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International Economic & Energy Weekly [redacted]

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21 December 1984

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International Economic & Energy Weekly [redacted] 25X1

21 December 1984

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Synopsis

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Briefs

Energy

Big Seven Oil Consumption Rises at a Slower Pace

[redacted]

Big Seven oil consumption rose only 3 percent in third quarter 1984 over year-earlier levels, compared with a nearly 6-percent increase in the first six months of the year. In addition, more than one-third of the third-quarter increase can be attributed to the continuing UK coal strike. As a result, heavy fuel oil consumption in the United Kingdom nearly tripled, more than offsetting declines in the other six countries. During the same period, Big Seven gasoline use rose by less than one-half of 1 percent, while light fuel oil consumption increased by more than 9 percent. The slowdown in overall consumption growth and the sharp rise in heavy fuel oil use have caused a significant disparity in the demand for light and heavy crudes and compounded OPEC's problems in stabilizing oil prices. [redacted] 25X1 25X1

Threat to West European Energy Security

[redacted]

As part of a larger effort against the military establishment, at least two European terrorist groups have targeted NATO energy facilities in West Germany and Belgium. The NATO pipeline system, constructed for wartime use, is highly flexible, and it is complemented by railroad and truck distribution and an effective military contingency plan. Terrorist attacks are unlikely to affect operations significantly. The extensive West European crude oil and gas pipeline distribution systems are also accessible to terrorists. Alternative transport systems, excess pipeline capacity, and a versatile natural gas distribution system would minimize the effect of local terrorist attacks. Successful terrorist attacks on key choke points—large power plants, control centers, and substations—in the West European power grid, however, could cause a significant economic disruption. Repair of these choke points could take months, and there is little surplus grid capacity to provide alternative power supplies. Despite their ability to damage the electrical system, West European terrorist groups are likely to hold back from such attacks to avoid public acrimony. [redacted] 25X1 25X1

Libya Resumes Oil-Beef Barter Talks With Ireland

[redacted]

Tripoli and Dublin have resumed negotiations on a $30-50 million exchange of oil for Irish beef. Tripoli canceled a $100 million beef contract in November following Dublin's decision to reduce imports of Libyan oil. The US Embassy in Dublin says that Qadhafi agreed to restore beef imports from Ireland following discussions with the leader of the opposition Fianna Fail. Although Qadhafi has not tied the restoration of beef trade to new crude oil purchases, the Irish petroleum company has offered to process and market Libyan crude. If this new deal holds together, Qadhafi will have advanced his goals of increasing oil sales to Western Europe and seeking West European support against Washington's policy toward Libya. [redacted] 25X1 25X1

Soviet Union To Provide Oil to Mozambique

[redacted]

According to press reports, the Soviet Union has agreed to provide Mozambique with about 4,600 barrels per day (b/d) of refined oil products in 1985—enough to meet 60 percent of Mozambique's oil needs. We believe that Mozambique's inability to obtain a secure source of oil because of its foreign currency shortage induced it to accept the Soviet offer. Although Moscow generally has demanded payment in hard currency in its commercial deals with African countries, this agreement reportedly includes three years of credit. Moscow's willingness to finance sales to Mozambique despite Maputo's foreign currency crunch probably reflects an effort to regain some of the ground the Soviets lost when Mozambique signed a nonaggression pact with South Africa in March. [redacted]

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Nicaraguan Oil Problems

[redacted]

Shortages of crude oil probably will force a shutdown of Nicaragua's only refinery again this week. US Embassy officials report that available stocks will keep operations going only a couple more days, [redacted] oil tanks at Puerto Sandino empty. [redacted] a chartered Nicaraguan tanker has been docked in Pajaritos, Mexico, since 4 December awaiting approval to take on oil. The last Soviet crude oil delivery was in October, and no Soviet shipment is en route. Mexican oil officials will probably not release the tanker for its 10-day trip to Nicaragua until financing is arranged or Managua again makes a high-level demarche to Mexico City. The Soviets want Mexico to continue to supply a large portion of Nicaragua's oil needs, but Managua's deepening financial problems could leave Moscow with no choice but to make the oil deliveries themselves. [redacted]

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International Finance

Philippine Financial Rescue Package

[redacted]

The IMF's approval on 14 December of a $615 million loan for the Philippines—combined with commitments from international banks for over 90 percent of the $925 million new commercial credits sought by Manila—concludes long-stalled negotiations to resolve the country's $25 billion foreign debt crisis. Additionally, a Paris Club meeting on 19 December has established terms for rescheduling up to $3.1 billion in debt owed to official bilateral creditors. Formal conclusion of the commercial bank financing package in mid-February—including rescheduling over $8 billion in debt repayments—will be the final step paving the way for Manila's gradual return to financial stability. [redacted]

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The accompanying IMF adjustment program includes wide-ranging economic policy reforms, including a floating exchange rate, severe spending cuts, significant tax increases, and higher interest rates. Although the economy will benefit from a bout of belt-tightening and economic reforms—modest economic growth could resume in 1986—the political costs of the austerity program will be substantial. The restrictive monetary and fiscal measures requested by the IMF will contribute to the economy's projected decline in output of 2 percent next year. [redacted]

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Mexico-IMF Agreement Delayed

[redacted]

The IMF has postponed approval of the third—and last—phase of Mexico's Extended Fund Facility until January and advised the government that more must be done to reduce Mexico's proposed 1985 budget deficit and liberalize trade [redacted] Mexico City, however, already has announced a 1985 budget with a deficit equal to 5.1 percent of GDP, nearly 2 percentage points above the original goal. In addition, Mexico recently hiked prices of key staples—bread and tortillas—over 50 percent, and increased the peso depreciation rate from 13 to 17 pesos per day. Mexico City will have a difficult time staying within its proposed 1985 budget, let alone adhering to a more austere spending program—particularly in an important election year. Mexico is having difficulty meeting this year's less stringent deficit target of 6.5 percent of GDP and is postponing expenditures equal to 2 percent of GDP into early 1985, according to the US Embassy. A major delay in reaching an agreement with the Fund could jeopardize prospects for reaching a final settlement with private bankers to reschedule $48.5 billion in public debt. [redacted]

[redacted]

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Vietnam's Access to IMF Funds Threatened

[redacted]

[redacted] the Fund voted earlier this month to deny Hanoi further access to IMF resources unless payment of $23 million in arrearages on existing IMF obligations is made by 15 January. With Vietnam's weak foreign exchange position, it will probably have trouble meeting this deadline. Hanoi has made no payments on IMF loans since last February, and we estimate it is behind in total foreign debt payments by approximately $400 million. Hard currency shortages are so acute that Vietnam recently was forced to sell some of its gold holdings—possibly to finance rice imports. Hanoi may try to make token payments in the hope of preventing the threatened cutoff, but near-term improvement in its ability to service its foreign debt is unlikely. [redacted]

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Global and Regional Developments

European Parliament Vetoes EC Budget

[redacted]

The European Parliament last week overwhelmingly rejected the 1985 EC budget, a move that may force the Community to curtail some spending next year. According to press and diplomatic reporting, Parliament members were unhappy that the Commission's draft budget would cover essential expenses only through October, leaving at least a $2 billion shortfall. They also wanted to register their displeasure over erosion of the Parliament's budgetary powers by recent Council decisions to impose automatic EC spending controls. Under the Treaty of Rome, 1985 EC spending will be on a monthly basis, with each month's allocation equal to one-twelfth of the 1984 budget. The Commission probably will give priority to compulsory agricultural expenditures, and it may be forced to cut back foreign aid and social and regional development spending. If the Parliament accepts a revised budget before next summer, the Commission may be able to avert a serious spending crunch. The final EC budget almost certainly will not cover projected 1985 spending, necessitating a supplementary budget late next year. [redacted]

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Turkey, Iran, and Pakistan Revive the RCD

[redacted]

The agreement by Turkey, Iran, and Pakistan to revive the Organization for Regional Cooperation and Development (RCD), inactive since 1979, reflects a desire in all three capitals to lessen Iran's regional isolation and increase trade. Turkey and Pakistan hope that a revived RCD will help moderate Iran's foreign policy. Iran, which already is the largest export market for Pakistan and the second largest for Turkey, is mainly interested in increasing oil sales to its neighbors. Overland trade between the RCD states bypasses the Persian Gulf, where shipping is subject to Iraqi attacks. Prospects for the RCD's success, however, are threatened by overloaded transportation systems, tight budgets in all three countries, and ill-defined organizational objectives. [redacted] 25X1 25X1

Libya-Malta Ties Improve

[redacted]

Tripoli and Valletta recently signed a far-reaching security and economic agreement that promises Libyan support of Malta against any external threat and training for the island's small military. Both parties also agreed not to allow foreign military operations—including NATO operations—on their territory. Malta will welcome any Libyan financial assistance and an opportunity to ease unemployment by supplying workers to Libya. Qadhafi probably views the treaty as a way to secure a convenient platform for launching foreign intelligence operations and expanding Libya's military presence in the central Mediterranean. Relations had been cool during the past four years because of disputed claims to potentially rich offshore oil reserves. The real test of the rapproachement probably will come with the World Court decision on this boundary dispute scheduled for late February, even though both sides have agreed to abide by the Court's decision. [redacted] 25X1 25X1

