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International Economic & Energy Weekly

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8 March 1985

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8 March 1985

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Synopsis

1 **Perspective—*South American Democracy and Debt*** 25X1

Although the new civilian governments in South America recognized the necessity of economic stabilization to maintain creditor cooperation and lay the foundation for recovery, we believe the freer political environment will complicate management of these countries' financial rescue programs. 25X1

13 **Summit Issues: Thatcher's Troubles With the Falling Pound** 25X1

The falling pound has placed Prime Minister Thatcher in a difficult political and economic situation. The cost of dollar-denominated defense programs is rising, and London's decision to support the pound by raising interest rates threatens to retard economic growth. 25X1

17 **Latin America: Tenuous Economic Gains** 25X1

The key Latin American debtors—Brazil, Mexico, Venezuela, and Argentina—probably will avoid serious payments difficulties this year, but the other small debtors remain vulnerable to serious financial disruptions that could further reduce living standards and aggravate political strains. 25X1

21 **Indonesia: More Austerity in Store** 25X1

We believe Jakarta has sufficient financial and policy options to withstand another modest decline in oil prices without extreme austerity measures but would face very tough choices if oil prices were to drop precipitously. 25X1

25 **Eastern Europe's Food Situation: Problems Persist** 25X1

Over the past three years, East European consumers have seen an erosion of many of the qualitative and quantitative gains in food supplies achieved in the 1970s. Last year's record grain harvest and improved output of many nongrain crops will provide some relief in 1985, but problems will persist, particularly in Poland and Romania. 25X1

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31 **Sub-Saharan Africa: Coping With Economic Adjustment**

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Efforts at economic adjustment by the Sub-Saharan African countries have produced some modest gains and, if maintained, hold the promise for major restructuring of the region's economies over the longer term.

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Perspective

South American Democracy and Debt

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The inaugurations of elected presidents in Brazil and Uruguay this month underscore the steady return of civilian government throughout the region—eight out of 10 South American [1] countries now are or soon will be ruled by civilians. Newly installed civilian governments have found that a price of democracy is a more politicized approach to economic problems. Although the new civilian governments in South America recognize the necessity of economic stabilization to maintain creditor cooperation and lay the foundation for recovery, we believe the freer political environment will complicate management of these countries' financial rescue programs.

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In the newer democracies, consolidating civilian rule has tended to eclipse the dictates of economic stabilization. Argentina, for example, came to terms with the IMF only after lengthy delays caused by political exigencies. Peru let its IMF program lapse to halt the government's declining popular backing, while Bolivia has been unable to implement coherent economic measures because of domestic labor discontent. After three years of recession, domestic interest groups throughout the region are insisting on a return to economic growth and increased social spending to boost living standards. Organized labor, in particular, will intensify demands for real wage increases. These demands will be especially strident in Peru, Bolivia, Colombia, and Argentina, which all face important elections in the next 18 months.

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As popular pressures collide with stabilization programs, we remain concerned that South American countries will seek compromise through patchwork policies. We expect most governments will take steps to stimulate their economies—mainly by increased public spending—in order to expand employment. Simultaneously, price controls likely will be imposed and the pace of devaluation slowed to hold down inflationary pressure, and exchange controls probably would be retained in an effort to prevent a resurgence of serious payments problems.

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We judge that such a policy response will help consolidate civilian rule but pose difficulties for sustaining financial progress. In the next several months, we anticipate that Argentina, Bolivia, Brazil, Colombia, Peru, and Uruguay will encounter difficulties in complying with IMF-supported targets and in securing more lenient terms from creditors. Consequently, we believe South American debtors will find it harder to obtain the development money needed

[1] Excluding Guyana, Suriname, and French Guiana.

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to foster economic recovery and strengthen the external accounts. Under these conditions, we remain concerned that domestic policy miscalculation—such as overly ambitious expansion programs—could jar the rescue programs off track. 25X1

We believe that debtors will increasingly turn to Washington for help in sustaining their rescue programs. As 1985 wears on, we speculate that debtors will press US officials to:

- Intervene in disputes with the IMF to balance the requirements of economic reform against the political imperatives of democratic government.
- Nudge lenders to provide credit and debt rescheduling.
- Help design financial strategies that support economic recovery and convince creditors that more flexible terms are necessary to improve long-run performance.

At the same time, pressure may also come from South America's creditors to pressure recalcitrant debtors to resume payments and continue necessary economic adjustment 25X1

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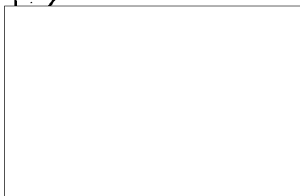
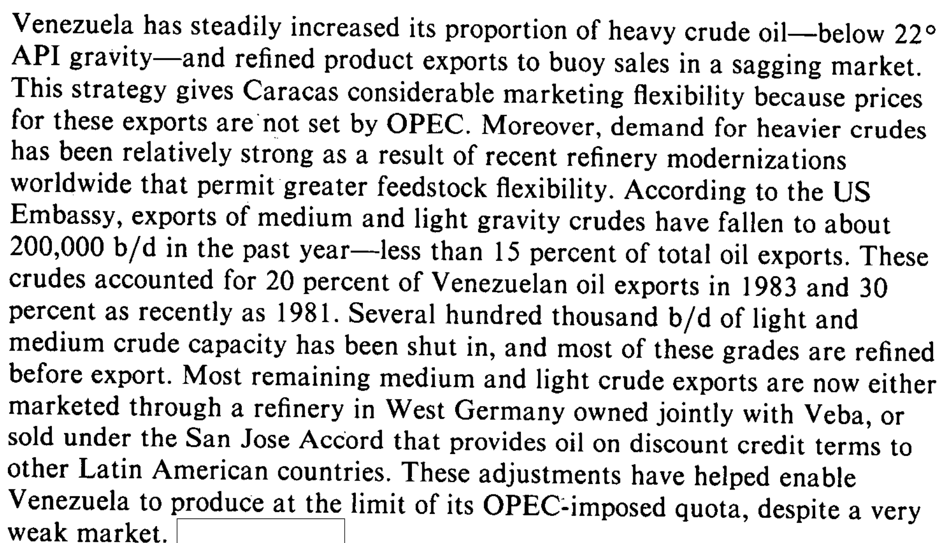
Briefs

Energy

Venezuela Pushes Heavy Crude and Oil Products Exports





Venezuela has steadily increased its proportion of heavy crude oil—below 22° API gravity—and refined product exports to buoy sales in a sagging market. This strategy gives Caracas considerable marketing flexibility because prices for these exports are not set by OPEC. Moreover, demand for heavier crudes has been relatively strong as a result of recent refinery modernizations worldwide that permit greater feedstock flexibility. According to the US Embassy, exports of medium and light gravity crudes have fallen to about 200,000 b/d in the past year—less than 15 percent of total oil exports. These crudes accounted for 20 percent of Venezuelan oil exports in 1983 and 30 percent as recently as 1981. Several hundred thousand b/d of light and medium crude capacity has been shut in, and most of these grades are refined before export. Most remaining medium and light crude exports are now either marketed through a refinery in West Germany owned jointly with Veba, or sold under the San Jose Accord that provides oil on discount credit terms to other Latin American countries. These adjustments have helped enable Venezuela to produce at the limit of its OPEC-imposed quota, despite a very weak market.

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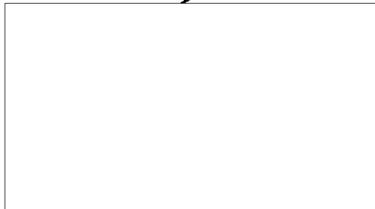
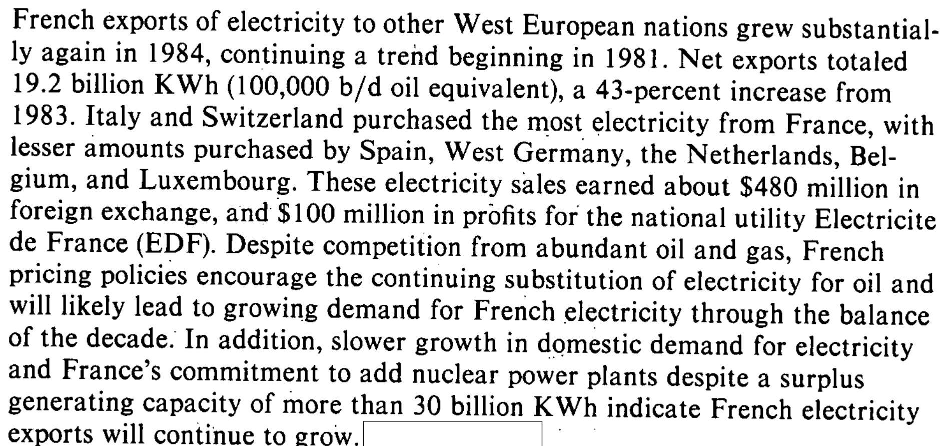
French Electricity Exports Surge





French exports of electricity to other West European nations grew substantially again in 1984, continuing a trend beginning in 1981. Net exports totaled 19.2 billion KWh (100,000 b/d oil equivalent), a 43-percent increase from 1983. Italy and Switzerland purchased the most electricity from France, with lesser amounts purchased by Spain, West Germany, the Netherlands, Belgium, and Luxembourg. These electricity sales earned about $480 million in foreign exchange, and $100 million in profits for the national utility Electricite de France (EDF). Despite competition from abundant oil and gas, French pricing policies encourage the continuing substitution of electricity for oil and will likely lead to growing demand for French electricity through the balance of the decade. In addition, slower growth in domestic demand for electricity and France's commitment to add nuclear power plants despite a surplus generating capacity of more than 30 billion KWh indicate French electricity exports will continue to grow.

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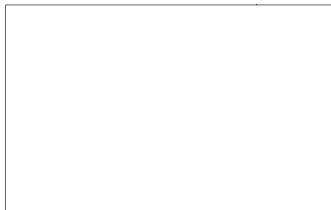
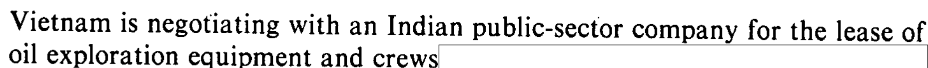
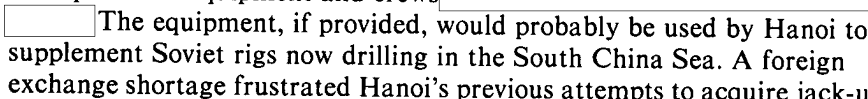
Vietnam Seeks Indian Help in Oil Exploration





Vietnam is negotiating with an Indian public-sector company for the lease of oil exploration equipment and crews



The equipment, if provided, would probably be used by Hanoi to supplement Soviet rigs now drilling in the South China Sea. A foreign exchange shortage frustrated Hanoi's previous attempts to acquire jack-up rigs

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from Japan and Singapore, and the Vietnamese are likely to ask New Delhi to extend credit for this deal. We are uncertain whether the proposed lease will divert equipment away from India's own oil exploration effort. Even if it does, however, New Delhi may be counting on commercial opportunities as well as some good will from Hanoi to offset the costs. 25X1

International Finance

Paraguay's Growing Financial Difficulties

Paraguay is one of only two South American countries that has not rescheduled its foreign debt, and we judge its day of reckoning is fast approaching. According to the US Embassy, foreign banks are growing tired of Asuncion's continued foot-dragging on its $175 million in arrearages. Commercial creditors are becoming increasingly reluctant to syndicate new credits, and the government has been unable to find $15 million in cofinancing to complement a World Bank loan to Paraguay's livestock fund. Meanwhile, export revenues from the Itaipu hydroelectric project have slowed to a trickle. According to IMF estimates, imports and debt service exceeded exports and long-term capital inflow by $163 million in 1984. Moreover, capital flight totaled an estimated $130 million last year. The Central Bank drew down foreign reserves by 23 percent to $471 million between December 1983 and September 1984. With a minimal reserve cushion to meet mounting payments, Asuncion probably has little alternative but to seek a rescheduling agreement this year that will entail economic stabilization measures. 25X1

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New Zealand Currency Float

Volatile trading of the New Zealand dollar on financial markets last week—possibly caused by fear of US trade sanctions in the wake of the ANZUS port access crisis—encouraged Finance Minister Douglas to enact the float he has been preparing for months. Douglas had already strengthened the financial sector by building up foreign exchange reserves, freeing interest rates, liberalizing barriers on international flows of capital, and allowing an increase in the number of foreign exchange dealers. Because the float has produced no marked revaluation in trading this week—the currency has been trading around 43.3 US cents since the float—Douglas has been able to fend off criticism that it would harm exporters and risk external manipulation of the exchange rate. The float will allow the Lange government greater flexibility in controlling inflation—currently about 15 percent at an annual rate—and in managing foreign debt financing. Moreover, progress in reducing inflation and achieving this year's modest growth target would allow Douglas to continue imposing his conservative economic policies on an often-fractious Labor Party caucus. We believe it would undercut the party's left wing, which has been urging Lange to return to traditional policies of stimulating the domestic economy and protecting jobs. 25X1

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Global and Regional Developments

USSR Opens New Cargo Line to Nicaragua

According to press reports, the Soviets recently inaugurated a second regular cargo line between Leningrad and the Nicaraguan port of Corinto. The new service will utilize vehicle-carrying Magnitogorsk-class roll-on roll-off (RO/RO) ships, the largest in the Soviet merchant fleet. The actual opening of the line may predate the announcement. Two Magnitogorsk-class ships have already called at Corinto since December. Both delivered military-associated equipment (at least 600 trucks) as well as commercial cargo (for example, 500 automobiles). These RO/RO ships permit greater security and faster unloading than the conventional freighters of the Soviet Baltcapas line that has served Corinto since January 1981.

