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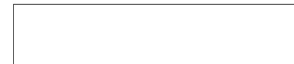

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Synopsis

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1 **Perspective—*Eastern Europe: Adjustment Efforts***

Most of Eastern Europe has made progress in adjusting to the Western credit squeeze and reduced Soviet subsidization. Over the next several years, East European leaders may be forced to make tough decisions to burden already disgruntled consumers and to reform their Soviet-style management systems.

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17 **Eastern Europe: Adjusting to the Debt Crisis**

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Eastern Europe's economic decline seems to have bottomed out, and some growth in trade and GNP is likely in the near term.

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25 **EC–Eastern Europe: Limited Trade Dialogue**

25X1

Despite attempts by countries in Eastern Europe to secure greater access to West European markets, the European Community so far has negotiated only limited bilateral trade agreements—largely for political purposes—and has avoided making concessions that would weaken Western Europe's already troubled industrial sector.

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31 **Eastern Europe: Declining Soviet Support**

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Trade results for 1983 show that Soviet economic support for Eastern Europe declined significantly for the second consecutive year. The East Europeans hope to slow this trend at the upcoming CEMA Economic Summit, but prospects for relief appear limited.

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37 **USSR-Finland: Economic Ties**

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Moscow has turned increasingly to Finland as a source of advanced machinery and equipment.

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41 **Chile's Military: The Impact of Economic Crisis**

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Chile's economic decline has caused President Pinochet to tightly control military spending. Although he has accomplished this without provoking military officers, escalating unrest could cause the military to reassess its domestic political role.

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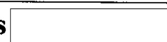
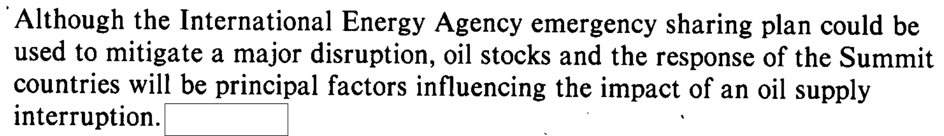
47 **Summit Issues: Oil Emergency Response Programs**  25X1


Although the International Energy Agency emergency sharing plan could be used to mitigate a major disruption, oil stocks and the response of the Summit countries will be principal factors influencing the impact of an oil supply interruption. 25X1

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Perspective

Eastern Europe: Adjustment Efforts

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Most of Eastern Europe has made progress in adjusting to the Western credit squeeze and reduced Soviet subsidization. East European adjustment policies have been influenced by concerns about unrest similar to those of Third World debtors. Although debt problems have eased slightly and growth has revived, the timidity of the region's adjustment measures, their intractable internal constraints, and the largely hostile external environment imply no easy fix to economic problems. Over the next several years, East European leaders may have to make tough decisions that would force them to burden already disgruntled consumers and to reform their Soviet-style management systems. One positive result of recent problems may be a new stimulus to reform, now that Soviet and Western cushions are diminishing.

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Eastern Europe's debt problems peaked in 1982 at the same time that the CEMA members had to deliver more goods to the USSR to reduce trade deficits and to offset deteriorating terms of trade. Adjustment was already under way—with some debt relief arranged—by the time that the debt crisis hit Latin America. Eastern Europe had little choice but to close the door on imports as sources of credit dried up and exports lagged because of the Western recession. Because there was no time to deal with longstanding problems of export competitiveness, the regimes took quick and comparatively easy steps to try to adjust.

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The first step was to deflate their domestic economies to shift resources to exports. The policies chosen demonstrate that the lessons of the Polish crisis at least initially weighed heavily on the minds of the East European leaders. To forestall political unrest, total consumption—public and private—has been less affected than investment. With the exception of Poland and Romania, most countries have registered positive—albeit slow—growth in real consumption over the past three years. Even in Poland, Warsaw's attempt to win a modicum of popular support led to a rise in real consumption in 1983 after previous sharp declines.

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Investment in fixed capital has undoubtedly suffered even though there is considerable fat in East European investment budgets resulting from overspending on inventories and unfinished projects. This will impair necessary modernization and improved competitiveness. The short-term protection of consumption may not be worth the longer term cost in terms of poor prospects for growth and exports, as well as living standards.

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Adjustment measures—combined with Western financial help—have brightened the financial picture for most of the region. Net debt has declined for all countries except Poland and Yugoslavia, and borrowing prospects have improved. Creditors have been impressed with the region's improved trade performance, as well as the lack of serious political unrest over stabilization measures. The West helped in terms of rescheduling for Poland and Romania, refinancing and credits for Yugoslavia, credits for Hungary, and the opening of the West German umbrella over East Germany. In the cases of Poland and Romania, however, the help has protected the interests of Western creditors more than improved the financial situation of the debtors. In any case, we expect credit flows to remain well below the peaks of the 1970s, in part because of the caution of both Western creditors and East European borrowers. 25X1

Most countries remain vulnerable to further liquidity problems and external shocks from both East and West. In addition, financing requirements—although lower except in Poland—still are burdensome. For the reschedulers, the day of reckoning is fast approaching when the period of debt relief will end. Most have not taken the steps needed to sustain improved performance, and little progress has been made in generating the hard currency needed to repay the debt. The outlook for East Germany, Hungary, and Yugoslavia is far brighter than for Poland and Romania, while the debt crisis had little impact on Bulgaria and Czechoslovakia except to reinforce their financial conservatism. 25X1

Some of the East European countries continue to look for help from Western governments, banks, and international financial institutions and for better treatment of their goods in West European markets. But the region will continue to suffer along with LDC debtors—some of whom can compete more effectively—as a result of Western Europe's gradual recovery. Political forces may lead to more trade and credits, but the political stalemate over Poland remains a problem; Western hopes for political liberalization and economic reform are now focused on Hungary. 25X1

The USSR's economic problems are likely to preclude increased assistance to its CEMA partners. The CEMA Summit in June will help clarify whether the economic squeeze on Eastern Europe will tighten and what steps toward greater integration and cooperation the Soviet Bloc will take. Some hints of joint economic policies over the next five-year plan period (1986-90) may emerge. Some East Europeans also may hope to obtain clues about Soviet toleration of economic reform, but early indications are that they expect little good news at the Summit. 25X1

In the case of Eastern Europe, fine tuning of adjustment policies and help from East and West are not enough. Sustainable improvement is not likely without fundamental reforms—except possibly in the case of East Germany. Even with reforms, the regimes still must deal with the secular decline in productivity and diminishing increments to the capital stock and labor force. In any case,

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decentralization and introduction of market forces are needed to enhance efficiency in investment and foreign trade decisions and to improve worker incentives. Hungary is the only country where reform measures have been combined with stabilization policies, and even here there has not yet been much of a payoff in industrial efficiency and higher exports. At the same time, the political fallout could be serious both internally and as a result of recent criticism from Moscow and Prague. Although tinkering will continue, we expect the CEMA countries to await encouragement from the Soviet leadership before taking major steps.

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Briefs

Energy

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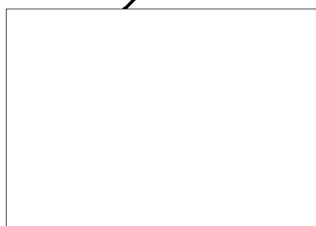
Libya Fears British Pullout



Tripoli fears that the current political friction between the United Kingdom and Libya could cause an overzealous Libyan citizen to retaliate against British nationals living in Libya, forcing their recall by London. Such a move could seriously cripple the country's oil operations for at least three to six months, until other foreign nationals could be recruited to replace them. British personnel occupy key management and technical positions in two of the major oil companies operating in Libya, and their expertise is critical to maintaining the output of the largest single oil producer in Libya, The loss of British oil workers would expand the already serious exodus of managerial and skilled technical personnel—both Libyan and foreign nationals—that has taken place during the past 10 years. If this occurs, Libya's production capacity could begin to deteriorate and many of the country's ambitious downstream projects, such as the refinery and petrochemical complex at Ra's al Unuf, could be further postponed.

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Aramco Security Remains Lax

Increased threats to oil facilities from the Iran-Iraq war and from terrorists have caused senior Aramco management to continue its campaign of attempting to raise the security consciousness of employees. these efforts are being viewed with cynicism by many Western workers. many expatriates feel that the company is actually covering up threats to their personal safety—for example, Aramco's attempt to downplay the sinking in March of one of its service vessels, probably by a Iraqi missile—and that physical security procedures within the company still remain relatively lax. Although a personal identity card is required for access to most Aramco facilities, most guards apparently fail to positively identify personnel. people have been allowed aboard drilling rigs simply by displaying a credit card and that only a cursory check of bags or luggage is usually conducted. This lack of security is contributing to unease among Aramco's expatriate work force, whose morale is already low due to the curtailment in recent months of many personal activities by Saudi religious authorities.

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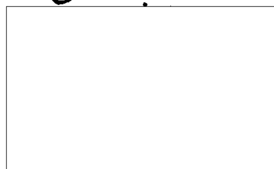
Saudis Request Bids on New Refinery



Saudi Arabia recently called for bids on the construction of a $250 million lubricating oil refinery at the Yanbu industrial complex on the Red Sea, according to the trade press. The million-barrel-per-year refinery, a joint venture between Petromin—the Saudi Government oil-marketing company—and a major US multinational oil corporation, would meet all the country's domestic lube oil needs plus provide an additional 350,000 barrels per year for export. Financing problems and a final decision on the location of the plant

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have delayed release of bids for almost a year, and availability of funds may yet impede the project.

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Riyadh currently is asking the companies to cover 60 percent of the cost with either contractor or export-import credits, while the remainder would come from the joint venture's equity fund and Saudi commercial financing.

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Iraqi Oil Assistance Program Renewed

The US Embassy in Kuwait reports that the Saudi-Kuwaiti oil assistance program for Iraq will be extended another year. Under terms of the agreement, Saudi Arabia and Kuwait will continue to provide Iraq's customers with 248,000 b/d of crude produced by the Arabian Oil Company (AOC) in the Neutral Zone. AOC will deposit the revenues accrued from the sales directly into the foreign accounts of Iraq's national oil company. The new agreement goes into effect on 1 August and is worth $2.5 billion. Saudi Arabia and Kuwait provide Baghdad's customers about another 85,000 b/d from their own production.

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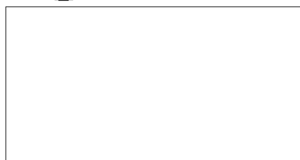
Dutch Gas Price Flexibility



The Netherlands—Western Europe's largest gas supplier—has indicated a willingness to provide additional gas supplies to Italy at the present price, according to US Embassy reporting. Two months ago, the Dutch were demanding a higher price as a premium for being a secure gas supplier, The Hague's softening on prices follows recent bidding to sell gas to the United Kingdom; the Dutch were surprised to learn their offer was less competitive than the Norwegian offer. Dutch price flexibility bodes well for consumers with gas contract renegotiations this year, especially because additional volumes of Dutch gas are likely to be made available. Larger Dutch gas supplies have the potential to partially meet future demand growth and minimize Soviet sales until the Norwegian Troll Field can be developed in the mid-to-late 1990s.

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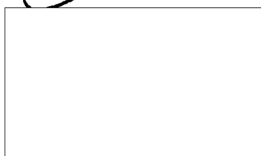
Indonesian Price Adjustments



Indonesia has adjusted export prices of several types of its crude oils and other fuels retroactive to 1 April. the price of Duri crude will fall from $27.85 to $25.95 per barrel; the price of Arun condensate will drop from $30.95 to $29.00. Jakarta intends to raise the price of its residual fuel by 25 cents per barrel to $27.25. These moves are unlikely to draw criticism from other OPEC members because there is no price change for Indonesia's Sumatra light crude that is pegged to OPEC's benchmark prices. the price adjustments are "long overdue" and reflect the continuing weak oil market.

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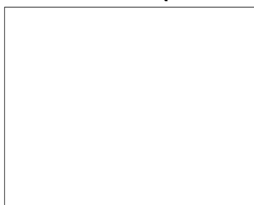
International Finance

South American Debtors Urging Less Austerity



Argentina's leading role in South America in calling for economic growth, rather than continued spending cuts, as the solution to foreign debt problems will put new strains on international financial rescue programs. Buenos Aires fears the political consequences and is opposed to implementing an IMF-supported adjustment program that might cause even a brief recession. The Argentine Government instead intends to stimulate growth to increase popular support and to generate the financial resources for debt repayment.

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Chile, according to new Finance Minister Escobar, is seeking to relax spending limits under its IMF program to create jobs and to reduce unemployment. The US Embassy in Brasilia reports that major contenders for the presidency are appealing to popular dissatisfaction with austerity and are calling for more growth. Venezuela is avoiding an IMF agreement in order to stimulate its economy.

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Argentina's position will find increasing favor in other South American countries, which are widely criticizing continued declines in economic activity as politically dangerous. Any financial declaration by these countries issued before the London Economic Summit would be likely to embrace this new rationale to blunt austerity programs, but there is no evidence of any coordinated approach to the debt issue. Nonetheless, difficult relations with foreign creditors probably will result as the debtors urge the IMF to ease spending constraints. Foreign commercial bankers may support easier repayment terms to stimulate growth, but they are reluctant to extend new loans.

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Argentina's Domestic Economic Woes

President Alfonsin's failure to curb inflation is causing labor unrest and could undermine the government's economic program. Price rises, according to US Embassy reports, slowed moderately in January, but prices rose 20 percent in March, double the expected rate. A wage policy that grants salary increases in excess of price rises has been a major factor in keeping inflation high, according to the Embassy.

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The increase in prices, has helped to unify the Peronists. Their demands for higher wages have intensified, and the number of strikes by Peronist-led unions has increased in the past several weeks. Two weeks ago the Peronists publicly rejected collaborating with the government on economic policy and vowed to resist a slowdown in salary increases. In an effort to reach an agreement with the Peronists, Alfonsin recently appointed a representative to try to mollify labor, and he began talks with Peronist political bosses, according to press and Embassy reporting. Last week Alfonsin replaced his combative labor minister with a moderate who, according to the Embassy, is more acceptable to the Peronists.

