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Directorate of
Intelligence

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International Economic & Energy Weekly

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14 October 1983

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International Economic & Energy Weekly

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14 October 1983

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Indicators

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International Economic & Energy Weekly (U)

Synopsis

Perspective—*Japan: Bracing for the President's Visit*

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Prime Minister Nakasone will try to focus President Reagan's visit to Japan on global issues such as arms control in an effort to build his image as a world leader. Nakasone realizes that Japan must offer some progress on bilateral issues including defense and trade, but he has instructed his ministers not to make undue sacrifices to solve them.

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International Financial Situation: Political Stresspoints

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Political strains continue to mount in several key LDCs facing debt repayment problems.

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The Philippines: Flirting With a Financial Fall

25X1

Despite Manila's devaluation of the peso last week and its new round of financial austerity measures, the Philippines face a severe liquidity crisis.

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Indonesia: The Painful Consequences of Financial Austerity

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Indonesia is experiencing its second consecutive year of declining export earnings and slower growth as the world oil glut and sluggish commodity markets persist. The government is walking a tightrope between keeping a lid on rising political tensions and waiting for a strong recovery in the world economy.

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Yen Appreciation and Japan's Current Account Surplus

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With Japan's current account surplus headed for record levels this year and likely to expand further in 1984, Tokyo has grown increasingly concerned about protectionism in key foreign markets, particularly the United States. Only a rapid runup in raw materials prices, a radical change in Japan's capital account, or a much larger yen appreciation than is now foreseen would contain the surplus.

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International Economic & Energy Weekly

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14 October 1983

Perspective

Japan: Bracing for the President's Visit

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Prime Minister Nakasone will try to focus President Reagan's visit to Japan on global issues such as arms control in an effort to build his image as a world leader. At the same time, he realizes that Japan must offer some progress on bilateral defense and trade issues and has instructed his ministers to examine these issues but not to make undue sacrifices to solve them.

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Japanese bureaucrats feel pressure to make progress on economic issues because Japan's current account surplus is growing rapidly at a time when the US trade deficit is mounting. Tokyo realizes there are no quick fixes to Japan's growing global surplus. Most officials view the import promotion measures that are scheduled to be announced before the President's visit as window dressing:

- The Trade Ministry reportedly is pushing for some economic stimulus beyond the small cut in income taxes that is likely to be introduced; the Finance Ministry is opposed because of the budget deficit.
- For its part, the Finance Ministry is examining ways to induce foreign investment into Japan to help appreciate the yen.
- Various ministries are arguing over how best to improve financing for imports.

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The defense issue may be an equally difficult problem. Recent Soviet actions—including the shootdown of the KAL airliner—have improved the popular standing of the Japan Self Defense Forces. Nonetheless, many Japanese officials are concerned that if Washington presses too hard for a greater Japanese effort, popular opinion will swing back. Reflecting this, Tokyo is quietly requesting a low-key US approach to the issue.

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Nakasone is walking a political tightrope. On the one hand, he wants to demonstrate that he can successfully manage the US-Japanese relationship and that his ties to President Reagan are strong. On the other hand, with elections no later than next June, Nakasone does not want to alienate key supporters in the Liberal Democratic Party, including farmers, by sacrificing their interests in the bilateral negotiations with the United States.

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Nakasone has not decided on the timing of elections for the lower house of the Diet. We believe he will wait until after the President's visit. If it goes well, Nakasone may opt to test his popularity at the polls as early as December.

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Briefs

Energy

OPEC Production Continues Steady Climb

OPEC production in September averaged 18.9 million b/d—the highest level this year. September's boost in production helped push the cartel's third-quarter average 1 million b/d above the 17.5 million b/d self-imposed quarterly ceiling established in March. Saudi production rose an estimated 700,000 b/d from August levels, primarily on the strength of short-term deals that forced customers to accept increasing amounts of Saudi light oil in order to obtain larger volumes of the currently more desirable heavier crudes. Nigeria's production fell slightly below its allocation in September, partly because deliveries to local refineries were more than 1 million b/d under scheduled levels. Because of high output early in the quarter, however, Nigeria's third-quarter production still averaged 100,000 b/d above its ceiling.

OPEC: Crude Oil Production, 1983 *Million b/d*

	Quota	August [a]	September [a]	3rd Qtr [a]
Total	**17.5**	**18.4**	**18.9**	**18.5**
Algeria	0.725	0.6	0.6	0.6
Ecuador	0.2	0.2	0.2	0.2
Gabon	0.15	0.2	0.2	0.2
Indonesia	1.3	1.4	1.4	1.4
Iran	2.4	2.5	2.5	2.5
Iraq	1.2	1.0	0.9	1.0
Kuwait	1.05	0.9	0.9	0.9
Libya	1.1	1.1	1.1	1.1
Neutral Zone	[b]	0.5	0.5	0.5
Nigeria	1.3	1.3	1.2	1.4
Qatar	0.3	0.3	0.3	0.3
Saudi Arabia	5.0 [c]	5.5	6.2	5.6
United Arab Emirates	1.1	1.2	1.2	1.2
Venezuela	1.675	1.7	1.7	1.7

[a] Preliminary.
[b] Neutral Zone production is shared equally between Saudi Arabia and Kuwait and is included in each country's production quota.
[c] Saudi Arabia has no formal quota; it acts as swing producer to meet market requirements.

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According to US Embassy officials, a directive to restrict output in the fourth quarter to within Nigeria's OPEC allocation has been issued to all equity producers by the Nigerian National Petroleum Company. Other OPEC members—Indonesia, Iran, and the UAE—continue to overproduce their quotas. OPEC's four-member market monitoring committee has scheduled a meeting on 27 October to reassess the market and compliance with the cartel's production and pricing accord. [ ] 25X1

Soviet Gas Pipeline Developments

Moscow has announced that the Soviet minister responsible for overseeing the construction of the gas export pipeline to Western Europe has been named a Hero of Socialist Labor, because the pipeline has been completed ahead of schedule. The announcement is part of the Soviet propaganda effort to flaunt pipeline progress despite US sanctions. Western engineers working on the pipeline have reported that the pipeline is not ready for full-scale operation. They say the Soviets may instead use domestic pipelines parallel to the export pipeline to transport some of the initial gas to Western Europe. The engineers believe that the Soviets will be capable within the next three or four months of delivering up to 9 billion cubic meters annually, using spare capacity from the domestic pipelines. As a result, the USSR is likely to have little difficulty in meeting export commitments to Western Europe in 1984. [ ] 25X1

West European Gas Demand Rebounds

West European gas consumption rose 4 percent above year-earlier levels in the first half of 1983, reversing the downward trend in demand begun in 1980. Gas demand in West Germany—Western Europe's largest gas consumer—rose nearly 1 percent, while France, the United Kingdom, and the Netherlands experienced increases of 9, 7, and 5 percent, respectively. Increased gas use in the residential and electricity-generating sectors accounted for most of the additional demand. Rising gas use in Dutch electric power stations—a move sanctioned by the Hague to boost gas revenues—accounted for nearly one-third of increased West European demand. [ ] 25X1

