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International Economic & Energy Weekly

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The focus of the agenda for the Tokyo Economic Summit, on 4-6 May, has not yet emerged clearly. Much will depend on the participants' responses to positive US signals on international monetary reform, bilateral trade disputes, interest and exchange rates, oil prices, and the global debt situation. 25X1

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The violence that has plagued South Africa's black townships for the past 18 months and resulted in over 1,200 deaths has undermined investor confidence in the country and delayed economic recovery. Long-term economic prospects appear poor so long as continued unrest, combined with the impact of likely future economic sanctions, progressively isolates South Africa from international investment and credit. 25X1

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Perspective

Issues for the Tokyo Summit

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The third preparatory meeting for this year's Economic Summit was held last weekend, but the focus of the agenda for the sessions in Tokyo, on 4-6 May, has not yet emerged clearly. Part of the reason is that the expectations of the participants may be somewhat lower than for previous summits. In addition, several meetings, involving many of the same countries and agenda items, will precede the Tokyo gathering, including an IMF interim meeting, an OECD Ministerial, and a preparatory meeting on the new trade round. 25X1

More important in shaping the summit will be developments over the next six weeks in areas such as responses to positive US signals on international monetary reform, bilateral trade disputes, interest and exchange rates, oil prices, and the global debt situation. Terrorism, narcotics, SDI, or Gorbachev's latest arms control proposals could also become major themes. 25X1

Paris and Rome applauded President Reagan's request that Treasury Secretary Baker explore once again the usefulness of a conference to consider improvements to the international monetary system—looking in particular for greater exchange rate stability. Most discussion focuses on some kind of reference or target zone system—which, President Mitterrand pointed out, he has been advocating since 1981. Rome also favors an attempt to create a European Monetary System–type arrangement encompassing the yen and the dollar. Bonn and Ottawa have often expressed unhappiness with exchange rate volatility but, along with London, are extremely skeptical that summit governments will be able to control exchange rates unless they become much more willing than at present to subordinate domestic economic policies to foreign exchange rate or other international economic trends. Tokyo, particularly the Ministry of Finance, argues that such policy coordination is an absolute prerequisite to exchange rate stability. 25X1

The new trade round has been endorsed in principle by all the summit participants, but some of the endorsements have been less than ringing. Little more than a restatement of support is likely in Tokyo—in particular because of French and EC reluctance to move very far or fast on setting agendas or timetables. Protectionism, unfair subsidies, and market opening will be discussed, with all three points of the trade triangle—the United States, Japan, and the EC—taking potshots at the other two. The most serious problems, however, probably will be papered over in Tokyo—perhaps helped by another Japanese import promotion package just before the summit. 25X1

Economic growth, deficits, and interest rates will once again be on the agenda. Japan and France had been pushing for a coordinated lowering of interest rates—coordinated to prevent inordinate downward pressure on their currencies—and they have expressed satisfaction with the nearly simultaneous central bank discount rate cuts last week. The French and Italians have also recommended putting the "locomotive theory" back on the track, focusing it on West German and Japanese expansionary measures. Bonn, however, has been reluctant to implement any measures that might retrigger inflation. Tokyo is putting together a small stimulus package in hopes of forestalling criticism at the summit. Both Tokyo and Bonn will oppose any suggestion at the summit that they act in any coordinated way as locomotives. [redacted] 25X1

The impact of falling oil prices undoubtedly will be a key point of discussion. As long as the British and other non-OPEC producers refuse to cooperate with OPEC by cutting output to hold up prices, however, the issue is unlikely to become contentious. The Japanese are worrying about the negative effects—fewer incentives for conservation (and thus the possibility of a resurgence of demand in the future), payments problems for oil exporters, some bank difficulties, and instability and uncertainty generally. Most other summit participants, however, appear to want to stress the positive results of the decline. Of the summit countries, only the United Kingdom is unlikely to benefit quickly and directly from lower oil prices. Even in Britain's case, gains will probably outweigh losses relatively soon as its manufactures exports to other industrial countries pick up and as inflation slows. Canada, a net oil exporter, but whose exports center on the United States, will almost certainly ride on US coattails and enjoy a net boost immediately. [redacted] 25X1

The North-South agenda is likely to focus on Secretary Baker's initiative to increase lending to 15 major debtor countries, provided they move toward more market-oriented economic policies. The other summit participants have expressed various degrees of cautious support. Obtaining firm agreement to implement the program, however—particularly given rapidly changing interest rate and oil market conditions—is likely to be difficult. France, for one, has criticized the list of potential recipients as skewed toward Latin America—whose debt is largely owed to the United States—to the detriment, for example, of African countries with which France is more involved. The LDCs will try to find a standard bearer (France is the leading candidate) to push for concessions to ease their debt service burden. Several leading LDCs are also strongly opposed to including trade in services and investment in the new trade round; France again is the best candidate to represent LDC interests. In addition, Tokyo has announced the visit of a special envoy to several Asian LDCs just prior to the summit, promising that Asian views will be reflected there. Italy and Canada (although the latter less so under Mulroney) also will claim some share of the role of LDC spokesman. [redacted] 25X1

As noted, the important themes, or headline grabbers at least, may not yet have emerged. However, with several thousand journalists looking for headlines in Tokyo, it can be virtually guaranteed that they will find them. [redacted] 25X1

[redacted] 25X1

Summit Issues: Exchange Rates, Trade, and Growth

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There are increasing signs that the near 20-percent trade-weighted decline in the dollar between February 1985 and March 1986 has begun to hurt exporters in most Big Six countries. On the basis of our Linked Policy Impact Model (LPIM), we estimate that a continuation in the fall of the dollar during 1986-87 would dampen the relatively strong domestic economic expansion now taking place in those economies. In addition, a falling dollar would increase protectionist pressures in Western Europe and Japan and make preparations for the new GATT round more difficult. Most Big Six governments do not want the dollar to depreciate further and will probably urge at the Tokyo Summit that action be taken to stabilize currencies at or near current exchange rates. We expect France, Italy, and possibly Japan to urge more formal arrangements among the major countries to coordinate exchange market intervention.

Impact of the Strong Dollar

The Big Six economies, as well as others, enjoyed substantial economic benefits from US growth and an appreciating dollar following the end of the recession in 1982. About half the economic growth in the Big Six during 1983-84 was attributable to the dollar's rise—16 percent over the yearend 1982 level and 31 percent over the yearend 1981 level—and to the strong US recovery. Big Six exports to the United States jumped 43 percent in dollar terms over the two-year period. At the same time, the Big Six also benefited from improved export competitiveness in third-country markets vis-a-vis US firms hurt by the strong dollar.

The Turnaround in 1985

The direct effects of US import demand on the Big Six began to fade in 1985. Although about one-third of Big Six growth was still attributable to US

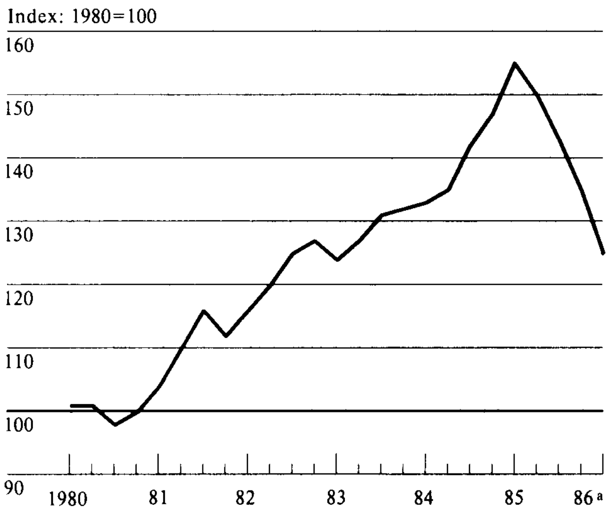
Methodology

We used our Linked Policy Impact Model (LPIM) to estimate the impact on OECD exports and economic growth of the expansion in US import demand during 1983-85 and, similarly, the impact of a 10-percent annual depreciation of the dollar during 1986 and 1987. 25X1

We determined the difference between actual trade and GNP growth for 1983-85 and the simulated results for the same variables, assuming no growth in US imports. For the March-December 1985 period in which the dollar depreciated, we compared the results of a model simulation in which the dollar remained at its March 1985 level against the baseline case, which reflected exchange rate movements through December. 25X1 25X1

To estimate the impact of a falling dollar over 1986 and 1987, we constructed a baseline forecast of OECD economic performance, assuming roughly constant exchange rates at January 1986 levels. Against this forecast we compared the results of a model simulation in which the dollar fell 10 percent each year for three years against all of the other OECD countries except Canada. We assumed that the dollar fell of its own accord: no policy change or other explicit factor led to the fall. We also assumed that the US-Canadian exchange rate remained constant, and that Canadian export prices did not change. In addition, we assumed that Japanese exporters cut prices by the equivalent of 40 percent of the appreciation in the yen. 25X1 25X1

US Dollar: Changes in Trade-Weighted Value, 1980-86



a 1986 data through 4 March.

[redacted]

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import demand, our model indicates that the dollar's 13-percent decline from March to December cut potential Big Six growth by 0.3 percentage point. Foreign governments are concerned that the dollar may continue its decline and are prepared to take action to ease the impact on exporters:

- Tokyo has decided to extend low-interest loans to small- and medium-sized firms but is leaving larger companies to decide if they want to cut profits or market share.

- Bonn views 2.2 deutsche marks to the dollar as a threshold below which German competitiveness would be severely hurt [redacted] and probably would consider intervention around that rate to prevent further appreciation of its currency. (The rate moved to 2.27 DM/dollar in early March.)

- Paris and Rome now would generally like to see exchange rates stabilized: [redacted] Rome considers 1,400 lire to the dollar as the point where Italian export competitiveness would be severely eroded—the lira/dollar rate was 1,542 in early March.

- London's outlook has been influenced more by falling oil prices than by the drop in the dollar.

