



**Directorate of
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International Economic & Energy Weekly



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19 September 1986

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*DI IEEW 86-038
19 September 1986*

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**International
Economic & Energy Weekly**

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Comments and queries regarding this publication are welcome. They may be directed to [Redacted] Directorate of Intelligence [Redacted]

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Synopsis

1	Perspective—The IMF/IBRD Annual Meetings: Still Wrestling With LDC Debt	25X1
	The joint annual meetings of the IMF and the World Bank are again bringing creditors and debtors together under a cloud of LDC debt problems. The more important discussions will occur in the informal sessions focusing on the current debt problems and the strategy for dealing with them.	25X1
3	LDC External Debt: Significant Trends and Risks	25X1
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7	Mexican-IMF Agreement: The Risk of Spillover	25X1
	We believe the Mexican-IMF agreement announced on 22 July breaks new ground on debt negotiations, and it is likely to become a model for other debtors. The precedents established in the agreement could create new risks for debtor-creditor cooperation.	25X1
13	International Financial Situation: Outlook for Key East Asian Debtors	25X1
	Commercial bankers, battered by their troubles in Latin America, are becoming more apprehensive as the East Asian LDC's ability to repay their foreign debts deteriorates. While none of these countries is in a crisis, all with the exception of South Korea may require debt relief within the next two years.	25X1
19	Soviet Oil Trade in a Weak Market	25X1
	Crude oil sales picked up in the second quarter and Moscow can keep oil exports high for the rest of the year because of continuing high domestic oil production and increased reexports of Middle Eastern oil. Nonetheless, a rise in domestic demand could dash any plans for increased exports and further depress earnings.	25X1

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Western Europe's Automobile Industry: Stiff Challenge To Restructuring



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The performance of the West European automobile industry has improved recently because of generally better economic conditions, but continued excess capacity and political constraints on reducing the labor force cast a shadow over longer term prospects. Although Western Europe's major producers are, to varying degrees, turning to robots and automated design and production processes to improve efficiency, these efforts will not be enough to beat back the Japanese, who have increased exports and are expanding assembly operations in Western Europe.



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Perspective***The IMF/IBRD Annual Meetings: Still Wrestling With LDC Debt***

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The joint annual meetings of the IMF and the World Bank are again bringing creditors and debtors together under a cloud of LDC debt problems. The mood is not one of apprehension over the stability of the international financial system as it was in Toronto in 1982 following the shock of the Mexican and the Brazilian financial crises, nor is there the sense of anticipation felt last year in Seoul when the United States unveiled the initiative now known as the Baker Plan. The feeling instead seems to involve a deepening frustration by debtors and other financial players with the slow progress made in reducing the debt burden on LDCs.

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This series of meetings, which begin on 28 September with the IMF Interim Committee meeting, have a variety of topics scheduled for discussion, including aid coordination in Sub-Saharan Africa, World Bank investment programs, and a World Bank capital increase. The more important discussions, however, will occur in informal sessions. These bilateral meetings, involving commercial bankers and government financial officials from creditor and debtor countries, undoubtedly will focus on the current debt problems and the strategy for dealing with them.

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In this arena, the chief issue will be the contention of the LDCs and even some creditor banks that a revised approach extending beyond the general guidelines of the Baker Plan is needed. For their part, the common theme of the LDCs has been a return to economic growth instead of additional austerity. In practical terms, this translates into additional funds from creditors with reduced or minimal conditionality. A number of debtors believe the IMF has outlived its usefulness, and the World Bank—or a new agency—should administer the adjustment process in individual countries over a longer time period. From the debtors' standpoint, this involves a much greater role for the developed country governments to ensure a steady flow of funds into the LDCs.

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Bankers also would welcome a greater creditor government role in the debt strategy to protect their position. Most bankers—particularly in the United States—want to reduce their foreign exposure and are extremely reluctant to continue involuntary lending to a core of debt-troubled LDCs. On the other hand, bankers realize that, without continued new lending, the risk of a payment interruption by one or more major debtors increases dramatically. In particular, there is a nagging fear that a major creditor such as Mexico will take some unilateral action—limiting payments to a share of export earnings, for example—that would take repayment decisions out of the bankers' control. Bankers, therefore, look to creditor governments to assuage the threat of any total or partial payments moratorium.

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We believe these trends may put the ball largely in the court of the developed countries, with the US Government being viewed as the leader; some players in the debt crisis may even use the meetings as a forum to increase such pressure. If developed country governments are forced to take on this role, they will face a difficult challenge. The most immediate task will be to keep the Mexican deal, already showing signs of bogging down, on track. Although the developed countries will reaffirm the need to adhere to the current debt strategy with some modifications to promote economic growth, a final resolution to the Mexican—and thus other—negotiations almost certainly will require the involvement of high-ranking Western government and banking officials.

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LDC External Debt: Significant Trends and Risks

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LDC debt probably will reach about \$855 billion by yearend 1986—up by some \$21 billion from yearend 1985. We project that LDC debt service payments will be about \$115-120 billion in 1986, about the same as last year. Given the stagnation of LDC exports, the aggregate LDC debt service ratio will remain high—above 20 percent—and constrain improvements in their debt situations. We expect a major resurgence in LDC demands for external financing and debt relief and increased deterioration in LDC economic performance.

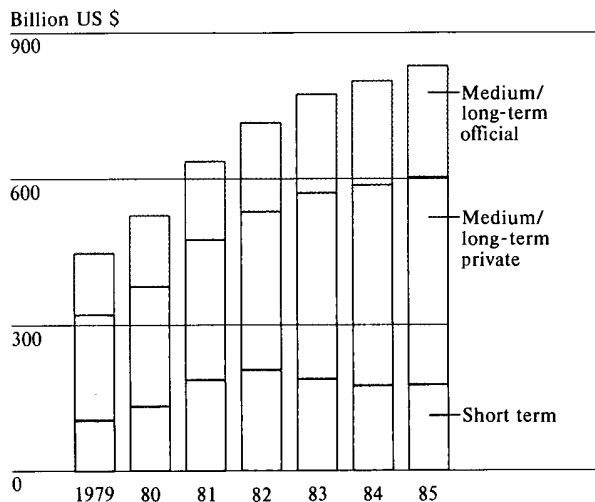
The Debtor's Perspective: Increased Relief Needed

Because of reduced bank lending, dubious prospects for other sources of financing—such as foreign aid or direct investment—and falling prices for many of their key exports, the major debt-troubled countries face an economic development crisis. Moreover, many LDC government officials believe that the approach to balance-of-payments adjustments taken by some since 1982—seeking to improve export performance and cut imports with monetary and fiscal measures and more realistic interest and exchange rate policies—has not worked. Finally, the debtor countries appear no closer to regaining access to voluntary, substantial medium-term loans from commercial banks.

As a result of these trends, LDC living standards have fallen, unemployment has risen, inflation remains a worry, a rising share of domestic savings goes into interest payments, and domestic investment has slowed dramatically. In effect, economic development for many LDCs has been deferred to preserve limited

[Redacted]

Aggregate LDC External Debt, 1979-85



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creditworthiness in the international financial markets. The net outflow of resources from these countries to commercial banks and creditor countries totaled some \$22 billion in 1985 and is continuing at a similar pace this year.

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Country Situations

Mexico—facing dwindling reserves, negative growth, and rising inflation—secured an IMF letter of intent in August. Current debt negotiations may lead to a

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\$12 billion international rescue package that may include \$6 billion in new commercial bank loans for 1986 and 1987 and a contingency fund to cover earnings losses from a further oil price decline. If bankers refuse to renew substantial lending or provide significant concessions this fall, we believe Mexico will again raise the specter of a payments suspension, possibly by opening a special account in the central bank where interest owed to foreign banks would be deposited in pesos rather than in dollars. [redacted]

After a good start, *Argentina's* Austral Plan is faltering and Buenos Aires is likely to ask for as much as \$1.5 billion a year in new money for 1986 and 1987, coupled with a program to reschedule about \$14 billion of debt due during those years. In addition, it might seek interest rate concessions. Argentina could, on its own, take some action to cap interest payments if domestic labor unrest grows worse and banks rebuff Buenos Aires's efforts to obtain the \$3 billion. President Alfonsin has reiterated the need for interest concessions to Argentina because of the depressing effect of US-subsidized sales to the Soviet Union on world wheat prices. [redacted]

According to Embassy reporting, *Venezuela* may request \$600 million in new money, ask for postponement of \$3.4 billion in principal repayments due during 1987-89, and seek further unspecified concessions on interest rates. Venezuela recently attempted a scheme to pay off private-sector debts totaling almost \$5 billion with low-interest, long-term bonds. The scheme was scrapped in the face of strong bankers' resistance. Caracas is now likely to seek a less objectionable rescheduling arrangement with bankers. [redacted]

Peru has serious problems with its relations with creditors, and there is a danger that it may be the first debtor in recent years to be formally declared in default. Already, the IMF has declared Peru ineligible to draw on Fund resources. Lima continues to limit debt payments to 10 percent of export earnings and would welcome similar actions from other debtors in support of its position. [redacted]

Bank creditors expect that *Egypt* will need a debt rescheduling soon—its first—to help offset sharply lower oil export revenues and worker remittances. In addition, *Nigeria* will need as much as \$1 billion in new loans annually over the next few years, according to World Bank estimates, even with maximum debt rescheduling. Lagos still must formalize an IMF standby arrangement to obtain commercial bank new money and a Paris Club rescheduling. [redacted]

In Asia, the greatest problem is the *Philippines*, which, despite some recent limited economic gains, remains burdened by its \$26 billion external debt. The most immediate challenge for President Aquino is to get foreign financial assistance flowing into the country again. Hopes are that an IMF-supported program will be in place in time for Manila to draw its final commercial bank new money disbursement before the end of the year. Executing a new economic plan without considerable new external financing will be difficult because of the discord among Aquino's Cabinet members. [redacted]

Creditors' Financial Positions and Perspectives

While debtor positions are growing more strained, some international banks—especially smaller US regional banks and West European banks—are in a better position now to deal with LDC payment difficulties than they have been since the debt crisis began in mid-1982. Most banks have increased their capital base while lending little additional money to debt-troubled LDCs, and they have built up reserves against some bad loans. As a result, these banks now feel they can refuse to participate in new lending if they find the arrangements unacceptable. [redacted]

In part because of their strong financial positions, commercial banks will remain unwilling to extend new medium-term loans to most LDCs unless pressured to do so in financial packages in conjunction with the IMF [redacted] Despite being more able to extend such loans, the banks

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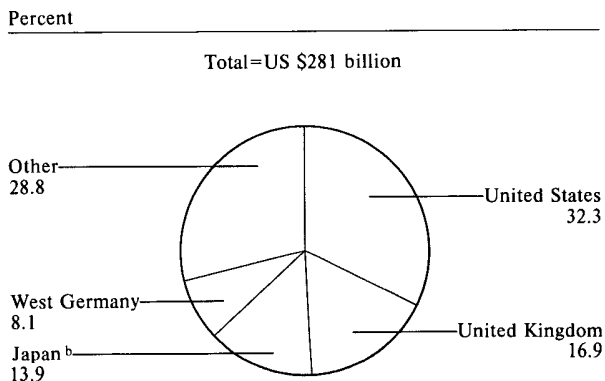
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Commercial Bank Exposure to 15 Troubled Debtors, 1985^a



^a Data are for December 1985. The 15 countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.
^b Estimated.

