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International Economic & Energy Weekly

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Perspective

Foreign Reaction to the New US Farm Program 25X1

Widespread foreign criticism of the 1985 US Farm Bill has centered on the $1 billion, three-year export enhancement program (EEP), and several countries are considering retaliation:

- The strongest reaction has come from the European Community, with Brussels particularly condemning targeted export subsidies under the EEP. France and the United Kingdom especially fear loss of traditional markets and escalation of a costly subsidy war among the major grain exporters.
- Thailand has protested that it will lose up to 40 percent of its rice export market this year, although the US Embassy has recently estimated a more moderate 10-percent loss.
- Buenos Aires believes aggressive US exports through lower prices and the EEP will seriously damage Argentina's grain exports this year.
- Uruguayan rice growers claim below-market US prices will cause irreparable damage to their rice industry by taking away markets in Peru and Brazil.

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Some US competitors have launched efforts to counteract the bill's effects. The EC will continue its aggressive marketing policies designed to match or undercut US export prices, and Canada and Australia have increased subsidies on their recent wheat exports to India and the Middle East. 25X1 25X1

Although the US legislation is only one factor influencing the world market, sharply lower US export prices for rice, wheat, and coarse grains and broader use of export subsidies to stimulate grain sales will almost certainly weaken world grain prices this year. According to industry analysts, changes in US agricultural policy could drive prices down 20 to 25 percent below last year's depressed levels and keep them low for at least the next two years.

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Large grain buyers such as Japan and the USSR will benefit from reduced import costs. Moscow has stated that exclusion from the EEP is an obstacle to their purchasing more US wheat. The USSR is obligated to purchase an additional 3 million metric tons of US wheat to fulfill the terms of the US-Soviet Long-Term Grain Agreement. As a result of favorable domestic production forecasts, the Soviets will undoubtedly fall short of this target. Nonetheless, we estimate that, because of lower US prices and the higher quality grain available only in the United States, they may buy an additional 200,000 tons in the next three months. Despite the recent fall in US prices, aggressive sales tactics by other major wheat exporters will continue to undercut US export competitiveness. 25X1

The Farm Bill is thus likely to increase tensions in relations with our allies and key LDC grain exporters but also will provide the United States negotiating leverage during upcoming GATT talks. Major grain exporters—including the EC, Canada, Australia, and Argentina—may see a severe drop in export revenues since global import demand is not expected to rebound substantially in response to the lower prices. Those without massive income and export subsidy programs to benefit farmers—notably Australia, Canada, and Argentina—will be hardest hit. Farmer unrest in these countries could escalate, magnifying this year's pattern of farm strikes and demonstrations. With other competitors such as Thailand, disputes over grain markets could complicate US initiatives in different areas, such as narcotics control. [redacted] 25X1

Increases in EC budget costs because of the US Farm Bill may push the EC toward addressing agriculture more broadly in a new GATT round of trade negotiations. Lower world prices could add at least $1 billion to EC export subsidy costs this year, according to State Department analysis. The looming budget crisis will make it increasingly difficult for the EC to match US export subsidies and will probably induce the Community to consider reforms. Although the EC is unlikely to allow a GATT round to substantially alter its protective Common Agricultural Policy, some changes, such as reductions in export subsidies, might become more likely, but only if domestic price supports in other countries are also discussed. [redacted] 25X1

[redacted] 25X1

Thai Rice Exports: Concern Over the US Farm Bill 25X1

Thai concerns about the negative effects of recent US farm legislation on Thai rice export earnings are causing tensions with the United States that could complicate US initiatives in a number of areas, including narcotics control and the new GATT round. Bangkok is accusing Washington of unfairly subsidizing US rice exports under the 1985 US Farm Act, depriving Thailand of at least $60 million a year in foreign exchange earnings. In fact, much of the recent decline in Thai rice earnings stems from weak demand and exportable surplus of lower quality rice—where the United States is not a major competitor. Thailand, the world's largest rice exporter, has not launched a major export subsidy program in response, but it has undertaken other efforts such as reducing export taxes to counter the Farm Bill's impact. Although the new US rice export policy is only one factor influencing the world market, Bangkok will probably continue pressing the US rice issue in international trade meetings and in bilateral forums.

Downward Trends

While world rice production has risen by 24 percent in the last five years, the amount traded internationally has fallen by about 1 million tons. Stockpiles amount to a record 24 million metric tons—about 8 percent of annual world consumption, according to USDA estimates. Total world rice export earnings fell by one-half during 1982-84, largely as a result of declining prices and reduced export volume, according to World Bank estimates, as big importers such as South Korea and Indonesia became self-sufficient and world recession reduced demand. By the end of June this year, the benchmark Bangkok price had fallen to $226 per ton from a high of $633 per ton in 1981.

Declining rice export earnings in recent years have thus spurred Thailand — along with other exporting countries—to explore innovative tactics for selling surplus stocks. Bangkok has boosted sales in traditional US markets with improved quality, low prices, government-to-government and barter arrangements, and aggressive marketing campaigns. The Thai effort has recently been complicated, however, by the US "marketing loan" program launched in April. Mandated by the 1985 Farm Bill, the new program allows farmers to repay government crop loans at prevailing world prices. Largely as a result of the program, US rice prices have fallen by more than one-third since the program was launched, according to the USDA, narrowing the gap with Thai prices to about $65 per ton. Prices have stabilized in recent weeks and the USDA expects them to remain level for the rest of the year. 25X1

Thai Response and Options

The decline in the rice market has considerable political and economic implications for Thailand. Although diversification had reduced the share of rice exports in total Thai agricultural exports, rice still provides jobs for more than one-half the Thai population. In addition, vested interests in the Thai rice trade continue to play a powerful political role in the country. 25X1 25X1

Faced with strong domestic protests from the politically powerful rice trade interests, Thai officials have reacted to stiffer US competition in international rice markets by:

- Launching a lobbying campaign against the marketing loan program, both within the United States and among other grain exporters such as Australia, Uruguay, and Canada.
- Making plans to buy 200,000 tons of milled rice to boost domestic prices. 25X1
- Removing most export controls on rice, such as stockholding requirements and export taxes.

World Rice: Production, Consumption, and Trade, 1975-86

Million metric tons

	Production	Consumption	Exports			
			Thailand	United States	Other	Total
1975	332.0	228.2	0.9	2.1	4.3	7.3
1980	378.6	262.6	2.7	3.0	7.0	12.7
1981	398.9	272.3	3.1	3.0	7.0	13.1
1982	412.7	281.5	3.6	2.5	5.7	11.8
1983	419.5	289.6	3.7	2.3	5.9	11.9
1984	452.7	308.1	4.5	2.1	6.0	12.6
1985	468.0	314.0	4.0	1.9	5.6	11.5
1986 [a]	463.9	313.6	4.3	2.2	5.5	12.0

[a] Forecast as of 7 July 1986.

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- Offering to arrange government-to-government barter deals, for example, Brazilian tractors for Thai rice.

Bangkok's room for maneuver, however, is constrained at least in the near term. While farm supports are an attractive option at a time when Thailand is beginning to profit from the declining cost of oil imports, according to Embassy reports, the expense of such an operation would strain Thai resources. Furthermore, declining rice revenues argue against encouraging increased production, because farm prices for rice barely cleared production costs in 1985, according to Embassy reporting.

Outlook and Implications

Prospects for an upturn in the world rice market are not good. World rice trade is expected to amount to only about 12 million tons this year, according to USDA estimates, only 4 percent above the very low level of 1985. The volume of Thai rice exports will be up this year by 300,000 to 400,000 tons, according to recent Embassy reports, because of significant increases in purchases from Brazil and Iran. However, continued price declines for lower quality rice and the probable loss of market share in high-quality markets in Western Europe are likely to result in rice earnings lower than the $825 million achieved last year.

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Over the longer term, most experts agree that a world rice glut is building, with no relief in sight for at least five years. Former importers such as Indonesia, India, South Korea, and the Philippines are now self-sufficient and may develop their own surpluses. Although Brazil plans to double purchases this year to nearly 1 million tons, policy shifts are already under way aimed at boosting rice production and regaining self-sufficiency. Falling oil prices will intensify cutbacks in rice imports by the Middle East and other oil-exporting countries, such as Nigeria.

