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International Economic & Energy Weekly

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5 July 1985

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DI IEEW 85-027
5 July 1985

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Synopsis

1 **Perspective—The Current LDC Financial Situation** 25X1

New developments in the LDC debt situation are a cause for increased concern. Although impressive gains have been made in LDC economic performance, their financial situation remains tight and political frustrations are becoming evident. 25X1

3 **The Philippines: Holding a Weak Hand for Economic Recovery** 25X1

We see no quick return to the politically acceptable 6- to 7-percent growth rates enjoyed in the late 1970s. Slow growth means that President Marcos will continue to be vulnerable to domestic criticism and will have to deal increasingly with social tensions. 25X1

7 **Israel: Seeking the Elusive Austerity** 25X1

The National Unity Government has been only marginally more successful than its predecessors in imposing the austerity needed to bring external deficits under control. The government appears ready to abandon the "package deal" approach, but we doubt it will follow through on any comprehensive programs. 25X1

13 **Persian Gulf Oil: Little Change in Long-Term Strategic Importance** 25X1

Although excess oil supplies and weak oil demand provide considerable protection against supply disruptions in the near term, industry forecasts indicate that the supply cushion will shrink in the years ahead. Dependence of the industrialized countries on oil from the Persian Gulf is expected to increase by the early 1990s, and they will be more vulnerable to supply cutoffs. 25X1

17 **Vietnam: Rubber Exports for Western Markets** 25X1

As part of its drive to circumvent the US-led embargo, Hanoi is looking to increase exports to the West from a rehabilitated natural rubber industry to earn desperately needed foreign exchange. This export push may increase strains with the Soviet Union because a 1983 agreement with Moscow requires Hanoi to pay for development assistance with exports of raw materials, chiefly rubber. 25X1

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21 **China: Coping With Accelerated Growth**

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Beijing welcomes rapid growth as an indicator that industrial reforms are achieving success but worries that an overheated economy will aggravate shortages of energy and raw materials, strain transportation facilities, and add to inflation. Beijing has adopted a combination of administrative measures and Western-style monetary and fiscal adjustments to bring the economy under control.

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International Economic & Energy Weekly

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Perspective

The Current LDC Financial Situation

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New developments in the LDC debt situation are a cause for increased concern. While impressive gains were made in LDC economic performance last year, they are not likely to be repeated. Moreover, the LDCs' financial situation remains tight, and political frustrations are more and more evident. Although falling interest rates have provided a large measure of relief in debt service, the political perception in some heavily indebted countries is that their financial situation has become too burdensome; many leaders are becoming increasingly outspoken about the need for new approaches to debt relief.

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In 1984 impressive trade gains were made, particularly in Latin America. This export boom restored an element of credit solvency and provided some resurgence in domestic economic growth. The export performance of most major debtors, however, now appears to be waning. We expect exports of the key debtors to decline by $1 billion this year—after a $14 billion surge in 1984. As US expansion slows, and domestic demand in Western Europe remains weak, the LDCs face deteriorating markets for their exports. Depressed commodity prices—and the strong dollar in which many commodities are priced—plus increasing OECD protectionism serve to limit LDC export earnings for a number of countries.

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The deterioration in LDC trade balances is being tempered by falling interest rates. The US prime rate and the six-month LIBOR are at their lowest level since 1978 and are 3 to 4 percentage points lower than last summer. We estimate that the lower rates are reducing total LDC debt service by about $12 billion. The net effect of falling interest rates on the overall LDC current account position will be a savings of about $9 billion annually, however, because of a $3 billion decrease in interest earnings on LDC floating-rate deposits.

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The softening oil market will provide mixed results. Lower oil prices probably will help spur OECD economies, further reduce interest rates, and cut oil import bills for many LDCs. These benefits, however, will occur with a lag and will not be sufficient to restore the financial footing of many nonoil LDCs. In addition, oil-exporting debtors such as Mexico, Egypt, Nigeria, and Indonesia would be seriously hurt by the loss of oil revenues.

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Even though their collective net current account position has not worsened substantially, disappointment over their inability to address creditor nations at the political level and difficulties with IMF-supported programs are heightening debtors' frustrations. As 1985 wears on, democratic governments in Brazil, Argentina, and Peru will face increasing political pressures as economic hardships continue.

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We believe that recent support from Latin leaders—such as Peru's Alan Garcia and Cuba's Castro—and prominent US figures calling for nontraditional approaches to the LDC debt problem may be raising debtors' hopes for a political solution. Moreover, we expect such public discussions to encourage further coalescence in debtors' responses to creditors. In our judgment, with little significant economic improvement foreseen in the coming months, changing political dynamics could lead debtor countries to more actively pursue additional concessions from creditors.

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The Philippines: Holding a Weak Hand for Economic Recovery

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We see no quick return to the politically acceptable 6- to 7-percent growth rates enjoyed in the late 1970s, even though the recent financial rescue package and easing of the IMF austerity program will probably slow the steep decline of the Philippine economy. The process of adjustment has far to go before the country could sustain the $3 billion current account deficit we estimate would result from even 3- to 4-percent annual growth. Slow growth means that President Marcos will continue to be vulnerable to domestic criticism and will have to deal increasingly with social tensions that are an outgrowth of the economic crisis. We believe these factors will combine to undermine his party's chances for victory in critical local elections next May and efforts by the military to contain the rapidly growing Communist insurgency.

The Damage Report

The Philippines continues to endure its worst economic crisis since World War II. The country's debt crisis and repayment moratorium dramatically illustrate the difficulty of doing business with meager levels of foreign exchange. Real GNP contracted by 5.3 percent last year, and bankruptcies and business closings have been widespread—800 of the country's top 2,000 corporations had to cease operations, at least temporarily, during the first quarter of 1985. Fairly reliable estimates put the unemployment rate at nearly 15 percent, about 3 million people. At the same time, less than half of those employed hold full-time jobs.

Real per capita income has now declined for four consecutive years and stands nearly 15 percent below the 1981 peak. Probably the most worrisome development, however, has been the recent lack of private investment. Real gross fixed capital formation fell by one-fourth last year after stagnating during 1982-83. In addition to the chilling effect of 20- to 30-percent average annual interest rates, press reports indicate that foreign and domestic anxieties about the political stability of the Marcos regime have further undermined investor confidence.

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Low international prices for export crops and sluggish local demand have hit insurgent-riddled rural areas hardest. Sugar and coconut prices have fallen 25 and 45 percent, respectively, over the past year. These two commodities provide the bulk of rural employment. In the sugar-dominated economy of Negros Occidental Province, for example, the shutdown of sugar mills is causing mass unemployment, starvation now afflicts many in the province. Such hardship has far reaching political overtones because approximately three-fourths of the 54 million population lives in rural areas.

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The Financial Squeeze

The Philippines "depression" is now largely the result of austerity measures including IMF-supported restrictions on the government budget deficit and growth of the money supply.[1] The budget deficit, for example, has been cut from $775 million in 1982 to just over $105 million last year, and the inflation-adjusted money supply has dropped by 40 percent since the first quarter of

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[1] The Philippines' financial crisis reflects over-borrowing in the face of a declining terms of trade. Agricultural export prices, over the longer term, have failed to keep up with the prices of imported manufactured goods.

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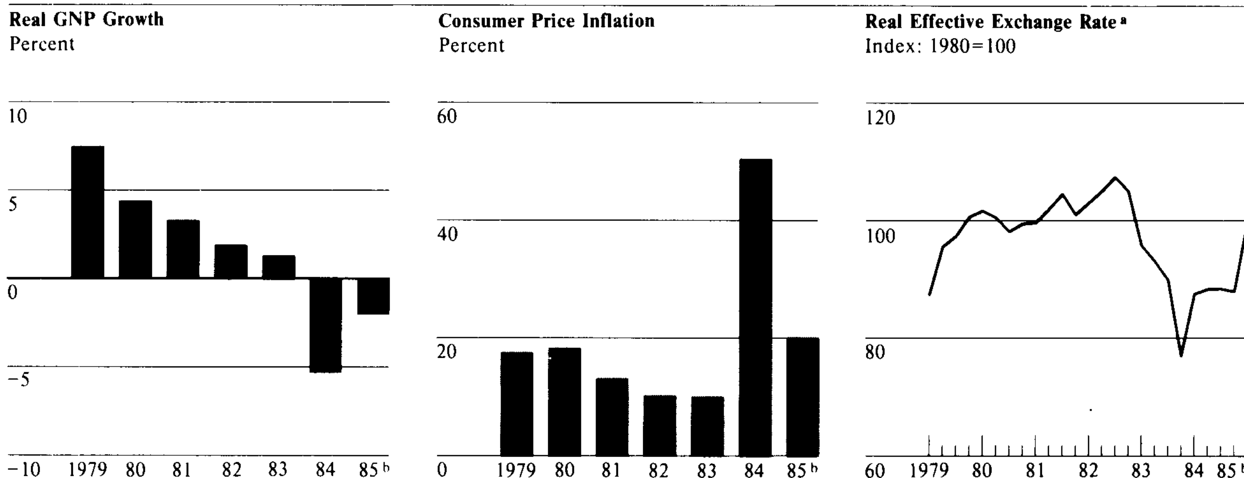
The Philippines: Economic Indicators



[a] Trade weight exchange rate−adjusted for inflation.
[b] Estimated.

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1983.[2] Spending cuts have produced a steep drop in inflation—from a nearly 50-percent annual rate late last year to only a 5-percent annual rate in March 1985, with prices actually declining in April.

We expect the current account deficit to improve from $3.2 billion in 1982 to a projected $1.0 billion this year. Slack demand has cut purchases from abroad sharply, with imports currently running at an annual rate of $4.9 billion, the lowest level since 1978. Export earnings in the first quarter fell nearly 10 percent below last year's already depressed levels. This reflected reduced earnings from coconuts and sugar and an unexpectedly poor showing by electronics products, the country's leading export. In addition to the slump in the US semiconductor industry, press reports indicate that overseas electronics companies are hesitant to place orders with Philippine firms because economic and political uncertainties threaten the industry's tight production schedule. Other significant foreign exchange earners, such as remittances from Filipino workers abroad have performed poorly.

