



Directorate of
Intelligence

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**International
Economic & Energy
Weekly** 

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2 September 1983

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**International
Economic & Energy
Weekly** [redacted]

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**International
Economic & Energy
Weekly** [Redacted]

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Synopsis

Perspective—*Western Europe: Responding to Dollar Movements* [Redacted]

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Although the dollar hit an all-time high against the French franc and a nine-year high against the West German mark on 11 August, West European leaders virtually ignored the development. The major West European governments currently appear to be decoupling their fiscal and monetary policies from movements in the dollar, a course that can be more easily continued as long as the dollar remains relatively strong. [Redacted]

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Big Six: Comparative Economic Forecasts [Redacted]

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Private and official forecasters expect a weak economic recovery in the Big Six in 1983, with increased momentum likely in 1984. Inflation in the Big Six is forecast to remain virtually unchanged at 5 to 6 percent in 1983-84, and forecasters agree that the Big Six balance of payments will improve significantly this year and next. [Redacted]

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Israel: Development of High-Technology Industries [Redacted]

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Many Israelis believe the development of high-technology industries will solve the country's economic problems. While we agree that the highly skilled labor force and the experience gained in sophisticated defense industries provide a promising foundation, we do not believe high-technology industries will prove quite the panacea many Israelis hope. [Redacted]

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China: Offshore Oil Developments [Redacted]

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Last week's signing of an Exxon and Royal Dutch Shell joint venture for rights to explore and develop two offshore blocks paves the way for intensive exploration of the promising Pearl River Mouth Basin. We consider the offshore oil program—particularly the Pearl River Mouth Basin effort—to be of critical importance to China's ability to maintain its position as an exporter of oil in the 1990s. [Redacted]

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[Redacted]

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Algeria: Losing Room for Maneuvering [Redacted]

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Algeria has so far weathered the soft oil market through a combination of cautious economic management, expanded sales of noncrude hydrocarbons, and a drawdown of foreign exchange reserves. The adjustment process has become increasingly difficult this year. [Redacted]

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Morocco: Living With Austerity [Redacted]

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Growing debt obligations have forced Morocco to stiffen austerity measures to secure a new IMF standby loan and to seek a debt rescheduling. Although the IMF program probably will open the way for additional financing from traditional benefactors—especially Saudi Arabia—a foreign exchange crisis is still possible before new money becomes available. [Redacted]

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Perspective

Western Europe: Responding to Dollar Movements 

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West European leaders are seldom happy when the dollar moves against their currencies, regardless of the direction. Although the dollar hit an all-time high against the French franc and a nine-year high against the West German mark on 11 August, West European leaders virtually ignored the development. The major West European governments currently appear to be decoupling their fiscal and monetary policies from movements in the dollar, a course that can be more easily continued as long as the dollar remains relatively strong. In contrast, any sustained weakening of the US currency would create divergent pressures within the European Monetary System (EMS), forcing West European governments to react and leading to further US-West European strains.

The mild response stems, in part, from a growing West European realization that a strong dollar is not all that bad for their economies. Of course, an appreciating dollar puts upward pressure on dollar-denominated import prices, such as for oil and some basic commodities, but the overall impact has been small, cushioned by weak oil prices. Since 1980 the dollar has appreciated 66 percent against the European Currency Unit (ECU), yet inflation in each of the Big Four countries has slowed by at least one-fourth.

A strong dollar is promoting West European exports to the United States and inhibiting imports. In the first six months of 1983, Western Europe's trade deficit with the United States was cut by more than one-half compared with the same period in 1982. Moreover, West European companies are more competitive vis-a-vis the United States in third-country markets. Simulations using CIA's Linked Policy Impact Model of the World show that the appreciation of the dollar in 1983 (assuming it stays at its present level through 1984) will boost West European economic growth by 0.8 percentage point above what it would have been had the exchange rate relationship remained constant.

Other factors have dampened criticism of recent dollar movements. Perhaps most importantly, the dollar's rise has had almost no impact on the EMS. Since the March 1983 realignment of the system, the mark has been near the bottom of the currency band—reversing the usual situation. Although the early August dollar-buying spree pushed the mark down a bit further against the franc, the system was never seriously threatened. Moreover, the

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Federal Reserve's intervention in the foreign exchange markets nipped in the bud possible West European complaints that the United States was not helping to calm a "disorderly" market. Lastly, August vacations undoubtedly lessened official concern about economic matters.

Passivity toward the dollar may reflect a growing determination by the West Europeans to follow their own economic policies. They appear to be consciously decoupling their economic policy from the vagaries of the dollar. If this policy leads to further strengthening of the dollar, West European leaders seem willing to accept it. Two days after the dollar reached 2.7 marks, Bundesbank President Poehl said that an increase in the 4-percent discount rate would be inappropriate, given West Germany's economic situation. Similarly, the other central banks have not announced interest rate hikes.

Ironically, the West Europeans would be agitated should the dollar significantly weaken—a development they previously have encouraged. Decoupling would soon be forgotten as pressures on the EMS intensified. A weak dollar would undoubtedly cause—or be caused by—large capital flows out of the dollar into other currencies. The transfer, however, would not be spread evenly among West European currencies. Dollar holdings almost certainly would move more strongly into marks than francs because the West German economy is still perceived—at least in a relative sense—to be the strongman of Western Europe. West German real GNP is expanding, albeit quite slowly; inflation is below 3 percent; and the current account surplus is growing. In France, on the other hand, growth is slowing; prices are rising at an annual rate of about 9 percent; and the current account deficit is likely to reach \$8 billion this year.

To counter pressures on the EMS, Bonn would have to reflate and Paris further deflate—unpalatable moves in both countries. Chancellor Kohl's coalition and the opposition Social Democrats want to shrink the budget deficit, not expand it, and polls show President Mitterrand's austerity program has helped make him the least popular president under the Fifth Republic. Massive intervention, perhaps a short-term policy option, is not a viable alternative in the long run, and in any event, France already has borrowed heavily. While the EMS can accommodate further realignments, Bonn is not likely to accept them without accompanying policy adjustments in the weak currency countries. France came close to pulling out of the EMS last March when an internal economic policy dispute spilled over into the negotiations. The system may not be able to withstand another fractious battle.

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Aside from the impact on the EMS, Western Europe would gain little from a weak dollar. Lower prices for dollar-denominated imports would be of relatively little positive political benefit to West Germany or the United Kingdom, given already low inflation. What would matter, however, would be that West European goods would lose their competitive edge in the US market—one of the few expanding markets for West European exports.



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Briefs

Energy

Iranian Threats Against Iraqi Oil Pipeline

Tehran has renewed its threat to blow up Iraq's pipeline through Turkey, Baghdad's only oil export route. A senior official in the Iranian Foreign Ministry recently was quoted in the Turkish press as saying that Iran views the pipeline as belonging solely to Iraq and that increased trade between Iran and Turkey would compensate Turkey for the loss of transit fees. Since late June, Iraq has increased the flow of oil through the pipeline to about 800,000 barrels a day. [REDACTED]

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The Iranian official's statements probably are intended to warn Baghdad not to interfere with oil exports from Khark Island, which the Iraqis recently have been threatening. Although loss of the pipeline would be economically devastating to Iraq, Tehran would need to destroy a pump station to shut down exports for an extended period. Past sabotage to pipeline sections has been repaired in a few days, and Turkey is unlikely to honor Iranian requests to close the pipeline. [REDACTED]

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Nigerian Crude Output Tops Ceiling Again

For the fourth consecutive month, Nigeria's crude production has exceeded its OPEC-mandated ceiling. [REDACTED] August output averaged 1.5 million b/d—200,000 b/d above Nigeria's quota. After drawing sharp criticism from other OPEC members for overproducing in June and July, Lagos reportedly ordered equity producers to reduce liftings in August to 1.2 million b/d to allow third-quarter production to drop within the ceiling. Crude output will have to drop below 1 million b/d in September if Lagos intends not to violate its quarterly ceiling for the second time. Nigerian crudes remain extremely attractive, and Lagos's dire need for foreign exchange will make it difficult to voluntarily restrict output in September to this level. [REDACTED]

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Possible Impact of EC Coal Policy

To increase domestic energy production, the EC Commission has developed a comprehensive program to promote greater use of solid fuels. Much of the program involves using subsidies to modernize marginally economic mines or increase production of peat and lignite. One aspect of this plan, however, is a subsidy scheme to reduce the Community's nearly 56 million tons of coal stocks. This is the highest level since 1978. The plan would provide a subsidy of \$8.50 per ton for up to 10 million tons annually. Producers receiving these funds could use them for any purpose, including directly subsidizing selling prices by 12 to 16 percent per ton. [REDACTED]

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If EC producers dump an additional 10 million tons of coal on the EC market, it is likely to be at the expense of third-country suppliers. The United States is already one of the highest cost suppliers to the EC, and it probably would bear

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the brunt of most of the lost sales. The potential additional domestic coal represents about 30 percent—or about \$600 million worth—of US coal exports to the EC. The principal beneficiary of the subsidy would be the United Kingdom, which is the EC's largest coal producer. The subsidy might be one method of providing additional EC budgetary flows to the United Kingdom to offset what London regards as its excessive contribution to the Community budget. [redacted]

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*Norway Eyeing US
LNG Market*

[redacted] the Ministry of Oil and Energy has commissioned Norsk-Hydro to undertake a study—to be completed in October—of the technical and economic viability of liquefying Troms gas and exporting it to the United States. Expected stiff competition from other suppliers in the European gas market in the 1990s has prompted the Ministry to examine alternative markets for Troms gas, Norway's northernmost gas find. While sufficient gas reserves have not been proved in the area to support a major export project, Oslo believes sufficient additional discoveries will be made to justify a commercial venture. Development of Norwegian LNG export terminals could reduce leadtimes in bringing new exports to market by a year or two and would add to the flexibility of the West European gas infrastructure. [redacted]

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*Brazil Shores Up Oil
Supplies*

Brazil's purchases late last month of 145,000 b/d of crude oil on 120-day credit from Saudi Arabia, Kuwait, and Qatar should ease pressure on its dwindling oil supplies. Since May, when the suspended IMF program led to a severe foreign exchange shortage, Brazil has found it difficult to finance critical oil imports. A number of traditional supplier—including Algeria, Libya, Nigeria, and Venezuela—increasingly demanded that Brazil pay for their oil with cash, terms Brasilia has been unable to meet. As a result, Brazil was forced to cut back its oil imports from \$600 million in May to \$400 million in July. [redacted]

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[redacted] In some parts of Brazil, particularly Recife and parts of Sao Paulo state, spot shortages of gasoline, diesel, and other petroleum products emerged. To deal with the growing oil shortfall, Brasilia instituted major oil product price increases and restrictive distribution quotas. [redacted]

