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International Economic & Energy Weekly

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13 July 1984

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International Economic & Energy Weekly

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Synopsis

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Most recent estimates put the street value of illegal drugs sold annually in the United States in the range of $50-75 billion, an amount equal to at least 4 percent of all recorded US retail sales. These cash revenues give enormous economic power to the criminal organizations handling this trade and contribute to mounting gray market economic activity in source and transit countries. 25X1

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27 **Shrinking Export Market for Jet Combat Aircraft** 25X1

Large inventories, serious foreign exchange constraints by many potential buyers, and the high cost of new jet fighters suggest that export demand for jet combat aircraft will decline by a third in the 1984-93 period compared with the previous 10 years. 25X1

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Perspective

Narcotics Trafficking: Avenue to Economic Power

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By almost any measure, the illicit narcotics market is immense. Most recent estimates of the street value of illegal drugs sold annually in the United States alone are in the range of $50-75 billion, an amount equal to at least 4 percent of all recorded US retail sales. Revenues from illegal drugs in the United States far exceed drugstore sales or the retail value of all alcoholic beverages. They are at least twice as large as the proceeds from illegal gambling, the second-largest illicit business, according to the IRS. 25X1

Each year some $5 billion to $15 billion of these drug revenues flow abroad, either temporarily to be laundered for subsequent legitimate investment in the United States, or permanently for expenditure or investment abroad. This money constitutes only a small share of total capital movement into and out of the United States and an even smaller fraction of financial flows through the international banking system. Nonetheless, this movement of drug revenues places enormous financial resources in the hands of the Sino-Thai, Mexican, and Colombian traffickers, and traditional organized crime groups largely responsible for supplying drugs to the US market. We believe the repatriated earnings of these groups account for almost two-thirds of the drug money moving out of the United States each year. 25X1

Because so much of the drug money leaving the US market passes initially through one of the offshore financial centers in the Caribbean, Latin America is now the major financial crossroads for the illicit narcotics trade. Another important reason for Latin America's prominence as a drug money corridor has been the emergence of the region—originally an exporter primarily of marijuana—as a principal source of several drugs. Mexico has joined Asia as a major heroin producer; and sales of cocaine, produced almost entirely in the Andean countries, have been outstripping those of other drugs. 25X1

To move drug money through international channels, trafficking organizations use a number of underground international financial networks capable of transferring large sums quickly and secretly over long distances. These networks include the money exchange houses of Latin America, the Chinese banking system operating through family businesses in ethnic Chinese communities, and the financial arm of organized crime. Not surprisingly, the managers of these gray money facilities expertly evade exchange and banking regulations and exploit bank secrecy and liberal corporation laws of offshore banking centers. They are equally facile at handling a wide variety of other clandestine financial operations, such as illegal capital flight and the financing of smuggled goods, including arms. [redacted] 25X1

The all-cash drug trade and the underground financial networks that service it help sustain the dollar-fueled gray economies now prevalent in many countries. The most clearly affected regions are the northern-tier Latin American countries, where the US dollar is as or even more acceptable than local currency; Italy, where an estimated 25 percent of all transactions occur outside the recorded economy; and Burma, where more than half of all economic activity may be gray. [redacted] 25X1

The enormous recession-proof incomes generated by trafficking organizations make them an economic force to be reckoned with in the formal economies of countries where the illicit drug trade originates or transits. The most conspicuous example is Colombia, where traffickers' earnings from the illicit sale of marijuana and cocaine are equivalent to 70 percent of all recorded exports of goods and services and where investments financed by the share of these earnings that is repatriated dominate many local economies. In Mexico, where the drug trade is dwarfed by other economic activity, there is evidence that traffickers are now sought-after business partners because of their access to foreign exchange held abroad. Even in Italy, [redacted] attributing 25X1
the growing legitimate economic power of the Mafia to proceeds from heroin sales. [redacted] 25X1

The financial power of the drug trafficking groups is almost certain to grow. Most recent evidence indicates an increased supply worldwide of both heroin and cocaine. Traffickers are attempting, with some success, to expand their market for these drugs, particularly in Western Europe, Australia, and several Arab countries. They are also limiting the access of newcomers to their markets and sources of supply by moving toward further vertical integration. The new markets and a greater command of retail markups in older ones should result in substantially larger revenues for already-powerful criminal groups. [redacted] 25X1

Although several West European countries take strong antitrafficking measures and support crop control in source areas, the United States is the only nation attempting to disrupt the enormous flow of illegal assets generated by the narcotics trade. Switzerland is the only international financial center cooperating with the effort. In 1977 the United States and Switzerland signed a Treaty of Mutual Assistance on Criminal Matters, and the Swiss have since become increasingly responsive to US requests for court-admissible information related to drug money cases. [redacted] 25X1

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Cooperation from other money centers may be slow. The most likely candidates are international investment centers, either actual or emerging, which like Switzerland have a varied business and an international image to uphold. The least likely are the small offshore banking centers with tight bank secrecy laws that serve primarily as transit points for international money. As relative newcomers to the banking scene, they can easily be supplanted by competitors and therefore fear the loss of business from lessened bank secrecy at least as much as the stigma of becoming known as a dirty money crossroads. In the long run, multilateral action may be necessary to prevent increases in trafficking groups' already considerable economic power and almost certainly will be required to barricade the drug money escape route. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

Increased Persian Gulf Oil Exports

[redacted]

Persian Gulf oil exports last month rebounded to about 9.6 million barrels per day—up an estimated 1 million barrels per day over May levels. [redacted] 25X1
[redacted] Tokyo signed a short-term contract with Riyadh for 10-12 million barrels of Saudi oil in June, partly offsetting reduced Japanese purchases of Iranian oil. The Japanese purchase accounts for about half the 600,000-barrels-per-day increase in Saudi exports. Iran's sales in June were also up about 300,000 barrels per day from May's, when Iraqi air attacks disrupted tanker loadings at Khark Island. [redacted] 25X1 25X1 25X1

The increased Saudi exports probably reflect the delayed loading of some tankers originally scheduled to enter the Persian Gulf in May. Some of the crude may also be destined for Saudi oil stockpiles outside the Gulf. Tehran's decision in June to lower oil prices—offsetting previous increases in freight and

Persian Gulf: Oil Exports [a] *Million b/d*

	April [b]	May [b]	June
Total	**9.1**	**8.6**	**9.6**
Iran	1.8	1.5	1.8
Iraq [c]	0	0	0
Kuwait	1.0	0.9	0.9
Neutral Zone	0.4	0.4	0.4
Saudi Arabia	4.2	4.1	4.7
Persian Gulf	3.8	3.6	4.0
Red Sea/Yanbu	0.4	0.5	0.7
Qatar	0.4	0.4	0.5
United Arab Emirates	1.3	1.3	1.3

[a] Estimated, including natural gas liquids (NGLs) and refined petroleum products.
[b] Revised.
[c] Iraqi oil exports, averaging about 900,000 barrels per day over the last three months, are made almost entirely through the Iraq-Turkey pipeline to the Mediterranean.

