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Directorate of Intelligence

Colombia: Sustaining Economic Reform [redacted]

Intelligence Research Paper

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Colombia: Sustaining Economic Reform [redacted]

Key Findings

Information available as of 1 December 1993 was used in this report.

Colombian President Gaviria almost certainly will be able to sustain his market-opening—or *apertura*—program through the end of his term in August 1994, although impediments in some key areas will continue to slow implementation. Relatively few of the more than 60 pieces of economic legislation that he has pushed through Congress since 1990 will fall victim to political trade-offs during the current election campaign. After tough sledding in 1991-92, his reforms are beginning to take hold: inflation is declining steadily, the fiscal deficit is being contained, and international trade—notably imports—is surging. During his last year in office, Gaviria is likely to keep the pressure on Congress to pass already submitted legislation and to pursue international trade agreements that would make it more difficult for his successor to dismantle the reform program. In addition, the President will look to Washington to publicly acknowledge and reciprocate in tangible ways for the bold steps Colombia has taken. [redacted]

Gaviria will leave office in August 1994 having finally seen the economy begin to respond to his far-reaching reforms. During 1991, for example, economic activity slowed appreciably in response to the shock of his broad reform program, which included simultaneously implementing market-opening steps and pursuing a tough anti-inflation policy. Unexpected setbacks in 1992—notably a severe drought, an energy crisis, and the escape of drug kingpin Pablo Escobar, which undercut the President's personal authority—further slowed implementation. Some sectors of the economy finally began responding to the reforms by late 1992, aided by the government's shift from stringent, inflation-cutting measures to looser, more growth-oriented policies. The continued improvement in the domestic economy during 1993—primarily through the maintenance of relatively low domestic interest rates—is enabling Gaviria to achieve many of his macroeconomic targets:

- Inflation has dropped from nearly 30 percent in 1990 to a projected 22 percent this year.
- Economic growth has recovered from 2 percent in 1991 to an estimated 4 to 5 percent this year. [redacted]

We do not expect Bogota to reverse its overall commitment to trade liberalization or to other major tenets of the reform program, although some minor backsliding is likely during the presidential campaign. The President realizes that the *apertura* program will be a key factor in judging his presidency, and we doubt that he would retreat on reform now that he is

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[redacted]

beginning to see some of the benefits accrue. Gaviria seems determined, for example, to keep inflation under control. This will reduce the chance that economically inspired unrest might complicate election dynamics. However, persistent criticism by leading presidential contenders of the harsh effects Gaviria's market-opening program probably will cause the president to reimpose measures to protect some domestic industries—such as textiles and agriculture. In addition, pork-barrel spending may lead Gaviria to loosen slightly his previously tight control over government expenditures. [redacted]

Gaviria's weakened political standing and significant resource constraints are likely to impede efforts to address the structural problems that still handicap implementation of the President's reform program. Perhaps most important, Colombia's decrepit infrastructure will keep transportation costs high and interfere with local firms' efforts to improve their international competitiveness despite productivity gains. Tough union opposition is likely to continue to stall efforts to cut back the bureaucracy and to privatize key parastatals—although sales of a few firms already in the pipeline may be completed. The government increased social spending by 23 percent in the 1994 budget, but, as occurred in previous years, a portion is likely to be diverted to the military and judicial sectors. As a result, spending on health and education will remain insufficient, slowing development of the skilled work force Colombia needs to support a more advanced economy. [redacted]

Leading presidential candidates, noting the deficiences in Gaviria's program, are using the *apertura* program as a platform to express their own economic views. Indeed, how leading contenders view Gaviria's market-opening program and to what extent they would alter it probably will be key issues in the campaign. The top candidates have questioned Gaviria's rapid pace of reform and are proposing that the country take time to review and assess the changes made to date before pursuing new structural reforms. [redacted]

Instead of pushing for new reforms during the remainder of his term, Gaviria probably will seek to consolidate the changes he has already made and to gain approval for legislation still before Congress. Gaviria is forming a committee composed of leading Colombian industrialists to help institutionalize *apertura* and is likely to devote considerable attention to promoting export expansion among businessmen to balance surging imports. [redacted] the President's priorities also will be to expand economic cooperation with Mexico under the Group of Three and with Chile in hopes of deterring any future backsliding on reform by his successor. He probably will push hard for social security reforms in the legislature, where strong union opposition is delaying action. Any approved legislation probably will fall short of Gaviria's goals, however, leaving the social security system as a major drain on government coffers.

In the year ahead, Gaviria almost certainly will maintain pressure on the United States to reward Colombia for the comprehensive economic reform measures that have been enacted. He hopes to obtain a US commitment to conclude either a bilateral free trade agreement or to place Colombia near the top of the list of countries to accede to NAFTA. As additional quid pro quos, he is likely to offer to strengthen protection for intellectual property rights and to sign a bilateral investment treaty. In meetings with US officials, Gaviria almost certainly will cite the expanding trade relationship, along with the ongoing close antidrug cooperation, as a reason to broaden bilateral ties.

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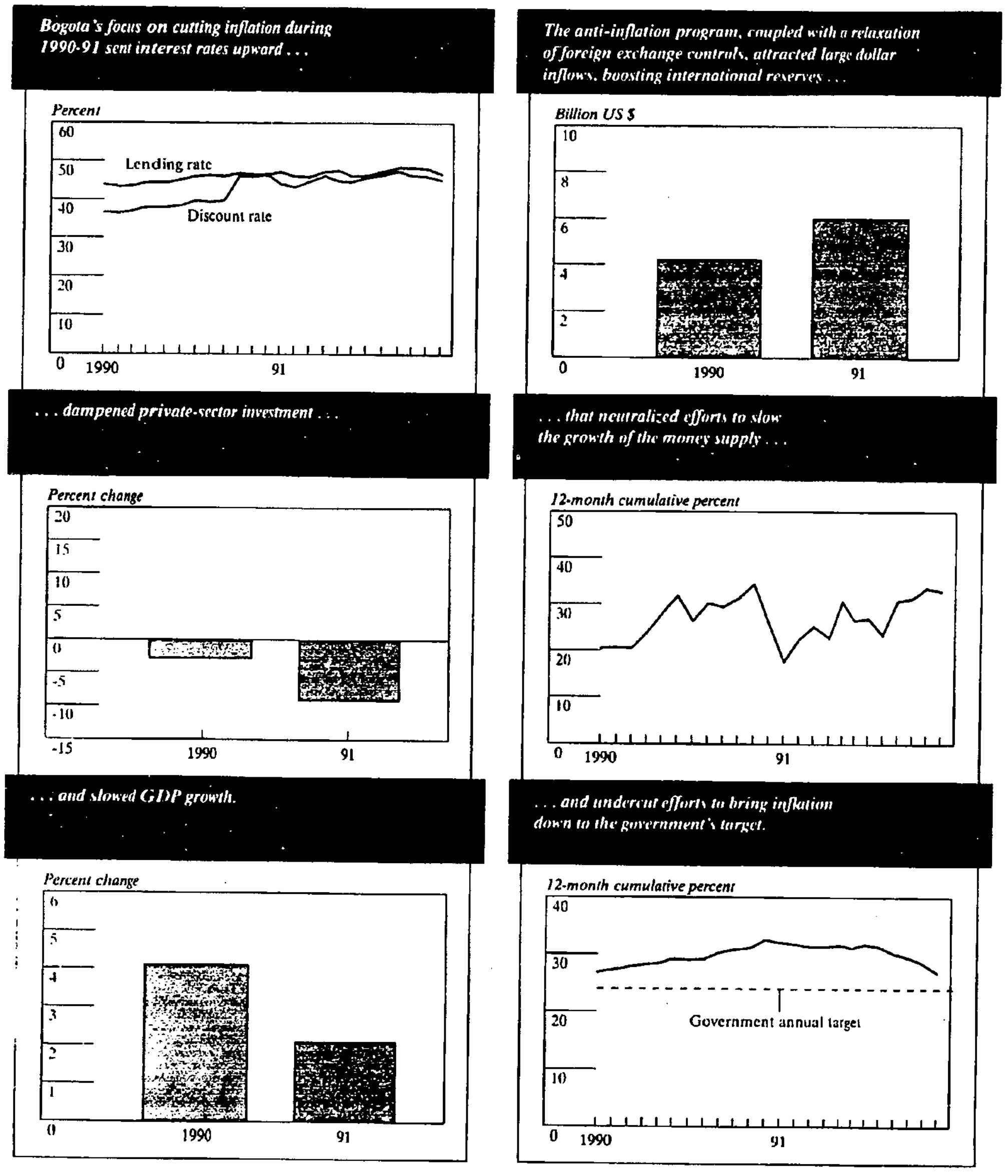
Figure 1
Colombian Economic Reforms: Initially at Cross-Purposes