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The US Consul in Rio de Janeiro believes the new contracts with the three Arab Gulf countries, together with likely additional purchases from multinational corporations, will permit Brazil to restore its oil imports to levels originally programed for 1983 and to begin replenishing its domestic stocks. As long as Brazil's foreign exchange crisis persists, however, its oil supplies will remain vulnerable to any disruption of short-term trade credits. Moreover, should Iraq—now Brazil's second-largest supplier—curtail its sales because of Brazil's growing relations with Iran, Brasilia's oil situation would deteriorate rapidly, leading possibly to additional forms of rationing. [redacted]

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Iraq Studies Oil Pipeline Across Jordan

Embassy reporting indicates that Iraq is considering construction of a crude-oil export pipeline across Jordan to the Red Sea. [redacted] Baghdad has apparently concluded that its agreement with Riyadh to build a similar pipeline through Saudi Arabia is dead, and Iraq is still intent on diversifying its oil export routes. Few details of the project—which is still in a preliminary stage of study—are available, although the cost is said to be about \$1 billion, significantly less than the \$3-4 billion price tag for the proposed Iraq-Saudi pipeline. The latter apparently has foundered on Iraq's inability to arrange independent financing when Riyadh refused to provide the cash. Embassy sources report it could also take Iraq and Jordan two to three years to find financial backing and another three years to complete construction. The trans-Jordan pipeline would terminate at the northern Red Sea port of Aqaba, and its capacity most likely would be in the 1.0-1.5 million b/d range, similar to that of the proposed Saudi line and approximating the 1.2 million b/d capacity of the now closed Iraqi-Syrian pipeline. [redacted]

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Colombian Oil Prospects

Occidental Petroleum's discovery in mid-July of light crude oil in northeastern Colombia has renewed government and industry hopes for substantial oil finds in the Llanos Basin. [redacted] well flows exceeded 3,900 b/d from each of two producing zones. More wells are being drilled to assess the field's potential, which Occidental officials currently place at 40-50 million barrels. The discovery comes on the heels of Exxon's determination that its Arauca field—once considered by industry experts to be the most promising Colombian oil find in the past 20 years—will only be a small, break-even producer. Occidental plans to explore several other promising structures near the July discovery. We believe that finds will have to be large, or numerous and close together, in order to make a proposed integrated Llanos pipeline feasible. [redacted]

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International Finance

French Financing for Soviet Sour Gas Project

[redacted] in February the Soviets designated the French bank Paribas to take the lead in arranging financing for the construction of the \$300-400 million Tengiz gas desulfurization plant in northwestern Kazakhstan. Credit for a period of 8.5 to 10 years is to be at an interest rate of 7.8 percent. The difference between that rate and the OECD consensus rate of 12.8 percent for conventional French financing is to be reflected in higher prices charged by equipment suppliers. The Soviets have long insisted on interest rates below those prevailing in the markets in which they are dealing, perhaps to maintain the appearance of special treatment by Western lenders. They evidently will agree to pay higher equipment prices to do so. [redacted]

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Construction reportedly will take 42 months. Four consortiums are still reportedly competing for the Tengiz contract. As was the case with the Astrakhan gas project, plans at Tengiz to drill into highly pressured and corrosive reservoirs have forced the Soviets to seek advanced Western equipment and process design. The Tengiz field initially is likely to produce 60,000 b/d of oil, 2 billion cubic meters of gas, and about 400,000 tons of sulfur annually, possibly rising to peak production of 300,000-400,000 b/d of oil in 1990.

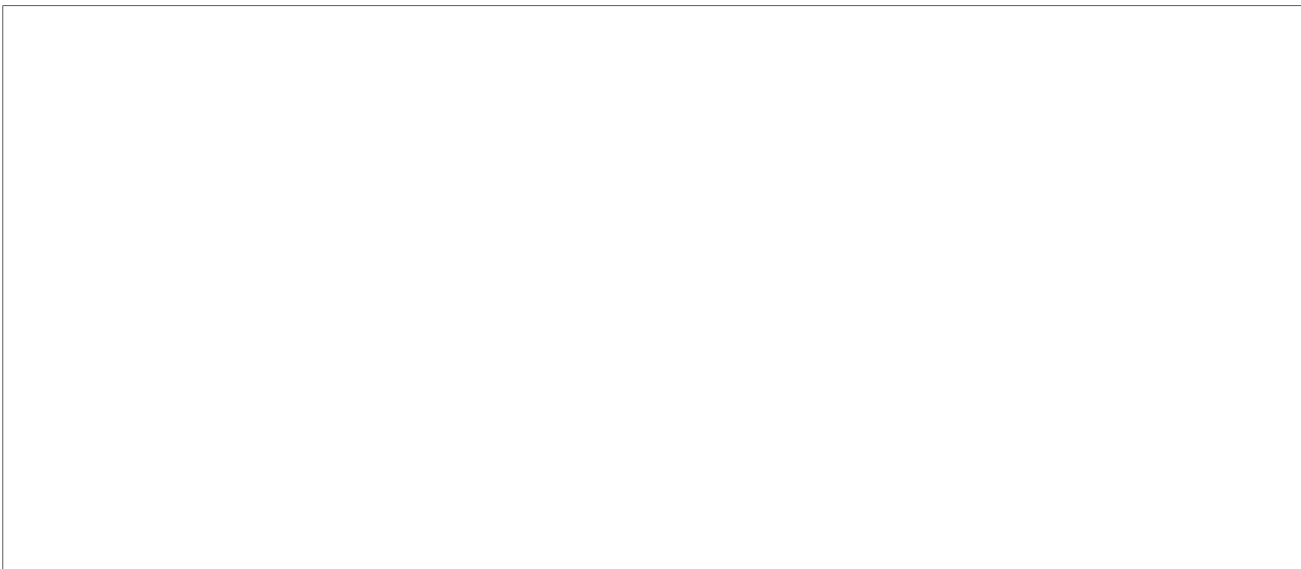
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*Sudanese Compliance
With IMF Standby
Agreement*

The Bank of Sudan, acting on IMF recommendations, has implemented further import and credit restrictions. Import licenses will not be issued for luxury items such as cars and refrigerators, and advance deposits on other imports were increased to 100 percent from 40 percent. In addition, the Central Bank has established ceilings on the growth of the money supply and has required approval on loans exceeding \$115,000. These new policies demonstrate Sudan's continued commitment to the IMF standby arrangement worked out earlier this year and should reassure foreign lenders that Sudan intends to pursue necessary reforms.

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Global and Regional Trends



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*China May Join
Multifiber
Arrangement*

The Chinese have requested a mid-September meeting in Geneva with the GATT Secretariat and the United States and other delegations to discuss membership in the Multifiber Arrangement (MFA). The MFA is administered under the GATT and governs international textile trade by setting standards for bilateral textile trade agreements. Although not a member of GATT, China can join the MFA by acceding to provisions of the Arrangement and receiving the approval of GATT's Textiles Committee. Although membership in

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the MFA would not help China increase exports of textiles covered by current bilateral agreements, it would give Beijing a forum to cooperate with LDC textile producers in attempts to liberalize international restrictions on their textile exports. [redacted]

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Japanese Firm Ignores Government Policy in Dealings With the USSR

[redacted] Ishikawajima-Harima Heavy Industries, one of Japan's largest industrial conglomerates, has reversed the recent decision of the firm's former president that called for downgrading trade relations with the USSR. The original decision was made after two Soviet officials were expelled from Japan for engaging in industrial espionage.

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[redacted]

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This is the first known instance of a Japanese firm opposing the Foreign Ministry's recent efforts to control technology exchanges with the Soviets. It is uncertain if this action will affect an earlier decision by the firm to cancel its negotiations with the Soviets to build a large floating drydock. The United States had urged Japanese Government officials to stop the project last year, after another drydock built by the firm for the Soviet merchant fleet was put to military use. The ensuing international incident caused the United States to prompt COCOM to consider controlling the export of drydock technology.

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National Developments

Developed Countries

Portugal Closer to Meeting IMF Targets

Preliminary government figures for the first half of 1983 indicate a rapid improvement in Portugal's balance of payments. The current account deficit for the first six months was only \$1.2 billion, compared with \$2.2 billion for the same period last year. Approximately 80 percent of the improvement is attributable to cuts in imports. Government decisions to draw down petroleum reserves and delay grain purchases, as well as a lack of foreign credit, led to a 17-percent reduction in imports. At the same time, exports rose about 10 percent. Less improvement is likely in the second half, since the drought this year probably will boost food imports. Nevertheless, it now seems likely that Lisbon's current account deficit for the year as a whole will be close to the IMF's \$2.0 billion target. [redacted]

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To meet the IMF targets for reducing the budget deficit, Lisbon is planning to propose several measures at a special parliamentary session next month, including a one-time 2-percent tax on fourth-quarter incomes; tax hikes on automobiles, stamps, gambling, and real estate; and a reduction in public-sector investment. In addition, Lisbon will review controlled prices on a

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monthly basis to ensure that market prices fully reflect import costs to the government trade monopolies. Further budget measures for 1984 are under review and will be debated in parliament later this year. If approved, these measures would cut the budget deficit in real terms by about 30 percent this year and 20 percent in 1984. [redacted]

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*Expansionary
Australian Budget*

The 1983/84 budget the Hawke government presented to Parliament last week provides for sharply higher outlays for social security, welfare, health, unemployment, and housing but also underscores the government's commitment to rebuild Australia's armed forces. The budget will push up real spending by 7.2 percent while projected real tax revenues are expected to remain flat because of the sluggish economy. As a result, the budget deficit will nearly double to \$7.4 billion or 4.7 percent of GDP from 2.7 percent last year. Because of the projected deficit, Canberra will find it difficult to lower interest rates without intensifying inflation, which slowed to an 8.6-percent annual rate in the second quarter of 1983. [redacted]

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Less Developed Countries

*Libyan Domestic
Problems*

[redacted] discontent over chronic food shortages has increased, and dissatisfaction with Libyan leader Qadhafi is being expressed to foreigners more openly. The special treatment afforded the military reportedly is a growing source of irritation to most Libyans. Shortages of consumer goods at this time probably are only partially a result of Libya's campaign in Chad. Because information about Chad is closely controlled by the government, rumors and speculation are prevalent, and the shortages, which are commonplace, are being mistakenly linked to the war effort. The growing perception that current economic ills are a result of Qadhafi's unpopular adventures, however, will serve to heighten resentment of the regime. [redacted]

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Communist

*Chinese Announce
Huge Water Project*

Beijing has announced plans to begin constructing a project to divert water from the Chang Jiang (Yangtze River) across the Huang He (Yellow River) into drought-prone areas of North China. The scheme has been under consideration for over 30 years, although it was rejected only three years ago as being impractical. Support for the plan was recently rekindled because ground water tables are dropping in the North China Plain and wells in many areas are going dry. [redacted]