South Africa–Mozambique Sign Fishing Agreement

[redacted]

Mozambique and South Africa have signed an agreement that provides financial assistance to the Mozambican fishing industry and allows South Africa to fish in Mozambican waters, according to the US Embassy. The agreement sets quotas on the amount and types of fish South African firms can catch and calls for joint programs to investigate marine resources and exchange scientific and technical information. Mozambique will also earn much needed hard currency from license fees and taxes levied on the South African catch. The fishing agreement represents the latest bilateral economic accord since the nonagression pact concluded last March. In a further effort to revitalize its ailing fishing industry, Maputo has announced a new agreement with China, which exchanges the right to fish in Mozambican waters for technical assistance. [redacted] 25X1 25X1

National Developments

Developed Countries

Kohl Rules Out New Tax

[redacted]

West German Chancellor Helmut Kohl abruptly decided last week against new tax measures to replace a surtax on upper-bracket taxpayers ruled unconstitutional in November. The surtax would have brought in $1 billion.
[redacted] 25X6

[redacted] 25X6

Rome Liberalizes Capital Controls

[redacted]

Rome recently further eased foreign exchange controls on investment and tourist expenditures abroad. These measures were probably designed, in part, to meet EC appeals for capital liberalization. The ceiling on currency that Italian tourists can take abroad is increased from about $160 to $500 per trip and free use of credit cards for tourist purchases is permitted. The amount Italian investors must deposit in noninterest-bearing accounts is lowered from 50 percent to 40 percent of the total value for direct investments in OECD countries. A similar requirement on investment in securities of official EC institutions is reduced from 50 percent to 30 percent. The changes will have relatively more impact on Italian tourists than on investors. The mandatory deposit on direct investment has been routinely waived for some time, while portfolio investment should still be effectively barred. Moreover, Rome will still retain control over credit card use, since tourists must document 75 percent of all purchases over a $2,600 yearly limit to prove their tourist nature. [redacted] 25X1 25X1

Ottawa To Ease Foreign Investment Restrictions

[redacted]

The Mulroney government introduced legislation on 7 December that will shift the tone of the foreign investment review process toward encouraging foreign investment. The Foreign Investment Review Agency (FIRA) will be replaced by a new agency, Investment Canada. The threshold for review of direct investment will remain at US $3.75 million, but the threshold for indirect investment will rise from US $12 million to US $37.5 million. The new agency will continue to review all ventures in the oil and gas industries and in culturally sensitive sectors such as publishing and telecommunications. The legislation, which the government hopes will be passed by March, would exempt from review 90 percent of all investment proposals previously covered by FIRA. Although FIRA approved a vast majority of projects, many foreign investors were discouraged by the lengthy bureaucratic approval process. Many foreign investors are likely to see how Ottawa moves on such issues as liberalized trade and the proposed revamping of the National Energy Program before undertaking new investment in Canada. [redacted] 25X1 25X1

Less Developed Countries

US-South Korean Steel Compromise

[redacted]

South Korea's agreement to voluntarily limit finished steel exports to the United States over the next five years will help avert a major trade showdown. South Korea, which currently accounts for 2.4 percent of the US finished steel market, had earlier pushed to keep exports at that level. The 1.9-percent market share agreed on satisfies the Koreans, who were under domestic political pressure to maintain 1985 finished steel tonnage shipped to the 25X1

United States at least at the 1983 level. The steel export issue has challenged the influence of the liberalizers in the Chun government who advocate greater reliance on market forces. The appearance of equal treatment with other steel exporters such as Japan and a reduction in US dumping duties on Korean color televisions announced this week will, we believe, help bolster the position of the liberalizers as well as ease strains in US–South Korean trade relations. [redacted] 25X1

Panama's Austerity Program on Hold

[redacted]

Panama's two-month-old civilian government has been unable to regain the initiative following the recent political crisis that forced the repeal of President Barletta's austerity program. After an earlier agreement to replace the law with a less stringent one, on 9 December the President bowed again to continuing protests and announced an unconditional repeal. He promised a more widely coordinated compromise measure, which probably will be reviewed by the Assembly sometime in January. Barletta, who had attributed the need for immediate belt-tightening to comply with IMF targets for meeting debt payments, was able to get some short-term help from the international banking community. Terms were quickly negotiated for a 90-day extension of payments due to banks so that the FY 1985-86 IMF loan can be restructured. This should enable the President to obtain legislative approval of the 1985 budget and seek new fiscal measures early next year. [redacted] 25X1 25X1

Agrarian Reform in Mexico

[redacted]

After two years of inactivity on agriculture, the de la Madrid administration has unveiled a new Land Rehabilitation Program aimed at putting government-owned land farmed by peasants to better use, improving productivity and agribusiness, and settling land disputes. The apparent goal is to increase support among peasants before next summer's elections and reduce violence in economically depressed rural areas. The administration, recognizing that no more idle land is available for distribution, is hoping that these measures will increase agricultural production. To offset the continuing demand for more land, the President recently promised to redistribute land confiscated for drug violations, although few landless peasants will benefit. While the government may attract greater support in rural areas, steps announced so far will not assuage peasant dissatisfaction or end small-scale land seizures. Following the elections, we expect agricultural problems to slip from national attention once again. [redacted] 25X1 25X1

Costa Rica: Impact of Banana Operation Shutdown

[redacted]

San Jose fears considerable economic dislocation and leftist labor unrest if a US firm follows through with plans to close down its banana plantation on Costa Rica's Pacific coast. The company's decision is based on falling profits resulting from banana disease and a recent two-month Communist-inspired strike. According to the US Embassy, the firm has rejected a government proposal to lease their Golfito operation to a growers' cooperative and is trying to sell the property for $15 million. [redacted] 25X1 25X1

The shutdown would hurt Costa Rica's already troubled economy. Before 1984, the Golfito plantations produced about $40 million annually in foreign exchange earnings—almost 5 percent of Costa Rica's total exports. The loss of these earnings would hurt debt service capacity and probably undermine the proposed standby agreement with the IMF. Moreover, plans to fire 1,000 of the 2,500 workers by 31 December 1984 would increase the 10-percent unemployment rate. Leftist labor leaders would probably encourage workers to seize the land, possibly provoking armed clashes with security forces. [redacted] 25X1

[redacted] 25X1

[redacted]

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Thai Devaluation Further Cuts Rice Prices

[redacted]

Thai rice prices continue to decline from already record-low levels as a result of the November devaluation. The gap between Thai export prices and those of the United States, its nearest competitor, had widened to $236 per metric ton by 14 December, making Thai rice less than half the cost of comparable grades of US rice. Thailand—the world's leading rice exporter—has eroded US market shares in the Middle East and Africa in recent years through aggressive marketing, good credit terms, low prices, and advances in product quality. The latest price declines will begin to put pressure on US sales to Western Europe in 1985. [redacted] 25X1

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Deteriorating Bangladesh Economic Performance

[redacted]

Inflationary and foreign payments pressures are adding to strains in the Bangladesh economy. The increase in money supply, combined with the removal of grain and fuel subsidies and the large wage hikes granted to unions this year, could fuel inflation, now running at an estimated annual rate of 18 percent. Growing import demand could reduce foreign exchange reserves to a meager $230 million, hardly enough for one month's imports. In response, Dhaka has increased interest rates, tightened credit for imports, and widened the gap between the exchange rate for expatriate workers and the official rate to stem the outflow of foreign exchange. Bangladesh officials will probably agree to even more stringent reforms, if pressured by US and IMF authorities, but would seek to phase them in to defuse political opposition. [redacted]

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Nepal Loan Scandal

[redacted]

An international loan scandal involving high-ranking Nepalese officials, as well as an Indian film actress, has implicated the Prime Minister and resulted in the dismissal of the Governor of the Central Bank. This group allegedly attempted to profit from a scheme to borrow money from West European banks under government guarantee to relend at higher interest rates. According to US Embassy reports, the Prime Minister sacked the highly respected Central Bank Governor because he interfered with the ploy. We believe the scandal will tarnish Nepal's reputation in international banking circles and possibly damage Kathmandu's efforts to secure funds for expensive hydroelectric projects needed for the country's development. [redacted]

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Communist

Soviet–East European 1985 Trade Protocols Continuing the Trend of Recent Years

[redacted]

Trade protocols for 1985 signed recently with Poland, Hungary, Czechoslovakia, and East Germany indicate that Soviet exports will grow, but almost entirely because of price increases, while the East Europeans will have to deliver more goods. East European exports will include increased quantities of agricultural machinery for the Soviet Food Program, high-quality consumer goods, and Polish coal and raw materials. Moscow will maintain energy and raw material deliveries in 1985 at this year's level. Poland will receive credits to cover a planned 1985 deficit of 500 million rubles—down from this year's planned deficit of 700 million rubles—but Moscow apparently is insisting on balanced trade with its other East European allies. [redacted]

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Soviet Agricultural Transport and Equipment Problems

[redacted]

There has been an unusually high number of complaints about the poor preparedness of agricultural and transport equipment this year. Wet fields prolonged the 1984 harvest and caused excessive equipment wear. Maintenance personnel were being used to help with the harvest. Even though most crops were smaller than last year, the nearly total withdrawal of military support from the 1984 harvest increased the burden on the civilian equipment fleet. [redacted] the fleet's performance deteriorated and off-season repair schedules were delayed, possibly increasing pressure on the leadership to use additional military support next year. [redacted]

