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Directorate of Intelligence

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(b)(3)

International Economic & Energy Weekly (U)

19 December 1986

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DI IEEW 86-050
19 December 1986

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International
Economic & Energy Weekly (U)

19 December 1986

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International Economic & Energy Weekly (U)

Synopsis

DI IEEW 86-050
19 December 1986

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Key GATT Country Groupings

Cairns Group	***LDC Hardliners***	***LDC Moderates***
Australia	*Brazil*	*Singapore*
Canada	*India*	*South Korea*
Argentina	*Egypt*	*Colombia*
Brazil	*Yugoslavia*	*Chile*
Uruguay	*Argentina* [a]	*Uruguay*
Thailand		
Hungary		
Chile		
Malaysia		
Indonesia		
Philippines		
Colombia		
Fiji		

[a] *Has recently distanced itself from the group.*

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International Economic & Energy Weekly (U)

19 December 1986

Perspective

GATT's Uruguay Round: Keeping the Ball Rolling [redacted] (b)(3)

We believe that the burden of maintaining the momentum of the GATT negotiations will largely fall on the United States but may provide opportunities to further US trade policy interests. To maintain progress in the negotiations, the United States will have to contend with several power groups:

- The ***hardline LDCs***—chiefly Brazil and India—are continuing their efforts to hinder progress in the areas of key interest to the United States—services, intellectual property rights (IPR), and investment. By engaging in their usual tactics of obstruction and delay, they are attempting to isolate the effort on services and limit the scope of IPR and investment. On other issues, they are pushing for special treatment for the LDCs, probably in an attempt to solidify LDC opposition to the US initiatives. Efforts to rebuild their power base, which was fragmented during the GATT Ministerial, may be difficult because both countries have already alienated a number of LDCs by claiming to speak for all LDCs without prior consultation and by their uncompromising, hardline positions.

- The ***moderate LDCs*** are not inclined to take a leadership role in the negotiations, especially on the new issues where support is weak. They expect the United States to take the initiative. They were instrumental in reaching a compromise for the draft agenda at the GATT Ministerial and now look for something in return. They expect adherence to the "standstill/ rollback" commitment and rapid progress on traditional GATT issues such as tariffs and subsidies to gain greater access to the US market. We believe that with encouragement they could participate more assertively and, as a bloc, provide powerful opposition to hardliner initiatives.

- The ***developed countries*** are split over agriculture. The United States, Canada, and Australia are pushing for rapid liberalization, while the EC and the rest of Western Europe hope to slow and narrow the focus of the negotiations. On the whole, the developed countries are committed to progress on traditional issues and services and will boost US efforts in these areas. [redacted] (b)(3) [redacted] they will look to the United States for leadership on IPR and investment. (b)(3)

- The ***Cairns group*** of nonsubsidizing agricultural exporters will be the key force on the agriculture issue. The group is attempting to maintain cohesion, meeting informally to coordinate positions. While they maintain the common goal of rapid agricultural liberalization, they differ on tactics. The United States may be forced to play the role of mediator between the group and the EC, as it did during the Ministerial. They also expect the United States to fulfill its pledges on agricultural reform. [redacted] (b)(3)

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International economic developments to a large extent will determine the level of LDC support for the round. If the global economic situation declines, pressures to raise trade barriers, rather than to liberalize, will predominate. The key indicators will be progress on the debt issue, developed country protectionism, and bilateral disputes. We believe a worsening in any of these areas, particularly the first two, will cause the LDCs to seriously question the value of participating in the negotiations. [redacted] (b)(3)

[redacted] (b)(3)

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Modernizing the Soviet Steel Industry: No Easy Solutions [1] [redacted] (b)(3)

Modernizing the Soviet steel industry is crucial to the success of General Secretary Gorbachev's industrial modernization effort. Nonetheless, this sector presents some formidible problems. The overall record of the steel industry during the past 10 years has been one of repeated failure to meet expectations, despite substantial imports of Western equipment and technology. The preponderance of out-of-date domestic machinery has resulted in low quality, a narrow assortment, and frequent shortages of steel products. On balance, we believe the Soviets will fall far short of their steel modernization goals. Without major improvements in the quality and variety of steel products, the General Secretary's program to develop and produce modern technologically sophisticated machinery and equipment will be seriously hampered. [redacted]

The Modernization Program

Moscow has adopted a wide-ranging program for reequipping the Soviet steel industry. In contrast to the past focus on increasing production capacities, the current plan emphasizes plant renovation and replacement of outmoded equipment, specifically by:

- Reconstructing older steel plants.
- Replacing open-hearth steelmaking furnaces with basic oxygen or electric furnaces. Open-hearth steel still accounts for more than one-half of Soviet crude steel compared with less than 10 percent in the United States and none in Japan or West Germany.
- More than doubling the share—currently only about 12 percent—of steel produced by continuous casting by 1990. The US share is about 31 percent; the Japanese and West German, 86 and 72 percent, respectively.
- Upgrading rolling mills and pipe-producing shops to provide the 500 types of new steel products called for in the 1986-90 plan. [redacted]

To reach these goals, the Soviet press reported that 50 percent of investment in the ferrous metals industry during 1986-90 will be used to renovate existing plants, 30 percent will go toward improving variety and quality, and only 20 percent will finance capacity expansion. This is in sharp contrast with past plans, which allocated up to 75 percent of investment to capacity expansion. Overall gains in finished steel output are to be achieved not with increases in production of either inputs such as coke and pig iron or in the size of the labor force, but with increases in labor productivity and resource savings. [redacted] (b)(3)

Roadblocks to Modernization

(b)(3)

The cost of effectively carrying out the program may outstrip the resources available for it. Replacement and renovation of steelmaking furnaces and rolling mills will still require large investment outlays for new equipment and, in many cases, for new facilities to house the equipment at a time when national investment resources will be stretched thin by other demands of Gorbachev's economic revitalization effort. Moreover, domestic machine builders will be unable to meet the demand for more reliable and sophisticated metallurgical machinery until an improved mix of high-quality steel products starts rolling out of steel plants on a large scale. [redacted] (b)(3)

Qualitative improvements in metallurgical equipment production will be further inhibited because such equipment is a sideline at heavy-machine-building enterprises. The proportion of metallurgical equipment in the total volume of output is declining at several of these plants. Moreover, machine-building plants generally lack appropriate incentives for the complex and labor-intensive production of metallurgical equipment. [redacted] (b)(3)

(b)(3)

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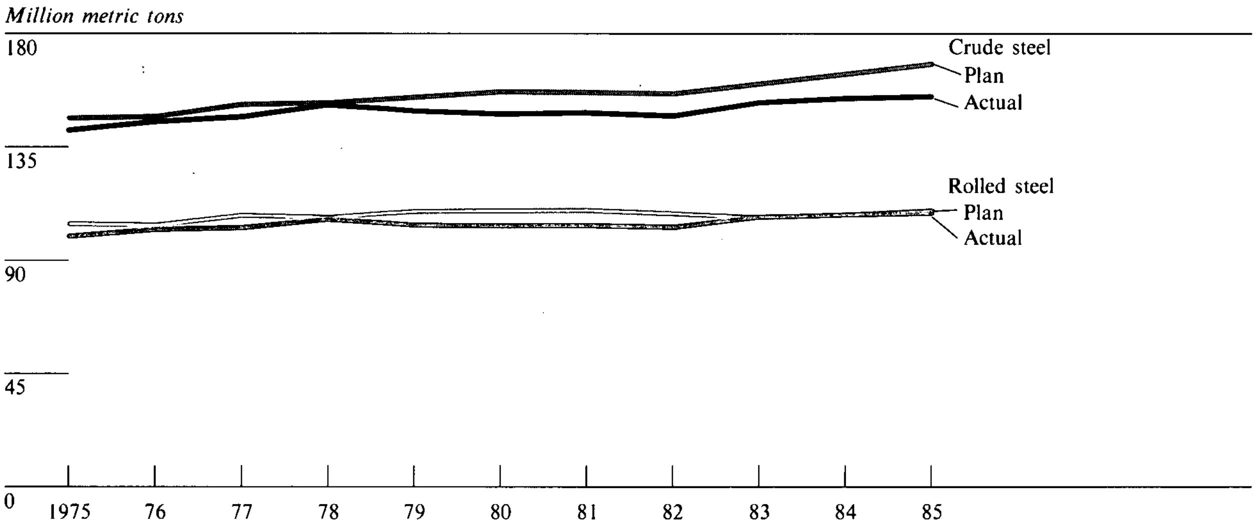
USSR: Production of Ferrous Metals, 1975-85