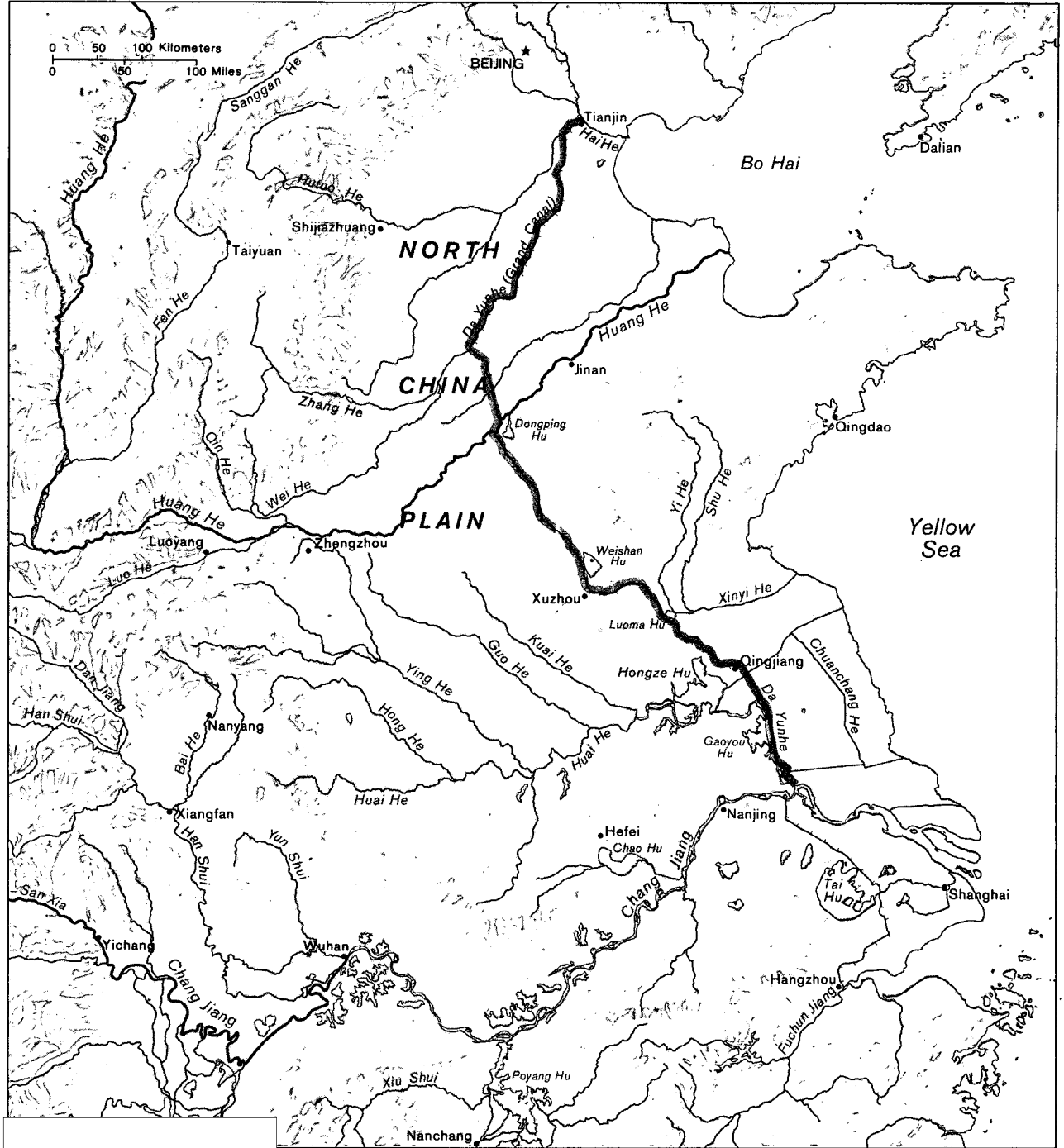
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The plans for the project are incredibly ambitious and will strain the entire economy. The project is designed to transport 1,000 cubic meters of water per second along a 1,150-km route following the ancient Grand Canal. Over that distance the water must be raised 40 meters requiring 30 pumping stations,

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China: Water Diversion Project



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each larger than any currently in operation in China, as well as concomitant electric power supplies. Engineering problems will also arise when water from the project must be pumped either over, or more probably under, the Yellow River. Beijing has set an optimistic completion date of 1990, and we expect foreign assistance will be called on to attempt to meet that deadline. [redacted]

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Romanian Economic Problems

The Romanian economy is facing growing problems that may jeopardize Bucharest's goal of avoiding another debt rescheduling in 1984. Exports slumped 11 percent in the first five months of this year because of the lack of competitiveness of Romanian products in weak Western markets. Party leader Ceausescu's drive to boost coal production to offset reduced oil imports is faltering; miners are reacting to longer working hours with lower productivity and increased absenteeism. The IMF delayed the scheduled disbursement in July of \$100 million because of Bucharest's foot-dragging on IMF recommendations that Romania increase domestic energy prices and adjust exchange rates and interest rates. [redacted]

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Ceausescu strongly resents IMF "interference," and continuation of the current stalemate with the IMF will almost certainly hurt borrowing prospects with Western governments and banks. Ceausescu probably will continue to give priority to improving the trade balance at the expense of domestic growth. If Ceausescu continues to bear down on the miners, however, the potential for strikes in the critical coal sector will increase. [redacted]

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Big Six: Comparative Economic Forecasts ¹

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Private and official forecasters expect a weak economic recovery in the Big Six—Japan, West Germany, France, the United Kingdom, Italy, and Canada—in 1983, with increased momentum likely in 1984. Among the Big Six, Japanese real GNP is generally expected to advance most rapidly in 1983, but some forecasters believe the Canadian economy may outpace Japan's next year on the strength of exports to the United States, especially automobiles and construction materials. All forecasters expect the Big Four West European economies will be less buoyant, with France and Italy posting little or no growth in 1983.

Inflation in the Big Six is forecast to remain virtually unchanged at 5 to 6 percent in 1983-84 with only Italian prices expected to rise at double-digit rates. Projections of the Big Six current account balances, however, vary widely. Forecasters agree that the Big Six balance of payments will improve significantly this year and next, but projections differ by as much as \$20 billion for 1983 and \$14 billion in 1984, largely because of differences in projections of US economic growth.

Improving Prospects for Growth

Most forecasters think that the economic upturn in *Japan* will start later this year and accelerate in 1984. Lower oil prices and a stronger yen (compared to most non-US currencies) should improve

¹ The US Embassy forecasts were made in August 1983; the OECD projections come from the July 1983 *OECD Economic Outlook*; the Blue Chip forecasts represent the averages of projections made by about 40 organizations and printed in the 15 August 1983 issue of the *Blue Chip Economic Worldscan*; DRI's estimates were made in the July 1983 issue of its *European Review*, the June 1983 issue of the *Canadian Review*, and the Spring 1983 issue of the *Japanese Review*; the forecasts prepared by the Deutsches Institut fuer Wirtschaftsforschung (DIW), an economic research institute based in West Berlin, were made this spring.

the terms of trade, thus sustaining growth in domestic demand despite high real interest rates and tight fiscal policy. The expected recovery in the OECD—and especially in the United States and Canada—should result in a substantial advance in Japanese exports of manufactures. The expansion of foreign sales, however, will not be as rapid as in past recoveries because of the imposition—and threats—of trade barriers by the United States, Canada, and Western Europe. Excess manufacturing capacity and a widespread desire by Japanese businessmen to improve slumping profits are generally expected to lead to lackluster investment—at least by past Japanese standards.

Almost all forecasters agree that an anemic economic recovery in *West Germany* should get under way this year. Estimates of 1983 GNP growth range from the 0.5 percent projected by DIW to the US Embassy estimate of 0.8 percent. Unlike past recoveries, foreign demand for West German goods is not expected to provide much stimulus; West Germany's four most important trading partners—France, the Netherlands, Italy, and Belgium—which together buy almost 40 percent of its exports, are all implementing austerity policies that will dampen import demand. Slow growth in investment worldwide should also hold down West German exports, which are concentrated in capital goods. Domestically, a more relaxed monetary policy and interest rate subsidies should promote new housing construction. Bonn, however, is keeping a tight rein on the budget deficit, so little stimulus is expected from government spending. High unemployment and modest wage hikes, along with higher tax rates, should hold down household income and thus private consumption.

The austerity program that Paris announced in March 1983 is expected to push the *French* economy into recession this year; the pickup in other

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**Big Six: Comparative
GNP Growth Rates**

Percent

	1982	1983	1984		1982	1983	1984
Big Six	0.8			United Kingdom	1.4		
US Embassy		1.6	2.9	US Embassy		3.1	2.0
OECD		1.4	2.5	OECD		1.8	2.3
Blue Chip		1.6	2.9	Blue Chip		2.2	2.3
DRI		1.6	3.1	DRI		2.4	2.3
DIW		1.3	2.2	DIW		2.0	2.0
Japan	3.0			Italy	-0.3		
US Embassy		2.7	4.5	US Embassy		-0.5	2.5
OECD		3.2	3.5	OECD		-0.7	2.0
Blue Chip		3.2	4.1	Blue Chip		NEGL	2.3
DRI		3.2	4.1	DRI		-0.2	3.9
DIW		3.0	3.5	DIW		NEGL	1.0
West Germany	-1.1			Canada	-4.8		
US Embassy		0.8	1.9	US Embassy		3.0	4.7
OECD		0.7	1.8	OECD		1.9	4.8
Blue Chip		0.7	2.7	Blue Chip		2.3	4.1
DRI		0.6	2.5	DRI		2.2	4.7
DIW		0.5	2.0	DIW		1.0	3.5
France	1.6			DIW	1.0 3.5		
US Embassy		NEGL	1.0				
OECD		-0.4	0.5				
Blue Chip		-0.1	1.3				
DRI		-0.2	1.2				
DIW		NEGL	NEGL				

OECD countries should enable France to register some growth in 1984, although not much. Higher taxes and utility rates should hold down private consumption, which accounts for two-thirds of GNP. Utility and transportation rates were raised an average 8 percent, and oil import tax hikes offset the fall in oil prices to consumers. Paris boosted social security tax rates by 1 percentage point and increased excise taxes on tobacco and alcohol. The Mitterrand government also placed a 10-percent surtax on all people liable for at least \$625 in income tax. Lackluster consumer spending is expected to depress investment. Government efforts to control the budget deficit and inflation

are widely expected to lead to slower growth in government consumption and the money supply. On the other hand, the weakness of the franc should make French goods more competitive, thereby boosting sales abroad and slowing imports.

Most forecasters expect that the recovery that began in early 1982 in the *United Kingdom* will accelerate during 1983-84. The outlook for private consumption is bright because of income tax cuts earlier this year and an anticipated reduction in the savings rate. Several forecasters expect a strong

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pickup in investment because of the strength of consumer spending and the decline in excess manufacturing capacity that began in 1982; moreover, low British inflation should allow lenders to lower interest rates. Moderate growth in public investment and revival of housing construction are also expected to boost investment. Forecasters believe that the fall of the pound should boost exports by as much as 4 percent in real terms in 1984. Moderate wage demands stemming from low inflation and high unemployment—expected to hover at about 13 percent of the labor force in 1983-84—should avoid a major decline in British price competitiveness.

