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International Economic & Energy Weekly

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International Economic & Energy Weekly

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19 **Colombia: Impact of the Insurgency on the Economy** 25X1

The Colombian economy appears to be on the road to recovery after five years of sluggish activity, but efforts by the new Barco government to sustain growth may be hindered by the insurgent campaign against a variety of economic targets. 25X1

[redacted] 25X1

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Perspective

New Third World Agricultural Competitors: The Growing Challenge [redacted] 25X1

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[redacted] 25X6 Advances in agrotechnology and shifts to more market-oriented agricultural policies have transformed a few countries such as Brazil, Malaysia, and Thailand into major international suppliers of grain and other farm products in recent years, and we expect their strength to expand through 1990. Several other LDCs, including Argentina, India, and Indonesia, will probably join the ranks of diversified agricultural exporters within the next five years. [redacted] 25X1

[redacted] 25X6

Several factors indicate that expansion of LDC farm exports will probably continue. Most important, nearly all the new Third World agricultural competitors are efficient producers, relying little on production or export subsidies. Only in Brazil has such support played a major role in boosting export capacity. We believe that increased LDC competitiveness will continue to stem primarily from government policies offering strong production incentives and from lower labor costs, more productive investments, and natural comparative advantage. [redacted] 25X1

In addition, LDC agricultural sectors have only begun to tap the benefits of agrotechnology. While several of the new LDC competitors have been using high-yielding varieties of grain and advanced farm inputs, most have improved their productivity without substantially relying on the products of agricultural research. As agricultural export revenues expand, LDC governments will be able to increase funding for research on and imports of new agricultural technology. Even more effective application of traditional farming methods will substantially improve productivity in some LDCs. [redacted] 25X1

[redacted] 25X1

We believe that additional LDCs could become agricultural competitors in the 1990s. Although overall agricultural prospects in Africa and Latin America are not good, selected countries—including some in hard-pressed regions—will make advances in exporting certain commodities. If they follow relatively market-oriented policies and exploit new farming techniques, several LDCs could achieve strong growth in exports of selected products—cotton in Panama, Zimbabwe, Sudan, and Pakistan; and palm oil in Papua New Guinea, Colombia, and Ivory Coast. Many of these countries, however, will first have to deal with domestic instability and the politically explosive issue of land reform. 25X1

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Japanese Fiscal Policy: The View From Tokyo [redacted]

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Despite Tokyo's commitment to fiscal austerity, the prospect for continued sluggish economic growth has renewed the debate over whether to use government spending and taxing policies to stimulate the economy. We believe the discussions will focus on whether a policy of short-term economic stimulus is worth the long-term costs, particularly decreased investment and higher inflation. [redacted]

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[redacted] Japanese economic policy makers are in agreement: spending and tax reductions would bring additional economic growth but not a large increase in imports. In our judgment, however, this view understates the potential role of domestic demand in shifting investment away from export-related industries. We also believe Japanese economists do not give enough weight to the impact of higher domestic growth in slowing the drop in wholesale prices [redacted]

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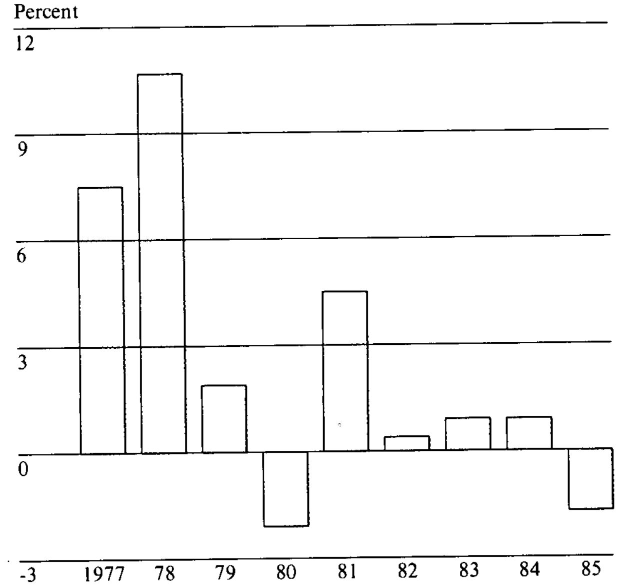
Japan: Growth in Real Government Spending, 1977-85



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The Looming Fiscal Debate

The near certainty that economic growth will fail to meet the government's 4-percent target for the fiscal year ending next March is prompting some leading politicians, MITI officials, and businessmen to encourage the Nakasone government to alter, at least for the time being, its austere fiscal stance. In our judgment, the outcome of the debate will depend on how Tokyo evaluates several factors:

- The effectiveness of a bond-financed increase in government spending or cut in taxes in pulling the economy out of its doldrums.
- Whether any such increase would ease trade tensions with Washington.
- How many long-term economic problems would be caused by this policy shift.
- Most important, whether the deterioration of the economy is serious enough to require a boost in government spending to maintain growth. [redacted]

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The Short-Term Impact of Fiscal Policy

On Economic Growth. [redacted] an increase in government spending or a tax cut financed by the sale of government bonds will, in the short term, boost real GDP. [redacted]

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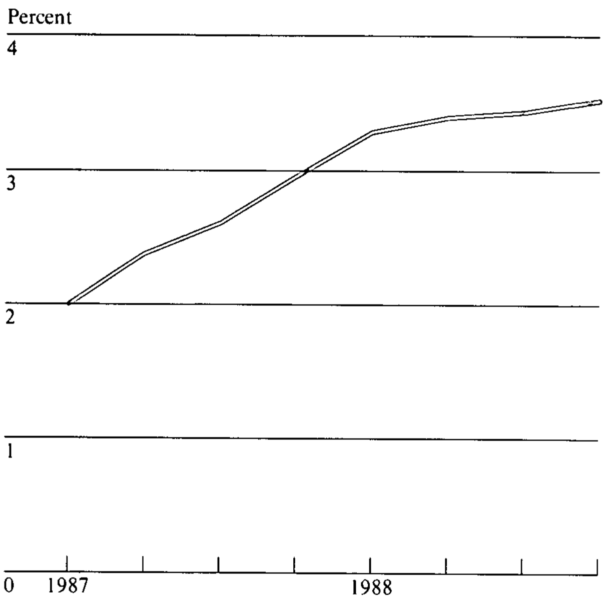
Japan: Effect on Real GNP of a Sustained 10-Percent Increase in Government Spending, 1987-88



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We believe there is ample evidence to support this judgment. Simulations conducted with our econometric model of Japan suggest that a sustained 10-percent increase in government spending—$35 billion roughly split between government consumption and public investment—would boost real economic growth by 2.5 percentage points in the first year and 1 percentage point in the second year. An OECD study last year came to a similar conclusion.

On the Current Account Balance. Despite the effectiveness of fiscal policy in boosting real economic growth in the short term, Japanese economic policy makers claim that faster growth would do little to reduce the country's large current account surplus. Indeed, EPA Director General Kondo made this argument publicly at the recent GATT talks in Uruguay. Both the Finance Ministry and the EPA argue that higher Japanese growth has a minimal effect on imports of commodities because the Japanese economy is moving away from industries that are heavy users of energy and raw materials. Japanese models also show only a modest impact on imports of manufactures from higher growth. 25X1

Japanese Government economists support their judgment on the relationship between the current account and fiscal policy with results of simulations done on large econometric models. The EPA model, for example, shows that a 10-percent increase in government spending would reduce the trade surplus by only $4.5 billion. According to these calculations, GNP growth would have to increase by more than 6 percentage points to achieve even a $10 billion cut in the trade surplus. For its part, the Ministry of Finance calculates that a 10-percent increase in government spending would boost imports by only $2 billion and that a one-third—$30 billion—cut in taxes would increase imports by only $700 million. 25X1

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Although our model and OECD studies produce a similar current account impact, we believe large-scale macroeconomic models fail to capture two important results that tend to decrease exports over time. The models do not account for the fact that increasing domestic demand boosts the return to investment in nonexport-related industries. Consequently, their forecasts understate the drop in exports as investment shifts away from export industries and toward products geared to domestic sales.[2] 25X1

