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Directorate of
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International Economic & Energy Weekly

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3 October 1986

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International
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Comments and queries regarding this publication are welcome. They may be directed to Directorate of Intelligence,

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International Economic & Energy Weekly

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Synopsis

1 **Perspective—The Impact of Sanctions on South Africa** 25X1

Pretoria is moving on several fronts to circumvent current restrictions and blunt the effect of new measures by implementing a wide range of clandestine export strategies. Although South Africa will probably evade most trade sanctions, over the long term they will cause greater inflationary pressures, somewhat slower technological development, and shortages of financial and physical capital needed to exploit South Africa's resources and reduce unemployment. 25X1

3 **Nicaragua: Food Shortage Crisis** 25X1

Nicaraguan consumers are suffering the worst food shortages since the 1979 revolution. While Managua probably will seek even larger food donations from the Soviet Bloc, pressures are likely to mount over the long term as the Sandinistas continue to consolidate control over the economy and add to production disincentives. 25X1

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11 **The Maghreb: Population Problems and Political Stability** 25X1

The countries of Maghreb face serious social problems as the demand of a large, rapidly growing population clash with the meager financial resources available to meet basic human needs. These problems almost certainly will lead to major political challenges in these countries over the next decade. 25X1

17 **Mexico/US: Bilateral Commercial Talks** 25X1

After a year-long hiatus, Mexican officials have agreed to return to the negotiating table this month on a bilateral commercial agreement with the United States. Although Mexico has made some headway in removing major trade irritants with the United States in the past year, a number of problem areas remain. 25X1

21 **Canada: Tax Reform Picks Up Momentum** 25X1

Ottawa has decided to move tax reform to the top of its domestic economic agenda to boost tax revenue and to make sure Canada is not disadvantaged by the imminent restructuring of the US tax system. 25X1

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International Economic & Energy Weekly

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3 October 1986

Perspective

The Impact of Sanctions on South Africa

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The intensive action in the United States, Europe, and Japan on economic sanctions is a major issue in South Africa as government and businesses concentrate on means for coping. Pretoria is moving on several fronts to circumvent current restrictions and blunt the effect of new measures by implementing a wide range of clandestine export strategies. Although South Africa will probably evade most trade sanctions, over the long term they will cause greater inflationary pressures, somewhat slower technological development, and shortages of financial and physical capital needed to exploit South Africa's resources and reduce unemployment.

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The intensification of sanctions comes at a time of economic vulnerability. South Africa's economic growth has slowed since the peak rate of 8 percent in 1980. Real GDP grew by an average of only about 1 percent a year since then and fell 1 percent in 1985. Furthermore, growth in net fixed investment has declined for the past five years and may be negative for 1986 as business confidence has been hit by internal unrest, external pressures, and low export prices. Moreover, we expect South Africa's current account surplus will decline in the short term as a result of sanctions on some South African exports.

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Restrictions on the flow of financial capital to South Africa will have little direct short-term impact because domestic demand for capital is low. Private-sector investment has not recovered, despite an easy money policy pursued by the Reserve Bank—interest rates are less than half what they were 15 months ago, and decidedly negative in real terms. The inflow of foreign direct investment is practically nil, so that bans on additional foreign investment will have little practical effect. Nonetheless, technological development would be hindered in the long run.

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Sanctions against South African textiles, agricultural products, iron and steel, and uranium are likely to be more effective because alternative suppliers are readily available. In order to circumvent these sanctions the government has created a Secretariat for Unconventional Trade within the Department of Trade and Industry. In addition to helping exporters evade sanctions, the secretariat will offer financial incentives and direct cash grants to exporters affected by increased costs resulting from sanctions. Nevertheless, South Africa will probably suffer a loss in export earnings because of a reduction in the volume of sales and the cost of evading sanctions.

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Pretoria is also concerned that, over the long term, markets once lost will not be recovered even if sanctions are later removed. Because all of the proposed trade sanctions would reduce competition in the world market from South African

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products, there is some cynicism about the motives of those proposing or imposing sanctions. For example, Canada and Australia have been singled out for hiding protectionism under the garb of sanctions. 25X1

Paradoxically, there is considerable speculation within the South African business community that sanctions may provide needed stimulus to the economy. Sanctions, it is reasoned, will provide protection behind which new import-substitution industries will be able to develop, and traditional industries will have less concern about foreign competition. Realistically, however, any such advantages will at best be limited and short term. Government policies have fostered the development of import-substituting industries for years, and further steps in this direction will be costly because of the small size of the market. 25X1

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Nicaragua: Food Shortage Crisis

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Nicaraguan consumers are suffering the worst food shortages since the 1979 revolution. Record food donations from the Soviet Bloc have not offset the impact of plummeting real wages, lower agricultural production, corruption, and failed Sandinista distribution policies. To deflect responsibility for the crisis, Managua blames outside forces, principally the insurgency and the US embargo. Growing food-related unrest, however, indicates that citizens are tiring of excuses. While Managua probably will seek even larger donations from the Soviet Bloc, pressures are likely to mount over the long term as the Sandinistas continue to consolidate control over the economy and add to production disincentives.

Production Continuing To Decline

The regime is trying to boost production by encouraging farmers to increase their workday—which has plummeted to an average of two hours, according to the US Embassy—and offering cash incentives for production above quotas. Nevertheless, this year's basic grain harvest is likely to be the worst in three years and may fall 20 percent short of the government's goals, according to official Nicaraguan statistics.

Government policies, in our opinion, are the principal cause of falling food production. The Sandinistas began to take direct control over the agricultural sector just after the revolution, when all properties belonging to former President Somoza and his associates—nearly 15 percent of Nicaragua's farmland—were confiscated and reorganized into state farms and cooperatives. The Land Reform Act of 1981 and subsequent revisions legalized the expropriation even of efficient private farms, and we calculate that Managua has now increased its holdings to at least 60 percent of all arable land. Moreover, press reports indicate that private farms in need of inputs are routinely denied access to credit and foreign exchange. Such disincentives have discouraged independent growers from investing in their enterprises.

Government pricing policies also have contributed to the decline in production. Managua controls all farm input costs and forces producers to sell crops and livestock to the state at set prices. As a result, according to the US Embassy, official prices often do not cover costs, and many producers are driven out of business. To avoid bankruptcy, ranchers often smuggle their cattle into Costa Rica and Honduras, where prices are 10 times higher, according to press reports.

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Manpower and material shortages, poor weather, and government incompetence have added to the problem. 25X1 severe labor shortages due to military conscriptions and forced relocation. In addition, the scarcity of hard currency has resulted in a critical lack of seed, fertilizers, and spare parts. The northwest was hit with floods in May that ruined large supplies of stored foodgrains and drowned hundreds of cattle. This was followed by a three-month drought that destroyed the corn crops of many independent farmers. 25X1 blunders by Sandinista managers this year include irrigation of the wrong fields, failure to order poultry feed—thereby starving 200,000 chickens, roughly 10 percent of the total—and allowing crops to rot in the fields while imported harvesting equipment sat on the docks at Corinto.

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Dismantling Free Market Distribution

We believe the state-dominated distribution system has compounded the shortages. The Sandinista policy of ever-tightening controls is diverting food from state stores onto the black market, where most Nicaraguans cannot afford to shop. Moreover, food remaining under government control is spread unevenly, creating areas of chronic shortages.

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Centralized distribution has been a Sandinista strategy since 1979, when government agencies were given sole authority to import, export, and wholesale basic

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Plunging Real Wages

Soaring inflation and relatively inflexible wages have combined to ravage the average Nicaraguan's purchasing power. Government subsidies and commodity price controls kept inflation in the 30-percent range during 1980-84, despite a surge in the money supply and declining production. Eventually, however, budget pressures forced Managua to begin boosting official food prices and to rely more on the printing press to pay its bills. As a result, food prices increased four times, fueling an overall inflation rate of 334 percent in 1985, and we believe it may reach 500 percent this year.

After a 40-percent salary hike in 1979, the Sandinistas virtually froze wages until 1983, when a new scale provided some pay increases for low-skilled workers. We estimate that average real wages fell by half between 1979 and 1984, and a further decline of 20 percent during 1985 despite three wage hikes. For the average Nicaraguan consumer, consumption has been driven down to 1960 levels.

foodstuffs. Over time, Managua has tightened distribution controls by undercutting retail markets with subsidized state-owned outlets, closely monitoring wholesale and retail price ceilings, and setting up a new agency to control produce wholesaling.

