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International Economic & Energy Weekly

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6 January 1984

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DI IEEW 84-001
6 January 1984

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International Economic & Energy Weekly

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Synopsis

1 **Perspective—*Western Europe: The Implications of High Unemployment***

Western Europe is facing a prolonged period of high unemployment, possibly averaging 12 percent through the end of the decade. This will increase pressure on political and social institutions within the region and could disrupt economic, political, and security relations with the United States. 25X1 25X1

15 **International Financial Situation: Debt Arrearages** 25X1

This article in our series on economic and political aspects of the international financial situation examines the sharp increase last year in debt arrearages. At least 52 LDCs and East European nations were behind in their debt repayments at yearend, compared to 36 countries a year earlier, and the total amount of arrearages was $30-35 billion compared to $20 billion a year earlier. 25X1

17 **Western Europe: The Unemployment Crisis** 25X1

Although the recent recession has aggravated the region's unemployment problem, the primary causes are structural in nature—rapid labor force growth, high labor costs, and an inability to restructure economies to changing circumstances. 25X1

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29 **Iraqi Oil Export Options: Financing the War Effort** 25X1

Iraq's deteriorating economy has prompted Baghdad to seek ways to expand its crude oil exports and earn the revenues it needs to continue the war with Iran. 25X1

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6 January 1984

Perspective

Western Europe: The Implications of High Unemployment [redacted] 25X1

Western Europe is facing a prolonged period of high unemployment, possibly averaging 12 percent through the end of the decade. This persistent trend will increase pressure on political and social institutions within the region and could disrupt economic, political, and security relations with the United States. [redacted] 25X1

Many West European countries may enter an era of oscillation between governments of the left and right. High and rising unemployment has made incumbent governments in Western Europe vulnerable to charges that they are unable to devise solutions to unemployment. In polls throughout the region, overwhelming majorities of respondents say unemployment is their countries' leading economic problem and that governments are responsible for solving it. With unemployment remaining high even after economies resume growth, campaign promises of opposition parties will become more appealing. [redacted] 25X1

Youth unemployment poses particularly serious long-term problems for Western Europe. Much of an entire generation faces poor employment prospects, sustained periods of joblessness, and underemployment. Resultant feelings of despair and discontent could engender disillusionment with democratic institutions. College-educated youth, who normally would become their countries' political and intellectual leaders, will be especially susceptible to political alienation or extremism when they are unable to find jobs. [redacted] 25X1

Persistent unemployment will exacerbate other social strains within and among West European countries. Foreign workers are likely to be a particular target of resentment. In a recent French opinion poll, 51 percent of the respondents said the repatriation of foreign workers would be the best way to solve the unemployment problem. The foreign guest workers problem already troubles West Germany's relations with Turkey and—to a lesser extent—with Yugoslavia. The issue of labor mobility is a stumblingblock in the European Community's accession negotiations with Spain and Portugal. [redacted] 25X1

With pressures mounting to reduce the number of unemployed, trade tensions between Western Europe and the rest of the world—including the United States—are likely to intensify. The recent disagreements over steel and agricultural trade may become the rule rather than the exception, as West

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European countries look for unemployment cures. The European Community will take a careful look at imports from the United States that have made inroads into European markets, including such disparate items as corn gluten feed and computers. Futhermore, the Ten will increasingly challenge what they view as US attempts to take over third-country markets, particularly traditional agricultural markets. [redacted] 25X1

The United States will be affected indirectly by West European–Japanese and West European–LDC trade relations as well. In many areas of trade, Western Europe views Japan, not the United States, as its chief rival. To protect jobs in the automobile industry, for example, the United Kingdom, West Germany, France, and Italy have for a number of years tightly controlled the import of Japanese autos. More recently, Tokyo agreed to restrict exports to the entire European Community of a number of products produced by EC industries whose jobs are threatened. Japanese producers are likely to redouble their sales efforts in the United States to compensate for setbacks in Western Europe, [redacted] Western Europe also 25X6 has restricted imports of steel and textiles from developing countries such as South Korea and Taiwan, and, as a result, these producers may begin to push sales in US markets more aggressively. [redacted] 25X1

Continuing high levels of unemployment may cause West Europeans to view trade with the Soviet Union and Eastern Europe more favorably. The unemployment problem will put pressure on West European governments to relax—or enforce less strictly—trade restrictions on sales to the Bloc. In addition, Western Europe's disadvantage in high-technology areas may force the region to look eastward to sell the less technologically advanced products it cannot sell elsewhere. [redacted] 25X1

Dim unemployment prospects will make it more difficult for West European countries to meet their defense commitments to NATO. Expenditures resulting from high levels of unemployment have severely strained government budgets. These expenses seem certain to continue, keeping the guns-versus-butter issue in the forefront of public debate. With West European budgets likely to remain tight for some time, pressure to curb defense spending will mount. Opinion polls in Western Europe indicate strong support for cutting defense spending and little support for curtailing social programs. [redacted] 25X1

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Briefs

Energy

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Egypt Adjusts Oil Prices

[redacted] 25X1

Egypt has cut prices for its two medium crude export blends by $0.50 and $0.25, respectively, to make them more competitive in European markets. The price cuts—Egypt's Suez Blend now sells for $28 per barrel and Belayim is $26.50—follow a similar move by the Soviet Union in early December. Official Egyptian prices are close to those in the spot market and serve to undercut OPEC's official prices for similar crudes. The price differential plus Egypt's comparative advantage in transportation costs should enable Cairo to market its exports of 270,000 barrels per day. Although the Egyptian move is a response to the general weakness in the market for those types of crude, a simultaneous decision to raise by $0.25 per barrel the price of its heavy Ras Gharib crude—used primarily for fuel and industrial purposes—reflects greater buoyancy in that market. [redacted] 25X1

Uncertainty Surrounds Canadian-Japanese LNG Project

[redacted] 25X1

Although initial hearings by the National Energy Board on Dome Petroleum's proposal to ship 4 billion cubic meters per year of liquefied natural gas to Japan have been completed, the issue of gas supply for the project remains unresolved. Dome's President reports that volume and price discussions with British Columbia and Alberta—the provinces expected to supply the gas—could require an additional nine months. Canadian producers are concerned that any cost overrun in construction of the LNG facilities will affect their return because the Japanese selling price has been set. According to the Japanese buyers, uncertainty beyond mid-1984 could jeopardize the project. Moreover, a recently proposed reorganization of Australia's LNG export project to Japan would allow significant Japanese equity in both production

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and marketing and could thus give the Australian project priority over the Canadian venture. [redacted] 25X1

International Finance

Brazil's Soya Exports on the Upswing

[redacted]

[redacted] Brazil's soya exports should reach a record-tying $3.5 billion in the 1984 marketing year (October-September) because of an upswing in world prices. Since June 1983 world soybean prices have increased by slightly more than 30 percent, largely because of the drought-reduced US crop. Brazil plans to pursue export sales aggressively in the coming months, before next summer's US soybean crop—which is expected to be large—can drive prices lower. Large soya earnings will help Brazilian efforts to meet its IMF target of a $9 billion trade surplus in 1984. [redacted] 25X1 25X1 25X1

Brazil: Soya Exports [a]

	Thousand metric tons			Soya Exports (*Billion US $*)
	Soybeans	Soybean Meal	Soybean Oil	
1980	1,239	5,493	523	1.9
1981	1,812	8,587	1,265	3.5
1982	739	8,130	908	2.4
1983	1,504	8,623	1,076	2.8
1984 [b]	1,700	8,600	950	3.5

[a] October/September marketing year.
[b] Estimated.

[redacted] 25X1

Prospective Portuguese Gold Sale

[redacted] 25X1

The Bank for International Settlements agreed last month to extend the maturity date for Lisbon's short-term $300 million loan from December until some time in January or February, according to US Embassy officials. The Soares government probably hopes to meet part of the payment with hard currency, but an official at the Bank of Portugal expects Lisbon will sell all of the 23 tons of gold pledged against the loan. The gold sale will lower Portugal's gold reserves to about 612 tons. Under an agreement drawn up by the members of the coalition government last year, total gold reserves were not to drop below 600 tons. Lisbon probably will seek about $1.5 billion in commercial loans this year to cover part of its projected $2.8 billion foreign exchange requirements. Existing commitments from the IMF and other multinational institutions, bilateral assistance, and direct foreign investment should cover the remainder. [redacted] 25X1

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Global and Regional Developments

New EC Steel Measures

[redacted]

The EC Council last week approved emergency measures to aid the Community's ailing steel industry, primarily in response to West German complaints of dumping by other EC producers. While the new measures may provide some price stability to the EC steel market, they will not solve the key problems of weak demand and excess capacity. The new package replaces existing guideline prices with mandatory minimum prices for steel products and establishes a certification system to enable the Commission to monitor country of origin for intra-EC steel trade. The minimum prices are below the old guideline levels but still above current market prices. To enforce the new minimum prices, steelmakers will be required to post a bond of $12 for each ton of steel sold in the EC; the bond is forfeited if the EC Commission uncovers a violation of the price guidelines. Although the minimum price portion of the package went into effect 1 January, technical problems have delayed implementing the bond and certification systems for at least a week. [redacted]

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EC Coal Policy in Disarray

[redacted]

