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International Economic & Energy Weekly

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16 May 1986

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Synopsis

1 **Perspective—Libya: Wrestling With the Economy** 25X1

Libyan leader Qadhafi is facing increasing economic pressure as a result of the weak oil market and the confrontation with the United States. 25X1

3 **UN Special Session on African Economic Problems** 25X1

The United Nations Special Session on African economic problems scheduled for 27-31 May in New York will provide a major forum for African countries to continue their dialogue with the international economic community. In our judgment, the African request for debt relief and additional economic assistance would require significantly more aid than international organizations and non-African donors are planning to extend. 25X1

7 **East Germany: Steady Economic Course for 1986-90** 25X1

Economic policies and goals for 1986-90, released at the 11th Communist Party (SED) Congress last month, continue the course of recent years that has produced comparatively rapid growth, by East European standards, and prompted public praise from Soviet leader Gorbachev. 25X1

11 **Spain: High Unemployment Continues** 25X1

Spain's unemployment rate—now about 22 percent—is the highest in Western Europe, and there is little prospect for any short-term improvement. We do not anticipate any major repercussions over the near term from high unemployment, however, because the political opposition is weak and the thriving underground economy provides an important safety valve. 25X1

15 **LDCs: Impact of Changes in US GSP** 25X1

Recent modifications in the US Generalized System of Preferences (GSP) has raised concern among beneficiary countries that restrictive trade measures such as the GSP modifications will soon stem their export expansion and economic growth. 25X1

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International Economic & Energy Weekly

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16 May 1986

Perspective

Libya: Wrestling With the Economy

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Libyan leader Qadhafi is facing increasing economic pressure as a result of the weak oil market and the confrontation with the United States. Additional losses in oil revenues would force Tripoli to make difficult and risky political choices this year. At current export levels, Libya loses about $30 million per month for each one dollar decline in oil prices. Conversely, if Tripoli holds prices at $14 per barrel, every 100,000-b/d drop in oil exports costs the regime $42 million per month. [redacted] the regime may need to cut imports by half, which would have to include both civilian goods and military equipment, magnifying already unprecedented domestic grievances over the regime's economic mismanagement. Declining oil revenues also will hinder Tripoli's ability to repay $4 billion in arrears owed to major trade partners.

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The declining cash flow is intensifying an already worrisome deterioration in living standards. The quality of health care and education, hallmarks of Qadhafi's revolution, has fallen sharply. Food lines are growing longer and consumers more contentious. Hoarding has become a way of life for most, and a thriving black market has evolved despite government efforts to suppress it. The regime is attempting to consolidate its control over the economy by halving the number of government ministries. This, however, will not solve the problems of an inept bureaucracy and inappropriate regime policies, and could further isolate the regime from the general populace.

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Libya probably will be able to maintain, or even increase, oil production as long as Tripoli can retain foreign expertise and its European oil markets. Oil exports have not been significantly affected by the slump in international oil demand and even jumped by about one-third last month. This surge probably was a one-time effort to empty crude oil storage tanks Tripoli considered vulnerable to attack, rather than an indication of improved market conditions. The pattern of Libyan oil exports, however, has changed since the imposition of US sanctions. Exports to West Germany are down by more than one-third, while exports to refiners in Spain, Italy, and Turkey have remained strong.

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The continuation of low oil prices could create some long-term problems in Libya's petroleum industry. Spare parts shortages are cropping up, probably because Libya does not have the cash to import them. Moreover, oilfield development projects and drilling programs have been cut.

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The US airstrikes have not yet caused a significant exodus of the foreign workers. [redacted] the regime has avoided hostile actions against foreign nationals and is providing special protection to US and British citizens. Some US oilworkers have left Libya, but as many as 400 could be there at any given time. The fear of future military action has nevertheless prompted large numbers of dependents to leave and could still result in the departure of additional workers. [redacted] 25X1

Tripoli has responded to West European actions against Libyan diplomats by randomly expelling small numbers of British, Spanish, Italian, and other foreign workers and diplomats. The slowdown in the economy gives Tripoli leeway to draw down the foreign work force, but Libya remains heavily dependent on foreign expertise to operate its economy, especially the oil sector. [redacted] 25X1

The Tokyo Economic Summit declaration probably will have only a small impact on Western countries' economic relations with Libya. While the summit participants were relatively forthcoming in condemning Libyan support for terrorism, any policy response is likely to come mainly in the form of stricter antiterrorism measures at home or reduced diplomatic ties. Most Western governments still oppose economic sanctions for a variety of reasons, including a belief that sanctions are ineffective, an unwillingness to lose business, a concern about setting potentially troublesome precedents, and a fear of Libyan retaliation. [redacted] 25X1

[redacted] 25X1

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UN Special Session on African Economic Problems

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The United Nations Special Session on African economic problems scheduled for 27-31 May in New York will provide a major forum for African countries to continue their dialogue with the international economic community. On the basis of US Embassy [redacted] we do not expect real progress toward resolving major issues such as Africa's debt crisis or the rehabilitation of regional agriculture. In our judgment, African requests for debt relief and additional economic assistance would require significantly more aid than international organizations and non-African donors are planning to extend. [redacted]

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Pre-Session Maneuvering

The Special Session—the first to address the economic problems of a particular region—comes as a result of a lobbying effort by African countries and the Organization of African Unity (OAU). It also reflects international recognition of the severity of Africa's economic situation, particularly south of the Sahara. [redacted]

The African countries have seized the initiative by having a document, prepared by the OAU with input from the United Nations Economic Commission for Africa, made an official working document of the Preparatory Committee for the session. This ensures its availability to delegations during and after the session. This working document advocates the implementation of a medium-term economic recovery program—Africa's Priority Program for Economic Recovery, 1986-90—adopted by the OAU last July. [redacted]

The African document is politically controversial because of its reference to the Sahrawi Arab Democratic Republic (SADR), the disputed territory of Western Sahara, where rival claims by Morocco and the Polisario liberation movement remain unresolved. Morocco has protested the inclusion of the SADR in the document and at one stage threatened to sabotage the Special Session by preventing a final consensus, should the OAU-prepared paper become a formal UN document at the session. To help head off a conflict, the Preparatory Committee is submitting its own working paper to the Special Session. The African countries will, however, play a role in the preparation of this paper. According to diplomatic sources, the Africans have tabled, as the proposed Special Session declaration, the UN Program of Action for African Economic Recovery 1986-90, which substantially repeats the presentation of the African position paper submitted to the Preparatory Committee. [redacted]

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African Proposals

The participants in the session generally agree on the causes of Africa's economic crisis and on the necessity for economic reforms, according to diplomatic sources. The African position paper acknowledges the need for structural reform throughout the region. This position is similar to current thinking in OECD countries and multilateral institutions such as the African Development Bank, the IMF, and the World Bank. The European Community's position paper on the Special Session also emphasizes the importance of structural reform to cope with the economic crisis. [redacted]

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The African states, however, are proposing a new set of relationships between Africa and the international community based on a principle of "co-responsibility." Under this principle, massive economic support for the region would be reinforced

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by African efforts to mobilize domestic resources and efficiently use them in effecting economic adjustment. Coresponsibility would be a major feature of the implementation of the OAU's 1986-90 Priority Program. The non-African participants in the Preparatory Committee have not endorsed this principle so far, but the European Community has suggested possible areas for cooperation between Africa and donor countries in trade and economic aid.

The African states also propose the establishment of a followup mechanism to monitor the implementation of the OAU Priority Program on a continuing basis. According to US Embassy reporting, however, statements by Western government representatives in the Preparatory Committee reject the proposal for new mechanisms and unanimously endorse the use of existing institutions to implement followup measures.

Upping the Financial Ante

The African countries are seeking a sizable increase in developed country aid and debt relief. The Africans estimate in their position paper that implementation of their 1986-90 economic recovery program would require $128 billion in new financing, of which $83 billion would be raised domestically. This leaves an external resource gap of $45 billion, or $9 billion annually, to be financed by the international community. This $9 billion would be in addition to the current approximately $20 billion in annual net financial flows to the continent (South Africa excluded), according to OECD data.

The OAU request for financial assistance goes even further. The African position paper describes the annual debt servicing burdens of $15-25 billion as unsustainable. To obtain relief the paper proposes:

- Converting all official development assistance (ODA) debts and interest obligations to grants. This would provide relief of $3-5 billion a year, according to the paper.

- Consolidating all non-ODA official debt due during 1986-90 into long-term loans repayable over 30 to 40 years on concessional terms with a 10-year grace period. This would produce savings of $4-6 billion a year.

- Reducing interest rates on commercial debt and consolidating debt service payments for repayment over several years. The gains here cannot be estimated at this time, because the reduced interest rates and the extended repayment periods are not specified.

