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International Economic & Energy Weekly

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11 May 1984

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DI IEEW 84-019
11 May 1984

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International Economic & Energy Weekly

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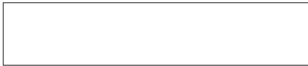

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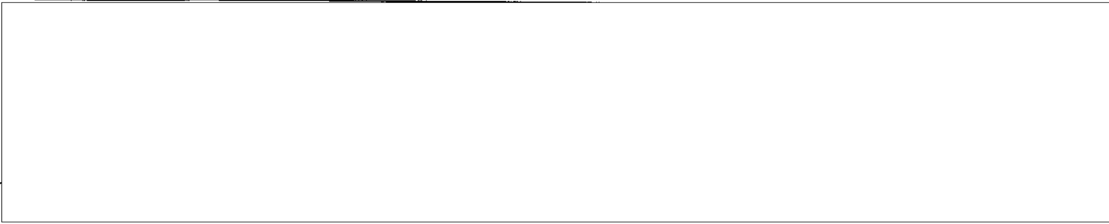

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International Economic & Energy Weekly

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Synopsis

1 **Perspective—*Mexico: The Politics of Austerity***

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De la Madrid's ability to address Mexico's financial crisis without triggering widespread unrest reflects the nation's capacity to handle unaccustomed stress. Nonetheless, considerable downside risks remain as austerity measures continue to depress living standards.

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15 **Mexico: A Gloomy Economic Forecast**

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Mexico will continue to face serious economic problems even if it can avoid political dislocations and maintain austerity through 1984. We see no source of economic revival that can stem the decline of the economy during the next few years.

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27 **Summit Issues: Acid Rain**

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Acid rain is likely to be a controversial topic at the London Summit.

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31 **Summit Issues: Big Six Views on High Technology**

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All of the Big Six governments perceive a need to promote high technology to maintain their international competitiveness, and, in varying degrees, all intervene in the market to achieve this end. Japan appears to have achieved the greatest results.

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35 **Argentina: Medium-Term Financial Outlook Under Alternative Economic Scenarios**

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We project Argentina will be plagued by serious foreign financial difficulties throughout the decade.

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43 **Implications of a Significant Oil Discovery in North Yemen**

Oil may have been discovered near North Yemen's border with Saudi Arabia and South Yemen. A major find would have a substantial impact on North Yemen's economy, internal politics, and relations with Saudi Arabia and the United States.

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Perspective

Mexico: The Politics of Austerity

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President de la Madrid's belt-tightening measures have earned high marks from foreign observers and relieved Mexico's foreign liquidity crisis at least for the moment. His ability to implement the harsh steps necessary to address the financial crisis he inherited from Lopez Portillo without causing widespread unrest or instability reflects the capacity of the nation's political system and its leaders to handle unaccustomed stress. Although most elements of society are chafing under austerity's heavy burden—higher prices for imports, spot shortages of basic goods, reduced public services, and falling real income—serious social and political unrest has not materialized. This is in sharp contrast to other Latin American nations facing analogous situations. Organized labor and peasants—the ruling Institutional Revolutionary Party's (PRI) largest constituencies—are quiescent. So far, only isolated strikes and demonstrations have occurred; the government remains firmly in control.

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De la Madrid's mastery over the PRI—one of Latin America's most effective political machines—and his skill in juggling the conflicting demands of powerful interest groups have boosted public confidence. By displaying a keen sense of the political consequences of his economic moves, he has consolidated his power, built a consensus behind austerity, and undercut issues around which antigovernment sentiment could coalesce. Focusing job creation programs on hard-hit regions, continuing politically sensitive subsidies for food and transportation, and the dispensing of food in urban slums have helped de la Madrid to fulfill campaign pledges to protect the needy. A vigorous anticorruption campaign has been the centerpiece of efforts to demonstrate that under his aegis Mexicans can expect a more honest and responsive government. Judicious use of the regime's imposing security apparatus, by putting potential troublemakers on notice to keep a lid on protests, has boosted confidence in the government's ability to maintain order.

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Continued success is by no means guaranteed, however, and we see pitfalls ahead as the President maneuvers to maintain the ruling party's longstanding hegemony. We project that, even under the best of circumstances, real personal consumption will not reach levels achieved under his predecessor for the remainder of de la Madrid's term. We believe maintaining social and political peace—even though key elements of the polity show few signs of radicalization—will become increasingly difficult.

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To preserve political stability in the face of continuing austerity, the President will have to balance calls for an end to falling standards of living with pressure from the international financial community to maintain economic adjustment policies. Even though most Mexicans still support the need for belt tightening, de la Madrid's room to maneuver has been reduced by the sacrifices already made by the population. Political missteps by the President, internecine bickering among the ruling elite, alienation of key interest groups, or growing opposition-party muscle could turn around the prevailing favorable political outlook. 25X1

Retaining the support of organized labor will be key to keeping austerity going. If opposition parties could convert discontent with the economy into enough national political support to end the PRI's monopoly on power, this would shake the foundations of Mexico's political system. Moreover, differences among the governing elite over economic or political tactics—now manageable—could grow to become irreconcilable. De la Madrid's efforts to alter the political system to better reflect the growing importance of the middle class could fuel divisive intraparty rivalries. Perceived inequity in public policy—or a loss of confidence in the government's management of a particular issue—could cause important interest groups to increase pressure on de la Madrid to reverse key aspects of his economic package. 25X1

Over the short term, we expect some disruptive incidents. The greatest potential for unrest probably is in urban squatter areas. Moreover, resistance by regional powerbrokers to political reform measures could cause existing tensions within the ruling party to lead to sporadic outbursts of violence. Opposition-party frustration with PRI electoral fraud could also translate into antigovernment demonstrations. Nevertheless, the PRI's well-established lines of communications with its grassroots constituency and the demonstrated flexibility of the governing elite probably will minimize serious disorders. If needed, de la Madrid will employ force to maintain order. 25X1

The middle years of the President's six-year term in office—1985 and 1986—will be pivotal for de la Madrid and the Mexican political system. A viable longer term economic strategy will be needed to resolve the current conflicts among the government's economic goals of (a) meeting austerity guidelines under its IMF-supported adjustment program, (b) maintaining basic consumption to reduce the likelihood of public disturbances, and (c) stimulating economic growth. If economic recovery lags in 1985 and 1986, we believe the President will be unable to resist pressure to loosen austerity. More expansionary policies, however, would risk reigniting rapid inflation and cutting off access to international funds. In these circumstances, the domestic business community would be hard pressed to continue their tacit support for de la Madrid. Poor PRI showings in midterm elections would aggravate intraparty tensions and embolden the political opposition. 25X1

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On balance, we expect the political system to adjust enough to allow Mexico to weather the storm. The fluidity of the situation, however, makes for considerable downside risks. Although a political crisis is by no means inevitable, latent frustration could well create one. We have no accurate way to gauge how long the discipline exhibited by Mexicans in the face of economic adversity will be maintained. We think, however, the enormous social and economic tensions already created by the financial crisis are sufficiently great that further economic decline, bad luck, or bad decisions risk igniting a political upheaval.

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Briefs

Energy

Soviets Step Up Oil Deliveries to Nicaragua

Mexico's harsher terms for oil deliveries are prompting Nicaragua to turn to the USSR to cover most of its oil requirements. Mexico cut its deliveries to only $19 million worth of oil during the first four months of this year—about one-third of 1983 levels. Over the same period, however, the Soviets sent Managua $27 million worth of oil—equal to about 60 percent of Nicaragua's consumption. 25X1

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Moscow's willingness to supply oil to Nicaragua indicates the high priority it attaches to shoring up the Sandinistas. Although the Soviets probably are urging Managua to find other sources, they apparently are willing to be suppliers of last resort. 25X1

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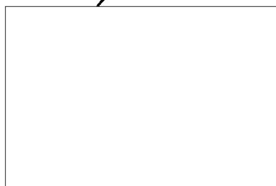
Another Iraqi Attack on Shipping



Iraq's attack on an oil tanker on Monday probably will not cause changes in the spot market price for crude oil. A 117,000-ton Saudi tanker was hit and abandoned about 90 nautical miles south of Khark Island, where it had just been loaded. This is the fourth tanker to be attacked since 27 March. Insurers have raised insurance rates by as much as 2 percentage points for tankers calling at Khark Island. Freight rates have risen moderately since the last Saudi ship was hit on 25 April. To entice shippers, Iran may discount oil prices. It already is offering insurance to cover damage inflicted in Iraqi attacks. Iran also will try harder to intercept Iraqi aircraft over the Gulf and may try to interfere with shipping for Iraq. 25X1

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Iran and Syria Agree on Oil

Iran recently agreed to renew its oil agreement with Damascus despite Syria's inability to pay for all the oil. Tehran will continue to provide Syria with about 120,000 barrels of oil per day—100,000 b/d at a reduced price and the balance at no charge. Despite easy terms on previous sales, Syria owes Iran about $900 million. 25X1

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Syria's debt to Iran has been a source of friction since the oil agreement was first signed in 1982, but it is unlikely to jeopardize new oil deliveries. Iran wants to make sure Syria keeps the oil pipeline from Iraq closed, and its aid gives Syrian President Assad—who distrusts Iraqi President Saddam Husayn—the financial incentive to keep the pipeline shut down. Syria, however, now requires larger Iranian credits, partly because of a reduction in aid from its Arab supporters. 25X1

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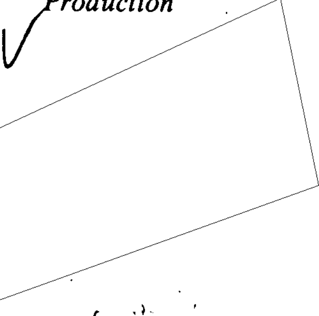
Nigeria Orders Increased Oil Production



The US Embassy reports that Nigeria has reversed a decision to hold oil production to its OPEC-mandated ceiling of 1.3 million b/d and is directing oil companies to increase daily production immediately by between 300,000 and 400,000 barrels. Lagos is warning the companies that failure to comply will result in further nationalization. Nigeria reportedly wants to maintain the higher production until it earns $2.5-3 billion, an amount Lagos estimates is necessary to meet its financial needs this year. [ ] 25X1

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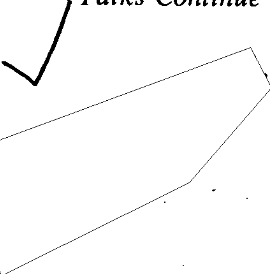
The threat of further nationalization underscores the government's need for additional oil revenues to ease its economic crisis. Head of State Buhari announced a new austerity budget this week and probably realizes that, without IMF credits or aid from other sources, current oil output will not finance essential imports and debt servicing needs. To earn the needed revenue, Nigeria would need to maintain production at 1.8 million b/d and hope that OPEC would ignore the overproduction for at least six months. The oil market remains weak, however, and higher output by Nigeria will put additional downward pressure on prices. [ ] 25X1

Greek-Soviet Gas Talks Continue



[ ] talks are still underway between Athens and Moscow on the proposed gas pipeline from the southern USSR to the northern Greek industrial area. We doubt, however, that any formal agreement will be reached for several years. The proposed pipeline to Greece would have a capacity of 2 billion cubic meters per year. The Greek-Soviet talks have centered on a starting date for the previously agreed-on pipeline feasibility study expected to last two years. The parties are also discussing the barter exchange of Soviet natural gas for Greek aluminum products from a new plant. [ ] 25X1

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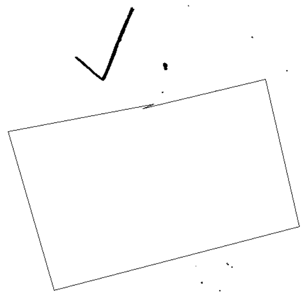
International Finance

Pressure on the Mexican Peso



Higher-than-expected inflation in the first quarter and the widening gap between the exchange rate available on the Mexican and the US side of the border is spurring rumors of an accelerated peso devaluation. Local bankers have told the US Embassy that the Mexican Government is considering either depreciating the peso by 20 instead of 13 centavos a day or devaluing by 10 percent and then retaining the current daily peso slide. We and US Embassy officials believe the government will wait until after the midyear wage adjustment and then increase the daily slide of the peso. Mexican Government officials probably are concerned that a faster depreciation would fuel inflation and be an admission that the 50-percent target for increases in the cost-of-living index this year is unattainable. Mexico City, however, does not have enough reserves to support the current exchange rate policy for very long if capital flight accelerates. Moreover, Mexico City needs to maintian a competitive exchange rate if it is to meet its goal of increasing manufactured exports by at least 17 percent this year to $4.3 billion. [ ] 25X1

