Back from the Brink: Economic and Financial Reform in Colombia

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Abstract

Despite the challenging domestic security environment Colombia’s program of economic and financial reform is continuing. As will be argued below the egregious level of civil strife that has saturated the country over the last five decades has adversely affected all the major components of the national economy including the construction of infrastructure, the demographic profile of the population, the formation of human capital, not to mention the general business environment. Consequently, the growth in living standards lagged those of the continent at large during the 1990s despite the favorable ingredients for growth that Colombia is endowed with i.e., mineral resources, access to both the Atlantic and Pacific Oceans, modest population growth rates, etc. The paper uses a well-known framework to describe and assess Colombia’s ongoing reform program. The Uribe Administration, in office since 2002, has successfully lowered the level of violence in the country, improved public safety, and restored economic confidence, all of which are enhancing the performance of the economy and the prospects for improving living standards.

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Introduction

On the eve of the new century, in contrast to the rest of the 1990s, economic growth in Latin America began to stall, triggering fears of a return to the economic stress of the “lost decade” of the 1980s. During the 1980s, according to the United Nations (United Nations, 1998), the average annual rate of growth in gross domestic product (GDP) and per capita GDP in the countries that comprise the region was 1% per annum (p.a.) and -1% p.a., respectively. In the “reform decade” of the 1990s on the other hand, between 1991-8, growth in GDP and GDP per capita averaged 3.5% p.a. and 1.7% p.a., respectively.

However, from 1999-2003, as a result of economic and political stress in the region, along with slowing global growth – particularly in the rich developed countries – Latin American GDP growth averaged only 1.2% p.a., and GDP per capita declined by 0.4% p.a. (United Nations, 2004). Since the global economic recovery began in 2003, the resumption of growth in most of the developed countries along with continued strong growth in Asia – particularly in China and India – and the firming of international commodity prices, growth was restored to Latin America, with GDP growth averaging 6.2% in 2004, 4.6% in 2005, 5.5% in 2006, and estimated growth in 2007 was 5.6% (United Nations, 2007). More specifically, very strong growth in Venezuela and Argentina, along with solid growth in Brazil, Chile, Colombia, Mexico and Peru is responsible for the restoration of economic growth in the region over the last four years.

While Brazil, Chile, and Mexico, for the most part, continue to adhere to orthodox reform programs vetted by the International Monetary Fund (IMF), Argentina, Venezuela, and, to a lesser extent, Bolivia and Ecuador have abandoned the orthodox models and replaced them by returning to the well-tested though failed nationalist, populist, anti-liberalization, and anti-globalization policies of the past (Gruben and Alm, 2007). By June 2005, three quarters of the countries in South America were governed by left-of-center governments (Forero, 2005). One intriguing question that students of the region are debating is: are the impressive growth rates of the last four years -- particularly in Argentina and Venezuela -- simply the result of “catch-up” from the region’s poor economic performance during the 1999-2003 interval, in effect riding the crest of firming natural resources prices which are likely to moderate (or even collapse) if the external environment deteriorates? Or, on the other hand, can these enviable growth rates -- fueled by import substitution and growth in private and public consumption -- be sustained over the long-term?

Part one on this paper presents some vital statistics, historical information, and some important recent political and social events that are influencing the contours and the performance of the Colombian economy. As we shall see throughout the paper, central to this overview is the extremely tense political environment that prevails in Colombia as a result of almost five decades of civil strife, along with the principal lubricant of this violence, the production of, and trafficking in, illegal drugs. Part two provides a brief description of the methodological framework used to describe and to assess the Colombian reform program, a modified “Washington Consensus” (WC). Part three of the paper examines the ongoing Colombian program of economic and financial reform that is presented using the WC as anchor for the reforms. The last part of the paper summarizes the principal successes and shortcomings of the Colombian reform program, and assesses
the prospects for improving the performance of the economy and enhancing future living standards in the country over the next decade.

**Part 1. Vital Statistics, Historical Information, and Recent Significant Political and Social Events**

Colombia, Latin America’s fourth largest economy, is bordered on the east by Venezuela, on the west by Panama and the Pacific Ocean, on the south by Peru and Ecuador, and on the north by the Caribbean Sea. The fifth largest country in Latin America in land area, Colombia is approximately 1,139,000 sq. km, about twice the size of France. The country extends from approximately 12º north latitude in the north to about 4º south latitude in the south. According to a 2005 national census (EIU, 2006, p.3), Colombia’s population was 41.2m people, the third largest populated country in Latin America after Brazil and Mexico, and, in 2006, the annual rate of growth in population was 1.7% per annum (p.a.). In 2006, per capita income was US$ 2,938 at the market exchange rate, though considerably higher, US$ 8,352, on a purchasing power parity basis (EIU, 2007a, p.3). An estimated 60% of the population is mestizo (mixed race), 20% European, 18% of African origin, and 2% indigenous (EIU, 2006). Colombia’s population, as is the case in most of Latin America, is highly urbanized at 75% in 2005, the result not only of natural migration of people out of rural areas as traditional agriculture yields to modern farm management techniques that drastically reduces the demand for farm labor, but, as we shall see in much more detail below, to the chronic and horrific violence that has been plaguing Colombian society for almost half-a-century.

**Fifty Years of Civilian Government**

This year, Colombia marks a half-century after the restoration of civilian government. From 1953-58 military governments tried to bring order to a country that for more than a decade was suffering from an undeclared civil war between the Partido Liberal (PL) and the Partido Conservador (PC) that claimed 300,000 lives. A formal arrangement between the two parties resulted in a power-sharing pact (Frente Nacional) that allocated government positions between the two parties, and also agreed to alternate presidential candidates that, once implemented, reduced the level of violence in the early 1960s. However, as a result of being locked out of the political mainstream, leftist guerrilla groups and marginalized poor people, along with the continent-wide influence of ascending communist and socialist ideologies, spawned several rebel groups which, by the end of the 1980s and early 1990s, congealed to form the Fuerzas Armadas Revolucionarias de Colombia (FARC) and the Ejército de Liberación Nacional (ELN), the two main guerrilla groups. To counter these leftist guerrilla groups during the 1980s, farmers and drug-traffickers, in order to protect their interests, formed right-wing paramilitary groups, the largest of which was the Autodefensas Unidas de Colombia (AUC). The dangerous cocktail spawned by the drug trade, the random violence, and the endemic corruption, manifested by widespread kidnappings, murder, and extortion in the 1990s, left the country’s political and social foundations in tatters.

The vicious circle of drug trafficking, corruption, random murders, and kidnapping contributed to a lack of economic confidence that, in turn, resulted in deep-seated (and justified) political cynicism that was maintained through the 1990s because the successive governments were unwilling or unable to achieve a military or political
solution to the “virtual” civil war. Since 1985 more than 2.8m people have been displaced because of civil strife; in the six years ending in 2001 more than 1m Colombians emigrated from the country (The Economist, 2001) and by the turn of the century the level of violence was so elevated that the resulting judicial and regulatory uncertainty was undermining the democratic stability, and even the foundations, of the state. At the beginning of this century Colombia was the source of 80% of the world’s cocaine output and a growing percentage of the world’s heroine production, the main source of financing for the left- and right-wing terrorist groups. By 2002 when the Uribe administration took office, Colombia recorded 8 kidnappings and 80 homicides a day, the highest rate in the world (Forero, 2006). According to one right-wing militia leader (now in jail), Colombia is “a narco-economy and a narco-society” (Romero, 2007).

