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International Economic & Energy Weekly [redacted]

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Oil prices may fall by another $5 from the current $15 per barrel world average over the next several months in response to weak seasonal demand and continued ineffectual action by OPEC. An improvement in non-Communist oil consumption combined with little or no growth in non-OPEC supply would make it easier for OPEC producers to hammer out an agreement to arrest the price slide later this summer. 25X1

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Perspective

Oil Market Outlook: Continued Price Volatility [redacted] 25X1

Oil prices may fall by another $5 from the current $15 per barrel world average over the next several months in response to weak seasonal demand and continued ineffectual action by OPEC. The longest OPEC meeting in history ended on Monday without any agreement on individual production quotas. Although the majority of members agreed to an annual output ceiling of 16.7 million b/d—compared with current production of about 18 million b/d—OPEC members remain divided on fundamental issues. Iran, Libya, and Algeria wanted to restrict output even further in an attempt to raise prices back to $28 per barrel. [redacted] 25X1

The market will be especially vulnerable to a price war over the next several months. Seasonal factors will reduce demand by as much as 2 million b/d, and competitive pressures could drive the world average oil price to $10 per barrel or less. Individual OPEC countries probably will be reluctant to make substantial production cuts without assurances that other producers will cooperate. Moreover, a resolution of the Norwegian oil strike—likely by the end of May—would return 900,000 b/d to the market adding to downward price pressure. Mexican exports could also rise by as much as several hundred thousand b/d if the new Mexican Energy Minister adopts a more aggressive marketing strategy. These potential increases more than offset an expected decline of several hundred thousand b/d in UK North Sea output due to routine summer maintenance. [redacted] 25X1

In our view, if prices fall below $10 a barrel, there is no economic reason for them to rise appreciably for some time. Any significant rebound would require producer cooperation. Even though industry estimates point to a rise in demand of 1-2 million b/d later this year due to recent price drops, it is not enough to substantially change the market situation in the absence of producer discipline. Of course, any increase in demand reduces the degree of discipline needed to return control of the market to OPEC. If industry estimates of increased oil consumption prove correct, OPEC producers may find it easier to hammer out an agreement to arrest the price slide later this summer. [redacted]

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In any case, supply and demand factors and market psychology are likely to cause continued price volatility. Spot oil prices in recent weeks have fluctuated by over $3 per barrel. Seasonal factors, inventory behavior, and the changing nature of oil marketing will reinforce price volatility over the coming months, unless OPEC producers reach a consensus to again defend prices. [redacted] 25X1

[redacted] 25X1

Summit Issues: West German and Japanese Economic Performance and Prospects for Reflation

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The potential for stronger, more balanced growth in West Germany and Japan is likely to prompt other summit nations to ask Tokyo and Bonn to abandon their austere budget policies, but both countries will resist the role of "economic locomotive." Tokyo and Bonn have been uniquely successful in curbing government budget deficits, in virtually eliminating inflation, and in generating record current account surpluses. Unless their economies deteriorate sharply—which we do not expect—Tokyo and Bonn will continue the anti-inflation, budget-balancing programs that they view as desirable over the long haul. Without a shift to expansion, however, their economies will continue to generate the large trade and current account surpluses that have provoked trade frictions in the past.

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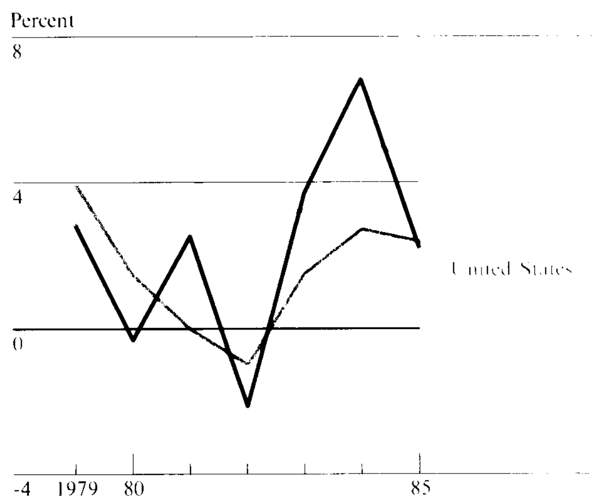
Big Three: GNP Growth Rates, 1979-85



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Policy Goals and Growth in the 1980s

In rejecting calls for economic policy relaxation, Tokyo and Bonn will cite the ill-fated "locomotive" programs that they agreed to at the 1978 Bonn summit. The result was a short-lived recovery, followed by several years of weak or negative growth, escalating inflation, and large current account deficits. Although these unhappy outcomes were the result of the confluence of several factors—the second oil price shock and the lagged impact of dollar depreciation through 1978—the experience soured both governments toward cyclical demand-management policies.

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Several years of budget austerity have almost eliminated the Japanese and West German central government deficits, and the trend will continue this year. Monetary policies in both countries also sought to end inflation, as both the West German and Japanese central banks focused on tighter control of monetary aggregates.

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Economic growth in the two countries came largely from the foreign sector—as real net exports were stimulated by the bouyant US recovery and the strong dollar. Strong foreign demand together with weak domestic demand—largely the result of tight economic policies—shifted the trade and current account balances of each country from large deficits at the start of the decade to hefty surpluses by 1985.

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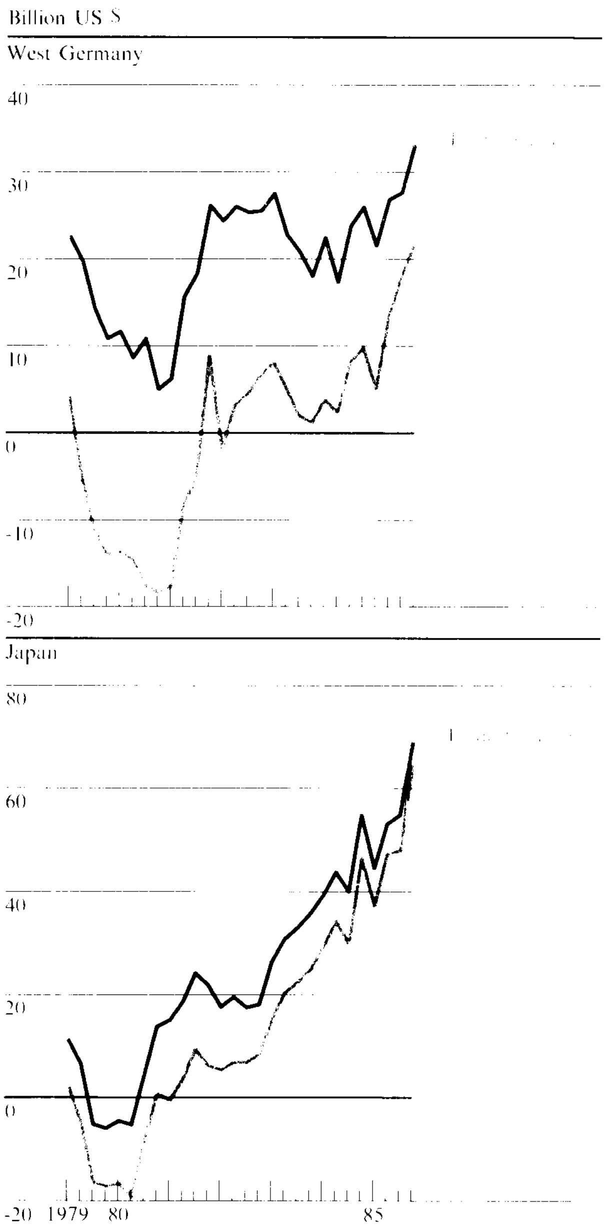
Trade and Current Account Balance, 1979-85



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Concern Over the "Weak" Dollar

When the US dollar began its ascent in 1980, the West Germans and the Japanese initially denounced the strong dollar for inflating domestic prices and siphoning-off domestic saving. By late 1985, however, exchange rate realignments had reversed the concerns of Tokyo and Bonn from dollar strength to dollar weakness, and they are now anxious that the dollar not depreciate further. Since the dollar's peak in February 1985 the yen has appreciated 25 percent in real effective terms, compared to 12 percent appreciation by the mark. 25X1

Tokyo and Bonn are both concerned that appreciation of their currencies will threaten growth and jobs, and, hence, the political fortunes of the ruling parties. A double election for the Japanese Diet now seems likely by early summer, and the ruling Liberal Democratic Party is worried that the deflationary impact of a rising yen will damage its prospects. The West German Government faces federal elections next January, and the coalition parties have recently suffered a string of election setbacks in state and municipal elections where unemployment was a major voter concern. 25X6
West German farmers—a pivotal voter bloc for the conservatives—are agitated over the government's handling of EC agricultural policy. The strong performance of the export-dependent manufacturing sector is an economic highlight that the government does not wish to lose. 25X6 25X1

Outlook Through 1987

Although dollar depreciation will dampen West German and Japanese export prospects, other forces—lower oil prices, reduced inflation, and interest rate declines—will take up the slack to stimulate some moderate growth. 25X1

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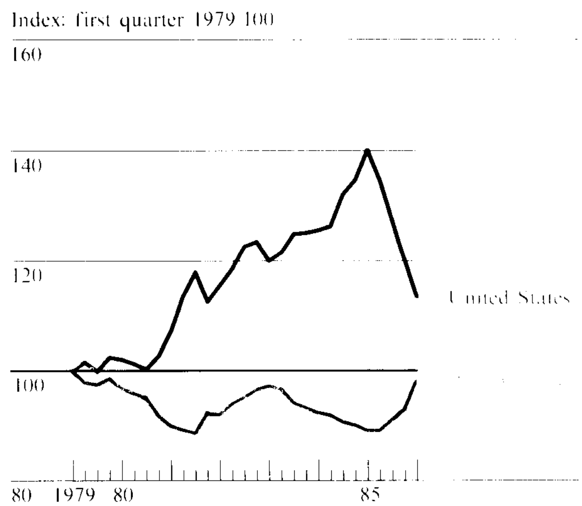
Japan. We believe the stronger yen will hold Japanese GNP growth to about 3 percent in 1986, well below the growth rates of recent years. Consumer spending will remain sluggish as a result of the small wage settlements negotiated so far this year. Our econometric model of Japan indicates that the stronger yen—which Japanese firms are not fully passing through to dollar export prices—will cut export volume at most 5 percent in 1986. Nonetheless, lower oil prices and the relative price effects of yen appreciation will probably push the current account surplus to a record $65 billion in 1986, up from $50 billion in 1985. 25X1

Japanese economic prospects are likely to improve slightly in 1987, largely because of stimulus from lower interest rates and oil prices. Even so, we expect growth to remain well below 4 percent. Neither consumer nor government spending will rise fast enough to offset the continued slowdown in foreign demand. More important, plant and equipment investment, which had risen sharply in 1984-85 in response to burgeoning exports, will probably slow substantially. We expect that the current account will begin to turn around in mid-1987, trimming the surplus to $60 billion for the entire year. 25X1

Real Effective Exchange Rates, 1979-86 [a]



[a] Trade-weighted, inflation-adjusted exchange rates.