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Colombia: Sustaining Economic Reform [redacted]

Economy in 1990

Colombian President Cesar Gaviria inherited an economy that had weathered the 1980s in better shape than most Latin American countries. Nonetheless, when Gaviria took office in August 1990, Colombia was struggling with slowing growth, accelerating inflation, and an expanding fiscal deficit. Although the traditionally conservative management style of Colombian economic officials had enabled Bogota to deal effectively with the debt crisis—it never had to reschedule its foreign debt—other domestic difficulties had frustrated efforts to promote more dynamic growth. Under President Virgilio Barco (1986-90), the economy had grown only about 2.5 percent per year. Meanwhile, influential unions were thwarting attempts to scale back state ownership in the economy, resulting in a bloated public sector and excessive wage costs. [redacted]

President Barco's military campaigns against the Medellin narcotics cartel and leftist insurgents emptied government coffers, causing the fiscal deficit to exceed 2 percent of GDP in 1989. Moreover, Bogota's focus on counternarcotics and counterinsurgency diverted funds from infrastructure development, which resulted in high transportation costs and a decline in domestic firms' price competitiveness. Colombia's ports, railways, and roads deteriorated greatly—the ports, in particular, were among the most expensive and most inefficient in the world. [redacted]

Gaviria's Bold Economic Reforms

By the time Gaviria took office, most Colombians recognized that the previous, inward-looking policies were impairing more rapid economic growth and accepted the need for more market-oriented policies. Having noted in his inaugural address that "only nations that export can overcome their crises," Gaviria moved quickly to initiate a series of reforms collectively referred to as the *apertura*, or market-opening, program.[1] *Apertura's* goals were to combat inflation and the fiscal deficit, reinvigorate the economy, and improve Colombia's international competitiveness. A vocal advocate of market-oriented policies, the President strongly believed that the private sector could be the engine for future economic growth, primarily through export expansion. [redacted]

Gaviria hoped that, by increasing productivity and changing businessmen's insular attitudes, Colombia's growth rate would return to the 6 to 7 percent per annum enjoyed in the 1960s and 1970s. In addition, he argued that the market-opening process was necessary to help in the fight against inflation, which was approaching 40-percent per annum and rapidly becoming the country's top economic concern. [redacted]

The measures enacted by Gaviria touched on almost every area of economic activity, from trade and investment to labor policies and financial reform. By February 1991, more than 60 pieces of legislation had been pushed through Congress, virtually without change. The key reforms, listed in order of extent of changes made to each sector, are shown in the appendix. [redacted]

Initial Setbacks, Gradual Gains

Elusive Macroeconomic Targets

Although inflation has trended downward since 1991, it has remained above Bogota's 22-percent annual target until this year. The economic team—composed mostly of young, market-oriented technocrats determined to cut inflation—aggressively

[1] The *apertura* program actually began during the latter part of the Barco administration but was greatly expanded and accelerated by Gaviria. (U)

Figure 2
Inflation

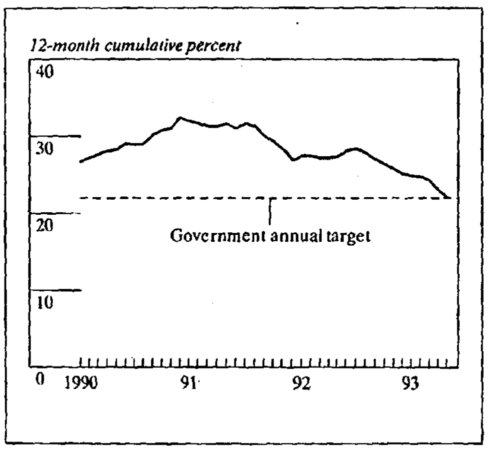

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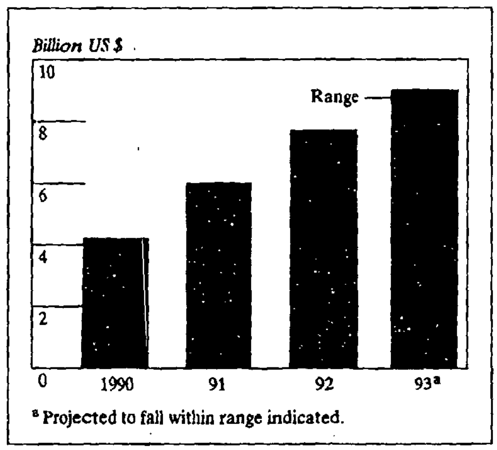
Figure 3
International Reserves



[a] Projected to fall within range indicated.

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pursued such open-market operations as tightening access to credit and increasing interest rates in late 1990 and 1991. These efforts, however, were neutralized by an unexpectedly large flow of funds into the economy. The elimination of most foreign exchange controls had spurred Colombians, including narcotics traffickers, to repatriate their foreign assets. As a result, Colombia's international reserves increased from $4.2 billion in 1990 to $7.7 billion at the end of 1992. In response, Gaviria's economic team abandoned its tight monetary policy approach in early 1992 and allowed interest rates to fall appreciably. Anti-inflation efforts also have been stymied by concessions granting public-sector employees annual wage adjustments above yearly inflation during the past three years. Nevertheless, lower import tariffs have helped reduce some domestic prices by providing producers cheaper access to inputs and creating, to some extent, increased competition in the economy. So far in 1993, lower agriculture prices and continued import competition are enabling Gaviria to reach his 22-percent annual target for the first time since taking office. [redacted]

Gaviria's tax reforms and Colombia's traditionally conservative approach to fiscal policy have kept the budget deficit from spiralling upward but have fallen short of balancing the budget. The 1992 tax reform package, although watered down by congressional opponents, created some new taxes, increased the value-added tax, and strengthened enforcement capabilities against tax evaders. As a result, central government revenues increased 185 percent in nominal terms between 1990 and 1993, [redacted] These new measures, however, did not fully compensate for the revenues lost from cuts in import tariffs, which had been a major source of government funds. Tariff earnings, which accounted for 36 percent of the government's total revenue in 1991, fell to only 18 percent in 1992. At the same time, central government expenditures continued to grow, increasing by 192 percent in nominal terms between 1990 and 1993. A large share of the increase went to strengthening the military and