Progress on Spanish-Algerian LNG Talks

Spain and Algeria have reached a tentative agreement on the price of LNG, breaking a deadlock in negotiations that has lasted for almost a year. [ ] Madrid has agreed to pay $3.94 per million Btu, which is roughly equivalent to the price currently paid by Algeria's other West European LNG customers. The accord probably means that Spain will resume LNG imports, suspended since last November because of a pricing dispute. Madrid reportedly has also offered to pay $60 million during each of the next four years as compensation for its failure to take the full annual contract volume of 4.5 billion cubic meters over the past six years. Final action on the agreement is not expected until after Algeria holds its national elections early next year. [ ] 25X1 25X1

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Sudan Pipeline Contract Awarded

A consortium of Italian, Japanese, US, and Saudi firms was selected last week to build a 1,500-kilometer pipeline from oilfields in southern Sudan to Port Sudan. Financing for the pipeline has not yet been completed, but Chevron, the concessionaire, is optimistic the project will be completed on schedule in late 1985, according to the US Embassy in Khartoum. Unrest in southern Sudan and an unreliable indigenous labor force could upset this timetable. Chevron recently boosted estimates of oil availability from its fields; 60,000 b/d could be produced today if the pipeline were in place, and 100,000 b/d may be available when the pipeline is completed.

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Possible Reopening of Iraqi Pipeline Through Syria

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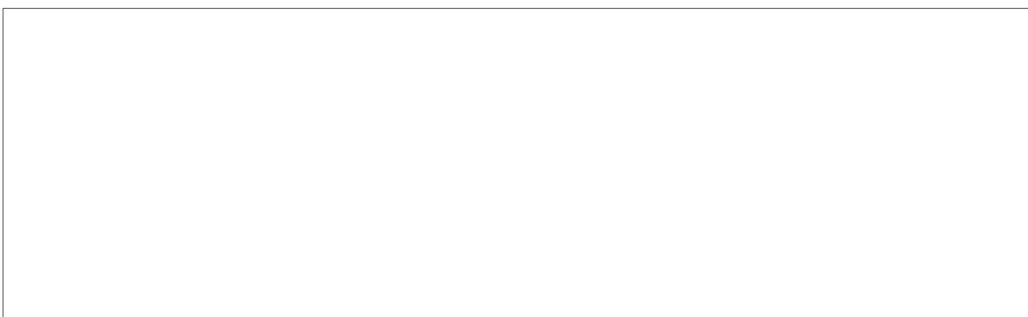

should the pipeline reopen, this would be a major shift in policy by Syria, which has supported Iran for much of the war. President Assad probably sees an opportunity to extract additional assistance from the Saudis and Persian Gulf states by going along with the mediation effort. In addition, Syrian acquiescence in a move to help calm the crisis in the Persian Gulf would boost Syrian aspirations to Arab leadership

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Iraq's earnings could be increased by some 50 percent from the current level of $7 billion annually even if only the Syrian part of the pipeline were opened—there is a spur ending in Tripoli, Lebanon. This additional income would reduce the pressures on Iraq to intensify the war in the Gulf. A Syrian agreement to reopen the pipeline would be a serious blow to Iran; its hardline position on mediation, however, probably will not change any time soon.

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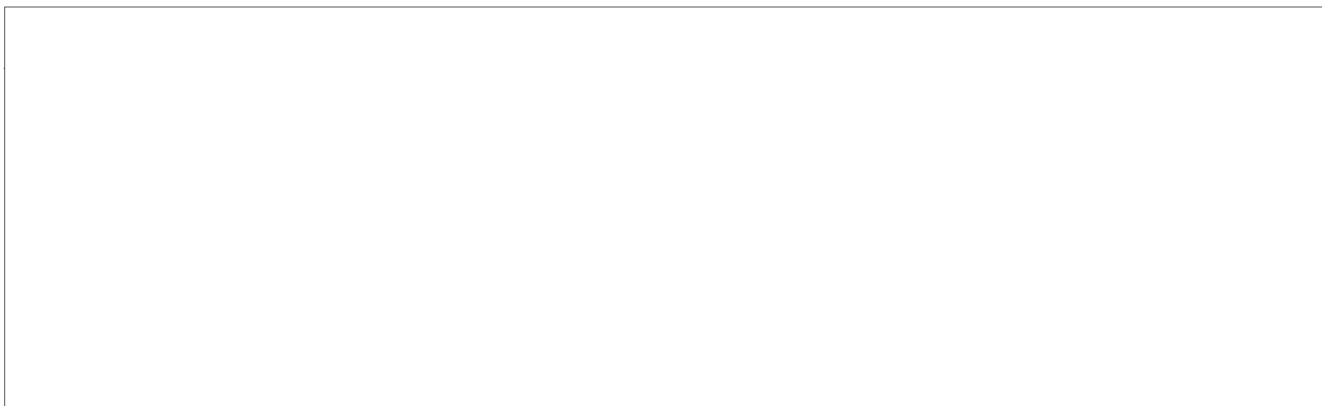

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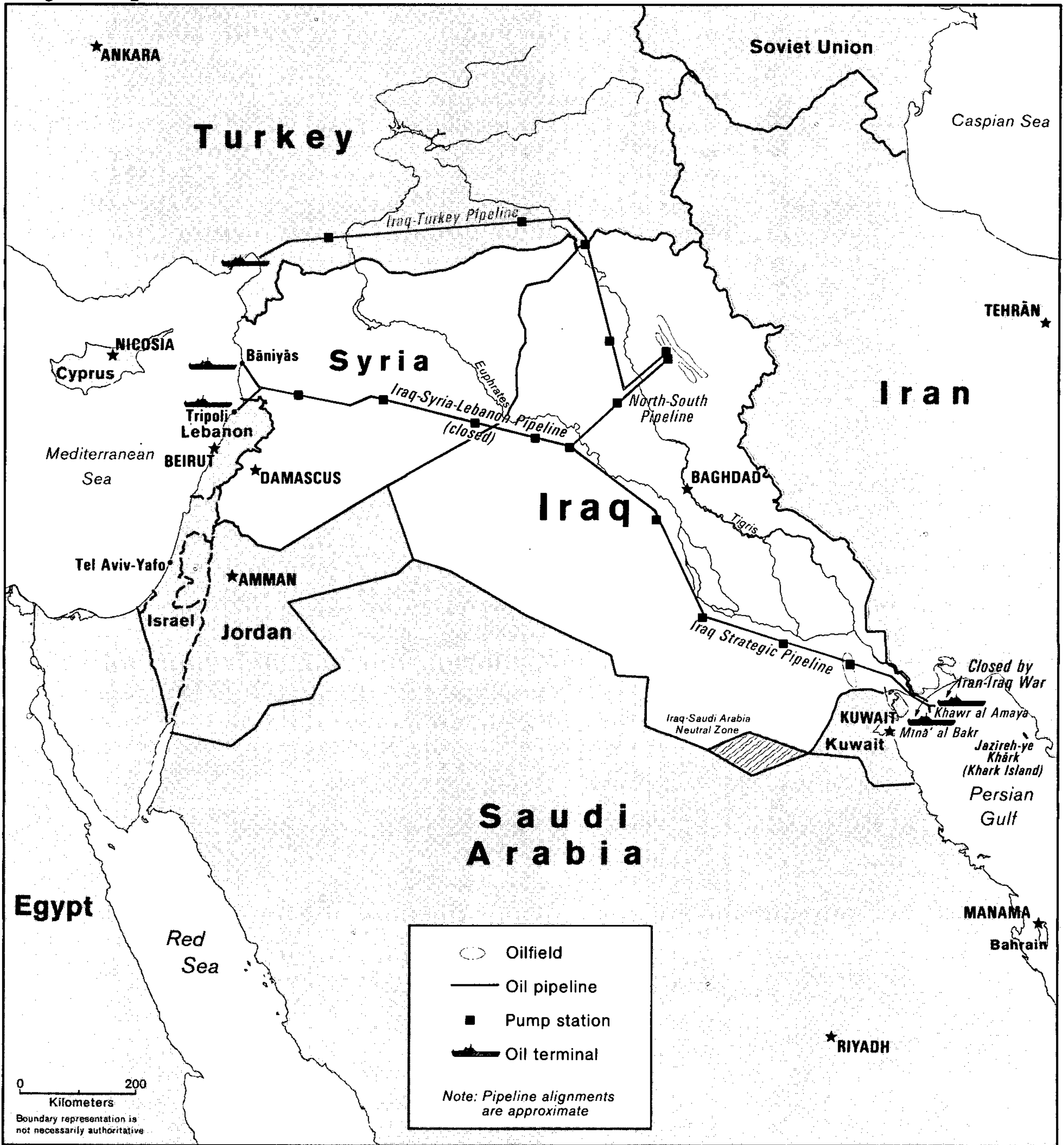
Major Iraqi Oil Facilities



