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International Economic & Energy Weekly

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26 July 1985

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International Economic & Energy Weekly

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International
Economic & Energy Weekly

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Synopsis

1 **Perspective—Key LDC Debtors: Domestic Pressures Mount Over the Longer Term**

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We believe economic, social, and political pressures will increase in the key LDC debtors as international financial problems linger over the longer term. Although these pressures have been successfully vented so far, they could become difficult to manage during the next five years.

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3 **Oil Stocks and Government Policies of Industrialized Countries**

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A further sharp reduction in commercial inventories combined with uncertainties regarding strategies to liquidate government-controlled stocks would leave the industrialized world more vulnerable to a major supply disruption.

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7 **India: Growing Opportunities for Technology Diversion**

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India is likely to offer an increasingly attractive target for Soviet science and technology collectors in the years ahead. Although India apparently intends to protect sensitive US technology under a Memorandum of Understanding signed last year, New Delhi will be hard pressed to offer the degree of security Washington expects.

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11 **EC-Italy: Aftermath of the Lira's Plunge**

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The European Monetary System (EMS) came through its realignment last weekend with flying colors following the unexpected plunge of the Italian lira on Friday. Despite the good performance of the EMS as a whole, "black Friday" puts the Italian Government in a poor light as the perception grows that it bungled a planned devaluation of the lira.

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13 **Eastern Europe: Uncertain Economic Recovery**

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East European economic performance improved in 1984, but the likelihood of a sustained recovery is not great. Over the longer term, external constraints and systemic weaknesses will make it difficult for the region to return to the generally good economic performance of the early 1970s.

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19 **USSR: Renewed Interest in Seabed Mining**

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Recent efforts to acquire Western deep sea mining technology and equipment and to resolve conflicting ocean-mining claims signal renewed Soviet interest in seabed mining.

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Perspective

Key LDC Debtors: Domestic Pressures Mount Over the Longer Term

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It is clear that the key LDC debtors [1] will be plagued by international financial problems for at least the next five years. Although interest payments are falling, a slowdown in export growth, rising imports, an upcoming bulge in principal repayments, and increased capital flight will likely boost the foreign capital requirements of these countries. At the same time, their access to foreign capital probably will remain restricted. We believe commercial banks will strive to reduce their exposure in debt-troubled LDCs, official lending will increase only marginally, and foreign direct investment will remain depressed. These trends in the demand and supply for foreign capital will result in a financing gap that we believe will have to be closed by several more years of austerity.

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Domestic economic pressures surely will increase as austerity drags on. Our projections of lackluster investment performance and sluggish export growth portend historically slow economic growth in the key LDC debtors at least through 1990. Major private forecasts confirm this, indicating that GDP will grow at least 40 percent slower than during the 1970s. Given population projections, sluggish economic growth would allow only minimal improvement in already depressed living standards and probably would lead to worsening unemployment—nearly 40 million persons could enter their work forces during the next five years. Frustrated by the lack of opportunities in the traditional labor market, an increasing number of job seekers will turn to the underground economy, including illicit activities such as the narcotics trade, smuggling, and street crime.

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Social pressures are also building as a result of prolonged austerity. If massive government deficits are to be reduced significantly, the governments of the key LDC debtors must begin cutting social welfare spending. Such cuts would have a highly visible effect on public education, health, and housing, compounding the hardships of a populace already smarting from falling incomes and unemployment and providing a rallying point that could focus popular discontent on the government. In addition, social tensions could rise between ethnic and religious groups as competition for jobs and social services becomes more intense.

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These rising economic and social pressures will come at a time of political uncertainty in most key LDC debtors. In Argentina, Brazil, and Peru, democratic governments will strive to consolidate their positions. In Chile and the Philippines, opposition to autocratic regimes will rise. Nigeria's military

[1] Key LDC debtors include Argentina, Brazil, Chile, Mexico, Nigeria, Peru, the Philippines, and Venezuela.

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government will be plagued by continued coup plotting. While still a potent political force, Mexico's ruling party probably will command less popular support if serious economic problems persist. Against this backdrop, governments will face the challenge of implementing politically unpopular adjustment measures such as subsidy cuts, which will result in higher prices for food and fuel. In some countries such as the Philippines and Peru, the necessary adjustment will be complicated by insurgencies, which could capitalize on the increased hardship that will accompany continued austerity.

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Faced with the domestic pressures of prolonged austerity, the key LDC debtors will increasingly look beyond their borders for relief. Countries with IMF-supported adjustment programs will lobby even harder for more liberal economic performance targets. If the Fund proves uncompromising, some countries—Peru is a likely candidate—may bypass the IMF and seek direct relief from private and official sources. Other countries may play the game of adopting a revised program, quickly falling out of compliance, and requesting another revision. Individually, or possibly in groups, the key LDC debtors will try to extract concessions and increased lending from commercial banks. They will also press governments and international organizations to boost their lending and development assistance. In addition, their pleas to developed countries for indirect relief will become more forceful. They will lobby the developed countries to take their needs into account during the formulation of macroeconomic policy. The debtors will also press developed nations to reduce trade barriers and absorb more of their exports.

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Oil Stocks and Government Policies of Industrialized Countries

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A further sharp reduction in commercial inventories combined with uncertainties regarding strategies to liquidate government-controlled stocks would leave the industrialized world more vulnerable to a major supply disruption. In July 1984 International Energy Agency (IEA) members agreed to coordinate stock drawdowns in future oil disruptions and urged countries with low inventories to improve their stock situation. Weak consumption and ample excess crude oil productive capacity, however, continue to spur companies to reduce stocks. Renewed expectations of lower oil prices will encourage further reductions. We estimate oil stocks in the OECD countries fell about 40 million barrels last year as increases in government-owned stocks only partly offset the decline in commercial inventories. Moreover, budgetary constraints and soft market conditions have slowed additions to government stockpiles and related compulsory inventories in some countries.

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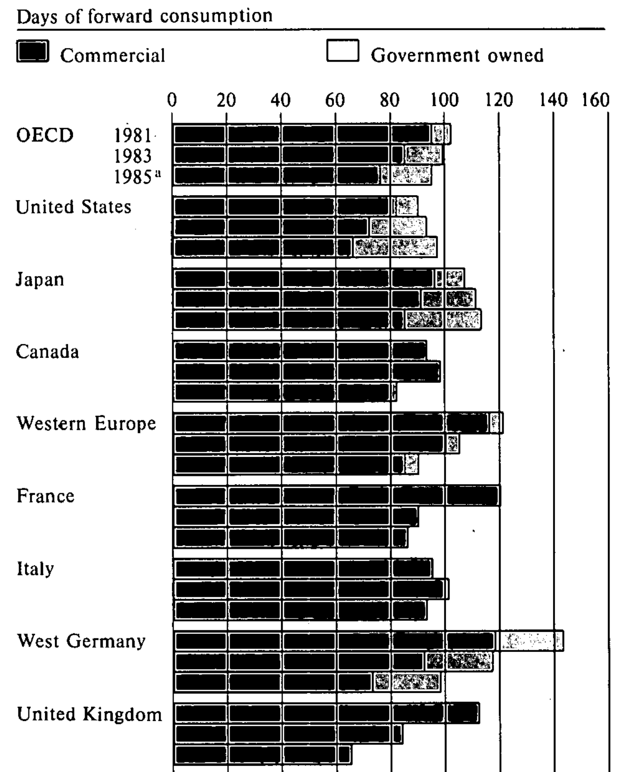
The Present Stock Situation

We estimate that total primary oil stocks including government-owned stocks in the industrialized countries stood at approximately 3.0 billion barrels—about 95 days of forward consumption at the end of March 1985. In contrast, government and commercial stocks in 1981 approximated 120 days of forward consumption in most West European countries. The overall stock situation in the United States and Japan, however, has remained at about 1981 levels. Declines in commercial stocks have generally been offset by increases in government-owned stocks. Government-owned stocks, which were practically nonexistent 10 years ago, now amount to about 20 days of forward consumption.

Total stocks, however, do not represent actual stocks available for drawdown in the event of a supply disruption. [25X1] a

OECD: First-Quarter Oil Stocks



[a] Estimated.

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large portion of commercial stocks—about 55 to 60 days of consumption—represent minimum operating stocks needed to ensure smooth functioning of the distribution system. Another 10 to 15 days

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First-Quarter Oil Stocks in Industrialized Countries

	Million Barrels					Days of Forward Consumption				
	1981	1982	1983	1984	1985	1981	1982	1983	1984	1985
Total stocks including government owned	**3,423**	**3,281**	**3,139**	**3,098**	**3,047**	**102**	**100**	**99**	**94**	**95**
United States	1,401	1,392	1,372	1,444	1,459	90	91	93	93	97
Canada	155	144	131	125	116	93	91	98	87	82
Japan	448	478	436	427	450	107	115	111	106	113
Western Europe	1,369	1,222	1,154	1,059	980	121	108	105	95	90
Of which:										
France	215	194	159	145	134	120	106	90	88	83
Italy	157	158	155	146	142	95	95	101	99	98
West Germany	311	274	256	246	213	143	126	117	110	98
United Kingdom	160	130	117	108	107	112	88	84	62	63
Australia	41	37	39	37	35	6	6	7	6	6
New Zealand	9	8	7	6	7	11	11	9	9	10
Government owned	**222**	**424**	**446**	**547**	**633**	**7**	**13**	**14**	**17**	**20**
United States	121	299	312	392	462	8	20	21	25	31
Japan	46	70	79	94	110	11	17	20	23	28
West Germany	55	55	55	55	55	25	25	25	25	25
Italy	0	0	0	6	6	0	0	0	4	4

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represent compulsory stocks that companies maintain to meet government regulations. The balance of about five days of consumption represents usable commercial stocks that provide added flexibility to meet seasonal as well as unexpected changes in demand. This stock has declined from about 20 to 25 days in the early 1980s and now provides only a small cushion against oil supply cutoffs. Moreover, because oil is the primary backup fuel for gas, elimination of discretionary stocks would leave West European countries more susceptible to gas supply curtailments.

