Directorate of
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International Economic & Energy Weekly

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Synopsis

Perspective—*Producer Collusion in the Oil Market?* [redacted] 25X1

The cooperation of major non-OPEC exporters has been instrumental in OPEC's success in upholding the current price structure. [redacted] 25X1

International Oil Market: Midyear Assessment [redacted] 25X1

Recent gains in OPEC oil production and a firming in spot oil prices have signaled a return to more stable conditions in the oil market. Price weakness could reappear in early 1984 if OPEC expands production too rapidly and overshoots demand later this year. [redacted] 25X1

USSR: Status of Construction on the Gas Export Pipeline [redacted] 25X1

[redacted] 25X1

Mexico: High Costs of Maintaining Austerity [redacted] 25X1

President de la Madrid appears willing to test the limits of what is necessary to stay in compliance with the IMF stabilization program, even though meeting the targets is provoking more severe economic problems than international bankers or the Mexican Government had foreseen. He has the support of organized labor and the grudging cooperation of business and the middle class, but it is becoming much harder to maintain consensus. We believe that worsening economic conditions will force Mexico City to seek adjustments in IMF restrictions in the next few months [redacted] 25X1

Lebanon: Economic Impact of Partition [redacted] 25X1

Under the very poor security conditions that exist now and would remain after a partial Israeli withdrawal, Lebanon's economy will stagnate. President Gemayel may appeal to the United States to halt Israeli penetration of Lebanese markets and will continue to press for US economic aid to finance large budget deficits. [redacted] 25X1

International Economic & Energy Weekly [redacted] 25X1

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Perspective

Producer Collusion in the Oil Market? [redacted] 25X1

Improved prospects for OECD economies have contributed to buyer expectations that the slide in oil consumption is coming to a halt. This, combined with general producer compliance with production quotas and the anticipated end to inventory reductions, has dramatically changed the psychology of the market in just the last three months. Spot prices for crude oil are now near official prices, and industry observers generally agree that the fall in nominal oil prices has probably bottomed out. [redacted] 25X1

The cooperation of major non-OPEC exporters has been instrumental in OPEC's success in upholding the current price structure. OPEC representatives met with UK and Mexican officials last winter and spring in an effort to secure cooperation, and in early June the Algerian Oil Minister represented the cartel in similar discussions with Moscow. [redacted] 25X1 25X1 25X1 London set prices last spring that Nigeria had previously indicated were the minimum acceptable without provoking retaliation. Mexico has held its exports near a 1.5-million b/d self-imposed cap despite customer requests for more supply. [redacted] 25X1 Following the meeting the Soviets realigned their export price with the $29 per barrel OPEC benchmark by imposing their second 50-cent increase in a two-month period. [redacted] 25X1

The cooperative effort stemming from common interest in upholding oil prices has been effective so far, but it is ill-equipped to deal with further declines in oil consumption. In such an event, we expect that non-OPEC producers, as well as a number of OPEC members, will again contribute to price pressures by trying to maintain or expand their market shares. Mexico's tenuous financial position permits little leeway for export restrictions if prices drop further, and we believe that the Soviets' need for hard currency would lead them to continue to export near their maximum. Britain is constrained to follow the market by provisions that require the British National Oil Company to purchase North Sea crude at the reference price. Britain must then dispose of crude unwanted by producing companies in the spot market. [redacted] 25X1

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The ability of producers to maintain stable prices in the near term hinges largely on non-Communist consumption. Despite the improved economic outlook, oil consumption has continued to decline. If economic recovery gains momentum during the second half of the year and causes a rise in oil consumption, demand for OPEC crude could rise by 2 million b/d and reach about 19 million b/d. Such a rebound would help further stabilize the market and improve the producers' ability to uphold prices. 25X1

One major hurdle for OPEC will be the manner in which the cartel members establish new production quotas when demand exceeds the present 17.5 million b/d ceiling. OPEC's Ministerial Conference next week in Helsinki is likely to address the raising of individual quotas as well as Nigeria's failure to comply with its ceiling—exceeded by 100,000 b/d in the second quarter. Because of the pressing financial needs of Nigeria and several other OPEC members, we believe there will be a great temptation to produce too much too soon. Unless there is a sustained rebound in oil consumption, these pressures could again lead to the accumulation of excess inventories and a return to the weak market conditions that prevailed in early 1982 and 1983. Under these conditions, and lacking the continued support of non-OPEC producers, we believe OPEC members would be unable to prevent a further decline in prices. 25X1

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Briefs

Energy

OPEC Production Update

OPEC production in June averaged 17.4 million b/d, matching May's level and nearing the cartel's 17.5 million b/d ceiling imposed at the March ministerial meeting. Production in Saudi Arabia rose 300,000 b/d as Riyadh boosted output to meet its war relief commitment to Iraq. [redacted] 25X1
[redacted] the Saudis currently provide roughly 250,000 b/d of oil to 25X1
Iraq's customers to enable Baghdad to fulfill its export contracts. An increase

OPEC: Crude Oil Production *Million b/d*

	1982	1983	1983							
		Quota	Jan	Feb	Mar	1st Qtr	Apr [a]	May [a]	Jun [a]	2nd Qtr [a]
Total	**18.8**	**17.5**	**17.0**	**14.9**	**15.9**	**15.9**	**15.9**	**17.4**	**17.4**	**16.9**
Algeria	0.6	0.725	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Ecuador	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gabon	0.2	0.15	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Indonesia	1.3	1.3	1.2	1.0	1.1	1.1	1.4	1.4	1.3	1.4
Iran	2.3	2.4	2.7	2.5	2.6	2.6	2.3	2.3	2.3	2.3
Iraq	1.0	1.2	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Kuwait	0.7	1.05	0.6	0.8	0.9	0.8	0.7	0.8	0.7	0.7
Libya	1.2	1.1	1.4	1.2	1.3	1.3	1.1	1.1	1.1	1.1
Neutral Zone	0.3	[b]	0.3	0.2	0.2	0.2	0.4	0.5	0.4	0.4
Nigeria	1.3	1.3	0.8	0.7	0.9	0.8	1.2	1.6	1.5	1.4
Qatar	0.3	0.3	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.3
Saudi Arabia	6.3	[c]	4.6	3.6	3.6	3.9	3.9	4.6	4.9	4.5
United Arab Emirates	1.2	1.1	1.2	1.1	1.1	1.2	1.2	1.2	1.2	1.2
Venezuela	1.9	1.675	2.1	1.8	2.1	2.0	1.7	1.7	1.7	1.7

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

[redacted] 25X1

in liftings by the former Aramco partners also helped Saudi production rebound to nearly 5 million b/d, its highest level this year. Output in Indonesia and Nigeria dropped slightly from May levels, but Lagos still exceeded its quota by 200,000 b/d. According to officials from a major international oil company, the Nigerians are likely to urge OPEC to increase its allocation when the cartel meets next week in Helsinki. With the exception of the UAE, other OPEC producers—including former recalcitrants Iran and Libya—continued to restrict output within their assigned quotas in a show of cartel unity. 25X1

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Synfuel Outlook Dims

A major US oil company has recently slashed its long-term synthetic fuels forecast. The firm now expects non-Communist synthetic liquids production to reach only 600,000 b/doe in 1990 and 1.2 million b/doe in the year 2000—66 percent and 75 percent below projections made two years ago. The company contends that weak oil prices combined with long construction leadtimes and technological uncertainties will limit the capital commitments for synfuel projects. 25X1

International Finance

IMF Proposes Reduced Support for India

The IMF has proposed that India borrow only $1.3 billion during July 1983–June 1984, rather than the $2.5 billion envisioned when a three-year Extended Fund Facility was arranged in November 1981. The IMF's revised, more favorable, estimates of India's trade and current account deficits reflect lower-than-anticipated international inflation. Indian officials have expected at least part of the proposed cuts and are less likely to see an anti-India bias here than in curtailed concessional aid from the World Bank. Reduced IMF support for

India would ease the Fund's strained liquidity position and permit higher loans to countries with immediate problems. In our judgment, India can probably cope with the revised level of IMF support this year, but its medium-term 25X1 balance-of-payments prospects are heavily dependent on the success of current oil exploration efforts. 25X1

Colombia's Troubles With Bankers Continue

Lenders are now indicating to Bogota that it will have difficulty securing the $600-800 million in loans needed this year to cover its payments deficit. According to an Embassy report, Central Bank officials learned recently that most lenders are willing to maintain their current lines of credit but not provide new money. Bankers' reluctance to increase their exposure mainly reflects their concern about Colombia's mounting payments problems and sluggish domestic economic conditions. Moreover, a recent negative IMF evaluation of Colombian trade, fiscal, and monetary policies will cause more difficulties on the borrowing front. Given this critical assessment, we believe the IMF will most likely impose severe conditions on Colombia if Bogota is unable to obtain the new international lending necessary to avoid a debt financing crisis in coming months. 25X1

Philippine Financial Decisions Loom

Manila's aid consortium chaired by the World Bank pledged $1.2 billion for 1984 last week in Paris, exactly what Manila is receiving this year. The government used a special "third day" to review its economic program for commercial creditors, but many banks elected not to send representatives. Manila is now expected to turn its full attention to the financial crisis growing out of the country's $8-9 billion short-term debt. 25X1

[redacted]

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Liberia's Financial Noose Tightens

The Doe regime once again is heading for a financial crisis. According to Embassy reporting, Monrovia will probably be without funds from the IMF and international banks for the next three to four months. The IMF has refused to disburse the last two tranches under the current $60 million standby arrangement until Monrovia makes arrangements to reschedule some $25 million owed to international banks for past oil purchases. Monrovia's access to additional funds from US and other private banks, currently financing oil and other essential purchases, will be restricted without IMF money. International bankers are worried about the government's ability to cover the cost of salary as well as oil and debt payments. Monrovia already is at least one month behind on distributing paychecks, even though Doe promised last December to regularize payments in exchange for popular acceptance of hefty reductions in wages. The Fund is insisting on further salary reductions and the paying off of outstanding commercial debts as conditions for a new standby loan. Protracted negotiations almost certainly will prompt Doe to seek Washington's help in persuading the Fund to accept a less stringent program and in obtaining US bank loans. He also may request increased allocations of US Government assistance. [redacted] 25X1

