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**Development Centre
Studies**

**The Economics
and Politics of Transition
to an Open Market Economy:
Colombia**

INTERNATIONAL DEVELOPMENT



OECD 

By Sebastian Edwards

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The Economics and Politics of Transition to an Open Market Economy: Colombia

by

Sebastian Edwards



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Foreword

This study was carried out under the Development Centre's research programme entitled: "Major Regions and Large Countries", as part of a project to analyse the political preconditions for the success of economic policy reform in transitional and developing economies. Other studies in the same series have been carried out on China, Egypt, India, Russia and Vietnam.

Colombia



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Table of Contents

Acknowledgements	6
Preface	7
<i>Chapter 1</i> Introduction	9
<i>Chapter 2</i> The Political Economy of Reform: Actors, Issues and Controversies	13
<i>Chapter 3</i> The Colombian Reforms: Background and Actors	27
<i>Chapter 4</i> The Reform Policies	43
<i>Chapter 5</i> A Fractured Reform Process: From Euphoria to Standstill	59
<i>Chapter 6</i> Conclusions	83
Bibliography	93

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Preface

During the 1990s, the number of countries which embarked on fundamental economic policy reforms leading to open, competitive market economies grew dramatically. Centrally planned economies in Eastern Europe and East Asia, as well as countries with highly interventionist policy regimes such as India or Brazil, have been eager to reduce government involvement in economic decision making, to ensure macroeconomic stabilisation, and to open up to international trade and capital flows. Based on these experiences, a considerable amount of knowledge about critical reform ingredients and the timing of their implementation has been accumulated.

Experience has also shown, however, that reforms are not always carried through, or are stalled during the reform process, owing to opposing political interests. Economic reform always creates winners and losers, and frequently the losers include politically powerful groups. In 1996, the OECD Development Centre launched a research project to analyse the political preconditions for the success of economic policy reform in transitional and developing countries. The objective is to study the interplay between economic necessities and political challenges during the implementation of policy reform, thereby generating recommendations for dealing with political opposition to reform.

The project focuses on the experience of six countries: three large economies, China, India and Russia, and the smaller Colombia, Egypt and Vietnam. The distinction between large and small countries was made because the regional dimension adds to the problems of reform in large countries, while outside influences may play an important role in small economies.

Colombia was selected for this project because the country undertook major economic policy reforms in the first half of the 1990s without going through a major crisis. Furthermore, reforms included a deregulation of labour markets. Such a broad approach to economic reform has rarely been observed in other developing countries. The objective of the study is to trace the impact of interest groups on the design and the timing of reforms, as well as to identify reasons for the collapse of reform efforts in the second half of the 1990s.

Jorge Braga de Macedo
President
OECD Development Centre
June 2001

Chapter 1

Introduction

In early 1990 presidential candidate César Gaviria promised that, if elected president, he would launch a major transformation of Colombia's economic system. In speech after speech he argued that the development path followed by Colombia since the 1940s had become obsolete and that, in order to achieve rapid growth and improve social conditions for the majority of the population, significant reforms had to be undertaken; he called for a major shake-up of the Colombian economy¹. On 7 August 1990 César Gaviria was inaugurated as Colombia's constitutional president. During the next 18 months a set of policies aimed at drastically changing the nature of Colombia's economic structure were put into effect: exchange controls were abolished; imports were liberalised; labour legislation was reformed; controls over foreign direct investment were relaxed; the financial sector was deregulated; legislation governing ports operations was modified; the insurance industry was liberalised; and the tax system was modernised. Later during the Gaviria administration the reform of social security was initiated, attempts were made at reforming the education and health sectors, and at implementing a mild privatisation programme. Additionally, during the 1990–94 period, the Central Bank — *Banco de la República* — was granted a greater degree of autonomy, decentralisation was pursued, and the budgetary process was modified².

But the economy was not the only area targeted by Gaviria's reformist efforts. In late 1990, a Constitutional Assembly was convened, and by July 1991, Colombia had a new constitution which, after more than 100 years, introduced a new political system into the country. At the same time President Gaviria undertook an effort towards eradicating the influence of drug traffickers in Colombia's society. To that effect he called for the implementation of a campaign aimed at bringing the drug lords to justice — the “*sometimiento a la justicia*” policy.

Colombia provides a unique opportunity for analysing the process of economic reform in a democratic setting. What makes this case particularly interesting is that in many respects the Colombian experience appears to be quite different from what manuals recommend, and what other countries have experienced. For instance, in the conclusion of a 13-country study on the political economy of reform, John Williamson (1994) argues that Colombia is the most atypical of all the countries analysed³.

According to him, and in contrast with most cases, the starting point of the Colombian reforms was not a major crisis⁴. Also, the sequencing followed in Colombia — with the labour market being reformed very early on — contrasts sharply with other reform episodes, where labour market reform has been postponed until the very end⁵.

In other respects, however, Colombia appears to exhibit elements in common with other reform attempts, including the resistance of powerful interest groups to change. Also in Colombia the technological “class” — what has been called the *technopols* — played a fundamental role in the design and implementation of the modernisation programme. Moreover, Colombia provides a genuine case — and indeed, arguably, one of the very few — where the multilateral institutions influenced the course of economic policy.

The purpose of this study is to analyse, from a political economy perspective, Colombia’s experience with structural reform during the first half of the 1990s. The focus is on understanding what prompted Colombian politicians to embark on this project; how different groups — political parties, the private sector, the labour movement, the military, and more generally the civil society at large — reacted to events; and how the political dynamics affected the way in which the reforms were implemented.

The analysis presented in this study clearly suggests that the Colombian experience is significantly more complex than is usually thought — plainly put, things were not quite as simple as they seemed at first. It is argued that the Colombian experience during the first half of the 1990s is a quintessential case of an incomplete reform effort; in spite of some spectacular measures early on during the Gaviria administration, interest groups were able to regroup and to block some essential initiatives, including major privatisations, the reform of the social sectors, and, perhaps more importantly, the reform of the institutions of the state. The fragility of the reforms was such that César Gaviria was replaced in the presidency by a reform-sceptic, President Ernesto Samper, whose early rhetoric called for major changes to the reform initiatives, and whose record on economic modernisation — as well as on political issues, security and handling of terrorism — was dismal.

The rest of the study is organised as follows: Chapter 2 discusses some important analytical issues related to the political economy of reform. Chapter 3 provides background information on the Colombian economy, and concentrates on the initial conditions and on the principal actors who participated in the reform process. Chapter 4 provides an analysis of the reform policies themselves, as well as on some of the economic implications of the 1991 constitution. Chapter 5 concentrates on the political economy of the reforms. It is discussed how the government devised an early strategy that effectively confused and disarmed the reform’s potential opponents. The Gaviria administration followed a two-pronged political approach in order to advance the reform agenda: first, a broad-based political coalition, that included some of the reform sceptics, was forged. Second, a sophisticated compensation mechanism, aimed at obtaining the support of different groups, was implemented. It is argued that this compensation mechanism went well beyond the sphere of economics, and included

social and political compromises and concessions. This chapter also deals in some detail with the role of the multilateral institutions, the technocrats, political forces and the civil society. It is shown how, during the latter part of the Gaviria administration, interest groups regrouped and were able to slow down the reform effort considerably. Chapter 6 is the conclusion, and provides a brief analysis of the reform effort in Colombia during the post-Gaviria period. The main point is that, although there was no wholesale return to the policies of the 1980s, the reformist momentum was badly hurt during the Samper administration. It is argued that at this point it is by no means clear that Colombia will continue moving in the path of modernisation and liberalisation.

Notes

1. His speeches called for a “revolcón de la economía”.
2. There is by now a small literature on Colombia’s reform effort during the first half of the nineties. See, for example, Cepeda (1994), Departamento Nacional de Planeación (1995a), Urrutia (1994), Montenegro (1996) and World Bank (1994).
3. Williamson (1994, pages 478–81) considers 14 hypotheses on the political economy of reform. He argues that Colombia exhibits the highest degree of non-conformance; its experience does not fit five of those 14 hypotheses.
4. Cepeda (1994).
5. Argentina is a good example of this approach. The Menem administration only began to discuss labour market reform seriously in 1996 when, as a consequence of the Mexican crisis — the so-called “tequila” effect — Argentina plunged into a serious recession. By mid-1997, however, only minor changes to Argentina’s labour legislation had been introduced.

Chapter 2

The Political Economy of Reform: Actors, Issues and Controversies

During the last few years there has been a proliferation of works dealing with the political economy of reform¹. While some of them are analytical in nature, others are historical, and still others are of the “how to” type. The last try to illuminate policy makers on the most effective ways of proceeding with economic modernisation. Most of this literature has emphasised the role of interest groups, the media, initial economic and political conditions, and the role of the external environment. This chapter provides a very brief discussion of the most important aspects of this literature, and presents a list of key hypotheses on the dynamics of the political economy of reform. In the rest of the study these hypotheses are viewed in light of Colombia’s political experience during 1990–94. The discussion in the chapter is deliberately brief, and concentrates on those issues that are particularly important for the analysis of Colombia’s experiment with economic reform².

Basic Issues

Traditional political economy approaches to economic reform in general, and trade liberalisation in particular, have focused almost exclusively on distributive conflicts. The basic framework is based on some variants of the Heckscher–Ohlin theory of international trade, including Stolper–Samuelson and Ricardo–Viner models, and considers a finite number of actors in the reform process³. Some groups will be hurt by the reform and will oppose it, while those that benefit will support it. This approach has been implicitly followed by Rodrik (1994) in his analysis of the political economy of trade reform, where he considers three groups of actors: *i*) import substituting industrialists; *ii*) holders of import licences; and *iii*) users of imports, including producers who rely on imported inputs. Depending on the underlying model of an economy (i.e. whether factors of production are industry-specific or not), it is possible to add to this list any number of groups with special characteristics, including:

iv) agricultural producers, who often argue that food self-sufficiency is a matter of national security; v) organised labour, especially those employed in import-competing industries; and vi) labour in the informal sector, which tends to be dispersed and disorganised, but with a large number of workers employed throughout Latin America, including Brazil, Chile, Colombia and Mexico. In this particular set-up the political support for the reform effort will be proportional to the difference between redistributed income and net efficiency gains from the reforms; what Rodrik (1994) calls the “political cost-benefit ratio”.

Reforms, however, are seldom restricted to one area of the economy. This means that in order to have a better understanding of the overall process, and in particular of the interaction between different interest groups, a broader constellation of players and sectors should be considered⁴. For example, if financial sector reform is being considered, the role of banks, speculators and debtors should be incorporated into the analysis. Moreover, as long as privatisation is a key component of the reform agenda, the role of state-owned enterprises (SOEs) in the reform process has to be considered explicitly. Commenting on the political economy of privatisation, the World Bank (1994) has argued that “the reform of SOEs can cost a government its support base, because reform almost invariably involves eliminating jobs and cutting long-established subsidies”. Also, to the extent that a reform programme includes the reform of public sector institutions, the role of public sector unions and the bureaucracy should be taken into account in an explicit fashion in the analysis. According to Haggard and Webb (1994), “frequently, the most vociferous opposition to a change comes not from interest groups, legislators or voters, but from ministers and bureaucrats within the government”.

Furthermore, Bates and Krueger (1993) argue that one possible explanation for the failure of interest groups to prevent or shape economic reforms is that, “in the context of comprehensive economic policy reform, it is difficult for particular groups to calculate where their interests lie. Ideological struggles therefore can outweigh competition among organised interests as a determinant of policy change”. In contrast, Fernández and Rodrik (1991) propose a theoretical model where uncertainty about the future benefits of reforms can produce a “*status quo* bias”, thus inhibiting reforms. It is possible to argue, however, that the various components of policy packages can act as compensation mechanisms that can help reduce opposition and perhaps raise support for a programme that includes trade liberalisation. Moreover, political (even symbolic) compensation schemes can also be devised to tame opposition to reforms, such as offering political appointments to influential representatives of a particular interest group.

In recent policy discussions it has become customary to distinguish between “first” and “second” generation reforms⁵. First generation policy reforms represent a change in economic policies that alters some (very) basic aspects of the economic structure of the country in question. In addition to trade liberalisation, these policies include fiscal reforms and adjustment, the elimination of exchange controls, financial liberalisation, the implementation of minimal social safety nets, deregulation and some

privatisation. Understanding the way in which these different reforms interact among themselves is important from a political economy point of view. In contrast, second generation or institutional reforms aim to change drastically the institutions of the state. These reforms are politically and technically more difficult to implement than the first generation reforms, because they entail changing the functioning of fundamental institutions, such as the judiciary and the civil service. Other second generation reforms include: reforming labour market institutions (including the relationship between unions, business and the government); reforming the way in which social services, mainly education and health, are provided; reforming social security; implementing administrative and political decentralisation; implementing a major privatisation programme; and creating independent, professional and strong economic institutions aimed at providing simple, impersonal and clear rules of the game that will help reduce the costs of engaging in productive activities.

In sum, recent analyses of the political economy of economic reforms have gone beyond pure economic issues and have emphasised five interrelated aspects: *i)* Distributive conflict among different groups, including exporters, industrialists and unions, among others; *ii)* the country's political organisation and structure, including the system of checks and balances (i.e. executive branch discretion) offered by a country's constitution and the number and nature of political parties; *iii)* the role of the bureaucracy; *iv)* the role of ideas and of professional and intellectual groups; *v)* external actors, including the international multilateral institutions, such as the IMF and the World Bank and, in some cases such as Colombia, the role of foreign governments (the DEA). This broader perspective, taken by Haggard and Webb (1994), Tommasi and Velasco (1995) and Burki and Perry (1997) among others, recognises the relevance of a rich list of actors. Moreover, in this framework, both short- and long-run coalitions play an important function, as do politically motivated compensation schemes.

The Dynamics of Reform

Each episode of economic reform is historically unique. Nonetheless, recent work on the political economy of policy reform has been able to detect some regularities in the phases followed by most reform episodes. A number of authors have argued, for example, that a major economic crisis almost always precedes the launching of a reform effort. In an early contribution Lal (1987) argued that "the typical stabilisation-cum-adjustment programme is launched when the country is in a 'crisis', usually an incipient or actual balance of payments crisis that necessitates a reduction in the level of current expenditures". Bates and Krueger (1993) are, possibly, the strongest advocates of this "crisis" view of reform initiation. According to these authors, "[t]here is no recorded instance of the beginning of a reform programme at a time when economic growth was satisfactory and when the price level and balance of payments situations were stable. Conditions of economic stagnation...or continued deterioration are evidently prerequisites for reform effort". Likewise, Rodrik (1994) explains that:

“The reasons for the free trade bandwagon are more or less unique and derive from the intense, prolonged macroeconomic crisis that surrounded developing countries during the 1980s...which overshadowed the distributional considerations....” After examining 13 episodes of economic reforms, Williamson and Haggard (1994) reach a more cautious conclusion: “Crisis is clearly neither a necessary nor a sufficient condition to initiate reform. It has nevertheless often played a critical role in stimulating reform”⁶.

According to this “crisis hypothesis”, in the midst of an economic crisis highly trained social scientists, who in normal times have little or no political influence, are called by politicians and asked to help forge a way out of the crisis. All of a sudden, the incoming *technopols*’ ideas — usually based on the Anglo-Saxon economic tradition and consistent with the views of the multilateral institutions — become highly influential⁷. As this contest takes place in the marketplace of ideas, the proponents of the old, protectionist development strategy will try to dismiss the new approach as being foreign and/or imposed by the multilateral institutions. The *technopols* then try to persuade politicians and the public at large that their programme is based on sound scientific principles and that it is supported by international empirical evidence. Ideas are not only important in formulating the reform plan, but also in implementing the actual liberalisation programme, because issues related to speed and sequencing become important. Moreover, at the implementation stage the *technopols* usually find out that the realities of politics conflict with the simple world of economics. Their ability to understand political trade-offs and to design sellable strategies may determine the success of the reform effort.

Although the actual way in which the reforms are implemented varies across countries, the early phases of the process are often concentrated on basic economic issues, and in particular on macroeconomic stabilisation and trade liberalisation. The co-ordination of macroeconomic and trade reform policies becomes crucial at this time. The political effect of these early reforms, particularly the support they will elicit from the population, will depend on a number of factors, including: *a*) whether the government is able to put in place an effective public relations effort; *b*) the performance of the economy — if growth declines and inflation is slow in falling, political support will tend to erode quickly; *c*) the government capacity to put in place compensation schemes that will defuse opposition to the reforms; and *d*) the government’s ability to forge broad political coalitions.

Reformist governments able to form broad coalitions and, more importantly, to compensate (potential) losers will be able to neutralise opponents, and will face an easier task in pursuing the reform agenda. As Haggard and Webb (1994) have argued, most successful compensation schemes have been rather complex, and have not been based on simple monetary transfers to those who are directly hurt by the reforms. Table 2.1 provides a description of five commonly used compensation schemes. The first one, called *direct compensation*, includes the traditional mechanisms used by governments to “buy” the support of certain groups directly affected by the reform process. An example of this type of mechanism would be the distribution of shares in privatised companies to workers in those companies. The next three compensation

schemes are subtler, and are not as straightforward. *Indirect mechanisms* rely on making policy adjustments in areas unrelated to the reforms proper, in order to compensate (potential) opponents; *cross compensation* mechanisms, on the other hand, try to “buy” the support of groups not directly affected by the reforms. This is usually done by transferring resources to these groups. *Exclusionary compensation* mechanisms try to deflect opposition by certain groups, by not including them among those affected by particular reform measures. The final category in Table 2.1 — political compensation — goes beyond the purely economic sphere and concentrates on political mechanisms, including the appointment of reform sceptics into key government positions. In a way, the reform government will try to co-opt (some) reform opponents, by allowing them to share in the trappings of political power.

Table 2.1. The Political Economy of Reform and Compensation Mechanisms

Compensation Mechanisms	Main Features and Some Historical Examples
A. Direct Compensation	Groups directly affected by the reform policy are compensated through the transfer of cash or financial securities. In this way the authorities expect to see a reduction in the extent of opposition from that group to that particular reform. Examples of this type of compensation mechanisms include the distribution of shares of privatised firms to workers in that particular firm. The increase in take-home pay following a social security reform is another good example of this type of direct compensation scheme.
B. Indirect Compensation	This mechanism implies compensating (some of) the groups affected by a particular reform through the adjustment of a different policy that indirectly raises their revenues or reduces their costs of production. In some cases this type of indirect compensation is “automatic”, and is the result of normal economic forces at work. In others it is the result of specific policy measures. One of the most important indirect compensation mechanisms is given by the real exchange rate (RER) adjustment following a trade reform. By devaluing the real exchange rate, import-substituting sectors are partially compensated, while exporters experience an additional boon. Providing tax exemptions to sectors affected by deregulation constitutes another common form of indirect compensation.
C. Cross Compensation	This mechanism entails transferring resources — either directly or indirectly — to groups not directly affected by the reform, in order to obtain their political support. Transferring shares of privatised firms to the population at large — as in Bolivia’s capitalisation programme — is a good illustration of this mechanism at work.
D. Exclusionary Compensation (i.e. Exemptions)	Entails excluding certain powerful groups from the effects of a reform, or implementing policies that in effect exempt some sectors from the reform in order to defuse their political opposition. By allowing these groups to maintain their old privileges it is expected that they will not become active antagonists. The special treatment given to the Chilean armed forces regarding that country’s social security reform is a classic example of this type of compensation mechanism.
E. Political Compensation	This mechanism encompasses political “carrots and sticks”. For example, the appointment of influential representatives of certain groups affected by the reforms to high government posts often sends a signal to interest groups that their concerns will be addressed.

Exporters are usually among the early supporters of reform-oriented governments. They benefit directly from the reduction of import tariffs affecting their inputs of production, and from the exchange rate depreciation that often takes place during the early stages of a stabilisation programme. Producers of import-competing goods are usually among the opponents of trade reform initiatives, but are often at least partially compensated by the real depreciation of the currency. In addition, losers of trade liberalisation can also be compensated through other schemes. In particular, if the reform process is seen as a package, of which trade liberalisation is only one component, some import-substituting groups may support the reforms if they perceive that they will directly benefit from privatisations or financial liberalisation, for example. Unions representing the employees of state-owned enterprises are almost always among the most vehement opponents of economic reforms. Reformers often try to win them over, or at least to neutralise them by offering some participation in the newly privatised firm.

Support from the multilateral institutions — either in the form of technical assistance or through the provision of funds — may help the reform effort, once it has been launched. However, there is significant evidence that the multilaterals — and mostly the IMF and the World Bank — have not usually played a fundamental role in the initiation of the reforms (see Edwards, 1997*a*). According to Lal (1997), in order to encourage the reform government to undertake its tasks, “sweeteners which ease its fiscal problems, in the form of soft loans or grants from multilateral and bilateral foreign governments, may be desirable. Beyond that the role of foreign assistance seems limited”. Also, Haggard and Webb (1994) have argued that there are no recorded reform episodes since the mid-1970s that have failed exclusively owing to a lack of financial support from the multilateral financial institutions.