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Failure to slow inflation is likely to encourage investors to shift funds from productive ventures to more speculative fields. Labor is almost certain to call for more wage hikes, which Alfonsin will be hard pressed to resist. Further salary increases will complicate both Alfonsin's domestic growth strategy and his relations with foreign lenders whose credits are vital to industrial recovery. Additional wage hikes, however, are unlikely to placate Peronists, who seem inclined toward confrontation. Peronist leaders also probably will try to exploit Alfonsin's setbacks before the congressional elections scheduled for next year. Moreover, the economic problems have opened rifts in Alfonsin's own party, which will complicate his efforts to cope with the Peronist challenge.

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Philippine Financial Negotiations

The IMF and Manila's commercial creditors are beginning to disagree over the amount of new financing to be provided in the Philippines' debt rescheduling agreement, The IMF is concerned that the $3.3 billion in new credits originally intended to cover the Philippines' financial needs this year will be insufficient to tide it over through the end of 1985. the IMF is proposing that an additional $700 million be

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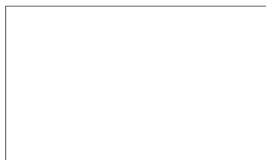
added so that Manila will not have to ask for money again early next year. The proposal would raise to $2 billion the amount to be supplied by commercial creditors, who would prefer instead that Manila return to the negotiating table in early 1985 to ensure the government's accountability for economic policy reform, 25X1

Manila's principal commercial creditors will meet on 7 and 8 May in New York to consider the issue. The commerical creditors will be reluctant to come up with more than $1.65 billion this year. They already believe this amount would be hard to raise because many small banks may refuse to contribute. The banks probably will insist that the IMF stick to its original proposal in order to avoid lengthy rescheduling negotiations after the Philippines and the IMF reach agreement on a $650 million standby loan. 25X1

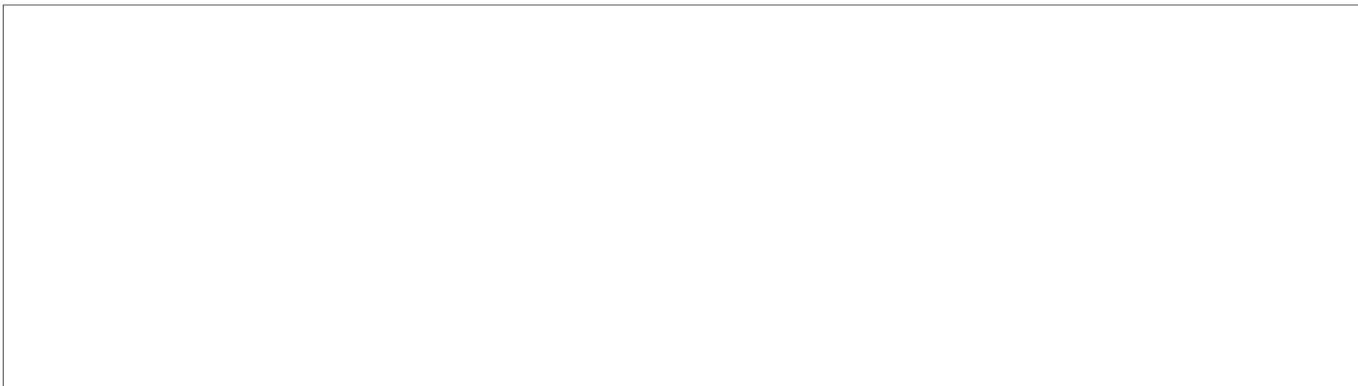
Summit Issues

Japan's New Trade Package



Prime Minister Nakasone is characterizing the trade liberalization measures he announced last week as a demonstration of Japan's willingness to take its proper role in strengthening the free trade system. The package focuses on tariff cuts. It also includes measures to promote imports and investment and statements on energy cooperation and on the possibility of future purchases of foreign communications satellites. In addition, Tokyo emphasized its recent steps to reduce trade frictions over agricultural products and high-technology imports. Tariff reductions on some agricultural goods, however, such as forestry products, were omitted because of opposition by the farm bloc among Diet members, according to Embassy reporting. 25X1 25X1

Although the package is directed primarily at improving relations with the United States, it also addresses concerns of the West Europeans and less developed countries. Nakasone wants to use the package to smooth the way for a visit by Vice President Bush and also to set the stage for a successful performance at the London Economic Summit. The Prime Minister, who is facing difficulty getting his domestic program through the Diet, needs foreign policy successes to maintain his political strength. 25X1



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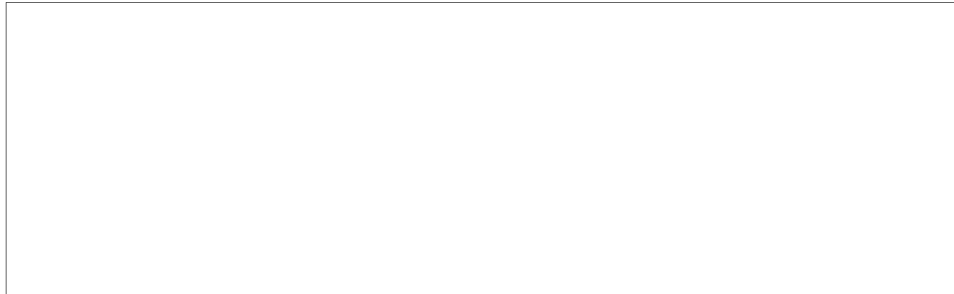

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French Economy Slightly Stronger Than Expected

French real GDP rose 1 percent in 1983, a stronger performance than had been anticipated. As a result, Paris is likely to claim it is making economic adjustments without creating a recession. A 2.3-percent increase in exports and reduced demand for imports were important in spurring GDP growth. Private consumption spending, however, rose by only 0.8 percent, the slowest growth in the past 10 years. Although real investment fell for the third straight year and is causing concern over the long-run prospects for the economy, retained earning of firms jumped 30 percent. Last year's improved current account balance, slowed consumption, and improved financial position of firms are all objectives of the French austerity program.

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First-quarter data indicate, however, that the French are likely to maintain austerity. The first-quarter current account deficit, although better than in the first quarter of 1983, still ran at an annual rate of about $7 billion. In addition, inflation was slightly more than 8 percent at an annual rate. We expect both President Mitterrand and Finance Minister Delors to use these results to argue that austerity is working but is still necessary.

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Global and Regional Developments

Brazilian Steel Export Reduction

Brazil decided last week to voluntarily reduce exports of certain carbon steel products to the United States by 47 percent. Last year, the United States accounted for about 70 percent of Brazil's foreign steel sales. Earlier this year Brazil tried and failed to negotiate a voluntary restraint agreement with the United States in an effort to avoid the imposition of antidumping and countervailing duties. In late March, in an attempt to offset US countervailing duties, Brazil levied a 27.4-percent export tax on the carbon steel products—cold-rolled sheet, hot-rolled sheet, and carbon steelplate in coil—under investigation. The tax, however, was imposed too late to be incorporated into the Commerce Department's deliberations, which found that Brazilian subsidies amounted to a weighted average 37 percent of the value of shipments.

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The Brazilian steel export quota was accompanied by other actions designed to discourage the United States from imposing countervailing duties. A law

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introduced in the Brazilian congress on 26 April would allow Brasilia to retaliate against countries that introduce restrictive measures against Brazilian products. In addition, Brazil is working to publicize its determination to appeal the countervailing duty decision through US courts or bring it before the GATT. [redacted] 25X1

Impact of Mozambique–South African Security Agreement

The short-term economic benefits to Mozambique of its recently signed security pact with South Africa are likely to be minimal. If the accord holds—by no means a certainty because of deep mutual distrust—it will only slowly reduce the damage being done to Mozambique's transportation and communication network by South African-backed insurgents and will clear the way for Western aid. Other potential economic benefits—a share of revenues from the Cabora Bassa dam, greater private foreign investment, and increased transport fees—will promote development but only over the longer term. [redacted] 25X1 25X1

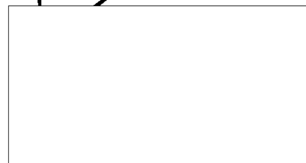
Representatives from South Africa, Mozambique, and Portugal have been discussing ways to restore profitability to the giant Cabora Bassa dam, a hydroelectric project in Mozambique that is owned by Portugal and supplies South Africa with electricity. Low tariffs and sabotage of transmission lines have made the dam a financial drain on Portugal. An agreement to double tariffs and to give Mozambique a bonus if it can protect the facilities from sabotage reportedly is about to be signed in Cape Town. Security problems, however, are likely to continue to limit any significant increase in the dam's foreign exchange earnings. [redacted] 25X1

Foreign investment opportunities in Mozambique—such as agricultural processing facilities—will remain limited until there are repairs to the infrastructure and a streamlining of government policies. South African investment discussions so far have centered on tourism and port facilities. A South African company has agreed to build a $40 million luxury hotel on Inhaca Island. The same company has expressed confidence that the port of Maputo—the closest port to South Africa's industrial heartland in the Transvaal—could be profitably repaired and updated. Before Mozambique's independence, the port at Maputo handled some 6 million metric tons of South African goods per year, third after Durban and Port Elizabeth. Expansion of the Durban port facilities and competition from the newer and more secure facilities developed by South Africa at Richard's Bay have reduced tonnage at Maputo to 1.1 million tons per year. [redacted] 25X1

National Developments

Less Developed Countries

Saudi Arabia's Budget



Recently released official data indicate that Riyadh is still trying to weather the slump in oil revenues without resorting to large and politically sensitive

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spending cuts. The budget for the fiscal year that began on 1 April projects expenditures of $74 billion compared with the $63 billion the government claims it spent last year. The biggest increase is slated for military purchases, but allocations for consumer subsidies and all other major categories are up as well. Riyadh anticipates that oil and other revenues will total $61 billion.

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Riyadh probably hopes its larger budget will signal that the current financial difficulties will not cause a slowdown in economic activity. The decision to boost military spending and consumer subsidies probably reflects the royal family's decision to keep key interest groups satisfied. Nevertheless, revenues are likely to be somewhat lower than projected, which will leave Riyadh with difficult choices later this year about where to make spending cuts. One way Riyadh kept spending down last year was to delay payments on at least $10 billion owed to foreign contractors.

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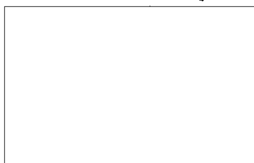
South Korea Eases Restrictions on Foreign Banks



Seoul's financial sector reforms—announced 20 April—provide most of the concessions sought by foreign bankers, including access to Bank of Korea rediscount facilities by 1986. We believe Finance Minister Kim Mahn Je and other market-oriented economic policy makers convinced President Chun that their plans for opening the country's heavily regulated financial sector by allowing increased foreign competition would spur domestic banks to improve their efficiency. In addition, Seoul hopes that the banking concessions will combine with recent import liberalization measures and an easing in foreign investment regulations to reduce economic friction with Washington and help diffuse US protectionism. Implementation of the financial reforms, in our view is likely but not necessarily assured as the measures will face tough questioning in the National Assembly.

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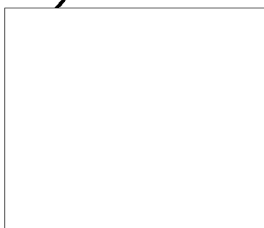
Dominican Republic Economic Pressures



Tensions remain high as price increases on basic commodities and planned hikes on petroleum products threaten to push inflation to 40 percent this year compared with 10 percent in 1983. These price hikes will particularly hurt the unemployed and underemployed; estimates run as high as 60 percent of the work force. So far, the government has promised to back wage hikes now before Congress and to expand the social security system but has not met union demands to rescind the price increases on basic commodities, which sparked the recent violence. Strict budgetary controls that are required under the IMF-supported adjustment program will limit wage increases and probably will require new taxes. Nevertheless, President Jorge Blanco appears determined to carry out austerity while maintaining public order by granting limited concessions and by continuing tight security. Negotiations with the IMF on the second year of a three-year agreement, however, could last well into May, requiring Jorge Blanco to expand his search for official and commercial bridge financing.

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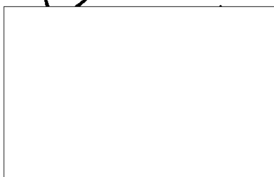
Brazil's Manufactures Imports To Rise



Brasilia's efforts to spark an export-led recovery will require increased imports of manufactured products this year, an adjustment that probably will not jeopardize meeting targets under its IMF program. In 1983 we estimate that Brazil's imports totaled $15.5 billion, down 20 percent from the previous year. Lower oil imports accounted for over $2 billion of the decline, while imports of manufactured products from the Big Seven industrial countries fell by $1.4 billion. Machinery and chemical imports were the hardest hit, falling by $1.2 billion. Although Brazil has been able to manage a modest export boom in the first quarter, we believe imports to supply key export industries will have to rise to sustain the recovery. Imports historically have represented 25 percent and 40 percent, respectively, of total Brazilian supplies of machinery and chemicals, according to a recent World Bank study. These are essential inputs for Brazil's manufactured exports. Moreover, additional imports will be required as the government continues its efforts to increase investment in the domestic economy.

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Despite the need for greater imports as exports and the domestic economy expands, Brasilia is confident it can reach the trade targets in its IMF program. According to local press reports, Brazil's oil imports for the year will decline by up to $2 billion because of substantially higher domestic petroleum production. The United States, which has had its exports of manufactured products to Brazil fall from $3.2 billion in 1980 to $1.7 billion in 1983, should be a major beneficiary of Brazil's import rebound.

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Brazil's Agricultural Drive Sputters

The Figueiredo administration's campaign in the 1980s to boost agricultural production through subsidized credits, higher price supports, and other production incentives has not yet achieved the hoped-for contribution to Brazil's stabilization program. Brasilia assigned high priority to agriculture in 1979 to combat inflation through increased food production, boost export earnings, and develop alternative energy sources. Since then, however, output of basic foodstuffs has risen only slowly. In 1983, Brazil's per capita production of these consumer foodstuffs was considerably less than in 1979, according to the US Foreign Agricultural Service. Shortages caused higher food prices last year and growing caloric deficiency among Brazil's poor.