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[2] In the late 1970s and the early 1980s, the slowdown in Japan's domestic demand caused firms to look to export markets to maintain sales. Indeed, 30 percent of Japan's investment spending during the 1980s has been export related, according to estimates made by the US Embassy. The share of exports in total sales increased from less than 20 percent in 1974 to 26 percent last year, according to Japanese Government statistics. 25X1

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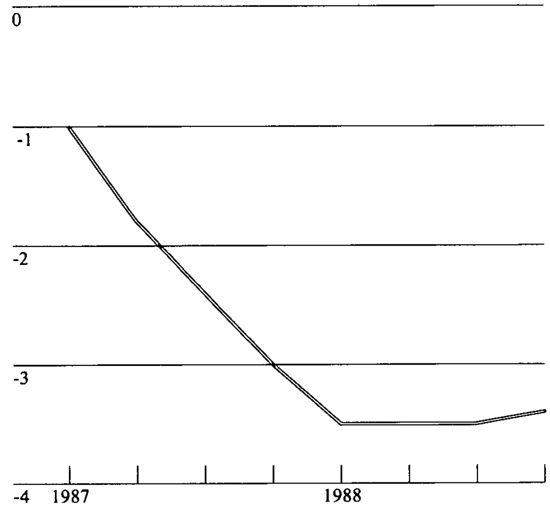
Japan: Effect on Current Account Surplus of a Sustained 10-Percent Increase in Government Increase in Government Spending, 1987-88

Billion US $



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In addition, most economists contend that more robust domestic demand is necessary for a currency appreciation to reduce the trade surplus. Without an increase in domestic demand, we believe even the gains made thus far—export volume has declined since early this year, while import volume is up sharply—could erode. Failure to stimulate the economy could lead to price reductions that would go far in restoring the competitive position Japan enjoyed before the yen appreciation. In some respects, this adjustment process is already occurring: wholesale prices, which have fallen for 17 consecutive months, are now declining at an annual rate of over 10 percent. An increase in domestic demand would dampen their slide [redacted]

Long-Term Problems

While Japanese policymakers agree that boosting government spending or cutting taxes can provide short-term stimulus, they are equally convinced that in the long run it leads to serious economic problems. They believe, for example, that a bond-financed fiscal expansion increases inflation and interest rates, thereby discouraging domestic investment and reducing potential production. Recently, Director General Umezawa of the Finance Ministry Tax Bureau suggested that expansionary fiscal policy actually reduces economic growth. Indeed, many of the individuals and organizations who are in positions to influence fiscal policy—such as close advisers to Nakasone and the Finance Ministry—appear to be the most concerned about the long-term implications of adopting a policy of fiscal expansion. Last month's pump-priming package demonstrates these views because the package will probably include only small amounts of new funds, making the effect on the economy minimal. [redacted] 25X1

An OECD study suggests that Tokyo's concerns may be valid. OECD simulations show that long-term interest rates—an important determinant of the cost of capital for private investment—increase sharply in Japan following a bond-financed increase in government spending. The study even suggests that interest rates rise more in Japan than in the other Big Seven countries for a similar increase in government spending. We suspect that the narrow and tightly regulated government bond market accounts for these results. 25X1 [redacted] 25X1

In addition, many Japanese officials argue that over the long term increased deficit spending will limit Tokyo's flexibility to use fiscal policy in response to natural disaster or full-fledged recession. [redacted] 25X1 A key long-term concern is the increased government spending that will be needed to support Japan's aging population. [redacted] 25X6 25X6

Political Pressures

A growing number of Japanese officials apparently believe that the current economic slowdown is serious enough to warrant acceptance of some longer term costs. Many of these groups [redacted] are under pressure from small- and medium-size export firms, who have been particularly hard hit by yen appreciation. This suggests that if the economy continues to weaken in the months ahead—a likely prospect in our view—the calls for fiscal stimulation will increase. [redacted] 25X1 25X1 25X1

A key player to watch in the months ahead will be Finance Minister Miyazawa. Unlike former Finance Minister Takeshita who tended to rely on the Finance Ministry bureaucracy for policy guidance, Miyazawa is taking a more active role. Miyazawa has publicly expressed interest in using countercyclical fiscal policy to offset the negative aspects of yen appreciation. If this in fact is his personal policy preference, and not just a political posture adopted to distance himself from the Prime Minister, he could then develop into an important voice in favor of a more expansionary policy. Success would strengthen his currently poor chance of succeeding Nakasone as LDP President and thus as prime minister. [redacted] 25X1

[redacted] 25X1

West Germany: Kohl's Economic Agenda

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When Chancellor Helmut Kohl visits Washington next week, he will be prepared to defend his economic policies as well as to emphasize Bonn's perennial concerns over West European security, Moscow-Washington relations, and inter-German affairs. Past bilaterals have been reasonably free of economic frictions, but escalating international criticism of his country's slow economic growth, widening current account surpluses, and tight economic policies has put Kohl on the defensive. While Kohl wants a harmonious visit to bolster his coalition's electoral prospects in next January's elections, he cannot appear to capitulate to US pressure or to repudiate the programs he has championed for the last five years. He may even conclude that standing up to the United States would blunt Social Democratic criticism that he is too docile in dealing with Washington. Kohl—whose government is likely to win reelection—will resist calls for change, arguing instead that his next term will focus more on growth-oriented structural reform programs.

An Economy in Transition

The dramatic appreciation of the deutsche mark—particularly since the September 1985 (Group of Five) accord—has undercut Bonn's reliance on export-led growth, leaving Kohl to preside over an economy making the difficult transition to domestic-led expansion. West German officials had earlier hoped that declines in oil prices and interest rates would offset the deflationary impact of mark appreciation. Growth in first half 1986 was essentially flat, however, with a strong pickup in April-June compensating for a dismal first quarter. Industrial production appears to have plateaued this summer and export-oriented industries—which so far have been filling contracts secured before the mark's spectacular rise—are increasingly concerned about declining foreign orders. On the positive side, West German consumers may finally be spending more in response to higher real incomes.

West Germany: Supply-Side Constraints on Growth

The West Germans argue that their capacity for noninflationary growth has diminished during the 1980s because of structural or supply-side factors—chiefly rigidities in the labor maket. High and sticky real wages, reduced pay differentials between skilled and nonskilled labor, and high nonwage labor costs—mainly social security, unemployment, and severance charges—are blamed for inducing firms to substitute capital for labor, thereby increasing structural unemployment. Indeed, capital utilization rates in West German manufacturing are presently on par with those experienced during the last cyclical peak in 1979, while unemployment remains several times higher. 25X1

The Kohl government's progress in addressing labor market rigidities has been slow and somewhat mixed. New labor legislation has increased flexibility for hiring youth and part-time workers, but the government added to the labor cost problem by hiking mandatory social security contributions. In addition, many labor market rigidities result from collective bargaining decisions that are beyond the government's direct control. 25X1

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We agree that structural rigidities keep unemployment higher than it otherwise would be, but believe the impact of such rigidities on economic growth is exaggerated. While capacity utilization rates are high in the export-dependent manufacturing sector, capital is not a constraint in the labor-intensive construction and service industries. Tight economic policies, by weakening domestic demand, have discouraged investment and the economy's capacity to grow. We also believe the West German tax system is itself a major contributor to structural unemployment. Social charges per employee are equal to 80 percent of wage costs, according to a survey by a West German institute, while taxes on earned income are among the highest and most progressive in the OECD. 25X1