The Uribe Administration (2002 - ).

The peace talks with the guerrillas that were initiated by the Pastrana Administration (1998-2002) were contingent on providing FARC with a “state within a state” -- control of a 51,000 sq km demilitarized zone (DMZ). It became apparent that this territory was used as a “warehouse” and “transport center” for equipment, provisions, and arms, and for the production of illegal crops, whose profits were used to finance their terrorist operations. The talks with FARC proved to be an unqualified failure, and the Administration abandoned the negotiations and authorized the Colombian army to reoccupy the DMZ.

With the violence reaching unacceptable levels, in May 2002 Alvaro Uribe was elected president vowing to defeat the guerrillas with military force. Despite the tough -- and even extraordinary -- measures employed against the guerrillas by the new administration that has the strong support of the Colombian people, along with substantial military support from the Bush administration (approximately $700m a year), the military campaign against FARC which, to be sure, has forced them to retreat to their rural bases, has stopped well short of outright military victory. In the interim, in July 2004, formal talks began with the right-wing paramilitary leaders for the demobilization of the militias.

Between 2004-06 both Congress and the Constitutional Court passed two important pieces of legislation to improve the country’s public security situation: First, approval was given to allow President Uribe to stand for a second term, and second, the controversial Peace and Justice Law was approved that sets down the conditions for the amnesty of demobilized paramilitary (and potentially, also, left-wing guerrilla) forces. In May 2006, Mr. Uribe was elected for a second term of office (until 2010) with an enviable 62% of the vote.

Despite this vote of confidence by the populace and the successful demobilization of the right-wing militia, AUC, a Supreme Court investigation has uncovered links between Uribe supporters and AUC. In conjunction with alleged anti-union and human rights violations against the Uribe Administration voiced by the Democratic-controlled US Congress, and in spite of continued strong support from the now lame-duck Bush Administration, ratification of the US-Colombia Free Trade Agreement has remained elusive, and US aid to Colombia is expected to be modestly re-allocated from military aid to aid for social programs.

In spite of these setbacks, popular support for the hard-line position taken by the Uribe Administration against FARC is undeniable. In February 2008, hundreds of
thousands of demonstrators in Colombia (and all over the world) gathered to protest the
daily abductions and killings carried out by FARC. According to the New York Times, “
until several months ago a mass gathering against FARC would have been improbable in
Colombia” (Gonzalez and Romero, 2008). With a little more than two years remaining in
the mandate of the Uribe Administration, it appears that the guerrilla organization is
finally on the defensive, both militarily and politically. What is uncertain is whether the
Uribe Administration will run out of political capital in the Colombian Congress and with
the US before FARC can be marginalized. To be sure, the outcome will have
consequences that extend not only to the region, but also globally.

The Constitution
To address some of Colombia’s considerable institutional weaknesses, in 1991 a
new constitution was adopted that enhanced civil liberties, re-allocated political power
from the executive branch to the legislature and the judiciary, guaranteed the
independence of the central bank, created a new system of fiscal federalism -- the
mechanisms for transferring tax revenues from the central government to the departments
and municipalities -- and, at least in theory, enacted provisions to open up the political
system that, in the past, had been dominated by the two major parties, the PL and the PC
(see page 5, above). Their long-standing political stranglehold is alleged to be the source
of chronic corruption in the public and private sectors.

However, by devolving power away from the executive branch to the judiciary,
the Constitutional Court, and the regions, new problems were created: While enhancing
human rights protections the courts have been overwhelmed with cases, but their
resources have not been increased in tandem. As a result, these inefficiencies have
limited the ability of the judiciary to process less than 10% of the crimes committed.
Or, because of the excessive authority provided by the new constitution to the
Constitutional Court to examine decrees and laws, legal uncertainty has been increased
and economic policymaking has been made more complicated (EIU, 2006, p.8). In
addition, the mechanisms adopted in the 1991 constitution to transfer central government
funds to the regions contributed to Colombia’s chronic fiscal imbalances. While some
reforms to the constitution were approved (please see section B, below), the public
finances are still stressed (see section A, below), the effectiveness of the judiciary is still
suspect, and corruption -- to be sure, aided and abetted by the flourishing illegal drug
industry -- is still rampant.

Part 2. The Methodological Framework
In its 1991 World Development Report, the World Bank articulated four broad
requirements that would have to be met in order to characterize a national economy as
"battle ready" to meet the challenges of the fiercely competitive world economy on the
eve of the 21st century. They include:

- a stable macro-economy characterized by both fiscal and external balance and low
  and stable inflation;
- the adoption of a competitive micro-economy that includes a substantial reduction
  in state ownership and management of productive assets and the elimination of
  price distorting subsidies and taxes;
- strong global linkages that include adherence to GATT (now the WTO), low and
  uniform tariff rates, absence of non-tariff barriers, a uniform and market-
determined exchange rate, a liberalization of the rules governing capital flows and
direct foreign investment, and;
an active government policy that promotes social and economic investment,
especially in the areas of education, infrastructure, and health.

The World Bank, in its 1997 World Development Report, expanded the reach of
the fourth requirement to include the promotion and enforcement of property rights,
reducing the level of corruption in the country, and ensuring a reliable legal system—
some of the so-called “second tier” reforms.

The global economy is imposing strict discipline on the range of acceptable
economic and financial policies that can be prescribed in developed and developing
countries alike. The December 1994 Mexican debacle, the Asian meltdown in 1997, the
Russian collapse in 1998, the Brazilian devaluation in January 1999, the Turkish crisis in
2001, the debt default in Argentina in late 2001, and the threat of a Brazilian default in
2002 all serve as frightening reminders of the dangers of macro-economic imbalances,
micro-economic inefficiencies, and institutional weaknesses in a world of free capital
movements. Nevertheless, in the first decade of the 21st century there is compelling
evidence to demonstrate that a necessary, though not sufficient, condition for sustained
improvements in material life can be realized only by constant exposure to, and continued
rationalization with, the ever-widening global economy (Fischer, 2003). As ever in
economics, a decision in favor of global integration involves a trade-off: enhanced
opportunities for future economic growth and improved living standards on the one hand,
accompanied, on the other, with considerable short- (and often medium-) term economic
pain, along with the risk and responsibility of continuously adjusting the national
economy to the increasingly demanding dictates of the global economy.

enumerated a list of desirable conditions (anointed the “Washington Consensus”) that, if
adopted and adhered to, would, over time, put reforming countries on the path to success
in today’s global economy. Since the late 1990s, because of its alleged failure to address
the issue of poverty reduction directly, the Washington Consensus has been subjected to
heated intellectual debate within academia and the major international organizations
such as the World Bank (Beattie, 2000; Finance and Development, 2003). Nevertheless,
this framework continues to assume a central role in the debate on development
strategies for low- and middle-income developing countries in the first decade of the 21st
century. For example, evidence is beginning to emerge that in the post-Soviet “transition
economy” countries “that adopted far-reaching reforms -- generally following the
recommendations of the Washington Consensus -- tended to experience higher growth
rates, lower inflation, and received more foreign investment” than countries that
introduced less comprehensive reform programs (Havrylyshyn, 2007).