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prefer to further reduce their exposure and improve the integrity of their loan portfolios. Private creditors—primarily commercial banks—probably will boost their lending by only 3 to 5 percent during 1987. Moreover, most of the increase in bank lending will come in conjunction with debt restructuring packages for a handful of major debtor countries. [Redacted]

We believe raising new money for heavily indebted countries will even be difficult when the country has IMF support and, at the same time, IMF support need not preclude a debtor from seeking concessions from creditors. US regional banks and other foreign banks with small exposure, for example, would prefer to write off their Mexican debt and take a loss than to contribute to a new loan they believe would not be paid back. Thus, the forced bank lending to LDCs over the medium-term probably will be concentrated even more among the largest commercial banks in the world—increasing both the burden and the risk of new LDC exposure for these banks. [Redacted]

New lending to LDCs is also discouraged by a secondary market that trades LDC debt at a deep discount and the rapid evolution of financial markets that is changing bank lending strategies away from sovereign country lending. [Redacted]

[Redacted] banks complain about what they perceive as conflicting signals from their regulators that penalize them for lending new money, even within the context of the Baker initiative. For example, in Japan and several European countries, supervisory authorities require sizable reserves against both old and new loans. As a result, these banks must take a charge against earnings when they make new loans, and often this charge is not tax deductible. [Redacted]

Outlook: Compromise Likely, But Risks Remain

In our view, debtor-commercial bank negotiations during the next 18 months probably will result in some middle ground between large forced lending or partial debt forgiveness by commercial banks and unilateral debtor action—the costs to both parties of a complete breakdown in debtor-creditor relations are extremely high. From the creditor point of view, the Baker initiative provides a broad framework within which bilateral negotiations will be carried out. [Redacted]

[Redacted] On the debtor side, while they will continue to press for concessions, they, too, probably will accept compromise—agreeing to actions such as changing the basis for interest rates from US Prime to LIBOR, for example. Nevertheless, a break from the current debt strategy—by either a major debtor or creditor—cannot be ruled out. [Redacted]

In this environment of increased debtor demands for relief and commercial bank reluctance to lend, we believe there may be a number of situations where the US Government may be called on to intercede between the two groups:

- Almost certainly, Washington will have to stay involved in the Mexican financial negotiations. The

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short-term risks are that foreign creditors will remain unconvinced of the extent of economic reform and be unwilling to supply new money in the amount requested. In addition, disagreement over Mexican proposals could drag out negotiations, in which case there would almost certainly be difficulty in meeting interest payments on the external debt.

- If a major debtor country chooses to unilaterally curtail interest payments, the United States will be called upon by international banks to use its leverage to bring the debtor around or to provide new regulatory changes to help cushion the resulting bank losses.

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Washington's need to intervene in resolving LDC debt difficulties also will be affected by global economic policies and conditions. If the industrial West, particularly the United States, were to go into a recession, if dollar interest rates were to rise, or if trade protection continues to grow, LDC debt service problems would increase and debtors almost certainly would demand countering actions from Washington.

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Mexican-IMF Agreement: The Risk of Spillover

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We believe the Mexican-IMF agreement announced on 22 July breaks new ground on debt negotiations. It is likely to become a model for other debtors who are facing similar financial difficulties. They will probably put strong pressure on creditors for comparable debt relief, citing a bleak financial outlook, prior economic reform efforts, or a special relationship with creditors. The precedents established in the agreement could create new risks for debtor-creditor cooperation. For example, if key debtors fail to receive what they consider to be equal treatment, it is possible that they may adopt unilateral measures to limit their debt service payments.

Latin American Debtors

We believe several Latin American countries are candidates for spillover. These debtors will base arguments for debt relief on current financial hardships, the need for renewed economic growth, and prior structural adjustment achievements. These countries have closely followed the Mexican talks and are positioning themselves to demand similar concessions.

Argentine officials will be quick to point out the progress of the year-old austerity program, the Austral Plan, which has sharply lowered the inflation rate, reduced the government budget deficit as a share of GDP, and set the stage for short-term industrial improvement. Nonetheless, agricultural exports have been depressed by falling prices, and Buenos Aires also will cite the US decision to subsidize agricultural sales to the Soviet Union as wreaking further havoc with their foreign payments position.

Buenos Aires already is drawing out its negotiations to see the outcome of the Mexican agreement.

Brazil—with a foreign debt of more than \$100 billion, massive debt service payments, and a high debt service ratio—is also likely to seek Mexican-type

The Mexican Program

Major concessions of the IMF-Mexico letter of intent include:

- **The amount of new financing.** *The agreement assumes over \$12 billion in new money between now and the end of 1987, with half coming from commercial banks, according to financial press reporting. Multilateral banks, led by the World Bank and IMF, will supply nearly \$4 billion. The remaining \$2 billion are international export and US farm credits.*
- **Tying additional loans to commodity prices.** *A contingency fund has been created under the letter of intent to insulate Mexico from the further effects of declining oil prices. New money would be made available automatically if oil prices fall below \$9 a barrel for more than 90 days during the first nine months of the accord, less if prices rise above \$14 per barrel.*
- **An orientation toward growth.** *The Fund agreed to let Mexico tailor an economic recovery program that allows real GDP growth of at least 3 percent starting in 1987. In addition, a \$500 million reserve was established and will be disbursed to bolster domestic investment if the economy fails to recover by the first quarter of 1987.*
- **The longer term creditor commitment.** *Mexico can seek medium-term lending commitments from creditor banks beyond the 18 months covered by the IMF-supported program. In addition, the letter of intent reportedly allows Mexico to automatically renew the IMF package for another year at the end of the program.*

Although most of the official funding has been approved for the package, Mexico's commercial creditors have yet to agree to provide the \$6 billion laid out in the accord.

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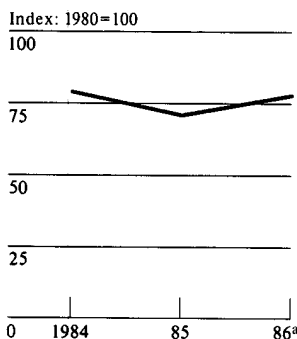
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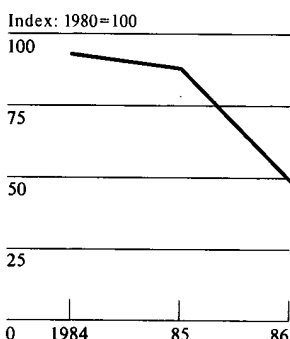
Key LDC Debtors: The Road to Financial Problems, 1975-86

Note scale changes

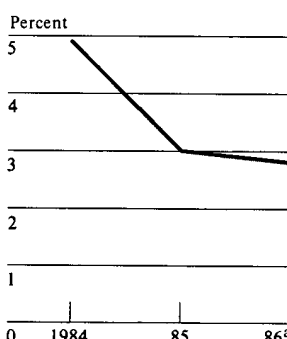
Low Commodity Prices . . .



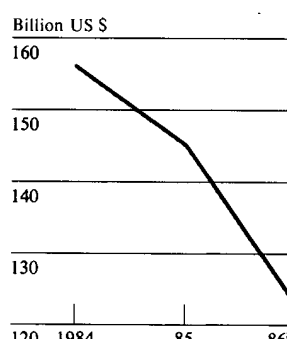
Plunging Oil Prices . . .



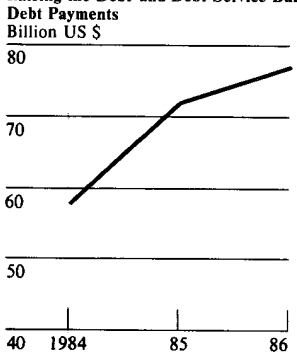
And Slowing OECD Real GNP . . .



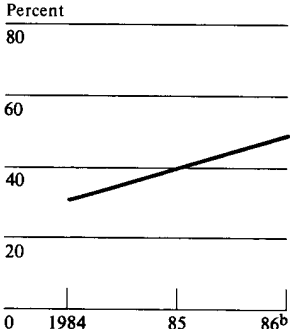
Have Sharply Cut Export Earnings



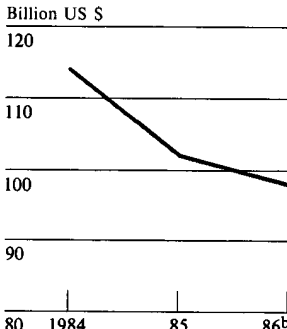
Raising the Debt and Debt Service Burden . . .



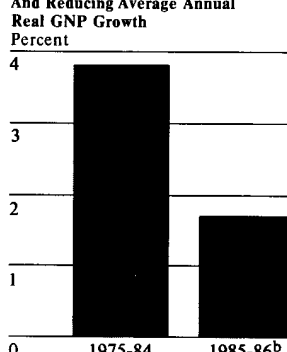
Debt Service Ratio



Forcing Import Cutbacks . . .