How well the reform effort fares from a political economy perspective will also depend on the political structure of the country, including the degree of democratisation, the nature of the party system, the degree of decentralisation, the importance of the bureaucracy in implementing policies and the degree of political polarisation. For example, countries with a two-party system and a low(er) degree of political polarisation may find it easier to forge a national project and implement reforms with a long pay-off period, including the so-called institutional reforms, than those countries (such as Brazil) with a highly fragmented political system. More generally, countries with a high degree of political conflict may tend to get easily bogged down in political struggles. The sequencing and speed of reform also matter for the political economy of reform; they determine how fast the economy grows and whether it is feasible to compensate losers in an appropriate fashion. This issue is discussed in greater detail in the next section.

A question of particular relevance concerns the relationship between the extent of democratic practices and tradition, and the political constraints faced by reformers. More specifically, do authoritarian regimes face political constraints, or do they essentially face a free hand? There is little doubt that in the absence of electoral competition a reformist government has more degrees of freedom. This does not mean, however, that reformers have a completely free hand in a dictatorship. In fact, even

within a dictatorial regime there will be factions that will represent different interest groups. In this case the *technopols* still have to convince strongmen, usually high-ranking military officers, that their policies are appropriate for the country. More specifically, the market-oriented perspective often clashes with the strongly nationalistic and state-centred views of the military. Moreover, the authoritarian government will still demand results — although it may give the reformists more time to obtain them — and would like to maintain some degree of legitimacy, while political repression will tend to be targeted to specific groups⁸. A related issue concerns the extent of freedom of expression under authoritarian regimes, which may limit the scope of the market of ideas.

With time, and as the original crisis subsides, reform sceptics and opponents — and in particular, those groups that have traditionally captured rents generated by government policies (including public sector unions) — are able to regroup and to challenge the reform. Their efforts to slow down the modernisation process — and even to reverse it — can be successful if the reforms have failed to generate significant improvements in economic conditions, including higher real wages and lower unemployment. Such attempts to reverse the reforms will usually be present in both democratic and authoritarian settings. While in some cases nostalgia and the populist temptation are strong enough to bring the reforms to a standstill, in others the modernisation forces are able to continue moving forward until the reform process is consolidated. The way in which a reformist government reacts to the anti-reform challenge is also an important determinant of the fate of the modernisation effort. For example, in order to regain some public support the authorities may reduce the pace of key reforms, or they may relax the public sector budget constraint to face a political challenge, such as a mid-term election or a plebiscite in the case of an authoritarian ruler seeking to enhance his legitimacy.

Speed, Sequencing, Exchange Rates and Protective Structure

Recent discussions of the political economy of reform have focused on the tensions between “optimal” and “feasible” trade reform strategies. Much of this literature has focused on two issues: *i*) the adequate speed of reform; and *ii*) the sequencing of reform. The role of “transition costs”, and particularly of the unemployment consequences of trade liberalisation has been at the centre of these discussions. For a long time analysts argued that a gradual liberalisation was preferable to a big bang approach (Little *et al.*, 1970; Michaely, 1985). According to these authors, gradual reforms would give firms time for restructuring their productive processes and, thus, would result in low dislocation costs in the form of unemployment and bankruptcies. These reduced adjustment costs would, in turn, provide the needed political support for the liberalisation programme. During the early 1990s, however, the gradualist position came under attack. It was argued that slower reforms tend to lack credibility, inhibiting firms from actually engaging in serious restructuring.

Lal (1997) has argued that “once the crisis of the state seems to be manageable, there is no further incentive for the predatory state to continue with liberalisation...This suggests that a ‘crisis’ provides an opportunity for liberalisers — but it may be of short duration. A big bang may therefore be desirable...” (see also Rodrik, 1989a; Calvo, 1989; and Martinelli and Tommasi, 1995). Moreover, the experience of a number of countries during the 1980s and 1990s has shown that a gradual (and preannounced) reform allows those firms negatively affected by it to lobby (successfully) against the reduction of tariffs and the modernisation process.

The thinking on the speed of reform has been influenced by considerations of the short-run unemployment consequences of trade liberalisation. To the extent that reform increases unemployment, there will be an active opposition to it. The strength of this opposition will largely depend on who becomes unemployed. It is not the same if those unemployed belong to a powerful union in the protected sector (including a privatised SOE) as if they come from the ranks of workers in the informal sector. According to the standard view — based on specific-capital (Ricardo–Viner) models, with wage rigidities — a gradual reduction of trade restrictions allows firms to reallocate capital out of the unprotected sector and into the export industries, without generating employment dislocations. At the end of the day, however, whether trade reform will generate an increase in aggregate unemployment is an empirical issue. A World Bank study on liberalisation episodes in 19 countries led by Choksi *et al.* (1991) suggests that, even in the short run, the employment costs of reform can be small. Although contracting industries will release workers, those expanding export-oriented sectors that are positively affected by the reform process will tend to create employment opportunities. Edwards and Lederman (1998) have argued that in the presence of labour market distortions a trade reform may reduce the extent of overall unemployment, generating political support among some labour groups.

The sequencing of reform issue was first addressed in the 1980s in a systematic way in discussions dealing with the Southern Cone (Argentina, Chile and Uruguay) reform experience of the late 1970s and early 1980s, and emphasised the macroeconomic consequences of alternative sequences. It is now generally agreed that the fiscal accounts have to be (partially) under control at the time that a major structural reform effort is launched. Most analysts also agree that financial reform should only be implemented once a modern and efficient supervisory framework is in place. The importance of reforming the supervisory framework — and in particular, of having strong banks — has become particularly evident in the aftermath of the 1994 Mexican currency collapse, and the 1997–98 East Asian currency crises. These episodes have clearly shown that a weak and unsupervised banking sector can generate a tremendous degree of vulnerability, transforming a run-of-the-mill external sector crisis into a major eruption with unforeseeable political ramifications.

One of the most hotly debated issues in the sequencing literature refers to the order of liberalisation of the trade and capital accounts. The behaviour of the real exchange rate is at the heart of this discussion. The central issue is that liberalising the capital account would, under some conditions, result in large capital inflows and in an

appreciation of the real exchange rate (McKinnon, 1991)⁹. The problem with this is that an appreciation of the real exchange rate will send the “wrong” signal to the real sector, frustrating the reallocation of resources demanded by the trade reform. The effects of this real exchange rate appreciation will be particularly serious if, as argued by McKinnon (1982) and Edwards (1984), the transition period is characterised by “abnormally” high capital inflows that result in temporary real appreciations. If, however, the opening of the capital account is postponed, the real sector will be able to adjust and the new allocation of resources will be consolidated. According to this view, only at this time should the capital account be liberalised¹⁰. Some recent work by Valdés and Soto (1996) and Edwards (1999), however, has questioned the effectiveness of capital controls — or at least capital controls of the Chilean type — for avoiding situations of real exchange rate overvaluation.

Real exchange rate behaviour has important implications for the political economy of trade liberalisation. According to traditional manuals of “how to liberalise”, a large devaluation should constitute the first step in a trade reform process. Maintaining a depreciated and competitive real exchange rate during a trade liberalisation process is also important in order to avoid an explosion in import growth and an eventual balance of payments crisis. Under most circumstances a reduction in the extent of protection will tend to generate a rapid and immediate surge in imports. On the other hand, the expansion of exports usually takes some time. Consequently, there is a danger that trade liberalisation will generate a large trade account disequilibrium in the short run. This, however, will not happen if a real exchange rate depreciation encourages exports and helps maintain imports in check. Moreover, as it was argued above, the depreciation of the real exchange rate constitutes one of the most important indirect compensation mechanisms (see Table 2.1). Many countries, however, have failed to sustain a depreciated real exchange rate during the transition. This has mainly been the result of expansionary macroeconomic policies that generate speculation, international reserve losses and in many cases lead to the reversal of the reform effort. According to Choksi *et al.* (1991), “In terms of economic performance and policies, liberalising countries are characterised by a much faster growth of exports, generally lower budgetary deficits and (less clearly) budgetary expenditures, and clearest of all, long-term stability of the real rate of foreign exchange”.

Discussions on the political economy implications of the sequencing of reform have expanded their area of emphasis and have focused on a variety of markets. An increasing number of authors have argued that the reform of the labour market — and in particular the removal of distortions that discourage labour mobility — should precede the trade reform, as well as the relaxation of capital controls. As argued in Edwards (1988; 1995*a*), it is even possible that the liberalisation of trade in the presence of highly distorted labour markets will be counterproductive, generating overall welfare losses for the country in question. More importantly, perhaps, an early labour market reform has important consequences for the political economy of trade liberalisation. For example, the easing of hiring and firing regulations is an important form of “indirect” compensation. Owners of capital that would otherwise oppose a trade reform may support it if trade liberalisation comes with more flexible labour market regulations.

Edwards and Lederman (1998) have noted that this is exactly what happened during Chile's trade liberalisation effort in the 1970s. On the other hand, unions in the formal sector will usually oppose labour market reforms that reduce their political and economic influence.

The sequencing between “policy”(or first generation) and “institutional” (or second generation) reforms also matters for the political economy of reform. As the terms “first” and “second” generation suggest, there is an implicit assumption regarding the sequencing of these two types of reforms. *Policy reforms* are implemented earlier — both for technical and political reasons — while *institutional reforms* are usually postponed in time and are only attempted at later stages (Naim, 1995; Tommasi and Velasco, 1995; Burki and Perry, 1997). Recent experiences increasingly suggest, however, that the adherence to this linear sequencing may be counterproductive, costly and inefficient. The postponement of institutional modernisation until the first generation reforms are firmly in place could, in fact, generate unwanted — and even negative — economic effects. This was the case, for example, in Chile in the 1970s and early 1980s, where the liberalisation of the financial sector without the creation of an adequate supervisory structure resulted in a major financial crisis. Likewise, the liberalisation of international trade in the absence of the modernisation of labour market institutions will in many cases generate unemployment and high dislocation costs. An inefficient — and worse yet, corrupt — judiciary system will increase the transaction costs associated with private initiative, and will result in sub-optimal investment levels. And privatising utilities without putting into place an appropriate competition policy will result in monopolistic pricing and distortions.

The postponement of institutional reform will not only affect the efficiency of the economy, but is also likely to generate undesirable distributive effects. These could include, among others, the appropriation of rents by private operators of newly privatised utilities, the reduction of the level of employment in certain sectors affected by labour market rigidities, the erosion of the real (expected) value of pensions for the poor, and the delivery of low quality social services to the less fortunate groups of the population. A large number of Latin American countries have been affected by many of these problems in the last few years. All of this, of course, suggests that in order for the modernisation reforms truly to bear fruit and be successful an effort should be made to implement institutional reforms early on — ideally alongside the economic reforms proper.

Table 2.2 presents a summary of the main hypotheses on the political economy of reform discussed in this chapter. As will be seen in the rest of this study, most of the issues identified in this discussion as important — speed, sequencing, unemployment consequences, and real exchange rate behaviour, among others — played an important role in the unfolding of the Colombian reforms. What is particularly interesting is that, in the end, both the policies as well as their effects were significantly different from what the Colombian policy makers — and some outside observers — had expected.

Table 2.2. **Eleven Key Hypotheses on the Political Economy of Market Oriented Reform**

Hypothesis	Comments
1. Crisis Hypothesis	A market-oriented reform is usually initiated in the midst of a major economic crisis.
2. Technocratic reform team leads the modernisation effort	The reforms are designed and implemented by a team of technocrats — the <i>technopols</i> .
3. Ideas matter	The <i>technopols</i> have a clear ideology. The design of the reforms, and their outcome, are affected by this ideology. The reform process goes beyond purely distributive issues. In some cases the political leader does not have a reform ideology at the beginning of the process; in others, he hides his ideology from voters. This is the so-called <i>voodoo-economics</i> hypothesis.
4. A strong public relations effort helps increase the support for the reforms	The average citizen has mixed feelings about the reforms. In the midst of a crisis he is willing to experiment with new policies; on the other hand, he is apprehensive about new ideas. A strong marketing effort will help him understand the true nature of the reform programme.
5. Compensation schemes can help reduce the opposition to the reform effort	The reforms have profound effects on income distribution. Naturally those groups hurt by the reform will oppose them. The use of broadly defined compensation schemes, that usually go beyond the economic sphere, can effectively help deflect this opposition.
6. Sequencing matters	The order in which reforms are undertaken has economic and political consequences. It affects the nature of the distributive conflict, and the authorities' ability to implement effective compensation schemes.
7. Speed matters	The speed at which the reforms are implemented has important political effects. There usually is, however, a trade off between <i>credibility</i> and <i>adjustment</i> costs. Gradual reforms will have lower adjustment costs, but will tend to have a low degree of credibility. To the extent that there is a "honeymoon period" a more rapid reform during the initial months may be effective.
8. Political institutions are important	The nature of political institutions matters. Some of the most important aspects are the degree of decentralisation, the strength of the executive, and the degree of independence of the judiciary and the central bank.
9. External support may be important at certain junctures	Support from the multilaterals — IMF and World Bank, for example — may help launching the reforms. In some cases technical advice can also be useful. The importance of external actors tends to be exaggerated in the popular media.
10. Coalition building can ease the political costs of the transition	Forging a broad coalition — or a national project — around the reform effort will greatly reduce the political opposition and facilitate the transition. By their own nature, however, broad political coalitions are fragile and may break easily. This suggests that an effort should be made to make progress while the coalition holds in place.
11. The opposition to reform tends to grow through time, as those negatively affected by it regroup	As the sense of urgency created by the initial crisis subsides, the appeal of reforms declines. Opponents see an opportunity to regroup. The extent and success of this opposition will depend, among other things, on the performance of the economy. If growth is fast, wages increase and unemployment is down, the support for reform will be sustained.

Notes

1. I am indebted to Daniel Lederman for his assistance in revising this chapter.
2. Readers interested in a more detailed coverage of the analytics of the political economy of reform should consult, for example, Williamson (1994), Haggard and Kaufman (1992), and Tommasi and Velasco (1995).
3. In spite of their elegance, however, models based on the Stolper–Samuelson framework have a number of limitations. They assume that the interests of workers and capitalists are independent of the sector where they operate initially, and they ignore important macroeconomic considerations, including the potential role of the exchange rate. Extensions of the basic Stolper–Samuelson framework, however, allow for additional actors, as well as for complex relationships between them. A powerful extension — and one that has become very popular among political scientists working on the political economy of trade — assumes that some of the factors (capital, say) are sector specific. In this case, capitalist interests differ depending on which commodities they are producing at the time the reforms are launched. That is, in this framework capital involved in the production of exportables, importables and non–tradables may (and usually will) have conflicting interests. Moreover, if the country in question is characterised by a semi–enclave traditional exportable sector — oil in Venezuela, copper in Chile, coffee in Colombia — there will be conflicting interests between this traditional sector and the rest of exportables.
4. This, of course, does not mean that the basic principles of international trade theory cease to be relevant. In fact, the extended general equilibrium framework sketched here, and favoured by many analysts, continues to be extremely powerful.
5. On the distinction between “first” and “second” generation reforms see Naím (1994, 1995).
6. For additional arguments in favour of the crisis hypothesis, see Drazen and Grilli (1993), Tornell (1995), and Bruno and Easterly (1996). For a sceptical view, see Rajapatirana *et al.* (1997), who show that historically many macroeconomic crises in Latin America have resulted in the “tightening” of trade policies.
7. Domínguez (1997, p. 7) defines *technopols* as follows: “Technopols are a variant of technocrats. In addition to being technocrats... technopols are political leaders *i*) at or near the top of their country’s government and political life (including opposition political parties) who *ii*) go beyond their specialised expertise to draw on various different streams of knowledge and who *iii*) vigorously participate in the nation’s political life *iv*) for the

purpose of affecting politics well beyond the economic realm and who may, at times, be associated with an effort to ‘remake’ their country’s politics, economics, and society. Technopols so defined may operate in either authoritarian or democratic regimes”.

8. For instance, a Chilean sociologist, Garretón (1985), wrote that in the case of Chile, “we are...dealing with a program to lay the groundwork for a new social order... We must direct our attention to the capacity of diverse sectors in the dominant power bloc to achieve hegemony within it. The attempt to restructure society... can take several directions depending on the capacity of particular sectors to generalize these interests or to impose their own ideology within the victorious coalition.” In fact, the general issue of “state autonomy” from economic and social interests has had a long trajectory in the social sciences.
9. This would be the case if the opening of the capital account was done in the context of an overall liberalisation programme, where the country would become attractive for foreign investors and speculators.
10. Lal (1985) presents a dissenting view.

Chapter 3

The Colombian Reforms: Background and Actors

This chapter provides some background on the Colombian reforms, setting the stage for the political economy analysis undertaken in Chapters 4 and 5. Emphasis is placed on three issues: the initial conditions faced by the Gaviria administration; the most important actors in the Colombian reformist effort; and finally, ideas and politics.

Initial Conditions

Colombia was one of only two major Latin American countries that was not devastated by the 1980s debt crisis — the other was Chile. Throughout the 1980s Colombia exhibited a positive rate of growth of GDP per capita, did not reschedule its foreign debt and was able to maintain inflation under (relative) control (Table 3.1). Moreover, during the 1970s and 1980s most social indicators in Colombia exhibited major improvement. The Gini coefficient showed a declining trend, poverty was reduced, and regional disparities narrowed significantly (Londoño, 1995). It is not an exaggeration to say that Colombia was one of Latin America's best performers — if not the very best — during the 1980s.

Table 3.1. **Colombia: Main Economic Indicators 1980–1990**

	1980–85	1986–90
Real GDP growth	2.6%	4.6%
Inflation	23.1%	25%
Public Sector Balance as percentage of GDP	–5.7	–1.1
Current Account Balance as percentage of GDP	–5.1	0.5
Investment (gross) as percentage of GDP	19.7	19.7
Gross National Savings as percentage of GDP	14.6	20.2
Unemployment	11.0	11.5

Source: World Bank (1994).

Colombia's achievements during this decade were not, however, the result of "good" policies, but rather the reflection of the country's ability to avoid major crises. By keeping out of trouble, Colombia had historically been able to avoid the stop-go cycles that have plagued the Latin American economies. Starting in the early 1960s Colombia followed a "pragmatic" economic policy based on selective but firm government intervention, that neither fully choked the private sector with over-regulation, nor allowed it to flourish. This hybrid policy stance led Carlos Díaz-Alejandro (1985) to argue that "[s]ocial scientists have had a difficult time fitting Colombian experience of the last 30 years into fashionable categories such as monetarism, structuralism, bureaucratic-authoritarianism and such". According to Urrutia this "pragmatic" stance permitted Colombia to avoid populist outbursts, to pursue a stable macroeconomic policy aimed at avoiding real exchange rate overvaluation — through a crawling peg exchange rate regime — and to follow a largely progressive public expenditure policy. Urrutia (1994) credits four features of Colombia's political and social system with these results: a strong political system based, since at least the 1960s, on a two-party system; a decentralised social arrangement built on "clientelism"; a professional and efficient technocratic class; and a free press. Martz (1993), and to a lesser extent Cepeda (1994), have argued, however, that Colombia's political institutions have traditionally been very weak, resulting in an increasing degree of influence of pressure groups and in a declining popular participation in the democratic process.

During the late 1980s, and in spite of what some considered to be an adequate performance, the Colombian economy had increasingly become more and more regulated. Government intervention grew significantly and red tape increasingly stood in the way of private investment. Some of the more clear distortions included:

- By 1985 Colombia had one of Latin America's — and the world's, for that matter — most distorted trade regimes: Average nominal import tariffs were 74 per cent, the average rate of effective protection exceeded 60 per cent and more than 75 per cent of imports were subject to prior import licences.
- Labour legislation was antiquated and generated severe costs to the private sector. In an effort to protect employment labour regulations discouraged job creation and tended to generate informality.
- The financial sector was highly distorted. Banks had forced credit allocations and interest rates were controlled by the authorities. For many years real interest rates were negative and credit allocation was highly distortive.
- Since 1967 Colombia had an extensive system of massive exchange controls. Originally this system had been devised as a way of allowing the Central Bank to carry out a nominal exchange rate policy based on frequent mini devaluations. The purpose of this exchange rate policy — which at the time of its inception was considered to be extremely creative — was to avoid real exchange rate overvaluation and to maintain export competitiveness. With time the mini devaluations policy became the staple of Colombia's policy making. Ironically,

perhaps, economic agents came to believe that it was a fundamental determinant of Colombia's (relative) economic stability. By the late 1980s the Exchange Controls Statute had become an institution universally revered in the country.

- Foreign direct investment (FDI) was subject to a surrealistic array of controls. The legislation governing FDI had its origins in the Andean Pact's infamous Article 24 which, for all practical purposes, was aimed at cutting the Andean nations from the world economy.
- The tax system was seriously distorted. Inflation eroded tax assessments, distributed earnings were subject to double-taxation, evasion was rampant and a number of sectors had been able to obtain significant exemptions.
- The public sector played an important role in the productive process — both at the national and decentralised levels. Even though state-owned enterprises were not as important as in other Latin American nations, they still covered some of the key areas, including telecommunications, power and oil.

Although Colombia did not suspend payments to foreign creditors during the 1980s, the international financial community drastically reduced its Colombian exposure after 1982¹. In José Antonio Ocampo's (1989) words, Colombia was the victim of a "neighbourhood" effect — it suffered the consequences of being a Latin American nation — and experienced a severe decline of net resource transfers from the rest of the world. Moreover, during the early 1980s Colombia faced a significantly negative terms of trade shock, as the price of coffee — the country's main export — declined significantly in the world economy.