Renewed expectations of lower oil prices will encourage oil companies to draw down inventories to minimum levels to avoid losses that would occur with a price drop. A substantial drawdown of usable commercial stocks would sharply reduce demand for OPEC oil and further exacerbate downward price pressures. The liquidation of most usable commercial inventories, however, would leave companies more vulnerable to a major supply loss.

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Major Government-Owned Stockpiles

Individual member governments have instituted a variety of stockpile policies to meet their IEA commitments. There are three basic forms of stockpile programs in the industrialized countries:

- Government-owned stockpiles intended for civilian use.
- Public storage corporations set up with government assistance to finance or administer energy reserves.
- Government requirements that the oil industry maintain emergency reserves.

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Major Developed Countries: Stock Ownership

	Government Owned	Stockholding Entities	Company Owned
United States	X		X
Canada			X
Japan	X		X[b]
Austria		X	X
Belgium			X[b]
Denmark		X	X[b]
France			X[b]
Greece	X		X
Ireland	X		X[b]
Italy	X		X[b]
Luxembourg			X[b]
Netherlands		X	X
Norway			X
Portugal			X[b]
Spain			X[b]
Sweden	X		X
Switzerland			X[b]
Turkey			X
United Kingdom			X[b]
West Germany	X	X	X
Australia			X
New Zealand	X		X

[a] Includes stocks held by companies that are partly or fully owned by governments and stocks held by certain large consumers, such as utilities, in some countries as required by law or otherwise controlled by governments.
[b] Includes stocks held to meet mandatory stockholding requirements.

Some governments have adopted more than one of these programs. The responsibility for procuring and storing oil stocks has been given to commercial firms in most industrialized countries. The firms maintain physical control over stocks and carry the financial burden of storage, although concessions are granted in some countries. In three countries—the United States, Japan, and West Germany—the governments have become major stockholders through the purchase and storage of crude oil.

United States. Until the establishment of the Strategic Petroleum Reserve (SPR) in 1975, all oil stocks in the United States except military requirements were controlled by commercial firms with no government involvement. The SPR totaled 462 million barrels at the end of March 1985 and is expected to increase to 489 million barrels by 1 October 1985. The current objective of the program is to accumulate 750 million barrels by 1991.

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Japan. Tokyo's stockpile program requires the petroleum industry to maintain 90 days' product equivalent of the previous year's consumption with the MITI responsible for setting annual objectives. In addition to this, in 1977 the government decided to develop its own stockpile with the objective of acquiring 189 million barrels by 1988. Purchases began in 1978, and by March 1985 the government-owned stockpile held 110 million barrels. Tokyo has assured the United States that it will meet its stockpile target.

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West Germany. Bonn initially required refiners and importers to meet the IEA stockpile objective even though the government had been accumulating a separate strategic stockpile since 1970. In 1978 responsibility for compulsory stocks was shifted to the Compulsory Storage Corporation (EBV), a state corporation. EBV was required to purchase a 65-day supply of oil based on the previous year's consumption and acquire sufficient storage capacity for these supplies. In early 1983, EBV stocks stood at about 117 million barrels. The government also requires refiners to hold an additional 25 days of inventory as working stocks. In addition to these compulsory stocks, the government's strategic stockpile currently contains 55 million barrels with an ultimate goal of 73 million barrels. Budgetary constraints have prevented Bonn from adding to the strategic reserve since 1981.

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Stockpile Programs in Other Countries

Companies operating in ***France*** must maintain stocks equivalent to 90 days of the previous 12 months' inland sales; the government has expressed

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no interest in maintaining a separate strategic reserve. The French Government reportedly is considering easing mandatory stock requirements to save foreign exchange. In general, Paris favors imposing demand restraint measures in the initial stages of a disruption rather than drawing down stocks.

Increasing domestic production has enabled the ***United Kingdom*** to reduce stock requirements. Oil companies maintain the bulk of oil reserve stockpiles. ***Canada*** and ***Norway***—the two other major oil-producing OECD countries—have announced no stockpile programs.

The ***Italian*** Government requires oil companies to maintain 90 days of emergency oil stocks. The Italian strategic reserve is held by SOGESCO, a company under the control of ENI, the state oil company. In ***Sweden***, industry is required to hold stocks equal to 110 days of the previous year's consumption. Government-owned stockpile levels and target goals are a closely guarded secret, but we estimate that current government inventories total about 45 million barrels.

Belgium relies on oil companies to meet IEA objectives. Private petroleum companies are obligated under a 1965 law to hold stocks equivalent to 90 days of the previous year's consumption. In a crisis, control of Belgian stocks would pass to the National Emergency Sharing Organization. The government presently has no plans to build a government-owned stockpile.

In ***Switzerland***, compulsory stocks are equivalent to 180 days of the previous year's consumption and are held by industry. Oil companies in the ***Netherlands*** are required to hold stocks equivalent to 90 days of the previous year's consumption, and oil traders are required to hold an additional 70 days of stocks. the public-sector corporation, COVA, also has acquired 30 days of supplies including a mix of crude and products.

Outlook

Commercial stocks, as measured in days of forward consumption, are now approaching levels that existed in the mid-1970s and could even go lower. If oil companies believe that oil prices will continue to fall, an estimated 100-200 million barrels of inventories could be dumped on the market. Should another major supply disruption occur, we believe companies will have little cushion available in the form of usable stocks to offset reduced oil flows.

We believe the increase in government-owned oil stocks will only partially affect this drop because of budgetary constraints. Nevertheless, effective deployment of government-owned stocks under IEA coordination could play an important role in offsetting any future oil supply disruption. The key players in any coordinated strategic stock drawdown would be the United States, Japan, and West Germany. The major problem will be the design and implementation of a program believed to be effective and equitable. In addition to demand restraint measures, countries without government-owned stockpiles could share the burden of a disruption by augmenting supplies through a relaxation of mandatory commercial stockpile requirements.

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India: Growing Opportunities for Technology Diversion [1]

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India is likely to offer an increasingly attractive target for Soviet science and technology collectors in the years ahead. Prime Minister Rajiv Gandhi has introduced sweeping economic reforms that promise to encourage imports of sophisticated Western technology and boost India's ability to manufacture its own high-tech products. Faced with increasing difficulties in procuring Western high-tech elsewhere, Moscow almost certainly anticipates reaping a bountiful harvest of controlled technology once New Delhi begins to import it. Although India apparently intends to protect sensitive US technology under a Memorandum of Understanding signed last year, New Delhi will be hard pressed to offer the degree of security Washington expects.

India as a High-Technology Target

India is poised for an unprecedented expansion of its technological capabilities. After decades of slow and uneven growth, India has built its heavy industrial infrastructure and is moving increasingly into high-tech areas such as electronics and computers. We believe the scope for such expansion is vast—India boasts a broad range of scientific activity and an impressive reservoir of technically trained manpower. Advanced technology is expected to play a central role in Rajiv Gandhi's driving ambition to modernize India by improving productivity and government efficiency.

India's technological expansion poses a double challenge to the international trade control mechanism. Imports of controlled technologies will almost certainly increase significantly and offer opportunities for diversion. Gandhi has already liberalized key aspects of India's overregulated economy—including rules on foreign joint ventures and import/export policies—to fuel efforts to modernize with new technology. New Delhi signed a Memorandum of Understanding (MOU) on technology transfer with the United States last year—setting the stage for a takeoff in US high-tech sales—and several other Western countries are offering attractive technology packages in order to gain a foothold in India's burgeoning electronics market.

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In addition, India's ability to produce indigenously high-technology items of interest to the Soviets is likely to increase significantly during the next decade. Gandhi is eager to make Indian high-tech goods competitive in world markets. The development of software for export, for example, is receiving particular emphasis. With an abundance of trained, English-speaking software engineers and low labor costs, India enjoys a comparative advantage in software production that it is only beginning to exploit on a large scale.

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Although Western Europe and East Asia remain the primary focus of Moscow's efforts to acquire high technology, three major factors make India a potential source:

- India's large, active, and capable scientific community.
- The ease with which sensitive information can be acquired in a developing country with democratic traditions.
- New Delhi's close and longstanding relations with Moscow.

