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International Economic & Energy Weekly

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12 October 1984

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DI IEEW 84-041
12 October 1984

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International Economic & Energy Weekly

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12 October 1984

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Synopsis

1 **Perspective—*Third World: Problems in Resuming Economic Growth***

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The recent IMF/World Bank annual meetings underscored resumption of Third World economic growth as the next key issue. The LDCs, however, face some formidable barriers.

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11 **Egypt: How Much Reform?**

25X1

President Mubarak and his ministers fear that drastic changes in the "social contract" will cause widespread popular opposition reminiscent of the 1977 bread riots. Additional action by the government on energy prices, food subsidies, and exchange rates will, therefore, be slow and deliberate.

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15 **Mozambique: Reeling From Economic Blows**

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The Mozambican economic situation is among the worst in Sub-Saharan Africa, with economic activity almost in continuous decline since the country became independent in 1975. Mozambique's problems are so deep seated that we see scant prospect that it can regain preindependence levels of output by the end of the decade.

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19 **Debtor LDC Import Cuts: A Major Factor in Global Trade Decline**

25X1

Import reductions by 12 key LDC debtors in the past two years have sharply depressed the export earnings of both developed countries and all LDCs, with industrialized countries bearing the brunt of export declines. Although first-half 1984 data indicate the decline in debtor LDC imports is bottoming out, we do not expect a return to rapid import growth in the near future, which will continue to retard world export growth.

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23 **Zimbabwe's Military: The Impact of Economic Austerity**

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Despite the foreign exchange crunch and significant cuts in the defense budget, the Zimbabwe Defense Force continues its modernization program. Although we expect the armed forces will have to reduce, spread out, or forgo foreign procurement, defense expenditures in fiscal year 1985 probably will exceed allocations and increase friction within the government and hinder negotiations between Harare and the IMF.

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29 **Smaller LDC Debtors: Economic Plight and US Interests**

Although Mexico, Brazil, and Argentina have been the focus of discussions on LDC debt, a number of smaller LDCs with equally severe economic difficulties have received considerably less attention. US interests in these countries go beyond the international financial system.

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Perspective

Third World: Problems in Resuming Economic Growth

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The recent IMF/World Bank annual meetings underscored resumption of Third World economic growth as the next key issue. The LDCs, however, face some formidable barriers. First, international economic conditions beyond their control have a major impact on their progress. Second, the LDCs' own economic policies are constrained by domestic and political-social factors that are likely to hamper performance.

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Despite recent improvements in the international economy, a number of external factors could pose constraints to LDC growth:

- The pace of industrial-country growth, which has provided a strong boost this year, seems certain to slow in 1985. Some observers are even warning of a possible recession.
- Increasing protectionism in industrial countries also threatens LDC exports, particularly for such key goods as textiles, shoes, steel, and agricultural products.
- Weak commodity prices (for example, copper, sugar, precious metals) will hold down developing country export earnings. High interest costs on inventories, price cuts by US producers to counter the strong dollar, substitute technologies, and expected bumper crops in agricultural commodities are maintaining downward pressure on prices.
- The flow of external capital from official sources, commercial lenders, and private investors seems almost certain to remain below the pace that buttressed LDC growth in the late 1970s.
- A slack labor market for foreign workers will also tend to hold back LDC growth in those countries—for example, Pakistan, Morocco, Egypt, and the Philippines—that depend heavily on remittances from overseas workers.
- Any increase in oil prices later in the decade would hit just as restructured debt payments were falling due.

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Along with the international trends, the success of developing countries' economic growth efforts will rest heavily on these countries' domestic policies and economic management. A number of key policy shifts will be necessary, including: stimulating economic efficiency, implementing major price reforms,

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promoting a stable investment climate, increasing attention to agriculture, and instituting realistic exchange-rate regimes. Adoption of efficient and productive economic policies is also essential to restoring investor confidence.

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In many countries, political-social factors may give economic policy makers only limited room to maneuver. IMF austerity programs may provoke dissent, causing governments to water down reforms. In addition, uneven distribution of growth benefits could contribute to disaffection. Population pressures are also becoming significant in many debtor countries—for example, Mexico, the Philippines, Egypt, and Morocco—and could be a serious drag on growth. Insurgencies and military actions, moreover, are causing substantial drains on resources and growth efforts in countries such as Peru, the Philippines, and Morocco.

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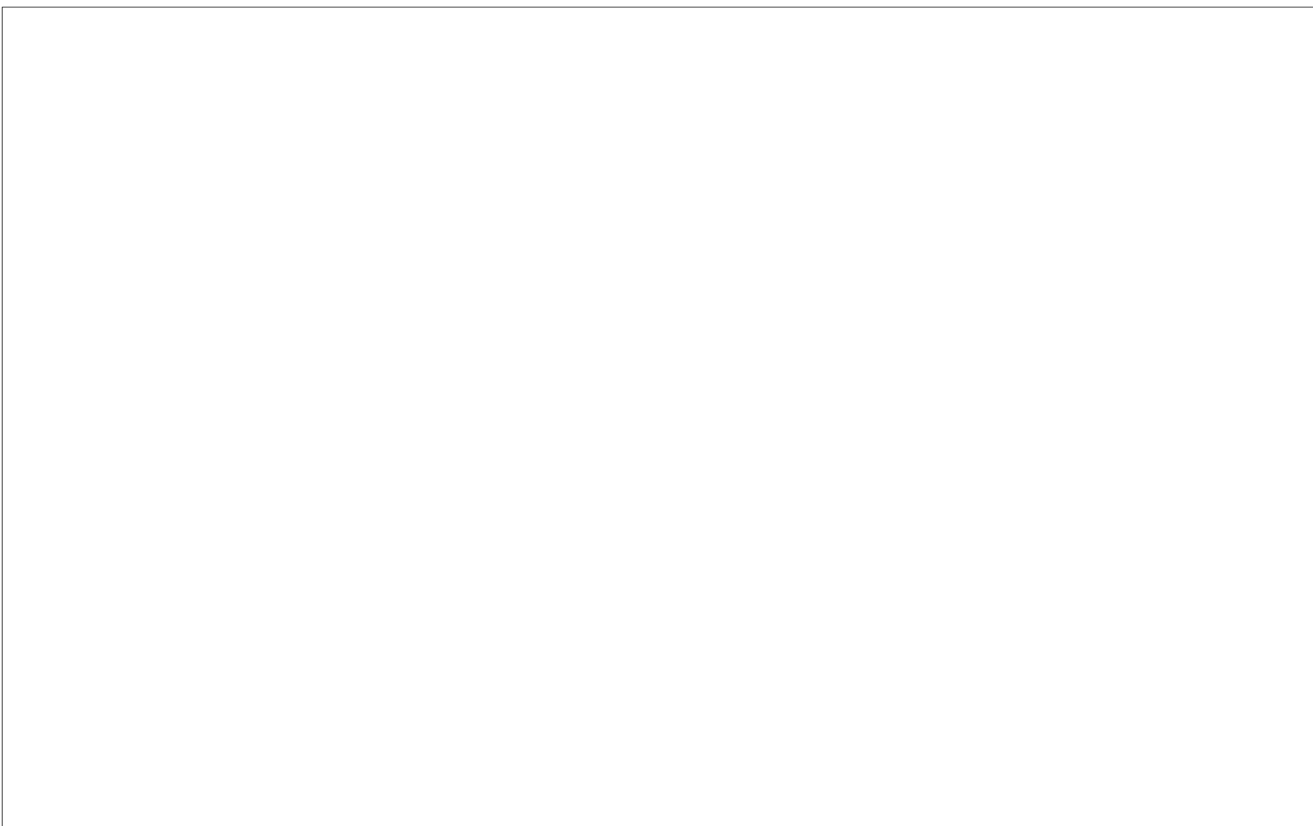
Briefs

Energy



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British Oil and Gas Production Forecast

United Kingdom Offshore Operators Association—the association of oil companies involved in North Sea operations—predicts that a new development boom could slow the decline in output expected after 1985 and keep Britain self-sufficient in oil into the next century. Britain's oil output in the year 2000 could be as much as 1.4 million barrels a day—slightly more than half the current record production level of 2.6 million barrels a day, while potential gas production is put at 55 billion cubic meters annually, up from current output of about 43 bcm. This forecast is optimistic, however, and hinges on the development of 96 fields—some bypassed earlier as uneconomical—containing an estimated 4.1 billion barrels of oil and 2.8 trillion cubic meters of gas.

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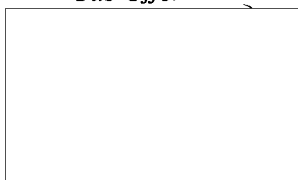
Sweden Likely To Reject Soviet Gas Offer



Swedegas, Sweden's state natural gas supplier, has concluded that the proposed project to deliver 1 billion cubic meters of Soviet gas to Sweden via Finland by 1988 is not economically feasible. The report states that the costs

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of the pipeline across the Gulf of Bothnia and the Swedish gas distribution network would exceed $870 million, and would not be economical based on present gas price assumptions. Swedegas also noted the reluctance of Swedish industrial customers to become dependent on the Soviet Union as sole supplier. As an alternative, Swedegas recommended extension of the existing pipeline north from Denmark to serve central Sweden. The Swedish Government is likely to present these conclusions at the next meeting of the Swedish–Soviet Mixed Commission.

