

PN - ABI - 916  
10/17/85  
→ The, Pakistan  
COSS

DISCUSSION PAPER

A UNITED STATES ECONOMIC ASSISTANCE PROGRAM  
FOR PAKISTAN AFTER FY 87

PREPARED FOR USAID/PAKISTAN'S PROGRAM WEEK  
MARCH 18 - 22, 1985

USAID/PAKISTAN  
MARCH 1985

Secretary of State Schultz before the House Foreign Affairs Subcommittee for Asian and Pacific Affairs, February 20, 1985:

"A major foreign policy objective in South Asia is to obtain a negotiated settlement to get the Soviet Union out of Afghanistan so that the refugees can return and Afghans can exercise their own sovereignty and independence. In our efforts to achieve this goal, it is vital that we help ensure the security of Pakistan in the face of Soviet intimidation. Our six year assistance program for Pakistan serves this goal.

"It is designed to support Pakistan's economy and its development and to help strengthen its defenses...."

Under Secretary of State for Political Affairs, Michael Armacost at the World Affairs Council in Philadelphia, December 12, 1984:

"Pakistan, a leader of the moderate Islamic Nations, plays a significant role in ensuring the security of the Persian Gulf and has been transformed into a front-line state by the Soviet occupation of Afghanistan."

Under Secretary of State for Political Affairs, Michael Armacost at a public press briefing, December 20, 1984:

".... We continue to view Pakistan as the key to our policy toward Afghanistan. The continuation of a reinvigorated security relationship with Pakistan is a vital element of the equation. We believe the Pakistan approach to the United Nations is serious and forthcoming. Under increasing Soviet pressure manifested in a series of destructive cross-border attacks -- in which I believe more than 200 Pakistanis have been killed this year [1984] -- they appear neither nervous nor unrealistic in the face of Soviet pressure."

"We believe they will remain on course, resistant to pressure and insistent on a peaceful settlement entailing a Soviet withdrawal. We intend to maintain our own policy as well and to continue to support the cause of freedom in Afghanistan...."

Deputy Assistant Secretary of State, Robert Peck, before the House Foreign Affairs Sub-Committee for Asian and Pacific Affairs, February 20, 1985:

"Soviet intimidation was stepped up as cross-border attacks from Afghanistan into Pakistan left several hundred civilians in Pakistan dead or wounded. Harsh Soviet threats aimed at undermining Pakistan's sense of security continued throughout the year. Pakistan stood steadfast despite these threats, refusing to recognize the Soviet controlled regime in Kabul or to acquiesce in the continued Soviet efforts to subjugate the Afghan people."

"Soviet pressure on Pakistan has increased...."

"... we most emphatically do seek to correct the dangerous military imbalance resulting from the intrusion of Soviet forces into Afghanistan through an early Soviet withdrawal."

"We have also shaped, with the support of Congress, a substantial six-year package of economic assistance to help support the continuation of Pakistan's economic development despite new defense burdens and the largest refugee population in the world."

"...In the absence of a political settlement in Afghanistan, we [the United States] must continue urgently to address Pakistan's security needs...."

"...[Pakistan is a] vital junction point of South, Southwest and Central Asia with the Indian Ocean.... Our program in Pakistan is now in the fourth of its six years, and we are beginning to look to the future to assess what the shape and composition of a follow-on program should be."

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	
I. PURPOSE OF DISCUSSION PAPER	1
II. RATIONALE FOR THE CURRENT FY 82 - FY 87 ECONOMIC ASSISTANCE PROGRAM	1
III. SUMMARY OF THE FY 82-87 ECONOMIC ASSISTANCE PROGRAM	1
A. Goals	1
B. Magnitude	2
C. Sectoral Profile	2
D. Functional Distribution: Categories of Assistance	2
E. Policy Thrusts	4
F. Obligations, Expenditures & Pipeline	5
G. Program Management & Flexibility	6
IV. IMPACT OF THE FY 82 - FY 87 ECONOMIC ASSISTANCE PROGRAM	6
V. RATIONALE FOR THE POST FY 87 ECONOMIC ASSISTANCE PROGRAM	7
VI. POST FY 87 ECONOMIC PROSPECTS, PROBLEMS AND POLICIES	8
A. Balance of Payments Outlook	8
B. Economic and Development Problems	9
C. Policies	9
VII. PRELIMINARY INDICATIONS OF THE GOP'S OBJECTIVES FOR THE POST FY 87 ECONOMIC ASSISTANCE PROGRAM	10
A. Order of Magnitude	11
B. USAID Comments	11
VIII. INDICATIVE POST FY 87 PROGRAM	12
A. Goals	12
B. Policy Quids	12
C. Multi-Year Commitment	13
1. Political Considerations	13
2. Management Aspects	14
3. Technical Factors	14
D. Funding Sources and Terms	15
E. Composition	16
F. Program Magnitude	16
G. Illustrative Levels	17
H. Staffing	21
IX. NEXT STEPS	21

SUMMARY

The current U.S. economic assistance program for Pakistan spans a six-year period, ending in FY 87. President Reagan has assured President Zia that there will be a post FY 87 follow-on program.

The USG rationale for such a program consists of several judgements: (1) the range of USG interests which gave rise to the current assistance effort are no less relevant for the next several years; (2) the existing program has worked; (3) the GOP has carried off its part of the arrangement and is likely to continue to do so; (4) Pakistan's economic and development assistance requirements will continue to be very substantial; and, (5) it is vital that an economic assistance program be used, in a significant and visible way, to ameliorate the burdens associated with Pakistan's defense and refugee burdens.

The GOP rationale for a six-year economic assistance package is congruent with our own. It consists of five premises: (1) for Pakistan to sustain its foreign policy positions with respect to Afghanistan and other issues of mutual concern requires substantial U.S. economic assistance; (2) the foreign exchange and domestic resource requirements of the GOP for the FY 88-FY 93 period will be great; (3) the current six year program has been a political and economic success; (4) the linkage between economic and military assistance has been a sound one and should be retained; and, (5) important areas of parallel geopolitical interest between our two countries will continue for the foreseeable future and programs which support and sustain those interests should be continued. Accordingly, the GOP has requested, on a preliminary, informal basis, what it regards as an appropriate post FY 87 economic assistance program. The key elements of that preliminary request are:

- a six-year total of about \$2.8 billion;
- an enhanced fast-disbursing balance of payments component of the program, including an increased PL 480 program;
- continuation of our current sectoral emphases, i.e., agriculture and energy;
- maintenance of a sizeable unearmarked reserve; and,
- the inclusion of support to the GOP's Kalabagh project.

