

Declassified in Part - Sanitized Copy Approved for Release 2011/12/08 : CIA-RDP88-00798R000200220003-5

**Page Denied**



Directorate of  
Intelligence

~~Secret~~

[Redacted]

25X1

# International Economic & Energy Weekly

[Redacted]

25X1

24 January 1986

OFFICE OF GLOBAL ISSUES (OGI)	6	685	590
PRODUCTION GROUP			
ROOM 3604	(A-3/1)		
HQS			

~~Secret~~

DI IEEW 86-004  
24 January 1986

Copy 685

**Page Denied**

**Secret**  
[Redacted]

25X1

**International  
Economic & Energy Weekly** [Redacted]

25X1

24 January 1986

iii	Synopsis	
1	Perspective—Plunging Oil Prices: Widespread Benefits, But Problems for Some [Redacted]	25X1
3	LDCs: Uneven Impact of a Drop in Oil Prices [Redacted]	25X1 25X1
7	Persian Gulf OPEC States: Increased Financial Strain From Lower Oil Prices [Redacted]	25X1
11	Saudi Arabia: Calm Before the Storm [Redacted]	25X1 25X1
17	Mexico: The Producer/Debtor Dilemma [Redacted]	25X1 25X1
19	North Sea Oil Producers: Economic Implications of Falling Prices [Redacted]	25X1 25X1
23	Soviet Oil Production and Exports: Outlook for 1986 [Redacted]	25X1 25X1
29	Briefs Energy International Finance National Developments	

[Redacted]

25X1

*Comments and queries regarding this publication are welcome. They may be directed to [Redacted], Directorate of Intelligence, [Redacted]*

25X1

25X1

Secret

25X1

**International  
Economic & Energy Weekly**

25X1

**Synopsis**

1	<b>Perspective—Plunging Oil Prices: Widespread Benefits, But Problems for Some</b>	25X1
	If oil prices do plunge, economic gains would be widespread, but lower oil prices will create significant problems for several oil-exporting countries.	25X1
3	<b>LDCs: Uneven Impact of a Drop in Oil Prices</b>	25X1
	An oil price decline will provide widespread benefits for most developing countries. For the heavily indebted LDC oil exporters, however, revenue losses will necessitate further economic adjustment measures at a time when they are weary of adjustment.	25X1
7	<b>Persian Gulf OPEC States: Increased Financial Strain From Lower Oil Prices</b>	25X1
	Persian Gulf producers this year have little chance of raising oil revenues because of the oil market's limited ability to absorb additional production without depressing prices further. As a result, these countries face hard decisions on how to cope with lower revenues amid growing domestic criticism over how their economies are being handled.	25X1
11	<b>Saudi Arabia: Calm Before the Storm</b>	25X1
	Although the Saudis are still concerned about a long-term market for their oil, short-term revenue needs have become the driving force behind Saudi oil policy. Despite the ramifications of recent actions, domestic pressures to end the recession and the desire to regain a more powerful role in the oil market point to further wrenching decisions on oil and economic policy.	25X1
17	<b>Mexico: The Producer/Debtor Dilemma</b>	25X1
	The soft oil market probably will force Mexico City to backslide on this year's austere budget and could derail attempts at economic adjustment. Moreover, since oil receipts make up 70 percent of export earnings and are about equal to this year's debt burden, it is becoming increasingly likely that the country will be unable to fully honor its financial obligations.	25X1

Secret

DI IEEW 86-004  
24 January 1986

Secret



25X1

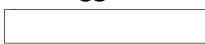
19

**North Sea Oil Producers: Economic Implications of Falling Prices**



25X1

The United Kingdom and Norway, as net oil exporters, would not be badly hurt by lower oil prices, but would have problems in dealing with the substantial loss of oil tax revenue. The United Kingdom could suffer, however, if lower oil prices triggered a run on the pound, causing London to boost interest rates.



25X1

23

**Soviet Oil Production and Exports: Outlook for 1986**



25X1

The Soviet plan for 1986 calls for raising oil production to more than 12.3 million b/d, but the production outlook is precarious. At the extreme, export reductions, compounded by anticipated oil price declines, could cost Moscow as much as \$4-6 billion in hard currency earnings.



25X1

Secret

Secret

[Redacted]

25X1

**International  
Economic & Energy Weekly**

[Redacted]

25X1

24 January 1986

**Perspective**

***Plunging Oil Prices: Widespread Benefits, But Problems for Some***

[Redacted]

25X1

Over the past week oil prices have plummeted. Spot prices for North Sea and US crudes tumbled to as low as \$20 per barrel, a drop of \$5 in some cases. Prices on the highly speculative futures market also fell, although spot prices for OPEC crudes stayed above the \$25 per barrel level. How far prices fall will depend on the market share that OPEC ultimately stakes out. OPEC producers will begin a series of meetings next week in Vienna in an attempt to formalize a market defense strategy. Unless the group chooses a volume below its current output level, all prices are headed for a major break this year—perhaps falling well below \$20 per barrel. We now believe that there is a 50-percent probability that prices will average below \$20 per barrel in 1986. This is in contrast with the oil industry consensus that prices will average about \$22 to \$23 per barrel. Market psychology and uncertainty about producer actions in any event will likely cause wide price fluctuations.

[Redacted]

25X1

Trends in oil demand will provide no relief for producers. We estimate that 1986 non-Communist oil consumption will remain at 1985 levels. With demand in the spring expected to drop by as much as 3 million barrels per day below winter levels, downward price pressures will be especially strong during the next several months.

25X1

25X1

If oil prices do plunge, economic gains would be widespread. Our econometric model indicates that a \$20 per barrel average price during 1986-88 would boost the current forecast for OECD-wide real GNP growth by an additional 0.4 percentage points in 1986, 0.8 percentage points in 1987, and 0.3 percentage points in 1988. The United States would benefit most, while Canada and several West European economies would also gain. We estimate that oil at \$15 per barrel would almost double these gains. Moreover, most oil-importing developing countries—particularly the major debtors—would benefit from lower oil import costs, increased import demand in the industrial countries, and the likely fall in interest rates.

25X1

On the other hand, lower oil prices will create significant problems for several oil-exporting countries. Oil-producing LDCs with large debt burdens will be especially hard hit, although oil-exporting industrial countries also will experience difficulties:

- Mexico, Nigeria, and Venezuela, which rely heavily on oil earnings to pay their debts, will be the most negatively affected, even though lower interest rates will soften the impact of reduced oil revenues.
- Some oil exporters, such as Algeria and Indonesia, could encounter increasingly serious debt servicing problems.
- Oil-exporting industrial countries such as Norway and the United Kingdom

Secret

DI IEEW 86-004  
24 January 1986

Secret

will also suffer, at least initially, as the reduction in oil revenues outweighs the benefits of lower interest rates and inflation.

- The Soviet Union will face diminished hard currency oil earnings, and thus the prospect of having to divert oil from Eastern Europe to Western markets.

[Redacted]

25X1

For the oil-exporting LDCs, a drop to \$20 per barrel would be manageable for most, but governments would face politically difficult decisions regarding import restrictions and budget austerity. At substantially lower oil prices, however, revenue losses would make the debt servicing burden untenable for countries such as Mexico, Nigeria, and Venezuela. In this situation, more debt-ridden LDC oil exporters would be likely to impose restrictions on debt payments. [Redacted]

25X1

[Redacted]

25X1

Secret



Secret

### LDCs: Uneven Impact of a Drop in Oil Prices

An oil price decline will provide widespread benefits for most developing countries. For the heavily indebted LDC oil exporters, however, revenue losses will necessitate further economic adjustment measures at a time when they are weary of adjustment. Some oil exporters such as Algeria, Egypt, and Indonesia—which previously had not been considered financially troubled—will face increasing debt servicing difficulties and could join the list of troubled debtors. Further erosion of oil prices—below \$20 per barrel—would certainly push the heavily indebted oil-exporting countries into serious financial straits. Some countries may opt to try to follow the example of Peru and Nigeria by limiting debt service to a fixed percentage of export earnings.

#### Substantial Benefits to Oil-Importing LDCs

According to our econometric model, non-OPEC LDCs as a group will benefit from an oil price decline. Heavily indebted LDCs with large oil import levels will receive the major gains. In addition to lower oil costs, LDCs would save on debt servicing costs because of a probable decline in interest rates. Higher OECD economic growth spurred by cheaper energy and lower interest rates also would boost LDC export earnings. For Brazil and South Korea, a drop in oil prices to \$20 per barrel would mean savings in the first year of about \$1.7 billion each, according to our analysis.

Against these savings, however, these countries would face falling demand from oil producers for their exports. South Korea, for example, saw its construction contract business fall off by 65 percent in 1984 as the Middle Eastern countries began to experience an economic slowdown. Likewise, Turkish gains would be limited because one-third of its exports go to OPEC countries.

#### Oil-Importing LDCs: Impact of Changing Oil Prices

Million US \$

	Oil Savings	Interest Savings	Estimated Export Gains <sup>a</sup>	Combined Impact
World oil at \$20 per barrel				
Argentina <sup>b</sup>	-62	240	17	195
Brazil	780	844	77	1,701
Chile	140	174	11	325
Philippines	356	199	22	577
South Korea	1,365	244	74	1,683
Thailand	550	48	18	616
Turkey	736	140	13	889

	World oil at \$15 per barrel			
Argentina <sup>b</sup>	-109	425	31	347
Brazil	1,380	1,493	142	3,015
Chile	248	308	21	577
Philippines	630	352	40	1,022
South Korea	2,415	432	138	2,985
Thailand	974	85	33	1,092
Turkey	1,301	248	24	1,573

<sup>a</sup> Estimated export gains to OECD countries only.

<sup>b</sup> Argentina is included among the oil-importing LDCs despite being a small net exporter, because the overall impact of price declines for Argentina is positive.

#### Greater Costs to Oil-Exporting LDCs

In contrast, a significant oil price decline will hurt severely the major LDC oil exporters, especially those already debt-troubled countries—such as

Secret

DI IEEW 86-004  
24 January 1986

Secret

**Oil-Exporting LDCs:  
Impact of Changing Oil Prices***Million US \$  
(except where noted)*

	Revenue Loss	Interest Savings	Estimated Export Gains <sup>a</sup>	Combined Impact	Combined Impact as a Share of Reserves <sup>b</sup> (percent)
<b>World oil at \$20 per barrel</b>					
Algeria	-1,661	38	49	-1,574	58
Ecuador	-475	51	8	-416	71
Egypt	-650	26	16	-608	68
Indonesia	-3,575	57	75	-3,443	71
Malaysia	-546	111	41	-394	9
Mexico	-3,575	862	104	-2,609	58
Nigeria	-3,630	169	46	-3,415	416
Venezuela	-3,322	205	45	-3,072	32
<b>World oil at \$15 per barrel</b>					
Algeria	-2,938	67	91	-2,780	102
Ecuador	-840	90	15	-735	125
Egypt	-1,150	46	29	-1,075	120
Indonesia	-6,325	101	139	-6,085	125
Malaysia	-965	195	75	-695	16
Mexico	-6,325	1,525	193	-4,607	102
Nigeria	-6,422	299	85	-6,038	735
Venezuela	-5,876	363	82	-5,431	58

<sup>a</sup> Estimated export gains to OECD countries only.<sup>b</sup> Include central bank reserves less gold.

