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34 briefs
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International Economic & Energy Weekly

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7 December 1984

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Comments and queries regarding this publication are welcome. They may be directed to [redacted] *Directorate of Intelligence,* [redacted] 25X1 25X1 25X1

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19 **Persian Gulf: Impact of a Major Oil Price Decline** [redacted] 25X1

This article speculates about the impact on Persian Gulf countries if oil prices were to fall to around $20 per barrel. A major price decline would have negative implications for US interests in the region. [redacted] 25X1

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23 **Libya: Living With Less** [redacted] 25X1

Libya has weathered the soft oil market by cutting back sharply on imports, scaling back the Five-Year Plan (1981-85), slowing payments to suppliers and resorting to oil barter deals. As a result, Qadhafi will be less able to offer generous economic aid and trade incentives to strengthen ties with pro-Western regimes and counter Washington's Libyan policy. [redacted] 25X1

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29 **Debtor LDCs: Devaluations Slowing** [redacted] 25X1

The $26 billion increase in the collective trade surplus of 12 major LDC debtors in 1982-83 can in large measure be attributed to the real devaluation of their currencies. Preliminary 1984 data, however, indicate the pace of real devaluation is slowing for this group. [redacted] 25X1

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Perspective

Western Europe: Economic Solutions Yet To Come [redacted] 25X1

Europessimism—the fatalistic view that the West Europeans have about the region's poor economic prospects—may be gradually giving way to new efforts to create a more competitive, market-oriented economy in the region. Although these developments are encouraging, many more fundamental changes in the structure of the region's economy will be necessary to achieve rapid economic growth and lower unemployment over the remainder of the decade. [redacted] 25X1

To loosen government control over the economy and promote competition, some West European governments are moving to "privatize" state-owned companies. Indeed, British Prime Minister Thatcher has made the selling of many state-owned industries the centerpiece of her program to restructure the British economy and increase competition. In a departure from past policies, the Kohl government of West Germany has partially privatized its national oil company and is planning to sell parts of Volkswagen and Lufthansa. Italy has begun selling parts of its enormous state industrial holding company, IRI, while the Socialist government of President Mitterrand has halted the program of nationalizing private industries and is working to reduce government subsidies to state-owned firms. [redacted] 25X1

Efforts to encourage investment through changes in tax laws and other incentives indicate the renewed importance West European governments are placing on investment to stimulate economic growth. Bonn has eliminated some taxes on new stock issues. London has lowered overall taxes on corporate earnings this year. Rome is encouraging investment in small and medium-sized firms by providing low interest rate loans to such enterprises; below-market interest rates on loans for retooling and updating obsolete facilities in the depressed machine tool industry also are being offered. [redacted] 25X1

Another positive development is the recent slowdown in wage hikes. The rapid escalation of wages in the 1970s has been a major factor contributing to the region's unemployment problem. High unemployment probably is the main force holding back wage advances. Nonetheless, employers and union leaders increasingly realize that if Western Europe is to improve its international competitive position wage increases cannot outstrip productivity gains as in the past. Recent data, however, indicate that productivity is continuing to rise at about the same rate as in the 1970s. [redacted] 25X1

While these developments represent a favorable shift in the West European economic climate, more fundamental changes will be necessary to alter the region's poor long-run growth and employment prospects. The difficult decisions to remove structural rigidities, such as government regulations affecting the hiring and firing of workers, and to oppose entrenched interest groups, including farmers and traditional industries, have yet to be made. For example, West European governments continue to subsidize traditional industries, such as steel, textiles, and agriculture, while support for high-tech industries remains limited. The EC spent more money in 1983 to subsidize grain exports than it has earmarked to support high-technology research and development over the next five years. [redacted] 25X1

Despite rapidly rising unemployment in the past three years, almost no progress has been made by West European governments in reducing the nonwage portion of labor costs—payroll taxes paid by employers for social welfare benefits. These taxes add 80 percent to wage costs in West Germany and 60 percent in France, versus only 28 percent in the United States. Yet only the United Kingdom, where payroll taxes are already among Western Europe's lowest at 36 percent of wage costs, has attempted to reduce this disincentive to hire workers by abolishing a 1-percent National Insurance surcharge on employers. [redacted] 25X1

Government redtape continues to be complex, time consuming, and discouraging. National laws governing the creation of new businesses and bankruptcy proceedings are generally much more stringent than in the United States. Moreover, despite the 27-year existence of the European Community, nontariff barriers, such as differences in product and professional standards, still prevent most EC companies from enjoying the economies of scale the 10-member Community should offer. As a result, the Community remains a collection of small to medium-sized markets. For those products that are traded among EC countries, additional costs are incurred because of various customs regulations. Unless the West Europeans more fully address these structural rigidities to growth, Europessimism will become a self-fulfilling prophecy. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

French Requirements for Soviet Gas

[redacted]

Limited French demand for Soviet natural gas may reduce France's interest in the further development of Soviet resources, at least for the next two or three years. Officials of Gaz de France have told the US Embassy that the French Government will not allow gas supplies from any single country to account for more than 5 percent of total French energy demand and that deliveries under present contracts effectively bar any new Soviet gas deals. The Embassy also reports that French officials are disappointed with their failure to renegotiate the price of Soviet gas under current contracts. If Moscow were to insist on linking the purchase of French equipment and technology to signing new gas contracts, there would be little incentive for France to support construction of a second pipeline. Nonetheless, France almost certainly would not support any embargo in view of its past opposition to embargoes and its other commercial interests with the USSR. [redacted]

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Dutch Seek To Maintain European Gas Market Share

[redacted]

The President of Gasunie, the Dutch state gas-exporting company, publicly confirmed that the Dutch plan to maintain their one-third share of the European gas market for an additional 10 years. Dutch exports in 1983 to five major European gas consumers amounted to over 35 billion cubic meters (bcm). While new gas exports could be as high as the 35 bcm implied by Gasunie, Embassy sources indicate that 25 to 28 bcm of new gas are more realistic. By providing a low-cost alternative supply of future gas, the Dutch announcement may delay development of high-cost Norwegian gas supplies. Continued exports of Dutch gas could also lessen the ability of the Soviet Union to increase gas sales to Western Europe in the next decade. [redacted]

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Dutch Planning Nuclear Power Expansion

[redacted]

Dutch Government officials are completing plans for the construction of three, or possibly four, additional 1,000-megawatt nuclear power plants intended to replace existing oil- and gas-fired units. The government hopes that when they are completed the Netherlands will be able to increase gas exports while at the same time enhancing energy security. Parliamentary approval is by no means assured. Supported by widespread public concern over safety, the opposition Labor Party and a number of leftwing Christian Democrats oppose nuclear expansion. To ease public concern, the Dutch are considering the unprecedented step of linking reactor orders—most likely with a foreign firm—to contracts for the disposal of the spent fuel outside the country. A key member of Parliament recently suggested a two-phase ratification—conditional acceptance now, with final approval delayed until 1987. This could keep the question from becoming an issue in the 1986 election, but it increases uncertainty over the final outcome. If approval is obtained next year, the first of these plants will be operational around 1994. [redacted]

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Japan To Sign Contract for Australian LNG

[redacted]

As a result of an agreement between Japanese utilities and Australian suppliers in November, a contract for gas deliveries is expected to be signed at the end of this year or early in 1985, according to Embassy reporting. The agreement calls for the delivery of 6 million metric tons of liquefied natural gas (LNG) annually for 19 years beginning in 1989-90. Japan signed a letter of intent in 1981, but financial difficulties among the Australian backers, together with downward revisions in Japanese energy demand, delayed the initial target date of 1986. When Mitsui and Mitsubishi became equity participants earlier this year, the project's financial difficulties were eased. Australian LNG is expected to provide for about 15 percent of Japanese LNG demand after 1990, and will generate for Canberra about $1.5 billion a year in export revenues. Tokyo now has sufficient supplies lined up to meet the majority of its natural gas requirements through 2000. [redacted]

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Libyan Offshore Oil Development Scheduled

[redacted]

Development of the offshore Bouri field, Libya's first offshore project and the largest oilfield yet developed in the Mediterranean, is proceeding steadily. The Italian oil company, AGIP, is developing the field near the Tunisian border at an estimated cost of over $2 billion. [redacted] a consortium of the Italian firm SAIPEM and the South Korean firm Hyundai has been awarded a $155 million contract for fabrication and delivery of processing and drilling facilities, while the Italian consortium Micoperi-Belleli has a $230 million contract for the drilling and production jackets. [redacted] Production from Bouri will be split 81 percent and 19 percent between the Libyan National Oil Company and AGIP. If AGIP can keep the project on schedule, the new capacity will come on line when some of Libya's older fields begin to deteriorate sharply and most industry forecasters are projecting an increase in world oil demand. [redacted]

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Big Seven Electricity-Generation Growth Remains Strong

[redacted]

Electricity-generation growth in the Big Seven countries in second quarter 1984 increased 7.5 percent—about 1.5 million barrels per day (b/d) oil equivalent—compared to the same period a year earlier. French electricity generation soared by nearly 10.5 percent in the second quarter, and more than 40 percent of this increase went to increased electricity exports. Power generation also showed strong gains in Canada and West Germany, growing by 8.0 and 8.5 percent, respectively. A near 70-percent increase in electricity imports allowed Italy to meet increased demand with only a nominal increase in electricity generation. We expect electricity-generation growth to remain strong through next year, because West European economic recovery is forecast to continue. [redacted] 25X1 25X1

International Finance

Cloudy Outlook for Brazilian Debt Talks

[redacted]

Prospects are dimming for a multiyear debt restructuring agreement with Brazil's foreign bank creditors in the next few months. Before it leaves office in March, the Figueiredo administration wants to reach an accord similar to the Mexican agreement—rescheduling debt due during the rest of the decade for 14 years at interest rates 1.125 percentage points over LIBOR—to ensure essential policy continuity under the new civilian government. Foreign banks are generally willing but only if the new president elected next month—probably opposition candidate Tancredo Neves—publicly pledges full support for the accord. [redacted] 25X1 25X1

