



Intelligence Report

Office of African and Latin American Analysis

21 December 1995

Colombia: Drug Scandal Stirs Economic Discontent

President Samper's entanglement in the scandal over drug kingpin donations to his election campaign has disrupted Colombia's financial markets, dimmed its near-term economic outlook, and worsened its bilateral economic relations with Washington.

- Polls and press reports indicate that the business community believes the scandal has deterred investment and increased tension with the United States on trade issues.
- Private-sector leaders also question the government's estimate that GDP grew by 5.4 percent this year, pointing to an increase in unemployment and a contraction in the manufacturing sector in August as evidence that growth will more likely reach only about 4.5 percent--well below last year's 5.3-percent expansion.

The economy's underlying strength--especially the petroleum sector--will probably enable it to weather the crisis.

- *Strong growth in a few sectors while other, more labor-intensive industries experience a sharp slowdown could, however, increase private-sector discontent over Samper's management of the economy.*

Distracted by the scandal, Samper has lost the focus on regional trade integration that previously had dominated his foreign policy agenda.

- *He is likely to shy away from new integration commitments in the near term and might introduce protectionist measures that focus on a few key products to shore up his support in the business community, as he has in the past.*
- *Worsening relations with Washington could also cause Samper to take a more pro-Latin stance on trade issues, but his wish to maximize Colombia's access to foreign markets will keep him from renouncing hemispheric trade integration.*

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Market Fears, Government Assurances [redacted]

Incriminating revelations of the connections between the Cali cartel kingpins and President Samper's election campaign have had their greatest economic effect on Colombia's financial markets. The stock market has plunged by more than 15 percent since Santiago Medina, Samper's campaign treasurer, was arrested on 26 July, and it is down by nearly 30 percent from its peak in January 1995. The peso, meanwhile, has dropped by about 9 percent since Medina's arrest and roughly 15 percent since January, overshooting the 13.6-percent depreciation target set by the government at the beginning of the year. Reflecting in part the disruption in the markets, 75 percent of the businessmen surveyed in a poll conducted in October by a major newspaper thought that the political crisis had damaged the economy. A quarter of those surveyed considered the economy's major problem to be the uncertainty caused by the scandal. (U)

The government claims that the economy has not suffered damage from the scandal, citing as evidence its estimate that real GDP expanded by 5.4 percent this year, roughly the same as last year's 5.3-percent growth. Bogota attributes the relatively strong showing to a pickup in the petroleum and agricultural sectors and to a roughly 25-percent surge in exports related to the declining peso. Hard currency reserves have roughly stabilized following their fall from record highs in the aftermath of Medina's arrest, with unexpectedly low international prices for coffee offset by increased exports. Inflation, moreover, decelerated slightly, allowing the Central Bank to lower reserve requirements from 60 percent to 40 percent in mid-October. [redacted]

Private-sector sources have questioned the government's figures, however, and identify weaknesses in other key sectors of production. According to private-sector estimates, GDP is growing at a roughly 4.5-percent pace. Business sources point out that sales have slumped and that inventories are piling up; auto sales, for example, fell by about 10 percent in the first 10 months of this year, with an 18-percent dropoff in October. One leading think tank claims that political uncertainty and high interest rates have caused businesses to cancel or postpone one-third of the investment projects planned at the beginning of this year. An increase in unemployment from 7.6 percent in September 1994 to 8.7 percent this September gives credence to their criticism. In late November, even the government acknowledged that industrial production during the first eight months of 1995 had fallen to its lowest level in four

This memorandum was prepared by [redacted] Office of African and Latin American
Analysis, [redacted]
[redacted]

years, and that the sector contracted in August. Some economists believe that the crackdown on drug cartel kingpins has added to economic difficulties stemming from the political crisis. Diminished inflows of laundered hard currency have helped push up the exchange rate and have dampened growth by reducing trafficker investments in the construction sector, especially in the Cali area, according to press [redacted]

[redacted]

Looking Ahead: A Sturdy Economy With Some Flaws [redacted]

The economy has the underlying strength to withstand the crisis over the next six months or so, even though its rate of growth may well be slowing. The petroleum sector probably will continue to prosper because oil investors take a long-term view of their involvement with Colombia and have been undaunted by Samper's troubles. The economy will also benefit from the lagged effects of an upswing in nonpetroleum foreign investment, which grew by 160 percent through July, according to official government figures. The strong performance of nonpetroleum exports probably will help boost GDP as well. Most local forecasters continue to predict that growth for next year will be higher than 4 percent, even though few find the government's projection of 5.1-percent growth plausible. [redacted]