Mexico, Nigeria, and Venezuela—that rely on oil revenues to pay their foreign debts. Other oil-exporting LDCs such as Algeria, Egypt, and Indonesia may also face serious debt servicing difficulties. Our analysis of the major oil-exporting LDCs outside the Persian Gulf indicates that a fall in oil prices to \$20 per barrel could reduce export revenues in these countries by as much as 30 percent.

indicates that only Mexico—with a relatively small proportion of its debt at fixed interest rates—benefits significantly from an interest rate decline. At \$20 per barrel, Nigeria, for example, will receive less than \$50 million from export gains to the OECD, but experience oil revenue losses of \$3.6 billion.

Lower interest rates and higher OECD economic growth will provide minimal help when compared to the sizable oil revenue losses. Our analysis

25X1

25X1

25X1

Secret

4

**Adjustment Options**

To compensate for lost revenues, policymakers in oil-exporting LDCs will have to draw down foreign exchange reserves, cut imports, boost oil exports, obtain new money from international creditors, or undertake some combination of these actions. Of the major debt-troubled LDC oil exporters, only Venezuela has a reserve cushion large enough to cover its revenue loss if oil prices fall to \$20 per barrel. Other producers such as Ecuador, Egypt, and Indonesia—whose losses would equal about 70 percent of their foreign exchange—are not likely to rely solely on their reserves. [redacted]

At the same time, the substantial import cuts that LDCs have already made in the past three years will make further cuts politically more difficult. Furthermore, most LDC producers cannot boost oil exports to a level that would significantly improve their current account position. As a result, LDCs probably will seek new loans from creditors. Bankers, however, will be more reluctant to lend given the LDCs' deteriorating ability to service their debts. A fall in oil prices to \$20 per barrel could change the list of debtor countries receiving assistance from the Baker plan, as LDC oil exporters would require a larger percentage of the funds available, while LDC oil importers would need less financial help. [redacted]

At \$15 per barrel—our worst case scenario—LDC oil exporters will face grave economic difficulties. Erosion of oil prices to this level would certainly push the financial needs of the heavily indebted oil-exporting countries beyond the resources of the Baker plan unless additional strong austerity measures were taken. Their net revenue losses would outstrip reserves and require adjustment well beyond that of the past few years. Mexico, Nigeria, and Venezuela—whose combined external debt totals \$155 billion—would stand to lose nearly \$19 billion in revenues in one year, making their

---

*Estimating the Impact of an Oil Price Decline*

*Our two scenarios present the costs and benefits to LDCs in the first year of an oil price decline. World oil prices drop by \$6.50 to \$20 per barrel in the first scenario, and by \$11.50 to \$15 per barrel in the second. To determine the amount of interest savings, we assumed each \$5 per barrel decline in the price of oil would lead to a decline in interest rates of 1 percentage point. These declines were then applied to estimates of the amount of debt each country held at floating interest rates, using BIS and World Bank data. The estimates of LDC export gains assumed a 1-to-1 relationship between changes in OECD growth and changes in the OECD demand for LDC exports. OECD growth projections were derived from our Linked Policy Impact Model (LPIM) of the world economy. [redacted]*

25X1

25X1

debt servicing burden untenable. Nigeria—like Peru last July—has already limited debt payments to a percentage of its export earnings. We believe that in the face of substantial oil revenue losses other oil producers would consider similar restrictions. [redacted]

25X1

[redacted]

25X1

25X1



Secret

### Persian Gulf OPEC States: Increased Financial Strain From Lower Oil Prices

Persian Gulf OPEC producers<sup>1</sup> this year have little chance of raising oil revenues because of the oil market's limited ability to absorb additional production without depressing prices further. As a result, these countries face hard decisions on how to cope with lower revenues amid growing domestic criticism over how their economies are being handled. Iran and Iraq will have to make the deepest domestic cutbacks because foreign exchange reserves already are at minimal levels and could be forced to find a solution to the six-year-old conflict. Even if Saudi Arabia sharply increases production and exports, financial difficulties probably will remain.

#### Adjusting to Lower Revenues

Last year's soft oil market again forced the Persian Gulf OPEC states to cut spending. Aggregate oil exports (including natural gas liquids) of these countries dropped to an estimated 7.9 million b/d, down from 9.0 million b/d in 1984, and the weighted average price per barrel was down \$1.30:

- Saudi Arabia has shouldered most of the burden for the decline in demand for OPEC oil, and its current account recorded an estimated \$18 billion deficit in 1985.
- In Kuwait, Qatar, and the UAE, the current accounts have remained in surplus because sparse populations and declines in economic activity made cutting imports easier. Nonetheless, these economies have suffered and many financial institutions are on the brink of failure.
- Iran lopped almost \$4 billion off its import bill—largely at the expense of the civilian sector—to bring its deficit down to a more manageable \$1 billion.

<sup>1</sup> The Persian Gulf OPEC producers are Saudi Arabia, Kuwait, the United Arab Emirates (UAE), Qatar, Iran, and Iraq.

#### Persian Gulf OPEC States: *Billion US \$* Current Account Balances, 1980-85

	1980	1981	1982	1983	1984	1985
Saudi Arabia	47.5	49.7	7.5	-15.0	-20.0	-18.0
Kuwait	15.0	11.4	3.8	5.1	5.8	4.7
UAE	9.2	9.4	6.4	6.5	7.4	5.6
Qatar	3.0	2.7	1.0	1.2	2.3	1.5
Iran	0.5	-2.4	6.2	-0.9	-3.9	-1.0
Iraq	7.6	-17.1	-19.9	-8.8	-5.3	-4.9

- Iraq's \$2 billion rise in oil revenues was offset by a similar rise in imports, leaving its current account deficit only slightly improved.

In addition to import cutbacks, most Gulf countries have either drawn down or slowed the growth of their foreign assets. Saudi Arabia financed much of its current account deficit from foreign exchange reserves. Liquid reserves, however, were down to \$70 billion; the rest consisted of loans to LDCs and substantial cash and oil credits to Iraq.

Kuwait, the UAE, and Qatar all added to their foreign assets, but not by the magnitudes of the current account surpluses. We believe fears of Iranian attacks, stagnating economies, and banking problems have spurred considerable capital flight in all countries and inhibited the growth of reserves. For Iran and Iraq, the continuation of the Gulf war has helped force liquid reserves to minimal levels.

25X1

25X1  
25X1

25X1

25X1

25X1

25X1

25X1

Secret

DI IEEW 86-004  
24 January 1986

Secret

**Persian Gulf OPEC States:  
Official Foreign Assets, 1980-85<sup>a</sup>**

Billion US \$

	1980	1981	1982	1983	1984	1985
Saudi Arabia	95	146	153	135	126	101
Kuwait	54	62	69	67	70	74
UAE	27	33	35	39	35	39
Qatar	6	8	8	9	10	11
Iran	19	10	14	9	6	5
Iraq	31	21	8	8	2	2

<sup>a</sup> Yearend data.

**Outlook for 1986**

Because of the soft oil market, the Gulf OPEC states will have little chance to raise oil revenues unless other suppliers are willing to reduce production, an unlikely scenario. If oil prices were to fall to \$20 per barrel in response to an additional 1 million b/d of OPEC production, Gulf revenues could fall by nearly \$12 billion; at \$15 per barrel, Gulf revenues could decline by \$27 billion.

Under either price scenario, Iran and Iraq would face difficult decisions. If oil prices remain steady, continued high production for Iraq and low import levels for Iran will limit deficits to \$1-2 billion. A collapse in prices to \$15 per barrel could push revenues below \$10 billion for each. With no reserves and little ability to increase sales, they would experience current account deficits of up to seven times current levels.

For Saudi Arabia, financial difficulties probably will remain whether oil prices and production remain steady or prices fall to \$20 per barrel. Assuming that Riyadh's imports and net services remain at 1985 levels, we believe that Saudi Arabia will have to cover only a \$2 billion increase in its current account deficit next year. Nonetheless, liquid foreign assets would decline to below

**OPEC Oil and Financial Prospects, 1986**

	Price Stability	\$20 per Barrel	\$15 per Barrel
Production Under Different Price Scenarios <sup>a</sup> (thousand b/d)			
<b>Total</b>	<b>17,300</b>	<b>18,300</b>	<b>19,300</b>
Saudi Arabia <sup>b</sup>	4,000	5,000	5,000
Kuwait <sup>b</sup>	1,000	1,000	1,100
UAE	1,250	1,250	1,300
Qatar	300	300	300
Iran	2,350	2,350	2,500
Iraq	1,800	1,800	1,800
Other OPEC	6,600	6,600	7,300

	Revenues Under Different Price Scenarios (billion US \$)		
<b>Total</b>	<b>127.7</b>	<b>104.0</b>	<b>83.1</b>
Saudi Arabia	28.3	28.7	21.5
Kuwait	7.2	5.4	4.6
UAE	11.2	8.5	6.6
Qatar	2.9	2.2	1.7
Iran	14.8 <sup>c</sup>	11.2	9.1
Iraq	14.8	11.4	8.3
Other OPEC	48.5	36.6	31.3

	Current Account Balances Under Different Price Scenarios <sup>c</sup> (billion US \$)		
<b>Total</b>	<b>-20</b>	<b>-44</b>	<b>-66</b>
Saudi Arabia	-20	-20	-27
Kuwait	5	3	2
UAE	6	3	1
Qatar	2	2	1
Iran	-1	-4	-7
Iraq	-2	-6	-8
Other OPEC	-10	-22	-28

<sup>a</sup> Including natural gas liquids.<sup>b</sup> Including Neutral Zone.<sup>c</sup> Based on 1985 import levels.25X1  
25X1

25X1

25X1

25X1

25X1

Secret

8

Secret

25X1

**Soft Oil Markets: Heavier Burden for the Gulf Combatants**

25X1

25X1

The soft oil market and the potential for lower—possibly sharply lower—oil prices are adding to the economic and political woes of Iran and Iraq. Neither country wants to impose additional austerity measures that would reduce morale. Both, however, lack sufficient foreign assets to ride out a fall in revenues. Indeed, Iraq has already contributed to downward pressure on oil prices with the opening of its pipeline through Saudi Arabia. Possible Iranian efforts to export more oil and shore up its finances would add still more pressure. A sharp oil price drop—below \$20 per barrel—would threaten both regimes, and perhaps could spur Tehran and Baghdad to seek a compromise to end the six-year-old conflict. [redacted]

A collapse of oil prices to the \$15 level would cut further into essential consumer and military goods imports. Tehran might claim the price fall was engineered by Western enemies of Iran and threaten to close the Strait of Hormuz or attack Gulf states who "support the West." These threats would be largely for domestic consumption because such actions would risk Western military intervention. Economic difficulties are likely to lead to a rise in public discontent. This could weaken the radical Musavi cabinet, already under attack by conservatives for the poor state of the economy, and favor more moderate clerics in a post-Khomeini power struggle. Moreover, the regime may be pressed to reach an accommodation on the war. [redacted]

Iran already has suffered severely from the soft oil market. During the past two years, only Saudi Arabia has experienced a larger decline in its oil revenues. Tehran slashed imports by one-third in 1985 to preserve foreign exchange assets of about three months' import coverage. The vulnerability of its oil exports to Iraqi attack has heightened regime concerns about a financial crisis and the need for such reserves. Import cuts have caused a contraction in all sectors of the economy except agriculture. Industrial production and construction have suffered considerably from a lack of imported materials and spare parts, increasing already high unemployment. Consumers can find some goods only on the black market at highly inflated prices. [redacted]

Iraq's financial position has improved a bit since the opening of the Saudi pipeline last October, but a major price drop would cause significant economic hardships. Financial aid from Arab allies and debt reschedulings based on an anticipation of higher oil revenues have so far prevented sharp cuts in consumer imports. Iraq's oil exports are near capacity, however, and a collapse of world oil prices could force Baghdad to trim living standards for its already war-weary populace. [redacted]