In 1982 Managua started a program to control distribution at the household level by issuing ration cards for seven basic food items—rice, beans, corn, cooking oil, salt, sugar, and sorghum—and guaranteeing future supplies at subsidized prices. A more stringent Cuban-style ration system was established in 1983, and neighborhood Sandinista officials were charged with distributing the cards and ensuring that official prices were honored. Unable to deliver on its promises of adequate supplies, Managua last April instituted a third rationing plan that reduced the "guaranteed" food items to rice, salt, sugar, and cooking oil, and gave administrative control to the Ministry of Internal Commerce, according to the US Embassy. Cracks in the new plan began to appear almost immediately, however, when more than 10 percent of the population went uncounted and did not receive cards.

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Regime supply priorities dictate that military personnel and other government employees receive food first, then peasants and factory workers, and finally service-sector employees and others. In addition, government supporters in rural areas and war zones have priority over city dwellers. Most of the population is now living near subsistence level, but there are growing disparities. Most soldiers eat well, while many Miskito Indians in the northeast and residents in Managua's slums are near starvation.

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Mismanagement and Corruption

Government mismanagement and corruption also have been evident. Press reports indicate 250 metric tons of produce recently rotted due to negligent storage, and 10 tons of high-quality beef spoiled in a government warehouse in May because the refrigeration was turned off. Moreover, many government employees in charge of food distribution are corrupt. The US Embassy reports a Sandinista warehouse employee was recently arrested for selling $600,000 worth of goods on the black market, and several government price inspectors were arrested in August for selling confiscated goods to, and accepting kickbacks from, black-market vendors.

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Corruption has blunted the benefits of record Soviet Bloc food donations. The USSR has responded to the crisis by delivering its planned 1986 wheat donations early and by doubling the planned rice donation with an emergency 45-day supply last spring. Moreover, East Germany agreed last week to send 30,000 tons of corn to help relieve the crisis. According to the US Embassy, port records show Managua has been exporting rice to earn hard currency, and Internal Commerce Minister Ramon Cabrales is reportedly getting rich off the scheme. In addition, the Embassy reported in August that donated wheat probably is being sold and that $1.5 million in oats and other cereals have been exported to Honduras since 1981.

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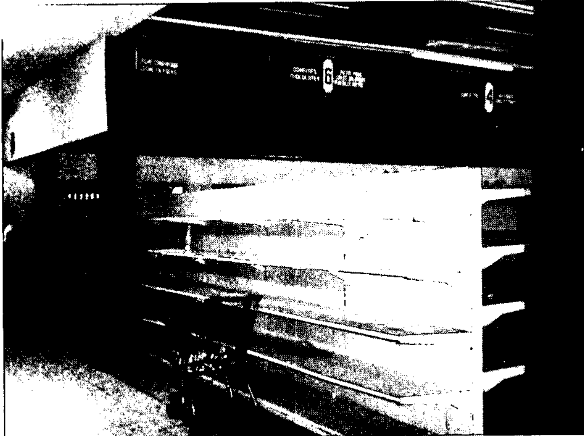

Empty shelves await Nicaraguan consumers

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Shifting the Blame

We believe recent public discontent has spurred Managua to redouble efforts to blame others for food shortages. President Ortega said in June that the environmental policies of former President Somoza had caused low production, and other Sandinista officials have publicly blamed the recent drought on US meteorological warfare, according to press reports. Moreover, the regime has publicly exposed some low-level corruption.

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Sandinista excuses have not placated the population, however, and reports of civil unrest have surfaced, according to the US Embassy. In June, a peasant mob reportedly attacked a state truck loaded with corn and made off with its cargo. In two other cases, mobs took corn and Soviet rice during raids on state farms and the port of San Juan del Sur in late July. Moreover, two government market inspectors were killed in separate incidents earlier this year when they tried to enforce Sandinista policies, according to the US Embassy. A third was attacked by a crowd standing at a bus stop when he tried to arrest a woman for selling beans.

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Bleak Prospects

We believe the food shortage crisis will continue to worsen for at least the remainder of this year. Major food donors—including the USSR and France—already have completed their scheduled deliveries for 1986, and domestic winter harvests are not likely to fill the gap. As a result, more food disturbances are likely, and the Sandinistas probably will respond with tighter internal security and more appeals for Soviet Bloc aid.

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For the longer term, ideological priorities require the state to gain control over the private sector, even at the expense of food production and distribution. As a result, the Sandinistas are not likely to implement the reforms needed to increase production and improve the flow of goods. Moreover, increasing Soviet Bloc aid will probably, at best, only keep consumption at minimum levels.

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The Maghreb: Population Problems and Political Stability

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The countries of the Maghreb [1] face serious social problems as the demands of large, rapidly growing populations clash with the meager financial resources available to meet basic human needs. These problems are as apparent in leftist Algeria as in moderate Morocco and Tunisia. In each country rapid population growth undermines governmental efforts to maintain social stability, equity, and living standards for the population and limits further social and economic development. [2] These problems almost certainly will lead to major political challenges in these countries over the next decade.

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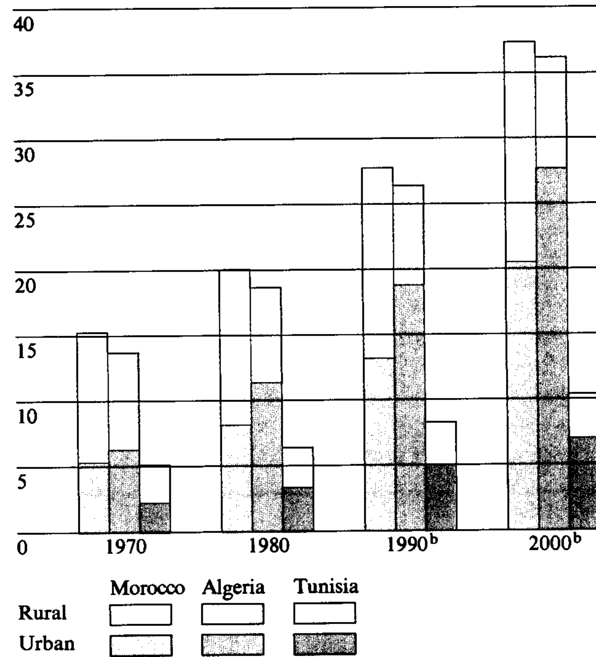

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The Demographic Millstone

The Maghreb's explosive population growth, currently 2.8 percent annually, is expected to continue—the UN projects only a slight decline to 2.4 percent by the year 2000. High population growth over the last 30 years has been largely a result of a steady decline in mortality with no comparable change in the birth rate. As a result, about 1.5 million people were added to the population in the past year alone. The projected population will be about 84 million at the end of the century, almost triple the level in the late 1950s. We estimate that even with population growth held to only 2 percent annually—an optimistic assumption—projected population in the region would reach 71 million by the end of the next decade.

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Fertility control programs are not expected to significantly alter these trends, because it would take two decades under the best of circumstances to stabilize lower birth rates. Although the governments of the Maghreb have all begun to recognize the need for population control, only Tunisia has allocated more than a small share of its health budget to family planning programs. Moroccan and Algerian officials have publicly stated that their national economies can accommodate twice the current population, but they privately admit that rapid population growth is one of their most urgent problems.

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The rapid surge in population combined with poor economic performance since 1980 has aggravated unemployment. Regional GDP growth of 3.6 percent

[1] This article covers Morocco, Algeria, and Tunisia but excludes Libya, because its small population and relative wealth make it atypical in the region.

[2] Demographic data and projections are based on a contract study.