Neves, however, is reluctant to associate himself with the debt negotiations, and we believe this may derail a multiyear rescheduling. [redacted] In our judgment, Neves, for political reasons, wants to avoid endorsing a multiyear accord negotiated by the current unpopular government, but probably would honor it in his first year. As a result, the current negotiations may result in a single-year rescheduling for 1985 and a tougher fight later over repayment terms for subsequent years. [redacted] 25X1 25X1

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Yugoslavian Rescheduling of Negotiations

[redacted]

Last week's meeting with official creditors dashed Belgrade's hopes for a multiyear rescheduling agreement and a reduction of the IMF's role in the country's adjustment effort. Although the creditor group left its official position on rescheduling terms vague, most governments indicated that they oppose a single rescheduling of 1985-88 maturities. The creditors stood firm in requiring an IMF standby program for next year before any rescheduling agreement is concluded. [redacted] 25X1 25X1

Belgrade's reluctance to accept another rigorous IMF program is likely to drag out the rescheduling negotiations. The Yugoslav Finance Secretary has told creditors that he is prepared to negotiate with the Fund. Prime Minister Planinc, however, warned publicly last week that Belgrade will not accept a strict 1985 program. Because of continuing high inflation, the IMF and Belgrade's creditors will almost certainly insist on tough conditions again next year. [redacted] 25X1

[redacted] 25X1

Global and Regional Developments

OPEC Imports From Big Seven Fall

[redacted]

OPEC imports from the Big Seven industrialized nations fell 13 percent in first half 1984 from a year earlier. Imports by these countries from the Big Seven dropped 18 percent for all of 1983. Imports of financially troubled Iraq and Nigeria fell by about one-third. At the other extreme, the imports of Ecuador and Venezuela rose substantially. While the Iran-Iraq war contributed to the decline, the import reduction was largely in reaction to the falloff in 25X1 oil revenues—down an estimated 44 percent since 1980. With oil earnings down slightly since midyear, OPEC imports almost certainly have dropped further since then. [redacted] 25X1

OPEC: Imports From Big Seven [a]

Country	Million US $		Percent Change
	First Half 1983	First Half 1984	
Total	**39,368**	**34,096**	**−13.4**
Algeria	3,026	3,132	3.5
Ecuador	432	536	24.1
Gabon	310	290	−6.5
Indonesia	3,521	3,075	−12.7
Iran	4,020	3,709	−7.7
Iraq	2,916	1,998	−31.5
Kuwait	2,317	2,350	1.4
Libya	2,180	1,761	−19.2
Nigeria	2,236	1,474	−34.1
Qatar	536	334	−37.7
Saudi Arabia	13,314	10,968	−17.6
United Arab Emirates	2,389	2,011	−15.8
Venezuela	2,169	2,459	13.4

[a] The data were derived from the Big Seven exports to OPEC.

[redacted] 25X1

GATT Annual Meeting

[redacted]

After negotiations that press reports described as stormy and frantic, last week's annual GATT meeting approved a new work program. Industrial countries hope the program will prepare the way for a new multilateral trade round and announced they would seek a special GATT session next summer to start preparations. This session was not endorsed by developing countries—they stood by their demand that the industrial countries implement trade concessions before the LDCs will discuss a new round. [redacted] 25X1 25X1

The key to the work program agreement was a compromise on services. For the first time, the United States obtained assent for GATT Secretariat work on services, including compilation and distribution of information generated by national services studies. Discussions will begin in a year on whether GATT rules should be expanded to cover services. Because the LDCs continue to deny GATT competence to regulate services, we believe services will remain a contentious issue. Another important US issue, trade in counterfeit goods, was included in the work program. [redacted] 25X1

Increased EC Beef Exports Burden World Market

[redacted]

EC agricultural trade policies will be severely challenged at next week's International Meat Council (IMC) session in Geneva. As a result of its policies over the past decade, the EC has emerged as the world's largest exporter of beef. High internal EC support prices and slaughter of dairy cows in response to stricter dairy production quotas have led to massive beef surpluses and subsequent dumping in the Middle East, North Africa, and Eastern Europe. [redacted] 25X1 25X1

With EC beef currently priced well below that of other world suppliers, EC exports have jumped 62 percent in the past year alone. According to Embassy reporting, Argentina will propose a two-year phaseout of EC export subsidies and a reduction in EC domestic prices to boost internal beef consumption. The Community probably will offer to moderate export subsidy increases, but will make no commitments on price reductions. [redacted] 25X1

EC Support for Law of the Sea Convention

[redacted]

The EC is likely to sign the UN-sponsored Law of the Sea Convention before the deadline on 9 December. The convention permits an international organization to be a party to the accord, provided that a majority of its members sign as individual states. West Germany announced last week that it would not sign the convention but declared that it would not block Community assent. Since 25X1 the decision to sign the treaty has to be unanimous, Community approval rests with the United Kingdom, which probably will be the only other EC member to reject the convention. London is likely to agree to EC participation, however, to maintain a common EC front and to avoid further antagonizing the convention's Third World supporters. EC participation in the convention, however, would be mainly symbolic. [redacted] 25X1

Japanese Corn Purchases From China Up Sharply

[redacted]

Japanese firms have contracted to buy nearly 1 million metric tons of corn from China, according to Japan's Ministry of Agriculture, Forestry, and Fisheries. The Japanese began buying cautiously earlier this year, but import figures are expected to show a rapid rise beginning in November. Aggressive 25X1 Chinese sales tactics have begun to overcome Japanese concerns about the quality and reliability of Chinese supplies and offending major US suppliers. [redacted] 25X1 After a series of good harvests, the Chinese have a surplus of corn—mostly in northeast China, with ports close to Japan. [redacted] 25X1

Indonesia Considering Direct Trade With China

[redacted]

Most key officials of the Soeharto government have endorsed the resumption of direct trade with China, which was halted in 1967. Armed Forces Commander Murdani recently told reporters he foresaw no unmanageable security problems from such a move. The Director General of Foreign Trade told a US Embassy official in late November that the only remaining 25X1 requirement was a formal statement from President Soeharto. Although

Jakarta's primary motivation is to boost its export earnings, no major gains are likely. Indirect trade is already taking place through Hong Kong and Singapore middlemen, and Jakarta and Beijing will need time to work out acceptable procedures for direct trade links. 25X1

National Developments

Developed Countries

Italian Tax Reform Package Clears Parliamentary Hurdle

The Italian Senate last week approved a value-added tax (VAT) reform package that officials estimate could bring in about $5 billion in additional revenues, about 9 percent of the 1983 budget deficit. The measure, now in the Chamber of Deputies, is designed to broaden the tax base and reduce evasion. 25X1 Labor unions, whose members believe they bear a disproportionate share of the tax burden because of evasion by the self-employed, have held a series of strikes in support of the bill. 25X1

The bill is causing divisions within the Socialist-led five-party coalition government. Anticipating next spring's national elections, Christian Democrats, Liberals, and Social Democrats are seeking to amend the bill to soften the tax blow on affected constituencies. As a result, Prime Minister Craxi may resort to a decree (emergency) law to have the bill go into effect at the beginning of 1985. More important, the tax reform raises the threat of a government crisis in Rome, since Republican Party leader Spadolini has already threatened to bring down the coalition if the bill is modified significantly. 25X1

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[redacted]

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New Israeli Budget Cuts

[redacted]

The Israeli Cabinet approved budget cuts last Friday touted to be $375 million. Because the Israeli fiscal year is already two-thirds over, however, the actual budget reduction will only be about $125 million. Moreover, most of the cuts will not materialize unless some enforcement mechanism is devised. Defense Minister Rabin, who abstained on the Cabinet vote, publicly stated that he does not know what the defense budget is and, therefore, cannot judge whether the $33 million defense reduction will damage Israel's security. Other ministers traditionally have refused to pare their budgets in the absence of defense cuts. Cabinet discussion continues on where to pare an additional $175 million. [redacted]

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Less Developed Countries

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Mexican Imports of Military Equipment

[redacted]

Defense officials appear to be resuming substantial imports of equipment in 1985, despite the country's serious economic problems. [redacted] that plans are proceeding for a new order of US F-5 jets, to cost more than $150 million. [redacted] Mexico has reached tentative agreements to purchase West European helicopters, armored vehicles, and antitank missiles. Deliveries of this expensive equipment, largely unsuited to current internal security needs, would be the strongest indication to date of the armed forces' unusually favorable standing under the de la Madrid administration. The military has already been granted supplemental appropriations for force expansion and pay raises that far outstrip civilian wage gains. The purchase of showy equipment would worsen budget overruns that are already complicating IMF consultations and would reduce funds available for social expenditures before next year's elections. [redacted]

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Peruvian Strike Intensifies Pressures on Government

[redacted]

The US Embassy says that the nationwide general strike on 29 November which was called by Peru's Communist-controlled labor confederation, disrupted normal economic activity and prompted sporadic violence. [redacted] the strike was held to protest President Belaunde's austerity policies and to gain publicity before the papal visit in January and

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before the presidential campaign intensifies. Meanwhile, a high-level government delegation came to Washington this week to negotiate with the IMF, bankers, and US officials for help with the country's critical economic situation. Although the strike did not attract strong popular support, unions demonstrated their political influence. The administration is unlikely to bow to the confederation's economic demands, but the work stoppage will reinforce Lima's fear of imposing new austerity measures. This, in turn, will prevent any quick reconciliation with international bankers. 25X1

Panama's Opposition to Austerity Program

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Widespread opposition to President Barletta's recent austerity legislation has resulted in repeal and put the new civilian government on the defensive. The austerity program included a sizable tax on services and a freeze on government wages. Business and professional organizations threatened demonstrations and a general strike, maintaining that the private sector was being forced to bear the financial burden of government mismanagement and military corruption. Following negotiations with his critics, Barletta agreed to less drastic measures that would be drafted by a coalition of business and government leaders. Nonetheless, last week some 50,000 demonstrators in Panama City protested government overspending and corruption within the military. This austerity setback will almost surely complicate ongoing negotiations to reschedule $700 million in commercial debt. Bankers are already upset with the size and terms of the proposed refinancing. Business and government leaders will have to quickly design policies that will permit Panama to pay, in the first six weeks of 1985, the $100 million it needs to comply with refinancing terms required by the international banking community. An economic upswing is essential if Panama is to meet international financing requirements. 25X1

