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International Economic & Energy Weekly

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10 April 1987

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Synopsis

1 **Perspective—Global Trade Conflicts: Political Stakes Growing** 25X1

Developed countries are embroiled in increasingly tense bilateral disputes sparked by persistent trade imbalances—particularly Japan's large surpluses—growing protectionism, and market uncertainties created by massive currency fluctuations. For their part, LDCs generally believe the intensity of these disputes hurts them by souring the global trade atmosphere and threatening the success of ongoing multilateral negotiations in the Uruguay Round. 25X1

3 **International Financial Situation: Update on LDC Debt** 25X1

7 **Summit Issues: GATT Round Tactical Maneuvering** 25X1

The Uruguay Round is now fully under way and GATT members have begun to reveal their negotiating tactics, which will present US policymakers with obstacles as well as opportunities 25X1

11 **Summit Issues: Attitudes Toward Agricultural Reform** 25X1

The Big Six have made only marginal progress toward agricultural reform since the Tokyo summit, and are unlikely at the Venice summit to go beyond a call for supporting work in the GATT's Uruguay Round and the need to cut farm surpluses 25X1

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21 **International Financial Situation: The Philippines—Struggling Toward an Economic Recovery** 25X1

Since assuming office almost 15 months ago, President Aquino's economic team has adopted a strategy that emphasizes market-oriented policies and less government intervention in the hope of restoring growth in an economy debilitated by years of mismanagement and plunder. Although progress has been made on inflation, interest rates, and restructuring the foreign debt, growth has been insufficient to ensure political stability. 25X1

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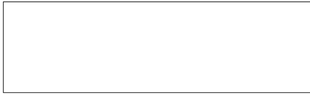

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25 **Nicaragua: The Burden of US Sanctions** 25X1

Trade disruptions and the diversion of financial and managerial resources to circumvent US economic sanctions have put significant additional pressure on the already staggering Nicaraguan economy. We estimate that the embargo has directly cost Managua about $85 million in lower export earnings, more expensive imports, and new middlemen fees since sanctions were initiated. 25X1

29 **Malaysia: Economic Problems Cloud Election Prospects** 25X1

Prime Minister Mahathir faces the most serious challenge of his six years in office as he tries to retain the presidency of the dominant Malay party—and the prime-ministership—in the election scheduled for 24-27 April. Whoever wins the party presidency will face several difficult years trying to cope with a burdensome foreign debt, an unprofitable heavy industry sector, and an electorate whose expectations far exceed the economy's likely performance. 25X1

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Perspective

Global Trade Conflicts: Political Stakes Growing

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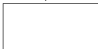
Continued turmoil in the global economic environment has aggravated trade conflicts and considerably raised the political stakes for successful resolution. Developed countries are embroiled in increasingly tense bilateral disputes sparked by persistent trade imbalances—particularly Japan's large surpluses—growing protectionism, and market uncertainties created by massive currency fluctuations. LDC governments are also encountering severe domestic economic and political strains in coping with large external debt burdens in the face of the continued slump in commodity prices, restricted export markets, and declining sources of development financing.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Many countries are finding bilateral negotiations on specific trade problems increasingly difficult, and several recent disputes among the three major players—the United States, Japan, and the EC—have escalated to the brink of trade war. In these disputes, trading partner demands have clashed with the imperatives of increasingly vocal domestic interest groups, elections, and national policy:

- In disputes with the United States over the trade effects of EC enlargement and the fats and oils tax, EC officials' leeway has been restrained by the politically powerful agricultural lobbies and the concerns of member state governments facing coming elections.
- Prime Minister Nakasone, under increasing international pressure to open Japan's markets to reduce its trade surpluses, is constrained by a slowing of the domestic economy and controversy over his tax reform plan.
- Canadian Prime Minister Mulroney—heavily staking his political future on the success of a freer trade agreement with the United States—could find that his falling popularity will hamper his ability to successfully broker an agreement acceptable to divergent Canadian interests.

For their part, LDCs generally believe the intensity of these disputes hurts them by souring the global trade atmosphere and threatening the success of ongoing multilateral negotiations in the Uruguay Round.

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In this increasingly charged environment, US trading partners, particularly the LDCs, are concerned with the specter of increased trade protectionism in the United States. To some extent, this threat has produced positive spillover. There is evidence, for example, that concern over US protectionism is causing some relaxation of East Asian trade policies, and is helping propel the Uruguay Round negotiations forward. Over the long run, however, we are concerned that, if protectionism actually continues to increase, this would damage the credibility of the United States as the key advocate of trade liberalization. US opportunities to set the tone and pace of Uruguay Round negotiations would be undercut, and, ultimately, progress in the negotiations would slow

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The growing intensity of international trade problems has elevated their resolution to a higher level of political involvement. As a result, trade will undoubtedly be a major topic at the OECD ministerial and the Venice economic summit and participating political leaders will probably reaffirm commitments to maintain the momentum toward reform. Ultimately, however, domestic political considerations will restrict their room to maneuver.

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International Financial Situation: Update on LDC Debt

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Major developments in LDC debt situations this week focus on Brazil, Egypt, Nigeria, and the creation of a Paris Club working group to examine ways to alleviate debt pressures on the poorest LDCs:

- ***Brazil*** presented its five-year economic plan to its National Congress and foreign creditors in the past week, but thus far few details on the domestic measures to stabilize the economy are known. In addition, President Sarney has created a Presidential Advisory Commission for the negotiation of the foreign debt, chaired by Finance Minister Funaro, according to Embassy and press reporting. Funaro stated on 2 April that the government will need about $4 billion annually from commercial banks, official agencies, and multilateral institutions over the next five years to achieve its annual growth target of 7 percent. At the same time, he proposed that creditors sharply lower Brazil's debt servicing costs, automatically refinance interest payments, and convert some debt into investment. Funaro and Central Bank President Gros discussed the plan with creditor governments and commercial banks during talks this week. Commercial creditors, who continue to demand that Brasilia implement a coherent economic plan to boost the trade surplus, probably will not want to begin serious financial negotiations based on this proposal. Instead, international banks may react by demanding repayment of short-term trade and interbank credits in coming weeks.

- ***Egypt*** and the IMF completed the technical annex to the letter of intent, but otherwise made little progress on the actions Cairo would take to advance economic reform efforts, according to the US Embassy. An IMF negotiating team—which left Cairo on 1 April—had hoped to ascertain Egyptian intentions with regard to future movements on exchange rates, interest rates, and energy prices. Egypt, however, noted that this information is not required under the terms of the standby until September and will not address the issues until that time. The lack of progress in clarifying Egyptian intentions aggravates existing Fund doubts about the viability of the program and Cairo's political willingness to implement the necessary reforms. This may delay approval of the letter of intent and risk accelerating financial instability in Egypt.

- Suffering from a severe foreign exchange shortage, ***Nigeria*** missed 1986 IMF performance targets by allowing rapid credit growth and accumulating new external arrears, jeopardizing the country's economic reform program. The IMF was unable to complete the first review of the program because of the uncertain reserve situation and questions on the prospective financing gap for 1987. Similarly, the World Bank has withheld the second tranche of the trade policy loan, pending Nigerian action on dismantling foreign exchange accounts that fund special construction projects. With its reserve position shrinking, Lagos may be unable to continue funding the second-tier foreign exchange market without incurring substantial arrears—which would alienate creditors—or accepting further, politically risky devaluations.

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Key LDC Debtors:
Economic/Financial Indicators

	Total Debt [a]	International Reserves [b]	Other Indicators
Brazil	110	2.0 (Feb 87) 3.5 (Nov 86)	Trade surplus $260 million in February, double January's surplus; slow start to reaching 1987 target of $8 billion.
Mexico	104	6.3 (Dec 86) 4.0 (Jul 86)	Inflation rising, estimated 130 percent by yearend, up from 106 percent in 1986; money supply growth up.
Argentina	50	2.0 (Dec 86) 3.5 (Sep 86)	Inflation projected at 94 percent for 1987, up slightly from 82 percent in 1986.
Venezuela	36	5.0 (Jan 87) 6.1 (Oct 86)	Inflation rising; annual rate of 14.3 percent in February, up from 12.7 percent in December; could top 30 percent for year.
Indonesia	40	8.1 (Dec 86) 9.6 (Sep 86)	GDP stagnant in 1986 after 2.0 percent rise in 1985; growth of less than 1 percent projected for this year.
Egypt	30	0.9 (Dec 86) 0.9 (Sep 86)	Inflation running at annual rate of 30 percent, up from 17 percent rate last year.
Philippines	28	2.6 (Jan 87) 1.9 (Oct 86)	1986 GDP growth 0.1 percent, first increase in three years; project 3.0 percent to 3.5 percent in 1987.
Chile	19	2.3 (Jan 87) 2.2 (Oct 86)	Trade surplus of $1.3 billion in 1986, 54 percent higher than 1985; inflation declined to 17 percent in 1986.
Nigeria	19	0.5 (Mar 87) 0.7 (Dec 86)	**Reserves at lowest level in at least 15 months, cover roughly one month of imports.**
Peru	14	0.8 (Feb 87) 1.0 (Nov 86)	Inflation at 100 percent annual rate during January-February.

[a] Billion US dollars, yearend 1986.
[b] Billion US dollars.