Figure 4
Government Budget Deficit

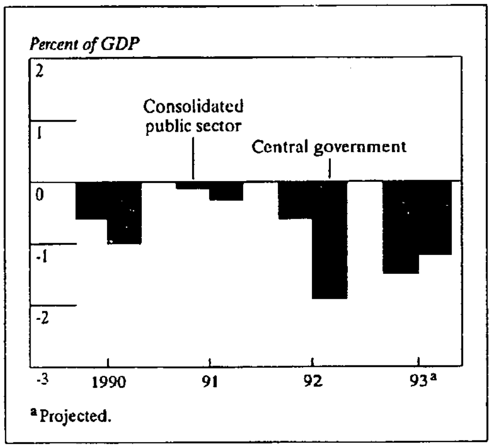

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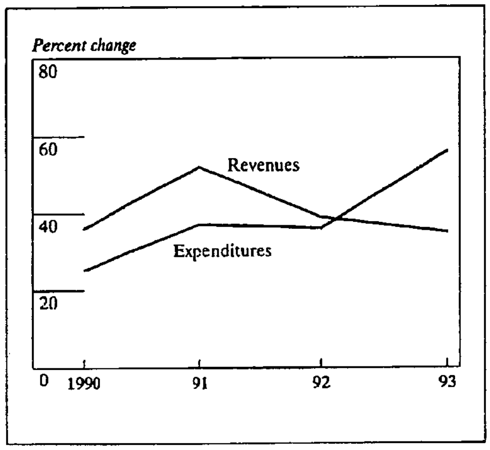
Figure 5
Central Government Revenues and Expenditures



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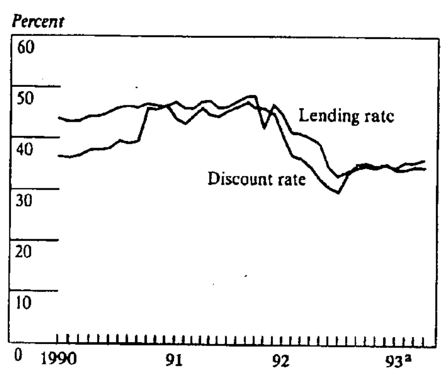
judiciary in their fights against insurgents and narcotraffickers—including the search for drug kingpin Pablo Escobar. Despite efforts to tighten government outlays in 1992 and 1993, Bogota has been forced to make larger than planned transfers to state-owned firms and the perennially plagued agriculture sector and to continue funding a lopsided social security system until reform legislation passes. The budget deficit has been widening in 1993—it is likely to be 1.5 percent of GDP by yearend—as Gaviria pumps up spending on social programs during the election year and refunds more than $250 million collected in 1992 and 1993 under a special "war tax" that was declared illegal.[2]

Economic activity in Colombia, which slowed in the wake of initial anti-inflation measures, is only now regaining its 1990 level. High interest rates in 1991, along with general uncertainty about the course of Gaviria's economic policies, slowed GDP growth to 2.1 percent. The economic team's decision to push down domestic interest rates in early 1992, however, led to a quick recovery in capital investment, construction activity, and consumer spending. Business efforts to increase sales abroad, however, have been thwarted by a stronger peso. Finance Minister Hommes has allowed the peso to appreciate during the past two years because he is concerned that a faster pace of devaluation would create additional inflationary pressures. Problems were compounded in 1992 by a severe drought, which lowered reservoir levels and dramatically curtailed hydroelectric power—the source of 80 percent of Colombia's energy supply.[3] As a result, major cities across the country incurred blackouts

[2] Despite government pleas to the public to forgo the refunds, fewer than 1 percent of them have been waived as of late June, according to press reports. (U)

[3] The drought resulted from the *El Nino* weather phenomenon. *El Nino*, which occurs every five to eight years, is caused by shifts in the position of the cold Humboldt current in the Pacific Ocean, which changes rainfall patterns, temperatures, and tidal flows. (U)

Figure 6
Interest Rates



[a] Through April 1993.

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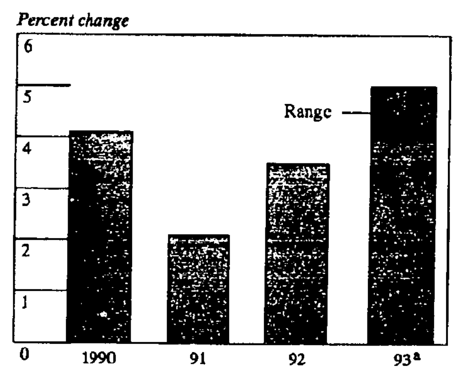
Figure 7
GDP Growth



[a] Projected to fall within range indicated.

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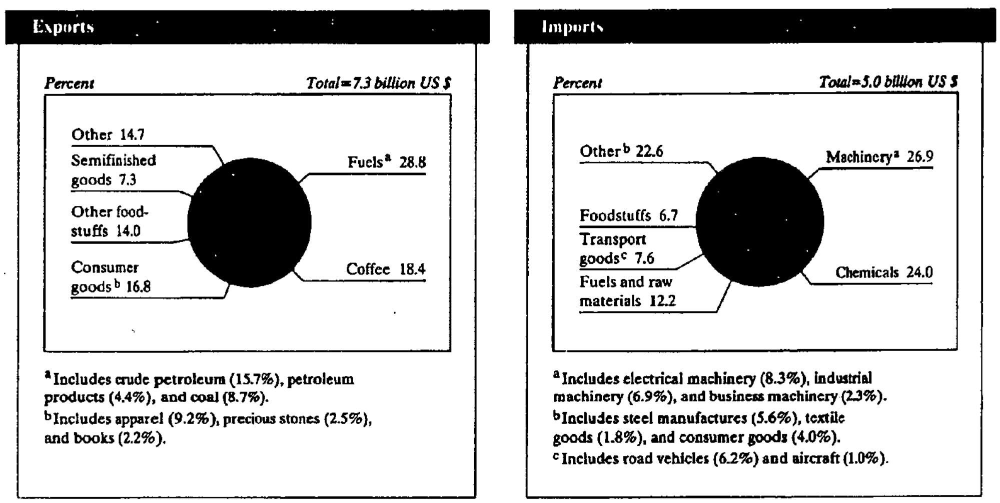
of up to 10 hours a day. Nevertheless, Colombian firms were able to adapt, aided by lower import barriers that made it easier for them to acquire inexpensive generating equipment from abroad. As a result, GDP growth rebounded to 3.5 percent in 1992 and is expected to reach about 4 to 5 percent this year. [redacted]

Weakened Trade Balance

Liberalization has reversed Colombia's longstanding trade surplus. In 1991, the economic slowdown deterred local firms from taking advantage of lower duties, resulting in an 11-percent drop in imports. The country's stronger performance in 1992, however, coupled with the implementation of free trade agreements with Venezuela and Ecuador and progress in eliminating trade barriers with other Andean Pact countries, caused imports to jump 35 percent, contracting the trade surplus by $2 billion, to $232 million. Attempting to satisfy pent-up demand for foreign goods, firms and individuals purchased all types of products, including machinery and equipment, automobiles, apparel, and jewelry. Colombian officials currently are projecting imports to increase by about 20 percent this year and to exceed exports for the first time since 1985. [redacted]

Exports, in contrast, began to stagnate as Bogota cut subsidies, global commodity prices fell, and the peso appreciated. Sales abroad fell by 5 percent in 1992, primarily the result of falling prices for traditional exports—oil, coffee, and coal, which accounted for nearly 50 percent of Colombia's 1992 export earnings. Some nontraditional exports—such as chemicals, plastics, and agricultural products—showed gains last year, but overall growth of nontraditional exports remained flat because of the stronger Colombian peso.

