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International Economic & Energy Weekly

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30 May 1986

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Perspective

Tokyo Summit: Tenuous Progress 25X1

For the Big Six leaders, the Tokyo Summit achieved the goal of outward unity by the statement condemning terrorism and a declaration aimed at improving the international monetary system. West European leaders also generally regard the summit as a domestic political plus because each came away able to claim at least some success. Prime Minister Nakasone, on the other hand, has come under fire from his political opponents, who claim that the summit was a failure for Japan. His chances for staying in office beyond October, undoubtedly hurt by the outcome of the summit, remain tenuous despite the recent announcement of joint lower and upper house Diet elections for July. 25X1

The declaration on terrorism formalizes a generally harder line that began emerging before the summit. Although the Big Six governments remain opposed to economic sanctions, they are focusing on promoting international cooperation, improving security, and expelling possible terrorists. The power-sharing arrangement between Prime Minister Chirac and President Mitterrand probably will bring an even tougher French stance because neither wants to appear soft on the issue. Paris, however, may still resist some forms of cooperation if it believes they would compromise its independence on foreign policy. Rome is trying to reduce its vulnerability to Libyan moves by loosening economic links now that most Italians have left Libya. Nakasone, however, was sharply criticized by both his Foreign Ministry and the ruling party for agreeing to single out Libya in the summit statement. As a result, Tokyo is sending a delegation to the Middle East in an effort to assuage domestic concerns, limit damage to its relations with Arab countries, and protect its oil supplies—70 percent of which come from the Middle East. 25X1

While the summit made progress on terrorism, Big Six governments will have difficulty building on this accomplishment. Another successful terrorist attack on US interests, for example, almost certainly would renew strains among summit countries. West European and Japanese officials do not believe the statement on terrorism approves the US raid on Libya and probably hope that the stated commitment to cooperate will help them head off a similar US response to future terrorist acts. 25X1

Most summit leaders are publicly expressing satisfaction at what they portray as good progress on monetary cooperation despite their uncertainty as to when and how they can follow it up. Prime Minister Craxi, in particular, is attempting to benefit domestically from Italy's admission, along with Canada, to a newly formed Group of Seven (G-7). The Italians—next year's summit host—are likely to try to solidify their position on monetary affairs by pushing for a strong role in enacting the multilateral economic surveillance plan agreed to at Tokyo. 25X1

West Germany and Japan reject the notion that multilateral surveillance should force them to change their policies in response to the economic indicators listed in the summit declaration. Bonn remains concerned that the surveillance scheme could compromise its control over its economic policies and eventually fuel inflation, while Tokyo fears that indicators might be used by other countries to argue for a further appreciation of the yen. Both still worry that other summit countries may try to push cooperation further. They also are disappointed that the United States gave no pledge to shore up the dollar. Nakasone's domestic critics continue to snipe at his failure to arrange joint intervention against the yen's rise. 25X1

Monetary cooperation is likely to be modest until summit countries establish the type of consensus on exchange rate policy that was reached at the Group of Five meeting last September. If the dollar begins to drop again, Bonn and Tokyo almost certainly will press hard for the United States to intervene. Italy and Canada, meanwhile, are likely to bristle if the continuing Group of Five makes the major decisions on monetary matters and they remain shut out despite membership in the G-7. 25X1

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International Financial Situation: Chile's Creditors Pushing for Political Liberalization 25X1

We believe Chile will be able to obtain sufficient foreign lending this year to cover its financing requirements and support Santiago's export promotion program. Nonetheless, it will be another year of tight budgets and restricted imports that could keep economic growth under 3 percent. Santiago's economic plan for 1987 calls for economic growth of more than 4 percent and will probably require additional foreign lending. Creditor countries, however, are already threatening to vote against needed development bank lending unless President Pinochet agrees to political liberalization measures that would ensure a transition to democracy. Should creditor countries threaten only to veto new project lending, Pinochet could probably defer—or cancel—lending requests until late 1986 or early 1987 without hurting the economy. Delays or cancellations in Santiago's World Bank structural adjustment loan program could undermine Chile's economic growth this year and further erode Pinochet's domestic support. 25X1

1985 Economic Performance

Chilean data indicates that the economy achieved more than 2-percent growth in 1985 despite depressed commodity prices and tight economic policies. According to the US Embassy, Chile's main exports—copper and agricultural products—remained even with 1984 levels because of increased export volume. Moreover, Santiago cut its current account deficit through a 13-percent reduction in imports. Additionally, Santiago met its IMF-supported program targets by maintaining relatively tight fiscal and monetary policies. Even with these austerity measures, Santiago still claims to have reduced unemployment by two percentage points to 11.9 percent and increased real wages in 1985 by almost 2 percent. 25X1

The Chilean press and private economic studies paint a grimmer picture of the economy. For instance, they reveal that, although unemployment

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Chile's Foreign Financing Program

Chile concluded a three-year foreign financing package last year to support an export expansion program designed to encourage economic growth and provide foreign exchange to service its debt. The main features of this program include:

- *An IMF Extended Fund Facility providing $750 million over three years for balance-of-payments support. Repayment, however, of past IMF drawings will reduce the net benefit of these funds.*
- *A World Bank structural adjustment lending program that provides for three consecutive loan years of $250 million each, with disbursement each year contingent upon successful completion of the previous year's program and formal approval by the executive board for the next year's loan.*
- *A World Bank cofinanced loan of $300 million with commercial banks.*
- *A collection of project loans from the World Bank and the Inter-American Development Bank—some already approved and others yet to be requested—to cover Chile's remaining financial gaps.*
- *A commercial bank rescheduling of more than $6 billion in 1985-87 loan maturities and $700 million in loans to be disbursed in 1985 and 1986.* 25X1

Chile: Balance of Payments, 1984-87 *Million US $*

	1984	1985 [a]	1986 [b]	1987 [b]
Current account	**−2,060**	**−1,329**	**−1,377**	**−1,288**
Trade balance	293	713	723	907
Exports, f.o.b.	3,650	3,647	3,900	4,273
Imports, c.i.f.	3,357	2,934	3,177	3,366
Net services and transfers	−2,353	−2,042	−2,100	−2,195
Interest	−2,158	−1,889	−1,867	−1,930
Capital account	**1,978**	**1,333**	**1,338**	**1,296**
Foreign direct investment	67	81	90	90
Net foreign borrowing	1,684	994	1,078	1,070
Net IMF credit	227	258	170	136
Change in reserves	**−82**	**4**	**−39**	**8**

[a] Estimated.
[b] Projected.

[redacted]

may have dropped, job creation was heavily weighted toward low-paying and low-productivity commerce and service sectors—such as street vending and household help—while shantytown dwellers are turning to the growing black market to find employment. Small businessmen and middle-class homeowners—hurt by tight credit and a crushing personal debt burden—are increasingly disgruntled with government policies. [redacted]

[redacted]

Politics Shaping Economic Policy

Until recently, Pinochet's economic policies were primarily shaped by the dual pressures of foreign creditor demands for fiscal and monetary austerity and timely debt repayment and domestic demands for economic recovery. Moreover, beginning last year Pinochet has had to contend with a new factor: international pressures for political liberalization. Creditor countries—upset with Pinochet's harsh repression and imposition of a state of siege—withheld support for a loan package to shore up the country's deteriorating external accounts. By June, Pinochet bowed to international pressure for lifting of the state of siege, and the loan package came together at yearend. [redacted] 25X1

Creditor countries are again threatening to withdraw support for Chile in international financial institutions unless Pinochet agrees to political liberalization measures that would ensure a transition to democracy. In our view, Chile needs its present multilateral loans to maintain growth in 1986 and will require an additional $300 million in 1987 to keep its economy from stagnating. We believe that Pinochet is sensitive to these threats because he realizes that a worsening economy will give the opposition additional issues with which to confront his regime. Nevertheless, we doubt that economic growth will significantly cool domestic political unrest that is largely fueled by popular support for Pinochet's departure from office—his term expires in 1989. [redacted] 25X1 25X1

