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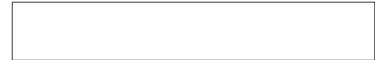

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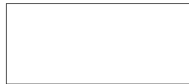
International Economic & Energy Weekly



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International Economic & Energy Weekly

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26 August 1983

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Comments and queries regarding this publication are welcome. They may be directed to Directorate of Intelligence,

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International Economic & Energy Weekly

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Synopsis

Perspective—*Third World Arms Exporters*

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As Third World arms suppliers gain the ability to provide a wider range of arms—either from domestic production or by transferring arms purchased from developed countries—the ability of major powers to control arms flows will diminish.

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Third World Arms Exporters: Developments and Patterns

25X1

Third World arms suppliers have traditionally held 3 to 5 percent of the international arms market. We expect they will maintain this market share through the mid-1980s, with annual sales in the $3 billion range.

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Internationalization of Commercial Aircraft: A Growing Security Issue

25X1

The dominance of US aerospace firms in the commercial aircraft market is being steadily eroded by firms in Western Europe and Japan. Foreign governments are funding the development of indigenous aeronautics sectors and are using their leverage as owners of airlines to gain contracts for domestic firms.

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Iraq: Postwar Role in the World Oil Market

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Once the war with Iran ends, Baghdad should be able to increase oil exports by 2-2.5 million b/d within one year. With petroleum demand expected to increase slowly over the next several years, however, oil market price stability would be threatened by large Iraqi sales.

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Perspective

Third World Arms Exporters

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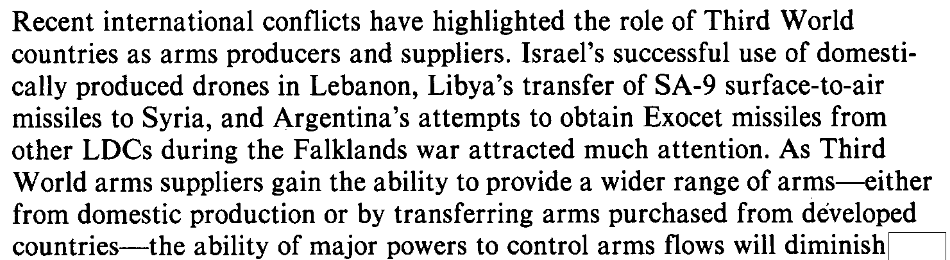

Recent international conflicts have highlighted the role of Third World countries as arms producers and suppliers. Israel's successful use of domestically produced drones in Lebanon, Libya's transfer of SA-9 surface-to-air missiles to Syria, and Argentina's attempts to obtain Exocet missiles from other LDCs during the Falklands war attracted much attention. As Third World arms suppliers gain the ability to provide a wider range of arms—either from domestic production or by transferring arms purchased from developed countries—the ability of major powers to control arms flows will diminish

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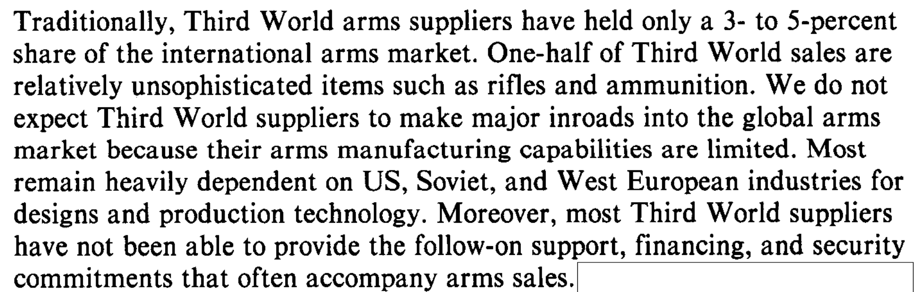

Traditionally, Third World arms suppliers have held only a 3- to 5-percent share of the international arms market. One-half of Third World sales are relatively unsophisticated items such as rifles and ammunition. We do not expect Third World suppliers to make major inroads into the global arms market because their arms manufacturing capabilities are limited. Most remain heavily dependent on US, Soviet, and West European industries for designs and production technology. Moreover, most Third World suppliers have not been able to provide the follow-on support, financing, and security commitments that often accompany arms sales.

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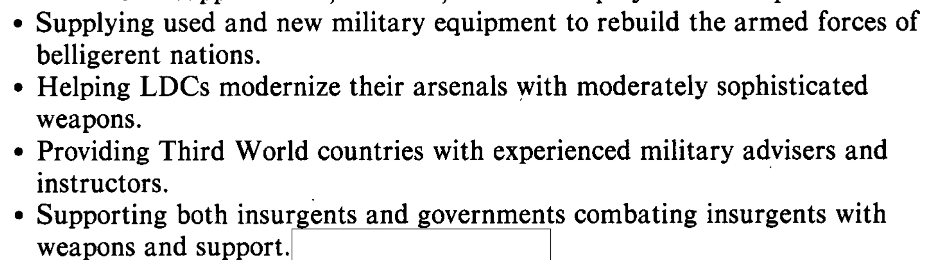

Third World suppliers will, however, continue to play several important roles:
- Supplying used and new military equipment to rebuild the armed forces of belligerent nations.
- Helping LDCs modernize their arsenals with moderately sophisticated weapons.
- Providing Third World countries with experienced military advisers and instructors.
- Supporting both insurgents and governments combating insurgents with weapons and support.

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In particular, several countries bear watching:
- Israel will continue to combine foreign technology with indigenous design efforts and a skilled labor force to produce high-quality weapons systems.
- Brazil should move beyond the production of light armored vehicles and trainer aircraft to the manufacture of fighter aircraft and tactical missiles.
- Singapore will complement its small arms industry with the assembly and refurbishment of jet attack aircraft, missile patrol boats, and armored vehicles.
- South Korea will energetically seek exports of small arms and crew-served weapons to sustain its underutilized defense industries.

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We doubt that these or other Third World suppliers will produce sophisticated weapons that are directly competitive with advanced US systems. Nevertheless, they will export weapons that give recipients new capabilities to threaten their neighbors, and thus have the potential to affect US interests.

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Briefs

Energy

Higher Iraqi Oil Output

Recent information indicates that Iraq was able to increase its crude oil exports to 700,000 b/d and production to 900,000 b/d in the second quarter of this year by discounting some sales. Baghdad reportedly has arranged for an oil firm to take discounted crude that Iraq cannot market itself at official prices, which the company resells in the spot market. This arrangement helped the Iraqis boost both exports and output by 100,000 b/d over first-quarter levels. Since late June, Iraq has further increased oil shipped to the Mediterranean through its pipeline in Turkey—Iraq's sole remaining export route—to about 800,000 b/d by injecting chemicals to enhance the flow. We believe Iraqi output, including deliveries to domestic refineries, currently may be more than 1 million b/d for the first time since the Syrian pipeline was closed in April 1982. Iraqi officials reportedly expect that new pumps being installed along the pipeline in Turkey will be in place and operating by mid-October. The pumps will allow Iraq to further increase throughput to 950,000 b/d.