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West Germany. Our quarterly model indicates that West Germany will enjoy a spurt of GNP growth in 1986, followed by a slowdown in 1987. Private consumption this year will benefit from the first stage—about $5 billion—of personal income tax cuts in both 1986 and 1988 and from real wage increases. We anticipate that the savings from cheaper oil will be largely passed on to the consumer and will boost GNP growth about 0.5 percentage point in 1986. Even with these favorable factors, however, we expect the economy to begin to slow by midyear, as real net exports decline, and as lower export earnings cause West German firms to reassess investment plans. We forecast that the effects of currency appreciation will be more manifest in 1987, and that, with continued fiscal restraint, the economy will reenter the slow growth pattern that has characterized West Germany in the 1980s. 25X1

Unemployment, the government's major failing, will remain high. We expect the number of unemployed will decline only 50,000-60,000 this year, yielding an average 9.0-percent unemployment rate. We expect another marginal decline in 1987. Inflation rates this year and next will be postwar lows. 25X1

Prospects for Reflation

Bonn and Tokyo are unlikely to shift gears abruptly and reflate unless confronted with imminent recession. West German Finance Minister Stoltenberg, backed by Chancellor Kohl, has ruled out advancing the $4 billion in tax cuts planned for 1988. The Bonn coalition expects that the improved economic outlook for 1986 will be enough to secure its

Japan and West Germany: Economic Outlook, 1985-87

Percentage point contribution to GNP growth (except where noted)

	Japan			West Germany		
	1985	1986	1987	1985	1986	1987
Private consumption	1.4	1.9	2.1	0.9	1.9	1.5
Government consumption	0.3	0.5	0.4	0.2	0.7	0.4
Residential construction	0.1	0.2	0.4	−0.8	0.4	0.1
Plant and equipment Investment	1.6	2.0	1.1	0.6	1.1	0
Inventory	0.2	0.8	0.6	0.4	0.8	−0.2
Exports	1.2	−1.1	1.1	2.5	1.2	1.3
Imports	−0.2	−1.2	−2.2	−1.4	−2.1	−1.5
GNP [a] *(percent)*	4.6	3.1	3.5	2.4	4.0	1.6
Inflation *(percent)*	2.0	1.0	1.5	2.0	0.8	1.2
Unemployment *(percent)*	2.7	3.0	2.8	9.3	9.0	8.8
Current account *(billion US $)*	49.3	65.0	60.0	14.8	29.0	29.0

[a] Assumptions: Yen and mark rates of 180 and 2.2 against the US dollar from second quarter 1986 onward; oil price of $15 per barrel. If the yen and mark appreciate to 160 and 2.0 in the second quarter of this year, our analysis indicates GNP growth in Japan would decline 0.3 and 0.7 percentage points in 1986 and 1987, respectively, with corresponding reductions of 0.5 and 0.4 percentage points in West Germany.

[redacted]

reelection next January. The government hopes to downplay unemployment and concentrate instead on lower inflation, improved real incomes, and record current account surpluses. A devastating defeat in the next state election—Lower Saxony in June—could cause the coalition to reassess its economic strategy, but time is running out for major policy changes before the federal elections. [redacted]

Unless Japanese GNP growth falls well below 3 percent, we also expect Tokyo to stick to its deficit reduction program, which calls for little or no growth in current government expenditures. The recommendations of the Maekawa Commission, Nakasone's special advisory commission on trade policy, do not suggest an imminent shift in Tokyo's fiscal stance. The report urges that Tokyo focus on medium- and long-term measures to wean the economy away from its dependence on export-led growth. [redacted] 25X1

Both governments are contemplating tax reforms to reduce high marginal rates, but relief is not likely soon. West German tax reform will not even be debated until 1987, and Stoltenberg insists any direct tax cuts must be largely balanced by indirect tax increases or reduced subsidies. Japanese tax reform might have little expansionary impact. Tokyo may recommend $16-17 billion in personal and corporate tax cuts later this year, but a new value-added-type tax may be recommended because the powerful Finance Ministry wants tax reform to be revenue neutral. [redacted] 25X1

Tokyo and Bonn could resort to expansive monetary policies both to stimulate domestic demand and to push down their exchange rates. We believe that this scenario is unlikely, but we do not rule out that the Bank of Japan may engage in substantial currency intervention or another cut in the discount rate if the yen again appreciates strongly. The Bundesbank, a reluctant participant in the coordinated discount rate cut of last March, is unlikely to engage in additional rate cutting. [redacted] 25X1

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At the Summit

When summit discussions focus on economic policy coordination, West Germany and Japan may conflict with other attendees. The Italians, for example, believe that the refusal of West Germany and Japan to reflate is the main cause of disequilibrium in the world economic system. The French believe a key monetary issue is how to recycle the Japanese and West German current account surpluses to assure world economic growth, new credit to LDCs, and reduced protectionist pressures. [redacted] 25X1

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West Germany and Japan, for their part, are likely to endorse greater economic policy coordination in principle, but will resist foreign interference with their economic policies. Japanese Finance Ministry officials are concerned the United States may recommend targets for a series of macroeconomic variables, a plan which Tokyo will strongly oppose. If pressed to relax its fiscal policy, Bonn is likely to retort that the United States should first put its own house in order by solving its government and trade deficit problems. 25X1

A more even distribution of the global current account—that is, smaller surpluses in West Germany and Japan matched by lower deficits in the United States and the debtor LDCs—would increase prospects for trade liberalization under the new GATT round. Both governments endorse multilateral trade liberalization but contend that the deficit countries should be the ones to adjust their economic policies. Without a shift, West Germany and Japan will continue to accumulate large current account surpluses over the next two years, fueling foreign protectionist pressures. 25X1

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Summit Issues: Monetary Reform Faces Long-Term Debate

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Big Six leaders do not intend to put international monetary reform at the forefront of topics discussed at the Tokyo Summit in May. They are prepared, however, to endorse the modest aims of the Group of Ten [1] (G-10) communique—greater coordination of domestic economic policy and further study by the IMF of the use of exchange rates and other indicators to measure policy consistency—issued before the IMF Interim Committee meeting earlier this month. The major advocates of reform—France and Italy—almost certainly will not mount any major initiatives on monetary reform at the summit, because they believe ambitious proposals would meet stiff resistance from West Germany, the United Kingdom, Japan, and Canada. Meanwhile, Italy and Canada, and perhaps the EC Commission, are likely to make a pitch that they be included in the Group of Five (G-5) to improve international monetary coordination.

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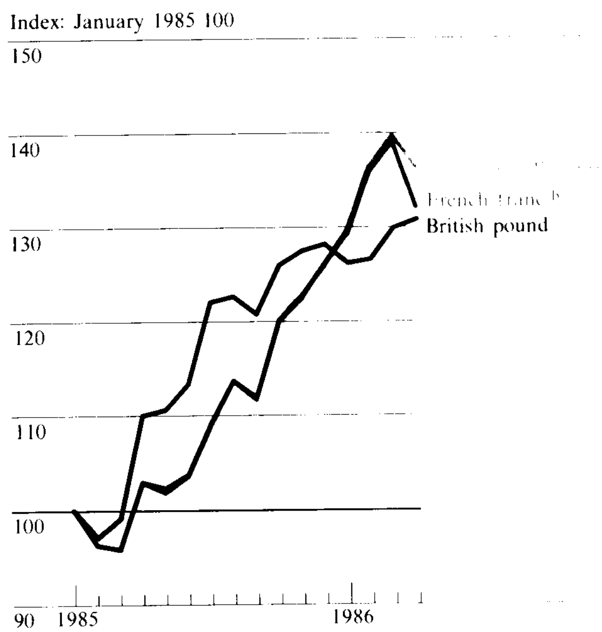
G-5 Currencies: Changes Against the US Dollar, 1985-86 [a]



[a] Nominal rates through 17 April 1986.
[b] The West German mark and French franc are linked through the European Monetary System.

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Increased Monetary Cooperation

The major industrial countries since last summer have been moving toward adopting a slightly more managed floating exchange rate system:

- The G-5, in September 1985, agreed that the US dollar was too strong and pledged joint action to bring it into line with "fundamental economic conditions."
- President Reagan's call in February to study the question of convening an international monetary conference provided the impetus for further discussions on reform.
- Italy and Canada have lobbied for G-5 membership, arguing that monetary cooperation among the major countries needs to be broadened.
- The IMF's main advisory group, the Interim Committee—in response to G-10 recommendations—called on the IMF to study the use of "objective" indicators and other measures to promote exchange rate stability and economic policy consistency without sacrificing the flexibility of the current system.

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[1] The G-10—the main forum in which industrial countries discuss international monetary affairs—comprises 11 countries: the United States, Japan, West Germany, France, the United Kingdom, Belgium, Canada, Japan, the Netherlands, Sweden, and Switzerland. The first five countries comprise the G-5.

