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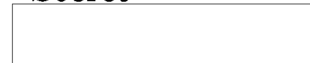

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International Economic & Energy Weekly

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9 December 1983

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International Economic & Energy Weekly

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Synopsis

1 **Perspective**—***New Economic Stresses and Opportunities in the Caribbean***

25X1

Despite the tentative world recovery, the fragile Caribbean economies are unlikely to recover much over the near term. Expected interruptions in international lending will prompt Caribbean nations to seek increased economic support from Washington.

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17 **International Financial Situation: Big Seven Economic Recovery on Track**

25X1

This article is part of our series on the economic and political aspects of the international financial situation. Outside of North America, the economic recovery among the Big Seven industrial countries is developing much as private and official forecasters expected. The debt situation of the financially troubled LDCs will not change significantly given the present course of the recovery.

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19 **International Financial Situation: Nonoil LDC Terms of Trade Bottoming Out**

25X1

This article in the series on the economic and political aspects of the international financial situation examines the gains in the nonoil LDC terms of trade in the first half of this year, ending a five-year slide.

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23 **International Financial Situation: Fading LDC Hopes for Commodity Trade Revival**

25X1

This article in our series on the international financial situation examines commodity price trends. While commodity prices have recovered somewhat, we see little prospect in the near term for a strong pickup in LDC earnings from either mineral or agricultural commodities.

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27 **Grenada: Picking Up the Pieces**

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Grenada's recently appointed interim governing council has inherited an economy beset with widespread unemployment, breakdowns in public services, and depleted public coffers. Over the next few years, continuing external assistance will be required to restructure the economy and lay the groundwork for sustained economic growth.

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33 **Cuba: Patterns and Prospects of Soviet Economic Aid** 25X1

Fidel Castro's goal of making the Cuban economy independent of foreign powers has become increasingly distant after 25 years of his rule. Soviet economic aid in 1982—valued at about $4.6 billion—corresponded to somewhat more than 30 percent of Cuba's output. 25X1

41 **Hungary: New Horizons for Private Entrepreneurs** 25X1

Since 1981 the Kadar regime has further legitimized and thereby spurred an increasingly wide range of activities in Hungary's huge "second economy" in a bid to ease some of the country's economic ills. Even though the Western press overplays the "capitalist" aspects of the new ventures, such measures—if sponsored vigorously over the long term—could transform Hungary's economy into an even bolder model for change in the rigid, inefficient systems of other Soviet Bloc countries. 25X1

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International Economic & Energy Weekly

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Perspective

New Economic Stresses and Opportunities in the Caribbean

25X1

US policies in the Caribbean can be expected to face new challenges—particularly in light of recent events in Grenada—as economic difficulties continue to batter the region. Despite the tentative world recovery, the fragile Caribbean economies are unlikely to recover much over the near term. Although gradual improvement in world agricultural and mineral prices, a pickup in tourism and offshore assembly industries, and benefits from the US-sponsored Caribbean Basin Initiative (CBI) could provide some relief by late 1984, interruptions in IMF and other lending could easily offset any gains. Prolonged economic retrenchment by a number of Caribbean governments has narrowed their maneuvering room for accommodating the IMF on existing or new austerity programs. Meanwhile, concerns about the creditworthiness of the larger debt-saddled Latin American countries are prompting international bankers to manage their Caribbean loan portfolios more cautiously, thereby further jeopardizing the viability of IMF programs. We expect Caribbean nations to seek increased economic support from Washington.

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The economic deterioration in the Caribbean has not been as severe as that in Central America, but it has been longer lived and generally more deepseated. The Caribbean economies reacted sooner to soaring prices for oil and other imports, a world recession-induced decrease in tourism, and stagnant export earnings. Tighter local restrictions and growing political uncertainty clipped foreign investment inflows. Lacking sound credit ratings needed to raise long-term foreign capital, most Caribbean countries resorted to a patchwork of short-term commercial credits, small-scale economic assistance, and foreign reserve drawdowns. Subsequent belt tightening, particularly direct import controls, caused real growth in the region to dwindle to 2 percent annually during 1978-82; many Caribbean ministates performed substantially worse.

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Although a number of Caribbean governments are evincing a more rational approach to economic decision making than previously, the patterns of deterioration and international responsiveness are changing with worrisome implications. Regional output will drop about 1 percent in 1983, the first such decline in nearly two decades, partly because governments of most of the region's largest economies have slashed spending to qualify for IMF help. Where IMF agreements are in place, we see potential long-term positive effects; implementation has improved tax collection, trimmed and redirected the bloated public sector away from make-work projects toward productive investments, raised interest rates to encourage domestic saving, and stimulated

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the search for foreign investment. Nevertheless, in the short term economic hardships have worsened because other financial backers have failed to respond adequately to the IMF imprimatur. The resulting import cuts are likely to shrink the region's combined current account deficit in 1983 to under $1.5 billion—the first such decline in six years. Even so, the burden of the region's external account adjustment is becoming more onerous as popular dissatisfaction with austerity deepens. 25X1

The situation in Jamaica, the Dominican Republic, and Haiti—where three out of four non-Cuban Caribbean nationals live—typifies the region's problems:

- Jamaica's long-awaited recovery is sputtering. Any economic upturn must await a rekindling of demand for bauxite and alumina, which we believe is at least a year off. Jamaica recently devalued its currency 43 percent and abandoned its IMF Extended Fund Facility in favor of a 15-month standby program to begin in January. Opposition-led civil disturbances in the coming months could threaten recovery.

- In the Dominican Republic, sinking sugar prices and government overspending had brought the economy to its knees by 1982. Borrowing shortfalls and a delayed Paris Club debt rescheduling appear to have pushed the country out of compliance with its 1983 IMF targets, thereby undermining an already limp recovery.

- Under the IMF's aegis, Haiti's byzantine public finances are becoming less opaque, but a drought-inflicted drop in coffee production will limit economic recovery through 1984. 25X1

The smallest English-speaking islands continue to face intractable development problems. Banana production, which contributes more than 40 percent of their export earnings, has yet to regain 1979 levels because of a series of hurricanes. 25X1

Until recently, there were at least a few bright spots. Trinidad and Tobago, the Netherlands Antilles, and The Bahamas experienced oil-based economic booms that had begun to spread to other sectors. Despite their perennially high unemployment, these countries had become a magnet for many other Caribbean nationals seeking jobs surreptitiously. Declining oil prices—and in the case of Trinidad falling oil production—have seriously dimmed economic prospects over the near term. For its part, The Bahamas has taken steps to expel the 40,000 or so illegal immigrants, mainly Haitians, residing there. 25X1

Despite this gloomy picture, we do not expect any resurgence in Communist influence over the short term at least. In Jamaica, for example, Prime Minister Edward Seaga has called for elections next week in order to capitalize on the popularity he gained by supporting US action in Grenada. An opposition boycott to protest the use of outdated voter lists has assured Seaga's election.

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Meanwhile, Brasilia's bid to preempt Cuba in Suriname—reinforced by recent events in Grenada—appears to be succeeding. Well-established democratic traditions and strong labor movements will continue to vent popular grievances over individual austerity programs elsewhere. 25X1

The region's economic deterioration and worsening divisiveness in the Caribbean Community (CARICOM) will almost certainly mean increased petitioning of Washington for help. Grenada could need $20-40 million through 1984 to replace lost sources of foreign funding. Caribbean leaders probably are overly optimistic in hoping that revived investor interest in Grenada will have a substantial spillover effect in the region. The CBI's duty-free benefits and the expected hardening of Generalized System of Preference terms for other LDCs after 1984 have sparked US, Asian, and other investor interest in the Caribbean. Probable lapses in IMF and other foreign funding, however, will crimp the ability of Caribbean countries to broaden their export bases in order to take full advantage of the CBI and world recovery. Moreover, CARICOM's cohesiveness is frayed over local trade restrictions and the region's involvement in the Grenada crisis, thereby further complicating regional solutions to the area's problems. In these circumstances, Caribbean countries are likely to ask Washington not only to take a larger hand in revitalizing their economies but also to prod the IMF and other benefactors to keep their money spigots open. 25X1

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Briefs

Energy

Japanese Ease Suspension of Iranian Liftings

Agreement by Japan's Seaman's Union to permit Japanese tankers to load crude at Iran's main oil export terminal at Khark Island on a case-by-case basis eases recent restrictions that had interrupted Japanese liftings. Concern about a possible escalation of military activity in the Persian Gulf prompted by the sinking of a Greek merchant ship by Iraq off Bandar-e Khomeini late last month had led the union to ban all liftings at Khark. Japan currently has contracts to lift nearly 400,000 barrels per day of Iranian crude. Should the ban be reimposed, we believe Japan probably would charter foreign vessels to transport Iranian crude outside the Persian Gulf. Last summer Tokyo chartered Norwegian flagships during the height of Iraqi strikes at Khark. For its part, Tehran could opt to lighter or shuttle oil to ports at Sirri and Lavan Islands for export if ships refuse to go to Khark. The Iranians probably would offer substantial crude discounts or enter barter agreements as well in order to maintain oil exports. 25X1

Iranian Oil Well Blowout

25X1 Iran experienced a well blowout at its offshore Firouzan field on 14 November. The blowout reportedly occurred during routine maintenance being performed by a US drilling company at a five-well platform, resulting in a spill of nearly 3,000 barrels of oil per day into the Persian Gulf. This marks the second serious Iranian oilspill this year. Two platforms in Iran's offshore Norwuz field—located approximately 120 kilometers north of Firouzan—were set ablaze in March by Iraqi airstrikes and continue to leak at a rate of 1,000 to 2,000 barrels per day. The spills threaten water supplies and operation at desalination plants along the Gulf. We believe the Iranians do not have the expertise needed to perform the difficult capping operations at Norwuz or to stop leakage at Firouzan and will need foreign assistance. According to the US Embassy in Bahrain, the Iranians probably plan to task a team of US experts to plug Firouzan. 25X1

Saudis Lose LPG Sales

The US liaison office in Riyadh reports that 1984 LPG sales may fall 25 percent below Riyadh's goal if the Saudis fail to meet Japanese and other customers' demands to lower LPG prices from about $235 per ton to $200 per ton. Earlier this year most LPG buyers signed long-term supply contracts with the Saudis that appeared to offer reasonable hope of stabilizing prices. Low oil production levels in the second quarter of this year, however, forced cancellation of a large number of deliveries and allowed Riyadh to hike prices to $280 per ton. The runup in prices caused many companies to invoke phase-out clauses in their contracts, and Japanese companies, which take close to half the

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kingdom's LPG exports, probably will refrain from signing long-term contracts. Riyadh apparently does not now intend to accede to customer pricing demands because of expectations of a tighter LPG market, but unless demand picks up the Saudis face a potential revenue loss of over $250 million next year. 25X1

Saudi Arabia Planning Increases in Domestic Petroleum Prices

Petromin, Saudi Arabia's state-run oil company, is proposing as much as a threefold increase in domestic petroleum product prices for the next fiscal year—beginning in April 1984—according to the US Embassy in Riyadh. The increases are aimed at reducing the estimated $1 billion annual subsidy on petroleum products. The move would bring Saudi petroleum prices more in line with those of other Gulf states for products such as gasoline, diesel, kerosene, and LPG. Petromin and Ministry of Petroleum economists hope that higher prices will moderate the increases in petroleum product consumption, which have averaged more than 20 percent annually over the past three years. Gasoline products, however, will still be viewed as a bargain; premium gasoline currently costs only $0.25 per gallon. Although King Fahd did not agree to price increases recommended earlier this year by a special ministerial committee, he probably will approve at least modest increases for the next fiscal year because of pressure from other members of the Gulf Cooperation Council to standardize prices for petroleum products. 25X1

Soviet Offshore Oil Platforms

The Soviets intend to begin construction of a facility on Sakhalin Island early next year that will produce offshore platforms for oil and gas exploration and production, 25X1 They are discussing contracts for the project with Japanese, French, and Canadian firms but favor the Canadians because of their expertise in harsh environments. Being able to build offshore oil platforms would make the Soviets less vulnerable to possible Western economic sanctions. The length of time needed to construct a production plant, however, and the Soviets' difficulty in handling the associated advanced technologies, would keep the USSR from becoming self-sufficient in this field for many years. The exploratory drilling phase off Sakhalin reportedly is complete—the fields are expected to begin producing oil late in the decade—and the Soviets presumably will continue to rely on Western-built platforms and other oil-related equipment for some time. 25X1

Saudi Named President of Aramco

Ali Naimi, the current Senior Vice President for Oil Operations, has become the first Saudi national to be elected president of Aramco. The change was widely expected and is effective 1 January 1984 when the current president, an American, retires. Naimi has bachelors and masters degrees in geology from the United States and has been an Aramco vice president since 1975. 25X1 25X1 the oil industry consider Naimi to be a highly capable individual with the necessary experience to fill the post. His appointment is not expected to result in any major changes in the company's operations. Naimi