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Indo-Soviet Ties: A Special Concern

The USSR is uniquely positioned to acquire technology in India because of its close and longstanding relations with New Delhi. Although their relationship is based on a congruence of national interests and not ideological affinity, it allows the Soviets to maintain a large official presence in

[1] This article summarizes a forthcoming study.

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India that reinforces bilateral cooperation across a broad front—political, economic, military, and scientific—and provides an excellent cover for intelligence collection operations. We estimate that the KGB S&T contingent in India consists of about 13 officers—one of Moscow's largest S&T efforts. Although evidence of their operations is scarce, we believe they have proved adept at targeting Indians with special knowledge or with relatives in the United States who can supply technical information of interest to Moscow.

India's nonalignment and Gandhi's preference for Western over Soviet technology have prompted New Delhi to adopt a more evenhanded approach toward the superpowers than in the past. Nonetheless, Gandhi cannot afford to jeopardize the significant economic and military benefits India receives from Moscow as he seeks new ties to the West. Despite recent attempts at arms diversification, India will continue to rely on the Soviets for most of its sophisticated weaponry for at least the rest of this decade.

For the Soviets, India's growing interest in expanded ties with the West and its quest for advanced technology present both a challenge and an opportunity.

hardening attitudes in the industrialized countries toward Soviet espionage and illegal technology procurement activities have forced the Soviets to seek alternative sources in the LDCs.

Acquisition Mechanisms

The Soviet Union acquires technology in India through a variety of mechanisms, including legal and illegal purchases, cooperation and exchange agreements, and intelligence operations. We have no evidence that formal trade agreements themselves promote illegal technology transfer. On the other hand, well-established bilateral cooperation over a broad range of scientific disciplines enables Soviet scientists to profit from access to their Indian counterparts. Many scientists in India were trained in the United States and have retained informal contacts with colleagues here—both US and Indian—in high-technology fields. We believe these contacts—which the Indian Government encourages—offer immense scope for technical data diversions that are almost impossible to monitor.

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We have persuasive evidence that some controlled US technology—mainly computer-related items such as software with both civilian and military applications—has been transferred by Indian firms and individuals to the USSR over the last decade. In our view, these transfers occurred without the official approval of the Indian Government, although in some cases employees of government-controlled institutions have been implicated. transfers of other controlled items—including Western military technology—have occurred

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Indian Security Practices

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Indian officials believe their security procedures are adequate to support assurances to the United States and to deny the Soviets access to Western technology within the government, the military, and public-sector enterprises. Indeed, over the past two decades, the Indian Government has demonstrated—to the extent we can verify—an ability to compartment and restrict access to sensitive technologies, especially at military installations. New Delhi is far less sanguine of its ability to prevent diversions through the private sector—where we believe they are most likely to occur—but has warned the United States not to sell to certain companies suspected of working for the Soviets.

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Good intentions aside, New Delhi will be hard pressed to offer the degree of protection Washing-

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ton expects. Recent revelations of widespread espionage within the government and private industry suggest that India would be vulnerable to aggressive S&T collection efforts. Through improved licensing, enforcement, and security practices, however, India may be able to prevent actual diversions of hardware and equipment.

Protecting sensitive technical data will prove far more difficult.

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If Soviet collectors can locate US equipment protected under the MOU, we believe that in time they can almost certainly gain physical access to the machines and their technical data.

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Perceptions and Prospects

We believe the Indian Government has become sensitized to US concerns about unauthorized diversions of sophisticated technology and is fully committed to upholding its security obligations under the MOU. Both New Delhi and Indian private industry fear loss of access to US technology if illegal transfers occur and are discovered because they recognize the importance of high technology to India's economic development.

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Despite pledges to protect US technology as the price of acquiring it, we believe India would resist strongly any pressure from the United States to subscribe to international technology controls or to restrict exports of its own high technology to any country, including the USSR. Indian officials would resent such pressure as an attempt to undermine India's sovereignty, limit its freedom of action, and prevent it from challenging the West in world markets.

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Although New Delhi clearly prefers US equipment and technology, some West European and Japanese suppliers are offering attractive alternative packages with favorable financing and fewer restrictions on use or reexport.

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India would turn increasingly to these suppliers if US requirements prove onerous. In the long run, we believe only a coordinated position by COCOM member countries on controlled high-tech exports to India will prove effective in limiting technology diversions to the USSR.

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EC-Italy: Aftermath of the Lira's Plunge

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The European Monetary System (EMS)[1] came through its realignment last weekend with flying colors following the unexpected plunge of the Italian lira on Friday. For the first time in the system's history, technical experts handled the realignment without having to call in the EC finance ministers. Despite the good performance of the EMS as a whole, "black Friday" puts the Italian Government in a poor light as the perception grows that it bungled a planned devaluation of the lira.

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The Realignment

The lira's 18-percent plunge against the US dollar began when the government-owned energy holding company ENI placed an order for $125 million on the Milan exchange, which normally trades about $60 million a day in foreign currency. According to the US Embassy, ENI was rumored to have advance word that the government would be pushing for a devaluation of the lira at last weekend's regularly scheduled meeting of the EC finance ministers. Later press reports discount this, but note that the Bank of Italy pressured ENI to postpone the transaction until Monday.

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As pressure on the lira mounted, the Bank of Italy refused to intervene, and, in a 15-minute period, the dollar jumped from 1,860 lire to 2,200 lire by the Milan exchange's normal closing hour. Treasury Minister Goria then ordered the Bank of Italy to suspend foreign exchange operations involving the lira for the rest of the day, and other EMS central banks followed suit.

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[1] The EC countries set up the EMS in 1979 to stabilize their exchange rates in preparation for a monetary union with a common currency. The 10 EC currencies make up the European Currency Unit—the basket against which the EMS countries try to maintain exchange note stability. Although members of the EMS, the United Kingdom and Greece have not pledged to intervene in the exchange markets to stabilize their currencies against the other EMS currencies.

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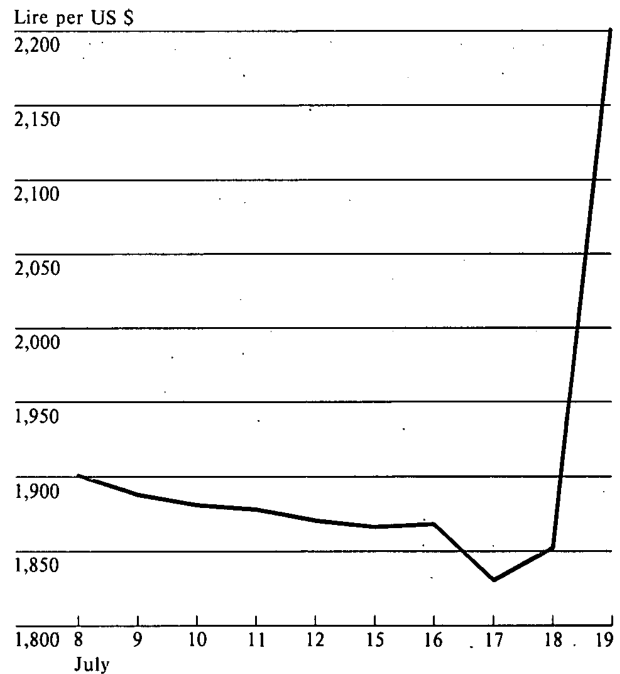
US Dollar–Italian Lira Exchange Rate, 8-19 July 1985



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Technical experts from the EMS countries, who had been scheduled to meet in Basel, Switzerland, on Saturday, worked out the details of the realignment Friday night and announced them Saturday morning. In the realignment, the lira was devalued 6 percent against the European Currency Unit (ECU)—the basket of the 10 EC currencies that stands at the center of the EMS. The other EMS currencies were revalued by 2 percent against the

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ECU to compensate for the impact of the fall in the lira on the ECU's value, thereby keeping all other exchange rates constant. In effect, the lira was devalued 7.8 percent within the EMS.

Factors Behind the Realignment

The Italian Government apparently decided during its policy review last week to push for a lira devaluation to reverse the country's declining trade competitiveness. Growth of Italian exports has slowed sharply in the past year largely because Italy's inflation rate—8.7 percent for the 12 months ending in June 1985—remains almost double the average rate of its major trading partners. With economic growth spurring import demand, the trade deficit rose to $7.4 billion for January-May 1985—50 percent higher than the level of the same period last year. Moreover, projections of a record current account deficit this year raised fears that Italy would have difficulty attracting enough capital from abroad to avoid a devaluation.

Rome wanted to devalue before growing market speculation against the lira eroded the country's international reserves. According to the US Embassy, Italy's monetary authorities further reckoned that moving now would allow the government to take advantage of declining oil prices to cushion the devaluation's inflationary impact on imports.

Implications for the EMS and Italy

The fact that technical experts for the first time worked out the details of a realignment bodes well for the future of the system. Past realignments have often been acrimonious as finance ministers attacked each other's economic policies. Although the decision for a realignment remains a political one, the absence of finance ministers at last weekend's meeting indicates that the EMS governments now look at the magnitude of a realignment as a technical problem. If finance ministers stay out of discussions on future realignments, the chances of the EMS breaking up should be much lower.