Industrial countries generally welcome G-5 intervention in currency markets and the exploration of refinements in the current monetary system, but they differ sharply on whether to go beyond ad hoc exchange rate management and on whether the G-5, as presently constituted, is the appropriate forum for setting international monetary policy. [redacted] 25X1

Views of Summit Countries

Despite disagreement among summit participants on what form the international monetary system should take in the long run, there is likely to be little dispute on monetary affairs at the summit. [redacted]

France—a longtime advocate of reference, or target, zones for exchange rates—was especially pleased with the G-5 meeting last September as well as President Reagan's subsequent remarks on an international monetary conference. Paris believes these events signal increased US willingness to consult on monetary issues, and, therefore, wants to avoid extreme proposals that might cause Washington or other summit participants to back away. [redacted] political maneuvering between President Mitterrand and Prime Minister Chirac probably will result in the French delegation taking a low-key approach to most issues. [redacted]

West Germany and the ***United Kingdom***—both firmly opposed to any departure from floating exchange rates—will seek to play down monetary reform at the summit. Bonn and London believe that, despite some weaknesses, the current system is working adequately. They were greatly disturbed earlier this year by what they perceived as a shift in US policy on floating rates and feared it would open the door to French proposals for sweeping reforms. Both the West Germans and the British reject the concept of reference zones. [redacted] 25X1

[redacted] British officials [redacted] have their hands full with other issues—deregulation of capital markets, the debate over entry in the European Monetary System, and the fall in oil prices. Bonn and London, nevertheless, are likely to go along with increased multilateral surveillance of macroeconomic policies—as long as it involves no mandatory adjustments—and closer consultations in such forums as the G-5. [redacted] 25X1

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Japan is likely to support in principle the consensus on monetary affairs reached at the IMF Interim Committee earlier this month. The Japanese probably will seek summit endorsement of the G-10's work to improve the current system through closer industrial country cooperation on economic policy decision making. The adverse impact of the rapidly appreciating yen on politically important small exporters, however, has led some politicians to speculate publicly about the need for monetary reform to stabilize exchange rates. Although Prime Minister Nakasone has endorsed President Reagan's proposed study of an international monetary conference, Tokyo is unlikely to push for the idea unless Washington takes the lead. The Japanese, furthermore, remain flatly against target zones, which they consider unworkable because of the strong effect of international capital flows on exchange rates; they believe coordinated economic policies must come first and that stable exchange rates will follow. [redacted] 25X1

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Italy and ***Canada*** probably will endorse G-10 and IMF work on international monetary coordination and stress that other summit participants should grant them a larger role in world monetary cooperation by admitting them to the G-5. Rome—like Paris, a strong backer of monetary reform—has been trying to line up G-5 countries behind its membership drive. Ottawa is likely to contend, along with Rome, that no summit country should be excluded from the G-5. Reaction among the

LDCs and Monetary Reform

LDCs are taking a more active role in advocating monetary reform for pragmatic reasons. Most of them peg their currency to the dollar, the French franc, or some composite of advanced country currencies. The major part of Third World debt, furthermore, is denominated in dollars as are virtually all oil prices

LDCs state their views on international monetary developments through the Group of 24 (G-24), a group of LDC representatives linked to the IMF. Most of their recent attention has been focused on Third World debt, but in August 1985 they issued a G-24 report to the IMF on the functioning of the international monetary system. The LDCs stressed in their report that:

- *The present exchange rate system is seriously flawed and should be replaced by a system of target zones.*
- *An international conference should be convened to discuss not only monetary reform but also debt and development matters.*

The G-24 reaffirmed these points in a communique before the IMF Interim Committee meeting earlier this month. G-24 representatives also expressed concern that their August 1985 report was not being considered by the Interim Committee, and they called for at least $40-45 billion in Special Drawing Rights (SDRs) over the next several years in order to increase the flow of resources to the Third World.

major countries has been lukewarm despite some public support for Italian membership. Most are wary about G-5 effectiveness if the group is expanded to include all seven summit countries, and they probably fear that if the group is enlarged the EC Commission also will seek membership, a move they all are likely to oppose. 25X1

Beyond the Summit 25X1

Differences among major countries over developments in the currency markets are sure to make monetary reform the subject of continuing controversy. An international monetary conference, however, still appears to be a long way off. All Big Six countries generally believe that a greater developed country consensus on monetary cooperation and on enhanced IMF surveillance should come first. Discussion of monetary reform, therefore, is likely to be on hold at least until the fall when the IMF study on indicators is scheduled to be completed. Big Six leaders also fear that an international conference easily could break out into a political shouting match between the Developed Countries and the LDCs on a wide range of items, including debt and development issues. 25X1 25X1

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International Financial Situation: Argentina's Financial Prospects

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Creditors probably will support Buenos Aires's requests for new money this year, but actual disbursements will be less than anticipated because of slow-going loan negotiations and delays arising from missed IMF-supported program targets. Although Argentine backsliding in 1986 may frustrate creditors, we think President Alfonsin believes he needs time to outmaneuver his domestic opponents and maintain public support for his restructuring plan. In our view, Buenos Aires will continue to service its debt and liberalize the economy if it can generate some growth this year. Nonetheless, a prolonged holdup in foreign credit disbursements might derail Alfonsin's restructuring program, threaten confrontation with creditors, and renew domestic demands for a moratorium on interest payments.

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Economic Performance in 1985

Alfonsin negotiated an IMF-supported program in December 1984 that ended Argentina's confrontational approach with its creditors and helped Buenos Aires begin to reschedule its 1982-85 debt maturities and arrange for new commercial loans. With external support and drawing on middle-class desires for reform, Alfonsin began a program to liberalize the economy. Nevertheless, a loose monetary policy set off a price spiral that quickly eroded Alfonsin's public support and slowed negotiations for new money from commercial bankers. The government regained the political initiative and assuaged creditor concerns in June 1985 with economic shock treatment—called the Austral Plan—that used wage-price controls, a new currency, and a fixed exchange rate to restore confidence in domestic financial markets and give the administration time to establish more comprehensive policies.

The Austral Plan had a dramatic impact: inflation slowed from 30.5 percent in June to an average monthly rate of 2.5 percent during the last quarter of the year. Argentina began clearing its private-sector arrearages—as a bonus its debt service burden dropped with falling international interest rates. Buenos Aires's current account deficit fell by half when exports rose over 1984 levels, and effective restrictions sharply reduced imports. Polls revealed that the government's decisive anti-inflationary measures and the overall improved economic environment significantly bolstered Alfonsin's popularity and contributed to his party's good showing in last November's congressional elections.

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Sources of Funds

According to press and Embassy reporting, Buenos Aires intends to use a variety of foreign financing methods to support domestic growth. The government will ask commercial bankers to reschedule over $5 billion in 1986 maturities while seeking a Paris Club rescheduling. In addition, we think Buenos Aires will roll over more than $1 billion in short-term bond maturities as well as issue additional dollar-denominated bonds. The government believes foreign direct investment will provide $610 million—nearly one-third less than 1985 levels. Additionally, Argentina anticipates receiving $500 million in World Bank loans in 1986 and negotiating for $1 billion in 1987. Although Buenos Aires probably will receive $1.2 billion in commercial bank loans from last year's agreement, the economic team probably will press for an additional $2.4 billion in loans to be drawn in 1986 and 1987. Likewise, Argentina will draw nearly $500 million under its 1985 IMF agreement and negotiate for over $1 billion in its next agreement. Buenos Aires, however, will net roughly half this amount as a result of repayment of past IMF loans. 25X1

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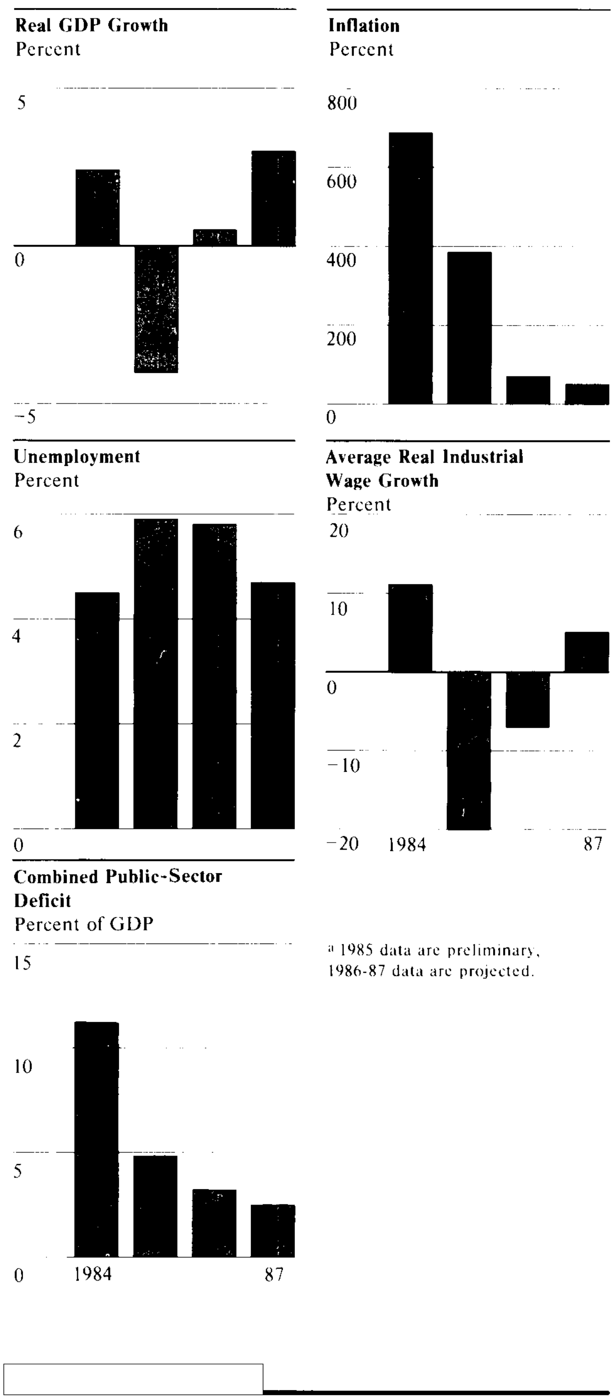
Argentina: Balance of Payments, 1984-87 *Million US $*

	1984	1985 [a]	1985 [b]	1987 [b]
Current account	−2,391	−1,200	−2,330	−2,100
Trade balance	3,523	4,400	3,140	3,500
Exports, f.o.b.	8,107	8,300	7,790	8,500
Imports, c.i.f.	4,584	3,900	4,650	5,000
Services and transfers	−5,914	−5,600	−5,470	−5,600
Interest	−5,537	−5,260	−5,150	−5,210
Capital account	613	3,100	1,960	1,800
Foreign direct investment	268	920	610	800
Net foreign borrowing	−562	3,700	2,350	900
Net IMF credit	−34	1,000	400	340
Change in arrears	941	−2,520	−1,400	−240
Change in official reserves	−34	1,900	−370	−300

[a] Preliminary.
[b] Projected.