Figure 8
Composition of Trade, 1991



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Colombian firms also have been slow to develop export strategies and to exploit their preferential access to the US market under the Andean Trade Preference Act—total exports under ATPA amounted to less than $190 million in 1992. They also failed to take major steps to prepare for more competitive market conditions. A recovery in some commodity prices, such as coal, is helping to boost exports this year—possibly by 7 percent, but the gain is not enough to offset the continuing surge in imports. [redacted]

Foreign Investment Recovering

Although Gaviria's significant liberalization of foreign investment regulations has helped foreign investment rebound somewhat since he took office, it remains weak except in a few specific sectors, such as petroleum. In 1992, foreign direct investment totaled $740 million, with less than half going to nonpetroleum sectors. In response, Gaviria established a commission in early 1993, composed of various senior government and private-sector representatives, to develop new ideas to attract foreign investors. Bogota also has permitted the creation of foreign-managed investment funds to attract portfolio investment. During 1992, only $60 million was received, although the funds are capitalized at more than $700 million. Nonpetroleum investment is projected to reach $450 million this year, a large portion of which is going into the financial sector, [redacted] Gaviria also has taken some steps to improve protection of intellectual property rights—primarily through the Andean Pact, but they still fall short in some key areas [redacted]

Gaviria Pursues Regional Integration

In conjunction with his sweeping trade reforms at home, Gaviria has aggressively pursued closer economic ties to Colombia's regional trading partners. Gaviria is using regional trade to diversify the country's export markets and to help prepare local producers for the rigors of global competition. In addition, the President probably hopes that the creation of regional trade arrangements will impair potential efforts by future administrations to reverse his market-opening program.

The most significant accomplishment has been the economic opening between Colombia and Venezuela. In January 1992, the two countries established the only operational customs union in the region, with a common external tariff ranging from 0 to 20 percent. With only a few exceptions—tariffs on vegetable oils and automobiles and quotas on some steel products—the two allow free movement of goods across their border. Total bilateral trade ballooned from $578 million in 1990 to $1 billion in 1992. In the first quarter of 1993, Venezuela's exports to Colombia increased by 83 percent over the same period last year, making Colombia second only to the United States as a destination of Venezuelan products. The two economies have exhibited a healthy complementarity. Examples abound of sectors taking advantage of the bilateral opening to form joint ventures, modernize to compete, and invest across the border—including petroleum, chemicals, telecommunications, iron and steel, and financial services. In addition, Colombia and Venezuela jointly entered into a free trade agreement with the Central American countries—except Panama—in February 1993.

The Colombia-Venezuela agreement has strengthened bilateral economic ties in other areas as well. Venezuelan financial institutions, for example, have purchased Colombian banks to help support the growing number of Venezuelan firms active in the Colombian market and have invested in various commercial and industrial sectors. The two countries signed a monetary agreement this spring to allow increased cross-border use of their currencies and an open-skies agreement that has resulted in a ninefold increase in passenger flights between the two countries, according to press reports. Harmonizing macroeconomic policies, such as exchange rates and price stability, is the next major step, but it also will be the most difficult. Venezuela's deteriorating fiscal accounts could cause inflation to exceed 40 percent this year—much higher than Colombia's 22-percent target. Further discussions also are needed over health and phytosanitary requirements, differing technical norms, administrative delays, and firm legal foundations for some agreements.

President Gaviria has been a leading advocate of the renewal of trade cooperation among Andean Pact members. In March 1993, the members reached a consensus on common external tariffs, which will enable the Pact to begin functioning as a customs union in January 1994, assuming all members enact the necessary legislation. Furthermore, in October 1992, a bilateral free trade agreement was initiated with Ecuador. Recent efforts to eliminate remaining barriers, however, have been frustrated by dissension and delays among Andean Pact members.

Colombia, Venezuela, and Mexico—acting as the Group of Three (G-3)—signed a free trade agreement in November 1993 that will gradually be implemented over 10 years. Colombia hopes that lowering trade barriers with Mexico will bring additional economic benefits and pave its entry into an expanded North American Free Trade Agreement (NAFTA). The potential for increased trade and investment between the three members is substantial—in 1991 the share of total trade accounted for by G-3 partners was only about 0.5 percent for Mexico, 4 percent for Venezula, and 8 percent for Colombia. Negotiations addressed almost every topic covered in NAFTA—including energy, agriculture, environment, tourism, science and technology, duty drawbacks, safeguards, government procurement, and technical standards.

Economic Reform and the Narcotics Industry

President Gaviria's economic reform program is creating unintended benefits for narcotics traffickers, including facilitating the movement of narcotics abroad and the repatriation of drug profits to Colombia. The liberalization of foreign exchange controls, along with the limited tax amnesty and initially high domestic real interest rates in 1991, resulted in over $3 billion being repatriated to Colombia during the past three years, some portion of which is clearly drug related. [redacted] *Tariff reductions probably are enabling traffickers to more easily use drug earnings to purchase abroad and import finished goods, which are then sold at below cost on the domestic market to obtain Colombian pesos.* [redacted]

The lack of hard economic and financial data, however, makes it difficult to draw broader conclusions regarding the impact of narcotics money on the Colombian economy. Various academic studies have attempted to quantify the amount of narcodollars repatriated into Colombia each year, but the results have varied considerably. Estimates range from $200-300 million to as much as $2-3 billion annually, making it among the largest export earners for the Colombian economy. Traffickers increasingly are seeking productive investments with their repatriated earnings, including the construction industry, drugstore chains, radio stations, restaurants, bars, and sports teams. In the past, purchases of real estate—including rural properties, luxury apartments, and cattle ranches—were common. [redacted]

[redacted]

Gaviria's apertura *program also may interfere with drug interdiction efforts. For example, the privatization of Colombia's port operations probably will undermine efforts by Colombian antidrug forces to interdict narcotics shipments through the country's largest ports. By the end of 1993, Bogota expects to have transferred operations of Colombia's five largest ports to private hands. Counternarcotics officials, who previously could launch surprise raids on the ports, will need the permission of newly established civilian authorities to search containers and vessels,* [redacted] *Bogota is concerned that some of the new port operators will be associated with narcotics-related front companies and may compromise antidrug operations.* [redacted]

The Gaviria administration is attempting to gain more control over the inflow of illicit money into Colombia but is hamped by weak laws and poor enforcement. Technically, no Colombian law makes money laundering a crime, nor is any such law currently under consideration. The government has implemented financial reporting requirements, similar to those in the United States, for transactions over $10,000, but Colombia has no central repository for the information, enforcement is lacking, and penalties are vitually nonexistent. [redacted]

Figure 9
Foreign Trade

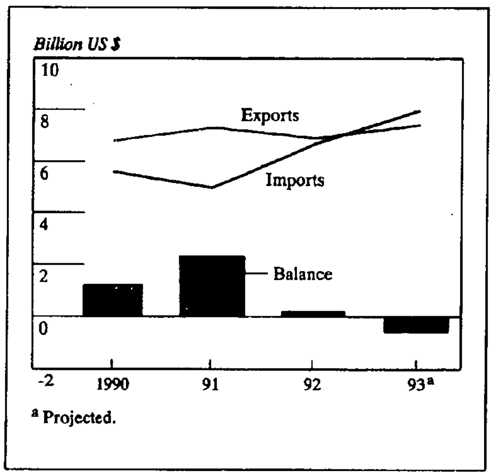

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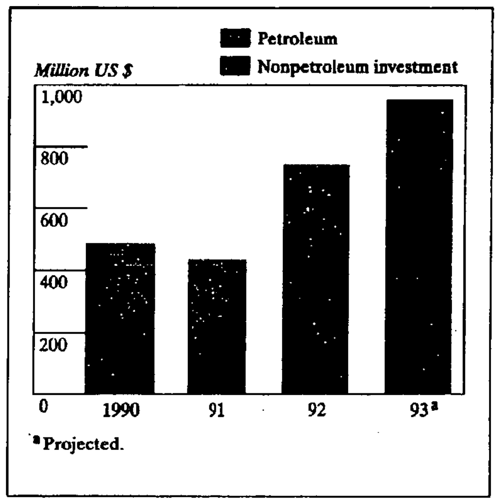
Figure 10
Net Foreign Direct Investment