An FY 88-FY 93 program makes sense. The case for a multi-year program is powerful and persuasive. In political terms, a departure from the present mode, especially in light of the GOP's request, would be seriously harmful. In management and technical terms, the multi-year framework maximizes the chances of achieving several important USG objectives.

The USG and the GOP would be best served by a post FY 87 economic assistance program which continues many of the features of the current efforts, including its sectoral emphases on agriculture and energy. It should be keyed to two major preoccupations:

- (1) macro-economic policies to support the balance of payments and to mobilize critically needed domestic resources; and,
- (2) structural policy reforms, focusing on the implementation of "privatization" (including enhanced opportunity for free markets throughout the economy) and the social sectors. These concerns should be integrated by relating policy reform understandings to macro and sectoral resource transfers. Current funding sources (ESF, PL 480) and terms, and the existing grant/loan composition should be continued.

USAID and the Embassy have not yet completed their analyses (neither has the GOP) of the economic and military assistance requirements. Pending the outcome of that work, an initial examination of some of these requirements (for example, Pakistan's prospective balance of payments and budget deficits, including some analysis of anticipated military and other debt repayment schedules) suggests that in terms of need, the GOP request is justified.

In 1985, the U.S. Government must elaborate an overall strategy for multi-year assistance to Pakistan taking into account not only economic development and security assistance goals, but also our political objectives, e.g. vis-a-vis Afghanistan, India, and nuclear non-proliferation. The resulting package must be both negotiable with Pakistan and attractive to Congress.

This paper is a contribution to the process of elaborating such a comprehensive strategy.

## I. PURPOSE OF DISCUSSION PAPER

The USG and the GOP have separately initiated internal discussions concerning the size, composition and other characteristics of a post-87 economic assistance program. USG inter-agency and GOP inter-ministerial discussions are on-going. Informal preliminary talks have been held between USAID and the GOP.

This paper is designed to contribute to the discussion process in Washington and in Islamabad. It will be followed in a few months by a Country Team assistance proposal to Washington and will, at that time, probably be integrated with the Country Team's recommendations as to the combined economic-military assistance package.

Although this paper is a USAID/Pakistan document, prepared for dealing with the post FY 87 economic assistance subject in the context of AID's Pakistan "Program Week" in Washington, it has received Country Team sanction as a preliminary discussion paper. It represents neither a final recommendation of the Country Team nor of USAID.

## II. RATIONALE FOR THE CURRENT FY 82-87 ECONOMIC ASSISTANCE PROGRAM

Any consideration of what a U.S. post 87 economic assistance package should look like should first examine the reasons for the current multi-year program. The principal reasons are succinctly captured by the statements quoted at the beginning of this paper:

"It is vital that we help ensure the security of Pakistan in the face of Soviet intimidation. Our six-year assistance program for Pakistan serves this goal" -- Secretary Shultz

"We continue to view Pakistan as the key to our policy toward Afghanistan" -- Under Secretary Armacost

We have ... a substantial six-year package of economic assistance to help support the continuation of Pakistan's economic development despite new defense burdens and the largest refugee population in the world" -- Deputy Assistant Secretary Peck

This rationale, prompted by a series of geopolitical and military events which came together in 1979, was the basis for USG-GOP negotiations, successfully concluded in September, 1981. The result was a jointly agreed \$3.2 billion, six-year military and economic assistance package.

### III. SUMMARY OF THE FY 82-87 ECONOMIC ASSISTANCE PROGRAM

#### A. Goals

The goals of the current program were to:

- "provide balance of payments support to help address short and medium term foreign exchange shortfalls, thereby reducing development constraints and strengthening the economy;
- "reactivate a long-term development assistance relationship, which the U.S. views as important because of Pakistan's size, poverty, strategic location and other multi-faceted U.S. interests;
- "address key economic problems which will help enable Pakistan to achieve self-sustaining growth and manage its debt burden;
- "complement and support IMF and IBRD assisted programs, improving their overall impact; and,
- "expand resource availability for local cost financing."

#### B. Magnitude

The economic component of the combined package came to \$1.625 billion, just over half of the total projected assistance. Table 1 shows how the economic assistance component has been programmed and allocated among 23 projects and programs. The level of the economic assistance effort was determined by considering the need to help offset Pakistan's expanded defense and mushrooming refugee burdens, and the requirements for growth and development. Particular weight was given to the balance of payments requirements growing out of Pakistan's defense and economic needs and to the country's domestic resource gap.

#### C. Sectoral Profile

In broad terms, agriculture (excluding PL 480) and energy are the sectors of emphasis, together accounting for almost 70% of the total program. Population and health activities come to just under 10%. PL 480 amounts to almost one-fifth of the program. See Table 1 for a detailed description.

#### D. Functional Distribution: Categories of Assistance

The foregoing sectoral framework reflected the subject focus for the program. Within that framework, each of the projects and programs

Table I  
 SECTORAL DISTRIBUTION OF  
 PROPOSED U. S. ECONOMIC ASSISTANCE FOR PAKISTAN  
 UNITED STATES FISCAL YEAR 1982 TO 1987  
 (Millions of United States Dollars)