Government efforts to bring the public-sector deficit and inflation under control are expected to keep the *Italian* economy in the doldrums in 1983. The brunt of the efforts to stabilize the economy has been borne by monetary policy. To finance the public-sector deficit—now about 16 percent of GNP—without adding more inflationary pressures, the Banca d'Italia has restricted private credit expansion, forcing the business sector—including the dynamic underground economy—to trim output. The stagnation in real income is generally expected to depress private consumption. A decline in the price competitiveness of Italian exports, mostly due to inflation and the relative stability of the lira in the European Monetary System, is expected to harm trade performance. All the forecasters believe that the Italian economy will stage a recovery in 1984; little agreement exists on the size of the upturn, however, with estimates ranging from 1 percent to almost 4 percent. The key factors determining the 1984 forecasts are the stringency of credit controls and Italian export performance.

Given the strong US economic recovery, most forecasters believe the *Canadian* economy will pick up speed rapidly, particularly in 1984. The Canadian economy usually follows the US business cycle closely because Canada sells 70 percent of its exports—30 percent of GNP—to the United States. The manufacturing sector is expected to benefit most from the recovery—especially export-oriented industries and those serving the construction sector. The automobile industry should see

sales rise briskly from an expected pickup of demand in the United States and Canada, coupled with continuing US and Canadian restrictions on imports of Japanese cars. The renewed trend to larger cars also should help the industry. While housing construction probably will improve because of recent cuts in interest rates, excess capacity is likely to dampen business investments. Private consumption should gain from an anticipated increase in employment, lower inflation, and a fall in the savings rate as fears of layoffs ease. Government spending also should boost demand as Ottawa follows an expansionary fiscal policy.

The Outlook for Inflation and the Current Account

Forecasters believe that inflation in the Big Six countries will stabilize in the 5- to 6-percent range during 1983-84. The slow pace of the recovery, high excess capacity, and high—and in Western Europe growing—unemployment are expected to prevent bottlenecks that would force prices upward. Moreover, oil prices, which triggered the past two major bouts of inflation in the OECD, are widely expected to stabilize or even decline through 1984; several forecasters cite increased supplies from non-OPEC countries and slow growth in OECD oil demand as factors that could create downward pressure on prices.

Unlike the inflation projections, forecasts of Big Six current account surpluses vary widely, ranging from \$6 billion to \$26 billion for 1983 and from \$16 billion to \$36 billion for 1984. Most of the gaps are due to differing forecasts of the Japanese current account surplus, and, to a lesser extent, the size of the West German surplus. These differences, in part, reflect diverse projections of US economic growth. Generally, the forecasters who expect strong US growth believe that the United States will run a substantial balance-of-payments deficit, which will be mirrored by a large Big Six surplus.

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**Big Six: Comparative
Inflation Rates***Percent*

	1982	1983	1984		1982	1983	1984
Big Six	7.6			United Kingdom	8.5		
US Embassy		5.3	5.3	US Embassy		4.6	5.8
OECD		5.6	5.1	OECD		6.8	6.0
Blue Chip		5.7	5.7	Blue Chip		5.6	6.4
DRI		5.5	6.1	DRI		5.6	8.9
DIW		6.2	5.5	DIW		6.0	6.0
Japan	3.0			Italy	16.6		
US Embassy		1.9	2.3	US Embassy		14.5	13.5
OECD		1.7	2.5	OECD		14.6	12.3
Blue Chip		2.3	2.9	Blue Chip		15.0	13.5
DRI		2.4	3.0	DRI		14.1	11.2
DIW		3.0	3.0	DIW		15.0	13.0
West Germany	5.2			Canada	10.8		
US Embassy		2.9	3.6	US Embassy		5.6	6.5
OECD		3.0	3.0	OECD		6.2	5.5
Blue Chip		3.1	3.2	Blue Chip		6.2	6.1
DRI		2.9	3.7	DRI		5.5	5.2
DIW		3.5	3.0	DIW		7.2	6.0
France	11.6						
US Embassy		9.5	7.4				
OECD		9.3	7.5				
Blue Chip		9.4	8.5				
DRI		9.3	9.8				
DIW		10.0	8.0				

Clouds on the Horizon

At this stage of the recovery, few forecasters are willing to estimate the duration of the upturn—especially in light of the poor record in projecting the course of the last recession. Nonetheless, they do point to areas that could shorten or weaken the overall recovery in the Big Six economies.

An almost universal concern is the effect of large US Government deficits on interest rates in the Big Six. If interest rates go up abroad, interest-sensitive consumption would slacken, housing construction would slow, and investment needed to sustain the

recovery would remain sluggish. The deflationary effects of high interest rates on West Germany, France, and Italy would be particularly strong because of the reliance of their business sectors on banks for financing new investment. Moreover, higher rates could further dampen demand by debt-ridden countries for Big Six exports. Another effect emphasized particularly by the OECD Secretariat is that higher interest rates would shake consumer confidence, thus making people less willing to spend.

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**Big Six: Comparative
Current Account Balances***Billion US \$*

	1982	1983	1984		1982	1983	1984
Big Six	0.7			United Kingdom	7.2		
US Embassy		24.9	36.3	US Embassy		1.4	2.2
OECD		16.0	22.5	OECD		1.8	1.3
Blue Chip		11.8	16.2	Blue Chip		0.1	-0.5
DRI		7.6	16.6	DRI		NEGL	0.7
DIW		6.0	17.0	DIW		1.0	1.0
Japan	6.9			Italy	-5.5		
US Embassy		21.4	24.7	US Embassy		-2.1	-2.0
OECD		18.2	21.8	OECD		-1.5	-2.0
Blue Chip		16.1	18.0	Blue Chip		-2.9	-2.5
DRI		15.9	19.3	DRI		-4.0	-3.9
DIW		11.0	18.0	DIW		-4.0	-3.0
West Germany	3.1			Canada	2.0		
US Embassy		10.6	13.5	US Embassy		2.9	2.1
OECD		4.5	2.0	OECD		2.2	3.5
Blue Chip		5.8	6.3	Blue Chip		1.3	0.3
DRI		5.2	10.1	DRI		-1.4	-4.3
DIW		5.0	4.0	DIW		0.5	2.0
France	-13.0						
US Embassy		-9.3	-4.2				
OECD		-9.2	-4.0				
Blue Chip		-8.6	-5.4				
DRI		-8.1	-5.3				
DIW		-7.5	-5.0				

The source of investment needed to keep the economic upturn going, particularly in Western Europe, is cited by both the OECD and DIW as a major worry. In their view, Western Europe remains poorly positioned in the industries that are expected to face growing demand. With stagnant or declining demand for West European products, internally generated investment funds will be limited. Most West European governments also are likely to hold back on investment projects in an attempt to reduce already large budget deficits.

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Israel: Development of High-Technology Industries [REDACTED]

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Many Israelis believe the development of high-technology industries will solve the country's economic problems. While we agree that the highly skilled labor force and the experience gained in sophisticated defense industries provide a promising foundation, we do not believe high-technology industries will prove quite the panacea many Israelis hope. Even though these industries will play an increasingly important role, high-technology firms face a number of pitfalls—raising venture capital for research and development is probably the most important, especially for small new companies. [REDACTED]

Current State of High-Technology Industries

Defense needs have provided the major impetus to the development of high-technology industries in Israel. According to the US Embassy, as Israel expanded its defense procurement to include increasingly complex weapons systems, defense-related firms acquired growing capabilities in high technology. As major Israeli firms won contracts to provide high-technology products to the Israel Defense Force (IDF), high technology was diffused to smaller companies through contracts to supply subsystems and components. [REDACTED]

Approximately 500 Israeli firms are active in research and development projects compared with only 200 six years ago, according to Israeli press reports. The most successful firms are those that have concentrated on securing markets too small to be of much interest to large firms in the United States, Western Europe, or Japan. Newer, smaller firms are involved in biotechnology, robotics, computer software, cad-cam (computer-aided design, computer-aided manufacture), and fiber- and electro-optics; a recently established kibbutz is devoted entirely to the development of computer software. [REDACTED]

Because the domestic market is so small, high-technology companies are export oriented. Exports of locally developed science-based products in recent years have grown twice as fast as overall exports, reaching \$1.3 billion in 1981. Science-based exports constituted one-fifth of all exports in 1981 (the most recent year for which data are available), compared with 10 percent in 1976. According to a recent study by the Israel Productivity Institute, about 140 firms are exporting science-based products. Exports of electronics for civilian uses exceed \$500 million, according to a press report, and Elscint reportedly is the third-largest supplier of the computerized axial tomographic scanner—known as the CAT scanner—in the United States. [REDACTED]

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Potential for High-Technology Industries

Many Israelis believe that the country's brain-power gives it a comparative advantage in research and development. They believe high-technology industries will provide jobs, exports, and a higher standard of living. According to reporting from the US Embassy, the Israelis believe they can compete with anyone in the high-technology field. [REDACTED]

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The Israel Defense Force is an important source of highly trained individuals for science-based industries. Since almost all are required to enter military service at 18 years of age or after completing high school, many young Israelis are exposed to high-technology military equipment. Those who do not go on to college can apply their practical knowledge in the area of equipment maintenance. The college bound may be motivated to further develop these skills in their university studies. [REDACTED]

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Israel: Selected High-Technology Companies

	Products	Number of Employees	Sales	Exports
Cycon, Ltd.	Programing and machine control systems for mold and die milling applications	76	Sales scheduled to begin in the second half of 1983	
Elbit Computers, Ltd.	Computers, military equipment, medical equipment, and communications equipment	1,700	\$72.7 million (1 April 1981-31 March 1982)	\$29.2 million (1 April 1981-31 March 1982)
Elex Control Systems, Ltd.	Computerized numerical control systems	90	\$1.6 million (1982)	\$1 million (1982)
Elscint, Ltd.	CAT-scanner, nuclear medical imaging equipment	NA	\$71.9 million (1 April 1981-31 March 1982)	NA
Fibronics, Ltd.	Fiberoptic fibers, cables, components, and communications systems	150	\$1.7 million (1982)	\$1 million (1982)
Intelligent Information Systems, Ltd.	Communication and terminal products for large computer systems	35	\$3 million (1982)	\$800,000 (1982)
Israel Aircraft Industries	KFIR aircraft, missiles, radar, and communication equipment	20,000	\$820 million (1981)	\$520 million (1981)
Koor Electric & Electronics, Ltd.	Telephone exchanges, military telecommunications equipment, data transmission systems, medical equipment	2,700	\$110 million (1982)	\$25 million (1982)
Metalworking Lasers International, Ltd.	Industrial carbon dioxide lasers	30	Production to start in late 1983	
RAD Computers	Data communications	25	\$900,000 (1982)	\$120,000 (1982)
Rafael—Armament Development Authority	Specializes in R&D; products include special purpose computers and special communications systems	Several thousand	NA	NA
Sharnoa Electronics, Ltd.	Computerized numerical control equipment for lathe and milling machines, robotics	43	\$3.7 million (1980)	\$3 million (1980)
Tadiran Israel Electronics Industries, Ltd.	Electronics and telecommunication equipment	9,000	\$340 million (1981)	\$140 million (1981)

Israelis believe they have other advantages and opportunities that they can exploit. These include:

- Israel already is an exporter of major military equipment.
- Israel's high-technology firms take advantage of the country's expertise in other fields, such as agriculture and health care, to a greater extent than do competing firms abroad. For example, Israel's reputation for water resource management is a strong selling point for its computerized irrigation systems.
- Israel can compete in the United States and Europe by adapting technology to meet the needs of small users. A government official claims that many large Western firms are simply not interested in tailoring products to meet specific markets if sales potential is small.
- Latin America and Africa also offer promising markets for Israeli high-technology products, according to some Israeli businessmen, because Israel offers these countries simplified maintenance and training.