[redacted] 25X1

insurance costs for tankers calling at Khark Island—brought a quick response from European traders and balanced the loss of Japanese sales. Current Iranian oil exports of about 1.8 million barrels per day are at 1983 levels. [redacted] 25X1

Declining Persian Gulf Charter Rates

[redacted]

Rates demanded by tanker owners for carrying oil from Persian Gulf terminals have fallen, despite the renewal of attacks on crude carriers by both Iraq and Iran. Reduced chartering costs will diminish pressure on exporters such as Iran and Kuwait to further discount prices of their crude. [redacted] 25X1 Although Iraq attacked two tankers near Khark Island during the last week of June, rates for liftings from that terminal have dropped to $2.05 per barrel, down almost 20 percent from an 11 June peak of $2.50 per barrel. Rates from Kuwaiti and Saudi ports on the upper Gulf have fallen 35 percent, from a peak of $1.75 per barrel in mid-June to $1.10 per barrel at the end of the month. Rates for voyages from lower Gulf Arab ports, which peaked at $1.15 per barrel on 17 June following Iran's first attack on a tanker in the lower Gulf, dropped 25 percent to 86 cents per barrel on 9 July—despite a second Iranian attack in the lower Gulf on 5 July. [redacted] 25X1 25X1

The drop in rates from upper Gulf Arab terminals can be attributed in part to the halt in Iranian attacks in the upper Gulf since 24 May. Another factor, which may help explain the drop in rates at Khark Island and Arab ports as well, is the return to service of laid-up tankers by owners seeking to profit from the still high rates available in the Gulf. From mid-May to mid-June, 18 large tankers with a combined capacity of more than 3 million deadweight tons came out of layup to seek business in the Gulf. No major changes in war-risk insurance rates have been confirmed since rates for Khark Island rose to record levels on 25 May and charges for lower Gulf ports went up on 11 June. A plan to reduce Khark rates was scrapped after Iraq renewed attacks on shippng on 24 June. [redacted] 25X1

Iraq-Turkey Pipeline Expansion

[redacted]

The second-stage expansion of the Iraq-Turkey pipeline to 1 million b/d is expected to be fully operational by 20 July, according to [redacted] 25X1 the Turkish press. The extra capacity could generate an additional $1 billion per year in revenues for Iraq if oil flows can be maintained. The estimated 100,000-b/d increase in crude oil throughput, however, will require operating pressures to be raised above current levels, making the pipeline more susceptible to leaks. Turkey, in an effort to minimize leaks, is inspecting the structural integrity of its portion of the pipeline. Unless Iraq makes a similar survey and restores war-damaged sections of its pipeline that have been repaired with quick fixes, Baghdad will run a high risk of a serious rupture. 25X1 The Iraqi lines suffered several breakdowns in late 1983 and early 1984 during the first phase of the pipeline expansion. [redacted] 25X1

[redacted]

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United Kingdom and Norway Discuss Sleipner Gas

[redacted]

The British Minister of State for Energy, Alick Buchanan-Smith, recently visited Oslo to convey to the Norwegian Government the proposed British modifications to the Sleipner gas sales agreement. Contrary to earlier press reports and industry speculation, the United Kingdom apparently did not suggest an absolute reduction in the volume of gas to be purchased, but rather an extension of deliveries over a longer period of time, according to US Embassy and press reporting. Because this proposal would reduce the cash-flow to the field's partners—Statoil, Esso, and Norsk Hydro—we do not expect that the partners will agree to this modification unless other features of the contract, including the price, are also altered. Press reporting indicates that Oslo's reaction to the proposed changes was negative, and Norwegian Energy Minister Kristiansen confirmed earlier official statements that any modifications to the agreement will be negotiated by Statoil and the British Gas Corporation (BGC), rather than by their respective governments. [redacted]

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We believe Statoil and BGC will work together to try to renegotiate the contract—albeit at a higher price. Discussions on the proposed changes could be lengthy, however, and it remains unclear whether London will approve a modified agreement that calls for a higher base price. Furthermore, we expect substantial opposition from Statoil to an additional British proposal that condensate from the Sleipner field be landed via a British pipeline instead of a Norwegian pipeline. [redacted]

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Soviets Put Pressure on Dutch Gas Prices

[redacted]

The Netherlands' Gasunie has cut gas prices by 15 to 20 percent on sales to Belgium's Distrigaz. The price cut, which applies only to gas destined for Belgian chemicals manufacturers, will remain effective until 1 October 1984 and involves about 500,000 cubic meters, or 10 percent of Distrigaz imports from Gasunie. We believe The Hague has shown price flexibility to counter Belgian chemicals manufacturers' criticisms of uncompetitive pricing and to

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blunt Soviet attempts to sell gas to Belgium. The Dutch-Belgian gas supply contract is up for renegotiation this fall, and Brussels has not yet ruled out Soviet gas purchases after 1 October. As a result, Dutch producers may be forced to make further price concessions to retain their 60-percent share of the 8-billion-cubic-meter Belgian gas market. [redacted] 25X1

Ottawa Passes Nova Scotia Offshore Legislation

[redacted]

Legislation recently passed in Ottawa and Halifax activates the Ottawa–Nova Scotia Energy Agreement of 1982 and establishes an Offshore Oil and Gas Board to oversee energy exploration and production activities in the waters off Nova Scotia. The Board will have three federal and two provincial members, indicating that Ottawa will retain final decisionmaking authority over development. On the other hand, the Agreement gives the economically depressed province the lion's share of revenues derived from offshore energy production—Ottawa's share of these revenues will increase only after Nova Scotia's per capita tax revenue exceeds 110 percent of the national average. Some of Nova Scotia's revenues will come from the participation of the provincially owned oil company, Nova Scotia Oil and Gas, in offshore development. Under the existing National Energy Program, Ottawa has the right to a 25-percent retroactive share, or "back-in," in all energy activity on federal lands. The new legislation, however, allows Nova Scotia Oil and Gas to purchase up to half of the federal government's interest in a natural gas field and up to one-fourth of Ottawa's share in any oil discovery. [redacted] 25X1

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Several oil companies and foreign governments have criticized the retroactive nature of the "back-in" provision. Indeed, Conservative Leader Mulroney has described it as punitive and confiscatory and has promised to eliminate it if his party wins the election in September. Mulroney, however, probably would be unable to change it significantly because modifications would have to be approved by both federal and provincial lawmakers. Nova Scotia Premier Buchanan estimates the revenue accruing to the province from the Venture natural gas field alone will be more than $4 billion (US) over the field's productive life, and he would stoutly resist changes without compensation from Ottawa. [redacted] 25X1

Brazil Reduces Oil Import Bill

[redacted]

According to US Embassy reporting, Brazilian oil production reached a record last month of 500,000 b/d. The production increase, coupled with a substantial drop in domestic oil consumption, should enable Brasilia to cut net imports to under 500,000 b/d this year. Net oil imports already had declined from an average of 780,000 b/d in 1981 to about 620,000 b/d in 1983. As a result, Brazil's net oil import bill has declined from about $9.7 billion in 1981 to $6.7 billion last year and should be in the $5-5.5 billion range in 1984. [redacted] 25X1

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International Finance

The Philippines Calls Aid Donors Meeting

[redacted]

Manila last week invited 21 bilateral and 11 multilateral aid donors to a meeting on 24-25 July to discuss the economy and review foreign assistance levels. The meeting began as a proposal by the Asian Development Bank for an informal meeting of technical-level staff but has been transformed by President Marcos into a formal and highly publicized gathering. The aid consortium was not scheduled to meet until next January. [redacted] 25X1 25X1

Convening the donor community serves two purposes for Marcos. First, by appearing to take a leadership role in resolving Manila's foreign debt crisis, he wants to outflank his domestic political opponents, who have contended that his government is bowing to IMF dictates. Second, by appealing directly to the donors, Marcos is hoping that the meeting will pressure the IMF into agreeing to easier terms for a long-stalled $650 million standby loan. [redacted] 25X1

Portuguese Eurodollar Syndication a Success

[redacted]