SECTOR/PROJECT TITLE	6/81	FY82	FY83	FY84	FY85	FY86	FY87	TOTAL	PERCENT
<b>AG., IRRIGATION &amp; RURAL DEVELOPMENT:</b>	TOTAL	73.20	101.00	123.00	138.30	88.80	113.40	637.70	39.24
Agricultural Research	G	3.20	NA	NA	NA	NA	NA	3.20	.20
On-Farm Water Management	G	7.00	3.00	NA	NA	NA	NA	10.00	.62
Irrigation Systems Management	G	NA	20.50	19.40	18.00	.00	22.10	70.00	5.54
Agricultural Commodities and Equipment	TOT	60.00	60.00	70.00	70.00	40.00	.00	300.00	18.46
	L	34.00	40.00	30.00	43.00*	30.00	.00	177.00	19.89
	G	26.00	20.00	40.00	27.00	10.00	.00	123.00	7.57
Tribal Areas Development	G	3.00	5.00	5.00	.00	5.00	6.00	24.00	1.48
Baluchistan Area Development	G	NA	NA	5.10	6.00	8.00	20.90	40.00	2.46
Rural Roads	G	NA	NA	NA	16.10	.00	23.90	40.00	2.46
North-West Frontier Area Development	G	NA	2.50	9.50	7.20	5.80	5.00	30.00	1.85
Transformation and Integration of the NWFP's Provincial Agricultural Network	G	NA	NA	4.00	11.00	10.00	10.50	35.50	2.18
Management of Agricultural Research and Technology	G	NA	NA	5.00	3.00	10.00	10.00	30.00	1.85
Food Security Management	G	NA	NA	5.00	5.00	10.00	15.00	35.00	2.15
<b>ENERGY:</b>	TOTAL	8.00	70.00	61.00	73.00	132.00	104.00	448.00	27.57
Rural Electrification	TOT	9.00	50.00	31.00	25.00	27.00	27.00	169.00	10.34
	L	NA	27.00	25.00	25.00	.00	27.00	104.00	6.10
	G	8.00	23.00	6.00	.00	27.00	.00	64.00	3.74
Energy Planning and Development	G	NA	15.00	5.00	.00	5.00	7.00	30.00	1.85
Forestry Planning and Development	G	NA	7.00	3.00	.00	8.00	7.00	25.00	1.51
Energy Commodities Equipment	TOT	NA	NA	22.00	48.00	30.00	.00	100.00	6.15
	L	NA	NA	20.00	15.00	15.00	NA	50.00	3.08
	G	NA	NA	2.00	33.00	15.00	NA	50.00	3.08
Lahra Coal Power Generation	TOT	NA	NA	NA	.00	62.00	63.00	125.00	7.69
	L	NA	NA	NA	.00	32.00	55.00	87.00	5.35
	G	NA	NA	NA	.00	30.00	8.00	38.00	2.34
<b>POPULATION AND HEALTH:</b>	TOTAL	11.30	22.50	35.00	33.70	34.20	17.30	154.20	9.49
Population Welfare Planning	G	4.30	4.80	14.80	16.10**	15.00	15.00	70.00	4.31
Social Marketing of Contraceptives	G	NA	NA	5.50	8.00	4.00	2.50	20.00	1.23
Primary Health Care	G	5.50	.00	8.00	.00	6.50	NA	20.00	1.23
Malaria Control II	G	1.50	17.70	6.70	9.60	8.70	NA	44.20	2.72
<b>OTHER:</b>	TOTAL	7.50	6.50	6.00	3.00	20.00	20.00	63.00	4.09
Commercial Funding and Investment Corp.	L	NA	NA	NA	.00	15.00	10.00	25.00	1.54
Development Support Training	G	NA	4.00	6.00	.00	5.00	10.00	25.00	1.54
Project Design Fund	G	7.50	2.50	.00	3.00	.00	.00	15.00	.92
PROJECT RESERVE	TOT	.00	.00	.00	.00	.00	20.10	20.10	1.24
	L	.00	.00	.00	.00	.00	.00	.00	.00
	G	.00	.00	.00	.00	.00	20.10	20.10	1.24
<b>TOTAL</b>	TOT	100.00	200.00	225.00	250.00	275.00	275.00	1325.00	81.54
	L	34.00	67.00	75.00	83.00	72.00	72.00	443.00	27.26
	G	66.00	133.00	150.00	167.00	183.00	183.00	882.00	54.28
P.L. 480 TITLE I (edible oil imports)	L	50.00	50.00	50.00	50.00	50.00	50.00	300.00	18.46
<b>GRAND TOTAL</b>		150.00	250.00	275.00	300.00	325.00	325.00	1625.00	100.00

\* Includes \$37.8 million in DA funds. \*\* Includes \$12.2 million in DA funds.

provided one or more of commodity, technical, training and local cost assistance. Table 2 describes the distribution of these categories.

Table 2

DISTRIBUTION OF CATEGORIES OF ASSISTANCE\*

	<u>%</u>	<u>Millions of \$</u>
Technical Assistance	10.58	140.3
Training	3.92	52.0
Commodities	65.86	872.8
Local Costs	16.68	221.1
Contingency	2.96	39.2
	<u>100.00</u>	<u>1,325.4*</u>

\* Does not include two projects yet to be designed (Lakhra, Rural Roads) nor planned increases to authorized projects.

The sectoral emphasis, project and program composition and distribution of types of assistance were explicitly designed to achieve the economic and development goals of the program. For example, the fact that two-thirds of the program and one-sixth of the package represented commodity and local cost support was largely responsive to balance of payments objectives and requirements, as well as to domestic resource needs. The development side was addressed in several ways, including technical assistance and training, the strategic deployment of commodity and local cost financing to reinforce the TA and training, and the use of projects, programs and the policy dialogue to achieve institutional, organizational and a variety of policy reforms.

E. Policy Thrusts <sup>1/</sup>

USAID and the Embassy pursue a wide spectrum of economic and development policy objectives. For some objectives, our strategy has been to support and reinforce other donor initiatives, e.g., macro and structural reforms sought by the IMF and World Bank. In other areas, we use our work and presence in Pakistan and other forums (Consortium, DAC) to encourage, exhort and stimulate. In addition, studies are undertaken and presentations made to the GOP on critical economic and development problems, whether or not substantial U.S. assistance is projected to address the identified problems and solutions. We are, of course, most active on those subjects and in those areas to which USAID projects and programs are directed.

---

<sup>1/</sup> For a detailed description of USAID's work in the policy area, see a variety of USAID documents on the subject, including the policy dialogue status paper prepared for "Program Week", March 1985.

In one way or another, the Mission is addressing most of the themes identified by the Administrator in his "POLICY DIALOGUE CHECKLIST" (State 045804, February 14, 1985). If there is one overall theme which reflects the Mission's dominant policy thrust, it is "privatization". This is expressed in several ways: reliance on market forces, revision of relative price structures, user costs, denationalization. This pervasive policy thrust is pursued in several sectors and subsectors (agriculture, energy, fertilizer, irrigation and water management, population, edible oils.) Even in Pakistan's major public enterprise, WAPDA, the Mission is promoting a more rational price structure, in addition to organizational, administrative, financial and operational reforms.

USAID is also engaged in dialogues on planning, resource mobilization and resource allocation at national, sectoral and provincial levels. As suggested above, a feature of our work in the policy arena is the Mission's close coordination with other donors, principally the World Bank and the ADB.