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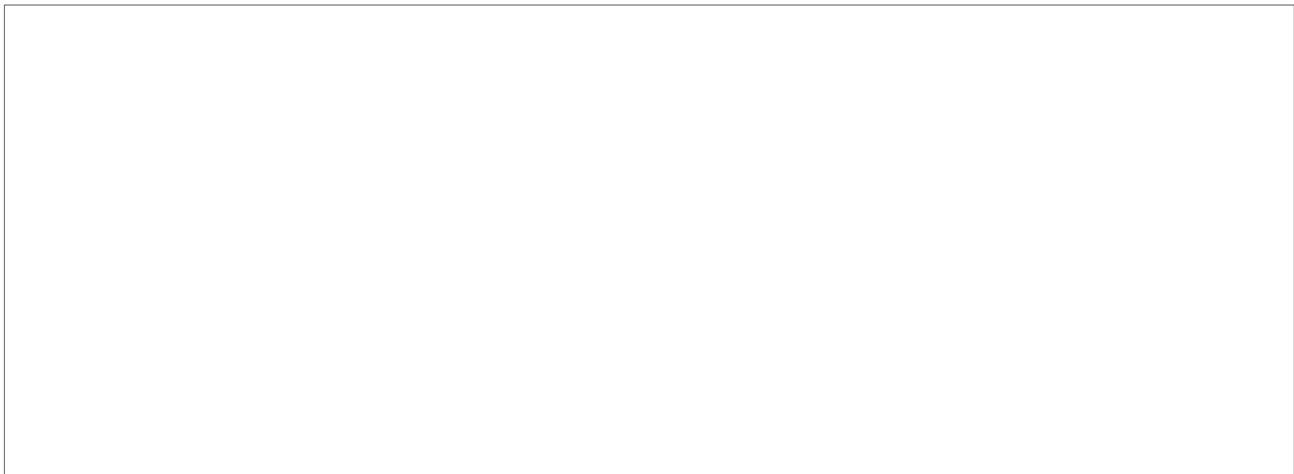

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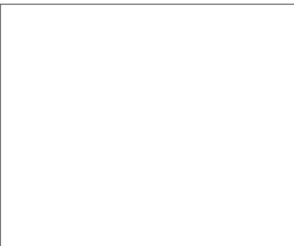
International Finance

Peru Jeopardizes Its Credit Rating



Peru's refusal to meet interest payments on its debt will jeopardize foreign financial support for the remaining nine months of President Belaunde's term. Central Bank officials recently indicated that they do not intend to draw on Peru's $1 billion in foreign exchange reserves for debt payments until foreign bankers release the final $100 million installment of an embargoed loan. According to the US Embassy, Lima now owes $100 million in payments.

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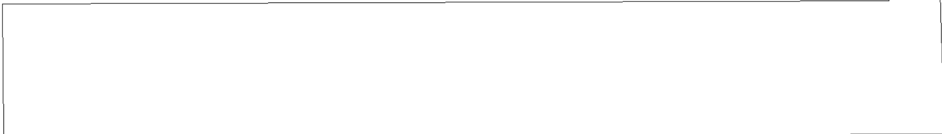

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Lima's pressure tactic is likely to backfire. The unpaid interest will complicate reconciliation with the IMF and make foreign bankers more reluctant to release the $100 million loan, renew trade credit, and refinance maturing debt. Some banks have lowered the status of Peruvian loans and have stopped recording the accrual of interest on them, according to the Embassy. Moreover, the $2.5 billion refinancing plan for this year, originally scheduled to be signed on 31 August, has been postponed until at least 10 October. If cash problems intensify, Belaunde might suspend talks with bankers. As a last resort, he could also declare a moratorium on foreign debt payments in hopes of rallying nationalist sentiment.

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Nigeria Meets Official Creditors Halfway

US Embassy Paris reports that Lagos—after dragging its feet since the sharp downturn in oil exports in 1982—has offered to begin paying interest on its $2-3 billion in officially guaranteed short-term debt to restore normal commercial financing and trade relations. Nigeria has volunteered to make payments at least equivalent to interest arrearages accrued since January 1984 at a rate of 1 percentage point above LIBOR. Paris Club members, while congratulating Lagos for making a gesture in the right direction, have firmly stressed the need for an early IMF agreement and official debt rescheduling before official export cover can be restored. We believe that Nigeria's growing inability to meet minimum import needs—deliveries in the first six months of 1984 reportedly dropped about 30 percent from the already depressed level of first half 1983—has spurred the Buhari regime to seek another stopgap solution to its debt problems. In our view, however, the regime does not have the will or the popular support to agree to a rigorous IMF agreement that would include a devaluation.

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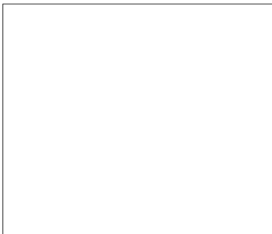
Global and Regional Developments

EC Budget Settlement



The agreement last week by EC foreign ministers on a supplementary budget for the rest of the year provides almost $750 million in emergency revenues—interest-free loans from member states to be repaid when new Community tax measures become effective in 1986. The plan is contingent on the EC Council's final approval of new regulations to curb agricultural spending. The 1985 budget continues to provide expensive agricultural price supports and will almost certainly cause further cost overruns. These will require special steps again next year. EC attempts to control farm spending are unlikely to prove effective, and the Community probably will repeat its cycle of budgetary problems in 1986 and 1987.

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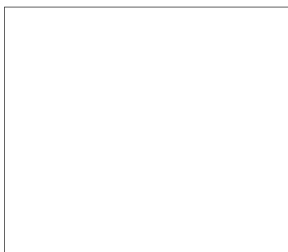
National Developments

Developed Countries

Rome Submits 1985 Budget



Italy's five-party coalition government recently submitted to Parliament a budget for 1985 that aims to hold the state-sector deficit to $51 billion. This amount would equal 14.3 percent of GDP, a reduction of 1.4 percentage points from the 1984 figure. The government is counting heavily on health-spending cuts and a 7-percent limit on nominal wage increases for government employees to hold the rise in current spending, excluding debt service, to 7 percent in nominal terms and no increase in real terms. In addition, Rome is expecting a reform of the value-added tax system and a tax-amnesty proposal to boost revenues by an estimated $8 billion. The Christian Democrats already are reacting to criticism from small businesses by calling for modifications in the Republican-proposed tax-reform measure. Trade unions, meanwhile, are balking at government attempts to hold real wages constant and could seek to relax the government's key spending-control measure.

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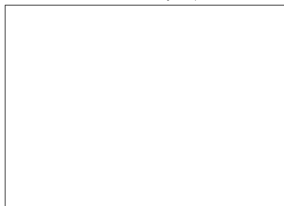
Dutch Cabinet Presents Budget



Continuing an austerity policy begun in 1983, the Christian Democratic–Liberal coalition Cabinet has approved a 1985 budget that contains harsh spending cuts in public-sector and social programs, a reduction in social security contributions, and minimal personal tax relief. While approving the spending cuts, Dutch employers were angered by the decision to cancel the previously promised reduction of corporate taxes, claiming that the cut in social security contributions by itself will not be sufficient to boost employment. Unions, whose members will bear the brunt of the social-spending cuts, accuse the government of playing one social group against the other. Despite these complaints, we believe the budget will accomplish Prime Minister Lubbers' goal of reducing the share of the deficit in national income from 10.5 percent in 1984 to 9.7 percent in 1985.

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France Boosts Research and Development Spending

Recently announced increases in expenditures will maintain the French civil research and development budget as "an island of prosperity in an ocean of rigor," according to Technology Minister Curien. The $4 billion budgeted for 1985 represents a real increase of 10 percent over the previous year. Including military research, total R&D spending will equal about 2.2 percent of GNP, up from 1.8 percent in 1980. Part of these outlays will fund an additional 536 research positions at a time when the total government payroll is being cut by about 5,500. The increases reflect the importance that the new Prime Minister, Fabius, attaches to research and development.

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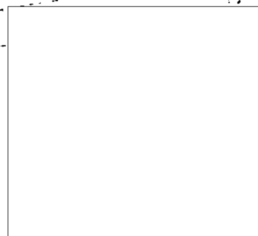
Spanish Social Pact Announced



The Gonzalez government has successfully brokered an agreement covering wage guidelines, labor market regulations, and job programs between business and the Socialist UGT labor union. For 1985, wages are set to rise 5.5 to 7.5 percent. This would mean a fall in real wages of up to 1.4 percent if inflation stays within the 7-percent target. The wage band for 1986 is still under discussion. In return for worker concessions, the government has committed itself to provide funds for job training and other programs. Business leaders won a reduction in employers' social security contributions, but failed to persuade the Socialists to make layoffs easier and cheaper. A tripartite commission will study dismissal laws in the EC and present a report next year. The government, however, is reluctant to press too hard for reforms that the UGT believes threaten job security.

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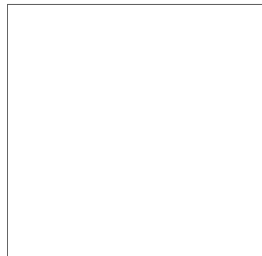
Portugal's Performance Under IMF Program



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Preliminary figures indicate that Portugal is not complying with IMF ceilings for domestic credit growth and probably cannot meet the Fund's yearend inflation target. The IMF program calls for Lisbon to cut the growth of domestic credit to public-sector enterprises from 40 percent in 1983 to 23 percent this year; state firms' domestic borrowing was up by about 42 percent in July compared with the same month last year. Similarly, government domestic borrowing grew by 21 percent, versus the Fund's yearend 16.9-percent limit. We estimate Lisbon's failure to rein in public-sector borrowing pushed it about 17 percent above the Fund's ceiling for 31 July and threatens to prevent compliance with the remaining limits this year. Despite falling

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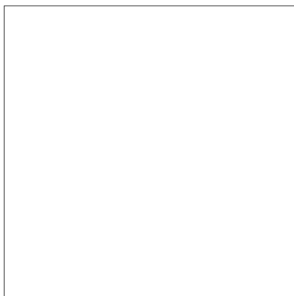
domestic demand, inflation is still running at about 31 percent. Price hikes on government-subsidized goods this month probably will put the Fund's 23-percent inflation target out of reach. 25X1

Lisbon should easily meet the targets for the current account deficit and foreign debt. Reflecting the pinch of austerity measures, imports fell $490 million during the first half, while exports rose $240 million. Additional improvements in the trade account should allow Lisbon to trim last year's $1.7 billion current account deficit to $800 million or less, well below the Fund's $1.25 billion target. With foreign debt rising $600 million to $15 billion during the first half of 1984, Lisbon should also stay within the IMF's $16 billion limit. 25X1

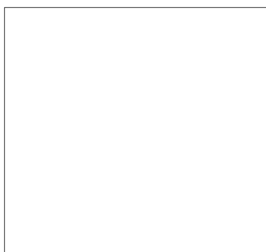
British Bank Rescue



To avert a major disruption to world gold markets, the Bank of England last week acquired Johnson Matthey Bankers (JMB) in the biggest bank rescue since the British banking crisis 10 years ago. With only $2.5 billion in assets, JMB—whose parent company is one of the world's biggest gold-bullion dealers—probably posed a comparatively small danger to the world financial system. 25X1 25X1

