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International Economic & Energy Weekly

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International Economic & Energy Weekly

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Synopsis

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5 September 1986

Perspective

OPEC: The Saudi-Iranian Rivalry

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The August OPEC agreement to cut production largely represents a temporary lull in the struggle over oil policy between Saudi Arabia and Iran. Saudi interest in a stable long-term market for their oil with relatively low prices contrasts sharply with the more immediate Iranian need for high prices for economic recovery and development. As long as the Saudis remain the undisputed leader within OPEC, oil prices will probably remain relatively low over the next few years. A shift toward greater Iranian influence would alter the price outlook significantly. If Iran clearly gains the upper hand in the war with Iraq, Tehran could reemerge as the dominant force in the world oil market.

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Current weak oil market conditions and the war against Iraq have hindered Tehran from advancing its oil policy objectives and have allowed Riyadh to dominate the oil policy struggle in recent years. Barring a major supply disruption, we expect prices to remain near their current level of about $15 per barrel over the next few years. A breakdown in producer discipline could force prices even lower—perhaps well below $10 per barrel. In the meantime, uncertainty about producer intentions will continue to cause price volatility.

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Over the next several years, we expect that current oil price levels will work in favor of a reemergence of market control by Persian Gulf producers. We believe that Saudi Arabia and Iran will have the powerful combination of oil wealth and military might to be particularly influential in Persian Gulf affairs. Coupled with the conditions that gave OPEC producers market power in the past—especially strong demand growth and limited growth in supplies from other countries—the rivalry between Saudi Arabia and Iran will become even more heated.

The outcome of the Iran-Iraq war will play a large role in determining who eventually has the most influence over the oil market:

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- As long as the stalemate continues—or the war ends in a draw—we believe the Saudis will have the upper hand. Riyadh will push for steadily rising prices, but well below levels reached as recently as last year. Saudi long-term oil objectives favor a stable energy environment to boost oil demand and slow oil and alternative energy supply development in high-cost areas like the United States. This would clearly increase US import dependence on low-cost suppliers such as the Saudis.

- An Iranian victory, however, would shift the balance of power in the Gulf region and the oil market, especially if Tehran is able to control or substantially influence Iraqi oil marketing policies. Tehran's market power would be even greater if it was able to influence Kuwaiti oil policy—a likely possibility with a major victory in the war. Taken together, Iran, Iraq, and Kuwait have about 8 million b/d of oil productive capacity—enough to seriously challenge Riyadh's dominance.

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In any event, oil supplies will become more concentrated in the Middle East, regardless of whose influence dominates the oil market. Internal and intraregional friction, economic problems, and acts of terrorism will continue to pose potential threats to the security of Western oil supplies. Despite the near-term benefits, if low prices continue for several years, there will be a greater risk that any supply disruption will increase the economic and security consequences for the West.

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Oil Productive Capacity Outside the Persian Gulf

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Oil producers outside the Persian Gulf do not have sufficient excess productive capacity to offset a major disruption of Gulf supplies. Persian Gulf countries, which export some 11 million b/d or about one-fourth of total non-Communist oil supplies, also contain most of the world's current excess productive capacity. About two-thirds of the surplus oil productive capacity outside the Gulf is concentrated in Venezuela, Libya, Nigeria, Algeria, and Egypt. In the event of a disruption to Persian Gulf supplies, we believe current financial difficulties would strongly motivate all non-Gulf producers, except possibly Libya, to raise oil production. Available excess productive capacity, even with a drawdown of US strategic reserves, is not likely to prevent price runups if disruptions limit Persian Gulf exports to about 8 million b/d or less. Price pressures could build even in the absence of an actual shortage because of uncertainties about the duration and size of the disruption.

Persian Gulf Exports *Million b/d*

	90-Day Export Capacities	July 1986 Exports
Total	**16.0**	**11.0**
Saudi Arabia	7.6	4.9
Iran	2.6	1.5
Iraq	1.6	1.5
Kuwait	1.4	1.0
United Arab Emirates	1.6	1.4
Others	1.2	0.7

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Recent Losses in Productive Capacity

Available productive capacity outside the Gulf has slowly eroded over the past year. The conventional measure of capacity is the level that a country can produce within 90 days of a decision to raise output. We estimate that available productive capacity outside the Persian Gulf has suffered a net loss of about 500,000 b/d over the last 12 months. This dropoff is due primarily to financial constraints, increasing well maintenance problems, and declining production from maturing oilfields

Nigeria's available productive capacity has declined by about 400,000 b/d over the last year to about 1.8 million b/d Moreover, productive capacity probably will continue to decline because of poor maintenance practices and the absence of significant drilling activity. Nigerian oil officials hope to raise productive capacity by about 200,000 b/d by reinjecting natural gas

but we believe that budget constraints and slack demand could affect these plans.

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Libya's available productive capacity has fallen to only 1.6 million b/d because of deteriorating well performance and the need for additional drilling and modifications to existing pumping and pipeline systems,

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Oil production in *Indonesia* has risen to about 1.5 million b/d, which is the limit of the country's available capacity, according to Oil Minister Subroto. Our Embassy reports that achieving an additional 100,000 b/d of capacity would take at least six months to complete.

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Mexico's oil productive capacity has slipped by about 200,000 b/d over the past year to about 3 million b/d, based on [redacted] our reservoir engineering analysis. Maintaining even this level of production would require the overhaul of many wells and the refurbishing of surface oil collection facilities, as well as the discovery and development of new oilfields to offset production declines at existing fields. [redacted]

Distribution of Excess Capacity[1]

The largest concentration of surplus capacity outside the Persian Gulf is in North and West Africa, which accounts for about 1.5 million b/d. One-third of this excess capacity is in Libya and the rest is divided among Nigeria, Algeria, and Egypt:

- ***Libya*** could raise production by 500,000 b/d from the present level of 1.1 million b/d within 90 days, [redacted] Our own analysis [redacted] strongly supports this judgment. The departure of US firms has not affected Libyan capability to achieve this level because non-US company personnel have routinely performed the operations required.

- ***Nigeria*** could rapidly raise production by about 300,000 b/d to 1.8 million b/d, [redacted] although additional increases are limited by technical problems [redacted] The Nigerians have severely restricted expenditures for maintenance and development because of their financial problems.

- We estimate that ***Algeria*** could increase oil production by about 400,000 b/d from recent output levels within a short period.

