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# International Economic & Energy Weekly



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11 October 1985

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**International  
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**International  
Economic & Energy Weekly**

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**Synopsis**

1 **Perspective—Mexico: Financial Implications of the Earthquake** 25X1

Notwithstanding the human tragedy of Mexico's disaster, the effect on the economy should be minimal. Meanwhile, Mexico City is trying to take advantage of the disaster by linking their external debt problems to rebuilding efforts.

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3 **USSR: Good Grain Crop Cuts Import Needs** 25X1

With the harvest nearing completion, the USSR appears headed for a grain crop this year of some 200 million tons, its best since the 1978 record of 237 million tons. The good crop year also means that Moscow would need to import only about half of the record 53 million tons of grain purchased last year to meet its estimated domestic needs.

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9 **Poland: Financial Crisis Continues** 25X1

The recent conclusion of a rescheduling agreement with Western governments has done little to brighten Poland's financial outlook. Difficulties will increase next year as more repayments of principal on previously rescheduled debt fall due.

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13 **LDC Income Tax Reforms: Promise and Pitfalls** 25X1

Although the IMF is recommending higher taxes to reduce budget deficits in some debt-troubled LDCs, several developing countries are considering income tax rate reductions to bring about greater economic growth and expanded government revenues through broader tax compliance. Nonetheless, such efforts could fail to produce the anticipated economic growth unless accompanied by fundamental improvements in the tax administration and collection process.

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15 **West Germany: The Gap in Computers and Microelectronic Components** 25X1

West Germany—a distant third behind the United States and Japan as an exporter of computers and microelectronic components—faces major obstacles in trying to close the gap. While the overall gap will remain large for the foreseeable future, West German firms have had good success in applying microelectronics to the production process and in incorporating microelectronics into finished products.

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**Israel: Inflation and Indexation**



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The National Unity Government's campaign to curb Israel's triple-digit inflation has focused on reforming the wage indexation system. Indexation is not the sole problem, and the government must take stronger measures to cut inflation.



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**Perspective**

**Mexico: Financial Implications of the Earthquake** [Redacted]

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Notwithstanding the human tragedy of Mexico's disaster, the effect on the economy should be minimal. Only 2 percent of the city sustained major damage, and there was no significant effect on the country's industrial base or oil production facilities. Although cost estimates of the destruction are sketchy—the US Embassy estimates about \$2-3 billion— we expect Mexico City to receive substantial rebuilding assistance from insurance claims and international relief funds. In the short term, the reconstruction effort will even create jobs and will stimulate economic activity. [Redacted]

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Public criticism of the government's handling earthquakes relief will dampen the administration's apparent resolve to reduce the deficit this year. [Redacted]

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[Redacted]

Because President de la Madrid appears to recognize that a postponement will sharpen the eventual trauma of economic reform and constrain new lending, however, we believe he is likely to resume belt tightening as soon as possible. [Redacted]

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The de la Madrid administration is using the disaster to strengthen its case for financial assistance and new lending. The country's immediate hurdle of meeting a \$950 million amortization payment eased as bankers, realizing they had little choice, reluctantly agreed to Mexico's request for a six-month deferment. [Redacted] Mexican officials blamed their inability to pay on the earthquakes, although they acknowledged that the economy was already in very poor shape. Based on our estimate of Mexico's foreign exchange reserves, however, we believe they had already planned to delay payment prior to the disaster. Meanwhile, Mexico City has informed international banks that, as a result of the earthquakes, its new money requirement has grown to \$5 billion, almost twice the previous estimate. [Redacted]

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International bankers are willing in the near term to pursue a nonconfrontational approach in recognition of the high degree of emotion surrounding the tragedy and growing charges by Latin debtors that banks are making excessive demands on their already strained economies. We believe that since bankers view the earthquake damage as a short-term crisis, however, they soon will return to pressing for the long-term structural changes that they believe are necessary to solve Mexico's economic problems. Mexico City realizes that banks view a new IMF-supported program as a prerequisite for new lending and has announced its intention to sign another agreement with the fund—despite concern that this would fuel domestic opposition to de la Madrid's policies. [Redacted]

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[Redacted]

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**USSR: Good Grain Crop  
Cuts Import Needs <sup>1</sup> [redacted]**

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With the harvest nearing completion, the USSR appears headed for a grain crop this year of some 200 million tons, its best since the 1978 record of 237 million tons. Prospects are also good that the production of forages—a major livestock feed—will reach an alltime high, allowing for further increases in livestock products. As a result, total agricultural output in 1985 probably will exceed the 1983 record. Production at this level will improve supplies of quality foods—and enable General Secretary Gorbachev to claim credit for getting the Food Program back on track. The good crop year also means that Moscow would need to import only about half of the record 53 million tons of grain purchased last year to meet its estimated domestic needs. US grain sales to the USSR during the marketing year that began on 1 July may plunge by more than 50 percent from last year's peak of some 22 million tons. [redacted]

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year's grain crop by some 25 million tons.<sup>3</sup> These losses, however, are much smaller than in the past. Since 1978, we estimate that the combination of adverse weather and declining grain hectarage has cost Moscow an average of roughly 55 million tons of potential grain output annually. [redacted]

The outlook for forage crops is excellent. According to Soviet data, forage procurements as of late September were running 5 percent ahead of the record 1983 pace. Given this performance, we believe that unless the weather deteriorates markedly in the coming weeks, forage production will set a new record this year. Since harvested forages comprise slightly more than one half of the nutrient content of the Soviet livestock ration, the outlook for feed supplies is quite good. [redacted]

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**Remaining Uncertainties**

**An Improved Harvest**

Given normal weather for the rest of the season, the 1985 Soviet grain crop is likely to be about 20 million tons larger than both last year's estimated output and the estimated average for 1980-84.<sup>2</sup> The US Department of Agriculture currently forecasts the crop at 190 million tons. Estimates by other Western grain analysts range from 180 million to 200 million tons. [redacted]

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Despite this favorable outlook, several bouts of hot, dry weather in important growing regions, and the continuation of the downward trend in the area sown to grain have cut the potential size of this

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Although available evidence thus far suggests that the 1985 Soviet grain crop will be the largest since 1978, there remains some uncertainty regarding its exact size. In the unlikely event that excessive rainfall occurs during the final few weeks of the harvest campaign, combining operations could be seriously hampered, leading to losses in both grain quantity and quality. Moreover, because the harvest is running about one week late, slightly more grain than normal would be lost if an early snowfall precluded its completion. The latest Soviet harvest progress report indicates that a maximum of some 10 million tons of grain are at risk. [redacted]

<sup>3</sup> The cutback in grain area appears to be a consequence of Moscow's policy to greatly expand the amount of arable land put into fallow. Between 1977 and 1984, the harvested grain area of the USSR declined steadily from a record high of 130.4 million hectares to 119.6 million, while fallow increased from 11.7 million hectares to 20.1 million. [redacted]

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<sup>2</sup> The 200-million-ton figure is our best estimate of the 1985 Soviet grain crop, but one that is subject to error. On the basis of our analysis of best and worst case scenarios, there is a 90-percent probability that the crop will come in between 190 million and 210 million tons, and a 75-percent chance that it will range between 195 million and 205 million tons. [redacted]

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**USSR: Grain Production <sup>a</sup>***Million metric tons*

	1976-80 Average	Estimated <sup>b</sup>				
		1981	1982	1983	1984	1985
<b>Total</b>	<b>205.0</b>	<b>158.0</b>	<b>180.0</b>	<b>195.0</b>	<b>179.0</b>	<b>199.0</b>
<b>By republic</b>						
RSFSR	113.9	78.0	99.5	112.0	94.5	112.0
Ukraine	43.1	38.2	42.0	39.0	44.5	43.0
Kazakhstan	27.5	23.8	19.5	25.0	17.5	21.0
Other	20.5	18.0	19.0	19.0	22.5	23.0
<b>By crop</b>						
Wheat	99.7	81.0	90.0	80.0	77.0	88.0
Coarse grains <sup>c</sup>	95.1	68.0	80.0	102.0	92.0	99.0
Other <sup>d</sup>	10.2	9.0	10.0	13.0	10.0	12.0

<sup>a</sup> Measured in bunker weight, that is, gross output from the combine, which includes excess moisture, unripe and damaged kernels, weed seeds, and other trash. For comparison with US or other countries' grain output, an average discount of 11 percent should be applied.

<sup>b</sup> The USSR has not published overall grain production or yield statistics since 1980. Total grain production in 1981 was unofficially reported at 158 million tons. Data for Kazakhstan for 1981 and 1982 are official. All other figures represent our estimates.

<sup>c</sup> Coarse grains comprise rye, barley, oats, corn, and millet.

<sup>d</sup> Other grains include pulses, buckwheat, and rice.

A number of factors, on the other hand, could boost this year's grain production above 200 million tons, perhaps by as much as 10 million tons. We estimate that the amount of grain growing on land that was previously fallow increased again this year, continuing the upward trend begun in the late 1970s. Although following sacrifices production in the year in which the land is idled, it usually results in higher, more stable yields in subsequent years.