Nigeria's Continuing Struggle With Trade Debt

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Nigeria has agreed to make an interest payment on its $3-4 billion in outstanding short-term trade debt as part of an effort to gain the confidence of foreign suppliers without submitting to an IMF agreement. The payment of about $350 million, due in January, will be equal to the interest accrued during 1984 on those trade debts to private companies covered by official guarantees of their home governments. Last April Nigeria agreed to convert $6.5 billion in nonguaranteed trade debt to six-year loans with interest payable quarterly at 1 percentage point above LIBOR. As a first step, the Nigerian Central Bank last month issued notes to cover $258 million of this trade debt. 25X1

We believe that Nigeria is unlikely to have sufficient cash to cover its 1985 debt service payments because of probable lower oil earnings. Payments on its $12 billion in medium- and long-term debt are already falling behind. Nigeria's liquid foreign exchange reserves totaled only $464 million on 15 November, an amount equal to imports for about one month. The net effect of the bunching of short- and medium-term debt repayments will be to push Nigeria's debt service ratio to as much as 50 percent within the next three years. 25X1

Iranian Budget Reflects Problems

[redacted]

Prime Minister Mausavi presented a $42 billion budget to the Majles last week for the fiscal year starting in March. According to press reports, despite a 6-percent decline in spending, the budget, which includes $14 billion in war-related expenses, still projects a $3 billion deficit. Concern in the Majles over original projections of a larger deficit led Mausavi to make last-minute budget cuts—mostly in spending on capital projects. [redacted]

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The smaller budget and foreign exchange restrictions reflect the constraints of lower oil revenues. Iran is trying to reverse this decline by offering large price discounts to increase oil exports. The Prime Minister stressed that the budget aims at alleviating inflation, unemployment, and declining industrial production despite heavy war spending. We believe this indicates growing government concern over popular complaints about the economy. [redacted] 25X1

Sudan Adopts New Economic Measures

[redacted]

Sudan has reportedly implemented a new set of fiscal measures designed to increase government revenues. According to Embassy sources, Khartoum has adopted new excise taxes designed to raise an additional $80 million in revenues and has reinstituted the income tax. Sudan's Finance Minister told Embassy sources that the price of gasoline would soon be raised by about 70 cents per gallon and that sugar prices had been adjusted upward by 15 percent. These measures, which were adopted without formal announcement, partially reverse several of the Islamization policies initiated during the past year. The Nimeiri regime took them to blunt further pressure from the IMF and other lenders for more drastic reform of Sudan's tottering economy. [redacted]

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Thailand's Postdevaluation Austerity

[redacted]

Having weathered the immediate political backlash from the 17-percent devaluation early last month, the Thai Government has introduced additional economic austerity measures to support the devaluation. Late last month, the Cabinet cut the fiscal 1985 budget by 10 percent across the board and postponed "nonessential" government projects. Bangkok has also reduced the 1985 ceiling for government-guaranteed foreign loans by 30 percent to $1.6 billion. These measures will make it difficult for Prime Minister Prem to keep his promises to military and labor leaders to offset the inflationary effects of the devaluation. As a result, Prem's coalition government will remain vulnerable to renewed attacks by the political opposition, some military leaders, and labor groups in the coming months. [redacted]

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Philippines Planning Additional Rice Imports

[redacted]

According to USAID reporting, Manila plans to import between 300,000 and 400,000 metric tons of rice in 1985, in addition to imports of 350,000 tons this year—a significant departure from the modest rice exports achieved since the mid-1970s. Philippine rice production is suffering from declines in acreage, a

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shift to low-yielding rice varieties requiring less imported fertilizer and pesticides, and recent typhoon damage. The unexpectedly large rice purchases—equivalent to 20 days of Philippine consumption—will further deplete record-low Asian export supplies and exert upward pressure on world prices. Manila, which spent $93 million for rice imports this year, is seeking rice on concessional terms from the United States, the ony major rice exporter holding large stocks. 25X1

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Communist

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Chinese Sales Boost Global Cotton Exports

Global cotton trade in 1984/85 (August-July) is expected to increase by 5 percent to more than 20 million bales, reflecting resumption of normal exports by Pakistan, Mexico, and a sharp increase in cotton exports by China, the world's largest producer. Exports from China this season are expected to reach 1.2 million bales, mainly to Asian markets, compared with only 750,000 bales last year. This reflects estimated record Chinese production of 25.3 million 25X1 bales, a 19-percent jump from 1983/84. Greater Chinese sales efforts are expected. [redacted] 25X1 CHINATEX is also adopting the world standard bale size, a source of complaints from its foreign buyers. [redacted] 25X1

Tokyo To Insure Japanese Investors in China

[redacted] 25X1

Japan's Ministry of International Trade and Industry (MITI) last month began offering insurance for Japanese investments in China, making it the first Communist country to be covered by MITI's overseas investment insurance system. The program provides partial compensation for losses due to such acts as nationalization and war. Fourteen Japanese investors, in such fields as machine tool leasing and hotel management, have already applied for the insurance. Tokyo's move was partly an attempt to compete with investors in the United States, West Germany, and other Western countries that offered similar insurance. The Japanese are wary of the lack of an adequate legal framework and other problems with the investment climate in China, but did not want to wait for the conclusion of ongoing talks on a bilateral investment treaty. [redacted] 25X1

Cambodia's Rice Prospects

[redacted] 25X1

We believe that it is too early in the crop season to confirm a serious shortfall in 1984/85 rice production, as predicted by Phnom Penh. In early November, Cambodia's Agriculture Minister announced that drought and floods had held rainy season rice sowing to only 1.2 million hectares, or 64 percent of the plan. Extensive crop destruction and damage had been reported since August. Our preliminary assessment of Cambodia's rice prospects, however, is that reports of sowing shortfalls and crop damage appear exaggerated. Our analysis of [redacted] 25X1 weather data shows that this year's monsoon was normal, with no extended dry periods and no unusual flooding across large areas. Moreover, [redacted] 25X1 most rice crops have not suffered significant flood damage. While provincial sowing progress reports from summer and early fall show this year's rice area falling behind the 1.4 million hectares achieved by the same time last year, we expect additional sowing data to narrow or eliminate the shortfall, as it did last year. [redacted] 25X1

Big Four West European Countries: Slight Economic Upturn in 1985 [redacted] 25X1

GNP growth for the four major West European economies—West Germany, France, the United Kingdom, and Italy—is expected by most forecasters to average 2.4 percent in 1985, up only slightly from this year's estimated pace of 2.1 percent. The slight acceleration in growth will almost certainly be too small to keep jobless rates from rising. Inflation appears likely to bottom out next year, however, because of continued tight monetary and fiscal policies and softness in commodity prices and labor costs. A significant slowdown in US economic activity or a dramatic fall in the dollar would worsen Big Four growth. A drop in the dollar, however, probably would be accompanied by lower interest rates, easing the impact of reduced competitiveness. [redacted]

Big Four West European Countries: GNP Growth [a] *Percent*

	1980	1981	1982	1983	1984[b]	1985[b]
Big Four	**1.0**	**−0.2**	**0.6**	**1.1**	**2.1**	**2.4**
West Germany	1.8	−0.3	−1.1	1.3	2.6	2.7
France	1.1	0.2	2.0	0.7	1.2	2.1
United Kingdom	−2.6	−0.7	2.1	3.4	2.3	2.3
Italy	3.9	0.2	−0.4	−1.2	2.4	2.6

[a] OECD Secretariat data.
[b] Consensus forecasts [redacted] The consensus forecast is calculated as the average of projections [redacted] 25X1 25X1 25X1

Growth Prospects

[redacted] the West European "recovery" is shaping up as the weakest in the postwar period. Growth in consumption, which makes up two-thirds of GNP, will lag because of the small expected increase in the number of jobs and in real aftertax income. Although lower wage hikes should improve West European competitiveness and business profits, the expected slowdown in US and Canadian growth will force West European countries to rely on business investment and trade among themselves and with other countries for economic expansion. [redacted] 25X1

Unlike past recoveries, Big Four GNP growth probably will receive only a small boost from private consumption. Annual increases in real disposable income this year and next are expected to be only 1.2 percent—2 percentage points lower than the annual average increase in the 1972-80 period [redacted]

To cut budget deficits without crippling investment needed for restructuring, West European governments generally have chosen to shift more of the tax burden from the business sector to the household sector while holding the line on transfer payments. The exception has been the United Kingdom, where 1982 income tax cuts spurred an earlier start to its recovery. Moreover, anti-inflationary monetary policies have helped keep interest rates high—West European real rates are about 3 percentage points higher than the average of past recoveries—thereby dampening growth in consumer spending, particularly for housing. On the other hand, high unemployment in the Big Four probably will continue to moderate wage increases. [redacted] 25X1 25X1

Investment already is making an important contribution to Big Four growth—a trend that should continue in 1985. Cost cutting and rapidly growing

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Big Four West European Countries: GNP Forecasts by the OECD Secretariat *Percent*

	1983	1984	1985
Big Four GNP growth	**1.1**	**2.1**	**2.6**
Private consumption	1.5	1.2	1.4
Government consumption	1.6	1.1	0.6
Gross fixed investment	0.6	3.6	4.0
Public	0.1	−1.2	1.3
Private residential	3.7	1.8	1.2
Private nonresidential	−0.1	5.3	5.6
Stockbuilding	−0.1	0.5	0.4
Exports of goods and services	1.5	5.9	5.7
Imports of goods and services	1.5	6.4	4.7

[redacted]

Big Four West European Countries: Consumer Prices [a] *Percent*

	1980	1981	1982	1983	1984[b]	1985[b]
Big Four	**13.1**	**11.4**	**9.8**	**7.2**	**6.1**	**5.9**
West Germany	5.5	5.9	5.3	3.0	2.7	2.9
France	13.6	13.4	11.8	9.6	7.6	6.8
United Kingdom	18.0	11.9	8.6	4.6	5.3	5.8
Italy	21.2	17.8	16.6	14.6	11.3	10.1