In contrast, Ottawa's concern is that the Canadian dollar has actually fallen further than the US dollar. [redacted] 25X1

Impact of a Continued Drop

We simulated for this year and the next a 10-percent annual decline in the dollar from its January 1986 level. The resulting impact on the Big Six appears significant enough to draw policy responses from most of the governments. [redacted] 25X1

Japan experiences the largest loss among the Big Six in real exports and GNP. This would occur despite our model assumption that Japanese exporters partly offset the dollar's depreciation by cutting prices to maintain market share. [redacted] major exporters are passing along only half of the increased export costs. We expect exports from politically important small and medium-sized firms will suffer the biggest drop in volume. [redacted] 25X1 25X1 25X1 25X1

West Germany fares slightly better than Japan from a declining dollar because its main export to the United States is luxury autos, whose demand is relatively unaffected by price changes. The effect of the dollar would be equally felt across the rest of West German industry. [redacted] 25X1

The ***United Kingdom***'s exports of petroleum and petroleum products account for about 21 percent of total exports, and, although oil is denominated in dollars and would not be directly affected by changes in the value of the dollar, government revenues from oil—dollars converted to pounds—would be cut. Next week, in fact, London will 25X1 25X1 25X1

Big Six: Impact of a 10-Percent Nominal Depreciation of US Dollar, 1986-87

Difference from baseline scenario

	Real GNP *(percentage point)*		Export Volume *(percent)*		Unemployment *(percentage point)*	
	1986	1987	1986	1987	1986	1987
Big Six	−0.2	−0.7	−1.2	−2.1	0	0.1
West Germany	−0.2	−0.7	−0.7	−1.3	0	0.2
United Kingdom	−0.2	−0.8	−1.2	−2.6	0.1	0.3
France	−0.2	−0.8	−1.1	−2.5	0.1	0.3
Italy	−0.3	−0.7	−1.3	−2.9	0.1	0.2
Canada	0.9	1.2	0.7	2.8	−0.2	−1.0
Japan	−0.4	−0.9	−2.1	−3.5	0	0.1

[redacted] 25X1

decide whether to scale down or possibly shelve the proposed tax cut for this year, and, because of the decline in the price of oil, may even increase taxes on cigarettes, alcohol, and petroleum. Elsewhere in the economy, British manufacturers would bear most of the loss and are already complaining that price competitiveness is restraining export growth. Nonetheless, according to US Embassy reporting, British Treasury officials are arguing the benefits of a stronger pound: lower inflation and import costs. [redacted]

France and ***Italy*** both suffer significant impacts from the falling dollar. This would be tempered, however, by a likely realignment of their currencies within the European Monetary System (EMS) that would improve their export competitiveness in West European markets. [redacted] This would also help Italian exporters, since a realignment of the EMS would almost certainly include a depreciation of the lira. [redacted]

Canada is the only country in the Big Six where economic growth improves. We assume a fixed US-Canadian exchange rate during the dollar's depreciation, causing the Canadian dollar to depreciate vis-a-vis the European and Japanese currencies, making Canada a more effective competitor in the world as well as in the US market. Canadian auto exports would probably benefit the most because of both increased US demand and the relatively higher price of Japanese autos. [redacted] 25X1

Implications for the United States

The deterioration in five of the Big Six countries' export sectors would be reflected in a gradual reduction in the US trade deficit. Under our scenario, the US trade balance would improve by $15 billion in 1986, $17 billion next year, and, if extended to 1988, another $19 billion, for a three-year total reduction of $51 billion. [redacted] 25X1 25X1

A declining dollar probably would create new bilateral trade tensions, particularly with the European Community. Irritated by disputes with the United States over citrus and steel, EC Commissioner for External Relations de Clerq has expressed his concern over the "aggressiveness" of US trade policy. Furthermore, a declining dollar would probably encourage West European governments to strengthen their export promotion programs. This might include better deals for the Airbus, higher export subsidies for agricultural goods—especially grains—and undercutting the 25X1 25X1

OECD consensus on subsidizing interest rates on official export credits. West European protectionism would almost certainly increase and Japanese promises to open domestic markets would likely remain mostly rhetoric, casting a shadow over the upcoming GATT round. [redacted] 25X1

A Push for Exchange Rate Stability

We believe that the summit participants will seek efforts to stabilize current exchange rates. Nonetheless, the Big Six countries differ widely in their approaches. Although another 5-percent decline in the dollar would not markedly hurt the Japanese and West Europeans, they now appear more concerned with preventing a major and rapid decline in the dollar resulting from a loss of market confidence. France has already proposed the idea of confidential target zones for the major countries, which Italy at least might support. Although Prime Minister Nakasone has expressed support for arrangements to stabilize exchange rates and some industry spokesmen are prodding him to support target zones, Japan's powerful Ministry of Finance strongly opposes fixed reference zones. Both West Germany and the United Kingdom dislike the idea of fixing exchange rates, and Bonn, for one, has publicly ruled out the idea of explicit target zones. West German officials, instead, will probably only argue for closer coordination of economic policies.

[redacted] 25X1

International Financial Situation: Mexican Politics and the Debt [redacted]

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There is a growing political debate in Mexico over suspending payments on the country's $98 billion foreign debt. Leftist opposition parties and independent labor unions are calling for a debt moratorium, as are several influential cabinet members. President de la Madrid, consistent with his own preferences and the advice of Finance Minister Silva Herzog, for the time being is resisting a radical approach. He will, however, probably use the threat as a bargaining chip with creditors. Nonetheless, should Mexico City be unable to reach an accommodation with creditors on a new debt relief package in coming weeks or should government retrenchment policies lead to significant social unrest, de la Madrid almost certainly would cite domestic considerations as an excuse for charting a more confrontational course. [redacted]

Domestic Pressures for Debt Relief

Despite the administration's generally moderate stance on the debt issue, a number of domestic forces are urging a more confrontational policy. [redacted]

Programing and Budget Minister Salinas, Foreign Minister Sepulveda, and Energy Minister Labastida favor a moratorium on interest payments and oppose deeper spending cuts—maintaining that more stringent austerity will lead to greater unemployment and heighten the potential for social unrest. In contrast, Finance Minister Silva Herzog has advised against confronting creditors and urged that government outlays be further cut—particularly through the sale of government-owned enterprises—to reduce the public-sector deficit and need for debt relief. [redacted]

Leftist political parties, independent labor unions, and a number of intellectuals have taken a militant stand, in some cases calling upon the government to repudiate the foreign debt either unilaterally or jointly with other debtors. Pressures for a more radical stance on the debt issue also have come from influential sectors within the ruling Institutional Revolutionary Party. Nationalists within the party argue that Mexico City's current debt strategy enables outside forces to dictate the country's internal policies. While not going so far as to endorse a moratorium, Fidel Velazquez, head of the powerful Mexican Confederation of Workers, has asserted that present debt arrangements impose an unbearable burden on Mexicans and that the "sacrifice of the Mexican worker cannot last forever." [redacted] 25X1

Business groups and the conservative National Action Party, the country's strongest opposition force, have avoided extremist positions on the debt issue. Business leaders generally favor renegotiation of the debt, believing a default would seriously damage the economy by drying up future sources of credit for the public and private sectors alike. Political conservatives ascribe Mexico's present financial predicament to what they view as the misguided and inconsistent policies of de la Madrid and his predecessor, Lopez Portillo. [redacted]

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De la Madrid's Views

Although de la Madrid, for his part, has taken a moderate stance on the debt issue in the past, his stance could shift with prevailing political currents. Because de la Madrid has not provided firm direction to Mexican debt policy, the influence of his advisers and the general public is greater than normally would be the case. [redacted]

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Capitalizing on the Debt Issue

Mexico City is attempting to use domestic support for a moratorium to increase its leverage with Washington and the banks. [redacted] For this reason, it has encouraged some media coverage of the issue, tolerated political demonstrations in support of a moratorium, and participated in Cartagena Group meetings. Nonetheless, Mexico City's assertion that it must adopt a tough stance in debt negotiations is more than simply a bargaining posture. In our judgment, the de la Madrid administration is seriously concerned about the prospect of social unrest if the debt burden is not eased. [redacted] The view of de la Madrid and other Mexican leaders that major unrest could occur in 1986 unless Mexico receives substantial debt relief almost certainly will condition the decisions they make on the debt issue in the future. [redacted]

Prospects

In the months ahead, de la Madrid will attempt to avoid a radical solution to the debt issue, in our judgment, and is unlikely to repudiate Mexico's foreign debt or to join with other debtors in a regional moratorium. The longer negotiations drag on, however, the more likely he will be to sharpen his rhetoric and take actions to dramatize the seriousness of Mexico's plight. We believe there is a better-than-even chance that Mexico City, even while pursuing a settlement with creditors, will suspend some interest payments. Even so, de la Madrid probably would assert that the interruptions in payments are temporary and due to circumstances beyond Mexico City's control. [redacted] 25X1

To obtain a combination of new money and other debt concessions, Mexico City will commit itself to additional cuts in public spending and structural reforms. The administration will promise more than it will deliver, however, because it is unlikely to permit the standard of living to fall much below present levels. Moreover, most of the reforms Mexico City adopts will be implemented in the next 12 to 18 months. After that time, the government is likely to restimulate the economy in advance of 1988 presidential elections and to postpone politically unpopular measures. [redacted]

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In the less likely event de la Madrid chooses more radical action on the debt, he may cite domestic imperatives as necessitating such a move. In our judgment, he would be most likely to do so if creditors failed to grant adequate debt relief; if the country experienced significant new oil price or other external shocks; or if government retrenchment measures led to major social unrest. Under such circumstances, Mexico City probably would pursue more populist and nationalistic policies, some of which, while proving popular domestically, would strain relations with Washington and Mexico's creditors. [redacted]

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Libya: Reaction to US Sanctions [redacted] 25X1

US sanctions have disrupted some Libyan oil exports by increasing marketing difficulties and have had some adverse impact on agriculture and selected development projects. Moreover, the current drop in oil prices will limit the Libyan leader's ability to redress domestic grievances and provide a focal point for his opponents to gain popular support. Nonetheless, US actions probably have bought Qadhafi some respite from antiregime activity that had spread to his security forces and his inner circle of advisers by the end of last year. Qadhafi can be expected to be aggressive in looking for ways to circumvent US economic measures and strike out at US or Western interests, including possible terrorist operations targeting Saudi Arabian oil facilities. [redacted]

Allied Response to US Sanctions

None of our allies have implemented broad sanctions—many countries have publicly refused to do so—although most have expressed some sympathy for US sanctions against Libya and have agreed to stop exports of arms. Only Canada, Italy, France, and West Germany have taken some positive steps to limit relations with Libya:

- ***Italy*** has prohibited public firms from filling in and is pressuring private firms to go along. All military trade with Tripoli is suspended until further notice. Rome admits, however, that it has little control over smaller Italian firms who may be eager to do business with Libya.
- ***Canada*** canceled export insurance for firms doing business with Libya and is banning the sale of some petroleum-related equipment.
- ***West Germany*** will not provide export credit guarantees to firms that are filling in for US firms.
- ***France*** apparently has stopped shipments of spare parts for civilian aircraft, but did so because of recent Libyan military activity in Chad.
- Other West European states and ***Japan*** have either taken no action or only advised domestic firms not to fill in for US companies. In many cases, this advice is having little impact. The Confederation of British Industries last month reaffirmed its longstanding policy that trade should be carried out on the basis of commercial considerations. [redacted] 25X1

Filling the Gap

Qadhafi may be going on the economic offensive to circumvent US sanctions. [redacted] 25X1 25X1 Tripoli will continue to pressure wealthy Arab states for financial assistance if cash flow difficulties become acute; so far, Qadhafi's requests for Arab economic support have fallen on deaf ears. [redacted] 25X1

While available evidence suggests that some foreign firms are filling in for US companies, it is often difficult to determine whether a specific company's activity is an effort to undercut US sanctions, or part of an ongoing business relationship [redacted] 25X1

Libya:
Replacement of US Companies

We believe that declining business opportunities worldwide, especially for oil service companies, probably will lead more foreign firms to pursue openings left by US companies. Foreign firms, including several from South Korea, Spain, and Japan, have expressed interest in—or have actually taken over—previous US contracts for civil engineering and construction projects in Libya such as the Great Manmade River project. [redacted] 25X1

Impact on the Oil Industry

[redacted] US companies in Libya are complying with the law and have stopped all liftings. [redacted] the US restrictions have delayed some petroleum-related projects but caused no serious disruption in oilfield operations. We believe most US citizens have left Libya—an estimated 200 remain. The freeze on Libyan financial assets has prevented Tripoli from collecting some $150 million for oil sold in December. [redacted] 25X1 25X1 25X1

We have no evidence that other countries are cutting back oil purchases in response to US sanctions. In several instances European firms have recently initiated new petroleum contracts with Tripoli. French officials claim they will press their oil companies to reduce imports of Libyan oil, and Spain has discontinued government-to-government oil purchases from Libya—in both cases for reasons unrelated to US sanctions. [redacted] 25X1

Libya is experiencing some difficulty marketing its oil because of the soft oil market as well as the US sanctions. [redacted] Libyan oil production may have fallen by as much as 200,000 b/d in the last month, to about 1 million b/d. [redacted] A further drop in exports is possible in the current glutted oil market, however, without sharp price discounts. By midyear Tripoli may be able to make up for most sales lost because of US sanctions by increasing crude product exports from the Ra's al Unuf refinery and by distributing more products in 25X1 25X1 25X1

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Italy from Libya's recently purchased TAMOIL refinery. [redacted]

An increasingly tough posture toward the US producing companies probably indicates that Tripoli now realizes they must be replaced. [redacted]

Firms from several countries, including Argentina, Austria, Italy, and Hungary, are interested in taking over US oil concessions in Libya. With US producing companies unable to sell their assets to foreign firms or subsidiaries, however, Libya will try to buy out the US concessions on attractive terms. Forced nationalization probably would be a last resort because it would further damage Tripoli's reputation and might hamper resale of US concessions to foreign interests. [redacted]

The Domestic Impact of US Sanctions

US sanctions have contributed to growing popular grievances by reducing Qadhafi's room to maneuver domestically. The assets freeze caught the regime off guard, denying it access to at least $750 million—13 percent—of total financial reserves. [redacted]

The confrontation with the United States, however, has provided Qadhafi with a brief respite from the deterioration of his internal position. [redacted]

[redacted] Potential coup plotters probably will lie low for the time being to avoid identified as US puppets. At the same time, Qadhafi has been unable to use the current tensions with Washington to expand his dwindling domestic support. [redacted]

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Outlook

In a recent speech to the Libyan General People's Congress, Qadhafi declared that Libya had "won" its confrontation with the United States and reiterated his determination to defend the Gulf of Sidra. The congress also issued resolutions calling for economic sanctions against the United States and continued support for "liberation movements." While many of Qadhafi's comments seem defensive, the lack of US military action against Libya almost certainly has bolstered Qadhafi's conviction that he has once again weathered the crisis with Washington. Qadhafi may well choose to pursue a more aggressive policy—including terrorist activities—against US and Western interests, especially if he can conceal his hand by operating through anti-Arafat Palestinians or groups. [redacted]

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Soft oil market conditions pose the greatest threat to the economy and probably the regime. While a $20 per barrel oil price this year probably would have little impact on the economy, given current export levels, an average price of $15 per barrel would force Tripoli to make difficult and politically risky choices. The oil glut will make it even harder for Tripoli to maintain oil barter arrangements with the Soviets, the Italians, and others, who are owed some $4 billion. Mandatory import reductions under the $15 per barrel scenario almost certainly would cause domestic discontent to reach regime-threatening levels and force Qadhafi to rely even more heavily on repression and security forces to remain in power. [redacted]

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[redacted]

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South Africa: Black Unrest Clouds Economic Prospects 25X1

The violence that has plagued South Africa's black townships for the past 18 months and resulted in more than 1,200 deaths has undermined investor confidence in the country and delayed economic recovery. Pretoria has responded in the short run by shelving some key aspects of its economic liberalization program and by introducing measures intended to stimulate the economy. Over the long haul, the government requires a sustained economic recovery to support its gradualist program of limited economic and political concessions intended to co-opt urban blacks. Long-term economic prospects, however, appear poor so long as continued unrest, combined with the impact of likely future economic sanctions, progressively isolates South Africa from international investment and credit.

Shifting Economic Priorities

The slow pace of racial reform and Pretoria's often heavyhanded response to unrest have heightened investor concerns about South Africa's political and economic future. This crisis of confidence has delayed economic recovery much more than the direct impact of the violence, which has been largely confined to nonwhite areas. Moreover, an accelerated withdrawal of foreign credit lines and some disinvestment have depressed the exchange value of the South African rand—now at 50 cents—and pushed the inflation rate above 20 percent by January as the cost of imports has soared. Economic and political uncertainties also have combined to encourage white emigration, which, though a minute fraction of the white population, has resulted in the loss of skilled labor and some savings.

The loss of investor confidence has led Pretoria to slow its economic liberalization efforts. Abandoning its reliance on market forces to stem the capital outflow, Pretoria suspended on 1 September principal repayments on $14 billion of South Africa's $24 billion foreign debt. At the same time, foreign exchange controls on nonresidents were reinstated to penalize disinvestment, and plans to relax exchange controls on residents and emigrants were postponed. In addition, a 10-percent customs surcharge was imposed on many types of imports. Although the government has continued to stress privatization of some of its assets as a lauditory goal, political and economic uncertainties probably have delayed significant action by depressing their market value. 25X1

Pretoria also has shifted away from previous anti-inflationary policies in spite of the rising inflation rate. Government officials publicly have justified this shift by citing a need to spur economic recovery to restore local business confidence and to quiet 25X1
black unrest, but, in our view, a more important consideration probably has been to blunt criticism of government economic management by opposition political parties. In any case, Pretoria has cut the prime commercial lending rate from a high of 25 percent as recently as May 1985 to the prevailing 15.5 percent. Pretoria also commited funds to create jobs and relaxed some credit restrictions on consumer borrowing. 25X1

Although the Botha government, in our view, remains committed to improving the living conditions of urban blacks in an attempt to co-opt them into accepting limited racial reforms, Pretoria is loath to jeopardize white support by massively redistributing income in a weak economy. Pretoria thus has only provided limited new opportunities for black advancement:

- Nonwhites working in white areas as executives, managers, or technical employees are no longer 25X1
  subject to the legislative "color bars" that restricted them to jobs where they worked under the full-time supervision and control of whites.

Pretoria's Economic Liberalization Efforts

The South African economy has been buffeted in recent years by falling world gold prices—gold accounts for nearly one-half of export revenues—and a severe drought. Real GDP growth averaged less than 1 percent per year during 1981-85—far short of the 2.3 percent needed to keep per capita income from declining. The brunt of this mediocre economic performance, in our view, has fallen on blacks and has contributed significantly to the violence in black townships. Overall, black unemployment exceeds 25 percent [redacted] *and probably is over 50 percent in some riot-torn areas. Moreover, a recent government study suggests that, without new foreign investment, long-term growth prospects are likely to fall considerably short of the 5-percent real average annual rate needed to prevent black unemployment from rising further.* [redacted]

We believe concern over the country's long-term growth prospects has been reflected in Pretoria's effort since 1979 to liberalize its economic policies in order to promote manufactured exports, attract new foreign investment, and boost domestic savings. A key element has been the removal of selected import and foreign currency controls that protected high-cost domestic industry from foreign competition. In addition to allowing the rand to float against foreign currencies, the monetary reforms eliminated ceilings on domestic interest rates. Some selective promotion of exports also is envisaged, but, as a GATT member, South Africa is limited in the types of export subsidies that it can use. [redacted] 25X1

Another important element of economic liberalization plans has been the gradual reduction of government involvement in agriculture and industry. According to South African data, some 70 percent of farm output is sold to 29 agricultural marketing boards. State-owned companies dominate several industries and hold some 15 percent of the country's physical capital. Approximately one-third of the consumer price index consists of prices controlled by the government or its companies. The government is the sole purchasing agent for petroleum imports, and markets gold for the mining companies. Overall, the government and its companies sell more than half of the country's exports, and buy more than one-third of its imports. Pretoria has promised to review these activities with the objective of selling some state-owned companies and deregulating markets. [redacted] 25X1

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- Pretoria has announced that it will promote the development of small businesses by reducing government redtape, providing low-cost loans, and opening parts of some central business districts to all races; cumbersome licensing procedures, legal impediments and limited access to finance currently stifle black business initiative.

- Proposed multiracial councils for urban areas would channel additional revenues to black local authorities, according to government officials.