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Part of the reason for the export slump this year is the appreciation of the peso, which has reduced the competitiveness of Philippine products in world markets and discouraged repatriation of export proceeds. The peso has appreciated nearly 15 percent on an inflation-adjusted, trade-weighted basis since last November—an anomaly in the adjustment process that has dismayed the IMF.

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Regulatory factors account for much of the appreciation; legal limits on the foreign exchange holdings of Philippine commercial banks have forced banks to sell foreign exchange in a market where the Central Bank is the only major buyer. Recent rumors that the Central Bank wants the peso to depreciate are persistent, and Manila has taken

[2] All figures in US dollars converted at the February 1985 exchange rate.

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The Philippines: Balance of Payments *Million US $*

	1980	1981	1982	1983	1984	1985 [a]
Current account	**−2,046**	**−2,215**	**−3,211**	**−2,750**	**−1,298**	**−970**
Merchandise trade	−1,938	−2,223	−2,646	−2,482	−679	−110
Exports	5,788	5,722	5,021	5,005	5,391	5,660
Coconut products	807	743	582	694	702	726
Sugar	620	556	415	290	268	250
Imports	7,726	7,945	7,667	7,487	6,070	5,770
Crude petroleum	1,857	2,081	1,784	1,755	1,471	1,400
Net services	−542	−464	−1,039	−740	−855	−1,110
Of which:						
Interest payments [b]	975	1,374	1,911	1,929	2,380	2,504
Net transfers	434	472	474	472	236	250
Capital account	**2,939**	**1,635**	**2,488**	**−648**	**1,406**	**2,035**
Net investment	44	295	17	111	−7	35
Other long-term capital	935	1,110	1,548	1,089	539	1,200
Other short-term capital	2,290	691	1,117	−1,768	623	800
Errors and omissions	−330	−461	−194	−80	251	
Foreign exchange reserves [c]	**2,846**	**2,064**	**885**	**746**	**574**	**483 [d]**

[a] Projected.
[b] Including interest arrears.
[c] End of period.
[d] April.

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some preliminary steps in this direction, including raising the amount of foreign exchange assets commercial banks may hold.

Ingredients of an End to the Slide?

We believe that the signing of Manila's long-stalled financial rescue agreement with nearly 500 private banks in mid-May will provide a modicum of financial relief for the economy. The agreement includes a nine-year $925 million loan, rollover of $3 billion in short-term trade credits, and restructuring of $5.7 billion in principal payments falling due during 1983-85.

Most of the economic benefits from the rescue package will come from the revolving trade credits, which will allow an immediate increase in imports by reducing the cost of import financing. Since the onset of the financial crisis in late 1983, the import shortage has forced firms to delay or cancel production schedules.

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In the meantime, the IMF Executive Board has agreed to some softening of the financial performance conditions set late last year. Under the new terms, Manila can expand reserve money by 15 percent this year, up from 11 percent. The higher ceiling is aimed at building international reserves and allowing the Central Bank to rescue financially ailing banks. Also, Manila has scrapped plans for higher corporate and sales taxes.

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Overall, we expect the Philippine economy to contract by 2 percent this year—albeit an improvement over last year's drop. Nonetheless, we believe that the commercial bank rescue package is unlikely to provide major relief for the economy in the

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short term. The country will use most of the $925 million loan to settle overdue interest payments—leaving only about $225 million to finance imports. In addition, the release of the first $400 million and establishment of the trade facility are contingent on Manila's compliance with the IMF's financial targets for the end of May. Although we expect the IMF will render a favorable verdict, the earliest the Philippines can draw on the funds is early this month because data was not available until late June. By meeting the targets, Manila will also be able to draw $107 million in delayed IMF credits.

Outlook: More Adjustment in Store

The medium-term outlook is clouded by the need for further adjustments. For one thing, the lack of new investment means that the Philippines will find it difficult to support an increase in demand without rekindling inflation or an unacceptable leap in imports. We estimate that the Philippines cannot sustain current account deficits of $3 billion that would develop if the economy grew at a 3- to 4-percent annual rate—still less than the 6 to 7 percent achieved in the late 1970s.

From Marcos's perspective, the political costs of the economic crisis are far from over. The sluggish economy and a projected 3.3-percent annual increase in the Philippine working-age population means that joblessness will continue to increase, contributing to growing worker unrest. Strikes are already increasing rapidly. During the first four months of this year, 31,000 workers staged 127 strikes—an increase of 51 percent over the same period last year.

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The economy will hurt Marcos in local elections next May and presidential elections in 1987. Marcos's ruling party is taking the brunt of the criticism on the economy, a development that is underscored by the opposition's success in increasing its representation from 12 to 59 in last year's National Assembly elections. We also believe the economic crisis will continue to be a valuable asset to the Communist Party, which has made rapid military and political gains in the country's most economically depressed areas.

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Israel: Seeking the Elusive Austerity

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The National Unity government has been only marginally more successful than its predecessors in imposing the austerity needed to bring external deficits under control. Social concerns and political realities have hindered the implementation of a long-term stabilization program and have encouraged the coalition government to devise a series of wage-price package deals acceptable to both labor and producers. The inequities and distortions created by these "quick fixes" have only aggravated underlying economic weaknesses and recently have sparked new strikes and work actions. With the effective collapse of the latest package plan, the government has proposed a host of new austerity measures, but its political will to implement them remains uncertain.

A Failed Agenda

The formation of the National Unity government last September was meant in part to assure bipartisan support for tackling Israel's growing economic morass. Seven years of Likud Party rule had left Israel with soaring inflation and widening external deficits. The political goals of the Begin governments—such as returning the Sinai to Egypt, expanding settlements in the occupied territories, and eventually invading Lebanon to remove the PLO—in themselves were costly for this resource-poor state. Likud added to the economic problems by protecting the voters' pocketbooks to blunt public opposition to its broader political and security strategies. Thus, economic downturns were short lived with private consumption growing sharply.

The new coalition government—with Labor and Likud controlling at least 85 of the Knesset's 120 seats—possessed the political clout to push through a long overdue austerity program. Moreover, consumers were psychologically prepared for such a move—the memory of the bank shares collapse in October 1983 was a costly example to Israelis that living beyond their means had to end.

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The government acted quickly upon entering office, proposing substantial budget cuts, devaluing the shekel by 8.3 percent, and raising energy prices 9 percent. The next step was to seek a wage-price accord to cool inflationary expectations and give the government time to develop a more comprehensive economic program. After weeks of squabbling, Prime Minister Peres's personal intervention finally resulted in the first package deal. As modest and inconclusive as these moves were, they nonetheless paid some shortrun dividends in terms of a needed economic slowdown:

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- The slide into hyperinflation slowed as the monthly CPI dropped to 3.7 percent and 5.3 percent in December and January, respectively, compared with monthly rates exceeding 20 percent before the accord.
- Real wages began to erode rapidly because of temporary modifications in the indexing system.
- Consumption also dropped sharply in the last quarter of 1984, resulting in a 5-percent decline for the entire year.
- Unemployment grew to 6.9 percent in the last quarter, with the 5.9-percent yearly rate for 1984 the highest in nearly two decades.

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The government failed, however, to use the breathing space provided by this accord—as well as the early provision of US economic aid—to implement a more lasting stabilization program. Moreover, it encountered great difficulty in executing the bud-

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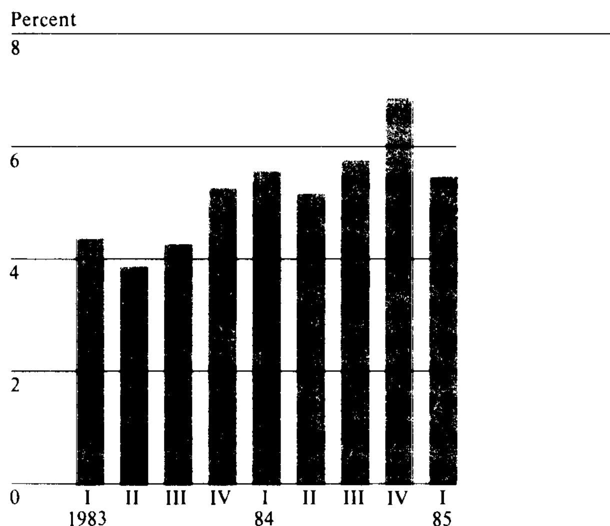
Israel: Unemployment Rate, 1983-85



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get cuts initially agreed upon. What few cuts actually occurred were soon negated by revenue shortfalls and rising expenditures on subsidies because of the inclusion of government goods and services in the price freeze.

The coalition frittered away the last month of Package 1 seeking minor, politically palatable ways to correct its deficiencies and since then has adhered to this quick-fix approach. Package 2, Package 2a, and the spate of additional measures—tax hikes, higher travel fees, import restrictions, and the like—were merely cut-and-paste attempts to close the budget deficit, halt foreign exchange losses, and recapture the public optimism generated in the first weeks of Package 1.

The one clear opportunity for action—the 1985 budget commencing 1 April—was also wasted. The $23.3 billion budget agreed to was slightly higher than the budget passed in 1984. This year's budget aims at reducing the deficit largely by continuing subsidy cuts—eliminating most of last year's overspending—by increasing fees and taxes, and only partly by reducing other expenditures.

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The coalition's waffling already is beginning to reverse the achievements recorded in the last quarter of 1984:

- Inflation averaged almost 13 percent per month between February and May and may have exceeded 20 percent last month.
- Preliminary estimates for the first quarter of 1985 show the unemployment rate dropping sharply to 5.5 percent.
- Private consumption shows signs of reviving somewhat instead of falling as predicted, due in part to periodic upswings in imports of durable goods.