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Saudis Establish Oil-Marketing Firm

The trade press reports that a new Swiss firm, Norbeck, Ltd., has been handling sales of an estimated 200,000 to 500,000 b/d of Saudi crude oil since early this year. the firm in fact is a front organization established by the Saudi Petroleum Ministry to assist in the marketing of its crude oil. With the Ministry's authority, crude is provided directly to the firm by Aramco, bypassing Petromin—the state oil-marketing company—which had been responsible for handling all Saudi oil not taken by the former Aramco partners. Norbeck reportedly sells oil through either spot deals or term contracts up to a year in length at official government prices and on 30-day credit. The firm appears to be the result of Riyadh's efforts over the past year to adopt more imaginative sales methods to counter the current soft oil market and gives the Saudis greater flexibility in marketing crude. Existence of Norbeck also represents a major change in Saudi marketing strategy; by allowing oil to be sold semiofficially on the spot market, Riyadh now has the ability to directly influence spot prices.

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Japan Revises Energy Outlook

A draft report by the Ministry of International Trade and Industry's Energy Study Council places total energy requirements for 1990 at 19 to 23 percent below the last official forecast made in April 1982. The revision was largely the result of a reduction in the forecasted rate of annual economic growth from

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MITI's Long-Term Energy Forecast [a] *Million b/doe*

	1982 [b]	April 1982 forecast for 1990 [b]	Revised Forecast	
			1990 [b]	1995 [b]
Total	**7.1**	**10.7**	**8.2-8.7**	**9.1-10.0**
Oil	4.4	5.3	4.4-4.6	4.4-4.6
Coal	1.3	2.1	1.5-1.6	1.6-1.9
Gas	0.5	1.2	1.0-1.1	1.2
Nuclear	0.5	1.2	0.9	1.4
Other	0.4	0.9	0.6-0.8	0.9-1.1

[a] Forecasts have been adjusted on the basis of the fact that 1 barrel of oil equivalent equals 5.62 million Btu. MITI assumes that 1 boe equals 5.93 million Btu.
[b] Fiscal year (1 April through 31 March).

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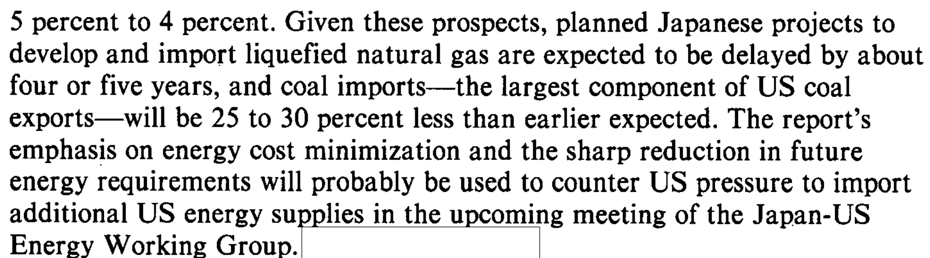

5 percent to 4 percent. Given these prospects, planned Japanese projects to develop and import liquefied natural gas are expected to be delayed by about four or five years, and coal imports—the largest component of US coal exports—will be 25 to 30 percent less than earlier expected. The report's emphasis on energy cost minimization and the sharp reduction in future energy requirements will probably be used to counter US pressure to import additional US energy supplies in the upcoming meeting of the Japan-US Energy Working Group.

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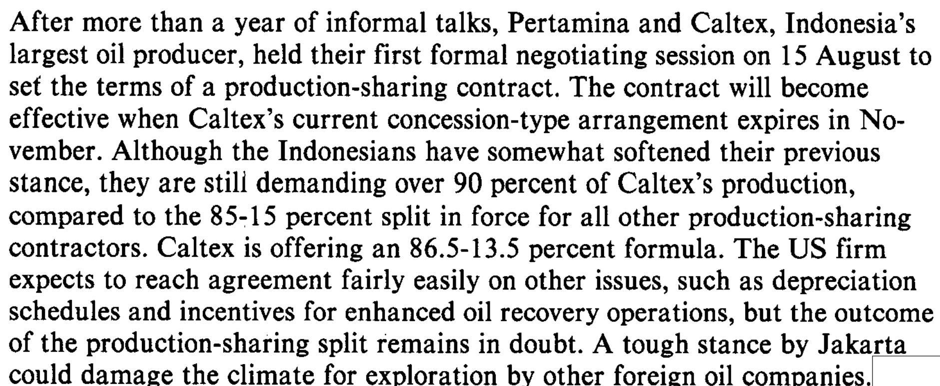
Indonesian Oil Negotiations



After more than a year of informal talks, Pertamina and Caltex, Indonesia's largest oil producer, held their first formal negotiating session on 15 August to set the terms of a production-sharing contract. The contract will become effective when Caltex's current concession-type arrangement expires in November. Although the Indonesians have somewhat softened their previous stance, they are still demanding over 90 percent of Caltex's production, compared to the 85-15 percent split in force for all other production-sharing contractors. Caltex is offering an 86.5-13.5 percent formula. The US firm expects to reach agreement fairly easily on other issues, such as depreciation schedules and incentives for enhanced oil recovery operations, but the outcome of the production-sharing split remains in doubt. A tough stance by Jakarta could damage the climate for exploration by other foreign oil companies.

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International Finance

Brazilian Pressures for a Debt Moratorium

Discontent with the government's new austerity measures and the suspension of foreign loans are increasing popular support for a debt moratorium, but key economic officials remain opposed to such a drastic step. The US Embassy reports that there is a growing political backlash against the protracted IMF negotiations, with influential businessmen warning the government that further retrenchment will accelerate bankruptcies. The working class is complaining about high unemployment and substantial reductions in real wages. Early this month slightly more than half of Brazil's federal deputies petitioned the government to break its tentative agreement with the IMF and declare a debt moratorium. A recent poll indicates that most of the middle class favors some form of moratorium. 25X1

Senior economic officials are resisting the pressure, hoping it will ease soon. An IMF announcement of support for Brazil's revised austerity program, followed by foreign bank moves to resume lending, probably would undercut popular agitation. The government has already imposed a limited de facto moratorium by deferring interest payments up to 60 days. It recognizes that more radical steps would jeopardize new loans and vital trade credits. If Brasilia does not obtain more foreign financial support, it probably will be less willing to honor its debts. Central Bank President Langoni has cautioned US officials that the IMF accord could unravel. Langoni said the government may not be able to muster enough backing in Congress to support IMF-mandated austerity. Without an IMF-approved program, however, most foreign banks would curtail their lending to Brazil. 25X1

Polish Rescheduling Agreement With Banks

Poland and Western banks agreed on terms for rescheduling 1983 debt during talks in Vienna last week. 25X1 25X1

The memorandum of understanding reschedules 95 percent of principal due the banks in 1983 over 10 years, including a five-year grace period. The banks insisted that the interest on unrescheduled debt and the remaining 5 percent of principal be paid by the end of the year, but they agreed to relend to Poland 65 percent of the interest payments as trade credits. Terms for this year are somewhat more generous than in 1982 but much tougher than the 20-year rescheduling of all debt service that Warsaw proposed when talks opened in February. 25X1

Warsaw will have trouble paying by the end of the year the estimated $700 million required by the agreement in addition to meeting some $900 million in payments due to the banks under the agreements concluded in 1981 and 1982. Poland apparently is falling $300-400 million short of its originally projected payments capacity of $1.9 billion because new credits are less than expected.

