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The 65-percent appreciation of the yen relative to the US dollar over the past two years is generating only a modest increase in Japanese imports. We believe that a more significant increase would require an upturn in Japan's economic growth. 25X1

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Perspective

Brazil's Debt Moratorium 25X1

We believe Brasilia's announcement last week of a moratorium on its $65 billion medium- and long-term commercial debt was designed to send a message to creditors, whom Brazil views as having become unsympathetic to its plight. Other debtor governments are closely watching the situation, but probably will not follow suit, especially if new financial packages from commercial bankers appear likely. Nevertheless, we expect continuing expressions of solidarity with Brazil's actions. They probably believe the Brazilian developments have strengthened their own bargaining positions. Moreover, leaders of other debtor nations will note that support for President Sarney's government increased following his announcement. Whether other debtors initiate Brazil's actions will depend on the scope for growth allowed under new money packages 25X1

Brasilia has indicated interest in beginning negotiations with commercial banks around mid-March. Nonetheless, we believe that, given the reluctance of creditors to make concessions and Brazil's actions and statements this past week indicating it will no longer give in to creditor demands, the risks that an agreement will not be reached in these negotiations has increased:

- Financially, Brazil believes it can do little else but reduce its debt service outflows. Cash reserves have been drawn down rapidly in recent months and are currently estimated at only about $2 billion—less than two months of imports. The economy also is in bad shape, with interest rates and inflation both heading toward quadruple digits.

- Politically, Sarney has gained time to rebuild a consensus behind his leadership and to consider additional measures to shore up the economy. Moreover, Brasilia almost certainly believes it has gained the upper hand in coming negotiations with banks by announcing a suspension of payments. 25X1

International bankers are uncertain about what steps Brazil will propose in future negotiations. They are especially concerned about Brazil's lack of a credible domestic economic program and Brasilia's apparent refusal to agree to IMF supervision. A few banks withdrew a portion of Brazil's $15.5 billion short-term trade and interbank lines. In response, Brasilia on Tuesday sent instructions to Brazilian banks overseas directing them to not repay international banks that seek to withdraw these credit lines, but instead deposit the money in an account with Brazil's Central Bank, according to the US Embassy. 25X1

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Other key debtors have not imitated Brazil's action:

- Buenos Aires calmed fears of an Argentine debt moratorium by implementing stopgap measures to halt inflation and spur growth. Nonetheless, if the program unravels or if international bankers fail to provide sufficient money quickly to generate growth, political pressure for a moratorium will almost certainly mount.
- In our view, Mexico does not plan to follow Brazil's lead, but seemingly has tried to take advantage of Brasilia's announcement by imposing a 20 March deadline for full creditor approval of its new money package. [redacted] 25X1

We believe Third World debt negotiations have entered a critical new phase. The resolve of debtor governments to hang tough has strengthened; in particular, they are more willing to act in the face of perceived creditor inflexibility. At the same time, creditor banks feel compelled to draw the line. They are moving quickly to settle outstanding issues with other debtors in order to isolate Brazil and to deter other countries from following suit. Over the long run, however, Brazil's actions could harden attitudes toward future concessions and new money for all debtors. [redacted] 25X1

[redacted] 25X1

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LDC Debt: The Role of Debt/Equity Swap

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Schemes for converting bank loans into equity are being touted as an important new way to cope with the LDC debt burden, but we believe they will play only a marginal role. Debt/equity swaps appear attractive because they reduce LDCs' foreign debt, encourage badly needed new investment in LDCs, and ensure that creditors get something back from their poorly performing loans. At the same time, debtor country restrictions on foreign investment, bank reluctance to absorb the losses resulting from discounted loan sales, and the shortage of profitable investment opportunities in countries with attractive swap programs limit the potential of these schemes in LDC debt management.

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What Are Debt/Equity Swaps?

In a debt/equity swap, a creditor sells debt at a discount to a multinational corporation or individual investor who in turn redeems it in the debtor country at near or full face value in local currency. The proceeds are then used to purchase equity in local businesses. In these swaps, European and US regional banks are the primary suppliers of LDC debt; they see selling off some of their exposure as a way to limit risks, to clean up their loan portfolio, and to avoid the pressures of debt reschedulings and new money packages. Money-center banks—who hold the majority of LDC debt paper—and investment banks typically act as brokers. Although some major US banks have swapped small portions of their debt, and in certain cases have retained shares in foreign businesses, US accounting rules discourage them from selling large amounts of their LDC debt.

Latin debtors have taken the lead in debt/equity swap programs, and we estimate that these programs have reduced Latin America's total $219 billion commercial debt by about $4.5 billion. Chile's $1.2 billion program, launched in June 1985, is the most successful because of Santiago's open investment climate and the clarity of the rules governing the program. Mexico's program amounted to $650 million at yearend 1986, while Ecuador is currently creating the legal framework for a debt/ equity mechanism and expects to convert $200-300 million this year. In contrast, the Governments of Argentina and Brazil show little commitment to implementing programs more acceptable to foreign investors.

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Swapping debt for equity has been slower to catch on outside Latin America. Most countries entertain swap proposals on a case-by-case basis, but only the Philippines has a formal program in place. Debt burdens in Indonesia, Malaysia, and Thailand and many African LDCs are high enough to warrant swap programs, but investor interest has yet to develop.

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Swap Programs—How Attractive Are They?

LDCs' restrictive foreign investment climate and the regulations attached to swap programs are discouraging foreign companies from making significant new investments through the debt/equity mechanism. Multinational corporations particularly dislike LDC rules requiring local control of their subsidiaries. Moreover, foreign exchange controls, cumbersome and lengthy approval procedures, the limited availability of profitable opportunities for equity investments in many LDCs, and limited protection for intellectual property rights—copyrights, patents, and trademarks—also deter investors

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Other key problems that are restricting investor interest in swaps include:

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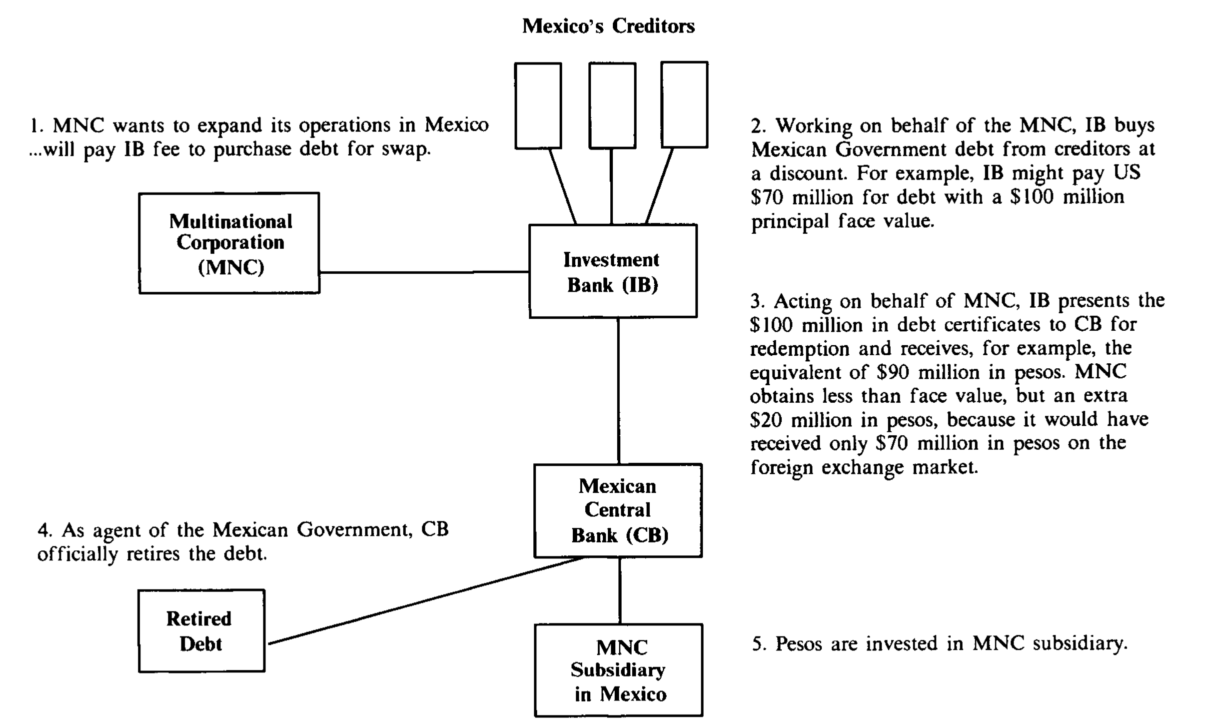
- ***Government Fees.*** Most LDCs charge conversion fees; the Philippines, for example, charges a 5-percent fee for export-revenue-earning projects and 10 percent for low-priority industries. Mexico charges an application fee regardless of whether the swap is approved.