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Requests Unlikely To Be Met

The size of the African request for additional financial assistance is well beyond the range of current aid proposals for the region. The African proposal exceeds by far the additional $2.5 billion annually that the World Bank estimates Sub-Saharan Africa still needs under a regime of economic adjustment. Moreover, the external financing mechanisms for Africa for the rest of the decade are already in place for the most part. For example, the IMF's $3 billion Structural Adjustment Facility has already been set up through 1991 with no further enlargement contemplated. The World Bank is sounding out its membership on a $12.5 billion replenishment of the International Development Association, its concessional arm. This replenishment contains a $1.5 billion Special Fund for Africa that is the same size as that of 1985. European Community members favor the World Bank proposal, and we do not anticipate that bilateral official donors, already working under tight domestic budget strictures, will radically alter their aid policies to favor Africa further at the expense of other regions. The OECD, for example, forecasts the growth in its bilateral assistance worldwide at an average of 2 percent per year for the foreseeable future, implying much less aid for Africa than the Africans are asking for in 1986-90.

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In our judgment, although African states—who feel they have greater influence in UN forums—

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will try to gain political capital from the Special Session, they have little leverage to push the international community to promise massive additional aid or support potentially costly followup mechanisms. The Special Session will put Africa's economic needs in the public spotlight again, but we believe any aid increases will continue to be pursued through the established multilateral financial institutions and bilateral relationships, mechanisms acceptable to Africa's major donors.

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East Germany: Steady Economic Course for 1986-90

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Economic policies and goals for 1986-90, released at the 11th Communist Party (SED) Congress last month, continue the course of recent years that has produced comparatively rapid growth, by East European standards, and prompted public praise from Soviet leader Gorbachev. East Germany's goals are ambitious in light of its serious resource constraints, cutbacks in investment in recent years, and uncertainties surrounding Soviet trade demands. Moreover, the regime has probably wrung out most of the easy improvements in economic performance through organizational restructuring and tighter management. Nonetheless, East Berlin has a good chance of meeting its goals, especially if its modernization program continues the gains in productivity and efficiency achieved in recent years.

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Recent Performance

After a sharp slowdown in growth in 1982 associated with austerity measures to avert financial crisis, the economy has recovered to become, by most measures, the most successful in Eastern Europe. We estimate that, after stagnating in 1982, GNP growth rebounded to 3.2 percent in 1984 and 2.4 percent last year. The government claimed sizable gains in labor productivity and declining production costs. The chronic hard currency trade deficits of the 1970s became surpluses in 1981-85, and East Berlin sharply reduced its ruble trade deficits with Moscow. At the same time, the East Germans built hard currency reserves to at least $5.9 billion by September 1985, according to Bank for International Settlements data, by far the highest of any East European country.

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The 1986-90 Directive

The regime's satisfaction with its economic achievements and prospects was plain at the SED Congress, and the party reaffirmed the 10-point "economic strategy of the 1980s" promulgated at the 10th Congress in April 1981. Overall, party leader Honecker's address was markedly more upbeat than Gorbachev's remarks in East Berlin and the soul searching of the Bulgarians at their congress in March. The SED called for growth rates that are among the highest in Eastern Europe. Goals for produced national income are in line with those of recent years although industrial production is to grow slightly less rapidly. The regime is counting on productivity gains of over 8 percent per year to provide 90 percent of growth.

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Industry. The regime will continue to push strongly the development of its comparatively high-technology industries—robotics, computers, electronics, and machine building, for example—in the interest of greater efficiency and labor savings. At the same time, the East Germans will phase out production of high-cost, labor-intensive products. The government also is emphasizing production of consumer goods, which apparently are destined for export as well as domestic use.

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Energy. The economy will continue to rely heavily on domestically produced lignite, which already accounts for over 70 percent of primary energy consumption. Production costs, however, are rising sharply as shallow beds are exhausted. With Soviet oil deliveries capped, East Berlin will have to boost lignite production above the 312 million metric tons mined in 1985 to keep industrial output growing and support East Berlin's policy of electrifying industry and the rail lines to conserve liquid fuels. Using more lignite, however, will exacerbate the country's already serious air pollution problem. Although world energy prices are down, the East Germans remain committed to this costly energy "independence" program.

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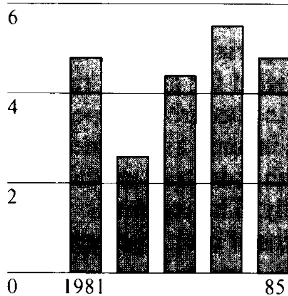
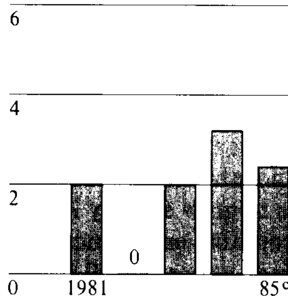
East Germany: Selected Economic Indicators, 1981-85

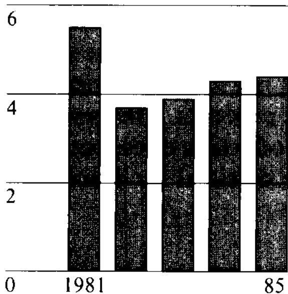
Growth in Produced National Income [a]
Percent



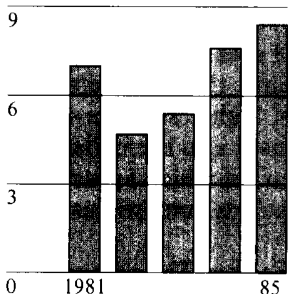
GNP Growth [b]
Percent



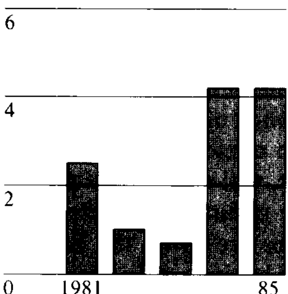
Growth in Industrial Production [a]
Percent



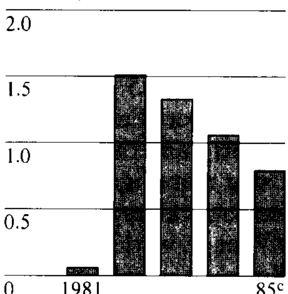
Industrial Productivity Growth [a]
Percent



Growth in Retail Sales [a]
Percent



Hard Currency Trade Balance [b]
Billion US $



[a] Official East German statistics.
[b] CIA estimate.
[c] Preliminary.

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Agriculture. East Germany hopes to keep agricultural output on the rise. In 1984 the government introduced major organizational changes and financial incentives for farm managers and "cooperative peasants," which apparently contributed to consecutive record grain harvests in 1984 and 1985. If East Berlin can reach its goal of 12 million tons of grain by 1990, it would be able to reduce imports further and conserve hard currency. As a result, prospects for US grain exports to East Germany, which were sharply reduced in the early 1980s, could remain poor.

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Investment. The plan directive contained a significant increase in badly needed investment spending but was vague about how it will be allocated. East Berlin cut back investment sharply in 1982-84 as part of its effort to avoid financial crisis, but did not begin to increase investment until late 1985, well after the end of its financial problems. We suspect that the bulk of projected average annual spending of a record 69.2 billion marks—up from 50.5 billion marks in 1984—will be devoted to high-technology industry, machinery, electronics, chemicals, energy, and pollution control. We also expect the continuing need for industrial modernization to lead to somewhat higher imports of high-technology capital goods from the West.

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S&T. The regime is strongly committed to making improvements in science and technology the engine of future economic growth, but the party shed little new light on the new five-year plan for S&T that Honecker promised last June. The plan directive highlights microelectronics, computers, computer-aided design and manufacturing systems, flexible manufacturing systems, nuclear power, and biotechnology as priority areas. The party reaffirmed its S&T cooperation with the USSR and CEMA through the year 2000. Premier Stoph emphasized improved cooperation between East German research institutes, the universities, and the industrial combines. To increase the effectiveness of the R&D effort, the combines will directly pay for and supervise economically important research. Honecker also announced a new science curriculum for the schools.

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East Germany: Economic Goals for 1986-90

Average annual percent growth (except where noted)

	1986-90	1985 Plan	1985 Actual [a]
Produced national income [b]	4.4 to 4.7	4.4	4.8
Industrial production [b]	4.1 to 4.4	4.3	4.5
Productivity in industry	8.3 to 8.5	7.1	8.4
Unit production costs in industry	−2.2	−2.7	−2.2
Unit consumption of raw materials	−4.0	−2.8	−3.5
Personal monetary income	3.9 to 4.1	4.0	3.9
Retail trade turnover	3.9 to 4.1	4.0	4.2
Investment per year *(billion East German marks)*	69.2	56	62
Grain production per year *(million metric tons)*	11.8 to 12.0	10.7	11.6
New or reconstructed housing units per year *(thousand units)*	212.8	203.1	212.2

[a] Plan and actual performance data are not exactly comparable because historical data exaggerate real economic growth by including inflation and some double counting. Plans, by contrast, do not purposely incorporate such biases.