Financial analysts have criticized the Bank of England for its unprecedented protection of a nonbanking market, and some fear that the rescue may be taken as a precedent that leads other bankers to take less care in their operations. Critics also are likely to point out that this move is in conflict with Thatcher's plans to sell state-owned industries to the public. The ongoing deregulation in London's financial markets probably will complicate banking supervision even more in the future as other conglomerates like JMB are being created out of banks and entities with interests very remote to banking. 25X1

NTT Attempting To Corner Telecommunications Market



According to the press, the Nippon Telegraph and Telephone Public Corporation (NTT) is speeding up its plans by more than one year and will introduce a digital information system to link the Tokyo-Osaka corridor in January 1986. NTT will be able to offer high-speed facsimile and data services at very low rates because of the lower unit costs of digital communications. NTT, now a government-regulated monopoly, is trying to secure Japan's most important corporate telecommunications market before being compelled to face market forces if the planned return of the firm to the private sector begins this spring. The decision to hasten the system was no doubt spurred by the announcement of the formation of a new telecommunications company that would have focused on the same market. 25X1

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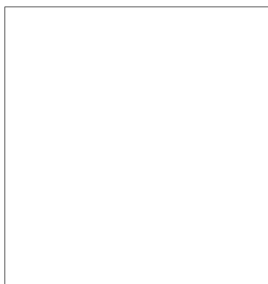
Israel's Stopgap Economic Measures



Unable to get Cabinet or labor backing for a comprehensive economic "recovery" package, the Israeli Government is falling back on stopgap measures. According to press reports, the Finance Ministry has conceded that the $1 billion budget cut approved in principle by the Cabinet several weeks ago will amount to only $500 million because the fiscal year is already half over. Most of the ageed "cuts" are actually additional fees for government services. We believe that the six-month ban on the import of 50 luxury items and tightened foreign-currency controls were imposed in a tactical effort to impress US officials before Prime Minister Peres's visit to Washington.

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In our view, the steps taken so far do not tackle the structural problems underlying Israel's economic woes—particularly the indexation of wages to inflation and ineffective monetary policies—and, thus, will have only a marginal impact. Moreover, the price controls that have been imposed on domestic producers of banned imports will be difficult to enforce.

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Less Developed Countries

Foreign Investment in Mexico Plunges

Direct foreign investment in Mexico reached only $29 million during the first six months of 1984, more than a 90-percent drop from the already depressed level of the same period in 1983, according to figures just released by the Bank of Mexico. Even though the government has loosened some investment restricitons and claims to be dealing more flexibly with foreign investors, new industrial reorganization codes have substantially increased regulation of foreign-controlled industries. The most controversial of these, the pharmaceutical decree published this February, boosts state involvement in such basic business decisions as purchases of raw materials, pricing, labeling, and packaging. Moreover, foreign investment was given a small and largely undefined role in Mexico's latest industrial and trade development plan announced in August.

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fear of growing state control is the principal cause of the sharp falloff. Continued weak consumer demand and project-eroding price controls also discourage new investment. While some rebound in investment during the next year or so is likely by well-established firms, the poor investment climate will discourage most foreign firms.

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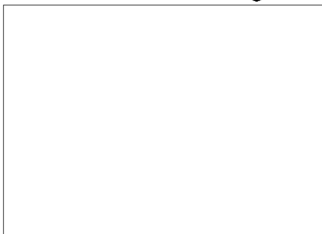
Panama Refurbishes Its Financial Image



To counter accusations of heavy involvement by Panamanian banks in drug-money laundering, the Panamanian Banking Association has adopted a code of conduct that discourages acceptance of unexplained cash deposits in excess of $100,000 and establishment of named or numbered accounts by poorly identified clients. Since the code has no legal status, its impact will depend solely on the degree of moral suasion exercised by the banking community itself. Its stipulations, even if enforced by the banks, will be weakest for established drug-money flows, most of which are handled by local agents well

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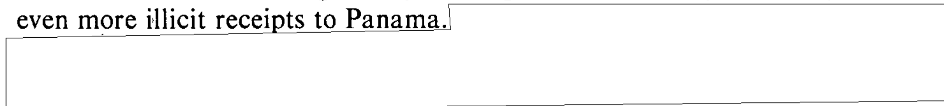
known to the banking establishments with which they deal. Moreover, the US-British accord on drug-money investigations in the Caymans may shift even more illicit receipts to Panama.



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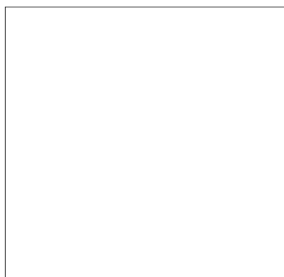
Ecuador Liberalizes Foreign Trade



The Febres-Cordero government has introduced a floating exchange rate to improve the trade balance and gain favor with the IMF and bank creditors. In August, the administration replaced its crawling peg-exchange single-rate system with a dual system of a freely floating and a fixed official rate. The free market rate has fallen by 75 percent since the new system was introduced. All foreign trade except petroleum exports and imports of essentials will be paid for at the free market rates. In addition, import tariffs—which range up to 300 percent on some goods—have been halved and the ban on all manufactured imports, except that on automobiles, has been lifted.

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The large devaluation should offset the effect of tariff cuts on imports and improve the competitiveness of Ecuador's nonoil exports—nearly 50 percent of the total. An IMF team is to visit next week, and once an accord with the Fund is reached the government hopes to arrange $350 million in loans from commercial banks.

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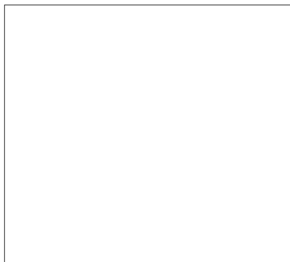
Nigeria Moves To Avert Student Confrontations



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The Buhari regime has delayed university openings, probably through the fall semester, to avoid possible confrontations with students unhappy over sharp hikes in boarding fees, according to the US Embassy. Lagos's determination to decrease its burgeoning federal budget deficit by ending costly university subsidies will push student food costs five times higher than last year's. Buhari is taking precautions to avoid a repeat of bloody student riots that were set off in 1978 when an earlier military government tried to increase school fees. The US Embassy believes that for now student leaders are resigned to cost hikes and and are not anxious to spark a violent protest for fear of government reprisals. Student attitudes could change over the coming months, however, if the economy continues to decline and the government's image deteriorates further.

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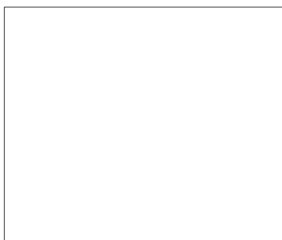
Communist

Moscow Shops for Construction Equipment



The USSR will need to purchase about 80 to 90 pipelayers, 200 bulldozers, and 140 excavators—worth about $100 million—for construction of the Yamburg-Yelets gas pipeline. The Soviets appear to be playing one heavy-equipment manufacturer off against another to receive the most favorable prices and financing terms. [redacted] US bulldozers performed very favorably during testing, most of the equipment order probably will go to the Japanese because they offer lower prices, more favorable financing terms, and faster delivery. The Japanese earlier offered the USSR interest-free first-year financing on a smaller sale of pipelayer equipment. We believe, however, that the USSR may purchase some US heavy equipment to maintain some supplier diversity.

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Egypt: How Much Reform?

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There is widespread acceptance within the Egyptian Government that reforms are necessary, but President Mubarak and his ministers fear that drastic changes in the "social contract" will cause widespread popular opposition reminiscent of the 1977 bread riots. Public disturbances last week over subsidy cuts and hikes in social security contributions will further slow the pace of Egypt's tentative economic reforms. Additional action by the government on energy prices, food subsidies, and exchange rates will, therefore, be slow and deliberate. When pressed by bilateral and multilateral donors, Cairo will point to the disturbances as a reason for not pursuing further reform. The Egyptians will also expect the tentative steps they have taken to win them more favorable treatment on issues of importance in their relationship with the United States.

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Egypt: Budget Estimates *Million Egyptian pounds*

	Egypt FY 1984 Budget	IMF FY 1984 Estimates	Egypt FY 1985 Budget
Total expenditures	15,193.0	15,815.0	18,277.2
Of which:			
Wages	2,925.0	2,835.0	3,295.0
Subsidies	1,686.4	2,409.0	2,057.7
Investment	4,400.0	5,054.0	4,865.0
Total revenues	11,197.2	10,237.0	12,877.2
Gross deficit	**3,995.8**	**5,578.0**	**5,400.0**

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The Need for Reform

The need to attack Egypt's pervasive subsidy system, bloated bureaucracy, and inefficient parastatals is unquestioned both inside and outside the country. Egyptian officials are well aware that the country cannot afford to continue running budget deficits around 5 billion Egyptian pounds annually or to depend on the growth of external resources—either aid or the country's own foreign exchange earnings—to partially offset these deficits. The government is under pressure from its bilateral and multilateral donors to reduce expenditures and to undertake measures that will increase efficiency, spur nonoil exports, and provide a reasonable rate of return on commercially and donor-financed development projects.

Control of current expenditures is the key to restraining the budget deficit. The tax system is considered adequate by the IMF, and investment has already been squeezed. Among the categories remaining, subsidies and the public-sector wage bill loom largest. In FY 1984 (July-June), Egypt's direct-subsidy budget—$3.4 billion at the official exchange rate—constituted 15 percent of total budgeted expenditures, according to the IMF.[1] Roughly one-third of these funds was spent on bread, the most politically volatile commodity. Compounding the problem is the implicit energy subsidy of about $2.25 billion, which is the difference between what Egyptians pay for electricity and petroleum products and world market prices.

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The subsidy policy along with high population growth and higher-than-average economic growth, has fueled consumption of subsidized goods. Food imports consume about 30 percent of Egypt's total foreign exchange earnings—compared with a

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[1] One Egyptian pound (LE) equals US $1.42 at the official exchange rate, $0.89 at the commercial or tourist rate, and about $0.81 at the "own" or parallel market rate.