Lisbon has decided to increase its Eurodollar borrowing from $300 million to $400 million after receiving more commitments than anticipated. Last year's dramatic improvement in the current account deficit—it was halved to $1.7 billion—and the recent revision of targets in its IMF standby agreement undoubtedly encouraged bankers to increase their exposure in Portugal. International banks also provided slightly more favorable terms. The new, seven-year loan is priced at 0.75 percentage point over LIBOR for the first three years and 0.875 point over LIBOR for the remaining four years, whereas the spread on last December's credit was 0.875 of a point over LIBOR. According to the US Embassy, the loan probably will be signed at the end of July, enabling Lisbon to draw on the loan in August. [redacted] 25X1 25X1

Global and Regional Developments

New Mineral-Investment Strategies

[redacted]

[redacted] new investment strategies are emerging in the world minerals markets. Mineral exploration and development plans are being redirected primarily toward multimineral projects that lower production costs while reducing the risks of volatile price swings for individual metals. As a result of this shift, new mineral projects are likely to take one of the following forms: 25X1 25X1

- Development of ore bodies that contain precious and high-value strategic metal byproducts.
- Investment in facilities that recover these high-value metals from mine tailings.
- Development of metals that have low processing costs, such as certain industrial minerals used for construction, chemicals, fertilizers, or ceramics. [redacted] 25X1

Income for precious-metal byproducts can be critical to the profitable operations of many lead, zinc, and copper mines. Industry analysis shows that byproduct revenues reduced net copper production costs by 25 to 30 cents per pound in the early 1970s and by 50 cents on average in the early 1980s, when precious-metal prices soared. Although precious-metal prices have since fallen sharply, silver and gold are still nearly double and triple, respectively, their average price levels during the 1970s. [redacted] 25X1

Examples of the multimineral approach are beginning to appear. Papua New Guinea recently opened its new $1.2 billion OK Tedi mine. Initially, only gold is being produced, but by the late 1980s, copper and byproduct molybdenum will be mined. [redacted] a Mexican firm has begun processing spent copper mine tailings to recover gold and silver. Using a new precipitation process, the five-year project could yield $100 million worth of gold with the Mexican Government receiving 30 percent of the proceeds. [redacted] the Zimbabwe's Mineral Development Corporation (MDC) is seeking funds to build a pilot plant to extract lithium from mine tailings. [redacted] 25X1 25X1 25X1

Trade Balance of Debtor Countries Continues To Improve

[redacted]

The overall trade surplus for 14 key LDC debtors resumed its upward trend in first quarter 1984 after a slight pause in the final quarter of last year. The continuing increase in exports pushed the surplus in the first quarter to over $50 billion on an annual basis. For the group as a whole, foreign sales rose 5 percent over the previous quarter on a seasonally adjusted basis. On the basis 25X1

Key Debtor Countries: Trade Balances [a] *Billion US $*

	1982	1983	1984 First Quarter [b c]
Total	**10.2**	**36.3** [c]	**50.7**
Argentina	2.2	3.4 [c]	4.1
Brazil	−0.9	5.0	10.1
Chile	0.2	1.1	0.4
Colombia	−2.4	−2.0	−1.6
Ecuador	0.2	0.7	0.4
Indonesia [d]	4.9	8.4	9.9
Ivory Coast	0.1	0.4 [c]	0.2
Mexico	6.2	12.9	15.5
Morocco	−2.2	−1.4	−1.4
Nigeria [d]	3.2	3.7	9.4
Peru	−0.3	0.5	0.9
Philippines	−3.3	−3.1	−1.6
South Korea	−2.5	−1.9	−2.2
Venezuela [d]	4.8	8.6	6.6

[a] Exports f.o.b. and imports c.i.f.
[b] Seasonally adjusted at an annual rate.
[c] Estimated from preliminary partial data.
[d] Based on imports derived from OECD exports to the country.

[redacted] 25X1

of data on trade with OECD countries, we estimate that Nigerian exports rose more than 40 percent as Lagos pushed oil exports beyond its OPEC quota. Brazilian and Mexican sales climbed 17 and 14 percent, respectively. Chile, Ecuador, and Venezuela also posted export gains, but increased imports resulted in a worsening in their trade balances over the previous quarter. 25X1

LDC exports should continue to rise in response to the OECD economic expansion. A further increase in the overall trade surplus of these debtor LDCs, however, will depend on the extent to which these countries continue to constrain imports. Given the extremely low levels to which these countries' imports have been pushed—the first-quarter import level for the 14 countries as a group was 22 percent below the 1982 level—we believe imports could soon begin to rise more rapidly. 25X1

National Developments

Developed Countries

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South African Rand Hits Record Low

The value of the South African rand hit a record low of 66 US cents on Monday, a 10-percent drop from the previous week. The rand has been hurt by the falling price of gold—which generates one-third of South African foreign exchange earnings—and by the strength of the dollar. The price of gold fell below $340 per ounce last week, down from $395 as recently as March. By allowing the value of the rand to float downward, South African authorities hope to improve the foreign payments this year, even though this could stop economic growth. The fall in the value of the rand will reduce imports and will push South Africa's 10-percent inflation rate back toward last year's peak of 15 percent. We expect the lower price of South African goods abroad to stimulate an increase in nongold exports, but most of this benefit will be delayed until 1985 because of contractual commitments and a shortage of exportable agricultural goods, a result of three consecutive years of drought. 25X1

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Australia To Allow Foreign Bank Entry

The ruling Labor Party, at its national conference this week, approved Treasurer Keating's controversial proposal to allow foreign commercial banks to operate in Australia. The terms of the agreement require that applications be examined on a case-by-case basis, that Canberra attempt to secure a minimum of 50-percent local equity—as with other foreign investment—and that banks be established as subsidiaries with independent capital bases rather than as branches of the parent institutions. The Cabinet will not officially vote on the proposal until late September or October, and licenses are not likely to be granted until the end of the year. 25X1 25X1

Less Developed Countries

Nicaraguan Shipping Difficulties Continue

Nicaragua continues to encounter difficulties with its ocean shipping trade operations at its main foreign trade port of Corinto. Ships entering Corinto have suffered delays because of both cargo discharge problems and port congestion. Where normal turnaround time for liners was three days, prior to the mining incidents of last spring, it is now about six days. The principal causes for the delays derive from the poor condition of cargo-handling equipment, labor shortages, and continuing concerns that mines are still in the harbor. Until repairs are made, maintenance is improved on the cargo-handling equipment, and the peak agricultural export season has passed, congestion at Corinto will persist. 25X1 25X1

Glimmer of Optimism About Lebanese Economy

A mood of cautious optimism is spreading in Beirut with the reopening of the airport and the port this week. The US Embassy reports that the Lebanese pound appreciated more than 2 percent against the US dollar early last week as the government's security plan was put in place. Many businessmen, however, will probably wait until the security plan holds awhile before making repairs and expanding output. Meanwhile, a US Embassy officer who recently traveled to northern Lebanon reports that, with the exception of some factory closings in recent months, the area's economy is prospering. There is a great deal of new construction, road repair and maintenance is under way, electricity service is generally reliable, and municipal services run smoothly. 25X1 25X1

Kenyan Budget Problems

Severe drought is likely to derail Kenya's budget, which was released only a month ago. The government had anticipated a $340 million deficit, $20 million higher than last year, but still only 5.2 percent of GDP. Now, however, sharply lower coffee and tea production is expected to reduce export duty earnings, and import duties and sales taxes will fall as the government imports food at the expense of other products. Drought-associated expenditures could total $430 million, according to the US Embassy, far in excess of the $35 million allocated in the budget. Nairobi has started to slash proposed development spending and is asking major foreign aid donors to increase aid commitments. 25X1 25X1