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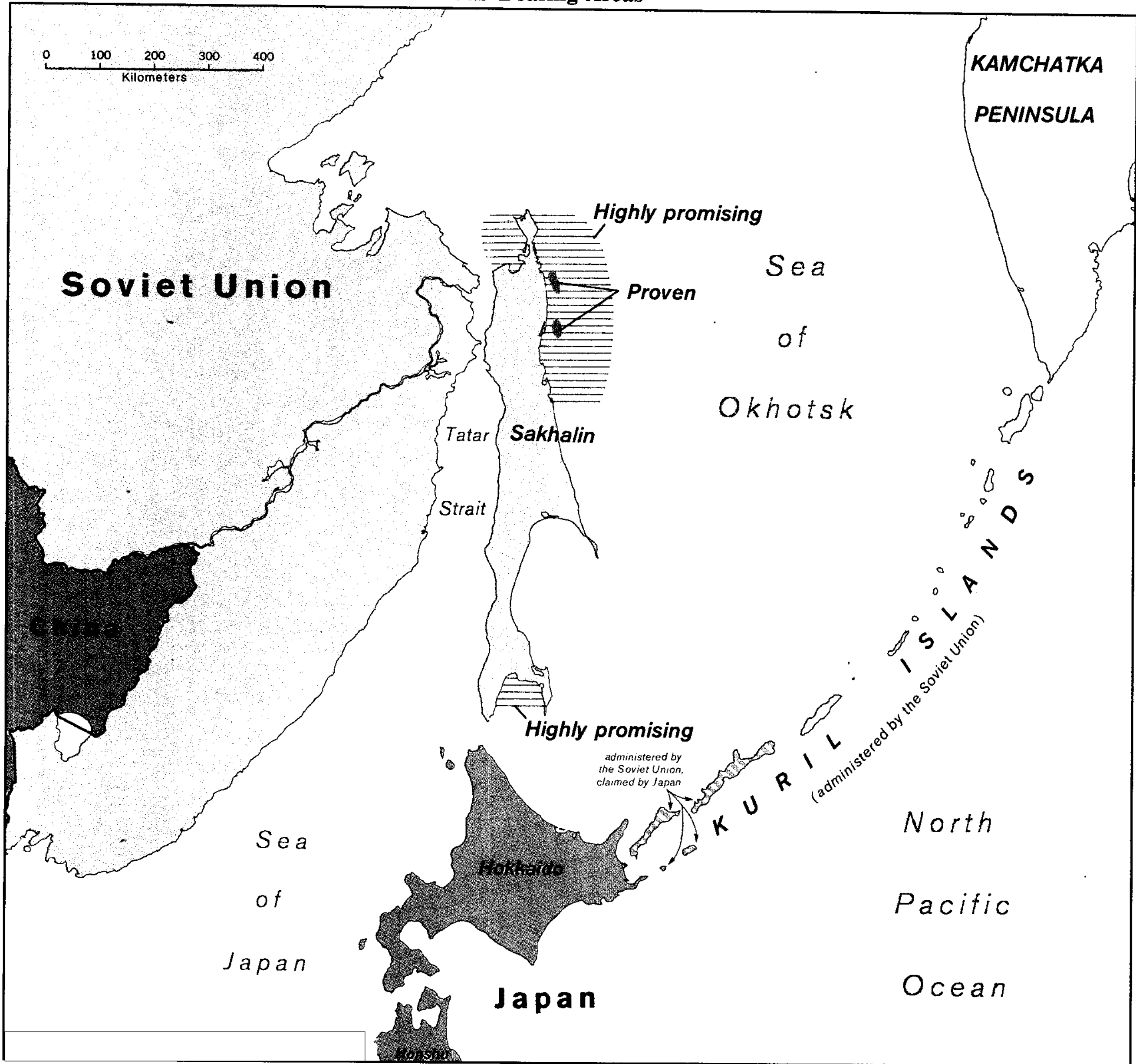
Sakhalin Island's Petroleum and Natural-Gas-Bearing Areas



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must also be considered a front-runner to fill the Chairman's position if Riyadh eventually chooses someone from within the company for Aramco's top slot—a post held by an American since the company's formation in 1933.

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Trucks Stop Carrying Iraqi Oil to Jordan

Jordanian transport authorities ordered a halt to truck shipments of Iraqi fuel oil on 9 November because of damage to the Baghdad-Aqaba highway, according to information obtained by the US Embassy in Amman. Two Jordanian trucking firms had been using a fleet of about 600 trucks to deliver a contracted volume of 15,000 b/d of fuel oil produced at Iraq's new refinery at Baiji. The trucks weigh 30 tons each and are capable of carrying 60 tons of oil fully loaded. Trucking officials say the new regulations would permit only half loads, which they consider unprofitable. While the shutdown of the Jordanian export outlet affects only a small volume of oil, it still is a setback to Baghdad's efforts both to maximize oil export earnings and to dispose of surplus fuel oil. Baghdad's main export outlet remains the crude oil pipeline through Turkey, which is expected to reach a throughput of 900,000 b/d early this month.

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Indonesia Discounting Oil Prices

In an effort to boost crude export volumes and revenues, Pertamina is marketing crude oil under arrangements that effectively discount the oil by $1 to $2 per barrel below the official OPEC selling price, 25X1

25X1 Although each $1-per-barrel price cut costs Indonesia about $300 million in foreign exchange earnings on an annual basis, each additional 100,000 b/d of exports earns about $1 billion annually. Indonesian crude output in recent months has exceeded its OPEC production ceiling of 1.3 million b/d, and the source estimated that November production might be 200,000 to 300,000 b/d above the ceiling.

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International Finance

IMF Resources Increase

The IMF confirmed on 30 November that member nations representing more than 70 percent of total member subscriptions—the minimum share necessary for the quota increase to be implemented—had ratified the eighth general quota increase. As a result the Fund lifted restrictions on the approval of new standby and extended programs, which it had imposed out of concern for its liquidity position. The $31 billion quota increase will provide the fund with roughly $16 billion in hard currencies with the remainder being in domestic currencies of weaker economies. Those smaller nations that have not yet indicated their consent will be allowed two additional months to respond.

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We now expect that central bank governors of the G-10 countries (less the United States) and Switzerland will move forward with the $3 billion interim financing facility that will cover IMF financial commitments until the quota

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increases are paid in. We expect the BIS will announce a final decision on the $3 billion loan following its meeting on 12 December. A favorable BIS response should then release a $3 billion short-term loan from Saudi Arabia that has been linked to the BIS action. These actions put the Fund in a much better position to make large balance-of-payments loans to countries such as Argentina, Nigeria, Egypt, Yugoslavia, and Hungary, which are presently negotiating or considering large financing programs. The new financing also should demonstrate to commercial creditors and debtors alike that the major industrialized nations remain committed to the current debt management strategy. 25X1

Peru's Growing Financial Problems

Lima's deteriorating fiscal position and continued large military outlays are generating problems with the IMF and commercial banks that could upset Peru's financial rescue package. According to Embassy reporting, the government is now renegotiating targets under the IMF program because it failed to reduce the public deficit as stipulated in the agreement. Instead, Peru's federal deficit doubled to 9 percent of GDP this year because of (a) the fall in tax revenues caused by the 10-percent decline in economic activity, (b) the higher public spending necessitated by both the increase in inflation to 130 percent and programs to blunt the impact of natural disasters, and (c) the inability to trim military and security outlays. 25X1

Dismayed by Lima's failure to comply with the IMF program, international lenders are now delaying some project loan disbursements. 25X1 these funds are likely to remain frozen, in part, to express displeasure with large military expenditures such as a planned $800 million purchase of Mirage aircraft. 25X1 As a result of these loan delays, Lima probably has been forced to cover this year's $1.1 billion current account deficit in part through reductions in its foreign reserves by more than the IMF agreement permits. Failure to get the IMF program restarted soon—a task now made more difficult by rising domestic opposition to austerity and the planned departure of the finance minister next month—will jeopardize more than $800 million in rescheduling and new loans arranged earlier this year and Lima's ability to obtain $400 million in new loans it claims to need in 1984. 25X1

Dominican Republic Breaks Off Talks With IMF

Negotiations between the Dominican Republic and the IMF to set 1984 performance targets under the country's $450 million Extended Fund Facility apparently have broken down and are unlikely to resume before January. Santo Domingo has rejected as politically unacceptable Fund stipulations that the Dominican Republic slash the public sector's projected $600 million budget deficit, eliminate foreign payment arrears, and move toward unifying the dual exchange rate—either by an official devaluation or the transfer of at least $140 million in trade transactions to the more costly parallel exchange rate. The government's intransigence arises from labor pressures over chronically high unemployment and shrinking real wages, business opposition to new

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tax increases, and denunciation by both factions of the ruling party of any devaluation of the peso. Failure to reach agreement soon on 1984 performance criteria would further delay Paris Club renegotiation of some $400 million in official debt and would be likely to freeze international lending necessary to restock depleted petroleum and food reserves. 25X1

Global and Regional Developments

Soviet Purchase Squeezes Palm Oil Market

In late November the USSR purchased 250,000 metric tons of Indonesian palm oil—about 5 percent of world palm oil trade—for shipment through July of next year, 25X1 Soviet vegetable oil imports have increased dramatically from 200,000 tons in 1978 to 870,000 tons in 1982 because of declining production and growing consumer and industrial use. Although Soviet vegetable oil production picked up in 1983, we believe imports will remain high—650,000 to 700,000 tons in 1983 and at least 600,000 tons next year. 25X1

Palm oil prices have risen about 80 percent since the first of the year; the large size of the Soviet purchase could push prices even higher in the weeks ahead. Pressure on palm oil prices, however, is expected to ease some time next year because production worldwide is projected to reach a record 6.5 million tons, according to USDA estimates. Supplies of most other vegetable oils are expected to remain tight and prices high during the 1983/84 crop year. 25X1

Vegetable Oil Prices

	Price (*US $ per metric ton, Rotterdam*)	Percent Change Since 1 Jan 83
Peanut	1,010	117
Cottonseed	879	78
Coconut	860	100
Sunflower seed	723	58
Soybean	687	72
Palm	671	78
Rapeseed	656	71
Linseed	601	44

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EC Moves on Wheat Surplus

New EC efforts to reduce burgeoning wheat stockpiles—currently at over 12 million tons—may undercut US exports of nongrain feed substitutes, such as corn gluten; in 1982 the United States exported $700 million of these products to the Community. The EC Commission has instituted a three-month program to use up to 2 million metric tons of surplus wheat in animal feed. The wheat will be sold to EC feed producers at approximately $170 a ton, about 3 percent below the current EC support price. EC officials have debated this measure since November, but it was delayed because of opposition from Belgium and West Germany who feared it would seriously distort the Community's domestic grain market.

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The measure is another in a series of patchwork EC efforts that are intended to dispose of surplus agricultural output rather than address the fundamental causes of excess production—high support prices. In October the Community provided extra export subsidies for wheat flour sales to Egypt, and since July the EC has sold 1.7 million tons of subsidized grain to the Soviet Union. The EC Commission is also considering a proposal to tax imports of nongrain feed substitutes in order to encourage domestic wheat consumption. Some Community members, particularly France, insist that imports of corn gluten must be limited as part of an overall plan to contain runaway EC farm spending.

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Eastern Europe Reselling Libyan Oil

At least three East European countries—Bulgaria, Hungary, and Poland—are reselling Libyan crude oil to bolster their hard currency trade performance. During January-June 1983, the three countries imported nearly 60,000 b/d from Libya compared with almost nothing during the same period a year earlier. Polish and Hungarian oil exports for hard currency, in turn, have tripled over this period while Bulgarian sales increased at a slower pace. The resold oil brought in an estimated $225 million for Hungary, $120 million for Poland, and $140 million for Bulgaria. The importance of the resales is shown by the fact that Hungary's total hard currency exports grew by only $155 million during January-June 1983 compared with the first half of 1982, Poland's exports were up by $330 million, and Bulgaria's fell by $135 million.

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The three countries apparently have obtained the Libyan oil under different terms. The Poles have announced that their imports came from a $230 million Libyan credit for oil. Because of its desperate need for cash, Warsaw had to resell the oil at a loss of well over $2 a barrel. Bulgaria and possibly Hungary appear to have received their oil as repayment for past credits extended to Tripoli. Both Sofia and Budapest were pressing Libya last year to cover late payments. Some market observers, however, believe that the Hungarians obtained some of their Libyan oil on 360-day credit and then resold it for cash. Such transactions would enable the Hungarians to show a desperately needed gain in exports this year and prop up faltering cash reserves. The practice would bode ill for 1984, however, when Budapest must cover a sharply rising level of debt repayments to Western banks.