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Soviets Seek Western Synthetic-Fiber Technology

[redacted]

The Soviets have solicited bids from the United Kingdom, West Germany, and Japan for the five-plant, $1 billion polyester complex. This turnkey project will be financed on a compensation basis and is scheduled for completion before the end of the 1986-90 Plan. The complex, to be sited at Blagoveshchensk near Ufa, will have an annual capacity of 230,000 metric tons of terephthalic acid and 100,000 tons of polyester fibers. Feedstock for the complex will come from a Western-built paraxylene plant recently opened at Ufa. Construction work probably will be handled by Yugoslav or Finnish companies. [redacted]

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Soviet Housing Construction Increase Continues

[redacted]

Pravda reports that new housing completed in 1984 will reach 113.7 million square meters—a 1.2-percent increase over the 112.4 million square meters commissioned in 1983. Although this year's increase was small, it follows a sharp rise of 4.2 percent in 1983 and virtually ensures substantial overfulfillment of the modest target of the Five-Year Plan (1981-85). If next year's goal of 114 million square meters is met, the five-year average will be 111 million square meters. The leadership has apparently upgraded the priority of housing, particularly in rural areas, where most of the increase in residential construction has occurred. [redacted]

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Soviet Program To Fight Air Pollution Unveiled

[redacted]

The Politburo recently announced a "vast" program to fight industrial air pollution. It includes measures to build new air pollution control installations and improve those already in operation; tighten enforcement of air-quality laws; convert polluting facilities to cleaner types of fuel; and, when necessary, remove industry from residential areas. No details on implementation were given, but all "relevant" ministries and departments were charged with preparing plans for inclusion in the scientific-technical program for the 12th Five-Year Plan. The vagueness of the program, coupled with past inaction, suggests that Moscow is unwilling to significantly increase investment in environmental control equipment or change the incentive system for industry by raising the priority of environmental protection relative to output goals. The program seems primarily an attempt to heighten the awareness of plant managers to decrease the likelihood of "catastrophic" pollution accidents. [redacted]

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China Buys US Dairy Cattle

[redacted]

China has completed arrangements for the purchase of 220 US dairy cattle, its first purchase of dairy stock from the United States. China plans to increase milk production by more than 90 percent by 1988 under a four-year World Food Program dairy development project designed to improve herd size, processing facilities, and technical knowledge. China now has joint dairy ventures with the United States, New Zealand, the Netherlands, and Sweden involving sales of milk products and livestock. In addition to purchases of dairy stock, China's dairy program will generate significant imports of animal genetics, equipment, and technology from the United States and other countries. US industry experts predict US dairy cattle sales to China totaling some 20,000 head over the next three to five years. [redacted]

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Japan: Seeking To Maintain Economic Momentum 25X1

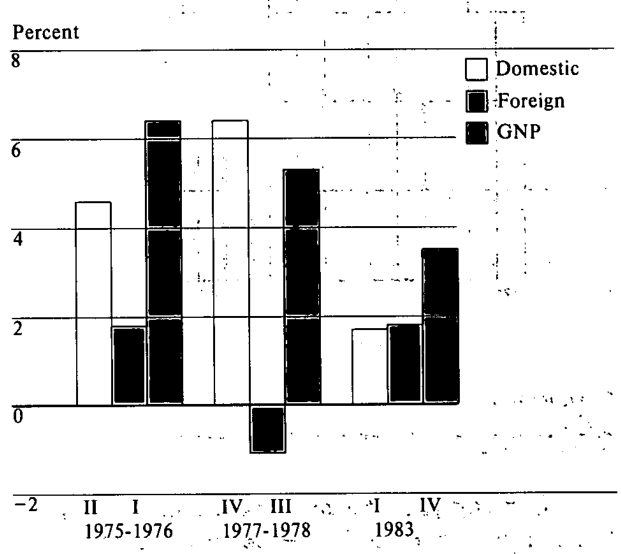
Japan's economic recovery since early 1983 depended heavily on exports to the United States. With foreign demand slowing, Tokyo now must bank on domestic demand to pick up the slack. While increased investment spending has bolstered the domestic economy in recent months, consumption—which makes up over half of GNP—remains weak. Moreover, some Japanese analysts are concerned that investment could decline when net exports drop off. Stimulative fiscal policies are constrained by the persistent budget deficit, leaving Tokyo, in the short run, with limited options to sustain growth. 25X1

Foreign Demand

Foreign demand accounted for half of the increase in GNP in 1983,[1] the first year of the current recovery, and net exports continued to provide a substantial proportion of the economy's growth during the first half of 1984. Strong US demand for imports was a major factor in pushing export earnings to the fore. Japan's quarterly trade surplus with the United States roughly doubled in 1983, from $3.1 billion in the first quarter to $6.3 billion in the fourth quarter. Exports to the United States during the year were up by $4.2 billion, while Japanese imports from the United States rose by only $1.0 billion. Sales to Asian NICs were also up, but the rising surplus with the United States accounted for 72 percent of the increase in Japan's trade surplus during the period. 25X1

The yen's persistent weakness, especially against the dollar, has been a major factor in Japan's strong export growth, boosting the competitiveness and profitability of Japanese exporters. Forecasts of substantial appreciation of the yen this year

Japan: GNP Growth in the First Year of Recovery,[a] Foreign and Domestic Components



[a] Last quarter over last recession quarter.

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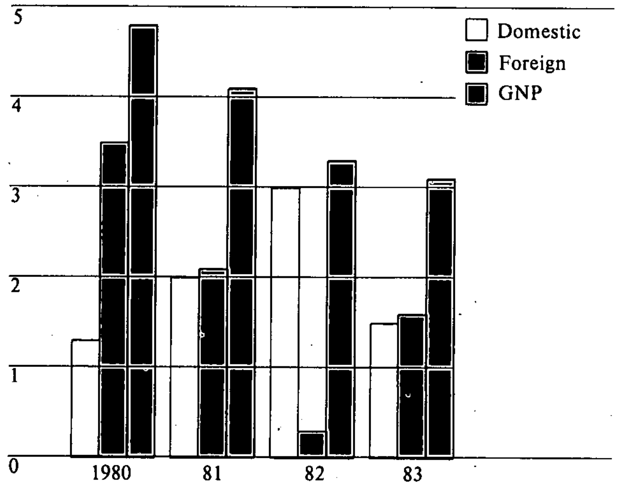
proved wrong. Capital outflows continued to accelerate in response to higher overseas interest rates, preventing the current account surplus from driving the exchange rate up. 25X1

In fact, foreign demand was buoying the Japanese economy even during the 1980-82 recession. Net exports have accounted for half or more of GNP growth in three of the last four years. The foreign sector's strength in 1983 was a sharp contrast to previous postwar recoveries, when foreign demand never accounted for more than one-third of GNP 25X1

[1] Calendar years are used in this article. 25X1

Japan: GNP Growth,[a] 1980-83



[a] Calendar year average over previous year.

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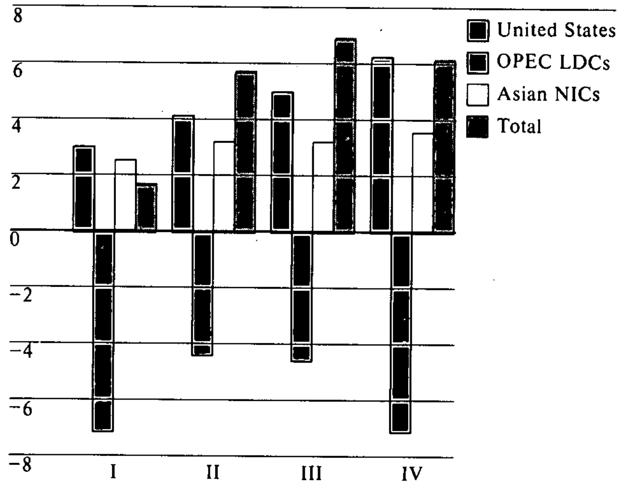
Japan: Trade Balance, 1983



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growth in any year, except for the post-oil-shock years of 1974 and 1975. The behavior of net exports during most of the postwar period was countercyclical—declining during expansions and increasing again during recessions.

Domestic Demand Slowing?

In the absence of much stimulus from government fiscal policy since 1979, domestic growth has been very low by Japanese standards—averaging 2.0 percent per year in 1980-83, compared with annual averages of 5.2 percent in 1970-79 and 10.7 percent in 1960-69. Private consumption, which accounts for over half of GNP, has lagged despite some increase in real incomes. During the first year of recovery, private consumption increased more slowly than it had during the previous recession year.