In addition, Moscow almost certainly will realize some benefit from a large-scale program in intensive wheat cultivation that is being undertaken on some 17 million hectares—nearly 15 percent of the area sown to grain. According to

Soviet press reports, Moscow has purchased large amounts of Western insecticides, herbicides, and fungicides in an attempt to raise

average wheat yields by 1 ton per hectare on the intensively cultivated areas. Because of the experimental nature of the program, we have been conservative in incorporating potential gains into our 200-million-ton figure. We believe that problems with deliveries of the chemicals to farms and with field applications will hold this year's results well below the planned increase of 16-18 million tons. Nevertheless, we judge that gains of 5 million tons or more are possible because many of the test areas experienced favorable growing conditions this year.

**Soviet Grain Requirements and Imports**

**Reduced Grain Needs.** This year's crop, coupled with more efficient livestock feeding practices,

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### Estimated Soviet Grain Yields, Late September 1985



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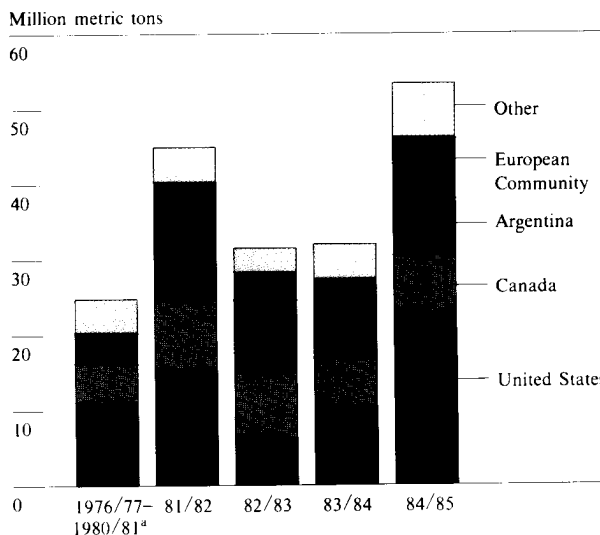
means that Soviet grain import needs during the current marketing year (1 July 1985-30 June 1986) will be down sharply from a year ago. Last year, the USSR imported roughly 53 million tons of grain, a new record. Assuming a 200-million-ton grain harvest this year, Moscow would be only 25-30 million tons short of the quantity of grain we believe necessary to maintain recent levels of seed, food, and industrial use, and to sustain growth in the production of meat and dairy products. This figure could be somewhat less if livestock feeding efficiencies continue to improve, as we believe likely. [redacted]

**Slack Grain Buying Activity.** Soviet grain purchases thus far in MY 1985/86 are running well behind last year's record pace. By the end of September, Moscow had lined up only 12-13 million tons of grain for shipment during the current marketing year compared with about 24 million tons a year ago. Moreover, the USSR reportedly has bought only 2.7 million tons of US corn, in marked contrast to last year at this time when total purchases from the United States already stood at over 12 million tons. Moscow has yet to buy US wheat, despite high-level Soviet assurances given to Agriculture Secretary Block in late August that it would buy the remaining 1.1 million tons of wheat called for under the US-USSR grain agreement before 1 October. [redacted]

The USSR's reduced grain-buying activity probably reflects more than just lower import requirements. World grain markets are soft—prices are at their lowest level in several years and exporters are anxious to sell off stocks—thus putting Moscow in a good bargaining position. Moscow's ability to play the market is somewhat limited, however, by long-term grain agreements (LTAs) and protocols with the United States, Canada, Argentina, France, Brazil, and Eastern Europe that commit the USSR to buy some 20-23 million tons of grain in MY 1985/86.<sup>4</sup> [redacted]

<sup>4</sup> Recent actions indicate that Moscow may be readjusting its thinking on LTAs in light of the growing competitiveness of world grain markets and its own long-term hard currency outlook. For example, in negotiations with Argentina—competing for a larger share of the Soviet market—Moscow has resisted pressure to increase commitments. [redacted]

**Grain Exports to the USSR, 1976/77-1984/85**



<sup>a</sup> Average.

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The slow buying to date does not necessarily mean that imports during MY 1985/86 will fall to the 25- to 30-million-ton minimum implied by estimated domestic needs. Purchases of this magnitude are already virtually assured because of LTAs and recent trading patterns that suggest the Soviets probably will buy another 6 million tons of grain outside LTA obligations. Given the favorable market situation for grain buyers, however, Moscow could choose to import even larger amounts of grain and thereby expand the livestock sector beyond plan or add more grain to stocks. Even so, estimates of up to 41 million tons by grain traders, who generally see a somewhat smaller Soviet grain crop, currently appear to be high. [redacted]

**Few Import Constraints.** The USSR should encounter few constraints—either financial or logistic—importing the amounts of grain it needs this marketing year. Although hard currency earnings probably will be down about 10 percent—as a

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result of lower oil and gas revenues—Moscow may be able to offset part of these losses through increased exports of gold, diamonds, and platinum. In addition, world grain prices are low, Western credits and loans are readily available, and grain imports from India and China—perhaps 2-3 million tons—are largely on a barter basis. As for logistics, the massive grain import program in MY 1984/85 proved that the Soviets have greatly reduced the transportation bottlenecks that previously curtailed grain shipments to the USSR.

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### Implications

The prospect of a sizable drop in Soviet grain imports during the current marketing year means that US sales to the USSR will fall well below the record 22.3 million tons exported last year. While some additional purchases of US corn are likely in the near term, Moscow could remain out of the US wheat market for several more months given the large global supplies of exportable wheat. If so, US wheat prices—already at low levels—could decline further. Moreover, total US corn exports could be hurt should Moscow begin substituting low-priced wheat—from the United States or other exporters—for corn.

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The USSR's potentially best agricultural year ever has some favorable implications for Soviet consumers as well as for General Secretary Gorbachev. The drop in per capita food supplies that occurred in 1984 should be remedied this year, giving new momentum to the Food Program. Higher quality food on Soviet tables almost certainly would boost worker morale and productivity. Meanwhile, the possibility of a cutback in grain imports of up to 50 percent from a year ago means that Moscow could save as much as \$2.5-3 billion in hard currency outlays. Such savings would help offset the expected downturn in hard currency earnings this year. For example, Moscow should now be in a position to make fewer cuts in imports of high-technology goods than otherwise would have been necessary.

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**Poland: Financial Crisis Continues** 

The recent conclusion of a rescheduling agreement with Western governments has done little to brighten Poland's financial outlook. Warsaw will be hard pressed to meet the payments required under this agreement and others made with banks. Poland probably will not achieve its planned hard currency trade surplus for 1985, and creditors remain reluctant to extend enough loans to cover the financial gap. Difficulties will increase next year as more repayments of principal on previously rescheduled debt fall due. The regime probably will try to bridge the gap by favoring payments to banks over governments with the hope that the Paris Club—as in the past—will not declare default. Another option is a request for further rescheduling of repayments due on the 1981 and 1982 agreements.

**Financial Situation in 1985**

Poland signed an agreement with the Paris Club of 17 Western government creditors in July—after more than a year of talks—to reschedule the more than \$10 billion in principal and interest due during the period 1982-84. By eliminating Warsaw's massive arrearages to Western governments, the agreement was a vital step toward normalizing relations with creditors. The two sides had initialed terms in January, but formal signing was delayed when Warsaw tried to obtain new credits from the governments and failed to make required payments on arrears from the 1981 rescheduling agreement. The Poles claimed that without new credits they could not meet payments required under the agreement. Warsaw signed the accord only after Western creditors agreed to reconsider the situation if problems develop

The Paris Club agreement carries very generous terms. The overdue debts were rescheduled for 10 years with a five-year grace period ending in 1990. Half of the interest due this year was rescheduled

**Poland: Debt Service Due** <sup>a</sup>*Million US \$*

	1984	1985	1986
<b>Total</b>	<b>15,750</b>	<b>14,797</b>	<b>4,835</b>
Paris Club	12,602	12,807	2,109
Of which:			
Arrears	9,717	11,649	
Banks	1,185	1,570	2,014
Other	1,963	420	712

<sup>a</sup> Polish financial data.

over four years; subsequent interest payments will be paid in full when due. To implement the agreement, the Poles must pay 50 percent of the 1981-83 interest arrears on the 1981 rescheduling agreement—about \$200 million—and conclude bilateral agreements with the individual governments. Warsaw must also come up with approximately \$1 billion in interest payments due this year under two previous rescheduling agreements with the Paris Club. New credit commitments will be decided between Poland and Western creditors during bilateral talks in the coming months.

**Financing Shortfall**

We believe Warsaw lacks adequate resources to meet these payments plus its obligations due under bank rescheduling agreements. Excluding the nearly \$12 billion in debt relief from the Paris Club, we estimate that Poland can come up with only \$2.4-2.6 billion this year compared with Warsaw's projection of \$3.6 billion. The Polish estimate for a

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hard currency trade surplus of \$1.5 billion appears overly optimistic—the surplus in the first eight months of 1985 was \$613 million, about \$350 million less than the same period last year. Warsaw, so far, has not cut imports as in past years to meet its goal. Imports during January-July were up about 11 percent, while exports to the West decreased 2.5 percent. [redacted]

Requests to Western governments for \$600-800 million in new credits have produced only minimal results:

- By the end of August, Austria had signed a bilateral rescheduling accord with the Poles and provided \$20 million in new commodity credits—less than 15 percent of Warsaw’s original request—and a \$20 million extension of an existing line of credit for agricultural items.
- France signed a bilateral agreement in late September. While Paris did not announce any new credits, it previously had hinted that it might grant about \$10 million.
- West Germany may grant \$30 million and Switzerland \$20 million if bilateral accords are signed.
- The Japanese, Danish, and Spanish Governments claim they will extend no new credits.