Nevertheless, "black Friday" will make significant initiatives toward monetary union even less likely in the near term. Rome will be more reluctant to adopt the 2.25-percent band in which other EMS currencies are allowed to fluctuate without forcing a realignment; the lira is the only EMS currency with a 6-percent band. Other EMS countries, particularly West Germany and the Netherlands, probably will renew their insistence that capital controls among EMS countries should be dismantled before new measures to foster monetary union are taken; they almost certainly will cite the lira's fall as a consequence of capital controls that help keep Italian financial markets thin.

The devaluation of the lira probably is too small to wipe out the Italian trade deficit. More stringent measures are needed to reduce inflation and increase industrial productivity before Italian companies can significantly improve their trade competitiveness. Prime Minister Craxi probably will redouble his efforts to reduce existing capital controls and seek tougher economic measures to address the trade and public-sector deficits. The government's inability to handle the devaluation smoothly, however, highlights the riskiness of investments in lire and probably will slow the broadening of Italian financial markets.

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Eastern Europe: Uncertain Economic Recovery

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East European economic performance improved in 1984, but the likelihood of a sustained recovery is not great. Most of the growth resulted from large gains in agricultural output due to good weather. This year, although the region has rebounded from the harsh weather this past winter that disrupted industry and transport and damaged some crops, economic growth probably will fall below last year's level. Over the longer term, external constraints and systemic weaknesses will make it difficult for the region to return to the generally good economic performance of the early 1970s.

Growth in 1984

Eastern Europe's economic growth improved significantly compared with the early 1980s. Romania scored the largest gain among the CEMA Six,[1] but the economic turnaround by Bulgaria and Hungary was impressive.[2] Yugoslavia's economic performance also showed a significant recovery from 1983's decline. Although the region's overall performance was the best in this decade, growth rates are still well below the relatively high levels of the early 1970s.

Last year's economic gains resulted largely from good weather that helped push agricultural production to record levels in most of the region. Every country except Bulgaria harvested a record grain crop, and Bulgaria's was still a substantial improvement over its 1983 results. The increase in grain production—following two years of above-average harvests—and improved output of many nongrain crops supported strong growth in livestock production.

Although industry's gains lagged agriculture's, East European industry continued to recover from its 1981-82 downturn. Hungary and Czechoslovakia, which had the poorest performance in 1983, recorded the largest improvements last year. Poland led the region in industrial growth for the second consecutive year, even though the rate of increase slowed. Poland's high rate of growth, however, is largely a rebound from the severe depression of 1980-82 when industrial production fell more than 15 percent.

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Some easing of external problems as well as adjustment to reduced Western imports and Soviet oil deliveries underlie the modest revival of East European industry. Economic recovery in the West helped boost hard currency exports 7 percent in dollar terms. This increase in sales and a greater availability of trade financing allowed all of the regimes, except Budapest, to ease import restraints imposed during the 1981-83 financial crisis. Although hard currency imports remained well below their 1980 peak, last year's small increase probably improved domestic supplies of key raw materials and manufactured goods, helping to ease bottlenecks and support the upturn in industrial production. Planners also have probably shifted production and distribution patterns somewhat, enabling the East European economies to substitute domestic production for goods previously imported from the West and to conserve on the use of materials. Moreover, East Germany, and, to a lesser extent, Hungary and Czechoslovakia, which suffered cutbacks in Soviet oil deliveries after 1981, have achieved some success in energy conservation and substitution.

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Consumption, which most East European regimes had already favored over investment in adjusting to financial problems, benefited further from last

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[1] Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and Romania.

[2] We estimate Romanian GNP growth at 4.3 percent, but, because of the large distortion in the underlying official indexes, we have less confidence in this estimate than in those for the other countries.

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Eastern Europe: GNP Growth [a] *Average Annual Percent*

	1971-75	1976-80	1981-82	1983	1984 [b]
Bulgaria					
GNP	4.7	1.0	2.9	−1.6	3.1
Agriculture	2.2	−3.4	5.2	−12.4	7.5
Industry	5.7	3.4	2.5	1.9	2.3
Other	5.7	1.6	1.9	1.2	1.7
Czechoslovakia					
GNP	3.4	2.2	0.7	1.0	2.3
Agriculture	2.4	1.4	−0.4	1.7	4.2
Industry	3.9	2.8	1.4	0.9	2.5
Other	3.3	1.9	0.4	0.8	1.4
East Germany					
GNP	3.5	2.3	0.8	1.6	3.0
Agriculture	2.8	0.7	0.8	3.1	8.3
Industry	3.4	3.0	1.7	1.9	2.0
Other	3.7	2.2	−0.1	0.8	2.6
Hungary					
GNP	3.3	2.0	2.2	−1.2	1.3
Agriculture	3.9	1.6	5.8	−5.8	2.1
Industry	2.6	2.2	1.6	1.0	2.1
Other	3.5	2.1	0.7	−0.3	0.3
Poland					
GNP	6.5	0.6	−3.2	4.6	3.4
Agriculture	1.1	−1.0	4.4	4.7	3.9
Industry	7.6	0.6	−7.9	5.2	4.1
Other	10.0	1.8	−3.9	4.2	2.7
Romania					
GNP	6.7	3.9	1.5	0.2	4.3
Agriculture	5.3	3.2	4.1	−0.3	11.4
Industry	9.2	4.4	0.8	3.1	3.8
Other	5.4	3.9	0.2	−2.6	−1.2
CEMA Six					
GNP	4.9	1.9	0	1.6	3.1
Agriculture	2.5	0.4	3.5	0.6	6.2
Industry	5.5	2.4	−1.0	2.6	2.9
Other	5.7	2.2	−0.9	1.3	1.6
Yugoslavia					
GNP	6.1	5.6	1.1	−1.3	1.7
Agriculture	2.9	2.2	5.6	−1.8	1.1
Industry	5.8	7.2	1.0	1.4	1.8
Other	7.6	5.8	−0.3	−2.9	1.8

[a] Caution must be used when viewing the rates of growth for total GNP and by sector of origin for the CEMA Six. While they are useful in illustrating individual country differences from the average, their primary shortcoming stems from the fact that they are an artificial measure that is the combination of individual countries measured in different factor costs.
[b] Preliminary.

year's pickup in economic growth. Poland recorded the fastest growth rate in private consumption as the government backed away for the second consecutive year from stringent austerity measures in order to curry popular support and to show progress in resolving the country's economic problems. East Germany and Czechoslovakia recorded increases in consumption on a par with those of the 1970s while Hungary at least recouped 1983's losses. Only Yugoslavia and probably Romania suffered a drop in private consumption. Although private consumption was up for the region as a whole, imbalances continued resulting in shortages, price hikes, and—in Poland and Romania—rationing of some food and consumer goods.

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Growth rates for investment were much more mixed than those of consumption. Although tight control on investment since 1980 has raised concern in Eastern Europe about long-term growth, East Germany, Hungary, Bulgaria, and Yugoslavia continued to limit, if not reduce, investment to free up output for export and consumption. Poland, Romania, and Czechoslovakia accelerated investment, but much of this spending went to reviving large, heavy industrial projects that will probably have little, if any, payoff. Many of these projects were ill conceived from the outset and due to the long leadtime for completion will be technologically obsolete.

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1985: Recovery From a Bad Start

Last year's economic upturn probably will not carry over to 1985 for most of the East European countries. The region was hit by extremely harsh winter weather that led to energy shortages, disruptions in transportation and production, poor hard currency trade performance, and damage to winter grain crops in Bulgaria and parts of Romania. some recovery from the first-quarter losses is taking place, but the more hard-hit and fragile economies are still struggling:

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- ***Romania*** is unlikely to match last year's growth rates. Lack of energy reserves may have cut industrial production as much as 7 percent compared with first quarter 1984, and worsening

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Comparing Official and Reconstructed Growth in Eastern Europe

Two frequently used measures of economic activity are the official national income produced (NIP) used in Marxist national income accounts and GNP as conventionally measured in the West. NIP and GNP differ in three ways: services, prices, and depreciation. Marxist national income accounts exclude as nonproductive most services, including housing, education, government administration, and consumer services. Prices also distort Marxist national income accounts. Goods are valued in purchasers' prices that include turnover taxes—taxes on sales to consumers that vary from item to item. Western-style GNP accounts, on the other hand, value goods and services at factor cost—the value of labor and capital services used in their production. A change in turnover taxes will, therefore, affect Marxist national income, but not Western-style GNP. NIP measures also suffer an upward bias resulting from underestimation of price increases in official indexes. This upward bias is due to two factors: (1) the declining quality of goods while their prices remain the same and (2) the introduction of new products whose prices are set excessively high, although the new product may be in reality an older product with some insignificant alteration. The third difference is that GNP measures do not deduct depreciation from gross fixed capital formation while Marxist national income measures do.

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As a result of these accounting differences, growth rates measured in Western-style GNP terms differ markedly from growth rates expressed in Marxist national income terms. Movement in Western-style GNP growth measures tends to be less extreme than their Marxist counterparts because services, excluded from Marxist accounting practices, usually are more stable on a year-to-year basis than the other components of production.