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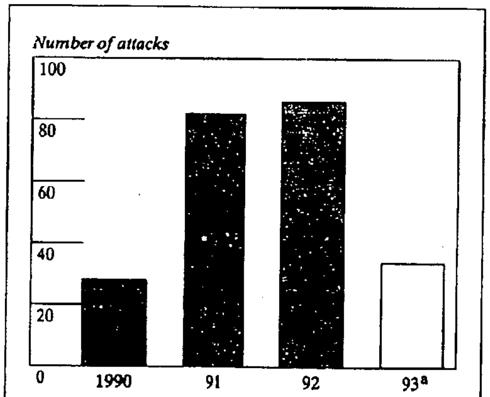
The high levels of insurgent and narco-related violence—which often takes the form of kidnapping and the ransoming of foreign executives—as well as general political uncertainty have deterred foreign investors. [redacted] Even in the petroleum sector, industry observers believe that insurgent attacks against oil facilities are delaying exploration and development of new fields. In 1992, insurgents attacked petroleum installations and pipelines 86 times, causing about $200 million in damage and lost revenues, [redacted]

Domestic Investment Rebounding

Many Colombian companies finally have begun implementing restructuring and modernization plans in response to Gaviria's trade and investment liberalization measures. A recent survey of more than 350 Colombian companies conducted by Fedesarollo, a leading Colombian economic think tank, noted that nearly nine out of 10 respondents believe that lower tariffs for industrial inputs are having a positive impact. Further, to maintain competitiveness, almost one-third of those surveyed are introducing new technology, and 42 percent have improved their plants and quality control. Following three years of decline caused by slow economic growth, high financing costs, and uncertainty over the course of economic policy under

Figure 11
Insurgent Attacks Against Petroleum Sector



[a] January through August.

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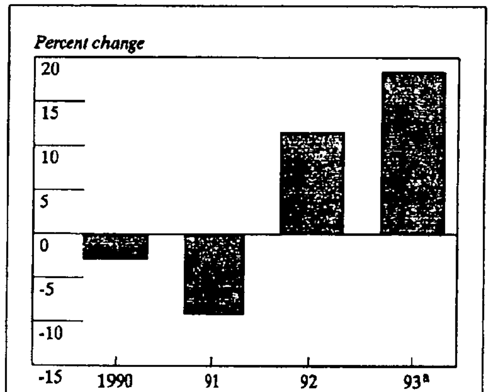
Figure 12
Private Investment



[a] Projected.

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Gaviria, private domestic investment expanded by 12 percent in real terms in 1992 and is expected to rise by about 18 percent in 1993. The highest levels of investment have gone into the machinery and equipment, housing, and transportation industries.

Agriculture Sector Struggling

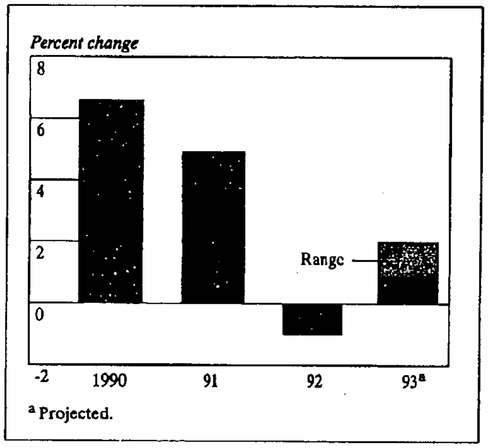
Colombia's agriculture sector has had a particularly hard time adapting to the liberalized domestic environment. Gaviria's market-opening measures dismantled much of the farm sector's tariff protections, subsidies, and preferential access to credit. The tough measures, coupled with the severe drought, a stronger peso, and record low prices for some commodities resulted in stagnant agriculture sector growth in 1992. In addition, guerrilla- and narcotics-inspired violence in rural areas kept beef production stagnant. In recent months, various agriculture associations have successfully lobbied Bogota to reinstate some protectionist measures—on poultry and textiles, for example—and channel new financial aid to the sector. Agricultural output is expected to recover somewhat this year, with growth of about 1.5 percent.

Impediments to Further Progress

Delayed Infrastructure Investment

Gaviria has consistently diverted resources away from improving the country's transportation and energy sectors to support other priorities, such as the military and judiciary. The lag in infrastructure development is hurting domestic firms' ability to exploit the competitive gains they are making through increased capital investments. Colombia's National Planning Department estimates that over $2 billion is needed to improve Colombia's transportation infrastructure, including $1 billion for roads and $350 million each for railroads, ports, and airports. Bogota has increased budget

Figure 13
Agricultural Sector Production



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allocations to these areas each year but has then redirected the resources to cover unexpected military outlays for increased security and to repair damage caused by guerrilla attacks.

As a partial solution, Bogota has implemented deregulation measures that encourage competition and investment by private companies in the transportation, communications, and energy sectors, which traditionally have been controlled by state-owned firms. In the transportation sector, for example, the National Railway Company was replaced by a mixed enterprise, while the operations of Colombia's largest ports were transferred to private operators. The monopoly of domestic telecommunications services by the state-owned company, Telecom, was struck down, allowing the parastatal to enter into joint ventures with foreign and domestic companies. At the same time, private firms now can provide domestic telecommunications services, cellular telephony, and some satellite communications. Similarly, the Ministry of Mines and Energy is now authorized to contract with private companies for the generation, transmission, and distribution of electrical power.

Labor Opposition

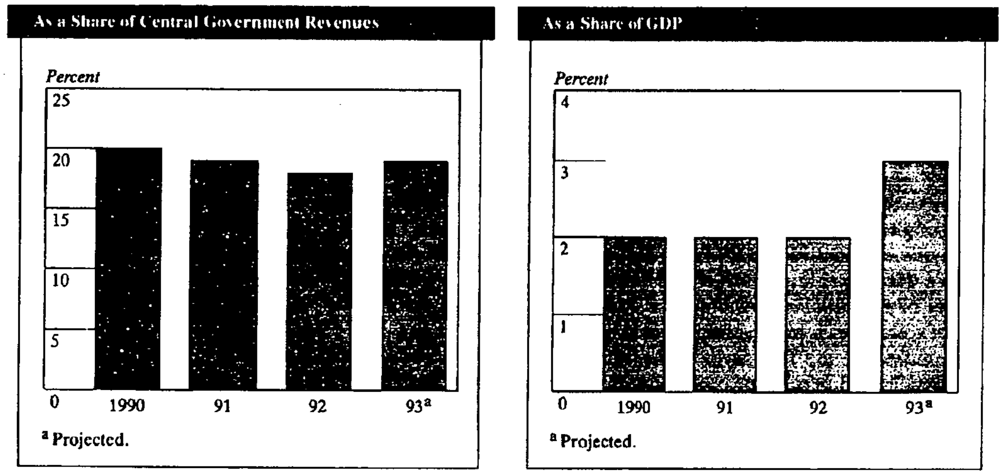
Union resistance has limited Gaviria's progress in privatizing major state-owned companies and streamlining the bureaucracy. Although state ownership in Colombia historically has been less extensive than in other countries in the region, Gaviria's plan to sell off the country's largest parastatals suffered a major setback in mid-1992, when he pulled back legislation proposing the sale of Telecom after a wave of strikes and labor protests culminated in workers shutting down Colombia's international telecommunications links for a week in April 1992. Although less than 10 percent of Colombia's total work force is unionized, fully one-third of Telecom workers are union members, accounting for their clout.

Instead, the administration shifted its focus away from sectors heavily influenced by unions and toward less controversial projects. These included reprivatizing three of five financial institutions nationalized during an early 1980s banking crisis and selling the government's stakes in a number of smaller enterprises.[4] In early 1993, Gaviria announced an initiative to earn up to $2 billion from the sale of 77 state enterprises before his term expires in August 1994. Although most of the firms listed were already scheduled for sale, Bogota's decision to coordinate the proposal among government agencies and publicize it as a single, comprehensive plan that more effectively challenged union opposition was a marked shift from its earlier, ad hoc, privatization efforts.