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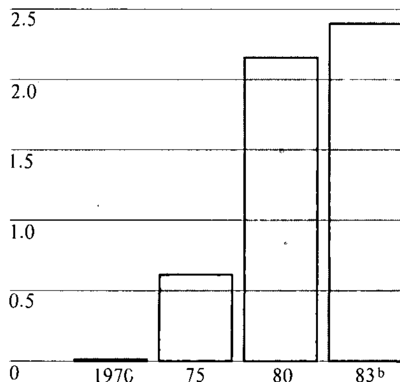
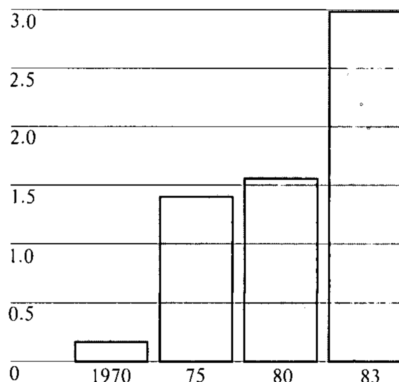
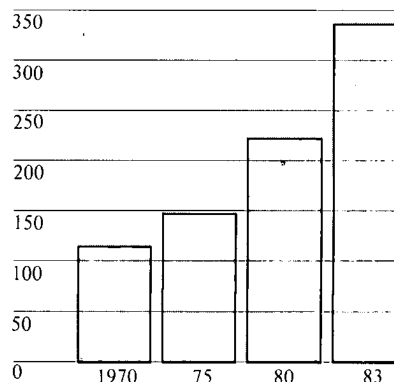
Egypt: The Impact of Subsidies, 1970-83







[a] Fiscal years.
[b] Budgeted.

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13-percent LDC average—and domestic energy consumption is now rising at rates approaching 15 percent annually. Subsidized products are available to all consumers in unlimited quantities irrespective of income levels. According to Embassy reporting, even Egypt's rationing system—covering 97 percent of the population—is often disregarded.

The IMF and the World Bank have put energy reform at the top of their lists of recommended policy changes. The World Bank and US AID have suspended lending for energy projects until Egypt agrees to raise prices to world-market levels. Since early 1982, Egypt has increased electricity rates by 30 percent, but the base was so low—less than 15 percent of international levels—that prices remain well below production costs and the impact on demand has been minimal.

The government indirectly subsidizes wages by being the employer of last resort for university graduates. According to US Embassy estimates, public-sector employees constitute 30 to 40 percent of the labor force. In FY 1984, the wage bill was $4 billion, higher than the allocation for direct subsidies.

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Like many LDCs, Egypt has a confusing system of exchange rates with the official rate overvalued by about 40 percent compared with the parallel market rate. The overvalued exchange rate has added to inefficiency in some public-sector firms by giving them access to cheap imports. It also makes nonoil exports uncompetitive in overseas markets.

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The existence of the commercial and parallel exchange markets limits the foreign exchange available to the government for paying its debts. The

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IMF estimated that only 45 percent of Egypt's foreign exchange earnings took place in the official market in 1982, and the percentage has probably declined because the pound has become more overvalued. Thus, the Central Bank is almost always short of foreign exchange even when flows into the country are increasing.

New Cabinet and a New Budget

President Mubarak has instituted a more systematic and collegial approach to economic policymaking—a marked contrast to President Sadat's more haphazard and personal approach. Nevertheless, economic policy decisions continue to be predominantly shaped by political considerations. President Mubarak remains extremely cautious and is more comfortable with slow, almost imperceptible steps to reform. That caution has been only slightly tempered by the death of Prime Minister Fuad Muhi al-Din—considered Mubarak's chief adviser on political issues and the main obstacle to economic reform.

The policies of Kamal Hassan Ali, Muhi al-Din's successor, so far have differed little from those of his predecessor. The Cabinet is expected to proceed gradually, with Prime Minister Ali only marginally more inclined than Muhi al-Din to stand up to public pressures on economic policy issues. According to US Embassy reporting, earlier this year a World Bank official put Ali in the camp of those who advocate caution and restraint rather than among the short list of reformers that includes the Ministers of Electricity and Agriculture. In fact, a Cabinet reorganization last June resulted in the removal of the latter two from the powerful Committee on Higher Policy.

Before the budget was presented to the People's Assembly in September, the government engaged in a media campaign that appeared to be preparing the public for extensive reforms, including bread and energy price increases. Prices of locally manufactured cigarettes were raised by 21 to 29 percent, and the government made it known that it intended to cut total government expenditures by at least $400 million.

Conversations with government officials and preliminary analysis of the budget, however, suggest there are no substantial cuts in expenditures, but the deficit may narrow slightly because of new revenue measures. Expenditures are programed to increase about 15 percent over IMF estimates for actual expenditures in FY 1984. Increases in the public-sector wage bill reflect some salary adjustments that took place in early July. The projected decline in subsidies is linked mostly to plans to double the price of a loaf of bread, which has been increased in size but not proportionately. Promised electricity increases were not announced and, according to conversations between the Ambassador and Prime Minister Ali, will probably be postponed at least until February.

New tax measures have been announced, but revenue goals probably will fall short of expectations. Part of the projected 25-percent increase in revenue is based on oil earnings increasing by 27 percent, an unrealistic assumption unless there is a substantial rise in world oil prices. A new, 2-percent surcharge on incomes over $18,000 has been announced, but the number of affected taxpayers will be small. Additional revenue is likely to be generated by new road taxes and increased fees for passports and residence permits. Revenues would be further enhanced if all imports were revalued at more realistic exchange rates before calculating customs duties.

Even before the demonstrations last week, Cairo's strategy for reducing the size of the bread price subsidy was to minimize both the effect on the poor and the danger of political repercussions. The government remains concerned that leftist and fundamentalist exploitation of the issue could cause unrest to spread, especially with the opening of the universities this week. To forestall further disturbances, Cairo is trying to prominently target price rises and revenue measures to well-to-do Egyptians and is publicizing a crackdown on profiteers. In addition to the prominent announcement of the new income tax surcharge, President Mubarak has directed that cheaper loaves of bread be produced in quantities sufficient for all low-income areas, and prices for macaroni and cooking oil have also been lowered. Mubarak has instructed ministry officials

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to ensure that prices for other staples are not raised without high-level approval and merchants that have illegally done so are to roll back prices to former levels.

Before the disturbances occurred, President Mubarak planned to convene a conference of government and opposition leaders and representatives from the academic community to consider further policy changes, including additional subsidy reductions. He probably hopes that the conference will produce a consensus on the need to reduce subsidies that will preclude opposition members of the People's Assembly from exploiting the issue. He will probably scrap the idea, however, if public unhappiness spreads.

Prospects

The government's paranoia about a repetition of the 1977 bread riots and its determination to maintain the living standards of the average Egyptian will continue to be primary determinants of the pace and direction of economic policy reform. For example, Cairo will continue its piecemeal approach to energy policy reform—with small periodic adjustments in electricity prices—unless forced to adopt a more stringent adjustment program out of financial necessity. The government will continue to be reluctant to attempt comprehensive energy reform because of the linkages to other sectors of the economy. If public unhappiness over the new loaf of bread grows, it is very likely that the government will act to rescind the increases.

The Egyptian Government will almost certainly use the recent disturbances to counter donor pressure on economic reform and to lobby specifically for more favorable US Government support on outstanding economic issues. Cairo has, in the past, referred to the 1977 bread riots as proof that it must proceed cautiously. Egyptian officials will, at the same time, point to the bread price adjustments and promised further increases in electricity prices as proof that they are serious about reform. As a quid pro quo, the Mubarak government will press specific demands that the US Government reverse a decision by a quasi–US Government agency not to finance the participation of a US company in the El Daaba nuclear project. The agency based its decision on the infeasibility of the project without substantial energy price rises. The Egyptians will also expect the United States to move on its request for relief on its US military debt. Although this issue is not directly related to economic reform, Cairo would view debt relief as an important contribution to helping it improve its economy.

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Mozambique: Reeling From Economic Blows

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The Mozambican economic situation is among the worst in Sub-Saharan Africa, with economic activity in almost continuous decline since the country became independent in 1975. A critical shortage of skilled personnel, armed insurgency, deteriorating economic relations with South Africa, and the effects of Marxist-oriented economic policies have discouraged domestic production and foreign investment. The economic decline has accelerated since 1981 because of the growing insurgency and a series of natural disasters including cyclones, flooding, and the worst drought in the country's history that has produced famine conditions in parts of the country. Improved relations with South Africa since the signing of a nonaggression pact with Pretoria in March and a negotiated cease-fire with the insurgency movement this month have not yet had any significant positive economic impact. Mozambique's problems are so deep seated that we see scant prospect that it can regain preindependence levels of output by the end of the decade. Even moderate economic growth by then may require a substantial reorientation of Maputo's economic policies.

Causes of Economic Decline

Mozambique has an unusually long list of economic handicaps:

- Since independence, the country has suffered from a chronic shortage of skilled personnel. The illiteracy rate is 85 percent, down from 95 percent in 1975, and 80 to 90 percent of the population is engaged in subsistence agriculture.
- Poor relations with South Africa since 1975 have substantially reduced the country's earnings from transportation services and remittances from Mozambican mineworkers in South Africa, important items in Maputo's foreign exchange earnings.
- The Marxist-oriented economic policies of the government have hobbled economic activity with widespread nationalizations, huge and inefficient state farms, and an extensive regime of price controls.
- Through 1979, Mozambique sustained substantial economic damage from the Rhodesian civil war. The closing of the border with Rhodesia in 1976 cost Maputo $100-150 million annually in Rhodesian transport fees. Punishing raids by the Rhodesian military against Zimbabwean black nationalists based in Mozambique also proved costly to Mozambican transportation facilities and to the economy.
- Since 1979, Mozambique has been subjected to periodic cyclones, floods, and droughts that have dealt serious blows to agricultural production.
- Since 1981, agriculture, transportation, and other economic activity have been severely hampered by the guerrilla activity of the Mozambique National Resistance (RENAMO), the antigovernment group backed by South Africa to discourage Mozambican support for African National Congress guerrillas operating against South Africa.