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Poland: Bank Rescheduling Agreements

Date of Agreement on Terms	Date of Signature	Obligations Covered	Amount of Debt Relief	Repayment Terms		Comments
				Interest Rate	Repayment Period	
August 1981	6 April 1982	95 percent of payments on medium- and long-term debt due during 26 March 1981–31 December 1981	$2.3 billion	LIBOR plus 1.75 percentage points	December 1985–December 1988	1981 interest payments completed in March 1982.
August 1982	7 November 1982	95 percent of principal on medium- and long-term debt due in 1982	$2.2 billion	LIBOR plus 1.75 percentage points	September 1986–September 1989	Interest paid in three installments, November 1982, December 1982, and March 1983. Separate agreeement provided that 50 percent of interest payments be relent in the form of six-month trade credits, rolled over for three years at an interest rate of 1.5 percentage points over LIBOR.
August 1983	November 1983 (planned)	95 percent of principal payments on medium- and long-term debt due in 1983	$1.3 billion	LIBOR plus 1.875 percentage points	January 1988–June 1992	Principal repayment schedule is graduated: 10 percent due in 1988, increasing 5 percent annually to reach 30 percent in 1992. Separate agreement provides for 65 percent of interest payments to be relent in the form of six-month trade credits, rolled over for five years at an interest rate of 1.75 percentage points over LIBOR.

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The agreement will give the banks a further lead over government creditors, who expect to begin Paris Club negotiations in October. The governments have not rescheduled since 1981 as a sanction against the martial law regime, and Warsaw has made virtually no payments to them in the meantime. [ ] 25X1 [ ] the banks may propose in October or November to reschedule 1984 obligations under the same terms—a move that could further complicate the efforts of Paris Club creditors to receive Polish payments. [ ] 25X1 25X1

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Argentine Economic Moves

Argentina's IMF financial package came close to unraveling two weeks ago because of the junta's reluctance to lift foreign exchange controls on British firms in the country. Once the government agreed to end the discriminatory loan practice, however, the IMF approved Buenos Aires's second draw on loan funds. The leadership also approved a new set of economic measures designed to curb inflation, which is now at an annual rate of over 300 percent. The measures include restraints on wage, price, and interest rate hikes as well as on new government investment. A steep surcharge was placed on income taxes, but, to placate industrialists, the value-added tax was slightly reduced. 25X1

Reconciliation with the IMF has paved the way for new funds necessary to sustain the recovery program. In addition, bankers should now be willing to reschedule Buenos Aires's large short-term debt. Although price controls will repress inflation for now, the market distortions they create will set the stage for substantial jumps later in the year. Interest rate ceilings and reduction in the value-added tax also will work to restrain near-term inflation, but they will discourage savings and spur capital flight. Moreover, the tax package will not prevent higher deficits. This will add to the inflationary pressures that will be one of the early challenges facing the civilian administration. Labor is already pressing the regime to back away from the austerity measures, and we expect the unions to increase their pressure on the new government. 25X1

Soviet Participation in Aid Package for Yugoslavia

The Soviet-owned bank in London reportedly will commit $11 million to the $600 million in new credits that Western banks are providing to Yugoslavia. The bank also agreed to participate in refinancing the medium-term principal payments that Yugoslavia owes. Yugoslavia's debt to Soviet banks in the West is about $250 million, or little more than 1 percent of Belgrade's total hard currency debt. It owes about $130 million to the Soviet bank in London, while its assets with the bank total only $20 million. 25X1

The amount of Yugoslav debt the Soviet bank intends to refinance probably is roughly $27 million, falling due over one year. The USSR's contribution to the package is small, but it is commensurate with its share in the total debt. Moscow may calculate that this contribution will improve its image in Belgrade and enable it to claim some credit for helping Yugoslavia avoid a financial crisis. 25X1

Thailand's Strong International Credit Rating

25X1 Thailand's international creditworthiness now exceeds that of any borrowing country in Asia. They cite as an example the Bank of Thailand's recently arranged eight year, $200 million standby loan at a spread of only a 0.375 percentage point over LIBOR. Thai private-sector borrowers with government guarantees are also having little trouble arranging foreign borrowing. Spreads have risen recently for other Asian borrowers; both Malaysia and South Korea are paying spreads of a 0.500 percentage point or higher on their most recent foreign loans. 25X1

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Bangkok's improved creditworthiness is a result of its relatively strong economic performance during the global recession, its conservative economic policies, and its manageable debt service ratio of about 16 percent. Moreover, unlike most Asian borrowers, Thailand—helped by a smaller current deficit last year—has slowed the growth of its foreign borrowing. The $200 million standby credit is the only large commercial syndicated loan the Thai Government plans for this year, according to the financial press, although state corporations will take out several small yen-denominated loans.

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Global and Regional Developments

Brazilian-Iranian Trade Agreement

The reported signing last month by Brazil and Iran of a protocol for some $1.2 billion in total trade over the next 12 months may encourage Brasilia to begin sizable arms sales to Tehran.

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A high-ranking Iranian mission, including four military personnel, arrived last week in Brazil under the guise of an economic delegation.

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The trade deal, which would permit Brazil to save at least $400 million in foreign exchange for oil imports, probably is closely linked to progress on arms sales. Late last month all three Brazilian service chiefs recommended that Acting President Chaves approve weapons shipments to Iran, which has been urging Brasilia to conclude an arms accord.