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South African Coal Pricing Jeopardizes US Exports

South African attempts to market additional quantities of coal in the already depressed world market—especially in Western Europe and the Far East—are likely to put downward pressure on world coal prices. Because South Africa is one of the world's lowest cost coal producers, higher cost US suppliers will be hard pressed to compete. In the past, port capacity constraints caused South African coal exporters to follow the United States' lead in setting world steam coal prices. With expansion nearly complete at the Richards Bay coal terminal, [redacted] expect port capacity to reach 37-39 million metric tons by 1984 compared with estimated exports of around 27 million tons this year; South African coal exporters already are competing among themselves in price-cutting wars. [redacted]

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Global and Regional Trends

Closer Canadian-Chinese Relations

Ottawa evidently hopes that improved relations with Beijing will facilitate increased trade. External Affairs Minister MacEachen and Foreign Minister Wu met in Ottawa last week to exchange views on a number of bilateral and international issues and signed a bilateral agreement laying the groundwork for increased economic and technical cooperation. Ottawa's interest in better ties probably results from its desire to attain improved access to Chinese markets. The value of Canadian exports to China increased from $736 million in 1980 to $1 billion in 1982, with grain constituting 60 percent of the total. Canadian Wheat Board representatives are now in China, and prospects for additional grain sales appear encouraging. [redacted]

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Canada also is seeking to sell China military and high-technology equipment. [redacted] the Canadians are trying to expand their role in developing China's offshore energy resources. Two Canadian firms are participating in a consortium that recently was awarded contracts by China's national oil company for exploration projects in the South China and Yellow Seas. Canada hopes to increase exports of energy technology, and the agreement signed by Wu may lead to more trade in this field. [redacted]

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National Developments

Developed Countries

New Israeli Economic Measures

The Israeli Cabinet announced several measures earlier this week designed to stem the recent run on the shekel and cut government spending. The new steps included:

- A devaluation of the shekel by 18.6 percent.
- A boost in most government-controlled prices by 50 percent, including the price of bread and milk.
- A plan to give incentives to holders of bank shares to keep them for five years. [redacted]

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The Cabinet was forced to act by the public's rush to buy dollars last week in anticipation of a devaluation. Many Israelis sold stocks, particularly bank stocks, for shekels to purchase dollars, precipitating a stock market crash and forcing its closure for a week. Several factors fueled the run on the shekel:

- Recent press reports citing rising foreign debt and declining foreign exchange reserves.
- A public perception that the government was doing little to correct economic problems—triple-digit inflation and a poor export performance leading to a growing trade deficit.
- A similar but less extensive run on the shekel in August resulted in a 7-percent devaluation, convincing Israelis not to be left out this time. 25X1

The immediate impact on the economy will be higher prices. Inflation this year will almost certainly exceed the 132.9-percent record set in 1980. US Embassy contacts claim the inflation rate could be 160 percent. Finance Minister Aridor's publicly stated intention to reduce cost-of-living adjustments threatens the cushion Israelis have had against triple-digit inflation; if he is unsuccessful, however, much of the impact of these new steps will be mitigated in January when wages and pensions are adjusted for inflation. 25X1

The Histadrut, the large labor organization, took the relatively mild step of striking for two hours on Thursday. Press interviews with Israelis indicate that, although people are not happy about the moves, they accept the need for stringency. We believe, however, that support for the Shamir government's policies will begin to erode as the price hikes spread through the economy, especially if wages and other income are not adjusted to compensate for higher prices. 25X1

Less Developed Countries

More Tough Talk in Mexico

In his first formal press conference since taking office last December, President de la Madrid last week reaffirmed his commitment to pragmatic decisionmaking and tough economic stabilization policies. He rejected "demagoguery and populism," vast new foreign loans, and rapid oil development as solutions for Mexico's financial problems, instead prescribing continued austerity and reduced inflation as keys to eventual economic recovery. The President indicated that, while 1984 will be a better year than 1983, the standard of living will continue to fall below the levels of the recent past. He cautioned against backsliding and suggested, in part by a rejection of price freezes, reliance on free enterprise and a continuing prominent role for the private sector. 25X1

De la Madrid's policy of looking for nonoil solutions to financial problems also points to more realism in decisionmaking and is enhancing the President's reputation for integrity and conservative planning. The President's downplaying of oil led to project that the new National Oil Plan to be 25X1

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published this fall would scale back Mexico's estimated oil reserves 20 percent or more. Top energy officials, however, discounted the speculation, emphasizing that Mexico had not changed its oil reserve estimates. We believe that new Mexican oil officials are assessing oil reserves and may well downgrade reserves. In any case, even a large cut in estimated oil reserves would almost certainly not lower oil production or export capacity, or complicate ongoing bank negotiations for 1984 financial support. Even if Mexico City decided to lower oil and gas reserves 30 percent (from 72 billion barrels of oil equivalent to 50 billion barrels), reserve levels would be adequate to satisfy domestic consumption and allow a substantial boost in exports from current levels of about 1.5 million b/d at least through the year 2000. 25X1

Mexican Progress on Inflation

More moderate consumer and wholesale price increases in recent months indicate that tough austerity measures are finally curbing inflation. After rising at an annual rate of 100 percent during January through July, consumer prices in August and September slowed to an annual rate of 51 percent. Wholesale prices did even better, falling from an annual rate of 120 percent in the first seven months of 1983 to an annual rate of just 31 percent in August and September. Progress in slowing inflation has resulted from delaying price decontrols and depressed demand. Domestic public-sector spending has plunged 30 percent this year, and real wages for most nonunionized workers are off by an equal amount. 25X1