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In addition to the difficulties in obtaining new and better machinery, a program based on reconstruction and technical reequipment poses near-term difficulties for the operation of the Soviet steel industry. For example, the renovation strategy has traditionally been resisted by managers of steelmaking enterprises because the downtime required to replace old machinery, as well as the uncertainty inherent in new production processes, threatens their achievement of short-term performance goals. An equal concern is how quickly workers adapt to the new equipment, which often is more complex and requires more training to operate and maintain. Appropriate incentives must also be given to construction firms that have generally steered clear of renovation projects because they tend to be more labor intensive than new construction. [redacted]

Turning abroad for help, Moscow will find little near-term relief from this Catch-22 situation. The collapse of world oil prices will limit Soviet foreign exchange spending to items of the highest priority, probably for the rest of the decade. In this context, most of the steel industry's projects for 1986-90 that are slated to use Western equipment are those that involve additions of new capacity and are already well under way. As a result, renovation projects appear to be more vulnerable to cancellation. [redacted] (b)(3)

The volume of future imports of Western equipment is likely to depend largely on the terms Moscow is able to negotiate with Western firms. Moscow has an excellent credit rating and may push for additional loans with lower interest rates and longer repayment terms for pending projects. The Soviets cannot expect to depend heavily on their East European client states, which already supply Moscow with a large share of their machinery production and are ill prepared, and (b)(3) probably unwilling, to meet heavy new demands for more and better machinery exports. [redacted] (b)(3)

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Outlook

On balance, we believe the Soviets will fall far short of meeting their goals for modernizing the steel industry. As a result, we can expect to see:

- Continuing complaints from various ministries (especially the machine-building ministries) about inadequate variety and quality of steel products that, in turn, will inhibit progress in modernizing the machine-building sector—the centerpiece of Gorbachev's industrial modernization program.
- Machines that, compared with Western counterparts, perform fewer functions and need to be repaired or replaced more often—thus siphoning scarce resources away from modernization and into capital repairs.
- Continued need for imports of many Western steel products, such as plate and sheet for the machine-building branches and pipe for the oil and gas industries, adding to the strain on dwindling hard currency resources. [redacted]

Soviet planners will have to weigh carefully the tradeoffs between purchasing Western plant and equipment to upgrade the technological level of the steel industry and importing Western steel products. Cutbacks in Western equipment purchases would further slow the pace of steel modernization and lengthen the Soviets' technological lag in ferrous metallurgy. New Western steel technologies would be particularly beneficial to the Soviets because they offer flexibility in the use of raw materials, save energy, and cost less per metric ton of installed capacity than conventional processes. As a result, Moscow may well decide to initiate within the next few years an aggressive program for their acquisition through joint ventures or other arrangements that minimize the up-front outlay of hard currency. But the payoff from such a program would not materialize until well into the 1990s. [redacted]

Despite potential advantages to Moscow of joint ventures, Western steel firms are unlikely to rush to enter into such deals. Years of dealing with the cumbersome Soviet bureaucracy, poor-quality Soviet materials and semifinished goods, and negotiations that go on interminably will make most Western businessmen wary. Moreover, the Soviets themselves are apt to approach such negotiations cautiously. Granting the amount of control over production processes that would probably be required by the Western firms would go against the grain of most Soviet managers. [redacted] (b)(3)

USSR: Imports of Western Steel Products, 1980-85 *Million US $*

	1980	1981	1982	1983	1984	1985
Total	**3,158**	**3,217**	**3,964**	**3,355**	**3,093**	**3,201**
Rolled steel	1,650	1,412	1,353	1,135	1,174	1,332
Pipe	1,508	1,805	2,611	2,220	1,919	1,869

This table is Unclassified.

The failure to make major improvements in the steel industry over the next few years will make industrial (b)(3) modernization more difficult and protracted, increasing the risk that Gorbachev's ambitious modernization goals for the remainder of the decade will not be met. As the Soviet leader is able to assess how modernization is faring, he may be in a position to better plan improvements that could be implemented in the 1990s. For example, he could double the value of imports of Western equipment—by increased borrowing in the West—to modernize steelmaking without increasing the share of domestic investment resources for steelmaking and finishing processes. Prolonged delays and setbacks to current modernization plans, however, will also increase pressure on the regime to either back off its ambitious program or make more fundamental changes in the system that might provide both the incentives and the resource slack necessary for meaningful improvements to take place. [redacted] (b)(3)

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Indonesia: The Imperative for Economic Reform [1] [redacted]

(b)(3)

In the absence of either far-reaching economic reforms or dramatic increases in the price of oil, Indonesia's economy appears incapable of generating the growth necessary to stem rising unemployment. We believe Jakarta must ease protection and overregulation of domestic industries, curb pervasive corrupt business practices, and diversify its oil-dependent and inefficient, government-dominated economic system to attract foreign investment and rekindle economic growth. The key to meaningful economic reform, in our view, is President Soeharto, who is the final arbiter of all major economic and political decisions in the country. We see little prospect, however, that Soeharto would jeopardize the political structure he has created over 20 years [redacted] Barring comprehensive reform, the Soeharto government almost certainly will face increasing social unrest and violence in the next few years. (b)(3) [redacted]

An Ailing Economy Forces Jakarta to React

The sharp decline in Indonesia's economic growth—a result of the collapse in world oil prices earlier this year—is forcing severe retrenchment in the Indonesian economy. Jakarta is reacting to reduced government revenues with draconian spending cuts—a tactic that has received kudos from foreign bankers although it stifles economic growth. In September, Jakarta announced a 31-percent devaluation in an attempt to cut its current account deficit, which we calculate could reach $6 billion this year. This action was followed two weeks later by a series of additional economic measures that include dismantling six import monopolies and the elimination or reduction of a wide range of import duties. The government hopes this will increase the efficiency of manufacturing industries and, together with the devaluation, promote nonoil exports. [redacted]

(b)(3)

[redacted]

An Economy Under Stress

Since 1981, Indonesia's economy has reeled under the pressure of falling oil prices:

- *In the last four years, petroleum receipts fell more than 25 percent, resulting in $17 billion in cumulative current account deficits.*
- *In real terms, the budget for FY 1987—beginning 1 April—will be about 85 percent of what it was in 1984, and about on a par with that of 1981, according to our estimates.*
- *During 1982-85, average annual real economic growth has been 3 to 4 percent, compared with about 8 percent in 1973-81. Growth this year could be zero or negative.* (b)(3) (b)(3)
- *According to our estimates, unemployment in urban areas is on the order of 35 percent, with substantial underemployment as well.* [redacted] (b)(3)

(b)(3)