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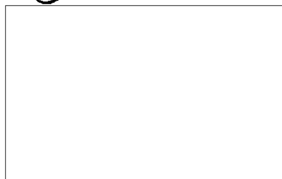
Libyan-Turkish Arrears Mount



Libya's refusal to pay off its arrears to Turkish firms is a major cause for Ankara's careful handling of Libyan leader Qadhafi. Libya has piled up $490 million in accumulated arrears and owes at least another $1 billion on equipment purchases and guaranteed notes. The two countries temporarily resolved their payment differences in 1983 when Ankara agreed to double its imports of Libyan oil—about 60,000 b/d and 20 percent of total oil imports—with Tripoli using half of the revenues to pay arrears to Turkish contractors. The US Embassy in Ankara says that this agreement has not been met over the past several months. Qadhafi has been using financial arrears to gain political concessions from other trade partners and probably is looking for a goodwill gesture—a state visit to Turkey—as the price for resuming payments under the 1983 accord.

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National Developments

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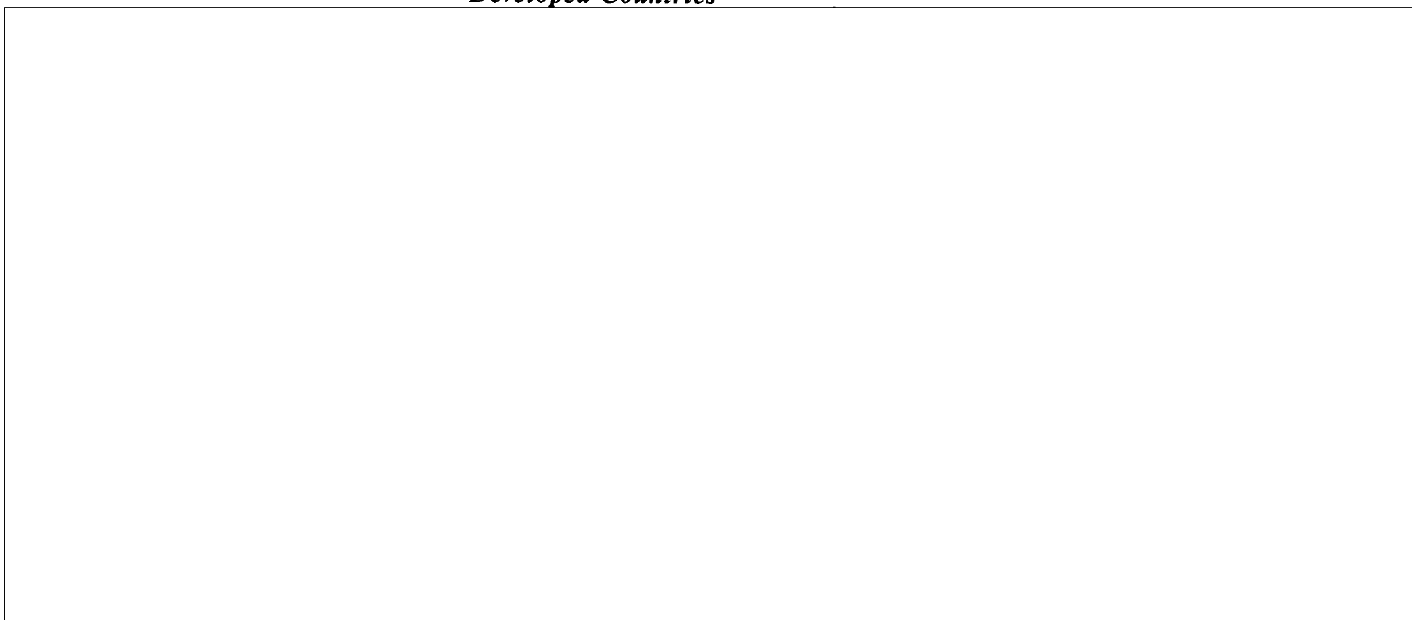
Developed Countries



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Japanese Concession on Medical Equipment

The Ministry of Health and Welfare and Travenol Japan, a US kidney dialysis manufacturer based in Japan, have agreed to raise National Health Insurance reimbursement fees for Japanese doctors who use this manufacturer's dialysis equipment—widely acknowledged as the world's best. The Health Ministry has decided that reimbursement limits be more than doubled to $230 per patient per month; an advisory council to the Ministry had recommended an increase of only $7. Other changes include additional reimbursements for telephone consultations and relaxing the qualifications for medical facilities authorized to use this equipment. These revisions represent about 90 percent of Travenol Japan's goal and will likely result in increased usage of this dialysis therapy in Japan. Tokyo probably will use the agreement to counter US criticism during the 12 March bilateral talks to discuss opening the pharmaceuticals and medical equipment markets.

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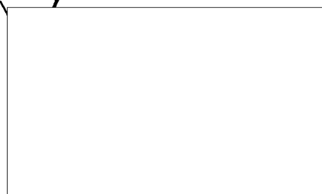
Spanish Unemployment Rises in 1984



Falling domestic demand prompted a 3.3-percentage-point increase in the Spanish unemployment rate last year—raising it to 21.7 percent, nearly five times the 1975 level. Preliminary statistics show job losses were sharpest in construction and services industries, reflecting drops in private consumption and investment. The government's replacement of an agricultural make-work program with unemployment benefits played a smaller part, pushing the jobless rate up an estimated 1 percentage point. A number of factors suggest that the unemployment rate may begin to stabilize this year. Real unit labor costs fell 5.5 percent in 1984, strengthening firms' financial positions. Increasing profits in the export sector, a slowdown in inflation, and the Socialist trade union's agreement to reduce wage demands should help stimulate investment and job creation this year.

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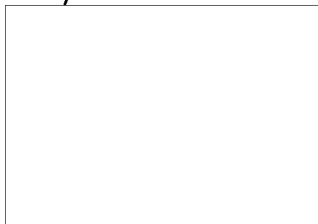
Greek Budget Avoids Austerity



The 1985 Greek budget fails to provide the fiscal stringency necessary to reduce inflation and stem the deterioration in the foreign payments position. The proposed spending and tax changes in this election year favor principally farmers and lower income groups. Nominal expenditures are projected to rise 27 percent—compared with 18-percent inflation—with the largest increases slated for social services, agriculture, public works, and education. Defense spending will remain around 5 percent of GDP, but, as a share of the budget, it will decline to about 13 percent—down from 21 percent in 1979. Costs of servicing the public-sector debt are projected to jump by nearly 50 percent. The anticipated 30-percent rise in revenues probably will not materialize despite a boost in direct taxes as well as better enforcement measures and a speedup in collection of past years' taxes. Past revenue projections have nearly always fallen short of their target, given the high level of tax evasion in Greece. As a result, the public-sector deficit is expected to climb further, from 15.7 percent of GDP in 1984 to 16.4 percent in 1985.

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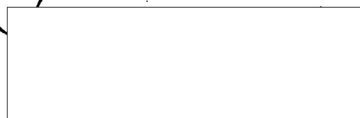
Canadian Defense Spending



Ottawa's spending estimates for the next fiscal year, announced on Tuesday, indicate that Canada will, as it has since 1980, meet the NATO goal of 3-percent real growth in defense spending. As with many NATO countries,

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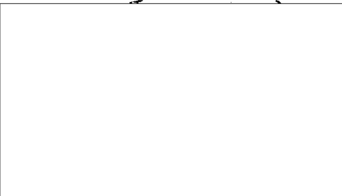
however, this amount will not allow Canada [redacted] to fully meet its force modernization program and its NATO force goals. As a result of former Prime Minister Trudeau's underfunding of the military in the 1970s, defense spending would have to grow by much more than 3 percent to fulfill Canada's current NATO commitments. Prime Minister Mulroney has progressively limited his government's ability to increase military outlays. The Tories now seem bent on spending programs to reduce the 11.2-percent unemployment rate and are waffling about cutting social benefits and transfer payments to the provinces because of the possible political costs. Whether Ottawa uses its next budget to reduce deficits or to increase jobs, there will be little left for growth in defense spending, and Mulroney seems averse to raising taxes. Its rhetoric notwithstanding, the government is coming to realize that there is virtually no political support in Canada for major increases in defense spending. [redacted] 25X1

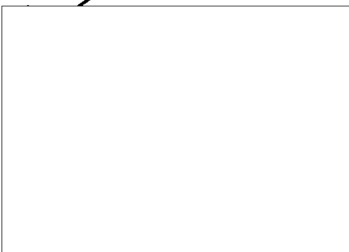
Less Developed Countries

Bolivian Labor Protests Increasing

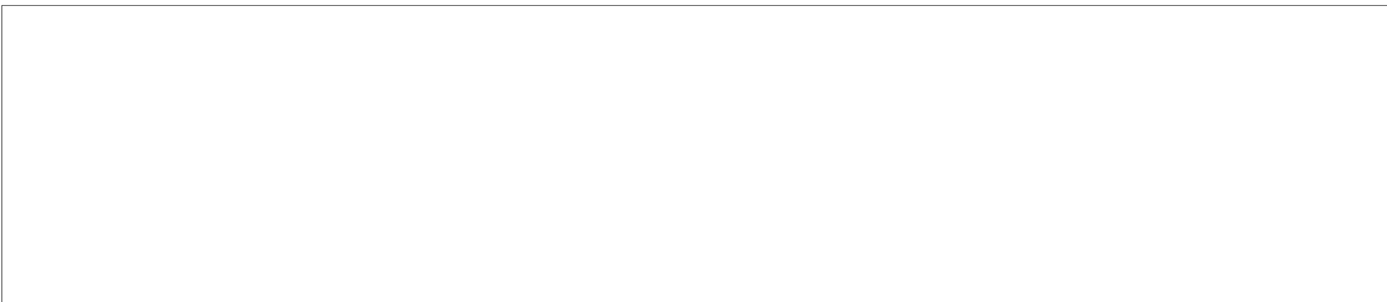


A labor demonstration in La Paz on Monday, which press accounts say involved almost 50,000 workers, was the largest antigovernment rally since President Siles took office in 1982. It followed a decision last Friday by the telecommunicators union to begin an indefinite strike to protest government austerity measures. Meanwhile, the Defense Minister has warned that the military is prepared to take over essential state services to prevent a breakdown in order. The protests reflect a decision by Bolivia's largest labor confederation to avoid a general strike for now in favor of more limited actions. Miners and other labor militants, nevertheless, are increasingly restive; their penchant for violence risks provoking a confrontation with government troops. The military's promise to control labor demonstrations and the apparent lack of serious coup plotting point to a growing military acceptance of presidential elections scheduled for 16 June. [redacted] 25X1

