CIA/OER /S-07592-75 BRIEFING MATERIAL FOR MR. HENRY LEE
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23 July 1975

MEMORANDUM FOR THE RECORD

SUBJECT: Briefing Material for
Mr. Henry Lee

The attached briefing package was prepared for use by Mr. Henry Lee, US Alternate Executive Director, Asian Development Bank. In addition to the written material, Mr. Lee was given a verbal briefing on 23 July 1975 on the South and East Asian area, including Mainland China. The briefing included both OER and OCI analysts and extended from 9:00 A.M. to 3:30 P.M.

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Industrial Nations Division
Office of Economic Research

Attachment:
As stated

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1 - David Laux (Treasury)

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Briefing Material

for

Mr. Henry Lee

US Alternate Executive Director (Designee)

Asian Development Bank

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Political and Economic Briefing

on

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18 April 1975

I. The Current Political Situation in the People's Republic of China

Peking in recent months has devoted primary attention to putting its domestic house in order, a precondition for carrying out its stated goal of building a modernized China by the end of the century. Repeated calls for unity and stability suggest that China's leaders are trying to put behind them the personal and political animosities that have plagued the leadership for the past nine years and have slowed economic development. Political instability over the last several years has contributed to an erosion of public confidence in China's leaders. This has been especially true of local officials, who have been reluctant to carry out Peking's orders for fear of being caught in a sudden shift in the political line.

Major party and government meetings held last January emphasized the unity theme and, more importantly, laid the groundwork for a relatively orderly succession to the current aging leadership. China's current leaders are essentially the same group that has ruled the country since the Communists came to power in 1949. As none of these people can be expected to survive for more than 10 years, a priority need is the grooming of younger leaders who are capable of directing China's economic development program for the next 25 years.

The succession question took on greater urgency last summer with the hospitalization of Premier Chou En-lai who is generally regarded as the architect of China's current domestic and foreign policies and the leader of the moderate coalition in the party. Chou remains in a rest home but seems still to be in overall control of affairs of state. The supervision of day-to-day affairs, which was Chou's primary task for more than 20 years, has now been turned over to 70-year-old Teng Hsiao-ping. At the meetings in January, Teng was named first deputy premier and is Chou's apparent successor.

Teng seems to be in general agreement with Chou En-lai's policies and is not expected to make any major changes if and when he becomes premier. Teng has a well-earned reputation as a strict disciplinarian and an able and experienced administrator. At the meetings in January, Teng was named to top positions in the party and the national military hierarchy, thereby giving him important posts in China's three major bureaucrasies – the party, government, and military.

At his age, however, Teng is an interim successor at best. Behind him are several competent officials in their 40s, 50s, and 60s who were also given important jobs last January. The State Council that was appointed in January consists primarily of these and other officials of moderate persuasion. Several are known proteges of Chou.

The extreme left wing of the party, which is headed by Mao's wife, Chiang Ching, was all but excluded from the new government and has lost influence in party affairs as well. The power of the military, which was the dominant political force until a few years ago, has also been sharply reduced. Civilians have been named to several top military posts, and many of the most influential military men in the provinces were transferred away from their power bases and sent to new areas where they have been denied top party and government positions. Peking had reason to believe that some of these military men may have been involved in an alleged coup plot in 1971.

As Peking builds toward the future, the position of China's top leader, Mao Tse-tung, has come increasingly into question. Mao has been out of Peking since last summer, his longest absence from the capital since coming to power. Recently he has stopped meeting foreign visitors, and there are signs that Chinese officials are beginning to take a critical view of many of Mao's former policies. Some people seem to hold Mao responsible for the political instability of recent years. Although Mao is on record as endorsing the unity and stability theme, his physical separation from the rest of China's leaders raises questions about his actual view of current developments. Mao is kept fully informed of all major developments, but the Chairman's prolonged absence from the capital suggests that he may not fully endorse some recent decisions.

II. The Chinese Economy

Premier Chou En-lai in his government work report to the National Peoples Congress last January surveyed the mixed performance of the economy in 1974 and suggested that the leadership expects economic growth to be gradual for some time. Although Chou provided few statistics on either planning or performance, we believe that the Chinese economy grew in 1974 by only 3% – down from almost 10% in 1973. Growth in industry slowed to 4%, from a respectable 12% in 1973, and agricultural output barely matched the increase in population (about 2%).

Among the factors holding back industrial growth in 1974 were:

- the persistence of imbalances among the extractive, processing, and finishing industries, highlighted by shortages of coal;
- sporadic work stoppages, lowered worker morale, and reduced productivity created by the anti-Confucius campaign; and
- the overburdening of the transportation system, particularly the railroads.

The sharpest decline occurred in steel output, which fell by 6% in 1974 to about 24 million tons. On the positive side, the petroleum industry continued its strong growth, with a 20% increase in crude output to the 65 million ton level during the year, while the production of electric power, tractors, chemical fibers, and cement also showed increases.

Agricultural growth during 1974 was adversely affected by generally unfavorable weather for winter wheat and for fall-harvested grains. Grain output exceeded the 1973 level of 250 million tons, rising to about 255 million tons. Nevertheless, grain production in 1974 was clearly less than the authorities hoped for. Imports of grain, which were 7 million tons in 1974, will continue, with 5.4 million tons already slated for delivery in 1975.

In foreign trade, total exports rose last year, with the rapid expansion of earnings from oil exports more than offsetting the impact of shrinking world markets for traditional Chinese exports. Imports grew even faster as worldwide inflation pushed up China's import costs. China's hard currency trade deficit increased from the 1973 level of $370 million to perhaps $1.3 billion in 1974, in part from heavier use of medium-term credits to finance whole plant imports.

Chou reaffirmed the development priorities of agriculture, light industry, and heavy industry which have prevailed since late 1972 and reiterated Chinese interest in expansion of trade relations with the non-Communist world. The reduction of economic ministries and commissions – from 40 to 25 and from 12 to 3, respectively – announced at the NPC and Chou's statement that the PRC is drawing up a ten-year plan in addition to five-year and annual plans suggest that the degree of centralized planning and management of the economy is to increase.

Chou also singled out the period of the Fifth Five-Year Plan (1976-80) as crucial to PRC attainment of economic "front rank" status in the world by the end of the century. The basic problem remains that of lifting the long-term rate of grain production above the rate of population growth. Solution of this problem through expanding industrial inputs to agriculture – including inputs of foreign technology – is clearly implied in Chou's speech. In sum, Chou En-lai appears to have charted a course of carefully planned but slow growth for the economy over the next 15 years. The leadership is in transition and, given the PRC's past experience with radical turns in economic policy, the present moderate approach may be difficult to maintain.

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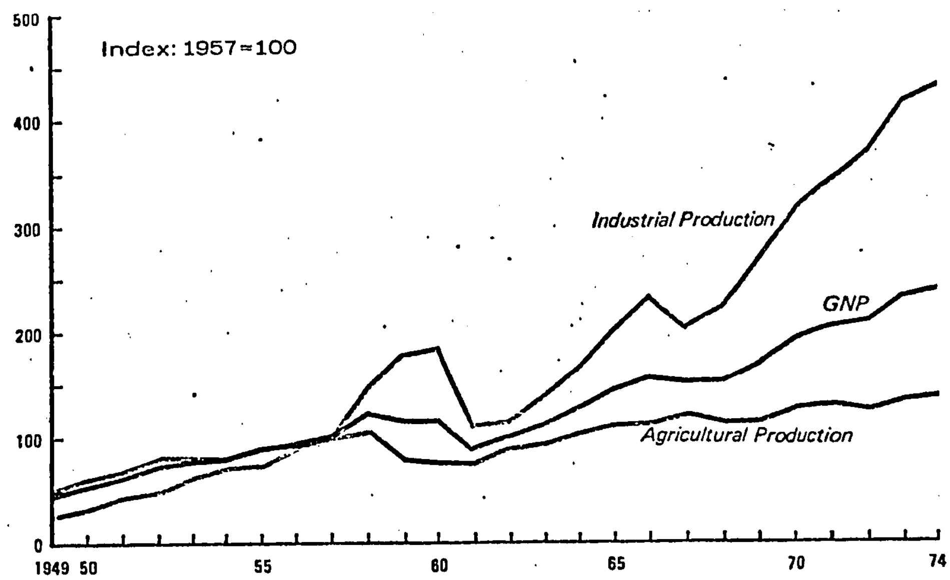
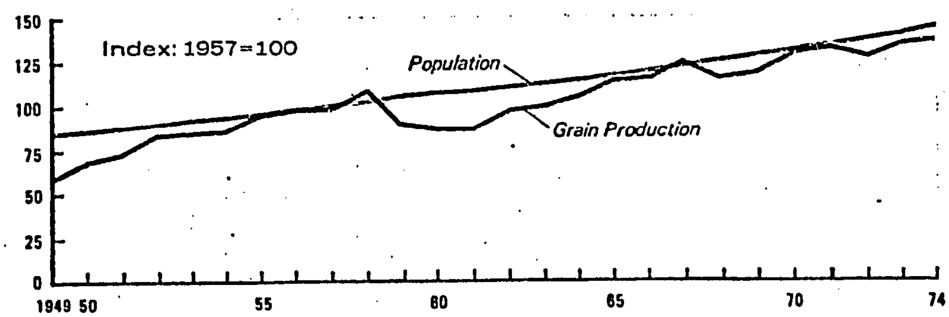
China: GNP, Industrial Production, and Agricultural Production



China: Grain Production and Population



People's Republic of China: Economic Indicators

June 1975

	1952	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974 (Prelim)
GNP (billion 1973 US $)	67	94	113	107	106	82	93	103	117	134	145	141	142	157	179	190	197	217	223
Population, mid-year (million persons)	570	641	657	672	685	695	704	716	731	747	763	780	798	817	837	857	878	899	920
Per capita GNP (1973 US $)	117	147	172	160	155	118	133	144	160	179	190	180	178	192	214	222	225	241	243
Grain (million metric tons)	154	185	200	165	160	160	180	185	195	210	215	230	215	220	240	246	240	250	255
Cotton (million metric tons)	1.3	1.6	1.7	1.2	0.9	0.8	1.0	1.2	1.7	1.9	1.8	1.9	1.8	1.8	2.0	2.2	2.1	2.5	2.5
Industrial production index (1957 = 100)	48	100	145	177	184	108	114	137	163	199	231	202	222	265	313	341	371	416	432
Crude steel (million metric tons)	1.35	5.35	11.1	13.4	18.7	8	8	9	10.8	12.5	15	12	14	16	17.8	21	23	25.5	23.8
Coal (million metric tons)	66.5	130.7	230	300	280	170	180	190	204	220	248	190	205	258	310	335	356	377	389
Electric power (billion kilowatt hours)	7.3	19.3	28	42	47	31	30	33	36	42	50	45	50	60	72	86	93	101	108
Crude oil (million metric tons)	0.44	1.46	2.3	3.7	5.5	5.3	5.8	6.4	8.7	10.8	13.9	13.9	15.2	20.3	28.5	36.7	43	54.5	65.3
Cement (million metric tons)	2.86	6.86	10.7	12.3	12.0	8.0	6.9	9.1	10.9	14.8	16.9	14.2	17.4	19.6	19.8	23.0	27.5	29.9	31.6
Chemical fertilizers (million metric tons)																			
Supply	0.4	2.1	3.2	3.3	3.6	2.9	4.0	6.6	7.6	10.8	13.2	13.8	15.6	17.9	21.4	24.2	27.6	32.2	30.5
Production	0.2	0.8	1.4	1.9	2.5	1.8	2.8	3.9	5.8	7.6	9.6	8.1	9.5	11.3	14.0	16.8	19.9	24.8	24.8
Imports	0.2	1.3	1.8	1.4	1.1	1.1	1.2	2.7	1.8	3.2	3.6	5.7	6.1	6.6	7.4	7.4	7.7	7.4	5.7
Machine tools (thousand units)	13.7	28.3	30	35	40	30	25	35	40	45	50	40	45	55	70	75	75	80	N.A.
Trucks (thousand units)	0	7.5	16.0	19.4	15	1	8.4	16.8	20.3	30	43	32	27	60	70	86	100	110	N.A.
Locomotives (units)	20	167	350	533	602	100	25	27	27	50	140	200	240	261	285	205	225	240	N.A.
Freight cars (thousand units)	5.8	7.3	11	17	23	3	4.0	5.9	5.7	6.6	7.5	6.9	8.7	11	12	14	15	16	N.A.
Cotton cloth (billion linear meters)	3.83	5.05	5.7	6.1	4.9	3.3	3.5	4.6	5.1	6.4	6.7	5.5	6.0	6.6	7.5	7.2	7.3	7.6	7.6
Foreign trade (billion current US $)																			
Total	1.89	3.06	3.76	4.29	3.99	3.02	2.68	2.77	3.22	3.88	4.24	3.90	3.76	3.86	4.29	4.72	5.92	9.88	13.7
Exports f.o.b.	0.88	1.62	1.94	2.23	1.96	1.53	1.53	1.57	1.75	2.04	2.21	1.95	1.94	2.03	2.05	2.41	3.08	4.90	6.3
Imports c.i.f.	1.01	1.44	1.82	2.06	2.03	1.49	1.15	1.20	1.47	1.84	2.03	1.95	1.82	1.83	2.24	2.31	2.84	4.98	7.4

Source: Central Intelligence Agency, Office of Economic Research.

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III. China's Foreign Trade in 1974-75

Highlights in 1974

China's foreign trade boom fell victim in 1974 to the growing problems of the world economy. Total trade increased by about 25%, to roughly $12.5 billion, well below the 67% increase in 1973. Most of the increase is attributable to higher prices, with little or no growth in volume. Worldwide inflation pushed up China's import bill while the economic slowdown in the West cut demand for Chinese exports, resulting in the largest trade deficit in China's history – perhaps $1.3 billion with the non-Communist world, and despite a surplus with the Communist world, about $1 billion overall.

Despite these difficulties, China's balance of payments is not in crisis. Reserves are well in excess of the trade deficit, the level of foreign debt is manageable, and Peking's credit rating is excellent.

China began taking steps to relieve the financial squeeze last fall. Contracts for agricultural products were deferred or canceled. Fertilizer deliveries were postponed. Peking also increased its use of short- and medium-term credits.

Trading Partners

Trade with the non-Communist countries posted the largest gains, accounting for almost 85% of China's total trade. Imports from the developed West shot up to slightly above $5 billion from $3.4 billion in 1973, largely due to increased purchases of agricultural products and machinery. China's deficit with the developed countries was roughly $2.9 billion.

Sino-Japanese trade jumped 50%, to $3.3 billion. China's imports, boosted by sizable deliveries of machinery and equipment, exceeded exports by more than $800 million. China's exports of 4 million tons of crude oil worth about $380 million more than offset the decline in its traditional exports to Japan.

US-China trade totaled $935 million, a smaller increase than anticipated at mid-year because China canceled contracts for US grain worth about $300 million. Wheat, corn, cotton, soybeans, and other agricultural products composed about 80% of total US exports of $820 million (see the table). US machinery and equipment exports rose as delivery began on equipment for the ammonia plants purchased in 1973 and the second half of the $150 million Boeing contract was

US-China Trade[1]

	1972	1973	1974
			Million US $
US exports	63	690	820
Agricultural products	61	578	~~656~~ 670
Of which:			
Wheat	35	278	234
Corn	24	132	96
Soybeans	....	43	140
Cotton	....	101	186
Vegetable oils	2	19	8
Machinery and equipment	2	69	107
Of which:			
Aircraft, including engines, parts, and accessories	....	63	76
Steel scrap	....	24	12
Other	....	19	31
US imports	32	64	115
Food, beverages, and tobacco	4	7	16
Bristles and other crude animal materials	8	8	10
Textile fibers	4	6	5
Nonferrous metals	2	8	11
Chemicals (including fireworks)	2	8	18
Cotton fabrics	2	7	26
Antiques and works of art	3	6	8
Other	7	14	21

1. Source: US Department of Commerce data.

completed. Growing purchases of cotton textiles helped boost US imports of Chinese goods to $115 million, up from $64 million in 1973.

US-China trade encountered several problems last year. Chinese complaints over the quality of US grain caused delays in wheat shipments and the cancellation of soybean contracts. US controls on scrap steel exports prevented delivery on several contracts. On the import side, shipments of Chinese shrimp were rejected by the Food and Drug Administration, and the Chinese at the Fall Canton Fair were more vocal about the lack of most-favored-nation status for their exports.

Commodity Flows

Purchases of agricultural products, machinery, and transport equipment were largely responsible for the growth of China's total imports. China contracted for almost 10 million tons of grain in 1974, but shipping delays and contract cancellations dropped actual deliveries to 7 million tons, down from 7.7 million in 1973. Higher grain prices, however, pushed the cost up to over $1 billion. Imports of soybeans and cotton were up substantially from 1973. Machinery and equipment imports rose sharply as large-scale deliveries began on the $2.5 billion worth of whole plants and other equipment ordered in 1973.

Peking signed contracts for $900 million worth of whole plants in 1974 – down from the record $1.2 billion level in 1973. Rapid inflation and tight world credit markets, plus China's need for a breathing spell to absorb the large amount of technology already purchased, were the major reasons for the slowdown in purchases. Contracts worth $550 million for the Wu-han steel rolling complex composed much of the purchases, with the balance going for additional synthetic fiber, fertilizer, and electric power plants. In contrast to the whole-plant program, new orders for machinery and transport equipment in 1974 were off sharply from the record level of 1973.

China's exports rose by roughly $1 billion in 1974; petroleum accounted for almost half of the increase. Sales of crude oil and petroleum products to Japan, the Philippines, Hong Kong, and Thailand amounted to about 4.5 million tons worth $440 million. Rice exports benefited from high prices, but other traditional Chinese exports, particularly silk and cotton textiles, faced declining demand.

Outlook for 1975

China's trade this year will be tempered by Peking's attempts to reduce its trade deficit. Export growth will be small, reflecting poor sales of traditional products at the 1974 Canton fairs and recession-weakened demand in the West. An expected doubling of petroleum exports may do little more than offset the decline in other exports.

Imports of machinery and equipment will be substantial as large-scale deliveries continue on 1973 and 1974 contracts. The successful 1974 harvest and declining textile exports will permit cutbacks in grain and cotton imports. Other, less essential imports will be curtailed and the pace of new plant contracts may slow further.

The $700 million surplus enjoyed by the United States in its trade with China in 1974 will be cut sharply in 1975. US exports to the PRC could fall to one-third last year's level, while US imports will continue to rise. China's current low interest in US agricultural products stems from an adequate domestic crop last year, a determination to ease a tight foreign exchange situation, and dissatisfaction with the quality of US wheat, corn, and soybeans. Peking canceled contracts for almost 1.0 million tons of US wheat in early 1975, thereby eliminating the United States as a supplier at least for the time being. As for cotton, contracts called for delivery in 1975 of 500,000 bales worth about $100 million. Chinese interest in US cotton has diminished, however; one contract for 200,000 bales has already been canceled and additional cancellations may occur.

In contrast to farm products, US industrial exports should continue to rise in 1975. Although new orders for US machinery totaled only $15 million in 1974, deliveries under 1973 contracts -- notably equipment for the eight Kellogg ammonia plants -- will peak in 1975. With export controls off, US sales of steel scrap could rebound to the 1973 level or higher. Gains are likely for such US manufactured goods as paper, aluminum, fertilizer, and other chemicals.

The steady rise in US imports of Chinese goods is likely to continue -- from $115 million in 1974 to $125-$150 million in 1975. Chinese interest in the US market is growing at a moderate pace. Dramatic changes in products or marketing arrangements are not to be expected this year.

IV. The PRC Petroleum Situation

Introduction

Fifteen years ago, the People's Republic of China relied on the USSR for more than half of the oil it consumed. Today, China is the world's 13th largest oil producer and has emerged as a potentially large oil exporter. This paper briefly reviews the development of China's petroleum industry and the recent growth of its oil exports and assesses the prospects for future exports.