[redacted]

Argentina: Economic Indicators, 1984-87 [a]



[redacted] 25X1

Nevertheless, several developments foreshadow trouble for Buenos Aires in 1986 and 1987. Economic activity in 1985 fell 4 percent, and both organized labor and the general public are pressuring for growth this year, according to US Embassy reporting. Unemployment also rose last year, and there is no sign that increases in private domestic and foreign investment will reverse the trend during 1986. Bureaucratic inertia—which has slowed banking reform—and competition between the federal and provincial governments for available savings threaten to keep private credit tight. Additionally, the government missed its IMF fiscal deficit target last year and has made insufficient progress in either cutting expenditures or reforming the tax system to fully meet this year's target. [redacted] 25X1

Current Economic Policy

Buenos Aires plans to use both domestic and foreign funds to aid in restructuring its economy in 1986, according to press and US Embassy reporting. Meanwhile, Embassy reporting indicates that

[redacted] 25X1

Alfonsin believes economic growth is necessary to maintain his political strength in urban areas and that direct government spending in the countryside is necessary to enhance his political base in the provinces. Press reports outline the government's plans:

- Pare the budget deficit to 3 percent and use external savings to cover the remainder of Argentine investment needs.
- Devalue the Austral and continue to lower export taxes to improve the competitiveness of agricultural exports.
- Liberalize the import regime and payment system to assist manufacturers.
- Gradually lift private-sector price controls—faster and more completely for small as opposed to large businesses—while allowing public corporations to raise prices to reflect costs, thereby making them viable for eventual privatization.
- Convince organized labor to accept general guidelines for a slow return to market-determined wages.
- Stabilize monetary policies and regulations to bolster the banking sector while maintaining positive interest rates to encourage savings and the repatriation of overseas assets.
- Increase revenue through tax reform, a forced savings program, and other stop-gap measures.

Argentina will ask the IMF, World Bank, and commercial bankers to help cover the financing gap with additional lending this year. Buenos Aires also plans to reschedule its 1986 commercial and bilateral maturities and clear up its arrearages, while repaying a collection of IMF and bond obligations.

Financial Prospects

We believe creditors will be amenable to this plan but doubt that the full amount of funds that Buenos Aires desires will be disbursed during 1986. Although the IMF hopes to have a new standby program in place by the end of May when the present agreement expires, negotiations did not begin until late April. Delays in reaching a new IMF standby could further retard commercial bank negotiations, making a final agreement unlikely before the end of the year. We believe further delays are probable should Argentina miss some of its IMF targets without seeking waivers. According to press reporting, World Bank loans in the pipeline and negotiations for additional loans could be held up by wranglings with public Argentine firms over how and through whom loans should be disbursed to the private sector. 25X1

Outlook for 1986

We foresee a year in which Argentina will have increasing difficulty meeting its IMF performance criteria, resulting in delayed loan disbursements and revisions in its program. Alfonsin's restructuring plan, in our view, is sound, but its implementation is sparking opposition from labor, the Peronists, and even sectors of the President's Radical party. Furthermore, the government is making only modest headway in breaking down bureaucratic resistance to privatization, tax reform, and other streamlining measures. We expect that in practice the program will achieve mixed results and that Alfonsin may be tempted to spur the economy through an accommodating monetary policy to cover revenue shortfalls, resulting in missed IMF monetary and deficit spending targets. Additionally, we think Buenos Aires will face a lower trade surplus that will slow the clearing of its public debt arrears and encourage the use of other short-term financing. 25X1

We believe that Alfonsin is dedicated to fundamental economic reforms, but that he believes that political realities dictate that he implement them slowly. Although creditors probably will find Argentina's backsliding on its IMF program frustrating, the government will use the extra flexibility it thereby garners to offer some concessions to domestic opponents and help maintain public support for its restructuring program. We believe that Buenos 25X1

Aires's balancing act between foreign creditor demands and domestic political pressures will produce marginal economic growth and a small drop in unemployment at the cost of 70- to 100-percent inflation. Demands by international creditors, however, that Buenos Aires show faster progress and stricter compliance with its IMF program could produce prolonged holdups in credit disbursements that might derail Alfonsin's restructuring effort. This would threaten confrontations between the government and creditors over debt servicing and renew demands by the opposition and sectors of the President's party for a moratorium on interest payments. [redacted] 25X1

[redacted] 25X1

Global Privatization: Gaining Momentum

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Privatization—the transfer of ownership or control of a state asset to the private sector—is gaining momentum worldwide. Following the lead of Britain, which has progressed the fastest and furthest in terms of number of assets sold and revenues earned, many other countries have already begun or are planning privatization programs. Most of the progress has been registered by non-US OECD countries. Although numerous LDCs have announced intentions to reform their public enterprises, implementation has come slowly and fitfully. In such instances, powerful special interest groups—the military, labor organizations, industrialists, consumers, or the bureaucracy—are impeding reform in economies where legal prohibitions, economic policy, and established practice have long favored government-led development.

Britain Leads the Way

Since taking office in 1979, Prime Minister Thatcher has made the sale of state-owned assets a hallmark of her domestic economic program to revitalize the economy through private initiative. Her government has spelled out four specific goals for its privatization program: to reduce the size of the government sector; to promote competition and efficiency in the denationalized sector; to expand share ownership; and to raise revenues to help finance the government's budget deficit. The government intends to sell off gradually a wide range of public assets including not only the nationalized industries, but also major public utilities, state-owned housing, defense industries, and social service institutions.

Britain's privatization program has made substantial progress. Between 1979 and the end of 1985, the Treasury had received a total of roughly $11 billion from the sale of state assets. London began speeding up the pace in late 1984, increasing revenues to more than $3 billion a year. It also introduced bigger ticket items, most notably 50.2 percent of British Telecom (more than $2 billion) and 100 percent of Enterprise Oil ($530 million). Government budget estimates for 1986-88 anticipate a further escalation in revenue earnings from privatization to almost $7 billion a year from assets such as British Gas Corporation, the British Airports Authority, the Royal Navy Dockyards, and parts of the Water Authorities Association.

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Despite wide public support as shown in public opinion surveys, the most frequently heard objection is that the government is "selling off the Georgian silver" to finance current spending, robbing future generations of wealth. Other arguments center around the proper regulatory authority to oversee monopolies—such as British Gas. Particularly in recent months, a surge of British nationalist sentiment has emerged in reaction to the proposed sale of parts of British Leyland to General Motors,

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Others Follow Suit

Notwithstanding the potential pitfalls, numerous other industrial countries have already begun or have plans to begin privatization programs in the near term.

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Canadian Prime Minister Mulroney came to power in 1984 pledging to reduce Ottawa's direct involvement in the economy by selling as many of the Federal government's Crown corporations as possible to the private sector. These wholly owned companies, which account for roughly 12 percent of Canada's GNP, are involved in a wide range of industries including transportation, broadcasting,

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Trends in Privatization: Selected Countries

	Divestiture	Liquidation	Partial Divestiture	Joint Venture	Management Contract	Comments
Industrial countries						
United Kingdom	British Aerospace, Cable and Wireless, Britoil, Enterprise Oil, British Gas,[a] British Airways,[a] British Airports Authority [a]		British Telecom, Water Authorities Association [a]		The Royal Dockyards [a]	The government has maintained special privileges in several of these industries to veto actions that it believes are not in the country's best interest.
France			Industrial companies including Thomson,[a] Pechiney,[a] Rhone-Poulenc;[a] Elf Aquitaine;[a] several retail banks;[a] and Paribas and Suez financial groups [a]			New government plans to privatize nine major industrial groups and 36 banks nationalized by Mitterrand. Although the specifics have not been worked out, the government is likely to maintain sizable minority holdings in all enterprises involved.
Japan	Japan Air Lines [a]		Nippon Telegraph and Telephone,[a] Japan Tobacco,[a] and Japan National Railways [a]			Tokyo plans to gradually sell shares in these firms through the end of the decade.
Spain	Textile factories, tourism and catering firms, and a truck company	Integrated steel manufacturer	Car manufacturer	Electronics firm		Part of the government's industrial restructuring program to make Spain more competive in the EC.
Developing countries						
Bangladesh	Jute and textile mills		Government-owned banks,[a] national airline,[a] shipping lines,[a] and telephone system [a]			Has sold or plans to sell 100 companies since the government announced a new industrial policy in 1982.
Pakistan		National airline [a] and government-run cement, petroleum, and textile facilities [a]				On 20 January, Pakistan formally announced the initial phase of its planned disinvestment of six major public-sector firms worth over $100 million.
Mexico	Nacional Hotelera		Mexicana Airlines [a]			Of 482 public enterprises offered for sale, closure, or merger since February 1985, Mexico has sold 21 relatively small firms for a total value of about $40 million.
Brazil			CVRD mining company, Petrobas			President Sarney intends to privatize 42 parastatals listed for reform under the previous administration and add another 12 firms to the list.

[a] Planned.