In light of the experience of the late 1990s (increasing poverty rates and stalled
economic growth due to an adverse external environment), proponents of the Washington
Consensus amended the original framework to ensure that fiscal policy is counter-
cyclical to support economic growth in an economic downturn, and to focus on reducing
income inequality by insuring that the poor have access to assets, i.e., education, land
titling, micro-credit and land reform, that will enable them to work themselves out of poverty (Williamson, 2003).

While the “reform decade” of the 1990s did restore growth in GDP and GDP per capita in Latin America when compared with the “lost decade” of the 1980s as was mentioned above, many observers of Latin America contend that the “neo-liberal” reforms of the 1990s have not only “failed to deliver sustained growth, but have made the region more vulnerable and have increased unemployment, poverty and inequality. As a result of all this, some political pundits assert that Latin America is sinking back into populism and/or anti-market leftist nationalism” (The Economist, 2003). At the end of 2007, this last statement is borne out for many countries in Latin America, and, in particular, in Venezuela and most recently, in Bolivia.

On the other hand, some students of the region are arguing that the reason growth stalled again in Latin America at the turn of the century was the failure of reforming countries to adhere to the core principles of the “Washington Consensus” -- fiscal and monetary discipline, opening up to foreign trade and investment, and large-scale privatizations and deregulation” (The Economist, 2003). In addition, what is also needed are so-called “second generation” or institutional reforms that range from improving health and education to strengthening legal codes, improving financial oversight, and reducing corruption in both the private and public sectors (Williamson and Kuczynski, 2003).

Table 1 presents this modified “Washington Consensus” which I have been using for more than 15 years of research on South American economic and financial reform programs.

Table 1. Modified "Washington Consensus"

| A. Fiscal and monetary discipline                  |
| B. Redirection of public expenditure priorities towards health, education, and infrastructure |
| C. Tax reform and improved tax administration     |
| D. Unified and competitive exchange rates          |
| E. Modernization of government and "quasi" government institutions |
| F. Deregulation                                    |
| G. Trade liberalization and regional integration  |
| H. Privatization                                   |
| I. Elimination of barriers to direct foreign investment |
| J. Banking reform and financial liberalization     |

Part 3. Economic and Financial Reform

Before providing a description and analysis of Colombia’s macro-economic profile it is useful for readers to have an overview of the country’s key macro-economic variables over the last five years, which is presented in Table 2, below.
Table 2. Key Macroeconomic Variables, 2003-2007

<table>
<thead>
<tr>
<th>MACROECONOMIC VARIABLE</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth (annual % change)</td>
<td>3.9</td>
<td>4.9</td>
<td>4.7</td>
<td>6.8</td>
<td>7.0</td>
</tr>
<tr>
<td>Inflation (annual % change)</td>
<td>6.5</td>
<td>5.5</td>
<td>4.9</td>
<td>4.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Central Gov’t Deficit (% of GDP)</td>
<td>-4.7</td>
<td>-4.3</td>
<td>-4.8</td>
<td>-4.2</td>
<td>-3.3</td>
</tr>
<tr>
<td>Current Account Surplus (% of GDP)</td>
<td>-1.2</td>
<td>-1.0</td>
<td>-1.6</td>
<td>-1.7</td>
<td>-4.0</td>
</tr>
<tr>
<td>Rate of Unemployment (%) (urban)</td>
<td>16.7</td>
<td>15.4</td>
<td>14.0</td>
<td>13.0</td>
<td>11.6</td>
</tr>
</tbody>
</table>


A. Fiscal and Monetary Discipline

Until the 1990s, in contrast to most other countries in Latin America, Colombia boasted solid macro-economic management eschewing, on the one hand, populist economic policies and, on the other, extreme free-market experiments that characterized the policies of most of the countries in the region during the 1970s and 1980s.

However, with a view towards greater adhesion to the world economy through the adoption of measures to liberalize its trade and capital accounts in the early 1990s, the Colombian economy was subjected to macro-economic imbalances that were caused by some poorly designed provisions in the newly adopted 1991 Constitution that by the end of the decade increased the country’s vulnerability to external shocks. For example, the non-financial public sector deficit reached an historic high of 6.8% of GDP during the 1988-89 recession, and the debt ratio – the percentage of debt to GDP – as a result, continued to rise from 30% in 1997 to 57% in 2002, triggering a fiscal adjustment program agreed with the International Monetary Fund.

During the second half of the 1990s the official rate of unemployment more than doubled, and by the end of the decade the urban unemployment rate reached 20% (among the 18-24 years-old the rate was 35%, and among the poorest 10% of the population the unemployment rate above 60%). These macro-economic imbalances, in conjunction with relentless civil strife increased the crime and murder rates, encouraged massive emigration of skilled and educated people, and entrepreneurs. This had an adverse impact on Colombia’s stock of human capital, and together with the accompanying reduction in both domestic and foreign investment the growth prospects of the Colombian economy were impaired. As a result of the appalling levels of violence in the rural areas, by 2006, more than 2m Colombians had migrated to urban areas, contributing to the high rate of urban unemployment and the increasing poverty rate that had been falling until 1995 but reached 60% by 2003. Because of the poor policy framework in the 1990s (including wage and price indexation and a crawling peg exchange rate system, in place since 1997 though abandoned at the end of the decade) the inflation rate was approximately 20% per year for most of the 1990s.

More recently, the fiscal adjustment program agreed with the IMF (2002-06) included revenue-raising and cost-cutting measures to rein in the non-financial public sector deficit and, ultimately, to reduce Colombia’s chronically high debt ratio. (For a catalogue of these measures, please see (EIU, 2006, p.24.)) Colombia instituted an inflation targeting framework which, in conjunction with its appreciating currency – the result, in large part, to rising international prices of commodity exports (including cocaine!) – succeeded in reducing annual inflation to 4.5% in 2006, though it increased to 5.4% in 2007. Because of the favorable external environment, tight fiscal policy, and the
inflation targeting framework by the end of 2005 the non-financial public sector deficit was eliminated (though it widened again over the last two years), and the public debt – both the central government and the non-financial public sector -- ratios fell by about 20% from 2003 to 2007.

While economic growth registered 6.8% in 2006 and 7.0% in 2007, and the market-friendly policies followed by the Uribe Administration have improved the public finances, reduced inflation, and strengthened the financial system (please see section J, below) there is currently renewed short-term fiscal stress and increasing debt levels, in part, because of the endangered ratification by the US Congress of the stalled Free Trade Agreement and the renewal, to the end of this decade of Plan Colombia – an existing initiative for economic and military aid to Colombia.

With regard to securing long-term sustainability of its public finances, Colombia will need structural reform of its tax regime, pensions, and central government transfers of revenue to the provinces (more about this below) as well as further progress in reducing, and eventually, eliminating the endemic and disruptive civil stress of the last 40 years.