Despite a great reluctance to increase downward pressure on oil prices, Iran's new Minister of Petroleum, Qolam Reza Aqazadeh, may be tempted to ease economic troubles by using some of Iran's 1 million b/d surplus oil production capacity to increase export volumes. Aqazadeh is closely associated with Prime Minister Musavi and other ministers who have long advocated increasing oil sales. Moreover, Aqazadeh has threatened to export two barrels for every one Iraq exports through Saudi Arabia. [redacted]

Although Iraqi President Saddam Husayn still retains a strong grip on power, popular morale is depressed and could worsen with deteriorating economic conditions. Iraq's conduct of the war and its relations with Saudi Arabia and Kuwait could both be affected. Baghdad might increase its attacks on Iranian oil facilities or other economic targets in an attempt to press Iran. On the financial side, Iraq would increase pressure on its Arab allies—Saudi Arabia and Kuwait—to maintain, rather than trim, large aid flows. Moreover, short-term debts with Western Europe and Japan probably would have to be rescheduled. [redacted]

25X1

25X1

25X1

25X1

25X1

Secret

Secret

25X1

\$50 billion. If prices fall below \$20 per barrel, we believe financial difficulties would worsen significantly. [redacted]

25X1

Kuwait, the UAE, and Qatar would be able to maintain small current account surpluses at 1985 expenditure levels, under all price scenarios. All could face reserve drains, however, if Iranian attacks or declines in public confidence spur further capital flight. [redacted]

25X1

The moderate Gulf countries, especially Saudi Arabia, will have to continue to cut budget expenditures and imports this year as oil prices fall. In Saudi Arabia, even with spending cuts, reserve drawdowns will be necessary. We concur with the US Embassy's assessment that the Saudis probably will draw \$5 billion of ARAMCO funds for budget support early this year. The Saudis also probably will borrow on international credit markets before liquid reserves fall much below \$50 billion. [redacted]

25X1

[redacted] With no official debt and significant reserves, Riyadh is a solid credit risk. Given the bleak outlook for oil revenues, all Gulf governments also will have to make some difficult decisions about their domestic economies. Retrenchments in budget spending and imports will have to continue. Growth in GDP in these countries probably will shrink this year, and little growth will occur until the demand for OPEC oil increases—probably in the 1990s. [redacted]

25X1

25X1

Secret



Secret

### Saudi Arabia: Calm Before the Storm

25X1

Mounting economic pressures and frustration with OPEC indiscipline have forced Riyadh to reevaluate its oil policy. Although the Saudis are still concerned about a long-term market for their oil, short-term revenue needs have become the driving force behind Saudi oil policy. Riyadh's recent aggressive pricing and production decisions indicate that the Saudis are prepared to let prices drop sharply to force cooperation from both OPEC and non-OPEC producers. Despite the ramifications of recent actions, domestic pressures to end the recession and the desire to regain a more powerful role in the oil market point to further wrenching decisions on oil and economic policy.

nearly \$2 billion per month—a pace that would exhaust foreign reserves in less than three years.

25X1

Riyadh has had limited options to ease mounting economic pressures:

- Draw down international liquid assets by more than \$10 billion a year—which the Saudis, in our judgment, would be reluctant to continue.
- Keeping the budget deficit at \$10 billion, which would have required cutting expenditures by an additional \$15 billion—an almost impossible feat because of political and bureaucratic constraints.
- Borrow funds on the international market.
- Unilaterally boost oil production.

25X1

25X1

#### Pressures Build

Saudi Arabia's efforts to cut expenditures and limit imports have been insufficient to contain growing budget and current account deficits, or to slow the drain on the country's financial reserves. Riyadh failed to balance the FY 1985/86 budget (22 March 1985–11 March 1986) despite spending cuts totaling 8 percent that even included cancellation or postponement of a number of defense projects. Unlike previous cutbacks, which primarily hurt expatriate laborers and foreign companies, these cutbacks had a direct impact on Saudi citizens. Moreover, popular dissatisfaction with Riyadh's handling of the economy has been compounded by the growing perception that the royal family has insulated itself from the effects of the recession.

#### Riyadh Breaks Ranks

Saudi Arabia decided late last summer that boosting oil production was its most palatable option to avoid further belt-tightening, even if this risked a price war. To that end, Riyadh renounced its role as OPEC's swing producer. King Fahd also asserted Saudi Arabia's right to price its oil unilaterally. Subsequently, a series of contracts based on netback pricing<sup>1</sup> were signed. This move effectively discounted Saudi prices by \$1 to \$2 per barrel, and the volume of netback contracts quickly rose to 2.2 million b/d, more than half of current export levels.

25X1

25X1

The new Saudi marketing strategy sent a signal to other oil producers that Riyadh will give top priority to national interests and ensure a growing demand for its oil.

25X1

25X1

Saudi Arabia's problems worsened as oil production fell. Weak demand for OPEC oil caused Saudi output to plummet to a 20-year low of 2.2 million b/d last August, far below the 3.8 million b/d target upon which the current budget is based. Faced with a budget deficit approaching \$25 billion and a current account deficit of \$18 billion, Riyadh began drawing on its financial reserves at a rate of

<sup>1</sup> The netback price is a price equivalent to what a barrel of crude oil is worth after it has been refined into products such as gasoline and naphtha, minus transportation and refining costs.

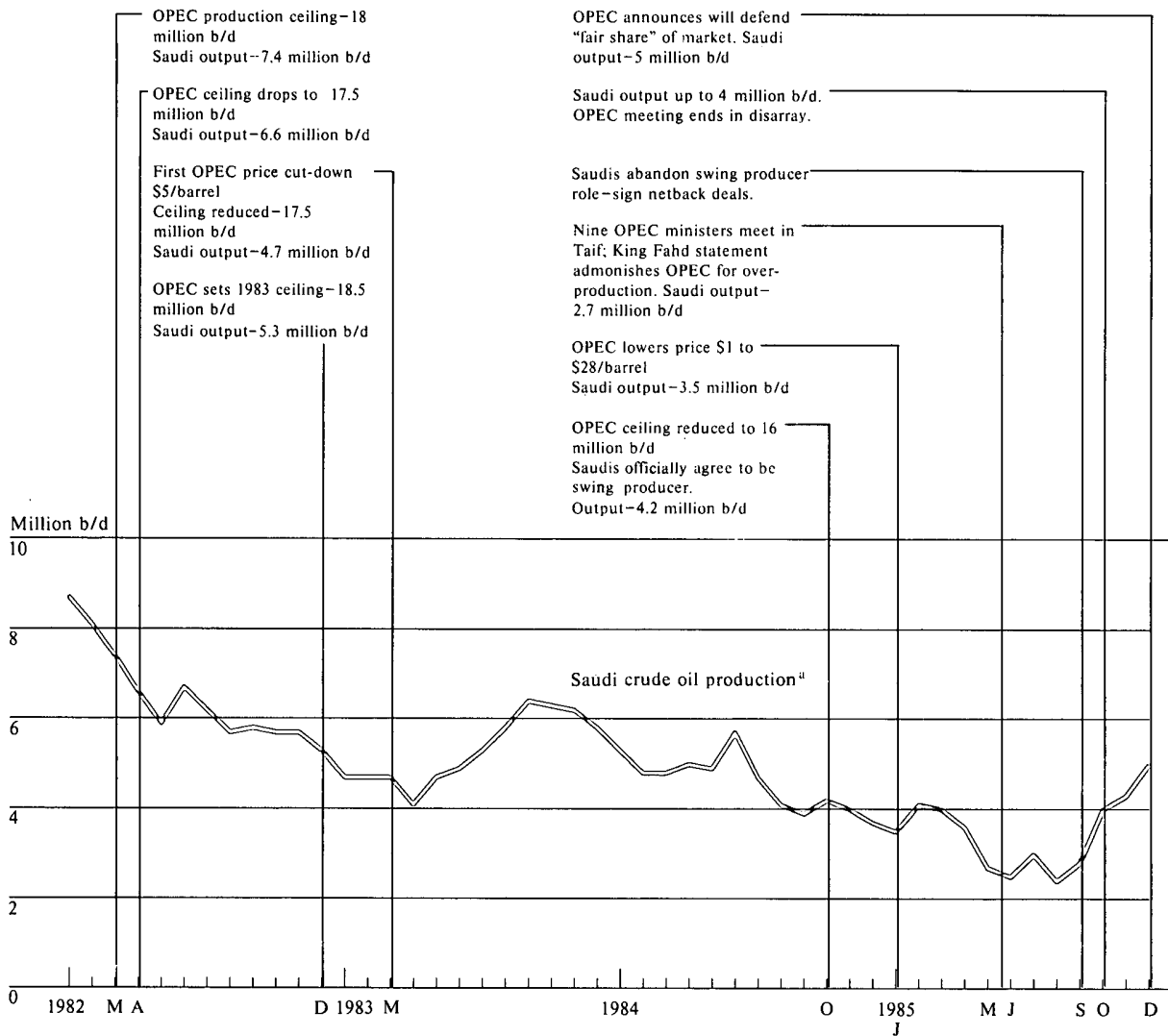
25X1

Secret

DI IEEW 86-004  
24 January 1986

Secret

**Evolving Saudi Oil Policy**



<sup>a</sup> Including Saudi share of Neutral Zone production.

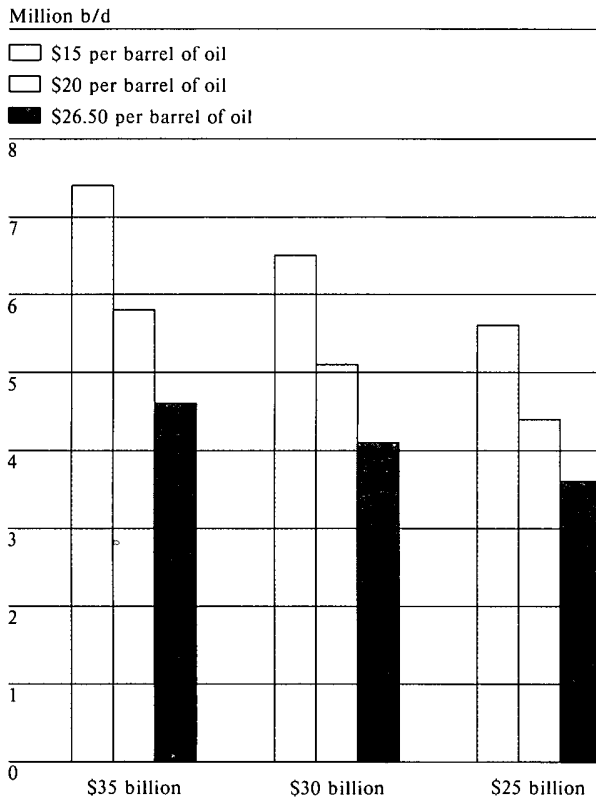
307997 1-86

25X1

Secret

Secret

### Saudi Arabia: Oil Production Under Various Oil Revenue Targets



307998 1-86

### Oil Price Scenarios

Saudi Arabia's current revenue needs will be a key determinant of its oil production decisions and, thus, of world oil pricing this year. We believe the Saudis are loath to cut defense expenditures further, and last year's deep budget cuts make further reduction in civilian spending difficult. Therefore, Riyadh probably will seek to bolster oil revenues to \$35 billion, which, with an additional \$15 billion in nonoil revenue, would allow expenditures of \$50 billion without drawing down foreign assets or borrowing in the international market. Ensuring this \$35 billion level, however, would require oil production of 4.6 million b/d at a \$26.50 per barrel price.