Energy Supply Position

The PRC produced an estimated 460 million tons (SFE basis)* of primary energy in 1974. In the late 1950s, China relied on coal for 95% of its primary energy. Since then the primary energy mix has undergone considerable change. As shown below, the role of coal has declined, while both oil and natural gas have risen in importance.

Percent of Primary Energy Produced

	1957	1974
Coal	95	64
Hydro	2	2
Natural gas	1	18
Oil	2	17

Currently energy supplies are tight; coal production has not kept up with demand. Although the rapid growth of petroleum production gives Peking the option of substituting oil for coal, the government has taken only limited steps in this direction, at least partly because of China's huge reserves of coal. More important, Peking appears to believe that increasing oil supplies are better used to expand the petrochemical industry and to earn much-needed foreign exchange.

Crude Oil Output, Reserves, and Exploration

China achieved self-sufficiency in crude oil production in the mid-1960s and in 1974 was the world's 13th largest producer, behind Indonesia. Crude oil output grew at a rate of 22% per year during 1965-74 and reached 65 million tons (1.3 million barrels per day) in 1974 (see the table).

* Standard Fuel Equivalent (calorific value of 7,000 kilocalories per kilogram).

China: Crude Oil Production

Year	Million Metric Tons	Thousand Barrels per Day
1950	0.2	4
1955	0.9	18
1960	5.3	106
1965	10.8	216
1966	14.0	280
1967	14.0	280
1968	15.0	300
1969	20.3	406
1970	28.5	570
1971	36.7	734
1972	43.0	860
1973	54.5	1,090
1974	65.0	1,300

The overwhelming portion of crude output is produced at relatively new fields in Manchuria (the Ta-ch'ing field), north China (the Ta-kang and Sheng-li fields), and central China (the Ch'ien-chiang field). Older fields in the west and northwest (Yu-men, Tsaidam, Karamai, and Yen-ch'ang) produce a relatively small share of total output. (For the location of the major Chinese petroleum facilities, see the map.)

There are no authoritative estimates of oil reserves in the PRC. Proved reserves are thought to be at least 1 billion tons. Considering that large areas have not been surveyed, potential reserves probably are much larger. The main thrust of the Chinese exploration and development effort is still on land.

Offshore exploration has only recently begun and has been concentrated in the shallow Po Hai Gulf. The Po Hai deposits, which are adjacent to and probably part of the oil basin underlying the important onshore Ta-kang and Sheng-li fields, should begin to produce significant quantities of oil in the next few years. Activity in the deeper water of the Yellow, East China, and South China seas has been limited to geological surveys and preliminary drilling. During the last year, however, China has purchased about $150 million worth of rigs and supply ships for offshore exploration. Aside from the development of the Po Hai, which should proceed apace, other offshore exploration and development will be deliberate. PRC activity here appears to be based more on the fear that foreign rivals will stake out prior claims on the continental shelf, rather than on a need for additional oil.

Oil Refining and Transportation

The PRC has given high priority to refinery construction since the mid-1960s. Current refinery capacity is probably in excess of 50 million tons, and additional capacity is under construction. The progress in construction and the absence of Chinese interest in importing refinery equipment suggests that China is able to construct sufficient refining capacity for its own needs.

Transportation facilities have been pressed to keep pace with the growth of crude oil production. Until recently most of China's oil was carried by rail. Now, tankers and newly constructed pipelines are carrying rapidly growing quantities of oil.

Almost half of the domestic tanker fleet, which now totals about 600,000 DWT, has been acquired or built since 1971. About one-fifth of the crude produced is moved in domestic tankers (all smaller than 50,000 DWT), mainly from Dairen, Tsingtao, and Ch'in-huang-tao, to refineries in Shanghai and Nanking.

In 1974, the PRC completed two major pipelines, running from the Ta-ch'ing field in Manchuria to new oil-loading facilities at the port of Ch'in-huang-tao and from the Sheng-li field in Shantung Province to the port of Tsingtao. These pipelines are mainly to facilitate the export of oil, which previously moved to port by railroad tank cars.

Petroleum Consumption

Consumption of petroleum products by sector cannot be estimated with any precision, but it is clear that the sharply increased supply of petroleum is causing important changes in almost every sector of the economy. The increased use of petroleum in transportation and industry has characterized China's economic growth in recent years. The agricultural sector and the infant petrochemical industry particularly have benefited from plentiful oil. The leadership maintains strict control over the allocation of petroleum. Supplies are channeled to priority users, and recurrent campaigns are mounted for the conservation of petroleum.

Petroleum Exports: 1974 and 1975

Peking began to export crude oil in 1973 with the sale of 1 million tons of crude oil (20,000 b/d) to Japan. Prior to this, exports had been limited to small quantities of petroleum products for political allies such as Albania, North Korea, and North Vietnam. Four million tons (80,000 b/d) of crude oil, worth about $400 million, were sold to Japan in 1974.* Another 250,000 tons of crude were to be shipped to the Philippines in the final quarter of 1974. China also exported small quantities of petroleum products to Hong Kong (200,000 tons) and Thailand (50,000 tons). Crude oil exports to Japan this year should reach 8 million tons (160,000 b/d), worth about $700 million. The Philippines may receive 750,000 tons of crude oil in 1975. Hong Kong and Thailand will continue to receive small quantities of products.

Crude oil is a welcome addition to China's exports. Large imports of wheat and an aggressive program of whole-plant purchases, beginning in 1972, have forced Peking to seek new means of financing its trade. In the next few years, exports of petroleum will provide more than $1 billion in hard currency annually, thus contributing measurably to China's ability to pay for its rapidly expanding imports.

Political Uses of Oil Exports

The agreements to ship diesel fuel to Thailand and to sell crude oil to the Philippines are part of PRC attempts to normalize relations with these states. [redacted]

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Prospects for Oil Exports

A goal of 50 million tons of crude oil for export in 1980 appears feasible. Reserves are large enough. If production continues to grow at 22% -- the rate achieved during 1965-74 -- the PRC could export 50 million tons in 1980 and

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* PRC oil imports are minimal. Some crude is imported from Albania and the Middle East, and special products are imported from several other countries.

still have ample supplies of oil for modernizing the economy. Presumably most, or all, of any crude oil exports would go to Japan. If an agreement with Japan is eventually concluded, the export of 50 million tons of oil in 1980 would provide Japan with 12% of its projected consumption and, at current prices, would earn China more than $4 billion.

If the PRC encounters unexpected difficulties in achieving the output of crude oil necessary to meet increased domestic and export requirements, it conceivably might change its attitude toward foreign participation in the development of its petroleum industry. China presently rejects joint ventures, direct foreign investment, and product sharing. Nevertheless, other arrangements cannot be ruled out. Exploitation of the deeper waters off the Chinese coast is likely to require foreign, and particularly US, technology.

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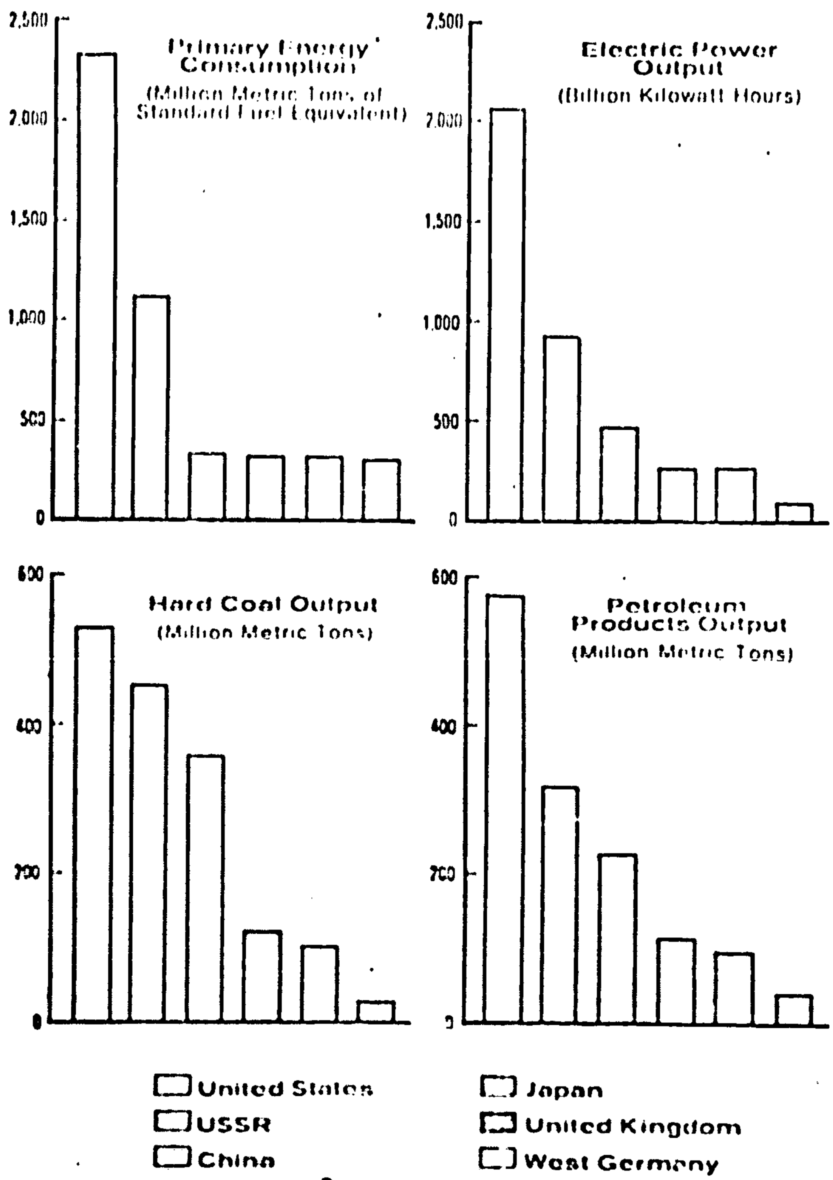
Energy Comparisons, 1973



*Data are for 1972

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China: Selected Petroleum Facilities

564833 12-74

TAB B

Indonesia: Recent Changes in Fortune

In the last few years, Indonesia has shifted from heavy dependence on foreign financial aid to a position of relative financial independence. High world prices, particularly for oil, pushed exports to the US $3 billion mark in 1973, contributing to a gain of more than $200 million in foreign exchange reserves. The performance in 1974 was even better as oil brought the Indonesians $2.2 billion, and their exchange reserves rose to some $1.5 billion.

Accompanying the strong foreign sector gains was real annual growth on the order of 8%-10% during 1973-74. This surge beyond earlier average rates of 6%-7% came from a combination of improved agricultural performance, increased oil output, contract revisions that allow Indonesia to keep more of the gains from oil, and the related stimulus to other sectors.

Although living standards have doubtless improved, oil revenues have yet to be translated into major development gains for most Indonesians. The majority of them live on Java in crowded urban slums or farms too small to support the average family. While there is great potential for increasing agricultural yields and farm incomes over the longer term, only limited progress has been made in this area so far. The result has been a large-scale migration to urban areas, where jobs are still relatively scarce and living conditions poor. Many of the resulting social problems and political pressures have been difficult for the Suharto government to control.

More rapid inflation has recently begun to distort economic and social progress. The Indonesians had ample experience with inflation during the 1960s and have carried through effective stabilization programs, but the institutional base for controlling rapid increases in the money supply and prices is still weak. In 1973, prices rose more than 30%; in 1974 new monetary and fiscal regulations failed to keep inflation below 40%.

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Notwithstanding the serious social and economic problems Indonesia faces, the outlook for rapid gains over the rest of this decade is generally good. No significant increase in foreign earnings is expected in 1975. Barring a sharp downturn in oil prices, however, export revenues should thereafter rise steadily as the developed world recovers from the current recession. These earnings, combined with moderately increasing net capital inflows, would amply cover financial capital requirements for national output growth on the order of 7%-9%.

DISCUSSION

Introduction

1. For the first time in modern history, Indonesia has begun to show some of the growth its large resource base has long portended. The legacy of aid clientism appears to be at end, but there are signs of other pressures that could threaten the stability of government. An understanding of these new directions and pressures requires some perspective on key economic events since the mid-1960s. Drawing on that base, this report focuses on the surge in growth in 1973-74 and considers Indonesian development needs and prospects in the coming years.

Recent Economic Experience (1967-72)

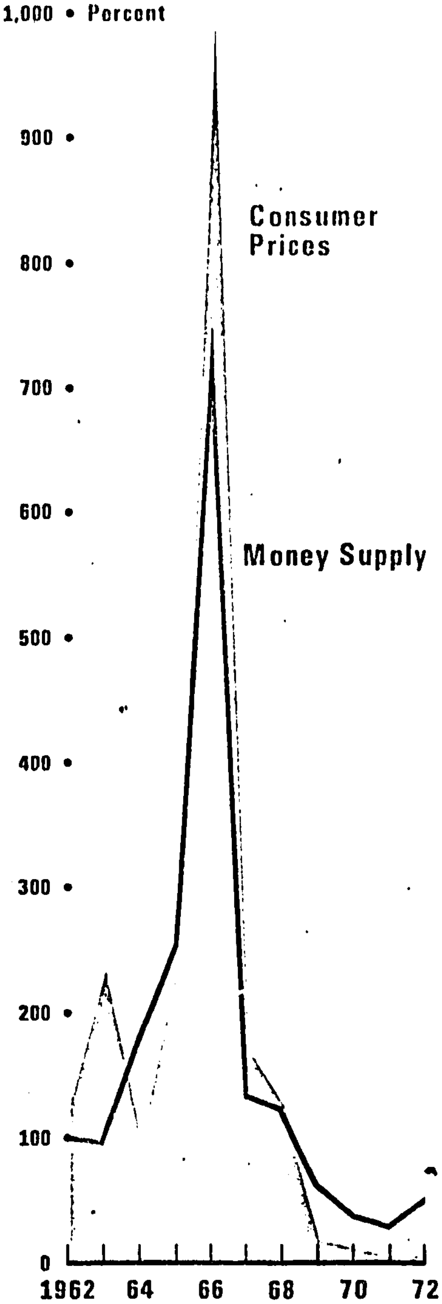
2. The Sukarno era left the Indonesian economy with much to overcome. Particularly during the period of "guided democracy" (1954-65), when development was subordinated to political and military objectives, Indonesia's economic performance was poor compared with that of other LDCs. Although others faced similar obstacles to growth because of inflation and large international payments deficits, conditions in Indonesia were especially severe, as average real incomes declined. The effects of this decline were sharpened by the population pressures on Java, the third most densely populated large area in the world.

3. The abortive Communist coup of 1965 and subsequent fall of the Sukarno regime provided the sort of clean break with the past that allowed the introduction of completely new economic policies. Urged by creditors and international organizations, the new administration of General Suharto embarked on a major stabilization program and began relaxing some of the controls that had hobbled the private sector. In a buoyant world economy, results were not long in coming. During 1966-72, inflation slowed from an annual rate of almost 1,000% to a low of 4% (see Figure 1). In the same period, real GNP growth climbed to an average of 6%-7% per year, compared with less than 3% in the early 1960s (see Figure 2). Gross investment as a share of GNP, encouraged by stability and government incentives, rose gradually to reach 17% in 1972, more than double the share during the Sukarno era (see Figure 3).

Engines of Growth

4. Financial stability was the first priority for Suharto's new government. The budget was balanced in 1967, largely because of improved revenue collection

Indonesia: Growth of Money Supply and Consumer Prices FIGURE 1



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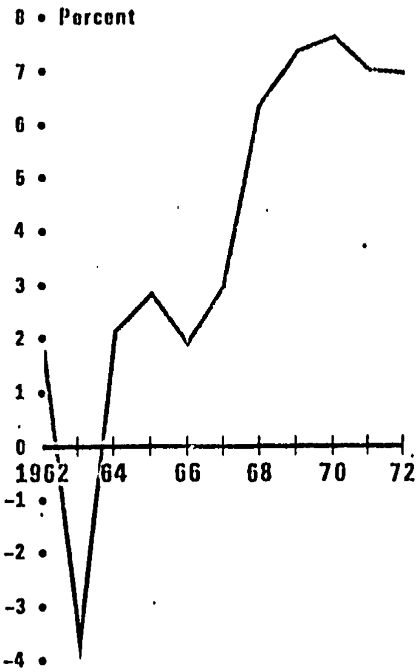
Indonesia: Growth of GNP FIGURE 2



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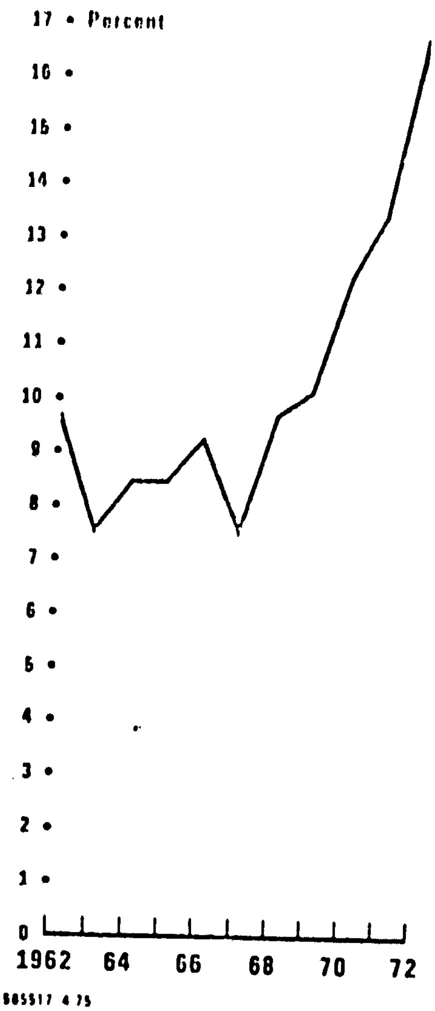
and the move to put responsibility for its preparation and implementation in the hands of a single government agency. Credit tightened as interest rates were raised to 9% monthly instead of annually. As a result, the money supply grew only 130% in 1967, compared with nearly 750% in 1966, and its growth continued to taper off through 1971.

5. Determined to give the market a chance to work, Suharto adopted a general policy of decontrol at the same time. Price controls were limited to a few basic commodities, and quantitative import restrictions were virtually eliminated. Import tariffs were raised, and the export tax lowered. Concurrently, the

Indonesia: Investment as a Share of GNP FIGURE 3



fixed exchange rate system was replaced by a simpler, more flexible multiple rate system to help discourage less essential imports and encourage exports. A new law granted liberal incentives and assurances to foreign investors, and foreign properties nationalized in 1965 were returned to their owners. State industries, previously enjoying favored access to foreign exchange and subsidized credit, were forced to rely more on their own resources for rehabilitation and expansion. Further interest rate reform in 1968 brought about a rapid increase in time deposits in state banks.

6. These policies restored confidence for both domestic and foreign businessmen, a point that could soon be observed in key economic data series. Wholesale price increases, which earlier had reflected the strong drive to hoard goods, began to taper off only a year after the major stabilization measures were introduced, and the relevant price index actually declined in 1969. Domestic investment jumped 40% in 1968 and continued to grow more than 20% annually for the rest of the period. In 1968, after several years of stagnation, direct foreign investment began an upward trend. Foreign creditors once again began to believe that the Indonesians could service larger amounts of debt, and official long-term loans began a steady climb in 1967, with an increase for that year alone of $130 million.

7. Renewed domestic stability coincided with a world boom that eased the way for Indonesia to expand its exports nearly 15% annually during the period, an above-average performance for LDCs in this stage of development. Thus, the export sector, which included traditional agricultural products as well as the more aggressive petroleum industry, was able to make an exceptionally strong contribution to GNP growth.

Evolution of National Policy

8. With more rapid growth, economic policies were directed at improving domestic stability, international payments, and some institutional shortcomings. Reflecting the pressures of creditors (who had agreed to massive debt rescheduling) and the conservative philosophy of IMF advisers, economic policies tended to stress international solvency and domestic credit restraint. This financial conservatism, however, often meant limited support to such "unknown" risks as the farmer or small businessman.