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The following tabulation compares percentage growth in NIP and GNP terms for 1984:

	GNP	NIP
Bulgaria	3.1	4.6
Czechoslovakia	2.3	2.8
East Germany	3.0	5.5
Hungary	1.3	2.8 to 3.0
Poland	3.4	5.1
Romania	4.3	7.7

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payment problems have led the regime to slash already sparse imports and redouble its export drive. Because of weather problems and shortages of inputs, the outlook for agricultural production is mediocre.

- ***Poland's*** economy had its worst start since 1982. Data for the first quarter indicate industrial production stagnated, and the hard currency trade surplus fell to $250 million from $360 million in the same period last year. While results from April and May show growth in industrial production, Polish officials are pessimistic about this year as a whole.

- ***Bulgaria*** seems likely to turn in one of its poorest economic performances in years. The regime's effort to make up for weather-related production losses through a six-day workweek does not seem to be yielding results. Agricultural performance will likely suffer due to continuing drought and low reservoir levels.

- ***Yugoslavia's*** goal of recording major gains over 1984 has been dashed, although some growth is likely. Industrial production slumped during the first quarter while a falloff in exports and an

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Eastern Europe: Private Consumption Growth *Average Annual Percent*

	1971-75	1976-80	1981-82	1983	1984
Bulgaria	3.8	1.6	3.2	0.5	1.7
Czechoslovakia	2.7	1.6	0.8	0.9	2.0
East Germany	3.9	2.0	0.2	0.5	3.7
Hungary	3.3	2.2	1.3	−0.8	1.0
Poland	5.5	2.4	−5.6	5.2	5.1
Romania	5.1	4.7	0.4	−1.9	NA [a]
Yugoslavia	5.2	4.9	−0.5	−1.7	−2.0

[a] The Romanian Statistical Office has ceased publication of key data necessary for the calculation of private consumption.

Eastern Europe: Gross Fixed Investment *Percent*

	1971-75	1976-80	1981-82	1983	1984
Bulgaria	8.6	6.1	6.1	0.4	1.0
Czechoslovakia	8.3	3.0	−3.5	0.6	4.4
East Germany	4.8	3.4	−1.3	0	0
Hungary	7.0	2.4	−3.7	−2.7	−1.0
Poland	18.5	−3.0	−17.5	9.4	8.0
Romania	11.4	8.5	−5.5	2.9	6.1
Yugoslavia	5.8	5.5	−7.7	−10.0	−6.0

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increase in imports produced a current account deficit of $359 million through April in contrast to a $31 million surplus in the same period of 1984.

- ***Czechoslovakia, East Germany,*** and ***Hungary*** will probably come close to matching last year's economic performance. Although all of these economies were affected by the harsh weather, overtime and other administrative measures have helped overcome the first-quarter deficiencies.

Prospects

Although this year's slowdown is largely related to the unusually harsh winter, external factors and systemic weaknesses will limit economic growth for the rest of the decade. We doubt that the region can sustain GNP growth of more than 2 percent annually over the next few years, far below the growth rates obtained during the 1970s:

- The East Europeans will face strains in their economic relations with both the West and the USSR. Large hard currency debt service requirements and caution among Western creditors will continue to limit imports and require improved export performance. At the same time, the East Europeans can no longer count on Soviet largess. To bring the economic relationship into closer balance, Moscow is insisting that the East Europeans provide more and better quality goods, along with investment resources, in return for energy and raw material exports.

- Growth of inputs needed to sustain economic growth will be slow. In all the countries except Romania, the rate of growth in the labor supply will decline during 1986-90. Because of external constraints and unease over reductions in domestic consumption, most regimes will probably keep investment rates below historical levels, limiting improvements in productivity.

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- Most of the countries suffer from low energy reserves and inefficient energy-intensive industries, and the possibility of more reductions in Soviet oil deliveries is always present.

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- Although most of the regimes recognize the inefficiency of their economic systems, only Hungary has undertaken meaningful action to decentralize decisionmaking, rationalize prices, or increase the role of market forces in the economy. Hungary's economic performance, however, is not an unequivocal testament to reform. Although the Soviets are pressing the East Europeans for greater economic efficiency, most regimes appear uncertain about the degree of reform Moscow is willing to permit and are unlikely to do more than tinker with their existing systems.

Given this outlook, the East European regimes will face tough decisions allocating the limited growth of output between the competing uses of investment, consumption, defense, and exports.

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USSR: Renewed Interest in Seabed Mining

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Recent efforts to acquire Western sea-mining technology and equipment and to resolve conflicting ocean-mining claims signal renewed Soviet interest in seabed mining. Although this interest may be driven by several factors, including military applications, we believe Moscow's primary motivation is the future extraction of minerals, especially manganese, largely because of the declining quality of domestic manganese ore.[1]

Soviet Motivation

The USSR is the world's largest producer of manganese ore, but Soviet high-grade manganese ores, which have a lower metal content than those normally mined in the West, could be completely exhausted at the two major mining areas of Chiatura and Nikopol in nine and 20 years, respectively. This would leave only lower-grade ores that are much more difficult and expensive to process. The large Bolshoy Tokmak deposit, which the Soviets are just beginning to develop, consists almost entirely of low-grade ores. The poor quality of Soviet ore has contributed to inefficiency in steelmaking.

The Soviets have had a longstanding interest in locating and analyzing ocean-bottom mineral deposits, especially manganese nodules. They first reported the recovery of nodules in 1957 from the Pacific Ocean. [redacted] he USSR started developing technology for seabed mining in the late 1960s. An organization in Siberia developed the chemical techniques for separating metals of interest. Additionally, Moscow has made several attempts in the last few years to buy from Western companies a submersible nodule mining vehicle, an oceanographic camera system, a seabed miner built on a drill ship hull, and a transfer and storage vessel.

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We believe that the Soviets are interested in seabed mining primarily because of their need for higher grade manganese ore. Manganese ore extracted from nodules is of poorer quality than that available from many international suppliers, but it is superior to most domestic reserves. In addition, much of the seabed mining research has occurred following warnings from Soviet geologists that high-quality manganese ore was being rapidly depleted.

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The USSR's interest in manganese nodule mining could also be driven by several other factors:

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- A desire to prevent other countries from cornering the market.

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- National pride because the United States and Japan have developed and tested prototype systems for manganese nodule mining.

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- A desire to obtain Western seabed technology for military applications. The technology involved in mining operations at depths down to 6,000 meters is directly applicable to deep-ocean military activities such as the implantation and retrieval of weapons and antisubmarine warfare sensors.

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[1] Manganese nodules consist mainly of manganese and iron oxides, but they also contain copper, nickel, cobalt, aluminum, titanium, lead, vanadium, molybdenum, zinc, and chromium. Of most economic interest are nickel (used primarily in steel production), copper (widely used in electrical equipment), cobalt (used in the electrical and aerospace industries), and manganese. Deposits of these small, dark brown, irregularly shaped nodules are normally found at depths of 4,000 to 6,000 meters. The distribution of nodules is uneven, but the largest deposits are thought to be in the Clarion-Clipperton zone, an area of the Pacific Ocean that extends from Central America to south of Hawaii.

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Seabed Mining of Manganese Nodules

Many Western countries, including the United States, Japan, the United Kingdom, Canada, and West Germany, have been actively involved in studying the potential of commercial seabed mining. Development, however, has been slowed by continuing legal, economic, and technical questions.

The Law of the Sea (LOS) Treaty, signed by over 100 nations in 1982, formed a regulatory agency and outlined some controversial conditions for seabed mining. The treaty, however, has not been signed by the United States and several other Western countries. It is unclear what will happen when claims filed with the regulatory agency conflict with mining rights claimed outside the LOS framework.

Economic questions also hamper the development of seabed mining. A recent US Bureau of Mines study estimates that a four-metal mining project that processes 3 million tons of nodules annually would require an estimated $2 billion capital investment and operating expenses of $150 per dry ton and would yield a rate of return after taxes of about 7 percent. Most Western investors would probably require a rate of return of about 20 percent before undertaking such a risky venture.

The markets for metals produced from the seabed are fairly uncertain, and the technology for mining and processing is even less clear. Four major components are involved—a mining system, a mother ship to provide the focus of mining operations, ore transporters, and processing plants. The weakest link in the chain is the mining system. Systems that include either self-propelled or towed collection apparatus with lifting devices attached to a continuous line bucket have been tested on a pilot basis.

Dependence on Western Equipment

If the Soviets undertake full-scale nodule mining operations, they will almost certainly depend on Western equipment and technology, particularly for the mining phase of the operation. Because of the possible military applications, however, the Soviets have had trouble obtaining submersible craft for this purpose. Equipment capable of performing beyond 1,000 meters is COCOM controlled, although some suppliers such as Finland are not COCOM members.

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The Soviet Ministry of Geology reportedly ordered two ocean-mining research ships from Finland in early 1985. The two ocean-mining research ships will each be equipped to support a 6,000-meter manned submersible. the Soviets signed a contract with the Finnish firm Rauma Repola in May for a 6,000-meter submersible vehicle.

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Outlook

Although Soviet demand for manganese may level off because of slow growth in steel production and modernization of the industry, manganese will remain an essential ingredient in steelmaking. The Soviets probably can get by using their domestically produced ore for the next 15 to 20 years for most applications. New refining techniques and methods for lowering the amount of manganese necessary for steel production may alleviate some of the problems associated with using low-grade ores.