[a] OECD Secretariat data.
[b] Consensus forecasts [redacted]

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export demand have helped revive West European profit margins. Lower inflation rates have brightened the outlook for reduced nominal interest rates, which will cut the cost of financing plant and equipment and make financial assets relatively less attractive as an alternative for capital. Capacity utilization rates have risen substantially since the recovery began, in part because outmoded plants have been closed; if the effects of the West German metalworkers strike are taken into account, capacity utilization in the European Community was 81 percent in the third quarter of 1984, only 3 percentage points below the 1979 peak. [redacted] According to EC data, industrial investment should increase next year by about 10 percent in real terms in France and the United Kingdom. West German and Italian intentions suggest much less robust industrial investment, with real increases this year of 2 percent and 1 percent, respectively. [redacted]

Much of the intended increase in investment will be channeled into restructuring traditional industries, according to the EC surveys. French executives this year plan to invest a whopping 75 percent more in real terms in the metallurgical industries, while West German and British metal companies intend to spend at least 15 percent more. Investment in the British textiles, footwear, paper, and plastics industries is slated to rise 20 percent in real terms, while the Italian food processing industry should invest 15 percent more in 1984 than in 1983. [redacted] 25X1

The Big Four countries are expected to continue benefiting from the recovery in world trade. In the first half of 1984, world trade volume expanded 20 percent at an annual rate; US import volume grew a phenomenal 40 percent during the period, accounting for about one-third of the increase. Soft commodity prices and the competitive edge given West European producers by the strong dollar have helped improve business profits and set off the investment surge. The West Europeans expect to continue winning market shares worldwide because of continued strength in the US dollar. Thus, forecasters believe that the foreign trade sector will give the Big Four economies as much, if not more, of a boost next year despite the projected slowdown in US import demand. [redacted] 25X1

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Big Four West European Countries: Unemployment Rates [a] *Percent*

	1981	1982	1983	1984[b]	1985[b]
Big Four	**7.5**	**8.7**	**9.4**	**9.8**	**10.3**
West Germany	4.6	6.7	8.2	8.3	8.3
France	7.3	8.0	8.2	9.3	10.6
United Kingdom	9.5	11.0	11.5	11.6	11.8
Italy	8.7	9.1	9.7	10.1	10.5

[a] OECD Secretariat data.
[b] Forecast.

[redacted]

Inflation

Inflation appears likely to bottom out in 1985, according to the Blue Chip survey. Commodity prices, including that of oil, show few signs of firming up. Indeed, spot oil market prices have been falling in recent weeks, and the financial press has reported speculation on more cuts in official oil prices. Moreover, with moderation in wage hikes, [redacted] Big Four unit labor costs to grow much slower than the annual average for the past 10 years. Last, continued tight monetary and fiscal policies should contain inflationary pressures. [redacted]

Unemployment

The slight increase in Big Four growth projected for next year almost certainly will be insufficient to keep unemployment—Western Europe's most severe economic problem—from rising. Efforts to restructure traditional industries are expected to continue; more layoffs thus can be expected as businesses cut costs by shedding excess capacity and seeking more labor-saving means of production. According to the OECD Secretariat's latest draft forecast, jobless rates in three countries of the Big Four should top 10 percent in 1985; only West Germany is expected to have a chance of holding the line on the unemployment rate. The OECD forecast implies an increase in the number of jobless in the Big Four of 550,000; the largest rise—about 325,000—should occur in France, where nationalized companies are paring their work rolls in line with government directives to operate at a profit. [redacted] 25X1

Uncertainties in the Forecasts

Forecasters point to several factors that would cause them to reassess their 1985 projections. For example, a fall in oil prices of $2 to $5 per barrel would shift growth among countries and industries but would keep the average Big Four growth rate virtually unchanged. As a net oil exporter, the United Kingdom would experience slower growth, while the other three economies would enjoy a somewhat faster expansion. On the other hand, if OPEC countries significantly cut back their imports—which are weighted toward capital goods—much of the gain from lower oil import bills would be offset. [redacted] 25X1 25X1

The US economy poses greater uncertainty for the West European economies. Most projections of US growth in 1985 are clustered close to the Blue Chip average of 3.3 percent. Although recent US economic performance has been below expectations, causing some forecasters to hedge, most analysts still seem to think that US import demand will not fall enough to reduce Big Four GNP growth significantly. [redacted] 25X1 25X1 25X1

Future movements in the dollar also could influence West European growth prospects. Most forecasters are assuming a slight fall in the value of the US dollar, but they have been expecting it for more than two years. If the dollar falls more than expected, Big Four international competitiveness would deteriorate, thus reducing economic growth. West European governments, however, could take advantage of a weaker dollar to cut interest rates, which would offset some of the effects of lower sales growth at home and abroad. [redacted] 25X1

[redacted] 25X1

Persian Gulf: Impact of a Major Oil Price Decline

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The oil market will remain vulnerable to an unraveling of prices for at least the next few years because of increasing output from non-OPEC suppliers and attempts by some OPEC producers to maintain their market shares through price discounts and barter deals. If oil prices were to plummet, there is a good chance that the Iran-Iraq war would escalate, instability would grow in the Arab Peninsula states, and US interests in the area would be harmed. This article is not an oil market forecast, but instead speculates about the impact on Persian Gulf countries if oil prices were to fall to around $20 per barrel.

Impact on Iran-Iraq War

Iraq would be the Gulf country most seriously affected by a major oil price decline. A drop in prices to $20 per barrel would cost Baghdad slightly more than one-fourth of its revenues—30 percent of the loss would result from the lower value of Saudi Arabian and Kuwaiti oil sold on Iraq's behalf. Iraq will be unable to increase oil exports to offset a drop in prices until the war's end allows reconstruction of Iraq's Gulf terminals, the oil export pipeline through Saudi Arabia is completed, or the Iraq-Turkey pipeline is again expanded. In the meantime, sharp austerity that would be required to offset large revenue losses would increase the risk to President Saddam Husayn of serious domestic unrest.

In contrast, Iran has more than enough excess productive capacity to offset the impact of $20 per barrel oil. Rather than risk imposing tough austerity measures, we believe Iran would ignore its OPEC production ceiling and employ aggressive marketing tactics to sell as much oil as it needs to maintain food and military imports. In our judgment, only if Iranian efforts to maintain essential imports failed and the regime came to believe its hold on power was threatened by economic problems, would Tehran consider ending the war with Iraq. 25X1

If Baghdad faces revenue shortfalls and austerity-induced unrest while Iran maintains earnings, we would expect Iraq to intensify attacks against Iranian oil shipments, and perhaps even oil facilities. After all 20 Exocet-equipped Mirage F-1 aircraft are received from France during the next few months, Baghdad will be able to attack tankers and Iranian economic targets almost daily. Although Baghdad has preferred low-risk conservative tactics, it probably would delay an escalation only briefly while making one more try at ending the war through diplomatic channels. 25X1 25X1

If a desperate Iraq escalates the war, Iran would respond. Although constrained by its smaller and less effective Air Force, Iran has the ability to increase attacks on tankers carrying Arab oil, particularly in the lower Gulf beyond the range of Saudi air patrols. If Baghdad attacks and seriously damages Khark Island oil facilities or halts tanker traffic to Khark, Tehran probably would launch commando, terrorist, or air attacks against the Iraqi-Turkish pipeline or Arab oil facilities. 25X1

Unpleasant Choices for Saudi Arabia and Kuwait

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Saudi Arabia and Kuwait might seek to restrain Baghdad by providing additional massive financial transfusions. Such aid, however, would magnify the problems posed by their own large oil revenue losses and make decisions on domestic spending cuts, foreign asset drawdowns, and oil production levels even more difficult. An escalation of the Gulf war, however, would pose serious risks as well, particularly for Kuwait, whose oil facilities are a likely target if Iran retaliates for Iraqi attacks. On balance, we believe the Saudis and Kuwaitis would decide ultimately to make up some of the Iraqi revenue losses. Nonetheless, the likely delays in providing aid and the failure to offset Iraq's financial losses totally would keep the risk of escalation high.

We believe the Saudis are ill-prepared to deal with the economic reversals that would stem from a major oil price decline. Saudi Arabia has coped so far with declining oil earnings by putting development projects on hold, paying bills late, reducing foreign aid, and drawing down assets by $15 billion a year. Although the Saudis still have about $120 billion in official foreign assets, they do not want reserve drawdowns to accelerate, because reserves are considered an endowment for future generations.

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Saudis have become accustomed to a wide range of government subsidies and improvements in living standards. Saudi citizens would not welcome the belt-tightening necessary after a sharp fall in revenues, especially if the royal family does not share the burden.

Sharply lower oil prices also have the potential to generate serious tension within the Saudi Government about its commitment to OPEC. The Saudi role in OPEC has benefited the kingdom and has ensured a place of leadership within OPEC councils and in making international oil policy. Faced with painful spending cutbacks, however, some Saudi leaders are likely to argue that Saudi national interests come first and that oil production should be increased even if this harms other OPEC states.

A sharp fall in oil prices would cause Kuwait fewer financial problems than other oil-producing countries. Kuwait's nearly $70 billion in foreign assets provides a more-than-adequate buffer for its small population. Moreover, extensive foreign equity investments in the West probably would rise in value as oil prices fall. Nonetheless, Kuwaiti citizens would blame the government for any cuts in domestic spending caused by lower oil revenues and increased aid to Iraq. Although Kuwait has the productive capacity to increase oil output to offset lower prices, such increased production would only put additional downward pressures on oil prices.