[b] Using Western accounting practices, we tentatively estimate GNP and industrial production growth in 1985 to have been 2.4 percent and 2.2 percent, respectively. Western accounts usually yield lower growth rates because they remove distortions of turnover taxes in prices and include such "nonproductive" sectors as housing and government that generally grow more slowly than industrial output.

The Consumer. The plan calls for comparatively slow growth in consumer-related goals, and we expect only modest increases in real personal consumption. Price increases for "luxury" goods probably will account for most of the projected increase in retail sales, but the state will continue to heavily subsidize prices of basic goods and services, such as bread, milk, rents, and public transportation. Tacitly admitting nagging shortages, Honecker reiterated the need to assure availability of the "1,000 little things of everyday life" and announced expanded, more "consumer-friendly" retail store hours. The party increased marriage and maternity benefits, apparently to try to increase birth rates and stem the continuing population decline. Although housing construction will continue at current rates, the regime expects housing shortages to be eliminated by 1990. We believe these measures are likely to keep consumers generally mollified and allow the government to convince the populace that harder work will be rewarded by a better standard of living—a key to its efforts to boost productivity.

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Trade. Key aspects of trade plans were not revealed, but it appears that the growth of foreign trade will slow considerably from the rates of recent years. The Soviet–East German plan coordination protocol signed last October called for annual increases of only about 3 percent over the 1985 level—down from double-digit rates in the early 1980s. Similar trade growth was projected with other socialist countries, which, with the Soviet Union, account for about two-thirds of overall East German foreign trade. Although the leadership was vague about trade with the West, we expect East Berlin to keep its policy of maintaining modest hard currency trade surpluses, meaning that the overall growth of this trade would depend largely on East Germany's ability to export. Nevertheless, we expect the composition of trade with the West to shift somewhat toward imports of high-technology capital goods; East Berlin is creditworthy enough to be able to obtain long-term financing for its technology needs. Commerce with LDCs may stagnate, however, given continuing Third World debt problems and East Berlin's unwillingness to extend more credits to several trade partners seeking to reschedule existing loans.

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Several factors could hamper achievement of these trade growth targets:

- Despite a signed protocol, the USSR could ask for more manufactured goods or cut resource deliveries, possibly including oil, as happened in 1982. The Soviet economy must cope with declining oil export revenues, and East Germany is a high-quality producer within CEMA.

- The value of Soviet exports to East Germany could fall well below plan as the CEMA price formula begins to reflect lower world oil prices.

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- The falling world price of oil should cut hard currency earnings from refined oil exports.

- The impact of the Soviet nuclear accident remains unclear. It could reduce the Soviets' small electricity deliveries, increase pressures on Moscow to cut coal and oil shipments, and force more East German reliance on domestic and Western energy sources. Greater use of lignite, however, could require additional Western equipment to control emissions and shift investment allocations somewhat. 25X1

Economic Management. The Honecker regime has made clear that it is pleased with its basic economic structure and that no major organizational changes or "reforms" are in the works. The East Germans give little indication of feeling pressure from Gorbachev's calls for improvements in Soviet Bloc economic management and performance. We expect East Berlin to continue to tinker with the economy as it strives to "perfect" the management system. A reform of industrial goods prices to improve economic decision making is possible in the late 1980s, but tight central control will remain a hallmark of the East German economy. 25X1

Outlook

Although the growth targets are the lowest for a five-year plan in decades, they are ambitious in light of East Germany's serious resource constraints, low investment of recent years, delays in modernization, and uncertainties surrounding Soviet demands. The organizational improvements of recent years have exhausted the easy fixes to improve efficiency and productivity, and East Berlin's ability to keep growth strong remains problematical. The regime's S&T push probably is its best bet, but the East Germans must do a better job of putting technological innovations into practice. Nonetheless, the East Germans seem to have the best economic management skills among the East Europeans, and they will probably be able to keep growth comparatively high by regionwide standards. 25X1

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Spain: High Unemployment Continues

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Spain's unemployment rate—now about 22 percent [1]—is the highest in Western Europe, and there is little prospect for any short-term improvement. Structural rigidities in the labor market—particularly Madrid's strict labor laws—are a major hindrance to job creation. High wages produced by post-Franco collective bargaining arrangements and high nonwage labor costs mandated by the state also have eaten into company profits and have made employers reluctant to increase their work forces. We do not anticipate any major repercussions over the near term from high unemployment, however, because the political opposition is weak and the thriving underground economy provides an important safety valve.

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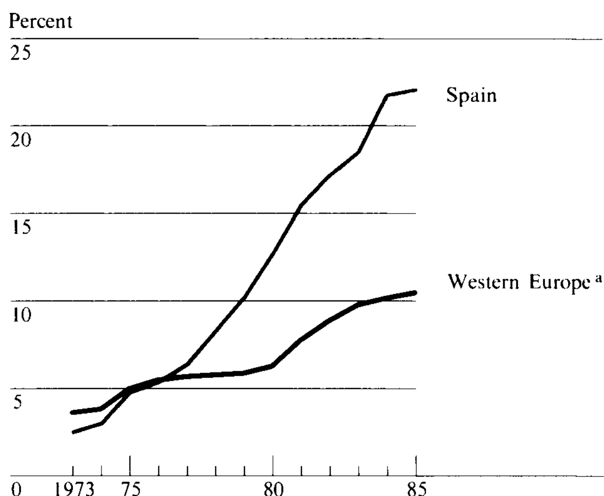
Spain: Comparative Unemployment Rates, 1973-85



[a] Western Europe excluding Spain.

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Dimensions of the Problem

Spain experienced the sharpest rise in unemployment in Western Europe between 1973 and 1985. During this period, the unemployment rate soared from 2.4 percent of the labor force (280,000 people)—about one percentage point below the West European average—to 22 percent (2.9 million people), more than double the average. Joblessness is particularly high among women and the young. Long-term joblessness is also a problem—the share who had been unemployed for more than one year climbed to over 54 percent in 1984; those unemployed over two years rose to 29 percent. Although total employment increased last year for the first time since 1974, it is still 18 percent below the 1974 level. More than 2 million jobs have been lost and fewer people are employed now than in 1964. Industrial employment has shrunk 30 percent since 1974 while agricultural employment has fallen by 40 percent.

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[1] The official figure does not take into account those employed in the underground economy. We estimate actual unemployment is in the range of 16 to 17 percent—still one of the highest in Western Europe.

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Causes

Spain's unemployment problem stems in part from external causes. The two oil price shocks of the 1970s hit Spain hard because of its above-average dependence on imported oil, and the subsequent world recessions decreased Western demand for Spanish goods. Average annual real GDP growth dropped from 7.3 percent in 1960-74 to 1.6 percent in 1975-83, the sharpest drop in the OECD. Meanwhile, as West European governments began to limit the number of migrant workers, the escape valve of emigration began to close; between 1975 and 1983, about 270,000 Spaniards returned home.

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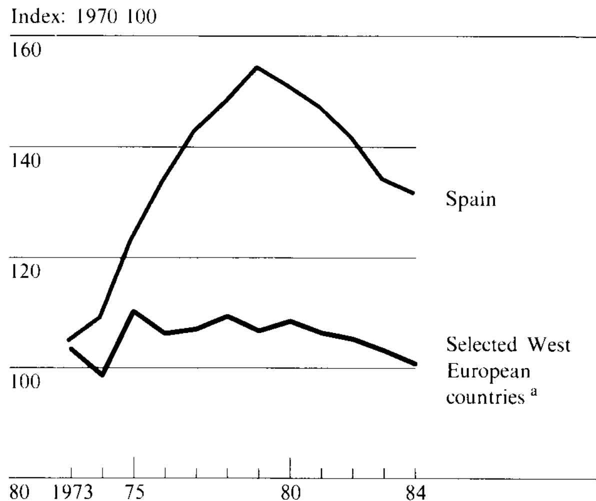
Spain: Comparative Real Unit Labor Costs in Industry, 1973-84



a Trade-weighted average based on shares of world exports in 1980. Selected countries include Belgium, Denmark, France, Italy, the Netherlands, United Kingdom, and West Germany.