And Reducing Average Annual Real GNP Growth



^a Data for 1986 is for the first half.

^b Estimated.

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concessions, despite its strong current account position and substantial foreign exchange reserves. The Sarney administration has repeatedly argued that foreign creditors should give Brazil the easiest financing conditions in Latin America because of that country's economic adjustment achievements. Brasilia can cite the elimination of a current account deficit that was \$16 billion in 1982, tax reform, and budget consolidation. More recently, the Cruzado Plan—Brazil's six-month-old austerity program—has weakened the in-

flationary spiral, reduced interest rates, and set in motion some market-oriented reforms that could strengthen the economy.

Venezuela may argue for debt relief on grounds of a poor financial situation, the need to revive a stalled economy, and bank reluctance to provide new funds. Low oil prices will cost Venezuela \$5-6 billion in

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export revenue this year, and we forecast a 2-percent decline in real GDP. As a result, Caracas may request a postponement of \$3.4 billion in principal payments due during 1987-89. In our opinion, a rescheduling of public- and private-sector debt, coupled with the use of foreign exchange reserves, should be sufficient to cover the loss of export revenue in the near-term.

[redacted]

Despite a strong record of economic management, **Ecuador**, beset by the sharp drop in oil prices that will slash export revenues by \$500-600 million this year and increase the current account deficit to \$750 million, has had to negotiate increased financial assistance and institute additional economic reforms. Given Ecuador's poor financial outlook, we believe that Quito is a strong candidate for requesting concessions.

[redacted]

The Central American **Core Four** countries—Costa Rica, El Salvador, Guatemala, and Honduras—may be candidates for spillover. We expect total debt service will remain near 40 percent of goods and services exports—more than double the 1980 level. We forecast a slight increase in real GDP this year that will do little to offset the 5-percent decline from 1980 to 1985. Despite an expected improvement in the trade picture this year due to higher coffee prices and lower petroleum imports, we expect most of these debtors to seek payment concessions and new financing citing the need to compensate for five years of eroding export earnings, the continued fall in per capita income, and the need to combat insurgent threats.

[redacted]

Peru's financial outlook is clouded by a number of adverse factors, including persistently low commodity prices. Because of President Garcia's attempt to secure de facto debt relief by linking debt repayments to export revenues, and a near-complete lack of investor confidence, Peru almost certainly will not obtain major debt concessions from commercial banks or the IMF unless it substantially alters its hardline position on debt repayment.

[redacted]

Other Key Spillover Candidates

In general, the potential for spillover is not as great in Asia as in Latin America. Most of these countries have considerably stronger financial positions. Moreover, Asian debtors are less belligerent toward creditors and are more amenable to implementing measures to permit full servicing of debt obligations.

[redacted]

Indonesia and **Malaysia** have suffered economic and financial reverses during the past two years. Lower oil prices and, for Malaysia, a drastic decline in commodity prices have sharply reduced export earnings for the two countries, and the decline of the US dollar has boosted debt servicing costs on the portion of foreign debt that is nondollar denominated. While short-term measures such as use of foreign exchange reserves and modest increases in foreign borrowing will be sufficient to cover the financial gaps during the next 18 months, over the 1988-90 period both countries will need substantial amounts of new funding to maintain high GDP growth and absorb labor force increases unless oil and commodity prices rebound. If these funds are not forthcoming, Mexican-like debt concessions could be requested.

[redacted]

The **Philippines** is an exception to this more optimistic Asian picture. Since 1984, Philippine export earnings have been depressed by a 40-percent drop in commodity prices, imports have been slashed, and real GDP has fallen more than 2 percent. Moves by President Aquino, however, have put economic adjustment measures into effect—tax measures have been passed, trade liberalization is under way, and reform of financial institutions has begun. With renewed economic growth a top government priority, Manila is seeking the support of its foreign donors for a growth-oriented economic strategy that includes a multiyear debt rescheduling and tolerates a high government budget deficit.

[redacted]

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Among the major Middle Eastern and African debtors, *Egypt's* export revenues have been devastated by lower oil prices and a sharp drop off in worker remittances, and even with modest import cutbacks we believe Cairo will require substantial new funding to meet financial needs. Egypt will probably also point to a new economic reform package as justification for debt relief, although Cairo has proven more adept at proposing reforms than at implementing them. Finally, Egypt will continue to cite its special relationship with the United States as an argument for debt concessions. [redacted]

Nigeria could make the argument that its financial condition is worse than Mexico's and that major debt relief is a necessity. The oil price drop will slash Nigerian export earnings by as much as \$5 billion this year, and political considerations will make meaningful austerity measures difficult. Nevertheless, Nigeria does not seem willing to press the issue of debt relief. Lagos is aware that past actions—such as accumulation of large debt arrearages and refusal to make needed reforms—have made creditors reluctant to undertake further lending. [redacted]

Risks and Opportunities

We believe the precedents established in the Mexican agreement may create new financial risks for both major debtors and international creditors:

- The conduct of current debt negotiations may deteriorate. The Mexican package makes it politically more difficult for other debtors to continue paying without extracting concessions from creditors and harder to operate under the old strategy where continued financing was contingent on a strict IMF-supported program. If a debtor fails to receive what it considers adequate financing or payment terms, or cannot find other ways to reduce debt payments, there is a greater possibility that it will use its leverage and unilaterally act to curtail payments.
- Financial relations will become more complicated. Key debtors with narrow export bases—such as Argentina, Indonesia, and Venezuela—could demand terms linking commodity export prices to repayments. Similarly, LDCs may follow Brazil's lead and try to link debt payments to GDP.

Alternative Payment Schemes

While we believe debtor demands for relief will be modeled after the Mexican financial package, alternative schemes have been proposed—and some implemented. These include tying payments to export revenues (Peru and Mexico), issuing bonds to service debt (Venezuela), and domestic currency deposit schemes (Mexico). Some of these proposals could surface again as debtor countries search for ways to ease their financial problems. Creditors have generally responded harshly to unilateral attempts at reducing debt payments, viewing such payment schemes as setting dangerous precedents and as obstacles to financial negotiations. When unilateral actions are taken, banks often retaliate against the LDC by cutting back short-term trade financing. They may, however, also take more drastic steps: banks threatened legal action against Venezuelan firms when the bond system was first announced. [redacted]

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- The question of spillover will grow in importance as future LDC debt negotiations progress. Debtors may step up bilateral contacts and keeping each other informed of current negotiating strategies. Troubled debtors may use this network to time announcements of alternative payment schemes to maximize their effect.
 - Commercial creditors will become more opposed to negotiating with debtors if the Mexican accord becomes the standard. They will also remain hesitant to extend new longer term loans to most LDCs unless pressured to do so in conjunction with an IMF-supported program. Involuntary bank lending over the next few years will fall more heavily on the world's larger banks, increasing their risks and exposure. [redacted]

Offsetting these risks is the perception that Fund flexibility with Mexico—allowing larger budget deficits and tying further assistance to growth—may encourage other recalcitrant debtors to stay within the case-by-case strategy and not go it alone, as Peru has done. However, should key debtors fail to receive

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what they consider to be equal treatment, it is possible that they may adopt unilateral measures to limit their debt service payments.

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**International Financial Situation:
Outlook for Key East Asian Debtors**

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Commercial bankers, battered by their troubles in Latin America, are becoming more apprehensive as the East Asian LDCs' ability to repay their foreign debts deteriorates.² With their exports hit hard by depressed prices for oil and other commodities and by protectionism in the industrialized countries, the economies of the East Asian countries are beginning to show serious signs of strain. While none of these countries is in a crisis, all with the exception of South Korea may require debt relief within the next two years.

Changing Financial Positions

Indonesia's financial position has suffered the greatest deterioration. With petroleum accounting for more than 70 percent of its foreign exchange earnings, the sharp drop in world oil prices has cut Jakarta's export earnings by \$6 billion this year. Because Jakarta earns dollars for its oil and much of its debt is in yen, depreciation of the dollar will probably raise Jakarta's total debt obligations by \$800 million. We believe Indonesia's external financing gap will jump to almost \$5 billion a year for the next three years—compared with \$2 billion in both 1984 and 1985. While Jakarta's foreign exchange reserves and undrawn credit lines provide some cushion, Indonesia will be forced to increase its external borrowings this year. In the past, Indonesia has enjoyed excellent access to capital markets. Some bankers, however, are concerned by its growing debt servicing obligations—almost \$6 billion in 1986—and are reluctant to lend more. At the same time, officials in Jakarta are concerned over the potential for rising social unrest, political instability, and unemployment—already estimated at 35 percent—if the prices of oil and natural gas languish at present levels or fall further.

² We have analyzed four East Asian countries with significant debts to commercial banks—Indonesia, Malaysia, South Korea, and Thailand. The Philippines was not addressed in depth because its financial troubles have been well documented.

Assessing a Country's Debt Burden

There is no precise way to measure how much debt a country can safely carry. Ultimately, the breaking point comes when creditors as a group perceive that the load is too heavy and begin to pull back their credit lines. Creditors' perceptions are not based exclusively on arithmetic ratios—political and psychological considerations also play a role—but creditors do look at the numbers:

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- *Total debt in relation to gross national product. A ratio above 40 percent is worrisome; 50 percent and above sounds alarms.*
- *Total debt in relation to exports of goods and services. Any figure above 200 percent raises eyebrows.*
- *Short-term debt as a share of total debt. Anything over 25 percent is undesirable; a growing share is also a danger sign.*
- *Total debt service—principal and interest—in relation to exports of goods and services. The most widely used benchmark. A country in the 25-percent range is in the danger zone, higher than 30 percent raises red flags.*
- *Foreign exchange reserves as a share of total debt. A low level of reserves is a danger signal. Reserves that are more than 20 percent of total debt are reassuring.*
- *Total interest in relation to exports of goods and services. This ratio is considered critical at levels above 20 percent.*

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Key East Asian Debtors: Indicators of Debt Servicing Ability, 1980-86

	Indonesia							Thailand						
	1980	1981	1982	1983	1984	1985	1986	1980	1981	1982	1983	1984	1985	1986
Total debt as a share of GNP	⊙	⊙	⊙	⊙	⊙	○	○	⊙	●	●	●	●	○	○
Total debt as a share of exports	⊙	⊙	⊙	⊙	⊙	○	○	●	●	●	●	●	●	○
Short-term debt as a share of total debt	⊙	○	⊙	⊙	⊙	⊙	⊙	○	○	○	○	○	○	●
Total debt service as a share of exports	⊙	○	○	○	○	○	○	⊙	●	⊙	○	○	○	○
Foreign reserves as a share of total debt	○	⊙	⊙	⊙	●	⊙	○	○	○	○	○	○	○	○
Total interest as a share of exports	⊙	⊙	⊙	⊙	⊙	⊙	○	⊙	●	⊙	●	●	●	●

Note: Six categories of indicators were used to determine the threshold beyond which a country's ability to repay its debts would be in jeopardy.