How a Debt/Equity Swap Works: A Mexican Example



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- ***New Money Requirements.*** In Argentina, foreign investors must put up $1 in new money for each dollar swapped, while, in Brazil, investors may be required to invest new money equal to the discount they receive through the swap.

- ***Limits on Profit Repatriation.*** Profits may not be repatriated before the scheduled amortization of principal on the swapped debt; Brazil, for example, warned investors that profits resulting from swaps could not be repatriated for 12 years.

- ***Foreign Exchange Risks.*** Investors must consider that the value of their LDC assets probably will be reduced over time because of currency devaluations.

Moreover, domestic opposition may pressure LDC governments to revise their swap programs—foreign investors may be reticent to participate if they feel the rules will change at some future date. 25X1

Country Programs

	Discounted Loan Prices [a]	Date Program Implemented	Key Elements	Problems
Argentina	62-65	Delays in Argentina's debt negotiations will delay full implementation	Debt is converted at official exchange rate (usually more expensive for foreign investors). Local currency must be invested in export-oriented industries. Investor must match converted debt with equal amount of new money, also converted at official rate.	"New money" requirement and conversion at official as opposed to free market exchange rate probably will continue to discourage investors. Nationalistic sentiments and concerns over monetary expansion will limit government commitment to program.
Brazil	74-76	Case-by-case program since early 1983	Conversions authorized only when investor is original creditor. Swaps down to $400 million in 1986 from $746 million in 1984. In November, Finance Ministry rejected Central Bank recommendations to liberalize swap program.	Business community's success in recent elections probably will lead to more severe restrictions on foreign investment. Brazil's worsening economy will deter potential investors.
Chile	66-69	June 1985	Least restrictive, most straightforward swap program. About $1.2 billion, or 4 to 5 percent of total outstanding debt converted so far. Two methods of conversion; one for foreign investors, one for Chilean nationals.	Chilean program may be constrained by unattractive political climate. Majority of Chile's debt locked in portfolios of large US banks; only limited amount available to market from US regional and smaller European banks.
Ecuador	63-66	December 1986	Total value of swaps limited to $1.2 billion. Both foreign and domestic investors permitted to swap debt. Local company must use full amount provided by investor to pay off debts owed to Central Bank.	No real productive asset is created if local industries use investment to pay off existing debts.
Mexico	53-56	May 1986	Maximum target of $100 million in swaps per month. A total of $3-4 billion in debts expected to be converted. More than half of swaps involve international auto firms. Largest Mexican exporters soon will be able to participate in swap program.	For the most part, only investors established in Mexico are using swap mechanism; many had plans to invest anyway. Swap program will become gradually more restrictive, eventually eliminated, according to Mexican officials.
Philippines	71-74	August 1986	Bankers estimate $200-500 million may be converted by end of 1987. Central Bank charges 5- or 10-percent conversion fee. Government unwilling to allow foreign investors equity holdings greater than 40 percent.	Limits on type of debt paper accepted for conversion, and Central Bank fees deter investors.

[a] Cents per dollar of face value. Prices on the secondary market do reflect creditor confidence in a country's economy, but only the attitudes of those creditors who are actively trading—and might in fact be particularly anxious to "unload" the debt. Most money-center banks are not selling large portions of their debt.

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Creditor Bank Concerns

Many money-center banks say their interest in preserving business relationships with LDCs prevents them from selling their own LDC loans at deep discounts, but we believe these banks are deterred more by US bank regulations and accounting rules. For example, a bank must realize a loss when it decides to sell a portion of its loans on the secondary market. Contrary to press reporting, however, the bank does not have to write down its entire portfolio of loans to that country, nor does it necessarily have to take a loss if it swaps debt for equity and retains the new asset in its portfolio. When a major US bank acquired a pension fund in Chile, for example, accountants recognized the investment at the full face value of the debt.

There are still major disagreements, however, between accounting firms on how to value the new asset—should it be recognized at the full face value of the traded debt, should the accountant make an estimate of the LDC industry's worth, or should valuation be based on the value of the local currency received from the debtor government? Until the accounting profession clears up the ambiguity surrounding US bank participation in swaps, major banks probably will remain reluctant to swap loans in the amounts necessary to have an impact on their large Latin exposures.

LDC Hesitations

On the other side of the ledger, LDC governments are holding back because of the monetary and political consequences of implementing swap programs. On the monetary side, LDC governments must either create local currency or borrow on the domestic market to buy back loans originally made in dollars. Large-scale use of swaps could result in excessive money creation and send already high inflation soaring out of control, while borrowing on the domestic market could increase the budget deficits of LDC governments. Chile, for example, has attempted to control the monetary impact by imposing a cap on the monthly total of debt conversions. Moreover, LDC governments fear that active trading of a country's debt at a substantial discount will reduce the government's credit rating and make it more difficult to raise new money from creditors. 25X1

Politically, liberalizing foreign investment regulations is often interpreted domestically as a capitulation to foreign interests under the pressure of the debt problem. Political opposition and labor groups in Ecuador, for example, have accused the government of "selling out the country to foreigners," while Mexican businessmen complain that swaps give foreign corporations a steep discount in a local currency that is already substantially undervalued. LDC governments also fear the political fallout if debt/equity swaps result in "round tripping," a practice by which the foreign investor makes a profit on the debt conversion and then pulls his money out of the country—leaving 25X1 the central bank with a loss and the country without the investment. We believe there is a high potential for such abuse. 25X1

The potential for "undesirable" buyers using debt/equity swaps also has forced debtor governments to take a closer look at the players involved, and to tighten program restrictions. In Guatemala, for example, international narcotics dealers used laundered profits to strengthen their position in the country by converting debt into equity investments. Latin American and Caribbean bank regulators—concerned about the incident—called a meeting to discuss how 25X1 to curb such activity. Furthermore, Ivory Coast's President Houphouet, afraid that Libyan leader Qadhafi planned to oust him by secretly purchasing a majority of Abidjan's debt on the secondary market, pressured commercial banks to insert a clause in the country's rescheduling agreement that limits creditors' ability to sell Ivorian debt. 25X1

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Outlook

Following the flurry of activity last year, in recent months the swap market for Latin American debt weakened because most small banks and European banks have already sold off unwanted holdings or switched portfolios to their regional or country preferences, [redacted] 25X1 25X1
it is much more difficult now to find debt paper that the Mexican Government will accept for use in its swap program; all LDC governments generally have restrictions on the type of debt paper acceptable. Debtors have been guarded about the future of swap programs—Ecuador has put a $1.2 billion cap on its nascent progam, while Mexican officials have publicly stated that the swap program is a temporary mechanism that will gradually become more restrictive and eventually eliminated. [redacted] 25X1

Debt/equity swaps will make at best a modest contribution to alleviating the LDC debt problem. In our judgment, any recovery of the swap market in 1987 and greater participation by the major banks—which continue to hold huge amounts of debt paper—is contingent on an LDC liberalization of foreign investment regulations that we do not expect in the near term. If LDCs were to undertake the reforms necessary to attract investment, demand for LDC debt paper might grow, pushing up loan prices on the secondary market. Money-center banks probably would be more willing to swap if the resale price of loans were closer to face value, thus reducing the loss they have to take. Without some indication that losses will be marginal, whether it be through substantially higher loan prices on the secondary market or changes in US bank regulations and accounting rules, money-center banks probably will remain hesitant about selling LDC loans. [redacted] 25X1

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Overview

Iran-Iraq: Wartime Economics 25X1

This overview, and the two subsequent articles, examine the impact of the Iran-Iraq war on the respective countries' economies. 25X1

Iran's recent military successes near Al Basrah have strengthened the leadership's will to bring down the Iraqi regime and eased growing popular frustration over the dismal state of the economy. Nevertheless, Tehran almost certainly remains concerned that chronic economic weakness will undermine its long-term ability to maintain political stability and sustain strong military pressure. In contrast, Iraq—despite its weakened military position and morale—probably faces somewhat better economic prospects than Iran in the coming year as a result of increased Iraqi oil exports. 25X1

The Iranian ground attacks near Al Basrah represent a victory for those in Tehran who are pressing for strong execution of the war. Iran's success will strengthen the position of Majles Speaker Rafsanjani who has taken a prominent role in directing the aggressive war strategy. Near the end of 1986, various reports of discontent and unrest indicate that the capacity of the Iranian people to endure economic hardships is beginning to be strained. Nonetheless, the severe economic problems of the past several months and fear of military failure had prompted some in Iran's leadership to counsel against taking the risks of further major offensives in favor of redirecting resources to the civilian economy 25X1

Balancing civilian economic needs and military priorities will be an increasingly complex task. In our view, Tehran will be hard pressed to sustain lengthly attacks such as the recent Al Basrah offensive. Tehran has already been forced to impose gasoline rationing on some of its military units and to trim military perquisites. Low oil revenues will also hamper replenishment of its military arsenal after major ground offensives. 25X1

Battlefield losses, not the economy, present the greatest threat to Saddam Husayn's rule. Until this past year, Baghdad has been able to largely insulate the living standards of the relatively small population from the impact of the war. Saddam's continued rule, however, would face substantial challenges should Al Basrah fall. Assuming the Iranians are contained, Baghdad should see some minor improvement in its economy over the next year, even though large foreign debts will hinder economic performance. Arab financial aid should provide enough for Baghdad to meet its military requirements and essential consumer imports.