- ***Egypt*** could increase its production by about 300,000 b/d, according to the US Embassy. Marketing problems caused by higher production from Saudi Arabia and other Persian Gulf producers are primarily responsible for the emergence of surplus capacity in Egypt. [redacted] 25X11

We estimate surplus available capacity in the Western Hemisphere at roughly 1 million b/d—located primarily in Venezuela and Mexico:

- [redacted] ***Venezuela's*** oil production could increase immediately by 200,000 b/d from the current level of about 1.6 million b/d. In addition, another 700,000 b/d of output could be achieved in about six weeks, [redacted] Venezuela is one of the few exporters to increase capacity despite the slumping market. 25X1 25X1 25X1 25X1

- ***Mexico's*** spare capacity is currently about 200,000 b/d. We believe Mexico could raise output by this amount fairly quickly. Sharp cutbacks in maintenance expenditures and outlays for spare parts have reduced Mexico's capability to sustain higher levels. [redacted] 25X1 25X1

Impact of a Persian Gulf Oil Disruption

The prospects that excess capacity outside the Persian Gulf would be made available during a Gulf disruption are good. In general, we believe most producers—including Algeria, Mexico, Nigeria, and Venezuela—would be strongly motivated to raise output for financial reasons. Libya's response to a disruption is uncertain. Libya may not be willing to help offset a supply shortfall instigated by Tehran, despite its precarious financial position. As a result, we believe less than 3 million b/d of excess capacity would be made available within 90 days to offset the loss of Persian Gulf oil exports. [redacted] 25X1 25X1 25X1 25X1

Strategic stockpiles, including 500 million barrels held by the United States, 129 million barrels in Japan, and 55 million barrels in West Germany, could play a large role in helping to offset a disruption. Commercial stocks, are relatively low compared with levels of a few years ago and their contribution to offset lost exports would be limited. Saudi Arabian

[1] Because excess capacity is the difference between a country's available capacity and its current rate of production, estimates are sensitive to production fluctuations caused by market or operating conditions. [redacted]

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Estimates of Surplus Capacity *Million b/d*

	Available 90-Day Capacity	Production Including NGL[a]		Surplus Capacity	
		July 1986	Under OPEC Quotas	Under July 1986 Production	Under OPEC Quotas
Total	**54.05**	**45.71**	**42.46**	**8.34**	**11.59**
Persian Gulf	18.40	13.50	10.98	4.90	7.42
Saudi Arabia	8.50	5.80	4.35	2.70	4.15
Iran	3.40	2.20	2.30	1.20	1.10
Iraq	1.90	1.80	1.80	0.10	0.10
Kuwait	1.60	1.50	0.90	0.10	0.70
United Arab Emirates	1.70	1.50	0.95	0.20	0.75
Qatar	0.60	0.30	0.28	0.30	0.32
Neutral Zone	0.60	0.30	0.30	0.30	0.30
Bahrain[b]	0.10	0.10	0.10	0	0
Non–Persian Gulf	35.65	32.21	31.48	3.44	4.17
OPEC	9.00	6.80	6.07	2.20	2.93
Algeria	1.10	0.70	0.66	0.40	0.44
Ecuador	0.30	0.30	0.23	0	0.07
Gabon	0.20	0.20	0.14	0	0.06
Indonesia	1.50	1.40	1.19	0.10	0.31
Libya	1.60	1.10	0.99	0.50	0.61
Nigeria	1.80	1.50	1.30	0.30	0.50
Venezuela	2.50	1.60	1.56	0.90	0.94
Non-OPEC	26.65	25.41		1.24	
Canada	1.80	1.80		0	
Egypt	0.90	0.60		0.30	
Malaysia	0.55	0.51		0.04	
Mexico	3.00	2.80		0.20	
North Sea	4.00	3.60		0.40	
United States	10.70	10.50		0.20	
Others	5.70	5.60		0.10	

[a] Based on information available as of 8 August.
[b] Non-OPEC.

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stocks of about 70 million barrels held outside the Persian Gulf could also help offset a short-term loss. At a drawdown rate averaging about 2 million b/d, the US Strategic Reserve would last about eight months. If other strategic stocks were drawn down over the same period, these reserves could provide a total of about 3 million b/d in supplies.

Considering both non-Gulf excess capacity and strategic stockpiles, additional supplies of about 6 million b/d appear available. The psychology of the oil market, however, requires a cushion of roughly 2-3 million b/d in available supplies to maintain stable prices. Consequently, additional non-Gulf supplies are

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Erosion of Available Capacity Outside the Gulf *Million b/d*

	June 1985	July 1986	Percent Change
Total	**34.5**	**34.0**	**−0.5**
Indonesia	1.6	1.5	−0.1
Libya	1.8	1.6	−0.2
Nigeria	2.2	1.8	−0.4
Venezuela	2.4	2.5	0.1
Mexico	3.2	3.0	−0.2
Other non-OPEC non-Communist	23.3	23.6	0.3

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available to offset a loss of only about 3-4 million b/d of Gulf supplies without putting severe upward pressure on prices. 25X1

With Persian Gulf exports now running at 11 million b/d, this means an export capacity from the Gulf of at least 8 million b/d is needed to balance the market near recent export and price levels using some combination of non-Gulf excess supplies and strategic reserves. With current export capacity from the Gulf totaling about 16 million b/d, this represents a present Gulf cushion of about 8 million b/d in surplus capacity. Substantial damage to export systems in Iraq, Iran, and Kuwait, and even some loss in Saudi Arabia, technically could still be handled, but the psychological impact of such events on the market probably would drive prices upward. Major damage to Saudi export facilities in addition to those of the northern Gulf producers would go well beyond what non-Gulf excess supplies could offset, even with the use of strategic reserves. 25X1

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Iraq: Coping With Economic Downturn

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Sharply lower oil revenues are forcing Iraq to implement austerity measures that will cause the first significant decline in living standards since the beginning of the war with Iran. Recent debt rescheduling agreements and large pledges of financial aid from Iraq's Arab allies should help maintain essential war and consumer imports. Nonetheless, Iraqis can expect shortages of other goods until the war ends or oil prices rebound.

Impact of Oil Price Decline

The large fall in oil prices since the beginning of the year has left Baghdad with little recourse but to slash nonmilitary spending, including imports and government subsidies. We estimate export revenues—about 95 percent from oil sales—will decline to about $7.4 billion this year from $11.4 billion in 1985. Combined with the fall of the dollar, the purchasing power of Iraq's foreign exchange earnings probably will decline about 60 percent this year. Just to maintain recent import levels of military goods and food, Iraq would have to use nearly all of its current monthly oil revenues and financial aid from Saudi Arabia and Kuwait. Defense expenditures have not been cut and, in our view, are not likely to be reduced given recent fighting, Iraq's expectation of a major Iranian offensive later this year, and promised Arab aid.

Lower oil earnings have again forced Iraq to reschedule foreign debts. Since early this year, Iraq has rescheduled repayment of about $4.6 billion in debt owed its major creditors. Deals with France, West Germany, and Japan shift repayment of debt due this year to 1987-90, including a two-year grace period. Agreements with Turkey, Yugoslavia, Italy, and India call for a large portion of bilateral debt to be paid in oil. Press reports indicate that Japanese banks will reschedule about $250 million on the same terms.

Iraqi Insulation From Economic Hardships Eroding

Lower oil revenues are forcing the Iraqi leadership into uncharted territory. Following the oil price increases of the early 1970s, and in particular since the start of the war with Iran, the regime has helped maintain support for its policies by insulating the public from economic hardships. Government policies have included:

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- Heavily subsidized public services, with some provided free.
- Subsidies to maintain low prices on basic necessities such as food and pharmaceuticals.
- Price controls on many other goods.
- Gifts—or sales at below cost—of big-ticket consumer items to military officers, martyrs' families, and other politically favored groups.

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After oil prices peaked in 1981 and the war dragged on, the government gradually reduced the magnitude of its largess. Baghdad initially was able to soften the decline by using $30 billion in foreign exchange reserves, another $30 billion in "soft" loans from Arab allies, and by running up foreign debts to about $14 billion currently. Although austerity measures in 1982-83 cut imports in half, the reduction was achieved largely by canceling, postponing, or curtailing large development projects rather than cutting consumer goods imports. This year, however, the sharp drop in oil prices and the rising debt burden made sustaining the regime's policies unaffordable.