9. Although economic policies did not deal directly with increasing incomes in the agricultural sector (where most Indonesians are employed) or with providing jobs for the growing urban population, some limited progress was made in these areas. In keeping with its policy to increase foreign exchange revenues, the government encouraged traditional agricultural exports, which benefited farmers who grew those crops.

10. Some progress was made toward greater self-sufficiency in foods, even though per capita rice consumption steadily increased. Commercial policies and government attitudes toward foreigners made it easier to bring in needed chemicals and modern techniques. Supported by new monetary policies and institutional changes, rural credits for farmers increased 80% or roughly 50% in real terms during 1968-72. Together, these factors permitted an introduction of high-yielding strains on 18% of total riceland. This facilitated increases in rice yields averaging 6% annually during the period despite near-constant prices.

11. No particular program was instituted in the cities to increase incomes or employment. Nevertheless, encouraged by government policies, increased domestic and foreign investment boosted manufacturing and construction, which had stagnated during the Sukarno years. Growth in these industries, and the accompanying expansion of the services sector, provided many new jobs.

12. In short, the government learned much about the role of budgets and monetary policy in controlling inflation. Although it did not deal directly with the longstanding problem of realigning the domestic market in ways that would assure the most rapid and widespread growth, the overall economic stability and prosperity tended to have some positive effect on the living standards of many Indonesians.

Residual Problems

13. Despite the considerable economic gains in this period, relatively little headway was made against some basic problems that have plagued Indonesia throughout its history. Agriculture and food marketing remained splintered into largely isolated local markets because of both inadequate internal transportation and inept government pricing policies. The financing and implementation of public works and much needed improvements in the educational system were severely inhibited by the weakness and lack of training of the bureaucracy. Extremely low salaries for government workers continued to encourage corruption, a problem as intense in Indonesia as in other nations of Southeast Asia. Heavy reliance on foreign technicians was not matched by a parallel effort to build up indigenous technical and administrative skills. In short, as has occurred a number of times in Indonesia, there was rapid growth in export lines and national output without commensurate diffusion of economic and social progress among the populace.

14. Although aspects of these problems could be cited in other LDCs, their sheer scale and intensity in Indonesia, particularly on Java, make them especially serious as sources of political ferment. Encouraged by visible signs of commercial progress, peasants swarmed into Jakarta throughout this period to help drive its population up some 1.3 million during 1967-72 and make it the fifth largest city in the developing world. Efforts to accelerate a rather limited birth-control program had little impact on a population growth rate of about 2.5% by the end of 1974.

Developments in 1973-74

15. The most prominent feature of Indonesian gains in 1973-74 was the rise in foreign earnings that accompanied the boom in the oil sector. Indonesia's net earnings from oil (see Appendix A) were up nearly 600% during the period. This was caused by dramatic price increases, a change in production-sharing arrangements that gave the government a larger share of the export revenues, and an output gain of 29%. Non-oil export commodities also benefited from strong world demand and high prices. Export earnings were supplemented by continued large-scale aid, and the net result was a 160% increase of foreign exchange reserves.

16. The rapid improvement on external accounts permitted greater government spending for consumption and development. Although budget data are still too sparse to trace the public sector's spending fully, there are some general

indications of how it was allocated. Pertamina,[1] an important contributor to development spending, was involved in a number of large projects in heavy industry and petrochemicals that absorbed much foreign exchange. Civil servants' salaries were increased at several intervals over the period. Food imports, primarily rice, were up dramatically as the government moved to build food stockpiles. Fertilizer imports, which the government subsidizes, also increased substantially.

17. The private sector was slow to catch up with the rapid pace of government spending. Consumption, in the national accounts sense, rose only 3% in 1973 but probably more than 10% in 1974 as income gains began to be distributed more widely. Imports of a variety of consumer goods increased almost 20% both years. With the exception of textiles, domestic industries producing directly in response to spending appear to have expanded considerably faster than during 1967-72. Foreign funds arrived in unprecedented amounts despite the student upset of January 1974 and boosted investment in manufacturing for the growing domestic market.

18. Even with this surge of spending and investment, the growth of Indonesian productive capacity substantially lagged the income gains. Rapidly rising food prices abroad and the weakness of the Indonesian central monetary system also contributed to inflation of about 40% during 1974. Consequently, stabilization policies re-emerged as key concerns for the first time since the immediate post-Sukarno days.

Growth in Real Output

19. Even discounting the distinctive feature of international gains, the petroleum sector continued to show rapid progress that only slackened in mid-1974. Crude oil production rose 23% in 1973 and another 4% last year (see Table 1). In 1974 the increase in earnings retained by the Indonesians in the sector was much larger than the production gain, however, because of new income-sharing arrangements with foreign oil companies concluded early in the year. For 1974 these factors resulted in net returns of \$2.2 billion from oil exports and receipts in kind—\$1.6 billion more than in 1973—thereby supporting a 30% gain in the contribution of the mining sector to GNP[2] (see Appendix B). Oil revenues were

1. Pertamina, Indonesia's state-owned oil company, has a monopoly over the refining and distribution of all petroleum products in the domestic market.

2. The impetus for growth on this order was present even before developments in the Middle East, but the dramatic series of price increases beginning in late 1973 caused some acceleration in exploration activities. Foreign oil companies spent nearly \$1 billion during the two-year period in addition to Pertamina's own outlay of more than \$500 million.

Table 1

Indonesia: Petroleum Production and Export Earnings[1]

	1970	1971	1972	1973	1974[2]
	Million Barrels				
Crude oil production	312	326	396	489	510
Exports	264	274	345	426	440
Crude	228	240	299	370	390
Refined products	36	34	46	56	50
	US $ per Barrel				
Average price of crude (f.o.b.)	1.69	2.08	2.87	4.00	11.92
	Million US $				
Value of oil exports	471	559	877	1,348	4,690
Net government receipts	158	205	330	565	2,194

1. Oil export data for a given calendar year represent earnings from shipments lagged by one quarter (see Appendix A).
2. Estimated.

sufficient to cover two-thirds of total government expenditures in 1974, compared with one-third in 1973.

20. Hard minerals primarily tin, copper, and bauxite also registered a strong performance in 1973, but this slowed somewhat in 1974 with industrial recession in the principal market, Japan. There were no new foreign investment approvals in mining during the period. Established foreign mining companies are, however, pushing forward with surveys, exploration, and development. Alcoa continued exploration and planning for a facility to produce 1.6 million tons of alumina annually from low-grade bauxite in East Kalimantan. The International Nickel Company began construction of a plant to produce nickel matte.

21. The importance of oil and minerals notwithstanding, agricultural performance remains the key determinant of Indonesian growth; gains here were encouraging. Favorable weather aided agriculture in 1973, and output increased 6% over the drought year of 1972. Growth was about the same in 1974. Rice production rose to 14.5 million metric tons in 1973 and reached 15.3 million tons in

1974. Production still falls short of domestic demand, however, and imports in both years were in the range of 1.2-1.4 million tons. Much of the imports went into building government rice stocks that had grown to 900,000 tons by October 1974, a vast improvement over 1972's low of 150,000 tons. The presence of these stocks and the general adequacy of market supplies kept retail rice prices[3] far enough below government ceiling prices[4] to curtail the need for market intervention.

22. The failure to achieve the goal of self-sufficiency in rice by 1973/74 was caused in part by the soaring price of fertilizer and other chemical inputs that, despite government subsidies, far surpassed concurrent increases in crop prices. The loss of incentive for the farmer to use chemical inputs meant that agricultural yields did not increase as rapidly as planned. Although the government imported about 600,000 tons in 1973 and another 1 million tons in 1974, the availability of fertilizer at the village level was hampered by distribution problems resulting from high transportation costs, poorly located market outlets, and untimely arrivals. In addition, government regulations often limited fertilizer use to certain crops and areas.

23. Yet some important steps are in train to increase yields. The support price of paddy was raised in April 1974 to help compensate farmers for the increased cost of inputs, particularly fertilizer. Another price rise went into effect in February 1975. In addition, government plans for increasing output should make Indonesia self-sufficient in fertilizer by 1980, even allowing for a 15% annual increase in consumption. Despite the technical problems involved, the government is also encouraging the establishment of capital-intensive rice estates by domestic and foreign private enterprise. Pertamina and two US companies are working on an estate in south Sumatra that will begin small-scale production in 1975, and according to present plans will be producing 300,000 tons annually by the end of the decade. Caltex is undertaking a feasibility study for a similar project in central Sumatra on a smaller scale.

24. The output of other domestic food crops, while stagnating in 1973, rose in 1974, spurred by higher prices and increased acreages and yields. BIMAS[5]

3. The price of rice is particularly important for stabilization efforts, as rice accounts for 30% of the cost-of-living index.

4. Recognizing the constraining effect of artificially low official rice prices on production, the government adopted a more flexible rice-pricing policy in late 1972 and has allowed the official ceiling price to rise gradually in keeping with market forces.

5. BIMAS is an agricultural extension program designed to help farmers obtain credit and improve their use of irrigation, fertilizers, high-yielding seed, and new agricultural techniques.

programs were extended to corn, cassava, soybeans, peanuts, cotton, and smallholder sugar crops. More attention was also given to improving fertilizer and insecticide distribution and to bringing more irrigated land into the program.

25. After years of stagnation, traditional export crops responded well to the boom in world commodity markets, which lasted through the first half of 1974. Rubber production, for example, was up 15% in 1973. To assure smallholders a share in the benefits of higher prices, measures were taken to organize farmers into project management units, to establish a nucleus system under which large estates would provide technical assistance to smallholders, and to establish rubber coagulating centers to process raw materials. The government also subsidized high yielding seedlings for smallholders. Other export crops, including palm oil, coffee, tobacco, and copra, also registered increased output during the period.

26. The production of timber, the largest non-oil export crop, was up 25% in 1973, but growth slowed to around 5% in 1974. Causes of the slowdown included sharp declines in construction in the United States and Japan and excessive cutting in recent years. In response to both these factors, the government enforced reductions in output in the second half of last year, a move in keeping with the recent tendencies to discourage further foreign capital from moving into cutting and to restrict foreigners to joint ventures in processing.

27. Data collection on manufacturing industries is weak in Indonesia because much production occurs in small enterprises scattered outside the major cities. Progress during the period was not particularly impressive largely because of the sluggish performance of textiles; growth in 1973 was only 3%, with an upsurge to 8%-10% in 1974. Nevertheless, new capacity created in industries such as cement, chemicals, and vehicle assembly should pave the way for more rapid expansion of production in coming years.

International Payments Gains

28. The most striking feature in the 1973 international payments picture was the unanticipated boost to oil prices, a trend that greatly intensified in 1974. Oil accounted for almost half of Indonesia's export revenue in 1973 and climbed to more than two-thirds in 1974 (see Table 2). The volume of oil exports rose a dramatic 23%, to 426 million barrels in 1973. Shipments were slightly higher in 1974, but softening demand in the fourth quarter prevented a significant increase over the previous year's exports. Nevertheless, net oil receipts nearly quadrupled to

Table 2

Indonesia: Balance of Payments Summary

Million US $

	1972	1973	1974[1]
Exports (f.o.b.)	1,757	2,957	6,890
Oil	877	1,348	4,690
Non-oil	880	1,609	2,200
Imports (c.i.f.)	-1,403	-2,679	-4,320
Oil	-30	-43	-200
Non-oil	-1,373	-2,636	-4,120
Trade account	354	278	2,570
Invisibles	-832	-1,083	-2,761
Non-oil services	-315	-343	-465
Oil	517	-740	-2,296
Foreign oil company profits	-300	-428	-1,038
Foreign production costs ("write off")	-117	-170	-675
Pertamina production costs	-100	-142	-583
Current account	-478	-805	-191
Private capital (net)	427	498	700
Direct investment (net)	258	290	455
Other	169	208	245
Official capital (net)	385	550	635
Loans grants	447	624	735
Debt repayment	-62	-74	-100
Overall balance	334	243	1,144
Net errors and omissions	53	-10	-459
Change in official reserves[2]	-387	-233	-685
Yearend reserves	574	807	1,492

1 Estimated

2 A minus sign indicates an increase in reserves

$2.2 billion as the average price per barrel of Indonesian crude rose to nearly $12 from 1973's $4.

29. The spectacular petroleum developments tended to mask some sharp gains in other export lines, which rose above the $2 billion mark in 1974 despite the slowdown in the second half of the year (see Appendix C). Moreover, there were signs of some broadening of the export base, and investment in key resource areas brightened prospects for more rapid growth with industrial recovery in the developed world.

30. Imports (c.i.f.) reached $2.7 billion in 1973 and increased to an estimated $4.3 billion in 1974, reflecting buoyant domestic demand and high world

prices. Sharply rising capital goods and imports, particularly for petroleum production, and higher food and fertilizer prices were largely responsible for this trend. Also putting upward pressure on import expenditure was the acceleration of development project-related imports in the last quarter of 1974.

31. Net private capital inflows increased in both years. Direct investment in 1973 reached $290 million and was up to $455 million in 1974, despite new restrictions on foreign investment (see Appendix D). Much of this capital is associated with Pertamina investments, where the strictures relating to domestic equity participation or closure of certain sectors to foreign investment are likely to be ignored.

32. Official capital inflows were some 15% above the previous year's level. In 1973 the IGGI[6] pledged $840 million in aid to Indonesia; $624 million was spent by the end of December. Contrary to earlier expectations, foreign aid continued at a relatively high level in 1974, despite improvements in Indonesia's balance-of-payments and budget positions. Actual expenditures of IGGI aid in 1974 were an estimated $585 million, somewhat less than in 1973. However, disbursements under a Japanese government-to-government loan for development of the oil sector brought another $150 million, for a total of $735 million.

33. Indonesia paid $124 million on official external debts (principal and interest) in 1973 and was scheduled to pay another $145 million in 1974. The government has failed to respond positively to suggestions by its creditors that debt repayment be accelerated, so repayments will most likely continue to follow the schedule. Total public debt service[7] as a share of gross commodity exports was about 7% in 1974, down from 9% the previous year.

34. These payments patterns taken together netted foreign exchange reserves of $1.5 billion by the end of December 1974, an increase of $0.7 billion over 1973. Reserves of such magnitude—equivalent to about 4 months' imports—are a new phenomenon in Indonesia and will undoubtedly be a major factor in donors' aid decisions in 1975.

6. Intergovernmental Group on Indonesia (IGGI) members include Australia, Austria, Belgium, Canada, France, West Germany, Italy, Japan, the Netherlands, New Zealand, Switzerland, the United Kingdom, and the United States.

7. This includes repayments on public corporation loans as well as official government loans.

Inflationary Pressures

35. For the first time since 1968, inflation became a serious problem in 1973-74. Prices in Jakarta rose 32% and about 40% in these two years. Some of this was due to external factors. Inflation for Indonesia's trading partners, compounded by the effective depreciation of the rupiah relative to the yen, led to higher import costs. Import prices rose 88% between 1972 and the third quarter of 1974 as reflected in the following tabulation:

Index 1972 = 100

1973		1974	
I	110	I	155
II	129	II	181
III	140	III	188
IV	160		

Rice, fertilizer, and cement imports were among the items whose prices skyrocketed.

36. On the domestic side, inflationary pressures were intensified by rapid increases in credit to the private sector and state enterprises, which nearly doubled in 1973 and continued an upward trend in early 1974. The ultimate sources of these funds were increased non-oil export earnings and foreign capital. The latter was attracted to time deposits by high interest rates and the improved credit rating of private (and Pertamina) borrowers.

37. Domestic institutional factors also contributed from the supply side to inflation. As usual, goods shortages occurred in more remote areas because of inefficient local transportation; credit applications for small businessmen were delayed in administrative bottlenecks; and complex customs procedures often prevented imported goods from getting into the market on schedule. [redacted] 25X6

25X6

38. The various institutional impediments to price stabilization were similar to those Indonesia faced in the 1960s. What was distinctive about the 1973-74 case was that the source of much of the excess liquidity was not overworking of government printing presses, but the rapid net inflow of money from export earnings. New policies were required to deal with this new source of inflation.

Policy Formulation in the New Environment

39. Because Indonesia's financial position changed so rapidly in 1973-74, the government did not have time to adequately develop a concerted program to allocate its newfound wealth in a way that would best serve its three major goals: controlling inflation, reducing income inequality, and providing for long-term development needs. The policy mix adopted brought the economy a few steps closer to each goal but revealed that the government has yet to decide exactly what its priorities are.

40. The government, which still accounts for a remarkably small portion of national expenditures, proved inadequate to the task of acting as a conduit for the greatly increased export earnings. Despite planned 60% increases in both current and development budgets in 1974 and an 80% pay raise for government workers, the most notable event of the period was a shortfall in receipts in late 1974—and possible deficit—because of revenues withheld by Pertamina. Nevertheless, the government showed some capability in manipulating fiscal policy as demonstrated by increases in luxury taxes and cuts in taxes on mass consumption goods. In addition, the government pressured Pertamina to curtail its foreign borrowing and submit to closer scrutiny of its financial activities.

41. Pertamina, vaunted as an aggressive agent of development, expanded its extrabudgetary role with mixed consequences. With a company budget of $2 billion (roughly half the size of the combined current and capital accounts of the national government), it continued to move into housing, office buildings, hotels, roads, fertilizer plants, and metalworking plants. This further branching out, combined with cost overruns from inflation and a shortfall in projected 1974 oil earnings, resulted in a debt crunch with foreign creditors and a $560 million tax delinquency to the government.

42. A new monetary policy package directed toward stemming consumer credit expansion, increasing domestic savings, and controlling foreign borrowing was introduced in early 1974. Interest rates on savings deposits and for some state bank lending were increased. Credit ceilings were imposed on commercial banks. Reserve requirements for state and foreign banks were increased. Private enterprises were required to deposit 30% of all foreign loans in non-interest-bearing accounts with the Bank of Indonesia. Although these policies were correctly aimed at major sources of inflation during the period, they were difficult to enforce because the state banks are powerful enough to effectively circumvent the will of the central bank when they wish to do so.

43. The government chose not to appreciate the rupiah to promote increased imports. It continued to subsidize food and fertilizer imports, however, and attempted to streamline the customs bureaucracy to facilitate more rapid flow of imported goods into the country. Moreover, capital goods imports for development projects were accelerated during the last quarter of 1974.

Outlook for 1975-80

44. The economic outlook for Indonesia over the next five years or so appears bright. During 1975-76, the key stimuli for growth will be continued access to foreign capital and increasing domestic demand for foods and consumer goods. Thereafter, industrial recovery in the developed world should again provide the basis for rapid export expansion. With no sharp break in oil prices, Indonesia should enjoy foreign exchange revenues throughout the period that will permit average national output gains of 7%-9% (close to those of 1973-74). Significant as this performance may appear, it will hardly produce an affluent society; given the expected population expansion, per capita income in 1980 will be on the order of \$200 to \$225 (1974 prices), compared with about \$150 at present.

Sector Performance

45. Some of the most important developments should occur in agriculture. After years of erratic support and uncoordinated intervention, the government has recently allowed greater play for market incentives. Without abandoning this new position, it will be taking on greater responsibilities for extension services and public investment to support farm production. Irrigation, new technology, and credit are being channeled to other crops after initial concentration on rice. Projects are in train to bring more land under cultivation in the outer islands and to develop a number of large rice estates. The government is expected to boost expenditures in transportation and communications to enhance domestic marketing. Moreover, domestic fertilizer production – primarily from Pertamina projects – will increase sharply in 1977 and should rise steadily for the next several years. By 1980, plans call for an increase of 20% in rice yields as a result of increased fertilizer application, double-cropping, and expansion of high-yielding varieties, which will make up close to two-thirds of total acreage, compared with one-third at present. World demand for food and other agricultural products should begin to rise after the current recession. On balance, these factors promise agricultural growth on the order of 4%-5%.

