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International Economic & Energy Weekly

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International Economic & Energy Weekly

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Perspective

West European Arms Exports 25X1

West European arms sales have declined over the past five years amid declining oil revenues and growing debt problems in the Third World and the completion of many weapons modernization programs in the Third World and Western Europe. West European sales of arms fell from an alltime high of $18.6 billion in 1980 to $14.1 billion in 1984.[1] Our preliminary estimate for 1985 indicates that West European exports will total about $10 billion in current dollars, continuing the downward trend. 25X1

The 17 West European nations exporting arms still account for about 25 to 30 percent of the global market, but only France and Spain have been successful in maintaining or expanding their market shares, largely because of aggressive sales campaigns. French exports have averaged $6 billion annually, while Spain doubled its sales to about $1 billion in 1983 and 1984, pushing it ahead of Great Britain's sagging sales in those years. The other major suppliers—West Germany and Italy—have also experienced dramatic drops in their export programs. Secondary suppliers with small but well established niches in the market, such as Belgium and Switzerland, have experienced proportionally smaller declines. 25X1

West European countries export about 50 percent of their arms production, compared to about 15 percent for the superpowers, and the sales decline has led to cuts in production and employment. We believe these cuts are boosting the unit costs of equipment and placing an extra burden on already tight West European defense budgets. Declining profits in the defense sector are also reducing the funds available for investment in new plant and equipment and in weapons research and development. Such economic pressures are a major reason, in our view, for Western Europe's strong interest in new major defense cooperation ventures, such as the European Fighter Aircraft and the proposed new family of military helicopters. 25X1

West European arms exports could rebound somewhat in the next few years if Middle Eastern states are unable to acquire desired weapons from the United States. British arms sales received a boost in September when Saudi Arabia chose to buy the Tornado and Hawk jet aircraft, rather than wait for the United States to offer additional F-15s, for example. Decisions next year by Jordan and Morocco whether to buy the Tornado or French Mirage-2000—even though both prefer US aircraft—would indicate renewed strength for West European sales in the region that already accounts for 50 to 75 percent of sales by major West European suppliers. Over the longer term, any

[1] The magnitude of the decline may be exaggerated by the growing strength of the US dollar during this period. 25X1

sustained increase in West European arms exports will depend on improved economic conditions in the Third World that would allow a weapons modernization cycle to begin in the 1990s. [redacted] 25X1

The shrinking arms export market provides a strong incentive for West European nations to substitute indigenously produced arms for US weapons now in their inventories. The United States has reduced its favorable arms trade balance with Western Europe from over 9 to 1 to about 3 to 1 in recent years by buying more European military equipment, but we believe US allies will continue to press for more access to the US defense market, still the largest in the non-Communist world. At a minimum, the Europeans will insist on more offset purchases when they buy weapons from the United States in the future. [redacted] 25X1

[redacted] 25X1

OPEC Decision Will Precipitate Oil Price Decline 25X1

Oil prices could fall next year if OPEC aggressively follows through on its recent decision to defend its "fair" share of the oil market. Oil demand is expected to fall in early 1986, primarily reflecting a seasonal decline in consumption. Demand for OPEC crude oil will fall as low as 15 million b/d during the summer months and average 16 million b/d next year—the present OPEC production quota. If OPEC attempts to maintain crude production at its current level of 18 million b/d, oil prices would fall sharply in order to balance supply and demand, perhaps to as low as $15 per barrel—compared to the present official benchmark price of $28.

OPEC's Challenge

OPEC's decision is intended to pressure non-OPEC producers and oil companies to share the burden of maintaining prices. For the OPEC strategy to work production cuts would probably have to be made by Mexico, the United Kingdom and US producers among others. OPEC recognizes that without the threat of a price war, the non-OPEC producers are unlikely to reduce output voluntarily. Some oil companies estimate that as much as 750,000 b/d of production mainly in the United States may become uneconomic at prices somewhat below $20.

OPEC's failure to announce the specific production level it will attempt to defend indicates that it will not act precipitously. The prospect of greater financial pressures may cause OPEC to adopt a production floor closer to its current 16 million b/d output ceiling. Because oil consumption is relatively unresponsive to price changes in the short run, a $10 price drop would raise oil consumption by only about 1 million b/d. In this case, annual OPEC revenues would fall one-third or by more than $40 billion

The Saudi Role

The level of production OPEC ultimately decides to defend will depend in large part on Saudi actions. Although Saudi Arabia has abandoned its role as the OPEC swing producer, if oil prices begin to plummet, Riyadh could choose to restrain its production in an attempt to stabilize prices in the $20-25 range. Riyadh probably would resume its role as swing producer only in exchange for increased production restraint from both OPEC and non-OPEC producers or if oil demand prospects improved sufficiently to guarantee Saudi Arabia a growing market for its oil. 25X1

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Because of the complexity of the international oil market, it will be difficult for OPEC to control a rapid price decline. Unless short-term demand prospects improve more than expected, declining export earnings will increase pressures to boost output even further in order to maintain revenues. The downward price pressure that would emerge could force prices below $15 per barrel, at least temporarily. 25X1

Implications of Lower Prices

The prospect of lower oil prices is generally good news for energy consumers. Falling prices help keep inflation under control and give impetus to economic expansion. Some consuming countries may raise taxes or implement import tariffs to reduce budget deficits. Oil exporting debtor countries such as Mexico, Nigeria, and Venezuela, however, would suffer major economic setbacks if 25X1

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prices fall sharply, perhaps triggering another international financial crisis. At $15 per barrel, Mexican oil revenues would be reduced by about $6 billion. For the longer term, lower prices could raise oil demand, slow oil and gas supply development, and hasten a return to a tight market situation.

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Spanish Arms Exports: A Successful Program Facing Economic Constraints [redacted]

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Spain has become a competitive arms supplier to the Third World in the last six years and is trying to expand its niche in the market. Spanish arms sales to developing nations totaled more than $3 billion in 1979-84, making Spain the leader among Western Europe's "second-tier" arms suppliers. The Socialist government—despite its original pledge to tighten arms export policy—is trying to increase sales further to finance modernization of the defense industry, maintain domestic employment, and improve Spain's trade position. The government's effort will probably be unsuccessful because of the general downturn in Third World arms purchases and stiff competition from larger suppliers, such as France. In the face of these problems, Madrid will likely approve more sales inimical to US interests while pressing Washington for a better balance on bilateral arms trade. [redacted]

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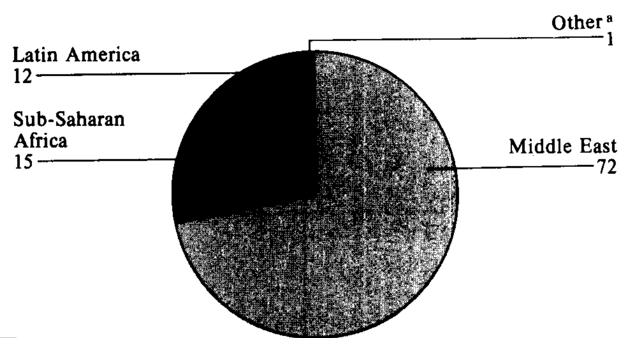
Spain: Arms Sales by Region, 1979-84

Percent



[a] Exports to Asia and Europe.

[redacted]

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Recent Trends

Madrid's concentration on the Third World market enabled it to sell more than $3 billion worth of military equipment and services in 1979-84, almost quadrupling sales of the preceding six years. Although Spanish sales do not approach the $2 billion or more that France, Britain, Italy, and West Germany each sells annually, Spain has moved ahead of all other second-tier West European suppliers, such as Switzerland, Belgium, and Sweden. Unlike the top four, none of the second-tier suppliers can produce a full range of naval, air, and ground weapons. As a result, each focuses on a more limited range of products. Spain has carved out a niche in the Third World market by building a reputation for quality production of ammunition, small warships, and jet trainer and transport aircraft. [redacted]

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International market conditions have provided a further boost to Spanish sales:

- Latin America became Spain's third-largest market when Chile and Argentina were forced to turn to alternative suppliers after US embargoes were imposed in 1976. The brief Soviet embargo of Iraq and sales limitations imposed by larger West European suppliers on Iran also created openings.

Spanish Arms Sales:
Leading Customers, 1979-84

	Total (*million US $*)	Equipment
Egypt	1,429	Warships, personnel carriers
Iran	389	Ammunition, antitank guns
Sudan	330	Ammunition
Saudi Arabia	219	Amphibious vehicles
Iraq	154	Ammunition, military construction
Mexico	147	Patrol boats
Argentina	112	Patrol boats
Somalia	53	Ammunition
Chile	50	Jet trainers
Equatorial Guinea	38	Ammunition

[redacted]

- Conflicts in Latin America and the Persian Gulf have provided opportunities to Spain. Madrid's lack of sales restrictions have allowed it to sell transport aircraft to both Nicaragua and Honduras and ammunition to Iran and Iraq.