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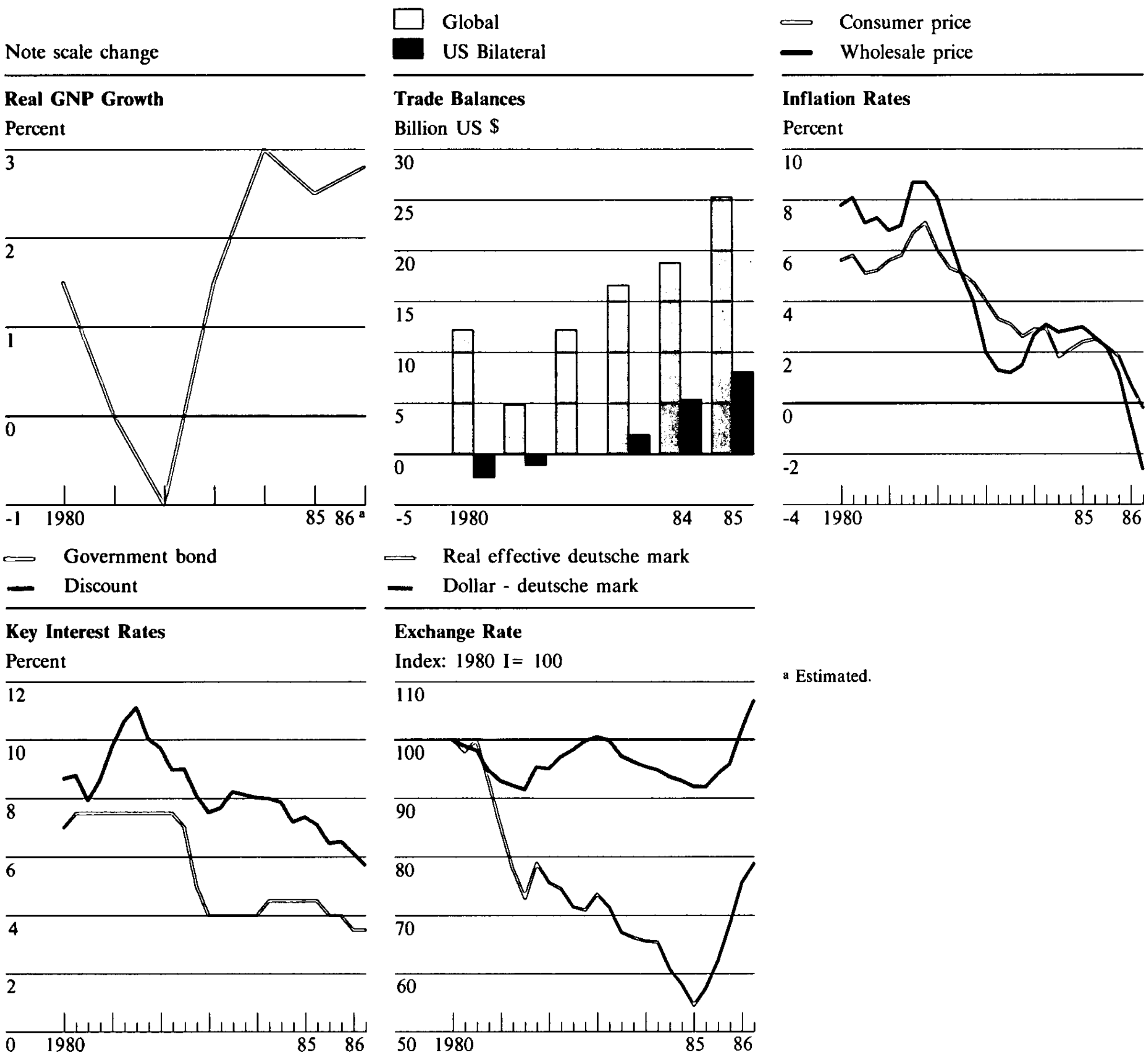
West Germany: Selected Economic Indicators, 1980-86



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The economy faces a continuation of the unimpressive growth that has plagued West Germany during the latest cyclical upswing. The major West German economic institutes have revised their 1986 growth forecasts downward—by about 1 percentage point—to 2.5-3.0 percent, with roughly the same growth rate expected in 1987, while the government is maintaining its official forecast of 3 percent growth this year. We expect West German GNP to rise 2.8 percent both this year and next, based on simulations of our econometric model.

West Germany's mixed economic performance provides arguments for both the government and its critics. Kohl boasts that 600,000 jobs have been created since 1983, while the Social Democrats stress that 2.2 million Germans—nearly 9 percent of the work force—remain unemployed. The government argues that its tight economic policies have tamed inflation, while skeptics worry that recent price declines at both the wholesale and retail levels could worsen the bankruptcy rate and generate a deflationary spiral. Even the robust current account surpluses have been accused of squeezing LDC debtors and contributing to worldwide protectionist pressures.

The overriding economic concern in Bonn is that a further sharp decline in the dollar could have an additional impact on the mark by forcing a revaluation of the West German currency within the European Monetary System (EMS). West German industry, which we estimate is just about breaking even on foreign sales at the present dollar-mark rate, would probably react to falling export revenues by slashing investment, thus weakening domestic demand. Moreover, a devaluation of the franc within the EMS would embarrass French Prime Minister Chirac and strain relations with Paris, which has been particularly critical of West Germany's refusal to reflate the economy.

Kohl's Economic Brief

Kohl and his ministers reject foreign pressures for Bonn to abandon—even temporarily—its tight economic policies and stimulate domestic demand. Kohl reportedly remains optimistic that the economy is on an upswing, and that his medium-term programs of deficit reduction and expenditure restraint have set the stage for balanced, sustainable growth. Kohl has stated that his predecessor, Helmut Schmidt, erred in acceding to US requests at the 1978 Bonn Summit to adopt stimulative policies. 25X6

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The government recently submitted the 1987 budget to Parliament. Expenditures are programed to rise a scant 2.9 percent and, unlike in 1986, no tax cuts are planned. In presenting the new budget, Finance Minister Stoltenberg ruled out any loosening of fiscal policy after 1987. 25X1

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Kohl can hang tough in defending his economic policies partly because polls indicate a strengthening of his government's popularity, although voter sentiment toward his handling of the economy is clearly ambivalent. Barring a major personal gaffe or scandal, we expect Kohl's coalition to be returned to power. Paradoxically, the Social Democrats, whose talents for economic leadership are held in low esteem by the voters, second US calls for more expansionary policies. [redacted]

Monetary and Exchange Rate Options

Interest rate cuts could have a dual benefit of stimulating West German internal demand while dampening further appreciation of the mark. [redacted]

Short of interest rate cuts and politically unattractive capital controls, Kohl has few policy tools to prevent an unwelcome rise in the mark. West Germany led a concerted joint European intervention effort earlier this month to defend the dollar and stabilize the EMS, but we believe a repeat performance is unlikely. The West Germans believe intervention without US participation would ultimately prove futile and would only inflate the domestic money supply. [redacted]

Kohl's Next Term

Kohl is most likely to emphasize that his next administration will focus on more fundamental reforms. [redacted] success in 25X1

expenditure restraint has not been matched by improvements in the quality of expenditure. Subsidies for inefficient sectors such as agriculture and mining have continued to grow—for example, while public investment has been slashed. The government has also indicated willingness to pass on future savings to consumers in tax cuts. Finally, Bonn plans to accelerate its much-postponed privatization effort and to debate reforms for regulated sectors, such as telecommunications. [redacted] 25X1 25X1

Implementation of these concepts, however, is unlikely to assuage proponents of faster growth. Tax reform is to be the centerpiece of Kohl's next term, and Finance Minister Stoltenberg has suggested about 40 billion DM in tax cuts, one-half of which is to be financed by reduced grants and tax subsidies. The next 20 billion DM tax relief is roughly 7 percent of expected government revenue. Cuts in politically sensitive subsidies, however, could easily be derailed by coalition infighting. Moreover, Stoltenberg favors a two-stage implementation that could delay the full impact of tax reform into the next decade. [redacted] 25X1 25X1 25X1

Bonn's medium-term fiscal and economic plans both suggest only marginal policy changes if the Kohl's center-right coalition is returned to power. The fiscal plan envisages expenditure increases of less than an average annual of 3 percent over the rest of the decade while the economic plan targets a moderate 2.5-percent GNP growth rate. Adoption of this slow growth path suggests Bonn will have to rely on demographic shifts—for example, the waning of the baby boom generation—to make a substantial dent in unemployment. [redacted] 25X1

[redacted] 25X1 25X6 25X6

Morocco: Economic Problems Persist [redacted]

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A record grain harvest and lower oil and interest costs have fueled a rebound in Morocco's economy after years of sluggish performance. A large foreign debt burden and lax fiscal policies, however, limit prospects for additional foreign borrowing and economic growth. This, coupled with reduced foreign aid inflows, puts Rabat's ability to finance economic development and military modernization in jeopardy. With little chance for improvement in living standards in the coming years, popular disgruntlement over the economy almost certainly will increase, forcing King Hassan to rely even more heavily on his security forces to maintain order. [redacted]