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Internal causes also played a major role in boosting Spanish unemployment. After Franco's death in 1975, the newly legalized trade unions pressed for large real wage gains in the face of rapidly accelerating inflation. As a result, total real labor costs jumped 66 percent between 1974 and 1982—about double the average European rate—while productivity grew only 28 percent. Firms saw their unit labor costs soar and found themselves unable to compete either with their West European counterparts or with the newly industrialized countries whose competitiveness in traditional sectors such as footwear, steel, and textiles cut into Spain's export markets.

While real wages have moderated in the last several years, government social welfare policies have kept total labor costs high. Employers' contributions to social security represent 21 percent of total labor costs in Spain—the highest share in Western Europe after France. In addition, the ceilings on wages subject to social security contributions encourage employers to lean toward more highly skilled, higher paid workers, while the lower social security tax rates on overtime pay have led employers to extend work hours rather than hire new workers.

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Rigid labor laws inherited from the Franco era also have played an important role in Spain's inability to create jobs. They make it virtually impossible for an employer to lay off workers without reaching an agreement with the government or one of the main labor unions. As a result, employers are reluctant to hire new workers even in prosperous times because any future dismissals would be costly and time consuming. The labor laws have particularly affected small, labor-intensive private firms and have pushed many of them into the underground economy.

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Government Efforts

Center-right governments of the early 1980s implemented a number of measures aimed at holding down unemployment, but they were largely unsuccessful. The Workers Statute of 1980 introduced more flexible temporary contracts, reduced allowable overtime, raised the minimum working age, and established a mandatory retirement age. Under the National Employment Pact of 1981, the trade unions agreed to a cut in real wages in exchange for the promised creation of 350,000 new jobs through increased public investment and fiscal incentives. Implemented in a piecemeal fashion, these measures did not prevent the unemployment rate from rising above 16 percent by the time the Socialists came to power in 1982.

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The Gonzalez administration has placed more emphasis than earlier governments on promoting wage moderation and labor market flexibility to boost employment. It succeeded in persuading the Socialist General Union of Workers to accept a slowdown in real wage increases for 1985 and 1986 through the Economic and Social Pact. It has also limited

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Labor Rigidities

Three types of layoffs are officially permissible:

- *For an **individual layoff**, the case is first presented for arbitration under the Ministry of Labor. If agreement cannot be reached, the case goes to the courts. If approved, a severance payment is usually required equal to 20 days' pay per year of employment to a maximum of one year's salary. If disapproved, the employer must readmit the worker or pay him 45 days of salary per year of employment to a maximum of 42 months' salary.*

- *For a **collective layoff**, the employer must obtain approval from the Ministry of Labor. If approved temporarily, the "Salary Guarantee Fund" makes up the difference in income received from unemployment compensation, and the firm is required to rehire these workers at the same salaries. Permanent collective layoffs require the same severance payments as do individual layoffs.*

- *For **layoffs resulting from industrial restructuring**, workers who have not been released through early retirement have the choice of either receiving a severance payment as well as unemployment compensation for up to 18 months or surrendering their severance payment to an "Employment Promotion Fund." The Fund provides redundant workers with improved unemployment benefits, while retraining them for new opportunities.*

employers' obligations to pay indemnities for laid-off workers, stepped up training programs for youths between 20 and 25, and put youths on their parents' social security benefit plans, thus allowing employers to hire young workers without making social security payments. Restrictions on temporary contracts have also eased: they now may have a duration of up to 3 years and can be used by employers launching new activities or products.

The Socialists' efforts, so far, have been no more successful than those of their predecessors: since 1982, 600,000 jobs have been lost, and the unemployment rate has risen by 6 percentage points. Part of the reason lies in government efforts to modernize and restructure industry. Madrid's industrial reconversion plan will have eliminated about 82,000 jobs by the end of 1986, while measures to boost investment in capital equipment have encouraged Spanish firms to reduce their work forces and shift to more capital-intensive methods of production. More important, however, the government has done little more than tinker with the rigidities in the labor market. While there is pressure to move Spanish labor legislation closer to the EC norm, the process of dismissing unnecessary workers remains highly regulated and costly.

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Outlook

An improved economic performance in 1986—resulting from more vigorous growth in the European Community, modernization policies, and lower oil prices—will not be enough to reduce unemployment. We expect the jobless rate to stay near 22 percent through the end of this year. With GDP growth projected at 3 percent, the economy will not be able to absorb much more than about half of the 120,000 people who will enter the job market this year, and only a small percentage will be able to emigrate to northern Europe. Agricultural employment will undoubtedly continue to fall, while services and industry—in the midst of restructuring—probably will not pick up the slack. EC entry will contribute to the problem in the near term as Spanish tariffs are dismantled and relatively inefficient industries are exposed to European competition. The government is not likely to budge from its austerity course and adopt expansionary measures to boost employment. Moreover, the long-overdue reform of Spain's rigid labor laws has been postponed at least until after the national elections in June.

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The Underground Economy

Spain's underground, or "black" economy—employers not registered with the government and employees not covered by social security—is thriving. Madrid estimates that the black economy accounts for more than 25 percent of all economic activity and employs between 600,000 and 800,000 people. The black economy is particularly strong in textiles and footwear where officials estimate that 30 percent of "unemployed" textile workers and 40 percent of "unemployed" shoe workers hold jobs. Spain's shoe production, for example, increased 50 percent between 1981 and 1984, while official employment in the industry fell by 50 percent. Many small firms go underground to escape the restrictive labor laws and excessive social security taxes. They typically declare bankruptcy and then resume production without notifying the authorities. Employees benefit not only from the jobs, but also, in many cases, by collecting unemployment compensation from the state. These small workshops usually act as suppliers to larger, legal companies.

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Implications

We do not anticipate major political or social repercussions from continued high unemployment. Prime Minister Gonzalez faces a weak and fragmented opposition, and opinion polls indicate that he will have little trouble winning reelection on 22 June. Despite resistance from labor over his wage policies and from business over the neglect of labor reform, we do not expect the Socialists to suffer much as long as the only alternative is the right-wing Popular Alliance. Although authorities have decried the evils of the black economy—poor working conditions, lack of labor legislation, and evasion of taxes—they will probably tolerate it as a safety valve that provides at least part-time work for many on the unemployment rolls and keeps social tensions down.

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LDCs: Impact of Changes in US GSP

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Recent modifications in the US Generalized System of Preferences (GSP)—a program under which LDC exports to the United States are accorded favorable tariff treatment—has raised concern among beneficiary countries. The changes are putting increased economic pressures on a number of LDCs that are dependent on GSP trade for a significant share of GNP. These major beneficiaries fear that restrictive trade measures such as the GSP modifications will soon stem their export expansion and economic growth.

Recent Trends and Modifications

US GSP duty-free imports more than quadrupled over the past decade, rising from $3.2 billion in 1976 to $13.3 billion in 1985 as shown in the following tabulation:

Billion US $

	1976	1978	1980	1982	1984	1985
Imports	3.2	5.2	7.3	8.4	13.0	13.3

Last year GSP imports accounted for 40 percent of total US imports from GSP beneficiary countries. More than 3,000 products from 140 developing countries and territories are granted US GSP benefits. The top five beneficiaries in 1985, however—Taiwan, South Korea, Brazil, Mexico, and Hong Kong—accounted for almost two-thirds of US GSP imports.

As a result of changes in the US GSP this year, on 1 April duty-free import privileges were lifted for a wide range of products imported from GSP beneficiary countries.[1] These modifications become effective for the year beginning 1 July 1986 and remove $839 million worth of goods from free treatment because they accounted for more than half of US imports of the products. Access also has been denied for another $2.4 billion in goods because of the US "graduation" policy.[2] On the other hand, some products where there is no comparable US product were added to the GSP list, and Micronesia, Greenland, and Hungary were added to the list of GSP-eligible countries.

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Hardest hit by the new GSP changes will be Taiwan, Hong Kong, South Korea, Singapore, and Mexico. Collectively, these five LDCs are being denied duty-free status for $2.8 billion worth of products—some 35 percent of their GSP exports to the United States. Argentina, Chile, Brazil, Israel, Peru, and Zambia also are being denied redesignation on a wide variety of products.

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Reaction to 1985 US GSP Modifications

According to Embassy reporting, even before the most recent changes in the US GSP, some developing countries were already expressing opposition to

[1] A review of product eligibility is performed annually as directed by the Trade Act of 1974 in order to update changes to the GSP. During an annual review, interested parties (private industry and governments) can petition for the addition or removal of products from the program. A general review of the US GSP, mandated by Congress in 1984, is performed as necessary to review the competitiveness of all beneficiary countries. As a result of either the general or the annual review, the "competitive need" limits will be lowered for products where a beneficiary country is determined to have demonstrated enough economic strength to compete without GSP benefits.