Global and Regional Trends

LDC Foreign Exchange Reserves Decline

LDC foreign exchange reserves fell by $9.5 billion during first-quarter 1983, following a $20 billion drop in 1982. Despite most countries' attempts to constrain imports, slack export earnings and high debt service burdens have depressed reserves. According to IMF data, first-quarter reserves stood at $130 billion, their lowest level since 1978. Nearly all of the first-quarter decline was accounted for by OPEC members, which lost $8 billion. Venezuela and Nigeria, which began drawing down reserves in 1981, continued to do so

LDCs: Foreign Exchange Reserves [a]

Billion US $

	1978	1979	1980	1981	1982	1983 [b]
Total	**120.9**	**144.4**	**163.8**	**159.4**	**139.6**	**130.1**
OPEC	58.6	72.5	92.1	93.1	83.4	75.4
Nigeria	1.9	5.5	10.2	3.9	1.6	1.6
Venezuela	6.0	7.3	6.6	8.1	6.5	5.3
Latin America	28.1	33.9	32.3	30.0	20.6	19.2
Argentina	5.0	9.4	6.7	3.3	2.5	3.4
Brazil	11.8	9.0	5.8	6.6	3.9	3.5
Chile	1.1	1.9	3.1	3.2	1.8	1.3
Mexico	1.8	2.1	3.0	4.1	1.0	NA
Asia	29.1	32.5	33.4	31.2	31.1	31.2
South Korea	2.7	3.0	2.9	2.6	2.8	2.3
Philippines	1.8	2.3	2.8	2.2	1.7	1.7
Africa	5.0	5.6	6.0	5.1	4.5	4.3

[a] Total reserves minus gold.
[b] First quarter 1983.

[redacted] 25X1

under pressure from depressed oil revenues and mounting debt service obligations. Brazil's reserves are only 30 percent of their 1978 level, and Mexico's reserves had dwindled to near zero by February of this year before being boosted by $1.7 billion from commercial banks in late March. [redacted] 25X1

Although foreign exchange reserves continue to fall, the ratio of reserves to average monthly imports—an important measurement of a country's liquidity—has stabilized. Import restrictions and other austerity measures have squeezed the level of imports far below normal. Reserve levels in 1982 were equivalent to almost four months of imports, only a small decline from 1981. We expect non-OPEC LDC reserves to increase slightly throughout the rest of this year as export markets pick up and new borrowing begins to increase after traditional first-quarter lags and as debt rescheduling eases repayment flows. OPEC members, however, will have to curb imports further to reverse the erosion in their reserves. [redacted] 25X1

[redacted] 25X1

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West European Space Program

The European Space Agency's (ESA) successful flight of the Ariane launch vehicle on 16 June will help restore customer confidence in the commercial space program. Success was crucial; so far two of six launches have failed, and another failure could have led several customers to cancel their contracts and thus jeopardize the Ariane program. ESA must still launch the seventh Ariane successfully if the consortium is to be competitive with the United States in the estimated $25-30 billion market for space launch services over the next 10 years. 25X1

ESA has already announced a delay in the next scheduled flight, from 18 August to 15 September, probably to ensure time for a thorough checkout. 25X1

Italy Rejects EC Steel Cuts

Italy's caretaker government has rejected an EC-ordered 16-percent cutback in steelmaking capacity by 1985. The cuts, which would amount to 5.8 million tons and come mainly from Italy's lossmaking state steel group Finsider, are more than double the Italian proposal of 2.4 million tons. While the EC proposal would probably improve Finsider's profitability, the cutbacks would, according to official estimates, result in a loss of 15,000 jobs. More important, the government would have to shut down one or more plants in high unemployment areas such as Naples or Genoa. The prospects of increased layoffs coupled with a continued impasse in major wage negotiations could increase labor unrest. The political sensitivity of the issue has been increased by the delicate negotiations to form a new government in the wake of last month's election. [redacted] 25X1

Although the government's final position probably will await the formation of a new governing coalition, the options include a suit in the EC Court of Justice against the EC decision or a refusal to participate in the steel allocation scheme. The latter course could launch a "steel war" and result in Community safeguards against Italian steel. A new government is likely to favor compromise but will be anxious to find a solution that cushions the impact on labor.
[redacted] 25X1

EC Rejects OECD Export Credit Compromise

At the 11 July EC Finance Ministers meeting, France and Italy blocked ratification of the US-backed compromise for revising the OECD export credit arrangement. The compromise proposes that minimum interest rates on loans to relatively rich countries remain at 12.4 percent, rates to medium-income countries be reduced by 0.65 percentage point to 10.7 percent, and rates to the poorest countries drop 0.5 percentage point to 9.5 percent. France continues to demand that minimum interest rates be reduced by 1 to 1.5 percentage points and wants agricultural products to be covered by the arrangement—presently the consensus only involves industrial products. Paris's hardline position also reflects discontent with the EC Commission's conduct of the negotiations and suggests that the French are attempting to place control of negotiations more firmly in the hands of the finance ministers. Italy apparently was unable to accept the compromise because the caretaker government was unable to formulate a position on the issue. [redacted] 25X1

The Community issued a communique following the meeting requesting extension of the existing arrangement until 31 October 1983 and the beginning of new OECD negotiations before the end of September. We expect the other non-US participants in the consensus to go along with the EC extension request. In the future, Community positions are likely to be developed by the finance ministers, and, as a result, EC negotiators may be even more inflexible.
[redacted] 25X1

Less Developed Countries

Mood of Egyptian Private Sector Improves

Private-sector confidence in President Mubarak apparently has risen in recent months, according to the US Embassy. Concerns that Mubarak would renege on President Sadat's open-door economic policies have been put to rest as Mubarak has made clear in speeches and meetings with businessmen that he supports a major role for the private sector. Business community fears about possible domestic political instability also have eased. On the negative side there is continued criticism of Prime Minister Muhi al-Din because of his strong support for public-sector industries, and complaints persist about tightened import controls. The private sector probably will remain supportive of the President as long as there is no serious civil unrest in Cairo. 25X1

Increased Labor Unrest in Brazil

Concern over unemployment and declining real wages has provoked workers to stage walkouts at two publicly owned oil refineries. Metalworkers in Sao Paulo have struck several foreign-owned auto plants and other industries, and some 50,000 workers have staged generally peaceful demonstrations there. The government has removed the leaders of a petroleum workers' union, fired 30 refinery employees, and put local Army units on alert. Nonetheless, other metalworkers in the city and some government bank employees have scheduled one-day work stoppages next week, and workers at a third oil refinery have voted to strike. 25X1

Brasilia is concerned about the possibility of more widespread demonstrations against the government and about a possible shortage of petroleum products. It probably will act quickly to curtail additional walkouts, particularly in public-sector enterprises. The recent disruptions, following strikes last month by public employees, also will stiffen the resistance of government officials to tougher austerity measures being sought by the IMF. 25X1

Nicaraguan Land Reform Accelerated

Nicaragua has announced that it intends to allocate about 100,000 hectares of land in time for the fourth anniversary of the Sandinista takeover 19 July. An additional 275,000 hectares are to be released in the next few months. In contrast, Managua has distributed less than 120,000 hectares to peasants since the beginning of the program in 1981, although the government has confiscated nearly 200,000 hectares from private owners. The regime is speeding land reform in order to boost rural support and to reward those who participate in the government's efforts to defeat the counterinsurgency. At the same time, Managua is using property confiscations as a weapon against those allegedly aiding the insurgents. 25X1

Stepped-up land reform probably will reduce agricultural production because the government will be unable to supply the advisers or credit needed to maintain output. Although some of the land to be distributed to peasants could come from the 730,000 hectares owned by the state and not currently under cultivation, additional productive medium and large private properties are likely to be nationalized. [redacted] 25X1

[redacted] 25X1

Seychelles' New Economic Measures

President Rene announced earlier this month a series of measures to increase public revenue and bolster sagging foreign exchange reserves. The measures include a ban on automobile imports, a more comprehensive sales tax, a boost in the tax rate on upper level incomes, and a major increase in local bus fares. The US Embassy reports that the reforms, which already are generating popular resentment, will not be enough. To curb spending Rene must modify his expensive social programs, such as universal health care. Reviving the tourism industry, which accounts for nearly half of GDP, would require a currency devaluation, something Rene believes is too politically risky. [redacted] 25X1

Communist

China Lobbying IDA Donor Countries

Beijing's Finance Minister Wang Bingqian called in representatives of the major World Bank donor countries last week to press China's case for receiving "a fair and reasonable share" of the upcoming IDA replenishment. The 33 donor countries are scheduled to meet next week in Tokyo to discuss the Bank's proposal of $16 billion for IDA VII. This is the first time China will be eligible for IDA funds since joining the Bank in 1980, and Wang argued that China's record $11 billion foreign exchange reserves should not influence the IDA decision on the allotment because China would be in deficit in a few years. Wang claimed that, if China receives assistance now, it will become an IDA donor country by the 1990s. Although Wang did not specify a figure, the US Embassy in Beijing believes China would like to receive as much as India, about $1 billion a year, or 25 percent of the proposed replenishment. Beijing thus will be competing for the Bank's resources with other LDCs at a time when it is seeking to promote closer ties with them. [redacted] 25X1

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USSR Hard Currency Trade Deficit Up

The Soviet hard currency position deteriorated in first-quarter 1983, as the trade deficit climbed to $2 billion, compared with $1.2 billion in January-March 1982. Exports fell by about 6 percent, due primarily to a $500 million reduction in sales to Iraq. The value of exports to the developed Western countries was about the same as in first-quarter 1982. An apparent drop in the value of oil sales (due to a likely leveling off in volume and a roughly 12-percent decline in price) was offset by increases in nonoil exports. 25X1