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National Developments

Developed Countries

New Israeli Austerity Program

The Israeli Cabinet on Sunday approved, in principle, a package of austerity measures that we believe will have minimal impact on the economy. The package includes spending reductions of 3 percent in real terms, but the Cabinet must still decide which ministries will absorb one-fourth of the cuts. Almost half of the $500 million expenditure reductions will come from the defense budget; manpower and construction in the Negev will bear the brunt of these cuts, according to a press report. In addition, the purchase tax on luxury goods will be increased by 10 percent, the travel tax will be doubled to $100, and a new tax on educational allowances for large families will be imposed in order to increase government coffers. The three-member TAMI Party is threatening to leave the government—which would leave the government with

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a one-seat majority in the Knesset—because it apparently believes the austerity program comes down too hard on the party's relatively less affluent Sephardi constituency. 25X1

We are skeptical that the budget cuts will actually be implemented; in FY 1982, which ended on 31 March, civilian expenditures rose 2.6 percent in real terms based on Finance Ministry estimates despite "cuts" approved last August to help finance the invasion of Lebanon. Ministers are adept at using "unanticipated" price hikes to justify their actual outlays. Even if the budget cuts materialize, the impact on the economy will probably be minimal because real wage gains are fueling private consumption growth; real wages increased 7 percent in the first quarter of this year compared with the same period in 1982, according to Bank of Israel data. The outcome of the recent doctors' strike, now in arbitration, will probably generate heavy pressure for large wage increases in other sectors. 25X1

Greece To Break Drachma-Dollar Link

Athens early this month announced plans to uncouple the drachma from the US dollar and link it instead to a basket of unspecified West European currencies. The US Embassy believes the decision will mean a drachma devaluation of 10 to 15 percent against the dollar, on top of the 15 percent devaluation implemented in January. Much of the impact of the earlier devaluation was lost, however, because the subsequent strengthening of the dollar caused the drachma to appreciate against the currencies of many of Greece's major European trading partners. 25X1

Although the devaluation will force up domestic prices—at a time when inflation is already running at over 20 percent—it should improve the overall competitiveness of the Greek economy and provide at least some balance-of-payments relief. Greece reportedly is also considering joining the European Monetary System in order to qualify for a $1-2 billion balance-of-payments loan, but it is by no means certain that the current EMS members will be willing to take on the task of supporting the drachma. 25X1

Possible Expansion of Foreign Bank Operations in Canada

A Canadian parliamentary committee is examining the possibility of allowing foreign-owned banks to expand their Canadian operations. Canada's Bank Act of 1980, which for the first time allowed foreign banks to incorporate in Canada, limits the aggregate domestic assets of these banks to 8 percent of total banking assets. In addition, individual bank assets are limited to 20 times their initial authorized capital—which in turn is held to $4.5 million—although increases can be authorized by the Minister of Finance. The parliamentary committee, which appears to favor raising the foreign-bank ceiling to 10 to 12 percent, plans to make its recommendations by the end of September. 25X1

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The current 8-percent ceiling was instituted to guarantee Canadian control of the banking system while still allowing foreign banks to expand along with the Canadian banking sector. There has been no growth in domestic assets of Canadian-owned banks for more than a year, however, and as a result the growth of many foreign banks, which are at or near their statutory limits, has been constrained. Total assets of the 18 US banks operating in Canada amount to over $7.3 billion—47 percent of aggregate foreign bank assets in Canada. US banks are among those most affected by the current ceiling on operations. In support of raising the ceiling, the chairman of the parliamentary committee points out that the foreign banks have targeted as customers small and medium-size businesses, not well served by Canadian banks. A June report on the banking sector maintains that foreign banks have made a "significant contribution to competitive banking" by bringing in $455 million in new capital and investing $972 million in Canada. Of the five major Canadian banks, two strongly support increased foreign bank participation, two are somewhat less committed, and the other—Toronto Dominion—is steadfastly opposed.

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Less Developed Countries

Mexican Government Accord With Business and Labor

A tripartite agreement signed in mid-August reaffirms qualified labor and business backing of President de la Madrid's tough stabilization policies. A similar pact was signed last December when de la Madrid offered new fiscal incentives and a six-month price freeze on basic commodities and public transportation fares in return for support from labor and business leaders. The new accord suggests that belts must be tightened further but again pledges to distribute burdens evenly and reduce the impact on the poor by providing basic consumer goods. According to Embassy officials, the new pact commits businessmen to preserve jobs, improve work conditions, boost investment and foreign trade, and hold down price increases. In exchange, labor promises to moderate wage demands.

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Crucial labor support for austerity, however, is not unconditional. After signing the accord, union chief Velazquez said that while workers will continue to sacrifice, the tripartite pact does not mean that labor demands will end. According to press reports, he linked holding up labor's end of the bargain to government and business success in slashing triple-digit inflation. On balance, the pact will probably boost foreign and domestic confidence in de la Madrid's ability and mandate to stabilize the economy. We believe formal recognition of the key role of business in reversing the economic crisis will help reduce concerns over creeping socialism, while wage restraints will help cash-short private-sector firms maintain current employment. Government promises to support basic consumer items, however, preclude cutting subsidies—and the public budget—as fast as international financiers have expected.

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Saudi Arabian Spending Cuts

Saudi Arabia's public announcement last week that government spending is lagging behind budgeted levels probably is intended to prepare businessmen for the possibility of more austerity. Finance Minister Aba al-Khayl says government expenditures of $20 billion for the first four months of the fiscal year, which began last April, were behind the budget plan. He also notes that the spending rate is below that for 1982, when total spending reached $71 billion. At the time the budget was presented, King Fahd tried to reassure the population that falling oil revenues would impose no hardships on the private sector. Since then, however, Riyadh has delayed payments to both foreign and Saudi contractors and has declared a moratorium on new contracts. To cushion the impact of the spending slowdown on the business sector, the government recently issued a decree requiring foreign companies to subcontract 30 percent of their contracts to Saudi firms. 25X1

The budget still will be in deficit this fiscal year by an estimated $8 billion, even in the likely event oil sales pick up later in the year. To cope with the shortage, Riyadh has been delaying payments and drawing on reserves. Aba al-Khayl's announcement alerts the private sector that the government is serious about fiscal discipline, but cash-short Saudi businessmen are unlikely to be mollified. As oil revenues continue gradually to increase later this year, the private sector and key ministries will urge the government to raise spending to budgeted levels. 25X1

Communist

Chinese Looking at Hungarian Economic Reforms

The Chinese are once again showing interest in the Hungarian economic reform program:

- Chinese bankers, who visited Budapest in May, were particularly interested in the way the Kadar regime successfully used fiscal and credit regulations in 1978-82 to control investment funds held by free-spending enterprises—a problem Beijing has been grappling with since 1978 when its own limited financial reforms were first introduced.

- In June a group of Chinese Government economists looked closely at Budapest's latest experiments in allowing a small private sector in domestic trade and services.

- Most recently, Finance Minister Wang Bingqian, speaking to foreign diplomats in Beijing, singled out Hungarian management reforms as those which China is examining in its search for an improved management structure for industry.

