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Perspective

Shifting Focus in World Countertrade 25X1

Countertrade transactions over the past year have become increasingly complex, reflecting the continuing problems of slow world trade growth, high LDC debt burdens and growing protectionism. Such contracts have shifted from simple, short-term barter transactions to more complex, counterpurchase and offset agreements that can last up to 10 years. These contracts increasingly involve products and technology transfer that governments hope will help stimulate economic development and strengthen military capabilities. 25X1

In 1985 the most rapid growth in countertrade occurred in military offset deals between developed countries. Military offsets are usually designed to promote the purchaser's defense industry capabilities. They range in complexity from counterpurchase of military goods to joint production or some form of technology transfer. Financial constraints faced by importing countries have tightened the world arms market to the point where exporters regularly lose sales if they fail to offer some form of countertrade. As a result, military countertrade—dominated by aerospace products, communications, and electronics—has grown from 47 to 79 percent of total US countertrade during 1980-84, and continues to grow worldwide. These types of transactions may result in a gradual shift in production of lower technology military hardware away from the industrialized countries to new military exporters. For example, Brazil and Egypt have been aggressive exponents of countertrade as well as growing competitors in the international arms market. 25X1

The most frequently countertraded commodity in 1985 was oil. With the deterioration in the world oil market, OPEC countries—most notably Iran, Iraq, Nigeria, Libya, and Saudi Arabia—sought to maintain market share and minimize the decline of the earning power of their oil. Countertrade deals served to circumvent production quotas and disguise price discounts. Altogether, countertrade probably accounted for 10 to 20 percent of total OPEC oil sales last year, according to press reporting. 25X1

LDCs continue to countertrade primarily to expand exports and limit import costs in the face of sizable debt burdens and a lack of hard currency. There are signs that weak markets for traditional exports are causing them to also use countertrade to boost nontraditional exports. Debtor country import restrictions and foreign exchange constraints are creating conditions that encourage the private sector to seek alternatives to hard currency transactions. Although governments are increasingly wary of the complications and inefficiencies inherent in countertrade, for the most part they have not sought to formalize regulatory policies. 25X1

While more countries became involved in countertrade in 1985, growth in the volume of countertrade probably slowed as a large number of deals fell through. Oil countertrade activity dropped dramatically toward the end of 1985 as its widespread use and the breakdown of the OPEC official price structure negated the advantages for producers. Moreover, falling prices frequently wiped out the hidden discount by the time importers received the oil. Exporters' motivations for countertrading oil will probably turn to maintaining market share and to obtaining technology transfer. Countertrade remains only a small share of total world trade—estimates vary significantly, but it probably amounts to about 6 percent at most. Its inherent inefficiencies and complications probably will continue to limit its use. 25X1

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USSR–Third World: Potential for Expanded Countertrade 25X1

Faced with depressed markets for raw materials, increasing protectionism in the developed West, and severe restrictions on their borrowing, many Third World countries may become increasingly receptive to Soviet trade overtures. Moscow's offers to barter industrial goods for energy or raw materials appear to be more attractive to some hard-pressed LDCs. While Soviet goods, in many cases, are poor substitutes for Western items, barter would enable these countries to maintain import levels and conserve scarce hard currency. Likewise, for the Soviets, such deals provide an outlet for goods with limited markets in the West and reduce import costs at a time when hard currency export earnings are shrinking. Although we expect an upturn in Soviet LDC countertrade, a major shift in LDC trade from the West is unlikely. Nonetheless, the Soviets probably calculate that, in some cases, the overall political benefits may exceed the modest commercial gains.

Soviet Interest in Countertrade

The USSR has traditionally sought to barter its technology and equipment for LDC commodities as a means of both conserving hard currency expenditures and finding outlets for manufactured goods that cannot compete on Western markets. Trade under clearing account agreements is balanced in the aggregate rather than on a case-by-case basis.[1] Moscow is selective in its countertrade offers, however; the USSR seeks to obtain hard currency whenever possible for arms sales even when the alternative has been in heretofore marketable goods such as oil.

[1] Other types of countertrade include straight barter deals, counterpurchases (contractually linked sales), buybacks (involving the provision of equipment for an industrial project with payment made in the form of the enterprise's output), offsets (involving a license with or subcontract to a firm in the partner country), and switch trading (in which three or more countries are involved). 25X1

Soviet interest in countertrade has quite likely strengthened considerably over the last year. General Secretary Gorbachev needs increased inputs of technology and equipment, semimanufactures, and consumer goods to fuel his economic revitalization program. This demand, however, comes at a time when hard currency import capacity is being increasingly circumscribed by falling domestic oil production and a soft oil market. Expanded countertrade could potentially allow Moscow to conserve its hard currency expenditures for those goods available only from Western industrialized countries. 25X1

In many cases political considerations play a major role in Soviet economic dealings with the Third World. Moscow often sees expanded economic relations as a first step in the development of political linkages. Moreover, the USSR often takes advantage of its commercial presence to expand intelligence-gathering capabilities and support pro-Soviet political factions. 25X1 Such political calculations may also have grown in recent months as part of the new regime's desire to reinvigorate what had been an increasingly stagnant policy regarding much of the Third World. 25X1

LDC Incentives for Countertrade

Declining Western demand has seriously affected many LDCs, particularly those dependent on one or two raw materials for foreign exchange earnings. The impact is particularly serious given the high current indebtedness of many of these countries, which effectively prevents them from covering export shortfalls with additional borrowing. 25X1 Producers of raw materials, such as oil, that face slack markets may become even more receptive to Soviet countertrade arrangements. While LDCs are not excited over the prospect of having to settle for second best, Moscow is usually capable of providing a level of technology and equipment adequate to meet basic Third World requirements. The ability to obtain such goods with exports that cannot be effectively sold in the West is often sufficient to close the deal. [redacted]

The willingness to expand commercial contacts with the USSR is often linked to other factors as well. Specifically, Third World leaders may see commercial transactions as a means of maintaining a positive, albeit low-profile, relationship with Moscow. In some cases, LDCs may wish to increase commercial contacts with the USSR to gain leverage with Western patrons. For example, Imelda Marcos asserted during a trip to Moscow in early November that the Philippines should engage in more barter trade with the USSR, describing such trade as a countermeasure against industrialized countries' growing protectionist policies. [redacted]

Ongoing Negotiations

Asia. A visit by Deputy Prime Minister Ryabov to Malaysia, Indonesia, and Burma last fall probably represented an effort to reinvigorate commercial ties to ASEAN states, and perhaps to allay suspicions of Soviet support for Vietnam. In Malaysia—where Moscow never has been able to balance its rubber imports with equipment shipments—Ryabov reportedly offered Soviet aid for oil exploration and drilling, the exploitation of tin, and the establishment of industrial and power plants. In discussions in Jakarta, Ryabov reached an agreement for Soviet loans for equipment to increase production of palm oil, tea, and coffee, with repayment in kind, [redacted] The Soviet offer to accept nonoil exports came at a welcome time, since Indonesia has been trying hard to boost such exports to offset dwindling petroleum revenues. [redacted]

The Kremlin apparently also has tried to capitalize on pressure to tighten US textile restrictions. In recent months, according to Embassy reporting, Moscow offered to accept about $1 million worth of shirts produced in Thailand on a countertrade basis in order to pick up the slack from lower US imports of garments. Moscow probably believes that Thai labor protests of US textile restrictions and demands that the government expand trade with the Soviet Bloc will improve the position of those in the Thai Government who support closer ties to the USSR. The Soviets may well make similar offers for rice if Washington acts against Bangkok on a pending countervailing duty case involving alleged rice subsidies. [redacted] 25X1

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Latin America. In 1983, the USSR restructured $200 million in payments on Peru's $1-2 billion debt scheduled for 1983-85; the Soviets allowed Lima to cover part of the repayment in goods, mainly manufactures such as textiles. In 1985, Moscow agreed to convert the cash repayments due that year into commodity repayments. [redacted] 25X1 25X1

Such deals ensure that Peru makes at least some repayment, but the Soviets no doubt believe that they generate good will that will spill over into political relations [redacted] 25X1

[redacted] 25X1 The Kremlin probably realizes that Peruvian leaders welcome deliveries to the Soviet market as a way of reducing unemployment in Peru's hard-pressed industrial sector; in June 1985, a Soviet diplomat claimed that the USSR's willingness to accept Peruvian goods helped the country "to reactivate its textile and shoe industries." [redacted]

Moscow also has tried to use commercial offers for political gains in Bolivia. The US Embassy in La Paz reports that the USSR—a traditional importer of Bolivian tin—offered to buy all the tin Bolivia can produce in exchange for purchases of Soviet machinery. Although La Paz is formally considering Moscow's offer, the administration that came into power last August probably would not risk alienating the IMF and Western creditors by committing a large share of its hard currency exports to a barter deal with Moscow. Nonetheless, the USSR

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has continued to seek ways to capitalize on the damage inflicted on the Bolivian economy by the collapsing tin market. According to Embassy reporting, Soviet officials, appearing on local television programs, have pointed to tin sales by the US General Services Administration as a contributor to Bolivia's crisis, and they used that forum to reiterate the USSR's barter offer.

