



**Directorate of  
Intelligence**

~~Secret~~  
[Redacted Box]

25X1

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

25X1

**25 July 1986**

~~Secret~~

*DI IEEW 86-030  
25 July 1986*

*Copy* **832**

**Page Denied**

Secret

[Redacted]

25X1

**International  
Economic & Energy Weekly**

[Redacted]

25X1

25 July 1986

iii	Synopsis		
1	Perspective—South America's War on Inflation	[Redacted]	25X1 25X1
3	Argentina: Austral Plan Running Out of Steam	[Redacted]	25X1 25X1
7	Brazil: Uneven Progress Under the Cruzado Plan	[Redacted]	25X1 25X1
11	Near-Term Oil Price Outlook	[Redacted]	25X1
15	Kuwait-USSR: Expanding Economic Ties	[Redacted]	25X1
19	LDC Banking Systems: Impact of Liberalization	[Redacted]	25X1 25X1
23	Briefs	Energy International Finance International Trade Global and Regional Developments 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

DI IEEW 86-030  
25 July 1986



Secret

25X1

**International  
Economic & Energy Weekly**

25X1

**Synopsis**

1	<b>Perspective—South America's War on Inflation</b>	25X1
	The civilian governments of Argentina, Peru, Brazil, and Bolivia—perceiving that unabated price spirals in the three-to-five-digit range could be their downfall—have moved boldly to slash inflation in the past year. In our judgment, however, these gains will prove temporary unless greater attention is directed to eliminating the root causes of inflation and labor demands for wage increases are held in check in 1987.	25X1
3	<b>Argentina: Austral Plan Running Out of Steam</b>	25X1
	Argentina's year-old economic austerity program, the Austral Plan, has reined in chronic inflation and budget deficits, but President Alfonsin has largely failed to exploit this success to reduce the size and role of government in the economy and create a more favorable climate for private investment. We expect the economic gains from the program to dissipate over time and that Argentina's persistent payments problems and strained relations with international creditors will re-emerge.	25X1
7	<b>Brazil: Uneven Progress Under the Cruzado Plan</b>	25X1
	Brazil's five-month-old Cruzado Plan so far has checked the growth of inflation. While economic growth does not appear to have been hurt, the plan—because of growing skepticism about the government's willingness to curb its spending—has not dampened consumer spending, encouraged savings, or spurred investment, a sign that Brasilia has not yet succeeded in breaking inflationary expectations.	25X1
11	<b>Near-Term Oil Price Outlook</b>	25X1
	The oil market during the next six months will be characterized by substantial price volatility. We believe that oil prices will average between \$10 and \$15 per barrel, but we do not expect a smooth pattern.	25X1
15	<b>Kuwait-USSR: Expanding Economic Ties</b>	25X1
	Kuwait and the USSR have concluded an agreement that will strengthen bilateral ties and provide Moscow loans and access to state-of-the-art Western oil technology. If these projects are successful, Moscow probably will increase its use of commercial arrangements for political as well as economic gains with other Persian Gulf countries.	25X1

**Secret**

[Redacted]

25X1

19

**LDC Banking Systems: Impact of Liberalization** [Redacted]

25X1

The banking systems of some key LDCs are undergoing major changes as a result of debt-related reform programs and past bad management policies. LDC governments' efforts to liberalize their banking systems could complicate relations with international creditors if further bank failures are the result. [Redacted]

25X1

**Secret**

Secret

[Redacted]

25X1

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

25X1

25 July 1986

**Perspective**

***South America's War on Inflation*** [Redacted]

25X1

The civilian governments of Argentina, Peru, Brazil, and Bolivia—perceiving that unabated price spirals in the three-to-five digit range could be their downfall—have moved boldly to slash inflation in the past year. In the face of growing nationalistic sentiment and impatience with externally prescribed austerity, each developed “stabilization formulas” independent of the IMF, although Argentina and Bolivia subsequently concluded loan agreements with the Fund. These self-designed programs are slowing South American inflation dramatically from a 1985 average of 280 percent to a projected 50 to 60 percent this year. In our judgment, however, these gains will prove temporary unless greater attention is directed to eliminating the root causes of inflation and labor demands for wage increases are held in check in 1987. [Redacted]

25X1

The centerpieces of the stabilization strategies adopted by Argentina, Peru, and Brazil have been comprehensive and, ostensibly, temporary price and wage freezes. Argentina and Brazil supplemented these controls with some significant reforms, including issuance of new currencies and an end to indexation practices that perpetuated past inflation. Deindexation and the price and wage freezes were expected to break the psychological back of spiralling inflation, restore savings and investment incentives, and give governments time to address structural imbalances in their economies. For these three countries, stronger fiscal and monetary discipline has played a secondary role in their strategies. Only in the case of Bolivia did the government’s anti-inflation package closely resemble conventional IMF prescriptions. La Paz has made large reductions in government spending, substantially reduced the public-sector deficit as a percent of GNP, and stopped money creation. [Redacted]

25X1

All four programs have throttled inflation effectively, but the consequences have differed. In Bolivia, real wages and social programs have borne the brunt of the stabilization efforts although the Paz Estenssoro administration has not come under any immediate threat so far. In contrast, the price freezes in Argentina, Peru, and Brazil have come to represent a form of “tax” on the countries’ private-sector producers but led immediately to sharp cuts in monthly inflation rates, widespread popular support for the programs, and immense political gains for the administrations of Presidents Alfonsin, Garcia, and Sarney. [Redacted]

25X1

Secret

We believe the prospect for long-term success is clouded for all four stabilization programs, despite their differences. Bolivia—already impoverished—cannot sustain continued draconian measures without substantially increased foreign financial assistance. Moreover, the government will be hard pressed to withstand intense pressure from labor for large wage increases, traditionally a major determinant of inflation in Bolivia. In the other countries, the selective gains of the price freezes in the early months—not the least of which have been political—may obstruct the longer term economic prospects for success. In our judgment, Argentina and Peru are backing away from earlier plans to slash bloated public-sector spending and are maintaining the major parts of their freezes longer than initially indicated. The Brazilian Government, bent on getting its favored candidates elected to Congress in November, may be headed down the same path.

[redacted]

25X1

Excessive reliance on price freezes, we believe, will have self-defeating effects. Instead of providing incentives to save and invest, the controls—if maintained—will fuel ongoing consumer spending booms while prompting private investors to delay plant expansion until further government intentions become clearer. As a result, product shortages are likely to grow, black markets may develop, and inflationary pressures will mount. Already, in Argentina, Peru, and Brazil inflation rates are inching up as businesses find ways to circumvent government efforts to enforce price controls.

[redacted]

25X1

Before prices can be fully decontrolled, the governments of Argentina, Peru, and Brazil need to begin important structural adjustments such as slashing government subsidies, privatizing more state-owned corporations, and cutting government payrolls. The danger is that the government leaders in these three countries will continue to shirk tougher reforms and squander their opportunities to create the conditions for low inflation and high growth in the future. President Sarney's announcement this week of new measures to reinforce Brazil's fight against inflation falls short of redressing structural imbalances but does hold out some hope that Brasilia may be willing to take increasingly tough steps to ensure the program's longer term success. As for Bolivia, its government probably will be unable to withstand political opposition and pressure from labor for large wage hikes unless additional foreign financial assistance becomes available to lessen the social sacrifices required to make needed adjustments.

[redacted]

25X1

[redacted]

25X1

Secret



Secret

## Argentina: Austral Plan Running Out of Steam

25X1

Argentina's year-old economic austerity program, the Austral Plan, has reined in chronic inflation and budget deficits, but President Alfonsin has largely failed to exploit this success to reduce the size and role of government in the economy and create a more favorable climate for private investment. Although Alfonsin may tinker further with economic policy, we doubt he will carry out the radical restructuring needed to generate long-term growth. We therefore expect the economic gains from the program to dissipate over time, and that Argentina's persistent payments problems and strained relations with international creditors will reemerge. [redacted]

### Short-Term Success

The Austral Plan worked quickly to stabilize the economy. Its freeze of wages and prices, introduction of a new currency, and end to printing-press financing slashed monthly increases in the consumer price index from more than 25 percent during the first half of 1985 to 3 percent during the second half of the year. The government deficit as a share of GDP shrank, and real wages leveled off from their free-fall. Alfonsin's popularity as measured by public opinion polls soared. [redacted]

The economic program, which stole the public spotlight from labor unions and opposition parties demanding a moratorium on foreign debt payments, was also popular with the international financial community. The plan paved the way for a revised \$1.4 billion standby agreement with the IMF and \$4.2 billion in new lending from commercial banks. Buenos Aires liquidated its interest arrearages—many of which had been pending since 1982—and increased reserves by \$1.9 billion, according to US Embassy reporting. [redacted]

In addition, the program set the stage for short-term industrial improvement. Euphoria over price stability, combined with uncertainty over how long it would

last, increased demand for consumer durables. Manufacturing, steel production, and electricity consumption all rose significantly during the first quarter of 1986 over year-earlier levels, according to press reports. Help wanted ads indicate that demand for labor has risen sharply over the past year. [redacted]

25X1

### Disappointing Followthrough

Despite its initial promise, the Austral Plan has turned out to be largely an emergency measure to overcome hyperinflation and maintain political stability, rather than a well-conceived project to reform Argentina's economy. We believe that Alfonsin frittered away his political honeymoon following the plan's implementation, missing what the US Embassy has dubbed "an historic opportunity" to introduce structural reforms that could have spurred private investment and reduced Argentina's bloated public sector. The policy supplements that Buenos Aires has added to the Austral Plan in the last six months confirm our view that Alfonsin is resigned to making only incremental changes that will not reduce significantly the government's role in the economy. [redacted]

25X1

Alfonsin's recent initiative to privatize six large state-owned enterprises—a badly needed move in a country where the government controls over 350 companies and state activity accounts for one-half the GDP—is only a drop in the bucket. Moreover, few Argentine firms have sufficient capital to acquire these companies, and stiff nationalistic resistance is likely to hamper foreign purchasers. At the same time, Alfonsin announced a list of companies he would not privatize that includes the largest money losers. He has also created a ministry to oversee state enterprise activities and announced a hiring freeze in a bid to stem their losses. We doubt, however, that the President will be much more successful than his predecessors at increasing efficiency of the public concerns.