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The opposing oil policies of the combatants—Iraq's drive to increase oil exports and Iran's desire to hold down OPEC production—are likely to increase tension among Persian Gulf oil producers. Iran, with almost no military capability to interdict Iraqi oil exports, will intensify pressure on other states in the Persian Gulf to halt financial support for Iraq. Iran could step up attacks on Kuwaiti tankers or sponsor further sabotage against Kuwaiti oil facilities. Increased Iraqi attacks on Iranian economic and civilian targets raise the likelihood that Tehran would use subversion or military attacks on Gulf Arab states [redacted] 25X1

[redacted] 25X1

Iran: Weak Economy Complicates War

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The foreign exchange crunch that dominated Iran's economy in 1986 shows little sign of easing in 1987. Even under optimistic oil price assumptions, Iran's foreign exchange situation would allow little or no increase in imports. Iran's economy faces substantial threats from a renewed oil price war or an intensified Iraqi air campaign against economic targets. Political deadlock over the proper role of government in an Islamic economy will continue to hamper Tehran's ability to cope with its problems. The shrinking economic pie also intensifies factional maneuvering in anticipation of Ayatollah Khomeini's death.

Economic Performance in 1986

Iran's economy, particularly the industrial sector, was hit hard by lower oil prices, Iraqi attacks on economic targets, and the fall of the dollar—oil prices are dollar denominated. The purchasing power of Iran's oil receipts fell by about two-thirds in 1986 compared with 1985, forcing Tehran to slash imports and government spending. The import-dependent industrial sector bore the brunt as war spending was untouched. The regime was also hard pressed to maintain politically sensitive welfare programs to the urban poor. Iraqi attacks on oil export and production facilities, refineries, power stations, and other industrial targets seriously compounded Iran's economic difficulties. Demonstrations, open grumbling, and disregard for authority increased throughout the country in response to deteriorating conditions. Unrest did not, however, reach a level that threatened continued conduct of the war.

Little Improvement in 1987 Finances

We estimate Tehran's oil revenues will be only slightly higher in 1987 than last year, forcing continued austerity. We assume an average price of $15 per barrel for Iranian crude and a moderate level of Iraqi military pressure that holds export volumes to 1.4 million b/d. We expect Iran to maintain the deep import cuts begun in mid-1986, making total imports for 1987 about 20 percent lower than last year. Although Iraq has the military capacity to halt almost all Iranian oil exports, we believe Baghdad will most likely maintain only moderate pressure. Even under more optimistic assumptions that oil prices average $18 per barrel and export volumes are not affected by Iraqi attacks, we expect that Iran will relax import restraints only a little. A worst case scenario of very low oil prices—$10 or less—and/or strong Iraqi pressure on oil exports would probably force Tehran to make substantial cuts in imports of food, fuels, and medicine. Only under these conditions would Iran be likely to seek substantial foreign loans, though we doubt foreign governments or banks would be willing to make large loans under such circumstances.

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Iran's nonoil export promotion campaign is likely to have only minor near-term benefits for Tehran's financial position. This year we estimate nonoil exports will rise by about 30 percent, but still account for less than 15 percent of total export revenues. Incentives for exporters remain weak because of the overvalued official exchange rate and government confiscation of earnings. Maintaining Syrian political support and war-imposed transportation costs will be additional drains on Iran's revenues. We estimate free oil to Syria will continue at 1986 levels of some 35,000 b/d, worth about $170 million. The cost of Iran's oil shuttle is at least $200 million a year. 25X1

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The severe foreign exchange crisis following the revolution has made Iran extremely cautious regarding its foreign payments and assets. For example, despite domestic pressures to maintain imports in the face of serious economic difficulties in 1985, Tehran cut imports by more than was necessary to balance its accounts in order to add to its emergency reserves of foreign exchange. As a result, we believe Tehran will avoid substantial borrowing or further depletion of its

Iran: Current Account, 1984-87

Billion US $

	1984	1985	1986	1987 [a]	1987 [b]	1987 [c]
Trade balance	−0.9	2.3	−2.2	−2.1	0.9	1.6
Exports (f.o.b.)	17.1	15.6	7.8	4.7	8.7	11.6
Oil	16.8	15.1	7.0	3.6	7.7	10.5
Nonoil	0.3	0.5	0.8	1.0	1.0	1.0
Imports (c.i.f.)	18.0	13.3	10.0	6.8	7.9	10.0
Net services and transfers	−3.0	−1.5	−1.2	−0.9	−0.9	−1.0
Balance	−3.9	0.8	−3.4	−3.0	NEGL	0.6

[a] Low assumption: Oil exports are 1 million b/d at $10 per barrel.
[b] Medium assumption: Oil exports are 1.4 million b/d at $15 per barrel.
[c] High assumption: Oil exports are 1.6 million b/d at $18 per barrel.

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reserves. We estimate Iran began 1987 with $1.5-2.0 billion in readily accessible official cash reserves; $2.3-2.5 billion in gold, silver, and jewels; and about $6 billion in less liquid assets, including assets frozen in escrow accounts and uncollectible loans to less developed nations. Islamic ideology also militates against foreign borrowing.

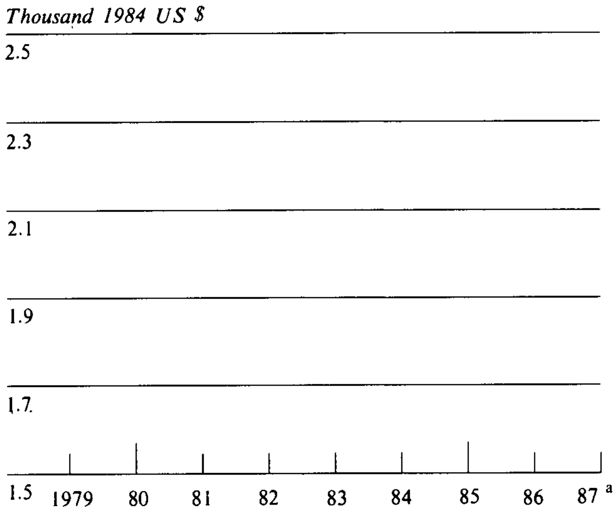
Falling Living Standards

Iran will find it increasingly difficult to divert resources from the civilian sector to maintain its war effort. We estimate Iran spends about $4 billion annually in foreign exchange for military equipment and supplies. Iran made some cuts in food imports last year, but pressure to maintain supplies to the lower class and slack domestic production will probably require that Tehran import $2.5-3.0 billion in food, medicines, and agricultural inputs. Iran imported about $500 million in refined petroleum products in 1986, and this amount could double in 1987 if Iraqi attacks on refineries continue. Under what we believe are the most realistic assumptions, oil revenues would barely cover requirements for food, fuel, and military supplies. 25X1

Living standards in Iran this year will continue the downward trend of the past four years. Using middle-range estimates of oil production and prices, we estimate real per capita GNP will decline about 7.8 percent in 1987 following an estimated 16.4 percent decline in 1986. The fall in per capita GNP understates the impact on the average citizen because an increased proportion of domestic production was diverted to the military. 25X1 25X1

Lower imports, declining domestic production, and competition by the military for scarce resources will cause further inflation. We estimate inflation on the black market will be 20 to 25 percent in 1987, following a jump of at least 40 percent in 1986. Strong economic pressures will probably force the government to allow official prices to rise by about 15 percent following increases of only about 10 percent last year, but these efforts to regulate prices will worsen shortages. The increasing gap between official and black-market prices will raise incentives to divert goods from official channels and inhibit productive investment. High unemployment will persist although government handouts will moderate the impact on those laid off. 25X1

Iran: Estimated Real Per Capita GNP, 1979-87



[a] Projected.