During the last quarter of the year, we believe consumer and wholesale price inflation will rebound a bit because of scheduled public-sector price adjustments, steady depreciation of the "free" peso that began at the end of September, and shortages caused by falling production and import restraints. Thus we project December's price level to be 80 percent above December 1982. 25X1

We believe President de la Madrid's goal of slashing inflation to the level of that in major trading partners, as reaffirmed in his 5 October press conference, will require sustaining harsh economic policies over the next several years. Most important will be continuing fiscal restraint, including meeting IMF targets for sharply cutting the public-sector deficit in 1984 and 1985. Keeping a cap on wage increases also will be crucial and perhaps more difficult politically. Forthcoming negotiations over the amount of the 1 January 1984 hike in minimum wages will be the next tough test. 25X1

Widening Economic Impact of Pakistani Civil Disturbances

According to the US Consulate, disruption of road and rail transportation in Sind Province has led to spot shortages in Karachi, to piling up of imported goods at the port of Karachi, and to curtailment of fuel shipments to rural areas. We believe a sustained interruption of highway and rail traffic or attacks on gas and oil pipelines and the national electric grid would cause significant shortages of consumer goods and disrupt industrial production in Sind and other areas of Pakistan. Even without an increase in dissident

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activity, the antigovernment protests already appear to have damaged Pakistan's longer term economic prospects. The current five-year plan is based partly on a revival in the private sector, which is expected to contribute a larger share of investment for industrial development. Fresh doubts about Pakistan's long-term stability are likely to inhibit both foreign and local investment in private industry; a recent survey indicates that small and medium-sized Pakistani businesses already are drawing down bank assets.

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India Revises Electronics Policy

In a preelection move to lower prices of consumer electronics, New Delhi has substantially reduced import duties on many electronic components and lowered excise taxes on consumer goods and computers. The government also has proposed the elimination of ceilings on production by private manufacturers and plans to invest in high-technology industries. Press comment suggests that officials may also believe that past restrictions on luxury consumer goods have inhibited the development of electronics technology for defense industries. US exporters could gain if the new policies are implemented aggressively, but greater Indian Government interest in electronics could also lead to increased resentment of US export controls, which are designed to prevent diversion of advanced technology to the Soviet Union.

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Haitian Budget

Haiti's recently released 1983/84 budget calls for a $10 million budget deficit, comparable to the FY 1983 deficit but far below the deficits of the previous three years. The government has announced a fiscal package designed to improve income tax and customs duty collections and has switched some ongoing programs from the development budget to the operating budget in an effort to help cover a 10-percent increase in overall expenditures. In a related development, the Haitian Central Bank and its commercial arm, the National Credit Bank (BNC), just completed a legal and financial separation initiated two years ago under IMF pressure, which should theoretically restrict the Haitian Government from using BNC funds to finance the budget deficit.

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Communist

Laotian Concern Over Economic Activity

At a party plenum in August, the Laotian Central Committee expressed concern over the slow progress of the economy. According to recently available information, the Committee decided to strengthen local economic administration by weeding out incompetent and corrupt officials but to refrain from accelerating agricultural collectivization or the elimination of free market activity. The regime apparently hopes to avoid repeating mistakes made in the 1970s, when an attempt to force collectivization and eliminate the free market depressed food output and created a shortage of consumer goods. Actual improvement in economic performance, however, is unlikely without some measures to encourage production.

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International Financial Situation: Political Stresspoints

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The risks of disruptions in the international financial system have increased in recent weeks. Uncertainty over the future level of IMF funding, coupled with political unrest in a number of key LDCs, underscores the fragile nature of the system. We will continue to monitor economic and political aspects of the international debt crisis.

Political strains continue to mount in several key LDCs facing debt repayment problems. In some cases the impact of austerity measures has sparked unrest. Elsewhere, political turmoil is being driven more by internal political divisions. Regardless of the causes, political disruptions—given the fragile state of banker confidence—run the risk of upsetting the delicate balance in the international financial arena.

Indeed, with economic recovery under way in the United States and some other OECD nations, the political situation in the major debt-plagued countries is probably the most worrisome aspect of the international financial situation. Over the past few weeks political clashes—including a number of violent confrontations—have called into question the status of financial rescue programs in several key LDC debtors—Argentina, Brazil, the Philippines, and Chile. While the situation in Mexico is comparatively calm, it could deteriorate as the current austerity program takes its toll.

Argentina

Barring a coup, most observers expect civilian leaders to assume power following the 30 October elections, ending seven years of military rule. The preelection period has been marked by tension. The military is concerned over its role in a new government; labor unions have tried to wrest wage and other concessions before a new government takes power; and pressure from organized labor and hardline nationalists is jeopardizing debt financing programs. An Argentine judge temporarily blocked the rescheduling of public-sector debt and briefly arrested the president of the central bank for allegedly violating national sovereignty by following the longstanding practice of assigning to US courts jurisdiction should disputes arise over US bank loans. According to the US Embassy, nationalist Air Force officers were behind the judge's ruling and have threatened to leave the junta over this issue. Unrest in the other services has intensified as a result of the injunction and tensions created by last week's successful general strike.

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The external debt will remain a contentious political issue even after the civilians take office in December or January. No matter which party—the Peronists or the Radicals—assumes power, the debt will undergo close scrutiny. Both major contenders have promised to honor debt obligations, but will probably attempt to placate nationalists by adopting a tough posture toward lenders. Despite mandated austerity programs and repayment schedules, their primary goal is to revitalize the economy. Sentiment for a repudiation of the $40 billion debt could grow if the banks cut off credits because of noncompliance; the government could try to use the threat of repudiation as a lever for better terms.

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Brazil

President Figueiredo's administration appears adrift. The tough austerity measures mandated by the IMF have sparked food riots and labor unrest.

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Opposition leaders have used these incidents to garner congressional support against the government's austerity measures. Moreover, economic dissatisfaction has spread to the middle class, the business community, and the middle echelons of the armed forces. Widely publicized statements by prominent business leaders criticizing the government's handling of the economic crisis underscore this shift. The country's precarious international payments situation has prompted major political and business groups, as well as a majority of federal deputies, to call for a moratorium on debt repayments aimed at forcing foreign bank creditors to reduce interest charges and lengthen repayment periods.

The growing political backlash could force Brasilia to soften its pledge to cut spending and impose wage restraints, which the IMF and foreign bankers are insisting on as preconditions for additional financial help. Although Brazil and its creditor bank advisory committee announced preliminary agreement last week on a new $12 billion medium-term financial package—with easier terms than were negotiated early this year—final agreement remains in doubt. Already Figueiredo, fearing congressional rejection of his wage restraint law, has publicly stated that he will consider proposals for alternative plans. Moreover, many bankers are becoming increasinglv reluctant to come up with their share of the overall package.