The EC coal industry enters 1984 in disarray. Coal stocks are still growing and demand forecasts for coal use through the year 2000 are down. Cancellation of the December Energy Council meeting has left several EC energy programs affecting the troubled coal industry in limbo. [redacted] No successor is in place for the coking coal subsidy scheme that expired at the end of 1983. Proposals are still under debate to provide grants for coal industry modernization, to provide for worker retraining and to help new industries locate in areas affected by mine closures. Britain and West Germany are major proponents of these proposals, but France has been strongly opposed to EC coal initiatives. The French presidency of the EC in the first six months of 1984 will reduce prospects for agreement. [redacted]

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EC Agreement With Spain on Japanese Quotas

[redacted]

The European Community and Spain in mid-December reached agreement on the retention of Spanish controls on Japanese imports following Spain's entry into the EC. Madrid will be permitted to retain quotas on 37 Japanese goods for a period of six years following Spain's planned accession in 1986. Details on the items involved are being kept confidential while the entry negotiations are under way. This agreement marks a small forward step in the negotiations, but more contentious issues—particularly agriculture—remain. The accord probably was facilitated by the Community's current protectionist attitude toward Japan. Other EC members, primarily France and Italy, still retain national quotas on Japan that existed prior to their EC entry. [redacted]

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NIC Trade Surplus With Big Seven Grows

The six newly industrializing countries (NICs) recorded an $8 billion rise in the trade surplus with the Big Seven in the first three quarters of 1983 compared to the same period in 1982. According to Big Seven trade data, exports of the six NICs rose 8 percent in the nine-month period. Almost all of the gain came in sales to the United States. Hong Kong and Taiwan led the group, with export gains of 12 percent. A 7-percent drop in NIC imports stemmed from cuts by the two Latin debt-troubled NICs—Brazil and Mexico. In fourth-quarter 1983 and this year we expect NIC imports to approach prerecession levels and exports to increase further in response to Big Seven demand for manufactures. [redacted]

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East Germany–West Berlin Agree on Rail Line

East Germany agreed in late December to transfer West Berlin operations of the S-Bahn, an urban rail system, to West Berlin authorities. The deal concludes negotiations begun in October after East Germany threatened to shut down operations on 1 January. In addition to relinquishing S-Bahn operations, East Germany agreed to turn over 119 four-car trains and some real estate. West Berlin takes over operating expenses and will pay the East German state railroad to use its facilities. [redacted]

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The accord resolves disputes over service and subsidies that date back to 1945, when Soviet occupation forces assumed control of rail operations throughout Berlin. West Berlin Mayor von Weizsaecker called the agreement an "important event for Berlin and East-West relations," and the pact received widespread approval in West Germany. Although East Germany's primary interest was financial—East Berlin reportedly lost DM 1.5 billion on the system since 1970—the speed of the negotiations indicates the continued desire by both East and West Germany to maintain intra-German relations during the period of East-West tensions over INF deployments. [redacted]

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Bullish Market Prospects for Platinum

[redacted] demand for platinum group metals (PGM) could more than double by 1990, while newly mined supply will grow by less than one-third. Recycled metal will make up the supply shortfall. [redacted] the price of platinum could more than double by 1990, while palladium's price could triple. Bullish demand prospects are attributed to increased use of PGM-bearing catalytic converters as European countries adopt auto emission standards similar to the United States. In addition, analysts predict greater commercial use of platinum-using fuel cells, increasing substitution of palladium for gold in electronics applications, and more widespread popularity of platinum jewelry. [redacted]

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South Africa and the USSR—which account for 95 percent of world PGM production—will be the primary beneficiaries if large price increases materialize. Since 1978 South Africa has earned from $400 million to $1 billion per year—3 to 5 percent of total foreign exchange earnings—from PGM sales.

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NICs: Seasonally Adjusted Trade Balance With the Big Seven [a]

Billion US $

	1982					1983 [b]		
	Total	I	II	III	IV	I	II	III
NICs								
Exports	67.4	16.4	16.8	17.7	16.7	17.7	18.3	19.1
Imports	64.3	17.6	16.5	16.2	13.9	14.5	15.4	16.9
Balance	3.1	−1.2	0.3	1.5	2.8	3.2	2.9	2.2
Brazil								
Exports	10.5	2.6	2.6	2.6	2.5	2.5	2.8	2.8
Imports	7.1	1.8	2.0	1.8	1.4	1.4	1.6	1.4
Balance	3.4	0.8	0.6	0.8	1.1	1.1	1.2	1.4
Mexico								
Exports	18.3	4.2	4.3	5.2	4.7	4.7	4.9	5.1
Imports	15.5	5.1	4.3	3.9	2.2	2.8	2.7	3.2
Balance	2.8	−0.9	0	1.3	2.5	1.9	2.2	1.9
Hong Kong								
Exports	9.6	2.4	2.5	2.5	2.4	2.9	2.5	2.6
Imports	9.9	2.7	2.5	2.5	2.2	2.3	2.6	2.8
Balance	−0.3	−0.3	0	0	0.2	0.6	−0.1	−0.2
Singapore								
Exports	5.0	1.2	1.3	1.2	1.3	1.2	1.4	1.5
Imports	9.9	2.6	2.4	2.5	2.4	2.6	2.7	2.6
Balance	−4.9	−1.4	−1.1	−1.3	−1.1	−1.4	−1.3	−1.1
South Korea								
Exports	10.6	2.7	2.7	2.7	2.5	2.7	2.9	3.1
Imports	11.8	2.8	2.8	3.1	3.2	3.1	3.2	3.6
Balance	−1.2	−0.1	−0.1	−0.4	−0.7	−0.4	−0.3	−0.5
Taiwan								
Exports	13.4	3.3	3.4	3.5	3.3	3.7	3.8	4.0
Imports	10.1	2.6	2.5	2.4	2.5	2.3	2.6	3.3
Balance	3.3	0.7	0.9	1.1	0.8	1.4	1.2	0.7

[a] NIC exports to the Big Seven were derived by dividing imports from the NICs by 1.1, while NIC imports were obtained using Big Seven export data. Both import and export data are valued f.o.b.
[b] For some Big Seven countries, third-quarter data are estimates.

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The Soviet Union has sold between $200 and $400 million annually. Higher prices could reduce US reliance on PGM imports—currently about 85 percent of consumption—by making domestic production feasible at the Stillwater complex in Montana. 25X1

National Developments

Developed Countries

Pickup in Japanese Growth

Japan's GNP grew at a seasonally adjusted annual rate of 6.2 percent in the third quarter, well above the rate for the first half of the year. Domestic demand contributed most of the increase as private consumption picked up and private housing investment rebounded. Net exports, which were up by 9.4 percent, also continued to fuel the expansion. The third quarter results make it likely that Tokyo will reach its target of 3.4 percent growth for fiscal year 1983, which began in April. 25X1 25X1

For fiscal year 1984 the Economic Planning Agency is expected to announce a growth target of at least 4 percent. The Ministry of Finance—which is trying to hold down government spending to reduce the persistent budget deficit—had lobbied for a target closer to 3 percent. The opposition parties' new strength in the Diet following the December election, however, is likely to increase pressure on the government to make fiscal policy less austere than originally planned. Prime Minister Nakasone has endorsed the 4-percent target, and private forecasters are calling for growth of 4 percent or more. 25X1

West German Business Optimistic

Business optimism, one of West Germany's most closely watched leading economic indicators, reached a four-year high in November. According to the regular survey by the Ifo Economic Research Institute in Munich, manufacturing, retail sales, and construction were the sectors expressing the most optimism. Ifo, along with almost all forecasters, recently raised its 1984 real GNP projection to 2.5 to 3.0 percent. Resurgent exports and strong investment are the main factors for the upward revision. 25X1 25X1

Israeli Budget Maneuvering

Amid public threats by most of the small parties making up Prime Minister Shamir's parliamentary majority to leave the coalition because of opposition to Finance Minister Cohen-Orgad's austerity budget, the Cabinet last Sunday agreed to an expenditure ceiling that would limit real outlays in FY 1984—beginning on 1 April—to about the same level as the current budget. Although budget allocations to individual ministries must still be negotiated, an increasing share for debt-servicing costs will result in real declines in social welfare programs. The smaller parties' opposition centers on proposals to 25X1

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freeze settlement activities, to eliminate free high school education, and to sharply curtail other social programs, according to press reports. TAMI, with a low-income constituency, has reportedly presented an alternative program that would boost taxes on higher income groups, including a proposal that would require Israelis earning more than $18,000 annually—less than 10 percent of all households—to give up a month's salary. 25X1

Strikes and work slowdowns have increased recently, and more are planned as workers demonstrate opposition to the erosion of real wages by record price hikes in recent months and to Cohen-Orgad's call for a 12-percent cut in real wages next year. Civil service workers in the Foreign Ministry were the latest to join protest action in government offices by refusing to receive foreign diplomats or members of the public, according to press reports; tax officials are refusing to collect taxes, Interior Ministry workers are not issuing passports or identity cards, and workers in the Ministry of Labor and Social Affairs have stopped payments to institutions for delinquent youths and the mentally handicapped. The Deputy Secretary of the Histadrut, the large labor organization, told a US Embassy officer that he is afraid that the debate over cutting real wages and the worsening economic situation could lead to widespread strikes. 25X1

New Turkish Economic Measures

Turkish Prime Minister Ozal last week announced measures that address his government's main economic goals—reducing inflation, minimizing state intervention in the economy, and making the economy more responsive to market forces. The new statutes: 25X1

- Permit Turks to hold unlimited foreign exchange deposits, whereas previously only Turkish workers abroad were allowed to do so.
- Direct the Central Bank to change up to $3,000 worth of lira for any Turk traveling abroad.
- Lift restrictions on the number of foreign trips a citizen can make.
- Allow commercial banks to buy and sell foreign currencies in line with margins set by the Central Bank.
- Make it legal for Turks to buy foreign consumer goods in Turkey. 25X1