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Privatization: How It's Done

Privatization—the transfer of assets and activities from government to the private sector—can occur in any of the following ways:

- ***Divestiture** is the disposal by the government of all of its ownership and control of an enterprise. The most common form is sale of the enterprise to an individual or group of investors.*
- ***Liquidation** is an extreme form of divestiture in which a government allows, or forces, an enterprise to go out of business. It does not directly expand the private sector. It usually occurs after it is found that there is no way to make the enterprise profitable.*
- ***Partial divestiture** occurs when the government disposes, usually by sale, of some of its ownership in a company. By selling less than 50 percent of an enterprise, the government retains formal and, in some cases, actual control.*
- ***Leasing** of assets, rather than the outright sale, does not diminish the value of state wealth and transfers the responsibility for its operation to the private sector.*
- ***Minority joint ventures** with the private sector, domestic or foreign, provide outside funds to parastatals without sacrificing government control of the companies.*
- ***Management contracts** are most frequently used when the state wishes to retain ownership of an enterprise but finds that it needs specially skilled labor or managerial talent not available in the public sector.*

wheat sales, and manufacturing. Ottawa has made some progress toward this goal in the past two years, despite the poor financial shape of many of the corporations and public sentiment that this national legacy should not be sold off indiscriminately or, even worse, to foreigners. Thus far, Ottawa has sold De Havilland Aircraft (to Boeing for $112 million) and Canadian Arsenal, an arms manufacturing company. Bids are currently pending on Canadair, which manufactures corporate jets, and Teleglobe Canada, a monopoly on overseas telephone traffic. 25X1

France's newly elected conservative government has vowed to establish a more free market economy. The centerpiece of its program is the privatization of nine major industrial groups and 36 banks, nationalized when President Mitterrand came to power in 1981, and other major companies that have been in state hands since World War II. The list of firms in the new government's five-year privatization program, which could raise as much as $27 billion, includes Elf Aquitaine, the petroleum enterprise; Thomson, a major electronics group; Pechiney, the aluminum giant; and the Rhone-Poulenc chemical firm. Also on the list are France's three largest retail banks, which together hold over 40 percent of all French deposits. 25X1

According to the financial press, ***Italy*** is running a close second to, or perhaps even surpassing, Britain in its drive to privatize state assets. Craxi's socialist government is doing so with as little fanfare as possible, however, to minimize domestic opposition. The process in Italy is different because of the country's unique industrial structure, whereby the state owns and manages companies in partnership with the private sector. The state holding firm IRI raised $1.6 billion between 1983 and August 1985 through the sale of assets including equity holdings and property. It is expected to bring in another $1.5 billion over the next year by issuing shares in enterprises such as the Aeritalia aerospace company and Selenia electronics firm. The state energy holding group, ENI, raised $628 million by selling 20 percent of its pipe-laying subsidiary, Saipem, in 1984. Over the next three years, Rome is likely to earn another $500 million from the phased sale of up to 51 percent of the SIP telephone utility and roughly $210 million from the Banco Nazionale del Lavoro, which is offering 25 percent of its equity to Italian investors and a further portion to its staff. 25X1

Japan plans to shrink its small public sector by privatizing all or part of four major enterprises by 1990. To spur competition and appease foreign complaints of protectionism, the government began to allow competition in the telecommunications and tobacco industries as of 1 April 1985. This was done in preparation for the gradual sale of its shares in Nippon Telegraph and Telephone and Japan Tobacco during the next several years. Tokyo also plans to eventually privatize, with hopes of rejuvenating, the loss-making Japan National Railways by splitting it into several private firms. Finally, the government most recently announced its intention to sell its 35-percent share of Japan Air Lines.

West Germany has done less in the area of privatization than the other major West European countries but shows signs of becoming more active in the future. Bonn's only action so far involved reducing its stake in the Veba energy conglomerate from 44 percent to 25 percent in 1984. The government will be offering shares with an estimated value of $333 million, including a 40-percent stake in VIAG, the large energy, chemicals, and aluminum firm; a 47-percent portion of Prakla-Seismos, an energy exploration and services group; and 45 percent of IVG, a property and transport group. Bonn is also exploring the possibility of privatizing a state-owned mortgage bank and selling shares in two other banks as well as reducing its holdings in Salzgitter, a state-owned steel firm, and Saarbergwerke, a small coal mining firm.

Several of the smaller West European countries also have shown interest in shifting more economic activity into the private sector. ***Spain***'s socialist government, for example, has already sold eight major state enterprises since taking office in 1982. This comes as part of its effort to reduce its public-sector deficit and enhance Spain's competitiveness in the EC. ***Turkey***'s Prime Minister Ozal has an ambitious "master plan" to privatize 32 state enterprises—under the tutelage of a US commercial bank—and the ***Swedish*** government is negotiating to sell its 75-percent stake in Pripps, the country's leading brewery.

Increasing LDC Interest

Privatization has also become an increasingly important issue in the Third World during the past two years. Numerous countries have announced their intention to reform public enterprises as a result of rising domestic and foreign debt burdens, pressure for reform from lenders and donors, and efforts to promote export competitiveness. Often the commitment to privatization, however, appears to be more rhetorical than real. Reform has come slowly and fitfully as a result of opposition from powerful interest groups—the military, labor organizations, established industrialists, subsidized consumers, and the bureaucracy—and weak local financial markets. 25X1 When reform has occurred, the major "strategic" parastatals in energy, minerals, utilities, and heavy manufacturing generally have been excluded, leaving relatively small or unprofitable companies for sale. 25X1

Several LDCs have announced their intention to implement comprehensive divestiture of selected public enterprises. However, only a few governments have actually begun the process:

- In February 1985, ***Mexico*** announced its intention to sell, close, or merge 236 public-sector entities out of some 1,100 as part of an austerity program. This list was recently expanded to 482 enterprises. So far, the government has sold 21 relatively small parastatals at a total value of around $40 million. 25X1 According to press reports, in October 1985 the Mexican Government also sold the Nacional Hotelera chain to a private investment group for an estimated $84 million.

- In ***Bangladesh***, more than 30 jute mills and more than 20 textile mills, which had been nationalized in 1972, were sold back to the private sector during the first year of the New Industrial Policy, which was announced in 1982.

- In October 1985, ***Malaysia*** sold 30 percent of its shares of the Malaysian Airlines System (MAS). Over the next three years MAS is scheduled to become a private corporation. Divestiture of a 25X1 container handling facility is also planned.

- ***Jamaica*** has sold or leased most of its sugar refining and hotel interests.

In place of complete divestiture, most LDCs are opting for partial divestiture, leasing, management contracts, and minority joint ventures that do not generate such strong political opposition and that are more possible given the limited financial networks:

- ***Saudi Arabia*** has begun to privatize its $10 billion Saudi Arabian Basic Industries Corporation by selling shares to Saudi citizens and investors from Arab Gulf states.

- ***Argentina***'s national oil company is leasing strategic oil drilling rights to the private sector.

- ***Brazil*** has sold minority shares in important parastatals such as the giant CVRD mining company. The government also offered nonvoting shares for 25 percent of Petrobas, the national oil company, in November 1985, and the US Embassy reports that further offerings may be made in telecommunications and electric utilities parastatals.

- ***Mexico*** is seeking to bring its 58-percent participation in Mexicana Airlines down to 51 percent by selling off stock.

- In ***Thailand***, the government has decided to privatize, through stock offerings, parts of the Electricity Generating Authority of Thailand and Thai Airlines International.

- ***Bangladesh*** plans to sell, through stock offerings, up to 49 percent of the state-owned banks, shipping lines, the national airline, and the telephone system. The government has also contracted out the management of some publicly owned hotels.

- In January 1986, ***Pakistan*** announced a plan to offer shares worth over $100 million in six major public-sector firms to private investors. The firms include Pakistan International Airlines, the State Oil Corporation, and cement and textile mills. A second offering probably would not be as attractive because it includes 12 money-losing enterprises, some of which are not even functioning. 25X1

- In ***Chile***, shares are now being sold in the power company Chilectra and in two banks the government took over after their collapse in 1983.

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In our judgment, parastatal reform will continue to proceed slowly in most LDCs. While the potential economic benefits of reform are clear, the perceived high political costs and weak capacity of local financial markets will sidetrack major reform efforts. Lacking leaders with a clear commitment to change, most LDCs are likely to continue implementing only limited reforms such as leasing, joint ventures, and management contracts. Without significant pressure from international donors and lenders, few LDCs are likely to implement more important reforms needed to reduce parastatal excesses and inefficiencies. 25X1

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High-Definition Television: Search for a World Standard

The meeting of the International Telecommunication Union (ITU) in Dubrovnik, Yugoslavia, next month is slated to consider a worldwide technical standard for high-definition television (HDTV). We believe the decision on the next generation of TV technology will shape the television industry that will emerge by the end of the century. HDTV, which is not expected to reach the home market for 15 years, delivers a fourfold increase in picture clarity and stereo sound, bringing TV viewing close to 35mm film quality. If the standard is adopted, Japan and the United States are likely to receive the most commercial benefit. Japan leads in the new technology and has already spent $100 million on HDTV. The United States could extend its dominance in the field of international program distribution. Soviet Bloc support is pivotal for adoption of this Japanese/US-backed proposal. Key West European countries, most notably France and the Netherlands, will oppose the HDTV standard to protect investments by domestic firms in alternative television technology. Defeat or delay of the standard--the likely outcome—would result in several competing standards and higher costs for all involved.