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The Office of the Chief Scientist of the Ministry of Industry and Trade is the main source of government funds for R&D. According to US Embassy reporting, approximately \$50 million was spent in FY 1982 for a program that funds up to 50 percent of the costs of R&D projects in industry and up to 60 percent for a newly established company. We believe limited financial resources are, and will continue to be, the major constraint on government efforts to help the industry. [redacted]

Economic Panacea?

Many Israelis believe that high-technology industries will provide the catalyst for economic growth, lower unemployment, and better living standards. Experience shows that for every dollar invested in industrial R&D, Israel will export \$8 to \$10 worth of products. [redacted] In their aid request for FY 1984, Israeli officials stated that, by 1986, 55 percent of industrial exports (excluding diamonds) will be products based on Israeli research and development. The import component of Israel's high-technology industries, moreover, is lower than that of traditional industrial products; for example, the major component of computer software is the brainpower that created it. Thus, the import bill associated with \$100 million of production from science-based industries will be lower than the bill associated with \$100 million of production from more traditional manufactured goods like furniture and plastics. [redacted]

High-technology firms face a number of pitfalls that may prevent the industry from becoming quite the panacea the Israelis foresee. Raising venture capital to finance R&D is probably the most important, in our view, especially for the newer, smaller companies. The "crash" of the Tel Aviv Stock Exchange last January and proposed changes in its operation will probably result in a period of uncertainty that will make it difficult for high-technology firms to raise capital. Another potential source of funds, foreign direct equity investment, is rare in Israel. [redacted]

Other pitfalls include:

- The problems of backing good technology with adequate marketing.
- The reluctance of many governments and foreign companies to purchase Israeli equipment; some African and Latin American countries that rely on Arab financial assistance do not want to jeopardize those aid flows. 25X1
- Israel's skilled labor force is not likely to grow rapidly enough to accommodate the degree of high-technology expansion many Israelis apparently hope to attain. [redacted] 25X1

Outlook

High-technology industries, while not a panacea, will play an important role in the Israeli economy. Israel's comparative advantage lies in using its highly skilled, well-educated labor force in the development of high-technology products, and its strength will continue to be adapting existing technology to meet specific needs. We agree with the US Embassy's judgment, however, that a shaking-out period is likely and that some firms will not survive; for example, the Embassy reports that there are 25 companies engaged in robotics. [redacted] 25X1

Several steps have already been taken to deal with the problems confronting Israeli high-technology industries: 25X1

- Some companies have arranged to sell their products to West European and US firms who then resell them under their own trade names. [redacted] 25X1
[redacted] This practice frees 25X1
Israeli firms from undertaking their own marketing programs and results in Israeli products reaching customers who would not deal directly with Israeli firms. 25X1

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- The Ministry of Industry and Trade gives incentives to employ new immigrants and returning Israelis as researchers by providing up to 80 percent of the cost of their initial employment, according to reporting from the US Embassy. [redacted]

Israelis appear to realize that some sectors of high technology will not be profitable. One government official said that Israel could never compete with Japan and the United States in manufacturing silicon chips. [redacted]

[redacted] the country will never be a major producer of consumer electronics because the domestic market is too small and Israel's advantage is not in manufacturing. There appears to be a general consensus that Israel's comparative advantage lies in using its brainpower in the development of software that can be sold to foreign companies. [redacted]

The development of Israel's high-technology industries will not solve all of the country's economic problems; indeed, it probably will only ease some of them. We used the CIA econometric model of Israel to project the economic impact of a boost in high-technology exports of \$250 million annually¹ in 1984-86 over a baseline scenario. While the civilian goods and services deficit in 1986 would be reduced by \$600 million, it would still reach \$4.3 billion. The unemployment rate would be 0.6 percentage point lower than in the baseline, but, at 7.7 percent, the rate would still be unacceptably high to the Israeli public; real GNP would increase at an annual rate of 4.1 percent compared with 3.5 percent in the baseline case. [redacted]

Implications for the United States

While we do not believe Israeli products will offer much competition to US firms engaged in large-scale production of major systems and components, they may have an impact on sales in certain specialized areas. In addition to competing in the US market, Israeli companies will be vying with US exporters for market shares in third countries;

¹ This is roughly equivalent to the gains made in recent years. [redacted]

Israeli products may have an advantage in Western Europe because they receive certain tariff concessions from the EC not available to US exports. We agree with the US Embassy's judgment that, particularly in Latin America where Israel's reputation as a supplier of military equipment is established, US exporters may find strong Israeli competition in certain sophisticated civilian product lines, such as computers, telex equipment, and electronics. [redacted]

We believe Israeli firms will look to the United States for joint venture or licensing deals that will provide them with technology that would be too expensive to develop domestically and for marketing arrangements whereby the US firm sells Israeli equipment under its own name. Israeli firms will also be looking to the United States for financing. According to an Israeli press report, nine Israeli companies, most of them oriented toward science-based industry, publicly trade their stock in the United States; Scitex recently raised \$37 million in the equity market. In addition, we believe Israeli executives could well look for financing from US banks. [redacted]

Financing will also come from joint US-Israeli organizations that receive US Government support. The Binational Science Foundation and the Binational Agriculture Research and Development Foundation provide funds for basic research. Money for the process of turning an innovation into a commercial product can come from the Binational Research and Development Foundation (BIRD-F). The US Embassy reports that demand for BIRD-F financing is already so great that the foundation must impose limits on the financing available for new projects. [redacted]

We agree with the US Embassy's judgment that the Israeli Government will continue to push its proposal for a two-way free trade area as an alternative to the Generalized System of Preferences (GSP) that will help in marketing Israel's high-technology products in the United States.

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According to US Embassy reporting, Israeli officials are already concerned that Israel may not be considered an LDC, and thus not be eligible for the tariff reductions when the legislation is renewed. The Embassy reports that Israel has already come up against the competitive need limitations on GSP because of its tendency to specialize in narrow markets. A country can lose the preference on a specific item if the country accounts for more than half of total US imports of that item or the country's exports of that item to the United States exceed a specific value limit.

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In their aid request for FY 1984, Israeli officials stated that Israel's need for US assistance will diminish if the civilian goods and services deficit declines. Israeli officials are reluctant to severely cut back imports because of the negative impact on economic growth and living standards, so major improvement in the civilian goods and services deficit would have to come from export growth. Even under the best of circumstances, however, we do not believe the impact of export growth on Israel's civilian goods and services deficit, and thus its need for economic assistance, will be substantial in the next few years. In order to make major inroads on the deficit with high-technology exports, the Israelis will have to overcome the marketing, financing, and manpower problems they face, which will require tremendous skill and not a little luck.

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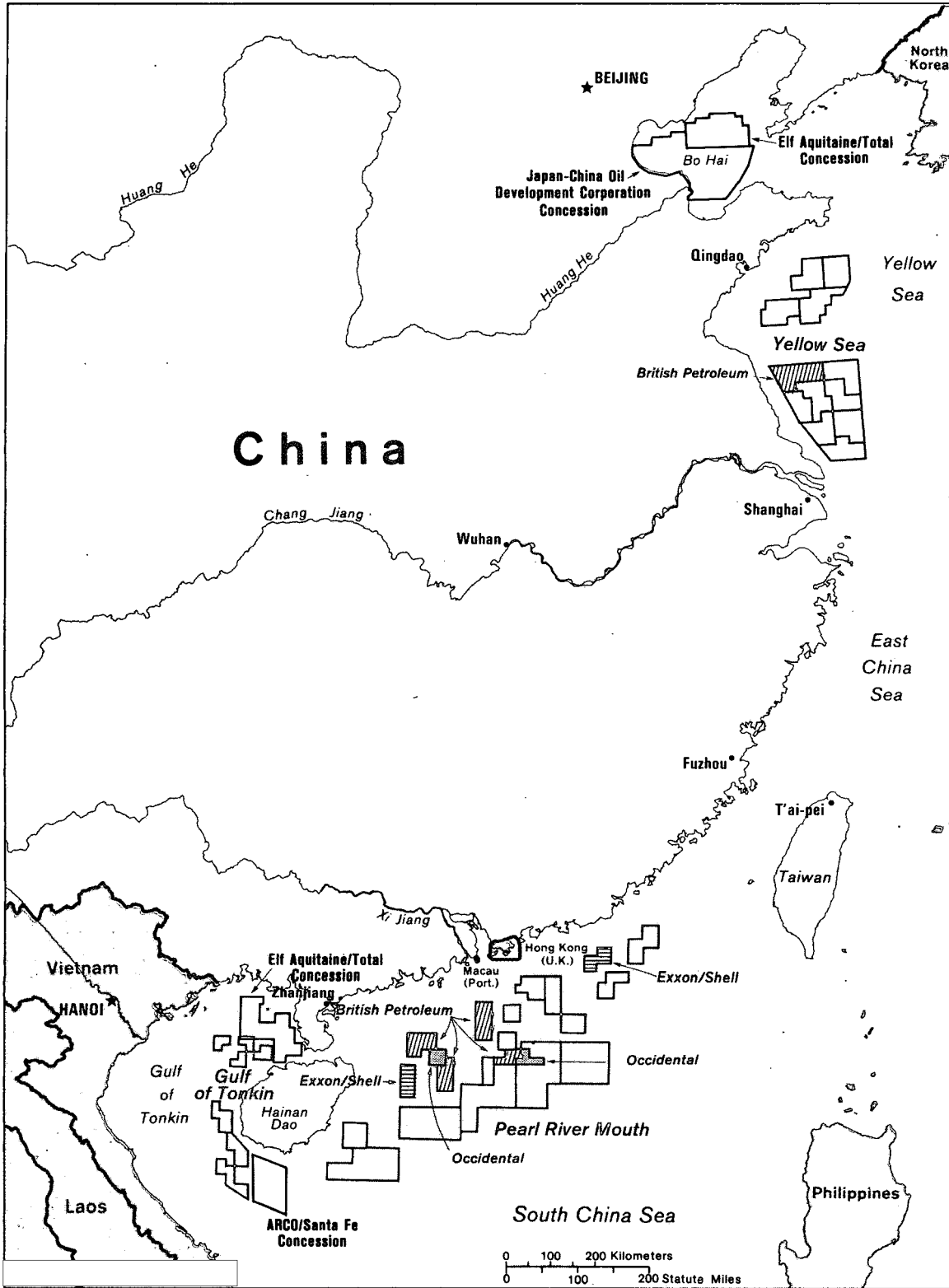
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Offshore Oil Bid Blocks



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China: Offshore Oil Developments 25X1

Those who cooperate with China need courage, but will suffer no losses in the end.