In our judgment, however, the devaluation and most other economic remedies will not significantly spur growth or remedy unemployment as long as Indonesia's economy remains dependent on the oil sector. According to our projections, which assume world oil prices of $15 to $18 per barrel through the end of the decade and modest growth in nonoil exports, economic growth will average no more than 3 to 4 percent annually—the World Bank and the IMF estimate that 5 to 6 percent growth is needed to employ the 2 million entrants to the work force each year. Although the unemployed pose no direct threat to the regime at this time, the steady increase in their numbers, particularly in the cities, could easily fuel antiregime activity. In the past, Jakarta reacted to rioting and public tensions by using oil revenues to remedy the symptoms, but must now come to grips with the shortcomings of an economic policy that has done little to lay the groundwork for sustained growth and alleviating the plight of the country's poor. [redacted]

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A High-Cost Economy

We believe Indonesia's economic troubles in part reflect manufactured exports that are not competitive in world markets. Despite plentiful and low-cost labor, Indonesia's high-cost economy is an outgrowth of the government's dominant role, which is a reflection of its colonial legacy and its political culture. We believe several factors contribute to the high cost of doing business in Indonesia:

- *A pervasive financial and investment regulatory structure that frustrates domestic and foreign investment.*
- *Extensive trade barriers—including high tariffs, severe quantitative restrictions, tortuous customs procedures, conflicting regulations, import monopolies, a profusion of middlemen, licensing requirements, and other impediments that permeate most aspects of Indonesian economic activity.*
- *The Javanese disdain for a competitive environment necessary to develop an efficient economy. Indonesians prefer, instead, to maneuver behind the scenes to gain an advantage over business rivals.* [redacted]

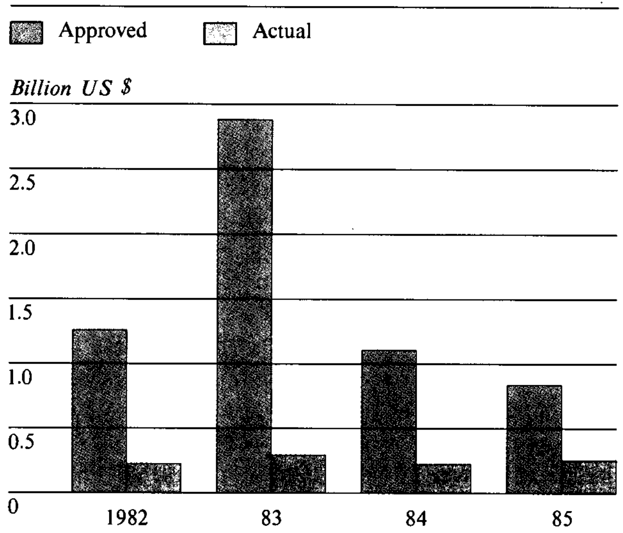
(b)(3)

Focusing on the Cure

The Soeharto regime is grappling with the task of rejuvenating the economy while avoiding the political risks associated with reforming a complex regulatory structure in which personal connections and political favoritism dominate. Since coming to power two decades ago, the Soeharto regime has used its virtual monopoly over economic access—control of government contracts, jobs in the bureaucracy, business permits, and state bank financing—to reinforce its political dominance. In addition, authorities have stifled critics by threatening their economic interests, according to US Embassy reporting. The IMF and the World Bank have repeatedly recommended a strategy of export-led growth using Indonesia's abundant labor supply. Key elements of such a strategy include simplifying investment regulations and licensing procedures; eliminating or reducing import quotas, tariffs, and other trade barriers; and moving to privatize the economy. [redacted]

(b)(3)

Indonesia: Direct Foreign Investment, 1982-85



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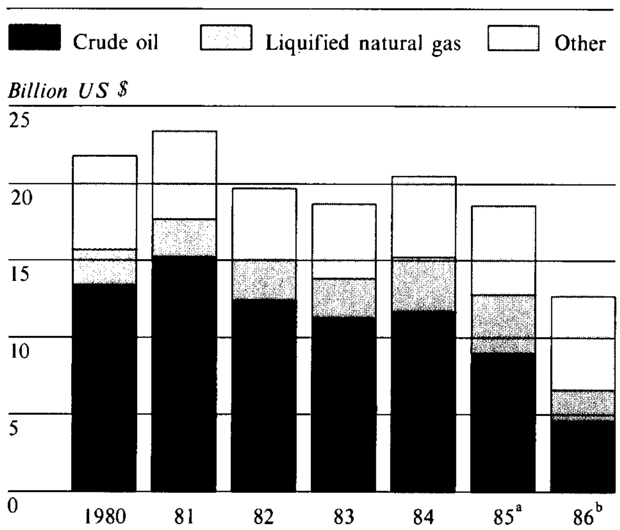
According to US Embassy reporting, a major debate is brewing within the government over the most appropriate strategy for economic development. The so-called technocrats or reformers—led by a cadre of Western-trained economists—are vigorously arguing that the best way to foster increased efficiency is by dismantling the protectionist regulatory structure. The other faction, made up of entrenched protectionist interests—the so-called developers—argue that the road to economic growth lies in continuing, state-led development behind protectionist barriers for all phases of production, from raw materials to finished products. They see protection from imports as a means to shelter Indonesia's high-cost, undeveloped economy. [redacted]

(b)(3)

Indonesia: Merchandise Exports, 1980-86



[a] Estimated.
[b] Projected.

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Stumblingblocks to Reform

Economic reform would undercut powerful interests, [redacted] As a result, we are not optimistic that the government will follow through with effective implementation of reform measures—a problem with various reform packages that Jakarta has announced over the years. According to US Embassy reporting, for example, two of the most striking exclusions from the recently announced list abolishing some import monopolies are plastics and steel, [redacted] Moreover, according to press reports, only a small share of Indonesia's imports will be affected by the monopolies Jakarta plans to eliminate. [redacted]

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As of yet, we see no indication that disparate elements of society have begun to make common cause against the ruling elite and the system of economic access, although signs of unease—such as the incidents of bombing and arson conducted by Muslim fundamentalists in 1984-85—are clearly present. Despite the lack of popular participation in the political and policymaking processes, we cannot rule out the possibility that the growing perception of Jakarta's unwillingness to move against vested business interests could generate pressure for reform from such institutions as the parliament, bureaucracy, military, and middle-class and Muslim groups. [redacted] (b)(3)

Outlook

If the regime fails to make needed reforms or to deal effectively with the social strains stemming from the weak economy, we believe that the potential for popular violence is likely to increase, beginning with violence aimed at the relatively prosperous but widely resented Chinese. Even in the unlikely event that Jakarta moves ahead with economic reform, we believe that tangible results would take several years at least to materialize. In the meantime, increasing rural landlessness, migration to the cities, disappointed expectations, and growing dissatisfaction with poor living conditions will continue to exert severe strains on the government's financial and managerial resources. [redacted] (b)(3)

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Israel: Economic Pressures Threaten Reform Package [redacted] (b)(3)

The prospect of a sharp increase in Tel Aviv's budget deficit looms as the major obstacle to Prime Minister Shamir's much-heralded economic program. Competing demands from labor, business, and even his own ministries, threaten to undermine his attempt to contain the projected deficit. A failure to resolve conflicting economic policies could disrupt Shamir's reform package, and, in the worst case, lead to a political crisis and an early election. [redacted]

A Tough Act To Follow

Shamir has inherited a much-improved economy as a result of former Prime Minister Peres's initiatives, but not without some costs. Tighter monetary policy and stringent fiscal measures lowered the budget deficit and slashed inflation from triple-digit levels in 1985 to about 20 percent this year. An 18.9-percent devaluation of the shekel—and substantial US financial assistance—contributed last year to the first positive foreign payments position in more than 30 years. These gains, however, came at the expense of higher unemployment—currently about 7.9 percent compared with 6 percent before austerity was imposed—and a recession that has affected many businesses. [redacted]