One additional comment: The six-year economic assistance program and the understandings associated with it did not include any explicit or specific policy reform quid pro quos. Nevertheless, for reasons associated with the positive policy environment in Pakistan, the receptivity of key GOP officials, the hearing we are accorded because of the size and continuity of the economic assistance program, the selective project and program use of conditionality, there has been a substantial and reasonably effective effort, overall, in the promotion of sound economic, institutional and development policy.

#### F. Obligations, Expenditures and Pipeline

The obligation-expenditures-pipeline pattern reveals the following:

- Planned annual obligations are on schedule, rising from \$150 million in FY 82 to \$325 million in FY 86 and 87;
- Annual expenditures are also steadily rising, from \$50 million in FY 82 to a projected more than \$300 million in the final year of the six-year program; and,
- The current pipeline total will not change much through the remainder of the program, as annual expenditures are expected to keep pace with rising obligations.<sup>2/</sup>

Thus, for the second half of the six-year program, expenditures and obligations are expected to offset one another. The pipeline is under control.

---

<sup>2/</sup> See the pipeline paper prepared for "Program Week" for more details.

### G. Program Management and Flexibility

Several mutually reinforcing factors have been critical to achievement of program objectives, meeting obligation targets and controlling the pipeline:

- Multi-year programming (reflecting the USG's long run commitment);
- The designing of several large projects;
- The decision not to fully fund each project when authorized;
- The substantial inclusion of fast-disbursing activities in the program mix; and,
- The use of a non-earmarked reserve to respond to unanticipated requirements and new initiatives (e.g., narcotics, energy commodities program).

Despite severe staffing constraints, these factors provided considerable flexibility in managing the program: funds were obligated each year as required by the portfolio, to initiate new activities and provide resources to those projects and programs which were making good progress. Consequently, the Mission was under no pressure to obligate, simply to meet annual targets. In this fashion, the qualitative integrity of the program was also sustained.<sup>3/</sup>

### IV. IMPACT OF THE FY 82-87 ECONOMIC ASSISTANCE PROGRAM

For several reasons, the program, to date, can be judged to have been successful. Obligation targets have been met at the same time that the pipeline was reasonably contained. Balance of payments objectives have been achieved, including the handling of an unanticipated short-term emergency. U.S. economic assistance has been positively associated with commendable Pakistan growth performance and with economic stability. The defense and refugee burden has been managed. A critical USG concern, unreflected in the original 1981 negotiations and programming -- opium poppy production interdiction -- was rapidly and effectively accommodated. Important economic and development problems are being addressed (energy shortfalls, low agricultural yields, human resource strengthening, institutional reform, etc.) Movement in the policy arena, although slow and difficult, has been meaningful and the prospects for continuing progress are good. Donor coordination in particular with the World Bank and ADB, has been effective and is likely to achieve major results before the six-year program is concluded.

---

<sup>3/</sup> The flexible response capacity of the program is illustrated by the timely provision of \$ 24 million to import cotton. This activity was unforeseen, but at the GOP's request, the cotton was procured within a few months, thereby helping to cover critical raw material shortfalls and quell harmful speculative and inflationary pressures.

In political terms, the economic assistance program has done its job. The GOP is pleased with program design and its implementation. It uses the USG program as a model for other donors. It has been satisfied with the level of "net aid flows", arising from the good disbursement record set against GOP repayments. It considers the program to be essentially in harmony with its on-going Sixth Five-Year Plan. The GOP appreciates the concessionality profile of the program and its demonstrated flexibility. It highly values the multi-year commitment. A relationship between the USG and the GOP on economic assistance questions has evolved which the GOP regards as constructive and productive. Key GOP officials not only accept but request USG assistance on policy as well as resource transfer matters. This relationship has contributed in a crucial way to the overall goal of building GOP confidence and faith in the reliability of the USG as a valued partner.

In short, the program has been true to AID's program and policy thrusts, has met its specific economic and development objectives, has avoided crippling implementation problems, and has evoked the desired GOP response which in turn contributed to the on-going building of a critical, hopefully enduring partnership in key foreign policy areas. The economic assistance program has worked.

#### V. RATIONALE FOR THE POST FY 87 ECONOMIC ASSISTANCE PROGRAM

In considering the question of a post FY 87 economic assistance program, the following conclusions emerge, five years after program negotiations were initiated:

- USG interests, both those which arise from its positive goals and needs and those which respond to the goals and actions of other countries in the area, are essentially unchanged from those which caused the economic assistance program to be launched;
- The geopolitical and security situation existing during 1979-1981 remains much the same; a prudent planning assumption is that that the essential characteristics of that situation will prevail for the foreseeable future (the Soviet Union, however it performs on particular issues, is not likely to alter its long run objectives);
- The goals of the economic assistance program are sound and, based upon experience and performance, are achievable -- the economic assistance program in Pakistan is a proven, effective tool of U.S. foreign policy;
- Pakistan's economic assistance requirements (linked to its defense and refugee burden, its growth and development status and needs, its foreseeable serious budgetary and structural problems, and its economic goals) will continue to be very substantial; and,

- The GOP has delivered, in political terms, and with appropriate U.S. support, is likely to continue to do so.

## VI. POST FY 87 ECONOMIC PROSPECTS, PROBLEMS AND POLICIES

For the next several years, Pakistan's economic problems are expected to remain grave, with its balance of payments and budgetary situations likely to be most vulnerable. During this period and beyond, many of Pakistan's structural problems -- export-import relationships, debt service, domestic resource mobilization, human resource development, population growth, public-private sector issues -- will require sustained and increasing attention. In fact, the economic outlook for the next several years is less promising than it was at the outset of the FY 82-87 economic assistance program. For the long run, even though some progress has been achieved, the immediate problems associated with prospective balance of payments and foreseeable budgetary crises will inhibit the implementation of policies and strategies essential to the resolution of Pakistan's deep-seated structural problems.

### ( A. Balance of Payments Outlook

Several factors contribute to the prospect of a serious balance of payments situation during the next several years:

- ( Worker remittances, \$3.1 billion in 1983, have dropped sharply, falling to a current annual rate of about \$2.3 billion. The outlook is uncertain; an optimistic projection would be for remittances to remain at their current nominal rate;
- Export prospects are discouraging. The world rice market is small, volatile and real prices are below those of the past 20 years. Real cotton prices are expected to hold relatively stable but demand for Pakistan's production may fall as China becomes self-sufficient;
- Imports of Pakistan's big import items -- e.g., oil, edible oil, fertilizer -- are expected to grow; and,
- Pakistan's debt service ratio, now relatively modest, will begin to rise as grace periods expire and payments for past concessional assistance and for defense procurement mount. A serious debt service problem is in prospect.