Although these measures will help some blacks in the short run, Pretoria probably recognizes that over the long haul only higher GDP growth rates will create the larger economic pie necessary to make income redistribution more palatable to whites. [redacted]

Vulnerability to Sanctions

Black unrest in South Africa has amplified the international clamor for tough economic sanctions. Despite years of policies to promote economic independence, the country is far from invulnerable to widespread bans on foreign investment or trade boycotts that cut export earnings. On the basis of our economic model of South Africa, we estimate that each $1 billion of withdrawn foreign capital or forgone export earnings would trim GDP growth potential by about 1 percentage point per year. In our judgment, South Africa's poor recent economic performance is due in part to a relatively small net capital inflow, and the resulting need to fund industrial development largely through domestic savings from export revenues. Net foreign capital

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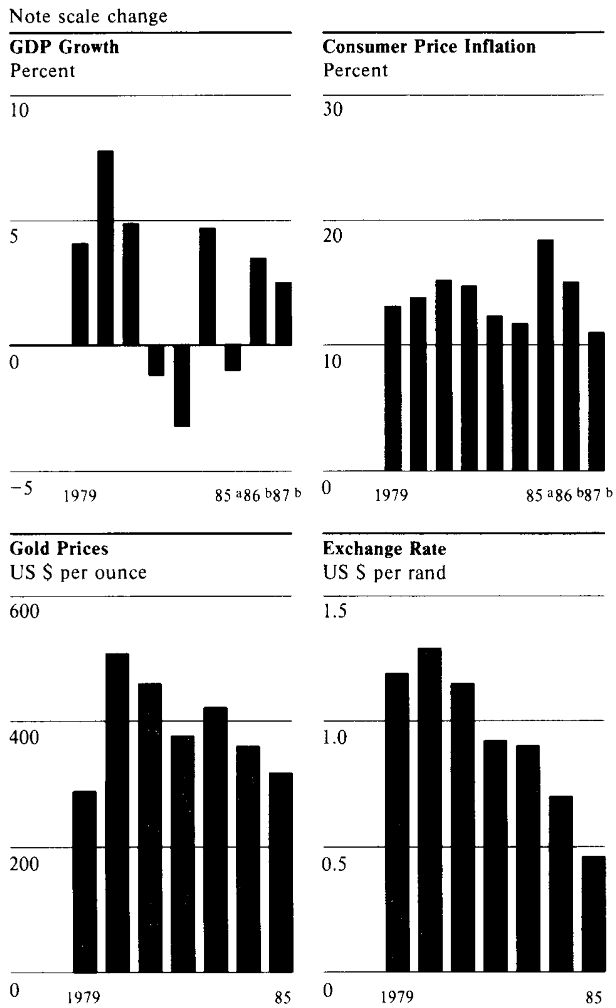
South Africa: Selected Economic Indicators



[a] Estimated.
[b] Projected.

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inflows, including loans and investment, have accounted for only 12 percent of gross domestic investment since 1977.

South Africa: Balance of Payments, 1981-86

Billion US $

	1981	1982	1983	1984	1985 [a]	1986 [b]
Current account balance	−4.6	−3.0	0.2	−0.7	2.7	2.0
Merchandise trade balance	−9.8	−7.3	−5.1	−5.7	−1.7	−2.7
Merchandise exports, f.o.b.	11.0	9.4	9.3	9.1	9.6	9.7
Merchandise imports, f.o.b.	20.8	16.6	14.4	14.8	11.3	12.4
Net gold exports	9.6	8.0	8.9	8.1	7.4	8.2
Net services and transfers	−4.3	−3.7	−3.6	−3.1	−3.0	−3.5
Capital account balance [c]	1.0	2.9	−0.9	1.3	−2.6	2.0
Total reserves, yearend [d]	4.3	4.0	4.1	3.1	2.5	2.5

[a] Estimated.
[b] Projected.
[c] Including errors and omissions.
[d] Total reserves are not the sum of changes in reserves and the previous year's total reserves because of year-to-year changes in exchange rates and the value of gold reserves.

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Outlook

South Africa is poised for a modest economic recovery this year. A tentative consensus reached during a meeting between South African officials and major creditors last month potentially represents a major step toward normalization of the country's international financial relations. Our model indicates that the economy can generate the $2 billion current account surplus that Pretoria believes it will need for debt repayment this year under the tacit agreement, and still afford 3- to 4-percent real GDP growth. Key assumptions that underlie the forecast include an average gold price

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of about $350 per ounce, a corn harvest of at least 8-9 million metric tons, and no more than a modest tightening of economic sanctions. 25X1

The recovery, however, is likely to be export- and consumption-led, with domestic investment remaining depressed and black unemployment rising slightly. The budget that will be introduced in Parliament next week and take effect 1 April probably will be mildly expansionary, and may include a modest increase in social spending for nonwhites. Past business cycle behavior and current negative real interest rates suggest some risk that Pretoria will overstimulate the economy, cutting into needed current account surpluses and forcing new austerity measures to rescue the debt rescheduling plan. 25X1

Over the longer term, South Africa's economic isolation is likely to increase with the failure to achieve an internationally acceptable resolution of the country's political dilemma. Continued unrest, in our judgment, is likely to spark new calls for tough Western economic sanctions. Sanctions that are being considered by several countries include bans on new investment, more extensive boycotts of South African coal and agricultural exports, divestiture of equity in South African companies, and selective embargoes on sales of capital equipment. Combined with the psychological impact of the unrest on investor confidence, additional sanctions would undermine the country's ability to repay debt without further contracting the domestic economy, and thus push average GDP growth below 3 percent in 1987 and beyond. Black unemployment and economic grievances probably will continue to grow in spite of a modest increase in social spending, with some 200,000 new job market entrants each year failing to find modern-sector employment. 25X1

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The Soviet Consumer Goods and Services Program

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The long-awaited Consumer Goods and Services Program for 1986-2000 lays down ambitious goals but promises more than it can deliver. It fails to provide for the needed investment, relying instead on increases in labor productivity and efficiency to achieve the goals. Although some gains are possible, major increases in output are not likely to be sustainable over the next five years, calling into question the leadership's ability to follow through on its commitment to the consumer.

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Goals of the Program

Chronic shortages of goods and services as well as poor quality and an undesirable product mix probably have contributed to lackluster worker performance in recent years. General Secretary Gorbachev is hoping to boost labor productivity and, like his predecessors, has stressed the need for improving the lot of the Soviet consumer as a key element in this effort.

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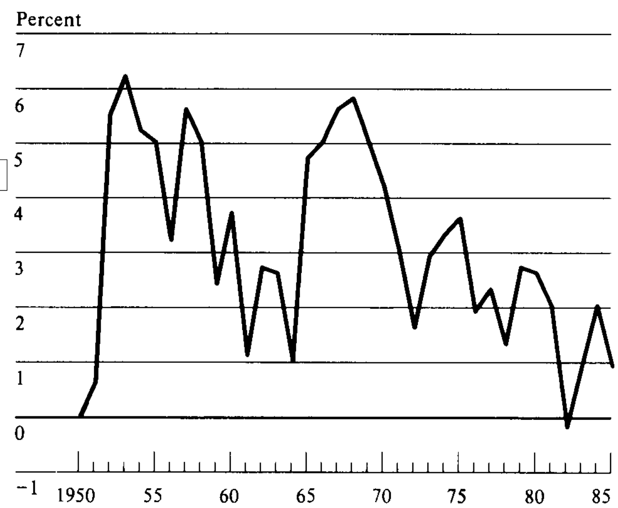
The consumer program, which has been in the making for almost three years, lays out highly ambitious production targets that in almost all cases call for growth rates not achieved since the late 1960s or earlier. Production of soft goods (primarily textiles and clothing) is planned to grow in 1986-90 at an average annual rate more than double that achieved in 1981-85. In addition to stepped-up growth of consumer durables output in 1986-90, the program also calls for:

- More household appliances in order to reduce the time Soviet working women spend on housework.
- Better quality and product mix to meet consumer demand, including increased output of video cassette recorders from currently minuscule levels.
- Production of more spare parts to improve the servicing of consumer durables—demand for automobile spare parts is supposed to be fully met by 1990.

USSR: Growth of Per Capita Consumption, 1950-85



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No goal, however, is presented for the durable good most sought by the Soviet consumer—the automobile—suggesting that increases in future production will be minimal at best. Currently, Soviet auto production is running at about 1.3 million units per year compared to US production in 1984 of 7.6 million units.

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The new program also calls for increases in the quality as well as the availability of a wide range of consumer services.[1] The program also calls for

[1] In the USSR, health and education services are largely free. Consumers pay for other services such as personal transportation, communication, recreation, and personal care and repair services, as well as some financial services, hence the category "paid services." The Consumer Goods and Services Program is aimed at boosting output of paid services.

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USSR: Trends in Key Consumer Goods and Services and Consumer Program Goals

Average annual growth in percent

	1966-70	1971-75	1976-80	1981-85 [a]	1986-90 Plan [b]	1986-2000 Plan [b]
Nonfood goods [c]	**8.2**	**5.1**	**4.0**	**2.8**	**5.4**	**4.2**
Soft goods	7.2	2.7	2.6	1.7	3.9	3.5
Textiles	3.4	2.4	0.7	1.4	3.7	2.9
Knitwear	6.4	2.9	2.7	1.2	5.7	4.6
Hosiery	−0.2	2.2	2.2	2.2	3.9	1.9
Footwear	6.9	0.6	1.2	1.2	2.7	1.7
Consumer durables	11.7	11.2	6.6	4.7	6.9	4.9
Radios	8.6	1.4	0.2	0.7	6.2	3.6
Tape recorders	16.7	16.2	3.8	8.4	5.4	3.8
Televisions	12.8	0.8	1.6	4.6	2.8	2.1
Of which:						
Color	0	6.7	30.9	11.7	9.9	6.2
Refrigerators and freezers	19.8	6.2	1.2	0	2.9	2.4
Sewing machines	11.8	−0.6	−0.5	4.2	9.9	5.4
Washing machines	8.8	−6.5	3.0	6.1	3.4	1.8
Vacuum cleaners	13.5	14.1	1.9	4.0	4.9	2.6
Services [d]	**7.4**	**6.0**	**4.3**	**3.4**	**6.2**	**5.4**
Personal care and repair [e]	2.5	10.2	7.4	4.8	7.0	6.2
Communications	8.8	7.3	5.8	4.5	5.8	7.2
Housing and communal [f]	3.1	2.6	2.2	2.6	5.9	5.7
Of which:						
Number of places in hotels		9.8	3.8	5.6	5.8	6.3
Sanatoria, health resorts	4.8	13.4	4.9	2.7	5.0	6.0

[a] Preliminary estimate for 1985.
[b] Where a goal is expressed as a range, we have used the midpoint for the purpose of this table.
[c] Includes soft goods and consumer durables.
[d] Volume of paid services. Excludes such free services as health and education. Includes personal care and repair, personal transport, personal communications, housing and communal, tourism, sports, legal and personal financial services and services performed by consumer cooperatives.
[e] Includes laundry and dry cleaning as well as automobile, housing, and other repair services and rentals of durables.
[f] Includes maintenance of state housing and utilities.