Brazil Expected To Change Mix of Soybean Exports



[redacted] Brazil is expected to boost its exports of soybeans from 1.6 million metric tons during the 1984/85 market year (February/January) to as much as 3 million tons this season. At the same time, exports of soybean meal are expected to fall below the 7.6 million tons exported last season, while soybean oil exports are likely to remain at about the 1-million-ton level. This shift away from the higher valued processed products is largely because of weak demand for meal in Western Europe. Brazil, the world's second-largest soybean producer and exporter, earned an estimated $2.5 billion from soybean and product exports in 1984—roughly 9 percent of its total export earnings. The shift from meal to bean exports is not likely to greatly alter Brazil's earnings potential for 1985. [redacted] 25X1



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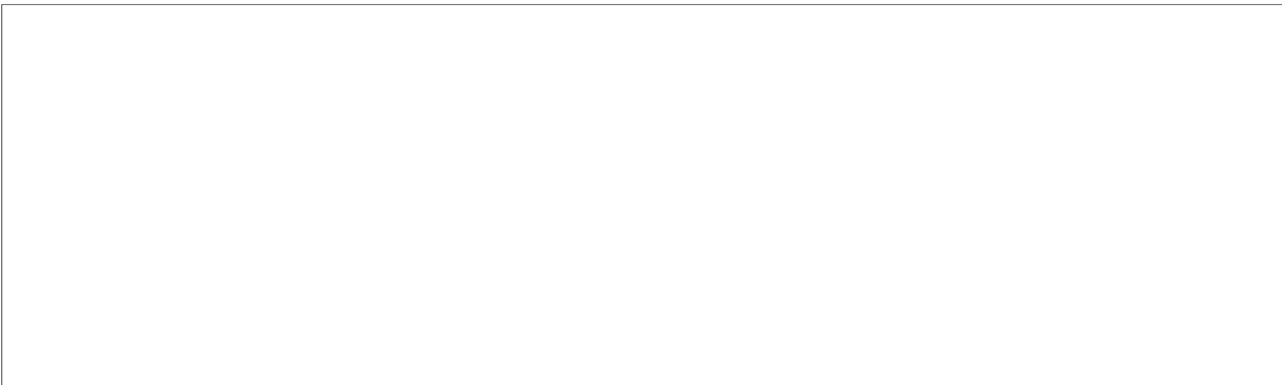

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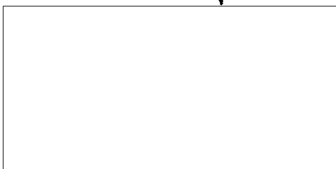
Moroccan Grain Outlook



Morocco faces bleak prospects for meeting its grain needs again this year. The US Embassy estimates that, even with the possibility of the best harvest in five years, Morocco will deplete available grain stores by July if US CCC credits remain frozen and additional concessional food aid is not forthcoming. The Embassy confirms French willingness to supply 250,000 metric tons of concesssionally priced wheat, far short of the 600,000 tons requested by Rabat. Paris is reluctant to provide more because Rabat already is in arrears on outstanding French loans. If no new concessional sources are located, Morocco will have to spend $80 million in scarce foreign exchange to cover necessary wheat imports through the end of 1985 or reduce consumption that would sharply increase the risk of domestic unrest.

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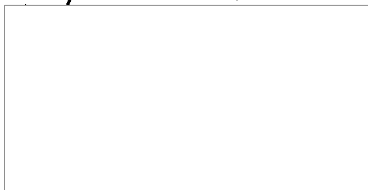
Moroccan Inflation Unabated



Morocco's official inflation rate hit 12.5 percent last year—double the 1983 level and the sharpest increase since 1981—and the US Embassy anticipates little relief this year. The actual level of inflation almost certainly is higher—probably around 15 percent—because the official price index includes many subsidized goods and no longer accurately reflects consumption patterns. The opposition press has focused on inflation to justify its charges that wage hikes budgeted for 1985 are insuffícent to protect living standards. In addition, the $210 million budget allocation for consumer subsidies has been attacked as inadequate to keep food prices stable. The bad news on prices will seriously hinder government efforts to hold consumer discontent at bay while attempting to deal with the IMF, foreign creditors, and a growing food problem this spring.

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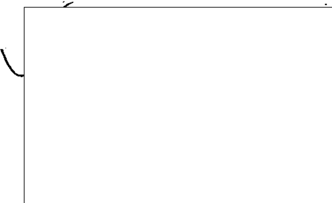
Liberian Economy Deteriorating



Management of Liberia's economic crisis is taking second seat to preparations for national elections in October and a return to civilian government in January 1986. Diplomatic observers believe Head of State Doe will continue to avoid austerity measures that would further erode living standards. Instead, we believe that Monrovia will resort to ill-conceived stopgap measures that will compound the country's financial problems. Doe, for example, may issue more unbacked Liberian $5 coins, which would fuel inflation, increase capital flight, and violate a longstanding arrangement that the government has with

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affiliates of US commercial banks designed to shore up the country's dollar-based financial system. The government will also feel pressured for political reasons to pay for imported necessities in lieu of debt servicing, which could bring foreign debt arrearages to $140 million by the end of the year and almost certainly scuttle negotiations with international lending institutions for new assistance.

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Zimbabwean Reforms Threaten Commercial Farming

Harare has proposed two agricultural measures that could dampen foreign investor confidence and demoralize the commercial farming sector. According to US Embassy reporting, Zimbabwe intends to nationalize grain milling, although budgetary constraints probably will hamper implementation. The milling industry has net assets totaling at least $75 million, one-third of which is owned by foreign shareholders, according to Embassy sources. Nationalization would disrupt the industry, further discourage foreign investment, and complicate negotiations with the IMF for a needed standby agreement. A proposed land acquisition bill would curtail property rights based on preindependence law by giving the government first right of refusal for any rural land offered for sale. In addition, emigrating white farmers would be penalized because Harare would no longer be required to buy land with foreign currency, nor to pay full market value. Although the bill is unlikely to be introduced before the national elections in June, the Embassy believes it is certain to pass.

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Angola Ready To Sign Lome Convention

Angola is expected to join the Lome Convention soon, thereby making it eligible to receive badly needed EC development aid, Luanda's refusal to accept a clause linking West Berlin to the convention had prevented accession. Angola's Bloc allies flatly reject the clause and apparently had warned the dos Santos regime against signing any agreement containing even an implied reference to West Berlin. Under a compromise solution proposed by the West Germans, Angola will sign the convention without making specific reference to Berlin. Once the agreement is signed, Bonn will send a note to Luanda stating that the German Federal Republic understands that Angola recognizes the clause. Bonn does not expect Angola to reply.

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Burmese Rice Exports Slump

According to the US Embassy, Burma's rice exports for the fiscal year ending in March are unlikely to exceed 612,000 metric tons—two-thirds the volume of the previous year. Although the 1984/85 crop was good, Rangoon is finding it difficult to meet procurement targets because farmers prefer to sell their rice on the black market at substantially higher prices. Rice exports—the leading foreign exchange earner—probably will remain depressed throughout 1985 as well. Burma, the world's fourth-largest rice exporter, has lost several traditional customers because of poor quality and high prices—Thai prices on comparable grades of rice are now $20 lower per metric ton. Rangoon over the past year has expressed concern that US rice exports under PL480 have undercut its exports, and may become even more vocal about US sales as Burmese exports decline.

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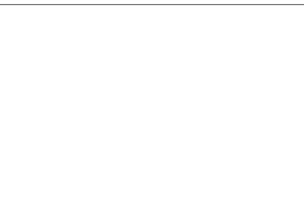
Soviet 1984 Gold Sales



The USSR sold 30 metric tons of gold in December 1984 On the basis of Soviet hard currency needs and the fall in gold prices in 1984—particularly the sharp drop in the second half—we estimate net Soviet gold sales in 1984 were probably just over 60 tons. The high December volume, however, did not represent new sales of gold shipped from the USSR. Rather, the gold was sold to offset future purchase commitments undertaken previously by gold dealers at the Soviet-owned Wozchod Handelsbank. The Swiss-national dealers were recently fired for unauthorized speculative gold trading, and the Soviet former president of the bank was recalled to Moscow to face criminal charges. It has been clear for several months that Moscow would have to take steps to offset Wozchod's purchase commitments and reduce the total cost to the Soviet financial network of the gold trading scandal.

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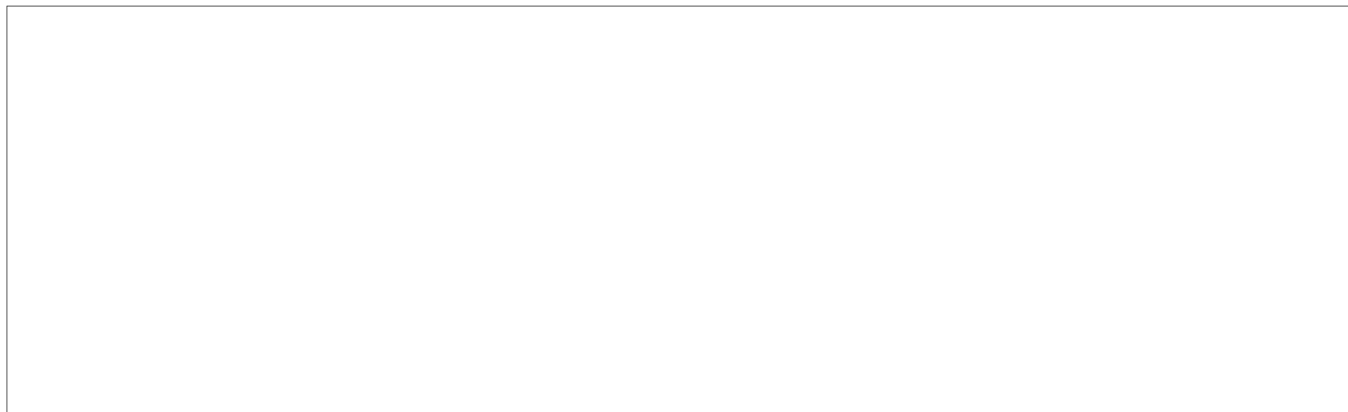

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Polish Price Hikes

Warsaw has started implementing price increases that will raise the cost of living about 3.8 percent this year. The government responded to public criticism by phasing in the increases over the next four months, reducing the planned hike in coal prices, postponing until next year increases for central heating and hot water, and boosting compensation for low-income workers. The authorities maintained rationing on all staples except flour and grain products, and increased the prices on these latter staple foods as well as milk and sugar by 20 to 70 percent on Monday. Retail prices of electricity, coal, and natural gas will rise by 20 to 30 percent on 1 April, while the most politically sensitive increases—10 to 15 percent on meats and fats—are scheduled for 3 June.

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This response to public criticism shows a lack of commitment to austerity measures that would be required for large IMF credits. Such backsliding will perpetuate imbalance in the food market and stimulate black-market activity. By yearend, the cost of subsidies probably will exceed the present 33 percent of

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the budget because prices of most staple foods will still remain 30 to 40 percent below production costs, and farm procurement prices are likely to rise again in July. Moreover, price hikes in many manufactured consumer goods are still limited to 10 percent.

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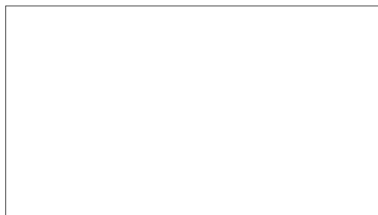
Czechoslovakia Relaxes Import Controls



The Czechoslovak Government has decided to boost imports from the West significantly this year. The policy change comes after another year of slow economic growth and government concern that the industrial sector is increasingly out of date and uncompetitive in international markets. The top priority for new purchases will be high-technology goods and machinery aimed at modernizing such key sectors as electronics and chemicals. During 1981-84, Czechoslovakia's determination to reduce its dependence on the West led to a 27-percent decline in imports from the West and a jump in the share of trade with socialist countries from 70 percent to almost 80 percent. Nonetheless, the government's desire to avoid new borrowing and to completely pay off its small hard currency debt—about $2 billion at the end of 1984—probably will limit its new opening toward the West.