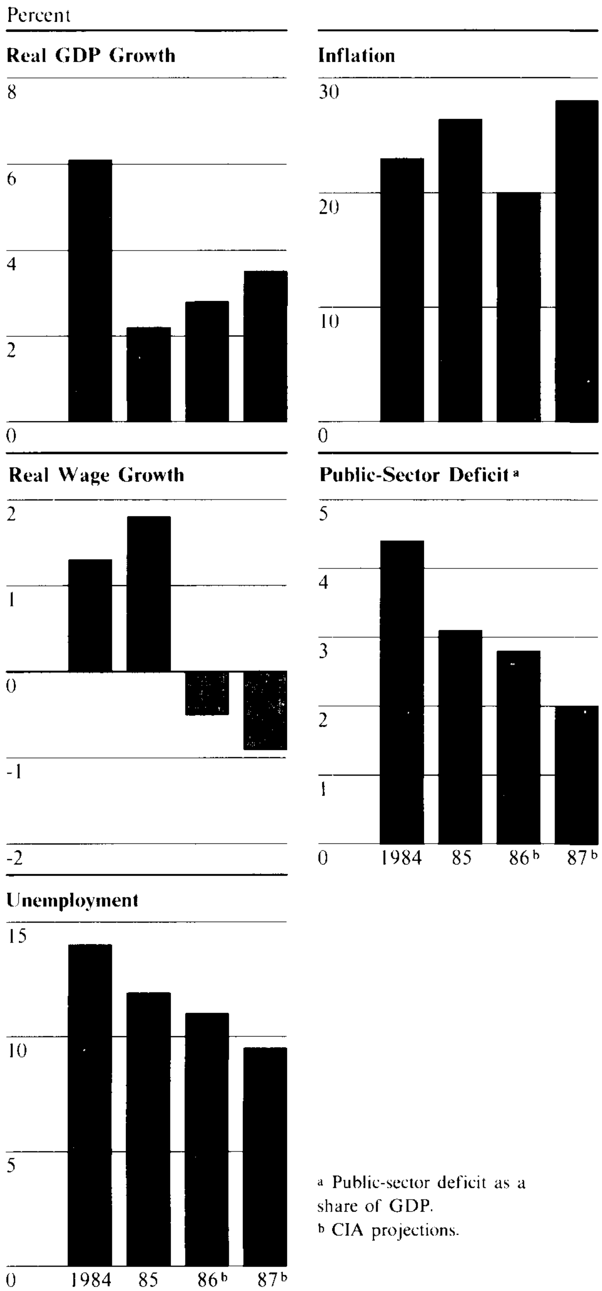
Santiago, [redacted] 25X1
will comply with the conditions of its IMF program by:

- Continuing its export-oriented program to spur growth and earn foreign exchange to service its debt.
- Encouraging import-substitution to conserve foreign exchange and support domestic manufacturing. 25X1 25X1
- Shifting borrowing to multilateral lending institutions to obtain lower interest rates and easier repayment terms.
- Decreasing the public-sector deficit by trimming government work programs and delaying cost-of-living increases.
- Allowing a rise in interest rates to foster savings and to reduce growth in domestic consumption to spur investment. [redacted] 25X1

Outlook

We believe that Chile's 1985-87 IMF program provides a good framework for Santiago's efforts to reduce the burden of the public sector on the

Chile: Selected Economic Indicators, 1984-87



[a] Public-sector deficit as a share of GDP.
[b] CIA projections.

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economy and to boost exports. Although we believe foreign lending levels are adequate for Chile to meet its external obligations this year, growth probably will remain below 3 percent because of continued tight budgets, sluggish world commodity prices, and restricted imports. The standard of living for the lower and middle classes will probably stagnate—although unemployment may fall slightly, real wages probably will decline. Chile's export push could begin to bear fruit by 1987, but only if Santiago obtains another $300 million in loans. Chile could achieve over 3-percent growth should the creditors grant these loans in 1986 and disburse them in a timely manner in 1987. 25X1

Pinochet's negative response to growing foreign insistence on political liberalization, however, could hurt Chile's economic program. Creditor countries are threatening to deprive Santiago of access to multilateral development bank funds by voting against new project loans and delaying Chile's 1986-87 World Bank structural adjustment program. Nevertheless, should creditor countries declare that they will only veto new project lending, Pinochet could probably avoid an international confrontation and a loss of prestige at home by deferring—or canceling—new loan requests until late 1986 or early 1987. Although this could mean delays in receiving needed funds in 1987, Santiago could cover its financing gap by drawing down net reserves—currently around $1 billion—and seeking IMF waivers on its program targets until new loans were arranged. This would give Pinochet more time to try to defuse domestic pressures and probe foreign government intentions before deciding what concessions to offer. 25X1

Pinochet, however, would face a more serious domestic threat if creditor countries announce that they will delay Chile's second structural adjustment loan—one-half of which is due to be disbursed this year—when it comes up for World Bank Board approval in October. Loss of these funds could provoke capital flight, take Chile out of compliance with its IMF program later this year, and slow commercial bank loan disbursements to

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Santiago. It would also accelerate the decline in foreign direct investment—Finland recently withdrew from a major copper mining project, reportedly over human rights concerns. 25X1

Under these circumstances we believe Pinochet would either tighten fiscal and monetary policies—hurting economic growth—or draw down reserves to keep the economy moving. In either case, we believe the President's support would erode as the public—and, in all likelihood, the military—put the blame for the country's economic troubles on Pinochet's mismanagement. In the end, the President probably would have to either make political concessions or risk even greater challenges to his rule.

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Kuwait: Weathering the Drop in Oil Revenues

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Kuwait faces a number of economic challenges—the decline in oil prices, the Iran-Iráq war, and the lingering effects of the stock market crash in 1982—that are hampering government efforts to revitalize the economy. Nonetheless, with a foreign asset cushion of $80 billion and a small population, the government probably will be able to shield most Kuwaitis from serious economic hardships. To limit the impact of lower crude prices, the government has boosted oil production by pricing it competitively and marketing products through its distribution networks in Western Europe. The National Assembly will closely monitor the government's efforts to manage the economy and will intensify its criticism of the regime if it is dissatisfied with the government's performance.

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Kuwait: Budget Deficits, 1983-86 [a]

Million US $

	1983	1984	1985 [b]	1986 [c]
Revenues	10,501	9,149	10,744	6,411
Oil	9,745	8,160	9,657	5,520
Other	756	989	1,087	891
Total expenditures	10,902	10,829	13,009	11,408
Current expenditures	9,741	9,801	11,832	10,767
RFFG [d]	1,058	925	1,074	641
Increase in KFAED capital [e]	103	103	103	
Deficit [f]	**401**	**1,680**	**2,265**	**4,997**

[a] Fiscal year beginning 1 July of stated year.
[b] Budgeted.
[c] Proposed.
[d] Reserve Fund for Future Generations is set at 10 percent of total revenues but may not be used until 2001.
[e] Kuwait Fund for Arab Economic Development.
[f] Deficits are covered by withdrawals from the State General Reserve Fund. Budget deficits are misleading, however, because transfers to the reserve funds are included in expenditures, but investment income is not included in revenues.

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Tinkering With the Budget

Kuwait's oil earnings—which account for nearly 90 percent of government revenues—have fallen by almost one-half since 1982. Since then the government has carefully adjusted its budget and for FY 1984 (July 1984–June 1985) adopted a series of austerity measures to keep spending in check. Although defense expenditures were maintained, the government cut development spending and foreign aid and without public announcements reduced actual expenditures 17 percent below budget projections, according to the US Embassy in Kuwait.

