Adjustment with growth: Colombia's experience

Resolute domestic policies, combined with external financial and policy assistance, can help achieve both

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A characteristic of the first half of the 1980s has been the external debt problems facing many developing countries, especially in Latin America, and the efforts to cope with them. It has become increasingly apparent that domestic policy adjustments, especially if they are to be politically and socially acceptable, are unlikely to be sustainable over the medium term unless they are accompanied by economic growth.

The experience of Colombia during this period illustrates the scope for adjustment with modest growth based on domestic policy reforms and coordinated support from the international financial community. In the wake of increasing external sector problems, Colombia adopted in stages a package of stabilization measures affecting exchange rate, fiscal, monetary, and external borrowing policies, supported by pro-trade reforms and investment programming aimed at maintaining growth. This was an important step in the development of a growing consensus regarding the need for a medium-term approach to adjustment and structural reforms. The understandings reached among the government authorities, the commercial banks, the IMF, and the World Bank concerning the economic program, and the associated financing support and monitoring arrangements, described below, are the major elements of the Colombian program.

There are significant differences between the Colombian case and that of many other major debtor countries. Most important, perhaps, is that Colombia had not overborrowed in the 1970s and become embroiled in severe debt-servicing difficulties; the ratio of total debt service to exports of goods and services in the early 1980s was about 30 percent. While the country's terms of trade declined sharply in the early 1980s from their high levels during the coffee boom (1976–80), they were similar to the levels of the first half of the 1970s. Overall, the Colombian economy has not been characterized by severe distortions, and the needed adjustment was, therefore, relatively mild. Nevertheless, Colombia faced a potential balance of payments crisis in the first half of the 1980s, and the process of anticipating and averting it, while addressing medium-term growth issues, makes the Colombian case an interesting one. It is also worth noting that each country experience would be in some sense unique, and this factor should not detract from drawing useful lessons.

Need for adjustment

Colombia has achieved significant economic growth over the past quarter of a century, contributing to the transformation of a predominantly rural economy into one that is more diversified, urbanized, and industrialized. Successive governments have, by and large, shown pragmatism in policy making, placing a premium on gradualism and caution. Major policy swings have been avoided, including the temptation to borrow excessively from external sources during the 1970s. Despite these positive elements, however, certain shifts in economic policy—partly triggered by external factors—led to economic difficulties in the first half of the 1980s.

An outward-looking, growth-oriented strategy pursued from the mid-1960s to the mid-1970s produced impressive results in performance (see table). In particular, non-coffee exports took advantage of the more liberal trade policies: in addition to an increase in traditional exports, such as textile and leather goods, a variety of products, such as flowers, children's books, stoves, and workers' gloves, registered an impressive showing. In the second half of the 1970s, economic developments were dominated by a boom in export earnings from coffee (and also from unrecorded exports) and, partly as a result, the outward-looking policies with strong incentives for non-coffee exports began to weaken. The coffee revenue boom which lasted until 1980, together with favorable external conditions (e.g., for borrowing), sustained growth and employment.

The post-1975 policies led to certain structural weaknesses, which were further compounded by developments in the early 1980s. The coffee boom of the 1970s set in motion two forces that contributed to a significant appreciation of the real exchange rate. First, the real exchange rate may be thought of as the price of tradable goods relative to that of nontradable goods; higher disposable incomes generated by the boom increased the demand for both. The prices of tradables are largely determined internationally, whereas the prices of nontradables tend to rise in view of the increased demand, implying an appreciation of the real exchange rate. Second, the accumulation of foreign exchange, not fully offset by higher imports or by sterilization, produced increased domestic credit expansion, higher inflation, and an appreciation of the real exchange rate.

While the coffee boom was over in the early 1980s, the growth in aggregate demand was maintained through higher public expenditures and foreign borrowing, thus sustaining inflation and the appreciation of the real exchange rate. This, together with worsening external conditions—that is, falling commodity prices and a tightening of capital markets—created serious difficulties for the external sector. Mainly in view of Latin America's debt problems, Colombia also suffered cuts in trade credit lines and normal commercial bank lending. At the same time noncoffee exports declined and international reserves fell sharply (see table). The balance of payments problems served to highlight a variety of constraints of a short- and medium-term nature. With an appreciated exchange rate, Colombia began to lose ground in international markets not only in commodities experiencing falling prices but also in such items as textiles in which the country traditionally had a comparative advantage.