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Output of export crops—soybeans, coffee, sugar, orange juice, and cocoa products—also has not risen rapidly since the beginning of the decade nor provided the boost to Brazil's trade balance the government sought. As a result of the only moderate rise in production and weak global commodity prices, agriculture's share of total exports fell from 42 percent in 1979 to 37 percent in 1983. Brazil's most successful agricultural-related achievement has been its hike in the production of alcohol fuel distilled from sugarcane from 2.5 billion liters in 1979 to 5.8 billion liters last year; this substitutes for 100,000 b/d of imported oil.

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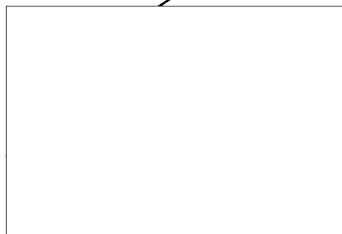
Impact of the Drought in Senegal



Senegal is facing its worst crop year since independence in 1960 because of late and inadequate seasonal rains throughout the country. Total cereals production is projected at only 400,000 metric tons this year, nearly 1 million tons short of Senegalese needs. Production of groundnuts—the country's major export—is down 50 percent from last year's level and foreign sales are expected to be down at least one-third from last year.

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Lower Senegalese earnings from the sale of groundnuts will significantly reduce farmers' incomes. Moreover, farmers will be forced to purchase imported foods because local production of dietary staples such as millet is expected to decline by as much as 30 percent. Farmers are likely to lack funds to purchase seeds and fertilizers needed for the next year's crop. Senegalese industry will suffer from lower groundnut production because a large segment of the country's work force is engaged in harvesting, processing and exporting groundnuts. These problems are likely to result in additional aid requests from Western donors.

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Communist

Hungarian Economic Reforms

The Hungarian party plenum last week approved in principle economic reforms that probably will face a cool reception in Moscow. The most controversial measure will permit worker representatives in medium and large firms to participate with management in enterprise councils to make "strategic decisions" on the firms' activities. Workers in small plants will be empowered to select and recall managers, although ministries will retain veto power. Other measures call for prices to reflect real costs and for greater wage differentiation. Except for the enterprise councils, the reforms announced so far continue programs that have been evolving since the late 1970s. Far-reaching proposals to restructure the banking and credit system may still be under debate.

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The leadership is committed to the need for major new reforms but faces a long road ahead in working out details and timing. It also must convince workers that inflation, unemployment, and greater wage differentation that is likely to accompany the reforms are shortrun pains needed to generate gains in living standards in the longer term.

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The Hungarians are walking a tightrope in explaining their reforms abroad. Budapest wants to show the IMF and Western creditors that it is making structural changes to stabilize its financial position. At the same time, it must convince its skeptical hardline allies that the reforms are no more than a fine-tuning of the socialist systems. According to the US Embassy, senior Hungarian officials have requested that the US Government and news media play down the reforms. A Hungarian banker expressed concern about the difficulty of "selling" the reforms to other CEMA countries and said that a recent visitor—probably Soviet Foreign Minister Gromyko, according to the

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Embassy—was upset by the extent of the reforms. The Czechoslovaks—and to a lesser extent the Soviets—have recently criticized Hungary publicly for deviating too far from the Soviet model and for seeking unilateral advantages from the West. 25X1

East German Medium-Term Loan

East Germany has obtained commitments from a US and a Japanese bank for an untied five-year credit of $50 million, 25X1 East Berlin reportedly will pay 1.0 percentage point over LIBOR or 0.625 point over the US prime rate. The East Germans have been paying much higher rates for short-term trade credits. Although a $50 million credit would provide only a fraction of East Berlin's estimated 1984 financing requirement of $3.6 billion, this is the first medium-term loan since 1981 and the reopening of the market represents a major accomplishment. The loan reflects Western bankers' appreciation of East Germany's improved trade performance; the East Germans reported a $1.3 billion hard currency trade surplus for 1983 and ran a roughly $160 million surplus with West Germany in the first quarter. Despite its reentry into medium-term credit markets, East Berlin will remain interested in securing another loan guaranteed by the West German Government. 25X1

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Eastern Europe: Adjusting to the Debt Crisis

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Eastern Europe's economic decline seems to have bottomed out. Although some growth in trade and GNP is likely in the near term, it will not approach the rapid gains of the 1970s. It is still too soon to predict a sustained recovery; the region has done little to solve several basic problems that cloud prospects for long-term growth.

Improved Financial Performance

Eastern Europe's financial position improved in 1983 following the severe difficulties of the previous two years. The region posted a hard currency trade surplus of $4.2 billion, more than double the surplus of 1982 and a sharp reversal of the $3.7 billion deficit recorded in 1981:

- Yugoslavia accounted for much of the improvement, paring $1.7 billion off its 1982 trade deficit of $3.5 billion. Belgrade continued large import cuts and boosted exports 13 percent as a result of its devaluation and the redirection of sales away from CEMA markets.
- Romania ran a trade surplus slightly in excess of $1.5 billion for the second consecutive year. The large decline in imports appears to have ended, while exports nearly reached the 1982 level thanks to a surge in oil product sales late last year.
- Poland almost tripled its trade surplus to about $1 billion. Imports were about the same, while exports increased 10 percent, mostly increased coal sales and reexports of Libyan oil.
- Czechoslovakia increased its trade surplus to $770 million by maintaining tight import policies. Prague failed to boost exports as planned because of difficulties in meeting production targets.
- The Hungarian trade surplus climbed $100 million to $880 million. Budapest ran another sizable convertible currency surplus with its CEMA partners and managed a slight improvement in hard currency trade elsewhere, also the result of increased exports of oil and oil products.
- East Germany's trade surplus dropped $200 million to about $1.3 billion. The regime boosted imports about 8 percent and took advantage of its special relationship with West Germany to obtain needed imports without spending hard currency.
- Bulgaria's trade surplus shrank from $640 million to $460 million because of trade problems with LDCs. Sales were off significantly to Iran, Iraq, and Libya, which are among Sofia's largest trading partners outside the Communist bloc.

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Hard currency trade surpluses for six of the countries along with lower interest payments helped steer current accounts into the black. The region as a whole ran a nearly $1.8 billion current account surplus—a significant improvement over the $2 billion deficit recorded in 1982. Even Yugoslavia was in the plus column for the first time since 1976 as tourism, worker remittances, and other service earnings offset outflows.

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The current account surpluses helped a majority of the regimes to reduce their net hard currency debt for the second consecutive year. Bulgaria, Czechoslovakia, East Germany, Hungary, and Romania cut net debt by an average of 14 percent. In addition, foreign exchange reserves grew by 25 percent regionwide, nearly offsetting the precipitous drop that occurred in 1982 at the height of the credit crunch. Only the large increase in Poland's net debt, largely the result of arrearages to West-

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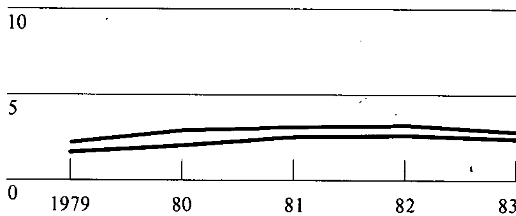
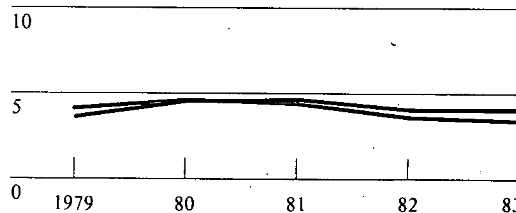
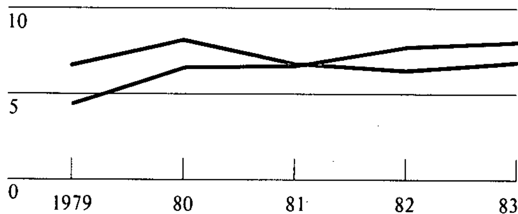
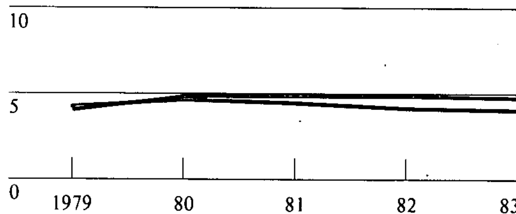
Eastern Europe: Hard Currency Trade, 1979-83

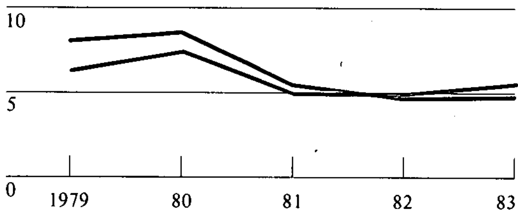
Billion US $
—Exports
—Imports

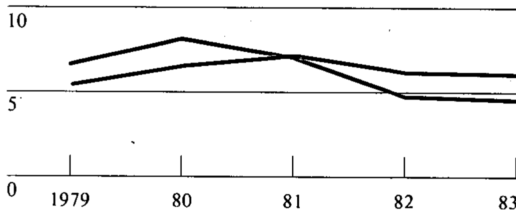


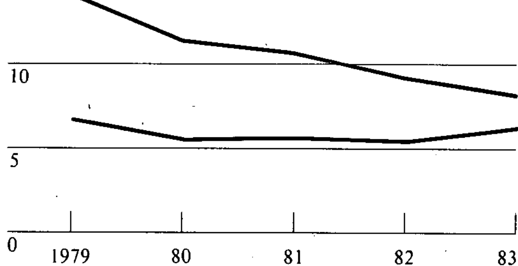












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Eastern Europe: Net Hard Currency Debt

Billion US $

	1981	1982	1983 [a]
Eastern Europe	**75.8**	**72.3**	**72.2**
Bulgaria	2.2	1.7	1.4
Czechoslovakia	3.4	3.3	2.8
East Germany	12.3	10.7	8.6
Hungary	7.0	6.6	6.3
Poland	24.7	23.8	26.4
Romania	9.8	9.4	8.8
Yugoslavia	16.3	16.8	17.9

[a] Preliminary.

ern official creditors rather than new credits, prevented more than a marginal decline in the region's net hard currency debt.

Eastern Europe's financial position was helped by support from international institutions and generally improved relations with Western creditors. Loans from the IMF and World Bank encouraged Western bankers to provide nearly $500 million in syndicated loans to Hungary. A $400 million government-guaranteed bank loan from West Germany helped revive lending to East Germany. Czechoslovakia's leading creditors arranged a $50 million loan as a symbolic move to get Prague back into the Euromarkets. In contrast to 1982, Romania quickly negotiated rescheduling agreements with Western banks and governments. Negotiations proved more difficult for Poland and Yugoslavia last year, but both countries eventually obtained favorable rescheduling terms from Western banks. Yugoslavia also obtained a package of new credits from the banks, Western governments, the IMF, and World Bank. Although still at loggerheads with its official creditors, Poland obtained de facto debt relief through its self-imposed moratorium on payments to Western governments.

Less Help From the East

The hard currency trade performance was even more surprising, given the economic pressures applied by the Soviet Union. The terms of trade continued to rise in Moscow's favor last year, forcing the East Europeans to export a greater volume of goods to the Soviet Union just to maintain existing import volumes. In addition, Moscow apparently stepped up its pressure on some of its Warsaw Pact allies to cut their persistent trade deficits, a means by which the Soviet Union has implicitly subsidized these economies over the past decade. Last year's aggregate trade deficit with Moscow for Poland, Bulgaria, and East Germany dropped by $1.1 billion to $1.5 billion.

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Domestic Economies Fare Less Well

Adjusting to severe external constraints continued to take its toll on the domestic economies in 1983. Although growth picked up for some countries, spurring claims that the region has turned things around, the rebound was limited to the northern-tier countries, and their spurt in growth was neither large nor necessarily sustainable:

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- Poland's GNP grew nearly 4 percent—its first growth since 1978. Given the depths to which the economy had plunged, an increase in output was not surprising once some domestic stability was achieved. The regime's efforts to increase working hours helped industry grow 4.8 percent, while good weather boosted agricultural output by 3.8 percent. Warsaw's failure to pay its Paris Club creditors allowed it to devote more resources to the domestic economy.

- The East German economy recovered from 1982's dismal showing of no growth, with GNP increasing 2.0 percent. Industry remained a strong performer, growing at about 2.3 percent, while agricultural growth of 3.1 percent was its best showing since 1979. East Berlin appears to

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have relied on tough management rather than systemic reforms to boost productivity and conserve raw materials. Even so, last year's achievements would have been difficult without the West German trade and financial umbrella.

- Czechoslovakia's GNP rose 1.7 percent in 1983, up marginally from 1982. Good weather not only boosted agricultural output, but helped keep a lid on energy demand. Moreover, another large trade deficit with the Soviet Union suggests Prague felt little pressure to divert scarce goods eastward.

Economic performance in the southern-tier countries lagged behind 1982 growth rates by a substantial margin. Adjustment burdens weighed heavily on some of these countries, while severe drought depressed agriculture:

- Bulgarian GNP increased by only 0.5 percent compared with a 3-percent average annual growth rate in 1981-82. The economy was slowed mostly by a 5-percent drop in agricultural output as growth in other sectors was generally on target.

- Hungary's GNP fell slightly—about 0.5 percent—because of a bad harvest and maintenance of its economic stabilization efforts. A relatively good performance in the private and semiprivate sectors prevented growth from dropping further.

- GNP declined at least 1 percent in Romania as drought cut agricultural output at least 6 percent. Given last year's adversity, Bucharest's rather optimistic claims of strong economic performance cast doubts on the reliability of Romanian statistics.

- Yugoslavia's GNP dropped 1.5 percent, the first decline since the 1960s. Belgrade reined in the domestic economy as agreed to in its IMF-supported adjustment programs.