We doubt that Beijing will find much in Hungary that can be directly transplanted in China—the countries are simply too diverse in size, population, resources, economic structure, and stage of development. The continuing interest in Hungarian reforms more likely reflects Beijing's desire to learn how to avoid unwanted side effects of altering economic management systems.

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Third World Arms Exporters: Developments and Patterns

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Third World arms suppliers [1] have traditionally held 3 to 5 percent of the international arms market. We expect they will maintain this market share through the mid-1980s, with annual sales in the $3 billion range. The bulk of Third World arms exports consist of unsophisticated ground forces equipment, but they have also transferred modern weapons purchased from the West or the Bloc to other Third World customers.

Third World Arms Sales

After record sales of almost $7 billion in 1981—when the Iran-Iraq war boosted the Third World arms suppliers' market share to 17 percent—sales in 1982 slipped to less than $3 billion, returning Third World arms suppliers to their traditional 5-percent market share. During 1976-82:

- Middle Eastern countries purchased 60 percent of known Third World arms sales as Brazil, Yugoslavia, North Korea, and Egypt cultivated ties with wealthy oil-producing states.
- Latin American buyers turned to Brazil and Israel for ground forces equipment and aircraft, absorbing 20 percent of all sales.
- Asia and the Pacific became primary arms export markets for South Korea and Singapore, accounting for 10 percent of all Third World sales.

The bulk of Third World arms exports consist of unsophisticated products such as ground forces equipment, consumables such as uniforms and ammunition, and spare parts. High-priced items such as aircraft and naval vessels account for less than 25 percent of total Third World arms sales. Most of the value of these sales is made up of propulsion, electronic, and weapon systems, many of which have been purchased from Western suppliers and installed by Third World manufacturers in the equipment they export. Only a handful of indigenously designed aerospace and naval weapons systems have been marketed:

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- Israel and Yugoslavia have exported locally designed jet combat aircraft. The Israeli Kfir and Yugoslav Gastreb contain, respectively, US and British engines.
- Israel, Singapore, and South Korea export fast missile attack boats, and Yugoslavia offers a locally designed submarine.
- Israel and South Africa offer the Shafrir and Kukri air-to-air missiles and the Gabriel/Scorpion antiship missile.

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The quality of Third World military manufactures varies considerably. Well-designed and carefully produced weapons are available, as are cheap imitations characterized by shoddy workmanship:

- ammunition produced in South Korea is of such high quality that it is used by Colt Industries to test M-16 rifles, ammunition manufactured by Charter Industries of Singapore causes breech explosions, the result of repacking used cartridges.

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- Trade publications acknowledge that pistols produced by Taurus of Brazil are high quality copies of Italian models, but imitations produced by Egypt are poorly manufactured.

- Attache reports indicate that the light armor and limited mobility of armored vehicles designed and

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[1] "Third World" refers to all countries except members of the Warsaw Pact and NATO as well as Australia, Austria, China, Finland, Ireland, Japan, New Zealand, Switzerland, and Sweden. "Arms sales" refer to all agreements to provide arms, support equipment, military construction, training, and related services.

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Shares of the International Arms Market *Percent*

	1976	1977	1978	1979	1980	1981	1982
United States	50	30	41	36	32	28	43
Non-US NATO	13	25	32	24	32	18	23
Other developed [a]	2	2	3	2	2	3	1
USSR	28	36	14	27	28	21	21
Non-Soviet Warsaw Pact	3	5	6	5	3	5	4
China	1	NEGL	1	1	1	8	3
Third World	3	2	3	5	2	17	5

[a] Austria, Ireland, Finland, Sweden, Switzerland, Japan, New Zealand, Australia.

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produced in Brazil make them capable of performing only internal security missions, while Israel's Merkava tanks have been designed to survive on modern battlefields.

- Fighter aircraft like the Indian Marut have been produced in limited numbers because of their relatively poor performance; conversely, the Israeli Kfir has performed well in combat and has been successfully exported.

In addition to equipment produced domestically, Third World suppliers sell used equipment. We estimate transfers of such equipment, mostly sophisticated weapons produced in the United States, the USSR, and Western Europe, account for 10 percent of all sales by Third World suppliers. Used equipment is often attractive because of its relatively low cost, short delivery time, proven performance, and compatability with existing inventories. Even in small quantities, such weapons can have an immediate impact. Israel, Libya, and Saudi Arabia have transferred used aircraft—Mirage IIIs, MIG-23s, and F-5 Tigers—from their own inventories to Argentina, Syria, and North Yemen, respectively, during times of crisis.

Role of Third World Suppliers

Third World countries provide an alternative source of war supplies, equipment for military modernizations, support for insurgent groups, and training. Many customers, like Argentina, Libya, Iran, and Iraq, have turned to Third World arms suppliers in order to diversify their sources of armaments and circumvent restrictions and embargoes imposed by traditional suppliers. Indeed, we have only a few indications that Third World suppliers attach broad restrictions to their arms sales. Brazil's Foreign Minister recently stated in a press interview that Brazil never supplies arms if doing so would upset a local balance of power. Almost all arms exporters make this argument publicly, however, and Brazil's sales to Iraq and Libya underscore Brazil's overriding commercial interest.

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War Supplies. Third World suppliers play an important role during and after conflicts by supplying new and used military equipment and consumables.

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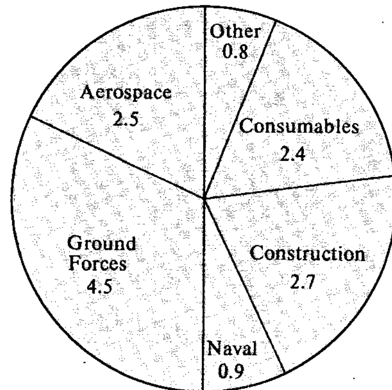
Third World Arms Sales, by Equipment, 1976-82

Billion US $



Total: 13.8

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Assistance to Insurgent Groups by Major Third World Arms Suppliers

Supplier	Recipient
Egypt	Islamic National Insurgency (Afghanistan)
India	South-West African People's Organization (Namibia) African National Congress (South Africa)
Israel	Cabinda Liberation Front (Angola) Phalange (Lebanon)
Libya	Polisario (Western Sahara) Somali Democratic Salvation Front Various Chadian factions Palestine Liberation Organization South-West African People's Organization
North Korea	Palestine Liberation Organization
Pakistan	Palestine Liberation Organization
Saudi Arabia	Palestine Liberation Organization
Singapore	Kampuchean People's National Liberation Front
South Africa	National Resistance Movement (Mozambique) Union for the Total Independence of Angola

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Deliveries have helped belligerents both to continue fighting and to quickly rebuild their inventories. According to attache reports:

- During the Iran-Iraq war, Egypt has supplied Iraq with over $300 million worth of largely Soviet-built aircraft, ground forces equipment, and spare parts. South Korea has also sold nearly $300 million worth of consumables to Baghdad, while Brazil has found an Iraqi market for armored vehicles, ammunition, and artillery rockets. North Korea and Libya have provided Iran with $750 million and $300 million, respectively, worth of Soviet ground forces equipment.