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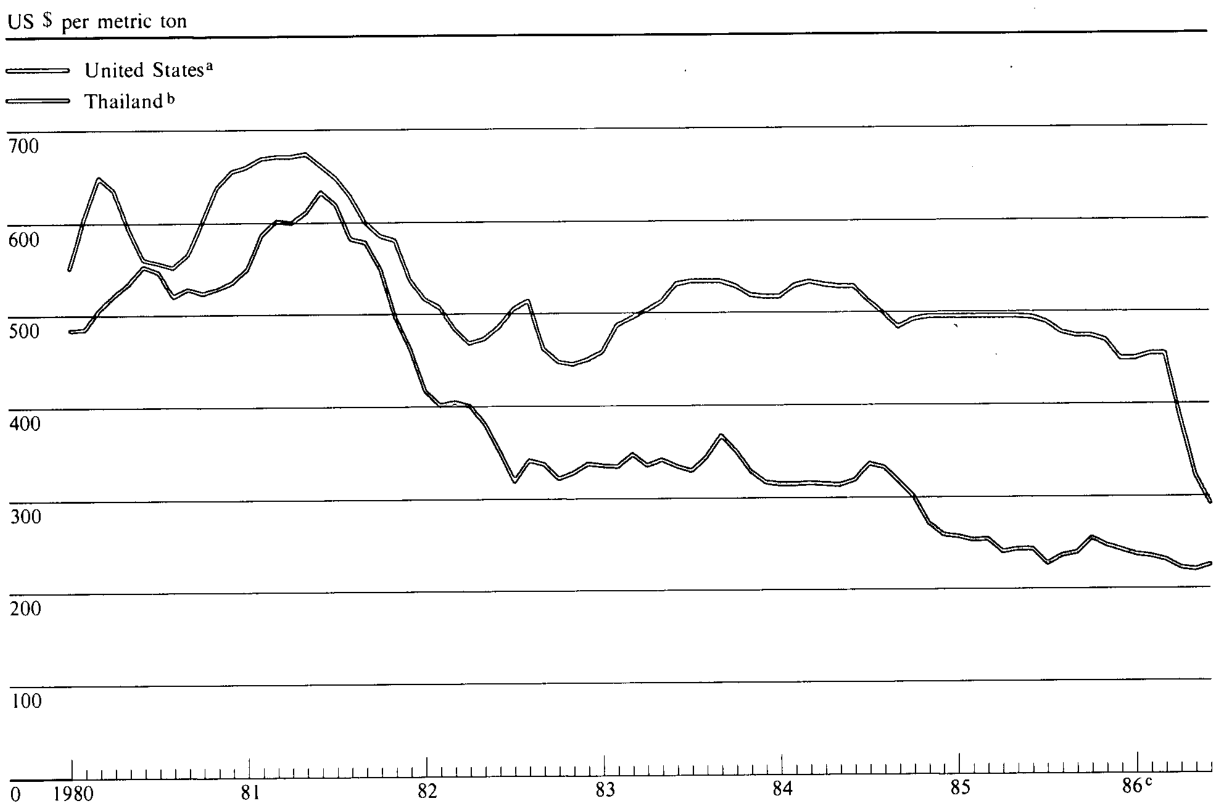
Although the new US export policy is only one factor influencing the world market, Bangkok will probably continue pressing the US rice subsidy issue in international trade meetings and with Washington. Bangkok has gained support from some grain exporters, such as Australia, though its complaints so far have failed to evoke a significant

Thailand and the United States: Monthly Average Rice Prices, 1980-86



[a] Number 2, Milled, 4-percent c.i.f. Rotterdam.
[b] 100-percent grade B c.i.f. Rotterdam.
[c] January through June.

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response from other US competitors, such as Pakistan, China, and Burma. The Thais will host a conference of "nonsubsidizing agricultural exporting nations" in Pattaya on 22-24 July, where the rice issue will be a featured agenda item. Invitations to the meeting have been sent to Australia, Hungary, Argentina, Uruguay, Brazil, Colombia, Chile, Canada, Indonesia, Malaysia, New Zealand, and the Philippines.

More generally, if the US-Thai rice issue remains heated, it may begin to erode Thai cooperation with the United States on issues such as Cambodian refugees and narcotics. Within Thailand, the US Farm Bill—coupled with proposed US legislation potentially damaging to Thai trade interests, such as limits on textile imports—remains a politically contentious issue. If Bangkok does not mount a costly effort to subsidize exports any time soon,

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Thailand: A Model of Agricultural Diversification

Despite its concern for rice export earnings, Thailand has the most diversified agricultural sector in Southeast Asia. Its total agricultural exports are worth about $4 billion annually, about 60 percent of total exports. Both agricultural and total export earnings have expanded significantly in recent years, fostered in part by a dramatic change in the composition of Thailand's major exports. As recently as the mid-1960s, rice accounted for about one-third of total exports and over 50 percent of agricultural exports. In 1985 rice accounted for less than 12 percent of total exports, but earned more than $800 million, more than three times the level of the mid-1970s. Over the last decade, however, nontraditional exports such as tapioca products, corn, sugar, fruits, and seafood—along with manufactures—have fostered significant earnings growth and have laid the foundation for a broader, more stable Thai export base. [redacted] 25X1

The government and the private sectors have played complementary roles in this expansion. The government has contributed by constructing roads and irrigation systems and developing high-yielding crop varieties. In the private sector, [redacted] *farmers and traders have responded quickly to favorable world market opportunities.* [redacted] 25X1 25X1 25X1

opposition forces may try to exploit resulting farmer discontent. There are also indications that the USSR, which has increased purchases of Thai rice in recent months, may attempt to exploit US-Thai trade friction. According to press reports, Moscow has offered to barter technology for rice and has attempted to depict the United States as responsible for Thai rural poverty. [redacted] 25X1

[redacted] 25X1

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Thailand: Easing of Austerity After Election Likely [redacted] 25X1

Despite the lack of debate over economic issues preceding the election on 27 July, we believe the next government—whatever its composition—will move to ease the unpopular two-year austerity program. A consensus has developed among Thailand's major parties that the recent fall in world oil prices provides an opportunity to compensate for the effects of depressed commodity prices and austerity that have widened economic disparities among important domestic interest groups. As a result, we believe the new government probably will begin to stimulate the economy while making little headway on economic reform. This, however, may threaten Thailand's recent progress toward financial stability and intensify the concerns of its international creditors. [redacted]

Economic Pressures Building

Political observers expect the biggest winners in the balloting—and the key parties in the new coalition—will be the Democrat Party (DP) and the Thai Nation Party (TNP). Most likely, Prime Minister Prem, who has been in office since 1980, will head the new coalition government. The DP favors increased development spending and government stimulation of the economy, while the TNP advocates a freer hand for the private sector and relies on business interests for much of its political strength. Whatever the outcome of the election, major financial problems await the new government:

- A government budget deficit, that has been stuck at almost 5 percent of GDP since 1984.
- With over $18 billion in foreign debt, debt-service costs are now nearly 25 percent of the budget and likely to rise, [redacted]
- Trade-related problems probably will rein in Thailand's current account receipts for the rest of the decade. We expect prices to remain depressed for the country's major commodity exports, especially rice. Rising protectionism in the developed countries threatens diversification into manufactured exports. [redacted] 25X1

As a result, Thailand faces another year of modest growth by its own standards. Government economists recently revised their forecasts slightly upward, largely on the strength of the decline in the price of oil, which comprises nearly one-fourth of Thai imports, and we expect that real growth will remain in the 4- to 5-percent range through 1987. This would be a far cry from the 8- to 10-percent annual rates of the late 1970s. [redacted] 25X1 25X1

After the Election

We believe that any new government will ease austerity, despite the large budget deficit, and begin stimulating the economy in response to the spending demands of businessmen, farmers, and military leaders who are, [redacted] 25X1
[redacted] all increasingly frustrated by conservative economic policies. 25X1 As a result of the decline in oil prices, demands for more government spending are probably too politically attractive to be ignored, according to the US Embassy. The biggest hitch in this likely scenario is whether Finance Minister Sommai—the architect of the austerity program who has hinted he may retire—will remain in the government. With Sommai, whose toughness is well respected among international bankers, the government probably could successfully manage higher spending while retaining the confidence of its major international creditors. Without Sommai, however, we believe the government is less likely to keep the budget deficit to a level acceptable to its 25X1
lenders. [redacted] 25X1

There are several likely areas for increased spending:

- *Introduction of commodity price supports.* Such a program probably would benefit only middlemen and fail to encourage needed diversification out of rice production.