At best, consumers experienced marginal gains even in those countries that recorded economic growth. Poor harvests kept food supplies down in

Eastern Europe: Domestic Economic Indicators

Percent change

	1981	1982	1983 [a]
Bulgaria			
GNP	3.0	3.2	0.5
Industry	2.7	2.8	2.6
Agriculture	5.0	5.7	−5.0
Consumption	3.4	1.1	2.0
Investment	9.0	−5.3	5.0
Czechoslovakia			
GNP	−1.5	1.5	1.7
Industry	1.9	0.8	1.6
Agriculture	−10.3	8.5	3.1
Consumption	1.4	1.3	1.6
Investment	−4.6	3.2	0
East Germany			
GNP	2.1	0	2.0
Industry	3.2	1.1	2.3
Agriculture	2.9	−1.5	3.1
Consumption	1.6	1.3	1.0
Investment	2.7	−6.4	1.5
Hungary			
GNP	0	1.5	−0.5
Industry	−0.9	0.3	0.7
Agriculture	−0.9	5.8	−2.9
Consumption	1.8	0.9	−0.5
Investment	−5.6	−2.6	−5.0
Poland			
GNP	−5.3	−0.6	3.8
Industry	−12.5	−2.2	4.8
Agriculture	4.3	4.5	3.8
Consumption	−3.6	−9.3	1.0
Investment	−22.7	−19.0	5.0
Romania			
GNP	0.4	2.4	−1.0
Industry	0.3	1.4	1.5
Agriculture	0.4	8.0	−6.0
Consumption	2.1	−0.4	−2.0
Investment	−7.1	−2.5	1.0
Yugoslavia			
GNP	1.5	0.3	−1.5
Industry	3.9	−0.5	−1.3
Agriculture	1.5	7.4	−2.1
Consumption	−1.0	0.5	−1.7
Investment	−9.3	−6.3	−7.0

[a] Preliminary.

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some countries. Some regimes used increased production to direct goods to export markets and to resume investment, both at the expense of personal consumption:

- Consumption growth remained positive in Bulgaria, Czechoslovakia, and East Germany, although increases were far less than those of the 1970s. Because of their less pressing financial problems, Sofia and Prague have not been forced to lower living standards; the West German financial cushion has helped East Berlin protect consumption levels through the period of financial strain.

- Poland boosted consumption marginally last year after a 9-percent drop in 1982. The Jaruzelski regime is making an effort to protect living standards in the hopes of staving off unrest. Nonetheless, consumer problems remain acute with rationing continuing for many staples. Warsaw is only postponing its problems because the marginal gains to consumers are not enough to help boost productivity or resolve the regime's political problems.

- Budapest has had some difficulties restraining demand because of the active underground economy. Consumption may have dropped marginally last year because of stronger government austerity measures and price boosts in the second half of the year. Consumer grumblings remain few, however, given Hungary's relatively high standard of living vis-a-vis the rest of Eastern Europe.

- Consumers were hit hardest in Romania and Yugoslavia as both economies suffered from severe energy problems and downturns in agriculture. The Ceausescu regime continued to bear down on consumers in order to keep factories running and to maintain exports. Yugoslavs were confronted with serious shortages of some imported goods and an inflation rate running at an annual rate of slightly more than 100 percent at the end of 1983.

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1984 Prospects

The slight momentum generated by some East European economies in 1983 probably carried over to 1984. Most of the region appears to have turned the corner regarding the debt crisis. Excluding Poland, Eastern Europe's foreign financing requirements will drop 20 percent this year. Moreover, prospects for new borrowing seem better than at any time in the last four years. Eastern Europe's standing with bankers appears to be rising largely because of its trade and current account surpluses.

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Nonetheless, bankers remain cautious and are limiting most lending to short-term, trade-related credits, preferably with Western government guarantees. The East Europeans remain equally cautious about resuming borrowing. Some countries—Bulgaria, Czechoslovakia, and Romania, in particular—intend to run current account surpluses to reduce debts. Trade credits and project financing are sought by all the countries, but on a much more limited scale than in the past. Any untied money secured this year is expected to come almost entirely from the IMF. Because the net inflow of credit probably will be small this year, we expect the region again to run sizable trade and current account surpluses—around $3 billion and $4.1 billion, respectively.

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Trade turnover with the West will pick up for a second straight year, aided by the economic recovery in Western Europe. Even so, hard currency trade is unlikely to increase at the double-digit pace common in the 1970s. Hard currency sales probably will increase by less than 10 percent while import growth will be slower, possibly around 5 percent.

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The domestic economic performance may fare slightly better this year:

- Bulgaria and East Germany—the region's most

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growth of around 2 percent. East Berlin could generate further productivity gains, while Sofia will continue to benefit from its financial prudence and extensive Soviet support.

- Czechoslovakia's modest recovery is likely to continue with GNP growth again slightly in excess of 1 percent. Prague, like Sofia, feels few external pressures at the moment, but this could change should Moscow press for reduced trade deficits.

- Both Hungary and Yugoslavia could see some resumption of growth this year after last year's declines. Both countries appear to have secured sizable amounts of financing already this year, which will help ease external financial constraints.

- Poland's economy will grow again this year but probably not at last year's rapid pace. Growth of industrial production was already tapering off at the end of last year as the one-time gains made from increased work hours ended. Agriculture is unlikely to experience another bumper harvest. Warsaw's bankruptcy will preclude a significant inflow of new credits to finance imports needed by industry and agriculture.

- Romania's economy may decline again this year as energy shortages and erratic management hobble industry and agriculture. Ceausescu's preoccupation with resolving Romania's financial problems quickly will continue to plague domestic economic performance.

Longer Term Outlook

Eastern Europe's economic prospects over the longer term remain poor. The present rebound in some economies stems, in part, from an improving external environment, including Western economic recovery; reduced interest rates; and less volatile world prices for energy and other raw materials. In addition, the usually cumbersome and awkward centrally planned economic networks responded more effectively than anticipated. Administrative directives enabled these countries to slash imports and investments, sharply cut domestic allocations of scarce resources, and redirect goods to export markets.

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It is doubtful, however, that current conditions will lead to a strong, sustainable economic recovery. Economic growth on the order of 1 to 2 percent a year, as is now the case, is probably the best Eastern Europe can hope for over the next few years. Too many obstacles lie ahead to allow for attaining the annual growth rates of 3 to 4 percent common in the 1970s:

- Despite improving financial indicators, bankers remain reluctant to plunge back into Eastern Europe. Lending is likely to increase, but the amount of loans will not reach the levels of the 1970s. Lending also remains heavily influenced by the political climate, and any perceived difficulties—whether in US-Soviet relations or internal instability—could well limit activities by Western banks.

- Overall trade with the West will pick up slightly. Without sizable new credits, East European imports will be constrained by export earnings, which remain hampered by poor quality and growing LDC competition. Last year's export growth was primarily due to reexports of OPEC oil, and this opportunity is unlikely to continue indefinitely. Moreover, some Western economists already project that the West European economic recovery could end as early as 1985, limiting a rebound in East European sales.

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- The East Europeans will find it difficult to turn to the Soviets for additional economic support. Moscow will continue to press its CEMA allies to deliver more and better quality goods to reduce deficits, and another round of oil cuts in the near future is not out of the question.

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Unlike the 1970s, Eastern Europe will have to rely primarily on its own resources and management to sustain economic growth. Annual increments to the

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sustain economic growth. Annual increments to the labor force are slowing, and energy reserves are, for the most part, meager. With respect to management, the regimes must go beyond the quick fixes of the past few years and seek ways to boost productivity. But with the exception of Hungary, no country has undertaken meaningful, structural changes that could improve efficiency. East Germany has benefited from recentralization to some extent, but its measures cannot easily be transferred to other East European countries. Even if systemic changes were made immediately, the payoffs could not be felt anytime soon, and, indeed, the short-run costs would slow growth. Productivity is likely to suffer a further setback once the full effects of recent import and investment cuts are felt by an aging, and in some cases obsolescent, capital stock. Moreover, labor productivity will suffer from serious morale problems. Workers accustomed to steady improvements in living standards in the 1970s can expect few rewards over the remainder of the decade.

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EC–Eastern Europe: Limited Trade Dialogue

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Despite attempts by countries in Eastern Europe to secure greater access to West European markets, the European Community so far has negotiated only limited bilateral trade agreements—largely for political purposes—and has avoided making concessions that would weaken Western Europe's already troubled industrial sector. Hungary and Czechoslovakia last year approached the European Community (EC) to negotiate bilateral trade agreements that would expand their sales to Western Europe. They did this despite the meager results of Romania's agreement with the EC. With EC-CEMA talks stalled since 1979, the Hungarian and Czechoslovak efforts apparently signaled a softening of Moscow's opposition to bilateral agreements between East European countries and the EC.

Limited Progress in the Past

Trade agreements between the EC and Eastern Europe date from the early 1970s, when the Community negotiated nonpreferential agreements that extended MFN status to Yugoslavia. By the late 1970s, Yugoslavia and the EC Commission saw the need for a comprehensive preferential agreement. Negotiations on a new pact bogged down, however, because West European industries pressured the EC Commission to retain tariffs and quotas on many important Yugoslav exports.

Discussions between the EC Commission and the CEMA Secretariat began in the mid-1970s. The talks proved fruitless because Moscow and the EC had little common interest in an agreement. The EC insisted on a very limited agreement with CEMA and bilateral trade pacts with individual countries. The EC saw no economic gain in the umbrella agreement proposed by CEMA and judged that such a pact would only strengthen Moscow's hand in managing East European trade with the West. Moreover, the West Europeans contended the CEMA Secretariat lacked the legal authority and believed an umbrella agreement would unduly enhance the Secretariat's stature. The USSR, whose main exports of energy and raw materials were not burdened by EC trade restrictions, had little reason to make concessions in order to obtain an agreement.

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Only the East Europeans saw economic advantages in a trade pact. Several East European countries had negotiated marketing agreements that ensured access to the EC for steel, textiles, and chemicals, but only under very tight quotas. The East Europeans believed that a more general lifting of the EC's discriminatory import restrictions was needed to reduce rising trade deficits. By the end of the 1970s, several East European countries had grown impatient with the slow pace of the CEMA-EC negotiations and lobbied unsuccessfully in EC capitals and in Moscow for more flexible approaches to the discussions.

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The Romanian and Yugoslav Agreements

Hoping to improve its sales in Western Europe, Romania broke with the CEMA negotiating position in 1979 to pursue an industrial products agreement. The negotiations proved difficult because Romania pressed for maximum liberalization of quotas on industrial products and for developing country status that would entitle it to preferential tariff reductions. In 1980 the EC and Romania reached a compromise and signed the first sectoral trade pact between a CEMA member and the EC Commission. The agreement reduced EC restrictions on roughly 100 Romanian industrial products and obligated Bucharest to maintain, if not increase, Western Europe's share of Romania's hard currency imports.

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Eastern Europe: Trade With the EC

Million US $

Commodity	1980	1981	1982	1983 [a]
Exports	**17,188**	**14,452**	**14,128**	**13,978**
Agricultural products	2,058	1,831	1,749	1,578
Raw materials	1,936	1,440	1,387	969
Fuels	3,430	2,971	2,827	2,931
Manufactured goods	9,553	8,060	8,018	8,500
Chemicals	1,253	1,269	1,253	NA
Semifinished goods	2,769	2,186	2,299	NA
Machinery	1,336	1,071	1,014	NA
Transport equipment	641	539	449	NA
Consumer goods	3,554	2,995	3,003	NA
Other	211	150	147	NA
Imports	**20,719**	**17,368**	**14,578**	**13,749**
Agricultural products	1,979	2,248	1,436	1,393
Raw materials	988	747	612	542
Fuels	798	855	624	583
Manufactured goods	16,574	13,102	11,541	11,231
Chemicals	3,937	3,340	2,995	NA
Semifinished goods	4,363	3,299	3,065	NA
Machinery	6,055	4,641	3,964	NA
Transport equipment	1,145	961	742	NA
Consumer goods	1,074	861	775	NA
Other	380	416	365	NA

[a] Preliminary.

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In 1980 the EC made major concessions to Yugoslavia to conclude a preferential agreement. This agreement went beyond the earlier accords in lifting restrictions on nearly all industrial products and some agricultural goods. The pact also included financial measures and provisions concerning Yugoslav guest workers in Western Europe, technology, and energy.

At the time, Tito's health was failing and West European governments were concerned that an economically troubled Yugoslavia lacking strong leadership might look to the Soviet Union for assistance. The EC also was troubled by the shift during the 1970s in Yugoslavia's trade away from Western Europe toward Communist countries. The West Europeans reasoned that a comprehensive trade pact would help Yugoslavia by increasing its hard currency exports and would demonstrate Western Europe's interest in orienting Yugoslavia toward the West.

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The EC agreements with Yugoslavia and Romania have had mixed results. Yugoslavia's trade position in the EC showed little improvement in 1981-82 despite the EC trade accord. Following a small

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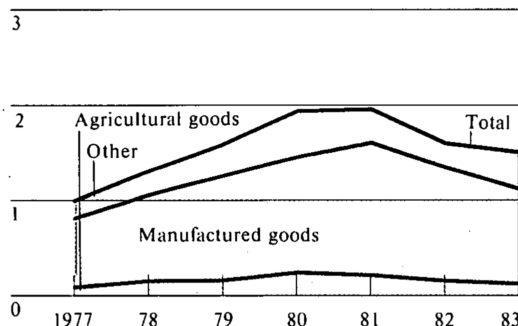
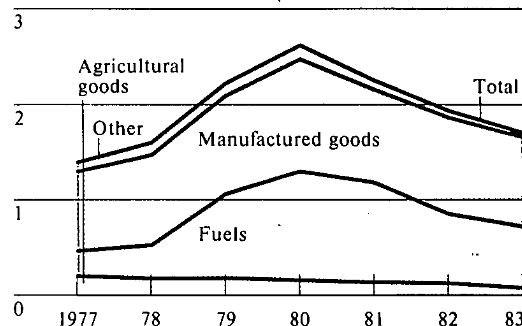
Eastern Europe: Exports to the European Community, 1977-83

Billion US $

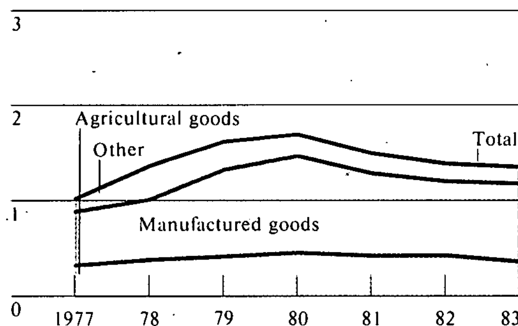
Czechoslovakia



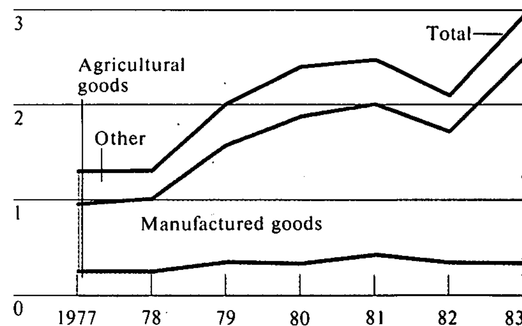
Romania



Hungary



Yugoslavia



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increase in 1981, exports fell nearly $400 million the following year. Manufactured goods accounted for most of the decline in exports, but Yugoslavia also lost nearly $80 million in 1982 in meat sales to Greece after Athens joined the EC in 1981. Yugoslavia's poor export performance—particularly at a time when Belgrade was struggling with severe debt payment problems—convinced both sides that the 1980 agreement was not working well. In early 1983, the Yugoslav-EC Cooperation Council met to seek ways to increase Yugoslavia's exports. Although the EC delegation expressed a willingness to identify trade barriers that could be lowered, no firm concessions were made.