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Maghreb: Demographic Statistics, 1985 and 2000 [a]

	1985			2000 [b]		
	Morocco	Algeria	Tunisia	Morocco	Algeria	Tunisia
Population *(million persons)*	23.64	22.28	7.29	37.26	36.21	10.38
Annual population growth rate *(percent)*	3.0	2.8	2.3	2.8	2.5	2.0
Urban population *(million persons)*	10.38	14.11	3.81	20.51	27.67	7.03
Annual urbanization rate *(percent)*	4.3	5.2	3.7	4.2	4.0	2.8
Urban population as a share of total population *(percent)*	44	67	57	55	76	68
Life expectancy at birth *(years)*	59	60	62	66	66	69
Population under 20 years of age *(percent)*	56	57	51	50	55	47
Unemployment and underemployment *(percent)*	25	25	22	NA	NA	NA
Demand for physicians [c] *(number of physicians)*	2,130	3,986	1,518	3,365	6,478	2,162
Literacy rate *(percent)*	28	35	62	58	65	79
Per capita GDP *(US $)*	490	2,230	1,136	NA	NA	NA
Average annual GDP growth, 1981-85 *(percent)*	2.5	4.3	3.9	NA	NA	NA

[a] CIA data.
[b] Projected.
[c] Holding the current population-to-physician ratio constant; 11,100 per physician in Morocco, 5,590 per physician in Algeria, and 4,800 per physician in Tunisia.

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over the past five years was only marginally ahead of population growth and down by almost half from the previous five-year period, according to the IMF. As a result, unemployment and underemployment have risen steadily to an estimated 25 percent of the labor force, more than double the 1980 level. Morocco will need to provide 320,000 jobs per year for new entrants over the next 15 years; Algeria, 275,000; and Tunisia, 80,000. We estimate that to accommodate the swelling number of entrants into the job market, regional GDP would have to grow at an unrealistically high average rate of over 9 percent annually. Such a high level of growth would be needed because the increasingly capital-intensive development strategies of these countries will create fewer jobs for a given increase in GDP.

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The Maghreb is experiencing a growing gulf between food production and demand, with limited prospects for closing the gap. Roughly self-sufficient in food at independence, IMF estimates show that the region now imports over one-half of its food, and agricultural imports account for 20 percent of total imports. According to Moroccan and Tunisian Government statistics, agricultural productivity has increased at barely half the rate of population growth for the last 20 years. Poor government management, low farm prices, and inadequate agricultural extension services share much of the blame. We estimate that the cost of annual food imports will grow by at least 40 percent—$1 billion—by the year 2000 if agricultural productivity is not improved.

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Rising Urbanization

The rapid increase in population and the limited job opportunities in rural areas, along with improved education, have fueled an enormous increase in urbanization. Over 53 percent of the Maghreb's population is already concentrated in urban areas. Over the years, city residents have become a key constituency for political leaders who have consequently invested heavily in urban improvements. Urban food subsidies, modern services, and the protection of urban wages, however, encourage rural-to-urban migration, creating added pressure for further investments.

Political Strains

Rapid population growth has eroded the old land-based, family-oriented, traditional Islamic society of the Maghreb faster than governments in the area have been able to promote development of economically advanced and urban-based societies. The popular unrest fueled by this circumstance has been aggravated by the economic slump of the past several years. In all three countries unmet rising expectations among the burgeoning, youthful population are becoming a major source of discontent, according to US Embassy reporting. Studies by the World Bank conclude that Morocco's educational system is not geared to providing the skills needed for technical and industrial jobs and contributes, instead, to urban unemployment—a condition we believe also prevails in Algeria and Tunisia. Social scientists of the region also say that young people are increasingly blaming their governments for mismanagement of the economy and are vigorously resisting cuts in education benefits and other subsidies required under economic austerity. The US Embassy in Rabat reports that crime in urban slums is rising at an alarming rate as a result of the growing number of unemployed youth.

Rapid population growth and the erosion of traditional Islamic values contribute to the appeal of militant fundamentalism in all three countries. Although fundamentalism and leftist agitation have been fed by rapid population growth, they have not reached dangerous proportions. There are clear signs, however, that these movements pose a potential threat.

Obstacles to Improvement

We believe that Maghreb leaders will face growing difficulty mobilizing the financial resources needed to tackle the social and economic problems resulting from population growth. An inadequate fiscal base will make it especially hard to revitalize food production. Most farmers cannot afford needed investments in agricultural technology and expertise, and government budget deficits will continue to curtail subsidies for new equipment. We believe, moreover, that leaders will be reluctant to dismantle inefficient government organizations that control food production, prices, and distribution because they provide an important source of patronage and political control. Leaders also recognize that eliminating urban subsidies would produce unrest in the cities.

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Water will remain a key constraint to infrastructure development. According to social scientists, many existing sources of water are already overused, leading to saltwater encroachment, pollution of aquifers, and reduced supplies. Demand for water will probably double by the year 2000 with limited options for expanding supplies, according to the World Bank. Improving the efficiency of current water resources—through methods such as emphasizing drip irrigation and water-efficient crops—will require a significant improvement in education and changes in traditional farming methods. Development of new water resources will entail even greater expense and require significant foreign expertise to achieve.

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The Maghreb region's harsh environment is likely to increase the impact of these shortcomings. Less than 10 percent of the land is under cultivation and much of the remaining land is in semidesert zones that receive barely sufficient rainfall even in good years. If the population projection of 84 million in the Maghreb by the turn of the century is correct, regional agricultural productivity would have to increase by an average of 8.2 percent annually—6.3 percent in Morocco, 11.2 percent in Algeria, and 7.1 percent in Tunisia—to achieve a balance between cereal production and demand. In addition, the pressure for government policies favoring irrigated agriculture will intensify competition between rural and urban areas.

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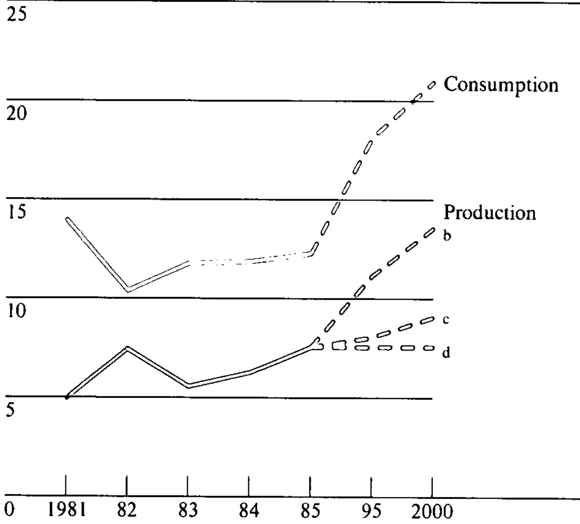
Maghreb: Cereal Production Gap, 1981-2000[a] Million metric tons



[a]CIA data. The data for 1986-2000 are projections.
[b]Assumes 4-percent average annual growth.
[c]Assumes 1.3-percent average annual growth.
[d]No growth.

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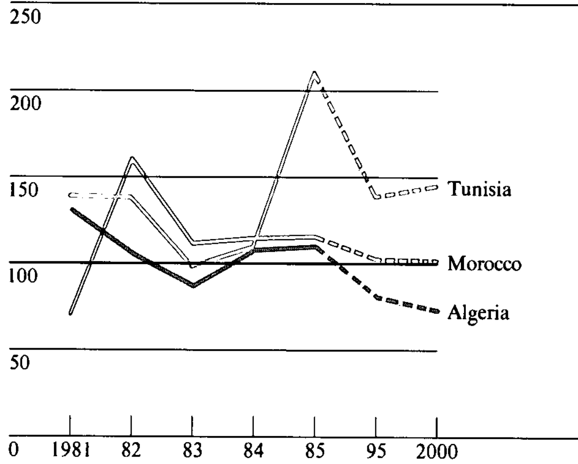
Maghreb: Per Capita Cereal Production, 1981-2000 [a] Index: 1974-76 average=100



[a]CIA data. The average annual growth in production for each country during 1981-85 is maintained for the projection in 1986-2000.

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Outlook

Although the Maghreb governments are committed to reducing population growth, their leaders will continue to worry that promoting population control aggressively could offend the traditional values of many of their citizens. The governments' concerns with minimizing that potential source of political unrest are likely to hinder their population control programs for some years to come.

Regional leaders are already well aware that demographic problems do not yield to quick fixes and that the payoff from expensive and socially sensitive programs to lower population growth rates will not be apparent for a decade or more. They are also likely to continue to believe that their most immediate and overriding concern must be to ensure political stability and their continuance in power. That concern is likely to exert sustained pressure on them to divert attention and scarce resources from treatment of the root cause of their demographic crisis—rapid population growth—to treatment of its more politically pressing symptoms, such as unemployment and urban slums.