A longstanding desire by Soviet economic planners for stable sources of supply probably best explains various recent barter deals with Jamaica and Guyana. In 1984, Moscow and Kingston agreed that Jamaica would deliver 1 million metric tons of bauxite annually for seven years, balanced largely by Soviet deliveries of Lada automobiles. This deal, signed under the Manley administration, may have to be renegotiated; Jamaicans have so far shown a clear distaste for the car. Moscow also has a barter arrangement with Guyana under which it receives bauxite in return for Soviet-made tractors. Furthermore, in 1985, the USSR concluded a deal to deliver a TU-154 transport aircraft to Guyana, with payment partly in bauxite.

Moscow, however, has been unsuccessful in its attempts to get both Argentina and Brazil to reduce their respective hard currency bilateral surpluses by boosting their purchases of Soviet merchandise, particularly manufactured goods. The Soviets have been particularly persistent in trying to sell Buenos Aires machinery for major projects such as the grain loading port at Bahia Blanca to offset Argentina's large, multiyear grain sales.

Middle East. The USSR's largest barter arrangements are with its OPEC arms customers. For several years, the Kremlin has been accepting significant volumes of petroleum from Libya, Iraq, Algeria, Saudi Arabia (acting on behalf of Iraq), and occasionally Iran, in lieu of cash payments for arms. Given the financial constraints faced by these countries, payment in commodities may be preferable to delayed cash payments. Nonetheless, unless these countries increase their purchases of Soviet weapons, the value of these oil barter deals is unlikely to grow.

Outlook

With no end in sight to the financial crisis plaguing LDC debtors, the dim prospects for raw material markets, and protectionist trends in the West, Moscow appears to be in a good position to improve its links to economically pressed Third World countries. These countries need to find a way to finance continued technology and equipment imports as well as maintain export outlets. Moscow, for its part, will be increasingly pressed to find soft currency sources for goods traditionally purchased in the West. The Soviets, however, face a number of severe and longstanding handicaps that are likely to prevent a major shift in LDC trade shares from the West.

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Soviet goods have a poor reputation for quality and reliability; to a large extent, their machinery embodies outmoded technology and there are frequent difficulties with the availability of spare parts and aftersales servicing. For these reasons, LDCs still seem to prefer the more up-to-date Western equipment, even at a higher price.

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The USSR's reputation for commercial inefficiency also may frustrate increasing countertrade with the Third World. Even if LDCs are willing to invest the extra time and effort required for countertrade, the difficulties of dealing with Moscow can be particularly daunting. LDCs encounter frequent and lengthy delays from officials who often lack negotiating authority, and they usually need to deal with representatives from at least two foreign trade organizations (one for the import side and one for the export side). Out of concern over potential Soviet meddling, Western-leaning LDCs may avoid orders for large, industrial projects on a compensation basis in order to avoid a prolonged presence of large numbers of Soviet technicians.

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Nonetheless, the USSR may win a few more contracts at the expense of Western firms because of a willingness to accept repayment in kind. US firms seem particularly averse to countertrade, and some Soviet commercial successes are likely to impinge on US interests. The Kremlin will have a

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special advantage if it accepts repayment in those products, such as textiles and other manufactures, that face Western import restrictions. 25X1

More important, the Soviets probably see such deals as a way to achieve small, but not insignificant, political gains. The Kremlin undoubtedly values highly any commercial gains in key LDCs that might later translate into more significant political breakthroughs. The recent approaches to Indonesia and Thailand are prime examples. Thus the Soviets probably calculate that, in some cases, the overall political benefit from countertrade deals may exceed the modest commercial gains. 25X1

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West Germany: Unemployment and the Elections [redacted]

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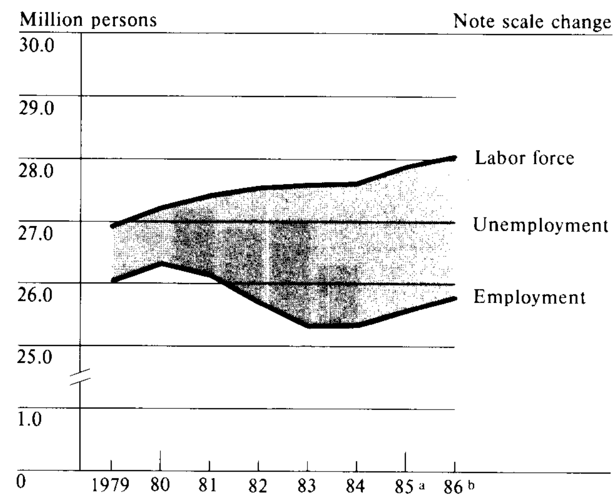
The opposition Social Democrats are certain to make West Germany's record high unemployment rate a key issue in the January 1987 national elections, but the Kohl government should be able to deflect the criticism. The government coalition will stress that joblessness has leveled off since 1983 because of steady economic growth, while both inflation and the foreign payments position have improved dramatically. It also plans a major publicity blitz, headlining forecasts that unemployment will fall this year for the first time since 1979. On balance, we believe the economy will be a plus for the coalition's campaign, although the government's plan to change the law governing unemployment pay during strikes has the potential for erupting into a damaging labor-government confrontation. [redacted]

West Germany: Labor Force, Employment, and Unemployment, 1979-86



a Estimated.
b Forecast.

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[redacted]

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Solid Recovery But High Unemployment

West Germany is entering its fourth year of recovery with the economy growing at a 2.5- to 3.0-percent rate. The domestic sector is strengthening, taking up the slack as the export boom that led the recovery moderates. Almost every major economic indicator is favorable: inflation is down to 2 percent and the trade and current account surpluses both set new records in 1985—$25 billion and $12 billion, respectively. [redacted]

The only fly in the ointment is unemployment—2.3 million people or 9.3 percent of the dependent labor force in 1985.[1] This is the highest level in the Federal Republic's history and polls consistently show that unemployment is now the chief economic concern of West Germans. The regional burdens vary widely. In heavily industrialized northern Germany, jobless rates are as high as 15 percent (Lower Saxony/Bremen), in contrast to 5 and 6 percent in the southern states of Bavaria and Baden-Wuertemberg, respectively, where the automobile, electronics, aerospace, and other high-technology industries are concentrated. Moreover, most of the joblessness dates back to the economic downturn of the early 1980s when the economy lost nearly 1 million jobs, and unemployment soared from 890,000 in 1980 to 2.26 million in 1983. [redacted]

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Total employment last year grew by 234,000, but unemployment still edged upward as a result of rapid labor force growth. Almost all the job growth was in the services and government sectors. Despite substantial hiring in the booming automobile, machine-building, and electronics industries, industrial employment rose by only 33,000 because of the