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Even without new concessions, Yugoslavia recorded a substantial improvement in trade with the EC in 1983. Exports rose about 40 percent compared with 1982, largely as a result of increased sales of manufactured goods. Belgrade's large devaluation of the dinar and diversion of goods from CEMA

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A Comparison of the EC Agreements With Yugoslavia and Romania

Yugoslavia obtained a much more favorable agreement from the EC than did Romania. The Yugoslavs received reductions in discriminatory trade barriers for nearly all their industrial products and some reductions for agricultural goods. The EC granted improved treatment for roughly 100 Romanian industrial products, but refused to consider quota reductions for agricultural products, claiming this sector was too sensitive. Yugoslavia was given the status of a developing market economy, which allowed it to introduce limited restrictions on EC exports. Romania was placed in the state trading country category, which gives the EC Commission greater powers to prosecute antidumping cases and to impose protective measures. Romania, moreover, agreed to increase imports from the EC at a rate no less than that of other countries belonging to the General Agreement on Tariffs and Trade (GATT). The Cooperation Council established with Yugoslavia was to meet at the ministerial level, and its decisions would be binding in resolving disputes. The EC turned down Romania's demand for a joint ministerial council, and the EC-Romanian commission obtained only limited powers to enforce solutions to trade disputes. The Yugoslavs, but not the Romanians, were allowed to borrow from the European Investment Bank. One common element in the two agreements was the safeguard clause permitting the EC to ban without prior notice goods deemed a serious threat to EC industries.

markets underlie the surge in exports to Western Europe, but the quota increases and lower tariffs granted in the 1980 agreement presumably facilitated Yugoslavia's export drive as well. The strong performance has eased pressures for new concessions from the Commission and in fact prompted charges that the Yugoslavs were dumping some chemicals and metal products in Western Europe.

Romania's performance has not been as good. Exports to the EC fell from $2.6 billion in 1980 to $1.7 billion in 1983. Reduced sales of oil products—the result of Romania's own energy problems and softer world prices—accounted for much of the decline, but exports of manufactured goods also fell despite the increased quotas.

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In response to the poor export performance, the Romanians unsuccessfully petitioned the EC for greater liberalization of trade barriers on industrial products, an easing of restrictions on agricultural goods, and endorsement of countertrade and joint ventures. The Romanians also complained about antidumping procedures initiated by the EC and requested the formation of a cooperation council. The EC responded that, in addition to dumping goods, Bucharest had ignored its obligation to facilitate West European sales to Romania. The EC asserted that the Romanian request for a cooperation agreement was nothing more than a ploy to get financial credits.

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Hungary and Czechoslovakia Come Calling

After a two-year hiatus in talks between the EC and the CEMA Secretariat, Hungary and Czechoslovakia approached the EC in early 1983 about negotiating bilateral agreements. The Hungarians requested a pact that would eliminate discriminatory import quotas on industrial and agricultural goods—particularly on beef—and establish preferential tariffs for Hungarian exports. Budapest stressed that it did not want an agreement limited to the industrial sector, such as the Romanian pact, but a comprehensive agreement at least as favorable as the Yugoslav pact. The Hungarians in effect wanted to be removed from the category of state trading country and to be given all the advantages available to other GATT members. Czechoslovakia's request was more modest: a reduction in EC restrictions on a number of industrial goods such as shoes, glassware, cars, tractors, wood products, and chemicals. Shrinking export earnings and the prospect of tougher competition in West

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European markets explain the interest of Budapest and Prague in trade agreements with the EC.

Moscow's Views

The Hungarian and Czechoslovak efforts apparently signaled a softening of Moscow's opposition to bilateral agreements between East European countries and the EC. The Hungarians claimed that they had to keep discussions secret from the Soviets, but EC officials believe Budapest consulted with Moscow. Moreover, the Hungarians never complained about the publicity given to the discussions. Hungary's warning may have been a ploy to strengthen the EC's belief that an agreement would work against the USSR's interests. The Czechoslovaks stated that they cleared their initiative with Moscow. the Soviets have placed the EC-CEMA issue on the back burner, and the individual East European countries may pursue bilateral discussions with the Commission. Moscow probably has given the East Europeans more latitude because the financially strapped region needs to boost exports in order to service hard currency debts.

A Lukewarm Reception

The EC received Hungary's request with only slightly more interest than Czechoslovakia's. We believe the EC chose to pursue Budapest's initiative for political reasons—to show support for the most liberal Warsaw Pact regime and possibly to loosen Hungary's ties to the East. On economic grounds, however, the West Europeans oppose the concessions requested by Hungary. For example, a wholesale lifting of import restrictions would add to problems faced by troubled sectors in Western Europe—agriculture in particular—and would establish a precedent for dealing with other East European countries. Although signaling a willingness to talk with the Hungarians, the EC rebuffed the Czechoslovaks because it could see neither political nor economic advantages in an agreement with Prague.

The preliminary discussions between the EC and Hungary moved at a snail's pace through 1983. Italy, Ireland, and France, whose economic interests would be most affected by more generous treatment for Hungary, dragged their feet on authorizing the Commission to begin formal negotiations. In an attempt to move the discussions forward, the Hungarians lobbied the Germans and the British, who showed the most interest in the political ramifications of an agreement and seemed less concerned about the economic costs. In early 1984, the EC foreign ministers' council authorized the EC Commission to begin formal negotiations, but only if Budapest accepted the EC's general terms of reference for an agreement.

The EC's proposed terms fell far short of Hungary's goals, and Budapest sharply rejected the EC proposal in March 1984. For example, the EC insisted upon maintaining: quantitative restrictions on most goods; preferential tariff treatment only on products for which Hungary is the major EC supplier; a safeguard clause by which the EC can halt imports posing a serious threat to West European industries; and a commitment by Budapest to reciprocal treatment of EC exports. Moreover, the EC's chief negotiator stated that the Commission could not agree to terms that would remove Hungary from the category of a state trading country and give it a status comparable to that of Yugoslavia.

Outlook

Despite Hungary's rejection of the EC proposal, the dialogue will continue at a working-level meeting in Brussels on 15 May. The EC chief negotiator indicated that some Commission officials and member governments wanted to drop the effort, but West Germany and the United Kingdom probably persuaded other EC members to continue low-level discussions. The Hungarians remain interested in an agreement, but Budapest's apparent unwillingness to compromise may reflect sensitivity to recent criticism by its allies about its increased contacts

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with the West. The Hungarians probably anticipate that in time the EC will offer some concessions and that the climate in the East will become more favorable to negotiations with the West Europeans. But even if the exploratory talks advance to formal negotiations, conclusion of a final agreement would be likely to take at least two years.

The stalling of the EC-Hungarian talks precludes any expansion of contacts between the Commission and Eastern Europe. The West Europeans show no sympathy for Romania's complaints about its relations with the EC, and the Commission's quick rebuff to the Czechoslovaks indicates little interest in talks with other CEMA countries. Poland apparently has been following the Hungarian developments closely, and EC officials speculate that a generous agreement for Hungary would soon produce a Polish demarche.

Even if a trade agreement is eventually concluded with Hungary or another CEMA country, the economic payoff for the East Europeans would be limited. We believe the EC would maintain tight restrictions on most agricultural products, textiles, clothing, steel, and chemicals—Eastern Europe's most competitive exports. The Commission would monitor closely East European export performance under any agreement and would move to stem any surge in sales that threatens a troubled industry in Western Europe. Indeed, with the exception of Yugoslavia, the West Europeans probably will continue to give more favorable treatment to LDCs with which they have already concluded preferential trade agreements than to East European countries.

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Eastern Europe: Declining Soviet Support

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Trade results for 1983 show that Soviet economic support for Eastern Europe declined significantly for the second consecutive year. Moscow's insistence on reduced trade deficits—coupled with deteriorating terms of trade—forced the East Europeans to ship larger quantities of goods in exchange for Soviet energy and raw materials. With Soviet oil prices to Eastern Europe now at OPEC levels and trade moving toward balance, the Soviet subsidy to Eastern Europe will probably decline further this year. The East Europeans hope to slow this trend at the upcoming CEMA economic summit, but prospects for relief appear limited.

Lower Deficits

In 1983, Eastern Europe pared its deficit with the USSR from nearly 2.0 billion rubles to just over 1.6 billion rubles by boosting exports 13 percent while keeping the growth of imports to 11 percent.[1] This reduction in the trade deficit, following a 1.2-billion-ruble cut in 1982, has reversed the trend of generally rising deficits between 1974 and 1981. Eastern Europe's deficit had increased through 1981 as the Soviets extended trade credits to cover the rising cost of energy deliveries and special assistance to Poland during the 1981 crisis. Reduced economic aid to Warsaw accounted for most of the decline in the region's 1982 deficit.

East Germany, whose deficit fell from a record 644 million rubles in 1982 to 202 million rubles last year, recorded the largest reduction, followed by Poland and Bulgaria. Although Romanian and Hungarian imports grew more than exports, trade remained nearly balanced for both countries.

Czechoslovakia is the only exception to the trend toward balanced trade. Prague's deficit rose for the third consecutive year and totaled 452 million rubles. This development may be explained by growing shipments of natural gas the Czechoslovaks receive as transit fees for conveying Soviet gas to Western Europe. According to the Czechoslovak press, this fee is approximately 2 billion cubic meters of gas a year, worth an estimated 250 million rubles.

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The trend toward smaller deficits with the USSR parallels the shift in Eastern Europe's trade with the West from large deficits prior to 1982 to sizable surpluses over the past two years. The process of adjustment, however, has been different. Although the East Europeans have boosted exports more than imports in trade with the USSR, the region slashed Western imports to offset slumping hard currency sales and reduced credits.

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Deteriorating Terms of Trade

Deteriorating terms of trade for Eastern Europe have compounded the decline in Soviet assistance through trade deficits. The East Europeans have had to deliver a greater volume of goods to the USSR not only to reduce trade deficits, but also to offset the faster increase in the prices of Soviet energy and raw materials. According to Polish and Hungarian statistics, import prices rose 4 to 6 percentage points more than export prices in trade with the USSR in 1983. This adverse price movement, combined with lower trade deficits, reduced the net flow of real resources from the USSR to all countries except Romania.

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[1] The USSR valued the ruble at $1.38 in 1982 and $1.35 in 1983 for computing hard currency trade statistics. The exchange rates have little relevance to the valuation of intra-CEMA trade.

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Eastern Europe: Trade With the USSR *Million rubles*

	1974	1981	1982	1983
East European exports	**8,600**	**21,151**	**24,322**	**27,528**
Bulgaria	1,426	3,697	4,288	5,053
Czechoslovakia	1,518	4,105	4,732	5,420
East Germany	2,151	5,155	5,776	6,596
Hungary	1,148	3,300	3,746	4,007
Poland	1,745	3,221	4,097	4,787
Romania	612	1,673	1,683	1,665
East European imports	**8,705**	**24,299**	**26,297**	**29,153**
Bulgaria	1,479	4,374	4,885	5,511
Czechoslovakia	1,511	4,382	5,048	5,872
East Germany	2,165	5,526	6,420	6,798
Hungary	1,134	3,307	3,707	4,058
Poland	1,838	4,931	4,813	5,274
Romania	578	1,779	1,424	1,640
East European balance	**−105**	**−3,148**	**−1,975**	**−1,625**
Bulgaria	−53	−677	−597	−458
Czechoslovakia	7	−277	−316	−452
East Germany	−14	−371	−644	−202
Hungary	14	−7	39	−51
Poland	−93	−1,710	−716	−487
Romania	34	−106	259	25

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- The volume of goods shipped from the USSR in 1983 fell 6 percent for East Germany, 3 percent for Hungary and Poland, and increased 2 to 3 percent for Romania and Czechoslovakia. Bulgaria received roughly the same quantity of goods.

- The volume of goods shipped to the USSR grew 8 to 11 percent for Bulgaria and Poland, 6 to 8 percent for Czechoslovakia and East Germany, and 2 to 4 percent for Romania. Hungary shipped nearly the same volume of goods.

Trade Prospects in 1984

The bilateral trade protocols for 1984 provide only limited insight into the likely trend for Soviet–East European trade. The negotiation of these annual agreements has been made more difficult by the economic problems facing both sides:

- The USSR is increasingly reluctant to supply Eastern Europe with fuel and raw materials that are needed domestically or that can be sold for hard currency. Moscow is demanding increased deliveries of higher quality manufactured goods and food in exchange.

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- The East Europeans are urging Moscow to maintain current levels of energy and raw material deliveries and are hoping that the USSR can help cushion the impact of debt and other problems hindering trade with the West.