As a result of these two external shocks — the cut of external financing and the worsening in the terms of trade — Colombia was forced to implement a major adjustment in the first half of the 1980s. The adjustment programme was based on the implementation of a real exchange rate depreciation — through an acceleration of the pace of mini devaluations — a timid fiscal correction, and a major hike in the degree of protection. Average (nominal) import tariffs (including tariff surcharges) were hiked from 32.5 per cent in 1980 to 61 per cent in 1984. More important yet, import licences increased very significantly during this period: while in 1980, 30 per cent of imports required a licence, by 1984 99.6 per cent of imports were either prohibited or required prior licences! (Table 3.2).

Table 3.2. The Extent of Protection in Colombia: 1980–88

	1980	1984	1988
Average Nominal Tariffs	26%	57%	27%
Average Effective Rates of Protection	43%	n.a.	n.a.
Percentage of Imports Subject to Prohibitions or Licences	31%	99%	62%

Source: World Bank (1994).

By 1984 it had become evident to many observers — including Colombian academics and the staff of the multilateral institutions — that this high degree of protectionism was suffocating the economy. In 1984, the World Bank initiated discussions with the authorities on the need to implement a trade reform programme that would reduce Colombia's staggering degree of protection. A World Bank report on agriculture policy dated 20 April 1984 argued in characteristically guarded Bank language that "[a] reversal of the recent restrictive measures would be desirable ... Liberalization may need to proceed in stages in order to ameliorate adjustment costs ... [A] major liberalization while the exchange rate is appreciated can be problematic from the point of view the domestic industry." In May 1985, and after extensive discussions with the Colombian authorities, the World Bank approved a Trade Policy and Export Diversification Loan whose main purpose was to assist Colombia move towards a more open trade system. This operation was followed by a second trade-related loan — the Trade and Agriculture Policy Loan — approved by the World Bank's board of directors in 1986. While the first loan was considered to be a major success, the second ran into difficulties and many of the policies that it contemplated (explicitly or implicitly) were either postponed or not undertaken. The delay in the implementation of these policies generated serious strains between the World Bank and the Colombian authorities until mid-1990 (Cepeda, 1994; Urrutia, 1994).

By 1988, and as a result of the reforms sponsored by the World Bank, Colombia's trade regime had become less restrictive, but still maintained a considerable degree of discretion, mostly in the form of very high coverage of import licences (Table 3.2). A particularly important achievement of the trade liberalisation effort initiated — albeit timidly — in 1985, was that it had been carried out at the same time as a real exchange rate depreciation was achieved. In fact, since at least 1967 one of the most important concerns of Colombian policy makers had been to avoid real exchange rate overvaluation. As Díaz-Alejandro (1976) and Wiesner (1997b), among others, have argued, the main purpose of the exchange controls statute — the *Estatuto Cambiario* — adopted in 1967 was to allow for a crawling peg exchange rate regime that would protect the real exchange rate from the erosion of inflation (Figure 3.1)².

During the second half of the 1980s, inflation — which had traditionally been rather mild by Latin American standards — became more and more entrenched. Indexation mechanisms became generalised, and efforts to return the country to (relative) price stability systematically failed. By the late 1980s inflation had acquired a significant degree of inertia, and seemed to be stuck at around the 25 per cent annual mark (Figure 3.2). Although most economists agreed that reducing inflation was an important requirement for improving overall performance, this was not perceived as a major priority by the public at large. The proliferation of indexation mechanisms — both formal and informal — had eliminated the urgency to reduce inflation.

Figure 3.1. **Bilateral Real Exchange Rate**
(1990=100)

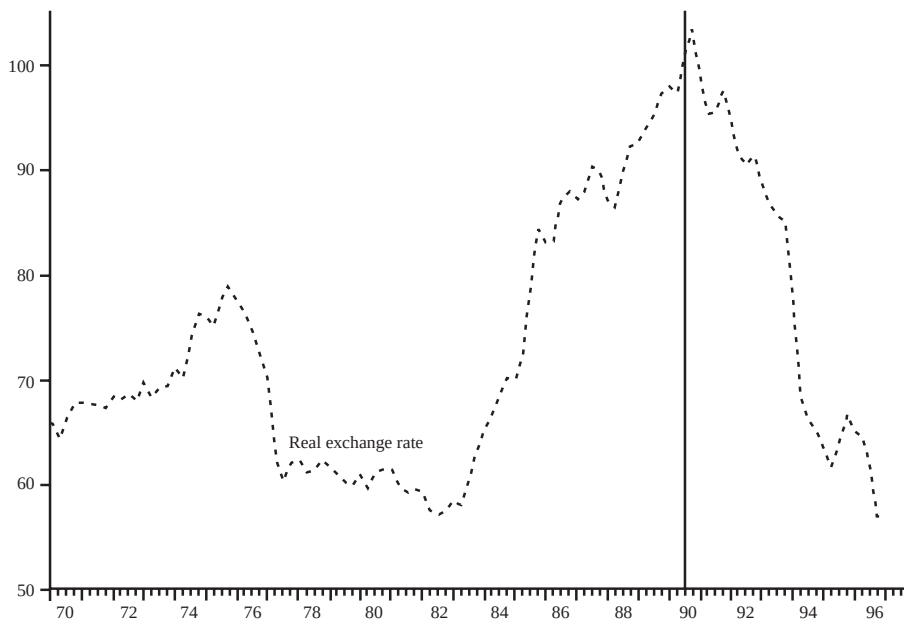
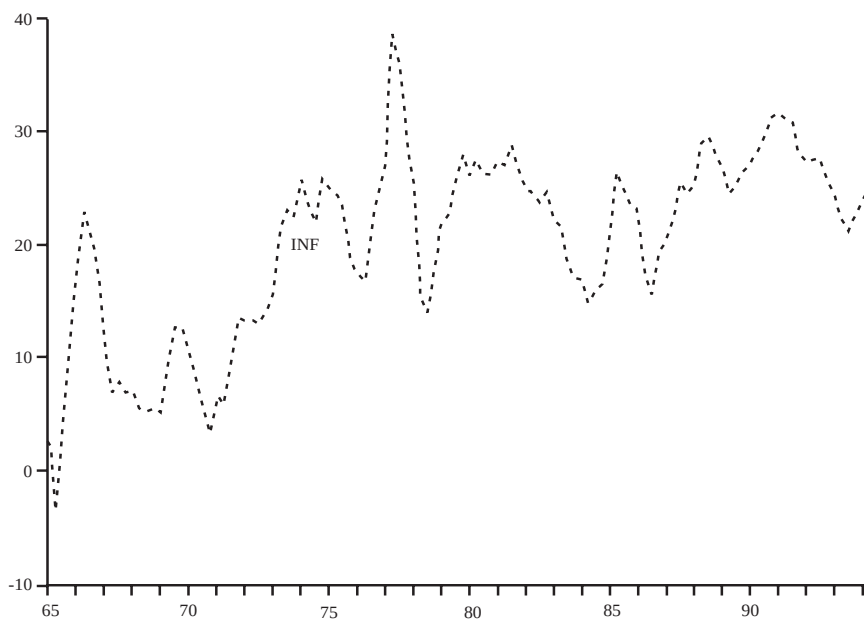


Figure 3.2. **Annual Rates of Inflation 1965–95**
(quarterly data)



In February 1990, and after much internal debate, the Barco administration decided to liberalise international trade further. The plan, which was explained in the official document *Modernización e Internacionalización* (CONPES and CDCE, 1990), was extremely complicated, and classified imports in groups subject to different import procedures. While some goods (those considered to be necessities) could be imported freely, others were subject to previous licences and yet others had to obtain a licence through a cumbersome auction system. In spite of its administrative complications, the Barco trade reform genuinely began to open the Colombian economy. As Ocampo and Villar (1992) have pointed out, this process was carried out — or perhaps, more accurately, was planned — within a long-standing Colombian tradition: first, the opening up of the economy was to be gradual. In fact, the *CONPES Modernización e Internacionalización* document itself stated that the success of the proposed reforms would depend on them being implemented gradually, avoiding “a shock policy”. And second, the reduced degree of protection was supposed to be compensated by a significantly depreciated real exchange rate that would help maintain (if not enhance) the country’s degree of international competitiveness. In fact, as Figure 3.1 shows, during the last two years of the Barco administration Colombia’s real exchange rate was at the most depreciated level it had experienced since the adoption of the crawling peg regime in 1967. It was in fact the assurance that the reform would be gradual and that real exchange rate would remain highly depreciated (and even that it would depreciate even further) that finally convinced two of the most important private lobbies in the country — textile and steel producers — not actively to oppose the reforms. As will be discussed in detail in Chapter 5, the behaviour of the real exchange rate became one of the fundamental issues — if not *the* fundamental issue — in discussions on the merits of the reform path during 1992–94.

This plan to open further the economy to international competition was to be supplemented by a series of measures geared at reducing the extent of government control and modernising Colombia’s economic institutions. According to Cepeda (1994) the Barco administration went a long way in trying to persuade the population — and especially the most influential pressure groups — that this proposed opening up had not been imposed by the multilateral institutions, and did not follow a “foreign” pattern (see also Alarcón, 1995). Urrutia (1994) has argued that this reform effort was in part the result of a sense of inevitability; since the Barco economic team recognised that liberalisation and market-orientation had become a powerful global trend, that could not be opposed: if you cannot fight them, join them³. There is little doubt, then, that during the second half of the Barco administration, a reform process was initiated. Plans were designed, programmes were drafted and some specific measures were implemented. Overall, however, these efforts were timid. They were in fact timid both in relation to what the Gaviria administration would do during its first two years, and they were timid when compared with the reform frenzy that at that time was beginning to engulf many of the Latin American nations.

Although by 1990 the Colombian economy showed some weaknesses — inflation had become stubborn, inefficiencies were piling up, and growth had decelerated somehow — it was far from facing a major crisis. Indeed, as already noted, during the 1980s Colombia exhibited the strongest performance of any Latin American country.

The absence of a major balance of payments crisis has led some analysts, such as Williamson (1994), to argue that the initiation of the Colombian reforms does not conform to the “crisis hypothesis” discussed in Chapter 2. This view misses, however, two fundamentally important issues. First, the Colombian reforms during the Gaviria administration went well beyond the economic sphere. In fact, as pointed out in Chapter 1, the administration’s intention was to introduce major changes on the political, narcotics and economic fronts. Second, although the economy was not in dire straits, the country was indeed facing a major political and social crisis. Drug trafficking — which for a long time had only been considered an annoyance — was becoming severely entrenched. Violence was spreading rapidly and, in spite of some successes in the effort to forge a peace agreement, the guerrilla movement continued to operate with quasi-impunity in vast regions of the country. The political system had also entered into a deep crisis. Congress had increasing trouble passing meaningful legislation, the relationship between the provinces and the national government was tense, and voters showed considerable apathy.

Many observers have indeed argued that in the late 1980s Colombia could be characterised as a “blocked democracy”. The institutional arrangement through which the Conservative and Liberal parties shared power — formally from 1958 to 1968, and then informally — appeared to be exhausted⁴. During the 1970s and 1980s several efforts were made to get over the political impasse through a reform of the 1886 constitution. The latest of these efforts had taken place in 1988 during the Barco administration. At that time César Gaviria, then Minister of Government, had led the administration’s strategy to obtain the required support to go through with the reform. That time, as in two previous occasions the previous three decades, the country’s Supreme Court declared the legal procedures used to reform the constitution voided⁵.

On 15 August 1989 Senator Luis Carlos Galán, the founder and leader of the *Nuevo Liberalismo* wing of the Liberal party, and the indisputable front runner in the Liberal Party’s primary campaign, was assassinated by gunmen hired by the Medellín drug cartel. Galán had been an unrelenting proponent of the modernisation of Colombia’s political system, and had argued with great vehemence that the government should use an extremely hard line when dealing with drug dealers. In many ways Galán had become the candidate of morality and anti-corruption. In terms of economic policy, for a long time Galán had followed the Liberal Party’s tradition of supporting import substitution and a high degree of government intervention. However, starting in 1987, and after returning to Colombia from a year in the United Kingdom, Galán’s views on the economy began to change. Increasingly he called for modernising the economy and opening up to international competition (Vargas, 1993).

In his effort to become a presidential candidate who would unify the Liberal Party, Galán had asked former minister César Gaviria, who did not belong to the *Nuevo Liberalismo* wing of the party, to become his campaign manager (*Jefe de Debate*). In this position Gaviria not only gave the campaign a sound organisational base, but also helped Galán develop a reformist view regarding the economy. Vargas (1993) has argued that as the campaign proceeded Galán and Gaviria grew closer and closer, and that the latter's economic ideas slowly started to have an increasing importance in Galán's views.

On 20 October 1989, Galán's elder son — who at the time had barely turned 17 years old — surprised the *Nuevo Liberalismo* leadership when at his father's funeral he publicly, and emotionally, asked Gaviria to take over as the movement's leader. A few days later Gaviria officially joined the Liberal Party's primaries as the clear front runner. In March 1990, and after a campaign marred by threats from the drug cartels, and conducted mostly through TV and radio, Gaviria defeated his two Liberal rivals — Ernesto Samper, who would eventually succeed him as president in 1994, and Hernando Durán Dussán — and started his campaign for the presidency.

The months that followed Galán's assassination were particularly bloody and reflected, with all its terror, the deep institutional, social and political crisis that the country faced. In the last four months of 1989 alone, close to 90 bombs exploded in Colombia's major cities; the headquarters of a leading newspaper were destroyed; banks and corporate buildings were subject to terrorist acts; a powerful bomb went off in the security forces headquarters killing 63 people and wounding more than 600; and an Avianca plane was bombed killing more than 100 people⁶. When the 1990 presidential elections were finally over on 27 May 1990, three presidential candidates had been assassinated — Galán, Bernardo Jaramillo Ossa from the left wing UP, and Carlos Pizarro from the former guerrilla movement M-19. Additionally, Ernesto Samper, one of the leading Liberal Party pre-candidates, had been seriously wounded in an attack aimed at the Communist leader José Antioquera. When César Gaviria Trujillo, the 43-year old economist, became Colombia's constitutional president on 7 August 1990, Colombia was facing one of its worst crises. The economy may have been doing rather well, but the sense of institutional disintegration was evident to perceptive analysts and, clearly, to almost everyone living in the country.

The Actors

Traditional political economy models of reform tend to distinguish between two main actors — owners of capital and labour. As argued in Chapter 2, however, reality (and in particular Colombia's reality) is significantly more complex than what these crude models suggest. For instance, capital in different sectors has different interests, labour in different industries has heterogeneous views, the military has a saying, the bureaucracy has its own turf to protect, and ideology (including ideas) plays an important role in determining the course of policy. Colombia has traditionally had a unique way of organising its social, political and economic relationships. Urrutia (1983),

Table 3.3. **Main Actors in the Political Economy of Colombia's Reforms: Degree of Influence and Views Regarding Core Aspects of the Reforms**

	Degree of influence and power	Opening of international trade	Relaxation of Exchange Controls	Labour reform	Financial reform	Privatisation
A. Labour Movement	Dualistic. Low degree of unionisation, especially in comparison to other Latin American countries. Public sector and large firms (including SOEs) unions very powerful. Influence exercised through political channels.	Opposed strongly.	Opposed.	Mixed feelings. Opposed labour market "flexibilisation", although in favour of any measure reducing the costs of creating new unions.	Opposed.	Opposed very strongly.
B. Gremios						
– FEDECAFE (Coffee)	Extremely powerful and influential until 1988. Since then declining level of influence.	Favoured to the extent that it would result in lower costs and a more depreciated real exchange rate.	Favoured to the extent it meant a more efficient system for obtaining the returns from foreign exchange.	Supported.	Favoured if it resulted in reduced financial costs.	In favour, although not very enthusiastically.
– SAC (Agriculture)	Relative degree of influence, exercised through direct lobbying and through members of congress from agriculture producing zones.	Mixed feelings. Willing to support selective opening that lowers costs of inputs while protecting them from fluctuations of commodity world prices. Very strongly opposed reforms that would expose them to international competition.	Opposed, since perceived as increasing real exchange rate volatility.	Supported.	Opposed, because perceived as reducing forced credit allocations to agriculture.	Supported mildly.

	Degree of influence and power	Opening of international trade	Relaxation of Exchange Controls	Labour reform	Financial reform	Privatisation
– ANALDEX (Non Traditional Exports)	Increasingly powerful as a result of the diversification of exports.	Mixed feelings. Supported to the extent that it implied a real exchange rate depreciation. Opposed elimination of export incentives.	Mixed feelings. On one hand seen as a force towards reducing cost of (marginal) credit; on other as possible source for real exchange rate overvaluation.	Supported.	Mixed feelings. Wanted export subsidies programmes to continue.	Supported, as long as institutions that provided export promotion were maintained. Supported privatisation of ports.
– ANDI (Manufacturing)	Powerful, representing a diverse group of industries. Mostly focused on obtaining protection — either through tariffs/licences or depreciated real exchange rate.	Mostly opposed, although some non-traditional exporters in favour. Most groups willing to accept it only if accompanied (or preceded) by real exchange rate devaluation.	Mostly opposed as seen as disturbing exchange rate stability.	Strongly favoured.	Favoured, as seen as a modernising force contributing to lower financial costs.	Favoured.
– FENALCO (Commerce)	Grouping of a very large number of retail commerce owners. At times highly vocal.	Favoured, as seen as providing a major blow to wholesale smuggling (“San Andresito”)	Favoured.	Favoured.	Favoured.	Mixed feelings.
– ANIF (Financial Sector)	Highly sui generis “gremio”. Its views usually correspond to the personal views of its president.	In favour of gradual reform that did not open the economy fully.	Opposed to the extent that it meant an end to the revered crawling peg regime.	Favoured.	In favour of gradual and selected opening that would maintain some barriers to entry to the sector. In favour of ending administrative allocation of credit.	Favoured limited action in this area.

	Degree of influence and power	Opening of international trade	Relaxation of Exchange Controls	Labour reform	Financial reform	Privatisation
– ASOBAN-CARIA (Banking)	Quietly influential. Strong links to “modern” intellectual community. Exercises influence through technical assessments of the economy.	Favoured. Considered to be a needed modernising force in the country.	Largely favoured. Banks believed that they would be able to intermediate new foreign funds flowing into the country.	Favoured.	Favoured.	Favoured. Seen as opening opportunity for new deals and increased level of operations.
C. Military	Stayed mostly out of politics after 1957. Interested in maintaining large budget. Involved in fight against leftist guerrillas, and increasingly against drug lords. A military named minister of defence since 1964.	Favoured gradual opening. Main concern is border trade with Venezuela.	Mixed feelings.	Mixed feelings. Clearly opposed any attempt at reducing their economic positions.	No strong views.	Mixed feelings. Wanted to maintain parity with Venezuela.
D. Catholic Church	Largely conservative. Influential and interested in maintaining strong Catholic education. Highly concerned with morality — and family oriented — issues.	Neutral.	Neutral.	Mixed feelings. Some members of the church opposed it, since it was seen as reducing workers’ past “conquests”.	Neutral.	Neutral.
E. The Civil Society	Extremely weak. Almost does not exist beyond private business lobbying groups — the “gremios”.	No coherent views.	No coherent views.	No views.	No views.	No views.

	Degree of influence and power	Opening of international trade	Relaxation of Exchange Controls	Labour reform	Financial reform	Privatisation
F. Politicians	Initially grouped in the two traditional parties. Later joined by ex-guerrilla movement (M-19). With convocation of Constitutional Assembly their traditional (high) degree of influence greatly reduced. Very diverse views, depending on party and/or faction within party.	Very diverse views (DV). In general, the Gaviristas favoured an array of reforms, while the traditional Liberals (Samperistas) were significantly more sceptical. Conservador party slightly more prone to support reform.	DV	DV	DV	DV
G. The Bureaucracy	Technocrats in the economic ministries highly influential. Top levels moved in and out of government with ease. Views very consistent and favourable towards reform among top “change team”. Views among lower ranks highly diverse.	DV	Opposed.	Opposed.	Mixed feelings.	Opposed.
H. Drug Cartels	Increasingly influential as they tried to gain social respectability. Increasingly active in social and political activities — either directly or indirectly.	Mixed feelings. Opposed it if it meant a greater degree of scrutiny of the country by the rest of the world.	Favoured strongly.	Favoured.	Favoured to extent that it facilitated the movement of funds in and out of the country.	Favoured.

Source: Elaborated by the author.

for instance, has argued that what best characterises the country is a relationship of “clientelism” between social and economic actors and powerful institutions. Martz (1993) and Bushnell (1993), among others, have pointed out that the country’s two-party arrangement — based on power sharing — generated a highly underdeveloped democratic system. In contrast with other large countries in the region, labour unions are relatively weak — except for public sector unions and, what is perhaps more perplexing to the uninformed observer, the military has played a reduced political role since the 1960s.

The purpose of this section is to deal with the main (broadly defined) actors who participated in Colombia’s reform process. A distinction is made between internal and external actors. In analysing the different actors, the framework delineated in Chapter 2 is employed, and it is discussed how each group positioned itself with respect to the different reforms that were considered by the Gaviria administration. Table 3.3 contains a systematic discussion of the most important internal actors in Colombia’s economic life, including a brief commentary on their general position regarding economic modernisation, as well as a detailed discussion on the way these different actors viewed specific aspects of the reforms agenda. As may be seen, Colombia’s socio-economic landscape is extremely complex, and full of land mines that any reformist government has to face with extreme care. The table also shows that some groups favoured certain measures while strongly resisting others. When taking over power, the Gaviria administration faced the difficult task of forging a reform path that would maintain support at a minimal level and — perhaps more importantly — would minimise active opposition to the reform agenda.

