activities pick up.

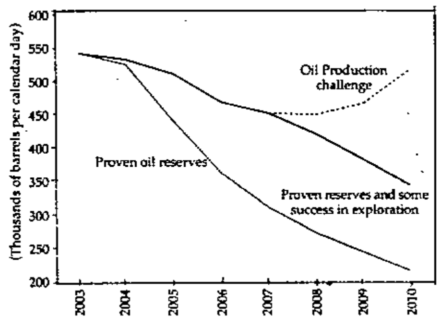
have recently been reformed (basically lower amounts per capita) due to fiscal constraints (see Section II.E.1). Demand for these subsidies has not yet adjusted to these changes.[6] Finally, construction activity related to civil engineering is contracting due to lags in the execution of regional public projects and fiscal constraints.

In the near term, the construction sector could regain significance as a source of growth if the social housing and civil engineering-related activities pick up.

Mining

The mining sector, which represents 4.6% of GDP, grew 12.4% in 2003 and an estimated rate of 4.1% in 2004, mainly because decreasing oil production has been partially offset by high international prices (Table II.1), and increased production and exports of coal and nickel. As a matter of fact, the mining sector confronts mixed prospects for the next couple of years, which on average may tilt to the positive side.

Chart II.7
OIL PRODUCTION: THREE SCENARIOS



Source: Ecopetrol.

On the one hand, oil production faces dire straits. The lack of new oil reserves' discoveries has meant declining production and constant reserve depletion from its 1999 all time high (the "proven oil reserves" scenario in Chart II.7). The Colombian state oil company (Ecopetrol) has acknowledged that if new oil reserves are not found soon, the country will likely become an oil importer by

[6] See Fedesarrollo (2004), "La política de vivienda en Colombia".

2007. Such an event would have balance of payments (BOP) effects since oil's foreign sales at present account for 26% of total exports as international prices show record highs.[7] Additionally, the fiscal effects of declining oil production would be considerable because Ecopetrol's profits have contributed to reduce the public sector's consolidated fiscal deficit since 1998.[8]

The mining sector's prospects are mixed. Oil production is declining and reserves depletion persists while new discoveries are pending.

In order to avoid this situation, the Ministry of Mines and Energy of Colombia implemented a series of institutional reforms since 2003, which basically were oriented to increase investment in oil exploration. As a result, the reforms have effectively multiplied oil exploration activity by oil companies and Ecopetrol.[9] In 2003, over 25 new oil wells' perforations were initiated and in 2003 this number reached 21. For 2004, Ecopetrol estimates that nearly 40 new oil wells will be perforated. With these investments, the probability of finding new oil reserves rises.

Rising investment in oil exploration, stimulated by recent institutional reforms, increase the probability of finding new oil reserves.

On the other hand, Colombia is a very competitive producer of coal and nickel, among other mining products.[10] Coal's production is projected to increase from 50 million tons in 2003 to 73 million tons by 2010, according to a specialized government agency. This development may mean an export expansion of near 46% by 2010.[11] Currently coal reserves stand at 6,648 million metric tons (Mt) and exports represent 11% of Colombia's total foreign sales.[12] Colombia's main markets for coal are Japan (29% average coal export share during 1997-2001), South Korea (10%), Great Britain (5%), India (4%) and Germany (4%).

Declining oil production has been partially offset by high international prices, and by increased production and exports of coal and nickel.

Colombia is the world's largest exporter of nickel -with a 33% average share of global sales during 1997-2001-, while its domestic

7 Colombia's exports crude oil to the following main markets: United States (24% average export share during 1997-2001), Japan (13%), South Korea (7%), Germany (6%) and France (5%).

8 In Section II.D we discuss these fiscal effects.

9 A national hydrocarbons agency (Agencia Nacional de Hidrocarburos) was established in 2003 to regulate these resources and define the sector's policies. Before this reform, these functions were under the realm Ecopetrol, creating some conflict of interest. Now Ecopetrol is meant to operate as any other petroleum company, though it does not have private capital participation.

10 Reina, M., C. Gamboa and M.L. Guerra (2004), "El sector minero-energético en las negociaciones comerciales regionales", Fedesarrollo, August.

11 Source: Unidad de Planeación Minero Energética, quoted in Fedesarrollo (2004), "Petróleo y carbón: situacón actual y perspectivas", pg.34

12 Source: British Petroleum (2004), Energy in Focus: Statistical Review of World Energy 2004, British Petroleum, London.

production is sold almost entirely abroad. In 2004 the commodity price boom increased annual foreign sales of nickel by 51%: exports reached US$ 414.7 million in 2003 and rose to US$ 626.1 million in 2004, mainly to the European Union, Asian and US markets. This happened even though the corresponding quantity sold abroad fell slightly, from 131,931 metric tons (Mt) in 2003 to 123,602 Mt in 2004. Given Colombia's proven nickel reserves (40 million Mt), this level of production is expected to continue in the near term.[13] Thus, overall the mining sector's outlook is positive since investment in oil exploration is increasing and other mining segments reveal an important dynamism and export competitiveness.

The manufacturing sector, which represents 14.4% of GDP, has shown higher growth rates as external demand for Colombian goods has risen.

Industry

Colombia's manufacturing sector had slowly recovered after the crisis of 1998-1999, and has recently shown higher growth rates that are closely linked to the surge in external demand for Colombian goods. The sector represents 14.4% of GDP and expanded at an annual rate of 4.2% in 2003. Recent data reveals that manufacturing could have achieved its best result in 2004 after three years of underperformance. In 2004 the most dynamic industrial production sectors were the following: automobiles, chemicals, food manufacturing, coffee threshing, leather products, plastics, and publishing.[14]

In 2004, several manufacturing segments were very dynamic, like automobiles, chemicals, food manufacturing, coffee threshing, leather products, plastics and publishing.

Agriculture

The agricultural sector has been gradually increasing its expansion pace up to an annual rate of 3.3% in 2003, mainly due to enhanced domestic security and credit conditions. According to the official statistical agency (DANE), the cultivated area increased in 274,000 Ha between 2002 and 2003 and, thus, total cultivated areas reached 4.6 million hectares (Ha). At present, the agricultural sector represents 13.9% of GDP and is considered a central piece in the government's strategy to provide improved economic options for the illegal armed forces to demobilize and join the legal economy. The official policy towards this sector involves a number of instruments, which sometimes includes considerable tariff protection for some basic crops (see Chart IV.6 in Section IV.D of

Agriculture is recovering mainly due to enhanced domestic security and credit conditions.

[13] Source: Unidad de Planeación Minero Energética (2003), pg.33.

[14] Source: DANE - Monthly Industrial Survey (Muestra Mensual Manufacturera), December 2004.

this document). The sector's main exports are coffee, bananas, fresh-cut flowers, sugar and palm oil, while great foreign market potential could be found in segments like fruits and vegetables if the anti-export bias generated by the high levels of tariff protection were removed.[15]

Coffee

Coffee production is recovering from the structural changes that shuddered global coffee markets in the 1990s. Coffee exports reached US $1,054 million in the 2003-2004 year, a figure that had not been observed since 2000.

The Colombian coffee industry, which currently represents 1.7% of GDP, is recovering from the structural changes that shuddered global coffee markets in the 1990s, particularly the breakdown of the quota system in 1994, and the appearance of relatively large, low cost and low quality producers such as Vietnam. As a result of the coffee crisis, the percentage share of Colombian coffee sales in its total exports has been declining, from 21.1% in 1990 to 5.8% in 2004.

In spite of this market transformation, Colombia is today the world's third largest exporter of this commodity. Significantly, Colombia has been able to maintain its export levels in the mild *arabigas* segment during the present decade, in comparison to close competitor countries like Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and México.[16] As a matter of fact, Colombia's coffee exports totaled US$ 1,054 million in 2004, surpassing for the first time in the last four years the US$1,000 million mark, even though export volumes declined 3.14% in 2004 (to approximately 10.15 million 60kg bags).[17] This result has come about in the context of improving coffee prices because of excess world demand (see Table II.1 for recent price evolution).[18]

Success in weathering the effects of the coffee crisis relies partly on product differentiation and the generation of greater value-added in dynamic export segments. Nearly 50% of coffee exports get a quality related premium.

The Colombian success story in weathering the effects of the coffee crisis is closely related to a product differentiating strategy, which focuses on establishing clear-cut differences in favor of the country's coffee in a highly competed market. According to the National

[15] See World Bank (2003), and Reina, M. and S. Zuluaga (2003).

[16] Source: National Federation of Coffee Growers of Colombia.

[17] Source: National Federation of Coffee Growers of Colombia, export figure is for coffee year 2003/2004.

[18] The International Coffee Organization (ICO) has estimated that world coffee supply is about 108 million bags and global consumption 115 million. The resulting deficit of 7 million 60 kg bags has been pressing prices upwards, while inventories in both consuming and producing countries are starting to fall (estimated at near 40 million bags).

Federation of Coffee Growers, nearly 50% of exports receive a quality-related price premium. Additionally, the country has advanced in generating greater value-added in dynamic coffee export segments, like single serving coffees (PODs), specialty coffees and free ze dried coffees. Finally, Colombia has made use of its coffee trade mark *Juan Valdez* to position processed coffees direct to the consumer, and has opened 14 coffee shops with the worldwide recognized trademark, both domestically and abroad.

Colombia has maintained its export levels in the mild *arabigas* segment during the present decade, in contrast to the experience of close competitor countries that observed declining export shares.

Notwithstanding the above, the persistence in time of coffee sector's crisis has inevitably affected the income of nearly 560,000 Colombian families that depend on the crop, creating social tensions in coffee producing regions. This reality has been met with policies in two main fronts. One the one hand, the past two administrations have increased expenditure to rise social welfare in coffee producing regions and have made cash transfers to support the producer's internal price, alleviate producer's financial burdens, and promote higher levels of research and development. On the other hand, the National Federation of Coffee Growers has adopted programs to adjust Colombian production to the new market realities, mainly directed to enhance the quality of exports and increase the productivity of coffee crops. Regarding the latter, since 1998 the National Federation of Coffee Growers has supported a program to renovate coffee plants. As a result, the crop's productivity rose 45% between 1999 and 2002, and hence production levels have remained constant (around 12 million bags) notwithstanding total cultivated areas have been reduced. Additionally, accounting for the fact that coffee producers nowadays receive a larger share of the external price, the end result is that producer's income has improved during the past three years.

As policy continuity for the coffee sector is expected and if its international prices keep rising, export revenues should continue to improve in the near term.

As program continuity is expected, and if international coffee prices keep rising, the productivity of coffee, its quality and its export revenues are expected to continue improving in the near term.

Services

The services sector has continued to expand in the past years. Financial intermediation services have shown positive results for two years in a row.

Commerce and other services sectors grew at an annual rate of 5% and 2.1%, respectively, in 2003 as the economy has recovered and confidence has improved. Overall, services represent 67.1% of GDP (including government services, see Table II.2). It is worth underlining that the financial intermediation services, a sub-sector that suffered strains in the aftermath of the 1999 recession but without bursting into a full-blown financial crisis, has shown a positive evolution in the past two years (see Section II.C).

3. *Robustness of Colombia's External Accounts*

Colombia's external accounts have been a positive factor for recent economic performance. In the following lines we discuss the country's trade balance, as well as capital flows receipts and workers' remittances, all of which have comfortably financed the country's current account deficit of 1.7% of GDP and 1.5% of GDP in 2002 and 2003.

Trade Balance

Increased global demand and the recovery of exports to Venezuela have meant strong export growth for the past two years. As a matter of fact, exports increased at a nominal annual rate of 26% in 2004, reaching an unprecedented US$ 16,483.1 million. Imports have recently been growing at a relatively faster pace because of the peso's nominal appreciation of about 25% during the past two years, particularly those of consumer goods. However, it is noteworthy that capital and intermediate goods imports have also been increasing in consistency with the higher levels of domestic investment. Colombia's trade balance evolution is shown in Chart II.8.

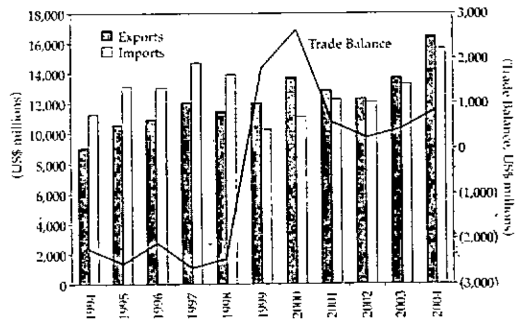
Capital account

Foreign direct investment (FDI) and short-term capital have been attracted to Colombia because of increased appetite for investment in emerging markets -as international real interest rates have been quite low and the US dollar has been globally weak- and the enhanced confidence effects of Uribe's security policy. Total FDI flows are gradually recovering and reached US$ 1,850 million in 2003, with significant growth of investment directed to the mining sector (Chart II.9).

Short term capital has been tapping the strong returns offered by the local stock market (one of the world's best performers in 2004) and, to a lesser extent, acquiring peso-denominated sovereign debt (TES bonds).[19] Chart II.10 shows that the current level of net capital inflows is below the mid-1990s highs.

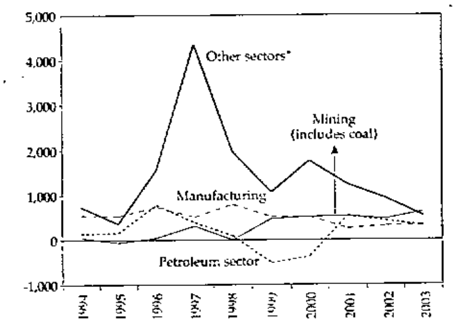
Colombian workers' remittances have been rising exceptionally since 1999, due to the increased migration attributed to the escalation of the internal conflict in the mid 1990s and the end of the

Chart II.8
COLOMBIA: TRADE BALANCE 1994-2004
(US$ MILLIONS)



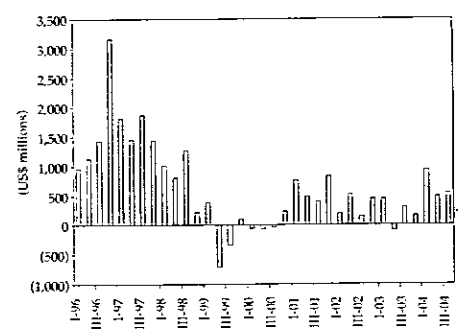
Source: DANE and Fedesarrollo.

Chart II.9
COLOMBIA: FOREIGN DIRECT INVESTMENT (FDI) FLOWS BY SECTORS, 1994-2003



Agriculture, Commerce, Restaurants and Hotels; Construction, Electricity, Gas and Water, Financial Sector, Community Services and transportation, Storage and Comunications.
Source: Banco de la república.

Chart II.10
COLOMBIA: CAPITAL ACCOUNT
1Q 1996 - 3Q 2004

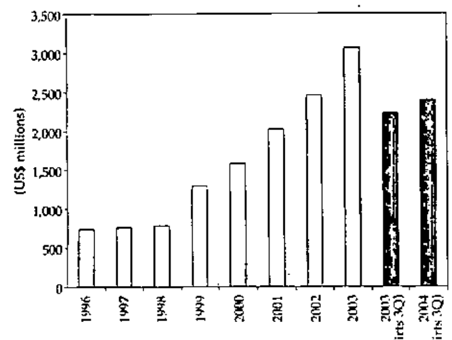


Source: Banco de la República.

[19] See the Section II.C.2 on recent measures taken by economic authorities on short term capital flows.

decade recession. Discrepancies abound regarding the number of Colombians that have left the country, but they may add to around 2 million since the mid-1990s. The importance of those migrants for the Colombian economy is outstanding. In 2003 the Colombian workers' remittances represented 50% of total non-traditional exports and 3.8 times the value of coffee foreign sales (Chart II .11).[20]

Chart II.11
COLOMBIAN WORKERS' REMITTANCES FROM ABROAD, 1996-2004



First 3Q: first three quarters of the year.
Source: Banco de la República.

C. Monetary and Exchange Rate Policy

As mentioned above, the Colombian economic authorities have adopted several measures to enhance the country's development prospects. In this regard, policies in the monetary, exchange rate and credit areas are of the utmost importance. Significantly, between 1999 and 2004 those policies have been very successful in several fronts: achieving disinflation, establishing a flexible exchange rate regime, avoiding a full-blown financial crisis, and, more generally, promoting economic growth. The basis of such outcomes mainly rest on the institutional arrangement that gives independence to the Central Bank (Banco de la República, BR), a provision which was determined by the 1991 Constitution along with its condition of lender of last resort.[21]

When domestic and international shocks have occurred, the BR has been able to modify its monetary stance and exchange rate (ER) policy as deemed necessary. For example, by the end of the 1990s the ER band system could not resist the pressures from the foreign exchange crisis fuelled by the 1997-1998 Southeast Asian crisis and its contagion on Russia and other emerging markets.[22] As a result, the BR decided to float the peso in September 1999. Furthermore, a year later the BR adopted a new monetary policy framework, labeled as inflation targeting.[23] The new inflation targeting mechanism, which maintains accomplishing that goal,

Monetary, exchange rate and credit policies have been very successful in achieving disinflation, establishing a flexible exchange rate regime, avoiding a financial crisis in the late 1990s, and promoting economic growth.

[20] The value of coffee exports was US$806 million in 2003. (Source DANE). Non-traditional exports include coffee, coal, petroleum, and nickel.

[21] Since 1991, the BR is the monetary, exchange rate and credit authority of Colombia. The constitutional mandate of the BR has a hierarchical character: to pursue low and stable inflation, but to do so in line with the government development plan, which targets high growth and low unemployment.

[22] The exchange rate band integrated a gradual devaluation of the peso that fixed the ER at its weak or strong ends.

[23] It is worth mentioning that the BR has had a mandate to pursue low inflation since 1991.Under inflation targeting, the BR makes a global assessment of macroeconomic variables, to analyze the output gap (potential vs. current GDP) and demand pressures to decide on interest rates, and achieve the inflation and economic activity goals.

has been successful as a signaling mechanism to stimulate domestic interest rate reductions and to achieve disinflation. The latter is a significant accomplishment for a country that had observed moderate inflation (22% per year) over the three previous decades.[24]

1. *Inflation Targeting Framework and Positive Results*

As mentioned above, the inflation targeting framework has been very successful in stabilizing inflation. The initial effects of the recession caused the inflation rate to collapse from 16.7% in 1998 to 9.2% in 1999. After the initial recession-related disinflation the monetary policy mechanism has allowed annual inflation to fall to 5.5% (Chart II.12). It should be highlighted that this achievement has implied important benefits for the poorest segments of the population.

Additionally, the inflation targeting mechanism has allowed the BR to adopt policies that are in line with the international tendency of relaxing the monetary stance in the presence of low inflation. Chart II.13 llustrates that the BR has provided ample liquidity to the economy in the past couple of years.

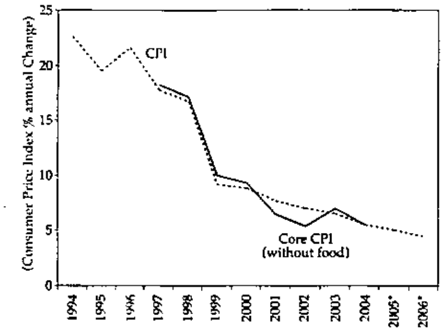
The BR has reduced the monetary policy reference rate on several occasions to signal downwards the economy's interest rates. The BR's reference interest rate reductions began as early as 1998, but by April 2002 the size of the cuts became more aggressive. These interest rate cuts have been transmitted with the usual lags to the rest of the economy's interest rates. Consequently, nowadays the real certificates of deposit (CD's) interest rates are at historical lows (Chart II.14).

In the future, as the Colombian economy grows and international interest rates rise, the BR will probably increase gradually its monetary policy reference interest rate. Also, inflation targets are expected to be achieved without major problems in the next couple of years. The BR's long-term inflation target is 3-4%.

2. *Exchange Rate Dynamics and Policy Responses*

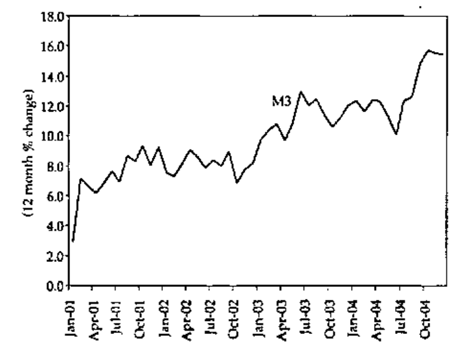
As mentioned before, in September 1999 Colombia abandoned an exchange rate band regime as a result of a series of international shocks and adopted a floating exchange rate, which works as an

Chart II.12
COLOMBIA: INFLATION 1994-2006*



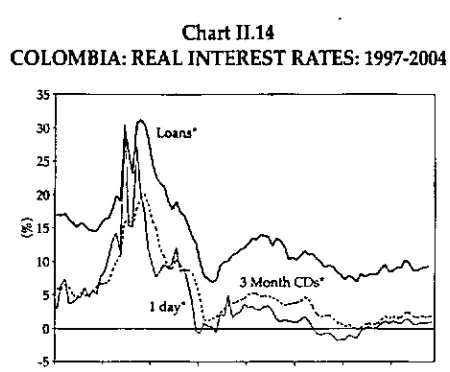
* Forecast.
Source: DANE and Fedesarrollo.