B. **Redirection of Public Expenditure Towards Education, Health Care and Infrastructure**

In order to improve the distribution of the benefits of economic growth to all segments of society and to enhance the growth prospects of the national economy by increasing the country’s stock of human capital, reforming countries have been prodded by the international organizations to increase the share of public expenditure allocated to education, health care, environmental protection, and physical infrastructure – including transport and communication. To that end it is useful to review the status of these “infrastructure” services in Colombia.

The new Constitution, adopted in 1991 (see page 8, above), established a system of automatic revenue sharing from the central government to Colombia’s sub-national governments that consist of 32 departments and 1,098 municipalities in order to finance the provision of educational and health services at the local level.

By the end of the 1990s it was apparent that there were serious structural deficiencies in the 1991 Constitution regarding the “automatic” feature of the revenue sharing provisions that resulted in a lack of fiscal discipline at the sub-national level. As the transfer revenue continued to grow, the departments and municipalities had insufficient incentives to control their spending that led to serious sub-national deficits, and ultimately, to unsustainable (sub-national) debt burdens resulting in the financial collapse of several departments and bailouts from the central government. Also, despite a decade of high transfer payments to local governments for social spending, the quality of social services remains poor and Colombia’s social indicators showed little improvement (IMF, 2005).

The 2001 reforms implemented in the “fiscal federalism” program placed limits on the transfers made to local governments. The rate of growth in transfers was capped at 2-2.5% per year, and these payments by the central administration were also restrained by the rate of growth in national GDP.

**Education**

Public spending on education almost doubled as a percentage of GDP, rising from 2.5% in the 1990s to 4.8% in 2004, one of the highest percentages in Latin America.
The 2001 reforms are acknowledged to have increased basic and primary education coverage from 9.6m to 10.9m students over the 2001-05 interval, and the average number of years of schooling – at nine years – is higher than Brazil but lower than Argentina, Chile, and Mexico.

Despite these recent improvements a large disparity persists in educational coverage between the urban and rural areas as would be expected in developing countries. Many teachers, particularly in the rural areas, are poorly qualified, especially in math and related subjects. In addition, because of the absence of vocational training in secondary schools, industrial and services employers complain of a skills shortage that may also be attributed, at least in part, to the high number of Colombian emigrants seeking refuge from the incessant violence and civil strife in the country.

Public Health and Health Care

Average life expectancy in Colombia increased by 50% in the half century from 1950 to 72.2 years in 2004, slightly above the average for all of Latin America. However, as always in Colombia, even the country’s demographic profile has been affected by the continuing violence with a wider than normal disparity between male and female life expectancy (69.2 vs. 75.3 years, respectively.) In addition, the 2002 murder rate of 66 per 100,000 inhabitants declined by more than 40% by 2007 to 36 per 100,000 inhabitants, though it is still high by international standards. Significant improvements in the rate of infant mortality occurred between 1990-2003, with the rate dropping by more than 40% to 18 per 1,000 live births, one of the lowest in Latin America.

With respect to water and sewage services, again, characteristically for developing countries, there exists a wide gap between the urban and rural areas in the provision of these important amenities. While in the main cities 97% of the population has adequate supplies of water and 92% have sewage services, in the rural areas those percentages decline sharply to 50% and 25%, respectively (EIU, 2006).

Access to the health care system has improved measurably over the last 15 years. Reforms implemented in the early 1990s encouraged employment-based plans – with premiums shared by employers and employees – and, as a result, by 2005 approximately 75% of the population had access to health care services compared with 21% of the population in the early 1990s before the reforms were introduced. Nevertheless, despite the relative success of the reformed system, health care in Colombia still suffers from under-funding, in part because an estimated one-third of premium payments are evaded. Also, as is characteristic in developing countries, there is a considerable disparity in the quality of health care services between those delivered in the urban areas and those provided in the rural areas, similar to the differences in the quality of educational services already mentioned.

Environmental Protection

With the adoption of the 1991 Constitution Colombia began to enact legislation for environmental protection and, in 1993, established the Ministry of the Environment. Colombia is a signatory to the Kyoto Protocol and the United Nations Convention on Climate Change.

Even the environment has not escaped the omni-present twin problems of Colombian society over the last three decades – drug trafficking and civil strife. Chemicals used in the coca-refining process and in the aerial spraying of this illicit crop with glyphosphate - - a very toxic herbicide – have contaminated some rivers. Also, acts
of sabotage by guerrillas to oil pipelines and other oil infrastructure have caused spillage of crude oil into local rivers. In the capital, Bogotá, air pollution levels exceed acceptable standards, and because of excessive soil erosion almost two-thirds of the country’s municipalities could face water shortages by 2015 (EIU, 2006).

Transport

Turning to transport infrastructure, even though road travel is the main mode of transport of people and cargo – 54% of all cargo is moved on the roads – 85% of Colombia’s 115,000 km of roads are unpaved (EIU, 2006). However, government plans include a major upgrade of roads, including awarding concessions to build 5,000kms of new secondary roads. If Colombia is to succeed in enhancing the competitiveness of its two leading exports – coal and coffee – by reducing the cost of transporting them to port, rail infrastructure will need to be significantly upgraded.

In part because of its unique topography as well as for reasons of security as a result of the country’s long experience with kidnappings and murders of businessmen, Colombia is an airport-intensive country, with more than 70 main airports used by business to transport executives and valuable goods (EIU, 2006).

Telecoms

Finally, turning to the telecommunications sector that is so critical in today’s global economy, in the 1990s this sector, as was the case in many other countries, was subjected to liberalization and technological change that reduced tariffs because of greater competition, improved efficiency, the introduction of new products and services, and the extension in coverage of telephone service, especially in the rural areas.

With the decade ending in 2005, fixed-line telephone density increased by more than 70%, and the introduction of mobile phones -- by 2006 there were 22m vs. 8m fixed-line phones – resulted in a penetration rate of 53%, the third highest in Latin America after Chile and Argentina. There is still little competition in the fixed-line market that continues to be dominated by state-owned companies, but the liberalization of long-distance services, along with the introduction of mobile phones, has reduced prices appreciably for consumers.

Internet penetration remains low – about 5% in 2005 – because of the low level of computer penetration in the country. But that is likely to rise substantially in the near future as computer literacy expands society-wide, the prices of computer hardware continue to fall, and new products that can access the internet -- such as blackberries -- are more widely diffused.

C. Tax Reform and Improved Tax Administration

The Uribe Administration’s initiative to overhaul Colombia’s public finances – whose “bottom-line” objective is to reduce the public sector deficit in compliance with its agreements with the IMF – was substantially weakened after the 2003 referendum on spending cuts and political reforms was defeated (Financial Times, 2003). Preceding the failed referendum, in 2002, the first year the Uribe Administration was in power, a temporary tax of 1.2% on companies and individuals with more than US$ 600,000 of assets was imposed to pay for the military buildup to combat the leftist guerrillas. In the aftermath of the referendum’s defeat (and in place of the spending cuts) the administration focused on increasing tax revenues in an efficient way so as to maintain a “friendly” business environment.
Recognizing that one-third of potential tax revenue is never collected, the government encouraged the adoption by consumers of electronic payments (through credit and debit cards) in place of cash that would generate a paper trail of receipts making tax evasion by merchants more difficult. (In addition, a tax on debit card transactions of 0.4% was also imposed.) To provide the necessary incentives to encourage electronic payments, the administration announced a 2% discount on value-added tax (VAT) but, predictably, and perhaps as an indication of the success of this policy, merchants countered by offering a 2% discount for cash purchases (Webb-Vidal and Lapper, 2004).