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In the meantime, the demographic crisis and the increased social and economic problems flowing from it almost certainly will continue to grow and to fuel Islamic fundamentalist and leftist unrest. Political leaders who fail to accommodate or co-opt either fundamentalist or leftist aspirations are likely to have increasing difficulty governing. Those leaders who lean too far toward either fundamentalism or leftist radicalism, however, will probably stir up opposition from the other quarter. We doubt that any Maghreb leader can arrive at a fully satisfactory resolution of

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these challenges. Fundamentalism and leftist radicalism point ultimately in very different political directions, and the underlying conflict between them means that politics in the Maghreb countries will become increasingly turbulent.

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Mexico/US: Bilateral Commercial Talks

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After a year-long hiatus, Mexican officials have agreed to return to the negotiating table this month on a bilateral commercial agreement with the United States. The pact will provide a framework for trade and financial dealings, consultation and dispute settlement procedures, and guidelines for investment. Although Mexico has made some headway in removing major trade irritants with the United States in the past year, a number of problem areas remain. The most difficult are patents and trademarks, restrictions on foreign investment, local content requirements, and export performance requirements.

Giving Ground on Intellectual Property Rights

the Mexicans are willing to move forward with changes in patent and trademark laws.

The government also presented draft amendments on the inventions and trademarks law to the Mexican Senate in mid-September. If enacted, these amendments would go far beyond President de la Madrid's 1985 decision to overturn a regulation prohibiting US drug firms from using brand names and forcing them to disclose trade secrets.

In large measure, the revisions are primarily aimed at protecting pharmaceuticals and biotechnology, but they also will cover other products, such as chemicals, previously excluded from patent rights.

Under the proposed patent law, manufacturers will be able to obtain compulsory licensing that will prevent other firms from copying their products and to seek injunctions against companies suspected of breaking the law. The draft law proposes some tough sanctions—the government could close down plants for two weeks as a warning and could shut plants permanently if violations continued. In addition, the new law makes it easier to prove that patent and trademark rights have been infringed by permitting firms to present the products as evidence in court.

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the proposal may provide only nominal protection because of several loopholes. Compulsory licensing and injunctions are in fact very difficult to obtain in Mexico. Moreover, ambiguous wording may allow "pirate" firms to interpret the law to their advantage.

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Dim Prospects for Changing Investment Laws

Mexican willingness to negotiate on intellectual property rights is not likely to be matched by a similar attitude on foreign investment.

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while at least some government officials believe relaxing foreign investment restrictions is critical to revitalizing Mexico's economy, the protectionist bent of key members of the Cabinet—as well as of business and leftwing opposition—make significant changes in foreign investment rules unlikely.

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In our opinion, a wariness toward foreign investment and a desire to prevent multinationals from driving local firms out of the market are likely to remain the underpinnings of Mexico's investment policy. Despite some steps taken two years ago to chip away at administrative delays and to lower barriers on foreign investment in priority sectors, the government has authorized only a handful of US investments with more than a 50-percent US share. Mexico also has recently allowed 100-percent Japanese ownership of

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Mexico: Legal Obstacles to Investment

Several laws put into place in the 1970s form the core of an investment strategy that has discouraged foreign investment and obliged the government to meet most of its financing needs by borrowing abroad. The most important constraint is Mexico's 1973 law limiting the share of foreign investors in company holdings to 49 percent, except for assembly plants. The law affects not only new investments, but also plant expansions, relocations, and new products.

Regulations weakening intellectual property rights are powerful disincentives to foreign multinationals. Under Mexico's technology transfer law, foreign companies can expect trade secrets to be kept for only 10 years and may charge no more than 6 percent of sales for royalty payments. In return, they must provide scholarships, high-quality technology, improved technial aid, projects that enhance Mexican R&D, and projects that promote import substitution and exports. The 1976 inventions and trademarks law—currently being revised—made it easier for Mexican firms to copy foreign products. The law prevented firms from patenting a number of products, set a maximum of 10 years for patent rights, and gave the government a free hand to transfer patent rights to another company if a patent was not used during the first three years.

several plants. Nevertheless, we believe these moves are in line with previously announced policies to allow majority foreign ownership only in a limited number of sectors where the Mexicans seek foreign technology, such as electronics and chemicals, and subject to numerous constraints. At the same time, Mexico has imposed higher local content and export performance requirements that hinder foreign investors. The government shows no signs of permitting majority foreign ownership in politically sensitive sectors, such as banking, insurance, and brokerage, where Mexican firms would have difficulty competing with multinationals.

The Mexicans reportedly are drawing up explicit regulations on foreign investment to eliminate some of the vagaries discouraging multinationals from investing in Mexico. The categories of acceptable and unacceptable foreign investments in electronics, for instance, currently overlap. If Mexico follows through, the regulations could at least clear up uncertainties and contradictions in the government's policy.

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Concessions Mexico May Seek

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Mexico is almost certainly coming to the talks with the hope of making inroads into the US market. The collapse of oil prices has prompted Mexico to diversify and increase nonpetroleum exports, particularly to the United States, its most important trading partner. Last year's subsidies agreement went part of the way toward achieving this goal by obtaining a US commitment to assess whether US firms are injured by Mexican exports before applying countervailing duties and antidumping margins. In exchange, the Mexicans promised to phase out export subsidies.

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Mexico City has moved further to encourage trade since the signing of the subsidies agreement. It has eased import licensing restrictions, lowered tariffs, and joined the GATT. These steps will markedly increase US exporters' access to the Mexican market and improve protection afforded to US manufacturers. Mexican officials probably view these changes as bargaining chips for extracting additional agreements from the United States, such as promises not to impose new tariffs or nontariff barriers; a rollback of US countervailing duties on Mexican exports; and easier access for such Mexican goods as textiles, auto parts, steel, meat, tuna, and sugar. Mexico may also want to recover some of the tariff concessions it lost during the last US review of the Generalized System of Preferences.

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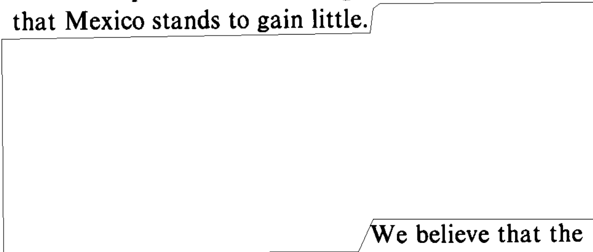
Divisions Within the Cabinet

Opposition to a wide-ranging bilateral agreement within the Cabinet is likely to place limitations on any agreement and may cause the Mexicans to drag their feet on negotiations. Secretary of Commerce Hernandez advocates a framework agreement, but he probably will have a harder time selling it than GATT membership or the subsidies agreement if it appears that Mexico stands to gain little.



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We believe that the Mexicans would be willing to agree to consultation and dispute settlement procedures and to fold intellectual property rights into an agreement, but, if they are pressed on foreign investment, they are likely to balk.

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Canada: Tax Reform Picks Up Momentum

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Ottawa has decided to move tax reform to the top of its domestic economic agenda to boost tax revenue and to make sure Canada is not disadvantaged by the imminent restructuring of the US tax system. The Mulroney government's proposals—which continue its policy of shifting the base of taxation toward consumption—would enhance Ottawa's ability to control the budget deficit and result in a small improvement in Canada's foreign payments position. Despite such benefits and the potential popularity of lower rates, tax reform has traditionally been a contentious issue in Canada, and Ottawa may be hard pressed to implement a comprehensive reform package.

Eroding Tax Revenue

An important goal for Ottawa's reform effort is to reverse the erosion of the federal tax system's revenue yield since the mid-1970s. Despite numerous hikes, tax revenue as a share of GNP is now about 1.6 percentage points lower than in fiscal year 1975. The decline has occurred in all three major sources of federal tax revenue:

- The ***personal income tax***, which accounted for 42 percent of budgetary revenue in 1984, has fallen because tax brackets have been indexed for inflation since 1974, the allocation of portions of the tax to the provinces, and the growing number of tax exemptions.
- The ***corporate income tax***, which contributed 13 percent of budgetary revenue in 1984, has suffered the largest decline—more than 1-percentage-point drop as a share of the GNP—due in part to the slow growth of corporate profits over the past decade. In addition, tax credits and loss carryover provisions have halved the effective tax rate.
- ***Sales and excise tax receipts***, which brought in 20 percent of budgetary revenue in 1984, fell in real terms in the last decade because Ottawa exempted a number of goods and cut the tax rate by at least 3 percentage points for most goods.