46. Although petroleum output is temporarily stagnating, there is every likelihood that it will shortly begin to move upward. The recent reef-type discoveries have the potential to push crude production up to 3 million barrels per day by 1980. The current world recession, conservation measures, and attempts to expand alternative energy sources by developed countries will limit demand in 1975. Subsequently, the Indonesian government will probably push production as rapidly as demand allows and is unlikely to participate in formal or informal prorationing schemes within OPEC. Similarly, the fact that oil company contracts in Indonesia allow the highest per-barrel return among OPEC countries virtually assures that the companies will be motivated to maximize production. Around 1978, sales of liquefied natural gas (LNG) will begin to add to petroleum earnings. A 20-year contract has been negotiated with a group of Japanese utility and industrial consumers for 400,000 barrels (crude oil equivalent) of LNG per day, worth some $22 billion (1973 prices) over the life of the contract. Annual growth of energy production during 1976-80 is not likely to fall much below 10% unless oil prices deteriorate markedly.

47. Manufacturing probably will grow faster than in any comparable period in Indonesian history. Foreign investment interest in non-oil projects showed no signs of flagging last year despite tightening of investment laws, as Japanese investment approvals alone increased $450 million, or 68% over 1973. Netherlands approvals also increased by roughly $100 million, and Hong Kong approvals rose to a total that rivals the United States for second place. Although US non-oil investment was down to one-fifth the average of the past seven years, this tends to overlook active negotiations for multi-million dollar projects in petrochemicals and mining. Government programs call for expansion of manufacturing on a wide scale. Toward the end of the 1970s, several large industrial projects are scheduled to come on stream, including fertilizer plants, petrochemical installations, oil refineries, and the country's first steel complex. A variety of installations also will be opening in processed foods, metal fabrication, finished lumber, and construction materials. In sum, the government looks for 13% average annual growth in manufacturing through 1980; allowing for the usual lags in implementing projects, an estimate of 10% is probably more realistic.

48. Other economic sectors will respond to this broad growth. Domestic commerce should prosper as output increases and transportation and communications facilities improve. The tempo of industrial construction will continue to boom, and there will remain a sustained demand for new office space and housing. Growth in services will most likely continue its present trend as incomes rise and increased urbanization affords more opportunity for jobs in the cities.

International Payments

49. We estimate that Indonesia will require average import growth of 20% (14%-15% in real terms) to achieve 7%-9% real growth in national output. Although this is roughly comparable to what occurred in 1967-72, programs to increase domestic production of some consumer and producer goods will allow the capital goods component to grow more rapidly than in the earlier period. Continued emphasis on food output, for example, will greatly reduce the need for food imports. Plans to expand capacity for fertilizer, cement, chemicals, steel, and sugar production will allow import substitution in raw materials and intermediate goods. The result will be capital goods imports rising at a rate of 30% (25% in real terms) or more, sufficient to support the projected growth path.

50. Indonesia should have little difficulty financing this growth of imports, even without concessionary aid. We expect rapid increases in both oil and other exports once recovery from the current global economic recession begins. The only reasonable contingency that could create serious balance-of-payments problems for Indonesia during the next few years would be a major break in oil prices. We do not believe such a break to be likely, at least through 1977; indeed, oil prices in 1976-77 are likely to increase at about the same rate as the prices of the goods Indonesia imports. Beyond 1977, prospects for the international oil market are much more uncertain; prices could decline, but, if OPEC sticks together, there would be strong incentives to push prices up further to relieve the growing balance-of-payments pressures on many OPEC countries, at least temporarily.

51. Table 3 presents what we believe to be a reasonable projection of Indonesian balance of payments through 1980. It shows continuing surpluses through 1979, with foreign exchange reserves building up to more than $4 billion, or more than two and one-half times the current level. A deficit is projected beginning in 1980, but only on the assumption that oil prices remain constant after 1977, while import prices continue to rise.

52. We project roughly a doubling of exports during 1975-80. Oil alone should bring in $9 to $10 billion by 1980, as production reaches some 2.2 million b/d.[8] LNG shipments, scheduled to begin in 1978, will further boost earnings. Non-oil exports, targeted for increased diversification in the current development plan, also have good prospects. The traditional raw material exports such as timber,

8. This output level is based on no increase in 1975, a 7% increase in 1976, and a 10% annual increase thereafter.

Table 3

Indonesia: Balance-of-Payments Projections[1]

	1974	1975	1976	1977	1978	1979	1980
	Million US $ in Current Prices						
Exports	6,890	7,440	8,810	10,160	11,710	13,210	14,750
Imports	4,320	-5,190	-6,240	-7,540	-9,020	-10,790	-12,920
Trade account	2,570	2,250	2,570	2,620	2,690	2,420	1,830
Invisibles	-2,761	-2,820	-3,030	-3,350	-3,690	-4,060	-4,470
Current account	-191	-570	-460	-730	-1,000	-1,640	-2,640
Capital account[2]	1,335	1,160	1,250	1,370	1,500	1,680	1,870
Change in reserves	685	590	790	640	500	40	-770
Yearend reserves	1,490	2,080	2,870	3,510	4,010	4,050	3,280
		Percent					
Inflation rates assumed for							
Oil exports		0	8	5	0	0	0
Non-oil exports		0	6	6	5	5	5
Non-oil imports		6	6	6	5	5	5

1. These projections are based on the following real growth rates:
   1. Oil exports: 0% in 1975, 7% in 1976, 10% thereafter.
   2. Non-oil exports: 0% in 1975, 5% in 1976, 10% thereafter.
   3. Oil imports: 0% in 1975, 7% in 1976, 10% thereafter.
   4. Non-oil imports: 15%.
   5. Oil invisibles: 0% in 1975, 7% in 1976, 10% thereafter.
   6. Non-oil invisibles: 11%.
   7. Official capital: -30% in 1975, 0% thereafter.
   8. Private capital: 15%.
2. Including debt service payments.

rubber, and hard minerals will expand steadily, especially in view of previous Japanese and US investment in these areas and Indonesia's reputation as a reliable supplier in both these markets. Light manufactures, chemicals, new food crops, and processed fish are among product lines likely to grow more rapidly in coming years.

53. Official capital inflows will most likely level off at about $500 million annually. Traditional donors will probably decrease their lending to the $300 to $350 million range in response to Indonesia's improved financial conditions. Most

new loans are assumed to take the form of credits from official export banks abroad and to be largely on commercial terms. The remaining $150 to $200 million will come from drawdowns in the IGGI aid pipeline. Although there has been much discussion of development loans with the Soviets and East Europeans, no significant commitments have yet been made and such amounts as are received from the Communists in this period will likely remain modest.

54. Outside of the oil sector,[9] private capital inflows should be up about 15% annually, in line with import growth. Although the projection appears conservative in view of the 1967-72 average increase of 50%, total foreign investment in Indonesia has already reached a high level -- more than $1.5 billion -- and the capital-intensive mining and forestry sectors are now being closed to foreigners. Future private funds will probably be drawn to joint ventures in manufacturing and medium-term loans for development projects in such areas as transportation, communications, real estate, and utilities. Despite new, more stringent foreign investment regulations, the government will continue to court foreign investors to help support its ambitious development plans.

Development Consensus and Strategies

55. Within these broad themes, the particular course taken by the economy over the next several years will be strongly influenced by the ways in which the Indonesian government adjusts to its new gains. Even this year, with foreign exchange reserves up sharply and the volume of imports growing rapidly, Jakarta is preoccupied with an anomalous short-term foreign debt crisis at Pertamina that can only serve to remind the Suharto administration of how recently the country has recovered from the chaos of Sukarno. Spurred by these reminders and by shrinkages in official aid from the IGGI, senior officials can be expected to continue major efforts to drum up support abroad among Communist and other non-traditional donors, and they will behave for some time in ways that highlight the nation's underlying poverty rather than its recent additions to earnings.

56. As the Indonesians become more accustomed to sustained growth and greater financial flexibility, various factions will begin to focus on particular development strategies. For the moment, rapid development through

9. In keeping with accounting conventions, oil sector investment, which automatically reverts to Indonesia and is written off by the foreign companies when production begins, is included in the invisibles account in the projections in Table 3.

capital intensive resource investment has captured the attention of most politicians, planners, and Pertamina officials. If present advisers remain close to Suharto, the emphasis on development through this route is likely to continue, qualified only by the concern that foreign exchange holdings be kept fairly high.

57. There will probably continue to be some social unrest. Rapid growth in manufacturing and services and increasing productivity in farming will continue to encourage further migration of unskilled workers to urban areas. Consequently, the slum population of Jakarta and other cities will grow steadily, providing a stark contrast to improving living standards among employed workers. The most serious disturbance in recent times has come from student agitators, who with other pressure groups can be expected to exploit the income gap through demonstrations and other political activities in coming years. Nevertheless, so long as the top military leadership maintains its present consensus on goals and methods, the Suharto regime should have sufficiently strong hold on domestic order to assure that these intermittent pressures will not significantly alter national economic policy.

APPENDIX A

OIL SECTOR BALANCE OF PAYMENTS

Table A-1 is a summary of available information on Indonesia's oil sector balance of payments. A more detailed breakdown was shown in ER RP 74-26, *Indonesian Energy Developments*, December 1974. The accounting procedure is that used by the International Monetary Fund. Oil export revenues are calculated in gross terms, while company profits and production costs are treated as foreign exchange expenditures.

Table A-1

Indonesia: Net Receipts from Oil Exports

Million US $

	1973	1974
Gross oil exports	1,348	4,690
Oil imports (c.i.f.)	-43	-200
Invisibles	-740	-2,296
Foreign oil company profits	-428	-1,038
Foreign oil company production costs	-170	-675
Pertamina production costs	-142	-583
Net oil exports (net foreign exchange receipts from the oil sector)	565	2,194

Oil exports are estimated on a payments basis, assuming an average lag of three months from shipment. Thus they represent shipments during the first three quarters of the year and the last quarter of the previous year. A further, more irregular, lag can occur when Pertamina falls behind schedule in transferring its tax payments to the central bank. This can cause discrepancies between Indonesia's actual foreign exchange reserve position and the reserve position implied by the current and capital accounts. For example, on 31 December 1974, Indonesia reported $1.492 billion in official reserves, whereas known data would have suggested a figure closer to $1.8 billion. The "missing" funds are very difficult to trace, but for accounting purposes are shown in the net errors and omissions account of Indonesia's balance of payments. Most of the problem is Pertamina's occasional difficulty in meeting demands from foreign creditors on its income, and the company has been using some of these funds to roll over short-term debts.

APPENDIX B

NATIONAL ACCOUNTS DATA FOR 1974

Because output data on Indonesia are somewhat sparse and slow in appearing, it was necessary to estimate national accounts for 1974 (see Table B-1). For most sectors, this required only a relatively straightforward extrapolation of the output series and other statistical indicators. In the case of petroleum, the increase in Indonesia's share of earnings and the corresponding decline in the foreign companies' share result in a much larger growth of the contribution to gross national product, which excludes the earnings of the foreign companies, than to gross domestic product, which includes these earnings.

Table B-1

Indonesia: GNP Growth by Sector

Percent

	Sector Share					Average Annual Rate of Growth				
	1969	1970	1971	1972	1973	1970	1971	1972	1973	1974[1]
GNP	100.0	100.0	100.0	100.0	100.0	7.5	7.0	6.9	8.2	8.8-10.3
Agriculture	49.4	47.8	46.4	44.3	43.2	4.1	3.8	2.1	5.6	5-6
Mining	4.4	4.9	4.8	5.6	6.3	17.5	5.5	23.1	23.2	30
Manufacturing	8.9	9.0	9.6	9.4	9.0	9.7	13.5	5.2	3.3	8-10
Construction	2.3	2.7	3.0	3.4	3.9	25.6	18.4	22.2	22.7	20-25
Transportation	3.1	3.1	3.6	3.9	3.4	5.5	26.4	13.6	11.3	5-10
Trade	16.9	17.7	17.8	19.1	19.7	12.8	7.8	14.8	8.0	10-15
Services	5.7	5.5	5.3	5.0	4.7	2.7	2.6	2.5	3.1	4-5
Other	9.3	9.3	9.5	9.3	9.8	8.8	9.0	6.9	6.5	10-12

1. Estimated.

Overall Growth

GNP probably grew 8%-10% in real terms, slightly above the 1973 rate because:

- agriculture again performed well;

- the mining sector expanded at a record 30%, with unusual changes in production-sharing, and

- other sectors and services expanded in response to higher oil and farm output.

Sector shares were derived from available production and national accounts data; the methods used to estimate the growth rates of various components of GNP are described below.

Agriculture

Agriculture grew an estimated 5%-6% as it did in 1973. Rice production was up 5%-6%, other food crops continued to recover from the drought and to make gains under agricultural improvement programs, and timber output rose about 5%.

Mining

Driven by petroleum earnings, this sector grew 30%. About 5% of the growth reflects increased oil output; the other 25%-30%, contract revisions that allow more of the oil profits to accrue to Indonesia. Other mineral production also expanded 5%-6%.

Manufacturing

A growth rate of 8%-10% in manufacturing was led by gains in the production of fertilizer, assembled vehicles, and auto parts. A slowdown in textiles prevented more rapid overall expansion in the sector. Growth in import volume for the first half of 1974 – 40% – suggests that Indonesian producers are not encountering significant difficulties in gaining access to raw materials and capital equipment.

Construction

Sustained demand for new buildings, factories, and homes should have kept the construction industry growing at 20%-25% as in 1973.

Transportation

Transportation probably again grew in the 5%-10% range because of expanding production of motor vehicles and increasing emphasis by the government on improving local transportation systems.

Trade

Rapidly increasing imports and strong demand should have supported trade growth of 10%-15%.

Services

Services are estimated to have grown 4%-5%, slightly more rapidly than population, in support of growth in other sectors.

Other

This sector is estimated to have grown above trend at 10%-12% as its main components, banking and public administration, expanded in response to increased financial activity and higher government salaries.

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APPENDIX C

NON-OIL EXPORT COMMODITIES

Non-oil exports in 1974 climbed an estimated 35%, following an 85% rise during the previous year. Most of the increase was caused by higher prices as commodity markets remained relatively buoyant, but many products registered volume increases also (see Tables C-1 and C-2).

Table C-1

Indonesia: Non-Oil Exports

	Million US $			Percent of Total Exports, 1974
	1972	1973	1974[1]	
Total[2]	880	1,609	2,200	100
Timber	229	574	733	33
Rubber	190	392	500	23
Tin	70	93	162	7
Copper	5	64	142	6
Palm oil	41	70	140	6
Coffee	77	78	108	5
Tea	31	26	41	2
Tobacco	30	40	34	2
Pepper	22	29	27	1
Copra cake	13	17	24	1
Bauxite	6	7	12	1
Palm kernels	4	5	10	Negl.
Copra	4	5	....	....
Other	158	209	267	12

1. Estimated.
2. Because of rounding, components may not add to the totals shown.

In 1972, *timber* became Indonesia's second largest export; it retained the position in 1974, as export earnings more than tripled the 1972 level. The boom was caused by sharp price rises resulting from the revival of Japanese demand, increased US demand, and improved quality control. When demand tapered off in the second half of 1974, prices fell, but not enough to offset gains earlier in the year. Such spectacular growth is not likely to continue throughout the decade, as sharp demand increases would be hard to sustain. In addition, the government

Table C-2

Indonesia: Non-Oil Exports[1]
1974

	Thousand Metric Tons[2]	Price per Unit (US $)	Million US $
Total[3]			2,200
Timber	18,800[4]	39	733
Rubber	800	625	500
Tin	24	6,835	162
Copper	237	600	142
Palm oil	280	500	140
Coffee	115	940	108
Tea	50	816	41
Tobacco	34	1,000	34
Pepper	17	1,588	27
Copra cake	220	109	24
Bauxite	1,200	10	12
Palm kernels	29	345	10
Other	N.A.	N.A.	267

1. Estimated.
2. Unless otherwise noted.
3. Because of rounding, components do not add to the total shown.
4. Thousand cubic meters.

already has plans to follow the lead of the Philippines and Malaysia in restricting cuttings and promoting log processing. The market for processed lumber is a much more competitive one in which Indonesia, at least in the short run, will not have an advantage.

After a long period of stagnation, *rubber* exports revived in 1973. This was caused mainly by the doubling of prices, although production expanded 15% as it became profitable to tap older trees. The revival was slowed by falling prices in the second half of 1974, but earnings still were up nearly 30% during the year. Recent growth in production has come from smallholders, who produce 70% of Indonesian rubber. Through the rest of the decade, estates will play a greater role in growth as more attention has been given to their rehabilitation.

Palm oil and kernels are produced only on estates, both government and private. Production was up in 1973 as crops recovered from the 1972 drought and acreages expanded in response to improved world markets. The value of palm oil exports increased 70% in 1973 and doubled in 1974 as prices remained high. Palm kernel exports will continue to taper off because the kernels are being used domestically in the new crushing mill that opened in October 1973.

Coffee, primarily Robusta, is grown on estates and small farms. Production has recovered from the drought of 1972 and increased slightly in 1973. High prices continued to boost export receipts in 1974, but the volume of exports remains constrained by the slow growth in world demand.

Tobacco production and quality were adversely affected by drought in 1972 and heavy rains in 1973. Some improvement in 1973 was due to the expanded use of fertilizers, improved seed, and irrigation, combined with better weather. Export volume was about the same as in 1973.

Pepper exports have stagnated in recent years because of lack of maintenance, fertilizer, and credit and of vulnerability to disease. Export earnings in 1974 dropped slightly. Planned rehabilitation of the pepper industry should result in export increases in keeping with world market growth of 2% per year by the end of the decade.

Production of *tea* is expected to remain constant for the rest of the decade. Three estates are being rehabilitated, but output on others will continue to decline. Export earnings will depend on world prices, which rose at the end of 1973 and remained relatively high to increase earnings by nearly 60% in 1974.

Copra production has been hampered in recent years by drought, pests, and aging trees, but there was some recovery in 1974. Exports of copra have been banned since October 1973 because shortages on the domestic market were causing severe losses for processing mills and driving up the price of coconut oil. *Copra cake*, on the other hand, will continue to be exported and take advantage of higher prices.

The state *tin* enterprise, currently the sole producer in Indonesia, is pursuing a vigorous policy of expansion and rehabilitation. Production was up 5% in 1973 and another 10% last year. Processing capacity is also being expanded, and by the end of 1975 Indonesia may be exporting only tin metal. High prices and the end of the International Tin Council quota system should continue to boost export revenues, which were up an estimated 75% in 1974.

Freeport Indonesia, Inc., began exporting ***copper*** concentrates from Irian Jaya in October 1972. The volume of exports in 1974 reached 237,000 tons, double that of 1973. High prices, especially during the first half of the year, brought an even greater increase in revenues.

Other non-oil exports, mainly corn, cassava, soybeans, livestock, and fish, accounted for 12%-18% of the total during the period. The government plans to further diversify non-oil exports in coming years, with emphasis on capturing markets for petrochemicals and light manufactures.

Even with the projected improvements in the traditional export commodities, it is clear they will lag behind the more dynamic oil, mineral, and timber sectors. This has definite implications for employment and income distribution. A large portion of the rural population depends on the production of the older labor-intensive commodity exports for its livelihood. New jobs in expanding capital-intensive sectors cannot fully absorb the large number of rural unemployed from the slow-growing traditional export sector, providing yet another obstacle to narrowing the gap between rich and poor, which is a primary goal of the Indonesian government for the present five-year plan (April 1974-March 1979).

APPENDIX D

NEW FOREIGN INVESTMENT POLICIES

Three new pronouncements affecting the foreign investment climate in Indonesia were issued last year by President Suharto. Initially, there was confusion within the government and among existing and potential foreign investors, but now it appears that the new rules will not markedly discourage the inflow of private capital.

In response to strong pressures to increase indigenous ownership in foreign corporations, the following principles to guide foreign investment were announced on 22 January 1974:

- all foreign investments should be in the form of joint investments with Indonesians,
- the share of ownership by Indonesian nationals in foreign enterprises should be increased gradually to 51%,
- the list of industries closed to foreign investment should be extended,
- the tax incentives given to foreign investors should be reduced, and
- the number of foreigners employed in foreign enterprises should be kept at a minimum by instituting training programs for Indonesians.