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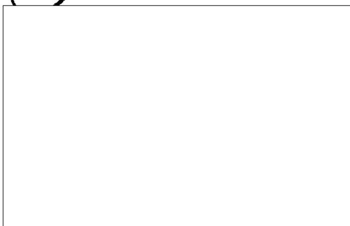
Bulgarian Weather Aggravates Energy Problems



Harsh winter weather has aggravated problems in Bulgaria's import-dependent energy system, leading to electricity outages, school and factory closings, and transportation problems. The US Embassy reports that electricity is being supplied for three-hour intervals nationwide, and long lines have formed at gas stations. According to one Bulgarian official, freezing temperatures have hampered lignite mining and slowed coal deliveries from the Soviet Union. In response, the Ministry of Energy and Raw Materials, formed in January 1984, has been redivided with former Power Supply Minister Todoriev recalled to head the new Ministry of Power Supply. An ambitious program is under way to develop domestic energy supplies, primarily by expanding nuclear and low-calorie coal facilities, but it is fraught with construction delays. Compounding Sofia's problems, Moscow is insisting on more and better quality Bulgarian food products and consumer goods in exchange for its raw material deliveries. The problems will probably lead Sofia to place a higher priority on completing new power plants, accelerating investment in energy-efficient equipment, and converting oil-burning facilities to coal and natural gas.

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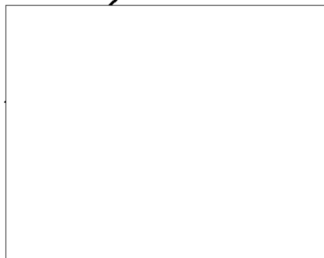
US Indirect Trade With Vietnam Increases



Preliminary Hong Kong trade statistics indicate that US exports to Vietnam through Hong Kong tripled to $1.8 million in the first six months of 1984, as compared with the same period in the previous year. The US products consisted largely of chemicals and spare parts and machinery for Vietnam's dilapidated industry but also included parcels sent by Vietnamese residents in the United States. Although the statistics suggest that US imports from Vietnam through Hong Kong—frozen seafood and raw materials—fell by a fourth to $150,000, we do not believe this indicates a sharp overall drop in US purchases of Vietnamese goods. Although most of the US products reaching Vietnam go through Hong Kong, a substantial share of US imports from Vietnam flow through Singapore.

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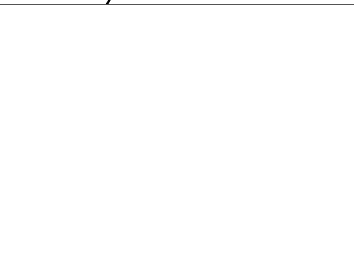
Lao Census Fuels Currency Depreciation



Fears surrounding the first nationwide census—which ended this week—contributed to a 31-percent depreciation in the black-market value of the kip in late February to 350 kip per US dollar. [redacted] the public suspects that the government has ulterior motives for the census—including confiscating property, enhancing internal security, and recalling the currency and issuing new kip. Concern was particularly evident in the countryside, according to the US Embassy, and large numbers of rural dwellers flocked to Vientiane to buy gold. In an attempt to halt the kip's slide, government officials have arrested several gold traders in Vientiane for overpricing and are increasing their supervision of exchange markets. Another further sharp drop in the black-market rate would probably make Vientiane more amenable to longstanding IMF recommendations for an official devaluation of the currency. [redacted]

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Summit Issues: Thatcher's Troubles With the Falling Pound

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The falling pound has placed Prime Minister Thatcher in a difficult political and economic situation. Despite her efforts to lay blame on external factors such as oil prices and the "unprecedented" strength of the dollar, the Labor Party is charging economic mismanagement. The cost of dollar-denominated defense programs is rising, and London's decision to support the pound by raising interest rates threatens to retard economic growth. Should oil prices fall again—which many oil experts expect—the pound is likely to continue its slide. This would further improve British industrial competitiveness in the longer term, but, if accompanied by continuing high interest rates, it would reduce real economic growth prospects. Moreover, a prolonged pound crisis might threaten the entire "Thatcher Revolution" by convincing supporters that the country is on the same "stop-go" treadmill that the Tories promised to stop.

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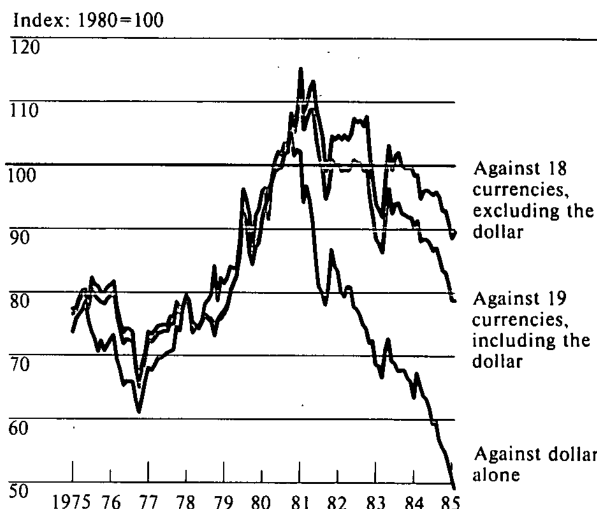
United Kingdom: Trade-Weighted Price-Adjusted Exchange Rates, 1975-85



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Exchange Rate Policy

Thatcher prefers to let the exchange markets determine the value of the pound, but, for political as much as economic reasons, she has felt compelled to act. Indeed, she recently painted her government into a policy corner by stating flatly that the pound should remain above parity with the dollar.

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In early January, in an effort to shore up the plummeting pound, the Bank of England supported the commercial banks when they raised the base lending rate a percentage point, and then the bank took the initiative by boosting the rate by 1.5 percentage points a week later.[1] Renewed weakness in oil prices, however, caused a resumption of the slide, and on 28 January commercial banks boosted their lending rates an additional 2 percentage points to 14 percent—producing the highest real interest rates in 150 years, according to the *Financial Times*. Despite such high rates, the pound touched an all-time low of $1.039 on 26 February.

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The Bank of England also has intervened in the market by selling dollars. Such intervention generally has been limited, however, and appears to have had little effect. London bankers have told our

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[1] This is the third major occasion that the Thatcher government has boosted interest rates sharply to halt a run on the pound. After the first two instances, in October 1981 and July 1984, the pound temporarily stabilized. Most interest rates, however, came back down rather quickly, returning to precrisis levels within about six months.

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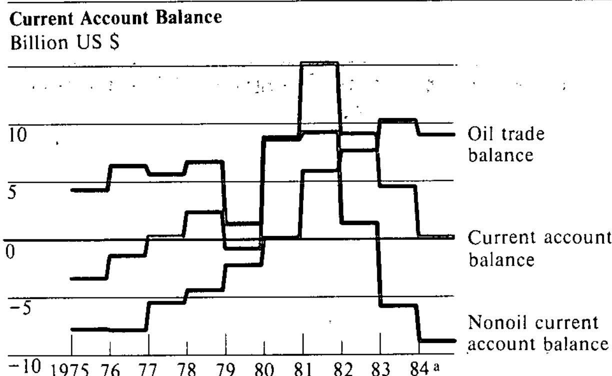
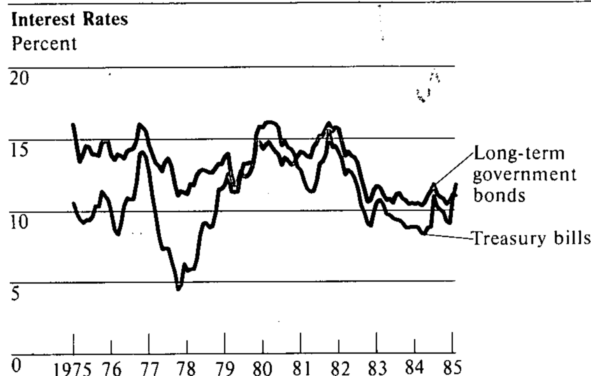
United Kingdom: Current Account Balance and Interest Rates





[a] Estimated.

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Embassy they believe there is a growing split between the Treasury and the Bank of England over the question of intervention. The Bank seems to believe that more intervention is necessary but is under pressure by the Treasury to hold back. Nonetheless, the Bank apparently intervened heavily—along with a number of other central banks—on 26 February.

Budget Consequences

The fall in the pound and the subsequent interest rate hikes will make it more difficult for the government to stay within its planned budget. Thatcher sees reduced public spending as a key to sustained economic growth, but the budget already is under pressure because of increasing outlays for unemployment compensation and the effect of the coal strike on government borrowing. Defense costs are particularly affected by the exchange rate. The pound's fall has added at least 25 percent to the estimated cost of the US-built Trident system, for example, and has forced the government to spread the cost over an additional five years. Higher interest rates will also increase other government expenditures. The US Embassy in London estimates that debt service will rise this year by almost $800 million if interest rates remain at their current levels for six months.

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Chancellor of the Exchequer Lawson added to Tory nervousness when he recently told Parliament he might have to abandon widely publicized plans to cut personal taxes by $1.5-2.0 billion this spring. Lawson has been torn between wanting the tax cut to stimulate consumer spending and fearing the cut's possible inflationary consequences. Cancellation of the promised tax cut almost certainly would fuel criticism of the government's tight fiscal policy—as well as its indecisiveness.

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Economic Consequences

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Using our Linked Policy Impact Model (LPIM), we estimate that, had interest rates remained at the late 1984 level of 9.5 percent, the fall in the pound against the dollar from $1.20 to $1.12 would have a negligible impact on GNP and unemployment in 1985 and a slightly beneficial economic impact in

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The Ups and Downs of the Pound

The pound has experienced sharp oscillations during the last decade, abetted in part by Britain's shift from being a large net oil importer to being a significant net oil exporter. After a period of relative stability in the mid-1970s, the pound began to appreciate sharply at the end of 1978 as domestic oil production rose. By first half 1981, we calculate that—on a trade-weighted and price-adjusted basis against 19 currencies—sterling had risen 43 percent above its 1975-77 average.

In 1981 the pound reversed course, and, by the end of February 1985, its trade-weighted price-adjusted value had dropped back almost to the 1975-77 average. Most of the decline has been a correction from the previous overvaluation—which seriously eroded British international competitiveness and led to an $18 billion deterioration in the nonoil current account balance between 1981 and 1984. The general strength of the dollar also has placed downward pressure on the pound. Between first half 1981 and 28 February 1985, the trade-weighted price-adjusted pound fell 27 percent against all currencies in our index but only 20 percent against currencies other than the dollar. In other words, the rise of the dollar accounts for almost one-third of the fall in the pound since early 1981.

Sterling's latest episode of weakness began in mid-December. After seeming to stabilize at about $1.20, the pound plunged nearly 8 percent in a month, reaching $1.11 on 14 January. This decline mainly reflected pound weakness rather than dollar strength because sterling fell almost as much against other major currencies. The pound weakened primarily because of uncertainty over future oil prices and growing questions about London's resolve in fighting inflation. The coal strike also was a contributing factor—we estimate that reduced coal output and increased oil imports were costing Britain $5 billion at an annual rate in forgone foreign exchange earnings.

1986. The immediate impact would be mixed because the lower pound would raise import prices, thus reducing real consumption spending, but also would increase exports somewhat as British goods became more competitive. The longer run effect—again assuming unchanged interest rates—would be clearly positive because British consumers would over time lower spending on higher priced imports and increase spending on relatively lower priced domestically produced goods. Also, the competitive advantage reaped on the export side would boost sales abroad.

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London's efforts to halt sterling's decline by raising interest rates, however, could more than offset these potential gains. If rates stay up for more than a few months, GNP growth this year is unlikely to reach the 3.1 percent widely forecast before sterling fell below $1.20. We estimate that, if interest rates are maintained at the present level of 14 percent through 1986, GNP growth will be slower both this year and next because of sharply reduced growth of private consumption and investment. A substantial improvement in the current account probably will be insufficient to offset these negative effects on GNP.

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Political Impact of the Falling Pound

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Thatcher has said that the value of a nation's currency reflects a country's basic strength, a notion her opponents are already throwing back at her. She also has often indicated that Britain's economic problems are domestically produced and must be domestically resolved, but she is frustrated by the weak pound, which she holds is at least partly due to the strong dollar and thus is beyond her control. On 31 January, the Labor Party moved to censure the government's handling of the economy, but the motion failed by a wide margin.

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Government efforts to support sterling, especially if made for a prolonged period, run against Thatcher's conviction that the government should

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United Kingdom: Economic Impact of a Weak Pound and High Interest Rates [a]

Percentage point change from baseline scenario

	Case I Weak Pound With Stable Interest Rates		Case II Weak Pound With Higher Interest Rates	
	1985	1986	1985	1986
Real GNP growth	−0.1	0.2	−0.6	−0.7
Of which:				
Private consumption	−1.8	−0.4	−2.9	−2.5
Government consumption	−0.1	−2.4	0.3	−1.4
Investment	−0.6	0.1	−1.8	−2.1
Exports	0.9	1.2	0.8	1.0
Imports	−2.6	−1.6	−3.8	−3.7
Unemployment rate	0	−0.1	0.1	0.2
Inflation (consumption deflator)	1.8	1.1	1.6	0.8

[a] Simulation using CIA's Linked Policy Impact Model (LPIM). In the baseline scenario the pound and short-term interest rates are set at their late 1984 levels—$1.20 and 9.5 percent, respectively. In case I the pound is lowered to $1.12, with no change in interest rates. In case II the pound is kept at $1.12, and short-term rates are raised to 14 percent.