Austerity Pays Off

Morocco has made progess over the past three years toward stabilizing the economy. Under the auspices of an IMF standby loan program, Rabat has reduced domestic consumption, stimulated savings, and gained greater control over national finances—the $13 billion foreign debt has been rescheduled twice since 1982. Real GDP growth probably will top 4 percent again this year, [redacted] compared with the 2.4-percent annual average for 1981-84. Inflation—7.7 percent last year—fell below the double-digit level for the first time since 1982. [redacted]

Much of the gain, however, has come from external factors. Sharply higher GDP growth reflects the recovery of the agricultural sector after several years of drought and overshadows continued weakness in the industrial sector. Greater domestic food production, combined with the 45-percent drop in petroleum prices, resulted in a substantial reduction of Morocco's import costs both this year and last. The more than 9-percent appreciation of the dirham against the US dollar and sharply lower international interest rates since 1984 trimmed an additional $200 million off Rabat's annual foreign payments burden. [redacted]

Financial Problems Persist

Despite progress toward economic reform, Morocco has not cinched its fiscal belt tight enough. A growing budget deficit has been financed by expansionary monetary policy and slow payment of commercial obligations—arrears topped $500 million last spring. The surging budget deficit caused Morocco to lose access to badly needed IMF funding earlier this year. [redacted]

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Negotiations with the Fund for a new $275 million, 18-month, standby loan are under way. The US Embassy reports that a new round of austerity measures including lower budget deficits and monetary growth will be part of the package. The government also must secure $350 million in long-term, concessional money from official and commercial sources to help cover the remaining financial gap this year. New austerity measures, however, probably will be difficult to sell domestically given rising popular expectations of continuing economic recovery. Nevertheless, if donors cooperate and Rabat moves forward with fiscal reforms, a letter of intent for a new standby program could be signed by late November. [redacted]

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Rescheduling Morocco's foreign debt has become increasingly difficult for the government. Rabat has not signed the rescheduling agreement with London Club banks for debt due in 1985-86 and probably will have to negotiate additional rescheduling agreements with both Paris and London Club members for debt payable next year. The government's refusal to guarantee rescheduled debt payments has resulted in a protracted series of meetings with commercial lenders and has generated considerable ill will toward Morocco. In addition, relations with Paris and London Club creditors have been tarnished by payment delays. Maintaining Morocco's important short-term credit line of $450 million with commercial banks is of

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Morocco: Current Account, 1982-87

Million US $

	1982	1983	1984	1985 [a]	1986 [a]	1987 [a]
Current account balance	**−1,990**	**−1,127**	**−1,381**	**−666** [b]	**−547** [b]	**−520** [b]
Trade balance	−1,774	−1,214	−1,407	−1,020	−983	−1,000
Exports, f.o.b.	2,042	2,086	2,162	2,167	2,365	2,600
Phosphates and derivatives	913	925	1,010	921	780	950
Imports, f.o.b.	3,816	3,300	3,569	3,187	3,348	3,600
Fuels and lubricants	1,174	988	1,021	700	650	780
Food	581	533	660	506	320	320
Net services	−216	87	26	354	436	480
Receipts from tourism	329	374	409	537	575	600
Worker remittances	982	977	930	1,009	1,070	1,100

[a] Projected.
[b] Includes effect of $400 million Saudi oil grant.

[redacted] 25X1

particular concern [redacted] 25X1

Morocco's trade position also remains weak, despite significant improvement. Export growth continues to be sluggish because of reduced demand and prices for phosphates and citrus—the primary exports. Moreover, imports have turned upward again despite the savings on oil and food imports. This, in part, reflects government foot-dragging on achieving the trade liberalization goals of the IMF program. As a result, Morocco's foreign exchange reserves remain below $70 million—about one week of import cover. [redacted]

Heavy defense spending puts an added burden on scarce government resources. Defense costs have averaged about 22 percent of the national budget and 6 percent of GDP over the past decade. Over $700 million was allocated for national defense last year alone. Only education claims a larger share of national revenues. Moreover, Hassan announced a $1 billion, multiyear modernization program in April 1985 to upgrade air and armor capabilities. These defense priorities have even caused Rabat to divert $250 million in Spanish economic assistance to purchase transport equipment needed for the military effort in Western Sahara. Neither Saudi Arabia nor France—the major sources of military assistance in the past—have committed new aid for the military modernization effort. [redacted] 25X1

The greatest casualty of Morocco's austerity program, however, has been economic development. Capital expenditures have declined as a share of GDP from over 11 percent in 1980 to less than 3 percent last year. Many development projects have been delayed or scrapped. The decline in investment is especially troubling given Morocco's rapid population growth (2.8 percent annually) and youthful population (56 percent is under 20 years of age).[1] Unemployment already tops 25 percent. Coupled with new fiscal restraints most likely under the next IMF program, there is only a limited chance for improvement in economic growth and living standards in the years ahead. [redacted] 25X1

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[redacted] 25X1

Domestic Political Implications

There is little evidence that King Hassan's domination of the political scene in Morocco will be threatened in the near term, despite continuing economic uncertainty. The political opposition has either been co-opted by the King or isolated. Moreover, Hassan does not appear to have lost any domestic support as a result of his meeting with Israeli Prime Minister Peres in July. Although several radical Arab states—including Libya and Syria—opposed the meeting, most moderate Arab states including Saudi Arabia have taken a neutral position. The meeting with Peres also offered Hassan a convenient opportunity to break the increasingly uncomfortable Arab-African Union with Libyan leader Qadhafi and to improve relations with Washington. In addition, Hassan has taken significant measures to improve domestic security against hostile actions by some radical Arab groups. [redacted] 25X1

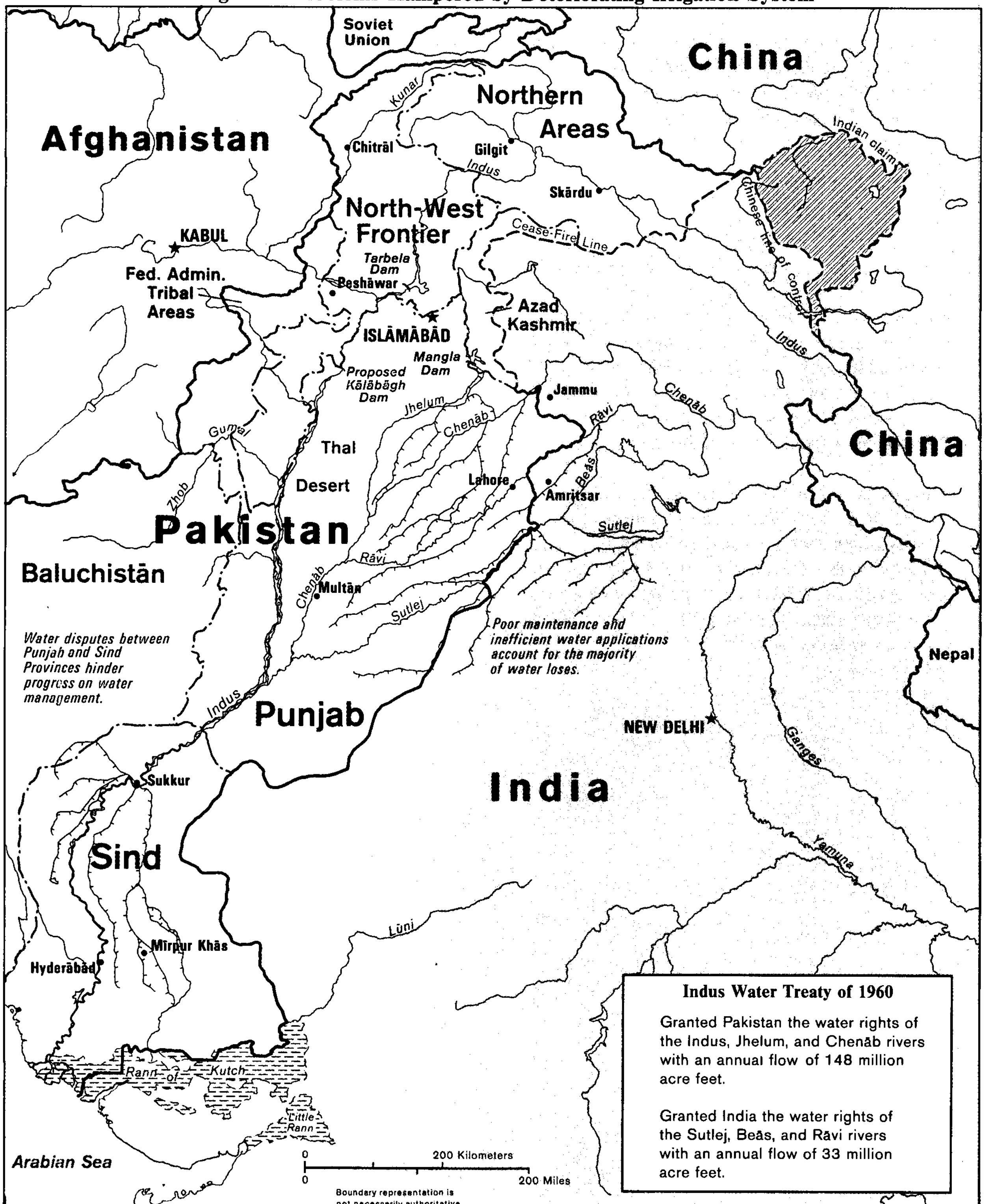
Rising popular expectations, however, present a long-term challenge to the King. Dissatisfaction created by deteriorating economic conditions flared into violence in 1981 and 1984 when the government attempted to reduce sensitive subsidies. In addition, military morale could be adversely affected by a sharp reduction in defense spending. [redacted] 25X1