- *Subsidized interest rates to the housing sector.* While boosting the depressed housing sector, this would divert funds from other more productive sectors.

- *Revival of the eastern seaboard industrial development program.* Critics argue that the $4-5 billion program has too low an economic return and could add substantially to the worrisome debt problem. [redacted]

Important economic reforms, that in our judgment would greatly improve Thailand's growth potential over the near term, are likely to make little headway under the new government. For example, reform of deficit-plagued public enterprises—the most inefficient sector of the Thai economy—will suffer because of the political power of military board members, public enterprise bureaucracies, and public-sector unions. Moreover, an outmoded tax structure that limits Thailand's ability to compete in world markets might also elude further reform under the next government. In the financial sector, however, the new government will be under pressure to implement effective banking regulation in the wake of last year's highly publicized bank failures. [redacted]

The Danger Ahead

We believe any move by the new government to stimulate the economy will raise concerns among international creditors about the competency of economic management and about Thailand's ability to handle its outstanding debt. [redacted]

Longer Term Economic Concerns

Low savings and investment rates. *Inadequate domestic savings, from which the government finances most of its budget deficit, are straining the economy through high interest rates and a growing debt service burden. The US Embassy reports that Thailand invested roughly 21 percent of its GDP last year, down from 28 percent in the late 1970s, and the savings rate is similarly down,* [redacted] 25X1 25X1

Inadequate and inefficient tax structure. *Heavy indirect taxes, which provided over three-fourths of all government revenue in 1984, encourage inefficient import substitution and discourage manufacturing for export. Tax evasion is widespread, with almost half of all corporations declaring losses for tax purposes,* [redacted] 25X1 25X1 25X1

Depressed farm incomes. *The agricultural sector contributes one-fourth of Thailand's GDP. The third year of buoyant crop production in Thailand pushed wholesale agricultural prices down almost 9 percent in 1985. Rapid expansion of land under cultivation has forced new farmers onto increasingly marginal land, while lack of modern farm technology has resulted in soil depletion, growing environmental and irrigation problems, and agricultural yields among the lowest in Asia, according to the US Embassy.* [redacted] 25X1

Growing unemployment. *Total unemployment, including underemployment, is currently about 7 percent, and some foreign observers believe it may reach double digits by 1990. We believe that economic growth would have to be accompanied by reform of Thailand's education system to alleviate the long-term unemployment problem.* [redacted] 25X1 25X1

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[redacted] international commercial banks now consider medium- and long-term lending to Thailand to be a high risk. Most banks, moreover, have reduced their medium-term exposure in Thailand in the last two years, troubled by apparent instability, falling commodity export prices, and a growing view that the Thai Government is fiscally irresponsible, [redacted]

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France: Modernizing the Financial Markets 25X1

The French Government over the past two years has engineered a near revolution of French financial markets. The final 18 months of the Socialist government—ending in March—saw an unprecedented freeing and rationalization of the markets that should improve their efficiency and the allocation of capital. These reforms will allow Paris to control the money supply through open market operations rather than quantitative credit controls. They should also better equip France to compete in worldwide capital market integration and bring the French financial system more closely in tune with that of the United States.

The Previous System

The French financial system traditionally has been heavily regulated and rigidly compartmentalized. Three distinct submarkets—a money market, a mortgage market, and a securities market—operated under different rules and the rates charged different borrowers varied greatly. In addition, credit controls, fixed fees, and regulated interest rates destroyed competition among banks and brokers, raising the cost of financial operations and reducing options for investors.

The absence of a unified financial system responsive to market forces also made monetary policy less effective. Because, at most, one-half of all credit was sensitive to market interest rates, large rate increases were required to stem the demand for credit—increases that threatened the solvency of many small and medium-sized firms. Consequently, monetary policy after 1972 relied mainly on quantitative credit controls imposed on a monthly, bank-by-bank basis with substantial penalties for banks exceeding the limit. The controls were inefficient, however, because some financial institutions were practically exempt, some forms of credit were only partially controlled, and the Bank of France was obliged to supply funds to refinance export credits at fixed rates, guaranteeing banks easy access to liquidity. 25X1

The Socialist Reforms

After decades of study and inaction by the right, it was ironic that a Socialist government began liberalizing the financial system. Under the direction of Finance Minister Beregovoy, the government in late 1984 began a series of financial reforms that together constitute an almost revolutionary change. 25X1
Most of the impetus for reform came from economic factors, although the desire to curb the monopoly powers and privileged position of banks also played a role. In addition to seeking greater capital market efficiency, the government recognized that without modernization France would be left far behind in the competition for international financial business. Moreover, the Socialists realized that streamlining 25X1
French financial markets would aid in the fight against inflation and might also lower the government's own substantial financing costs.

New Financial Instruments. One of the focal points of the Beregovoy reforms was the creation of new 25X1
financial instruments, particularly in the short-term market, to better suit the needs of both investors and borrowers. This also tended to unify the market by allowing capital to flow more freely and efficiently. The chief reforms include:

- Opening a market in negotiable short-term government bills—initially with maturities of 2 to 6 years—and the creation of certificates of deposit for 6-month to 2-year terms, with negotiable interest rates for amounts greater than $750,000. Both measures will provide firms, mutual funds, and individuals with an important alternative to bank deposits, and the competition should help lower the cost of financing.

- Authorizing firms to issue commercial paper for 10- to 180-day terms, thus giving them direct access to capital markets and reducing their costs. A private credit rating agency, set up to evaluate the risks in this market, should help provide the public with more information about traditionally tightlipped French firms.

- Creating long-term, government-guaranteed, mortgage-backed bonds similar to Ginnie Maes. This should make more mortgage money available and increase the liquidity of financial institutions by allowing them to sell their real-estate-backed assets. It will probably also give a boost to the beleagured French construction industry. [redacted]

Deregulating Financial Markets. A second goal has been to relieve financial institutions of burdensome regulations, allowing them to operate more efficiently and respond more easily to competition. Among the major reforms in this area are:

- Easing foreign exchange controls to permit more French foreign investment, to give French firms more flexibility in their international operations, and to allow them more leeway to hedge against foreign exchange risks.

- The creation of a financial futures market that will enable companies to protect themselves against changes in interest rates.

- The introduction of negotiable bank fees and brokerage commissions to increase competition and reduce charges to customers.

- The opening of a limited morning trading session on the Paris stock exchange, as a step toward a system of continuous trading. Related stock exchange reforms include authorizing brokers to become market makers by trading on their own accounts and holding inventories and the creation of an unlisted securities market.

- Treating interest, dividends, and capital gains equally for tax purposes.

- Reducing the volume of government-subsidized loans—from $40 billion in 1984 to just over $30 billion in 1986.

- Allowing bond issues of less than $150 million without prior authorization to improve bond market access for small and medium-sized firms.