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Initial Confusion Delays Austerity

Initial disagreement among the Iraqi leadership over how to respond to the collapse in oil prices delayed austerity measures and their full impact on the Iraqi populace. President Saddam Husayn first created a "Presidential Committee" to make foreign exchange allocations. This undermined First Deputy Ramadan's economic authority—he had long had responsibility for major economic decisions—and caused bot-

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Iraq: 1986 Debt Rescheduling Agreements and Repayment Schedule, 1987-92

Million US $

	Rescheduled Payments Due in						Oil Payments [a]	Amount Rescheduled [b]
	1987	1988	1989	1990	1991	1992		
Total	**310**	**1,323**	**1,111**	**394**	**186**	**186**	**1,070**	**4,580**
France	0	125	250	125	0	0	0	500
French banks	0	0	57	114	114	114	0	400
West Germany	0	290	290	0	0	0	0	580
Japan	0	150	150	0	0	0	0	300
Japanese banks	0	0	36	72	72	72	0	250
Italy	0	0	0	0	0	0	200	200
Turkey	310	350	0	0	0	0	540	1,200
India	0	80	0	0	0	0	120	200
South Korea	0	83	83	83	0	0	0	250
Yugoslavia	0	245	245	0	0	0	210	700

[a] Oil to be delivered in 1986-87 in lieu of cash payments.
[b] Rounded to the nearest $10 million.

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tlenecks in implementing austerity measures. In July, Husayn was pressured to share more decisionmaking and returned economic authority to Ramadan.

Baghdad probably will soon intensify spending cuts. Ramadan—who orchestrated the steep spending cuts in 1982-83—is finalizing the 1986 budget, and he is expected to apply the same determination to the austerity measures needed this year. New austerity policies are likely to include subsidy reductions, tax increases, and cutbacks in government development expenditures that will hit consumers. Basic services probably will deteriorate as development projects take a back seat to more immediate needs: several water supply, sewerage, and transportation projects already have been put on hold. The prices of many goods, including food, are rising rapidly. To try to assure equitable distribution, Iraq's rationing program—previously limited to basic food staples—is being expanded. ration cards are now being distributed for such consumer goods as tea and sugar.

Special groups within Iraqi society already have begun to lose some of their perquisites. Financial benefits given to government workers, military personnel, and families of war dead are being reduced. The US Embassy reports that Ramadan has ordered that cars will now be sold to senior government officials rather than given as gifts. Ramadan reportedly is also stopping the widespread practice of transporting people to and from work at government expense. Even Husayn seems to be curtailing his customary largess by telling petitioners there is no more money for him to hand out.

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Financial incentives to military officers—a standard practice in the past to reward loyalists and build up morale—also are diminishing.

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In addition, benefits to families of war dead also are

Ramadan Regains Economic Authority

Deputy Prime Minister Ramadan regained broad powers over economic decision making at July's extraordinary meeting of Iraq's ruling Ba'th Party. President Saddam Husayn, who summoned the party leaders to the surprise session, returned to Ramadan authority that Husayn had appropriated for himself earlier in the year. Ramadan's "victory" over Saddam reflects his ability to manage Iraq's economic affairs and control Iraq's bureaucracy.

Ramadan's power stems from his control over Iraq's technocratic elite. His experts in key economic ministries carry on the day-to-day operations of the government and are in charge of strategic economic planning and budgets. These experts play a key role in Iraq's command economy—in which practically every area of society is bureaucratized. The First Deputy not only directs these technocrats, but also has been able to wield them into an effective political constituency. According to the US Embassy, when Ramadan imposed his campaign of "working to rule"—he refused to carry out decrees from the Presidential Committee without a direct order from Husayn—activity in the economic ministries practically came to a halt.

Under Ramadan's direction, Iraq's ability to cope with drastically lower oil prices is likely to improve. His proven ability to direct economic ministries should result in more effective implementation of policies than under Husayn.

Iran: No Better Across the Border

Lower oil revenues have also placed a severe strain on Iran's economy. Tehran is blaming the war and "Western plots" in the oil market to justify its severe austerity measures. Top priority has been given to military and food imports at the expense of development projects and industrial production. Lack of raw materials and spare parts have caused factory closures throughout Iran. Over the next several months, this could reduce industrial output by 65 percent and double unemployment to 4 million—about one-third of Iran's work force. Already severe shortages, including many food items, will worsen unless oil prices recover

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Tehran appears increasingly concerned that its deteriorating economy could eventually hamper its war-making ability while Arab aid and additional oil export pipelines will bolster Baghdad's longer term financial prospects. Iran, however, believes that the military setbacks it has inflicted on Iraq this year and Baghdad's current economic problems have weakened Iraqi morale. Tehran believes this has improved its chances of victory if it moves soon, probably by launching a major offensive this fall. If Iran does not make significant gains in the war over the next year, domestic shortages and unemployment could be serious enough to require the regime to reevaluate its war strategy

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being curtailed. At the beginning of the war, the family of an Iraqi killed in battle received a car, 3,000 Iraqi dinars (then worth about $10,000), and a plot of land. few "martyr" families are receiving cars and most are being told they will get one "after the war."

Civilian Imports Likely To Be Slashed

The Iraqi economy is heavily dependent on imports, and large cuts will further curtail economic activity and the availability of goods. According to the US Embassy, Ramadan has promised to cut civilian imports by 65 percent. The full weight will fall on remaining development projects, imported inputs for industry, and nonfood consumer items. According to the US Embassy, spot shortages of formerly available imported goods began to appear in Baghdad late this spring. Baghdad has banned imports of luxury goods and semifinished products In addition, Iraq's private sector has not received any allocations of foreign exchange for imports this year, according to the Embassy. Although the private sector represents a small fraction of total imports, it is heavily involved in the domestic manufacture of consumer goods.

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Baghdad's difficulties in dealing with its foreign creditors will add to shortages. The US Embassy in Ankara reports that Turkey, Baghdad's second-largest supplier in 1985, last month discontinued export financing to Iraq because of Baghdad's demand for two-year credits—Ankara is willing to finance for only one year.

The large amounts of financial aid reportedly pledged to Iraq by its Arab allies during Ramadan's recent swing through the Persian Gulf states will ease financial pressures on Baghdad, but not remove the need for austerity measures. Sources of the US Embassy in Baghdad report that Saudi Arabia and Kuwait have committed $4 billion and $1.5 billion, respectively. The US Embassy believes the new Saudi funds are earmarked for military equipment. This will allow Baghdad to maintain military purchases and enable Iraq to use other resources to continue essential consumer imports. Although this improves Iraq's chances of "outlasting" Iran, Iraqis will not see any major improvements in the economy until the war ends or oil prices rebound. 25X1

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What's Ahead

High prices, shortages, and reduced government benefits over the coming months are likely to be accompanied by heightened military activity. President Husayn recent open letter to Iran calling for peace was aimed, in part, at preparing Iraqis for the next major Iranian offensive and high Iraqi casualties. This is part of a government drive to encourage Iraqis to have a more realistic expectation of future sacrifices stemming from the war and low oil prices. 25X1

Hungary: Economic Troubles Continue

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Hungary's poorly performing domestic economy and further worsening of its external accounts this year pose mounting problems for the Soviet Bloc's most reform-oriented regime. Budapest's timid response to the economy's troubles reflects concern that renewed austerity would alienate large elements of society. Decisionmaking has also been impeded by uncertainty over the succession to aging party leader Kadar. If Budapest continues to avoid the tough measures needed to improve the economy, lending by Western banks is likely to decline, which could lead to serious debt servicing problems.