Chart II.13
MONEY SUPPLY: M3
2001-2004



M3: M1 (monetary base + cash) + quasimoney + fiduciary liabilities + overnight deposits + financial system's bonds.
Source: Banco de la República.

Chart II.14
COLOMBIA: REAL INTEREST RATES: 1997-2004



* Monthly averages. CDs: certificates of deposit.
Source: Banco de la República and DANE.

[24] Dornbusch and Fischer (1992).

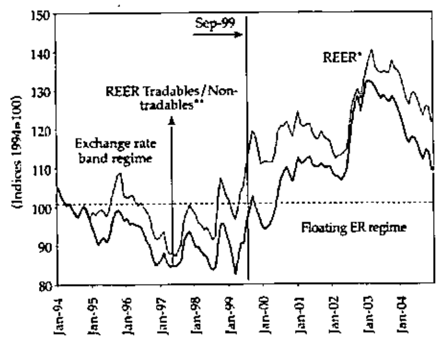
automatic price mechanism that absorbs those shocks. Chart II .15 illustrates that the real exchange rate (REER) has been at competitive levels ever since (index 1994=100).

Since the last quarter of 2003, the peso has been appreciating against the dollar, which can be explained by four main factors: high international prices of commodities; the recovery of non-traditional exports to Venezuela and the US; higher workers' remittances; and renewed capital inflows. As previously discussed, the latter are by-product of low international real interest rates and increased investor confidence in Colombia. Thus, the nominal ER has appreciated nearly 25% since the mentioned quarter.

Even though the real exchange rate (REER) is still undervalued (competitive), since it is above its 1994 reference level, pressures from exporting sectors have been escalating on the Central Bank (Banco de la República, BR) for it to act and halt the peso appreciation process. The Central Bank's intervention in the FX market totaled US$ 2,405 million in 2004 (Table II.3), which increased its international reserves up to US$ 13,535 that year (Chart II.16).

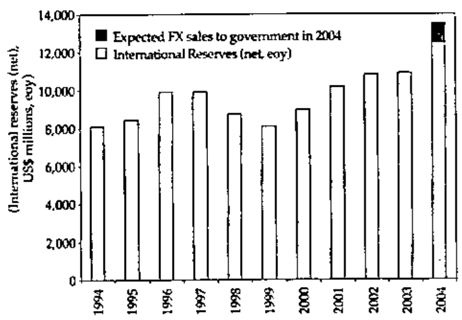
The economic authorities issued a decree that bans short-term (1 year) capital flight in December 14, 2004.[25] The measure is directed to curtail the peso's nominal appreciation, but in our view will likely be ineffective since such controls have not proven to be successful in the past, in Colombia and a large number of additional countries. Recognizing this empirical evidence, the Ministry of

Chart II.15
COLOMBIA: REAL EXCHANGE RATE (REER), 1994-2004



* Nominal exchange rate corrected by relative producer price indexes of Colombia and of its mayor trading partners; ** Relative price of tradable and non-tradable goods.
Source: Banco de la República.

Chart II.16
COLOMBIA'S INTERNATIONAL RESERVES, 1994-2004



eoy: end-of-year.
Source: Banco de la República and Fedesarrollo≠.

Table II.3
COLOMBIA: CENTRAL BANK'S OPTIONS OF FOREIGN EXCHANGE (FX) IN 2004

	US$ millions
FX purchases	2,905
Put options for accumulation of International Reserves	1,400
Put options for ER volatility control	180
Discretional Intervention*	1,325
FX sales	500
Government	500
Net FX Purchases	2,405

* New intervention rule since October 2004.
Source: Banco de la República.

[25] The capital flight ban means that foreign portfolio investment will have to remain in Colombia, from now on, for at least a year, while profits resulting from such investments can be repatriated sooner.

Finance has stated that it is considering eliminating such controls during the first semester of 2005.[26]

Finally, it is worth mentioning that the fiscal deficit and its financing requirements are putting some strains on the BR's institutional arrangement (see next section on fiscal policy). President Uribe has requested the BR to lend international reserves to the government to finance a portion of its deficit. The Colombian Constitution prohibits the Central Bank from lending directly to the government, unless all seven members of the BR's board vote unanimously in favor of this transaction.[27]

The nominal appreciation of the peso against the dollar is the result of four main factors: high international commodity prices, the recovery of exports, higher workers' remittances, and renewed capital inflows because of low international interest rates and increased investor confidence in Colombia.

The mentioned restriction, however, has been diplomatically circumvented in practice. Last year the government borrowed US$ 500 million to finance the budget.[28] Furthermore, the government recently announced that it would borrow an additional US$ 1,000 million in 2005 to finance a liability management transaction (see Chart II.16).[29]

Notwithstanding, the flexible exchange rate regime is expected to outlast punctual pressures for intervention taking into account Colombia's traditional respect towards its institutional arrangements. Additionally, economic authorities acknowledge that a flexible ER is an adequate automatic adjustment price mechanism to possess in the context of unforeseeable international shocks.

D. Fiscal Policy

Throughout the last 10 years, the central government (CG) finances have revealed a persistent deficit that can be best described as a

The Central Bank's intervention in the foreign exchange market totaled US$ 2,405 million in 2004, which increased its international reserves up to US$ 13,535 million that year.

[26] The IMF has stated in the past for the Colombian case that such controls could raise questions on the degree of ER flexibility and, thus, could potentially weaken the credibility of the inflation targeting framework. See IMF (2004), pg.22.

[27] The BR's Board of Directors has seven members: the Minister of Finance (president of the Board), a chairman, elected by the Board, and five members designated by the president of Colombia. Every four years, the president must ratify three of five as members of the board, for concomitant four-year periods.

[28] The government borrows from the BR through a three-step transaction: i) the government issues TES bonds through regular auctions to local market participants; ii) the BR buys the TES from the secondary market; and iii) the government uses the peso proceeds from the TES auction to buy dollars from the BR. The net effect is that the BR's holdings of TES bonds increase and the government has the BR's dollars in its treasury, with no change in the economy's monetary aggregates.

[29] The liability management transaction involves pre-paying an Inter-american Development Bank (IADB) credit of US$ 1,250 million.

structural problem. Both the non-financial public sector (NFPS) balance (the central government and decentralized entities) and the consolidated fiscal balance (NFPS plus the financial public sector) underscore the fragility of the country's fiscal accounts. The continuous increase of the central government's deficit reflects spending rigidities, which in 2005 are compounded by unforeseen pension outlays. Unless a meaningful pension reform is approved and/or taxes are raised, the central government's deficit can be expected to continue to grow in the medium term. If the surplus of the decentralized sector reduces over time, the outlook of the fiscal sector depends on whether structural reforms are approved and the growth of the central government's deficit is curbed. The central government's deficit is expected to reach -6.1% of GDP in 2005, up from -5.6% in 2004.

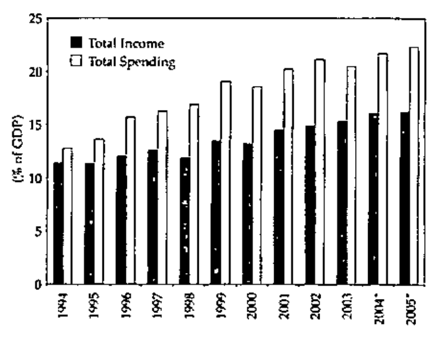
The central government's deficit is best described as structural problem. Spending rigidities, mandated by the Constitution and subsequent laws, and unforeseen pension outlays explain the persistence of the fiscal problem.

The structural fiscal imbalance can be traced to the Constitution of 1991 and subsequent laws, which in an effort to decentralize public administration tied government expenditure to income. The Colombian Constitution mandates that: i) transfers to the regional governments and municipalities grow 2% in real terms per year until 2008 and thereafter will increase at the current revenue's pace;[30] ii) public sector wages and pension payments must be indexed to CPI inflation. The transfers to the regions, in turn, are tied to public education (teacher payrolls) and health care expenditures. As the central government has undertaken these payments, it has also faced other liabilities, like backing with current revenue the exhaustion of the reserves of the public pensions' pay-as-you-go system (PAYG) in 2004.[31]

Fiscal reform efforts have not been very successful in curbing spending and providing a structural solution to the unfunded public pensions system. Tax reforms to raise revenue has been reiterated: a total of eight were approved in the 1980-2003 period.

It is worth mentioning that the Ministry of Finance has estimated that over 90% of the annual budget is not flexible, as it relates to spending mandated by legislation -like transfers to the regions- and obligations assumed by the public sector -mainly interest payments and public pensions outlays-. Chart II.17 shows that total CG revenue represented 11.4% of GDP in 1994 and increased to 16.1% of GDP in 2004. During those years, expenditure rose from 12.8% of GDP to 21.7% of GDP.

Chart II.17
COLOMBIA: CENTRAL GOVERNMENT'S REVENUE AND EXPENDITURE, 1994-2005*, % OF GDP



* Forecast.
Total spending: interest payments + other spending.
Source: Confis.

[30] Fedesarrollo (2005b). This current constitutional mandate is the result of a constitutional reform in 2001. Before that year, the Constitution established that regional transfers should grow at the same pace as current revenue. However, since 2009 regional transfers will grow again at the same rhythm as current revenue.

[31] The PAYG public pension system is unfunded because for many years benefits have not corresponded to contributions.

From a political economy standpoint, the CG's budget disequilibrium persists because meaningful expenditure reforms require constitutional amendments for which political support is hard to build. Therefore, the Executive has been inclined to choose the reiterated introduction of tax reform legislation for Congress' approval, with the objective of increasing revenue.[32]

As a matter of fact, a total of eight tax reforms were approved in the 1980-2003 period. Along with improved growth rates, total CG revenue has risen from 11.4% of GDP in 1994 to 16.1% in 2004. Recent research persuasively argues in favor of a comprehensive overhaul of the country's tax code to increase revenue further while eliminating tax distortions.[33]

Favoring a strategy of gradual central government deficit reduction, this government has succeeded in enacting several fiscal reform initiatives: one pension reform and two tax reforms.

A structural tax reform acquires more importance taking into account that declining oil production will likely impact fiscal accounts in the medium term. The profits from the state-oil company, Ecopetrol, have been important for the overall surplus generated by the decentralized public sector (see Table II.4) that has alleviated the financing required to cover the central government's deficit. Ecopetrol's profits reached 0.55% of GDP in 2003, which financed 10% of the central government's deficit in that same year.[34] Ecopetrol's transfers to the central government are estimated to be null

Table II.4

COLOMBIA: DECENTRALIZED PUBLIC SECTOR, 2000-2004*

Overall balance, % of GDP	2000	2001	2002	2003	2004*
Ecopetrol	0.7	0.4	0.2	0.6	0.0
Social Security (includes regions)	0.3	0.6	1.2	0.8	1.5
Regional and municipal governments	-0.2	0.0	0.4	0.4	0.5
Other**	1.2	0.9	0.5	0.6	0.9
Total decentralized public sector	**2.1**	**1.9**	2.3	2.4	**2.9**

*estimate; ** other includes principally the oil stabilization fund (FAEP), state-owned telecom and electricity companies, regionally-owned utilities and the National Coffee Fund.
Source: Confis.

Meaningful pension reform and/or tax increases should be expected in order to curb the growth of the central government's deficit in the medium term.

32 See Fedesarrollo (2005b), "La agenda económica 2005:¿cuáles son las prioridades?".

33 See Fedesarrollo (2003), "Misión del Ingreso Público" and Fedesarrollo (2005a), "Ante la oportunidad perdida en 2004 el 2005 debe ser el año de la reforma tributaria estructural". Sánchez, F. and S. Espinosa (2005) argue that the tax reforms enacted between 1980 and 1993 were successful in boosting government revenue to finance the fiscal deficit in the short and medium term, but did not increase tax productivity.

34 Fedesarrollo (2004), "Petróleo y carbón: situación actual y perspectivas", pg.19

in 2004, since the company is expected to concentrate its resources to investment in oil exploration in 2005 (see Section II.B.2).

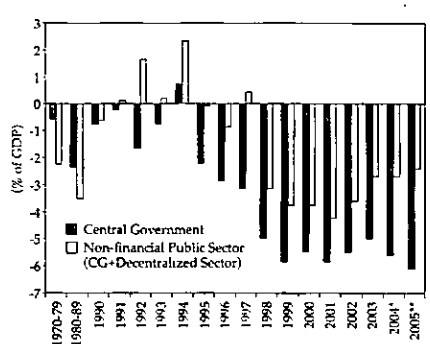
Consequently, the central government's (CG) deficit has been increasing since the mid 1990s, from -2.2 % of GDP in 1995 to -5.8% of GDP in 1999. According to the official forecast, it is expected to reach -6.1% of GDP in 2005 and -5.6% of GDP in 2006 (see Chart II.18).[35]

The non-financial public sector's (NFPS) deficit is lower than that of the central government since its balance is relieved by the overall surplus of the decentralized public sector (Table II.4).[36] As a matter of fact, the regional government's balance turned into a surplus in 2001 after bailouts carried out by the central government and, mainly, successful policy adjustments that mitigated the effects of indebtedness that characterized their accounts by the end of the 1990s (see Chart II .18).[37]

It is worth highlighting that the International Monetary Fund's programs with Colombia, in force since 1999, have not been useful for accomplishing expenditure reduction at the CG level. Rather, the IMF programs have been very important to enhance the government's credibility to finance the CG's deficit through tapping into multilateral agency loans (mainly World Bank and the Inter-American Development Bank) and, more generally, through borrowing from international capital markets by means of issuing sovereign debt.[38]

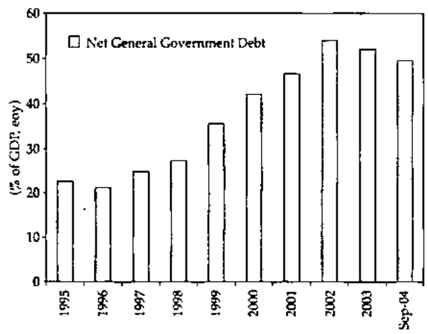
As a result of all of the above factors, Colombian public debt has doubled in less than 10 years, from 22.7% of GDP in 1995 to 49% of GDP in 2004 (Chart II.19). Recent public debt dynamics include a

Chart II.18
COLOMBIA: CENTRAL GOVERNMENT AND NON-FINANCIAL PUBLIC SECTOR (NFPS) FISCAL BALANCE, 1970-2005*



* Preliminary; NFPS: central government + decentralized entities.
Source: Confis.

Chart II.19
COLOMBIA: TOTAL NET GENERAL GOVERNMENT DEBT, 1995-2004



eoy: end-of-year.
Source: Banco de la República-SGEE, quartely statistics on public debt, December 2004.

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[35] Source Confis.

[36] The non-financial public sector is the sum of the central and decentralized levels of government.

[37] See Echavarría, J.J., C. Rentería and R. Steiner (2002), "Decentralization and Bailouts in Colombia". It should be noted that the government passed important legislation to restrict spending and indebtedness (Law 358 of 1997 and Law 617 of 2000), which partly explains the recent surpluses. In the last couple of years, the regional fiscal balances also have benefited from the collection of a surcharge on gasoline.

[38] The Uribe administration is renewing a Stand-by program as of April 2005, which will include leniency to accommodate investment in infrastructure equivalent to 0.3% of GDP. The consolidated fiscal deficit (that adds to the NFPS the results of the financial public sector) is expected to fall from 2.5% of GDP in 2004 to 2.0% of GDP in 2006. See Annex 2.

reduction of nearly 10 percentage points of GDP between 2002 and 2004. Though the Uribe administration has been very active in liability management operations to improve the debt payments' profile, concerns persist on the sustainability of public debt since meaningful adjustment at the CG level has not taken place. It should be underlined that in its recent history (since 1930), Colombia has never defaulted on its international financial obligations.

Recent public debt dynamics include a reduction of nearly 10 percentage points of GDP between 2002 and 2004. The Uribe administration has been very active in liability management operations to improve the debt's profile.

1. *Fiscal Reform and Central Government's Deficit Financing*

Favoring a strategy of gradual CG deficit reduction, the Uribe administration has promoted a number of fiscal reform initiatives. Colombians voted a referendum in October 2003, which contained imperative fiscal adjustment measures that unfortunately did not hold the threshold to come into force. The successful initiatives have been basically two tax reforms, an overhaul of the state entity in charge of tax collection with the objective of increasing its efficiency, a state downsizing policy that has restructured 150 state-owned enterprises, and one pension bill in 2003.

Regarding the approved pension reform, it achieved a reduction of the net present value (NPV) of the public pensions' actuarial deficit from 206% of GDP to 187% of GDP (NPV calculated for the 2003-2049 period).[39] As previously mentioned, the public pensions systems' reserves were exhausted in 2004, underscoring the need for passing additional and meaningful pension reform in the near term.[40] A solution in the right direction, but that still falls short of providing a structural solution, is the constitutional amendment that Congress will be debating for second round during the first semester of 2005, regarding the costly special pension regimes. The current version of the bill should generate savings of 13% of GDP by 2035.[41]

IMF programs with Colombia have enhanced the government's credibility to finance the fiscal deficit by tapping into multilateral loans and borrowing from the international capital markets by issuing sovereign debt.

The central government faces other expenditure pressures, mainly from interest payments, and increased military expenditure for upholding the democratic security policy (Chapter III).

[39] NPV estimates cited by the Ministry of Finance. Law 797 and Law 806 of 2003. A Constitutional Court ruling declared that Law 806 violated constitutional provisions. That law sought to accelerate the transition period for the reduction of benefits, which meant that the pensions deficit NPV was not reduced by an additional 17% of GDP.

[40] See Fedesarrollo (2004), "¿Cuál es la reforma pensional que necesita Colombia?", *Debates de Coyuntura Económica*, no.57, October.

[41] Source: "IMF Chief Outlines Colombia's Challenges; New Loan Eyed", Dow Jones Newswires, February 16, 2005.

The government has been very active in providing solutions to adequately cover the CG deficit. Therefore, financing the central government deficit of -6.1% of GDP in 2005 seems manageable. On the one hand, the government plans on relying on domestic debt (TES bonds) to finance 80.4% of this year's budget (Chart II.20). This level of TES issuance will likely be supported by the existence of a captive domestic investor base, composed of the private pension funds and decentralized government agencies that are forced to invest a given percentage of their portfolios in TES bonds. On the other hand, the government executed an aggressive pre-financing external debt issuance plan, which has achieved a completion of over 85% of planned external issuance for 2005.

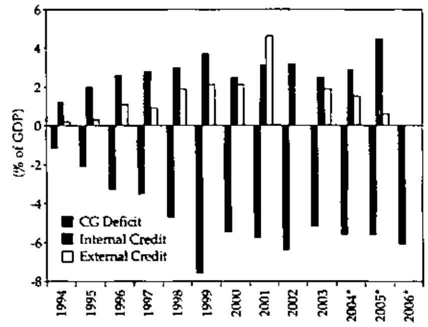
However, there are some caveats in regard to the government's assumptions on privatization proceeds. In fact, the 2005 financing strategy includes as revenue the expected privatizations of the utility companies Ecogás and ISA (see Chapter V). Using one-time revenues to finance spending that tends to become permanent raises doubts on such strategy. In addition, privatizations have proven to be politically difficult to carry through in Colombia, as exemplified by the two public banks expected to be sold since 2003 (Bancafé and Granahorrar). Therefore, if programmed privatizations do not materialize for 2005, the government will have to establish other financing alternatives.

2. *Public Debt Sustainability*

As mentioned above, the Uribe administration has been very active in liability management operations to improve the debt payments' profile (Chart II.21). In recent months the government swapped up to US$ 1,825 million of dollar denominated sovereign debt bonds for peso denominated sovereign bonds, which eliminates the exchange rate risk for Colombia as their issuer. Such transactions are expected to continue in 2005 to rollover amortizations payments, in particular for interest payments for 2007 and 2008.

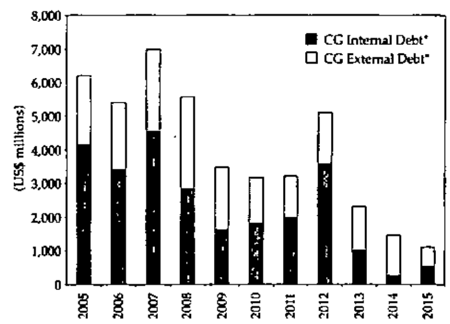
Using a medium-term fiscal framework, the government continues to work in order to reduce public debt as a percentage of GDP. The main objective is to bring it down to 40% of GDP in a 10-year period (the "baseline medium-term projections" in Chart II.22) For 2005 the Ministry of Finance has announced an expected public debt to GDP ratio reduction of 1.1% of GDP. It should be mentioned that public debt sustainability is still vulnerable to shocks, like a sharp depreciation of the peso against the dollar, which adds to the need of curbing spending by the central government to reduce its exposure to such eventualities.