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Other Arab States

The other Arab peninsula states that depend heavily on oil revenues also would need to cut spending. Their decisions on foreign asset drawdowns and oil production would be similar to those faced by Saudi Arabia and Kuwait. Each has special problems that would be made worse by lower oil prices:

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- Strains within the UAE between "have" and "have not" emirates would worsen.
- Oman would have to reconsider expensive military purchases, primarily from the United Kingdom.
- Qatar's Amir, determined to avoid a recurrence of the brief recession of 1983, would almost certainly violate OPEC production quotas and would further delay paying foreign aid commitments to Iraq, Syria, Jordan, and the PLO.
- Bahrain's dependence on Saudi aid would increase and the ruling Khalifa family probably would face increased Iranian-sponsored dissidence among Bahrain's 70-percent-Shia population.

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Implications for the United States

A major price decline would have negative implications for US interests in the Persian Gulf region. Governments friendly to the United States would face greater problems dealing with troubled economies and popular discontent. They also would be less able to meet their foreign aid commitments to pro-Western Third World countries. For its part, the USSR might gain increased leverage in Iraq and perhaps Kuwait by offering favorable terms on military equipment. An escalation of the Iran-Iraq war would generate pressures for greater US military involvement. Although this might create opportunities for closer US cooperation with states in the region, it also would have the potential for confrontations between US and Iranian forces.

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Libya: Living With Less [redacted]

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Libya has weathered the soft oil market by cutting back sharply on imports, scaling back the Five-Year Plan (1981-85), slowing payments to suppliers, and resorting to oil barter deals. Economic activity in real terms is below that of 1979. Despite rising popular unhappiness over the cause of the slowdown, Libyan leader Qadhafi has consolidated his control over the small population and further implemented his revolutionary ideals. The regime's still substantial foreign reserves and sizable military arsenal also allow Qadhafi considerable flexibility in supporting dissident groups worldwide, and the continuation of present oil market conditions will not limit his ability to support international terrorism. He will be less able to offer generous economic aid and trade incentives, however, to strengthen ties with pro-Western regimes and counter Washington's Libyan policy. [redacted]

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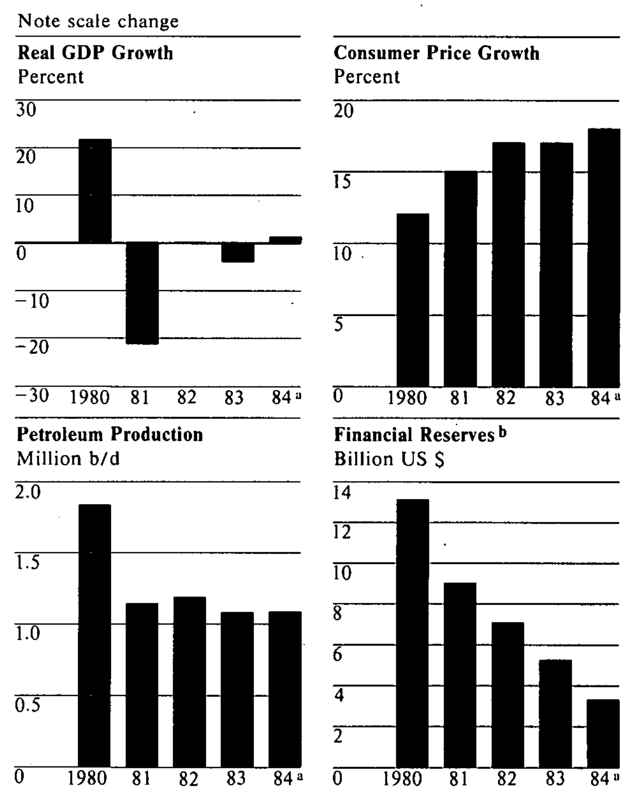
A Smaller Pie

Qadhafi's guns and butter economic policies have been dealt a stiff blow by soft oil market conditions since 1980. Oil is the mainstay of the economy and the source of Qadhafi's international influence. Petroleum exports account for virtually all foreign exchange earnings, 55 percent of GDP, and 80 percent of government revenues. Real GDP has declined for the past three years, causing a 30-percent decline in per capita GDP. Overall economic activity has fallen below the 1979 level. Libya's foreign trade position has deteriorated sharply since the oil boom ended. Projected 1984 exports of $10 billion and imports of $8 billion are off by half from their peak in 1980 and 1981 respectively. A positive trade balance has been maintained by adjusting imports. Declining investment receipts

Libya: Economic Indicators, 1980-84



[a] Estimated.

[b] End of period, excluding 3.578 million ounces of gold.

[redacted]

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Libya: Current Account Balance *Billion US $*

	1980	1981	1982	1983	1984 [a]
Current account balance	**9.2**	**−5.3**	**0.6**	**−1.8**	**−2.5**
Trade balance	11.9	−1.3	4.3	2.8	1.9
Exports (f.o.b.)	22.8	15.2	13.6	11.2	10.0
Oil	22.8	15.2	13.6	11.2	10.0
Imports (f.o.b.)	10.9	16.5	9.3	8.4	8.1
Non-Communist	8.6	13.0	5.9	5.9	5.9
Military	0.9	0.7	1.1	0.6	0.5
Communist, nonmilitary	1.0	1.8	1.7	1.3	1.2
Soviet	0.3	0.3	0.3	0.4	0.4
Other	0.7	1.5	1.4	0.9	0.8
Communist, military	1.3	1.7	1.7	1.2	1.0
Soviet	1.1	1.1	0.8	0.6	0.4
Other	0.2	0.6	0.9	0.6	0.6
Net services	−2.4	−3.6	−3.1	−4.2	−4.0
Freight and insurance	−1.3	−2.0	−1.1	−1.0	−1.0
Investment income receipts [b]	1.2	1.5	1.1	0.8	0.6
Other	−2.3	−3.2	−3.1	−3.9	−3.6
Grants	−0.3	−0.4	−0.5	−0.4	−0.4
Capital account balance	**−2.4**	**1.2**	**−2.5**	**0**	**−0.6**
Change in reserves	**6.8**	**−4.1**	**−1.9**	**−1.8**	**−1.9**

[a] Estimated.
[b] Earnings from official assets only.

[redacted] 25X1

and growing service costs associated with financing Libya's share of oil industry investments, however, contributed to current account deficits in two of the past three years. Foreign exchange reserves have been drawn down by $10 billion since June 1981 and are now nearly $3 billion. [redacted]

Government efforts to deal with the decline have placed an increasing burden on the population. Most basic consumer goods are available albeit at reduced quality and greater inconvenience. Import restrictions on a wide spectrum of consumer goods and luxury items have been in place since early 1982. Food imports have been cut over 50 percent, causing shortages and sharply higher prices. Ration books have recently been distributed to prevent hoarding. Nominal wages have been reduced as much as 20 percent and currency restrictions implemented to curb consumption and help finance priority development projects. [redacted] 25X1 25X1

[redacted] the population is increasingly pessimistic about the future as a result of the economic decline and the growing restrictions on traditional lifestyles. [redacted] 25X1 25X1

Libya's domestic problems are compounded by Qadhafi's chaotic efforts to nationalize the economy. These measures, in combination with Libya's fading oil wealth, have sapped domestic morale and curtailed individual incentive. The system of national supermarkets, established to replace traditional bazaars, has exacerbated already serious distribution problems and added to food shortages. Qadhafi recently mandated the creation of neighborhood food cooperatives to improve distribution and reduce growing corruption. Plans to socialize agriculture, the last major economic activity still in private hands, have been delayed because of vigorous opposition by farmers, who resent the regime's meddling with traditional Islamic land policies. [redacted]

Libyan cities have been inundated by dirt and uncollected garbage since the government decision last spring to dismiss sanitation workers—primarily Tunisians and Turks—and require citizens to collect their own garbage and clean the streets. The popular disdain for such work and Libya's already poor sanitation system have compounded the trash problem and hastened the spread of related disease. Libya is urgently negotiating the purchase of substantial amounts of rat poison to combat a serious rodent infestation in major urban centers. [redacted]

Tightening the Domestic Belt

The development budget has been another casualty of the revenue shortfall. Official estimates state that development spending has declined by one-fifth since 1980, but [redacted] actual spending probably has been 40 percent lower than stated levels. The administrative budget also was trimmed slightly this year, the first time since Qadhafi came to power. These cuts have caused great confusion among government administrators, who are unable to meet development goals. [redacted]

While the soft oil market has prompted the government to reassess development goals, several prestige projects continue to have priority, although completion will be delayed. Heading the list is the $11 billion Great Manmade River, which will bring water from southern Libya to coastal regions confronted with severe water shortages. Completion of this project, along with that of other large-scale development programs—the multibillion-dollar steel mill at Misratah, an aluminum smelter at Zuwara, and the large petrochemical facility at Ra's al Unuf—has been delayed for several years to conserve foreign exchange. Agriculture retains Qadhafi's personal interest, but poor planning caused grain production to fall 10 percent this year. The impact of the development slowdown on the average Libyan, however, is limited. Much of the labor force is foreign—about 40 percent—and the affected projects are not oriented toward producing goods for domestic consumption. [redacted]

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Defense spending has been the last area to feel the pinch of declining revenues. We estimate that military imports have declined to about $1.5 billion this year from their peak of $2.8 billion in 1982, but most of this decline reflects the completion of deliveries under existing contracts. Defense spending as a percent of the administrative budget, however, has remained relatively stable over the past five years. Qadhafi came to power through a military coup and is well aware that the military poses the greatest threat to his regime. Qadhafi has been careful to meet the needs of the military and will continue to do so. [redacted]

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Nevertheless, payment arrears on military contracts have strained relations between Tripoli and Moscow—Libya's primary arms supplier. [redacted] Moscow has accepted about 110,000 barrels per day (b/d) of crude oil—worth about $1.2 billion annually—since mid-1982 in payment for arms. Moscow continues to push for lower prices for the bartered oil and for hard currency payments on the remaining $4 billion in outstanding contracts for arms

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deliveries. Despite the acrimonious nature of Libyan-Soviet arms negotiations, Tripoli has no alternate source of sophisticated military hardware. [redacted]