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Although the insurgency is expected to be held in check with the negotiation of the cease-fire this month, RENAMO has been a major cause of the present economic chaos. The insurgents—estimates of their total number range from under 10,000 to 15,000—have been operating in all Mozambican provinces, attacking rail and road transportation links, electricity transmission lines, foreign assistance projects, and foreign workers. This year, RENAMO has cut the Maputo-Zimbabwe rail line

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at least four times, curtailed the rehabilitation of the Nacala-Malawi rail line, sabotaged and temporarily closed the Beira-Mutare petroleum pipeline, and destroyed several power-transmission pylons for the Cabora Bassa hydroelectric project. RENAMO attacks on the transport of food relief have been hampering emergency assistance efforts in drought-stricken areas. The guerrilla activity has forced Maputo to divert a sizable portion of its resources from economic development to defense and has contributed to the flight of Mozambicans into neighboring countries.

Economic Impact

The cumulative effects of these developments have practically crippled the Mozambican economy. Although official Mozambican economic data are few and unreliable, we estimate—on the basis of US Embassy reporting —that agricultural exports fell last year to one-half the level of 1981 and that sugar production fell to 90,000 metric tons, about one-third of sugar output 10 years earlier. Industry is chronically short of raw materials and spare parts and operates at no better than 15 to 20 percent of preindependence capacity. There are severe shortages of imported petroleum because of a critical lack of hard currency. Consumer goods have all but disappeared from shops, and basic commodities are strictly rationed.

The drought has affected eight of Mozambique's 10 provinces. In Inhambane Province alone 100,000 people died last year, according to press reports. Since 1981, famine has claimed at least 170,000 lives, according to estimates by international relief officials. The country has no locally grown food reserves. Some 1.5 million of Mozambique's 13 million people are now directly dependent on international emergency food aid, principally from Western bilateral donors. Agricultural production has been so hard hit that one Mozambican agricultural official last year estimated that it would take several years to recover even to previous levels that were themselves inadequate.

The famine will continue to worsen this year and reach a critical point in early 1985, according to a June United Nations report. A high Mozambican economic official has stated similar views. In the meantime, tens of thousands of starving Mozambicans have fled, mainly to Zimbabwe, in search of food.

The country's current account has suffered from South African economic pressures. Transit fees are down sharply as Pretoria's exports and imports through Maputo plummeted to 1.1 million tons last year, compared with 6.8 million tons in 1973. Hard-currency earnings from Mozambican mineworkers in South Africa have dropped as the number of workers has fallen to around 45,000 from 118,000 in 1975.

The Mozambican authorities have estimated the total cost to the country of South African economic pressure at $4 billion. Most of the amount reflects the subsidy lost when South Africa unilaterally canceled a 50-year arrangement in 1978 under which a portion of the wages of Mozambican mineworkers was paid to Lisbon in gold at official prices that since 1971 had been well below market prices.

In the external accounts, the country's overall trade deficit widened to nearly $500 million in 1983, leading to a current account deficit of at least $300 million. Maputo's external debt stood at $1.4 billion by the end of the year. For the first time Maputo, in 1983, fell into arrears on debt service payments to Western lenders; arrears, including those on trade, totaled $200 million, with a further $242 million in debt service payments due in 1984.

Coping

The country's economic plight has forced Mozambican President Samora Machel to seek broader foreign relations since the early 1980s, when it became obvious that Eastern Bloc countries would be unable to provide aid on the scale that Mozam-

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Mozambique: Current Account *Million US $*

	1979 [a]	1980 [a]	1981 [a]	1982 [a]	1983 [a]	1984 [b]
Current account balance	**−167**	**−251**	**−321**	**−283**	**−310**	**−380**
Trade balance	−286	−393	−457	−444	−490	−560
Exports (f.o.b.)	232	228	219	197	160	120
Imports (c.i.f.)	518	621	676	641	650	680
Net services	119	92	88	90	80	70
Net transfers		50	48	71	100	110

[a] Estimated.
[b] Projected.

bique required. Essentially, Machel has tried to cultivate the West while remaining in the good graces of his Communist allies. Most of the major developments have occurred this year as Mozambique speeded up its effort to exercise dwindling options for economic support:

- Mozambique in March effected a reconciliation with South Africa through the Nkomati accord, under which each country agreed to cease supporting insurgency groups operating against the other. Maputo expects increased trade, aid, and investment from South Africa as a result, but so far it has received few tangible benefits.

- Maputo last month drew up a new Investment Code more favorable to foreign investment than earlier statutes. The code is intended to encourage investment in agriculture, industry, and mining, areas that have attracted little foreign capital.

- The country last month joined the International Monetary Fund and the World Bank. Membership will provide Mozambique with new sources of financial support and development and technical assistance. Mozambique is expected to complete a standby arrangement with the IMF soon, and funds from that organization are expected to be forthcoming before the end of the year.

- Negotiations with Paris Club and other creditors have been going on this year for the rescheduling of Mozambique's $1.4 billion external debt to the West. These negotiations are expected to speed up with Maputo's IMF membership and a standby arrangement with the Fund. The rescheduling would ease the pressure on Mozambique's balance of payments and provide a more orderly external debt structure.

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Outlook

In our view, the shifts in Mozambique's foreign economic policy will not yield substantial results for some time. We do not expect economic recovery over the next two years at least because of the ravages of drought and the disruption caused by insurgent activity. Despite the cease-fire negotiated with RENAMO, the lack of a more lasting accommodation with the insurgency movement probably will hamper the inflow of foreign capital that Mozambique badly needs.

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In our judgment, Mozambique's economic prospects over the longer term are not bright. The economy was never a robust one, even in colonial times, and the economic structure, based on a limited range of agricultural products subject to fluctuating world prices and on transportation services vulnerable to events in neighboring countries, is unlikely to undergo much change.

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South Africa holds the key to Mozambique's economic fortunes as Mozambique's largest trading partner and the chief source of foreign exchange earnings for transportation and labor that largely support the Mozambican economy. We expect Pretoria to condition its contribution to the revitalization of the Mozambican economy on a greater shift from Marxist ideology by Maputo than has taken place so far.

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Debtor LDC Import Cuts: A Major Factor in Global Trade Decline

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Import reductions by 12 key LDC debtors [1] over the past two years have sharply depressed the export earnings of both developed countries and all LDCs, with industrialized countries bearing the brunt of export declines. LDC exports also suffered as close trade ties, particularly between Latin American debtors, were disrupted by austerity measures. Although first-half 1984 data indicate the decline in debtor LDC imports is bottoming out, we do not expect a return to rapid import growth in the near future, which will continue to retard world export growth.

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Extent of Debtor LDC Import Cuts

Economic recession and tough austerity measures forced the 12 key debt-troubled countries to slash imports by $47 billion during 1982-83. Several recorded declines in imports of 50 percent or more between 1981 and 1983. Among key countries, Brazil cut imports from $24 billion to $17 billion; Mexican imports fell $16 billion over the period; and Nigeria reduced foreign purchases from $18 billion in 1981 to $9 billion in 1983.

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Impact on Partner Exports

Key debtor import cutbacks contributed substantially to the overall decline in world exports from 1981 to 1983. The $47 million in lost sales to these 12 accounted for over one-fourth of the overall decline in world exports during the period. Industrialized countries suffered the brunt of export declines, but overall LDC foreign sales were also adversely affected, as LDC exports to key debtors dropped 33 percent.

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[1] The group includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Indonesia, Mexico, Nigeria, Peru, the Philippines, and Venezuela.

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Changes in Non-Communist Exports: Influence of Key LDC Debtors *Billion US $*

	1978-79	1980-81	1982-83
World exports	**478.3**	**312.8**	**−166.6**
To key debtors	23.9	39.8	−47.2
OECD	336.7	165.7	−78.6
To key debtors	16.7	29.0	−36.6
Japan	21.2	49.2	−4.5
To key debtors	1.5	6.1	−6.2
United States	60.7	51.7	−33.2
To key debtors	9.8	13.4	−16.2
European Big Four [a]	147.2	28.7	−31.4
To key debtors	2.7	6.5	−9.4
LDCs	141.6	147.1	−88.0
To key debtors	7.2	10.8	−10.6
Oil-exporting LDCs	61.6	68.9	−85.0
To key debtors	2.7	4.5	−3.5
Nonoil LDCs	80.0	78.2	−3.0
To key debtors	4.5	5.6	−7.1
Argentina	2.1	1.3	−1.2
To key debtors	0.4	−0.1	−0.7
Brazil	3.1	8.1	−1.4
To key debtors	0.9	2.2	−2.3
Mexico	4.8	10.4	1.8
To key debtors	0.1	0.7	−0.2
Nigeria	5.4	4.0	−7.0
To key debtors	0.1	0.6	−0.6
Venezuela	4.8	5.7	−3.8
To key debtors	0.1	1.1	−0.5

[a] Includes France, West Germany, Italy, and the United Kingdom.

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OECD. Although sales to the 12 debt-troubled countries account for only 5 percent of total OECD exports, losses in these markets were almost half of the $79 billion overall drop in OECD exports over the past two years. Most of the cuts came in machinery, transport equipment, and other industrial goods.

The **United States** was particularly hard hit because 15 percent of all US exports go to the 12 debtor countries. Austerity measures, especially by important Latin American trading partners, resulted in a $16 billion, or 40 percent, decline in exports to key debt-troubled LDCs between 1981 and 1983. This was nearly half the $33 billion drop in total US exports during the period and contrasts with an average annual 20-percent increase in US exports to this group of LDCs between 1970 and 1980.

Japanese exports are less dependent on sales to key debtor countries, but a 40-percent decline in exports to this group between 1981 and 1983 proved a drag on export growth. Japanese exports declined $4.5 billion between 1981 and 1983. Had sales to key debt-troubled LDCs remained at the 1981 level, total exports would have risen nearly $2 billion during this period.

Among other major industrialized countries:

- **West Germany's** sales to key debtor LDCs dropped almost $4 billion during 1982-83, over half of the decline in West Germany's total exports.

- **France's** exports to these LDCs fell $1 billion between 1981 and 1983. Exports to Chile, Nigeria, and Venezuela declined by more than 25 percent.

- The **United Kingdom's** exports to debtor LDCs fell $3 billion between 1981 and 1983, with Nigeria accounting for one-third of the drop.

- **Italy's** sales to this group of LDCs dropped nearly $2 billion during the period, three-fourths of the decline in Italy's total exports. Sales to Argentina, Chile, and Mexico fell more than 50 percent.