[redacted] 25X1

Improving Monetary Control. Beregovoy loosened the so-called Encadrement du Credit, or system of credit ceilings, and moved toward replacing it with a regulatory mechanism based on depositing reserves with the Bank of France. The object was to allow a greater leeway in lending and to permit more effective central bank control of the credit 25X1 base. In addition, the government imposed the same reserve schedule on all banks. Eventually, the Bank of France hopes to be able to transmit interest rate signals through its open market operations to control credit growth more quickly and effectively, although this may come at the cost of more short-term interest rate volatility. [redacted] 25X1

Outlook Under the New Government

The conservative Chirac government has taken some steps to continue the reforms begun under Beregovoy, notably the further easing of exchange controls. It has also abolished the much maligned *devise titre* system under which investors wishing to purchase foreign securities had to pay a premium for the necessary foreign exchange. Meanwhile, the Finance Ministry has announced that, barring an unexpected increase in inflation, it will abandon all quantitative credit controls by 1 January 1987. It has also expanded the maturities permitted for some bonds, commercial paper, and certificates of deposit, and has permitted banks to set their own hours. [redacted] 25X1

Prereform Barriers to a Dynamic Financial Market

- *About one-half of all French credits were subsidized through numerous channels at greatly varying rates. Housing and exporters, rather than industry, were the main beneficiaries.*
- *The medium- and long-term bond markets were regulated to keep interest rates low, and credit was rationed by a system favoring official or quasi-official borrowers. Since small- and medium-sized borrowers had little direct access to long-term credit, they were heavily dependent on bank loans.*
- *Monetary policy relied primarily on credit controls rather than reserve requirements and interest rates. Controls generally heavily penalized any bank growing faster than its allowed norm, preventing more efficient banks from growing relative to their competitors.*
- *The system created special deposit-taking institutions—the Post and National Savings Banks—that collected deposits and were required to lend them to special borrowers or to retail banks. This limited the access of some retail banks to low-interest funds and made them vulnerable to small interest rate changes.*
- *Most interest rates on deposits as well as banking and brokerage fees were regulated.*
- *Firms and individuals did not have direct access to the money market, but rather had to go through banks.*
- *Short-term government liabilities could be held only by banks. Financial markets were not innovative, and savings instruments for small savers were particularly limited.*
- *The Paris stock exchange was anachronistic, with prices being fixed once a day in a brief afternoon session, during which brokers matched buy and sell orders. In addition, brokers did not buy for themselves or keep inventories to make markets but only engaged in pure brokerage, which meant the market was thin and clumsy.* 25X1

Despite these initial steps and the free market rhetoric of the Chirac government, the continuation of the reform process is not assured, in our view. The controlled financial system in France was, after all, largely the ad hoc creation of previous conservative governments. Although we believe the conservatives will try to press ahead with financial deregulation, they may backtrack in the event of resurgent inflation or an otherwise deteriorating economic situation. A key indicator of the government's commitment to reform will be the speed with which it pushes denationalization and the extent to which it encourages the denationalized banks to take full advantage of the less restrictive operating environment. In addition, by further reducing subsidized credits and by announcing continued increases in reserve requirements, the Bank of France can signal its intentions to move toward a full dismantling of credit controls.

Ultimately, the new monetary control system will require greater day-to-day involvement by the Bank of France in managing the price of money through open market operations. The conservatives have already proposed a new charter for the Bank of France to grant it greater autonomy, and the issue is likely to be taken up by the National Assembly this fall. 25X1

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Central bank officials believe, however, that the new government will move cautiously toward an interest-rate-based policy out of fear of exacerbating the turmoil that bank denationalization is already likely to cause. Diplomatic reporting indicates that the French banking community is also

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skeptical that the right will entirely abandon all vestiges of quantitative controls, and fears that the government may fall back on controls as a safety net if the liberalization thus far appears inflationary. 25X1

Finally, for the modernization to continue and for Paris to compete internationally, the most pressing need now is for the locus of innovation to move from the government to the private sector. The financial sector has been so tightly controlled in the past that most bankers and brokers no longer think in terms of innovation, assuming the government will not allow it. The recent reforms and the election of a government committed to the free market may have brought a suitable environment for private initiative. If the new government reaffirms its commitment to reform and does not discourage innovation by excessive regulation, it will be a healthy sign for continued modernization and the emergence of Paris as a world-class financial center. 25X1

Overall, the financial reforms are likely to have a positive impact on the French economy. Although the French financial market is likely to experience growing pains as it adjusts to a more open regulatory environment, the reforms should lead to more efficient investment decisions and facilitate a more effective monetary policy. They will also make the French financial system more closely resemble that of the United States, and should help further capital market integration in the European Community. Over the long run, the reforms should help open the French economy to foreign investment and boost Paris's standing as an international financial center. 25X1

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China: Seeking Foreign Technology for Telecommunications 25X1

Acquisition of foreign equipment and technology is a key element of China's plans to modernize its inadequate telecommunications network. Over the last several years, China has sharply increased imports of telephone switching, fiber optics, and other equipment and production know-how. Japan has been China's major equipment supplier, but other countries are competing fiercely to expand their share of China's telecommunications market—often using low-cost financing to capture Beijing's business. Imported equipment will boost telecommunications services, particularly for the major cities and the energy sector, although we believe continuing problems in procuring and assimilating equipment and technology will slow the modernization.

Modernization Goals

China's outmoded and overworked telecommunications network is unable to meet rapidly growing government and commercial telecommunications needs. Beijing's goals for modernizing during the next five years are ambitious, especially compared to its recent achievements. China plans to expand and improve the telephone system, especially in key cities and coastal areas; upgrade and extend the entire network; and develop a domestic communications satellite network.

Acquiring foreign telecommunications equipment and technology is crucial to this modernization strategy. For example, China intends to use digital communications to meet its needs for high-speed data transmission and secure communications, but it produces mostly analog equipment. Although China's telecommunications research has progressed, China's ability to move from prototypes to volume production is poor because of equipment shortages, an unskilled work force, poor management, and lack of familiarity with sophisticated production processes. The sheer size of demand also dictates acquiring equipment and production capacity from abroad. 25X1

Improving the Telephone System

The waiting list for a telephone exceeds 200,000 nationwide, according to Chinese statements, and presumably would be even longer if applicants thought they could reasonably hope for installation. China intends to increase the number of telephones from about 5 million in 1985 (about one phone per 200 people) to 13 million in 1990 and 33 million in the year 2000, a significant investment of money, resources, and personnel. The addition of 28 million phones over 15 years would require, on average, almost 1.9 million installations per year—more phones than were installed over the past five years combined. We believe China exaggerated the improvements in its telecommunications network during 1981-85 and that plans for 1986-90 are beyond China's capabilities. 25X1

Technology Priorities and Acquisitions 25X1

China's strategy calls for advanced technology for priority needs and older systems for other requirements. Beijing is most interested in buying manufacturing machinery and know-how to improve its ability to produce its own equipment. Although some Chinese buyers are willing to purchase equipment for selected priority uses, Beijing underscored its emphasis on technology transfers in mid-1985 when it formally tied future purchases to technical cooperation. Priorities include advanced telephone switching, fiber optics, and satellite communications; China also wants pulse-code modulation, advanced microwave, and multiplexing technology. 25X1

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Telephone Switching. Although China claims it has begun producing an indigenous microprocessor-controlled switch, domestic production is largely

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limited to crossbar systems without stored-program controls. Two major agreements signed in the last several years with foreign suppliers—one, a joint venture with a Belgian subsidiary of ITT for the production of 300,000 lines of advanced switching systems annually—will greatly boost China's production capabilities. Press reports suggest China is interested in perhaps one other major purchase of switching technology. Canada, France, Italy, the Netherlands, Sweden, Switzerland, the United States, and West Germany have supplied telephone switching and related equipment and know-how. [redacted]

Fiber Optics. China has produced several dozen short, low-capacity fiber optic systems that are in operation in major cities, but we believe they are experiencing technical problems with higher capacity, single-mode optical fibers, transmission devices, and large-scale production. [redacted] In the past two or three years, [redacted] China has signed agreements with several foreign suppliers for high-speed 140-megabits-per-second fiber optics systems for both intracity and long-distance transmission systems; they have also acquired technology, equipment, and training to produce fiber optic cable and components. We estimate these purchases will allow China to begin deploying a fiber optics network by 1991, five years or so earlier than if China had relied solely on indigenous capabilities. China is continuing to seek fiber optics production technology; suppliers include Italy, Japan, the Netherlands, the United Kingdom, and the United States. [redacted]

Satellites. China has launched two communications satellites, a significant accomplishment, but evidence indicates they are experiencing operational difficulties. Progress also has been slow in developing a direct broadcast communications system. Beijing postponed the purchase of a foreign broadcast satellite and production technology after extensive negotiations with a US firm and a West German consortium, in part, because of disagreements within the Chinese bureaucracy on the type of system preferred, which foreign supplier to use, or even the need for foreign procurement. Although Beijing plans to continue to launch indigenous communications satellites, current problems with this program may cause China to reopen negotiations for the purchase of satellites or production technology. To help meet its immediate needs, China recently purchased two Intelsat transponders to augment several already under lease. Although China produces its own ground stations, it has also purchased ground station equipment from Canada, the United States, and Japan. [redacted] 25X1