Hungary: Selected Domestic Economic Indicators, 1981-85 *Percent growth*

	1981	1982	1983	1984	1985
Gross national product	**0.7**	**3.7**	**−1.0**	**2.7**	**−0.9**
Industrial production	1.5	1.5	1.0	2.5	0.8
Agricultural production	−0.8	13.0	−5.8	6.4	−4.1
Private consumption	1.9	0.3	−0.7	1.3	1.1
Gross investment	−5.2	1.0	−9.3	−5.3	−4.4 [a]

[a] Preliminary.

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The Economy Falters

The Hungarian economy has grown slowly since the late 1970s, mainly as a result of adjustment policies designed to halt the growth of hard currency debt. Sizable trade and current account surpluses in 1983-84, however, encouraged Budapest to loosen controls on domestic credit, government spending, and imports last year. Although these measures were designed to allow for the first small rise in domestic demand since 1981 and a modest increase in growth, economic performance fell far short of plan. We estimate that GNP declined 0.9 percent in 1985, reflecting a sharp drop in agricultural production and weak industrial growth. Unusually cold weather in the first quarter disrupted production and exports and aggravated energy shortages. These problems, coupled with the continued decline of agricultural export prices, produced a sharp deterioration in the country's external accounts. The hard currency trade surplus fell by about 75 percent to $295 million, pushing the current account into deficit for the first time since 1982.

Economic performance in the first half of this year showed little improvement. Industrial output rose only 1.3 percent in this period compared with the first half of the previous year, which is extremely sluggish given the much harsher weather and sharp fall in output experienced in early 1985. Moreover, drought is threatening agricultural output. At the same time, hard currency imports are growing at twice the rate of exports. In the first five months of this year, the hard currency trade deficit was more than double that of the same period last year. A prominent Hungarian Government economist recently predicted that national income will stagnate this year, while the National Bank revised its yearend current account estimate downward from a modest surplus to a deficit of up to $230 million.

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Poor export performance stems in large part from a decline in earnings on oil reexports and reduced sales to the USSR under special hard currency trade arrangements. Both have been key props for Hungary's hard currency trade in recent years. The Ministry of Industry has estimated that lower world oil prices will cost Hungary $100-150 million in lost reexport earnings. As lower oil prices also limit Soviet hard currency receipts, Moscow may become increasingly reluctant to purchase Hungarian goods for hard currency. Hungary's hard currency surplus with the socialist countries has already been steadily dwindling, dropping from $800 million in 1982 to $337

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Hungary: Financing Requirements and Sources, 1980-85 [a]

Million US $

	1980	1981	1982	1983	1984	1985
Financing requirements	**4,492**	**4,973**	**4,397**	**3,286**	**3,905**	**4,683**
Current account balance	−370	−727	−92	298	330	−457
Trade balance	276	445	766	878	1,236	295
Exports	4,863	4,877	4,876	4,848	4,965	4,475
Imports	4,587	4,432	4,110	3,970	3,729	4,180
Net interest	−409	−1,100	−976	−662	−744	−725
Other net invisibles	−237	−72	118	82	−163	−27
Repayment of medium- and long-term debt	811	826	894	1,216	1,681	2,114
Repayment of short-term debt	3,172	3,347	2,848	1,764	2,123	1,421
Net credits to other countries	139	73	353	304	431	691
BIS payments	0	0	210	300	0	0
Financing sources	**4,624**	**4,816**	**4,310**	**3,141**	**3,833**	**4,655**
Credits	4,952	4,291	3,577	3,751	4,500	5,623
Medium and long term	1,605	1,443	1,068	1,276	2,643	4,014
Short term	3,347	2,848	1,764	2,123	1,421	1,705
IMF, net	0	0	235	352	436	−96
BIS	0	0	510	0	0	0
Change in reserves [b]	328	−525	−733	610	667	968
Errors and omissions	**−132**	**157**	**87**	**145**	**72**	**28**

[a] Trade data are on a payments basis.
[b] Includes change in gold holdings.

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million last year. In the first five months of this year, this trade even slipped into deficit. Without a large surplus in hard currency trade with the socialist countries, Hungary will no longer be able to offset its chronic deficit in nonsocialist trade. Budapest, moreover, may have to divert goods destined for Western markets to the USSR to meet Soviet demands for higher quality goods.

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Foreign Debt Surge

Despite poor trade results, Budapest continues to enjoy good access to international credit based on success at improving its external payments situation between 1982 and 1984. The favorable lending climate has lessened the urgency Budapest attached to stabilizing the foreign debt. As a result, medium-to-long-term borrowing has surged since the beginning of 1985, pushing foreign debt to a record $12.9 billion in the first quarter of this year. After meeting debt service payments, Budapest has used most of the remaining borrowings to bolster its creditworthiness by:

- Prepaying more expensive existing loans and lengthening the debt's maturity structure. Prepayments totaled over $500 million in 1985, including $96 million owed to the IMF, and are expected to total about $300 million this year.

- Building up foreign exchange reserves. At midyear, we estimate that reserves, excluding gold holdings, were equivalent to about nine months of hard currency imports.

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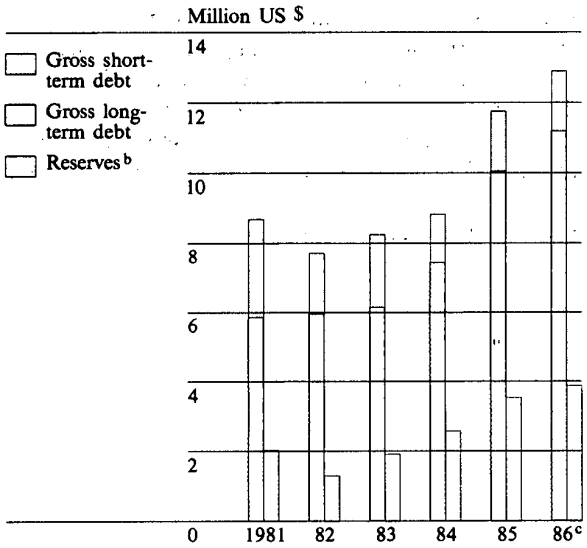
Hungary: Gross Hard Currency Debt and Reserves, 1981-86 [a]



[a] Because a large portion of Hungary's debt is denominated in hard currencies other than the US dollar, we estimate the depreciation of the dollar accounts for about 35 percent of the increase in foreign debt between January 1985 and the end of March 1986.
[b] Includes gold holdings valued by Hungary at $226 per ounce until 31 March 1985 and $275 thereafter.
[c] First quarter.