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The cuts planned for FY 1985 proved inadequate once oil prices began their precipitous slide. Last February the government announced an additional 15-percent reduction in expenditures from those projected in the FY 1985 budget. Retrenchment included the cancellation of nonessential development projects, reduced benefits for expatriates, and a freeze on the employment of foreigners. Despite vociferous opposition from the National Assembly and accusations of widespread mismanagement and corruption, the drastic decline in revenues even led the government to consider cutbacks in generous domestic subsidy programs. Last November the government proposed an increase in electricity rates—the first since 1966—that would save $450 million per year and has considered imposing fees for medical and other services that are currently free. Although only 1.5 percent lower in real terms than in the FY 1984 amended budget, the reduced spending prolonged Kuwait's economic slump because of the key role the government plays in stimulating economic growth.

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The draft FY 1986 budget reflects the government's goal of trimming fat and reducing subsidies without choking economic growth. It projects a 40-percent drop in revenues and a nearly 10-percent cut in current spending compared to last year's budget. For the most part, the cuts will not directly affect Kuwaiti citizens. Kuwait's annual contribution of about $100 million to the Kuwait Fund for Arab Economic Development has been dropped. Spending for government salaries has increased, however, and Finance Minister al-Khurafi affirmed that cutbacks would not affect previously planned social services and housing projects, according to press reports. [redacted] 25X1

The government will be able to cover the nearly $5 billion deficit projected in the new budget. The deficit figure is misleading because of Kuwaiti accounting practices, which understate revenues to keep expenditures down. The government excludes investment income as revenue, and counts contributions to the government's two investment funds as expenditures. According to the US Embassy, investment income has been averaging $4 billion in recent years and could be even higher if the government sells some of its equity holdings. [redacted] 25X1

Financial Sector Bailout

The economy is still suffering from the effects of the collapse of the unofficial stock market in 1982. When the speculative bubble burst, nearly 6,000 investors saw their financial positions crumble. Banks were faced with huge writeoffs because of the liquidity crunch suffered by many borrowers and the plummeting value of collateral—mainly securities and real estate. The government intervened to rescue failing companies and increased its ownership from 36 percent of all shares on the stock market to more than 50 percent. [redacted] 25X1

The government recognizes the magnitude of its economic problems and last November called in the World Bank and the IMF to chart a future course for the economy. Meanwhile, it proposed to buy out local shareholding companies at a cost of $700 million and is looking for ways to resolve the debt crisis faced by commercial banks as a result of the crash. Reaching a solution has been complicated by disagreement over who is to blame for the problem and by the influence of some of the biggest losers in the crash. [redacted]

Although willing to bail out some banks and borrowers to preserve the integrity of the financial system, the government has proposed sharing the burden among all three parties. A compromise plan put forward by the Kuwaiti Chamber of Commerce calls for the government to provide long-term deposits at favorable rates, guarantee all commercial banking activities for the next decade, and strengthen the central bank's regulatory role. Banks would be forced to absorb part of their loan losses and accept reduced profits by rescheduling debts at concessionary rates. The plan also deals harshly with debtors—many of whom refused to pay their obligations even when they had the means to do so—but this would be difficult to implement because of the high number of [redacted] influential businessmen among the debtors. [redacted] 25X6 25X6 25X1

National Assembly leaders are worried about the government's growing power within the economy and oppose its ownership of such a large proportion of Kuwaiti private companies. Some members are concerned that the private sector is becoming too dependent on government financial assistance. Others believe that no public money should be used to bail out banks because bankers' greed is to blame for the debt crisis, according to the Embassy. [redacted] 25X1

Outlook

Kuwait probably is better able than any other Arab oil producer to cope with the current downturn in the oil market. In addition to its $80 billion foreign asset buffer and small population, the government has diversified the oil sector into downstream operations—it has captured about 6 percent of the retail market in Western Europe, [redacted] —assuring an outlet for its crude and refined products. The current account surplus has been shrinking, but cuts in imports will keep it at a healthy $4.5 billion for this fiscal year. The government has also responded to the decline in oil prices by aggressively pricing its exports and boosting production to more than 1.5 million b/d, its highest level in five years. [redacted] 25X1 25X1 25X1 25X6

Despite a relatively sound economic position, the required budget cuts will further depress the economy—economic growth was less than 1 percent last year and probably will be negative this year. Retrenchment will increase the efficiency of economic operations in Kuwait, but the expatriate and business communities probably will suffer disproportionately. The impact of the loss of large numbers of foreign laborers is unclear; reduced spending on expatriates will provide some savings, but replacing these laborers, particularly skilled managers and technicians, will be difficult. The business community will face declines in company earnings, share prices, and bank profits. Capital flight probably will increase because of fears generated by economic uncertainty, declining investment opportunities, and the recent flareups in the Iran-Iraq war. This will leave few resources to revive the economy. 25X1

The government's efforts to manage the economy will be further complicated by its need for National Assembly approval of the budget. Many members are unhappy with the government's management of the economy and are unlikely to accede to government-proposed cuts in subsidies and benefits. The increasing assertiveness of the Assembly probably will make the government more responsive to its demands. Compromise with the Assembly would give government decisions broader support but would make it difficult for the government to make some of the tough policy choices it believes are required. 25X1

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LDC State Trading Organizations: Stunting Development and Obstructing Trade 25X1

State trading organizations (STOs) play a significant role in many developing country economies and are important actors in world trade. These organizations are located throughout most of the developing world, usually trading in economically important commodities such as foodstuffs, industrial inputs, and energy resources. In our judgment, these organizations create numerous distortions in LDC domestic economies that hamper the development process and obstruct international trade. Many LDC governments are beginning to recognize that corruption, costly subsidies, and inefficiency plague these trading organizations and are acting to reduce their role through privatization, budget cutbacks, and streamlined procedures.

STOs: A Definition

We define STOs in broad terms to include:

- ***Government departments****—buy or sell goods on the nation's behalf.*

- ***Marketing boards****—organizations set up to channel exportable goods through a single government body. Domestic producers are usually required to sell all of their output to the board, giving it the power to set domestic prices. Government marketing boards largely exist because of the lack of a sophisticated tax infrastructure—they are one of the few reliable means of collecting revenues.* 25X1

- ***Public production enterprises****—firms using either their own trade infrastructure or sales agents abroad to market their output. The state-owned oil and steel companies are the most significant examples of public production enterprises involved in foreign trade.*

- ***State trading companies****—government-controlled commercial corporations that are primarily engaged in activities related to international trade and that are organized and operated for the purpose of carrying out their entrepot mission.* 25X1

Stunting Development

STOs dominate the trade relations of many LDCs. While no reliable data on the total number of STOs are available, we believe that their number has grown rapidly over the past few decades. STOs are especially important in countries, such as Algeria, Burma, Guinea, Iraq, Syria, Uganda, and Zaire, whose foreign trade sectors have become virtual state monopolies. STOs have some positive effects on LDC economies, such as increased employment opportunities, but, in our view, these are largely overshadowed by their negative impacts. Indeed, we believe STOs have stunted Third World development by causing numerous distortions:

- They have ***created inefficiencies*** that have driven up domestic prices, pulled capital away from private firms, and sapped LDC treasuries of scarce resources. For example, Mexico's food-importing STO, CONASUPO, is expected to lose about $1.5 billion in 1986—equivalent to nearly 1 percent of GDP.

- LDCs' state coffers have been drained of billions of dollars through STO-related ***corruption***. For example, a Brazilian Coffee Institute audit of warehouse records discovered that nearly 17,000 bags of coffee worth nearly $900,000 disappeared in March 1985. In another example, Zaire's President Mobuto has siphoned off at least $1 billion from the state mining enterprise SOZACOM, according to local press reports. 25X1

- ***Foreign investment*** has been blocked by these domestic monopolies and by practices that discourage the inflow of foreign funds, restricting competition, efficiency, and flow of technology. Foreign investment in LDC oil industries is impaired by tight restrictions on foreign participation that often includes majority control by the national oil company.