Today's Television Standards

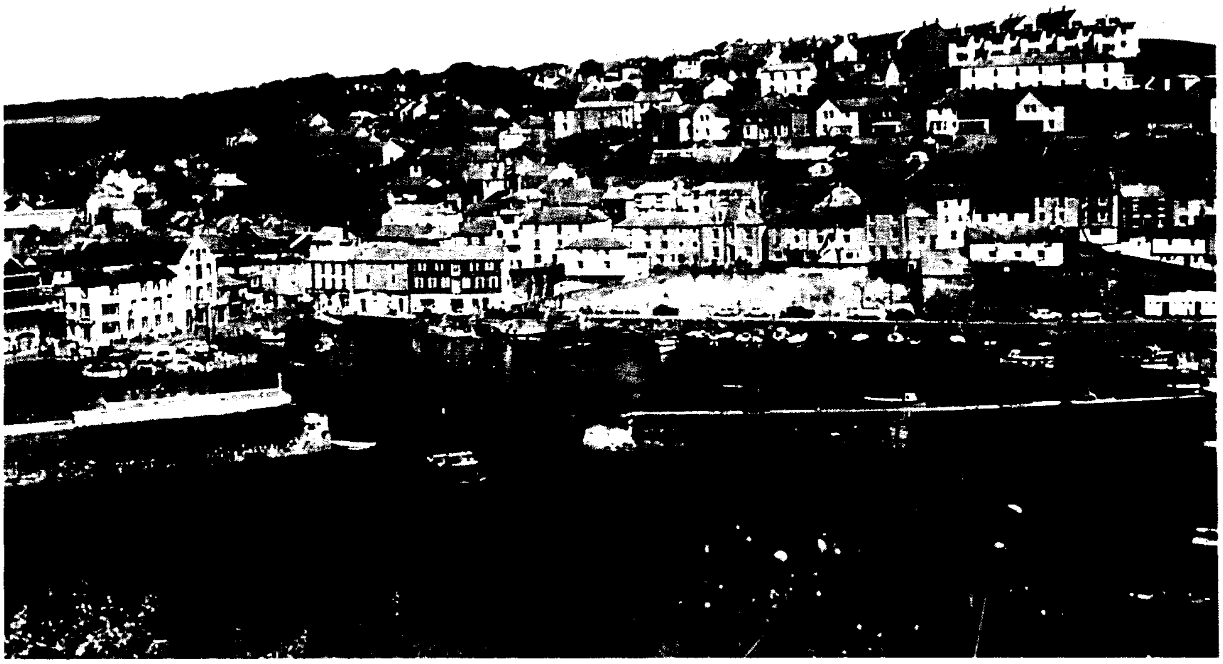
Color television technology emerged in the 1950s, predating worldwide program distribution by satellite. Broadcasting began at the national or regional level, permitting nations to set separate technical specifications for recording, transmitting, and receiving television signals. Program exchange, currently facilitated by satellites, must undergo signal conversion when sent among different broadcast regions. Today, there are three families of color television transmission standards, all incompatible:

- *The National Television Standards Committee (NTSC) television systems used in North America and Japan.*
- *The Sequential Color with Memory System (SECAM) used in France and Greece, Eastern Europe including the Soviet Union, Northwest Africa, and parts of the Middle East.*
- *The Phase Alternation Line System (PAL) used in the rest of Europe, Asia, and some other countries.*

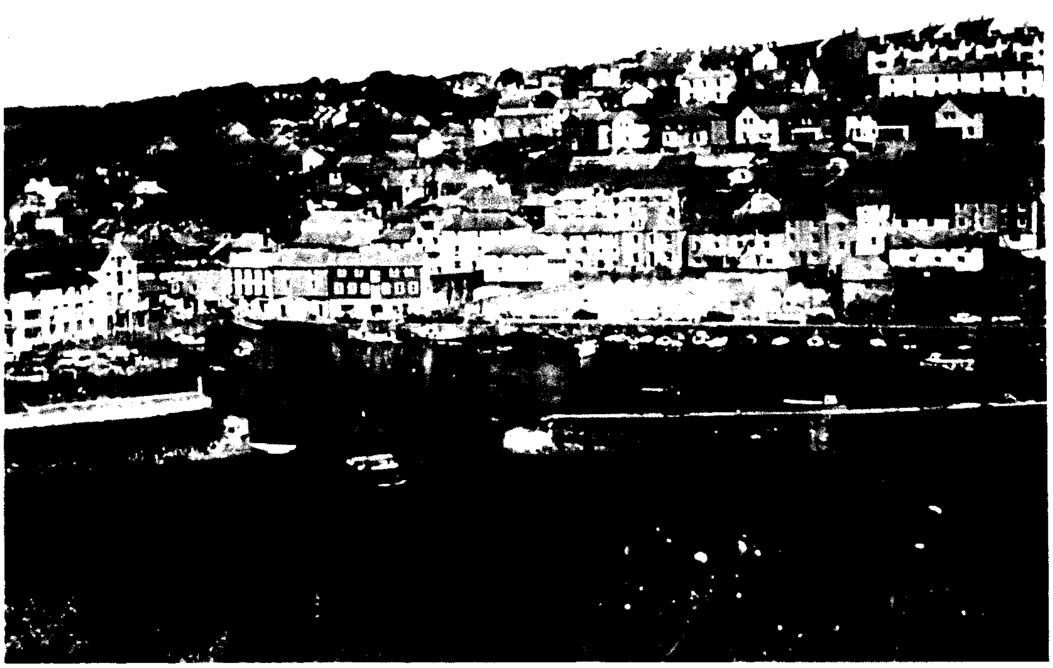
The Debate

A decision on the HDTV standard for television studio production equipment will engender strong debate in Dubrovnik as many of the participating countries come with substantial commercial interests to protect. The new standard is supported by Canada, Japan, and the United States. In addition, US State Department officials currently believe Italy, Portugal, Spain, Sweden, and Switzerland will endorse the proposed standard, and reporting from Geneva last November indicated that Denmark, Finland, and Norway may support the recommendation.

European opposition to the standard is centered in the Netherlands, France, and the United Kingdom, where several consumer electronics firms have developed an alternative HDTV technology. Instead of offering something all new, Philips of the Netherlands, Thomson of France, and the Independent Broadcast Association in Britain have developed enhanced versions of today's equipment—a family of transmission techniques called MAC (multiplexed analog components). These nations argue that the proposed HDTV standard is not suitable



The proposed high-definition television production standard 25X1



Compared to standard television pictures 25X1

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for reception by European television sets. This opposition is aimed in part at keeping foreign equipment out of their markets. Indeed, advanced television technology may be incorporated into a EUREKA project on broadband telecommunications. [redacted]

France is committed to use the MAC system on its upcoming TDF-1 broadcast satellite scheduled for launch in November 1986. Adoption of the Japanese/US standard could mean HDTV would compete with European alternatives, most likely bringing early obsolescence of MAC. [redacted]

In March, the French Government began a campaign, aimed primarily at West European countries, to forestall adoption of the standard. Since the recent French parliamentary election, however, we have received conflicting reports on the current French position. US industry experts claim that the new Directorate General of Telecommunications is more amenable to the Japanese/US proposal. Such a reversal could undercut the rest of Western Europe's opposition. However, US Embassy officials in Paris and the Secretary General of the ITU still believe Paris will defend what the French industry sees as its own interests. [redacted]

The Soviet Bloc could prove pivotal on endorsement of the standard. [redacted] At this time, the USSR uses SECAM technology. [redacted] the Soviets want to skip enhanced versions of television for HDTV but want assurances that HDTV technologies will not fall under Western export controls before committing themselves. [redacted]

Possible outcomes from the ITU debate include:

- ***Approval of the standard.*** Chances for approval are very good if France shifts its position and the Soviets agree to support the standard.

- ***Defeat of the standard.*** Defeat of the standard could occur only if the issue came to an open vote. Voting in this forum is not unprecedented, but unlikely.

The New Standard

In November 1985, the ITU study group responsible for television broadcasting recommended a standard for HDTV studio equipment. The new standard is only for the studio production system used to record and edit films and programs. The study group recommends: 25X1

- *Doubling the horizontal screen lines to 1,125. More densely packed display units create the sharpness of 35mm film images.*
- *Changing the display screen to a 16-to-9 width-to-height ratio. This ratio duplicates the dimensions of cinematic screens and takes advantage of the eye's natural wide viewing angle. Current TV receivers use a 4-to-3 ratio.* 25X1
- *A 2:1 interlace and 60 Hertz (Hz) field rate. This rate is superior to the 50 Hz standard in Europe where the human eye perceives a "flickering" as images change.* [redacted] 25X1

These recommendations will go before the ITU for acceptance in May 1986. While adherence to an ITU standard is voluntary, historically countries, for the most part, follow the standards. We believe endorsement of an HDTV standard is likely to shape the direction of the television industry for years to come. Indeed, some industry officials feel the choice of a standard in May will be a factor in determining funding levels for research and development in the United States. [redacted] 25X1 25X1 25X1

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- ***Delay of the standard.*** In the likely chance of protracted debate and no consensus, the standard will be sent back to the ITU study group for review. The next opportunity for endorsement will be 1990. In the meantime, several incompatible standards are likely to evolve. [redacted] 25X1 25X1

Japan and the United States To Benefit Most

We believe the Japanese electronics and US video industries will be the primary winners if the proposed HDTV studio standard is adopted in May.

The Japanese electronics industry is already well ahead in developing HDTV cameras and editing equipment. The current lead is built on moves in the early 1970s when the Japanese national broadcasting company (NHK) began a $100 million project in conjunction with several Japanese electronics firms to advance HDTV technology. Major Japanese companies involved with the NHK project are Hitachi, Matsushita, Sharp Electronics, and Sony. No US companies have followed suit. Toshiba Corporation has developed and patented a range of HDTV equipment for broadcast stations, including a color TV camera, a video tape recorder, transmission equipment, and a home-use receiver with a 40-inch color display. Japanese firms, in an effort to push HDTV as the standard technology, have promised to license their equipment to broadcasters worldwide. Some Japanese companies have even developed a converter that will make the incoming HDTV signal compatible with European television sets.

As the current world leader in film and television programing production, the United States earns $1.3 billion annually from video exports. An industry report notes that programs of US origin represent 25 percent of total daily broadcast time on all channels in France, Germany, Italy, and the United Kingdom. In addition, markets for US programing are expanding as foreign purchases of video material for cable TV and VCRs are growing at 20 percent annually.

In the film industry, HDTV will change video from the physical medium of film to an electronic stream, thereby eliminating one step in sending the signal from the studio to the viewer. Industry experts claim that the HDTV production system will save film makers 15 percent on total costs over the 35mm film system used for many TV programs and motion pictures. By moving to electronic distribution, television and motion picture exchange worldwide could be instantaneous. Currently, some major Hollywood film studios and at least one television network are conducting experiments to display an HDTV signal on a standard home television.

Aside from film and production applications, we believe HDTV technology will spark growth in several other fields:

- ***Semiconductor devices.*** Because the HDTV picture is so detailed, future television sets will need image memory devices to temporarily store and process the final television picture. Japanese firms are predicting 10 megabits of memory per TV set.