These problems have already had serious repercussions and even more are in the offing. The 1982/83 payments balance of a surplus \$414 million changed to a 1983/84 deficit of \$275 million -- a negative shift of almost \$700 million in one year. Since June 1984, the situation, as reflected in

Pakistan's gold and foreign exchange reserves position, has sharply deteriorated. Reserves fell in the second half of 1984 by 50 percent (to about \$1.25 billion).

Even if concessional assistance continues to rise at recent past annual rates, projected financial gaps are formidable.<sup>4/</sup> Heroic measures would be required to bring the financial gap down to manageable proportions. Imports would have to be restrained. Domestic public and private investment would have to be curtailed. Commercial borrowing (which in turn shortly results in a higher debt service ratio) would have to be increased. These measures, made necessary for financial reasons, would reduce growth, impede development and contribute to economic instability.

### B. Economic and Development Problems

*COIE  
Note*

The USG has a stake not only in the successful management of Pakistan's immediate and near term economic problems, but also in sustained development progress in Pakistan over the long pull. Even growth does not assure a reliable and contributing partner, capable of managing its domestic political and economic affairs, not to mention one able to play an effective role in foreign policy areas of interest to the USG. The highest rate of population growth in Asia cannot be sustained without grave economic, development and political problems. Pakistan's performance in the other social sectors (education, health) is probably the poorest in Asia, increasingly pointing to a crisis in terms of the country's ability to organize itself in coherent national terms, or in meeting its needs as an emerging, modernizing state. Pakistan's energy generation gap, already acting as a serious constraint to production, employment and growth, will worsen during the next decade, without heroic investment and effective project implementation. Agricultural yields, among the lowest in the developing world, will, unless substantially raised, continue to limit national economic growth and constrain the development of Pakistan's rural areas where 70% of its population resides. These and other development problems should be addressed in any post FY 87 economic assistance package. The challenge will be to balance short, intermediate and long run objectives and requirements.

### C. Policies

Many of the policies required to deal effectively with Pakistan's economic and development situation have been well defined, by Pakistan and by its donor partners. Others remain

---

<sup>4/</sup> Depending upon the assumptions relating to growth, investment, exports, imports, remittances, official external assistance and other variables, the financing gap in 1994-95 is projected to range between approximately \$2 billion to \$8 billion.

to be developed and defined. Most remain to be more vigorously pursued, whether it is denationalization, market liberalization, user charges, a reduced government role in production and in the provision of social services or public sector resource allocation or a revised revenue structure.

The policy dialogue will remain an integral part of any post FY 87 economic assistance program. While reforms and modifications in various sectors and sub-sectors will pose challenges to both partners in the dialogue, perhaps the two most difficult overall problems will be, first, to find and implement an enlightened balance between short and long run concerns, and second, to accelerate the pace of policy reform in what promises to be a more troublesome economic environment. There may be a silver lining, however, in the dilemma which this just mentioned problem appears to create: hastening the pace of policy reform may well be the answer to managing the problems, for example, of inadequate investment and production, which in turn would allow increasing attention to some of Pakistan's long neglected development problems. The visible realities of Pakistan's economic problems and the recognition of the consequences of a failure to cope with them rationally should help the USG and the GOP to translate the policy dialogue into meaningful policy reform. In any case, however, the policy dialogue road will not be easy.

#### VII. PRELIMINARY INDICATIONS OF THE GOP'S OBJECTIVES FOR THE POST FY 87 ECONOMIC ASSISTANCE PROGRAM

As earlier indicated, the GOP has been considering what, in its view, the post FY 87 program should look like. GOP meetings have been held involving key officials (Minister of Finance, Minister of Planning and Development, Secretary General of Economic Affairs, Secretary General of Planning, and representatives of the Ministry of Foreign Affairs). Staff work has been initiated.

The GOP has shared with us the results of these meetings, with the emphasized caveat that they are preliminary and may be modified following the conclusion of detailed analysis now underway on the military and economic components of the projected package. What follows is a summary of these preliminary views:

- The on-going USG program has been successful.
- The next program should: 5/
  - . Link economic and military assistance;
  - . Involve a multi-year USG commitment (six years, FY 88 - FY 93, to align the program with the last year of the GOP's Sixth Five Year Plan and its Seventh Five-Year Plan);
  - . Continue the two-thirds, one-third grant/loan split (excluding PL 480);
  - . Increase the PL 480 program (in view of rising edible oil imports, "even if all of USAID policy recommendations in this field are adopted");

5/ The GOP officials acknowledge that there was little likelihood that all the elements of their comprehensive list could be accommodated in one package and that choices would have to be made during the negotiations.

- . Increase the fast-disbursing character of the program (more commodity assistance, program and sector lending);
- . Provide for a balance of payments loan;
- . Retain an unearmarked reserve on the order of 20%;
- . Increase the proportion of assistance to infrastructure;
- . Continue to focus on the energy and agriculture sectors;
- . Maintain an emphasis on lagging areas, especially the Tribal Areas;
- . Rely to the fullest extent possible on ESF rather than DA funding (more helpful because of the GOP's domestic resource mobilization problems); and,
- . Include financing for the Kalabagh project ("if the USG does not help, then other donors will be less forthcoming and this indispensable project will not be undertaken").

On a more general plane, the GOP officials agreed that more emphasis needed to be placed on human resource development and one official asserted that if he had to choose between such an emphasis and on-going economic problems, he would opt for the former. (This was in response to the point that what the GOP seemed to be preferring was, in fact, a continuation of its historic over-emphasis on immediate and short-term issues, and a relative neglect of the social sectors.) The GOP officials also acknowledged that their objectives justified agreement on development policy understandings as an explicit part of the total assistance package.

#### A. Order of Magnitude

Without as yet knowing what the military assistance implications would be for the economic assistance component, it was too early, we were told, to propose a final economic assistance total. Nevertheless, we were advised that the GOP was thinking along the following lines: The program should build on the last year of the present program (\$325 million) and increase at 10% per year, "reflecting inflation and recognition that the USG economy and budget will be expanding. Pakistan should at least hold its own as a proportion of US resources."