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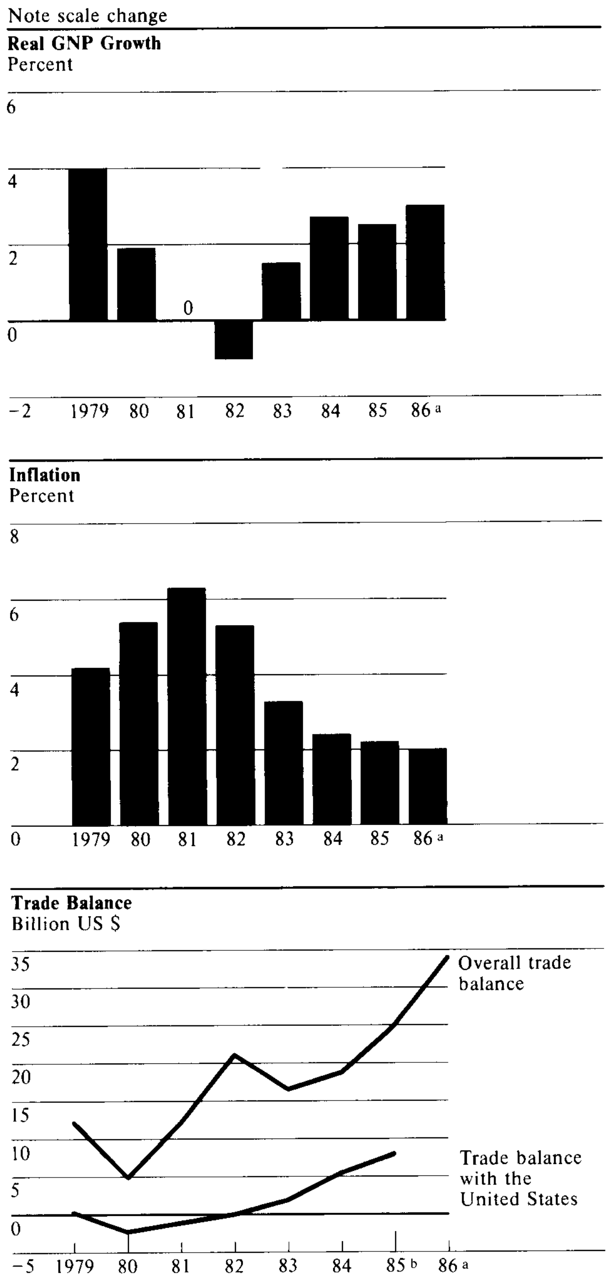
[1] As a share of the total labor force—including the self-employed—the unemployment rate is 8.3 percent. (U)

West Germany: Economic Indicators, 1979-86



[a] Forecast.
[b] Estimated.

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loss of over 100,000 positions in the construction industry. The surge in the labor force reflected large numbers of school leavers and women entering the job market for the first time, as well as the return of many workers who had dropped out of the labor force during the recession. 25X1

Opposition Criticism

The opposition Social Democrats (SPD) expect their most potent campaign theme to be the government's inability to reduce unemployment. They will argue that:

- Total employment is lower than in October 1982 when the SPD left office.
- The government's much-heralded budget deficit reductions have cost jobs by cutting public investment.
- Most workers have been hurt by social program cuts and increased worker contributions to pension and unemployment insurance funds.
- The government is manipulating the unemployment statistics by allowing jobless workers over 58 to leave the registered unemployment rolls while retaining unemployment benefits. 25X1

The SPD's view is that economic growth alone is not enough to bring down unemployment. Consequently it favors government action to shorten the workweek, introduce a comprehensive training and education program for workers, and create a special investment fund financed by excise taxes on fuels and a surtax on high incomes. In addition, SPD chancellor-candidate Rau is calling for more worker participation in management. Rau also wants to restore some of the Kohl government's social program cuts, although so far he has specifically mentioned only funds cut from student support. 25X1

Government Response

Chancellor Kohl's Christian Democrats (CDU) will contrast the rapid rise in unemployment in the last two years of SPD government with its near stand-

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West Germany: Changes in the Labor Force, Employment, and Unemployment

Thousand persons

	1979	1980	1981	1982	1983	1984	1985	1986 [a]
Labor force change	240	294	199	126	47	23	272 [b]	166
Employment change	360	281	−184	−435	−378	15	234 [b]	220
Unemployment change	−120	13	383	561	425	8	38	−54

[a] Forecast.
[b] Estimated.

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still since 1983. They will emphasize the steady economic growth since they took office, the healthy increase in jobs last year and the unanimous public and private forecasts of further job growth and a fall in unemployment in 1986. Furthermore, they will boast that this improvement has been achieved not with big state spending programs—such as the SPD unsuccessfully attempted in the late 1970s—but rather with reductions in the budget deficit from $15.2 billion (2.5 percent of GNP) in 1981 to an expected $9.6 billion this year (roughly 1.2 percent of GNP). The CDU will also point out that:

- A $4.3 billion tax cut took effect on 1 January 1986 and another $3.4 billion cut is scheduled for 1 January 1988.
- Youth unemployment is the lowest in the EC and one-third below the EC average.
- Inflation has been cut two-thirds since the party took office, to the lowest rate since the late 1960s, and that in the OECD only Japan has a lower rate.
- The trade and current account surpluses will be even larger in 1986.

Led by Christian Democratic Finance Minister Stoltenberg, most government officials continue to dismiss calls for a more expansionary fiscal policy. Within the coalition, for example, elements of the two smaller parties in the three-party government coalition—the Free Democrats (FDP) and the Bavarian Christian Social Union (CSU)—believe additional stimulus would improve their chances in the election. At a minimum, these critics want the $3.4 billion tax cut scheduled for 1988 to be brought forward. The government view is that this would result in higher inflation, rather than higher output, and would throw the budget consolidation course off track.[2] 25X1

The most serious danger to the coalition probably is the chance of a major confrontation with labor. The problem is not so much in the annual wage round, because the unions are seeking moderate pay hikes and probably will settle for something in the 3.5- to 4.5-percent range. Workers are angry, however, over a proposed labor law revision that eliminates unemployment benefits for certain workers idled as an indirect result of a strike. The labor union federation, supported by the SPD, has vowed to fight the change. Union actions, probably including demonstrations and work stoppages plus intensive lobbying, should climax at the time of the Bundestag vote on the legislation sometime in late winter or early spring. Even if a serious confrontation is avoided, the coalition could lose some of the 34 percent of blue-collar union members who voted 25X1
CDU/CSU in the 1983 election, providing roughly 14 percent of the total CDU/CSU vote. 25X1

[2] Using our Linked Policy Impact Model we estimate that moving the 1988 tax cut up to July 1986 would have no impact on inflation, while boosting real GNP 0.1 and 0.3 percentage point in 1986 and 1987, respectively. Unemployment, unaffected in 1986, would fall by 0.3 percentage point in 1987, and imports would rise slightly.

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Labor Legislation

The Kohl government can claim credit for several initiatives in labor legislation. Last May, it took a first step toward easing labor market rigidity by reducing limitations on the use of temporary and part-time workers and introducing new flexibility in hiring and firing. Preliminary surveys indicate as many as half the companies polled will hire additional workers under the new rules. In 1984 the government passed a bill permitting workers 58 to 62 to retire at 70 percent of their pension. If an unemployed worker is hired to replace the retiree, the government will reimburse the employer for one-third of the cost of the pension. Although less effective than expected, the government estimates this measure created 34,000 to 39,000 jobs last year. 25X1

Last September, Chancellor Kohl was also able to reinstitute regular tripartite meetings of labor, management, and government representatives to discuss economic conditions and goals; the meetings had stopped eight years earlier when labor pulled out during a dispute with the employers. The September meeting produced an understanding that became law on 1 January. The new law increases the maximum duration of unemployment pay for those over 44, increases incentives for training and job creation, and reduces employee/employer contributions for unemployment insurance. The cost of the measures is to be financed out of the surplus in the unemployment compensation fund 25X1

Outlook

Kohl and his coalition should go into next January's election holding most of the economic trump cards. The recovery probably will peak this year and, in addition to the good news concerning inflation and the balance of payments, unemployment almost certainly will fall. Job creation should be close to last year's level, while labor force growth will slow to a more normal pace, reducing joblessness by perhaps 50,000. Finally, Kohl's coalition is running on a platform that features tax cuts—in effect or planned—in contrast to the opposition's plans for tax increases. 25X1

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Israel: Austerity Takes Hold 25X1

