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International Economic & Energy Weekly

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1 November 1985

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DI IEEW 85-044
1 November 1985

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International Economic & Energy Weekly 25X1

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Perspective

Rajiv Gandhi's Economic Scorecard 25X1

In the year since Indira Gandhi was assassinated, Rajiv Gandhi has moved to transform the Indian economy into a more dynamic and competitive force. His strong interest in upgrading technology and productivity has prompted him to accelerate liberalization moves begun several years ago. Gandhi still intends for the government to retain overall control of the economy, but he believes that less bureaucratic meddling and more competition in the private sector will spur modernization, limit corruption, and ease strains on the government budget. 25X1

Gandhi's policy reforms have fueled an atmosphere of optimism in the business community. Manufacturers in several industries may now set up new operations or expand capacity and vary their product mix without seeking government permission. He has also relaxed antimonopoly legislation, lowered personal and corporate tax rates, encouraged imports of high technology, and pushed the bureaucracy to expedite decisions that affect business. 25X1

Rajiv's efforts already are showing some signs of success. The incentive programs and a crackdown on tax evasion apparently have struck a responsive note with the middle class and business leaders—government officials estimate that more than $4 billion in taxable income will surface from the underground economy this year. Indian monetary officials believe revenue from taxes will be 20 percent higher this year. Private businessmen have moved to increase investment in response to the Gandhi administration's decision to ease licensing requirements in several industries, and investor confidence remains high, as demonstrated by a booming stock market. Improved Indo-US ties, following Gandhi's successful visit to Washington in June, have contributed to the approval of US export licenses for over 60 advanced high-technology systems. 25X1

Gandhi's economic modernization program is not without its limitations. Rajiv is probably very much aware of government revenue shortages—a major factor in his push to free the private sector—and the limits they set on additional tax concessions. He will also have to weigh looming foreign payments strains against his desire to promote productivity through increased technology imports. Trade data for the first quarter of the current fiscal year indicate the deficit is almost 70 percent greater than for the same period last year. 25X1

Rajiv also must contend with potential domestic opposition to his economic measures:

- Many businessmen have benefited from economic controls.
- Cutting food subsidies or closing unprofitable factories to reduce public-sector losses run the risk of increased social unrest.
- Bureaucrats have traditionally resisted efforts to reduce their authority.
- Farmers, last month, held their first major public protest against his economic policies.
- Perhaps most importantly, Gandhi hopes to deflect charges, particularly coming from within the Congress Party, that he is widening the gap between the rich and poor. ([redacted] 25X1

[redacted] 25X1

India: Deteriorating Foreign Payments Prospects [1]

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A deterioration in India's comfortable foreign payments position is highly likely before 1990. New Delhi expects to cope with these strains mainly by increasing exports of manufactured goods much faster than in the past. We believe Indian efforts to ease constraints on production of exportable goods will have some success, but not enough to compensate for the increasing payments burden. Prime Minister Gandhi will likely move to limit growth in imports, even at the cost of a slowdown in the domestic economy. Such a policy reversal would curb opportunities for US suppliers not yet established in the Indian market.

Payments Improvement Since 1980

India's current foreign payments position is manageable. Its reserves are equivalent to four to five months' merchandise imports; the trade deficit is substantially lower than in the early 1980s; and debt service payments are probably less than 20 percent of current foreign receipts:

- India's net oil import bill last year was only half that in fiscal year 1981 [2] because of increased domestic crude oil production and a decline in world oil prices.
- Foreign aid has continued at more than $3 billion annually.
- The IMF has provided $4.2 billion in credits over the past four years.
- Private remittances and bank deposits from Indians who live and work abroad continue to add more than $3 billion in hard currency each year.

Increasing Strains Likely

The outlook is gloomy, however. Indian Finance Minister V. P. Singh has publicly warned of an "impending foreign exchange crunch." Several factors indicate that this probably will take place:

- Gandhi's push to improve industrial efficiency will increase demand for imported capital goods and technology.
- The volume of petroleum imports is likely to go up by as much as 7 percent a year, as New Delhi pushes for faster growth. The net oil import bill, at current world prices, could easily exceed $6 billion per year by FY 1989, compared to $2.8 billion last year. 25X1
- Past purchases of military equipment, as well as arms currently under negotiation, could bring cash payments and debt service for military goods to as much as $2.4 billion a year in the early 1990s.
- India's debt service burden will escalate over the next five years as obligations to the IMF and commercial banks are added to the substantial repayments due on aid received over the past 30 years. We believe the official Indian projection of principal and interest payments in FY 1989 of $3.2 billion is conservative because it excludes military payments and loans now being negotiated.
- The terms of financial support available to India from bilateral donors and multilateral lending institutions have already begun to harden. World Bank support is shifting from highly concessional credits to more expensive loans. 25X1

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Efforts To Ease the Strain

Indian officials look primarily to a sharp increase in exports, particularly manufactured goods, to keep anticipated foreign payments strains manageable. According to press reports, the Five-Year Plan for FY 1985-89 will call for 6.8-percent annual growth

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[1] This article summarizes a forthcoming Intelligence Assessment.

[2] The Indian fiscal year begins 1 April.

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India: Estimated Balance of Payments, 1980-85 [a]

Million US $

	1980	1981	1982	1983	1984	1985
Trade balance [b]	−7,546	−6,825	−5,970	−5,700	−4,490	−4,540
Petroleum	−6,661	−5,575	−4,570	−3,130	−2,790	−3,040
Nonpetroleum	−885	−1,250	−1,400	−2,570	−1,700	−1,500
Exports	8,316	8,660	9,455	9,600	9,530	8,800
Petroleum	11	237	1,245	1,540	1,530	400
Nonpetroleum	8,305	8,423	8,210	8,060	8,000	8,400
Imports c.i.f. [b]	15,862	15,485	15,425	15,300	14,020	13,340
Petroleum	6,672	5,812	5,815	4,670	4,320	3,440
Nonpetroleum	9,190	9,673	9,610	10,630	9,700	9,900
Private transfers, net	2,688	2,314	2,510	2,600	2,500	2,500
Interest payments [b c]	526	591	948	1,233	1,350	1,425
Current account balance [b]	**−2,950**	**−3,200**	**−3,050**	**−2,850**	**−2,100**	**−2,200**
Principal repayments [b d]	−851	−887	939	−938	−960	−1,150
Aid disbursements [b]	2,049	1,833	2,211	1,989	1,763	NA
Grants	707	595	560	514	463	
Loans	1,342	1,238	1,651	1,475	1,300	
IDA	652	786	1,109	974	800	
Nonconcessional loans [e]	515	858	887	1,378	1,450	NA
IBRD	174	421	288	471	250	
IMF receipts	1,187 [f]	710	1,958	1,365	210	NA
Nonresident deposits	145	179	592	838	700	NA
Bilateral accounts	−94	−323	−364	194	200	NA
Direct investment	8	10	65	62	61	NA
Change in reserves	**−346**	**−2,397**	**504**	**882**	**263**	NA

[a] Fiscal year beginning 1 April of the year stated. Major balances may not add because of categories not shown.
[b] Excluding military. Annual cash and debt service payments for military imports have risen gradually from approximately $600 million in 1980 to around $800-1,000 million in 1985.
[c] Including payments to the IMF and on nonresident deposits.
[d] Including IMF repurchases.
[e] Medium- and long-term only.
[f] Including Trust Fund loan and SDR allocation.

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in export volume. During the past five years, the volume of nonpetroleum exports grew less than 2 percent annually. [redacted]

The Indians hope to boost manufactured exports by improving productivity and easing infrastructure constraints. Gandhi's greatest interest is in overcoming technological obsolescence, which has contributed to the high cost and low quality of much of India's production. He expects productivity gains from cooperation with foreign firms, greater competition within India, and reduced bureaucratic interference. New Delhi is continuing financial incentives—cash payments, tax refunds, income tax concessions, and transferable import privileges—to make production for export more profitable. [redacted]

In our view, however, electricity supplies—about 11 percent short of estimated requirements in FY 1984—are the major obstacle to increasing the output of exportable goods. New Delhi's efforts to speed construction of new power capacity by concentrating financial resources on projects already under way and to improve operational efficiency of thermal power plants will probably not be sufficient to eliminate this bottleneck. [redacted]

Import substitution remains a major theme of foreign trade policy. The current emphasis on developing indigenous high-technology industries, however, could risk encouraging a new generation of uncompetitive manufacturing sectors with minimal net foreign exchange savings. Increased production of oilseeds and natural gas could lead to significant foreign exchange savings, but a marked impact in these sectors is not likely before the early 1990s. [redacted]

While India is not seeking direct foreign investment, receipts from commercial borrowing are likely to increase during the next five years. Nonetheless, the total will remain below the $3.6 billion annual average recommended in a World Bank high-growth scenario. Indian bureaucrats remain leery of falling into a debt trap. Some have recommended a clampdown on imports if debt service payments seem likely to exceed 20 percent of current receipts. [redacted]