Key Reforms

With an eye to the next election that must be held no later than the fall of 1988, Shamir knows he needs economic successes to match those of his predecessor. To put his imprint on the economy, Shamir has introduced an amalgamation of earlier programs that emphasizes both growth and austerity. In his inaugural address to the Knesset in October, Shamir called for improving the standard of living, increasing employment opportunities and reducing the government's role in the economy through a program of tax reform, restructuring the capital market, and privatization. At the same time, he intends to resist policies—especially wage increases—that might enhance his popularity with the electorate but undermine the still fragile gains of the austerity program. [redacted] (b)(3)

In our judgment, Shamir has strong economic incentives to implement some degree of ***tax reform*** before the next election. Reducing Israel's heavy tax burden—the average effective tax rate is 25 percent—would spur industrial productivity and growth, stimulate investment, and eliminate distortions that hinder efficient economic activity. Moreover, a political consensus is building within the government and the private sector for tax reform. A number of government officials believe that unless a tax change is made many firms and individuals, especially highly trained workers, will find it more profitable to move overseas, according to the US Embassy. [redacted] (b)(3)

(b)(3)

Shamir and his Likud colleagues intend to move ahead on ***capital market reform*** begun under the Labor government. A restructuring of the capital market is aimed at eventually breaking the government's near stranglehold on available capital and freeing badly needed money for private investment. Finance Minister Nissim has already won initial approval from the Peres-led inner cabinet for reform measures that include restricting government acquisition of funds to the exact amount needed to finance the budget deficit and allowing private companies to raise money directly. [redacted] (b)(3)

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Shamir also is committed to ***privatization*** of government enterprises as a way to raise revenue and, if possible, rid Tel Aviv of financially troubled companies that are a drain on the budget. In 1985, Israeli

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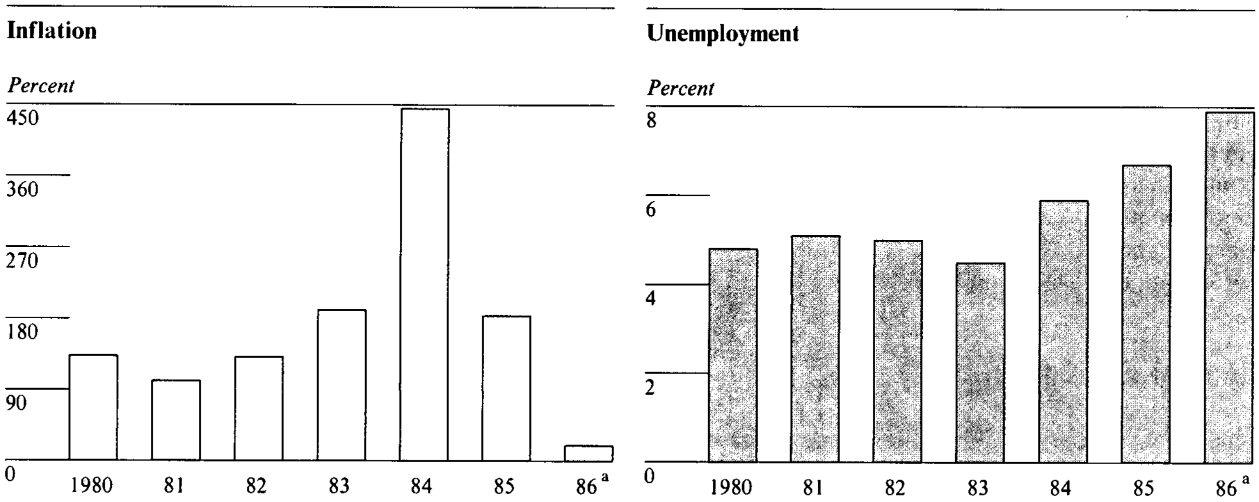
Israel: Consumer Price Inflation and Unemployment Rate, 1980-86

Note scale change



[a] Estimated.

[redacted] (b)(3)

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parastatals lost over $44 million, including $10 million in red ink posted by El Al Airlines. The Israeli Government Corporations Authority plans to sell or offer shares in 11 companies. On the auction block are the government's $80-100 million share of Paz, the national gas company, and 74 percent of Mamen, the management authority for Israel's airports. The government also will attempt to sell equity shares in foreign markets and on the Tel Aviv Stock Exchange. [redacted]

The Budget Deficit—A Conflict

The government is struggling to reduce this year's budget deficit—the prerequisite for any major economic reform action. Shamir so far has achieved only about one-half of the $480 million mandated reduction for the fiscal year ending in March 1987 by taking politically easy chops at development programs and government purchases of goods and services. He has made no headway, however, on lowering expenditures for programs that directly affect the populace, such as social security and many transfer payments. Moreover, cutting these budget items must have the approval of the Knesset, whose members predictably oppose any measures that adversely affect their constituents. We do not believe Shamir has the necessary backing to lower spending to the targeted level. As a result, the budget is likely to run a slight deficit this year despite about $1.5 billion in additional revenue from a series of one-time taxes. [redacted] (b)(3) (b)(3)

An almost certain drop in revenue for the fiscal year beginning 1 April 1987 will require additional budget cuts if Shamir is to keep the stabilization program on track. Automatic expiration of the temporary taxes, including a car levy and tax on child allowances, will cost the government about $170 million, according to

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Israel: The Government Budget, 1984-87 [a] *Billion US $*

	1984	1985	1986	1987 [b]
Expenditures	11.1	10.1	14.8	19.1
Deficits	3.2	1.7	3.5	0.8

[a] Fiscal period ending 31 March of the stated year.
[b] Projected.

[redacted]

the US Embassy. A planned reduction in customs duties, in accordance with an agreement with the European Community, is scheduled to take effect this January, and may further reduce government revenue by up to $200 million. In addition, employers will reduce payments to the National Insurance Institute by $300 million. [redacted]

Special Interests Limit Options

Any attempt to reduce spending or, as a last resort, to raise taxes would meet with stiff opposition within Shamir's Cabinet. According to US Embassy reporting, Finance Minister Nissim has ruled out any tax increase to solve the deficit problem and is endorsing tax reform. Ariel Sharon, the Minister of Industry and Trade and a strong supporter of industrialists, already has proposed assisting exporters with additional subsidies—on top of the $1.5 billion already provided. Other big spenders have taken an even tougher stand, including the Ministry of Defense that has publicly announced it will seek a $200 million increase in its budget for FY 1988, and the Ministries of Health and Education that probably will resist further budget reductions. [redacted]

Although the populace remains generally satisfied with the government's handling of the economy, they probably are not ready for another round of austerity. Eliminating popular subsidies would alienate consumers, business, and Histadrut, Israel's powerful labor organization. Recent Israeli press reporting that suggests a budget cut is not necessary probably has weakened private resolve to support tough future measures. [redacted] (b)(3)

Histadrut, a Labor Party stronghold, has warned it will not support a reform program that reduces the standard of living of its constituents. As a result, the government has avoided further subsidy reductions or tax increases that would offend the unions and has found it virtually impossible to implement a planned reduction in the government payroll. Indeed, the government currently is using some of the extra (b)(3)
revenue from this year's temporary taxes to subsidize the employers' contributions to social security. The loss of key subsidies would trigger compensating demands for higher wages and lead to a spiral of price increases that would effectively kill the stabilization program. [redacted] (b)(3)

(b)(3)

No Resolution in Sight

Lacking strong political and popular support, Shamir probably does not have the personal prestige to win approval of controversial expenditure reductions, the key to the success of the reform. We believe—and Israeli economic policy makers agree—that the best Shamir can do is to hold the line on spending increases. Even if discretionary spending were frozen, he still would face automatic spending increases triggered by population growth and inflation. This would force Shamir to adopt highly inflationary measures of borrowing or printing money to cover the deficit. [redacted] (b)(3)