- STOs have ***distorted production incentives*** by setting artificially low producer prices. In Tanzania, the producer price of coffee was $1.42 per kilo while the export price was $3.25 during February 1986. These policies have caused major declines in agricultural production in many LDCs. For example, in Ghana—which earns well over 50 percent of its export revenue from cocoa sales—low producer prices have been the principal cause of the decline in cocoa production from a peak of about 540,000 metric tons in 1965 to about 158,000 tons in 1984. [redacted]

STOs' Share of National Trade in Selected LDCs [a]

Percent

	Exports	Imports
Algeria	100	100
Argentina	4	13
Brazil	35	65
Burundi	95	50
Egypt	90	72
India	20 [b]	60
Mexico	75	43
Peru	87	27
Sri Lanka	12	38
Syria	89	8
Tanzania	75	75
Venezuela	95	20

[a] CIA estimates.
[b] Exports have run as high as 50 percent in recent years as a result of crude oil sales that are expected to be a temporary phenomenon.

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[redacted] 25X1

Obstructing Trade

In addition to their adverse impacts on LDCs' domestic economies, STOs engage in a number of practices that are inimical to free trade. STOs often engage in ***unfair export practices***—dumping and subsidies—to boost employment, expand the volume of goods traded, increase their share of foreign markets, and earn needed foreign exchange. [redacted] Many LDC governments also subsidize STOs in targeted export industries, which in turn allows the STOs to sell at lower prices. For example, the Commerce Department has found that the majority of US imports from the Venezuelan state-owned steel enterprise were subsidized at a rate of about 75 percent. [redacted]

STOs may also ***restrict trade*** by raising the price of or placing quantitative limits on imported goods. Paraguay, for example, restricts wheat imports through an STO as part of its National Wheat Self-Sufficiency Program. Indirectly, the inefficiency of STOs also leads to restricted trade through higher cost imports and lengthy, burdensome administrative procedures. The inefficiency of Zaire's SONATRAD adds 10 to 12 percent to the purchase price of imported goods [redacted] 25X1 25X1

STOs have been a significant force behind the growth of ***countertrade***—a challenge to a liberal trade environment because it raises costs and often results in discriminatory trade practices. Nonetheless, the governments of many LDCs encourage these countertrade arrangements in hopes of increasing exports and conserving foreign exchange. STOs can justify the added costs as necessary to meet national goals and can often force such deals through their monopoly or monopsony positions. In 1982, Brazil's state-owned oil company announced

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that all countries exporting oil to Brazil were required to purchase an offsetting amount of Brazilian goods. As a result, according to US Embassy reporting, countertrade deals have been concluded with Algeria, Iran, Iraq, Malaysia, Mexico, Nigeria, and Venezuela.

The Future of STOs: Pressure for Reform But Political Resistance

STOs will continue to play an important role in LDC domestic economies and the world trading system. We believe the growth in their number will slow from the pace of the past few decades, however, because many LDCs are beginning to recognize that corruption, costly subsidies, and inefficiency plague the organizations. The government of Trinidad and Tobago intends to reduce the ranks of the national sugar enterprise by 4,500 jobs over the next three years. In a few cases, LDC governments—Argentina, Brazil, Guinea, Mexico, and Pakistan, for example—are seeking to privatize or liquidate some smaller public enterprises, but the large STOs are not likely to be affected. In addition, some LDCs—such as Ghana, Nigeria, and Zambia—are likely to disband the boards, reduce their inefficiency, or raise producer prices as part of agricultural reform.

Compliance with IMF-backed austerity programs also is driving some LDCs to undertake certain structural adjustments that directly affect STO Mexico is eliminating most food subsidies. Similarly, the IMF has pressured Mali to reduce losses of the trading company SOMIEX by terminating its monopoly on the sale of basic foodstuffs. In a tentative understanding between the IMF and Sierra Leone, Freetown has agreed to reduce the role of the Precious Metals Marketing Company, the Gold and Diamond Office, and the Produce Marketing Board.

Despite these pressures for reform, the dismantling of LDC STOs is meeting considerable political resistance. STOs often serve the vested interests of many LDC elites. Some LDC leaders siphon off huge sums of money from STOs for political or personal purposes. STOs also play an important role in maintaining political stability by subsidizing critical commodities. Moreover, attempts to eliminate STOs could stir nationalist sentiment as the domestic economy is increasingly exposed to foreign competition. 25X1

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Implications for the United States

The United States has a considerable stake in the outcome of STO reform. The dismantling of these organizations would help the US efforts under the Baker Plan to promote structural adjustment in the Third World to reduce the burden of large LDC debts. Such adjustment would also reduce LDC needs for increased economic aid and other concessions. In the long run, reform would support US interests in enhancing political stability by reducing domestic economic frustration resulting from low economic growth. Finally, reform could reduce political strains stemming from growing economic disparities between LDCs and industrialized countries. On the commercial side, US firms would gain from an improved investment climate, greater access to LDC markets, and a reduction in countertrade, dumping, and subsidies. 25X1

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LDC Domestic Deficits: The Other Debt Problem

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While much attention has focused on the LDC external debt situation, many LDC governments are also struggling with a growing internal debt. Although the LDCs have made some progress since 1982, the measures taken to slash overall deficits have come at the cost of long-term growth and economic reform. Prospects for further substantial reductions are limited because cuts would increasingly hit politically sensitive areas such as public-sector wages and consumer subsidies.

Large Internal Deficits: Inflicting Economic Damage

Beyond enlarging the role of the government in LDC economies, internal public-sector deficits can create obstacles to broader economic goals. To finance their deficits, without borrowing from abroad, LDC governments must choose between two unattractive alternatives. Borrowing from the nonbank private sector drives up real interest rates—reducing private-sector investment. Borrowing from the domestic monetary authorities increases the money supply—fueling inflation. 25X1 25X1

Moreover, rather than channeling the borrowed funds into public investment, LDC governments have spent more heavily on current consumption. Because these increased government expenditures are not matched by increased taxes, overall domestic demand grows—raising imports and undercutting investment in export industries. As a result, large deficits have weakened LDC balance-of-payments positions—reducing the LDCs' ability to service their external debts—and have hurt industrial development prospects. 25X1

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Budget Deficits Since 1980: Soaring, Then Falling

In the years preceeding the LDC financial crisis, overall public-sector deficits soared. In 1980-82, annual deficits as a share of GDP roughly doubled in Argentina, Brazil, Mexico, and Peru, and more than tripled in the Philippines. With the onset of the LDC debt crisis in 1982, external financing of budget shortfalls began to decline, and in several LDCs internal financing ballooned to compensate. Because of IMF pressure and the inability of domestic capital markets to handle the increase, many of the major LDC debtors—including Mexico, the Philippines, Argentina, and Peru—took steps to reduce public-sector deficits.