Lifting foreign exchange controls is a first step toward making the lira readily convertible on the world market. The hope is that this will attract needed foreign investment. The easing of import restrictions are intended to dampen inflation—currently running about 35 percent—by pitting Turkey's protected manufacturers against foreign competition. The government hopes increased competition ultimately will improve the quality of output and help boost exports—critical to Ozal's longer term development plans. 25X1

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South African Financial Woes

[redacted]

The South African Government is looking for ways to deal with its budget crisis. [redacted] Pretoria has ordered spending cuts in all areas except defense and education. The government reportedly will raise the national sales tax from 6 to 8 percent next month as well. Pretoria has had difficulty controlling spending in the fiscal year that ends on 31 March, in part because of the costs of stepped-up military operations in Namibia and of drought relief. Revenue, meanwhile, is lagging budget projections because of recession—real growth declined by 3 to 4 percent last year—and low gold prices. The budget situation is unlikely to improve much until later this year unless gold prices rebound. [redacted] the government's financial problems could delay constitutional reforms set for midyear because they will entail a costly expansion of the legislative bureaucracy. [redacted]

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Less Developed Countries

Tunisian Bread Riots

[redacted]

The rioting that erupted late last week in Tunisia's poorer southern and central regions was in anticipation of the 125-percent bread price increase effective January 1. By early this week the riots—spurred by university and high school students—had spread north to the capital and forced President Bourguiba to declare a state of emergency and to order the military to quell the disturbances. Press reports indicate at least 20 casualties so far. The removal of subsidies is part of efforts to reduce the budget deficit and ease foreign payments problems. On Tuesday Prime Minister Mzali in a televised address remained firm on the removal of bread subsidies but stressed that the middle and poorer classes would receive welfare assistance to ease the adjustment to the higher prices. [redacted]

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Indian Inflation Persists Despite Bumper Harvest

[redacted]

An upsurge in prices has heightened unrest and reduced the chances that Prime Minister Gandhi will call for parliamentary elections early this year. Gandhi and her advisers had expected recent record harvests to moderate price rises and were considering elections a year before they are due. Increases in wholesale food prices, however, accelerated from an annual rate of 6 percent last spring to 11 percent in December. Although agricultural prices usually taper off as the autumn crop reaches the market, this year price pressures have remained strong because of higher procurement prices, strong domestic demand for edible oils, and more buoyant international markets for traditional agricultural exports such as cotton, tea, and spices. Even small food price increases concern the government because the urban and rural poor are a potent political force at election time. The opposition parties have been quick to blame the unexpected price rise on extravagant government spending, deficit financing, and corruption. In our view, Prime Minister Gandhi will delay parliamentary elections until inflation subsides and may increase imports as well as reduce exports of essential commodities to ease price pressures. [redacted]

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Mexican Flexibility on Foreign Investment

Mexico City is showing flexibility in implementing new foreign investment guidelines. The strong reaction by foreign businesses to restrictive government policies probably has caused this change. According to the US Embassy, a major foreign auto firm in Mexico had threatened to close its operations. After receiving favorable assurances from Mexico City, however, the company in 25X1 mid-December reached a preliminary agreement to stay and carry out earlier investment plans. By dropping public opposition to government policies and building a $500 million plant in northern Mexico, the company received substantial financial incentives from the government and an exemption from tough local content requirements. 25X1

Mexico City for the second time has postponed publishing strict new regulations on the production and marketing of pharmaceuticals. Business sources have told the US Embassy that the government now expects the decree to be published in February or March. In the meantime, industry representatives are holding regular meetings with government officials to redraft the decree line by line. 25X1

If Mexico City fails to take into account business views before the final pharmaceutical decree is published, this would further sour the investment climate. International businessmen believe nationalistic Mexican laws are a major impediment to direct foreign investment. Although recent compromises may encourage firms with large commitments to stay in Mexico, we believe the government will have to go much further to attract new investors. 25X1

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Communist

Yugoslav Resistance to Some IMF Recommendations

[redacted]

Prime Minister Planinc's warning in late December that Yugoslavia cannot adopt all of the IMF's policy recommendations in 1984 is meant to secure concessions from the Fund and to show domestic opponents that she will not sacrifice national interests to secure foreign exchange. Government leaders especially object to two IMF proposals. The Fund wants Yugoslav enterprises to turn over to the National Bank all foreign exchange earned through export sales, and it insists that Belgrade raise interest rates above the rate of inflation. Belgrade is reluctant to adopt these measures partly because they would undercut arrangements with the republics and provinces—achieved with great difficulty—on foreign exchange and interest rate policies. [redacted] 25X1 25X1

Planinc has stated that Yugoslav authorities will establish a "demarcation line" beyond which IMF proposals would constitute interference in the country's affairs. According to US Embassy sources, the leadership has drawn up a go-it-alone program in case negotiations with the IMF and foreign creditors fail. We believe, however, the authorities realize that a breakdown in negotiations with creditors would disrupt foreign trade and damage the economy. Planinc's warning thus may be intended to deflect domestic critics opposed to relying on financial ties to the West. It also is a plea for Western understanding of the limits of her power in Yugoslavia's cumbersome decentralized system. Go-it-alone policies would cause even greater hardships without providing a path for economic recovery. [redacted] 25X1

Yugoslav Price Hikes and a Freeze

[redacted]

On 24 December the Yugoslav Government announced price hikes for certain essential products and a freeze on most other goods and services for six months. Prices were raised for electricity, coal, train fares, petroleum products, chemical products, laundry detergents, tobacco, and cooking oil in line with IMF recommendations to eliminate underpricing of these goods. Belgrade's reimposition of a general price freeze—five months after lifting a yearlong lid on prices—is a desperation bid to suppress inflation, which is now running at 55 percent. Belgrade's inability to slow inflation was a major failure in Yugoslavia's 1983 economic stabilization program. The new price freeze, however, fails to attack its causes. Moreover, the government did not take steps to control wages; enterprises soon could be constrained by fixed prices, rising costs, and government pressure to increase industrial production for export. [redacted] 25X1 25X1

Hungary's Slow Progress With Stabilization

[redacted]

Hungary's economic stabilization program for 1984, awaiting final IMF endorsement, is unlikely to avert debt-servicing problems in the coming year. The program calls for only a minimal slowdown in the economy from roughly 1-percent growth in 1983 to no growth this year. The main burden of 25X1

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adjustment will fall on investment, which is to decline by 8 percent, while real disposable income is projected to fall only 1 percent. Hungary's failure to meet similar targets last year resulted from the buoyant private economy and excessive credit expansion. The leadership plans to rely on more restrictive credit policies, tougher restraints on wages, and reductions in subsidies. It promises to begin a more comprehensive structural reform program later in 1984. 25X1

The regime probably will cut corners in carrying out some of the toughest measures of the program, jeopardizing the balance-of-payments targets. The leadership remains reluctant to restrict consumption and continues to resist reining in the expanding private sector, which provides a supplement for the official economy. The IMF estimates that following the program could yield a 1984 current account surplus of $400 million, up slightly from the $300 million surplus last year. Budapest will need to borrow at least $1.1 billion—including $450 million from the IMF—to cover the remainder of its debt repayments of $1.5 billion. Failure to control domestic demand would generate more difficult debt-servicing problems by increasing credit requirements.

25X1

Soviet Efforts To Spur Labor Brigades

Two party-state decrees in early December sharply criticized the halfhearted way Soviet industry has introduced the brigade system of organizing labor—small groups of workers that are assigned resources and tasks according to a contract with enterprise management. The lack of success of the high-visibility brigade program is another example of the difficulty Andropov has encountered in implementing even relatively moderate reforms. The new decrees listed several incentives for brigade leaders, which are designed to breathe new life into the system but failed to provide monetary rewards for enterprise managers to encourage the introduction of brigades; this omission makes it likely that the decrees will have minimal impact. 25X1 25X1

The Soviet leadership has been pushing hard for extensive use of brigades since 1979, touting the brigade method as an effective way to raise productivity through enlisting worker self-interest. A worker's remuneration under the brigade system is tied both to the output of the brigade as a whole and to his individual contribution to that output. Andropov has given even greater emphasis to the brigade system than Brezhnev, making it a key element in his plans for revitalizing the economy. Although 60 percent of industrial workers have been organized into brigades, most brigades, according to the December decree, exist in name only or have not been integrated into actual production. Only half of the brigades are operating under contracts, and wages continue to be paid on an individual basis, ignoring the link with brigade performance. A key reason for the limited use of brigades appears to be opposition by ministerial and working-level managers, who see the contractual arrangements of the brigade system as diluting their authority over workers. 25X1

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International Financial Situation: Debt Arrearages [redacted] 25X1

This article is part of our series focusing on the economic and political aspects of the international financial situation. [redacted] 25X1

The continuing international debt crisis is pushing a growing number of countries into arrears on their external debt repayments. At yearend 1983, at least 52 LDCs and East European nations were behind on their debt repayments, a sharp jump from the previous high mark of 36 countries at the end of both 1981 and 1982. We estimate the total amount of debt arrearages to be $30-35 billion at yearend 1983, a substantial increase from the 1982 total of $20 billion and the 1981 mark of only $7 billion. The $30 billion arrearage figure equals about 20 percent of scheduled 1983 debt repayments for these countries. [redacted] 25X1

An important development during 1983 was the emergence of large-scale arrearages in key debtors:

- *Poland* has accumulated an estimated $13 billion in arrearages in the past three years. About $7.5 billion of this total is owed to Western governments. Several West European countries are anxious to conclude rescheduling agreements, but Warsaw's negotiations with the Paris Club are moving slowly. Another $5 billion in payments are overdue to creditors in socialist countries, Latin America, and the Middle East. Unlike other problem debtors, Poland is roughly current on payments to Western banks. Rescheduling agreements have covered most of the payments due to the banks between 1981 and 1983, and Warsaw has devoted its limited resources to meet the remainder.