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Economic Warfare

Iraqi air attacks against economic targets have the potential to seriously erode Iranian living standards. Even limited Iraqi damage to critical economic targets could further weaken the civilian economy as well as hamper Iran's warmaking ability. Supplies of refined oil and electric power will remain tight through 1987 even without further Iraqi attacks, and both industries are more vulnerable to disruption as a result of last year's bombings. Transportation networks, basic manufacturing, and military industries are probable future targets of Iraqi raids. [redacted] in response to increasing Iraqi attacks some foreign firms are curtailing operations in Iran. This will affect Iran's ability to repair damaged industries. A far more intensive Iraqi campaign would likely have devastating effects on Iran's economy. [redacted]

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Economic Policy Deadlock

In addition to external factors, a political deadlock over economic policies is handicapping Iran's ability to cope with its problems. Neither the radicals who favor government domination of the economy nor conservatives favoring more traditional private-sector control have the power to impose their will throughout the government. The lack of a coordinated policy to reduce Iran's dependence on oil revenues has resulted in various parts of the government working at cross purposes. Conservatives, backed by Western-trained economists, want the regime to promote non-oil exports through incentives to the private sector. Radicals, on the other hand, worry that export promotion encourages dependence on foreign trade and hurts the poor by allowing the growth of private sources of wealth and power. Building domestic industries—albeit inefficient ones—to take over production of imported goods is linked by the radicals to Islamic notions of independence. [redacted] 25X1

Political influence and corruption protect a policy of fixed exchange rates that vastly overvalues the rial robbing the economy of productive capital investment and causing gross inefficiencies. The policy encourages imports, discourages exports, and channels capital into trading rather than domestic production. The influence of the Bazaar—the merchant class—and the existence of widespread official corruption probably preclude any major change in exchange rate policies. [redacted] 25X1

Political deadlock and unwise policies also play havoc with agriculture and industry. Food subsidies and inaction on land reform discourage greater agricultural production. The conservative Council of Guardians has consistently vetoed efforts by the more radical Majles—Consultative Assembly—to enact comprehensive land ownership legislation. Tehran must also sort out the government's role in industry. A maze of overlapping ministries and quasi-governmental organizations operate the extremely inefficient economic system with little chance of working itself out, given the current political impasse. [redacted] 25X1

Austerity and Political Maneuvering

[redacted] the populace is losing faith in clerical management of the rationing and distribution systems. Late last year, Iranian newspapers became far more strident in their criticism of economic management, which they charged is overcentralized and corrupt. In the budget for 1987, the regime pledged to maintain food subsidies and other welfare programs, but this appears impossible given likely tax and oil revenues. [redacted] 25X1 25X1

Competition for dominance over economic policy will be an important issue between regime factions as they maneuver for power in anticipation of Ayatollah Khomeini's death. Both radicals and conservatives are blaming each other for the current economic difficulties. Declining living standards also intensify rivalries over perquisites that go with political influence. [redacted] 25X1 [redacted] Speaker Rafsanjani is devoting considerable effort to gaining control of the Iranian economy as part of his campaign to consolidate power. Such machinations raise the risk of miscalculation by competitors and heighten the potential for open fighting when Khomeini dies. 25X1
[redacted] 25X1

[redacted] 25X1

Iraq: Financial Problems Despite Higher Oil Revenues [redacted] 25X1

Although the Iraqi economy is likely to improve slightly over the coming year because of higher oil revenues, Baghdad's huge foreign debt and continuing military expenditures remain drags on economic performance. We expect economic development efforts to remain stagnant while the regime directs any additional resources toward improving the availability of consumer items. Economic austerity is unlikely to provoke unrest that could threaten President Saddam Husayn. Iraq's military performance and the level of casualties will be the regime's chief vulnerabilities. [redacted]

Financial Pressures in 1986 Force Austerity

Plunging oil revenues in 1986 severely strained Iraq's finances. Iraqi oil revenues dropped about 40 percent to $7.0 billion in 1986 from $11.4 billion in 1985, despite a 300,000-b/d increase in oil exports. Moreover, Arab financial aid—almost entirely from Saudi Arabia and Kuwait—declined slightly. As a result, Baghdad failed to keep up with payments on its roughly $17 billion in non-Arab foreign debts. Iraq was forced to reschedule nearly $6 billion in debt payments last year. Import credits became scarcer and more expensive as official export agencies and suppliers lost confidence in Iraq. [redacted]

The large fall in oil prices and increased fighting forced Baghdad to abandon its "guns and butter" policy and slash nonmilitary spending. The Iraqi people felt the sting of new austerity measures as government subsidies on consumer goods were reduced, taxes increased, development expenditures slashed, and some benefits to military personnel and families of war dead were eliminated. The prices of many goods, particularly food, increased rapidly. Since late last year, essential foodstuffs, selected equipment for the petroleum industry equipment, and fabrics are the only civilian imports assured of receiving foreign exchange allocations. [redacted]

Finances Remain Tight

We estimate that higher oil export volumes and prices will raise oil revenues in 1987 to about $9.5 billion, an increase of 35 percent. We assume exports averaging about 1.7 million b/d at $15 per barrel. The boost in oil exports—from about 1.5 million b/d in 1986—will come from a 500,000-b/d expansion of the second Iraqi-Turkish pipeline that should be completed this summer. [redacted] 25X1

Despite higher export revenues and continued Arab aid at 1986 levels, Baghdad still faces a roughly $3.5 billion shortfall in foreign exchange in 1987. To finance this deficit, the regime probably will continue to limit civilian expenditures while seeking additional debt reschedulings and new foreign credits. We believe creditors ultimately will reschedule a large part of the at least $3-4 billion in debt payments that we estimate are due this year. [redacted] a consortium of commercial banks recently agreed in principle to defer some civilian debt payments due in 1987 for two years. [redacted] 25X1 25X1 25X1 25X1

The amount of foreign credits Iraq receives this year will be a major determinant of Baghdad's ability to hold the line on austerity. Although Iraq's creditors probably are encouraged by Baghdad's more orderly approach to debt management, we believe they remain cautious about new lending. According to the US Embassy, Iraq has had some problems lining up financing for a second oil pipeline across Saudi Arabia. Nonetheless, Baghdad is likely to obtain sufficient trade financing to ensure essential consumer imports such as food and medicines. [redacted] 25X1 25X1

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Iraq: Current Account, 1984-87

Billion US $

	1984	1985	1986 [a]	1987 [b]
Current account balance	**−4.6**	**−4.2**	**−5.2**	**−2.2**
Trade balance	−1.6	−0.8	−2.6	0.6
Exports (f.o.b.)	10.6	11.7	7.4	10.1
Oil [c]	10.4	11.4	7.0	9.5
Non-oil	0.2	0.3	0.4	0.6
Imports (c.i.f.)	12.3	12.5	10.0	9.5
Net services and private transfers	−2.9	−3.4	−2.7	−2.8
Arab financial aid	3.6	2.5	2.3	2.3

[a] Estimated.
[b] Projected.
[c] Oil revenues in 1987 are based on average exports of 1.7 million b/d at $15 per barrel.

[redacted] 25X1

Impact on Industry, Development Projects, and Labor

Iraqi industry and development plans are heavily dependent on imports. As a result, the large cuts being made in imports of materials and machinery will force more factories to curtail production or shutdown, reducing supplies of some consumer items and hurting domestic construction. Baghdad will probably concentrate its development efforts on a few selected petroleum, petrochemical, agricultural, and power plant projects. Despite recent public statements by First Deputy Ramadan that the large-scale development effort will be revived, we believe the program will be largely hindered by Iraq's inability to convince foreign contractors—already stung by missed payments—to cut costs and offer more attractive financing. Basic infrastructure probably will deteriorate as development projects take a back seat to more immediate needs. One exception, however, is the second oil export pipeline across Saudi Arabia—construction is scheduled to begin this spring and Baghdad will pay higher financing costs if necessary. [redacted]

The continuing manpower drain of the war will further aggravate Iraq's labor shortage. In addition, restrictions on foreign remittances and cutbacks in development spending probably will reduce the number of foreign workers in Iraq to about 900,000 from about 1.2 million at the end of 1985. This loss will hinder efforts to improve agricultural production, disrupt some retail services, and contribute to factory closures. [redacted] Saddam's insistence that all Iraqis participate directly in the war effort has caused a shortage of skilled technicians in the petroleum and banking industries. [redacted] 25X1 25X1