Denationalization and the Private Sector in Bangladesh

[redacted]

The Bangladesh Government's two-year-old denationalization program has produced some benefits, but the overall business climate remains depressed. According to the US Embassy, the government's return of the key jute and textile industries to the private sector has resulted in better management and improvements in productivity and income. Six new private banks have facilitated foreign trade and offered businessmen personalized services unmatched by public-sector banks. There has not been a dramatic increase in overall investment in the economy, however, and a recent large labor settlement and general concern about the stability of the government have contributed to the lack of business confidence. Moreover, with more than 85 percent of the population dependent on agriculture, improvements in private business and industry have relatively little impact on Bangladesh's overall living standards. [redacted] 25X1

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Communist

Hungary Meeting IMF Requirements

[redacted]

Budapest expects a favorable review by the IMF of its financial stabilization program next month, but it will have to restrain economic activity at least through next year. The Hungarian National Bank official responsible for relations with the IMF told the US Embassy recently that Hungary has complied with most of the criteria in the stabilization program. Since the beginning of the year, Budapest has removed many of the import restrictions introduced in 1982, devalued the currency roughly 8 percent against the US dollar, and raised domestic interest rates. The official admits that the IMF remains concerned about excessive activity in the legalized private sector. He says real incomes there are increasing at an annual rate of 32 percent, and real incomes in the socialist sector are declining. In addition, the official notes that Hungary is making only slow progress in meeting the IMF's instruction to reduce the amount of its short-term foreign debt. Nonetheless, he does not foresee any major problems over these issues. He claims that, because of adequate lending by Western banks, Budapest can use the remaining IMF credits available this year to build up its foreign exchange reserves. [redacted] 25X1

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The IMF almost certainly will give Hungary a favorable evaluation, despite some reservations about its performance. In addition to meeting most program targets, Budapest has kept its promise to introduce a new comprehensive economic reform package. Large debt service obligations through at least next year, however, will require Budapest to continue to restrict domestic demand and hard currency imports. Growing social tension over the wide disparity in incomes between the private and social sectors is putting additional pressure on the authorities to contain private activity. Although Budapest may take limited measures, it remains reluctant to clamp down on the most productive and innovative sector of the economy. [redacted] 25X1

[redacted]

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Vietnamese Economy Shows Growth

[redacted]

[redacted] real GDP rose 5.9 percent last year. This is down from the 8.2-percent growth in 1982 but far better than the declines recorded in 1979 and 1980. The introduction of producer incentives in 1980-81, some decentralization of economic control, and a period of good weather have spurred performance in industry and agriculture. Industrial output—largely handicrafts and light industry—increased by 15 percent in 1983, and production of cement and basic consumer goods for the domestic market also rose. In addition, food-grain production increased 2.4 percent to a record 16.8 million metric tons, allowing Hanoi to eliminate nearly all food imports. [redacted]

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Despite these improvements, Vietnam remains one of the world's poorest countries, with a per capita income of less than $200. The outlook for 1984 is for slower growth. Early bad weather and a shortage of diesel fuel for irrigation pumps have damaged the rice crop in the north. Hanoi's growing arrears on its $1.5 billion hard currency debt will limit imports of fertilizer, other raw materials, and spare parts. Moreover, in an attempt to limit the burgeoning free market, Hanoi recently has rescinded some economic liberalization measures and sharply increased taxes. These actions are likely to discourage production. [redacted]

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International Financial Situation: Impact of Interest Rate Increases on LDCs

Rising world interest rates continue to aggravate burdensome LDC debt service costs and could prolong the economic adjustment efforts of individual countries. With the US prime rate now at 13 percent and the three-month LIBOR slightly above 12 percent, interest rates are at their highest level since mid-1982 and are about 2 percentage points higher than at yearend 1983.

We estimate that the increases in interest rates thus far in 1984 will add about $8 billion to total LDC debt service over a 12-month period. The net effect on the overall LDC current account position will be only about $6 billion annually, however, because of a $2 billion increase in interest earnings on LDC floating-rate deposits. The recent interest rate hikes will be felt primarily in 1985 because base interest rates on floating-rate loans generally are set only every three to six months. Moreover, further changes in world interest rates would adjust the impact accordingly.

Impact on Individual Debtors

Although the share of total LDC debt that is on floating rates is nearly 60 percent, the average for 10 major debtors—Argentina, Brazil, Chile, Indonesia, South Korea, Mexico, Nigeria, Peru, the Philippines, and Venezuela—is about 75 percent. For all remaining LDCs, the floating-rate portion of total debt is only about 30 percent because those countries—mostly in Africa and South Asia—rely heavily on fixed-rate loans from official sources and have limited access to floating-rate loans from private sources.

Mexico and Brazil will feel the biggest impact in dollar terms by higher interest rates; the 2-percentage-point rise since yearend 1983 will add about $1.6 billion to each country's debt service costs in 1985. Other debtors, such as Venezuela and Chile, have in excess of 85 percent of their total debt based on floating rates and will be hard hit relative to most other debtors. In all cases, however, the impact of the interest rate increases on these countries probably will be substantially less than the impact of the 20-percent increase in US imports projected for 1984 by the OECD. We estimate that for each 1-percent rise in US imports, assuming constant trade shares, LDC exports increase by $1 billion.

Estimated Impact of a 1-Percentage-Point Change in World Interest Rates [a]

Billion US $

	Total Debt Yearend 1983	Floating-Rate Debt	Impact on Debt Service	Floating-Rate Deposits	Impact on Deposits	Net Impact on Current Account
Total LDCs	**700.0**	**400.0**	**4.000**	**110.0**	**1.100**	**2.900**
Of which:						
Argentina	43.2	35.6	0.356	4.7	.047	0.309
Brazil	101.1	81.8	0.818	4.2	.042	0.776
Chile	18.7	15.9	0.159	2.6	.026	0.133
Indonesia	28.7	10.5	0.105	5.5	.055	0.050
Korea, South	39.3	24.6	0.246	2.4	.024	0.222
Mexico	98.1	82.8	0.828	11.6	.116	0.712
Nigeria	15.0	12.6	0.126	0.9	.009	0.117
Peru	13.1	6.6	0.066	1.7	.017	0.049
Philippines	23.1	15.3	0.153	2.3	.023	0.130
Venezuela	34.4	31.4	0.314	10.1	.101	0.213

[a] Figures indicate the impact over a 12-month period, beginning three to six months after the increase in interest rates.

[redacted] 25X1

Reaction From Latin Debtors

The most recent half-point increase in the US prime rate provoked a flurry of criticism in Latin America, especially from the press:

- The most strident official comment came from Mexican Finance Minister Silva Herzog, who termed the action a reprisal for convoking the meeting at Cartagena.
- An Ecuadorean official interpreted the rate hike as a "provocation," and Venezuelan President Lusinchi called it an assault on the debtor countries.
- Chile, Bolivia, and Brazil criticized the interest rate increase, but their official comment was restrained.
- The Argentines, who were embroiled in negotiations with the IMF and bank creditors, reacted mildly. [redacted] 25X1

Despite the generally subdued responses, many Latin officials indicated that it was regrettable that the increase came on the heels of Cartagena, and that the rate hike may yet cause debtors to consider a more confrontational approach. Some officials stated that the recent increase makes it imperative for the debtors to remain united because interest rate hikes are undermining the adjustment process and the ability to service debts. Peru stated that higher debt service costs threatened its ability to maintain compliance with its IMF-supported adjustment program. [redacted] 25X1

[redacted] 25X1 25X1

Chile: Weighing Economic Options

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Concerned by the potential for greater political unrest, Chile's new economic team probably will opt for government spending this year in excess of IMF guidelines. President Pinochet has come to regard the struggling economy as a significant threat to political stability, and Finance Minister Escobar seems willing to accept a near doubling of inflation to 40 percent in the hope of bringing unemployment down 2 percentage points to 13 percent. We believe that with greater stimulation Chile might achieve 4-percent growth in 1984, but at the cost of at least 35-percent inflation and the ill will of foreign bankers. Moreover, recovery would probably falter in 1985 if lenders restricted access to trade credits. In the less likely event that Santiago risks popular discontent by keeping within IMF guidelines, our projections show the economy would grow only 2 percent this year, inflation for the year would drop below 20 percent, and relations with creditors probably would not deteriorate.