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Libyan-Italian Commercial Payments Problems

Libya has made little progress in resolving its $625 million payment arrearages to Italy, [redacted] Tripoli's reliance on trade with Italy and Rome's long-term interest in developing Libya's offshore petroleum resources, however, weigh in favor of a near-term settlement. In the meantime, the payment difficulties have caused Rome to stop issuing export insurance coverage on new credits to the Libyans. Qadhafi probably will remain intransigent on the payments problem, however, until Rome agrees to larger purchases of crude oil and natural gas at higher prices. Complicating the issue further is Qadhafi's demand in October that Italy pay large indemnities for the colonial occupation of Libya; the Italians have been unable to elicit any clarification of the demand. [redacted] 25X1

National Developments

Developed Countries

West Germany Unveils Early Retirement Plan

Labor Minister Norbert Bluem has unveiled a government plan to encourage early retirement in an effort to slow the growth of unemployment. If the plan is adopted early next year, as expected, workers could retire at age 59 and receive a pension of 65 percent of their gross wage. The government would pay 40 percent of the pension if the employer hires a replacement from the ranks of the unemployed. Full pensions would continue to commence at age 63 for men and 60 for women. Government labor statistics show that about 800,000 German workers—4 percent of the labor force—could take advantage of the program. [redacted] 25X1

Italian Labor Talks Begin Today

Crucial talks among government, labor, and management on the Italian economy began today and probably will focus on Italy's wage indexation system. The Craxi government wants to modify the indexation system and reach an agreement on a broad incomes policy in an effort to bring inflation down from 15 percent this year to 10 percent in 1984. Confindustria, the employers association, will join the government in pushing for a reduction in indexation; the group has called for its elimination. The United Federation, Italy's umbrella union, is divided on the indexation issue although it can agree on the need to contain inflation. The unions are likely to make concessions on wage indexation if new government employment programs and favorable changes in labor laws currently under consideration are enacted. [redacted] 25X1

Exports Boost Spanish Economic Growth

Strong export growth during the first 10 months has prompted Madrid to boost its 1983 economic growth projections from 1.7 percent to 2.1 percent. In real terms, exports were up 8 percent from the same period a year earlier—well above Madrid's target of 5 percent. Imports remained stagnant. In our view, the export surge reflects improved competitiveness since the end of 1982, the US economic recovery, and the slight economic upturn elsewhere in Western Europe. Although the 2.1-percent economic growth rate will be

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Spain's best since 1977, it remains short of the 3.5-percent growth Madrid estimates is needed to hold unemployment steady. Unemployment has continued to creep upward, reaching 17.8 percent at the end of the third quarter. While the strong export performance is expected to continue next year, Madrid and the OECD predict that economic growth will improve only slightly, to 2.5 percent, as private consumption spending remains sluggish.

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Declining South African Gold Production

Gold production, the largest single source of government tax revenues and foreign exchange earnings, has fallen roughly one-third since its peak of 1,000 metric tons in 1970, and average yields have dropped from 11.2 grams per ton in 1970 to 6.6 grams last year. On the basis of a mine-by-mine review, we believe that output will decline further to about 600 tons by 1990. This expectation is based on the belief that no major new discoveries will occur and that ore grades will continue to decline. The depletion of gold reserves is inducing the South African mining industry to shift its attention to coal mining, according to the South African Chamber of Mines. Unless gold prices regain high levels for a sustained period—$800 an ounce or more—we estimate that investment in the South African gold industry will soon begin to decline.

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Less Developed Countries

New Bolivian Economic Policies

The Siles administration decreed new economic policies last month to deal with Bolivia's worsening financial crisis. These first steps represent a gradual approach that is about the best that could be expected given Siles's tenuous political position. To smooth the way for austerity, however, La Paz announced a 72-percent increase in minimum wages on 5 November. This was quickly followed by austerity measures to improve the payments accounts and qualify for IMF assistance. The Siles government:

- Devalued the peso by 60 percent.
- Removed food and gasoline subsidies.
- Hiked transport fares and electric power tariffs 50 percent.

As a further palliative to workers and businessmen, La Paz announced income tax reductions for the last quarter of 1983 and new credits for farmers, industrialists, and exporters.

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The IMF representative in La Paz has expressed disappointment with the measures, according to the US Embassy, because they did not go far enough. To qualify for an IMF loan, Siles may be required by the IMF to slash the budget deficit, tighten monetary policy, and close the remaining gap between the official and the free market exchange rate. We believe it will be hard for Siles—who faces a serious threat of a coup—to implement more painful economic adjustments. Indeed, the recent measures caused brief work stoppages and public demonstrations. Serious social unrest sparked by tougher austerity could give military coup plotters the pretext needed to replace Siles.

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West Bank Economy Slowing

The buoyant West Bank economy—real income has grown at an average annual rate of 12.7 percent since 1968—is beginning to feel the impact of Israel's economic problems. The purchasing power of West Bankers employed in Israel or by the Israeli Civilian Administration has been temporarily squeezed by large price hikes for such goods as bread, milk, and fuel. These workers, however, will receive the same cost-of-living adjustment scheduled to be paid on 1 February as Israelis. A Ramallah merchant claims local sales have dropped by 30 percent since summer, according to reporting from the US Consulate in Jerusalem. In addition, the West Bank press reports that West Bankers, as well as Israelis, are being laid off at Israeli factories. 25X1

Remittances from relatives in the Gulf states and the United States and sizable accounts abroad, however, are enabling many middle- and upper-class West Bankers to maintain living standards. The Consulate reports that such residents in Ramallah are still buying expensive clothes and large appliances. Local travel agents report that business has not declined. 25X1

Finding jobs for young West Bankers who will increase the labor force by 5 percent annually over the next few years is the area's most pressing economic problem. While still very low, the 2.4 percent unemployment rate in the first quarter of 1983 was the highest recorded in more than a decade. Since the soft oil market is forcing Gulf states to scale back development plans, these countries cannot be counted on to provide job opportunities for the growing West Bank labor force. The Consulate reports that West Bank university graduates are having difficulty finding employment in the Arab countries. The number of West Bankers working in Israel has stabilized in recent years and is unlikely to increase any time soon. 25X1

Impact of Sluggish Economy in the United Arab Emirates

The UAE government has responded to the protracted soft oil market with limited austerity policies—instituting controls on bank lending, insisting on loan repayments, cutting back on new contracts, and reducing foreign employment. The downturn in the economy and stricter government policies have threatened some major UAE businessmen with bankruptcy. Many local businessmen became rich quickly during the mid-1970s because of the oil price boom, but subsequently went deeply into debt because of lavish spending and bad investments. According to the US Embassy in Abu Dhabi, several families who have built large enterprises face major losses. We believe the government will continue its austerity measures, despite the rising bankruptcies. 25X1

Communist

Soviets Cut Retail Prices

The USSR on 1 December reduced prices by 13 to 30 percent on selected consumer durable goods. This is the second round of retail price cuts in four months. The price reductions—like those in the past—probably are designed to reduce inventories, particularly of poor-quality items. So far, however, the cuts apparently have not spurred sales. 25X1
sale signs in stores have attracted little attention. 25X1

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By lowering prices the Soviet leadership may hope to offset earlier price increases and limit 1983 inflation. Official state retail price indexes show an unprecedented inflation rate in 1982 of 3.8 percent. Soviet data for the first six months of 1983 show an annual inflation rate of 1.7 percent—still high by Soviet standards—reflecting unannounced retail price increases in February. The September and December price cuts could well be an effort to hold 1983 inflation to the lower past levels.

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International Financial Situation: Big Seven Economic Recovery on Track

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This article is part of our series focusing on the economic and political aspects of the international financial situation.

Outside of North America, the economic recovery among the Big Seven industrial countries is developing much as private and official forecasters expected at the beginning of 1983.[1] In the United States the recovery picked up steam far more rapidly than most forecasters had earlier predicted, and the US advance in turn has boosted Canadian growth. While most economic observers believe that the US and Canadian economies will stay buoyant for the next year, the recovery is expected to remain weak in Western Europe and Japan. In general, the debt situation of the financially troubled LDCs will not change significantly from earlier predictions given the present course of the recovery in the Big Seven countries. More rapid US economic growth, however, should provide some extra export earnings for Latin American and East Asian countries. If the Big Seven recovery starts to falter in late 1985 or early 1986, as many forecasters now expect, this could worsen LDC debt problems.

Few Surprises in the Recovery

The strength of the US economy has been the major unexpected development in the current recovery. Real GNP boomed in the first three quarters of 1983 and now is projected to advance 3.3 percent for the year as a whole. The rise in US GNP in turn is pulling the Canadian economy along because Canada sells 70 percent of its exports to US customers. Accordingly, Canada is expected to post 2.7-percent growth in 1983, compared with expectations of 1.3 percent at the beginning of the year.

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The growth of the Big Four West European economies in 1983 is somewhat less than had been expected. In Western Europe, the effects of tighter French and, to a lesser extent, Italian monetary and fiscal policies have outweighed the improvement in the West German and British economies. GNP in France and Italy for 1983 is now expected to contract. The West German economy is expected to grow nearly 1 percent this year, double earlier expectations, because workers are spending more than previously expected. British growth for 1983 is now projected at 2.3 percent, up from earlier estimates because of tax cuts implemented in April.

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As expected, the recovery in Japan is relatively sluggish. Despite a healthy pickup in exports to the large North American market, GNP growth is lagging largely because of weak corporate investment. Forecasters now expect Japanese real growth to advance only 3.3 percent in 1983. Even the recently announced stimulus package failed to affect the economic outlook because many of the important measures will not take effect until next year.

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Outline for 1984

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Most forecasters believe GNP growth will pick up across the board in 1984. Consolidating the gains made this year, US and Canadian economic growth rates are projected to reach, or even exceed, 5 percent. Trade barriers and attempts to control the

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government budget deficit are expected to hold Japanese growth to about 4 percent, lethargic by past Japanese standards. Forecasters think that all four major West European countries will post GNP advances next year, with growth averaging 2 percent. Slow growth among trading partners, the effects of anti-inflationary policies, and the loss of international competitiveness in basic industries are the principal factors that will hold down the pace of recovery in Western Europe next year.

Impact on LDCs

Although marginal improvement in Big Seven economic growth prospects will help LDC trade performance, the overall financial outlook for the debt-troubled LDCs is barely affected. Using CIA's Linked Policy Impact Model, we estimate the pickup in Big Seven growth adds only a few billion dollars to nonoil LDC exports. With their economies closely tied to North America, Latin American and East Asian LDCs benefit the most from the extra boost in the US economy. African and South Asian countries, on the other hand, may be slightly worse off since they trade more with Western Europe. In the first half of 1983, Big Seven imports from the four largest LDC problem debtors—Mexico, Brazil, Argentina, and Chile—were about $1 billion higher than in the same period a year earlier; the United States accounted for almost all of the advance.

After 1984

Forecasters increasingly believe that the Big Seven countries may suffer a short, mild recession starting in late 1985 or early 1986. This could compound LDC debt problems as grace periods from recent debt rescheduling run out. Most forecasters expect inflation to pick up in all the Big Seven countries in 1985, causing them to adopt more restrictive policies. Many forecasters point to large budget deficits and low saving rates in several of the Big Seven as the major factor behind the projected upswing in inflation, although several also believe that this year's upsurge in money supply growth will contribute to faster price increases. Most forecasters presently expect that the next recession will be mild; they believe that governments will not let inflation get out of control before adopting anti-inflationary programs and thus will not have to rein in as hard as they did in 1980 to 1982.

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International Financial Situation: Nonoil LDC Terms of Trade Bottoming Out

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This article is part of our series focusing on the economic and political aspects of the international financial situation.

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The five-year decline in the nonoil LDC's terms of trade appears to have ended. We estimate that the terms of trade in the second quarter of this year rose about 7 percent from the low point reached in fourth-quarter 1982 because of rising prices for LDC primary export commodities and the continuing slide in prices of imported manufactures. More favorable terms of trade would make it easier for LDCs to service foreign debts, rebuild reserves, and reverse sharp import cuts, but the outlook for further improvement is uncertain.

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Five-Year Decline Bottoming Out

Nonoil LDC terms of trade—the ratio of their export prices to their import prices—fell 28 percent between 1977 and 1982. During 1977-80 the decline was due to rising import prices—particularly for oil—which soared 60 percent, more than offsetting a 39-percent gain in export prices. In 1981 and 1982 the situation was reversed; although import prices began to decline in early 1981, this gain was outweighed by a 14-percent drop in export prices between 1980 and 1982 as recession in the developed world reduced demand for LDC raw materials.

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Although current export and import price data are not available for most LDCs, our estimates indicate that the sharp terms of trade decline has finally bottomed out. The estimated 5-percent rise in the first half of this year from second-half 1982 is the first sustained improvement in nonoil LDC terms of trade since 1977.