The Israeli economy appears to be responding strongly to the austerity measures imposed last July. Inflation has abated and the foreign reserve position has improved, but at the cost of declining real wages and higher unemployment. While public reaction has been muted, pressures appear to be building for the government to ease up a bit. Key economic issues on the agenda in the coming months—the budget, indexation, and tax reform—will test the resolve of the National Unity government. In addition, should Prime Minister Peres renege on the power-sharing deal with Likud leader Shamir, Peres may be tempted to back off on austerity to woo votes in an early election. 25X1

Developments in 1985

The current austerity package has proved more effective than the National Unity government anticipated. The key elements of the 1 July program—new wage and price restraints, a 19-percent shekel devaluation, and additional deficit-reducing measures—were designed largely to slow the monthly inflation rate to about 4 percent and to offset overspending from the first few months of the fiscal year. By the end of the year, the program appeared to have wielded quite an impact:

- The monthly inflation rate slowed markedly, averaging under 1 percent for the last two months of the year. The inflation rate for all of 1985 dropped to 184 percent, compared with the record 445 percent recorded in 1984.
- Per capita consumption declined for the second year, largely because of falling incomes. Real wages plummeted 18 percent during the second half of the year compared with the first half.
- The unemployment rate climbed to 8 percent by the last quarter of the year, its highest rate in nearly two decades. The job losses were largely in the private sector, as the bulk of the layoffs planned for the public sector have yet to be implemented.
- The slump in domestic economic activity helped pare the civilian trade deficit by $500 million, slowing the drain on foreign exchange reserves. By yearend the infusion of new US aid boosted reserves from $2.4 billion to a comfortable level of $3.7 billion. 25X1

Why the Improvements?

The determination of Prime Minister Peres and the willingness of the Israeli consumer to shoulder additional hardships have been instrumental in helping the government program exceed expectations. Although Peres initially caved in on some minor points, he has since stuck with the program and resisted demands by trade union leaders to ease up. His task has been made easier by the muted response of labor's rank and file. 25X1

The Israeli public appears to have accepted the leaner times in exchange for the unaccustomed stability resulting from slowing inflation. Much less time is now spent juggling assets or making purchases to hedge against rapid price hikes. In addition, consumers have postponed buying many durable goods—especially imported automobiles— and drawn on relatively high savings to help cope with lower real wages. 25X1

The government also has demonstrated a suprising ability to hold the line on expenditures. The sharp slash in subsidies under the July program helped put the budget back on track, and the government has since fended off most ministerial requests for

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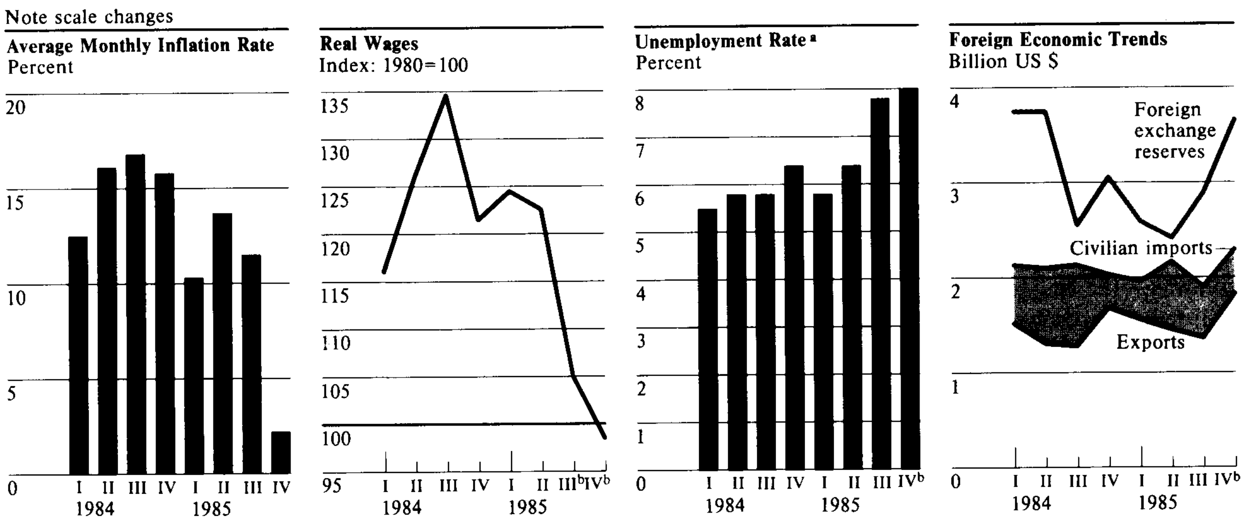
Israel: Economic Indicators, 1984-85



a Seasonally adjusted.
b Estimated.

[redacted]

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additional funds. The fight to reduce the deficit also has been helped by revenue-enhancing measures: increased taxes on property and the self-employed, in particular, contributed to a 10-percent climb in real tax revenues last year. [redacted]

The slowdown in domestic economic activity—especially the sharp drop in real wages—held off pressures for a further large devaluation of the shekel. Given the large imported component of most Israeli goods, shekel devaluations have been strong contributors to the inflationary spiral. The shekel-dollar rate held relatively steady over the latter half of the year, and the dollar's slide vis-a-vis the currencies of Israel's major European trade partners boosted Israel's export competitiveness. [redacted]

Tasks for 1986

The government now confronts the more formidable task of maintaining the current economic calm while introducing reforms needed to ensure continued progress. Several key economic issues on the agenda for the next few months will test the resolve of the government. They include:

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- *Reducing the budget deficit.* The most immediate concern is final Knesset passage of the budget for the 1986 fiscal year beginning 1 April. The budget proposes to slash the deficit by $600 million. Only $200 million, however, represents actual spending cuts—most of the reduction is the result of increased revenues, largely new user fees. Some officials are also hoping to proceed with the sale of a few government businesses.

- *Tax reforms.* The government hopes to introduce some reforms at the start of the fiscal year, if not sooner. The major objective is to reduce marginal income tax rates—the top rate currently is 60 percent—to boost labor productivity. The government anticipates some initial revenue losses, but hopes to lessen the impact by continuing with its efforts to improve tax collection.

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- *Indexation modifications.* Finance Minister Moday already has publicly stated his intention to "deindex" the Israeli economy. Wages are likely to be tackled first because the existing indexation agreement expires at the end of March, and the government already has had some success in suspending indexation under its previous wage-price accords. The leader of Histadrut, the powerful trade union confederation, opposes deindexing wages unless financial assets are unlinked as well. The government has made some minor moves on this issue recently, but is proceeding cautiously. [redacted] 25X1

While some policies to help long-term growth would be helpful, too hasty a move at this time would only reignite high inflationary pressures and lessen the prospects for meaningful structural adjustments. Pressures already are building to reflate the economy. Some wage hikes are currently being introduced, which, given the lower inflation rate, will produce real wage growth over the next few months. Moreover, concerns about the high unemployment rate could prompt the government to continue foot-dragging on its proposed public-sector layoffs and possibly bail out some financially troubled firms in the private sector. [redacted] 25X1

The Election Threat

Long-term economic progress also hinges on Peres's political strategy. At some point in the next few months, Peres will probably decide whether to relinquish his position to Likud leader Shamir next October as stipulated in the coalition agreement. Should Peres split the coalition to avoid stepping down, he might be forced to call for an early national election. [redacted] 25X1

Historically, economic austerity and elections have not gone hand in hand, and the current program would be particularly vulnerable. The latest polls show Israeli voters about evenly split on whether the economic plan is succeeding, with the vote falling along party lines. Peres may be inclined to stimulate the economy to encourage defections from Likud ranks and boost Labor's chances of doing well enough at the polls to form a new government. A somewhat more vigorous economy would particularly appeal to the working-class Sephardim, who constitute the bedrock of Likud's support and who have been hurt the most during the current economic slowdown. [redacted] 25X1

[redacted] 25X1

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The World Rice Surplus: Problems for Asian Producers

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Excessive rice stocks are depressing rice prices and as a result are cutting critical foreign exchange earnings for such LDCs as Thailand, Pakistan, and Burma. In addition, farm subsidies and stockpiling costs have soared, contributing to mounting budget deficits in other LDCs, such as India, Indonesia, and South Korea. The harvest of another bumper crop is under way in Asia, intensifying storage problems and stepping up competition for export sales. A complicating factor for Asian producers will be the effect of recent legislation making US rice exports more competitive. This is likely to put additional downward pressure on world prices and bring another year of declining earnings for Asian exporters and lower prices to Asian farmers—problems that could spill over into the domestic political arena, particularly in Thailand.