Thus far, there are few specific plans for implementing these principles. The government hopes to spread the benefits of ownership gradually through intermediary trusteeship or escrow arrangements or by transferring shares to retirement or welfare funds that benefit indigenous groups. Some tax arrangements have been changed; Freeport Indonesia, for example, has had to shorten its tax holiday from three years to one year. Such moves, however, do not appear to be widespread. Suharto admits privately that he does not want to make foreign elements feel threatened or to hamper development. Rather, he wants the critics of foreign involvement in Indonesia to know his intention that the fruits of business be shared more equitably.

On 26 March 1974, the government announced that a $100 per month head tax would be imposed on each expatriate employee of foreign businesses that are not meeting their obligations to hire and train Indonesians. Although it has been interpreted more widely by foreign investors, this regulation is meant to apply primarily to forestry in which more than 10,000 foreigners work. The real offenders, however, are not foreign-owned logging companies but Indonesian concessionaires who turn over their tracts to Filipino, Malaysian, and Singaporean contractors who hire few Indonesians. All foreign investment agreements contain a detailed schedule for replacement of expatriates by Indonesians; most companies are adhering to these schedules. Political pressures, however, have recently encouraged the government to convey the impression that foreign investors are breaking the rules.

The third new regulation concerning foreign investment was among the anti-inflation measures of 9 April 1974. The requirement that 30% of certain funds borrowed from abroad must be deposited in non-interest-bearing accounts was aimed chiefly at foreign companies. This measure undoubtedly had some effect on stemming credit expansion, but was dropped in late 1974 when inflationary pressures abated.

25X6 The consensus seems to be that most foreign investors have not been put off by the new laws because they do not expect them to be strictly enforced. [redacted] Unless potential investors are given more substantial cause to change their perceptions, they will continue to bring their business to Indonesia.

25X6

TAB C

The Philippines: Recent Economic Performance and Outlook

A solid economic recovery in 1973 and an unexpectedly bright trade picture for 1974 provide the Philippines with the best opportunity in years to achieve solid economic development.

- Foreign exchange holdings grew by more than US $600 million last year. Strong export performance again this year will offset higher costs of oil and other imports and, with growing capital inflows, will result in another large international payments surplus.

- Agriculture has recovered from the disastrous floods of 1972. Grain stocks are still low, but the current outlook is for a 4%-5% increase in crop production this year.

- Industrial production grew 11% in 1973, although growth will slow somewhat this year because of shortages of some key materials and a cost squeeze.

Taking advantage of this good economic fortune and its greater political freedom of action under martial law, the Marcos administration has shown aggressiveness in introducing reforms aimed at resolving some of the more persistent development problems.

- In the past two years the government at long last has moved intensively on land reform. Holdings of tenanted rice and corn lands in excess of 24 hectares have been authorized for redistribution. By January 1974, some 150,000 titles had been transferred to tenants.

- There has been progress in building up the tax base. In only two years, tax revenues as a share of GNP increased from 9% to 14%.

- Establishment of law and order, especially in Manila, as well as policy-induced incentives, has attracted more foreign investment, much of it into export lines.

Sustaining the momentum of growth over the longer term, however, will require more difficult decisions than the Marcos administration has had to make since coming to power.

- Further progress in agriculture will require strong price incentives to farmers, as well as continued land reform. This objective would tend to conflict with attempts to arrest the erosion of real wages, which Manila may consider necessary in order to avoid urban unrest.

- Curbing inflation may require tightening of credit, which could, however, slow industrial expansion.

- Rapid economic development, particularly in agriculture, will require a substantial growth of public spending. These needs will increasingly compete with the rising expenditures for national security and will require a large expansion of the tax base.

DISCUSSION

Introduction

1. Pressing economic problems since the declaration of martial law in September 1972 have not diverted President Marcos from his long-term program for economic and social reform. Since last fall, he has successfully dealt with a potentially explosive situation in Manila brought on by acute rice shortages and has managed to minimize the impact of petroleum shortages. At the same time, the power to legislate by decreee has resulted in a flood of reform measures that deal with more basic economic issues.

2. Many of the reforms would have been impossible in the political climate preceding martial law. However, with the decline in the political power of some of the wealthy families and greater economic policy responsibility in the hands of capable government technocrats, several far-reaching policy initiatives have resulted. An ambitious agrarian reform program has had a good beginning, although it is expected to run into landlord opposition as the time approaches for breaking up smaller landholdings. Changes in industrial incentives have improved prospects for development of manufactured exports. The administrative and financial system has been completely revamped; tax measures stalled for more than a decade in Congress are now an integral part of the fiscal system. Rules and regulations governing foreign investment have been greatly modified.

3. A remarkable economic recovery last year, while having relatively little to do with the reforms, has provided some breathing room in which the administration can pursue its strategy for accelerating economic growth and development and has generated a high degree of optimism regarding Philippine prospects. This report looks at the persistent problems underlying the mediocre performance of the Philippine economy in the years leading up to martial law and, in light of new corrective policies, assesses the likelihood that the momentum gained in 1973 will continue.

Persistent Problems and New Policies

Obstacles to Growth

Illusive Self-Sufficiency in Food

4. Achieving self-sufficiency, particularly in rice and corn, is still a major government objective, important not only to strengthen the balance of payments, but also as a means of raising incomes for most of the population. Farming and related activities account for well over one-third of GNP, yet the Philippines must import more than 1 million tons of foodgrains in bad years.

5. Severe setbacks in agriculture slowed progress toward self-sufficiency and limited economic growth in the years immediately preceding martial law. In 1969-72 the value of crop output increased at an average annual rate of only 2.5% as the output of rice, the principal staple, declined an average 1.1%. Sluggish growth was the result in part of unprecedented floods and crop diseases and in part of inept policies such as unnecessarily tight credit, price controls, serious deficiencies in the distribution of agricultural inputs, and the nonfunding of promised price supports for high-yielding varieties (HYVs) of rice. The poorest performance came in 1972 after the worst floods in recent history devastated crops in the major rice-producing area of central Luzon only to be followed by widespread drought that hit hardest in corn-growing Mindanao. Predictably, the principal impact of the recent setbacks has been on foodgrains. Major export crops have not been seriously affected over the last few years and have provided increasing foreign exchange earnings.

6. The experience of the last few years has been a sobering one for development planners. In 1967-68 the rapid adoption of HYVs of rice led the government to expect achievement of self-sufficiency, and the chief concern of agronomists was finding markets for expanded production. Production setbacks have demonstrated that output is still primarily dependent on the weather and that sustaining rates of technological advance will require more painstaking efforts than in the past, particularly expansion of irrigation and flood control facilities. The phase of very rapid expansion through the use of HYVs is over. They now blanket the irrigated area, which accounts for only one-third of the lowlands paddy area. Moreover, yields on the irrigated area have already declined, in part because of substitution of new, better-tasting (but lower-yielding) varieties of rice.

Industrial Stagnation

7. Industrial output in the Philippines grew at a modest 6.8% annual rate during 1967-72. This growth created few new employment opportunities and, despite preferences in the US market, contributed relatively little to export earnings. There was, however, rapid growth of industrial exports from a small base after the 1970 peso devaluation.

8. Several studies of Philippine industrialization have shown that over the last two decades exchange controls, and later tariffs, fostered the development of high-cost industries unable to compete in export markets. Most were finishing and assembling operations at a relatively late stage in the production process. A chronically overvalued peso permitted industry to acquire raw materials and capital inputs abroad at artifically low cost – thus discouraging linkages with domestic manufacturers and preventing greater labor absorption – while industrial output commanded high prices and earned high profits in a sheltered market.

9. Investment in industry stagnated during 1968-71 and declined sharply in 1972, in part because opportunities for easy import substitution diminished. Reflecting this, foreign investment in manufacturing, quite buoyant in the early 1960s, showed a net outflow toward the end of the decade. Later, a slowdown in real growth led to slackening consumer demand and substantial increases in idle capacity.

Inadequate Public Investment

10. The small size of public development outlays has also tended to brake economic growth in recent years. An important factor was the consistent failure of administration-sponsored tax measures to win approval from Congress. With the significant exception of the export tax introduced in May 1970, virtually all tax proposals made in the five fiscal years leading up to martial law were defeated, including a comprehensive tax reform package submitted with the administration's FY 1973 budget request.[1] In FY 1972, tax revenues as a proportion of GNP amounted to only 9.5%, one of the lowest ratios in Southeast Asia. Total public expenditures as a percentage of GNP were somewhat higher at 10.5%, but less than one-fifth of these were for development purposes. As a result, improvements in the transport system and in irrigation and flood control facilities have been inadquate for support of an extensive rural development program.

Accelerating Inflation

11. Inflation has been a serious problem in the past several years. After rising an average 11% annually during 1969-72, consumer prices jumped 27% in 1973 (see Table 1). The underlying pressures in this inflation came from a devaluation in 1970, shortages of agricultural commodities in subsequent years, and, more recently, a sharp rise in import and export prices. The problem of dealing with domestic inflation has been complicated by ineffective controls, inefficiently administered subsidies, and world trends beyond Philippine control.

12. Rapidly rising prices have aggravated a longstanding problem of a grossly distorted income distribution. Low income laborers have been hit hard. Indices show that real wages of both skilled and unskilled workers have declined drastically over the past several years. There are no specific data on other occupational groups. However, the income share of the lowest quintile of the population stands at about 4%, slightly lower than a decade ago. This share compares very unfavorably with most other developing countries. Studies suggest also that nutritional standards in the Philippines are low, even in comparison with other countries in the region with appreciably lower per capita incomes. While it is hazardous to draw conclusions from notoriously weak data, an ECAFE study in 1971 attributed low nutrition in part to the pattern of income distribution.

1. The Philippines' fiscal year coincides with that in the United States. The particular tax package noted here was submitted in May 1972.

Table 1

Philippines: Indexes of Prices and Wages

1965 = 100

	Consumer Prices	Real Wages[1]	
		Skilled	Unskilled
1971 Jun	149.1	N.A.	N.A.
Jul	155.3	89.3	98.6
Aug	158.1	87.9	96.4
Sep	159.5	87.1	96.1
Oct	161.9	87.6	96.7
Nov	160.7	88.4	97.3
Dec	160.7	88.4	97.2
1972 Jan	165.3	87.1	98.9
Feb	165.2	87.1	99.1
Mar	165.2	87.2	99.4
Apr	163.9	88.3	100.3
May	164.9	88.2	100.9
Jun	166.6	87.3	100.0
Jul	172.0	85.5	94.9
Aug	177.9	82.9	91.5
Sep	176.8	83.9	92.3
Oct	171.5	87.0	96.1
Nov	169.3	88.3	97.3
Dec	167.9	89.3	98.0
1973 Jan	168.8	89.8	98.7
Feb	169.4	89.6	97.8
Mar	171.2	88.5	96.3
Apr	175.0	86.8	94.3
May	179.0	85.1	92.5
Jun	181.4	84.1	90.8
Jul	184.0	84.7	92.8
Aug	194.3	80.4	88.7
Sep	204.0	76.8	83.8
Oct	200.4	....	....
Nov	209.0	....	....
Dec	213.8	....	....
1974 Jan	223.9	....	....
Feb	225.2	....	....
Mar	235.5	....	....
Apr	238.7	....	....

1. Money wage deflated by the consumer price index.

Economic Reforms under Martial Law

13. Since martial law was declared, the government has assumed a much more active role in economic development. Recent reforms, although cautious in most instances, have made a good start in removing some of the obstacles to development.

14. In agriculture, the government has taken important initiatives, in particular by attempting to remove some of the institutional barriers to increased grain production and pushing ahead with reform of the tenancy structure. Through the so-called Masagana 99 program, the government sharply increased credit to farmers. The program was launched in May 1973 and by the end of the year 380 million pesos ($56 million) were added to the nation's agricultural credit resources.[2] The public funds were funneled through the Philippine National Bank, the Agricultural Credit Administration, and rural banks in order to increase lending

2. Agricultural credit in 1972 from public and private institutions amounted to 3.5 billion pesos, or 10.2% of total domestic credit.

on a no-collateral basis for purchase of farm inputs. The rural banking system is being primed for a much larger role in agricultural development financing. The Central Bank has introduced special borrowing and rediscount facilities for these banks, and plans are being implemented for a 60% increase in the number of rural banks and for their agricultural lending capability to be more than doubled in four years. In June the government also lifted a 13-year ban on alien participation in the rice and corn industry, thus legalizing Chinese involvement in milling and wholesale trade -- a move that should improve marketing and distribution facilities. Marcos' ambitious agrarian reform program, which he still considers the "cornerstone of the new society," although now running into problems, accomplished more in its first year than in all the years since 1963, when the goal of eliminating share tenancy was first established.[3]

15. Marcos has also introduced a number of measures to boost industrial growth and to reverse the net outflow of foreign investment. Most important from the standpoint of foreign business interests have been the liberalization of policies with regard to repatriation of capital and remittance of profits, a broadening of the Export Incentives Act to include more types of industries, relaxation of visa requirements, and creation of a Labor Relations Commission to settle all labor disputes.

16. Other measures aimed at rationalizing the industrial structure seem to constitute a constructive and pragmatic approach to undoing the years of overinvestment in internationally uncompetitive lines. Not yet able to undertake fundamental tariff reforms without severe local consequences, the Marcos administration has sought to relieve some of the waste of resources in other ways. The Board of Investment has been given broader powers in forestalling investment in "overcrowded" industries[4] and in channeling funds according to a strategy aimed at employment generation, regional dispersal, and export growth. In the case of textiles, for example, a condition of removing it from the "overcrowded" list was that 50% of additional capacity must be for export. This approach, of course, continues to run the risk of misallocation through poor administrative decisions or corruption and is, therefore, only a partial substitute for further tariff reduction that would force greater production efficiency.

17. Reform of the tax structure has allowed broader scope for public investment activity. Tax measures introduced since martial law have markedly increased the government's revenue base. Higher personal income taxes and excise taxes, tariff code changes that slightly increased the tax burden on imports, higher

3. For a detailed discussion of agrarian reform, see Appendix A.

4. The list of "overcrowded industries" is periodically revised. It currently includes tin refining; vehicle and tractor assembly; manufacture of paper, cold rolled steel, fertilizer (except urea), cement, paint, tires, copper and steel wire, radios and certain electrical appliances; processing of coffee, cocoa, soybean oil, and meat products; and brewing. Sugar milling was recently deleted from this list.

real estate taxes, and a one-shot amnesty tax aimed at delinquent accounts helped support a 50% increase in public development cash expenditures in FY 1973, although this was mostly for flood rehabilitation. These expenditures were originally projected to double in the current fiscal year, but actual cash outlays are likely to fall well short of this goal in view of the trimming necessary to reduce inflationary pressures. Nonetheless, revenues will far exceed earlier projections, mainly as a result of an increase in export taxes decreed in February. In FY 1974, revenues as a percent of GNP should be on the order of 14%-15%.

Key Elements of the 1973 Performance

18. The reforms – with the exception of tax measures – contributed little to the sharp rise in economic growth in 1973. A weather-induced recovery in agriculture and a record surplus in international payments, coming largely from sharp price rises on world commodity markets, permitted economic growth on the order of 8%-10%, up sharply from the 5.5% annual average of 1967-72. Buoyant economic conditions led to a revival of investment activity. Fixed capital formation grew nearly 8% after stagnating for the previous five years.

Sharp Gains in Domestic Production

19. Agriculture was the key to recovery. The sector (including forestry and fishing) grew 11%, pushed along by large gains in poultry and livestock output and particularly in forestry production. Forestry led all other sectors, reversing its steady decline of the preceding five years. Crops, which account for the bulk of production, expanded at a rate of 5.5% against near stagnation in 1972. Although rice and corn, the principal staples, made notable gains, these were not realized until the last quarter. For most of the year, supplies were extremely tight. Indeed, in the July-September period rice was in such short supply that city dwellers were forced to eat a rice-corn mix. Rice imports in the second half of the year amounted to some 250,000 tons and would have been larger had it not been for world market shortages.

20. Other sectors of the economy, except mining and commerce, also exceeded their average performance for the previous five years. Manufacturing output rose 11.1% in 1973 according to revised figures. Large gains were recorded in metal products, cement, textiles, wearing apparel, and footwear. Many of these items made important breakthroughs to export markets. Construction, in steady decline for several years, continued the rapid growth that began after the severe floods of 1972.

Record Surplus in International Payments

21. The Philippines' international payments improved markedly in 1973. The overall payments surplus soared to some $665 million, compared with $95 million in 1972 (see Table 2). The improvement reflected a strong export performance,

Table 2

Philippines: Balance of Payments

					Million US $
	1970	1971	1972	1973[1]	1974[2]
Goods and services	-85	-56	-105	398	100
Trade balance	-7	-38	-122	275	0
Exports (f.o.b.)	1,083	1,148	1,108	1,837	2,600
Imports (f.o.b.)	-1,090	-1,186	-1,230	-1,562	-2,600
Services	-78	-18	17	123	100
Transport and insurance	-91	-77	-87	-128	N.A.
Travel	67	38	98	60	N.A.
Investment income	-130	-101	-125	-112	N.A.
Services to the United States military	31	36	41	42	N.A.
US veterans' pensions	64	69	71	74	N.A.
Other	-19	17	19	187	N.A.
Transfers	55	64	117	159	50
Private	29	34	81	97	N.A.
Government	26	30	36	62	N.A.
Capital	199	141	190	184	250
Private long term	66	-38	-39	42	100
Direct investment	-25	-1	-11	N.A.	N.A.
Other	91	-37	-28	N.A.	N.A.
Private short term	76	92	56	64	50
Central government	39	70	157	78	100
SDR allocation	18	17	16	0	N.A.
Net errors and omissions	-147	-143	-107	-76	0
Monetary movements[3]	-22	-6	-95	-665	-400

1. Preliminary.
2. Estimated. Rounded to the nearest $50 million.
3. A minus sign indicates an increase in foreign assets of the Philippine banking system.

substantial gains in services, and an increase in private and official transfers. At the end of 1973, international reserves amounted to $876 million, compared with only $288 million a year earlier.

22. Earnings from trade were extraordinarily high, resulting in an estimated surplus of $275 million in 1973 (compared with a deficit of $122 million in 1972). Most of the trade surplus – $249 million – was realized in the first half of the year. Later, general import demand and prices began to rise more rapidly, the yearend grain squeeze led to a sharp increase in that account, and sugar receipts fell seasonally during July-October. Overall, however, the most important single element in the 1973 trade picture was the unprecedented gain in world market prices for traditional exports, particularly coconut products, logs, and lumber.

23. Another notable feature of the Philippines' international economic performance in 1973 was the turnaround in private capital flows. Preliminary balance-of-payments data show a net inflow of $42 million in private long-term capital in 1973, compared with a new outflow of $39 million the previous year. Much of the increase probably reflects increased equity investment by foreign banks.

24. Other key payments accounts generally showed sizable surpluses as well. Net service receipts increased more than $100 million, despite the curious fact that earnings on the travel account showed a decline that appeared to conflict with reports of an extraordinary increase in tourist arrivals. Large gains were recorded in private and official transfers, mainly donations for flood rehabilitation.

Quickening Inflation and Incomes Effects

25. The 1973 recovery was marred by rampant inflation and further erosion of real wages. Measures introduced by Marcos in September 1972 to control retail prices[5] were successful for a time; prices actually dropped in the last quarter of 1972 (see Table 2). By early 1973, however, the effectiveness of controls had dissipated partly because Philippine policies could not cope with international inflation. Consumer prices rose only slowly at first, mainly in response to higher costs for imports and goods with a high import content. Inflation sharply accelerated after midyear, as prices rose for such items as cereals, fish, fruits and vegetables, clothing, fuel, and utilities. Wholesale prices showed even sharper increases because of higher weights given to internationally traded goods and lower weights assigned to price-controlled items. The largest increases were in manufactured goods, chemicals, petroleum products, and export commodities that are also used for home consumption, especially coconut oil. According to official indices, consumer and wholesale prices were up 27% and 51%, respectively, for 1973 as a whole.