Chart II.20
COLOMBIA: CENTRAL GOVERNMENT'S FINANCING 1994-2006*



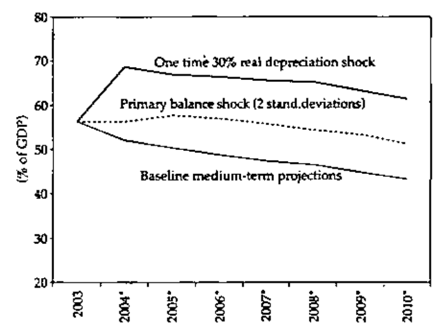
* Forecast.
Source: Confis.

Chart II.21
COLOMBIA: PUBLIC DEBT PAYMENTS PROFILE (OCTOBER 2004), 2005-2015



* Information updated October 29, 2004.
Source: Ministry of Finance.

Chart II.22
PUBLIC SECTOR DEBT SUSTAINABILITY FRAMEWORK 2003-2010



* Forecast.
Source: IMF (2004), pg. 31.

Summing up, the Uribe administration has favored a gradual fiscal reform approach that has rendered some positive results. However, the CG deficit is still significant and its financing relies on constantly evolving factors, which are hard to predict. Therefore, a key event to monitor during 2005 and 2006 will be any announcement of the new government's fiscal reform agenda. As the CG's deficit persists, the new administration might be compelled to use its political capital to solve Colombia's structural fiscal problem.

Public expenditure in the social sector almost tripled in recent years: from 4.3% of GDP in 1990 to 11.3% of GDP in 2003. These resources have been transferred to the regions mainly for health and education.

E. Social Policy

Since the beginning of the 1990s, Colombia's public expenditure in the social sector has almost tripled as a percentage of GDP. Average social spending by the central government in 1990 was 4.3% of GDP and currently runs at 11.3% of GDP. These resources have been transferred to the regions for health and education, and have aided in increasing the coverage rate of these public services (see below). To increase the efficiency of this expenditure, the Pastrana administration introduced key legislation in 2001 to change the way education and health expenditure was allocated, focusing on targeting demand instead of subsidizing supply (the reform of Law 60 of 1993).

Building on those efforts, the Uribe's administration has paid special attention to the social sector. The government has undertaken the challenge of structuring an operating social protection system, which seeks to coordinate the operation of its five main components: health, labor markets, development, child protection and social assistance.[42] Based on other countries' experiences, the basic notion of the system is to protect consumption of the vulnerable segments of population instead of focusing on preserving their incomes.[43]

This government is structuring a social protection system, which articulates several components to protect consumption of the vulnerable segments of the population.

The social protection system partly builds on experience of a social safety net that was designed in response to the economic crisis of 1998-1999. The social safety net, which targets the most vulnerable segments of the population, includes education incentives based on nutrition subsidies, labor retraining programs, and public works employment programs (see Table II.5, "targeted support to most vulnerable population", for recent execution of some of these programs). Some of these subsidies are better targeted than others,

[42] See F. Pérez (2004).

[43] The head of this initiative is the Ministry of Social Protection. As background, it should be mentioned that the Uribe administration merged the Ministry of Labor and the Ministry of Health into a new Ministry of Social Protection during the last quarter of 2002.

Table II.5
SOCIAL EXPENDITURE-RELATED GOALS OF THE URIBE ADMINISTRATION

Project Description	Baseline Dec-2002	Accumulated result Dec-2004	Goal Dec-2006	Current shortage to meet 2006 goal
Basic (social) housing				
Total subsidized credits assigned for the acquisition of social housing both urban and rural, which includes those granted by Fonvivienda, CCF, CPVM, Banco Agrario,FNA and Findeter	69,824	199,452	400,000	200,548 50.1%
Education				
New public education openings for basic elementary and middle school	347,372	734,413	1,500,000	765,587 51%
New public education openings in universities	1,000,148	103,903	400,000	296,097 74%
Instructed students by the Integral Professional Formation Program (includes titled and complementary)	1,142,798	2,964,799	4,000,000	1,035,201 25.9%
Public Health				
New affiliates to the Subsidized Health Regime (includes total and partial subsidies)	381,292	4,677,641	5,900,000	1,222,359 20.7%
Annual coverage of triple-viral vaccines for babies under 1 year	93	92.7	95	2.3%
Targeted support to most vulnerable population				
Children benefited by the *School Restaurant's Program* (Acum)	78,152	503,663	1,000,000	496,337 49.6%
Third-age Balanced Nutrition Program	-	25,660	400,000	374,340 93.6%
Families benefited by the last cycle of the *Families in Action* Program	320,434	328,455	400,000	71,545 17.9%
Other				
Teenagers members of the'*Rural Young Program*	-	107,472	155,214	47,742 30.8%

Source: Ministry of Finance-Dirección General de Presupuesto (February 2005).

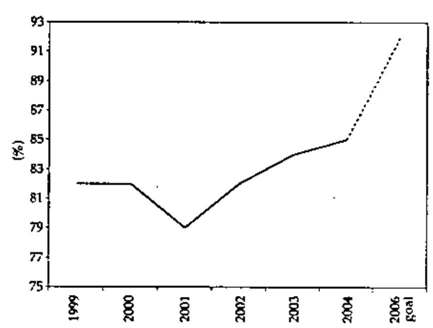
but overall they are a positive step in the design of public policy oriented to the most vulnerable population. Currently, the government struggles to guarantee financing for such programs as they were mostly funded with multilateral loans.

1. *Social Expenditure-related Goals of the Uribe Administration*

As previously mentioned, the Uribe Administration has paid great attention to social policy. Table II.5 summarizes the main social expenditure-related goals of the Uribe Administration and their results. Public education and health are given high priority, since they count with significant levels of resources that could increase the population's welfare if used more efficiently.

Chart II.23 and Chart II.24 ilustrate the government's satisfactory results in increased coverage rates for basic elementary and middle school public education, and of the subsidized health regime.[44]

Chart II.23
COVERAGE OF BASIC ELEMENTARY AND MIDDLE SCHOOL EDUCATION



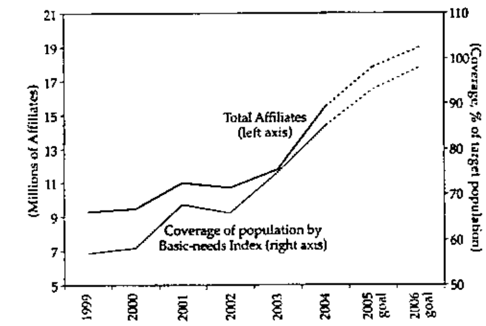
Source: Ministry of Education, Sinergia, Reportes de Evaluación. February, 2005.

[44] Social Security reforms were undertaken in 1993. In the health sector they opened the possibility of private participation in areas that had been exclusively provided by the public sector. Additionally, a system of subsidies for the population of lower incomes (the subsidized health regime) was created.

Efforts in the first area are positive, as basic elementary and middle school public education coverage rose one percentage point between 2003 and 2004, to 85%.

Chart II.24 shows that the subsidized health regime reached an additional 3.6 million people in 2004, which meant reaching 85% of targeted population according to the basic needs index. As a percentage of total population, the coverage of the subsidized health system reached 35.3% in 2004.[45]

Chart II.24
COVERAGE OF THE SUBSIDIZED HEALTH REGIME



Source: Ministry of Social Protection.

The government's social programs go beyond basic health and education. During his presidential campaign, Uribe stressed on the importance of giving out publicly subsidized credits for the acquisition of lower social strata housing (or *social housing*), both urban and rural. As mentioned in Section II.B.2, the construction of *social housing* has greatly depended in the past on the fiscal availability of government resources to subsidize credits for its purchase. This program has been subject to recent reforms, which have basically lowered the per capita subsidy amounts to reach more individuals. However, as these changes have meant new rules of the game, the demand for subsidies will take some time to adjust. Thereafter, social housing construction could be expected to regain dynamism. Currently the public social housing program is falling 50% short of its 2006 goal.

Summing up, since the early 1990s Colombia has undertaken new initiatives to mitigate the impact of shocks on the poorest segments of the population, and consequently Colombia has dedicated increasing resources to social expenditure. As these resources put strains on the fiscal accounts, more attention is being granted on improving their social efficiency. Thus, in the near term social indicators can be expected to continue improving in Colombia, particularly if the country reaches higher economic growth rates.

Social indicators are expected to continue improving in Colombia, particularly if the country reaches higher economic growth rates.

2. *Unemployment and Poverty in Colombia*

The recession of 1998-1999 meant an important setback regarding the unemployment and poverty reduction achieved in Colombia up to the mid-1990s (see Table II.6). In 2001 poverty and extreme poverty peaked at 67% and 26%, respectively. These rates had been

[45] The Ministry for Social Protection has used several strategies to attain that result: a redirection to the health of transfers to regions' resources; a refinement of databases for possible multi-affiliates; liquidation of municipalities' contracts that correspond to previous fiscal years; and the use of municipalities' own resources.

last observed in the mid-1980s. By 2001 urban unemployment was among the highest in Latin America, as it averaged 18.1% that year. However, the economy's recent recovery has meant declining poverty and unemployment rates (see Table II.6 and Chart II.5).

The severity of the unemployment phenomenon motivated the Uribe administration to undertake a labor reform. Thus, it presented to Congress a labor bill that was approved in the last quarter of 2002. To date Uribe's labor reform has had mixed results.[46] In fact, unemployment remains high (15.5% in the urban areas in 2004), with a weaker incidence level in rural areas (9.1% in 2004).[47]

Although the unemployment rate has declined steadily during the past three years, it remains high: 15.5% in the urban areas. This situation dampens domestic consumer confidence.

As it is well known, high and sustained levels of economic growth are an essential condition for the creation of new jobs. In turn, unemployment is closely related to poverty. Thus, Colombia faces the challenge of achieving higher and sustained rates of growth. According to C.E. Vélez *et al.* (2003), Colombia needs to grow at least at a 4% annual rate during the next decade in order to reduce extreme poverty back to the 1995 level: from 26% of total population in 2001 to 21% (see Table II.6).[48]

Table II.6
COLOMBIA: POVERTY AND INEQUALITY 1978-2001

	1978	1988	1995	1999	2001
National Poverty Indicators (%)					
Poverty rate*	80	65	60	64	67
Poverty band**	46	32	29	34	64
Extreme poverty rate	45	29	21	23	26
Average per capita monthly income, Colombian pesos of 2001	131,000	213,000	251,000	245,000	230,000
Urban (%)					
Poverty rate	70	55	48	55	59
Extreme poverty rate	27	17	10	14	17
Rural (%)					
Poverty rate	94	80	79	79	80
Extreme poverty rate	68	48	37	37	42

* The poverty rate is the percentage of the population under the poverty line; ** The poverty band describes the average distance to the poverty line.
Source: C.E. Vélez (2004) using DANE-Encuesta Nacional de Hogares and the World Bank's Colombia Poverty report of 2002.

The Colombian economy must grow at least at a 4% annual rate during the next decade for significant unemployment reduction to take place, and for extreme poverty to fall back to the 1995 level of 21%.

[46] A. Gaviria (2004) shows that i) the labor reform of 2002 had a measurable impact on the hiring of apprentices, and a likely (a positive) impact upon hours (specially in the service sector); ii) the effect upon employment and job formalization were slight; and iii) the remedial programs created by the reform have not functioned properly.

[47] Source DANE.

[48] C.E. Vélez et al. (2003), "El reparto del crecimiento, pobreza y desigualdad", in M.Guigale et al., *Colombia: Fundamentos Económicos de la Paz*, pg.57.

III. THE DEMOCRATIC SECURITY AND DEFENSE POLICY

The internal conflict is one of the most critical problems that Colombia has faced in the last decades. The violence generated by illegal armed groups since the 1960s resulted in a deterioration of the domestic security environment and played a role in the spread of ordinary criminality and drug trafficking. As it has been mentioned throughout this document, one of the most outstanding features of the Uribe administration has been the so-called Democratic Security and Defense Policy. Though it's still too soon to make a final assessment, the preliminary results of this policy allow for an optimistic view about the future resolution of the internal conflict.

One of the most outstanding features of the Uribe administration has been the Democratic Security Policy, which has spurred growth and investor confidence.

A. Background: the Internal Armed Conflict in Colombia

The origins of Colombia's modern internal conflict date back to the 1960s, when several guerrilla organizations appeared as part of the "armed communist resistance" phenomenon. Although some of these organizations were isolated from the internal conflict, due to successful peace settlements and demobilizations, others have remained active. Among them, the most important at the present are the Revolutionary Armed Forces of Colombia (FARC) and the National Liberation Army (ELN).

Preliminary results of the security strategy allow for an optimistic view about the resolution of Colombia's internal conflict.

In 1964 the FARC emerged as an agrarian communist guerrilla organization of less than 300 armed men. All along the first two decades of its existence, the FARC's main concern was overcoming the efforts of the Colombian army to eliminate it. Nevertheless, since the 1980s this organization has systematically multiplied the number of their fronts. To the present date it is the largest guerrilla organization with around 20,000 combatants.

The second largest guerrilla organization, the ELN, had a different origin from that of the FARC, being both ideologically and organizationally close to the Cuban-style revolution. Historically, the ELN's forces have been significantly less than those of the FARC, currently reaching at most 5,000 armed men. In recent years the strength of this guerrilla group has been severely diminished.[49]

There are smaller active guerrilla groups that operate independently. The People's Liberation Army (EPL) was also organized in the 1960s, but followed an anti-Moscow Maoist ideological current. After major losses in the counter-insurgency campaigns of the late 1980s, the EPL signed a peace settlement with the Colombian government in 1991. However, a dissident faction of the EPL kept fighting. Finally, in 1994 the Colombian army captured EPL's senior commanders and dismantled most of this organization.[50] The EPL currently has several hundred fighters. Other smaller active guerrilla organizations include the People's Revolutionary Army (ERP), the Guevarist Revolutionary Army (ERG), and the Jaime Bateman Cayon group.

The internal conflict suffered a structural change in the 1990s. Drug trafficking became a source of income for the illegal armies, and the paramilitaries emerged as a new actor in the conflict.

Meanwhile, in the last decades the Colombian State has undertaken successful peace processes with the following groups: the April 19th Movement (M-19), the Workers' Revolutionary Party (PRT), the Armando Quintín Lame Movement (MAQL), the Socialist Renewal Stream (CRS), the F. Garnica Front, and the Ernesto Rojas Commandos (CER). All of the guerrilla organizations have had different social origins, ideological projects, organizational structures, war tactics, and relationships with the population. Due to these deep-seated divergences, all of these groups have negotiated different peace settlements on different dates (Table III.1).

In the last decades Colombia has undertaken successful peace processes with several groups. Currently, the Uribe administration is negotiating peace with the paramilitary armies.

B. The Structural Change of the Internal Conflict

At least two factors could be identified as principal determinants of the structural change of the Colombian internal conflict in the 1990s. First, the consolidation of drug trafficking as a source of income for the illegal armies involved in the conflict. Second, the emergence of paramilitary armies as a third primary actor in the conflict. Both of these features led to an intensification of the armed conflict in the 1990s and the current decade.

1. *Insurgent's Links to the Drug Trade*

During the 1990s Colombia consolidated as one the most important drug producing nations in the world. Between 1989 and 1999

[49] Deas, Malcolm (1999). "Colombia-Your questions answered?". Biblioteca Virtual del Banco de la República. www.lablaa.org/blaavirtual/letra-d/deas/deas.htm.

[50] Echandía, Camilo (1999). El conflicto armado y las manifestaciones de violencia en las regiones de Colombia. Presidencia de la República.

Table III.1
PEACE SETTLEMENTS IN COLOMBIAN GOVERNMENT AND GUERRILLA ORGANIZATIONS

Organization	Agreement Date	No. of Combatants Demobilized
M-19	March 1990	900
PRT	January 1991	200
EPL	February 1991	2,000
MAQL	May 1991	157
CRS	April 1994	433
F. Garnica Front	June 1994	150
CER		25
Total		3,865

Source: Palacios (1999).

Colombia's coca leaf production increased 549%, rising from 33,900 to 220,000 metric tons. In fact, at the end of that decade Colombia became the world's leading coca leaf producer (producing more coca leaf than Peru and Bolivia together).[51] This production expansion happened in spite of the permanent eradication program of the National Police of Colombia that fumigated a record of 65,000 hectares of cocaine only in 1998. Moreover, Colombia maintained its position as the main cocaine refiner, providing nearly 80% of the total illegal United States' imports of cocaine in 1999. Likewise, the production of poppy (the raw material of heroin) reached 61 metric tons metric in 1998 whereas in 1989 there was no poppy production. At the end of the decade Colombia became the first supplier of east coast United States, exporting near six metric tons of pure heroin annually. Colombia also continued being an important marihuana producer throughout the decade, supplying roughly 40% of total imports of the United States.[52]

During the 1990s Colombia became one of the most important drug producing nations. The Colombian government has responded with aggressive drug eradication and interdiction operations. In 2004 more than 136,000 hectares of cocaine and 3,060 of poppy were eradicated through aerial fumigation. Likewise, 178 metric tons of cocaine were seized and 200 drug producing laboratories were destroyed.

Drug trade transformed the financing structure of guerrilla organizations, allowing for the expansion and strengthening of these groups in the 1990s. Since 1982 the FARC engaged indirectly in the drug production and trading business through the collection of "taxes" on coca leaf producers, on the use of processing laboratories, illegal runways and other basic infrastructure services needed in the production and distribution chain.[53] At the end of the 1990s,

51 GAO (1999).

52 Bagley, Bruce Michael (1999). "Narcotráfico, violencia política y política exterior de Estados Unidos hacia Colombia en los noventa".

53 Rangel, Alfredo (1999). In: *Reconocer la Guerra para construir la Paz.*

evidence suggested that some fronts of the FARC could have been operating their own coca processing facilities in remote areas of the country. According to the Colombian Armed Forces briefings, in 2000 over half of the FARC fronts derived some income from and protected the drug trade. On the other hand, only one sixth of the ELN fronts were linked to drug trading.[54] Moreover, the weakening of the organized drug cartels of Medellín and Cali gave the guerrilla organizations the chance of increasing their participation in the prosperous drug industry. The Colombian government estimated annual drug traffic gains of the FARC in US$ 400 million at the end of the 1990s. Additionally, other gains from kidnapping, extortion and robbery summed up to approximately US$ 500 million annually. Drug trade gains have given the FARC the ability to capture sufficient resources to support the quantitative and qualitative development of their military forces, and have broadened the range of strategic options available to the guerrillas.[55]

As the organized drug cartels of Medellin and Cali have been weakened, some of the drug trade has been taken up by the FARC guerrillas. Similarly, the paramilitary armies have also succeeded in entering the drug trafficking business.

2. *The Rise of Paramilitarism*

The creation of paramilitary armies in the 1980s responded mainly to the demand of defense against guerrilla organizations in zones where the State had no effective presence. The paramilitary phenomenon in Colombia has involved a collection of different groups with diverse social origins, rationality, and strategies. Although paramilitarism was originally the response of the unprotected share of civil society against the rise of communist guerrilla armies, this defensive profile disappeared gradually and has led to the institution of a third war actor.

As the other illegal armies involved in Colombia's internal conflict, paramilitary armies have successfully entered the drug trafficking business. Some of the most intense confrontations between paramilitaries and guerrilla organizations have been carried out in strategic regions for drug production and distribution.[56]

The most significant change in the evolution of the paramilitary phenomenon was the centralization of most of the paramilitary

[54] Rabasa and Chalk (2001). "Colombian Labyrinth: The Synergy of Drugs and Insurgency and Its Implications for Regional Stability", www.rand.org/publications/MR/MR1339/

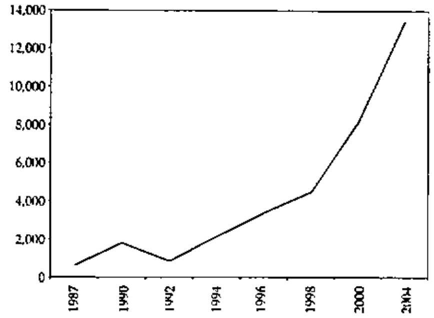
[55] Bagley (1999).

[56] The Associate Press (2000). "Colombian Militias Tax Drug Trade", The New York Times, January 10th, 2000.

organizations around the United Self-Defenses of Colombia (AUC), created in April of 1997. Yet, the AUC still have a high degree of internal diversity and the central command of the organization does not have control over all of the groups classified as paramilitary forces.