The impending financial crunch means Shamir probably will have to accept a sharply curtailed version of his tax reform proposal or perhaps even postpone the plan altogether. Enough opposition still exists to kill (b)(3)
any reform that is not linked to a simultaneous reduction in tax rates. Unless Shamir can find other ways to replace all the lost budget income—an unlikely event—he probably would not get a tax package approved by the Knesset Finance Committee. Nissim

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is not apt to press the issue unless public opinion polls show a popular majority supporting further reform. [redacted]

Without reducing the budget deficit, the Shamir government has no chance of making significant progress on capital market reform before the next election. Instead, Tel Aviv again will need to tap the capital markets for debt financing. Even if the program were on track, the government would still have to contend with vested interests that would oppose and complicate the reform effort, according to the US Embassy. [redacted]

Privatization will not come close to meeting the government timetable because of a lack of viable purchasers, investor reluctance, and ministerial opposition. Most domestic companies do not have the cash to buy a government enterprise. Many foreign buyers will remain reluctant to entertain Israeli offers because of concern over the long-term prospects for the stabilization program, the Arab boycott, and the possibility of another Arab-Israeli war. Moreover, Tel Aviv probably will experience protracted difficulties with ministers who do not want to lose the political power that goes with the control of manpower and patronage of government ownership. [redacted]

If Shamir approaches the election with no significant economic accomplishments, he may come under heavy pressure from his party to implement popular measures such as wage hikes and subsidy increases. Shamir may well acquiesce to head off maneuvering by Sharon and Deputy Premier Levy, his major Likud rivals, who want to unseat him as Likud leader. Shamir also is likely to attempt to pass some of the blame for any shortcomings onto Peres and the Labor Party. In the worst case, failure to agree on an economic policy that resolves the conflict between the deficit and the reforms could lead to a political crisis and early elections. [redacted]

Implications for the United States

Israel almost certainly will turn to the United States for additional supplemental aid to cover its budget shortfalls. Shamir probably will argue in part that it would be unfair for the United States to deny assistance to his government after granting Peres $1.5 billion in supplemental aid during his tenure. Tel Aviv is likely to press for additional money for a wide range of specific projects in defense and high-technology industries. The Israelis also will push to sell large government enterprises on US markets. [redacted]

[redacted]

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China: New Foreign Investment Incentives Unveiled [redacted] (b)(3)

To improve the country's deteriorating investment climate, in October Beijing announced new regulations to encourage foreign investment. A major goal of the guidelines is to channel foreign investment into joint ventures that produce primarily for export or introduce advanced technology. The new policies, however, offer little relief for the problems of repatriating foreign exchange and access to China's domestic market—the two issues of most concern to foreign investors. Even so, the measures represent a step in the right direction. The high-level attention afforded these changes, moreover, suggests significant pressure will be applied at the grassroots level to encourage successful implementation and experimentation. Successful local programs probably will serve as models for future changes in national policy. [redacted]

New Regulations

On 11 October, Beijing announced its long-promised and much-touted new guidelines for encouraging foreign investment. The regulations seek to reverse a reported 20-percent decline in overseas investment commitments for the first six months of this year as compared with the same period in 1985. The US Consulate in Hong Kong believes the decline was even greater—its figures show the value of foreign investment commitments dropping 42 percent during the first half of 1986 to $1.2 billion. [redacted]

The new guidelines include a number of provisions affecting all foreign enterprises:
- Guaranteed autonomy over production, funds, inputs, wage and bonus levels, and personnel—including the right to hire and fire workers and senior managers.
- Import license exemptions for machinery and equipment, vehicles, raw materials, and spare parts required for production.
- Export licenses, where applicable, obtainable at six-month intervals rather than on a case-by-case basis.
- Exemption from income taxes on profits subsequently reinvested in expanding or establishing export-oriented or advanced technology enterprises.
- Authority for foreign enterprises to transfer foreign exchange among themselves.
- Maximum three-month waiting period for official responses to investment matters that require approval by state and/or local departments.

Granting foreign investors autonomy over their enterprises mirrors many of the domestic economic reforms implemented in recent years, such as labor and enterprise management reforms. [redacted] (b)(3)

In addition to these across-the-board incentives, export-oriented and advanced technology enterprises are singled out for special treatment that includes: (b)(3)
- Exemption from the payment of state wage subsidies to Chinese employees, with the exception of labor insurance, welfare, and housing.
- Reduction and standardization of site use fees.
- Priority status for the provision of water, electricity, transportation services, and communication facilities at rates on a par with those paid by state enterprises.
- Preferential access to short-term loans.
- Reduced income taxes after the expiration of applicable tax holidays as well as income tax exemptions on profits remitted abroad. (U)

Earlier this month Beijing issued new customs regulations eliminating the need for foreign-invested enterprises to obtain import licenses for materials and parts used in manufacturing exports. These imported inputs are also exempt from industrial and commercial consolidated tax if used in finished export products. Furthermore, the Ministry of Labor and Personnel has formally announced a new labor regulation in support of the earlier announced guidelines that espouse autonomy for foreign joint ventures over employment, wages, and welfare funds. It also stipulates (b)(3)

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Doing Business in China: The Litany of Complaints

Complaints about the difficulty and excessive cost of doing business in China largely result from frustration and disappointment among foreign investors who rushed in to take advantage of China's "open door" policy. Many discovered that the opportunity to secure a share of the world's largest untapped potential market was available only under extremely restrictive conditions. Moreover, the Chinese are sensitive about being cheated, and measures to guard against this have led to the creation of artificial price structures and resulted in excessive costs. Consequently, in matters involving labor, taxes, customs duties, and living costs, foreign investors have been marked for discriminatory treatment, which has often made doing business in China more expensive than in Tokyo or Hong Kong. (b)(3)

Although low labor costs initially attracted many foreign investors to China, the taxes and subsidies levied on top of the wages of Chinese workers in foreign-funded enterprises significantly increased the cost of labor. Recently, the Foreign Investment Administration announced that Chinese wages in joint ventures could be up to 150 percent higher than those of workers in state-owned factories. This wage premium, largely pocketed by the government, makes China less competitive for unskilled labor than some neighboring countries in Southeast Asia. (b)(3)

In addition, foreign enterprises are often plagued with poor productivity because many state-assigned workers are unqualified. The inability of foreign enterprises to fire incompetent workers and long delays in obtaining more suitable replacements perpetuate the low productivity that, according to some investors, makes production costs higher in China than in Western Europe or the United States. (b)(3)

Furthermore, in its efforts to restrict long-term foreign involvement in its economy, China has carefully limited the penetration of joint ventures in its domestic market, the life expectancy of such joint ventures, and the period of protection of intellectual property rights. The foreign investors are expected to transfer technology and management know-how, produce products for export to pay for the transfer, develop markets for these products abroad, and depart after the expiration of joint venture contracts. (b)(3)

China's nonconvertible currency is another major sticking point. Only a few investors—mainly owners of luxury hotels built to accommodate foreign tourists and business executives, which have guaranteed hard currency earnings—are untouched by the problem. But most joint ventures have yet to show a profit in anything but local currency, a profit of questionable value. (b)(3)

enterprise responsibility for the pensions, unemployment insurance premiums, and housing subsidies of its Chinese employees. Additional investment incentives, reportedly to be introduced soon, include greater market access for foreign enterprises that produce goods currently imported, with part of the hard currency saved payable to the enterprise. (b)(3)