Outlook

Hassan is not, in our opinion, blind to his economic problems and the political difficulties they imply. Nonetheless, the nation's financial difficulties, even with additional foreign financing, will remain acute for at least several years and will require that the King devote more of his attention to the economy. With current account deficits likely to persist through the end of the decade, the government will be hard pressed to launch most aspects of its current development plan. Even with renewed access to IMF loans, Rabat faces additional debt rescheduling on stiffer terms over the next several years. Economic growth will be slowed by continuing austerity, and unemployment will remain a troubling issue. Living standards almost certainly will decline further to accommodate necessary economic reform and military modernization. As a result, Hassan may have to rely more heavily on the country's security forces to contain any rise in domestic unrest. [redacted] 25X1

[redacted] 25X1

Pakistani Water Management Problems Hampered by Deteriorating Irrigation System



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Pakistan: Deteriorating Irrigation System [redacted]

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Pakistan must address longstanding water management problems if it is to boost food production for its growing population. Growing water shortages, in our view, are likely to make it increasingly difficult for Pakistan even to maintain its current level of agricultural production, adding to the country's import needs and foreign payments problems. Improvement of the archaic and inadequately funded irrigation system is a first priority. Government efforts, however, are hindered by provincial competition and obstruction by politically powerful farmers. Moreover, water rights to the subcontinent's rivers are an ongoing issue with India. [redacted]

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An Agricultural Economy

The agricultural sector employs 50 percent of the labor force, earns approximately 70 percent of the export revenues, and contributes roughly 25 percent of GDP. Use of advanced agricultural inputs—high-yielding varieties of seeds, fertilizers, and pesticides—and increased farm mechanization have contributed to Pakistani food self-sufficiency. In fact, food exports earned Pakistan $300 million last year—12 percent of total exports. Nevertheless, water shortages continually threaten output of foodgrains and several cash crops, including cotton and sugar, reducing export potential and, in some cases, necessitating imports. Some 90 percent of the harvest depends on irrigation water. [redacted]

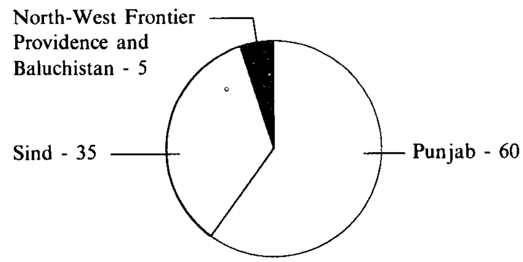
Crumbling Irrigation System

Pakistan's Indus River Irrigation System—extending about 57,100 kilometers, the largest in the world—irrigates about 70 percent of the 20.5 million hectares of cultivatable land. Completion of the Mangla and Tarbela reservoirs in 1967 and 1976, respectively, have increased the amount of water available for irrigation, but additional capacity is still limited by domestic political feuding over the location of new reservoirs and funding. [redacted]

Pakistan: Provincial Area Covered by the Indus River Irrigation System, 1986

Percent

Total = 14 million hectares



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Half of the water entering the irrigation system is lost because of poor maintenance and inefficient application. Seepage from unlined canals, evaporation, and poor drainage have also contributed to the high water losses. Several programs to improve water channels have been carried out. Pakistan has already rehabilitated 4,800 kilometers of canals with the help of the United States and the World Bank, but the situation is little better because of poor maintenance. [redacted]

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According to press reports, government management of the irrigation system ends with the main distribution channels where local farmers take control. Groups of farmers in a particular area designate one person to manage the water courses between the government system and each farmer's fields based on schedules determined decades ago. Moreover, sporadic supplies force farmers to use water when available regardless of requirements because the water might

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Indus Water Treaty

Pakistan's creation in 1947 left the Indus River irrigation system divided by international borders. Disputes arose between Pakistan and India because the headwaters for a number of canals irrigating Pakistani land were located in India. The Indus Water Treaty of 1960 gave the water rights of the eastern rivers—Ravi, Beas, and Sutlej with an annual flow of 33-million-acre feet (maf)—to India and the western rivers—Indus, Jhelum, and Chenab with an annual flow of 148 maf—to Pakistan. The treaty also provided for the construction of a large link canal system and several dams to transfer water from the western rivers to areas in Pakistan formerly served by Indian-assigned tributaries. One of the most recent irritants in Indo-Pakistani relations has been Islamabad's public charges that New Delhi plans to divert water from the Jhelum River to India in violation of the treaty.

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not be available at their next scheduled turn. This practice has contributed to serious waterlogging and salinity problems, leaving many hectares unproductive.

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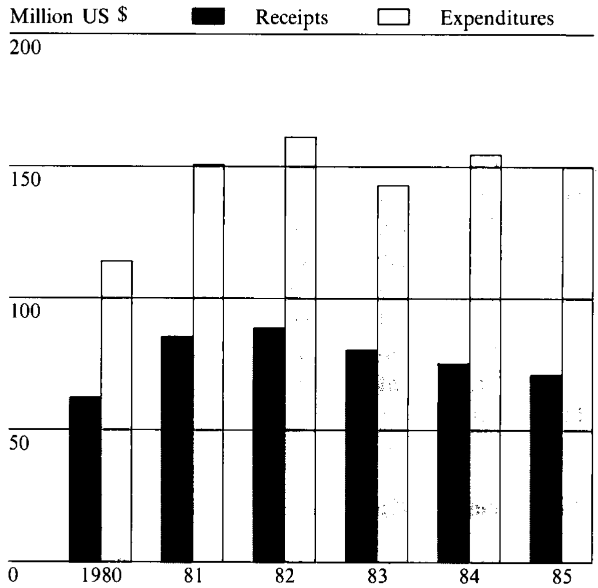
Water charges are inadequate to cover operation and maintenance costs, let alone to expand the system, but Islamabad has been reluctant to ask politically powerful farmers to cough up more money. The share of operating and maintenance costs covered by water charges has fallen from 57 percent in fiscal year (FY) 1982 [1] to 48 percent in FY 1985. the last nationwide increase in water charges was in FY 1982. Minor rate hikes have been enacted in most provinces, but rates in Punjab Province—the largest provincial water recipient—have remained unchanged. Reductions in development funds for irrigation have also contributed to poor maintenance.

[1] The Pakistani fiscal year is 1 July to 30 June.

Pakistan: Irrigation Receipts and Expenditures, 1980-85 [a]



[a] Fiscal year data beginning 1 July of the stated year.