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retail stores to adopt more convenient operating hours, and more eating facilities are to be set up at places of employment.

Major Resource Constraints

The prospects for success of Gorbachev's ambitious program are not bright, at least in the next five years, primarily because we see no indications that a major shift of investment in favor of the consumer is in the offing. On the contrary, the sectors of the economy producing consumer goods and services are likely to face increased competition for scarce investment resources because of Gorbachev's

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ambitious plans to modernize heavy industry. Premier Ryzhkov's speech at the recent Party Congress reemphasized that top priority will be given to machine building—the sector most critical to modernization. The energy sector is scheduled to receive a sharp boost in investment resources as well, while the share of investment devoted to agriculture and its supporting industries will remain stable. [redacted]

With total investment growth planned to average 3.5 to 4.0 percent per year, the sectors responsible for nonfood consumer goods and services are almost certain to be squeezed. A member of the interagency commission responsible for developing the program reported in January 1985 that the commission was having trouble obtaining commitments for the resources needed to fulfill the goals of the program. Furthermore, a Gosplan official told the US Embassy that there would be little, if any, increase in resources for the consumer in the 1986-90 period. Judging by past performance, a reduced or constant increment in investment resources will not support the production increases called for in the program [redacted]

Measures To Boost Efficiency

It appears that the leadership plans to meet the consumer program targets on the cheap by better utilizing existing productive capacity and resources. For example, the program continues a campaign initiated under Brezhnev to increase consumer goods production in heavy industry by using "hidden reserves"—leftover raw materials and idle capacity. But, with the heavy emphasis in the 1986-90 plan on conserving raw materials, fewer "leftovers" are likely. [redacted]

According to a resolution adopted shortly before the Politburo approved the program, enterprises in heavy industry will be tasked with producing a specified amount of consumer goods. Such an approach has not been effective in the past because it does not relieve enterprises of their obligation to meet primary output targets. Future demands on heavy industry to meet high output targets to support Gorbachev's modernization program will limit the ability of this sector to supply consumer goods. [redacted] 25X1

According to the consumer program, all factories and places of employment also will be assigned goals for providing various personal care and repair services to the general public. Earlier resolutions have called for an expansion of such activity, but 25X1
this is the first time that the requirement has been made mandatory for all enterprises. Most enterprises, however, are simply not equipped to provide any but the most basic services. [redacted] 25X1

Other Measures

The consumer service experiment begun in July 1984 in some areas is to be expanded throughout the country, according to the Soviet press. This involves:

- A reduction in the number of targets that participating service enterprises must meet.
- Greater freedom for these enterprises to use their profits. 25X1
- Increased use of labor brigades—small groups of workers paid according to their performance.

[redacted] 25X1

Soviet press comment indicates that the experiment has had some success in increasing quality and output of services, but that shortages of resources continue to hamper fundamental progress in developing the services sector. A *Pravda* article said that although the experiment could be termed a success "there still remain enterprises where the plan is not being fulfilled and service quality has not improved . . . the work of consumer service enterprises under the new conditions is not yielding the anticipated results." [redacted] 25X1
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Other measures called for in the program are aimed at boosting the labor supply. These prescriptions include:

- Increased use of pensioners and part-time labor in service establishments.

- A larger role for at-home production of consumer goods by pensioners and others not readily employable in factories.
- Greater use of workers on collective and state farms to produce consumer items during slack seasons.

Such initiatives could provide some relief for the consumer sector, especially in the area of labor-intensive services. Pensioners are already widely employed in producing services: some 18 percent of all employees of personal care and repair enterprises in Moscow are retirees. [redacted]

Limited Alternatives

Reduced restrictions on private activity in the services sphere—already a major source of services—could significantly improve output and enhance prospects of meeting the services goals. According to the Soviet press, one-half of all shoe repairs, 45 percent of apartment renovations, and 40 percent of all car repairs are done by private entrepreneurs. The new consumer program, however, contains no indication that the leadership plans to significantly enlarge private-sector activity. In fact, a Gosplan official has publicly stated that the private sector would not be the source of an increase in services because the new consumer program ensured the state's ability to boost output of services. [redacted]

We cannot rule out, however, the possibility of future movement in this area. Gorbachev hinted in May that he favors a policy of allowing a greater role for private initiative in services, and at the recent Party Congress he hinted at some willingness to consider a limited role for private activity. No new initiatives were announced at the Party Congress, however. [redacted]

The regime could also boost living standards by stepping up imports of consumer goods. [redacted]

Eastern Europe will be hard pressed to meet Soviet expectations for soft goods as production prospects there appear bleak. Nor does it seem likely that the Soviets will turn to the West for more nonfood goods. Faced with declining hard currency revenues, the leadership probably will be unwilling to alter the traditional low priority assigned hard currency purchases of nonfood consumer goods.
[redacted] 25X1

Implications

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Gorbachev's industrial modernization program could eventually pay off for the consumer if it results in substantially more machinery and equipment that could be channeled into the consumer sector. In the meantime, Gorbachev, like his predecessors, will probably give less resource priority to consumption—particularly services and nonfood goods—than other sectors of the Soviet economy. Premier Ryzhkov implied at the party congress that the share of consumption in national income will fall in 1986-90 despite the ambitious goals of the consumer program, suggesting inconsistencies within the plan. [redacted] 25X1

Although the consumer program tries to provide reassurance of regime concern with living standards at a time of calls for greater labor discipline and sacrifice, we judge that increases in production of nonfood goods and services in the 1986-90 period will continue to be slow. Failure of the much touted program to provide incentives for greater worker effort will hamper Gorbachev's efforts to raise labor productivity and would undermine his credibility with the Soviet consumer. [redacted]

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Soviet–East European Trade Plans for 1986-90

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Plans call for trade between the Soviet Union and Eastern Europe to grow more slowly in the next five years than at any time since the 1960s. Rapid increases in East European exports in recent years have resulted in roughly balanced trade with the USSR, and we expect both the value and volume of those exports to grow much more slowly. Soviet pressure is likely to force the East European regimes to make tough choices about exporting to the West and supplying domestic needs. Moscow's ability to export to Eastern Europe will be limited by declining oil production and a hard currency squeeze. Any major cuts in oil exports could well disrupt East European economies and dramatically alter Moscow's economic relations with Eastern Europe.

Review of Recent Trade Trends

Beginning in the mid-1970s, the USSR permitted its East European partners to run large trade deficits because of their inability to generate enough exports to cover the rising cost of Soviet oil deliveries. In recent years, Moscow has become less willing to support Eastern Europe and may have become impatient with the East Europeans' inability to close the trade gap. Moscow's push for more balance narrowed the annual trade deficits from 1981 to 1984, and may have nearly eliminated them in 1985 for all countries except Poland.

Over the past decade the Soviets enjoyed a sharp improvement in their terms of trade with the East Europeans because energy prices were rising faster than other prices in intra-CEMA trade. In *value* terms, Soviet exports to and imports from Eastern Europe more than doubled from 1977 to 1985. But, according to our estimates, the *volume* of Soviet deliveries to Eastern Europe rose by less than 10 percent over the entire period, while real import volumes from the region increased by nearly 50 percent.[1]

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1986-90 Trade Plans: Slower Growth

The 1986-90 protocols concluded in the final months of 1985 call for trade to total 380 billion rubles over the period. This target implies a nominal average annual growth rate of only 5 percent—the slowest growth in planned trade in the past 15 years. The modest targets in the protocols belie the oft-discussed need to increase trade and cooperation within CEMA, as well as statements by officials in some East European countries who say that trade will be diverted away from the West toward the USSR.

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The slowdown in trade projected through 1990 reflects, in part, planners' expectations of slower price increases than in the early 1980s. With energy prices falling and at least some price increases likely for East European exports, Moscow faces a deterioration in its terms of trade for the next several years. Any effort by the Soviets to overcome this deterioration—by changing the pricing formula in their favor or through item-by-item negotiation—would meet with strong East European resistance.

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[1] Estimates are based on the use of Hungarian ruble price indexes as price deflators of official Soviet foreign trade statistics. Soviet and Polish indexes for prices and trade volumes show similar trends but are not as comprehensive as the Hungarian data.

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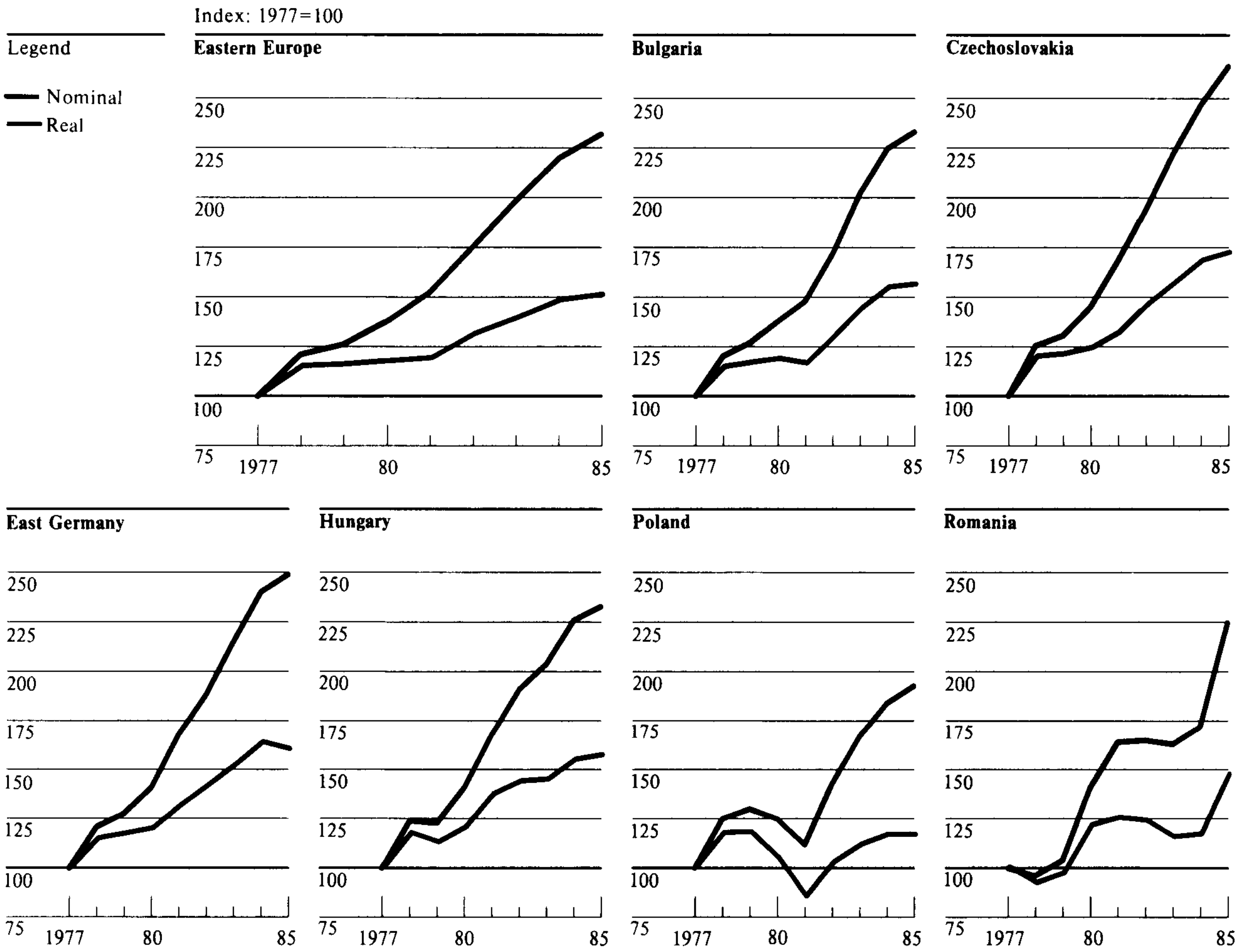
Index of Soviet Imports From Eastern Europe, 1977-85[a]