*Premier Zhao Ziyang
Comment to Exxon chairman Garvin
24 August 1983*

Last week's signing of an Exxon and Royal Dutch Shell joint venture for rights to explore and develop two offshore blocks paves the way for intensive exploration of the promising Pearl River Mouth Basin. We consider the offshore oil program—particularly the Pearl River Mouth Basin effort—to be of critical importance to China's ability to maintain its position as an exporter of oil in the 1990s. In what must appear to Beijing as a less than totally successful offering, thus far eight of the 23 Pearl River Mouth blocks have been leased but only one of the concurrent 12 Yellow Sea offerings and none of the eight Gulf of Tonkin blocks. 25X1

China's Need for Oil

Crude oil and product exports of about 400,000 b/d last year contributed more than 20 percent of the country's foreign exchange earnings. Onshore reserves have been drawn down over the past decade, however, as exploration results have not been good. Currently, close to 90 percent of the country's 2-million-b/d output comes from fields that are in mature stages of production. Of particular concern is the strong likelihood of a downturn in production from the country's only supergiant field, Daqing, which produces half of China's output. The offshore basins offer the greatest hope for preventing a long-term drop in China's oil output, but even if exploration there is successful, it will take at least six years for significant production to begin. 25X1

In 1978, after a decade of attempting to explore the Continental Shelf on its own, Beijing realized that its decline in reserves was becoming a critical problem and in a major change of policy invited foreign firms to take over much of the effort. Contracts were quickly signed with a Japan National Oil Company (JNOC) consortium which took over much of the Ministry of Petroleum's effort in the Bohai Bay, and with two French firms, Elf Aquitaine and Total Exploration, which took over from the Chinese in another part of the Bohai and in the Gulf of Tonkin. These companies have already invested about \$450 million drilling 25 wells in the Bohai and the Gulf. 25X1

In 1979 Beijing asked Atlantic Richfield (ARCO) to take over the Ministry of Petroleum's work south of Hainan Island. A contract was finally signed last September and two wells have been drilled. One was dry, but the second made a possibly large natural gas discovery. Only months after the request to ARCO, Beijing invited a group of largely US firms to run seismic surveys of much larger and potentially richer basins in the Yellow and South China Seas in preparation for competitive bidding for contracts in those areas. These firms were invited to bid for blocks in August 1982, a process which is only now resulting in firm contracts. 25X1

The Pearl River Mouth Basin Contracts

Despite their headstart, it is unlikely that either the Bohai or the Gulf of Tonkin will make enough 25X1

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difference to offset expected declining onshore oil output. The Pearl River Mouth Basin, on the other hand, has considerable potential. Western geologists estimate that the basin may ultimately yield over 5 billion barrels of oil. Seismic surveys, as reported by company officials, have turned up approximately 130 separate structural prospects which range in possible capacity from 50 million to over 1 billion barrels. Approximately half of these prospects were included in the lease program. A good hydrocarbon source rock is known to underlie the area. The key question concerns the quality of reservoir rock in the structures—a factor that has a major impact on well productivity. In geologically similar onshore basins, reservoir rock has often been found to have poor characteristics, which has necessitated very intensive development. Offshore, such tactics could be very, if not prohibitively, expensive. [redacted]

In the eight blocks already leased in the basin and in the one Yellow Sea block, the foreign firms have committed themselves to drill about 25 exploration wells in the next three years. To retain the blocks they will have to drill probably 30 to 40 wells in the following two to four years. British Petroleum hopes to start its first well late this year. The others will begin early next year. Next year's pace will not be rapid but several of the key prospects will probably be drilled; a good idea of the area's potential should thus be gained. [redacted]

So far two US firms, Exxon and Occidental, have signed contracts for the equivalent of two full blocks out of the nine contracted so far in China's competitive bidding program. Two more groups, Texaco/Standard of California and Japan National Oil Company/Getty, however, are expected to sign within a few weeks. Exxon has one of the most attractive prospective fields in its westernmost block, but British Petroleum, which together with four Commonwealth and Brazilian companies was the first to sign last May, has many more but generally smaller prospective fields in its five blocks. We have little geologic data on the two blocks signed by Occidental and six other non-US firms in early August. Several major companies—

all of them American—that had participated heavily in seismic surveys, were told in May that their bids were not competitive. Beijing is continuing to hold discussions with these firms—including Amoco, Mobil, Phillips, and Pennzoil—but contracts, at least in this round of bids, are not likely. As a result, US firms will not dominate the Pearl River Mouth Basin and the Gulf of Tonkin to the extent originally envisioned by both the Chinese and many of the companies. Consequently, the exploration program will be more narrowly focused and more dependent on early discoveries than the broader and more comprehensive program originally planned by Beijing. [redacted]

Contract Terms

The contracts, a form of production sharing, will require the companies to pay for all exploration expenses over a five- to seven-year period. If exploration is successful, the China National Offshore Oil Corporation (CNOOC) will be entitled to enter into joint ventures that will be established for the development of each field, as an up-to-51-percent partner, contributing its share of development costs and gaining rights to the same share of the joint venture's profit oil. When production begins, 17.5 percent of the oil will go to the Chinese Government in the form of a royalty; up to 50 percent of the oil will be used to pay operating expenses and to repay the capital costs of the joint venture—including CNOOC's share if it decides to participate—and a percentage of the remainder, known as the X factor will go to the joint venture as its profit share for 15 years. [redacted]

This X factor or profit share—which constitutes a major part of the bid—is further complicated in that bids are differentiated with respect to the productivity of individual fields. For small fields a firm can specify a high X factor while for very large fields it must specify a low factor. This will prevent a foreign firm from making "extravagant" profits should it make a very large discovery. The X factor is split between CNOOC and the foreign partners on the basis of their participation in the

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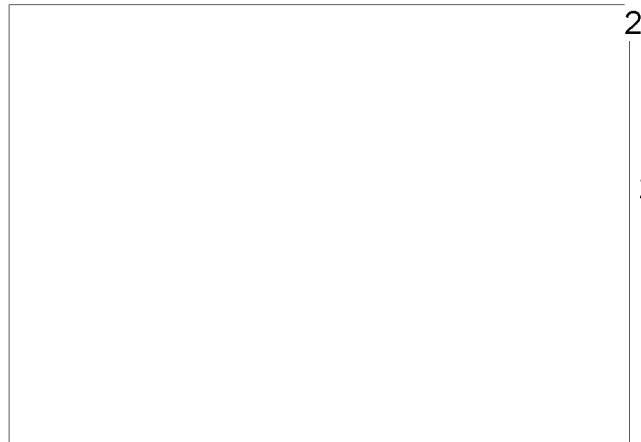
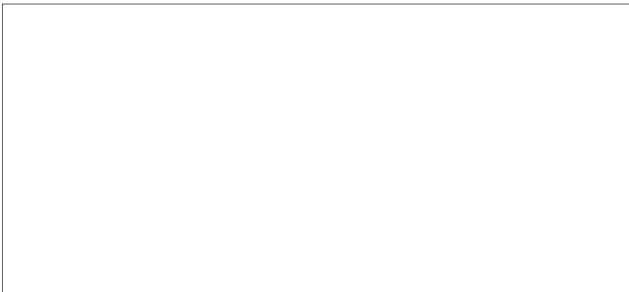
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joint venture. The foreign companies' profits are then taxed at a 50-percent income tax rate. This tax is generally creditable against income tax in the companies' home countries.



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If China is to maintain oil production at current levels, we believe offshore production must reach approximately 1 million b/d by the mid-1990s. After that an additional field would have to be discovered each year to compensate for the natural decline of the existing fields. Oil exports from the offshore fields may peak at about 300,000 b/d, which we believe would substitute for and not augment current exports from Daqing and other mature onshore fields. 

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Algeria: Losing Room for Maneuvering [REDACTED]

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Algeria has so far weathered the soft oil market through a combination of cautious economic management, expanded sales of noncrude hydrocarbons, and a drawdown of foreign exchange reserves. The adjustment process has become increasingly difficult this year. [REDACTED]

[REDACTED] Self-induced austerity so far has not affected the populace much, but further belt tightening may pose problems. The long-range outlook for Algeria hinges upon the oil and gas market; current investment and maintenance patterns suggest that Algeria's gas development program faces setbacks in the next few years. [REDACTED]

Game Plan

Shortly after nationalization of the oil industry in the early 1970s, the Algerian Government designed an ambitious investment program using oil revenues to finance diversification and industrialization of its economy before oil reserves would be depleted at the end of the century. This program which allocated 40 percent of GDP to investment directed money primarily toward heavy industry. By 1977, Algerian leadership, faced with rapidly escalating foreign debt and only marginal progress in industrialization altered its development strategy and postponed or canceled some large gas development projects. In the most recent development plan (1980-84), investment is focused on previously neglected sectors such as transportation, housing, public services, and light industry; nevertheless, hydrocarbons still receive the largest share of investment funds. [REDACTED]

Despite a decade of efforts to diversify the economy, hydrocarbons still provide 95 percent of Algeria's export earnings and represent more than

30 percent of GDP. Current crude oil production is half the peak 1978 level and crude export volumes have dropped 75 percent for the same period. [REDACTED]

Performance Under Adversity

Expanded sales of noncrude hydrocarbons—condensates, liquefied petroleum gas, refined products, and natural gas—and sound economic policies have partially offset the effects of the soft oil market. In 1982 export volumes of the noncrude hydrocarbons increased by an average of 260,000 b/d to 756,000 b/d. This offset the decline in crude oil exports, which fell more than 220,000 b/d to 304,000 b/d. At the same time, Algeria's drive to establish price parity between natural gas and crude oil began to pay off. Algeria's natural gas export prices in 1982 were more than four times the 1977 average. [REDACTED]

Despite these efforts, export earnings declined from \$13.5 billion in 1981 to \$12.4 billion in 1982. The government sharply cut imports, particularly consumer goods, starting in the third quarter of 1982, and for the year imports fell 9 percent. As a result, the Algerian trade surplus of \$2.4 billion matched the year before. [REDACTED]

Foreign borrowing has been tightly controlled by the government, and Algeria has avoided the massive foreign debt problems of other LDCs. Since 1979, Algeria has limited its borrowing almost exclusively to supplier credits for trade financing. Algeria's resolve to avoid debt problems is evidenced by the lack of growth in medium- and long-term disbursed debt since 1979. [REDACTED]