Surpluses Mount

After two years of record crops, world rice stocks are high, standing at a comfortable 7 percent of consumption, according to USDA. The major rice consumers—China, India, Bangladesh, Indonesia—have large surpluses. US stocks, cut back briefly by the 1984 government acreage reduction program, rebounded to a near-record 2 million metric tons in 1985. As world stocks have grown, prices have fallen in real terms to the lowest level in over 20 years. Thai prices, which serve as the world benchmark, declined by 6 percent during 1985. US prices declined slightly but remained nearly double the world average.

The global surfeit stems in large part from a surge in Asian rice production in the last three years, resulting from exceptionally good weather in combination with augmented government investment in agriculture. Increased plantings of high-yielding varieties, expanded use of fertilizers and chemicals, and investment in irrigation has improved land productivity, and farmers have reacted to price incentives by planting more land to rice. In India and Indonesia, for example, during 1983-85, yields increased by 17 and 5 percent, respectively, and rice acreage increased by 8 percent, in response to government price policy and subsidies on inputs such as fertilizer, pesticides, and irrigation.

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Stagnating Demand

Although production has risen, global import demand has stagnated since 1982. Indonesia, India, and South Korea—the biggest importers in the preceding decade—have achieved self-sufficiency. Slack rice trade and depressed prices have forced the major exporters—Thailand, Pakistan, China, Burma, and the United States—to scramble for sales. While the United States, handicapped by relatively high prices and shipping costs to big markets, saw its world market share decline from 21 percent in 1982 to 16 percent in 1985, most competing exporters were able to sell increased amounts of rice:

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- Thailand boosted sales to markets in Africa, the Middle East, and Europe formerly dominated by the United States. The Thai share of world rice trade rose from 31 percent in 1982 to 37 percent in 1985.

- In China, government pressure to boost export revenue has increased the flow of Chinese rice in world trade—largely shipments of relatively low-quality rice to Africa and nearby Southeast Asian markets. China's market share rose from 4 percent in 1982 to 9 percent in 1985.

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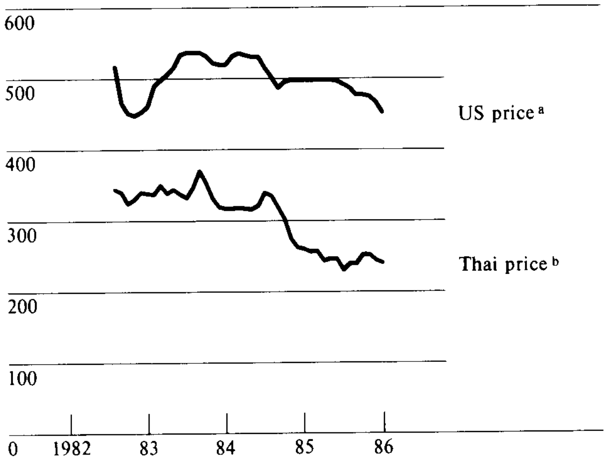
- In Pakistan, government marketing efforts in West Africa and Brazil, as well as trade promotions—including countertrade deals and credits—in predominantly Muslim Asian countries, such as Malaysia, are largely responsible for a gain in trade shares from 7 to 8 percent in 1982-85.

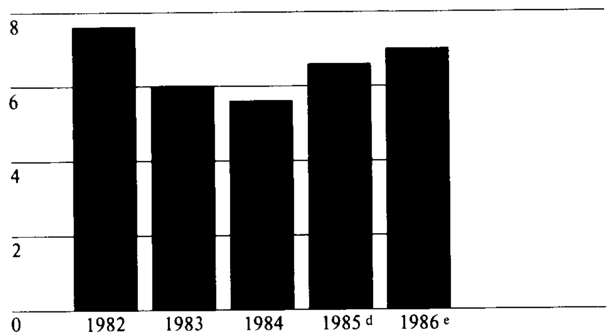
Rice Prices and World Rice Stocks, 1982-86

Note scale change

Rice Prices
US $ per metric ton



World Rice Stocks as a Share of Consumption [c]
Percent



[a] Average monthly price, c.i.f. Rotterdam, for No. 2, milled, 4% bagged.
[b] Average monthly price, c.i.f. Rotterdam, for SWR 100%, grade B, bagged.
[c] Stocks are measured as of 31 July, the end of the marketing year.
[d] Estimated.
[e] Projected.

[redacted]

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World Rice Production 1982-86 [a]

Million metric tons

	1982	1983	1984	1985	1986 [b]
Total	**412.7**	**419.5**	**452.3**	**468.8**	**465.2**
China	144.0	161.2	168.9	178.3	172.0
India	80.0	70.7	89.7	89.3	90.0
Indonesia	32.8	33.6	35.3	38.0	39.0
Bangladesh	20.5	21.3	21.8	22.0	22.5
Thailand	17.8	16.9	19.6	18.3	18.8
Burma	14.1	14.4	14.4	14.8	14.5
Japan	12.8	12.8	13.0	14.8	14.8
Vietnam	12.6	13.8	14.0	13.8	14.0
Brazil	9.2	7.8	9.0	9.0	9.0
Philippines	8.1	7.7	7.8	8.1	8.5
South Korea	7.1	7.3	7.6	8.0	7.9
Pakistan	5.1	5.2	5.0	5.2	5.1
United States	8.3	7.0	4.5	6.2	6.0
USSR	2.4	2.4	2.7	2.8	2.8
Other	37.9	37.4	39.0	40.2	40.3

[a] Data for rough rice production during the marketing year ending 31 July of the year stated.
[b] USDA projections.

[redacted] 25X1

In contrast, Burma lost ground in the years 1982-85 as its market share declined from 6 percent to 4 percent. A major customer was lost when India achieved self-sufficiency and Burmese official prices were set too high. [redacted] 25X1

Export Losses

The surge in rice production has created a new set of problems for Asian governments. Despite impressive marketing efforts, export earnings of LDCs dependent on rice exports for a large part of

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World Trade in Milled Rice, 1982-86 [a]

Thousand metric tons

	1982	1983	1984	1985	1986 [b]
Total exports	**11,800**	**11,900**	**12,644**	**11,555**	**12,085**
Thailand	3,600	3,700	4,528	4,250	4,800
United States	2,500	2,300	2,129	1,900	1,800
China	500	600	1,168	1,000	900
Pakistan	800	1,300	1,057	900	1,000
Burma	700	800	727	450	450
Other	3,700	3,200	3,035	3,055	3,135
Total imports	**11,800**	**11,900**	**12,644**	**11,555**	**12,085**
Iran	600	700	730	750	800
Iraq	400	500	490	500	550
Saudi Arabia	500	500	530	550	550
Nigeria	700	700	450	500	500
Malaysia	403	357	437	450	500
USSR	859	400	450	400	400
Vietnam	150	30	300	400	400
Senegal	370	362	375	350	350
Brazil	124	326	272	400	800
Ivory Coast	357	434	368	250	250
Bangladesh	296	82	588	300	200
Liberia	93	95	85	70	80
Indonesia	300	1,200	387	50	50
India	10	315	745	10	10
South Korea	200	200	7	0	0
Philippines	0	0	10	429	300
Other	6,438	5,699	6,420	6,146	6,345

[a] Calendar years.
[b] USDA projections.