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not attempt to solve problems better left to market forces. Both Thatcher and Lawson, in answer to critics who demand greater public spending to alleviate unemployment, have claimed that market forces are ultimately the most effective means by which inefficient industries can be reformed and the economy lifted from its long malaise. Thatcher has also argued that, however painful in the short term, her policies are the only realistic way of dealing with long-term problems. The recent weakness of the pound is being portrayed by her opponents as a direct challenge to both notions. Yet failure to act could revive speculation that the government does not care how fast or far sterling drops, something that Thatcher has said is not the case.

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The plight of the pound also undercuts Thatcher's claim that she is leading Britain to a painfully achieved but lasting improvement in the economy. Pound crises, and subsequent interest rate hikes and budget cuts to "restore confidence," have been an all too familiar episode in postwar British history. The current situation could persuade voters who supported Thatcher in 1979 and 1983 that, despite brave rhetoric, the country is on the same treadmill that the Tories promised to stop.

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Latin America: [1] Tenuous Economic Gains

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The big Latin American debtors—Brazil, Mexico, Venezuela, and Argentina—probably will avoid serious payments difficulties this year, but the others remain vulnerable to serious financial disruptions that could further reduce living standards and aggravate political strains. Improved creditor/debtor relations, however, have reduced the likelihood of unified action by Latin American debtors and have calmed fears about certain debtors. We nevertheless remain concerned about potential confrontations if creditors begin to view debtor austerity programs as inadequate and stiffen their terms for restructuring debt and providing new money.

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Financial Adjustment in 1984

Economic adjustments under IMF-supported programs enabled the region to reduce its current account deficit last year by 63 percent from 1983 levels to $2 billion. Preliminary government statistics indicate that the major Latin American debtors increased their combined trade surplus 19 percent to $38 billion on the strength of higher exports. On a country basis, however, the improvement was uneven:

- ***Brazil*** doubled its trade surplus to a record $13 billion by increasing industrial exports—particularly to the vigorous US economy—and cutting imports.

- ***Argentina's*** trade surplus grew by one-fourth to $4 billion as both agricultural and manufactured exports rebounded.

Latin America: Balance of Payments, 1983-85 *Billion US $*

	1983	1984	1985
Current account balance	−5.4	−2.0	−6.4
Trade balance	32.3	38.3	38.1
Exports	78.9	87.5	90.5
Imports	46.6	49.2	52.4
Services and transfers	−37.7	−40.3	−44.5
Of which:			
Interest payments	33.3	39.2	39.1
Capital balance	0.3	8.7	2.1
Of which:			
Principal payments	13.1	12.4	13.6
New borrowing	38.2	39.8	25.7
Changes in international reserves	−5.1	6.7	−4.3

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- The oil economies—***Mexico, Venezuela,*** and ***Ecuador***—posted a 3-percent drop in their combined trade surplus to $22 billion, because increased imports more than offset marginally higher oil exports.

- The ***Andean debtors'*** trade surplus almost evaporated, reflecting depressed world commodity prices and modest import growth.

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General adherence to IMF-supported adjustment programs and the export rebound improved creditor confidence, enabling several countries to attract new financial support. On the basis of bank and financial press reports, we estimate that foreign

[1] In this article Latin America includes only the major debtors: Argentina, Brazil, Bolivia, Chile, Colombia, Ecuador, Mexico, Peru, and Venezuela.

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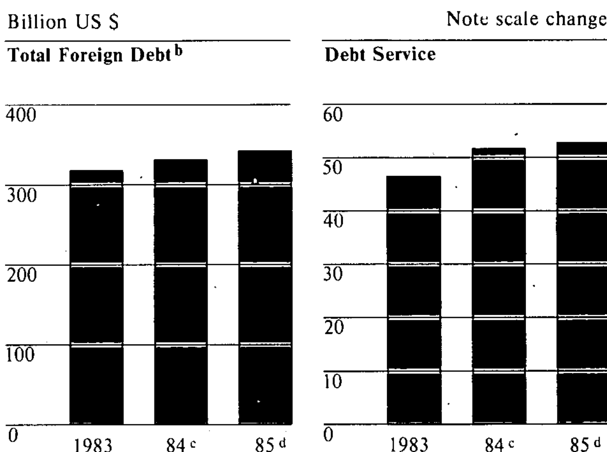
creditors provided $40 billion of gross lending to the region, 4 percent more than in 1983. They provided large-scale new loans and rolled over existing credits in support of Brazil, Chile, and Mexico and restored short-term credit lines to most countries. Moreover, the IBRD cofinanced some of the first voluntary long-term bank loans to Latin America since 1982 in Colombia, Brazil, and Paraguay. Financial stress eased as the region rescheduled maturing debt and added about $7 billion to foreign exchange reserves.

Cooperation between creditors and debtors steadily improved after midyear, when interest rates began to decline. Instead of urging a debtors' rebellion, Latin American finance and foreign ministers expressed moderate views at the June debt conference at Cartagena, Colombia. To encourage continued moderation and to support long-run economic adjustment, bankers negotiated provisional multiyear reschedulings with Mexico, Venezuela, and Ecuador. These agreements, in turn, helped restore confidence within the region and reduce capital flight in most countries.

Latin America[a]: Total Foreign Debt and Debt Service, 1983-85



[a] Includes data for Brazil, Mexico, Venezuela, Argentina, Colombia, Chile, Peru, Ecuador, and Bolivia.
[b] Short-, medium-, and long-term debt.
[c] Estimated.
[d] Projected.

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A Turning Point?

Although the overall debt repayment bill rose 11 percent to an estimated $52 billion in 1984, export recovery held the debt service ratio at 59 percent. A variety of sources indicate that several countries—notably Brazil and Mexico—were able to reduce arrearages and maintain near-normal interest payments. In contrast, Argentine and Venezuelan interest arrearages grew, as did those of the smaller debtors—notably Bolivia and Peru.

Financial gains and export-led growth—supported by a general increase in agricultural production—halted the erosion of living standards in Latin America in 1984. We estimate that the region's economies expanded 2.6 percent last year—after having declined 3 percent in 1983—and all major debtor economies grew except Venezuela's and Bolivia's. We believe that gains in employment—although limited—helped Argentina, Brazil, Chile, Peru, and Colombia deflect domestic pressure for extreme debt action.

Economic Progress Tested

We expect Latin America's current account deficit to increase to over $6 billion this year as the trade surplus declines and as the balance on services and transfers continues to deteriorate. Most large debtors will face slower growth in manufactured exports because OECD economic activity is likely to moderate and protectionism probably will mount in developed countries. The Latin oil exporters face the prospect of reduced prices in a deteriorating oil market, and the Andean debtors—dependent on agricultural and mineral sales—expect the strong dollar and worldwide deflation to hold down commodity prices. At the same time, despite slower export growth, Latin American officials have plans to stimulate economic expansion that call for increased imports.

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The region's recovery plans will tend to conflict with the continued need for adjustments to resolve serious economic imbalances. The political pressures for growth will be especially strong in Brazil, Mexico, Peru, and Uruguay, where leaders face heightened popular expectations of improved living standards. Even if global interest rates continue their moderate decline, Latin American debt servicing payments will increase to $53 billion because the stock of debts is growing. Thus, as export growth wanes, the servicing burden will become more onerous, and growth and employment probably will suffer. Should Latin leaders attempt to protect growth through deficit spending, they would jeopardize the cooperation of lenders that is essential to economic reform.

Prospects for the Region

We expect the large debtors will avoid serious financial strains this year, although temporary setbacks are likely. Financial press reports indicate that Brazil, Mexico, Venezuela, and Argentina probably will receive the bulk of new lending to the region—estimated at about $10 billion—after reaching formal agreement with bankers on their debt restructuring packages. Mexico expects its restructuring program to be formally implemented in April, and Venezuela probably will conclude a multiyear rescheduling later in the year after assuring creditors that private-sector debt will be serviced on schedule. Brazil, Mexico, and Argentina, however, are encountering difficulties complying with IMF monetary, inflation, and fiscal targets that could jeopardize their provisional debt agreements. Nevertheless, we judge that the three countries will conclude formal debt agreements with creditors this year.

The financial problems of the smaller debtors, however, could prove serious:

- ***Chile*** must overcome banker resistance to providing $1.2 billion of new credit, without which it faces the possiblity of severe recession at a politically sensitive time and the disruption of debt servicing.

- ***Peru's*** resistance to stabilization measures and mounting interest arrears probably will prevent any agreement for new funding from the IMF or bankers before the inauguration of a new president in July. This probably would force US banks to downgrade Peruvian loans.

- ***Colombia*** needs over $1 billion of new money during 1985-86 but continues to refuse creditor demands for an IMF program. Without renewed financial support or adequate reserves, debt payment disruptions could occur in the second quarter of 1985.

- ***Bolivia*** probably will not resume interest payments suspended since last summer—despite legal action by creditors—because political uncertainty and severe financial problems, including hyperinflation, have hurt its debt servicing capability.

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Debtor Response

Despite the potential for some serious debt payment disruptions, US Embassy and press reporting indicate that support for unified regional action against creditors is dwindling. The Cartagena group again resisted radical proposals—such as tying debt service to exports or capitalizing interest payments—at its February meeting in Santo Domingo. Instead, Latin Americans called for increased financing on easier terms through existing multilateral channels and for a political dialogue with creditor countries. we judge that the Cartagena group will maintain this position and will probably only support positions that do not interfere with bilateral renegotiation of foreign debt.

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We believe, therefore, that Latin debtors will continue to deal individually with creditors and that most of the region's leaders will remain willing to honor debt obligations. Nevertheless, we judge that Latin officials will increasingly view financial problems in political terms and consequently intensify

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Latin America: Foreign Debt, 1984 [a]

Billion US $

	Total Foreign Debt	US Bank Debt
Latin America	**331.6**	**84.0**
Brazil	100.2	23.6
Mexico	95.9	26.6
Argentina	46.0	8.2
Venezuela	32.6	11.0
Chile	20.6	6.7
Peru	13.5	2.4
Colombia	11.9	3.0
Ecuador	7.1	2.2
Bolivia	3.8	0.3

[a] Estimated.

demands for easier stabilization programs and long-term restructuring arrangements similar to those negotiated by Mexico and Venezuela last year. Creditor concessions, however, may encourage debtors to opt for patchwork adjustment policies that placate domestic critics and also heighten vulnerabilities to financial stress points.

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This case-by-case debt strategy can temporarily succeed in the absence of external shocks and with continued banker flexibility in dealing with short-term financial strains. In the most likely scenario, creditors will reward good faith efforts at economic adjustment with long-term reschedulings, structural adjustment loans, and loans cofinanced with multilateral institutions. Such policies will encourage structural reform and lighten the debt burden. We remain concerned that a sharp oil price drop or a sudden interest rate jump could significantly increase external payments strains for many Latin debtors. Moreover, creditors may take a hard line with debtors—such as Bolivia and Peru—that resist stabilization measures. In this unlikely case, we foresee the rescue programs fracturing—accompanied by prolonged payments suspensions. The likely proliferation of nationalistic policies would only postpone the adjustment measures needed to restore investor confidence and stabilize growth.

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Implications for the United States

We believe that Washington increasingly will be pressed for financial concessions. Although the US trade deficit with the region widened in 1984—by one-third to $20 billion—this will not blunt demands for increased access to US markets. US monetary and fiscal policies are a likely target of Latin criticism, especially if interest rates should rise further. Moreover, Latin Americans probably will press the United States to intervene with the IMF and commercial banks to provide innovative debt relief and to encourage more lending.

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Indonesia: More Austerity in Store

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President Soeharto's recently announced budget underscores Indonesia's continuing adjustment to less buoyant economic prospects. We believe Jakarta has sufficient financial and policy options to withstand another modest decline in oil prices without extreme austerity measures but would face very tough choices if oil prices were to drop precipitously. The budget calls for overall spending restraint to avoid an external payments crisis, while shifting priorities to stimulate domestic demand.