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Provincial Squabbles

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Water disputes between the provinces of Sind and Punjab—these two account for almost 95 percent of the land irrigated by the Indus irrigation system—hinder progress. The politically dominant farmers of Punjab receive a disproportionate share—about 75 percent—of tubewell [2] and canal water. Sind, located at the end of the irrigation system, receives the remainder, which contains high salt concentrations after passing through Punjab.

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[2] A tubewell pumps water from the ground by using a motor attached to a sunken tube.

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Provincial rivalries have stymied the proposed Kalabagh Dam project that approaches the joint capacities of the Tarbela and Mangla Dams. Because the Tarbela Dam is frozen in winter, the Kalabagh Dam project is designed to increase the winter water supply. Farmers and other land owners in the North-West Frontier Province claim that their land would be flooded for the economic benefit of the Punjab. Moreover, Sind Province farmers are concerned that the Punjabis will siphon off the additional water.

Islamabad established a commission in 1977 to resolve provincial differences. The commission's main objective is to coordinate cropping patterns to get the most efficient use of irrigated water. Objections by Punjabi farmers and the large bureaucracy managing the country's water supply, however, have thwarted the commission's efforts to improve water distribution.

Outlook

Pakistan's Sixth Five-Year Plan (1982-88) will focus on balancing canal rehabilitation with larger projects such as the Kalabagh Dam and improving operation and maintenance through steady increases in water use fees. Funding has been provided by several multilateral development banks to expand Islamabad's rehabilitation efforts. But, growing operation and maintenance costs, particularly for the country's dams, coupled with the likelihood that water charges will not be increased significantly may force Pakistan to curtail future development efforts and engage in quick-fix projects to increase water availability in the irrigation system. 25X1

Although the government has proposed more private-sector participation in the installation of tubewells, Punjabi farmers and government bureaucrats are likely to forestall any significant private-sector programs that might undermine their control. The new civilian government of Prime Minister Junejo, which is already displaying a marked reluctance to undertake risky initiatives in the wake of August's political violence, is unlikely to challenge those powerful interest groups. 25X1

Islamabad is unlikely to raise the several hundred million dollars annually needed to rehabilitate and expand the irrigation system. As a result, Pakistan will have a difficult time, particularly if there should be a severe drought, maintaining the current level of agricultural output, let alone increasing it. 25X1

Implications for the United States

The $4.02 billion aid package for US fiscal years 25X1
1988-93 offers little hope of relief for Pakistan's deteriorating irrigation system. According to the US Embassy, the economic assistance portion of the package will have $1.5 billion allocated to economic support funds and $300 million for development assistance. Most of the $1.5 billion, however, will cover debt service on existing loans, and there are many competing uses—health care, education, and transportation—for the remainder. 25X1
Islamabad is almost certain to ask for Washington's support for increased funding and technical assistance from such donors as the World Bank and the Asian Development Bank for irrigation projects. If agricultural shortfalls contribute to a foreign exchange shortage, Islamabad may seek additional US aid. 25X1

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Colombia: Impact of the Insurgency on the Economy 25X1

The Colombian economy appears to be on the road to recovery after five years of sluggish activity, but efforts by the new Barco government to sustain growth may be hindered by the insurgent campaign against a variety of economic targets. Guerrilla activity is imposing increasing costs on the Colombian economy in terms of capital damage, production losses, and rising protection expenses, especially in the most frequently targeted energy sector. In addition, guerrilla attacks on small businesses and banks—to obtain cash—have become frequent. At a minimum, the insurgency will hamper Barco's promised efforts to accelerate development, stimulate agrarian reform, and attract new foreign investment. 25X1

Violence in Colombia, 1980-86 *Number of incidents*

	Kidnapings	Guerrilla-Related Deaths	Extortions	Attacks Involving US Businesses
1980	11	28	NA	2
1981	62	206	NA	2
1982	93	251	NA	2
1983	113	379	183	5
1984	299	359	162	5
1985	200 [a]	440-460	39 [b]	13
1986 [c]	NA	615	NA	9 [d]

[a] Minimum estimate.
[b] First quarter.
[c] January-May.
[d] January-September.

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The Evolving Guerrilla Strategy

The guerrillas' campaign to undermine the economy has gained momentum in recent months. Previously, sabotage operations tended to be against random targets of opportunity, such as local wealthy landowners and private businesses to obtain food, money, weapons, and recruits for their cause.

More recently, insurgent groups have systematically begun to attack oil and power facilities and multinational corporations, and their executives have been increasingly targeted. Since 1980, Colombia has ranked first in Latin America in recorded terrorist incidents involving US investors. The National Liberation Army (ELN) has been particularly active in northeastern Colombia, where Occidental and Shell—in association with Ecopetrol, the state oil company—are developing a new field, with estimated reserves of over 1 billion barrels.

Economic Costs

Guerrilla activity has probably begun to erode business confidence. New foreign investment in 1985 amounted to only $86 million—one-half the 1984 level and the lowest figure since 1978. In addition, guerrilla disruption of ranching and farming activity is partly responsible for the high food import bills, averaging $400 million annually since the early 1980s. 25X1

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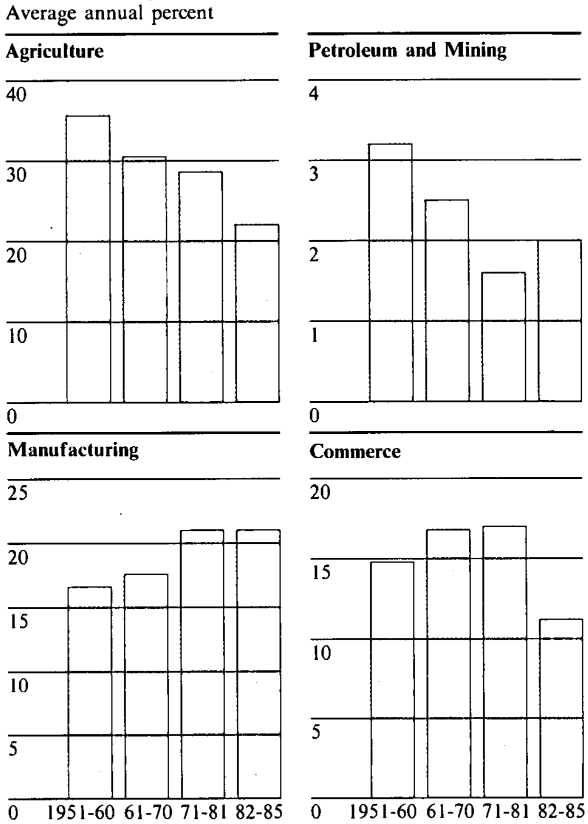
Colombia: Selected Sectors as a Share of Real GDP, 1951-85

Note scale change
Average annual percent



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Impact by Sector

Energy. The oil sector has been particularly hard hit by the insurgents:

- Bombing of Colombia's major pipeline in early October inflicted damages estimated at $10 million and spilled $200,000 to $300,000 worth of oil destined for export.
- A September attack on Chevron's Rio Zulia oilfield and pipeline inflicted damage estimated at $2-2.5 million.
- A late-August takeover and bombing of an Occidental production tower forced the company to reduce oil flow from 180,000 b/d to 120,000 b/d.
- Sabotage of the new Cano Limon pipeline in July and August stopped the oil flow for several days.
- A May 1985 strike at an Occidental drilling site inflicted damage estimated at $2 million.

Electrical pylons and transmission substations that are easily damaged and frequently located in remote areas have become frequent targets

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Agriculture. The farm sector—which accounts for more than 20 percent of real GDP, over 30 percent of the labor force, and 60 percent of export earnings—has been a frequent target of the insurgency. Rural crime and guerrilla attacks on cattle ranchers contributed to an 80-percent fall in beef export volume—from 21,600 metric tons in 1981 to 4,100 tons in 1985. Insurgent activity has hindered agricultural development especially in the western region, according to press and US Embassy reports. Major guerrilla groups also have begun to foster agitation among rural laborers.