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Previous Tory Reform Efforts

Since assuming power in 1984, Prime Minister Mulroney's government has tried to stimulate investment by creating a pool of liquid capital to support entrepreneurial activity—a Tory attempt to break the traditionally risk-averse nature of Canadian economic behavior. The measures include a $360,000 lifetime exemption on capital gains and increases in the ceiling on contributions to pension funds. These steps lowered the effective tax rate on savings and investment, thereby shifting the base of the personal income tax system toward consumption.

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Changes in the personal income and sales tax have included measures to broaden the tax base and raise rates. The Registered Home Ownership and Savings Program deduction was abolished, and a minimum income tax was introduced in order to dispel notions that high-income Canadians too often use loopholes to escape paying taxes. Revenue from the personal tax system has also been raised through temporary surcharges and the partial deindexation of income tax brackets to cover only increases in inflation above 3 percent. The federal government has increased the sales tax rate sharply—raising it three times in the past two years—and lifted exemptions on a number of goods including soft drinks and health products.

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The principal aim of corporate tax reform already implemented has been to foster an environment in which investment decisions are guided more by economic incentives than by tax considerations. Ottawa has sought to broaden the tax base by eliminating a number of deductions while lowering the statutory rate applied to corporate income. In last year's budget, Ottawa announced the phaseout of the investment tax credit and eliminated inventory adjustments—with projected gains to the government of $775 million over the next two years. Tax rates will also be reduced over a three-year period. Although

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the system is designed to be revenue neutral—effective tax rates will remain near 18 percent—it will generate increased revenue until broader tax reform and lower rates are fully in place. Temporary surtaxes have also been levied on corporate income, primarily on larger corporations.

A Change in Direction

Ottawa's intention to go beyond its piecemeal approach and completely overhaul the tax system was sparked by the move toward lower marginal personal tax rates in the United States. The US tax reform initiative, which Canadian officials fear would draw people and investment to the United States, forced the Tories toward comprehensive action. Tax reform is now expected to be the centerpiece of the Tories' domestic economic agenda over the remaining years of their mandate.

A New Sales Tax. According to Finance Minister Wilson, the keystone of the Canadian reform effort will be the introduction of a VAT-style tax called a Business Transfer Tax (BTT). The BTT is a broadly based tax—covering both goods and services—that will enable the Tories to eliminate the current federal sales tax, remove the tax surcharges, and lower personal tax rates. Press reports indicate a hallmark of the BTT will be its administrative simplicity, which suggests it will resemble a consumption-style VAT and further shift the tax base toward consumption activities. The primary attraction of the BTT, however, is its broad base—which means that the BTT need only be set at 4 percent in order to collect as much revenue as the current 12-percent federal sales tax. Ottawa, which is struggling to control the budget deficit, thus could raise substantial revenue with only small hikes in the tax rate—rather than resorting to highly visible surcharges that invite heated attacks by business lobbies and the opposition. Because of its broader base and lower rates, the BTT would also contribute to a more efficient resource allocation as compared with the current sales tax that is frequently criticized for being inefficient and inequitable.

Corporate Reform. The continuation of corporate tax reform probably will be a secondary component of the government's program. The most important tax provision targeted for change is a reduction in the speed with which firms are permitted to write off capital costs. Changing this provision would fit well with Tory philosophy of lessening the role of tax considerations in investment decisions. Other aspects of corporate reform being considered include reducing the time lag between when income is reported on financial statements and when it appears in the taxable income base, and integrating the corporate and personal tax systems in order to ensure that all investment income is taxed equally.

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Roadblocks to Success

While any proposals for fundamental tax changes will be carefully examined by the media and opposition parties, the BTT seems likely to draw the most fire. The very characteristics that make the BTT an effective fiscal tool also open it to a number of criticisms. Because the tax would cover a broad base, a number of service industries and small businesses would be subject to a sales tax for the first time. While small business lobbies have supported minor extensions to the sales tax base, the scope of Ottawa's plans is certain to be criticized as excessive. Opposition from small business could be especially damaging because the Tories look to such groups as a mainstay of support.

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The BTT is also likely to be criticized as a tax that will fall disproportionately on low-income Canadians. As a result, Ottawa probably will introduce refundable tax credits for low-income Canadians and exempt some goods. The Tories are also likely to argue that past initiatives, such as the implementation of the minimum tax, have reduced the regressive nature of the Canadian tax system.

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Ottawa's desire to eliminate a large number of personal and corporate exemptions may also produce significant opposition. Attempts to reform the tax system in the past—such as the 1966 Carter Commission recommendations and a Liberal attempt in the

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Motivation for Corporate Tax Reform

Concern about the instability of the corporate tax base has been the driving force behind efforts to reform the corporate tax system. The Department of Finance study reports that 60 percent of corporations in 1981—the last year for which figures were available—paid no corporate taxes, although one-half of these firms registered a profit. The primary factor behind this disparity was the huge buildup of unused investment tax credits, capital cost allowances, and loss carryover provisions. According to the report, firms had "stockpiled" an additional $10 billion in writeoffs to be used in subsequent years—a figure 75 percent higher than revenue generated by the corporate tax in 1981. These tax credits have been a continual source of instability in tax receipts, heightening the uncertainty attached to government budget estimates. They have also exacerbated the already large disparity in effective tax rates on different industries, and hence increased the inefficiency spawned by the corporate tax system. Past government efforts to plug these revenue leaks have contributed greatly to the complexity of the Canadian tax system.

Ottawa also believes that the buildup of unused credits has hampered its ability to influence investments via tax incentives. Department of Finance studies suggest that, because only about 30 percent of investment is done by firms that can reasonably expect to use tax incentives immediately, both the value of incentives and Ottawa's ability to use them as a policy lever are correspondingly reduced.

1981 budget—were scrapped after running into fierce opposition from domestic interest groups. The Mulroney government thus far has not demonstrated much resolve in pushing controversial proposals, and will have to exhibit much more determination if a comprehensive reform package is to be in place by early 1988. Unless demonstrable progress on tax reform is made next year, the prospect of national elections—due in 1989 but widely expected in 1988—will be a powerful constraint on any controversial tax proposals.

Implications for the Canadian Economy and the United States

Despite likely domestic opposition, the Canadian economy would almost certainly benefit from the changes Ottawa is considering. In the first place, we think Ottawa is correct in fearing some negative impact on investment unless its tax laws are changed in response to US tax reform. In addition, the BTT would enable the government to better control its budget deficit that, combined with a continued rhetorical commitment to deficit reduction, should begin to restore its badly bruised reputation for fiscal competence. Such renewed confidence about Ottawa's economic management in the international financial community would strengthen the Canadian dollar, allowing a lowering of interest rates that would boost investment. Lower rates and the elimination of a wide array of discriminatory tax incentives would also provide greater scope for market forces to operate.

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The tax reforms being considered probably would slightly improve Canada's trade balance, including its surplus with the United States. Critics of the current sales tax point out that it actually discriminates against Canadian goods: because of the way the tax is applied, domestic products on average are taxed at a rate one-third higher than imports. Canada's trade balance could also benefit from the partial substitution of the BTT for personal and corporate income taxes, because GATT rules permit the rebate of indirect taxes on exported goods. Any benefit on this score, however, is likely to be small at least in the short run, especially if Ottawa sticks to its current plan of having a low-rate BTT that covers a wide range of goods and services.

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Briefs

Energy

Safety Concerns Delay Polish Nuclear Power Program

Work on Poland's first nuclear power plant was halted for several months this summer, probably because of the Chernobyl' disaster. Following the Soviet mishap, some 3,000 Poles petitioned parliament to suspend nuclear power plant construction, and Polish scientists warned that planned safety systems were inadequate. A parliamentary commission, citing limits on domestic coal production and imports of Soviet energy, reiterated the importance of nuclear power but promised that safety was a priority. Earlier this month, the Council of Ministers ordered a review of blueprints for the plant, and Polish nuclear officials announced that fire-prevention equipment and monitoring devices would be upgraded. According to a regional party newspaper, Polish nuclear experts rejected poor-quality cement deliveries and have noted quality problems with Polish steel and electrical cable. Warsaw probably will have to seek additional technical assistance—possibly from East Germany or the West—to address safety concerns and alleviate materials shortages. Despite the delays and mounting costs of the plant, plans for a second plant are moving forward. Nonetheless, officials do not expect nuclear power to contribute significantly to Poland's energy supply before the year 2000.