25X1

If prices slip to \$20 per barrel, Riyadh would have to raise output to nearly 6 million b/d to meet an oil revenue target of \$35 billion. Such an increase in sales probably would be unattainable in the face of the fierce competition that would emerge. More likely, the Saudis would only be able to earn approximately \$30 billion with production of about 5 million b/d. This would force foreign exchange reserve drawdowns of \$500 million per month or budget cuts of \$6 billion—an additional 12 percent over already assumed cutbacks in the new budget.

25X1

If oil prices were to plummet to \$15 per barrel, Saudi output would have to average over 7 million b/d to meet a \$35 billion revenue goal—a level even less attainable. If Saudi Arabia produced only 5 million b/d worth \$22 billion in revenue, foreign reserves would have to be drawn down at the rate of slightly more than \$1 billion per month or the budget would have to be pared by an additional \$13 billion.

25X1

25X1

### The Saudi Strategy

Riyadh apparently intends to produce more oil to shore up revenues if prices begin to fall. Over the past several months, Yamani has referred to the

25X1

Secret

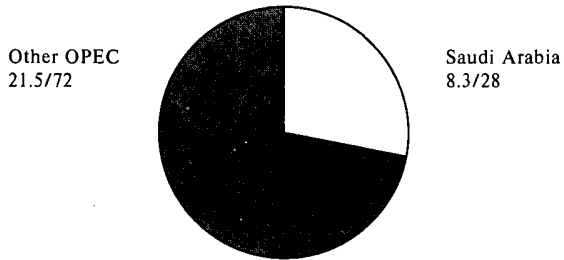
Secret

**Saudi Arabia: Share of OPEC Crude Oil Production<sup>a</sup>**

Million b/d / Percent

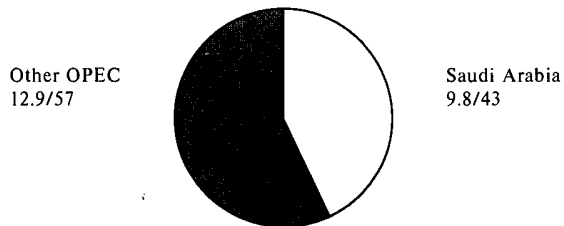
1978

Total OPEC: 29.8 million b/d



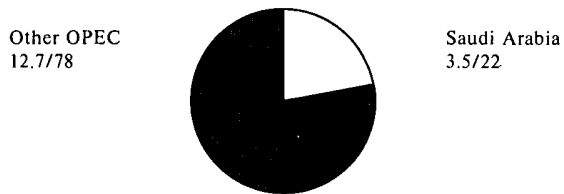
1981

Total OPEC: 22.7 million b/d



1985

Total OPEC: 16.2 million b/d



<sup>a</sup> Including the Saudi share of Neutral Zone production.

307999 1-86

**Indicators of Saudi Intentions Regarding Oil Policy**

Signals of a change in Saudi oil policy include:

- *Statements by King Fahd or Minister of Petroleum Yamani regarding oil production or prices.*
- *Changes in volumes under netback deals. For example, growing volumes priced on a netback basis would indicate that Riyadh intends to keep production levels high. A reduction in netback deals, on the other hand, might be a precursor to cutting back output.*
- *The emergence of large volumes of oil exports destined for Far Eastern markets. The region initially was excluded from netback sales and thus increased sales would indicate Saudi resolve to maintain or increase oil production.*
- *A liberalization of terms of the netback contracts or outright price discounting. This would point to more aggressive marketing tactics.*
- *Replacement of Yamani. Yamani's departure would make it even more difficult for OPEC to formulate and implement any price defense strategy.*

possibility of oil prices of \$18 to \$20 per barrel. Saudi Arabia may believe that oil prices are too high and that the only way to spur demand is to force prices sharply lower. Yamani also asserts that the Saudis, with ample excess productive capacity, could maintain revenue levels by doubling current oil exports even if prices fall to \$14. For this strategy to work, however, either demand for oil

25X1

25X1

Secret

Secret

will have to grow significantly at the lower prices—an unrealistic assumption given the unresponsiveness of consumption to price changes in the short term—or Riyadh will need to increase its market share. If prices begin to fall rapidly, countries desperate for revenue—such as Nigeria and Mexico—may also try to garner a greater market share, causing a further downward price spiral. [redacted]

Riyadh probably believes that a more aggressive stance may help shield it from domestic criticism resulting from economic hardships. Still, if oil prices plummet, Riyadh might have to become more flexible about its oil revenue goals because competition for market share would be fierce. It could again decide to draw down international reserves rapidly to cover revenue shortfalls, but this asset cushion—currently approximately \$70 billion—is insufficient to cover large deficits for a protracted period. Riyadh probably would also try to pare expenditures, but this would be difficult to do without affecting the Saudi population. Such cuts would also risk growing public dissatisfaction if the royal family continues to avoid sharing the burden of lower oil revenues. [redacted]

25X1

Saudi Arabia is gambling that non-OPEC producers, as well as other OPEC members, will curb output once they see that Riyadh is intent on ensuring oil revenues. If the other producers demonstrate a willingness to work together, we believe that Riyadh might then be willing to resume a role as OPEC's swing producer in an attempt to stabilize prices in the \$20 to \$25 per barrel range. Riyadh probably would seek a guarantee from the group, however, that the Saudis would be able to secure an annual market share of 4-5 million b/d—including output from the Neutral Zone. [redacted]

[redacted]

25X1

25X1

Cooperation will be difficult to achieve. Most of OPEC's other members face even more difficult financial problems and would be hard pressed to make further sacrifices. Non-OPEC producers are unlikely to bow to Saudi pressure. [redacted]

[redacted] Moreover, because of the complexity of the international oil market, Saudi Arabia and the other producers could have difficulty regaining control of prices if they decline rapidly. [redacted]

25X1

25X1

25X1

Secret



Secret

### Mexico: The Producer/Debtor Dilemma

25X1

The soft oil market probably will force Mexico City to backslide on this year's austere budget and could derail attempts at economic adjustment. Moreover, since oil receipts make up 70 percent of export earnings and are about equal to this year's debt burden, it is becoming increasingly likely that the country will be unable to fully honor its financial obligations. Analysts argue that Mexican oil, at an average of \$24 per barrel, is still overpriced by an average of \$1 per barrel. Given the critical need to maintain market share and export revenues, we believe the country must demonstrate uncharacteristic flexibility and adjust its price accordingly. Our analysis suggests that Mexico's financial gap this year may rise \$3.3 billion—to a total of \$9 billion—assuming a fall in world oil prices to \$20 per barrel and the likelihood of no appreciable increase in the level of nonoil exports.

#### Significant Fall in Prices<sup>1</sup>

25X1

25X1

25X1

In the more likely case—that Mexico's oil prices fall \$6 and stabilize around \$18 per barrel<sup>2</sup>—the annual revenue loss would reach \$3.3 billion. In this scenario, the country faces far greater problems. Unable to offset the loss through increased internal financing, Mexico would be required to undergo more severe belt-tightening and seek greater external assistance in the form of additional new lending, debt restructuring, and other help.

25X1

at current export levels \$8 of each barrel sold abroad is needed to cover actual costs, \$10 to fund social programs, and the remainder is applied to the debt burden. Consequently, if Mexican oil fell to \$18 per barrel, there would be a direct trade-off between social programs and debt repayment once sources of new lending were exhausted. Given the political atmosphere and the fact that the government already plans to cut spending deeply, we believe Mexico City would attempt to find a way to reduce debt payments in order to minimize cuts in social programs.

25X1

25X1

Mexico's loss in oil earnings would be partially offset after a 6- to 9-month lag by reduced interest payments as interest rates fell in response to lower energy prices. We estimate that this price would lower international interest rates roughly 1 percentage point, providing Mexico an \$850 million reduction in debt servicing.

#### Current Losses

Mexico's latest price adjustment—a 90 cent per barrel reduction on 30 December—will yield a revenue loss of about \$500 million if targeted export levels of 1.5 million b/d are maintained. While this clearly implies an increased burden on the Mexican economy relative to last year, it is manageable without making substantially deeper spending cuts, seeking a debt rescheduling, or asking for a greater amount of new money. In fact, government planners already had assumed a \$2 per barrel price drop when they calculated this year's budget. As a result we still expect that real GDP will contract by 0.5 to 1.5 percent and the current account will suffer a deficit on the order of \$1-2 billion if oil prices remain at current levels.

<sup>2</sup> Because of their lower quality, Mexican crudes are priced below the world average. An \$18 per barrel Mexican price corresponds to a \$20 world average price.

<sup>1</sup> This analysis assumes that Mexico maintains current production rates and only increases its export target of 1.5 million b/d in the worst case scenario. Even though world demand would rise in response to lower prices, we believe the investment needed to step up production and the longer term problems of overproducing existing fields are too costly.

25X1 25X1 25X1  
25X1 25X1

Secret

DI IEEW 86-004  
24 January 1986

Secret

[Redacted]

judgment that Mexico will be unable to increase oil production suggests that the government may initiate a policy of domestic rationing in order to free more petroleum for the export market. For example, by diverting 10 percent of domestic supplies, \$550 million more in export revenues would be realized. In addition, OECD growth fueled by lower energy prices and inflation would significantly boost the demand for Mexico's nonoil exports. Even with this relief, however, a tremendous gap would exist between income and expenditures.

25X1

25X1

25X1

25X1

25X1

Tighter domestic austerity and greater foreign assistance probably would enable Mexico to surmount its immediate financial hurdles, but a greater share of public spending would have to be funded through internal financing. As a result, the country's chronic financial problems—massive deficits and high levels of inflation and capital flight—would worsen, increasing the trauma associated with economic reform. [Redacted]

We believe that a combination of debt relief, limited new lending, and increased US imports would be insufficient to solve Mexico's problems in the absence of major structural reform. To avert economic collapse, policymakers would be forced to implement long-needed structural adjustments, drastically reducing the role of government in the economy, and welcoming increased foreign investment. This type of policy shift surely would cause intense dissent among the more populist members of the ruling Institutional Revolutionary Party, who favor statist policies and view the government as the "rector" of the economy. [Redacted]

**Oil Price Collapse**

If Mexican oil prices would plunge to \$13 per barrel<sup>3</sup>—a worst case scenario, in our view—oil revenue losses would total about \$6 billion, partially offset after a lag by an estimated \$1.5 billion saving in interest payments. In the near term, this oil market collapse would dictate an abrupt shift in Mexican economic policy, force a suspension of debt payments, and lead the de la Madrid administration to seek substantial assistance from abroad. Over the longer term, economic restructuring would put added pressure on the political system. [Redacted]

[Redacted] While we believe these policies are mandatory for sustainable growth, their quick implementation in such a crisis would cause severe hardships and constitute a grave threat to social order. [Redacted]

25X1

25X1

25X1

Mexico's creditors, encouraged by lower energy costs, might be more forthcoming with increased lending since oil-importing debtors would be in better position to service their debts. Still, additional funding would be tempered by the realization that an improvement in Mexican economic health would come only well into the future. In addition, as the positions of oil-importing debtors began to improve, Mexico City would lose the threat of inciting multilateral debtor action, a tool we believe has enhanced its negotiating power in the past. Our

<sup>3</sup> Corresponds to a world average price of \$15 per barrel. [Redacted]

25X1

Secret



Secret



**North Sea Oil Producers:  
Economic Implications of  
Falling Prices**

25X1

The United Kingdom and Norway, as net oil exporters, would not be badly hurt by lower oil prices, but would have problems in dealing with the substantial loss of oil tax revenue. If oil prices fell to \$20 per barrel we estimate that both countries would experience slower economic growth in the first year following the decline, but that the loss could be more than made up subsequently. The United Kingdom could suffer, however, if lower oil prices triggered a run on the pound, causing London to boost interest rates. We also do not believe that lower oil prices would significantly affect British or Norwegian energy production during the remainder of this decade. Beyond 1990, however, \$20 per barrel oil probably would slow the development of many small North Sea oilfields and might deter development of Norway's giant Troll gasfield.