Foreign Competition

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Chinese imports of telecommunications equipment have risen rapidly over the past several years. Japan is China's leading direct supplier of telecommunications equipment; its dominance is particularly strong in microwave technology. According to Nippon Electric Company, it has installed a total of 4,700 kilometers of microwave systems—equivalent to about 25 percent of China's microwave network—and won 80 percent of Chinese microwave orders in the last several years. According to trading partner data, the value of Japanese telecommunications equipment sales to China in 1985 was five times greater than that of the United States, the second-largest single supplier. The value of West European exports to China exceeds US sales, however, and individual suppliers—particularly the United Kingdom, France, and West Germany—are narrowing the gap with the United States. [redacted]

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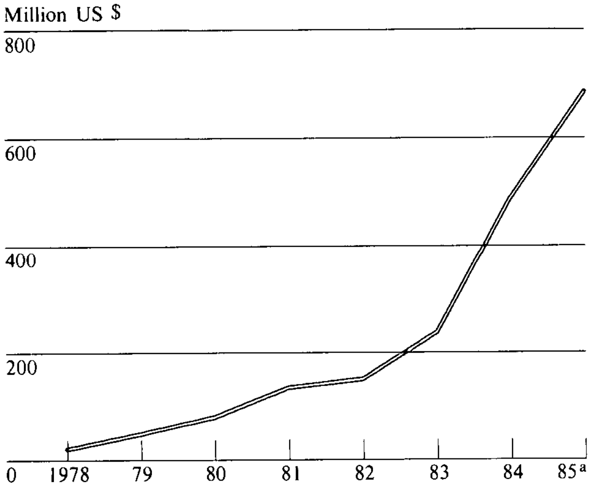
Foreign suppliers foresee $3-5 billion in sales to China over the next five years and are scrambling to secure their market positions amid indications that Chinese purchases will eventually be limited. Foreign estimates of the Chinese market may be high; Chinese officials have publicly stated they plan to spend $3-4 billion on telecommunications modernization by 1990, a figure that includes domestic expenditures as well as imports. Central government concern about the compatibility of foreign equipment has led some officials to try to limit the number of suppliers; others have indicated, however, that China is looking for additional

Chinese Imports of Telecommunications Equipment, 1978-85



[a] Estimated.

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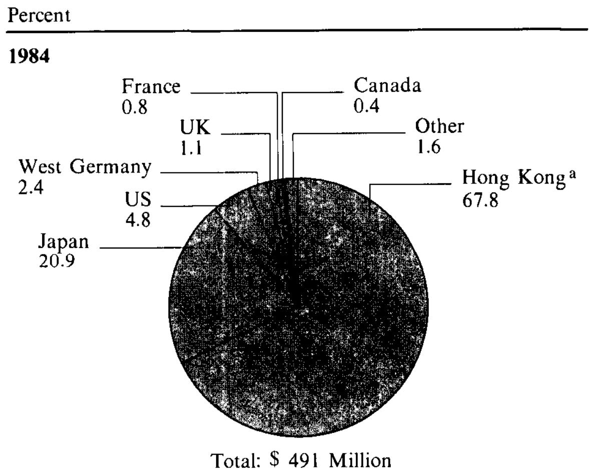
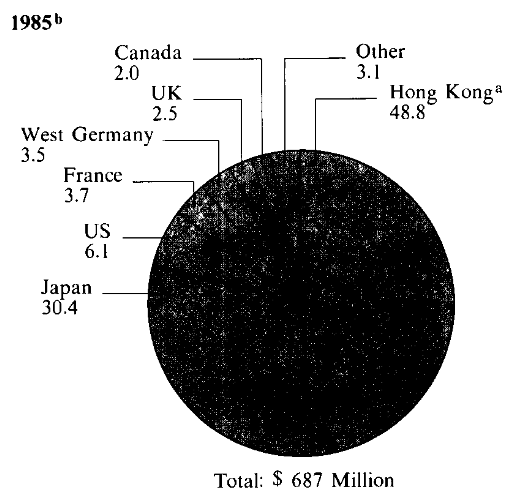
Sources of Chinese Telecommunications Equipment Imports





[a] Hong Kong data are largely reexports, of which approximately 54 percent are from Japan, 4 percent are from the United States.
[b] Estimated.

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sources of technology—including Eastern Europe—to avoid dependence on any one supplier. Beijing is also attempting to reduce costly duplication in technology imports. Furthermore, acquisitions of foreign production technology will in time reduce China's import needs.

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China is skillfully playing competitors off against one another to get more technology and better financial terms. Chinese officials have assured foreign visitors that telecommunications remains a priority despite the current policy of conserving foreign exchange, but they stress that proposals that would reduce China's foreign exchange costs will be considered the most favorably. The procurement process can be frustrating to both foreigners and the Chinese; the numerous Chinese entities involved in producing, buying, and using telecommunications equipment often result in confusion over the requirements, funding, and authority for purchases. Although COCOM approvals for transfers of advanced technology to China are increasing, the COCOM process delays the acquisition of systems and know-how. We expect that Beijing—as well as US allies in COCOM—will continue to press Washington to further loosen COCOM controls for transfers to China.

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Principal Players in Chinese Telecommunications

Ministry of Posts and Telecommunications. *Owns and operates national communications facilities; a major purchaser of foreign equipment and technology.*

Ministry of Electronics Industry. *Develops, manufactures, and procures telecommunications equipment for the common carrier network, industrial users, and the military.*

The Military. *Uses its own communications systems as well as the common carrier network; involved in research, planning, and deployment, including the fiber optics and communications satellite programs.*

Ministry of Petroleum Industry. *Purchases foreign equipment to support offshore and onshore oilfield communications operations and pipeline maintenance.*

Ministry of Water Resources and Electric Power. *Plans to expand communications supporting power grid maintenance; seeks foreign equipment.*

Ministry of Railways. *Procures foreign equipment and services for upgrading its independent telecommunications network.*

Ministry of Coal. *Seeking foreign equipment to support communications with remote mining operations.*

Outlook for US Firms

US firms have sold China a variety of telephone switching, radio, fiber optics, cable, satellite ground station and multiplexing equipment and technology. US firms are at a marketing disadvantage compared to their foreign competitors, however, for several reasons:

- Many foreign firms are offering government-subsidized financing for telecommunications projects. France, Italy, Japan, and the United Kingdom have all offered credits or low-cost loans.

The Belgian Government granted two soft loans valued at $12 million and assumed 10-percent ownership in the switching equipment joint venture to help its firm close the deal. According to press reports, Sweden is prepared to offer similar support to assist a Swedish firm in becoming China's third major switching technology supplier.

- US firms entered the market relatively late—Japan has been selling telecommunications equipment to China since at least the early 1970s. Statements by Chinese officials suggest that West European suppliers such as France have also benefited from longstanding political ties to Beijing. 25X1 25X1

- US equipment based on North American standards is less attractive to Beijing, which wants to adopt the standards used by most other countries. 25X1

Chinese officials frequently express a preference for US technology, however, and US firms appear more willing to transfer technology than some other suppliers; Chinese officials are particularly critical of Japanese firms for their reluctance to transfer technology. In addition, US firms generally offer training and support services, both sought by Beijing. 25X1

Prospects for Chinese Telecommunications

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Foreign purchases, in addition to indigenous efforts, will speed improvements in key projects such as communications support for energy development and telephone and data links between major cities. We believe that military communications—already far superior to civilian systems—will also benefit from the increased speed, capability, and flexibility offered by fiber optics and advanced switching systems. Nonetheless, China's civil communications services are likely to continue to be inadequate to support the growing demands of economic modernization, in our view. Improvements in China's production capabilities will take time.