Rather than borrowing, the Algerian Government has relied on foreign exchange drawdowns. The buildup in foreign exchange reserves to \$3.8 billion

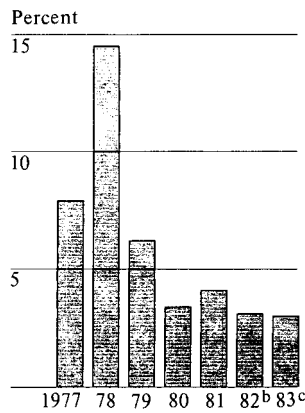
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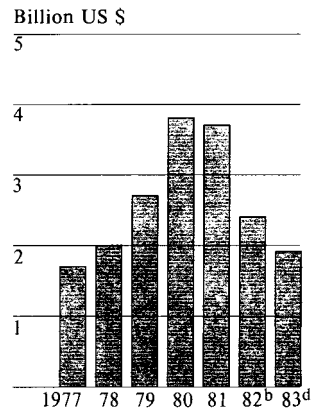
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Algeria: Selected Economic Indicators

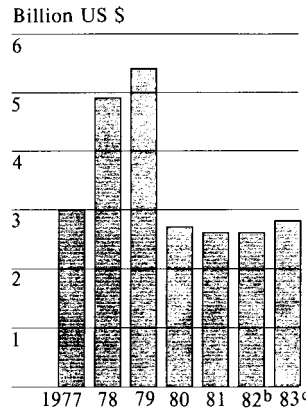
Real GDP Growth



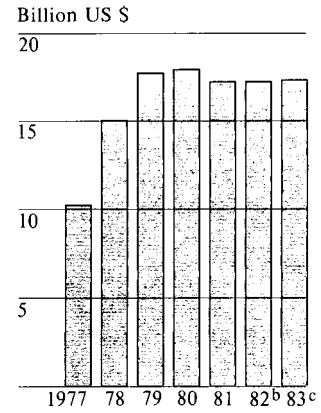
Foreign Exchange Reserves^a
(Excluding gold)



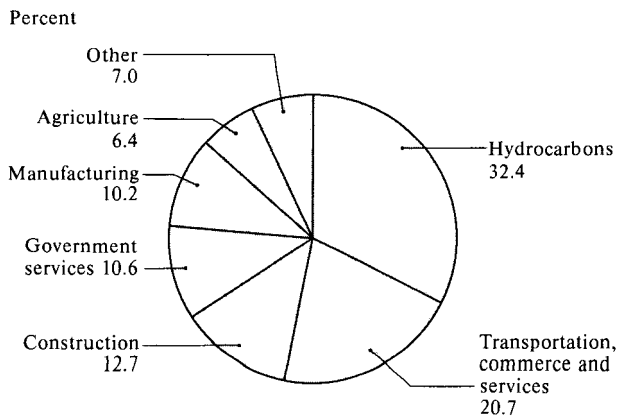
New Debt Commitments



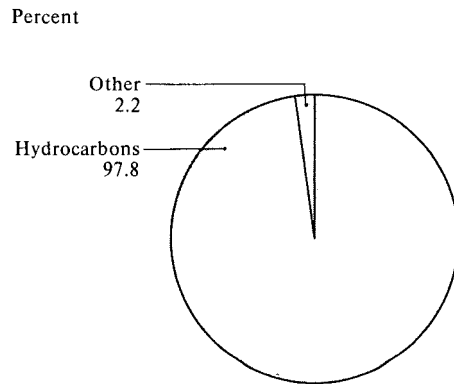
Disbursed Debt



Composition of GDP, 1981



Composition of Exports, 1981



^a End of period.
^b Estimated.
^c Projected.
^d June reserve level.

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


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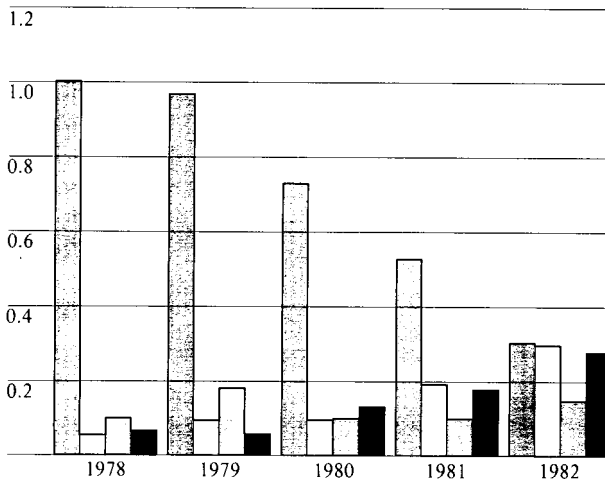
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Algeria: Hydrocarbon Export Mix

Million b/d oil equivalent

-  Crude oil
-  Condensates
-  Natural gas
-  Refined products



[Redacted]

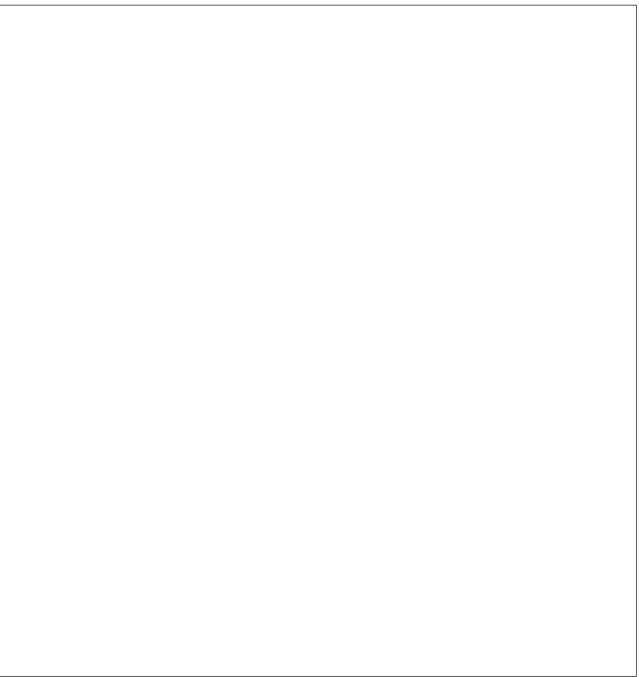
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following the 1979-80 boom in the oil market enabled Algeria to draw down \$100 million in 1981 and \$1.3 billion in 1982. By yearend 1982, reserves of \$2.4 billion were equivalent to about three month's imports. [Redacted]

More Adjustments in 1983

The weak oil market continues to be the major factor affecting Algeria's economy. Algeria's Minister of Energy, Belkacem Nabi, told an interviewer earlier this year that the March OPEC decision to cut oil prices \$5.00 per barrel would reduce Algerian revenues by \$2 billion in 1983. In addition to lower prices, falling crude production

also is cutting into oil revenues. Algeria's oil production for the first half of 1983 was below the country's 725,000 b/d OPEC quota. [Redacted]



In response to these revenue cuts, Algerian officials have scaled down the 1983 import program by \$1 billion to \$9.5 billion so far. Items most affected are "nonessential" consumer goods such as refrigerators and cars and equipment for lower priority investment projects. An exception is food imports, which will rise because a drought is reducing the 1983 harvest. [Redacted]

As export revenues have fallen this year, foreign reserves declined to \$1.9 billion in June. Algeria was forced to seek a \$500 million loan for a Sonatrach project. This is the country's first substantial new borrowing on the Euromarket since 1979; the loan received a very favorable response and was oversubscribed by \$200 million. Despite this success, Algerian officials are still committed to limiting medium- and long-term debt, preferring to finance imports through supplier credits that are often at concessionary rates. [Redacted]

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Algeria: Current Account*Billion US \$*

	1974	1975	1976	1977	1978	1979	1980	1981	1982 ^a	1983 ^b
Trade balance	1.2	-0.7	0	-1.6	-1.6	1.2	5.6	2.4	2.4	2.3
Exports (f.o.b.)	5.3	4.9	5.3	5.9	6.6	9.5	15.9	13.5	12.4	11.8
Oil	4.7	4.2	4.8	5.6	6.0	8.8	14.9	12.3	10.7	8.9
Nonoil	0.6	0.6	0.5	0.3	0.5	0.7	1.0	1.2	1.7	2.9
Imports (f.o.b.)	4.1	5.6	5.3	7.5	8.2	8.2	10.3	11.0	10.0	9.5
Net services	-0.5	-0.8	-1.6	-2.4	-2.8	-3.3	-3.8	-4.1	-4.8	-4.7
Freight and insurance	-0.4	-0.7	-0.6	-0.9	-1.0	-1.0	-1.2	-1.3	-1.2	-1.1
Investment income	0.1	0.1	0.1	0.2	0.2	0.5	0.7	0.8	0.6	0.4
Other	-0.2	-0.3	-1.1	-1.7	-2.0	-2.8	-3.3	-3.6	-4.2	-4.0
Grants	-0.1	0	0	0	0	-0.1	-0.1	-0.1	-0.1	-0.1
Current account balance	0.6	-1.6	-1.6	-4.0	-4.4	-2.2	1.7	-1.7	-2.5	-2.5

^a Estimated.^b Projected.

Lower oil earnings have spurred efforts to improve domestic economic efficiency such as decentralizing public-sector companies, reorganizing the government-controlled distribution system, and allowing the private sector a greater role in the economy. The government also has hiked prices of subsidized goods to reflect production costs. For example, prices have been increased in 1983 for bread, eggs, cooking oil, fuels, cement, tobacco, and transport tickets. To partially offset the impact of austerity a 10-percent minimum wage increase was granted last December, the tax exemption limit has been raised, substantial subsidies have been retained on more basic food items, and conveniences such as checking account services and government supermarkets have been set up.

Outlook

The government does not yet seem to be in any danger of public disapproval for its economic

Algeria: Gas Contracts*Billion Cubic Meters*

	1983	1984	
	Exports ^a	Exports ^a	Contracts
Total	17.7	20.4	28.6
LNG	16.7	14.1	22.3
Belgium	2.5	1.5	2.5
France	9.0	8.0	9.4
United States	3.2	3.3	5.9
Spain	2.0	1.3	4.5
Pipeline			
Italy	1.0	6.3	6.3

^a Projected.

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actions. Despite the austerity measures applied thus far, the Algerian populace has been fairly quiescent and has not yet put pressure on the government to alter its course. Unless the oil market strengthens substantially, however, the government faces further and potentially risky domestic austerity measures or larger foreign borrowings.

[Redacted]

Algeria's longer term financial outlook is clouded because, we believe, it will have difficulty offsetting declining oil reserves with increased production from its enormous gas reserves. There is likely to be increased pressure on the Ministry of Energy for higher gas production and exports. Increasing gas production significantly in a short period, however, will prove difficult.