More Regional Competition for Investment

The State Economic Commission has encouraged localities to experiment with the new guidelines, and they have responded with added enticements to encourage foreign investment. Ironically, excessive diversity could increase uncertainty for foreign investors, who already complain about the lack of consistency in China's investment climate. In most cases, however, the local incentives offer only minor variations of the central regulations. In several instances, however, the critical issue of foreign exchange was treated in more detail, including offers of local government funds to cover temporary foreign exchange imbalances. Shanghai officials had previously experimented with several other measures to ease foreign exchange shortages for joint ventures, including a widely publicized currency swap last July between a Sino-US joint venture short of foreign exchange and a Sino–Hong Kong venture with excess foreign exchange. Last month another currency swap was enacted between the Great Wall Sheraton Hotel and the Beijing Jeep Corporation. Some localities also

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are offering access to the domestic market for sales—at least partially in foreign exchange—of previously imported goods. [redacted]

The Scorecard

The new regulations represent a positive step, but fall short of the advance rhetoric and fail to adequately address the major impediments faced by foreign investors—access to the domestic market and the inability to remit profits. Concerns over the country's continuing foreign exchange shortages probably had a dampening effect on immediate efforts to resolve foreign-exchange-related problems.[1] We believe the provision allowing foreign enterprises to adjust their foreign exchange balances among themselves may have been a concession to those in the leadership who argued against more liberal provisions in light of the country's foreign exchange shortage. Beijing also may have dictated limits to the supplemental guidelines offered by the local governments, according to the US Consulate in Guangzhou. Guangzhou's investment guidelines, for example, omitted a provision disclosed earlier to US Consulate officers allowing foreign-funded enterprises to convert profits into foreign exchange—up to the level of foreign exchange equity capital invested by the enterprise—for overseas remittance. [redacted]

Outlook

Although the measures will provide relief from many of the fees and taxes burdening foreign enterprises in China, they fall short of the "bold measures" promised by the leadership. Despite the initial disappointment among foreign investors, however, we believe foreign investment commitments will improve slightly in the near term. The publicity surrounding the regulations and the recent resolution of problems in the AMC Jeep joint venture will reassure investors of Beijing's commitment to foster successful relationships with foreign-funded enterprises. An initial increase in investment, however, probably will represent planned investments that have been postponed in anticipation of more favorable regulations. According to the US Consulate in Hong Kong, the decline in (b)(3)
foreign investment in the first half of 1986 reflects, in part, such delays by investors. [redacted] (b)(3)

In the coming months, we expect Beijing to keep a watchful eye on the implementation of local supplementary incentives, particularly with regard to foreign exchange. If these regional experiments proceed smoothly, we believe Beijing will be ready to undertake the more difficult issues over the next year. To maintain investment momentum in the longer term, Beijing will need to tackle the more thorny issues—particularly market access and profit repatriation—that dog foreign investors. Chinese officials have stated that the country's investment climate cannot be changed overnight, but that further amendments will follow. How the regulations are implemented at the local level will be a key indicator for assessing the impact of these new incentives. The high-level attention afforded this issue suggests that significant pressure is being applied at the grassroots level to encourage success. [redacted] (b)(3)

[redacted] (b)(3)

(b)(3)

[1] China suffered a severe depletion of foreign exchange reserves over the last year and a half, with reserves falling from a high of \$16.7 billion at yearend 1984 to a current level of \$10.3 billion. To control rampant imports, Beijing imposed tighter foreign exchange controls in March 1985. (U)

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Briefs

(b)(3)

Energy

[redacted]

[redacted] (b)(3) (b)(1)

Brazil's Looming Electricity Shortages

Reduced hydropower production along with higher energy consumption may lead to blackouts and electricity rationing in southern Brazil during 1987. According to the US Consulate in Porto Alegre, hydropower—ordinarily 80 percent of the power for Brazil's industrial south—has suffered as sparse winter rains this year left reservoirs well below normal levels. Brasilia can compensate by adding new transmission lines from the Itaipu Dam and by completing construction of fossil-fuel plants, but such fixes would take several months. Meanwhile, industry—the largest end user of electricity—is at near full capacity to meet overheated consumer demand caused by the Cruzado Plan. Moreover, press reports indicate that electricity prices are among the lowest in the world, encouraging wasteful consumption. Electric power presents a long-term structural bottleneck to growth. Electricity demand, growing at 10 percent annually, is outstripping the country's ability to finance new generating capacity. [redacted] (b)(3) estimated $5 billion per year in new investment is necessary to bring sufficient capacity on stream. Given Brazil's limited access to Western capital markets, we believe that a continued lack of investment could lead to widespread shortages of electricity in the future. [redacted] (b)(3)

Britain Likely To Build New Nuclear Power Plant

London is likely to approve the constuction of a new nuclear power plant, a move which would represent the largest expansion of a nuclear power program since the Chernobyl' disaster. A 27-month government study, issued this fall, raises no serious questions about the safety, necessity, and environmental impact of nuclear power expansion. The report also says that nuclear power has economic advantages, although it disagrees with the Central Electricity Generating Board's claim that a nuclear plant would be significantly cheaper than a coal-fired one. While

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Parliament has yet to study the report, the electricity industry is confident of approval because Prime Minister Thatcher and Energy Secretary Walker are strong supporters of nuclear power and have expressed a desire to start building the new plant by June 1988. Opponents have not given up hope, however, and probably hope that a future Labor government would reverse Thatcher's approval. [redacted] (b)(3)

International Finance

Mexican Private-Sector Debt Rescheduling

Mexican negotiators expect to reach a preliminary agreement soon with international bankers on terms for restructuring $11.7 billion in private-sector debt covered by a government foreign exchange risk program. Without a rescheduling, a number of firms included in the plan probably could not continue making principal payments presently set to rise from $200 million this year to $3 billion in 1987. [redacted] (b)(3) (b)(3) (b)(1)

Brazil Worried About Worsening Financial Position

The Sarney administration has expressed deep concern about Brazil's dwindling cash reserves [redacted] (b)(1) So far, however, the government has taken only limited steps to shore up its slumping exports and stem capital outflow. Substantial price hikes in November to dampen domestic demand provoked strong public protests—notably the 12 December general strike—making important followup measures unlikely very soon. Although Brasilia has instituted daily minidevaluations to boost exports, the US Embassy reports that the private sector continues to wait for a much larger devaluation. [redacted] (b)(3) (b)(3) (b)(1)

Egypt Upbeat on IMF Talks

Egyptian officials appear satisfied with the support they received from key IMF executive directors at a 4 December Fund discussion of the country's economic reform program, but may be overestimating the imminence of Fund approval of a standby arrangement. Cairo believes that the support voiced at the meeting indicated IMF acceptance that the proposed reform package is the most that is

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(b)(3)
(b)(1)

politically possible for Egypt, setting the stage for speedy Fund agreement on a standby arrangement. Critical elements of the standby negotiations—including agreement on economic performance criteria—are still ahead, however, and the details of exchange rate unification and interest rate hikes—each a potential sticking point—remain to be worked out. To the extent that the IMF insists on tougher reform measures, standby talks will be contentious. Meanwhile, informal talks on Cairo's financial problems continue with a Paris Club discussion today and a meeting of key IMF executive directors scheduled for next week. [redacted] (b)(3)

[redacted]

[redacted] (b)(3)

Indonesia's Pending Financial Crisis

[redacted] (b)(3) (b)(1)

[redacted] Indonesia has been unable to earn the $6 billion in foreign exchange required to continue servicing its nearly $40 billion foreign debt, and Jakarta has already drawn heavily on its $2.5 billion credit lines with foreign lenders. As a result, the government will probably have to rely on its dwindling foreign exchange reserves that totaled about $10 billion last April. [redacted] (b)(3)