- Arab states seeking to diversify their arms suppliers have favored Spain because of its pro-Arab stance despite recent moves toward establishing relations with Israel. Saudi Arabia has become a major customer at least partly for this reason. [redacted]

An Economic Motivation

Domestic economic conditions are the primary factors behind the effort to increase foreign sales:

- Orders from the Spanish military are small and sporadic, and exports are necessary to keep production lines open and reduce unit costs.

- Foreign sales have helped the arms industry remain a bright spot in an otherwise dismal national employment picture. While many Spanish industries have been forced to cut production since 1978, the arms industry continues to work around the clock. Although unemployment since 1980 has risen from 18 to 22 percent, employment in the arms sector of 65,000 workers—less than 1 percent of the labor force—has remained stable in the same period.

- The defense industries export 60 percent of their production and account for almost 3 percent of Spanish exports. [redacted] 25X1

Prior to assuming power in January 1983, the Socialist Party was critical of arms exports to pariah states or regions of tension in the Third World and promised more restrictive regulations. The strength of Spain's arms sales program and its impact on domestic employment apparently convinced the Socialists by late 1983 to revise their position and seek to further increase exports. In fact, arms sales since the Socialists took office have risen almost 500 percent over the level of the previous two years. [redacted] 25X1 25X1 25X1

Keys to Success

Spain has used cooperative production agreements with US and West European firms, meant originally to serve Spanish military needs, to acquire technologies and experience for developing weapons geared to the needs of Third World customers. [redacted] Construcciones Aeronauticas, for example, designed the multirole C-101 Aviojet trainer and C-212 Aviocar transport with US and West German assistance. Empresa Nacional Bazan—which coproduces Italian and Swedish naval guns—teamed with a research organization to develop the Meroka point-defense gun. The Meroka's reliability and simple operation have generated much market interest. [redacted] 25X1 25X1 25X1

Spain has followed a very permissive sales policy approving arms sales to almost any government regardless of human rights or political considerations. [redacted] Spain has helped fill the gap for governments, such as Argentina, Chile, and Iran, embargoed by the major suppliers. Spain—like other second-tier suppliers—is also willing to maintain secrecy in politically sensitive sales to such governments. [redacted]

The Spanish Government aggressively markets its products through DEFEX, the official arms marketing organization. [redacted] most Spanish arms producers have traded their right to sell their products independently in exchange for the government's agreement to absorb all promotional and marketing costs. DEFEX maintains offices worldwide and does multilingual merchandising through catalogues and trade journals. DEFEX agents reportedly are given wide autonomy to approve sales without prior consultation with Madrid, [redacted]

The Spanish Government also supports its arms sales by providing export credits. According to US Embassy reporting, the Ministry of Commerce extends credit through the Development Assistance Program at interest rates as low as 5 percent with 18-year repayment and no downpayment. The Spanish financing apparatus is not as formidable as that of larger West European suppliers, such as France and Italy, and financing for any purchase is usually limited to $50 million or less. [redacted]

Outlook

The Socialist effort to increase sales is unlikely to succeed because of economic problems and changing market conditions in the Third World. Large public-sector budget deficits and international debts in many of Spain's major Third World markets are already having a negative effect. [redacted] Argentina has experienced difficulties paying for naval craft bought from Spain, and funding shortages forced Cairo to request aid from a Saudi businessman to finance the bulk of its 1983 naval purchase. The US Embassy reports that a high-ranking Spanish official has expressed anxiety over the credit terms that Madrid continues to offer to clinch deals. [redacted]

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Spain is facing greater competition from other suppliers bent on maintaining their own sales in a declining world arms market. [redacted] Brazil, for example, is stepping up its marketing efforts throughout the Third World, while British and French manufacturers continue to concentrate on the Middle Eastern market. We believe Spain will be unable to meet the favorable financial terms larger governments are offering on major equipment, but Spanish sales of less expensive, lower technology items such as ammunition are unlikely to be affected as much. Purchases of major equipment to diversify suppliers may also dwindle under the growing requirement to standardize inventories in a time of budgetary constraints. [redacted]

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Implications for the United States

Declining earnings from arms sales will hinder Spain's efforts to expand and modernize the arms industry and provide fewer funds to meet startup costs for new programs. Moreover, Spain's own tight defense budget is unlikely to offer much help. [redacted]

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In our view, lagging Spanish arms sales will prompt Madrid to pursue more arms transfers that are inimical to US interests. Spain appears willing, for example, to sell arms to Libya and Nicaragua. Although Madrid has taken into account US concerns in some sensitive sales, [redacted]

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The downturn in Spanish sales will also put more pressure on Madrid to seek a more favorable balance in arms trade with the United States. Madrid wants Washington to purchase more Spanish arms under the revised Mutual Defense Treaty to allow it to justify further purchases of US equipment. Spain claims that the US response will be a major factor in its decision to renew the Defense Treaty in 1987. We believe this is an overstatement, but Madrid will probably use the US response in part to determine the level of future purchases of US arms. 25X1

On the positive side, the United States may benefit indirectly from those Spanish arms sales that extend Western influence and security assistance to countries where a direct US connection is difficult—for example, Iraq and Taiwan. Spain's pro–Third World stance, moreover, places it in a good position to offset the Soviet presence in some Sub-Saharan African and Middle Eastern nations that do not buy US arms—such as Angola. 25X1

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United Kingdom: Revival of Arms Sales [redacted] 25X1

A series of recent agreements with several Third World countries will end a four-year slump in British arms sales and bring renewed life to UK defense industries. Besides the sale of Tornado aircraft to Saudi Arabia and Oman, the British have negotiated major deals with Jordan and India for ships, planes, missiles, and communications equipment. The revival is due in part to a more sophisticated British sales program combining more attractive financing and Prime Minister Thatcher's personal support. These new incentives may presage a more aggressive export campaign in other Third World countries. The increase in arms sales will benefit British industry and encourage NATO purchases of British equipment by reducing unit costs for individual systems, providing a greater return on R&D investment, and—in the case of the Tornado sale—reducing startup costs for the new European Fighter Aircraft. [redacted]

Estimated Dollar Values of Military Equipment Deliveries by West European Suppliers in 1984

	Billion US $
France	3.3
West Germany	2.2
Spain	1.0
United Kingdom	0.97
Italy	0.95

[redacted] 25X1

The Slump and Its Impact on Industry

For most of the post–World War II era, the United Kingdom was among the world's leading arms exporters, ranking third behind the United States and the Soviet Union. Since 1981, however, Britain's position in the international arms market has declined steadily, slipping by 1984 to fourth in Western Europe behind France, West Germany, and Spain. [redacted]

The arms export market is critical to the profitability and survivability of British defense industries, which typically employ some 400,000 workers. Exports generally account for about a fourth of production, including more than half the fighter, attack, and trainer aircraft. Sixty percent of aerospace manufacturing and one-third of shipbuilding are devoted to military work. [redacted]

Declining export sales since the late 1970s have led to layoffs in several defense industries and have forced the closing of at least one shipyard. According to attache reporting, Vickers, a tank manufacturer, plans no new hiring and will streamline its 25X1
current work force through attrition. The Royal Ordnance factories also will cut employment once production of gun tubes for Egyptian tanks ends. Without the recent Tornado sale, some 30,000 workers reportedly would have been laid off when Tornado production ended. [redacted] 25X1

Foreign Buyers

Sales of British armaments are concentrated in a few Middle Eastern and South Asian countries that 25X1
maintain close security assistance relations with the United Kingdom. India, Saudi Arabia, Jordan, and Oman accounted for roughly half of UK military deliveries during 1980-84. Elsewhere, Britain sells arms to its European allies and has developed a limited market for aircraft in Nigeria. The British also have established joint ventures with US firms for production of Harrier jet fighters and Hawk trainers that promise to bring several billion dollars 25X1

of defense work to British industry over the next few years. In fiscal year 1984, for example, the United States bought nearly $500 million worth of British military equipment.

Aerospace and electronic equipment account for more than half of British military exports, with Jaguar fighters and Hawk trainers heading the list. Ground forces equipment—such as Chieftain tanks and FH-70 field guns—have played a lesser but still important role, representing 15 to 20 percent of annual exports. The British also provide substantial training and support services. In 1982, for example, they signed a $581 million contract with the Saudi Air Force for training and maintenance.

The Nascent Revival

The large sales of British military equipment this year reflect a continuing reliance on their primary export markets rather than a major expansion into new markets:

- India has agreed to purchase the aging aircraft carrier Hermes—which will be overhauled by British firms—plus 11 Sea Harriers and 26 Sea Eagle antiship missiles for $316 million.

- The deal with Saudi Arabia involves 72 Tornado fighters and 30 advanced Hawk trainers for $5.6 billion. British industry will receive approximately $3.6 billion from the Saudis with the remainder going to Britain's West German and Italian partners in the Tornado program. Support packages—including spares, technical assistance, and service over the life of the aircraft—will generate another $5 billion.