Uncertainty in the face of the labor market's continuing weakness and slow growth in real disposable incomes may underlie the weakness in consumption. Japanese observers expect disposable incomes to rise next year if strong corporate profits result in higher yearend bonuses and larger real wage settlements next spring. 25X1

Investment demand has generally been strong during this recovery, but this sector is smaller and typically more volatile than the consumption sector. Corporate fixed investment has increased rapidly, on the basis of higher earnings and the prospect of more rapid growth in the near term. Housing investment, however, stagnated during the 1980 recession and has declined slightly since the beginning of the recovery. 25X1

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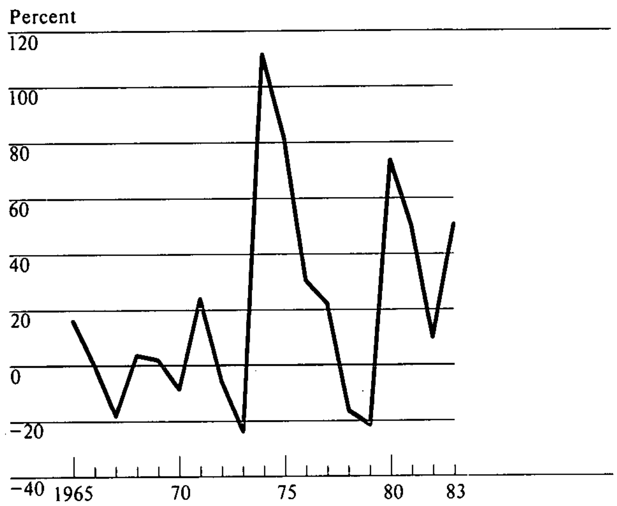
Japanese surveys show companies plan to invest more during the coming year, but there is uncertainty over whether the investment boom will continue once export growth slows. Some Japanese officials argue that business cost cutting and interest in continued technological improvement will 25X1

Japan: Foreign Demand as a Share of GNP Growth, 1965-83



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fuel strong investment demand for some time to come. They point to surges of investment in industries such as pulp and paper as examples. More pessimistic observers—supporting the Economic Planning Agency's preference for fiscal stimulus—argue that most of the current pickup in investment is based on export-fueled demand. They insist that in the long run the changing structure of the economy will reduce the need for expenditures on new capital, as less capacity will be added in capital-intensive heavy industry. A slowdown in foreign demand would therefore cut short the investment boom, leaving the economy with no source of strong growth.

The government's continuing efforts to reduce the persistent deficit mean fiscal stimulus will probably provide little economic growth. Tokyo's policy could change, of course, and some Liberal Democratic Party (LDP) politicians have argued for more spending, but we expect that any changes in the short run will be too small to help much. The LDP's supporters in the business and financial community favor even tighter spending controls and a smaller government sector, as does the powerful Ministry of Finance, making a change in government commitment to fiscal austerity unlikely soon. 25X1

When Export Growth Slows

Without stimulus from the foreign sector, it is difficult to see how Japan can sustain economic growth at the 4-percent level called for in most long-term forecasts and in the government's long-term economic "visions," let alone at the 5-percent rate called for by Prime Minister Nakasone's commission on the economy. If the growth rate of net exports should decline, domestic demand would have to grow faster than in recent years to maintain even the 3-percent GNP growth rates Japan achieved during the 1980-82 slowdown. 25X1

Our own analysis, based in part on our econometric model, shows a significant decline in real growth if foreign demand slows: 25X1

- The baseline forecast projects growth of 5.2 percent in 1984 and 4 percent in 1985 on the basis of real merchandise export growth of 6.5 percent. If exports to the United States stopped increasing, however, growth would drop immediately. With exports to the United States held constant at the level of 1984's first quarter, the growth rates are 4.6 percent and less than 3 percent in 1984 and 1985 respectively.

- If exports are slowed by an increase in the value of the yen, the effect is delayed but eventually is as severe. Appreciation of the yen to 180 per dollar (the baseline case calls for 215 per dollar) would not affect growth significantly in 1984, but GNP would increase by only 3 percent in 1985. 25X1

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Most forecasters expect Japan's trade surplus to remain at high levels for the foreseeable future and to provide some stimulus to growth for the next few

Japan: Sectoral Contributions to GNP Growth *Percent*

	Total GNP	Net Exports	Domestic Demand	Consumption	Investment	Government Spending
1965	5.4	0.9	4.5	5.0	−1.3	0.8
1966	11.0	0.0	11.0	6.4	2.3	2.3
1967	10.7	−1.9	12.6	5.8	5.8	1.0
1968	12.7	0.5	12.2	4.9	5.3	1.9
1969	12.3	0.3	12.0	5.8	5.1	1.1
1970	10.0	−0.8	10.7	3.9	5.4	1.4
1971	4.7	1.1	3.6	3.2	−1.3	1.7
1972	8.9	−0.5	9.4	5.2	1.6	2.5
1973	8.9	−2.1	11.0	5.3	4.3	1.4
1974	−1.2	1.4	−2.6	−0.4	−1.3	−0.9
1975	2.4	2.0	0.4	2.3	−3.1	1.2
1976	5.3	1.6	3.7	1.9	1.1	0.6
1977	5.3	1.2	4.1	2.2	0.5	1.4
1978	5.1	−0.8	5.9	2.5	1.3	2.1
1979	5.2	−1.1	6.2	3.3	2.4	0.5
1980	4.8	3.5	1.3	0.7	0.8	−0.3
1981	4.1	2.1	2.0	0.4	0.8	0.9
1982	3.3	0.3	3.0	2.2	0.6	0.2
1983	3.1	1.6	1.5	1.8	−0.5	0.2

[redacted] 25X1

years. This year's EPA white paper on the economy sees a growing role for Japan as a capital exporter as a result of its chronic trade surplus and the excess of savings above domestic investment. Forecasts by the Japan Economic Research Center, Nomura Research Institute, and others also predict continuing trade surpluses and capital exports. [redacted]

It is possible, despite these forecasts of a growing surplus, that the foreign sector has already turned the corner. Import growth is picking up as the modest domestic expansion continues, and the current account surplus has not been growing rapidly in recent months. A drop in net exports in third quarter 1984 cut GNP growth to an annual rate of 3 percent. Should US growth slacken, growth of net exports will slow even more. Import demand in the past has grown rapidly in the expansion phase of the business cycle. A combination of yen appreciation, slower growth, protectionism in major foreign markets, and growing imports would reduce the growth of net exports enough to keep them from contributing significantly to GNP growth. [redacted] 25X1

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Tokyo's Options

The slow growth of the domestic sector is already a political issue. Nakasone's rivals within the LDP have used their own proposals for boosting economic growth to raise questions about his handling of the economy:

- Former EPA Director General Komoto has repeatedly called for fiscal stimulus.

- Kiichi Miyazawa, a potential prime minister, has advocated more public works spending to "double the nation's assets."

These traditional pump-priming measures—or others that could be devised—would be limited by the government's commitment to cutting the persistent budget deficit. Even so, they would please at least some domestic constituencies and would give the appearance of action designed to increase growth, whether or not they proved successful. [redacted] 25X1

We have examined the effect of several possible measures to stimulate specific sectors of the domestic economy—more public investment, business tax cuts, sharper wage increases—under the assumption of slower export growth. In all the simulations, we assume that slower growth is accompanied by appreciation of the yen to 180 yen per dollar. [redacted] 25X1

Our simulations suggest that increased government spending would have the strongest effect on growth. If total government spending (both consumption and investment) were increased by 10 percent, GNP growth would reach 4.7 percent in 1985, compared with 2.9 percent if fiscal policy were unchanged, despite the slowdown in export growth. [redacted] 25X1

Private consumption and investment would be difficult to stimulate directly. Rapid wage increases might boost consumption but not by enough to offset the induced decline in net exports. According to our simulation, even a dramatic increase in wages and salaries would increase real growth only slightly. Inflation would also increase. A corporate tax cut has been proposed to boost the economy by stimulating investment, but in our simulation even a large cut produced only a slight effect. [redacted] 25X1

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Flexible Manufacturing Systems: Competitive Impact and National Security Implications

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Flexible manufacturing systems (FMS)—the integration of advanced manufacturing technologies into computer-controlled systems—are revolutionizing production in a wide variety of industries and may have an impact on manufacturing as dramatic as microelectronics has had on the electronics industry. While no country enjoys an across-the-board advantage in FMS technologies today, we believe there is a strong potential for foreign leadership. The most innovative uses of FMS thus far are occurring in Western Europe, primarily in the aircraft, auto, machine tool, and computer industries. Moreover, we expect the major West European governments to increase their support of research and development for new FMS systems, as well as to provide incentives that increase the use of FMS. Japan's leadership in industrial robots and its excellence in computers almost assure a strong presence in this technology during the next several years.

As the potential benefits of FMS become more widely recognized, we believe countries that most quickly go ahead with FMS installations will be better positioned to quickly and effectively expand the technology's use in the future. While not all industry experts agree, those close to manufacturing operations believe that, if US business falls behind the leading edge of FMS technology or application, US commercial competitiveness, especially in such industries as electronics and aerospace, will be at risk. Similarly, in the manufacture of advanced weapons systems, the United States may not benefit from the latest in production efficiencies and, over the long term, become increasingly dependent on foreign sources.