26. As might be expected, real wages of urban laborers were eroded significantly in 1973, continuing the trend for the past several years. At the end of 1973, real wages for both skilled and unskilled workers in Manila were 20%-25% below their 1965 level.

The Outlook for 1974

27. Continuing price pressures and tight food supplies may pose serious problems for Marcos, particularly in late summer and early fall, but the overall economic outlook for 1974 is only slightly less promising than last year and should still provide the basis for considerable buoyancy in investment. Real growth will probably slow to about 7%-8%, a still very healthy rate. Exports will again provide

5. Controls cover a very broad list of industrial and consumer goods and services, including utilities, petroleum products, fertilizer, rice, corn, sugar, coconut oil, textiles, and bus and taxi fares.

the major impetus. Despite pessimistic Philippine assessments, growth in export earnings may exceed 40%, even if there is considerable softening of prices in the latter part of the year. It will be hard to slow inflation, however, because price increases are being caused largely by external pressures. The erosion of real wages is fast becoming intolerable and may demand corrective action. Despite good spring crops, food supplies will remain a problem. Rebuilding of depleted stocks and speculative hoarding could cause serious shortages by late summer. Heavy imports of fertilizer have improved the outlook for fall harvests. Barring an unfavorable turn in the weather, growth in crop production should be about 4%-5% for the year. Industrial growth will slow somewhat because of shortages of some imported materials and squeezing of profits in other areas by higher costs and price controls.

Stabilization and Incomes Problems

28. Inflation is certain to be one of the most difficult and politically pressing problems. The stabilizing effect of good harvests has been less than hoped for, and prices continued to advance rapidly through the first four months of 1974. At the end of April, wholesale and consumer prices in Manila were up 70% and 36%, respectively, over April of last year.

29. Apart from administered pricing for most consumer goods, the government's anti-inflation policy has relied primarily on fiscal discipline. A windfall gains tax on exporters, a tough line on wages, and sluggish implementation of public works projects have resulted in a large budget surplus in FY 1974 instead of the deficit of 2 billion pesos originally projected. The government has, however, been reluctant to risk a slowdown in economic activity by imposing stringent credit controls. At the end of April, commercial bank credit was up 45% over a year earlier.

30. In any case, the government has little leverage in holding down prices because much of the inflation derives from world market pressures on internationally traded goods. There is little indication that these pressures are abating substantially. Prices remain high for such essential imports as grain, crude oil, and industrial raw materials as well as for certain export commodities that are also consumed domestically. Persistent local shortages of such export items as sugar and coconut oil, for example, recently forced the government to assume control of sugar exporting and to pressure coconut oil producers to limit exports.

31. Inflation will hit real incomes unevenly, with particularly sharp impact in some key areas. Farmers producing a surplus generally will continue to benefit from high prices for rice, corn, and coconuts, while urban laborers will bear the brunt of cost-of-living increases. Recent labor code provisions are peripheral to the central issue of higher wages and are undoubtedly small consolation to workers who have seen the deterioration in their living standard quicken since Marcos assumed martial law powers. The labor movement in the Philippines, however, is

poorly organized, and its leaders are intimidated by a government with arbitrary powers. Apparently, Marcos feels that the risks of civil disturbance at this time are not great. Up to now he has granted a minor cost-of-living allowance to civil servants and has pressured private industry to follow suit. On the advice of Cabinet ministers, he has remained opposed to raising the minimum wage, hoping that cheap labor will attract foreign investment. He would probably be quick to reverse his wage policy, however, in the event serious civil unrest threatened.

Domestic Production

Agriculture

32. Grain supplies are tight, and serious shortages are possible later in the year. Although rice and corn production for the crop year ending in June 1974 exceeded previous highs set in 1971, the government had been counting on much larger harvests. The latest estimates put the combined output of rice and corn some 700,000 tons below original projections, which were probably excessively influenced by exaggerated claims for the government's Masagana 99 program. Reports also claimed, however, that conversion of land to export crops was a significant offset to the government's drive for greater grain production.[6] In any case, harvests have been inadequate to keep markets well-supplied and to allow for the necessary rebuilding of stocks after last year's crop failure. Stocks of both rice and corn are extremely low. Wheat stockpiles are also well below normal as a result of price controls that forced millers to cut back on imports. Rice prices, although well below levels reached last fall, have remained unusually high and in April were 68% above a year earlier. Indications are that speculative holdings are increasing in anticipation of even higher prices later in the year.

33. Current market conditions have given the government a bad case of nerves regarding prospective grain supplies in late summer. It recently issued an executive order requiring domestic corporations and partnerships with more than 500 employees either to go into rice and corn planting or to import the required grain for their employees at the risk of stiff penalties for noncompliance. It has also reversed its import policy. On the basis of original crop estimates, officials had earlier decided that imports of rice and corn would be unnecessary beyond amounts already scheduled for delivery by the end of June. Since April, however, the government has been feeling out international grain markets and recently contracted for 50,000 tons from China. In addition to large wheat imports already contracted for, the government probably will need at least 200,000 tons of rice and 100,000 tons of corn to avert serious shortages in the lean months ahead. These may be difficult to obtain in the prevailingly tight global markets. Meanwhile, the National Grains Authority continues its optimistic pronouncements while cracking down harder on price-control evaders.

6. This trend was probably attributable as much to landlord efforts to avoid land reform (see Appendix A) as to the increased attractiveness of export crops.

34. The outlook for the fall harvest has improved with the heavy deliveries of fertilizer in the past few months. According to the Director of the Fertilizer Industry Authority (FIA), inventories are already adequate to meet national demand through July, which will cover the major planting period. This does not include direct imports by end-users. The FIA is still negotiating for about 150,000 tons for the balance of 1974. Total fertilizer consumption in 1974 is likely to be on the order of 700,000 tons, less than half domestically produced.

Industry

35. Some slowdown in industrial growth is likely as a result of international shortages of intermediate goods and industrial raw materials upon which Philippine industry depends heavily. Consumer goods industries have been affected somewhat from the tight supply of polyvinyl chloride. Plans to promote the domestic machinery and electrical equipment industries are also reported to be experiencing difficulties because of a decrease in steel supplied by Japan. Some industrial firms are also experiencing cost pressures, arising in part from protective barriers that force them to purchase locally produced intermediate goods that are frequently more expensive than comparable imported items.

36. One key question on inputs at the start of the year was whether industry would be able to import sufficient fuel. The Philippine government moved quickly and aggressively to acquire needed oil, and the situation appears to be well in hand now.[7] Output in the highly energy-intensive cement industry, an exception, has dropped off seriously because of fuel problems. Domestic fertilizer production has also been sluggish, but this is only partly the result of limited availability and high costs of petroleum-based inputs. Lack of production incentives arising from price controls is probably the more important reason for slow growth in output. Transportation has also been caught in the inflationary squeeze by the combination of rising fuel costs and controls on prices charged for service. Nonetheless, essential transport services have not been disrupted, and, apart from cement and fertilizer, no serious slowdowns have occurred in industry.

37. Changes in general business conditions in developed economies will also affect foreign demand for Philippine industrial commodities. Although the economic slowdown in Japan and the United States appears to have had limited repercussions thus far, if conditions in these economies do not improve, some impact on Philippine output and employment, particularly in the mining and wood-processing industries, can be expected in the second half of the year.

38. The investment climate, however, seems to remain favorable. Solid investment growth seems assured at least for the balance of this year, given the large number of proposed investments in advanced stages. In textiles and garments,

7. Although foreign exchange costs will be very large, the Philippines signed a contract with Kuwait in February, which brought prospective crude supplies in 1974 to about 65 million to 70 million barrels, compared with actual deliveries in 1973 of 63 million barrels.

electrical components, wood processing, coconut oil milling, and mineral processing, new investments aimed at the export market are pending, approved, or in process. Plant expansions and new investment in the textile industry are well under way, with many scheduled to commence operations before the end of the year. Recent investment approvals for production of electrical components will markedly increase capacity in this industry, where previous export performance has been extremely poor compared with the relatively new competitors in Taiwan or South Korea. The government drive to encourage greater domestic processing of local materials for export drew a quick response from potential investors in wood processing and coconut oil production. Several Japanese firms are planning joint ventures with local capital in fully integrated wood-processing facilities. Current proposals for new investments in coconut oil production, either pending or approved, are adequate to process nearly all the exportable supplies of copra. Recent Board of Investment action virtually closes this industry to further investment. Although excess capacity continues to limit investment possibilities in some lines (see footnote 4), foreign investors, primarily Japanese, are currently exploring possibilities in mineral processing, steel manufacture, shipbuilding, certain light manufacturing industries such as footwear and feed milling, and tourist-related services.

International Payments

39. Contrary to earlier fears, the Philippines should have a large payments surplus this year. Unusually high prices for most of the country's major exports should put the trade account very nearly in balance despite a rapidly rising import bill.

40. This outlook should do a good deal to assuage the anxieties of Filipinos concerned with the effects of fundamental commercial policy questions arising this year, in particular the impending loss of a very substantial US sugar quota. The need for new trade concessions from the United States to compensate for the recent loss of other preferences in the US market is also less pressing.[8]

41. If current prices hold, the total import bill may reach \$2.6 billion, up 66% over last year. Crude oil imports could exceed \$600 million in 1974, compared with \$210 million in 1973, while soaring world prices of chemicals, machinery, transport equipment, and iron and steel will sharply escalate the import bill for these essential items. Agricultural imports will also be up because of higher prices for wheat, cotton, rice, and corn. Export receipts, on the other hand, may also reach \$2.6 billion, up 42% over last year, because of persistently high prices for the country's most important primary export commodities.[9] Prices for sugar,

8. The sugar quota ends with the expiration of the US Sugar Act on 31 December 1974. Other Philippine trade preferences on the US market were finally phased out in July with the expiration of the 20-year-old Laurel-Langley Agreement governing economic relations between the two countries. The Filipinos are very interested in obtaining new concessions, but they recently suspended negotiations on a new economic treaty with the United States and probably will await resolution of the Trade Reform Act in Congress before resuming talks.

9. For a more detailed discussion of export prospects for the principal commodities, see Appendix B.

coconut products, and logs and lumber have held up extremely well thus far. Only copper prices have dropped markedly in recent weeks. Although some general softening of prices is expected in the second half of the year, most commodity groups will post substantial gains for the year as a whole.

42. Net earnings from other current account items probably will decline somewhat this year. Much of the increased costs of transport and insurance should be offset by larger earnings from tourism. Tourist arrivals in the first five months were up 65% over the comparable 1973 period, the result of an improved peace-and-order situation and heavy government promotion efforts. Private transfers on the other hand should decline substantially because of the termination of flood-related assistance.

43. The improved outlook for private foreign investment probably will bring in as much as $100 million in long-term capital during 1974 (see Table 2). Businessmen are undoubtedly still wary of the durability of the regime and its new policies, but these fears seem to be fading gradually. Foreign investment in banking has already been exceptionally large this year and probably will be accompanied by other long-term gains in the industrial lines noted above. Private short-term capital inflows probably will be slightly lower than last year in view of new restrictions on foreign borrowing by commercial banks. The country faces a reduction in certain categories of foreign assistance. Official transfers are projected to decline, and it also appears that PL-480 assistance from the United States will consist of only a small allocation for tobacco imports. On the other hand, foreign assistance in the form of project loans will be sharply higher. The IBRD has already approved a loan package totaling $158 million.

44. On the basis of these projections, the basic balance could be in surplus by as much as $400 million in 1974. For international payments alone, it would appear that the Philippines will have little need to draw upon its greatly expanded credit lines in order to backstop reserves. It has access to $700 million in long-term credit lines arranged earlier with bank consortia in the United States, Europe, and Japan in anticipation of serious balance-of-payments pressures. It also has access to $300 million to $400 million in oil credits provided by foreign banks. In addition the International Monetary Fund has recently approved a standby loan of up to $47 million for meeting international payments over the next year.

The Longer Term Outlook

45. Sustaining growth momentum will require more difficult decisions than Marcos has had to make since he came to office. The recent reforms in the tax structure, industrial regulations, and land tenure have by and large hurt only the very wealthy, whose political influence is sharply diminished. By contrast, food shortages and rising prices, which thus far have caused Marcos few political problems, have hit particularly hard in the urban working classes and even among

poorer farmers. For the time being, unified labor pressure is lacking, students are intimidated and have remained quiet, and landless farmers have been satisfied with initial progress on land reform. Discontent is growing, nonetheless, and Marcos obviously cannot afford to risk prolonged social unrest if for no other reason than that it would quickly erode the confidence of domestic and foreign investors painstakingly built up under martial law. Price controls and direct government interventions in marketing, the devices used thus far to cope with threats to living standards, are at best only stopgaps. Moreover, because of their negative effect on production incentives, they virtually assure that the shortages will recur. Although substantial progress has been made in increasing credit to farmers, much greater efforts are needed to improve agricultural extention programs, to increase the availability of agricultural inputs, and to expand irrigation facilities to provide for dry-season cropping.

46. Manila will also have to face up to the need for greater monetary and fiscal restraint. Although leverage over inflation is limited by external developments, private credit, which has been expanding rapidly, has become an increasingly important source of price pressures and will have to be under stricter controls. A more flexible interest-rate policy is also called for to increase saving and to maintain the government's domestic borrowing program. Although the government's budget performance has been good, it is largely the result of growth in revenues at a rate unlikely to continue. Moreover, security expenditures have risen sharply and now pose a serious threat to long-range development goals. Although official figures put military allocations at less than 15% of the total budget, actual defense costs are undoubtedly far higher. If the costs of administering martial law and carrying out military operations against the Muslims cannot be contained, the government will be forced to trade off scarce domestic resources necessary for support of a development program.

47. Over the longer term, exchange ratio and reserve management policies could present problems for the Philippines. Since April 1972, only very minor fluctuations have occurred in the peso-dollar exchange rate, even though the Philippine price level has increased about 50% during this period, compared with about 10% in the United States. Recent sharp gains in export prices have so improved the balance of payments that there is no pressing need for exchange rate devaluation. Indeed, with foreign exchange reserves growing rapidly, a strong case can be made to support some appreciation of the peso in order to increase imports as an anti-inflationary measure. On the other hand, should export prices break sharply, a peso devaluation may be needed. In either event, past Philippine governments have been notoriously slow to act on exchange rates, a pattern of procrastination that has generally tended to discourage export growth and foreign investment in industry. So far, there have been no signs of a better track record under martial law.

48. The Philippines is nevertheless in a much better position to cope with temporary balance-of-payments pressures that might result, for example, from a

cyclical weakening of demand for primary exports. While economic momentum would certainly be slowed considerably in the event of a recession in world trade, the country's much-improved debt structure, greatly expanded credit lines, and assurances of continued financial support from the international community would serve to cushion the impact.

49. Clearly the Philippines now enjoys the best opportunity in years to realize its full growth potential. There is little question that the country has the resources, both physical and human, to improve upon its rather disappointing performance over the last decade. The economy would have to expand by an average of at least 5%-6% annually in order to absorb a rapidly expanding labor force and to increase the standard of living. To achieve such growth will require as a first priority a very large increase in government expenditures on public works projects, designed primarily to increase productivity in agriculture. Manila will also have to continue its shift in emphasis toward export industries so as to increase manufacturing's share of employment and foreign exchange earnings.

APPENDIX A

AGRARIAN REFORM

As testimony to the importance Marcos places on fostering peasant support for his regime, agrarian reform is billed as the "cornerstone of the New Society." Through the 1960s, relatively little attention was given to the plight of the sharecroppers by Philippine leaders, including Marcos. The few attempts that were made to restructure agrarian society inevitably ended in capitulation to landed interests. Although the current program is now showing signs of faltering, it can boast remarkable achievements. Although the program is seen as a crucial element in the country's drive for self-sufficiency in food production, for reasons discussed below, its income redistribution effects are likely to be far more important for the foreseeable future.

The goal of converting tenants to owner-cultivators was established in 1963 with enactment of the Agricultural Land Reform Code but was not pursued with any intensity until 1970. Between 1970 and Marcos' October 1972 decree, land reform activities were directed toward the intermediate goal of leasehold rather than ownership and were limited for all practical purposes to the rice-farming population. By the end of 1971, only about 90,000 share tenants had been converted to lessee status, about 70% of them in the pilot area of Nueva Ecija.

The goal of Marcos' program is the abolition of the share tenancy system on all rice and corn lands, which account for about 63% of the nation's cropland. Data on the number of tenants and landlords and on the size, distribution, and location of holdings are inadequate, but it is estimated that the Marcos decree brought some 1 million tenants on 1.8 million hectares of rice and corn lands held by some 350,000 landlords within the scope of the program. The Land Bank, established in 1963, is to be the key agency in transferring funds to landlords. Landlords are given several compensation options from which to choose: small initial payments in cash, supplemented with bonds, government stocks, or annuities.

Marcos' attempt to accelerate the transition to owner-cultivatorship has been successful thus far. There have been isolated reports of landowner resistance, including ploys to avoid land reform by subdividing, changing the status of tenants to agricultural workers, converting rice and corn land to other crops, and outright eviction of tenants. It is difficult to judge how widespread this resistance is because reporting, apart from government sources, is scant. Nonetheless, it is claimed that through January 1974 some 150,000 tenants had become landowners through the program, involving about 270,000 hectares (or an average of about 1.8 hectares per new owner). The financial base of the Land Bank has been strengthened and, in a yearend decree, Marcos ordered compensation payments to begin.

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Marcos now finds himself in a rather delicate political situation. The land reform decree stipulated that landlords will be allowed to retain 7 hectares if they are self-cultivated. Thus far, however, only landholdings exceeding 24 hectares have been authorized for distribution, which would cover about 540,000 hectares, or about 30% of the goal. It is feared that moving beyond the 24-hectare limit would risk the wrath of an estimated 320,000 landlords, many of whom are said to be police and military officers or government officials who represent an important segment of the regime's support. Consequently, Marcos ordered an investigation on 4 November 1973 into the effects of land reform on owners of 24 hectares or less.*

Even if the decision is made to distribute holdings in the 7-24 hectare range, it will be necessary to expand the scope of the program if announced goals are to be accomplished. A zero retention limit for landlords was originally proposed to Marcos in order that all tenants on rice and corn land be included in the program and to prevent landlord subterfuge via subdivision to phantoms. This was rejected as politically unworkable. Even with a zero retention limit, however, it would have been impossible to expand the size of tenant holdings beyond the present average of 1.8 hectares. If the 7-hectare retention limit stands and non-tenanted rice and corn land (two-thirds of total rice and corn land) is exempted, a large number of tenants would be excluded from the program.

The effects of land reform in the Philippines are still obscure. There are no data yet available on the effects of transition to owner-cultivatorship. Moreover, studies have established no correlation between productivity and the earlier transition to leasehold. The main effect in this case was one of income redistribution, with lessees retaining a much larger share of the harvest. Shifts to lessee status did not result in significantly higher expenditures on inputs. This is possibly attributable to the breakdown of traditional relationships between landlord and tenant, particularly in the provision of credit. Lessees had difficulty obtaining loans; whereas, in the sharing system, landlords generally lent money for, or themselves paid for, farm expenses. Agricultural extension services were also inadequate to replace the landlord's management function.

Comparisons of the Philippine agrarian reform program with South Vietnam's remarkably successful land-to-the-tiller (LTTT) program are frequently overdrawn. The Philippine program has a similar goal, but the circumstances under which land reform is pursued are quite different. Apart from the fact that the motivation to succeed was much stronger in South Vietnam, where the country's survival hinged

* The current study ordered by Marcos should shed light on the claim that to proceed with land reform would destroy part of the regime's political base. As of now, however, there are no adequate data to substantiate it. In South Vietnam, opposition spokesmen made the same claim prior to the land-to-the-tiller program. Opposition was torpedoed, however, when a research unit thoroughly documented the fact that only 10% of village officials were landlords and only 2% of landlords were military officers.

on the defeat of an enemy whose principal appeal was the promise of land, there are other important differences. According to the best available data, the average size of holdings in South Vietnam subject to land reform was more than twice as large as in the Philippines -- 13.5 hectares compared with 5.1 hectares -- whereas the number of tenants affected was slightly smaller. South Vietnam's larger holdings were in the Southern Region. The Philippine agrarian structure may more closely approximate central Vietnam's where the LTTT program did not comfortably fit the situation, because many landlords were perhaps little better off than tenants. Studies showed that half of all landlords in central Vietnam were renting only 1 hectare or less to tenant farmers.