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government revenues have been stunted by low prices and weak demand. The fiscal cost of farm price and input subsidies and storage of surpluses has soared, contributing to mounting budget deficits. The South Korean grain management account—which makes up the difference between the cost of procuring rice from farmers and the price at which it is sold—regularly runs a deficit of about $1.5 billion, according to Embassy reports. The current costs for food and fertilizer subsidies in India—much going to support rice farmers—will amount to over $2 billion, a sum nearly equal to the estimated overall budget deficit. Indonesian Government revenues, crimped by falling oil prices, were insufficient this year to procure enough rice to support domestic floor prices. At the same time, government stocks, currently costing about $2.5 billion to finance, according to Embassy reports, are of a quality too low to sell on world export markets at a price covering the cost of production.

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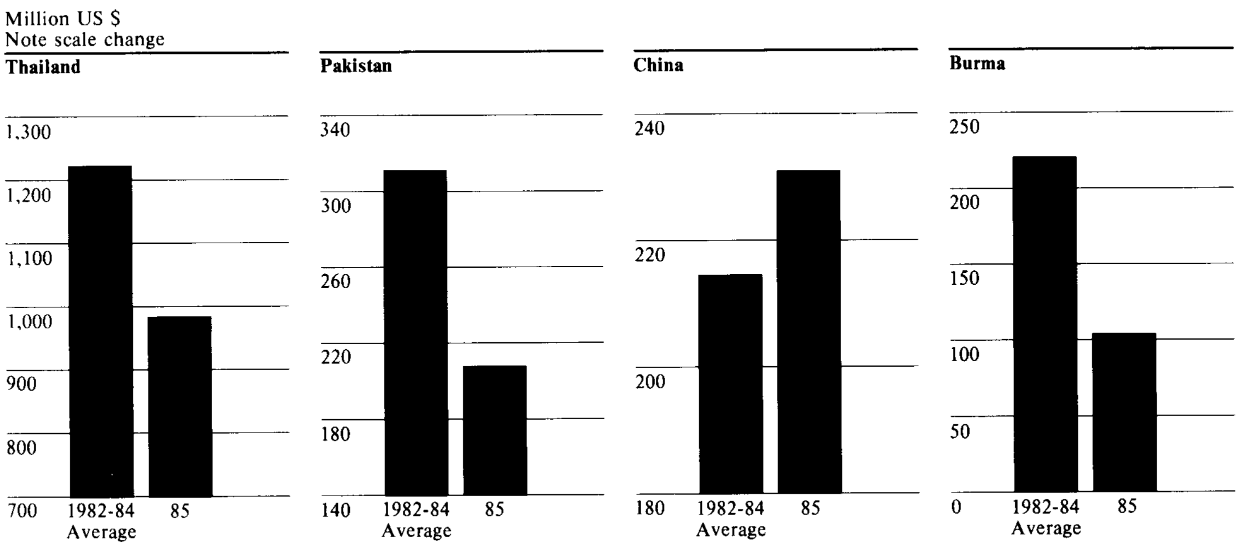
Selected Countries: Rice Export Earnings, 1982-85



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Beneficiaries of Low Rice Prices

Low world rice prices have enabled the governments of importing countries such as Nigeria, Liberia, Senegal, and Brazil to keep supplies flowing to urban areas. For example, the Brazilian Government, concerned about widespread malnutrition in the cities as well as in the countryside, imported 400,000 tons of rice in 1985 to replenish federally owned stocks sold at low prices to urban consumers. Anticipating shortfalls as a result of drought, the government recently announced plans to increase 1986 imports substantially. Similarly, countries in West Africa, where maintenance of a steady supply of high-quality rice to the cities is often a politicized issue, have been able to simultaneously build stocks and keep supplies flowing in spite of foreign exchange shortages.

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Outlook and Implications

With another bumper crop now being harvested, prices are likely to take another steep plunge in 1986. According to Embassy reports, prices in Bangkok dropped precipitously during the first week the new US farm bill was in effect, in anticipation of declining 1986 US prices. Embassy reporting further indicates that exportable Thai rice supplies will be at record levels next year, indicating continued intense competition and downward pressure on Asian prices. 25X1

Moreover, US export sales of rice are likely to accelerate in 1986, as a result of export incentives mandated by recent US legislation. As of 15 April, government payments to rice farmers will be indexed to Asian prices, allowing US farmers to sell at a profit in world markets. As a result, USDA now expects the gap between US and Asian prices to melt away, and customers are expected to return to US rice, which is generally valued for consistent quality. 25X1

Downward pressure on world rice prices means another year of declining earnings for Asian governments and lower prices to farmers, bringing increasing political problems for LDC governments—especially Thailand. The government of Prime Minister Prem, which has been pressured in recent months both by the military and by opposition party coalitions, is particularly concerned about criticism of his economic policies. 25X1

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Briefs

Energy

OPEC Production Update

[redacted]

Saudi Arabia reportedly has revised its oil production target downward for January [redacted] Preliminary data indicate that OPEC production in January may fall to about 17-17.5 million b/d—down more than 1 million b/d from December levels—with the Saudis absorbing more than half of the decline. OPEC production may slip even further in February if Libyan output drops in the aftermath of US sanctions and Iran makes good on its threat to drastically cut exports. The decline in Saudi production may indicate that companies are not taking all the oil to which they are entitled under netback contracts, which link crude oil prices to the spot prices of refined products. At this point it appears that any drop in Iranian production and exports—the result of a successful Iraqi attack—will probably be short lived. Downward price pressure could temporarily abate if other OPEC members make no major attempt to boost output, but aggressive marketing could cause prices to tumble further over the next few weeks. [redacted]

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[redacted]

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Iran Cuts Oil Production

[redacted]

Iran announced Sunday that it intends to stop selling oil on the spot market and to halve oil production in an effort to buoy oil prices. It called on other oil producers to follow suit, claiming that the industrialized nations and Saudi Arabia are engaged in a plot to bring down the price of oil. [redacted] [redacted] damage to Iran's Ganaveh manifold from the Iraqi attack on 23 January cut off the flow of oil to the Kharg Island terminal. Damage at Ganaveh, which will take seven to 10 days to repair, has forced at least a temporary reduction in exports, and the announcement appears to be an attempt to make the best of a bad situation. Iran is unlikely to reduce exports

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voluntarily for more than a couple of weeks after repairs are made. Tehran probably hopes to rally support for cuts by other producers at the OPEC special marketing meeting in Vienna next week, but the announcement will not be persuasive. [redacted] 25X1

Iraq Plans 1986 Oil Production Increase

[redacted]

[redacted] Iraqi oil production for 1986 is targeted at 2 million b/d, about 300,000 b/d above current production levels. Of this total production, Baghdad is planning to use netback and spot-market related prices to increase exports by 250,000 b/d to a total of 1.7 million b/d. [redacted] Baghdad probably cannot reach the 1.7-million-b/d export target unless shipments through the Iraq-Saudi pipeline reach 600,000 b/d—100,000 b/d more than Riyadh has agreed to. Iraq's pipeline through Turkey is operating near capacity, and logistic difficulties limit trucked shipments through Jordan and Turkey. [redacted] 25X1 25X1 25X1 25X1

Libyan Oil Industry Adjustments

[redacted]

Libya is moving ahead with its oil exploration and development program for 1986. [redacted] despite US economic sanctions, the Sirte Oil Company will drill six new wells in western Libya and proceed with offshore work close to the Tunisian border. Sirte has contracts with two US firms for all seismic work planned for this year. Companies in the United Kingdom or West Germany are good alternatives, although Romanian or Bulgarian crews could do the work [redacted] The withdrawal of US service companies probably will not delay other planned oil exploration and development work in Libya. West European or Eastern Bloc firms, as well as subsidiaries of US companies, can complete seismic work albeit at some delay or increased cost. [redacted] 25X1 25X1 25X1 25X1

[redacted] 25X1

Venezuela Expediting Foreign Oil Ventures

The US Embassy reports that the state oil company, PDVSA, has accelerated its plans to acquire refining and distribution facilities abroad to protect its market share. According to the Embassy, PDVSA is concerned that Saudi attempts to force production limits by engineering a temporary decline in prices may backfire. Caracas fears, instead, an extended period of cutthroat competition and sharply reduced prices. As a precautionary measure, PDVSA has expedited agreements on joint-venture deals with two refiners—one in Sweden and one on the US Gulf Coast—and with a Washington, DC area oil products distributor. Reportedly, these investments will give PDVSA an assured outlet for about 200,000 b/d—in addition to exports of 150,000 b/d to Veba Oel, PDVSA's West German partner. According to the Embassy, additional deals are under consideration, with PDVSA's ultimate objective being 600,000 b/d of assured exports to joint ventures. Neither the acquisition costs nor the sources of financing for these deals have been reported, but the required outlays are likely to be formidable, further straining hard currency reserves as oil revenues fall.