- In Jordan, the provision of $360 million in military equipment for the most part supports British equipment already in Jordan and may include a training package similar to that regularly provided Saudi Arabia.

The revival of arms exports will help stem the growing costs of British weapon systems to other countries and may enable the Ministry of Defense to preserve procurement programs in the face of tighter budgets. Higher production runs will lower unit costs and allow for the recovery of R&D costs. In the case of aircraft, for example, the equipment purchaser pays a unit manufacturing cost plus a proportional share of the total R&D cost of the aircraft. The R&D costs are divided over the projected total quantity of aircraft to be produced. When additional aircraft are sold, each buyer may be refunded a portion of its original R&D costs. R&D expenditures make up about 11 percent of the UK defense budget and represent important seed money necessary to keep design teams together and develop new weapon systems.

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Prospects

The $3.6 billion Tornado sale should keep Tornado production lines open until the new European Fighter Aircraft (EFA) takes its place in the early 1990s. With the transition to EFA, Tornado facilities will have to be retooled, but other potentially large startup costs, including training skilled workers, should be reduced. The Tornado sale also should give a significant boost to overall economic activity and employment. Using our econometric model of the British economy, we estimate that, if the sale had not gone through, 30,000 jobs in the aerospace industry would have been lost, plus another 20,000 to 30,000 laid off from jobs indirectly dependent on Tornado production. The sale also should raise real GDP about 0.4 percent, and the foreign trade balance should improve by about $300 million. If UK arms sales reach $8 billion in a three-year period, as the press has speculated, the economic effects would be roughly double those of the Tornado sale.

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Many of the new arms deals are attributable to a more sophisticated sales effort and aggressive, personal lobbying by Prime Minister Thatcher—tactics that may continue to help exports. For example, British negotiations with India were successful in large part because of London's ability to offer flexible financing and pricing, including a 2.5-percent discount for the Sea Harriers. Rigid financing and high unit costs in the past have made

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Major British Deliveries of Military Equipment, 1980-84

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System		Recipients
Aerospace		
Jet combat aircraft Jaguar Hawk		Finland, India, Indonesia
Transport aircraft		Burkina, Madagascar, Suriname
Helicopters Sea King Lynx Commando		Australia, India, Argentina, Norway, West Germany, France, Denmark
Missiles and launchers Blowpipe Rapier Swingfire		Australia, Thailand, Qatar, Egypt, Singapore, Chile, Nigeria, Portugal, Norway, Ecuador
Ground forces		
Tanks Chieftan Vickers		Jordan, Oman, Nigeria, Kenya
APCs, AFVs, and ARVs		Malaysia, Nepal, Kenya, the Philippines, Sri Lanka, Thailand Nigeria, Iraq, Tanzania, Portugal, Oman, Ireland, UAE
Artillery pieces FH-70 105-mm field gun		Saudi Arabia, UAE, Ireland, Nepal
Naval craft		
Patrol boats		Australia, Nigeria, Trinidad and Tobago, Lebanon, Saudi Arabia, Oman, Egypt
Mine-clearing vessels		Greece
Frigates		Bangladesh

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Implications for the United States

Continued British aggressiveness, particularly in courting the Middle Eastern arms market, could present a serious challenge to US industry. Recent sales suggest that Middle Eastern countries are attempting to diversify their Western arms purchases to avoid an overdependence on the United States. According to press and attache reporting, many Middle Eastern customers view the US decisionmaking process in arms sales as overly political and heavily burdened by technology-transfer issues that are less a problem with European arms producers. [redacted]

London's recent sales could provide the British with incentives to offer the same attractive financing arrangements in future sales to make their high-quality weapons available to other countries that may prefer a non-US supplier for their weapons. [redacted]

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British military equipment unattractive to financially constrained Third World countries. And, according to attache and press reports, the Prime Minister's personal salesmanship played a key role in winning the Saudi aircraft contract and also helped seal both the jet fighter deal with Oman and the Jordanian arms package. [redacted]

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British industry still must overcome several weaknesses before it can return as a viable long-term competitor with other Western suppliers. The recent sales indicate Britain has not broadened its narrow customer base. France and Italy, for example, make sizable sales in Latin America, East Asia, and Africa in addition to the lucrative Middle Eastern market. The new British pricing discounts and financing packages may increase their competitiveness in these markets. Nonetheless, British industry continues to design and develop equipment primarily suited for use on the European battlefield and has yet to follow the lead of France and Italy in tailoring its weapon designs for Third World use. [redacted]

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[redacted]

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Iran: Increased Vulnerability of Economic Facilities [redacted] 25X1

Deterioration of Iran's economic facilities since the revolution has made them more vulnerable to Iraq's recently expanded war of economic attrition. In the past few weeks, Iraq has augmented hitting Khark Island with limited attacks on industrial targets, including pipelines feeding Iran's refineries, a steel plant, and hydroelectric stations. Although these attacks so far have not imposed significant additional hardships on the Iranian people, an Iraqi campaign that damages key facilities would seriously undermine Iran's economy. Should this occur Tehran is likely to retaliate against similar Iraqi targets and threaten to hit industrial targets in Kuwait or other Gulf states. [redacted]

Iran's Vulnerability

The tenuous condition of the industrial sector and Tehran's financial straits make Iran more vulnerable to Iraqi attacks. Lack of spare parts and raw materials have forced many factories to shut down or operate far below capacity. Moreover, Tehran is hard pressed to repair war-damaged facilities because of shortages of foreign exchange and skilled technicians. [redacted]

Most critical economic facilities in Iran are virtually undefended because of limited air defense systems. Even those economic facilities that are defended are susceptible to determined Iraqi attacks. For example, Khark Island's defenses are more extensive than those at other economic targets, yet they have been unable to stop repeated high-altitude bombing or even occasional low-altitude Iraqi air raids. [redacted]

Despite the vulnerabilities, recent Iraqi attacks on economic targets besides Khark appear so far to have had little effect on Iran's economy. Baghdad has launched only a few raids on industrial facilities near the border and shown no determination to destroy the targets. The three industries attacked—electric power, oil refining, and steel—however, already suffer from production problems. [redacted] 25X1

Persistent Electric Power Problems

This past summer, without Iraqi interference, Iran suffered its worst power shortages since the revolution, according to the Iranian press. There were regular blackouts of up to eight hours a day in Tehran and most other major cities. Subsequent repair to some facilities and reduced demand for electricity in the cooler weather have eased problems somewhat. [redacted] 25X1 25X1

Iran's electric power troubles have grown as the government has pursued a strategy of providing power to as many people as possible. Capacity limitations have been aggravated by widespread maintenance problems, isolated acts of sabotage, and a shortage of skilled technicians. Moreover, Iran's failure to integrate its power grid has led to more frequent and severe outages than would otherwise be the case, [redacted] 25X1 The regime blamed last summer's outages on other nations, in particular the Soviet Union, which withdrew technicians from several plants last spring following Iraq's bombing of cities. [redacted] 25X1 25X1 25X1

[redacted] periodic power outages have dampened already weak industrial output. Electricity failures not only reduce production directly but also cause voltage fluctuations that burn out difficult-to-replace equipment. Loss of refrigeration during power outages also has damaged valuable supplies of food and medicine, according to the Iranian press. [redacted] 25X1 25X1 25X1

Vulnerability of Iranian Economic Targets to Iraqi Attack

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Iran's electric power system is especially vulnerable to attacks on transmission lines, but the most serious damage would be at principal transformer stations or generating plants that serve large urban centers and industrial complexes. Since September, Iraq claims to have attacked both of Iran's principal hydroelectric plants, [redacted]

These two plants are located less than 200 kilometers from the Iraqi border and account for 15 percent of Iran's electrical capacity. [redacted]

Refineries Fall Short of Domestic Needs

Iran has recovered considerably from the loss of its Abadan refinery early in the war, but still must import about 100,000 b/d of refined products—one-seventh of domestic needs. To keep imports down, refineries have been operated as much as 30 percent above design capacity [redacted] Refinery capacity is concentrated at Tehran and Esfahan that provide 75 to 80 percent of output [redacted] Another 10 to 15 percent is provided by the refinery at Tabriz. Moreover, all refineries—except the very small refinery on Lavan Island—receive oil by pipelines from Iran's southern oilfields. [redacted]

A prolonged shutdown of a large portion of Iran's refining capacity would create severe economic problems. With limited stocks, Iran would suffer almost immediate shortages of gasoline and heating fuel. Iran's transportation system would be disrupted, creating urban shortages of a wide variety of items and causing logistic problems for the military. Winter fuel shortages, a recurring source of considerable domestic discontent, would worsen. Tehran would be unable to import significant additional supplies to offset the shortfall because unloading facilities are near capacity. [redacted]