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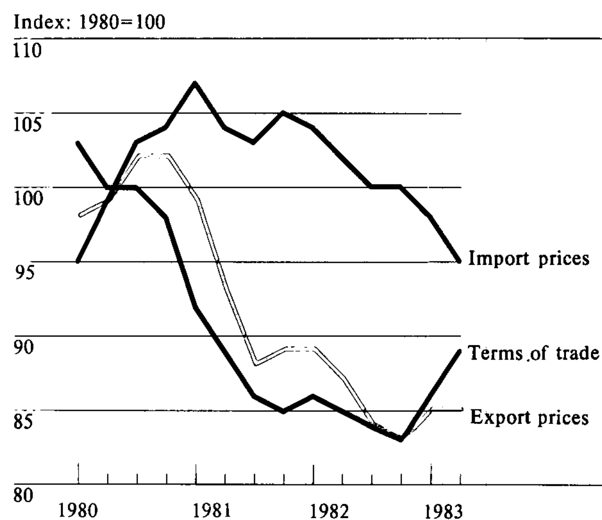
Nonoil LDC Terms of Trade



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The improvement in first-half 1982 was due both to a turnaround in commodity prices and a continuing decline in dollar import prices for oil and OECD manufactured goods. The strength of commodity prices is confirmed by the *Economist* and the *Journal of Commerce* indexes; in June both were almost 20 percent higher than a year earlier. At the same time, prices for manufactured imports from developed countries continued to fall, dropping an estimated 6 percent between first-half 1982 and first-half 1983.

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Estimating the Terms of Trade

Most nonoil LDCs lack current and accurate export and import price data. To estimate export prices for these countries, we took dollar price indexes for 13 commodities (or commodity aggregates), plus a proxy for manufactures export prices, and calculated a trade weighted average. Import prices were estimated by taking dollar export price indexes for 13 developed countries plus a world oil price index, and again calculating a trade weighted average. This methodology provided terms of trade estimates which are considerably more current than those provided by the IMF's International Financial Statistics *and are probably more comparable on a cross-country basis since individual LDCs often have differing methodologies and limited data. Using the IMF's definition of nonoil LDCs, our estimates match the IMF's historical data quite closely, although some divergence occurs in the second half of 1982 when the IMF series relies on only a few LDC reporters. Our final nonoil LDC series excludes Mexico, Ecuador, and other net oil exporters included in the IMF's nonoil LDC grouping.*

Regional and Country Developments

The nonoil LDCs in Latin America have shown substantial improvement in their terms of trade. Argentina's terms of trade in the second quarter of this year was nearly 10 percent above the fourth-quarter 1982 level. Brazil showed even more improvement with its terms of trade up about 17 percent over the same time period. This increase followed a decline of more than 50 percent between 1977 and 1982. Mostly because of higher copper prices, Chile recorded a 16-percent jump in its terms of trade in first-half 1983; copper prices subsequently weakened.

In Asia, terms of trade developments were mixed. Our estimates indicate a moderate gain by the Philippines between fourth-quarter 1982 and second-quarter 1983. Asian LDCs more dependent on manfactured exports—Taiwan, South Korea, Hong Kong, and Singapore—showed less improvement, but they had also shown far less deterioration in recent years. Prices for manufactured and semimanufactured goods tend to be less volatile and tend to lag the price swings of primary commodities. These countries are likely to benefit from a gradual rise in export prices as well as a higher volume of sales to developed countries.

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For African nonoil LDCs the situation remains grim. Although Kenya's terms of trade rose an estimated 18 percent in the second quarter of this year from the low point reached in the fourth quarter of 1981, it is still 60 percent below the 1977 peak. Kenya's heavy dependence on coffee and tea exports makes it particularly vulnerable to price swings in those commodities. Zaire showed a slight terms of trade gain, mostly on the strength of copper prices in the first half of this year.

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Selected Nonoil LDCs: Export Prices, Import Prices, and the Terms of Trade

Index: 1980=100

	1980				1981				1982				1983	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
Nonoil LDCs														
Export prices	**98**	**99**	**102**	**102**	**99**	**93**	**88**	**89**	**89**	**87**	**84**	**83**	**85**	**85**
Import prices	**95**	**99**	**103**	**104**	**107**	**104**	**103**	**105**	**104**	**102**	**100**	**100**	**98**	**95**
Terms of trade	**103**	**100**	**100**	**98**	**92**	**89**	**86**	**85**	**86**	**85**	**84**	**83**	**86**	**89**
Argentina														
Export prices	92	95	105	110	104	97	91	86	85	84	79	77	80	84
Import prices	98	99	102	102	102	99	97	99	99	98	96	95	96	95
Terms of trade	94	95	103	107	102	98	93	87	86	85	82	81	83	89
Brazil														
Export prices	100	100	102	100	95	88	82	80	82	80	76	74	78	80
Import prices	94	98	103	105	108	107	106	108	107	105	104	104	101	96
Terms of trade	106	102	100	96	88	82	77	75	77	76	73	72	78	84
Chile														
Export prices	110	95	99	96	90	86	84	82	79	75	72	72	77	82
Import prices	97	99	102	103	104	102	101	102	103	101	99	98	99	97
Terms of trade	113	96	97	93	86	84	83	80	77	74	73	73	78	85
India														
Export prices	99	99	102	102	98	92	89	90	89	86	82	81	84	85
Import prices	96	99	103	104	105	102	99	102	101	99	97	96	95	92
Terms of trade	104	100	99	98	93	91	89	88	88	87	85	84	88	93
Kenya														
Export prices	108	108	99	92	88	82	73	73	79	79	74	72	78	77
Import prices	95	99	103	104	105	102	99	102	100	98	97	96	93	91
Terms of trade	114	109	96	88	84	81	74	72	79	80	76	75	83	85
Philippines														
Export prices	96	98	104	104	101	91	86	85	84	80	76	74	77	80
Import prices	95	99	102	105	108	106	105	107	106	104	102	102	101	98
Terms of trade	100	99	102	99	93	86	83	79	80	76	74	73	76	82
South Korea														
Export prices	97	99	103	102	100	95	92	95	94	92	89	88	90	89
Import prices	95	99	102	105	109	107	106	108	107	106	104	103	102	99
Terms of trade	102	100	100	97	91	88	86	88	87	87	86	85	88	90
Taiwan														
Export prices	97	99	103	103	100	95	92	95	94	92	88	87	89	89
Import prices	95	99	102	105	109	107	105	108	107	105	103	102	101	98
Terms of trade	102	100	100	97	92	89	87	88	88	87	86	85	88	91
Zaire														
Export prices	104	97	100	99	95	91	88	87	87	85	83	82	84	84
Import prices	99	100	102	100	97	92	90	93	92	91	88	87	88	87
Terms of trade	105	97	98	99	98	98	97	94	94	93	95	95	95	97

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International Financial Situation: Fading LDC Hopes for Commodity Trade Revival

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This article is part of our series focusing on the economic and political aspects of the international financial situation.

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Debt-troubled LDCs have been hoping that a revival in commodity markets would help solve their financial problems. During the recession, a steep slide in commodity prices—the most severe and prolonged since World War II—together with sizable falloffs in export volumes severely crimped revenues. While prices have recovered somewhat, we see little prospect in the near term for a strong turnaround in LDC earnings from either mineral or agricultural commodities.

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Selected LDCs:
Commodity Export Dependence, 1982

	Commodity	Commodity Export Earnings as a Share of Total Export Earnings (*percent*)		Commodity	Commodity Export Earnings as a Share of Total Export Earnings (*percent*)
Argentina	Corn	19	Morocco	Phosphates	27
	Wheat	14		Citrus fruit	9
	Hides and skins	10	Peru	Petroleum	22
	Meat	9		Copper	14
	Wool	6		Zinc	8
Brazil	Soybeans	11		Lead	7
	Coffee	9		Silver	6
	Iron ore	9		Fishmeat	6
	Sugar	2		Iron ore	3
Chile	Copper	45	Philippines	Coconut products	12
	Iron ore	4		Sugar	8
Costa Rica	Coffee	27		Copper	6
	Bananas	27		Wood	6
	Beef	6	Zaire	Copper	40
	Sugar	2		Coffee	19
Ivory Coast	Cocoa	22		Diamonds	12
	Coffee	20		Cobalt	7
	Wood	9			
Kenya	Petroleum	26			
	Coffee	25			
	Tea	14			

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Commodity Price Developments

	Percent Change		Major Non-Communist Exporters
	January to October 1983	1979-80 Peak to October 1983	
Palm oil	79.7	−3.6	Malaysia, Singapore, Indonesia, Ivory Coast
Soybean oil [a]	79.4	−1.8	United States, Brazil, European Community
Soybeans [a]	49.0	−3.0	United States, Argentina, Brazil
Corn [a]	47.0	−2.8	United States, Brazil, Argentina
Aluminum	45.6	−30.1	United States, Canada, Japan
Sugar [a]	42.3	−78.8	Australia, Brazil, Philippines, European Community
Rubber (natural) [a]	31.2	−30.2	Malaysia, Indonesia, Thailand, Sri Lanka, Liberia
Zinc	26.6	1.2	Canada, Australia, Peru
Nickel	23.5	−34.5	Philippines, Canada, New Caledonia, Australia
Cotton [a]	22.2	−15.7	United States, Pakistan, Brazil
Cocoa	17.6	−43.9	Ivory Coast, Ghana, Brazil, Nigeria, Cameroon
Cobalt [a]	12.0	−78.0	Zaire, Zambia
Coffee [a]	10.7	−30.9	Brazil, Colombia, Indonesia, Ivory Coast, Uganda
Tin	8.4	−25.4	Indonesia, Thailand, Bolivia, Brazil, Malaysia
Beef	7.6	−22.8	Australia, Argentina
Rice	2.9	−33.9	Thailand, United States, Australia, Pakistan, Burma
Tungsten ore	−3.4	−49.4	Canada, Bolivia
Wheat [a]	−4.0	−21.7	United States, Canada, Argentina, Australia
Copper	−10.4	−51.9	Chile, Peru, Philippines, Zaire
Lead	−11.1	−67.8	Peru, Mexico

[a] Based on price data through the first week of November.

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Recent Price Performance

Early in 1983, evidence that the US recovery was under way sparked a rally in commodity prices. By August the *Economist* price index of industrial materials was up about 20 percent from its November 1982 low, although it has since dropped slightly. The rise in many commodity prices was touched off by speculators anticipating a strong surge in demand similar to that which followed other recessions. With the exception of zinc, however, none of the major commodities has regained its prerecession price level; several remain 40 percent or more below their peak prices. Indeed, prices of some commodities are below those of a year ago. Particularly disappointing from the LDC exporters' point of view has been the performance of copper; its current price is 10 percent below the January 1983 level.

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Poor Commodity Trade Outlook

Prospects for an export turnaround on the commodity front are considered poor by most trade sources, particularly for metals. Demand for metals is highly sensitive to the business cycle, and the current OECD recovery is neither as widespread nor as rapid as the 1976-80 recovery. Even if the recovery gains some momentum, we believe that several

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Differing Commodity Market Responses to Recent Recoveries

Circumstances this year differ dramatically from those of the last two recoveries. When commodity prices rose sharply during 1973-74, the United States, Western Europe, and Japan were experiencing a synchronized and rapid recovery. Industrial production, and therefore demand for many primary commodities, grew rapidly. In addition, fear of shortages, inflationary expectations, and the imposition of price controls stimulated speculative demand.

During the same period, none of the normal buffering mechanisms existed to moderate the price pressures. Inventories were low, and metal productive capacity was in short supply. This was due, in part, to uncertainty over currency values under the then new system of flexible exchange rates, costly environmental regulations that deterred new investment, and a general belief that growth during the 1960s had been excessive. In addition, unfavorable weather conditions and political events led to production shortfalls. Droughts in the USSR, Asia, and Africa ruined wheat, sugar, rice, cocoa, coffee, and corn crops. Frost reduced Brazil's coffee output, and heavy rains flooded Malaysian tin mines. Political chaos in Chile and Zambia's decision not to use a Rhodesian railway led to decreased copper production. These events, coupled with the surge in oil prices, led to market disruptions and soaring prices. After a sharp decline in prices during a recession in 1975, the developed world again shared a common business cycle leading to increases in commodity prices.

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The current recovery is different from the previous two. There has been no synchronized surge in demand, and inflation is expected to stay relatively low. Large producer and institutional stocks are restraining prices. High interest rates and low industry profits will continue to restrain investment in new plant and equipment. In addition, the increased participation by industrializing LDCs as commodity importers during the past decade has slowed considerably because of low export earnings and severe debt problems.

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factors will continue to constrain metals price increases:

- Capital investment activity—which is metal intensive—is still slow because of high interest rates and low industrial capacity utilization—79.6 percent in the United States and 77 percent in the EC.
- Consumer goods industries, although enjoying a revival in the United States, have reduced their material demands because of down-sizing and synthetic material substitution.
- Metal fabricators are likely to limit stockbuilding, buying only to cover current consumption because of oversupply and expectations of continued low prices.
- LDC demand will remain weak as financial problems and IMF-mandated austerity measures limit imports and investment.
- LDCs—reluctant to cut exports—continue to increase metals production using new capacity that results from ambitious development plans conceived years ago.