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Political Constraints

The government's continuing inaction on the economy is largely the result of severe political constraints. The most obvious shortcoming is the failure of the two major parties to set aside ideological differences—Likud tends to favor free enterprise while Labor espouses a quasi-socialist philosophy—and present a united front.

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In addition, political posturing has plagued economic strategy sessions because the specter of an early national election continues to encourage Labor and Likud leaders to move cautiously. The fragility of the coalition—deriving directly from the uneasy Labor-Likud association—makes the government's early demise a possibility.

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Another issue that compounded the paralysis in economic decision making was the mid-May election in Israel's dominant labor confederation, the Histadrut, that embraces nearly 90 percent of the work force. Although Histadrut is controlled by Labor, Likud had made unexpected inroads in past elections, and both parties felt compelled to play to their constituencies. This was the major factor leading to the revisions of Package 2—in particular the two-month price freeze that, to no great surprise, lasted until shortly after the election.

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Israeli Package Deals

Program	*Key Measures*
Package 1 (4 Nov 1984–4 Feb 1985)	*Prices of all goods and services frozen at 2 November level. The 2 November exchange rate used to determine import prices. Cost-of-living allowances for wages held to two-thirds of existing indexation system. A 5-percent income tax credit for three months starting in February.*
Package 2 (4 Feb 1985–4 Oct 1985)	*Immediate price hikes of 25 to 55 percent for fuel, water, public transportation, and basic foodstuffs due to subsidy cuts. Additional hikes of 12 to 13 percent on average expected later. Lump sum payments to workers for two months equal to one-third anticipated CPI rise of 6 percent. Normal indexation for CPI rise above 6 percent. Price boosts for nonsubsidized goods held to a one-time 5-percent hike followed by monthly increases of 3 to 5 percent thereafter. Exemption of government goods, services, fees, and taxes from price controls. Higher travel tax, increased deposits on imports, boosted property taxes, and the elimination of interest payments on some types of saving schemes.*
Package 2a	*Price hikes averaging 7 percent on 1 April to be followed by a two-month price freeze. Additional price adjustments equal to 80 percent of shekel devaluation in June followed by another two-month price freeze. Supplemented in mid-May by a hike in the VAT; a doubling of the travel tax; and a freeze on public-sector hiring, wages (excluding normal indexation), and contracts.*

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Election paranoia essentially prevents any politician from being linked directly to policies leading to rising unemployment and falling living standards, both of which would necessarily result from the major reforms needed to resolve Israel's economic crisis. Indeed, an unwritten tenet in Israel is that the economy must remain strong enough not only to continue attracting new Jewish immigrants but also to prevent an outflow of those now residing in the state. An upturn in emigration last year coupled with the recent wave of labor unrest no doubt weighs heavily on the minds of Israeli decisionmakers.

But Are the Cows Sacred?

We believe the government can and must implement a tougher austerity program. Many political constraints at the moment are more illusory than real. The Histadrut election is over, and the threat of an early national election appears to have receded. Recent public opinion polls suggest that Prime Minister Peres's opportunity to force a new election in hopes of forming a labor-dominated government has passed. And Vice Prime Minister Shamir—the Likud leader—clearly recognizes that his best hope

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The ATA Dilemma

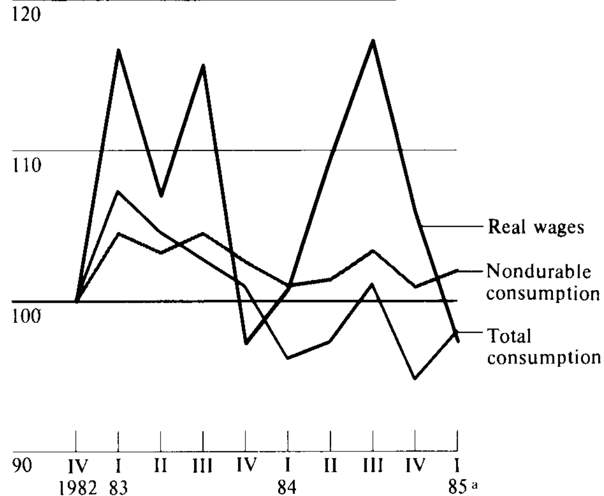
The problem Israeli governments have in coping with austerity is demonstrated by the troubles surrounding the ATA textile firm. This company located near Haifa, employs about 2,200 people as well as indirectly offering support to numerous small businesses nearby. The plant is nearly 50 years old and for several years has lost money because it cannot compete effectively with newer, more efficient textile plants worldwide. [redacted] [redacted] *is about $20 million in debt and would require an additional $20 million to upgrade.* [redacted]

Israeli governments have not let the plant die because of the limited employment opportunities in the immediate vicinity for such a large number of employees. At least several million dollars of government funds already have been pumped into the plant over the past couple of years to stave off closure. Nonetheless, about 400 employees were released in March. [redacted]

Sharp divisions within the coalition exist as to how to handle the situation. Peres would like to keep the company going although some of his economic advisers, including Finance Minister Modai, wish to do nothing. Industry Minister Sharon has unsuccessfully sought to obtain government funding to help find a private buyer. Histadrut leader Kessar has supported the Sharon plan and proposed that the union confederation buy some of the company's assets, particularly land, to help raise funds. [redacted]

The issue has been complicated by a 28 May ruling in the Haifa district court to close the plant. ATA workers immediately barricaded themselves in the plant, and some began a hunger strike. Press coverage of the protesters, who include Holocaust survivors, is generating a great deal of public sympathy. On 30 May an estimated 1.3 million Histadrut members staged a one-hour strike to demonstrate solidarity. The ATA plant has become a test case on unemployment for the National Unity government. [redacted]

Israel: Private Consumption and Real Wages, 1983-85



a First quarter 1985 is a preliminary estimate.

[redacted]

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of assuming power is to wait for his turn in the prime-ministership in the fall of 1986 under the terms of the coalition agreement. [redacted]

In addition, we believe that consumers would accept a further dose of austerity, despite official claims of the severity of last year's downturn:

- Although real wages plummeted in the final quarter for the year, they finished only slightly below the 1983 level.
- The "unprecedented" drop in consumption was due largely to reduced imports of consumer durables such as TVs, VCRs, and cars. Consumption of most other goods was much less affected.
- A thriving "underground" economy allows many Israelis to circumvent official policies. For example, last year's wage decline was surprisingly

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accompanied by a sharp rise in the private savings rate according to the IMF and Bank of Israel. Thus, a comfortable nest egg still exists for many Israeli citizens.

The government may be deterred by recent work actions instigated by both labor and producers. To date, much of the unrest, however, reflects the concerns of those most heavily hit by the inequities resulting from wage-price accords, and this unrest does not necessarily imply that the populace will not tolerate any erosion of living standards. Strikes or shutdowns by taxi drivers, truckers, gas station dealers, and food producers, for example, stemmed from growing losses directly attributable to price ceilings. The sudden surge of work actions by public workers probably arose out of the latest government machinations that give tax breaks and hints at better job security to workers in the "producing sectors" of the economy. And strikes by teachers and textile workers can be partly linked to some policies that predate the National Unity government.

Outlook

With the effective collapse of Package 2, the government has approved a new plan for more equitably applied economic stabilization. Its main features are:

- Reducing government spending by $750 million on an annual basis.
- Imposing additional taxes on corporations, self-employed individuals, and luxury apartments.
- Reducing public-sector employment in selected ministries.
- Allowing price increases to correct for subsidy reductions along with partial real wage compensation, to be followed by a three-month general wage-price freeze.
- Devaluing the shekel by nearly 19 percent.

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Reaction to the new austerity plan predictably has been sharply critical. Cabinet voting split essentially along party lines as seven of 10 Likud members opposed it, and most Labor members voted in favor. In addition, the Histadrut argues that the plan disadvantages workers. Histadrut has called for a national strike as a show of force against the plan, but support for it appears to be diminishing.

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Prime Minister Peres continued high-profile personal intervention will be imperative to maximum prospects for implementing the new program.

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Persian Gulf Oil: Little Change in Long-Term Strategic Importance

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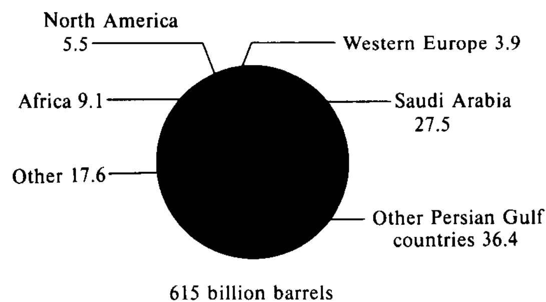
Although the present combination of excess oil supplies and weak oil demand provides considerable protection against supply disruptions in the near term, industry forecasts indicate that the supply cushion will shrink in the years ahead. The dependence of the industrialized countries on oil from the Persian Gulf is expected to increase by the early 1990s because of rising consumption and lower oil production. At the same time, they will be more vulnerable to supply cutoffs and renewed upward pressure on oil prices despite the success of policies to conserve energy, diversify away from oil, and build strategic oil stockpiles. Weak market conditions, however, are causing some complacency in consuming countries and are reducing incentives to invest in new productive capacity.

Non-Communist Proved Oil Reserves, Yearend 1984



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Dependence on Persian Gulf Oil Supplies

The Persian Gulf region remains a critical source of oil supplies for the non-Communist world. The Persian Gulf countries produced an estimated 12 million b/d in 1984, roughly 25 percent of total non-Communist output while available productive capacity approximates 17 million b/d. Currently, nearly 80 percent of the supply cushion is in Saudi Arabia. Despite lower use and increased production, OECD countries as a group still relied on the Persian Gulf for about one-fifth of total consumption in 1984. US oil imports from Persian Gulf countries were 500,000 b/d—roughly 3 percent of consumption. Western Europe and Japan are more dependent, relying on the Persian Gulf countries for about 25 percent and 60 percent of oil requirements, respectively.