The slowdown in the rate of growth and sectoral imbalances, however, could increase private-sector and labor discontent over Samper's management of the economy. Industries that face dimming prospects--such as construction, retail sales, and manufacturing for the local market--are labor intensive and politically powerful, whereas the economy's bright spot, the oil sector, employs relatively few people. Moreover, the Central Bank has said that it expects to tighten its monetary policy early next year, reverting to its 60-percent reserve requirement, a move it probably sees as necessary to offset the inflationary effect of a planned 23-percent hike in government spending. Disgruntlement in the sectors most sensitive to interest rate changes, such as construction, could also increase if the unsettled political crisis continues to push down the peso, maintaining upward pressure on rates. Demand for local credit would rise as the depreciating peso increased the cost of foreign borrowing. The Central Bank also might choose to boost rates if capital flight induced by the sliding peso increased significantly, forcing the Bank to find methods other than its customary market intervention tactics to control the exchange rate and protect reserves. These effects would be magnified if political uncertainty drove away new foreign investment or if successes against drug traffickers' laundering networks sharply restricted illicit hard currency inflows. [redacted]

Weakened Political Position Diverts Samper From Trade Integration [redacted]

Samper's political support in the business community--crucial to his survival in office--has diminished greatly over the last few months, press [redacted]

[redacted]

indicate, although he retains the backing of a few key magnates. In addition to their concerns about a slowing economy, many businessmen have been alarmed by Bogota's deteriorating relationship with Washington's [redacted]

[redacted]

[redacted]

[redacted]

moreover, the private sector disapproves of Samper's plan to increase public spending and has loudly objected to the tax hikes needed to finance it. [redacted]

As Samper struggles with the political challenges resulting from the scandal and focuses on domestic economic issues to regain popular support, he has paid far less attention to regional trade-opening initiatives than he did earlier in his term. This comparative neglect allows him to avoid further agitating the business community, where backing for additional lowering of trade barriers is mixed. Polls indicate that a significant number of businessmen, especially those in agriculture and textile manufacturing, believe that trade liberalization was implemented by the previous government too quickly and that it hurt their industries. [redacted]

Given his other problems, Samper is unlikely to antagonize these businessmen--or risk worsening Colombia's current account deficit, still growing despite a surge in exports this year--by pressing for new agreements that would require Bogota to lower tariffs significantly in the near future. His tendency to introduce narrow protectionist measures, as he did with rice and sugar imports from Venezuela earlier this year, to assuage business complaints suggests he may even take small steps backward if he calculates that they would shore up his support. But because he, his advisers, and a number of businessmen also wish to maximize Colombia's access to foreign markets, he is not likely to renounce regional trade integration. Indeed, he probably will strike a constructive pose toward the proposed free trade area of the Americas, raising his profile on the issue if he is still in office when the hemispheric trade ministerial approaches in March. [redacted]