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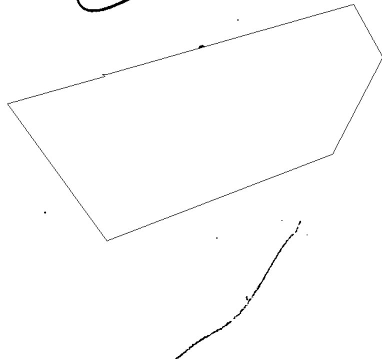
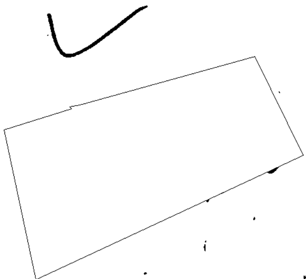
Peru's Economic Policy



The Belaunde government's sustained commitment to its austerity program will be severely tested this year. According to US Embassy reporting, the IMF in late April approved $340 million in credits under the compensatory financing and standby credit programs after Lima agreed to new austerity measures. Despite slightly easier terms than the previous agreement, the public-sector deficit target—relaxed at Lima's request from the previously agreed 3.8 percent of GDP to 4.1 percent—will still require sharp cuts in government spending and large tax increases. Moreover, the relaxation of price controls and higher import surtaxes will probably cause inflation to accelerate beyond last year's 111-percent rate, further eroding living standards and raising social tensions. 25X1 25X1

Although the US Embassy reports that Peru met first-quarter IMF performing criteria, we believe Peru will have severe difficulties remaining in compliance with the agreement because of social unrest. Prices rose by 33 percent in the first quarter, and we doubt Lima will be able to meet its goal of 70-percent inflation for the year. Public employees are demanding wage increases to compensate for the rising living costs. According to the US Embassy, there is a threat of another nationwide labor strike against the adjustment policies of the agreement with the IMF that could further pressure Belaunde to ease austerity. Moreover, the tendency to spend during an election year will be strong. An alternate scheme for economic revitalization mainly through easier credit for employment-intensive industries and new export incentives for nontraditional goods is gaining the support of Central Bank President Webb and other government officials. Should Lima switch to such a program, its relations with the IMF would deteriorate, and this would risk commercial bank financing and other foreign financial assistance. 25X1

Guatemala-IMF Confrontation Looming



Guatemala and the IMF appear to be heading for a major disagreement. The Fund maintains that unless Guatemala alters its fiscal policies it will fall out of compliance with agreed-on limits to its budget deficit. As a result, the remaining $60 million under Guatemala's standby agreement might not be made available. Although the Fund is suggesting an immediate 10-percent tax hike, Chief of State Mejia and other senior Guatemalan officials have publicly repudiated any tax increases. The Fund also has suggested an 11-percent cut in spending, based on projections that the government's current policies will severely erode Guatemala's foreign payments position later this year. Despite worsening economic prospects, Guatemala is unlikely to accede to the Fund's conditions easily. According to the US Embassy, if Mejia does make policy adjustments to secure IMF credits, he might dismiss some of the country's senior finance officials in an effort to create scapegoats. 25X1 25X1

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Summit Issues

Big Six Exports Prosper in the US Market

Last year, the rebounding US economy coupled with the strong dollar provided the major bright spot for exports by the Big Six countries. Their sales to the United States grew 15.0 percent in real terms compared with a 3.8-percent increase in total Big Six exports. Canada and Japan, the two major US trading partners, garnered the largest gains from the US recovery, while the United Kingdom received the least benefit because oil sales dropped. The slow-growing West European countries were the weakest developed country market. Although Japan was able to boost its sales, the four major West European countries experienced only sluggish sales gains to their neighbors. West Germany, in particular, was hurt by import cuts by France—its major export market. Big Six exports to the LDCs fell by 3.5 percent because of continuing LDC debt problems and declining LDC oil revenues.

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Big Six: Average Annual Real Export Growth, 1983 [a] *Percent*

	World	Developed Countries					LDCs	Communist Countries
		Total	United States	Japan	Western Europe	Canada		
Total	**3.8**	**6.0**	**15.0**	**6.5**	**3.1**	**22.4**	**−3.5**	**12.6**
Japan	8.6	13.8	18.3		9.3	28.4	2.8	12.6
West Germany	0.3	1.8	15.2	7.3	0.6	23.7	−9.0	9.2
France	3.6	5.5	15.4	5.5	4.5	45.1	−4.4	27.6
United Kingdom	0.3	3.5	3.2	7.5	5.3	0.2	−10.4	3.0
Italy	5.2	6.4	11.8	10.8	4.5	20.8	−0.2	24.1
Canada	8.4	11.8	16.5	4.9	−9.4		−13.4	0.1

[a] Growth calculated from constant 1980 US dollars.

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Global and Regional Developments

Copper Price Developments

After a strong price surge during March, copper prices have plunged below their pre-rally levels. According to industry statistics, during 13 of the past 18 years, first-quarter prices have displayed seasonal upswings because the housing and automobile industries began accumulating inventories for summer sales. The unusual March increase this year apparently was spurred by a shortfall in Zambian deliveries of good-quality metal. Although we expect prices to rise slowly throughout the rest of the year, the 1984 average is likely to be little changed from the 1983 average of 72 cents a pound. Robust buying

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by the US housing and auto sectors continues. Japanese and European demand is increasing, and, according to press reports, the Chinese are expected to make major purchases this year. Most LDC producers, however, are operating at or near capacity to maximize foreign exchange earnings. Even slightly higher prices are extremely important to debt-troubled producers; a 5-cent rise in copper prices would generate approximately $140 million annually in additional export earnings for Chile, $60 million for Zambia, and $45 million for Peru.

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Argentina Barters Grain for Fertilizer

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the Argentine Farmers' Federation recently struck a barter deal with the USSR to exchange about 160,000 metric tons of wheat for 65,000 tons of urea fertilizer. The deal follows similar grain for fertilizer arrangements with Mexico and Bulgaria. Barter deals such as these are a way for Buenos Aires to export wheat in the current soft market. These transactions underscore the Alfonsin regime's efforts to boost grain production by using more fertilizer. Argentine fertilizer imports could reach 275,000 tons this year, a 60-percent increase over the 1983 level.

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Argentina's Latin Grain Trade Growing

The US Embassy reports that President Alfonsin's drive to boost grain exports to neighboring countries stems from his desire to strengthen regional economic ties and to reduce dependence on sales to the USSR, which currently takes about 40 percent of Argentine grain exports. The share of Argentina's grain exports going to other Latin American countries jumped from 6.4 percent last year to 21.6 percent during the first quarter of 1984. A willingness to provide credits has helped buoy sales. The US Embassy reports that Mexico, which purchased no Argentine grain in 1983, is likely to be a growing market this year as a result of the recent 18-month bilateral agreement. Brazil, however, which sharply increased its purchases of Argentine grain in the absence of US commodity credits during the first quarter of 1984, is likely to slow its purchases from Buenos Aires now that US financing is available. Cuba, recently the recipient of a $200 million trade credit from Buenos Aires, has increased its share of Argentine grain trade.

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National Developments

Developed Countries

Attempt To Limit Israeli Inflation

The Israeli Government's May price hikes of 9 percent on government-controlled items such as milk, bread, and gasoline are smaller than recent monthly increases. This is in keeping with the government's desire to limit inflation prior to the 23 July election. As a result, the government will increase the subsidies on these goods. Finance Minister Cohen-Orgad is under great pressure from his cabinet colleagues to engage in "election economics," according to US Embassy sources in the Finance Ministry. We believe he will

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try to avoid blatant manipulation of the economy prior to 23 July, but he probably will succumb to pressure to hold the line on prices controlled by the government and to ignore the proposed cuts in government spending that are in the current budget.

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Turkish Exports Rise

Turkey's first-quarter exports were up 37 percent in dollar terms over a year earlier. Imports declined by 7 percent, reducing the trade deficit to around $325 million. The promising trade figures will be a boost to Prime Minister Ozal's new economic program, which emphasizes export growth as a key to long-term development. Moreover, with large payments on Turkey's rescheduled debt falling due later this year, a good export performance is necessary to limit foreign borrowing needs and sustain the growing confidence of international lenders.

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Spanish Labor Negotiations

Prime Minister Felipe Gonzalez has reasserted his intention to pursue an austerity program and has called on trade unions to tighten their belts. He has requested new labor contract negotiations and signaled his willingness to participate directly in collective bargaining sessions with business and union leaders. Gonzalez is banking on his personal influence to win support for austerity in these talks. If—as seems likely—labor and business agree to the negotiations, they will cover wage gains for 1985-86 and labor regulations. Madrid probably hopes to persuade both sides to agree to real wage cuts, more flexible labor laws, and reductions in both employers' social security contributions and employees' benefits. We believe agreement on these issues is essential for Madrid to curb inflation and unemployment. Although Gonzalez has made it clear that he will not depart from his austerity program, he may make commitments to create jobs and stimulate investment in return for labor and management concessions.

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Less Developed Countries

Jamaican Bauxite Developments

Jamaica and the four US and Canadian aluminum companies operating on the island have reached a new five-year tax agreement to replace the one that ended last December. The package includes production incentives, a slight reduction in the levy charged on sales of aluminum, and an increase in the royalties paid per metric ton of bauxite. The companies also have agreed to maintain investment at the 1983 level and to make monthly rather than quarterly payments to the government. This should help smooth Jamaica's chronic cash flow problems. Jamaican officials estimate that the new incentives and the upturn in world aluminum demand will help boost bauxite production almost 20 percent to 9 million tons this year. Higher production and the new tax schedule could add as much as $10 million to government revenues.

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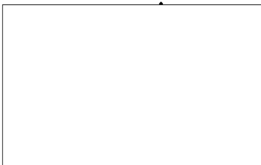
Labor negotiations this summer, however, still cloud the outlook for the mining industry. Bauxite workers and management have been awaiting the outcome of the tax discussions before negotiating a new contract. The quickening pace of inflation and the probability that opposition leader Michael Manley will represent labor could politicize and prolong the talks. 25X1

Dominican Republic Crackdown Continues



The arrests of more than 100 members of opposition groups last weekend and of two labor leaders on Monday probably were designed to head off more strikes and demonstrations. various groups are considering strikes to force changes in the government's economic policies, but they are not acting in concert. President Jorge Blanco has maintained control so far by using tough tactics to intimidate the opposition. He continues to be aided by the inability of opposition elements to decide on a common approach. The newly formed Popular Struggle Committees—active in last month's disturbances—are a new feature in domestic politics. Consisting largely of the unemployed, they apparently are not controlled by any of the established political parties. 25X1

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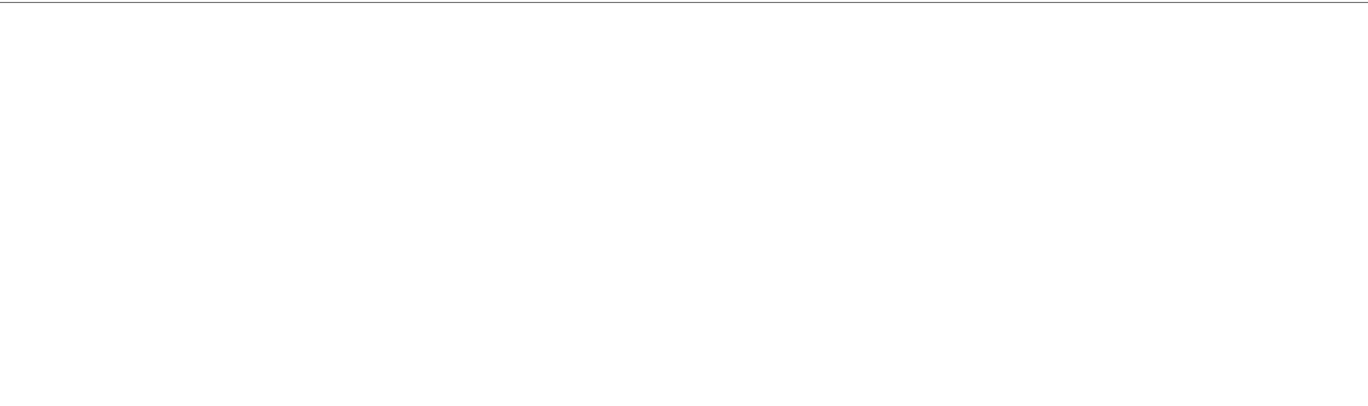

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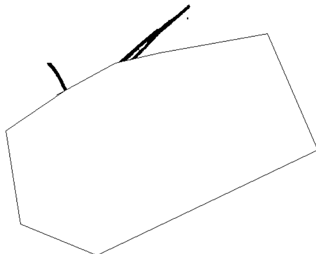
Kuwaiti Stock Market Activity



The Kuwaiti Government recently halted its 18-month-old program to support share prices on the official stock exchange. After the government withdrawal, the fall in share prices was accompanied by an increase in trading activity in both the official and the unofficial Manakh markets. US Embassy sources report that the decision to withdraw from the market indicates that the government has recognized the failure of its $3 billion program to stimulate investor confidence, badly shaken after the market crashed in 1982. Instead, the government now plans to underwrite funds to pay off creditors of bankrupt traders. The plan would provide almost $2 billion to pay off creditors if approved by the cabinet. Many Kuwaitis believe this program indicates that the government finally is coming to terms with the stock market crisis, and we expect this spending will boost Kuwait's flagging economy. The actual outlay, however, could run higher than $2 billion because losses probably are higher than government estimates. 25X1

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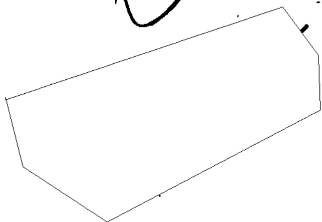
Chad's Good Economic News



The relative tranquility Chad has experienced since the arrival of French peacekeeping forces in July 1983 has sparked an increase in economic activity:

- Production of cotton, the country's principal export, has regained pre-1978 levels.
- Significant increases have been made in cattle and food crop production despite the prolonged drought.
- The Habre government has been able to restore some basic public services.
- Most of Chad's industries—including textile factories, sugar plantations, and breweries—have increased production, putting many Chadians back to work.