Both developed and developing countries will remain highly dependent on oil from the volatile Persian Gulf. We expect that at least one-fourth of total non-Communist supplies will continue to pass through the Strait of Hormuz into the mid-1990s. Even the United States—despite its sizable oil stockpile—would not be immune to an oil supply disruption. A rise in world oil prices would cause an equivalent increase in domestic US prices. IEA members have agreed in principle that any shortfall would be shared.

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The Outlook to 1995

Most market forecasts project that the non-Communist world will experience real economic growth of about 3 percent per annum in 1985-95 and that oil prices will fall in real terms through 1990 and then hold fairly steady for the next five years:

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- Non-Communist oil consumption is expected to rise slowly through the mid-1990s. Most of the growth in oil use is expected to occur in the less developed countries while consumption in OECD countries holds steady or rises slightly.

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Non-Communist Oil Production and Available Capacity, 1984

Million b/d

	Production	Available Capacity	Surplus Capacity
Total	**45.0**	**53.3**	**8.3**
OPEC	18.9	26.8	7.9
Persian Gulf	11.6	17.2	5.6
Iran	2.4	3.2	0.8
Iraq	1.2	1.2	0
Kuwait	0.9	1.3	0.4
Qatar	0.4	0.6	0.2
Saudi Arabia	4.4	8.0	3.6
United Arab Emirates	1.2	1.7	0.5
Neutral Zone	0.5	0.6	0.1
Natural gas liquids	0.6	0.6	0
Non-Persian Gulf	7.4	9.6	2.2
Algeria	0.7	0.8	0.1
Ecuador	0.3	0.3	0
Gabon	0.2	0.2	0
Indonesia	1.4	1.6	0.2
Libya	1.1	1.8	0.7
Nigeria	1.4	2.2	0.8
Venezuela	1.7	2.2	0.5
Natural gas liquids	0.6	0.6	0
Non-OPEC [a]	26.1	26.5	0.4

[a] Excludes refinery gain of about 600,000 b/d.

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- Most forecasters expect non-OPEC supplies to trend downward. According to most industry forecasts, higher LDC output will be more than offset by lower production in the United States and Western Europe and a decline in net exports from Communist countries.

Reduced spending on development and maintenance of oil productive capacity in OPEC countries has already caused available capacity to decline 8 million b/d from its 1977 peak of nearly 35 million b/d. Given our estimate of demand for OPEC oil, surplus available capacity will range from 2 to 5 million b/d in the early-to-mid-1990s. Industry analysts believe 2-3 million b/d of spare capacity is needed to ensure price stability. Industry assessments indicate that surplus production capacity will become increasingly concentrated in the Persian Gulf region.

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Future Import Dependence and Vulnerabilities

We expect that US oil import dependence will rise, and other major developed countries will remain

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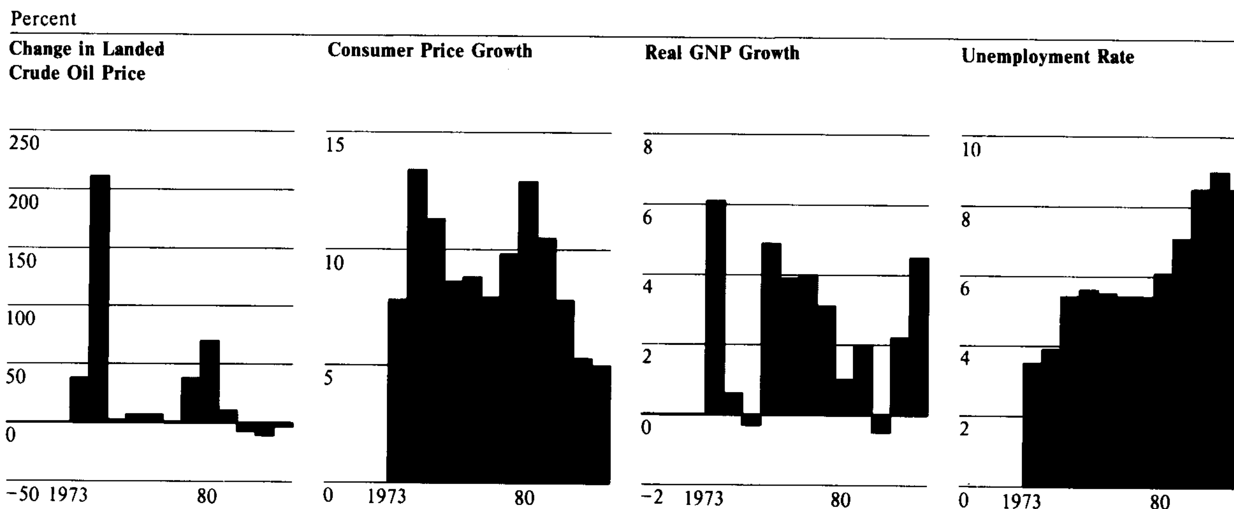
OECD: Economic Indicators and Oil Price Trends, 1973-84



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heavily dependent on oil imports—particularly from the Middle East—through the mid-1990s. Nearly 65 percent of total non-Communist oil reserves are located in Persian Gulf countries:

- US oil imports will be more than one-third of oil consumption by 1995, according to industry studies.
- Western Europe will rely on imports for about three-fourths of oil requirements.
- Japan will remain virtually totally dependent on foreign supplies.

Industrialized countries have considerable protection against a short-term oil supply disruption because available surplus capacity is about 9 million b/d this year. Only some 2-3 million b/d of that surplus, however, is outside the Persian Gulf. As excess productive capacity erodes, the non-Communist world will face increased reliance on Persian Gulf oil supplies. Under these circumstances even a relatively minor disruption could trigger another crisis.

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Producing Country Policies and Interests

The availability of alternate oil supplies in the event of a disruption depends in large part on the willingness of countries with excess capacity to increase output. The Persian Gulf countries are not homogeneous in production capabilities or policies. Because Saudi Arabia accounts for the largest portion of this excess capacity, an early decision by Riyadh to raise production to offset a supply shortfall in a disruption—assuming Saudi production and export capabilities were still intact—would be critical to minimize market uncertainty and upward pressure on oil prices.

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Oil Supply and Demand Projections *Million b/d*

	1984 Preliminary	1995	
		Range	Midrange
Non-Communist oil consumption	45.7	49.5-53.5	51.0
Of which:			
United States	15.7	14.5-16.5	15.8
Western Europe	11.5	11.8-12.6	12.1
Japan	4.5	4.1-4.8	4.5
Oil supplies [a]	45.7	49.5-53.5	51.0
Of which:			
OPEC	18.9	21.3-29.2	25.5
Non-OPEC	26.1	24.2-29.4	25.5
Of which:			
United States	10.4	7.6-8.9	8.6
Western Europe	3.8	2.7-3.6	3.1
Net Communist exports	1.6	−2.0-1.9	1.3
Net import requirements			
United States	4.7		6.6
Western Europe	7.7		9.1
Japan	4.5		4.5

[a] Total oil supply figure includes refinery gain.

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Decisions taken by Saudi Arabia and each of the other Persian Gulf oil-producing countries regarding their oil productive capacities and price policy will influence the future path of oil prices, even in the absence of an oil supply disruption. The precise role each of these countries will play is difficult to assess, but, because Riyadh has an interest in preserving a long-run market for Saudi oil, Saudi price policy probably is more complementary to the interests of the oil-consuming nations than other producers with larger populations and lower oil reserves. The negative effects of past supply disruptions and the resulting decline in the demand for OPEC oil in recent years appear to have reinforced the Saudi belief that major oil producers and consumers have a common interest in world oil price stability.

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Vietnam: Rubber Exports for Western Markets

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As part of its drive to circumvent the US-led international trade and aid embargo, Hanoi is looking to increase exports to the West from a rehabilitated natural rubber industry to earn desperately needed foreign exchange. Vietnam has already had modest success in reviving neglected and war-damaged plantations in the south, and, over the next two years, we expect Hanoi to accelerate attempts to obtain modern rubber-processing equipment and technology from the West and possibly seek to join the International Natural Rubber Organization (INRO). This export push may increase strains with the Soviet Union because a 1983 agreement with Moscow requires Hanoi to pay for development assistance with exports of raw materials, chiefly rubber.

Rubber Rehabilitation Strategy

In the mid-1960s the natural rubber industry in South Vietnam—although small by international standards—was the country's top foreign exchange earner. The French-owned plantations produced a high-yield, premium-priced latex. The Vietnam war, however, cut the area under cultivation by two-thirds to about 40,000 hectares in the early 1970s, with production and exports dropping proportionately. Much of the rubber-processing equipment was also destroyed.

Hanoi's initial efforts at renovation after taking control of South Vietnam in 1975 proved disastrous. Nationalizing the plantations and processing companies drove out the remaining French managerial and technical talent. Many of the skilled Vietnamese workers also fled the country, and a large share of the hundreds of thousands of unemployed who were moved to rubber-growing areas without adequate provisions and shelter soon left, preferring life as undocumented urban residents. In addition, the Vietnamese invasion of Cambodia in 1978 cut Hanoi off from international development aid, technology, and potential markets. As a result, as many as 80 percent of the trees planted in 1976-79 died, according to Vietnamese press accounts.

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The situation improved somewhat in the early 1980s because of a combination of incentive-based economic reforms and a sharp increase in Soviet Bloc aid aimed specifically at the rubber sector. With Moscow's help, Hanoi drew up systematic plans for renovating existing plantations and expanding the area under cultivation. The Soviet Union and Bulgaria agreed to supply material and equipment for planting 70,000 hectares of rubber, effectively doubling productive capacity. Moscow, moreover, provided the tractors, fertilizer, technology, petroleum, and markets Hanoi could no longer get from the West.