Bilateral accords with several other countries are held up over which interest rate would apply, and a few countries are undecided on granting new credit. [redacted]

Warsaw, in addition, may have some hidden payment reserves that do not show up in the projections provided to creditors. Private savings include about \$1.2 billion in hard currency deposits in domestic state banks, including \$340 million put in earlier this year as a result of increased interest rates and incentives for travel. Moreover, data from the Bank for International Settlements (BIS) showed Polish deposits in Western banks at \$1.6 billion in March 1985; Warsaw claims these are “working balances” for banks and enterprises. Although the Poles do

not consider either of these as reserves, Warsaw probably could draw upon some of this money if forced to do so. [redacted]

**1985 Obligations**

Even with the rescheduling of 1982-84 debt and assuming the rescheduling of all 1985 maturities, Poland this year owed about \$3.1 billion, leaving a financial gap of \$500-700 million. In addition to payments to the Paris Club, Warsaw owed bank creditors \$1.6 billion and other creditors over \$400 million. Through the end of the year, payments due to governments and Western banks totaling \$1.4 billion will be particularly difficult to meet. [redacted]

The Poles already have failed to clear all the interest arrears on the 1981 government debt. As a result, the September Paris Club meeting to finalize the 1985 rescheduling accord were postponed concerning the 1982-84 accord as well as bilateral talks with several governments. [redacted]

**Financial Situation Worsens in 1986**

We believe the gap between sources of financing and payments due will widen next year. Warsaw will owe about \$4.8 billion next year assuming Western governments reschedule almost \$1 billion due in principal and interest on original maturities. Banks and Paris Club governments are due about \$2 billion each under previous rescheduling agreements, and other creditors are owed \$700 million. The bank payments include \$568 million in repayment of principal under the 1981 agreement and \$316 million from the 1982 accord, while repayments to the Paris Club include \$550 million in principal due from the 1981 agreement. [redacted]

We estimate that Poland probably can pay only \$3.6-3.8 billion next year. Nonetheless, the Poles project covering all payments. We believe Warsaw

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**Poland: Sources of Financing**

Million US \$

	1984 <sup>a</sup>	1985		1986	
		Polish Estimate	CIA Estimate	Polish Estimate	CIA Estimate
<b>Total</b>	<b>3,917</b>	<b>15,264</b>	<b>14,064-14,264</b>	<b>5,202</b>	<b>3,622-3,822</b>
<b>Earned <sup>b</sup></b>	<b>2,035</b>	<b>1,900</b>	<b>1,500-1,700</b>	<b>2,050</b>	<b>1,700-1,800</b>
Hard currency trade	1,456	1,500	1,200-1,400	1,650	1,400-1,500
Exports	5,828	6,300	5,700-6,100	6,850	6,000-6,400
Imports	4,372	4,800	4,500-4,700	5,200	4,600-4,900
Services and transfers, net	396	500	400	500	400
Interest earnings	183	-100	-100	-100	-100
<b>Borrowed</b>	<b>1,882</b>	<b>13,364</b>	<b>12,564</b>	<b>3,152</b>	<b>1,922-2,022</b>
New credits	218	1,000	200	1,830	600-700 <sup>c</sup>
Recycled interest <sup>d</sup>	240 <sup>e</sup>	815 <sup>f</sup>	815 <sup>f</sup>	440	440
Credits extended, net	-176	-100	-100	-100	-100
Debt relief	1,600	11,649	11,649	982	982
Banks	1,600 <sup>g</sup>	0	0	0	0
Paris Club	0	11,649 <sup>h</sup>	11,649 <sup>h</sup>	982	982

<sup>a</sup> Polish financial data.<sup>b</sup> Earned payment capacity equals the current account balance excluding interest.<sup>c</sup> Assumes \$400-500 million in credits from the IMF.<sup>d</sup> Separate agreements during the bank rescheduling accords of 1982, 1983, and 1984 provided that certain percentages of interest payments be relent in the form of short-term loans.<sup>e</sup> Net figure: The Poles received \$1.18 billion in revolving credits in 1984 but repaid \$940 million.<sup>f</sup> Warsaw plans to use \$465 million in bank credits in 1985 and carry over \$350 million from last year.<sup>g</sup> The bank rescheduling of July 1984 covered payments due between 1984 and 1987.<sup>h</sup> Includes rescheduling of about \$10.3 billion due in 1982-84, and \$1.4 billion due in 1985.

is once again being overly optimistic in its projections of the trade surplus. Warsaw is estimating that 1986 exports will increase by 9 percent and imports by 8 percent. Based on 1985 performance, however, exports are likely to rise only half that amount, mainly due to a continued lack of raw materials and quality goods to sell in the West. Imports probably will be lower than planned because of the lack of hard currency revenue. Thus, the trade surplus is likely to fall short of Warsaw's forecast by \$150-250 million.

In addition, Poland is not likely to receive the large amount of credits projected for 1986. Warsaw is counting on readmission to the IMF and hopes to obtain over \$1 billion in new credit from that source next year. Warsaw, however, most likely will have access to no more than \$400-500 million in IMF loans after entry. To receive more than this amount, Poland would have to negotiate and adhere to a stabilization program. Such negotiations

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probably would be long and difficult, and would require the support of workers whose continuing demands for increased consumption would conflict with the austerity needed to improve Poland's capacity for debt repayment. Since lifting martial law, the regime has backed away from austerity policies out of concern over provoking worker protest. Poland is not likely to receive much credit from Western governments next year—Warsaw has requested over \$2 billion—because most governments will continue to regard Poland as uncreditworthy. [redacted]

**Warsaw's Options**

While the recent Paris Club agreement has created the impression of progress, Warsaw continues to be mired in a financial crisis. The lack of funds to make rescheduling payments will force the regime to make some choices:

- **Pay the banks, not the governments.** The Paris Club allowed Poland to run up arrears of more than \$10 billion in 1982-84 without calling Warsaw in default. As a result, Poland most likely will delay payments to Paris Club members. Moreover, [redacted] Warsaw has implied it would favor banks over governments, even if payment problems arise. While Paris Club members most likely would protest, they have no real leverage over Warsaw.
- **Keep pressing for new credits.** Another round of requests for loans from Western governments—without more serious attempts by Poland to improve its trade performance—is not likely to have much success.
- **Cut imports.** The regime slashed imports in 1983 and 1984 to achieve hard currency surplus targets when exports did not reach planned levels. Warsaw apparently is holding off on this option, hoping exports will increase by yearend.
- **Further rescheduling of the 1981 and 1982 bank and 1981 government agreements.** Creditors would not welcome such a request [redacted]

A rescheduling of the agreements would require the cooperation of banks and governments in sharing Poland's payments—which has not occurred to date. If IMF reentry occurs in 1986, the Fund could play a role in guiding future negotiations. The IMF probably would press governments and banks to provide more debt relief and new credits before extending its own loans under a standby program. [redacted]

In any case, these options will provide just another short-term solution to an immediate financial crisis. Warsaw has not made the policy changes necessary to stimulate hard currency exports and escape the endless cycle of more credit and debt reschedulings. An adjustment policy formulated by the IMF in cooperation with the regime may offer some hope of improvement, but any progress will be slow. [redacted]

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## LDC Income Tax Reforms: Promise and Pitfalls

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Although the IMF is recommending higher taxes to reduce budget deficits in some debt-troubled LDCs, several developing countries are considering income tax rate reductions to bring about greater economic growth and expanded government revenues through broader tax compliance. India has already implemented such a plan, and as many as seven other LDCs may do likewise in the next year. Although the personal income tax comprises less than 10 percent of government revenues in many LDCs, these actions suggest that LDC governments are increasing their encouragement of private-sector growth. Nonetheless, such efforts could fail to produce the anticipated economic growth unless accompanied by fundamental improvements in the tax administration and collection process. Without these, tax evasion could continue at a high level, stifling needed revenue gains even if new economic growth emerges. This could add to LDC budget deficit woes while discrediting needed tax reform in the Third World.

### India Steps Ahead

India has recently implemented lower and less progressive income tax rates in conjunction with other important economic liberalization measures, including some deregulation of production controls and investment licensing. Embassy reporting indicates that marginal income tax rates were lowered across the board with the intent of encouraging higher tax compliance and increased investments. For 1985-86, the highest marginal personal income tax rate was reduced from approximately 62 percent to 50 percent, down from its 1973-74 high of nearly 98 percent.