Progress on the economic front nonetheless could be short lived if political stability cannot be maintained or if aid donors and investors reduce their support.

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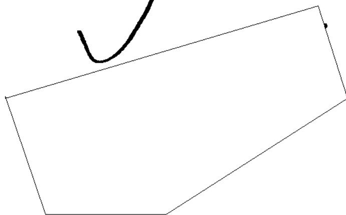
Economic Reforms in Guinea



Guinea's new military government, in a move calculated to win public favor, has eliminated some of former President Toure's socialist economic policies. President Conte has ended tax payments for trade unions and regional development schemes that had caused riots when they were initiated by the previous regime in January. He has also moved to gain the confidence of merchants by reinstating their rights to privacy in financial transactions and the use of banking institutions of their choice. In addition, a limit on local currency withdrawals has been discarded. In the livestock industry, Conte abolished ENCOBE, the state's livestock marketing board, which previously purchased cattle at controlled prices that reportedly were less than production costs. The government has yet to tackle the problems of Guinea's numerous unproductive and inefficient state enterprises.

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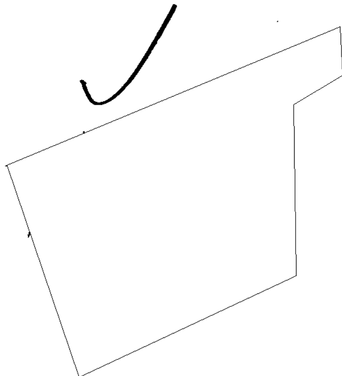
Labor Opposition to Malian Economic Reforms



Mali's labor leaders on May Day attacked President Traore's IMF-supported economic policy program at their annual rally. The unions demanded a return to state enterprises, salary increases when Mali reenters the French-backed West African Monetary Union (UMOA) in June, and denounced the policy of examinations for new civil servants. The US Embassy reports that these demands represent the first organized opposition to the government's economic reform program since it was introduced two years ago. Although the May Day rally ended peacefully with union officials promising to negotiate their demands with the regime, the potential for unrest will increase as the government deals with economic deterioration. In recent years Mali has begun turning from socialism toward a more open economy and to Western donors for increased aid. Moreover, it has been one of the few black African countries to date to successfully meet IMF performance criteria.

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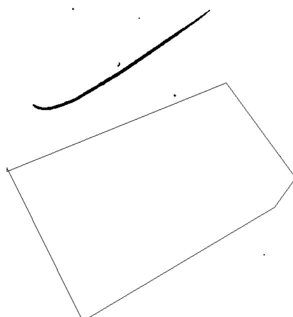
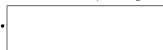
Yugoslavia Lifts Price Freeze



Yugoslavs are bracing for higher prices after the government last week lifted a price freeze that was imposed last December. The move complies with one of the conditions for a $380 million IMF standby credit that will help secure $3.4 billion from Western governments and banks needed this year. Although the new price policy conforms to the IMF agreement, the federal government can still intervene in cases where prices rise too rapidly. This could occur, because we expect financially strapped enterprises to attempt to cover mounting losses by seeking much higher prices. As a result, Belgrade is likely to face increasing consumer frustration as well as pressures from financially troubled industries in the months ahead. 

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Mexico: A Gloomy Economic Forecast

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Harsh austerity policies implemented since President Miguel de la Madrid took office in December 1982 have relieved Mexico's international liquidity crisis but only through unprecedented cuts in investment, economic activity, and living standards. We believe de la Madrid's economic team remains committed to austerity, but further belt tightening will be more difficult to achieve. We expect significant slippage from the tough IMF-supported stabilization program as Mexico City is confronted with growing antiausterity sentiment, including perhaps some violent demonstrations.

Mexico will continue to face serious economic problems even if it can avoid political dislocations and maintain austerity through 1984. Although Mexico has succeeded in reducing imports and the growth in foreign debt, we see no source of economic revival that can stem the decline of the economy during the next few years. The need to accommodate the ruling party's populist constituency and stave off potentially explosive public demonstrations severely limits de la Madrid's decisionmaking flexibility. As Mexico continues to be plagued by both extremely depressed economic activity and high inflation, we believe debates over economic policy will take an increasingly nationalistic turn and will force the ruling party to reinstate populist consumer policies and reflate the economy. This policy relapse would in turn lead to a recurrence of financial crisis, triple-digit inflation, and economic decline.

Improved Foreign Accounts

The most visible aspect of Mexico's austerity has been the sharp turnaround in Mexico's foreign payments situation. In 1983, Mexico stood alone among Third World countries in its record of addressing its financial problems. This success earned the respect and applause of the foreign financial community. Citing the financial turnaround, the international banking magazine *Euromoney* honored Jesus Silva Herzog as the Third World's outstanding finance minister for 1983.

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By yearend 1983—after nearly a year of moratorium on interest payments—Mexico had largely caught up on interest arrears and has since stayed current on the $1 billion per month it pays in foreign interest obligations. Net foreign exchange reserves at yearend had risen to $4 billion, up from virtually nothing when de la Madrid took office.

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By depressing domestic demand, Mexico achieved its first current account surplus since 1955. Merchandise imports in 1983 were one-half the 1982 level. Imports for the private sector fell sharply because of stringent import licensing; imports for the public sector fell only slightly because of the need for larger food purchases. The surplus on current account of $5.5 billion contrasts to a deficit of $4.9 billion in 1982.

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Mexico's tough deflationary steps have kept the country just within the bounds of its IMF-supported stabilization program. Official statistics released in March 1984 indicate that Mexico missed its public-sector budget deficit target slightly in 1983 (8.7 percent of actual GDP compared with the target of 8.5 percent). Because the shortfall occurred as a result of GDP falling more than anticipated, the IMF is overlooking this small breach. Targets in the IMF accord on increasing net international reserves and reducing debt service arrears were met by comfortable margins; criteria for limits to foreign borrowing and domestic credit expansion were barely met.

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Mexico: Foreign Financing Gap

Million US $

	1981	1982	1983 [a]	1984 [b]
Current account balance	−12,544	−4,879	5,546	3,000
Trade balance	−3,003	7,644	14,508	13,000
Exports, f.o.b.	20,927	22,081	22,228	23,000
Oil and gas	14,573	16,477	16,002	16,300
Manufactures	3,665	3,869	4,494	4,700
Agriculture	1,481	1,233	1,285	1,400
Minerals	1,208	502	447	600
Imports, f.o.b.	23,930	14,437	7,720	10,000
Net services and transfers	−9,541	−12,523	−8,962	−10,000
Interest	−8,383	−11,264	−9,861	−11,000
Debt amortization due	6,629	8,000	9,000	8,000
Financial gap	**−19,173**	**−12,879**	**−3,454**	**−5,000**
New medium- and long-term capital inflows	18,325	15,700	8,500	6,000
Rescheduled medium- and long-term debt payments	0	2,000 [c]	28,700 [c]	6,000 [c]
Net short-term capital	10,233	356	−29,208 [d]	−1,000
Errors and omissions	−8,373	−8,362	−1,432	−2,000
Changes in reserves	1,012	−3,185	3,106	4,000
Other financial items				
External debt (at yearend)	75,061	87,875	90,000	94,000
Short term	22,654	28,641	10,000	9,000
Debt service ratio (*percent*)				
Due	48.7	66.6	66.7	60.0
After debt relief	48.7	59.7	41.9	40.0

[a] Estimated.
[b] Projected.
[c] Includes debt relief on $2 billion in 1982, $7 billion in 1983, and $6 billion in 1984 on medium- and long-term debt principal due; and $22 billion in 1983 in short-term debt rescheduled as long-term obligations.
[d] Includes rescheduled short-term debt.

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High Cost to the Domestic Economy

Mexico's stabilization program has been severely deflationary:

- Real wages fell by about one-fifth during 1983. Although organized labor is disillusioned, it has accepted de la Madrid's explanations for the need for austerity and has shown more concern over protecting jobs.
- Real government spending in 1983 was slashed by 30 percent. Public investment was cut by 40 percent, the impact falling heavily on oil development expenditures.
- Subsidies were cut 20 percent in 1983, nearly in line with the IMF program. Producer subsidies were slashed 40 percent, substantially more than

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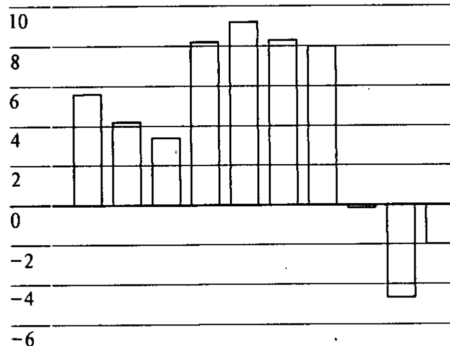
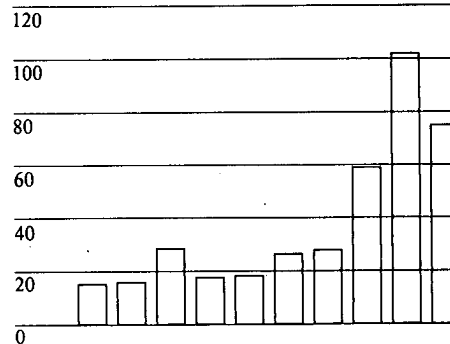
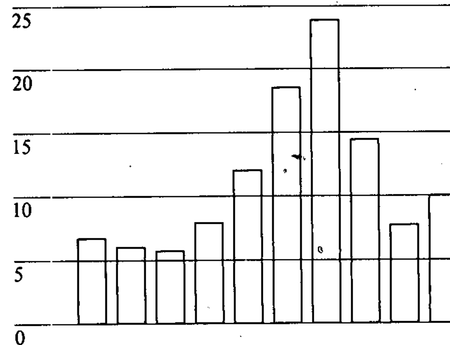
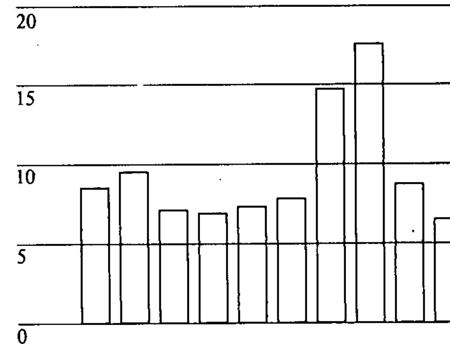
Mexico: Economic Indicators, 1975-84

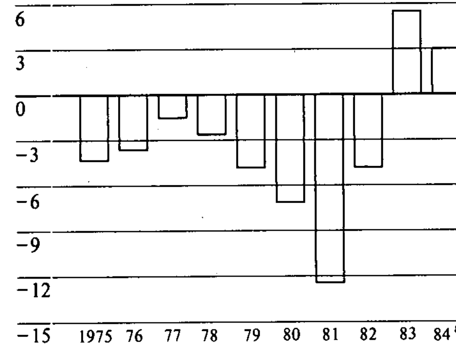
Note scale change

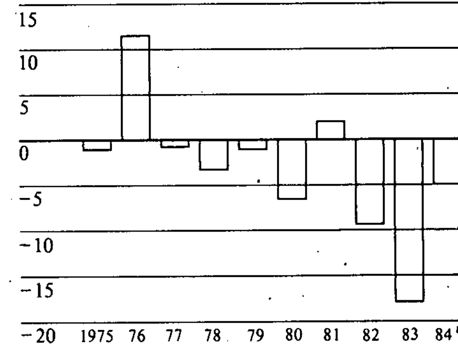












[a] Projected.