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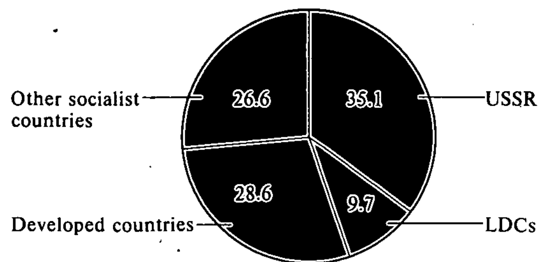
Eastern Europe: Share of Imports and Exports, 1980 and 1983

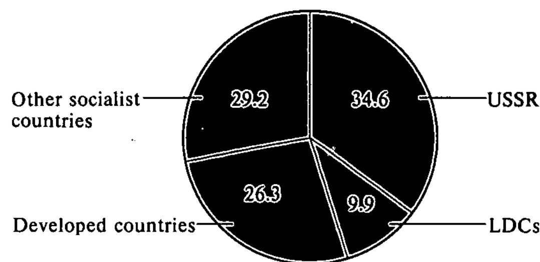
Percent

1980

Imports

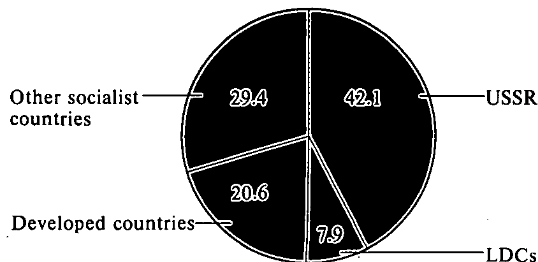


Exports

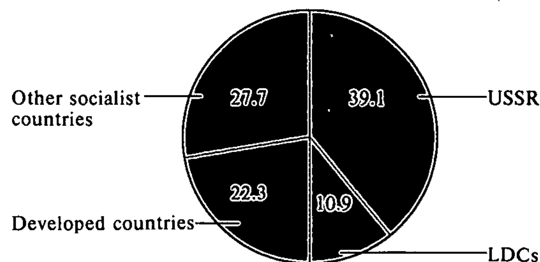


1983

Imports



Exports



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The 1984 bilateral protocols indicate that increases in nominal trade turnover will range between 8 and 12 percent, in line with the growth of the past few years. We estimate that about one-fifth of the increase in turnover for countries other than Romania will result from higher CEMA oil prices. When adjusted for inflation in nonoil goods, real trade with the USSR will increase 6 to 8 percent for Romania, 4 to 6 percent for Bulgaria and Czechoslovakia, and 3 percent or less for East Germany, Hungary, and Poland. 25X1

Eastern Europe will probably remain in deficit to the USSR but at a reduced level from 1983. The Polish protocol, which is the only one to provide export and import targets, envisions a continuing Polish deficit, but exports are to grow nearly twice as fast as imports. The USSR reportedly has pressed East Germany and Bulgaria to make further cuts in their trade deficits. 25X1

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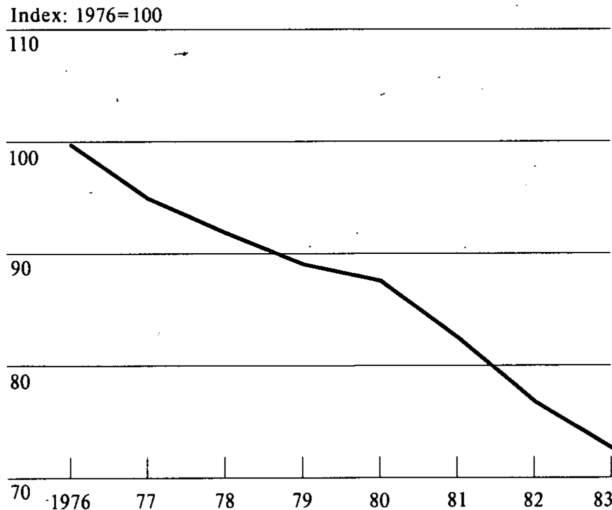
Eastern Europe: Terms of Trade With the USSR, 1976-83[a]



[a] Based on Hungarian ruble trade price statistics.

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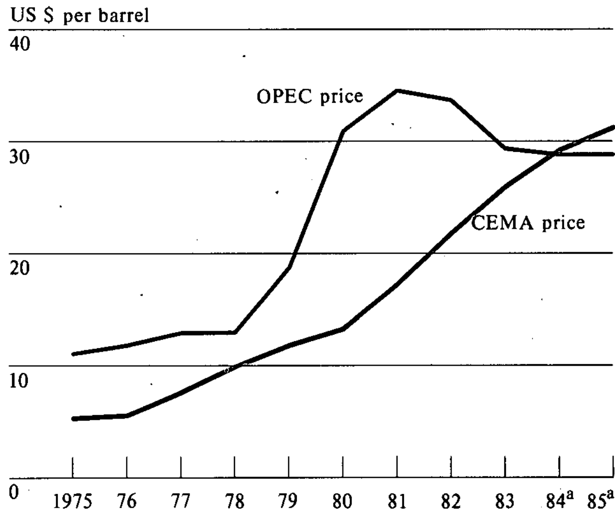
Eastern Europe: Crude Oil Prices, 1975-85



[a] Projected.

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Oil Prices Catch Up

Oil is the pivotal commodity in trade between Eastern Europe and the Soviet Union. Eastern Europe relies heavily on imported Soviet oil, both to satisfy domestic energy demand and to obtain hard currency by exporting oil and oil products to the West. After reducing exports to several East European countries in 1982, the Soviets maintained deliveries in 1983. We believe the Soviets will supply Eastern Europe in 1984 at last year's levels with the exception of Romania, which will receive more oil in exchange for agricultural goods and possibly oil equipment.

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Because intra-CEMA oil prices are determined by the five-year moving average of world prices, the price of Soviet oil to CEMA countries was considerably below the price the Soviets could obtain in world markets until this year. With the drop in world oil prices, however, CEMA prices have caught up and now probably exceed those in world markets, thus eliminating the oil price subsidy the Soviets were granting the other CEMA countries. The East Europeans, however, still receive oil from the USSR on better terms than could be obtained in world markets because—except for Romania—they pay for Soviet oil largely with manufactured goods that could not be sold in the West and that are probably overpriced.

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Trade at the CEMA Summit

Trade relations are likely to be discussed at the CEMA Summit in June. Soviet and East European leaders could consider several issues affecting trade relations: pricing arrangements, trade balances, deliveries of Soviet energy and raw materials, and the quality and quantity of East European exports. East European leaders undoubtedly will want to focus discussion on the adverse impact on their

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economies of current trends in intra-CEMA trade and on their need for a stable supply of energy and raw materials. The Soviets, on the other hand, will want to concentrate on broader structural issues such as closer integration of planning, increased industrial specialization, and East European investments in Soviet energy and natural resource development.

The East Europeans are unlikely to achieve significant economic relief at the Summit. With trends moving in Moscow's favor, the Soviets have little incentive to alter trading arrangements. Moreover, the Soviets may well believe that the East Europeans will soon be able to begin reducing their debts to the USSR.

Although the East Europeans are unlikely to reverse the trend toward less Soviet subsidization, they still obtain important benefits from trade with the Soviets. Trade deficits with the USSR, although smaller, are likely to persist at least through the current five-year plan, while the region will still have to run large surpluses with the West. More important, the East Europeans will continue to pay for vital Soviet imports mainly with goods that cannot be easily marketed in the West.

Nonetheless, the decline in Soviet economic support shows that Eastern Europe cannot count on the USSR to cushion difficulties in trade with the West. Reorienting trade to the East offers scant help for dealing with the region's economic problems. The USSR cannot provide substitutes for the Western technology and investment goods needed to revive the East European economies, nor can the Soviets supply the food and consumer goods demanded by the East European populace.

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USSR-Finland: Economic Ties

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Moscow has turned increasingly to Finland as a source of advanced machinery and equipment. For their part, the Finns find the USSR a stable market for manufactures exports and a source of petroleum. Further growth of this trade, however, will be constrained by Finland's limited capability to produce high-technology goods.

The Special Trade Relationship

Finland's special political relationship with the Soviet Union has given birth to a special economic relationship. Finnish-Soviet trade is essentially a barter arrangement whereby Moscow can pay for imports in rubles on the understanding that, at the end of each five-year interval, its purchases and sales are to be equal in value.[1] Even when allowance is made for the impact of oil price increases, the economic relationship has enjoyed impressive growth. Two-way trade grew almost sixfold from 1973 to 1982, according to Soviet data. Moscow's trade with Finland now ranks a strong second to Soviet–West German commerce and exceeds Soviet trade with Japan, France, Italy, and the United States. In 1981 Finland ranked second only to Japan among Western suppliers in the value of manufactured goods sold to the Soviet Union. Finnish manufactured exports to the Soviet Union rose ninefold from 1972 to 1981, compared with an increase of only 3.5 times for the rest of OECD. Although Soviet exports to Finland consist mostly of raw materials, especially petroleum, Finnish sales to the USSR include a wide variety of machinery and equipment.

Benefits to Moscow. The USSR's primary benefit is access to high-quality Finnish machinery and equipment. Although high-technology goods represented only 4 percent of the country's total 1981 sales to the USSR—compared with 15 percent for West Germany, 12 percent for Italy, and 11 percent for Japan and France—the USSR puts a premium on the equipment that Helsinki does provide, especially lumber processing machinery, merchant ships, offshore drilling vessels and platforms, and capital goods needed to expand extraction of nonferrous metals, particularly copper. The Soviets also purchase Finnish products that incorporate technology from other Western countries. For example, Finnish shipyards often outfit the drilling rigs they sell to the USSR with Western drilling tools and electronic gear.

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The Finns undertake large construction projects in the Soviet Union. The Soviets have awarded contracts for a broad range of facilities, including a goods terminal at one of Moscow's airports, a railroad car depot near Leningrad, expansion of grain-handling facilities at the Tallinn harbor, and several raw materials processing projects.

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Trade with the Finns also is attractive to the USSR because its imports do not have to be paid for in hard currency. the Soviets preferred purchasing oil rigs from their Nordic neighbor in 1982 because the bilateral barter arrangement eliminated the need for significant hard currency financing. The advantage to Moscow of trading under a soft currency barter regime is lessened in periods such as the present, however, when the Soviet hard currency payments position is relatively strong. In addition, although the USSR does not pay for Finnish goods directly with convertible currency, it does provide Helsinki with oil and other "hard goods" that could earn hard currency if they were sold on other Western markets.

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[1] The commodity composition and value of the trade are established by 15-year cooperation agreements, five-year trade accords, and annual commercial protocols.

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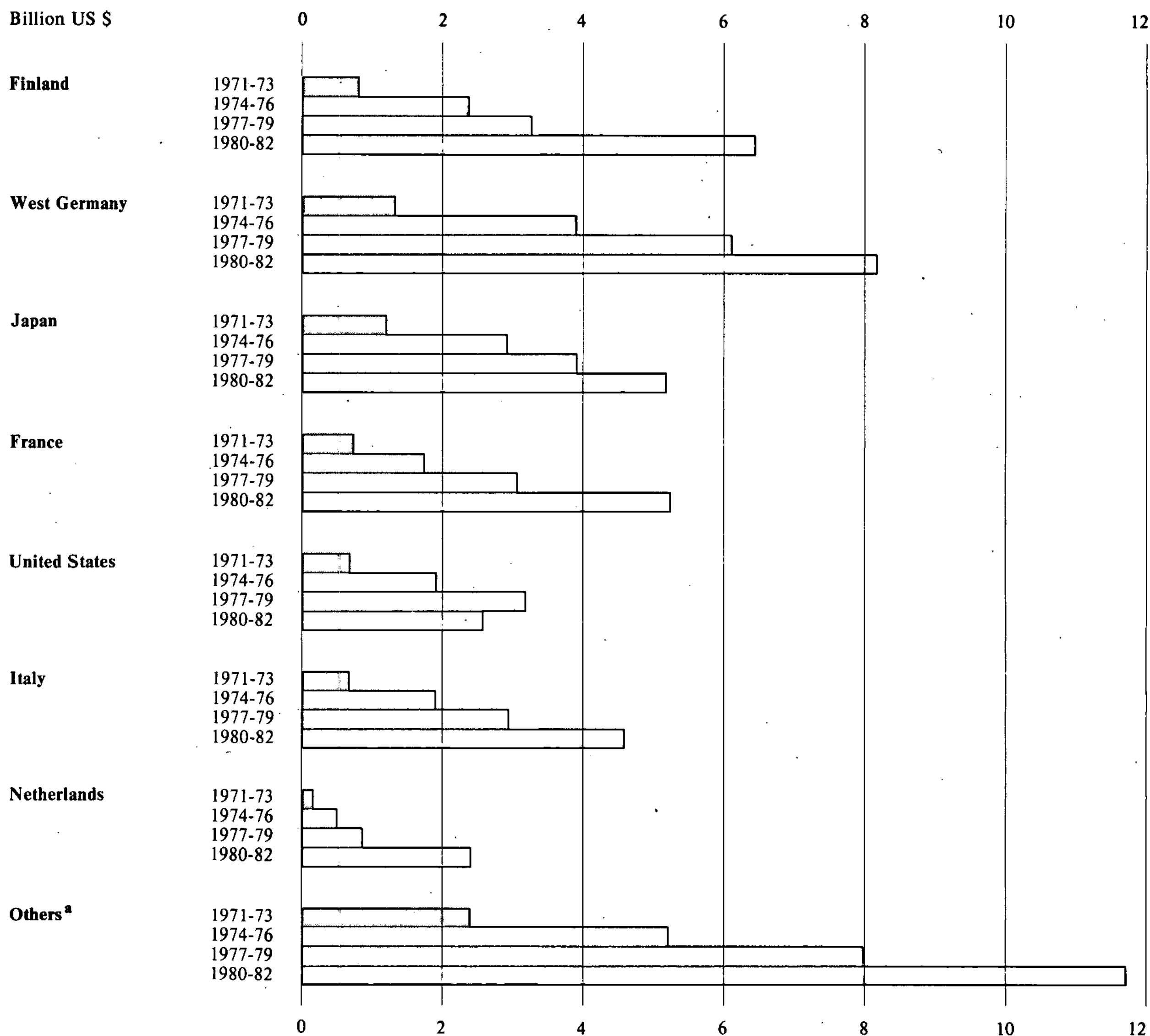
USSR-OECD: Trade Turnover
Triennial Averages, 1971-82



[a] Australia, Austria, Belgium, Luxembourg, Canada, Denmark, Greece, Ireland, Norway, Spain, Sweden, Switzerland, and United Kingdom.