Countries With External Payments Arrearages at Yearend 1983

Latin America		
Argentina	Ecuador	Mexico
Bolivia	El Salvador	Nicaragua
Brazil	Guatemala	Paraguay
Chile	Guyana	Peru
Costa Rica	Haiti	Venezuela
Cuba	Honduras	
Dominican Republic	Jamaica	
Africa/Middle East		
Benin	Guinea	Senegal
Cameroon	Guinea-Bissau	Sierre Leone
Central African Republic	Ivory Coast	Somalia
Chad	Jordan	Sudan
Comoros	Liberia	Tanzania
Congo	Madagascar	Togo
Egypt	Mali	Uganda
Gambia, The	Mauritania	Zaire
Ghana	Nigeria	Zambia
Asia		
North Korea	Vietnam	
Philippines	Western Samoa	
Eastern Europe		
Poland	Romania	

[redacted] 25X1

- *Brazil*'s debt arrearages were estimated [redacted] 25X1 [redacted] to be between $2-3 billion in late December 1983. Most financial observers expect these arrearages to be eliminated when the first tranche of the $6.5 billion loan from commercial banks is disbursed, which we expect to occur in January. [redacted] Brazil is likely to face a renewed buildup of arrearages during first-half 1984. 25X1 25X1 25X1

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- *Venezuela*'s arrearages were about $1 billion in December, [redacted] with most of the total consisting of private-sector interest payments. Venezuela has angered bankers by intentionally withholding repayments even though liquid foreign reserves are estimated by one source to be $5.7 billion. Bankers have insisted that interest arrearages be brought current before beginning debt renegotiations, and we do not expect a quick resolution to this issue.

- *Argentina* currently has interest arrearages of about $2 billion, according to press reports. The most serious problem is in the private sector where many arrearages are older than 90 days and face nonperforming status in US banks, [redacted] We do not expect Argentina's arrearages to be cleared up until the current rescheduling efforts are completed.

- *Philippine* debt arrearages have been mounting since Manila initiated a moratorium on principal repayments in mid-October 1983. [redacted]

- *Nigeria* is in arrears on its short-term trade-related debt by as much as $5 billion [redacted] Lagos completed two refinancing agreements with its bank creditors during the past six months, but arrearages have remained at high levels. [redacted] Efforts to resume debt negotiations by the new military government—which ousted former President Shagari last weekend—are likely to be delayed as the new regime consolidates its position. [redacted]

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In contrast, *Mexico* has sharply reduced its debt arrearages over the past several months as a result of successful debt reschedulings and improved economic performance. We estimate arrearages to be as much as $2 billion in late 1983, most of which are accounted for by the private sector. We believe further progress in private-sector debt rescheduling efforts should allow Mexico to eliminate most of its arrearages over the next few months. [redacted] 25X1

The most important aspect of debt arrearages to US commercial banks involves the delay of interest payments beyond 90 days. If interest on a loan is more than 90 days overdue, banks must classify the loan as nonperforming and may need to set aside a portion of their capital as a reserve against the loan. Such a move on a large scale could severely damage the profitability and the lending ability of several large US banks. [redacted] 25X1

[redacted]

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Western Europe: The Unemployment Crisis [redacted] 25X1

Western Europe is struggling with its highest levels of unemployment since the reconstruction period following World War II, and the situation is expected to deteriorate further over the rest of this decade. As of mid-1983, 18 million workers—10.6 percent of the labor force—were jobless. Although the recent recession has aggravated the region's unemployment problem, the primary causes are structural in nature—rapid labor force growth, high labor costs, and an inability to restructure economies to changing circumstances. Although labor costs should rise less rapidly over the next several years, weak economic growth and inadequate restructuring efforts likely will cause the region's unemployment rate to rise slowly throughout the decade and exceed 12 percent by 1990. [redacted] 25X1

Western Europe: Midyear 1983 Unemployment

	Rate (*percent*)	Number Unemployed (*thousands*)
Total	**10.6**	**18,306**
Big Four countries	10.1	9,577
West Germany	8.9	2,320
France	8.5	2,029
Italy	9.7	2,258
United Kingdom	12.4	2,970
Smaller countries	11.8	8,729
Austria	3.2	145
Belgium	11.9	510
Denmark	10.6	285
Finland	6.8	150
Greece	10.0	370
Iceland	1.3	1
Ireland	14.2	146
Luxembourg	1.3	2
Netherlands	17.4	841
Norway	3.4	61
Portugal	9.0	390
Spain	17.5	2,141
Sweden	3.4	135
Switzerland	0.8	52
Turkey	20.0	3,500

[redacted] 25X1

Severity of the Problem

Unemployment has reached record levels in nearly all of Western Europe. The composition of the 18 million unemployed is nearly as disturbing as the overall levels:

- By mid-1983 a full 40 percent of those unemployed had been out of work for more than a year.
- Prime working-age males (aged 25 to 54) account for about one-third of total unemployment.
- One out of every four persons between the ages of 15 to 24 is unable to find work in Western Europe. [redacted] 25X1

The severity of Western Europe's employment problems are even more apparent when comparing US and West European job creation during the 1970s. During that period, when economic growth was about comparable for the two areas, the West Europeans added only 5.3 million new jobs, despite an 11.7-million increase in the labor force; the United States, meanwhile, added 20.6 million jobs with a jump of 24.2 million in the labor force. If job creation in the United States had been as poor as it was in Western Europe, by 1980 the US unemployment rate would have topped 16 percent. [redacted] 25X1

The Causes of Unemployment

Structural economic deficiencies are the main factors contributing to Western Europe's unemployment problem. During the 1970s, demographic trends boosted the labor force growth rate at the same time that economic growth slowed; wage and

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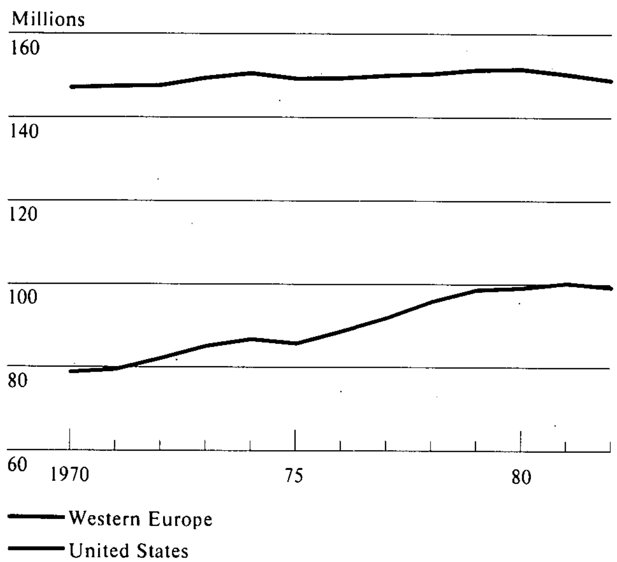
Western Europe and the United States: Employment



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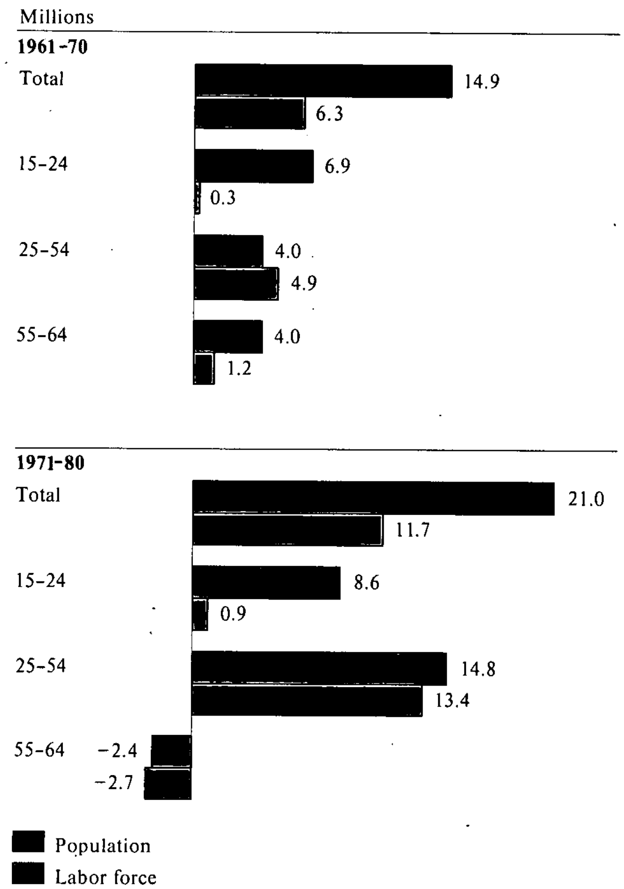
Western Europe: Population and Labor Force Changes, by Age Group



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nonwage labor costs rose rapidly, encouraging employers to trim work forces; and new industries were created too slowly to offset jobs lost in noncompetitive old-line industries. In 1982, these structural problems are estimated to have accounted for slightly more than 40 percent of the region's unemployment. The West European recession, which started in late 1980, caused an additional 27 percent of the unemployed, and frictional factors—normal labor turnover—accounted for the remainder.