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Papua New Guinea's Oil Discovery

The first significant oil discovery in Papua New Guinea has been announced by British Petroleum and two Australian oil firms working in the area. Total potential production from the discovery well is estimated at 6,000 b/d. The find, however, is located in the island's isolated, rugged interior—currently accessible only by helicopter—which will hamper exploitation. Nonetheless, a fourth international partner in the exploration reportedly committed up to $1 million in late August for site preparations in advance of commercial production. In addition to site preparation, a 250-kilometer pipeline will be built to one or more tidewater ports. Because no plans for a refinery have been announced, the discovery will probably not reduce Papua New Guinea's total dependence on imported oil, but Port Moresby is likely to encourage development efforts as a means of boosting export income.

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International Finance

Proposals for OECD Export Credit Group Meeting

At next week's meeting, the OECD's Export Credit Group will focus primarily on strengthening the guidelines on the use of tied aid credits. Most participants, including the formerly reluctant EC, appear willing to increase the minimum grant element from 25 to 35-40 percent to lessen the use of tied aid credits as trade promotion devices. The main area of contention is the method of calculating the grant element. The EC and the United States have proposed using a differential discount rate (DDR) system to better reflect the actual cost of providing aid. Japan, however, has linked acceptance of the DDR system with the elimination of all remaining export credit subsidies—a move the EC opposes. Because the DDR system will most adversely affect low interest rate countries such as Japan, the EC probably would agree to upper and lower limits on the DDR system so as to partially offset its disadvantages, and obtain Tokyo's support. During this meeting, most participants hope to devise an outline for a DDR system that would be completed in December.

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Moroccan Progress on New IMF Accord

The IMF has approved the framework for a new $275 million 18-month standby for Morocco on the condition that Rabat gets $100 million in new concessional bilateral aid commitments for 1987. The Fund wants Morocco to obtain 12- to 15-year money at no more than 4-percent interest from a group of donors including the United States, moderate Arabs, France, and other West Europeans. The bilateral funds would allow Morocco to undertake capital investment projects and ensure a reasonable rate of economic growth while Rabat proceeds with its IMF adjustment program. The Fund also expects commercial banks to contribute another $250 million in new money during 1986/87. If donors cooperate, negotiations on the standby will be concluded in October and a letter of intent signed. Bilateral lenders may be more willing with assurances from the Fund that the new loans will lead to an IMF accord. International bankers, on the other hand, are miffed over Rabat's lax payments practices and may not be nearly as forthcoming.

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Tunisia Wins Additional Aid

The World Bank approved a much-needed $150 million agricultural-sector loan for Tunisia last week and Italy agreed to provide Tunis $100 million in trade credits. Italy's aid is in addition to the $300 million already committed through 1987. Both actions follow Tunis's signing earlier in September of a letter of intent for an IMF standby that could net Tunisia another $250 million over the next 15 months. Until now, Tunisian pleas for aid have gone largely unheeded. These new commitments, however, only cover about one-half of this year's expected $470 million financial gap. Buoyed by IMF and World Bank support, Tunis will probably redouble efforts to garner more bilateral aid. Tunisia's traditional benefactors—particularly France—have not been forthcoming, largely due to the country's uncertain political future, and may still not be willing to offer new assistance. Unless oil prices sharply rebound, Tunisia will face even greater financial needs next year.

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Hungarian Borrowing Surge

Hungary is raising a $100 million loan to help bridge a widening current account deficit, according to a Western press report. Budapest has enjoyed good access to international credit this year, and its foreign debt has risen from $11.8 billion at the end of 1985 to $13.9 billion in June. Hungarian officials recently told the US Embassy that Budapest plans to borrow $2.5 billion in 1987, mostly to roll over existing debt. The readiness of bankers to lend to Hungary despite the poor domestic economic performance and continued deterioration of its external accounts this year may reflect a lack of better lending opportunities elsewhere. Although Hungary's foreign debt currently appears manageable and large reserves provide a cushion, the steady rise in the debt will make Budapest increasingly vulnerable to a change in the lending climate. Unless Hungary can move further with its economic reforms and improve trade performance, Budapest is likely to have increasing difficulty maintaining the confidence of the banks.

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International Trade

US Trading Partner Surpluses Still High Despite Dollar Drop

Despite the sharp depreciation of the dollar this year, foreign trade surpluses with the United States have increased for nearly every major US trading partner. For some partners—notably West Germany, Japan, and Italy—bilateral surpluses continue to grow in spite of declines in the value of the US dollar against their currencies ranging from 15 to 30 percent. Only France has registered a small decline. At the same time, the surpluses of major partners such as Canada, South Korea, and Singapore—whose currencies have changed little against the dollar—are likely to increase, adding to the US trade imbalance.

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US Bilateral Trade Balances, 1984-86 *Billion US $*

	West Germany	United Kingdom	France	Italy	Japan	South Korea	Singapore	Canada
1984	−8.7	−2.8	−2.5	−4.1	−36.8	−4.0	−0.5	−20.4
1985	−12.2	−4.3	−3.9	−5.8	−47.9	−4.8	−0.9	−22.2
1986 [a]	−15.3	−4.3	−3.4	−6.0	−55.2	−6.4	−1.3	−24.2

[a] Projected.

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French Views on the GATT Meeting

Philippe Jurgensen, the Director of External Economic Relations in the French Trade Ministry, told the US Embassy that France is pleased with the results of the Punta de Este meetings and believes that the negotiations provide a good basis for the new trade round. Jurgenson stated that US flexibility was a very important element in the successful outcome and that the French Government looked forward to continued bilateral discussions and cooperation. Paris was disappointed with the failure to address Japan's rights and obligations, and intends to continue to pressure the Japanese for more balanced trade. According to Jurgenson, France plans to raise this issue as often as possible in the negotiations and to bring up Japan's trade imbalance in other relevant forums including the OECD and the Sherpa meetings preparing for the economic summit. Despite Jurgenson's optimism, France will continue its hard line on agricultural trade.

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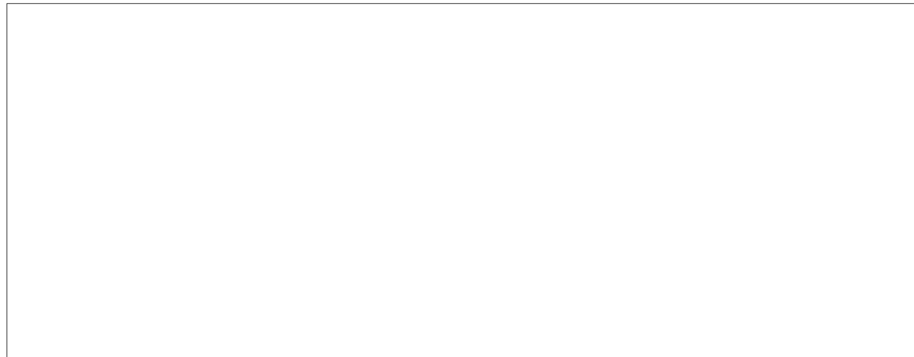

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Global and Regional Developments

Soviet Grain Agreements Unfulfilled

Moscow has not purchased the remaining 3.8 million metric tons of wheat called for in the third year of its long-term agreement (LTA) with the United States, which ended 30 September, and it probably will fail to fulfill similar agreements with Argentina for coarse grains. The Soviets are required to make minimum annual purchases of 4 million tons each of US wheat and corn. Despite the US offer of subsidized wheat, Moscow has shunned US grain in favor of cheaper Canadian and French wheat. 25X1 Soviet purchases of Argentine coarse grain—currently estimated by trade sources at 0.7 million tons—fall far short of the 4-million-ton minimum stipulated by the LTA. Shipping delays, problems with quality, and lagging Argentine purchases of Soviet goods contributed to the slow sales. Although Soviet purchases of Canadian grain reached 6 million tons—exceeding the 5-million-ton average called for under Moscow's agreement with Ottawa—the Soviets successfully demanded concessions on quality standards. Moscow continues to prefer other sellers despite the US subsidy because of their greater willingness to accept stringent Soviet quality demands. Meanwhile, ample world stocks and new harvests continue to depress grain prices already at 12-year lows, further reducing Soviet incentives to fulfill current agreements. 25X1

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National Developments

Developed Countries

Canada's Dome Petroleum Maneuvering To Avoid Liquidation

Dome Petroleum officials are meeting with the company's lenders this week in Switzerland in an attempt to convince them to extend the 28 October deadline for rescheduling Dome's $4.4 billion debt and for making payments to unsecured creditors. The financial press reports, however, that at least one Swiss bank is unwilling to postpone payments, a position that would force Dome into default. To counter this threat, Dome is prepared to go to court and request protection under Canada's Companies Creditors Arrangement Act—similar to US Chapter 11 bankruptcy. The Act would require Dome to file a reorganization plan and separate its lenders into categories for purposes of repayment, but would prevent the banks from forcing Dome to liquidate its assets. Dome almost certainly believes this threat, along with its earlier claims that unsecured creditors will lose all of their investment should it be forced into receivership, will convince the banks to give it another four months to negotiate a rescheduling agreement.