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the IMF goal of 20 percent. Consumer subsidies—such as public transportation and basic staples—increased 7 percent, compared with the IMF goal of a 25-percent cut.

- Despite the decline in economic activity, increased peso earnings from foreign oil sales kept the fall in public-sector income at only 4 percent in 1983.

The deflationary impact was even greater than anticipated. The economy is so depressed and the economic environment so changed that—after 16 months of harsh austerity—the public debate has switched to the halting of further economic declines.

According to official estimates, which may be optimistic, output fell 4.7 percent in 1983, and investment dropped by one-fourth. Utilization of industrial capacity decreased by one-third or more in numerous industries. Industrial production declined 10 percent last year and 13 percent at an annual rate in the last quarter. The commercial sector has suffered because of dwindling supplies, lower purchasing power, and higher taxes. Sales data show that commercial activities have fallen 15 percent. Although sales of basic consumer goods have changed little, merchants report retail sales of other goods off 20 percent to 50 percent.

Agriculture has improved somewhat as favorable rains in 1983 ended two years of widespread drought. Farm recovery was limited, however, by lower real farm price guarantees, shortages of imported inputs, and a tightening of crop credits. As a result, the farm sector was not able to take advantage of good weather, and plantings and harvests last year were still far below predrought levels.

Job losses—particularly among unskilled labor—have become severe. We believe the rate of unemployment has more than doubled since mid-1982 and now stands at over 20 percent; it is close to 30 percent in urban areas. Official statistics indicate that the number of workers employed in modern manufacturing has fallen 15 percent from its 1981 peak. The bulk of the 800,000 young Mexicans who normally enter the labor force each year are resorting to make-work jobs, staying in school, or crossing the US border for temporary work. Most new entrants have been added to the ranks of the underemployed.

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Growing unemployment and underemployment and lower real wages have substantially reduced purchasing power. Moreover, import cuts and the slowdown in economic activity have resulted in growing scarcities of some manufactured goods. Price imbalances caused by government controls on basic foods have led to reduced production of such key goods as milk, eggs, meat, and tortillas.

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These trends have lowered personal consumption. Organized labor, including government workers, has been shielded by substantial fringe benefits. Workers earning the official minimum wage or less—at least 60 percent of the work force—and many independent merchants and other businessmen have not been so lucky. The government has continued subsidies on basic foods and public transportation to lessen the blow. Even so, the situation has forced most Mexicans to eliminate luxuries and draw down savings. it has also resulted in increased illegal work trips to the United States, particularly as poor families find coping more difficult.

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Intractable Inflation

To Mexico City's chagrin the tough austerity measures and the effects of depressed demand have not yet curbed inflation. Mexico City eased price controls moderately over the course of 1983, and the higher costs associated with peso devaluation have just begun working their way through the economy. In addition, the peso's continuing devaluation at a 34-percent annual rate maintains upward pressure on prices of a number of critical imports. Despite the reduction in the budget deficit, domestic financing requirements remained as high as ever because of much lower foreign borrowing. Moreover, continued capital flight also has kept interest

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rates and inflationary expectations high. Prices in 1983 were 100 percent higher than in 1982. Although inflation eased slightly in the second half of last year, it has recently picked up, running at a 96-percent annual rate in the first quarter.

Policy Dilemmas

The Mexican leadership faces enormous difficulties in developing a politically palatable economic strategy. In addition to divergent opinions on the respective roles of the public and private sector and on the utility of foreign investment, economic decisionmakers must take account of the inherent conflicts among the government's three economic goals of: (a) meeting IMF guidelines by reducing inflation and government budget deficits, (b) avoiding regime-threatening public disturbances by maintaining basic consumption levels to keep the lid on public discontent, and (c) stimulating economic growth.

Maintaining the Austerity Course. The most pressing short-term issues facing de la Madrid lie in keeping Mexico within the IMF guidelines at a time of continuing high inflation and rising public discontent over austerity. Foreign adulation of the austerity record has reinforced the determination of de la Madrid's financial advisers to meet the IMF guidelines. Others, such as labor boss Fidel Velazquez, demand loosening policies that retain real wages and consumer subsidies.

At the beginning of 1984, Mexico City and the IMF agreed to extend the stabilization package for the second year of its three-year schedule. Performance targets, however, will be tougher. Domestic credit will remain tight and foreign borrowing low, and Mexico City will be required to slash its budget deficit again—lowering the deficit as a share of GDP another 2 percentage points, to 6.5 percent.

Financial authorities agree that cutting the budget deficit this year will be harder than in 1983. Little margin remains for savings on foreign exchange losses, which provided a major portion of budget cutting last year. Mexico City will again have to slash spending. To do this, it is planning to further lower public investment, reduce its wage bill 20 percent, and cut consumer subsidies by nearly 40 percent. To meet these goals, the government almost certainly must cut back on heretofore untouched food and transportation subsidies, and on military, parastatal, and central bureaucracy budgets, a necessity that gives pause to the top leadership.

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Mexico City is concerned—we believe justifiably—that further austerity measures may provoke violence. Public criticism is mounting. Organized labor has openly conditioned its crucial support on maintenance of union jobs and on basic consumer subsidies. The grudging cooperation of the business community and the middle class remains even more fragile. Moreover, opposition politicians and labor leaders have become more strident in their calls for an end to austerity.

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De la Madrid must soon make some tough choices between austerity and stability in the near term:

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- Inflation is highly unlikely to close out the year anywhere near the 50-percent IMF target, unless drastic measures are taken.
- Rising costs of basic inputs are squeezing businessmen, who are forced to produce and sell at controlled prices; shortages are becoming more prevalent and instances of illegal price hikes more common.
- Discussions will soon begin on midyear wage adjustments affecting all Mexican workers.

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We judge that de la Madrid will hold fast to the spirit of the IMF-supported austerity program, although we foresee significant slippage as political considerations cause Mexico to fail to live up to the letter of the agreement. The most difficult areas will be wage policy and budget cuts (including lowering subsidies). Mid-April adjustments on some staple prices convince us that Mexico City will face up to these sensitive standard of living items.

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The sensitive issue of prices and austerity is illustrated by tortillas, the dietary staple for most Mexicans. The government reacted to price control violations by tortilla makers with widely publicized fines and closures in March. The administration realizes that the tortilla makers must be compensated for higher corn prices, either by an increase in the subsidy on corn or a boost in the price of tortillas. To overcome this problem, de la Madrid's economic team has tested the waters unsuccessfully with a combination tortilla price hike and food stamp program.

Attempts To Stimulate Economic Growth. President de la Madrid believes—and we agree—that the revival of private investment is essential to restore Mexican economic growth. His approach contrasts with the philosophy of the past decade, which called for increased government control of the economy and reached its height with the bank nationalization in 1982. It has set the President squarely against the bureaucratic mainstream, Mexican popular opinion, and the views of key party figures such as Fidel Velazquez. De la Madrid, despite some false starts, has attempted to revitalize investment by:

- Streamlining the foreign investment bureaucracy, sending financial emissaries abroad, and courting foreign investors.
- Widely publicizing selected offers of 100-percent foreign equity participation in Mexican-based investments.
- Engaging in personal dialogues with industrialists and instructing officials to ease regulations to boost exports and stimulate industrial expansion.

Even so, the President has been unable to restore domestic or foreign business confidence. The entrepreneurial spirit among businessmen is flagging because of low demand and persistent high inflation; they doubt de la Madrid's ability to ease government restrictions on private investment and resent the pervasive antibusiness cast of official policy. We see few signs of major deals, and those in the works are largely by foreign business groups already in Mexico through previous investments.

Continued Economic Deterioration

We believe that de la Madrid has little chance of stimulating the economy any time soon:

- Preliminary industrial statistics in 1984 indicate that the economy is still declining.
- Domestic demand continues to fall. Personal savings have been depleted in many cases, and wages and government spending are declining further. Many plants are running at a fraction of capacity.
- Potential exporters fear that Mexico City will support the peso at an artificially high level because of the need to protect existing businesses and hold down inflation.
- Many US businessmen and bankers believe that Mexico will return to a hard line on foreign investment once the economy regains momentum; they are particularly concerned that de la Madrid's overtures for majority equity participation are not legally binding.
- Those Mexican industrialists who could invest are concerned about the durability of the government's commitment to the private sector; many prefer to maintain their financial holdings abroad.

Because of these problems, most US econometric services, the IMF, and the Mexican Government project a zero- to 2-percent growth in the GDP for 1984. We are more pessimistic. Preliminary estimates using our econometric model of Mexico indicate that falling consumption and investment called for by continued austerity in Mexico's IMF program will result in at least a 2-percent decline in economic activity in 1984.

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Mexico: Forecasts of Key Economic Variables, 1984

	GDP Growth *(percent)*	Consumer Price Growth *(percent)*	Current Account Balance *(billion US $)*	Imports *(billion US $)*	Exports *(billion US $)*
Data Resources, Inc.[a]	1.0	58	−2.2	13.9	21.8
Wharton Econometric Forecasting[b]	2.0	60	0.6	13.0	22.2
Chase Econometrics[c]	0.3	62	2.3	10.6	22.2
International Monetary Fund[d]	1.0	50	−1.0	14.0	23.9
Mexican Government	0	50	1.0	12.0	24.0
Central Intelligence Agency	−2.0	75	3.0	10.0	23.0

[a] *Latin America Forecast Summary*, Data Resources, Inc., March 1984.
[b] *World Economic Outlook*, Vol. VI, Number 1, Wharton Econometric Forecasting Associates, May 1984.
[c] *Latin America Forecasts and Analysis*, First Quarter 1984, Chase Econometrics, March 1984.
[d] IMF Staff Report, 30 January 1984.

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Looking Ahead

Steering a stable course through the next 18 months will require expert timing, nerve, considerable luck, and continued outside support. Specifically, precipitous cuts in staple prices or growing food shortages could trigger violence. Strikes by independent labor unions over meager wage adjustments or major plant closures are possible. Reduction of the bureaucracy, at a time when a depressed economy offers loyal government workers no ready alternative, would undercut essential support. Unfavorable international developments, higher interest rates, or reduced international lending would put additional strains on Mexico's austerity. For example, recent increases in the US prime interest rate will cost Mexico an additional $1 billion on existing debt this year. 25X1

The days of relying on increasing oil revenues,

The days of relying on increasing oil revenues, more foreign borrowing, big government, and an overvalued peso are gone. As the social fallout of continuing stagflation forces the government to act, the populist base of the ruling party probably will prevent timely changes to encourage private investment and government efficiency. We thus envision tremendous pressures on Mexico to reflate the economy under government stimulus. Such a reflation, after temporarily boosting personal consumption and investment, almost surely would lead to another economic crisis, involving a plunge in output and employment, triple-digit inflation, and massive arrears in debt payments. 25X1

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Summit Issues: Acid Rain

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Acid rain is likely to be a controversial topic at the London Summit. The Canadians and West Germans probably will seek general agreement from the Big Seven countries to reduce sulphur dioxide (SO_2) emissions by 30 percent over the next decade. Chancellor Kohl and Prime Minister Trudeau enjoy nearly universal domestic support for this goal. France and Japan probably will support reductions, while Britain probably will insist that further acid rain research is necessary before expensive abatement procedures begin. London will expect support for its position from the United States.

Background

Since the early 1970s, many scientists, especially those in Scandinavia, have claimed that SO_2 emitted by industrial and power plants, along with nitrogen oxides (NO) from automotive exhausts, combine with atmospheric moisture and return to earth as acidic precipitation. They claim the resulting deposition of acidic materials destroys fish life in fresh water, depletes fertile soil, and damages forest areas. The Norwegian Government, for example; asserts that 1,750 of Norway's lakes are devoid of fish and 900 others show reduced fish stocks because of acid rain. The Scandinavian governments were the first to focus on the problem of long-range transboundary air pollution (LRTAP) and have been the strongest advocates of international arrangements to reduce SO_2 emissions. In recent years they have been joined by the Canadians and, more recently, by the West Germans.