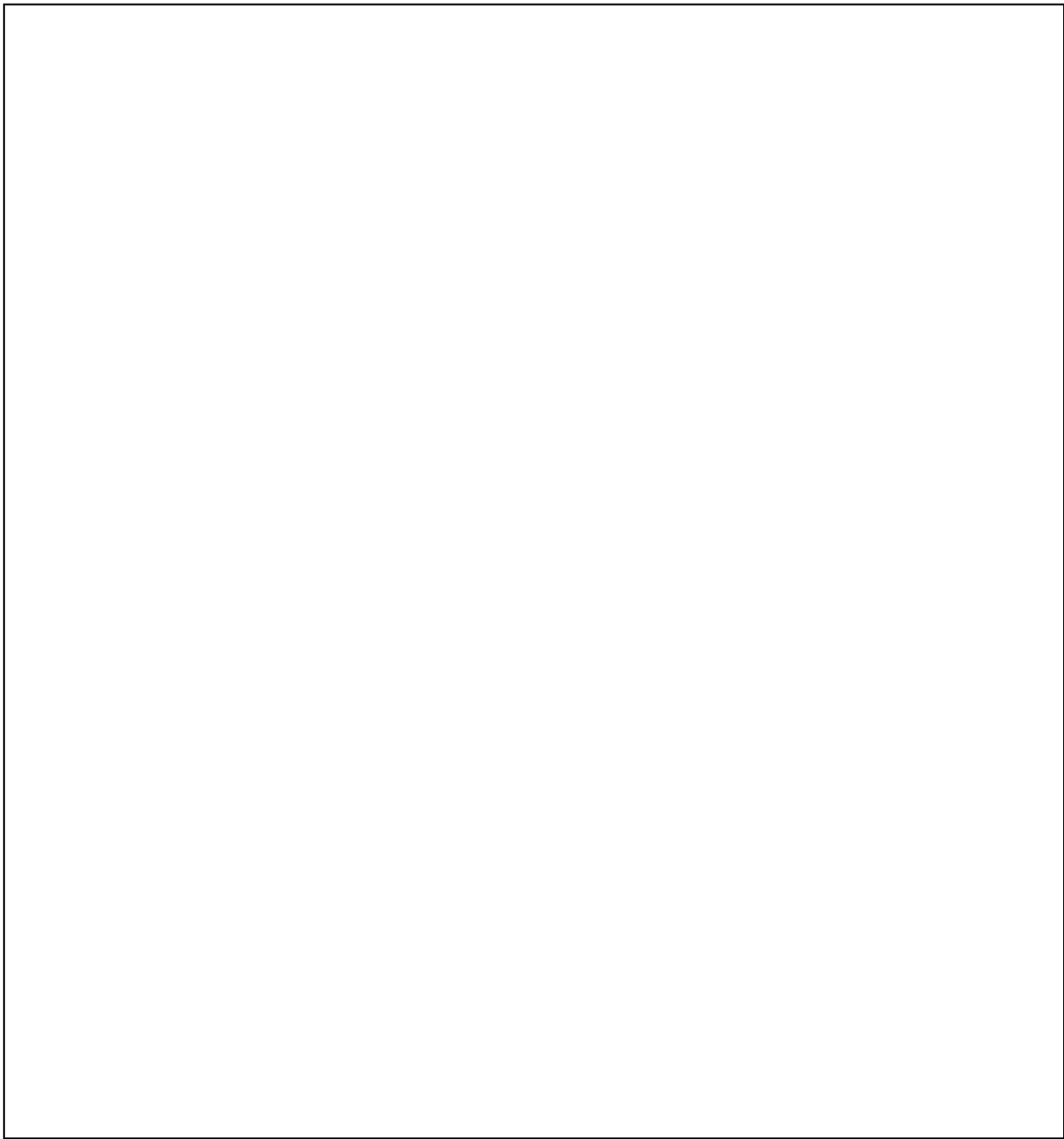
Prickly Relations With United States Affect Policy [redacted]

Rising tensions with Washington are affecting Bogota's stance on several trade and investment issues, despite the desire of businessmen--and the Samper administration--to protect their US trade privileges. [redacted]

[redacted]

[redacted]


As long as bilateral tensions remain high, Samper is more likely to focus attention on South American integration than on possible NAFTA accession as a prelude to a hemispheric free trade area. This stance would continue a turn southward that became evident early this year and would be reinforced if the US Congress fails to approve fast track legislation for negotiations with Chile. Bogota is unlikely to take a confrontational approach in its trade relations with the United States, however, for fear of losing its preferential US market access, further alienating the business community, and being ostracized from the hemispheric integration process largely guided by Washington.

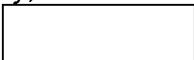




Harbingers of a Much Weaker Economy

The economy could weaken more dramatically than we anticipate if several, relatively unlikely, events occur.

- If Samper resigns or is forced to leave office, a prolonged breakdown in the constitutional system for presidential succession could greatly damage investor confidence, deter new capital inflows, and increase capital flight.
- An all-out insurgent assault on the petroleum infrastructure could derail large projected increases in crude production next year, crimping both hard currency inflows and government revenues.
- A significant downturn in international oil or coffee prices or in drug money inflows would also have severe, but less costly, ramifications. 

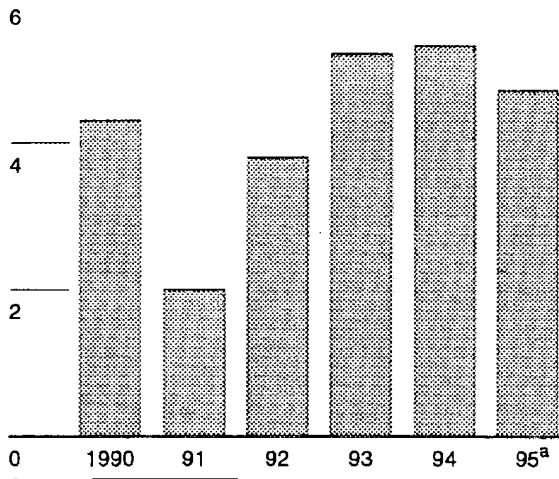
Policy missteps by the government could also diminish prospects for growth, although their effects would be less dramatic. Runaway spending at the municipal level and a slowing economy could throw off current budget projections. If Bogota fails to revise its spending plans to keep them in line with revenues as the year proceeds, inflationary pressures could kick up, leading the Central Bank to boost interest rates still further. The economic downside of these developments would be steeper if the government responded by taking steps to eliminate or drastically limit the Bank's autonomy, which could erode investor confidence in the country's monetary stability. 