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Boldface indicates change over the previous week

Status of Debtor-Creditor Relations	Domestic Political Scene
Discussed five-year economic plan with creditor governments and commercial banks this week.	Rumors that Finance Minister Funaro to be fired; we doubt any action in the short term.
Signed $7.7 billion commercial bank package 20 March; disbursement of $3.5 billion available by end of April.	Moderate GDP growth will limit political problems, helping to ensure a smooth PRI victory in 1988.
Bank talks began mid-February, now discussing terms; $1.8 billion IMF package approved in February.	Congressional and gubernatorial elections in September.
Bank agreement reached; interest rate spread reduced; saves Caracas $2 billion in payments over three years.	Most industries ignoring limits on price increases; labor groups plan to ask for pay hike of 15 to 20 percent.
Jakarta likely to reschedule if oil prices fall below $15 per barrel; still maintains limited access to commercial credit.	Parliamentary election in April; may determine timing of rescheduling or reforms.
Completed technical annex of IMF letter of intent; little progress made on reforms scheduled for September.	**Ruling party expected to win large majority in April parliamentary election.**
Reached agreement to reschedule $13.2 billion in bank debt over 17 years; investment note scheme accepted by banks.	Rescheduling agreement—particularly less than 1-percent spread—political victory for Aquino and Finance Secretary Ongpin.
Bank agreement concluded 24 February—no new lending, but lower rate spreads and single annual interest payment. Met with Paris Club 2 April.	Retiming could aid growth, but not enough to overcome political difficulties.
IMF unable to complete first program review; World Bank has yet to disburse second tranche of trade loan.	Babangida implementing economic reforms; discontent may rise if economy remains weak, however.
Bank negotiations in limbo; IMF owed $250 million in arrearages.	Garcia remains highly popular; worried about 1987 economic prospects.

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- ***Paris Club*** governments have set up a working group, which will meet 24 April, to explore the options and detail possible approaches to reschedule the debts owed to them by the poorest and most heavily indebted LDCs, according to Embassy reporting. One proposal is to reschedule the official debts over a longer period—15 to 20 years instead of the usual 7 to 10 years—at substantially reduced interest rates with a longer grace period. Other options include using the IMF Compensatory Finance Facility primarily in these LDCs or creating a new funding body.

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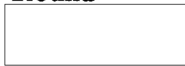
Summit Issues: GATT Round Tactical Maneuvering



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While developing countries as a whole are very supportive of the Uruguay Round of negotiations, which are now fully under way, hardliners led by Brazil and India are continuing their efforts to block progress on the new issues—services, intellectual property, and investment. Agriculture will be the most contentious issue of the Round, with progress restricted by the political constraints on the participants, particularly the EC. The tactical maneuvering during this year's first phase of the Uruguay Round, in addition to the status of several external factors, such as LDC debt and bilateral trade disputes, will ultimately affect the ability of the United States to achieve its goals.

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Negotiating Obstacles

LDC Hardliner Tactics. The LDC hardliners, primarily Brazil and India, are continuing their efforts to obstruct progress on the new issues—services, intellectual property rights, and investment, according to Embassy reporting. The group will do this primarily by perpetuating old debates, by procedural delays, and by narrowly interpreting the Uruguay Round negotiating mandate for these issues. The hardliners will resist any attempt to quicken the pace of discussions, and will take advantage of any weakening in developed country support for these issues. Brazil will probably continue efforts to solidify the LDCs as a negotiating bloc, and will claim to represent overall LDC interests. This tactic, however, has failed recently as many LDCs are increasingly taking independent positions in GATT and resent Brazil's obstructive tactics that threaten to immobilize the talks.

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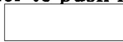
EC Tactics on Agriculture. The EC wants to protect its present Common Agricultural Policy (CAP) based on variable import levies and export subsidies. Given its priorities, the EC will probably attempt to narrow negotiations and will continue to oppose setting a timetable for the talks. The key challenge will be to prevent France and West Germany—CAP's staunchest defenders—from blocking progress. A unified EC position on agriculture will not come easily, however, because there is considerable divergence of views among the member states on the future course of EC internal policy. The EC will also be challenged by numerous developed countries and LDCs who have banded together to push for broad agricultural reform in the GATT. 

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Uruguay Round Negotiating Structure

Following the completion of detailed negotiating plans for two groups and 14 subgroups, substantive negotiations began in February. Phase I of the negotiations will continue throughout 1987 and focus on information collection and research. Several of the topics have already been the subject of lengthy discussions in GATT, such as tropical products, and early agreements may be reached that can be implemented provisionally.

Group of Negotiations on Goods

Tariffs
Nontariff measures
Natural-resource-based products
Textiles and clothing
Agriculture
Tropical products
GATT articles
MTN agreements and arrangements (Tokyo Round GATT codes)
Safeguards
Subsidies and countervailing measures
Trade-related aspects of intellectual property rights
Trade-related investment measures
Dispute settlement
Functioning of the GATT System

Group of Negotiations on Services
(No subgroups as yet)

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Uruguay Round: Key Country Priorities and Tactics

The European Community
Defensive position on agriculture, seeks to protect fundamentals of CAP, opposes fast track and addressing agriculture concurrently in subsidies group . . . supports framework services agreement, keeping LDCs on board . . . supports examination of intellectual property norms, broadened counterfeit code; concerned rules not become trade restrictive . . . believes new investment rules may not be necessary, does not want to antagonize LDC by being overly ambitious . . . advocates parallel progress on all issues.

Japan
Wants to limit and slow talks on agriculture, avoid overemphasis on domestic subsidies . . . proposed 11 concepts for services negotiations, supports identifying barriers but does not want talks delayed by definitional questions or data collection . . . supports broad intellectual property rights (IPR) code . . . supports negotiations on investment, but faces internal disagreement.

Other OECD
Australia, Canada actively support early, comprehensive agricultural reforms; Nordics, Switzerland, Austria support EC . . . Nordics, Canada, Australia, New Zealand support services agreement, will follow US lead, also on IPR . . . investment not priority, concerned that overly ambitious goals will alienate LDCs . . . Canada, New Zealand, Australia support comprehensive subsidies, countervailing duties talks, including agriculture.

Brazil
Wants to unite LDCs and lead opposition to developed country initiatives, and to get special treatment for LDCs . . . moderate supporter of agricultural reform . . . leads opposition to initiatives on services, investment, IPR; wants to avoid setting GATT standards in these areas, attempting to delay progress, proposing extensive studies; denies any link with goods talks . . . pushing for early progress on safeguards, market access.

India
Key interest is market access, particularly phase-out of Multifiber Agreement . . . supports agricultural reform, not active participant . . . along with Brazil, seeks to limit negotiations on services, investment, IPR; to stall progress by procedural delays; proposes extensive data collection . . . seeks special treatment for LDCs in all areas.

ASEAN
Top priority is tropical products, wants rapid progress not tied to agriculture, access to developed country markets . . . supports reform, special treatment for LDCs in agriculture . . . other interests include dispute settlement, nonselective safeguard actions . . . Singapore likely to be active participant in services.

Other LDCs
Key interests are traditional topics—market access, nonselective safeguards, subsidies . . . want broad agricultural reform . . . wary of services, IPR, investment; want more research, special treatment; moderates South Korea, Hong Kong will participate.

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Informal Country Alliances

The group of LDC hardliners formed during 1985 to oppose US efforts to launch a new GATT round and, failing that, the inclusion of new issues—services, intellectual property rights, and investment—in the negotiations. According to Embassy reporting, the second group was formed at the initiative of Canada, Japan, and Sweden in 1987 to counter disagreements between the EC and the United States, weaken the influence of Brazil and India, and encourage moderate LDCs to actively participate in the negotiations.

Hardliners	***Middle of the Road***		
Brazil	*Canada*	*Pakistan*	*Hungary*
India	*Japan*	***ASEAN***	***European Free Trade Association***
Egypt	*Australia*	*Singapore*	*Sweden*
Yugoslavia	*New Zealand*	*Philippines*	*Norway*
Argentina	*South Korea*	*Indonesia*	*Finland*
Tanzania	*Zaire*	*Malaysia*	*Iceland*
Zimbabwe	*Mexico*	*Thailand*	*Switzerland*
	Colombia	*Brunei*	*Austria*
	Uruguay		

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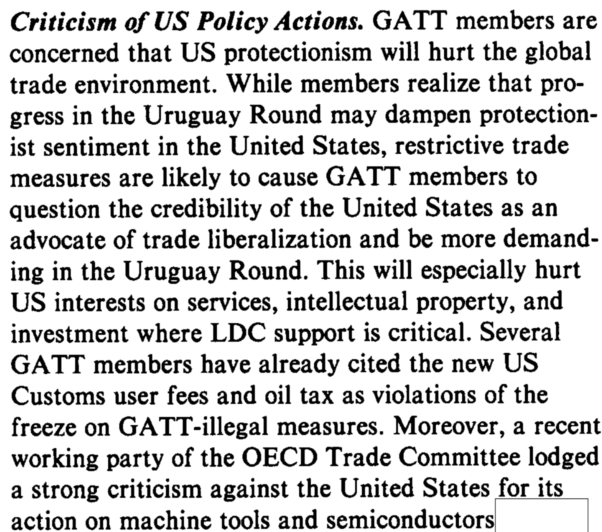
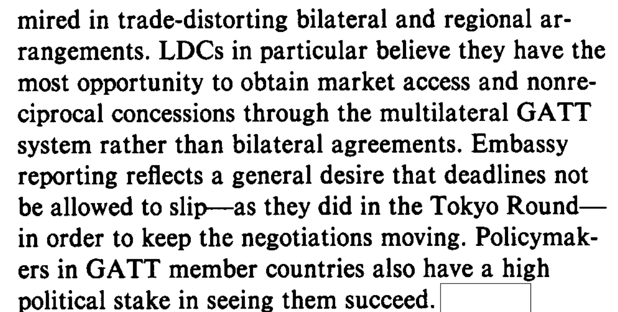


Criticism of US Policy Actions. GATT members are concerned that US protectionism will hurt the global trade environment. While members realize that progress in the Uruguay Round may dampen protectionist sentiment in the United States, restrictive trade measures are likely to cause GATT members to question the credibility of the United States as an advocate of trade liberalization and be more demanding in the Uruguay Round. This will especially hurt US interests on services, intellectual property, and investment where LDC support is critical. Several GATT members have already cited the new US Customs user fees and oil tax as violations of the freeze on GATT-illegal measures. Moreover, a recent working party of the OECD Trade Committee lodged a strong criticism against the United States for its action on machine tools and semiconductors

Negotiating Opportunities

Widespread Commitment to the Negotiations. Many GATT members—particularly LDCs—fear that failure of the Uruguay Round will cause the world trade environment to deteriorate even further, as it becomes mired in trade-distorting bilateral and regional arrangements. LDCs in particular believe they have the most opportunity to obtain market access and nonreciprocal concessions through the multilateral GATT system rather than bilateral agreements. Embassy reporting reflects a general desire that deadlines not be allowed to slip—as they did in the Tokyo Round—in order to keep the negotiations moving. Policymakers in GATT member countries also have a high political stake in seeing them succeed.