A sharp drop in oil prices would have its greatest impact on government finances. London probably would not carry out the tax cuts of \$2.8-3.5 billion planned for the March budget, given its determination to reduce the budget deficit to \$10 billion in the 1986-87 fiscal year. The Treasury's forecast allows for a drop in oil prices to about \$26 per barrel. Since each one dollar fall in oil prices reduces tax revenue about \$740 million, a fall to \$20 would cost London about \$4.4 billion annually. Our projections are supported by two prominent London brokerage houses, which recently released reports estimating that lower oil prices will leave London no room to cut taxes in March; a third analysis sees the possibility of a smaller tax cut.

1, 2, 3

25X1

25X1

The impact of a fall in oil prices to \$15 per barrel would be roughly double that of \$20 per barrel oil. GNP would fall by 1.2 percentage points in 1986, but would rebound even more strongly in 1987 because of a sharp rise in investment. The fall in inflation would be greater, 2.5 percentage points in the first year and almost 2 points in the second. A \$15 per barrel oil price would lower British oil exports by about \$8 billion per year and put significant downward pressure on sterling. In this scenario, it is very likely that there would be a repeat of last year's sterling crisis, and the pound could approach parity with the dollar unless London took steps to stop its fall.

3,

25X1

25X1

**The UK Economy and Lower Oil Prices**

By itself, an oil price decline would slow British economic growth during the first year, but the economy would quickly rebound during the second year, according to our Linked Policy Impact Model (LPIM). A fall in oil prices to \$20 per barrel would cut the value of British oil exports by more than \$4 billion annually. In the first year, we estimate GNP growth would be reduced by 0.6 percentage point. Lower exports, both oil and nonoil, and lower investment would be the main contributors to slower growth, more than offsetting the stimulus provided by lower inflation and interest rates. By the second year, however, the benefits of lower oil prices to the overall economy would begin to take hold. Lower inflation and interest rates would boost consumer spending and investment, while exports would rebound because of increased growth by Britain's trading partners. Unemployment would rise by about 0.2 percentage point in each year because of higher real wages, but inflation would be reduced by 1.4 percentage points in the first year and continue to decline in following years.

**Sterling and Interest Rates**

The ultimate impact of lower oil prices on the British economy will depend on how Prime Minister Thatcher reacts to downward pressures on the pound. Using the LPIM, we estimate that if the fall in oil prices to \$20 per barrel is accompanied by a 20-percent depreciation in sterling, 1986 GNP would still be reduced by 0.5 percentage point but 1987 GNP would get almost a 3-percent-point boost, due to higher export volume and investment.

3

25X1

2, 3

2, 3

Secret

DI IEEW 86-004  
24 January 1986

Secret

**United Kingdom: Economic Impact of Lower Oil Prices <sup>a</sup>***Percentage point change from baseline scenario*

Economic Policy	GNP		Inflation		Export Volume		Investment	
	1986	1987	1986	1987	1986	1987	1986	1987
<b>\$20 per barrel oil</b>								
No change in the exchange rate or economic policy	-0.6	0.6	-1.4	-1.0	-0.5	0.1	-0.8	1.9
10-percent depreciation of the pound	-0.5	1.7	1.3	-0.1	2.0	1.9	-1.0	2.2
20-percent depreciation of the pound	-0.5	2.9	4.0	0.6	4.2	3.4	-1.3	3.5
3-percentage-point interest rate hike to prevent pound depreciation	-1.3	0	-1.4	-0.9	-0.6	0.2	-2.5	1.1
<b>\$15 per barrel oil</b>								
No change in the exchange rate or economic policy	-1.2	1.0	-2.5	-1.9	-1.1	0.4	-1.5	3.6

<sup>a</sup> Results from our Linked Policy Impact Model. The baseline scenario assumes an oil price of \$26.50 per barrel, an exchange rate of \$1.38 per pound, and interest rates of 11.5 percent.

[Redacted]

25X1

With a 20-percent depreciation, however, the loss of oil tax revenues would be almost totally offset because a decrease in the pound/dollar rate raises the sterling receipts of oil companies and, hence, government revenues. [Redacted]

slow economic growth below the 2.5-percent rate generally forecast for next year. Our model estimates that, if London raises interest rates by an additional 2 points, it would reduce inflation by 1.4 percentage points, but at the cost of reducing GNP growth by 1.3 percentage points. [Redacted]

25X1  
25X1

In our judgment the actual pound depreciation resulting from \$20 per barrel oil probably would be less than 20 percent—about 10 percent seems most likely. In this case GNP is reduced by 0.5 percentage point in the first year and boosted 1.7 percentage points in the second year, while inflation in both years is lower than in the baseline scenario. [Redacted]

**Norway**

A drop in oil prices probably would slow economic growth more in Norway than in the United Kingdom because of oil's relatively larger economic role. We estimate that a price fall to \$20 per barrel early in 1986 would cut about 1 percentage point from the expected 3-percent GDP growth rate.<sup>1</sup> A fall to \$15 could reduce the rate to about 1.5 percent. The 3-percent projection is based on large increases in investment spending resulting from record profit

25X1

To keep the falling pound from reigniting inflation, Thatcher probably would again raise interest rates, as she did last winter. In fact, London recently encouraged British banks to raise their base lending rates by 1 percentage point to 12.5 percent. Efforts to control inflation through higher interest rates could more than offset the benefits of lower oil prices and a lower pound. Such a move would help Thatcher hold inflation in check but would also

<sup>1</sup> The LPIM does not include a specific submodel for Norway. [Redacted]

25X1

Secret

Secret

**Oil's Role in the Economy**

*United Kingdom.* North Sea oil has provided the British economy a major boost since production began in 1975, with crude petroleum now accounting for about 17 percent of British exports and 6 percent of GDP. North Sea oil is important for the Treasury as well, providing about 7 percent of government revenues. Production has increased rapidly, to about 2.7 million b/d last year, although output is likely to peak sometime in early 1986 and decline sharply over the next decade. While oil has stimulated the growth of new industries to provide oil equipment and services, it also has added to problems in older manufacturing industries by keeping the pound's value high and damaging traditional exports.

3

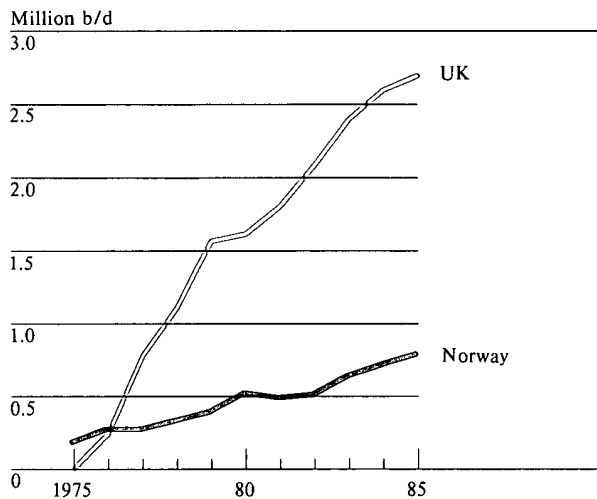
*Norway.* Oil plays an even larger role in the Norwegian economy. As in the United Kingdom, oil production began in the mid-1970s; it reached 800,000 b/d in 1985 and could top 1 million b/d by the end of the decade. Norway's oil wealth has to a large extent facilitated expansive economic policies that over the last decade have enabled Norway to achieve sustained economic growth with very low unemployment. Petroleum royalties now finance about 16 percent of the central government budget, and petroleum accounts for almost 30 percent of exports of goods and about 15 percent of net national income. While there probably has been some negative impact on traditional industries, it is less noticeable than in the United Kingdom because the Norwegian industries generally had fewer problems to begin with.

3

levels in the last three years. We think that the government's gloomy forecasts based on the prospect of lower oil prices have already dampened short-run business expectations, which will hold down investment.

The government budget would also be hard hit because oil accounts for 16 percent of Oslo's tax revenue. With the marginal tax rate on oil around

**UK and Norway: North Sea Oil Production, 1975-85**



25X1

308001 1-86

25X1

85 percent, a drop in oil prices from \$26.50 to \$20 per barrel would slash government revenue by more than \$1.0 billion, even if oil production increased by as much as 100,000 b/d this year. A fall to \$15 would further reduce revenues by almost \$0.9 billion. As in the United Kingdom, the revenue loss in domestic currency would be less to the extent that the oil price drop caused the krona to depreciate against the dollar. Nevertheless, Oslo probably would be faced with its first budget deficit in more than a decade.

2

25X1  
25X1

The budgetary impact probably would lead to increased confrontation between the governing Conservative coalition and the opposition. The minority government is warning of significantly diminished oil tax revenues during the rest of the decade, but will probably accede to opposition demands for spending increases this year. Under a

3

25X1

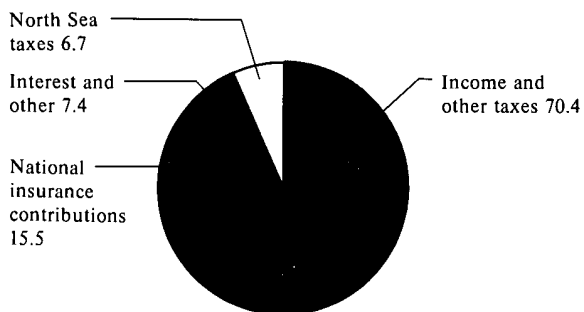
Secret

Secret

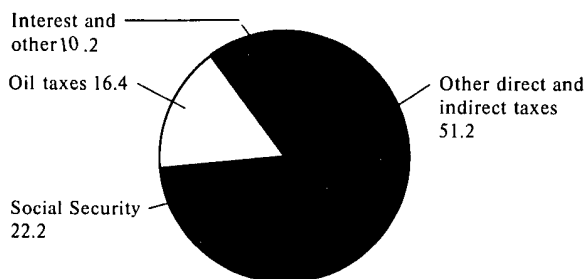
**UK and Norway: Sources of Government Revenue**

Percent

UK



Norway



308002 1-86

demands for spending increases this year. Under a \$20 per barrel scenario—and even more so under a \$15 one—Conservative opposition to spending increases would probably strengthen, because reduced oil tax revenues are unlikely to be offset by increases in other taxes.

3 With net oil exports likely to be between 600,000 b/d and 650,000 b/d this year, a \$6.50 fall in the price per barrel would cut annual export revenue by close to \$1.5 billion. Norway's current account balance already has been declining from its \$3.2 billion peak in 1984, and this loss would just about

wipe out the surplus expected in 1986. The lost oil export revenue would almost certainly cause some depreciation of the krona, but because of Norway's exceptional economic stability over the last decade the chance of an exchange rate crisis is much less than in the United Kingdom. Consequently, the likelihood of the government imposing restrictive policies to support the exchange rate is also much less. At \$15 per barrel, a current account deficit would not necessarily result if increased West European economic growth boosted Norway's non-oil exports.