Since 1992 the number of paramilitary combatants has increased continuously, at an annual average rate of 26% (Chart III.1). While in 1992 paramilitary organizations had a total of 850 armed men, in 2004 they reached 13,500 armed men (more than half of the estimated total number of combatants of the FARC and the ELN).

Chart III.1
NUMBER OF ACTIVE PARAMILITARY COMBATANTS



Source: Rangel (2005), "Sustainability of the Democratic Security Policy Forum"

C. Pastrana's Strategy: Carrots and Sticks

In 1998-2002 president Andrés Pastrana implemented a "carrots and stick" policy as a solution strategy for the internal conflict. At that point the Colombian government faced a stronger than ever FARC. Simultaneously, Colombia's Military Forces were relatively weak and incapable of fully responding to the new challenges of the internal conflict. The *carrots* policy was the commitment to the instauration and development of the peace dialogue with the FARC. The *stick* policy was the design and implementation of a comprehensive modernization and restructuring process of the Military Forces.[57] Both components of the internal conflict policy were strategically necessary.

The peace dialogues under the Pastrana administration were not successful. However, Pastrana's initiative to modernize and restructure the military forces built the necessary foundations for today's achievements regarding enhanced internal security conditions and renewed investor confidence.

1. *Peace Dialogues with the FARC*

In order to facilitate the peace dialogues, in November of 1998 President Pastrana approved the creation of a demilitarized zone of 42,000 square kilometers (nearly the same area of Switzerland) in the Caquetá department, in which the negotiations could physically be carried out. This agreement established that the Colombian Armed Forces had to retire completely from this clearance zone, and even more, prohibited all combat and intelligence operations in the area.

Soon this demilitarized zone became practically a sanctuary for the FARC, with the instauration of its *de facto* government and with approximately 5,000 troops permanently stationed there. During

[57] Actually the transformation process of the Colombian military forces took place during the 1998-2003 period (throughout Pastrana's presidency and President Uribe's first year of mandate).

its existence this clearance zone was used by the FARC to hide kidnapped victims, collect illegal taxes and extortions, train new troops and terrorist commandos, construct antiaircraft batteries and other military fortifications, and run drug trafficking operations.[58]

In the first trimester of 2002, peace dialogues were broken. The main reason was that the FARC radically rejected the controls that the government had established around the demilitarized area, arguing that this left them no guarantees to continue at the peace negotiations. Although the clearance zone concession given by President Pastrana gave the peace dialogues a true chance, it also gave the FARC the opportunity to get financially and militarily stronger.

The peace dialogues with the FARC broke in the first months of 2002 since the guerrillas rejected the government's controls of areas surrounding the demilitarized area, arguing that this left them with no guarantees to continue in the peace negotiations.

2. *The Colombia's Military Forces Transformation Process (1998-2003)*[59]

The transformation process of the Colombian Military Forces during 1998-2003 not only had the objective of attaining a more efficient use of its potentials, but also the development of completely new capacities in order to deal with the FARC's continuous expansion. Through this modernization and restructuring process, Colombia's Military Forces adjusted to the new challenges of the public order crisis in the late 1990s.

The structure of this transformation was based on three essential strategies:

During 1998-2003, the Colombian military forces undertook a drastic reform. Recent military transformation seeks upgrading its technology, institutional reform, and doctrinal changes. Additionally, the size of the troops has been incremented to 358,000 active men.

- Technological upgrading: The most relevant technological developments were the enhancement of aerial mobility and aerial combat support, the accomplishment of the capacity to perform night-time operations, and the improvement of intelligence, control and communications infrastructure.

- Institutional changes: There were several institutional reforms within the Military Forces during its transformation process. First, there was a substitution of non-professional soldiers by professional soldiers. This way the Military Forces could count

[58] B. Bagley (2000). "Narcotráfico, violencia política y política exterior de Estados Unidos hacia Colombia en los noventa".

[59] This section is based on the publication: *Fuerzas Militares para la Guerra, la agenda pendiente de la reforma militar*. Fundación Seguridad y Democracia. November 2003.

with better trained, more experienced and motivated troops. Between 1998 and 2002 the total number of professional soldiers increased from 22,000 to 55,000. Second, the legal framework of the evaluation and promotion of military personnel was changed in order to advance toward a more flexible regime. Third, the General Command Office of the Military forces was profoundly restructured with the creation of various subordinate offices.

- Doctrinal changes: The main doctrinal change of the Military Forces was going from a defensive and static attitude, to a proactive, offensive and mobile operational concept. The second most important doctrinal change was the integration of the Human Rights and the International Humanitarian Laws to the instruction cycle of all of the Military Force personnel.

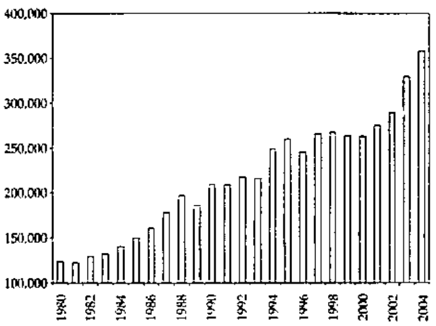
Additional to these internal reforms and technological upgrading, the Colombian Military Forces began an expansion process of its troops. While in 1998 the Military Forces had approximately 267,000 active men, in 2004 it had almost 358,000 active men (Chart III.2).

The transformation process of the Military Forces was supported by a gradual and constant expansion of the Nation's defense and security expenditure. During the 1998-2004 period defense and security expenditure as percentage of GDP grew in average 6.4 percent annually (Chart III .3). Likewise, between 1998 and 2004 participation of the military and police budget expenditure on the GDP grew 32%, from 2.5% to 3.3% of GDP (Chart III.4).

D. Democratic Security and Defense Policy

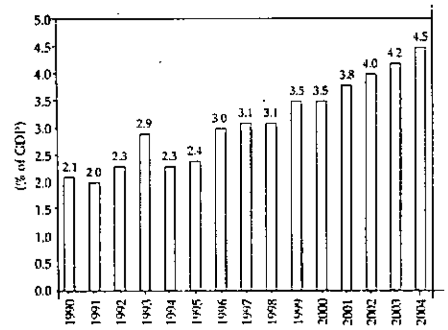
Since his presidential campaign, President Alvaro Uribe proposed the Democratic Security and Defense Policy as the main axis of his government platform. He has relentlessly asserted that "restoring order and security -a basic prerequisite for the strengthening of civil liberties and human rights- is a central concern of this government. Democratic Security is what is required to guarantee the protection of the citizens. If the State protects all its citizens equally and without discrimination, all Colombians will be able fully to enjoy their rights".[60] The key principle of this policy framework is that security is essential for the development of democracy, and

Chart III.2
TOTAL NUMBER OF TROOPS OF THE COLOMBIAN MILITARY FORCES



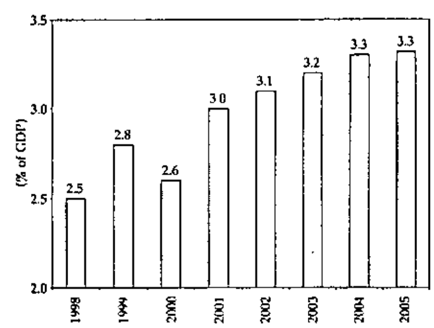
Source: Ministry of Defense.

Chart III.3
NATIONAL DEFENSE AND SECURITY EXPENDITURE AS PERCENT OF GDP



Source: DNP.

Chart III.4
MILITARY AND POLICE EXPENDITURE AS PERCENT OF GDP (WITHOUT PENSION EXPENDITURE)



Source: Ministry of Defense.

[60] President Alvaro Uribe. "Democratic Security and Defense Policy". Presidency of the Republic and Ministry of Defense, 2003.

that Colombian democracy has been constantly threatened by all illegal armed forces. Hence President Uribe established national security policy as the central column of his political agenda. Moreover, he has legitimized the Democratic Security and Defense Policy through democratic support and the transparency of his mandate.

President Uribe's new approach to the internal conflict has placed the *carrot* policy well below the *stick* policy in the priority list. The transformation process of the Colombian Military Forces has continued, while future peace dialogues with illegal armed groups have depended on true initiatives shown by these organizations and not on concessions offered by the government.

The expansion of Colombia's defense and security expenditure has supported the military transformation. Between 1998 and 2004 military and policy expenditure rose from 2.5% of GDP to 3.3% of GDP.

1. *Main Objectives of the Democratic Security and Defense Policy*[61]

The Democratic Security and Defense Policy has five strategic objectives that are essential for the fulfillment of its general aim: strengthening the rule of law throughout the country. These objectives and their more specific goals are the following:

- *Consolidation of State control throughout the country:*
  - Gradual restoration of the presence of the Armed Forces and the National Police in all municipalities.
  - Increase in judicial action against crimes of high social impact.
  - Strengthening and extension of the administration of justice and State institutions in areas where state control has been strengthened.
  - Zero tolerance regarding human rights violations.

The Uribe administration has emphasized that its security and defense policy is essential for the development of democracy and to spur economic growth since it improves investor confidence.

- *Protection of the population:*
  - Dismantling of terrorist organizations.
  - Reduction of kidnapping and extortion.
  - Reduction of homicide.
  - Prevention of forced displacement and facilitation of the return of displaced populations to their places of origin.
  - Reintegration into society of organizations, groups or individuals who renounce violence.
- *Elimination of the illegal drugs trade in Colombia:*
  - Interdiction at sea, on rivers and on land of the traffic of illegal drugs and chemical precursors.

[61] This section is based on the official document "Democratic Security and Defense Policy" developed by the Presidency of the Republic and the Ministry of Defense.

  - Eradication of coca and poppy cultivation.
  - Dismantling of illegal drugs trafficking networks.
  - Confiscation of the property and finances of illegal drugs traffickers.

- *Maintenance of a deterrent capability:*
  - Protection of land, sea and river borders.

- *Transparent and efficient management of resources:*
  - Achievement of greater impact through the most efficient use of resources.
  - Savings through a review of the administrative structures and processes.
  - Development of transparency and accountability mechanisms.

Additionally, the government has developed six policy guidelines in order to achieve these five strategic objectives. The first set of policies has the purpose of enhancing the coordination among State agencies. These are the creation of the National Defense and Security Council and the Joint Intelligence Committee, the structural reform of the Ministry of Defense, and the development of inter-agency support structures. The second group of policies, aimed to augment the protection of the population, involves the strengthening of the judicial system, the Armed Forces, the National Police, and intelligence agencies. The third group of policies has the goal of consolidating the control of the State over the national territory. These policies involve "restablishing the normal operation of the justice system, strengthening local democracy, meeting the most urgent needs of the population, broadening state services and initiating medium to long term projects aimed at creating sustainable development".[62] The fourth set of policies aims to protect the rights of Colombians and the nation's infrastructure from the illegal armed groups' actions. The fifth group seeks to encourage the cooperation of Colombian citizens and international institutions with Colombian authorities, providing information related to the illegal armed groups. The last group of policies is aimed to keep the public fully informed of developments in all areas relating to the Defense and Democratic Security policy, and promoting the responsible handling of information from the national and international media.

The government is working to strengthen the rule of law throughout the country. In its strategy, cooperation between government agencies, Colombian citizens, and international institutions is stressed.

[62] Presidency of the Republic and the Ministry of Defense (2003).

2. *Results of the Democratic Security and Defense Policy*

Recent evolution of violence indicators related to the internal conflict show a very positive outlook. Although the internal conflict's end seems remote, the stance of illegal armed organizations has certainly deteriorated, the protection of the population and national infrastructure has improved, and the drug trafficking industry has been severely hit.

The offensive doctrine established by the transformation process and the Democratic Security and Defense Policy has increased the number of attacks led by the Military Forces. Between 2002 and 2004 the number of total attacks initiated by the Military Forces grew roughly 42% (Chart III.5) rising from 717 to 1,023. While the number of initiatives of the Military Forces against the FARC grew 20%, the initiatives against ELN and AUC grew 49% and 242%, respectively. Additionally, Table III.2 illustrates that the mentioned offensive strategy translated into rising numbers of deserters from the illegal armed group's lines, mainly from the paramilitary ranks. However, the number of attacks of illegal armed organizations to the Military forces also increased in that period (around 27%, Chart III.6).

The rates of homicides and kidnappings have been falling sharply since 2002 (Chart III.7A and Chart III.7B). Moreover, between 2002 and 2004 the rate of homicides has decreased almost 33%, reaching its lowest level in 19 years. The rate of kidnappings has been continuously falling since 2000, at an annual average rate of 2%. In the 1996-2003 period the FARC in average have been responsible for 27% of the kidnappings, followed by the ELN (22%) and ordinary delinquency (18%).

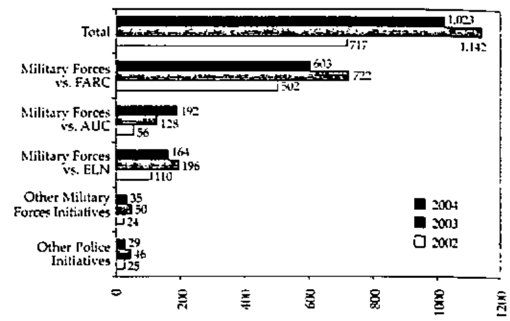
Other violence indicators confirm the positive evolution of the security situation in Colombia. For instance, the total number of attacks to towns and settlements decreased 87% between 2000 and

Table III.2
ILLEGAL ARMED GROUP'S DESERTERS, 2003-2004

Illegal Group	2003	2004	% change
FARC	1,372	1,298	-5.4
Paramilitaries	691	1,268	83.5
ELN	404	334	-17.3
Others	64	70	9.4
Total	2,531	2,970	17.3

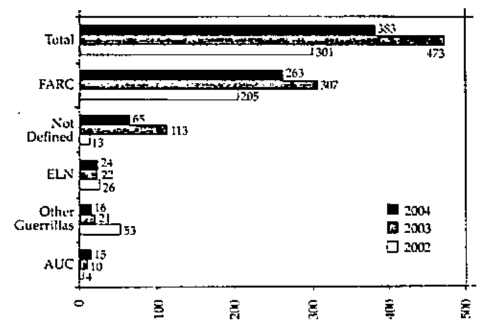
Source: Ministry of Defense.

Chart III.5
COLOMBIAN MILITARY FORCES
INITIATIVES



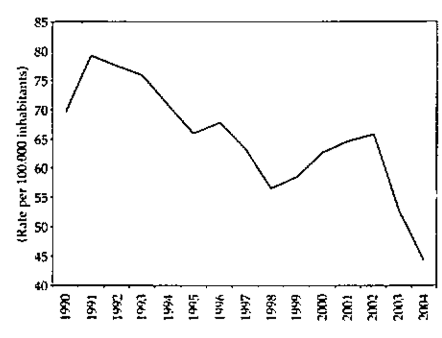
Source: Fundación Seguridad y Democracia.

Chart III.6
ATTACKS TO THE MILITARY FORCES



Source: Fundación Seguridad y Democracia.

Chart III.7A
RATE OF HOMICIDES
RATE PER 100,000 INHABITANTS



Source: Ministry of Defense and National Police.

2004 (Chart III.8). While 110 massacres occurred in 2000, involving almost 700 victims, in 2004 only 28 massacres took place involving only 157 victims (Chart III.9). Additionally, between 2002 and 2004 the number of terrorist attacks sharply fell, at an annual rate of 45% (Chart III.10).

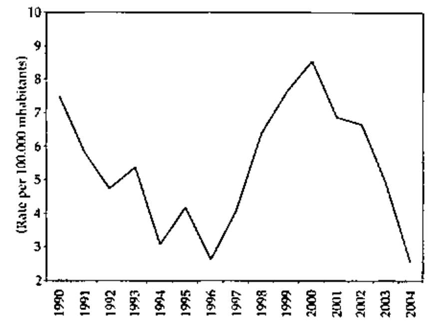
The only violence indicator that has evolved negatively in the past few years is the number of victims of anti-personal land mines. From 2000 to 2004 the number of land mine victims has increased around 160%.

Since 2002, the attacks against infrastructure and other type of assets have also been reduced. While attacks on road infrastructure fell approximately 96% between 2002 and 2004, attacks on telecommunication infrastructure and on energy infrastructure decreased 94% and 82%, respectively (Chart III.11).

According to the most recent report of "International Narcotics Control Strategy", published by the Department of State of the United States, in 2004 Colombian authorities have surpassed all the previous records in drug war results. Drug eradication and interdiction, the destruction of laboratories, arrests and extraditions of narcotics traffickers reached historical high points. More than 136,000 hectares of cocaine and 3,060 of poppy were eradicated through fumigation last year. In addition, other 11,000 hectares of cocaine and 1,500 of poppy were manually eradicated. In the aggregate, these results surpass the 133,000 and 3,000 hectares (respectively) that were eliminated in the 2003, which already represented a record in that moment (Chart III.12). The hectares of cocaine fumigated represent between 520 and 625 metric tons of cocaine, which would cost about 60,000 million dollars. Likewise, 178 metric tons of cocaine were seized, and about 200 drug processing laboratories were destroyed. More than 60,000 delinquents were arrested, and 181 were extradited to the United States in the last two years.[63]

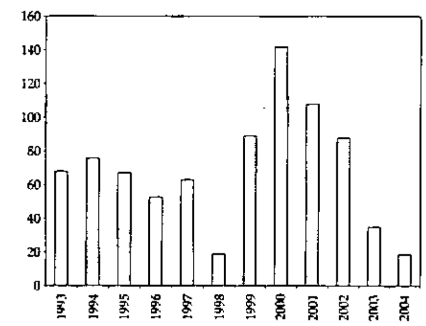
Notwithstanding all these achievements, Colombia continues to be one of the greatest drug producers, accounting for 90% of the cocaine that circulates in the world and 50% of the heroin that enters the eastern United States.[64]

Chart III.7B
RATE OF KIDNAPPINGS
RATE PER 100,000 INHABITANTS



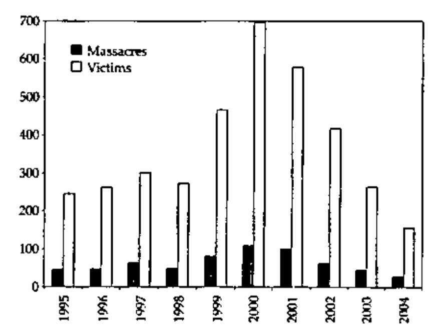
Source: Ministry of Defense and National Police.

Chart III.8
NUMBER OF ATTACKS TO TOWNS AND SETTLEMENTS



Source: DNP and National Police.

Chart III.9
NUMBER OF MASSACRES AND MASSACRE VICTIMS



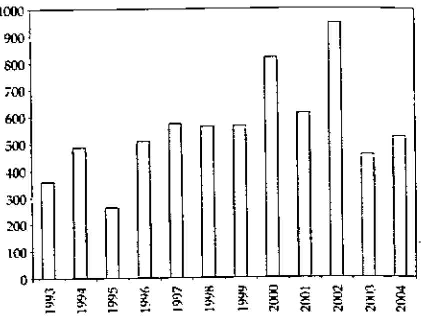
Source: DNP and National Police. First semestre data.

63 El Tiempo (2005). "Colombia batió todas sus marcas históricas en la lucha contra las drogas". March 4th, 2005.

64 El Tiempo (2005).

In this context, US aid to Colombia for the war against drug production and trafficking has been very important. Chart III.13 illustrates that the amount of US aid to the country has been increasing significantly in recent years compared to 1997 levels. As a matter of fact, the Colombian government gained full US support for the *Plan Colombia* in 1999. The *Plan Colombia* was designed to internationally promote the peace process, and fight the drug trafficking industry. US aid for such purposes reached US$1,300 million by means of a package signed by president Clinton in July 2000. The aid is grouped into two main segments: military and police programs, and economic and social assistance programs.

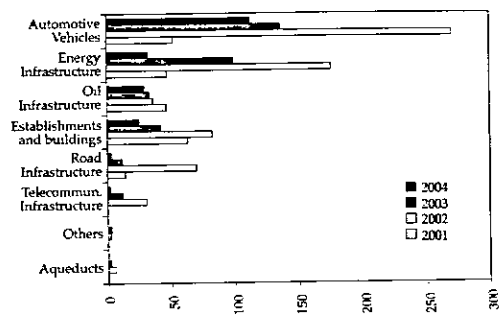
Chart III.10
NUMBER OF TERRORIST ATTACKS



Source: DNP and National Police.

Initially, the resources directed to the military and the police had to be used only in drug eradication and interdiction operations. However, this restriction was eased in 2001 after diplomacy rendered its results and the US Congress accepted that the aid could be used for fighting the illegal armed groups.