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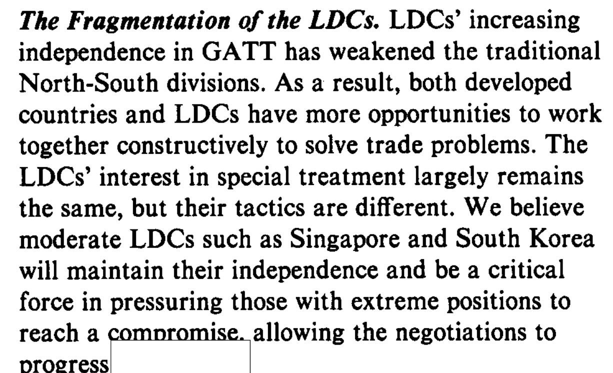
The Fragmentation of the LDCs. LDCs' increasing independence in GATT has weakened the traditional North-South divisions. As a result, both developed countries and LDCs have more opportunities to work together constructively to solve trade problems. The LDCs' interest in special treatment largely remains the same, but their tactics are different. We believe moderate LDCs such as Singapore and South Korea will maintain their independence and be a critical force in pressuring those with extreme positions to reach a compromise, allowing the negotiations to progress



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Expectations of US Leadership. The United States is largely considered the driving force of the Uruguay Round and thus many GATT members expect it to take the lead, particularly on the new issues. They probably believe that the United States offers the best chance to break the continuing cycle of economic brinksmanship and provide them a real opportunity for sustainable economic improvement. This will allow Washington the opportunity to set the pace and initiate substantive negotiations, as well as influence countries' positions. On the other hand, many GATT members also expect the United States to make the biggest concessions.

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Outlook

In our view, Uruguay Round negotiations will be long and hard fought; the Round is scheduled to last four years, but the Tokyo Round dragged on for six. While this year will focus on tactical positioning and information collection on most issues, the real challenges begin next year when more detailed, substantive negotiations begin. GATT members' positions will then be more developed and the defense of national interests more compelling. While the United States has several opportunities to propel the negotiations forward, obstacles to progress over the course of the Round should not be underestimated. LDCs will strive to keep their options open on the new issues but may become less conciliatory if their debt problems grow, bilateral disputes escalate, industrial countries invoke bilateral restraint agreements, or any final Uruguay Round agreements involve changing national policies with no special provisions for LDCs. The developed countries, too, could find their interests diverging as elections approach or trade imbalances continue, particularly among the United States, the EC, and Japan.

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Summit Issues: Attitudes Toward Agricultural Reform

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The Big Six have made only marginal progress toward agricultural reform since the Tokyo summit, and are unlikely at the Venice summit to go beyond a call for supporting work in the GATT's Uruguay Round and the need to cut farm surpluses. Structural reform of the EC's highly subsidized Common Agricultural Policy (CAP) remains politically unpalatable to most member states, especially West Germany and France, and Japan and Canada have barely begun to grapple with their domestic farm subsidy systems. EC members are unlikely to propose any bold initiatives on agricultural reform at Venice, although France may push for a world grain marketing cartel. Canada will almost certainly press the United States and the EC to reduce their export subsidies, but Japan will attempt to keep a low profile on the topic.

Impetus for Reform

Agricultural reform has become a central problem in the economic relations of the summit countries. At an enormous budgetary cost—the United States and the EC each are spending about $25 billion supporting farmers this year—the current agricultural policies of the developed countries have fostered huge commodity surpluses that disrupt trade. World grain stocks are projected to rise this year to a level that could supply the entire world grain trade for two years.

European Community

The Community's chronic budget crisis—largely a result of supporting the CAP—will continue to be the major driving force behind reform efforts. EC commitments for 1987 are already beyond the limit of its resources, even though revenues were boosted by 40 percent last year. Despite a 10-percent cut in the milk production quota and cuts in beef support prices last year, the EC expects a budget shortfall of an estimated $5.7 billion this year. The shortfall has worsened

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The OECD Report on Agriculture

In January Secretary General Paye of the OECD prepared a draft note outlining for the OECD ministerial meeting in May the causes of the current crisis in agriculture and possible solutions. The crisis is characterized largely as the result of flat demand—stemming from a saturation of consumption at higher income levels and slow population growth—and production increases in traditional food importing countries. Government farm policies are fraught with contradictory objectives. The use of support prices to guarantee farm incomes, usually accompanied by import restrictions and export subsidies, has exacerbated strains on the world agricultural market. The costs of farm policies to national budgets and consumers have increased remarkably.

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The solution must involve adjusting to real market conditions. While little can be done to boost demand, farm support levels must be reduced and output cut. Support measures should be refocused on the poorest farmers who need them the most. Some farmers should be encouraged to quit producing, and all should lower their costs. Governments should consider the use of direct income aid to guarantee farm incomes.

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The GATT Uruguay Round is the logical forum for negotiating reform of agricultural policy. For the talks to proceed smoothly a number of suggested conditions would require governments to:

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- *Acknowledge their collective responsibility for the present difficulties.*
- *Make an inventory of their direct and indirect support to agriculture.*
- *Agree on the methods to be used to reduce the levels of protection.*
- *Agree to setting a timetable for the dismantling of protective barriers.*

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10 April 1987

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because the declining dollar has added to the cost of subsidizing farm exports and because spoilage has forced some writeoffs in the value of stockpiles

The EC Commission has presented a plan to boost revenues further, but it is unlikely to be approved by the member states until EC spending—two-thirds goes to agriculture—is brought under better control. To this end the EC Commission has proposed:

- A price freeze in the next marketing year for most products, and cuts for others, including an almost 3-percent cut for grain.
- A limit on the Community's role as a purchaser of last resort for commodities, thus forcing more farmers to rely on the free market.

Reform efforts by other agricultural exporters, to the extent that they lower world prices, also would amplify the budgetary pressures on the EC to reform the CAP.

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Despite increased realization that the CAP must be reformed, progress will almost certainly continue to be limited to small improvements in the way the subsidies work. Powerful farm voting blocs in many member states, dependent on high CAP support prices for the maintenance of their incomes, make any direct attack on the CAP politically impossible. This is particularly true for France where the presidential election in 1988 almost guarantees that the government will tolerate little more than tinkering with the CAP for the time being. For the longer term, France generally favors cuts in surpluses and holding down spending increases, and even some French farm leaders cautiously support a more market-oriented approach for the CAP.

West Germany, where disgruntled farmers helped to reduce Chancellor Kohl's governing party's vote total last January, has adopted a hard line against the Commission's price cut proposal. Agriculture Minister Kiechle has been arguing strenuously for direct national payments to farmers as a way of getting around the budget constraint. Kiechle's proposal is highly controversial and if adopted could be a first step toward dismantling the CAP. Ending the common market for agricultural products and abolishing common financing, however, would hurt poorer member states that count on EC farm support funding. Nevertheless, we believe that adoption of some form of increased national direct payments to farmers—perhaps with the Commission setting strict rules and supplementing spending in the poorer member states—is likely within the next two years. The change would make it easier for members to agree to CAP price cuts and help solve the budget crisis

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The United Kingdom—with a politically weak farm sector—is the strongest advocate of farm budget discipline and is seeking cuts in price and production support levels. Italy also favors substantial reductions in the CAP budget, but wants more aid for farmers in Mediterranean regions who have benefited relatively less from the CAP because of its bias toward northern products such as milk and grain.

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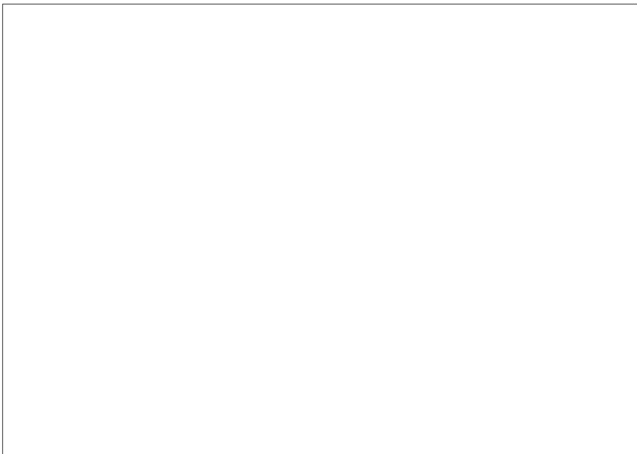

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Japan

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Tokyo is an agricultural importer and is beginning to appreciate the need to open its own protected and subsidized market. Prime Minister Nakasone has called for domestic farm prices to be more closely aligned with world prices,

However, Tokyo has shown no sign of liberalizing imports of other farm products for which it maintains quotas. It is unlikely to open its rice market, a politically sensitive and emotional issue.

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Outlook for Venice

Neither the EC member states nor Commission President Delors are likely to propose any major new initiatives on agricultural reform at Venice. EC member states would probably support a summit statement endorsing a step-by-step Uruguay Round negotiating plan without commitment to a specific timetable, and are likely to argue that the Community has already made some limited progress toward reform. They probably will defend the fundamentals of the CAP, and, with France and West Germany leading the way, assert the political imperative of preserving farm incomes.