Gaviria has had even less success in his efforts to cut back the government bureaucracy. In 1992, he announced a state modernization program that

[4] These sales have consisted mainly of selling minority shareholdings acquired by the state-run Industrial Investment Institute, which helps finance mostly small, startup industrial firms by providing equity. (U)

Figure 14
Public Investment



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called for the elimination of 20 public institutions, the restructuring of nine ministries, and the consolidation of various agencies. Because these reforms would eliminate 25,000 public-sector jobs, they remain bogged down by stiff union opposition and court challenges.

Recalcitrant Conglomerates

The presence of large industrial groups, which dominate major sectors, has helped to undercut President Gaviria's goal of fostering a more dynamic, competitive economy. Ownership in Colombian industry traditionally has been concentrated among a few families and conglomerates, which over the years have aggressively expanded both horizontally and vertically within industries and then diversified into unrelated sectors. The small size of the domestic market, combined with economies of scale, encouraged the growth of these oligopolies. The 1960s and 1970s, in particular, provided a favorable mix of factors—including a stable domestic economic environment and severe limits on foreign competition—that enabled Colombia's large firms to further increase their control. Government attempts to limit the size of the industrial giants have been stymied by inadequate antitrust legislation, limited enforcement capabilities, and the substantial political influence of these groups.

Important Colombian industries are dominated by a handful of large conglomerates. The largest of these, the Santo Domingo Group, consists of more than 100 companies, most of which are controlled by multimillionaire industrialist Julio Mario Santo Domingo. Santo Domingo's holdings range from beer to banks and include radio and television stations, insurance and finance companies, and the country's flagship airline, Avianca. In 1992, the group's total sales exceeded $2 billion, with profits of about $200 million, [redacted] Colombia's second-largest group, Grupo Ardila Lulle, controls much of the domestic soft drink market, owns the country's largest textile company, and [redacted] is the second-largest employer in Colombia behind the national government. Finally, a less homogeneous—but equally powerful—group is Sindicato Antioqueno, which is composed of approximately 150 companies from the Medellin area. Member firms represent diverse industries, including finance, cement, and food production. [redacted]

Besides their extensive holdings across industries, these conglomerates tend to have a virtual monopoly on one or more local sectors. In the cement industry, for example, Cementera de Occidente, a member of the Sindicato Antioqueno, controls most of Colombia's major cement companies. Furthermore, the top four firms in the industry accounted for 53 percent of production in 1990, and almost all cement firms belong to one of three conglomerates, according to a World Bank study. Similarly, within the beverage industry, beer production is concentrated among five firms that belong to the Santo Domingo group, while only three firms control the nonalcoholic beverage market. In the chemical sector, 44 percent of production was accounted for by the top four plants in 1990. [redacted]

Consequently, as Gaviria's reform programs have increasingly threatened the protected status of some of these groups, they have begun using their near-monopoly control, collusion, and political influence to stem increased domestic competition. Success at limiting this backlash to economic reform requires a tougher response than Gaviria has mounted to date, including active enforcement of anticompetitive practices and penalties to deter such behavior. As a first step, Gaviria restructured the Superintendency of Industry and Commerce to strengthen its authority and more clearly define what are considered anticompetitive practices, but comprehensive antitrust legislation, which would reinforce the Superintendency's mandate, remains bogged down in the Congress. [redacted]

Costly Social Security System

The Social Security Institute continues to run an annual deficit, which now totals about $1 billion, handicapping Bogota's ability to balance the budget. The social security system covers less than 20 percent of the population but has one of the highest expenditure levels per insured among similarly developed countries in Latin America, according to a World Bank study. Despite strong government lobbying, legislation to overhaul the bankrupt social security system and extend coverage to all Colombians, as required under the 1991 Constitution, remains bogged down in the Congress. The bill calls for establishing an alternative, privately operated pension system, separates the health care system from the retirement system, and raises total contributions by 70 percent. [redacted]

Inadequate Social Spending

Other budgetary priorities and an unresponsive Congress have forced Gaviria to scale back his goal of significantly expanding resources to social sectors, especially health and education, in order to create a more productive, capable work force. According to a recent study, for example, 85 percent of 150 businessmen interviewed said the Colombian education system does not adequately educate. As part of his "peaceful revolution" announced in December 1991, the President proposed greatly expanding government expenditures on primary and secondary education, health services, and low-income housing. A government study reports, however, that Bogota's budget for social spending declined from 36.6 percent of government spending in 1990 to 29.7 percent in 1993, [redacted]

Weakened Leadership

Since 1992, Gaviria's administration has been overwhelmed by multiple crises that led to a sharp decline in the President's political standing and, consequently, his ability to push new economic

Figure 15
Budgeted Social Spending, 1993

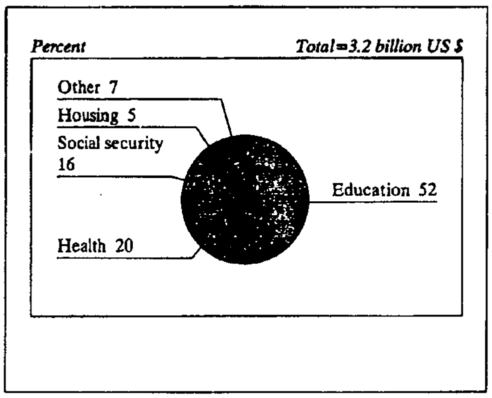

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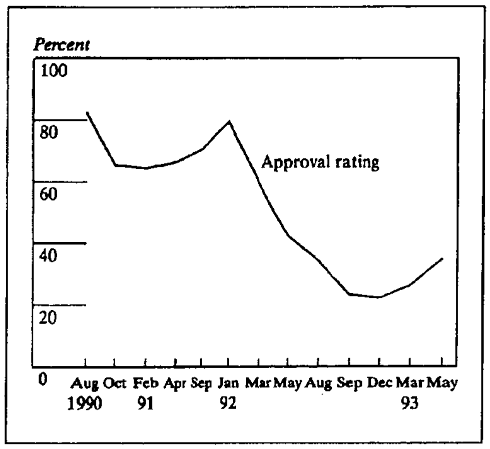
Figure 16
Gaviria's Popularity



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reform measures through a recalcitrant Congress. Gaviria's approval rating fell from about 80 percent in early 1992 to about 30 percent in mid-1993. As a result, his own party became increasingly divided over the pace of implementation of the *apertura* program.

The President's image as a strong, innovative leader took a beating in 1992:

- The Gaviria administration's lack of forewarning to the public of the impending energy crisis sent businessmen scrambling to maintain production. The President was held accountable for the subsequently revealed mismanagement, corruption, and inefficiency in the energy sector, especially the failure to maintain backup energy facilities.

- In international coffee agreement talks, Gaviria was blamed for his apparent failure to persuade consumer countries, notably the United States, to accept a compromise proposal that would help boost global coffee prices as a quid pro quo for Colombia's increased antidrug efforts.

- The public has been critical of the administration's inability to curtail guerrilla activities and remains skeptical that the increased funding is being used efficiently, even though it generally has supported Gaviria's hard line toward the insurgents.

- Gaviria was humiliated by the escape of drug kingpin Pablo Escobar and Colombia's failure to recapture him and by revelations that Escobar continued his trafficking activities from within the luxurious confines of Envigado "prison."

In addition, as the initial effects of economic reform—notably the rapid growth of imports—began to threaten the dominant role of local firms in some sectors, influential business leaders and farm groups became increasingly vocal in pressing the administration to slow the pace of reform. Gaviria's popularity improved somewhat during 1993 for various reasons, including the end of energy rationing, stronger economic performance, and the decline in narco-related violence.