The comprehensiveness of the Indian economic liberalization program has greatly boosted economic expectations. The US Embassy reports that the overall program has created a widespread perception that the business climate in India will be less

constrained by government redtape and will offer more and better opportunities for profitable investments. The US Embassy notes, however, that voluntary tax compliance in India has been almost nonexistent—the roughly 1.4 million noncorporate taxpayers represent only about 0.6 percent of India's families. The government has let it be known that credibility of the tax reform program is at stake and that failure to comply with tax laws may lead to reversal of the recent concessions.  25X1

### A Flurry of New Proposals Elsewhere

Partly in response to the publicity surrounding India's program, several other countries plan to implement, or are considering, similar income tax rate reductions:

- *Pakistan's* Finance Minister Mahbubul Haq has proposed a reduction of the top marginal rate from 60 to 45 percent in the 1985-86 budget. According to US Embassy reporting, he has argued that lower tax rates will decrease tax evasion while boosting savings, investment, and economic growth. A national commission is due to present a detailed review of the entire tax system at yearend. 25X1
- *Taiwan's* Executive Yuan has agreed to a package of individual and business income tax changes which, if implemented, would reduce the top individual income tax rate from 60 percent to between 45 and 50 percent, liberalize several personal deductions, and reduce the number of tax brackets from 15 to 12. Press reports indicate that, if enacted, the entire income tax reform package could initially reduce government revenues by up to 3 percent. 25X1

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- **Jamaica's** June 1985 "Green Paper" on tax reform, prepared with substantial US technical assistance, recommends that individual income tax rates be cut, tax credits drastically simplified, the number of tax brackets reduced, and the tax base broadened. Under the plan, which the government's Revenue Board seems to prefer, according to the US Embassy, the Green Paper proposes reducing the top rate from nearly 58 percent in 1985 to 40 percent in 1990. The Green Paper, however, indicates that comprehensive tax reform will not succeed without a major improvement in the administration of the individual income tax. Final government tax reform recommendations go to parliament next January.
- In his July inaugural address, **Peru's** President Garcia announced that he would seek improvement of the tax system, which now collects only about 25 percent of taxes due, according to the US Embassy. No more than one-third of the work force files tax returns, and substantial underreporting of income is commonplace. Garcia has asked the Congress to increase the penalties for tax evasion and has stated that his government will no longer declare tax amnesties. The US Embassy estimates that if only half of the income taxes due were collected Lima could cut its fiscal deficit roughly in half.
- **Egypt** is considering a five percentage point reduction in personal income tax rates for all but the top bracket, which would drop from 80 to 70 percent. By so doing, the US Embassy reports, it is hoped that a reduction in widespread tax evasion might increase overall tax receipts. Under a current USAID agreement, the Finance Ministry is now computerizing its tax evasion monitoring.
- **Morocco** plans to simplify its complicated tax system as part of tax reforms scheduled for late 1985-86. The US Embassy expects this to include equalization of tax rates on income from different sources, a broader tax base, and no increase in overall tax burden.

- **Mauritius** will cut personal income tax rates by 50 percent beginning next year, according to the US Embassy. The government has slashed the top rate from 70 to 35 percent, reduced the number of brackets, and increased the level of personal deductions. The Finance Minister declared during his budget speech in June that an excessive income tax burden has become a major disincentive to work effort and risk taking.

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**Potential Fallout**

We believe that LDC tax reform can spur economic growth and increase needed government revenues while fostering development through broader voluntary participation in a country's formal economy, as the example of India suggests. Moreover, social and economic pressures in numerous developing countries are likely to strengthen continued attempts to restructure and simplify personal income taxes in the Third World.

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In our view, the most successful income tax reform efforts are likely to occur in those countries, such as India and Jamaica, where tax rate reductions are part of a well-coordinated fiscal package incorporating improvements in administration and enforcement as well as policy. Without basic upgrading of tax administration and collection procedures, we believe rate reductions alone are unlikely to wean higher income taxpayers from traditional habits of tax evasion. If so, these tax rate cuts may fail to generate substantial additional revenues even if economic growth is forthcoming. Such a demonstrated fiscal failure could weaken the appeal of tax reform for other LDCs in which reform might otherwise fruitfully be implemented.

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## Israel: Inflation and Indexation

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The National Unity government's campaign to curb Israel's triple-digit inflation has focused on reforming the wage indexation system. Because indexation has taken much of the sting out of inflation, successive Israeli governments have been able to get by with stopgap measures that have not realistically addressed other pressing issues. Indexation is not the sole problem, and the government must take stronger measures to cut inflation, including reductions in real government expenditures.

### The Inflationary Spiral

Israeli inflation—growing from the two-digit levels in the early 1970s to 445 percent in 1984 and currently running at about 275 percent (at an annual rate)—has been caused by a series of external shocks and government policies:

- Inflation during the 1970s was largely due to increases in oil prices. The first oil price shock alone increased Israel's oil import costs by an amount exceeding 3 percent of its gross national product. The second oil price hike in 1979 proved even more damaging because of the loss of domestic oil resources with the return to Egypt of the Sinai oilfields.
- Excessive demand, fueled by government spending, has also been a major factor. Starting in 1977, Likud-led governments resorted to an expansionary fiscal policy to curry favor with Israeli consumers, while pursuing such costly projects as the expansion of settlements on the West Bank and the invasion of Lebanon. Large annual budget deficits were financed by either borrowing in the private sector or by printing money. Furthermore, exchange rate policies designed to boost exports also increased import prices.

- The lifting of capital controls at the end of 1977 added further impetus to inflation by allowing Israelis to hold both foreign currency and foreign bank accounts. In particular, Patam accounts—dollar-linked shekel accounts—further increased the money supply as the shekel fell against the dollar.

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### The Indexation Link

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Indexation of wages to the consumer price index (CPI) has been an important—but not predominant—factor in the inflationary process. Indexation was originally promoted as a mechanism to help ensure social justice, but more recently, it has become a political necessity to protect Israelis from the ravages of triple-digit inflation. In the process, indexation has expanded into virtually every aspect of the Israeli economy:

- The current wage agreement—temporarily suspended by wage-price accords—indexes wages at 80 to 90 percent of the previous month's increase in the consumer price index.
- Pensions and welfare payments are fully linked to the CPI.
- Most financial assets—such as long-term savings accounts or government bonds—are partially or fully linked to the CPI or some foreign currency.
- Taxes are fully linked to the CPI and adjusted on a quarterly basis.

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### The Costs of Indexation

Wage indexation does not by itself completely protect Israeli workers from inflation. With indexation at less than 100 percent and applied with a one-month lag, real wages theoretically would fall and thus dampen demand. Normal promotions and

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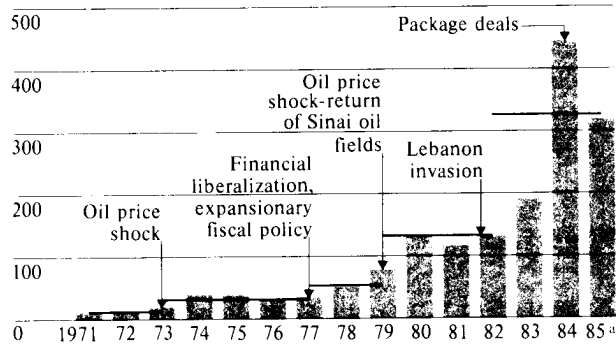
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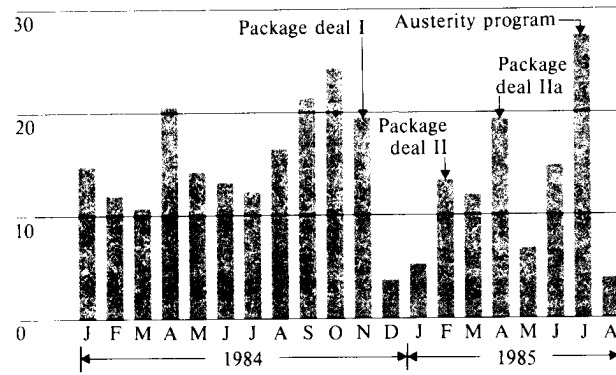
**Israel: Inflation**

Percent

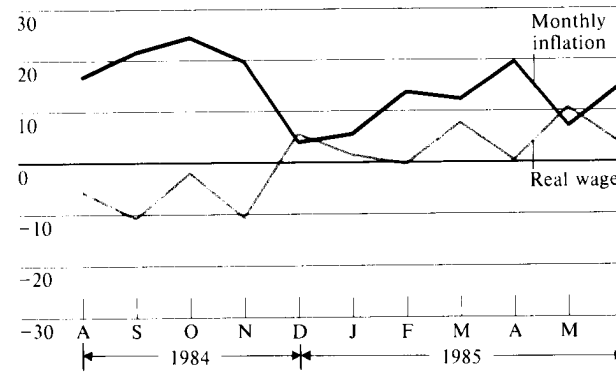
Annual inflation



Monthly inflation



Real wage growth and monthly inflation



<sup>a</sup> Projected.

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the high level of success enjoyed by most labor unions in securing additional wage boosts, however, have combined with indexation to raise real wages an average of 5.3 percent annually during 1977-83 and was close to 1 percent last year, despite a sharp economic slowdown.

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Such wage growth has discouraged the serious social disruption typical of countries with triple-digit inflation. Work actions are common but usually are mounted to press the government to adopt tougher anti-inflationary policies, not for higher wages. Because indexation has taken much of the sting out of inflation, successive Israeli governments have been able to get by with stopgap measures that have not realistically addressed other pressing issues, such as reforms in monetary policy and curbs on government spending.

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An additional problem is that high wage growth has not been matched by increases in labor productivity, ensuring that aggregate demand continues to outstrip supply. Labor productivity grew by just 1.6 percent per year during 1977-81 and has steadily dropped the past three years. Some of the main factors contributing to this decline include:

- The hesitancy of employers to lay off workers for fear of labor unrest or being caught short when demand strengthens.
- High marginal tax rates that have reduced workers' incentives.
- The use of substantial blocks of work time to juggle personnel assets and make purchases to hedge against inflation.