Two comments regarding Table 3.3 are in order. The first point is related to the business sector pressure groups, or *gremios*. For a long time there has been the idea that these groups have had a significant degree of influence in Colombia. In the preface to his extensive study on the *gremios*, Urrutia (1983) points out that already in the 1960s the guerrilla priest Camilo Torres argued that the *gremios* had become increasingly influential, yielding a tremendous (indirect) power. Moreover, the founder of the *Nuevo Liberalismo* faction of the Liberal Party, Luis Carlos Galán, argued in 1981 that the *gremios* power had increased so much that it had even surpassed that of congress⁷. Although the *gremio* formed by coffee producers (FEDECAFE) is the best known, as Table 3.3 shows, there are a number of other highly influential *gremios*. Urrutia (1983) lists 106 active *gremios* in 1980, up from 51 in 1960, and merely 22 in 1950. The long list of prominent *gremios* in Table 3.3 illustrates, with remarkable clarity, that what in analytical models is generically referred to as “owners of capital” is, in most historical instances, a highly heterogeneous group. In fact, as Table 3.3 indicates, many of these *gremios* had antagonistic views regarding important aspects of the reform programme.

The *gremios* have traditionally exercised their influence in a number of ways: they lobby in a way similar to their US counterparts, they directly help finance political campaigns for members of congress, and they finance think tanks that develop the intellectual rationales for their positions. Traditionally most Colombian *gremios* have

focused on short-term economic issues affecting their members. They have tried to influence legislation, and in the pre-1991 era they lobbied for obtaining import licences and other rents generated by the state. According to Urrutia (1983) *gremios* have had two main features. First, most *gremios* — with the possible exception of the banking *gremio* ASOBANCARIA — have traditionally opposed the government. In that regard, a particularly interesting historical episode refers to the vehemence and force with which the ANDI opposed the trade liberalisation reform attempt of 1979–80⁸. And second, and in contrast to popular belief, according to Urrutia (1983), once everything has been done and said the *gremios* real power has been somewhat limited; so much so, that he refers to them as “paper tigers”.

The second important aspect of Colombia’s political economy captured by Table 3.3 refers to labour. Colombia has traditionally been characterised by a dualistic labour movement. While, in general, unions have traditionally been weak, public sector unions — and especially teachers’, health workers’, and state owned enterprises’ unions (Telecom and Ecopetrol, in particular) have been extremely powerful. Compared with other large Latin American countries the degree of unionisation in Colombia is very small — it peaked at 13.4 per cent of employment in 1984 and was only 8 per cent in 1990 (see *Misión de Empleo*, 1986). Existing unions, however, have been quite combative effectively using strikes as a pressure tool (*Misión de Empleo*, 1986).

As argued earlier, in 1990 the political and institutional crisis was becoming increasingly serious. This created a polarised environment that affected virtually every actor in the Colombian social and political landscape. Members of congress — which largely formed the traditional “political class” — were decisively on the defensive, as there was an increasing feeling among the public that they were unable to pass meaningful legislation. Voters’ rejection of the political status quo reached a peak in March 1990, when in an almost spontaneous way they overwhelmingly voted for convening a constitutional assembly. This episode became known as the vote of the “*séptima papeleta*”, and became instrumental in the Gaviria administration’s effort to reform the constitution.

Drug traffickers, who during the 1970s had become increasingly influential in all spheres of Colombia’s public life, had also taken a defensive stance — albeit a very aggressive and violent one — as the Barco administration had stepped up the war against them. They feared extradition to the United States, and saw their empires at risk by police actions. And finally, the guerrilla movement, which for years had waged a war of attrition with the government, had accepted to enter into serious negotiations geared at finding conditions under which they would lay their weapons down. By mid-1990 a major guerrilla group, the M-19, had deposited its arms and had joined the democratic political process and a number of other groups were about to follow suit. The M-19 did surprisingly well in the presidential election of 1990, suggesting to many that Colombia’s two-party system was coming to an end. Table 3.3 lists many of these groups — congress, the Catholic church, drug lords — as important actors, and describes briefly their position (if any) regarding the different aspects of the reform process.

In Colombia, as in most developing countries during the late 1980s and early 1990s, policy discussions were also affected by the views of the multilateral institutions. Possibly the most important “external” actor was the World Bank which, as discussed in the preceding section, had a fruitful, long-term relationship with Colombia. As pointed out, the Bank was particularly important in helping launch the trade liberalisation effort during the last year of the Barco administration. However, as was often the case in Latin America during the early 1990s, the Bank’s position on modernisation was a timid proposal, in comparison to what the reformist government was suggesting. The Gaviria policies became significantly deeper than those endorsed by the Bank staff. The IMF, on the other hand, had significantly less influence, as Colombia had tried (successfully) since the late 1960s to avoid entering into IMF-sponsored programmes. However, to the extent that World Bank quick-disbursement structural adjustment programmes required IMF support, the IMF became increasingly involved in monitoring the Colombian macroeconomy.

In many ways Colombia faces a unique external environment, since the US Drug Enforcement Administration (DEA, 1994) plays an important role in determining the US attitude towards the country. The DEA advises the President on whether to “certify” different governments as having made progress with respect to the war against drugs, and is very influential in determining the administration’s support — or lack of it — for certain programmes. In a September 1994 report the DEA argues — in an almost paranoid-surrealistic fashion — that drug traffickers had taken advantage of the Colombian reforms. The report is remarkable for its naivety and lack of rigour; after reading it one cannot fail to come out with the impression that the State Department bureaucrats are convinced that the whole reform effort was masterminded and carried out by the drug cartel forces⁹.

Notes

1. Interestingly enough, during his brief tenure as Finance Minister in the Barco administration César Gaviria took the strong position that, in spite of the costs involved, it was essential for Colombia to remain current in its international debt payments. This view was contested by others, including a number of economists close to Ernesto Samper.
2. As is the tradition in the Latin American countries, in Figure 3.1 an increase in the real exchange rate index captures a real exchange rate depreciation, while a decline reflects a real exchange rate appreciation.
3. See, however, the memoirs of Barco's Minister of Finance, Luis Fernando Alarcón (1995).
4. After the Rojas Pinilla dictatorship (1953–57) the Conservative and Liberal parties forged an alliance and agreed to share power. This arrangement — known as the *Frente Nacional* — was based on two premises: *a) alternación*, a process through which the presidency is alternated by the two parties; and *b) paridad*, which assures parity for both parties in senior cabinet positions. By 1968 the agreement was revised, and while *alternación* was rescinded, *paridad* was maintained. See, for instance, Bushnell (1993), and Martz (1993).
5. There were efforts to reform the constitution in 1977, 1979 and 1988.
6. See Silva (1997).
7. See Urrutia (1983, p. 15–16).
8. See Urrutia (1983, p. 160–61).
9. The report, for example, asserts that the Colombian government privatised electricity and telecommunications companies (p. 1). It didn't.

Chapter 4

The Reform Policies

From the early days of his administration President César Gaviria decided to tackle four major, and interrelated, issues that in his view were standing in the way of Colombia's progress. The first one was the reform and modernisation of the economy. Second, Gaviria's programme was aimed at modernising Colombia's political system, broadening the extent of democracy and reducing the power of local political lords. The third major objective of the administration was bringing drug lords — and in particular the leaders of the Medellín cartel — to justice, and the fourth was to forge a peace agreement with the different guerrilla movements that had been roaming Colombia's countryside since the 1960s. What makes the Colombian experience particularly fascinating is that these four objectives — and in particular the economic and political reforms — were undertaken simultaneously.

César Gaviria had become convinced that in order to modernise Colombia's political system — and to move beyond the legacy of the *Frente Nacional* — it was essential to reform the constitution. At the same time, he was aware that this was a very difficult political challenge. As President Barco's Minister of Government, Gaviria had become painfully aware of the difficulties of launching a major political modernisation when, in 1988, he had led a failed effort to reform the constitution. Gaviria understood that, although the *séptima papeleta* movement had given popular legitimacy to the idea of reforming the constitution, the programme still faced formidable institutional challenges. In particular, the administration feared that the Supreme Court would, as it had in the past, block any attempt at reform by declaring it unconstitutional. In order to minimise the justices' political opposition, the administration strategists decided that the President should convene a Constitutional Assembly with a limited mandate. In particular, it was decided that the chances of having a positive Supreme Court ruling would be higher if the Constitutional Assembly was banned from dealing with international treaties and other international issues. Under these restrictions, a Presidential Decree convening the Constitutional Assembly was issued in October 1990.

Vargas (1993) and Silva (1997) report the intense efforts made by the Gaviria administration to convince the Court that decree 1926 convening the assembly — which was based on legislation enacted in 1957 — was indeed legal, and that the members of the assembly should be elected. At first it appeared that the Court would favour repeating history, and would block the constitutional reform process. However, after a period of significant uncertainty, serious intellectual debate and strenuous negotiations an agreement was reached: the Court would rule in favour of convening an assembly, if the administration would remove all limitations regarding the topics the assembly could address. The administration decided that this was a gamble worth taking, and it amended the convening decree. The assembly was elected in December 1990. Surprisingly, this election resulted in a massive backing of the ex-guerrilla movement M-19, and many analysts predicted a decisive change in the Colombian way of doing politics. As will be seen, however, nothing of the sort happened.

During the first eight months of the Gaviria administration most of the public's attention was on the political reforms. In particular, people wondered whether the leftist party M-19 — which, as pointed out, was led by former guerrillas — was going to be able to “hijack “ the constitutional assembly. This allowed Gaviria's economic team quietly and rapidly to make progress on the economic reform front. As analysed in detail in Chapter 5, by following a strategy based on broad alliances and the dispensation of compensations, the Gaviria administration was able to make tremendous progress in a period of 30 months. In the following, key economic aspects of the reforms undertaken by the Gaviria administration are briefly described, and an analysis is made of some of the most important economic aspects of the 1991 constitution. The discussion on the political economy process surrounding this reform process is the subject of Chapter 5.

The Economic Reforms: Itinerary and Content

The Gaviria administration attacked several economic reform fronts simultaneously. Table 4.1, which contains a schematic chronology of the most important reforms, illustrates the speed and sequencing of this modernisation process. In order to have a broader idea of the content and depth of the reforms, the rest of this section provides details on some of these policies. In particular, the discussion that follows focuses on:

- i) Labour reform.
- ii) Trade liberalisation reform.
- iii) Abolition of exchange controls.
- iv) Financial reform and reform to the foreign direct investment statute.

Table 4.1. **The Colombian Reforms: An Itinerary**

Reform	Date Reform Was Initiated	Comments
Financial Reform	– Presented to the lower chamber of congress on 31 October 1990 – Enacted on 19 December 1990	The basic piece of legislation regarding financial reform was Law No 45 of 1990.
Tax Reform	– Congress discussion started on October 1990 – Enacted on 31 December 1990	Law No 49 of 1990 included important provisions regarding capital repatriation by Colombians (tax amnesty). In 1992 a second tax reform that raised the VAT rate to 14%, as a way to finance some of the increase in public expenditures mandated by the new constitution.
Labour Reform	– Congressional debate started in early October 1990 – Enacted on 1 January 1991	Law No 50, approved on 1 January 1991.
Housing Policy Reform	– Congressional debate initiated in December 1990 – Approved in mid-January 1991	Law No 3, 1991 approved on 16 January 1991.
Exchange Controls Reform	– Proposal submitted to congress in mid-September 1990 – Final approval on 17 January 1991	Law No 9, 1991 put an effective end to almost 25 years of exchange controls in Colombia. Law 9 of 1991 drastically reformed the regulations governing direct foreign investment. It effectively put an end to the surrealistic array of controls established by art. 24 of the Acuerdo de Cartagena.
Ports Deregulation Reform	Approved on 21 January 1991	Law No 1 of 1991.
Trade Liberalisation Reform (“ <i>La Apertura</i> ”)	Announced during the presidential campaign as a “gradual” and “selective” process. First phase carried out in the second half of 1990; in September 1991 the elimination of trade barriers was accelerated.	At first it was seen as a continuation of the Barco reform; it quickly became apparent that it would be a significantly more radical process.
Central Bank Independence Reform	Law approved on 4 January 1993	The independence of the Banco de la Republica was established by the constitution of 1991. A law, however, was required to make the constitutional provision operational. The idea of granting independence to the Bank was originated among Bank staff, and was initially opposed by the administration.
Financial (De)regulation Reform	Approved in early January 1993	The new constitution established that financial, stock exchange and insurance activities had to be regulated by law (art. XX). This law (Law 35 of 1993) provided such specific regulatory framework.
Decentralisation Reform	Approved in August 1993	Law 60 of 1993 provided the details on the decentralisation process mandated by the constitution of 1991. The most important aspect of this reform was that it established that increasing amounts had to be transferred to departments and municipalities.

Table 4.1 (continued and end)

Reform	Date Reform Was Initiated	Comments
Social Security Reform	Approved in December 1993 (Law 100), after approximately three years of congressional debate and negotiations	Allows workers to choose between two retirement systems: a) a defined benefits system run by state; and b) a capitalised, defined-contribution system run by private pension fund management companies. Workers are free to transfer, every three years, across systems. For both systems the reform implied an increase in contributions from 8% to 13.5% of salaries. The reform of the national health system was also included as a long term objective (to be completed by year 2000) by this law.
Privatisation Reform	Through a number of executive orders and decrees the government privatised a number of assets, and opened up areas previously reserved to the public sector. Many of these measures were established, at least in principle, by the 1991 constitution.	A large number of financial sector firms were privatised. Some participation in Ecopetrol owned firms was also sold, as were some interests in tourism concerns. In Colombia SOEs had traditionally been limited. After the tele-communications strike a very limited effort to implement further privatisations was made.

Labour Reform (Law 50 of December 1990): As has been the case in a number of Latin American countries, Colombia's traditional labour legislation was extremely rigid, imposing very high costs on formal sector firms. Workers could not be dismissed after ten years in the job, and received a very high severance payment in case of "unjust" dismissal — one month per year worked. Workers were also eligible for an unemployment subsidy (*auxilio de cesantia*) in case they lost their jobs. These payments — which also amounted to one month per year — were paid by the firm and were fully indexed to wage increases. These funds could be (partially) withdrawn at any time, even if the worker did not leave his job. Moreover, these *cesantías* were indexed to the worker's final salary, independently of whether the funds had been withdrawn¹. This practice received the name of "*doble retroactividad de la cesantía*". Not surprisingly, one of the most important consequences of this legislation was that firms avoided keeping workers for more than nine years. It has been calculated that during the 1980s 100 000 manufacturing workers were fired every year in order to avoid granting them job tenure. According to Hommes, Montenegro and Roda (1994) the probability of a worker staying in a job for more than ten years was 2.5 per cent. The stated purpose of the reform was to increase job stability². The new legislation modified the old unemployment subsidies (*cesantías*) system, eliminating its indexation clause. Instead, firms were required to make yearly deposits into workers' individual accounts. Funds accumulated in these accounts yield the average deposit rate, and can be withdrawn to finance the acquisition of a house and/or to pay for education expenses. Severance payments in the event of unjust dismissal were increased. Temporary contracts were made more flexible and temporary workers were granted certain rights. Labour contracts also became more flexible — hours worked, for instance, were made a negotiable item — and rules governing different types of payments (salaries, overtime,

fringe benefits) were made more transparent. These two measures were expected to reduce uncertainties regarding labour costs. According to calculations presented by Hommes, Montenegro and Roda (1994), the labour reform reduced the cost of dismissal of an employee with ten years of service by 56 per cent — under the old legislation the dismissed worker had the right to 30.8 monthly salaries, while under the new one he was eligible to receive the equivalent of 13.5 monthly salaries.

The labour reform was also incorporated into the Labour Code provisions in a series of ILO conventions that Colombia had signed throughout the years, but had failed to implement. These included a number of measures aimed at strengthening unions, and at improving the efficiency of conflict resolution mechanisms. Maximum periods for strikes were increased to 60 days and the government was denied an active role in the collective bargaining process. The government tried to include the reform of the social security system as part of the labour reform package. Congress, however, rejected the idea and decided that the pensions issue should be tackled separately.

Trade Reform (la “apertura”): The dramatic opening up of international trade is, perhaps, the most impressive aspect of the Colombian reforms during the first half of the 1990s. When President Gaviria took office almost one half of all imports were subject to import licences. By 1991, less than 3 per cent of all imports — and only items considered to be hazardous — were subject to import licences; in mid-1990 average import duties (import tariffs plus surcharges) were almost 40 per cent and by 1992 they had been reduced to 11.7 per cent. Average effective protection was reduced from 67 per cent in 1990 to 21.5 per cent in 1992 (Tables 4.2 and 4.3).

Table 4.2. The Itinerary of Colombia’s Trade Liberalisation Reforms
Nominal Import Tariffs and Surcharge
(percentages)

Type of Goods	1990	1992
Consumption goods	53.2%	17.4%
Intermediate inputs	35.7%	9.9%
Capital goods	34.3%	10.3%
Total	38.6%	11.7%

Source: Hommes, Montenegro and Roda (1994).

Table 4.3. The Itinerary of Colombia’s Trade Liberalisation Reforms Effective
Rates of Protection
(percentages)

Type of Goods	1990	1992
Consumption goods	109.2	37.3
Intermediate inputs	60.8	17.6
Capital goods	48.3	15.0
Total	66.9	21.5

Source Hommes, Montenegro and Roda (1994).

Already on the campaign trail candidate Gaviria announced that, if elected, his administration would continue to implement the trade reform initiated by the Barco administration³. He promised, however, that the reform would be carried out in a Colombian style: it would be gradual and it would be preceded (or at least accompanied) by a real exchange rate depreciation. In that regard, he argued, the exchange rate movement would compensate — or, better yet, fully offset — the deprotection resulting from the reduction in import licences coverage and tariff reduction. Interestingly enough, at the time the Gaviria administration embarked on the trade reform the real exchange rate had already reached its most depreciated level in many decades. As discussed in Chapter 5, efforts to maintain the real exchange rate at approximately the level it had reached in 1990 introduced serious instability during 1991, encouraging speculation and attracting large capital inflows.

The Gaviria trade reform consisted of three broad measures: *a*) reduction of protective structure; *b*) rationalisation of the export promotion mechanisms; and *c*) the creation of new trade-related institutions, including a Ministry of International Trade. The first two of these measures could be carried out by presidential decree, while the third one required congress-approved legislation.

During its early months the administration virtually eliminated the import licences scheme, announced a timetable for gradually reducing tariffs, and made an effort to maintain — and even increase — the degree of real exchange rate depreciation attained during the latter months of the Barco administration. It was expected that the reform would generate a rapid increase in imports putting additional pressure on the real exchange rate. Surprisingly, however, instead of increasing, imports declined (Figure 4.1). This, plus large capital inflows encouraged by the opening of the capital account, generated a large and unexpected balance of payments surplus and accumulation of international reserves (Figure 4.2), which made monetary management exceedingly difficult.

In September of 1991, the government decided to tackle this situation by accelerating the planned tariff reductions and the elimination of import licences (Table 4.4). In retrospect, there is little doubt that from a political economy perspective this was one of the most daring — and one could even argue, most costly — decisions made by the Gaviria administration; the other one was backing-off from the attempts to privatise the telephone company. Paradoxically, what was supposed to be a slow and gradual trade liberalisation experiment became, overnight, one of the most abrupt openings of international trade experienced in the Western Hemisphere. The political economy details behind these policies — including the reaction of different actors to this change of speed — are the subject of much of Chapter 5.

Table 4.4. Import Licence Coverage, Selected Years 1985–1991

Year	Import Licences Coverage (%)
1985	83
1990 (March)	43
1990 (September)	24
1990 (November)	3.3
1991 (January)	3.3

Source: Edwards (1995a) and Hommes, Montenegro and Roda (1994).