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Fragile Recovery in 1984

Indonesia achieved about 5-percent growth in 1984 largely because new production facilities boosted liquefied natural gas output more than 30 percent. In addition, good weather helped produce another record rice crop, and Jakarta boosted oil export volumes sufficiently to offset declining prices. Primary product exports turned in a strong performance early in the year, but slowed later as foreign demand sagged. Manufacturing grew only 4.8 percent—far below the government's 9-percent target—largely because lower personal incomes and government spending cuts restrained domestic demand.

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Nonetheless, the government recorded a number of significant financial achievements last year:
- Foreign exchange reserves rose to nearly $10 billion ($5.7 billion in official reserves and $4.3 billion in foreign assets of the banking system), up from $7.3 billion in mid-1983.
- Inflation was held below 9 percent despite a 28-percent devaluation in April 1983 and further depreciation of the rupiah in 1984.
- Jakarta made another cut in the current account deficit from the record $7.1 billion deficit of 1982.

The key to cutting the deficit has been Soeharto's willingness to hold the line on public-sector construction to reduce foreign exchange expenditures. The 1983 rephasing of the $21 billion industrialization program, for example, is expected to cut imports by some $10 billion over a period of several years.

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The Economic Scene in 1985

Oil Earnings Soft. The persistent world oil surplus threatens to reduce Indonesia's annual export earnings by $300-400 million for each $1 drop in the official OPEC price. Jakarta is already exceeding its OPEC production quota by at least 100,000 b/d and has little additional capacity to expand exports. LNG exports will not repeat the 1984 performance because no new facilities will come on line. Furthermore, any drop in official oil prices translates into a comparable fall in LNG revenues because LNG prices are tied to Indonesia's official oil export prices.

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While Investment Problems Are Rising. Declining oil prices and signs of hardening nationalism are certain to further cool the investment climate this year. Spending on exploration by foreign oil companies, which exceeded $1 billion annually in 1982 and 1983, fell below $900 million in 1984 and shows no sign of recovery. Manpower Minister Sudomo conducted campaigns throughout 1984 to investigate expatriate employees, found numerous violations of regulations, and deported a number of foreign workers. A precipitous drop in private domestic and foreign investment applications in the first half of 1984, however, led Soeharto to order Sudomo to relax his efforts and to reaffirm the

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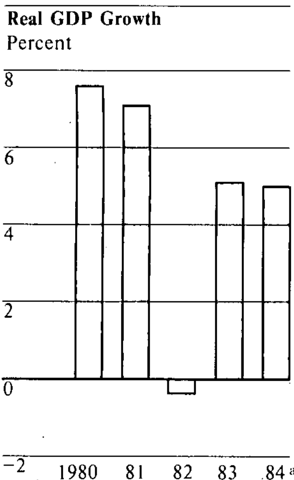
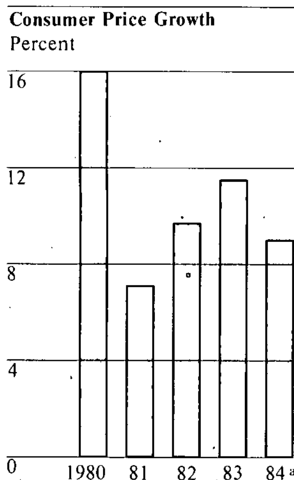
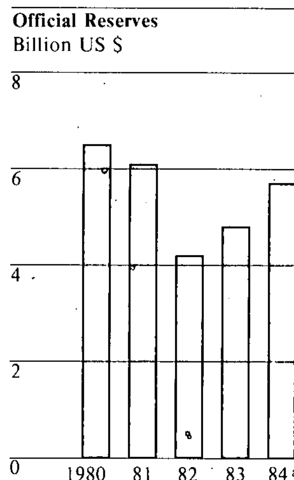
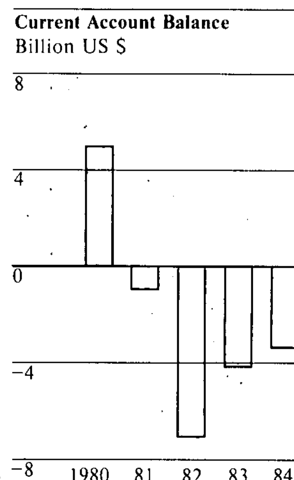
Indonesia: Economic Indicators, 1980-84

Note scale change









[a] Estimated.

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authority of BKPM (the Capital Investment Coordinating Board) to issue work permits. Other barriers, however, are still deterring potential new investors, such as the elimination of tax holidays, uncertainty over other tax revisions, generally poor market prospects, traditional bureaucratic obstacles, and a wave of antigovernment violence and suspicious fires and explosions in Jakarta and other major cities.

And Other Options Offer Limited Gains. Efforts to reduce dependence on oil exports by increasing traditional nonoil exports, developing new manufactured exports, and opening up new markets have had limited success so far. The Indonesians had adopted a countertrade program in 1982 to boost sales of depressed primary products to nontraditional markets. Jakarta so far has signed countertrade deals worth only about $500 million and has actually exported less than half that amount.

Jakarta has already run into problems in boosting manufactured exports, primarily textiles and plywood. Import quotas under the Multifiber Agreement are slowing Indonesia's penetration of foreign textile markets—particularly the US market—after explosive growth from 1980 through 1984. In addition, US textile producers are seeking countervailing duties on Indonesian apparel to offset alleged export subsidies, an issue that has caused serious frictions between Jakarta and Washington. Similar frictions have arisen between Jakarta and Tokyo over Japanese import duties on Indonesian plywood.

Even with lowered expectations, Jakarta's revenue projection for the fiscal year beginning 1 April appears overly optimistic. The proposed budget

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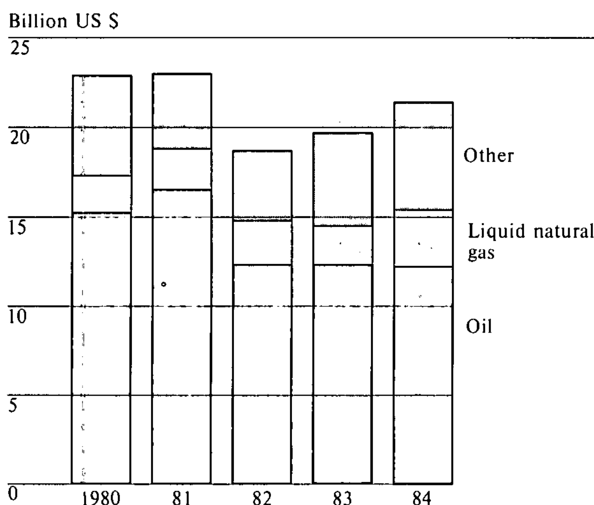
Indonesia: Exports, 1980-84



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calls for a 6-percent nominal increase in oil revenues that government officials claim results from an expected modest depreciation in the exchange rate. The budget is also projecting a 30-percent increase in nonoil revenues based on introduction of a new value-added tax on 1 April and substantial broadening of the income tax base. With less than 750,000 registered taxpayers in a nation of nearly 170 million, Indonesia's income tax base is among the lowest in Asia. As one of the major income tax revisions introduced last year, Jakarta offered a pardon for new taxpayers to register by December 1984, and has now extended the amnesty to June 1985. Given the past performance of Indonesia's cumbersome bureaucracy and the lack of trained personnel to administer the income and value-added tax programs, prospects for achieving the government's tax revenue goals are not bright.

Policy Initiatives

Soeharto is moving vigorously to improve economic management. He has shaken up the leadership of BKPM in an effort to reinvigorate the investment climate. In addition, he has replaced the president of the state oil company, Pertamina, as well as the director general of Oil and Gas in the Ministry of Mines and Energy, in order to improve the financial and marketing management of Indonesia's most important resource. Both of the new oil industry officials initially won high marks, but continuing problems have convinced some foreign oil companies that Pertamina's new president has not yet gained full control. In any event, we believe powerful figures close to Soeharto are unlikely to yield total control over Pertamina's finances.

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Soeharto's new budget reflects his determination to hold down expenditures. The proposed 12-percent growth in spending is less than half the increase budgeted for the fiscal year just ending, and represents less than 3-percent real growth if inflation remains at last year's level. Within the overall budget, spending priorities reflect Jakarta's concern with stimulating domestic demand by boosting personal incomes through 20-percent pay raises for the military and civil servants and even larger increases for pensioners. At the same time, capital spending is to rise only 2 percent in nominal terms as the government holds the line on the public-sector projects shelved in the 1983 rephasing program. As in the past, the government probably will slow capital spending further if revenue shortfalls threaten to unbalance the budget.

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Jakarta, meanwhile, is exploring opportunities to boost foreign exchange earnings in trade with Communist countries. High-level trade delegations visited the USSR and Eastern Europe in 1984 and signed trade and cooperation agreements with several of them. Jakarta also has made preparations to

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resume direct trade with China, which had been broken off since Soeharto came to power in the aftermath of the Communist coup attempt in 1965.

Difficult Times Ahead

We believe Jakarta will be hard pressed to maintain this year the 5-percent growth rates achieved in 1983 and 1984. The current disarray within OPEC suggests that even lower oil prices may be in the offing, further dampening prospects for oil and LNG earnings. Growth of nonoil exports—either traditional primary products or newer manufactured goods—is dependent in large part on conditions beyond Indonesia's control.

The drop in private investment, along with the government's spending reductions, reduces even further the already poor prospects for creating jobs for the expected 2 million new job seekers this year. Jakarta will have to continue relying on the informal sector such as pedicab driving, street vending, and similar personal services—essentially forms of underemployment. The government will also have to bank on continuing good fortune in agriculture, including another bumper rice crop, to provide a cushion both for employment and subsistence for the rural population.

On the plus side, Jakarta's successful adjustment to the oil glut and its conservative attitude toward foreign debt have avoided an external payments crisis and have left the government a range of policy options to deal with a modest drop in oil prices. Although none of the choices are attractive to government policymakers, and all promise negative economic or political effects, Jakarta still has a sufficient financial cushion to keep the economy growing at least modestly without incurring an unmanageable foreign debt. In addition to substantial foreign exchange reserves, the government has substantial lines of unused credit and could impose import restrictions on consumer luxury items or on capital goods through further project rephasing. The government could also devalue the rupiah further to spur nonoil exports and slow imports.

If oil prices were to plunge, however, Jakarta would face a prolonged period of slower growth and higher unemployment that seem certain to intensify social discontent. Jakarta might find it necessary to reverse long held economic policies such as free convertibility of the rupiah and repatriation of earnings, which have been hallmarks of the Soeharto government's development strategy.

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Eastern Europe's Food Situation: Problems Persist

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Over the past three years East European consumers have seen an erosion of many of the qualitative and quantitative gains in food supplies achieved in the 1970s. Import restraints, increased food exports, below-average output of many nongrain crops, and problems in state procurements from farmers have more than offset impressive gains in grain production. Government efforts to alleviate food supply problems through rationing and by raising food prices have increased consumer grumblings. Last year's record grain harvest and improved output of many nongrain crops will provide some relief in 1985, but problems will persist, particularly in Poland and Romania.

Recent Belt-Tightening

Measures to limit domestic demand for food were introduced by all East European regimes in the early 1980s, but they have had the greatest impact in Poland and Romania. Warsaw started to ration meat, flour, milling products, butter, and chocolate in February 1981 and announced price hikes—averaging 150 percent—in February 1982, followed by smaller increases for selected items in 1983 and 1984. Romania began rationing a broad range of foods in the fall of 1981 and raised food prices by an average of 35 percent in early 1982. Following 1983's poor grain harvest, Bucharest reduced rations for meat, flour, milk, cooking oil, and sugar.

The effect on consumers has been evident. The share of Polish workers' total expenditures going to food rose from 36 percent in 1980 to 43 percent in 1984. Per capita meat consumption in Poland fell from 74 kilograms in 1980 to an estimated 55 kilograms in 1984, near the level of consumption in 1971. Per capita consumption of meat in Romania, already one of the lowest in Eastern Europe, declined 24 percent from 1980 to 1983 to roughly 34 kilograms. In most other East European countries food prices have increased faster than overall retail prices and personal income.