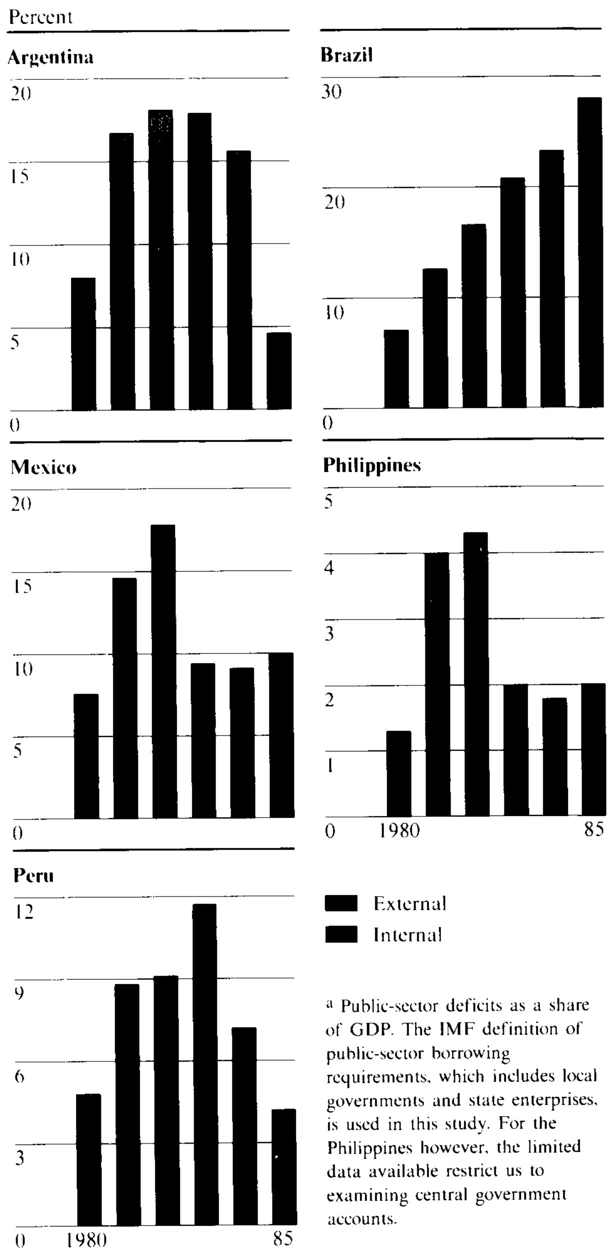
Despite budget-cutting measures, other LDCs have not been as successful. Brazil's public-sector deficits, for example, have continued to rise at an average 4 percent of GDP every year since 1980, and stood at 28 percent last year—almost completely financed internally. Although Brasilia has nearly brought revenues in line with capital expenditures and current outlays, interest payments on the debt continue to swell the fiscal gap.

Measures To Slash Deficits: Mixed Blessing

To slash public-sector deficits, LDC governments took actions both helpful and harmful to the long-term development of their economies. On the positive side, several LDCs have attempted to sell money-losing parastatals. In particular, the Mexican Government has tried to ease the strain on the federal budget by selling unprofitable enterprises, according to Embassy reporting. The government reports that, as of late 1985, 129 entities were sold, dissolved, or transferred to local governments since the onset of the LDC debt situation. This has had little impact on the budget deficit, however, be- 25X1
cause as the economy contracted, the government, to protect employment, was forced to absorb more companies than it sold or dissolved. 25X1

Even when they cannot rid themselves of such parastatals, governments have often taken steps to decentralize—forcing local authorities to fund their

Selected Debtor LDCs: Financing Public-Sector Deficits, 1980-85 [a]



[a] Public-sector deficits as a share of GDP. The IMF definition of public-sector borrowing requirements, which includes local governments and state enterprises, is used in this study. For the Philippines however, the limited data available restrict us to examining central government accounts.

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own operations rather than rely on central government subsidies. For example, in 1985 five Argentine enterprises—including the national telephone and oil companies—that accounted for more than 16 percent of treasury transfers in 1984 lost direct access to central funds. This loss of subsidies creates incentives to set more realistic prices. Overall, many of these deficit-reduction measures reduce the share of the economy controlled by the public sector—freeing resources for the more dynamic private sectors. 25X1

Some government policies to deal with public-sector deficits are, however, impairing long-term growth and other reform measures:

- ***Delaying Exchange Rate Reform.*** Because LDC governments must often buy dollars from private exporters to service external public-sector debt, devaluations raise the domestic-currency cost of debt service—putting additional pressure on the deficit.

- ***Postponing Investment.*** Governments often choose to shift the political effects of expenditure reduction by targeting long-term productive investment, rather than popular programs such as food and energy subsidies. To meet its 1986 IMF deficit target, for example, Argentina agreed to cut investment in its nuclear and hydroelectric projects, according to the US Embassy.

- ***Increased Taxation.*** One obvious way to reduce deficits in the short term is raising taxes. For example, the tax bite in Argentina rose 2.5 percentage points of GDP last year.

In addition to raising taxes, governments often opt for indirect revenue measures. Last year, for example, Argentina began a forced-savings plan requiring individuals and businesses to lend money to the government, with repayment conveniently scheduled after the current administration leaves office, according to Embassy reporting. In addition, we have seen more government operations simply postponing payments to their domestic suppliers—which slows the overall economy and, at high LDC interest rates, makes the ultimate debt worse. 25X1

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Obstacles to Further Reform

Given the lack of progress after the initial deficit cuts, we are not optimistic about further reductions. Budget projections in Brazil and Argentina call for smaller deficits in 1986, but these countries and most other debtors have poor track records in meeting their budget austerity goals. In most other major LDCs, cuts in public-sector expenditures have been directed at central government programs, which are under closer federal government control—spending by parastatals and local governments has been more difficult to restrain. In the extreme case of Peru, President Garcia's move to unilaterally limit foreign debt-service payments reduced the pressure on the domestic budget. Other economic reform measures—particularly devaluations—are adding to the LDC budget burden. [redacted] 25X1

In our judgment, political pressure for increased government spending is likely to be particularly acute for the major LDC debtors over the next few years. Further expenditure cuts that would increasingly hit politically sensitive programs such as public-sector wages, direct consumer subsidies, and subsidized parastatal prices would worsen the decline in living standards. Embassy reporting from Brasilia predicts that subsidy expenditures are likely to rise as this November's nationwide election approaches. The new Philippine Government is unlikely to take drastic measures to cut its deficits. [redacted] 25X6

[redacted] In Argentina, President Alfonsin has already faced increased opposition to his reform programs from labor, and large repayments on the government's forced-savings plan will be necessary in four years. [redacted] 25X6 25X1

[redacted] 25X1

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Briefs

Energy

Iran Resuming Oil Shipments to Syria

Iran is attempting to shore up its political ties to Damascus by increasing oil shipments to Syria. The decision was apparently made during the Syrian Foreign Minister's recent visit to Tehran. Since last summer, Syria's failure to pay for previous shipments and a pricing dispute have held oil shipments to well below the agreed 120,000 b/d. Tehran is probably trying to prevent a Syrian tilt away from Iran, to ease tensions over Lebanon, and to stay on good terms with Damascus at a time when both countries face increased international criticism for their involvement in terrorism. Syria would have difficulty making large payments on its Iranian debts—which may be as high as $2 billion—but could make at least partial payments on new oil shipments. Iran is also short of foreign exchange but probably would accept token payments to maintain its political links to Damascus. 25X1

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International Finance

Somalia's IMF Troubles Not Over

Somalia's 1985 IMF standby arrangement, recently threatened by a buildup of arrears, was rescued by a combination of bridge loans from US banks and Western donor support. Mogadishu, however, will continue to have difficulty making its $147 million in scheduled payments to the Fund for the 1987-90 period. Since 1981, exports have averaged only about $100 million per year, and Somalia almost certainly will require substantial external assistance. 25X1

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China Seeks Western Financing

Beijing officials recently told Western banking officials that China intends to spur economic growth by raising $50 billion from foreign sources over the next four years. The funds are to come, in approximately equal portions, from new loans, joint ventures with foreign firms, and other foreign investments in China. This marks a significant change in China's international financial activity. Since opening to Western markets in 1979, China has absorbed an average of $3 billion in foreign funds annually, only two-thirds of the amount pledged by foreign entities. Although the new foreign investment goals are significantly higher, domestic investment is also scheduled to increase dramatically over the next four years, keeping foreign funds less than 5 percent of total Chinese investment. 25X1

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Sri Lanka May Seek Additional Aid

Higher defense expenditures to counter the growing Tamil insurgency may prompt Colombo to seek an IMF standby agreement as well as ask for increased assistance during a 3 June meeting with aid donors. Defense spending has aggravated the country's budget deficit, which in 1985 increased from a projected $800 million to about $2 billion. Meanwhile, the price of