The Philippine reform program is more broadly based, with emphasis on credit and cooperatives. Farmers are required to join a cooperative prior to receiving title as a means of insuring payments, whereas South Vietnam's peasants were given land free, with the government assuming the cost of compensation. Provision of supporting services -- critical to the success of the Philippine program -- was not a serious problem in South Vietnam, because landlords did not normally participate in the production process. The South Vietnamese program also had the advantage of sophisticated surveying techniques and use of aerial photography.

Most important, perhaps, the success of the LTTT program is attributable to the decreased attractiveness of farmland under wartime conditions. The war in the countryside caused large-scale population migration to urban areas, and this greatly altered rural Vietnamese society and facilitated land reform. Many landlords had long before moved to cities because of insecurity; indeed, some had not received rental income for a decade or more. Few had significant influence in rural areas or in village or national politics.

APPENDIX B

EXPORT PROJECTIONS

Philippine exports will enjoy rapid growth again this year. Export earnings this year are estimated to be some $2.6 billion, up a remarkable 42% over last year. This contrasts sharply with pessimistic Philippine estimates of zero export growth in 1974, made at the end of the first quarter. Presumably, wide disparities in price expectations account for the difference between CIA and Philippine estimates because our estimates of annual volume are, if anything, lower than official Philippine estimates.

Actual receipts from the four principal export commodities* amounted to $727 million in the first five months of 1974, as shown in the tabulation below. On the basis of admittedly scant data, it appears that, except in the case of copper, export volumes were sharply lower than for the comparable 1973 period.

	Estimated Volume (Thousand Metric Tons)	Estimated Average Price US $ per Metric Ton	Actual Value (Million US $)
Total			727
Logs and lumber[1]	1,050	128	134
Coconut oil	158	928	147
Sugar	700	337	236
Copper concentrates	350	600	210

1. Thousand board feet.

For the balance of the year, export earnings for logs and lumber, sugar, and copper concentrates were estimated by assuming that Philippine export prices would move in a trend determined by the current spot price and the future price for yearend deliveries. It was further assumed that shipments of logs and lumber would accelerate sharply in the latter part of the year, although export volume on an annual basis would still be nearly 20% below last year's. For coconut products, US Embassy (Manila) estimates of both volume and value were used. These projections and assumptions yield the following results:

* These commodities alone accounted for nearly 60% of Philippine merchandise exports in 1973.

	Thousand Metric Tons	Average Price US $ per Metric Ton	Value (Million US $)
Total			899
Logs and lumber[1]	1,650	120	198
Coconut oil	292	800	234
Sugar	750	352	264
Copper concentrates	450	450	203

1. Thousand board feet.

Earnings from other commodities are estimated to increase markedly over last year, as follows:

	1973			1974		
	Thousand Metric Tons	Average Price (US $ per Metric Ton)	Value (Million US $)	Thousand Metric Tons	Average Price (US $ per Metric Ton)	Value (Million US $)
Total			774			999
Copra	734	226	166	500	492	246
Copra meal	264	83	22	300	82	25
Dissicated coconut	78	423	33	70	929	65
Plywood[1]	903	64	58	800	87	70
Bananas	455	92	42	500	110	55
Canned pineapple	91	219	20	90	220	20
Gold[2]	469	83	39	500	120	60
All others			394			458

1. Thousand board feet.
2. Thousand troy ounces.

In most cases, average commodity export prices for the year should easily break previous records, even if prices decline rapidly in the second half as expected. Export volumes are expected to be sharply lower for copra and higher for meal, consistent with plans for greater domestic processing. Continued strong demand is expected to boost earnings for plywood and bananas. Other non-traditional exports, mainly manufactures such as fabrics, clothing, wood products, paper products, furniture, and electrical appliances, should continue to do well from a low base.

EAST ASIA: EXPORTS TUMBLE

Exports of the smaller East Asian countries -- Taiwan, South Korea, Singapore, and Hong Kong -- are plummeting, ending more than a decade of rapid expansion. During the 1960s and 1970s, their exports, mainly light manufactures, expanded twice as fast as world trade, permitting the economies to weather global slumps with ease. The current decline reflects the severity of the present world recession, and, to a lesser extent, import restrictions in Australia and Western Europe. South Korea and Taiwan have been hardest hit by the trade falloff, while Singapore has been less affected because of its position as a major entrepot.

The Export Drive

East Asian exports nosedived in the second half of 1974, the volume falling at a 30% annual rate. A sharp contraction in US and Japanese demand, particularly for textiles and electronic products, was the chief cause. These two categories account for roughly two-thirds of East Asian exports. South Korea, with 40% of its sales going to Japan, has been particularly vulnerable to the Japanese downturn. The East Asian countries have not been able to expand their share of the shrinking US market as they did in the 1971 slump. In the past few years, they have upgraded their product lines and in some instances lost a considerable portion of their cost advantage because of currency changes. Both developments have been putting them more directly in competition with US firms.

The timing and severity of the export decline is as follows:

Taiwan – Export volume began dropping in the second quarter of 1974, with the annual rate of decline reaching 60% in the fourth quarter. By early 1975, volume was 40% below the year earlier level.

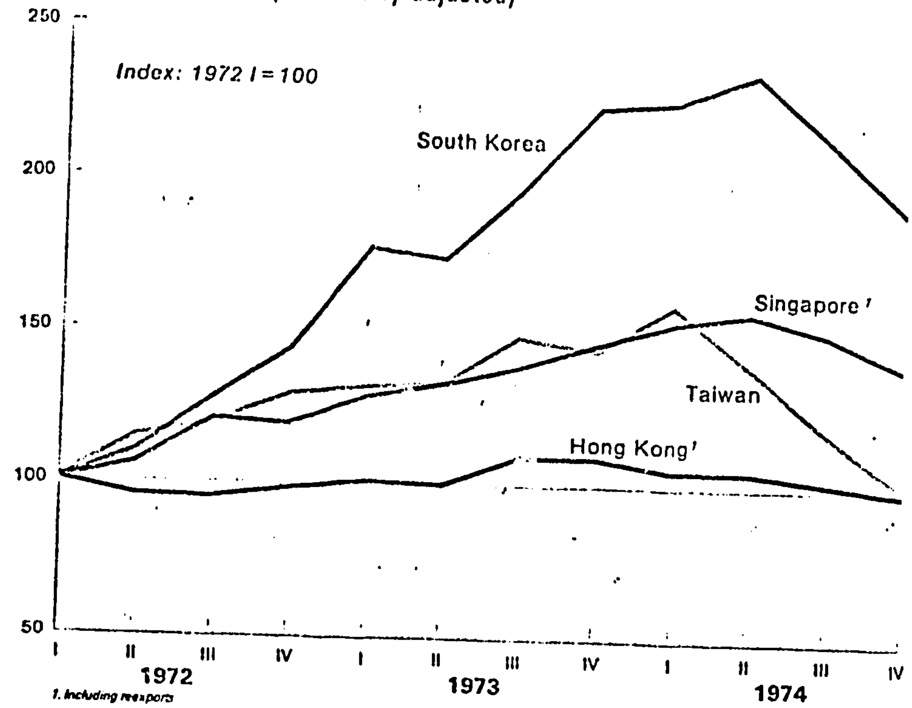
South Korea – After reaching an all-time high in mid-1974, export volume fell at a 23% annual rate in the second half.

Singapore – Export volume climbed through mid-1974, but by yearend had dropped more than 10% below the peak.

Hong Kong -- Export volume fell off through most of 1974, ending 10% below the last quarter of 1973.

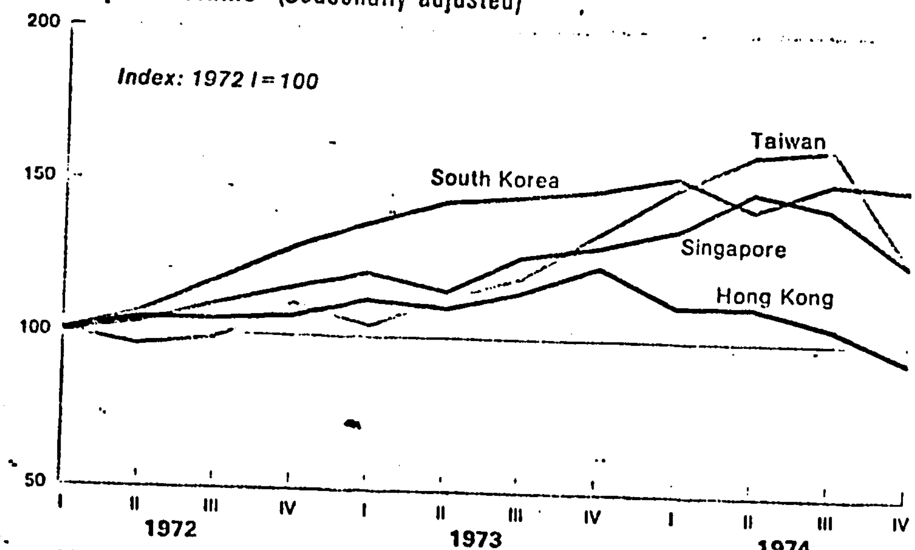
EAST ASIA: TRENDS IN TRADE VOLUME

Export Volume (Seasonally adjusted)



1. Including reexports

Import Volume (Seasonally adjusted)



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Fragmentary data indicate that the declines continued for all countries into early 1975. Textile exports have been hardest hit. In the fourth quarter of 1974, the value of textile exports was at least one-third below the previous year; the drop in volume was even greater. Exports of consumer electronics, light machinery, and most other manufactured goods have also declined substantially.

Domestic Impact

Because of the fall in exports – the engine of growth in these economies – real GNP in Taiwan, South Korea, and Hong Kong leveled off or declined in the second half of last year. Only Singapore has managed to grow at all since mid-1974. Unemployment in the past nine months has steadily risen (particularly in South Korea) with the reduction in the pace of key industries. All four East Asian governments have shifted fiscal and monetary policy away from restraint to moderate expansion, falling back on the anti-inflationary front.

The falloff in domestic economic activity has resulted in a decline of imports of raw materials, component parts, and intermediate products used largely in the export-oriented industries. Imports of capital equipment also show signs of weakening as unused capacity becomes widespread. The volume of imports fell in the second half of 1974 at an annual rate of 28% below the first half peak. Because import prices in 1974 rose faster than export prices, the composite trade deficit jumped \$4 billion, to \$6 billion. With the exception of South Korea, financing the deficit has not yet become a major problem. Seoul was among the largest borrowers from the IMF oil facility last year and will need additional funds in 1975.

Outlook

East Asian trade will not revive until late 1975 or early 1976, after the expected upturn in US and Japanese demand. Even then considerable time will be needed for the countries to regain high rates of trade growth as they make the necessary changes in the structure of their exports. We believe the growth rate of their exports, although below the level of the 1960s, will be among the highest of any regional group. (Confidential)

* * * *

TAB D

THE SOUTH KOREAN ECONOMY

Current Situation

1. South Korea's economy has been hard hit by the world economic slump. Although real growth averaged 8.2% last year all the gain came in the first half. Since mid-1974 output has stagnated, unemployment risen and inflation soared. Real output this year will increase only marginally, largely because of sluggish foreign demand for South Korean goods. The payments deficit, up sharply last year, will bulk even larger this year. Unless substantial improvements in the trade account occur in the last half of this year, financing the deficit will become increasingly difficult.

The Domestic Scene

2. Real output, after increasing sharply during the first half of 1974, slumped in the second half and has remained sluggish. Although official data point to moderate gains in industrial output since early 1975, most of the increase has gone into already large producer's inventories. Stock volume is up 18% over this time last year. Inventories of textile, electronics products and basic metals are especially large. Even with continued inventory accumulation, output of many products still remain only slightly above mid-1974 levels.

3. The slump has pushed the jobless rate to 6.2% at the start of 1975. Since then the rate has almost certainly increased somewhat. In addition to job reductions, numerous firms have cut work hours. Foreign owned firms have faced at least some government pressure to maintain their work force despite stagnate output. The number of bankruptcies has also increased sharply over the past year, although most have been small-sized operations.

4. Korea's three year-old price spiral remains a serious problem. During the first five months of 1975, consumer prices rose at a 37% annual rate, substantially above last year's 25% rate. Wholesale prices were up 31% (annual rate) during January-May. Seoul's 17% devaluation in December was a chief factor spurring inflation in early 1975, although rising wage costs have excerbated the price problem. In addition the Korean economy has been hurt by soaring costs for imported manufactured and

intermediate products coming from Japan and the United States. Altogether, these factors have more than offset the decline in world market prices for key raw materials.

Government Policies

5. Seoul is trying to balance its conflicting goals of maintaining output and employment while bringing inflation and a large trade deficit under control. Although holding the line on some expenditures, the budget deficit this year is expected to reach nearly $1 billion, compared with $300 million in 1974. Much of the deficit is directly linked to increased government subsidies on grains and fertilizers. Defense expenditures are also rising rapidly, financed partly from a recently enacted defense tax, applied to several items including some imports. Public works and welfare outlays are all rising fairly rapidly.

6. Credit policies, remain fairly easy. Real interest rates are still negative by a substantial margin and credit allocation to the private sector is increasing. Money supply has also increased sharply over the past 12 months, largely because of Central Bank financing of the budget deficit. Seoul is still providing some industries with special loans to avoid bankruptcies, although the need for these funds appear to be diminishing.

7. So far, Seoul's policy measures have been of more help in bolstering output than in controlling inflation. As a result, the government has relied increasingly on direct price control measures to help slow the inflation spiral. Since late 1974, Seoul has maintained price controls on a variety of key commodities, including electricity, as well as consumer products. Periodic increases in controlled prices have been aimed at dampening demand and improving depressed profit margins. Food prices have been increased to help finance subsidy programs for farmers.

The Current Account Balance

8. Seoul's most pressing economic problem is the country's deteriorating trade and payments position. Last year's trade deficit jumped to $1.7 billion from $560 million in 1973 largely because of higher oil and other commodity prices. The current account deficit totaled $1.8 billion, up from $309 million in 1973. We estimate that the current account deficit in 1975 will increase to about $2.2 billion. During the first half of 1975 the deficit totaled approximately $1 billion.

9. Exports have been falling since mid-1974. In first quarter 1975 export value was down 12% and volume down 30%, compared to first quarter 1974. Most of Korea's export shortfall stems from the economic slump in Japan which absorbs 31% of Korean overseas sales. Exports to Japan are down 40% this year compared with last year. Shipments to the United States, Seoul's largest market, are up only slightly from last year. Leading indicators, such as letters of credit, are still sluggish indicating a substantial recovery in exports is still some months away.

10. Efforts to stimulate overseas sales thus far have showed few concrete results. The edge provided by Seoul's 17% Won devaluation has already been largely lost because Korean inflation has risen more severely than in Taiwan, Singapore, and Hong Kong. Korea's chief competitors. Progress in deversifying exports has also been slow, although Korean sales to OPEC countries have risen sharply, they still account for a small share of total exports. Korean suppliers have been hurt by increased trade restrictions by countries such as Australia and Canada. EC countries have also made it difficult for Koreans to sell in their markets.

11. Despite the slump imports have failed to decline significantly in value terms. Initially higher oil and raw material costs boosted the import bill. More recently, however, the sharp rise in prices for intermediate products have prevented imports from being cut. To help dampen demand for imports, Seoul has initiated several measures, including an import deposit scheme and higher tariffs on certain items. To substantially reduce purchases from abroad, however, Seoul will have to move more aggressively to dampen domestic demand.

Financing the Deficit

12. As a result of Seoul's good credit rating, last year's deficit was financed with little difficulty by tripling net capital inflows over the 1973 level. Long-term capital inflows accounted for $1 billion and short-term credits contributed $850 million. For 1975, even heavier foreign borrowing will be needed. With lenders reluctant to extend long-term funds its likely that a greater share of more than $2 billion in needed capital will have to come from short-term borrowing.

13. We think Seoul will probably get by the rest of 1975 without resorting to large foreign exchange drawdowns. Although falling short of requirements, some $1.2 billion in long-term loans have already been lined up for the rest of the year. This includes $200 million from the United States, $160 million

from the IMF oil facility, and $300 million in World Bank Credits finalized last month. The US and Japanese EXIM Banks have also extended credits. Government delegations have recently toured Europe and several Middle-East countries attempting to round up additional financial assistance and direct investment.

14. A serious financing squeeze could develop by the start of 1976 unless the trade and current account deficit is substantially reduced. At the moment, Seoul is counting on a substantial recovery in export demand to reduce the deficit and financing requirements. Recovery abroad, however, is likely to be slower than Seoul anticipates. Meanwhile, foreign commercial banks are less than eager to commit large financial resources to Korea until global economic conditions improve. Thus far, Korea has managed to get by on the strength of its good international credit rating and low debt service ratio -- still under 15%. To maintain this position, however, Seoul will almost certainly have to take stronger actions to bring the deficit in line.

TAB E

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INDONESIA: SUHARTO TO PRESS CASE FOR AID

President Suharto will underscore the need for continued US economic and military aid to Indonesia during his unofficial visit on 5 July. He will show particular sensitivity to the decline in US financial commitments to the Intergovernmental Group on Indonesia (IGGI) over the past two years.

Other stops on Suharto's global itinery also feature aid and trade discussions:

Iran -- a $200 million loan for a fertilizer complex, and OPEC oil pricing policy;

Yugoslavia -- an $80 million loan for electric generating equipment;

Canada -- financial participation in IGGI; and

Japan -- government backing for the $900 million Asahan aluminum and electric power project, and trade prospects, with emphasis on slumping Indonesian oil sales.

Current Economic Situation

The Indonesian case for increased foreign financial backing on a concessional basis has weakened in recent years. Eight years of Suharto government have brought solid and sustained economic gains, with annual growth in real GDP ranging from 7% to 10%. The gush of oil revenues in 1973-75 has added momentum to the process of growth and augurs well for long-run financial stability. Nevertheless, the country is plagued by widespread unemployment and underemployment, lack of social services and educational opportunities, pervasive poverty in rural areas, and extreme population pressure in the central island of Java. [redacted]

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The pace of economic expansion has been temporarily slowed because of world recession. The government's problems were compounded when Pertamina, the national oil company, proved unable to repay short-term debts to foreign banks totaling about $100 million. Pertamina also failed to transfer to the Indonesian treasury hundreds of millions of dollars in tax obligations funneled to it from foreign oil companies. Arrangements subsequently worked out with foreign bank groups will reschedule maturities of roughly $1 billion in Pertamina notes formerly due in 1975. Foreign earnings and foreign exchange reserves must cover an additional $500 million to $1 billion of 1975 obligations.

The Pertamina problem has not fundamentally altered Indonesia's real growth prospects for 1975 of 6%-7% -- excellent prospects for an LDC in this year of global recession. Export gains will slow, however, given the soft international market. Foreign receipts, assisted by capital inflows, will probably leave foreign exchange reserves near the $1 billion mark. Manufacturing and construction projects already under way will continue to stimulate demand and employment. The outlook for agriculture is favorable notwithstanding recent losses from floods and pestilence. Stocks of fertilizer and rice are sufficient to prevent significant shortages.

Outlook, 1976-80

For the remainder of the decade we estimate that Indonesia will have sufficient export earnings and capital inflows to sustain real growth averaging 7% to 9% annually. If, as expected, the world economy begins to move up again in 1976, export opportunities will revive and, in turn, stimulate investment and expansion in the domestic economy. Crude oil and liquefied natural gas will be the key foreign exchange earners. Other exports also should increase steadily as efforts continue to diversify production and to improve the quality of goods.