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Less Developed Countries. The import cuts of key debt-troubled countries depressed overall LDC export earnings as well. Although sales to key debtors account for only 4 percent of total LDC exports, 12 percent of the $88 billion decline in overall LDC exports between 1981 and 1983 can be attributed to the drop in shipments to these debt-troubled countries. Nonoil LDCs were especially hard hit, recording a $7 billion decline in sales to debtor LDCs during the period, more than offsetting a $4 billion increase in exports to the OECD.

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Intradebtor exports—sales from one debt-troubled country to another—fell 45 percent between 1981 and 1983. Several large debtor nations recorded substantial reductions in exports to other key debtors:

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- **Argentine** exports dropped 45 percent—from $1.5 billion in 1981 to $848 million in 1983—more than half the overall decline in Argentina's total foreign sales during this period.
- **Brazilian** sales to debtor LDCs fell over $2 billion during the 1982-83 period, as exports to Mexico and Nigeria declined 75 percent.
- **Venezuelan** exports fell from $1.7 billion in 1981 to $1.2 billion in 1983. Sharp declines in sales to Brazil and Chile accounted for most of the drop.

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Developments This Year

Preliminary first-half 1984 data indicate the decline in key debtor imports is bottoming out. Certain debtors such as Chile and Mexico have even increased imports over the same period in 1983. Reflecting this trend, first-half OECD exports to key debtors were up 0.5 percent over a year earlier, the first such increase in three years. Recovery of OECD export sales to debtors, however, has been uneven. Among major industrial countries, the United States, Italy, and West Germany rang up

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export increases totaling $1.6 billion, while France, Japan, and the United Kingdom recorded a combined $1.2 billion drop in sales to these LDCs.

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Despite some recovery in key debtor imports this year, we do not expect a return to rapid import growth soon. In our judgment, debtor LDC imports will grow at a much slower rate than during the 1970s, which will retard world export growth. For example, if key debtor imports rise 11 percent next year, world exports would still be $9 billion less than if these countries' foreign purchases were to grow at the 22-percent rate of the 1970s.

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Zimbabwe's Military: The Impact of Economic Austerity

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Despite the foreign exchange crunch and significant cuts in the defense budget, the Zimbabwe Defense Force continues its modernization program. Although we expect that the armed forces will have to reduce, spread out, or forgo some foreign procurement, defense expenditures in fiscal year 1985 (July 1984–June 1985) probably will exceed allocations, increase friction within the government, and hinder negotiations between Harare and the IMF.

The Role of the Military

Since independence in 1980, the military has been tasked with both defending against foreign threats and helping the understrength national police to maintain internal security. Recently, however, Harare appears to be reevaluating its futile pursuit of an anti–South African capability.

The Army assumed a third mission in November 1982 by sending three battalions into Mozambique at the request of President Samora Machel. These units—the first deployed outside Zimbabwe—were to protect the critical Beira-Mutera oil pipeline from Mozambican insurgents, and to patrol the border with Mozambique's Tete Province. Zimbabwe increased its commitment in Mozambique this year when a fourth battalion was sent to replace

Mugabe and the Military

The civil war yielded two tribally based and competing guerrilla armies, an expanded white Rhodesian security force, and the general militarization of Zimbabwean society. At independence, all these armed forces were combined into a national Army. Deeply rooted tribal and personal rivalries were often only papered over, however, and have resurfaced as several units have mutinied.

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Mugabe moved to strengthen discipline and firmly control the Army, initially by retaining the defense portfolio for himself and by restructuring the forces. As the Army shrank from over 60,000 to about 42,000 troops today, Mugabe attempted to create a force that would be dominated by those former guerrillas loyal to the ruling party. The government also created two Army units composed of party loyalists [redacted] *a 5,000-man 5th Brigade and a 3,000-man Presidential Guard. Moreover, the* [redacted] *People's Militia, organized in 1982 to help control dissidents and ultimately to include 20,000 members, is intended to be the ruling party's "eyes and ears," according to Secretary of Defense James Chitauro.*

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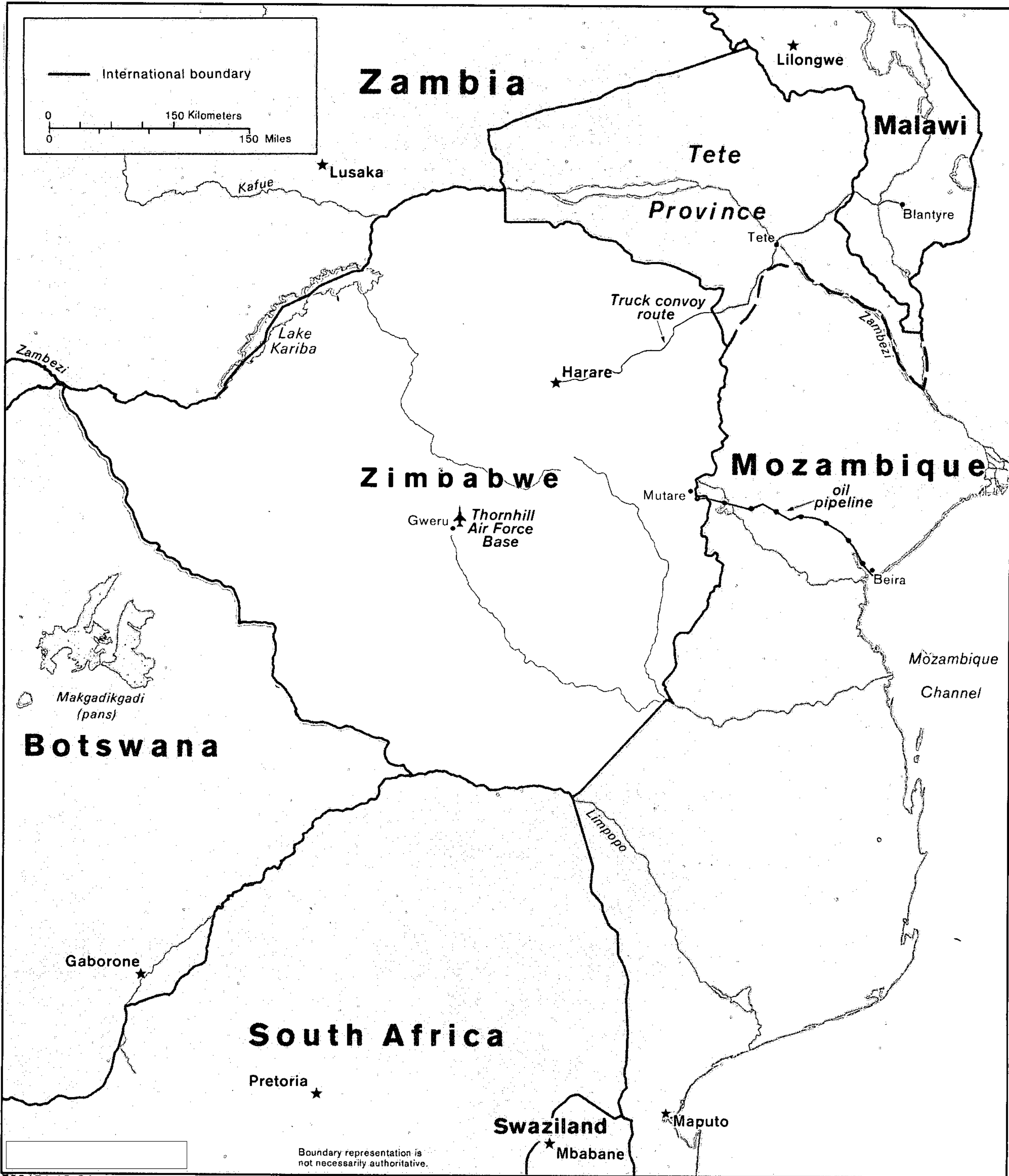

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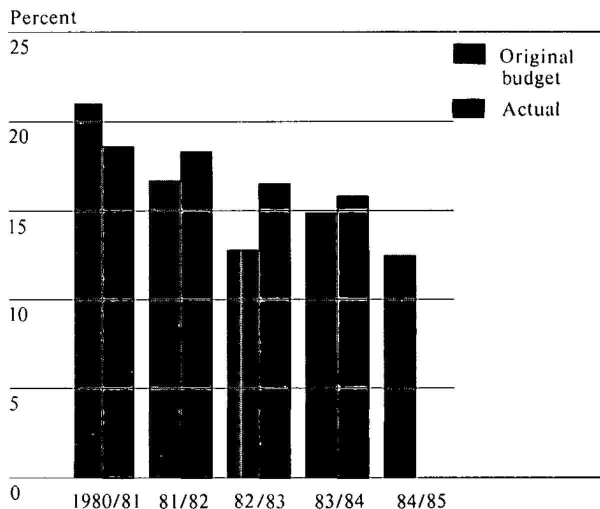
ineffective Mozambican forces escorting truck convoys from Malawi to Zimbabwe. We believe that Zimbabwe now has about 3,000 troops in Mozambique.

Zimbabwe: Defense Expenditures as a Share of Total Budgetary Expenditures, 1980/81-1984/85



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The Political and Economic Backdrop

Prime Minister Robert Mugabe's stated goal is to transform Zimbabwe into a one-party socialist state. Financial realities have slowed Mugabe's progress toward this goal and his economic reforms so far have been cautious. Zimbabwe now faces its worst economic crisis since independence. Three years of devastating drought and the continuing effects of worldwide recession have caused a slowdown in real GDP growth from annual rates of 12 percent in 1980 and 1981 to only 2 percent in 1982, and a decline of about 3 percent last year. Harare has reacted by cutting back on social spending and food subsidies, imposing wage controls, increasing taxation, and restricting foreign payments.

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Zimbabwe's budget for fiscal year 1985 is aimed at slowing the rising government deficit. Expenditures are set to increase by only 7 percent, although the prevailing rate of inflation is 19 percent. Nevertheless, the planned deficit of $560 million represents 11 percent of projected national income—substantially above the IMF's guideline of 5.5 percent—and may hinder negotiations between Harare and the IMF. Harare's last standby agreement with the IMF collapsed when it could not meet the Fund's targets, and, as a consequence, little foreign exchange is available for overseas purchases.