Prime Iraqi targets are the two pipelines feeding refineries at Tehran, Esfahan, and Tabriz. [redacted] in the first week of November Iraq damaged three pumping stations along these lines, [redacted] So far there are no indications that refinery operations have been affected. [redacted]

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Steel Industry: A Tempting Target

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Iran's steel mills are crucial to its industrial development plans and the biggest nonoil industrial employer. Steel capacity is split almost evenly among three mills, two near Esfahan and the third in a suburb of Ahvaz. Also near Ahvaz are facilities that produce steel pipe for the National Iranian Oil Company. None of the mills are operating at full capacity because of a lack of raw materials, spare parts, and skilled technicians. The Soviet-built facilities near Esfahan, in particular, are experiencing difficulties because of the departure of Soviet technicians last spring, according to the Iranian exile press. [redacted]

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The proximity of the Ahvaz steel mill to Iraqi airbases makes it an easily accessible target. In early November the plant was bombed twice in some of the largest air raids of the war; Iraq used about 30 planes in each attack. Tehran admitted that 28 workers were killed in the first attack and several more in the second [redacted]

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The attacks on Ahvaz to date probably will have only a minor impact on the Iranian economy. Further attacks, particularly in combination with attacks on the mills around Esfahan, however, would harm construction and factory operations. Repairs are already under way at Ahvaz, and Iran's other steel mills may be able to make up most of the loss. To the extent Iraq reduces Iran's steel output, Tehran would be forced to reallocate scarce foreign exchange in order to make up the shortfall. [redacted]

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Outlook

Despite Iran's vulnerability, Baghdad's irresolute use of its air power probably will prevent it from doing any serious harm to the Iranian economy. For example, Iraq would have to knock out several pump stations on both refinery pipelines to shut down refinery operations in Tehran, Esfahan, and Tabriz. Attacks such as those on the Ahvaz steel plant will be ineffective as long as other facilities can pick up the slack. [redacted] 25X1

Baghdad's expanded attacks on economic targets probably reflect frustration over the ineffectiveness of its attacks on Khark Island and the need for further means of putting pressure on Iran. Recent Iraqi statements have been playing down the importance of attacking Khark Island and have stressed the near impossibility of knocking out Iran's oil exports. Nevertheless, the US Embassy in Baghdad reports that Iraqi officials insist the campaign against Khark will continue and that the other bombing raids represent a widening of the air war. [redacted] 25X1

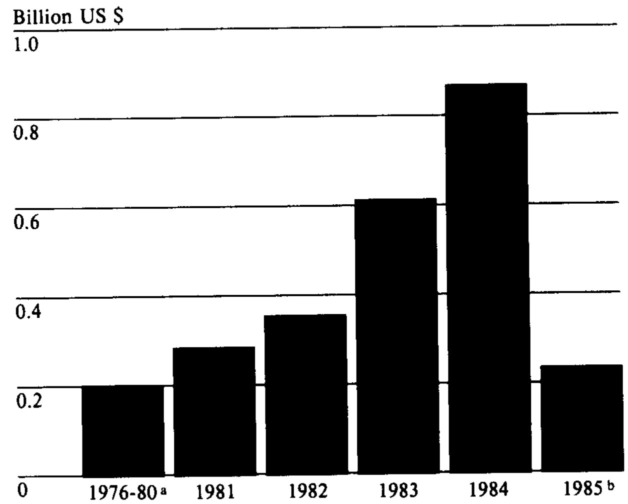
If Iraq mounts an effective campaign against Iranian industrial targets, Tehran would retaliate against economic facilities in Iraq or possibly other Gulf states. Past Iranian attacks on economic targets in Iraq, however, have been largely ineffective because of Iraqi defenses and the poor state of Iran's Air Force. For the time being, we believe Tehran hopes the threat to expand the war to other Gulf states will be sufficient to put pressure on Iraq to stop its attacks. In the face of broader Iraqi raids, Iran may feel compelled to carry out its threats, probably against refineries or desalination plants in Kuwait. [redacted] 25X1

[redacted] 25X1

Angola: Oil Boom Amid Economic Decay [redacted] 25X1

The cost of battling the UNITA insurgency probably has offset most of the economic benefits of the current oil boom in Angola. Oil production, which accounts for nearly 95 percent of Angolan exports, has roughly doubled since 1982 and is projected by industry experts to double again by about 1990. The nonoil sector of the economy, however, is suffering from the impact of the fighting. We believe that growing hard currency payments by Luanda for arms purchases and military services from the USSR, Cuba, and other Communist military suppliers stand in the way of any effort to use the foreign exchange windfall from oil exports to alleviate domestic hardships and spur investment. Even though arms deliveries have declined this year, we believe that service requirements on existing military debt are continuing to rise. As a result, little economic relief for hard-pressed consumers can be expected through 1986. [redacted] 25X1

Soviet/Warsaw Pact Military Deliveries to Angola, 1976-85



a Annual average.
b Estimated value of deliveries through third quarter 1985. Data on additional deliveries to Angola in fourth quarter 1985 are not yet available.

[redacted] 25X1
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Economic Stagnation

We believe that the Angolan economy has achieved little or no economic growth in the 1980s,[1] following a precipitous economic contraction as a result of the exodus of about 400,000 Portuguese settlers after independence a decade ago. The economic problems stem mainly from the impact of fighting the UNITA insurgency, but recovery prospects have been undermined by Luanda's efforts to impose socialism on the society. [redacted] 25X1

The deterioration of Angola's coffee and diamond industries—prior to independence the country's two largest sources of export earnings and employment—exemplify the economic decline:

- UNITA attacks on bridges and poor road maintenance have forced the state-controlled diamond mining company (Diamang) to operate a costly 1,900-kilometer airlift to get fuel, machinery, and supplies from Luanda to the mines. Shortages resulting from these transport constraints and severe losses from smuggling have reduced diamond production by 40 percent since 1980, according to a press statement by the president of Diamang. Reduced volume, plus a steep drop in diamond prices, cut the value of diamond exports by 85 percent to $64 million in 1984.
- In addition to problems caused by the insurgency, the coffee industry has suffered from managerial deficiencies. Only about one-fourth of the area planted in coffee when colonial rule ended is in

[1] Angola has not published any economic statistics since independence. [redacted] 25X1

full production, according to a recent press statement by the Vice Minister of Agriculture for Coffee. Production totaled less than 25,000 metric tons in 1984—only about 10 percent of preindependence output—[redacted]

Production of corn and cassava, the main food staples in Angola, has dropped sharply. More than 200,000 people have been driven from the central and southern food producing regions of the country by the fighting, according to Red Cross data. In addition, the government's socialist programs have not replaced the Portuguese-run transportation and marketing systems that provided distribution channels for output by small farmers. These problems have forced Angola, which had exported corn and cassava before independence, to devote up to one-fourth of its export earnings to food imports. Severe food shortages, nonetheless, are widespread in both urban and rural areas. [redacted]

With manufacturing output severely depressed because of the economy-wide shortages of imported parts and raw materials, electric power outages, transportation interruptions, and deficiencies in technical and managerial expertise, sketchy press reporting indicates that few factories are operating at more than about 40 percent of capacity. Food processing plants, which normally account for about one-third of manufacturing output, suffer from transport problems and foreign exchange shortages. Shortages of imported raw materials may force the important textile enterprise in Luanda, ENTEX, to close down, according to reporting in the city's major daily and the official regime mouthpiece, *Jornal de Angola*. Angola's only tire factory is still in operation, but has been forced to shut down for several days on repeated occasions this year because of frequent loss of electric power, [redacted]

Angola: Export Earnings, 1974-84

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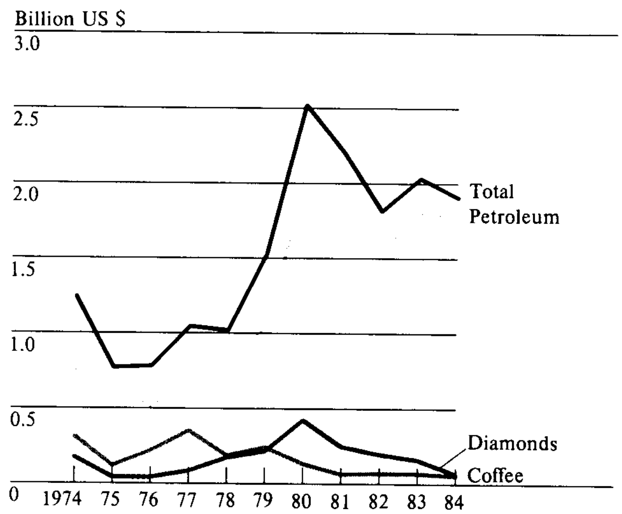

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[redacted]
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Oil Boom

Oil production has been the only bright spot in the economy. Funded and operated by Western oil companies, the oil industry has roughly doubled its output since 1982 to almost 250,000 b/d currently, according to press accounts. Despite the slippage in international oil prices, the rise in production has

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resulted in large increases in Angola's foreign exchange earnings. [redacted]