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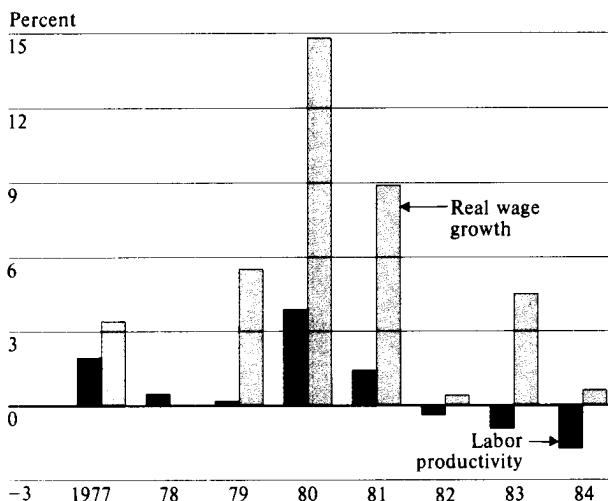
Indexation also has contributed to resource misallocations with investment a major casualty. With most financial assets indexed, Israelis have been unwilling to risk investing money in capital goods with uncertain real rates of return. Real investment fell more than 9 percent last year and is projected to drop 10 to 15 percent this year, contributing to poor productivity performance.

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**Israel: Labor Productivity and Real Wage Growth, 1977-84**



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**Recent Indexation Adjustments**

Since the first wage-price package deal in 1984, the government has reached several agreements with the Histadrut labor federation to revise the cost-of-living-adjustment (COLA) formula. For a brief period the indexation formula was reduced by one-third, but more recently the COLAs have been suspended outright. The government's agreement to grant supplemental lump-sum wage payments, however, has helped offset these losses. Nonetheless, real wage growth during the first nine months of the coalition government was less than it would have been without the revisions, and, since the imposition of July's austerity program, real wages have fallen to the level of about four years ago. Moreover, the government recently gained Histadrut's agreement in principle to forgo further special wage adjustments until 1 April 1986, when the current public-sector wage agreement expires.

[Redacted]

**Outlook**

The government's recent adjustments to the wage indexation formula are steps in the right direction, but record July inflation of 27.5 percent and the struggle to keep monthly inflation under the current 4-percent target suggest that stronger measures are needed. Moreover, broad popular support for current policies—as reflected in public opinion polls—could wane in the coming weeks if workers perceive that they are once again bearing the brunt of austerity. To deal effectively with triple-digit inflation, the government must enforce the entire package of restrictive policies outlined in its July program plus implement additional measures, including:

- Freeing the Bank of Israel from monetizing budget deficits. The Bank of Israel would then be better able to coordinate monetary policy with the government's inflation targets. Legislation has been introduced to accomplish this.
- Additional reductions in real government expenditures and going ahead with the planned dismissal of thousands of public-sector employees.
- Further indexation reform, especially of financial assets to spur investment. Next April's expiration of the current wage accord would be an opportune time for such an adjustment.
- New tax reforms designed to cut tax rates and boost worker incentives. [Redacted]

[Redacted]

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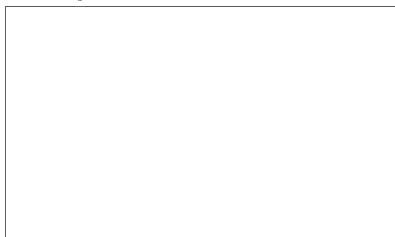
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**Briefs**

*OPEC Meeting Ends  
in Discord*



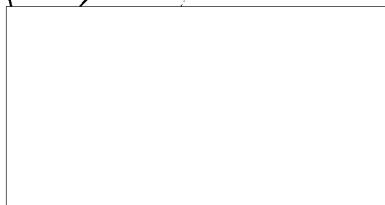
**Energy**

OPEC ministers adjourned their two-day session last Friday after failing to reach any new agreements. Six of the group's 13 members requested higher production quotas, but, with Saudi Arabia unwilling, a compromise could not be forged. Ecuador boycotted the last day of the session, vowing to reconsider its membership. Failure to compromise on output quotas sets the stage for members to increase production unilaterally. Prices might not weaken in the near term, however, because of higher winter demand, and current uncertainty about Iranian and Soviet oil exports. Although unlikely, if no further damage is sustained at Khark Island, Iranian exports could begin to increase as early as next month, renewing intense downward pressure on prices. [redacted]

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*Iraq Lines Up  
Customers at  
Iran's Expense*



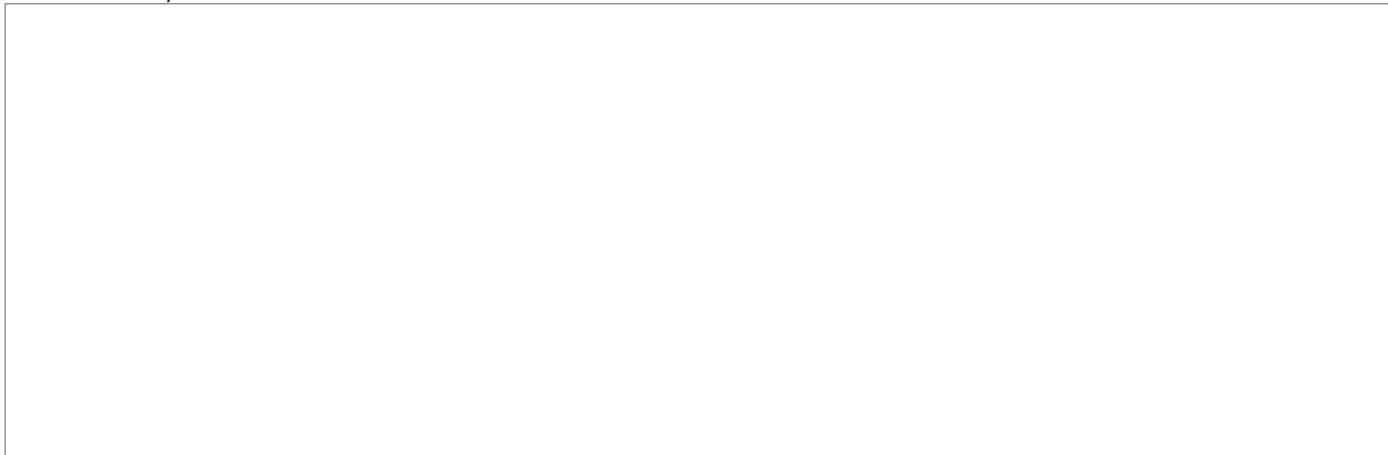
Iraq has lined up customers for the 330,000 b/d of Basrah light crude to be exported over the last three months of this year via the recently completed Iraqi-Saudi pipeline. Iraq has won term contracts by pegging prices 40 to 60 cents per barrel below spot prices on comparable crudes, [redacted]. Japanese firms are buying most of the oil—up to 200,000 b/d. Iran will be particularly irritated by Iraqi sales to Japan—Iran's most important market—and may be compelled to match Iraqi discounts. Moreover, Baghdad will probably try to convince Japanese firms and other Iranian customers that it is a more reliable supplier considering Tehran's recent difficulties in exporting oil from Khark Island. [redacted]

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*Norwegian Gas Sales Negotiations*

Negotiations for the sale of 15 billion cubic meters of gas per year from Norway's giant Troll field to a consortium of West European buyers are progressing, according to press reporting. Although agreement in principle has been reached on volumes and on a 1995 startup date, price discussions have yet to begin. West German industry officials believe a commercially acceptable price, estimated by industry at \$3.70 to \$3.80 per million Btu, may not be sufficient to cover the high development costs of the field. If so, Oslo may face pressure to alter its production tax on Troll. Both Statoil, the Norwegian state oil company, and the continental buyers, led by West Germany's Ruhrgas, are optimistic, but past sales negotiations suggest talks could drag on much longer than expected. If agreement is reached, continental West European dependence on Soviet gas in the year 2000 could be reduced to about 30 percent of consumption compared with a projected level of nearly 40 percent if Troll is not developed. [redacted]

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*Soviet Gas to West Berlin*

Siberian gas began flowing to West Berlin last week, as scheduled, under the terms of a 1981 contract that calls for the annual delivery of up to 650 million cubic meters. The contract runs to the year 2008 with optional five-year extensions. The gas reaches the city via a new pipeline spur through East Germany. An Allied precondition for the contract—which has been met—was that West Berlin provide storage for one year's supply to guard against the possibility of interruption. Although Soviet gas is expected to cover only about 8 percent of West Berlin's total energy consumption, it will account for all of West Berlin's gas supply. [redacted]

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*North Korea Faces Oil Problems*

The sinking of a North Korean oil tanker during an Iraqi attack on Khark Island on 19 September will exacerbate longstanding energy shortages caused by inadequate oil imports and a poorly developed electric power system. This loss comes at an especially bad time, with fuel needed for the fall planting now under way. The 225,000-ton tanker, was roughly twice the size of North Korea's only other tanker and was used primarily to carry Iranian oil. The Iranian connection has been very important because it has enabled P'yongyang to barter arms for oil. Iran has supplied about one-third of North Korean crude, with the remainder coming from the USSR and China. As a short-term solution, P'yongyang [redacted] is also attempting to acquire additional supplies from the USSR. Given Soviet oil production problems, Moscow may be unwilling to help out at this time. China could easily assist, but its oil is heavier than Iran's and thus less suitable for making the lighter products. For the longer run, P'yongyang probably will want to buy another tanker, although its extremely poor credit rating may make it difficult to do so. [redacted]