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The Soviets have political motivations for trading with the Finns as well. Given Finland's special political relationship with the USSR, Soviet planners probably believe that Helsinki is less likely to go along with Western sanctions against the USSR than NATO governments. Moreover, although Helsinki has not been shown to be a transit point for shipments of controlled technology to the USSR, Moscow presumably values its neighbor's refusal to adhere formally to COCOM.

Benefits to Helsinki. The main benefit the Finns obtain from trading with the USSR is the guarantee of an assured market for their goods. This market grows especially important during times of weak Western demand. Moscow has bought an increasingly large share of Finland's exports over the last decade—12 percent in 1972, 21 percent three years later, and 25 percent in 1981.

Helsinki's dependence on the Soviet market, however, is potentially risky. Any cutback in sales to bring trade back into balance probably would cause unemployment in the affected sectors. Soviet media have cited estimates by "Finnish economists" that Soviet orders account for 150,000 Finnish jobs.

Recent Trade Strains and Soviet Responses. In 1981, when Finland used the Soviet market to buoy its economy during the Western recession, a large Finnish trade surplus started to accumulate. This surplus amounted to an interest-free loan and was resented by the Finns. As the value of oil—the Soviets' largest export—fell, the USSR's bilateral trade deficit grew even more. By 1982 the two countries had agreed to increase the maximum allowable imbalance in the clearing account (the account through which the barter is handled) to 300 million rubles. When the Finnish surplus exceeded even that limit, they decided to transfer 300 million rubles from that account into a special interest-bearing account owned by Finland. Throughout much of 1983, the USSR's total trade deficit with Finland was around 600 million rubles ($825 million); a little more than half this amount was in the interest-bearing account.

Throughout 1982 and 1983, the Soviets attempted to solve the problem by pressing the Finns to purchase more Soviet arms and natural gas and to buy a 1,000-megawatt nuclear power plant. 25X1

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The Finns resisted the Soviet pressure, and Moscow failed to make good on its ultimatum. Helsinki's reluctance to increase its gas purchases centered around the high price offered and the cost of building the required pipeline extension. Concern that energy supplies would exceed demand was an important factor for both the gas and the power plant, and political pressure from Finnish environmentalists added to official coolness toward the power plant.

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An even bigger factor in correcting the trade imbalance was the Soviet decision to maintain large petroleum sales. In 1982 the USSR sold the Finns 20,000 b/d of Libyan crude oil, which the Finns resold on the West European market. (In addition, the Soviets have been delivering around 200,000 b/d of domestically produced petroleum to Finland annually.) Last year the Finns had contracts to deliver 26,000 b/d of crude oil, probably of Libyan origin, to the international market, and for 1984 Moscow has again acceded to its neighbor's request for more Libyan crude. The current deliveries, which will probably allow the Finns to continue hard currency resales, are intended to produce a modest Soviet trade surplus that will improve the overall 1981-85 trade balance.

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This year's trade agreement also gives Finland an option to increase its nonoil imports beyond the protocol level by accepting less oil, but this probably represents wishful thinking on Moscow's part. Helsinki will have little incentive to accommodate the Kremlin's drive to sell more manufactured goods if it is permitted to meet its import obligation primarily through oil purchases. In early February,

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however, Helsinki and Moscow did come to terms on gas sales, with Finland's agreeing to quadruple its purchases by the year 2000. A Soviet decision to lower prices apparently clinched the deal.

Prospects

Moscow's willingness to make concessions to the Finns on the trade imbalance issue reflects its recognition of the importance of its commercial relationship with Finland. The Soviets' main gain from the trade—access to high-quality manufactured goods—has become even more important now that they are giving preference to non-US suppliers in order to reduce vulnerability to sanctions.

Although Moscow has been willing to pay the price necessary to maintain the level of trade, we believe that this trade will not experience the same growth that occurred in the past decade. The Finnish economy's modest production of advanced manufactures will significantly affect commerce if Moscow decides to limit its hard currency outlays by giving priority to high-technology imports. On the Soviet side, sales are likely to be constrained by potential shortfalls in the quantity of oil available for export and a continuing inability to produce goods other than fuels and raw materials that can readily be marketed in Finland.

With energy comprising 80 percent of the USSR's exports to Finland, uncertainties in international oil and gas markets cloud the medium-term outlook for maintaining growth in the bilateral trade. Possible fluctuations in future energy prices will make it difficult for Moscow and Helsinki to fine-tune their trade accord.

Over the longer term, there may be more basis for optimism. Both sides are likely to be willing to make the sacrifices needed to prevent a downturn in trade because each perceives advantages in maintaining strong economic and political ties. Moreover, a Soviet decision to move forward with developing the Barents Sea oil deposits will provide considerable impetus to bilateral trade. Finland would probably win some contracts under this project, which is estimated to cost at least $10 billion.

Leading Commodities in Soviet-Finnish Trade, 1982

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	Million US $	Percent
Soviet exports	**3,306**	**100**
Crude petroleum and oil products	2,479	75
Coal	132	4
Natural gas	107	3
Wood and paper products	99	3
Other	489	15
Soviet imports	**3,861**	**100**
Wood and paper products	696	18
Ships	581	15
Clothing and fabrics	205	5
Equipment for processing timber and paper	168	4
Food products	150	4
Footwear	142	4
Other	1,919	50

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Chile's Military: The Impact of Economic Crisis

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Chile's domestic political crisis and the depressed economy are eclipsing the armed forces' traditional concerns about the military balance with rival forces of its neighbors, particularly Peru and Argentina. The armed forces, who prefer a purely military role, have been strained in recent years by their political role in supporting President Pinochet and the ruling military junta. The development of broad, active opposition to the regime has aggravated that strain, and the armed forces face critical choices in the coming months. In contrast with some Latin American democratic governments that feel compelled to accede to demands by politically powerful militaries for new weapons, Pinochet has used his dual government/military leadership role to tightly control defense expenditures, in part to comply with guidelines on government spending under Chile's IMF-supported economic adjustment program. Selected weapons purchases continue, but the determination to maintain fiscal discipline—combined with the continuing international arms embargo against Chile—will limit Santiago's ability to modernize its arsenal and we believe will degrade operational effectiveness.

The Military's Role

Defense of Chile's long, vulnerable frontier from external attack remains the military's preeminent responsibility. Chile's armed forces—victors in a series of wars in the 19th century and trained by successive European military missions—have a long tradition of professionalism and are perhaps the most competent in Latin America. Although they have not engaged in combat since crushing Peru and Bolivia in the War of the Pacific (1879-1883), periodic border tensions between Chile and its neighbors—most recently in 1978 when Chile and Argentina almost clashed over the Beagle Channel—have encouraged high professional standards. Strategic planning still centers on a perceived need to field forces simultaneously against Peru, Argentina, and Bolivia. To this end, the armed forces are almost exclusively trained and equipped for conventional warfare.

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During 1973-80, Chile contracted for over $1 billion worth of arms and military services, including jet fighters, warships, armor, and air defense equipment. The size of the armed forces increased as well during this period, with the Army growing from 32,000 to 53,000. Despite this effort, Chile's military remains underequipped and heavily outnumbered by the combined forces of Peru, Argentina, and Bolivia. Peru and Argentina, Chile's principal rivals, each have spent more than Santiago, giving them a growing qualitative edge as well. The international arms embargo against the Pinochet regime for human rights violations—adhered to by the United States, which had been Chile's principal supplier—has denied the Chileans access to many modern weapons and occasionally forced Santiago to purchase less satisfactory equipment from sources such as Israel.

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The military is reluctant to assist the National Police (Carabineros) in maintaining internal security. Unlike most Latin American police forces, however, the Carabineros are relatively well trained and only rarely do they require direct military assistance. Moreover, the armed forces are mindful of jeopardizing the respect still accorded them by many middle-class Chileans and recognize their own lack of internal security training. In August 1983, for example, inexperienced troops reinforcing the hard-pressed police in Santiago fired on demonstrators and inflicted heavy civilian casualties. The military's major involvement in internal security matters is through the National Information Center—a military intelligence organization attached to the Interior Ministry that has

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acquired a brutal reputation—and through the occasional deployment of special forces troops against isolated terrorist elements.

The Chilean military until recently had usually avoided direct involvement in domestic politics. The quality of civilian leadership has been generally high since independence was achieved in 1818, and the Armed Forces usually have stepped in only when they have completely lost confidence in the civilians' ability to maintain control. Even then it has occurred only after extensive debate within the military. The reluctance and indecision that beset the high command prior to overthrowing President Allende in 1973—the military's first direct intervention in over 40 years—are illustrative. A continuing lack of confidence in the competence and judgment of Chile's current political party leaders underlies the military's support for Pinochet's decision to delay the return to democratic rule until 1990.

The Political and Economic Backdrop

The crippling recession that struck Chile in late 1981 prompted the first broad-based opposition to Pinochet in his 10-year rule. After a five-year boom period, Chile's economy suffered a serious reversal in 1982 when GDP plummeted 14 percent, the unemployment rate nearly doubled to 25 percent, real wages dropped, and hundreds of businesses failed. The regime's reluctance to adjust its policies despite declining foreign demand and a liquidity crunch induced by the drying up of foreign credit gave impetus to the opposition movements.

By mid-1983, opposition groups had drawn wide support from political and labor circles. These groups demanded an accelerated transition to civilian rule, and this gave the movement a political dynamic independent of economic grievances. Pinochet opened a dialogue with the opposition last August and granted a number of concessions that appeared to represent limited moves toward democratic government. The failure of the government to continue in this direction, however, has contributed to the resurgence of protests this year.

The military, as Pinochet's primary power base, holds the key role in the political crisis. Recognizing this, moderate opposition forces are attempting to persuade officers that the President would jeopardize the institutional interests of the armed forces to keep himself in power. Some officers, particularly in the Air Force and Navy, have expressed concern that Pinochet's unwillingness to speed up the political transition will fuel domestic turmoil and aggravate political polarization, creating opportunities for the radical left. According to the US Embassy, the Army, the most important service, still stands behind Pinochet, but the high command is sensitive to military interests and almost certainly monitors events closely.

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Impact on the Military

The economic decline has had a serious impact on the military. Advised by his economic team to curtail sharply government expenditures, mindful of limits on military imports under Chile's IMF program, and probably hoping to show the public that the armed forces are not exempt from fiscal austerity, Pinochet has tightly controlled the military budget. As head of the junta and the military, Pinochet has accomplished this without provoking a backlash in the armed services. The US Embassy estimated last year that programed defense expenditures in 1983 equaled $600 million, representing roughly the same percentage of the overall budget as the previous year. In addition to budgeted expenditures, the Chilean military receives by law 10 percent of the receipts from CODELCO, the government-owned copper company. The US Embassy estimated that this provided the armed forces an additional $190 million in 1983, bringing total military appropriations to about $800 million or about 5 to 6 percent of GNP. Preliminary figures published by the government in early 1984 suggest that defense will, at best, maintain its share of the budget this year.

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The government's tight rein on military expenditures over the past two years has prevented Chile from matching the military buildups of Peru and

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Chile: Major Arms Orders

Service	Item	Source	Quantity	Approximate Cost (*million US $*)	Status
Army	Armored vehicles	Domestic	200	Unknown	100 licensed-produced Swiss-Mowag vehicles reportedly in service at present.
	Air defense equipment	Unknown, possibly United Kingdom	Unknown	Unknown	Army has longstanding requirement for air defense equipment. May have evaluated UK Rapier system. No firm orders yet.
Navy	Guided-missile destroyer	United Kingdom	1	20	Second "County"-class DDG due in 1984.
	Type 209 submarine	West Germany	2	130	Ordered in 1980, both due in 1984.
	ASW helicopter	United Kingdom	6	Unknown	United Kingdom offering six Westland Lynx originally ordered by Argentina—reportedly generous terms.
	Landing ship	Domestic	1	10 (at least)	Chile plans to build a third French-designed "Batral"-class landing ship.
Air Force	Fighter-bombers	United Kingdom	14	70 to 100	Negotiations continuing for 14 Jaguar fighter-bombers. Contract expected in 1984. Will replace aging Hawker Hunters. Option to buy 26 more.
	Jet trainers/light attack aircraft	Spain–domestic assembly	At least 16	Unknown	12 Casa C-101 (T-36) now operational. Three more due by June 1984.
	Prop-driven trainer	Domestic assembly	Eventually up to 100	Unknown	At least eight to 10 T-35 Pillan trainers have been assembled. Progress delayed because of technical problems. DAO estimates Chileans can assemble 10 to 15 a year.

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Argentina. We believe that this would have been the case, however, even if Santiago were not under an embargo by some major weapons suppliers. [redacted] to retain Chilean support following the Falklands war, the United Kingdom offered Santiago a wide range of weapons—including air defense equipment and aircraft—at substantially reduced prices. Although Chile has purchased shoulder-launched surface-to-air missiles, Hawker-Hunter fighter bombers, Canberra reconnaissance aircraft, and electronic surveillance equipment from the United Kingdom, budgetary considerations apparently have kept Chile from buying other British equipment, such as the aircraft carrier Hermes and armored vehicles. Purchases from other major foreign military suppliers have been minimal. [redacted]

Training likewise has suffered because of budget constraints. The US defense attache's office reported last March that the Navy had received authorization for only 30 days of at-sea operations per ship this year. Although high-priority training, such as an amphibious exercise later this year and the annual UNITAS regional naval maneuvers, will proceed as scheduled, the high cost of fuel and munitions will probably preclude other major exercises. [redacted]

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Military pay has been hit by the economic squeeze. Early last year, for example, US defense attache sources reported that grumbling by junior Army officers over low pay and inadequate housing was

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beginning to concern senior commanders. We believe, however, their circumstances would have to deteriorate considerably before the junior officers in this strictly hierarchical and disciplined military would confront the high command with their grievances.