The economic benefits from the oil boom, however, have been limited. Although rising oil exports have more than compensated for the loss of foreign exchange earnings caused by the decline of the coffee and diamond industries, new employment opportunities in oil production have fallen far short of the number lost on coffee plantations and in diamond mines. Employment in coffee and diamond production has fallen from more than 325,000 workers before independence to about 50,000 to 60,000 currently, according to press reports. In contrast, the oil industry employs only a few thousand workers, and most of these are expatriate technicians and managers. [redacted]

Paying for Communist Arms

Payments to Communist countries—mainly the USSR and Cuba—for arms and military services significantly limit Luanda's ability to use its oil windfall to alleviate economic shortages, in our judgment. We believe that Angola pays hard currency for most of its military assistance, including weapons, foreign personnel, and support. [redacted] Angola also pays hard currency for Cuban combat forces that supplement the Angolan Army. [redacted]

[redacted] payments to Communist countries for arms and military services may equal roughly $1 billion annually. Deliveries of fighter aircraft, helicopters, and air defense and ground force equipment to Angola totaled over $2.5 billion during 1980-85, according to our estimates. In addition, Angola incurred hard currency obligations to pay for military training for Angolans, for the services of technicians to help maintain and operate imported equipment, and for the presence of about 42,000 Cuban troops and technicians. [redacted]

Angolan exports to Communist countries have averaged little more than about $100 million a year since 1980, according to our estimates. As a result,

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payments to Communist arms suppliers have absorbed virtually all of the foreign exchange surpluses earned from oil exports to Western countries. Angola's trade surplus with the West totaled about $1.1 billion in 1984, for example, but net foreign exchange outflows to Communist countries probably exceeded $1.4 billion. [redacted] 25X1

Government Measures

Public statements by government leaders indicate growing concern about the dismal performance of the economy. Economic problems, for example, were a major theme at a national conference of the ruling party in January 1985. Two newly created commissions were instructed to present reports at 25X1 the Second Party Congress this month on ways to improve the economy's performance. Despite speculation [redacted] that the 25X1 Congress would call for increased reliance on private enterprise to supplement operations by large state enterprises, the Congress moved to increase economic centralization. [redacted] 25X1

The regime is seeking Western economic help. It signed an agreement with France in January 1985 for aid to help restore coffee production. Angola 25X1 also has called on Western firms—particularly the oil companies—for help on a variety of economic 25X1 projects, such as road repairs, hotel construction, and agricultural assistance. Angola signed the 25X1 Lome Convention in April 1985, opening the possibility of EC credits and aid. [redacted] 25X1 25X1 25X1

Prospects

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Prospects for achieving an economic turnaround in 1986 are poor, in our judgment, despite the probability of significant increases in oil production.

Angola: Current Account, 1980-85

Million US$

	1980	1981	1982	1983	1984	1985
Current account balance	**−250**	**−560**	**−125**	**−90**	**−150**	**50**
Trade balance	−60	−135	95	40	100	250
Western	240	200	575	1,000	1,100	900
Communist	−300	−335	−480	−960	−1,000	−650
Service balance [a]	−190	−425	−220	−130	−250	−200

[a] We believe that these data on services, which were published by the National Bank of Angola, do not include foreign exchange outflows for Communist military support. The addition of payments by Angola for the services of Cuban combat forces and Communist technicians would increase the deficit for services by $300-700 million annually, according to our estimates. [redacted] 25X1

[redacted] 25X1

Major problems such as food shortages, disrupted transport, electric power interruptions, and below-capacity manufacturing will continue. [redacted] 25X1

We believe that Angola's oil industry will prosper over the next several years, but with no end in sight to the civil war this improvement will be unlikely to reverse the decline in the rest of the economy. Western oil companies are expanding investment in exploration and development of offshore oilfields, and Luanda has set a production target of 500,000 b/d by 1987. We believe that such volume increases over the next several years probably will more than compensate for any income losses from lower oil prices and that Angola's foreign exchange earnings will continue to rise. Any downturn in world oil sales probably would not significantly affect demand for high-quality Angolan crude oil, which is exported mainly to US East Coast markets. [redacted] 25X1

Prospects for increased Western investment outside of oil production, however, are poor because of the military conflict and the aversion of potential Western investors to Angola's socialist economic system. Although recent comments by Angolan President dos Santos [redacted] indicate his interest in strengthening the private sector in Angola, little liberalization in the planned economy is likely. UNITA leader Savimbi's public threat earlier this year not to release foreign technicians and workers captured by UNITA in Angola has dampened the already marginal enthusiasm of Western firms for further investment. [redacted] UNITA's recently announced intention to target Angola's petroleum industry also undermines investment prospects. [redacted] diamond production—an active UNITA target—will continue to be severely curtailed for the next year or so. [redacted] 25X1 25X1 25X1 25X1 25X1 25X1

The decline in arms deliveries in 1985 will not significantly reduce arms-related foreign exchange outflows over the next year or so, in our judgment, because of continuing requirements to service debt to the USSR and other Communist countries. Paying for Cuban combat forces and other Communist technicians also will continue to drain foreign exchange. [redacted] 25X1

[redacted] 25X1

Eastern Europe–China: Expanding Economic Relations [redacted]

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Eastern Europe's economic links to China are on the upswing after languishing for decades since the Sino-Soviet split. Trade with China has increased this year, and several agreements signed by trade delegations have paved the way for future growth in commercial contacts. Chinese Vice Premier Li Peng in May led a delegation—the highest ranking group to visit Eastern Europe in more than 20 years—to East Germany, Poland, and Hungary that underscored each side's interest in expanded ties. Nonetheless, Beijing's continued interest in acquiring advanced Western technology and growing Soviet pressure for intra-CEMA economic integration are likely to prevent such trade from acquiring major significance for either China or Eastern Europe. [redacted]

Renewal of Trade Ties

Soviet and East European advisers helped China build many industrial plants in the 1950s but left abruptly when Moscow and Beijing broke relations in the early 1960s. Although Beijing continued some cooperation with Eastern Europe, such as a Sino-Polish joint shipping company, most ties were suspended. The first signs of a thaw in relations did not appear until the early 1970s when Romania's desire to demonstrate its independence from Moscow led Bucharest to establish closer links to China. Romania soon became China's single-largest trading partner in Eastern Europe, but economic relations with the other countries remained minimal. In fact, Sino–East European two-way trade declined about one-third from 1980 to 1984, and Eastern Europe's share of China's trade dropped from 6 percent to 3 percent over the period. [redacted]

In the past two years, both sides have sought to revive commercial ties. In 1984, a delegation from the Chinese State Economic Commission followed by Chen Muhua, then the Minister of Foreign Economic Relations and Trade, visited several East European countries. Several delegations explored mutual cooperation and ways to improve economic efficiency. [redacted] Chinese Vice Premier Li Peng's May visit to Eastern Europe resulted in five-year trade pacts with Warsaw and Budapest. Since then, the other East European states except Bulgaria have concluded five-year trade pacts with China as well as other formal economic agreements. Li Peng is scheduled to visit Bulgaria to promote trade in mid-December, and a long-term trade accord may be reached then. [redacted]

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Of all the East European countries, Poland is expanding its trade with China the fastest. According to the Polish press, total trade will nearly triple this year, led by large sales of Polish mining equipment and vehicles. Polish exports to China in the first half of 1985 were 72 percent greater than those for the same period of last year, according to Polish trade statistics. On 23 November, the senior economic planning officials for China and Poland signed an agreement calling for closer contacts between the state planning commissions of the two countries. At the signing, both officials said that bilateral trade between the two countries over the next five years would actually be about 40 percent greater than the amount planned in their five-year trade protocol signed last May. Hungary's trade with China also increased in the first half of 1985, with exports rising 90 percent and imports 74 percent over the same period last year. Czechoslovakia and Bulgaria planned 30-percent increases in their trade with the Chinese for this year. Although Romania continues to be China's major trading partner, Beijing is resisting Romania's pitch for

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Chinese Trade With Eastern Europe, 1983-84 [a]

Million US $

	Chinese Exports		Chinese Imports		Trade Balance	
	1983	1984	1983	1984	1983	1984
Total	**668.1**	**587.4**	**840.2**	**1042.6**	**172.2**	**455.2**
Bulgaria	23.9	27.9	14.7	20.2	9.1	7.7
Czechoslovakia	90.1	103.8	112.7	124.6	−22.6	−20.8
East Germany	59.0	85.9	186.8	131.2	−127.8	−45.3
Hungary	25.9	27.8	45.3	58.9	−19.4	−31.1
Poland	163.5	100.6	99.8	160.0	63.7	−59.5
Romania	289.7	222.8	309.1	448.9	−19.4	−226.1
Yugoslavia	16.0	18.6	71.8	98.8	−55.9	−80.2

[a] Although Eastern Europe's trade with China is conducted primarily in barter, prices are attached to traded goods and any deficits are registered in clearing accounts. Through the 1980s, the Chinese have run sizable deficits with East European countries and are pressing them to close the deficits by importing more Chinese goods.

even greater trade, in part because of improved ties to the rest of Eastern Europe, according to the US Embassy in Bucharest.