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France, however, is likely to use the summit to push for its longstanding idea of a world grain exporter's cartel as a way to reduce stockpiles and guarantee market shares. French Agriculture Minister Guillaume recently resurfaced this idea as a "Marshall Plan" for Third World agriculture. Under the plan, the five major grain producers would fix a minimum price for grain sales to wealthy countries, and use some of the profits to fund LDC agricultural development projects.

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Canada is likely to call for an endorsement of the need for fast-track negotiations on agriculture at the Uruguay Round. As a member of the Cairns group of nonsubsidizing exporters, it will want to focus attention on US and EC grain export subsidies, although it is unlikely to push the United States too hard because of ongoing bilateral trade talks.

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The Venice summit is unlikely to go beyond adopting some kind of general blueprint for negotiations on agriculture at the Uruguay Round. The OECD ministerial meeting this May is likely to draw upon the work of OECD Secretary General Paye in drafting such a blueprint. The EC and Canada already have endorsed Paye's recommendations.

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International Financial Situation: The Philippines—Struggling Toward an Economic Recovery

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Since assuming office almost 15 months ago, President Aquino's economic team has adopted a strategy that emphasizes market-oriented policies and less government intervention in the hope of restoring growth in an economy debilitated by years of mismanagement and plunder. Their plans focus on reviving the rural economy, where dismantling the country's coconut and sugar monopolies and increasing government spending in the countryside have already boosted employment and incomes. In addition, Manila's economic recovery program includes simplifying the tax system, liberalizing trade and investment policies, and privatizing some public financial and nonfinancial enterprises. Another key component is negotiating a financial package with foreign commercial creditors and aid donors for the funding needed for a sustainable economic recovery. Although progress has been made on inflation, interest rates, and restructuring the foreign debt, growth has been insufficient to ensure political stability.

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Mixed Economic Performance

Aquino's economic team has made progress in establishing a stable economic environment that would set the stage for economic recovery. Effective fiscal and monetary policies—along with steps taken to restore democratic institutions and increase confidence in the country's political stability—have contributed to dramatic reductions in inflation and interest rates, a stable foreign exchange rate, growing foreign exchange reserves, and a booming stock market. In addition, Philippine officials claim that the government's "pump priming" program for the rural economy, its reforms of the coconut industry, and a doubling in the price of coconut products are largely responsible for the nearly 2-percent growth in the economy recorded in the last quarter of 1986. The fourth-quarter spurt helped push growth for the entire year to 0.1 percent, reversing the 9-percent contraction in 1984-85.

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The Problems Aquino Faced

The new administration inherited a number of deep-seated economic challenges:

- *National output had declined by 9 percent in the two-year period before Aquino took over; per capita income had fallen 15 percent since 1980, and 40 percent of the work force was underemployed.*
- *Widespread poverty and income inequality, according to Philippine academics, put over 70 percent of Filipinos at or below the World Bank poverty line. For rural Filipinos, low agricultural productivity and government-authorized marketing monopolies depressed living standards and contributed to a growing Communist insurgency.*
- *The country was overborrowed; its $27 billion in foreign debt was absorbing nearly 40 percent of domestic output, and investment capital was flowing out of the country.*
- *Economic policies discouraged investment, especially in export production.*

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Nonetheless, these gains are less dramatic than Manila hoped and, by themselves, have not weakened the Communist insurgency or ensured political stability:
- Increases in agricultural output during 1986 were offset by declines in construction, industrial production, and other urban-based activities.
- Investment by local businesses in 1986 was nearly one-third below the previous year's level, and foreign corporate investments were one-half of the 1985 total.

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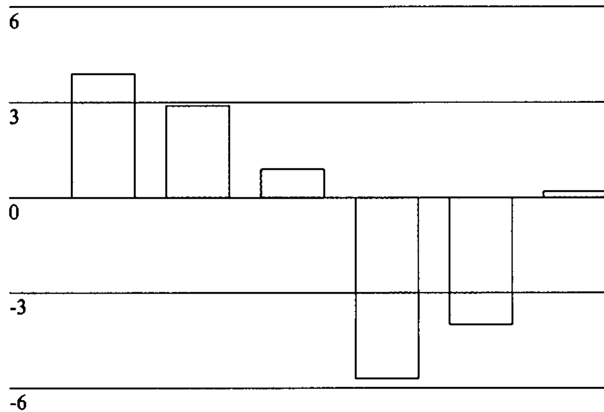
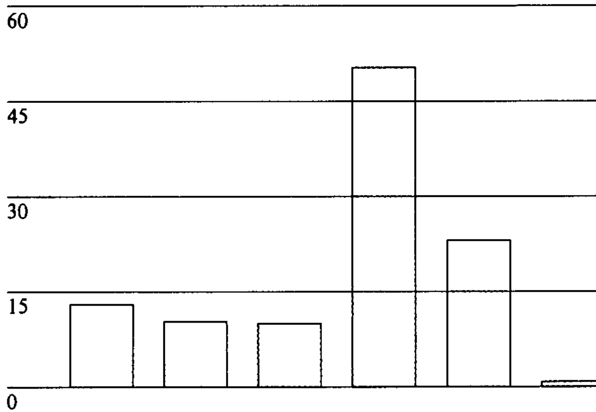
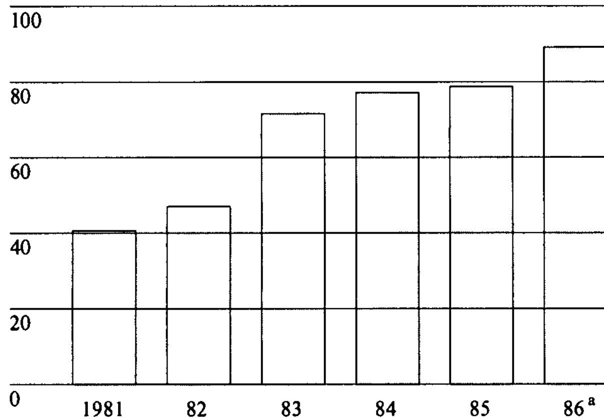
Philippines: Economic Indicators, 1981-86

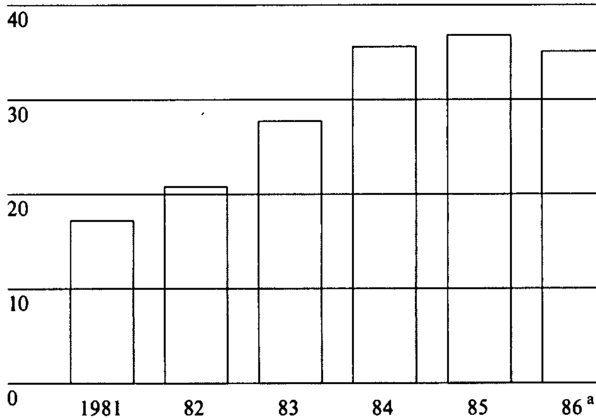
Note scale change

Percent









[a] Estimated.

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Although Aquino's advisers developed a sound strategy, implementation has been slow. For example, Manila has yet to finalize a wide-ranging investment code despite the priority attached to encouraging new investment. In another instance, it has taken a year of pressure from the left, repeated concern from many quarters over Manila's inattention to the economic causes underlying the Communist insurgency, and a bloody confrontation in January between farmers and security forces before the Aquino government recently approved a six-year, $3 billion land reform program. Even so, funding for the program is a major problem, and US officials report that planning still is bogged down.

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Philippines: Balance of Payments, 1985-87

Million US $

	1985	1986 [a]	1987 [b]
Trade balance	−482	−78	−760
Exports, f.o.b.	4,629	4,806	5,140
Imports, c.i.f.	5,111	4,884	5,900
Services and transfers	490	1,108	700
Interest on debt	2,461	2,045	1,680
Current account	8	1,030	−60
Capital account	2,083	291	1,120
Net direct investment	−9	100	150
Overall balance	2,091	1,321	1,060
Foreign exchange reserves [c]	1,061	2,382	3,442

[a] Estimated.
[b] Projected.
[c] At yearend.

Debt Agreement Reached

Despite the limited progress on the economy, Manila has negotiated financing packages on terms that, we believe, reflect creditors' confidence and support for the Aquino government. Late last year the IMF approved a $500 million balance-of-payments loan; in January 1987 Manila and its Paris Club creditors rescheduled $870 million in debt payments; and Manila's Consultative Group of key bilateral and multilateral aid donors agreed in January to provide $1.5 billion in new economic assistance this year.

Manila and its commercial creditors agreed last month to reschedule payments on $13.2 billion in bank debts over 17 years—concluding negotiations that began in November but later stalled over the issue of interest rates. Settlement was reached when the banks agreed to accept Manila's proposal for a lower interest rate in return for prepayment of a portion of the Philippines' outstanding debt:

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- Manila will repay $37 million annually until 1989 on the $925 million borrowed in 1985.
- In return, the banks accepted an interest rate spread of 0.875 percentage point over LIBOR as long as

Philippine Investment Notes

Under Manila's debt restructuring agreement with its commercial creditors, the banks have the option of converting some of their interest receipts into Philippine Investment Notes (PINs). Those banks that agree to purchase the six-year, dollar-denominated PINs—sold at a discount against their face value—have three options:

- *They can hold the PIN to maturity: after six years they will receive the full value of the note in dollars.*
- *They can trade the PIN in secondary markets to potential investors who wish to cash the note for its full peso value.*
- *They can redeem the note for its full value in pesos at any time before maturity and invest the proceeds in government-approved projects under Manila's debt-to-equity conversion program.*

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Manila hopes the innovative plan will conserve its foreign exchange and attract foreign investment. The plan's success, however, is not assured. Foreign investors remain on the sidelines—even though labor unrest has diminished in recent months—citing uncertainty over investment regulations, the Communist insurgency, and the long-term stability of the Aquino government. In addition, an adequate secondary market is needed to make the PIN program work, but the thin trading in other Third World debt instruments suggests that the necessary resale market may not develop.