25X1

25X1

Secret

DI IEEW 86-030  
25 July 1986

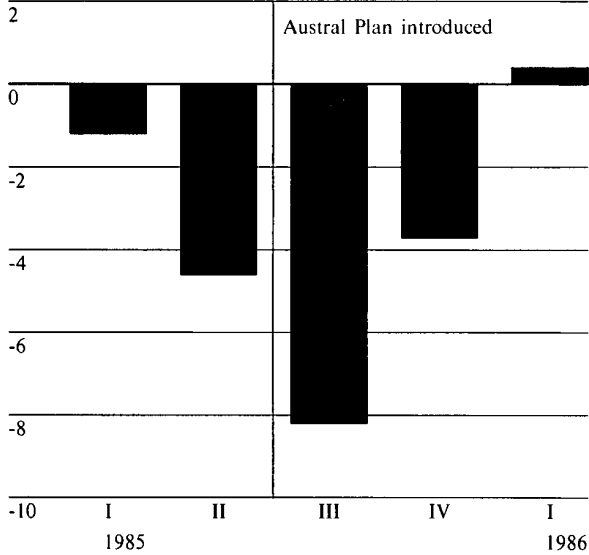
Secret

**Argentina: Economic Indicators, 1985-86**

Note scale change

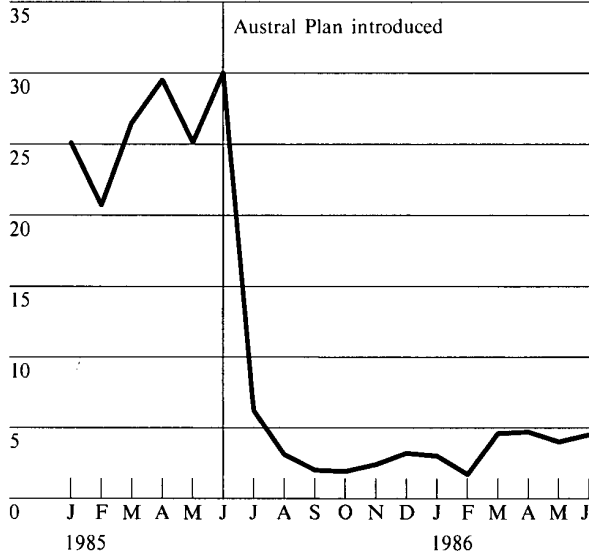
**GDP Growth<sup>a</sup>**

Percent



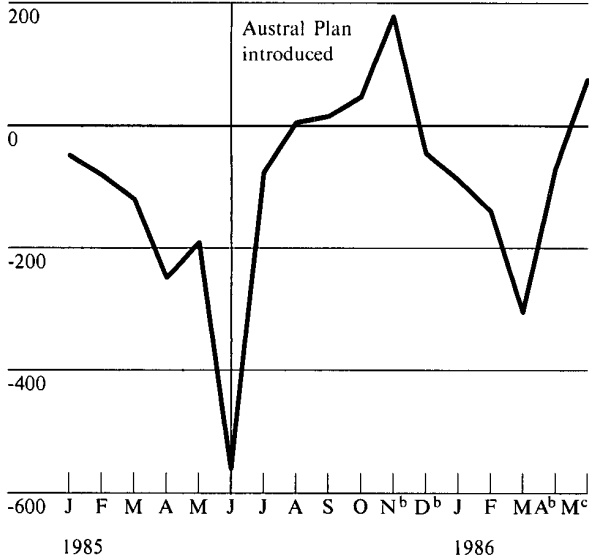
**Monthly Inflation**

Percent



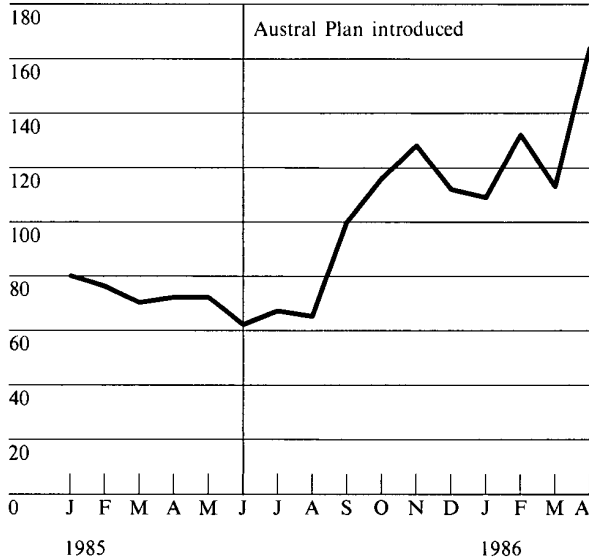
**Treasury Surplus Deficit**

Million Australes



**Demand for Labor**

Index: 1974=100



<sup>a</sup>Percent change from year-earlier levels.  
<sup>b</sup>Including collections from forced savings plan.

<sup>c</sup>Due to a strike at the Central Bank, some public employees' salaries were not paid on time. Had they been paid, a deficit of 200 million Australes would have resulted.

310007 7-86

25X1

Secret

Secret

He has already pledged to avoid the massive layoffs needed before profitability could be restored. [redacted]

refunded after five years—funnels surplus capital to the government and discourages foreign investors from making new commitments. Tight money policies have helped stem the flow of capital abroad, but the government has had little success inspiring Argentines to repatriate their capital. [redacted]

25X1

In the area of banking reform, Argentina lowered 100-percent reserve requirements and allowed banks to introduce a free-market interest rate. It then partially negated the effect by requiring banks to deposit the money freed by this measure in blocked accounts and to purchase Central Bank bonds yielding government-regulated rates of return with money deposited in “free” accounts. There was little attempt to improve the efficiency of the overstuffed and costly financial system, and credit remains expensive and scarce. [redacted]

In addition, Alfonsin is losing room to maneuver politically. Recent public opinion polls show that his popular support, while still high, is beginning to erode. Nationwide strikes—a 24-hour work stoppage last month was honored by 70 to 80 percent of the population in Buenos Aires, according to US Embassy reporting—underscore labor’s impatience to regain real wages lost before the program was implemented. Farmers, too, are becoming increasingly vocal; they recently struck for 48 hours to demand relief from low commodity prices and high export taxes. [redacted]

25X1

This spring Alfonsin replaced the wage and price freeze in force since June 1985 with an administered price system. The new scheme, however, is scarcely more market oriented than the freeze: it clamps maximum prices on 50 essential products and requires case-by-case approval of price hikes on other goods produced by medium- and large-sized firms. This system is already bogging down—a strike in the Commerce Ministry forced the government to set the most recent changes unilaterally. [redacted]

25X1

25X1

Buenos Aires has, for the time being, closed the gap between official and parallel market exchange rates, which will help make exports more competitive. Moreover, it obtained World Bank financing for a scheme to replace export taxes with a production-enhancing tax on land. We believe, however, that a new plan to promote industrial exports could backfire as it widens the bureaucracy’s discretion in awarding incentives and complicates the regulatory maze already confronting exporters. [redacted]

Meanwhile, Argentina’s international position remains precarious. Flooding in agricultural areas last fall contributed to a 20-percent drop in exports during the first three months of this year, the Embassy reports. Despite last year’s sizable debt rescheduling and the \$875 million the IMF and commercial banks disbursed last month, Buenos Aires is not meeting all of its current commitments. Argentina continues to unilaterally withhold payments on Paris Club debt due this year, and makes only sporadic payment on the rescheduled bilateral debt, according to a US government official. [redacted]

25X1

25X1

#### Outlook

#### Problems Reemerging

The bloom of Alfonsin’s initial success is already starting to fade. GDP growth during the first quarter was an unimpressive 0.4 percent. Inflation has begun to inch up over the past four months, and this year’s fiscal deficit will probably equal 6 percent of GDP—double the government’s initial projection. Investment continues to stagnate as a forced savings plan—essentially an additional tax that is supposed to be

Alfonsin may further refine the Austral Plan over the next year, but we judge that he is unlikely to announce an “Austral Plan II” centered around far-reaching fiscal and structural reforms. The President and his economic team believe their gradualist approach toward recovery is working. [redacted] Moreover, Buenos Aires’s economic decisions are molded primarily by politics, and it is likely that Alfonsin believes that radical adjustments are not politically feasible at this time. [redacted]

25X1

25X1

25X1

25X1

Secret

Secret

[Redacted]

25X1

Over the long run, however, the outlook is somewhat more hopeful. Alfonsin's turn toward free-market solutions such as privatization, wage increases based on productivity gains, and the promotion of foreign investment—all previously associated with the discredited military regime—is, in our view, helping to change the rhetoric of Argentine economic policy making for the better. Alfonsin has laid some of the groundwork that may enable a more secure civilian government to take bolder actions at a later date. The President's proposal to move the capital to Viedma—in the underdeveloped southern portion of the country—could be a politically acceptable way to cut the size of the government, as thousands of employees are expected to quit rather than move from Buenos Aires.

[Redacted]

25X1

Declining interest rates and a favorable reserve position have diminished short-term pressure on the debt front, although problems are likely to resurface next year.

[Redacted]

25X1

We believe Buenos Aires will eventually conclude a new IMF standby agreement, but will continue its pattern of falling in and out of compliance during the coming year. [Redacted]

25X1

[Redacted]

25X1

Secret

Secret

## Brazil: Uneven Progress Under the Cruzado Plan

25X1

Brazil's five-month-old Cruzado Plan so far has checked the growth of inflation. While economic growth does not appear to have been hurt, the plan—because of growing skepticism about the government's willingness to curb its spending—has not dampened consumer spending, encouraged savings, or spurred investment, a sign that Brasilia has not yet succeeded in breaking inflationary expectations. Because the plan is still very popular with the general public, Brasilia appears reluctant to make major adjustments to the program before the important November domestic elections. Although President Sarney announced new measures this week, they were little more than fine-tuning adjustments. Even so, if rosy economic forecasts for the remainder of this year hold up, Sarney will enter the November elections in strong shape. In order to prevent the unraveling of his Cruzado Plan next year, however, we believe the President will need to ease the controls soon after the elections and, at the same time, exercise tighter budget and monetary restraint.