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Agricultural markets are less closely related to the business cycle, but huge stocks—especially of grain, cocoa, sugar, and coffee—will keep farm prices depressed. In addition, better farming technology, increased acreage under production, and subsidies in OECD countries that encourage overproduction are all working to dampen agricultural prices.

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On the demand side, trade analysts report that China and some Middle Eastern food importers have recently canceled or postponed deliveries on agricultural commodity contracts because of improved domestic supplies or because of financial strains. Changing consumer tastes, substitution, and more efficient processing will also depress demand in the industrial countries. Examples include the trend toward use of artificial sweetener, lower demand for red meat, and higher recovery in instant coffee processing.

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While the near-term economic outlook for LDC commodity producers remains dim, countries that depend on the sale of one commodity face the most risk and are likely to fare the worst. For example, we expect that Chile and Zaire, which depend on copper for nearly half their export earnings, will continue to suffer because of weak copper demand and low prices. On the other hand, countries such as the Philippines, which depend on markets in the United States and Japan, should enjoy improved earnings sooner than those selling to other OECD countries and to each other.

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Grenada: Picking Up the Pieces

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Grenada's recently appointed interim governing council has inherited an economy beset with widespread unemployment, breakdowns in public services, and depleted public coffers. If the government is unable to replace economic assistance from previous donors, it eventually will be forced to adopt unpopular austerity measures that could jeopardize its political acceptability. New donors already have promised $4.5 million in economic assistance and are considering more, but these funds may not fully offset lost foreign aid from Cuba and Arab and Soviet Bloc countries and other foreign exchange losses that could total $20-40 million through 1984. Over the next few years, continuing external assistance will be required to restructure the economy and lay the groundwork for sustained economic growth.

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Grenada: Basic Data

GDP (1983, estimated)	$119 million
Population (1983) [a]	85,000 to 100,000
Land	344 square kilometers: 44% cultivated; 4% pastures; 12% forests; 17% unused but potentially productive; 23% built on, wasteland, other
Exports	Main products: cocoa beans, bananas, nutmeg, clothing, fresh fruits, mace Major buyers: United Kingdom (32% in 1982), Trinidad and Tobago (26%) Netherlands (10%), West Germany (10%)
Imports	Main products: food, machinery and transport equipment, oil (mainly from Trinidad and Tobago) Major sellers: United States (20% in 1982), Trinidad and Tobago (19%), United Kingdom (15%)

[a] We do not believe the population data released by the Bishop regime. Most estimates seem to fall within this range.

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Economic Legacy of the Bishop Regime

Former Prime Minister Maurice Bishop's leftist New JEWEL Movement (NJM) overthrew the government of Sir Eric Gairy in March 1979 and soon began expanding the government's role in the economy. It also began to strengthen ties with the Soviet Bloc—particularly Cuba—and some Arab states such as Algeria, Iraq, Libya, and Syria. Initially the regime won kudos from international financial institutions for its efforts to tighten fiscal management by centralizing and controlling expenditures, improving tax collection, and reducing longstanding debts to regional institutions. Tensions with the private sector developed, however, when the government began appropriating privately held agricultural land, took control of commodity marketing boards, and declared itself the sole importer of rice, sugar, cement, and milk powder.

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Recognizing the need to upgrade the island's transportation network and utilities, the government also embarked upon a large-scale investment program. The centerpiece of the regime's efforts was the airport project at Point Salines, which accounted for nearly half of all capital expenditures during 1979-83. Other projects included the extension of feeder roads and expanded access to piped water.

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The regime increasingly turned to Cuba and Arab countries to finance development projects that many Western donors considered too large for the government's limited financial resources and not adequately supported by the island's tourist infrastructure. Reflecting Bishop's longstanding ties with Fidel Castro, Cuba became the largest donor. According to Grenadian data, Cuba provided over half of the $65 million in grants of technical assistance, supplies, capital equipment, and cash received during 1979-83.[1] An additional $15 million or so in grants was provided mostly by Arab states, and the USSR also provided a small amount of assistance. Moreover, East Germany, Libya, and Iraq authorized large loans, although most of the promised Iraqi and Libyan funds apparently never materialized. In addition, the USSR also promised about $26 million in free military aid.

At the same time, trade relations with Communist countries were strengthened. The regime turned to Cuba for sugar and cement, and, in 1982, signed a five-year trade agreement with the USSR calling for the export of about 500 metric tons of nutmeg annually—close to one-fifth of the crop—and an unknown quantity of cocoa.

Economic Activity

With the increased centralization of economic decision making, public spending became the major force behind an average annual economic growth rate of 2.9 percent between 1978 and 1983. Public-sector employment swelled as the government built up its security forces and hired workers for development projects. These projects particularly benefited the construction sector, which more than tripled its share of GDP—to 7 percent—by 1982.

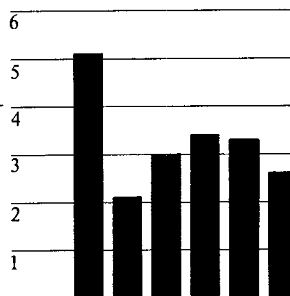
Other sectors of the economy were hit by the world recession as well as growing domestic and Western apprehension over Bishop's political and economic intentions. Disease, poor weather, tight credit, labor shortages, and falling prices disrupted farm

[1] Although official Grenadian figures are not entirely accurate, and may well have overstated the value of aid flows, we judge that these data correctly describe general economic trends over the past four years.

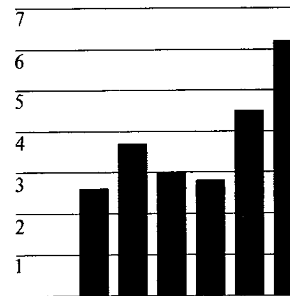
Grenada: Economic Indicators

Note scale change

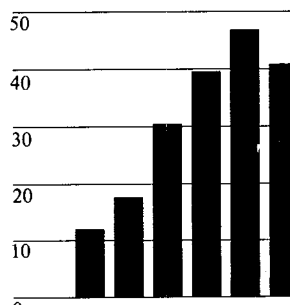
Real GNP Growth
Percent



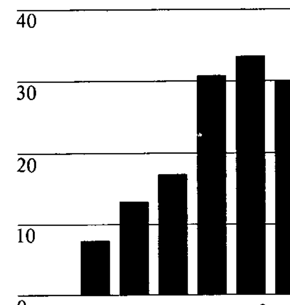
External Debt Service Ratio
Percent



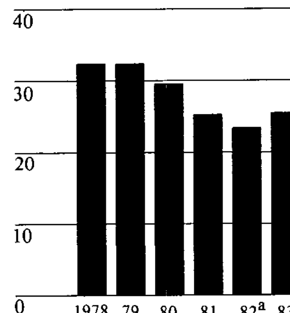
Current Account Deficit
Percent of GDP



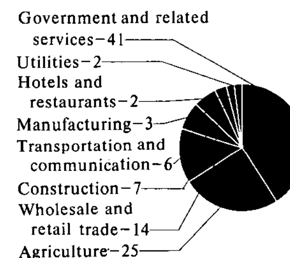
Overall Public Sector Deficit
Percent of GDP



Stayover Visitors
Thousand Persons



Origin of GDP, 1982[a]
Percent



[a] Preliminary.
[b] Official projections reported by the IMF before the recent fighting.

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Grenada: Balance of Payments

Million US $

	1978	1979	1980	1981	1982	1983 [a]	1984 [b]
Current account (excluding transfers)	−7	−13	−27	−37	−50	−48	−54
Trade balance	−16	−23	−35	−38	−46	−47	−48
Exports (f.o.b.)	17	22	17	19	19	21	23
Imports (f.o.b.)	33	45	52	57	65	68	71
Net services	9	10	8	1	−4	−1	−6
Tourism	14	15	16	14	13	15	9
Transfers	8	15	26	27	31	36	35
Net private transfers	7	8	13	14	14	15	15
Net official transfers	1	7	13	13	17	21	20
Capital account	1	0	2	13	12	13	7
Net direct investment	1	0	0	0	2	1	1
Long-term capital	0	2	1	7	7	16	10
Short-term capital, including errors and omissions	0	−2	1	6	3	−4	−4
Change in gross reserves	2	2	1	3	−7	1	−12

[a] Estimated.
[b] Projected. Assumes the loss of $15 million in Communist and Arab grants and loans; and the inflow of $17 million in project-related grant aid from the United States.

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output. These factors caused a 5-percent drop in agricultural production during 1979-82 and continued to hamper farm activity in 1983. Tourism was hit by a 30-percent drop in stayover visitors, reflecting Western recession, adverse publicity in major tourist markets, and the closure of a major hotel. The number of arrivals rose earlier this year because of the world recovery but probably fell short of the 1979 peak. Moreover, local businessmen, fearing eventual government takeovers, and unable to borrow domestically in 1982-83 because the government was absorbing available credit, adopted a wait-and-see attitude.

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Soaring budget deficits—projected at close to 30 percent of GDP this year compared with 7.5 percent in 1978—emerged from the regime's policies. The rapid increase in government spending since 1978 far outweighed revenue gains from sharply increased excise and trade taxes, including a specific import duty to help fund the airport. Moreover, external assistance for the airport failed to reach planned levels, as some backers reneged on their pledges. Although the regime began to lay off government workers in 1981, delayed salary and other payments, and eventually slowed investment spending, the budget deficit continued to climb. To cover it, the government borrowed at home and abroad, appropriated additional money from the domestic banking system, and siphoned funds from the National Insurance Scheme.

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The Bishop government's increasing role in the economy led to a deteriorating foreign payments situation, particularly in 1981-83 when the investment program was under full steam. Encouraged

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by Cuban grants and increasing remittances from Grenadians living abroad, the government pushed the current account (excluding transfers) deeply in the red. The deficit rose from $7 million (12 percent of GDP) in 1978 to $50 million (47 percent) in 1982, according to official figures released to the IMF. Merchandise export earnings stagnated in 1979-83, as sharply falling export volumes or prices for Grenada's traditional crops (nutmeg, mace, cocoa, and bananas) offset gains in sales of nontraditional agricultural and manufactured products. At the same time, imports doubled because of rising oil prices and government purchases. Uncertainty over political and economic conditions led to capital flight. Faced with rising payments pressures and low foreign exchange reserves, the government turned increasingly to external borrowing, including a $6 million IMF loan in 1981 and a three-year, $14 million Extended Fund Facility for 1983-86.

As the economic situation deteriorated, policy rifts within the ruling NJM increased. Bishop, heading the more moderate faction, favored the expansion of Western—especially US—tourism and investment. The more ideological faction led by former Deputy Prime Minister and Minister of Finance Bernard Coard, preferred increased economic ties with the socialist bloc. Indeed, personal tensions between Bishop and Coard apparently sparked the upheaval in October.

Economic Challenges Ahead

Grenada faces severe economic difficulties over the coming year with the most intense problems likely to occur in the next few weeks. The new government must deal both with the economic troubles inherited from the Bishop regime and with political and economic reconstruction. Unemployment is a major concern. As many as 7,000 Grenadians were out of work before the recent conflict—up to 25 percent of the labor force—and now up to 1,600 People's Revolutionary Army and militia members, 400 airport workers, and 150 people formerly employed by Cuban and Soviet personnel are without jobs as well, according to US Embassy reporting. Infrastructure and basic services damaged by fighting and neglect need to be repaired and upgraded. The expulsion of Cuban and other doctors, teachers, and technical personnel has disrupted health and education services.

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During the coming year Grenada will need to replace some $20-40 million in aid-in-kind, project funding, and foreign exchange earnings:

- Severing ties with Communist and Arab countries has cut off almost $15 million in project loans and Cuban grants expected in 1984 by the previous government. These funds were tied to airport construction, agricultural assistance, industrial expansion, communications, and health- and education-related projects.

- Grenada's IMF program—under which the government was to receive $1.2 million in November and $4.7 million in 1984—has been suspended, apparently because the IMF is reluctant to disburse funds until a stable government has taken control. The program probably will have to be renegotiated because of the changed economic environment.

- Tourism earnings in 1984 are likely to fall sharply below the $18 million projected by the previous government because of the political uncertainty that is coinciding with the current peak tourist season. Although expenditures by military and press personnel are offsetting much of the loss in tourism revenues at present, almost all of the military and much of the press may be gone by January.

- As much as $1 million in nutmeg exports to the Soviet Bloc will be lost in 1984 and prospects for sales to other markets are dim because Indonesia is dumping nutmeg on the world market.