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Improved Prospects for 1985

Last year's record grain harvest of 109 million metric tons and improved output of many nongrain crops will provide some early relief to consumers, except possibly in Romania. Most countries face higher food prices, but shortages will be largely confined to luxury foods—spices, coffee, chocolate, and citrus.

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Polish consumers should see the greatest improvement in food supplies this year, but they will pay higher prices. Last year's record grain harvest of 24 million tons was Poland's third consecutive above-average crop. Moreover, higher procurement prices have increased sales of grain to the state by nearly 11 percent. An above-average harvest of rye and record output of rapeseed should permit increased exports, generating hard currency for the purchase of other foodstuffs and permitting an increase in rye-for-wheat barter with the USSR. Dairy product supplies will also improve. Despite improved feed supplies and better price incentives for farmers, the slow recovery in livestock numbers will limit the planned growth of meat output to only 1.1 percent in 1985, an improvement over last year, but still below the depressed 1983 level.

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Warsaw had announced plans to raise food prices in March 1985.[1] Following criticism by official

[1] In January Warsaw issued three proposals for public discussion ranging from large price hikes and an end to rationing (except for meat and chocolate) to smaller price rises with most rationing continued.

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Eastern Europe: Measures To Deal With Food Supply Problems, 1981-84

	Major Food Price Increases	Formal Rationing	Comments
Bulgaria	May 1983—meats up 23 percent, citrus up 35 percent, local beverages up 28 percent	No	May 1983 decree against hoarding bread and flour issued; increases blamed on drought; seasonal prices and 10-percent consumption tax introduced in restaurants.
Czechoslovakia	January 1982—meat up 27 percent, rice up 100 percent, tobacco up 39 percent, wine up 18 percent October 1984—beer prices doubled	No	Meat prices had previously remained fixed at 1953 levels when consumption was half current level. Meat consumption down 10 percent in 1982.
East Germany	January 1984—major price increases for selected luxury foods	No	Prices for a few basic foods remain fixed at 1960's level; increases in prices of other food items are unannounced and occur regularly.
Hungary	June 1981—meat up 10 percent August 1982—bread, flour, bakery products up average 20 percent; citrus up 25 percent May 1983—sugar up 23 percent, cooking oil up 20 percent, bread up 16 percent January 1984—meat and meat products up 21 percent; poultry and fish up 10 percent	No	1982 price increases needed to maintain balance between production and consumption and to reduce subsidies. Increases in 1984 ostensibly attributed to drought in 1983.
Poland	February 1982—food prices up average 150 percent, pork up 325 percent, sugar up 340 percent, coffee up 40 percent January 1984—prices up average 10 percent	February 1981—meat, sugar, fats, chocolate, butter, flour, and rice rationed	In early 1982 meat rations cut to 2.5 kg per month. Promises to end "temporary" rationing have gone unfulfilled.
Romania	February 1981—food prices up average 35 percent, meat up 64 percent October 1983—prices raised for bread and dairy products	October 1981—ration decree issued, consumers restricted to specified markets 1982—broader rationing of bread, flour products, rice, sugar, and cooking oil 1984—meat and flour rations reduced	Rationed items and levels differ locally; problems worsened by large cuts in imports, poor harvest in 1983. Private transportation of foodstuffs within country forbidden; restrictions on sale of privately produced foodstuffs.
Yugoslavia	September 1982—sugar up 18 percent, cooking oil up 17 percent, margarine up 18 percent February 1983—fresh meats up 31 percent, basic agriculture produce up 22 percent	February 1983—coffee and cooking oil temporarily rationed in Belgrade and other areas	Problems exacerbated by high inflation, difficulties in procuring grain from private farms, and poor producer price incentives.

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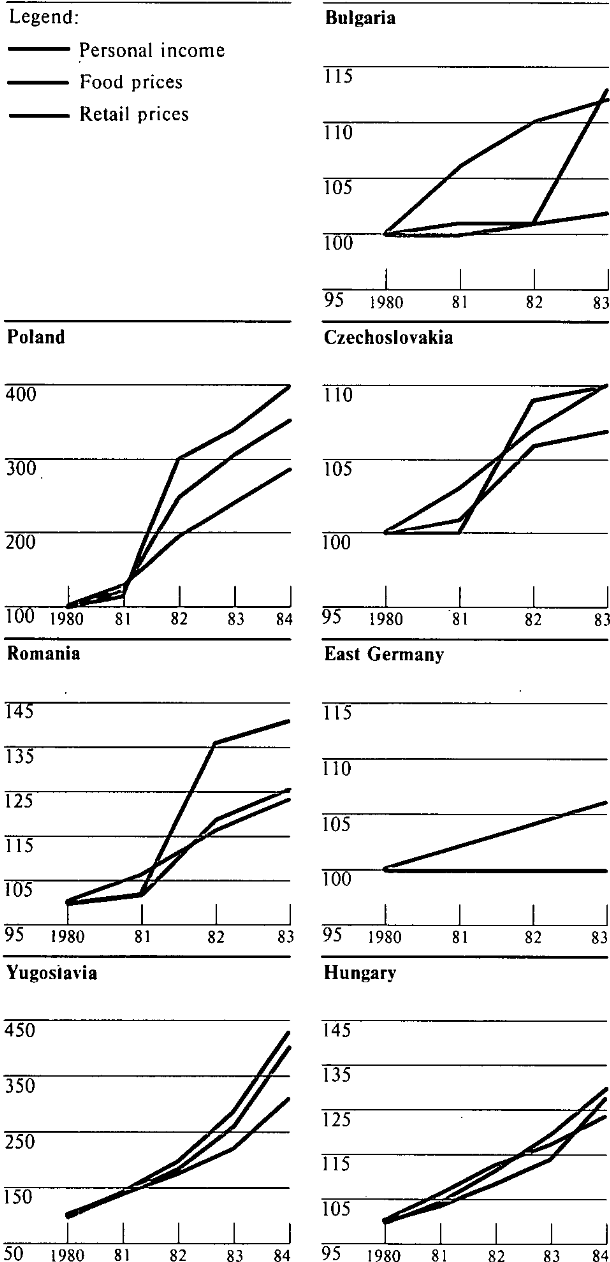

trade unions and the banned "Solidarity," however, the government recently announced that price increases and selective curtailment of rationing would be implemented in three stages beginning this month. Officials have stated that price increases are necessary not only to limit demand, but also to avoid increases in food subsidies resulting from higher procurement prices put into effect last July.

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Romania's prospects for any significant improvement in food supplies in 1985 appear bleak. We estimate last year's grain output was up slightly from 1983, but still almost 1 million tons below the 1978-82 average. Official data show that 1984 goals for corn, potatoes, vegetables, and fruits were exceeded, and meat and dairy production was up. Past experience, however, suggests that such claims may be exaggerated.

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Any gains in 1984 will not benefit consumers significantly unless imports of grain, feedstuffs, and food are increased, exports curtailed, and greater priority given to domestic consumption—none of which is likely to occur. With Bucharest's emphasis on reducing its hard currency debt, we believe further cuts in agricultural imports are likely and that priority will be given to increasing, or at least meeting, export commitments.

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In the rest of Eastern Europe:

- Consumers in ***Hungary*** should be best supplied in 1985 thanks to last year's recovery in both the crop and livestock sectors. Sharply higher prices for many foods will be only partially offset by increased wages and benefits.

- Consumers in ***East Germany*** will benefit from last year's record grain harvest and good potato crop. Supplies of meat, milk, and eggs should rise, and increased subsidies will hold prices of many basic foods at mid-1960s levels.

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Record Grain Production, Declining Food Supplies

Grain production is the primary determinant of total food supplies in Eastern Europe, but other factors play an important role. Despite the region's three consecutive above-average grain harvests, food availability declined sharply in 1981-84 as a result of the following:

- *A 17-million-ton increase in domestic grain output from 1981 to 1984 was partially offset by a 7-million-ton decline in imports.*
- *Poor output of many oilseed crops and a falloff in sugar beet production led to rationing of cooking oil and sugar in some countries.*
- *Below-average output of many domestic forage crops, including potatoes, reduced total feed supplies and led to a decline in livestock output.*
- *Lower imports of high-protein feeds diminished the effectiveness of other livestock feeds, primarily grain, partially offsetting increases in grain output.*
- *In Poland and Yugoslavia, where the private sector is the main supplier of agricultural products, difficulties in procuring grain because of unfavorable pricing policies resulted in shortages of state feed supplies at a time of record grain output.*
- *The quality and diversity of domestic grain output was not always sufficient to meet grain requirements for either food or livestock use.*
- *Financial problems curtailed imports of luxury foods such as coffee, tea, and citrus.*

- In ***Czechoslovakia***, a 3.5-percent upturn in agricultural output and a record 1984 grain harvest should allow continued improvement in livestock output. Price increases for milk and milk products are rumored, however.
- ***Yugoslavia's*** excellent grain crop in 1984 should reduce wheat imports sharply and allow for increased exports of corn to generate hard currency for the purchase of other agricultural goods. The current surplus in meat supplies—because of falling domestic consumption caused by higher prices and dwindling export demand—could change abruptly if cattle raising remains unprofitable and producers reduce herds.
- ***Bulgaria's*** below-plan output of corn, sugar beets, sunflowers, and potatoes last year, following the poor harvest of 1983, will limit livestock output and could force additional imports of grain, vegetable oils, and sugar. Market supplies may tighten, but Bulgarian consumers will still fare relatively well.

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Consumer Discontent

Unusually tight supplies of luxury foods and meat during the past holiday season and rumors of higher prices heightened popular discontent throughout the region. Even where severe shortages have not occurred, availability and selection have often been less and prices higher relative to past years. In many instances, however, consumer dissatisfaction appears out of proportion with actual declines in availability, suggesting sensitivity to any perceived drop in living standards and impatience over government failures to live up to previous commitments.

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Although complaints will continue, we see little potential for political fallout from food supply problems except in Romania and possibly Poland. The East European regimes have defused troublesome situations in the past by releasing food from state stocks and in a few instances by allowing additional imports of selected food items. Most governments will likely sweeten the pill of higher prices by ending rationing where feasible, improving social benefits, and selectively increasing wages.

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Polish consumers will be the most vocal in registering their complaints. Although the gap between past and current levels of supply will remain large, particularly for meat, we do not foresee serious unrest. Increases in procurement prices are likely in July, adding to retail price pressures. Nonetheless, Warsaw is expected to remain cautious about upsetting public opinion even if it means increased food subsidies.

The situation in Romania will remain more uncertain. If Bucharest permits market supplies to improve or at least stabilize, the situation could remain quiet. Having experienced the major price and rationing shocks of 1981-82, Romanian consumers may be resigned to their present lot and preoccupied with just "getting by" on a daily basis. Some evidence suggests that an increase in second economy transactions, private arrangements made through contacts and relatives in the country, and bargains with store clerks and restaurant employees have helped ease decreased food availability in state outlets. If, on the other hand, Bucharest decides to squeeze the consumer even harder, or a sharp downturn in agricultural output in 1985 reduces food supplies still further, there would be greater potential for unrest.

Longer Term Outlook

Reduced Expectations. The problems of the past few years have led East European regimes to postpone or at least scale back future commitments for an improved diet. Polish and Romanian officials have been candid in warning consumers that expectations must be lowered, particularly with regard to meat consumption. Romanian President Ceausescu has even chided consumers for overindulging in daily caloric intake, despite the decline in the quality of their diet over the past three years. In Poland per capita meat consumption is planned not to exceed 63 kilograms by 1990, compared with 74 kilograms at the beginning of this decade. Even Czechoslovakia, which faces few financial difficulties, has announced that the target for meat consumption will be reduced to enable the country to become self-sufficient in grain. Most countries are counting on increased consumption of dairy products to compensate for the drop in meat consumption. Such changes will be difficult and involve extensive propaganda and educational efforts.

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Higher Food Prices. Consumers will face more frequent price hikes as the regimes continue to dampen or redirect demand and reduce sizable budget outlays for food subsidies. Food price policies of most counties will fall between those of Hungary, which is trying to make prices reflect more closely the true cost of production, and those of East Germany, which continues to hold prices of many basic food items at the level of the mid-1960s. Prices of imported luxury foods are likely to rise the most, prices of staple items such as bread and flour the least. Although meat is one of the most heavily subsidized foods, most regimes probably will be more cautious about increasing meat prices because supplies and prices are a sensitive issue with consumers. Any shortfalls in domestic output that result in increased imports could lead to sharply higher food prices. In fact, a downturn in output attributable to bad weather—even if not very severe—would provide a ready excuse for additional price hikes.