India: Recent Economic Trends[a], 1980-85

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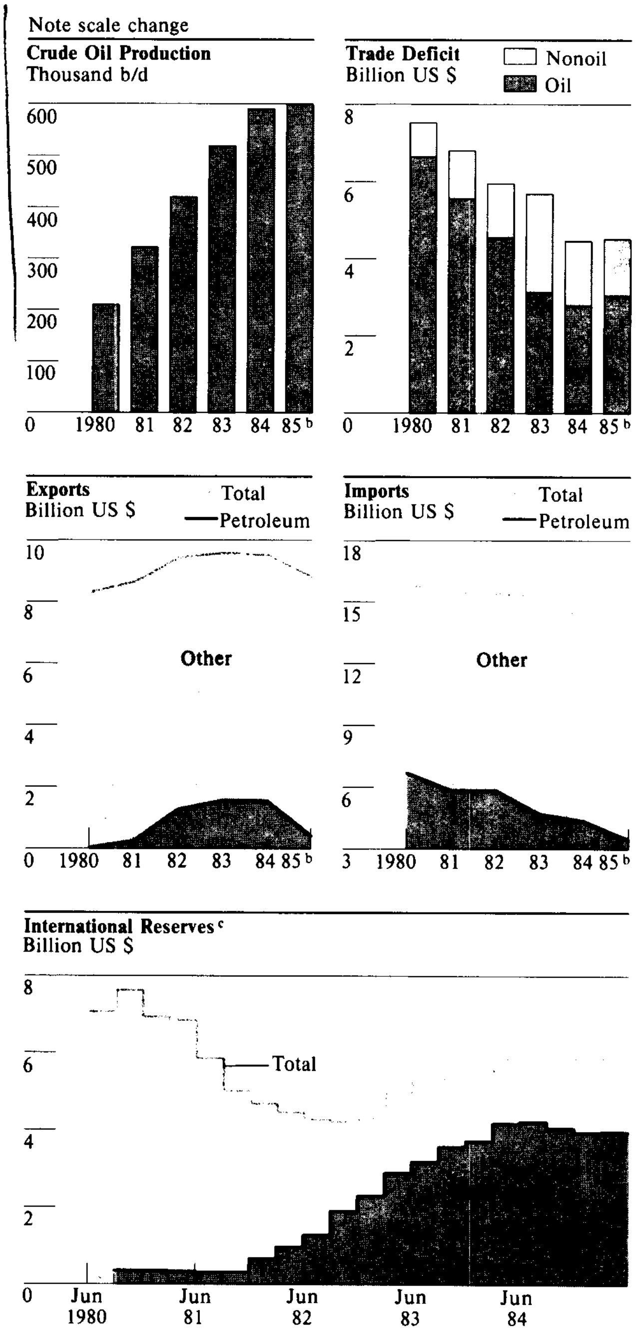

[a] Fiscal year beginning 1 April of the year stated.
[b] Estimated.
[c] End of period.

[redacted]

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Policy Response

We foresee gains in export growth and in easing domestic supply constraints over the next five years, but too little improvement to overcome the increasing burden of petroleum imports, military purchases, and debt service payments. Business complaints about import competition will likely mount, and foreign commercial banks probably will harden their lending terms. [redacted]

Rather than risk unmanageable debt servicing problems, New Delhi, under such circumstances, probably would sacrifice some import liberalization measures. We believe the government would initially try to meet demand for imported petroleum, fertilizer, and grain and preserve access to foreign technology. We speculate, however, that Gandhi would postpone plans to spur domestic efficiency through increased import competition and might close off recently introduced opportunities for import-intensive production of vehicles and consumer durables. [redacted]

Gandhi's support for simplifying bureaucratic procedures suggests that he would emphasize tariffs rather than discretionary import licenses to slow import growth. The administrative structure for tighter licensing controls remains in place, however, and New Delhi probably would take some steps in this direction. Policy-induced cutbacks in the volume of imported capital goods and industrial inputs would lower India's potential overall growth, but not necessarily force it below the average annual rate of 3.8 percent maintained since the mid-1960s. [redacted]

Implications

Opportunities for US suppliers will be curtailed if, as we expect, Indian exports do not grow fast enough to ease the foreign payments burden. Import restrictions and slower Indian growth would reduce demand for foreign goods. Purchasing decisions by Indian Government agencies would probably give greater weight to price and financial terms, even in high-technology areas, which might provide an advantage for Japanese or European suppliers. US exporters who have established ties to Indian firms would probably suffer less than newcomers, since New Delhi usually considers import history when allotting licenses to Indian businessmen. [redacted] 25X1

The United States could also face some political fallout from any marked slowdown in Indian growth. Some Indian officials already see an anti-India bias in US policies that limit Indian access to loans from multilateral financial institutions. [redacted] 25X1

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The Soviet Union, however, could reap benefits from a deterioration in India's payments situation. New Delhi's dependence on the Soviet market for its manufactured goods will increase if sales to hard currency buyers falter, and Moscow would undoubtedly highlight the benefits of bilateral agreements that obviate the need for payment in hard currency. [redacted] 25X1

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Questions may be raised about Indo-Soviet relations, however, when targets for the next five-year bilateral trade agreement are announced, probably in December. We anticipate that a massive Indian merchandise trade surplus with the Soviet Union will be planned to balance payments for military purchases.[3] This surplus will provide the Indian business and intellectual communities with an indication of the payments burden for Soviet military equipment, which so far has attracted only small intermittent press attention. [redacted] 25X1

[3] Economic ties to Moscow for imports, exports, and debt service are made through a clearing account that avoids the use of hard currency. To avoid large or persistent payment imbalances, the two governments negotiate quantity or value targets for commodity trade annually as well as in five-year agreements. [redacted] 25X1

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[redacted] 25X1

South Korea: Loosening the Reins To Spur Growth 25X1

Seoul is cautiously loosening four years of austerity to reverse a broadly based economic slowdown. The sense in South Korea that the economy is faltering is a serious political problem for President Chun, potentially providing a common ground for his critics in the National Assembly, the labor movement, and on campus. Nevertheless, economic policymakers have avoided "quick-fix" inflationary policies in favor of programs that will poise South Korea for future growth. Moreover, stronger policy actions are constrained by a large foreign debt and provisions of the latest IMF standby agreement. If Seoul's remedies fail and sluggish growth persists, pressures from business and the bureaucracy to slow the government's market opening program will intensify, and this, in turn, could produce heightened trade frictions with the United States.

Reacting to a Year of Slow Growth

Seoul has reacted slowly to the yearlong slide in economic growth, waiting until April to stimulate the domestic economy in order to take up some of the slack from an export falloff. Government economists continued to forecast 7.5-percent real GNP growth for 1985 until early this summer. Since then, they have successively downgraded the outlook to a still optimistic 5 to 6 percent. In the first half of 1985, real GNP grew at 3.3 percent, a four-year low. We believe the economic planners were counting on continued strength in the foreign sector to buoy the economy and may have deferred action until they were confronted with slack export growth in the first half of this year.

In our view, the mounting criticism of President Chun also figured prominently in the decision to prime the pump. In fact, the slowdown in growth has already deprived Chun of one area in which he has been able to claim success in the past. For some of Chun's advisers—and perhaps the President himself—an effort to improve the economy now offers a means to deny more ammunition to his opponents. 25X1

Seoul Steps Back From Austerity

Chun's economic technocrats are cautiously backing away from their heretofore steadfast adherence to monetary and fiscal austerity. The success of the restrictive policies in helping to put the economy on a firm footing after negative real GNP growth in 1980 and taming the inflation of the preceeding decade has made them reluctant to alter this strategy. Their willingness since spring to use these levers to spur growth underscores their concern over current economic and political problems. 25X1

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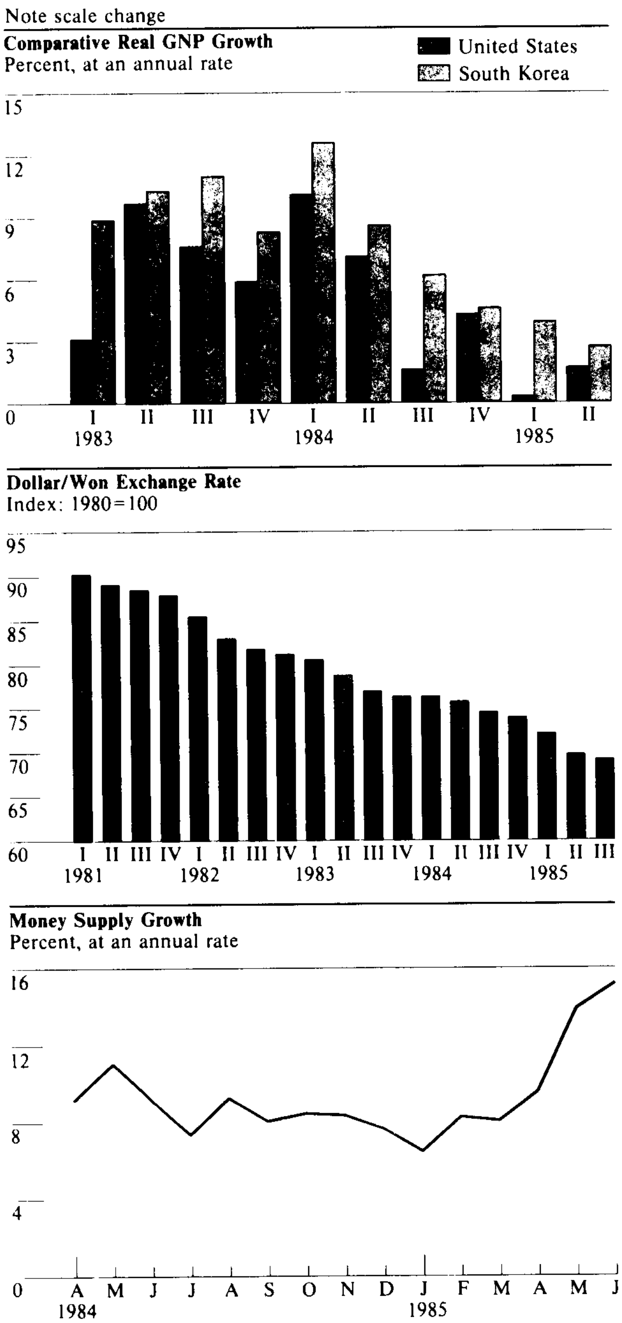
Loosening Monetary Policy. The focus of Seoul's newly relaxed monetary policy has been to ease the current financial difficulties of domestic banks and large conglomerates and to boost lagging investment. Since the easy credit days of the 1970s, South Korean banks, particularly commercial banks, have been saddled with an increasing number of loans made to debt-heavy conglomerates—often at the behest of the Ministry of Finance—that have gone bad. Government officials acknowledge $4.6 billion in corporate bad debt—three times commercial bank equity. Much of the debt is held by overseas construction companies, which are active in the Middle East. Their contracts have dried up as dropping oil prices have forced cuts in development projects. 25X1

Seoul has moved to ease the financial sector's liquidity squeeze by: 25X1

- Abandoning the targeted 9.5-percent annual growth of the money supply.