Chinese trade with Yugoslavia and Albania also is increasing. According to the Yugoslav press, total trade between China and Yugoslavia for the first 10 months of 1985 was double that of the same period last year. The two countries signed a five-year trade protocol in October that calls for Sino-Yugoslav trade in the 1986-90 period to increase fourfold over the level for the previous five years. Politburo member Hu Qili visited Yugoslavia in November mainly to encourage greater economic cooperation, according to the US Embassy in Belgrade. On 3 December, China and Albania signed a trade protocol for 1986 and a trade pact for 1986-90, their first long-term trade accord since they split in 1978.

Motives for Expanded Trade

Both Eastern Europe and China see gains from closer economic cooperation. Trade may expand without using limited hard currency reserves because each produces goods the other can use and is willing to barter. Also, each side gains an outlet for goods that are not competitive in international markets because of low quality, low demand, or protectionist measures. While not as advanced as Western equipment, East European–manufactured goods—vehicles, machine tools, agriculture and mining equipment, and electric power generating equipment—can still make a useful contribution to China's modernization effort. Chinese shoes, textiles, clothing, tools, and agricultural products can help ease chronic shortages of food and consumer goods in Eastern Europe.

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Political motives also have figured in the recent moves to expand economic relations. The Chinese probably see trade as a lever to increase their influence in Eastern Europe and partially offset current Soviet efforts at closer CEMA integration. For their part, the East Europeans apparently have concluded that closer economic links are now acceptable given the warming of Sino-Soviet relations, particularly the signing of a Sino-Soviet five-year trade accord earlier this year. Moreover, the

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Sino–East European Five-Year Trade Pacts

China has signed bilateral trade protocols this year with virtually every country in Eastern Europe. Bulgaria, the sole exception, is still negotiating with Beijing. Coming as the countries' five-year plans are being completed, the trade agreements are intended to assist central planners in coordinating their long-term foreign trade. Each agreement sets out a general framework for negotiating annual trade protocols plus broad targets for the volume of trade over the 1986-90 planning period. Moreover, the pacts provide the Chinese and East Europeans with a rationale for continued dialogue and improvements in overall political and economic relations:

	Date	China Delivers	China Receives
Poland	May	Rice, maize, soybeans, shoes, cotton, clothes, textiles, porcelain, minerals, tea	Power generators, trucks, mining equipment, copper
Hungary	June	Rice, fruits, shoes, tea, cotton, clothes, vegetables, cooperation in agriculture	Steel, aluminum, trucks, medical instruments
East Germany	July	Rice, oil, corn, textiles	Railroad cars, trucks, combines, agricultural harvesters
Romania	October	Coal, coke, crude oil, chemicals, nonferrous metals, clothing	Railroad cars, tractors, oil drilling and mining equipment
Czechoslovakia	October	Cereals, meats, tea, chemicals, minerals, clothing	Machinery, iron, steel, railroad cars, technical assistance in energy production
Yugoslavia	October	Textiles, rice, soybeans, oil	Sheet metal, trucks, buses, fertilizer
Albania	December	Cotton, tires, rice, chemicals	Chromium, copper
Bulgaria	Negotiations continue		

[redacted]

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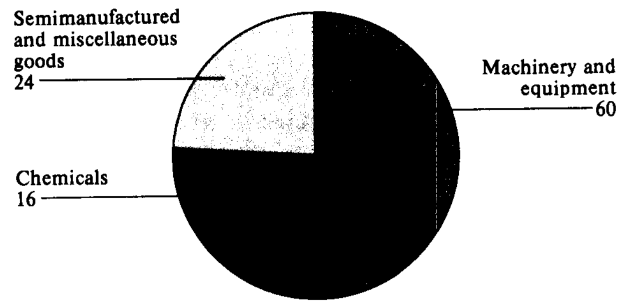
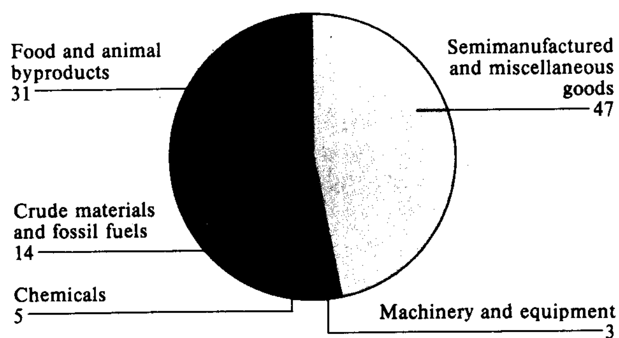
Chinese Trade With Eastern Europe by Commodity Category, 1984[a]

Percent

Chinese Imports From Eastern Europe



Chinese Exports to Eastern Europe



[a] Excluding Yugoslavia and Albania.

[redacted]

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East European regimes have their own interests in cultivating Beijing. East Germany, for example, sees this as enhancing its international prestige while the reform-minded Hungarians want to build relations with a similarly inclined socialist state. Outside the Bloc, Albania and Yugoslavia probably want to improve their relations with another non-aligned Communist country. Albania's recent agreement to a five-year trade pact with China may indicate that the successors to the late Party boss Enver Hoxha want to modify his xenophobic and autarkic external policies.

Outlook

The recent bilateral trade and cooperation agreements set the stage for growth in trade between the two regions through the rest of the decade. Nonetheless, several factors will prevent the trade flow from acquiring major significance:

- Eastern Europe lacks sufficient production capacity to meet a large share of China's total demand for manufactured goods.
- China's main needs are products embodying higher levels of technology and quality available only in the industrial West.
- Eastern Europe's need to satisfy increasing Soviet demands for more and higher quality exports will limit the amount of goods available to support trade with China.
- Each side's need to maximize hard currency earnings means the Sino–East European connection will receive only secondary attention.
- The inflexibility of a barter system will restrict trade to the extent that each has only a limited need for the products of the other.

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We believe that political developments will continue to influence the growth of East European-Chinese trade. The East Europeans will watch closely the evolution of Sino-Soviet relations in deciding how to approach their commercial dealings with Beijing. While the Chinese will assign a small role to Eastern Europe in their trade as long as they continue to expand relations with the West, this could change if political or economic considerations forced Beijing to curtail trade with the West. 25X1

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Briefs

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Energy

Algerian Gas Contract Renegotiations Under Way

Algiers is currently renegotiating its natural gas contracts with Belgium and Italy, with France to follow at the end of next year. We believe the process will drag on for at least six months. According to Embassy reporting, Distrigaz—the Belgian state gas company—is seeking either a price cut or an agreement to stretch out deliveries. The Italian buyer Snam is asking for a reduction in price, now that Rome has removed its subsidy for Algerian gas purchases. Algerian gas costs European customers as much as $1 per million Btu more than gas from alternative suppliers. The pressure 25X1

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on Algiers to agree to a more realistic price is partially offset, according to Embassy reporting, by Belgian fears of having exports to Algeria shut off and Italian and French hopes of increasing their own sales to Algiers. [redacted] 25X1

Dutch To Purchase Coal From China

[redacted]

The Netherlands signed an agreement last week to purchase 4 million metric tons of Chinese coal during 1986-90. The agreement is China's largest single commodity deal with a West European country. Coal imports—historically from the United States and Australia—cover about 10 percent of Dutch energy demand and generate about 30 percent of the country's electricity. At current coal prices, China is likely to earn as much as $36 million annually. [redacted] 25X1

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International Finance

Spanish Foreign Debt Reduced

[redacted]

Spain's net foreign debt totaled $27.9 billion (17 percent of GDP) in June 1985, down from $31 billion (19 percent of GDP) a year earlier. This is the lowest debt figure since the summer of 1982. The improvement is due to the turnaround in Spain's current account balance—from a $2.7 billion deficit in 1983 to a $2.3 billion surplus in 1984 and a projected $1.9 billion surplus this year. With Spain set to enter the EC next month, this improved debt position will give Madrid some breathing room in adapting to EC membership. The required dismantling of tariff barriers and an inflation rate about 4 percentage points above the EC average will very likely lead to a deterioration in Spain's external accounts. We nevertheless expect a sizable current account surplus in 1986 and a continuation of successful debt management. [redacted] 25X1

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Dutch Capital Market Deregulation

[redacted]