Colombia: Macroeconomic Indicators Stable

Note scale change

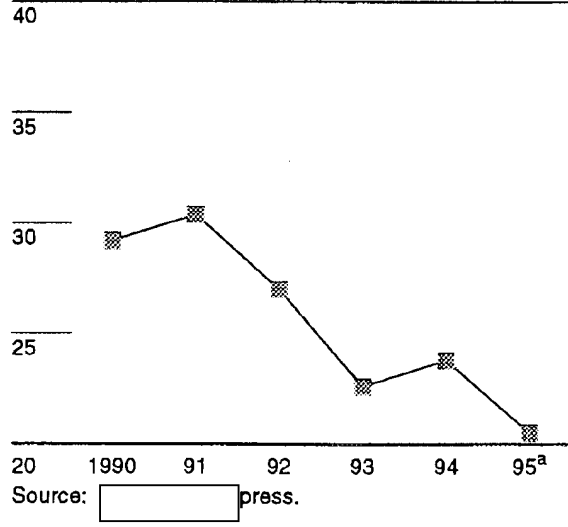
Real GDP Growth

Percent change



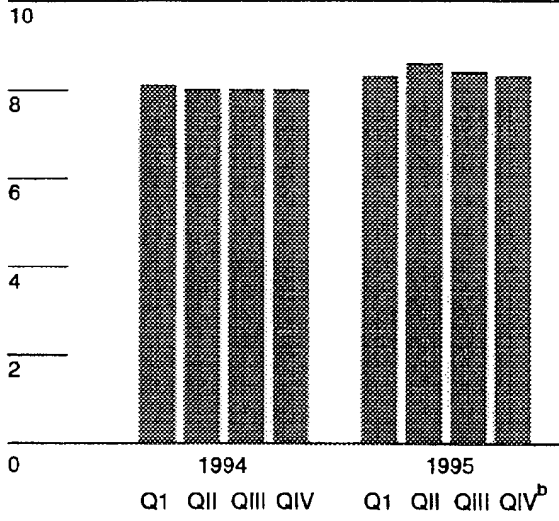
Inflation

Percent



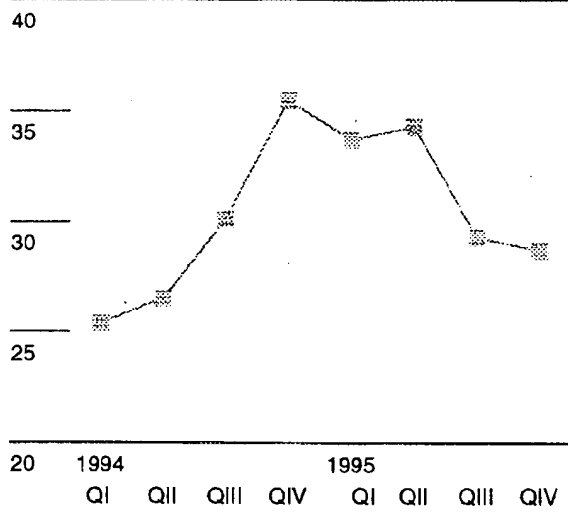
Foreign Exchange Reserves

Billion US \$



Interest Rates

(90-day CDs)



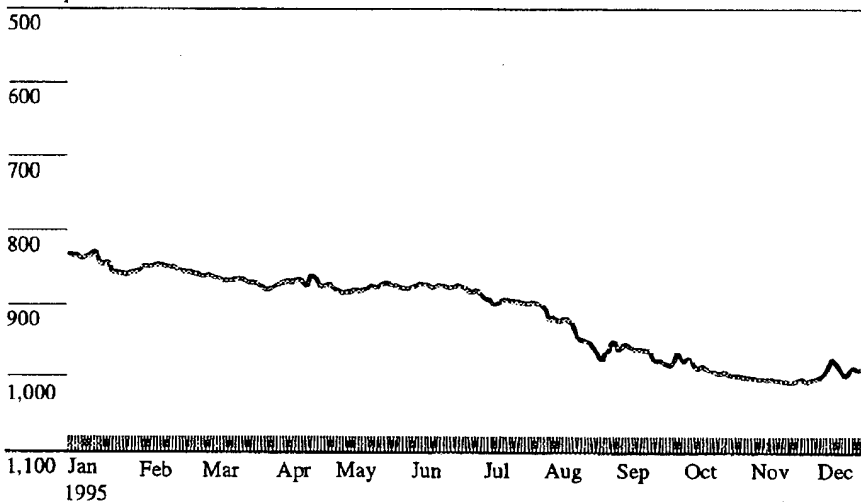
^aProjected.