Prelude to the Summit

In 1979 the United Nations Economic Commission for Europe concluded a "Convention on Long-Range Transboundary Air Pollution" (CLRTAP). The Convention, which came into force last year, is the only multilateral air pollution agreement and has 30 signatories, including all the Big Seven countries.

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In March of this year a group of the signatories held a conference in Ottawa to mark the first anniversary of the Convention. The March conference produced the "Ottawa Declaration" in which Canada, West Germany, France, Austria, Switzerland, the Netherlands, Denmark, Norway, Sweden, and Finland promised to:

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- Reduce SO_2 emissions by 30 percent by 1993, using 1980 as a base year.
- Undertake further SO_2 reductions if environmental conditions do not improve sufficiently by 1993.
- Work for measures on the national and international levels to decrease NO emissions by 1993.
- Urge all CLRTAP signatories to reduce their SO_2 emissions by 30 percent.

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The Ottawa Declaration was intended to launch, according to a Canadian environmental official, a "diplomatic offensive" against the "villains of acid rain"—in his estimation, the United States, Britain, East Germany, Poland, and Czechoslovakia. All of those countries signed the Convention but have not pledged specific SO_2 reductions. The Ottawa meeting was meant to focus international attention on these states and to serve as a springboard for two conferences, that will discuss acid rain for later in 1984: the Multilateral Environmental Conference in Munich in June and the second session of the Executive Council of CLRTAP nations in Geneva in September.

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What is Acid Rain?

Acid rain is believed by many scientists to occur when sulphur dioxide (SO_2) and nitrogen oxides (NO) oxidize and then combine with atmospheric moisture to form mild solutions of sulphuric and nitric acids. The sulphur dioxide generally is believed to emanate from the smokestacks of utility plants or smelters, the nitrogen oxides primarily from smokestacks and automobile and truck exhausts. Sulphur oxides currently are thought to be the main cause of acid rain.

Acidity is measured by the pH scale of zero to 14. For example, bodies of water with a pH reading of 7 are neutral, those with higher readings are alkaline, and those with lower ones acidic. Clean, normal rain over continental areas usually is slightly acidic with pH readings of around 5.6. (The carbon dioxide naturally present in the air sometimes combines with moisture to form weak carbonic acid). When the pH drops one point, the acidity is 10 times greater. A pH of 4, for example, is 100 times more acidic than one of 6.

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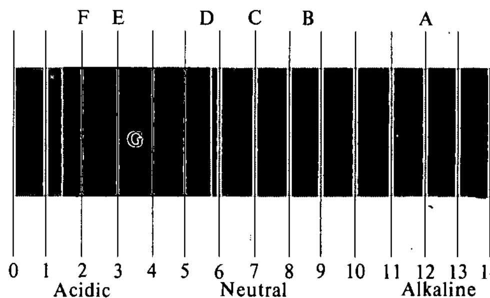
Acid Rain on the pH Scale



Substance	pH
A. Ammonia	12.0
B. Baking soda	8.4
C. Distilled water	7.0
D. Pure rain	5.6
E. Vinegar	3.0
F. Lemon juice	2.0
G. Acid rain	1.5 to 5.6

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Country Positions at London

Because the Summit is the most publicized of regularly scheduled international meetings, Bonn and Ottawa almost certainly will seek to make acid rain a prominent topic of discussion. Both consider US and British cooperation indispensable to a workable international accord and probably will pressure the United States and Britain to begin SO_2 reductions immediately.

Canada. In the mid-1970s, Ottawa concluded that acid rain was seriously damaging Canada's environment and since then has aggressively sought a treaty with the United States to reduce SO_2 emissions in both countries. Ottawa's efforts to secure a treaty thus far have failed, and it currently is seeking to move the issue from the bilateral to the multilateral sphere.

Ottawa believes acid rain is endangering sectors of its economy that account for nearly 8 percent of GNP; the Canadians are particularly concerned about damage to their forests, which provide one of every 10 jobs in Canada. Ottawa claims that at least 50 percent of the acid rain that falls in Canada is caused by pollutants emitted in the United States.

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Prime Minister Trudeau is retiring in June and probably will seek to make a distinctively Canadian contribution to his last Summit. He is likely to refuse to compromise on his demands for immediate SO_2 reductions. His attitude will be steeled by recent Gallup polls showing 86 percent of Canadians favoring emission controls regardless of cost. In addition, Trudeau's personal truculence will be

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reinforced by Canada's belief that the United States is not cooperating in acid rain abatement and by Ottawa's delight in having, for the first time, a major ally in Kohl and the West Germans.

West Germany. Chancellor Kohl has said the resolution of the acid rain problem is a matter of "inestimable importance" to West Germany. Environmental officials in Bonn estimate that 34 percent of West Germany's forest areas, with a value of about $1 billion, have been damaged by acid rain. Government statistics indicate that 50 percent of the 7 million metric tons of acidic materials falling in West Germany annually come from foreign sources, particularly France, Britain, and East Germany.

The importance of forest areas to the German psyche, the electoral success of the ecologically oriented Green movement, and the evidence of the damage attributed to acid rain—which in terms of total damage to trees, fish, soil, and buildings is estimated to approach $1.5 billion per year—have produced outrage and a sense of urgency among West Germans. In response, Kohl's government is attacking acid rain in two ways: strict domestic antipollution regulations that will require the installation of costly emission-control devices and an ongoing effort to promote international environmental cooperation

Bonn believes air pollution has peaked in West Germany but at much too high a level and maintains that SO_2 emissions must therefore be cut "prior to obtaining decisive scientific evidence" linking them to acid rain. Moreover, the government is promoting international cooperation on acid rain. Within the European Community, Bonn is seeking EC-wide standards for SO_2 emissions and automotive exhausts. In addition, West German representatives were prominent at the Ottawa Conference, and Bonn has signaled its intention to do likewise at the Munich and Geneva conferences later this year.

Chancellor Kohl is likely to support the Canadian acid rain position at the Summit. Kohl probably enjoys domestic support on acid rain as nearly unanimous as Trudeau's—both leaders draw support internally from an ethos that stresses the importance of pure forests and other natural resources to the national identity. Bonn's bottom line for the Summit probably was expressed at the Ottawa Conference by Carl-Dieter Spranger of the Ministry of the Interior, who stated, "Those advocating delay under the pretext that we still know too little, must receive a definite 'no.' "

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United Kingdom. London urges there is not enough evidence to demonstrate conclusively that SO_2 emissions cause acid rain and believes that expensive abatement procedures are not justified until an irrefutable link is made. The Treasury Department and the public-sector Central Electricity Generating Board (CEGB) estimate that a 30-percent reduction in British SO_2 emissions would cost $6 billion for installation of scrubbers, boost the CEGB's operating costs, and drive up electricity prices 10 to 15 percent.

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Refusing to begin reductions has left Britain isolated within the European environmental community. Britain currently is estimated to produce 4 million tons of SO_2 annually—the most of any West European country—and nearly two-thirds of it reportedly is carried eastward out of the country by the wind. The Scandinavians long have contended that British SO_2 is blown across the North Sea and deposited in the Nordic region; the British recognize this possibility, as witnessed by the CEGB's allocation of $7.5 million to study acid rain jointly with the Swedish and Norwegian Governments. Nevertheless, at the Summit, Britain is likely to stand squarely behind its Department of Trade and Industry's report on acid rain, which concluded, in January 1984, that there is "insufficient basic information available . . . to say with certainty that manmade acid deposition is a significant environmental problem in the United Kingdom."

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France. French interest in acid rain is a recent

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France. French interest in acid rain is a recent phenomenon, prompted by the damage to West Germany's forests and the discovery of similar damage to forests in northern and eastern France. Paris has undertaken surveys of the problem—which indicate damage in French forests is growing rapidly—and is moving toward a comprehensive national policy. The principal French objectives regarding acid rain appear to be:

- A 50-percent reduction in SO_2 emissions by 1990—largely the byproduct of conversion to nuclear power and the resulting elimination of coal-fired electricity plants.
- Cooperative efforts with other European countries to reduce SO_2 emissions.
- A publicity campaign to educate the French population on the dangers posed by acid rain.

President Mitterrand probably will support Kohl and Trudeau on acid rain at the Summit. Paris already is committed to SO_2 reductions greater than those being urged by Bonn and Ottawa. Endorsing Kohl's position gives Mitterrand an opportunity to strengthen the recent trend toward more intimate Franco-German cooperation in other fields. In addition, Paris's support for the German-Canadian position could win Mitterrand points among the small domestic environmental constituency.

Japan. Tokyo is actively reducing domestic SO_2 emissions and pollutants in automotive exhaust. In 1983, for example, fewer than 3 percent of Japanese cars burned leaded fuel. Japanese industry has cut SO_2 emissions by one-half since 1970, and the number of flue scrubbers operating in Japan rose in the same period from 100 to more than 1,000. Tokyo also created a Committee on Acid Rain Countermeasures in 1982 that is now conducting a five-year research program on acid rain.

Prime Minister Nakasone is likely to feel uncomfortable on the acid rain question at the Summit. Tokyo has scientific and technical cooperation agreements with the United States and West Germany under which acid rain and other environmental problems are discussed. The Japanese do not want the Summit disrupted by a controversy over acid rain, but because of Tokyo's own environmental policies and the presence of an ecological constituency in Japan, Nakasone probably will support Bonn and Ottawa in the attempt to gain reduction pledges from the United States and Britain.

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Italy. Rome has shown little interest in addressing the problem of acid rain in either its domestic or international context. At London, Craxi probably will be sympathetic to Kohl and Trudeau but would be satisfied if the Summit simply concluded that the issue should receive more study before major pollution abatement programs begin.

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The East-West Angle

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West German and French interest in promoting agreement on acid rain at the Summit will in part be influenced by their desire to negotiate SO_2 emission standards with Eastern Europe and the Soviet Union. Bonn and Paris share the view of Scandinavian governments that some of the pollutants causing acid rain in their countries come from the East. Seasonal fluctuations in prevailing wind patterns permit atmospheric pollutants produced in Eastern Europe and the Soviet Union to be carried into Western, Nordic, and Southern Europe. Moscow has indicated a willingness to begin a 10-year SO_2 abatement program in 1985, according to Norwegian officials. The Soviets and East Europeans will attend both environmental conferences later this year. Bonn, Paris, and Ottawa probably believe that a definite Summit commitment to SO_2 reductions will strengthen the West's hand in dealing with the Soviet Bloc.

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Summit Issues: Big Six Views on High Technology

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All of the Big Six governments perceive a need to promote high technology to maintain their international competitiveness and, in varying degrees, all intervene in the market to achieve this end. Although there is little solid evidence as to what these efforts have accomplished, Japan appears to have achieved the greatest results. In the computer, telecommunications, and semiconductor sectors, Tokyo has supported all phases of the innovation process, from initial research and development through sale of the final product. Recently, new materials and biotechnology also have become the focus of research and development activity.

The major West European countries and Canada share a common fear that they are falling behind the United States and Japan technologically. All five are also burdened by declining industries that absorb large amounts of government funds that might otherwise go to support new technologies. With its long tradition of government involvement in the economy, France probably has been the most active in this area, achieving mixed results. Even the market-oriented governments in Bonn and London, however, are unwilling to leave technological innovation entirely to the private sector; both provide various forms of financial support for research and development activities. Rome is working on new measures to promote high technology, although we expect greater results from the trend among Italian firms to establish ties with US and Japanese companies. Ottawa tends to rely on direct investment of government funds in selected high-tech fields.

In an effort to catch up with the United States and Japan in the field of information technology, the West European members of the Big Six this March joined with their EC partners to implement a Community research and development effort. The ESPRIT program—the European Strategic R&D Program in Information Technology—is the Community's principal cooperative effort to support research activities of business and academic institutions. It is intended to improve the EC's technological base in advanced microelectronics, computer software, advanced data processing, computer-controlled manufacturing, and office systems. The program is scheduled to cost a total of $1.3 billion over the next five years with equal shares provided by the EC and the private sector. Although well received throughout the Community, ESPRIT nonetheless is a relatively small program—IBM and AT&T together spend $2 billion annually on similiar research. Moreover, ESPRIT does not address the EC's more fundamental problem—the inability to adapt technological innovations to commercial applications.