25X1

Demographics

Western Europe's labor supply grew unusually fast in the past decade. From 1970 to 1980 the labor force expanded 7.7 percent—adding almost 12 million more prospective workers—compared with 4.3 percent growth, or 6.3 million workers in the 1960s. Much of the rapid labor force growth was caused by the changing age distribution of the population. The number of people in the prime working-age category—aged 25 to 54—jumped dramatically and was coupled with increasing female participation rates. Moreover, in the 1975 to 1980 period, the number of youths aged 15 to 24 looking for work jumped sharply for the first time in two decades because the downward trend in youth participation rates leveled off.

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Labor Costs

Surging labor costs depressed the demand for labor during the 1970s. In the Big Four countries, total real labor costs in manufacturing rose by an average of 60 percent between 1970 and 1980; in contrast, real labor costs in the United States rose only about 12 percent during the same period. With this rapid escalation in the price of labor, companies increasingly found ways to get more output out of each worker—either by buying more productive equipment or by eliminating featherbedding. For the most part, the productivity savings did not result in direct layoffs; firms simply did not replace retiring workers.

Labor costs in Western Europe rose rapidly because both wage and nonwage costs accelerated. The increase in direct wages accounted for more than one-half of the advance in total labor costs. Unions in Western Europe were particularly powerful in the early 1970s when economic growth was buoyant and they were able to secure sizable wage gains. For the decade real wages in Western Europe grew about 40 percent, whereas in the United States real wages grew only 2 percent. Nonwage costs, generally in the form of employer-paid fringe benefits, were rising even more rapidly. For the Big Four countries, these employer expenses more than doubled in real terms over the last decade and in several West European countries began to rival the cost of direct wages.

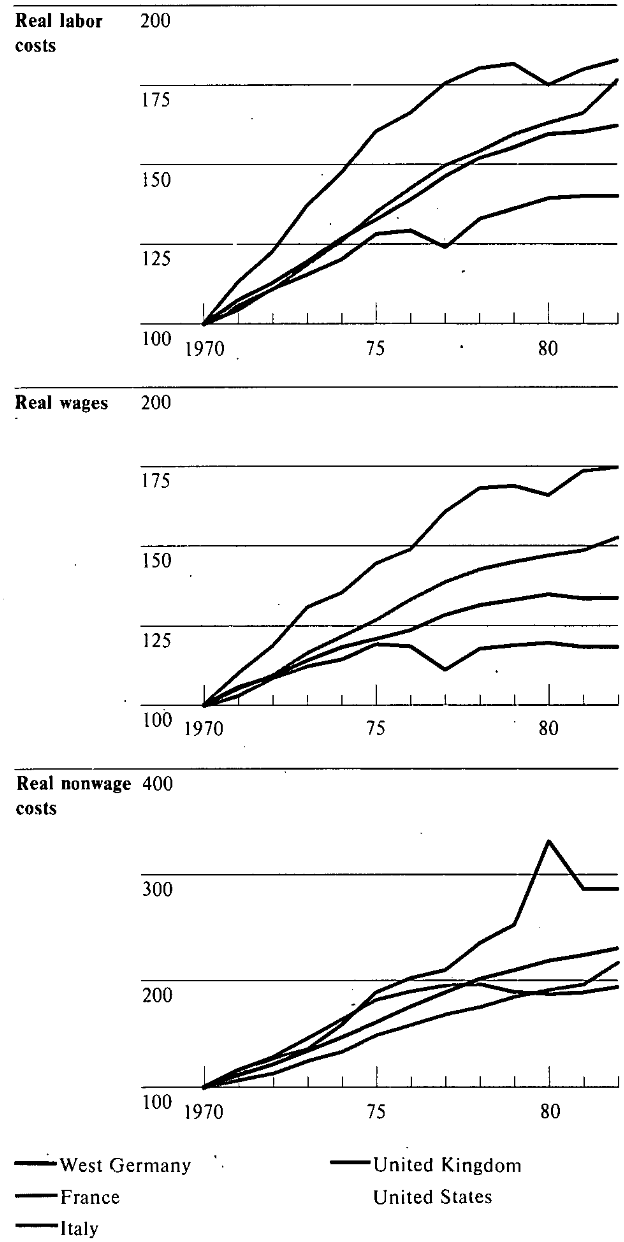
Restructuring

Western Europe's inability to adjust its economic base in the face of stagnant or declining output in traditional industries such as steel and textiles further depressed labor demand. Rapidly increasing labor costs and the advancing industrial sophistication of many LDCs have resulted in a number of old-line West European industries losing domestic markets to import competition. At the same time, Western Europe's agricultural employment has dropped dramatically—down 18 percent from 1970 to 1980. The region, however, has not moved

Big Four and the United States: Index of Total Labor Costs, Wages, and Nonwage Costs

Index: 1970=100

Labor costs, both wage and nonwage, rose faster in the Big Four than in the United States . . .



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rapidly enough into new employment areas such as high technology and services—two areas of exceptional growth in the United States—to offset employment losses elsewhere.

The region's inability to shift from "smokestack" industries to new, more advanced industries and services is a result of a number of complex and interrelated economic, political, and social factors:

- Much of labor and management in Western Europe appears satisfied with the status quo, preferring not to adopt new technology.
- A plethora of government regulations within West European countries has added innumerable delays and expenses to doing business and has decreased the private sector's flexibility.
- Venture capital is not readily available in Western Europe, and this has inhibited investment in the innovative, emerging companies needed to foster restructuring.
- The small size of individual West European country markets forces many companies to seek foreign markets, thereby adding more uncertainty to corporate planning and increasing marketing and production costs.

Government Policies

For the most part, governments are concentrating their efforts on relatively insignificant employment programs—such as reducing working hours and government subsidies for hiring long-term unemployed. These do little more than redistribute the present unemployment. Few countries are encouraging overall employment by holding down or reducing labor costs. Moreover, governments are continuing to prop up outmoded, uncompetitive industries rather than promote investment in new, more dynamic industries; according to the EC Commission, subsidies by member governments to their faltering steel industries totaled an estimated $20 billion between 1975 and 1981, and nearly that much again is planned through 1985. A number of West European governments are implementing small-scale programs to promote new industries in the high-technology area; these are unlikely to advance significantly the region's high-technology competitiveness. Indeed, the need for government programs reflects on the lack of private initiative. 25X1

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Prospects

Based on simulations of the CIA's Linked Policy Impact Model we expect the unemployment rate in Western Europe to remain in double digits through the end of the decade. For the region as a whole, the rate probably will edge up to 12 percent before trending downward after 1990. This forecast is based on several key assumptions:

- Labor costs will rise less rapidly than during the 1970s.
- More prospective workers will enter the labor force than in the past decade.
- Economic growth for the region as a whole will average 2.4 percent annually from 1985 to 1990.
- Restructuring will continue to proceed slowly. 25X1

25X1

Labor cost trends in the remainder of the 1980s should have a positive impact on employment because a number of factors affecting both wage and nonwage costs are working to limit the rise in total labor costs. Excess labor will continue to flood labor markets, thus putting downward pressure on real wages. The French, West German, and Dutch Governments already are cutting their generous social welfare programs, which in turn should reduce the growth in the employer's share of payroll taxes. Other governments are likely to follow suit. 25X1

Labor force trends, however, will be even more of a problem during the 1980s than in the previous decade. Projections by the OECD show that the

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Western Europe: Baseline Projection for Economic Conditions and Unemployment

Percent

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Western Europe									
Real GNP growth rate	0.5	0.8	2.2	2.4	2.4	2.4	2.4	2.4	2.4
Labor/capital cost ratio	2.2	2.0	2.1	2.2	2.2	2.2	2.2	2.2	2.2
Labor force growth	0.8	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.6
Employment growth	−0.5	−0.7	0.7	0.5	0.5	0.4	0.5	0.5	0.5
Unemployment rate	9.8	11.1	11.2	11.5	11.8	12.0	12.2	12.4	12.5
Big Four									
Real GNP growth rate	0.4	0.9	2.2	2.4	2.4	2.4	2.4	2.4	2.4
Labor/capital cost ratio	2.2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Labor force growth	0.6	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.3
Employment growth	−1.1	−0.6	0.5	0.3	0.3	0.3	0.3	0.3	0.4
Unemployment rate	9.4	10.5	10.6	10.9	11.2	11.3	11.4	11.5	11.5
West Germany									
Real GNP growth rate	−1.1	1.0	2.9	2.5	2.5	2.5	2.5	2.5	2.5
Labor/capital cost ratio	1.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Labor force growth	0.3	0.3	0.3	0.3	0.2	0.1	0	−0.1	−0.2
Employment growth	−2.3	−1.5	0.3	1.0	0	0	0	0	0
Unemployment rate	7.5	9.1	9.2	9.4	9.6	9.7	9.7	9.7	9.5
France									
Real GNP growth rate	1.9	−0.1	0.2	2.5	2.5	2.5	2.5	2.5	2.5
Labor/capital cost ratio	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Labor force growth	1.0	1.0	1.0	1.0	0.8	0.6	0.6	0.6	0.4
Employment growth	−0.3	−0.2	1.0	0.6	0.5	0.5	0.5	0.5	0.5
Unemployment rate	8.5	9.6	9.6	9.9	10.2	10.3	10.4	10.4	10.3
Italy									
Real GNP growth rate	−0.3	0.4	2.9	2.5	2.5	2.5	2.5	2.5	2.5
Labor/capital cost ratio	1.0	0.7	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Labor force growth	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Employment growth	−0.4	0	0.1	0.2	0.4	0.6	0.7	0.8	1.0
Unemployment rate	9.3	9.8	10.1	10.4	10.5	10.4	10.3	10.0	9.6
United Kingdom									
Real GNP growth rate	1.5	2.3	3.0	2.0	2.0	2.0	2.0	2.0	2.0
Labor/capital cost ratio	3.0	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Labor force growth	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Employment growth	−1.0	−0.4	0.5	0.3	0.3	0.2	0.2	0.2	0.2
Unemployment rate	12.3	13.3	13.5	13.8	14.2	14.6	15.1	15.5	16.0