Hard currency imports, meanwhile, rose by 5 percent. A sharp drop in agricultural imports was more than offset by increased purchases of pipe, machinery and equipment, and of Libyan oil for resale to Soviet customers in the West. Total imports from the major suppliers for the Siberia–to–Western Europe gas pipeline—France, Italy, and West Germany—increased 32 percent. Purchases of Libyan oil rose by an estimated 160,000 b/d, to more than 200,000 b/d in first-quarter 1983. According to US data, Moscow purchased no US soybeans and reduced the volume of grain it bought from US suppliers. 25X1

USSR: Hard Currency Trade With Selected Countries *Million US $*

	January-March 1982			January-March 1983		
	Exports	Imports	Balance	Exports	Imports	Balance
Total	**6,358**	**7,600**	**−1,242**	**5,994**	**7,979**	**−1,985**
Developed West	5,215	6,406	−1,191	5,262	6,512	−1,250
Of which:						
Australia	2	182	−180	1	283	−282
Austria	274	166	108	208	263	−55
Belgium	392	278	114	322	212	110
Canada	10	208	−198	6	341	−335
France	659	488	171	604	687	−83
Italy	824	409	415	1,043	548	495
Japan	262	1,121	−859	274	916	−642
Netherlands	444	198	−246	529	181	348
United Kingdom	307	236	71	318	291	27
United States	33	1,371	−1,338	76	736	−660
West Germany	1,401	1,041	360	1,191	1,316	−125
LDCs	1,143	1,194	−51	732	1,467	−735
Of which:						
Argentina	10	435	−425	10	514	−504
Brazil	61	167	−106	6	130	−124
Iraq	586	2	584	75	NEGL	75
Libya	62	115	−53	117	551	−434

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Soviet Grain Buying Activity

Following a two-and-a-half-month hiatus, Moscow reentered the world grain market last week [redacted] 25X1

The purchases are the first in the new marketing year and may reflect a Soviet need to line up grain shipments for the summer months. Prior to last week, Moscow had only 2 million tons of grain scheduled for delivery during the July-September quarter. With the outlook for a much-improved Soviet domestic crop—currently estimated at 210 million tons—imports are likely to total 25-30 million tons this year, compared with 33 million tons last year. Given the ambitious export plans of non-US exporters and existing Soviet long-term accords for up to 14 million tons annually, the USSR should have little difficulty meeting most, if not all, of its grain imports from non-US sources, if it so desires. [redacted] 25X1

International Oil Market: Midyear Assessment [redacted]

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Recent gains in OPEC oil production and a firming in spot oil prices have signaled a return to more stable conditions in the oil market. Although non-Communist consumption has continued to fall and inventories are being depleted, the willingness of producers to cooperate and prospects for economic recovery should, in our view, cause prices to hold at current levels through December. In the absence of a sustained economic recovery and a rebound in oil use, the willingness of financially pressed producers to cooperate and hold the line on prices is likely to wane. Price weakness could reappear in early 1984 if OPEC expands production too rapidly and overshoots demand later this year. [redacted]

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Recent Trends

Consumption Patterns. The decline in oil consumption continues. Based on oil industry data, we estimate that non-Communist oil consumption fell by about 5 percent during first-quarter 1983, the 14th consecutive quarter that oil sales have declined from year-earlier levels. Partial data for the second quarter indicate that the decline in oil sales is continuing, albeit at a slower rate than in 1982. Oil consumption in the United States and Italy fell by an estimated 3 percent in April-May. During the same period oil sales in France approximated year-earlier levels. [redacted]

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Inventory Adjustments. Industry expectations of a price decline caused a large inventory liquidation in recent months and contributed to the depressed demand for OPEC oil. We estimate non-Communist oil stocks on land declined to about 3.9 billion barrels at the end of the first quarter or about 92 days of forward consumption. We believe secondary and tertiary stocks—oil held by wholesalers, retailers, and users—were also drawn down in anticipation of an oil price decline. Based on the historical relationship between stock levels and consumption, stocks at the end of March were still above normal by about 100-200 million barrels, representing two to four days of forward consumption. On the basis of our estimate of consumption and current supply levels, we believe commercial inventories during the second quarter held roughly steady or declined by up to 1 million b/d. This is in marked contrast to a normal seasonal buildup.[1] [redacted]

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Non-Communist Primary Oil Stocks on Land [a]

	Billion Barrels				Days of Forward Consumption			
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
1978	3.6	3.7	3.9	3.9	74	76	74	69
1979	3.5	3.8	4.2	4.3	72	78	81	82
1980	4.3	4.6	4.8	4.6	91	99	97	93
1981	4.5	4.6	4.7	4.6	101	104	100	96
1982	4.3	4.2	4.3	4.3	97	98	97	96
1983	3.9 [b]				92 [b]			

[a] End of period. Estimates include government-owned stocks in Japan and the United States that have increased from 18 million barrels in first-quarter 1978 to about 385 million barrels at end of first-quarter 1983. The increase amounts to about nine days of forward consumption.
[b] Estimated.

[redacted]

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[1] Because of historical seasonal fluctuations in the level of oil consumption, non-Communist primary oil stocks are normally accumulated during the spring and summer months. The buildup is usually about 1.5 million b/d during the second quarter and approximately 2.5 million b/d during the third quarter. These stocks are then depleted during the fall and winter to meet peak consumption needs. The drawdown is normally about 1 million b/d during the fourth quarter and about 3 million during the first quarter. [redacted]

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Production Trends

Preliminary data [redacted] indicate OPEC crude oil production in June averaged 17.4 million b/d, more than 1 million b/d above April levels and approaching the cartel's production ceiling of 17.5 million b/d set in March. Nigeria, the UAE, and Indonesia are the only nations to have exceeded their individual production quotas; second-quarter production in all three nations was close to 100,000 b/d above their ceilings. Major non-OPEC exporters have signaled their intentions not to undermine the price structure. According to statements made by senior Mexican oil officials, Mexico has adopted a temporary 1.5 million b/d export ceiling. While maintaining output at near capacity levels, the United Kingdom dropped prices only slightly in April. [redacted]

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Oil Price Trends 1983 [a] *US $ per barrel*

	February	March	April	May	June
Arab Light					
Official	30.00	29.00	29.00	29.00	29.00
Spot	28.00	29.00	28.85	28.60	28.90
Yield	25.54	26.57	28.02	27.31	27.49
Kuwait Medium					
Official	28.30	27.30	27.30	27.30	27.30
Spot	27.50	26.25	27.25	26.95	27.10
Yield	24.69	25.67	27.05	26.31	26.26
Bonny Light					
Official	30.00	30.00	30.00	30.00	30.00
Spot	28.00	28.50	30.00	29.75	30.20
Yield	26.54	27.82	29.40	28.81	29.65

[a] End-of-month prices and yields.

[redacted]

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Recent Price Developments

Producer willingness to hold down production, coupled with buyer acceptance of the British National Oil Company's minimal price reduction in April and the lack of retaliatory cuts by Nigeria and other OPEC members, has helped firm prices in recent months. Spot crude oil prices continue to fluctuate around official prices. Arab Light prices are now only 10 cents below the official price, while spot crude prices for Bonny Light are running about 20 cents above the official level. Most [redacted] expect further price fluctuations in the coming weeks as the market attempts to sort out supply and demand trends. [redacted]

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Demand Outlook

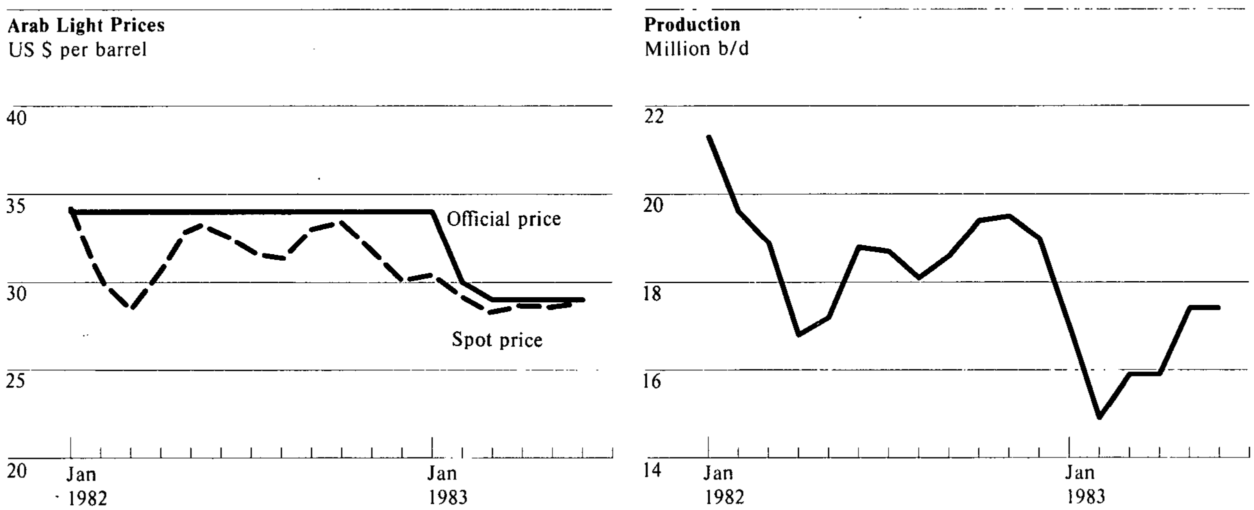
Consumption Factors. Oil market conditions during the remainder of this year will depend in large part on consumption trends. Predicting future consumption patterns, however, is difficult:

- Forecasters have had limited success in predicting the sharp decline in consumption during the past few years. Moreover, estimates differ on how much of the decline was due to conservation versus the recession.

- The pace of economic activity and its impact on oil consumption are uncertain. Many forecasters believe a recovery will bring a rebound in oil use because increased activity in energy-intensive industries and oil's traditional role as a swing fuel should bolster oil demand.

- Accurate and timely data on end user consumption of oil are not available. The apparent consumption measured by companies includes secondary and tertiary stock movements, the effect of which cannot be easily separated from actual oil use. If, as we expect, significant drawdowns of these stocks occurred in early 1983, a reversal in

OPEC: Crude Oil



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this trend could cause major international companies to overestimate final consumption in second-half 1983, unnecessarily boost imports, and wind up with excess oil stocks.