^bAs of 3 November 1995.

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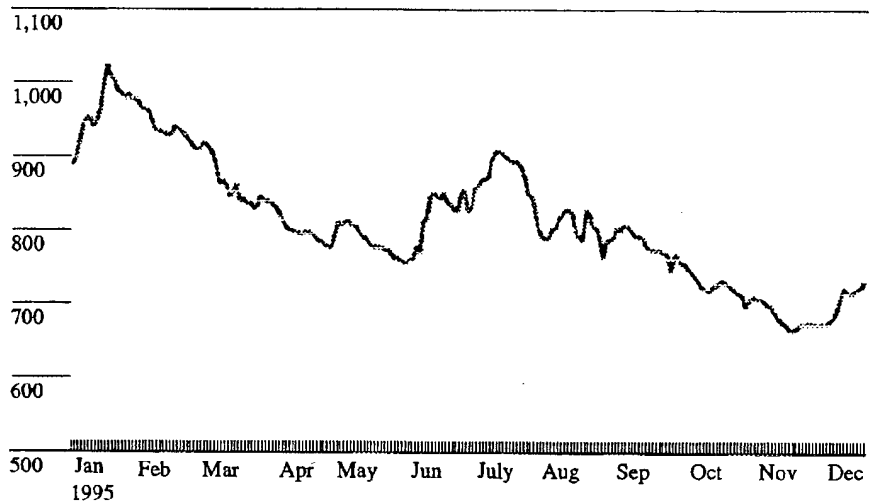
Foreign Exchange Rate