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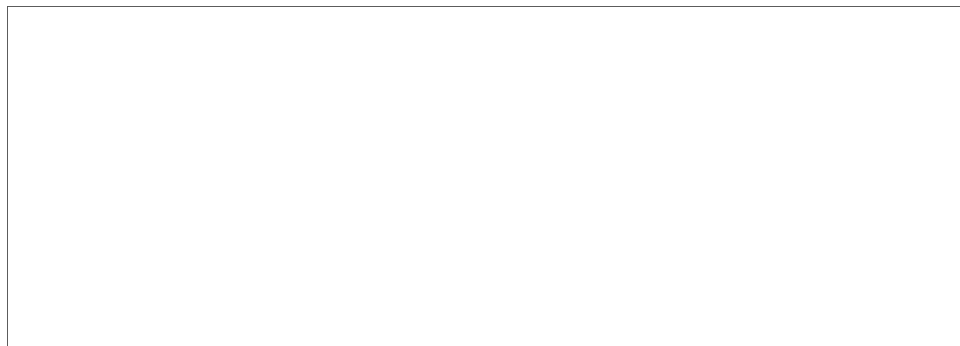
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*Tokyo's Currency Intervention Policy*



**International Finance**

The Ministry of Finance (MOF) will probably continue to support Group of Five currency intervention efforts until the yen reaches the 200-per-dollar level [redacted] The yen has strengthened from 242 to about 216 per dollar since the joint intervention began in late September.

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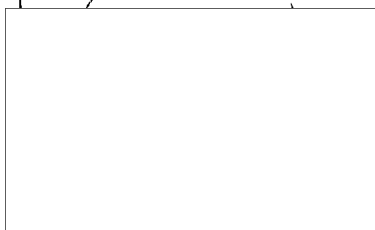
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Nonetheless, we believe Japanese commitment to exchange rate intervention may soon waver if high US interest rates continue attracting large amounts of Japanese capital. [redacted]

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*Guyana's Financial Crisis*



Guyana's severe foreign exchange bind threatens to further depress the economy—1984 output was only 76 percent of the peak 1976 level—and increase pressure on President Hoyte to find viable solutions as he gears up for elections required by next March. In September, Trinidad and Tobago suspended its oil credit facility because of Guyana's inability to pay arrears of \$217 million; future purchases apparently will be made in cash. Meanwhile, Guyana reportedly will repay this debt by exporting monthly 3,000 metric tons of rice, a Guyanese staple already in short supply.

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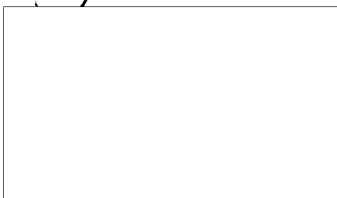
[redacted] Finding the \$19 million to cover Guyana's IMF arrears, a prerequisite for a new program, is likely to prolong negotiations. Meanwhile, worsening rice and petroleum shortages are likely to undercut Hoyt's recent efforts to consolidate business and labor support, as well as increase the chances of social unrest and increased repression.

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**Global and Regional Developments**

*EC Commission Proposes To Cut Steel Subsidies*



The EC Commission took its first step toward a new steel policy by prohibiting subsidies to the struggling industry except in specified cases. If the proposal is approved by the Council of Ministers, as expected, subsidies after 1 January 1986 would be permitted only to help cover research and development, meet

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environmental regulations, or to assist plant closures. Under the current EC steel program, companies have received about \$4 billion annually as aid for restructuring. By sharply cutting back subsidies, the Commission hopes to reduce excess production capacity, estimated by the EC at 20-25 million metric tons, roughly 12 to 15 percent of the total. Tighter curbs on subsidies will be only one element of the Commission's next steel program. Between now and the end of the year, discussions covering price, production, and import controls will be held between the Commission and EC member states. [redacted]

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*India's Increased Economic Ties to Japan*

India and Japan are moving to increase bilateral economic cooperation. In mid-September Prime Minister Gandhi's economic adviser, L. K. Jha, went to Japan to pave the way for the Prime Minister's visit in late November. In talks with Japanese officials and businessmen, Jha stressed Indian hopes for stronger economic ties, including increased Japanese investment and cooperation in high technology. New Delhi believes Japanese technology could avoid the potential political burdens of a similar relationship with the United States. Japanese businessmen are keenly interested in New Delhi's hints that it will liberalize trade and joint venture regulations [redacted]

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[redacted] The Japanese Government, for its part, has been increasing its economic aid to India. [redacted]

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**National Developments**

*Developed Countries*

*Possible Japanese Economic Stimulus*

The fall session of the Diet, which begins next week, will consider measures to ease trade friction by expanding domestic demand. The commitment to budget austerity by Prime Minister Nakasone and the powerful Finance Ministry, however, probably rules out sharp increases in government spending or major tax cuts over the next year. The government instead is likely to reduce regulations governing private business and introduce measures to encourage private-sector financing of public works. Tokyo may also open some previously

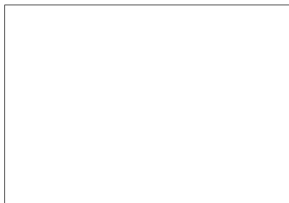
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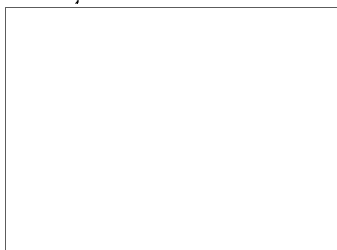
restricted land to intensive real estate development, sweeten an existing tax break on housing, and implement a small cut in personal income tax rates. We believe the ruling party's recent announcement of a 17-point agenda for expanding domestic demand—including government-financed public works, major tax cuts, and an easier monetary policy—has little chance of passage this fall and was intended largely as a public relations gift for Nakasone and ruling party leaders to bring on October trips to the United States.  25X1

✓ Possible Japanese Aluminum Industry Concessions



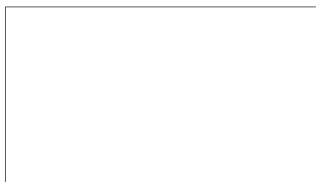
Tokyo may announce measures prior to Prime Minister Nakasone's 23 October meeting with President Reagan to forestall a potential US unfair trade practices action (under Section 301 of the Trade Act) against policies protecting Japan's aluminum industry. MITI officials believe the Aluminum Stockpiling Program—under which Tokyo purchases aluminum ingot from domestic refiners—will not be continued beyond its planned expiration in November 1985, according to Embassy reporting. Also, support is growing among domestic producers for a tariff reduction on imported rolled aluminum, according to Japanese press. They would probably accept a reduction in the tariff from the current 9.2 percent to 6 percent—Washington has requested a 3-percent level. Japan's tariff rebate to domestic aluminum refiners and support of special industry cartels, however, have yet to be addressed.  25X1

✓ Revamping Japan's Spring Wage Offensive



Several Japanese unions are attempting to restructure the shunto—the annual spring wage offensive—in an effort to increase wages in small and medium-sized firms. Recent shuntos have granted these workers much smaller pay increases than male permanent employees of large corporations who fare better because of seniority and sex differentials built into their wage system. Some unions fear this wage discrepancy will discourage workers in smaller companies from participating in union activity at a time when overall union membership is dropping. Although the details of the restructuring are still being formulated, its proponents believe unions in high-tech industries should take the lead because they are in a better position to bargain than present negotiators, such as the steelworkers. A substantial change in the shunto is likely to be difficult, however, because of opposition from unions at large companies who realize increased wages for the smaller firms—principal suppliers for the larger enterprises—will affect their own company's prices, sales, and export competitiveness.  25X1

✓ Japan May Buy US Grain for Foreign Aid



Tokyo is again debating the purchase of US grain for use as food aid for LDCs. According to the US Embassy, Prime Minister Nakasone wants Japan to buy 10 million metric tons of grain from the United States over seven years. Last March, Washington called on Japan to purchase up to 10 million tons of wheat over four years—Tokyo bought 77,000 tons of US wheat for food aid programs in 1984. Funding, however, continues to be the sticking point. A 10-million-ton program would cost about \$1.5 billion at current prices, more than 10 times Japan's food aid budget for 1984.  25X1



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[Redacted]

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[Redacted] Tokyo will likely gauge Washington's reaction to overtures made during the high-level ruling Liberal Democratic Party delegation's early October visit before deciding on the project. [Redacted]

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*Japanese Advance in Semiconductor Materials Technology*

Japanese researchers have fabricated a complex optoelectronics circuit using technologies for crystal growth and doping of semiconductors combined for the first time in a single piece of equipment. The new equipment is potentially capable of making higher quality devices—conventional integrated circuits as well as optoelectronics circuits—and achieving better yields. Key to commercializing the new equipment will be reductions in process cost, an aspect at which the Japanese are adept. Japan's major semiconductor companies, such as Fujitsu and Hitachi, have ready access to the research of a MITI-sponsored laboratory staffed by these firms. [Redacted]

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[Redacted]

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*French Inflation Continues Downward*