- Fluctuations in currency exchange rates will cause oil prices, and hence consumption, to vary between countries.

Consumption Outlook

To assess the market outlook for the balance of 1983, we have examined two scenarios for oil consumption. Under our base case, we assume that the economic recovery combined with erosion in real oil prices raises oil consumption above year-earlier levels in the fourth quarter. Although the OECD economies now appear to be pulling out of the recession, the recovery is neither uniform nor rapid. Most economic consulting firms expect growth in the United States and Japan, for example, to outpace the level of growth in Western Europe. These same forecasters expect that average OECD growth will approximate only 2 percent for the year. To accommodate the uncertainty about economic recovery and the possibility of continued high rates of conservation, we have examined an

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Estimated Non-Communist Oil Supply and Demand

	1982					1983									
						Base Case					Low Consumption Case				
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Year	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Year	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Year
Consumption [a]	47.5	44.0	43.2	44.6	44.8	45.0	42.5	42.8	45.4	43.9	44.7	42.0	41.0	43.0	42.7
Inventory change [b]	−3.3	−1.8	0	0.2	−1.2	−4.2	−0.6	1.6	−1.2	−1.1	−3.9	−0.1	1.9	0	−0.6
Supply	44.2	42.2	43.2	44.8	43.6	40.8	41.9	44.4	44.2	42.8	40.8	41.9	42.9	43.0	42.1
Non-OPEC	23.3	23.6	23.8	24.4	23.8	24.1	24.2	24.4	24.4	24.3	24.1	24.2	24.2	24.3	24.2
OPEC	20.9	18.6	19.4	20.4	19.8	16.7	17.7	20.0	19.7	18.5	16.7	17.7	18.7	18.7	17.9

[a] Including refinery gain.
[b] Including stock change afloat.

[redacted] 25X1

alternative case that assumes that the rate of decline in oil consumption in developed countries continues at its recent pace through yearend. Under both scenarios we assume LDC oil consumption remains relatively flat. [redacted] 25X1

Inventory Behavior. Movements in oil inventories will play a key role in determining the level of oil demand for the balance of this year. Companies still have some leeway to reduce stocks and probably will strive to keep inventories at minimum levels. Our base forecast, however, assumes that at some point in the next few months inventory depletion will be halted—either because stocks will be approaching minimum levels or companies perceive that the price decline is over. Because of differing levels of inventories, some companies may have already ceased drawing down stocks, which probably accounts for the recent rise in OPEC production. On balance, the resumption of normal inventory patterns later this year could alone raise oil demand by nearly 2 million b/d. Under our alternative case, we assume excess inventories remain through yearend because international oil companies continue to overestimate future consumption levels. [redacted]

Near-Term Price Outlook

The Base Case: Prices Hold. Should oil consumption rebound and inventory changes return to historical patterns during second-half 1983, demand for OPEC oil would increase to about 20 million b/d including 1 million b/d of natural gas liquids. Under this base case scenario, demand for OPEC oil would rise above the present quota system by the fourth quarter. Such an increase should help underpin the present pricing structure and lessen pressures for some OPEC members to cheat on their quotas. While OPEC members appear determined to prevent a further slide in oil prices, production controls will remain essential to maintaining price stability. We expect OPEC members to have a difficult time apportioning new quotas once demand exceeds the present level. [redacted] 25X1

Alternative Forecast: Price Weakness. Should the lower consumption case materialize, demand for OPEC crude oil would average roughly 17.5 million b/d during second-half 1983, approximating the current OPEC ceiling. Under this scenario OPEC members would have a difficult time preventing a further price decline. Should OPEC

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production increases overshoot actual consumption levels, excess stocks would persist and spur another downturn in demand for OPEC oil this winter. Under these circumstances and without a sustained rebound in oil consumption, serious price pressures could return in early 1984, repeating the pattern of the previous two years. [redacted]

Another key in the near-term market outlook will be the behavior of non-OPEC producers. Although oil market stability remains in their interest, we believe coordination with OPEC would wane should oil demand drop sharply:

- Renewed market weakness would put pressure on Mexico to lower prices, given its financial difficulties and desire to sell up to its export capacity.
- The United Kingdom would face increased pressure to cut prices should sales plummet as a result of market weakness or attempts by other exporters to increase market share.
- The Soviet Union would be among the first to shave prices to maintain volumes and ensure vital hard currency earnings. [redacted]

Looking Ahead

Even though we believe cooperation among oil producers and a slight improvement in oil demand will result in stable oil prices through the end of the year, oil exporters are by no means out of the woods. Given the financial difficulties faced by many producers, a sustained rebound in oil consumption will be needed to maintain cooperation and to avoid the temptation to cheat on pricing and production guidelines in an attempt to improve market share. Equally important will be the ability of OPEC members to establish new quotas once demand exceeds the present 17.5 million b/d ceiling. We expect these negotiations to be difficult, and considerable pressure will be generated by several financially pressed members to obtain as large a share of the new quota as possible. The danger for OPEC would be to produce too much too soon, causing the market to accumulate excess inventories once again. If this were to happen, we would expect another serious crisis to develop early in 1984 when the market approaches the normal seasonal drop in oil consumption. [redacted] 25X1

The size of a possible supply glut—measured as the excess of desired production over demand for OPEC oil—provides an indication of the potential for downward price pressures. To estimate OPEC's desired production level, we calculated the level of production each country needs to maintain total financial assets at yearend 1982 levels, assuming current prices hold and austerity measures remain in place. On this basis, we estimate that OPEC's desired production approximates 23-24 million b/d including natural gas liquids—nearly 5 million b/d above our 1983 base-line demand estimate. Should OPEC members attempt to achieve this desired production level, prices would probably fall sharply, perhaps to $20 per barrel or lower. [redacted] 25X1

OPEC's problems would be further compounded in the unlikely event that the Iran-Iraq war ends. Any attempt by Iran and Iraq to increase exports would put downward pressure on prices and force OPEC into difficult rationing decisions. While Iranian production is not constrained to its present level by the war, Iraq would require only four to six months after the war to increase exports by 1-2 million b/d. Even the anticipation of such an increase in supplies would soften the market and pose serious problems for producers attempting to maintain oil prices. [redacted] 25X1

[redacted] 25X1

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USSR: Status of Construction on the Gas Export Pipeline

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Soviet Pipelaying Reports

Information in the Soviet press suggests that pipelaying for the gas export pipeline probably will be completed in the third quarter of 1983. As of 20 May 1983, 4,237 km of the pipeline's total length of 4,451 km had reportedly been insulated and laid in the pipeline trench. The Soviets hope to have pipelaying completed by September—three months ahead of schedule.

According to Soviet media reports, most of the pipelaying on the difficult eastern portion of the route—from Urengoy through the Urals—has already been completed and is undergoing testing.

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The Soviet press, however, later reported that pipelaying proceeded on a faster-than-average pace once the swamps froze. The pipelaying progress claimed in the Soviet press is possible if the Soviets made good use of November and December for acquiring and stockpiling supplies and materials, for welding linepipe into jointed lengths, and for repair and maintenance of pipelaying equipment. 25X1

A late May Soviet media report announced that over 3,000 km of the gas export pipeline had already been tested with water at a pressure of 90 atmospheres—15 atmospheres above actual operating pressure. On the Ukrainian section of the pipeline, pipelaying operations are still in progress. Soviet media have announced that pipelaying in this area may not be completed until September—primarily due to the rugged and difficult terrain along the pipeline route through the Carpathian Mountains. 25X1

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[redacted]

Now that pipelaying operations on the Siberia–to–Western Europe gas export pipeline are apparently nearing completion, the Soviet press has reported that some of the 20,000 workers employed in pipelaying activities are being transferred to work on construction of a new gas pipeline from Urengoy to Yelets. The Soviets would need this and another pipeline in order to attain their gas production target for West Siberia in 1985. [redacted] 25X1

Status of Compressor Station Construction

The Soviet press has reported that 18 compressor stations for the gas export pipeline will be completed in 1983. [redacted] 25X1 25X1

We believe, however, that the Soviets will not attain their goal of having 18 compressor stations operational by the end of the year. In building compressor stations, the Soviets have had a history of not being able to bring the right men and material to the right place at the right time.

[redacted] 25X1 25X1

The USSR now has 22 Western Frame V turbine and compressor sets—enough to equip seven compressor stations and to provide sufficient power to move all the gas contracted for to date. At the end of 1985 the Soviets should receive delivery of the last of the Frame V turbines and compressors and will already have installed enough compressor power to accommodate the scheduled sales of gas to West European buyers (including the Italian purchase still being negotiated). [redacted] 25X1

How the Soviets will use these Western turbines and compressors is still unclear, however. Accord-

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ing to Soviet press reports, some stations on the gas export pipeline will be equipped with the Frame V turbine-and-compressor sets and other stations with newly developed Soviet sets. [redacted]

With respect to the efficiency and reliability of pipeline operation, use of Soviet turbines is clearly an inferior alternative to equipping the line with the Western equipment originally ordered. Nonetheless, Moscow may consider the use of Soviet turbines to be advantageous in terms of a riposte to the recent US embargo, as well as an assertion of Soviet technical prowess and determination to become self-sufficient. By using some of their domestically manufactured turbines on the gas export pipeline, moreover, the Soviets could use some of the Western turbines and compressors that will be delivered over the next two years on another pipeline moving gas to the western USSR for domestic use or, potentially, for export. Because of the "looping" effect, this would enhance the combined reliability of operation of those gas pipelines. [redacted] 25X1

Soviet Turbine Development

The Soviet-produced GTN-25, GTN-16, and GPA-16 turbine and compressor units are newly developed, have not been adequately field-tested, and probably will prove to be considerably less reliable than the Western equipment. Although there were problems with production of the turbine blades for the GTN-16 (a 16-MW industrial-type unit) some of these problems apparently have been resolved. We believe the Soviets are having more serious problems in obtaining blades for their 25-MW turbine. [redacted] 25X1

[redacted] Soviet press reports have also announced the intention to increase output of the GPA-16 (a jet engine derivative) at the Sumy Turbomotor Plant to 55 this year [redacted] 25X1 25X1 25X1