Furthermore, recognizing the need to attract more foreign investment, and as a part of the strategy to shift the tax burden from business to consumers, in 2004 the administration reduced the state’s share of oil revenues from foreign oil companies to 50-55% from 70% (Webb-Vidal and Lapper, 2004.) This policy is certainly at variance with the current trend in oil producing and exporting countries such as Venezuela, Russia, and the Canadian province of Alberta.

As a measure of the success of the Uribe Administration’s “business plan” the World Bank, in 2004, named Colombia as “one of the world’s most improved business environments” (O’Grady, 2006), but, on the other hand, cited the country in its 2006 “Doing Business” report as ranking 145 of 155 countries in the category of corporations “paying taxes” – absorbing 432 hours and 54 payments annually. The report indicated that reducing the corporate income tax was necessary but not sufficient since the corporate tax code was still full of distortions because of the many exclusions, exemptions, and other loopholes that were embedded in the code.

Other measures of the revenue-raising segment of the administration’s fiscal adjustment program include: a widening of the VAT base that targets a 10% VAT rate on most previously exempted items; standardizing the basic VAT rate at 16% from the current range of 2-35%; and the creation of a new 25% VAT rate on luxury goods. Some of the higher VAT revenue realized from the above measures would be allocated to poverty alleviation programs. The “temporary” tax mentioned above on personal assets (now increased to US$ 625,000) has been made permanent. The top tax rate on income of 38.5% in 2006 is expected to decline to 32% by 2009. In addition, there are proposals to tax pensions, and to set a ceiling of US$3,300 on monthly pensions (The Economist, 2004).

In conclusion, much more work must still be done to eliminate the remaining “loopholes, distortions, and unfairness in the tax code”, and to substantially widen the taxpayer base (EIU, 2007b), and stricter monitoring and enforcement measures will be needed to increase the tax base if Colombia is to meet its target of a consolidated primary surplus of 2.7% of GDP and a consolidated public sector deficit of 1.7% of GDP in 2007 (EIU, 2006). Preliminary data indicate that these were +3.6% and -0.7 %, respectively, in 2007 (United Nations, 2007).

D. A Unified and Competitive Exchange Rate

The importance of a unified and competitively-determined exchange rate cannot be underestimated for the purposes of macro-economic stability and for micro-economic efficiency. To underscore this the experience of the Asian financial crisis at the end of the last century, and more recently (and closer to home for Colombia), the Argentine financial meltdown in 2001 both serve as “text book” examples of the perils of pegged
exchange rates in a world of open capital accounts. In the 1990s, the reform decade in Latin America, the Colombian government aggressively liberalized trade by cutting tariffs and eliminating most non-tariff barriers causing, not unexpectedly, a rising trade deficit as imports soared. An appreciating peso over the next eight years exacerbated the trade imbalance by slowing the growth in exports. Currency liberalization was implemented gradually during the first half of the 1990s. A managed float – permitting the exchange rate to fluctuate within a prescribed band – was implemented in 1993 to the end of achieving a gradual devaluation of the currency.

Simultaneously with the Asian financial crisis in 1999, the Central Bank eliminated the exchange rate band and adopted a free-floating exchange rate, but in order to reduce the peso’s volatility the Central Bank instituted an intervention mechanism to strengthen or weaken demand for the peso. The precarious domestic security situation in the country during the next four years (1999-2003) led to an annual depreciation of the exchange rate by 15% because capital inflows collapsed as a result of the continuing civil strife, along with a significant strengthening of the US dollar over this interval.

With the Uribe Administration’s determination to lower the level of violence and improve the country’s business environment and, more generally, the level of economic confidence, during the 2002-06 interval, along with declining US interest rates and the gradually improving terms of trade for Colombia’s exports as energy and other commodity prices firmed on world markets, the peso appreciated by 15% per year in 2004-05. The peso appreciation continued into 2006-07 to such a degree that by mid-2007 capital controls – that required foreign portfolio investors to deposit 40% of their investments in a non-interest bearing account with the Central Bank for six months – were announced. The peso appreciation was attributed to renewed foreign direct investment (mostly in coal and oil projects in light of the run-up in energy prices) and the repatriation of foreign profits by Colombian companies, the result of the decline in the value of the US dollar in the international currency markets (EIU, 2006; Molinski and Landauro, 2007).

E. Modernization of Government and Quasi-Government Institutions

The principal obstacle impeding Colombia’s public sector from functioning in a more productive and efficient way in delivering essential social services to the country’s population is acknowledged to be the revenue sharing system that automatically transfers funds from the central administration to the sub-national governments that are designated by sectors to fund health and educational services at the local level. The mechanism for these transfers – along with the growth in the level of these required entitlement programs – were enshrined in the 1991 Constitution, and were, early on, recognized to be fiscally unsustainable (see page 9, above). This was the case because of the lack of clarity in specifying the expenditure responsibilities at the different levels of government that resulted in fiscal laxness at the sub-national level, aggravating the fiscal problems of the central government.

These problems were addressed, in part, by the 2001 constitutional reforms that resulted in retarding the rate of growth of inter-governmental transfers during the 2002-08 interval. As spending grew less rapidly at the sub-national level their deficits declined -- in fact, in 2001 and 2004 small surpluses appeared -- and these reforms led to a dramatic improvement in the fiscal discipline of the local governments.
The 2001 reforms mitigated the major “fiscal federalism” shortcomings of the 1991 Constitution but because of other expenditure rigidities (such as mandated expenditure outlays) the central government’s fiscal deficits, according to the IMF, were likely to increase in the future. Consequently, in a recent review of Colombia, the IMF acknowledged that “without additional reform, the intergovernmental transfer system will continue to pose challenges for the conduct of fiscal policy” (IMF, 2005, p.27). Readers interested in a more detailed list of the IMF’s recommendations to reduce the stresses on the central administration’s expenditures are referred to the above-cited IMF document.

Another example of the modernization of Colombia’s government institutions, and also a product of the 1991 Constitution, concerns granting Colombia’s central bank, Banco de la República (Banrep), independence from the central government. As is the case in other countries – both developed and developing – when governments have granted their central banks independence, it has led to an improvement in national monetary and exchange rate policies, allowing them to respond to the changing economic and financial environment better and faster than the politically-motivated policies of central banks that remain agents of their governments.