Philippines

President Marcos's regime is beset by political and financial woes as key interest groups such as the business community, the middle class, and organized labor withdraw their support. The latest blow to the prestige of the regime was the mass resignation on 10 October of members appointed to the commission investigating the assassination of Benigno Aquino.

we believe the senior officer corps remains loyal and Marcos's security forces are intact. The opposition has proven itself capable of sustaining the pressure on the President by conducting almost daily antigovernment rallies and demonstrations throughout Manila and elsewhere in the country.

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The outlook is for continued disaffection from the regime, possibly intensified by government financial problems. Although Marcos announced price freezes to moderate the impact of the 21-percent devaluation of the peso last week, public reaction to this and other austerity measures is bound to be sharp. The possibility of default on debt repayment obligations would further complicate Marcos's political problems.

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Chile

In Chile, the growth of a strong opposition movement has been fueled by recession and President Pinochet's reluctance to accelerate the timetable for returning the country to civilian rule before 1989. Political and labor coalitions have sponsored "days of national protest" each month since May and two national strikes. The massive protest in Santiago this week highlights the underlying unrest. Security forces have responded sternly; 49 civilian protesters had been killed as of mid-September. The protests have led moderates inside the government to press Pinochet to grant concessions; he has lifted the state of emergency and is considering holding a plebiscite to amend the 1980 constitution and allow the election of a congress before 1989.

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While the dispute between the government and opposition groups has centered on political rather than economic conditions, Chile's economy has been in a nosedive. GNP dropped 14 percent in 1982, and we expect another 4 to 5 percent decline this year. Opposition groups are charging that the government has gone overboard in meeting IMF targets, making the situation even worse. While Chile has arranged the foreign financing most

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observers believe it will need through 1984, agreements with the Fund and bankers could unravel if the goverment is forced to ease up in response to political unrest.

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Mexico

The Mexican political climate has improved in the last few months. This is due to the President's political skills, the ruling party's sophistication, and the government's success rekindling some faith in the economy. The important labor sector continues to support the government, but the rank and file expect some rewards, such as more effective price controls or other non-wage benefits, for their sacrifice. The largest opposition organization, the center-right National Action Party, has made some headway in exploiting the crisis, but similar attempts by leftist parties have foundered on internal divisions and disorganization.

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Violence has been avoided, but small-scale peasant and student protests in October reflect the continuing potential for unrest. Early in the month, peasants seized government vehicles and blocked access to oil facilities to protest the government's failure to pay compensation for damage to farm land. As a result, some 300 wells were temporarily shut in. Two days later, students marched in downtown Mexico City to protest austerity mesures and commemorate the 1968 student violence. Several firebombs were tossed at the National Palace but caused no significant damage. Overall, the de la Madrid administration has had few problems in controlling protests and demonstrations. Opposition leftists' ability to rally support for a national strike against austerity on 18 October will serve as an indicator of progress in overcoming internal disunity and as a gauge of discontent.

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The Philippines: Flirting With a Financial Fall

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Despite Manila's devaluation of the peso last week and its new round of financial austerity measures, the Philippines faces a severe liquidity crisis. The government must restructure $4.2 billion in short-term debt owed by financial institutions and line up a new medium- to long-term "jumbo" loan by January—its traditional foreign borrowing season. If the government fails either of these tests, rescheduling or payments arrearages are likely. Even under the best circumstances, the economy is likely to grow more slowly as the price of financial adjustment, and this will add to President Marcos's already formidable political problems.

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Financial Developments in Early 1983

The Philippines has not experienced the dramatic reversal in its external payments fortunes that policymakers have counted on. Many of the international economic events that Manila has hoped for have materialized, but even with lower international oil prices, weakening global interest rates, and firming commodity export prices, the current account shows little sign of improvement from the $3.3 billion record deficit in 1982. Drought during the first half of the year has compounded already bleak current account prospects for the rest of 1983 by requiring unanticipated imports of corn and reducing exports of coconut products.

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Interest payments on the $22.7 billion foreign debt for the first time have replaced oil imports as the single largest drain on the country's financial resources. Moreover, Manila's ability to finance the stubborn trade gap has sustained critical damage; Prime Minister Virata told US officials in June that private credit commitments to Philippine borrowers had contracted by $700 million since late 1982. Despite a $375 million balance-of-payments standby loan and a $205 million Compensatory Financing Facility from the IMF, Central Bank liquidity has plummeted sharply. The Central Bank's cash position became so serious in April that it began to resort to overnight loans to accomplish daily clearing operations and prevent payments arrearages on its own $2.2 billion short-term foreign debt.

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The Philippines: Foreign Debt, June 1983 *Millions US $*

Total	**22,700**
Medium and long term:	14,000
Public and publicly guaranteed	9,735
IMF	1,363
Other official sources	3,284
Multilateral [a]	2,098
Bilateral	1,186
Private banks	3,563
Bonds	1,002
Supplier credits	523
Private	4,265
Private banks	3,665
Supplier credits	600
Short term, owed by nonbanks	4,460
Revolving trade credits	4,460
Short term, owed by financial institutions [b]	4,240
Central Bank	2,157
Commercial banks [c]	2,083

[a] Including World Bank.
[b] Reserve financing.
[c] Net, liabilities $5,183 million, assets $3,100 million.

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The Philippines: Balance of Payments *Million US $*

	1979	1980	1981	1982	1983 [a]
Current account	**−1,576**	**−2,072**	**−2,589**	**−3,347**	**−2,900**
Merchandise trade	−1,541	−1,939	−2,667	−2,805	−2,450
Exports (f.o.b.)	4,601	5,788	5,733	4,995	4,600
Of which:					
Coconut products	965	759	756	647	550
Sugar	238	474	609	324	400
Copper concentrates	330	679	544	340	500
Forest products	484	433	383	340	400
Manufactures	1,520	1,135	1,294	1,050	1,245
Imports (f.o.b.)	6,142	7,727	8,400	7,800	7,050
Oil	1,385	2,248	2,458	2,396	2,190
Other	4,757	5,479	5,942	5,404	4,860
Services (net)	−390	−555	−392	−992	−900
Interest payments	−591	−846	−1,101	−1,811	−2,200
Other	201	291	709	819	1,300
Transfers (net)	355	422	470	450	450
Capital account	**997**	**1,720**	**2,029**	**2,212**	**1,800**
Direct investment (net)	99	49	407	259	400
Medium- and long-term loans (net)	1,061	1,044	1,185	1,252	1,350
Short-term loans [b] (net)	−193	446	37	423	50
Balance	**−579**	**−352**	**−560**	**−1,135**	**−1,100**

[a] Projection based on first three quarters.
[b] Including errors and omissions.

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The government began the first in a series of "last ditch" efforts to avert financial crisis in midyear. Manila devalued the peso by 7 percent, raised commercial bank reserve requirements to rein in private liquidity, canceled five large industrial projects, and scrapped the Consumer Price Equalization Fund—its social pricing scheme for subsidizing domestic oil products—in favor of a 10-percent price increase.