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[2] As products from the more advanced beneficiary developing countries become competitive in the United States, these products are exempted or "graduated" from the program. Graduation is based on a beneficiary's level of development, competitiveness in a product, and the overall economic interest of the United States.

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What Is GSP?

A total of 20 OECD countries provide preferences under unilateral GSP programs to developing countries. Currently about 140 countries, including South European or Mediterranean countries, certain centrally planned economies, dependent territories, and countries not belonging to the United Nations, are accorded beneficiary status. Under these programs, preferences are generally available for all manufactured and semimanufactured products, with exceptions being allowed for imports that compete with products of "sensitive" sectors in OECD countries.

The US GSP is a program that permits duty-free entry into the United States of allowable products from eligible developing countries. Implemented by the United States on 1 January 1976, the primary objective of the GSP is to promote LDC economic development and diversification of trade.

Individual GSP imports have resulted in significant increases in import penetration of US markets for several different commodity groups such as agricultural products, forest products, chemicals, minerals and metals, and miscellaneous manufactures. GSP imports, however, have not resulted in significant increases in the overall import share of the US market. On a sector-by-sector basis, the growth of GSP imports relative to total imports is small.

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Although the benefits of the US program have encouraged increased LDC exports in certain sectors, several factors limit the extent of market penetration: the limited product coverage; the selective nature of the GSP program, which excludes import-sensitive commodities; periodic program reviews and "graduation"; and constraints imposed by limited technology, manufacturing capacity, basic infrastructure, skilled labor, and capital in many GSP beneficiary countries.

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the program of graduation, asserting that despite solid economic performances in some areas, they remain underdeveloped and need trade preferences. Many of the countries interpret the recent GSP modifications as yet another example of the international trade environment becoming increasingly unfavorable to export-oriented developing countries. Some, such as Singapore and Malaysia, complain that they are innocent victims of internal protectionist pressures in the United States.

The ASEAN [3] countries are particularly concerned about what they perceive as the recent lack of US support for them on important trade issues. In addition to the GSP modifications, ASEAN is troubled by the failure of the United States to support the prices of tin and rubber in the face of sharp declines. According to Embassy reporting, the group is also worried about US efforts to renegotiate a tougher Multifiber Arrangement (MFA). Thailand, in particular, feels that it has been unjustly injured by the rice export price provisions of the US Farm Act and that Washington is using GSP as a mechanism to pressure Bangkok into making concessions on market access and intellectual property rights. Outside of ASEAN, Taiwan fears that the general review could result in even more of its exports being graduated from the GSP.

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Implications

In general, US GSP modifications could cause the LDCs to become less flexible in bilateral negotiations, especially in the areas of investment, intellectual property rights, market access, the new GATT Round, and the upcoming MFA renegotiation.

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[3] The members of the Association of Southeast Asian Nations are Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

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Major US GSP Beneficiaries, 1985

	GSP Exports to US [a] (*Million US $*)	GSP Exports as a Share of Total Exports to the US	Share of Country's Total Exports
		Percent	
Total	**11,803**		
Taiwan	3,221	35.8	10.5
South Korea	1,655	44.3	7.7
Brazil	1,278	62.4	6.3
Mexico	1,239	20.6	4.6
Hong Kong	1,208	32.4	5.1
Israel	748	79.8	13.7
Singapore	674	32.3	6.2
India	286	84.9	4.0
Yugoslavia	273	93.8	5.3
Thailand	235	78.8	4.1
Argentina	226	64.7	5.0
Philippines	219	50.8	3.8
Malaysia	190	43.5	1.3
Portugal	185	81.1	3.5
Peru	166	87.8	6.7

[a] GSP exports derived from US trade statistics.

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Moreover, major LDC debtors such as Mexico are likely to view cuts in GSP eligibility as inconsistent with US encouragement of structural economic reforms to foster export expansion and diversification. In our judgment, cuts in GSP access may add fuel to arguments of domestic forces in debtor countries that oppose liberalization of their governments' economic policies.

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Briefs

Energy

OPEC Production Update

OPEC crude oil production averaged 18.7 million b/d in April, an increase of 1 million b/d from March levels. Saudi Arabia, Iran, Kuwait, and Indonesia accounted for the rise. The Norwegian oil strike took 900,000 b/d off the market for most of the month, which contributed to a temporary increase in OPEC market share despite the end of the winter heating season. Low OPEC prices also crowded out some non-OPEC producers, particularly Mexico and Egypt. Sharply lower prices have also caused underlying demand to increase somewhat compared with the same period last year.

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OPEC: Crude Oil Production, 1986 *Million b/d*

	Quota	First Quarter	March	April
Total	**16.0**	**17.8**	**17.7**	**18.7**
Algeria	0.66	0.6	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2
Indonesia	1.19	1.3	1.2	1.3
Iran	2.30	2.3	2.1	2.4
Iraq	1.20	1.7	1.7	1.7
Kuwait [a]	0.90	1.2 (1.0)	1.3 (1.1)	1.5 (1.3)
Libya	0.99	1.0	1.0	1.0
Nigeria	1.30	1.5	1.7	1.7
Qatar	0.28	0.3	0.3	0.3
Saudi Arabia [a]	4.35	4.5 (4.3)	4.3 (4.1)	4.6 (4.5)
UAE	0.95	1.3	1.4	1.4
Venezuela	1.56	1.6	1.6	1.6

[a] Amount in parentheses excludes production from the Neutral Zone, whose output is divided between Saudi Arabia and Kuwait and included in their country quotas; the Neutral Zone has no production quota of its own.

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Spot Oil Market Developments

Spot oil prices have firmed over the past several weeks. Key North Sea and US crudes are selling for $13.60 and $15.90 per barrel, respectively, up as much as $4 per barrel from early April lows. World average prices are approximately $15.50 per barrel. Although oil demand is showing signs of increasing in response to low prices, a number of supply factors are likely to keep the lid on prices during the next several months. The 900,000 b/d of Norwegian production is back in the market following the end of the three-week oil workers' strike. According to press reports, Mexico hopes that its new, more competitive pricing system will boost exports by 200,000 b/d. In addition, Saudi Arabia's recent decision to offer discounts on its netback contracts has been followed by price cuts on term contracts by both Abu Dhabi and Oman.

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Saudi Arabia Keeps Pressure on Oil Market

Saudi oil production in April increased to about 4.6 million b/d—some 300,000 b/d more than in March. To encourage a further increase, Riyadh is offering some customers discounts of more than one dollar per barrel for purchases in excess of levels in April.

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This response to customer threats to buy other OPEC oil at lower prices will probably help undercut the recent modest increase in spot market prices. Riyadh clearly intends at a minimum to sustain its current market share and, in order to keep pressure on OPEC, may not want the market to stabilize before OPEC's next ministerial session on 25 June. To increase production to as high as 6 million b/d, however, Riyadh would have to lower prices by at least several dollars more, which might encourage even Saudi allies to begin condemning its oil policy.

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Lower Norwegian Oil Production Considered

The new labor government is willing to discuss ways of stabilizing the world oil market with OPEC officials, according to press reports. A growing number of prominent Norwegians, including Energy Minister Oien, support cooperation with OPEC. According to US Embassy reporting, Ministry of Energy officials have drawn up contingency plans to reduce production by as much as 200,000 b/d should a policy of output restraint be adopted. Low oil prices are expected to contribute to a $4 billion current account deficit and to reduce by 70 percent oil tax revenues, which last year totaled $7 billion. Oslo has already devalued the krone and has announced that it will tighten fiscal and monetary policy. Although the new government appears to be considering oil production cutbacks, it is unlikely to act unilaterally. The government probably hopes that positive signals from Norway might encourage other producers to consider greater cooperation.