- Indicates that the threshold was exceeded.
- Indicates a ratio came within 10 percent of exceeding the threshold.
- ⊙ Indicates a ratio in the safe range.

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Thailand's worsening ability to service its debts stems from falling commodity prices, the appreciation of the yen against the baht, and a spiraling government budget deficit. Indeed, the budget deficit—expected to top \$2.3 billion this year—endangers Bangkok's compliance with its IMF-supported adjustment program. Structural weaknesses in Thailand's financial sector also could hurt its previously good credit rating. Nonetheless, the newly elected government faces strong political pressures to increase spending. Without a modest improvement in the economy, the government can expect increasingly vocal opposition across the political spectrum. Two important issues that could prove to be the most difficult politically, in our opinion, are the establishment of a system to better regulate financial institutions and a more efficient system of tax collection.

Malaysia's financial situation is also becoming precarious. Falling prices for oil, tin, and other commodity exports, in conjunction with weaker demand for Malaysian electronic exports, have worsened Malaysia's debt outlook. The rapid rise in Malaysia's total debt in relation to its GDP—the ratio nearly doubled from 1981 to 1985—is clearly cause for concern.

In contrast, **South Korea's** debt servicing ability has improved this year due to the combined impact of low oil prices, low interest rates, and increased export competitiveness as the yen appreciates against the

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Key East Asian Debtors (continued)

Malaysia							South Korea							
1980	1981	1982	1983	1984	1985	1986	1980	1981	1982	1983	1984	1985	1986	
○	○	○	○	○	○	○	○	○	○	○	○	○	○	Total debt as a share of GNP
○	○	○	○	○	○	○	○	○	○	○	○	○	○	Total debt as a share of exports
○	○	○	○	○	○	○	○	○	○	○	○	○	○	Short-term debt as a share of total debt
○	○	○	○	○	○	○	⊙	○	○	○	○	○	○	Total debt service as a share of exports
○	○	○	○	○	○	⊙	⊙	○	○	○	○	○	○	Foreign reserves as a share of total debt
○	○	○	○	○	○	○	⊙	○	○	○	○	○	○	Total interest as a share of exports

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won. Seoul's large debt and heavy reliance on short-term credit lines, however, leaves it vulnerable to shifts in bankers' confidence. Specifically, with short-term debts of \$17 billion against foreign exchange reserves of \$8 billion, Seoul is highly exposed to almost any disruption in its access to the financial markets. While not overly concerned with the current level of political unrest, bankers' skittishness could increase if the political situation worsens. If they were to respond by cutting trade credit lines, South Korea would find itself faced with immediate financial difficulties. [redacted]

The Road Ahead

Indonesia, Malaysia, and possibly Thailand, because of their reliance on commodity exports, may, over the next two years, require debt relief. These countries, however, will try to protect their access to private capital markets, and therefore are unlikely to take

radical debt actions. Indonesia—the prime candidate for relief—may take a nontraditional approach by trying to reschedule bilaterally with individual creditors such as Japan. Moreover, encouraged by the terms Mexico received in its recent debt negotiations, Indonesia could conceivably push to have its debt repayments tied to the price of oil as well. Indeed, if debt relief is needed, each of these East Asian countries is likely to argue that it is entitled to substantial concessions given its past performance in fulfilling its debt obligations. [redacted]

As South Korea's debt servicing capability improves, Seoul is likely to take advantage of favorable economic trends to reduce its reliance on foreign borrowing. Without debt relief, the other East Asian countries

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Secret**East Asian LDCs: Key Economic Indicators, 1982-85***Billion US \$*
(unless otherwise indicated)

	1982	1983	1984	1985
Indonesia				
Current account balance	-5.3	-6.3	-2.1	-3.0
Total debt	27.9	30.6	32.7	34.1
Total debt service	4.6	4.3	5.0	5.3
Debt owed to US banks	3.0	3.6	3.4	2.7
GDP growth (percent)	0.1	3.2	5.8	1.5
Malaysia				
Current account balance	-3.6	-3.5	-1.6	-0.9
Total debt	11.4	16.5	18.0	19.3
Total debt service	1.4	1.8	2.5	2.7
Debt owed to US banks	1.4	1.8	1.7	1.1
GDP growth (percent)	5.6	6.3	7.6	2.8
South Korea				
Current account balance	-2.7	-1.6	-1.4	-0.9
Total debt	38.9	42.8	45.4	50.2
Total debt service	6.3	6.2	7.0	7.6
Debt owed to US banks	11.0	11.5	10.0	9.2
GDP growth (percent)	5.4	11.9	12.6	5.1
Thailand				
Current account balance	-1.0	-2.9	-2.1	-1.5
Total debt	11.3	13.1	14.4	16.6
Total debt service	1.8	2.1	2.6	2.5
Debt owed to US banks	1.8	2.1	2.2	1.9
GDP growth (percent)	4.1	5.8	6.0	4.1

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will have to undertake significant domestic adjustments that will slow economic growth even more. Given the extent to which they have already cut imports and slashed development spending, these countries will be forced to make economic choices that will be politically painful. One option is to open up their economies to more foreign investment. Thailand and Indonesia have each announced a new program of incentives in an attempt to lure such capital inflows. Such investment, however, will be slow to materialize and the measures needed to encourage the necessary levels of investment would force the governments to relinquish a significant portion of their economic control. []

The ability of these countries to repay their debts and stimulate their economies is determined largely by factors beyond their control. In the short run, we believe the degree of adjustment required could threaten the status quo:

- Tensions between various ethnic groups are likely to increase if economic conditions continue to deteriorate. In Indonesia, resentment is focused on the economically powerful Chinese business class.

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- Conflict is likely to increase as religious leaders take on a larger political role. The full implications of the emergence of clerics as critics of political and economic policies remain to be seen. The reemergence of Islamic fundamentalism has the potential to cause problems for the political leadership in Indonesia and Malaysia.
- Cuts in military expenditures as part of economic adjustment could lead to a breakdown in the traditional military-government partnership.

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Implications for the United States

Washington can expect the East Asian countries to become increasingly vociferous in demanding preferential treatment on a number of issues. In the debt area, the East Asian LDCs can be expected to push for concessions that equal, if not exceed, any granted to the troubled Latin debtors. The East Asian countries can also be expected to intensify their lobbying efforts on trade issues with emphasis on US legislation aimed at protecting agricultural products and textiles. Moreover, these countries could prove to be more resolute and less cooperative during the new round of GATT negotiations. In a broader context, in an attempt to play major creditors against one another, key East Asian countries may actively court Japanese financing and hint at preferential treatment for creditors that are the most forthcoming in an attempt to win additional concessions from US interests.

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Soviet Oil Trade in a Weak Market

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The USSR's crude oil sales lagged badly in the first part of the year as domestic needs cut into supplies and Moscow's rigid pricing policy made its oil uncompetitive on the slack world market. Only higher sales of refined products kept total oil earnings from dropping even further. Crude oil sales picked up in the second quarter and Moscow has the potential to keep oil exports high for the rest of the year because of continuing high domestic oil production and increased reexports of Middle Eastern oil. Moscow has a strong incentive to boost oil exports over the remainder of the year—petroleum is the largest Soviet hard currency earner. Nonetheless, a rise in domestic demand could dash any plans for increased exports and further depress earnings. How the Soviets resolve some current pricing disputes with West European buyers and Middle Eastern suppliers over the next month should give a clearer indication of the direction in which sales are heading. If Moscow resolves pricing problems to the satisfaction of both West European buyers and Middle Eastern suppliers, then higher exports are likely.

In contrast to the falloff in crude sales in the first quarter, exports of refined products increased about 25 percent compared with average first-quarter product sales over the last five years. These sales helped keep oil revenues from plunging further as the average price of Moscow's products was about one-third higher than that of its crude oil.

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By late winter a pressing need for hard currency, increased oil availability due to rising domestic production, and the probable recognition that prices were likely to remain depressed for an extended period prompted Moscow to reconsider its pricing policies. Soviet price competitiveness improved with the adoption in March of netback pricing—an arrangement that sets crude oil prices on the basis of prices received for products refined from that crude. Buyers responded by boosting second-quarter volume purchases 20 percent over the same period in recent years to roughly 1 million b/d.

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Problems with hard currency sales apparently had little impact on Soviet deliveries to Communist clients. The lack of complaints from East European capitals and the absence of unusually high spot purchases by East European buyers suggest that Moscow maintained deliveries close to the 1985 level of 1.4 million b/d. Similarly, the Soviets continued to keep up oil supplies to Nicaragua and Cuba.

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Crude Oil Sales Off to a Slow Start

Soviet hard currency crude oil sales in 1986 got off to a slow start for the second consecutive year. First-quarter export volume was only 250,000 b/d compared with an average of 500,000 b/d for the same period in 1980-84. High seasonal domestic demand and oil production problems hindered early sales as they did in 1985, but Moscow's unwillingness to competitively price its crude oil was also to blame. Moscow's stubbornness most likely reflected an inability to properly assess the extent or duration of the weakening market and make corresponding price adjustments quickly. The Soviets clung to their official contract price of \$28 per barrel in early January while world spot prices were falling, and even when the Soviets began to offer discounts by midmonth their price remained above world levels. The Western press reported that buyers had suspended spot market purchases and most hard currency contract deliveries by late January.