Prospects for Populace Unrest

The Iraqi people will see little improvement in living standards during 1987. Although the 1987 civilian import plan gives top priority to the provision of essential consumer items, the availability of many goods will fluctuate. Difficulties in the distribution of goods, including food—along with the growing diversion of many items into the black market—are likely to add to the uncertain supply situation. As a result, shortages are likely to drive inflation to about 25 percent during 1987, from about 15 percent in 1986. 25X1
The regime may be encouraged to relax spending restrictions toward the end of the year, but this will depend on the amount of debt reschedulings and new loans from foreign creditors. [redacted] 25X1

Iraq: Rapidly Rising Debt Burden

The oil price collapse and Iraq's extensive use of foreign loans since 1983 have thrust Baghdad into the league of problem debtors. We estimate that Iraq's military and civilian debt totals roughly $17 billion, up from about $5 billion in 1979. This amount does not include about $30 billion in "soft" loans from Baghdad's Arab allies, which will not be repaid any time soon. 25X1

Iraq's debt buildup stems from the regime's decision early in the war to substantially increase economic development expenditures despite the cost of the war and reduced oil revenues. Imports in 1981 and 1982 were $20 billion and $25 billion, respectively, up from about $12 billion in both 1979 and 1980. Meanwhile, oil revenues plunged from $25 billion in 1980 to $9.5 billion in 1982 because of war damage to Iraq's two Persian Gulf export terminals and the closing by Damascus of Iraq's pipeline through Syria. 25X1

To finance this gap, Baghdad ran down its foreign reserves and borrowed from trading partners and its Arab allies. According to statistics from the Bank for International Settlements (BIS), Iraq's assets in Western banks plunged from $25 billion in 1980 to about $1 billion in 1982. In 1983, when assets ran out, Baghdad slashed imports by 50 percent and began borrowing heavily from commercial banks to finance civilian imports. Baghdad's debt to Western banks has increased to $5.6 billion from about $450 million at the end of 1982. 25X1

Iraq's use of foreign loans came back to haunt Baghdad last spring when the oil price collapse and a bulge in payments caused a cash flow crisis and confusion among Iraq's financial managers. Subsequent poor financial management by Iraqi officials worsened already strained relations with foreign bankers. Beginning in the latter part of 1986, Baghdad improved control of its finances by sorting out its foreign debt priorities and making some repayments to selected creditors. Even without new borrowing, we estimate that Baghdad will face nearly $15 billion in principal and interest payments during the next three years. 25X1

Iraq: Foreign Payments, 1987 *Billion US $*

Foreign exchange requirements	15.9
Food imports	2.5
Nonfood civilian imports	2.5
Military imports	4.5
Principal payments due on foreign debt	3.5
Interest payments due on foreign debt	1.5
Net Invisibles [a]	1.4
Foreign exchange revenues	12.4
Oil exports	9.5
Nonoil exports	0.6
Arab financial aid	2.3
Financial Gap	**3.5**

[a] Includes foreign worker remittances and oil pipeline transit fees.

Despite consumer discomforts, economic austerity this year is unlikely to provoke unrest that could threaten the regime's hold on power. We believe that the potential for unrest hinges more on Iraq's military performance—especially the level of Iraqi casualties—than on economic conditions. Moreover, Iraqi security forces remain ruthless in attacking any antiregime elements that may attempt to exploit economic issues. Late last year Iraq's ruling Ba'th Party issued notice of severe penalties for criticism of the government, including the death penalty for public insult of the President, the National Assembly, or the Revolutionary Command Council, 25X1

Nonetheless, continuing high casualties and the Iraqis' extreme weariness of the war will make the regime wary of pushing austerity too far. 25X1

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Japan: Sluggish Import Response to Yen Appreciation [redacted]

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The 65-percent appreciation of the yen relative to the US dollar over the past two years is generating only a modest increase in Japanese imports. We believe that a more significant increase would require an upturn in Japan's economic growth. Even if the economy rebounds later this year—and without further yen appreciation, we believe it will—the outlook for US exporters is not bright. Rather, the changing economic relationship between Japan and other East Asian countries will probably make them the primary beneficiaries of any increase in Japanese imports [redacted] 25X1

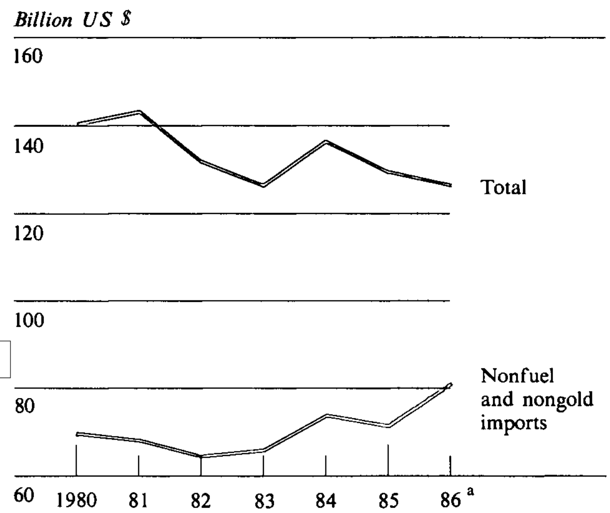
The Import Response to Date

We believe that Japanese import performance last year—imports fell 2.4 percent or $3 billion—is not an accurate indicator of the response to the yen appreciation. Two factors clouded the picture. We estimate that Japanese oil imports plummeted by $17 billion last year because of falling prices. On the other hand, the import total reflects an $8 billion purchase of gold—$6 billion higher than usual—that was used to mint commemorative coins for the 60th anniversary of the Emperor's reign. Excluding fuels and gold, the dollar value of imports increased 13 percent during the first 10 months of 1986—a slightly brisker pace than the concurrent rise in import volume. [redacted] 25X1

Japanese import demand has varied widely by product type. In contrast to the lackluster increase in industrial raw materials, consumer imports—such as fish, fruit, leather goods, knitted goods, and furniture—rose sharply. Moreover, according to a variety of press reports, Japanese consumers are responding to the advantages of a strong yen by purchasing imports by mail order from overseas manufacturers, a small but promising trend. [redacted]

The strong showing of consumer products probably accounts for most of the huge increase in imports from the Asian NICs—particularly Hong Kong, Taiwan, and South Korea—as well as from the European Community. During the first 10 months of 1986, imports from these countries increased an average of 45 percent. Besides being the source of inexpensive consumer products, the NICs have benefited because their currencies are tied to the US dollar and thus have weakened against the yen. In contrast, nonfuel, nongold Japanese imports from the United States—long concentrated in raw materials and capital goods—were virtually unchanged during the first 10 months of 1986. [redacted] 25X1

[redacted]n: Imports, 1980-86



[a] Estimated.

[redacted] 311960 2-87 25X1

The Role of the Japanese Distribution System

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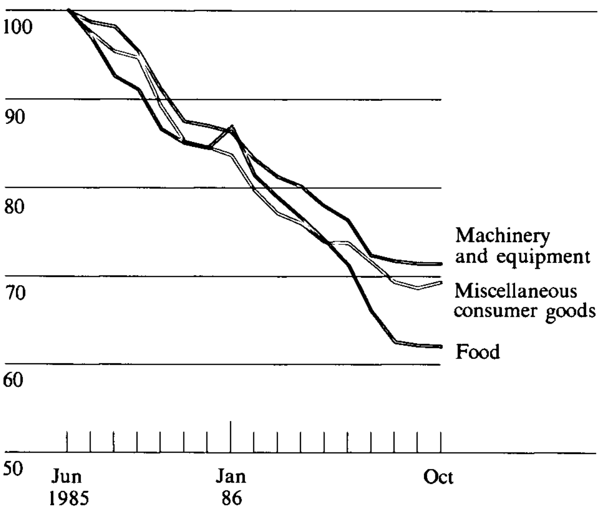
Imports have not been more responsive to the yen appreciation, partially because the stronger yen has not automatically translated into lower retail prices for foreign goods. Prices paid by Japanese importers

Japan: Yen Import Prices,[a] 1985-86



[a] Prices paid by Japanese importers.

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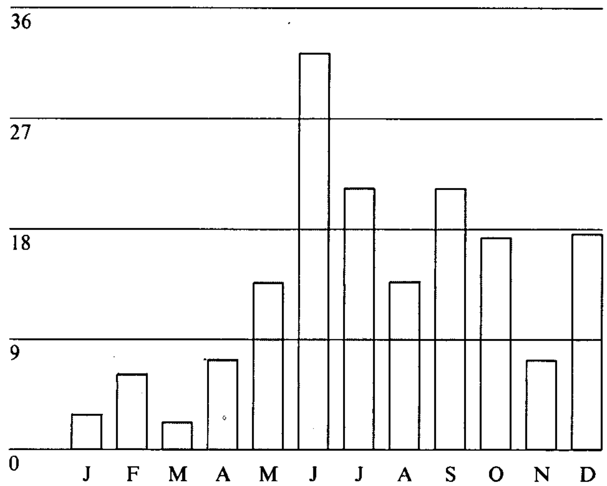
Japan: Import Volume,[a] 1986



[a] Growth from the same period in 1985. Includes gold and fuels.