Chart III.11
TYPE OF ASSET AFFECTED BY ILLEGAL ARMED GROUPS



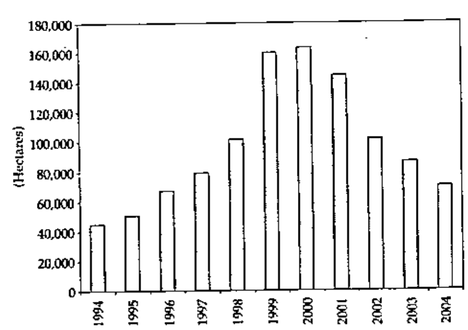
Source: Fundación Seguridad y Democracia.

Even though *Plan Colombia* officially expires this year, the recent 2006 US budget can be interpreted as continued support for Colombia. The absolute levels of aid projected for 2006 are similar to those of 2005, while the lion's share of the 2006 funds will go to fighting cocaine production and transportation (US$ 463 million). Therefore, the US is highly committed to continue supporting the country in its efforts to eradicate drugs and provide assistance for social programs.

3. *Peace Negotiations with the AUC* [65]

Álvaro Uribe has been the first Colombian president to open peace talks with paramilitary organizations. The government and the United Self-Defenses of Colombia (AUC) officially initiated peace negotiation dialogues in July 2003. The AUC's unilateral ceasefire was a pre-condition established by President Uribe. In January 2004, an agreement was met with OAS Secretary General César Gaviria to commit the OAS to monitoring and assisting the AUC and any other peace process that got underway in Colombia. Almost 4,000 paramilitaries had turned in their weapons since the demobilizations began in late 2003, and the AUC pledged to fully demobilize by December 2005.

Chart III.12
HECTARES OF ILLICIT CROPS

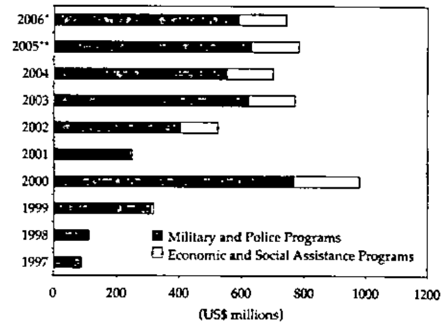


Source: DANE and DNP.

[65] Source: Arnson, Cynthia J. (2005), "The Peace Process in Colombia with the Autodefensas Unidas de Colombia-AUC". Woodrow Wilson Center Report on the Americas No. 13.

There has been considerable controversy because of the lack of definition of the legal framework for the reintegration of AUC members into society. A profound national debate about the "price" of peace has developed, dealing with issues such as if paramilitary leaders should reenter society without relinquishing their vast, illegally-acquired fortunes and facing prosecution for major crimes or drug trafficking charges in the United States. The government has determined that the legal framework of the reintegration of AUC members will be defined in Congress.

Chart III.13
U.S. AID TO COLOMBIA 1997-2006
US$ MILLIONS

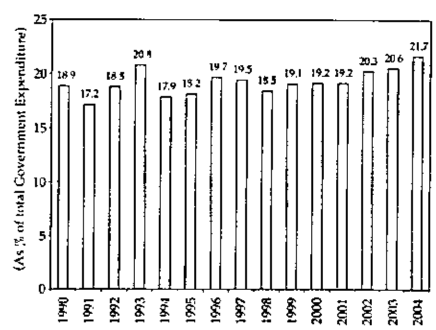


* Estimate; ** Requested.
Source: Center for International Policy, Feb. 7, 2005 (www.ciponline.org/colombia/aidtable.htm).

E. Defense and Security Expenditure: Is it Enough?

Several analysts of the Colombian internal conflict have questioned if current defense and security expenditure levels are sufficient to effectively defeat the FARC and other illegal armed groups. Even more, they argue that the budget is not enough to face the challenge of recovering national security, maintaining the offensive against the illegal armed groups, and fighting drug trafficking. As mentioned before, between 1998 and 2004 defense and security expenditure has increased almost in 1.4% of GDP (see Chart III.3). Yet, the magnitude of expenditure as percentage of GDP is below international standards (Chart III.14 and Chart III.15).

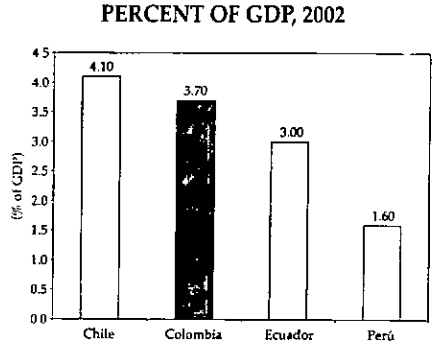
Chart III.14
DEFENSE AND SECURITY EXPENDITURE AS PERCENT OF TOTAL GOVERNMENT EXPENDITURE



Source: DNP.

Furthermore, a comparison of the total number of helicopters and troopers of countries that have had similar internal conflicts shows that Colombia still needs to make a great effort to increase its defense and security expenditure (Chart III.16). During their internal conflict, El Salvador and Vietnam had and helicopter for every 314 and 50 square kilometers, respectively. In contrast, Colombia has one helicopter per 3,800 square kilometers. Likewise, while Colombia has an effective trooper per 3.5 square kilometers, El Salvador and Vietnam had 0.5 and 0.3 troopers per square kilometers. Nonetheless, it has to be considered the fact that Colombia has approximately 3 times more land area than Vietnam, and roughly 48 times more land area than El Salvador.

Chart III.15
DEFENSE AND SECURITY EXPENDITURE AS PERCENT OF GDP, 2002



Source: Fundación Seguridad y Democracia.

2. *Economic Sustainability of the Democratic Security and Defense Policy*

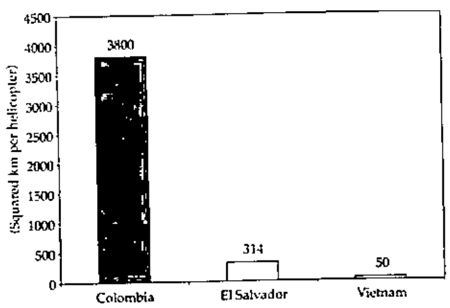
As mentioned in Section II.D, the Colombian government faces severe fiscal restrictions and inflexibilities. This suggests that there will be no budgetary room to fulfill the pending expansion of defense and security investment. However, the government has argued that the extra financing needed to consolidate this policy's success will come through two channels.

In the short run, this investment would be financed with the substitution of public bureaucratic expenditure with defense and security expenditure, and the more efficient use of the resources available. Simultaneously, the distribution within defense and security expenditure would be assigned considering the strategic needs of the Military Forces and the National Police.

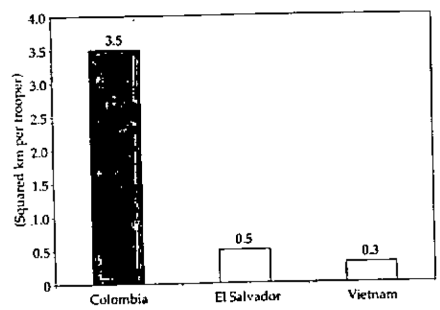
In the long run, the permanent expansion of defense and security investment would be supported by the growth of tax revenues. The government seems to lack political space to introduce new taxes or raise current tax rates, but it expects that the tax base would broaden due to economic growth and anti-evasion efforts. National security would attract new local and foreign investment, which would directly promote economic growth and increase the government's tax revenues.[66]

Chart III.16
INTERNATIONAL COMPARISON OF SQUARE KILOMETERS PER HELICOPTERS AND TROOPER

A. Square kilometers per Active Helicopter



B. Square kilometers per Trooper



Source: Fundación Seguridad y Democracia.

[66] Arias, A. and L. Ardila (2003). "Military Expenses and Economic Activity". CEDE 2003-20 Documents.

IV. TRADE POLICY: REFORMS, POLICY CONTINUITY AND NEW INTEGRATION GOALS

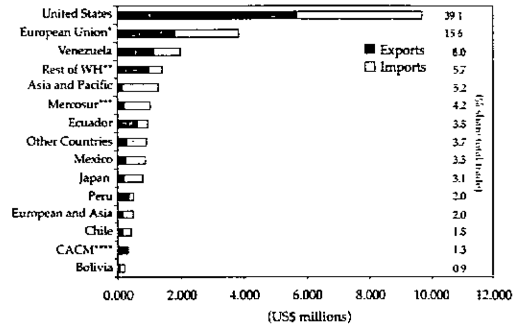
Colombia's trade policy has successfully dealt with the challenges brought about by globalization, mainly through pursuing significant trade liberalization and reform at three levels: unilateral, multilateral and regional. Since such policy actions have been maintained and, to some extent, deepened in recent years, Colombia enjoys privileged access to global markets that adds to its strategic geographic location for foreign investment. During the 1999-2003 period, the United States, the European Union and Venezuela have been Colombia's main trading partners, with a percentage share in total trade (sum of exports and imports) of 39.1%, 15.6% and 8%, respectively (see Chart IV.1). Colombia's five main exports currently are petroleum (26% of total), agricultural goods (14%, including coffee), coal (11%), chemicals (11%), and textiles and apparel (8.1%).

The past few years have been characterized by policy measures that have strengthened Colombia's outward-oriented trade policy. The existence of a proactive policy agenda, designed to improve the country's export competitiveness in international markets with an emphasis in new trade negotiations, has been particularly important in such purpose. Under this trade policy orientation, between 1994 and 2003 total exports and total imports grew at an annual (compound) rate of 5% and 1.7%, respectively (see Table IV.1). Also, the share of exports and imports of goods and services in GDP has increased since the early 1990s, and for the period 2000-2003 they are up to 21.3% and 21.7% of GDP, respectively (see Chart IV.2).

A. Unilateral and Multilateral Trade Liberalization and Reform

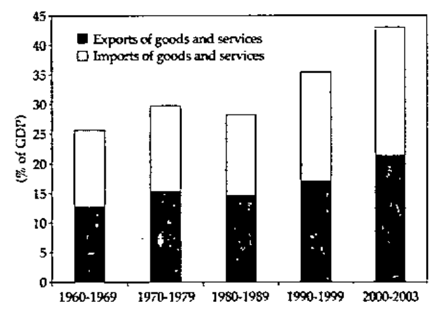
Colombia's autonomous unilateral trade reforms, which were implemented in the context of broader structural reforms, reduced tariffs and non-tariff barriers (NTBs) in the early 1990s. Indeed, the trade weighted ad-valorem tariff average fell significantly, from 29.3% in 1985-1987 to 12.8% in 1995, while NTBs were virtually eliminated. According to Edwards (1995), NTBs covered 73.8% of Colombian trade in 1985-1987 and their prevalence dropped to only 1.7% by 1992 (Chart IV.3).

Chart IV.1
COLOMBIA: FOREIGN TRADE BY REGIONS OR PARTNERS, PERIOD AVERAGE 1999-2003



*25 members; ** Westerm Hemisphere; ***Argentina, Brazil, Paraguay and Uruguay; **** Central American Common Market: Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.
Source: Fedesarrollo with DANE.

Chart IV.2
COLOMBIA: EXPORTS AND IMPORTS OF GOODS AND SERVICES AS PERCENTAGE OF GDP

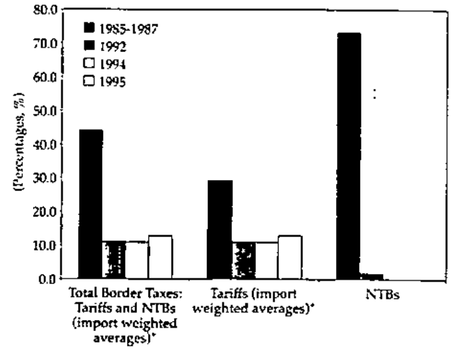


Source: Fedesarrollo with World Bank-WDI data.

Nominal most favored nation (MFN) tariff levels have not changed significantly since 1995, when the Andean Common External Tariff (CET) came into force. The average nominal MFN tariff currently stands at 11.7%. It is worth mentioning that preferential tariff levels are applied to trading partners under integration agreements and in the near future will be broadened by virtue of new trade agreements such as the Free Trade Area (FTA) Andean Community-Mercosur and the FTA with the United States (see below).

Other important unilateral trade reforms included a rationalization of export incentives and an institutional reform of trade policy entities, while supporting the country's full participation in the multilateral trading system.[67] In fact, the reform process of the early 1990s aided in building domestic support for full compliance with the rules and obligations of the multilateral trading system.[68]

Chart IV.3
COLOMBIA: TARIFFS AND NON-TARIFF BARRIERS (NTBS)

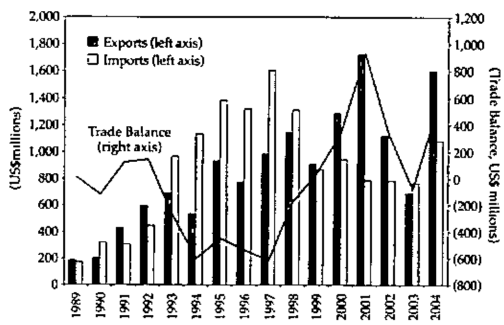


* 1993 Import weights.
Source: Echavarría (1998) and Edwards (1995) for non-tariff barriers (NTBs).

B. Regional Integration and Trade Preferences

One of the most outstanding features of Colombia's trade policy has been an active involvement in regional integration since the early 1990s. After years of failures, the Andean integration process was revived in 1992 when Colombia and Venezuela established a Free Trade Area, which reactivated economic integration with other Andean nations (Bolivia, Ecuador and Peru) as well as dormant regional integration institutions.[69] The success of this integration effort enabled Colombia-Venezuela bilateral trade to flourish (Chart IV.4), and allowed Venezuela to become Colombia's third export market and a key buyer of Colombian non-commodity foreign sales.

Chart IV.4
COLOMBIAN TOTAL TRADE WITH VENEZUELA, 1989- 2004



Source: Fedesarrollo with DANE data.

In 1994 Colombia negotiated a Free Trade Area (FTA) with Chile, and a similar trade arrangement with Mexico and Venezuela one

[67] J.J. Echavarría and C. Gamboa (2004). Colombia centralized trade policy with the creation of the Ministry of Foreign Trade in 1991, a considerable undertaking for a country that previously had 53 uncoordinated government entities involved in the formulation and execution of trade policy. A recent State reform led to the establishment in 2002 of the Ministry of Trade, Industry and Tourism, which added to its functions the surveillance of domestic commerce and tourism.

[68] Colombia has been a GATT member since 1981 and by signing the Marrakesh Agreement in 1994 the country is a founding member of the WTO. At present, Colombia is participating in the Doha round of negotiations.

[69] The Andean integration process dates back to 1969, but the process fainted for over two decades because initial goals were incompatible with dominant import substitution industrialization policies. Nowadays the Andean Community's members are Bolivia, Colombia, Ecuador, Peru and Venezuela.

year later, known as the FTA Group of Three (FTA G-3). Furthermore, Colombia's has actively participated since 1994 in the Free Trade Area of the Americas (FTAA) negotiations. It is worth mentioning that these hemispheric negotiations have lost its momentum, given the political differences between Brazil and the United States on critical issues such as agricultural subsidies, which upset meeting the December 2005 deadline.

Colombia's proactive trade policy translates into privileged access to global markets, which adds to its strategic geographic location for foreign investment.

Besides the preferential access provided by the aforementioned regional agreements, Colombia also benefits from bilateral tariff preferences from other Latin American countries. The country enjoys through the ALADI framework of tariff preferences with most Latin American nations that are mostly reciprocal.[70] Recently, the tariff preferences with Argentina, Brazil, Paraguay and Uruguay (the Mercosur customs union member states), negotiated under ALADI in the late 1990s, served as a starting point for FTA negotiations between those countries and the Andean Community. The final agreement between both blocks entered into force in January 2005 (see Section IV.D).

It is important to mention that Colombia has taken advantage of unilateral tariff preferences granted by the European Union (EU) and the United States (US), bestowed as recognition for the country's commitment against illegal drug production and trafficking. The EU, on the one hand, renewed in October 2004 the preferential market access conditions under the Andean Generalized System of Preferences (GSP) for 10 additional years.[71] The Andean GSP covers 7,200 tariff lines of the EU's 8 digit harmonized system (HS), which means that nearly 90% of Colombian exports to that market are duty free. Main foreign sales under the program are the following: fabricated metal products, flowers, fresh and frozen fruits, machinery, motor vehicle parts, palm oil, paper and cardboard, and processed shrimp and tuna fish.

Colombia's autonomous unilateral trade reforms significantly reduced tariffs and non-tariff barriers in the early 1990s. Trade liberalization has been further pursued at the multilateral and regional levels.

On the other hand, the US's unilateral preferences, known as the Andean Act, are due to expire December 2006. These preferences

[70] The ALADI is the largest Latin American integration group with 12 member countries, which seek the establishment of economic preferences in the region to ultimately create a regional common market. Colombia has also granted unilateral preferences to the Caribbean Common Market (Caricom) members through ALADI.

[71] European Commission (2004). The Andean GSP was created in 1990 and provides tariff preferences for all industrial products and some agricultural goods from Bolivia, Colombia, Ecuador, Peru and Venezuela.

cover 5,686 tariff lines of the US's 8 digit harmonized system (HS), including the following main products: brooms, chemical goods, crude petroleum, fresh-cut flowers, leather footwear and leather products, plastic products, jewelry, steel tubes, textiles and clothing, and tuna fish. It is worth noting that the average tariff that Colombia faces in the US market is reduced from 5.1% (MFN tariff average) to 2.4% because of those unilateral preferences. The Andean Act preferences are expected to transform into permanent and stable market access through current FTA negotiations between the Andean countries (except Venezuela) and the United States (see below).

The Uribe administration's trade policy seeks to strengthen the country's outward-oriented trade regime. Importantly, free trade area negotiations are underway with the United States.

C. Trade Policy under the Uribe administration

The Uribe administration gave continuity to the aforementioned regional integration efforts as well as to other policies aimed at improving export performance. Programs such as the *National Policy for Productivity and Competitiveness* and a *Strategic Export Plan 1999-2009* were continued. These programs were originally set forth to combat the negative effects of the 1998-1999 recession and the global economic slowdown, and include the following three main goals: i) to increase and diversify exports of goods and services taking into account the country's regional supply potential and world demand, through policy options like trade negotiations; ii) the promotion of foreign direct investment (FDI) to achieve export growth; and iii) the elimination of export-related red tape and promotion of an exporting culture among entrepreneurs.[72]

Colombian trade diplomacy was key for the Andean Community-Mercosur trade agreement to come into force in January 2005. The agreement is expected to boost trade flows between the two regions.

In line with the above policy goals, the Uribe administration has sought deeper integration with trading partners that have been defined as strategic for such purposes. Trade diplomacy has played a mayor role for success in this area, regarding both the Andean Community-Mercosur agreement and the FTA negotiations underway with the United States.

D. FTA Andean Community-Mercosur

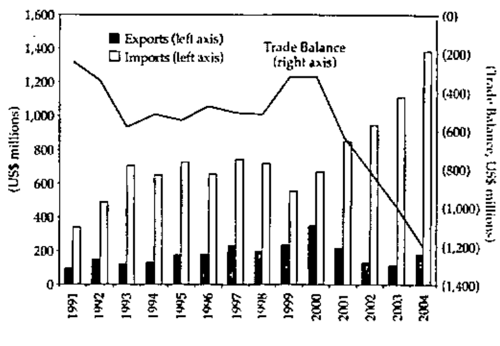
The Free Trade Area (FTA) agreement between the Andean Community (AC) and Mercosur was the product of a two-staged process that received an important boost at the presidential level towards the end of 2002, particularly by the enhanced political dialogue focused on strengthening cooperation between Brazil and

72 See Ministry of Foreign Trade (1999) and National Department of Planning (2003).

Colombia.[73] Trade negotiations between the AC and Mercosur took place during 2003 and 2004, and extended beyond the initial deadline of December 2003 till October 2004, mainly due to industrial and agricultural goods market access discussions. The FTA AC-Mercosur came into force in January 2005.[74]

Historically, trade flows between the Mercosur and the Andean sub-regions have been limited and the FTA aims to boost foreign trade levels. Chart IV.5 shows that throughout recent years Colombia has been a net importer of Mercosur's goods, while the bilateral trade balance has deteriorated continuously since 1999. At present Mercosur is Colombia's sixth main trading region: between 2000 and 2004, Colombia exported on average to the Mercosur countries US$ 200 million, while importing US$ 993 million.

Chart IV.5
COLOMBIAN TOTAL TRADE WITH MERCOSUR, 1991- 2004



Source: Fedesarrollo with DANE data.