South Korea: Selected Economic Indicators, 1981-85



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- Covering payment of bad corporate debts by extending $575 million in cutrate loans to domestic banks this year.

- Earmarking $530 million for investment in the manufacturing sectors that have the best growth potential—such as autos and electronics—areas dominated by South Korea's large conglomerates.

- Easing the cap on bank lending that prevented banks from extending more than 65 percent of their loans to the largest firms. Until lifted, these firms were unable to secure financing for many of their expansion plans, in part, because of this credit ceiling. 25X1

Officials in Seoul realize relaxation of money supply restraints and the infusion of liquidity into the banking system will do little in the near term to foster growth. But Seoul's policy reversal will improve the financial condition of commercial banks. In our view, it is also important for many large firms that are facing the consequences of both the economic slowdown and a squeeze on their liquidity. The collapse last spring of Kukje, once the country's sixth-largest conglomerate, illustrates the fragile financial condition of many South Korean companies. Seoul managed the reorganization of Kukje well, and we do not believe any other major firm or commercial bank is near collapse. But the demise of another large conglomerate could seriously undercut the confidence of the international financial community and scare off potential investors. 25X1

Boosting Government Spending. Seoul has accelerated several construction projects and some minor welfare programs in its $290 million supplemental budget passed in August. The steps clearly signal the government's commitment to a more expansionary fiscal policy after three years of tight budgets.[1] The new spending authorization boosts overall government outlays by 9 percent in real terms. The proposed 1986 budget, now before the National Assembly, also continues the expansionary trend by increasing government spending over

[1] Seoul passed a supplemental budget in 1984, but it was designed to aid victims of severe flooding and was not part of a deliberate expansionary policy. 25X1

10 percent. Seoul has some surplus funds already programed into the original 1985 budget to cover the new expenditures, but several special accounts often run in the red and the government's largess could quickly put it in the hole.

Bolstering Export Competitiveness

Seoul remains committed to promoting exports and has underscored this sector's importance by implementing a two-pronged program in August.

Improving Exporters' Efficiency. Seoul has announced a comprehensive export promotion package crafted to enhance the competitiveness of South Korean goods by:

- Offering favorable export financing and simplified export procedures, including faster refunds on duty paid for imported items used to produce export goods.
- Allowing accelerated depreciation of industrial facilities producing exports and increased loans to small- and medium-sized firms for export facilities.
- Providing $57 million to the textile industry for factory modernization.

These steps will improve the financial health of some exporting firms in the short run by reducing their costs. But we believe the measures will have virtually no impact on trade performance during the second half of this year because of the long-term nature of investment and the lag between a cost reduction and increased shipments.

Devaluing the Won. In a dramatic departure from last year, the Ministry of Finance this year has aggressively devalued the won vis-a-vis the dollar but was deaf to industry cries for a one-shot drop in the exchange rate. Devaluation will enhance South Korea's export competitiveness, particularly in the European market where the high dollar—to which the won is closely tied—battered sales last year. In addition, devaluation will aid Seoul's perennial efforts to discourage nonessential imports—in general, those not used to produce exports—as consumers face higher prices.

The devaluation strategy has substantial costs. Producers of VCRs and other advanced electronics goods, which have critical imported components that represent a high proportion of the product's cost, will be hard hit. Manufacturers of these items now enjoy substantial cost advantages over their rivals but may be forced to cut margins to remain competitive. Devaluation, moreover, will partially offset the benefits of recent declines in interest rates and oil prices.

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Growth Prospects

Seoul's stimulative tack should offer some help in boosting growth. Benefits will begin to accrue in the last quarter of 1985 as Seoul's resuscitation measures take hold in conjunction with an expected improvement in foreign demand in South Korea's major trading partners.

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We forecast real GNP growth of 4 to 5 percent during the last half of 1985, yielding 3.5-to-4-percent growth for 1985 as a whole. The cost of this growth, in our estimation, is likely to be rekindled inflation. As the stimulative policies combine with devaluation to force domestic prices up, inflation in South Korea could run as high as 7 percent over the next 12 months. This would be the highest level for South Korea in three years and is likely to be cited by government critics as indicative of Chun's incompetence in economic management. Indeed, South Korean officials have made curbing inflation the cornerstone of economic policy since 1980 and almost certainly will worry that the fears of inflation they have calmed will resurge once more.

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We believe that real GNP growth for 1986 should be about 6 percent—1 percentage point below the government's forecast. The economy could improve more vigorously, but will be heavily dependent on forces outside Seoul's control. On balance, although we are cautiously optimistic about South

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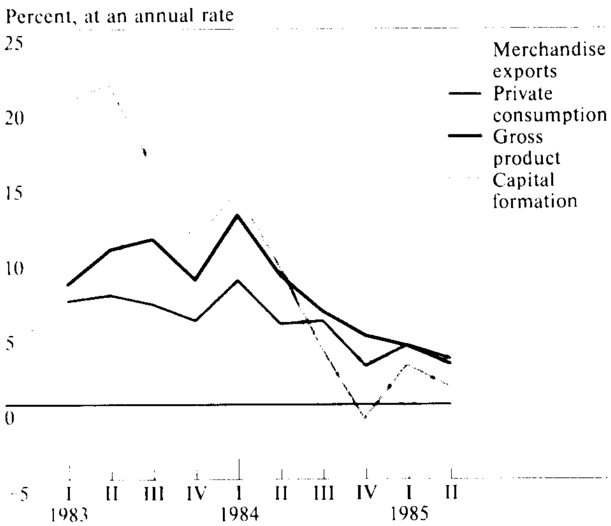
South Korea: Growth of Selected GNP Components, 1983-85[a]



[a] All growth rates calculated using 1980 US dollars values for each account.

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Korea's near-term performance, the prospects for 1986 could be clouded by slow economic recovery in developed countries, protectionist and other legal barriers to key exports, and reluctance of international bankers to increase their exposure in South Korea.

In our view, Seoul's willingness to use monetary and fiscal policy flexibility to spur growth does not presage a return to the "growth at any cost" approach of the 1970s. Such a choice already is circumscribed by a large foreign debt, slumping demand for Korea's exports, and a recently negotiated IMF standby agreement that calls for continued monetary and fiscal restraint, as well as a reduction of short-term debt. We believe South Korea remains committed to the notion of austerity, and will carefully gauge the inflationary impact of loosening the reins. When exports once again lead South Korea's growth, Seoul is likely again to tighten the money supply and government spending, although, in our view, without reverting to the overly restrictive policies that helped precipitate the current economic sluggishness.

Chun, thus far, has deflected much of the criticism aimed at his economic policies by pointing to cyclical factors, an upsurge in protectionism, and slack demand for Korea's exports. He has been especially adept at relieving political pressure by bowing to industry demands for easing austerity. A failure to stem the downturn, however, obviously could become a serious pocketbook issue and greater focus of popular discontent with Chun. The perception of increasing pressure on the President, in turn, could threaten foreign investor and business confidence that is critical to economic recovery—particularly if workers initiate strikes to demonstrate solidarity with the political opposition.

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Implications

However the growth rate fares in the next year, we believe US economic and political interests in South Korea will be increasingly linked to the performance of the Korean economy. In our view, there are several areas of concern that will become even more pronounced if the economic slide continues. These include: 25X1

- Diminishing ability to service a growing foreign debt. US interests hold about one-third of South Korean debt and have direct foreign investment of nearly $1 billion. Although a debt rescheduling, even under a worst case scenario, is remote, bankers may be reluctant to extend further credit in a loan market now considered safe. 25X1

- Intensifying resistance to market opening measures and possible backsliding on progress already made. Seoul's postponement last month of a major economic liberalization package—especially after encouraging highly visible press previews—and harsh reaction to US legal action to improve protection of intellectual property underscore the serious reservations about opening Korea's markets harbored outside the small circle of President Chun's advisers and liberalizers. For example, the ruling and main opposition parties,

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in a rare show of cooperation, have banded together to protect South Korea's markets. Forceful international insistence on additional liberalization during South Korea's economic doldrums could precipitate the replacement of one or more key proponents of market opening with more conservative advisers.