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Austerity Amid Political Crisis

Political events associated with the assassination of opposition leader Benigno Aquino in August have removed all remaining financial breathing room for

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the Marcos government. Preliminary data show that the balance-of-payments deficit for the third quarter alone reached $659 million, bringing the total for the first three quarters to an unprecedented $1.4 billion. Senior government officials have told the US Embassy that a "bunching" of repayment obligations is making Central Bank clearing operations difficult. Mounting arrearages by private Philippine borrowers are also adding to foreign bankers' anxieties about their Philippine portfolios, and several short-lived runs on the Philippine banking system have forced Central Bank authorities to revive an emergency funding facility used during a financial crisis in 1981.

The Philippines: Deficit Financing *Million US $*

	1979	1980	1981	1982	1983 [a]
Total balance-of-payments deficit	**579**	**352**	**560**	**1,135**	**1,441**
Net IMF drawings	93	217	94	−123	243
Central Bank	−31	466	859	1,141	550
Net, commercial bank	517	−331	−393	117	648

[a] Data for first three quarters only.

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Although major US banks remain committed to rolling over maturing short-term loan obligations, reporting suggests Japanese and West European banks are reacting to the recent antigovernment demonstrations in Manila by withdrawing from the Philippine loan market. In the third quarter alone, foreign banks terminated $493 million in short-term loans. According to excellent sources, the maturity of the short-term debt also has contracted sharply from 180- and 270-day financing to 30- and 60-day credits. The spread private banks have charged to roll over existing credits has nearly tripled to almost 2 percentage points over LIBOR.

Manila is implementing further financial belt-tightening measures in an effort to cope. The 1984 budget announced in September calls for a 34-percent reduction in capital spending, and allocations for the fourth quarter of 1983 are being drastically reduced. Rewards are being offered to Filipinos reporting illegal foreign exchange smuggling, and new Central Bank and Board of Investment restrictions on capital good imports are in place.

Manila is also aggressively pushing sales of new Treasury bills on an unenthusiastic business elite and in Japanese financial markets in a desperate effort to raise $500 million, while sounding out Central Banks in Jakarta, Bangkok, Kuala Lumpur, and Singapore for emergency foreign exchange swap arrangements.

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Manila's recent differences with the IMF have led to even more drastic financial policy changes. The Fund suspended disbursements under an existing standby in early September when it determined that Manila was out of compliance with restrictions on domestic credit creation. Since then, Manila has sought to have disbursements resume and to secure a standby for 1984 by implementing new austerity measures advocated by the Fund. Believing that they are in no position to bargain for more politically palatable policy adjustments, Manila has also implemented a strongly resisted 21-percent devaluation of the peso and plans additional controls on imports and domestic credit creation. These measures comprise the harshest austerity since the government was forced to reschedule its debts in 1970.

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The Liquidity Management Problem

Manila's present financial difficulty is a product of Central Bank reserve management practices since 1979. The Philippines has accumulated balance-of-payments deficits equal to $4.1 billion during this period at a time when Central Bank reserves fell only $600 million. The IMF has contributed $504 million of the required financing. The rest has been produced by short-term borrowing by the Central Bank and peso-dollar "swap" facilities that allowed the Central Bank to drain the commercial banking system of foreign assets. As a result of these practices, the Central Bank in June 1983 owed short-term obligations of about $2.2 billion and the commercial banking system has accumulated a net short-term foreign debt of about $2 billion.

Central Bank liquidity is even more seriously strained than official data suggest. Manila has raised cash this year by pledging its gold reserves against futures contracts, and at one point faced the need to repurchase $400 million of its own gold reserves or sell its remaining gold stock. In addition, all but a few hundred million of its foreign exchange reserves had been pledged as compensating balances against previously obtained foreign loans as a means of keeping financing costs down.

The Bank almost certainly has now exhausted its traditional mechanisms for financing reserves. June's small devaluation did little to ease pressure on Central Bank reserves, and September's political disturbances reportedly accelerated capital flight. Manila ran down its foreign exchange accounts by $170 million during July-August and sold gold equal to about $150 million to defend the peso.

Will the Bubble Burst in the Short Term?

Last week's 21-percent devaluation was the first decisive step in restoring the Central Bank's finances and placing the country's broader external accounts on surer footing. Manila still faces the need to refinance the Central Bank's short-term debt and "wind down" the banking system's swap obligations. This requires restructuring about $4.2 billion in short-term debt that is an outgrowth of previous reserve financing practices. Manila is almost certainly considering rescheduling these credits, but we believe the devaluation is intended to produce overall payments surpluses in the months ahead, permitting the Central Bank to restructure the obligations quietly and thus minimize damage to its creditworthiness.

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With the Central Bank currently resorting to overnight loans to meet its commitments, it is nonetheless likely that rescheduling will occur in the next several weeks. Prime Minister Virata and Central Bank Governor Laya reportedly are meeting with several major New York banks this week to consider the options. The US Embassy in Manila speculates that the meetings may conclude that rescheduling is inevitable.

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Manila is continuing efforts to obtain cash on a short-term basis in order to avert payments arrearages, and this may include further appeals for US Government assistance. Manila did not previously qualify for an Exchange Stabilization Fund credit because it had no future source of new funds to bridge to. It probably now believes it has a good case because of a likely agreement with the IMF for a $650 million, 15-month standby that will replace the current loan and carry through the end of 1984. Manila is also likely to cite the near certainty of obtaining a third Structural Adjustment Loan from the World Bank, which would probably accompany the new IMF standby, as another source of fresh financing in arguing its case with the United States.

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If the financial bubble does not burst in the interim, the next critical hurdle for the Central Bank will be securing a medium- to long-term "jumbo" loan in early 1984, the Bank's traditional borrowing season. Few private banks would have considered a new loan request before last week's

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devaluation, but restoring Central Bank liquidity will require that a new loan be successfully negotiated if another crunch is to be averted sometime in early 1984. If Manila determines in the meantime that the new loan is not feasible, rescheduling is almost certain.

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How Painful a Long-Term Adjustment?

If Manila survives its current troubles, its long-term prospects are far less bleak. With recovery in the Philippines' traditional export markets on the horizon, we believe that Manila has finally put in place a policy reform package that can generate successful adjustment in the economy. The World Bank's Structural Adjustment Program has already gone a long way to reduce tariffs and streamline the manufacturing sector. Price distortions for domestic energy products have—with the exception of those for electricity—largely been eliminated. However painful the inflationary impact in the short run, the October devaluation will accomplish more than any single measure in restoring stability to the country's external accounts.

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Even so, several years will be required before imports can resume the pace of expansion required for the 6-percent annual growth the Philippines averaged in the 1970s. The manufacturing sector is responsible for most of the foreign debt buildup of the late 1970s and early 1980s, and it will have to absorb the pain of financial adjustment for some time to come. Manila thus faces a prolonged period of austerity at a time the labor force is growing rapidly, and this does not bode well for political stability.

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Indonesia: The Painful Consequences of Financial Austerity

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Indonesia is experiencing its second consecutive year of declining export earnings and slower growth as the world oil glut and sluggish commodity markets persist. The government has adopted tough austerity measures to counter its financial difficulties; real economic growth in 1983 appears likely to fall below the 2.2 percent registered in 1982. Austerity and the sluggish economy are compounding social strains by reducing real incomes and increasing unemployment. With the labor force growing by nearly 2 million workers a year, rising unemployment, particularly among younger workers, has contributed to increased labor restiveness and to an upsurge in violent crime. As matters now stand, the government is walking a tightrope between keeping a lid on these tensions and waiting for a strong recovery in the world economy.