The 12-month inflation rate in August fell to its lowest level in over a decade, 5.6 percent, continuing an almost unbroken trend since late 1983. The slowdown reflects falling prices of imported raw materials, down by over 16 percent in the first eight months, in part due to the depreciating dollar. Moreover, the Socialist austerity program has helped hold wage increases to 3.2 percent for the first six months of 1985, as compared with 3.6 percent for the same period last year. We expect wages to moderate further in the second half because of weak demand and the traditional bunching of wage increases in the first half. The prime rate has also fallen by over 1 percentage point since the beginning of the year. If the dollar remains near its present level, the 12-month inflation rate by yearend will be only slightly above the official 5-percent target and well below the 6.7 percent recorded at the end of last year. [Redacted]

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*Chilean Economic Stimulus*

**Less Developed Countries**

Recent steps to revive Chile's stagnant economy and defuse mounting popular discontent may endanger its IMF-supported austerity program. Public-sector retrenchment—including sharply cut subsidies for refinancing mortgages and for small business loans—had stalled growth in the second and third quarters of this year. This, coupled with an annual inflation rate of over 35 percent, has left much of the middle class near bankruptcy and threatens major social unrest, according to Embassy reporting. In response, the economic team recently boosted the money supply, delayed a devaluation, and invoked protectionist measures to stimulate domestic growth by the end of this year. Although these moves will provide short-term relief, they will likely worsen the country's problems in 1986 by fueling inflationary expectations, provoking capital flight, depressing domestic savings, and stimulating import demand. Moreover, we believe Santiago will be forced to seek IMF waivers on its deficit spending and foreign exchange reserve targets by early next year. This could worsen already strained relations with its creditors and disrupt disbursements of critically needed bank funds.

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*Labor Pressures Venezuela's Lusinchi*

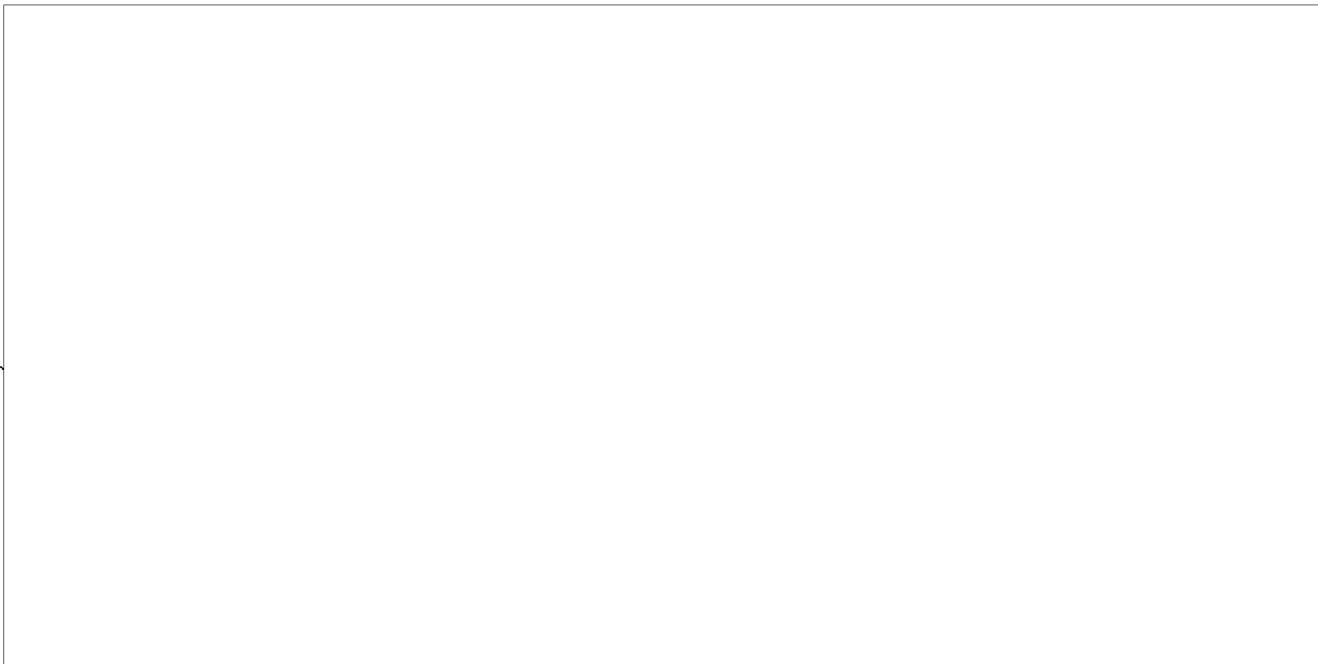
President Lusinchi may soon have to take steps to address labor's intensifying criticism of his economic stabilization program. Labor Federation head Delpino, at the Federation's May Congress, complained about sliding real wages, growing unemployment, and labor's unfair share of the austerity burden. In August, he and other labor leaders attacked the proposed debt rescheduling, saying that it would absorb needed domestic financing, and demanded a renegotiation with creditor banks to obtain better terms. In September, labor leaders called for increased outlays on public works, government subsidies for 30 staples, and a shakeup of the economic cabinet. Later in the month, labor leadership raised the specter of street demonstrations. Last week Delpino issued a call for across-the-board wage increases. Although we believe demonstrations are not imminent, the threat nevertheless signals a tougher stance by labor. Lusinchi will likely attempt to appease labor—a critical constituency—through such measures as an ambitious public investment program, the continuation of price controls, and a promise of an unemployment insurance program. While we do not believe that he will accede to labor's wage and subsidy demands, changes in the economic cabinet are likely early next year, after the debt deal is signed.

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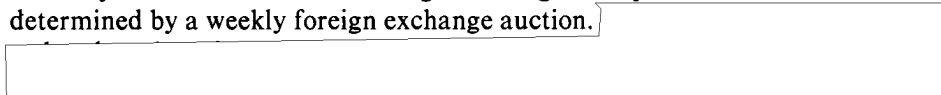
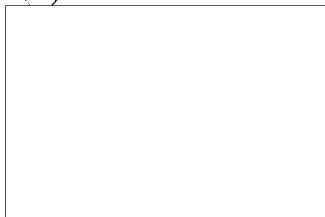
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*Zambia Implementing Major Economic Moves*

President Kaunda announced on 4 October that the exchange rate of Zambia's currency and the allocation of foreign exchange to importers will henceforth be determined by a weekly foreign exchange auction.



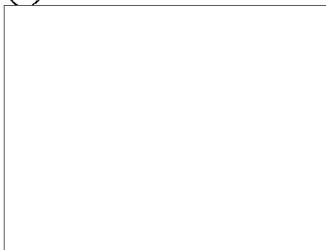
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These moves are the latest in a series of reforms begun in 1983 to reverse foreign payments deficits and the growth of foreign debt by reducing import demand. Zambia's foreign exchange problems stem from a decline of almost one-half since 1980 in copper exports, which account for 90 percent of total Zambian exports. The auction may lead to a devaluation of as much as 75 percent against the dollar, according to press reporting. Kaunda overrode the opposition of senior military officers who have increasingly expressed fears about the impact on military morale and the possibility of having to use troops to control civil disturbances.

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*Bangladesh Foodgrain Prospects*

Good weather and increased use of high-yielding strains have provided Bangladesh with record foodgrain crops, according to the US Embassy. Production of rice and wheat for FY1984-85 (July-June) is estimated to be a record 16 million metric tons, despite the severe cyclone last May, and projected to be 16.5 million tons this fiscal year. The Embassy predicts that the bumper crops will reduce this year's commercial food imports by more than 70 percent. Large government stockpiles, however, have depressed rice prices for farmers. Over the longer term, Bangladesh will have to continue major production gains to keep pace with its high 2.8-percent annual population growth rate.



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*US-Thai Trade Dispute  
Over Rice*

The US countervailing duty petition filed last month against rapidly increasing imports of Thai rice will heighten bilateral trade tensions. Following recent Congressional proposals to cut imports of Thai textiles and other manufactures, the petition undoubtedly will exacerbate Thai fears of reduced access to its leading export market. Bangkok has been coping with a soft world market for rice, the leading Thai export, by moving aggressively to increase export volumes. As a result of attractive prices and improved quality, Thai rice is cutting into traditional US markets such as Western Europe, Africa, and the Middle East. [redacted]

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*Nepalese Economic  
Problems*

Rapidly growing imports are likely to precipitate a serious foreign-payments problem this year. Foreign exchange reserves at the end of the fiscal year in mid-July fell to \$60 million, about one-half the previous year's level and equivalent to less than six weeks of imports. A team from the IMF recently found that a standby agreement is warranted. Targets for the standby are likely to include a 10-percent reduction in the regular and development budgets, an adjustment in the exchange rate, and other measures to increase exports and reduce imports. India has agreed to provide immediately about one fourth of a promised \$40 million grant for road construction to help cover imports until IMF funding is available. Nepalese government officials are reluctant to implement austerity measures during the October-November holiday season—particularly restrictions on purchases of consumer goods.