- Reductions in future outlays for national defense because of sluggish real GNP growth that could add up to $1 billion by 1991. Defense expenditures are tied to real GNP growth, and Seoul would have to increase the percentage of GNP devoted to defense to make up the shortfall. We believe such a move would act as a brake on future growth. [redacted] 25X1

The current response to the yearlong economic slide suggests that Seoul's economic technocrats may not be as strong an influence in decisionmaking as was Kim Jae-ik, who was killed in the 1983 Rangoon bombing. If a reshuffling of key economic advisers takes place in December as rumored—a usual response during economic doldrums—our uncertainty about the direction of economic policy will increase even if Chun continues to declare his proliberalization faith. In short, the current economic policy making team appears to us less certain of its course and less able to tip the balance in favor of liberalization and reform than was the old team around Chun. [redacted] 25X1

[redacted] 25X1

East Asian NICs: Slower Increases in Labor Costs [redacted]

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The East Asian NICs[1] as a group have maintained their huge labor cost advantage over the United States during the past five years despite a real decline in labor compensation costs for US workers after 1979. South Korea and Hong Kong, in particular, have become even more competitive in terms of labor costs, which have fallen as a percentage of US costs. We expect the NICs to maintain this advantage in the near term because the economic slowdowns that these countries are currently facing should reduce labor demand, resulting in downward pressure on wages. Over the longer term, we expect the East Asian NIC labor edge to narrow as these countries move into technology-intensive industries, which usually command higher wages. [redacted]

Labor Compensation Costs

Labor compensation costs are used rather than earnings comparisons because they better reflect the true cost of employing labor, and, therefore, the competitiveness of labor inputs in manufactured goods production. In contrast to earnings, this broader definition includes items such as: unemployment insurance costs, contributions to pension plans, all bonuses and special payments, pay for time not worked (that is, holiday, vacation, and sick pay), payment in kind (for example, housing allowances) and payroll taxes that are paid by the employer but that do not necessarily benefit the worker directly. [redacted]

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Real Wage Growth Slows

Low labor costs have been a key element in the East Asian NICs' ability to attract foreign investment and to manufacture competitive exports. Rapid growth in labor costs, especially before 1980, eroded NIC competitiveness in simple assembly and labor-intense production. Even though their labor cost growth has generally slowed in recent years, the NICs are now faced with sluggish demand and rising protectionism in global markets. Countries with even lower wages such as Thailand, Indonesia, Malaysia, and China are becoming increasingly competitive in producing goods with high labor content. As a result, the East Asian NIC governments are reevaluating their economic programs, including wage policies, targeted growth industries, and trade liberalization measures. [redacted]

Singapore was the only NIC to have faster growth in its manufacturing labor costs during the last five years than in the five years before 1979. The government of Singapore adopted a high wage policy in 1979 to accelerate the transition from labor-intensive, low-skill production toward more capital-intensive, higher value-added production. While the strategy has resulted in a more industrialized economic base, the current economic slowdown has induced the government to ask for a two-year wage freeze to improve labor cost competitiveness. [redacted]

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Taiwan has had real increases in domestic labor costs in each year of the last decade. Rapid productivity gains in Taiwan allowed real wage increases without hurting competitiveness. According to the US Embassy, Taiwan's growth in productivity far exceeded that of most other countries between 1974 and 1983. Because of rising wages, a shortage of unskilled labor, and lagging productivity growth in labor-intensive activities such as textiles and apparel, the US Embassy reports that Taiwan is also emphasizing capital- and technology-intensive growth. [redacted]

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[1] The East Asian newly industrializing countries (NICs) are Hong Kong, Singapore, South Korea, and Taiwan. [redacted]

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East Asian NICs: Changes in Real Domestic Labor Costs, 1975-84

Average annual percent

	1975-79	1980-84
Hong Kong	6.6	2.0
Singapore	7.0	8.7
South Korea	12.9	2.4
Taiwan	12.0	7.2
Asian average	9.8	5.2
United States	1.0	−0.5

South Korea's real domestic labor costs fell 9 percent from 1979 to 1981, but rose subsequently. The downturn in wages coincided with the global increases in oil prices, an overheated domestic economy, a failed grain harvest, and political unrest. The decline extended into 1981 because of government efforts to restrain wages as part of a broad stabilization program. Seoul also urges employers to maintain maximum employment, and, as a result, some firms have been saddled with inefficient or redundant labor. The success of the stabilization program has allowed Seoul to ease wage restraints in recent years.

Following British Prime Minister Thatcher's 1982 discussions in Beijing, real domestic labor costs fell slightly in ***Hong Kong*** as uncertainty about the colony reverting to Chinese control began to rise. But with Beijing providing increasing access to its markets, Hong Kong has had a large increase in domestic exports and in reexports to China in the first half of 1985, putting real domestic wages back on an uptrend.

Exchange Rates Enhance NIC Competitiveness

Because movements in the real exchange rate have increased the value of the US dollar against all NIC currencies during the past five years, the East Asian NICs have been able to maintain their labor cost advantage over the United States by more than could be expected from real wage changes denominated in their local currencies. In fact, we estimate that NIC cost competitiveness benefited from real devaluations that averaged 16 percent against the US dollar by 1984 compared to 1979 exchange rates. 25X1

The South Korean and Hong Kong currencies fell sharply against the dollar after 1979, contributing to actual declines in their dollar-denominated labor costs over the past half decade. South Korea posted a 26-percent real devaluation relative to the US dollar between 1979 and 1984, according to our calculations. This allowed real dollar labor costs to fall 18 percent even though real domestic costs rose 12 percent in the same period. Hong Kong's US dollar labor costs declined 14 percent on an estimated real devaluation against the dollar of 23 percent during 1980-84 caused, in part, by uncertainty over the colony's repatriation to China.[2] 25X1

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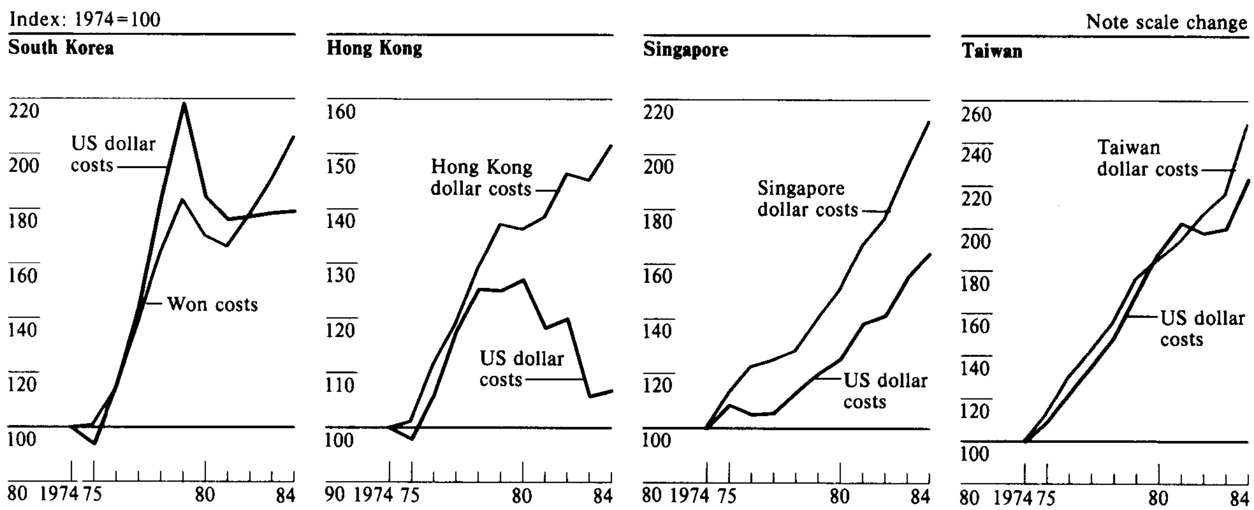
In contrast, US dollar labor costs in Singapore and Taiwan are higher than they were in 1979. Although both countries have experienced mild erosion in the value of their currencies relative to the dollar, authorities in Singapore and Taiwan prefer to maintain a strong exchange rate. As a result, their domestic labor cost increases are more fully reflected in their dollar costs, which grew 35 percent between 1979 and 1984. 25X1 25X1

Outlook and Implications for the United States

All of the East Asian NICs have a large labor compensation cost advantage over the United States. Average labor costs were $1.77 in the NICs, while comparative US costs were $12.59 in 1984. It 25X1

[2] The nominal value of Hong Kong's currency has been more stable since late 1983 when the central bank pegged the Hong Kong dollar to the US dollar. 25X1

NICs: Real Compensation in the Manufacturing Sector, 1974-84



[redacted] 25X1

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is difficult to predict trends in either labor costs or exchange rates, but we expect the differentials in NIC labor costs relative to the United States to remain fairly constant in the near term. We expect, however, the NICs labor cost advantage to erode in the long run, although these countries would still employ labor at only a fraction of current US costs through the 1990s. If the value of the US dollar falls against the NIC currencies, press reporting indicates that the NICs would adjust their currencies downward with the US dollar, minimizing the loss of NIC competitiveness in the US market while stimulating greater demand for NIC products in non-US markets. [redacted] 25X1

While weakening against the US dollar during the last five years, the currencies of the East Asian NICs actually strengthened against most others. This has resulted in a progressive loss of competitiveness for these countries in non-US markets since 1980. This reduced competitiveness, in turn, has increased dependence on the US market to fuel their growth. Sales to the United States accounted for 34 percent of East Asian NIC exports in 1984 as compared to 25 percent in 1981. The share of their sales going to the EC and Japan declined. [redacted] 25X1

East Asian NICs: Real Labor Costs, 1974-84 [a]

	1984 US $						Average Annual Growth 1975-79 *(percent)*	Average Annual Growth 1980-84 *(percent)*
	1974	1976	1978	1980	1982	1984		
Hong Kong	1.50	1.59	1.88	1.90	1.80	1.60	4.5	−3.1
Singapore	1.48	1.55	1.67	1.85	2.09	2.43	3.6	6.5
South Korea	0.76	0.88	1.40	1.40	1.35	1.36	16.9	−3.9
Taiwan	0.76	0.93	1.13	1.44	1.51	1.70	11.2	5.7
Asian average	1.13	1.24	1.52	1.65	1.69	1.77	7.9	1.5
United States	12.28	12.66	13.18	12.38	12.40	12.59	1.0	−0.5

[a] Hourly labor compensation costs expressed in domestic currencies were translated into nominal US dollars by using the average foreign exchange rates in each year; the resulting values were converted to constant dollars using a US price index. Primary data sources were BLS for cost data and the IMF for the price index.