The government preceives a major role for private investment in national economic development. Economic nationalism nevertheless is likely to lead to further restrictions on sectors open to foreign investment, to increased taxation, and to more stringent regulation of marketing arrangements, employment practices, and wages of foreign companies. We expect the issue of domestic participation in joint ventures with foreign corporations to be handled with reasonable flexibility. Efforts to maximize oil export earnings will continue to make Indonesia skeptical of OP... schemes to prorate production.

Support by international lenders and donors reinforces the favorable prospects for Indonesia. The recent IGGI meeting pledged another $900 million in new government aid for accelerated development aimed at Indonesia's unemployment and income distribution problems. In addition, previous consortium commitments for project aid are sufficient to allow disbursements of $360 million annually for the next five years. Foreign bankers and investors, spurred by the oil boom and high investment returns, have been quick to respond to Indonesian capital needs. With Pertamina's short-term debt crisis at least partially resolved, bank credit should continue to be available.

SINGAPORE: BRIGHT SPOT IN SOUTHEAST ASIA

Singapore's Prime Minister Lee Kuan Yew, due in town this week for an unofficial meeting with President Ford, will urge continued US private investment in Southeast Asia. The strong performance of the Singapore economy in 1974 and Lee's natural sense of independence should minimize appeals for other support. At the same time, Lee will be able to engage in candid and wide-ranging exchanges on such issues as Indochina and US oil policy.

Economic Successes

Unlike many Asian countries, Singapore has withstood the energy crisis and world recession with remarkable success. Real economic growth in 1974 came to an impressive 6.8%. Although well below the 11%-15% annual rates of 1966-73, it dispelled fears of a serious downturn in an economy heavily dependent on oil refining, entrepot trade, and financial intermediation. Soaring prices -- especially for petroleum products -- drove exports up 59% to $5.9 billion in the face of a 3% decline in volume. Imports rose 63% in value to $8.5 billion, almost entirely the result of stiff rises in the prices of raw materials and capital goods. As in the past, the trade deficit was more than offset by receipts from services and capital inflows. A sizable overall payments surplus pushed foreign reserves up to $2.7 billion at yearend.

Flexible fiscal and monetary policies have been instrumental in assuring comparative price stability and high employment. Consumer prices increased only 13% in 1974. Unemployment decreased to 4%, compared with 4.5% a year earlier. Even in industries hit hardest by low export demand, layoffs were limited to 16,000 persons, many temporary workers brought in from neighboring Malaysia. The recently announced budget for FY1975/76, while allowing for some job creation through public sector expenditures, calls for no appreciable tax increases.

Long-Term Factors

Since separation from Malaysia in 1965, the tiny island republic has capitalized on its strategic geographic position and outstanding managerial capabilities to become a major world trading and financial center. Singapore is the third largest oil refining center in the world and the focus of the Asian dollar market. It has emerged as the principal service zone for oil exploration and development in the region. Per capita income in 1974 exceeded $2,000. The economy is highly dependent on external trade and remains extremely sensitive to fluctuations in world markets.

For many years, the key to Singapore's development stategy has been its encouragement of foreign private investment in export-oriented, labor-intensive manufacturing industries. Through aggressive government solicitation, tax incentives, and low wage rates, Singapore has attracted substantial inputs of foreign capital, the largest share from the United States. By 1974 the book value of US investment totaled $600 million, mostly in petroleum refining, electronics, and light manufacturing.

Over the past year, the government has shifted its strategy toward capital-intensive, high-technology industries. This move was dictated by rising wage rates and tight labor markets, which reduced competitiveness in the established industries. The government is pushing shipbuilding and repair, oil equipment construction, and iron and steel in preference to the slumping electronic, textile, and woodworking industries. Because of generally slack demand in advanced countries, investors are not rushing in to these new lines.

Outlook for 1975

The outlook for this year is for growth of 6% or more, the rate depending on global economic conditions in the second half. Commodity exports are expected to expand only moderately, but oil-related service industries should continue to grow in line with the rapid pace of exploration in the region. Banking and financial services should also remain strong, particularly if OPEC investment funds are channeled into the area.

NORTH KOREA: SERIOUS PAYMENT PROBLEMS

Since late 1974, P'yongyang has experienced a series of difficulties in financing its non-Communist trade. North Korea is now in arrears on a large number of letters of credit issued to Japanese and West European banks.

- At the beginning of 1975, North Korea was in default on $40 million in outstanding loans from French banks.
- North Korea remains delinquent in its payments for a Finnish pulp plant delivered in 1974 despite a recent visit by a company delegation to P'yongyang.
- Several West European banks have restricted lending to North Korea as a poor credit risk.

Since early 1970 the North Koreans have signed contracts with firms in Japan and Western Europe for nearly $600 million worth of industrial plants and related equipment, most of which are to be financed by medium-term credits. Whereas trade with the West was roughly in balance in 1970-71 purchases of capital goods and grain on credit have subsequently led North Korea to run a growing trade deficit:

	Million US $
1972	75
1973	170
1974	400

In part, the current arrears in payments stem from improvident buying of so much equipment and grain. P'yongyang overestimated its ability to expand earnings from exports, which did well until the Western industrial boom turned sour and prices for principal export commodities fell. In addition, the problems reflect poor planning and management on the part of the North Koreans; their inexperience in Western trade and finance has been compounded by the inflation in prices of Western imports, freight services, and credit.

P'yongyang has shown little open concern about these payment defaults, taking its time responding to inquiries from Western bankers. It generally has adopted a business-as-usual attitude in requesting new loans, seeking bids for additional whole plants, and even attempting to purchase long-range transport aircraft. North Korea, however, will find it difficult to expand purchases until its present credit difficulties are cleared up.

HONG KONG AND THE GSP

Per Capita GNP

Hong Kong's per capita GNP in 1974 was an estimated $1,600. This substantially exceeds per capita GNP in other nearby East Asian countries. In South Korea and Taiwan, per capita GNP last year was $500 and $700 respectively. Hong Kong's per capita GNP exceeds that of any country scheduled to receive preferential treatment in the US market except that of Argentina and Singapore.

Export Trends

Global exports last year totaled $6.5 billion (including re-exports), up from $5.5 billion in 1973. Domestic exports are running about $5 billion annually, consisting almost entirely of manufactured products. In 1973 overseas sales of these items equaled roughly one-fifth of total LDC exports of manufactured goods. The only LDC's even approaching Hong Kong's share are Taiwan and South Korea.

Hong Kong's overseas sales are concentrated in a relatively few countries.

- The United States takes one-third of total domestic exports.
- The UK and West Germany come next, each taking about 10%.
- The Japanese market takes somewhat more than 5%.

Exports are also concentrated in a few commodity lines. Textiles and clothing account for roughly 40% of exports. Other light manufactured goods such as electronic products constitute most of the balance.

The recent growth in Hong Kong's exports both globally and to the US market has been substantially lower than those of other East Asian countries. During 1970-73

- Hong Kong's global exports rose 100%; sales to the US market rose 50%.
- Taiwan's global exports rose 200%; sales to the US market rose 220%.

- South Korean global exports rose nearly 300%; sales to the US market rose 160%.

- Singapore's global exports rose 130%; sales to the US market increased 200%.

Hong Kong's export growth continued to lag behind other East Asian countries last year, although the difference narrowed substantially. The colony boosted its sales to the UK market by 14% while Singapore and Taiwan registered gains of 20% and 18% respectively. Only South Korea continued to expand sales sharply, by 50%.

Hong Kong's US Exports

Exports to the United States totaled $1.7 billion last year. Clothing, the largest single item, accounts for roughly 35% of total sales to the US market. Including yarns, fabrics, and made-up goods textiles account for about 40% of Hong Kong's US exports. Transistors account for nearly 15% of exports. Plastic products, such as toys, dolls and artificial flowers constitute another 15% of the total. Precision instruments such as optical equipment, although still a small share have been the fastest growing export item over the past several years, roughly doubling in value during the first nine months of 1974 compared with the same 1973 period.

Hong Kong's position in the US market, although slipping, remains fairly strong. During the first half of 1974 for example, the colony accounted for 20% of US clothing imports, only slightly below the 21% share held in 1970. Although the colony has lost ground to smaller East Asian suppliers it has more than held its own against Japanese suppliers. The Colony's share of US yarns, fabric and made-up textile imports has doubled since 1970, going from 4% of total imports to 8% last year. Hong Kong also accounted for about one-fifth of US imports of toys, games and sporting equipment. Last year, despite its small size, Hong Kong accounted for 3% of total US imports of manufactured products.

Hong Kong and the GSP

Hong Kong's international economic position would not be seriously hurt if the Colony is excluded from the proposed US Generalized System of Preferences for LDCs. According to data supplied by the colony, goods eligible for GSP account for only about 10% of total exports to the US market. Most

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items are of little significance, with sales to the US market generally running less than $2 million annually. In terms of global exports, the items covered by the GSP account for only about 3% of Hong Kong's total overseas sales.

Hong Kong should do fairly well in the US market whether or not it receives preferences. Although losing ground to other East Asian suppliers, the colony maintains a strong competitive edge over Japanese exports of light manufactures to the US market. Wages in Hong Kong average about $0.60 per hour compared with nearly $2.00 in Japan. To meet competition from smaller East Asian countries the colony has continued to shift into product lines where price competition is less important. Hong Kong, for example, has become a significant supplier of telecommunications equipment to the US market.

Hong Kong has probably not benefited very greatly from preference systems adopted by other major nations, including the EC countries and Japan. In the case of the EC, several major countries have effectively limited Hong Kong's market penetration through a series of formal and informal contracts. In 1973, for example, exports to France totaled $35 million while sales to Italy were over $40 million. Exports to Japan, although increasing rapidly in recent years, amount ot less than $600 million annually, one-third the level of exports to the US market. Last year sales to Japan increased somewhat slower than exports to the United States.

TAB F

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THE PACIFIC BASIN:* RE-EXAMINING ECONOMIC TRENDS

1. Since the start of the 1960s the Pacific Basin has become increasingly integrated. Underlying the progress has been the strong pulling effect of the US and Japanese economies on one another, and, in turn, their pulling effect on others in the region. The United States has been the fastest growing major market for manufactured goods coming from Japan and the other northern-tier countries -- Hong Kong, Taiwan, and South Korea. Japan has become the largest market for the raw materials of southern-tier countries, such as Australia and Indonesia. The United States is Japan's leading supplier of both raw materials and sophisticated manufactures. The other Pacific Basin countries look mainly to Japan and the United States for imports of manufactures.

2. The trend toward economic integration has continued into the 1970s. Since 1970 trade within the region has risen 30% annually, reaching $93 billion last year. By 1974, 43% of Pacific Basin's total trade was within the region itself compared with 40% in 1970. The emergence of the northern-tier countries as major manufacturing exporters coupled with higher earnings for raw materials exporters in the south have been important factors behind the swelling in trade flows. The United States and Japan, however, still account for somewhat more than half of trade within the region.

3. Financial flows within the region have also increased rapidly since the start of the 1970s. Despite its growing interest in Latin America and the Mid-East, about 60% of Japanese foreign aid is still directed to Basin countries. A growing share of US and Japanese Export-Import Bank credits has also gone to others in the region. US direct investment in the Basin has risen from $7 billion in 1970 to $11 billion in 1974, while Japan's equity investment went from $500 million to some $4 billion. A growing share of capital flows has gone to raw material development projects in countries such as Australia, Indonesia, Malaysia, and the Philippines. Japanese investment in the United States has also become an important factor in recent years.

*The Pacific Basin is defined to include all countries bordering on the Pacific Ocean, Oceania, and the South Pacific Islands. Economic relations among American countries are excluded from the discussion. The northern-tier includes Japan, South Korea, Taiwan, and Hong Kong. The southern-tier includes the remaining countries minus the United States.

4. Growing economic interdependence has caused some friction within the past year or so. In large measure, however, the problem stems from the economic slump in Japan and the US. Their downturn has had a particularly pronounced impact on northern-tier countries. South Korea, for example, has suffered a 30% drop in export volume during the past 12 months largely because of falling sales to Japan. The southern-tier countries have also been hurt by declining raw material prices, brought on partly by the fall in Japanese requirements. Indonesia, the only Pacific Basin OPEC member, and Singapore, have continued to do well.

5. To cope with the problems of interdependence some countries are trying to diversify their foreign economic relations. South Korea, Taiwan, and Hong Kong are pushing for greater access to the EC market. Australia is seeking to develop non-raw material exports. Sluggish progress with these programs has prompted some countries to adopt trade restriction measures. Canberra, in the wake of surging imports in 1974 that swung the trade balance from a surplus of $2.7 billion in 1973 to a deficit of $100 million in 1974, placed import quotas on a long list of products. Japan has come under particularly strong pressure to ease its export drive to Australia and others in the region.

6. Over the longer-term the basic economic patterns already in train are unlikely to change much. Trade within the region will continue to expand rapidly although almost certainly slowing from the rapid pace of recent years. A major reason for the slowdown will be the expected slower rate of growth in Japan. While trade will continue to be important, financial flows will assume a growing role in fostering economic interdependence. Both northern and southern tier countries will upgrade their industrial structures and will be coming to Japan and the United States for most of the necessary investment funds. In the years immediately ahead, China is unlikely to have a significant impact on the region's economic patterns. Nor will recent developments in Indochina have much impact on the economic forces at play.

The United States And The Basin

7. The Basin economy has become increasingly important to the United States. US sales to the region grew 25% annually between 1970 and 1974, somewhat faster than total US exports. Last year sales reached $22 billion, one-fifth of total overseas sales. Shipments to Japan, Taiwan, South Korea, Hong Kong and Australia have grown especially fast, in line with their generally strong economic performance. Japan, our second largest customer after Canada, purchased $11 billion in 1974, about 10% of total US sales abroad. Foodstuffs account for one-fourth of US sales to the region. However, Basin countries are an even more important outlet for US machinery and equipment and other manufactures.

8. For many Basin countries the United States remains a crucial outlet for their goods. In 1974 Basin countries exported $24 billion worth of goods to the United States with Japan accounting for about half. Although substantially reducing its reliance on the US market since 1972, about one-fourth of Japanese exports still go to the United States. Taiwan, South Korea, Hong Kong and Singapore also send at least one-quarter of their exports to the United States. Their total sales of $6 billion in 1974 -- almost entirely manufactured goods -- were equivalent to one-third of our purchases from the European Community.

9. US investment in the region has also increased rapidly. Cumulative direct investment in the region reached $11 billion in 1974 and has been growing by almost $1 billion annually since the start of the 1970s. US investment in Australia alone, much of which has been in the mining industry, accounts for almost one-half of the total. As a result, Australia is the fourth largest recipient of US investments on a worldwide basis. Large US investments have also gone into mining industries in Indonesia and the South Pacific Islands as well as export-oriented manufacturing sectors in South Korea, Taiwan, and Hong Kong. Although investment flows have slowed because of the slump, the region remains highly receptive to US investments.

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[redacted]

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THE NORTHERN-TIER COUNTRIES

13. The northern-tier countries -- Taiwan, South Korea and Hong Kong -- are heavily dependent on their economic ties with others in the region, especially the United States and Japan. About 50% of northern-tier exports -- totaling $16 billion in 1974 -- go to these two countries. Moreover, almost all the growth in overseas sales through 1974 has been tied to the US and Japanese markets. The United States and Japan are also the chief suppliers of manufactured goods as well as investment funds. US sales to the group totaled about $4 billion in 1974, about one-fifth of our total sales to Basin countries.

14. Hard hit by the US and Japanese economic slumps, the northern-tier countries are trying to diversify their foreign economic links. Thus far, however, only Hong Kong has been able to accomplish much, largely because of its longstanding relationship with the European countries, especially the United Kingdom and Germany. South Korea has had only limited success in developing new markets largely because of formal or informal limits placed on Korean goods by West European countries. Despite efforts to attract investment funds from others, Japan and the United States remain the chief suppliers to all three countries.

SOUTHERN-TIER COUNTRIES

15. Southern-tier countries are more closely tied to Japan than any other single country. About 23% of their exports in 1974 went to Japan which supplied an even larger share of their imports. Trade and other economic ties with the United States are also extremely important to the group. The United States, for example, is the leading foreign investor in Indonesia, Australia and the Philippines and has increased its investment stake in Malaysia in recent years. Trade relations among the southern-tier countries generally are not particularly important except in the case of Indonesian-Australian trade.

16. Like their northern counterparts, the southern-tier countries are anxious to diversify their economic links. Both Indonesia and Australia, for example, are eager to increase domestic processing of raw materials with an eye towards selling

the output to Japan. Although pressures have intensified as a result of the recent slump in Japanese and global demand for raw materials, the basic economic ties remain strong. Compared with other LDCs, those in the Western Pacific have generally been less vocal in their demands for commodity and other types of agreements to increase raw material export earnings.

The Role of China

17. China has had little impact on overall economic patterns in the Pacific Basin. The bulk of its economic ties with the region are concentrated on Japan which has captured a substantial share of the Chinese import market. Japanese sales to China reached $2 billion in 1974, substantially more than any other country. Longer-term trade prospects are bright given the favorable outlook for overseas Chinese oil shipments to Japan Chinese trade with the United States, although increasing, remains relatively small. Trade with others in the Basin, with the exception of Hong Kong, is of little consequence.

Indochina

18. Recent development in Indochina are unlikely to have much impact on the economic trends in the Western Pacific. By the early 1970s most countries in the region had adjusted to the drop in US military spending in the area. Moreover, with few exceptions, the Indochina market was never particularly important to the Western Pacific suppliers. In 1974 total Pacific Basin exports to Indochina amounted to only $2 billion. Excluding the US exports, the total was only about $1 billion. For Japan the largest supplier, exports to Indochina accounted for less than 1% of the total overseas sales.

WESTERN PACIFIC AND US TRADE MATRIX, 1974

MILLIONS US$

EXPORTS FROM:

EXPORTS TO:	SOUTH KOREA	HONG KONG	TAIWAN	CHINA	PHILIPPINES	INDONESIA	MALAYSIA	SINGAPORE	AUSTRALIA	NEW ZEALAND	INDOCHINA	THAILAND	SOUTHERN PACIFIC ISLES	OTHER WESTERN PACIFIC	JAPAN
SOUTH KOREA	---	74	159	X	19	1,165	83	63	114	14	X	32	X	X	2,655
HONG KONG	151	---	337	910	32	25	49	387	150	22	9	171	7	25	1,360
TAIWAN	51	209	---	21	27	182	44	75	127	13	1	181	2	6	2,008
CHINA	X	59	X	---	13	NA	99	63	322	33	X	X	X	X	1,993
PHILIPPINES	9	57	46	24	---	2	43	48	143	33	X	29	X	X	911
INDONESIA	55	168	127	156	9	---	20	248	200	13	X	111	X	X	1,450
MALAYSIA	32	78	58	139	5	71	---	946	245	27	1	136	6	74	768
SINGAPORE	49	295	135	286	19	556	934	---	238	24	27	231	11	4	1,387
AUSTRALIA	71	292	191	126	30	74	100	281	---	256	X	21	145	X	1,999
NEW ZEALAND	1	64	11	26	3	4	16	81	735	---	X	3	43	X	484
INDOCHINA	15	29	37	X	3	X	1	237	14	2	---	48	X	X	118
THAILAND	18	67	69	5	3	8	27	149	84	16	10	---	4	9	951
SOUTH PACIFIC ISLANDS	X	56	7	X	9	X	2	94	404	60	X	1	---	X	200
OTHER WESTERN PACIFIC	X	63	1	X	1	X	15	55	1	2	X	7	X	---	36
SUB TOTAL	452	1,511	1,178	1,693	172	1,087	1,433	2,727	2,777	515	48	971	218	109	16,250
JAPAN	1,368	413	549	1,241	932	3,955	730	696	3,190	326	36	640	459	887	---
UNITED STATES	1,492	1,574	2,053	115	1,133	1,527	584	874	1,036	354	7	196	107	11	12,928
TOTAL	3,324	3,498	4,080	3,049	2,237	6,569	2,747	4,297	7,003	1,195	91	1,907	784	1,007	29,178
TOTAL TO WORLD	4,468	5,958	5,521	6,305	2,673	7,450	6,308	5,900	11,088	1,959	102	2,482	1,442	1,520	55,514

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