The Benefits

FMS can dramatically reduce production costs and thus increase the competitiveness of user firms. Specifically, the most important benefits of FMS stem from its ability to provide:

- *Flexibility.* An FMS is able to manufacture different products as demand shifts or as engineering design changes are introduced. Production volume can also be varied from one or two shifts to two or three shifts with little increase in manpower.
- *Improved Quality Control.* The high level of automation, the reduction in the number of machines visited, better designed permanent fixtures, and greater emphasis on part/machine alignment typically result in improved quality. Higher quality, in turn, reduces scrap and rework costs. 25X1
- *Higher Capital Equipment Utilization.* Computer control of parts flow within a plant maximizes equipment usage. Machine utilization rates of 70 to 80 percent are typically reported—more than double the rates achieved in conventional manufacturing. Moreover, the consistency of computer control results in higher peak load capacity for an FMS than for a conventional shop with the same nominal capacity.
- *Reduced Inventories.* Work-in-process inventories are reduced for a variety of reasons: efficient computer scheduling of parts, more process-

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Flexible Manufacturing Systems

The typical FMS today is built around metal-cutting machine tools. Usually it consists of a group of machining centers—multipurpose machine tools that can drill, mill, tap, and bore a fixed workpiece and are equipped with automatic tool changing and loading features—which are linked by a centralized computer system. A material-handling system, under control of the central computer, moves parts between machining centers. At its most advanced stage, a flexible manufacturing system requires no human intervention except for maintenance and programing for new parts. [redacted]

Bringing all these components under central computer control makes possible productivity gains and cost savings that are greater than the sum of the parts. Flexible manufacturing systems achieve these results primarily by reducing waiting time; industry studies show that 95 percent of the time a part spends in manufacturing is spent waiting to go on a machine. FMS also increases machine utilization by ensuring that machines do not stand idle waiting for parts. Users report machine utilization rates of 70 to 80 percent, compared with 30 to 50 percent in conventional manufacturing. [redacted]

Initially, most FMS will be used for products characterized by low-to-medium volume production, such as machine tools, construction equipment, and aircraft. If production volume is high, large expenditures for automated machinery dedicated to making a single part can be justified, as in the case of a transfer line to make automobile engine cylinder blocks. In addition, because FMS is expensive, it will tend to be used to produce high-value-added items. The ability of FMS to produce a variety of different items simply by changing the central computer program, for example, is unmatched by any other form of automation. [redacted]

ing on each machine, and closer machine spacing. In addition, spare parts inventories can be cut sharply because small batches of parts can be produced as needed simply by storing the parts programs. [redacted] 25X1

Many industry experts believe the benefits arising from the flexibility of FMS are more significant than the large reductions in production costs. Flexibility permits economic production of a wider range of models, rapid implementation of design changes, and better quality control. FMS also allows firms to produce profitably at lower output levels. Moreover, FMS allows aggressive firms to respond quickly to changing market conditions. [redacted] 25X1

Many of the benefits that accrue to commercial users of FMS are advantageous for defense production, especially the manufacture of advanced weapons. The ability of FMS to easily and economically accommodate engineering design changes, for example, is particularly useful in producing highly sophisticated weapon systems such as fighter aircraft. The ease with which FMS can add shifts also allows defense manufacturers quickly and economically to accommodate changes in procurement levels as well as providing surge capacity for mobilization. Moreover, the reduced need for large spare parts inventories can help hold down the cost of maintaining weapon systems. [redacted] 25X1 25X1 25X1

National Patterns of FMS Development and Use

Industry observers estimate that there are about 200 full-fledged FMS installations worldwide. Geographically, Western Europe has more systems than any other area, but on an individual-country basis Japan is the leading user. [redacted] 25X1

Japan. Applications of FMS in Japan, while the most numerous, are also the most narrowly based. Currently, according to several industry surveys, most are metal-cutting systems in machine tool 25X1 factories, many of which were built to showcase the machine tool builder's products as much as to improve productivity. The scope of FMS use in Japan has begun to broaden, however, involving areas such as sheet metal forming and assembly processes. Probably the fastest growing application of FMS in Japan is in electronics assembly. [redacted]

Western Europe. Compared with Japan, in Western Europe the range of FMS applications is broader and the usage more widespread. According to industry surveys, all of the major countries of the region boast some applications. West Germany is the region's largest user, with systems in the auto, aircraft, machine tool, and computer industries. Systems range from traditional machining systems to those for forming sheet metal parts and robotic assembly systems. In addition, West Germany is probably the largest and most sophisticated user of FMS based on metal-forming rather than metal-cutting machine tools. [redacted]

A wide variety of sophisticated systems have been installed elsewhere in Western Europe. In France, Citroen's FMS at Meudon for producing prototype engine parts has the largest tool-handling system of any FMS currently in use. In the United Kingdom, the 600 Group's SCAMP System for machining cylindrical parts for lathes incorporates an unusually diverse set of machines, including gear shapers and a broaching machine as well as lathes. In Italy, Fiat uses Robogate, a flexible body-framing system developed by Comau, its automation subsidiary. This system allows a mix of body styles to be produced on the same line and has proved so successful that Comau has sold several systems to US automakers. [redacted]

We believe that West European firms will move aggressively over the next few years to install new FMS. According to a worldwide survey of factory automation, many West European companies are planning to incorporate FMS in existing plants, and a wide variety of new plants have been designed for eventual inclusion of FMS. [redacted]

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Forces Influencing FMS Use

A key to FMS use is the nature of demand, in particular the speed at which demand for finished goods changes in either volume or type. Growing international competition spurs a more varied product mix and quicker introduction of new products. FMS provides an answer to the problem of holding down manufacturing costs in the face of fluctuating levels of demand and rapid changes in consumer tastes. In this respect, we believe Japanese and West European firms may have a stronger incentive for FMS use; their smaller domestic markets and greater reliance on export sales require more product variations in relatively smaller quantities. In contrast, the pressure for flexibility in manufacturing is often less on US firms because the large domestic market can make investments in equipment dedicated to a single product profitable. [redacted] 25X1

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The ease and cost of financing is a major factor influencing the spread of FMS. Firms in Japan are probably best able to afford the expense of FMS. Because their industries' financial structure allows them to take a long-term view, Japanese managers have less difficulty justifying these expenditures and generally face lower borrowing costs as well. In contrast, we believe the availability of investment funds is probably the most important constraint to potential FMS users in Western Europe. Vendors of FMS equipment point to the high cost of an FMS as a major deterrent to prospective users. As technology develops, however, we believe system costs will fall, primarily on the basis of the reductions in cost for software and electronics. [redacted] 25X1

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The social climate is another factor influencing the application of FMS. Foreign press reports highlight growing concerns that increased levels of automation will seriously increase unemployment. Unions in Japan and Western Europe have made it clear that they consider job loss from automation to be a subject for negotiation. In Japan, however, the

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organization of unions along company lines is an advantage for Japanese firms. Since workers have a strong stake in their company's welfare and many jobs are largely guaranteed, workers have so far posed few obstacles to efforts to automate. [redacted]

In contrast, the influence of organized labor in Western Europe is seen by some industry experts as a substantial constraint on management's freedom to introduce automation. We believe, however, labor's strength in Western Europe may actually provide an impetus to firms to introduce new automation. [redacted] firms would rather invest in automation than in new hires to increase output, because workers have strong legal protections against layoffs. An additional impetus comes from labor's drive for a shorter workweek, which will necessitate increased labor productivity if firms are to remain internationally competitive. The capacity of FMS to quickly and economically adjust to a wide range of production levels with little change in staffing requirements makes it an attractive proposition for West European manufacturers. [redacted]

According to industry observers throughout Western Europe, the perception is shared by labor, government, and business alike that steps must be taken to retain or regain the region's competitiveness in key industries. The involvement of organized labor in planning for new automation, the common perception of the need to boost productivity, and the difficulty of making short-term adjustments in the labor force combine to facilitate the move to FMS by West European firms. [redacted]

The adverse effects of changing demand patterns, financial constraints, and social climate can make government involvement a crucial factor in reducing the risk of FMS development and application. Although the scale and scope of foreign government support measures vary considerably among countries, we expect government involvement to grow on the basis of the announcement and implementation in major countries of new projects to increase support of manufacturing technologies. [redacted]

Foreign Technological Leadership

Leadership in various FMS technologies is scattered among the major industrial countries. The French are leaders in the design of sophisticated tool-handling systems, for example, and Japan leads in flexible assembly technologies; the United Kingdom excels in the design of control systems. [redacted]

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FMS technologies where foreign excellence exists, or, in our judgment, is likely to develop, include:

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- *Software.* Although the US National Bureau of Standards Automated Manufacturing Research Facility is conceptually more advanced in the design of an overall system for factory integration, we believe the French are the most advanced in developing software for FMS applications. The French research in robotics and artificial intelligence, for example, has produced the leading universal robot programing language, important in FMS installations where robots from a variety of manufacturers are used. Additionally, France's Dassault has brought to the market a Computer-Aided Design/Computer-Aided Manufacturing package for aircraft manufacturing that has achieved worldwide acceptance. 25X1

- *Sensors.* [redacted] West Germany leads in the integration of sensors and machine tools, providing the capability to inspect parts while still on the machine and monitor cutting operations in process. Such capabilities are vital to producing high-precision or very large parts such as airframe components, where in-process adjustments must be made for tool wear and other variables. These capabilities are important to the manufacture of a variety of defense products, such as components for nuclear weapons. 25X1 25X1

- *Tool Handling.* The French have demonstrated leadership in the design of sophisticated, high-capacity tool-handling systems, which are key to

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Flexible Manufacturing Systems: Government Support