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Sub-Saharan Africa: Coping With Economic Adjustment [1]

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Efforts at economic adjustment by the Sub-Saharan African countries have produced some modest gains and, if maintained, hold the promise for major restructuring of the region's economies over the longer term. Most countries have had to enlist IMF financial support over the past several years to deal with foreign payment problems and lagging growth in their hard-hit economies. Under IMF-supported programs, governments in the region have been encouraged to implement reforms on exchange rates, taxes, government spending, and state control of the economy. Although there are no resounding success stories, countries such as Ghana, Senegal, Togo, and Zaire have persevered in their programs and made some progress. In contrast, economic mismanagement in Liberia and Tanzania has created obstacles for continued IMF support, and Nigeria's go-it-alone reform program has failed to stem the economic decline resulting from plunging oil revenues.

Causes of Economic Problems

The economic problems of Sub-Saharan Africa reflect several years of adverse factors:

- The two oil price shocks of the 1970s.
- Commodity prices collapsed in 1978-80 and have only recovered moderately since then.
- Continued dependence on agricultural and mineral exports.
- Inadequate price incentives for agricultural production, overvalued foreign exchange rates, troublesome budgetary deficits, and inflationary monetary expansion.
- The worst drought in decades has ravaged the region for the past two years and created widespread food shortages and, in extreme cases, famine.

[1] This report covers all countries on the continent except Algeria, Egypt, Libya, Tunisia, Morocco, and South Africa, plus the islands of Comoros, Madagascar, and Sao Tome and Principe.

Their Impact

The economic impact of these factors on the Sub-Saharan African countries has been severe. Excluding the oil-exporting nations of Congo, Gabon, and Nigeria, we estimate the current account deficit of the region hit a record $11 billion in 1981. The deficit has declined since then to about $7 billion in 1984, mainly because of cutbacks in imports and a modest recovery in exports. Concomitant with the widened current account deficits, official medium- and long-term external debt for the region ballooned to an estimated $55 billion in 1984. At the same time, regional per capita output recorded no gain and actually declined in countries such as Ghana, Mozambique, and Tanzania. In the face of these growing economic pressures, 29 of the 46 countries in Sub-Saharan Africa made over 90 standby or extended arrangements with the IMF between 1978 and 1984 linked to economic policy adjustments. Fourteen of these countries had active arrangements at the end of January 1985.

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Moderate Successes

A number of countries have been moderately successful in terms of perseverance in their economic programs and modest economic achievement.

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Ghana began implementing an economic recovery program in 1983, with the support of the IMF and Western donors. The program calls for substantial currency devaluations, reduced public expenditure, gradual liberalization of price controls, and the rehabilitation of key economic sectors such as agriculture and transportation. So far, all IMF conditions have been met, and the US Embassy

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Sub-Saharan Africa: Selected Economic and Financial Data [a]

Billion US $

	1978	1979	1980	1981	1982	1983	1984
Current account balance [b]	−10.0	−2.0	−5.0	−17.0	−17.0	−12.0	−12.0 [c]
Current account balance [b] excluding Congo, Gabon, and Nigeria	−6.0	−7.0	−10.0	−11.0	−9.0	−7.0	−7.0 [c]
Net financial inflows from all sources	9.0	10.0	13.0	13.0	13.0	12.0	12.0
Net financial inflows from the IMF	0.1	0.4	0.6	1.6	1.2	1.6	0.4

[a] All countries on the continent except Algeria, Egypt, Libya, Tunisia, Morocco, and South Africa, plus the islands of Comoros, Madagascar, and Sao Tome and Principe.
[b] Goods, services, and private transfers.
[c] Estimated.

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estimates that the economic decline has been halted. The Ghanaian economy, however, is still far from achieving sustained growth.

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Ivory Coast began implementing an IMF-supported stabilization program in 1981. The program was not fully successful through 1983 because unfavorable export and import price trends impacted adversely on the government's receipts and expenditures. Since then, spending cuts and new tax measures have sharply reduced the public-sector deficit. Because of failure to meet December 1984 performance criteria, however, the IMF program was canceled last month and is being replaced by a new arrangement presently under negotiation. The economy remains affected by drought, and the IMF expects economic growth, negative since 1981, to be slight for the rest of the decade.

Kenya has been almost continuously implementing adjustment programs with IMF support since 1978. Nairobi has had problems, with three of the five programs canceled for failure to meet IMF targets. The World Bank has declined to make a third structural adjustment loan because of Nairobi's failure to meet loan conditions. Even so, substantial economic adjustment has been made over the years. Between 1981 and 1984, the inflation rate was slashed in half to 10 percent; the overall budgetary deficit as a percent of GDP was reduced from 10 percent to 5 percent over the same period; and the overall balance of payments recorded surpluses in 1983 and 1984. Mainly because of one of the worst droughts in Kenya's history, however, the economy had no growth last year and will be slow to rebound. The government is continuing its economic adjustment policies with IMF support.

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Mali's IMF-supported program started in November 1983. The country has made satisfactory progress since then, in the view of the IMF. Public-sector wages have been frozen since 1981 and government hiring has been curtailed. Some public enterprises are being liquidated, including the national airline. External arrears are being reduced and credit expansion has been well within the limits set by the program. The government remains committed to reform, despite drought conditions that have substantially reduced cereal production and the livestock herd.

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Senegal's economic adjustment efforts with IMF and other external support date back to 1979. Through 1983 results were mixed because the

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Sub-Saharan Africa: IMF Standby and Extended Arrangements in Effect as of 31 January 1985

Standby Arrangements	Starting Date	Ending Date	Amount (*million US $*)
Central African Republic	6 July 1984	5 July 1985	15
The Gambia	23 April 1983	22 July 1985	14
Ghana	27 August 1984	31 December 1985	183
Ivory Coast	3 August 1984	2 August 1985	84
Madagascar	10 April 1984	31 March 1985	35
Mali	9 December 1983	31 May 1985	42
Niger	5 December 1984	4 December 1985	16
Senegal	16 January 1985	15 June 1986	75
Sierra Leone	3 February 1984	2 February 1985	53
Sudan	25 June 1984	24 June 1985	93
Togo	7 May 1984	6 May 1985	20
Zaire	27 December 1983	26 March 1985	239
Zambia	26 July 1984	30 April 1986	228
Extended Arrangement			
Malawi	19 September 1983	18 September 1986	106

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programs were not always maintained. Better results have been achieved since then with a more rigorous application of policy measures by the government. Despite being hard hit by drought, all of Senegal's financial objectives were achieved in the IMF-supported program ending June 1984. Within 12 months the fiscal deficit as a percent of GDP fell from 8 percent to 5 percent; the current account deficit was reduced from 14 percent to 11 percent of GDP. Serious structural and financial problems remain, however, and the reform program continues.

Togo received good marks during 1983-84 for its adjustment efforts with financial support from the IMF, World Bank, and bilateral donors. Earlier programs were less successful. The government has launched a major denationalization of its many state enterprises. Other reform measures include rural development, the overhauling of tax and customs administration, restraints on public hiring, and a restrictive monetary policy. Inflation has been curbed. On the basis of partial data, we believe that prices may actually have fallen last year. Real economic growth is estimated by the IMF to have been about 1 percent in 1984 after continuous decline since 1980. The economy remains affected by drought. Togo is working closely with the World Bank in developing a medium-term development strategy supported by a structural adjustment loan from the Bank.

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Zaire remains committed to carrying out its latest of a series of IMF-supported programs that date back to 1977. The present program has included drastic exchange rate changes, tax reform, tight budget practices, and controlled credit expansion. The IMF regards the program as successful so far. The inflation rate fell from 76 percent in 1983 to an estimated 47 percent last year; the 1984 current account deficit of $230 million was smaller than the program called for; payments on rescheduled external debt are on time. Unresolved problems

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include the restructuring of public corporations and the rehabilitation of the agricultural sector. Prime Minister Kengo wa Dondo, a key figure in the reform effort, claims that President Mobutu intends to maintain "economic rigor" throughout his new seven-year term.

Less Successful Countries

Liberia, Nigeria, and Tanzania are prominent among the countries that have been less successful in implementing economic reform. In Liberia there appears to be a lack of resolve for a sustained effort in the uncertain political environment preceding a possible return of civilian government in October. Nigeria's program is only a year old and has not been fully formulated by a military administration of uncertain tenure. For Tanzania, the main cause appears to be unworkable economic policies based on President Nyerere's philosophy of "African socialism."

After showing signs of economic recovery, ***Liberia's*** situation has worsened alarmingly since mid-1984. With almost continuous involvement in IMF-supported programs since 1979, Liberia had achieved moderate success in its adjustment efforts. Although the country's financial position remained precarious, the government had eliminated all external arrears by mid-1984. Since then the resolve of the government has weakened as evidenced by unbudgeted expenditures and large revenue shortfalls. The Liberian treasury is nearly empty. The IMF program has been suspended since December because of failure to make repayments. Economic assistance from bilateral sources, the European Community, and the World Bank—most are pessimistic about the country's medium-term economic prospects—has been held up as a result.

Nigeria has not yet succeeded in stemming an economic decline that has been going on since 1980. The first priority of the government is dealing with the severe financial squeeze resulting from a near 60-percent fall in oil revenues between 1980 and 1983. The military administration has implemented an austerity budget with sharp cuts in expenditures, reductions in public employment, and the postponement of most capital projects. Severe import restrictions have been imposed. The program has brought mixed results, so far. Although official reserves doubled to $1.8 billion last year, the inflation rate was about 100 percent, according to a US Embassy estimate. The government has avoided using IMF support in its reform efforts and some military leaders have publicly adopted an anti-IMF attitude. Because of the still serious economic picture, however, senior civil servants including the Minister of Finance feel that Lagos will have to turn to the IMF, according to the US Embassy.

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Tanzania has met with little success in its economic efforts. The country has been without an IMF-supported program since 1980. Since then, some economic adjustment measures have been implemented as groundwork for an IMF-supported program that has not materialized because of failed negotiations or have been taken through broader economic programs drawn up by the authorities. Reform measures carried out last year include a currency devaluation and higher producer prices for coffee, cotton, and tobacco. These measures have been too little and somewhat late. The economy continues to decline, with negative growth each year since 1980 and living standards lower than they were 15 years ago.

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The Political Fallout

The governments of Sub-Saharan African countries have, on occasion, met with internal opposition to economic adjustment programs. For example:

- In Ivory Coast, where an IMF-supported adjustment program has been under way since its initial implementation in 1981, teachers organized a strike in 1983 to protest reduced housing subsidies.

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- The labor movement was active in Mali and Zambia last year protesting IMF-sponsored economic reform measures.

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There have been no instances of governments being ousted, however, because of the application of IMF-sponsored programs. The threat to stability appears to come more from worsening economic conditions that are belatedly or inadequately addressed. For example, the leaders of a successful coup in Mauritania last December blamed poor economic performance and mismanagement of state enterprises for their action.

The economic crisis in Sub-Saharan Africa is forcing many African political leaders to alter their views of foreign financial support and the need for economic reform. After years of dependence on official economic assistance—largely based on grants and project loans with no economic adjustment conditions—many leaders are now compelled to reform their economies in collaboration with multilateral financial institutions as a condition for continued foreign support. The many leaders publicly advocating economic reform measures and implementing them under IMF auspices include Presidents Siad Barre (Somalia), Diouf (Senegal), Kaunda (Zambia), Kountche (Niger), and Mobutu (Zaire). Similar support for reform by government leaders is also happening where there is no IMF-assisted program and even some anti-IMF sentiment, for example, in Burkina and Nigeria.

Outlook

We expect the Sub-Saharan African countries to expand the implementation of economic adjustment programs over the medium term. These countries are highly dependent on bilateral economic assistance to keep their economies afloat. Because of budget strictures, the bilateral donors have been increasingly linking their level of assistance to economic reform, particularly those supported by the IMF. The Sub-Saharan African countries have limited financing alternatives. Provided the adjustment programs are maintained, their emphasis on free markets, fiscal responsibility, and reduced government participation in production would be a marked departure from traditional economic policy in many of these countries. Because IMF financial assistance is intended to complement financial flows from other sources, the Sub-Saharan African states probably will expect the United States to play a major role in providing the additional external financing that they will require over the medium term because of their continued serious economic problems.

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