[Redacted]

[Redacted] In the event that gas contracts and expansion of production capacity are not forthcoming, Algeria will have to cut imports and investments further and step up its foreign borrowing. [Redacted]

Implications for the United States

The United States has an opportunity to expand exports to Algeria. Total US exports to Algeria—principally foodstuffs, machinery, and transport equipment—have increased steadily since 1978. Despite weakness in the oil market, Algerian contacts with US firms have increased during the last year, particularly since a trade investment mission headed by the US Secretary of Commerce visited Algiers last December. Algeria has been granted

[Redacted]

US foreign military sales eligibility, and a US/Algerian Joint Economic Commission is now being considered. The Algerian Ministers of Commerce and of Agriculture may visit the United States later this year. On the negative side there are two key factors. A downturn in the gas and oil market would further constrain Algerian imports. Secondly, should the FERC decision void Trunkline's Algerian natural gas contract, US exports could suffer. [Redacted]

[Redacted]

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Morocco: Living With Austerity [redacted]

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Growing debt repayment obligations have forced Morocco to stiffen austerity measures to secure a new IMF standby loan and to seek a debt rescheduling. Although the IMF program probably will open the way for additional financing from traditional benefactors—especially Saudi Arabia—a foreign exchange crisis is still possible before new money becomes available. Rabat has petitioned the United States for support for its stabilization program, and will view Washington's response as a measure of friendship. Popular outbursts are more likely as austerity continues, and King Hassan may have to use his security forces to quell disturbances.

there has been an exodus from rural areas into the overcrowded city slums. According to US Embassy reporting, unemployment in major cities now approaches 25 percent and is potentially a dangerous source of unrest. [redacted]

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The New Austerity

Morocco's foreign financial difficulties have forced Rabat to stiffen austerity measures. An extraordinary session of parliament was convened in late July to approve sharp cuts in the government's operating and development budget for the rest of the year. The revised budget even included marginal cuts in defense appropriations—the first in many years. The new program features a 50-percent cut in government hiring, a 25-percent hike in basic food prices, a schedule of devaluations over the next 16 months, and a sharp increase in the Saharan war tax. [redacted]

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The Legacy of Austerity

Harsh austerity measures were first implemented in 1978 following years of deficit spending and the 1976 collapse of the phosphate market—Morocco's primary export commodity. Austerity reduced the nation's trade and budget deficits at the cost of slow growth and unemployment. By 1981 the austerity measures were relaxed in order to stem the widening economic malaise. [redacted]

We believe that the current account deficit will show only a slight improvement to \$1.8 billion this year despite the new austerity measures. Exports will remain stagnant as demand for phosphate is depressed. Phosphate rock sales are Morocco's most important source of foreign exchange, accounting for 27 percent of merchandise export earnings last year. Falling rock prices—down almost 50 percent in the last 18 months—have spurred Morocco to seek a greater share of the world market. This effort, however, will have little impact this year. [redacted]

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Morocco's foreign financial problems have steadily worsened in recent years. The world recession and increased competition in the phosphate market have reduced export earnings. The high cost of the Saharan conflict and a severe drought in 1980-81 boosted food imports. Maintaining imports at the 1978 level necessitated heavy foreign borrowing and reliance on Saudi largesse. One consequence was a rapidly rising debt; Morocco's debt service ratio reached a staggering 45 percent this year. [redacted]

Imports will remain high as larger food purchases offset the impact of lower oil prices. The year's drought has cut the cereal harvest to 3.2 million tons this year, considerably below the annual 4.4-million-ton average during 1976-80. [redacted]

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Real GDP growth has averaged only 2.7 percent since 1978 compared with the 7-percent growth of the preceding five years. With stagnant real incomes and the countryside buffeted by drought,

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Morocco: Current Account Balance

Million US \$

	1978	1979	1980	1981	1982	1983 ^a
Current account balance ^b	-1,348	-1,565	-1,469	-1,893	-2,057	-1,784
Merchandise trade balance	-1,126	-1,336	-1,381	-1,557	-1,772	-1,480
Exports, f.o.b.	1,502	1,997	2,425	2,283	1,960	2,020
Phosphates and derivatives	585	744	1,009	1,080	874	756
Imports, f.o.b.	2,628	3,333	3,806	3,840	3,732	3,500
Fuel and lubricants	379	638	1,012	1,200	1,099	993
Foodstuffs	425	498	635	789	556	670
Services (net)	-235	-215	-96	-361	-313	-330
Receipts from tourism	290	333	356	338	340	350
Worker remittances	735	957	979	963	992	1,020
Private transfers (net)	13	-14	8	25	28	26

^a Projected.^b Balance before official grants.

Austerity measures have cleared the way for international financial assistance:

- Agreement has been reached with the IMF for a \$315 million standby loan.
- Saudi Arabia—Morocco's largest benefactor—reportedly provided \$100 million in August.
- The World Bank is considering a \$150 million loan designed to stimulate exports and employment.
- Press reports indicate that the new fishing agreement with Spain could yield \$650 million in medium-term development aid.

Until new financing actually is received later this year and next, Rabat will have to deal with serious foreign exchange shortages. Foreign exchange reserves—currently \$40 million—cover less than a week of merchandise imports.

Concurrent with Rabat's efforts to trim spending and secure additional foreign financing, the government is seeking to reschedule \$10 billion in

outstanding medium- and long-term maturities. Morocco has requested US support for its efforts to reschedule official debt through the Paris Club. Agreement among lenders may be difficult to achieve, however, because Rabat is \$1.2 billion in arrears to France despite an April 1982 rescheduling.

Given projected budget cuts and the drought, we expect growth of only 2 percent this year. While inflation was down sharply in the first half of 1983, it will decline only slightly to about 12 percent for the year, largely because of the recent food price hikes.

Domestic Political Repercussions

King Hassan II faces growing prospects for domestic unrest. As economic conditions deteriorate there is a very real potential for civil disorders like the food price riots in Casablanca in June 1981, in

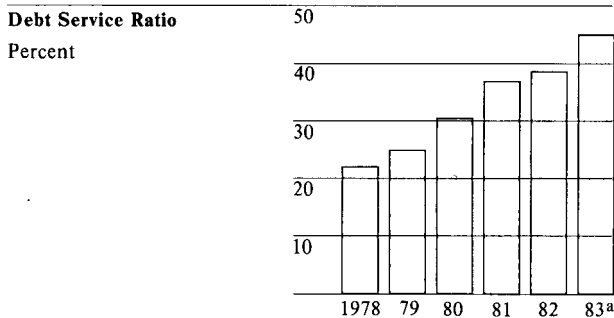
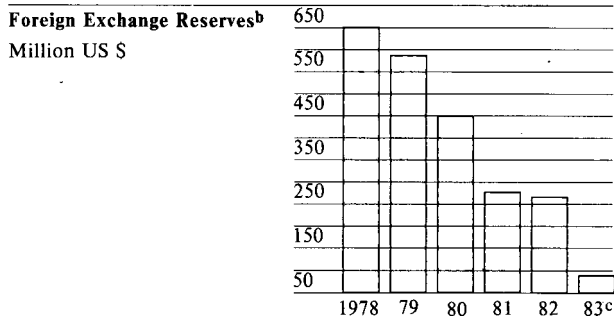
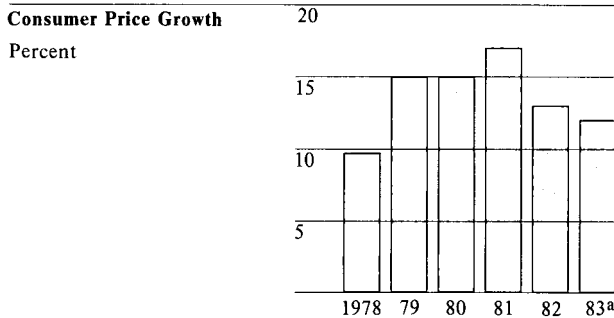
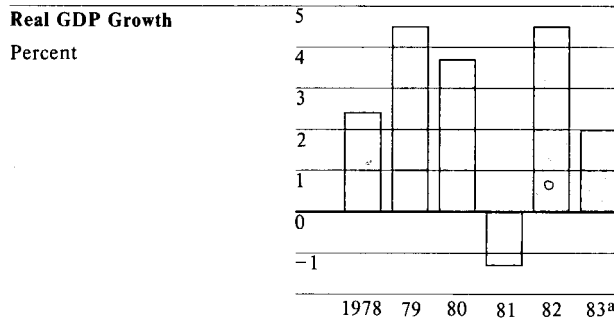
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Morocco: Economic Indicators



^a Projected.
^b End of period, excluding 704,000 ounces of gold.
^c Projected end of 3rd quarter data.

[Redacted]

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which 100 persons died. Embassy reporting indicates that initial criticism of the new austerity program has been limited because of careful advance preparation by the government and linkage by King Hassan of the nation's economic plight to the Saharan war effort, which remains popular. In addition, the impact of austerity on the nation's poor has been cushioned by a 20-percent increase in minimum wages. Discontent with the austerity measures could escalate, however, when students return to class later this fall. [Redacted]

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Despite criticism of the regime's economic policies by labor unions, students, and the unemployed, Hassan, so far, continues to have the support of Morocco's military and security forces. The government's past record of quickly extinguishing sparks of discontent provides some assurance that disaffection will not get out of hand. Nationwide civil unrest caused by rapid economic deterioration, however, could test the loyalty of junior military personnel who might sympathize with the disgruntled population and refuse to obey orders to suppress disturbances. Furthermore, if the government has to make additional cuts in civilian and military spending, this would heighten prospects for discontent. [Redacted]

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Outlook

The nation's foreign financial difficulties are likely to persist for the next several years and will demand that the King focus on the economy. Large current account deficits will limit the government's ability to launch most aspects of its development plan. Economic growth will be slow as austerity is pursued and unemployment will remain a troubling issue. Despite IMF loans and foreign debt rescheduling, the nation's tight financial position will increase its dependence on foreign aid—particularly from Saudi Arabia. [Redacted]

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Morocco's weak financial position impairs its ability to meet arms contract payment obligations, which could complicate relations with the United States. Rabat currently is about \$45 million in

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arrears to the United States for FMS payments. Morocco in May narrowly averted imposition of the Brooke Amendment, which would have preempted further US nonhumanitarian assistance. An additional \$10.8 million in FMS payments is due in September. If the September payment is not made, Morocco will not be able to draw on the \$52 million in restored FMS funding for FY 1983. The government's ability to meet the September payment is in doubt because foreign exchange may not be available in time. [redacted]

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Should US assistance not meet Rabat's expectations or if economic growth declines precipitously, close US-Moroccan ties could become a focus for criticism. Dissatisfied elements—including the military—would blame the King for failing to obtain sufficient US economic assistance in exchange for the Moroccan-US military access and transit agreement. Rabat recently refused landing rights for US aircraft participating in the Bright Star exercise and a Moroccan official linked this action to military assistance levels. Furthermore, if Morocco continues to move toward improved relations with Algeria and Libya as part of current Maghreb unity efforts and in pursuit of financial aid, Rabat is likely to seek a lower profile in its military and other relations with the United States. [redacted]

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