Global and Regional Developments

Persian Gulf Economic Aid to Jordan Decreases

Economic aid from Persian Gulf states to Jordan this year probably will be less than the 1985 level of $970 million—despite last-minute payments—and assistance probably will be even less next year. Kuwait has given Jordan $75 million in cash this year and promised an additional $50 million in 1987 in the form of petrochemicals. The US Embassy reports that Riyadh is up to date on its aid commitments but is still demanding that Amman pay the $195 million owed since last year for Saudi oil. Abu Dhabi gave $65 million in September, and Amman is confident that Oman will continue its monthly payments of $5.8 million through

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the end of 1987. If Riyadh does not forgive Jordan's oil debt, Gulf aid actually will be significantly below 1985 levels. Riyadh may waive the oil-import debt as partial compensation for reduced aid in 1987. Kuwait probably is offering petrochemicals, which it would have trouble selling in the glutted market. Omani aid probably will continue, and Qatar may still provide small amounts of assistance. [redacted] (b)(3)

Soviet-Iranian Economic Meeting Yields Little

Tehran has been more effusive than Moscow in assessing the results of a meeting last week of the Soviet-Iranian Joint Economic Commission, the first in six years. Iranian media report protocols on trade, energy, transportation, banking, steel mills, agriculture, fisheries, the holding of further commission meetings at six-month intervals, and the return of Soviet technicians to Iran. The Soviets have noted only that the two countries intend to expand cooperation in trade, transportation, and "other fields," and to continue regular ministerial-level contacts; they have not mentioned a return of Soviet experts. The media accounts indicate continued coolness in political relations. The Iranian version of the talks is probably more an effort to portray improved economic relations than an accurate reflection of significantly greater cooperation. The Soviets have said for some time that their technicians would return if their safety could be guaranteed, implying that Iran must first agree to negotiate an end to the war; there is no evidence that Moscow has changed its position. [redacted] (b)(3)

No Huge Saudi Aid Package for Sudan

Press reports that Saudi Arabia will provide Sudan with $1 billion a year in economic assistance for the next three years are greatly exaggerated. The reported aid package calls for the Saudis to provide $300 million in cash and $700 million in commodities, including oil, fertilizer, and manufactured goods. Sudan, in turn, would export surplus agricultural products to Saudi Arabia. Although Sudanese and Saudi officials are engaged in economic negotiations that Khartoum believes will yield substantial financial assistance, no agreements have been reached. Nevertheless, Saudi aid to Sudan next year is unlikely to rise above the nearly $300 million given in 1986. [redacted] (b)(3)

[redacted] (b)(3)
(b)(1)
(b)(3)

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Central American Trade Problems

Honduras's suspension of bilateral trade agreements with Guatemala and Costa Rica in late November and early December has dealt a new blow to faltering official commercial relations in Central America. Tegucigalpa acted after failing to gain concessions to reduce its large trade deficits with both countries, caused in part by its overvalued exchange rate. Guatemala last summer suspended local currency credit lines to Honduras because of Tegucigalpa's outstanding trade debt. Negotiations to reduce an imbalance with Costa Rica also have failed. The suspension effectively puts all trade between Honduras and the two other countries on a cash basis. Bilateral agreements with El Salvador and Nicaragua remain in force, in part because the trade balance favors Honduras, and Tegucigalpa has expressed an interest in expanding trade ties to San Salvador. The inability of the Central American countries to eliminate chronic trade debts will probably sabotage recent efforts to implement a new regional payments system and will continue to constrict trade. [redacted] (b)(3)

National Developments (b)(1)

Developed Countries

[redacted]

[redacted] (b)(3)

[redacted]

[redacted] (b)(3)

(b)(1)

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[redacted] (b)(1)

Positive Signs for Japanese Agricultural Reform

The momentum for reform of Japan's agricultural price supports generated by Prime Minister Nakasone's early October questioning of the system in the Diet shows no sign of abating. [redacted] This would undercut Agriculture Minister Kato's argument that all political parties favor subsidies for rice farmers and keep the pressure on the ruling Liberal Democratic Party to support reform. The influential agricultural cooperatives also are responding to mid-October complaints—indirectly endorsed by the Prime Minister—about the low efficiency of rice farmers. The cooperatives plan to begin importing limited amounts of lower cost foreign fertilizer, according to a Japanese newspaper. The cooperatives, which handle over 80 percent of all fertilizer sales and have major investments in Japan's fertilizer industry, have previously refused to purchase foreign fertilizer. [redacted] (b)(3) (b)(3) (b)(3) (b)(3)

[redacted] (b)(3) (b)(1) (b)(1)

[redacted] (b)(3)

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[redacted] (b)(1)

Portuguese Budget Deficit Continues To Plague Economy

Lisbon's projected 1987 budget deficit indicates that the government has still not come to grips with Portugal's chaotic public finances. The deficit is officially projected at 9 percent of GDP—about a 1-percentage-point increase from 1986—but may well be worse. Expenditures probably will increase by more than the projected 13 percent because efforts to cut spending are constrained by the large portion of fixed expenditures—interest payments and salaries account for more than 60 percent of current spending—and by the lack of significant cost-cutting reforms. Meanwhile, the government's projected 23-percent revenue increase is misleading. If petroleum tax receipts—previously excluded—are added to the 1986 budget figures, the projected 1987 revenue increase is only 8 percent. The larger deficit is likely to make it difficult for Lisbon to achieve two major goals of its recovery program. Increased internal demand may well hamper efforts to cut inflation by one-third to 8 percent, while more public borrowing—coupled with tighter domestic credit controls—is certain to depress private-sector credit growth. Given the weak financial positions of Portuguese firms, investment is likely to come in far below the 9.5-percent target. [redacted] (b)(3)

Less Developed Countries

Challenges Facing Brazilian President Sarney

Only six days after voters provided resounding support for Sarney and his anti-inflationary Cruzado Plan, the government's announcement of large price hikes—dubbed Cruzado II—on some luxury goods and on public services set off a firestorm of protest. Newly elected leaders of the ruling Democratic Movement Party criticized the administration for breaking the party's campaign promise not to increase consumer prices. A spontaneous protest on 27 November led to the largest and most violent antigovernment demonstration ever held in Brasilia. Labor unions announced plans for a general strike to protest the adjustments and to call for a debt moratorium. Since the announcement, Sarney has suffered a sharp decline in his personal popularity, [redacted] (b)(3)
The new adjustments have also aroused uncertainty among businessmen and bankers about the government's economic team, according to the US Consulate in Sao Paulo. The stock exchange there dropped 20 percent during the week following the announcement, and interest rates have jumped 50 percent. [redacted] (b)(3)

In the face of these challenges, Sarney will find it difficult to implement other adjustments to get the economy back on track, including broader price relief to slow consumer spending, to stimulate sorely needed plant expansion, and to stem the deterioration in the country's trade accounts. Despite economic imperatives, Sarney is likely to adopt a patchwork approach to economic adjustment, which would lead to lower growth, rising inflationary pressures, and more external payments problems. The overall decline in the President's popularity will probably weaken

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his ability to withstand the party's demands for greater influence in the cabinet and in key policy posts. Leftists, who fared poorly in the election in November, will probably exploit popular resentment over Sarney's austerity measures and over the burden of the country's foreign debt. In addition, popular growing expectations of a return to rampant inflation may spark wildcat strikes and antigovernment demonstrations. [redacted] (b)(3)