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To resume the growth it enjoyed in 1980 and 1981, Zimbabwe must resolve its foreign payments problems—including a ratio of debt service to exports exceeding 25 percent—and reduce government expenditures. Foreign exchange difficulties will worsen in fiscal year 1985 because Zimbabwe needs to import up to 400,000 tons of corn and wheat. Short-term opportunities to improve export performance are limited by the drought and by continued soft markets for Zimbabwe's mineral exports. Longer term prospects hinge on Harare's ability to attract foreign investment. Zimbabwe's investment policies, however, remain ambiguous; Harare welcomes investment, but manages the economy through controls that diminish private-sector incentives. We expect foreign exchange constraints to plague Zimbabwe for several years.

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The Military and the Budget

Military expenditures, particularly foreign purchases, will be targeted to narrow the budget deficit. The military's share of government expenditures has declined steadily since fiscal year 1981, even though defense spending in the past three fiscal years has exceeded allocations. The postindependence demobilization of one-third of the large national Army slowed the rate of increase in defense spending, while new social programs spurred increases in nondefense allocations.

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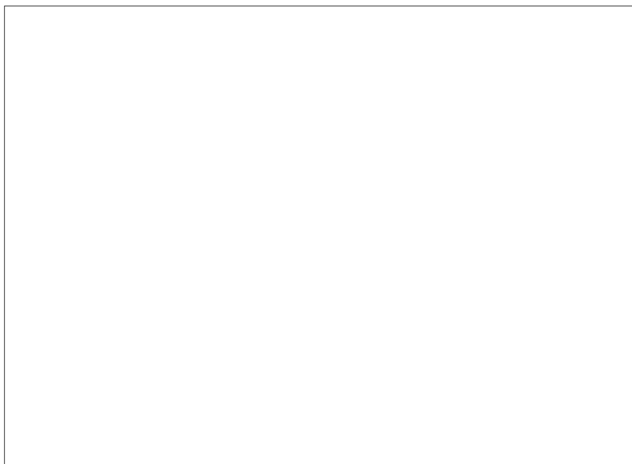
An important trend has been the increased demands by the military on Zimbabwe's scarce foreign exchange. Whereas over 75 percent of the fiscal year 1982 defense budget was devoted to personnel costs, emphasis has shifted recently toward foreign equipment and training of blacks to take over from white officers who are emigrating. Moreover, although total defense spending in terms of local currency has grown, the declining value of the Zimbabwean dollar has reduced the overseas purchasing power.



The defense allocation has been cut 16 percent in nominal terms for the fiscal year 1985 budget, an almost 36-percent cut in real terms on domestic purchases and 60 percent in real terms on equipment purchased abroad. Much of the reduction in foreign purchases represents the transfer of expected fiscal year 1985 funds into fiscal year 1984 to cover the accelerated purchase of the Brazilian armored cars. Funds for operation and maintenance of the Air Force are scheduled to be cut from $19 million to $12 million.

Foreign Military Procurements

Zimbabwe relies on Britain, North Korea, China, Pakistan, and Brazil for military training and over 90 percent of its equipment purchases. After independence, a British Military Advisory and Training Team (BMATT) arrived to assist with the transition to a national Army. The BMATT's services were funded entirely by London, and several British firms sold military equipment to Zimbabwe. The most notable of these purchases were the jets from British Aerospace. Zimbabwe's Air Force suffered a serious loss in July 1982, when sabotage of the Thornhill Base destroyed or damaged a dozen of these aircraft. The subsequent trial of several senior white officers accelerated the departure from the Air Force of other white personnel.

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Britain was supplanted as the major source of foreign military assistance following a 1980 North Korean commitment of military equipment

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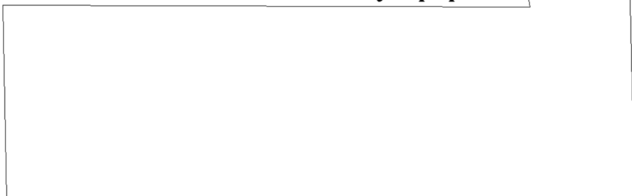

China also has become an important source of military equipment and training. About 30 Chinese instructors have been training Zimbabwean armored units since late 1983.

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Harare has ordered for delivery next year 20 Chinese F-6 jet fighters. Moreover,

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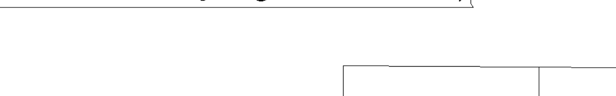

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Zimbabwe's Air Force suffers from shortages of skilled pilots and navigators, maintenance equipment, and repair skills. Last year, Zimbabwe signed an agreement with Pakistan for three years of training and logistic support for the Air Force.

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Zimbabwe's recent purchase of 90 Cascavel armored cars from Brazil is the largest defense acquisition by Harare since independence. The deal, part of a five-year program announced in early 1983 to replace obsolete Army vehicles, includes spare parts as well as training for gunners, drivers, and maintenance personnel. The purchase almost triples Zimbabwe's inventory of armored cars. The new relationship with Brazil further diversifies Zimbabwe's sources for arms but complicates training and logistic support.

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Zimbabwe: Major Arms Deliveries and Training, 1980-84

Year	Item	Cost and Supplier	Remarks
1980-84	Training		130 instructors reduced to 60 in 1983
1981-84	Training		
1981	22 T-55 tanks, fourteen 122-mm artillery and rocket launchers, 30 mortars, and over 4,000 rifles		
1981	Two Canberra bombers, five Hawker Hunter fighters	$2 million, Britai	
1982	107 trucks and 32 other vehicles		
1982	8 Hawk ground attack and trainer jets	$72.3 million,	
1983	Training	NA,	instructors
1983-84	Advisers and training	NA,	officers, and logistics specialists for Air Force
1983	Small arms and ammunition	$4 million, USSR	Only known Soviet delivery
1983	17 SF-260 turboprop trainers and two Bell 412 helicopters	$12.5 million, Italy	
1983	Two Casa 212 light transport aircraft	$5.8 million, Spain	$17 million deal includes four more aircraft to be delivered
1984	90 Cascavel armored cars	$41 million, Brazil	Largest arms deal since independence

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Outlook

Although Zimbabwe will remain incapable of defeating a determined South African invasion, foreign training and deliveries of military equipment are strengthening Zimbabwe's forces to deal with lesser and more likely threats. Most notably, improved mobility will enhance antidissident operations in Matabeleland and perhaps enable more effective protection of truck convoys in Mozambique.

Although we expect a supplemental defense allocation and overspending this fiscal year, in our judgment, the military will have to restrain its modernization program. Defense funding probably will become an increasingly contentious issue in the Zimbabwe Cabinet, as well as in negotiations between Harare and the IMF. 25X1

The military continues to explore other possibilities for acquiring major defense items. Such plans are likely to depend on concessionary financial terms, which many West European and Third World suppliers are increasingly reluctant to provide. As a result, Zimbabwe's financial problems might provide an opportunity for the Soviet Bloc to expand its incipient arms relationship, something that Harare has so far resisted. 25X1

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Smaller LDC Debtors: Economic Plight and US Interests [1]

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Although Mexico, Brazil, and Argentina have been the focus of discussion on LDC debt, a number of smaller LDCs with equally severe economic difficulties have received considerably less attention. The size of the debt of these countries is small compared with that of the top three debtors, but these countries' debt-service burdens relative to their economies are as great as those of the Big Three. US interests in these countries are considerable, moreover, and the potential damage to US interests is broader than impacts on the international financial system.

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Debt and Economic Problems

Colombia, Egypt, Indonesia, Morocco, Pakistan, Peru, and the Philippines best illustrate the problems of smaller debtors where the United States has substantial interests. These seven countries have a combined external debt of $125 billion, roughly half the combined total of Mexico, Brazil, and Argentina. In all but Egypt, Indonesia, and Pakistan, debt-service requirements are more than half of total export earnings, and all seven have current account deficits.

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Some of these countries have taken appropriate economic adjustment measures, while others have shunned tough measures or have insulated their population from external adversities:

- Peru and the Philippines are in the midst of severe economic and political crisis.
- Egypt and Morocco face increasingly difficult problems resulting from the need to cut rapidly growing budget expenditures.
- Colombia's economy is in moderate trouble.
- Indonesia and Pakistan, although not on a solid footing, appear to be in little immediate danger.

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Top of the Debtor List, 1983[a]

Billion US $

Legend:
- ● Severe problems
- ● Moderate difficulties
- **O** Potential problems
- ○ No current difficulties

	Country	Debt		Country	Debt
	Brazil	101.08	**O**	Malaysia	17.18
	Mexico	98.10	○	Algeria	16.37
	Argentina	43.22	●	Nigeria	15.01
○	South Korea	39.30	●	Peru	13.10
●	Venezuela	34.43	○	Thailand	13.09
O	Indonesia	28.68	●	Colombia	11.34
●	Egypt	25.69	●	Morocco	11.00
●	Philippines	23.05	**O**	Pakistan	10.40
○	India	22.51	○	Taiwan	9.82
●	Chile	18.72	●	Sudan	7.61

[a] CIA estimates.

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All seven countries, however, are highly vulnerable to external economic conditions such as high interest rates on debt, fluctuating commodity prices, uncertain commercial lending, and Western aid cutbacks.

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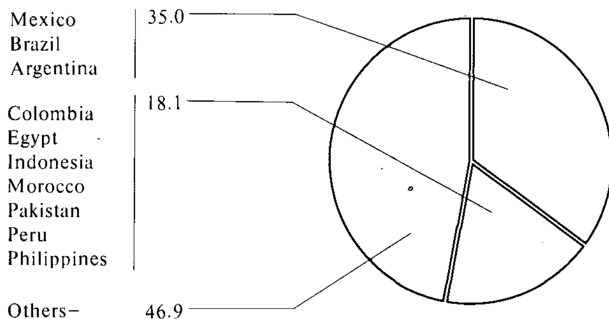
Share of Total LDC External Debt, 1983

Percent

Total: US $ 693 billion



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Case Studies

The Philippines has come to terms with the IMF on an economic stabilization program but still needs a fifth 90-day moratorium on principal payments. Debt now exceeds $25 billion. The country has one of the lowest growth rates in Asia and must cope with a large current account deficit, over 50 percent inflation, dwindling foreign exchange reserves, increased foreign exchange controls and a turn to black-market alternatives, a weakening domestic financial system, and in 1983 substantial capital flight. The deteriorating economy and resulting austerity measures have closed businesses, restricted imports necessary for production, increased unemployment, encouraged hoarding and panic buying of consumer goods, and caused declines in school enrollments. Labor strikes, widespread demonstrations, and increased strength of the New People's Army—the arm of the Communist Party of the Philippines—add to the country's instability and turmoil.