Table IV.1
COLOMBIA: EXPORTS, IMPORTS AND TRADE BALANCE, BY TRADING PARTNERS, 1994-2003, RANKED BY 1999-2003 AVERAGE VALUE OF EXPORTS

US$millions	Exports			Imports			Trade Balance	
	1994-1998	1999-2003	% Change 2003/1994*	1994-1998	1999-2003	% Change 2003/1994*	1994-1998	1999-2003
Total	10,357.9	12,485.8	4.9	13,903.2	12,362.6	1.7	(3,545.3)	123.2
United States	3,793.8	5,690.8	7.6	4,674.5	4,013.4	0.8	(880.7)	1,677.4
European Union **	2,555.7	1,825.8	-3.3	2,750.4	2,040.5	-1.2	(194.8)	(214.7)
Venezuela	883.4	1,160.7	2.8	1,350.9	823.2	-5.0	(467.5)	337.5
Rest of WH ***	684.1	1,011.1	10.5	637.2	411.4	-3.7	46.9	599.7
Ecuador	460.1	622.4	10.2	310.0	332.6	5.2	150.1	289.8
Peru	466.7	351.2	5.6	132.0	153.2	7.4	334.7	198.0
CACM ****	198.0	293.2	9.4	24.3	32.1	11.8	173.7	261.1
Other countries	188.0	281.8	17.2	346.4	639.7	13.5	(158.3)	(357.9)
Mexico	106.0	272.9	14.2	517.6	605.0	9.0	(411.6)	(332.1)
Mercosur *****	184.4	210.8	-1.3	697.7	827.4	6.2	(513.3)	(616.6)
Japan	339.4	207.3	-6.0	1,054.4	573.9	-6.2	(715.0)	(366.5)
Chile	158.4	175.5	5.4	203.7	264.5	9.8	(45.4)	(89.0)
Rest of E.Asia and Pacific Region	142.8	174.5	9.2	741.8	1,125.6	9.9	(598.9)	(951.1)
China & Taiwan	30.4	68.6	32.7	418.8	601.3	28.2	(388.4)	(532.6)
Rest of Europe and Asia	145.3	160.2	3.0	381.7	343.7	3.2	(236.3)	(183.5)
Bolivia	34.0	39.1	5.4	79.7	175.9	16.6	(45.7)	(136.8)
Unclassified	17.7	8.4	-57	0.9	0.4	-19.1	16.8	8.1

* Compound growth rate for the 1994-2003 period; ** EU: 25 members; *** Rest of Western Hemisphere; **** CACM: Central American Common Market: Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. ***** Mercosur: Argentina, Brazil, Paraguay and Uruguay.
Source: Fedesarrollo with DANE data.

73 The members of the Mercosur customs union are Argentina, Brazil, Paraguay and Uruguay.

74 Ministry of Trade, Industry and Commerce of Colombia (2005). "Decree 141 of January 26, 2005". It is worth noting that only three AC members (Colombia, Ecuador and Venezuela) signed the agreement, and consequently Bolivia and Peru do not participate in this liberalization effort.

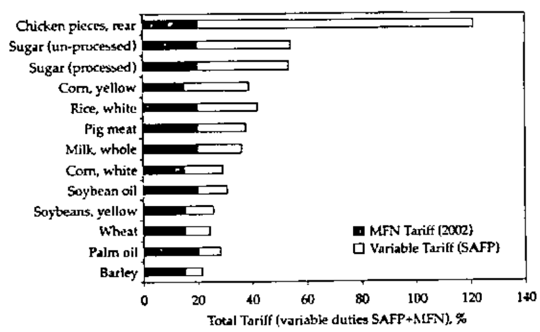
The FTA AC-Mercosur is structured under the ALADI framework, which limits its potential to achieve substantial trade integration between the two sub-regions.[75] The agreement, for example, does not include disciplines for services, investment, government procurement and intellectual property, among the most salient subjects.

The expected effects of the agricultural trade liberalization under the Andean Community-Mercosur agreement seem to be limited.

The FTA AC-Mercosur establishes the elimination of tariffs between the two blocks using a four-staged liberalization process that will take 12 years for industrial goods and 15 years for agricultural goods. Most raw materials and capital goods not produced domestically by any member country will be automatically liberalized, except some tariff lines that will be liberalized in six years. Also, those industrial products labeled as sensitive, with vulnerable domestic production with respect to imports, will be liberalized after a 15-year period. The sensitive goods in this FTA are the following: household appliances, wooden furniture, shoes, and agricultural products.

The expected agricultural trade liberalization effects of the FTA AC-Mercosur seem to be limited. Colombia agreed to eliminate only the most favored nation (MFN) tariff component of the Andean Price Band System (*Sistema Andino de Franjas de Precios*, SAFP), which imposes variable tariffs for 13 main or marker products and over 150 associated processed agricultural goods (Chart IV.6).[76] This means that effective tariffs may still be significant by the end of the established liberalization period, since variable tariffs can still be levied. Some agricultural sectors received a special treatment in the agreement. On the one hand, the FTA members agreed to decide on sugar liberalization further in the process. On the other hand, milk and meat products will receive special quota treatments in order to regulate market access.

Chart IV.6
AGRICULTURAL PROTECTION TO 13 MARKER GOODS OF THE ANDEAN PRICE BAND SYSTEM (*SISTEMA ANDINO DE FRANJAS DE PRECIOS*, SAFP), 1996-2003 PERIOD AVERAGE



Source: Fedesarrollo with Minagricultura data.

Finally, it is worth noting that the agreement recognizes the differences amongst member countries in terms of their size and relative stage of economic development. Colombia will receive faster market access improvements than Brazil or Argentina. For example, 24% of total Colombian exports to Brazil received on January 2005 tariff-free access; this percentage will increase to 89% in 6 years and to 98% in 8 years. In contrast, Brazilian exports to Colombia will receive tariff-free access in 12 years.

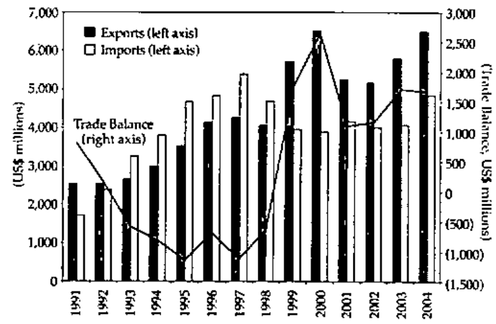
[75] ALADI (2004), "Acuerdo de Complementación Económica no.59".

[76] An exception to this negotiation result is the elimination of the variable tariff for wheat and barley.

E. FTA Negotiations with the United States

The United States (US) is Colombia's main trading partner and its third source of FDI. According to Balance of Payments data, net FDI flows from the US to Colombia averaged US$ 382.3 million per year between 1999 and 2003.[77] Regarding trade, Colombian exports to the US hold a 46.5% share of average total foreign sales during those years. Between 1999 and 2003, US imports covered 32.5% of total Colombian purchases from abroad (Table IV.1). Colombian exports to the US reached US$ 6,504 million in 2004, while imports from that market amounted to US$ 4,838 million that year (Chart IV.7).

Chart IV.7
COLOMBIAN TOTAL TRADE WITH THE UNITED STATES, 1991-2004



Source: Fedesarrollo with DANE data.

The five main Colombian export categories to the US are the following: oil and gas (US$ 2,226 million in 2004); agricultural products (US$ 978 million); minerals and ores (US$ 513 million); petroleum and coal products (US$ 564 million); and apparel and accessories (US$ 519 million). Colombia's main imports from the US are chemicals (US$ 972 million in 2004); machinery except electrical (US$ 515 million); computer and electronic products (US$ 462 million); agricultural goods (US$ 374 million); and transportation equipment (US$ 199 million).[78]

The trade agreement with the United States will mean a deeper economic integration between the two countries, since the negotiation goes well beyond tariff market access.

Since the early 1990s, Colombia has sought a NAFTA-type trade agreement with the United States.[79] However, political conditions in Washington were unfavorable to achieve such purpose during the past decade. In contrast, the new millennium brought about fertile grounds for launching these trade negotiations in May 2004. The new climate for a negotiation was the result of factors such as the political affinity between presidents Bush and Uribe, the strong commitment of Colombia in fighting drug trafficking and terrorism, and the virtual freezing of the FTAA negotiation. The bilateral agreement with the US will mean wide-encompassing economic integration between the two countries, since the negotiation goes beyond tariff market access. As a matter of fact, the FTA will additionally cover disciplines for services, investment, dispute resolution mechanisms, competition policy, sanitary requirements,

[77] Source Banco de la República. For the 1999-2003 period, average FDI flows reached US$ 2,026.7 million. Europe was the main source of those flows (33.5%), followed by the Antilles (24.3%).

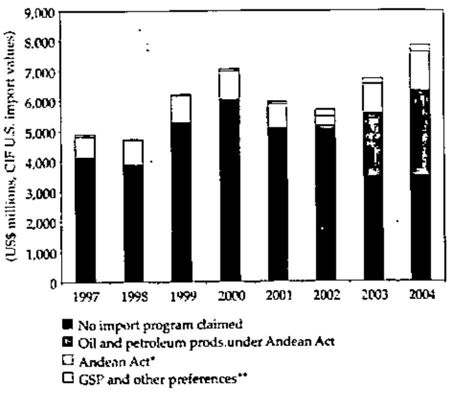
[78] Source USITC data.

[79] The North American Free Trade Area (NAFTA, 1993) members are Canada, Mexico and the US.

government procurement and intellectual property, among the most salient subjects. The FTA negotiations are expected to finish during the first semester of 2005, with final rounds concentrating on agricultural market access and intellectual property issues.[80]

As mentioned above, the US unilaterally grants Colombia tariff preferences in recognition for the country's commitment against illegal drug production and trafficking. Those preferences, known as the Andean Act, are due to expire December 2006. Chart IV.8 shows the increasing importance of the mentioned Andean Act preferences for Colombian exports to the US.

Chart IV.8
COLOMBIA: EXPORTS TO THE U.S. 1997-2004, US$ MILLIONS, CIF IMPORT VALUE



* Without oil and petroleum products exports under the Andean Act.; ** GSP: Generalized System of Preferences. Other preferences: Civil aircraft, Dyes and Pharmaceuticals.
Source: Fedesarrollo with USITC data.

This trade agreement can represent enormous benefits for Colombia. On the one hand, the country would be favored by greater stability in the rules of game with the negotiation of a comprehensive FTA that promotes deeper integration as it deals with subjects that surpass tariff reductions. On the other hand, with the future existence of a FTA between the two countries, the Andean Act preferences will be replaced with stable market access conditions to the US market, which will be a powerful magnet for both domestic and foreign investment.[81] It is worth highlighting that a stable preferential access to a market like the United States, the world's largest economy with 33% of global GDP, can only mean an increased level of Colombian exports and stimulate Colombian foreign sales' diversification. Additionally, the subscription of a FTA agreement with the US could allow Colombia to enjoy similar advantages to those already acquired by Mexico, Chile and the Central American countries, which compete with Colombia in similar product segments in the US market.

The FTA agreement with the United States may represent significant benefits for Colombia. Greater stability in the rules of the game can be expected, which will be a powerful magnet for foreign direct investment.

Finally, the subscription of a FTA agreement with this scope will be a key piece of the possible solution of the internal armed conflict, since it could strengthen the US's interests in Colombia as well as that country's cooperation to attain peace. In fact, even though *Plan Colombia* expires this year, the recent 2006 US budget can be interpreted as continued support for Colombia. As mentioned in Chapter III, the absolute levels of US aid to Colombia projected for 2006 are similar to those of 2005, while the lion's share of the

United States' interests in Colombia will continue to rise with a trade agreement, which will benefit that country's cooperation regarding the war against drug trafficking and the internal peace process.

80 Additionally, intense diplomacy also rendered its fruits last quarter of 2004, when the US agreed to return to the International Coffee Organization (ICO). The US had left the organization in 1993.

81 The FTA negotiations include and investment chapter, that will translate into enhanced certainty and stability for foreign investors in Colombia.

2006 funds will go to fighting cocaine production and transportation (US$ 463 million).

F. Future Trade Negotiations: A New Agenda

Recently the Colombian government approved a policy document that puts forward a strategy to implement an active integration agenda, beyond the FTAA with the United States. The targeted regions or countries are the following: European Union, Canada, Panama, Japan, India, Caribbean countries, Central American Common Market, China, South Korea, Poland, Russia, Thailand, Singapore and Malaysia.[82]

Colombia has targeted several countries or regions for future trade negotiations. Canada, India, Panama and other Central American countries have expressed interest in negotiation trade agreements with Colombia.

Of these listed countries, the following have officially expressed interest in conducting trade negotiations with Colombia: Canada, Central American Common Market, India and Panama. Therefore, the country's access to global markets is expected to continue to improve in the next couple of years.

G. Special Trade Regimes and Export Incentives[83]

Colombian trade policy has emphasized over the years the use of special trade regimes and specific export incentives to support export growth. The following five instruments are of interest to both national and foreign investors in export-oriented sectors.

The country's access to global markets is expected to continue to improve through new economic integration initiatives.

Free Trade Zones (FTZ): geographic areas established to promote industrial processing of goods and services, primarily for export. Free trade zones in Colombia offer a number of tax incentives, foreign exchange benefits and procedural incentives.

Special Economic Export Zones (SEZ): geographic zones and/or cities with a special regime for new export-oriented businesses. The main purpose of this regime is to attract investment in order to strengthen national export volume by creating special conditions favoring the entry of private capital to the zones, facilitating the

82 Superior Council for Foreign Trade of Colombia (CSCE, 2004), "Agenda para la integración dinámica de Colombia en el mundo", no.75, November 8. The countries are ranked according to selected economic and political criteria. The Central American Common Market member countries are Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.

83 This section is based on Coinvertir (2004a), "Colombia Competitive Advantages: Business Overview 2004".

exportation of Colombian goods and services. SEZ mainly provide advantages in labor and tax law.

Quimbaya Law: a special regulation created in reaction to the January 1999 earthquake that affected Colombia's coffee growing zone. This law created special regulations, including income and complementary tax exemptions, reimbursement of sales tax paid on the import or purchase of capital goods, and tariff exemptions on capital goods not produced in Colombia.

The Colombian government has established special trade regimes and specific export incentives to attract investment to export-oriented sectors.

Special import-export system (Vallejo Plan): a system that grants a partial or total custom duty and tax exemption on import of inputs, raw materials, intermediate or capital goods and spare parts, when destined to the production of related export goods or services.

Large Users (ALTEX): a special customs benefits for producers that achieve a 30% export quota on total sales and whose previous year exports amounted to a minimum of US$ 2 million.

V. INFRASTRUCTURE AND BUSINESS OPPORTUNITIES FOR FOREIGN INVESTORS [84]

This chapter discusses the recent developments in Colombia's infrastructure sector and highlights opportunities of interest for foreign investors. Oil and mining-related infrastructure are not discussed in this chapter because these sectors have a different analytical framework than traditional infrastructure: electricity, natural gas, water, telecommunications and transportation.

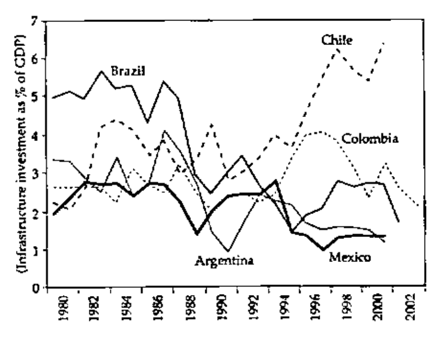
Colombia has sustained a relative stable flow of infrastructure investment compared to other Latin American countries, since it favors private sector participation in this sector.

It should be highlighted that Section II.B.2 mentions that the recent changes to the regulation framework governing oil exploration and mining activities have been key to attract higher foreign direct investment flows. In this chapter, Table V.2 illustrates two punctual investment opportunities in those sectors.

A. Public and Private Participation Framework

The enactment of the 1991 political Constitution and the framework law issued in 1994 introduced a new model for the provision of infrastructure services in Colombia, shifting the role of the State from the supply to the regulation of the services. Under this scheme, the private sector is conceived as the key supplier in the utility sectors. Meanwhile, the State should concentrate its efforts on regulating, controlling and supervising the way in which agents carry out their activities, with the objective of protecting the public wealth and interest.[85]

Chart V.1
TOTAL INFRASTRUCTURE INVESTMENT, LATIN AMERICAN COUNTRIES 1980-2002



Source: DNP for Colombia. Calderon y Serven (2003) for the rest of countries.

B. Private Investment Evolution and Distribution

Colombia has sustained a relatively stable flow of infrastructure investment compared to other Latin American countries (Chart V.1). Although average infrastructure investment increased to approximately 3.9% of GDP during the second half of the 1990s, in the

[84] This chapter uses the latest infrastructure diagnostics presented by the World Bank for Colombia in the REDI 2004 (short for Recent Economic Developments in Infrastructure). For more information visit www.worldbank.org/redicolombia.

first three years of the present decade this average fell to 2.8% of GDP (Chart V.2A). During most of the last decade infrastructure investment was heavily skewed towards the energy sector.[86] Nevertheless, since 1998 the telecommunications sector began to concentrate most of the investment flows (Chart II.9) mainly as a result of the market liberalization that took place in the sector (Chart V.2B).

The early and mid 1990s structural reforms successfully attracted private investment to infrastructure sectors. Although private infrastructure financing in Colombia began relatively late compared to other Latin American countries, it rapidly reached the regional standards (Chart V.3). In fact, private investment participation reached more than 40% total investment by 1997 (Chart V.4A). Historically the natural gas sector and the telecommunications sector have had the highest private investment participation, with an average of 81% and 39% of total investment in each sector, respectively (Chart V.4B).

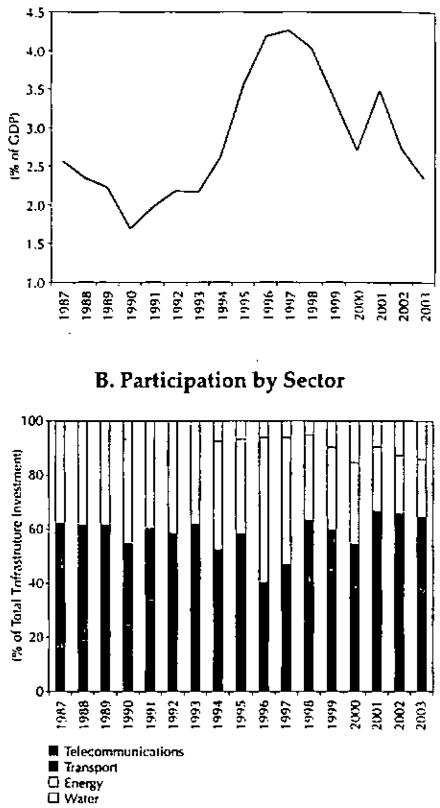
C. Electricity Sector

In the 1990s, major reforms were undertaken in the electricity sector to increase competition by means of the full liberalization of generation and retail activities, and the elimination of vertical and horizontal integration within the power industry. Due to the flexible attitude of the regulating governmental entities, vertical integration has persisted. Although effective competition has been successfully achieved on the retail segment, the generation segment remains highly concentrated due to economic links among various generation companies.

Chart V.2
TOTAL INFRASTRUCTURE INVESTMENT BY SECTORS, 1987-2003

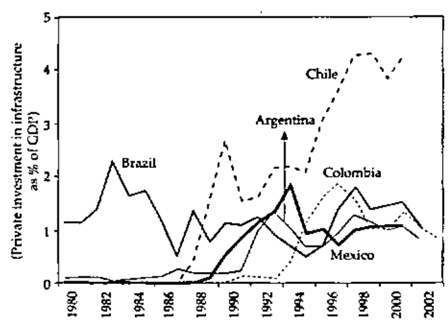
A. Evolution

B. Participation by Sector



Source: DNP.

Chart V.3
PRIVATE INVESTMENT IN INFRASTRUCTURE, LATIN AMERICAN COUNTRIES 1980-2002



Source: DNP for Colombia. Calderon y Serven (2003) for the rest of countries.

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[85] A complete institutional framework has been developed in order to guarantee the efficient provision of, and equitable accessibility to, public domiciliary services and infrastructure services. This framework includes three sectoral Ministries (Energy and Mines, Communications, and Transport), three Regulatory Commissions (Energy and Gas, Water and Sanitation, and Telecommunications), and a cross-sectoral Superintendence of Domiciliary Public Services (SSPD). Ministers are primarily responsible for policy-making, yet they also preside Regulatory Commissions and the boards of national state-owned enterprises. The Regulatory Commissions deal with each of the regulated sectors: energy, telecommunications and water. Under Colombia's institutional framework the task of regulation is separated from that of supervision. The cross-sectoral Superintendence (SSPD) has the supervision responsibility, covering a broad array of areas, including competition affairs.

[86] This fact is the result of the policy orientation towards the expansion of thermal plant generation aimed to diminish the dependency of hydroelectrical generation.

BY

Generation: Colombia's generation installed capacity is approximately 13.6 gigawatts. Two economic groups control more than 50% of this market. Although the country has succeeded in diversifying the generation portfolio, it has been dominated by hydroelectric schemes with very limited storage (around 65% of total generation capacity).