- During the Falklands war, Peru sent several Mirage fighters to Argentina while Brazil loaned Buenos Aires a few maritime patrol aircraft. After the war, additional Mirage aircraft were bought from Israel and Peru as Argentina rebuilt its Air Force.

Defense Modernizations. Most Third World suppliers sell weapons of moderate sophistication that are attractive to many poorer Third World countries seeking to upgrade their arsenals. Brazil has marketed its lightly armored vehicles in Chile, Colombia, Ecuador, Libya, and Paraguay. Israel has sold over 35 used A-4 aircraft to Indonesia and 12 new Kfirs to Ecuador. Yugoslavia has provided light attack aircraft to Libya and Zambia, and attache reports indicate that Argentina is attempting to sell its TAM tank to Peru and its Pucara light attack aircraft in Central America.

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Insurgencies. Third World suppliers have become actively involved in providing military assistance to insurgent and dissident groups, according to attache reports. Incomplete data suggest this assistance amounts to several hundred million dollars each year. We estimate that Libya alone spent $200 million on military assistance and training for subnational groups between 1978 and 1981.

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Third World suppliers also provide arms and assistance to governments combating insurgenices. According to military attache reports:

- Israel has sold small arms and ammunition to Guatemala.
- Saudi Arabia has provided North Yemen with F-5 aircraft, armored vehicles, and other equipment to combat insurgents backed by South Yemen.
- Libya has sent Nicaragua light attack aircraft and helicopters, probably for use in combating insurgents.
- North Korea has provided small arms and advisers to Uganda to help combat the Ugandan Liberation Movement.

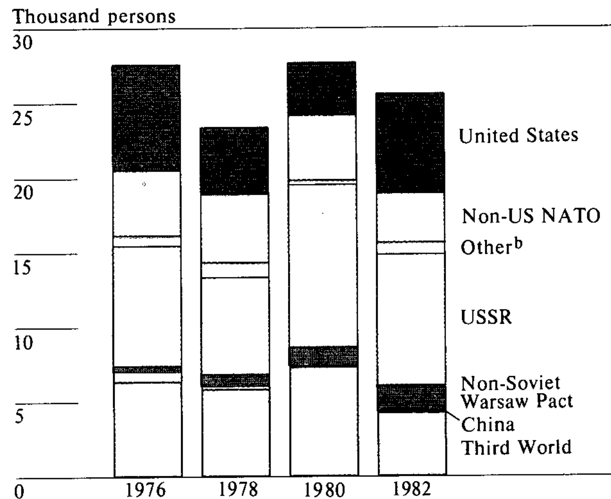
Training. We estimate that Third World arms suppliers have traditionally held some 20 percent of the global training market, a disproportionately large share compared with their share of the arms market. We believe that Third World training assistance is in demand because:

- Many military officials are impressed by the successful combat records of some Third World military forces facing security threats and environments similar to their own.

- Joint training can be used to demonstrate regional solidarity. Military attache reports note that Peru began training programs with Argentina in the aftermath of the Falklands war.

- Some Third World countries fear the domestic presence of large numbers of Soviet or Western advisers will lead to charges of neocolonialism and domestic instability, according to State and attache reporting.

Foreign Students Training In-Country[a]



[a] Data rounded to nearest 100.
[b] Austria, Ireland, Finland, Sweden, Switzerland, Japan, New Zealand, Australia.

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Prospects

Throughout the mid-1980s we expect the size of the international arms market to remain constant or decline slightly in real terms, largely as a result of the present global economic slowdown and the completion of military modernization programs by wealthy oil-exporting states. In this environment, competition among the major suppliers will increase; we expect them to pay greater attention and offer better terms to even minor customers in order to secure sales for domestic industries. Although this competition will probably prevent Third World suppliers from expanding beyond their traditional market share, they are likely to have annual sales in the $3 billion range over the next few years.

We believe Third World military suppliers will be able to compete in the market because their weapons:

- Do not carry the stigma of great power intervention.
- Are of appropriate cost and sophistication for less wealthy Third World states.
- Can be purchased through barter agreements unacceptable to traditional suppliers.
- Can be obtained when traditional suppliers impose embargoes.

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Some Third World suppliers will fare better than others. Brazil, North Korea, South Korea, and Yugoslavia will probably be able to preserve some of the recent gains they have made, in part because they produce ammunition and ground forces equipment compatible with Soviet and US weapons. Egypt and Israel should be able to maintain their current sales levels, partly by disposing of surplus Soviet and US equipment. Sales by other suppliers are likely to slip. Overall, we expect competition among Third World suppliers exporting the same type of equipment to increase. Those that lose out may be forced to close inefficient defense industries.

The technological sophistication of some arms offered by Third World suppliers will improve over the next few years as additional manufacturing technologies are acquired, primarily through licensing agreements. For example, according to trade journals:

- Brazil will begin producing jet attack aircraft and possibly antiship missiles.
- Israel will upgrade its tanks, drones, missiles, and aircraft.
- India will launch its first indigenously designed frigate.
- South Korea plans to develop an antiship missile.
- South Africa will probably begin producing replacements for its jet combat aircraft.

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Implications for the United States

The slow diffusion of military production technology to the Third World and the resulting proliferation of conventional arms suppliers will reduce the ability of the United States and other developed states to influence regional arms races and conflicts. Iran and Iraq, for example, have been able to carry on their fighting despite sales embargoes and reductions in deliveries by the United States, the USSR, and some West European states, in part because of arms delivered by Third World states.

Similarly, the potential of Third World states to supply arms will impede US efforts to use the provision or denial of security assistance as a foreign policy instrument.

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It is doubtful that Third World industries will produce much in the way of sophisticated weapons that will compete with US aircraft, naval systems, and ground forces equipment at the high end of the capability spectrum. Third World nations, however, will retain an ability to threaten US and allied forces by transferring sophisticated arms, purchased from the West or the Soviet Bloc, to potential Third World adversaries. British worries about third party transfers of Exocet missiles to Argentina during the Falklands conflict highlight this potential danger.

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Iraq: Postwar Role in the World Oil Market

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Once the war with Iran ends, Baghdad should be able to increase oil exports by 2-2.5 million b/d within one year. With petroleum demand expected to increase slowly over the next several years, however, oil market price stability would be threatened by large Iraqi sales. Under these circumstances, continued price stability would require substantial production cutbacks by other major producers as well as some restraint by Iraq. Iraqi insistence on rebuilding exports at the same pace as its facilities can be restored would soon impose unacceptable sacrifices on other producers, would sharply intensify pressure on oil prices, and would probably result in greater friction throughout the Persian Gulf and within OPEC.