When oil prices dropped in 1982-83, Indonesia quickly devalued the rupiah, reduced subsidies, scaled back or eliminated major development projects, deregulated banking, and instituted tax reforms. Although these actions helped external accounts and restored confidence, they have hurt Indonesians. Inflation is double digit, violent crime has increased, and unemployment has soared. With the world's fifth-largest population, high birth rates are worsening the employment outlook. Indonesia's dependence on oil exports and the recent decline in new investment make the country's economic future unclear.

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Pakistan is not in economic upheaval, but it is one of the world's poorest countries, with formidable external debt-servicing requirements, according to the US Ambassador in Islamabad. Although its economy grew rapidly for six consecutive years through 1983, it has had several debt reschedulings and an IMF Extended Fund Facility for which it could not meet conditionality requirements in 1984. The economy slowed in 1984, a result of a disastrous cotton crop and disappointing wheat harvest. The fragile economy could be weakened further by extreme population growth (now 2.6 percent); deteriorating real income for an already impoverished populace with highly skewed income distribution; continued decline in overseas labor remittances and return of overseas workers to the labor force; and tensions aroused by increased numbers of Afghan refugees.

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Morocco faces acute financial difficulties resulting from outside events and domestic economic policies. Severe droughts since 1981 have caused serious shortfalls in agricultural production and required heavy grain imports. On the export side, phosphate markets collapsed, European trade barriers have restricted Morocco's citrus and vegetable exports, remittances from overseas workers have leveled off because of economic slowdown in Western Europe, and tourism receipts have dropped. According to press reports, the war in the Western Sahara is pushing up defense costs, which now claim as much as 40 percent of the administrative budget. Expenditures for food subsidies and educa-

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Composite of Ten Debtor Countries, 1983

	Billion US $				Percent	
	External Debt	Debt Service	Merchants Export	Current Account	Real Growth	Inflation
Colombia	11.3	1.6	3.1	−3.2	−0.8	20
Egypt	25.7	4.2	9.8	−2.2	6.0	16
Indonesia	28.7	4.0	21.1	−5.5	2.3	12
Morocco	11.0	2.1	2.0	−1.2	0.6	6
Pakistan	10.4	0.9	3.4	−0.6	6.1	7
Peru	13.1	2.6	3.3	−1.1	0.6	111
Philippines	25.0	3.2	5.0	−3.0	1.4	10
Brazil	101.0	18.2	21.9	−6.2	−3.2	142
Mexico	98.1	19.4	21.2	5.3	−4.6	102
Argentina	43.2	6.7	7.9	−2.4	2.8	344

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tion also drain the national coffers. Officials expect the population to increase by 60 percent by the year 2000 and further strain economic resources. Unemployment is approaching 30 percent and will worsen as the young and growing population enters the market. In addition to these economic and social pressures, Morocco must service an $11 billion debt that required 45 percent of its export earnings before the 1983 rescheduling.

Egypt lives beyond its means and relies on external sources of income. Excesses in food and energy consumption supported by government subsidies have been masked by strong income performance from petroleum exports, Suez Canal revenues, tourism, and overseas worker remittances. Even so, Egypt's trade and current account balances are in deficit; Egypt ranks seventh among developing country debtors, and in 1983 it paid $4 billion in debt service. The country now imports 50 percent of its food; energy consumption rises 14 percent annually, and transportation, sewer, water, and other services are breaking down. Widespread poverty contrasts sharply with the wealth of the few. Egypt must deal with over 1 million births annually and needs to create 400,000 new jobs every year. According to press reports, Mubarak recognizes that the economy's decline threatens Egypt's stability, particularly by encouraging Moslem and leftist radicals who oppose his regime.

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Peru's financial crisis has put the country on a collision course with the IMF, foreign creditor banks, and the labor force. The US Embassy reports that Peru is ineligible to draw further on its IMF standby loan because of the excessive government deficit. This, in turn, jeopardizes foreign bank credit and debt financing, but political pressures will make reconciliation with the IMF difficult.

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The domestic economic problems are as great. Per capita income has fallen 25 percent since 1980, and underemployment exceeds 50 percent. Despite government-spending cuts and increased taxes, inflation races beyond 100 percent, and the budget deficit is twice limits suggested by an IMF standby agreement signed in April 1984. Social unrest, general strikes, and continued attacks by the Maoist insurgency, Shining Path, prevent President Belaunde from taking further austerity measures that will allow the government to service overdue debt payments and comply with the IMF.

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Colombia has withstood the economic turmoil endured by most of its Latin American neighbors, but it nonetheless is grappling with difficult economic problems. Much of the financial squeeze on Bogota has resulted from "guilt by association" with other Latin nations. Banks have refused to rollover Colombia's short-term debt—according to press reports, to have something positive shown on their books—and have resisted lending for a $700 million energy project loan package. Banks also criticized Colombia for hosting the June 1984 Cartagena meeting for Latin debtor countries arguing that this action would put it in the same troubled category as other debtors. Domestically, President Betancur's policies in 1982 to increase public spending and open markets to imports were supported by high international prices for coffee and illicit cocaine. Since these prices have dropped from their peak levels, the government has had to cope with declining export earnings and dwindling reserves. According to press reports, Colombia hopes its economy can hold out until its new coal project and oil discoveries come on line. At the same time, Betancur is wooing foreign investment and trying to change Andean Pact provisions that restrict investment. He also is hoping that minidevaluations will avoid the need for a larger currency devaluation. Still, for political reasons, Betancur is resisting an IMF arrangement that would call for greater austerity measures. [ ]

US Interests

These countries' present and potential economic and debt-servicing problems could threaten significant US interests that go beyond stability of the international financial system. [ ]

In foreign policy, the United States depends on these countries' pro-West and moderating influence in international forums. The Philippines and Indonesia play this role in North-South dialogues; Pakistan and Morocco counsel moderation on Arab-Israeli issues within Arab meetings; and Egypt is key to keeping the Camp David accords alive. Morocco was instrumental in returning Egypt to the Islamic Conference and in marshaling Arab support for the 1982 US Middle East peace initiative. In Latin America, Colombia has worked within the Contadora Group to resolve Central America's conflict. [ ]

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Severe economic problems in these countries have lead to a weakening of support of US foreign policy interests. For financial reasons, some already are seeking increased ties with the Soviet Bloc and, in the case of Morocco, with Libya. Indonesia has shown increased interest in Moscow's overture to improve trade relations, and the pace of official visits has increased. The Soviet Union is seeking increased commercial ties with the Philippines. The rest of Asia almost surely is watching how the United States treats an ally when in economic need. [ ]

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Economic decline also may injure US strategic and military interests in these countries. Insufficient US economic assistance, in the view of the governments or populace, could affect military agreements and transit rights. The United States depends on military and commercial passage through Indonesian waters and air space, and the Malacca Straits are particularly important. Bases in the Philippines are the key components of the United States's main line of defense in the Pacific and Southeast/South Asia. Clark Air Base is the largest US overseas base, and the Subic Bay complex is the largest naval supply depot in the world. Pakistan is the frontline state between Soviet-occupied Afghanistan and sea approaches to the Persian Gulf. Morocco gives the United States military access and transit and the use of four airbases for training and emergencies. Morocco also controls the "choke-point" entrance to the Mediterranean. [ ]

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US commercial interests also rank among important concerns. The United States has trade surpluses with Colombia, Egypt, Morocco, and Pakistan, and has only slight deficits with Peru and the Philippines. Given the widening US trade deficit, US export markets in developing countries are critical. The US investment position in these devel-

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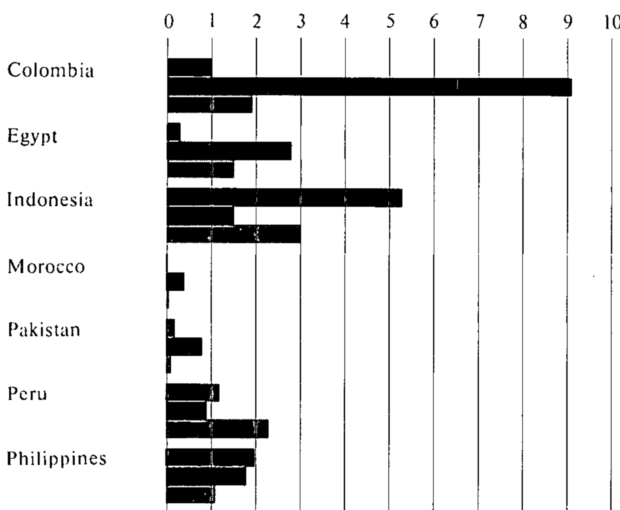
US Exports, Imports, and Investment Position, 1983

Billion US $

Legend: Imports, Exports, Investment



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US Economic and Military Assistance, FY 1984 *Million US $*

Worldwide	**16,300.6**
Colombia	11.3
Egypt	2,504.3
Indonesia	149.2
Morocco	124.4
Pakistan	584.3
Peru	67.4
Philippines	156.6

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oping countries—especially in Colombia, Indonesia, Peru, Egypt, and the Philippines—also contributes to US income that helps offset the US current account deficit. Because these countries have had to cut imports as part of economic-adjustment programs, US exports have dropped in 1983 below 1982 levels to all but Pakistan and Morocco. US firms in these countries also have had trouble importing goods and selling products and have experienced declines in production.

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The United States also has a substantial "aid investment" in these middle-income countries. With the deterioration of their economies, much of the development progress supported by US assistance has eroded. In the case of military assistance, arrears on debt service have accumulated. Countries are asking for increased economic assistance or bridge loans (Colombia, Peru, and the Philippines) and for rescheduling of military debt (Egypt).

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Other US interests include drug enforcement programs with Pakistan and Colombia and an agreement with Morocco for a new Voice of America transmitter—the largest in Europe. In addition, applications for immigration into the United States, as well as illegal immigrants, increase when economies deteriorate.

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