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Sudanese-Libyan Oil Trade

Sudan's increasing dependence on Libyan crude oil has made Khartoum more vulnerable to Qadhafi's blandishments, according to the US Embassy in Khartoum. Tripoli already has supplied two-thirds of the initial 300,000-metric-ton oil commitment free of charge, with the remainder expected to be shipped by April. Moreover, the Sudanese Minister of Energy has requested another 300,000-ton allotment to ensure Sudanese cooperation after planned elections in April, according to the US Embassy. The new oil deal would save Khartoum an additional $50 million in scarce foreign exchange. Qadhafi probably will continue his oil diplomacy to strengthen his position in Khartoum and reduce US and Egyptian influence.

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Soviet-Turkish Gas Dispute

The visit of Turkish Finance Minister Alptemocin to Moscow on 29-31 January will focus on a continuing dispute over payment terms for the proposed sale of Soviet natural gas. Ankara is tentatively slated to begin receiving 1.5 billion cubic meters of gas via pipeline in 1987 and 5-6 billion cubic meters annually by the 1990s. Although the original 1984 agreement called for payment in hard currency, the Turks have been trying to obtain a Soviet commitment to buy enough Turkish goods to offset the cost of the gas. If the Soviets fail to give a firm countertrade commitment or to compromise on price, Ankara may postpone contract negotiations indefinitely. The Soviets, however, have completed arrangements for construction of their portion of the pipeline and probably are anxious to avoid further delays. Prime Minister Ozal is likely to pursue the issue during his scheduled visit to Moscow in May.

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Progress on Chinese Nuclear Contracts

China this week reported its agreement in principle with the foreign companies supplying equipment and project services for the Guangdong nuclear power plant. Memorandums of understanding had been signed in December designating France's Framatome as supplier of two 900-MW nuclear reactors, with General Electric of Britain providing the turbine generators. Electricite de

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France is to supervise construction. The $3.5 billion plant will be operated by a China–Hong Kong joint venture using UK financing, and China will sell some of its electricity to Hong Kong to cover its share of the costs. China hopes to have letters of intent—the last stage before signing contracts—signed by 30 April. [redacted] 25X1

International Finance

Iran Seeks Foreign Credits

[redacted]

Iran is seeking a $300 million loan with a term of three years or longer with which to build a 1,000-MW power plant north of Tehran. We expect Japanese and other Western banks to provide the funds. In the past, Iran has avoided foreign loans for development projects because it wanted to be self-sufficient. Instead, Tehran used oil barter deals and foreign exchange reserves. Readily accessible foreign reserves, however, are now equivalent to only three months of imports, and, with oil prices falling, Iran does not want to reduce reserves further. [redacted] 25X1 25X1

Tunisian Cash Crunch

[redacted]

The steep drop in oil prices will have a chilling effect on Tunisia's shaky foreign exchange position and ability to meet debt service payments. Heavy drawdowns on outstanding credit lines helped boost total foreign exchange reserves to $250 million at the end of 1985 from a low of only $90 million in July. Nevertheless, planned budget expenditures early this year probably will cause reserve levels to tumble again. A $6 per barrel drop in oil prices coupled with a weak phosphate market could add $100 million to the current account deficit this year. A shortfall of this magnitude would wipe out much of the gain from Tunisia's current austerity program and push the debt service ratio above 25 percent. Tunis probably will have to seek additional foreign lending this year, but creditors may demand even greater fiscal stringency, which will strain already tense government relations with labor and consumers. [redacted] 25X1 25X1

IMF Cuts Off Liberia

[redacted]

The IMF this week formally declared Liberia ineligible to use Fund resources because of $47.5 million in overdue payments. The arrears had already triggered suspension of Liberia's standby arrangement in early 1985, and Monrovia's dim financial prospects almost certainly will prevent any repayment on outstanding IMF debt this year. Most government revenues were mortgaged through next July in President Doe's political campaign effort to pay overdue salaries. [redacted] 25X1 25X1

[redacted] local businessmen predict that foreign payments problems could lead to food and fuel shortages next month. [redacted] 25X1

Global and Regional Developments

[redacted] 25X1

Soviet–North Yemeni Economic Negotiations

[redacted]

North Yemeni and Soviet officials met in Moscow this week to discuss the repayment of North Yemen's debt to the USSR [redacted] 25X1 25X1 payments for the loans, most of which cover military purchases, are scheduled to begin in June. Last fall Moscow encouraged Sanaa to allow it to participate in North Yemen's emerging oil industry in return for easier repayment terms. [redacted] the Soviets two weeks ago dropped this precondition and expressed a willingness to postpone repayments until Sanaa's financial situation improves. Rescheduling would slightly improve North Yemen's financial situation. Moscow is trying to reingratiate itself with Sanaa following the coup in South Yemen, but is unlikely to drop efforts to secure a role in North Yemen's oil industry. [redacted] 25X1 25X1

National Developments

Developed Countries

[redacted] 25X1

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Japanese Discount Rate Cut

[redacted]

The Bank of Japan this week reversed its opposition to a unilateral reduction in interest rates and cut the discount rate by one-half percentage point to 4.5 percent. The recent strengthening of the yen against the dollar has, according to the US Embassy, eased the Bank's fear that lower domestic interest rates would accelerate capital outflows even if US interest rates hold steady. A modest reduction in Japanese interest rates is unlikely to provide much economic stimulus, however. Credit is widely available now for the larger firms, and the problems of the smaller firms stem mainly from reduced foreign demand. [redacted] 25X1 25X1

Tokyo Continues Launch Vehicle Development

[redacted]

[redacted] Tokyo has allotted funds for two programs—an engineering test satellite and a module compatible with the US space station. Both would involve the H-2 launch vehicle, which some Japanese aerospace industry experts expected to be canceled because fiber-optic technology has diminished demand for heavy communications satellites. [redacted] the National Space Development Agency wants to reduce dependence on US manufacturers for aerospace technology, a policy we believe is aimed at enabling Japan to launch satellites for foreign customers without obtaining US agreement. [redacted] 25X1 25X1 25X1 25X1

Italian Moves To Halt Speculation Against the Lira

[redacted]

We believe recent Italian efforts to stem speculative pressure against the lira will ultimately fail unless supplemented by additional action to bring down inflation. The new measures, announced on 16 January, include a ceiling on bank credit for the next six months, higher interest rates on short-term treasury bills, and a requirement that 75 percent of export credits be financed with foreign exchange. The moves at least temporarily reverse Rome's policy of easing credit and foreign exchange controls, which has helped boost business activity over the last two years. The Bank of Italy has spent nearly $7.5 billion since September in defense of the lira. If Rome wants to break the cycle of periodic devaluations, it will have to address the roots of the lira's weakness—high domestic inflation caused in part by excessive monetization of the huge public-sector deficit. [redacted] 25X1 25X1

Athens Proposes New Tax Bill

[redacted]

The Papandreou government has proposed stricter measures to reduce widespread tax evasion and trim the large budget deficit. Tax evaders could receive up to five years in jail. Possession of a private plane or pleasure boat will be considered sufficient proof to put owners in a high tax bracket. In addition, the bill establishes a minimum annual income equivalent to $3,740 for self-employed urban businessmen and professionals. The bill may help to boost revenues somewhat, but it is unlikely to help the government meet its optimistic target of a 32-percent increase in revenues this year. Papandreou probably will be forced to cut spending and increase taxes to meet tough EC conditions for the second tranche of a $1.5 billion balance-of-payments loan to be drawn in early 1987. [redacted] 25X1 25X1