Potential To Increase Exports

Moscow is likely to see improved oil supplies in the second half of the year:

- Domestic oil production through July is up by 300,000 b/d over the same period last year and may continue at about this rate for the rest of 1986.
- Moscow also will have additional supplies of Middle Eastern oil to reexport, as some countries step up oil shipments to pay for arms.

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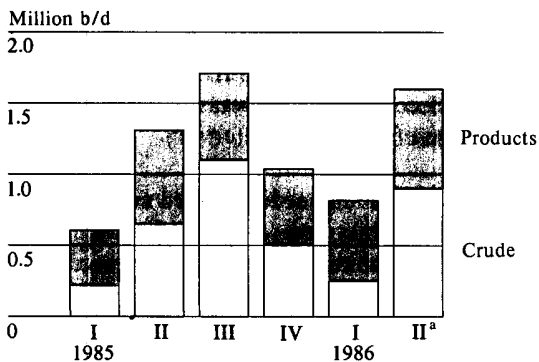
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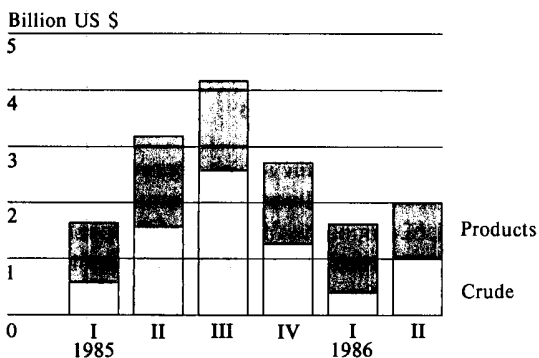
USSR: Hard Currency Oil Trade Indicators, 1985-86

Note scale change

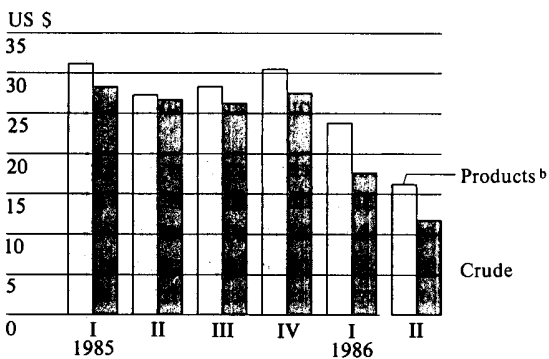
Hard Currency Exports to the West



Soviet Hard Currency Oil Earnings From the West^a



Soviet Oil Prices Per Barrel



^a Estimated.
^b Weighted average.

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Recent Middle Eastern Oil Deals

The Soviets signed an agreement with Libya in April to boost imports of oil by 70,000 b/d over the last eight months of the year. Algerian oil shipments—which averaged less than 20,000 b/d for the first six months of 1986—climbed to over 150,000 b/d in July-August, and a similar amount is scheduled for this month. Iraqi deliveries for the year are running about 30 percent ahead of last year's pace of 65,000 b/d. Although most Middle Eastern oil was reexported to soft currency partners in Eastern Europe and India early in the first half of the year, recent reports indicate that Moscow has increased reexports to the West. [redacted]

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How much of the additional oil will be available for export is problematical:

- Pressures to increase domestic consumption will be up as winter approaches and the Soviets try to compensate for Chernobyl¹ by increasing oil use at thermal power stations.
- Gorbachev's modernization program is likely to add to upward pressures on consumption. [redacted]

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At present, there is no indication that the USSR has dramatically increased oil sales. On the contrary, [redacted] Soviet pricing policies are still hurting sales. In mid-August, the Soviets cited a firming oil market as an excuse to impose somewhat stiffer netback pricing terms, resulting in a sharp drop in contract sales, according to the trade press. [redacted]

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Moscow has even run into some pricing disputes with its Middle Eastern suppliers. [redacted]

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How Moscow resolves these problems over the next month should be an indicator of its export plans. Should Moscow choose to play hardball with its pricing policies, then it may be that the Soviets have calculated that domestic consumption is likely to rise

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more than usual, taking priority over exports. If, however, Moscow resolves these pricing problems to the satisfaction of both its West European customers and Middle Eastern suppliers, then higher exports are likely for the last quarter.

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On balance, we expect hard currency oil exports to total 1.2-1.3 million b/d for the year. Even assuming that the Soviets can increase second-half export volume by 20 percent above first-half levels, earnings for the year are likely to be in the \$7-8 billion range. By comparison, Moscow's oil earnings peaked in 1983 at \$16 billion and were down to \$11.4 billion last year.

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**Western Europe's Automobile Industry:
Stiff Challenges To Restructuring**

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The performance of the West European automobile industry has improved recently because of generally better economic conditions, but continued excess capacity and political constraints on reducing the labor force cast a shadow over longer term prospects. In the near term, West European governments are reducing subsidies to automakers and instead are relying on trade restrictions and local content legislation to help the industry. Although Western Europe's major producers are, to varying degrees, turning to robots and automated design and production processes to improve efficiency, these efforts will not be enough to beat back the Japanese, who have increased exports and are expanding assembly operations in Western Europe.

- Income tax cuts in some countries—such as West Germany and Belgium—will help boost consumer confidence and spending.
- The appreciation of the Japanese yen has raised the price of Japanese cars in Western Europe, although not to the extent it has in the United States.

For many firms, restructuring efforts to reduce cost and improve efficiency have helped restore profitability. Some automakers, particularly the small, specialty producers—Mercedes, Jaguar, and Volvo, for example—took advantage of the US economic recovery and the strong dollar and concentrated on increasing exports to the United States. Four of the six West European volume automakers—Fiat, Peugeot, Volkswagen, and Ford of Europe—were able to turn a profit last year, primarily because of their extensive restructuring programs—Renault and GM of Europe sustained heavy losses. Fiat and Volkswagen in particular have trimmed labor forces and automated to the extent that break-even points are now at substantially lower output levels than in previous years.

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Present Situation

Automobiles, Western Europe's single largest industrial sector, is beginning to show some signs of recovery after five years of losses during 1980-84 totaling \$3 billion. Generally sluggish economic growth in Western Europe throughout the early 1980s and high unemployment yielded flat sales and output. Although the industry as a whole still lost money in 1985, the market began to improve and sales reached 10.6 million units, the highest since 1979.

Problems Facing Automakers

The major West European firms face a wide range of challenging problems that may be masked during upswings in the business cycle. Industry experts believe West European production capacity must be cut 10 percent, by 1 million units, in the next two years to bring supply in line with demand to guarantee profitability for the six volume producers. According to Data Resources Incorporated, however, without compensatory capacity shedding, the West European automobile industry will increase its capacity by about 1 million units to 14 million by 1990. In addition to expanded Japanese production in Europe, all the major producers except Renault plan to boost capacity.

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Prospects for continued improvement are good this year and next for automakers if, as we expect, West European economies continue their upturn:

- Consumer demand should remain firm as real personal income continues to rise. Declining inflation, aided by the declining dollar, has also worked to drive down interest rates, helping sales of consumer durables and autos in particular.
- Generally weak raw material prices are continuing to help producers hold down costs while low oil prices are benefiting both producers and consumers.

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A Look at the Volume Producers

The six volume producers in Western Europe—Volkswagen, Fiat, Renault, Peugeot, and the West European subsidiaries of Ford and General Motors—control more than 70 percent of the West European market. Among the volume producers, Fiat and Volkswagen have had the greatest success restructuring their operations and lowering costs. [redacted]

Fiat enjoys a highly protected home market that has helped profit margins. The Japanese can sell only about 2,500 vehicles per year in Italy because of an agreement dating back to 1953. Fiat's success is also the result of sharp reductions in production costs. Employment is down about 30 percent since 1979, and absenteeism—endemic in Italy—dropped from 20 percent in 1980 to just 4 percent by 1983. The Fiat example is important because the firm's automobile division is earning profits—almost \$280 million in 1985—despite having withdrawn from the US market. [redacted]

Surging exports enabled Volkswagen to overtake Ford last year and become the market leader in Western Europe. VW's worldwide profit last year was estimated at more than \$200 million, up from \$83 million in 1984. The company's success stems primarily from exports of high-priced Audis to the US market, windfall gains from the dollar during 1983-85, and the rising sales of its Golf model, the best selling car in Western Europe in 1985. [redacted]

Peugeot returned to profitability last year and is concerned about Paris's plans to bail out its state-owned domestic rival, Renault. Peugeot earned a \$60

million profit in 1985 after five years of losses. Company officials point out that their firm's recovery was achieved with comparatively little government support. Most of Peugeot's improved performance results from extensive restructuring and the popularity of its 205 model, one of Western Europe's best selling cars. Renault continues to perform poorly, and, with domestic sales down 23 percent in 1984 and another 7 percent in 1985, it piled up \$2.6 billion in losses. The company is implementing many of the structural reforms already under way in most countries, but at a much slower pace. [redacted]

GM, which owns Opel in West Germany and Vauxhall in Britain, has been pursuing a strategy of boosting its market share through aggressive price discounting. GM sold a record 1.2 million units in 1985 but lost \$372 million, in addition to the \$291 million lost the previous year. Its share of the West European market, however, rose from 8.2 percent in 1981 to 11.4 percent last year. GM is in the process of reorganizing its West European operations to increase production efficiency. Ford has consistently turned a profit throughout the decade. It already has a modern relatively low-cost production facility in Spain and is seeking to merge with another West European firm to reduce development costs; talks with Fiat and Alfa Romeo have thus far proved unsuccessful. [redacted]

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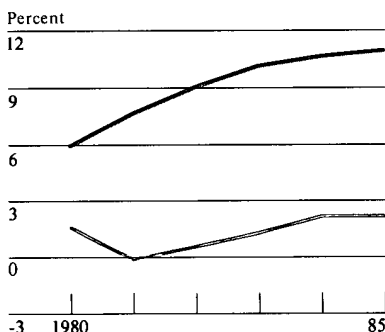
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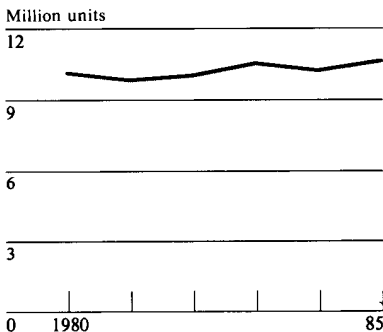
Western Europe: Selected Economic Statistics, 1980-85

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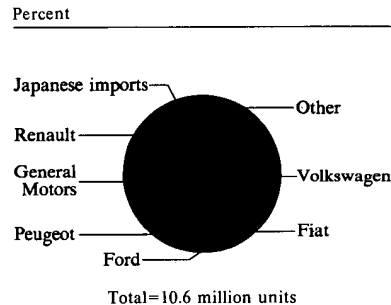
Slow GDP Growth and High Unemployment . . .