Chile: Economic Indicators *Percent* [a]

	1981	1982	1983	1984 [b] IMF Program	1984 [b] Growth Option
Real GDP growth	5.7	−14.1	−0.8	2.0	4.0
Inflation	9.5	20.7	23.1	20	35
Unemployment, yearend	11	24	16	13	15
Real wages growth	10	−8	−4	−1	1
Monetary expansion	7.5	−8.1	39.0	33.0	50.0
Public-sector deficit (as a share of GDP)	−0.8	3.4	3.1	5.6	6.6
Copper prices (US $ per pound)	0.79	0.67	0.72	0.66 [b]	0.66

[a] Growth rates calculated from December to December of the stated year.
[b] Projected.

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Regardless of which policy Santiago adopts, Chile will seek to boost copper exports—dampening international copper price increases. In addition, Pinochet has reacted to the threat of US import restrictions on copper and to rising interest rates—US banks hold half of the Chilean $11 billion private debt—by making veiled threats of a debt moratorium and support for a debtors club.

Cautious Reflation in 1983

After a 14-percent plunge in economic activity in 1982, Chile gradually reflated the economy last year to try to assuage domestic discontent while complying with its IMF standby agreement. Santiago refinanced domestic debt to ease financial constraints on strapped firms and doubled tariffs to 20 percent to limit import competition. Subsequently, the government increased public salaries 5 percent, announced new public spending that would create 160,000 jobs, and provided aid to small businesses and farmers. Nonetheless, Santiago complied with the terms of its IMF program and drew upon Fund credits to support its strategy.

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This strategy sparked recovery, and by the fourth quarter of 1983 the economy was growing at an annual rate of 6 percent. (For the year, real output declined 0.8 percent.) The rebound late in the year pushed unemployment down from 24 percent in December 1982 to 16 percent last December, while inflation rose from only 21 percent in 1982 to 23 percent in 1983. Despite a 20-percent increase in net foreign interest payments, Chile's current account deficit was reduced 40 percent to about $1.4 billion in 1983. Improvements in the external accounts and compliance with its IMF-supported loan program enabled Santiago to reschedule foreign commercial bank loans and raise $1.3 billion in new money. [redacted]

Pressing Political Realities

Despite some economic improvements, political discontent continued last year in the form of rallies, marches, and scattered violence aimed against the government. According to US Embassy reports, most Chileans suffered real wage cuts in 1983 of 4 percent, on top of the 8-percent drop in 1982. Moreover, the slow recovery resulted in further bankruptcies and an increasing number of bad debts. [redacted]

With living standards under stress and opposition protests continuing, pressure mounted for the adoption of even more growth-oriented policies. [redacted] The moderate opposition—primarily the Christian Democrats—also called for reducing unemployment through increased state spending on housing, mining, and public works projects. Press and US Embassy reporting indicate domestic businesses were pressing for further debt relief and faster economic growth. [redacted]

First-Half 1984 Performance

Despite these domestic pressures, Caceres continued to pursue only cautious expansionary policies into 1984. Sticking to the terms of Chile's IMF accord, Caceres aimed at achieving 4-percent growth while keeping inflation under 20 percent. Although cautious reflationary policies reassured creditors, they did not produce the quick economic improvements Pinochet expected. After inflation surged in March by 2.5 percent, unemployment rose to slightly above 15 percent, and opposition protests resumed. Pinochet on 2 April dismissed Caceres and his economic team. [redacted] 25X1

The new Finance Minister, Luis Escobar, took office [redacted] publicly announcing plans to stimulate the economy. He organized a forum of businessmen and workers to advise Pinochet on steps to reactivate the economy, and asked the IMF for an increase in the 1984 budget deficit from 4.8 to 5.6 percent of GDP to help finance his program. Escobar abandoned plans to dismantle the public works programs, and instead talked about doubling wages for those in the programs and lending funds to the provinces to increase employment. [redacted] 25X1 25X1 25X1 25X1

Although Santiago attempted to assure creditors that Chile would honor all international debts and remain within IMF spending limits, bankers doubted that Chile could enact more rapid growth policies and service the foreign debt. As a result, many banks balked at participation in a new $780 million loan. The bank advisory committee suspended the loan syndication in mid-April. With Chile's trade surplus narrowing in the January-April period, Chile's foreign exchange position was squeezed, and Santiago tried to tap credit lines at foreign banks to prevent a loss of reserves, according to the US Embassy. [redacted] 25X1 25X1

In recent weeks, Escobar has attempted to reassure bankers that Chile would meet IMF targets for the first half of the year, and that he would continue to pursue a moderate course in return for continued financial support. Before his June trip to Washington for discussions with the IMF, Escobar told a US Embassy officer that he was fighting cabinet moves to undermine strict compliance with Fund 25X1 conditions. Bankers responded favorably to Escobar's assurances by agreeing to complete syndication of the $780 million loan, and Chile obtained the first $390 million on 28 June. [redacted]

The Outlook at Midyear

Chile's economic team is facing domestic pressures to relax spending restraints while increasing government investment. These pressures include popular resentment against austerity, particularly among the unemployed. In addition, rising interest rates on the foreign debt and possible import barriers against Chilean copper are threatening to reduce foreign exchange earmarked for recovery efforts. President Pinochet has in turn suggested new approaches to debt repayment and left open the possibilities of a debt moratorium or creation of a debtors club. [redacted]

Santiago may yet opt for staying the IMF course to engineer a steady recovery and maintain harmonious relations with creditors. We believe, however, that the chances are greater that the government will decide to seek faster growth to alleviate domestic discontent. Although we judge the differences would be slight in near-term economic performance under either scenario, there are strikingly divergent longer run consequences. [redacted]

IMF Route. We believe there is slightly less than an even chance that Chile will adhere closely to IMF guidelines. The Fund probably will soon grant approval for Santiago to expand its deficit from 4.8 percent to 5.6 percent of GDP in the second half of 1984, unless Chile diverges markedly from other guidelines. Santiago would use the additional public-sector spending to stimulate the economy. For example, ENAP—the state oil company—wants to invest $150 million this year, $20 million more than last year, to help alleviate unemployment and cut oil imports. [redacted]

By complying with the IMF program, we believe Chile would remain in the economic doldrums. Domestic credit would remain tight; according to US Embassy reports, new government bond issues would crowd out private investment activity. In our opinion, GDP growth for 1984 would be held to 2 percent, unemployment would remain at 15 percent, and inflation would drop to 20 percent. The current account deficit, however, probably would 25X1 exceed the $1.3 billion IMF target. Copper export earnings and foreign direct investment are falling short of expectations, and interest payments have risen. As a result, Chile would have to draw down at least $300 million of its $2 billion in gross foreign reserves. [redacted] 25X1