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**Communist**

*Moscow Searching for  
Hidden Economic  
Resources*

Concrete examples of General Secretary Gorbachev's strategy for accelerating short-term growth may be emerging. [redacted]

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[redacted] The press also reports that two extra workdays have been scheduled for the last quarter of this year. [redacted]

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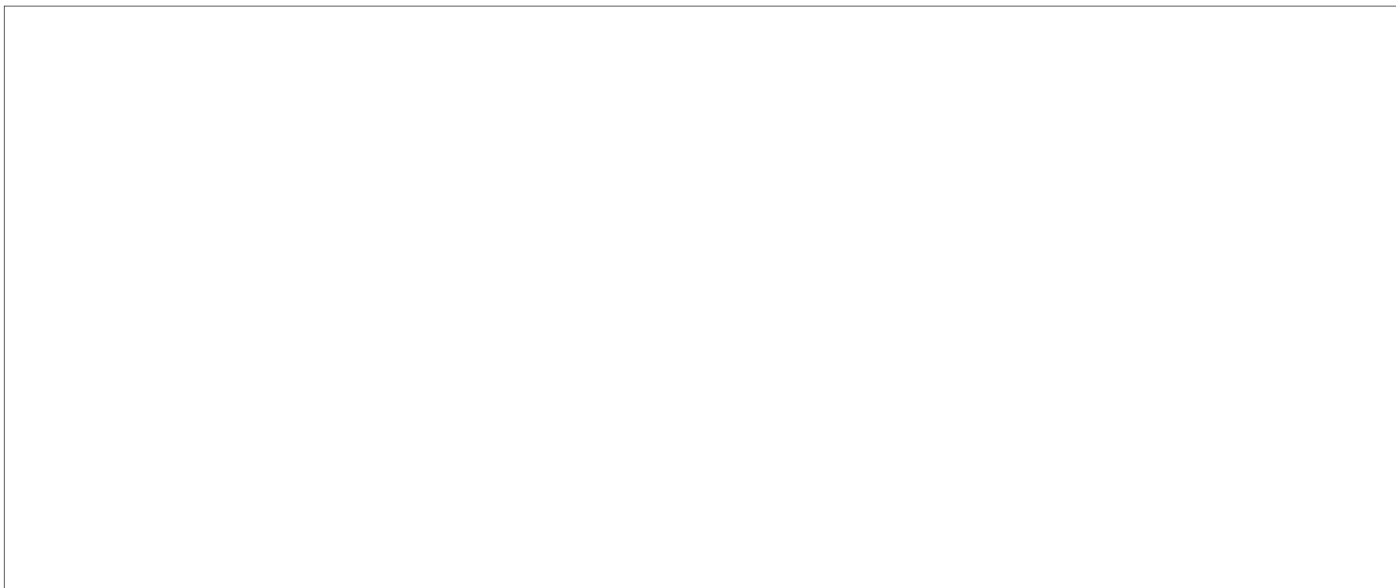
Gorbachev's most promising sources for sustained short-term growth are more intensive use of existing resources. Ordering cost reductions is another attempt to find investment reserves for more efficient use elsewhere. Across-the-board cuts in construction costs are probably in the cards for other ministries.

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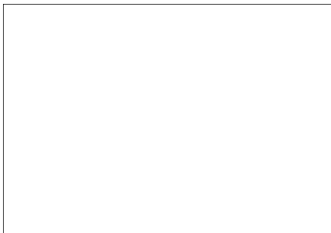
*Soviet Economic Experiment Sharply Criticized*



An article in the prestigious literary journal, *Novy Mir*, has sharply criticized the economic experiment introduced in 1984 for failing to attack the root cause of Soviet economic ills—the USSR’s system of central planning. The article notes that a key element of the experiment—making fulfillment of contractual sales obligations the principal yardstick for evaluating and rewarding enterprise performance—does little to ease the enormous waste of resources characteristic of the Soviet economy, for example, the huge accumulation of uninstalled equipment. The author also argues that the experiment, while giving enterprises somewhat more autonomy over wage and investment expenditures, will not promote technological innovation, to which Gorbachev has given priority. This is one of several articles in the Soviet press in recent months that are harshly critical of basic features of the Soviet economic system. These critiques suggest that the regime welcomes debate even on sensitive economic issues, as it struggles to formulate an economic reform game plan.

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*Eastern Europe’s Hard Currency Trade*



Eastern Europe’s surplus in its hard currency trade fell in the first half of the year to less than half that of the same period last year, reversing the trend of steadily improving trade balances over the last several years. Even with the economic recovery in Western Europe, East European exports fell by 4 percent. Imports rose by 6 percent as Eastern Europe increased purchases of energy and raw materials. Eastern Europe’s deteriorating trade performance, a result of harsh winter weather and declining commodity prices, has forced Bulgaria, Hungary, and Romania recently to seek loans. At the same time several East European countries have increased their exports to the USSR, possibly at the expense of hard currency sales. Declining export performance will complicate Poland’s struggle to make debt payments due later this year and Yugoslavia’s attempt to meet IMF foreign reserve targets.

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**Eastern Europe: Hard Currency Trade  
January-June 1984 and 1985 <sup>a</sup>**

*Million US \$*

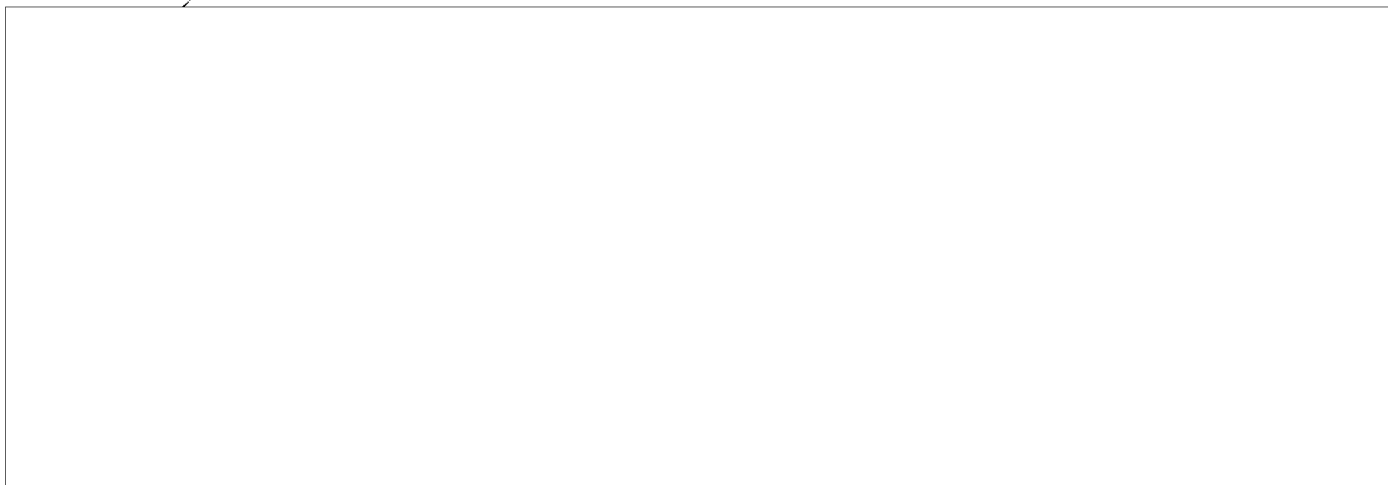
	Imports			Exports			Balance	
	1984	1985 <sup>b</sup>	Percent Change	1984	1985	Percent Change	1984	1985 <sup>b</sup>
<b>Total</b>	<b>15,231</b>	<b>16,110</b>	<b>5.8</b>	<b>18,085</b>	<b>17,356</b>	<b>-4.0</b>	<b>2,854</b>	<b>1,246</b>
Bulgaria <sup>c</sup>	1,153	1,274	10.5	1,483	1,335	-10.0	330	61
Czechoslovakia <sup>c</sup>	1,560	1,468	-5.9	2,160	2,004	-7.2	600	536
East Germany <sup>d</sup>	2,484	2,618	5.4	2,619	2,645	1.0	135	27
Hungary	1,994	2,313	16.0	2,450	2,213	-9.7	456	-100
Poland	2,152	2,246	4.4	2,957	2,835	-4.1	805	589
Romania	2,535	2,493	-1.7	3,434	3,285	-4.3	899	792
Yugoslavia	3,353	3,698	10.3	2,982	3,039	1.9	-371	-659

<sup>a</sup> Includes intra-CEMA hard currency trade.

<sup>b</sup> Preliminary.

<sup>c</sup> Estimates for trade with nonsocialist countries.

<sup>d</sup> Trade with OECD countries only. In recent years, East Germany has run large surpluses with developing countries.

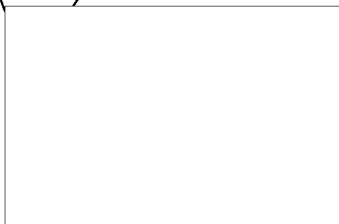


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*Beijing Devalues  
Currency*

China's State Administration for Exchange Control on 3 October announced a modest devaluation to a record low of 3 yuan to the dollar. The yuan's value against the dollar has declined by 46 percent since 1982, and is now 13 percent lower than one year ago. China's currency is inconvertible, but the government reportedly sets the exchange rate daily against an undisclosed basket of foreign currencies. The devaluation is yet another indication of the reform-minded leadership's growing commitment to using economic levers to regulate the



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economy. Faced with a large trade deficit this year, Beijing apparently decided, with the advice of the World Bank and IMF, to devalue in order to boost exports and cut imports. This move follows the recent party approval of the outline of the next Five-Year Plan (1986-90), which calls for a 50-percent increase in exports, but only a 40-percent rise in imports during the plan period.

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