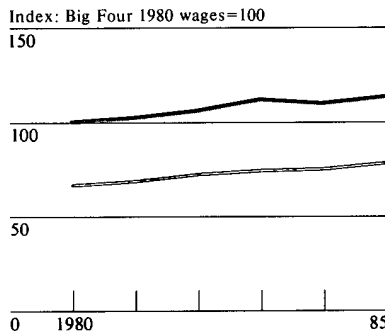
Have Contributed to Flat Automobile Sales in an . . .



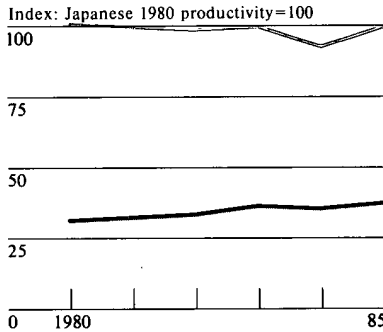
Intensely Competitive 1985 Market



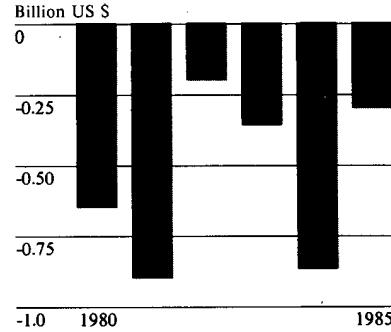
And, Together With Rising Automobile Industry Real Wages . . .



And Relatively Poor Motor Vehicle Industry Productivity . . .



Have Helped Produce a Chain of Automobile Industry Losses



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West European automakers suffer from a less flexible labor force than that in the United States. Temporary layoffs are not allowed and overtime is viewed by most labor unions as a management ploy to keep employment down. Recalcitrant labor unions also make it difficult to reduce wage costs. Although still lower than in the United States, wage rates in Western Europe are generally higher than in Japan, Europe's major competitor in the low-end market. Spanish wage costs are an exception, and, consequently, Spain

is viewed by some automakers as an ideal base for exports. Nevertheless, by preventing companies from laying off excess workers, unions have limited the use of labor-saving equipment.

In the past, government intervention created problems by enabling firms, which may have been forced to upgrade product lines and streamline operations or

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Secret**Selected Countries: Real Hourly Earnings
in the Automobile Industry, 1980-85^a**

US \$

	1980	1981	1982	1983	1984	1985
United States	15.88	15.41	15.54	15.21	15.34	15.62
Japan	6.93	7.15	7.54	7.74	7.83	8.15
West Germany	15.53	15.90	16.25	16.79	16.73	17.31
France	10.36	10.69	11.24	12.91	11.79	11.70
United Kingdom	8.24	8.05	8.44	8.65	8.84	9.46
Italy	8.08	8.52	8.78	8.75	8.98	9.46
Spain	7.11	7.94	7.95	7.88	7.71	7.87 ^b

^a Deflated hourly earnings converted at 1980 exchange rates.^b Estimated.

leave the market, to maintain operations despite heavy losses. Faced with rising unemployment rates, governments often thwarted the need for restructuring by trying to protect or create jobs in the industry. Although West European government attitudes are changing, too many jobs are at stake for them to completely abandon protection of the industry; roughly 5 million workers are either directly or indirectly employed by the West European automobile industry. Instead of direct subsidies, governments are now relying more on trade restrictions and local content legislation as a means of aiding the industry. []

Rising Japanese Penetration

For the past five years, Japan's auto producers have held approximately 10 percent of Europe's 9-11 million car market. Japanese auto manufacturers, however, increased their shipments of passenger cars to the European Community by 40 percent during the first seven months of 1986 compared with the same period last year. Mounting trade friction between the EC and Japan resulted in MITI's decision to voluntarily restrain exports of vehicles to the EC to approximately 1.1 million cars this year—still a 10-percent increase over the 1985 level. Japan's share is greatest in countries where there are no domestic vehicle industries to protect. For example, Japanese

automakers have secured 34 to 38 percent of the passenger car markets in Norway, Finland, and Denmark. West Germany and the United Kingdom remain Japan's largest markets with sales of over 515,000 vehicles in 1985. []

Japanese automakers are responding to growing import restraints by establishing production facilities in Western Europe. Plans are already in the works for local European production of 350,000 Japanese cars by 1990. This figure includes only models for distribution in Europe with Japanese nameplates. Other ventures by Toyota, Daihatsu, and Subaru could result in an additional 220,000 units, thus raising potential Japanese car production in Western Europe to nearly 600,000 by the late 1990s. This increased local production, combined with imports, could boost Japan's share of the market to roughly 15 percent by 1990. []

Outlook

Despite some recent improvements, West European automakers will continue to face stiff competition, low profitability, and excess capacity. Price will remain of

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secondary importance at the upper end of the market, but it will still play an essential role at the lower end, keeping the pressure on profit margins. As a result, reducing costs will become even more important over the medium term. Nonetheless, national pride and political realities make it very unlikely that any of the mass market producers would be allowed to fold.

[redacted]

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The continuing drive to restructure the West European automobile industry could be slowed because of the potential political impact. As firms strive to increase productivity and competitiveness over the next two years, more layoffs will be required at a time when the socialists in West Germany, France, and Great Britain will be vying for a comeback in national elections. Union disturbances are most likely to occur during these election periods when the jobs issue can receive maximum public attention. [redacted]

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Japanese exports and assembly operations in Western Europe are likely to exacerbate EC-Japanese trade relations. The Japanese are using their West European plants to concentrate on producing low-priced automobiles while boosting exports of more upmarket, high-profit models. If indeed the Japanese continue to increase their share of the West European automobile market as we expect—even if accomplished by direct investment—it is likely to fuel protectionist sentiments not only against Japanese automobiles but also other Japanese imports as well—consumer electronics, semiconductors, and machine tools are likely targets. [redacted]

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Briefs**Energy***Iraq Seriously
Damages Khark Island*

[redacted] Iraq's 16 September attack on Khark Island inflicted severe damage. Khark's T-jetty that had been the principal outlet for Iranian crude has been indefinitely knocked out. Tehran can maintain exports, however, by using Khark's Sea Island loading terminal and/or floating terminals northeast of the island. The Sea Island terminal has been experiencing electrical problems and is highly vulnerable to attack while tankers are loading. This latest attack will magnify Iran's recent export problems by making it extremely difficult to lure customers to load at Khark and relieve pressure on its overextended oil shuttle system. The attack reflects Baghdad's increasing pressure on Iran's economy and, if followed up, is likely to reduce Iranian export capacity. Iran apparently responded to the attack on Khark by using a small ship to attack a Kuwaiti tanker located in waters off the Saudi-Kuwaiti Neutral Zone. Sales of Neutral Zone oil production on Iraqi's behalf have been used by Kuwait and Saudi Arabia to support the Iraqi war effort. [redacted]

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*Iranian Pipeline
Projects Suspended*

Two Iranian oil pipeline projects have been shelved because of cost considerations, [redacted] Iraqi attacks against the oil loading facility at Khark Island prompted Iran to do feasibility studies on pipelines to carry oil south to Taheri where ships could load with reduced risk. While cost was definitely a consideration—at least \$2 billion to complete both pipelines—we believe Iran also was dissuaded by a recent Iraqi attack against Sirri Island. By demonstrating its ability and willingness to attack facilities well beyond Taheri, Iraq underscored the potential vulnerability of the pipelines. [redacted]

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*Impact of Sanctions on
South African Coal*

If consuming countries imposed sanctions on South African coal for five years, Pretoria would lose about \$750 million per year [redacted] The effects of mine deterioration, reduction of marketing and logistics infrastructure, and loss of markets to other exporters would cost South Africa an additional \$1 billion per year over a five-year period after the sanctions were lifted. [redacted]

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[redacted] Pretoria is presently earning about \$1.1 billion annually from coal exports, accounting for 14 percent of total export earnings. In response to sanctions, coal prices could rise in Western Europe and Japan by as much as \$12 to \$15 per metric ton over current levels of about \$40 to \$45 per ton. [redacted]

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Secret*Lower Retail
Product Prices*

Oil production prices have fallen sharply in all major consuming countries in response to lower crude oil costs. The rate of decline among individual products varied. Heavy fuel oil prices have registered the sharpest drop, probably reflecting strong competition from other fuels, while retail gasoline prices have registered the smallest decline because of a high tax component. Consumers in Japan have benefited the least because the government protects its refining industry. Italy, the United Kingdom, and France have raised taxes mainly on motor gasoline to raise revenue—and to hold down demand—while most other countries have passed lower crude costs through to the consumer.

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Selected Countries: Retail Product Prices*Percent*

	July 1986 ^a		
	Regular Gasoline	Heating Oil	Heavy Fuel Oil
United States	-23	-21	-46
Japan	-13	-11	-19
West Germany	-26	-60	-65
France	-16	-42	-44
United Kingdom	-21	-44	-63
Italy	-4	-24	-67

^a Compared to August 1985 prices.