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On the labor side, workers at rubber plantations designated as new economic zones were better provisioned, and a performance-based incentive system was introduced for planters, maintenance workers, and tappers. Hanoi also used division-sized army units to clear and plant rubber estates, according to refugee reporting.

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Progress So Far

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Vietnamese statistics indicate that recent efforts have begun to pay off. Beginning in 1981, planting accelerated sharply, and maintenance improved in response to higher procurement prices and other incentives. The area planted to rubber has trebled since 1975 and now approaches the level of the mid-1960s, according to Vietnamese statistics.[1] Exports, largely to the Soviet Bloc, totaled 45,000

[1] Yields, even on model estates, remain well below prewar levels.

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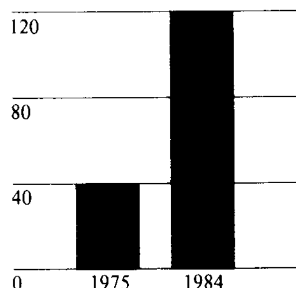
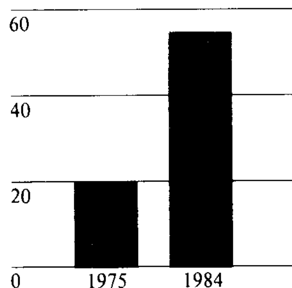
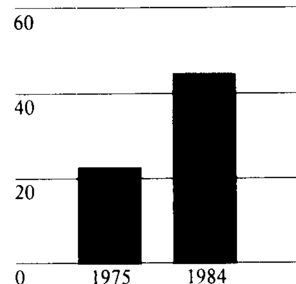
Vietnam: Rubber and Industry Recovery, 1975-84

Note scale change







[a] 1975 area excludes abandoned plantations.

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metric tons last year—about double since 1975. A few thousand tons were sold on international markets.

Although the survival rate of new trees is still low by industry standards, a substantial proportion planted since 1980 should begin producing latex in the next two to three years. Domestic use of rubber—for tires, shoes, and insulation—will probably expand, but Hanoi clearly intends to export most of the increased production for hard currency.

Hanoi hopes soon to export rubber and other crops to the West to ease Vietnam's hard currency debt burden.[2] Top Politburo members, moreover, have characterized rubber exports as a matter of "strategic significance."

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Eying International Markets

Hanoi is likely to find boosting rubber sales to the West more difficult than increasing production. Vietnamese officials admit that processing equipment is dilapidated and quality control poor. Hanoi will thus be forced to sell in the low end of an increasingly high-quality, standardized market. Moreover, world demand for rubber remains depressed, and Hanoi faces sharp competition from higher quality latex produced by Malaysia, Thailand, and Indonesia—the dominant rubber producers. Marketing—particularly competitive pricing—remains an alien concept to the Vietnamese.

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Nonetheless, to circumvent the US-led international trade and aid embargo, Hanoi is likely to try over the next year a variety of tactics to improve its prospects of selling rubber to the West:

- Stepping up efforts to obtain modern rubber-processing technology from companies based in Malaysia and Singapore.
- Encouraging Western investment in joint ventures to produce rubber products. Hanoi is already talking about establishing a modern tire factory in Ho Chi Minh City.
- Attempting to join INRO to improve its image as a natural rubber producer. Stiff opposition is expected from Malaysia, Thailand, and Indonesia, who oppose Hanoi's Cambodia policy.

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[2] Hanoi has been in de facto default on its $1.7 billion hard currency debt since 1982. The IMF in January suspended Vietnam's access to the Fund's general resources because of arrearages of about $30 million.

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New Hard Currency Export Push

Hanoi over the past few months has taken several halting, but nonetheless important, steps to boost foreign exchange earnings and regain access to Western credit markets. We believe these moves are part of a general policy to reduce the resources devoted to the occupation of Cambodia in order to get started on the 1986-90 economic plan:

Hanoi is encouraging West European countries to establish joint ventures.

- *Hanoi hopes to send Vietnamese guest workers to France and Italy to earn foreign exchange.*
- *Hanoi devalued the currency by 90 percent early this year in an attempt to boost exports.*
- *Possibly to pave the way for an approach to the IMF, the Politburo last month ratified long-debated measures to curtail expensive food and salary subsidies.*

- Expanding markets for rubber exports to Western Europe on both a cash and countertrade basis. Earlier this year Hanoi offered to pay for Spanish and Portuguese goods with rubber and rubber products.

Straining Soviet Relations?

A major stumblingblock to hard currency rubber exports is a 1983 long-term economic cooperation agreement with the Soviet Union. Under this agreement, we believe Hanoi promised to export increasing quantities of raw materials—including rubber—to the Soviet Union as payment for economic aid. Although we have no reason to believe Moscow opposes Hanoi's quest for trade with the West, the Soviets probably will put pressure on the Vietnamese to live up to the terms of the agreement.

We thus expect Vietnam to have moderate success in boosting rubber sales to the West over the next few years. Although the additional foreign exchange will by no means solve Vietnam's debt problem, it will help ease critical shortages of food, fertilizer, and fuel. Moreover, the experience gained in this venture can—if Hanoi takes advantage of it—be transferred to the marketing of other products in the West.

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China: Coping With Accelerated Growth

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China's industrial output has been accelerating since 1983. Beijing welcomes rapid growth as an indicator that industrial reforms are achieving success but worries that an overheated economy will aggravate shortages of energy and raw materials, strain transportation facilities, and add to inflation. Unlike in the past, when reforms were halted in the face of problems, Beijing has adopted a combination of administrative measures and Western-style monetary and fiscal adjustments to bring the economy under control. Growing worker expectations of improved living standards and the view of managers and local officials that rapid growth is the key measure of their performance, however, may make it more difficult to slow the economy than Beijing anticipates.

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China: Economic Performance *Percent change except where noted*

	1982	1983	1984	1985
Industrial output	7.7	10.5	14.0	23.0 [a]
Light industry	5.7	8.7	13.9	26.0 [a]
Heavy industry	9.8	12.4	14.1	21.0 [a]
Agricultural output	11.0	9.5	14.5	NA
National income	8.3	9.1	12.0	NA
Steel	4.4	7.7	8.4	6.0 [a]
Oil	1.0	3.9	8.0	10.3 [a]
Coal	7.1	7.4	8.0	10.3 [a]
Electricity	5.9	7.2	6.6	8.0 [a]
Retail prices	1.9	1.5	2.8	NA
Current account balance [b] (*billion US $*)	7.7	5.4	1.4	NA
Foreign exchange (*billion US $*)	11.3	14.9	15.1	11.2 [c]

[a] First-quarter output at an annual rate.
[b] CIA estimates.
[c] End of March foreign exchange balance.

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Causes of the Growth

We believe that the rapid industrial growth has been caused, in part, by sharp increases in personal income and investment spending. According to a PRC-controlled Hong Kong newspaper, in first quarter 1985, urban wage bills and bonus payments by state-run enterprises grew at annual rates of 41 percent and 104 percent, respectively, while capital investment rose at a 33-percent rate. This followed a 19-percent hike in wages and bonuses and a 22-percent jump in capital investment in 1984. Much of the growth in income and investment spending in 1984 was funded by domestic bank loans, and we believe the money supply grew much faster than planned.

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Bumper harvests—largely the result of agricultural reforms implemented during the past six years—have increased the availability of raw materials for industrial use, while boosting rural incomes and fueling consumer demand. China's economy probably has also benefited from efficiency gains caused by the appointment of better educated, technically competent managers and Beijing's increased emphasis on enterprise profitability. In addition, higher production was spurred by increased ability to sell over-quota production at prices above the state-set levels. The gradual extension of industrial reforms over the last few years has also had a positive impact.

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Dangers Ahead

Although welcoming the surge in industrial output as an indicator that policies are on track, Chinese leaders have expressed concern that such rapid expansion will exacerbate long-standing problems in the economy and, in fact, undermine reform efforts. Despite impressive increases in the production of coal, oil, and electricity in the first quarter,

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Economic Reform in China

In the last six years Beijing has implemented economic reforms that reduce the scope of central planning while placing greater reliance on market signals to guide China's economy. Although economic reform will not transform China into a capitalist country, it does represent a sharp break with orthodox Marxist economic practices.

Agricultural Reforms

The "household responsibility system" that was introduced in 1979 gave peasant families effective control—but not ownership—over farmland, allowed peasants to lease land, and gave them leeway to manage the land as they wanted. Peasants, in return, had to meet production quotas but could sell above-quota output to the state at premium prices or market it themselves. To encourage greater production, in the spring of 1979, Beijing raised procurement prices of all major farm products.

Industrial Reforms

Experiments with industrial reforms have been under way since 1979. In October 1984, the party formally approved a broad set of measures that are designed to improve industrial performance. The new policies will diminish the scope of central planning: only major products—such as steel, petroleum, and chemicals—will remain under mandatory state production quotas. Most other goods will be produced under state "guidance" plans flexible enough to enable enterprises to adjust to changing market conditions. Some consumer items, many agricultural products, and the over-quota production of most goods will be traded in essentially unregulated markets.

A major goal this year is to increase the authority of enterprise managers and reduce the control of party and government officials over decisionmaking in factories. Managers already have more leeway to develop production and marketing strategies and set prices and wages and are increasingly held accountable for profits and losses. Competition between enterprises is encouraged.

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Beijing has begun to adjust domestic prices by instituting a three-tiered price structure. Prices of key products, such as coal and steel, will still be set by the state but at levels that better reflect relative scarcities. The prices of many other products will fluctuate within bounds set by the state. Supply and demand alone will determine the prices of minor consumer goods and over-quota production of industrial goods.