The government recently resolved much of Libya's outstanding commercial payments arrears—about $2 billion, according to the Bank for International Settlements—through oil-barter arrangements. In addition to the Soviet deal, Italy, Greece, Turkey, South Korea, and India will take over $2 billion in oil over the next several years in payment on delinquent Libyan accounts and future contracts. Available evidence suggests this oil will come out of Libya's current OPEC production quota. The regime has frequently used its large arrears to extract economic and political concessions from trade partners. For example, Libya delayed granting a large contract for the development of its offshore oil reserves to an Italian company until the oil-barter agreement was signed by Rome. [redacted]

Prospects for Oil

The petroleum sector has been little touched by the wave of cutbacks in the domestic economy, and the 1982 withdrawal of US oil personnel has had little impact on production. Oil production has been reduced to 990,000 b/d under the new OPEC quota agreed to in October. This level, however, is only 55 percent of sustainable capacity of 1.8 million b/d. Maintenance is being carried out largely by West European personnel, although as many as 1,000 US workers have returned to Libya. The maintenance budget for 1985, however, has been increased to upgrade aging facilities. [redacted]

Spare parts have not been a major obstacle to oil production, because of the considerable excess capacity and production system redundancy. [redacted]

The economy's dependence on petroleum exports requires the regime to invest heavily in exploration and development of its petroleum resources. Tripoli is particularly eager to tap its large offshore reserves. Development of the Bouri field close to the Tunisian border—the largest oil project in the Mediterranean—is under way, with production 25X1
scheduled to begin in 1987. Sufficient new oil has been discovered in this field and onshore to keep overall proven reserve levels at about 22 billion barrels. [redacted] 25X1

We believe that Qadhafi has little choice but to abide by his OPEC quota in the near term because of market conditions. He can raise production quickly, however, if market conditions change. Qadhafi controls 25 percent of available non-Communist excess capacity outside the Persian Gulf and almost certainly would take advantage of a closure of the Strait of Hormuz with increased output. [redacted] 25X1

Political Dynamics of Slow Growth 25X1

The economic malaise has intensified the disaffection already generated by Qadhafi's local political excesses and radical foreign policies. The revolutionary committees, which have been increasingly relied on to implement economic policy, continue to rankle government technocrats. Food shortages and socialization of the economy have caused popular disgruntlement to increase [redacted] 25X1
25X1 Nevertheless, Qadhafi's ever-present security forces limit public criticism of the regime. [redacted] 25X1

The financial pinch has not hindered Qadhafi's efforts to export his revolutionary ideals or support foreign dissident movements. We estimate that 25X1
foreign aid—both military and economic—to governments peaked in 1981 at $770 million. As much as $500 million has been donated this year, almost all of which has gone to Morocco, Nicaragua, and Syria. Reduced oil revenues have not been a con- 25X1
straint on Qadhafi's support for international ter- 25X1
rorism. Cumulative expenditures on these activities probably total only several hundred million dollars since 1978. [redacted] 25X1

Outlook

Libya's economy probably will continue to show slow growth in 1985. With no significant boost in oil exports, the regime will be forced to restrain import growth for another year. Efforts to improve the internal distribution system and a slight increase in food imports programed for next year, however, may alleviate consumer disgruntlement over food shortages. Funds probably will be sufficient for the regime to proceed with the truncated development program. Qadhafi also will have sufficient wherewithal to meet most of his commitments of foreign aid [redacted] if he chooses to honor them. [redacted]

The Qadhafi regime could face severe economic problems next year if oil prices continue to fall. For example, if oil prices drop to $25 per barrel, Libya would face a current account deficit of $4 billion in 1985 at present oil production and import levels. Such a deficit would exhaust available foreign exchange reserves, forcing Tripoli to cut imports even more or resort to foreign borrowing—a measure Qadhafi has resisted. [redacted]

A sharp economic downturn would be a crushing blow to Qadhafi's prestige. Although revenues probably would be sufficient to meet the basic needs of the population, popular discontent with the regime would increase. Under these conditions, Qadhafi would have to rely even more heavily on his intelligence and security services to remain in power. Even under these conditions Qadhafi probably would be able to spend several hundred million dollars in support of dissident groups. [redacted]

Implications for the United States

The measures implemented by Libya to deal with domestic economic retrenchment have left Qadhafi financially leaner, but probably more dedicated to the cause of his revolution. The 8 May attack by Libyan exile groups against Qadhafi has convinced him of the need to tighten control over the population. Qadhafi's still sizable foreign reserves allow him considerable flexibility to export his brand of revolution and to strike at US interests anywhere he chooses. His weakened financial position, however, may prompt Qadhafi to extract a higher price for his aid in the form of greater alignment of dissident groups with his radical policies and efforts to strike at the United States and Israel. Libya's large and sophisticated arsenal makes Qadhafi a serious threat to regional stability. [redacted]

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Libya still provides an attractive market for West European, US, and Asian business interests. The heavy involvement of some West European countries in Libya will continue to limit their interest in coordinated efforts to control Qadhafi. In addition, the continued use of US firms in the oil industry and the Great Manmade River project almost certainly will be used by Tripoli to limit efforts by Washington to impose even stronger economic sanctions. [redacted]

[redacted]

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Debtor LDCs: Devaluations Slowing

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The $26 billion increase in the collective trade surplus of 12 major LDC debtors [1] in 1982-83 can in large measure be attributed to the real devaluation of their currencies. Preliminary 1984 data, however, indicate that the pace of real devaluation is slowing for this group. We believe concern over the role of devaluations in increasing inflation, and the resulting political and social fallout, is behind the slowdown, and will limit the potential for further real devaluations in the near term.

Sharp Real Devaluations

Many LDC debtors began to devalue their currencies in 1982, as part of comprehensive economic adjustment programs negotiated with the IMF. By lowering the foreign price of their exports and raising the domestic price of their imports, devaluations were intended to improve a country's trade position and its ability to service foreign debt. On average, the 12 LDC debtors devalued their currencies 8 percent in 1982-83. Nine of the countries we examined had lower real exchange rates in 1983 than in 1981. Argentina, Ecuador, and Mexico recorded real devaluations in excess of 20 percent. Chile and Brazil had real devaluations of 18 and 12 percent, respectively. Only Colombia, Nigeria, and Venezuela failed to devalue their currencies in real terms.

Impact on Trade Balances

The overall trade balance for the 12 key debtors improved $26 billion in the past two years, with nine countries recording gains. Mexico was the standout performer, with a trade balance improve-

Trade Balances and the Real Exchange Rate

We calculated the real—price adjusted and trade weighted—exchange rate by taking the ratio of the wholesale price index (or, when unavailable, the consumer price index) of each country to the trade-weighted average of the matching price indexes of the country's 16 main OECD trading partners, and multiplying it by the country's trade-weighted exchange rate. The base year for our comparisons is 1980. The calculated real exchange rates do not provide an absolute measure of overvaluation or undervaluation, but they provide a measure of recent changes in competitiveness. 25X1

To measure the impact of changes in the real exchange rate on imports and exports, we first estimated import and export equations for each key debtor. Imports were assumed to be a function of domestic GNP and the relative price of domestic versus foreign goods. Exports were assumed to depend on OECD GNP and relative prices. In the short run, oil exports are unaffected by exchange rate changes, since petroleum is priced in US dollars. The same is true for other commodities whose prices are dollar denominated. Therefore, to ensure proper specification of export equations, only nondollar-denominated exports were included for Argentina, Bolivia, Chile, Colombia, Ecuador, Indonesia, Mexico, Nigeria, Peru, and Venezuela—countries whose exports are heavily dependent on dollar-priced commodities. The derived coefficients on the relative price term were then multiplied by the calculated change in the relative price between 1981 and 1983 to obtain an estimate of the impact of this change on imports and exports.

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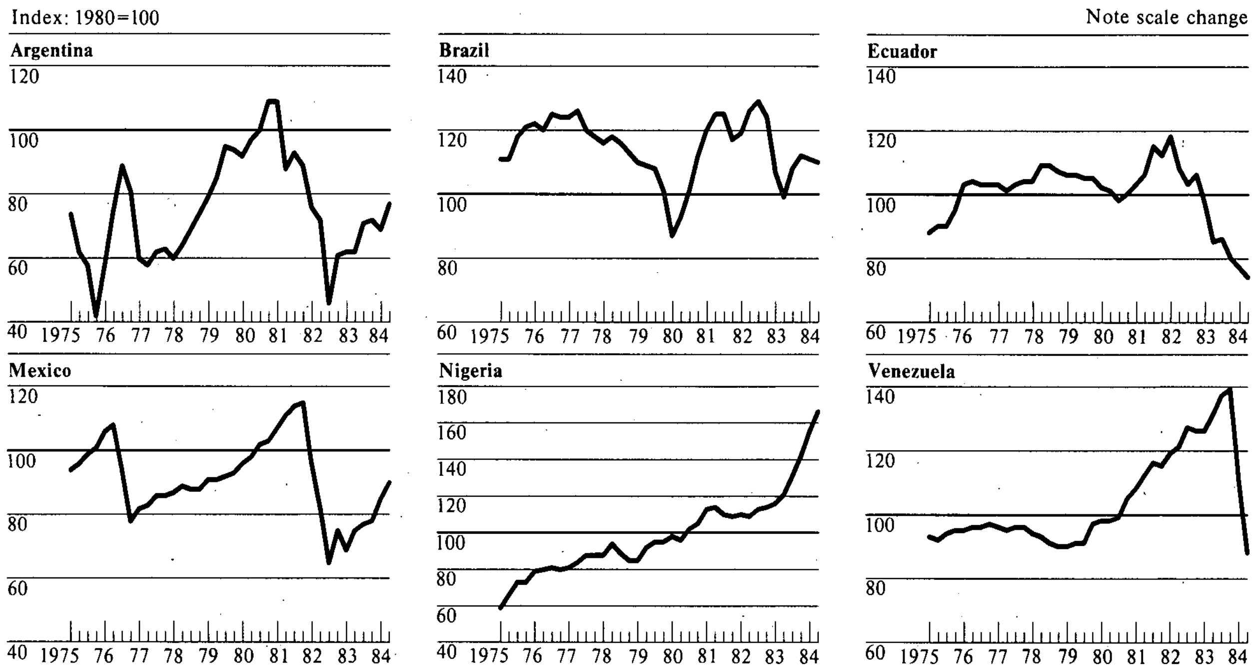
[1] The 12 countries we examined are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Indonesia, Mexico, Nigeria, Peru, the Philippines, and Venezuela.