Transmission: The integrated national power grid covers more than 30% of the country's territory and serves 96% of the population. Two of the eleven operators in this segment hold almost 85% of the national power grid. Terrorist attacks on transmission towers, the main problem this sector has historically faced, decreased by 58% in the first three quarters of 2004 as compared to the same period in 2003.

Distribution: There are 30 operative distribution companies in Colombia. Most of them show deficient performance indicators. For instance, average distribution losses are approximately 25% and average power outages are roughly 12 hours per month. This poor performance is linked to the poor maintenance of distribution infrastructure, and has often led to payment delays that affect the financial health of upstream activities.

Retail: There are 42 power retailers, though 90% of the market is controlled by four of them and most are vertically integrated. Customers with an electric energy demand larger than 0.1 megawatts are free to negotiate prices and currently represent 30% of the market.

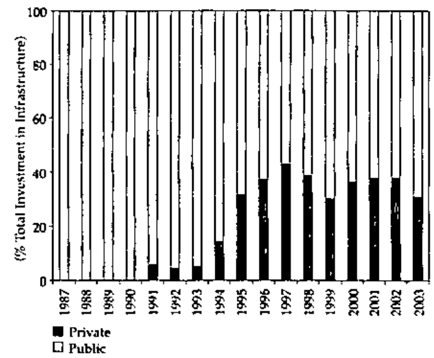
Electric power per capita production and consumption in Colombia are relatively low compared to other Latin American countries, which show opportunities for further growth (Chart V.5). Furthermore, Colombia's per capita electricity consumption ranks below the average of the lower middle-income countries. This situation could be explained by the relatively high price of electricity at residential, commercial and industrial levels (Chart V.6).

The poor performance of the distribution network position Colombia well below most of Latin American countries. In 2000, Colombia had substantially more electric power transmission and distribution losses than the middle-income countries average (Chart V.7).

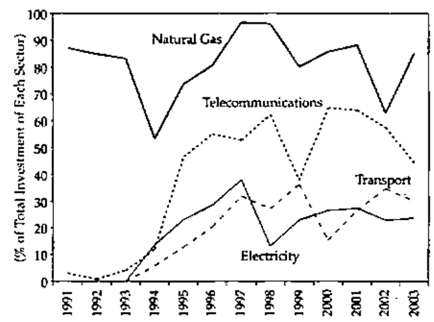
According to the World Bank, participation levels of private operators in electricity subsectors in Colombia are similar to those of

Chart V.4
INFRASTRUCTURE INVESTMENT: PUBLIC AND PRIVATE PARTICIPATION, 1987-2003

A. Total



B. Private Participation by Sector



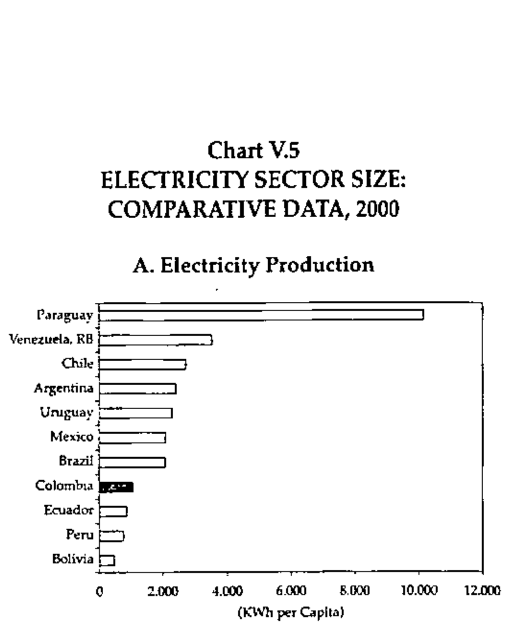
Source: DNP.

Opportunities for the private sector in utilities segments will increase as the economy maintains high growth rates and competition continues to be fostered.

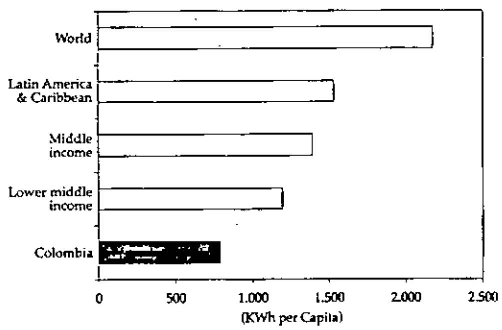
other Latin American countries (Chart V.8). Private capital introduction in this sector was successful during the last 10 years: private sector took over the operation of about 55% of generation, and 40% of distribution activities. Opportunities for the private sector will increase as the economy maintains high growth rates and competition in the sector is fostered.

Chart V.5
ELECTRICITY SECTOR SIZE: COMPARATIVE DATA, 2000

A. Electricity Production



B. Electricity Consumption



Source: World Development Indicators, 2000.

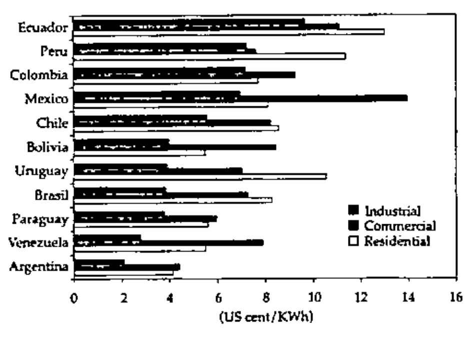
D. Natural Gas

In the 1990s the Colombian government fostered the massive use of natural and propane gas, both for electricity generation and domestic purposes, given the cost-benefit advantage of this resource.[87] The main objectives of the Gas Massive Scale-up Plan were: i) Improving energy supply to users, ii) reducing provision costs of the service, and iii) promoting the rational use of energy resources.[88] In addition, the Plan complemented the general policy of fostering the substitution of hydroelectrical energy generation by thermal generation. The fulfillment of these objectives was based on four basic policies:

- Fostering the massive use of propane gas in cities and rural zones.
- Encouraging private participation in the production and retail segments of the natural gas value chain.
- Determining and applying prices based of effective production and provision costs.
- Optimizing natural gas reserves utilization with the construction of a national gas duct system..

The Gas Massive Scale-up Plan was successful in several aspects. A rapid expansion process of the transportation network was achieved. Domiciliary gas connections to the national network increased approximately 400% between 1994 and 2003, growing from 790,000 to 3,164,815 connections. The 20 active gas distribution companies have increased coverage rates up to 77% of the potential residential market. Currently the propane and natural gas transpor-

Chart V.6
ELECTRICITY: RESIDENTIAL, COMMERCIAL AND INDUSTRIAL PRICES, DECEMBER 2003



Source: OLADE, December 2003.

87 According to the Ministry of Energy and Mines in 1991, the expected economic benefits of the Natural Gas Massive Scale-up Plan would approximately be: US$ 438.4 million for residential users, US$ 68.7 million for industrial users, and US$ 2.5 for the transport sector. This information was taken from: Yepes (2004). "Colombia: Desarrollo Econ6mico Reciente en Infraestructura (REDI) - Sector Gas Natural". World Bank - Finance, Private Sector and Infrastructure Unit. Latin America and the Caribbean.

88 Economic and Social Policy Council (Conpes), Policy Document 2571 (1991).

tation network covers all of the principal cities. This expansion was based on public-private partnerships.

Natural gas reserves along the Atlantic coast are significant, as well as recent discoveries in the Andean foothills. Nevertheless, Colombia's natural gas proven reserves and production are still relatively low compared to other Latin American countries, proving that the exploration and production segments of the value chain of natural gas Colombia have expansion potential (Chart V .9).

Domiciliary prices for natural gas consumption are relatively low in Colombia compared to those in other Latin American countries (Chart V.10). Similarly, natural gas shows a competitive profile as a power source for the industrial sector, compared to fuel oil and heavy petroleum derivates. However, it is not a competitive substitute for coal due to its higher price.

E. Telecommunications

Although the major reforms in the telecommunication sector in the second half of the 1990s laid their emphasis on market liberalization rather than privatization, market structures remain concentrated. Few dominant players control more than 70% of the market for each of the four major services (local, national, international, and mobile). Even though there are 29 local telephony operators, the national State operator (Telecom) serves 43% of this market. Long distance and mobile markets have only three operators each one.

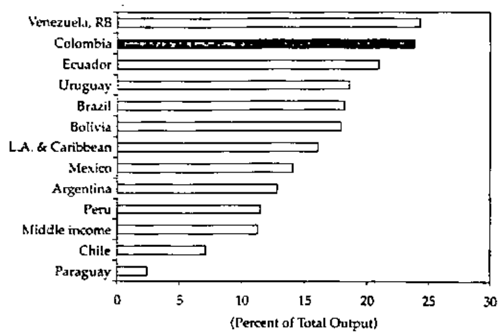
Public enterprises continue to play a dominant role in all activities of the telecommunications sector, except for mobile telephony (Chart V.11). The coexistence of public and private operators has implied the need of an adequate framework for competition.

Since the structural reforms of the second half of the 1990s, Colombia's telecommunications sector has undergone an extensive modernization. Among the most important features on this modernization process are the following:

- Local exchanges have been almost entirely digitalized.

- Three submarine wire and satellite connections were established, and carriers developed two extensive national optic fiber networks. This has provided multiple links to international networks.

Chart V.7
ELECTRIC POWER TRANSMISSION AND DISTRIBUTION LOSSES, AS PERCENT OF TOTAL OUTPUT, 2000



Source: World Development Indicators, 2000.

Chart V.8
PRIVATE OPERATORS PARTICIPATION IN LATIN AMERICAN COUNTRIES: ELECTRICITY SECTOR

Source: World Bank.

- Mobile service was introduced in 1994. By 2003 mobile density (the number of mobile subscribers per 100 inhabitants) reached 14%, yet it still is behind most of Latin American countries (Chart V.12). Service expansion has accelerated so intensely, that mobile telephone penetration was expected to reach the same level as fixed telephone penetration in 2004.

- Internet density (the number of internet users per 100 inhabitants) reached 6.2% in 2003, though it still lies below Latin American countries average (Chart V.13). Internet use remains heavily concentrated in the three largest cities.

- Broadband services are available in Bogotá and, to a lesser degree, in the cities of Medellín, Cali and Bucaramanga. Due to infrastructure bottlenecks, these services are incipient in other large cities. An additional constraint is that local telephony operators have exclusive rights to provide broadband services.

F. Water and Sanitation

The water sector has been fully decentralized in Colombia over the past decade. This service is provided by over 1,300 small and large companies. Small companies have a very weak operational and financial performance, and provide water of poor quality (in many cases without disinfection). Large companies present reasonable operational and commercial performance, and a significant number of them have private capital participation. Private and public joint ventures in this sector have operated under the following schemes: public and private sector board representation, private sector led operation, and public-private co financing of investments. Private participation in the water and sanitation sector is relatively restricted, according to Latin American standards (Chart V.14).

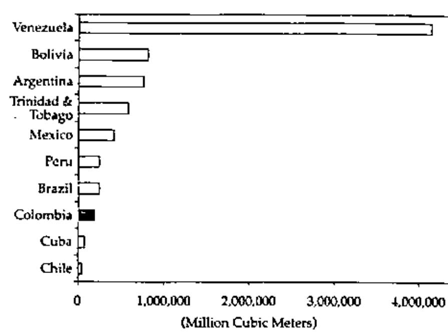
Colombia's access level to improved water sources and sanitation facilities are above the middle-income countries average. Approximately 91% and 86%of the population have access to these resources, respectively (Chart V.15).

G. Transportation

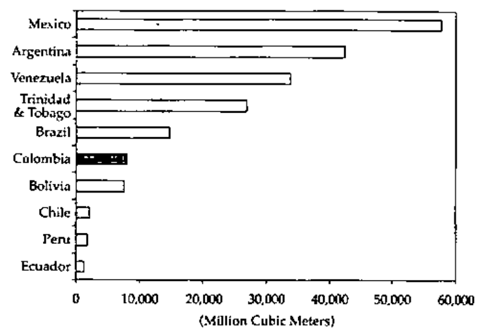
Roads are the main means of transportation for freight and passenger flows. Roughly 79% of freight is dispatched by road, and 92% of passenger trips are made by bus. On the other hand, maritime transportation covers most of international trade. Approximately

Chart V.9
NATURAL GAS: RESERVES AND PRODUCTION, 2003

A. Proven Reserves

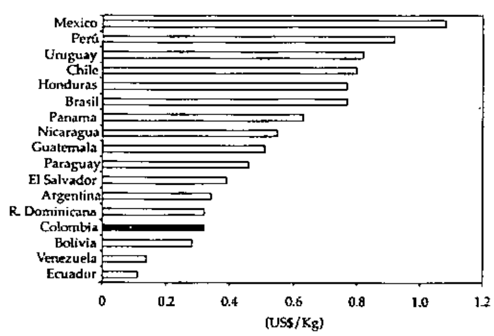


B. Production



Source: OLADE.

Chart V.10
NATURAL GAS: DOMESTIC CONSUMER PRICES WITH TAXES, DECEMBER 2003



Source: OLADE.

73% of exports and 60% of imports leave and enter the country through seaports (Chart V.16).

Roads: Invias, the national road agency, administrates the primary road network, while secondary roads have been decentralized to Department's level, and tertiary roads have been partially decentralized to municipal level. Although approximately 70% of the primary network is paved, only 15% of the overall network is paved. In 2003 almost 68% of the paved primary road network was considered to be in good condition. Most of the corridors that have enough traffic volumes to support toll-based concessions have already been contracted out to the private sector.

Railroads: The two major railroads are operated under concession to the private sector. These railroads present a cost advantage for the movement of dry bulk products and containers. Additional rehabilitation is required in order to exploit the rail's full potential contribution to the movement of freight towards the two coasts.

Ports: Five regional port societies (SPRs) given in concession to the private sector during the 1990s provide public access facilities. Although these operators have reported substantial performance improvements, they need to overcome bottlenecks in sea and land access, and to upgrade their capacity to handle larger volumes of trade.

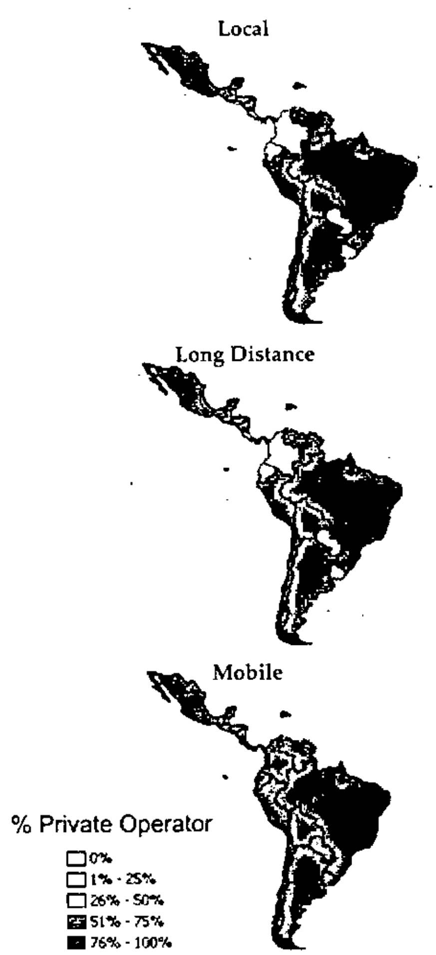
Airports: The total number of airports and runways in Colombia is approximately 513. Only 15% of the airports are currently under the jurisdiction of the Special Administrative Unit of the Civil Aeronautics (UAEAC) (Table V.1), and therefore follow the guidelines established by the International Civil Aviation Organization. Commercial transportation is concentrated in a handful of the larger airports. The main bottleneck of this sector is the lack of infrastructure needed for the efficient management of freight.

Table V.1
TOTAL AIRPORTS BY JURISDICTION

Region	Airports	Jurisdiction
Bogotá (city)	16	
Antioquia	16	
Atlántico	16	UAEAC
Valle del Cauca	12	
Norte de Santander	8	
Meta	10	
Other airports and plane airstrips*	435	Territorial entities or private agents

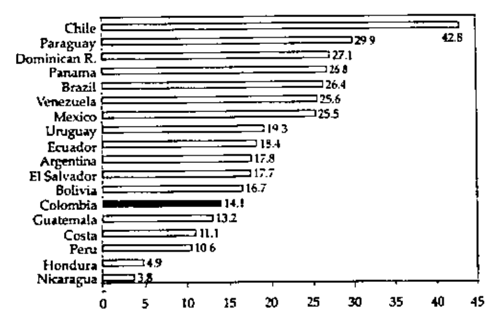
* Estimated.
Source: UAEAC and World Bank.

Chart V.11
PRIVATE OPERATORS PARTICIPATION IN LATIN AMERICAN COUNTRIES: TELECOMMUNICATIONS SECTOR



Source: World Bank.

Chart V.12
MOBILE SUBSCRIBERS PER 100 INHABITANTS, 2003



Source: ITU, 2003.

H. Future Challenges

1. *Investment requirements*

According to the World Bank, the required infrastructure investment necessary for the improvement of the productivity and competitiveness of the Colombian economy is estimated at US$ 2,600 million per year, or 3.2% of GDP. Approximately 46% of that amount is related to maintenance and rehabilitation expenditures, and 48% to investment in new infrastructure assets. The transport sector accounts for 50% of the total required investment, followed by the electricity sector with 3%.

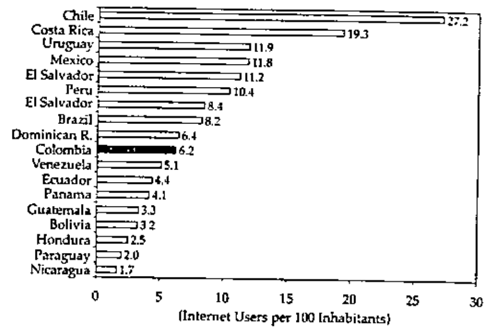
The participation of the private sector on these investments varies substantially across sectors, ranging from 18% in the transport sector to 100% in the natural gas sector. Overall, 31% of the required infrastructure investment necessary for the improvement of the productivity and competitiveness could potentially be financed by the private sector. This participation could rise to 40% depending on the possibility of expanding private participation in electricity generation and distribution.[89]

Investment requirements to meet universal access objectives are estimated to be US$ 1,500 million per year or 1.8% of GDP. The transport sector accounts for 39% of the total investment, followed by the water sector with 2%. The private sector could finance almost 18% of overall investment requirements, primarily related to expansion of fixed line telephone services).[90]

2. *The FTA with the United States*

The FTA negotiations with the United States involve significantly greater needs of future infrastructure investment, due to variations in trade volume, composition and routes.[91] Future investments have a high priority in international transport gateways (ports and airports), and road border crossings. Additionally, road traffic is expected to increase, specifically in segments that link international gateways with major centers of production and consumption.

Chart V.13
INTERNET USERS PER 100 INHABITANTS
2003



Source: ITU, 2003.

Chart V.14
PRIVATE OPERATORS PARTICIPATION IN LATIN AMERICAN COUNTRIES: WATER AND SANITATION SECTOR

Source: OLADE, December 2003.

Future infrastructure investments prioritize international transport gateways and roads, particularly as the FTA with the United States is expected to demand such improvements.

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[89] Foster, Vivien (2004). "Balancing Social and Productive Needs for Infrastructure". World Bank - Recent Economic Developments in Infrastructure (REDI).

[90] Foster, Vivien (2004).

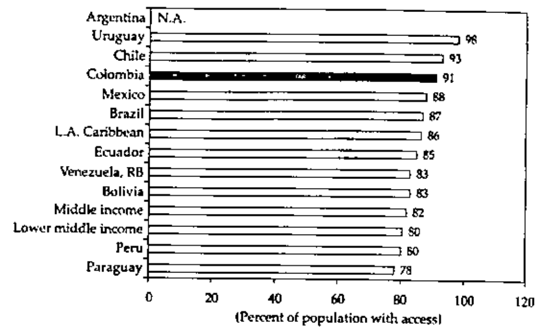
[91] Section IV.E presents an elaborate description of the FTA outlook.

I. Business Opportunities for Foreign Investors

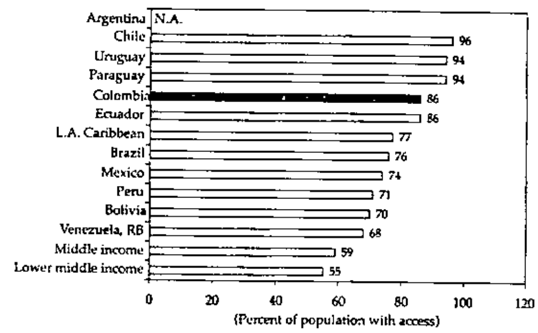
Table V.2 collects some of the most relevant information of the main business opportunities for foreign investors in infrastructure sectors. The information that it contains and the selection of these particular infrastructure projects were defined by the Colombian National Planning Department in its publication "Private Participation in Infrastructure, Guidelines" updated on March 2005.