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This summer China plans to introduce a wage system that will link workers' wages and bonuses with the economic results of their enterprises. Enterprise wage funds will float upward or downward based on profits and the amount of taxes delivered to the state. More productive workers will receive higher pay, and wages will also reflect seniority, the cost of living, and skills in demand.

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Beijing has eliminated the system under which enterprises were required to turn over all profits to the state. Enterprises now pay a share of their profits in taxes, and enterprise managers have considerable leeway to use aftertax profits for worker bonuses or investment.

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Reform leaders intend to transform China's banks from fund disbursing organs to independent banks—responsible for their own profits and losses—that operate under broad state supervision. Beijing is also encouraging the development of private credit institutions in the countryside as a supplement to the rural banking system.

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energy supplies are strained. Additions to the transportation network have not kept pace with the growth in industrial output, and the system remains seriously overburdened. Chinese media report that factories must suspend production occasionally for lack of electricity and raw materials.

Growth has also been accompanied by a rapid rise in imports. According to Premier Zhao Ziyang, recent output levels were possible only because China imported large amounts of raw materials. Imports of rolled steel last year, for example, were equivalent to about one-third of China's total steel production for the year, yet China's machinery industries still face shortages of rolled steel, as well as pig iron, copper, zinc, and other raw materials. Large imports, moreover, are cutting into China's foreign exchange holdings, which dropped by $5.5 billion since last September.

Inflation is a growing concern as the high demand for consumer goods, equipment, and building materials continues to outstrip production. Rising prices fueled by excess demand for finished goods and raw materials threaten public acceptance of the overall reform program.

Beijing seems especially concerned that recent economic successes may have induced local officials to set unreasonably high production targets, fearing that undue emphasis on growth will cause resources to be used wastefully. Chinese media report rising production costs, wearing out of equipment, increasing occupational hazards, and worsening pollution.

Measures To Slow the Boom

Beijing is moving to cool the overheated economy by implementing a combination of administrative controls and Western-style macroeconomic adjustments. China's 1985 budget, announced in March, calls for slowing the rate of growth of government spending, reducing administrative expenditures by government units, and narrowing the budget deficit. Beijing is also attempting to ease inflationary pressures by absorbing excess currency. According to press reports, Beijing this year is importing $2 billion worth of consumer goods—such as color TVs, refrigerators, and cars—and selling them in state-run stores. In April, Beijing raised interest rates on time deposits held by individuals and enterprises. Rates on loans for working funds and capital construction also were raised, and officials have stated their intention to raise rates for other types of loans soon.

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Beijing is tightening control of the banking system and the People's Bank of China, its central bank, in particular:

- The People's Bank will now set quarterly credit limits for its branches and China's specialized banks.
- Banks have been ordered to stop offering loans to inefficient enterprises and firms that produce poor-quality products for which there is little demand.
- No loans are to be extended for capital construction projects for which spending exceeds the state quota or for projects not listed in the state plan.
- Banks also have been ordered to make a better effort at collecting overdue loans, and a new regulation allows banks to take over assets of borrowers who cannot repay their loans.

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To prevent indiscriminate increases in wages and bonuses, enterprises must now establish special accounts for their wage funds, which will be monitored by the banks. Beijing has also ordered more rigorous efforts to recover back taxes on worker bonuses and has suggested that it will implement a tax on personal income above a designated level. Since 1 April no departments or work units have been allowed to increase their payrolls, and changes will not be permitted until this month.

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Outlook

We believe that these policies will achieve some success in slowing industrial growth. Nevertheless, the task will be more difficult than Beijing anticipates. Exhortations to "get rich" through hard

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work are generating rising expectations among workers for an increase in their standard of living. Moreover, many local officials view "reform" as synonymous with rapid growth in output and will continue pressuring enterprise managers to prove their competence by increasing production. Consumer spending will remain high for some time because of peasants' large cash holdings and the widespread expectation that prices will rise further.

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Beijing is determined to slow the economy gradually by strenghtening oversight and control without backtracking on fundamental reforms. This response seems to us qualitatively different from past reactions to similar economic problems. Beijing is proceeding with the reform program—implementing politically sensitive hikes in urban food prices, pressing ahead with management reforms, and reiterating its intention to implement wage reforms in July.

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Despite the gains from Beijing's policies, most of the industrial reforms remain controversial and therefore vulnerable to political setbacks. Reforms must be deepened and the contradictions resolved between managerial autonomy and the lack of market discipline for enterprises that make poor choices. Otherwise, rapid industrial growth will strain government revenues and foreign exchange holdings, energy and transport bottlenecks will worsen, and inflation will increase.

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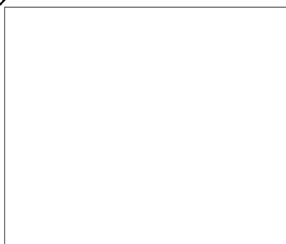
Briefs

Energy

UK Oil Technology Development



London has initiated a policy requiring that foreign oil companies seeking new offshore licenses must be willing to involve UK industry in new offshore technology and R&D projects through joint ventures or licensing arrangements. Similar policies have existed for some time in Norway and other countries. In the first test of the new policy, Royal-Dutch Shell—at the behest of the UK Department of Energy—pressured Bechtel GB Ltd. to form a joint venture with Britain's Wimpey Offshore Engineers to compete on the design contract for the Gannet/Kittiwate field in the central North Sea. The new UK policy will help Britain become more competitive in the worldwide offshore oil equipment and services market later this decade when most analysts see the next major market resurgence. These gains will be largely at the expense of the already troubled US petroleum equipment and services industry.

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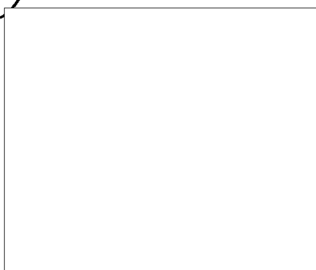
Norwegian Gas Sales Negotiations



Natural gas sales by Statoil—the Norwegian state oil company—to a consortium of West European buyers are progressing well, according to recent press reports The two sides tentatively have agreed that deliveries under a proposed 20-year contract will start in 1995. Volumes are to rise gradually to 15 billion cubic meters annually with an option to increase deliveries after 2000. Although the bulk of this gas will come from the Troll field, gas from other fields will be supplied as well. Questions on price and seasonal deliveries will be addressed in September. Statoil is optimistic that agreement can be reached by the end of the year, but past negotiations suggest these talks could take much longer. If agreement is reached, Continental West European dependence on Soviet gas in 2000 could be reduced to about 30 percent of consumption compared with nearly 40 percent if North Sea gas resources are not developed.

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PEMEX Increasing Safety Measures

Mexico's state-owned oil company PEMEX has stepped up the purchase and installation of safety equipment as a direct result of last year's explosion at a Mexico City gas storage facility. Financial constraints, however, including downward pressures on oil prices, may slow PEMEX's plans.

the Mexican press reports that PEMEX plans to hire over 5,000 additional workers to increase maintainence of outdated equipment. Despite financial problems, the public outcry after the San Juan Ixhuatepec disaster is likely to keep pressure on PEMEX to increase safety at its notoriously dangerous facilities.

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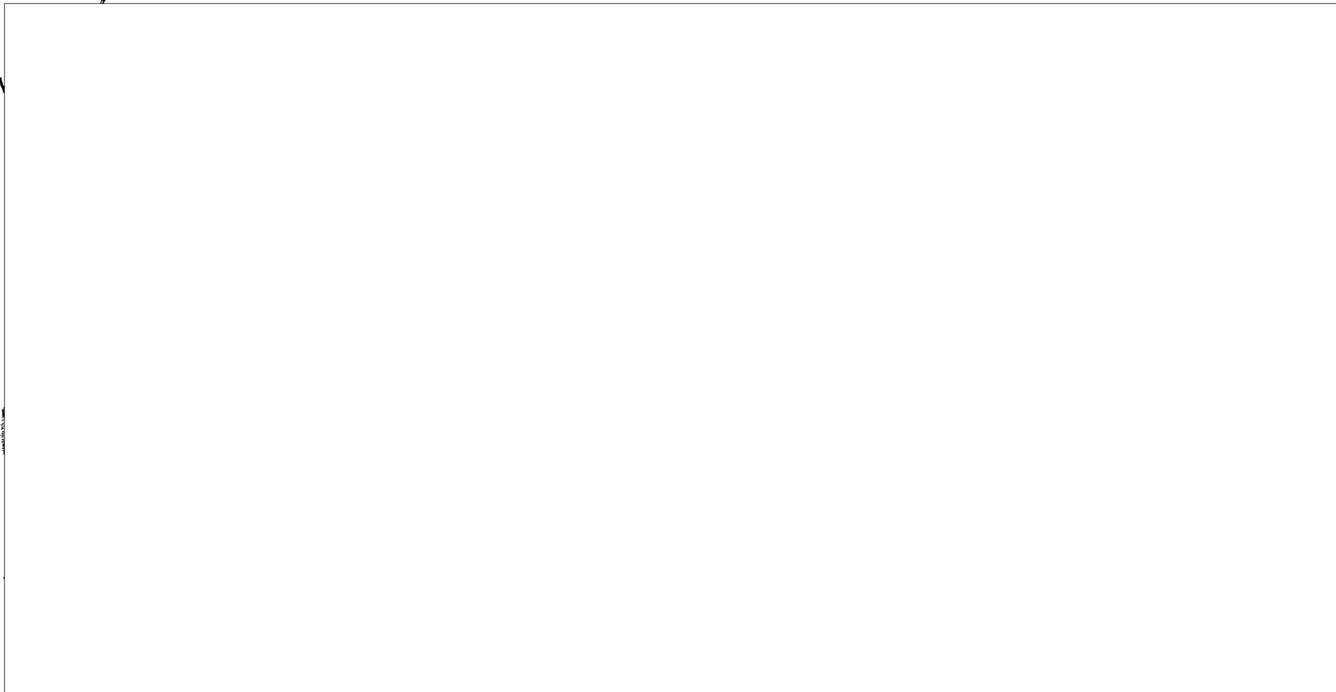

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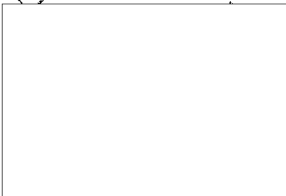
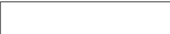
Moroccan Oil Supply Update



Morocco's oil import mix reflects Rabat's increasing dependence on concessional oil arrangemets. Deals with Saudi Arabia, Libya, and the UAE have provided up to 60 percent of Morocco's oil needs through May 1985 at up to $3 per barrel below official prices, according to the US Embassy in Rabat. These arrangements also allow for long-term payment or provide concessional loans to ease the burden on Rabat's weak foreign payments position. The difference between domestic petroleum prices and import costs is used to finance development projects and help meet Morocco's debt service obligations. The US Embassy says that public disclosure of these concessional purchases has been withheld to gain more favorable terms on a new IMF standby loan and debt rescheduling agreement. The import mix, however, is ill suited to Morocco's needs, yielding a surplus of light products and a shortage of fuel oil.