Although the Soviets probably will experience problems with these newly developed turbines and compressors, we believe that some may be used on the gas export pipeline as a matter of prestige. 25X1

[redacted] 25X1

Mexico: High Costs of Maintaining Austerity [redacted] 25X1

President Miguel de la Madrid is strengthening the austerity program he introduced last December with tough new initiatives on wage, subsidy, and administrative policies. He appears willing to test the limits of what is necessary to stay in compliance with the IMF stabilization program, even though meeting economic and financial targets is provoking more severe economic problems than international financiers or the Mexican Government had foreseen. [redacted]

Strong determination and skillful negotiating tactics have ensured de la Madrid the support of organized labor and earned him the grudging cooperation of business and the middle class. It is, however, becoming much harder to maintain consensus. Import and public spending cuts are sharply reducing economic activity, bankruptcies and job losses are multiplying, real wages and personal incomes are plummeting, and inflation is staying near triple digits. [redacted]

We believe that in the next few months worsening economic conditions will force Mexico City to seek adjustments in IMF restrictions on the public-sector deficit, money supply expansion, and overseas borrowing to hold the fall in employment and consumption to politically acceptable limits. Even if de la Madrid eases austerity, the steep economic decline is likely to persist throughout this year. If he continues to stand tough, Mexico would be in a more favorable foreign exchange and inflation position for regaining some economic momentum, perhaps by late 1984. [redacted]

Austerity Bites Deep

Meeting IMF Targets. De la Madrid has been moderately successful in managing his austerity program by devaluing the peso, restraining wages, cutting government spending, and freeing most price controls. In May, the IMF characterized austerity implementation as forceful, and—based on preliminary data—judged Mexico in compliance with first-quarter program objectives. More recently, the US Embassy indicated that Mexican officials expect to pass second-quarter targets also—but by a much less comfortable margin. [redacted] 25X1

We believe Mexico City cut its budget deficit 25X1
during the first half of 1983 to some 10 percent of GDP—from 18 percent of GDP in 1982—despite a falloff in tax revenues. The 1983 budget mandated a 20-percent real cut in non-debt-related spending and a 20-percent increase in revenues. Reduced spending—largely reflecting trimmed capital goods imports—appears to be at or below target, and the government has just announced further sharp reductions in food subsidies. Tax revenues, however, have sagged with lower world oil prices and declining revenues from business and personal income 25X1
taxes. [redacted] 25X1

Implementation of the IMF austerity program has slashed foreign purchases and enabled Mexico to meet its external financial targets and build foreign exchange reserves somewhat. We estimate that Mexican imports during January-June were 60 percent below the level during the same period in 1982. This boosted Mexico's trade surplus to $6.6 billion during the first half of the year, allowed $4.8 billion in interest payments on the foreign debt, and pushed the current account into surplus. Capital flight continued but at levels that were 25X1
offset by the new foreign loans allowed under the stabilization program. [redacted] 25X1

Mexico: Foreign Financing Gap

Million US $
(except where noted)

	1975	1980	1981	1982 [a]	1983 [a]		
					Jan-Jun	Jul-Dec [b]	Jul-Dec [c]
Trade balance	−3,159	−1,471	−3,003	7,802	6,550	3,250	6,950
Exports, f.o.b.	3,540	17,015	20,927	22,224	10,550	11,250	10,950
Oil and gas	464	10,306	14,441	16,362	7,500	7,500	7,500
Manufactures	1,831	3,726	3,797	3,742	1,900	2,400	2,100
Agriculture	892	1,544	1,481	1,233	650	750	750
Minerals	353	1,439	1,208	887	500	600	600
Imports, f.o.b.	6,699	18,486	23,930	14,422	4,000	8,000	4,000
Net services and transfer	−1,284	−5,290	−9,541	−10,486	−4,650	−5,650	−5,350
Interest	−1,437	−5,437	−8,383	−10,879	−4,750	−5,650	−5,650
Current account balance	−4,443	−6,761	−12,544	−2,684	1,900	−2,400	1,600
Debt amortization due	1,058	5,984	6,310	8,500	4,000	4,000	4,000
Financial gap	**−5,501**	**−12,745**	**−18,854**	**−11,184**	**−2,100**	**−6,400**	**−2,400**
Medium- and long-term capital inflows	5,431	12,460	18,006	16,698 [d]	5,500 [d]	20,500 [d]	−17,500 [d]
Net short-term capital (errors and omissions)	215	1,173	1,962	−8,514	−2,400 [e]	−13,100 [e]	−13,100 [e]
Changes in reserves	145	888	1,114	−3,000	1,000	1,000	2,000
Other financial items							
External debt, yearend	17,600	50,700	74,900	80,800	NA	86,800	83,800
Short term	5,200	11,100	22,500	23,200	NA	10,000	10,000
Debt service ratio (*percent*)							
Due	35.0	45.6	47.7	63.1	56.3	59.4	60.5
After debt relief	35.0	45.6	47.7	46.8	36.9	40.9	41.7

[a] Estimated.
[b] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[c] Assumes Mexico City keeps imports and public-sector spending at rock bottom rates through 1983.
[d] Includes $4 billion in 1982, $1 billion in first-half 1983, and $5 billion in second-half 1983 in debt relief on medium- and long-term debt principal due; and $1 billion in first-half 1983 and $12 billion in second-half in rescheduling of short-term into long-term obligations.
[e] Includes rescheduled short-term debt and arrears, and capital flight.

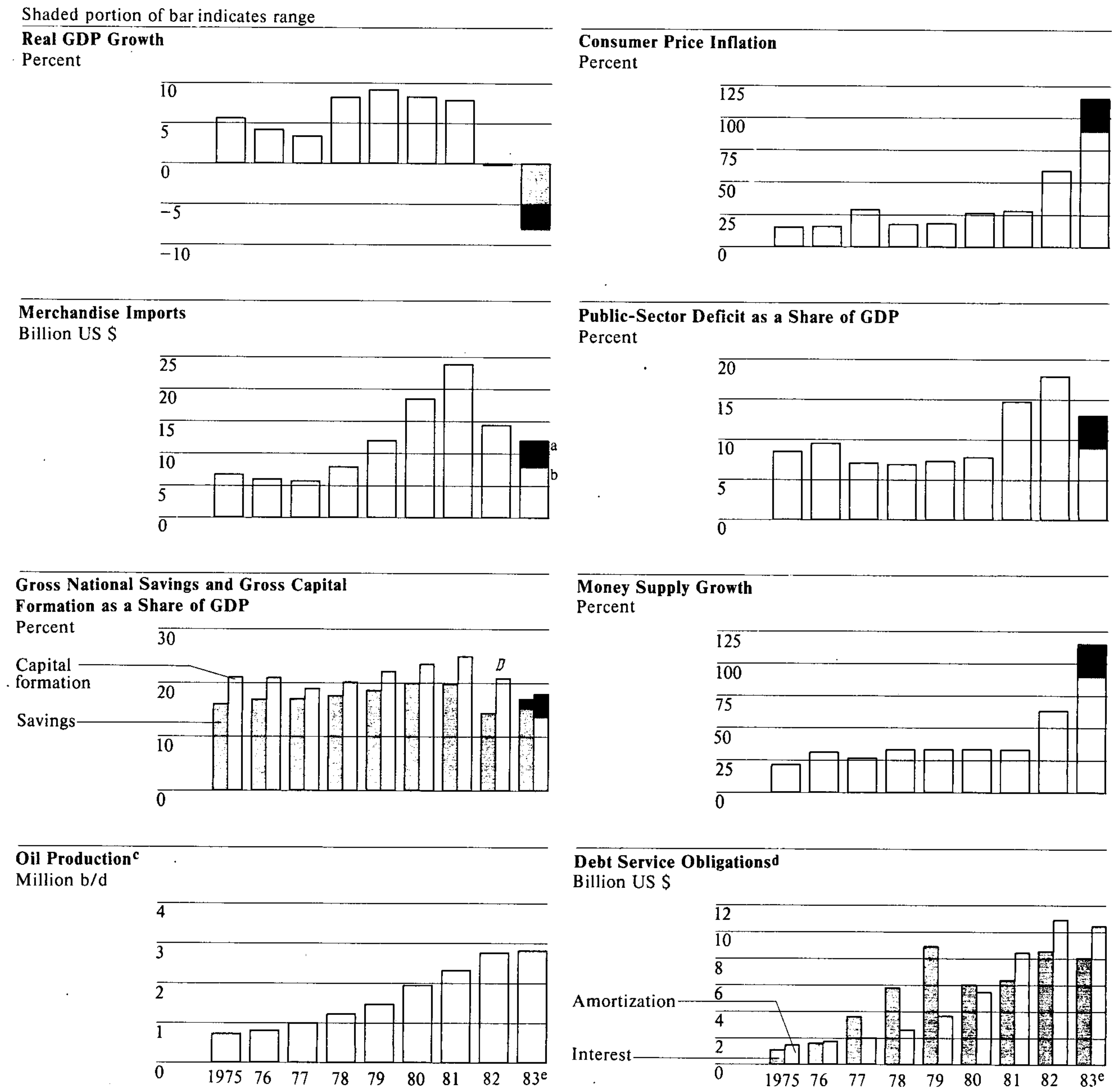
[redacted] 25X1

Domestic Economic Tailspin

Output. Financial restraints have provoked growing domestic economic problems, however. We calculate that economic activity fell at an annual rate of about 6 percent during January-June. [redacted] 25X1

Import shortages have hit industrial production hardest. Continuing price controls on basic commodities and shortages of imported raw materials, intermediate goods, machinery, and spare parts have eliminated profits for many firms and led to numerous bankruptcies and plant shutdowns. During the first half of 1983, idle capacity in industry grew rapidly; the 163 largest industrial firms were operating at two-thirds capacity, down from 90-percent capacity in 1982, according to a Bank of

Mexico: Economic Indicators



[a] Assumes Mexican policy makers relax austerity by increasing imports and public spending.
[b] Assumes Mexico City keeps imports and public spending depressed.
[c] Excluding natural gas liquids.