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Commerce. Guerrilla attacks on local banks and businesses have resulted in sizable financial losses. Guerrilla incidents this year have also included the theft of $6 million in gold from a miners' camp, kidnaping of businessmen, car thefts from dealerships, and bombings of stores and local factories when owners rejected extortion demands.

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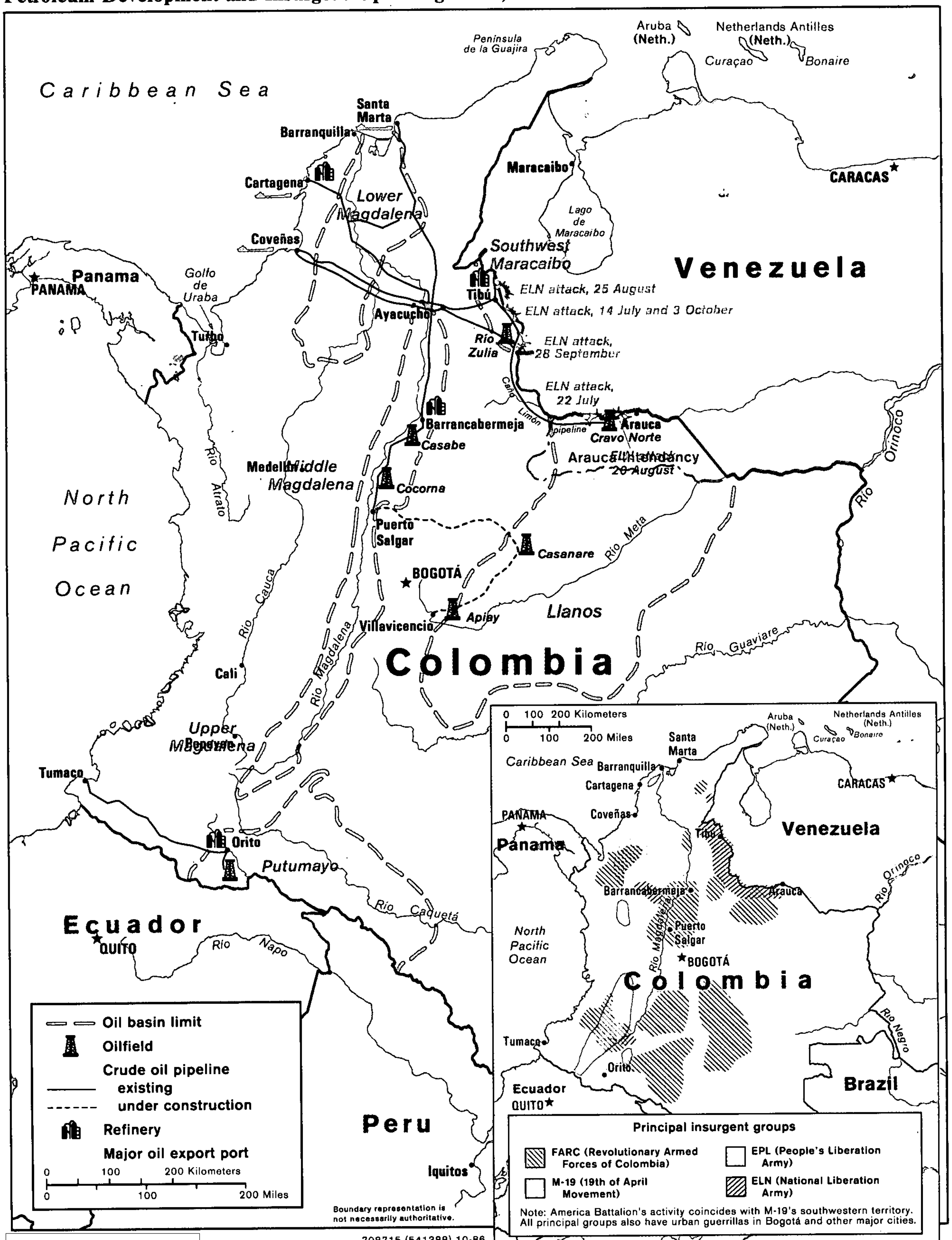
Outlook

The potential for more serious economic damage is high, given the lack of progress in the government's counterinsurgency capabilities. Bogota is concerned about the attacks on the economic infrastructure, but only recently has been able to expand official protection for highly vulnerable guerrilla targets, such as

Petroleum Development and Insurgent Operating Areas, 1986



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supreme court judges and threatened legislators. Although Defense Minister Samudio is working with Ecopetrol to develop a protection plan for Colombia's major oil pipeline, serious military manpower shortages and tactical mobility problems make it unlikely that the government will be able to defend important economic facilities or industries from guerrilla attack. [redacted] 25X1

Even if the insurgency does not escalate, the current level of attacks against economic targets could easily undermine President Barco's efforts to increase agricultural productivity and attract new foreign investment. Indeed, some guerrilla groups may focus more on rural targets, in response to Barco's stated belief that agrarian reform and increases in agricultural productivity would reduce popular support for the insurgency. [redacted] 25X1

[redacted] 25X1

Briefs

National Developments

Developed Countries

Ottawa Considers Aid for Farmers

The need for fiscal restraint stressed by Finance Minister Wilson probably means that Ottawa's recently promised aid to farmers will be less generous than anticipated by the agricultural provinces. The request for aid originally came from Saskatchewan's Tory Premier Devine, who is in danger of losing the 20 October provincial election. Prime Minister Mulroney—who has seen three Tory provincial governments fall since he took office in 1984—responded with a carefully crafted promise to work with Saskatchewan and other provinces suffering from low grain prices to devise an agricultural assistance program that could total more than $700 million. Since Mulroney's announcement two weeks ago, however, opposition questioning in parliament has revealed that the government is considering less generous options than Devine had envisaged—including loan guarantees for farmers already heavily in debt. Moreover, the aid package will be divided among all affected provinces and not just the western ones. These clarifications have almost certainly disappointed farmers in Saskatchewan and will do little to improve Devine's electoral prospects. 25X1

Canadian Task Force Recommends Broadcasting Changes

Ottawa's task force on broadcasting has recommended increasing the Canadian content of television programing on private networks as well as on the Canadian Broadcasting Corporation (CBC). The suggested changes could limit access for US broadcasters and cost the federal government $60-70 million more a year. To enforce the proposed content limits, the government's license review board would receive more authority and funding. The task force also recommended two new channels for the CBC, a tax credit worth 150 percent for Canadian advertising on certain programs, and creation of a joint federal/industry firm to buy US programs not already regulated. US broadcasters would stand to lose advertising revenue and sales of programs not broadcast simultaneously by Canadian networks. Taxes could also be increased for US cable programing and video-cassette sales. While implementation might take more than a year, in the interim the federal government could engineer a gradual increase in Canadian programing by raising content requirements in license hearings. 25X1

Outline of Japanese Tax Reform

Tokyo's Tax Advisory Council has nearly completed its recommendations for the first major reform of the Japanese tax code in the postwar era. In designing the $32 billion tax cut package, the Council apparently paid little attention to the meshing of tax reform with the Maekawa recommendations for turning growth inward, to developing measures to promote housing construction, or to the possibility that the reforms as a whole might increase Japan's trade surplus.

Instead, the Council concentrated on expanding the tax base, removing perceived inequities, and acquiring additional revenue. According to the US Embassy, the key proposals include reducing the number of personal income brackets from 15 to 5 or 6, reducing the top personal rate from 70 percent to 45 or 50 percent, reducing the top rate for large corporations from 44.3 percent to about 37.5 percent, accelerating the depreciation of selected plant and equipment, and modifying the system of tax-free savings accounts. The Council is currently debating a European-style value added tax (VAT) versus a simpler manufacturer's sales tax to make up for lost revenues. The Embassy expects only a modest stimulus to the economy from the current Council proposals—and only if the tax cuts take effect well in advance of any offsetting tax hikes. Moreover, the Finance Ministry's hopes of incorporating the Tax Council's final recommendations in its FY1987 budget submission, due in late December, will depend on the agreement of the ruling party's parallel Tax Council. Modification of the tax-free savings system and the introduction of an indirect tax are certain to generate strong political resistance.