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tea—which accounts for over 30 percent of government revenues—remains low. As a result, Colombo has relied on commerical borrowing to fill the gap. Despite Sri Lanka's apparent need for aid, donor nations have expressed concern over the impact of the insurgency on the economic health of the country and may threaten to withhold future assistance in an effort to pressure Colombo to seek a settlement. 25X1

International Trade

LDC Disagreement on MFA Renewal

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Textile-exporting LDCs continue to be divided over renegotiation of the Multifiber Arrangement (MFA) and are planning to meet on 5-6 June to deliberate issues such as product coverage and market access. Hong Kong, Pakistan, the Philippines, and South Korea would like any new agreement to be substantially more flexible and contain more favorable provisions, such as increased export quotas. Many LDCs are uneasy over India's proposal to phase out the MFA, and they oppose a return to GATT rules within three years. The Indian proposal is being interpreted by other LDCs as another attempt to pressure them into adopting a common position on the MFA and to providing a direct link between textiles negotiations and the new GATT Round. The lack of agreement over the MFA phaseout and other issues has caused a setback in the LDC efforts toward a joint strategy. 25X1

International Rubber Agreement Meeting Ends Without Accord

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A meeting to negotiate the Second International Natural Rubber Agreement (INRA) ended last week without an accord. As expected, the major stumbling-block was the floor price—the price below which natural rubber is not allowed to fall. Exporting members, led by Malaysia, view the current floor price as too low and want a sizeable increase reflecting the growing cost of production. Importing members, on the other hand, view a price increase as unacceptable and favor a pricing mechanism that more closely tracks market conditions. Plenty of time remains to hammer out a new agreement—the current INRA does not expire until October 1987. Success, however, will probably depend on how much exporters are willing to give in, since readily available supplies and probable continued slow growth in natural rubber demand have placed them in a weak bargaining position. 25X1

Global and Regional Developments

Britain Signs New Trade Agreements With China

25X1

London and Beijing last week signed financial and investment agreements that should improve Britain's competitiveness in the Chinese market and lead to a healthy expansion in bilateral trade—which totaled $900 million in 1985. A soft loan facility to promote British exports could make up to $450 million in concessional financing available for Chinese development projects over the next 20 years. Four projects—including the Yueyang power station in Hunan Province and telecommunications equipment for Shanghai—have already been approved by London and 10 more are under discussion. The loan package is the first offered by the United Kingdom under the new mixed credit system announced last fall; the program provides funds from the trade and aid budget to British banks to enable them to make long-term, low-interest loans to selected countries. Among other provisions, the agreement clarifies some areas of Chinese law that hampered British investment, and reportedly includes a guarantee for the repatriation of capital, profits, and fees and requires timely and full compensation if an investment is nationalized. [redacted] 25X1

Beijing Seeking US Jet Engines From Israel

[redacted]

[redacted] 25X1

[redacted] The Chinese reportedly 25X1
are considering the J79-GE-17 engine, built in Israel under a US license, for their F-8 fighter. Over the past five years, China has bought air-to-air missiles, tank guns, and other arms from the Israelis, but [redacted] has curtailed purchases from Israel recently because of political sensitivities. China's recent successes in acquiring military technology from Western Europe and the United States probably also have dampened enthusiasm for Israeli arms. Beijing is very interested in this offer, however, in order to gain Western engine technology or in case attempts to obtain engines from the United States fail. Tel Aviv recognizes that US approval is required to sell the J79 but may delay requesting permission for a transfer until a tentative agreement is reached with Beijing. [redacted] 25X1 25X1 25X1 25X1

Argentina and Britain Resume Trade Relations

[redacted]

Argentina lifted its informal trade ban against the United Kingdom and is encouraging private-sector commercial relations between the two countries. If this trade does not prove politically controversial, state-enterprise participation will follow, [redacted] Although the trade resumption reopens markets for Argentine steel and agricultural products, it may not fulfill Buenos Aires's hopes of enhancing its debt-servicing ability. During 1981—the last full year before the Falklands war—Argentine imports from Britain totaled $322 million while exports totaled only $218 million. Moreover, approximately half of these exports was beef, and Buenos Aires is unlikely to recapture its former dominant position in a market now well supplied by the EC. [redacted] 25X1 25X1 25X1

Venezuela Forging New Ties to Guyana

[redacted]

Venezuela is shipping 10,000 b/d of oil to Guyana under a one-year agreement designed to alleviate a severe petroleum shortage. According to US Embassy sources, Caracas will finance more than one-third of the shipments with a $24 million loan and has also agreed to buy 540,000 metric tons of bauxite this year and more next year. Venezuela is seeking new export markets for its petroleum products generally, but the concessionary terms suggest that President Lusinchi's main objective is to forge closer ties to Guyana's President Hoyte. Lusinchi apparently sees Hoyte as less radical than his predecessor, the late Forbes Burnham. Caracas may also have received reports 25X1 that Georgetown wants to shift its foreign policy toward the West. Guyana, desperately short of oil since Trinidad, its major supplier, demanded payment in cash last fall, probably is responding to Venezuela's initiative out of economic pragmatism. [redacted] 25X1

Honduran-Nicaraguan Barter Agreement

[redacted]

Under a mid-May accord, each country can export up to $10 million to one another during the remainder of 1986, according to the US Embassy. Any imbalance is to be settled every three months under the supervision of both countries' central banks. Some Nicaraguan firms—particularly transnationals 25X1
or others that have had close business contacts in Honduras—are likely to try to barter some of their final product to obtain currently unavailable supplies. The new barter deal apparently will not affect the nearly $60 million in Nicaraguan arrearages to Honduras. Nevertheless, Honduras probably hopes that renewed bilateral trade will eventually lead to the recovery of some of the debt. Nicaragua probably views the new accord as a way of reducing its economic and political isolation in the region. [redacted] 25X1

Vietnam Bartering for Malaysian Textile Mills

[redacted]

Vietnam is offering to exchange seafood products for the equipment and machines of idled Malaysian textile mills, [redacted] 25X1
[redacted]. Vietnam would hope to use the Malaysian equipment to produce 25X1
textiles for sale to other Communist countries. We believe this deal is not likely to be completed, however, because Malaysia has relatively little need for 25X1
Vietnamese seafood, and Hanoi has been hard pressed to fulfill its existing export commitments to the USSR for seafood and other products. Moreover, Vietnam's irregular electric power supply would almost certainly hamper operation of the mills, and its chronic shortage of foreign exchange would limit purchases of both raw material inputs and necessary spare parts. [redacted] 25X1

National Developments

Developed Countries

Canadian Economic Outlook Gloomier

[redacted]

Lower oil prices and a large budget deficit have prompted both public and private forecasters to trim projections of 1986 real GNP growth in Canada—all of the predictions are below the 1986 budget's 3.7-percent projected rate of growth. Forecasters now expect real GNP to expand by 3 to 3.5 percent this 25X1
year compared with 4.5 percent in 1985. A dropoff in capital expenditures in the energy sector is expected to be largely responsible for slowing real investment growth to one-half 1985's 8.1-percent pace, [redacted] 25X1
[redacted] Most forecasters agree that lower oil prices will reduce inflation and 25X1
spur consumer spending, but they anticipate that higher taxes will lower the rate of private consumption growth to 3.7 percent. In spite of the economic slowdown, the unemployment rate probably will fall by nearly 1 percentage point to 9.7 percent during 1986. [redacted] 25X1

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Canadian Concerns Over Foreign Ownership

Ottawa is concerned that its goal of 50-percent Canadian ownership of the energy industry by 1990 could be undermined by foreign takeovers of smaller Canadian companies. The Tory commitment to increasing Canadian control of the energy sector survived last year's measures to deregulate the energy sector, despite US objections. Ottawa's effort to promote a greater Canadian role in energy is further complicated by the need to ensure that any government aid to oil companies does not wreck its deficit reduction targets. A further hike in the gasoline tax, with the revenue earmarked for smaller companies, would be a likely, though politically unpopular, option. A less likely option, though reportedly favored by Energy Minister Carney, would require foreign firms to divest control of any new Canadian purchase within two years. 25X1