Finally, in recent years Colombia has developed some innovative ways to enhance its public sector efficiency. Acknowledging the political impediments to full-scale privatization of some state-owned assets, if a publicly-owned enterprise can be certified as “commercially run” it can be removed from the IMF’s country indicators and targets, permitting these enterprises to undertake investments without concerns for the target of the overall public sector deficit. This would enable the enterprise to expand its investment and borrowing strategy since it would be based solely on business considerations. In 2004, ISA, an electricity transmission company in which the government has a majority stake, was assessed as “commercially run”, and was excluded from the IMF’s fiscal indicators and program targets.

F. Deregulation

In order to modernize the micro-economic substructure of the economy with the objective of increasing the efficiency of the country’s scarce resources – and ultimately to increase Colombia’s material well-being – along with the privatization of state-owned assets and the removal of legal and financial impediments to the free flow of foreign-direct investment is the critical, though politically challenging, task of deregulating heretofore protected sectors of the economy and permitting the forces of competition to work. Even though the World Bank, in a 2005, report ranked Colombia as among the top performers worldwide in deregulation at the micro-economic level, this was not always the case (O’Grady, 2005).

During the late 1990s and the first years of the 21st century, as a consequence largely of the increasing level of violence that induced large scale migration to the cities, along with a corresponding deterioration in the level of confidence in the country’s economic prospects, there was a surge in the rate of unemployment in the major cities that was not entirely of a cyclical nature. In addition, because of the chronic violence compounded by the endemic drug trafficking, employment in Colombia’s informal sector, estimated at 52% of total national employment in 1999, rose to 60% by 2002 (IMF, 2005). By 2002, the official unemployment rate rose to 20% even though, to be sure, many of these officially unemployed workers were employed in the informal
economy. While the rising violence – and the accompanying migration to the cities – figured prominently in increasing the official (urban) rate of unemployment and increasing the employment rate in the informal sector, labor market rigidities were also blamed for the increase in both of these rates. By 2002, a major reform of the Colombian labor market was complemented with an attack by the Uribe Administration on the structural components of unemployment in order to increase labor market flexibility. Since the reforms were implemented, the official rate of unemployment (for 13 metropolitan areas) engaged in the formal sector of the economy had receded -- declining to 13% in 2006 and to 11.6% in 2007 (United Nations, 2007) -- however at this time it is difficult to ascertain if this is due to the reforms or to cyclical factors, i.e., the restoration of economic growth, as a result of the administration’s successful initiatives to lower the level of violence and crime since assuming power in 2002.

Some of the labor market rigidities cited by the IMF (2005, pp 6-8) include: substantial non-wage labor costs; a high minimum wage; costs borne by business for its employees that are security-driven, that is, caused by the civil strife and the drug-related violence; and other labor market regulations.

The Labor Reform Law of 2002 improved the flexibility of labor contracts, encouraged training through apprenticeships, expanded protection for the unemployed through training programs and temporary subsidies, relaxed or eliminated restrictions on the length of the workday and workweek to accommodate fluctuating levels in the demand for labor such as peak periods and weekends, and lowered employer severance payments for unilateral dismissals. Despite these significant improvements in the labor market, Colombia’s minimum wage is still considered high but the administration faces formidable political and constitutional impediments to reduce it further (IMF, 2005).

With a few towards the future, Colombia is acknowledged to suffer a skills mismatch and, as a result, needs programs to upgrade the human capital component of its current and future labor force through better education, training, and apprenticeships. With the continuing reduction in the levels of violence and crime, and improving levels of security and confidence in the economy since 2002, over time, a reduction in the rate of emigration – especially among young, educated and talented people – is likely to alleviate some of the aforementioned “skills problem”. On the other hand, the reduction in the level of violence and the decommissioning of former combatants is already putting pressure on the labor market as these people are absorbed into the formal economy.

Another part of the economy that was liberalized in the 1990s is the all-important telecoms sector where deregulation introduced new services, more widespread coverage, greater efficiency, and lower costs (and, by extension, lower tariffs for telecoms users, both business and households.) However, despite the successes in telecoms deregulation, competition in fixed-line local service is still weak since this sector continues to be dominated by state-run companies. Since fixed-line telephony is almost certainly a “sunset” technology, the cost to the broader economy of these local monopolies is declining as mobile-phones use increases and the intense competition among mobile-phone providers continues to drive down telecoms prices for households and business (EIU, 2006).

G. Trade Liberalization and Regional Integration
Another important ingredient that is critical for a national economy that is becoming “battle ready” for the competitive global economy in the early 21st century is a liberalized trade account and a commitment to continue reducing tariff and non-tariff barriers faced by the goods (and increasingly services) of its regional and global trading partners.

Over the last three decades Colombia has made enormous gains in liberalizing trade. In the 1970s and 1980s Colombia adopted policies that were designed to advance the then “trendy” policy of “import substitution” of industrial goods by domestic production. As economic growth in the 1980s declined to 3.4% per year, by the early 1990s this policy was abandoned with a reduction in tariff rates and the elimination of non-tariff barriers (EIU, 2006).

Since it was founded in 1969, Colombia has been a member of the Community of Andean Nations (CAN), a free trade area cum imperfect customs union, whose membership includes Bolívia, Ecuador, Perú and Venezuela, though the latter country has already given notice of its intention to leave the organization, effective in 2012. In 2004, CAN and Mercosur, the southern cone’s free trade organization and equally imperfect customs union, whose full members include Argentina, Brazil, Paraguay and Uruguay, agreed to full trade liberalization by 2019. CAN also participates in negotiations on the Free Trade Agreement for the Americas (FTAA), the stalled hemispheric initiative to liberalize trade from Alaska to Tierra del Fuego, and in 2006, the European Union (EU), which already grants Colombia’s exports preferential access to its markets through the General System of Preferences (GSP), and CAN opened exploratory talks regarding a future EU-CAN trade liberalization initiative. Colombia is moving towards a full trade liberalization agreement with Mexico by 2010 and forging deeper agreements with Central America and Chile. With regard to its increasingly cantankerous neighbor to the east, as President Hugo Chávez strengthens Venezuelan-Chinese trade relations, negotiations are ongoing between Colombia and Venezuela to facilitate transporting Venezuelan crude oil to Colombia’s Pacific coast for shipment to China. At the present time, because of Venezuelan price controls and the resulting decline in domestic food production, levels of Colombia’s exports of food and manufactured goods are significantly above recent trends.

Despite all the above-mentioned trade liberalization agreements already concluded or currently being negotiated by far the most important bilateral initiative on trade for Colombia is its pending Free Trade Agreement with the United States since the US traditionally purchases approximately 40% of Colombia’s exports. Under the proposed terms of the agreement – if it is ever ratified by the US Congress-- Colombia will receive duty-free access to the US market for almost all of its manufactured exports, and, as a result, according to some estimates, Colombia’s GDP could increase by 1% per year (Wall Street Journal, 2006).

Because of concerns in Colombia that (subsidized) US agricultural exports would threaten jobs and incomes that could cause some Colombian peasant farmers to shift their production to more profitable crops, i.e., coca, Colombia won a long-term (19 year) tariff on US rice and corn exports to allay these fears. At the time of this writing (February 2008), ratification of the US-Colombia FTA by the US Senate is still in doubt because of alleged human rights abuses by the Colombian government and, more generally, because of the putative “anti”-union position of the Colombian government. However, even if the
FTA is not ratified by the Democratic-controlled US Congress since the treaty is becoming a hostage of the approaching US elections later this year, the already existing trade promotion program with the US -- the Andean Trade Promotion and Drug Eradication Agreement (ATPDEA) -- has been extended for the 2009-11 period.