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Iranian Refinery Damage Assessment

Iraq's air raid on 7 May may have severely damaged the Tehran Petroleum Refinery. The facility, which provides more than 35 percent of Iran's refining capacity, will be shut down for at least two weeks and may not reach prestrike production levels for several months. One of the refinery's two crude oil distillation units—representing one-half of the

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250,000-b/d capacity—appears to have been burned and possibly ruptured. Major damage to the cooling towers has shut down one of two steam plants needed to run the processing units, and significant pipeline damage also occurred. The refinery is the largest supplier of gasoline in Iran. If one of the distillation towers is critically damaged, replacement could take six months, creating serious fuel shortages in Tehran and the heavily populated northern areas. Iran's distribution system is not capable of handling the volume of imports needed to offset a large loss in domestic production. 25X1

UK Gas Reserves Estimate Revised Downward

London is unlikely to change its policy toward importing gas from Norway's Sleipner field despite a downward revision in domestic gas reserves. This year's Department of Energy review estimates that gas reserves are 50 billion cubic meters less than was estimated last year. The new, lower gas estimate is in sharp contrast to last year's, which was used as justification for London's veto of the proposal by British Gas to purchase Sleipner gas. British Energy officials, already concerned about the sharp drop in oil exploration occurring because of low oil prices, appear unwilling to take any action that would reduce North Sea gas development over the next few years. 25X1

Setback for Yugoslav Nuclear Program

The Chernobyl' accident is strengthening antinuclear sentiment in Yugoslavia and casts further doubt on plans to build four nuclear plants by the end of the century. Last week the Republic of Croatia, questioning the need for nuclear power and citing Chernobyl', removed any commitment to nuclear energy from its development plan for 1986-90. This at least postpones plans for a $2.5 billion nuclear plant near Zagreb for which a US firm and the Soviets are competing. Zagreb health authorities have recently demanded a ban on all new nuclear construction. The Croatian decision reflects the growing debate over Yugoslavia's nuclear program. Antinuclear proponents, including some prominent party and republic leaders, argue that the program is economically infeasible and technically unsafe and that existing energy sources should be developed first. About 70,000 Serbian students have signed a petition against nuclear power, and the Republic of Slovenia earlier reduced its commitment to the Croatian plant. The Soviet nuclear accident could cause strains in bilateral ties if Belgrade asks Moscow for compensation. 25X1

India Unable To Meet Coal Production Target

A recent coal strike typifies the problems New Delhi faces in meeting its economic growth target. In a recent trend of joint union action, 700,000 miners responded to a call by Communist and democratic unions for a one-day strike over industry hiring practices. Labor unrest, persistent power shortages, underutilization of machinery and equipment, and transportation bottlenecks make it unlikely that India will meet its coal production goal. Annual coal production—currently some 150 million tons—must increase by 10 percent to sustain the current five-year plan's projected yearly growth rate of 5 percent for the economy. About 65 percent of the country's electricity is generated by coal-fired thermal power, and electrical shortages are a major obstacle to increasing productivity and output of exportable goods. 25X1

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International Finance

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Banks To Consider Romanian Debt Rescheduling

Bankers and senior Romanian officials will meet in London next week to discuss Romania's request that $260 million in 1986 commercial debt be rescheduled [redacted] The $260 million is the amount of principal due on debts of $1.3 billion rescheduled in 1982 for payment between 1985 and 1988. Romania reportedly is meeting its interest obligations, and officials have told [redacted] that it will continue to do so. The banks have little choice but to accede to the request. Romania already has deferred payments on other commercial loans this year. The requested rescheduling, however, probably will not fill Romania's need for financing this year, which is likely to be at least $500 million, and Bucharest probably will have to request additional refinancing later. The rescheduling request embarrasses President Ceausescu and is a setback to his effort to pay off the debt quickly but apparently does not signal a major departure from his prohibition on new borrowing. [redacted]

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Costa Rica's Growing Debt Problems

Costa Rica declared a temporary moratorium on foreign debt payments last week, just days after defaulting on interest obligations to commercial banks. The suspension follows the loss of $60 million in World Bank and IMF funding earlier this year because Costa Rica failed to meet economic stabilization criteria. [redacted] President Arias, who took office the day after the moratorium was announced, reportedly is committed to implementing reforms needed to win the release of embargoed World Bank and IMF funds. Costa Rican officials hope they can meet World Bank terms by late May, which could allow renewed drawings by the end of June. Meanwhile, IMF officials say no new standby arrangement is likely until August. Debt arrearages, which now exceed $110 million, will grow by $50 million each month the moratorium lasts. [redacted]

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London Approves Sterling Commercial Paper Market

The government is attempting to increase the role of London as an international financial center, but its latest action will complicate the conduct of monetary policy. London is creating a sterling-denominated commercial paper market to increase the ability of the City to compete against other financial markets. Chancellor of the Exchequer Lawson announced last week that the Banking Act will be amended to exempt commercial paper from the government's definition of a deposit to allow more companies to raise funds directly from lenders. Previously, only commercial banks were permitted to borrow directly. To protect investors, the government will restrict borrowers to large companies listed on the London Stock Exchange and to firms with assets of at least $78 million. British financial institutions believe that companies in need of short-term funds will no longer find it cheaper to borrow in US markets. British economists are concerned that changes in the government's monetary policy will be harder to discern because commercial paper, unlike bank lending, will not be part of sterling M3. 25X1

Global and Regional Developments

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USSR To Develop Nicaraguan Banana Fields

Moscow reportedly offered to provide all necessary financial and technical assistance to double Nicaragua's banana acreage, according to Embassy sources. the USSR has already informed Colombia and Ecuador it will end banana purchases from them in the near future. Once the $25 million investment becomes productive—in a minimum of two years—funds from banana sales are likely to be applied against Nicaragua's large and growing debt with the Soviets. Nicaragua's banana production has declined one-third since the Sandinistas nationalized the Standard Fruit plantations in 1981-82. Government figures indicate banana production will fall again this year. 25X1 25X1 25X1

Argentine-Soviet Trade Developments

Argentine officials are working to fulfill their promise to import $500 million in Soviet goods over the next five years. Buenos Aires recently contracted to purchase Soviet turbines for a hydroelectric project, the state-run gas company has already received Soviet-made jeeps and trucks In addition, evidence mounts that the USSR is a front-runner in bidding to dredge the port of Bahia Blanca. Moscow is responding positively to Buenos Aires's efforts. For example, the two countries recently announced several joint mining ventures, with Soviet investment to run between $5-20 million in each project. Moreover, the Soviets have agreed in negotiations on a bilateral fishing pact to purchase Argentine processed fish products equal to 20 percent of the Soviet catch from Argentine waters, and to allow an Argentine official on board each vessel to verify compliance. We believe that these commercial ventures will continue as long as both sides find them mutually advantageous, but that spillover into the political sphere will be minimal. 25X1 25X1 25X1

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Hong Kong Textile Firms Moving to Western Europe

A number of Hong Kong textile firms are moving their operations to the United Kingdom and Ireland to take advantage of industrial development incentives and to escape US quota restrictions and EC duties. Three textile firms have relocated to northern England and one to Ireland, and four others are looking for plant sites. In one case, a company received a British Government grant that covered 40 percent of its capital requirement, allowing it to establish a plant equipped with 40 Japanese-made knitting machines while laying out only $3 million of its own. While production costs—particularly for labor—in Britain and Ireland run 30 percent higher than those in Hong Kong, they are offset by the benefits from circumventing quota restrictions. In addition, Hong Kong manufacturers see overseas production bases as a means of diversifying their assets before the colony reverts to Chinese sovereignty in 1997.

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National Developments

Developed Countries

Diet Debates Japanese Aid Policy

Japan plans to double economic aid outlays by 1992, but recent Diet debates suggest that disbursements to countries of strategic interest to the United States will not be as large as earlier implied.

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Tokyo generally will not extend new yen loans to countries in the process of debt rescheduling. Thus, many Central and South American countries will probably receive only minimal amounts of aid from Japan.

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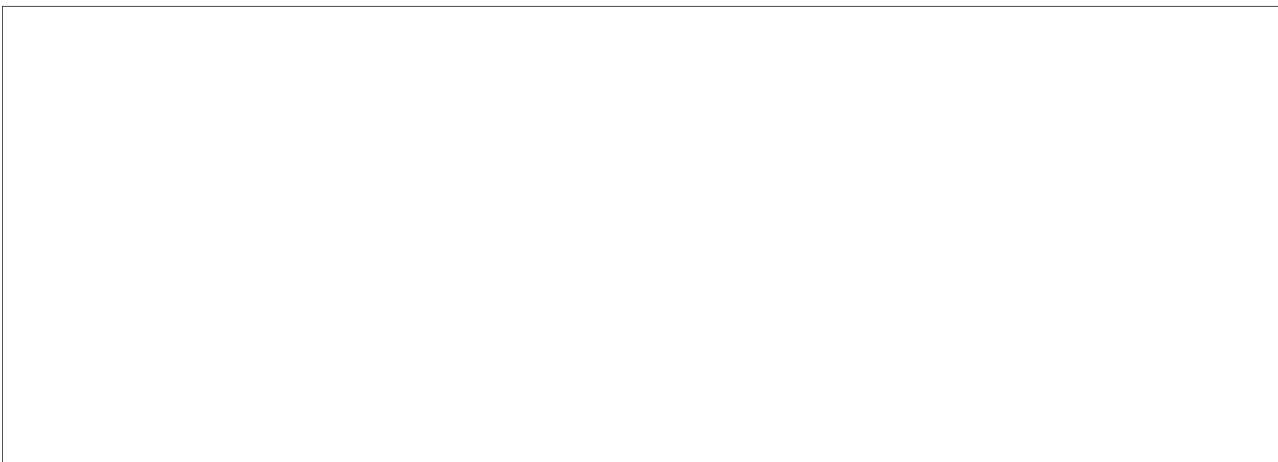

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West German Economic Forecasts

West Germany's five major economic institutes released their joint economic forecast shortly before the Tokyo Summit. The institutes foresee real GNP growth of 3.5 percent this year compared with 2.4 percent in 1985, consumer price inflation of only 0.5 percent in 1986, and a record current account surplus of 60 billion DM ($27 billion at 2.2 marks per US dollar). The report warns, however, that the low inflation rate may be the temporary result of deutsche mark appreciation, and cautions the Bundesbank to avoid overshooting its monetary targets, as it did during the first quarter. They also urge the Bundesbank to resist international pressures to cut interest rates. The institutes praise Chancellor Kohl for cutting government indebtedness, although they chastise the coalition for not implementing subsidy reductions or tax reform. Coalition spokesmen are citing the institutes' report as vindicating the government's policies.