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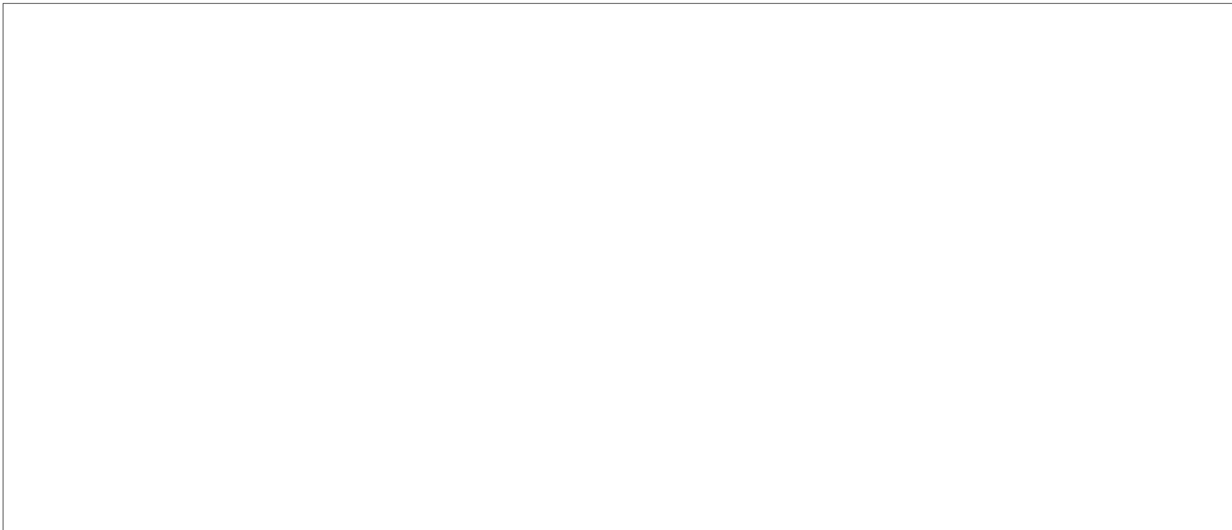

Quebec May Reduce Stock Market Tax Incentives

Confronted by a $2 billion budget deficit, Quebec's Liberal government is considering modifying the Quebec Stock Savings Plan (QSSP), which allows province residents to reduce their income taxes by investing in Quebec-based companies. The seven-year-old program—created by the former Parti Quebecois government—has raised over $3.5 billion in new capital for Quebec companies, and is extremely popular with Quebec taxpayers, who face the highest provincial income taxes in Canada. The deduction, however, has cost the province $436 million in lost tax revenues, and market analysts fear that QSSP stocks are often overvalued because investors in search of tax writeoffs frequently pay little

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attention to the actual prospects of the firm. To boost revenue, Quebec is considering lowering the maximum deduction, decreasing the share of investment that may be written off, and eliminating all deductions for large-asset "blue chip" stocks. Because public support for the program is so strong, however, the government will have to move cautiously even on the limited reforms now contemplated.

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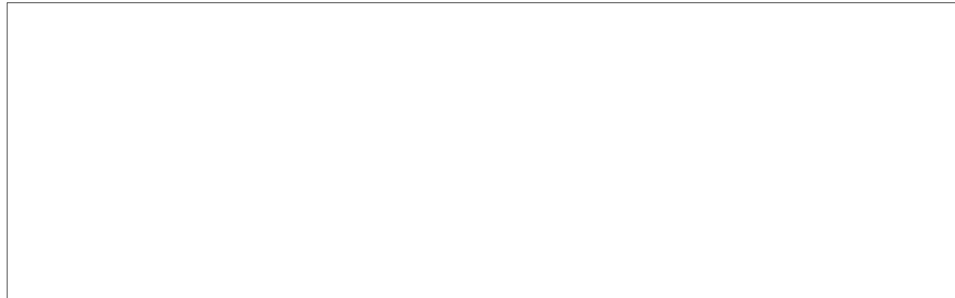

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British Current Account Deteriorates

Britain's current account suffered a record $600 million deficit in August because of rising imports and slumping exports. For the first eight months the current account was roughly in balance, making London's forecast of a $5 billion surplus for the year unattainable. Nonoil imports rose by 6.6 percent in volume terms and by 0.7 percent in price, while export volume was down by 7.8 percent and export prices up by 1.9 percent. Oil earnings also fell, reflecting the decline in oil prices and Britain's position as a net oil exporter. Officials noted that the August trade figures did not necessarily represent a trend and are expressing hope that a pickup in world trade will improve the current account for the remainder of 1986. The pound's depreciation since the beginning of the year should also help make British goods more competitive. As long as British exporters continue to face high real wage increases, however, any improvement in the trade picture due to a pound depreciation is likely to be transient.

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Dutch Unveil Austerity Budget for 1987

The Hague's recently announced 1987 budget combines spending cuts and tax increases to counteract the 50-percent fall in natural gas revenues. Although the budget deficit will still rise from 6.1 to 7.1 percent as a share of GDP, without the austerity measures it would have soared to 9.9 percent of GDP. To offset the projected $5.4 billion revenue loss, the government will cut expenditures $2.3 billion—the first cut in total spending in 30 years—by reducing departmental budgets, freezing public-sector wages, and delinking social security benefits from private-sector wage hikes. The Hague also plans to increase revenue by $2.9 billion by raising the VAT and energy excise taxes—the first tax increase in three years—and selling state holdings. While the budget cuts will dampen economic growth—forecast at 1.5 percent next year—continued low inflation and falling unemployment should cushion the negative impact.

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Belgian Collective Bargaining Agreement

Representatives of Belgium's trade unions, business federation, and small businesses have reached a tentative national collective bargaining agreement, the first such voluntary accord since 1975. Included in the deal is the first real wage increase since 1981 when the government imposed wage and working hour reductions and a requirement to increase hiring. The agreement, which still must be approved by the governing boards of the three groups, gives preference to raising lower wage levels and gradually increasing the monthly minimum wage. In addition, it calls for labor and management to work for greater job creation. Some

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estimates claim the agreement will create 10,000 jobs, though critics charge the government's austerity budget will more than offset this by leading to between 20,000 and 30,000 job losses. Brussels welcomed the accord because it avoids a confrontation with private-sector unions at the same time the government is facing opposition to its austerity measures from the public-sector employees. 25X1

Less Developed Countries

Peruvian Economic Policy Becomes Increasingly Isolationist

Although Lima is still trying to maintain a dialogue with its creditors, President Garcia has not made any financial concessions since the IMF declared Peru ineligible for new loans in August. Peruvian officials failed to offer commercial bankers any payment on $600 million in interest arrearages during talks last Friday, and Peru has fallen some $25 million in arrears with the Inter-American Development Bank, leading to a halt in loan disbursements from that institution. Consequently, the World Bank is the only major remaining source of medium-term loans for Peru. With little new foreign investment and weakening exports, President Garcia is trying to spur economic growth with consumer demand. This past weekend, Garcia announced wage increases of 25 to 100 percent for Peruvian workers, telling his audience he expected the increased spending power to support 6-percent GDP growth this year and next. Although his approach will produce short-term economic growth, the failure to offer investment incentives will eventually lead to strains on the limited industrial capacity, a rise in inflationary pressures, and a sharp economic slowdown. 25X1