Japanese Election Politics and Economic Policy

Prime Minister Nakasone this week won both Cabinet and ruling party endorsement for his plan to hold elections to both houses of the Diet on 6 July by promising to back a $17.6 billion supplemental budget this fall, according to the US Embassy. Press statements suggest that some party leaders are leaning toward substantial economic stimulation after four years of spending restraints; others characterize Nakasone's budget promise as a reversal of his commitment to fiscal austerity. Nonetheless, a major shift in Tokyo's budget policy is probably not imminent. Although larger than the government previously contemplated, the supplement would be only 6 percent more than the initial budget for fiscal 1986. Even this amount is not assured because of Finance Ministry opposition. Nakasone, moreover, has stated that any supplemental spending must not thwart Japan's goal of ending some types of deficit financing by 1991. It nevertheless is possible that Nakasone's wish to extend his term past October, ruling party leaders' desire to increase public works spending, and a sharp deterioration in the economy could create a consensus for a much larger supplemental budget before the Diet session in September. 25X1

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Japanese Current Account Projections Revised Upward

Over the past month, both public and private Japanese forecasters have substantially increased their projections of the current account surplus for fiscal year 1986, which began 1 April. 25X1 projects an $85 billion surplus, compared with the record $55 billion in the previous fiscal year. 25X1 Other Japanese forecasts now range from $70-80 billion. (Our current forecast—for calendar year 1986—is $70 billion.) The rapid growth of the current account surplus results principally from the stronger yen, which inflates the dollar value of Japanese exports—despite an expected decline in volume—and the sharp drop in the price of crude oil. Tokyo—with an eye on trade legislation being debated by Congress—has not yet publicly revised its official $60 billion current account forecast. 25X1

Tokyo Plans Measures To Help Small Businesses

According to press reports, MITI has recently drafted measures to assist small businesses hurt by the yen's rise. Although MITI claims no timetable has been set for implementation of the new programs, we believe measures will be enacted quickly given the likelihood of general elections in early July. Another possibility is that the funds will be set aside in the supplemental budget that 25X1 will be introduced this fall. Like measures enacted in February, the new programs would allow small and medium-sized companies—firms with fewer than 300 employees and less than $500,000 of capital—lower interest rates on outstanding government loans. In addition, the amount and scope of loans will be increased. Details are not yet available, but we suspect that the new package will have only a moderate impact on the ability of small companies to maintain long-term export levels if the yen remains strong. In our view, the political influence and economic importance of small firms is probably sufficient to ensure at least moderate relief measures remain part of Tokyo's efforts to alleviate economic sluggishness caused by the yen's rise. [redacted] 25X1

Greek Shipping Industry Fighting New Decree

[redacted]

The Greek Government and its ailing shipping industry are battling over a new government decree that increases shipowner contributions to the Greek Seamen's Pension Fund from 11 percent to 14 percent of their monthly wage bill. The move is intended to prevent bankruptcy of the fund, whose deficit reached $83 million in 1985 and is expected to top $140 million this year. 25X1
Shipowners claim that the new policy will accelerate the decline of the Greek fleet—down to 2,442 ships in January compared with nearly 3,900 at the end of 1981. The high wage levels of Greek seamen, as well as increasing government regulation and the international shipping recession, are the major causes of the decline. The industry's problems have worsened the country's already serious foreign payments problems. Receipts from shipping—traditionally an important source of foreign exchange—fell from $1.8 billion in 1981 to $1 billion last year. [redacted] 25X1

Less Developed Countries

Venezuela Confronting Declining Oil Revenues

[redacted]

The Lusinchi administration is confronting a projected $5 billion shortfall in oil revenue by extending controls on imports and negotiating revisions in the $21.2 billion debt deal reached with banks in February. Earlier this month the government cut the private sector's foreign exchange allocation for imports by 10 percent from last year's $5.1 billion. Certificates of origin on imported goods are now required to discourage overinvoicing and force greater use of trade financing. According to the US Embassy, the administration is avoiding 25X1
a devaluation because the resulting inflation would have negative political repercussions. Although the Embassy reports that the government has yet to finalize its negotiating strategy, we believe that negotiations with bankers are likely to be difficult and drawn out. According to Embassy and press reporting, possible demands include: interest rate concessions; rescheduling of $2.3 billion in principal due in 1987 and 1988; extension of the refinancing period to 15 years from 12; and $3 billion in new money. The government has decided to go ahead with the $750 million downpayment promised in February, according to the Embassy. Creditor banks will almost certainly insist that the government assume the external debt of two failed private banks in return for rescheduling the 1987-88 maturities and extending the refinancing period. In our view, new

money would only be possible if Caracas were to agree to an IMF or World Bank program—a step that Lusinchi has rejected in the past. Major concessions by creditor banks in the upcoming negotiations with Mexico could further complicate the Venezuelan negotiations. 25X1

Brasilia Moves Against Budget Deficit

Brazil's National Monetary Council recently enacted several measures to decrease the budget deficit. According to the US Embassy, interest rates on subsidized agricultural credits were raised, crop subsidies were reduced, and payments under price support programs were deferred. In addition, the council 25X1 limited lending by state banks to the public sector—a loophole that sank several previous attempts to control the deficit. While government officials are still publicly predicting a sharp decline in the budget deficit this year from last year's 3.8 percent, they apparently were concerned by the $900 million deficit in March. We believe that Finance Ministry officials recognize additional budgetary restraint now is necessary given the likelihood that the administration will increase spending to gain political support just before the November election. The recent measures, in our opinion, are important steps, but more vigorous measures, such as reducing state enterprise budgets, will be necessary to quash inflationary pressures. 25X1

New Honduran Economic Program

The economic program presented by President Azcona maintains policy reforms that have allowed Honduras some growth in the last two years, but delays implementation of the potentially most beneficial new measures. The US Embassy reports that the centerpiece of the program is a continued tight monetary policy that restricts growth of overall credit to 10.6 percent, with the 25X1 private sector receiving the largest share. To increase domestic savings and discourage capital flight, the program maintains current positive interest rates. As expected, the exchange rate is also unchanged. Some 29 additional measures—emphasizing tax and trade reforms, privatization, and budget controls—are currently under study, but may not be enacted until late 1986 or in 1987. Azcona probably feels that this program—coupled with cooperation on security concerns—strengthens his case for additional US economic support. In its present form, however, the package probably will not achieve the ambitious 1986 goal of 3- to 4-percent economic growth. 25X1

Libyan Salary Cuts

Tripoli is planning to trim the wages and salaries of government workers by 35 percent, probably to curb consumption and save foreign exchange. 25X1 the Libyan Government intends to proceed with 25X1 the reductions without waiting for approval from the People's Congresses. The reductions would be the first in several years and would affect many because 25X1 the government is one of the largest employers in Libya. Qadhafi has long held the belief that domestic wage levels are too high and the disparity in wages between the upper and lower classes is too great. Qadhafi's social experiments rankle much of the population even in the best of times, and this new measure is sure to exacerbate domestic disgruntlement over widespread food shortages and the already diminished standard of living. 25X1

Libyan Airline Spare Parts Secured

[redacted]

Libya has regained access to spare parts and maintenance for its Boeing 727 aircraft, [redacted] Libyan payment problems with Air France had disrupted Tripoli's longstanding maintenance relationship with the French firm since late last year. The payment dispute was resolved early last month, [redacted] at which time Air France resumed its assistance to the Libyan airline. These aircraft are being serviced at an airport outside Paris. Maintenance of Libyan Boeing 707s is not covered by the arrangement because these aircraft have been used for military purposes. The US trade embargo against Libya has had a major impact on Libyan access to spare parts for its primarily US-origin fleet. Libya has had to curtail flights and cannibalize some aircraft to maintain international service. The Air France arrangement will ease some of these problems and help the government maintain the current diminished level of flights. [redacted] 25X1