Export Facility Restoration

Before the war, Iraq's crude oil export system was the most flexible in the Middle East. Total capacity was more than 5 million b/d—well in excess of Iraq's prewar productive capacity of about 4 million b/d. When the war ends, we expect Iraq to begin immediate repair of its Persian Gulf terminals and to install four single-point mooring buoys (SPMs) that it has stockpiled in Bahrain since 1981. Installation of the first two buoys should allow export of 1 million b/d within four to six months. The remaining two buoys should be installed within eight to 12 months of the end of the war. Once all four SPMs are installed, Iraq's Persian Gulf export capacity will increase to 2-2.5 million b/d.

Export pipelines to the Mediterranean will provide at least 1 million b/d of capacity. Regardless of the course of the war, we believe work on expanding the capacity of the Iraq-Turkey pipeline will continue. If the end of the Iraq-Iran war also eases political tensions between Baghdad and Damascus, the reopening of the Iraq-Mediterranean pipeline system would also add immediately to Iraq's available export potential. Problems in Lebanon and Syria's reluctance to allow Baghdad to restore the Baniyas export terminal to full operation, however, could limit throughput to about 400,000 b/d.

We believe the lessons learned from the Iraq-Iran war will encourage Baghdad to continue development of a highly redundant export system. Full implementation of all planned export facility programs would provide export capacity of over 9 million b/d within three years of the end of the war. Even if the expansion program is delayed, we believe that Baghdad will develop sufficient export capacity to have some flexibility in meeting export requirements.

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Production Facility Restoration

The damage inflicted on Iraqi oil production and processing facilities will probably not constrain output significantly in the war's immediate aftermath. Indeed, productive capacity will probably exceed export capacity for the first year. Iraq should be able to restore all damaged oil production and transmission facilities within 12 to 18 months, as excellent preparatory work will eliminate postwar delays in repairing critical oil facilities. Industry sources report that the Iraq National Oil Company (INOC) has already stockpiled, ordered, or submitted design specifications for bid on many of the custom components that would normally have long lead times. These preparations should save Iraq anywhere from 3 to 18 months depending on the type of units involved.

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The loss of most of the storage capacity at the Al Faw tank farms will be a serious constraint on

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Iraq: Planned Oil Export Capacity [a]

Million b/d

	Actual		Elapsed Time After War		
	1980	Current	Six Months	Eighteen Months	Three Years
Total	**5.1**	**0.7**	**2.4-3.2**	**3.4-4.7**	**6.6-9.4**
Mina al-Bakr [b]	1.6				1.6
Khawr al-Amaya	1.6				1.6
Gulf single-point moorings			1.0	2-2.5	2-2.5
Turkey pipeline	0.7	0.7	1.0	1.0	1.0
Iraq-Mediterranean pipeline system	1.2	0 [c]	0.4-1.2	0.4-1.2	0.4-1.2
Red Sea pipeline [d]					0-1.5

[a] Assuming the war ends without significant additional damage to Iraqi oil facilities.
[b] Temporary repairs could allow some limited capacity within a few months of war's end.
[c] The existing 1.2-million-b/d pipeline capacity will not be available until political differences between Syria and Iraq are resolved.
[d] A final decision has not been made on the construction of this pipeline through Saudi Arabia.

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Iraq's production and export capability. Although Iraq needs only a limited amount of storage capacity to resume exports, its ability to sustain large-volume loading operations will be restricted without additional tankage because oil production would have to be substantially reduced, if not stopped, in the event of bad weather or tanker scheduling problems. We believe the additional tankage necessary could be available within 12 to 18 months of war's end. The postwar availabilty of other damaged facilities will depend in large part on Iraq's ability to perform repairs while the war continues.

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Long-Term Oil Plans

We believe that with effective postwar development, overall sustainable productive capacity could climb to 5 million b/d—more than 20 percent above prewar levels—within three years of war's end. Capacity from developed fields in southern Iraq could be increased from its prewar level of 2.3 million b/d to about 2.8 million b/d. An additional 500,000 b/d of capacity could also be brought on stream from southern fields currently under development. Capacity in the northern oilfields could be maintained at about 1.7 million b/d. Oilfields in central Iraq will probably add only marginally to productive capacity in the first three years of postwar development.

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In the longer term, Baghdad's plans call for development of three new potential supergiant fields [1]—Majnun, West Qurnah, and East Baghdad—as well as seven smaller fields. Although the complexity of these fields makes performance difficult to predict, Iraq claims production from these fields could ultimately reach 2 million b/d. Development of the new and existing reservoirs could enable Iraq to achieve and maintain a productive capacity of 6 million b/d or more without relying on the West

[1] The supergiant category includes those fields with reserves of 5 billion barrels or more.

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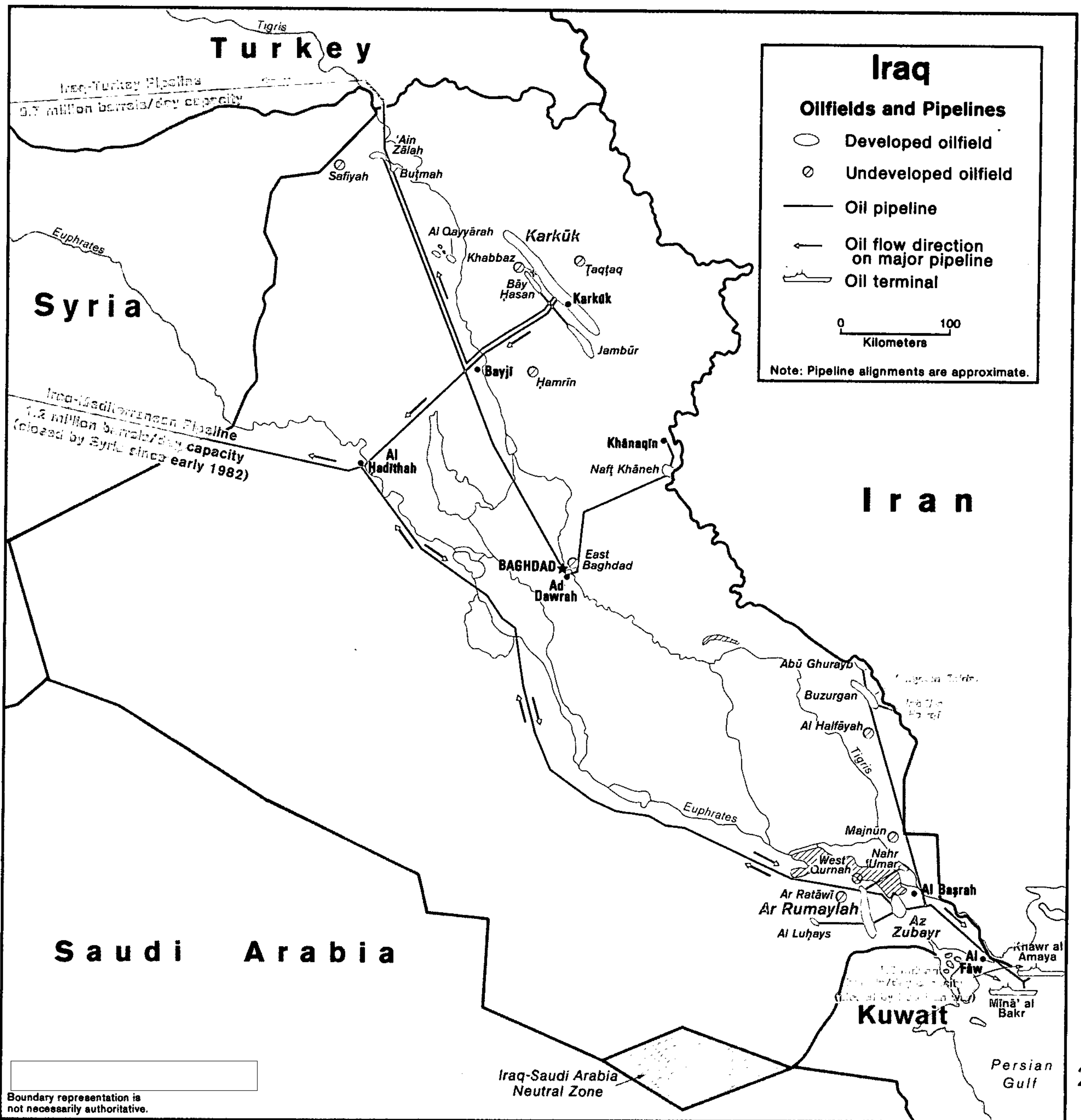