Less Developed Countries

Aftermath of Argentine General Strike

President Alfonsin's government is unlikely to yield to the demands of the Peronist labor groups that staged the 24-hour general strike on 24 January. The nonviolent strike halted most industrial and commercial activity in the country, according to the US Embassy. Workers are demanding that the 25X1 government reinstate real wages to the levels prevailing before Alfonsin's austerity program; this would require a 15-percent increase on top of the 5 percent granted this month. They also want the government to introduce a program to expand the economy and to declare a moratorium on Argentina's $50 billion debt. Union leaders will meet in February to plan further actions against the government. Widespread support for the strike indicates that the political credit Alfonsin earned with his austerity program is eroding, and his opportunities for making additional tough economic and political reforms are dwindling rapidly. Whether or not the President introduces the next phase of his economic programs, strike activity and support for the opposition will intensify. 25X1

El Salvador's Mild Policy Initiatives

The economic program President Duarte announced last week—his first since taking office in June 1984—is unlikely by itself to restore either domestic or international confidence in the economy. The program sharply increases prices 25X1 for industrial and automotive fuels, effectively devalues the colon by 20 percent, freezes most government spending, and restricts nonessential imports. Taking advantage of rising coffee prices, San Salvador substantially boosted taxes on coffee exports and scrapped proposals to hike other personal and business taxes. To blunt consumer reaction, the package froze prices on food staples, rents, utilities, public transportation, and medicines. At the same time, Duarte announced stiff penalties for violations of new price and exchange controls. While labor reaction to the measures has been restrained, most business leaders have criticized the program for "ignoring investment and production incentives" and for failing to cut government spending. The Embassy reports that poor prospects for the ongoing coffee harvest are likely to undercut hoped-for increases in government revenues. Before creditors renew loans to San Salvador, we expect they will demand that the government reverse new economic price and exchange controls and further restrict government and personal consumption. 25X1

Major US Firms Depart Costa Rica

Although the announced departure of three well-known US companies from Costa Rica is unlikely to have major immediate impact on the economy, it reflects San Jose's increasing difficulty in attracting and retaining foreign investment. According to the US Embassy, spokesmen for the Bank of 25X1 America and Firestone said corporate policies rather than local business conditions prompted their decisions to sell out. Union Carbide blames its pullout on the contraction of regional trade and losses caused by customers defaulting on payments. With short-term prospects for the recovery of regional trade bleak, some of the 100 remaining US-owned firms—many came 15 or 20 years ago to take advantage of the now-moribund Central America Common Market—are rethinking their choice of location, according to the US Embassy. [redacted] 25X1

Grim Saudi Budget Outlook

[redacted]

The US Embassy reports Riyadh is continuing to draw on Aramco's capital fund to cover current spending. A recent $5 billion withdrawal nearly exhausted the fund, which was more than $10 billion two years ago. Declining oil revenues—more than one-third below expected levels—leave the Saudi budget deficit at $15 billion for this fiscal year. Riyadh reportedly has begun preparing its budget for next year [redacted] Riyadh probably will borrow on the international market before it cuts important defense or subsidy programs. It has already curtailed its spending substantially and will find it difficult to pare future budgets without causing domestic hardships. Cutbacks will depress the economy further because Saudi Government spending is the driving force for economic growth. [redacted] 25X1

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Syrian Financial Troubles Mount

[redacted]

The black-market rate for the Syrian pound fell another 25 percent in the last week to 20 pounds to the dollar, according to the US Embassy. Illegal currency conversions in Syria were halted when authorities arrested a large number of money changers on 24 and 25 January. Prices have started rising rapidly on both legal and contraband goods, and some hoarding has been reported. The fall of the pound and rising prices are causing widespread concern, even among workers who up till recently have been largely sheltered by government subsidies and price controls. Bread riots, like those in Cairo and Tunis in past years, are not likely because of Syria's extensive security apparatus and the general popularity of President Assad. Criticism is being focused on Prime Minister Kasm and his cabinet, and Assad may decide to make some changes in his government, possibly after elections in March. The Syrians will look for additional aid, primarily financial aid from Saudi Arabia, but also oil aid. [redacted] 25X1

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Lebanese Balance-of-Payments Surplus

[redacted]

Lebanese Central Bank foreign exchange reserves stood at $1 billion at the end of 1985, up almost $380 million from their December 1984 level. Given a probable current account deficit of slightly more than $1 billion, capital inflows into Lebanon in 1985 were well in excess of $1 billion. Foreign funding for the various militias, particularly the PLO, probably account for a large portion of this inflow. Other inflows probably include black-market exports to Syria and money repatriated by Lebanese workers returning from the Gulf states. While 1985 was not too bad a year economically, the recent fighting in Christian East Beirut and the failure of the Syrian-sponsored Tripartite agreement has given 1986 a bad start. The Lebanese pound has fallen almost 28 percent in the last two weeks to approximately 23 to the dollar, and capital flight has undoubtedly increased. [redacted] 25X1

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External Economic Pressures on Nigeria

[redacted]

Nigeria's failure to obtain Western support for a rescheduling of official debt and plummeting world oil prices have undercut President Babangida's go-it-alone economic strategy. The US Embassy reports that Western creditor nations unanimously refused to enter debt negotiations unless Lagos secures an IMF agreement. The government probably will be unable to cushion the blow to the economy from falling oil revenues because of its poor relations with international creditors and its meager foreign exchange reserves. Economic decline, which contributed to the fall of the last two governments, may prompt yet another round of coup plotting by the military. [redacted] 25X1

Food Deficit Expected for Lesotho

[redacted]

Lesotho's corn harvest probably will fall short of domestic requirements, [redacted] To reduce dependence on South 25X1 Africa, Lesotho halted the spraying of herbicides and insecticides last spring 25X1 by South African agricultural consultants. As a result, insect infestation has sharply reduced corn production and could affect the crop for the next two to three growing seasons. South Africa, however, is expected to have a corn surplus this year and is favorably disposed to the new military government that ousted chief Jonathan last month. The new regime already has pleased Pretoria by expelling African National Congress guerrillas and harassing Soviet Bloc embassies. [redacted] 25X1

Pakistan Announces Privatization Plan

[redacted]

Last week Pakistan announced a plan to offer shares worth over $100 million in six major public-sector firms to private investors. The firms include the national airline, and government-run fertilizer, gas, and oil facilities. In an 25X1 effort to garner foreign exchange, Pakistan is allowing expatriates the first opportunity to purchase the high-dividend shares. The long-promised program will help relieve the budget deficit and provide needed capital for public-sector firms. The government believes the offering will be fully subscribed by May. We expect Islamabad to sell shares in other government-controlled firms, but many of these poorly managed, money-losing firms would likely be of limited interest to prospective investors. [redacted] 25X1

Communist

Moscow Warns Budapest on Economic Policy

[redacted]

An article in *Pravda* on 21 January emphasizes the importance to Hungary of economic ties to the USSR. It claims that cooperation with the West does not necessarily improve the quality or competitiveness of Hungarian goods. The article also warns of ideological contamination from the West and expresses 25X1 confidence that the Hungarian Communist Party would wage a vigorous counteroffensive. A piece in *Pravda* last month by the same authors was more positive about Hungary's economic policy. Moscow is indicating to the East Europeans on the eve of the Soviet party congress that the expected endorsement by the congress of the "diversity" of "socialist" experiences mentioned in the party's draft program applies mainly to domestic economic arrangements. In foreign economic policy, CEMA integration and closer Soviet–East European cooperation will continue to take precedence. While Budapest is unlikely to curtail economic relations with the West unless pressed hard by Moscow, Soviet warnings may strengthen the hand of hardliners in Budapest. [redacted] 25X1

[redacted] 25X1

Sino-Soviet Trade Protocol Signed

[redacted]

China and the Soviet Union last week signed a one-year trade protocol, within the framework of the five-year trade agreement signed in July 1985. Under the protocol, China will provide nonferrous metals, foodstuffs, and light industry products in exchange for Soviet manufactured goods. Over the past five years, 25X1 trade between the two countries has grown rapidly, from $248 million in 1981 to an estimated $1.6 billion in 1985. Despite this rapid growth, it is unlikely that bilateral Sino-Soviet trade by 1990 will exceed 5 percent of total trade for either country. [redacted] 25X1

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