In addition to a correction of the exchange rate, the trade regime needed reform in several ways: a reduction in import restrictions, a better functioning of the duty drawback schemes (i.e., tax credit in the equivalent amount of customs duties paid on imports of designated inputs), the removal of export barriers, and improvements in export quality. Equally fundamental, the underlying fiscal deficit had to be reduced, along with the rate of domestic credit expansion, in order to permit a reduction in inflation and an improvement in Colombia's competitiveness. Medium-term support to such macroeconomic reforms needed to be provided through better public investment programming and sectoral policies.

Historically, Colombia's economic performance has been influenced by coffee cycles. A basic difficulty affecting the external sector has been judgments concerning the duration of external shocks—whether coffee price booms or reversals in capital flows—and, therefore, the speed and degree of needed domestic policy adjustments. The problems of the early 1980s led to considerable debate regarding the appropriate policy responses. Eventually the authorities implemented a tax reform and adjustment program, discussed below, to avert a potential economic crisis. As a result, major economic indicators showed a sharp improvement in the economy by 1985; in particular the balance of payments strengthened while modest growth was maintained. Subsequently, coffee prices rose significantly in the first half of 1986, further improving the reserve position. The availability of increased resources provides the possibility for maintaining and firming up adjustments while revitalizing growth. It also calls for sustaining the incentives for non-coffee production and exports, and maintaining monetary and price stability.

The 1985 economic program

Key to the program have been stabilization measures reducing the public sector deficit and the rate of monetary expansion. Revenue measures produced additional revenues for the Central Government of 47 percent and, combined with expenditure reductions, lowered the overall public sector deficit as a percentage of GDP by over one third to less than 4 percent in 1985. At the same time, Central Bank financing of the deficit was cut by about three fourths. A concerted exchange rate policy, namely an acceleration of the depreciation of the currency, brought about an unprecedented 30 percent depreciation of the real exchange rate by the end of 1985.

Meanwhile, a gradual opening up of the trade regime began, paving the way for more medium-term adjustments in the future. During 1985: (1) the number of items under the free license regime was increased by 1,135 (out of a total of 5,011 items), raising the share of free imports from 30 percent to 56 percent of the value of total imports; (2) the number of prohibited items has declined from 828 to 69; (3) tariff reform has produced a reduction in the average tariff level from 36 percent to 28 percent in 1985, accompanied by a reduction in dispersion of tariff rates; and (4) the number of items affected by export restrictions has been reduced from 729 to 175.

In a complementary effort, the Government has been revising its public investment plans, reducing their scope to match available resources and reorienting their composition. In scaling down the public investment and borrowing targets in line with the requirements of the stabilization program, emphasis has been placed on investments geared toward export-oriented activities and essential infrastructure development (such as ports and rural roads), postponing or redesigning large lower-yielding investments, particularly in power and transportation. The analysis of the investment program has, in principle, placed emphasis on the following criteria, while their implementation is to be followed up over the medium term: (1) increasing output rapidly; (2) reorienting production toward exports and efficient import-competing goods; (3) supporting quick-yielding infrastructure investments, particularly those that enable the use of existing facilities more intensively; and (4) increasing domestic resource mobilization.

Financing arrangements

Fundamental to the adjustment program has been a restoration of normal credit lines (about $1.5 billion annually), a resumption of commercial bank lending to the country, increased exposure of the World Bank and the Inter-American Development Bank, and the underlying policy understandings among the Government, the World Bank, and the IMF. On the basis of the latter arrangements, a $1 billion commercial bank loan was signed at

Economic performance, adjustment, and growth, 1970–86

(Annual averages)

	Export-led growth	Coffee boom	Growth recession		Adjustment with growth		
	1970–75	1976–80	1981–83	1983	1984	1985[1]	1986[1]
Performance indicators							
GDP growth	5.7	5.5	1.3	1.6	3.2	2.9	4.5
Export growth[2]	6.9	7.4	−5.2	−11.9	9.8	13.9	22.0
Import growth[2]	2.2	11.1	3.2	−8.4	−7.8	0.8	2.5
Inflation rate	17.1	24.5	24.9	19.8	16.4	24.0	20.0
Current account/GDP ratio	−2.9	1.2	−6.5	−7.3	−5.3	−3.9	−0.5
Reserves (months of imports)	2.7	8.1	7.9	5.0	3.1	3.5	4.6
Debt-service ratio[3]	22.7	14.7	31.1	36.9	37.2	38.2	34.0
External factors							
Nominal coffee price index[4]	84	133	88	89	98	99	135
Net capital inflow (US$m)[5]	284	543	1,699	1,014	710	1,576	1,000
OECD growth rate	2.1	3.6	3.3	2.3	4.7	3.0	2.0
Domestic policy							
Real exchange rate index[6]	89	85	75	75	82	107	110
Money base growth	23	35	18	14	18	27	28
Public sector deficit/GDP ratio	3.0	5.5	6.8	7.6	7.6	3.7	2.0
Imports[2]/GDP ratio	15	15	17	16	14	16	17