- ***Home video.*** HDTV home movie cameras, recorders for playback, and videodisks may become consumer items as costs come down.

- ***Medical imaging.*** High-resolution electronic images will sharply enhance stop-motion X-rays and CAT scan pictures for medical diagnosis.

- ***Security surveillance.*** A California company is already offering a high-resolution surveillance 25X1
camera for homes and businesses.

- ***Military.*** Electronic imaging systems will improve battle simulators and range finders, and may be used as sensors for target detection. 25X1

Outlook

Japan will probably proceed with bringing HDTV technology to the Japanese studio market even if no 25X1
decision is reached in May or if the standard is defeated. Recently, a Japanese firm successfully transmitted an HDTV signal via optical fiber. The Japanese Government and NHK have scheduled domestic HDTV broadcast trials via satellite for 1991. In the United States, most industry experts believe the broadcast and film industries will continue to move toward commercial applications of HDTV—but more cautiously because financial outlays would be harder to justify. We believe that continued US corporate investment in HDTV technologies is directly related to the outcome of the May standards decision. The lack of investment in

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the consumer electronics side of HDTV has virtually conceded HDTV technology leadership to the Japanese. 25X1

The European opponents, particularly France, will consider delay a victory for European industry. We believe failure to adopt a new world standard will postpone the arrival of Japanese and US programing and equipment, cause proliferation of divergent standards, and create a more costly environment for all. 25X1

Over the longer term, we believe acceptance of the studio standard is only one step in the evolution of this new technology. Complete delivery of HDTV to the home depends on two additional systems: a transmission system for delivery of the television signal and a high-definition receiver/display system. The digital signal may be sent via satellite, cable, terrestrial broadcast, or transferred to videodisk or cassette. Several countries have proposed that the 1988 Space World Administrative Radio Conference, a conference with treaty-making power, allocate a worldwide frequency band for HDTV broadcasting. We believe obstacles to decisions on frequency band allocation and satellite transmission standards may encourage the production of videodisks and cassettes and transmission via cable before worldwide satellite distribution is achieved. Political problems may also slow any assignment of frequency allocations. Closed societies such as those in the Soviet Bloc will attempt to discourage any system that challenges their control over the flow of information. 25X1

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Briefs

Energy

First Delivery From New Colombian Field

Ecopetrol—the state oil company—has begun exporting crude oil from the Cano Limon field in northeastern Colombia. Ecopetrol delivered 400,000 barrels to Spain last week and is scheduled to deliver an additional 750,000 barrels to Japan and Jamaica during the next two weeks. The high-quality Cano Limon crude will be sold at spot market prices. Once the necessary infrastructure is installed, exports could rise to 90,000 b/d at the end of this month and double that by midyear. Government officials, however, may choose to slow or stretch out plans to increase production because of low world oil prices and political concerns that rapid oil development may fuel domestic inflation. Nevertheless, oil company officials are currently negotiating with the government to allow production levels beyond the current 35,000 to 40,000 b/d. [redacted] 25X1

[redacted] 25X1

International Finance

Yugoslavia's Official Debt Rescheduled

Yugoslavia last week reached agreement with Western government creditors to reschedule 85 percent of its approximately $400 million debt falling due between May 1986 and May 1987. Repayments extend over nine years with a four-year grace period. The governments also approved rescheduling a smaller percentage of loans falling due between May 1987 and April 1988, provided Yugoslavia continues its program of economic adjustment and reform. Although the agreement is not tied to a specific IMF standby arrangement, the Fund will monitor Yugoslav compliance with policy and performance targets. The agreement falls short of the 1986-88 rescheduling Belgrade sought, because Western governments balked at multiyear relief without stricter IMF oversight. Nonetheless, Belgrade can claim, for domestic consumption, that the accord is similar to the multiyear rescheduling with Western banks last year and provides evidence of increased creditor confidence and less IMF involvement in domestic affairs. [redacted] 25X1

Pressure Mounts on London to Join EMS

Recent statements by two British Cabinet ministers will increase the pressure on Prime Minister Thatcher to drop her opposition to bringing sterling into the European Monetary System (EMS). Foreign Secretary Howe, who would like London to join EMS to burnish its European credentials, recently told a group of Conservative MPs that Britain could not postpone its decision indefinitely. On the same day, Chancellor of the Exchequer Lawson hinted that he now favors full British membership but reiterated the government's position that the time is not yet right. Lawson said that membership in a fixed exchange rate system would, over the medium term, make it easier for London to maintain its anti-inflationary monetary policy. Proponents of membership argue that British manufacturers will benefit from increased stability of the pound, while opponents argue that membership will make London's economic policy subservient to Bonn. The Prime Minister may attempt to compromise, arguing that a decision on EMS should wait until after the general election, due in 1988, but widely expected in 1987. [redacted] 25X1

Algerian Financial Troubles Deepen

Algeria's failure to raise a $500 million syndicated loan underscores growing concern among international bankers over Algiers's reluctance to deal effectively with reduced hydrocarbons earnings—a decline of as much as 50 percent. [redacted] some banks may downgrade 25X1
Algeria's credit rating or follow the lead of at least one international bank that is reducing its Algerian financial exposure. Bankers are probably alarmed that, after lowering second-quarter gas prices, Algeria may have to do the same for the rest of the year. Moreover, the government has instituted few new measures to bring domestic spending more in line with revenues. Some new lending will probably continue—Algiers still holds about $3 billion in foreign exchange reserves—but bankers' doubts will probably translate into sharply higher interest rates and other charges. [redacted] 25X1

Mozambique Bank Scandal Jeopardizes IMF Agreement

Revelations of high-ranking, large-scale corruption in the foreign exchange department of the Bank of Mozambique may jeopardize a much-needed new IMF agreement with Mozambique, according to US Embassy reporting. Several bank employees have already been detained [redacted] 25X1
The arrests coincide with final government deliberation over adopting an IMF–World Bank reform strategy advocated by the accused bank governor. The bank scandal is likely to delay announcement of new reforms, previously anticipated at the end of this month. As a result, international donors may be less forthcoming in responding to Mozambique's urgent need for capital inflows. [redacted] 25X1

Global and Regional Developments

Soviets Make Up Nicaraguan Rice Shortfall

The USSR is donating 25,000 metric tons of rice to the Sandinistas to make up for the recent harvest shortfall, with the first shipment due via Cuba this week. The deal provides high-quality Soviet rice valued, for aid purposes, at $5 million—half the US export price. The donations are likely to allow Managua to meet rice ration requirements for the first time in months. [redacted] 25X1

Global Sugar Prices Turn Up Sharply

World sugar prices have jumped by 75 percent since early 1986, reflecting a drawdown in stocks as growth in global consumption for 1985/86 (Sept-Aug) appears to be outpacing production. Raw sugar prices in April have averaged 8.5 cents per pound, compared with the record low of 2.6 cents per pound struck last July. Increased Soviet buying has fueled the price rally in recent weeks. [redacted] the USSR, the world's largest sugar importer, purchased as much as 1.2 million metric tons since late March, including 150,000 tons from Australia. India, Egypt, and Pakistan have also been unusually large buyers in recent weeks. Another factor is increasing information that the 1985/86 Soviet and Cuban crops are down significantly from earlier estimates. Some traders believe prices could reach 12 to 14 cents per pound by the end of 1986—a level that would approach production costs for major sugar exporting LDCs such as the Dominican Republic, Brazil, and the Philippines. The current upturn in prices, if sustained, would probably increase foreign exchange earnings from their beleaguered sugar sectors. [redacted] 25X1

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Central American Economic Meeting

Vice presidents from Honduras, El Salvador, Guatemala, and Costa Rica met in San Jose last week for discussions aimed at reviving regional trade and preparing an economic agenda for the Central American Presidential summit to be held in May. According to Embassy and press reporting, the delegates agreed that the Central American Core Four should jointly press lenders for better debt terms and additional loans. The Costa Rican representative told the press that international organizations may be asked for as much as $300 million in new, soft loans. The additional financing reportedly would be used to clear up intraregional debt arrearages, which have been a significant factor depressing regional trade in recent years. According to Embassy reporting, the exclusion of Nicaragua was clearly intended as a political signal when the economic initiative was initially proposed by President Monge of Costa Rica. It probably was also prompted by a realization that Managua's participation would eliminate the chance of US support for new financial assistance. [redacted] 25X1

National Developments

Developed Countries

25X1

Japan Pushes Into US Truck Market

We believe that the Japanese medium and heavy truck manufacturers will expand their foothold in the US market and possibly achieve their ambitious goal of quadrupling current sales by the early 1990s. We estimate that the Japanese could capture up to 10 percent of the $9-10 billion US medium and heavy truck market. Faced with slack markets at home and in the Middle East, Asia, and Africa, Japanese truck producers are eyeing the already crowded and competitive US market. The Japanese are relying on a strong dealership network, a higher quality standard truck, and prices 10 to 20 percent below US levels to penetrate the market. Japanese truck builders are probably willing to accept losses to secure a long-term market share. 25X1

Tokyo Plans To Market Space Launch Services

As part of an aggressive overall effort to develop indigenous aerospace capability, Tokyo intends to commercially market its H-II launch services in Asia beginning in the 1990s. International sales are probably necessary to offset H-II program costs, especially because the recent breakup of Nippon Telephone and Telegraph has eliminated a major captive market for domestic launch services. Although the US Embassy indicates that officials of Japan's Science and Technology Agency plan to consult the United States before any such action, we doubt Tokyo will allow such consultations to interfere with prospective launch service sales. Current cost projections indicate H-II services will be competitive with comparable US and European programs. 25X1