If Santiago sticks with the IMF agreement, it probably will retain the support of the Fund and of the international banking community. Until copper exports strengthen, Chile will need new loans to finance its current account deficit and for investments in the extractive industries. [redacted] 25X1

Faster Growth Option. We believe it is more likely, however, that Pinochet will bow to concerns over 25X1 high unemployment and the threat of more demonstrations. We expect he will order bolder government action to spur the economy. These policies are likely to lead to government spending that will increase even faster than the relaxed IMF guidelines would allow. The public-sector investment and the public works programs that would be initiated to increase employment would be a step away from Chile's free market economic policies. To provide the private sector with substantial new credits, the 25X1 government probably would finance a new domestic debt relief plan by expanding the money supply well beyond IMF guideline levels. Subsidies to industry and agriculture also could proliferate. These moves would stimulate the economy but push inflation and the current account deficit above Fund targets. Should current Finance Minister Escobar hesitate to undertake aggressive reactivation measures, we believe he would be replaced.
[redacted] 25X1

We and several Chilean economic experts believe that such policies would produce at best a 4-percent 25X1 growth in 1984, but at a cost of accelerating inflation to at least a 35-percent rate by yearend. The unemployment rate would drop only slightly to

Chile: Balance of Payments

	1981	1982	1983	1984 [a]	
				IMF Route	Growth Option
	Million US $				
Trade balance	−2,598	218	1,001	900	600
Exports, f.o.b.	3,960	3,798	3,672	4,000	4,000
Copper	1,738	1,731	1,800	1,700	1,700
Imports, f.o.b.	6,558	3,580	2,671	3,100	3,400
Net services and private transfers	−2,200	−2,522	−2,363	−2,300	−2,300
Interest	−1,400	−1,350	−1,600	−1,800	−1,800
Other	−800	−1,172	−763	−500	−500
Current account balance	**−4,798**	**−2,304**	**−1,362**	**−1,400**	**−1,700**
	Billion US $				
International reserves, yearend	3.8	2.6	2.0	1.7	1.0
Total external debt, yearend	15.5	17.2	18.7	19.1	19.1

[a] Projected.

[redacted] 25X1

13 percent, probably insufficient to reduce significantly the level of social discontent. In this scenario the current account deficit would rise from $1.4 billion in 1983 to $1.7 billion as import demand surges. Once Chile clearly violated the terms of its IMF standby agreement, we would expect delays in disbursement of the new loan. Strapped for foreign exchange, the government could be forced to draw down exchange reserves by 50 percent to $1 billion.

[redacted]

Longer Run Consequences

Regardless of which strategy the government pursues, we believe Chile will need to increase both domestic savings and new foreign borrowing to spur investments and employment. In this regard, Santiago plans a major expansion of copper production to boost employment and increase foreign exchange earnings. According to press reports, plans call for increasing copper production from 1.2 million metric tons in 1984 to 2 million tons in 1988. [redacted] 25X1

Pursuit of the growth option, however, is likely to lead to conflicts with bankers and the IMF, restricting Chile's access to the foreign lending necessary to make such investments. Foreign banks might restrict trade credits and Chilean businesses would encounter growing difficulty in obtaining imports to support industrial growth. Moreover, foreign exchange stringencies might force Chile to restrict profit repatriation, which will stem foreign direct investment. More rapid inflation could undermine the new domestic saving needed to sustain growth. [redacted] 25X1

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Implication for the United States

With Chile banking on increased copper exports to reactivate the economy and help service its foreign debt, restrictions on sales in the US market would not lead Santiago to reduce planned production. Instead, in our view, Chile would step up its sales on the world market, depressing prices. This could put US manufacturers who use higher priced domestic copper at a disadvantage compared with foreign manufacturers. 25X1

If US interest rates continue to rise, Chile's debt repayment capability will be squeezed. We estimate that a rise of 1 percentage point in the US prime would increase Chile's current account deficit by $140 million. According to the US Embassy, rising interest rates and the threat of US quotas on copper imports have moved Pinochet away from assuring bankers of debt repayment to veiled threats of a moratorium and support of a debtors club. If Pinochet opts for a get-tough policy, US bankers—holding half of Chile's commercial bank debt—could find their loans subject to a debt service moratorium by Chile. 25X1

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World Cotton: China's Emerging Role

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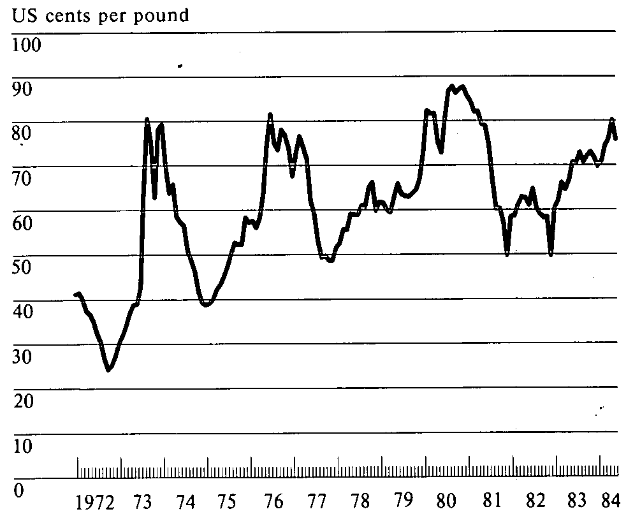
The cotton marketing year that ends this month experienced significant turbulence. With global consumption outrunning production by 1 million bales, prices were pushed to a three-year high, and exporters were forced to draw down stocks. Moreover, during the past 12 months China has emerged as a potentially important cotton exporter. This development portends trade problems for the United States.

The Market Setting

The current market year (August 1983–July 1984) has been characterized by disarray. Buyers found supplies rapidly tightening as rising consumption outpaced production. With the resurgence in the world economy, global cotton consumption climbed by 800,000 bales, reaching 68.6 million bales. In contrast, world cotton output for the season totaled only 67.6 million bales, about the same as last year. To meet the pickup in demand, global cotton stocks were drawn down by about 1 million bales. Cotton stocks in the United States have dipped to 2.8 million bales, a two-and-a-half-year low. This, in turn, led to a strengthening in prices, which are now at their highest level since the first half of 1981.

Cotton Prices[a]



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[a] Monthly averages, Memphis middling, 11/16 inch.

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Market Outlook

This year's seller's market is likely to be reversed in 1984-85 as producers respond to high prices. The US Department of Agriculture projects a 10-percent increase in world cotton production to an alltime high of 74 million bales. US production is forecast to rebound by 50 percent over this year's poor harvest. Gains also are likely in Pakistan, Brazil, and Mexico because of an expected return to normal weather and in Turkey and Argentina, from increased plantings. With world consumption expected to grow by only 3 percent, supplies should be plentiful, allowing a buildup of stocks. This should ease pressure on prices after significant volumes of the crop become available in October and November.

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Emergence of China

In only four years, Chinese cotton production has doubled, reaching a record 21.3 million bales, nearly a third of global output. This impressive growth is attributable to production incentives that

World Cotton Market Trends *Million 480-pound bales*

Year [a]	Beginning Stocks	Raw Production	Consumption (Mill Use)	Exports
1977/78	22.7	63.9	60.9	19.1
1978/79	26.1	59.6	63.3	19.7
1979/80	22.6	65.2	65.9	23.1
1980/81	21.9	64.8	65.7	19.7
1981/82	22.2	70.8	66.0	20.1
1982/83	25.6	67.5	67.8	18.7
1983/84	25.6	67.6	68.6	18.9
1984/85	24.7	73.9	70.5	19.2

[a] Marketing year, 1 August through 31 July.