This formula would produce these results:

- A cumulative six-year total of \$2.750 billion;
- An annual range rising from about \$360 million to \$570 million; and,
- An annual average of approximately \$460 million.

#### B. USAID Comments

It is evident that "negotiations", at their most preliminary and informal stage, have begun. Much of the GOP's thinking parallels the views held by USAID and the Country Team. From a substantive, conceptual point of view, at least as to program content, the USG and GOP representatives should not have a difficult time coming to agreement, unless disagreements emerge from a major difference as to program magnitude which would require tough decisions on sector, program and project choices. In contrast to the negotiations during 1980-1981, it

would also appear that the stage is set for a USG position which requires some economic and development policy understandings as part of the agreement on a multi-year, substantial economic assistance package.

### VIII. INDICATIVE POST FY 87 PROGRAM

#### A. Goals

Essentially, the post FY 87 economic assistance program would be driven by the same combination of objectives and purposes which informed the on-going program. This follows from three judgements:

- The political/strategic/military assumptions which influenced the shape of the assistance package in 1981 will be no less relevant for the post FY 87 period;
- The particular goals of the economic assistance component are, over time, achievable; and,
- Pakistan's economic and development problems and vulnerabilities will not have fundamentally altered and for the short run at least, may actually have worsened.

Some modifications in emphasis, however, should be considered. Project and program purposes in the social sectors and, if deemed feasible, resource allocations to these sectors should focus more on structural problems than in the FY 82-87 program.

#### B. Policy Quids

In 1981, one of the goals of the program was to "reactivate" the US-Pakistan long-term development assistance relationship. That goal has been achieved. A follow-on program should consolidate and deepen the relationship, and, if possible, use it as an instrument for more actively pursuing development policy reform. That possibility is likely to be more promising, even if still difficult to carry out, during the next several years. First, a cordial, open and substantive dialogue has been established; second, the GOP has articulated (the Sixth Plan and other pronouncements) a positive policy framework -- urging and helping the GOP to achieve its policy objectives is quite different from seeking to impose an externally designed set of policy changes; and, third, a number of new senior pro-policy reform GOP officials, not on the scene in 1981, are now functioning in key policy and decision-making positions. In fact, these circumstances are already operating and we have capitalized on them to work at the policy dialogue. Issues of sovereignty and national sensitivity will still remain; status quo interests will still seek to impede change; bureaucratic resistance will not disappear; success may well be outnumbered by disappointments. Nevertheless, while the GOP's legitimate sensitivities should be accommodated and respected, policy reform should be an explicit purpose of the follow-on program.

In addition to continuing the style, techniques and substance of the current policy dialogue, we should consider the approach employed by the World Bank (and IMF). This approach would involve the inclusion of policy conditions and understandings as part of rapidly disbursing, resource transfer mechanisms -- program loans, commodity import loans, sector lending, budget support. It would respond to and utilize the prospective serious balance of payments/domestic resources situation and the GOP's wish for increased U.S. assistance to deal with it, and it would assist in achieving our economic and development objectives.

As noted above, the circumstances are likely to be more positive for a stepped-up policy dialogue. How effectively we can exploit those circumstances will importantly depend upon how responsive the post FY 87 program is to the GOP's concerns.

### C. Multi-Year Commitment

USAID and the Country Team consider the case for a multi-year commitment and programming to be clear and persuasive. In broad terms, the many powerful advantages of this approach fall into three categories: (1) Political; (2) Managerial; (3) Technical.

#### 1. Political Considerations

The self-evident proposition that to switch from a multi-year commitment and multi-year programming to a year by year process would undermine one of the most important political objectives of the assistance package -- Pakistani confidence in U.S. reliability -- was reinforced by the GOP in its discussions with U.S. officials in Islamabad on the post FY 87 program.

The FY 82-FY 87 program has made it possible to build this confidence. But six years is only a beginning, when placed in the context of the history of U.S.-GOP economic assistance relationships. During the intervals between the three suspensions of U.S. economic assistance to Pakistan since the early 1950's, the U.S. provided uninterrupted assistance for periods as long or longer than the current program. The fact is that what the U.S. does following FY 87 will be regarded as a test of U.S. commitment and reliability. To the question still in Pakistani minds: Should we make or continue to make our positive relationship with the USG one of the cornerstones of our foreign policy?, to drop the multi-year commitment and programming strategy would at least risk if not assure getting the wrong kind of answer. It is not in our interest to encourage doubts as to our constancy.

On the U.S. domestic front, it would seem imprudent to slide back to the more traditional assistance mode and go to the Congress every year to seek a 620E waiver.<sup>6/</sup> Not only would such an approach

---

<sup>6/</sup> Section 620E of the FAA authorizes the President to waive the prohibitions of Section 669 of the FAA through September 30, 1987 to provide assistance to Pakistan if the President determines to do so is in the national interest of the U.S. The absence of that waiver authority forced the U.S. to suspend all economic and military assistance to Pakistan due to concerns about its nuclear program.

unnecessarily expose the issue, but it would invite uninformed or irresponsible attacks on an annual basis on one of the Administration's most important policy themes in Asia, and, in the process, do damage to U.S. foreign policy operations. Having had the provisions of Section 620E extended through September 1987 has made the task of the Executive Branch and of U.S. officials in Pakistan -- namely, to achieve the goals of the assistance package -- much more feasible and more likely to be successful.

To the Soviet Union and others, continuing what has worked so well would send an important signal as to our position and as to our willingness to put muscle behind it. Dropping the multi-year commitment would suggest a change in our policy, a lowering of Pakistan among our foreign policy priorities, and a weakening of our opposition to the Soviets in Afghanistan and to their objectives in the region. The wrong message would also be sent to others.

## 2. Management Aspects

The multi-year framework greatly facilitates effective financial management. Unjustifiably high annual individual project obligations can be avoided, while assuring that obligation targets can be met. Funds can be allocated more selectively to activities which are going well and with-held from those which are lagging. Only "ready" projects need be offered for approval and obligation. The pipeline is better controlled. Programming flexibility is improved.

The multi-year mode requires less staff. Annual programming calls for additional and more detailed analyses and documentation in Pakistan and in Washington, and would engage State and AID/W staff and management more intensively in preparations for and presentations within the Executive Branch, including OMB, as well as on the Hill.