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Italy: Improved Prospects for Wage Restraint 25X1

Current national wage negotiations in Italy are likely to result in a moderate settlement that will help industry contain labor costs and improve its international competitiveness. Rising unemployment and internal wrangling have weakened labor's bargaining position in the negotiations—which again will center on reform of the automatic wage indexation system. The final accord will probably include a reduction in the degree of automatic wage indexation as well as limits on overall wage increases, which will contain the advance in real wages to 0.5 to 1 percent annually over the next few years. The talks are likely to drag on into January because both sides want to appear firm and because of uncertainty over the outcome of parliamentary debate on the 1986 budget, which was postponed by the recent collapse of the government. If an agreement does not seem likely as the 31 January expiration for the present accord approaches, the government may intervene to force a conclusion.

Eroding Union Power

The current round of Italian labor negotiations is taking place against a backdrop of declining union strength. Although still very powerful, the unions have lost some control over the hiring and firing of workers over the past five years and have been unable to prevent a weakening of the previously unassailable automatic wage indexation system. In the last round of wage negotiations in 1982-83, they were forced to accept caps on wage increases for all three years of the contracts.

Part of the unions' problem is that slow economic growth and rising unemployment have put them on the defensive as rank-and-file members have become more concerned with job security than with large wage gains. This has resulted in a significant decline in the number of hours lost due to strikes in both 1983 and 1984. In addition, declining industrial employment and the decentralization of production activity have cut into union membership, allowing business leaders to exert a greater control over the workplace. A slight political shift to the right has also contributed to the decline of the unions whose policies are heavily shaped by the political parties. For example, recent setbacks to the Communist Party in local elections and in a referendum on wage policies have weakened the ability of CGIL—the Communist-dominated labor union—to influence government policy. 25X1

Disagreement among the unions over past wage reform has also hurt labor's bargaining position. Management's successful attempt to weaken wage indexation in 1983 was a major shock, and cracks emerged in labor's solidarity as the unions blamed each other for losing ground. In 1984 the CGIL's refusal to go along with the other two major unions—the Catholic-dominated CISL and the unaffiliated UIL—on changes in wage indexation openly divided labor along Communist/non-Communist lines. Leaders of the UIL have told Embassy officials that, although they have reached agreements with the other unions on specific issues, they doubt the three organizations can regain the degree of unity enjoyed before the split. 25X1

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Focus on the Wage Indexation System

The first issue which must be addressed in the negotiations is further reform of the automatic wage indexation system—the *scala mobile*. 25X1

Business Goals. Confindustria, the main business organization, has demanded a one-third reduction in wage indexation, although its officials have

How Italy's Labor Negotiations Work

Italian labor contracts are negotiated on two overlapping levels, with the more visible national talks taking place between the national union federation and various business groups. The three major unions are the Communist-dominated CGIL, the Catholic-associated CISL, and the unaffiliated UIL. The most important business confederation is Confindustria, representing most of the large, privately owned manufacturing companies. Other business organizations represent employers in agriculture, commerce, the small business sector, and the public sector. The national negotiations address general issues such as working conditions, hours of work, and—most important—wage levels, including increases in the scala mobile.

Supplementing the national contracts are plant level negotiations, which have become increasingly important over the past two decades. The provincial arms of the unions take the lead in these talks, which focus on piece rates, productivity premiums, job evaluation procedures, union rights, overtime pay, and vacations. The negotiation of additional wage benefits also can take place at the plant level, although the unions generally agree not to demand wage increases significantly different than set in the national accord. 25X1

In one way or another the government usually becomes involved in the labor negotiations. The unions are concerned with social reform and economic policy in general, and often present a list of demands to the government as well as business during the national contract talks. What the unions ultimately will settle for depends in part on what Rome does in matters such as taxes and social security. The government may also intervene more directly: to settle talks hung up on the issue of the scala mobile *in 1983, it virtually locked labor and industry leaders in a closed room until a settlement was reached. When all parties could not agree on further modifications to the system the following February, the government implemented emergency measures that limited increases in the* scala mobile *index to 8 points for the year, although actual price increases would have triggered a 12-point increase.* 25X1

confided to the US Embassy their willingness to accept a 20-percent reduction. The proposed change would mean that a 1-percentage-point rise in prices would cause only a 0.4-percentage-point rise in the wage index instead of the current 0.6. Confindustria also wants the automatic wage adjustments to be made semiannually rather than quarterly. Business blames the high automatic wage increases for perpetuating Italian inflation, because more than half of total wage gains over the last decade can be attributed to *scala mobile* increases. Moreover, the *scala mobile* has contributed to real wage growth in Italy that has greatly surpassed the EC average.

Confindustria also argues that more flexibility is needed in the wage calculations to encourage productivity improvements. By giving each worker the same absolute increase in salary, the present *scala mobile* system causes a gradual narrowing of wage differentials, which Confindustria views as a disincentive for employees to improve their skills. Confindustria would like to implement a system similar to that used prior to 1975 where the degree of wage indexation varied—within a set range—by job category. 25X1

Finally, Confindustria wants an explicit agreement that fractional-point increases in the *scala mobile* index will be permanently dropped from the calculation. Labor—as well as the government—argues that the fractions should be accumulated until equaling a whole point and then added to the wage 25X1
calculations. Since the last agreement in 1983, the accumulation of fractions totals 3 percentage

Italian Wages: Significance of the *Scala Mobile*, 1975-85 [a]

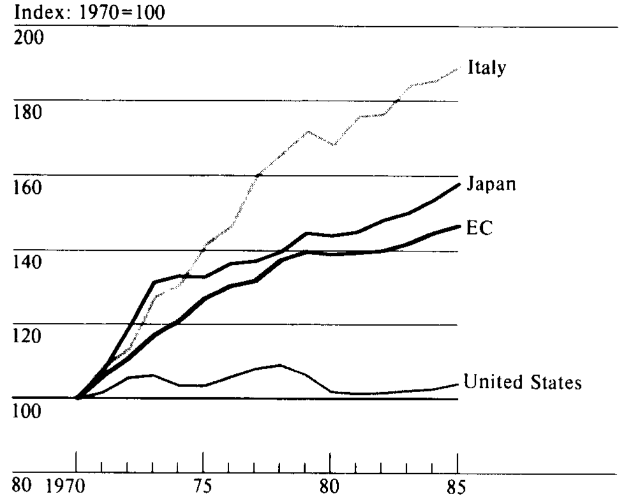
Percent

	Change in Compensation per Worker		Change in Cost-of-Living Index	Degree of Inflation Protection Provided by the *Scala Mobile*
	Total	Due to *Scala Mobile*		
1975	23.8	10.4	17.0	0.6
1976	22.1	9.7	17.1	0.6
1977	27.5	15.7	17.0	0.9
1978	16.5	10.1	12.2	0.8
1979	16.8	11.0	14.7	0.8
1980	21.1	13.0	21.2	0.6
1981	25.3	13.6	17.8	0.8
1982	17.0	10.9	16.5	0.7
1983	15.3	9.2	14.7	0.6
1984	13.0	4.9	10.8	0.4
1985 [b]	10.5	5.2	8.7	0.6

[a] *Scala mobile* currently provides for quarterly cost-of-living adjustments to the monthly wages of all public- and private-sector workers (except the self-employed) and pensioners.
[b] Estimated.

[redacted]

Italy: Real Wage Growth [a]**, 1970-85**



[a] Real hourly wage rates in manufacturing.