Figure 4.1. Imports and Exports
(quarterly figures, \$ million)

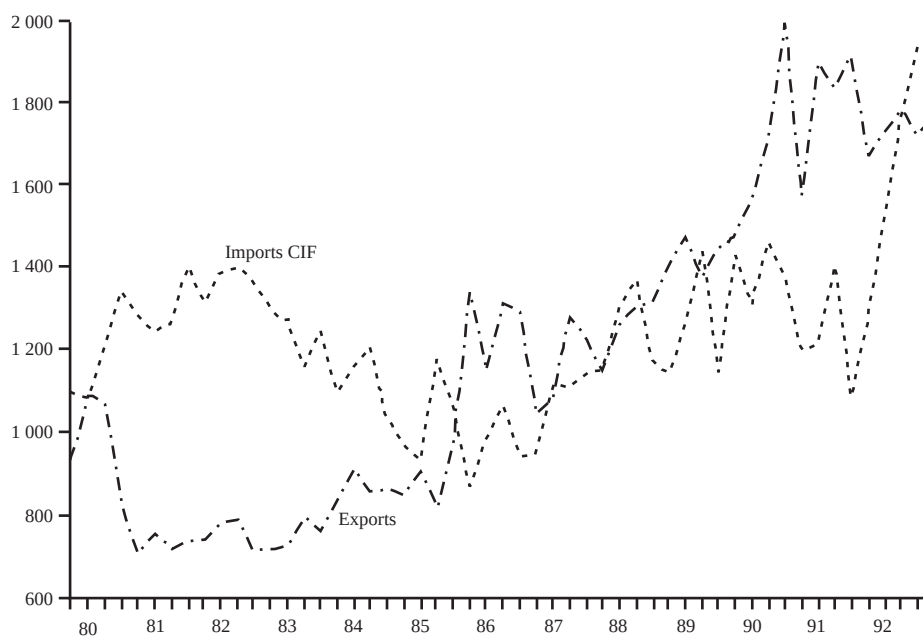
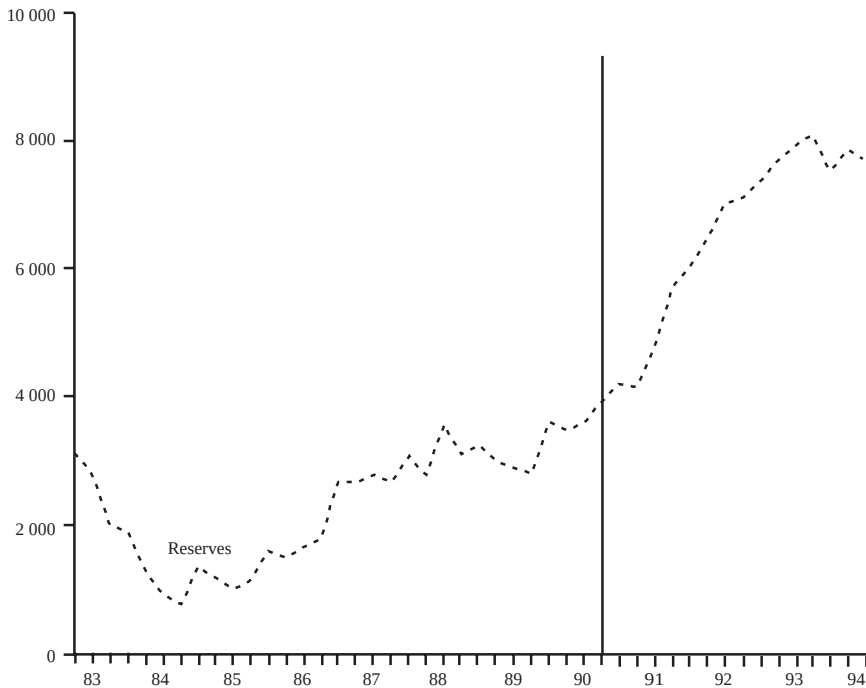


Figure 4.2. **International Reserves, 1983-94**
(\$ million)



The Abolition of Exchange Controls (Law 9 of January, 1991): In 1967, in the midst of a balance-of-payments crisis and with the explicit opposition of the International Monetary Fund, the government of President Lleras Restrepo implemented a generalised exchange control mechanism. This system, known as “*Estatuto Cambiario*” — or Decree 444 — became the centre of Colombia’s external sector policy. It established a strict control over foreign exchange transactions, while allowing flexibility in the nominal exchange rate policy through a crawling peg regime based on frequent mini-devaluations. For years this system was credited, by Colombian and foreign observers, as allowing the country to maintain a stable real exchange rate and avoiding recurrent balance-of-payments crises⁴.

In January 1991, Congress abolished Decree 444 and approved Law No. 9 on foreign exchange transactions. This is a very general piece of legislation — in contrast with the cumbersome *Estatuto Cambiario* with its 200 articles, the new law had only 33 articles — that gave ample powers to the Central Bank to determine the rules applicable to foreign exchange transactions, capital controls and the exchange rate regime. Between 1991 and 1993, the Central Bank adopted a number of regulations that virtually eliminated its monopoly over foreign exchange transactions, greatly reduced the extent of capital controls, allowed the public to hold foreign currency and implemented a floating-cum-bands exchange rate regime. As argued in Chapter 5 of this study this reform had a tremendous symbolic value, as it virtually eliminated the

one piece of legislation that was, at least in appearance, approved by the vast majority of the public and — perhaps more important and perplexing — by the majority of Colombian economists.

Financial Reform/Foreign Investment Reform (Law 45 of 1990 and Resolution 49 of 1991): As in most of Latin America, the Colombian financial sector was highly distorted and regulated during the 1960s, 1970s and 1980s. The number of banks was controlled, and ownership was highly concentrated; interest rates were subject to ceilings; forced credit allocation was very important; securities markets were discouraged; and supervision was lax. In the early 1980s, Colombia experienced a serious financial crisis, when two private conglomerates, which were at the centre of a web of interrelated and questionable financial transactions, failed. As a result of this, two medium-size banks — the Banco Nacional and Banco del Estado — which held 5 per cent of deposits, had to be taken over by the government. This led to a tightening of government regulations and to the flight of deposits from the banking system. Between 1982 and 1986 the Colombian government intervened in over 20 financial institutions, including banks, brokerage houses and insurance companies (Montes-Negret, 1988).

Colombia's experience illustrates how, even with fairly stable rates of inflation and stable fiscal policies, private securities markets can deteriorate. By the end of the 1980s fewer than 100 companies were listed on the stock exchanges as opposed to 400 in the 1960s, and privately issued securities (stocks and bonds) amounted to 2 per cent of total financial system liabilities versus 20 per cent in 1965⁵. In the 1980s the percentage of free voting shares relative to total shares in circulation was often no greater than 10 per cent for most companies⁶.

In December 1990, the Colombian congress passed Law 45 allowing the executive to implement sweeping reforms and a few months later — in April 1991 — the Gaviria administration presented its reform programme. The most important measures in the package included the relaxation of barriers to entry, the reduction and rationalisation of reserve requirements and the freeing of most (but not all) interest rates. In an effort to increase the degree of competition of the banking sector the government privatised some of the banks that failed during the first half of the 1980s.

From a supervisory perspective, an effort was made for all banks to comply with the capitalisation standards set forward by the Basel Accord. Forced bank investments on government securities were sharply reduced. Also, direct lending requirements to the agriculture sector have been limited to 6 per cent of total loans for large and medium-size farmers, and to 1 per cent for small farmers. The financial reform effort also affected the foreign direct investment statute. Law 9 of 1991 eliminated sectoral restrictions affecting FDI, established national treatment and eliminated the requirement of obtaining prior approval. Additionally, existing limits on the percentage of profits that foreign firms could transfer to headquarters were also eliminated. In spite of these reforms, there are still many lagging areas, including the development of securities markets. Steiner *et al.* (1997), for example, have concluded that the very high interest spreads that still affect Colombia's banking sector are largely the result of a lack of competition, stemming from remaining barriers to entry.

Some Economic Implications of the 1991 Constitution

In October 1990, President Gaviria convened a Constitutional Assembly to write a new constitution for the nation. The sheer fact that the Assembly was convened was a major accomplishment. Almost every Colombian president since Lopez Michelsen had tried to initiate a constitutional reform, only to see their efforts frustrated by different Supreme Court rulings⁷. Even before being sworn in as President, César Gaviria had managed to generate a political and legal compromise that allowed for the constitutional reform process to be launched (see Cepeda, 1994). In October 1990, and after the idea of convening a Constitutional Assembly had been supported by over 85 per cent of the voters in May 1990, the Supreme Court ruled that the convocation was constitutional, and the election for the members of the assembly could be called⁸. Once elected, the members of the Constitutional Assembly — a majority of which represented the opposition parties — worked hard, and on 5 July 1991, Colombia had a new constitutional order.

The new constitution is a vast document — with 380 permanent articles, plus 59 transitory articles — that regulates the main aspects of Colombia's political, social and economic life. Contrary to what the public expected at the time the assembly was convened, the new constitution did not reduce the power of politicians, nor did it result in reduced influence of interest groups. In fact, as Wiesner (1997a) has argued, many groups, and especially those associated with the provision of public goods (education, health and some infrastructure) were able to ensure, at the constitutional level, their ability to capture rents.

As in many Latin American countries — Brazil being the best example — the Colombian constitution establishes rights, regulations and obligations in an incredibly detailed way. This is almost unavoidable when the drafting of constitutional rule is the result of political compromise. Although providing a detailed analysis of the economic consequences of the constitution is well beyond the purpose of this study, this section discusses some of the ways in which it impinged on the economic organisation of the country⁹. It focuses on four points: property rights; constitutional provisions related to labour markets and social conditions; transfers, and in particular transfers to specific groups or regions; and the creation of institutions aimed at reducing transaction costs and, in general, at reducing the costs of doing business¹⁰.

Regarding property rights, the 1991 constitution provides an array of rules, which aim at striking a balance between, on the one hand, protecting private property rights (including promoting privatisation) while, on the other hand, promoting the state ownership of certain resources. For example, according to the constitution, all non-renewable resources and electromagnetic waves are the property of the state (Articles 63, 75 and 332). Article 58, on the other hand, guarantees private property rights, and Article 60 establishes that the state will promote access to private property by the population. More interestingly, Article 336 vows to protect the public from inefficient state-owned monopolies. Almost every provision protecting property rights,

however, pales in comparison to Article 63. This extremely ambiguous article leaves, for almost every practical purpose, the door open for massive state ownership. It is worthwhile quoting this article fully:

“Goods of public use, natural parks, the communal lands of indigenous groups, nature sanctuaries, the archaeological patrimony of the Nation and other properties established by law are not subject to alienation, and cannot be seized by creditors...”¹¹

Articles 64–65 provide a vivid illustration of the way in which the new legal order catered to some specific interest groups. Article 64 establishes that it is the State’s obligation to ensure that agricultural workers become, gradually, landowners. Additionally it states that it is the State’s obligation to promote peasants’ access to “education, health services, housing, social security, entertainment, credit, telecommunications, commercialisation channels for their produce, [and] managerial and technical assistance”. Not one word on how these services would be financed. Not one. And Article 65 states that the production of “foodstuffs will enjoy the State’s especial protection”. This article goes on to say that the State should support the activities of those engaged in the “agriculture, cattle, fisheries, forestry and agribusiness sectors, as well as those engaged in the provision of infrastructure” related to these sectors.

A large number of articles in the 1991 constitution are aimed at protecting labour rights and, more specifically, at protecting certain sectors of organised labour. Article 25, for example, establishes that “[e]very person has the right to a job in dignified and just terms”. Articles 39, 43 and 44 establish the rights of unions, ban gender discrimination and establish the rights of Colombian nationals with disabilities. Articles 48, 49, and 54 establish that social security, education and health provision are the responsibility of the state, even if the private sector can participate in their provision.

Article 54 goes well beyond the protection of civil rights, and establishes that it is “[t]he obligation of the state and employers to provide technical and professional training to those that require it”. And this is not all. Article 53 indicates that the indexation (of pensions) is a constitutional right: “the state guarantees the opportune payment and *periodical adjustment* of legal pensions” (emphasis added). Many of these articles suggest that the 1991 constitution is, undoubtedly, a very well intentioned document, but one that fully ignores the budgetary implications of its mandates. The most interesting constitutional provision regarding labour markets is, perhaps, contained in Article 334, which states that “[t]he state would intervene, in a very special way, to ensure that full employment of human resources is achieved...”.

The 1991 constitution established a significant degree of political as well as financial decentralisation. For example, Articles 339–344 state that the National Development Plan — including the National Plan of Public Investment — will have to be elaborated after a detailed process of consultation with the sub-national governments¹². A number of articles establish in a very specific way the magnitudes and modalities of financial transfers from the national to the sub-national governments — departments and municipalities.

Many of the provisions in the 1991 constitution implicitly protect rents related to specific activities and sectors of the economy. Article 356, for example, establishes that the national government will set, by law, a proportion of total national revenues to be transferred to sub-national entities — the so-called “*situado fiscal*”. It further establishes two crucially important points: first, these funds have to be used for financing education and health provision. Second, the amount of transfers will “increase annually until they have reached a percentage of the nation’s current revenues that allows the adequate provision of [educational services]”. Although money’s fungibility reduces the effectiveness of any legal rule that earmarks revenues for a specific use, the fact that the constitution establishes that national transfers are reserved for the provision — by the State — of two social services reflects the ability to extract rents by those involved in the production of these public goods (Wiesner, 1997a).

Article 357 of the 1991 constitution establishes that municipalities would have a participation in the nation’s current revenues. More interestingly, this article establishes that the share of revenues that the central government has to transfer to municipalities would increase annually, from 14 per cent of current revenues in 1993 to no less than 22 per cent of current revenues by 2002. This, independently of the country’s other obligations, or of its economic performance. As a safeguard, however, this article establishes that in order for additional resources to be actually transferred, the municipal authorities have to show that they are making progress in attaining their social goals.

Articles 360 and 361 regulate the use of income generated from the exploitation of natural resources. Although the provisions in these articles are quite general, it is not an exaggeration to say that they were written with the case of oil production — and more specifically of the state-owned oil company *Ecopetrol* — in mind. Article 360 establishes that the state will earn royalties from any activity related to the exploitation of non-renewable natural resources; Article 361 mandates that these funds will have to be spent on new mining projects. This provision constitutes, to a large extent, a major concession made by the Constitutional Assembly — with the government’s implicit support — to the oil workers’ union.

In addition to providing concessions to some interest groups, the 1991 constitution also established a number of economic and political institutions aimed at protecting the private sector and Colombian citizens from economic abuse. There is no doubt that the most important of these was the establishment of an autonomous central bank (Articles 371–373). Other constitutional provisions are aimed at restricting congress’s ability to increase, during the budgetary process, the fiscal imbalance. Article 351, for example, states that congress will not be able to increase any item in the nation’s budget without the explicit agreement of the corresponding minister. And according to Article 341, congress will only be able to modify the national public sector investment plan as long as overall financial balance is maintained.

In retrospect, and from the strict perspective of the economic reform process, it is possible to argue that the 1991 constitution was not particularly helpful. In fact, an analysis of the different economic provisions of the new constitution suggests that by providing special concessions to specific interest groups — the armed forces, teachers’

unions and other powerful labour groups — the constitution promoted rent seeking, and created an economic structure inconsistent with an efficient and impersonal modern economy. It may even be argued that from the point of view of the overall modernisation reforms, some of the most important provisions of the new constitution were not those directly related to economic matters, but those that established the transitional political organisation of the country during the second half of 1991, attempted to strengthened democracy and focused on the rights of minorities.

Transitory Article 3 abolished congress on the day the constitution was enacted (5 July), and transitory Article 6 established the creation of a transitory 36-member commission (*Comisión Especial*) that would take many of congress's responsibilities during the 15 July–4 October 1991 and the 18–30 November 1991 periods. This commission — which came to be known as “*El Congresito*” or “little congress” — played an important, although not always acknowledged, role during its brief tenure. It passed some important enabling legislation that made some key provisions in the constitution operational. Also, by passing the 1992 budget rapidly and without significant opposition it helped maintain the notion that economic matters were under control. As the Gaviria administration painfully found out in 1992, the new congress — elected on 27 October 1991, and sworn into office in December of that year — was not as willing to embark on the reform project with the same degree of enthusiasm as the *Comisión Especial* or, for that matter, as the old congress. In fact, as is discussed in greater detail below, starting in the early months of 1992 the new congress was openly opposed to many of the most daring reform propositions of the Gaviria administration.

Notes

1. Each salary increase — including inflation adjustments — applied retroactively to the *cesantía*, even if these had been withdrawn and spent! See Posada de la Peña (1995) for a detailed discussion of the labour reform.
2. See the discussions in Posada de la Peña (1991) and Uribe (1991). For the policy makers' point of view see Hommes, Montenegro y Roda (1994).
3. This is, perhaps, a good point in this story to remember that in some areas Gaviria presented his programme as being a natural continuation of Barco initiatives. Recall that Gaviria had served in two capacities in the Barco administration, first as Minister of Finance and then as Minister of Government.
4. As pointed out above, in 1987 20 years of exchange controls were celebrated with a major international seminar. Then President Virgilio Barco, as well as every living former president, participated in the celebration. Among others, papers were presented by Paul Krugman — he developed a small model justifying capital controls; by Roque Fernández, the current Minister of the Economy in Argentina; by Rudolf Hommes and Armando Montenegro, the architects of the Gaviria reforms; and by this author.
5. The increase in political and drug-related violence also affected the security market. Entrepreneurs feared that public listings of their companies could make them the target of terrorist attacks.
6. The deterioration in Colombia's securities markets during the decades of the 1970s and 1980s can be partly traced to four fundamental factors: increased government intervention in the intermediation of savings, both through government ownership of intermediaries and through an extensive network of directed credit and forced investment programmes; real trade restrictions coupled with a significant government presence through ownership of certain non-financial companies that lessened incentive to undertake investments and raise capital to remain competitive; a highly distorted taxation system; and capital controls and entry barriers to provision of financial services either by offshore institutions or domestic institutions (on the stock exchanges). These policies created disincentives for companies to raise capital through public offerings and permitted easier retention of control. On these issues see, for example, Glaesner (1992).
7. As Cepeda (1994) reports, and as pointed out earlier, Gaviria had been a central figure during President Barco's attempt at reforming the constitution during 1988.

8. As explained earlier, the process through which the assembly was finally convened was rather surrealistic and included a preliminary — almost spontaneous — vote in March 1990. This is the so-called “seventh ballot” — *séptima papeleta*.
9. Not surprisingly, the most important — and more controversial — aspects of the new constitution referred to the political and judicial organisation of the country. By far the most important provision — and one that strained the relationship between Colombia and the US — was the one that banned extraditions. This article (Art. 35) was clearly written with the case of narcotics drug lords in mind.
10. This constitution, as most constitutions do, set rather general principles. The discussion that follows concentrates on these principles, but also discusses some of the specific enabling legislation passed by congress to make the constitution operational.
11. In Spanish, this article states: “Los bienes de uso público, los parques naturales, las tierras comunales de los grupos étnicos, las tierras de resguardo, el patrimonio arqueológico de la Nación y los demás bienes que determine la ley, son inalienables, imprescriptibles e inembargables.”
12. Lleras de la Fuente (1996) argues that these provisions of the constitution would result in a new, enhanced and more efficient way in which the private sector interest groups (*los gremios*) would participate in the nation’s political and economic debates. In retrospect, however, this does not appear to have happened.

Chapter 5

A Fractured Reform Process: From Euphoria to Standstill

Until very recently Colombians were very proud of the country's socio-political arrangement, and in particular of the continuity of policies and the absence, since the mid-1950s, of military involvement. It is usual to hear among Colombian intellectuals the idea that "in this country nothing major ever happens; and when something does, it is always by consensus"¹. This benign notion of the political process only began to be revised during the Samper administration, when the level of violence and social tension — including heightened terrorism — reached new levels.

From the reform process perspective a key issue is: how can it be explained, that in little less than a year (1991–92), a president aided by a small band of technocrats in their thirties introduced major reforms? Why did the Colombian reforms take the form they did? Who opposed them? And, what form did this opposition take? This chapter will attempt to answer some of these questions. The analysis follows the framework discussed in Chapter 2 of this study.

The Overall Conception of the Reforms: Ideas and Strategy

A fascinating feature of many of the Latin American reforms of the late 1980s and first half of the 1990s is that they have been led by presidents who either campaigned against market orientation, or who had a long history of opposing that type of economic organisation. This has been the case, for example, of Presidents Menem in Argentina, Fujimori in Peru — remember that, as a dark horse, he won the presidential election by ridiculing Mario Vargas Llosa's reform programme — Perez in Venezuela and Cardoso in Brazil. Williamson (1994) has called this phenomenon of opposing the reforms in the campaign trail, only to embrace them once in office, "voodoo economics". Colombia, however, presents a clear contrast to this trend. As pointed out in Chapter 1, candidate César Gaviria stated from the outset that if elected president he intended to push for a major shake-up of the Colombian economy. In fact, he argued for a reform programme early on, during his primary campaign for the Liberal

Party's presidential post. This reform effort was supposed gradually to integrate the country into the rest of the world, reduce government intervention and encourage an enhanced private sector role in the development process.

How deep-rooted were Gaviria's market-oriented beliefs? How did César Gaviria, who after all appeared to many as a traditional professional politician, become a supporter of market orientation? Who, if anyone, had influenced him? Who were his close collaborators in this enterprise? How radical — or, should we ask, timid — was the original programme? What was the original strategy devised by the Gaviria administration to implement these reforms? How was the programme presented to the public? Did the Gaviria administration have — as many involved in reform efforts, including Piñera (1994) and Naím (1993), consider as essential — a concerted public relations programme aimed at reducing the population's opposition to the programme? These are some of the issues addressed in this and the following sections.

There is little doubt that from the beginning the reform programme was as much candidate Gaviria's as that of his closest associates, including Rudolf Hommes and Armando Montenegro, who would later become Finance Minister and Director of the National Planning Office respectively. César Gaviria was trained as an economist at the *Universidad de los Andes*, Bogotá's premier private university, and according to those who knew him during his years as a student, Gaviria developed from very early on a critical view regarding CEPAL's import substitution development strategies, then in vogue in most of Latin America. In particular, he thought that the private sector should take a leading role in development processes and that Colombia's way out of poverty required a greater integration of its economy into the rest of the world².