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Sharp Policy Shift

President Soeharto is moving aggressively to counter the deterioration in Indonesia's financial position. To avoid depleting foreign exchange reserves and to preserve its international credit standing, Jakarta has taken a number of steps so far this year:

- An austere budget was announced last January, which included sharp reductions in subsidies for fuel, food, and fertilizer, a continuing government pay freeze, and a squeeze on most other government spending.
- A 28-percent devaluation on 30 March restored the competitiveness of the rupiah lost since the previous devaluation in November 1978.
- A rescheduling of large-scale, import-intensive industrial projects valued at over $21 billion has postponed some projects and canceled others; this will save $3 billion in foreign exchange expenditures in 1983-84 and an additional $7 billion in subsequent years.
- Banking reforms are designed to encourage domestic saving and investment by liberalizing the complex regulatory system. In addition, the government is preparing a comprehensive tax reform intended to broaden the tax base, reduce Jakarta's dependence on oil revenues which now account for 60 percent of government receipts, and improve tax administration.

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The austerity program has won praise from foreign bankers and lenders, reversed the capital flight that occurred earlier this year, and appears to be holding down the current account deficit by slashing imports. According to US Embassy reporting, official foreign exchange reserves have recovered to about $4 billion, and net foreign assets of the banking system have remained at about $3.5 billion. If the government sticks with its program, we believe Jakarta can hold the 1983-84 current account deficit to less than last year $6.5 billion and gradually reduce the deficit in subsequent years.

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Jakarta's current economic policy stance represents an effort by the technocrats under the leadership of Economics Coordinating Minister Ali Wardhana to balance the need to maintain Indonesia's international creditworthiness against the need for economic growth and jobs for the labor force. In our judgment Jakarta can hold to its current strategy for the next year or two, but the technocrats are relying on recovery in the world economy to restore export earnings and permit a resumption of relatively rapid growth.

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Sluggish Economic Performance Continues

Jakarta's reliance on spending and import restraints to avoid a worsening financial position is a drag on Indonesia's economic growth. With oil and LNG accounting for over 80 percent of export earnings, the sluggish world oil market had already reduced the impetus to growth. Oil export volumes remain close to the 1.3-million-b/d quota adopted in March 1982, but earnings are below 1982 levels because of the OPEC price cut last March. LNG export earnings are down as a result of the indexing to oil prices, a drop in volume caused by reduced spot purchases by Japanese buyers, and an accident at the Bontang plant in Kalimantan last April that knocked out one of the country's five LNG production units for the rest of 1983. Although Indonesia has increased exports of some goods such as plywood, rubber products, and textiles over the depressed levels of 1982, world demand remains generally soft for primary commodities, which account for 15 percent of Indonesia's exports.

The manufacturing sector at best will achieve only modest gains this year. The government has followed an import-substitution industrial development strategy, and domestic manufacturers typically sell more than 90 percent of their output in heavily protected domestic markets. Because of depressed incomes, domestic demand for manufactured goods continues to be sluggish.

Agriculture remains a question mark. After recording gains averaging more than 8 percent annually for the preceding three years, rice output in 1982 grew close to the long-term average of 4 percent. Drought delayed planting of the main 1983 rice crop, which will result in a further slowdown in rice output growth this year. These developments have forced Jakarta to resume large-scale rice imports this year after attaining near self-sufficiency in rice production. Even if a return to more normal weather permits timely planting of the main 1984 crop in the next two months, Jakarta will need to continue large-scale imports to rebuild its rice stocks.

Social Costs of Austerity

The cutbacks in government spending and the industrial development program are helping to protect the country's international financial position at the expense of increasing economic hardship for the populace. Real incomes have fallen as a result of the cutbacks in fuel and food subsidies, the government-wide wage freeze, the devaluation, and rising unemployment. Although government officials have said they intend to divert some of the savings from the canceled industrial projects to more labor-intensive construction projects, in our judgment Jakarta is unlikely to create enough jobs to employ all the displaced workers.

Layoffs are compounding the problem of creating jobs for the fast-growing labor force. Although the government's official figure for unemployment was only 4 percent in early 1983, it drastically understates the problem. The US Embassy estimates that at least 20 to 25 percent of the labor force is effectively unemployed, with younger workers suffering most severely. A World Bank study calculated that 40 percent of urban males and 76 percent of urban females in the 20 to 24 age bracket were out of work in 1980 even before the current recession. Layoffs in rubber, coffee, and other plantations, as well as manufacturing industries, in the past two years have put more than 250,000 people out of work.

Besides increased labor unrest, many observers attribute an upsurge in violent crime to the rise in unemployment. The government has responded to the crime wave with a campaign of summary shootings of "known criminals" by four-member military squads that have probably killed over 1,200 suspects this year. Although the government ordered a halt to the killings in August, many observers believe the campaign is continuing, although on a reduced scale.

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Slower Economic Growth Ahead

We expect that the depressed world oil market and sluggish growth in rice output will result in economic stagnation in 1983. Efforts to promote private domestic investment and to attract foreign investment are not likely to be sufficient to offset the reductions in export earnings or government spending. Growth probably will resume in 1984, but at a considerably slower pace than the 1970s. Indeed, President Soeharto last August said he expects the economy to grow only 5 percent annually in the next five years, a rate the World Bank considers too slow to create enough jobs for the rapidly growing labor force. Slower growth will limit job opportunities for new entrants to the labor force and, indeed, could increase hardships for workers displaced by the slowdown in the industrial development program.

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The Soeharto government probably will have to deal with increasing dissatisfaction among students and other youths whose prospects now seem poorer than at any time in the past decade. Growing social discontent in our view is most likely to manifest itself in anti-Chinese riots, which could erupt at any time in Indonesia's cities from seemingly random incidents as happened in Central Java in 1980. Orthodox Muslim distaste for the Soeharto regime could also lead to clashes directed against the government.

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Soeharto's austerity program thus carries political costs that will be incurred before the potential benefits can be realized. The technocrats can offer no guarantee that their policies will cause faster growth or reduce unemployment; Indonesia remains dependent on volatile world commodity markets and the weather. If economic recovery should stall, we believe the technocrats would face increasing criticism from both anti-Western populist-oriented advocates of rural development and proponents of continuing investment in large capital-intensive projects. The social strains already evident in the form of rising unemployment and urban crime would increase pressure on Soeharto to ease restrictive economic policies.

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In our view, Soeharto has adopted the technocrats' belt-tightening program to avoid problems other debt-burdened countries have encountered. We believe he is willing to risk the political unpopularity of government spending cuts as long as he sees a prospect of economic recovery in the not-too-distant future. He has appointed hardliners to key cabinet posts such as the Ministries of Labor, Education, and Defense to suppress any opposition to his policies. If the economic recovery falters, however, Soeharto could make the technocrats the political scapegoats for the seeming failure of their policies and resort to more repressive policies to stifle dissent.