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Japan

Among the Big Six governments, Tokyo has been the most visible and probably the most successful in promoting high technology. The Japanese Government views high technology as the seed from which new, internationally competitive industries will grow and as a means of reinvigorating mature or declining industries. Acting mainly through the Ministry of International Trade and Industry (MITI), Tokyo assists all phases of the innovation process in selected industries. MITI, in conjunction with other government agencies, often encourages research and development, financial assistance for new production facilities, and an assured market. Procurement by the government-owned telecommunications monopoly, NTT, for example, helped launch the computer and semiconductor industries. Today, MITI relies heavily on cooperative research

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projects with large corporations to promote research and development in a broad range of high-technology fields. A major problem now facing the government is the apparent shortage of risk capital for new, small businesses.

MITI places special emphasis on computers, telecommunications, and semiconductors because these are high-value-added industries with expanding markets. Support is also provided for areas such as composite materials and biotechnology that could add to the competitiveness of major existing industries. Advances in biotechnology, for example, are expected to lead to new, less energy-intensive production processes for many chemicals.

France

Next to Tokyo, Paris probably has been the most visible among the Big Six governments in promoting technological development. The results have been mixed. Government-sponsored research has developed a wide range of sophisticated military equipment and has also made France a leader in nuclear power technology—especially fast breeder reactors. Paris also played a key role in the growth of the telecommunications sector and in the emergence of the Airbus consortium as an effective competitor on the world market for large jet airliners. On the other hand, Paris has tried for well over a decade—without great success—to bring the computer and machine tool industries up to the standards of their international competitors.

Since the 1981 election campaign, high technology has been a basic component of Socialist plans for the future of France. Technological innovation is expected to lead to the growth of new industries as well as improved productivity in traditional sectors. Although aging industries have continued to absorb a large share of government aid, recent decisions concerning coal, steel, and automobiles indicate that high technology will get growing support from Socialist decisionmakers. The new strategy will go beyond increased allocations of aid and credit to high-technology sectors. Awed by the Silicon Valley example, the French have decided to reduce bureaucratic barriers to launching new businesses and have taken steps to bolster the nearly nonexistent venture capital market.

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West Germany

Although West German manufacturing technology is among the most advanced in the world, government and business leaders fear that the country is being surpassed by Japan. This is a source of growing concern to a nation whose prosperity depends to an unusual degree on the export of relatively sophisticated manufactured products. Japan has overtaken West Germany in certain key technologies, such as microelectronics and robotics, and is challenging West German industry in other areas—including precision forging technology, medical electronics equipment, and advanced metalworking equipment. West Germany also lags behind some of the latest developments in the new industrial fields of biotechnology and high-tech materials.

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West Germany has been slow to translate new technology into mass production—laser technology and photographic equipment, for example. Possible reasons include an overconfident attitude in the past toward foreign competition and socioeconomic obstacles to new small-scale ventures that are often in the forefront of high-tech industries. The Kohl government's basic response to this and to other economic problems is to increase further West Germany's reliance on market forces. Bonn, however, is beginning to expand its support for research and development—particularly in smaller firms—by providing subsidies and tax breaks. Areas being aided include microelectronics, computers, biotechnology, and optical communications.

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United Kingdom

Prime Minister Thatcher and her key advisers believe that widespread application of high technology is essential if Britain's position as an advanced

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industrial nation is to be maintained. Although their Conservative ideology leads them to place considerable emphasis on creating a predictable climate for business and to use macroeconomic measures, such as tax policy, to foster private-sector initiative and productive investment, in practice they have been somewhat reluctant to rely entirely on market forces.

London has established a number of programs available to all firms, while others target only specific sectors. The effort in general focuses less on the development of new technology than on its implementation in the production process—even if the new technology must be imported. Government seed money has been made available, for example, to fund programs in computer-aided design, manufacture, and testing; the use of flexible manufacturing systems; fiberoptics; biotechnology; advanced computer design; and further development of the microelectronics industry. London also has provided funds to old-line industries hard hit by recession and foreign competition but considered too important in terms of employment and export earnings to sacrifice. An example of the latter is a new program to encourage the use of advanced equipment by small- and medium-sized firms in the clothing, footwear, knitting, and textile industries. The government hopes that the $425 million of new money allocated to its incentive programs in the current budget will generate an additional $1.7 billion in private investment by 1990.

Italy

With some notable exceptions—such as numerically controlled machine tools and nuclear technology—short-term profit pressures, an underdeveloped capital market, and mismanaged government policies have contributed to a technological gap between Italy and the other major industrialized nations. According to a recent study by Confindustria, Italy's employers' association, Italy lags these countries by approximately five to 10 years in moving from a reliance on traditional industries to a high-technology structure. Key government, business, and labor leaders generally agree that the remainder of the 1980s will be a critical transition period as Italy strives to improve its competitiveness by developing new high-tech industries and by introducing technological innovations to lower production costs in traditional industries.

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To close the technology gap, Rome plans to streamline existing government programs and institute new ones. Based on past experience with Italian Government programs, however, we believe that a more important development is the recent trend toward joint ventures and equity participation with US and Japanese companies. Italian public- and private-sector firms see these linkages as the least time-consuming and least costly way to gain access to technological developments. Since 1980, for example, Olivetti has purchased equity shares in over 20 small- and medium-size US firms operating in fields from microchip manufacture to mainframe computers, and has signed an accord with AT&T to provide access to Bell Laboratories. Some government officials and labor leaders are concerned, however, about the employment effects of introducing laborsaving technology. In addition, according to US Embassy sources, government study groups are meeting periodically to review potential problems of increasing foreign dependence in key sectors such as telecommunications.

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Canada

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Ottawa is convinced that it must encourage the development of high-technology industries to enhance Canada's international competitiveness and provide future employment opportunities. Indeed, the cornerstone of the Liberal government's much ballyhooed but largely unformulated industrial policy is a move away from resource-based and smokestack industries toward such high-tech endeavors as aerospace, telecommunications, communications electronics, and advanced oil and gas field equipment. In all of these fields, Canada has demonstrated—albeit on a relatively small scale—some ability to compete effectively in international markets.

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The government considers direct public-sector investment the best means of ensuring adequate levels of Canadian involvement in new high-technology industries. Ottawa consequently has invested large sums of federal money in such industries, most recently to spur the domestic production of helicopters. In addition, federal research grants and tax incentives are provided to promote research and development activities within Canada. The present high level of unemployment, however, has made it politically imperative for Ottawa to divert funds to support the more traditional, labor-intensive industries. Budget constraints are likely to prevent Ottawa from implementing its investment strategy for high-tech industries soon.

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Argentina: Medium-Term Financial Outlook Under Alternative Economic Scenarios [1]

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Although the 11th-hour agreement that narrowly prevented US commercial banks from classifying over $4 billion in Argentine loans as nonperforming eased Argentina's immediate financial crisis, many observers remain skeptical that Buenos Aires can obtain sufficient funds to satisfy its longer term borrowing needs and avoid a prolonged financial crisis. Our projections indicate that if favorable global economic conditions prevail through 1990 the country's annual net borrowing needs in 1985-90 would average 55 percent of peak borrowing in 1979-81.[2] Many experts believe lenders almost certainly would be unwilling to finance even this level. In the event of shocks to the global economy, however, Argentina's net borrowing needs would be even higher, and we believe lenders would be unwilling to satisfy these needs. Recognizing that economic shocks to the world economy are likely and that many experts are convinced that Buenos Aires's projected borrowing needs would not be satisfied by lenders even under favorable economic conditions, we believe Argentina will be plagued by serious financial difficulties throughout the decade.

Introduction

Argentina's recent financial difficulties can be understood by analyzing the surge in gross borrowing that began in 1979. This was caused initially by a shift of the trade account from a surplus into a deficit and later by sharply rising debt service obligations. In 1979 and 1980 a deterioration in the trade accounts, the result of a sharp real appreciation of the peso, occurred when exports and imports grew at average annual rates of 15 percent and 62 percent, respectively. During 1981-83, concurrent with a steady improvement in the trade balance, debt service costs rose dramatically to an annual average of $19 billion—up from $11 billion in 1980—because of sharply higher interest rates and a near doubling of principal repayments. As a result of this one-two punch, gross borrowing in the 1979-83 period totaled $86 billion—3.5 times the amount in the previous five years. This surge in borrowing pushed outstanding debt from $10 billion in 1978 to $40 billion in 1983.

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In addition to lenders' attitudes toward Argentina, the key to determining whether Buenos Aires's financial difficulties will persist throughout the decade is estimation of the country's net borrowing needs through 1990. Toward this end, we have developed a balance-of-payments simulation model. Given assumptions about future global economic conditions—such as economic growth, interest rates, oil prices, and export price inflation—and the future course of the Argentine economy, the simulation model projects the trade balance, interest payments, principal repayments, and other variables required to calculate net borrowing. We examined Argentina's net borrowing needs under four sets of assumptions regarding global economic conditions. One scenario assumed that favorable economic conditions would prevail through 1990, while each of the others assumed that the world economy would be buffeted by a different economic shock. Argentina's medium-term financial outlook in turn depends on lenders' willingness to finance the net borrowing projected in each scenario and the probability of each scenario occurring in the rest of the decade.

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[1] This article is the second in a series that assesses the longer term financial outlook for key debt-troubled LDCs based on simulation model results.

[2] *Net borrowing*—the sum of the trade deficit, interest payments, and miscellaneous net capital outflows—represents the required inflow of "new money" or the increase in foreign lender exposure in the country. *Gross borrowing*—net borrowing plus principal repayments—is the sum of "new money" loans and loans that "roll over" the principal repayments due on old loans.

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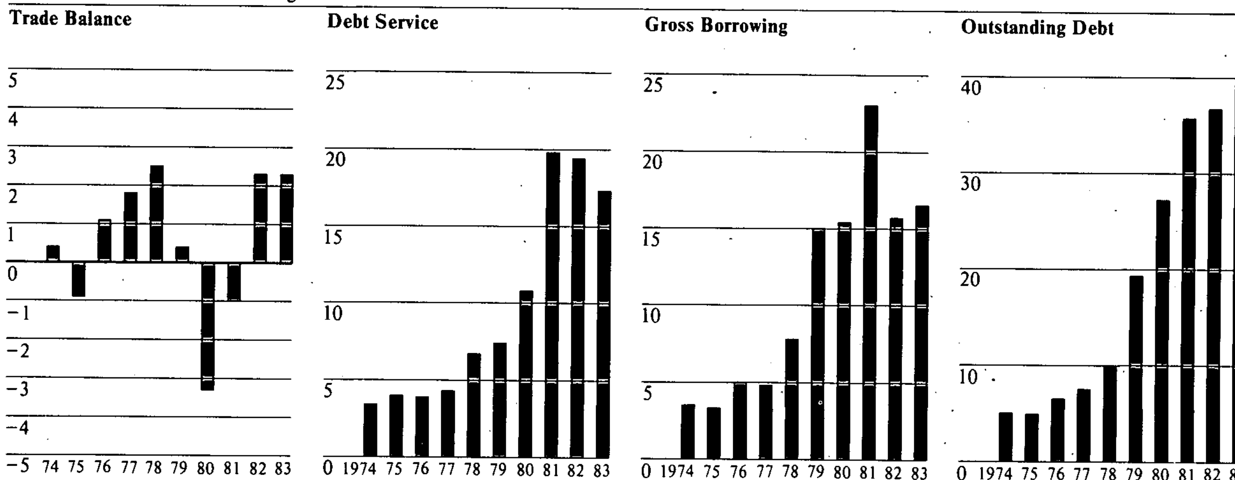
Argentina: Trends in International Trade and Finance, 1974-83[a]

Billion US $ Note scale change



[a] Values for 1983 are based on incomplete data. The short-term components of debt service and gross borrowing are estimated prior to 1980.

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Favorable Economic Conditions: Net Borrowing Remains High

We first projected Argentina's net borrowing needs through the rest of the decade assuming favorable economic conditions. We assumed that during the next seven years:

- World real GDP would grow at an average annual rate of about 4 percent.
- Interest rates would fall slowly by a total of 3 percentage points.
- Oil prices would rise by $1.00 per barrel each year.
- World export prices would grow, on average, at about 5 percent each year.

In addition, we assumed in this, and the other scenarios, that during the same period:

- Argentine real GDP would grow, on average, at Buenos Aires's target growth rate of about 5 percent per year, high by historical standards.
- The rate of Argentine price inflation and currency depreciation would slow nearly 80 percent.
- The prices and volumes of Argentine exports and imports would respond to changing economic conditions as they have in the past two decades.