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have fallen by about 25 percent over the last year, but a recent study by the Economic Planning Agency concluded that only one-half of the price decline had been passed to consumers by the end of 1986. Other surveys, including two by the Japanese Government, show a similar reluctance by wholesalers to pass on exchange-rate-related savings.

We believe that much of the blame for the slowness of retail prices to adjust to the drop in import prices rests with Japan's highly inefficient distribution system. Although there are differences among individual products, the Japanese distribution system for imported consumer goods is essentially a five-tiered arrangement: a product must pass through an importer, major distributor, regional distributor, wholesaler, and retailer before it reaches the customer. This suggests that several decisions to reduce prices must be made before consumers see the positive effects of the high yen. In addition, each level of the distribution chain—which ordinarily marks up foreign products by 2 to 5 percent—probably saw the yen appreciation as an opportunity to raise profits; thus the final price cut to the consumer was much less than the original appreciation. 25X1

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Sluggish Growth as the Main Culprit

Despite the effects of the distribution system, we believe that slow economic growth in Japan is primarily responsible for holding down the increase in imports—a judgment that we think is made clear by comparing the current yen appreciation with the last one in 1977-78.[1] Japanese Government statistics indicate that import volume increased approximately the same amount in the two periods. But this result is surprising because the yen has appreciated 63 percent since mid-1985, compared with only a 40-percent appreciation during the 1977-78 period. 25X1

[1] The length of the periods of yen appreciation is nearly identical—five quarters. 25X1

The contrast is even more striking because of structural changes in the Japanese economy that should have made import demand more responsive to appreciation-induced changes in prices. Among Japanese imports, the share accounted for by raw materials and fuels—commodities that are basically insensitive to changes in price—has declined, while the share of intermediate goods—items that are more price sensitive—has increased. A 1984 Bank of Japan (BOJ) study also asserted that manufactured imports have become increasingly responsive to changes in price in recent years. We have not been able to verify the BOJ's claim, but it is plausible in light of the numerous trade packages negotiated with other governments over the last several years that have opened the Japanese market somewhat—a circumstance that, in theory, should lead to additional price competition.

As such, we believe differences in economic growth between the two periods is the only factor to explain the dissimilar response of imports to the two appreciations. Real GNP growth during the recent appreciation is nearly 2.5 percentage points slower than during the 1977-78 round of yen strengthening, which in turn has held down imports. In our judgment, this divergence in growth rates can be traced to two factors:

- ***Tokyo's tight fiscal policy.*** Government spending is contributing virtually nothing to Japan's growth this year. This contrasts with the stimulative fiscal policy pursued by Prime Minister Fukuda's government during the 1977-78 appreciation.

- ***A more export-dependent economy.*** Exports account for nearly 20 percent of Japan's GNP, compared with only 14 percent in 1977. As a result, the recent yen appreciation—by reducing exports—has had a stronger negative effect on economic growth.

To gauge the impact of slow growth on imports, we ran several econometric simulations using our model of the Japanese economy. We assumed that economic growth during the recent appreciation followed the same pattern as in the 1977-78 period—when growth continued at 5 percent a year—rather than the sharp decline that has occurred over the past several quarters. We raised GNP growth by alternately increasing the components of domestic demand—government spending, private consumption, government investment, or private investment. Our simulations show that import volume would now be 5 to 10 percent higher—$6-14 billion in value—if growth had not slowed, with the trade impact greatest when private investment provided the stimulus. 25X1

Looking Ahead

The importance of growth suggests that nonfuel imports will increase further if the economy rebounds later this year—a likely prospect unless the yen continues to appreciate. We estimate that with an expanding economy total imports this year could be $15-20 billion higher than in 1986, leading to a significant reduction in last year's record $86 billion current account surplus. US exporters, however, probably will be able to garner only about $2 billion of this increase. If we are correct in assuming that economic growth will be led by consumer spending, then the NICs will continue to be the major beneficiaries of Japan's increased imports. This suggests that Japan's overall trade surplus will shrink much faster than the bilateral surplus with the United States.[2] 25X1

Moreover, changes occurring in the economic relationship between Japan and other East Asian countries will probably make it even more difficult for US manufacturing firms to compete in the Japanese market. We expect that Japanese firms will increasingly invest in production facilities in the Asian NICs as well as other East Asian countries, including China. In contrast to Japanese production in the United States—which is geared almost entirely to sales in the US market—production in other East Asian countries will increasingly come back to Japan as imports for either sale in the Japanese domestic market or assembly prior to export. Thus, US manufacturing firms will be competing against Japanese firms that are producing less expensive goods in low-wage Asian countries and that presumably have the skills and business connections to market products successfully in Japan. 25X1

[2] The dollar value of Japanese exports will probably decline slowly this year, with the fall most likely spread fairly evenly over Japan's export markets. 25X1

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Turkey: Ozal's Economic Program Showing Results

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Prime Minister Ozal's market-oriented economic program has cut the budget deficit and reduced government intervention while boosting real GNP growth to almost 8 percent last year. Unemployment has edged higher, however, and rapid monetary growth has kept inflation above 30 percent. Most troubling, though, are the jump in the current account deficit last year and the sharp rise in Turkey's foreign debt since 1983. Ankara's overriding needs are to achieve more balanced growth, to reduce the reliance on foreign borrowing, and to cut monetary growth. We think recent policy actions—including higher taxes and lira depreciation—will help achieve these objectives.

Ozal's Program

Ozal was elected in November 1983 on a platform calling for the reinvigoration of the 1980 economic stabilization program. Crafted by Ozal under the conservative Demirel government, that program began Turkey's dramatic transition from an inward-looking, state-dominated economy to one modeled more along open and free market lines. Ozal's numerous economic policy actions since 1983 include:

- Maintaining a competitive exchange rate and allowing exporters to keep a greater share of foreign exchange earnings.
- Implementing a major tax reform and introducing a value-added tax (VAT).
- Reducing many import restrictions, eliminating most foreign exchange controls, and liberalizing foreign investment rules to attract capital.
- Raising interest rates above the inflation rate.
- Taking the first steps toward privatizing at least part of Turkey's huge public sector.
- Beginning the development of a domestic capital market.

The 1984-86 Scoreboard

Ozal's main achievements have been in reviving economic growth, reducing the budget deficit, and laying the groundwork for privatization. His most visible failures have been his inability to reduce high unemployment, control inflation, and boost the inflow of foreign investment. The balance of payments also deteriorated in 1986 following two years of improvement. 25X1

Led by industrial output, ***real GNP growth*** averaged 5.5 percent in 1984-85 and reached almost 8 percent last year. Investment is booming, recording 13-percent real increases in both 1985 and 1986, and private consumption is also strong. Loose monetary policy has helped fuel the surge in domestic demand but has also kept consumer price ***inflation*** above 30 percent. Monetary growth (M2) approached 60 percent (December over December) in both 1984 and 1985 and was about 40 percent last year. VAT revenue, however, has surpassed the government's targets, helping to cut the ***budget deficit*** from 5.2 percent of GNP in 1984 to 2.5 percent in 1985, and perhaps a bit lower last year. 25X1

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Ozal has made some initial moves toward ***privatization*** by selling revenue participation shares in state-owned facilities such as the Bosphorus Bridge and the Keban and Oynapinar hydroelectric dams. Last year he pushed through parliament a bill authorizing the sale of state economic enterprises (SEEs) and abolishing the government's tobacco monopoly. According to press reports, Ozal is enthusiastic about a privatization study done by a US bank and plans to begin privatizing the SEEs by selling the banking operations of the Sumerbank conglomerate. Ozal also has revitalized the SEEs' financial health: their combined