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Yen Appreciation and Japan's Current Account Surplus

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With Japan's current account surplus headed for record levels this year and likely to expand further in 1984, Tokyo has grown increasingly concerned about protectionism in key foreign markets, particularly the United States. While past surpluses have been cut by large increases in raw material import prices such as the large oil price hikes of 1973 and 1979, most observers believe such increases are unlikely in the near future. For their part, Japanese officials apparently believe that yen appreciation would moderate foreign protectionist sentiment as well as reduce foreign efforts to enlarge access to Japanese markets. We believe, however, that yen appreciation to the range of 200 to 175 per dollar that most observers now think is reasonable would do little to improve the current account situation. Indeed, over the next year—a period when the political agenda in Japan's major trading partners could produce strong protectionist forces—rapid yen appreciation would temporarily add to Japan's current account surplus rather than reduce it. Only a rapid runup in raw material prices, a radical change in Japan's capital account, or a much larger yen appreciation than is now foreseen would contain the surplus.

The Surplus

We believe the 1983 current account surplus will more than triple last year's $6.9 billion level. Lower oil prices are responsible for an estimated $7-8 billion of the increase. Sluggish import demand, a reflection of the slack Japanese economy, is a secondary factor. On the export side, shipments have been rising since May, largely because of the yen's weakness and the recovery in Japan's number-one export market, the United States.

Japanese policymakers are aware of the foreign policy problems posed by the burgeoning surplus, but they have few acceptable options for limiting its growth. In September, the Nakasone government announced that import-promotion policies would be introduced, but we believe these will be mainly symbolic. Most Japanese leaders believe that stimulating domestic economic growth is a partial solution but doubt that it can be done on a large enough scale to make much of a dent in the surplus. Because of Tokyo's already large fiscal deficit, there is no support for a significant change in tax policy beyond a small income tax cut.

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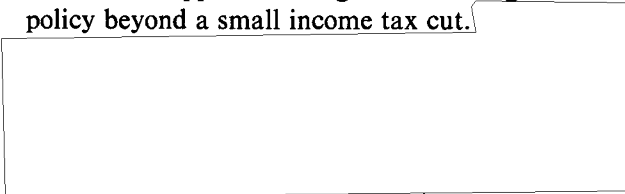

Role of the Yen

Most analysts in Japan believe that the weak yen is the underlying source of the current account surplus. Policymakers are now reviewing options for strengthening the yen

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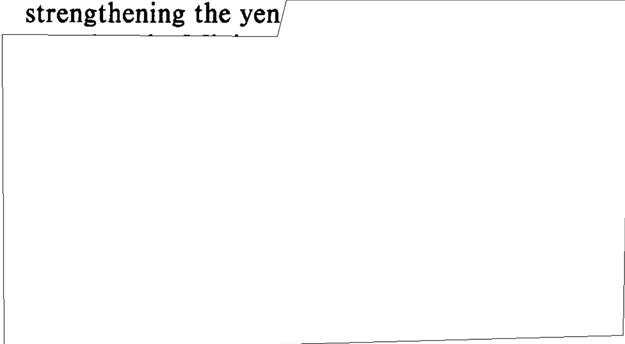

Most foreign observers agree with Tokyo that the yen is undervalued and that yen appreciation will erode Japan's huge current account surplus.

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Although few agree on what level the yen should reach, most believe it should be less than 200 to the dollar. Data Resources Incorporated, for example, believes the equilibrium rate—the rate that would eliminate Japan's cost advantage—is 200 to 180 yen per dollar. Labor unions and some US firms argue that it is closer to 175.

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To test the impact of yen appreciation on Japan's current account surplus we used the CIA Linked Policy Impact Model. None of our scenarios assumes any change in this year's surplus. Our baseline projection assumes that the yen appreciates slowly from 243 to the dollar in 1983 to 227 and 212 yen per dollar in 1984 and 1985, respectively. Using these rates, the current account surplus expands slightly to $24 billion in 1984 and grows rapidly after that.

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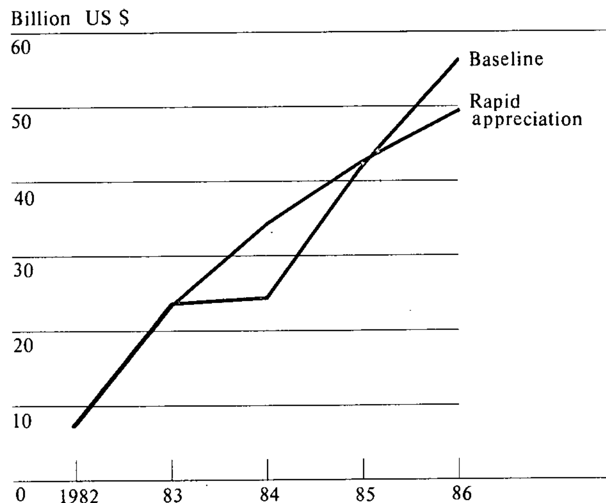
Against the baseline case we tested a scenario of more rapid appreciation with a yen value of 200 to the dollar in 1984 and 180 in 1985. Neither scenario brings Japan's current account surplus closer to balance within these two years. Under the rapid appreciation scenario the 1984 surplus would be about $10 billion above the baseline projection and in 1985 nearly $1 billion above. The growth of the surplus reflects delays in the ability of the market to adjust to the increased dollar price of Japanese goods. The initial decline in export volume is slight, so the dollar value of exports increases as Japanese businesses raise dollar prices to offset lost profits due to the appreciation. By 1986, however, the surplus is nearly $7 billion less than in the baseline case as the impact on export volume catches up with the price factor and the more rapid yen appreciation finally results in a decline in the surplus.

Possible Developments

Steep runups in raw material prices have turned large Japanese current account surpluses into deficits twice in the last decade. In the absence of an external interruption in supply, however, raw material prices are unlikely to rise rapidly enough to narrow the surplus. Moreover, changes in Japan's

Japan: Effects of Yen Appreciation on Current Account Surplus



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industrial structure have reduced import requirements for oil, copper, iron ore, coking coal, and other materials. Crude oil import requirements, for example, are now 3.5 million barrels per day compared to 4.9 million in 1973-74.

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Another possibility is that the surge in capital outflows that has helped depress the yen in recent years will slow. If US interest rates have peaked, US financial markets would begin to look less attractive. Indeed, some of the capital that has flowed to the United States in the last two years might return to Japan, thus strengthening the yen.

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A third possibility is that we are underestimating the scale of potential yen appreciation. In previous periods of rapid appreciation, the yen has risen far higher than most observers expected. In late 1977 when the yen broke the 240 to the dollar mark,

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almost all market participants thought that it had peaked. A year later it broke 180 to the dollar. A rise in the yen toward 200 to the dollar could set in motion inward flows of speculative funds that could push the yen far beyond the 180 mark. Under such a scenario the turnaround in export volume might occur much sooner, and import demand could rise sharply, thus reducing the massive current account surplus.

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Our analysis shows that an appreciation of the yen to the range foreseen by most observers will be insufficient to erode the current account surplus. Should none of the above developments occur, political pressure will mount on Tokyo to take more direct action.

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