Selected Key Debtors: Real Trade-Weighted Exchange Rates, 1975-84



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ment of $18.6 billion. Argentina, Brazil, and Chile recorded increases of $3-5 billion. The large oil exporters in the group were adversely affected by the weak oil market. Indonesia registered a $6.4 billion drop in its trade balance, largely the result of reduced oil revenues. Nigeria and Venezuela also recorded sharp declines in foreign petroleum sales, but managed slight trade balance improvements by deep import cuts.

Real devaluations were an important factor in the improvement in the key debtors' trade accounts. We estimate that real devaluations were responsible for one-fifth of the $44.6 billion drop in imports. Devaluation was also a valuable tool in minimizing export losses. Key-debtor exports, hard hit by the OECD recession and weak oil markets, declined $19 billion in 1982-83. We estimate that without real devaluations, the drop would have been about $24 billion, trimming the overall trade balance improvement by $5 billion. 25X1

Trends Now Reversing

Preliminary 1984 data indicate the pace of real currency devaluations is slowing. These devaluations averaged less than 1 percent in the first half of this year, down from 5 percent for the same period a year earlier. According to US Embassy reporting, mounting domestic opposition is a major 25X1

Key Debtors: Trade Balances and the Impact of Real Exchange Rate Movements, 1982-83

Billion US $

	Total Change in Trade Balance	Due to Shift in Exports	Due to Shift in Imports	Impact of Change in Real Exchange Rate on: Exports	Impact of Change in Real Exchange Rate on: Imports
Total	**25.8**	**−18.8**	**44.6**	**5.2**	**−9.7**
Argentina	3.0	−1.3	4.3	0.9	−1.5
Bolivia	0.1	−0.1	0.2	0.1	−0.1
Brazil	5.2	−1.4	6.6	1.5	−0.4
Chile	3.7	0	3.7	0.2	−0.6
Colombia	−0.2	−0.2	0	−0.2	0.8
Ecuador	0.3	−0.6	0.9	0.1	−0.5
Indonesia	−6.4	−5.3	−1.1	0.2	−0.9
Mexico	18.6	2.3	16.3	2.7	−11.4
Nigeria	0.7	−6.1	6.8	−0.5	3.3
Peru	0.9	−0.2	1.1	0.2	−0.1
Philippines	−0.2	−0.7	0.5	0.2	−0.3
Venezuela	0.1	−5.2	5.3	−0.2	2.0

[redacted]

factor behind the slowdown. By raising the domestic price of imports, devaluation has increased inflation and sparked dissatisfaction among the working class and the poor. To ease inflationary pressures, the pace of real devaluation has been curbed, and in some cases the real exchange rate has been allowed to appreciate. Among major LDC debtors:

- Argentina recorded a 1-percent real appreciation in the first half of this year. An October devaluation failed to offset the jump in the real exchange rate, but continued devaluation—linked to a new IMF program—may erase the increase by the year's end.

- Brazil registered only a 1-percent real devaluation of the cruzeiro in the first six months of 1984, compared with a 17-percent reduction in the same period a year earlier.

- Ecuador continues to devalue the sucre in real terms, but at a much slower pace than in 1983. The real exchange rate fell 6 percent in the first six months of 1984, compared with 14 percent a year earlier.

- Mexico has allowed the peso to appreciate 12 percent in real terms since the end of 1983, resulting, in part, in import growth of 13 percent in the first half of this year.

- Nigeria has consistently refused to carry out a major devaluation of the naira, although such a move is long overdue. The real exchange rate appreciated 13 percent in the first half of 1984 and stood 66 percent above its 1980 level. Lagos has managed to hold down imports only through a complex and burdensome system of controls.

- Venezuela has proved to be the exception, moving to correct its overvalued currency with a major devaluation. Since the end of 1983, its real exchange rate has fallen 29 percent. [redacted] 25X1

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Outlook

The trend toward slower real exchange rate devaluation probably will continue. Leaders of inflation-weary LDC debtors such as Argentina, Bolivia, and Peru probably will be reluctant to pursue aggressive devaluation policies for fear of increasing domestic unrest. Nigerian officials continue to resist IMF calls for a 25-percent devaluation, citing adverse effects on the public and threats to government stability. Finance Minister Junguito recently stated that to avoid popular discontent Colombia would not be able to fully accept IMF proposals for a massive devaluation. In November, Chilean leaders announced they would slow the pace of devaluation to help curb inflation. In our judgment, slower exchange rate devaluations will result in a loss of competitiveness for many LDC debtors that will reduce the hard-won trade surpluses to service their foreign debt. Alternatives such as tighter import controls would hamper economic growth and, perhaps, trigger the same discontent already feared, while export promotion measures risk protectionist reactions by trading partners. [redacted] 25X1

[redacted] 25X1

Japan: Economic Relations With the USSR Stalled [redacted]

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Despite recent gestures by the Japanese Government and business community to improve ties to the Soviet Union, the short-run outlook for bilateral economic relations is not promising. The sharp drop in bilateral trade that began in 1983 continues. Cuts in Soviet equipment purchases for stalled resource development projects in Siberia and declining demand in Japan for these resources have affected the two major components of the two-way trade. Moreover, the political climate has improved little since the invasion of Afghanistan and the KAL shootdown. Japanese businessmen are not anxious to undertake new ventures in the USSR and view increased bilateral exchanges largely as a means to keep channels open for possible future business. The government, meanwhile, is unlikely to encourage improvements in the economic relationship until it sees movement in US-Soviet relations. [redacted]

Trade Plummets

Since 1982, trade between Japan and the Soviet Union has fallen drastically; two-way trade declined to $4.3 billion last year, a drop of nearly 20 percent from 1982. Trade has fallen 10 percent in the first 9 months of this year, with exports down 15 percent and imports off 2 percent from comparable periods in 1983. [redacted]

Strained Political Environment

Strains in the political climate have helped to put a brake on the bilateral economic exchanges. The Soviet invasion of Afghanistan, martial law in Poland, the KAL incident, and the Soviet military buildup in the Far East have discouraged bilateral economic relations. The Japanese have become increasingly vocal in insisting that Moscow return the Northern Territories. [redacted]

Although Japanese sanctions following Soviet intervention in Afghanistan have been relaxed, an official from the Soviet Trade Representative Office has frequently pointed to these restrictions, which include limits on official export credits, as a major reason for the decline in trade. The Soviet official's remarks probably were meant to convince Japanese businessmen that the government was not serving their interests. After the KAL shootdown, however, many Japanese firms took it upon themselves to curtail contacts with the Soviets. [redacted]

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Slumping Demand on Both Sides

Although Japan has traditionally imported primary products from the USSR, demand has fallen in recent years despite the present recovery of the Japanese economy. One of the main reasons the Sakhalin offshore oil and natural gas project is on hold is the reluctance of Japanese electric power companies to commit themselves to buying liquefied natural gas. Their needs are filled into the early 1990s, and requirements after that are uncertain. [redacted] 25X1

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The stagnation of the Soviet economy because of heavy military expenses, imports of grain and other foodstuffs, and the burden of aid to satellite and developing countries has played a major role in reducing Soviet imports. Japanese exports of machinery and equipment to the Soviet Union fell more than 35 percent in 1983 as large-scale Soviet industrial and resource development projects ran into funding problems. The Soviet practice of conserving hard currency has led the USSR to push strongly for counterpurchase trade, which the Japa- 25X1

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Japan: Trade With the USSR

Million US $

Commodity	1982		1983		1984 (January-September)	
	Exports	Imports	Exports	Imports	Exports	Imports
Total Trade	3,899	1,314	2,821	1,456	1,879	1,073
Foodstuffs	4	87	2	89	1	91
Raw Materials	32	862	38	867	30	655
Fuels	36	262	31	276	28	198
Manufactures	3,729	76	2,634	68	1,732	45
Other	98	27	116	56	88	84

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nese have rejected. The Soviets have also asked for a major reduction in interest rates charged on deferred payments for Soviet imports, which the Japanese have also refused.

Prospects

We believe predictions of improvement in the bilateral relationship are optimistic, despite some resumption of exchanges and trade talks:

- The Fourth Japan-Soviet Roundtable, a private meeting of politicians, businessmen, scholars, and journalists, met in Moscow during 9-12 October.

- Soviet Politburo member Kunayev led a delegation from the Supreme Soviet to Japan in late October, the first such parliamentary exchange since the invasion of Afghanistan.

- The Japan-USSR Joint Economic Committee is scheduled to meet this month.

The Japanese, while perhaps willing to discuss new development projects, will be slow to make commitments. Soviet officials have told the Japanese that Moscow intends to emphasize the development of East Siberia in the 1986-90 Five-Year Plan. Ongoing joint resource development ventures, however, are progressing slowly, if at all. Japanese equipment manufacturers remain interested in sales to the Soviet Union, which such projects promote, but several factors discourage a larger Japanese role in Siberian joint development efforts:

- The Soviets insist that management of the projects remain strictly in their hands.
- Many resources of potential interest to Japan are in undeveloped areas that require huge infrastructure investments before they can be exploited.
- Capital shortages are frequent in the Soviet economy, and maintaining a reliable labor force in Siberia is often difficult.
- Given the extended slump in raw material demand, the Japanese are less concerned than in the past about lining up stable sources of supplies.

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Status of Ongoing and Proposed Joint Resource Development Projects

Sakhalin Offshore Oil and Natural Gas
Agreement has been reached on technical plans to develop the Chayvo deposit. Terms of sale of liquefied natural gas are still under discussion—Japan is reluctant to make a commitment, since its supply is secure until 1990. Production is not likely until the early 1990s.

Komatsu-Sedov Timber
The recent housing slump and lumber surplus in Japan have reduced the attractiveness of the project. The Soviets have agreed to limit lumber shipments but wish to increase exports of processed wood products—which are unlikely to meet Japanese quality standards.