### The Immediate Dividends

The Cruzado Plan has brought the Sarney administration good economic news. Deindexation—the elimination of automatic price adjustments to compensate for past inflation—and the comprehensive price freeze have for the time being broken the inflationary spiral. Since February, monthly consumer price increases have averaged less than 1 percent, a drastic reduction from the nearly 15-percent average in the months leading up to the plan. With lower prices and higher wages, consumer spending remains strong, at least temporarily removing the fear that the stabilization package will lead to a recession. The deceleration of inflation, according to an Embassy report, has also caused a sharp decline in interest rates, although nominal rates are still significantly above measured inflation, especially for consumer credit.

---

### The Cruzado Plan in a Nutshell

*Indexation of financial assets was eliminated, except for passbook savings accounts that will be corrected for inflation on a quarterly basis.*

25X1

*All prices were frozen for an indefinite period.*

25X1

*A new currency, the cruzado, replaced the cruzeiro. One cruzado equals 1,000 cruzeiros.*

25X1

*The dollar/cruzado exchange rate was fixed at 13.84 cruzados per dollar for an indefinite period.*

*Wages were increased 8 percent above their average value during October 1985–February 1986. The minimum wage was boosted one-third to 804 cruzados (\$58) per month.*

25X1

25X1

*Wages will remain frozen for a year or until cumulative inflation reaches 20 percent. Future cost-of-living adjustments will guarantee only 60 percent of past price increases, with the other 40 percent negotiable.*

25X1

25X1

*Rents and mortgage payments were frozen for a year.*

25X1

*A limited form of unemployment insurance was set up. Eligible workers will draw up to 1,206 cruzados per month (\$87) for up to four months.*

25X1

---

President Sarney has reaped substantial political benefit from his bold economic move. USIA polls indicate that his public approval rating—which stood at 35 percent before announcement of the plan—has reached an unprecedented 90

25X1

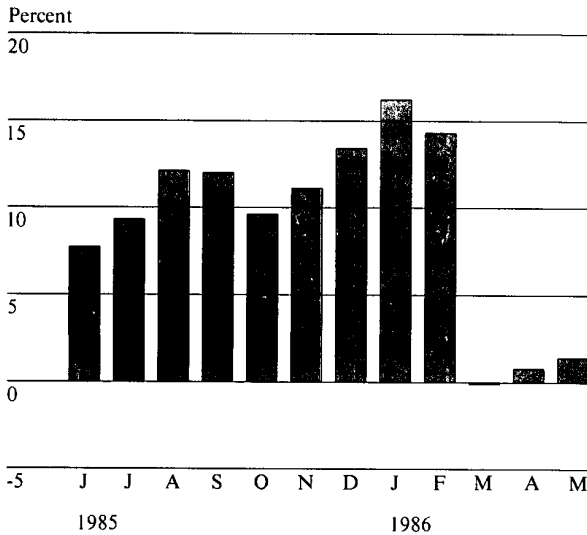
25X1

Secret

DI IEEW 86-030  
25 July 1986

Secret

**Brazil: Monthly Consumer Price Inflation, 1985-86**



310008 7-86

percent. According to the polls, most Brazilians believe they have benefited from the plan; the price freeze has been hailed by middle-class consumers, and wage earners have benefited from the 8-percent boost in real wages. Moreover, press reports indicate that the wage freeze is supported by most businessmen, although the hurried imposition of price controls has drawn their ire. [redacted]

The program has also set in motion some market-oriented reforms necessary to strengthen Brazil's economy. The US Embassy reports the domestic banking system was quick to recognize that deindexation would mean the end of huge profits from investing in indexed securities. Banks are streamlining their operations through layoffs and branch closures, and the government has enacted legislation to allow them to charge fees for various services. Moreover, stock prices surged as Sao Paulo's market index rose nearly 85 percent during March and April. Government officials are publicly expressing confidence that the stock market will become a source of equity capital for Brazil's heavily indebted private sector. [redacted]

**Problems Beneath the Surface**

We believe that the decision to proceed with the Cruzado Plan was predicated on Brasilia's conviction that inflationary expectations had become so ingrained as to constitute a major impediment to continued high levels of growth and that shock treatment was necessary. Stable prices were expected to stop consumers from hedge buying and increase incentives to save. The architects of the plan also hoped that the drastic reduction in inflation would spur badly needed investment in additional capacity. [redacted]

To date, however, neither consumers nor businessmen have reacted to the plan as expected. The US Embassy reports that consumers went on a spending spree, with retail sales increasing more than 40 percent during the first three months of the plan. Much of the spending, however, was fueled by drawdowns of saving accounts. Consequently, passbook savings—a key financial instrument for capital formation in Brazil—sharply declined from March through May. [redacted]

Meanwhile, new business investment continues to be sluggish while overall capacity utilization is about 80 percent, according to the US Consulate in Sao Paulo. Various investor surveys report most businessmen are still inhibited from sinking money into plant expansion because profits have been cut by the price freeze and because of uncertainty about future removal of price controls. Instead of investing in additional capacity, [redacted] businessmen are diverting production into more lucrative export markets. [redacted]

In addition, a recent wave of wildcat strikes in Sao Paulo's important industrial park indicates that labor support for the Cruzado Plan is faltering. Nearly 50,000 workers in more than 40 businesses are now on the picket lines demanding higher wages, according to the US Consulate in Sao Paulo. [redacted]

This behavior on the part of consumers, businessmen, and labor indicates to us that the Cruzado Plan has done little to dampen the psychology of inflation.

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

Secret

Secret

Indeed, reporting in Brazil's financial press indicates that investment in real estate and demand for dollars on the unofficial market—both traditional barometers of inflationary expectations—have increased rather than declined since 1 March. Moreover, the combination of rising demand and capacity constraints is causing the economy to begin to overheat, as evidenced by recent spot shortages of a wide range of goods. Although the government is encouraging imports to fill supply gaps, we believe the persistence of shortages could introduce serious distortions, such as black markets and hoarding. [redacted]

A significant part of the problem, in our view, is that Brasilia has not followed through on its pledges to curb its own spending habits. Soon after implementing the package, government officials contended that the real public-sector deficit would drop to only 0.5 percent of GDP this year, from last year's 3.2 percent, on the strength of increased taxes legislated last December. In contrast, large deficits registered during the first two months of the plan have led officials to admit that this year's deficit is likely to match last year's. According to the press, the government has introduced a subsidy to ensure ample supplies of milk and has granted tax breaks to some industries hit hard by the freeze—measures that enlarge the deficit. [redacted]

The government's monetary management is more difficult to gauge. Despite reforms earlier in the year designed to break the rapid rise in the money supply, official statistics indicate that the monetary base has increased by more than 90 percent since March. The government argues that this has not been inflationary because velocity has dropped dramatically; this is probably true, as consumers are now more willing to hold currency, but no data are available to confirm this. The US Embassy suggests that rapid expansion of the monetary base is slowing, as the economy adjusts to lower prices. [redacted]

These signs of trouble have not been lost on Brazilian economists such as former Planning Minister Delfim Netto and former Finance Minister Henrique Simonsen, who are expressing doubts in the press about the viability of the program. Although they agree that deindexation is an important first step, they argue

that the price freeze is not sustainable over a long period. Moreover, these economists contend that the public deficit will need to be controlled in order to prevent inflationary pressures from resurging. In Addition, many experts are questioning the wisdom of the fixed exchange rate and are urging the government to return to a policy of minidevaluations. Others advise more import liberalization and reform of the domestic capital market. [redacted]

25X1

### The Government's Reaction

25X1

Brasilia has been making economic adjustments in an effort to keep the program from faltering. In an attempt to prevent overheating, the administration recently tightened consumer credit terms. The National Monetary Council enacted measures to make savings accounts more attractive, and, in June, deposits exceeded withdrawals for the first time since February. Measures to cool stock market speculation were implemented in late April, but new issues and prices in May and June were still higher than before deindexation. The government is considering legislation that would limit use of the parallel market in foreign exchange, according to the US Embassy. To enhance monetary control, Brasilia also has limited lending by state-owned banks. [redacted]

25X1

While such measures are important, the government recognized they would not be enough, and, accordingly, unveiled new measures this week to shore up the Cruzado Plan. According to press reports, Brasilia took actions designed to dampen demand, encourage savings, and stimulate investment. These include:

25X1

- Excise taxes ranging from 25 to 30 percent on automobiles, fuel, foreign travel, and on the purchase of dollars.
- Creation of a fund to stimulate investment to be capitalized by the tax revenues.
- Easing of restrictions on foreign investment. [redacted]

25X1

25X1

The new measures probably will cool off the overheating economy and may help to promote some investment. However, President Sarney continues to avoid

Secret

Secret

making major adjustments to the plan—a course he is likely to continue through the gubernatorial and congressional elections set for November. He will probably be particularly loath to ease the price freeze because of its immense popularity, according to the US Embassy. Likewise, deep spending reductions would be politically difficult in an election year. Consequently, we believe the government probably will continue to respond with fine-tuning adjustments.

[redacted]

25X1

**Near-Term Outlook**

These relatively minor adjustments should be sufficient, in our view, to drop inflation from the 235-percent level recorded in 1985 to about 70 percent this year. We further anticipate that strong consumer demand will lead to an economic growth rate of 5 percent this year and will forestall major discontent with the program through the end of this year. Against this backdrop, we believe that moderates will make gains in the congressional elections and leftists will be kept in check. [redacted]

25X1

At the same time, however, we believe Sarney will have to move fairly soon after the elections to address fundamental problems that, if not dealt with, could lead to the ultimate unravelling of the Cruzado Plan. To prevent shortages and to stimulate investment, we believe Sarney will need to ease price controls quickly. In addition, he will have to implement tighter fiscal and monetary policies to prevent a resurgence of inflation as the controls are loosened. The key indicators of Sarney's resolve to tackle these problems will be his willingness to implement measures to reduce government subsidies, privatize state-owned enterprises, cut government payrolls, and avoid financing the public deficit by increasing the money supply.