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According to the US Embassy, National Bank officials are divided on the wisdom of the current borrowing strategy. Although principal repayments on many of the recent loans will not begin until the end of the decade, interest payments will steadily rise on the larger stock of outstanding debt. Consequently, debt service, which reached almost 60 percent of goods and service exports in 1985, will remain high, leaving Budapest dependent on continued support from Western bankers. Although Hungary's financial situation appears secure this year, several US bankers have told the Embassy that they are increasingly wary about new lending to Hungary.

Obstacles to Recovery

Prospects of reversing the current slowdown are clouded by Soviet trade demands—which may limit resources available for domestic investment—Hungary's aging industrial base, and piecemeal implementation of the regime's long-running reform program. In fact, Hungary's adjustment strategy has slowed industrial modernization by making deep cuts in investment to protect consumption. In addition to the 21-percent drop in total investment over the 1981-85 period, Budapest's decision to preserve investment in traditional heavy industries and energy at the expense of new technologies has weakened export competitiveness. A vicious cycle emerged as poor export performance forced Budapest to rein in imports of Western capital goods, which, in turn, further weakened the competitiveness of export industries.

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A more fundamental problem, however, is the regime's inability to push ahead with new reforms. While Budapest gave reform renewed emphasis at the March 1985 Party Congress, the regime has tended to introduce measures in such a slow or watered-down fashion that they have not significantly changed the way the economy operates. In a June speech to the Central Committee, Hungary's top economic policymaker, Politburo member Ferenc Havasi, pointed out that the Hungarian economy still labors under many of the same inefficiencies as other centrally planned economies:

- A price structure that does not reflect world market costs.
- Managerial incentives that reward volume more than profitability and quality.
- Inadequate technological development and inefficient use of raw materials and energy in industry.
- Slow structural change combined with disproportionately large extractive and energy sectors.

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Despite signs of growing concern in government and party circles about the economy's downward spiral, the government's response has consisted mainly of uncoordinated halfway measures, including an inadequate devaluation of the forint in February, tax incentives for export-promoting investments, laws enforcing greater labor discipline, slower issuance of import licenses, incentives to lease Western equipment, and somewhat liberalized joint venture regulations. Havasi's speech indicated that Budapest is

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reluctant to reimpose restrictions on investment and imports, as this could seriously limit future growth. The measures adopted so far, however, will not have an impact on the country's trade accounts for some time. Moreover, they will not produce the systemic changes needed to sustain long-term growth.

The Hungarian leadership apparently has not reached a consensus for more radical changes because such actions could entail reduced political control and more austerity that would alienate large segments of society. Stagnating living standards, increasing inflation, and income disparities have already contributed to rising social tension. The regime's ability to provide a firm sense of direction in economic policy is further weakened by uncertainty over how long 74-year-old party leader Kadar will remain in power and who will succeed him. According to various US Embassy sources, Kadar has been withdrawing from day-to-day policymaking, but has been disappointed by the Politburo's failure to assume more responsibility. Several midlevel officials have complained to the Embassy that lack of guidance from the top is accentuating the country's economic difficulties.

Outlook

The sharp downturn in Hungary's hard currency external accounts this year has dampened expectations for renewed growth. While continuing to talk about the need for more rigorous reforms, Budapest probably will stick to its cautious course for fear of provoking greater social tensions. The longer the regime delays tough decisions, however, the worse economic stresses will become, making it even harder to forge a consensus on economic policy and increasing the chances that banker confidence will erode. if current trends continue, Hungary will eventually have to reschedule its foreign debt. Budapest would then have little choice but to negotiate a stabilization program with the IMF, and force the population to shoulder greater austerity than it has in the past.

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Central America: Efforts To Revive Regional Trade

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Efforts to revive Central American regional trade—which has fallen sharply since 1980—are being given new emphasis in an attempt to boost the sagging economies of the five nations.[1] The May 1986 Central American presidential summit and subsequent meetings have resulted in several proposals to address some of the near-term obstacles to trade. Nonetheless, although the countries continue to recognize the importance of maintaining good commercial relations, a lack of movement in resolving other more fundamental economic problems probably will postpone any substantial progress in revitalizing regional trade. Even with some success in boosting regional exports, heavy dependence on US markets and bilateral economic aid will continue.

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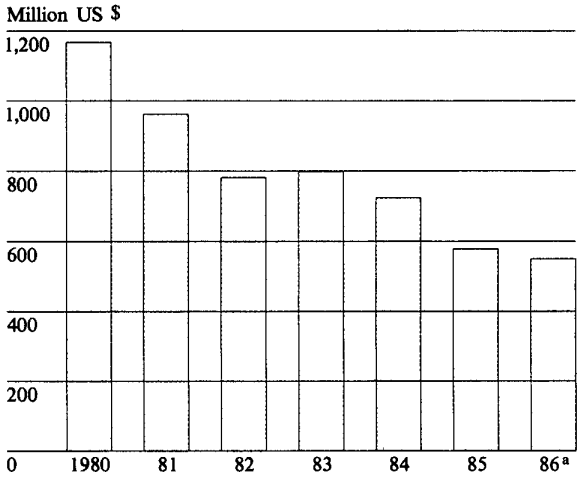
Central American Common Market: Regional Exports, 1980-86



[a] Estimated.

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Daunting Problems

Political turmoil and mounting trade and debt problems have substantially reduced regional trade in Central America. Since 1979, the value of trade has plunged from a high of over $1 billion to an estimated $580 million in 1985, and another decline is likely for 1986. The 25-year-old Central American Common Market (CACM)—the region's principal trade organization, which until 1980 was successful in promoting free trade in manufactured goods among the five countries—has been battered by regional developments. In an effort to boost economic growth, output, investment, and employment, the Central American countries have come out strongly in favor of restoring the CACM and its moribund institutions.

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Insurgencies in El Salvador, Nicaragua, and Guatemala remain the biggest obstacles to a resurgence of regional trade. In addition, Nicaragua's political isolation and increasing state control over its economy—in sharp contrast to its neighbors—constrains attempts to coordinate economic policies or obtain foreign aid. For example, according to US Embassy reporting, the former President of Costa Rica did not include Nicaragua in an economic initiative he announced in July of 1985, both because of political reasons and a realization that Managua's inclusion would greatly reduce prospects for new financial assistance, particularly from the United States. With or without Nicaragua's participation, however, efforts to revive regional trade face a number of more fundamental impediments.

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Large trade imbalances within the region make the task of revitalizing the CACM more difficult. In particular, the failure to maintain realistic exchange

[1] Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. Honduras formally withdrew from the CACM in 1971 but continued to participate in its regional institutions and maintain bilateral trade agreements with the other four members.

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rates has resulted in substantial trade deficits—for Honduras, in particular—because overvalued currencies have encouraged imports and made exports less competitive. These pressures have been exacerbated by differing levels of industrial development and by limited demand for each other's exports. As a result, some countries—most notably Costa Rica—have been able to run up trade surpluses with their neighbors. At the same time, uncompetitive exports as well as low commodity prices have led to unfavorable trade balances with the rest of the world for every country in the region, resulting in critical shortages of hard currency, import restrictions, and lowered production.