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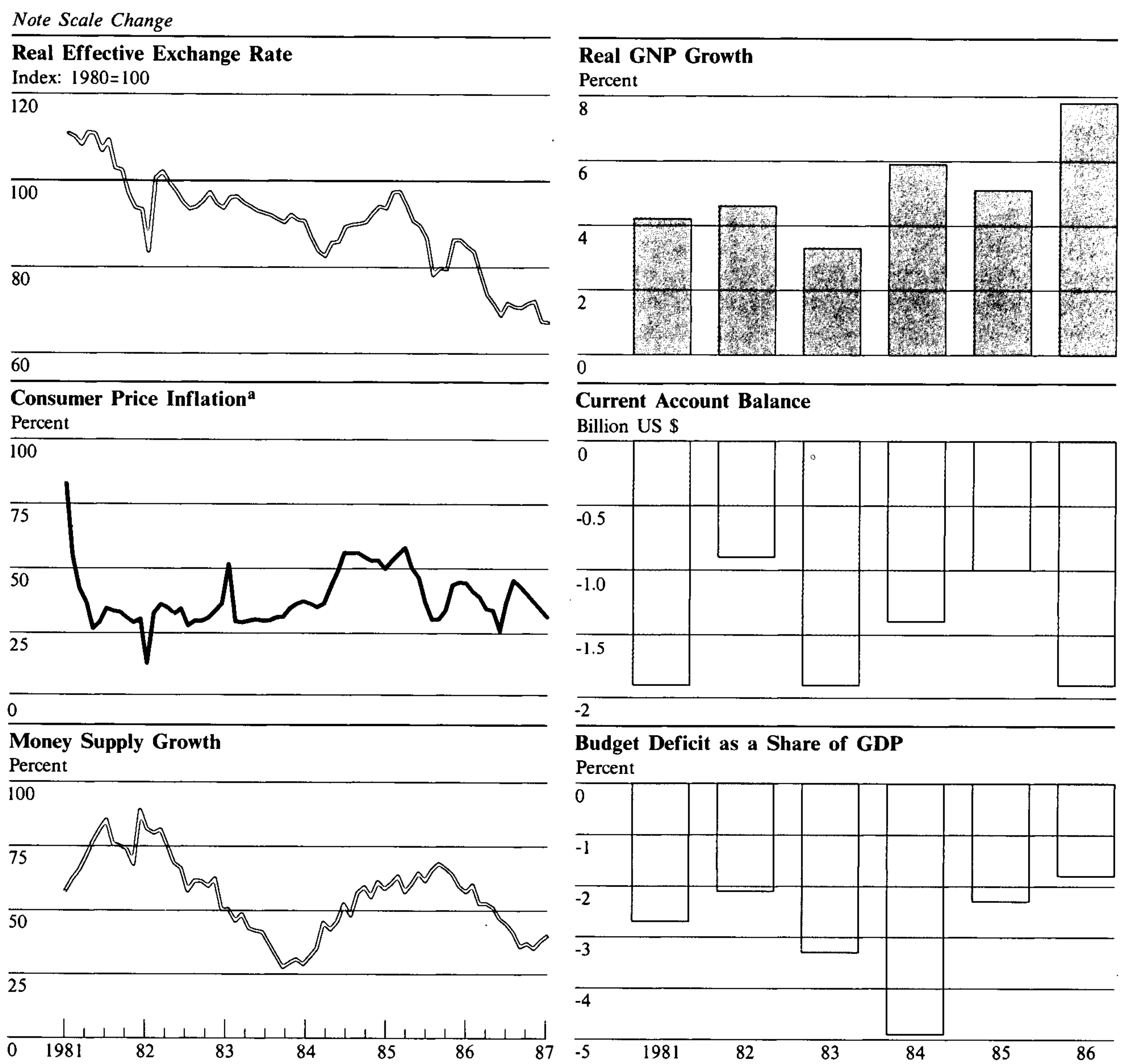
Turkey: Selected Economic Activity, 1981-86



[a] Change from the previous 12-month period.

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Turkey: Current Account Balance, 1980-87

Million US $

	1980	1981	1982	1983	1984	1985	1986 [a]	1987 [a]
Current account balance	−3,408	−1,919	−936	−1,898	−1,407	−1,013	−1,900	−1,300
Trade balance	−4,603	−3,864	−2,628	−2,990	−2,942	−2,975	−3,600	−3,300
Exports (f.o.b.)	2,910	4,703	5,890	5,905	7,389	8,255	7,600	8,300
Imports (f.o.b.)	7,513	8,567	8,518	8,895	10,331	11,230	11,200	11,600
Invisibles (net)	1,195	1,945	1,692	1,092	1,535	1,962	1,700	2,000
Tourism	222	277	224	292	271	770	650	850
Interest [b]	−1,138	−1,442	−1,565	−1,511	−1,586	−1,753	−1,900	−2,000
Other investment income	−25	8	92	62	199	433	500	550
Other services	−35	527	647	464	537	521	550	600
Worker remittances	2,071	2,490	2,140	1,513	1,807	1,714	1,600	1,700
Other transfers	100	85	154	272	307	277	300	300

[a] CIA estimate.
[b] Before debt relief.

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operating losses of $150 million in 1983 have turned into an estimated $1.9 billion profit last year.

Government and OECD estimates put ***unemployment*** close to 17 percent last year—up about 1 percentage point since Ozal took office. Job creation of about 1.5 percent annually has not kept up with the increase in the labor force. Belt-tightening at the SEEs adds to the problem, as does the return of some of the 200,000 Turkish workers from the Middle East.

Ozal has actively promoted ***foreign investment***, including reducing some bureaucratic obstacles and eliminating many barriers to repatriating foreign capital. Nonetheless, the actual inflow of foreign direct investment has been low—only about $100 million in both 1984 and 1985, and perhaps somewhat more last year. The issuance of foreign investment authorizations has risen steadily, however, from $103 million in 1983 to $364 million last year, suggesting that Ozal is gradually allaying foreign businessmen's doubts about the Turkish economy.

The ***current account deficit*** fell from $1.9 billion in 1983 to $1 billion in 1985 largely because of soaring exports—up 25 percent in 1984 and 12 percent in 1985 in dollar terms. Industrial exports—largely textiles—accounted for much of the increase and made up about 79 percent of total exports compared with 35 percent in 1979. Worker remittances also picked up; net tourism earnings almost tripled in 1985 to $770 million. Last year, however, the current account deficit jumped, perhaps as high as $1.9 billion, as soaring domestic output boosted demand for imports—especially machinery. Fear of terrorism and ill-advised hotel price increases also hurt tourism earnings. Meanwhile, declining sales to OPEC countries offset two-thirds of the gain from lower oil prices, according to the Embassy.

The rise in total ***foreign debt***—from $18 billion in 1983 to $29 billion at the end of 1986—is somewhat less alarming than it appears. Almost $4 billion of the

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increase is owed to Turkish citizens abroad—mainly Turkish workers in West Germany. Another $2 billion or so is due to dollar depreciation, which has boosted the dollar value of debts denominated in European currencies or Japanese yen.

Outlook

Ankara has taken steps to achieve better economic balance in 1987. Since November it has raised the VAT rate to 12 percent, cut the 1987 budget by 8 percent, introduced additional incentives for exports, boosted import surcharges slightly, and announced incentives for privately held firms to sell shares to the public. Most important, it accelerated the rate of lira depreciation last year: as of January we calculate that the real effective exchange rate of the lira was 20 percent below its year-earlier level.

Reflecting tighter fiscal policy, GNP growth probably will slow this year to about 5 percent. Investment and private consumption—the pillars of last year's expansion—should slow by almost half, more than offsetting an improved contribution from the foreign trade sector. Foreign direct investment should finally begin to rise because of the many projects already approved. Ozal has no chance, however, of meeting his 20-percent inflation target for 1987; because of past monetary growth, a rate close to 30 percent is more likely.

We expect the current account deficit to drop below $1.5 billion in 1987 despite higher oil prices. Exports, tourism earnings, and worker remittances should all benefit from the lira's huge real depreciation last year. Tourism should also get a boost from reduced fear of terrorism, new hotel construction, and more realistic room rates. In addition, Ankara finally settled its oil price dispute with Iran, leading to a new trade agreement, and also agreed to reschedule some Iraqi debts and provide a new line of credit to Baghdad. Increased exports to these and other OPEC countries thus will offset most of the rise in the oil bill.

The biggest challenge facing Ankara continues to be the hump in debt service obligations that will continue into 1989. Principal and interest payments were about $4.1 billion last year and will rise further in 1987. In addition to pressing the EC, bilateral donors, and the banks, Ankara increasingly will look to the World Bank for project loans to fund the foreign exchange requirements of domestic infrastructure projects. With the current account improving, we think enough funds will be forthcoming to avoid the need to seek another IMF standby agreement.

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Implications for the West

Despite its somewhat improved economic situation, Ankara will maintain its pressure on the United States to increase aid and alleviate its Foreign Military Sales (FMS) debt burden. The Turks have been pushing for early rescheduling or refinancing of past FMS debts and are asking that future funds be given on a grant basis. Ankara views FMS rescheduling as a quid pro quo for its initialing of a new Defense and Economic Cooperation Agreement in December. US failure to act on this issue—or to ratify last year's bilateral investment treaty with Turkey—would be a major political embarrassment for Ozal.