[redacted]

25X1

[redacted]

25X1

Secret



Secret

**Near-Term Oil Price Outlook** 

25X1

The oil market during the next six months will be characterized by substantial price volatility. The interaction of several variables—seasonal swings in oil demand, inventory behavior, producer intentions, and market psychology—will determine the extent of price fluctuations. We believe that oil prices will average between \$10 and \$15 per barrel, but we do not expect a smooth pattern. Indeed, prices could plunge well below \$10 per barrel followed by quick turnarounds. Under no circumstances do we anticipate that prices will rise above \$15 per barrel unless the Saudis decide to drastically change course. At this time there are no signs that Saudi Arabia is prepared to pare production.

**Recent Developments**

OPEC production in June—including natural gas liquids—averaged nearly 20 million b/d, some 3 million b/d above average 1985 levels. Nearly all the gain reflects increased Saudi output, which is now hovering around 6 million b/d. The only offset to Saudi gains has been a 500,000 b/d to 1 million b/d decline in non-OPEC output due in large part to marketing problems. On the consumption side, we estimate non-Communist oil usage during first half 1986 was about 500,000 b/d above last year's levels, less than some oil companies had expected. Delays in passing on lower crude costs combined with sluggish economic growth is for the most part responsible for the modest rebound in oil use.

OPEC has met four times so far this year to try to resolve its differences over the production-sharing issue. In the wake of OPEC's latest stalemate last month, spot prices have fallen sharply and are hovering near \$10 per barrel—the lowest level in 13 years. We estimate the world average oil price was \$12 per barrel last week, compared with \$27 per barrel last year. Spot prices have become extremely volatile—often fluctuating by as much as \$5 within a few weeks.

**Price Determinants**

Key determinants of price behavior over the next six months will be consumption patterns, inventory behavior, non-Saudi supplies, and Saudi oil production policy.

25X1

**Consumption.** The consensus view among forecasters looks for non-Communist oil consumption to increase at an annual rate of about 2 to 3 percent during the last half of the year. Almost all of the increase in demand will come from OECD countries, principally the United States. This assumes OECD real GNP growth of about 2 to 3 percent above year-earlier levels, roughly what the major forecasting organizations now expect. Oil consumption under these circumstances will approximate 45 million b/d during the third quarter and somewhat over 47 million b/d in the winter heating season. In general this forecast is consistent with prices in the \$10 to \$12 range. It could prove optimistic, however, if economic activity in the industrialized countries falters.

25X1

25X1

**Inventory Overhang.** Under normal circumstances we would expect a seasonal inventory drawdown in the fourth quarter of less than 1 million b/d. It could prove much larger this time, however, because of the large inventory overhang accumulated in recent months. This unusually high stock accumulation was driven largely by buyers' expectations that prices would rise later this year to the \$18-per-barrel level. This is unlikely to happen—the market is rapidly coming to recognize that prices will not rise to that level—and buyers may now decide that inventories are in fact far too high and accelerate the destocking that normally occurs. If this process happens too rapidly it would contribute to price volatility. Indeed, the high inventory accumulation that occurred in recent months probably prevented prices from falling even further than they have.

25X1

25X1

25X1

Secret

DI IEEW 86-030  
25 July 1986

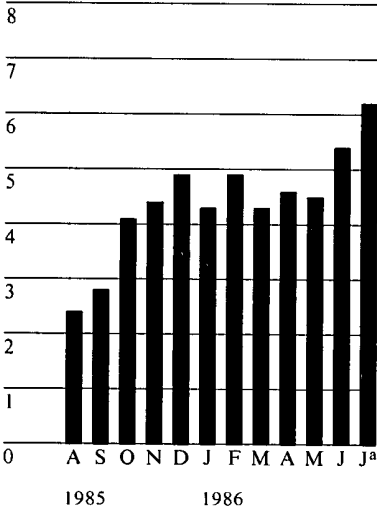
Secret

**Saudi Oil Production, 1985-86**

Note scale change

Volume Increases . . .

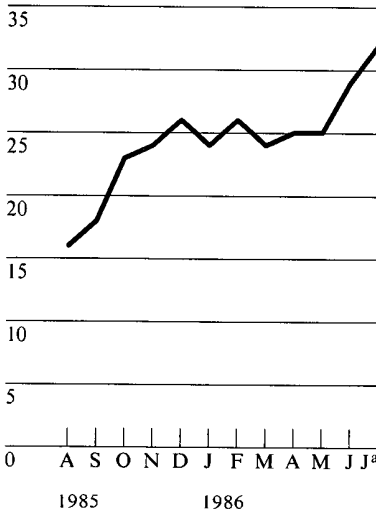
Million barrels per day



<sup>a</sup> Estimated.

. . . Dominating OPEC Output . . .  
(Saudi Share of OPEC Total)

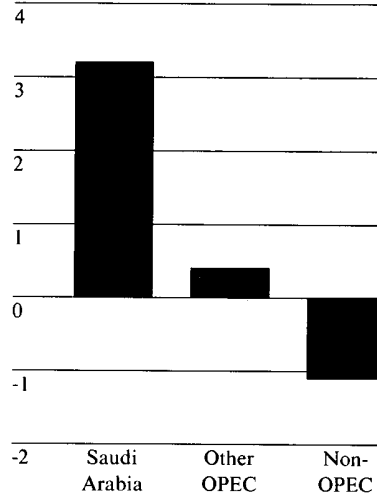
Percent



. . . And Crowding Out Non-OPEC Output

(Change in Volume: August 1985 - June 1986)

Million barrels per day



310009 7-86

25X1

**Non-Saudi Supply.** Although non-OPEC producers lost market share early this year, most have become more competitive in an attempt to recapture market share. Consequently, we expect their output to rebound by several hundred thousand b/d during the rest of the year, although some high-cost production in the United States and Canada is unlikely to come back on stream:

- Mexican liftings, down substantially in the first half, have rebounded to about 2.8 million b/d and could remain at these levels through yearend.

[Redacted]

- Production increases—expected prior to the price plunge—in Colombia, Brazil, Syria, and Angola are still likely.
- Net Communist exports have been increasing steadily since March and are expected to continue at least at current levels for the next several months.

[Redacted]

OPEC countries other than Saudi Arabia will want to produce about 14 million b/d, in our view. Financial pressures will prevent OPEC's poorer members—Nigeria, Indonesia, and Venezuela—from reducing output substantially. Indeed, Venezuela's state oil

25X1

25X1

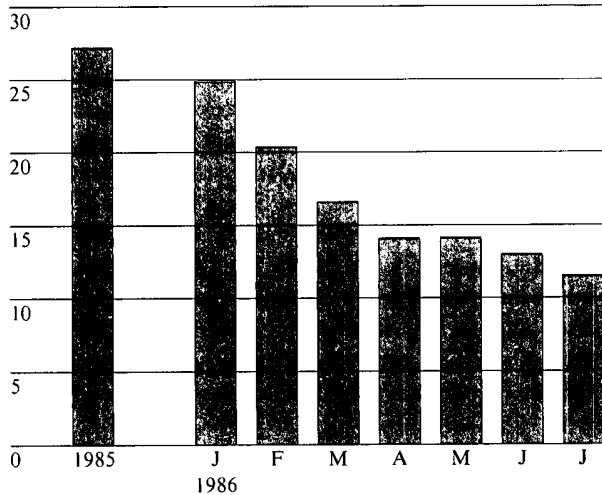
Secret

Secret

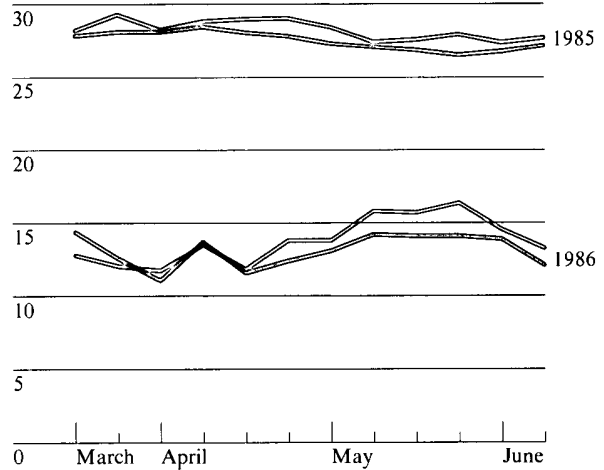
**Oil Market Prices, 1985-86**

\$ per barrel

**Oil Prices Plummet . . .**  
(Average World Price)



**. . . And Are More Volatile**  
(Spot Prices)



— West Texas Intermediate  
— North Sea Brent

310010 7-86

25X1

**Non-Communist Oil Supply and Demand Balance**

Million b/d

	1985					1986				
	I	II	III	IV	Year	I	II	III <sup>a</sup>	IV <sup>a</sup>	Year <sup>a</sup>
<b>Total consumption<sup>b</sup></b>	<b>46.6</b>	<b>43.3</b>	<b>43.6</b>	<b>45.9</b>	<b>44.9</b>	<b>46.7</b>	<b>44.2</b>	<b>45.3</b>	<b>47.4</b>	<b>45.9</b>
Inventory change	-2.6	0.2	-0.2	0.7	-0.6	-1.0	1.7	0.7	-1.0	0.1
Total supply	44.0	43.5	43.4	46.6	44.3	45.7	45.9	46.1	46.4	46.0
Non-OPEC	26.3	26.8	27.3	27.6	27.0	26.7	26.2	26.4	26.5	26.5
OPEC	17.7	16.7	16.1	19.0	17.3	19.0	19.7	19.7	19.9	19.5

<sup>a</sup> These figures are projections based on assumed trends in OPEC and non-OPEC production and an average price of about \$10 per barrel.

<sup>b</sup> Excludes refinery gains and includes natural gas liquids.