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*China Speeds
Oil Exploration
in Northwest*

Concerns about growing domestic oil consumption appear to be accelerating China's timetable for exploring and developing its northwestern basins.

Beijing indicated a willingness—not evident six months ago—to begin exploratory drilling even before completing a multiyear survey program. The Chinese said they expect domestic oil consumption, which only last year regained 1979 levels, to grow 5 percent annually through the end of the century. To reach its modernization goals for the year 2000, China needs oil to rapidly develop its commercial and transport sectors, but cannot count on its existing mature fields beyond the early 1990s. Despite Chinese efforts to attract foreign cooperation, Western firms will be reluctant to participate in the northwest on a large scale any time soon because of low world oil prices, reduced exploration budgets, and China's inadequate infrastructure for these remote basins.

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International Finance*LDC Summit
Declaration
on Debt*

In the closing declaration of the recent summit meeting of the Nonaligned Movement (NAM), the NAM suggests that LDC debtors should be able to limit debt service payments to a share of export revenues. This proposal, as in the past, is unlikely to be embraced by most major debtors. We believe Peru's appeal at the summit for a united, hardline approach to the debt problem will be undercut by the diverse financial situation of LDCs, the modest successes of Latin debtors' innovative adjustment programs, and the wait-and-see attitude of debtors toward Mexico's debt negotiations. The chief debt-related impact likely to emerge from the summit will be a strengthened LDC resolve to loosen the strings attached to official and multilateral development assistance. Specifically, debtors probably will call for more funds with less conditionality from international creditors when the IMF and the World Bank meet in Washington next week. [redacted]

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*Brazil's New
Multiyear
Debt Strategy*

The Sarney administration is eager to begin negotiating a new type of multiyear rescheduling of 1987-91 debt [redacted] During his visit to Washington on 11 September, President Sarney stressed to the National Press Club and the Congress that Brazil must negotiate lower debt service payments to permit increased imports, greater investment, and continued high economic growth. [redacted] Brasilia will be a tough negotiator in talks with creditors this fall and will push for a reduction of net debt servicing payments as a percent of GDP from this year's 4.0-percent level to about 2.5 percent next year. In the judgment of the US Embassy, however, the Brazilians will continue to avoid unilateral actions and probably believe they can attain the 2.5-percent goal by negotiating a switch in the base rate for interest rate payments from US prime to LIBOR, a reduction of the spread on 1987-91 maturities, and new commercial loan cofinancing with the World Bank. [redacted]

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*Iraqi Debt
Problems Continue*

Iraq continues to have difficulty making debt payments to international banks.

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[redacted] Baghdad is now seeking a two-year deferment of payments on a \$500 million loan obtained in 1983. Previously, Baghdad had hoped to continue payments on this loan—including a \$65 million payment due 30 September—to bolster its sagging credit reputation among Western banks that already hold overdue Iraqi short-term debt. [redacted]

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*Tunisian IMF
Negotiations
Progressing*

Tunis is moving quickly to secure \$250 million in badly needed financing from the IMF. The US Embassy in Tunis says that a signed letter of intent for the 18-month standby loan is likely by the end of September with IMF approval possible by late October. To smooth negotiations, the government has cut an additional \$50 million from the development budget at the risk of slowing efforts to reduce troubling unemployment. A primary goal of the new IMF package, however, is to boost Tunisia's foreign exchange reserves, which now cover only several days of imports. Nevertheless, any relief will be temporary as Tunisia's current account probably will remain in deficit next year. The government will have to secure additional funds to cover the projected \$350 million financing gap. While debt service is not yet a major problem, the government may have to consider some form of debt relief over the next several years if new sources of funds are not forthcoming.

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International Trade



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*Circumventing
US Import Quotas*

According to the US Embassy in Kuala Lumpur, shipments of textiles—towels—from Pakistan are being transshipped through Malaysia to circumvent US quotas. Some shipments depart Pakistan with correct declaration, then are believed to go to Hong Kong where the goods are relabeled. The goods are then sent through third countries such as Malaysia, Sri Lanka, or the Philippines for re-export to the United States. [REDACTED]

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*Taiwan To Restrict
Steel Exports to
the United States*

A series of recent public announcements confirm that Taiwan will restrict steel exports to the United States. In a unilateral move to counter a possible voluntary restraint agreement (VRA) the Taiwan Steel and Iron Industries Association plans to limit 1986 September to December steel exports to the United States to 20,000 metric tons per month. Allocation among Taiwan's steel manufacturers and traders will be based on their share in January to July shipments. To ensure compliance with the export restraint program, Taiwan's customs authorities are starting a shipment-checking procedure. Also, in order to control an export surge, Taiwan's Board of Foreign Trade (BOFT) will limit firms' exports during September and October to not more than one-half of their total allotment. BOFT is hopeful that Washington will accept these measures and that imposition of a VRA will not be necessary. [REDACTED]

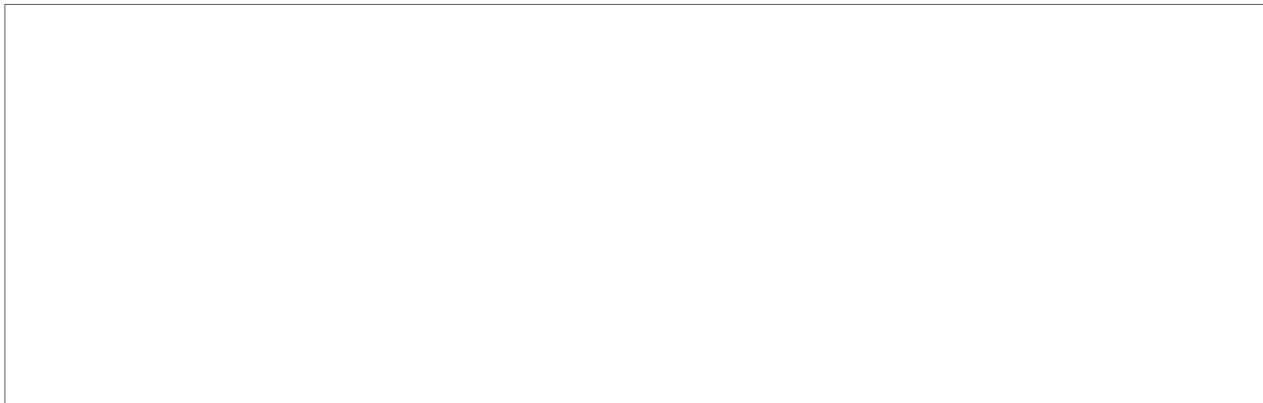
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Global and Regional Developments*EC Imposes
Limited South
African Sanctions*

EC foreign ministers meeting in Brussels decided on 15 September to impose limited economic sanctions on South Africa. The new measures include a ban on imports of iron, steel, and gold coins, as well as on new EC investments in South Africa. Coal, which was on the list of items tentatively agreed to in June, was not included because of Portuguese and, especially, West German objections. The iron and steel ban will take effect on 27 September, but the other sanctions will be delayed until means of enforcement are worked out. EC coal imports from South Africa are worth more than \$780 million, almost twice the combined value of imported South African iron, steel, and gold coins. The exclusion of coal ensures that the EC sanctions will have little effect on the South African economy. Strong advocates of sanctions, such as the Netherlands and Denmark, were forced to compromise in order to gain a consensus. While the question of sanctions is probably settled temporarily, the problem of South Africa is likely to remain high on the EC agenda. [REDACTED]

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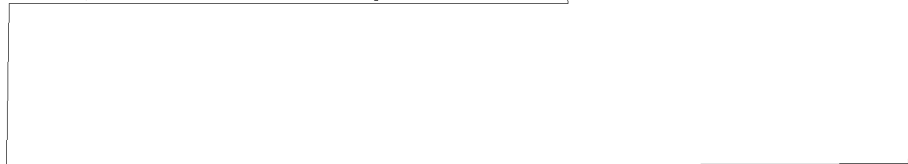
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*New Soviet
Hard Currency Loan
to Nicaragua*

The USSR provided Managua with a \$25 million hard currency loan late last month, but at a nonconcessionary rate of interest.



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The most recent Soviet loan apparently fulfills Managua's request in June for a total of \$100 million. This is double Managua's hard currency earnings this year and presumably will allow the Sandinistas to buy badly needed spare parts and repay some of their more pressing debts. Moscow has its own hard currency problems, but the amount it offered in this transaction is comparatively small.

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*Continued Progress
on Latin American
Regional Integration*

Latin American efforts toward regional economic integration continue to move forward. In August Uruguay formally joined the Argentine-Brazilian economic integration agreement.



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Mexico City is focusing on diversification of trade (away from the United States), increased exports to Latin America, and reassertion of Mexican preeminence in Latin American political affairs. Argentina is actively encouraging Mexican participation to offset Brazil's dominance in trade and other regional economic matters. Mexico hopes to begin negotiations with Argentina and Brazil before the end of the year.

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Secret**National Developments*****Developed Countries******Canadian
Grain Troubles***

A grain handler's strike is adding to the troubles of the Canadian grain sector. With prospects of a record 52-million-metric-ton harvest, Canadian exports already face falling world grain prices and increased competition from the United States and the EC. The walkout began 3 September and closed the port of Thunder Bay, which normally handles one-half of grain exports from the Canadian prairies. Current export orders can be filled from stockpiles, but if the strike lasts into October the Canadian Wheat Board may be forced to renege on several contracts. Rail shipments to other ports can handle only one-fourth the normal export volume, and increase transportation costs by about \$5 per ton. A long strike is likely to result in growing pressure on the federal government to pass back-to-work legislation. Such a move would displease labor, but the Mulroney government needs to be seen as active in defending Canada's grain market share, as well as sensitive to the demands of western Canada, a traditional Tory bastion.

[redacted]

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***Growing Role of
Government in
Brazilian Economy***

Despite the Sarney administration's stated commitment to increased private-sector participation in Brazil's economic development, the government's economic role continues to grow. The government increasingly has centralized decisionmaking and has expanded control over the economy this year, according to the US Embassy. The comprehensive price freeze enforced by the government in March as part of the anti-inflation Cruzado Plan—and which probably will not be eased in the foreseeable future, [redacted]—has discouraged much-needed private-sector investment. By contrast, according to the US Embassy, public-sector investment is rising considerably and the public-sector deficit this year will be at least as large as that of 1985, despite the Cruzado Plan.