China also faces continuing difficulties in integrating foreign equipment into the existing network and in assimilating foreign technology. Inadequate communications services are likely to remain, hindering business transactions, cooperation between central and provincial organizations, and development of outlying regions. [redacted] 25X1

[redacted] 25X1

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Briefs

Energy

OPEC Production Update

OPEC crude oil production averaged 18.9 million b/d in June, an increase of 800,000 b/d from May levels. This increase came primarily from Saudi Arabia, which used netback discounting and aggressive marketing to push its output up by 1 million b/d. Libya's output rose as well—by 200,000 b/d—as US oil companies raced to make the most of their equity rights before they were required to stop liftings on 30 June. These increases more than offset the fall in Iran's output as a result of Iraqi attacks on crude oil production facilities, reductions in the shuttle fleet due to desertions and tanker damage, and movement of the shuttle operation from Sirri to Larak. 25X1

OPEC Oil Production, 1986 *Million b/d*

	First Quarter	Second Quarter	May	June
Total	**17.8**	**18.5**	**18.1**	**18.9**
Algeria	0.7	0.7	0.7	0.7
Ecuador	0.3	0.3	0.3	0.3
Gabon	0.2	0.2	0.2	0.2
Indonesia	1.3	1.3	1.3	1.3
Iran	2.3	2.2	2.3	2.0
Iraq	1.8	1.8	1.8	1.8
Kuwait [a]	1.3 (1.2)	1.4 (1.1)	1.3 (1.2)	1.2 (1.1)
Libya	1.0	1.1	1.0	1.2
Nigeria	1.4	1.6	1.5	1.5
Qatar	0.3	0.3	0.3	0.3
Saudi Arabia [a]	4.4 (4.3)	4.8 (4.7)	4.5 (4.3)	5.4 (5.3)
UAE	1.2	1.4	1.5	1.5
Venezuela	1.6	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 Trends

Spot oil prices have fallen below $10 per barrel in the wake of the inconclusive OPEC meeting last week. Prices for North Sea and US crudes are near their early April lows, now trading at $9.70 and $11.20 per barrel, respectively. High OPEC production continues—a large volume of crude is still in transit and is expected to put further downward pressure on prices when it arrives in the market this month. Early indicators show that consumption during the first half of the year may have been less than anticipated, with substantial volumes of crude and products being stocked. This early stockbuild is likely to reduce demand for new oil in the later part of the year, thus erasing OPEC hopes for stronger demand. In the absence of production restraint, prices are likely to continue to be weak through at least the end of the summer. [redacted] 25X1

Kuwait Repairing Oil Facility Damage

The apparently Iranian-backed attacks on Kuwait's Al Ahmadi oil facilities on 17 June caused moderate damage but failed to disrupt significantly production or exports. According to the US Embassy, the critical central mixing manifold was almost completely destroyed and will take about three months to replace. This manifold blends crude from Kuwaiti oilfields and feeds the intake manifolds at both north and south tank farms. The south tank farm intake manifold and the north tank farm discharge manifold were less seriously damaged. The attacks initially cut Kuwait's productive capacity of about 2 million b/d by about half. Prompt repairs to the north tank farm discharge manifold and new connections installed to bypass damage, however, have restored capacity to about 1.6 million b/d—more than enough to maintain current exports of approximately 1.1 million b/d. The flexibility of the Kuwaiti oil system to cope with further attacks will be reduced until all of the damaged facilities are fully restored. [redacted] 25X1

[redacted] 25X1

Soviet Hard Currency Bind Affecting Pipeline Projects

[redacted] no new major pipeline projects will be undertaken in the next two years. [redacted] postponement of the gas pipeline to Eastern Europe as a result of budget cuts for the gas industry and the fall in hard currency gas revenues in the wake of the oil-price decline. The Soviets have scheduled six major pipelines from the Yamburg gasfield in the current five-year plan. One is already in operation and another is almost half finished. Construction of a third, the "Progress" pipeline to Eastern Europe, began in late May, but it is too early to gauge the pace of construction. Because all of the planned pipelines will require high-pressure pipe from Western Europe or Japan, hard currency considerations may impede the program as long as world energy prices and Soviet hard currency revenues from oil and gas sales remain depressed. [redacted] 25X1

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Chinese Oil Production Growth Slows

China produced 2.53 million b/d during the first half of 1986, only 2 percent more than during the same period last year. Production at Daqing, China's largest field, declined 4 percent because an accident in January shut down one of the field's major power stations for several months. [redacted] 25X1

The lower growth rate will have little effect on domestic oil supplies, which will benefit slightly from a drop in exports—down 11 percent in the first quarter. Nevertheless, Beijing will continue to ration domestic oil supplies tightly so it can expand exports if international prices rise. Significant new finds at Shengli probably will keep China's oil production growing through the rest of the decade. [redacted] 25X1

China's Coal Production Drops Slightly

China produced 403 million metric tons of coal during the first half of 1986, nearly 2 percent less than during the same period last year. According to statistics published in *China Daily*, most of the decrease was due to a 10-percent decline in production at small mines, while production at the large state-owned mines grew slightly. The small mines, operated by individuals and collectives, produced about one-fourth of China's coal last year. Small-scale coal production had grown rapidly during the past few years because Beijing allowed all of this coal to be sold at market prices, often four or more times the state's price. The proliferation of small mines, however, has depressed the market price of coal, which may have prompted some peasants to switch out of coal mining to other industries. A recent tightening of rural loans also may have contributed to the decline. Coal Ministry officials recently told US officials that some small mines in South China would soon be exhausted. Premier Zhao Ziyang recently encouraged more small-scale coal production, indicating Beijing is planning to continue relying on small mines for a significant portion of its coal. [redacted] 25X1

International Finance

South Africa Hints at Nonpayment of Debt

South Africa's top financial officials last week sought to moderate—but did not refute—a statement by Pretoria's Ambassador to the United Kingdom that South Africa would consider not repaying its foreign debt if economic sanctions were imposed. According to the US Embassy, Reserve Bank Governor de Kock and Finance Minister du Plessis gave assurances that South Africa intends to repay its debts, but each noted that sanctions against the country's exports would hurt foreign exchange earnings needed to meet its obligations. Du Plessis publicly described the Ambassador's remarks as a statement of fact rather than a threat. Pretoria probably views repudiation of its debt only as a last resort because the probable resulting exclusion of South Africa from international financial markets would complicate already serious domestic economic troubles. Moreover, this episode follows a pattern of similar veiled threats—restricting strategic mineral exports or expelling the foreign mine laborers—intended to discourage international pressure. As pressure for sanctions continues, however, some international banks might join South Africa in emphasizing the spillover effects on foreign creditors of sanctions against the country's exports. 25X1

Mexico Preserving Its Options on Debt

The Mexican Finance Ministry announced last week that the government's $600 million monthly debt service payments were current and expressed optimism about prospects for a new financial package by the end of July. The announcement, however, does not end speculation that the government may suspend foreign debt payments. Press statements indicate government officials are examining ways to protect the country's dwindling foreign exchange reserves, including a scheme to make interest payments temporarily through peso escrow accounts in Mexico. Mexico is in the final stages of formulating a new economic agreement with the IMF and probably sees no advantage in suspending debt payments now. Peso escrow accounts would limit foreign exchange outflows to foreign banks; this in turn would keep reserves from falling further. Mexico City might still halt debt payments if it reaches an impasse with the IMF or if reserves fall precipitately, as they did in 1982. 25X1

25X1

France Agrees To Reschedule Iraqi Debts

Iraq's recent agreement with French banks on debt rescheduling increases the chances for accommodation with other commercial lenders in Western Europe and Japan. [redacted] The French banks say they may also advance new credits to Baghdad. Iraq's failure to make payments on its commercial debt this year has caused many Western banks and export credit agencies to reduce credit lines to Baghdad. Paris had discontinued credit guarantees to Iraq in April when Baghdad missed a $120 million debt payment but recently rescheduled Iraqi official debts. Iraq may find it somewhat easier to reach agreements with commercial lenders in Japan, Baghdad's largest source of imports last year, who had said they would reschedule only if Iraq reached agreements with other lenders. Even so, Baghdad is unlikely to obtain substantial amounts of additional credit from commercial sources. [redacted] 25X1

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Egyptian Reform Package Falls Short of IMF Endorsement

IMF officials have stated that Egypt's recently released reform plan represents progress but does not yet constitute a basis for an IMF standby agreement. Specifically, Fund representatives cited weaknesses in addressing the budget deficit, credit expansion, and exchange rate reform. In addition, the Egyptians remain totally opposed to a multilateral debt rescheduling under IMF auspices. Cairo still appears convinced that the United States and other major creditors will provide debt relief on a bilateral basis, thereby avoiding a strict IMF-supported adjustment program. The country's growing inability to meet debt obligations and import requirements appears to make some form of debt rescheduling inevitable by the end of this year. [redacted] 25X1