The Hague's decision to further deregulate capital markets is aimed at keeping pace with British and West German deregulation plans and establishing Amsterdam as a leading European financial center. The changes, which take effect 1 January, will allow foreign banks to take the lead in forming syndicates for guilder bonds and to underwrite up to one-third of a bond issue; the current limit is one-fifth. Domestic and foreign banks will also be permitted to offer floating rate notes, certificates of deposit, and commercial paper. Finally, trading commissions on the Amsterdam Stock Exchange will be cut. We expect that banks will establish an Amsterdam interbank offered rate (AIBOR), modeled on London's LIBOR, to serve as a guideline for the new instruments. Domestic banks are worried about increased competition from foreign banks, which already have one-third of the Dutch financial market—US banks in particular are rapidly expanding their presence. [redacted] 25X1

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Global and Regional Developments

LDC Debtors' GDP Growth Projected To Slow

[redacted]

Forecasts by economic consulting firms basically agree with our estimates that growth in key LDC debtors will be about 3.0 to 3.5 percent this year but will decline in 1986 to about 2.5 percent. Mexico is expected to experience the sharpest decline in 1986, [redacted] Most 25X1

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forecasters also expect Brazil's growth to slow. More positively, the Philippine and Argentine economies are projected to bounce back in 1986 after witnessing negative growth in 1985. Chile and Venezuela are also expected to have higher growth next year. Peru is projected to continue to grow at about 2 percent. [redacted] Nigeria's growth will improve a bit in 1986, [redacted] 25X1

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[redacted] 25X1

EC Moves Toward Financial Integration

The EC finance ministers have adopted new directives that will allow a mutual fund to operate throughout the Community once any EC member approves the fund. Although the directives are not binding—each government is responsible for implementing them—they represent a statement of policy toward freer capital movements. The United Kingdom, West Germany, the Benelux countries, and Denmark probably will put the directives quickly into effect, partly because of their governments' support of open markets. France and Ireland probably will take more time because of concern over the impact on capital markets. Countries with foreign payments problems or underdeveloped capital markets—Italy, Greece, Spain, and Portugal—almost certainly will drag their feet until economic conditions are more favorable. Because of their financial sophistication, British brokers and US financial services companies with operations in the Community have a good chance of gaining a dominant share of the market. [redacted] 25X1

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Joint Sino-Japanese Commuter Aircraft Project

Leading Japanese aircraft manufacturers, MITI, and the Chinese are studying the feasibility of joint development of a 30 to 40 seat commuter aircraft. Tentative plans call for a twin turboprop aircraft that would be designed in Japan and produced in both countries. A production run of 600 units is planned, 200 of which would be sold to third parties. In addition to design work, this project could provide Japanese firms with an export market for newly developed avionics and other aircraft parts. The partners will probably have to import or produce under license a US or West European engine. Outside China and Japan this airliner would face stiff competition—manufacturers in nine countries are now marketing six models in the 30 to 40 seat range. [redacted] 25X1

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Libyan Aid to Nicaragua

Libya's austerity budget for 1986 apparently leaves little room for direct financial aid to Nicaragua. Since 1981 Tripoli has provided as much as $400 million to the Managua regime in grants, low cost loans, and oil barter deals. [redacted] Tripoli will help market Nicaragua's agricultural exports worldwide and import increasing volumes of these products to replace direct aid. Libya has imported at least $40 million in Nicaraguan agricultural goods so far this year and could easily double this amount in 1986. The Libyan Arab Foreign Investment Company, LAFICO, probably will manage the marketing effort. LAFICO's worldwide affiliations and frequent use as a tool of Qadhafi's radical foreign policy raise prospects that Tripoli might even try to market Nicaraguan goods in the United States. [redacted] 25X1

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[redacted]

National Developments

Developed Countries

Japanese Government Efforts To Moderate Impact of Stronger Yen

Bowing to political pressure, last month the Japanese Government agreed to temporarily provide low-interest loans totaling $500 million—an amount 10 times greater than what is currently available—to small- and medium-sized companies hurt by the rapidly strengthening yen. Small firms producing for the domestic market and export-dependent companies are now eligible for loans from government financial institutions at a 6.8-percent interest rate instead of the present 7.2-percent rate. [redacted] 25X1

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[redacted]

[redacted] MITI admits that some companies may use the loans to sustain exports, and to appease US concern that the loans would be a form of export subsidy MITI says it will advise the firms to reduce their dependence on exports. [redacted] 25X1

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[redacted]

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British Business Calls for Slower Wage Increases

At its annual conference this fall, the Confederation of British Industries (CBI) began a drive for slower wage increases. The business group argues that recent pay increases have outstripped gains in productivity, thus fueling inflation, hampering British competitiveness, and helping keep unemployment above 13 percent. Government officials are worried that the temporary pickup in inflation to 7 percent this July over last July may have raised union expectations for 1986 contract negotiations. Stressing that inflation is expected to fall to 3.5 percent by mid-1986, CBI leaders want the government to use its influence to keep pay settlements in check. Results from our Linked Policy

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Impact Model indicate that, if the relative price of labor remains constant during 1986-90, unemployment will fall to 11.3 percent by 1990, assuming GDP growth averages 2.5 percent a year. On the other hand, if unions continue the exceptionally high real wage gains of 1984-85 and cause the relative price of labor to rise 4 percent each year, unemployment could hit 16 percent by 1990. 25X1

Limited British Social Security Reform

According to the British press, Social Services Secretary Fowler will publish a White Paper on social security reform—delayed since September by strong public outcry against major welfare cuts—early next week. London reportedly will now propose only modest reductions in the State Earnings-Related Pension Scheme, a heavily subsidized supplement to the flat-rate universal pension, but will not abolish the program as originally planned. The government will also streamline social security by combining several benefits under one new program but has reportedly abandoned plans to cut housing benefits. 25X1 Prime Minister Thatcher is determined to win a third term and probably regards limited reform proposals as necessary to set the stage for later, more fundamental social security changes. The majority of voters and interest groups—including a sizable part of the Conservative Party—opposes any changes in the national pension system. Many moderate Tories, moreover, would prefer to avoid confronting welfare reform until after the next election. Rightwing Tories, however, will very likely criticize the proposed changes as falling far short of Thatcher's ambitious goals and providing only minimal savings. 25X1

Increasing West German Merger Activity

A wave of mergers is reshaping West German industry. The large auto and chemical firms, flush with export earnings, are searching for acquisitions that promise technological spinoffs, while defense suppliers, anticipating drops in military procurement, are seeking financially strong partners. Daimler-Benz recently paid $600 million for AEG, West Germany's second-largest electronics firm, with over $500 million per year in defense contracts. Earlier this year, Daimler-Benz acquired the aircraft manufacturer, Dornier, and the jet engine supplier, MTU. The carmaker is now West Germany's largest private concern and a major defense supplier. Messerschmitt-Bolkow-Blohm (MBB), the nation's largest aerospace firm, recently took control of Krauss Maffei, the 25X1 manufacturer of the Leopard II tank. The Bavarian State government is now urging BMW to buy control of MBB. BMW, however, has bought several small high-tech firms, and may be leery of such a major acquisition. The Cartel Office, which is reviewing the AEG purchase, is likely to approve any merger that promotes efficiency without unduly heightening industrial concentration in a particular sector. 25X1

French Current Account Improves

The French current account registered a small seasonally adjusted surplus for the first nine months of 1985, as compared with a year-earlier deficit of almost $1 billion. For the full year, the surplus should approach $1 billion—a roughly $2 billion turnaround from 1984 and a dramatic change from the $12 billion

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deficit recorded in 1982. Favorable factors include lower imported raw material prices in dollars, the increased dollar value of French exports, and the still slow rate of economic growth, which held down import demand. Nonetheless, a significant attempt to speed growth would quickly wipe out the surplus at a time when Paris is intent on reducing the substantial foreign debt accumulated in the early 1980s. 25X1

Sweden Rejects Major Capital Flow and Exchange Liberalization

After eight years, a divided parliamentary commission has proposed only limited reforms of Sweden's foreign exchange and capital control regime. The commission majority, appointed from the ruling Social Democrats and the trade unions, argued that foreign payments constraints preclude more extensive liberalization. The influential trade unions especially fear that increases in Swedish investment overseas would cost jobs at home and require greater wage restraint in order to maintain competitiveness. Consequently the report recommends only minor changes, such as permitting Swedish firms to hold foreign securities as a hedge against exchange risk and allowing small firms to retire foreign debts before maturity. Other proposals would strengthen central 25X1 bank control of Swedish overseas investment and thus may run counter to OECD agreements on capital flows. By contrast, the minority members, chosen from the opposition and the business community, sought much more extensive deregulation to impose discipline on domestic economic policy and control inflation. The report's main recommendations are subject to a six-month review before the government can introduce legislation to carry them out. 25X1

Swedish Unemployment Declines

An improving labor market is likely to thwart the Palme government's tough stance in the current round of wage negotiations. Total employment has increased by 47,000 since last October while the number of vacancies has also risen. Unemployment has held at about 2.5 percent for the past two months, down from 3.2 percent in September. The percentage of workers in special government-provided jobs has also declined—to 3.8 percent of the labor force, as compared with 4.5 percent a year ago. The government is stressing that large wage increases could weaken export competitiveness. Nonetheless, some 25X1 white-collar unions are seeking annual pay increases as high as 30 percent to increase their pay differential vis-a-vis less-skilled workers. The trade unions, for their part, intend to keep the differential at a minimum. Tight labor market conditions probably will mean higher wage settlements than the government would like. 25X1