	For R&D	For Users	For Suppliers
United Kingdom	A variety of government-sponsored research programs, including projects at the National Engineering Laboratory, at universities sponsored by the Science Research Council and the Production Engineering Research Association. The Automated Small-Batch Production Program provides some support for research projects in industry.	FMS scheme, government grants for up to half of costs to design of new equipment for FMS. Budgeted at $110 million through 1985.	None.
Japan	Flexible Manufacturing Complex provided with laser, 1977-85. Project funded at $60 million, research by consortiums of private companies under leadership of MITI's Mechanical Engineering Laboratory.	Some assistance available through programs aimed at robotics and NC machines. Not a significant source of funding.	See R&D.
France	FMS included in Advanced Automation and Robotics Research Program of the National Center for Scientific Research; 25-percent tax credit for research by firms provided under the Factory Automation Plan in the amount of $13.8 million.	A three-year Factory Automation Plan, launched in October 1983, includes extra depreciation and loans and grants from the Fund for Industrial Modernization (FIM). These funds are part of $1 billion disbursed by FIM in 1983-84.	Development contracts for manufacturers under the Factory Automation Plan. Some support also from French program to rationalize the industry and nationalize important firms.
West Germany	Grants to universities and research institutes to match contract funding from companies. Government funding contained in research budgets of Ministry of Education and Ministry of Research and Technology.	Manufacturing Technology Program to provide subsidies to users of robots and CAD/CAM, but not specifically aimed at FMS. Budgeted at $175 million over next four years.	None.
Italy	Italian National Council of Research Polytechnic of Milan.	None.	The Italian Machine Tool Builders Association seeking $320 million from the government to aid smaller firms incorporating new technology in both their plants and products.
Sweden	Government-supported research on FMS at the Royal Institute of Technology (KIT) and in joint projects between the Institute of Production Engineering Research and KIT and between Linkoping University and KIT.	National Industrial Board budgeted $2 million over the next three years to help small companies invest in FMS. The Swedish Board for Technical Development also subsidizes up to 50 percent of the costs of installing FMS.	None.

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FMS applications where complex machining operations or excessive tool wear require frequent tool changes. Japanese firms are rapidly catching up, however, with the capacity of recently installed systems approaching that of the French systems. [redacted]

Implications for the United States

According to major trade journals, US manufacturers have a favorable view of FMS in general, but few feel they can financially justify the high cost of FMS applications in their own plants at this time. Consequently, the application of FMS in the United States has been uneven, with some firms embracing it enthusiastically—usually installing multiple systems—while others, even in the same industry, remain aloof. The United States is in a strong position in some industries, such as agriculture and construction equipment, where US use of FMS is probably greater than anywhere else in the world. In other sectors, such as machine tools and electronics, industry experts generally agree that US firms substantially lag European and Japanese producers in the use of FMS. [redacted] 25X1

Foreign developments in FMS could have a major impact on the competitive position of the United States over the longer term. As indicated above, most US industrial analysts believe that the current pace of FMS development and application in Western Europe and Japan is significantly greater than in the United States. If this pattern is maintained over the next several years, it will provide foreign firms with a competitive edge by giving them the ability to meet surges in demand, quickly redesign products, and economically produce in small batches. [redacted] 25X1

We believe FMS development and application will be especially important to the modernization of the US defense industry, both in its ability to produce a wide variety of weapons and key components on a cost-effective basis and to meet surge requirements at varying levels of mobilization. Foreign defense industries have already had some success in modernizing their production of advanced weapon systems using FMS. If the United States fails to keep pace with FMS, we believe it will lose opportunities to reduce the time from design to production of new weapon systems, expedite design changes, and reduce costs for spare parts inventories. In addition, we believe the levels of investment necessary to achieve surge requirements for a wide variety of military components are likely to be much higher without FMS capabilities. [redacted] 25X1 25X1

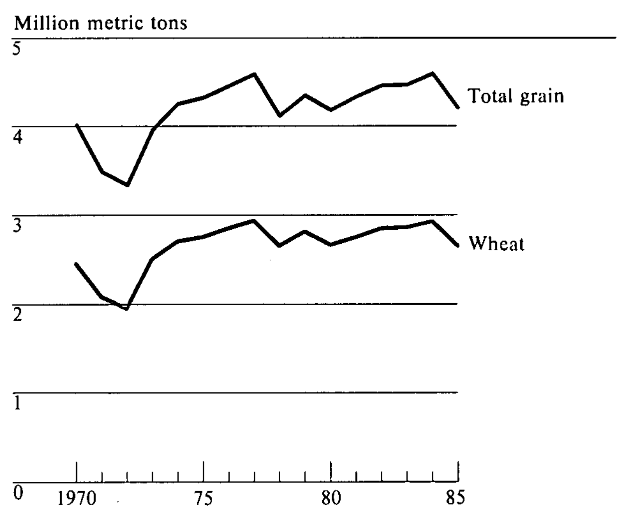
[redacted] 25X1

Afghanistan: The Economy Five Years After the Invasion [redacted] 25X1

The Afghan economy, primitive and slow growing even before the Soviet invasion in December 1979, continues to be disrupted by the ongoing hostilities. Although overall food output is probably near the level of the 1970s, some rural areas are facing serious food shortages because of below normal water levels, a disrupted distribution system, and military operations. The small industrial sector continues to be plagued by labor and raw materials shortages, frequent power blackouts, and fuel rationing. Economic development programs have fallen by the wayside because of a lack of security and the loss of Western assistance. [redacted] 25X1

The Soviets are increasingly involved in propping up the Afghan economy, but the financial costs are relatively small. The Soviets probably will not be able to reduce economic assistance soon because the deteriorating military situation makes any economic improvement unlikely. Increasing dissatisfaction with cuts in an already low standard of living makes it likely that more Afghans will join the insurgents. [redacted]

Afghanistan: Foodgrain Production, 1970-85[a]



[a] Fiscal year ending 20 March. 1970-84 Afghan Government statistics; 1985 CIA estimate. 25X1

[redacted] 25X1

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Agricultural Problems and Resiliency

Since the Soviet invasion, agriculture—the mainstay of the economy—has faced numerous disruptions, and we believe the land under cultivation has declined. About 3 million people have fled to neighboring Pakistan and Iran, and 3 to 4 million people have been displaced within Afghanistan. Routine maintenance of vineyards, orchards, and irrigation networks is being neglected. Commercial crops, such as cotton, have been particularly hard hit as farmers shift to food production. Local observers [redacted] however, indicate that destruction of crops and farms caused by military operations affects only a small portion of cultivated land. We believe that by and large the destruction is a byproduct of the fighting and not a result of Soviet policy. [redacted] 25X1

Overall Food Situation

Total food supply in fiscal year (FY) 1984 and most of 1985 probably was near the levels of the 1970s. We believe that in each of the last two years 25X1

[redacted]

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domestic production and imports have supplied 2.8 to 3.3 million metric tons of wheat to feed roughly 14 million people. Afghanistan was generally considered self-sufficient in wheat in 1976, when production reached 2.9 million tons and the population was roughly 14.5 million. Nonetheless, shortages still occur—especially in the rural areas—because of crop failures in isolated areas, distribution problems, private stockpiling and hoarding, and the destruction of some food in storage. [redacted]

We estimate the FY 1984 wheat crop at between 2.5 and 3 million tons, and analysis of [redacted] meterological data indicates that output in FY 1985 declined by about 10 percent because of less-than-normal precipitation. Although we cannot measure production of all crops, we believe the wheat harvest is a useful indicator of total food production. [redacted]

We estimate that between 300,000 and 360,000 tons of wheat were brought into Afghanistan—about half from the USSR and half from Pakistan—in 1983. According to [redacted] Soviet and Afghan press reporting, wheat imports from the Soviet Union increased from about 75,000 tons in 1980 to 160,000 to 180,000 tons in 1983. While we do not have specific reporting for FY 1985, we speculate that imports of wheat may have declined slightly because of favorable domestic production in FY 1984. We expect wheat imports to increase next year because of the poor crop this year. Most of the Soviet grain is sent to Kabul and to other major cities. We believe that in rural areas where domestic supplies are insufficient, particularly near the eastern and southern borders, shortages are largely alleviated by imports from Pakistan. Western observers estimate that 140,000 to 180,000 tons of wheat are brought in annually from Pakistan. [redacted]

Energy—Dependence on USSR

The Soviet Union is Afghanistan's primary petroleum supplier. Nevertheless, Kabul has suffered periodic shortages of virtually all petroleum products since 1980. These shortages have resulted from Soviet refusal to ship fuel until overdue accounts are paid and from delays caused by insurgent attacks on convoys and the pipeline from the Soviet Union. [redacted] 25X1

War-related disruptions of electricity are making Afghanistan increasingly dependent on the Soviets for deliveries of fuel for electric power generation. Brownouts and supply interruptions in Kabul are frequent because of insurgent sabotage of transmission lines carrying hydroelectric power to Kabul as well as a lack of precipitation to power the hydroelectric generators. The US Embassy reports that electricity shortages in 1984 have been among the worst since the Soviet invasion. [redacted]

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Afghan Gas Still Profitable

The Soviets dominate production and distribution of natural gas, Afghanistan's most important natural resource and major export. Since 1957, the Soviets have provided credits, equipment, and technical assistance for development, and the Soviets import nearly 90 percent of Afghan gas production. This gas, while not vital to the Soviets, is a useful supplement to fuel supplies in areas bordering Afghanistan as well as a feedstock for a nearby petrochemical plant. The Afghans use the remainder of their natural gas output in a nitrogen fertilizer plant and a gas-fired electric power station in Mazar-e Sharif, a textile factory in Balkh, and the city of Sheberghan. [redacted] 25X1