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labor force will expand by about 13.7 million people during the present decade—an 8.4-percent increase compared with a 7.7-percent increase during the 1970s. In other words, Western Europe will need to create 13.7 million new jobs just to keep unemployment steady in the 1980s; during the past decade employment rose by only 5.3 million workers. 25X1

Slow economic growth will be another factor keeping unemployment high. For the remainder of the decade real GNP growth will do well to average 2.4 percent a year for the region as a whole, compared with an average of 3.3 percent annually during the 1970s. 25X1

The pace of industrial restructuring in Western Europe is likely to pick up somewhat as the recovery gets under way, but not by enough to appreciably change the region's employment prospects. Venture capital may become more available as domestic stock markets expand. Investment by existing companies in new production methods should increase as the economic recovery proceeds and profits improve. Businesses increasingly appear more willing to pursue joint ventures with US and Japanese companies to acquire new technology. Governments are just now beginning to address the economic rigidities created by excessive regulation. The West German Government, for example, established an interagency group to identify and eliminate regulations and requirements that inhibit market adjustment and increase costs for the private sector. Although these various factors are moving in the right direction, we believe many more economic, political, and social adjustments would be necessary for industrial restructuring to proceed fast enough to significantly reduce the unemployment problem. 25X1

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Iraqi Oil Export Options: Financing the War Effort [redacted] 25X1

Iraq's deteriorating economy has prompted Baghdad to seek ways to expand its crude oil exports and earn the revenues it needs to continue the war with Iran. With its export capacity limited to the single pipeline through Turkey to the Mediterranean, Baghdad is trying to win approval for a new pipeline through Saudi Arabia or Jordan. Even if a new pipeline is built, however, Iraq may still opt for a dramatic military strike in the hope of bringing about a resolution of the conflict with Iran. A separate pipeline to the Red Sea would enhance the security of Western oil supplies by providing an alternative to the vulnerable shipping routes through the Strait of Hormuz. [redacted]

Options To Expand Exports Through Existing Facilities

Iraq is in a serious financial bind because of the war-related loss in oil export earnings. We estimate that Iraq's foreign exchange reserves were about $5 billion at the end of 1983—compared with $35 billion before the war—and that the current account deficit in 1984 will reach $10-12 billion despite large cutbacks in development spending and imports. Reduced revenues resulting from the weak oil market have also led to cutbacks of about 80 percent in direct financial aid by Baghdad's Arab supporters since 1981. As a result, Baghdad has begun to examine methods of expanding crude oil exports. [redacted]

Prior to the war, Iraq's crude oil export network was the most flexible in the Middle East, with a total system capacity of about 5 million b/d—some 1 million b/d above Iraq's prewar productive capacity. Over 3 million b/d of the capacity was located in the two sea-island export terminals of Mina al Bakr and Khawr al Amaya, which were severely damaged at the onset of the war. By utilizing single-point mooring buoys, a temporary export facility with a capacity of 1.5-2.0 million b/d could be operating in about 10 months. Without a cease-fire, however, Baghdad would find it difficult to hire the Western expertise needed to install the temporary loading equipment or rebuild the permanent structures. [redacted] 25X1

The 1.2-million-b/d Iraqi pipeline across Syria was closed by Damascus in April 1982 in support of Iranian attempts to topple Saddam Husayn; there is little hope the line will be reopened soon. Currently, Bagdad's sole oil export route is the Iraqi-Turkish pipeline to the Mediterranean. In the midst of a capacity-expansion program, Iraqi officials claim the pipeline is currently capable of carrying 900,000 b/d of crude oil and will reach the planned maximum of 1 million b/d by mid-1984. [redacted] 25X1

25X1

New Export Options: Pipelines Through Saudi Arabia and Jordan

The Iraqis appear to have little likelihood of substantially increasing oil flows through their export system as it currently stands. The best hope Baghdad has for increasing oil exports now appears to be the construction of a new pipeline through either Saudi Arabia or Jordan. [redacted] 25X1

The Saudi Link. The most timely option to increase oil exports is to construct a link to Petroline, the Saudi oil export pipeline to the Red Sea. This option would require a 640-kilometer connector line to Petroline to utilize a portion of the excess capacity in the line, ranging up to 1.6 million b/d in recent months. [redacted] 25X1

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Phase Two: The Parallel Line. Baghdad views a link to Petroline as only the first phase of the project and hopes to eventually construct a separate pipeline parallel to Petroline, extending from the linkup point to the Red Sea. This phase would take about four years to complete and cost approximately $4.5 billion. [redacted] 25X1

25X1

The Jordanian Connection. During the past year Baghdad and Amman have been exploring the possibility of an export route across Jordan to the Red Sea. Few details of the project—which has received only a preliminary study—are available, [redacted] The trans-Jordan pipeline apparently would run from the vicinity of Baghdad to the port of al Aqabah. We believe its capacity most likely would be about 1.5 million b/d, similar to that of the proposed Saudi line to the Red Sea. Although no detailed design work has been done on this proposal, a US Embassy source in Amman estimated it would cost at least $1 billion and take about three years to complete. We believe some shortening of this work schedule might be possible, albeit at a higher cost. [redacted] 25X1

25X1

25X1

The View From Baghdad. Baghdad is seeking new sources of oil revenue; the most attractive alternative is the pipeline link to Saudi Arabia's Petroline. This project has the potential to provide an additional $5 billion in annual revenue by 1985, assuming exports of 500,000 b/d. The Iraqis may also feel that existence of the line might increase the likelihood of approval to construct the second phase of the project—the 1.5-2.0-million-b/d parallel pipeline to the Red Sea—which could provide as much as $20 billion a year in extra oil revenue at current prices. [redacted] 25X1

Iraqi Government officials, for their part, appear to prefer the Saudi pipeline option. In recent months key Iraqi officials—including Iraqi President Saddam Husayn—have publicly stated their preference for the construction of a spur to Petroline. We believe the Jordanian pipeline is less attractive to Iraq because it offers no economic relief for at least two years. Because of the uncertainties involved, the cost also almost certainly will be greater than the $1 billion mentioned. Moreover, the proximity of a Jordanian line to Israel would pose an added security concern for Iraq. [redacted] 25X1

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Iraq: Petroleum Export Options

Export Option	Volume (*thousand b/d*)	Leadtime (*months*)	Cost (*million US $*)	Remarks
Saudi Petroline link	300 to 1,200	10	700	Throughput volume depends on where the connection with Petroline is made; average throughput is currently estimated to be 500,000 b/d. Cost estimate is based on an accelerated construction schedule.
Iraq–Red Sea pipeline	1,600	54	3,600 to 4,500	Based on a 1981 feasibility study.
Jordan pipeline	1,000 to 1,500	36	Over 1,000	Line is still in preliminary study stage.
Persian Gulf single-point mooring buoy	1,500 to 2,000	10	110	Based on current plans, which assume no further damage and sufficient onshore pumping capacity.

[redacted] 25X1

Funding for either project does not appear to be a major problem. [redacted] 25X1

A key unanswered question for Baghdad is the net revenue gain expected with any of these options. The potential $5 billion gain from a Saudi connector line could be offset by reduced Kuwaiti-Saudi oil sales on Iraq's account—currently estimated at about 250,000 to 300,000 b/d, or up to $3 billion annually—and a further decline in Arab financial assistance. Although larger scale projects offer the eventual promise of significant oil revenue gains, they are probably at least two to three years away. In the meantime, Baghdad must continue to finance its domestic economic programs and pay for the war with Tehran. [redacted]

The Saudi Perspective

Saudi Arabia apparently has agreed in principle to Iraqi requests to build a pipeline that would facilitate Iraqi oil exports to the Red Sea. [redacted] 25X1

We believe the Saudis are now willing to allow construction of the spur to Petroline. In our judgment, Saudi leaders probably calculate that they can maintain full control over the spur, given its limited capacity and "dependence" on the existing Saudi pipeline. Given the outlook for continued weak oil demand and Saudi concerns over oil prices, Riyadh may believe such an option would also provide it with some control over the level of Iraqi exports. Riyadh probably hopes that its approval of such an arrangement—while offering no immediate financial relief to Baghdad—would ease Iraqi concerns over current export limitations, diminish Baghdad's growing sense of desperation, and preclude a major military escalation by Iraq in 25X1

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the war with Iran. Saudi leaders may also envision some financial dividends accruing to them from a linkup to Petroline through oil transit fees and the need for reduced economic aid to Iraq. [redacted]

We do not rule out the possibility, however, that Riyadh will drag out negotiations over the spur and try to postpone implementation of the project. [redacted]

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We believe it is highly unlikely that the Saudis will agree to the establishment of a separate Iraqi pipeline to the Red Sea. [redacted]