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Under these favorable economic conditions, our simulation model indicates that Argentina's net borrowing needs through 1990, at 55 percent of the level in the peak borrowing years of 1979-81, would remain high. Net borrowing would rise to $6.5 billion in 1984—up from $3.3 billion in 1983—before falling back to an average of $4.5 billion per year in the 1985-90 period. Taking into account the rollover of principal repayments, gross borrowing would double over the decade rising from $16.5 billion in 1983 to $34 billion in 1990. Based on this projected level of borrowing, outstanding debt would rise by $34 billion, reaching the $74 billion level in 1990. Although the stock of debt is expected to grow at an average annual rate of 9 percent

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Argentina: Key Assumptions for Alternative Scenarios

	Favorable Economic Conditions	Classical Recession [a]	Tight Money Recession [a]	Oil Supply Disruption [a]
World real GDP growth	3.6 percent and 4.0 percent in 1984 and 1985 4.2 percent in 1986 through 1990	3 percentage points lower in 1985 2 percentage points lower in 1986 1 percentage point lower in 1987	3 percentage points lower in 1985 2 percentage points lower in 1986 1 percentage point lower in 1987	3 percentage points lower in 1985 2 percentage points lower in 1986 1 percentage point lower in 1987
World interest rates	Fall from an average of 10 percent in 1984 to 7 percent in 1990	1.5 percentage points lower in 1985 1.0 percentage point lower in 1986 0.5 percentage point lower in 1987	4.5 percentage points higher in 1985 3.0 percentage points higher in 1986 1.5 percentage points higher in 1987	4.5 percentage points higher in 1985 3.0 percentage points higher in 1986 1.5 percentage points higher in 1987
World oil prices	Rise from $30 in 1984 to $36 in 1990	$4 lower 1985 through 1990	$4 lower in 1985 through 1990	$60 per barrel vs. $31 in 1985 $55 per barrel vs. $32 in 1986 $50 per barrel vs. $33 in 1987 $45 per barrel vs. $34, $35, $36 in 1988 through 1990
World export price inflation	4.0 percent and 4.7 percent in 1984 and 1985 5.4 percent in 1986 through 1990	3 percentage points lower in 1985 2 percentage points lower in 1986 1 percentage point lower in 1987	3 percentage points lower in 1985 2 percentage points lower in 1986 1 percentage point lower in 1984	4.5 percentage points higher in 1985 3.0 percentage points higher in 1986 1.5 percentage points higher in 1987
Argentine real GDP growth	4.0 percent and 4.5 percent in 1984 and 1985 5.0 percent in 1986 through 1990	Same	Same	Same
Argentine prices and exchange rate	Close parity between price inflation and exchange rate devaluation rates Both rates fall sharply from 250 percent in 1984 to 60 percent in 1990	Same	Same	Same

[a] Compared with the favorable economics conditions case.

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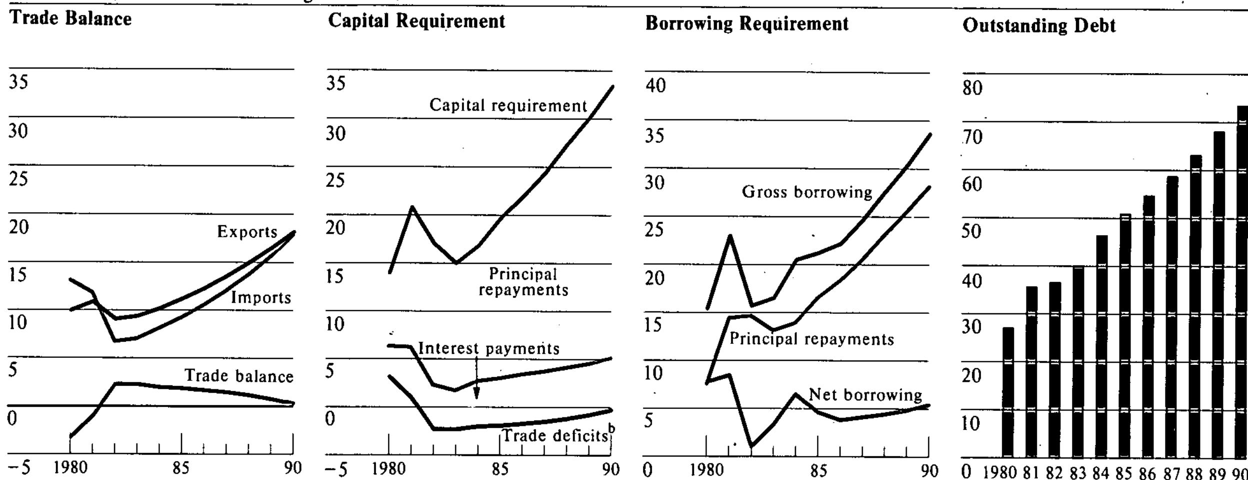
Argentina: International Trade and Financial Trends Under Favorable Economic Conditions, 1980-90[a]



[a] Values for 1983 are based on incomplete data.
[b] Negative value indicates a trade surplus.

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over the rest of the decade, the ratio of outstanding debt to exports—one measure of the burden of debt—would be unchanged in 1990 from last year's level of almost 4 to 1.

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Argentina's net borrowing would remain high under favorable economic conditions because of an evaporating trade surplus and slowly rising interest payments.[3] Our projections—implicitly assuming that the level of import control and export promotion returns to historical norms—indicate that exports and imports in real terms would grow at average annual rates of 3.2 percent and 9.0 percent, respectively, in the 1984-90 period. As a result of faster import growth, the trade surplus would shrink to $300 million in 1990, down from a healthy $2.3 billion in 1983. At the same time, interest payments would rise from $4.1 billion in 1983 to a peak of $5.5 billion in 1990—an increase of one-third. Although this sluggish trade performance and rising interest payments would require lenders to increase their exposure in Argentina, burgeoning principal repayments would force an ever larger rollover of old loans. Principal repayments are projected to rise from $13 billion in 1983 to $28 billion in 1990.

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[3] This finding contrasts sharply with Brazil's projected net borrowing needs under favorable economic conditions. Under similar assumptions, we projected that a widening trade surplus would outstrip increases in interest payments and cause Brazil's net borrowing needs to dwindle in the 1984-90 period.

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Economic Shocks: Net Borrowing Soars

Although we believe that Argentina's net borrowing needs would be high under favorable economic conditions, they are projected to be considerably higher under scenarios incorporating economic

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shocks. In the event of shocks to the global economy—a classical recession, a tight money recession, or an oil supply disruption—we estimate the country's net borrowing needs would approach 85 percent of the average level in the peak borrowing years 1979-81, compared to 40 percent in 1983. The classical recession would raise borrowing less than the other two economic shocks examined—adding $1 billion per year, on average, to net borrowing during the 1985-90 period. The oil supply disruption and the tight money recession scenarios would do significantly more damage—raising the projected level of average annual net borrowing during the period by $2.2 billion and $2.8 billion, respectively.

Classical Recession

As one alternative to the favorable economic conditions case, Argentina's net borrowing needs were projected assuming the occurrence of a classical recession. We assumed in this scenario that the global economy would be struck by a worldwide recession in 1985 as a result of sagging demand—possibly induced by tight fiscal policy in the industrial countries.

Of the three shocks to the global economy examined, a classical recession would raise Argentina's net borrowing needs the least, compared with the favorable case. Such a recession would push Argentina's net borrowing to an average of $5.5 billion per year in the 1985-90 period, compared with a projected $4.5 billion under favorable economic conditions. Using the favorable economic conditions scenario as a baseline, the additional amount of net borrowing generated by such a recession in this period would be $6 billion, and Argentina's outstanding debt would rise from last year's level of $40 billion to $79 billion in 1990.

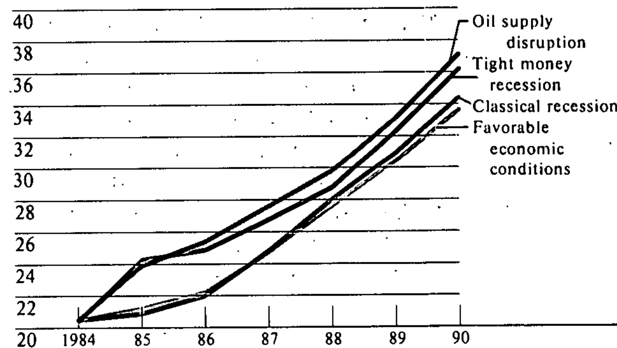
Oil Supply Disruption

As another alternative to the favorable economic conditions case, we assessed the impact of another oil supply shock on Argentina's net borrowing needs by assuming an oil supply disruption would occur in 1985. The assumed oil supply disruption

Argentina: International Financial Trends Under Alternative Economic Scenarios, 1984-90

Billion US $ Note scale change

Gross Borrowing



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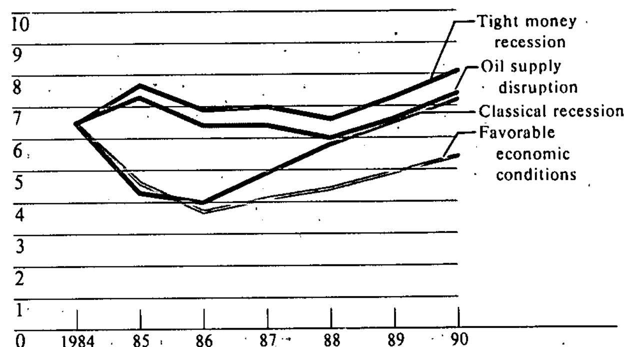
Net Borrowing



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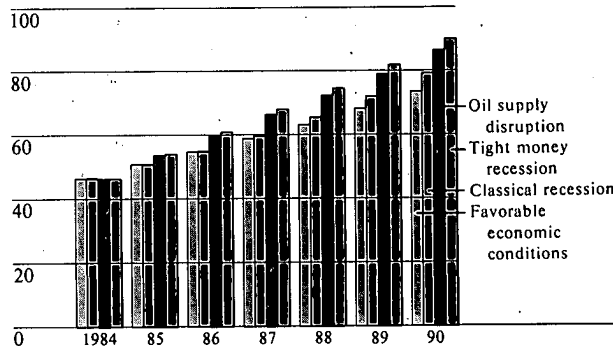
Outstanding Debt



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would be similar in magnitude to the one that would occur if Persian Gulf oil shipments were substantially curtailed. 25X1

Our projections indicate that an oil supply disruption would raise Argentina's net borrowing needs significantly more than a classical recession but less than a tight money recession. An oil supply shock would lift Argentina's net borrowing to an annual average of $6.7 billion in the 1985-90 period—nearly 50 percent higher than under favorable conditions. Total net borrowing following the oil supply disruption would exceed the favorable economic conditions baseline by $13 billion during this period and outstanding debt would jump nearly 120 percent from last year's level to $87 billion in 1990. 25X1

Tight Money Recession

As a third alternative to the favorable economic conditions case, Argentina's net borrowing needs were projected under the assumption that a tight money recession occurs. This recession, assumed to strike the global economy in 1985, might evolve if the central banks of the industrial countries adopt restrictive monetary policies. 25X1

In terms of its effects on Argentina's net borrowing needs, we believe that a tight money recession would do more damage than the other two global economic shocks examined. In the event of a tight money recession, Argentina's net borrowing would rise to an average of $7.3 billion per year in the 1985-90 period—nearly 85 percent as high as the average in the peak borrowing years of 1979-81. Compared to the favorable economic conditions baseline, the additional amount of net borrowing generated in the 1985-90 period by this recession would be about $16.5 billion, and outstanding debt would rise by $50 billion from its 1983 level reaching $90 billion in 1990. 25X1

Will Projected Net Borrowing Needs Be Satisfied?