[a] Data for 1985 are estimated on the basis of third-quarter Soviet and Hungarian statistics.

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Emerging Trade Patterns

Several factors in addition to the shift in the terms of trade suggest that East European surpluses are likely, reversing the trade deficits of the past decade:

- Because of domestic production difficulties Moscow's oil deliveries will be at best constant and could well decline.

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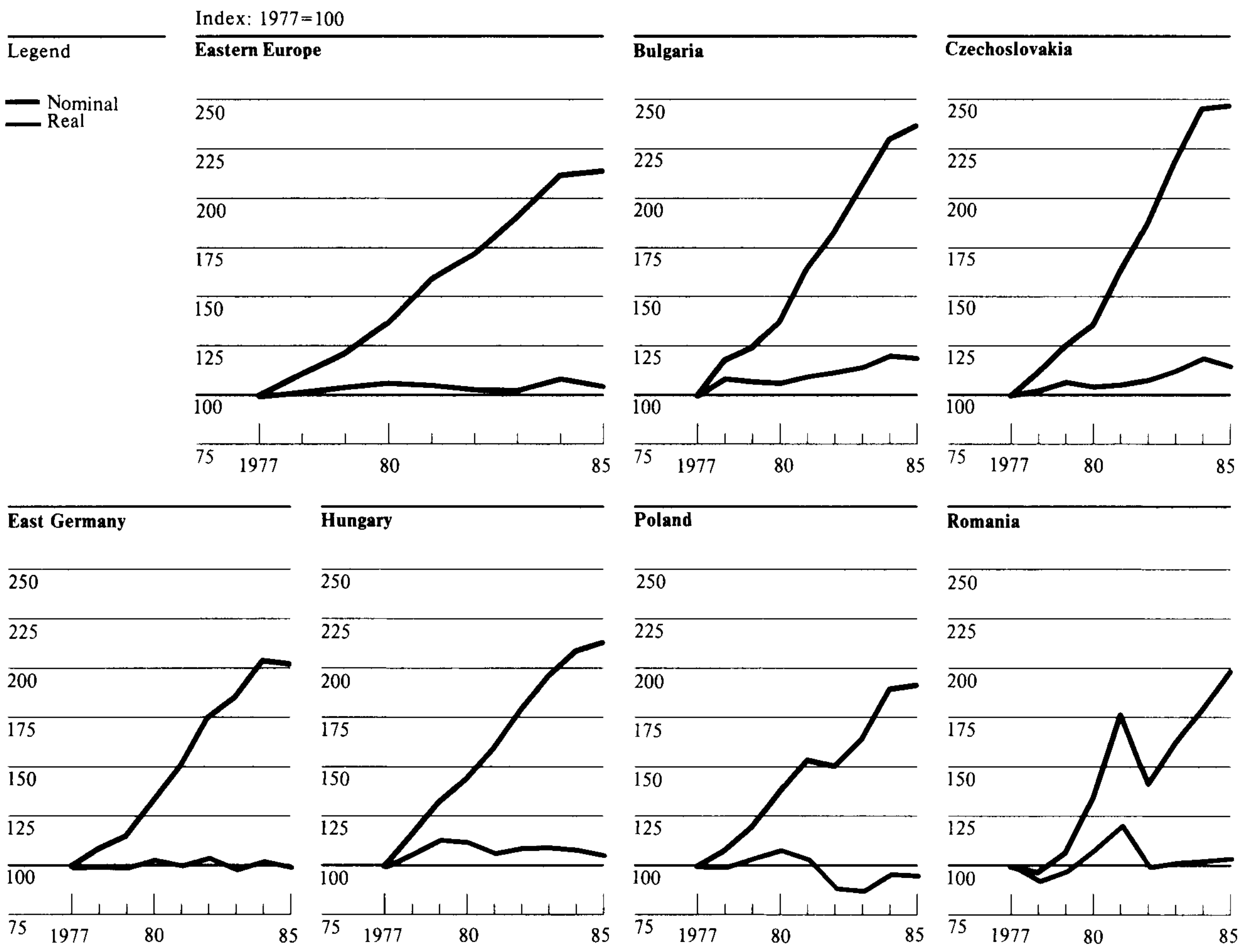
Index of Soviet Exports to Eastern Europe, 1977-85[a]



[a] Data for 1985 are estimated on the basis of third-quarter Soviet and Hungarian statistics.

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- The Soviet leadership clearly feels that its allies should repay the debt accumulated during the 1970s and early 1980s.

- The protocol for Poland—the country in the weakest position to meet Moscow's demands—calls for trade to be balanced over the next five years, and the Soviets may feel that the other countries could do even better.

Eastern Europe conceivably could run surpluses large enough to repay the entire 15-billion-ruble debt by increasing exports, in nominal terms, by 7 percent annually and holding import growth to 4 percent. 25X1

Soviet–East European Trade Plans

	Five-Year Trade Turnover [a] (billion rubles)		Increase [b]	Average Annual Increase [c] 1986-90 (percent)	Date Protocol Signed
	1981-85	1986-90	1986-90/ 1981-85 (percent)		
Total	**280**	**380**	**36**	**5**	
Bulgaria	52	70	35	5	20 December 1985
Czechoslovakia	55	73	33	4	29 October 1985
East Germany	66	82	24	3	31 October 1985
Hungary	40	51	28	5	28 November 1985
Poland	50	74	48	8	7 October 1985
Romania	17	30	76	12 to 15	14 December 1985

[a] Trade in 1985 estimated on the basis of six-month Soviet trade statistics and annual protocols.
[b] These estimates differ somewhat from several East European announcements for turnover growth with the USSR: 28 percent for East Germany; "approximately 40 percent" for Bulgaria; and "more than 30 percent" for Hungary.
[c] Calculated using estimates of trade in 1985 as base year.

[redacted] 25X1

Nearly all of the protocols, as well as other bilateral and CEMA agreements emphasize that the East Europeans must improve the *quality* of their exports. Meeting Soviet demands, in turn, may cut into their ability to earn foreign exchange—their best goods are normally sold in hard currency markets—and satisfy domestic needs. Implied Soviet threats to cut energy and raw material deliveries if the requisite quantity and quality of goods are not forthcoming are a potent lever. Moscow's demands for better machinery, food, and other consumer goods, however, will be tempered by Eastern Europe's ability to maintain domestic economic growth and remain financially solvent. Moreover, Moscow may still be willing to grant new trade credits or other concessions if an East European country's economic problems become serious enough. [redacted]

We expect the major constraint on trade in 1986-90 to be Moscow's inability to boost exports to Eastern Europe. Little growth can be expected in deliveries of oil and other fuels—the mainstay of the USSR's exports. Moscow will maintain oil deliveries at 1985 levels of about 70 million metric tons, according to statements by Soviet and East European officials. While the Soviets stand ready to increase oil deliveries to Romania, and possibly other countries, in exchange for dollars or for goods that could be sold for dollars, the East Europeans probably cannot afford major purchases on these terms. [redacted] 25X1

Gas deliveries will not grow substantially until 1989 when the Yamburg pipeline comes on line. All countries will invest machinery, equipment, or manpower in this project in exchange for a share of 20-22 billion cubic meters of gas annually over 20 years. East European participation in other joint projects, such as the Krivoy Rog iron ore complex, probably will lead to only moderate increases in some raw material deliveries. [redacted] 25X1

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Protocol Highlights

	Soviet Exports	***East European Exports***
Bulgaria	*Machinery and equipment for reconstruction of metallurgical, chemical, machine-building industries. Continuation of energy deliveries at reduced 1985 levels.*	*Increases in machine-building, electronic, electrical-engineering products. More consumer goods, fruits, vegetables.*
Czechoslovakia	*50-percent increase in machinery. Equipment for power, metallurgical, chemical industries and for Prague subway. Maintenance of oil and raw materials at 1985 levels.*	*"Substantial" increase in consumer goods. Equipment and 12,000 workers for construction of Yamburg pipeline and gas treatment plant at Karachaganak.*
East Germany	*Annual deliveries of 17.1 million tons of oil, 6.9 billion cubic meters of gas, 4.5 million tons of coal, 1.7 million tons of iron ore, 3.2 million tons of rolled steel.*	*40-percent increase in consumer goods and 50 percent in chemicals. Doubling of electrical engineering and computer-related products.*
Hungary	*15-percent increase in gas this year, probably in exchange for food and agricultural products. Additional 2 billion cubic meters of gas from Yamburg beginning in 1989.*	*Increase in oil and gas equipment. Equipment for reconstruction of Soviet chemical, agricultural machinery, light industries.*
Poland	*Maintenance of oil deliveries at 15 million tons annually. Additional 1 billion cubic meters of gas this year through Kobrin-Brest pipeline, plus another 5 billion cubic meters from Yamburg beginning in 1989.*	*"Large" deliveries of ships, heavy machinery, lathes, electric motors, textile and chemical industry equipment, roadbuilding and agricultural machinery. Increases in food and agricultural products.*
Romania	*2-3 million tons of oil annually. Increases in gas and iron ore.*	*Doubling of machinery deliveries to 6.5 billion rubles. 1-1.5 billion rubles in ships, equipment for oil drilling and exploration. 500 million rubles in agricultural machinery. Metallurgical equipment worth 1 billion rubles. Increase in consumer goods and chemicals.*