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Lebanese Pound Takes A Plunge

[redacted]

The Lebanese pound, which has fallen by 50 percent since early April, dropped to 29.5 pounds per US dollar on 22 May. Last week's decline—2.5 pounds in two days—came after the Central Bank eased support efforts, according to the US Embassy in Beirut. Extensive intervention began in April, but the Central Bank's critical foreign exchange resources are now practically exhausted after it sold about $75 million in reserves in May. Failed attempts to support the pound have reduced commercial bank confidence and actually fueled speculation of a further decline. Downward pressure on the pound appears mainly the result of the political stalemate and the eroding security situation in Lebanon, which has prompted many Lebanese to convert pound deposits into foreign assets. [redacted] 25X1

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Possible Indian Purchase of US Military Technology

[redacted]

India is seriously considering the purchase of US technologies for its light combat aircraft and a new missile test range. [redacted] Prime Minister Gandhi will make a decision soon on the engine technology for the aircraft. [redacted] Indian officials are willing to spend $60 million on developing a suitable engine with a US company; [redacted] these officials also prefer a US-built ejection seat. [redacted] India plans to spend an additional $20 million on US-built tracking equipment for a new 1,200-kilometer missile test range. The Indians see their light combat aircraft project as a means both to develop their aeronautics industry and to build a modern jet fighter for their Air Force. Plans for the new test range, which would complement the existing range on India's east coast, indicate India's interests in expanding its long-range missile and space vehicle program. [redacted] 25X1

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Money Changers Thrive in Kabul

[redacted]

Money changers continue to operate with relatively few restrictions under the new regime [redacted] 25X1
The money changers are free to set daily market exchange rates—which they determine by listening to foreign radiobroadcasts of exchange rates—and to open foreign currency accounts in foreign banks. Most of the union's 110 members have partners in Dubayy who provide them with links to Pakistan. In 25X1

return for this freedom, the money changers supply the government with needed foreign exchange at a preferential rate to finance foreign trade. The private sector continues to function in many areas of the Afghan economy, demonstrating the regime's willingness to compromise ideology for practical considerations. [redacted] 25X1

Communist

USSR Delays Purchases of Spare Parts for Gold Mining

[redacted]

In late April, [redacted] 25X1
[redacted] hard currency shortages prevented the purchase of spare parts needed for heavy equipment at Siberian gold mines. Although the size of the potential order is unknown, similar spare parts contracts with Western firms in the past have been relatively small—$10 million or less. [redacted] 25X1 25X1
frequent breakdowns of imported equipment because of overuse, improper maintenance, and very rugged operating conditions at most gold mines. A continued unavailability of spare parts could eventually affect Soviet gold output, which has been growing very slowly in recent years. The near-term impact on estimated Soviet hard currency earnings would be limited, however, because of Moscow's estimated stockpile of 2,800 metric tons compared with average yearly sales of less than 300 tons. Soviet gold sales earned nearly $2 billion in 1985, supplying about 6 percent of Moscow's hard currency needs. [redacted] 25X1

CEMA Executive Committee Meeting

[redacted]

The CEMA Executive Committee has approved a draft program for the construction of nuclear power and heat stations as part of the group's long-term Economic, Science, and Technology Program. At its meeting in Moscow last week, the Committee focused on establishing direct relations among enterprises and scientific institutions in the member countries and on the formation of joint enterprises and associations. After hearing a detailed Soviet report, the East Europeans expressed satisfaction with Moscow's handling of the Chernobyl' nuclear accident. The Executive Committee session sets the stage for the meeting of CEMA premiers next month, which probably will also concentrate on the Economic, Science, and Technology Program. Comments by Czechoslovakia's deputy premier suggest that the East Europeans have been reluctant to commit resources to the program and skeptical of its benefits. Although the East Europeans probably have more reservations about nuclear power than their public endorsements indicate, their approval of the draft program underscores their lack of alternative sources of energy. [redacted] 25X1 25X1

China Attempting To Gain Aerospace Technology

[redacted]

China has publicly announced that it will not offer full launch insurance—covering launch and satellite operation—unless satellite technology is shared, according to a recent Chinese press report. The announcement was in reference to launches for the US firm Teresat. Chinese officials immediately denied that access to technology is a precondition. Nevertheless, we believe past Chinese actions indicate that they are attempting to acquire satellite technology through a variety of methods. [redacted] 25X1 25X1

[redacted] 25X1
China was more interested in acquiring technology than selling launch services. In a related vein, the State Department reported that China rewrote contract specifications for firms bidding on its television broadcasting satellite. The requirements, if issued, will emphasize earlier demands for transfer of satellite technology and assembly know-how to China. [redacted] 25X1

China Orders Soviet Locomotives

[redacted]

China has ordered 100 Soviet electric locomotives to help upgrade its antiquated rail system, bringing to 750 the number of electric and diesel electric locomotives purchased from the United States, Western Europe, Japan, and now the Soviet Union since 1983. Over the next five years, China 25X1 plans to spend about $21 billion on railroad modernization aimed mainly at doubling the system's coal-carrying capacity—coal already accounts for 40 percent of rail freight. More than 13 million metric tons of coal were stockpiled in the first quarter of 1986 because of inadequate transportation—the figure for all of 1981 was 17 million tons. Domestic locomotive production plans—800 electric and 2,200 diesel locomotives—are well below anticipated needs through 1990, and nearly half of China's production capacity is still dedicated to making steam locomotives. [redacted] 25X1

Chinese Firm Goes Bankrupt

[redacted]

The Chinese press reports that a state firm has been declared bankrupt, the first such case ever. The workers will become unemployed, and assets of the unnamed firm—believed to be a collectively owned farm implement factory—will be liquidated under the provisions of a trial Shenyang city bankruptcy law. 25X1 The failing firm is undoubtedly a test case for Beijing's planners, who are currently drafting national bankruptcy and unemployment laws. The widely publicized bankruptcy is also a warning to other state-owned enterprises of the increasing penalties for failing to implement economic reforms and improve efficiency. [redacted] 25X1

Vietnam Drafts New Foreign Investment Code

[redacted]

Hanoi is preparing a new foreign investment code that will permit joint ventures or wholly owned foreign firms, [redacted]. 25X1 The draft code also allows key managerial posts to be filled by foreigners and puts no limits on repatriation of profits. Hanoi hopes investment under the new code will promote agricultural and mineral exports and sales of labor-intensive 25X1 goods and services such as tourism, ship repair, or aircraft maintenance. The draft code underscores Hanoi's continuing efforts to end its economic isolation from the industrial West, but we believe Vietnam's investment climate will remain unattractive. Besides the political obstacle of Hanoi's involvement in Cambodia, shortages of electric power and raw materials, transportation bottlenecks, and an inefficient, corrupt, and xenophobic bureaucracy pose major hurdles. [redacted] 25X1

Cuban Farmers' Markets Abolished

President Castro's decision to abolish the farmers' free markets this month represents a major defeat for the regime's economic pragmatists. The markets, established in 1980 as an incentive to boost agricultural productivity, provided peasants with an outlet to sell all production above government quotas. Castro 25X1
charged that the free markets promote corruption, contribute to the revival of the use of middlemen, and create millionaire farmers. Castro's action bodes ill for any liberalization in economic policy despite the country's worsening economic situation. His singling out of one sector of society is reminiscent of his past campaigns to divert attention from serious problems. In this case, Castro has removed a key incentive to private farmers—the most efficient and productive sector of Cuban agriculture—and a significant drop in productivity is almost certain. The general public, weary of continuing austerity, is likely to view abolition of the markets with dismay. 25X1

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