South Yakutsk Coal
The Japanese were to receive 100 million tons of coal over 16 years, but the Soviets missed the first deadline in 1983. Japan wishes to cut deliveries because of the slow recovery of the steel industry.

Udokan Copper
Baikal-Amur mainline railway—essential for development of the mine—is "completed," the Soviet press says, but will not be fully operational until 1988. The world copper market is in a long-term slump. Japan has resisted Soviet calls for a joint venture since the mid-1960s, even when world demand was more lively.

Yakutsk Natural Gas
Although exploration for this project was completed in 1979, development is at a standstill. The Japanese have lost interest, and prospects for resuming talks on the project are remote.

As for the political climate, Japanese diplomats in Moscow remain skeptical that the Soviets are heading for a major change in policy toward Japan. They believe Soviet agreement to expand contact is aimed solely at pressuring the Japanese to make concessions to the USSR. Indeed, the roundtable in October was largely a propaganda opportunity for the Soviets, whose calls for signing a "good neighbor" treaty—which the Japanese Government has long rejected—dominated the meeting. Recent interest by both Prime Minister Nakasone and Abe in stepping up the dialogue with Moscow was linked to the Liberal Democratic Party presidential election this fall. Both men tried to improve their political positions by claiming credit for responding to public concern over strained Japanese-Soviet ties. With Nakasone's election to a second term on 31 October and Abe's reappointment as Foreign Minister, the rivalry probably will continue. As long as the Soviets show no flexibility, however, little significant progress is likely. Because the Japanese probably will follow Washington's lead, the Foreign Ministry does not foresee significant changes until US-Soviet relations improve

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South Africa: The Economy and Racial Reform[1]

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The lackluster performance of South Africa's economy, in our judgment, will be a factor limiting the pace of racial reform. Economic austerity measures imposed during 1984 to reduce a large current account deficit, as well as persistent high inflation, will hold real economic growth in the 2-to-3-percent range for at least the next several years. As a result, Pretoria will be unwilling to shoulder major new spending programs for the nonwhite population, particularly for the huge black majority. Nonetheless, Pretoria will be under pressure to sustain some momentum of reform if the new Constitution granting limited political rights to Indians and mixed-race Coloreds is to gain legitimacy among these nonwhite minorities.

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A Gold-Dependent Economy

The level of economic activity in South Africa rises and falls with the world gold price and the government's attempts to keep current account deficits within manageable bounds. Pretoria has not been adept at balancing the surge in growth and imports that follows a gold price upturn against the inevitable current account deficits that follow a price decline. The price of gold—which accounts for some 40 percent of South Africa's foreign earnings—has dropped by almost 50 percent since 1980. As a result, South Africa's annual rate of real economic growth has fallen sharply from the 1980 peak of 7.3 percent to an estimated 1.5 percent for 1984. As in the past, Pretoria reacted to the current account deficit—as well as continued inflation and the depreciation of the rand—by implementing restrictive economic policies.

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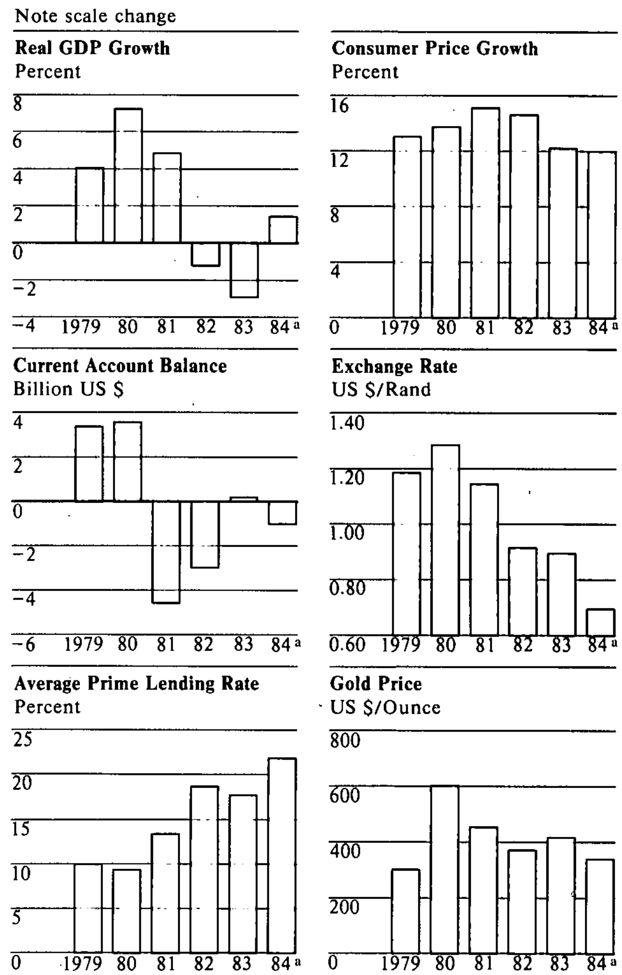
[1] This article summarizes a forthcoming Intelligence Assessment.

South Africa: Economic Indicators, 1979-84



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End of the Downturn?

In our view, the South African economy is poised for a modest upturn next year. Assuming a small increase in the average gold price to $370 per ounce, growth of world demand for nongold exports of about 3 percent, a normal corn harvest, and some continued economic restraints, we project 2- to 3-percent real growth and a small current account surplus for 1985. On the basis of similar assumptions, some private economic forecasters in South Africa and the United States expect a slight reduction of 1 to 2 percentage points in the rate of inflation.

Most South African economists argue for continued austerity to keep the current account in check. In particular, these economists contend that excessive government spending could trigger another increase in inflation and new foreign payment problems that would lead Pretoria to either reimpose austerity measures or increase foreign borrowing. On the basis of public statements and past "pay as you go" practices, however, we believe that Pretoria will attach considerable importance to avoiding sustained, heavy borrowing. South African officials probably are concerned already about the increase in the country's foreign debt—which has risen from about $7 billion in 1980 to more than $15 billion at present, according to the Bank for International Settlements.

The Impetus of Racial Reform

Against this backdrop of only modest economic performance that we expect to prevail for at least the next several years, President Botha's program of gradual racial reform is unlikely to include large-scale social-spending programs, particularly for the black majority. In our judgment, whites already hard hit by recession, inflation, recent tax hikes, and credit restrictions probably will be unwilling to foot the bill for costly racial reforms that would erode their privileged position. Even a speculative surge in gold prices would be unlikely to induce Pretoria to enact massive new spending programs for nonwhites because of the potential added burden during subsequent economic downturns. 25X1

We believe that the government must sustain some momentum in the reform process if the new Constitution is to gain legitimacy among the Colored and Indian populations. Less than one-fifth of eligible Coloreds and Indians voted in elections last August for the nonwhite chambers in Parliament. Moreover, the nonwhite members of Parliament will be particularly eager to belie the charge of having sold out South Africa's black majority, and will demand reforms that would benefit South African blacks as well. 25X1 25X1

In fact, according to press reports, Pretoria is considering several relatively inexpensive measures:

- New incentives to encourage the promotion of blacks into managerial positions in the private sector.
- Admission of more blacks to white colleges, universities, and technical schools.
- Relaxation of regulations on business activities of blacks in central city areas, as well as other restrictions on nonwhite businessmen.
- Elimination of bans on interracial sex and marriages—a step of great symbolic importance, especially for Coloreds.

Even with these reforms, however, the lives of most blacks are unlikely to improve enough in the near term to avoid periodic flareups of black unrest. 25X1 25X1

Implications for the United States

We do not expect that South Africa's economic troubles will give Washington much leverage over Pretoria's domestic or foreign policies. South Africa most likely will continue to plead for patience for its gradualist approach to racial reform, citing among other factors the economic constraints on the reform process. Recent US legislation, however, requires that US support for an IMF loan to South

Reforms Aimed at the Black Majority

Although South Africa is in no manner prepared to abandon white control of the government or the economy, recent reforms signal an important shift in Pretoria's domestic economic and social policies toward blacks residing in urban areas. Until recently, racial "separate development" has been built on the premise that all blacks could be assigned to tribal areas and would only have rights in those "homelands." Implicitly, the government now has recognized that South Africa has a large and settled urban black population in white areas.

The acceptance of a permanent black population in white areas is reflected by several recent reforms, including the introduction in the late 1970s of a leasehold system that allows urban blacks to lease land in white areas. Pretoria also has opened new job opportunities, increased spending on education, and legalized labor unions. Private-sector incentives have been introduced for additional black training. According to press reports, Pretoria even has considered imposing school fees on the families of white students to help fund increased educational expenditures for the other racial groups.

Despite the new realism implicit in recent reforms, President Botha's reform program in the near term probably will only marginally improve the lives of blacks living in white areas and will have even less impact on those in impoverished tribal homelands. Today, almost every aspect of daily life of blacks living outside of the homelands is regulated by a complex structure of discriminatory laws designed to maintain white privilege and control:

- ***Political Rights.*** *Apartheid envisions that blacks will exercise political rights only in the tribal homelands. When a homeland becomes "independent," South African blacks belonging to that tribal group lose their South African citizenship whether or not they were born in, or reside in, the homeland. Outside of the homelands, black political representation is limited to local councils that most blacks resent for cooperating with the* 25X1
white government. 25X1

- ***Residence.*** *Blacks living outside of the homelands are allowed to live only in designated black townships, which have poor or inadequate housing and services, and which are located far from jobs in white cities.* 25X1

- ***Travel.*** *Movement of blacks outside of the tribal homelands is severely restricted, often entailing separation of family members. Blacks must carry an identification "pass book" and legally can only stay in white areas for 72 hours unless they* 25X1
have a job or have gained residing rights. 25X1

- ***Education.*** *Separate and unequal educational facilities are maintained for the various racial groups, and black teachers often lack a high school diploma themselves. The government spends an average of seven times as much to educate a white child as a black child.* 25X1

Africa be contingent upon expected benefits for South Africa's blacks. Washington may gain some leverage if South Africa should approach the IMF for another standby loan—which it almost certainly would in the event of a serious economic decline.

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