Once again it is important to observe the poisonous role that Colombia’s continuing civil strife and associated drugs production and trafficking plays in the country’s relations with its most important regional partner, the United States, and how the inability to bring the violence and civil strife to a conclusion after decades of conflict continues to impede Colombia’s integration with the regional and global economy.

H. Privatization

Reducing the role of the state in the ownership and management of economic enterprises is another important ingredient to improve the micro-economic substructure of the national economy because privatization – when correctly implemented – enhances economic efficiency, reduces the level of corruption, and improves the public finances. For example, Colombian ports handle about 80% of international cargo. As a result of the privatization of Colombia’s ports in 1993, efficiency in handling cargo at the ports has improved greatly (EIU, 2006, p.19).

The 1990s was characterized by rapid economic liberalization and since the mid-1990s over 150 public enterprises –spanning over 19 different sectors – have been restructured, merged, or liquidated. At the end of the 2006, approximately 60 enterprises, mostly in the energy, telecoms, and social services sectors remained under government ownership. Privatization of these enterprises are deemed difficult because of political and even constitutional impediments (see the Introduction, above). Nevertheless, these enterprises are being restructured in order to become more “commercially oriented”, so they will ultimately contribute to, rather than make claims on, the public finances (please see section E, above). For example, in 2003 these enterprises, together, were loss making, with a short fall equal to 0.3 % of GDP, but by 2005, together, they were yielding profits equivalent to 0.7% of GDP (IMF, 2006, p. 3).

When opportunities for further privatizations arise the Uribe Administration has seized them. Because of its abundant hydroelectric capacity only 32% of Colombia’s electrical generating capacity is derived from thermal sources. To date about 50% of total electricity generation and distribution capacity is in private hands, but the government is planning to privatize a dozen regional distributors and to sell its stake in the largest transmission company (EIU, 2006, p.21). Ecogas, the state-owned gas company, was divested in 2006, and most of the banks, nationalized in 1998-9 in the wake of the deep recession and high interest rates, have been sold off with the exception of Banco Agrario that will remain in state hands. In addition, Colombia’s state-run coal company, Carbones de Colombia, was privatized in 2000.

Colombia’s oil production has declined from more than 800,000 b/d in the late 1990s to 540,000 b/d in 2006, with some experts voicing their concerns that without fundamental changes in the sector, the country, over time, will become an oil importer. The decline in oil production has been attributed to a combination of an unfavorable tax environment, capacity outages due to the continuing guerrilla-related violence, as well as technical reasons. The government decided to partly privatize Ecopetrol, the state-owned oil company, in order to improve the prospects for increasing oil production and to improve the public finances. As a result, bucking the trend in the region (and for that
matter, in the world), the Colombian government sold off 20% of Ecopetrol, the largest public enterprise in the country, which generated a surplus in 2005 equivalent to 3.6% of GDP. The share sale has contributed to raising investment capital to increase future production levels, and will also lead to an improvement in corporate governance by increasing the independence of the company’s board of directors from political interference.

As business confidence in Colombia is restored, to a large degree because of the improved security situation in the country, privatization and the sale of concessions have gained pace as government policy is deliberately targeting greater private and, in particular, foreign investment through regional trade integration (see section G, above), financial liberalization (see section J, below), along with a more attractive legal and regulatory environment (see section F, above).

I. **Elimination of Barriers to Foreign Direct Investment**

Another important metric in measuring the integration of a national economy into the global economy is the degree of its openness to foreign direct investment which facilitates the acquisition of modern technology and the transfer of innovative management skills to the end of increasing domestic labor – and more generally, total factor – productivity, and, ultimately, raising national living standards. Attracting (and retaining) foreign direct investment requires economic, regulatory, tax, legal, and security environments that are receptive to foreign capital.

Until recently, Colombia suffered from judicial, fiscal, and regulatory uncertainty that served as a significant obstacle deterring private sector investment in general, and foreign investment, in particular. In the critical energy sector the rules governing tax and royalty payments and other regulations, until recently, have been characterized as “moving targets” (Wilson, 2001). As ever in Colombia, over the last decade the militia- and guerrilla-related violence and civil strife (including the high kidnapping rate and other security risks) have been unhelpful in nurturing a business climate conducive to attracting foreign investment. The data on foreign direct investment, reported below, support this assertion.

As a result of the aggressive privatization program pursued in the 1990s (see section H, above), FDI peaked at US$5.6bn in 1997, but as the security environment deteriorated in the second half of the 1990s, by 1999 FDI fell to US$1.5bn (EIU, 2006, p.43). However, as a result of the improved economic, regulatory, tax, and political environment created by the Uribe Administration, in 2005 FDI increased to US$10.2bn.

Some of the measures introduced to attract more FDI since the turn of the century, include: a new mining code approved by Congress in 2001 to foster technological modernization in the antiquated precious metals sector. (Colombia is the world’s leading producer of emeralds, and the fourth largest producer of platinum). Along with a reduction in the royalty and tax rates (Webb-Vidal and Lapper, 2004), security concerns have receded, and international commodity prices have firmed, the large multi-national resource and energy companies have been returning to explore for and develop new resource deposits as the government provides security support in the country’s resource-rich regions. As was mentioned above, at the end of the last century Colombia – an under-explored country – was producing 830,000 b/d of oil and by 2005 that fell to 540,000 b/d, and without more exploration and development of new fields the country
risks becoming an oil importer (instead of a small oil exporter) by the end of this decade (Forero, 2004, Webb-Vidal and Lapper, 2004).

With the more stable investment environment that, in part, has resulted from the improvements in security along with critical tax and regulatory reforms and the continuing liberalization of economic activity that includes deregulation, privatization, and deeper regional and global integration, at this time FDI is “pouring into Colombia” (Farzad, 2007). These foreign investment flows extend from the traditional export sectors such as coffee, oil, flowers, and coal to utilities and financial services as well as the manufacturing sector, mainly into food processing, chemicals, and heavy industry (EIU, 2006, p.37).

Foreign companies such as BP-Amoco (UK), Occidental Petroleum (US), Chevron-Texaco (US), BHP-Billiton (UK-South Africa), Anglo-American (Australia), and Drummond (US) own oil, natural gas and coal assets, as well as pipelines to transport these commodities. Many of these mineral assets are co-owned with Ecopetrol, the partly privatized state-owned oil company. Coal assets were sold off during the privatization of the state-owned company, Carbones de Colombia, in 2000. In July 2006, construction began on a joint project between Colombia and Venezuela to build a 230 km pipeline to transport natural gas from the two countries to Central America, which is expected to be completed in the middle of 2008.