Sources: Colombian Ministry of Finance, IMF and World Bank estimates, and OECD *Outlook*.
[1] Preliminary. Note that the significant improvement expected in the balance of payments in 1986 is partly the result of the coffee boom.
[2] Goods and nonfactor services.
[3] As a proportion of exports of goods and services.
[4] 1970 = 100.
[5] Capital account balance, including errors and omissions.
[6] The calculations are based on a trade-weighted currency basket, with 1975 = 100. An increase is defined here as a depreciation of the peso.

the end of 1985. The World Bank's enhanced support was illustrated by the approval of a first policy loan in 1985, the Trade Policy and Export Diversification (TPED) loan for $300 million, and a second policy loan in 1986, the Trade and Agricultural Policy (TAP) loan for $250 million, which are to be seen as part of a total financial package in support of the program. The IMF's Board approved a *sui generis* monitoring arrangement without a stand-by arrangement for 1985–86.

These arrangements were set up against the backdrop of the World Bank's role in Consultative Group Meetings, which go back to 1961 when the first Bank-sponsored meeting was held for Colombia. In line with the shift from official to private lending for Colombia, the meetings in the 1980s have included representatives not only of the Government but also of commercial banks, and in 1983 for the first time, exclusively private financial institutions and representatives of export credit agencies. In the wake of the external sector difficulties, the commercial banks, in 1984, sought monitoring of macroeconomic performance by the Fund and of certain structural reforms by the Bank as a condition for restoring capital flows to Colombia. Together with overall assessments of the economy by both institutions, an arrangement has been established whereby the Fund would monitor stabilization performance (including fiscal, monetary, and exchange rate policies) and the World Bank would focus on trade and public investment (including import liberalization, export promotion, and investment priorities). Pursuant to these understandings, agreements in principle were reached on providing for the financing needs of Colombia at a bankers' meeting for Colombia during April 16–19, 1985.

Following the restoration of the lines of credit, the term facility of $1 billion was subsequently negotiated with commercial banks for 1985–86 to be disbursed in six quarters beginning with the third quarter of 1985 and ending with the fourth quarter of 1986. Conditions of the initial loan drawdown were confirmation by the Fund that the 1985–86 program would qualify for a stand-by arrangement had one been requested, and meeting of the target agreed with the Fund for end-June 1985. Subsequent quarterly drawdowns required Fund certification of satisfactory performance in the previous quarter. Disbursements in 1986 were also subject to Fund approval of the 1986 economic program and compliance with quarterly targets, as well as release of the World Bank's second tranche of the TPED loan. (This schedule, however, was delayed because the signing of the $1 billion loan took place at the end of 1985, and the financing became available for 1986.) The first Bank review was held in February 1986 and satisfactory performance enabled the release of the second tranche of the TPED loan. The review took into account the findings of the Fund, which conducted its review of the program at the same time. In connection with the TPED and TAP loans and subsequent sectoral adjustment loans, the Bank was to assess the medium-term policy performance, particularly in the areas of trade, and the investment and borrowing programs. Under the terms of the lending facility, Colombia undertook to make available to commercial banks the Fund and the Bank reports.

Lessons of experience

A well-designed and executed adjustment program is key to addressing the external sector and debt problems, although the decision-making process is by no means likely to be easy. In Colombia, opposition to import liberalization has been strong, as has been the case in regard to fiscal restraint. What has emerged from the country's experience, nevertheless, is the importance of accepting trade-offs and disagreements pragmatically, and acting decisively. Policy actions were taken in Colombia with a view to averting a crisis, even if somewhat late, rather than in reaction to one. The willingness and ability to stay the course, in the face of short-term costs, are equally important. Recent sweeping reforms in other Latin American countries perhaps also reflect the growing recognition of such an approach.