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points. Because the existing wording is vague, the government and some of the smaller employers' associations have paid the disputed points, but Confindustria has refused. [redacted]

Labor Demands. Labor insists that all businesses pay the disputed fractional *scala mobile* points, but is more willing to meet other business concerns. The unions agree on a shift to semiannual wage adjustments and are willing to reduce the degree of indexation—although not as far as Confindustria demands. The unions proposed a two-tiered scheme in July that would reduce the overall degree of indexation by fully protecting the first $312 of monthly wages, but indexing the remaining portion by only 30 percent. Ironically, the unions are now concerned that the *scala mobile* may have eroded their power. Labor leaders reason that large automatic wage increases make unions appear less necessary to the wage negotiation process. In addition, the Catholic-associated CISL wants more flexibility in contract negotiations because it believes that tailoring demands to a specific industry or company would result in bigger concessions from management. [redacted] 25X1

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The Other Issues

Once the indexing issue is settled, agreement will be needed on contractual wage increases beyond those determined by the *scala mobile*. We believe the union will demand more than the 6- to 7-percent annual wage increases offered by Confindustria to make up for the small gains in real wages since 1981; the unions will almost certainly demand more. Agreement should be easier in the public sector where the unions have indicated a willingness to accept a 6.5- to 7-percent annual increase in wages, only slightly above the government's offer of 6 percent. [redacted] 25X1

Next to the *scala mobile*, the most contentious issue appears to be labor's plan to reduce the workweek by two hours over the next three years. Although the reductions would be implemented on an industry-by-industry basis and only in conjunction with productivity improvements, Confindustria is strongly opposed. Job creation is another concern. With the unemployment rate at 10.5 percent and rising, the unions have demanded that companies hire new workers rather than invest their rising profits in labor-saving improvements as has been the case. Business, however, is reluctant to hire new workers unless the union's nearly complete control over hiring and layoffs is reduced.

Outlook

Although the atmosphere of the preliminary negotiations has been surprisingly good, a final agreement probably will not be concluded until January, at the earliest. Disagreement on several issues and the postponement of parliamentary discussions on the 1986 budget—because of the collapse of the government—seem certain to make the negotiations protracted. The unions will hesitate to settle on wage increases until the government's fiscal and social welfare policies are worked out, which is unlikely before yearend.

We believe the final agreement will call for only moderate wage increases. The degree of indexation in the *scala mobile* will probably be reduced to around 50 percent, with business perhaps agreeing to some kind of a two-tiered protection system. The issue of the fractional points is likely to remain unsolved, as Confindustria appears firm in its position and the unions probably would rather let the issue slide than take a direct defeat. Confindustria should also be able to hold contractual wage increases close to 7 percent annually since forecasts of slow economic growth, rising unemployment, and a growing trade deficit lend force to its demands for moderation in wages. Moreover, according to Embassy reporting, the union rank and file are not as concerned with wage increases as the leadership.

Business probably will be able to convince the unions that benefits should be more closely tied to improvements in productivity. As a result, the unions will be the most successful in pushing through reductions to the workweek in industries having shown improvements in productivity, but it is unlikely that widespread cuts will be accepted. An agreement on job creation is unlikely. Confindustria has made it clear that efforts to add new jobs will depend on the relinquishment of union control over hirings and firings—which the unions will be reluctant to grant. 25X1

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It is unclear what role the government will play in the present talks. In general, the government's interests tend to coincide with those of business, but it is extremely susceptible to pressure from the unions. Labor Minister De Michelis's position on reform of the *scala mobile* is not far from that of the unions. For this reason, Confindustria is resisting the government's involvement in the negotiations. Preoccupation with re-forming the five-party coalition government and the expected difficult debate over the budget will probably preclude the government from taking an active part in the talks. If agreement does not seem likely before the 31 January expiration date for the present accord, however, the government probably will step in. 25X1

Labor's inability to re-exert itself in the contract negotiations will allow Italy to continue the recent trend toward smaller real wage gains. While real wages are likely to advance by 2 percent this year, we believe the figure will drop to only 0.5 to 1.0 percent in each of the next two years because the inflation rate probably will rise. This represents a slowing of wage growth compared to the average annual increase of 3.8 percent in real wages during 1975-82. Moreover, less strike activity and a more incentive-oriented *scala mobile* should increase industrial productivity and reduce unit labor costs. This will give some relief to Italian businesses, which are seeking to improve their competitveness abroad. 25X1

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Moroccan-Libyan Union: Costs and Benefits [redacted]

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Both Morocco and Libya have received tangible benefits from the year-old Moroccan-Libyan union, even though they continue to have divergent long-term interests in North Africa. King Hassan has received substantial economic benefits, has effectively offset growing Algerian influence in the Maghreb, and has curtailed Libyan support of the Polisario. Libyan leader Qadhafi has used the union to promote his plans for Arab unity and to thwart US and Algerian efforts to isolate him. Despite some recent bilateral strains, we see nothing to suggest that Hassan will end the union. [redacted]

Foreshadowing the Union

The rapprochement between Morocco and Libya began in June 1983 when, with Saudi encouragement, Hassan agreed to see Qadhafi. Frustrated by his failure to obtain the chairmanship of the Organization of African Unity and Libya's isolation in the Arab world, Qadhafi had asked Riyadh to open the way for discussions with Hassan. [redacted] Hassan and Qadhafi signed the Arab-African Federation, as the union is formally known, on 13 August 1984 at Oujda, Morocco. [redacted]

In addition to the strategic considerations involving the struggle with Algeria over the Western Sahara, the timing of the accord suggests that the King viewed the union as a quick way to relieve growing domestic pressure over Morocco's deteriorating economic and social conditions. Widespread riots in January 1984 brought home to Hassan the severity of the domestic situation. He faced potentially divisive parliamentary elections in September 1984, a shortfall in Western aid—especially US—and considerable disgruntlement over planned cuts in education subsidies. Hassan also was aware of Libyan contacts with Moroccan opposition leaders. [redacted]

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Is the Well Half Full or Half Empty?

At the outset, King Hassan encouraged the popular belief that under the union Libya would provide about $1 billion to Morocco during the first year. We believe that this figure greatly exaggerated the level of support Qadhafi was willing to supply. Nevertheless, since the union, Libyan financial assistance has totaled about $150 million:

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- Tripoli advanced $50 million to Rabat in September 1984 to finance some of Morocco's international bank loans that had come due and to pay for Hassan's daughter's wedding.
- Tripoli extended a $100 million concessional loan to Rabat in May 1985 to support the purchase of 3.6 million barrels of Libyan crude oil—10 percent of Morocco's annual needs [redacted]

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In addition, Saudi Arabia—in what we believe is a sign of Riyadh's approval of the rapprochement—is providing 15 million barrels of crude oil this year, which covers Morocco's total oil needs for five months and saves Rabat nearly $400 million in foreign exchange. The grant is nearly double what the Saudi's gave Hassan in 1984. [redacted]

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Libya is providing a market for Morocco's agricultural and manufactured exports at a time when Rabat's traditional markets in Western Europe are threatened—partly because of the entry of Spain and Portugal into the European Community. Moroccan exports to Libya totaled $34 million in 1984, equal to Rabat's exports to the United States. Since the union accord, bilateral trade is up 200 percent, but still only represents 5 percent of Morocco's total trade. Morocco hopes to raise the total annual exports to Libya to $100 million by 1986, but this may be optimistic in view of reports of Libya's failure to pay its bills.

A particularly attractive part of the union agreement for Hassan was Qadhafi's offer to permit a substantially larger number of Moroccan workers in Libya. Morocco has a severe unemployment problem—30 percent of the urban labor force—and faces even greater difficulties as Moroccan workers return because of declining job availability in Western Europe. Worker remittances are Morocco's most important single source of foreign exchange—$870 million in 1984.

As part of his campaign to sell the union, King Hassan promoted the belief that Tripoli initially would take up to 80,000 Moroccan workers. We believe the increase to date has been about 8,000. Moroccan officials state that an average of approximately 1,000 workers enter Libya each month, but Embassy sources claim that the number actually has averaged 500 per month. Moreover, most of these are skilled or professional workers, which does little to ease Morocco's oversupply of unskilled labor. Morocco may benefit marginally from the recent expulsion of large numbers of other foreign workers from Libya. Tripoli agreed to raise the number of authorized Moroccan worker entries to 450 workers per week beginning 1 September 1985 and to employ 1,000 Moroccan teachers.

What's In It For Qadhafi?

The union furthers several of Qadhafi's goals. For example, Morocco is no longer being used as a training ground for Libyan dissidents and Hassan personally decided to turn over some dissidents to Qadhafi. Qadhafi also hopes the union will be viewed in the region as an example of Libyan cooperation with moderate Arabs and will preempt US and Algerian efforts to isolate him in the Middle East. For Qadhafi, the union symbolizes his ideological commitment to Arab unity as an example of Arab states with different political systems working together. In addition, Qadhafi has cited his reduced support to the Polisario and the economic benefits to Morocco as examples to persuade other states facing Libyan-supported local insurgencies and financial pressures—such as Sudan and Somalia—to strike a deal with him. Such 25X1
exhortations are accompanied by frequent reminders from Qadhafi of US unwillingness to back up its verbal condemnation of the union with concrete actions against Hassan. 25X1

Qadhafi has derived substantial political benefits from the union. Hassan has remained quiet on Libya's continued subversion in Sudan and has refused requests from Chadian President Habre to provide him with troops and other logistic support. Indeed, Hassan is playing a key role in attempting 25X1
to arrange a summit meeting between Qadhafi and Habre. The King has also taken a more restrained position on other Middle East issues, including a noticeable lack of support for both the Hussein-PLO peace initiative and Jordan's resumption of diplomatic relations with Egypt. Closer to home, Hassan's behavior during the current tension between Libya and Tunisia is in marked contrast to his response following a Libyan commando raid in Tunisia in 1980. At that time, Hassan sent helicopters as a gesture of support for Tunisia; during the present crisis, he has only sent two envoys in a halfhearted mediation effort. 25X1