Throughout the years, a small number of Colombian economists had argued that Colombia should turn its back on the CEPAL-inspired import substitutions strategy and open up to the rest of the world. This was to be accomplished through a reduction of import licence coverage and through a reduction in import tariff levels.

Rodrigo Botero was, perhaps, the father of the Colombian reformists. In the 1960s he became President Lleras' Economic Secretary of the Presidency, and later under the presidency of Alfonso Lopez Michelsen he became Minister of Finance in 1974³. From both of these positions he unsuccessfully tried to persuade the Liberal Party's political leadership to begin a gradual reform process. During the administration of President Julio César Turbay (1978–82) a new attempt at igniting a trade liberalisation reform was initiated. Among those in the administration that worked on the reform proposal was a young Vice Minister of Development: César Gaviria Trujillo⁴. This time, as in the past, the efforts were derailed by special interest groups, especially those associated with the powerful *ANDI*⁵.

Interestingly enough, in spite of having been Minister of Finance (1986–87) and Minister of Government (1987–90) during the Barco government, Gaviria did not participate very actively in the formulation of that administration's liberalisation programme. Gaviria's tenure as Finance Minister was rather short, and he devoted almost every effort to designing — and persuading congress to pass — a substantial

tax reform that, among other things, put an end to double taxation practices. Gaviria's views regarding the interaction between politics and economic policy had also been affected by his earlier tenure as Speaker of the House of Representatives during the Betancourt administration. From this position congressman Gaviria resisted some of Betancourt's populist initiatives. At that time he found out that the Banco de la República, with a long tradition of trying (not always successfully) to stabilise the economy, was a valuable ally in his efforts to deflect high expenditure and inflationary proposals.

As Minister of Government during the Barco government, César Gaviria devoted most of his time to addressing some of the most serious political problems faced by the administration. In particular, he spent time helping design the strategy for dealings with the guerrilla movement, as well as trying to set in motion a major revision of the constitution.

By the late 1980s, an increasing number of Colombian economists were embracing Rodrigo Botero's ideas, and were beginning to advocate the implementation of some type of reform package. As pointed out above, by 1989 the reform fever had even reached the Barco administration which, out of a sense of inevitability, designed a gradual trade liberalisation programme. Moreover, and clearly more importantly, a small number of young politicians were beginning to lean — albeit slowly — towards these ideas. The most important among them was Luis Carlos Galán, the young senator from the Liberal Party and the leader of its *Nuevo Liberalismo* wing, who in 1989 had clearly become the front runner in the Liberal Party's internal quest to become the next presidential candidate⁶. Moreover, given the Liberals' traditional domination of Colombian politics, Galán was extremely well positioned for becoming the country's next president. As noted in Chapter 4, Galán's economic programme contemplated continuing — and even deepening — the policies that at that time were being discussed by the Barco administration and that eventually would result in the reform manifesto *Modernización e Internacionalización*, issued in February 1990. As discussed in Chapter 2, when candidate Galán was assassinated in August 1989 he instantly became a political martyr.

Throughout most of 1989 and early 1990 a group of economists, mostly associated with the modern wing of the Liberal Party — a wing increasingly associated with Gaviria's name — began meeting in a Bogotá restaurant, the *Club Suizo*, to discuss the country's economic future. The *de facto* co-ordinator of the group — which quickly became known as the *Club Suizo* group — was Rudolf Hommes, who had advised Galán and later became Gaviria's main economic adviser.

What began as informal meetings, became a formal proposition for a new economic policy for the 1990s. This programme was published in March 1990 — two full months before the presidential elections — in the monthly magazine *Estrategia Económica y Financiera*⁷. The article, which was written by Hommes and synthesised the views of the *Club Suizo* group, was titled "An Economic Proposal for the Nineties" (*Una Propuesta Económica para los Noventa*). The importance of this document is that it is one of the very few that allows us to know what Gaviria's economic

team had in mind in terms of economic policy, before the elections. In fact, many of the most important elements of this document were later reproduced in the government's official National Development Plan (*La Revolución Pacífica*).

An interesting question — and one that has some bearing on the interpretation of the political economy of the Colombian reforms — is who was actually a member of this group? Cepeda (1994), for example, lists 11 people, most of whom had been associated with the economics department of the Universidad de los Andes. The “Proposal” article, on the other hand, in its opening footnote lists 26 names. Many of those listed went on to occupy very senior positions, including in the cabinet and sub-cabinet levels in the Gaviria administration. Two interesting features of these lists are worth noting: first, the vast majority of those involved in the *Club Suizo* deliberations had graduate degrees from top US or European universities. Moreover, almost none of them had participated actively in politics. In that regard, this group constitutes the core of the Colombian *technopols*, the technocrats turned reformers and politicians, who according to Williamson and Haggard (1994) and Domínguez (1997), among others, have played a key role in the launching of every one of the Latin American reforms. A second characteristic of this list that deserves some attention is that most of the members of Colombia's economic establishment are absent from it. For example, with the exception of Carlos Caballero, none of the past Executive Directors of Fedesarrollo participated in these meetings. Other prominent economists who for a long time dominated the Colombian economic debate were also absent from the group. There are, of course, several explanations for this fact, including the possibility that many members of the establishment did not agree with the general recommendations being made by the *Club Suizo* group. Although the members of the group were far from being unknowns, it may be argued that they were (at least partially) outsiders, with what appeared to be new, and even puzzling, ideas. Another interesting feature of the *Club Suizo* group is that many of its members had been associated with the Banco de la República and, as is usually the case with central bankers, had a relatively low profile.

From today's perspective, and in a comparative context, the proposals made by the *Club Suizo* group appear rather timid and even apologetic. Moreover, the *manifesto* clearly lacks the elements of a comprehensive, global and profound programme. The fact that the Gaviria administration quickly surpassed the policies proposed in this document tend to support the view that the original Gaviria programme was largely a “continuity programme”. The following are some of the most important aspects of the *Club Suizo* group manifesto:

- The document opens by providing a declaration of principles of sorts. It argues that while government intervention is key to correct market failures, it should not choke private sector initiative.

- A recurrent theme is that Colombia suffers a serious governance crisis and that any proposal for the nineties should be aimed at recovering the ability to govern. To that effect it proposes that the country should become significantly more decentralised, with departments and municipalities taking a greater responsibility in the provision of social services.
- It argues that the country's future economic development should be based on outward orientation and export growth. According to the document, a greater degree of global integration will result in enhanced productivity.
- It is argued that the economy should be opened slowly and partially: “[it is] convenient ...to moderately subject the mature sectors of the economy to the rigor of international competition (p. 13)”. There is only one possible reading of this statement: the opening up should be partial (*moderate*) and selective; that is, applicable only to those sectors that can survive with it (the *mature sectors*). Certainly, nothing radical here.
- The document clearly and explicitly supported a gradual approach to the reforms. On page 16 it says: “Regarding a rapid opening of our domestic market to foreign imports, ... we do not see the short and medium term benefits of such policy, but rather the short run costs in terms of output and employment”.
- The opening up was to be done in conjunction with an enhanced programme of export incentives, including export subsidies [“..a dynamic *Plan Vallejos*..(p. 17)”. The idea was that “gradually, and as a result of productivity increases in the domestic industry, it would be possible to reduce protection [to Colombian firms] (p.16)”.
- The list of forbidden imports was to be maintained, and only goods with which the domestic industry could compete comfortably were to be exempted from obtaining import licences. Only the importation of machinery and capital goods not manufactured in the country was to be exempted from import licences and from import duty surcharges.
- The document gave a central role to the real exchange rate in Colombia's economic future. It recognised that a “competitive” real exchange rate was a fundamental determinant of export performance, and argued that the “effective real exchange rate for exporters of [industrial and non-traditional] products, including subsidies and other incentives, should continue to be depreciated ... (p. 15)”. And it went on to say that “in general, the real exchange rate should not be allowed to appreciate at any time ... (p. 16)”⁸.
- The document recognised that inflation had got out of hand, and argued for its gradual control. The document talks about achieving inflation levels below 15 per cent in the medium run, and below 10 per cent in a ten-year period. Three factors were singled out as affecting inflation: a) excessive money creation; b) fiscal

imbalances; and c) the entrenched use of indexation, which had created a significant degree of inflationary inertia. The document went on to say that unless indexation came to an end, it would be very difficult to defeat inflation.

- Sectoral subsidies — especially to agriculture, food production and non-traditional exports — were an important component of the proposed strategy. Regarding the agriculture sector, the document states that “it is necessary to give a new impulse to the agrarian reform, and to complementary fiscal mechanisms that would encourage higher productivity in the countryside, as well as making land tenure more uniform (p. 13)”.
- Public expenditure was to be redirected towards the judicial system — this was part of the overall project to improve the country’s governance — and to the provision of social services — education and health — to the poorer segments of society⁹.
- The manifesto called for a mild financial reform, based on freezing the volume of forced credit allocation in nominal terms; a gradual increase in international competition and a slow reduction in interest rate subsidies.
- There is virtually no reference to capital mobility in the manifesto. The closest it gets is in discussing financial reform, where in a rather vague paragraph it argues in favour of allowing the inflow of foreign capital into the financial sector, as long as these funds are devoted to capitalising new financial intermediaries. The document has, however, three long paragraphs arguing that the country should be more open with respect to foreign direct investment.
- The manifesto recognised that labour issues — including unemployment — were central in the economic debate. It stated that since the construction sector was a major creator of jobs, it should continue to receive government support. Moreover, it argued that the public sector should continue to have the monopoly of low-income housing construction. The document also argued that it was essential, especially within the context of a more open economy, to reform Colombia’s labour market, including its minimum wage provisions.

Although candidate Gaviria participated in only a few of the meetings, this manifesto clearly represented the core of his campaign’s economic ideas¹⁰. He was, of course, aware of the *Club Suizo* group activities and received periodical briefings on the different issues being discussed by the group.

As the campaign progressed, however, Gaviria started to develop a number of new ideas of his own, many of which had not been discussed by the *Club Suizo* group — or, if discussed, had been discarded as ineffective. Perhaps the most important of these ideas referred to the abolition of the Capital Controls provision of Decree 444, that for more than 20 years had governed Colombia’s exchange rate policy. In fact, already in late 1989, still as a candidate for the Liberal Party’s presidential primaries, he stated that it was necessary to reform — but, notice, *not* abolish — the capital controls regulations¹¹.

Disarming the Opponents: The Politics of Coalitions, Compensation and Pre-emptive Strikes

The framework developed in Chapter 2, as well as extensive historical experiences (Williamson, 1994), suggests that many successful reformist strategies have been based on the government's ability to: *a)* forge broad political alliances; *b)* devise effective compensation schemes that neutralise losers; and *c)* isolate the reform opponents. During the first 18 months of his administration, César Gaviria proved to be a master at these three tasks. He was able to obtain broad support for his overall — and not only for his economics — programme, he seduced his opponents, and convinced the population at large that his programme was essential for the survival of the country. As discussed above, even before being sworn into office, Gaviria had been able to negotiate successfully with all political forces in the country, in order to open the door to convening the constitutional reform assembly.

As noted, it is only possible to understand Colombia's economic reforms within the broader context of the overall Gaviria programme, which as pointed out above had four main elements: *i)* Reforming the economy; *ii)* launching a major political reform, whose cornerstone was the constitutional reform; *iii)* forging a broad peace agreement with the guerrilla movement; and *iv)* eliminating the influence that the drug cartels had acquired in Colombia's society.

During the first months of the administration the political and drug-related programmes captured the attention of the public. The peace process launched on 30 August was considered a major breakthrough, as was the fact that the Constitutional Assembly had been convened. Moreover, the very high percentage of the vote received by the former guerrilla movement M-19 in the election of the assembly had become a dominant news item. Between August and September the war against drug trafficking was stepped up, when the drug lords went through a kidnapping rampage. A number of influential individuals were abducted, including journalists Diana Turbay — daughter of former President Julio César Turbay — and Francisco Santos, an heir from the *El Tiempo* newspaper dynasty. These major developments on non-economic fronts allowed the economic team quietly, but effectively to push forward with some of the most important early economic measures, including the labour, financial and tax reforms.

But the fact that the public was “distracted” by other initiatives is not the only — and maybe not even the most important — explanation behind the rapid implementation of the economic reform agenda during the first half of the administration. Nor can this progress be attributed to a run-of-the-mill “honeymoon” period. It was much more than that. In fact, it is possible to argue that the rapid implementation of a number of key reforms during the first 18 months of the administration was the result of a deliberate strategy aimed at forming broad coalitions and compensating key opponents in a variety of ways.

Five factors helped provide a positive environment for the implementation of the reform programme: *i)* the formation of coalitions; *ii)* the generous use of compensation mechanisms — either actual or based on promises; *iii)* the (surprisingly) early collaborative role of congress; *vi)* the role of public relations; and *v)* a largely positive international environment.

Colombia has a long tradition of forging political coalitions. In fact, between 1958 and 1968 — the so-called *Frente Nacional* period — the Liberal and Conservative parties had an arrangement that allowed them to alternate power. As soon as Gaviria won the elections he started forming a number of key coalitions that would provide his government with broad support. Early on he was able to attract three groups that, if left outside the government, had the potential of strongly opposing (parts of) his programme: *a)* the Conservative Party; *b)* the former guerrilla movement that had joined the democratic process; and *c)* the more interventionist wing of his own (Liberal) party, led by Ernesto Samper, his former rival in the Liberal primary and, eventually, his successor as president of the country. As a result of these coalitions, President Gaviria's initial cabinet looked like a cross section of Colombia's political spectrum, with 11 members from the Liberal Party — including Ernesto Samper as Minister of Development, a post that would give him a strong voice in implementing the opening of the economy — four members of the Conservative Party, one from the former guerrilla M-19 party and one from the armed forces. Later in his administration Gaviria would appoint Colombia's first civilian defence minister in a long time. This important step was an essential component of his plan to democratise Colombia further. In line with his overall strategy, Gaviria first “compensated” the armed forces by greatly increasing their budget, including officers' salaries.

It would be tempting to argue that the inclusion of Conservatives in the cabinet did not reflect an attempt to form a broad-based coalition, but was merely the result of applying Article 120 of the constitution that called for an “adequate and fair participation” of the “other” party in the cabinet. This, however, would be a mistaken reading of Gaviria's intentions. In fact, the exclusion — or voluntary abstention — of members of the Conservative Party in the Barco administration cabinet had put an effective end to the “*paridad*” principle.

The inclusion of Ernesto Samper in the cabinet was particularly important for advancing the reform programme. Samper was then an open reform sceptic, who believed in marginally (and very gradually) modifying the protectionist structure of the country. More importantly, perhaps, he was extremely popular among the more traditional liberal politicians and had a tremendous influence among members of congress — an institution in which he had served as senator. Moreover, Samper had also influence among some — but not many — groups in the private sector, and especially among those industrialists who more strongly questioned the wisdom of a rapid liberalisation of the economy¹². By having Samper in the cabinet, Gaviria was able to neutralise — if not get the open support — of the more traditional wing of the Liberals and the industrial lobby. In exchange, he assured Samper that no major policy related to the opening of the economy would be undertaken without his input. This, in

the eyes of most observers, would ensure that, as had been announced so many times, the reforms would indeed be carried out in a gradual fashion. Vargas (1993) reports that at first Samper resisted the Development post, as he thought that someone of his stature and ambition could only accept a post in Foreign Affairs or Government.

The Gaviria reform programme — or at least the way it was announced during the early months of the administration — had a number of key built-in compensation mechanisms which, either by design or *de facto*, reduced the opposition to the modernisation effort. Table 5.1 presents a schematic picture of the way in which some of the most important actors saw the reform prospects, including the areas where they expected to benefit from the modernisation process. The key feature of this table is that it explicitly lists the compensation mechanisms that were offered — either explicitly or implicitly — to these key actors, in order to gain their support for — or at least deflect their opposition to — the modernisation programme.

Four aspects of this table deserve some attention. First, these mechanisms were *promised* to these actors and, thus, their effectiveness rested largely on the tremendous credibility of the President of the Republic, and on his remarkable mastery at charming opponents. Second, no one — not even senior members of the administration — seemed to realise that many of these mechanisms were inconsistent and that, as a result of this, it was rather unlikely that the government could deliver on all of them. Third, given the extremely broad nature of the Gaviria administration's national project, it was possible to offer compensation mechanisms in areas different from the strictly economic. That is, in terms of the classification in Table 2.1, the Gaviria administration made intensive use of cross-compensation mechanisms.

And fourth, maintaining a highly depreciated real exchange rate — and even further depreciating it — was the key compensation mechanism offered to most of the influential private sector *gremios*, in order to obtain their support for the trade liberalisation reform. Exporters recognised openly that they had agreed to support the reform process because of the promise of a more depreciated real exchange rate. For example, in a 1992 speech, when disillusionment had already sunk in, the executive president of *ANALDEX* stated that “when the government announced the opening-up programme, it offered to compensate the loss in competitiveness...through a more depreciated real exchange rate” (Ramírez, 1992).

Between August 1990 and July 1991, when it was abolished, congress provided a wholesale support to the modernisation process, on both the political and economic fronts. Some observers have been puzzled by this behaviour, since at that time congress, as an institution, and its members as national leaders, were being seriously questioned by the population at large.

In December 1991, when the new congress was elected, things changed markedly, as its members became increasingly sceptical about the reform process. Suddenly, the support that the administration had enjoyed during its first 18 months became more guarded, and in some cases it just was not there. What makes this change of heart in congress's support particularly paradoxical is that in the October 1991 election,

Table 5.1. **Perceived Opportunities, Promised Compensation Mechanisms and Interest Groups**

Interest Group	Promised Compensation Mechanisms	Comments
Major public sector unions	– Possibility of consolidating rent seeking through provisions in new constitution. – By excluding them from most labour reform provisions they were more willing to support programme	– See the discussion on the 1991 constitution presented above.
Rest of labour movement	– Support to union activities and other ILO provisions in new labour law	– Although the reform reduced some of the benefits of formal sector workers, it greatly strengthened the position of unions.
FEDECAFE	– Labour reform – The promise that the real exchange rate would not be allowed to appreciate in the face of coffee booms was particularly attractive to them.	
SAC (Agriculture)	– Subsidies to agriculture sector supported by the <i>Club Suizo</i> group – Reduced protection to agriculture inputs, including machinery – A depreciated real exchange rate	– The depreciated RER was already in place when Gaviria took over – The special treatment to the sector could — as it ended up being the case — be incorporated into the constitution.
ANALDEX (Exporters)	– Depreciated real exchange rate – Additional subsidies to non-traditional exports	– Saw reform as package – Particularly interested in ports privatisation, reform of customs and maintaining subsidised export credit.
ANDI (Manufacturing sector)	– Depreciated real exchange rate – Lower interest rates in case financial reform was enacted – Labour reform – Reduced overall volatility of economic policy, and main economic variables in the future.	– Insisted from early on that the process should be seen as a package. It strongly favoured some of the components, such as labour reform – Sequencing was important for them.
FENALCO (Retail commerce)	– Lower interest rates – Lower import tariffs	

Table 5.1 (continued)

Interest Group	Promised Compensation Mechanisms	Comments
Major conglomerates	– Privatisation programme opened up opportunities to participate in business areas until then closed to them (i.e. telecommunications).	
Armed Forces and Judiciary	– Stepping up of the war against drug producers meant increased budgets and influence (the budget of the military increased significantly during 1990–94. The budget to the judiciary more than doubled in this period) – By excluding the military from the labour market provisions, they did not oppose that part of the programme (or the social security reform).	
Politicians	– A new constitution gave them the opportunity to increase their standing in society, as well as to increase their power – Regional politicians would benefit from a major decentralisation process.	
Drug cartels	– The non extradition provision in the new constitution was key to them – They expected that the financial reform would allow them to move funds more freely internationally – Privatisation would allow them to move into legal business.	
Bureaucracy	– Some saw an opportunity for greater influence, and especially for greater salaries, in the <i>Club Suizo</i> group's call for a major upgrading of the civil service.	

President Gaviria's Liberal Party maintained a comfortable majority in both chambers of congress — 54 per cent of the lower house and 55 per cent of the senate. As Silva (1997) points out, many of the Liberal Party members of congress were open critics of the reforms, and referred to them with utmost contempt as “cruel neo liberal reforms”.

How can this early backing and later scepticism be explained? The initial support was the result of two related factors: first, President Gaviria's coalition-making — and in particular the incorporation of his former rival Ernesto Samper into the cabinet — assured that his initiatives would be supported by all wings of the Liberal Party. Second, in 1990–91 politicians in general — and members of congress in particular — felt that they were under significant public scrutiny for having failed in

the past to deliver change and meaningful legislation. There was thus a generalised feeling among members of congress that by moving the government's legislative agenda swiftly, their reputation would be, at least partially, repaired. Moreover, with a new election in sight individual members of congress were under personal pressure to perform. By December 1991 the political picture had changed significantly, however. First, Ernesto Samper was out of the cabinet — having resigned because he disagreed on the increased speed of the reform process — and his (reform sceptic) supporters had a dominant position in congress. Moreover, the new congress had a very large contingent of rookies, who did not feel the reputational-based pressure of their predecessors.

As noted, a number of analysts have argued the existence of a comprehensive and effective media strategy is a fundamental component of any successful reform programme (Williamson and Haggard, 1994). Naím (1993) has gone as far as saying that the lack of such type of programme was at the heart of the failure of the Perez reforms in Venezuela.