[d] Interest on all debt, amortization due on medium- and long-term only; in 1982 debt moratorium and private sector arrears lowered actual debt payments $5 billion, in 1983 we expect debt rescheduling to reduce actual payments on interest and medium- and long-term debt by about $7 billion.
[e] Projected.

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Mexico survey. On the basis of first-quarter data released by the Mexican treasury, we estimate that industrial production dropped at an annual rate of 12 percent during the first half of 1983. [redacted]

Other sectors are also declining. We estimate that public and private construction activities are off nearly 75 percent. Traditional commercial activities have been cut sharply by the falloff in industrial output and imports and by the higher value-added tax. The outlook for agriculture is also poor because of falling real farm price guarantees and growing shortages of fertilizers, machinery, and other imported inputs. Even the minerals sector has been hit by sharp budget cutbacks and low world oil prices. [redacted]

Employment. In these circumstances, employment pressures—particularly for unskilled labor—have become severe. Private-sector economists in Mexico estimate that 1 to 2 million jobs have been lost since mid-1982 and that unemployment is now in the 20- to 30-percent range. While government authorities claim the figures are lower, they admitted in May that the unemployment rate had doubled during the last year. Job losses have thus far been concentrated in the private sector. Based on preliminary official data, we believe government jobs stayed constant or increased slightly because of the $2.7 billion public works program announced by Mexico City last January. [redacted]

Inflation. Inflation remains in the triple-digit range despite the recession and much higher unemployment. In January-June consumer prices rose 41 percent, an annualized rate of 100 percent, fueled by the soaring peso cost of imports, mounting consumer goods shortages, and the still high budget deficit. Wholesale prices rose substantially faster—at an annualized rate of 133 percent—as a result of raw material shortages, lower input subsidies, and fewer price controls. [redacted]

Selling Austerity

Public Relations Efforts. Recent public opionion polling indicates that the President's low-key and down-to-business style, his vigorous attack on inefficient policies, and his measures to curb official abuses of power have convinced many Mexicans that belt tightening is essential. 25X1 To maintain the cooperation of organized labor, business, and the middle class, the government is attempting to improve its reputation for honesty, efficiency, and fairness, and ensure that austerity is shared equally. A vigorous anticorruption campaign has even targeted key ruling party loyalists. De la Madrid's National Development Plan, published 30 May, is a major effort to retain public support for belt tightening. The plan suggests that 18 more months of tough austerity are needed but that equity will be considered and living standards of the poor improved, in part by eliminating privileges of the 25X1 rich. [redacted] 25X1

Private-Sector Hesitation. The middle class and private business have been pleased with de la Madrid's lack of rhetoric, his nonconfrontational style, and the anticorruption campaign, but they are concerned about the absence of an explicit role for private enterprise in the development plan. Even though the plan does not specifically call for more nationalizations, many businessmen believe government ownership of Mexico's productive capacity will increase. Mexican and US economists doubt the government's ability to greatly increase nonoil exports in the short or medium term—as the plan calls for—without substantial support from private 25X1 business. [redacted] 25X1

Winning Over Organized Labor. We continue to believe that retaining support of organized labor remains key to keeping austerity going. Gaining and maintaining unions' support thus far has been—in our opinion—de la Madrid's most notable achievement. Official labor unions have remained quiet despite the administration's unwillingness to make concessions on wages. In January, minimum wages were raised just 25 percent and in June only 25X1 15.6 percent. These increases lag far behind the rise in the cost of living. [redacted] 25X1

The President also has taken a hardline stance with small Communist-dominated unions. According to press and US Embassy reports, a monthlong strike by nonacademic employees of the National University, organized into Mexico's largest Communist-led labor union, ended in early July without a pay increase for the strikers. The administration was inflexible during bargaining sessions and was prepared to terminate the workers' contracts. Members of another leftist union were undercut by the announced liquidation of the government-owned company they were striking. [redacted]

Limited Progress on Debt Rescheduling

The IMF stabilization package—purchased at the short-term cost of economic austerity and possible social unrest—was intended to open a window to reschedule Mexico's mammoth foreign debt. Nonetheless, debt rescheduling efforts continue to slip. [redacted] Many public-sector agencies have not yet begun to work out individual terms with representatives of the banks. While most of the public-sector debt of some $67 billion will eventually be rescheduled, few bankers are pleased with the terms offered on $19.5 billion in arrearages and debt payments on public debt due through 1984. [redacted]

Even less has been accomplished in efforts to restructure private debt. The US Embassy recently estimated that as of mid-June only $200 million—of the $9 billion to be renegotiated—has been rescheduled despite Mexico City's offer to guarantee availability of foreign exchange to pay private-sector debt for loans rescheduled over six to eight years. The recent headway on Mexico's foreign accounts has encouraged the international financial community somewhat, but, because of the continued capital flight and problems in reducing debt arrearages, bankers remain skeptical about the government's ability to provide foreign exchange to pay private debt obligations. [redacted]

While Mexico has largely stayed current on public-sector interest obligations, the substantial interest arrearages owed by the private sector continue to grow. Over the last six months, government efforts to help the private sector reduce arrearages on interest obligations have been only partially successful because of the illiquidity of many Mexican firms and government foreign exchange shortages. As a result, we estimate that the past-due interest on private-sector debt during this time rose by $200 million to some $1.2 billion. [redacted] 25X1 25X1

Outlook for the Remainder of the Year

We project that the economic decline will persist throughout this year, whether de la Madrid eases up on austerity or not:

- If Mexico City backslides, and we put the odds at a little better than even that it will, GDP would 25X1

Mexico: Impact of Economic Deterioration, 1983

	Relaxed Austerity [a]	Continued Tough Austerity [b]
Change in GDP (*percent*)	−5	−8
Job losses (*millions*)	1.5	2.0
Inflation (*percent*)	115	90
Change in real merchandise imports (*percent*)	−25	−50
Decline in supplies of locally available goods and services (*percent*)	−7	−13
Change in investment (*percent*)	−15	−35
Change in per capita consumption (*percent*)	−7 −7	−10 −10
Current account balance (*billion US $*)	−0.5	3.5
Free market exchange rate, yearend (*pesos per US $*)	150 to 200	200 to 300

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[a] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[b] Assumes Mexico City keeps imports and public spending depressed.

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[redacted]

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decline 5 percent and consumption would dip 7 percent.

- On the other hand, if de la Madrid moves to maintain austerity, we see GDP falling 8 percent this year and personal consumption plummeting 10 percent.

Current estimates of changes in key economic variables by US econometric services and by the Mexican Government are nearly, but not quite, as pessimistic as our own, while the IMF is still holding to its initial economic growth and inflation projections.

The Relaxation Case. By relaxing austerity to boost imports and spending, we believe that Mexico City can stem—but not halt—the steep slide in the economy by yearend. Divisions among government officials over whether this should be done are growing. Many Mexican economists, business and nonestablishment labor leaders, and opposition politicians also are arguing that the adjustments have gone far enough.

Mexico would be able to slow the sharp drop in imports this year with improved first-half foreign exchange reserves and a renewing of some trade credit lines. This would relieve some critical shortages and enable some plants to raise production slightly. Even so, import volume is likely to be at best 25 percent below last year's result, and nearly 60 percent lower than the 1981 level. We would expect most businessmen to maintain a "wait and see" attitude before making substantial new commitments to purchase imports because they are suspicious of de la Madrid's commitment to private enterprise. 25X1

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In our judgment, it is more likely that the government itself would provide the principal stimulation to the economy. Increasing public spending enough to boost the budget deficit as a share of GDP 3 or 4 percentage points from the current 10-percent rate would slow the decline in economic activity by about one-third for the year. Higher public spending would spur both investment and consumption. 25X1

Mexico: Forecasts of Key Economic Variables, 1983

	Change in GDP (*percent*)	Inflation (*percent*)	Current Account Balance (*billion US $*)	Imports (*billion US $*)	Exports (*billion US $*)
Data Resources [a]	−4.4	110	−2.9	13.2	21.1
Wharton Econometric Forecasting [b]	−5.1	101	−0.8	11.8	20.6
Mexican Government [c]	−2 to −4	77	−1.0	13.8	22.3
International Monetary Fund [d]	NEGL	55	−2.0	14.5	22.6
Central Intelligence Agency	−5 [e] −8 [f]	115 [e] 90 [f]	−0.5 [e] 3.5 [f]	12.0 [e] 8.0 [f]	21.8 [e] 21.5 [f]

[a] Latin America Review Second Quarter 1983, Data Resources, Inc., June 1983.
[b] Latin America Outlook, Summer 1983, Wharton Econometric Forecasting Associates, July 1983.
[c] From National Development Plan, May 1983.
[d] IMF Staff Report, 9 May 1983.
[e] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[f] Assumes Mexico City keeps imports and public spending depressed.

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We believe, however, that any substantial rebound in government spending would aggravate inflation and boost the increase in consumer prices to an annual rate of 130 percent in July-December.

Sticking to the IMF Program. If de la Madrid stands firm on austerity, import volumes would stay at rock bottom, and the economic slide would accelerate. In this case, we project real imports in 1983 would fall 50 percent below last year, and almost 75 percent below the 1981 level. While industries would continue drawing down nearly depleted inventories, capacity utilization would drop to less than half. As a result, locally available supplies of goods and services would decline further.

With continued budget cuts and the contraction of demand, we expect that inflationary pressure would ease somewhat, and the increase in the cost of living would average some 80 percent for July-December. This, along with a more favorable foreign exchange position, should make it possible for economic recovery to begin by late 1984.