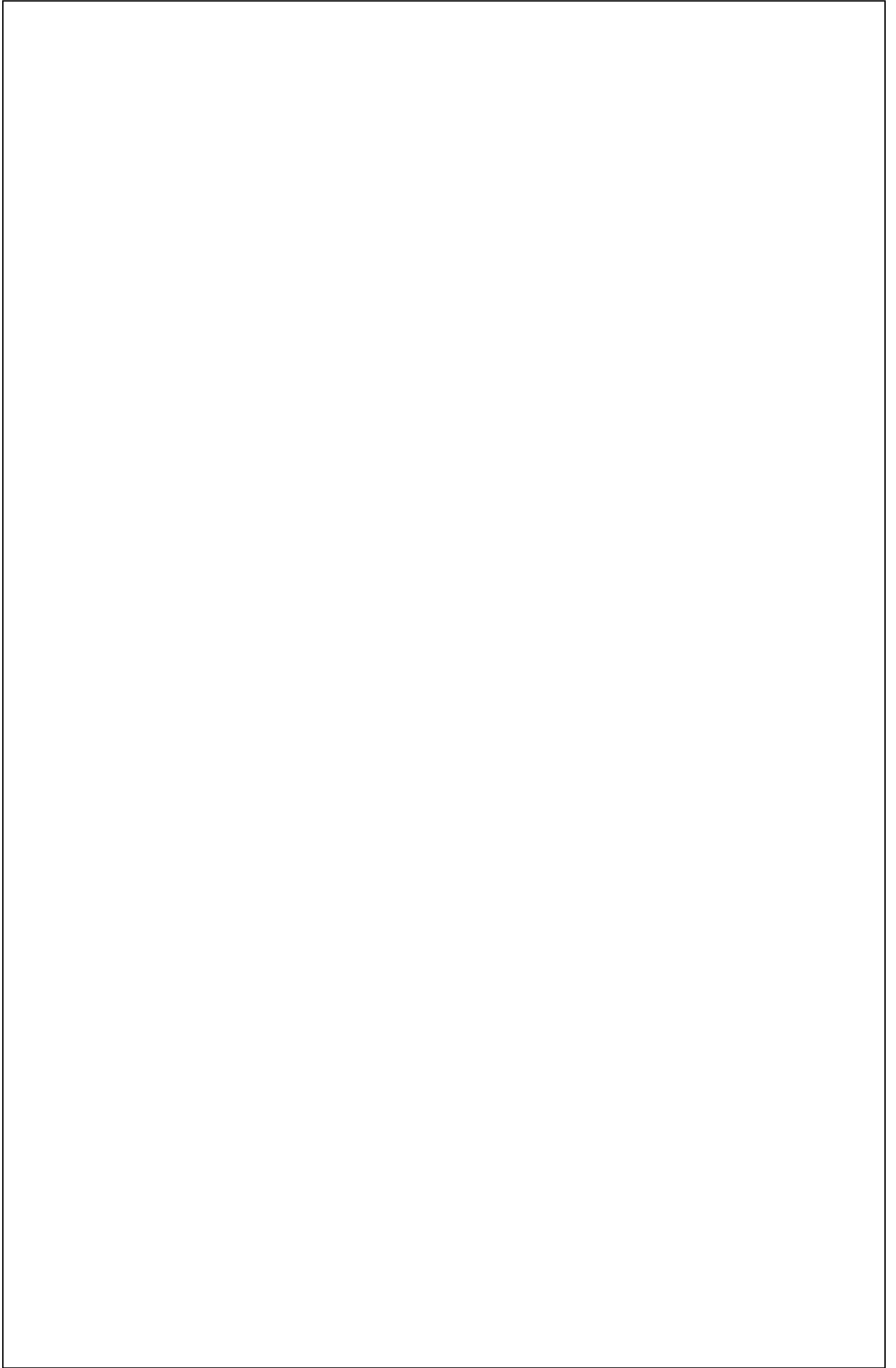
Pesos per dollar

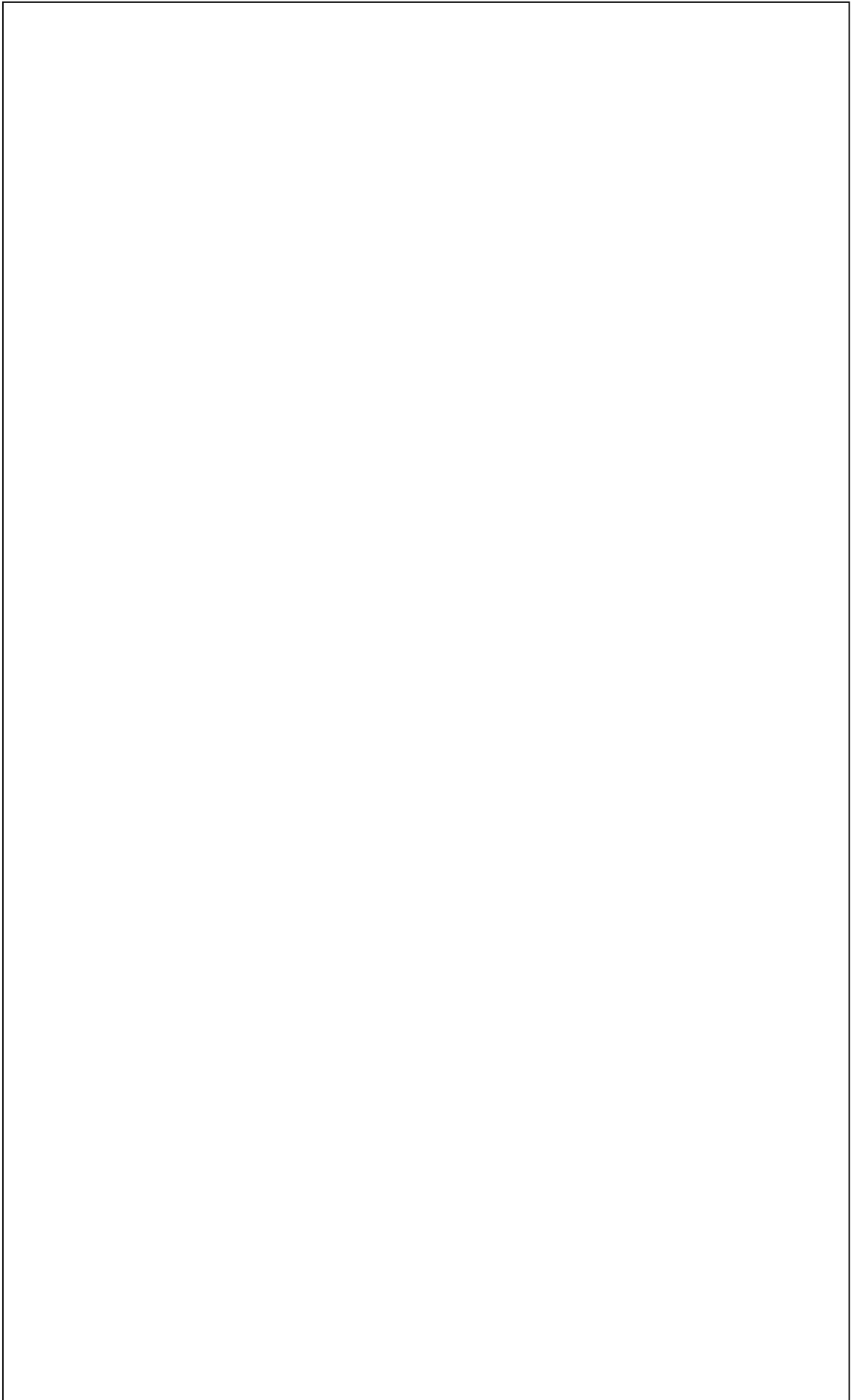