Foreign Exchange Shortages Threaten Zambian Currency Auction

Recent projections by the IMF indicate that Zambia is facing a financing gap of $165 million during the remainder of 1986. Lusaka already has accumulated arrears totaling $58 million to the IMF and about $50 million to Western commercial banks since it signed IMF standby and Paris Club agreements in March. Although the arrearages and looming foreign payments gap are in part the result of a decline in exports, they stem mainly from Lusaka's imprudent diversion of foreign exchange from debt service and mining imports to the foreign exchange auction in order to prop up the exchange rate. Growing pressures to reimburse these accounts could cut foreign exchange allocations to the auction later this year and lead to a devaluation of 50 to 55 percent, according to US Embassy estimates. We believe that a devaluation on this scale would induce Lusaka to tamper further with the auction and that, in a vicious circle, this would undermine IMF and foreign donor support needed to keep the exchange rate from declining even further. The growth of arrearages may jeopardize negotiations on disbursement of a $62 million IMF loan this fall, according to Embassy reporting. [redacted] 25X1

Global and Regional Developments

[redacted]

25X1

Soviet-Japanese Joint Ventures Stall

Japanese businessmen are increasingly pessimistic about the prospects for joint ventures proposed by Moscow at the mid-April meeting of the Japan–Soviet Union Joint Economic Committee. The Japanese initially regarded the joint venture proposal as some willingness on Moscow's part to accept foreign capital. The continued vagueness of Soviet proposals has subsequently tempered Japanese attitudes [redacted] The Soviet decision to postpone some of the projects and to assume full management and engineering responsibility for the remainder has weakened the original lukewarm Japanese response. [redacted]

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West European Agreement on EUREKA

West European foreign and research ministers meeting in London last week agreed to establish a secretariat for the European Research Coordination Agency and selected 62 projects worth at least $2 billion for R&D over 10 years under the EUREKA banner. Firms involved in EUREKA projects will provide their own financing, and the Governments of France, West Germany, the United Kingdom, and several other countries will offer subsidies, tax breaks, and special loan programs. The ministers agreed to locate the EUREKA secretariat in Brussels, to study ways of obtaining venture capital for projects, and to reject a membership bid by Yugoslavia. Direct government funding commitments for EUREKA remain relatively small, and the program has yet to attract the participation of large, technically advanced firms. [redacted] US Embassy reports indicate that major firms in Sweden are also skeptical of EUREKA. In addition, skepticism in official quarters, including Prime Minister Chirac's government, may make high-technology firms less likely to seek involvement. [redacted]

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Impasse on Soviet Alumina Plant in Greece

Negotiations for the construction of a 600,000-metric-ton-per-year alumina plant in Greece by the USSR seem to have reached an impasse. The viability of the $500 million project depends on the USSR and Bulgaria absorbing all of the plant's output. In 1985, after six years of negotiations, the three countries reportedly signed an agreement that called for the USSR to purchase 400,000 tons each year at favorable prices to compensate for the construction of the plant. Bulgaria agreed to purchase the remaining 200,000 tons, one-half to be paid for in hard currency, the balance in compensating trade. In mid-June, however, Sofia apparently reneged on the agreement, probably having second thoughts on the terms. Athens has now turned to Moscow to absorb the entire output of the plant, but the USSR probably does not need the extra amount. Moscow's primary motive for concluding this agreement was to provide a long-term source of alumina for expansion of its aluminum production, at a low hard currency cost. If the deal falls through, the USSR—which produces about 65 percent of the raw materials it needs to make aluminum—would probably turn to other countries, such as Jamaica, for its supply. 25X1

25X1

Afghan-Soviet Protocol for Housing Construction

The Kabul regime signed a protocol with the USSR on 3 July for housing construction in Afghanistan. Under the terms of the agreement, the Soviets will deliver material and equipment valued at 2.04 million rubles—approximately $2.9 million—to Afghanistan in 22 months. The regime plans to construct more than 1,500 residential apartments annually with this material. The expansion of housing construction—which was announced as a priority in the government's Socioeconomic Development Plan for 1986-91—has probably been necessitated by the large flow of refugees from the Afghan countryside into Kabul. Since 1979, the population of Kabul has expanded from 913,000 to over 2 million, according to census data and estimates obtained by the US Embassy in Kabul. 25X1

National Developments

Developed Countries

Canadian Pharmaceutical Legislation Stalled

Ottawa has again delayed introduction of a controversial bill—long desired by US companies—that would lengthen the period pharmaceutical innovations are covered by patents. Supporters of the bill claim it would generate $1.4 billion in investments and 3,000 new jobs, while opponents argue that its main impact would be to boost drug prices for Canadian consumers. Anticipation of widespread opposition to the planned changes, as well as ongoing trade disputes with the United States, led Ottawa to postpone announcement of the proposed patent legislation several times in recent months. The government will now use the summer parliamentary recess to gauge public reaction. We believe it will again stall on introducing a bill when Parliament resumes in the fall, particularly if the United States has imposed tariffs on softwood lumber in the interim. 25X1

Japanese Proposal To Shorten Workweek

Echoing the sentiments of Japan's labor leaders, the Labor Ministry's annual white paper advocates, for the first time, reducing work hours as a means of increasing productivity and consumer demand. The report urges employers and unions to make the five-day workweek a priority and notes that Tokyo is studying the feasibility of amending the Labor Standards Law to shorten the legal workday. The guidelines will certainly be cited as part of government efforts to reform Japan's export-oriented economy at the late July US-Japanese meetings on macroeconomic adjustments. Changes in the present system, however, will be incremental at best. In the past, influential Japanese employers' organizations have strongly opposed government recommendations to reduce work hours, arguing that an increase in leisure time and leisure-related expenditures will only generate inflation and reduce Japan's international competitiveness. According to the US Embassy, labor leaders are reluctant to challenge management's hardline position, in part, because of rank-and-file apathy on the issue. Moreover, a shorter workweek would do little to stimulate domestic demand unless the more difficult problem of wage increases were also addressed. 25X1

Parliamentary Opposition to Social Security Reform

Opposition to important aspects of the Thatcher government's social security reform legislation has surfaced in the form of two amendments passed by the House of Lords. The first change would reverse the government's plan to force all households, including those of the unemployed, to pay at least 20 percent of their local property taxes. (Currently, about 3.5 million households receive a full rebate on property taxes, and another 3.8 million households receive a partial rebate.) The other amendment would create a new community care allowance for the severely disabled to replace other benefits that the government's bill eliminates. Prime Minister Thatcher and Social Services Secretary Fowler oppose both changes, which together would add at least $700 million a year to public spending. Tory leaders claim that party discipline will be strictly enforced to overturn the amendments when they come before the House of Commons. Despite this rhetoric, London may be forced to accept changes in the bill because 13.3-percent unemployment and mounting controversy over inadequacies in the educational system and national health service have made social security an extremely sensitive issue. [redacted] 25X1

Postponement of British Water Authority Sale

London's decision to postpone the sale of 10 regional water authorities represents only a temporary setback to Thatcher's privatization program, but is politically embarrassing. The government announced last week that legislation authorizing the sale—expected to raise $7.7-$10.8 billion—will be delayed from this autumn's parliamentary session until after the next election, which could be held as late as June 1988. Environment Secretary Ridley explained that more time was needed—two difficult issues are whether to sell all 10 authorities at once and how to provide for the pensions of the 50,000 employees. Ridley also reportedly wants further studies on the impact of turning a basic public monopoly into a private monopoly. The Labor Party, pointing to recent privatization setbacks—British Airways and Royal Ordnance, the state arms and munitions company—accused the government of abandoning one of its central economic objectives. These delays, however, probably will not interfere drastically with the Tories' goal of raising about $7 billion in each of the next three years from the sale of state assets. Planning continues for sales, in a possible third Thatcher term, of assets such as the state-owned electricity network and parts of the National Coal Board and British Steel Corporation. [redacted] 25X1