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Gas exports to the Soviet Union last year were officially reported at 2.4 billion cubic meters, compared with the 2.9 billion cubic meters delivered in 1975, and, according to a Kabul press report, the FY 1985 contract for exports to the USSR calls for no increase in volume. The Soviets valued FY 1984 gas imports at $300 million. Gas exports now account for about 45 percent of government revenue, compared with less than 25 percent before the invasion. [redacted] 25X1

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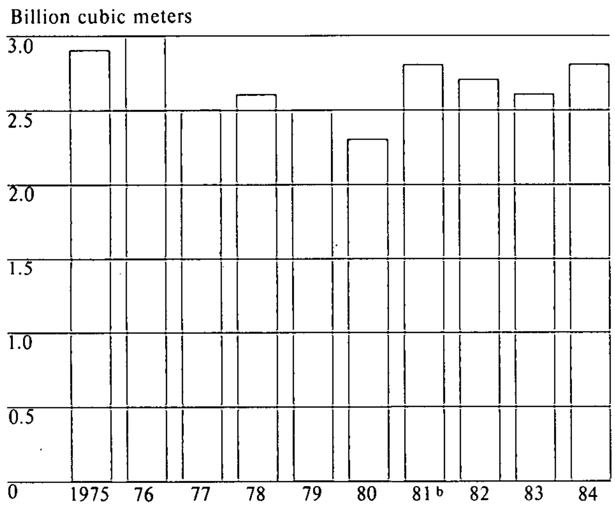
Afghanistan: Natural Gas Production, 1975-84[a]



[a] Fiscal year ending 20 March.
[b] New field on stream, but output significantly less than original target of 4 billion cubic meters.

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Other Industry Remains Depressed

The performance of the other industrial sectors has been weak in recent years, and production declines have been particularly pronounced in the textile, sugar, and vegetable oil industries. The decline is caused by damage to production facilities, shortages of agricultural raw materials, internal transportation difficulties, power outages, shortages of skilled labor, and the loss of Western markets.

Foreign Balances Go Into the Red

Afghanistan's foreign payments position went into the red in FY 1982, and the deficit probably reached about $170 million in FY 1984. Stagnating exports, rising imports, a decline in workers' remittances through official channels, and a cutback in foreign assistance from Western donors and multilateral aid institutions were the primary factors in the deterioration. Official foreign reserves are just over $200 million, less than half that in 1979. 25X1

Individual Western countries and most multilateral institutions have cut off economic assistance to Afghanistan. Total aid from Western countries and the Organization of Petroleum Exporting Countries was about $100 million annually in the late 1970s. In December 1980, the World Bank had almost 20 ongoing or proposed projects involving credits totaling more than $200 million. In October 1981, however, it canceled all but about $30 million in credits and currently is not making disbursements. The UN Development Program is one of the few international agencies that has maintained funding in Afghanistan, but annual contributions have declined to a few million dollars. 25X1

Soviet Financial Support Critical

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Soviet economic aid has become critical, with the decline in Afghan economic activity, the inability to collect taxes and buy food in the rural areas, and the decline in Western assistance. Moreover, the exodus of many of the educated bureaucrats has made it difficult for the government to provide sufficient services for areas under its control. Only with Soviet economic assistance—at least $1.3 billion since the invasion—and a tripling of the price the Soviets pay for gas has Kabul been able to meet its import requirements. 25X1

External debt has grown rapidly. The official debt was $2.4 billion in March 1984, an amount more than three times FY 1984 exports of goods and services and twice the preinvasion level. Over 80 percent of the debt is owed to Communist countries, primarily the USSR, with long maturities and at relatively low interest rates. The Soviets have repeatedly allowed the Afghans to delay payments of interest and principal. 25X1

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Afghanistan: Balance-of-Payments Summary [a] *Million US $*

	1975	1980	1981	1982	1983	1984
Current account balance	−3	−181	−112	−294	−157	−186
Trade balance	−28	−229	−193	−350	−251	−260
Exports (f.o.b.)	218	494	705	691	708	681
Imports (c.i.f.)	246	723	898	1,041	959	941
Net services	25	48	81	56	94	74
Nonmonetary capital	19	259	300	164	147	111
Errors and omissions	10	−18	7	97	−60	−93
Overall balance	**26**	**60**	**195**	**−33**	**−70**	**−168**

[a] Fiscal years ending 20 March of the stated year.

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Changing Trade Patterns

The value, composition, and direction of Afghan trade have changed dramatically over the past five years. Total recorded exports in FY 1984 were slightly less than $700 million, compared with about $340 million in FY 1979, with almost all of the increase resulting from increases in the price of gas paid by the Soviet Union. The volume of most commodities exported has remained relatively constant or has declined. Total recorded imports approached $950 million in FY 1984, compared with $630 million in FY 1979. Commercial imports, primarily fuel, manufactured goods, machinery, and food accounted for most of the increase, with price increases a significant factor. Commodity aid imports also increased, but project aid imports declined.

Trade with the Soviet Union has increased significantly. The Soviets' share of total recorded exports rose from about 35 percent before the invasion to almost 60 percent in recent years. The Soviet Union was Afghanistan's major export market even before the invasion, because it is the only feasible recipient of natural gas exports. The Soviet share of Afghan imports has more than doubled to about 70 percent in the past few years, largely because of increases in food and capital goods imports. 25X1

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Recorded trade with almost all non-Communist countries has declined. India and Pakistan continue to be important trading partners purchasing about 25 to 30 percent of Afghan exports. Japan provides about 10 percent of Afghanistan's commercial imports. Trade with the United Kingdom and West Germany, while still important, is about one-half the value of the preinvasion level. 25X1

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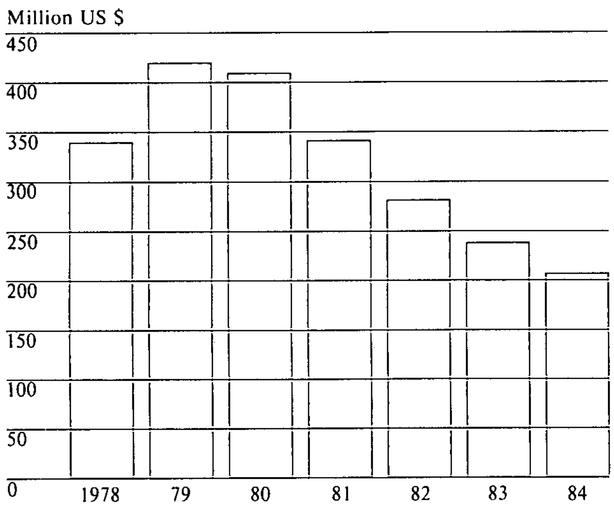
Afghanistan: Foreign Exchange Reserves, 1978-84 [a]



[a] Fiscal year ending 20 March.

[redacted] 25X1

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Outlook: Economic Improvement Doubtful

With no end in sight for the insurgency, we do not expect the Afghan economy to show any real improvement. As long as the insurgency continues:

- Transportation will be disrupted.
- The government will be unable to procure agricultural products and collect taxes from the countryside.
- Industry will face shortages of power, equipment, raw materials, and labor.
- The country will be more vulnerable to regional food shortages.
- Trade with and aid from the West will remain curtailed. [redacted] 25X1

The Soviets are unlikely to reduce the economic assistance they provide to the Afghan Government. They still must ensure that sufficient food and fuel are available to feed the population under its control and handle economic and military transportation needs. We do not believe economic assistance is a major issue in Soviet policy toward Afghanistan. [redacted] 25X1

The insurgency receives benefits from a deteriorating Afghan economy and disruption in government-sponsored economic activity:

- The Afghan population becomes more dissatisfied with the regime in Kabul and its Soviet sponsors, providing more recruits for the insurgent cause.
- Insurgent morale is bolstered by success in disrupting the economy.
- The cost to the Soviets of propping up the regime is increased. [redacted] 25X1

[redacted] 25X1

Thailand: Devaluation Brightens Economic Prospects [redacted] 25X1

Bangkok's large devaluation last month should help boost Thailand's lagging exports and slow the growth of its current account deficit. Equally encouraging for domestic economic management is the way the devaluation was planned and the skillful manner in which Prime Minister Prem defused the ensuing political outcry. It remains to be seen, however, whether Prem can overcome opposition to reforms to support the devaluation and to accelerate the diversification of Thai exports from commodities into light manufactures and processed agricultural products. [redacted]

Pressures Leading to Devaluation

The devaluation was aimed at easing Thailand's deteriorating external finances, which had tarnished an otherwise impressive economic performance since 1982. Export earnings over the past two years were depressed, not only by low prices for Thailand's key commodities—rice, sugar, tin, and rubber—but also by a substantially overvalued currency. The baht—last devalued in 1981—had been pegged to the US dollar and thus had been appreciating in terms of other currencies. A recent World Bank study showed that the trade-weighted exchange rate had increased by about 20 percent since 1981. [redacted]