The union also has been advantageous for Qadhafi domesticially. Libyans burdened with austerity at home can now travel to Morocco and purchase 25X1
goods in short supply or unavailable in Tripoli. Moreover, Morocco's willingness to barter agricultural goods for oil has helped Libya alleviate shortages of fruits and vegetables. Finally, Moroccan technicians allegedly have provided occasional, but much-needed, maintenance on Qadhafi's US-manufactured civilian aircraft. 25X1

The Costs of the Union

As with any marriage of convenience, Qadhafi and Hassan have not hesitated to do things that irritate the other partner. Tripoli's recent "strategic alliance" with Tehran, for example, prompted a strong

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response from King Hassan, who viewed that development as a threat against his and other moderate Arab monarchies. Moreover, the early departure of the Libyan delegation from the recent Arab League summit hosted by Morocco—as well as Tripoli's condemnation of the Bright Star–85 military exercises involving the United States, Morocco, and other moderate Arab states—embarrassed the King and highlighted the gulf between Hassan and Qadhafi on key security and diplomatic issues in the Middle East. [redacted] 25X1

Hassan also realizes that the union has damaged his relationship with Washington and has jeopardized acquisition of much-needed credits and weapons. Moreover, Moroccan Government officials are concerned that the union has accelerated the warming of ties between Algeria and the United States. Rabat probably believes that the Algerians will try to persuade the United States to support their position on the Western Sahara problem and to pressure Hassan into a settlement. [redacted] 25X1

The union also poses some domestic problems for Hassan. In particular, it has resulted in a sizable influx of Libyans, which increases the potential for subversion, especially if the union fails. Moroccan security officials are particularly worried about the lack of immigration controls over Libyans entering Morocco and about Libyan real estate purchases. [redacted] 25X1

Although the costs of union to Qadhafi have been minimal so far, he does have his own frustrations with it. [redacted] 25X1 Libyan officials are also frustrated by Morocco's reluctance to cooperate on defense, as called for in the treaty, and by its refusal so far to provide embargoed US parts for Libya's US-manufactured aircraft. [redacted] 25X1

In the longer term, the implications of the Moroccan-Libyan union may be ominous for Qadhafi. The union has served to polarize North Africa and to move Algeria toward a collision course with Libya. During the past year, Algeria and Egypt have moved into a closer relationship, based mainly on their opposition to Qadhafi. Tunisia—increasingly fearful of Qadhafi and doubtful of Hassan's continued support—has expanded its defense relationship with Algeria and improved its ties to Egypt. While this polarization of North Africa is not due solely to the Moroccan-Libyan union, we regard the union as a catalyst for heightened regional tension and more active efforts by Qadhafi's neighbors to stymie him. [redacted] 25X1

[redacted] 25X1

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Briefs

Energy

Iraqi Air Attacks on Additional Iranian Oil Facilities

[redacted]

The Iraqis claim their Air Force struck four pumping stations inside Iran on Monday, although the attacks have not been confirmed so far. The strikes follow extensive attacks last week against Iranian oil platforms in the Persian Gulf. The Iranian ability to keep Khark Island functioning despite continuing Iraqi attacks may have caused Baghdad to extend its operations into Iran's interior. Damage to critical pumping stations and other facilities could decrease refinery output, cut natural gas to Iranian cities, and reduce oil exports. The Iraqis, however, would need to make a determined effort to achieve these results. The raids against the oil platforms are designed to knock out Iranian early warning stations there, possibly as a prelude to a larger attack on Khark. [redacted] 25X1

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[redacted]

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Iraq Boosting Oil Exports

[redacted]

Iraq is aggressively lining up customers to load its oil at Saudi Arabia's Yanbu al Bahr terminal on the Red Sea. Baghdad has arranged to export more than 500,000 b/d this month from its new pipeline through Saudi Arabia. Despite Saudi claims to the contrary, Riyadh also continues to sell Saudi oil on Iraq's behalf. Iraq probably has urged Riyadh both to continue aid and to ease restrictions on the flow of Iraqi oil to Yanbu. Baghdad has been seeking greater economic relief to offset growing war weariness and political unrest. The spur line's capacity will rise from about 500,000 b/d to an estimated 800,000 b/d when additional pumping capacity is added early next year. Iraq's exports through Yanbu will nevertheless be limited by the amount of oil Saudi Arabia allows through the main pipeline, which has a capacity of 2 million b/d; Riyadh is now shipping about 500,000 b/d of its own oil through the line. 25X1
[redacted]

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Egyptian Oil Production Set To Increase

[redacted]

Egypt, which is now producing about 900,000 b/d, is expected to increase its production to 1 million b/d by late 1986, according to the US Embassy. Output is expected to stay at that level for two or three years as a result of new production near existing fields in the Gulf of Suez and new discoveries by a US company in the desert 200 kilometers west of Alexandria. The new western fields may come on stream in early 1987—producing between 20,000 and 50,000 b/d—and tenders have been let for a pipeline to the Mediterranean coast. This additional production will help offset rising domestic demand—now about 400,000 b/d and growing 10 to 15 percent per year. The Egyptian Government has publicly stated that its oil exports would cease in seven to 10 years if consumption is not curbed. Oil exports are expected to earn approximately $2.2 billion in badly needed foreign exchange during the current fiscal year. [redacted] 25X1 25X1

Insurgents Destroy Afghan Natural Gas Well

[redacted]

Afghan insurgents last month destroyed a natural gas well at Jar Qoduq—one of the most productive gasfields in Afghanistan—and ruptured the gas pipeline [redacted] Afghanistan, which exports more than 90 percent of its natural gas production to the Soviet Union, earns approximately $300 million for the roughly 2.4 billion cubic meters of gas exported annually. If such attacks continue, they would prove costly because of Afghanistan's heavy reliance on earnings from natural gas exports to help pay for its massive purchases of Soviet arms. [redacted] 25X1 25X1 25X1

International Finance

Jamaica's IMF Program in Jeopardy

[redacted]

State Department and press reports indicate that Jamaica widely missed September targets under its $118 million IMF program and that the Fund may not grant a waiver. Seaga, fearing a violent public reaction, told the IMF that he would not institute price hikes for food and petroleum or other belt-tightening required under the program. Instead, he wants to try to limit consumer imports to strengthen Jamaica's finances. Jamaica's grim economic outlook and insistence by donors and creditors on a valid IMF program as a prerequisite to new funds, give Seaga little choice but to begin negotiations for a new program should the current accord collapse. The talks are likely to be protracted, but, even if he secures another accord quickly, low world demand—particularly for bauxite/alumina, Jamaica's primary export—will limit economic recovery. Regardless of the outcome of IMF talks, the weakening economy is likely to continue to diminish Seaga's popularity, significantly aid Manley's efforts to force early elections, and further alienate the influential business community. [redacted] 25X1 25X1

Iraq Secures Additional Loans

[redacted]

Iraq has obtained a five-year $500 million syndicated loan from Arab, West European, and US banks, according to press reports. [redacted] The new credits will help ease Iraq's financial burden over 25X1 25X1 the next two years when already large rescheduled debt payments come due. Baghdad's ability to secure medium-term commercial financing—despite recent debt reschedulings—reflects creditor faith in Iraq's creditworthiness once the war with Iran ends. [redacted] 25X1

Global and Regional Developments

[redacted] 25X6

Bangkok Requests Reopening of Textile Negotiations With United States

[redacted]

Thai Foreign Minister Sitthi this week offered to send a high-level delegation to Washington to resume negotiations on the US embargo on imports of Thai apparel. Bangkok's request for further discussions reverses its earlier decision to accept the three-month halt in garment exports to the United States rather than face reduced quotas under a new trade agreement. According to the US Embassy, a continued cutoff of shipments would likely idle at least 50,000 textile workers and slash 1985 apparel exports to the United States—its major buyer—by 30 percent. Moreover, if Bangkok cannot obtain some relief from the embargo, Prime Minister Prem probably would be forced to bow to mounting domestic political pressure to endorse retaliatory action against US interests. Following September's coup attempt, Prem is seeking to rebuild his political standing at home, and a soft response to Washington's actions against Thai exports will likely make that difficult if tensions continue. [redacted] 25X1

EC–Middle Eastern Progress on Trade Agreement

[redacted]

EC members have tentatively agreed to propose reducing the tariffs on citrus fruit and other agricultural imports from 11 non-EC Mediterranean countries—including Morocco, Tunisia, and Israel—to preserve these nations' competitive position in the EC market after Spain and Portugal join the Community in January. The agreement, expected to be confirmed as formal policy by the EC Foreign Ministers late this month, will be the basis for renegotiating all the EC's preferential trade agreements with the Mediterranean countries. Despite a US deadline of 31 October for action, the EC probably will wait until the Mediterranean negotiations are nearly concluded 25X1 before addressing the US complaint that the new preferential agreements will hurt US citrus exports to the EC. The negotiations with the Mediterranean states, which could begin late this year, are unlikely to be concluded before next spring. [redacted] 25X1

[redacted]

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CEMA Increasing Aid to Nicaragua

[redacted]