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Belgian Steel Industry Continues To Lose Money

The continuing poor performance of the government-owned Cockerill-Sambre steel company is complicating Brussels' efforts to reduce the large budget deficit. The company lost $133 million last year and is predicting it will lose an additional $100 million in 1986. The Walloon steel industry has undertaken a major restructuring to improve its financial picture and reduce its dependence on financial support from Brussels. Thus far, the work force has been reduced by 5,000 people, mostly by early retirement, with an additional 2,000 expected to leave the industry this year. Continuing financial losses will increase pressure for even more drastic work force cuts. This, however, would add to the burden on government finances, because Brussels pays the social security costs of the early retirees. The government probably will resist calls to increase financial support for Cockerill-Sambre and press the industry to continue with its restructuring program.

25X1

Budget Troubles Await New Norwegian Government

Budgetary problems caused by declining oil prices—oil revenues could be cut by more than half this year—have already helped to bring down Norway's center-right government and could shorten the life of the Labor government that took office last week. Conservative Prime Minister Willoch resigned after losing a vote of confidence when the Progress Party—on whose support the coalition relied—refused to accept a modest tax increase and sided with Labor, who wanted the new taxes to be borne only by wealthier individuals. A flurry of krone speculation prompted the new Brundtland government to devalue and also announce intentions to impose fiscal and monetary austerity. The announcement is probably intended to help stabilize the financial markets, and the minority government may still search for policies more to its liking that will pass Parliament. Brundtland will at least try to make the tax system more progressive, but the Conservatives will challenge any proposals that are not broad based enough to address the oil revenue decline. Thus the Brundtland government may find as many obstacles to implementing new fiscal measures as did the preceeding government.

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Austria To Cut Federal Spending

Finance Minister Vranitzky wants to slash the federal budget deficit by 40 percent over the next five years, reducing it from its current 4.7 percent of GNP to 2.8 percent. For starters, he has ordered all federal ministries to cut 20 percent from their 1987 budgets. Because entitlement programs, research, and environmental expenditure are exempt, the move will yield less than a 3-percent reduction in spending. To meet the longer term goal, Vranitzky says entitlement programs also will have to be looked at—specifically agricultural subsidies and social security. Debt service is consuming a rapidly increasing share of federal spending—over 20 percent last year—and Vienna's room for fiscal maneuver is disappearing. Political observers suspect that Chancellor Sinowatz's socialist-liberal coalition may be planning a fall election and wants to fend off opposition criticism of the deficit. The government probably will await the outcome of the second round of the presidential election on 8 June before deciding on the timing of the parliamentary election, which must be held by April 1987.

25X1

Dim Economic Outlook for Northern Ireland

Economic prospects for Northern Ireland are worsening amid fears that violence will heat up again over the summer. The US Consulate in Belfast reports that bankruptcies for the first quarter of 1986 were up 30 percent over the same period last year. March unemployment, though down slightly from the previous month, was 21.4 percent. A recent survey indicates that business confidence has plummeted with the uncertain political climate, making it extremely difficult to attract outside investors. British and Irish officials almost certainly will point to the fragile economic situation to press Washington to continue encouraging US investment in Northern Ireland. They also will push Washington to move more quickly on its proposed aid package and to attach as few strings as possible. The British, in particular, will cite stringent requirements proposed by Congress, such as the need to hire a minimum percentage of Catholics workers, as major disincentives to foreign investors.

25X1

Israeli Cost-of-Living Agreement Signed

The Manufacturer's Association and Histadrut, the national labor federation, signed a new two-year cost-of-living adjustment (COLA) agreement on 4 May. The previous accord—negotiated in July 1985 as part of the government's austerity program—provided for an 80-percent adjustment for increases in the consumer price index. Under the new accord, wages will be adjusted on a sliding scale of between 70 and 90 percent, dependent upon the inflation rate. If inflation remains relatively low—in the current range of 1 to 3 percent per month—the new contract will reduce the frequency and amounts of wage adjustments. The government plans to extend the new COLA agreement to the public sector and to workers not otherwise covered.

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Less Developed Countries

Mexico's Trade Performance Weakens

Mexico City's trade surplus during the first quarter of 1986 was about 60 percent lower than for the same period in 1985, according to preliminary Mexican statistics, dropping from about $2.5 billion to less than $1 billion. Most of the decline was caused by the more-than-50-percent reduction in petroleum export revenues—from about $4 billion to less than $2 billion—since early last year. As a result, total exports dropped by one-third, from $5.7 billion to $3.9 billion, more than offsetting the 10-percent drop in imports due to a slackening in public-sector purchases.

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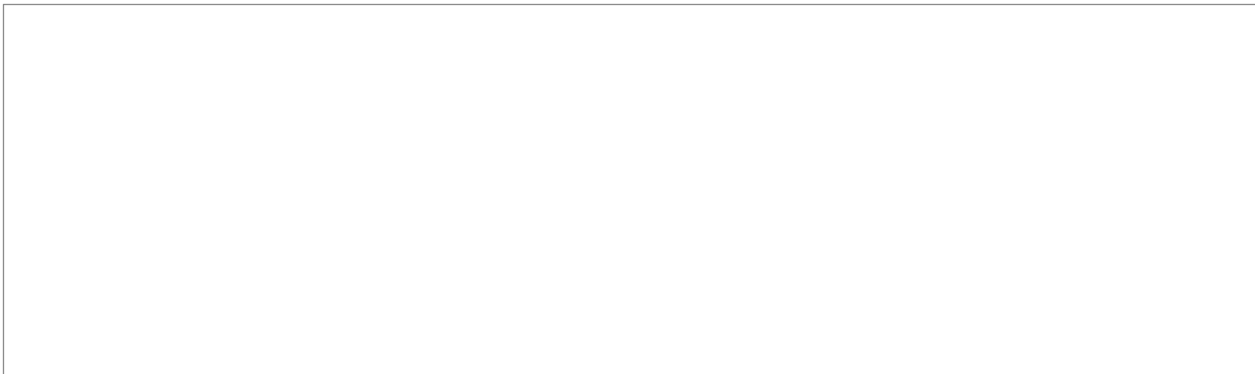

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Morocco's Value-Added Tax Troubles

Morocco's controversial value-added tax has already run into problems. The tax was introduced on 1 April as a replacement for fraud-ridden taxes on goods and services. The primary point of resistance is wholesalers, who until now paid taxes only on notoriously underdeclared profits. Many wholesalers are slowing their activities in protest, causing serious problems for manufacturers, whose stocks are piling up. Moreover, Rabat has done little to provide technical guidance on VAT procedures, which is hurting compliance by those wholesalers willing to accept the tax. The lack of independent qualified accountants is complicating matters further. Anticipated dramatic wholesale and retail price hikes, however, have yet to materialize—to the relief of the Hassan government. Many government officials had worried that any increase in inflation, coming on top of an already-declining standard of living, could provoke unrest.

25X1

Nigerian Economic Policy Under Pressure

Financial officials, after talks with commercial and official creditors, told the ruling military council last week that Lagos cannot obtain adequate debt relief unless it devalues the currency and obtains an IMF agreement, according to a source of the US Embassy. Other Embassy sources reported last month, however, that President Babangida fears he could not survive the political consequences of a devaluation.

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Deteriorating oil revenues and the poor prospects for a quick debt rescheduling may provoke a comprehensive reassessment of economic policy. Lagos has launched several abortive reforms in the past, however, and there is

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little evidence that it has the requisite political will to change course. Whether or not the government decides to pursue the recommended policies, debt payments will probably slow significantly and a sharp economic downturn is likely.