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amortization payments are on time; if Manila falls in arrears, the spread will rise to 1 percentage point.

- In a new wrinkle, the banks agreed to the option of converting some of their interest receipts into Philippine investment notes (PINs) that would finance government-approved investments in the Philippines.

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The new rate spread has symbolic as well as financial benefits as far as Philippine financial officials are concerned. It is the lowest rate granted recently to any Third World debtor except Mexico and will save the Philippines over $50 million a year in debt payments, according to Philippine officials. Manila estimates that another $50 million a year can be saved if the PINs program is successful. The agreement is also a political victory for President Aquino and her chief negotiator, Finance Secretary Ongpin, who had been under pressure to achieve a spread below 1 percentage point. In fact, Ongpin believes the Philippines got a better deal than Mexico, according to the US Embassy, and expects no difficulties for the bank advisory committee in selling the agreement to nearly 500 individual creditor banks holding Philippine debt.

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Philippines: Leading Economic Indicators, 1984-86 [a]

[a] Includes exports, imports, government revenues, manufacturing output and employment, and money reserves.

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Modest Gains Ahead

Manila officially predicts that 1987 economic growth will exceed 6 percent, but the US Embassy says Planning Secretary Monsod recently acknowledged that this performance will be hard to achieve. We believe the economy, slowed by the delays in implementing policies and development projects and investors' lingering doubts about the country's political stability, is likely to grow about 3-4 percent this year. Indeed, our index of leading Philippine economic indicators has shown little improvement in recent months, suggesting that a sustained economic recovery is not yet in place and that the economy will remain sluggish through at least the first half of 1987. For example, our indicators for manufacturing employment and output remain flat, suggesting that urban-based manufacturing industries are in a holding pattern. On the other hand, real money supply through December is up almost 25 percent, indicating a pickup in spending, most likely in the rural economy.

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Although Manila hopes the new debt agreement will boost investor confidence, foreign investors probably will wait to see the results of the May legislative election, as well as the government's continuing efforts against the Communist insurgency, before committing substantial new funds. In addition, we believe the prospect of a stagnating economy as a new legislature opens for business in July will do little to encourage investor confidence. If the past is any guide, the new congress will begin to flex its muscles, and there is likely to be more criticism by the left and the right that Aquino and her economic policies are not up to the job. Indeed, we believe such criticism will increase dramatically if the recovery effort is widely perceived to be faltering.

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Nicaragua: The Burden of US Sanctions [1]

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Trade disruptions and the diversion of financial and managerial resources to circumvent US economic sanctions [2] have put significant additional pressure on the already staggering Nicaraguan economy. We estimate that the embargo has directly cost Managua about $85 million through February 1987 in lower export earnings, more expensive imports, and new middlemen fees since sanctions were initiated. Nicaragua still has been unable to find new customers for much of its previous sales to the United States, and higher transportation costs have reduced net foreign exchange earnings for those commodity exports that the Sandinistas have been able to relocate. Although difficult to quantify, the indirect costs probably also have been significant.

Cost of Current Sanctions

Even before US sanctions were announced, Nicaragua's economy was in a tailspin because of the Sandinistas' economic and financial mismanagement, their hostility to the private sector, and dislocations caused by the growing civil war. We calculate US sanctions have directly cost Managua some $85 million through February 1987 because of the loss of access to US markets, higher freight costs for exports and imports, and new middlemen fees to circumvent the embargo. Sandinista claims that the embargo cost $165 million in direct losses through last year are, in our opinion, exaggerated to deflect blame from the regime for its general mismanagement of the economy.

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[2] The United States announced limited economic sanctions against Nicaragua on 1 May 1985. The sanctions became effective on 7 May 1985 and were phased in during the remainder of the year. They embargoed most direct trade relations—except for charitable donations, medical supplies, and educational materials—and terminated Nicaraguan air and maritime service to the United States. The sanctions did not call for an asset freeze, travel limitations, or prohibitions against doing business with Nicaragua either on a personal contract basis or through third-country subsidiaries.

On the export side, we estimate that direct, sanction-related losses have cost the Sandinistas $52 million in net foreign exchange losses since the embargo was announced. The impact is concentrated in a number of areas:

- We estimate that net hard currency earnings from beef exports fell some $14 million through 1986 as efforts to find alternate markets in Canada and elsewhere have been mostly unsuccessful.
- We estimate that loss of the US sugar market cost Managua about $11 million in the past two years because it has largely had to sell on the glutted world market at less than one-third the subsidized US price.
- We estimate that net foreign exchange earnings from banana exports fell by some $11 million since 1984 with new—but less profitable—sales to West European customers taking up some of the slack.
- Losses from lower passenger and cargo revenue and higher prices for maintenance and spare parts cost the state airline about $5 million since the embargo.
- Despite limited success replacing lost seafood and tobacco markets, we estimate that sanctions cut net foreign exchange earnings for these products by $7 million in 1985-86.

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On the import side, we estimate direct foreign exchange expenses from higher prices and new middlemen fees to regain access to priority US-sanctioned goods have cost the Sandinistas about $33 million. while the Sandinistas have found some new suppliers for much of the foodstuffs and raw materials formerly provided by US sources, they have not done nearly as well replacing

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Nicaragua: Direct Costs of Sanctions, 1985-87 *Million US $*

	1985 [a]	1986	1987 [b]
Total losses	**34**	**44**	**7**
Export losses	20	28	4
Beef	5	9	NA
Sugar	7	4	NA
Bananas	3	8	NA
Aeronica	2	3	NA
Seafood	2	3	NA
Tobacco	1	1	NA
Import losses	14	16	3
Machinery and chemicals	10	12	NA
Other	4	4	NA

[a] Embargo phased in beginning 7 May 1985; costs are estimated net foreign exchange losses.
[b] Through February 1987.

Nicaragua: Exports to the United States, 1976-86 *Million US $*

	Annual Average 1976-78	Annual Average 1982-83	1984	1985	1986
Total	**194**	**102**	**69**	**50**	**1**
Seafood	30	15	10	6	0
Bananas	21	20	33	23	0
Meat	48	32	11 [a]	13	0
Sugar	32	23	5 [b]	3	0
Tobacco	7	4	4	2	0
Coffee	28	3	6	2	0
Cotton	0	0	0	0	0
Other	28	5	0	1	1

[a] Meat products were banned for much of 1984 because of unsanitary conditions.
[b] Sugar quota revoked in 1983.

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imports of US-built machinery, agrochemicals, and spare parts. As a result:

- We estimate that, because of embargo-circumvention surcharges, the Sandinistas paid an extra $22 million since the second half of 1985 to buy priority US-manufactured spare parts, machinery, and chemicals.

- We estimate that Managua paid an extra $8 million in 1985-86 to retain access to other materials and semifinished and consumer goods.

We believe the indirect costs to the economy are also substantial, although much more difficult to quantify. maneuvering around US sanctions requires exhaustive bureaucratic attention, limiting Managua's ability to address other economic issues and development projects. Moreover, where the Sandinistas have been able to find replacement imports for US goods in either the West or the Soviet Bloc and thus avoid the circumvention surcharge, quality differentials often have resulted in adaptation problems and lower productivity. In the aggregate, we believe these factors have played a major role in dampening economic activity, increasing consumer and producer shortages, and accelerating triple-digit inflation rates.

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Search for New Trade Partners

Managua's search for new Western outlets to replace former US customers has been largely unsuccessful. Since the embargo, total exports to Western nations other than the United States have fallen by one-fifth, according to international trade statistics—only Belgium, Switzerland, and the Netherlands have increased their purchases by significant amounts. After nearly two years, the regime has not been able to find stable new markets for its beef, seafood, and tobacco. For example, Canadians have been reluctant to expand purchases of beef because of poor quality, according to Embassy reporting. Efforts to find new markets for seafood have suffered because of virtually prohibitive transportation costs, While Nicaragua has sold more bananas to Western Europe, the volume of total

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Nicaragua: Imports From the United States *Million US $*

	Annual Average 1976-78	Annual Average 1982-83	1984	1985	1986
Total	**192**	**126**	**112**	**42**	**3**
Manufactures	158	95	89	29	1
Chemicals	42	33	34	8	NEGL
Spare parts and machinery	69	42	37	17	NEGL
Other	47	20	18	4	NEGL
Foodstuffs	21	23	15	5	1
Raw materials	4	1	1	0	0
Fuels	3	5	3	4	0
Other	6	2	4	4	1

banana exports remains substantially depressed from presanction levels, according to Nicaraguan trade statistics. 25X1

While international trade statistics show that Nicaraguan imports from the West also have fallen substantially since the embargo was announced, Nicaraguan purchases from some non-US Western suppliers have helped fill the void. 25X1 25X1 the Sandinistas have been able to buy a small amount of spare parts for US vehicles and equipment from suppliers in Spain and the United Kingdom. Managua also has purchased some replacement chemicals and consumer goods from Switzerland, Belgium, France, and the Netherlands. 25X1

Growing trade relations with the Soviet Bloc have helped ease the impact of the embargo, but poor quality has limited Managua's exports to the Bloc. Nicaraguan exports to the Soviet Bloc actually fell after the embargo was announced because Bloc countries did not follow up initial 1984 sample purchases with new orders. During the past year Managua has been able to boost sales to East Germany and the Soviet Union, and total exports to the Bloc have partially rebounded. Managua plans to soon sign a new trade pact with Moscow that would provide for increased shipments of coffee, cotton, and sugar to the USSR at preferential prices. Even so, Bloc countries have shown little immediate interest in expanding purchases of the Nicaraguan beef, bananas, and seafood that have been most affected by the embargo. The USSR and Eastern Europe have sharply increased economic aid in the last two years—including some hard currency assistance designed to help offset the embargo—but most Soviet aid is in the form of trade credits for the purchase of Bloc goods. Nonetheless, Bloc suppliers are not able to replace most sanctioned US machinery, agrochemicals, spare parts, and luxury consumer goods. 25X1