Consensus building, which is essential to sustaining adjustment, requires a significant amount of time and the capacity to experiment. Addressing simultaneously the stabilization and adjustment requirements has been essential in Colombia; this is likely to be the case in other countries, although the phasing and sequencing of measures would depend on individual circumstances. The pace of reforms would have to take into account the sustainability of change, especially when various interest groups are affected. In Colombia private interests are represented in the Government decision-making process in a variety of ways: the participation of private sector representatives in the boards of government bodies; management of the Coffee Fund by the coffee producers together with the Government; and rotation of managers and personnel between the public and private sectors. Policy making has often been based on broad consensus and, as a result, policy changes have been gradual. In certain situations, therefore, such as the Colombian case, there may be a premium on gradualism in policy change, and on balancing economic, political, and social considerations, in order to avoid costly policy reversals.

While stabilization is essential, the goal of sustaining growth puts increasing emphasis on adjustments of trade and public investment policies. Where budget deficits are to be cut, some pruning of investment might follow once consumption expenditures are lowered and revenues are increased. To the extent that public investment is to be contained, even greater emphasis would need to be placed on a careful review of the program to ensure the protection of high priority projects and to facilitate greater yields per unit of investment. Similarly, to prevent demand management from unduly restricting imports, reforms of the trade regime to reduce any anti-export bias and to promote exports are desirable. Colombia has been able to combine a sharp reduction in the fiscal deficit with a vigorous real exchange rate depreciation and a gradual opening up of imports, thereby improving incentives for exports. In Colombia and elsewhere, support for increased domestic resource mobilization and export generation over the medium term is critical for sustained growth.

Structural changes—in macroeconomic policy and in sectoral and institutional areas, including the elimination or restructuring of state enterprises—need to be considered. Although they have a positive impact on economic growth, structural adjustments are often more difficult for governments to implement than a cut in expenditures or monetary restraint. Sometimes the negative impact of such adjustments is felt by some sectors before the positive effects are experienced in others. To be sure, an adjustment in the exchange rate and producer prices may have an immediate and favorable impact on growth, but the full impact may take time to emerge. Linking macroeconomic policies to sectoral reforms and financing would be key to minimizing the costs of adjustment at the sectoral level. Colombia's second policy loan seeks to improve agriculture's ability to adjust to macroeconomic reforms by improving investments, particularly in less accessible regions, and strengthening input supplies. In the financial sector, the Government has been assisting in the capitalization of entities facing severe problems, thereby improving the ability of the financial sector to adjust to the macroeconomic reforms.

The external financial community

The IMF and the Bank share common and complementary objectives: sound macroeconomic policies are an essential base for implementing structural reforms, and economic stability promotes sustained economic growth. Furthermore, the financial community has found that the Fund's macroeconomic country reports together with the Bank's assessments of the economy, the sectors, and the investment program provide a firmer base on which assistance programs may be formulated and financing requirements evaluated. In this manner the Bank and the Fund have complemented one another to assist Colombia with its adjustment efforts.

Considerable flexibility has been a helpful feature of the Colombian experiment. For example, external debt targets vary within a range depending on debt policies that can, in turn, be affected by the extent of the coffee boom. Moreover, flexibility has facilitated the coordination of decision making of the country, the IMF, the commercial banks, and the World Bank. Coordination of financing among the above and other external financing agencies is also desirable. While it is important for development agencies to frame assistance in a medium-term setting, it may also be important to be flexible and responsive to new development opportunities arising because of changing economic conditions. In this context, and as is being considered for Colombia, bilateral agencies might provide a proportion of their lending in quick-disbursing, untied assistance to support improved policies in addition to that for individual projects.

Timely mobilization of external private capital is also necessary. The catalytic role of policy-based lending by the Bank—by associating commercial bank financing with such lending operations—and the Fund's policy advice and monitoring role are a key aspect of the Colombian experience. Mobilization of private equity financing, involving reviews of the country's endowments, priorities, policies, and regulatory environment, is also likely to become increasingly important. In the Colombian case, the views of the various participants have gradually converged, although the financing interests of export credit agencies might be better tailored to the needs of adjustment.

In recent years, various proposals have been advanced, aimed at substituting generalized solutions for the present case-by-case approach to the debt management problems. They are all born of a conviction that the debt-servicing problems confronting many developing countries cannot be managed within the existing world economic framework characterized, inter alia, by historically high real interest rates and significantly curtailed commercial lending. These schemes have not achieved broad-based acceptance, particularly as they affect conflicting interests among countries and institutions. What the Colombian experience suggests, however, is that with an appropriate adjustment and stabilization program, suitable monitoring arrangements, and associated policy-based lending and support by multilateral agencies, commercial bank lending can be resumed at reasonable levels, with favorable effects for creditworthiness and economic growth. F&D

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