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Portuguese Economy Improving

Benefiting from declining interest rates and lower oil and commodity prices, Portuguese real GDP growth will reach an estimated 3.7 percent for the year. Investment—a major element in Prime Minister Cavaco Silva's recovery plan—is strong although its growth will fall several percentage points below the government's 9-percent target. Inflation probably will fall to about 13 percent by yearend—more than 6 percentage points lower than last year. The current account balance is also improving, with a $700 million surplus expected this year, paving the way for the government's proposed early repayment of some of the $16.6 billion foreign debt. Despite these improvements, several problems remain.

Projected real wage increases of 4 to 5 percent and real money supply growth of about 6 percent threaten to boost inflation next year. The public-sector deficit—equal to an estimated 11 percent of GDP in 1986—will continue to be a drag on the economy. Most important, the failure of the government to remove serious rigidities in the economy is likely to make it difficult for Portugal to cope with the challenge of EC entry. [redacted] 25X1

[redacted] 25X1

Less Developed Countries

Brazilian Debt Strategy

Brasilia is likely to push hard for concessions to reduce its debt repayment burden in negotiations that begin soon with foreign commercial banks to reschedule debts that fall due during the next five years. [redacted] 25X1 Although the government has yet to set its negotiating position, Brazilian officials repeatedly have said they will strive to reduce net debt payments from more than 4 percent of GDP this year to 2.5 percent next year. The difference will be used to fund additional imports and domestic investment. Officials have said they will attempt to reduce debt payments by negotiating a lower interest rate. Brasilia reportedly may also seek new voluntary loans that would further reduce the repayment burden. In return for lower interest payments, Brazilian officials may be prepared to negotiate an IMF agreement after the congressional election next month. The government realizes that an accommodation with the Fund is necessary to reschedule its debts to foreign government creditors through the Paris Club. [redacted] 25X1 If bankers do not offer concessions, Funaro may advocate again threatening them with only partial interest payments. [redacted] 25X1

Brazilian Finance Minister Drawing Fire

Growing dissatisfaction with the Cruzado Plan is hurting Finance Minister Funaro's standing among businessmen and the middle class. [redacted] 25X1
[redacted] Brazilian businessmen are increasingly critical of Funaro's unwillingness to ease the price freeze, and [redacted] the influential Sao Paulo business community now believes he is arrogantly pursuing unrealistic policies. Although the 23 July hike in surtaxes on cars, fuel, and foreign travel was unpopular, Funaro is still rated high in public opinion polls. [redacted] 25X1 25X1 25X1
[redacted] President Sarney has become irritated with Funaro over his handling of recent food shortages. We believe, however, that Sarney may use Funaro to deflect criticism of the Cruzado Plan by government opponents and is unlikely to dismiss his economic czar in advance of the November elections. If measures taken after the elections fail to stem dissatisfaction with the Plan, Funaro may end up a scapegoat and be replaced. [redacted] 25X1 25X1

US Seed Varieties Purchased by Ethiopia

According to US Embassy reporting, Ethiopia has entered into a deal with a US firm to buy seeds of improved wheat and corn varieties that could greatly increase yields. Trial plots are presently being grown in Ethiopia and early reports indicate the varieties were doing well. Because of the expense, use of such varieties will be limited to state farms—new seed has to be bought each year and there will be large requirements for fertilizers and pesticides. The production history of the state farms, however, suggests that the full benefit of the new varieties will not be realized. Moreover, similar instances in other underdeveloped countries have resulted in neighboring farmers pilfering seed and attempting to grow it on their own plots. Without proper management, improved varieties will not perform as well as local varieties—leading to a lack of confidence in improved varieties. We believe that, rather than limiting use to state farms, a program of subsidies to help local farmers obtain and grow the improved varieties would be more beneficial. [redacted] 25X1

Debate Over Indonesian Economic Reform

Indonesian officials are debating whether to tighten or relax economic controls to counter a faltering economy. Jakarta last month devalued the rupiah by 31 percent to stem Indonesia's deteriorating balance of payments—a move that has hit the middle class hard and provoked heavy criticism of the government's economic policy, according to the US Embassy. Technocrats trying to eliminate trade restrictions and favored monopolies are thwarted by protectionist forces intent on further insulating the economy from foreign competition. Jakarta's next moves on economic policy remain unclear. President Soeharto's pragmatic but image-conscious regime is reluctant to resort to deficit financing or heavy foreign borrowing to prop up government spending. Officials also deny that controls will be imposed to conserve foreign exchange. Although Jakarta's technocrats are studying options for removing certain trade barriers, the regime is unlikely to dismantle those regulations and monopolies that benefit business interests having close ties to elite elements, including the Soeharto family. [redacted] 25X1

Thai Policies To Stabilize Economy

Bangkok's economic cabinet—the Council of Economic Ministers—this week approved measures to reduce the country's dependence on foreign borrowing and imports and to sustain export growth. The package calls on the government to maintain a $1 billion annual ceiling through 1988 on new foreign borrowing, minimize exchange rate risks by spreading foreign exchange transactions across a wider range of currencies, and shift investment away from large-scale, capital-intensive projects. In addition, Bangkok plans to reduce its dependence on the US market—which last year took 20 percent of Thailand's total exports—in response to nervousness about US import restrictions. This move is probably timed to take advantage of the baht's recent decline against most foreign currencies, a major factor behind the almost 30-percent jump this year in exports to Japan and the EC. [redacted] 25X1

Burma's Foreign Exchange Shortage Intensifying

A severe foreign exchange shortage has slowed production in about one-half of Burma's highly import-dependent manufacturing enterprises [redacted] 25X1 25X1 Foreign exchange reserves were down to $17 million—less than one month of imports—at the end of June, in large measure because of low world rice prices and production shortfalls for teak, Burma's two major export commodities. Important manufacturing enterprises such as textile mills and an oil refinery are operating at no more than half capacity because they cannot obtain imported raw materials. Rangoon's principal response appears to be requests for additional financial assistance from Japan, Burma's largest aid donor. [redacted] 25X1

Communist

Czechoslovakia Pressing for Greater Productivity

Prague is planning to cut the wholesale prices of three-fourths of Czechoslovak industrial products by January 1988 to force improvements in productivity and efficiency. The price cuts—projected to amount to over $18 billion at official exchange rates—will require enterprises to reduce production costs in accordance with 1986-90 plan provisions in order to record a profit. This measure may result in some waste cutting but probably not enough to meet planned efficiency targets. The industrial sector has consistently fallen short of comparable goals in the past, and we expect it will continue to do so as long as the leadership refuses to undertake needed reforms, such as decentralizing decisionmaking or rewarding managers for technical proficiency rather than political suitability. As the deadline for implementing the price cuts approaches, Prague probably will be faced with the choice of either greatly reducing their magnitude or explicitly subsidizing enterprise losses. It is highly unlikely that the Czechoslovaks would force loss-making enterprises to go bankrupt. [redacted] 25X1

China Considering Short-Term Debt Refinancing

[redacted] 25X1
[redacted] Chinese short-term debt is largely denominated in yen and is thus more costly to repay as a result of the yen's appreciation. According to Western estimates, short-term debt—which nearly doubled last year to $9.6 billion—accounts for approximately one-half of China's total foreign debt. A new interministerial committee, formed to monitor the country's macroeconomic developments, will probably approve the refinancing package in the coming weeks. This committee is Beijing's first attempt to coordinate its overall debt and the activities of the various financial institutions. [redacted] 25X1

China Forms National Technology Market Group

Beijing has established the China Technology Market Development Group to promote technology development and transfer activities. According to Chinese press reports, the group—representing industry, research, and government—will cooperate with financial organizations to invest in technology development, to transfer results to rural areas, and to offer unspecified services relating to technology imports and regional technology development. Over the past several years, Beijing has encouraged technology sales and joint research and development contracts to increase the use of technology. Chinese officials report, however, that the volume of domestic technology commerce has declined significantly during the first half of 1986 compared with the same period in 1985. We believe the new organization may stimulate technology transfers by developing new sources of much-needed funding, but is unlikely to address the other key problems hampering technology trade: broken contracts, fraudulent sales, and an overreliance on low-level technology because of its lower initial costs. Moreover, the new organization is one of several competing national groups with similar mandates. [redacted] 25X1

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