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Iraq: Projected Maximum Sustainable Oil Production Capacity [a]

Million b/d

	Actual		Elapsed Time After War		
	1980	Current [b]	Six Months	Three Years	Seven Years
Total	**4.1**	**3.0**	**3.5**	**5.0**	**5.9-6.7**
Developed fields	4.1	3.0	3.5	4.5	4.4-4.8
Northern Iraq	1.8	1.0	1.3	1.7	1.4
Karkuk	1.4	0.9	1.2	1.4	1.0
Bay Hassan	0.3	NEGL	NEGL	0.2	0.2
Jambur	0.1	0.1	0.1	0.1	0.1
Ain Zalah and Butmah	NEGL	NEGL	NEGL	NEGL	NEGL
Naft Khaneh	NEGL	NEGL	NEGL	NEGL	NEGL
Al Qayyarah	NEGL	NEGL	NEGL	NEGL	NEGL
Southern Iraq	2.3	2.0	2.2	2.8	3.0-3.4
South Rumayla	1.4	1.4	1.4	1.4	1.1
North Rumayla	0.7	0.4	0.6	0.9	1.2
Zubayr	0.1	0.1	0.1	0.2	0.3
Luhays	0.1	0.1	0.1	0.1	0.1
Nahr'Umr	NEGL	NEGL	NEGL	NEGL	0.1-0.5
Maysan (three fields)	0.1	0	0	0.2	0.2
Undeveloped fields				0.5	1.5-1.9
Northern Iraq				NEGL	NEGL
Safiyah				NEGL	NEGL
Hamrin					
Khabbaz					
Taqtaq					
Southern Iraq				0.5	1.3
Al Halfayah				0.1	0.2
West Qurnah				0.2	0.2
Ratawi				NEGL	NEGL
Majnun				0.1	0.9
Central Iraq				NEGL	0.2-0.6
East Baghdad				NEGL	0.2-0.6
West Baghdad					

[a] Assuming the war ends without further significant damage or deterioration of existing oil facilities and reservoirs.
[b] Assumes the maximum loss of productive capacity probable from currently known damage.

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Baghdad region, an area of unknown potential west of the Euphrates River. The West Baghdad region's oil potential has been preliminarily assessed at as much as 25-30 billion barrels. Should even 10-15 billion barrels of the region's potential reserves prove to be available, Iraq could extend its production plateau well beyond the turn of the century.

To facilitate its complex development program, we believe Iraq will increasingly turn to Western oil equipment manufacturers and engineering companies to help carry out the projected export and production capacity restoration and expansion. Iraq has recently shown an increased willingness to seek technical assistance from Western firms. A critical factor for obtaining Iraqi contracts, however, will be the willingness of Western companies to offer favorable credit terms or accept payments made in oil through long-term contracts.

Oil Market Implications

Short-Term Risks. Should Iraq be able to expand its exports substantially in the next two to three years, soft oil market conditions would pose serious problems for producers attempting to maintain oil prices. According to most industry observers, the demand for OPEC oil is likely to increase slowly during the next few years, perhaps rising to only about 22 million b/d by 1985. Under such conditions, the chances of an oil price decline will be quite high if Iran and Iraq attempt to increase postwar exports. Indeed, oil prices could drop sharply if Baghdad alone were to attempt to increase exports by 2 million b/d or so without offsetting reductions by other OPEC members.

Avoiding this outcome will depend largely on Saudi Arabia. Riyadh has two policy options available to influence Baghdad's postwar oil policy and its effect on the market:

- Increasing financial aid to Iraq as an inducement to limit any postwar increase in oil exports.
- Reducing Saudi oil output to make room for increased Iraqi oil sales.

The cost to Saudi Arabia of maintaining price stability could become too great if Iran also attempts to increase its postwar oil exports substantially. Despite three years of fighting, Iranian oil production and export facilities have suffered relatively little damage. On the basis of what we know of the condition of the facilities, we believe the Iranians could raise production by more than 1 million b/d within two years of war's end.

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Long-Term Stability. If OPEC countries can cooperate enough to avoid serious market instability in the short run, the availability of Iraqi and Iranian capacity over the longer term will be a stabilizing influence on the market. Most industry forecasts project a gradually tightening oil market beginning late in the decade with the possibility of real oil price increases during the 1990s. Additional productive capacity in Iraq and Iran could be a key factor in minimizing or avoiding these price pressures, particularly if the present soft oil market causes some other producers to trim their productive capacity levels. The Saudis, for example, are already trimming sustainable capacity by 2.5 million b/d from a current level of 10 million b/d. Beyond this, the availability of 5 million b/d of Iraqi capacity along with some extra Iranian capacity would provide an important cushion against supply disruptions from other areas. As a result, although an early end to the Iraq-Iran war could create some instability in the oil market over the next few years, long-term stability may depend heavily on the increased availability of Iraqi productive capacity.

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