310010 7-86

25X1

Secret

Secret

**OPEC and Non-OPEC:  
An Unlikely Partnership**

*In the wake of the recent price collapse, we cannot rule out that nonmembers might join OPEC in an international production-sharing pact to stabilize the market. Norway's new government, for example, recently met with an OPEC minister and indicated it might be willing to support higher prices by limiting future increases in output.* [redacted]

*Recent trends suggest, however, that any such coalition will be shrouded in distrust and guided by a "you first" principle. The non-OPEC oil producers that have expressed a possible willingness to cooperate this year—Oman, Egypt, Mexico, Malaysia, Brunei, Angola, and China—have said that any cutbacks are contingent upon a new OPEC output ceiling substantially below current production levels. Moreover, the cutbacks they have suggested are less than the amount already reduced because of lost market share in earlier rounds of the price war.* [redacted]

*In our view, attempts to maintain a long standing agreement between OPEC and nonmembers probably would be thwarted. The wide divergence in interests among all oil producers probably would lead to the same kind of violations that currently plague OPEC and would work to undermine an international production-sharing pact. For example, the major non-OPEC exporters—the United Kingdom, Norway, and Canada—are industrialized nations with larger, more diversified economies and are less dependent than OPEC on oil for revenue. In addition, non-OPEC LDCs striving for energy self-sufficiency are unlikely to join in an effort that would dampen their production prospects.* [redacted]

company recently announced intentions to boost oil exports over the course of the year by about 200,000 b/d. Even wealthier OPEC states have suffered from the lower oil prices, and countries like the UAE, Kuwait, and Qatar appear adamant to keep oil exports at a high level. [redacted]

25X1

**Saudi Oil Production Policy.** Saudi Arabia will play the key role in determining market conditions over the balance of 1986. The Saudis now hold about 15 percent of the world oil market—about 6 million b/d. If Riyadh is determined to maintain this share of the market and demand fails to grow as market analysts are forecasting—either because of excessive destocking or slow economic growth—prices could drop well below the \$10 per barrel level and stay there until other producers back out. The Saudi dilemma is that at \$10 per barrel Riyadh's oil revenues approximate \$18 billion annually, below the level Saudi Arabia earned last year. Even if Riyadh adjusted its present stance and decided to shave output to bolster prices it may not work. Specifically, Riyadh has no guarantee that other producers would not replace Saudi supplies. [redacted]

25X1

25X1

25X1

We continue to believe that Riyadh would like to see prices stabilize, at least for a while, at around the \$15-per-barrel level. At this price we believe that the Saudis would be comfortable with a production level of about 4.5 million b/d—enough to generate a revenue flow of roughly \$20 billion. The 4.5-million-b/d level would also assure Riyadh's position as the world's largest oil exporter, a goal we believe was important to Riyadh when it initiated the market share fight last August. We doubt, however, that the Saudis will substantially reduce production to achieve the \$15-per-barrel price level unless they are reasonably certain that others will not simply increase their market share at Saudi expense. The major risk Saudi Arabia runs may be the danger of retaliation from Iran if Riyadh is unyielding on the production front. Tehran is pushing for higher prices and, if diplomatic pressures fail to convince Riyadh to stabilize prices, we are concerned that Iran may increase pressure on Saudi Arabia. [redacted]

25X1

25X1

[redacted]

25X1

Secret

**Kuwait-USSR:  
Expanding Economic Ties** [redacted]

25X1

Kuwait and the USSR have concluded an agreement that will strengthen bilateral ties and provide Moscow loans and access to state-of-the-art Western oil technology. The agreement, signed during the visit last week of a high-level Soviet delegation to Kuwait, is aimed at expanding economic cooperation, particularly in oil-sector development, investment, and finance. Kuwait also will participate in highly visible joint development projects with the USSR in third countries, particularly Arab states. If these projects are successful, Moscow probably will increase its use of commercial arrangements for political as well as economic gains with other Persian Gulf countries.

[redacted]

Konstantin Katushev, Chairman of the Soviet State Committee for Foreign Economic Relations, who plays a key role in Soviet economic policy formulation as well as in arms transfers negotiations, according to the US Embassy in Moscow. The parties agreed to pursue economic development projects valued at \$1 billion in Kuwait and the USSR, and to begin studies of joint ventures in Iraq, Greece, and Morocco. [redacted]

25X1

Kuwait and Moscow also agreed to cooperate on financial matters. Press reporting indicates Kuwait extended a \$150 million loan to Moscow, and the Soviets offered to allow Kuwaiti banks to purchase Soviet treasury bonds. After discussing Kuwaiti defense needs with Defense Minister Salim al-Ahmad, Katushev declared Soviet willingness to accept oil in payment for Soviet exports, according to press reports.

25X1

**Terms of Agreement**

The recent Kuwaiti-Soviet meeting in Kuwait was a followup to a meeting held last February in Moscow, in which the two countries discussed a broad range of issues and signed a memorandum of agreement that listed proposed areas of cooperation. [redacted]

[redacted]

25X1

[redacted] these included:

- Construction of oil and other facilities in Kuwait.
- Construction of oil, natural gas, and petrochemical facilities in the USSR, with Kuwait providing loans and technology.
- Cooperation in construction of energy and economic development projects in third countries, especially Arab nations.

**Santa Fe: The Western Connection**

25X1  
25X1

Moscow's conclusion of the agreement with the Kuwaitis appears partly motivated by its interest in obtaining Western oil technology through Kuwait's Santa Fe Corporation. According to press reports, Santa Fe—the largest employer of Americans in Kuwait—will play a major role in the proposed projects in the USSR. Moscow has expressed interest in Santa Fe's technology on oil refining, exploration—particularly in coastal areas in the USSR—and increasing the productivity of oil wells. Kuwait has also agreed to allow Santa Fe to explore for oil in South Yemen, according to the US Embassy in Kuwait.

25X1

[redacted]

- Development of ties between Soviet and Kuwaiti financial institutions.

In addition, Kuwaiti press reports speculated that the parties discussed bartering oil for weapons, but Kuwaiti officials denied these rumors. [redacted]

25X1

At last week's meeting in Kuwait, the parties agreed to implement some of the proposals discussed at the earlier meeting. The Soviet delegation was led by

The US Embassy in Kuwait reports that Kuwaiti officials are aware of the possibility of US export controls, and have equivocated about Santa Fe's

25X1

Secret

**The Many Skills of Santa Fe**

*Kuwait's efforts to build a world-class international oil industry took a major step when it purchased the US-based Santa Fe International Corporation for \$2.5 billion in 1981. At the time of purchase, the company employed 14,000 people and had reserves of \$1.2 billion. The company is split into four divisions:*

- **Santa Fe Drilling Company.** *One of the world's largest and foremost contract drilling operators. At the time of purchase it had about 85 rigs engaged in offshore and onshore operations in 16 countries, including several in the Middle East.*
- **Santa Fe Minerals, Inc.** *An exploration and production group set up in 1969. It is active in the United States and in the UK North Sea with a share in Thistle oilfield production. It also is involved in exploration work in the South China Sea.*
- **C. F. Braun.** *An engineering firm with an impressive list of work worldwide. This division designs, engineers, and constructs petroleum refineries, chemical and petrochemical plants, and power plants. It also has the available expertise to construct synthetic fuel plants.*
- **Santa Fe Engineering and Construction.** *This division is involved in marine construction, underwater services, and specialized shaft drilling for construction and mining industries.*

participation.



**Something for Everyone**

Both Kuwait and the USSR stand to benefit from the agreement, which probably will be more extensive than initial reports indicated. Access to Western

technology could enhance the Soviets' oil-processing capabilities. Moreover, the equipment comes cheaply to the Soviets, who may use the Kuwaiti loan to finance the purchase. While the Soviets would like to increase their oil exploration capabilities within the USSR, acquisition of the advanced technology could be used to improve their relatively poor oil exploration record in other countries. [redacted]

25X1

The composition of Moscow's delegation to last week's meeting is an indication of the significance the Soviets attach to their relationship with Kuwait and of their awareness that this agreement could allow them political rewards at little cost. Using Kuwaiti financing and technology, Moscow will participate in Kuwaiti development projects in third countries, which may make the Soviet presence appear less threatening. The Soviets probably hope that offering development assistance and high-quality technology will enhance their image in Arab and Third World countries and provide them political entree. [redacted]

25X1

The Kuwaitis, whose motivations appear primarily political, also will gain from the partnership. Since the US freeze of Libyan assets, the Kuwaiti Government has been under domestic pressure to reduce its investments in the United States. The well-publicized agreement with the Soviets will relieve some of this pressure and burnish Kuwait's nonaligned credentials. In addition, the superpower attention plays well in Kuwait. [redacted]

25X1

The Kuwaitis have become increasingly alarmed over the last six months about the possibility of an Iranian victory over Iraq. Although they believe that they can ultimately rely on the United States, the Kuwaitis probably hope to increase Moscow's investment in Kuwaiti security. The Kuwaitis also may be able to negotiate an arms deal with the Soviets on favorable terms. [redacted]

25X1

25X1

25X1

The economic benefits to the Kuwaitis are less significant. The returns from the proposed joint ventures, loans, and projects in the USSR, by themselves, are an insufficient incentive to pursue the deals. Still, the projects enable the Kuwaitis to keep their engineering

Secret

Secret

company operating in a period of slack construction, which will reduce earlier recriminations about the purchase of Santa Fe and its financial well being.