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If the USSR is to avoid sole reliance on its low-grade ore, it will have to import high-grade ore from the West or obtain Western technology to develop production from seabed nodules. The Soviets should have no problem importing ore in the near future. According to Western studies, current world operating rates of manganese mines average

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only 60 percent of capacity, and growth in worldwide demand is expected to be slow.

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Should the Soviets choose the seabed-mining option, full-scale operations probably are over 20 years away. In addition to the technological barriers, some workable legal framework for mining the seabed needs to be established. As an initial signer of the Law of the Sea Treaty, the USSR is guaranteed a minesite on the seabed.

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Earlier this year, a Soviet delegation met with delegations from Japan and France and reached tentative settlements of conflicts regarding their minesite claims. We believe, however, that the USSR claim conflicts with one or more of the claims of four multinational consortiums that include companies from the United States, the United Kingdom, West Germany, Canada, Italy, and Belgium.

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If the Soviets obtain the technology and undertake seabed-mining operations, the effect on international metals markets eventually could be dramatic. According to Western studies, an annual 3-million-ton operation might not only yield 500,000 tons of manganese ore, but also an estimated 40,000 tons of nickel and 7,000 tons of cobalt. Much of the yield from such an operation probably would be sold on the international market in direct competition with such metal suppliers as Canada, Cuba, Australia, Zambia, and Zaire.

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Briefs

Energy

Effects of Iraqi Attacks on Iran's Oil Shuttle

Iraqi missile damage to Iranian shuttle tankers on 9 and 12 July shows that the Iranian oil shuttle system can be briefly disrupted by sporadic aircraft attacks, but Iraq would need to intensify attacks over a long period to have a major effect on Iranian oil exports. Oil sales and barter so far this year account for 95 percent of the foreign exchange Tehran is expending to prosecute the war and provide essential commodities to its people. Since May approximately 80 percent of Iran's oil exports—which have averaged 1.7 million barrels per day—have been moved to the southern Persian Gulf by the shuttle operation between Khark terminal and Sirri Island. Baghdad would have to ensure that fewer than seven tankers are available on a day-to-day basis to drive the shuttle capacity below the level of current exports. With the ready availability of idle tankers in or near the Gulf, however, Tehran would have no trouble replacing a damaged ship within a few weeks—although it might have to pay higher charter rates. As a last resort, the Iranians could entice tankers back to Khark Island by offering lower oil prices, as they did during the height of the Iraqi attacks on tankers last spring.

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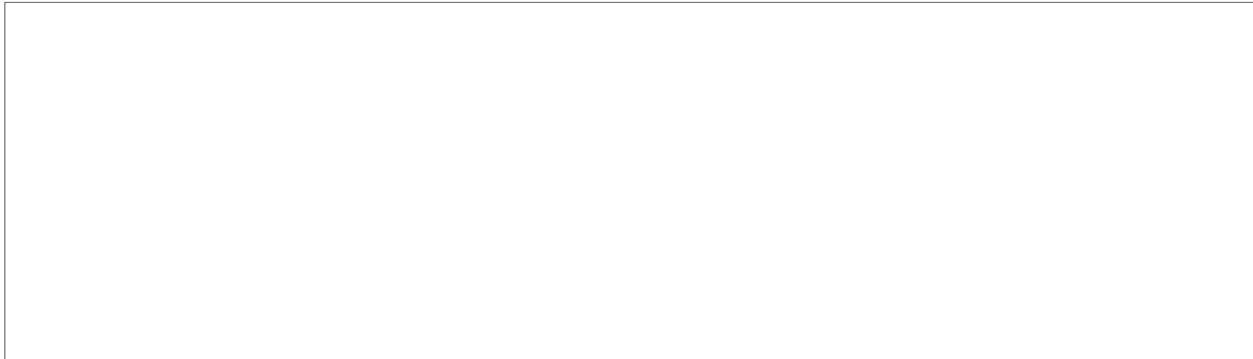

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International Finance

Nigeria To Repay US Exim Bank Arrears

The US Embassy reports that the governor of the Central Bank of Nigeria has pledged to repay all short-term arrears owed to the US Export-Import Bank. Nigeria is paying about $15 million to free up two undisbursed Exim medium-term loans, which will be used to purchase US-manufactured turbines and a pump assembly plant. Because the repayment proposal does not involve any rescheduling, it will not violate Paris Club guidelines prohibiting creditors from unilaterally rescheduling their outstanding loans.

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Iraqi Debt Relief

Iraq's major Western creditors are providing relief for Baghdad's current financial crunch. The US Embassy in Baghdad reports that an agreement appears likely with Japan to defer 75 percent of Iraq's 1985 payments by two years—some have been overdue since April. The Embassy also says that West Germany will continue to provide credit despite Baghdad's requests for rescheduling of loans due this fall. Iraq's financial troubles could become unmanageable if oil prices fall by more than a few dollars per barrel.

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British Lower Egypt's Credit Rating

The United Kingdom's Export Credit Guarantee Department (ECGD) put Egypt in its highest risk category last month, the first such state agency to do so. Cairo currently is in arrears on three loans from the ECGD totaling 2.87 million pounds ($4 million). The lower credit rating, combined with an across-the-board increase in interest rates for all ECGD-backed loans, means Egypt faces an effective 50-percent increase in premiums on new loan guarantees.

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Progress in Chilean Debt Package

After six months of stalemate, Chile's debt package is now moving along. The IMF agreed in principle on 15 July to a three-year, $765 million extended fund facility that cleared the way for a 17 July Paris Club rescheduling of $170 million. The World Bank responded to Santiago's lifting of the state of siege by approving a $140 million highway project loan in late June and authorizing negotiation of a $300 million cofinancing loan. The Inter-American Development Bank announced it will approve $400 million in loans this year to Chile. Santiago is counting on disbursements from the IMF in August, bankers in September, and the World Bank in late fall. We remain concerned that technical delays or resurgent political problems could temporarily untrack negotiations—in which case Chile would be unable to cover its current account deficit and meet its IMF reserve targets in 1985. Thus, we project Santiago will continue to experience foreign exchange strains this year—possible selling off some gold reserves to meet obligations—and will seek waivers from the IMF on its reserve and inflation targets.

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Moroccan Debt Rescheduling Delayed

Rescheduling of Morocco's official debt for 1985 and 1986 suffered another blow last week when Paris Club members postponed further consideration until at least September. Club members were reluctant even to meet the Moroccan delegation, according to the US Embassy in Paris, and did so only under pressure from the French delegation. Little progress is likely in

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September unless Morocco signs the long delayed 1983-84 London Club rescheduling agreement and negotiates a new IMF package. The delay in reaching such accords almost certainly will result in harsher rescheduling terms and possibly a reluctance by commercial banks to continue already limited short-term credit lines. With only $90 million in foreign exchange reserves remaining, Rabat is near the end of its financial rope unless wealthy Arab states or other benefactors appear. 25X1

Indonesian External Debt Rising

The World Bank announced last week that Jakarta's external public debt for yearend 1984 reached $24.6 billion, $2.9 billion above year-earlier levels, making Indonesia the fifth most heavily indebted nation in the world. Although its debt is increasing at a relatively modest pace as a result of sharp reductions in imports, Indonesia's debt horizon is clouded by continued softness in oil prices as well as a possible slowdown in the global economy. The US Embassy reported last week that export revenues in the first quarter of the fiscal year that began 1 April dropped by 25 to 30 percent over the same period last year. Although we believe Indonesia is capable of coping with $24 to $25 per barrel of oil, a drop to $20 per barrel would place severe strains on its external finances. Unlike two years ago when similar circumstances led to cutbacks in development projects and a rupiah devaluation, Jakarta's budget has already been sharply trimmed, and the government will be harder pressed to handle comparable declines in export earnings. 25X1

Jamaica's New IMF Agreement

The IMF approved a $118 million, 22-month standby loan for Jamaica last week, but the new program may soon be in jeopardy. The US Embassy reports that the ALPART alumina refinery probably will close by August. Strikes by public-sector workers protesting IMF-recommended adjustments—including 2,700 lay-offs—paralyzed the country for several days last month. Prolonged economic troubles will make it increasingly hard for Prime Minister Seaga to carry out planned austerity measures without creating more labor unrest. If ALPART ceases operations—eliminating 1,200 more jobs—sympathy strikes may occur. Jamaica already expects to lose $140-230 million largely as a result of weak demand for bauxite and alumina; the loss of additional bauxite revenue or lower tourist receipts that would result from violent labor unrest could cause the economy to decline by more than 4 percent this year—to a level barely matching that of 1980, Prime Minister Manley's last year in office. 25X1

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Global and Regional Developments

Reaction to US Stockpile Sales Policy

Brazil, Zimbabwe, and Botswana are adopting a wait-and-see attitude; they are carefully studying disposal plans for metals produced in their countries. The Peruvian Minister of Mines, however, in an unusually strong local press statement called any plan to sell stockpiled silver "truly a declaration of war"

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that would reduce his country's silver exports by 20 to 30 percent. Thailand is worried that US tin sales under the new plan may exceed the 3,000-ton-per-year limit provided for in a US-ASEAN memorandum of understanding. An Australian official has commented that sales from the US stockpile may further depress international commodity prices. More negative reactions are likely as governments study the proposal carefully and local producers and the press are briefed on the details. LDC producers of silver, tin, and cobalt—metals with the largest surpluses under the new program—are expected to be the most critical. Peru and Mexico, leading silver producers currently expanding production, are likely to protest sales. Tin producers, particularly members of the International Tin Council already suffering from export controls, probably will launch a collective lobbying effort to limit US sales.