- Up to $5 million more would drain from the economy if the US medical school were to leave

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the island—a move under consideration in October because of the school's proximity to the end of the Point Salines airport runway. Even if the school stays, we doubt that all the registered students will return in January—the scheduled reopening date—because they have been given the choice of continuing their studies in Barbados.

New aid to fill some of the shortfall already has been promised. The United States, the largest donor so far, has disbursed $475,000 in disaster assistance and is spending $2 million for infrastructure repairs. An additional $5 million in US balance-of-payments support and $10-15 million in project aid is under consideration. The United Kingdom has announced a $1.1 million grant, to be spent by March 1984, that will be used for public works projects and to provide equipment and training for a new Grenadian police force. Venezuela may ship 10,000 barrels of asphalt—previously promised but never delivered—to use on road resurfacing projects. In addition, Venezuela and Trinidad have begun discussing the possibility of supplying refined petroleum at concessional prices.

Quick disbursement of US project aid has allowed the interim government to begin tackling the employment, repair, and services problems. Two temporary road repair projects are employing close to 450 people. US personnel are providing medical services, and the government has been able to replace many of the expelled teachers with educators from neighboring Caribbean countries.

Meanwhile, cash shortages continue to haunt the inexperienced government. The government is having difficulties meeting public-sector payrolls and other current expenses, The former government had expected to use IMF disbursements for these outlays, but other sources now must be found. Moreover, domestic banks apparently cannot boost credit to the private sector because the government has had insufficient funds to repay local bank overdrafts. As a result, agricultural activity is being disrupted because landowners have been unable to borrow to pay workers, and businessmen are finding it difficult to repair shop damages and restock depleted inventories.

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Beyond these immediate financial problems, government leaders face several difficult policy and timing tradeoffs. By mid-1984, in addition to revenue losses attributable to the recent fighting, Grenada will face its normal seasonal low in tax receipts and foreign exchange earnings. Several factors will inhibit the imposition of new revenue levies or the reduction of outlays to ease budget problems; the existing tax burden is already high, there is intense pressure to maintain government payrolls and public works projects, and there are high expectations of additional aid from the United States. Moreover, promised project aid may be too narrowly directed to enable the government to meet politically necessary expenditures. Without increased general purpose aid or success in obtaining foreign loans, the governing council would face politically unpopular austerity measures.

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Economic Restructuring

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Over the longer run, the government needs to restructure the economy to revitalize the private sector and promote sustained recovery. A promising strategy suggested by the World Bank would be to increase foreign exchange earnings by stimulating agriculture, tourism, and manufacturing. Both export and domestic agriculture would benefit from expanded credit, improved extension services, better management of commodity marketing associations, and increased access to high-quality agricultural inputs, such as herbicides and pesticides. Investment in nontraditional fruit and vegetable production, tourist facilities, and light assembly and agroindustries also could lead to greater foreign exchange earnings.

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The government intends to complete the Point Salines airport, at an estimated cost of up to $20 million, to boost tourism earnings. The overall increase in visitors and earnings, however, would be

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sharply limited by the small number of hotel rooms—fewer than 800, of which fewer than 300 are considered first class, according to the World Bank and US Embassy reporting. To take full advantage of the airport, a minimum of some 1,500 luxury and first-class rooms would be needed.

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To spur other investment and production, the government probably will soon apply for the 12-year investment incentives and tariff-free access allowed for many Caribbean exports under the provisions of the US Caribbean Basin Initiative. In addition, the government probably would have to demonstrate that it could maintain order and had established political confidence, that it intended to reduce tariffs and revise the burdensome tax system, and that it planned to upgrade inadequate transport, power, communications, and sanitation networks.

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Grenada primarily will look to bilateral and multilateral assistance over the next few years to finance its infrastructure projects, and we think it will turn increasingly to the United States as the major source of this aid. Grenada's export and tourism earnings will be insufficient to pay for necessary investments. We believe international lenders—concerned about the payments performance of major LDC debtors and faced with increasing demands from major industrial borrowers—could be reluctant to substantially increase their exposure in Grenada.

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Cuba: Patterns and Prospects of Soviet Economic Aid [1]

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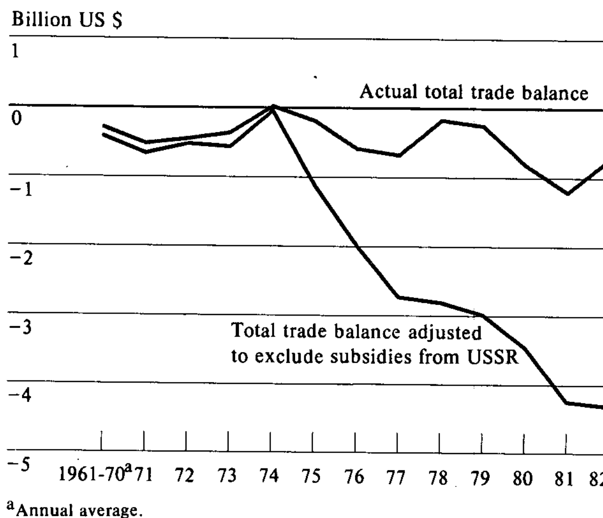
Fidel Castro's goal of making the Cuban economy independent of foreign powers has become increasingly distant after 25 years of his rule. The extent of Cuba's reliance on the USSR is most evident in its need for direct aid: whereas US economic aid to Cuba in 1958 was equivalent to less than 1 percent of national output, Soviet soft currency economic aid in 1982—valued at about $4.6 billion—corresponded to somewhat more than 30 percent of Cuba's output. Composed mainly of trade subsidies and development assistance, this soft currency aid has increased dramatically since 1974 and has totaled nearly $29 billion since 1960. In addition to the aid, Moscow helps Cuba through hard currency purchases. Without the Soviet help, Havana would be hard pressed to meet even basic consumption and investment needs.

As long as Moscow continues to derive significant political and military benefits from its preeminent Third World client, we judge that it will not slash its aid to Cuba. Moscow has made it clear to Havana, however, that there are limits to its largess. Unless the pricing formulas used in Soviet-Cuban trade are altered, we believe the annual aid flow will decline slightly over the next two years. In addition, we believe Moscow will demand more accountability for the use of its aid.

The Soviet Aid Record

Cuba depends on the Soviet Union for 60 to 70 percent of its total trade. Moscow supplies Havana with nearly all of its crude oil, petroleum products, grain, lumber, and much of its industrial, agricultural, and transport equipment. In turn, Cuba exports one-half its sugar crop as well as the bulk of

Cuba: Total Trade Balance Adjusted for Soviet Price Subsidies



a Annual average.

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its nickel and citrus production to the USSR. Nearly all of this trade is conducted in soft currency through a bilateral clearing account.

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Trade subsidies—totaling about $20.3 billion since 1960—are the principal component of Soviet aid to Cuba; Moscow pays artificially high prices for Cuban goods while pricing its own exports to Cuba below world market levels. The general pricing formula established in Cuba's current five-year (1981-85) trade agreement with Moscow is designed to maintain the purchasing power Havana had in 1974-75—the period of high world sugar prices and oil prices that averaged $11 per barrel. In 1982, for example, the USSR paid over five

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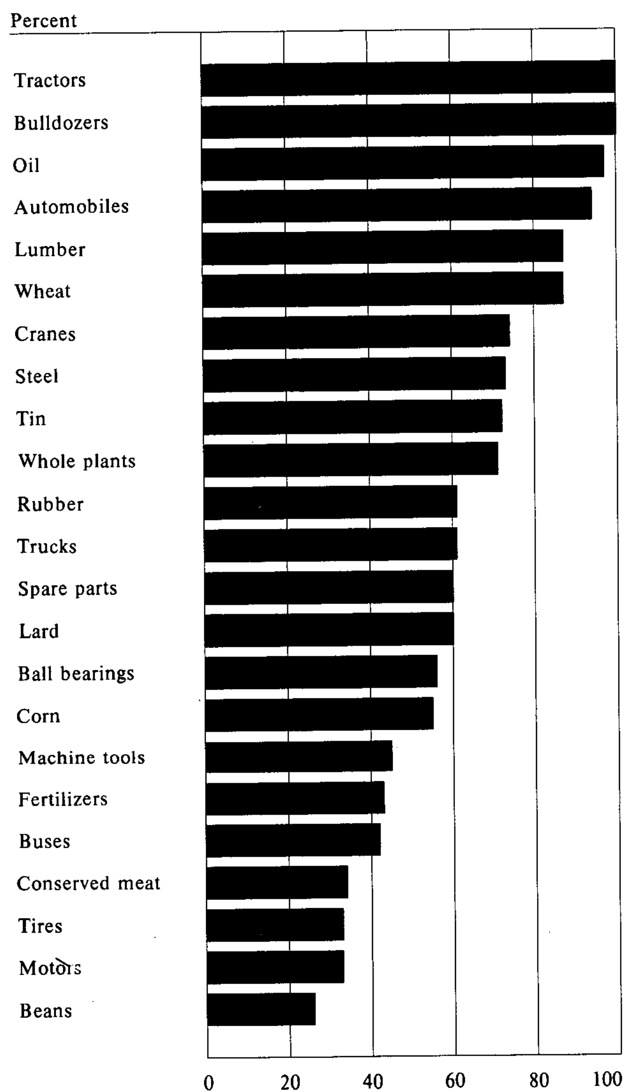
Cuba: Imports From USSR as a Share of Cuban Consumption, 1980



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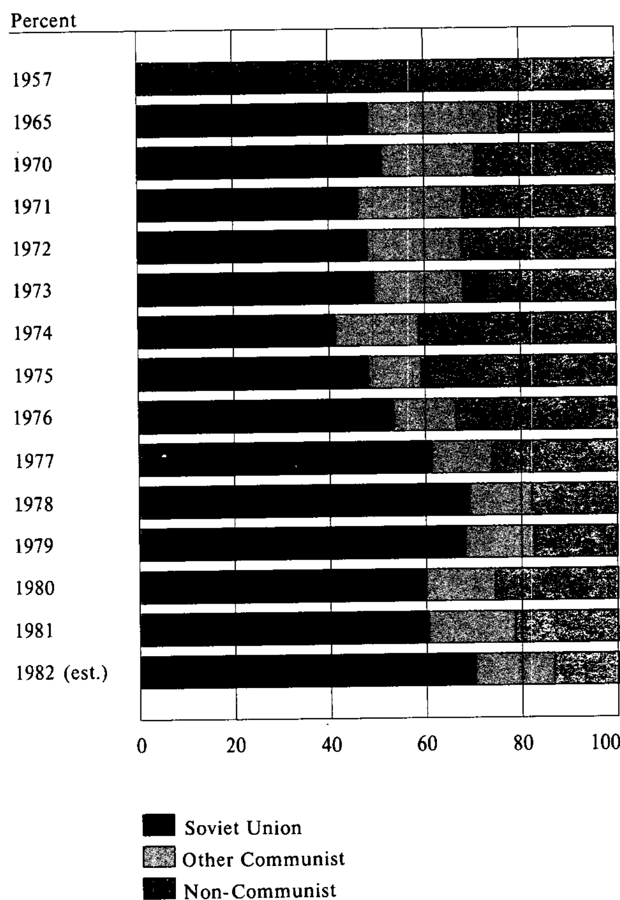
Cuba: Share of Total Trade, by Major Area



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times the world market price for Cuban sugar and charged Havana only about three-fifths of the OPEC benchmark price for oil. 25X1

The other major category of Soviet aid—totaling nearly $9 billion since 1960—consists of development assistance and easy terms for trade deficit financing. Both directly and through the Council for Mutual Economic Assistance (CEMA), Moscow provides materials, equipment, and advisers for

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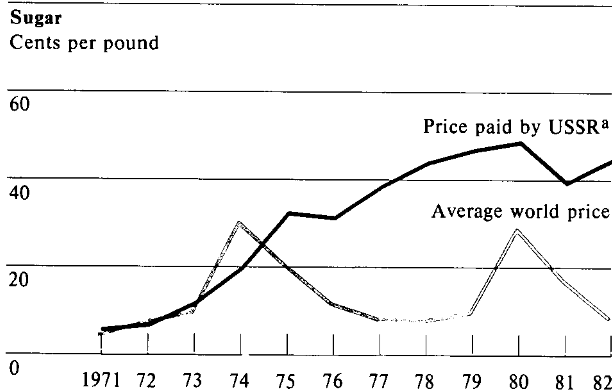
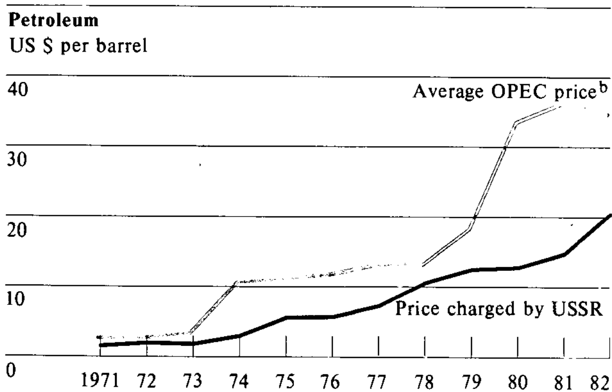
Cuba: Subsidized Versus World Market Prices

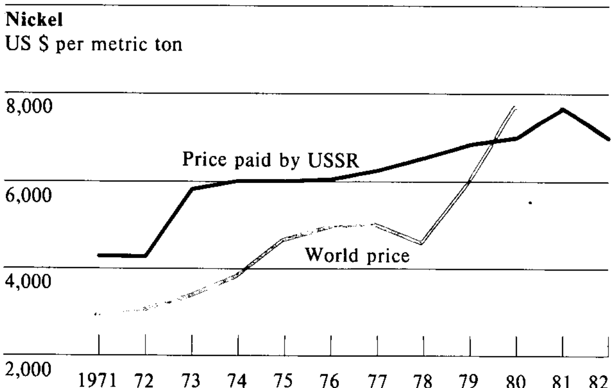
Sugar
Cents per pound



Petroleum
US $ per barrel



Nickel
US $ per metric ton



[a] Includes only soft currency sugar purchases.
[b] Based on crude product ratio of 60 to 40.