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UK Undershoots Deficit Goal

A sharp reduction in Britain's Public Sector Borrowing Requirement (PSBR) for the financial year that ended 31 March will probably induce London to further ease domestic interest rates. The PSBR totaled 5.9 billion pounds, down from 10.2 billion pounds in 1984-85 and 1 billion pounds below the Treasury forecast. The budget deficit figure was the lowest since the late 1970s in nominal terms and represented the lowest proportion of GDP—1.6 percent—since 1971. The borrowing requirement shortfall is due to a variety of factors, including higher-than-anticipated receipts from inland revenues, excise taxes, and national insurance contributions, as well as advance payments from the sale of British Telecom, which were not due until 1986. The budget windfall, along with a drop in inflation last month—to the lowest level in three years—and the stabilization of sterling against the dollar, is likely to push down base lending rates—down 2 percentage points in the past month to 10.5 percent—further in coming weeks. 25X1

Italy Eases Foreign Exchange Controls

In response to the early April European Monetary System realignment and a strengthening of the lira, the Italian Government has resumed its policy of gradually relaxing foreign exchange controls. On 14 April, Minister of Foreign Trade Capria lifted temporary exchange controls imposed in January to ward off heavy speculation against the lira and relaxed other restrictions. The January measures had forbidden importers to prepay their bills and required companies to finance in foreign currency 75 percent of those exports that had payments deferred beyond 180 days. The most significant new liberalization measures raise from $1.1 to $1.4 million the ceiling on forward operations in lira and allow Italian banks to grant lines of credit to foreign banks—payable within 10 days—for Italian exports. Although additional minor reforms may occur later this year, Treasury Minister Goria's concern over the huge public-sector deficit, an underdeveloped capital market, and historical current account deficits probably will prevent substantial capital market liberalization anytime soon. 25X1

New Portuguese Budget Ambitious

Lisbon is likely to have trouble meeting the ambitious deficit target set forth in its 1986 budget, and will probably have to submit a supplemental budget later this year. The budget foresees a deficit equal to 11.1 percent of GDP—down from 13.6 percent in 1985. Revenues will benefit from the stimulative effects of lower oil prices and a net inflow of funds from the EC, but Lisbon may not achieve the 23-percent increase the budget projects. The rigid tax system has undergone little change and still relies heavily on indirect taxes. Moreover, Lisbon has found it difficult to collect the new value-added tax (VAT) because of inadequate accounting systems in many small firms. Interest payments are expected to account for over one-fourth of total spending. Given the absence of significant cost-cutting reforms in social security, health and education, and spending on ailing public enterprises, expenditures are likely to exceed targets. 25X1

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Less Developed Countries

Argentine Economic Developments

On 4 April Economy Minister Sourrouille initiated a new phase of the stabilization plan by replacing the price and wage freeze with a system of limited price and wage increases. We doubt, however, that the new controls will mollify the increasingly militant labor movement, which seeks real wage hikes to compensate for a 20-percent drop in purchasing power last year. Sourrouille also implemented a 3.8-percent devaluation of the Austral. We believe that, with the spread between the parallel and official exchange rate running above 10 percent, the devaluation is too limited to enhance the competitiveness of Argentine exports. Meanwhile, members of Argentina's Bank Advisory Committee are currently debating whether to roll over BONODs—bonds issued by the Argentine Government in lieu of foreign exchange to private-sector creditors—falling due this year. Payment on the bonds this year would increase Buenos Aires's 1986 new money requirements by $1.2 billion.

25X1

Argentine Land Tax Proposed

The land tax proposal now being considered by the congress is designed to increase production incentives for farmers. The program—to be implemented with a $350 million World Bank structural adjustment loan—would allow Buenos Aires to replace taxes on exports, profit, and capital with a tax on rural land value. Removal of export taxes would further enhance Argentina's ability to compete in the international grain market and increase its capacity to pay the foreign debt. Since each hectare in a given area would be taxed equally, the scheme would favor land-intensive grain production over cattle ranching and would penalize inefficient farmers. Agricultural production has increased significantly over the past five years even with export taxes that often topped 25 percent; current estimates of up to 9 million metric tons in exports from this year's flood-damaged corn crop are still 30 percent above the 1985 total. The tax, however, is neither imminent nor permanent: it is designed as an emergency five-year measure that will start no earlier than 1 January 1988.

25X1

Mexico Signs Regulation Discriminating Against Foreign Trademarks

A regulation was signed last week that provides tax incentives to Mexican soft drink and water bottlers who do not use foreign trademarks. The tax incentive is extended only to 100-percent Mexican-owned and -managed companies that use only domestic inputs and do not pay for foreign soft drink formulas or technical assistance. The regulation is intended to strengthen the position of national trademarks in the domestic market. It comes, however, at a time when the United States is stressing improved protection of American intellectual property rights in a number of countries including Mexico.

25X1

Poor Nicaraguan Coffee Harvest

[redacted] Nicaragua's recently completed coffee harvest was the worst this decade, but higher prices may result in a slight gain in export earnings. According to officials of the Ministry of Agriculture and INCAFE, the government coffee trading monopoly, the 35,000-metric-ton harvest was one-third below the regime's target and 40 percent below pre-1979 levels. While officials cite poor weather and manpower shortages for the decline, private-sector coffee growers blame government controls. [redacted] 25X1 25X1

Floods Disrupt Transport in Peru and Bolivia

Recent flooding of Lake Titicaca has temporarily closed the InterAmerican Highway and disrupted rail shipments of Bolivian lead and zinc concentrates to Peruvian ports. US officials who surveyed the damaged area believe that the InterAmerican Highway may reopen shortly, but that the high water that has inundated the lake steamer-railroad terminal on the Peruvian shore and 15 kilometers of track will disrupt rail traffic for as long as two years. Local hydrologists indicate that the lake—now two meters above normal—will crest next month and then decline slowly. In Peru, the floods will force the resettlement of at least 75,000 people while an estimated 47,500 Bolivians have lost their homes and farms. With the collapse of the tin market, the increased importance of lead and zinc exports will probably spur La Paz to divert some ore shipments to Chilean ports. [redacted] 25X1

India Awards Gas Pipeline Contract

After more than two years of negotiations, a French-Japanese consortium has won the $600 million contract to build a pipeline that will bring gas from the Bombay High offshore area to northcentral India. When completed in 1989, the 1,700-kilometer pipeline will link the onshore terminal at Hazira with Bijaipur and Jagdishpur. The French-Japanese group won the contract over its nearest competitor, Snamprogetti from Italy, by offering a package that included concessionary financing and substantial participation by Indian companies. Six fertilizer plants now under construction or on the drawing-board will be supplied gas via the pipeline. This will help India hold down the growth in fertilizer imports—currently more than $1 billion annually—but increasing domestic demand will probably delay any significant import substitution until the 1990s. [redacted] 25X1

Nationwide Power Failure in Bangladesh

A 12-hour power failure in early April that paralyzed most of the country underscores Bangladesh's growing energy problems. The outage of the national grid was reportedly triggered by lightning, according to the US Embassy. Frequent power failures have disrupted industry and agriculture—the jute industry alone lost $2.2 million in January. Generating capacity meets only 80 percent of peak demand, according to US Embassy estimates. This capacity shortage is attributed to equipment failure as a result of poor maintenance and water shortages during the winter dry season, problems that will not be alleviated even when new generating capacity goes on line next year. [redacted] 25X1

Venezuela's Declining Foreign Exchange Reserves

The Lusinchi administration is concerned that a projected oil revenue shortfall of at least $5 billion this year, with little relief in sight next year, could cause nongold reserves to fall sometime next year below the $5.5 billion level that the administration considers a comfortable minimum. Nongold reserves have declined almost $600 million from mid-January's $10.4 billion level. To staunch the outflow, the administration has trimmed 1986 foreign exchange allocations to the public sector by $400 million and to the private sector by $1 billion. Importers have been directed to substitute Venezuelan products. The administration this week invoked the "contingency clause" in the $21.2 billion multiyear rescheduling agreement reached with banks in February, and probably will call for a followup rescheduling of principal due in 1987—about $1.1 billion. The Embassy reports that Caracas may even request a deferral of the $750 million "downpayment" due banks this year. Such a request would encounter stiff resistance from bankers, who considered the promised downpayment a prerequisite for the rescheduling. We believe, however, that Lusinchi is likely to make the promised downpayment rather than provoke a confrontation with bankers that could invalidate the debt deal and tarnish Venezuela's credit rating. [redacted] 25X1

Communist

Soviets Step Up Agrochemical Purchases

Moscow's commitment to increase grain yields has been highlighted by recent agreements to purchase large quantities of Western pesticides. [redacted] 25X1 The 1986-90 plan gives priority to grain cultivation by "intensive" technology—appropriate use of agrochemicals and land, planting of high-yield grain varieties, and improved transportation. This year the area of grain under intensive cultivation is to be nearly double last year's level—14 percent of total area sown to grain. Another doubling is planned in the near future. Preliminary analysis indicates that in many areas grain harvests were 60 percent higher than with conventional technology. [redacted] 25X1

China Orders US Passenger Jets

The Civil Aviation Administration of China (CAAC) reportedly signed a firm contract for four Boeing 747s and four Boeing 767s for its regional airlines last March, and will make the announcement at the Aerospace Exhibit in Beijing in May. Because passenger demand continues to exceed capacity and CAAC has the foreign exchange, additional purchases are likely. The acquisitions, however, will exacerbate shortages of qualified pilots; China is meeting only half its needs for pilot training, largely because of a difficulty in finding qualified applicants. [redacted]

25X1

China Enacts New Law on Foreign Investment

China's new law on wholly-owned foreign enterprises will only allow the establishment of enterprises that China deems conducive to its development and that export all or part of their products. The law is vague, however, on the key issues of expropriation and profit repatriation, leaving much to Beijing's interpretation. Given China's unwillingness to recognize international legal norms in the areas of profit repatriation, expropriation, and dispute settlement, this law will probably do little to attract new foreign investment in China.

25X1

Cuban Acquisitions of Western Computers

Since 1983, the Cuban Government has been making major purchases—legal and illegal—of small computers and has established a corporation for the assembly and sale of computers in Cuba. As of late 1985, approximately 1,500 personal computers were being used in the Cuban Government, especially in the Ministry of Basic Industry, the State Committee for Material and Technical Supply, the Ministry of Public Health, and the Ministry of Foreign Trade. Cuba has obtained computers from the United States, Japan, and Italy by both legal and illegal means.

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