Dealing With US Subsidiaries and Consultants

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The Sandinistas have regained access to a substantial portion of sanctioned goods and services by buying them from US subsidiaries in third countries and from US foreign trade brokers and consultants, as permitted by the 1985 sanctions. 25X1 25X1 the Sandinistas have been able to meet much of their priority agrochemical needs by using commercial trade credits or barter deals from subsidiaries of US companies in Western Europe, Japan, and Latin America. Managua also uses third-country US subsidiaries to obtain top priority hybrid seeds, chemicals, computer goods, and technical assistance. 25X1

A wide variety of services are also regularly provided to the Sandinistas by scores of US persons. According to recent press reporting, as many as 100 US citizens currently work full-time in Nicaragua for the Sandinistas, while perhaps another 2,000 to 3,000 work part-time or as volunteers on government projects. According to Sandinista press and US Embassy reporting, US citizens regularly travel to Nicaragua to provide consultations on computer software and hardware systems and technical support for agriculture and industry. 25X1 US

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firms frequently provide financial, insurance, and shipping services for the Sandinistas. Embassy reports indicate, however, that there has been no US direct private investment since the Sandinistas took power, and all but a few of the remaining US-owned businesses are fully staffed by Nicaraguan citizens.

Using Front Companies

With substantial Cuban support, Managua has developed—and plans to expand—a network of Sandinista-controlled front companies to help circumvent the embargo. they are used primarily to import spare parts, machinery, electronics, and computer and communications equipment. A few also are involved in redirecting Nicaraguan exports to US customers. Currently, we have identified Nicaraguan front companies, particularly in Panama, Costa Rica, Guatemala, Mexico, and Canada.

The Soviets have also been active in helping Nicaraguan front companies. A Soviet front company provided spare parts for US-made automobiles to a Nicaraguan front company during 1986,

Implications for Sandinista Vulnerabilities

We believe the current sanctions have hurt the Sandinista economy and probably increased Managua's vulnerability to internal dissent and armed insurrection. Moreover, tighter US economic sanctions would certainly restrict remaining Sandinista access to US goods, technology, and financing and would increase, even at the margin, the cost to Moscow of maintaining the regime. Even if sanctions were tightened, Managua would probably try to keep some limited access to US products and expertise—not only by relying more on front companies but also by focusing efforts on areas where US policy actions would, in principle, result in increased financial costs to US citizens and, possibly, some international legal challenges.

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Malaysia: Economic Problems Cloud Election Prospects

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Prime Minister Mahathir faces the most serious challenge of his six years in office as he tries to retain the presidency of the dominant Malay party—and the prime-ministership—in the election scheduled for 24-27 April. Mahathir's chief opponent, Trade Minister Razaleigh, has made headway in recent weeks by attacking the Prime Minister's leadership style and charging him with economic mismanagement and with tolerating financial improprieties by top government officials. Razaleigh's campaign, in our view, is also capitalizing on public discontent with Malaysia's economic stagnation over the past two years. Whoever wins the party presidency will face several difficult years trying to cope with a burdensome foreign debt, an unprofitable heavy industry sector, and an electorate whose expectations far exceed the economy's likely performance.

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The Tables Turn on Mahathir and on Malaysia

At the beginning of this year, political observers in Kuala Lumpur considered Mahathir's position virtually unassailable because he had led his United Malays National Organization (UMNO)—the dominant party in the 13-party ruling coalition—to a resounding victory in the general election last summer. Over the past two months, however, an unprecedented alliance between longtime bitter rivals—Trade and Industry Minister Razaleigh and Deputy UMNO President Musa—as well as growing public dissatisfaction with Mahathir's economic and political leadership dramatically altered this situation.

The challenge to Mahathir's leadership comes at a time when Kuala Lumpur is reassessing economic policy and Malaysia's medium-term economic prospects. Three years ago Malaysia topped the list of creditworthy Asian nations and was cited, according to many international financial analysts, as the LDC most likely to become a "newly industrializing country" in the next decade. From 1975 to 1984 economic growth averaged 7 percent a year and the Malaysian treasury benefited from taxes on burgeoning commodity exports. The decade of rapid growth also allowed Kuala Lumpur to keep communal tensions under control and make progress on its New Economic Policy (NEP)—the affirmative action program for ethnic Malays—without shrinking the incomes of the economically dominant Chinese community.

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The situation has changed substantially. Low commodity prices and the slowdown in world trade plunged Malaysia into its severest economic decline in 1985. GDP fell by 1 percent that year—the first drop in output since independence in 1957. Although the economy has perked up since late last year, even the government's official forecast calls for growth to remain in the 2- to 3-percent range through 1990.

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Mahathir's opponents blame him for much of the deterioration. Although we believe Mahathir is correct in his claim that low commodity prices are largely responsible for the recession and slow recovery, we also believe that his administration over the past six years implemented a number of policies that now make it harder to revive the economy.

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The Troubled Heavy Industry Program. Most potentially damaging, in our view, is Mahathir's effort to build an extensive heavy industry sector—including automobile manufacturing and iron and steel plants—largely at government expense. Because of its small population—16 million—Malaysia lacks a domestic market large enough to make such products economical. For example, the Malaysian car, the Proton Saga, is currently selling at a rate of 20,000 cars annually, well below the plant's 110,000-vehicle-per-year capacity, according to the US Embassy. Moreover, planned export of the Proton Saga to the United States next year will probably require a substantial government

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Razaleigh on Economics

We have little reason to believe Minister of Trade and Industry Razaleigh—Mahathir's opponent in the party election—would follow substantially different economic policies than Mahathir, although Razaleigh would probably not engage in strident criticism of the West. Known as the "Father of Malaysia's Economy" for his work in promoting and implementing the New Economic Policy, Razaleigh continues to be a strong supporter of the NEP. Among Malaysians, he has a reputation as both an economic innovator and a skillful bureaucrat. Razaleigh has publicly accused the West of having a vested interest in keeping the developing nations poor and dependent, and of hypocritically promoting the notion of free trade while erecting barriers against Third World products.

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Razaleigh has been unable to repair the damage to his political reputation caused by his connection to the Bank Bumiputra scandal. Although Razaleigh relinquished the chairmanship of the bank in 1976 when he became Finance Minister, he remained closely associated with the bank's management and operations. Because the government dodged a full investigation of the scandal, the extent of Razaleigh's—or Mahathir's—involvement may never be known. But Razaleigh has not been able to escape the suspicion that he was criminally culpable, and his Malaysian detractors frequently question his honesty and integrity.

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subsidy: the distributor plans to sell for $5,000 to $6,000 a car that now sells in Malaysia for roughly $9,000, according to press reports.

Accelerating Foreign Debt. Mahathir encouraged foreign borrowing in the early 1980s to pay for expensive development projects such as the auto industry. The country's medium- and long-term foreign debt nearly tripled between 1981 and 1986, to about $20 billion. Although the debt service ratio of 18 percent is low compared with that of many troubled LDC debtors, its rapid increase from 8 percent in 1981 has caused some international lenders to reassess Malaysia's creditworthiness,

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In addition, the government's self-imposed limits on foreign borrowing as well as a budget deficit approaching 18 percent of GNP will constrain the public sector's ability to stimulate the economy for several years.

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"Look East Policy." Mahathir's "look east policy" in which he cites Japan and South Korea rather than the "tired" United States or Western Europe as development models also is proving costly. As a result, Malaysia in the 1980s increased its borrowing from Japan to the extent that about 30 percent of its foreign debt is now denominated in yen, whose recent sharp appreciation has increased the debt repayment burden. According to the US Embassy, Mahathir's personal pleas last fall to Japanese Prime Minister Nakasone to lower the interest rate on official credits produced only token results.

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New Economic Policy. Mahathir's defense of preferential economic programs for ethnic Malays, who account for roughly one-half of the population and who have lagged behind the country's prosperous Chinese citizens, continued during the early stages of the recent economic slump. Although an astute tactic politically, Mahathir's public adherence to the NEP goals worried Chinese businessmen and led to as much as $1 billion in capital flight,

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Some of the money began returning late last year, however, as the economy picked up, but we are certain that much of it will remain abroad until the political situation becomes clearer.

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Tilting Against Foreign Economic Interests. Mahathir's pursuit of his self-chosen role as LDC spokesman on commodity issues led to constant clashes through the mid-1980s with the United States and several West European countries. Mahathir's opponents accuse him of driving away foreign investment and hurting sales of Malaysian commodities through

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years of caustic criticism of Western nations, according to the US Embassy. Moreover, Kuala Lumpur's attempt in 1983 to drive up the price of tin on the London Metals Exchange by functioning as a "mystery buyer" may have cost the government nearly $200 million, according to the international financial press, and tarnished Malaysia's international image when the government's role became public knowledge.

Financial Scandals

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Malaysia's image as a well-run, relatively corruption-free country was also tarnished in the past few years by a variety of financial scandals—some linked directly to members of Mahathir's administration. Mahathir's chief political liability, 25X1 is his close friend Finance Minister Daim. Daim retained controlling interest in two of the country's major banks and several of its top corporations after becoming Finance Minister. Although he sold his majority interests after a Cabinet directive last September, rumors abound of other corrupt practices.

Other financial improprieties include:

- Bank Bumiputra—the country's largest commercial bank—was taken over by the national oil company in 1984 after absorbing some $1 billion in losses from questionable loans of a Hong Kong subsidiary.

- Bad debt problems brought on by poor management and possibly fraudulent loans have forced a Central Bank acquisition of controlling interest in two other large commercial banks. As a result, five of the country's seven largest domestic banks are now in government hands, and another bailout is likely, according to the US Embassy.