[redacted]

have spurred an expansion of area planted to cotton, especially in northern China, and increased use of chemical fertilizers. Increased availability of improved seed varieties coupled with good growing conditions, especially this season, also have contributed to six consecutive record harvests. [redacted]

In contrast, cotton consumption in China has expanded only 3 percent a year during the last four years, which has permitted China to cut imports. During 1979-80, for example, China imported a record 4.1 million bales, nearly 20 percent of the cotton moving in world trade. This year China probably will be a net exporter of 400,000 bales. [redacted]

China probably will emerge as an important exporter of cotton. This development could significantly hurt US exports, especially to major East Asian markets. Indeed, in 1984-85 China is likely to harvest another bumper crop of about 20 million bales. Although down slightly from this year's record crop, China can draw on stocks of 7.2 million bales built up over the past few seasons as well as on new crop surpluses to market as much as 1.0-1.5 million bales in 1984-85—about 5 percent of the global cotton trade. [redacted] 25X1

[redacted]

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[redacted] 25X1

China: Record Cotton Production

The Production Responsibility System has been a key to increased cotton output, providing price bonuses for over-quota production. In addition, for cotton production above quota, farmers have been given the right to purchase additional chemical fertilizer to increase yields. Guaranteed grain rations for cotton producers were introduced to encourage farmers to switch to fiber crops. [redacted] 25X1

These policies have stimulated a sharp expansion in land planted to cotton. The harvested area jumped 23 percent over the last six years to a record 6 million hectares this season. China's northern provinces, particularly Shandong, Hebei, and Henan, account for about half of this season's record output. In contrast, procurement prices in Central China have undervalued cotton relative to grain, and—as a result—cotton area and production have remained relatively static. [redacted] 25X1

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For the 1984-85 crop, procurement policies have been changed to slow the growth in cotton output and to further shift production to the north. This planned slowdown suggests that China may be seeking to solve transportation and merchandising bottlenecks. Under the new procurement system in the northern cotton area, 20 percent of the cotton will be bought by the government at the established base price and the remainder at the increased price. In the southern area, 60 percent will be purchased at the base price and the rest at the increased price. Farmers in both regions have been assured that all above-quota production will be purchased by the state. [redacted] 25X1

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China: Cotton Market Trends *Million 480-pound bales*

Year [a]	Production	Consumption	Imports	Exports
1977/78	9.4	12.2	1.6	0.1
1978/79	10.0	13.1	2.1	NEGL
1979/80	10.1	14.1	4.1	NEGL
1980/81	12.4	15.1	3.6	NEGL
1981/82	13.6	16.2	2.1	NEGL
1982/83	16.5	16.4	1.0	0.1
1983/84	21.3	16.7	0.2	0.6
1984/85 [b]	20.0	17.5	0.1	1.0

[a] Marketing year, 1 August through 31 July.
[b] Forecast.

[redacted]

[redacted] In April, CHINATEX put out an international tender to sell nearly 460,000 bales for May-October shipment. According to trade reports, only slightly more than 20,000 bales were bid on before the Chinese withdrew the tender on 15 April. The lack of response from foreign buyers illustrates three problems that the Chinese will have to overcome:

- *Nonstandard bale size.* The Chinese cotton bale weighs only about 170 pounds as opposed to the standard 480-pound bale, which is the norm in world cotton commerce. As shipping, receiving, and processing equipment is generally standardized for 480 pounds, bids for the recent tender were low because of the extra costs foreseen in handling the smaller bales.

- *Uncertainty about grades.* The inconsistent quality of Chinese cotton has discouraged buyers.

- *Lack of arbitration rights.* The Chinese made the unrealistic demand in their tender that buyers waive arbitration rights. [redacted]

Efforts by the Chinese to standardize bale size will take time, as will improving their cotton-grading system and developing buyer confidence. In addition, international cotton traders emphasize that the Chinese will need to develop an equitable arbitration system. [redacted] 25X1

[redacted] China appears committed to becoming a large consistent exporter of raw cotton as demonstrated by the government's current program to construct additional storage facilities in cotton-growing areas and at transshipment points. [redacted] 25X1

Implications for US Cotton Trade

China's entry into the export market has adverse implications for the United States: 25X1

- US cotton exports to China, which totaled 847,000 bales in 1981/82, dipped to only 20,000 bales during 1982/83 and are expected to be even lower this season. 25X1

- China is a potential competitor with the United States in the Pacific Basin. China's shipments to its neighbors could seriously reduce US sales to these markets.

According to press reports, US cotton producers and exporters are extremely concerned, fearing China's potential intrusion into large US cotton markets in Hong Kong, Indonesia, Japan, South Korea, and Thailand. These five markets accounted for almost two-thirds of US cotton exports during 1982-83. [redacted] 25X1

According to the latest data, August-May shipments to these markets totaled 3.2 million bales or 55 percent of US exports during this period. For the year now ending, US cotton exports are expected to reach 7.0 million bales. For 1984-85, global US cotton exports are expected to drop more than 20 percent to about 5.5 million bales, reflecting sharply larger exports by US competitors and little improvement in world trade levels. US Department 25X1

US Cotton Exports *Thousand 480-pound bales* (except where noted)

Destination	Average MY 1976/81	MY 1981/82	MY 1982/83	August 1983–May 1984
Total	**6,321**	**6,567**	**5,207**	**5,894**
China, Mainland	947	847	20	12
European Community	454	538	559	749
Hong Kong	430	243	158	241
Indonesia	241	286	268	273
Japan	1,233	1,626	1,286	1,448
South Korea	1,251	1,412	1,322	1,059
Taiwan	499	777	378	448
Thailand	211	167	197	222
USSR	NEGL	0	192	269
Others	1,055	671	827	1,173
Total value *(million US $)*	**2,078**	**2,097**	**1,652**	**2,055**

[redacted] 25X1

of Agriculture analysts anticipate that part of the export decline—approximately 400,000 bales—will result from increased Chinese cotton exports. [redacted] 25X1

[redacted] China must consistently produce exportable surpluses and learn international merchandising before becoming a major threat. Although several market analysts believe this will take until the end of the decade, others expect it to occur sooner. [redacted] 25X1 25X1

[redacted] 25X1

Shrinking Export Market for Jet Combat Aircraft [redacted] 25X1

Rapidly expanding exports of jet combat aircraft in the last 10 years have allowed nations with limited domestic markets—such as Italy, France, and Great Britain—to enhance their production capabilities and manufacture fighters using sophisticated technologies. Since 1973, nearly 13,000 jet fighter and training aircraft have been exported. Now, however, large inventories, serious foreign exchange constraints by many potential buyers, and the high cost of new jet fighters suggest that export demand for aircraft will decline by one-third in the 1984-93 period compared with the previous 10 years. European aerospace firms already are cutting back, and it has become more difficult for Third World producers to get started. [redacted]

The Export Market: 1974-83

The export market for jet combat aircraft grew dramatically during 1974-83. Worldwide inventories of exported jet fighters expanded 40 percent, and jet trainer inventories grew almost one-tenth. Third World nations imported nearly four-fifths of the more than 10,000 jet fighters and about two-thirds of the 2,600 jet trainers/light attack aircraft exported during that period. The United States and the Soviet Union led suppliers, providing 80 percent of all jet fighters exported. Czechoslovakia was the primary exporter of jet trainers, providing about 35 percent of these comparatively inexpensive subsonic aircraft. We estimate that the value of these sales totaled about $73 billion. [redacted]

The sharp increase in demand for aircraft during the period resulted from:

- War and regional tension, which led North and South Korea, Vietnam, Pakistan, India, and the frontline states of the Arab-Israeli conflict to modernize and, except for Egypt, to expand their inventories.