The Jordanian Viewpoint

An Iraqi pipeline through Jordan offers a number of opportunities for Amman [redacted] Oil transit fees would give the government much-needed additional revenue. An Iraqi pipeline would also provide an alternative to Saudi Arabia's Tapline as a source of crude oil for Jordan's Zarqa refinery and offers promise for the development of a petrochemical industry within the country. In addition, King Hussein probably views the project as strengthening Jordanian economic ties with Baghdad and an opportunity for Jordan to recoup some of the financial losses incurred as a result of the slowdown in both entrepot and direct trade with Iraq since 1982. [redacted]

Outlook and Implications for the West

Even the completion of a link to Petroline would not eliminate the pressure on Iraq's Arab allies for continued financial assistance, and Baghdad would still be forced to maintain its economic austerity program and keep imports at reduced levels—in 1984 about 40 to 50 percent below the 1981 peak of $20 billion. For military and political reasons, however, Iraq cannot indefinitely fight a war of attrition with Iran, and solving Baghdad's revenue needs does not guarantee that it will not eventually attempt a dramatic military strike to resolve the conflict. [redacted] 25X1

Should the Petroline link fail to materialize, we expect Iraq to persist in its effort to establish another alternative to exporting oil through the Persian Gulf. Construction of a separate pipeline to the Red Sea that resulted in increased Iraqi exports could have major implications for the West. If the project were completed in the next two to three years when most forecasters expect oil demand to remain weak, oil prices could come under downward pressure in the absence of production restraint by other producers. Over the longer term, the Persian Gulf is expected to account for over one-third of non-Communist oil supply availability. Any new export outlet that provides an alternative to shipping this oil through the vulnerable Strait of Hormuz will enhance the security of Western oil supplies and potentially reduce the impact of an oil disruption. [redacted] 25X1

[redacted] 25X1

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USSR: Andropov and the Consumer [redacted] 25X1

The Andropov regime appears to be taking a cautious approach on consumer issues. Without impinging on defense or industrial investment, it has little room for maneuver until the Food Program pays some return and more resources can be spared for consumer goods. Moreover, the regime does not view major improvements in consumption as an urgent necessity. Andropov has been careful not to raise consumer expectations, downplaying the material aspects of consumption and stressing instead the role of socialist values and popular commitment to the system as determinants of the overall "quality of life." As a result, Soviet consumers cannot look forward to better housing, improved services, or more widespread car ownership this decade. [redacted]

What Andropov Inherited

Among the most difficult challenges facing Andropov when he became General Secretary one year ago was improving worker performance just as the increase in real consumption had virtually come to a halt. [redacted]

Although the standard of living had improved substantially during the Brezhnev era, by the late 1970s the Soviet Union was clearly in the midst of a slowdown in economic growth that tended to force greater attention to investment in priority sectors like energy, transportation, and heavy industry. In addition, four successive years of disappointing agricultural production, combined with continuing growth in personal disposable income, led to widening gaps in demand for and supply of "quality" foods. Queueing; informal rationing; and special distribution of meat, butter, and milk spread widely during 1979-82. [redacted]

What Andropov Has Done

The range of responses that Andropov considers appropriate and feasible to deal with the stagnation in consumption is limited. Under Andropov, the regime has generally followed the Brezhnev approach to consumption problems: it has endorsed the 1982 Brezhnev Food Program, it is slowing aggregate income growth, and it is pursuing administrative measures intended to force enterprises to produce a better quality and assortment of consumer goods. Since early last year, several decrees relating to consumer goods and services have appeared; their general tone indicates high-level frustration and irritation that the variety, quality, and general availability of consumer goods and services 25X1 are not improving. But the decrees do not appear to provide many, if any, additional resources. [redacted] 25X1

Finally, Andropov is trying to grapple with a situation apparent in the last years of the Brezhnev regime: having relied increasingly upon material incentives instead of discipline, the regime had neither strong positive or negative incentives at its disposal to influence worker performance in a 25X1 period of slowing growth of real consumption. Although Andropov would like to have both, he recognizes that the economy is not going to provide much consumption growth in the near future, and, accordingly, he has taken several disciplinary measures to improve worker effort. [redacted] 25X1

The most recent measure dealing with worker discipline and incentives was a decree in August calling for tougher measures against absentees, drunks, and other offenders. It provides for loss of pay and vacation privileges, demotion, or even dismissal for those guilty of such offenses. Although initially the concept of worker discipline 25X1

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was applied to blue-collar workers and directed largely at absenteeism, drinking on the job, and high labor turnover, Andropov has extended it to society at large. The concept of discipline now implies social order and popular commitment to the system.

Although the discipline campaign provides the negative incentives, Andropov's approach toward remuneration is designed to be a positive motivator. Andropov has harshly attacked wage leveling, and he is making a stronger effort to link remuneration to the contribution of each worker. So far, however, little movement in the direction of broader pay differentiation has occurred. Instead, factory managers and trade union leaders have been told to reward better workers with more bonuses and privileges.

What Andropov's Policies Will Achieve

The consumer welfare policies and approaches espoused by Andropov to date are not likely to result in significant benefits for Soviet consumers.

The Food Program. Although the Food Program has long-run potential for more efficient food production, implementation probably will be slow. Even if the program's 1990 targets for per capita consumption of quality foods are met, consumption of desirable foods would still remain substantially below present per capita intake achieved in countries with comparable levels of economic development. In addition, because of high demand for quality foods and because personal disposable income will continue to grow, the supply-demand gap for these products is likely to remain large.

Adjusting Enterprise Incentives. The pronounced disequilibrium in markets for individual consumer goods and services can be traced to the inability of the planning system to ensure a mix of goods that would satisfy consumer demand at existing prices and to the failure of quality control at all stages. Enterprises generally lack interest in the marketing side of their operations, despite an extensive history of government efforts to change this attitude. A new performance indicator that tasks heavy industry to produce a specified amount of consumer goods per ruble of the enterprise's wage fund is not likely to help much because it does not relieve enterprises of the obligations to meet their primary output targets.

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Labor Discipline. Andropov's efforts to improve discipline will not endure unless some way of tying worker remuneration to performance is devised. Although a revision of wage norms to reward higher skill levels and output would be necessary to carry out Andropov's intention of promoting productivity, this step would not be sufficient. Labor productivity growth is hampered by several problems outside the individual worker's control, such as late deliveries of supplies, equipment breakdowns, and faulty technical specifications. As it is, workers receive only one-half their wages when they are standing idle through no fault of their own, a situation that contributes to poor morale and falsification of output statistics by managers unwilling to antagonize their workers. Finally, even if the wage system is eventually structured so that payment corresponds more closely to contribution to production, better workers will be left with the quandary of how to translate their relatively higher incomes into an improved standard of living if the desired consumer goods are not available.

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Slowing Wage Growth. Andropov has stressed publicly that the consumer economy is plagued by excess purchasing power. The imbalances in the Soviet consumer goods market, however, are more the result of shortages of specific goods desired by consumers than the consequence of excess purchasing power. Slower wage growth thus will help contain inflationary pressures but have little impact on specific shortages.

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Looking Ahead

The Andropov regime, while trying to dampen consumer expectations and to instill a more conscientious attitude among workers, still hopes to achieve some slow growth in the availability of consumer goods and services. The 1984 economic plan and the discussions surrounding the compilation of the 1986-90 plan will provide more clear-cut evidence regarding Andropov's intentions. We judge that Moscow would be highly reluctant to allow consumption levels to decline from their present level and will continue to import substantial quantities of consumer goods, in part by pressuring its CEMA partners for more deliveries. 25X1

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LDC Commodity Problems: Prospects for Natural Rubber 25X1

During his visit to Washington next week, Malaysia's Prime Minister Mahathir is likely to broach the issue of renegotiating the International Natural Rubber Agreement (INRA), which expires in 1985. Mahathir believes that natural rubber producers need "fair" remuneration and may push the United States to support an increase in rubber prices at next June's INRA negotiations. The OECD recession sent rubber and other commodity prices into a tailspin, which, together with sizable declines in export volumes, severely crimped revenues. Commodity exporting LDCs will be watching Mahathir's Washington meetings closely, looking for encouragement to press their demands for other commodities. 25X1

Rubber: A Case Study

The difficulties experienced by natural rubber producers are typical of problems facing most commodity-producing countries. In the mid-1970s, however, industry experts predicted a great future for rubber. They believed:

- Skyrocketing oil prices would limit competition from synthetic rubber.
- Giant strides being made in natural rubber production technology would boost yields by up to 50 percent.
- The establishment of the Association of Natural Rubber Producers would benefit producers.
- Enormous surpluses that plagued other commodities such as copper and sugar could be avoided by natural rubber producers. 25X1

These promises went largely unfulfilled, and in the past few years the outlook has soured. A key problem was the drop in demand and price caused by the prolonged recession in the major OECD markets. From a record high of 80 cents per pound in 1980, rubber prices plunged nearly 50 percent by November 1982, severely crippling export earnings. Not all natural rubber producers were hurt equally. Thailand and Sri Lanka benefited from expansion projects that began in the late 1970s, which enabled some increases in export volumes. Even so:

- Thailand's earnings from natural rubber fell by nearly one-third over the 1981-82 period to $413 million, even though sales volume grew by nearly one-fifth.

- Sri Lanka's export earnings from natural rubber fell to $109 million in 1982, one-third lower than the peak level reached in 1979. This occurred despite a 2-percent increase in sales volume. Other producers experienced the full brunt of the recession.

- In comparison with 1980, Malaysia's 1982 export earnings from natural rubber fell 45 percent to $1,144 million, the lowest level since 1977.