Although it is difficult to predict lender attitudes toward any LDC several years in the future, many financial experts are convinced that lenders would be unwilling to finance Argentina's projected borrowing needs even under favorable economic conditions—an annual average of $4.5 billion in net borrowing during the 1985-90 period. They believe that Buenos Aires would not benefit from the modest recovery in voluntary bank lending to LDCs that many observers agree could occur under sustained favorable economic conditions. These experts believe that the projected long-term weakness of Argentina's financial position, as reflected in the alarming size of several financial measures—such as the debt service to exports ratio—and Argentina's unpredictable and intransigent behavior during the past two years have permanently soured lender attitudes toward the country. If lenders refuse to satisfy the projected net borrowing needs, Buenos Aires would have to institute harsher austerity measures and lobby for concessions from creditors even under favorable economic conditions in order to live within its external financing constraint. We tend to agree with those experts who believe that the country's projected net borrowing needs under favorable economic conditions probably would not be satisfied by lenders and that the need for tough austerity measures, and some concessions from creditors will persist. 25X1

There are, however, other observers who contend that Argentina's projected net borrowing of $4.5 billion annually in the 1985-90 period under favorable economic conditions could be satisfied. They believe that the country would indeed benefit from a modest recovery in voluntary bank lending to LDCs. They believe that the banking community

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has a relatively short memory and that the lure of potential profits could lead to a resumption of voluntary bank lending to Buenos Aires within a few years. If this limited resumption of voluntary bank lending occurs and official lenders step in to fund any shortfall in financing, these observers believe that Argentina could muddle through under favorable economic conditions.

25X1

There is little disagreement that Argentina's projected net borrowing needs—$5.5 billion to $7.3 billion per year—following the shocks to the global economy that we examined would be more than lenders would be willing to provide. Although lenders financed an average of $8.6 billion per year of Argentine net borrowing in the peak borrowing years of 1979-81, we believe new lending of this magnitude can be ruled out, given the recent sharp contraction of voluntary bank lending to LDCs. Shocks to the global economy, by reminding lenders of the frailty of their LDC loans, would further erode lender confidence in the longer term ability of debt-troubled LDCs to service their debt. As a consequence, lenders might decide to cut their losses by reducing even further their lending to these LDCs. In the event of such a cutoff of new credit, Argentina probably would have to adopt harsh austerity measures as well as reach a comprehensive agreement with creditors to stretch out repayment periods and reduce the interest burden of outstanding debt.

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On the basis of our projections of Argentina's borrowing needs and our assessment of lenders' willingness to satisfy this demand for credit, we believe that the country will be plagued by severe financial difficulties at least through 1990. There is a chance that Buenos Aires might succeed in muddling through under favorable economic conditions. If it fails or the global economy is buffeted by economic shocks, however, Argentina would experience a prolonged period of serious financial difficulties.

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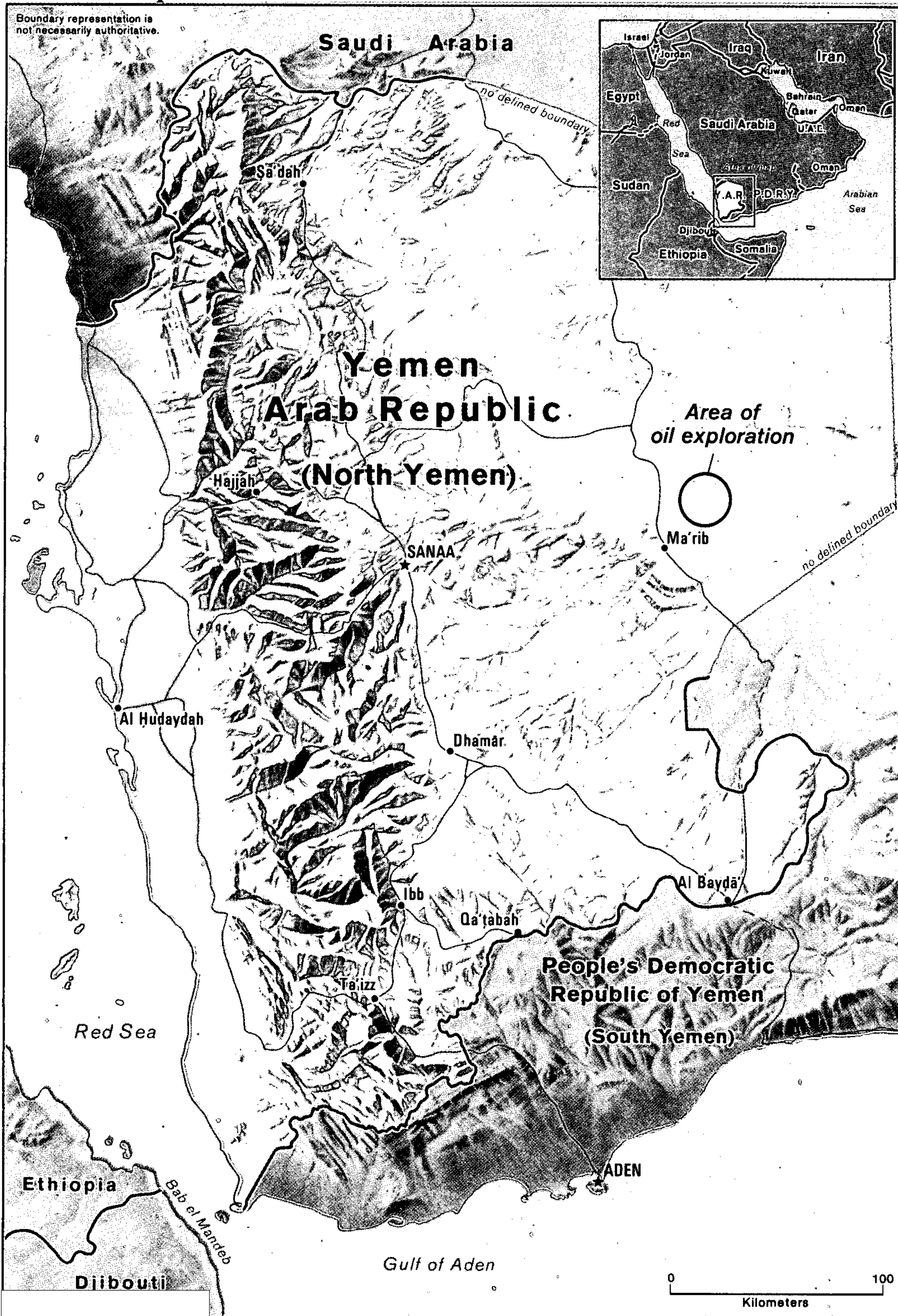
Recent Oil Exploration in North Yemen



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Implications of a Significant Oil Discovery in North Yemen

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Preliminary reporting indicates that oil may have been discovered near North Yemen's border with Saudi Arabia and South Yemen. The discovery of oil reserves comparable with those in southern Oman would have a substantial impact on North Yemen's economy, internal politics, and relations with Saudi Arabia and the United States. It would be at least four years, however, before substantial quantities of oil could be exported because North Yemen would have to develop the oilfield and build pipelines and shipping facilities.

Economic Implications

A US firm is drilling for oil in the eastern portion of North Yemen in the Ma'rib desert. The US Embassy in Sanaa reports that already there has been a significant show of hydrocarbons. Further testing will be required to determine the quantity and quality of the petroleum reserves. According to the Embassy, the company's break-even point to develop a find would be the discovery of about 250 million barrels of oil and production of around 100,000 b/d. We speculate that the size and type of oil deposits in North Yemen would resemble those found in southern Oman. Proved, recoverable reserves in the Dhofar region of Oman are about 1 billion barrels and consist mainly of heavy oil. Reserves of this magnitude could support a production rate of about 100,000 barrels per day for at least 20 years.

Such a discovery would not significantly affect the world market for oil, but it would be of major significance to North Yemen. Once oil revenues start flowing, Sanaa would be less beholden to foreign aid suppliers, and President Salih's development program would no longer be as threatened by the country's precarious financial position. New employment and trade opportunities would develop from an oil boom.

25X1

Although the construction of oil facilities might take three to four years to complete, North Yemen's economy would benefit in the interim, especially if Yemenis were able to contain their rising expectations. We believe Sanaa would obtain foreign financing more easily as its ability to repay debts improved. In the early stages of construction, contractors might provide their own financing, and the need for infrastructure and building materials probably would stimulate imports and foreign trade. On the other hand, North Yemen would face short-term economic problems if it overextended itself in the international capital markets.

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Many of the estimated 700,000 North Yemenis who work in Saudi Arabia and the smaller Persian Gulf states probably would return to North Yemen in anticipation of oil boom jobs. Their return, however, would be a mixed blessing. Although they would provide a ready supply of labor, they also would burden North Yemen's inadequate housing and social welfare programs as well as reduce the income from worker remittances.

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Internal Politics

President Salih almost certainly would use an oil find to strengthen his hold on power by taking credit for the discovery and the resulting economic growth. We believe economic modernization based on oil revenues would eventually reduce the political importance of Yemeni tribes and increase the importance of Western-educated technocrats in the central government. Until the discovery is exploited, however, the influential and largely independent tribes would remain a significant problem for

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North Yemen's Crippled Economy

North Yemen is one of the world's least developed countries—per capita income was less than $500 in 1982. In addition, Sanaa has one of the world's worst commodity trade imbalances, with exports typically financing less than 1 percent of imports. Instead, imports are financed primarily by worker remittances and aid. With worker remittances declining, foreign exchange reserves have fallen from $1.5 billion in 1978 to $313 million in October 1983, sufficient to cover two or three months of imports. Inadequate revenues forced Sanaa to scrap its original 1983 budget and cut back imports.

North Yemen has little prospect of improving its economic situation barring an oil discovery. Foreign aid, on which Sanaa relies, was $900 million in 1983, about half the 1982 level, and new commitments for 1984 are unlikely. If more foreign aid is not forthcoming, and current drought conditions persist, we expect little or no economic growth this year.

the central government, and the prospect of revenues from oil and construction would increase competition among tribes. A major oil find also would increase the already substantial political influence of North Yemen's military, because the military is Salih's power base and he would spend some of the early oil revenues on weapons.

North Yemeni–Saudi Relations

We believe that an oil discovery would reduce Saudi influence as North Yemeni dependence on Saudi financial aid declined. Even before a discovery could be exploited, North Yemen would seek greater independence from Riyadh, although Sanaa would still be constrained by its need for Saudi financial aid until oil revenues began to flow.

The Saudis would probably try to retain their leverage by increasing the subventions they pay to prominent North Yemeni tribal leaders and politicians or by increasing project aid. Riyadh might press for immediate concessions on outstanding issues, such as border demarcation, out of concern that its bargaining position would deteriorate as North Yemen became more financially independent.

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The Saudis' longstanding fear of an independent North Yemen could lead Riyadh to overreact to a discovery. Riyadh might attempt to persuade the US Government to encourage the US firm to cease its operations, arguing that the exploration was in territory claimed by Saudi Arabia. Alternatively, the Saudis might move troops to North Yemen's borders, as they did after an incident in late December, although Riyadh probably would not seek a major military confrontation.

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North Yemeni–South Yemeni Relations

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We judge that an oil find would encourage North Yemen to improve relations with South Yemen. A reunification of the two Yemens almost certainly would not result, although discussions of unity probably would increase markedly as Sanaa sought to express its independence from Riyadh.

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We believe South Yemen would try to strengthen its recent rapprochement with Sanaa. South Yemen might offer to allow North Yemen to build a pipeline to Aden, which has a refinery and harbor well suited for oil exports. We doubt that North Yemen, however, would allow its oil exports to become dependent on Aden's good will.

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25X1

Aden would also seek to build good will with the US firm working the North Yemeni concession. The same firm might conduct exploration in South Yemen, and the geology of the North Yemeni–South Yemeni border region is such that an oil find in North Yemen would increase interest in looking for oil in South Yemen.

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Implications for the United States

We judge that an oil discovery would help foster better relations between North Yemen and the United States. We believe that President Salih would seek Western technology and financial expertise to fully exploit potential oil and mineral resources, and that he favors closer cooperation with the West. An oil discovery—and reduced Saudi influence in Sanaa—would also help bring about a more direct US–North Yemeni relationship. The US agreement in 1979 to supply arms to North Yemen has led to problems among Washington, Riyadh, and Sanaa. Spare parts and maintenance for North Yemen's US-made equipment are funded by Riyadh, and the Saudis hold back on parts and repair to influence North Yemen's policies. A more direct US relationship with Sanaa probably would require high-level US discussions with Riyadh to define Washington's relationship with both countries. We would expect Riyadh to continue to discourage more direct ties between Washington and Sanaa. 25X1

The extent to which the United States is able to respond to Sanaa for a relationship independent of Riyadh's influence largely will determine the future of North Yemeni–Soviet relations. An expanded US presence in North Yemen would reduce the possibility that Moscow could increase its already substantial presence at the expense of US interests. Moscow has about 500 military advisers in North Yemen, and most North Yemeni military officers are Soviet trained. We judge, however, that any perceived reluctance by the United States to expand ties with North Yemen would cause Sanaa to turn to Moscow for increased technical aid, weapons, and political support. 25X1

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