Cepeda (1994) argues that the Gaviria administration masterfully managed the relationship with the press; a well functioning public relations team headed by Mauricio Vargas, a self-trained journalist in his late 20s, was swiftly assembled. This statement appears to go too far, however. As the administration's Communications Secretary Mauricio Vargas himself acknowledges in his memoirs (Vargas, 1993), from day one there were permanent leaks to the press, key communiqués were delayed, and some crucial initiatives, such as the attempt to privatise (partially) the telephone company, were undertaken without having previously launched a comprehensive public relations offensive.

During 1990 and 1991, Colombia faced an extremely positive international environment, which provided a friendly backdrop for undertaking the reforms. The price of coffee stabilised, international interest rates declined significantly and the international financial community was rediscovering Latin America. In 1990, there already was a surge of capital flowing into the region and in 1991. Latin America experienced, for the first time in a decade, a positive net resource transfer from the rest of the world. Moreover, the multilateral institutions — and especially the World Bank — became increasingly enamoured of Colombia, providing technical and financial support to a number of key initiatives, including decentralisation, financial reform and trade liberalisation. This multilateral support allowed the administration to claim, in various fora, that its economic policy programme was technically sound and had been given a “seal of approval” by an impartial institution.

The Abolition of Exchange Controls: A Symbolic Measure

In 1990, and to the surprise of many international observers of the Colombian scene, the foreign exchange market was liberalised, putting an end to almost 25 years of exchange controls. Although it is possible to argue that from a strictly economic point of view this constituted a minor reform, it had a tremendous symbolic effect. For

years Colombian economists, politicians and business people had credited Decree 444 of 1967 as a fundamental pillar of Colombia's economic success. By monopolising foreign exchange operations, the Banco de la República maintained a sense of stability, and had assured exporters that the real exchange rate would not become overvalued. Law 9, of January 1991, put an end to all of that. A number of decrees issued in the months to follow, as well as some key Banco de la República resolutions, opened up the door for a more modern treatment of foreign exchange transactions, as well as a more flexible nominal exchange rate policy. At the same time a general amnesty was given to Colombian nationals who had kept foreign exchange outside the country. The combination of these measures resulted, as will be demonstrated, in very massive inflows of capital into the country and in significant pressures towards appreciating the real exchange rate. This, in turn, complicated things considerably from a political economy point of view, as one by one groups that had supported the reforms turned their backs on them.

From a political economy perspective, the importance of the reform of the Exchange Rate Statute was not related to what happened after it was enacted, but what *did not* happen. There was no generalised outcry, nor accusations that a major institution had been abandoned, nor charges of excessive neoliberalism. Almost nothing happened. The reform barely made the front page of the papers, and in the midst of the reformist euphoria was quickly forgotten. Only a handful of professional economists had opposed it — including the staff and leadership of the Central Bank. Their position was argued on strict professional terms, but there is no doubt that there was also an element of self-interest. It was not a trivial matter for the institution that had monopolised foreign exchange transactions for so long to give up that role.

In order to avoid surprises, and make sure that the party elders would not turn against the measure, President Gaviria asked his collaborators to inform some key players about the plan. The main concern was that the highly respected former President Carlos Lleras, in whose administration 444 had been issued, would be critical. He listened carefully and recommended that before taking such a major step, in-depth studies on its consequences had to be undertaken.

The approval of Law 9 provided important lessons to the administration on the political economy of reform. Timing was essential. It was key to introduce changes from a position of strength, where opponents could be easily isolated. At the time exchange controls were abolished, the country was facing a benign, if not openly positive, international environment: foreign exchange was plentiful and the real exchange rate was still highly depreciated. In a way the reform was implemented at a time when the controls were not binding, and no one noticed — at least immediately — any changes. Law 9, however, allowed for a significantly higher degree of capital mobility. During most of 1991, Colombian nationals as well as foreigners made use of these provisions, as they took advantage of the existence of remarkably high interest rate differentials. Paradoxically, as will be seen in the discussion that follows, during most of 1991 the authorities (mistakenly) undertook policies that maintained these differentials, attracting further capital into the country.

The Opening of International Trade: the Dog that Didn't Bark?

There is little doubt that the 1990–91 Colombian trade reform was one of the most dramatic ever undertaken in a Latin American country — or in the world, for that matter. This was a major reform from various perspectives. First, the sheer magnitude of the reform was impressive (Tables 4.2, 4.3 and 4.4). Second, in spite of announcements and, perhaps more importantly, of Colombia's tradition with gradualism, the reform was carried out very quickly. In fact the acceleration of import duties reduction, implemented in mid-1991, constituted a major turning point in the Colombian approach to economic policy making. Third, this trade opening took place at a time when a powerful and open reform-sceptic — Ernesto Samper — was at the helm of the Ministry of Development. And fourth, the whole process took place with minimal opposition from those groups and *gremios* supposedly hit hard by the reforms. In particular the *ANDI*, which in the past had successfully opposed major liberalisation reforms, was remarkably quiet. It was, in Sherlock Holmes' parlance, the dog that did not bark.

As previously pointed out, the original programme was to finish the trade reform process by late 1994. By March 1991, it was becoming increasingly clear, however, that the reform was not having the effects the economic team had expected. Perhaps the most surprising fact was that imports were not growing and, as a result of it, the country was experiencing an increasing trade surplus (Figure 4.1). This, in conjunction with large inflows of capital — resulting from the abolition of exchange controls and the amnesty granted to foreign securities holders — was pressuring on money supply, making macroeconomic management very difficult. As inflation increased, the real exchange rate began to lose ground and both exporters and import competing sectors began to lose competitiveness.

The Banco de la República reacted to this situation by implementing a series of policies, which in retrospect appear to have been contradictory. First, an aggressive policy of sterilising reserve accumulation was undertaken. This was done by issuing indexed short-term securities (the OMAs). In the first ten months of 1991 the stock of these securities shot up from \$405 million to \$1.2 billion, or 85 per cent of the total monetary base. Naturally, this policy resulted in an increase in domestic (*peso* denominated) interest rates, and a significant interest rate differential. This attracted further capital into the country, frustrating the sterilisation policy itself. Second, the authorities decided — as they had done in the past when facing coffee booms — to postpone the monetisation of export proceeds. For this reason, in 1991 the Banco de la República started to issue “exchange certificates” (*certificados de cambio*) in exchange for foreign exchange. These certificates could be transacted in the secondary market, and initially had a three-month maturity, which was later extended to one year. Moreover the Central Bank established a maximum discount for the certificates in the secondary market of 12.5 per cent.

All of this, of course, amounted to an attempt at controlling too many variables — the spot and future exchange rates, the nominal interest rate and the stock of money — at inconsistent levels. During the first ten months of 1991 Colombia had been trapped in a vicious circle: a very rapid process of reserve accumulation generated high inflation and a real exchange rate appreciation; but the policies put in place to combat these phenomena created incentives for capital inflows and further reserve accumulation and appreciation of the real exchange rate. Paradoxically perhaps, one of the monetary authorities' main concerns in mid-1991 was how to engineer an end to the accumulation of reserves.

These events generated two political problems for the Gaviria administration. First, exporters and import competing sectors were becoming increasingly unhappy with the real appreciation of the *peso*; and, second, the lack of progress in the anti-inflationary front was a black spot in an otherwise quite positive picture. In a way, the administration was facing some unforeseen costs of the trade reform without getting its benefits in the form of higher imports. The question then was how to stimulate imports.

According to Vargas (1993), in May 1991 President Gaviria already contemplated the acceleration of the trade liberalisation process as a way of stimulating imports. Politically, there were pros and cons for this option. On the positive side, it would contribute to solving the macroeconomic management difficulties. Additionally, it would move forward in time the expected unemployment costs of the final rounds of trade reform¹³. This appeared to be attractive in a situation where the government was facing an unprecedented degree of popularity¹⁴. On the negative side, accelerating the reforms meant breaking up with Samper who, as Minister of Development, had been assured a fundamental say in the reform process. And, given Samper's background and his constituencies, it was highly unlikely that he would agree with this change in policy pace. Additionally, there was no assurance that the acceleration of the reform would actually work. Of course, it was possible that imports would not pick up, and that real exchange rate appreciation would continue. This would be the worst case. Tradable goods producers would be hit by the more rapid duty reduction, and would fail to be compensated through a real exchange rate change.

At the end Gaviria decided to take the gamble, and to move, in October 1991, straight to the final phase of the reforms. Vargas (1993) provides an insider's account of the process leading to this drastic change in policy course. From it, and from the accounts of others — including Gaviria himself — it is clear that this was the President's own idea, and that it was undertaken on the understanding that Samper would leave the cabinet. This he did, and in late 1991 he became Colombia's ambassador to Spain and started working on his presidential bid. In a farewell speech delivered at an *ANDI* meeting, Samper intimated that he had sympathy towards the industrial sector's growing apprehensions about the reforms. He said: "I share exporters' concerns...a few weeks ago I proposed an acceleration in the rate of devaluation, [and suggested] providing credit at more favourable conditions..." (Samper, 1991)

Why didn't the *gremios*, and especially the *ANDI*, Fedemetal and *ANALDEX*, react forcefully to the liberalisation process? Was it because, as Urrutia (1983) has argued, all *gremios* were "paper tigers"? Or was it because they understood that a market-oriented system, including a more liberal trade regime, was, in the end, beneficial to the whole country? The answer is complex, and has to do with regional rivalries, *ANDI*'s leadership, international experiences and Gaviria's policies of (indirectly) compensating the reform's potential opponents. As Tables 3.3 and 5.1 show, although the *ANDI* and the other industrial *gremios* had misgivings regarding trade liberalisation, they favoured most of the other reforms. In fact a number of the reforms, including the privatisation of ports and the labour reform, had direct positive effects on their activities. To the extent that the reforms were considered as a package — and as long as the government could deliver on its promised "compensations" — the *gremios* were willing — some more reluctantly than others — to support the package. This attitude was clearly influenced by the experiences of Chile and Mexico, which at the time were seen as important illustrations of successful reforms aimed at implementing a market-oriented economic system and at opening the economy up to international competition.

The fact that the *ANDI* considered the reforms as a package is clearly captured by the pronouncements of its leadership. For example, in a speech delivered in Cancún, Mexico in August 1990, Fabio Echeverri Correa (1990), the President of *ANDI*, pointed out that "[t]he process of modernizing the economy should not be understood as a simple program of imports liberalisation, that supposedly has the magic virtue of automatically making the productive sector more productive. No. Modernisation is a very complex process, that requires an integral, gradual and selective program". He emphasised that in order for this broad programme to work it was necessary to "modernize ports' infrastructure...[and] to create a financial market that would provide long term financing...". Moreover, he noted that it was essential to implement a "labor market's reform that would add considerable flexibility to the current labor legislation". The bottom line of *ANDI*'s position was unmistakable: the Colombian industrial sector would support this broadly defined reform package, "as long as it effectively removes the difficulties that currently limit the private sector efforts to become more efficient and productive..." In the same speech the president of *ANDI* noted his concerns regarding the pre-eminent role the administration had given to the exchange rate policy as a compensation mechanism. He reiterated that "Colombia's industrialists support, in general terms, the program's philosophy. We disagree, however, with some aspects...[T]he government has delegated too much responsibility on the exchange rate policy. This is not good because international economic relations are not transparent...".

In early 1991, *ANDI* came back to the idea that the reforms should be seen as a package. This time, however, it argued that there was an optimal sequencing of reform. According to a document prepared by *ANDI*'s Economic Vice-presidency, "before opening the economy to foreign competition, it is healthy and logical to solve the infrastructure problems, tackle the excessive red tape, and rationalize the size of the state...(ANDI, 1991)". This document comes back — one could argue, with dramatic premonition — to the real exchange rate issue: "We consider...that the exchange rate is a necessary but not a sufficient element for defining an opening strategy".

With time, however, some of the most important *gremios* ended up opposing many of the reforms, and in particular the trade liberalisation effort. Although in a way it was too late, they did what they could to regroup. Agriculture-based *gremios* were particularly successful, as they were able to obtain legislation aimed at protecting their interests, including surcharges, support prices and reference prices. In little over one year there was a remarkable contrast in the SAC's — agriculture's main *gremio* — attitude towards the reforms. While in August 1990, its president openly supported the reforms programme, in September 1991 the SAC executive board publicly expressed its concerns, and in particular argued that the persistent real exchange rate appreciation was greatly harming its ability to compete internationally. Its main grievance, however, was with the acceleration of the reform programme (SAC, 1991a, 1991b).

In spite of their efforts, during the Gaviria administration the traditional *gremios* began to lose power, and their historical role in Colombia's political system was increasingly taken over by the four largest conglomerates — the Santo Domingo group, the Ardila Lulle group, the Sarmiento group and the Sindicato Antioqueño group — or *grupos económicos*. These had highly diversified interests, and understood that what mattered was not so much a specific policy, but the overall policy stance. And in that regard, the Gaviria administration continued to push for a more open and market oriented system which these conglomerates supported.

The Old Guard Strikes Back

The year 1991 was a remarkable one for Colombia. A new constitution was approved after more than 100 years; peace negotiations with the guerrilla movement were showing promise; there was a newly elected congress; Pablo Escobar, the *capo di tutti capi*, had given himself up, and had been imprisoned; the country had its first civilian Defence Minister in decades; a number of reforms that had been unthinkable only a few months earlier had been enacted; new (and very large) oil reserves had been found; and the international community was seeing Colombia with new eyes.

Foreign observers had a very strong impression that things were going the administration's way. This was highly deceiving, however, as discontent was growing among the population. With traditional Latin American impatience, the public expected quick and palpable results in terms of growth, real wages, employment and a reduction in inflation. And, as may be seen from Table 5.2, in 1991 the results in these areas were meagre. Growth had declined to one of the lowest levels in modern history, inflation had actually increased, interest rates had been extremely high, and unemployment seemed to be stuck at approximately the 10 per cent level.

Table 5.2. **Key Economic Indicators during the Gaviria Administration**

	1986–90	1991	1992	1993	1994
Real GDP growth	4.6%	2.0%	4.0%	5.4%	5.8%
Inflation	25%	30%	27%	22.4%	22.8%
Public Sector Balance as percentage of GDP	–1.1	–0.3	–0.6	–0.8	–0.5
Current Account Balance as percentage of GDP	0.5	5.6	1.8	–4.0	–4.7
Investment (gross) as percentage of GDP	19.7	17.2	17.2	21.2	23.3
Gross National Savings as percentage of GDP	20.2	22.9	19.1	17.2	18.6
Unemployment	11.5	10.2	10.2	8.6	8.9

Source: World Bank (1994).

There were also political clouds on the horizon. Although the newly elected congress maintained a clear Liberal Party majority, most of its members — and clearly its leadership — were reform sceptics. Miguel Silva, Gaviria’s personal secretary, has pointed out that “the government’s leadership capacity inside the Liberal Party had been hurt...[T]he majority of [the party’s] candidates had campaigned against the fundamental reforms, including the opening up of the economy and the supposedly ‘neoliberal’ character of the government”.

The agriculture *gremio*, the SAC, was becoming particularly vocal in its criticism of the government. Although the liberalisation of trade had reduced (somewhat) the costs of its imported inputs, the vagaries of international agricultural prices was hurting them. And, as with the case of other tradable producing sectors, the real strengthening of the peso and the continuing high interest rates were making things even more difficult. What was particularly aggravating for the SAC was that this deterioration was taking place at a time when, as a result of a number of provisions in the new constitution, they expected a favourable treatment from the authorities.

In fact, and as pointed out above, in little more than a year there had been a remarkable shift in the SAC’s position regarding the modernisation programme. In August 1990 the President of SAC said that a gradual and selective opening, as announced by President Gaviria, “should not be a cause of concern for our agriculture. Quite on the contrary, its launching and implementation, according to the proposed plan, could result in the removal of the high costs and bottle necks” that the sector had traditionally endured (Cano, 1990). A year later, the SAC magazine published an editorial reiterating the view that the sector was willing to support the reform package, as long as the promised compensation mechanisms were, in fact, implemented: “We support the opening-up of the economy, within a gradual and pragmatic framework...Within these parameters we support the package of reforms proposed by

the administration...” (SAC, 1991*b*). The SAC complained, however, that the compensation mechanisms — including the real exchange rate — had failed and/or had been insufficient. As a way of remedying things it proposed six broadly defined measures, including the adoption of price bands, the harmonisation of Andean Pact policies, and minimal and variable import duties for basic products. The problems faced by the agricultural sector were translated into a serious deterioration in social conditions. In fact, as may be seen in Table 5.3, rural poverty experienced an increase between 1988 and 1992. Throughout 1992–94 the government increasingly gave in to the SAC and the rest of the agricultural lobby. As was pointed out above, special treatment was given, price bands were established, reference prices were used to calculate import duties and, in accordance with what was mandated by the constitution, a market-based agrarian reform was implemented.

Table 5.3. The Evolution of Extreme Poverty: 1978–92
(percentages)

	1978	1988	1991	1992
Percentage of people below the extreme poverty line in the rural sector	38.4	33.1	29.0	31.2
Percentage of people below the extreme poverty line in the urban sector	12.1	8.0	7.8	8.0
Percentage of people below the extreme poverty line in the country as a whole	23.6	18.7	16.9	17.7

Source: World Bank (1994).

In March 1992, things turned decisively against the government when, as a result of a series of factors — including a particularly dry year, as well as incompetence and corruption in the management of the government-owned electricity company — the country faced an energy crisis, and the rationing of power had to be implemented. At first electricity was rationed for only two hours a day. Later, as the rainy season got delayed, it was extended to as many as eight hours a day. Moreover, the wave of assassinations resumed. And worse yet, the generalised public discontent in Venezuela — discontent that was channelled into a *coup* attempt, led by Colonel Hugo Chavez, later to be elected as Venezuela’s president — made some people think that, maybe, the modernisation process was not such a good idea after all¹⁵.

Although President Gaviria’s popularity plummeted, he continued to be committed to the modernisation process. Several projects occupied his mind: first, and most important, it was necessary to approve a number of enabling laws that would make many of the new constitutional mandates — including Central Bank independence, the modernisation of the state and decentralisation — operational. Second, in order to finance new expenditures mandated by the constitution, it was necessary to increase government revenues. To this effect the administration presented to congress a tax reform project, whose main provision was raising the VAT rate from 12 to 14 per cent. Third, privatisation — which until then had been timid and had lagged behind other areas of reform — was scheduled to pick up. The administration

was particularly interested in an early (and partial) privatisation of the government owned telephone company. Fourth, the old pay-as-you-go social security system, which as in most of Latin America was facing eminent bankruptcy, was to be reformed. And fifth, the administration was highly interested in reforming the social services sector and, in particular, education and health.

As the year unfolded it became increasingly clear that the opponents of the economic reform programme were gathering force, and that it would be extremely difficult to carry out this ambitious agenda. In retrospect it is clear that as public and congressional support dwindled, President Gaviria decided to follow a two-pronged strategy: first, he decided to prioritise among different projects, spending his much reduced political capital in those programmes that were deemed passable by congress and that were considered to be essential for the administration's overall project. Many of these initiatives were related to political developments and were seen as strengthening democracy and the nation's institutions. Second, it was decided to continue with the coalitions and compensations strategy that had served the administration so well during the first 18 months.

Conditions, however, had changed, as the sense of urgency and anticipation was gone. From a practical point of view this meant that the government had to cave into many — although not all — of the demands made by interest and political groups. As a result, the make-up of the government coalition had to be revised continuously. Both of these strategies were actively pursued during 1992–93. The more traditional wing of the Liberal Party represented by Ernesto Samper and his followers got an increased participation in key positions: José Antonio Ocampo — the respected and able economist who had been Samper's principal adviser in the Ministry of Development and who in 1996 became his Minister of Finance — as Minister of Agriculture, and Horacio Serpa — who was to become President Samper's Minister of Government — became the national Peace Negotiator. Moreover, the traditional — and increasingly weak, in political terms — wing of the Conservative Party was replaced in the cabinet by the up-and-coming faction led by Bogotá's mayor Andres Pastrana, who years later was elected President of Colombia.

The extent to which the reform opponents' position had strengthened became painfully clear when, in the first quarter of 1992, the government submitted to congress proposed legislation to privatise the telephone company. Following the compensation approach that had become the government's hallmark, a plan that included the granting of an important percentage of shares to the company employees was devised. At the same time, the government announced that the proceeds from the sale would have two uses: first, a portion would be used to finance increasing coverage of social services to the population at large and, especially, to the lower income groups. And second, a portion of these monies would be devoted to irrigation projects that would benefit the increasingly unhappy agricultural sector.

According to Mauricio Vargas (1993), who by then had become Minister of Telecommunications, the government's project slowly gained supporters among members of congress. The Telecom union saw things differently, however. The leadership opposed the privatisation strongly and mobilised workers to protest against the government's plans. Interestingly enough, the guerrilla movement, until then had not participated actively in the debate on the reforms, backed the unions and released several communiqués opposing the "neo liberal" measure.

In spite of these developments, the authorities were confident that even if the union called a strike, service would be maintained and the union's position would quickly become unpopular with the public. Nothing of that sort happened, however. When the strike finally took place in late April 1992, the country went silent. Mysteriously the back-up computer programmes, that would have helped maintain service, had disappeared. The government showed a tremendous inability to cope with the situation and as days passed without the re-establishment of the telephone service, its popularity plunged. Some of the members of congress that had showed some inclination to support the privatisation started to back off. Worse yet, President Gaviria, who by then was in a defensive mode, decided not to go all the way out, and left his minister of telecommunications to fight for the privatisation on his own.