The development of Chile's domestic arms industry, initially spurred by the arms embargo, has been boosted by Santiago's need to reduce foreign weapons purchases. Chile now produces a wide range of materiel, including grenades, mines, general purpose and cluster bombs, small arms and ammunition, several types of armored vehicles, antitank missiles, and light antiaircraft guns. Chile's factories have produced about 100 license-produced Swiss Mowag armored vehicles for the The Chileans also have begun to assemble light training aircraft from imported parts—including the Spanish C-101 jet trainer (designated T-36 by Chile) and the domestically designed, prop-driven T-35 Pillan—to replace aging US-built trainers. The Navy has recently completed construction of two French-designed landing ships.

The government also hopes to export locally produced arms. Extensive coverage in trade journals, an aggressive export campaign by the primary private producer (Cardoen Industries), and displays at military exhibitions in the United States, the Middle East, and Southeast Asia appear to be achieving results. press releases by Cardoen indicate other countries in the Middle East and Latin America are also interested in these devices.

Outlook

We believe Chile's economic difficulties will prohibit substantial modernization or expansion of its armed forces over at least the next two years. Unless faced with an unambiguous threat of war, the Pinochet government will continue to limit military spending. Continued cutbacks in training, however, risk the loss of Chile's qualitative advantage over its traditional military rivals.

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We believe the government will authorize some improvement in military pay and living conditions to minimize discontent within the officer corps. Despite a commitment to promote an arms industry, Chile will remain heavily dependent on foreign sources for its military needs, including imported parts for domestic arms plants. Thus, we anticipate that the government will purchase weapons selectively from non-Communist countries, such as the United Kingdom, which offer reasonably modern equipment at advantageous terms.

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The armed forces could assume a more active political role if civil unrest and terrorism escalates. Should this occur, members of the high command are likely to urge the President to adjust economic policies to speed recovery and to accelerate the transition to democratic rule. Although the armed forces' tradition of acting by consensus and their doubts about civilian political leadership mean that military pressures on Pinochet would build only gradually, we judge that serious discussion about replacing Pinochet could occur if the Army believes his leadership is harming both national security and the military's institutional interests.

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Summit Issues: Oil Emergency Response Programs

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The escalation of the Iran-Iraq war and threats to Persian Gulf oil shipping have heightened concern about a disruption of oil flows. Industrial countries have a number of measures to reduce the impact of a disruption. Although the International Energy Agency (IEA) emergency sharing plan could be used to mitigate a major disruption, oil stocks and the response of the Summit countries will be principal factors influencing the impact of an oil supply interruption.

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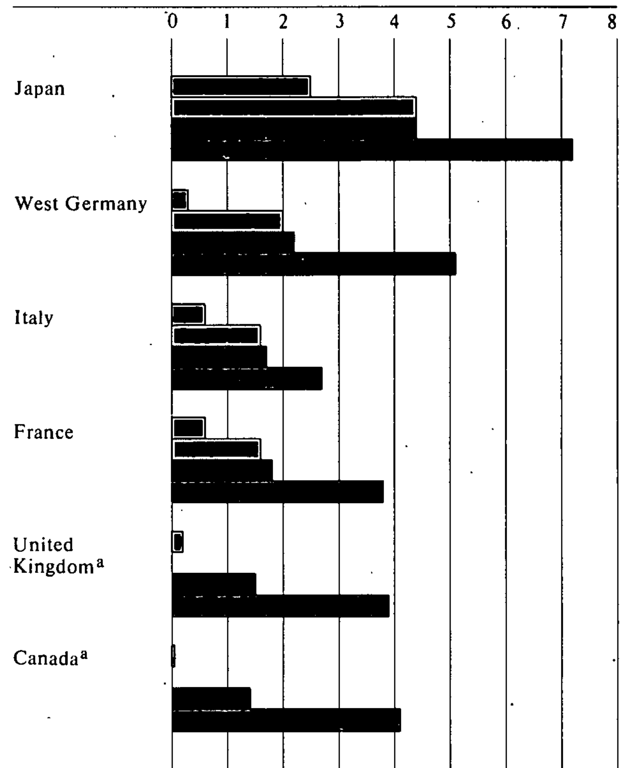

Note: Some 1983 data are still preliminary.
[a] The United Kingdom and Canada are net oil exporters.

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The IEA-Coordinated Emergency Planning

The IEA was established by the industrial countries in 1974 to develop an oil-sharing scheme, provide a forum for the exchange of information on energy markets, and reduce dependence on imported oil through conservation and substitution. All OECD countries except France, Finland, and Iceland are members of the IEA.

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The IEA's sharing scheme—the International Energy Plan (IEP)—requires participating countries to maintain emergency oil reserves equal to 90 days of net imports and to have contingency plans to reduce oil demand by 7 or 10 percent depending on the size of the supply shortfall. Specific methods for meeting the required reduction, however, are left to the discretion of each country.

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Emergency Response Programs

Japan. Japan imports nearly all of its oil, making it particularly vulnerable to supply disruptions. In 1983, Japan imported roughly 60 percent of its oil from Persian Gulf countries. Strict conservation efforts have been under way since the early 1970s, and substantial progress has been made in reducing oil use. Japan still relies on imported oil for about 60 percent of total energy needs, however, and

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Major Industrial Countries: Oil Stock Situation, Yearend 1983

	Oil Consumption 1983 *(million b/d)*	Million Barrels				Days of Consumption		
		Total Stocks	Government Owned	Minimum Operating [a]	Usable Stocks [b]	Total	Government Owned	Usable Stocks (Includes Government Owned)
Japan	4.4	446	94	220-260	186-226	101	21	42-51
West Germany	2.2	245	55	100-135	110-145	111	25	50-66
Italy	1.7	149	6	75-105	44-74	88	4	26-44
France	1.8	150	0	80-110	40-70	83	0	22-39
United Kingdom	1.5	113	8	65-90	23-48	75	5	15-32
Canada	1.4	118	0	84-88	30-34	84	0	21-24
United States [c]	15.2	1,453	379	900-950	503-553	96	25	33-36

[a] Minimum operating inventories equal stocks needed to maintain smooth operation of distribution systems. Japanese, Canadian, and West European ranges are based on IEA and industry estimates.
[b] Usable stocks defined as total stocks less minimum operating stocks.
[c] US data provided as a comparison—source is DOE.

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could have extreme difficulty reducing consumption quickly in the event of a disruption. The Petroleum Industry Law of 1962 centralizes crisis management control and responsibility for long-term energy planning in the Ministry of Trade and Industry (MITI). Additional legislation gives MITI the authority to allocate products and regulate oil prices.

In a recent simulation of the IEA oil-sharing scheme, MITI met the required Japanese oil consumption reduction by ordering an across-the-board cut in the supply of oil products while reducing oil stocks to 60 days of supply. There is no set procedure for use of inventories in a crisis, however, and we believe Tokyo generally plans to use stocks as a last resort. Japanese policies require commercial firms to hold inventories equal to 90 days of the previous year's consumption, and the government plans to assume responsibility for a 30-day equivalent stockpile by 1990. Japanese oil stocks totaled 101 days of supply or 446 million barrels at yearend 1983, including 94 million barrels or 21 days of government-owned inventories. According to IEA and industry estimates, stocks above minimum operating levels would meet about 40 to 50 days of supply at current rates of consumption.

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West Germany

The West German emergency program emphasizes market responsiveness, flexibility, and cooperation with industry to cope with a supply disruption. Policies are designed to minimize government intervention. In the event of a supply disruption, the government probably would pass higher oil prices to consumers to limit consumption.

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If tougher measures are required, Bonn plans to encourage fuel switching by industrial consumers, appeal for private-sector demand restraint, and

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increase public-sector conservation. In addition to these measures, the 1975 Energy Security Plan gives the government extensive powers to regulate oil production, distribution, and prices and to impose speed limits and ban weekend driving. As a last resort, Bonn would consider rationing.

West German petroleum stocks totaled 245 million barrels or 111 days of supply at yearend 1983, including about 55 million barrels of government-owned stocks. About half of current total stocks are considered minimum operating inventories. Bonn has stated that the government-owned stockpile is a final reserve and would not be drawn down initially. Other stocks under government control include those held by EBV, a stockpiling association established in 1978 to hold 65 days of compulsory stock levels and financed through government loans. EBV presently holds about 117 million barrels of oil inventories. The oil industry participates directly in the corporation through an advisory board and industry representatives constitute two-thirds of the members. The balance of West German oil stocks are held primarily by refineries. private commercial stocks in West Germany in late February were close to operating minimums. EBV and other compulsory stocks can be released by decree of the Minister of Economics to prevent an imminent disruption or to remedy supply shortfalls.

Italy

The Italian emergency response program is partially outlined in the Energy Plan of 1982 but has not yet been approved by the Parliament. Although Rome still plans to establish a number of specialized committees for dealing with energy emergencies, the Ministry of Industry remains responsible for energy policy and has the authority to direct domestic supplies. Rome also can resort to a legal decree to establish a domestic committee to coordinate and carry out emergency policy. Italy's demand restraint measures focus mainly on gasoline and include lower speed limits, increased taxes, and limited driving hours on Sundays and holidays. Italy also plans to increase the use of fuel-switching capacity and, in the event rationing becomes necessary, to allocate oil supplies away from "nonessential" users.

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Italian oil inventories totaled 149 million barrels or 88 days of supply at yearend 1983, including 6 million barrels of government-owned stocks. The current law requires oil companies to maintain stocks equal to 90 days of the previous year's inland oil consumption. After allowing for minimum operating levels, only about 44 to 74 million barrels or 26 to 44 days of supply of Italian stocks would be available in an emergency, including government-owned and compulsory stocks. commercial oil inventories approximated compulsory levels at the end of 1983. Use of compulsory oil stocks requires the approval of the Ministry of Finance

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France

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Although France is not a member of the IEA, it participates in EC emergency planning. France has attempted to insulate its economy from oil supply disruptions by reducing use of oil—particularly in electricity generation through an advanced nuclear program—and by securing new supplies through government-to-government deals. France relies on imported oil to meet about 90 percent of total oil consumption, but an increase in the use of North Sea oil has reduced dependence on Persian Gulf supplies to about one-third of total oil needs. All French oil stocks are held by commercial firms and totaled 150 million barrels—about 83 days of supply—at yearend 1983. Industry estimates indicate that about 80-110 million barrels are required to meet minimum operating levels. Stocks available to the government in an emergency would thus approximate 40-70 million barrels or 22 to 39 days of supply. Although we cannot predict with certainty how the French would respond, during past disruptions Paris has controlled product prices and maintained high compulsory stock requirements.

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United Kingdom

Because the United Kingdom is a net exporter of oil, British policies and options vary slightly compared to the major net importing countries. In general, London aims to provide a framework to ensure free market operation with minimum distortion. The Energy Act of 1976 empowers the government to regulate or prohibit the production, supply, acquisition and use of crude oil and petroleum products during an energy emergency. Because UK oil production is essentially at productive capacity, however, there would probably be little or no increase in production during a disruption.

London's initial emergency response measures are outlined in the Emergency Management Manual. It emphasizes restraining demand for gasoline and heating oil. Other measures include the Oil Product Allocation Scheme (OPAS), which allows London to direct oil products to consumers whose needs are deemed essential—for example, the military. For the most part, residential and small commercial consumers are not subject to reallocation under OPAS.

At yearend 1983 British oil stocks approximated 113 million barrels or about 75 days of supply including 8 million barrels of government-owned stocks. Some 65-90 million barrels of this total are considered minimum operating inventories. As a result, stocks available for use in an emergency—including government-owned inventories—would cover about 15 to 30 days of consumption at current rates. Measured in days of supply, the United Kingdom has the lowest level of inventory coverage of all major West European countries. Nevertheless, in the most recent test of the IEP, London chose to apply less stringent demand restraint measures and substituted a drawdown of oil stocks.

The British favor a coordinated early release of government-held petroleum stocks in a crisis. London has approached the United States, Japan, West Germany, and Canada on this issue. We believe that British support for an early release of inventories is influenced in part by the fact that as a net exporter the United Kingdom has no IEA emergency reserve commitment or obligation to draw down inventories under the IEA oil-sharing scheme.

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Canada

The Canadian National Energy Plan (NEP) seeks to insulate the economy from supply interruptions by maintaining oil self-sufficiency. Due to sharp declines in consumption from 1980 to 1983, Canada returned to a position of a net oil exporter in 1982, but it is unclear whether this position will be maintained. Restrictions on the export of light crude oil kept Canadian oil production below capacity in the first half of 1983, but by yearend output was close to available capacity. As a result, little incremental oil production would be available from Canada in the event of a disruption. In addition to the longer term goals of the NEP, Canada created the Energy Supplies Emergency Board, which can regulate prices, imports, exports, distribution, allocation, and rationing once Parliament has decreed that an emergency exists.

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All Canadian oil stocks are held by commercial firms and totaled about 118 million barrels or 84 days of supply at the end of 1983; only about 34 million barrels of this total are considered available stocks, assuming minimum operating inventories approximate 60 days of supply. Although Canada has a low inventory measured in days of supply, its position as a net exporter exempts Ottawa from the IEA obligation to maintain inventories equal to 90 days of net imports and eliminates Canada's emergency reserve drawdown obligation under the IEP. As a result, Canada, like the United Kingdom, is able to be more flexible in deciding policy on the use of inventories than some other major consuming countries.

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Coping With Oil Supply Disruptions

Despite the existence of individual country programs and the IEA oil-sharing scheme, industrial countries will face difficult decisions on specifically

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when to carry out emergency plans in the event of a supply disruption. Governments of most major oil-consuming countries, particularly the net oil importers, rely heavily on demand restraint measures in emergency planning.

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In our judgment, government policies on inventory use have become increasingly important in recent years because compulsory inventory requirements and IEA emergency reserve obligations have effectively transferred control of stocks in excess of minimum operating requirements from commercial firms to governments. We believe cooperation among IEA members could promote the effectiveness of both demand restraint measures and inventories under some supply disruption scenarios. A mechanism does not yet exist, however, for a coordinated response by governments in the event of a supply shortfall that is less than IEP trigger levels.

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