**Implications for Energy Production**

A \$20 per barrel oil price would not significantly affect British or Norwegian energy production during the remainder of this decade; Norway might even boost output somewhat to offset the lost revenue. Beyond 1990, however, the lower price could impede the development of the smaller, higher cost oilfields that London is counting on to slow the inevitable decline in oil output. More ominously, by pulling down the price of natural gas, the lower oil price could threaten the development of Norway's Troll gasfield. Even \$15 per barrel oil prices would not substantially reduce energy production during the remainder of the decade, barring a decision by Oslo to restrict output to prop up prices. North Sea output would, however, certainly decline in the 1990s, and development of Troll would become uneconomic if prices stayed that low. This giant gasfield continues to be Western Europe's principal alternative to greater reliance on Soviet gas after 1995.

25X1

25X1

25X1

25X1

25X1

Secret

Secret

### Soviet Oil Production and Exports: Outlook for 1986

25X1

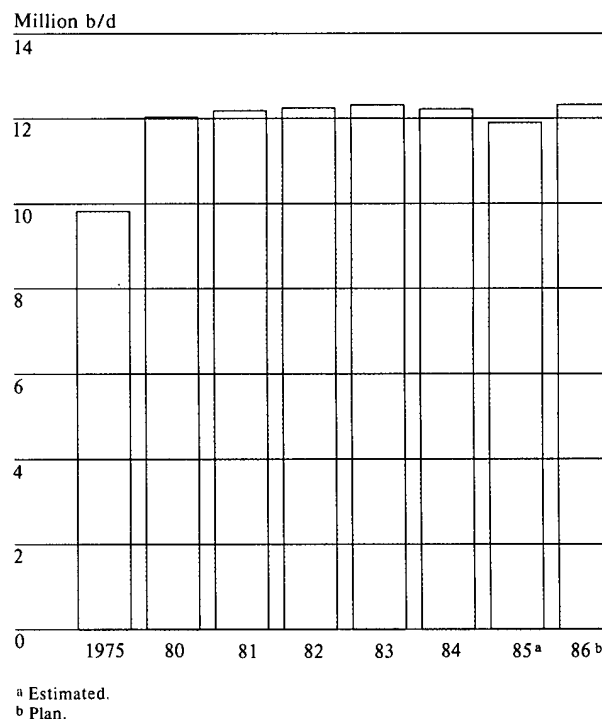
Soviet oil production in 1985 fell—for the second consecutive year—to about 11.9 million b/d, more than 300,000 b/d below the 1984 level. Hard currency receipts from oil exports dropped about \$3.5 billion—down roughly 25 percent. The Soviet plan for 1986 calls for raising oil production to more than 12.3 million b/d, but the production outlook is precarious, particularly for the key Tyumen' region, which accounts for 60 percent of oil output. On the basis of the oil industry's recent record of rising investment and falling output, together with extensive discussion in the Soviet press of a widespread lack of equipment, skilled manpower, and effective management in the industry, we conclude that:

- Even with the planned boost in investment for the oil industry, production is unlikely to rise above the 1985 level.
- Depending on the degree of slippage in the supply of resources to the oil industry, national output could fall another 300,000 b/d.
- Despite conservation and substitution efforts, domestic oil consumption is likely to remain at 1985 levels.
- Oil exports to hard currency countries will probably again bear the brunt of any production shortfalls. At the extreme, export reductions, compounded by anticipated oil price declines, could cost Moscow as much as \$4-6 billion in hard currency earnings.

#### Trouble in the Tyumen' Region

Development of Tyumen's largest and best oilfields began more than twenty years ago and the era of "easy oil" has certainly come to an end. Further

#### USSR: Oil Production 1975-86



308000 1-86

25X1

attempts to increase—or even sustain—production will be obstructed by several factors:

- Production is overly dependent on output from eight to 10 large but overworked oilfields developed during 1964-73. Production from most of them has peaked and output will probably continue to fall in 1986.

25X1

Secret

DI IEEW 86-004  
24 January 1986

Secret

- There is little likelihood for the imminent discovery of a new supergiant oilfield. New capacity will have to come from developing a much larger number of remote fields that are smaller, structurally more complicated, and far less productive than the oilfields developed during the 1970s. According to *Pravda*, however, the Soviets planned to commission 26 oilfields during 1981-85, but only 13 are producing. We judge that the plan to bring 18 new oilfields on line in 1986 is no more likely to be met.
- Average flow from new wells has been steadily declining—from 1,250 b/d in 1975 and 490 b/d in 1980 to about 220 b/d in 1985.
- Because of excessive water injection, the share of water produced with oil in Tyumen' has risen from 14 percent in 1975 to more than 50 percent in 1985, sharply escalating the demand for reliable pumping equipment and also increasing the production costs. Currently, pumps are used on more than 70 percent of the producing wells in the region, compared with about 20 percent in 1980.
- The Soviet press reports that production and support infrastructure in the Tyumen' oil region—pipelines, injection facilities, and storage tanks—is from four to five years behind the level needed to support planned production. Moreover, much of this equipment has been ravaged by corrosion. [redacted]

In 1985 Moscow sustained Tyumen' production by transferring substantial equipment and labor resources to this region from the older producing regions. Sustaining output in 1986 would require an additional increase in allocation of similar resources to Tyumen'. Further transfers, however, could result in accelerated loss of output in the older regions that could—because flow rates from new Tyumen' wells can no longer be assumed to be greater than those in some of the older regions—cause national output to decline. [redacted]

### Prospects for Production

We judge that General Secretary Gorbachev is not altering the thrust of oil policy and continues to favor production growth despite the high cost and the negative consequences for needed exploration. In reaction to the two-year decline in production, Moscow plans to raise oil output by more than 3 percent and increase oil investment by 31 percent in 1986. We do not believe that the measures outlined in Gorbachev's Tyumen' speech in September—increased application of science and technology, better equipment, a sharp increase in housing construction and the availability of amenities—are capable of increasing production in 1986. Although pressure from Gorbachev—most notably the firings of high oil industry personnel for poor performance—may lead to stepped-up production from older fields in the short run, such gains will be insufficient to push national output above the 1985 level and will be extremely difficult and costly to sustain for more than a year at best.<sup>1</sup> [redacted]

Moscow plans to allocate over 14 billion rubles to oil industry investment in 1986, most of which will be used in Tyumen'. Much of this investment, however, will be absorbed by sharply rising costs associated with providing sufficient capacity just to offset depletion. Some of the main factors contributing to this result are:

- In the past the Soviets were able to compensate for the downward trend in average well flows by more intensive drilling of established fields. According to the Soviet press, this option may no longer be available, and an increasing number of new fields must be tapped in areas remote from infrastructure.

<sup>1</sup> The new regime, in addition to replacing the Soviet oil minister, removed key personnel in Tyumen'. Moreover, two production associations that run oil operations in the European USSR were given control over three West Siberian production directorates in an unprecedented move to improve efficiency. [redacted]

25X1

25X1

25X1

25X1

Secret

Secret

- The costs for developing the smaller and more remote fields are escalating, but investment funds reportedly are allocated on the basis of the lower costs previously experienced in developing fields in more favorable locations—essentially dooming new output plans.
- On the average, 20 percent of the production wells in Tyumen' stand idle.
- The leadtime for new equipment orders means that delivery and timely installation in Tyumen' will not be possible much before next winter, when the ground is frozen hard and winter roads can be built. The new fields are located generally to the north of existing oil operations in areas entirely lacking infrastructure. [redacted]

#### Other Producing Regions

In aggregate, the oil and gas condensate output from the other producing regions has been declining since 1975 and will very likely fall again in 1986, although the drop may not be as large as in previous years. Newly developed oilfields on the Buzachi Peninsula in Kazakhstan and in the Caspian Basin (onshore and offshore), together with new condensate output from Karachaganak, Astrakhan', Shurtan, and Dauletabad, will help to offset declining output from the old regions west of the Urals. Production from the Volga-Urals area—the USSR's second-largest producing region—has experienced annual declines averaging about 200,000 b/d since 1978. [redacted]

#### Can Oil Consumption Be Reduced?

We believe that domestic oil consumption—which grew rapidly during the 1970s—has essentially stabilized. Of the major oil products—gasoline, kerosene/jet fuel, diesel fuel, lubricants, and fuel oil—we judge that the only oil product for which there exists a substantial opportunity (because of either improvements in efficiency or substitution) for reduced consumption is fuel oil.<sup>2</sup> Nonetheless,

during 1981-85 Moscow did not decrease the volume of fuel oil consumed by thermal power plants—a main goal of the oil conservation effort. Our analysis indicates that the volume of fuel oil consumed by power plants remained at nearly the same level in 1985 as in 1980—about 2.5 million b/d, 28 percent of total apparent oil consumption. Despite successes in substituting natural gas for fuel oil at many power plants, fuel oil consumption by coal-fired power plants increased during 1981-85 because of low-quality coal and coal shortages, thus offsetting the potential savings in the oil-to-gas conversion program. [redacted]

25X1

The chairman of the State Committee for Oil Products has indicated that, despite efforts to economize on the use of fuels and lubricants during the first nine months of 1985, automobile transport exceeded its planned allocation by more than 46,700 b/d of gasoline and 8,500 b/d of diesel fuel. [redacted]

25X1

25X1

We believe that oil consumption will remain essentially flat in 1986 because:

- The demand for oil products—such as gasoline and diesel fuel—in the transportation and agriculture sectors will probably grow.
- There is little opportunity to reduce oil consumption in the residential sector.
- The requirements for nonfuel oil products—such as lubricants and plastics—will probably remain constant.
- Fuel oil consumption in the electric power industry—which accounts for about 70 percent of total fuel-oil consumption—will probably decline only marginally in 1986 due to continuing problems with low-quality coal and coal shortages. [redacted]

25X1

25X1

<sup>2</sup> In 1986, the USSR plans to save about 25,000 b/d of gasoline—about 2 percent of current gasoline production—by using liquefied compressed gas to power about 100,000 automobiles. Increased demand for gasoline as a result of new automobile production—about 1.3 million vehicles annually—will easily offset this saving. [redacted]

25X1

Secret

**Implications for Exports**

If Moscow can stem the decline in production, the Soviets will at best be able to maintain total oil exports this year at the 1985 level—an amount we estimate to be 10 percent below the 1984 level. In the event output falls by as much as 300,000 b/d in 1986, Moscow could be forced to reduce exports an additional 10 percent. [redacted]

Moscow opted to absorb most of the 1985 production decline through reductions in oil exports to the West—at a cost in earnings of \$3.5 billion—while sustaining deliveries to its Communist partners. Maintaining 1986 oil exports to the developed West at last year's level—depressed by about 25 percent from 1984 levels—will continue to cost the Soviets much-needed hard currency—the more so if world oil prices drop further. Earnings from gas exports are scheduled to increase substantially by 1990, but will fall short of compensating Moscow for the expected decline in oil export revenues. [redacted]

**Tough Options**

Nonetheless, we believe it likely that exports to the developed West would, at least initially, bear the brunt of further reductions in oil production, costing the Soviets almost \$1 billion for every 100,000 b/d decrease (at \$27 per barrel). But the Soviets may still need to make some tough additional choices on how to allocate available exports in 1986. The East European countries, heavily dependent on Soviet oil, are already suffering from shortages. A cut in oil deliveries would cause them major economic difficulties at a time when they are under pressure to export more finished products to the USSR. Moreover, Moscow would have to weigh carefully the attendant risks of economic instability and increased political tensions that could result from a reduction in oil deliveries to these nations. [redacted]

Political considerations will also make it difficult to cut deliveries to Cuba, Nicaragua, and Moscow's other Third World client states, which account for almost 10 percent of Soviet oil exports. [redacted]

[redacted]

25X1

Oil deliveries to other Third World countries represent 6 percent of Soviet oil exports, providing the Soviets with another area where deliveries could be reduced. India receives the majority of this amount. Moscow, however, has shown concern for the political and strategic aspects of its relationship with India and would probably be reluctant to make a reduction there. [redacted]

25X1

25X1

**Impact on Hard Currency Earnings**

At the extreme, export reductions, compounded by anticipated oil price declines, could cost Moscow as much as \$4-6 billion in earnings, presenting Moscow with onerous choices between rapidly expanding its debt and reducing hard currency imports. Last year's fall in revenues was the major contributor to Moscow's deteriorating financial position. To offset earnings reductions, the Soviets stepped up borrowing dramatically and postponed some planned purchases. [redacted]

25X1

25X1

[redacted] the approval of the 1986 purchasing program has been delayed, in part, because of hard currency shortages. Recent personnel changes in the Foreign Trade Ministry and Gosplan could also be delaying the required approval. [redacted]

25X1

While Moscow could partially compensate for reduced earnings through further borrowing and larger gold sales, major additional import cuts may well also be in the cards, especially if Moscow cannot arrest the decline in oil production and if the fall in export earnings becomes particularly sharp:

- Additional gold sales of \$2-3 billion are possible, but any further sales would seriously affect gold prices, a reaction which the Soviets generally try to avoid.
- Traditional Soviet financial conservatism would probably put a brake on continued Soviet borrowings.