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projects relating to export development and import substitution. [25X1] over 200 projects valued at 1.2 billion rubles ($1.7 billion) were completed during Cuba's first five-year plan (1976-80). We estimate that plants built or modernized with Soviet participation since Castro took power in 1959 account for 100 percent of the output of sheet metal, 95 percent of steel, 50 percent of fertilizers, and 40 percent of electric power. As for the financing aspect, that part of Cuba's annual ruble trade deficit with the USSR not covered by development credits is financed on favorable terms. [25X1]

In addition to this large volume of soft currency assistance, Moscow also helps Havana to a lesser degree—$773 million in 1982—with its hard currency account. It does this by purchasing some Cuban sugar and other goods for hard currency and by making hard currency purchases of grain which it then resells to Cuba for soft currency. Without these direct and indirect cash infusions, we believe Cuba would have had to reschedule its hard currency debt months before the actual request in August 1982. [25X1]

Despite the huge volume of Soviet aid, Cuban economic growth during 1976-80 did not match the average of the non-OPEC LDCs. During this period these countries achieved an average annual real growth rate of 4.7 percent compared with our estimated 3.4 percent for Cuba.[2] Moreover, Cuba's hard currency debt increased by about 140 percent over the same period—nearly the same as the 145-percent average of non-OPEC LDCs. We believe that the centrally planned economy and lagging productivity were the main contributing factors. [25X1]

Because of the favorable trade agreements with socialist countries, Havana was not hurt as much as other LDCs by the drop in commodity prices after 1980. As a result, Cuban growth for 1981-83 is expected to average 2.3 percent compared with

[2] In 1981 Cuba received about $165 per person in official development assistance from the Soviet Union, Eastern Europe, and the West, or about six and a half times the per capita amount received by the average middle-income developing country. [25X1]

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Soviet Soft Currency Assistance to Cuba [a]

Million US $

	Total 1961-82	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983 [b]
Total	**28,892**	**338**	**1,064**	**1,569**	**2,270**	**2,946**	**3,178**	**3,463**	**4,438**	**4,561**	**3,944-4,560**
Development aid [c]	8,555	295	150	185	230	320	460	830	1,415	975	1,000-1,100
Trade subsidies	20,337	43	914	1,384	2,040	2,626	2,718	2,633	3,023	3,586	2,944-3,460
Sugar [d]	13,800	−408	577	989	1,638	2,427	2,324	1,165	1,366	2,580	2,644-3,160
Petroleum [e]	6,292	411	310	374	378	164	381	1,480	1,657	1,006	300
Nickel [d]	245	40	27	21	24	35	13	−12	0	0	0

[a] Based on official Cuban and Soviet trade data.
[b] Projected.
[c] Based on (a) estimated balance-of-payments aid necessary to cover Cuban trade deficits with the USSR; (b) Cuban purchases of capital goods from Moscow; and (c) public statements by Cuban and Soviet officials concerning the amount of development aid extended. This aid is repayable but terms are highly concessional. Projection for 1983 is based on preliminary trade data.
[d] Sugar and nickel subsidies are estimated as the difference between the price Moscow pays for these commodities and their world market value. The difference is considered a grant and not subject to repayment.
[e] The petroleum subsidy reflects the difference between the value of petroleum purchased from the USSR and the value of these imports at world market prices. It is considered a grant and not subject to repayment.

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about 1.2 percent for non-OPEC LDCs. Nevertheless, Havana was not totally sheltered from international conditions during this period, and the deterioration in its economic dealings with the West made Soviet aid even more important.

Moscow's Attitude

For the most part, the levels of trade and aid between Cuba and the Soviet Union through 1985 have already been established as part of the five-year trade agreement. Moscow is likely to meet the commitments set in this agreement, even if Cuba's exports fall short of plan due to weather-related crop problems, but we doubt that it will do more than this. In fact, unless Cuba's economic position experiences more damage from natural disasters or sanctions imposed by the West, Moscow probably will look for ways to make Cuba a less expensive client.

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Reportedly, Moscow already is irritated at Cuba's inefficient use of resources. Soviet complaints about Cuba's low worker productivity, inefficient utilization of land, and underutilization of Soviet advisers and technicians. In addition, Moscow apparently has been pressuring Havana to meet soft currency sugar contracts this year even at the expense of hard currency sales to the West.

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We expect Moscow's soft currency economic assistance in 1983 to total a little more than $4 billion—almost as much as last year. This figure is likely to decline to $3-4 billion by 1985, however, primarily because of the formulas used by Moscow and Havana to calculate the prices of traded goods. In

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Soviet Hard Currency Flows to Cuba [a]

Million US $

	Total 1961-82	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983 [b]
Total	**4,864**	**123**	**601**	**343**	**546**	**290**	**356**	**375**	**703**	**773**	**450**
Soviet sugar purchases	1,525	0	424	159	223	126	134	0	168	291	0
Grain/flour exports	2,605	123	174	173	216	133	213	234	319	266	250
Other [c]	734	0	3	11	107	31	9	141	216	216	200

[a] Based on Soviet and Cuban trade data.
[b] Projected.
[c] As reported in Cuban trade data, not further specified.

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particular the price Cuba pays for its approximately 200,000 b/d of oil imports—about $25 per barrel in 1983—will rise because it is based on a moving average of the world price of oil over the previous five years. The sugar price in turn is linked to the oil price and thus will increase by a few cents per pound. Furthermore, we estimate that Moscow's contribution to Cuba's hard currency balance will drop this year, to about $450 million, although it is likely to return to the $700-800 million range in 1984 and 1985.

Moscow probably will continue its hard currency purchases, but a poor harvest will keep the amount of sugar purchases negligible this year. As Cuba's sugar output recovers in 1984 and 1985, Moscow is likely to purchase perhaps 500,000 metric tons annually. Cuban trade projections indicate that Soviet hard currency purchases in the category of unspecified goods will continue at the 1982 level of $200 million annually through 1985. Part of this amount, however, could represent credit for petroleum Cuba did not consume. the Cuban press, reported that a 1981 agreement offered Havana convertible currency credits for oil saved from its protocol allotment. This Soviet incentive, unique to its trade with Cuba, probably represents an effort to lessen Havana's energy dependence without imposing the hardships of abrupt declines in oil shipments. We expect Soviet hard currency grain purchases on Cuba's behalf to grow more slowly over the next two years. The Soviets may encourage Cuba to utilize its $70 million Argentine credit line for corn purchases in order to decrease their own burden.

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Preliminary Soviet trade data indicate that its total development aid to Cuba in 1983 will remain large—$1-1.1 billion. We think this figure will be about the same in 1984 and 1985. According to public statements by Soviet officials, project aid is scheduled to rise by 80 percent during 1981-85 and total roughly $3 billion for the entire period. Important projects using this aid include a nuclear power plant that will decrease Cuba's oil needs by about 10 percent in the late 1980s and a new nickel plant that will double Cuba's output. In addition, Cuba's soft currency trade with the USSR is likely to remain in deficit—probably on the order of $500 million annually—through 1985, and Moscow will continue to provide favorable financing.

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According to Cuban data, repayments of Soviet development aid will begin to come due in 1985. Though Havana may be able to expand its exports enough to make the $125 million payment due that year, the problem will worsen in 1986 when the grace period on Cuba's recently rescheduled hard

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currency debt expires. We believe Havana is likely to give these latter debts priority to preserve its reputation for honoring commitments to the West, and Moscow probably will again reschedule, or perhaps even forgive, Cuba's debt.

Economic Impact of Reduced Aid

The expected decline in Soviet soft currency aid in 1984 and 1985 will force Havana to slow the growth of its imports from the USSR. Soviet oil deliveries are likely to stagnate at the reduced 1983 level, while imports of consumer goods—and capital goods not connected to certain Soviet-funded projects—will increase less rapidly than Havana would like. The oil shortfall is likely to slow Cuba's economic activity during the next two years, while fewer capital goods will contribute to slower growth beyond 1985 as investment projects are delayed.

After rising 30 percent during 1976-81, Cuban oil imports dropped 7 percent in 1982. Oil imports thus far in 1983 are slightly lower than for the same period last year, probably reflecting Cuba's desire to earn convertible currency in accordance with Moscow's incentive plan. We believe that Havana's hard currency needs through 1985 will force it to continue restricting oil imports. Thus, we do not expect deliveries to rise to the 1981 level again during this period even though energy demands will increase as new factories open.

We have no evidence that the fall of petroleum imports in 1982 and 1983 has resulted in shortages, but this is probably due mainly to a drop in demand. In particular the lack of foreign exchange has curtailed imports for industry and transportation. Thus, petroleum demand in these sectors—which account for about 70 percent of total oil demand—probably was depressed.

We believe the decline in oil deliveries will be felt in 1984 and 1985, however, when a moderate pickup in economic growth is expected. A new nickel plant is scheduled to come on line during this period, and this alone will increase total oil demand by 5 percent. In addition, thermoelectric power plants scheduled to open could raise needs by an additional 3 to 5 percent.

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Judging from the regime's past practices, we expect consumers to bear the brunt of any oil shortages. There will be very little or no impact on sugar production because most of its energy requirements are satisfied by bagasse—a byproduct of sugarcane milling. Tobacco production likewise uses only minimal amounts of petroleum, while the export industries most dependent on oil are nickel and seafood. There will very likely be brownouts to homes and to industries that produce for domestic consumption, as well as decreased availability of public transportation.

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Cuban Response

The prospect of coping with import shortages is likely to renew debate within the Cuban leadership over economic policy, especially the issue of motivating the labor force. In our judgment, moderates and technocrats will press again for increased material incentives, lowered restrictions on private enterprise activities, and greater autonomy for enterprise managers. Such policies go against the ideological grain of the hardline elements who currently dominate the leadership. The ideological purists' antipathy for liberalization was shown by the restrictions placed on the farmers' free markets—even though the markets had stimulated productivity.[3]

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[3] The so-called hardliners are primarily ex-guerrillas from the struggle against Batista. More than three-fourths of the Politburo fall into this category. They are politically unsophisticated, tend to view the world in black and white terms, and are intensely anti-American. Moderates in the hierarchy include veterans of the pre-Castro Communist Party and a younger group of "technocrats" who are largely responsible for the daily operation of the economy.

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Although Fidel Castro is, in our view, more pragmatic and sophisticated than the ideological purists in the leadership, he generally sees any economic liberalization as a necessary evil to resolve short-term problems. Like his hardline colleagues, he fears that such reforms will lead to a popular desire for additional liberalization and a decentralization of economic decision making. For these reasons, as long as Fidel Castro remains in power, significant economic liberalizations are unlikely. In Castro's mind, worker motivation must be accomplished through exhortation, ideological education, and repression. In periods of economic difficulty, he has sided with the hardliners who assert that tough measures are necessary to achieve improved productivity and to encourage proper "socialist behavior."

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Implications for Moscow and Washington

We believe that Moscow will continue to provide large amounts of aid to Cuba as long as Cuba reciprocates with the kind of political and military benefits it has provided in the past. Havana, for example, has been a valuable ally in assisting Moscow in its Third World policies. Cuban military personnel have played a key role in preserving pro-Soviet regimes; Cuban support was an important factor in the Sandinista victory in Nicaragua. Castro has promoted the USSR's political position on various international issues, and Cuba continues to afford the Soviets valuable military facilities in the Western Hemisphere. As long as Castro's position is not endangered by sharper economic difficulties than we now foresee, we believe he will continue to provide these benefits.