Tanzania Faces Loss of Cotton Exports

Tanzania faces a critical foreign exchange shortfall in 1987 and rising rural discontent if Dar es Salaam cannot market this year's bumper cotton crop. Cotton, which accounts for 12 to 14 percent of total exports, is second only to coffee as a foreign exchange earner. According to foreign press reports, 65,000 bales of cotton worth $18 million have yet to be purchased and transported to ports by the government—the sole legal marketing agent—and probably will soon rot in inadequate storage facilities. Another 60,000 bales are expected to be harvested before the end of the growing season, but crippling fuel and vehicle shortages probably will continue to hinder Dar es Salaam's efforts to move the crop to ports in a timely fashion. In a related development, farmers in northern Tanzania recently threatened to burn over 780 metric tons of unsold cotton piled up at railway stations. The farmers are angry that lack of transportation is preventing them from taking advantage of a recent 15-percent hike in cotton producer prices. The situation may erode support for President Mwinyi's four-month-old IMF program, which has yet to make a significant impact on Tanzania's deteriorated agrarian economy despite popular expectations of a quick boost in living standards. [redacted] (b)(3)

Fijian Economy Improves But Obstacles Remain

Fiji's economy is recovering from last year's 3.5-percent decline. According to the US Embassy, GDP this year will be up by 2.5 percent, and Suva expects a growth rate approaching 4 percent in 1987—a trend likely to further strengthen Prime Minister Mara's ruling Alliance Party in next February's election. The turnaround primarily reflects a rebound in sugar production—up nearly 40 percent from last year's storm-damaged crop—tourism, and manufacturing. Sustaining the recovery will be difficult, however. The government's budget deficit is nearly 5 percent of national output; the trade deficit—in part a result of low export prices for Fiji's traditional commodities—shows no sign of narrowing; and the economy remains dependent on sugar and a few other agricultural commodities. [redacted] (b)(3)

Communist

USSR Boosting Oil Sales to Romania

[redacted] the Soviet Union is sharply increasing oil deliveries (b)(3) to Romania in accordance with an agreement signed in December 1985. The Soviet Embassy in Bucharest reportedly announced at a press conference in October that the USSR would supply Romania with 120,000 b/d in 1986—as compared with an estimated 40,000 b/d in 1985. Soviet trade statistics for the first half of 1986 support the announcement. Total exports to Romania are up by $650 million over the same period in 1985—more than enough to account for the

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additional oil exports. Moreover, Romania reportedly intends to import 141,000 b/d of Soviet-supplied oil in December. Part of this year's increase is explained by Soviet reexports of 36,000 b/d of Middle Eastern oil to Romania in the first nine months of 1986, a practice not seen in previous years. Increased Soviet oil deliveries are tied to growing imports of Romanian goods. In contrast to the $400 million Soviet trade deficit with Romania in 1985, Moscow has been running a small surplus through the first half of 1986. [redacted] (b)(3)

Soviet Trade Show Opens in Beijing

The USSR is holding its first trade and industry exhibition in China in three decades, the result of a protocol on exchanges of trade exhibitions signed last summer. Displays include models of a Tokamak 15 nuclear fusion reactor, a Salyut orbital space station, and a Vega scientific satellite, in addition to the latest Soviet automobiles, aircraft, and other scientific and technological hardware. [redacted] the Soviets are also (b)(3) staging lectures and video presentations for Chinese technical groups in a separate exhibition hall. Approximately 300,000 people are expected to visit the trade show—including Vice Premier Li Peng, who participated in the exhibition's opening—matching the number of visitors to China's trade fair in Moscow last summer. This is yet another indication of warming economic relations between the two countries; bilateral trade more than doubled last year to $1.9 billion. We expect no major purchases by the Chinese as a result of this exhibition, however, as, contrary to Chinese press reporting, none of the displayed items are available for export. Moreover, some of the items are not yet available for sale in the Soviet Union. [redacted] (b)(3)

Improved East European Agricultural Performance

The economies of most East European countries will be boosted slightly this year by above-average harvests, primarily the result of good weather. Poland and East Germany reported record or near-record grain crops. Harvests of grain and most other crops in Romania, Bulgaria, and Yugoslavia—hit by drought last year—also increased. Drought in Hungary, however, cut grain production for the second straight year, although the Hungarian press reported that overall agricultural output might rival the record 1985 levels. In Czechoslovakia, production probably will be below average because of weather problems. These generally good results should ensure adequate consumer supplies and help trade performance. Yugoslavia should be able to export more than last year, while Poland and possibly East Germany and Bulgaria may reduce imports of Western grain. Disappointing crops in Hungary and Czechoslovakia will not pose major consumer problems; Budapest probably will cut exports to the West, and Prague will draw down reserves. Despite a better harvest, food supplies in Romania appear to be deteriorating sharply, probably because Bucharest is increasing exports to raise hard currency. [redacted] (b)(3)

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China To Increase Metals Output

Beijing plans to increase output of 10 major nonferrous metals by 1990. The largest increases will be in nickel—set to double over the next five years—and in aluminum, with planned growth of 90 percent. China also plans to increase production of lead and zinc by 31 percent and copper by 12 percent. China closely holds production data on nonferrous metals, but [redacted] estimate nickel output to be at least 20,000 metric tons a year and aluminum about 400,000 tons a year. The Chinese increased exports of nickel this year, but remain net importers of aluminum, copper, and zinc. [redacted] (b)(3) (b)(3)

Chinese Auto Loans

China is offering auto loans to government and private enterprises in an effort to move an overstock of imported cars [redacted] Under the policy, enterprises buying 10 or more cars will be extended credit for up to three years. An earlier discount program for cash payments on quantity purchases proved unsuccessful. The backlog of unsold autos probably is the result of volume purchases of foreign cars that were made without a buyer order. Similarly, the higher output at Chinese auto plants produced an overabundance of slow-selling domestic models. Although there is large potential demand for both imported and domestic models, the high cost of enterprise modernization leaves little cash for outright purchases. If the loan option succeeds at the enterprise level, credit will probably also be extended to individuals to entice the wealthier peasants and entrepreneurs into the new car market. [redacted] (b)(3) (b)(3)

Cuba Trying To Revive the Economy

President Castro, preoccupied with the failing economy, closed the recent Third Party Congress with a call for renewed revolutionary vigor and increased austerity. Necessary belt-tightening and Castro's apparent recommitment to economic and ideological positions reminiscent of 20 years ago are likely to erode Cuban productivity, increase social discontent, and possibly push Castro to seek new channels for emigration. Castro told the closing session that Cuba's current debt problems are the worst they have ever been, that imports will have to be cut by one-half to $600 million next year, and that exports must increase. Major investment would continue to go to the energy and export-earning sectors, leaving domestic consumption to absorb the brunt of the new stringencies. [redacted] (b)(1) Castro also termed overreliance on market mechanisms a serious ideological mistake and stressed that Communism will be built primarily through political and ideological work [redacted] (b)(3)

The announcement of a 50-percent reduction in hard currency imports may be more of a ploy to appease Cuba's creditors than a policy Castro intends to carry through. Moreover, Castro's renewed emphasis on ideology is at odds with the rationalization measures being pursued in the USSR by General Secretary Gorbachev. Any attempt by Moscow to assume more control over Havana's economic management could lead to increased friction, but a permanent rift is unlikely. More sacrifices for the average Cuban and increasing popular dissatisfaction with the regime will result from these policies. Castro may try to relieve this pressure by ridding Cuba of the malcontents through a renewed immigration agreement with the United States. [redacted] (b)(3)

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Cuba Looking to South America for Imports

Cuba's strategy of shifting from West European to South American suppliers for its import needs is foundering on Argentine and Brazilian unwillingness to extend trade credits. Argentina was Cuba's third-largest Western supplier in 1985, but trade stagnated this year after Buenos Aires suspended credits to Havana because of debt arrears. [redacted] (b)(3) (b)(1)

Buenos Aires is undoubtedly aware, however, that Cuban efforts to obtain trade credits from Brazil have been largely frustrated and is unlikely to retreat from its firm bargaining stance toward Havana. [redacted] (b)(1) (b)(3)

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