- The government still faces strong criticism for its handling of the collapse of 24 unregulated deposit-taking cooperatives last summer as a result of bad loans and massive insider dealings. The victims are mostly Chinese depositors who, according to the US Embassy, may never recover the bulk of their deposits under the government's rescue plan. 25X1

The UMNO Elections and the Malaysian Dilemma

Although the momentum and the aggressiveness of the Razaleigh-Musa campaign apparently took Mahathir by surprise, we believe his control of the national party machinery and attendant patronage, as well as the Malay tradition of loyalty to the leader, give him a slight edge. Mahathir is also fighting back by appealing to poorer, rural Malays who are UMNO's major constituency. His running mate, Deputy Prime Minister Ghafar, announced last month that the NEP would be extended indefinitely beyond its current expiration date in 1990, and its target of 30-percent Malay ownership of productive facilities would be raised to 50 percent by 2000 25X1

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Whoever wins the UMNO presidency and the prime-ministership that goes with it will face several difficult years of trying to turn around the Malaysian economy. Tighter domestic budgets and self-imposed limits on foreign borrowing have forced Kuala Lumpur to revamp its development planning in favor of private-sector rather than government-led growth. Under the Fifth Malaysia Plan published early last year, the private-sector share of total investment is targeted to rise from 50 percent in 1985 to almost 62 percent in 1990. 25X1

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The key to approaching this objective and boosting growth, in our view, is reviving the confidence of Malaysia's largely Chinese business community. We see little prospect of this happening soon, however. Although the economic picture has brightened somewhat since the last months of 1986 because of a slight improvement in the prices of key commodities—petroleum, palm oil, rubber, and tin—and an expansion in manufactured exports, the government appears to be focusing on attracting additional foreign rather than domestic investment. Mahathir has recently toned down his anti-Western rhetoric and promoted a

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number of more liberal foreign investment measures. But as long as the Chinese community remains concerned about its role in the economy and the influence it has in the ruling coalition, we do not expect it to step up investment in the kinds of small- to medium-scale manufacturing activities Malaysia needs to replace commodity exports as the engine of growth.

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Briefs

Energy

Libyan Petroleum Exports Down

Libyan petroleum exports in February and March fell to roughly 800,000 b/d, about 20 percent below the January level, [ ] The drop occurred primarily because several of Tripoli's longstanding West European customers have resisted Libya's high crude oil prices under OPEC's fixed pricing system. Tripoli also has cut back heavily on the oil the Soviets use primarily for re-export. [ ] the reduction of Soviet liftings is part of a Libyan attempt to coerce Moscow into providing additional military hardware despite disagreement over payments for past arms purchases. Oil prices have firmed in recent weeks—substantially narrowing the disparity between crude and refined products—and this should allow Libya to boost exports to Western Europe in the second quarter. In addition, demand for Libya's lighter crudes, which yield a higher proportion of gasoline, increases with the summer driving season. Libya's severe equipment losses in Chad should facilitate resolution of its current dispute with Moscow over the oil-for-arms deal. [ ]

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Kuwaiti-US Shipping Agreement Update

Kuwait is no longer interested in US naval protection for its shipping and has decided to request permission to operate only five Kuwaiti tankers under the US flag. Moreover, the government has told its senior officials that Kuwait never requested US protection for its oil shipments. The US Embassy says recent US press publicity led Kuwait to revert to its original request to reflag a small number of its ships. The Kuwaitis also have asked the United Kingdom, France, and China to lease them tankers, according to the US Embassy. Kuwait asked London for a written guarantee to protect chartered UK-flag ships, but London will not redeploy its Gulf fleet. France has no tankers available but would allow Kuwait to register tankers chartered elsewhere under the French flag. Kuwait's latest moves, coupled with the Soviet agreement last week to lease three tankers, seek to involve the permanent members of the UN Security Council. While playing down the bilateral relationship, Kuwait probably believes it can use US support within a larger framework to deter Iranian aggression and that Western powers would protect their flagged vessels even without a formal agreement. [ ]

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New Brazilian Oil Production

Oil production from Brazil's giant, deepwater (250 to 400 meter) oilfield, Albacora, is scheduled to begin in July at a rate of 18,000 b/d and then double by early 1988. According to press reports, this is the first of three phases of development anticipated for this 500-million-barrel oilfield, and represents an investment of roughly $100 million dollars. Development of this field will probably be spread over a period of eight to 10 years, with production eventually reaching 200,000 b/d. More than 90 percent of the services and equipment used in this first stage will be supplied domestically. This phase of development will provide

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extensive experience in the operation of subsea equipment, and will act as a testing ground for production in much deeper waters in the second and third phases. Brazil is currently working with US and West European firms to develop the technology required to produce oil from depths in excess of 800 meters. If successful, the Brazilians would be in the lead position to apply the technology to other deepwater areas worldwide. 25X1

International Finance

Yugoslavia's Debt Rescheduling Agreement

Western governments last week approved in principle the second phase of Yugoslavia's current rescheduling agreement, although formal approval awaits a forthcoming IMF assessment of Yugoslav economic policies. The accord reschedules $475 million in official debt, falling due between next month and March 1988, and clears the way for banks to activate the second stage of a multiyear refinancing agreement later this month. The accord strikes a compromise between Belgrade's demands for an automatic, unconditional refinancing and some governments' insistence on more explicit policy and performance guidelines. Creditors, who previously favored a tougher stand, probably were influenced by recent labor unrest and wished to minimize any threats to Yugoslavia's stability. Belgrade's victory may be short lived; a negative IMF evaluation could set up another confrontation as early as next month. Moreover, continuing liquidity problems will probably force Belgrade into another grueling round of negotiations later this year. 25X1

Iraqi Rescheduling Update

Iraq is making progress in rescheduling debt owed to major trading partners and international banks. Baghdad needs to reschedule as much as $4 billion in debt this year. The US Embassy in Rome reports that Italy agreed last month to reschedule $320 million in government-insured short-term Iraqi debt due in 1987. The agreement calls for repayment of $40 million in cash over the next five months and $280 million to be repaid from 1989 to 1992. Combined with a total of $450 million rescheduled by China and France earlier this year, Baghdad has rescheduled nearly $800 million so far. Recent repayments of overdue letters of credit also are improving Baghdad's chances for obtaining rescheduling agreements with international banks. 25X1

Iran Uses Gold To Obtain Foreign Exchange

Iran borrowed about $1 billion from West European banks last year by using gold for collateral. The terms of several gold swap arrangements called for Iran to pay a low interest charge and to buy its gold back within a few months. Iran usually extended the buy-back dates, however. This method of obtaining foreign currency allows Tehran to claim the exchanges do not involve foreign loans, and that the fees charged do not violate Islamic restrictions against paying interest. 25X1

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International Trade

Cuba Using Panama To Circumvent US Embargo

Cuba continues to use Panama as a channel to obtain goods in circumvention of the US embargo. Panama and Havana are reportedly negotiating the sale of $500,000 worth of computer equipment to the Cuban Ministry of Public Health. In addition to deals for high-tech goods, other transactions involve mostly brand name US-made products such as cigarettes, photographic equipment, office supplies, leather goods, and footwear. Besides Panama, Cuba is tapping other sources for US goods. Havana intends to purchase some of these goods from Puerto Rico and Venezuela. 25X1

Transshipment of Soviet Textiles to US Market

A Japanese trading company has advised a Pakistani trader in methods to circumvent US import regulations on Soviet-made textiles. The Japanese firm advised the Pakistani trader to transship through Pakistan, Bangladesh, or other East Asian countries in order to avoid the high US duties on Soviet textiles—20 to 25 percent on flannel material and 70 percent on bedsheets. In addition, the Japanese trader also suggested using these points to dye, print, and stitch the fabric to further disguise Soviet origin before final delivery to the United States. 25X1

Global and Regional Developments

Saudi-Moroccan Cooperation Agreement

During a visit last month, Saudi King Fahd apparently agreed to give Moroccan King Hassan extensive financial assistance in return for Hassan's pledge to station Moroccan troops in Saudi Arabia 25X1 25X1 25X1 A contingent of 10,000 Moroccans, equipped and supported by Riyadh, will be sent to Saudi Arabia soon. In return, Fahd promised Hassan an economic assistance package, including oil aid, and unspecified funding to modernize the military. The agreement, which has been under discussion for several months, reflects Fahd's continuing efforts to develop a credible military deterrent to Iranian aggression. The extent of Saudi financial aid remains unknown, but the proposed oil grant alone may exceed $450 million. About 3,000 Moroccan troops are already in the United Arab Emirates, and Hassan would welcome the Saudi deal as an opportunity to obtain hard currency, reduce high Moroccan unemployment, and free Moroccan funds for the purchase of F-16 or Mirage 2000 aircraft. 25X1

Breakthrough in Superconductors

25X1 researchers in Japan, Western Europe, and the United States have discovered superconducting ceramic materials that do not require the costly, ultralow temperatures that current materials do. The new technology has spread quickly—roughly two dozen labs claim recent success—because the approximate chemical compositions of the new ceramics are public knowledge and they are easy to make. Underscoring Japan's determination to seize the initiative, the Japanese press has announced the formation of a

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research consortium of companies, universities, and government labs to further develop the new superconductors. The new superconductors should enhance performance and reduce cooling costs for applications such as high-speed computer chips, low-loss powerlines, particle accelerators such as a "superconducting supercollider," and fusion power. Experts differ in their estimates of how soon the new superconductors can reach the market, but many of them see commercialization within five to 10 years. [ ] 25X1