Government Collapse Delays Italian Budget Planning

With the fall of the government on 27 June further discussion of the 1987 budget is likely to be delayed until the fall. Although the government traditionally does not begin its budget preparations until September, Parliament last month called on the Cabinet to set a 1987 budget deficit target before the August recess, rather than waiting for the spending program to be approved. Parliament had hoped this would speed passage of the budget and also encourage the Cabinet to make the difficult decisions about spending cuts. The Cabinet reportedly had agreed to a deficit target of $67 billion for 1987—as compared with $73 billion this year—but the government collapsed before it could present the proposal to Parliament. Party leaders and prospective cabinet members agree that the budget process must be improved and the budget deficit sharply reduced, but a new government is unlikely to tackle the touchy budget issue until after the summer holiday. [redacted] 25X1

Madrid Privatizes Car Manufacturer

Madrid took an important step last month in its effort to privatize unprofitable public enterprises. With the sale of Seat, the state-owned car company, to Volkswagen, Madrid rid itself of one of its top money losers. Seat had not made a profit since 1977, and last year accounted for one-fifth of the red ink at INI, the state industrial holding group, whose total losses amounted to about 1 percent of GDP. The sale should advance Madrid's goal of rejuvenating Spain's traditional industries because VW plans to invest $3.5 billion in new plant and equipment. Its technological and managerial expertise should also enhance Spain's ability to compete in the West European market. To secure the deal, INI had to pay $1.3 billion to liquidate Seat's past debts. In addition, VW plans to trim Seat's swollen work force by about one-fifth, or 4,500 jobs. This will stimulate some criticism in unemployment-plagued Spain, but the only serious opposition is likely to come from the Communist labor union, and we expect VW to have little trouble with its plans. 25X1

Less Developed Countries

Brazil's External Accounts Healthy

Brazil's strong trade performance so far this year will probably strengthen the government's resolve to stick with its independent stance on debt. The US Embassy reports that Brazil's trade surplus for January-May totaled $5.0 billion, up nearly 20 percent from the same period last year. The decline in the US dollar—to which the cruzado is tied—helped fuel a 10-percent increase in exports, to $10.3 billion, paced by sales of manufactured goods, coffee, soybean meal, and iron ore. Brazil's imports rose slightly to $5.3 billion, and their composition changed as well. Brasilia applied the 40-percent decline in its oil bill to increase food imports—offsetting shortages caused by increased domestic demand and the drought—while raw materials and capital goods imports climbed in the wake of booming industrial output. On the basis of a projected trade surplus of about $13 billion and lower interest payments, we estimate that the current account will balance this year, compared with a deficit of over $600 million in 1985. The improvement in the external accounts will ease the burden of interest payments, but it is also likely to make Brasilia even more adamant in its refusal to negotiate with the IMF as a prerequisite for future debt reschedulings. 25X1

Ethiopian Economic Pressures Eased

According to recent US Embassy reporting, Ethiopia's economic pressures have eased significantly this year. In Addis Ababa, retail prices are lower and food availability greater than expected earlier. Commercial imports of wheat are up because of increased foreign exchange availability from high coffee export prices and low oil import prices. Also, farmers are believed to be selling local grain stocks to purchase inputs for the bumper crops expected later this year in the wake of excellent rains. We do not believe the improved economic picture has firm underpinnings, however, given the economy's structural problems and softening coffee prices. 25X1

Pakistan Anticipates Record Wheat Harvest

Pakistan is expecting a record wheat harvest of at least 13.5 million metric tons for the fiscal year ending 30 June 1986—almost a 20-percent increase over last year's crop, which suffered from water shortages—according to US Embassy and press reporting. Increased production will allow Pakistan to eliminate wheat imports—1.8 million tons last year—for a savings of at least $200 million during the current fiscal year. Moreover, the Minister of State for Food and Agriculture said the government has given initial approval to the export of 500,000 tons of wheat this year, adding at least $55 million to export earnings, according to press reports. 25X1

Communist

Soviets Cut Civilian Titanium Allocation

The Soviet State Planning Committee reportedly is planning a "big cut" in the amount of titanium allocated to the Ministry of Nonferrous Metallurgy. This may be indicative of more widespread allocation reductions in the economy. Shortages could slow modernization and expansion programs under way in the nonferrous metals and chemical industries, which account for a large share of civilian titanium consumption. Products made with stainless steel could probably be substituted, but this metal is also in short supply. The cut could signal increased military demand. The defense industries, which traditionally have had the highest priority for allocations and are the largest consumers of the metal, use titanium products in the production of submarines, aircraft, and missiles. Slow production during 1981-85 has probably resulted in tight supplies—we estimate that production grew at an average annual rate of only about 1 percent during the period. In 1985, we estimate that the USSR produced approximately 71,000 metric tons of titanium, roughly two-thirds of global output. 25X1

Hungary Moves To Limit Wages

The Hungarian Government has ordered state enterprises to tie future wage increases to productivity. Compared with the first quarter of 1985, industrial and construction wages in first quarter 1986 rose 8 and 16 percent, respectively, outstripping plan targets as well as increases in productivity and inflation. Despite the 6-percent decline in real earnings over the previous five years, the 1986 plan called for average wage increases of only 5 to 5.5 percent—equal to projected consumer price inflation—to help restrain domestic consumption so more resources could be devoted to exports. Recent reforms giving enterprises greater control over revenues and increasing worker influence, however, led to larger pay raises. Strict enforcement of the new wage limits probably will bring wage increases within the planned range by yearend. Hungary's senior economic official, Ferenc Havasi, has indicated that even a minimal increase in real wages may not be possible until 1988. Any further decline in real wages in state industry is likely to aggravate social tensions over widening income disparities, especially among those who lack opportunities to moonlight in the private sector. 25X1

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East European Plant Fires Slow Microelectronics Development

Within the past two years, fires have heavily damaged three major East European integrated circuit (IC) plants. The latest fire, in May 1986, caused $30-45 million in damages to the Hungarian Microelectronics Enterprise (MEV), cutting Hungary's IC production capacity—estimated at 23 million ICs per year—by about 50 percent. A fire in August 1985 destroyed one of Czechoslovakia's leading microelectronics R&D centers and damaged its most advanced production line, causing about $2.5 million damage. Finally, in May 1984, a fire gutted a new Romanian IC plant outfitted with Western equipment just a few days before it was slated to begin production. [redacted]

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Although Hungary, Czechoslovakia, and Romania have probably moved quickly to offset the effects of the fires, development of IC industries will be considerably delayed. Within days, the Hungarians began contacting the USSR, East Germany, and Czechoslovakia, as well as West European firms, to negotiate joint ventures and equipment leasing schemes to replace equipment destroyed in the fire. Nevertheless, we estimate that it will take the Hungarians a minimum of two years to regain previous production levels. Czechoslovak R&D capabilities will be hampered until equipment and facilities can be replaced, but Romania has probably regained limited production capabilities and is geared up to full-scale production. Rebuilding these facilities will put considerable strain on the three economies, requiring diversion of investment funds and expenditure of limited hard currency to replace specialized Western equipment. Most of this equipment is COCOM controlled and has to be acquired illegally, slowing efforts to outfit the plants. The gap probably cannot be filled by other CEMA suppliers, and we expect increased efforts to import ICs from the West, many of which may be COCOM controlled. The USSR and Eastern Europe already legally and illegally import up to 100 million ICs annually from the West. [redacted]

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China's Devaluation

China devalued its currency by 13.5 percent against the dollar on 5 July in response to continuing concerns about its trade balance. We estimate that China ran a trade deficit of about $8 billion in 1985. Preliminary Chinese data indicate that the trade deficit in the first quarter of 1986 was about the same as in the same period last year. This devaluation follows a 7-percent devaluation in October, reflecting Beijing's determination to improve its trade performance by greater reliance on economic incentives. Premier Zhao Ziyang complained in March that, because of China's irrational price structure, the profits from domestic sales of many products are greater than profits from exports. Announced during an annual visit to China by an IMF delegation, the devaluation highlights Beijing's efforts to align its trading system with Western practices, and may be viewed by Chinese leaders as a step to smooth China's entry into GATT. In addition, Beijing undoubtedly hopes the devaluation will help reduce black-market trading of Chinese currency, but the yuan is still overvalued and may be devalued again before the end of the year. [redacted]

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