Trade imbalances have led to the breakdown of the regional payments system—the Central American Clearing House (CACH)—decreasing both trade opportunities and efficiency. The CACH was set up under the Common Market to facilitate regional trade by allowing trade debts to be settled in local currencies, with net surpluses or deficits balanced by hard currency payments between member countries' central banks every six months. The inability either to maintain balanced trade or settle imbalances in hard currency, however, has effectively forced the member countries to demand payment in dollars for their exports, eliminating the use of credit lines of local currencies through the clearinghouse. With the withdrawal of both Costa Rica and Guatemala from the CACH this spring, official trade in the region has effectively been put on a cash—hard currency only—basis. The breakdown of the payments system also has resulted in increased barter trade throughout the region. Honduras and Nicaragua, for example, signed a $10 million trade agreement in June.

Unsettled clearinghouse debts will be an obstacle to any renewal of regional trade. Embassy reporting indicates that total accumulated debt resulting from trade within Central America is $750 million. Although Nicaragua owes by far the largest portion—some $480 million,[2] other debtors in the region also have found themselves unable or unwilling to repay their smaller arrearages, which has led to increased trade friction. Costa Rica recently halted trade with Guatemala for several weeks because the Guatemalans had made little progress in repaying their $70 million trade debt. The two countries engaged in a similar standoff for over three months in 1985.

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New Initiatives Spark Hope

Although the serious decline in regional trade has been a topic of continuing interest in the region, the Central American summit last May focused new attention on the importance of maintaining and improving commercial relations. The presidents expressed strong support for reviving the CACM, in addition to calling for a united approach to developed countries on issues such as the region's debt burden and maintaining commodity prices, according to Embassy reporting. While no specific proposals came out of the summit, it has, in our view, generated increased momentum to solve the problems hampering the Common Market.

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Since the summit, Central American ministers of economy and central bank presidents have met twice to discuss eliminating trade arrearages and restoring the payments system. In July, the group proposed solutions that included linking regional debt amortization to total exports and arranging partial payment of debt in goods, according to the US Embassy. In August, they approved the creation of a new commercial instrument—the Central American Import Right (DICA)—designed to revitalize the payments system. The DICA will be denominated in US dollars but will be purchased from the importer's central bank using only local currencies at prevailing rates of exchange with the US dollar. Although it will not be convertible to dollars, it can be used to purchase goods from the issuing country, or it can be sold to third parties who want to import from that country. We believe the ability of holders to transfer the DICA should, at the very least, facilitate some trilateral barter trade deals.

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[2] Nicaraguan arrearages to CACM members as of mid-1986 were: Guatemala, $170 million; Costa Rica, $200 million; Honduras, $60 million; and El Salvador, $50 million (estimated).

Some exchange rate adjustments have also been undertaken. Guatemala and El Salvador both devalued their currencies this spring as part of their economic programs, according to US Embassy reporting. Paradoxically, the demise of the clearinghouse may also encourage efforts to adjust exchange rates to levels more attuned to the market. Honduras, for example, responded to Guatemala's withdrawal from the CACH by requiring that Guatemalan goods be paid for with foreign exchange either from Honduran exports to Guatemala or purchased at the free market rate in Honduras.

Nicaragua is taking advantage of the efforts to revive trade by moving to deal with a portion of its regional debt on a bilateral basis. Managua has approached both Guatemala and Honduras about rescheduling its debt. Embassy reporting from Guatemala indicates that the Sandinistas proposed a four-year grace period, with repayment over the subsequent six years. Although critical shortages of foreign exchange make Managua's repayment of debt almost impossible—even with exceptional concessions—Nicaragua's creditors probably believe that they have nothing to lose by rescheduling or accepting partial payment in goods.

Prospects Remain Dim

We believe the CACM in some form is likely to remain a major outlet for the regions's exports, but ineffective trade policies and declining export opportunities will continue to reduce production and employment and constrain economic growth. Until the underlying causes of the decline in regional trade are addressed, progress on specific problems—such as the breakdown of the payments system—will not be lasting. The creation of the DICA—although a marginally positive move—still fails to address the fundamental trade and payments problems facing the region. For example, exporters will still probably demand hard currency for their products if there is no third-party market for the nonconvertible DICA.

Moreover, the existing political instability will limit the ability of Central American governments to manage a regionally coordinated economic policy. Despite the small bilateral trade deals and debt negotiations with Managua, the Sandinistas remain politically isolated by their neighbors, making it unlikely that the Common Market can be revived in its original form, or regional trade restored to previous levels.

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The loss of employment and export opportunities will contribute to the region's continuing dependence on bilateral US assistance to provide balance-of-payments support and to maintain even small levels of economic growth. Although the Caribbean Basin Initiative has provided new opportunities for Central American exports to enter the US market, declining regional markets may put additional pressure on the United States to absorb an even greater share of exports.

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Briefs

Energy

OPEC Production Update

OPEC crude oil production averaged 20.5 million b/d in August, an increase of 500,000 b/d from July levels. Saudi Arabia increased output by 700,000 b/d—now it must cut back by 2.25 million b/d in September to comply with the recent OPEC accord. The Saudi increase was partially offset by a fall in Iran's output resulting from Iraqi attacks on Khark Island and the relocation of the oil shuttle operations several times in August. The other OPEC producers maintained July production levels, and all appear to be taking steps to reduce liftings in September in accordance with their new quotas. 25X1

OPEC Oil Production, 1986 *Million b/d*

	New Quota	First Half	July	August
Total	**16.65**	**18.3**	**20.0**	**20.5**
Algeria	0.66	0.7	0.7	0.7
Ecuador	0.23	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2
Indonesia	1.19	1.3	1.3	1.3
Iran	2.30	2.3	2.2	2.0
Iraq	1.80	1.8	1.8	1.8
Kuwait [a]	0.90	1.4 (1.3)	1.8 (1.6)	1.8 (1.6)
Libya	0.99	1.1	1.1	1.1
Nigeria	1.30	1.5	1.5	1.5
Qatar	0.28	0.3	0.4	0.4
Saudi Arabia [a]	4.35	4.6 (4.5)	5.9 (5.8)	6.6 (6.5)
United Arab Emirates	0.95	1.3	1.3	1.3
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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Iranian-Soviet Natural Gas Agreement

Iran's claim that it will resume natural gas exports to the USSR before the end of this year is intended to improve Tehran's economic ties to Moscow and to bolster its international image. Iranian media report both countries will undertake a three-month study to determine what repairs are needed along the 1,200-kilometer pipeline. Tehran has not used the line since it discontinued gas exports to the USSR as a result of a price dispute six years ago. Soviet media have yet to mention any agreement to reopen the pipeline. Iranian gas sales to the USSR are unlikely to resume for at least the next year. Repairing the pipeline will probably take six months to a year, and weak energy prices and the issue of who will pay for the repairs may still preclude a final agreement. Iran's optimistic announcement probably is another attempt to demonstrate that it is not isolated and can build relations with an important ally of Iraq. Tehran presumably also hopes that progress on the gas issue would improve prospects for the long-delayed meeting of the bilateral economic commission. Any broader breakthrough in relations remains unlikely. 25X1

New Delhi Seeks Modern Oil Technology

India is seeking to purchase Western oil equipment in an effort to increase the efficiency and output of its petroleum sector. New Delhi expects to begin contracting for up-to-date oil-metering equipment for use in two refineries late this fall. 25X1 India, which has traditionally relied on Soviet equipment and assistance, would like to expand its modernization program and is looking toward the West for the necessary technology. 25X1 India hopes to maintain imports at about 40 percent of its oil requirements, but imports are likely to account for about 60 percent of consumption by the end of the decade because of poor prospects for additional oil discoveries and inefficiencies in the oil industry. 25X1