Outlook

Campaign Debate Over Reform

The future of Gaviria's *apertura* program is shaping up as the major issue in the presidential campaign. According to a recent poll, most Colombians believe that inflation and unemployment are still the key economic problems facing the country, despite Gaviria's reform efforts. All leading candidates have criticized Gaviria's rapid pace of reform and are suggesting that the country take time to review and assess the changes made to date before moving ahead with additional structural reforms.

Various factors, both domestic and foreign, are likely to emerge during the campaign season that will shape the content and intensity of debate on economic issues. At home, questions over restructuring the social security system, how to most effectively utilize the expected windfall oil profits, and the efficacy of concluding economic integration accords with Mexico and other countries in the region, will dominate. External developments likely to influence the debate over economic directions include the favorable vote in the US Congress on the North American Free Trade Agreement (NAFTA) and the success of the GATT Uruguay Round. Candidates almost certainly will publicly evaluate the extent to which Colombia has gained quid pro quos in terms of greater access to foreign markets as a result of Gaviria's extensive market opening.

Gaviria's Lameduck Strategy

Despite campaign pressures, we believe Gaviria will strive to ensure that his major reforms remain intact. The President, who has invested a great deal of personal effort and political capital in the implementation of the *apertura* program, recognizes that the success or failure of his presidency will be judged, at least in part, by whether his economic reforms are sustained. Furthermore, after a fitfull start, his reforms are beginning to have significant impact on the economy, which probably will redouble Gaviria's commitment to sustain his reforms so they can become firmly entrenched. The recent slight upturn in his personal popularity, moreover, gives him a little more breathing room to resist pressure from special-interest groups to pull back on some aspects of reform. Nevertheless, some minor backsliding is likely during the runup to the presidential election. Sensitive industries, such as textiles, leather, and agriculture, that are being battered by surging imports probably will aggressively lobby the President for additional import protection.

Gaviria, aware that his political strength remains impaired, probably will focus on consolidating the economic reforms he has already enacted and on gaining congressional approval for some items still pending, rather than introducing new legislative proposals during his final year in office:

- The President plans to form a committee composed of some of Colombia's leading industrialists to help institutionalize his *apertura* program
- With Gaviria's encouragement, senior Colombian officials are undertaking media campaigns and establishing assistance programs to help increase exports and motivate Colombia's inward-looking business community to look abroad for new sales.
- The government is likely to privatize some state entities—such as the remaining two banks nationalized during the early 1980s and gasoline stations owned by Ecopetrol—to ingrain new ownership patterns.
- The President's priorities include concluding regional integration efforts with Mexico as part of the Group of Three and with Chile as a way to lock in aspects of his liberalization program,

Views of Leading Presidential Contenders on Economic Reform

*The candidate of the ruling Liberal Party, **Ernesto Samper**, favors slowing, if not reversing, some of the economic reforms implemented by Gaviria. As a populist, he most likely would try to boost social spending and would be less concerned than Gaviria about keeping a tight rein on inflation and the fiscal deficit. He has promised, for example, to build 100,000 low-income houses per year during his term in office, according to press reports. In the trade area, Samper has publicly criticized Gaviria for accelerating the pace of tariff cuts and exposing domestic industries to foreign competitors before completing other aspects of the reform program, such as improving the infrastructure and the efficiency of the custom's service. He resigned as Gaviria's first Development Minister, arguing that the reduction of tariff levels should have been more gradual.*

*The other leading candidate, **Andres Pastrana** of the Conservative Party, generally is more supportive of Gaviria's market-oriented policies. However, as with Samper, Pastrana has expressed reservations about the pace of economic opening and, if elected, would probably rethink the rapid tariff reductions. Pastrana favors an expanded role of the private sector in the economy and would probably continue, to the extent possible, Gaviria's privatization efforts. Pastrana also most likely would maintain Gaviria's conservative fiscal approach and focus on cutting inflation. As a result, Pastrana would be more likely than Samper to limit social spending in the face of budgetary constraints. One of Pastrana's closest advisers, Development Minister Alberto Moreno, supports liberalization of the economy and strengthening intellectual property rights protection, and like Pastrana, has close ties to the business community.*

Furthermore, Gaviria will attempt to gain congressional approval of his pending social security reform legislation, although prospects for passage are increasingly uncertain. Labor groups, who are opposed to some aspects of the legislation, almost certainly will drag out congressional debate of the bill's 250 articles, particularly those increasing employee contributions and extending the retirement age.

The President also may take some modest steps toward addressing, or at least circumventing, some of the impediments to his reform program. By developing alternative approaches and looking for unexpected opportunities, his economic team—most of whom are expected to remain in their jobs through the end of the President's term—may be able to implement low-key measures that sustain the reform program but do not require legislative approval or create a great deal of controversy. In a modest gesture toward addressing transportation problems, for example, Gaviria recently decided to broaden the scope of road concessions to allow private firms to construct new toll roads and repair existing highways.

In the months ahead, before Gaviria leaves office, Colombia's economy, on balance, should continue to benefit from the reform measures already implemented. Strong domestic investment will probably continue as industries pursue their modernization efforts and promising oil fields are developed. This, in turn, will probably ensure GDP

Indicators of Backsliding on Reform Program

Gaviria seems firmly committed to supporting apertura *through the end of his term, in August 1994. Adjustments are likely to be limited to politically motivated, but economically inconsequential, import protections for certain domestic sectors. Nonetheless, developments over the next year could undercut his efforts to consolidate reforms, leaving the program in some disarray and therefore more open to reconfiguration by his successor.* [redacted]

The high-probability, low-impact indicators of backsliding would include:

- *Implementaion of narrow import protections for such sensitive sectors as agriculture, textiles, plastics, and paper.*
- *Limited subsidies targeted at specific sectors facing increased import competition.*
- *Legislative inaction on social security reform.*
- *Accelerated government spending and transfers to municipalities and departments.*
- *Limited progress in the privatization program.* [redacted]

The low-probability, high-impact indicators of backsliding would include:

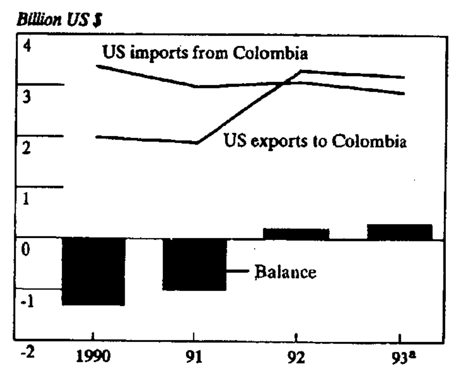
- *Enactment of broad-based trade barriers that impede imports across a wide spectrum of products.*
- *Reimposition of extensive foreign exchange controls.*
- *A wave of nationwide labor protests to various aspects of the market-opening program.*
- *A slowdown or halt to economic integration with Venezuela under its new president after February 1994.*
- *A major insurgent campaign that causes foreign investors to rethink joint petroleum ventures, reducing near-term profits that Bogota could use for infrastructure development and other key programs.* [redacted]

growth of at least 4 percent in 1994. Barring an unexpected drought that would cause food prices to jump, annual inflation next year may dip below 20 percent for the first time since 1986. Prospects for Colombia's trade sector and budget deficit are less certain, however. Unless Bogota successfully revives export growth, the country's trade balance is likely to worsen as imports of all types of goods continue unabated. Similarly, constitutional requirements that the central government transfer increasing levels of resources to local authorities, coupled with mounting pressures to significantly boost social, military, and judicial spending, may cause the budget deficit to grow from 1.5 percent of GDP currently to 3 percent by 1995, according to some preliminary government estimates. [redacted]

Implications for the United States

Before Gaviria leaves office in August 1994, Bogota almost certainly will press US officials for greater recognition of the extensive economic reforms already undertaken. Given the rapid growth in bilateral trade as a result of liberalization, the potential for further increases in exports to the United States as major oilfields come on line, and Colombia's cooperation in counternarcotics operations with the United States, Colombia is likely to push hard for a bilateral free trade agreement or consideration as an eventual candidate for NAFTA accession. Already, senior Colombian officials have raised the possibility of a free trade agreement with US officials during various meetings. Meanwhile, Colombian officials are likely to hold back on strengthening intellectual property rights and signing a bilateral investment treaty until they test Washington's willingness to grant new trade privileges. [redacted]

Figure 17
US-Colombian Trade



[a] Projected.