Paraguayan Economic Reform Program

President Stroessner has implicitly acknowledged the gravity of Paraguay's economic crisis by announcing an ambitious stabilization plan last week. The reforms include investment and export incentives, tighter fiscal policies, and a partial currency devaluation. The Embassy comments, however, that Asuncion has yet to implement the program and that the devaluation does not apply to cotton and soybean sales, which make up 80 percent of Paraguay's legal exports, or to petroleum, the country's largest import. The program is intended to help the credibility of Asuncion's economic management and to prompt the loan disbursements that multilateral development banks have withheld since last year because of Paraguay's overvalued currency. The partial devaluation, however, will spur inflation and double the cost of debt service while the other provisions do nothing to move Paraguay's underground economy—estimated at one-half of all economic activity—into the open, taxable market. Stroessner's longstanding belief that devaluations are politically destabilizing probably prevented a more sweeping exchange rate reform. 25X1

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Kenya's Widening Budget Deficit

Kenya's record grain harvests and high fixed prices paid to farmers may yield some political benefit to President Moi but are driving the government's budget deficit far above planned levels, according to US Embassy reporting. Kenyan economic planners, reacting to the 1984 drought and donor advice, have regularly raised agricultural producer prices so that farmers now receive a premium of about 43 percent above world market prices for both corn and wheat. These incentives, combined with favorable weather and the government's timely supply of agricultural inputs, produced a record grain harvest for the 1985/86 crop year and are expected to produce an even better harvest in 1986/87. The Embassy reports, however, that continuing financial support to the government's grain-marketing parastatal is the major factor behind a likely increase in the 1986/87 budget deficit to 7 percent of GDP from the original target of 4 percent.

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Effect of Lower CEMA Oil Prices on Eastern Europe

A leading Soviet economist has delivered the most authoritative statement yet on Moscow's plans to deal with declining CEMA oil prices—which are based on a five-year moving average of world oil prices. Oleg Bogomolov, head of the Soviet institute for research on CEMA, recently acknowledged that Moscow will find it difficult to balance trade with its allies as the value of Soviet energy exports falls. He said Moscow will have to look for new items to export. If world oil prices average $15 per barrel over the next few years, the value of Soviet energy exports to Eastern Europe could drop by 22 billion rubles over the 1986-90 period. Bogomolov's statement indicates the USSR is hoping to increase exports—probably of manufactured goods—rather than accept lower imports from Eastern Europe. Greater Soviet deliveries would reduce the cost to Eastern Europe of contributing to Moscow's modernization program.

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Increased East European Imports From the West

East European imports from the West increased substantially in the first half of 1986, reversing the trend of the past five years when financial pressures limited imports. Imports were about 16 percent greater than in the first half of 1985. Exports, on the other hand, increased by only 3 percent, and the midyear balance of trade for the region fell from a $2.1 billion surplus in 1985 to about $154 million. Nearly all countries have increased purchases of capital equipment and industrial materials, but Poland's largest increase was in consumer goods. East European planners apparently have shifted priorities from building up financial reserves to addressing domestic economic needs. The regimes probably are using lower debt service costs and generally better access to Western credit to finance ambitious modernization programs. To improve economic performance and avoid renewed debt problems, however, planners must do better at channeling Western imports into competitive industries. Poland's imports of consumer goods casts doubt on Warsaw's claims it will use new Western credits to concentrate on items needed by its export industries.

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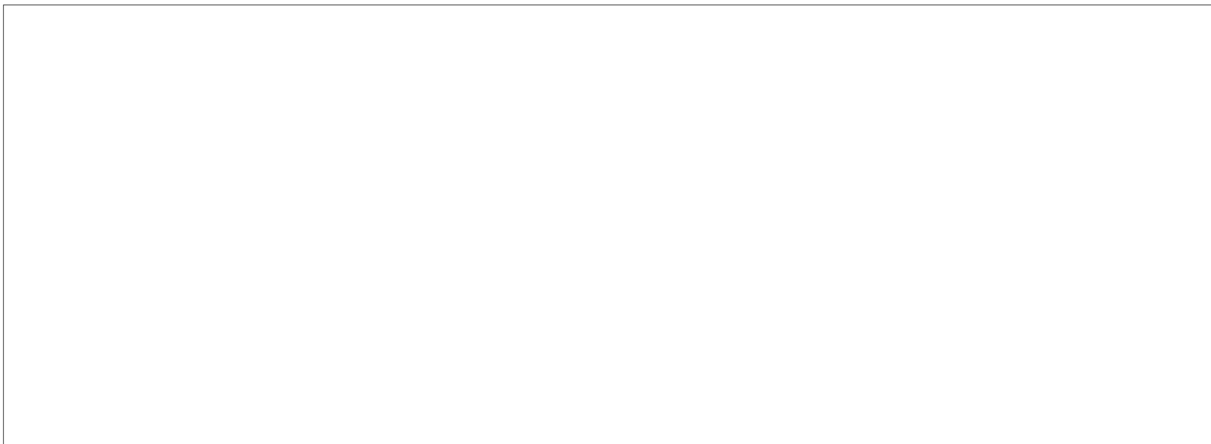

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Hungary's Poor Trade Results Lead to Devaluation

The National Bank of Hungary devalued the forint last week by about 8 percent against major Western currencies to help stem deterioration of Hungary's hard currency trade balance. This action follows a 3-percent devaluation in February, which proved too small to improve the country's trade performance. The National Bank initially resisted further devaluation for fear of fueling inflation, but a $375 million first-half trade deficit apparently convinced Budapest that the step was necessary to maintain the confidence of international lenders. The IMF has urged Budapest to adopt a more flexible exchange rate policy instead of relying mainly on tax incentives and preferential credits to promote exports. The new devaluation, coupled with the slower issuance of import licenses, may dampen imports, but it is unlikely to stimulate exports very much. Until Hungary abolishes producer subsidies and converts to a more market-oriented pricing system, exporters will be largely shielded from the effects of exchange rate changes.

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New East German–Soviet Rail Ferry Link

East Germany and the USSR this week began commercial operation of a new rail ferry srvice between Mukran, East Germany, and Klaipeda, Lithuania. The new ferry service will help ease congestion in East European rail networks and speed commercial deliveries. The 11,700 DWT ferries carry up to 103 rail cars. When all six ships are in operation in 1989, the East Germans expect them to carry 5.3 million metric tons of freight per year—compared with 8.5 mmt of total bilateral seaborne trade estimated for 1985. The link will also reduce transport costs by up to 80 percent The project will also lessen vulnerability of supply lines to political instability in Poland—a particular concern when the project was begun in 1982. It also will, to a limited extent, enhance the Soviets' ability to deliver military materiel in peacetime and could be used to move supplies and possibly units from the western USSR in wartime.

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China's Microelectronics Industry Depressed

Chinese imports of integrated circuits for the last two years have caused domestically produced electronic components—generally higher priced and of lower quality—to pile up in inventory. Moreover, the import of duplicate production lines has created excess capacity for some products. Because of sluggish sales, credit restrictions, and a delay in the State's funding allocations for the current five-year plan, many Chinese electronics factories are suffering from a shortage of operating funds. With greater responsibility over their own profits and losses as a result of economic reforms, some enterprises have been forced to stop paying bonuses, close production lines, lay off workers, or sell surplus equipment. At the national level, Beijing has begun to supervise imports of production lines more closely, and also is considering a 100-percent tariff on imported integrated circuits to protect the domestic industry. Sales of US and other Westen microelectronics production equipment will probably be slowed because of Beijing's actions. In addition, imports of some integrated circuits—primarily for consumer goods—will probably drop sharply, cutting primarily into Japanese sales. But China remains unable to produce sophisticated, high-quality components, and will continue to rely on imports for many of the integrated circuits needed outside of the consumer goods sector. [ ]

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New Competitor for China's Banks

Beijing will reopen its Bank of Communications this month in Shanghai. Established in 1908, the Bank of Communications was prohibited from conducting banking activities in China after 1949. Its Hong Kong branch, however, has continued to operate and is now one of the largest PRC-held commercial banks in Hong Kong. We believe Beijing intends competition from the Bank of Communications to force China's state-owned, specialized banks to operate more efficiently. China's four specialized banks now operate exclusively in the agricultural, urban, construction, and foreign exchange sectors. The new bank will compete with them to provide comprehensive banking services to all these sectors, according to senior Chinese banking officials. The bank's financial strength and experience in the rough-and-tumble Hong Kong market will make it a tough competitor. It will probably make its first move in the foreign sector, where the state-owned Bank of China also faces competition from a new branch of China International Trust and Investment Corporation. [ ]

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