Soviet Bloc countries promised to boost economic and technical aid to Nicaragua during the second annual meeting of the CEMA-Nicaragua Mixed Commission, which ended last Friday in Managua. According to the US Embassy and press releases, Sandinista policymakers claim the new accord will substantially increase aid, but they refuse to provide specifics. Projects that CEMA countries have been financing include cattle and vegetable farms, a deepwater port on the Atlantic coast, and scholarships for Nicaraguan students in the USSR and Eastern Europe. Diplomatic sources in Managua report that the Soviets and East Europeans rejected Managua's continuing attempts to become a full CEMA member, reflecting Moscow's concerns about its increased outlays if Nicaragua were to become a full member and possibly about adverse reactions in the West. [redacted] 25X1

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Joint Chinese-US Helicopter Production

[redacted]

A Chinese machine tool plant has signed a 20-year contract with a US firm to produce obsolete Sikorsky S-55, S-58, and S-62 helicopters in China. The joint company, which plans to produce more than 100 helicopters annually, will assemble the helicopters from the US company's large stock of parts and components for five years before switching to Chinese-manufactured parts. Production will be geared toward sales abroad—primarily in Third World markets. [redacted] 25X1

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National Developments

Developed Countries

Tokyo Considers Eliminating Tax-Free Savings

[redacted]

A consensus seems to be developing among ruling party officials and key government ministries to impose a small withholding tax—5 to 10 percent—on current tax-exempt savings accounts. Tokyo hopes such a tax would reduce Japan's high personal savings rate—about 17 percent of disposable income—while adding needed revenues to the government's coffers. Every Japanese is now entitled to hold the equivalent of about $50,000 in tax-free accounts. 25X1

[redacted] 25X6

Numerous efforts since the late 1970s to tighten restrictions on or tax these accounts have failed because of strong political opposition. The US Embassy now believes that increasing support from top ruling party officials—eager to demonstrate to Washington their commitment to encourage increased consumer spending—makes passage of a small withholding tax possible in fiscal 1986. In our view, Tokyo is unlikely to accompany such action by implementing a politically controversial proposal to prohibit anonymous savings accounts. [redacted] 25X1

[redacted]

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Portuguese Budget Deficit Out of Control

[redacted]

Lisbon's budget deficit—with government spending running 50 percent above last year's level—probably will equal almost 20 percent of GDP compared with 13 percent last year. Lisbon so far has failed to come to grips with the rising costs of social security, public wages, and health and education programs, while neglecting to reform spending on public enterprises and municipalities. In addition, revenues this year will likely be about a third less than expected—partly a result of an overly optimistic GDP growth projection. We do not expect an improvement in the deficit until Lisbon introduces fundamental reforms in its system of public finances, an unlikely prospect in view of the political uncertainties resulting from the elections earlier this month. With no party able to win a majority, the government will probably hold off on any major changes at least until after the presidential election early next year. 25X1

[redacted] 25X1

Sweden Eases Monetary Policy

The Swedish Central Bank last week announced that its penalty interest rate, the major instrument for influencing short-term rates, will be reduced by 1 percentage point to 14 percent in an effort to ease monetary policy and promote domestic growth. Last May the government pushed short-term rates up sharply in order to stem short-term capital leaving the country because of higher interest rates abroad. The recent announcement—which follows by one week a speech by Finance Minister Feldt advocating a looser monetary policy—indicates that the Central Bank is now worried less about capital outflows than about reviving sagging domestic production.

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Less Developed Countries

Kuwaiti Financial Troubles

The US Embassy reports that the Central Bank of Kuwait is being sued by three US banks trying to recover $13.5 million in loans made to the Abulhassan Foreign Exchange Company. The latter is one of Kuwait's largest moneychangers and one of many financial institutions still feeling the effects of the Kuwaiti stock market crash in 1982. Kuwait's handling of the company's debts—reportedly guaranteed by the government—has frustrated the US banks, and they are encouraging the government to bail the company out. Whether or not the banks collect their loans—and the prospect is dim—they want to register their annoyance with the central bank over what could become precedent-setting policy. Kuwait has not yet defined its commitment to financial institutions other than banks, and appears to be helping only selected recipients.

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Mexico's Decline in Tourism

Income from tourism, a promising nonoil foreign exchange earner, may drop because of the recent earthquake and price changes. Last year, tourism increased 10 percent earning about $2 billion—roughly 8 percent of total foreign exchange earnings. This year, however, half a dozen hotels collapsed and another six suffered significant damage in Mexico City, the leading tourist destination. On the Pacific coast, nearer to the earthquake's epicenter, several luxury hotels were also destroyed. Despite this destruction, tourist officials still hope to attract some 2,700 US winter charter flights to Mexico, but the US Embassy questions if all of these could be accommodated. In addition, price hikes for rooms and air fares made prior to the earthquake are discouraging visits to Puerto Vallarta and Guadalajara. In southeastern Mexico, an area unaffected by the earthquake, hotel occupancy rates are also down 15 percent,

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Indonesian Belt-Tightening

Anticipating a continued slide in oil prices, Finance Minister Radius Parwiro last week announced budget cuts designed to stem Indonesia's growing external debt—which now stands at over $30 billion. Although budget cuts and a cap on new foreign borrowing will help Indonesia keep its solid international credit rating, we believe that fiscal austerity will depress

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economic growth, aggravate unemployment, and increase the risk of antigovernment protests. Even if oil prices remain relatively stable, we estimate that economic growth over the next several years will at best average no more than 4.5 percent annually—probably insufficient to fully employ the 2 million workers entering the labor force each year. [redacted] 25X1

Growing Sri Lankan Defense Spending

[redacted]

The Sri Lankan parliament recently approved another increase in defense spending, bringing total allocations for the year to about $250 million—80 percent greater than the original budget. The dramatic acceleration in military spending to counter the Tamil insurgency has pushed defense to 12 percent of government spending, compared to 3 percent in 1982. Meanwhile, overall economic growth has slowed, and a 50-percent drop in world tea prices since January has cut government revenues. Spending on rural development projects, public-sector industries, the Mahaweli irrigation project, and some social welfare programs already has been reduced this year. Finance Minister de Mel has implied that additional cuts are likely. [redacted] 25X1 25X1

New Copper Smelter in Northern Mexico

[redacted]

Mexico continues to seek private foreign financing for construction of pollution abatement facilities for a new copper smelter near the US border, but low metals prices and the overall weakness of the Mexican economy are likely to make investors wary. The smelter—scheduled for completion by the end of the year and part of the huge La Caridad copper complex near Nacozari, Sonora—will have a capacity of 150,000 tons of copper per year, primarily destined to replace imports of finished metal. It will also produce some 1,300 tons per day of sulfur dioxide, a pollutant that must be treated in accordance with the 1983 US-Mexican Border Environmental Agreement. [redacted] 25X1 25X1 25X1

[redacted]

Ethiopia Raises Investment Ceiling

[redacted]

Ethiopia's Chairman Mengistu has announced that government ceilings on private investment will be raised in an effort to stimulate the domestic economy. The levels of savings and investment have declined steadily since 1979, and Addis Ababa forecasts an absolute decline in domestic savings this year. Although some investment opportunities have been constrained by low capital ceilings, the threat of nationalization and further political and economic uncertainty will continue to discourage investors. [redacted] 25X1 25X1

Communist

Expected Decline in Cuban Sugar Production

[redacted]

Cuba's 1985/1986 sugar crop—which experienced drought conditions in key areas—probably will be down some 15 percent to about 7 million tons. [redacted] 25X1 25X1 [redacted] The smaller crop also represents another setback to Havana's goal of lifting annual sugar production to 12 million tons by 1990. [redacted] 25X1

Bulgaria's Gloomy Energy Outlook

[redacted]

Bulgarian energy supplies remain insufficient to meet domestic needs because of a decline in the production of hydroelectric power caused by this year's drought and a cut in Soviet oil deliveries, and government officials expect the energy shortages to continue this winter and into next year. The US Embassy in Sofia reports that power outages and curtailed shop hours and services are becoming routine. The regime in September raised prices for electricity, heating oil, and motor fuels in an effort to improve energy conservation, but the current drive to recoup industrial losses suffered in the first half of the year almost certainly will frustrate conservation efforts. Reflecting continuing concern, Sofia in mid-October replaced the head of its State Planning Committee and created a Party-Government Commission on energy problems headed by Deputy Prime Minister Aleksandrov. Although the new Commission will encourage development of domestic resources and seek further conservation, it probably will also place even tighter controls on energy supplies. [redacted] 25X1

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Soviet-Bulgarian Production of Robots

[redacted]

The USSR and Bulgaria signed an agreement in Sofia last week to establish two joint "scientific-production associations" to produce robots and computer-controlled manufacturing systems. During the next five years the associations are to produce 13,800 numerically controlled lathes, 28,000 industrial robots, and other kinds of manipulators. These machines will be produced for third-country markets as well as for Bulgaria and the USSR. The Soviet-Bulgarian associations are similar to a Soviet-Czechoslovak robotics organization established last March, although it is not clear that the agreement with Bulgaria will require construction of new facilities. The agreement improves Soviet access to Western manufacturing technology licensed to Bulgaria and guarantees a market for Bulgarian robots and flexible manufacturing systems. [redacted] 25X1

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[redacted] 25X1

China Pushing Countertrade

China's Ministry of Foreign Economic Relations and Trade has established a new unit to handle a growing number of countertrade deals. Beijing is seeking to expand the use of countertrade to reduce trade deficits and buttress sagging foreign exchange reserves. Although China now encourages firms from all developed countries to engage in countertrade, US firms could be pressured to do so if China perceives that its trade balance with the United States is worsening or if US trade legislation now under consideration is enacted. 25X1

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