Implications for the United States

Prospects for prolonged austerity, a continued falloff in consumption, and mounting political pressures will cloud US-Mexican economic and political relations for at least the next two years. Despite substantial improvements in bilateral economic relations since de la Madrid took office last winter, grating bilateral episodes—such as an expropriation of properties owned by US firms or additional debt moratoriums—are still possible, particularly if the United States is blamed for increasingly poor economic performance. 25X1

We believe Mexico City's principal bilateral concern will still be to preserve Washington's backing in the international financial negotiations. De la Madrid has indicated his gratitude for the US leadership in arranging new financial credits and the progress on debt relief. Mexico City expects US officials to back its efforts to maintain austerity with additional credits from the Commodity Credit Corporation and help in restoring trade credits. In addition, Mexico will call for the United States to intercede with the IMF and international banks if it seeks to adjust the stabilization program and to obtain new loans over the next few years. 25X1 25X1

US-Mexican economic relations will suffer in several areas. We expect private-sector Mexican bankruptcies to cause US banks to write off $3-4 billion in bad debt over the next year or so. US exports to Mexico—our third-largest trade partner—will fall by $4-5 billion this year, after dropping $6 billion in 1982. US-owned businesses in Mexico that produce for the domestic market—the majority of the $7 billion US investment—will continue to face poor demand, and many will pull out because of mounting losses. Meanwhile, illegal migration to the United States will remain at record levels. 25X1 25X1

On the positive side, US-owned assembly operations along the border that process goods for reexport to the United States will increase profits because of lower real wages and the weak peso. During the next several years, the Mexican Government will be taking steps to keep US businesses operating so that the companies' home offices will still subsidize Mexican losses. Mexico City has already announced that to spur increased production for exports it will adjust rules and interpret its foreign investment laws liberally. 25X1 25X1

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Lebanon: Economic Impact of Partition [redacted]

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Under the very poor security conditions that exist now and would remain after a partial Israeli withdrawal, Lebanon's economy will stagnate. President Gemayel may appeal to the United States to halt Israeli penetration of Lebanese markets and will continue to press for US economic aid to finance large budget deficits. Without a stable peace, US aid will do nothing more than ameliorate living conditions in Beirut; domestic confidence in a safe and stable future is both the necessary and the sufficient condition for rapid economic revival.

As long as Syria remains committed to undermining the Gemayel government or Israel occupies a large chunk of Lebanese territory, we do not believe that the Arab Gulf states will grant Lebanon significant financial assistance. Indeed, if Arab donors believe Israeli-made goods are entering their markets through Lebanon, they may even impose a partial economic boycott.

Current Economic Situation [1]

Economic activity in Lebanon has remained low since the end of the fighting in September 1982. Farming has probably been the hardest hit sector. Last summer's fighting in the south and in the Bekaa Valley destroyed many crops and disrupted field work:

- The presence of large Syrian and Israeli occupation armies in the countryside continues to preclude normal farming operations.

- The departure of many Egyptians, Syrians, and Palestinians from the south since June 1982 has left farmers short of labor.

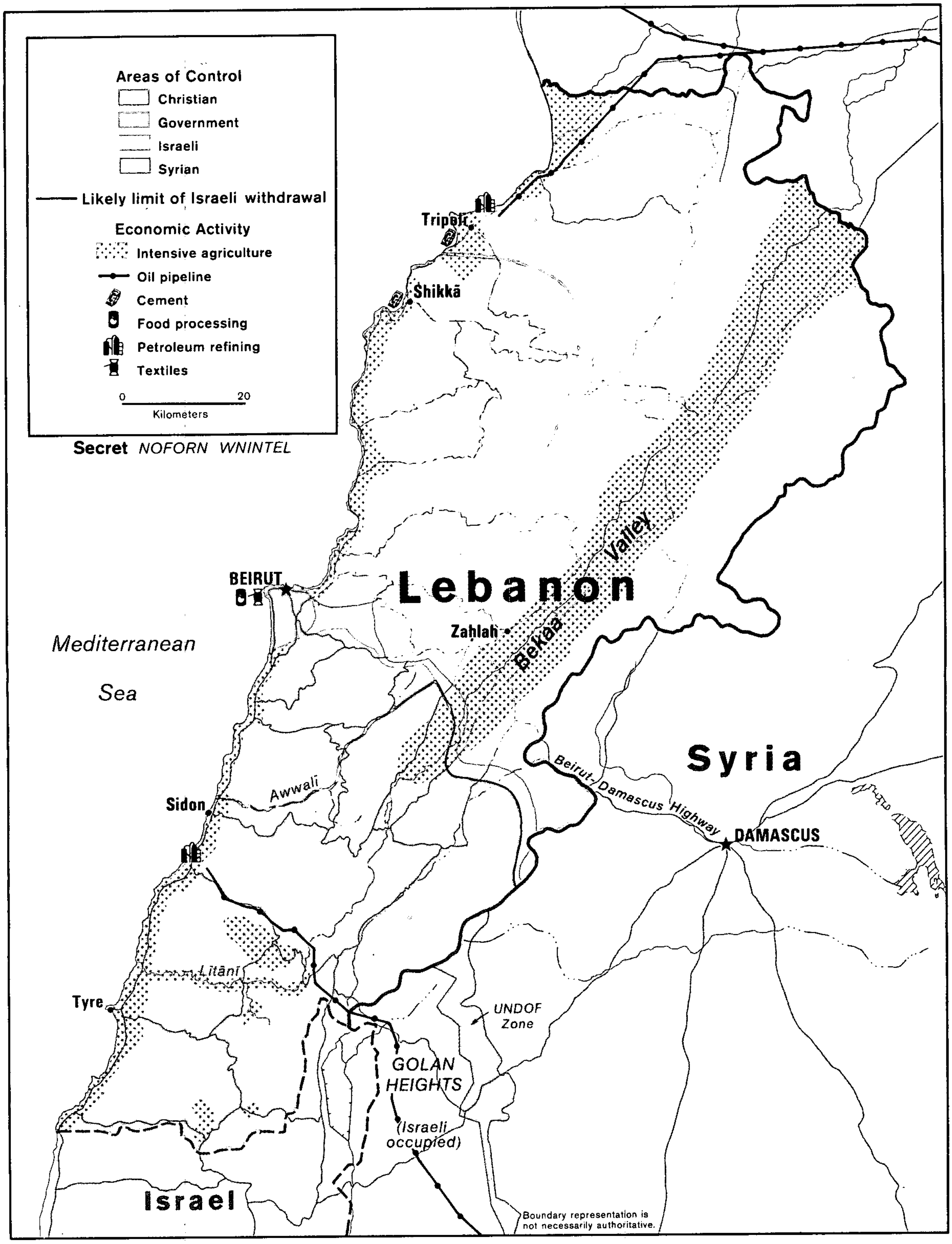
- Zahlah—the city in the Bekaa Valley that is the farmers' major source of key agricultural supplies—is a Christian community surrounded by the Syrian Army and Lebanese Muslims, making commerce difficult.

- Exports have suffered as Saudi Arabia and Jordan briefly banned the entry of some Lebanese goods earlier this year on the grounds that some were actually Israeli products falsely labeled to evade the Arab boycott of Israel.

- Travel on Lebanon's roads is hazardous and restricted. The Israel Defense Force (IDF) frequently closes the Sidon-Beirut road—the principal north-south route—and detains some Lebanese trucks carrying produce north to Beirut, frequently holding them until the produce is spoiled, according to the Embassy.

In accordance with the Arab economic boycott, trade with Israel has long been illegal. Since the end of the fighting, however, Israel has exported a steady flow of farm goods to Lebanon despite a public pledge in late 1982 not to export goods that compete with Lebanese products. According to the US Embassy, Israeli-grown produce has now captured a substantial share of the Beirut market that the south's Shia farmers have traditionally supplied. President Gemayel's failure to stem the flow of Israeli produce into Beirut increases Shia suspicions that Gemayel cares little for their fate and would welcome the permanent partition of Lebanon. In addition to its farm exports, Israel now permits Lebanese merchants to import goods duty free via Israel's port of Haifa. The US Embassy estimates that roughly 35 trucks leave the border each day carrying both Israeli produce and third-country goods into Lebanon.

[1] Our trade and national income statistics are rough estimates; Lebanon's Statistical Office closed in 1975 and never reopened.


Areas of Control
Christian
Government
Israeli
Syrian
Likely limit of Israeli withdrawal
Economic Activity
Intensive agriculture
Oil pipeline
Cement
Food processing
Petroleum refining
Textiles
0 20
Kilometers
Secret NOFORN WNINTEL
Tripoli
Shikkā
BEIRUT
Lebanon
Zahlah
Bekaa Valley
Mediterranean Sea
Syria
Beirut-Damascus Highway
DAMASCUS
Sidon
Awwali
Litani
Tyre
UNDOF Zone
GOLAN HEIGHTS (Israeli occupied)
Israel
Boundary representation is not necessarily authoritative.

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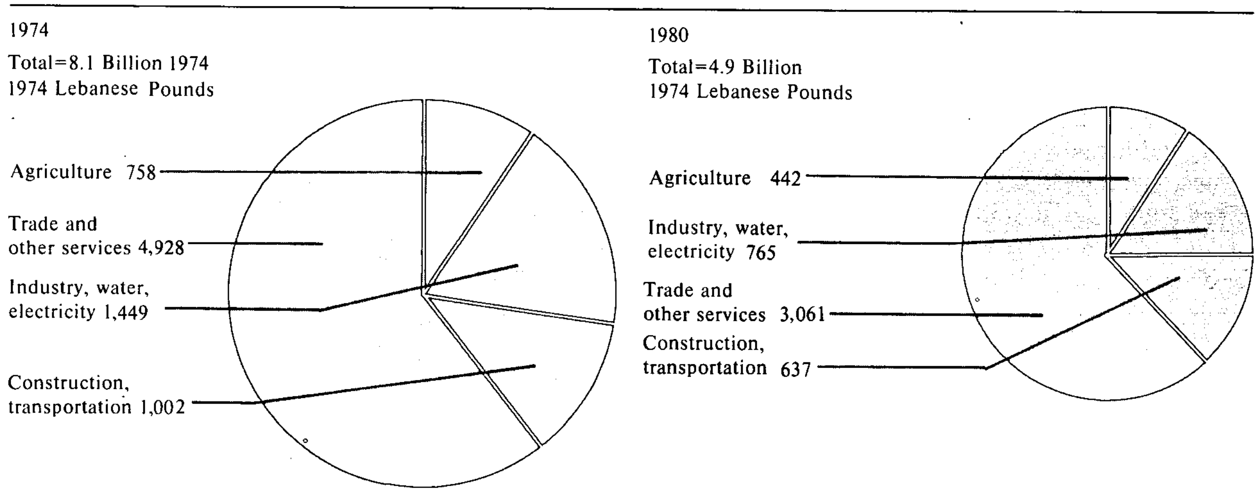
Lebanon: Changes in GDP



[redacted] 25X1

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Lebanon's small industrial sector has taken a beating in eight years of recurring hostilities. [redacted] only two or three factories of Lebanon's once flourishing textile industry still operate. Electricity systems have been heavily damaged, and power outages are frequent.