The overvalued baht—in combination with low international commodity prices and an expansionary monetary policy—led to a deterioration in Thailand's foreign payments position. Despite growing foreign exchange earnings from tourism and overseas remittances, the current account deficit reached a record $2.9 billion in 1983. By yearend, the government imposed a tight money policy and increased tariffs to slow imports, improve the trade balance, and ease the currency speculation that had reduced net foreign exchange reserves by nearly $1 billion in 1983. These measures produced only a slight improvement in the current account through mid-1984, however, while aggravating a domestic liquidity crisis. [redacted] 25X1

Bangkok became increasingly concerned with the increase in foreign debt from $10 billion in 1981 to $14 billion this year. The debt service ratio rose to 22 percent, primarily reflecting the expiration of grace periods on loans from the late 1970s. Plans by the military and some civilian officials to use relatively cheap foreign loans to fund a foreign spending spree promised to compound the country's debt payments. [redacted] 25X1 25X1

Heading Off Financial Strains

Prem initially resisted IMF and World Bank advice to devalue because of concern about possible political unrest. By late summer, however, his advisers had apparently convinced him that a currency adjustment was necessary to promote long-term export competitiveness. [redacted] 25X1 On 5 November, the government devalued the baht 17 percent against the US dollar and began floating the currency against a basket of trading partner currencies. Many businessmen, politicians, and some major Thai banks lost money with the devaluation. Nonetheless, Prem was able to defuse political reaction [redacted] 25X1 25X1

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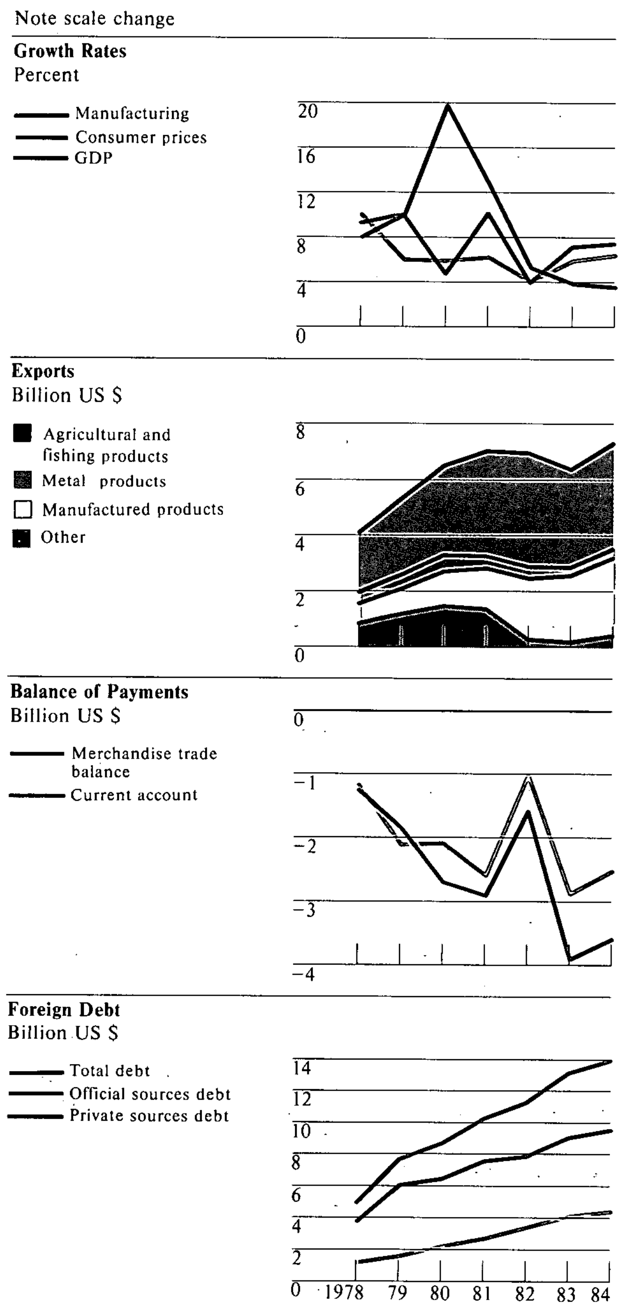
Thailand: Economic Indicators, 1978-84[a]



[a] Estimated.

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In addition, Bangkok has heeded World Bank and IMF advice to impose new austerity measures to limit increases in the budget deficit that would undermine the devaluation. The Cabinet last month cut the 1985 budget by 10 percent, froze civil service salaries, and postponed "nonessential" development projects. It also reduced the 1985 ceiling on government-guaranteed foreign loans by 30 percent to $1.6 billion. Tax increases—especially in the controversial exit tax on Thais traveling abroad—are also under consideration. 25X1

The government is also moving to reduce the burgeoning informal financial sector that lent to small manufacturers and exporters. Such lending mushroomed during the past year because of credit restrictions and high commercial interest rates. A Cabinet decree last month ordered "chit" funds—lending schemes with more than ten partners or deposits exceeding roughly $200,000—to disband within a year. Bangkok had been concerned that such schemes—which have many politically influential depositors—drain funds from the commercial banking system. 25X1

Early Payoff Limited

Although Prem easily survived the first round of political opposition, debate on economic reform will probably persist through 1985 as it becomes clear that the promised benefits of the devaluation will not materialize quickly. The current account should improve somewhat next year. We believe the deficit will decline to roughly $2.3 billion, with most of the improvement reflecting slower import growth. This, together with cutbacks in foreign borrowing, will add to popular dissatisfaction. 25X1

Export earnings are unlikely to be affected immediately. The international prices of rice, sugar, tin, and rubber, which are denominated in dollars, remain depressed. The volume of tapioca, sugar, and tin exports meanwhile are limited by international commodity agreements. Expected gains in

25X1

Political Fallout From the Devaluation

Opposition to the devaluation arose quickly from the military, the political opposition, and organized labor. Armed Forces Commander in Chief General Athit attempted to enhance his position as the leading contender to succeed Prem with a strident campaign against the government's action. In an emotional television address, Athit delivered what was in effect an ultimatum, calling for revocation of the devaluation and a Cabinet shuffle. At the same time, the major opposition party led a drive to convene a special National Assembly session to debate the move. [redacted]

Adding to the political tensions in Bangkok, labor leaders threatened action if their demands for wage adjustments to offset the anticipated inflationary effects of the devaluation were not met. Three days after the devaluation, railway workers began walking off their jobs in preparation for a nationwide strike. [redacted]

With the support of the Palace, Cabinet, and leading technocrats, Prem was able to weather the storm. He mollified critics of the inflationary impact of the devaluation by pledging to:

- *Subsidize domestic oil prices.*
- *Increase surveillance over prices of necessities to prevent profiteering.*
- *Lift recently imposed tax surcharges on imported products, except some luxury items.*
- *Increase foreign exchange available for military purchases.*
- *Review the government's September decision to freeze the minimum wage.*
- *Consider, on a case-by-case basis, remedies for business losses attributable to the devaluation.*

[redacted]

Athit withdrew his demands on 11 November, and, without military backing, support for reconvening Parliament withered. Furthermore, the railway strike proved largely unsuccessful [redacted]

exports of manufactured goods will be limited, however, by higher costs for imported materials for assembly operations that make up much of Thailand's export industry. [redacted] 25X1

The US Embassy notes that the devaluation was in part timed to take effect when most of the 1984 rice crop was still in farmers' hands, not yet sold to middlemen. We believe that higher farm income will encourage greater rice production next year. The devaluation has already allowed Thailand—the world's largest rice exporter—to reduce effective export prices roughly $20 a ton last month. This will further undercut sales by the United States, Thailand's major competitor in the world rice market. [redacted] 25X1

The size of the devaluation, moreover, has reassured most international bankers and foreign investors that currency speculation will not force another currency adjustment soon, [redacted] Bangkok is currently arranging a $300 million commercial line of credit on extremely favorable terms. Financial journals report a sharp increase in capital inflows in the last month, suggesting increased confidence in the Thai economy. [redacted] 25X1 25X1 25X1 25X1 25X1

Longer Term Reforms

We believe Thai economic policy makers—especially Finance Minister Sommai and chief planner Dr. Snoh—will use the devaluation as a springboard to implement other long-discussed, but politically controversial, reforms. They are designed, over time, to shift the structure of Thai exports from commodities—still 60 percent of export earnings—to processed agricultural products and manufactured goods. We believe these measures, which would involve a major restructuring of the tariff and tax systems, had been postponed because they would financially damage a number of influential business and military figures. If the measures currently under discussion are implemented, we believe they will—in combination with the tradi- 25X1 25X1 tionally strong and dynamic private sector—probably prevent the recurrence of serious external financial problems and allow the continuation of the current 6-percent growth rate through the end of the decade. 25X1

We believe Prem's deft handling of the devaluation has placed him in a strong position to implement reforms. His forceful resolution of numerous problems over the past few months—including limiting the military's access to foreign loans and restricting the chit funds—belies his previous reputation for indecisiveness. 25X1

We would not rule out the possibility, given the unpredictable nature of Thai politics, that the recent momentum toward economic reform could slacken. In the face of public demonstrations, Prem would probably shift tactics and slow the pace of reform as he has done in the past. A successful political challenge to Prem or a recurrence of his recent health problems, however, would probably cut short the implementation of these measures. 25X1

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