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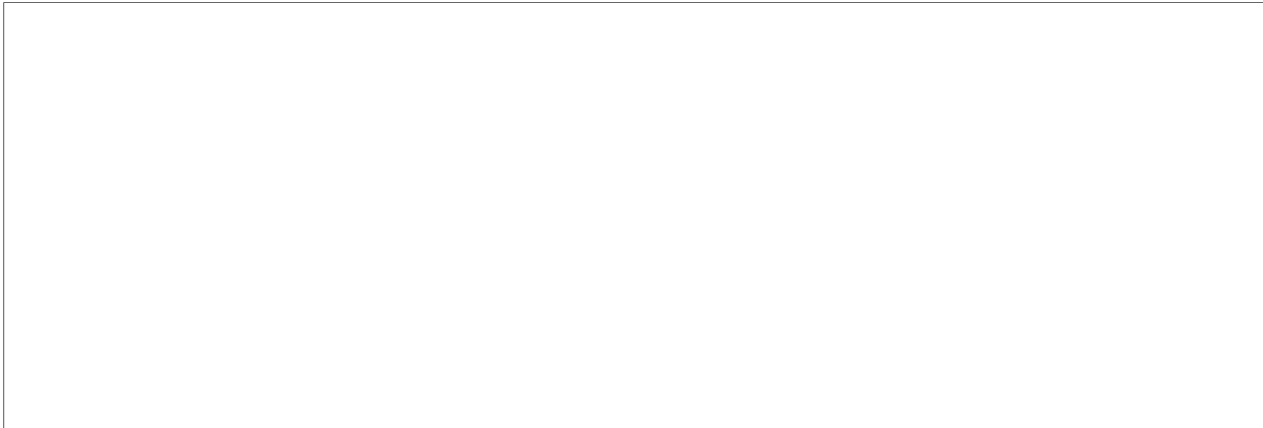

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Indonesian Export Promotion Efforts

In the face of sharply depressed oil export revenues and a widening current account deficit, Coordinating Minister for Economics Ali Wardhana last week announced a new economic package designed to boost nonoil exports. The most significant element allows export-oriented producers—those exporting at least 80 percent of output—to purchase locally produced raw materials at international prices or to import such raw materials without restrictions. We believe this represents a dramatic concession by the government—import barriers have traditionally raised raw material costs so high that many Indonesian firms could not export. Nevertheless, overall improvement in nonoil export growth is likely to be limited in the short term because corruption and other market distortions remain a significant and costly impediment to improving competitiveness.

25X1

Indonesia To Boost Plywood Exports

According to projections by APKINDO, the Indonesian Wood Panel Association, exports of plywood will exceed $1 billion in 1986—up from $796 million last year when they accounted for about one-fifth of nonoil export earnings. This reflects Jakarta's efforts to boost these earnings in the face of sharply lower oil revenues. According to US Embassy reporting, the optimistic forecast is based upon a recently revised plywood export allocation system and on increased overseas marketing efforts by APKINDO. Producers failing to meet government requirements to process domestic raw materials to increase domestic value added will now lose their export quotas to other firms. In addition, beginning 1 July, changes in plywood export price quotations will eliminate excessive price cutting among Indonesian exporters. According to APKINDO, this will encourage producers to pool their exports into larger shipments, which could reduce freight costs by up to $5 per cubic meter, thereby boosting cost competitiveness and revenues.

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Taiwan Shipyards Use Wrong Materials

The state-owned China Shipbuilding Corporation (CSBC) has admitted using the wrong steel plate in the first three 39,000-deadweight-ton containerships of an eight-ship order from Yangming Marine Transport Corporation. Although CSBC has offered to reinforce the ships at the cost of less cargo capacity, the shipping firm has refused delivery unless CSBC offers a 20-percent reduction in price. The buyer, which could have gotten the ships cheaper from Japan, bought from CSBC at the insistence of central authorities concerned about unemployment levels at Taiwan's shipyards. Because the first ship is scheduled to begin service on 2 June, a resolution of the problem will probably come soon. Nonetheless, CSBC—which has been operating in the red for several years—will lose money on the deal. In addition, Taiwan has criticized the US firm—hired by Yangming to certify that the ships were built to international standards—that failed to notice the mistake.

25X1

Communist

Reorganization of the Soviet Construction Sector

An official of the State Committee for Construction Affairs (*Gosstroy*) has confirmed to Embassy officials that changes in the construction sector are pending. As opposed to a new "superministry" like the recently created State Committee on the Agro-Industrial Complex, the change would include giving more power to *Gosstroy*. Indications are that this change will go into effect in September, the same time a new chairman of *Gosstroy* is expected to be named to fill the four-month-old vacancy. The failure to name a successor had led to speculation that a reorganization was in the works. Moves toward consolidating the construction sector would underscore the need for improved quality and timeliness in the sector's performance to support Gorbachev's industrial modernization plans.

25X1

Soviet Timber Ministry Criticized

A recent joint meeting of the Supreme Soviet commissions on industry and environmental preservation sharply criticized the Ministry of Timber, Pulp and Paper, and Wood Processing Industry for failures to meet production goals and improve resource conservation. This is but the latest in a series of criticisms leveled against the industry since last September and reflects mounting pressure to meet the large domestic demand for timber and paper products as well as export commitments. While timber production and deliveries increased in the first quarter of 1986, much of the gain is attributable to the mild 1985-86 winter. Minister Busygin has been severely criticized in the past, and—given the current hard currency shortage—the industry's failure to meet targets and earn more hard currency from exports could result in his ouster unless he takes action.

25X1

Chinese Barter for Italian Auto Plant

The China National Automobile Industry Corporation reportedly has signed a contract to swap commodities and handicrafts for a Fiat turnkey automobile plant to produce small passenger cars, presumably for the private sector. Because China apparently has problems letting foreign investors make money,

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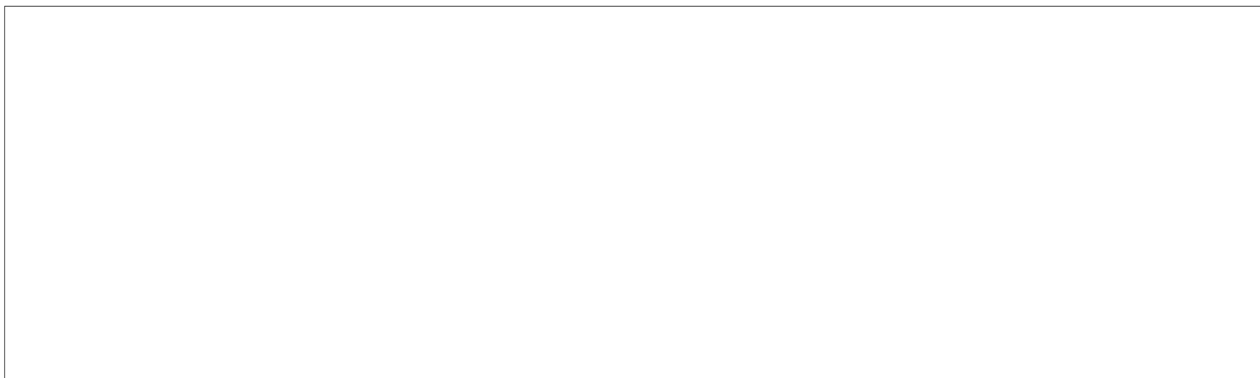
let alone take it out of the country, the Italian firm apparently agreed to accept goods in lieu of hard currency in the hope of penetrating the China market. And, unlike the auto plants built with US, French, and West German assistance, [redacted] the Fiat deal makes no mention of a percentage of production earmarked for export. The countertrade appears especially attractive to Beijing because foreign exchange restrictions have limited the purchase of US parts by the US-PRC joint venture jeep plant, causing a two-month production shutdown. However, the Fiat deal may never reach fruition because the central government—concerned about its already overcrowded roads—may restrict private ownership of cars. [redacted] 25X1

Chinese Nuclear Ministry Consolidating Control

In a move aimed at boosting the authority of the Ministry of Nuclear Industry (MNI) over Chinese nuclear development, Beijing has made MNI's Vice Minister for Research and Production, Zhou Ping, full-time executive officer of the Nuclear Power Leading Group—a key position for the implementation of China's nuclear power policies. The Leading Group coordinates nuclear policy under the direction of the State Council, China's highest level of government. Zhou's appointment will give MNI more bureaucratic power to enforce its decisions over other nominally equal ministries such as the Ministry of Water Resources and Electric Power (MWREP), MNI's longtime rival in the nuclear power field. Zhou's transfer underscores Beijing's determination to change the direction of its nuclear energy program away from imports of advanced Western technology toward small, locally produced, relatively inexpensive nuclear power plants. Zhou's appointment should smooth the transition as MNI absorbs MWREP's former responsibilities in China's nascent nuclear power industry. [redacted] 25X1



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