## 3. Technical Factors

The multi-year scenario enhances the policy dialogue. To get results from the dialogue requires time, persistence and continuity. An arrangement which institutionalizes continuity provides the optimum environment within which to analyze, define and promote policy reform.

The multi-year approach facilitates planning. It is a logical extension of the CDSS system. Moreover, in Pakistan, this approach would not only parallel the Five-Year Plan process, but would increase the chances of our influencing the GOP's long-term planning at the national and provincial levels. With the multi-year knowledge of the level and composition of assistance of one of Pakistan's largest assistance partners in hand, GOP planners can proceed to choose priorities and allocate resources with more confidence, especially in those areas of U.S. interest.<sup>7/</sup>

<sup>7/</sup> The Agency's comprehensive 1970 evaluation of "The Use of Program Loans to Influence Policy", found that Pakistan's top policy-makers were willing "to take some chances if U.S. assurances regarding" continued support were "reasonably certain". That report also found evidence that the extent of the GOP's willingness to carry out difficult policy reforms depended on the amount of resources made

The multi-year framework improves the chances of effectively integrating PL 480 with other U.S. resources to maximize program and policy results. Our experience during the last three years has demonstrated that the aligning of PL 480/ESF/DA resources, upon which the GOP could rely for several years, strengthened our hand in negotiating self-help conditions, and helped the Mission to shape a long run approach to sectoral problems.

It is important to move the GOP to assign higher priority to its long run, structural problems. Efforts in that direction are already a part of the policy dialogue. The enhancement of the policy dialogue has already been mentioned but beyond that, a multi-year approach would increase our ability to make progress on this key development effort.

The framework for more effective donor coordination would be strengthened by a multi-year approach. In particular, our work with the World Bank and the ADB, both of which work with the GOP on multi-year programming, would be facilitated.

The multi-year process reduces implementation delays. It is instructive to recall the experience associated in 1981-1982 with obtaining Congressional action to authorize the President to waive the legislative provision which prompted the suspension of assistance to Pakistan. That episode consumed several months. Decisions involving the funding of new projects or adding resources to on-going activities would have to be delayed, every year, if the President had to seek Congressional sanction each year.

In light of all the foregoing, the conclusion suggests itself that the multi-year framework is not only required in Pakistan, but is a model to be explored for other countries, where our interests are long-term and the program is sizeable. The desirability of budgetary flexibility, while legitimate and understandable, should not be determining where an alternative approach -- the multi-year framework -- is so key to the achievement of high priority foreign policy, development and management objectives.

#### D. Funding Sources and Terms

Because of U.S. goals and interests, ESF is the indicated funding source for an economic assistance program. In addition, Pakistan's balance of payments and domestic resource problems are most readily responded to from ESF resources. DA is less hospitable (although not absolutely precluded) to what are considered "resource transfers" even if associated with development conditionality. Program loans, sector loans, commodity import programs all generate host government receipts which would help to close Pakistan's serious and growing domestic resource gaps. Similarly, PL 480 is an ideal balance of payments tool as well as a generator of government-owned local currency. With ESF, there is no requirement for a specific host government contribution to USAID-funded activities, a welcome characteristic of external assistance to a financially hard pressed government.

The current program, including PL 480, is 54 percent grant, 46 percent loan. Excluding PL 480, the distribution is two-thirds/one-third, grant/loan. In view of Pakistan's low income status and keeping in mind its anticipated balance of payments and worsening debt service problems, the follow-on program should retain at least its present concessionality profile.

E. Composition

An important component of the post FY 87 program will consist of a continuation and expansion of selected activities initiated during the FY 82-FY 87 package.

A high proportion of the follow-on program would be devoted to balance of payments problems and will be structured to respond to Pakistan's domestic resource shortfalls. New modes of transferring resources tied to policy reform will be explored. PL 480 would continue as a key component of the package.

Agriculture and energy will continue to be the sectors of emphasis, in terms of resource allocation. At least within the policy dialogue and possibly in terms of resources, a higher priority will be assigned to the social sectors and structural problems -- education, health, population, "privatization".

New initiatives might include contributions in further capital financing in energy, a follow-on to CFIC in the form of assistance to Pakistan's capital markets, a major increase in the training area (Science and Technology, economic analysis and planning). Possible assistance in the nuclear energy field might well be considered as part of the post FY 87 program to assist the USG and GOP to reach agreement on international safeguards and related nuclear energy matters.

The program should include, as in the on-going effort, an unearmarked reserve and a project design fund. Consideration will also be given to a "project implementation fund" to help implement activities without drawing down on operating expenses or diluting project funds. (In fact, this possibility might be a candidate for inclusion in the last years of the current program.)

F. Program Magnitude

Ultimately, the level agreed to by the USG and GOP will be determined after analysis of several factors: for example, substantive requirements; policy understandings; terms; resource availabilities; political considerations; GOP preferences; USG goals; and, Congressional consultation.

A thorough review of substantive requirements is being undertaken based upon consideration of the following:

- A continuation of the linkage between military and economic assistance - what will be the balance of payments impacts of the current military program (repayment, spare parts acquisition)? what procurement and repayment will be associated with the post FY 87 military assistance program?;
- Additional balance of payments requirements arising out of projected financing gaps, GOP repayments to the U.S. from past U.S. assistance;
- Domestic resource requirements;
- Other donor financing;
- Funding required to sustain successful activities initiated during the FY 82-FY 87 economic assistance program; and,
- Funding required to undertake desirable new initiatives and give financial expression to shifts in sectoral and policy emphasis.

#### G. Illustrative Levels

The Ambassador and Country Team have expressed their views on the proposed AAPL levels for FY 88-FY 90. (See 1984 Islamabad cables 9400, May 2 and 9535, May 3). Beyond that, it might be useful to illustrate the levels which would be suggested by applying various assumptions.

These assumptions relate to the AID/W proposed AAPL for FY 88-FY 90, the real value of post FY 87 assistance, projected FMS repayments, and projected repayments on past U.S. concessionary economic assistance. Obviously, calculations of assistance requirements will ultimately take into account additional variables and determinants. However, as indicated, the assumption models presented below may be helpful, at this early stage of programming, to develop a "feel" for relevant orders of magnitude despite the fact that only a few variables are involved.