What had happened? Where was the combative young leader who was going to "shake up" the economy? How could the government have missed the public mood so badly? There are several explanations for these developments. First Gaviria, the consummate politician, realised that he was too weak to pursue too many unpopular causes. He decided that the effort to pass the tax reform would be too big and did not want to risk another major fight. Second, the public relations team failed badly, by not building up a major campaign in support of the project. This episode showed that when it came to major initiatives it was not enough to devise compensation schemes. Also, it reminded the administration that public sector unions continued to be an untamed "monster". This would be confirmed in the following months, as teachers' unions, *Ecopetrol* employees and health sector workers, among others, were able to extract more and more rents from the state (Wiesner, 1997b).

In retrospect, it is particularly interesting to note that at this crucial juncture the government failed to obtain support from the *gremios*. These had either become disillusioned or, as in the case of *ANALDEX* — the exporters' *gremio* — and the *SAC*, had become open opponents of the reform programme. In late April 1992, as the government was fighting for its programme's life, *ANALDEX* held a national meeting where it strongly criticised the administration's economic policy. *ANALDEX*'s president argued that the government violated the implicit contract by accelerating the trade reform, by not delivering on the promised compensation mechanisms and by altering the announced sequencing of reform (Bakalarz, 1992).

A government that only a few months earlier had the generalised support of the private sector had lost the support from congress, unions and the *gremios*, and was now standing alone. Unmistakably alone.

By 1 May — workers' day — it was clear that the government had lost its battle with the Telecom union, and on 4 May, the minister of telecommunications had resigned. The anti-reform forces had their first major victory. Even more importantly, they had managed to put the government on the defensive and, for all practical purposes, they had succeeded in taking privatisation — or at least major privatisation — off the agenda.

It is interesting to quote extensively what two of Gaviria's closest collaborators have to say about this episode and its sequel. According to Vargas (1993), "[A]fter Telecom's strike the privatisation program had been frozen". And Silva (1997) says: "[A]s with other topics on the government's agenda, the economic reform lost oxygen in 1992. As a result of the blackout, changes slowed down significantly that year. All effort was placed on the approval of the tax reform..." Summing up the first half of the year, Vargas (1993) says: "[A]t the end of the first semester of 1992, all Gaviria had to show was a tax reform that was as popular as the blackout [*apagón*]. The situation was quite bad, but the worst was yet to come".

The worst came on 21 July, when in order to avoid being moved to a safer prison Pablo Escobar, the sinister *capo* of the Medellín cartel, escaped. There was little the government could do. Several senior members of the administration and of the security forces were fired and the government agreed to co-operate with congress in a major investigation. Gaviria declared an all-out war on Escobar, and instructed the different branches of the police not to leave a stone unturned. Escobar, on the other hand, feared for his life and vowed not to give himself up. On 2 December, the cat and mouse game came to an end, when a tired and dishevelled Escobar was killed by the police as he tried to escape a safe house.

Remarkably, perhaps, during 1992 the economy did not do that poorly. As Table 5.2 shows growth picked up, inflation declined slightly and unemployment stabilised. During 1993, the government slowly built its support up, and towards the middle of the year it felt strong enough to push for the implementation of the social security and health reform. The former, however, had a number of design pitfalls — including the fact that it provides perverse incentives and maintains an inefficient public pillar — and the latter failed to tackle the traditional inefficiencies and inequalities of Colombia's health system. These half-baked and timid reforms showed that the magic was definitely gone from the Gaviria administration. What had begun as an auspicious "shake-up" was now clearly an incomplete reform programme. During the early months of 1994, the main political issue became Gaviria's succession and, more importantly, perhaps, whether the next president would continue the by then incomplete modernisation effort.

Notes

1. I believe that this view can be found implicitly, for example, in Urrutia's (1991) important essay on the absence of populism in Colombia.
2. Some have intimated that the fact that Gaviria came from the provinces (Pereira) affected his economic views. He is supposed to have been horrified by the influence of interest groups and by the multiplicity of deals that were cut between politicians and private sector representatives in Bogotá.
3. In 1970 Botero founded Fedesarrollo, Colombia's — and Latin America's, for that matter — leading economic think tank.
4. I am grateful to former Finance Minister Jaime Garcia Parra for discussing with me a number of important issues concerning the origins of Colombia's reformist ideas.
5. On *ANDI* see Urrutia (1983) and the brief description in Table 3.3 of this study.
6. In 1986 Galán had been a presidential pre candidate. He was defeated by president-to-be Virgilio Barco. After it was clear that Barco was the liberals' candidate, Galán declared that he would maintain his independence.
7. This magazine had been founded in the 1970s by Rodrigo Botero, Hommes and Maria Mercedes Cuellar, who under the Barco administration became Director of the National Planning Office, and who was later to become one of the first members of the board of Colombia's new independent Central Bank.
8. Interestingly, the document argued that even in the presence of a commodity export boom, real exchange rate appreciation should be avoided.
9. See Montenegro's (1994) fascinating analysis of the Colombian judiciary.
10. Cepeda (1994) argues that Gaviria did not participate in any of the meetings. In a personal interview, held on 4 September 1997, ex-President Gaviria told me that he had participated briefly in a couple of meetings. He also pointed out that many years earlier he used to discuss economic issues at the *Club Suizo* with a small group of people who included Rodrigo Botero. He also pointed out that for a long time he would periodically meet with Ernesto Samper, Juan Antonio Santos and Guillermo Perry to discuss public policy issues.
11. Cepeda (1994).
12. Samper had been president of ANIF, the financial institutions lobbying group.

13. As it turned out, however, there was very little unemployment generated by the trade opening reform.
14. Interview with President Gaviria, 4 September 1997.
15. On the Venezuelan reforms, and the public's discontent see, for example, Naím (1993).

Conclusions

In August 1994, and after a hard-fought election, Ernesto Samper was inaugurated as the new president of Colombia. During the many years that he had been involved in politics, Samper had become the influential leader of one of the more important wings of the Liberal Party. Although his views could not be classified as “leftist”, they were certainly less market-oriented than those of his predecessor, César Gaviria.

Soon after his inauguration, President Samper was caught in the middle of a major political scandal involving the alleged use of drug monies to finance his campaign. Although he was cleared of wrongdoing by congress, throughout his administration he maintained a major cloud over his head. In spite of this major political crisis, the economy managed to survive and continued to post positive rates of growth. However, the reform agenda that had been tackled with so much enthusiasm during the first half of the Gaviria administration came to a virtual stop during the Samper presidency¹.

Why did the reform effort stall in Colombia? There are two major, and somewhat related, explanations for this phenomenon: first, a large number of people — including influential analysts — incorrectly believe that Colombia has already advanced rapidly and deeply in the reforms sphere. This is, however, a misconception. As shown above, in many spheres the Colombian reforms were rather mild and incomplete. This becomes apparent when Colombia’s current degree of modernisation is analysed from an international comparative perspective, including when compared with the rest of the Latin American nations. And second, there is a belief that the country’s modest economic performance since 1996 was the direct consequence of the so-called neo-liberal reforms. There is, however, no compelling evidence supporting this view. On the contrary, it is possible to argue that Colombia’s current economic woes are largely the consequence of an incomplete reform programme, major external shocks and a deepening political crisis.

There are two general and recurrent themes in the recent reform-sceptic discourse in Colombia and, for that matter, in other Latin American countries. First, the popular belief that reforms have little, if any, effect on economic performance, and second, that reforms — and especially trade liberalisation — impact negatively on social

conditions and, in particular, on income distribution. Interestingly, these beliefs — many times perpetuated by the media — have little empirical or historical support. In fact, recent applied comparative research has concluded very emphatically that: *a)* broadly defined reforms have very important positive effects on economic performance, and especially on total factor productivity growth; and *b)* economic reforms, and in particular trade liberalisation, have no discernible direct effects — either positive or negative — on social conditions and income distribution. The same evidence indicates, however, that economic reform has a positive indirect effect (through economic growth) on social conditions and income distribution². This evidence suggests, then, that the deteriorating income distribution that has indeed been observed in some countries cannot be attributed (at least not easily) to the opening reforms.

Colombia experienced tremendous progress on the economic reforms front during the first half of the Gaviria administration (1990–92): trade was opened, some labour reform was implemented, financial distortions were eased, currency controls were abolished, a social security reform was attempted, and some general deregulation was put into place. Although during the 1993–94 period additional reform initiatives were launched, the pace and intensity of the transformation process diminished significantly. By late 1994 and early 1995, however, Colombia still faced a significant challenge in terms of reforms: basic economic reforms still had to be implemented or deepened — including fiscal retrenchment leading to stabilisation and a substantial reduction in inflation — and most of the institutional reforms had to be initiated.

During the 1996–98 period, however, Colombia basically made very little, if any, headway towards advancing the reform agenda. This assessment is supported by a World Bank document authored by Burki and Perry (1997). In this piece the authors show that Colombia made almost no progress in terms of trade reform since 1993, and made very little (if any) progress in terms of labour market modernisation. What is particularly interesting is that this passivity took place at a time when the vast majority of the countries in the region — and the world for that matter — continued to move forward in the effort towards liberalising their economies. Table 6.1 presents an indicator on the overall degree of market orientation in a number of countries for the 1995–97 period. This index goes from 1 to 5, with lower values capturing a lower degree of distortions and greater market orientation. As may be seen, according to this index in every one of these years Colombia has incrementally moved away from market orientation, becoming more distorted and plummeting in the overall ranking. Interestingly enough, in five of the seven Latin American countries included in the table for comparison purposes, there was either progress or no deterioration in the 1996–97 period. A particularly interesting aspect of this table is that it shows how large Colombia's indexes are relative to those of the East Asian and advanced countries in the sample. This clearly indicates that, contrary to popular belief, the Colombian reforms — and those of most Latin American countries, for that matter — have not been particularly deep when analysed from a comparative perspective.

Table 6.1. **Index of Market Orientation**

	Score			Ranking		
	1995	1996	1997	1995	1996	1997
<i>Latin American Countries</i>						
Argentina	2.85	2.65	2.65	35	37	42
Bolivia	3.20	2.75	2.85	58	46	59
Brazil	3.30	3.45	3.35	63	94	94
Colombia	2.90	3.00	3.10	37	66	78
Chile	2.50	2.45	2.25	20	30	22
Costa Rica	2.90	2.80	2.80	38	47	50
Mexico	3.05	3.35	3.35	51	86	94
Venezuela	3.00	3.50	3.60	46	100	108
<i>East Asian Countries</i>						
Hong Kong	1.25	1.25	1.25	1	1	1
Indonesia	3.35	2.85	2.85	69	54	59
Korea, Rep.	2.15	2.30	2.45	13	22	27
Malaysia	2.15	2.40	2.60	14	27	36
Philippines	3.30	2.90	2.80	66	57	50
Singapore	1.25	1.3	1.3	2	2	2
Thailand	2.30	2.30	2.30	19	22	23
<i>Selected OECD Countries</i>						
Australia	2.20	2.10	2.15	15	17	18
Austria	2.05	2.05	2.15	10	15	18
Canada	2.00	2.00	2.10	8	12	15
Finland	n.a.	2.3	2.3	n.a.	22	23

Source: Johnson and Sheehy (1995, 1996, 1997).

One of the main themes of this study has been that institutions matter. Tables 6.2 through 6.5 present comparative data, for the same group of countries but different time frames, on the strength of a number of institutions of the state. These data have been compiled by the IBC International Country Risk Guide and by Johnson and Sheehy (1995, 1996, 1997).

Table 6.2 concentrates on the prevalence of corruption in government, with a higher number meaning less corruption. Table 6.3 deals with the quality of the judiciary and the countries' law and order tradition; a higher number means a stronger judiciary. Table 6.4 summarises the quality of the national bureaucracy; again a higher number reflects a stronger institution. Finally, Table 6.5 has an index on the quality of political leadership with higher numbers indicating higher quality.

The picture that emerges from these tables is rather frightening. Colombia appears as having some of the weakest — and worse even, deteriorating — set of institutions in the complete sample. This reflects in all its dimensions the tremendous challenge that the country will face in the years to come.

Table 6.2. Corruption
(total points 6)

	1990	1994	1997
<i>Latin American Countries</i>			
Argentina	4	3	2
Bolivia	2	3	3
Brazil	4	3	3
Chile	3	3	4
Colombia	3	3	2
Costa Rica	5	5	5
Mexico	3	3	2
Venezuela	3	3	3
<i>East Asian Countries</i>			
Hong Kong	5	5	5
Indonesia	0	3	2
Korea, Rep.	2	5	4
Malaysia	4	4	4
Philippines	2	3	3
Singapore	4	4	4
Thailand	3	3	3
<i>Selected OECD Countries</i>			
Australia	5	5	5
Austria	5	5	4
Canada	6	6	6
Finland	6	6	6

This study analyses, from a political economy perspective, the market-oriented reforms undertaken during the César Gaviria administration in Colombia in 1990–94. The analysis has focused on the dynamics of reform and has emphasised the role of ideology, coalition building, compensation mechanisms and opposition to reform by interest groups. The key political actors are identified, and a detailed analysis on the specifics of different reforms is provided. Particular emphasis is given to understanding the factors behind the initial outburst of reform initiatives, and the subsequent slowdown of the process.

Table 6.3. **Strength of the Judiciary**
(total points 6)

	1990	1994	1997
<i>Latin American Countries</i>			
Argentina	3	5	5
Bolivia	1	2	3
Brazil	4	3	3
Chile	4	5	5
Colombia	1	2	2
Costa Rica	4	4	4
Mexico	3	3	3
Venezuela	6	4	4
<i>East Asian Countries</i>			
Hong Kong	1	6	5
Indonesia	6	4	2
Korea, Rep.	4	5	4
Malaysia	6	5	5
Philippines	1	4	4
Singapore	6	6	6
Thailand	5	5	5
<i>Selected OECD Countries</i>			
Australia	6	6	6
Austria	6	6	6
Canada	6	6	6
Finland	6	6	6

The hypotheses on the political economy of reform developed in Chapter 2 and presented in Table 2.2 provide a useful benchmark for these concluding remarks. Table 6.6 reproduces the eleven hypotheses from Table 2.2, and provides some comments based on the analysis of the Colombian economy undertaken in this study. As may be seen, the Colombian experience fits quite well within the political economy framework developed in the last few years and presented in Chapter 2. More specifically, the analysis presented in this study suggests that, although the Colombian reformist experience was highly complex and had some unique features, it followed a pattern that is broadly in line with the key hypotheses developed in the literature. Contrary to what some analysts have suggested, the Colombian reforms were triggered by a major crisis. That this was not a traditional balance-of-payments crisis is inconsequential. What really matters is that it was the public's sense of political and social desolation and frustration that allowed the Gaviria administration to move forward on so many fronts simultaneously.

As in other reform episodes, a technocratic reform team with a clearly defined and strong ideology — the *Club Suizo* group — designed and implemented the reforms. In order to move them through congress the Gaviria administration designed a strategy

Table 6.4. **Quality of Bureaucracy**
(total points 6)

	1990	1994	1997
<i>Latin American Countries</i>			
Argentina	3	3	3
Bolivia	1	2	2
Brazil	4	4	4
Chile	3	3	4
Colombia	4	4	2
Costa Rica	3	3	3
Mexico	3	3	2
Venezuela	3	3	3
<i>East Asian Countries</i>			
Hong Kong	3	4	5
Indonesia	1	3	3
Korea, Rep.	4	5	5
Malaysia	3	3	4
Philippines	1	2	3
Singapore	5	5	4
Thailand	5	5	4
<i>Selected OECD Countries</i>			
Australia	6	6	6
Austria	6	6	6
Canada	6	6	6
Finland	6	6	5

based on forming broad coalitions and using a variety of compensation schemes. As time went by, however, these compensation mechanisms proved to be mutually inconsistent. As they broke down the opponents to the reforms grew stronger and were able to launch a counterattack.

Possibly two of the most important lessons from the Colombian episode are that “sequencing matters”, and that early reform supporters can turn against the programme if their interests are affected. In Colombia, the early relaxation of exchange controls — plus the surge in capital inflows into Latin America — resulted in a strong real exchange rate appreciation, which hurt exporters’ competitiveness. The analysis presented in Chapter 5 clearly documents how some of the major players — *ANDI*, *SAC* and *ANALDEX* — changed their positions regarding the reform process, and moved from being (reluctant) supporters to being open opponents. This change of heart was largely, although not exclusively, affected by the real exchange appreciation discussed above. The slow reduction of inflation, as well as the sluggish rate of GDP

Table 6.5. **Political Leadership**
(total points 12)

	1990	1994	1997
<i>Other Latin American Countries</i>			
Argentina	4	8	8
Bolivia	6	7	8
Brazil	7	4	8
Chile	8	8	9
Colombia	6	6	3
Costa Rica	6	7	7
Mexico	8	6	9
Venezuela	6	6	8
<i>East Asian Countries</i>			
Hong Kong	1	5	8
Indonesia	6	7	11
Korea, Rep.	9	7	10
Malaysia	6	9	11
Philippines	1	6	10
Singapore	8	8	11
Thailand	5	7	9
<i>Selected OECD Countries</i>			
Australia	6	7	11
Austria	8	8	10
Canada	9	6	10
Finland	8	7	9

Source: ICBG.

growth also played a role. As the government lost its early supporters, it became increasingly isolated. Another important lesson of the Colombian episode is that unions in the social services sectors — education and health — and in some state owned enterprises can become very powerful and will defend their interests strongly. In Colombia, the political reform was partially hijacked by these interest groups. They even managed to have the new constitution sanction their right to capture rents.

Whether the Colombian reforms will move forward or whether there will be some backtracking is still an open question. What is clear, however, is that the reformist enthusiasm and euphoria of the early 1990s are no longer there and that, as a consequence of a combination of factors, Colombia has seen its political, economic and social circumstances greatly deteriorate. At the time of writing (November 1999) Colombia faces a serious probability of being left behind in the next decade or so. As the twentieth century draws to a close, it is possible that there will be no more reform in *Macondo*.

Table 6.6. Eleven Key Hypotheses on the Political Economy of Reform and the Colombian Experience, 1990–94

Hypothesis	Comments
1. Crisis Hypothesis	Although in 1990 Colombia was not facing a run-of-the-mill economic crisis, it was facing a major political and social crisis.
2. Technocratic reform team leads the modernisation effort	The <i>Club Suizo</i> group constituted a quintessential <i>technopols</i> team.
3. Ideas Matter	The <i>Club Suizo</i> group had a very clear ideology. Their ideas were put in writing in a coherent way before Gaviria was elected president. Although in retrospect, and in a comparative context, these ideas are far from being radical they did represent, at the time, a clear break with Colombia's economic tradition.
4. A strong public relations effort helps increase the support for the reforms	The Gaviria administration tried to put together a strong public relations team. From early on, however, the effort faced serious problems, including major leaks and an inability to read clearly the public's changes in political mood.
5. Compensation schemes can help reduce the opposition to the reform effort	From early on the Gaviria administration relied on (promised) compensation pay-offs to get support for the reform effort. The promised compensations were not mutually consistent, however, and could not be upheld. As some of the actors realised that the administration could not deliver, they turned their back on the reform effort.
6. Sequencing matters	The Gaviria administration made some effort — but not a whole lot — to follow a sequence that would not have political costs. The early relaxation of capital controls — and the foreign exchange amnesty — facilitated massive capital inflows that generated a massive real exchange rate appreciation, rendering one of the fundamental compensation schemes ineffective.
7. Speed matters	By promising a “gradual” and “selective” reform Gaviria was able to get the early support of the key <i>gremios</i> . When the trade reform was accelerated in August 1991, much of this support was lost. This, in turn, reduced the government's political ability to maintain the reform momentum.
8. Political institutions are important	The constitutional reform of 1991 created a complete new set of political institutions. Some of them had a negative effect on the ability to move the reform agenda; thus, such as granting independence to the Banco de la Republica, had a positive impact.
9. External support may be important at certain junctures	The World Bank played an important role during the Barco administration (mild) trade reform effort. Its role was very marginal during 1990–94.
10. Coalition building can ease the political costs of the transition	A very broad coalition was forged initially in order to get the Constitutional reform approved. The coalition also helped pass some of the important early economic reforms. As time went by, however, it began to disintegrate. As a result support for the reforms declined significantly.
11. The opposition to reform tends to grow through time, as those negatively affected by it regroup	As the inconsistencies of the compensation mechanisms became apparent, and the original broad coalition broke down, the opposition to the reforms grew. This reached a peak with the Telecom strike, which succeeded in slowing down the reform agenda very significantly.

Notes

1. In 1998 Andres Pastrana was elected president. His programme called for some reform measures. The first half of his administration, however, was consumed by an effort to achieve a peace agreement with the left wing guerrilla movement.
2. See, for example, Barro (1996), Sachs and Warner (1995), Edwards (1997*a,b*) and Edwards *et al.* (1998). For an earlier and very complete analysis of the relationship between trade regimes and income distribution see Bourguignon and Morrisson (1989). More recent discussions on these issues can be found in Wood (1994).

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