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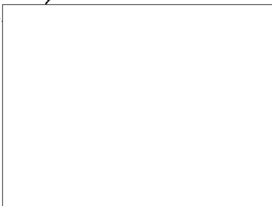
Oil and Gas Finds in Pakistan Confirmed



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Union Texas has confirmed oil and natural gas finds in the Badin area of Sind Province. These finds test at about 5,500 b/d of petroleum and 21 million cubic meters per day of natural gas. Pakistan's production is now about 35,000 b/d of petroleum and nearly 30 million cubic meters per day of gas. Limited pipeline capacity from the oilfields to refineries will probably hamper Islamabad's ability to rapidly exploit these finds. A Pakistani gas transmission company has recently signed a contract with a group of British and Japanese firms for a natural gas refinery. The refinery is to have a capacity of about 5 million cubic meters per day and be completed by March 1986.

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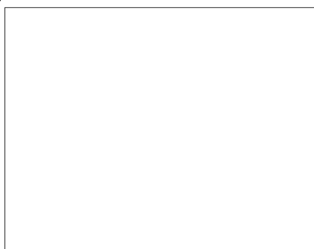
Bulgarian Energy Problems



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Bulgaria's recently created Ministry of Energy is anxious to upgrade energy production facilities to prevent a recurrence of last winter's energy shortage, according to the US Embassy. Energy Minister Todoriev has held talks with Western firms specializing in energy-related technology, and large hard currency outlays have been approved for modernization and construction of energy production facilities. The need for Western machinery and equipment is implicit in Bulgaria's investment plans, which emphasize energy efficiency and development of domestic energy sources. The Ministry's action may reduce some of the bureaucratic inertia that has slowed major energy development projects. Western imports will not solve the construction delays and shortages that have plagued large nuclear power and coal projects, nor enable Bulgaria to reduce significantly its dependence on the USSR for energy supplies.

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International Finance

Mexican Foreign Exchange Measure

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Mexico City's announcement last week that banks soon will buy and sell dollars at free market rates—currently between 75 and 100 pesos above the official "market" rate of 245 pesos per dollar—has eased pressures on the exchange market. According to the US Embassy, this reflects customers adopting a wait-and-see attitude about how the new measures will work. Financial officials are likely to see the market response as an indication that they can hold off other action on the exchange rate until after the 7 July midterm elections. The scope of this measure will be limited because about 80 percent of government transactions currently are made at the controlled rate of about 230 pesos per dollar. In our view, Mexico City's ability to stem currency speculation and capital flight over the longer term will depend on the government's willingness to devalue sufficiently to achieve a competitive exchange rate.

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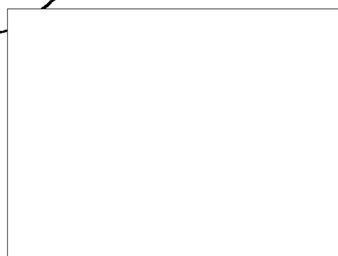
Thailand Receives IMF Package



The IMF earlier this month approved a $585 million assistance package to support the economic austerity program Bangkok launched last fall. In addition to $399 million in standby funds—which may be drawn in $50 million installments through March 1987—Bangkok will receive $185 million in compensatory financing. Thailand must meet performance targets that include ceilings on domestic banking credit and on new commitments of public and publicly guaranteed external debt. The IMF program will enable Bangkok to cut its foreign commercial borrowing and slow the growth of the country's debt service ratio, which rose from 17 percent in 1980 to 24 percent last year.

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Global and Regional Developments

Potential Lufthansa Purchase of Airbus

The board of directors of Lufthansa Airlines voted in mid-June to buy 50 Airbus Industrie (AI) aircraft and take options on 25 more. [25X1] The estimated $2 billion order includes 10 A300s, 25 A310s and 15 A320s; the options are for 25 A320s. Formal government approval and financing arrangements are still required to complete the deal. [25X1] the Lufthansa purchase included 10 Boeing 737-300s as interim aircraft until the A320 is available in 1988-89. [25X1] The massive Airbus purchase by Lufthansa—a traditional buyer of US aircraft—especially when combined with the recent Pan Am deal, will spur additional AI sales. Potential customers include United, Delta, Spain's Iberia, Belgium's Sabena, and perhaps British Airways. In addition, we believe Lufthansa's decision on the A320 may be tied to a commitment by AI to develop a long-range transport, the A330, long sought by the German carrier. The size of the Lufthansa sales, combined with a growing "family" of Airbus aircraft, likely means further erosion of US market share in an industry that is a major contributor to US exports [25X1]

European Fighter Aircraft Update

Uncertainty continues to mount over the future of the five-nation European Fighter Aircraft (EFA) program. [25X1] the British and French Defense Ministers continue to publicly express a quiet optimism, and President Mitterrand reaffirmed his commitment to EFA at the Paris air show. Dassault, France's premier builder of fighters, could find its intransigence tempered by the government's control of funding and by pressure from France's aerospace industry association headed by Mitterrand's brother. Despite a basic economic, political, and technical impetus for the group to remain intact, the next meeting of the defense ministers, scheduled for mid-July, could be pivotal. [25X1]

Fewer Egyptian Laborers in Saudi Arabia

Egyptian worker remittances from Saudi Arabia have decreased substantially as a significant number of expatriates have left the country, and many others are accepting lower wages, according to the US Embassy in Riyadh. Prime Minister Ali's claim that remittances this year are off by 50 percent is probably greatly exaggerated—firm data are unavailable—but the IMF has revised its estimate downward from $3.9 to $3.6 billion. The decline in worker remittances along with stagnation in foreign exchange earnings from oil and the Suez Canal will further complicate Egypt's foreign payments problems. Although Riyadh will continue to rely on a large foreign labor force, the number of Egyptians will continue to decrease from the 1984 level of 428,000 as increasing numbers of Saudi university graduates gradually replace many Egyptians as teachers and skilled civil servants, and skilled and unskilled Egyptian workers lose jobs to Asians who work for less money. [25X1]

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National Developments

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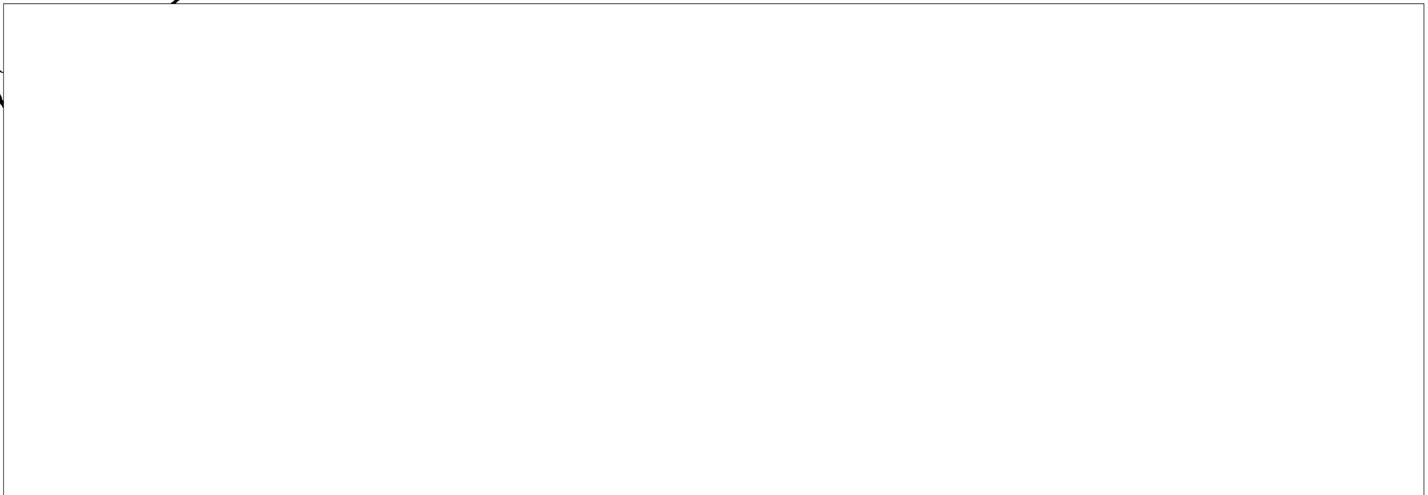
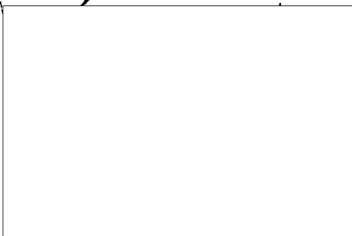
Developed Countries



Japanese Low-Cost Advanced Composite Fibers



Japan has developed a high-performance, low-cost carbon fiber from coal tar pitch that, if successful, will increase its world leadership in this technology, with applications in the aerospace and automobile industries. According to the *Japan Economic Journal*, a government industrial research institute has developed a carbon fiber that the institute claims is much better than current pitch-based fiber and as good as synthetic-based fiber, but much cheaper. Japanese claims of superior properties, however, tend to be based on their best laboratory results and usually exceed what is possible in near-term production. Full-scale Japanese production of high-performance, pitch-based carbon fiber could occur within two years. If industrial production of the fiber is successful, Japan will be in a position to dominate all facets of carbon-fiber technology, from precursors to finished fibers. The improved process will lower the price of carbon fiber without lowering the quality, allowing wider applications. Other countries, such as the United States and the USSR, have yet to develop such a fiber and many find it more economical to buy it from Japan or, if possible, to obtain the technology under license.