The only growth industry since the civil war has been labor exports. The number of Lebanese working elsewhere in the world more than tripled between 1974 and 1981, and remittances are now estimated to make up about 40 percent of GNP. The earnings Lebanese sent home may have reached $2.5 billion in 1981, thereby compensating for much of the decline in personal income caused by the destruction of the domestic economy.

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A surge of optimism about Lebanon's political prospects after the arrival of the multinational peacekeeping force (MNF) in September sparked a short-lived wave of rebuilding in Beirut. Few businessmen, however, have felt confident enough to invest in new enterprises. Most of the rebuilding was either minor repairs needed to make homes habitable and small businesses operational or the clearing away of rubble.

Government Finances

The government's financial picture brightened somewhat in early 1983, although the deficit remains high. Customs revenues rose after President

Gemayel closed several of the "illegal" ports operated by the principal Christian militia and directed ships to the government-controlled port of Beirut. Similarly, the perception in West Beirut after Gemayel took control there in February that the government was able to impose penalties for non-payment of taxes has boosted income tax receipts, according to the US Embassy. Nonetheless, Gemayel's writ still runs only in the greater Beirut area, and his government is unable to collect taxes or customs duties in the Christian heartland or in areas under Syrian and Israeli control. Moreover, customs duties continue to be hurt by the routing of Lebanese imports through Haifa.

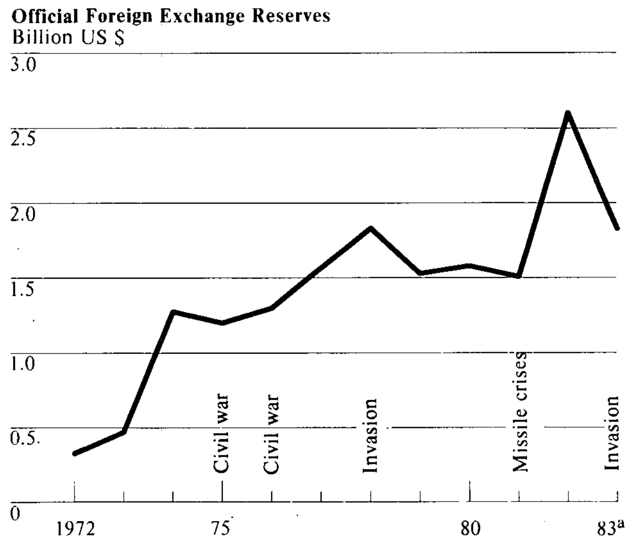
Beirut's expenditures have not fallen commensurately with the decline in the government's area of control. In a bid to retain the allegiance of the civil servants, the government has continued to keep them on the payroll even though most ministries have barely functioned for years and many employees show up only to pick up their paychecks.

By contrast, Lebanon's foreign exchange indicators remain strong, and official reserves afford Lebanon well over a year's import coverage. Local bankers agree that the private sector also has substantial liquid assets—both domestic and foreign—that could be mobilized to support reconstruction. Worker remittances, which are by far Lebanon's largest foreign exchange earner, are reportedly holding steady.

Through eight years of turmoil, Lebanon has never come close to a balance-of-payments crisis. Official foreign exchange reserves actually rose in 1978 and 1982—years in which Lebanon suffered major invasions. Although the Lebanese pound fell sharply immediately after the 1982 invasion, it had regained almost all of the lost ground by last October, and the Central Bank then resorted to dumping pounds on the market to slow the pound's rapid rise. By February 1983, the pound was stronger than it had been since 1980.

President Gemayel is immersed in his political and military problems, and we believe economic revival is among the least of his concerns. He is unlikely to push for a major reconstruction program any time soon and probably reasons, as do many of his finance officials and the private sector, that, if and when political and security issues are successfully resolved, economic recovery will follow of its own accord.

Lebanon: A Resilient Economy



[a] As of March 1983.

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Impact of Partition

We expect that Lebanon will be partitioned indefinitely. Syria will probably continue to refuse to withdraw its forces, and Israel will unilaterally pull out of the mountain districts just south of Beirut, remaining in the Bekaa and southern Lebanon. We also expect that the IDF, citing security problems, will expand its current restrictions on commerce and agriculture, keeping the south's economy depressed. The US Embassy reports that merchants in Sidon—the major city in southern Lebanon—recently went on two general strikes to protest

Israeli transportation restrictions and other perceived injustices. The strikes provoked a short-lived Israeli attempt to retaliate by closing the shops of some of the activists.

Resentment of other IDF moves will harden local anti-Israeli sentiment. In contrast to the IDF's frequent blockages of the Sidon-Beirut road, the Embassy reports that the highway connecting Israel and Sidon is usually open, leading many Lebanese to suspect that closures of the Beirut road are part of an Israeli campaign to force the south to direct its trade to Israel. Local anger has been heightened by a recent Lebanese press report that the IDF will not permit any merchandise to enter Israeli-occupied areas from Beirut or elsewhere in Lebanon unless the Israeli military commander in Sidon has given prior approval.

We believe the main goals of Israeli economic penetration—selling its own exports and promoting Haifa as an alternate import route—are to ensure that politically powerful groups in Lebanon have a financial interest in maintaining close political and economic ties with Israel and to erode their resistance should Israel decide to prolong its occupation. Israel probably recognizes that the Lebanese who profit from the Israeli moves—importers of manufactured goods and consumers in Beirut—are primarily politically influential Christians and the Sunnis. By contrast, the farmers in the south who are suffering from the Israeli restrictions are mostly impoverished and politically divided Shia. Although many Christians and Sunnis still refuse to violate the Arab economic boycott by trading with Israel, we believe that this sentiment will decline over time, as the potential profits from an Israeli connection become apparent.

Israel has long eyed the waters of southern Lebanon's Litani River as a partial solution to its own water shortages. Once the current international spotlight on Lebanon fades, Israel might well try to implement its already prepared blueprints for building a diversion canal. Such a move would certainly provoke loud protests from the local inhabitants and perhaps appeals from the Beirut government for US intervention with Israel.

We think it unlikely that Gemayel's army could secure the area left to his government without prearranged political deals with various religous factions and the continued presence of a sizable MNF contingent. If security is not assured, nervous entrepreneurs would continue to put off large-scale investment, and low loan demand would likely force closure of a few of Beirut's many small banks. To replace private-sector loan demand, the banks could continue to lend fairly large sums to the government and to seek international borrowers more aggressively.

Beirut will continue to look to Western donors and domestic borrowing to finance continued budget deficits. Domestic revenues will remain low since most of Lebanon will still be beyond the reach of Gemayel's taxmen, and the depressed economy and competition from Haifa port will keep customs receipts low. Large-scale aid from the Gulf states is unlikely to materialize, primarily because of the continued Israeli presence, but also because the Arabs face their own financial problems. Nor is the World Bank likely to provide large amounts of financing for Lebanon's reconstruction efforts. [redacted] they 25X1
would be very reluctant to do so unless the central government was in control of all Lebanese territory.

Critical balance-of-payments problems will be unlikely, however. Beirut's foreign debt is very low, and we doubt that the crucial inflow of remittances will decline. These funds are devoted mainly to covering the living expenses of local relatives, and, barring a complete and prolonged breakdown into chaos, we do not believe that many expatriate Lebanese will move their families out of Lebanon.

A Boycott?

It has been rumored that Syrian President Assad might close Syria's borders and airspace to Lebanon in response to what he views as excessive normalization of relations between Israel and Lebanon. A complete shutdown would cut Lebanon's only overland transport route to the Gulf states—

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which buy the great bulk of Lebanon's exports—and force air traffic to detour over the Sinai. Such a move would make economic recovery harder, but would not deal a major blow to the economy as it stands today. If the other obstacles to economic recovery eased, some exports could be rerouted through the port of Beirut and a smaller share could be sent out by air freight. We doubt, however, that Damascus would close the border entirely; Lebanon is a choice route for smuggling into Syria, an activity from which Syrian officials have long profited.

We think it unlikely that other Arabs would impose harsh economic sanctions. When Sadat signed the Camp David accords, the only trade sanction the Arab League imposed was a boycott of Egyptian firms dealing with Israel. Expatriate Egyptian workers were not sent home then, and we do not believe the Arabs would take such a drastic measure against Lebanon now. An Arab blacklist of Lebanese firms trading with Israel probably could not be enforced, especially in view of Lebanon's strict bank secrecy laws and Israeli efforts to protect the identity of their Lebanese trading partners.

A simple Arab boycott of Lebanese commodity exports, such as Jordan and Saudi Arabia briefly imposed earlier this year, would add another formidable obstacle to the many already faced by the farmers. If the boycott extended to third-country exports transiting Lebanon on their way to the Gulf, the transportation sector and government port revenues would be hurt.

Implications for the United States

President Gemayel may seek Washington's help on two fronts. He may ask the United States to pressure Israel into cutting back its exports to Lebanon, eliminating Lebanese access to Haifa, and easing restrictions in the south. Should Israel attempt to divert Litani waters, US mediation would likely be requested. Gemayel will probably also increase appeals for substantial US economic aid, pleading absence of Arab aid, low economic activity, and private-sector unwillingness to invest. Although current US economic aid can ameliorate living conditions in and around Beirut, it cannot spark a general economic revival. The primary impact of US economic aid would be to symbolize a commitment to the government in Beirut. If peace and stability ever occur in a reunited Lebanon, the Lebanese have the funds and the entrepreneurial ability to rebuild their country with little foreign assistance.

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