25X1

25X1

Secret



Secret

Anticipated drops in Soviet grain imports in 1986 may give Soviet planners some flexibility to avoid serious cuts in machinery and equipment imports. In fact, large equipment orders last year could mean some increase in imports for major development projects. However, major adjustments to imports in 1987 would almost certainly be necessary to prevent a sharp increase in Soviet debt service ratio in light of declines in oil export earnings and recent borrowing activity.

25X1

25X1

Secret



Secret

**Briefs**

**Energy**



25X1

*Record Chinese Energy Output in 1985*

China's energy production for 1985 showed marked growth in coal, oil, and power for the second straight year. Recent discoveries at existing onshore fields boosted oil production to 2.5 million b/d, up more than 9 percent over 1984. Coal output grew by almost 8 percent to 850 million metric tons. Electric power production reached 407 billion kilowatt-hours, up 8.6 percent. Totals have not yet been released for hydropower or natural gas production, but both were up 6 percent over comparable 1984 figures through November.

Secret

DI IEEW 86-004  
24 January 1986

Secret

Economic reforms and foreign technology have helped the Chinese increase energy output while encouraging conservation. Nonetheless, serious energy shortages continue. Most of the increased oil production was exported to earn foreign exchange, and bottlenecks in transportation have caused backlogs at many coal mines. [redacted]

25X1

**International Finance**

*New Peruvian Debt Signals*

Talks held on 15 January between Peru and its Western creditors could prove crucial in shaping President Garcia's stance on repayment of debt. [redacted]

25X1

[redacted] bankers in New York met with a Peruvian Government representative [redacted] to outline terms for reopening debt talks. [redacted]

25X1

The government's agreement to meet with the bankers is a concession and reflects Peru's concern over its deepening financial isolation. Western bankers are angry and frustrated by the debt impasse and are applying heavy pressure. At a minimum Garcia may decide to pay IMF arrearages rather than foresake \$500 million to \$1 billion in World Bank loans this year. Public pressure by creditors could backfire, however, and cause the volatile Garcia to repudiate some of Peru's debt.

25X1

[redacted]

25X1

*French Arms Credit Crackdown*

France recently has restricted the availability of arms credits for Third World states that already have large military debts to France until Paris can be assured of their ability to repay. Paris recently changed its delivery policy for Egypt's Mirage 2000s to one plane at a time, as payment for each is received, according to attache reporting. In addition, [redacted] the Ministry of Finance vetoed a proposal to finance a Mirage 2000 sale to Morocco by loaning 50 percent of the purchase price. [redacted]

25X1

[redacted] We believe that the credit crackdown reflects Paris's concern that it has extended too much credit—Egypt's military debt to France, for example, is \$1.4 billion. Nonetheless, because the arms sales program is important for political reasons as well as for reducing procurement costs for the French military, we expect liberal financing to resume as payments are received from previous loans. [redacted]

25X1

25X1

*East European Borrowing To Continue*

After securing \$3.4 billion in syndicated loans from Western banks last year—up 70 percent from 1984—Eastern Europe will remain active in the international loan market in 1986. The region's financing needs remain high with Eastern Europe's hard currency trade balance likely to deteriorate for the second consecutive year. In addition, Hungary, East Germany, and Romania still face large debt service requirements. Banks appear willing to provide new credits to most East European borrowers—at least in the near term—because of the shortage of lower risk borrowers among the developing countries. Banks [redacted]

25X1

Secret  
24 January 1986

Secret

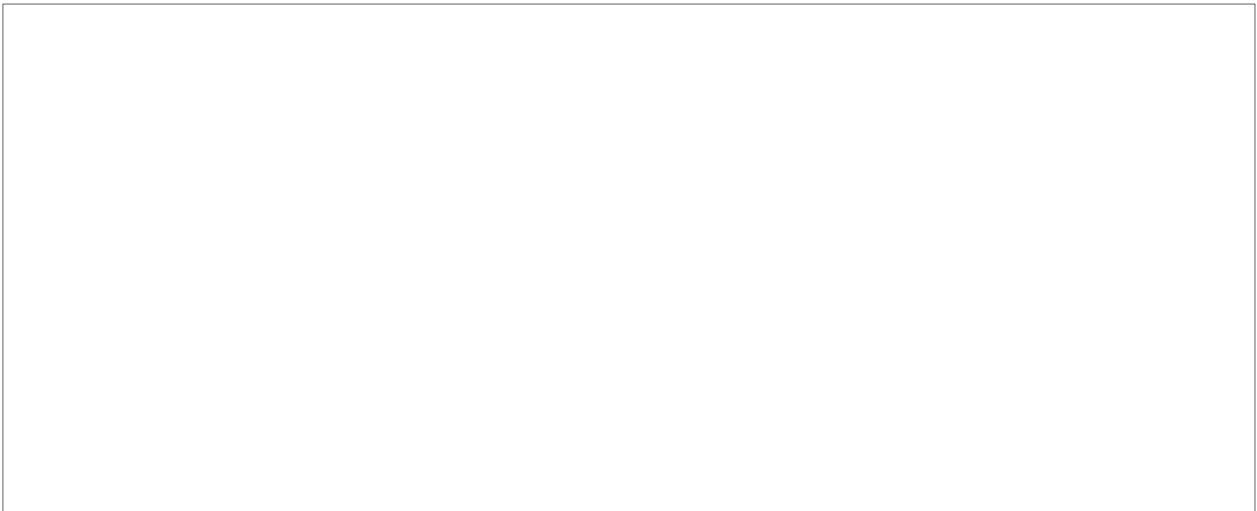
will prefer lending to East Germany, Bulgaria, and Czechoslovakia. Lenders are likely to keep a closer eye on Hungary, however, which many bankers fear has overborrowed, and remain cautious toward Romania. Debt-ridden Poland and Yugoslavia will remain shut out of the syndicated loan market.

25X1

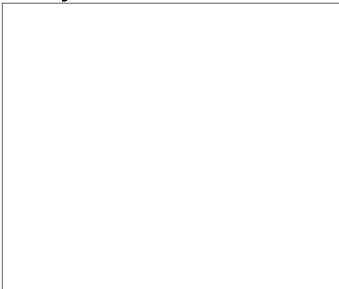
**National Developments**

*Developed Countries*

25X6



*Italian Wage Indexation System Reformed*



Italy adopted a new automatic wage indexation system on 1 January that, on average, will reduce workers' protection against inflation, although compensation for the lowest paid workers will rise. In contrast to the previous across-the-board indexation, the new two-tiered system indexes 100 percent of the first \$335 of monthly wages but only 25 percent of the remaining pay. In addition, wages will now be adjusted semiannually rather than quarterly. As a result, wages for the average worker will now automatically rise 0.5 percent for each percentage point increase in inflation, compared with 0.6 percent under the old system. Confindustria, the major business association, opposed the two-tiered system proposed by the unions, but welcomes the lower degree of automatic compensation because it will allow business to increase its use of incentive pay to encourage worker productivity. The unions accepted the lower automatic protection in the hope that it will increase their wage bargaining power in contract negotiations.

25X1

25X1

*Irish Fiscal Policy To Remain Tight*



Lower-than-anticipated tax revenues will force Dublin to maintain its tight fiscal policy in the 1986 budget due on 29 January. Last year's tax revenues were about \$122 million below target because of concessions on the value-added and excise taxes and higher-than-expected unemployment, which reduced income tax revenues. Last month, Prime Minister FitzGerald told the

25X1

Secret

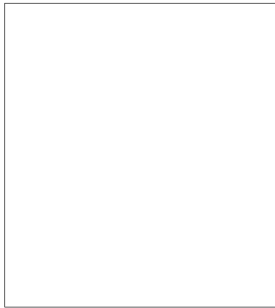
24 January 1986

Secret

legislature that the government now has little room to make tax cuts or raise public-sector pay and still reach its target of reducing the public-sector borrowing requirement to 11 percent of GNP by 1987—it was 15.7 percent of GNP in 1985. Despite its political benefits, the Prime Minister believes that a tax cut would only add to Ireland's large national debt, half of which is owed to foreigners. Although Dublin benefited from lower interest rates, total foreign borrowing continued to increase in 1985, and there is little hope for an improvement. FitzGerald plans to stick to his government's pledge of putting public finances in order by cutting spending. Dublin probably will not reach its spending targets, however, because the government is already expecting expenditures to be \$32 million above target, and the public-sector wage negotiations could push that figure higher. [redacted]

25X1

*Turkey's Defense Industry Fund*



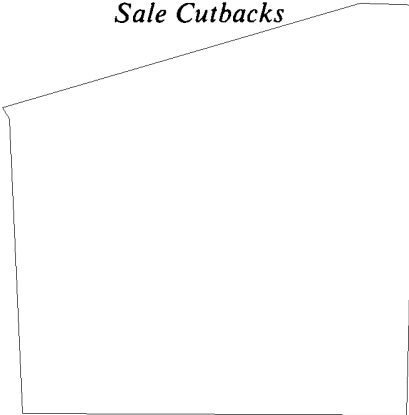
A new plant to manufacture 35-mm antiaircraft guns will be the first project financed from the recently established Defense Industry Fund. According to Turkish press reports, the plant will cost about \$66 million, with over 80 percent of the total provided by Swiss investors. Machinery for the plant will be imported from Sweden. The new fund is part of an ambitious effort by Turkey to develop a modern defense industry. Proposed by Prime Minister Ozal last fall and supported by special tax levies, the fund seeks to combine private enterprise, foreign capital, and government investment to finance armament production. The new program may eventually help ease the burden of foreign arms purchases but initially will require substantial foreign financial and technical assistance. Turkey will also continue asking the United States separately to contribute more to help develop Turkish defense industries. [redacted]

25X1

25X1

*Less Developed Countries*

*Argentine Grain Sale Cutbacks*



Flood damage to the 1986 wheat crop has forced Buenos Aires to cut back its grain exports, and Argentina's customers are responding by scaling back their purchases or reselling grain they had already bought. [redacted] the Soviet Union has discontinued talks with Argentina on further wheat purchases from the current crop. China reportedly sold back 150,000 metric tons of wheat to Argentina recently at a \$2.2 million profit. The US Embassy in Brasilia adds that Brazil has reduced the amount of wheat it plans to import under its bilateral agreement with Buenos Aires by 56 percent to 600,000 metric tons. These cutbacks should enable Buenos Aires to meet its domestic grain requirements while fulfilling remaining export commitments of about 1 million tons. The loss of at least \$500 million in export earnings, however, will complicate Argentina's efforts to pay interest on its \$50 billion foreign debt and will force further cutbacks in Buenos Aires's 1986 budget. [redacted]

25X1

25X1

25X1

25X1

*Syrian Pound Falls Further*

The Syrian Government's severe shortage of foreign exchange is starting to make itself felt on the offshore/black market for Syrian pounds. The offshore rate for the pound has fallen by 50 percent over the past year to 15 pounds to the dollar, despite the overall decline of the dollar. The Syrian Government


Secret

24 January 1986

Secret

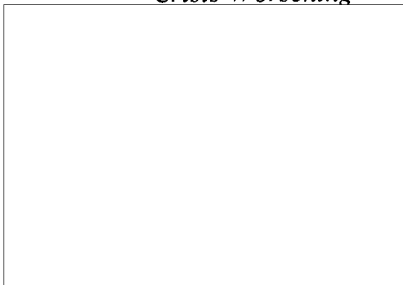


25X1


cannot supply even public-sector enterprises with foreign exchange, forcing both public and private companies to turn to the black market. While rumors of an official devaluation are rife, there are no indications that the government is willing to undertake the sizable devaluation that would be necessary to correct the situation. 