#### Assumption Model I

- . Straightline the proposed AAPL level through FY 93 (includes a continuation of a \$50 million PL 480 program for FY 88-FY 93).

This assumption yields the following results:

Nominal and Constant 1987 Value of AAPLs  
(\$million)

Fiscal Year	Nominal Value	Constant Value (87 Dollars)	Difference in Value from FY 1987*
<u>1987</u>	<u>325</u>	<u>325</u>	
1988	250	238	-87
1989	200	181	-144
1990	200	173	-152
1991	200	165	-160
1992	200	157	-168
1993	200	149	-176
Total FY 88 to 93:	1,250	1,063	-887
Annual Average:	208	177	-148

\* (Assumed Inflation Rate = 5%; Base Year = 1987)

Assumption Model II

- Straightline the real value of the FY 87 level, assuming a 5% annual inflation rate.

Program Required to Maintain the  
Real Value of the FY 87 Program  
(\$million)

<u>Fiscal Year</u>	<u>Level</u>
1988	341
1989	358
1990	376
1991	395
1992	415
1993	436
Total	<u>2,321</u>
Annual Average:	387

Assumption Model III

- Economic assistance program would cover only projected FMS repayments of the current military assistance program and a projected future military assistance program, assuming the same level and terms of the FY 83-FY 87 program.

Projected FMS Repayments  
( \$million)

<u>Fiscal Year</u>	<u>Current Program</u>	<u>Current Program Repeated During FY 88 to 93</u>	<u>Total</u>
1988	254	0	254
1989	270	39	309
1990	291	78	369
1991	290	134	424
1992	270	204	474
1993	251	270	521
Total FY 88 to 93:	1,626	725	2,351
Annual Average:	271	121	392

Assumption Model IV

- Economic assistance program would cover projected repayments from past AID, PL 480 and FMS assistance.

Estimated Repayments on U.S. Assistance  
( \$million)

<u>Fiscal Year</u>	<u>A.I.D.</u>	<u>PL 480</u>	<u>Sub-Total</u>	<u>FMS</u>	<u>TOTAL</u>
1988	92	43	135	254	389
1989	92	45	137	309	446
1990	93	47	140	369	509
1991	93	50	143	424	567
1992	98	55	153	474	627
1993	98	59	157	521	678
Total FY 88 to 93:	566	299	865	2,351	3,216
Annual Average	94	50	144	392	536

Assumption Model V

AID/W proposed AAPL, straightlined through FY 1993, (assumed to cover minimum requirements for sustaining current development projects) combined with Model III, FMS repayments.

Minimum  
Continuing Development Project Funding Needs and  
FMS Repayment Requirements  
( \$million)

<u>Fiscal Year</u>	(1) CDSS AAPL Levels	(2) Projected FMS Repayments	(1) + (2)	Real Value (1987 Dollars)*
1988	250	254	504	480
1989	200	309	509	462
1990	200	369	569	492
1991	200	424	624	513
1992	200	474	674	529
1993	200	521	721	538
Total FY 88 to 93:	1,250	2,351	3,601	3,014
Annual Average:	208	392	600	502

\*(Assumed Inflation Rate = 5%; Base Year = 1987)

The AAPL level (Model I) has little relationship to U.S. goals and interests in Pakistan and the region, and should not in our opinion be taken seriously. It does not appear to be consistent with President Reagan's assurances to President Zia as to a follow-on economic assistance program. Model II might be taken as an indicator of what might be minimally acceptable in political terms to the GOP, although it reduces the inflation assumption used by the GOP in preliminary discussions by 50%. Each of Models III, IV and V take into account only a few of the variables which need to be examined in any analysis of substantive requirements.

The computations reflected in Models II-V are compared below with the program magnitude preliminarily suggested to us by the GOP.

Illustrative Program Magnitudes  
FY 88-FY 93 U.S. Economic Assistance Program  
( \$million)

<u>Fiscal Year</u>	<u>Models II to V</u>	<u>Preliminary GOP Figure</u>
1988	254-480	357
1989	309-462	393
1990	369-509	432
1991	395-567	475
1992	415-627	523
1993	436-678	570
TOTAL	2,178-3,323	2,750

One major conclusion is suggested by the foregoing arithmetic exercise, to be confirmed by the results of further analysis of the military and economic assistance components: The preliminary GOP figure, despite its overly simple arithmetic formula, can be readily justified in terms of likely real requirements.

#### H. Staffing

Two brief comments are appropriate: (1) In contrast to the FY 82-FY 87 period, the first half of which was essentially a design and build up phase, the FY 88-FY 93 program would be, ab initio, a full-blown implementation effort combined with major design activities. (2) If the policy dialogue, policy reform and policy understandings are to be made more explicit in the negotiations and agreement for the post FY 87 program, the Mission's economic and development policy analytic and dialogue strengths will have to be expanded. This requirement is self-evident. The staffing implications of the first point remain to be determined by the Mission's experience during FY 86-FY 87, when both design and implementation activities will be intense.

#### IX. NEXT STEPS

The negotiations and agreement on the FY 82-FY 87 economic assistance package were preceded by little economic analysis or systematic project design. Following the September 1981 agreement, in order to launch the program as swiftly as possible, 20 "quasi-PIDs" were prepared and approved in a matter of a few weeks. Subsequently, in FY 82, 9 projects were designed and approved and a PL 480 agreement was signed.

The above process and schedule were not ideal. Extraordinary pressures were placed upon AID/W and USAID/Pakistan. We now have an opportunity, in connection with the post FY 87 program, to pursue a more orderly planning process.

It is important that project development work for the follow-on program be initiated as early as possible in FY 86, not only to provide adequate lead-times for project development and approval in FY 88, but also to provide the timely basis for program reviews in AID/W and presentations to the Congress.

Thus, final decisions on the post FY 87 program should be reached before the end of this calendar year. Such a target would be achieved if the following schedule was met:

- Informal discussions between the GOP and USG on the economic assistance component continue through July, 1985.
- Continuing USG inter-agency discussions and timely Congressional consultations over the next several months.
- Joint military assistance analysis and requirements estimates through the fall of 1985.

- Submission by the Country Team of a proposed combined program by the early fall of 1985.
- Consideration of the Country Team proposal in Washington in the fall of 1985, with the USG negotiating position determined by December 1985 on: magnitude of the total package; size of the two components (including PL 480); multi-year character of the program; terms; policy quids and policy thrusts; and, sectoral composition.