Finally, in May 2007, the “single enterprise free-trade zone” was launched and, to date, has attracted almost $900m in FDI. This investment initiative provides participating corporations with reduced tax rates of 15%, provided they meet certain investment criteria on investment levels and employment targets (O’Grady, 2008). The stalled FTA with the US is already affecting the success of this initiative since the exports of companies in “the free-trade zone” would enter the US duty-free.

J. Banking Reform and Financial Liberalization

Another important ingredient for globalizing a national economy is banking reform, and more generally, financial liberalization. According to a recent IMF study, “In an unliberalized financial system, the government plays a large role in determining who gives and receives credit and at what price… Proponents of liberalization point out that financial development is strongly associated with economic growth. They argue that the allocation of capital is more efficient in a increasing the funds available to finance investment. Moreover, government allocated credit tends to be characterized by poor lending decisions, weak repayment discipline, and government corruption, since those granted access to capital (usually at low rates) may buy influence to protect their favored positions” (Abiad and Mody, 2005).

The globalization of finance was begun over a quarter century ago as a result of the continuing liberalization in trade- and more recently, capital-accounts in both developed, transition, and emerging market economies along with the gradual adoption of market-based exchange-rate systems in all these groups of countries. This was complemented with a rational exploitation of technological changes manifested in the transport, communications, and information technology sectors, enabling policy makers in emerging market economies to recognize the importance of domestic financial liberalization and modernization that includes not only deregulation and privatization in
financial services -- including pension reform – but also through the adoption of “first world” banking, securities, insurance, and accounting regulatory standards in order to attract foreign portfolio capital for the purposes of increasing real investment in the domestic economy towards the objective of enhancing growth prospects and future living standards.

To this end, Colombia, in the 1990s, as a part of the liberalization of its services sector (see sections F and H, above), engineered a shift from specialized banking to a multi-functional banking system whereby credit institutions which specialized uniquely in commercial banking, mortgage banking, financing industrial projects, and financing the purchase of equipment or consumer durable goods through commercial loans or leasing agreements, and finance companies were gradually encouraged to offer the full spectrum of financial products (EIU, 2006, p.36).

The financial sector, as a result of the deep economic recession and high interest rates in 1998-99, was on the brink of financial collapse. The “clean-up” of the sector included the nationalization of a number of financial institutions and the liquidation of others, including a few foreign-owned banks.

With the restoration of economic growth in 2001 – and an economic boom since 2004 – lending to both business and households has increased and delinquency and default rates have fallen, all in response to the improved economic prospects that are, in part, attributable to the improved security environment as the level of violence and crime have been ratcheted down by the current government.

One area of concern that could dampen economic growth prospects is the rapidly increasing proportion of bank assets that are represented by government debt – around 60% in mid-2006 – due to the chronic deficits of the central government (see section A, above). Not only does this lead to a “crowding out” of private investment – resulting in higher cost of capital for business and households – but it also forges a direct link between banks’ balance sheets and the government’s financial credibility (EIU, 2006, p.37).

The Uribe Administration is re-privatizing the financial sector. In November 2005, Granahorrar, one of the three remaining state-owned banks was sold to a local branch of BBVA, a Spanish bank, and another state-owned bank, Bancafé, was privatized at the end of 2006. Only one commercial bank, Banco Agrario, is to remain state-owned.

Like many other developing countries, Colombia’s capital market is under-developed because of low savings rates and structural and environmental weaknesses that include economic uncertainty due to the decades of civil strife and political tensions that have been dissipating as a result of current government policies. In the past local banks have rarely committed money for more than three years, therefore the main source of long-term capital has been from foreign sources. Access to Colombia’s corporate bond market has historically been limited to the country’s top corporations. Following the global trend of consolidation of stock exchanges, in mid-2001 the Bogotá, Cali, and Medellín exchanges merged to form the Bolsa de Valores Colombia (BVC).

New legislation approved in 2005 on Colombia’s capital markets, once fully implemented, will improve corporate governance standards, provide greater protection for minority shareholders, and enhance the transparency of corporate financial statements, all in concert with recent global trends in these areas.
Finally, with regard to over-all regulation of the financial services sector, following the example of the United Kingdom’s all-embracing financial services regulator, the Financial Services Authority (FSA), since 2006 an umbrella regulator for the banking and securities industry, the Financial Superintendency, oversees all financial institutions in Colombia (EIU, 2006, p.37).

**Conclusions**

Throughout this paper I have enumerated the widespread economic and financial consequences to Colombia’s material wellbeing that have resulted from the sustained (and often horrific levels of) violence and lawlessness inflicted on both the country’s rural and urban population over the last half century. The unrelenting civil strife -- with the associated trafficking in illegal drugs -- has created a “laundry list’ of economic and social by-products: demographic imbalances, a loss of human capital because of widespread emigration, high rates of unemployment because of mass migration from the insecure rural areas to the less violent cities, increased poverty rates, lost inward investment because of a lack of economic and public security, reduced exports resulting from terrorist attacks on transport and distribution infrastructure, reduced government expenditure on education, health, and physical infrastructure because of bloated spending on military and other counter-terrorism expenses, continued (and increasing) stress on the public finances, an unfriendly business environment (manifested through high taxes, economic and regulatory uncertainty, fears of kidnapping and extortion), and even adverse environmental impacts on Colombian rivers because of the contamination caused by chemicals used in the aerial spraying of the coca crop.

Even Colombia’s continuing integration into the regional and global economies has been adversely impacted by the half-century of civil strife. As was mentioned above, it is becoming increasingly unlikely -- as US national elections approach later this year -- that Colombia’s pending FTA with the US will be ratified by the US Congress because of alleged human rights and anti-union violations committed by the Uribe Administration’s anti-terrorist policies.

Other major issues described above that are retarding the growth potential of the economy and an improvement in living standards, are: a more rational tax code, especially at the corporate level; further deregulation of the labor market and a reduction in the “underground” economy; reducing the level of corruption in state institutions (including regional governments); improvements in road, rail, and port infrastructure; and increased rural development – including land reform. Most of the institutional and political weaknesses described and analyzed in Alesina (2005) still have not been addressed. It is becoming increasingly likely that most of these issues, because of domestic political constraints, will not be resolved before the Uribe Administration’s term in office ends in 2010.

However, despite the likelihood of recession in the US in 2008-09, the ongoing once-in-a-generation “super-cycle” in commodities is likely to benefit Colombia as it exploits its comparative advantage in natural resources. With the largest coal reserves in Latin America, Colombia’s high quality thermal deposits are being brought into production, of which 90% is exported. Colombia is currently the fifth largest coal exporter in the world. One half of total Colombian exports are still based in commodities: coffee, coal, ferrous metals, emeralds, and oil. Opportunities over the next decade also
include the potential to be a significant exporter of ethanol, as a result of Colombia’s abundant acreage that is available for growing sugarcane.

In conclusion, over the last six years Colombia, in large part as a result of the efforts of the Uribe Administration, has made enormous progress in reducing the appalling absence of security in a country that has been at war with itself for the better part of the last 50 years. FARC, by almost any measure, is on the defensive, both militarily and politically. The costs to the population and to the economy, as this paper has tried to highlight, have been astounding. The big unknown is whether there is enough political will -- along with the resources -- to “finish the job”.

**References**


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