- The massive increases in oil prices in the early 1970s, which allowed OPEC countries to purchase large numbers of aircraft. The air forces of OPEC nations have more than doubled since 1974 from 800 to 1,900 fighters in 1983. In addition, Arab OPEC countries financed aircraft purchases by other Arab states. [redacted] 25X1

[redacted]

The Next 10 Years: The Declining Export Market

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We expect a much smaller export market for jet combat aircraft during the 1984-93 period. Discussions [redacted] indicate that the export demand for new fighters will drop by about 40 percent from the preceding 10 years. Barring substantial combat losses, we estimate that about 4,300 jet fighters will be ordered by the mid-1990s, in addition to the nearly 2,000 currently on order.[2] We estimate that the global export demand for jet trainers and light attack aircraft will approach the 2,500 level, approximately the same as the preceding 10 years. We believe sales of jet trainers could be even higher if buyers purchase these less costly aircraft to meet missions previously reserved for fighter aircraft. [redacted] 25X1

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Programs to extend the life of existing aircraft provide one attractive alternative to purchasing

[2] Replacement figures assume a 20-year operational life for jet combat aircraft in nonconflict situations. Therefore, fighters and jet trainers procured in the 1960s and early 1970s will need to be replaced by the early 1990s. Normal aircraft attrition rates, [redacted] are also factored into our estimates. [redacted] 25X1

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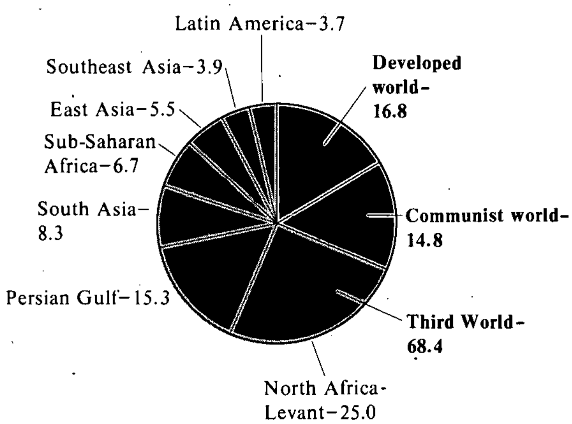
Recipients of Exported Jet Combat Aircraft, 1974-83

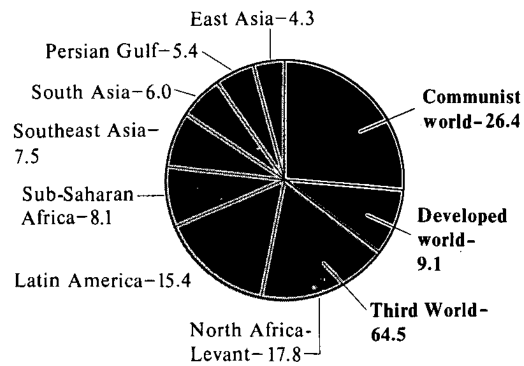
Percent

Jet Fighter Aircraft



Total: 10,315

Jet Trainer/Light Attack Aircraft



Total: 2,601

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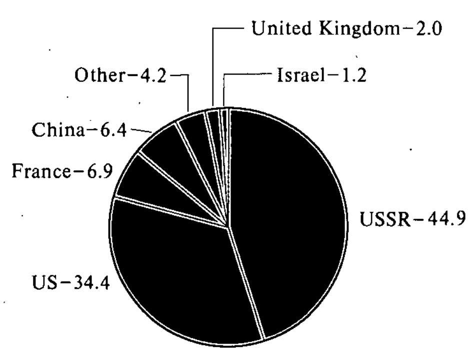
Suppliers of Exported Jet Combat Aircraft, 1974-83

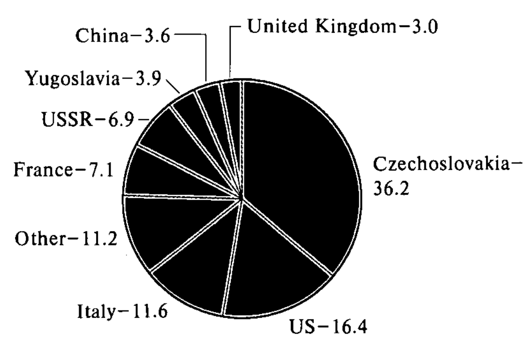
Percent

Jet Fighter Aircraft



Total: 10,315

Jet Trainer/Light Attack Aircraft



Total: 2,601

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Estimated Minimum Value of Initial Combat Aircraft Sales Agreements by Supplier, 1974-83

	Billion US $		Percent of Total Sales
	Total Weapon Sales	Combat Aircraft Sales [a]	
Total	**318**	**73**	**23**
USSR	87	26	30
United States	124	30	24
France	34	10	29
United Kingdom	17	2	12
China	7	2	29
Others	49	3	6

[a] Estimated value for initial aircraft sales only. Follow-on contracts for maintenance, spare parts, and consumables are not included, because data are incomplete.

[redacted]

[redacted] new aircraft. The modernization of existing fighters allows national air forces to enhance capabilities without enduring the high costs and logistic complications associated with introducing a new aircraft into their inventories. Such programs concentrate on improving the power plant, avionics, and weapon delivery capabilities. For example, Israel, West Germany, Japan, and Great Britain are planning improvements to their F-4s, [redacted]

The emergence of indigenous jet combat aircraft production programs in the Third World also could affect export sales over the next 10 years.[3] While the unit costs of aircraft produced in developing countries are usually high, this option remains attractive because of increased employment, possible foreign exchange savings, and the development of indigenous industrial capabilities. National programs will have the greatest effect on the jet trainer/light attack market as nations replace aging equipment with domestically produced planes. According to [redacted] Brazil, Argentina, India, Israel, Romania, and Yugoslavia will fly prototypes of their own jet combat aircraft before the end of the 1980s. [redacted]

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Impact of a Shrinking Market

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We believe emerging suppliers will at best make only limited inroads into the jet combat aircraft export market over the next 10 years. For instance, Israeli export efforts could be hampered by the extensive use of US components in their aircraft. Power plants and other subassemblies produced under US license will remain under US export restrictions. Exports of aircraft manufactured by new producers also will be adversely affected by the high costs of their less sophisticated products.

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[redacted]

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[3] Our estimates of the jet combat aircraft market assume that indigenous production programs currently under way will succeed in order to meet national air force requirements. Failure of these programs, however, would open export possibilities for other suppliers. [redacted]

Jet Combat Aircraft Programs in Developing Countries

	Aircraft	Primary Mission	Planned Deployment Date
Brazil-Italy	AM-X	Light attack	1987
Argentina	IA-63	Trainer/light attack	1987
India	LCA	Interceptor	—
Israel	Lavi	Close support	1990
Yugoslavia	Orao II	Ground attack	—

[redacted] 25X1

such as India and Yugoslavia, have also encountered problems that will increase their aircraft's unit prices. [redacted] 25X1

[redacted] 25X1

We believe a desire to retain design teams and a general slowdown in West European fighter production, also are driving efforts to codevelop a European fighter aircraft for the 1990s. [redacted] 25X1 25X1 25X1 We believe that the poor export performance of the Mirage 2000 has helped persuade French industrialists to seek cooperative development to sustain France's fighter aircraft industry. Great Britain, West Germany, and Italy also recognize the financial constraints of national programs and favor codevelopment. [redacted] 25X1 25X1

[redacted] 25X1

25X1

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