Less Developed Countries

Argentina's Grain Crops Damaged

Recent prolonged rains and flooding are believed to have taken a heavy toll on Argentina's wheat crop. As a result, USDA is expected to reduce its wheat production estimate for Argentina from 12.3 million metric tons to perhaps as low as 10.5. Similarly, available wheat exports could fall by 20 percent to

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below 6 million tons. In addition to the wheat setback, Argentina's sunflower seed crop is expected to be down at least 1 million tons and inability to plant corn due to the wet weather will reduce yields. According to a USDA official, current damage to the country's vital grain and oilseed crops could cost Buenos Aires up to $0.5 billion in critically needed export revenues in 1986. Grain and oilseed exports normally amount to $3 billion—roughly 40 percent of Argentina's total export earnings. [redacted] 25X1

Brazilian Drought Damages Agricultural Prospects

Severe drought in southern Brazil since May—"the worst in 100 years"— 25X1
probably will play havoc with Brazil's agricultural production, commodity 25X1
exports, and domestic economy in 1986, [redacted] Despite light rains in early November, [redacted] 25X1
the 1986 coffee harvest will be less than one-half the size of previous annual crops. Brazilian agricultural officials are concerned about 25X1
permanent damage to coffee bushes and citrus trees and about delayed soybean plantings. Production shortfalls of these three crops, which together 25X1
account for more than one-fourth of Brazil's total export earnings, could impede the government's efforts to bolster its trade surplus and meet its foreign debt payments. Furthermore, drought-reduced harvests of beans and corn will strain national food and feed supplies, fuel inflation, and put considerable pressure on the government's new stabilization program. [redacted] 25X1

[redacted] 25X1

Morocco's Mirage Financing Efforts Fizzle

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Morocco last month failed to convince France to provide credits for the purchase of 24 Mirage 2000 fighters. [redacted] 25X1
The decision reflects growing concern among Morocco's creditors over Rabat's financial viability. Morocco continues to have difficulty marketing phosphates—Rabat's primary foreign exchange earner—while agricultural 25X1
exports are affected by drought and the likely loss of European customers after Spain and Portugal join the EC next year. Nevertheless, Morocco is not likely 25X1
to abandon its three-year effort—the UAE, Libya, and Saudi Arabia have reportedly offered funds in the past although none have materialized—to finance the fighters. King Hassan believes Morocco urgently needs the aircraft to replace its aging US-made F-5s and Mirage F-1s. [redacted] 25X1

New Tunisian Investment Measures

Tunisia has sweetened terms for export-oriented foreign investment to boost the country's sagging finances. New investment incentives include an extended corporate tax exemption period, increased profit tax exemptions, and eased requirements for "Tunisification" of company personnel. The US Embassy believes these provisions will help attract investors, particularly those interested in inexpensive labor and easy access to West European, Middle Eastern, and African markets. Investor interest could cool, however, in the event of strong response from unions to removing the requirement for training and employing domestic labor. Unemployment is currently about 20 percent, and government-labor relations already are tense over wage and other austerity measures. Many investors will also remain reluctant until political concerns about Bourguiba's successor are resolved. [redacted] 25X1

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Much-Improved Ethiopian Harvest

[redacted] northern Ethiopia shows the harvest—to be completed this month—will be some 50 percent larger than last year. Rains in the region this year were near or above the norm of the past 15 years and the best since 1979. Crops are poor in some areas, however, especially in Eritrea. According to the UN Food and Agriculture Organization, about 2.5 million people are likely to suffer from malnutrition in the entire northern region. Although the crops are generally good in the north—the area hardest hit by last year's famine—substantial aid will still be required for those areas with poor crops because redistribution of the harvest will be limited and reserves need to be rebuilt. [redacted] 25X1

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Zimbabwean Agricultural Wage Controversy

Harare has partially reversed its decision to double the minimum wage for an estimated 40,000 agricultural workers. Last August, the Mugabe government decided to equalize minimum wages in the tea, coffee, sugar, timber, fruit, and poultry industries with those of miners. This put a number of major Zimbabwean agricultural exporters in a severe profit squeeze and spurred demands by mineworkers for similar increases to restore the differentials, according to US Embassy reporting. Some farm managers attributed the move to a desire by the government to force the closure of large foreign-owned farms, thus freeing some of the most productive land for domestic settlement. The 26 November decision to exempt all producers from the new minimum wage levels—except mainly foreign-owned large farms with processing factories—lends credence to this view. Pressures to exempt these farms are likely to increase, if rising labor costs force the closure of these major employers and foreign exchange earners. [redacted]

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Jute Slump Brings Labor Unrest to Bangladesh

Reduced world demand for jute—Bangladesh's major export—has depressed the prices jute farmers receive, leading to labor strikes and opposition agitation for government subsidies. The price has fallen by about two-thirds from a year ago—not enough to cover growers' production costs. Workers in Bangladesh's largest jute mill went on strike in early November to protest threatened government cuts in their wages. The government negotiated an end to the

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strike, but opposition parties and leftist labor unions held a national strike on 11 November to support the jute workers. The US Embassy reports that the opposition is also demanding that the regime guarantee a higher price for jute-growers. Depressed jute prices give the opposition an issue to use in national elections tentatively planned for next year. [redacted] 25X1

Food Prices Stable in Kabul

During the past year, food prices in Kabul have shown little change, and supplies have been adequate, according to US Embassy reporting. [redacted] food prices outside Kabul have risen, however, because war-related transportation disruptions cause occasional spot shortages. The Soviets have kept Kabul adequately supplied with food despite the city's rapid population growth over the past few years probably to avoid undermining efforts to build support for the Karmal regime. Despite food price increases in areas outside Kabul, weather data [redacted] suggest that supplies are generally adequate there as well. [redacted]

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Philippine Economy Bottoming Out

According to our index of leading indicators—money, prices, trade, profit expectations, government revenues, and manufacturing employment and production—the Philippine economy remains in the holding pattern it entered at midyear. Bullish signals for September include surging stock prices, money supply, and imports, while bearish indicators include declining exports and low inflation. The continued stability of the index suggests that economic growth in the second half of 1985 will probably be close to zero—a considerable improvement from the economy's 3.5-percent decline in the first half of the year. We believe, however, that strong growth in export volume is required before the economy can be judged to have safely turned the corner. Alternatively, continued poor export performance—or a particularly divisive presidential election campaign and heavyhanded manipulation of balloting in February—would unsettle the business climate and contribute to a further contraction of the economy. [redacted]

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Communist

Soviets Seek Western Assistance for New Steel Complex

The Soviets are seeking Western assistance in the construction of a turnkey steel project to be built in Orel, [redacted] The complex will cost over $1 billion and produce nearly 1 million metric tons annually of high-quality steel sheet and strip. Consortiums from Austria, Italy, Japan, and West Germany are bidding on the project, and Moscow is reportedly playing off bidders against each other to obtain the best price. The complex is one of several steel projects mentioned in the 12th Five-Year Plan 1986-90. [redacted]

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[redacted] 25X1

East Germany Buys Soviet Steel Mill

East Germany has purchased a hot-rolled steel mill with a 2.5-million-metric-ton annual capacity from the USSR for its main steel complex at Eisenhuettenstadt. The deal suggests a change in the recent East German policy of buying modern steelmaking equipment from the West, in particular from West Germany and Austria, and may preclude new Western contracts for whole steel plants for some time. East Berlin might have decided to heed Moscow's call for greater CEMA cooperation or found Soviet soft-currency terms offset technology that does not match Western standards. We estimate a mill this size would cost about $500 million if built in the West. While details remain sketchy, the plant could be completed by the end of the decade and could add significantly to East German rolled steel production—5.4 million metric tons in 1984, according to East German statistics. East Germany probably will use the new capacity to reduce imports—which come mainly from the USSR—but may also want to boost steel exports to the West. [redacted] 25X1 25X1

New Bulgarian Energy Measures

The government has restored nearly full electrical power to homes and shops in Sofia, at least temporarily suspending the rationing in effect since February, according to the US Embassy. According to Bulgarian press sources, Soviet leader Gorbachev agreed during his October visit to supplement Bulgarian electricity supplies from the Soviet power grid. A Council of Ministers decree effective 1 December set limits on household consumption. Violators will be subject to a surcharge, while rates will be cut for consumers who use less than the limit. Energy Minister Todoriev also warned of sanctions for chronic abusers of the new system. The increased Soviet supplies are probably a temporary measure to help with increased demand this winter. The regime will quickly reinstate central electricity rationing if the voluntary program fails, or if bad weather this winter strains reserves. [redacted] 25X1 25X1

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