25X1

*Tanzanian Oil Crisis Worsening*

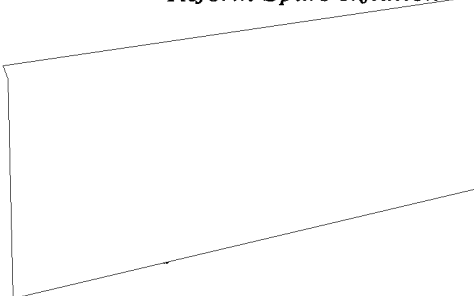


25X1


Tanzania's foreign exchange shortage has blocked government efforts to purchase crude oil on credit. Marcotrade, an independent commodity trading company that has been Tanzania's only oil supplier since September 1985, is holding up further deliveries pending total cash payment. Previous terms had allowed Tanzania to pay installments over a 90-day period for slightly higher than spot market prices. Marcotrade is following the example of other oil suppliers, including Angola and Iran, who now demand cash up front as a result of Tanzanian defaults. Tanzania last received a 30-day supply of crude oil in late November 1985 and is now experiencing long lines at gas stations, factory shutdowns, transportation halts, and acute food shortages in the capital. Dar es Salaam has yet to announce any economic recovery plan as infighting over allocation of meager foreign exchange resources and political fallout from the recent presidential succession continue to dominate the government's attention. 

25X1

*Zambian Economic Reform Spurs Inflation*

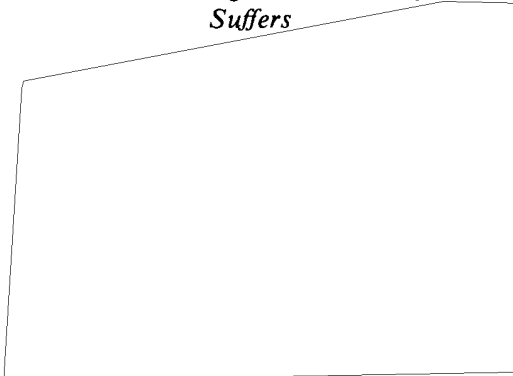


25X1

President Kaunda is pressing ahead with economic reform despite a doubling of inflation to almost 50 percent. Recent government data indicate that prices for gasoline, shoes, soap, and bread have more than doubled since last fall. Prices for cornmeal—the main food staple—have increased by one-half, the result of a sharp reduction in subsidies on corn last September and of a 62-percent currency devaluation since October. Although grumbling in the military has increased, Kaunda's strong public support for reform and an active campaign by party and government officials to garner grassroots acceptance appear to have defused most domestic reaction to the inflationary trend. Kaunda reiterated his commitment to reform in an 8 January news conference and endorsed new cost-cutting measures. 

25X1

*Ugandan Economy Suffers*



25X1

The seizure of power by General Okello in July has not stemmed the economic downturn that began under President Obote in 1984. Growth of agricultural output fell to an average annual rate of 3 percent in 1985/86 from 10 percent during the period 1982/84. According to US Embassy reporting, inflation jumped to 160 percent at an annual rate in late 1985, from a 30 percent annual rate during the first half of 1984. The increase was prompted by higher defense expenditures, a substantial rise in civil service wages in June 1984, and lower domestic production. Debt service now consumes about 70 percent of export earnings. In southwestern Uganda insurgents control about 50 percent of the coffee crop. Coffee accounts for almost all of Uganda's exports and is a principal source of government revenue. Despite the recent rise in coffee prices, substantial shortfalls in exports will further dampen economic activity,

Secret

24 January 1986

Secret

force expenditure cuts or inflationary borrowing, and aggravate the critical foreign exchange shortage. The government has devalued the shilling by about 67 percent since the coup and increased petroleum prices, but we believe that further adjustments, along with domestic reconciliation, will be required to stem economic decline. [redacted]

25X1

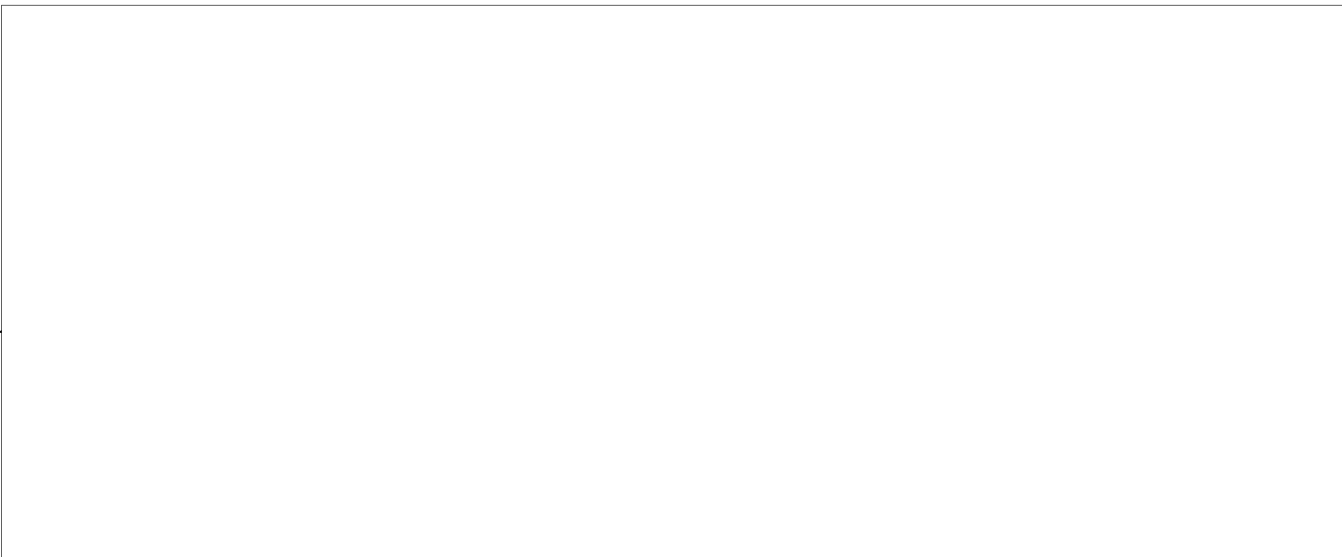
*Botswana Announces Trade Surplus*



Botswana recorded its first trade surplus last year, according to press reports. Exports totaled \$652 million, exceeding imports by \$185 million. Diamonds remain Botswana's largest export, contributing over 70 percent of total export earnings. Government officials expect an increase in both imports and exports in 1986, as a fifth consecutive year of drought forces Botswana to increase food imports, while a stronger diamond market improves export earnings. [redacted]

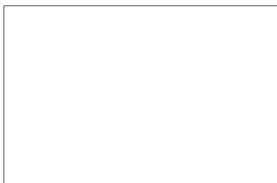
25X1

25X1



25X1

*Record Foreign Investment in South Korea*



South Korea approved \$532 million in foreign investment during 1985, surpassing the government's target by \$82 million. Seoul credited the rapid dismantling of barriers to direct foreign investment—part of a broader strategy to restructure its economy toward knowledge- and technology-intensive industries and to reduce South Korea's dependence on debt. Despite the record, economic policy makers are probably disappointed that only 30 percent went to the manufacturing sector—well below its 63-percent share in 1984. Foreign investors concentrated on the hotel and tourist services sector as part of a buildup for the 1988 Olympics. Since 1983, an ethnic Korean businessman residing in Japan has contributed over one-third of the \$1.2 billion invested from abroad by building hotels, including \$250 million last year for expansion of a Seoul hotel. Any concern over tepid foreign interest in manufacturing is probably tempered by the short-term boost to employment during the current economic slump from labor-intensive hotel construction projects. [redacted]

25X1

25X1

Secret

24 January 1986



Secret

*Taiwan To Export  
Automobiles*

In Taiwan's first entry into the world automobile market, Ford Liao Ho will assemble and export 30,000 cars per year to Canada beginning in July 1986. The car is based on the Mazda GLC. Initially, Taiwan will produce only 5 percent of the car's components—eventually increasing to 50 percent—with the remainder supplied by Mazda of Japan. Taiwan's ability to compete will depend in part on government willingness to supply adequate infrastructure and Taiwan's ability to overcome a reputation for producing substandard auto parts.

25X1

*Communist**Soviet Interest in  
Western Steelmaking  
Technology*

[redacted] Moscow currently is seeking Western assistance in producing high-quality parts for electric steelmaking furnaces. The expansion of a graphite electrode production plant in Turkmenistan is among the key industrial projects included in the Twelfth Five-Year Plan (1986-90). Discussions for the \$200 million turnkey facility—which will increase electrode production there 70,000 metric tons per year above the current 30,000 tons—are now being held with French, British, Italian, and West German firms. Although the companies contacted by the Soviets are technically knowledgeable about electric furnace steel production, they are not at the forefront of high-quality graphite technology. A prime consideration in awarding the contract will be the availability of foreign credits.

25X1

25X1

*Polish-Soviet Trade  
and Cooperation  
Problems*

Warsaw's failure to meet its export commitments to the USSR last year and its problems in fulfilling bilateral cooperation agreements were discussed at a recent Intergovernmental Commission meeting, according to Polish media. Delays in deliveries, particularly of coal, cement, rolled steel products, and machinery and equipment helped raised Poland's trade deficit with the USSR for the first nine months of 1985 to 845 million rubles, the highest level since 1981. In contrast, all other East European countries apparently reduced their deficits with the USSR last year or even ran surpluses. The Soviets and Poles at the meeting also criticized each other for low-quality, outmoded exports and for failing to achieve full cooperation between bilateral enterprises. Poland's performance demonstrates its dim prospects of achieving the 8- to 10-percent annual growth in exports implied in its trade agreement with the USSR covering 1986 through 1990.

25X1

25X1

Secret

24 January 1986



**Page Denied**

Next 1 Page(s) In Document Denied

**Secret**

**Secret**