International Finance

Obstacles to Nigerian IMF Accord

Financial officials are laying the groundwork for an IMF agreement, but President Babangida's failure to obtain backing from the ruling military council and continued discontent in the Army reduce the chances of reaching a formal accord. A visiting IMF delegation negotiated a draft economic reform program with officials in Lagos last month and expects to receive a formal request for a standby agreement soon, according to the US Embassy. The IMF team noted, however, that it talked only with civilian bureaucrats and did not know how receptive to an accord the ruling council would be. the 25X1 government remains concerned about discontent in the military. Even if Babangida goes ahead with some aspects of the agreement, such as the two-tier foreign exchange market, his willingness to accept a formal IMF program is doubtful as long as the ruling council remains opposed. Babangida is probably going through the motions of seeking an agreement, however, to show that the IMF approves his economic reforms, which in turn could facilitate a critical debt rescheduling. 25X1

Ecuador Negotiates $200 Million Syndicated Loan

Quito will obtain a $200 million commercial loan in mid-September secured by Ecuador's oil export revenues and used to help offset this year's estimated $750 million foreign payments deficit. Some of the proceeds will go toward repayment of a $150 million bridge loan from the United States. Commercial banks from Japan, Europe, and the United States have agreed to participate in this loan syndication. The loan may be renewed after one year. According to IMF estimates, Ecuadorean oil prices must stabilize at $12 per barrel to prevent serious financial shortfalls, which could require the implementation of additional economic measures such as import restrictions. 25X1

Tanzania's New IMF Agreement

According to a US official, the IMF Executive Board approved on 28 August a $75 million, 18-month standby arrangement with Tanzania, effective September 1986. This is Tanzania's first IMF standby arrangement since 1980 and has been the subject of protracted and difficult negotiations. The new government of President Mwinyi will implement drastic economic reforms as part of the IMF arrangement. Developed country financial supporters of Tanzania have insisted on the IMF program as a condition for continued support. Although Mwinyi is drawing up an economic recovery plan, ex-President Nyerere, a longtime IMF opponent, retains substantial influence. Tanzania has not demonstrated the will to overhaul its inefficient economic system, and we believe Tanzania will be hard pressed to sustain the IMF program over 18 months. 25X1

International Trade

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Global and Regional Developments

Britain May Pull Out of Airbus Project

British Aerospace is considering pulling out of a $3.7 billion Airbus Industrie project because of London's reluctance to pay the full British share of development costs. The A330 and A340, which are under development by the consortium, are medium- and long-range airliners, respectively, that would compete in the higher capacity markets dominated by Boeing. State-owned British Aerospace is responsible for designing and developing the wings for both aircraft. The company, however, says it will participate only if London provides roughly $1 billion to cover costs—the government is willing to put up half that amount. London apparently believes that space research is a better long-term investment and favors participation in the Airbus project by McDonnell Douglas, which is also developing a long-range airliner and has held preliminary talks with Airbus. We believe the British will not pull out because of the number of jobs involved and that a compromise reducing the UK share will be reached. Because West European budgetary funds are generally tight, Airbus would probably push to recruit other West European aircraft manufacturers, such as Aeritalia of Italy and Fokker of the Netherlands, if Britain abandoned the project. Although the French oppose a McDonnell Douglas role, perhaps the biggest obstacle to a McDonnell Douglas–Airbus agreement is that one side would have to abandon its long-range airliner program and hence become vulnerable to policy changes by the other partner. 25X1

Turkey Applying for EC Membership

Ankara may apply for full EC membership at a meeting this month of the Turkish-EC association council. Senior Foreign Ministry officials have long recommended pressing for full membership, but Prime Minister Ozal has been reluctant to set an early timetable. Ozal is almost certainly aware that an application at this time would be greeted unenthusiastically because the EC has actively discouraged the Turks from applying soon for membership. Ankara may hope, nonetheless, to use its application as a bargaining chip to extract concessions from the EC, including the release of approximately $540 million in aid frozen after the military takeover in 1980. The Greeks are already objecting to revitalizing the Turkish-EC association protocol, however, and a Turkish decision to press for full membership now could complicate these discussions. Any rebuff by the EC could also strengthen the position of those in the Turkish Government who want to distance Turkey from Western Europe. 25X1

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Kuwaiti-Soviet Exchanges Continue

Kuwaiti Foreign Under Secretary al Shaheen will visit Moscow in mid-September for talks on the Iran-Iraq war and other regional issues. The US Embassy in Kuwait says a second delegation will follow to discuss joint economic projects proposed during the visit of a Soviet delegation in late July. The economic delegation may be accompanied by the vice president of the Kuwaiti-owned, US-based Santa Fe Company, which uses state-of-the-art US oil technology. 25X1

These recent exchanges highlight efforts to strengthen bilateral ties and to benefit from what both countries probably see as an increasing convergence of interests. Moscow continues to show interest in the oil technology Santa Fe possesses and may use the loan to finance purchases of equipment. 25X1

National Developments

Developed Countries

Canadian Policy Dilemma

Ottawa faces a difficult choice between aiding its struggling energy sector and containing its large budget deficit. Gulf-Canada recently shut down its operations in the Beaufort Sea—where the company had earlier made one of the largest oil discoveries in Canada—claiming oil prices below $20 per barrel do not justify further development. Similarly, reports in the financial press indicate that low oil prices may also delay development of the large Hibernia field off Canada's eastern coast. Ottawa is attempting to maintain exploration by offering loan guarantees to private firms—including $700 million for Hibernia—and other assistance. The government's ability to shore up the energy sector is constrained, however, by fears of aggravating the budget deficit and causing a sharp depreciation of the Canadian dollar. This concern prompted Ottawa to reject calls for abolishing a revenue-based federal tax that is expected to bring in $400 million this year, and instead criticize Alberta for not lowering its provincial royalty rates. Although Ottawa is presently holding the line on spending, pressure to aid the depressed energy sector will certainly increase when Parliament returns this month. 25X1

Canada To Push Tax Reform

Faced with a continuing budget deficit and stagnant employment, Ottawa has decided to make tax reform the centerpiece of its economic agenda this fall. Although the government probably will meet its 1986 expenditure target, sluggish economic growth may cut as much as $1.5 billion from expected revenue; slow growth also brought job creation to a halt eight months ago. Ottawa is unwilling to buck the political opposition to expenditure cuts and apparently believes tax reform offers the best chance for restoring its reputation for fiscal competence among the business community. To buttress support for its proposals in the financial markets, Ottawa is planning to have Finance Minister Wilson make a nationwide address on the state of the economy and the government's economic agenda later this fall. The government probably also hopes that the prospect of lower marginal tax rates on personal incomes—and a resulting boost to economic activity—will reverse its slide in the public opinion polls. 25X1