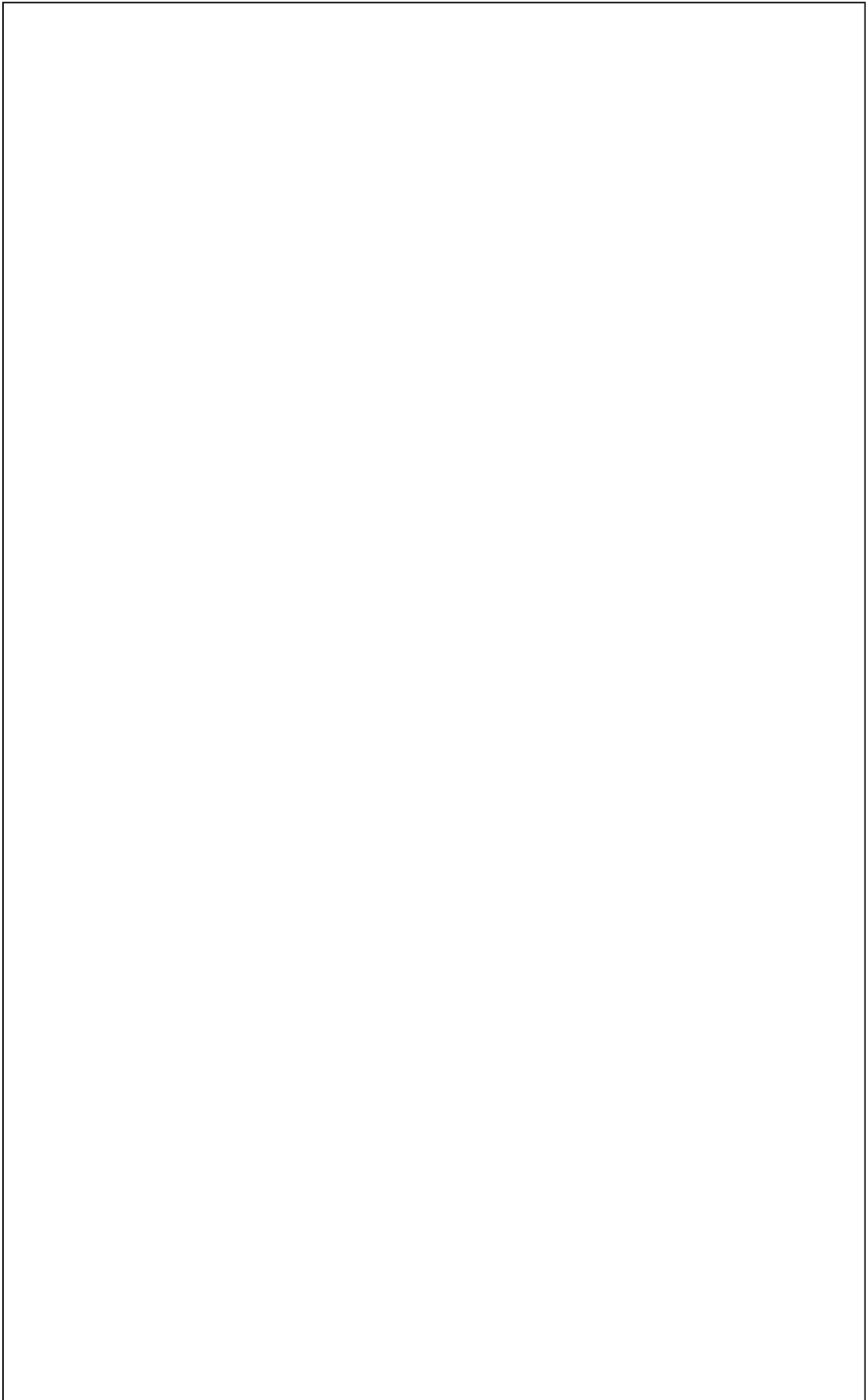
Bogota Stock Market

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