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Japan-India Auto Tieup

Honda entered into a capital and technical tieup with the Indian industrial giant Tata this month to produce small passenger cars. This investment—estimated at $160 million over the next five years—will be Honda's largest in Asia. India's demand for cars is expected to soar over the next few years in the wake of recent regulations to encourage competition in India's antiquated automobile industry. The Honda-Tata venture will probably be one of the most competitive among the Japanese tieups with India's auto manufacturers because Tata has the technical skills, capital, and infrastructure to overcome problems of tooling and parts supplies which will likely plague other manufacturers.

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Increasing competition in the emerging Indian vehicle market, coupled with a slowdown in Japan's domestic demand, has probably spurred Honda to expand its overseas passenger car market.

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Slow Progress on EUREKA

West European foreign and research ministers last week made limited progress setting up a framework and funding for EUREKA. President Mitterrand pledged $115 million for the program, and West German Research Minister Riesenhuber said Bonn would provide some funding. Even so, West Germany and the other West European countries made no firm financial commitments. The ministers made little headway on the structure or areas of research for EUREKA, despite detailed French proposals. A high-level group of experts—formed at British urging—will work on financial arrangements and solicit ideas from industry on possible projects in preparation for a research ministers' meeting in mid-November in Bonn. France probably views the meeting as a setback in its drive to attract West European companies to EUREKA. West Germany and the United Kingdom evidently prefer a cautious approach until a clear industry-oriented framework for EUREKA can be worked out. West European leaders agree that EUREKA should focus on civilian goals, but they are still at odds on how closely its research areas should match SDI's.

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EC Commission Maintains Mediterranean Citrus Preferences

The EC Commissioner for Mediterranean Policy has proposed that tariffs on citrus imports from non-EC Mediterranean states be reduced over a 10-year period in parallel with similar reductions for Spain and Portugal after they join the Community on 1 January. The declining tariff rates would apply to the first 800,000 tons annually—an average of import levels over recent years; a higher tariff would apply above the ceiling. The move reflects an EC commitment to promote economic development in the region and protect Mediterranean citrus exporters—primarily Morocco, Tunisia, Israel, and Cyprus—from the effects of enlargement. The proposal—which would form the basis for talks this fall with the Mediterranean states—has yet to be approved by the 10 member governments. It makes no mention of relatively higher tariffs on US citrus and would reduce the EC's ability to meet US demands at separate, upcoming EC-US negotiations on improving access to the EC citrus market.

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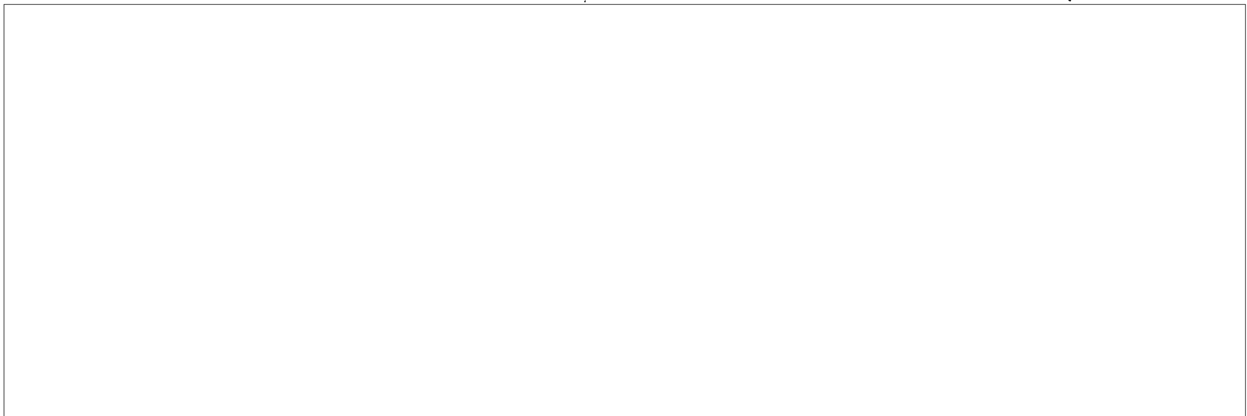
National Developments

Developed Countries



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French Nuclear Export Policy Toward South Africa

The French Government has informed Washington that it will, for the first time, refuse to endorse the sale of nonsensitive nuclear equipment to South Africa. At issue is Pretoria's bid for nuclear waste storage containers and associated training and technology for its Koeberg nuclear power plant. Paris banned sensitive nuclear exports to South Africa in 1983. We believe the French move reflects concern in Paris about recent domestic developments in South Africa. Though not binding, the move may in fact kill the sale and discourage future nonsensitive sales by French suppliers. Pretoria probably could obtain the container technology from other European nuclear suppliers.

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Large Turkish Budget Deficit

Turkey's continuing budget deficit is likely to keep inflation high and is the main reason Ankara was unable to reach a standby agreement with the IMF this past May. Ankara's reluctance to increase taxes is largely responsible for the budget shortfall which last year reached $2.6 billion—nearly 6 percent of GDP. Tax revenues as a share of GDP plunged from 17 percent in 1983 to just 13 percent in 1984, one of the lowest rates in the OECD. Little improvement is likely this year, despite the introduction of a value-added tax, because of other tax cuts. The IMF has stressed the need to raise more revenue and favors adjusting Ankara's 5.5-percent GDP growth target downward. In response to the large deficit, Prime Minister Ozal has decided to reduce government expenditures by up to 20 percent and may shelve many planned state investments, according to press reports. In addition, Ozal reportedly has postponed tax reform plans aimed at reducing the tax burden on low wage earners. The failure to reduce the deficit and control inflation may hurt Turkey's credit rating at a time when large repayments of previously rescheduled debt are falling due.

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Less Developed Countries

Conflicting Mexican Budget Pressures

Opposing demands on President de la Madrid are making it difficult for him to take strong action to stem the burgeoning government budget deficit. The President apparently believes that he cannot make drastic budget cuts, because Mexicans will not accept a further round of harsh austerity. Labor, the best organized sector of the ruling party, will strongly protest subsidy cuts or sharp reductions in real wages. Private-sector dissatisfaction, however, is becoming more intense because of the government's inaction on the deficit and exchange rate issues. Moreover, Mexico City's recent move to raise bank reserve requirements will aggravate businessmen's difficulties with higher interest rates and a greater scarcity of credit. Capital flight also is likely to continue at high levels as the administration temporizes on economic adjustment.

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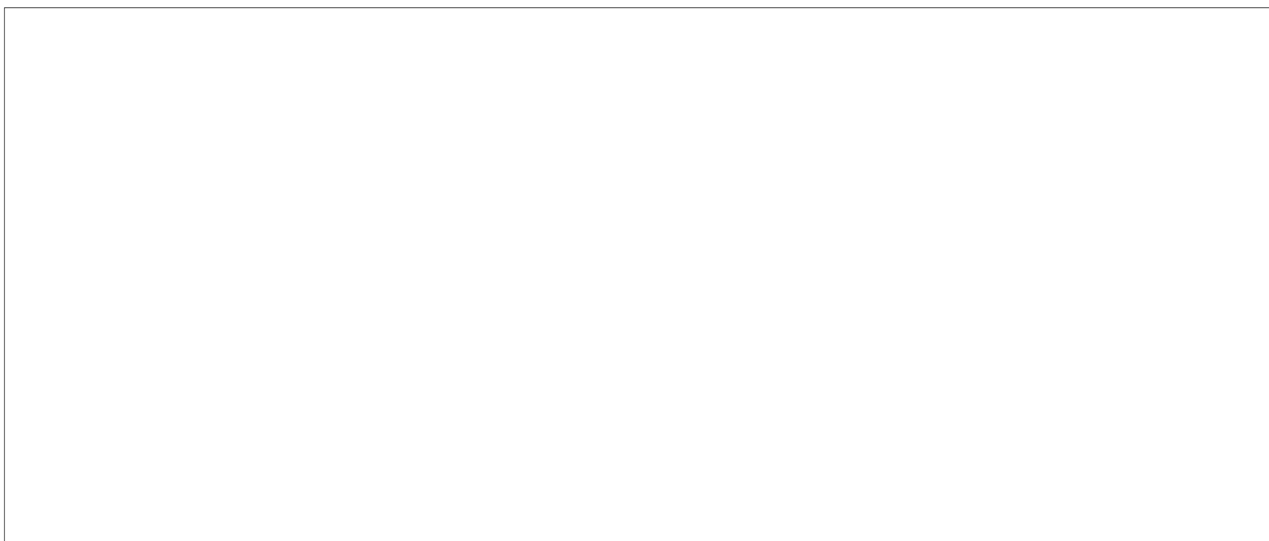

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Sudanese Pound Sliding

The Sudanese pound continues to slide on the black market, which has displaced official exchange dealers since the coup, according to the US Embassy in Khartoum. The growing disparity between the official and unofficial US dollar exchange rates—12 percent—is causing intense speculation and stifling the flow of badly needed remittances from Sudanese expatriates. The military council's failure, thus far, to devalue or adopt a floating exchange rate system puts it in conflict with the December IMF accord calling for a realistic commercial exchange rate. Chances are slim for a new IMF standby loan if the government fails to intervene. Nevertheless, intense pressure from labor and opposition parties makes a decision on the exchange rate risky for the regime that came to power on a wave of unrest over deteriorating living standards.