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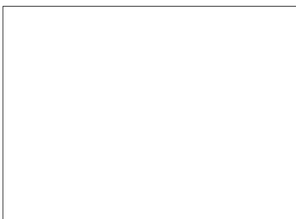
Portuguese Current Account Deficit Improves



Portugal's continuing recession prompted a first-quarter decline in the current account deficit to $69 million from $267 million in the first quarter of 1984. Weak domestic demand was largely responsible for a 14-percent fall in dollar terms in imports that more than offset negative developments in the current account. Exports increased only $5 million because of slower growth in Lisbon's major trading partners, while the services deficit widened by $25 million because of falling tourism receipts and rising interest payments. At the same time, worker remittances declined $100 million. Assuming domestic

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demand picks up during the last half, the current account deficit probably will again widen. The first-quarter results suggest, however, that the yearend deficit will come in under the government's $850 million projection. 25X1

Less Developed Countries

Kenyan Budget Reforms Lack Potential

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Kenya's recently announced fiscal year 1985 budget reiterates the government's commitment to improving investment incentives but contains few important changes in economic policy. The most significant measures are new tax incentives that increase the investment deduction rate from 20 percent to 50 percent for investments outside Nairobi and Mombasa, a reduction in the writeoff period for capital expenditures in agriculture from five years to three, and suspension of the capital gains tax. Price controls, local borrowing restrictions for foreign firms, and excessive government redtape for new investors, however, will continue to discourage investment. These impediments plus an 11-percent cut in development spending will keep the growth rate well below the projected 5 percent. As a result, Kenya's 4.2-percent population growth rate is likely to continue to impede economic progress. 25X1

Taiwan Investment in the Caribbean

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Under its two-year Caribbean and Central America investment incentive program (initiated September 1984) six Taiwan trade and investment missions have visited the Caribbean area over the past eight months. Taiwan hopes to boost its total investment to $50 million in the region by September 1986 by attracting $500,000 investments from 100 Taiwan companies. To date, however, Taiwan's Foreign Trade Commission has approved only six projects totaling $3 million for the Dominican Republic, Guatemala, Honduras, and Panama. The projects will produce yachts, sports shoes, asbestos shingles, furniture, and clothing—all likely to be targeted at the US market. The region offers a locale from which Taiwan can try to bolster sales dampened by quotas that restrict its direct exports. At least one Taiwan firm, however, has already left upon learning that Caribbean Basin Initiative incentives are not available to third-country firms. Taiwan's objectives are also politically motivated, serving to strengthen existing diplomatic ties and to express Taiwan's support for US policy. 25X1

Communist

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Less Military Support for Soviet Harvest

only limited military support for this year's harvest, suggesting the Politburo decision in 1984 to withhold large-scale military support is still in effect. 25X1

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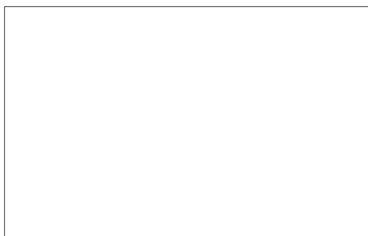
part of the harvest is greatest. General Secretary Gorbachev, in his plan to reduce waste in the economy, is likely to repeat last year's call for more efficient use of the county's 1.8 million trucks in agriculture, thereby eliminating the need for military equipment. 25X1

Soviet Plant Officials Jailed After Pollution Accident



Izvestiya has announced that five Soviet officials at a chemical plant in the western Ukraine have been jailed for a term of two to five years in connection with a pollution disaster that occurred in September 1983. The bursting of a chemical waste dam seriously polluted the Dnestr River, killed more than 2,200 metric tons of fish, and deprived large cities in the Ukraine and Moldavia of drinking water for several weeks. Plant officials had been warned on two occasions by government inspection teams but had failed to take corrective actions. These jailings mark a departure from past policy that enabled managers to flagrantly defy environmental laws with little risk of punishment. Although Moscow seems to be becoming increasingly aware of the costs of environmental neglect, significant gains will require more than increased discipline. Greatly increased investment in control equipment and major changes to raise the priority of environmental targets relative to output goals are also needed. Neither is likely in the current period of slow growth that puts a premium on productivity gains. Indeed, investment in environmental protection actually fell in 1983. 25X1

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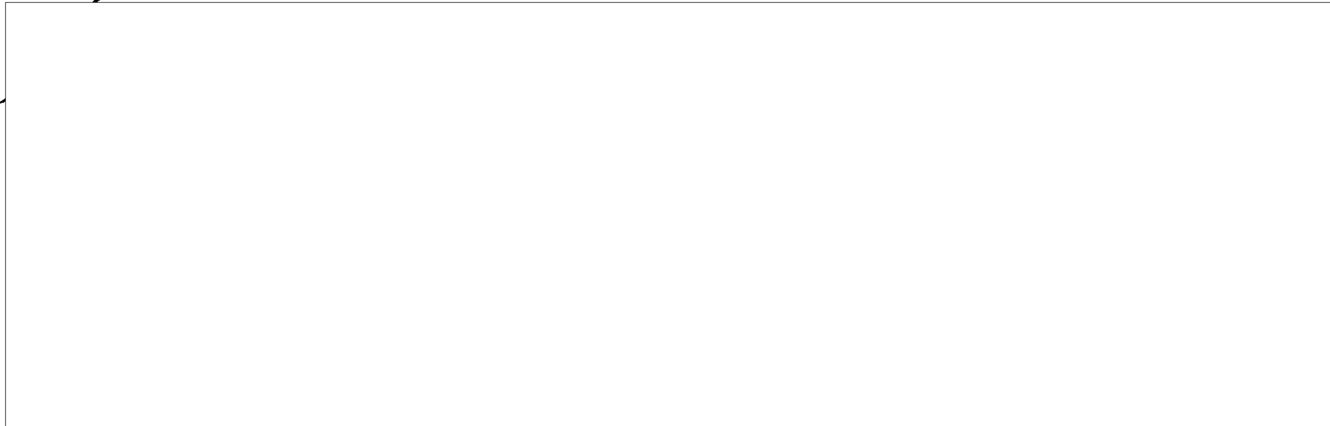

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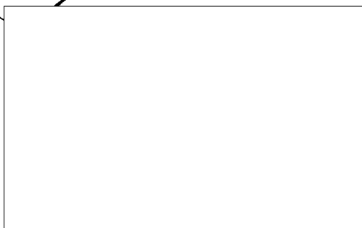
New Soviet-Vietnamese Economic Package



The USSR has agreed to increase economic assistance to Vietnam, according to a joint declaration signed on Saturday in Moscow. Moscow will grant new credits during the period 1986-90 on easier repayment terms, reschedule repayment of earlier credits, and increase exports of goods to meet Hanoi's "urgent needs." In return, Hanoi pledged to make every effort to fulfill its export commitments under the existing bilateral agreement and to increase exports of rubber and other commodities of particular interest to the Soviets. The agreement reassures Hanoi of Moscow's continued economic support just before Chinese Vice Premier Yao Yilin's visit to the USSR. It also indicates a

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tougher line on Vietnam's failure to meet export commitments to the USSR. Hanoi last week also requested a rescheduling of its debt to CEMA countries.

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Czechoslovak-Soviet Cooperation Agreement Signed

In late May, Czechoslovakia became the fifth East European country to sign an economic, scientific, and technological cooperation agreement through the year 2000 with the USSR. The agreement calls for a coordinated effort to modernize the machine-building industry through investment in new plant and equipment and for joint production of automobiles, nonferrous metals, and advanced agricultural and construction equipment. The two countries want to lessen dependence on the West by developing new technologies in computers, steel production, chemicals, agriculture, energy, and telecommunications. According to Embassy sources, Czechoslovakia will contribute 5 billion rubles ($5.8 billion) worth of investment and 1,200 technicians to construction of a new gas facility in Siberia over the next five years with repayment in gas deliveries in the 1990s. Although Czechoslovakia is Eastern Europe's strongest supporter of economic integration with the Soviet Union, Prague may well fail to meet all its commitments. The agreement does not seem to give Czechoslovakia much in return for the large investment requirements that could aggravate the country's economic problems.

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China Imports Beef Ranches

China has agreed to purchase a turnkey cattle ranching operation from a Canadian firm. The package includes the necessary equipment, buildings, purebred cattle, and training to create a 20,000-hectare ranch in Heilongjiang Province. Officials there are encouraging livestock production to increase domestic meat supplies and to take advantage of the province's vast grasslands and grain surplus. Meat from the new ranch, however—20 such operations are planned—will be primarily for export to other Asian nations and could compete effectively in the primary market for US beef exports.

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Record Chinese Steel Imports from Japan

China is expected to import a record 7.3 million tons of steel from Japan's six major steel companies during 1985. Last year the six accounted for about 80 percent of China's purchases from Japan. In the past two years, China has surpassed the United States as Japan's largest customer. A major factor in the increased sales reportedly were Japanese price cuts because of a projected worldwide glut of 4 million tons.

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