[redacted]

25X1

**Implications for the United States**

If the proposed agreement proves fruitful, the Soviets may be emboldened to seek similar arrangements with other Persian Gulf countries. The Soviets established diplomatic relations last year with Oman and the UAE, although these ties are developing quite slowly. It is not the policy of the other Gulf countries—as it is Kuwait's—to seek balanced relations with the superpowers, but they might be willing to respond favorably to overtures from the Soviets. Even so, the immediate political gains for Moscow would be minimal, and probably would not be commensurate with the commercial benefits. If Moscow proceeds slowly and cautiously in cultivating a long-term relationship with the Gulf states, including arms deals and security guarantees, US security ties to some Gulf states would be jeopardized. As Kuwait has done, the Gulf states would try to play the superpowers against one another to maximize their economic and political investments. [redacted]

25X1

[redacted]

25X1

Secret





Secret

## LDC Banking Systems: Impact of Liberalization

25X1

The banking systems of some key LDCs are undergoing major changes as a result of debt-related reform programs and past bad management policies. Despite domestic political pressure on governments to support failing banks, a number of institutions may be allowed to go under as a result of changes in LDC financial systems. Disagreements, however, over how to handle the debts that failed banks have outstanding to international creditors threaten to make debt restructuring negotiations more difficult. [ ]

removed indexation and drastically reduced the record profits earned by Brazilian banks. The inefficiencies, previously hidden by high real interest rates and indexation before 1986, are forcing the banking system to cut back on personnel and to charge for services that previously have been free. Embassy reporting suggests that, despite these cost-cutting measures, many banks continue to experience liquidity problems and that further bankruptcies are being avoided only by government-approved accounting methods that allow banks to ignore overdue debts from state-owned enterprises. [ ]

25X1

25X1

### Roots of the Problem

Third World banking systems historically have lagged behind the development of Third World economies. Most systems are comprised of highly inefficient state-owned institutions with officers who often lack the training necessary, or the willingness, to assess risks in a competitive loan market. These problems have been exacerbated by: forced low-interest loans to dying, yet still favored, industries; government-directed takeovers of poorly run firms; and government-approved accounting practices that overlook nonperforming assets. As both government spending and private-sector investment have fallen off, many LDC domestic banks have been left with the burden of managing large accumulations of bad debt. [ ]

Until 1985, these types of problems were solved by merging weak institutions with stronger firms and then having the government step in to stabilize the newly formed company and resolve its outstanding debts. President Sarney's government, however, has discontinued these types of bailouts. When three private Brazilian banks—Comind, Auxiliar, and Maissonave—failed last year, the government liquidated the banks and denied responsibility for the obligations of the three banks to foreign creditors. The government's position became a major obstacle in negotiations to reschedule \$31 billion in Brazilian commercial debt and trade credits, although a compromise settlement appears to be imminent. The current upheaval caused by the Cruzado Plan probably will cause a few more banks to close, but, if Brasilia's anti-inflation package is successful, other financial institutions should emerge in better shape. [ ]

25X1

25X1

### Case Studies

Three countries—Brazil, South Korea, and the Philippines—are illustrative of the problems and vulnerabilities of LDC banking systems. [ ]

In *South Korea*, the financial press has warned that there are billions of dollars of bad loans—accumulated through government-directed policy loans to favored industries—that render the Korean banking system technically insolvent. Most of these loans are long-term, low-interest government credits to South

25X1

The *Brazilian* banking system, one of the more sophisticated financial systems in Latin America, is now suffering the results of attempts at liberalization begun last year as well as recent monetary reform. The Cruzado Plan, implemented in March 1986, has

Secret

DI IEEW 86-030  
25 July 1986

Secret

Korea's huge shipbuilding and construction conglomerates. Such government support of these companies helped backstop the economic prosperity of the 1970s. These firms now are suffering the effects of a slump in the construction and shipbuilding industries, and the burden is being shouldered by Korean banks and the government, according to US Embassy reporting. For example, when the Kukje conglomerate, the country's sixth largest, went bankrupt last year, the government—faced with the prospect of letting Kukje's creditor banks fail—stepped in to guarantee all outstanding debts. Such support for domestic banks, however, has put a sizable strain on the national budget, and the economy would not easily sustain the failure of either a major bank or another major conglomerate. As a result, we believe Korean officials, under renewed pressure to protect domestic banks for local interests and nationalistic pride, may have to scale back their reform schedule. [redacted]

While the *Philippines'* financial system as a whole is in a stronger position than in 1984, there are some banks that remain vulnerable. A few of the largest commercial banks were able to show hefty profits last year, but a greater number of small commercial banks are still suffering from a liquidity crisis that began in 1984, according to press reports. Those private banks that have survived did so by maintaining a high degree of liquidity and channeling money into high-interest government securities. Many of these banks continued to increase in size by attracting deposits from weaker domestic banks and strengthening their capital base. [redacted]

Government-owned banks, holding 35 percent of the assets in the commercial banking system, are a weaker link in the Philippine financial sector, however. Recent press estimates state that up to 80 percent of their assets are nonperforming. Many of the problems of these institutions are the result of past policies that fostered low-interest loans to Marcos's political cronies. This has left the Aquino administration the unpopular task of implementing banking reforms needed to meet conditions for IMF and World Bank support. Of the total government deficit for 1986, about \$1 billion (65 percent) will be needed to stave off bankruptcies in state-run financial corporations, an amount equal to 17 percent of total projected government spending. [redacted]

Minimum capital requirements instituted by the new government will put pressure on undercapitalized state-owned banks—specifically the Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB)—to consolidate, potentially causing 15,000 employees to be fired, according to Embassy reports. In mid-July, the Central Bank Governor outlined a reform program that is to transfer nonperforming assets of the DBP and PNB to a management trust, thereby cutting in half the involvement of government banks in the system and accomplishing a primary goal of banking-sector reform. [redacted]

Because of many problems in the Philippine banking sector, the Aquino government will not attempt to significantly liberalize the financial sector this year, according to the US Embassy. International bankers agree, stating that it will be many months before a streamlining of the system is politically feasible. An IMF team visiting Manila in June 1986, however, observed steps under way to clean up government financial institutions, specifically citing one major government bank, the DBP, as moving ahead on reforms. Nevertheless, in our judgment, Aquino will accelerate banking reforms only if substantial improvement in the performance of the economy is forthcoming. [redacted]

**Outlook**

We believe many LDCs, including the Philippines and South Korea, will encounter some difficulties in reforming their banking systems, while a few such as Brazil will probably proceed with liberalization measures. LDCs that do move to reform their banking systems will do so in the face of significant domestic opposition:

- Financial-sector liberalization is opposed by those who are wary of increasing foreign influence in domestic markets.
- Reforms that increase competition in the banking sector probably will force more bank closures and increase unemployment.
- Greater privatization in the banking systems will decrease government power by transferring control of financial resources to the private sector. [redacted]

25X1

25X1

25X1

25X1

25X1  
25X1

Secret

Secret

LDC governments' efforts to liberalize their banking systems could complicate relations with international creditors if further bank failures are the result. In particular, most LDC banks have fully utilized credit lines with international banks and, as greater competition forces some banks to fail, loan obligations to foreign creditors could then hold up international debt negotiations. A large number of closures could easily overwhelm the abilities of some debtor governments to cover payments to foreign creditors. [redacted]

25X1

[redacted]

25X1

Secret



Secret

**Briefs****Energy***Turkish-Soviet  
Natural Gas Pipeline*

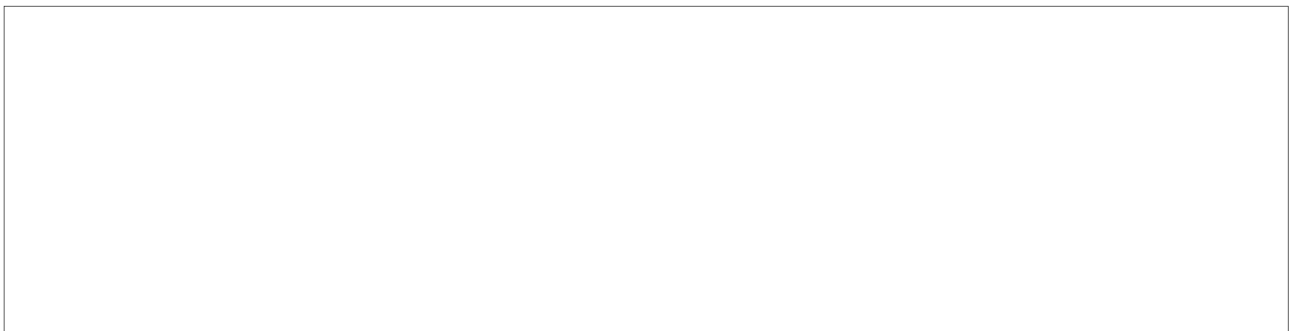
Ankara and Moscow last week signed a construction agreement for a natural gas pipeline linking Turkey and the USSR. The Turkish portion of the pipeline will be built beginning this September by a consortium of French, US, British, and Turkish firms at a total cost of about \$300 million. This agreement follows the natural gas contract signed in February that provides for delivery of 750 million cubic meters of Soviet gas in 1987 rising to an annual level of 4 billion cubic meters by 1992. In exchange, the Soviets must purchase Turkish exports equal to about 70 percent of the value of the natural gas in the first three years of the agreement (1987-89). In following years, Soviet purchases will gradually increase until all of the Turkish gas purchases are offset by exports. The final contract revised an earlier proposal calling for peak annual deliveries of 6 billion cubic meters.

25X1

*China Trying To  
Calm Hong Kong  
Nuclear Fears*

China is attempting to reduce Hong Kong's growing anxiety about a proposed nuclear plant 50 kilometers away at Daya Bay in Guangdong Province. According to press reports, since the Chernobyl' disaster Hong Kong residents have displayed surprisingly strong opposition to the planned joint venture with China; a petition against the project has drawn over 1 million signatures. The Hong Kong Government still supports the plant—70 percent of the electricity would go to Hong Kong—but is sufficiently concerned to send delegations to Europe and the United States to investigate nuclear safety issues. Beijing's recent press blitz includes reporting on Deng Xiaoping's support for the nuclear program, on extensive new domestic safety regulations, and on both new and continuing nuclear safety cooperation with France and the United States. The French, who hope to supply the plant's two reactors, agreed last week to provide full-scale nuclear safety cooperation to China free of charge; the United States last week sold China a simulator to train nuclear power plant operators. A pullout by Hong Kong would probably force China to cancel the project, further reducing its commercial nuclear program to plans for one to three domestically built reactors at Qinshan, near Shanghai.