Chart V.15
IMPROVED WATER SOURCES AND SANITATION FACILITIES, 2000

A. Water Sources



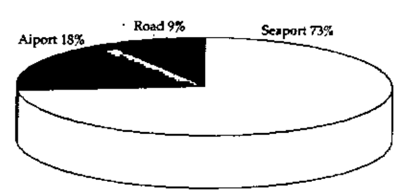
B. Sanitation Facilities



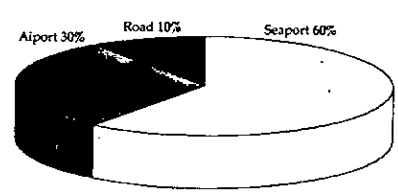
Source: World Development Indicators, 2000.

Chart V.16
INTERNATIONAL TRADE TRANSPORT DISTRIBUTION: EXPORTS AND IMPORT, 2003

A. Exports



A. Imports



Source: DIAN, 2003.

Table V.2
FUTURE PRIVATE PARTICIPATION IN INFRASTRUCTURE OPPORTUNITIES, 2005

Sector	Sub-sector	Project	Objective	Investments	Private sector participation
TRANSPORTATION	ROADS	Bogotá-Buenaventura corridor	To grant a concession for the construction, rehabilitation, enhancement, maintenance, and operation of the Bogotá-Buenaventura corridor.	The approximate cost of the works for the entire corridor is US$205 million. Additionally, an investment of US$230 million is estimated for the construction of the tunnel "La Línea".	Bidding Process for the Concession. Acceptable Bidders: Strategic Investors, Financial Investors, Institutional, Operators, and Construction Companies, among others.
		Rumichaca- Pasto - Chachagüí	To grant a concession for the construction, rehabilitation, enhancement, maintenance, and operation of the Rumichaca-Pasto-Chachagüí (Airport) road.	The National Institute of Concessions contracted a Investment bank that is in the initial phase of structuring of the project.	Bidding Process for the Concession. Acceptable Bidders: Strategic Investors, Financial Investors, Institutional, Operators, and Construction Companies, among others.
	URBAN TRANSPORTATION	Total massive transportation system for the Pereira-Dos Quebrada La Viginia metropolitan area	To grant a concession for the, construction, maintenance, and operation of the massive transportation system for the Pereira-Dosquebradas-La Virginia metropolitan area.	The approximate cost of the Integrated Massive Transportation System is: Infrastructure: US$22 million Buses: US$14 million.	The bidding process for the construction of the corridor, operation and collection. Possible participants: Foreign consulting companies associated with domestic firms, Colombian engineering firms, Financial Investors, mass transportation Operators among other. Bidding process to contract the route and collection operation of the IMTS. Currently the bidding process for the operation of the system is open. Bidding process for the construction of exclusive single carriagwat possible partipants: transportation and collection companies.
		Integrated Massive Transportation System for Cali	To grant a concession for the design, construction, maintenance, and operation of the massive transportation system for Cali.	The approximate cost of the Integrated Massive Transportation System (ITMS) for Cali is US$495 millions.	Bid process for the contracts involving the construction of infrastructure and the concession of the operation and collection services. The bidding process for the first corridor was on April of 2004 and more bidding processes for construction will open in 2005. Acceptable Bidders: Strategic Investors, Financial Investors, IMTS Operators, Equipment Suppliers and Construction Companies, among others.
		Integrated Massive Transportation System for Barranquilla	To grant the concession for the construction, maintenance, collection and operation of Barranquilla's massive transportation system.	Infrastructure: US$40 million Buses: US$19 million.	Bid Process for the concession of the design, construction, operation, and maintenance of the IMTS is scheduled to open the first semester of 2005. Acceptable Bidders: International consulting firms associated with national ones, Colombian engineering firms, Financial Investors, Urban massive transport operators among others.
		Integrated Massive Transportation System for Cartagena	To grant a concession for the construction, maintenance, and operation of the massive transportation system for Cartagena.	Infrastructure: US$55 million Buses: US$19 million.	Bid Process for the concession of the next phases of the construction, operation, and maintenance of the IMTS are scheduled to open in 2005. Acceptable Bidders: International consulting firms associated with national ones, Colombian engineering firms, Financial Investors, Urban massive transport operators among others.
		Integrated Massive Transportation System for Bucaramanga	To grant the concession for the construction, collection, maintenance, and operation of Bucaramanga's massive transportation system.	Infrastructure: US$60 million Buses: US$24 million	Bid Process for the concession of the design, construction, operation, and maintenance of the IMTS is scheduled to open in 2005. Acceptable Bidders: International consulting firms associated with national ones, Colombian engineering firms, Financial Investors, Urban massive transport operators among others.
	AIR	The El Dorado Airport Concession	Attracting private capital in order to obtain infrastructure, security, optimum levels of service and be prepared to confront the future of aviation.	To be defined. Up to US$800 million depending on the term of the concession.	Public tendering process for the Concession. Possible participants: Financial Strategic Investors, Institutional, Operational and Construction Investors, among others.

Table V.2 *(continued)*

FUTURE PRIVATE PARTICIPATION IN INFRASTRUCTURE OPPORTUNITIES, 2005

Sector	Sub-sector	Project	Objective	Investments	Private sector participation
TELECOMMUNICATIONS	LOCAL TELEPHONY	Broadband Bianual Expansion and Reposition Plans, 2004-2005	The plan is oriented towards the reposition of telephone lines in areas where new services are required. Its basic objective is to select projects that will develop biannual plans in broadband services by promoting participation of Basic Public Telephony. These projects will be part financed with state resources and will be assigned to the operator that needs the least budget to fulfill its business plan.	Close to US$19 million.	Contracting is expected to end in July 2005.
	LOCAL TELEPHONY AND ADDED VALUE SERVICES	Phase 2 of Compartel's Program to Provide Internet Access in Public Institutions-Broadband	The program will focus on providing internet access to those public educational institutions which have computers but no internet access. In addition, the program intends to connect these institutions through a web based on line educational service that will promote the use of information technology in the educational process. Furthermore, the possibility to offer internet access to hospitals, public health institutions, local mayor's offices and military bases is being contemplated. The strategy has two components: i) internet access, and ii) educational services and training	The estimated investment is US$ 42 million.	The project will be assigned through a public bidding process for a five-year term.
MINING AND ENERGY	HYDROCARBONS	Master Plan for the Development of the Cartagena refinery	Hire the supply of industrial services and attract private investment for the Cartagena refinery.	Industrial Services: US$ 70 million Product Treatment: US$ 736 million.	Bidding process for firms who offer industrial services. Possible Bidders: Companies that specialize in the construction of refineries and fuel services and private investors. Definition of the ideal scheme to attract private capital to the Cartagena Refinery.
	HYDROCARBONS AND GAS	Attraction of a Strategic Investor for the Transportation of Gas in ECOGAS	To attract a strategic investor and private operator, in order to coordinate and define the commercial strategy making possible to increase the use, consumption, and penetration of natural gas to all regional markets. Furthermore, the gas transportation business in the interior grid of the country must be competitive, comply with international standards and offer consumers the best quality service at the lowest prices.	To be defined.	Public bidding process is expected to begin the first trimester of 2005. Possible Participants: Strategic investors and institutional investors, operators, among others.
	ELECTRIC ENERGY	Substituting the State's participation in five companies of Services Public of Electrical Energy with private capital.	Shareholder sales and/or vinculación of capital in: the Energy Company of Cundinamarca S.A. (ESP-EEC), the Electrifying Company of Meta S.A. (ESP-EMSA), the Energy Company of Boyaca S.A. (ESP-EBSA), the Electrifying Company of Santander S.A. ESP-ESSA, and the Electricity Company of Santander S.A. ESP-ESSA, and the Electrifyng Centrals of Norte de Santander S.A. (ESP-CENS)	To be defined.	Hiring of an investment bank that structures the process. The process would begin in the second semester of 2005. Possible Participants: Strategic investors and institutional investors, operators, among others.

ITMS: Integrated Massive Transportation System.
Source: National Department of Planning of Colombia (2005), "Private Participation in Infrastructure, Guidelines", March.

VI. UPCOMING PRESIDENTIAL ELECTIONS AND POLITICAL PERSPECTIVES

A. Political Situation and Perspectives

The Colombian political landscape changed significantly with the enactment of a new Constitution in 1991, which allowed for a strengthening of the democratic process. The traditional two-party (liberal and conservative) dominance was altered in the 1990s with the explosion of the number of political parties running for the Congress. This outcome was fuelled by increased mistrust of Colombians in the two traditional political parties, a stance that now has important appeal on the electorate and has translated into previously unexpected voting outcomes. In fact, president Alvaro Uribe, whose origin can be clearly traced to the liberal party, was elected in 2002 running on an independent platform with record votes on the first round of presidential elections (shunning a second round). Uribe's campaign was centered on promises of providing security for all citizens by strengthening the armed forces, while eradicating corruption from politics.

In the 1990s the number of political parties multiplied, a process which was fuelled by increased mistrust of Colombians in the two traditional political parties. The electorate now favors candidates running on different platforms.

As a result of the above changes, today's congressional floor is composed of politicians that were elected as members of 65 different political parties. This sort of political fragmentation entails some difficulties in coalition building for the enactment of new laws. Legislation initiatives coming from the Executive branch face an additional difficulty, related to Uribe's open rejection of pork-and-barrel politics. Therefore, it is now common to observe in domestic politics a continuous change in the composition of the *Uribista* wing in Congress. It is worth noting that this situation is expected to improve in the medium term, when the effects of a party reform (*Reforma Política*) will affect the next congressional elections (second quarter 2006).[92]

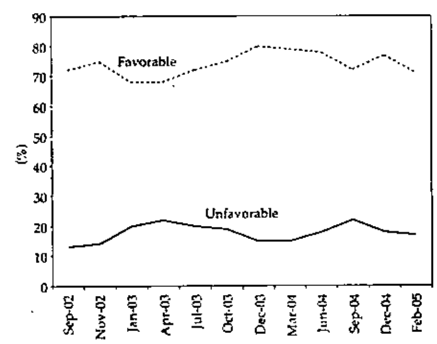
Political fragmentation in Congress, which entails some difficulties for coalition building for the enactment of new laws, is expected to decrease as party reform will affect the next congressional elections.

[92] The political reform of 2003 established that only those parties that reach a number of voters surpassing 5% of the total votes cast, both for the House and for the Senate, would get any seats. Thus, individual candidates will have to merge in order for the group as a whole to reach the threshold, which could aid in building up new parties and coalitions.

Notwithstanding the above conditions, President Uribe has managed to assemble majorities in Congress to support his initiatives. As previously mentioned in this document, during his first two years in office Uribe built congressional support to approve key fiscal pieces of legislation, two tax reforms and one pension reform.[93] Outstandingly, the Congress approved the Executive's Constitutional reform proposal related to instating presidential reelection in Colombia. Table VI.1 illustrates the composition of the political coalitions in the Colombian Congress during the fourth quarter of 2004, showing the *Uribista* wing majorities in both the House of Representatives and the Senate.

After the congressional approval of the Constitutional amendment for presidential reelection, that would allow Uribe to run a second consecutive term for office, the Constitutional Court must now rule on whether the amendment was in accordance with the provisions of Colombia's Political Contitution. Recent history shows that the Court's decisions are difficult to predict. Still, a favorable ruling could be expected due to the high political and popular backing of President Uribe (71% in February 2005, see Chart VI.1).[94]

Chart VI.1
PRESIDENT ALVARO URIBE'S APPROVAL RATINGS, SEPTEMBER 2002-FEBRUARY 2005
"Do you approve or disapprove of president Alvaro Uribe's administration?"



Source: Invamer-Gallup polls.

B. Presidential Elections of 2006

Campaigning for the 2006 presidential elections should start in full force by mid-2005, even if the Court has not ruled on the reelec-

If the re-election is deemed in accordance to the Constitution by the Constitutional Court, the high political and popular backing of President Uribe (71% in February 2005) makes him a very strong candidate for the May 2006 elections.

Table VI.1
POLITICAL COALITIONS IN THE COLOMBIAN CONGRESS
FOURTH QUARTER 2004, NUMBER OF CONGRESSMEN

Floor of the Senate		Floor of the House of Representatives	
Uribista wing	64	Uribista wing	110
Conservatives	31	*Conservatives*	46
Liberals	29	*Liberals*	64
Other	4		
Independent*	13	Independent*	8
Traditional liberals	22	Traditional liberals	48
Other*	3		

* "independent" and "other" belong to one of 63 Colombian political parties.
Source: Congreso Visible, Political Science Department of the University of Los Andes

93 As mentioned in a previous section of this document, the 2003 pension reform did not fully address the system's imbalances.

94 Source Invamer-Gallup February 2005 Poll.

tion yet. In the meantime, mainstream political parties are discussing coalitions and having popular consultations in order to present stronger presidential candidates to run for the presidential election of May 28, 2006.[95]

Prominently, the liberal party is likely to hold a consultation with its primary electorate to choose its candidate. Also, the liberal party is expected to regain strength since two liberal former Presidents of Colombia are seeking to unite the Liberal party to have more leverage *vis-à-vis* Uribe. Meanwhile, the political left is discussing an alliance between its two main parties, the *Polo Democrático* and the *Alianza Democrática*. The left is also evaluating the possibility of conducting a consultation with its popular bases, a similar process to that being considered by the Liberal party.

If the Constitutional Court approves the reelection bill, Uribe would be a very strong candidate for the 2006 elections. Uribe's potential reelection would secure continuity of the war against the guerrillas, which has spurred growth as documented in previous chapters of this report.

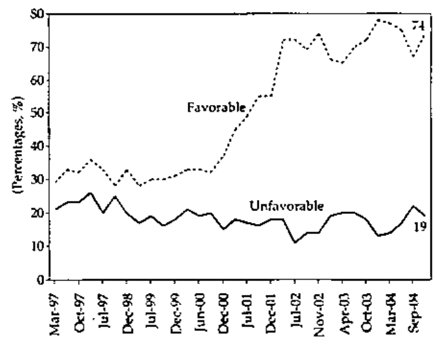
1. *Potential Presidential Candidates for 2006*

The following list of potential presidential candidates is ranked according to the December 2004 Invamer-Gallup poll favorability results (see Chart VI.2). Key points to evolve in the near future which are worth monitoring are, first, the aforementioned coalition building process by the Liberal party, on the one hand, and the Left, on the other hand. Secondly, the results from the paramilitary demobilization could affect the president's favorability levels *vis-à-vis* those of the other candidates. Thirdly, an unfavorable ruling from the Constitutional Court regarding the immediate presidential re-election could imply the emergence of new presidential candidates that may be different from those listed below. Finally, Congress should be discussing this year two laws that set out the rules of the game for Uribe and his opponents in the presidential election, the *Estatuto de Oposición* and the *Ley de Garantías Electorales*.

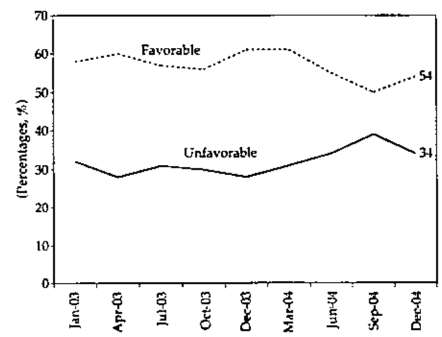
- **Alvaro Uribe**: the current president won the 2002 elections on an independent platform. If the reelection bill is approved by

Chart VI.2
OPINION POLLS ON POSSIBLE PRESIDENTIAL CANDIDATES FOR THE 2006 ELECTIONS:
"Do you have a favorable or unfavorable opinion of..."

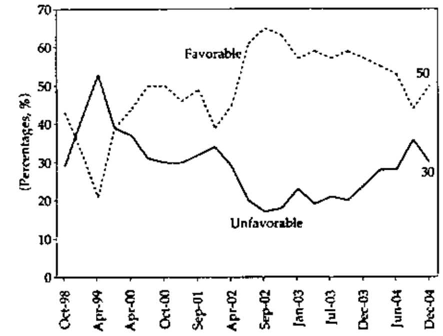
Alvaro Uribe*
(Mar-97/Dec-04)



Antanas Mockus - Independent
(Jan-03/Dec-04)



Enrique Peñalosa*
(Oct-98/Dec-04)



* Undefined political party platformyet.
Source: Invamer Gallup polls.

[95] If there is no absolute winner with more than 50% of the popular vote, a second round of presidential elections will be held in June 18, 2006.

the Constitutional Court, his record high popularity for any Colombian president entering a third year makes him a very strong candidate for the 2006 elections.

- *Antanas Mockus*: as an independent candidate he has won on two occasions the elections as mayor of Bogotá. The former Dean of the National University (the largest public university of Colombia) has a current favorability of 54%.

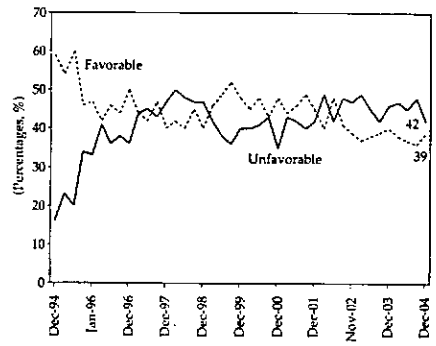
- *Enrique Peñalosa*: the former mayor of Bogotá (1999-2001) has expressed interest in participating in the consultations within the Liberal Party to run for the presidency in 2006. His favorability levels stand at 50%.

- *Horacio Serpa*: a loyal member of the Liberal Party, Mr. Serpa was Minister of State during the Samper administration (1994-1998). The former Colombian Ambassador to the Organization of the American States (2002-2003) lost the presidential election of 2002 against Uribe. His favorability levels stand at 39% and has never recovered their 1995 record level (60%).

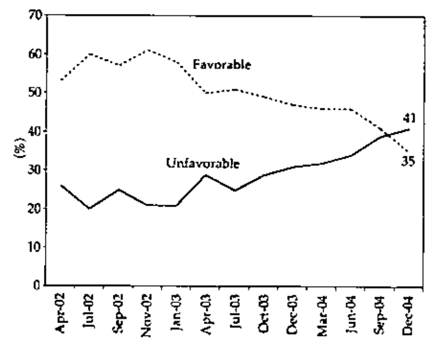
- *Antonio Navarro*: the Senator for the *Polo Democrático* Party (left) was a member of the M-19 guerrilla in the 1980s that successfully demobilized and currently participates in Colombian politics. The former mayor of the city of Pasto (located in the south-west of Colombia) has seen declining favorability that now stands at 35%.

Chart VI.2 *(Continued)*
OPINION POLLS ON POSSIBLE PRESIDENTIAL CANDIDATES FOR THE 2006 ELECTIONS:
"Do you have a favorable or unfavorable opinion of..."

Horacio Serpa - Liberal Party
(Dec-94/Dec-04)



Antonio Navarro - Polo Democrático Party
(Apr-02/Dec-04)



Source: Invamer Gallup polls.

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Annex 1
GENERAL INFORMATION ABOUT COLOMBIA

- Official Name: Republic of Colombia
- Area: 1,141,748 Km^2
- Land Frontiers: Venezuela, Brazil, Peru, Ecuador and Panama
- Coast Lines: Atlantic Ocean and Pacific Ocean
- Population (2004): 45,325,261 inhabitants (71% urban, 28% rural)
- Capital: Bogotá, 7 million inhabitants
- Climate: Tropical (climate based on altitude)
- Official Language: Spanish
- Currency (2004 Average): peso (COP vs. US$; COP$ 2,626.22=US$ 1)
- GDP (current prices 2003): US$ 78.6 billion
- GDP per capita (2003): US$ 1,794

Source: Fedesarrollo and Coinvertir (2004b).

Annex 2
COLOMBIA: SELECTED ECONOMIC INDICATORS AND FORECAST FOR 2005 AND 2006

	2002	2003	2004e	2005f	2006f
Economic growth	1.78	3.87	3.9	3.9	4.0
Current Account Deficit (% GDP)	1.7	1.5	1.6	2.3	2.9
Inflation (eoy)	6.98	6.49	5.5	5.0	4.5
Interest rate (nominal CD's rate, year average)	8.94	7.8	7.8	8.0	8.5
Nominal exchange rate ($ per US$, eoy)	2,865	2,778	2,390	2,522	2,665
Consolidated Public Sector (CPS) Deficit (% of GDP) *	3.6	2.8	1.2	2.5	2.6
Central Government (CG) Deficit (% of GDP) **	6.3	5.4	5.6**	6.1**	6.1**
Urban Unemployment (year average)	17.64	16.7	15.5	14.6	13.6

eoy: end-of-year; CD's: certificates of deposit; * Consolidated public sector overall deficit: includes balances of central government, decentralized sector, central bank, Fogafin and financial restructuring costs. ** CG deficit projections are from CONFIS, the official source of this data.
Source: DANE, Banco de la República, Ministry of Finance-CONFIS and Fedesarrollo's projections (January 2005).

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