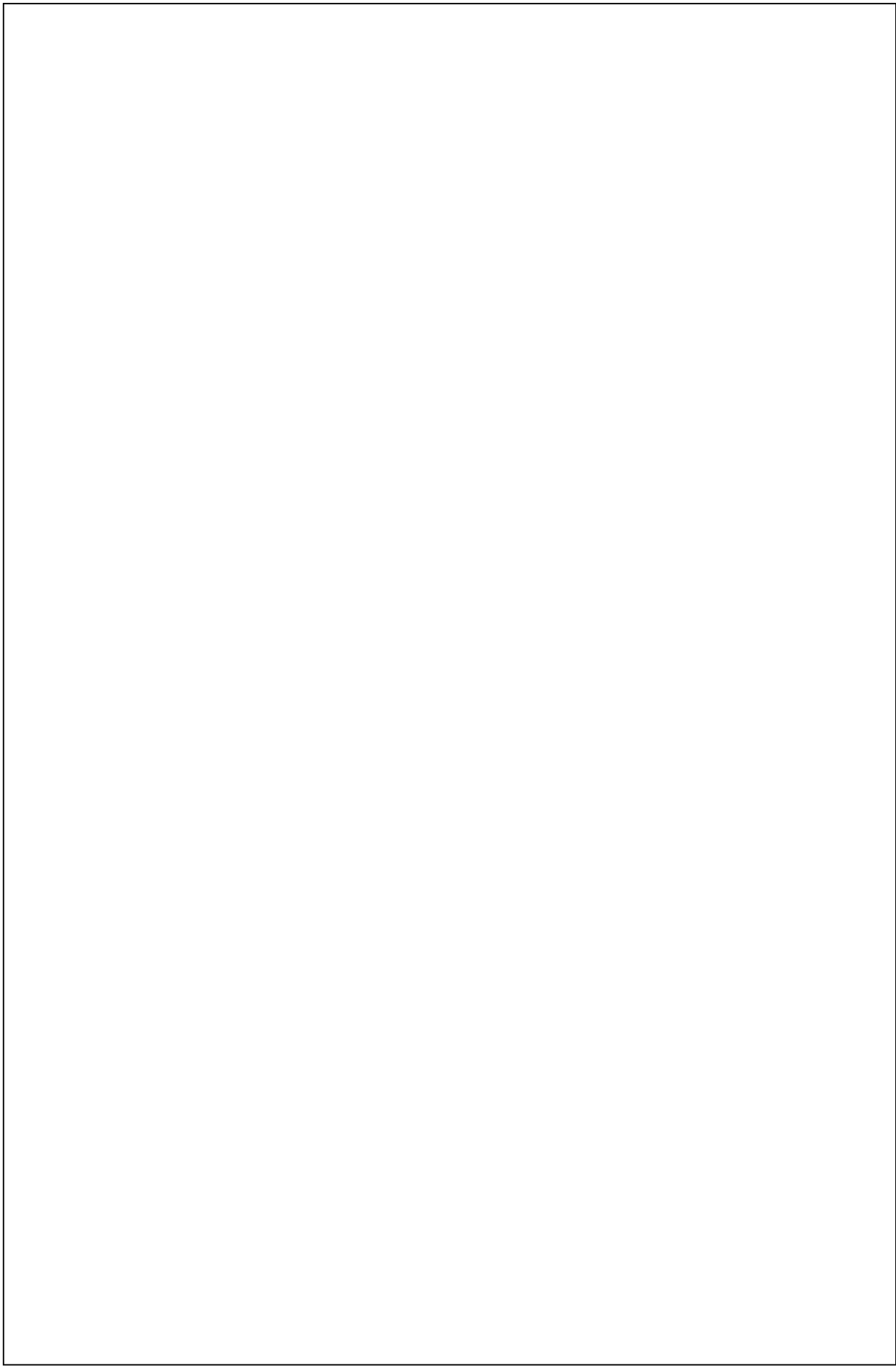








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