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Agreements by Country

There are important differences among the agreements signed with each country. The highest rates of growth in trade are projected for those countries with the most troubled economies—Romania and Poland. In contrast, the East German and Czechoslovak protocols call for much more modest trade growth, but these countries will probably face the strongest demands to improve the quality of their exports. [redacted]

Romania's agreement calls for a more than 70-percent trade increase—the highest rate in Eastern Europe. Bucharest's ailing economy, however, is unlikely to meet its export commitments. In 1985, for the second year in a row, Romania received little more than half of the oil it had contracted for because of its inability to provide the meat, other foodstuffs, and industrial machinery demanded by Moscow. [redacted]

[redacted] in *Poland*, the 1986-90 period will focus on the development of both economies—in contrast to 1983-85, when the Soviets extended substantial economic assistance to help Warsaw recover from its economic crisis. While Moscow will allow Warsaw to run trade deficits through 1987, the protocol calls for Poland to run surpluses in 1989 and 1990 large enough to balance trade for the five-year period as a whole. Repayment of 5 billion rubles owed to the Soviets will be deferred until after 1990. [redacted]

Moscow's negotiations on 1986-90 trade with East Germany—its largest trade partner—were difficult and long [redacted]

Czechoslovakia will contribute equipment and 12,000 workers for the construction of the Yamburg gas pipeline and a gas treatment plant in the USSR in exchange for 5 billion cubic meters of gas annually over 20 years. [redacted]

[redacted] *Hungary* has convinced Moscow to continue purchasing its meat surplus for hard currency by arguing that the planned elimination of such transactions by the Soviets would threaten Hungary's fragile hard currency position. [redacted]

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Bulgaria's relationship with Moscow over the past year has been strained. Soviet displeasure over Bulgaria's economic policies and the Slavicization campaign against the Turkish minority in the country probably is the major reason Moscow cut back on crude oil deliveries to Bulgaria last year. [redacted]

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Oil: The Key Unknown

Although we believe that the trade plans announced in the protocols genuinely reflect intentions, future developments could cause results to diverge from goals. The largest uncertainties are in Soviet oil exports. Although Moscow for the most part has so far insulated Eastern Europe from cuts in oil exports, it may find it increasingly difficult to do so if oil production and prices continue to fall. With hard currency shortages of its own, Eastern Europe would be hard pressed to replace any Soviet deliveries diverted to the West. The region already faces tight energy supplies as evidenced by severe shortages in several countries during the past year. Even modest cuts in oil deliveries could seriously undermine the economic performance of several countries. [redacted]

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Moreover, if Moscow chose to make the cuts large and abrupt, it would risk the entire structure of its economic relationship with Eastern Europe. The USSR has little to offer besides oil, especially in the short run, and the East Europeans would be forced to divert their trade to the West or to the Middle East to obtain oil. [redacted]

[redacted]

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Briefs

Energy

Iran Cuts Oil Shipments To Syria

Financial disputes between Damascus and Tehran are still interfering with oil deliveries to Syria. Since December Iran has delivered only about one-third of the oil that Syria contracted to receive by the end of March because Damascus has not paid for earlier deliveries. Similar problems and Iraqi attacks on Khark Island caused Iran to suspend deliveries to Syria for four months last year. The two countries will soon discuss the debt problem and negotiate an extension of the oil agreement beyond 31 March. Iran wants Syria to make larger cash payments for future shipments and to increase its payments on past debts—which amount to about $2 billion. Syria cannot afford additional payments and will urge Iran to continue deliveries at lower prices until an agreement on the debt is reached. Tehran probably will continue shipping the oil, probably at lower levels than Damascus would like, to retain Syrian political and military support.

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Problems Marketing Indonesian Crude

The growing gap between the official Indonesian price of crude oil and the market price—which has increased from roughly $7 to $13 per barrel since the beginning of the year—is further complicating Jakarta's ability to market its output. In a move designed to make Indonesian crude more attractive, in late January Pertamina—the national oil company—was granted authority to reduce oil prices by 15 percent, but the rapid decline in spot prices and increased international competition have continued to erode Indonesia's share of its traditional markets.

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Brazil's Success in Oil

Past investment and exploration is now enabling Brazil to raise oil output, cut its import bill, and strengthen its payments position. Bolstered by new offshore discoveries, oil production is up about 75 percent since 1983 to 600,000 b/d at yearend 1985, and will probably reach 630,000 b/d in 1986, according to the US Embassy. With domestic consumption declining since 1983—to less than one million b/d—because of intensified conservation and higher product prices, Brazil has cut oil import costs 30 percent to $5.8 billion in 1985. These oil import savings have helped Brasilia increase international reserves to $11.5 billion despite an export decline. In addition, the administration has new latitude to boost nonoil imports, up 5 percent in 1985, to aid domestic recovery.

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Continued growth in domestic production, together with the recent fall in world oil prices, will chop another $1.5-2 billion from the oil bill in 1986, according to a recent US Embassy report. Brasilia also is now carefully watching Mexican debt negotiations in hopes of benefiting from better repayment terms granted by creditors in the wake of crumbling crude prices. 25X1

London To Allow Natural Gas Exports

London's decision to end British Gas Corporation's (BGC) monopoly buyer position and allow UK producers to export North Sea gas is designed to encourage further exploration in the area. Oil companies have long pressed London to allow gas exports, charging that BGC has too much power in determining the rate of depletion of North Sea gas. The new rules, which will take effect after BGC is denationalized in November, will allow gas producers to find foreign buyers if BGC does not buy their entire production. The oil companies have said that such flexibility is needed to increase the profitability of gas production and encourage continuing exploration for new gasfields in the North Sea. London's revised export policy is unlikely to increase British gas exports in the near future. Although BGC presently pays marginally less for gas than other European companies, continental gas prices are falling because they are tied to oil prices, while domestic gas prices are likely to rise because BGC will no longer have control over prices. 25X1

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International Finance

Increased Philippine Financial Assistance

The Asian Development Bank met this week to discuss renewed lending to Manila, and a senior official of the bank told US officials that a new $100-200 million balance-of-payments loan will probably be made to the Central Bank. The World Bank is considering investing in a government-owned company being formed to return firms acquired by the Marcos government to the private sector. The Bank is also negotiating a $250 million loan to help service the debts of government financial institutions. Japanese Foreign Ministry officers recently told US officials that Tokyo will disburse $275 million that had been delayed by the political turmoil after last month's election. In addition, Prime Minister Nakasone and Foreign Minister Abe have pledged to increase aid to Manila, and Tokyo plans to send a team of economic experts to Manila soon. Australia yesterday promised to double its economic aid to nearly $18 million a year and is studying increased military assistance, according to the US Embassy in Canberra. Italy and West Germany are considering larger aid programs, according to press and US Embassy reports. 25X1

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The amount of new money to be made available to Manila has yet to be determined, but the Asian Development Bank's new loan would represent at least 20 percent of last year's $486 million trade deficit, and the total will substantially improve the prospects for economic recovery. Divestiture of state-owned corporations—valued at more than $5 billion—would aid efforts to control the budget deficit, which reached $500 million last year. 25X1

Kenya Avoids New IMF Standby

[redacted]

Kenyan and IMF officials have concluded that Kenya does not require a new standby arrangement this year because of improvements in the world coffee market and declining oil prices. The IMF has revised its 1986 projections for Kenya from a balance-of-payments financing gap of about $100 million to a surplus of about $170 million. 25X1 Kenyan officials have indicated they will continue to adhere to IMF targets, but the economic upturn and lack of IMF oversight make it less likely that Kenya will fully implement additional reforms needed for sustained economic growth. Moreover, despite this year's expected economic boost, Kenya still faces rapid population growth and probable foreign payments difficulties over the medium term. [redacted] 25X1

China Gets First Project Finance Package

[redacted]

China's first project finance loan will provide approximately $125 million toward a $400 million coal-fired power plant under construction by a joint venture in Shenzhen, near Hong Kong. Although China will not directly guarantee the loan, Guangdong provincial authorities are responsible for ensuring adequate coal deliveries and for buying at least 60 percent of the elec- 25X1 tricity generated. Moreover, the plant itself is collateral, though it is extremely unlikely that lenders could ever exercise their right to repossess state property in China. [redacted] this arrangement will set a precedent 25X1 for future project financing in China. Beijing may increase its use of similar commercial financing this year, but projects will be closely evaluated for their foreign exchange earning potential—this plant was undoubtedly approved because it will help China reduce electricity imports from Hong Kong. Joint venture partners, which include Hong Kong's Hopewell group (with a 50-percent share), and the Bank of China (40 percent), will operate the plant for 10 years, and then turn it over to China at no cost. [redacted] 25X1

International Trade

[redacted] 25X1

[redacted] 25X1

Bonn Concerned About US MFA Approach

[redacted] 25X1

West German officials are concerned that US calls for cutbacks and zero growth rates in next month's Multifiber Arrangement (MFA) renegotiation talks could undermine the more liberal EC position they see developing. Bonn hopes to offer increased market access for countries that open their own markets, but wants to reduce access for countries that unfairly subsidize textile exports. This position is supported by West German political parties, manufacturers, and unions. West Germany—the world's second-largest textile exporter and importer—particularly wants to liberalize offshore processing, on which its apparel producers depend. German officials also want to make textiles an important part of the new GATT round and would prefer new GATT arrangements to replace the next MFA. [redacted] 25X1

Possible Soviet-Fijian Trade Ties

[redacted] 25X1

The Fijian Government has raised the prospect of increased economic ties to the USSR, according to the US Embassy. Primary Industries Minister Walker said publicly last week that the government would not forbid Fijian companies from buying Soviet-caught fish, servicing Soviet ships, or selling timber to the USSR. [redacted] 25X1 Prime Minister Mara later told the US Ambassador he probably would conclude a sugar deal with the Soviets, but he was less positive about the cannery proposal. Walker's comments reflect unhappiness with what Fijians see as US unresponsiveness to their appeals for help in dealing with Fiji's economic problems. The government probably is also trying to blunt opposition accusations that the Prime Minister has moved the country too close to the US politically. Moscow would consider a ship-provisioning arrangement a victory after failing to obtain port access and servicing for Soviet ships in nearby Kiribati last January. [redacted] 25X1

Global and Regional Developments

[redacted] 25X1

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London Metals Exchange Takes Action in Tin Crisis

The London Metals Exchange (LME)—frustrated by the International Tin Council's (ITC) failure to agree on the most recent bailout proposal in the four-month-old tin crisis—decided last week to close all tin contracts at a fixed price and to end tin trading on the exchange permanently. The LME settlement price has been set at $4.12 a pound, 30 percent lower than the average price on outstanding contracts. As a result, LME brokers stand to lose $200-300 million, which could lead to bankruptcy for some. Cancellation of LME tin trading will mean more direct transactions, with prices largely set by the producers. Reference prices, however, will be available through the Kuala Lumpur Tin Exchange and the New York Commodity Exchange. The LME decision, together with ITC inability to control the market, will lead to still lower tin prices and a shakeout of high-cost producers—notably Bolivia and the United Kingdom.