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Castro's deeply held antipathy toward the United States and his dominance over Cuban policy suggest that, as long as he remains in power, Washington will have little direct leverage on Cuban policies and, short of war, can do little to reduce the military value of Cuba to the USSR. On the other hand, Cuba's economic problems will increase US opportunities for indirect influence in some areas. US demarches to Cuba's official creditors, for example, may help to reduce the flow of Western credit to Havana or tighten conditions for future reschedulings. In addition, as consumer disgruntlement and economic crime increase in Cuba, opportunities for the United States to exploit these feelings will be enhanced. Moreover, if—as we expect—the regime responds with even more repressive measures, such as executions of common criminals, its image in the Third World could be undermined. Eventually, however, Castro is likely to be tempted to export the dissidents as he did in 1980

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Hungary: New Horizons for Private Entrepreneurs

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Although a socialist country, Hungary has long tolerated private enterprise in agriculture and, to a lesser extent, in retail trade and consumer services. Since 1981 the Kadar regime has further legitimized and thereby spurred an increasingly wide range of activities in Hungary's huge "second economy" in a bid to ease some of the country's economic ills. Even though the Western press overplays the "capitalist" aspects of the new ventures, such measures—if sponsored vigorously over the long term— could transform Hungary's economy into an even bolder model for change in the rigid, inefficient systems of other Soviet Bloc countries.

With the onset of severe economic difficulties in the early 1980s, Budapest recognized the need for institutional reforms that further encourage private initiative, building on the "New Economic Mechanism" introduced in the late 1960s. We believe the Hungarian regime has come to appreciate that private market activity provides essential goods and services, supplements personal incomes during a period of austerity, and promotes a risk-taking entrepreneurial spirit lacking in the large, monopolistic, and grossly inefficient state and cooperative enterprises. Budapest has concluded that some enlargement of the legal private sector need not compromise its socialist principles and that legalization should strengthen its ability to record and tax the vast volume of economic activity going on outside the socialized sectors. Moreover, like most other East European countries, Hungary has been struggling to redress chronic balance-of-payments deficits while trying to avoid attendant declines in economic performance and living standards.

The Specter of Capitalism

The regulations expanding the scope of authorized private enterprise unleashed a flurry of reports in the Western media that Hungary was "going capitalist" and probably raised some doubts among Budapest's more orthodox CEMA partners. Earlier this year Party Chief Janos Kadar stressed that the new measures had nothing to do with capitalist methods and emphasized that 98 percent of the means of production in Hungary remains socialized property. Kadar also stated that, whereas private activity accounted for 14 percent of agricultural production in 1982, it contributed a mere 1.1 percent in industry and a scant 1 to 2 percent in retail trade. Although Kadar's numbers roughly portrayed the situation in 1982, they do not fully reflect the importance of the second economy in delivering some key goods and services nor the momentum of the small enterprise program in 1983.

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The Second Economy. Estimates by Hungarian researchers of the size of the second economy of legal, semilegal, and illegal private activities show:

- Three families in four in Hungary's population of 10.7 million enjoy a "secondary" income in addition to that received from state or cooperative sources.

- Roughly half the population, including urbanites, cultivate private plots full or part time, making agriculture the largest single employer in the private sector; for some food items—pork, eggs, potatoes, vegetables, and fruit—private agriculture is the primary supplier.

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An Enterprising Hungarian Family in the 1980s

A prominent Hungarian journalist, Istvan Lazar, writes that "a model of a very fortunate family in contemporary Hungary" could be described as follows:

- *The parents live in a village.*
- *The father enjoys the high income of a miner or receives a pension, having benefited from early retirement.*
- *The mother is a member or pensioner of an agricultural cooperative and works on her private plot.*
- *One son gets a good income from wages and large tips working as an automotive mechanic in the workshop of the industrial cooperative of a nearby town; on weekends, he moonlights for an untaxed supplementary income.*
- *Another son lives in Budapest, where he performs professional work and often travels abroad.*
- *A daughter lives in the county seat, working in the party or government power hierarchy.*
- *Most family members have a car and/or one or more weekend houses (for example, on Lake Balaton) which they rent out at a rather high fee during some part of the year.*

Lazar observes that since not all families in Hungary have lucrative pensions, private plots, or skills marketable in the second economy, certain social tensions inevitably arise. But he concludes that in a period of near-stagnant economic growth such tensions would be much worse without opportunities in the private sector.

- The second economy also supplies the bulk of workers in housing construction, maintenance, repair, and other consumer services.

Small Enterprises. Partial statistics indicate that by mid-1983 some 13,400 new small enterprises had been established, primarily in the industrial, construction, and service trades. Employment in these ventures totaled only about 81,000 persons, partly because the regulations limit the permissible number of entrepreneurs and employees per enterprise. If legally licensed private craftsmen and retail merchants are added, the number of persons working full or part time in small enterprises comes to 243,000, or roughly 5 percent of the labor force.

Hungary: Estimated Number of Units and Employees in New Small Ventures as of Mid-1983 [a]

	Units	Employees
Total	**13,425**	**81,265**
Socialist sector		
Small state enterprises	100	NA
Subsidiary enterprises	70	NA
Small cooperatives	155	NA
Semiprivate sector		
Business partnerships within socialist enterprises	5,862	52,831
Specialized work units within cooperatives:		
In agriculture [b]	2,688	NA
In industry and services	660	NA
Private sector		
Private business partnerships	3,481	NA [c]
Civil law partnerships	409	NA

[a] Our grouping of the units into socialist, semiprivate, and private sectors is provisional. Small ventures in the "semiprivate" sector are hybrids that seem to be neither purely socialist nor purely private enterprises.
[b] In agricultural producer cooperatives and state farms.
[c] Although documentation is lacking, press commentary makes it clear that private business partnerships are the second-largest employers among small ventures.

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Some examples illustrate the kind of sanctioned activity allowing private entrepreneurs to seek out opportunities complementing—and, in some cases, competing with—the much larger state and cooperative enterprises:

- A small advertising agency operating as a subsidiary of a state-owned corporation and designed to serve the needs of private entrepreneurs.
- Eight small cooperatives and 33 semiprivate business partnerships in a large state automotive enterprise that handle tool design, toolmaking, machinery design, and some transport tasks.

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- A private business partnership of professional mountain guides, called Sub-Alps, doing highrise repair work on state hotels.
- A two-person automotive repair service, named Non-Stop, which operates during the hours when state facilities are closed.
- Private taxi services, which for a fee can use state garage and service facilities and the VHF radio system.
- A private partnership producing small computers for hospitals.

We have not seen any figures suggesting the volume of previously semilegal or illegal activity that has been absorbed by the new small enterprise program. We suspect, however, that the bulk of unlicensed private entrepreneurs have adopted a wary, wait-and-see attitude.

The Property Rights Issue

In liberalizing its attitude toward private ventures, the Hungarian leadership has shown a willingness to adopt innovative approaches to the problem of mobilizing and managing capital in a socialist economy. But Kadar's stress on the continuing dominance of socialist ownership demonstrates that control over the means of production remains a highly sensitive ideological issue.

The most generally accepted form of small enterprise activity to date involves **leasing** arrangements in which groups of individuals or enterprises pool their money and engage in competitive bidding for the right to rent the facilities, equipment, land, or livestock of larger, unproductive enterprises. The group promising the largest sales and rental payment wins the lease. In another accepted variant, an enterprise needing investment capital sells **shares, stocks,** or **bonds** to its employees who receive a rate of return higher than the interest rates paid by banks on savings deposits.

At the same time, Hungarian economists, sociologists, and lawyers are locked in a wide-ranging debate over further institutional reforms that reach far beyond the small enterprise program now envisaged by the regime. One proposal calls for a separation of society itself into three distinct sectors—economic, government, and party—with the aim that the latter two not be allowed to interfere with the former. Capital in this system would be managed by **holding companies** that would make investment decisions as if they owned the assets under their control but in fact would be acting in behalf of the state. Still another proposal would foster competition for capital by creating a **commercial banking system** offering enterprises alternative sources for both loans and deposits.

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Advocates of the various proposals recognize that they are raising politically touchy issues of capital ownership rights—or, at least, the rights to use the means of production in pursuit of private or quasi-private ends. Accordingly, they adopt a certain ideological caution reflected by resort to terms such as a mixed socialist economy, three-sector socialism, or entrepreneurial socialism. Although policymakers remain less sanguine than many reform advocates about the tolerable limits for private activity, Budapest seems satisfied with the development of the small enterprise program and is ready to promote its growth.

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Climate for Expansion

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In recent months, the regime has been gradually reducing obstacles to rapid expansion of the small enterprise program. These impediments—excessively high taxes, limited provision for loan capital, and cumbersome legal restrictions—were probably introduced deliberately at the outset to gain policy consensus, especially among ideological hardliners suspicious of any "private" inroads into the socialist system. As the program has unfolded, official policies toward these constraints have eased.

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Punitive Income Taxes. The new tax codes introduced in 1981-82 generally extended to the small semiprivate and private ventures the income tax structure already in place for licensed private craftsmen and retail merchants. The tax was highly progressive, ranging from 6 percent on annual

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incomes of $400 or less up to 75 percent on incomes of $4,000 or more. The steep rates at the middle and upper ends of the scale had long been criticized on the grounds that they deterred many private entrepreneurs from joining the legal economy and encouraged those who were already legally licensed to understate their real earnings. More recently, the high taxes have come under fire for discouraging participation in the new small ventures. As a result, starting next year the lowest tax rate has been reduced to 2 percent on incomes of $400 or less per year and the highest rate has been cut to 65 percent on incomes of $12,000 or more.

Lack of Venture Capital. At the start, little provision was made for loans to prospective entrepreneurs. Recent decrees have authorized new "competitive" credit arrangements intended to encourage faster expansion of small ventures and channel their activities more along the lines preferred by the government. Small ventures already operating or about to be formed may apply to central authorities for loans amounting to the equivalent of several hundred thousand dollars. The amount is limited only by how much collateral the applicant can provide and how much risk he is willing to assume.

Legal Restraints. Existing regulations for setting up small businesses are extremely complicated, and the process of obtaining a license to operate has been protracted because of a maze of bureaucratic procedures. These legal restrictions are presently undergoing extensive review, with the aim of simplification and striking a better balance between the sometimes conflicting goals of greater uniformity in institutional forms and wider diversity of productive activities. Major modifications in these and other rules of the game probably will not be codified until the government gains more experience and has had more time to assess the various pros and cons of institutional alternatives.

Outlook

Official thinking seems ambiguous on how far legalized semiprivate and private activities should be pushed. Prospects for the program are difficult to discern. Little information exists on how many second-economy entrepreneurs have converted to legal status and the extent to which roadblocks are being created by large state and cooperative enterprises who view the changes as threatening.

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There are good reasons why second-economy entrepreneurs appear to have made no headlong rush to register as legal enterprises. Apart from the high taxes they face when successful, these people are being invited to exchange the risk of arrest on charges of engaging in illegal activity for the risk of policy shifts that might destroy their business. Only a consistent attitude by the authorities will gradually dispel such fears and suspicions.

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Since there are limits beyond which the government does not want small semiprivate and private ventures to grow, the large enterprises have little to fear in terms of quantitative competition for labor and market shares. Rather, qualms are more of a qualitative nature. In the case of labor, complaints have been voiced that young workers with above-average talent will switch their careers from state to higher paying jobs in the small ventures—threatening a "brain drain" from state enterprises. Perhaps even more unpleasant is the prospect that the small ventures, in their search for gaps in the market and under pressure to excel because of competitive risks, will further demonstrate the inefficiency of many large enterprises.

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The program is vulnerable to criticism for contributing to a more unequal distribution of income and is arousing resentment among those unable or unwilling to become private entrepreneurs. Workers in a steel mill, for example, even if they could acquire the necessary capital, generally have neither the education nor skills in demand for legalized moonlighting. In the first half of this year, the purchasing power of a worker earning only regular wages declined more than 5 percent, whereas incomes for participants in the second economy continued to far outpace the country's 8.5-percent rate of inflation.

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Expansion of legalized private activity may also be complicating the economic stabilization program Budapest worked out with the International Monetary Fund to help it through its financial difficulties. In its midyear assessment of the 1983 program, the Fund noted that the rapid expansion of income in the private sector was a major factor preventing the reduction in domestic demand needed to improve Hungary's current account balance. While the IMF probably sees merit in legalizing second-economy activity as a means of helping to prevent a serious decline in living standards, it apparently has been pressing the regime to further boost—rather than reduce—taxes on large incomes in the 1984 program.

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At this stage, we believe the regime still sees more benefits than drawbacks to broadening the scope of legalized private enterprise. Thus, we expect a steady but measured evolution of the small venture program. If the government sticks with it over the next decade and if the debates on concepts of property rights lead to even more novel institutional reforms, Hungary will stand in even sharper contrast to its less imaginative, hidebound CEMA partners. A "socialist" economy with ownership shared among state, cooperative, semiprivate, and private enterprises would constitute a challenging model for emulation—particularly if it succeeds in promoting the efficiency that has eluded centrally planned economies.

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