- Indonesia's sales of natural rubber brought in an estimated $555 million last year, down more than 50 percent from the peak year of 1980.

- Liberia's estimated export earnings from natural rubber of $50 million in 1982 were the lowest in nearly a decade. 25X1

After previous recessions, exporters were able to look forward to a sharp rebound in prices and sales. Producers may be in for a major disappointment, however, because the demand factors that caused the recent falloff in consumption seem likely to continue throughout the current recovery. Beyond 1984 prospects for world economic growth of

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roughly 3 percent per year over the next decade suggests a long-term demand growth rate of at best about 1.5 percent per year for natural rubber. This is half the 1960-79 average.

Even if the rate of world economic growth and the demand for rubber from the transportation sector increase more than expected, natural rubber may not benefit:

- Markets are being eroded substantially by new technology. Competition from synthetic rubber, which already holds 70 percent of the rubber market, is likely to intensify. Declining profit margins have forced synthetic rubber producers to become even more efficient, and to develop new products and markets.

- Shifting demand, due to energy conservation efforts and changing tastes, has reduced markets. The downsizing of cars, increased use of mass transit, and longer wearing tires are cutting back natural rubber use.

Of these two factors, we believe the challenge from synthetics is more significant. Synthetic rubber producers are in a better position to rapidly expand output; industry data show that nearly one-third of rubber-producing capacity currently is idle. As long as oil prices remain relatively stable, prospects are bleak that natural rubber producers can reverse the shift toward greater use of synthetic rubber. Moreover, the backward integration by tiremakers and forward integration by petrochemical producers into synthetic rubber production further encourage the production and consumption of synthetic rather than natural rubber.

Producer Response

Despite the slowdown in world demand, rubber producers have increased production. Since the early 1970s output has grown by about 1 percent per year. Investment projects now under way are aimed at maintaining this level of output growth:

- Thailand has successfully implemented its program to replant 160,000 hectares of rubber trees. As a result, industry experts expect output to grow by 20 percent between 1982 and 1985. 25X1

- Indonesia announced in 1979 a plan aimed at replanting 250,000 hectares in the smallholder sector between 1981 and 1985. Jakarta has recently announced that it will open up new areas to encourage planting of 180,000 hectares on some of the smaller islands. Together, these two programs could add about 15 percent to Indonesia's rubber output by the early 1990s.

- Malaysia has already begun implementing plans that call for some 50,000 hectares of new plantings a year between 1981 and 1985, about double the rate achieved in the 1970s. 25X1

To protect export earnings in the face of declining prices, the major natural rubber producers banded together in 1980 under UNCTAD auspices to establish the International Natural Rubber Agreement. At roughly the halfway mark in the first five years of its scheduled operation, the INRA has experienced more problems than successes: 25X1

- Buffer stock purchases have failed to keep prices from falling below the lower limit of the stabilization band during the first two years of INRA operations. Purchases had to be suspended because of a shortage of funds, and members are refusing to provide additional monies for this purpose, according to trade journal reports.

- The large quantity of rubber already in the official INRA stockpile—about 260,000 tons—is having a depressing effect on the recovery of rubber prices. 25X1

- Rubber price fluctuations have not been appreciably reduced. In the first three years of the agreement, average yearly fluctuations have been about 25 percent, greater than the average of the last 10 years. 25X1

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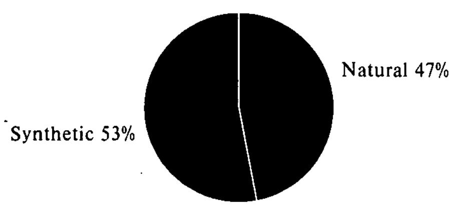
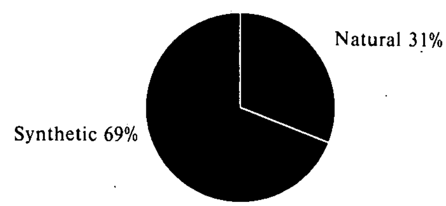
Natural Rubber at a Glance

Market Shares: Natural and Synthetic Rubber

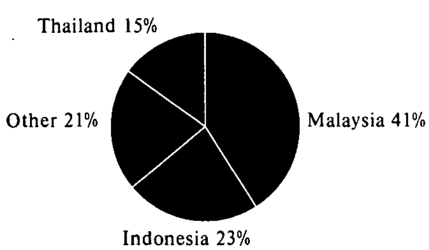
1960: 4.5 million metric tons



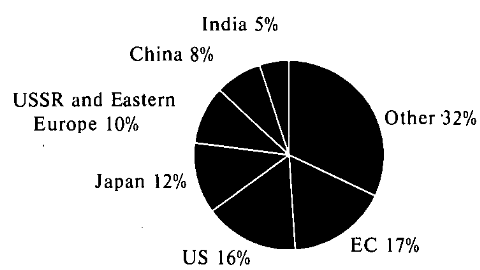
1980: 12.4 million metric tons



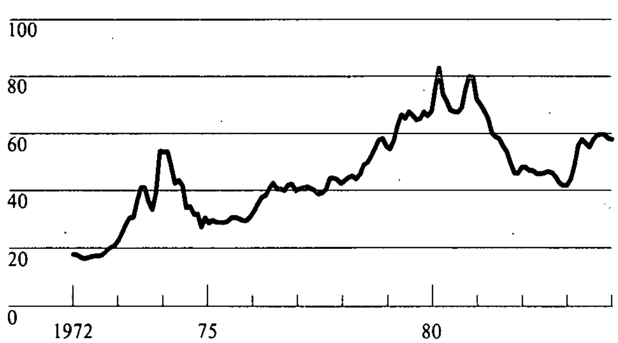
World Production, 1982



World Consumption, 1982



Natural Rubber Prices
US cents per pound



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More importantly, the key producers cannot agree on a future course of action. Malaysia, which produces nearly twice the rubber of its nearest competitor, is pushing for renegotiation of the current agreement that expires in October 1985. Kuala Lumpur would like a new agreement based on production and export controls rather than on a buffer stock. This would serve to guarantee Malaysia's current market share. Indonesia and Thailand, with greater potential to increase output, are pressing to retain the buffer stock but with higher floor and ceiling prices. In our view, these issues will be hotly contested at future INRA meetings as positions are prepared for the first UN Rubber Renegotiating Conference scheduled for June 1984. 25X1

Lessons From the Rubber Experience

Technological change will continue to undercut LDC commodity producers. Just as the development of a wide range of inexpensive synthetics has cut sharply into natural rubber's traditional markets, new processes and products are displacing other traditional commodities in the marketplace, some at an astonishingly rapid clip. For example:

- The sweetener market has been radically transformed by the introduction of a continuous enzymatic process for mass production of high fructose syrup made from corn (HFCS). By 1985 or 1986, industry analysts predict that HFCS consumption in the United States will have captured one-third of the domestic caloric sweetener market. This trend will soon spill over to the other OECD countries, greatly hurting world sugar demand.

- Optical fibers made of silicon glass are outcompeting copper wires in communications applications because of their greater message-carrying capacity.

- Composites (fiber-reinforced plastics), single-crystal and amorphous metals, and ceramics are displacing traditional materials such as iron and steel, aluminum, cobalt, and superalloys in aircraft and automobile bodies and engines. The technology to build an airframe entirely out of composites has already been demonstrated. The rate at which these exotic materials penetrate the metals market now depends only on cost factors.

- Manmade fibers have revolutionized the markets for thread, cloth, yarn, carpeting, and upholstery. From only 2 percent in the 1950s, manmade fibers rose to 44 percent of total world fiber output in 1982. In the United States, synthetics now hold 75 percent of the overall textile market. The easing of oil prices will help keep synthetics costs competitive. 25X1

The LDCs, in response to this technology onslaught, have continued to push for commodity agreements incorporating price controls, buffer stocks, quotas, and other market-sharing devices—not only in rubber, but in most commodities. Under the aegis of the UNCTAD Integrated Program for Commodities, the LDCs still hope to eventually bring 18 key commodities under some form of control, financed by a Common Fund. Although the rubber agreement is the only commodity agreement established through UNCTAD's efforts, talks and negotiations are continuing for cotton, hard fibers, jute, tea, tropical timber, bananas, and bauxite. 25X1

The problems the rubber agreement is having serve to illustrate some of the deficiencies of all commodity agreements. These include:

- *Direct cost.* Industry specialists estimate, for example, that a 500,000-metric-ton buffer stock would be needed to defend a 10-percent price band. At 50 cents per pound, the cost would come to about $550 million.

- *Inefficiency.* Commodity agreements that rely on quotas based on historical production or export averages to allocate market share tend to penalize new, more efficient entrants into the market.

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- *Indirect cost*. Because the effect of most commodity agreements is to raise the long-run average price above what it would otherwise be, they raise the cost to all consumers of products using the controlled commodity and encourage substitutes. 25X1

The LDCs are unlikely to achieve higher earnings by pushing commodity agreements. For most producers, however, the costs—both economic and political—of shifting out of raw materials with a dim future are high, especially given the foreign financial bind many of them face. Any adjustments taken now would come at a time when governments in debt-troubled LDCs are being asked by creditors and the IMF to tighten their belts until they can get their foreign finances in order. 25X1

US support for additional multilateral commodity agreements might ease LDC earnings problems in the short run but would perpetuate the basic excess supply problem of most commodities. Eventually, the commodity producing LDCs will begin to restructure their economies. Although we doubt that the LDCs will give up on their push for commodity agreements, we believe they will primarily seek US support in the form of development financing and market access for the products they produce in place of commodities. 25X1

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