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Sudanese Finance Minister Resigns

The US Embassy says Finance Minister Abdel Majeed resigned Saturday over union demands that Prime Minister Dafallah fire the acting governor of the central bank and separate the bank from the Ministry. The Embassy, however, speculates that the major reason behind Abdel Majeed's leaving was his inability to persuade the government to hold the line on wages and prices. Khartoum recently settled several strikes with the promise of pay hikes and decreased the price of diesel oil as a result of union pressure. Abdel Majeed's departure almost certainly will hurt Khartoum's ability to negotitate a stabilization program with the IMF next month. He was the only one in the government who understood economic issues, and Khartoum is unlikely to risk union unrest now by taking a firm line on prices and wages. A new finance minister may be chosen from the large pool of leftist-oriented academics who oppose the IMF and support reneging on debt obligations; few other qualified candidates can meet the criteria of not having worked for the former regime.

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Tunisian Bread Prices Rise

Bread and corn prices were raised 17 and 18 percent, respectively, last week in a surprise move—Tunis previously had indicated that price hikes would be postponed for the rest of the year. The increases in bread prices—which could reduce the budget deficit by as much as $10 million—are the first since last July and caught consumers offguard. Nevertheless, the action has provoked little more than grumbling, according to the US Embassy. The move appears to be a compromise to keep budget reform efforts alive, because—unlike price hikes that provoked the January 1984 food riots—prices for other cereal-based products remain unchanged. The limited scope of the increases, plus the announcement during the traditional vacation season, should limit adverse domestic reaction.

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Mauritanian Economic Crunch Persists

Chief of State Taya warned last week that an end to the rapid disintegration of Mauritania's economy is not in sight. Urgent concern was expressed for the nation's banking system. One major bank teeters on the brink of bankruptcy and deposits at other major banks are dwindling as consumer confidence wanes, according to the US Embassy. Government intervention to stem the crisis already has consumed a large share of meager foreign exchange reserves. Even harsher austerity measures will be necessary to stem the economic decline and restore confidence in the financial system. Moreover, with unemployment at a high level, additional restrictive economic measures will only complicate efforts by the Taya regime to control disgruntlement and return the government to civilian control.

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Ghana Expands Economic Reform

Ghana implemented a new investment code and significantly liberalized its foreign exchange controls in mid-July as part of its IMF-backed economic reform program. Ghanaians and resident non-Ghanaians may now maintain tax-exempt, interest-bearing bank accounts denominated in several hard currencies, including US dollars. These accounts will be free from foreign exchange restrictions, but cannot receive earnings from the export of Ghanaian goods and services. Accra hopes the scheme will encourage remittances from Ghanaians living abroad, but local reaction indicates lingering suspicions that such accounts would be vulnerable to future government intervention.

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Bangladesh's New Austerity Moves

The new Bangladesh budget for fiscal year 1985/86 (July-June) calls for reductions in food, fertilizer, gas, and electricity subsidies. New wage scales for government workers will take away the cost-of-living allowance and the elimination of paid vacations is planned. If fully implemented, these austerity measures would improve Bangladesh's chances of obtaining new IMF loans.

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Local businessmen, according to the US Embassy, have criticized the price hikes for essential commodities; the price of natural gas, for example, is expected to go up by 20 percent.

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Adjustment Successes in Mauritius

Mauritius' agriculturally based economy—centered on large sugar plantations—has emerged from a prolonged recession and may be entering a period of sustained economic growth. Exchange rate devaluations, wage restraints, reduced food subsidies, increased utility rates, and limitations on social service expenditures—undertaken to comply with IMF and IBRD adjustment programs—are now generating results. Real GDP growth increased from 0.3 percent in 1983 to 3.1 percent in 1984, and is expected to hit 5.3 percent in 1985. The annual inflation rate has dropped to approximately 7 percent, from a high of 42 percent in 1980. Budgetary restraint has caused the overall fiscal deficit to decline from 12.9 percent of GDP in 1982 to 6.5 percent in 1985. In addition, growth has been strong in the export-processing zones and tourism sectors with concomitant increases in employment. 25X1

Thailand Lobbying Against US Textile Proposal

In a bid to protect Bangkok's second-largest foreign exchange earner, high-level Thai policymakers are mobilizing to oppose the Thurmond-Jenkins textile bill. If passed, the legislation would cut Thailand's textile and garment exports to the United States—the country's largest market—by up to 64 percent. The National Assembly earlier this month called upon all legislators to use their contacts with US Congressmen in a concerted lobbying effort against the bill. In addition, the influential National Economic and Social Development Board has proposed that Bangkok implement unspecified "countermeasures" if the bill is enacted. Before taking such action, however, Bangkok would most likely seek an exemption from the legislation. 25X1

Communist

Favorable Soviet Grain Prospects

Grain crop conditions in the USSR are mostly favorable following a month of weather extremes. 25X1 crops in Kazakhstan and the Urals were damaged by hot, dry weather from mid-June through early July. In contrast, 25X1 crop vigor improved significantly in parts of the European USSR—especially the Volga Valley—because of unusually good weather. Crop losses in Kazakhstan and the Urals are estimated at about 6 million metric tons but appear to have been offset by the better-than-expected prospects elsewhere. As a result, total Soviet grain production this year is likely to be about 200 million tons. This is far short of Moscow's target of 245 million tons but would be the best since the record 237 million tons in 1978 and well above the estimated average of 180 million tons during 1980-84. 25X1

Hungarian-Soviet Economic Cooperation

The session earlier this month in Moscow of the Soviet-Hungarian Intergovernmental Commission for Economic, Scientific, and Technical Cooperation focused on the implementation of the program signed in April, for cooperation in these three areas to the year 2000. The commission also called for the implementation of the new CEMA agreement on cooperation in designing and producing computer-controlled production systems. The commission agreed to

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expand production sharing in the automobile, tractor, telecommunications, construction, rubber, and computer industries and signed extensions of more than 30 cooperation agreements that cover 40 percent of Hungary's exports to the Soviets and 15 percent of Hungarian imports. Four new agreements call for increased cooperation in the development of noncorrosive pipelines, telecommunications systems, medical microanalysis, and inventory maintenance and transport systems. The emphasis on accelerating these programs probably is a Soviet attempt to give them legitimacy and satisfy Budapest's request for quicker action. The agreement to increase cooperation in the transport, storage, and registration of goods appears to respond directly to Hungarian complaints during the June CEMA Council meeting of inefficient transportation procedures between CEMA countries.

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China Resumes US Grain Purchases

The US Department of Agriculture reports China has bought 510,000 tons of US soft red winter wheat in the past month, the first purchases since November. According to grain trade sources, Canada, Argentina, and France have made unannounced sales of wheat to China in recent weeks. There is some speculation the Chinese have also made purchases in the US grain futures market. The renewed Chinese interest has caught grain traders by surprise. China probably intends to sell some of its recent purchases of US grain at a profit. Beijing may believe that the United States does not have enough soft red wheat both to meet its trade commitment to China and to carry out its export enhancement program and that supplies will become tight and prices will rise. There have been reports China has already brokered US wheat to Tunisia and Pakistan.

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New Bank of China President

New Bank of China President Wang Deyan replaces Jin Deqin,

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Wang is a longtime bank bureaucrat with 32 years' experience in the Bank of China, including 18 in Hong Kong. The Bank of China, which specializes in international finance, has been closely monitoring China's foreign exhange situation since reserves dropped from $17 billion at the end of September 1984 to $12 billion at the end of March 1985. Controls adopted since then appear to be working, but Wang—echoing Beijing's continuing concern—advocated tighter control over foreign exchange and reduced imports of consumer goods at an international monetary conference held in Hong Kong in June.

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China's Transport System Hinders Agricultural Reforms

The success of Beijing's market-oriented agricultural reforms is being hampered by the limited ability of the state-owned rural transport system to move agricultural commodities to urban consumers. Recent adjustments in state agricultural procurement policies permit peasants to market a larger share of their harvest on the open market. They are using transportation more as they search beyond traditional markets to find the most profitable outlets for their goods. Beijing is encouraging peasant entreprenuers to develop private transport businesses, but local transportation units—anxious to protect their monopoly—are obstructing these efforts through such measures as taxation and route restrictions. Although Beijing has insisted that such barriers be eliminated if markets remain inaccessible and local market prices continue to fall, increasing rural discontent may force Beijing to revise its market-oriented policies.

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