25X1



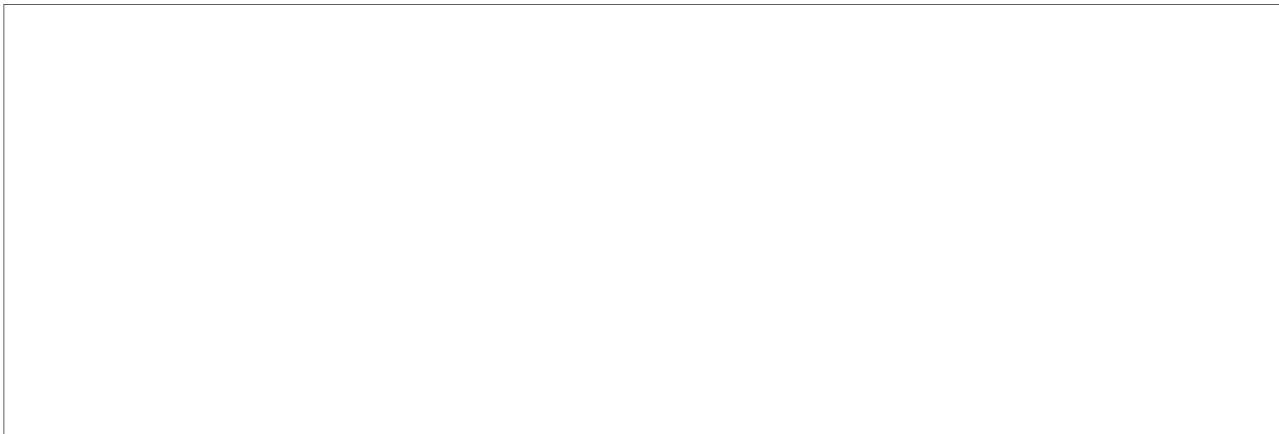
25X1

**Secret**



25X1

**International Finance**



25X1

*Ecuador Seeking  
\$200 Million  
Syndicated Loan*

Quito reportedly has asked the US Government and may ask the Japanese Government to help persuade commercial banks in their countries to participate in a \$200 million syndicated loan secured by oil receipts currently being put together. The loan is a key component of Quito's efforts to cover a widening external financing gap, but bankers apparently are increasingly nervous over the unexpected depth of the oil price plunge and its impact on Ecuador's economy. Although Febres-Cordero's management of the economy has earned him kudos from the IMF and the World Bank, the continuing slide of oil export prices has thrown the Ecuadorean economy into a tailspin—with negative economic growth and a current account deficit of about \$750 million expected this year. According to the US Embassy, the continuation of Ecuadorean oil prices at \$8.50 per barrel will necessitate the implementation of severe—and highly unpopular—austerity measures, and could force the government to secure relief from debt payments to assure minimum import levels.

25X1

**Secret**  
25 July 1986

Secret

*Poland Requests  
Debt Relief*

Western government creditors last week rejected Poland's request to renegotiate the 1986 rescheduling agreement initialed earlier this year and told Warsaw to seek relief from its commercial bank and CEMA creditors. The Poles blame their inability to meet obligations under previous rescheduling agreements on unexpected shortfalls of both new credits and hard currency. Warsaw agreed to approach commercial bank creditors again but warned that hope was slim for any further concessions. Earlier this year the commercial banks reluctantly agreed to reschedule \$1.7 billion in payments due in 1986 and 1987. The Poles probably face a gap of about \$1 billion between payments and earnings this year and will continue to appeal to all creditors for new loans and reschedulings. Ultimately, Warsaw will have to seek IMF assistance to balance creditors' demands and to develop a comprehensive package to deal with its debt problems. The IMF will require Warsaw to accept austerity measures as a condition for new credits. The Poles, however, as in the past, will resist measures that would reduce the population's standard of living. [redacted]

25X1

**International Trade***The Two Germanys  
Expand Trade  
Agreement*

West Germany and East Germany last month revised their 1951 trade agreement to include a payments mechanism for services. The pact further regularizes commerce, clarifies some language to speed transactions, and could facilitate further growth in bilateral economic links. Trade in services, including a number of East German services for West Berlin, has risen to nearly \$1 billion annually, or 13 percent of all commerce in 1985, and expanded into areas not covered by the original agreement. The US Mission in West Berlin reports that negotiations for the revision took two years. The pact reflects the interest of both Bonn and East Berlin in gradually expanding basic economic ties despite continuing, major political differences. [redacted]

**Global and Regional Developments***Airbus Industrie-  
McDonnell Douglas  
Discussions on  
Joint Program  
Continuing*

Negotiations between Western Europe's Airbus Industrie consortium and McDonnell Douglas Corporation are continuing, but we believe formalization of any agreement will not come quickly. Proposals to jointly develop a commercial aircraft for long-range, thinly traveled routes are currently dominating the discussions. [redacted]

25X1

25X1

[redacted] Industry experts believe this market segment is too small to support two separate aircraft. While the talks between Airbus and McDonnell Douglas are hampered by a lack of trust stemming from the failure of previous US-European cooperative aircraft projects, the limited market and growing development costs may force both parties to look seriously at joint development. [redacted]

25X1

**Secret***Japan Leaning Toward  
Joint Development of  
FS-X Aircraft*

Recent Japanese press reports indicate that the Japanese Defense Agency (JDA) is formally considering the codevelopment of its new multirole fighter, the FS-X, with US companies. This follows more than a year of planning for an indigenously developed fighter design. We believe the jointly developed FS-X would be a new design or an advanced version of a US F-16 or F-18 aircraft. Pressure over Japan's trade imbalance with the United States, high development costs, and some technological weaknesses are encouraging Japanese decisionmakers—primarily the Ministries of Finance and Foreign Affairs—to favor codevelopment. We believe some elements in the JDA and MITI as well as Japanese industrialists, however, still may prefer an independent program. In any event, we expect the JDA to request long lead funding for FS-X related programs in its FY 1987 budget; such funds could be applied to either independent or joint development.

[REDACTED]

25X1

*Cocoa Producer and  
Consumer Nations  
Negotiate New Accord*

Faced with the lowest prices in three years and the threat of liquidation of a 100,000-metric-ton buffer stock owned by the International Cocoa Organization, cocoa producer and consumer nations have negotiated the essential elements of a new five-year International Cocoa Agreement (ICCA) aimed at stabilizing world cocoa prices. The accord, replacing the Third ICCA due to expire on 30 September, calls for defending a price range of 85 to 121 US cents per pound by operating a buffer stock that will buy and sell cocoa. Moreover, prices under the new agreement are to be expressed in Special Drawing Rights rather than in US currency, a change designed to dampen exchange rate fluctuations. Agreement on the new pact largely turned on acceptance of a lower price range by Ivory Coast—the world's largest producer—and other key producers such as Ghana and Brazil. The new range generally reflects current market prices, which have averaged 85 cents per pound over the last four months, as well as projections of weak prices through the end of the decade due to continued oversupply. [REDACTED]

25X1

*India Continues  
Purchases of  
South African Diamonds*

Despite pushing for economic sanctions against Pretoria, India continues to import large amounts of rough diamonds from South Africa. India's thriving diamond-processing industry—one of the world's largest—imported over \$800 million worth of diamonds from the Central Selling Organization in London, which is controlled by De Beers, the South African conglomerate. The Indian diamond industry earns over \$1 billion annually, more than 11 percent of India's export earnings. As chairman of the Nonaligned Movement, India has supported South Africa's black majority and has urged economic sanctions and a boycott of South African goods. In the event New Delhi comes under public criticism for its double-handed policy, it probably would seek alternative routes to secure South African diamonds or alternatives suppliers, possibly the Soviet Union. [REDACTED]

25X1

**Secret**

25 July 1986

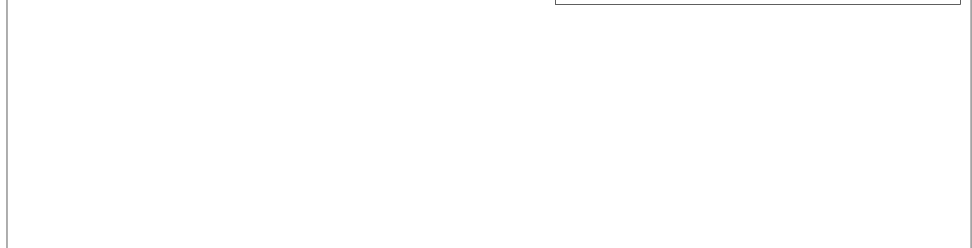


Secret

*Japanese Machine Tool Industry Increasing Investments in the United States*

Industry experts and trade journals report that several Japanese machine tool firms plan to build new facilities or expand existing production in the United States, a move that is seen as part of Japan's overall strategy to maintain an approximate 23-percent share of the US market. [redacted]

25X1



25X1

**National Developments**

*Developed Countries*

*New Japanese Finance Minister Favors Economic Stimulus*



Prime Minister Nakasone's appointment this week of Kiichi Miyazawa places a longtime advocate of increased public works spending at the helm of the powerful Finance Ministry. Miyazawa, who served in the Finance Ministry for several years before entering politics in the 1950s, is best known for his proposal to double spending on basic infrastructure over the next decade. He recently called for a \$19 billion supplemental budget this fall—a record if implemented—to spur Japan's lagging economy. We do not believe Miyazawa's appointment signals a major shift in Japan's five-year-old policy of budget austerity. Instead, it appears Nakasone gave Miyazawa, a longtime political rival, the post in part to quell his criticism of the Prime Minister's conservative economic policy. Although Miyazawa may be able—with the support of politicians and business groups concerned by the economic slowdown—to push through a modest pump-priming package this fall, his influence on the budget for the next fiscal year, which begins in April, is questionable. [redacted]

25X1

The previous Cabinet on Monday approved stringent guidelines for ministries drawing up budget requests for FY 1987. The guidelines, which call for a 1-percent increase in general government expenditures, again require cuts in most programs—except defense (allowed a 6.3-percent increase) and foreign aid (allowed a 7.5-percent rise). Recent public statements by Nakasone, moreover, suggest he remains committed to the goal of eliminating most types of deficit financing by 1991. The budget negotiations will continue through December, however, and another quarter of negative economic growth—following the first quarter's 0.5-percent drop—may result in a substantial increase in the budget Tokyo uses to finance public works; this spending is not included in the Finance Ministry's budget guidelines. [redacted]

25X1

**Secret*****Ottawa Considers  
New Tax as Remedy  
for Budget Deficit***

Ottawa's continuing budget deficit, as well as expected tax reform in the United States, is sharpening Finance Minister Wilson's determination to introduce a value-added tax—although under a different name. Wilson is worried by projections that Canada's 1986 budget deficit will be \$1.5 billion larger than initially forecast—reaching \$23 billion—mainly because of the impact of low oil prices. Two successive unpopular budgets—which emphasized personal and corporate tax surcharges and sales tax increases—and the expected widening of the divergence between marginal rates in the United States and Canada as a result of US tax reform, are curbing Ottawa's enthusiasm for hiking tax rates to control the deficit. Instead, Wilson favors introducing a business transfer tax (BTT)—in effect a value-added tax on consumer goods and services—to replace the narrowly based federal sales tax and the recent surcharges. The BTT's primary advantage is its broad base, which would permit Ottawa to raise substantial revenue with only modest increases in the BTT rate. The Cabinet guardedly approved Wilson's proposal two weeks ago, and it is expected to be the centerpiece of a tax reform plan to be released in the fall.