National Developments

Developed Countries

Japanese Economic Stimulus Package

Faced with mounting foreign and domestic pressure, the ruling Liberal Democratic Party (LDP) this week recommended measures designed to stimulate the economy. The package calls for a large supplemental budget and early implementation of public works projects. While noting US demands to stimulate the economy, the LDP statement also strongly reaffirms the Nakasone government's commitment to continuing its deficit reduction campaign. Although the LDP proposal is intended only as guidance to the government, it will essentially become official policy. A large supplemental budget could significantly boost the economy if it is funded with new money—past budgets have largely reallocated existing revenues—but such decisions will not be worked out until the fall. In any case, the LDP's statement suggests that even a genuine effort to stimulate the economy would be temporary. [ ] 25X1

Protectionism Gaining Ground in Japan

Advocates of import protection for depressed industries appear to be gaining influence within the MITI as a result of the yen's appreciation to the 140 to 150 per dollar range and the shortcomings of the US-Japan Semiconductor Agreement. Officials in the MITI bureaus responsible for the steel, cement, and textile industries believe that the yen's continuing rise has undercut industry efforts to carry out structural adjustments. They now insist that these sectors need import penetration ceilings to hold back competition from Taiwan, South Korea, and China, [ ] Vice Minister Fukukawa reportedly is in a poor position to resist such pressures because of his past advocacy of structural adjustment, including capacity reductions. Director of the Minister's Secretariat Tanahashi and Vice Minister for International Affairs Kuroda, who would normally be expected to resist protectionist proposals, are on the defensive within MITI because of their identification with the semiconductor agreement. 25X1

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Bundesbank Deemphasizes 1987 Monetary Targets

Press reports indicate that the Bundesbank has downgraded the importance of its 1987 monetary growth target out of concern that traditional efforts to slow monetary expansion will further hamstring the West German economy. After badly overshooting last year, the bank had attached great importance to meeting this year's target in order to restore its credibility. Primarily because of the

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continued strength of the deutsche mark, however, January's discount rate cut, an unorthodox attempt to slow monetary growth by widening the gap between short- and long-term interest rates, has done little—monetary growth remains 1.5 percentage points above its upper target. The announcement is almost certainly intended to weaken demand for the mark by removing the prospect that the bank will increase interest rates to slow monetary growth later this year. As it did last year, the central bank will probably point to the decision to tolerate higher monetary growth as a contribution to world economic adjustment. 25X1

Less Developed Countries

Chile Opts for Slower Growth

Faced with higher inflation and sharp increases in imports, Santiago has taken fiscal and monetary measures to slow growth. Economic growth was 5.7 percent last year and by January had accelerated to a 7-percent annual rate, heating up the economy and pushing inflation to 3.8 percent for the month. The consumption-led expansion also drove up imports by 24 percent last year, raising the danger of a deeper current account deficit and external financing problems this year. In March the central bank moved to cool off the boom by raising its lending rate to commercial banks and slowing monetary expansion from its 26-percent real increase last year. The scheduled cut in the fiscal deficit from 2.2 percent of GDP in 1986 to 1.7 percent this year will probably help to rein in growth to a more sustainable level. 25X1

Peru Gropes for Economic Remedies

President Garcia continues to favor labor over other interest groups, despite his growing concern over inflation—which jumped to a 100-percent annual rate during January-March, from 60 percent last year—and lack of new investment. In a speech last week he decreed a 40-percent rise in the minimum wage—which applies to one-fifth of the labor force—and 27- to 30-percent increases for nonunionized and government workers. At the same time he hinted that consumption may have to be curbed to allow for increased exports and greater domestic savings. Lima probably will steadily raise taxes and administered prices—Garcia also announced higher taxes on luxury consumer items and he recently raised gasoline prices 20 percent—to fight the budget deficit, but, to maintain his popular backing, Garcia also will ensure that the wages of the lowest paid stay ahead of the cost of living. His piecemeal approach is unlikely, however, to encourage domestic savings, particularly if the salaries of better paid workers are allowed to lag, and if interest rates on savings accounts remain pegged well below inflation. 25X1

Syrian Military Move Further Strains Economy

The additional financial costs posed by Syria's military intervention in West Beirut are sustainable for the near term. Over time, the move will further strain Syria's weak economy, especially if Damascus is forced to augment its 7,000 to 10,000 troops to maintain control. The US Embassy estimates the monthly cost of maintaining Syrian troops in West Beirut is about $500,000. 25X1
25X1 Damascus has sought Saudi help to defray the costs. Syria will probably finance its military operations in Beirut by limiting expenses in other areas;

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Damascus earlier eliminated the special bonus pay to soldiers serving in Lebanon. President Assad will portray his policies as consistent with moderate Arab interests, and almost certainly will seek assurances from Riyadh of oil deliveries and hard currency support if Syrian forces move against the Iranian-backed Hizballah in Beirut's southern suburbs.

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Pakistan Unveils Employment Program

Pakistani officials recently announced an employment program—the Youth Investment Promotion Society (YIPS)—to respond to growing unemployment among educated youth, according to US Embassy reporting. The plan is intended to assist educated youth to start small-scale businesses in industry, agriculture, trade, transportation, and other sectors. The Society, which will collaborate with the National Development Corporation, the Federal Bank for Cooperatives, and the Small Business Finance Corporation plans to make $35 million annually in soft loans and hopes to create 2,000 to 2,500 jobs each year. The government plans to contribute $5 million from its July 1986 $120 million employment package that uses windfall revenues created by lower world oil prices.

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India's Oil Import Outlook

India's dependence on imported oil is increasing as fuel demand grows and domestic production stagnates. According to press reports, Indian petroleum officials expect a 15-percent increase in India's imports of crude oil and petroleum products this year. In 1986 India imported 40 percent—some 391,000 b/d—of its petroleum requirements at a cost of about $2.5 billion. The Soviet Union will probably continue to provide about one-third of India's oil imports with the remainder purchased on the spot market or through barter arrangements. India's 7-percent annual increase in oil demand since 1985 is due in large part to the growing energy needs of the country's expanding industrial sector and the extensive use of irrigation pumps in the agricultural sector. Although India has recently discovered some new onshore oil reserves, the projected output from these new fields is expected only to offset declining output from current fields.

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Thailand Suspending Subsidized Rice Exports

Thai officials told the US Embassy last month that they plan to halt below-cost exports of rice from stocks that the government had accumulated since December to support domestic rice prices. The government's subsidy on the 720,000 metric tons of rice sold through mid-March—most of it to countries that are not traditional US markets—amounted to as much as $19 million, according to the Embassy. We believe the Prem government's decision to stop the sales is largely an outgrowth of a financial scandal associated with the program and the ensuing political uproar over the program's administration. Bangkok apparently also is concerned that Washington might retaliate by increasing its support to US rice exporters. Nonetheless, we cannot rule out the possibility that Bangkok will quietly renew its subsidies if, as most international traders expect, weak markets make sales difficult.

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Thailand Entering Auto Export Market

A Thai auto assembler has negotiated a six-year contract with Chrysler Canada to assemble a total of 100,000 "Lancer Champs" for export to Canada beginning in November, according to the US Embassy. The Thai firm, MMC Sitthiphon, will assemble kits sent from Japan by Mitsubishi—which produces the cars for Chrysler and owns a 48-percent stake in Sitthiphon—if it obtains reduced import duties on the cars under the Canadian GSP program. The firm hopes to use its foothold in Canada to enter the US market, according to Embassy reporting. We believe the deal is likely to serve as a test case in Thailand for other Japanese exporters anxious to preserve their sales to North America and Western Europe in the face of rising labor costs, a strong yen, and import restrictions. 25X1

Indonesia's Budget Crunch Intensifying

Department of Finance officials are concerned that declining revenues—caused by sharply lower oil prices—are insufficient to fund various politically important subsidy programs, including those for fertilizers and petroleum products. 25X1

Borrowings from Indonesian banks are providing a short-term fix to the cash-flow squeeze, but Finance officials recognize that this approach will ultimately aggravate budget problems by increasing the government's interest payments. To alleviate the crunch, Jakarta is apparently considering cutting subsidies and raising consumer prices, but these and other possible austerity measures will be postponed until after the parliamentary election on 23 April. Jakarta will then attempt to deflect public cricitism of economic policy by a publicity campaign on the need for national unity. 25X1 25X1 25X1

Communist

Potential Vietnamese Rice Shortage

Vietnam is requesting its UN Mission and several embassies in Western countries to solicit emergency aid to combat a severe insect infestation in key ricegrowing provinces in the north, Hanoi claims potential losses may exceed 300,000 metric tons—one-fifth of the production in the afflicted provinces. In addition, drought conditions are affecting more than 12 percent of the total rice acreage in the north, and the press reports delays in harvesting the spring crop because of shortages of fuel and spare parts for tractors. We believe Hanoi will probably petition the UN for food aid if the crop damage worsens. Vietnamese leaders probably believe they cannot count on Moscow to provide more than limited assistance. The Soviets in 1985 refused Hanoi's pleas for extensive food aid during that serious shortfall, and Hanoi was forced to use scarce foreign exchange for rice imports—an outlay from which it has still not recovered. 25X1 25X1

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Vietnam Expanding Labor Exports

Vietnam plans to increase the number of its workers in foreign countries by as much as 50 percent this year, according to a senior official in the Labor Ministry. The Vietnamese Party Congress last December had announced that expanded labor cooperation would be part of an accelerated effort during the 1986-90 Five-Year Plan to integrate the country's economy more fully into CEMA. Labor exports from its large underemployed manpower pool, in our judgment, is probably Hanoi's best means of offsetting its large debts and trade imbalances with the host countries. If Hanoi meets its reported target this year, approximately 30,000 additional workers will be sent abroad—primarily to the Soviet Union and Eastern Europe—augmenting a Vietnamese force of guest workers that has held steady at about 60,000 for the past several years. Despite such drawbacks as large salary deductions that go toward repaying the national debt, overseas workers earn far more than their counterparts in Vietnam, and we believe Hanoi will have no trouble attracting enough recruits.

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