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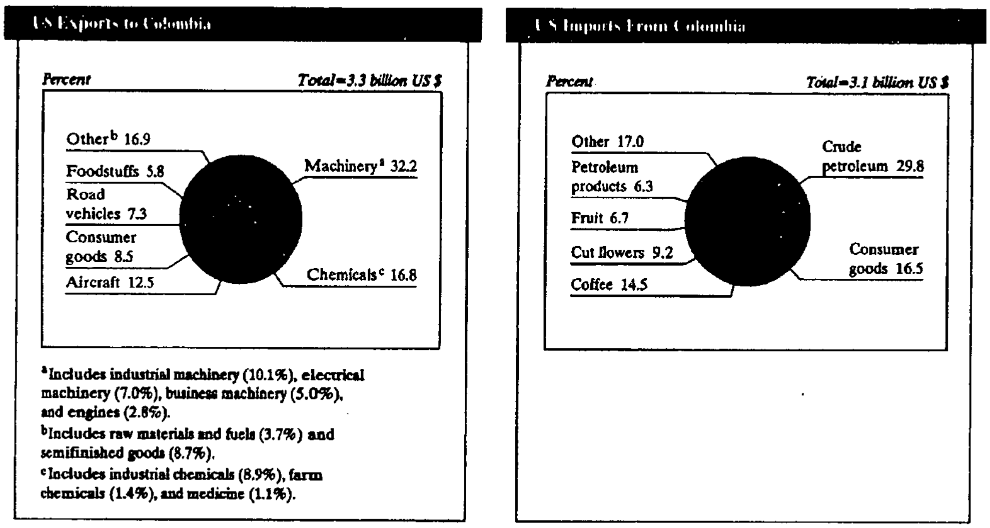
Despite Colombia's long-term interest in enhancing trade relations with the United States, some frictions are likely during the election year as Gaviria comes under pressure to aid domestic sectors facing tougher competition at home. He already has responded to intense lobbying by local groups by banning poultry imports in April and by pursuing antidumping allegations more aggressively. The President also has become increasingly vocal in criticizing what he views as discriminatory actions by the industrialized countries: their failure to support a new international coffee agreement, the European Community's imposition of a banana quota, and the continuing deadlock in the Uruguay Round that is delaying trade measures of benefit to developing nations. Nonetheless, the inauguration of Colombia's new president next August will provide both countries with an opportunity to clear the air and reaffirm long-term mutual economic interests. [redacted]

Meanwhile, US firms are well positioned to retain their growing share of Colombia's import market, although over time competition from Japan, the European Community, and Andean trading partners may stiffen. Colombia now is the fourth-largest market for US goods in Latin America, after Mexico, Brazil, and Venezuela. Colombian businessmen and consumers seem to prefer the high quality of US products, and longstanding business ties should facilitate increased cooperation. US industries currently are scoring strong sales in commodities such as aircraft, electrical generators, automobiles, and agricultural goods. Nevertheless, in coming years, competition from Japanese and West European firms is likely to increase in key

Figure 18
Composition of US-Colombian Trade, 1992



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sectors such as telecommunications, automobiles, and manufacturing equipment. Foreign companies also have indicated interest in investing in potentially lucrative oil pipeline and refinery projects. Over time, as Colombia consolidates its new regional trade arrangements, some smaller US firms may also feel pressure from Venezuelan, Ecuadoran, and other Andean-based companies.

Appendix

Colombia: Key Structural Reforms

Sector	Actions Taken	Comments
Trade	Eliminated prior import and other nontariff barriers for most products. Reduced and consolidated tariffs from an average of over 30 percent in 1990 to only 12 percent in 1992. Streamlined import/export procedures. Overhauled customs service. Created Ministry of Foreign Trade. Eliminated import surcharge that was 13 percent in 1990. Reduced export subsidies. Converted PROEXPO (the Export Promotion and Financing Agency) into an export-import bank.	Agriculture sector remains protected by price band system, and other key sectors, such as textiles, are successfully pressing for new protections. Emphasis has been on import liberalization rather than export promotion. New Foreign Trade Ministry has been a key voice for business sector in policy discussions.
Foreign investment	Eliminated virtually all prior approval requirements. Extended national treatment to foreign investors to permit 100-percent ownership in virtually all sectors. Authorized foreign investors to remit capital, profit, and interest up to 100 percent of capital registered in previous fiscal year.	Colombia now has one of the most open investment regimes in Latin America; domestic security concerns, however, continue to inhibit foreign direct investment.
Foreign exchange	Increased autonomy of Central Bank. Transferred most foreign exchange operations from Central Bank to private financial institutions. Introduced more flexible foreign exchange regime. Legalized holding by Colombians of foreign bank accounts.	Central Bank allows the exchange rate to fluctuate within a set band. Exporters have been highly critical of Central Bank's slow rate of peso devaluation. Strong capital inflows have caused Central Bank to issue 360-day certificates to limit inflation.
Tax code	Overhauled tax code. Eliminated capital gains tax on sale of stock. Enacted a temporary tax amnesty to attract flight capital. Increased value-added tax from 10 to 12 percent in 1991 and then to 14 percent in 1992. Modernized tax administration system. Broadened sanctions against tax evaders.	New tax measures have not succeeded in covering revenue shortfall from lower import duties. Followup efforts during 1992 to expand the use of value-added taxes were greatly watered-down.
Finance	Opened financial system to foreign investment—reduced barriers to entry and exit. Authorized foreign-managed investment funds. Approved creation of futures and options markets.	Venezuelan banks have aggressively entered market, purchasing three Colombian banks. Foreign investment funds capitalized at $700 million.

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Colombia: Key Structural Reforms (continued)

Sector	Actions Taken	Comments
Labor code	Replaced costly system of retroactive severance payments with a transparent pension fund program. Reduced state intervention in labor-management relations. Eased recognition of new unions. Authorized private companies to manage severance funds.	Business sector welcomes new code, but it is under intense attack by unions. Legislation currently in Congress would roll back some of the previous reforms.
Privatization	Reprivatized three of five financial institutions nationalized during an early 1980s banking crisis. Liquidated state-owned port and railway companies. Sold stakes in a number of smaller enterprises in which the state had acquired mostly minority shareholdings.	Tough labor opposition has halted attempts to privatize the country's largest parastatals.
Intellectual property rights	Passed new copyright law in 1993 that significantly increased penalties and expanded protection to software. Pushed through Andean Pact decisions to establish minimum basis for protection; frees Pact members to make unilateral improvements in domestic intellectual property rights protection. Broadened patent protection to include plant vehicles and biotechnology. Initiated efforts to modernize agencies responsible for enforcement. Improved trademark protection through Andean Pact Decision 313.	Bogota has played a leading role in Andean Pact to push for stronger intellectual property rights protection—hoping to avoid nationalistic backlash at home. Enforcement of existing laws continues to be major problem. Deficiencies remain in key areas of pipeline protection, compulsory licensing, and parallel imports.

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