25X1

***Spain Pushing  
Private Pension Funds***

To reduce the strain on the troubled government-run pension system, Madrid has introduced legislation that will not only allow the creation of private pension funds but will also encourage them with a series of tax incentives. The bill is supported by business and labor and should be signed into law before the end of the year. Government officials look to the new funds—70 percent of whose assets must be invested in government securities, stocks, bonds, and mortgages—to provide venture capital for startup companies and to offer alternative long-term financing to private firms. Businessmen believe that the reduction of their onerous social security contributions will enable them to increase investment. Labor unions have given their support with the stipulation that the government must continue to guarantee state pensions. We do not see this as a problem, however, since Madrid is not likely to abandon its constitutionally mandated responsibility. It aims, rather, to move toward the model prevalent in most other industrial countries in which state pensions are augmented by private pension plans.

25X1

***Less Developed Countries******Philippine Agricultural  
Output Improves***

According to government data, Philippine agricultural output in the first quarter of this year rose 2.5 percent above the level recorded during the same period in 1985, a sharp contrast to the performance of the industry and services sectors, which contracted by 3 percent, and total national output, which grew by less than 1 percent. Production of rice and corn—the two most common crops—increased by 8 and 13 percent, respectively, aided by good weather, government credit programs, and the elimination of price ceilings for major crops. The sector's only production decline was registered by sugar, where output dropped 10 percent in response to record-low world market prices. The growth of the rural economy has probably helped many Filipinos adjust to widespread unemployment in urban areas. Nevertheless, increasing the standard of living in the countryside—where incomes have been depressed by rapid population growth and marketing monopolies for agricultural products—is likely to require agricultural growth rates of over

**Secret**

25 July 1986

4 percent annually. To this end, President Aquino's government is developing market-oriented pricing policies and rural development programs that support crop diversification, land reform, voluntary family planning, and the elimination of marketing cartels. [redacted]

25X1

*Taiwan  
Coping With Its  
Trade Surplus*

Taiwan is taking steps to shift much of its \$30 billion foreign exchange surplus into overseas and domestic investment programs. [redacted]

25X1

[redacted] In addition, Taipei has announced it will increase domestic spending on social development projects from 3 percent of GNP to 15 percent over the next five years. Taipei may believe these measures will deflect foreign—principally US—criticism of Taiwan's trade surplus and huge foreign exchange holdings. However, these moves neither cut exports nor increase imports. Moreover, Taiwan has deferred several major industrial projects involving US firms that would have reduced its bilateral surplus, which topped \$10 billion last year and probably will approach \$12 billion in 1986. [redacted]

25X1

*Coffee Downturn  
Shortens Kenya's Boom*

Kenya's hopes of improving its foreign payments position and reducing its budget deficit have been hurt as world coffee prices have declined by about 25 percent since first quarter 1986, according to the US Embassy. Coffee earnings for 1986 probably will exceed 1985 receipts by only 40 percent, well short of earlier government projections of about 80 percent. The current account deficit could widen by more than \$100 million unless the government acts to reduce imports. Moreover, lower tax revenues probably will undermine Nairobi's plan to cut its budget deficit from the 1985/86 level of 4.5 percent of GDP to 3.5 percent of GDP for 1986/87. [redacted]

25X1

*Rising Food  
Prices in Kabul*

In a 9 July speech, Afghan Prime Minister Keshtmand expressed concern over the continuously rising price of some foods—particularly fruits and vegetables—in Kabul. While the overall foodstuff price index in Kabul rose only 7 percent in 1985, the index for fruits and vegetables increased 17 and 23 percent, respectively, according to official Afghan data. Keshtmand claimed rising transportation costs are partly responsible. The increase in transportation costs is probably the result of the poor security conditions in the countryside and the high demand for trucking services from both the private sector and the black market. Keshtmand also cited various production constraints including farmers' preference for growing wheat, inadequate irrigation and storage facilities, and a weak marketing infrastructure as contributors to rising produce costs. Fresh produce is frequently unaffordable for many Kabul residents. Lack of a varied diet has caused malnutrition in 60 percent of Kabul's children, according to recent reports from medical personnel in Kabul. [redacted]

25X1

**Secret**

*Turkish  
Current Account  
Deficit Rises*

Turkey's current account deficit more than tripled to \$690 million in first quarter 1986, compared with the same period last year, largely because of a 17-percent rise in imports and a drop in worker remittances and tourism revenues. The jump in imports follows liberalization by Ankara of restrictive import rules, although government officials attribute the rise to a temporary surge in imports for government investment. Net tourism revenues declined 22 percent, apparently because of concerns over terrorism and because Turks are increasingly taking advantage of their new opportunities to travel abroad legally. Worker remittances fell 31 percent to \$290 million, perhaps because of layoffs of Turkish workers in oil-producing countries. Dislocations in these countries also hurt Turkish exports. If it continues, the widening current account deficit will complicate Ankara's efforts to meet the high level of debt repayments due over the next several years and could shake confidence in the Ozal government's economic program. [redacted]

25X1

*Baghdad Reshuffles  
Economic Decision  
Making Authority*

The US Embassy reports that Iraqi President Saddam Husayn has returned some key economic powers to First Deputy Prime Minister Ramadan by appointing him head of the "presidential committee" that controls foreign exchange. The decision was announced during an extra session of the Ba'th Party Congress called by Saddam earlier this month to counter growing criticism of his monopolizing decisions on the war and the economy. The creation of the presidential committee by Saddam earlier this year—after the collapse in oil prices—had centralized decisionmaking and undermined Ramadan's role as the chief architect of economic policy. In retaliation, according to the Embassy, Ramadan—who orchestrated tough austerity measures in 1982-83—stymied decisions on several economic matters. By putting Ramadan back in charge, Baghdad probably will be better able to eliminate bureaucratic delays that have hampered efforts to deal with lower oil revenues. [redacted]

25X1

*Tanzania Presents  
New Budget*

Tanzania's 1986/87 budget presented last month calls for total spending increases of about 70 percent, a 25-percent exchange rate devaluation, and price increases of 30 to 80 percent for agricultural products, according to the US Embassy. Other measures—including reductions in income tax rates and increased allowances for public workers—probably were taken to appease opponents to economic reform. Although the government is avoiding a heavy reliance on domestic borrowing and has introduced additional taxes on a wide range of goods to help fund the increased expenditures, the boost in government expenditures may impair negotiations for an IMF program. Moreover, deep ideological divisions within the Mwinzi government remain a stumblingblock in implementing additional IMF-supported austerity measures. [redacted]

25X1

**Secret**  
25 July 1986

Secret

25X1

*Zimbabwean  
Budget Problems*

[redacted] Scheduled to be announced at the end of this month, the budget will show a \$520 million deficit, more than 10 percent of GDP. The government is negotiating a \$125 million loan from the World Bank but will have to resort mainly to inflationary borrowing from the domestic banking system to finance the deficit. Although the Cabinet has agreed on the need to cut recurrent expenditures in order to devote more to investment, it has been unwilling to make hard decisions on major line items such as education or defense spending for the maintenance of Zimbabwean troops in Mozambique. [redacted]

25X1

25X1

*Communist**Soviet Grain Prospects  
Less Favorable*

Meteorological and other reporting indicate that dryness in the southern and central Volga region—dating from April—continues and has spread to the North Caucasus, Central Chernozem, and northwestern Kazakhstan. A week of hot, drying winds further stressed crops in mid-June in the lower Volga and Rostov regions and in eastern and central Ukraine. The affected areas produce about 20 percent of Soviet grain. The remaining grain regions, including the New Lands, still look favorable. Given normal weather for the remainder of the season, Soviet grain production probably will reach only 190 million tons, below last year's estimated output of 195 million tons and far short of the goal of 220-230 million tons Agriculture Minister Nikitin recently mentioned to US Department of Agriculture officials. If weather conditions continue to deteriorate, the 1986 crop may fall below the estimated 184-million-ton average for 1981-85. [redacted]

25X1

*China's  
Large Trade  
Deficit Persists*

China had a \$4.8 billion trade deficit in the first six months of this year—according to State Statistical Bureau data—and China's 1986 trade deficit probably will be close to last year's level of roughly \$10 billion, according to estimates by the consulate in Hong Kong. As a result, China's foreign exchange reserves will continue to decline, and Beijing is likely to step up pressure on foreign countries to ease restrictions on imports of Chinese goods. Beijing has enjoyed striking success with its efforts to make up for lost oil revenues by promoting sales of grain, textiles, and coal; a surge in exports—up 13.3 percent over the same period in 1985—brought China's midyear deficit down from last year's level of \$5.3 billion. Continued growth, however, in imports—up 6.2 percent—was evidence of Beijing's inability to cut imports of capital equipment and raw materials needed for its industrial modernization. Despite cutbacks in imports of 16 commodities (including fertilizers, televisions, automobiles, and synthetic fibers), China's demand for iron ore and rolled steel remains strong. [redacted]

25X1

**Secret**

*New Chinese Bank  
Competing in  
Domestic Market*

China International Trust and Investment Corporation (CITIC)—Beijing's free-wheeling international finance corporation—is setting up a new bank to compete in China's domestic market. The move follows CITIC's purchase last month of the Ka Wah Bank in Hong Kong, an international bank with branches in the United States, Canada, and the PRC. CITIC's expansion is part of Beijing's continuing push to reform China's banking sector. Beijing probably hopes the new institutions will improve the sector's efficiency by competing with other state-owned banks—including CITIC's rival, the Bank of China—that have been criticized by the reform leaders as overly bureaucratic.

25X1

**Secret**  
25 July 1986

**Page Denied**

Next 1 Page(s) In Document Denied

**Secret**

**Secret**