Bleak Forecast for Japanese Economy

Our econometric model of the Japanese economy suggests that economic growth in Japan could fall below 2 percent this year with only a slight improvement in 1987. The economy's poor performance—the worst since 1974—is largely the result of the 53-percent appreciation of the yen against the dollar since last summer. Yen appreciation is cutting into both earnings and production of export-related firms—such as autos and electrical appliance producers—and is forcing them to cut investment spending. We expect the decline in export volumes to accelerate over the next few months as overseas purchasers react to higher dollar prices. Indeed, our model suggests a sharper drop in export volumes than that expected by private Japanese forecasters. For its part, the Japanese Government is beginning to admit that the economic outlook is dismal. According to the Japanese press, the Economic Planning Agency will soon lower its growth forecast for the fiscal year

ending on 31 March from 4 percent to only 2.8 percent—implying a growth rate of approximately 2.5 percent for calendar year 1986. The lowering of the EPA forecast will undoubtedly add to pressures within the ruling party and government ministries for a shift in Tokyo's austere budget stance. If Tokyo believes that the economic deterioration will continue into 1987, the Nakasone government may reconsider its opposition to stimulating the economy. 25X1

Japan Grapples With Budget Strategy

The Japanese press is seizing on Finance Minister Miyazawa's comment this week that he is preparing an 18-month budget (combining the fall supplemental budget with the budget for FY 1987, which begins on 1 April) as signaling a shift in Tokyo's five-year-old fiscal austerity. We believe, however, that it is still too early to tell whether the political lobbying for pump priming measures to spur the lagging economy can overcome working-level Finance Ministry resistance. The 18-month proposal may in fact be a Finance Ministry tactic to dilute political input into the budget process. The outcome of the debate, 25X1 is likely to be a package that 25X1 minimizes additional central government borrowing and relies instead on public works financed by Tokyo's "second budget" as well as by local governments. The politicians have not yet had their final say, but, in our view, the government's most influential economic policy makers seem to be resigned to growth in the 2- to 3-percent-range next year and prefer to rely principally on lower interest rates and the hoped-for stimulative impact of lower energy and import prices to boost the economy. 25X1

New President of West German Union

In October we expect Franz Steinkuhler, 49, to be elected president of IG Metall, the largest trade union in the non-Communist world—a position giving him the potential to wield considerable influence on German industrial and economic policy. We believe he will continue the militant stance of the 2.5-million-member union, whose strikes have occasionally shut down significant sectors such as the auto industry. To maintain membership levels, Steinkuhler may try to organize white-collar and technical workers in the metal industry, a move he hopes would strengthen his and IG Metall's political influence and popular appeal. After assuming the presidency, Steinkhuhler will fight for a 35-hour workweek and for protecting jobs threatened by new technology. In our view, the forceful and shrewd Steinkhuhler will use a mixture of conflict and collaboration with management and government to achieve his goals. 25X1

Lisbon Raises Minimum Capital Requirement for Banks

Lisbon's sudden 67-percent increase in the minimum capital requirement for banks has led the six newly established foreign banks to reconsider their investments. The new measure essentially affects only private banks because the nationalized banks already meet the stiffer requirement. Foreign bankers see in the new law—one of a series of regulations favoring nationalized banks—Lisbon's desire to protect the public banks from a competitive environment. They also feel that the required capital level is too large for the small Portuguese market, bears no relation to their banks' size or type of activities, and is certain to eat into profit margins. Some banks have hinted that they may liquidate at the end of the one-year deadline for meeting the new requirement. Foreign investment fell 16 percent in first quarter 1986, and a further deterioration in investor confidence is certain to hinder Lisbon's push for modernization through foreign capital and technology.

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Less Developed Countries

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Progress on Lebanon's Christian Airport

The Maronite Christian's controversial alternative to Muslim-controlled Beirut International Airport—Halat Airport north of Beirut—may begin service soon, according to defense attache reporting. Halat is a privately financed project designed to facilitate international travel for the Maronite Christian community, which currently relies on ferry service to Cyprus.

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Commercial service from the airport would increase Christian self-sufficiency and further formalize Lebanon's de facto partition. International response has been cool thus far, and Halat still faces stiff opposition from the Syrians, as well as Lebanese Muslims and Druze.

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Press reports in May indicate the runway was shelled by pro-Syrian Muslim militiamen. Public Works Minister and Druze leader Walid Jumblatt has refused to officially sanction Halat, although Embassy reporting indicates he will not actively oppose the project.

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Djibouti To Get French Bailout

France has decided to increase its budgetary assistance to Djibouti in 1987 but probably will require the Gouled regime to implement structural changes, according to US Embassy reporting. The move comes on the heels of a French assessment that Djibouti's fiscal status is unsustainable and should be corrected while the government is still solvent. President Gouled has subsequently adopted several belt-tightening measures that probably will pull Djibouti through 1986, but the government will deplete its reserves and still face a severe budget crunch in 1987 without greater external assistance, further fiscal reforms, or increased revenues. The French bailout probably will be timed to eliminate pressure on Gouled to make politically risky reforms—such as cutting civil servants' and military pay—before the presidential election in June 1987. After the election, however, Gouled probably will encounter strong French pressure to trim the bloated government bureaucracy, parastatals, and the country's generous social welfare programs. 25X1

Afghanistan's Troubled Trade Situation

Afghanistan's foreign trade situation is deteriorating because of rising imports and decreased earnings of hard currency, according to the US Embassy. Imports have increased in recent years because of the need to feed the growing urban population and provide capital goods to rebuild damaged infrastructure. At the same time, the cost of imports is rising and merchants regularly pay "taxes" to insurgent forces to ensure safe transit of their goods. Most Kabul merchants also use private trucks—which cost 40 percent more than government trucking—to reduce the risk of insurgent interdiction of their goods. Hard currency exports are suffering from increased competition in traditional markets—from California raisins in the important British market and from Indian carpets in international markets. 25X1

Afghan Regime Plans Population Resettlement

The Kabul regime plans to relocate 30,000 families from the eastern border areas to the sparsely settled western provinces, according to the US Embassy. A top Afghan Government official claims that overpopulation and surplus labor in the east are the primary reasons for the proposed population transfer. The plan, however, is almost certainly part of Kabul's effort to depopulate the east in order to eliminate the insurgents' base of support and to shut down their supply routes from Pakistan. Heavy fighting and bombing attacks in key regions in the east have already depopulated many areas. The official also said that, although the regime will not rely strictly on voluntary movement, it will not use force. Few families are likely to move voluntarily, however, and the government almost certainly will have to exert pressure to accomplish its goals. Forcible relocation would probably prompt many to flee to Pakistan. The government has not announced when the plan will begin. 25X1

Communist

Possible Chinese Currency Moves

Hong Kong newspapers have reported that China will stop issuing Foreign Exchange Certificates (FEC)—a convertible renminbi-denominated currency that can be used to purchase imported goods—on 1 October. The reports state that FECs will continue to be redeemable for foreign currency until March 1987, and suggest China will institute a voucher system to allow foreign travelers to reconvert renminbi into foreign currency when leaving the country. China may also devalue the renminbi to raise the domestic price of imports in conjunction with the FEC withdrawal. The US Embassy has reported unsubstantiated rumors that China's currency will be devalued roughly 20 percent this fall, and that the exchange rate may reach 4.5 yuan per dollar by yearend. China recently devalued its currency 13.5 percent in an attempt to reduce the country's trade deficit and slow the currency black market. Even with another devaluation, the withdrawal of the convertible FEC will fuel the black market in foreign currency and pinch some joint ventures. 25X1

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