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West German Shift on Hermes Spaceplane

Bonn has announced that it will decide whether to participate in the Hermes spaceplane project by this fall, instead of the original 1987 deadline. According to US Embassy reporting, the Kohl government has come under increasing pressure from both the domestic aerospace industry and Paris to join the French initiative. An official of West Germany's Research Ministry—whose director, Heinz Riesenhuber, is a severe critic of Hermes—told US Embassy officers that ministry officials were surprised by the announcement and believe that President Mitterrand personally persuaded Chancellor Kohl to make an early decision during the Franco-German summit on 27-28 February. While the decision suggests a shift in West German policy in favor of Hermes, it leaves some important questions unanswered, particularly the source of funding for Hermes. We believe that Bonn's announcement will not affect future US–West German space cooperation.

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Soviet Role in Argentine Port Project

Argentina is taking a new look at Soviet participation in rehabilitating the port of Bahia Blanca, according to Embassy reporting. Previously, Buenos Aires asked the World Bank to finance the entire project, rejecting a bid by Moscow it considered technically poor. To cut costs, however, the Bank is reevaluating Argentine plans for a major dredging of the port in favor of a cheaper topping-off facility. Buenos Aires is now considering splitting the project by financing the renovation of structures and loading facilities through the Bank and having the Soviets dredge the deepwater channels. The government has asked Moscow to bid on the dredging, and we believe there is a reasonable chance that Buenos Aires will approve such Soviet participation. Defense Minister

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Carranza—a decisive opponent of a Soviet presence—died in mid-February. Also, Moscow has been pressuring Buenos Aires to correct the heavy trade imbalance in favor of Argentina. Nevertheless, if the World Bank concludes that the split scheme is unfeasible it could still quash Soviet involvement by threatening to withdraw financing. 25X1

National Developments

Developed Countries

Ottawa Checking Bank Energy Loans

Ottawa is increasingly worried about the effect of the sharp oil price decline on Canadian banks. The government is asking banks to provide figures detailing loan exposure to the energy industry, and may require banks to set aside specific reserves to cover possible defaults—a provision already imposed on loans to a group of LDCs. Ottawa is anxious to avoid a repetition of last year's banking crisis, which was precipitated by the collapse of two small Western Canadian banks holding bad loans to the energy sector. Although Ottawa wants to be prepared to facilitate orderly mergers for small banks, its main concern is potential pressure on major banks. Financial analysts believe that the CIBC, Canada's third-largest bank, with 13 percent of outstanding loans to the energy-producing Province of Alberta, is most susceptible. 25X1

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Film Distribution in Canada Becomes a Major Issue

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[redacted] 25X1

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Less Developed Countries

Soaring Prices and Wages in Nicaragua

[redacted]

Large price and wage increases announced last Sunday are unlikely to reduce current food shortages substantially and will further exacerbate Nicaragua's triple-digit inflation, according to press and US Embassy reporting. Controlled prices on some 50 consumer goods were raised an average 150 percent. Milk, rice, salt, soap, sugar, and toilet paper, for example, were raised 130 percent, on the average, and corn and beans 300 percent. While most fuel and transportation prices rose about 50 percent, local bus fares were frozen. The Embassy reports that the new prices are still about one-third below black-market rates. Moreover, prices paid to farmers for their products lagged even further behind. For example, producer prices for corn and beans remained stable. Despite the second 50-percent wage hike this year, the Embassy reports that purchasing power continues to deteriorate. While the government claims inflation is running at about 200 percent, nongovernment economists estimate an annual rate of more than 400 percent. [redacted] 25X1

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Brazil's Economic Program Cheered by Public

[redacted]

The new economic reforms announced by President Sarney two weeks ago—including temporary price and wage freezes and gradual deindexation of the economy—received immediate strong public support. According to the US Embassy, domestic polls indicate initial approval of the inflation-fighting measures at 80 to 90 percent, even though most Brazilians believe that real incomes will suffer somewhat. Consumers are enthusiastically helping to enforce the price freeze, and there was a record 23-percent increase in the Sao Paulo stock exchange index. Both of Brazil's labor confederations initially threatened a general strike. In addition, Rio de Janeiro Governor Brizola, a leading leftist, condemned the package as IMF-style austerity. Nevertheless, since witnessing 25X1 the strong public backing, both labor leaders and Brizola have moderated their criticism. Public support may be weakening a bit. The government has vehemently denied the rumors of bank failures as a result of the new program, and it has taken steps to increase the liquidity of the banking system. In addition, after a sharp drop immediately following the announcement, the parallel market dollar exchange rate—traditionally a barometer of public confidence in the economy—is beginning to rise somewhat. [redacted] 25X1

Floods Add to Peru's Economic Problems

[redacted]

Flooding in the region around Lake Titicaca has cost nearly $3 million in crop and livestock losses and displaced at least 90,000 peasants, according to Peruvian and Bolivian civil defense officials. Food shortages already exist in Lima, and this disaster will boost domestic prices and require more imports, 25X1 thus eroding a planned $800 million trade surplus. President Garcia will probably seek credits from Argentina and Uruguay during his visits this weekend to cope with Peru's worst food crisis in 40 years. [redacted] 25X1

Tunisian Economy Plagued by Drought

[redacted]

Drought conditions throughout Tunisia threaten to devastate livestock herds and further widen the trade deficit this year. The US Embassy says forage is virtually nonexistent in large parts of the country, forcing farmers to slaughter 25X1 many animals and buy high-cost feed to sustain depleted herds. Livestock losses may top 40 percent in some areas and take years to replace. Crop losses could approach 600,000 metric tons, adding $90 million to the import bill this year and shaving 1 to 2 percentage points off GDP growth. The drought is a particularly hard blow in the face of sharply reduced oil export revenues and the loss of remittances from workers expelled from Libya last summer. Prime Minister Mzali probably will have to seek more foreign lending and rely even more heavily on domestic security services to stem growing labor disgruntlement with his austerity program. [redacted] 25X1

Pakistani Wage Rates Falling

[redacted]

An influx of returning workers from the Middle East has begun to depress wage rates in Pakistan. According to the US Consulate in Lahore, wages for semiskilled and skilled labor have dropped as much as 40 percent between January 1985 and January 1986. The Consulate estimates roughly 700,000 25X1 workers returned to Pakistan in this period. Falling world oil prices are likely to further reduce employment prospects for Pakistani workers in the Gulf and to increase the repatriation process. The absorption of the displaced workers into the already overcrowded domestic labor market will increase the possibility of political unrest. [redacted] 25X1

Rumors of Indonesian Devaluation

[redacted]

Ali Wardhana, Coordinating Minister for Economics, Finance, and Industry, appealed for calm last week following a sudden surge of US dollar buying in 25X1 local foreign exchange markets as businessmen hedged against a possible rupiah devaluation. [redacted] rumors of a 25X1 devaluation emerged in the wake of the dramatic decline in crude oil spot prices—which last week slumped to below $12 per barrel. The rupiah was devalued by almost 30 percent in 1983 and has since been tied to a basket of currencies. Jakarta can maintain the exchange rate at its present level but would be forced to choose between permitting greater foreign exchange outflows or allowing domestic interest rates to soar. Total foreign exchange reserves are ample—$10.3 billion—and, despite the slowdown in real economic growth, inflation has been kept under wraps. 25X1

Singapore Economic Policy Wrangle

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A tug of war over economic policy is emerging between the government-appointed special Economic Committee—composed primarily of private bankers and businessmen—and the central bank. The Committee proposes long-term, deregulatory solutions while the central bank is attempting to solve short-term problems by regulating the financial sector more strictly. In December, for example—after a three-day closure of the Singapore Stock Exchange—the government negotiated a privately funded credit line to rescue overleveraged brokers and prevent a collapse of the Exchange. The central bank has imposed such strict guidelines on the use of the funds, however, that heavily indebted brokerage houses have been denied access—three have failed. Similarly, on 21 February the central bank arrested the depreciation of the Singapore dollar by selling US dollars—contrary to the Committee's recommendations for a float. Two opposition members of Parliament charged that the Committee's proposed economic recovery package does not benefit the working class, prompting Parliament to add personal tax reductions. In our judgment, Prime Minister Lee must soon decide whether to let the Committee, headed by his son, or the central bank, headed by his longtime adviser, take charge of policy to retain any chance of a quick economic recovery. 25X1

Communist

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China To Reduce Imports of US Fertilizer

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Beijing has ordered further reductions in imports of diammonium phosphate (DAP) fertilizer from the United States, probably to conserve foreign exchange. Last year the United States sold more than 700,000 metric tons of DAP to China—about half the 1984 level—worth about $116 million.

China's Technology Import Boom Continues

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According to Chinese press reports, China's trade ministry approved imports of advanced technical equipment worth nearly $3 billion last year—triple the 1984 level. We estimate that China last year imported $2 billion worth of computers, telecommunications equipment, and scientific instruments—$500 million from the United States. The Chinese figures probably inflate the

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actual value of technology imports by including contracts for goods to be shipped in 1986 and later. They probably undervalue total technology contracts, however, by excluding imports negotiated by the more than 200 technology import and export corporations operating outside the trade ministry's jurisdiction. Nonetheless, technology imports should continue to show strong growth over the next five years, with priorities going to energy, transport, telecommunications, and advanced manufacturing equipment, according to Chinese statements. 25X1

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