[redacted] government efforts to streamline its large network of

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state corporations will be essentially cosmetic, at least until after November's national elections. Also, recent adjustments to the Cruzado Plan—particularly a forced savings scheme—has been heavily criticized in the business community as a means of financing a large public deficit disguised as an effort to cool off demand.

[redacted]
[redacted] the business community does not maintain a genuine dialogue with, or have significant influence on, the government.
[redacted]

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*Uruguay-Brazil
Trade Pact*

Montevideo and Brasilia signed a series of trade expansion accords last month, which, according to Finance Minister Zerbino, could double Uruguay's exports to Brazil—currently about 10 percent of its total foreign sales—over the next two years. According to press reports, Brazil has agreed to buy a substantial portion of Uruguay's agricultural exports, including 60 percent of rice production and one-half of meat production. In exchange, the Embassy reports that Montevideo has agreed to abolish duties on many industrial imports from Brazil, starting with 800 buses to be imported over the next five years. We concur with Montevideo's judgment that the sales will reinforce Uruguay's recent surge in exports, which during the first half of 1986 increased 20 percent over the same period last year. Moreover, despite Uruguay's inefficient production techniques and tendency to take only limited advantage of export opportunities, we feel the accords will significantly boost President Sanguinetti's export promotion plans and help generate economic growth of about 3 percent during 1987. [redacted]

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*Tunisian
Unions Reunited*

Tunis has moved to consolidate its control over the country's two primary labor movements—the UGTT and the UNTT—by reorganizing them into a single union. Although membership is being enforced by the government, some labor rank and file are shunning the new organization because of concern over government control, internal disputes over leadership, and the continued incarceration of labor leaders. [redacted] the government has promised union leaders independence if the new union neither sponsors nor encourages strikes, refrains from any political activity, and requests no salary increases—conditions labor militants are unlikely to accept. The UGTT, in particular, has gained labor support because of its aggressive stand on wages and willingness to confront the government on labor issues. Coupled with intraunion rivalries and the UNTT's more progovernment stand, the new union may actually prove to be an obstacle to labor harmony. Moreover, if the new union survives, it could become an even greater force to reckon with if government control cannot be maintained. [redacted]

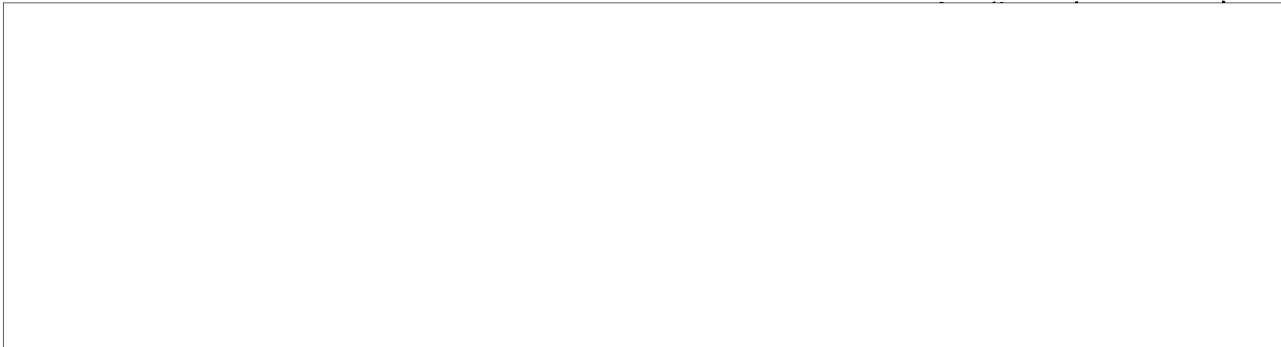
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*Kabul Businessmen
Apprehensive*

Minister of Commerce Jalalar, who has held his post since 1979, was criticized at a Politburo session in late July and in subsequent regime statements for failing to meet first-quarter trade goals and threatened with removal if foreign and domestic trade performance do not improve. The minister is generally regarded as a patron of private industry, according to the US Embassy, and businessmen in Kabul fear his removal could signal a crackdown on this sector. Businessmen are particularly concerned that Kabul may reverse a policy—promoted by Jalalar—of exempting them from military service. As a result, Kabul businessmen are shifting funds to foreign banks and limiting investment in joint ventures with the regime, according to the US Embassy. The threat against Jalalar—who has close ties to the Soviets—probably represents an attempt by General Secretary Najibullah to consolidate his power rather than a shift in attitude toward the private sector.



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*Bangladesh Announces
Annual Budget*

Bangladesh's current government budget—1 July to 30 June—addresses many of the policy issues raised by foreign aid donors, but Dhaka may find it difficult to implement needed reforms—removal of subsidies and expansion of private-sector participation. Even with projected foreign aid of roughly \$1.3 billion, Dhaka is still facing a \$100 million budget deficit. According to the US Embassy, emphasis will be placed on economic development—expenditures are budgeted to rise 6 percent in real terms—while nominal spending on other items is projected to increase only enough to keep pace with inflation. Many of the government's key priorities imply backsliding on important reforms. For example, Dhaka plans to increase subsidies on fertilizer and diesel oil to encourage expansion of irrigated acreage, and efforts to increase loans to the private sector by reducing interest rates threaten the already shaky banking system. Officials in Bangladesh are concerned that cutbacks in foreign assistance, particularly by the United States and the International Development Association, will force them to scale back their development effort.



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*Tanzanian Progress
Toward Reform*

A recently approved \$75 million, 18-month standby arrangement with the IMF and a government anticorruption campaign are likely to sharpen the conflict between Tanzanian President Mwinyi and party Chairman Nyerere. The government already has implemented preliminary reforms by increasing consumer and producer prices, freezing wages, devaluing the currency, and cutting the budget, [redacted] The US Embassy reports that at least two episodes of unprecedented civil unrest occurred in August as a result of the cuts in government spending, causing some officials to worry that further cuts will bring more violence. Mwinyi's campaign against corrupt officials has earned him widespread popularity [redacted]

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[redacted] Nyerere publicly supports the campaign, [redacted]

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[redacted] A longtime opponent of economic reform, Nyerere may try to reassert his political power by derailing the IMF accord. Mwinyi's newfound grassroots support may help cushion discontent over the austerity measures and allow him to consolidate his position by removing Nyerere appointees from the government or by reorganizing the Cabinet. Failure to act against corrupt members of Nyerere's clique, however, probably would cost him the essential support of important moderates in the government. [redacted]

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*Indonesian
Currency Devaluation*

Indonesia's unexpected 31-percent devaluation of the rupiah on 8 September is aimed at shrinking the trade deficit that widened by nearly two-thirds during the last year. According to US Embassy reporting, Jakarta's dramatic move—perhaps the first in a series of tough economic policy decisions—follows a nearly 40-percent decline in oil export earnings and a sharp increase in imports. According to the US Embassy, the devaluation will make it more difficult for Jakarta to service foreign debt, however, as well as possibly trigger widespread price increases. The devaluation is unlikely to correct the serious structural problems in Jakarta's high-cost economy, which make Indonesian manufacturers uncompetitive in the world market. Economic indicators had suggested the rupiah—which has been free of foreign exchange controls and had gradually depreciated in recent years—was not overvalued. The US Embassy reports that the growing imbalance in its external accounts suggests to bankers that Indonesia may have to reschedule its \$37 billion foreign debt by late next year. [redacted]

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*New Yugoslav
Wage Law Protested*

Yugoslav trade union and regional officials are protesting government-sponsored restrictions on wage increases and trying to amend the controversial law. The law in some cases requires workers to return what are now defined as wage overpayments made in recent months. Yugoslav officials and media report the new law is contributing to a growing number of strikes. The new government of Premier Mikulic is in a no-win situation. Strict enforcement of the law would raise labor discontent and provoke more strikes. Backing off would weaken Mikulic's credibility, reduce prospects for the adoption of future government proposals, and add to inflationary pressures. The intent of the new legislation—to tie wages more closely to productivity—is sound, but the government has been pushing implementation without having built a political consensus among Yugoslavia's regions and key interest groups. Enforcement will become even more difficult in the months ahead.

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*China Sweetens
the Deal for
Foreign Investors*

Beijing is taking steps to encourage new foreign investment, which officials claim has dropped 20 percent in the first half of 1986. Regulations may be issued in October to restructure joint-venture labor costs, to reduce fees and taxes charged joint ventures, and to give joint ventures greater authority to hire and fire workers. China has already extended tax holidays on foreign leasing and interest earnings, and has announced that the Bank of China will offer preferential loans to joint ventures. Premier Zhao Ziyang recently stressed the need for China to maintain competitive labor costs, tacitly admitting that joint-venture labor subsidy charges, combined with low productivity, erode China's comparative advantage. Joint-venture problems will probably persist, however. One reported plan for adjusting labor costs would reduce subsidies but raise wages, resulting in only a slight drop in joint-venture labor bills. In addition, although Zhao Ziyang has cited joint ventures problems in obtaining foreign exchange, local officials have indicated that in the future joint ventures will be required to negotiate individually for hard currency allotments, which may prove troublesome. Finally, some localities may resist central efforts to cut redtape and reduce joint-venture fees.

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*China Expects More
Earnings from
Labor Exports*

[redacted] worker remittances are fast becoming a major source of foreign exchange. To improve relations Beijing has often provided Third World countries with free labor and construction projects, but the Beijing Economic Daily says China since 1979 has charged for \$2.7 billion worth of completed construction and labor contracts in 81 countries and has already signed for another \$2.9 billion. Projects include school buildings, bridges, office buildings, and railroads—a 210-megawatt, \$53 million power plant built for Pakistan is the largest contract to date. More than 50,000 Chinese workers are presently overseas. They are paid only room and board while abroad, but upon their return to China they receive the yuan equivalent of about 10 percent of the foreign exchange paid to the Bank of China for their services. [redacted]

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