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Turkey also is likely to push hard for concessions from the EC, including release of $600 million in aid under the Fourth Financial Protocol and the free movement of Turkish workers between EC countries. Although the EC recently has made attempts to improve relations with the Turks on the political level—the holding of the EC-Turkish association council meeting last September was a significant step forward—Brussels is unlikely to be very cooperative in meeting Turkish demands for economic concessions. Release of the aid is obstructed by the threat of a Greek veto, and the Community is unwilling to allow in more Turkish workers while it is dealing with high unemployment and the accession of Spain and Portugal. A frustrated

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Ankara may respond by applying for full EC membership this year in an effort to force Brussels to be more accommodating. 25X1

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Briefs

Energy

Venezuela Opposes Possible US Oil Import Tax

Venezuela is strongly lobbying against the adoption of a US tax on oil imports, which it warns could seriously hamper Caracas's ability to service its $35 billion foreign debt. According to US Embassy reporting, a paper endorsed by the Venezuelan Government and major political parties will be presented to US officials this week, outlining the broad damage the tax would do to the Venezuelan economy and underscoring Caracas's reliability as a major US oil supplier. The 750,000 b/d that Venezuela supplies represents approximately 13 percent of total US oil imports and nearly 50 percent of total Venezuelan oil exports. Government officials argue that an import tax of $10 per barrel could lower Venezuela's export revenues by $500 million to as much as $2 billion, depending on its export product mix. In addition, they claim that the tax will require Venezuela to lower its oil prices to compete in the highly competitive world market. 25X1

South Africa To Develop Offshore Gas

The South African Government has authorized the final design phase of a $2.75 billion project to develop an offshore gasfield and a gas-to-diesel-fuel conversion plant at Mossel Bay in Cape Province. The project is expected to yield 20,000 to 25,000 b/d and to help compensate for insufficient diesel fuel in the product mix of South Africa's existing coal-to-oil plants. The Mossel Bay output will only modestly reduce South Africa's current dependence on imported oil—which we estimate at about 200,000 b/d or 15 percent of total energy needs—and further insulate the country from the effects of any potential cutoff of oil imports. However, Pretoria also expects that the government-financed project, which it estimates will have an import component of only 30 percent, will provide a significant boost to the depressed economy of the eastern Cape. Pending final Cabinet approval, contracts will be let this year by the parastatal Southern Oil Exploration Corporation, but Pretoria envisions eventual privatization of the project. Gas production is scheduled to begin in 1991 and have an expected life of 29 years. 25X1

Additional Offshore Oil Found in Brazil

Brazil's deepwater drilling efforts continue to yield positive results. According to press reporting, the Brazilian oil company, Petrobras, has discovered its third deepwater oilfield in the prolific Campos Basin. Preliminary testing indicates that the field may contain 300-400 million barrels of reserves. Petrobras is currently drilling in depths reaching 1,680 meters—the deepest waters drilled so far—to determine the extent of this field, and is developing the technology to produce oil at such water depths. In addition, new oil deposits have been discovered near Brazil's largest deepwater oilfield, Marlin. Early indications are that oil reserves in this field exceed 2 billion barrels. 25X1

Burmese Resisting Foreign Oil Exploration

Despite some Western hopes of a softening Burmese attitude toward foreign investment because of a poorly performing economy, [redacted] 25X1 25X1 Nonetheless, we believe that Rangoon apparently does not yet view its economic problems as serious enough to relax the prohibition against foreign oil firms, even though crude oil output from its aging fields is down 25 percent in the past two years and foreign exchange reserves equal less than two weeks of imports. [redacted] 25X1

Enhanced Natural Gas Security in Western Europe

Norway has announced a new gas storage program designed to enhance reliability of its natural gas deliveries. In the wake of Norway's decision to sell gas from the Troll and Sleipner fields to continental buyers, Statoil, the Norwegian state oil company, has signed a preliminary agreement with a private West German company to rent natural gas storage capacity near Emden, West Germany, and is considering the Netherlands as another potential storage site. Additional storage capacity by 1992 was a precondition in the Troll contract, which calls for deliveries beginning in 1993. The storage in West Germany will hold approximately 14 days' supply or about 825 million cubic meters—as required by buyers of Troll gas—and will be available in case of Norwegian labor disputes or other short-term supply reductions. [redacted] view these steps as limiting future seasonal spot purchases of Soviet gas and thereby contributing to increased energy security in Western Europe [redacted] 25X1 25X1

Proposals for Nordic Gas Network

Energy ministers of Sweden, Finland, Denmark, and Norway have commissioned a study on the integration and expansion of the regional natural gas pipeline network, according to US Embassy reporting. Sweden may advance its target date to phase out nuclear power from 2010 to 1995 in response to the Chernobyl' accident, and considers natural gas an attractive alternative. Elements of the pipeline proposals include extension of the existing pipeline in southern Sweden, extension of the Finnish pipeline to Sweden, a link between the Danish and Norwegian pipelines in the North Sea, and a direct link from Norway to Sweden. If Sweden moves to replace one-half of its nuclear power with domestic gas-fired electricity, as proposed by the government, industry sources estimate gas demand could increase by up to 7 billion cubic meters annually, and spur intense competition among Soviet, Norwegian, and Danish suppliers. Sweden is already buying Danish gas, and, if existing lines in the North Sea were linked, Sweden could gain access to Norwegian gas. Soviet gas via Finland is under discussion, but is more costly than gas from Denmark or Norway. [redacted] 25X1

Increase in OECD Nuclear Power Output

Nuclear power generation in the OECD countries increased almost 9 percent in 1986 compared with 1985. Nuclear electricity generation now accounts for about 8 percent of total primary energy. Twelve new reactors, with a capacity of 13,400 megawatts-electric (MWe), entered commercial operation last year, and two reactors (about 300 MWe) were retired. Nuclear power capacity in Western Europe alone grew by 9,300 MWe, with France accounting for nearly 80 percent of the increase. Despite increasing political opposition, nuclear capacity will continue to grow in coming years. Of the 65 reactors under construction in the OECD, more than one-third are in the United States. Of the 27 units being built in Europe, those in Italy and West Germany are facing the toughest opposition—largely as a result of the Chernobyl' accident. 25X1

OECD: Nuclear Electric Generating Capacity and Output, 1985-86

	Installed Capacity (*thousand MWe, net*)		Gross Electricity Generation (*terawatt-hours*) [a]	
	1985	1986	1985	1986
OECD	**216.4**	**230.8**	**1,201.4**	**1,303.9**
United States	83.6	87.2	404.0	433.6
Japan	24.7	24.7	152.0	164.8
Canada	10.3	11.8	62.9	74.5
Western Europe	97.8	107.1	582.5	631.0
Belgium	5.7	5.7	34.5	38.6
Finland	2.4	2.4	18.8	18.8
France	39.9	47.2	224.0	254.2
Italy	1.3	1.3	7.0	8.7
Netherlands	0.5	0.5	3.9	4.2
Spain	5.8	5.8	28.0	37.5
Sweden	9.9	9.9	58.6	70.0
Switzerland	3.1	3.1	22.4	22.5
United Kingdom	12.3	12.9	59.6	59.1
West Germany	16.9	18.3	125.7	117.4

[a] A terawatt is equal to 1 million megawatts.

25X1

International Finance

Moratorium Easing Pressure on Sarney

Brazilian President Sarney has temporarily regained the political initiative at home following the suspension of interest payments on Brasilia's debt, but he appears to be on a collision course with foreign creditors. Polls taken over the weekend show most Brazilians support Sarney's decision, according to press reports, and the moratorium has quieted leftist criticism. Meanwhile, Brasilia is sending conflicting signals to its creditors. In an official statement Monday, a key presidential adviser said Brazil will not demand debt solutions that involve losses for creditors. At the same time, however, Finance Minister Funaro told reporters Brazil will not negotiate away its growth targets and will impose unspecified measures against foreign banks should they withdraw short-term credits. The Central Bank President told US officials that he believes it will be impossible to reach an agreement with the banks within 90 days and that a rescheduling of interest arrears will be necessary. Brasilia apparently is still formulating the specific debt proposals it will present to creditors next month. It probably will announce further measures to deal with the deteriorating domestic economy but is not likely to agree to a formal IMF program. Given the confusion and uncertainty on the part of foreign bankers, some could begin to withdraw short-term credits soon. 25X1

Ecuador Remains At Impasse With Foreign Creditors

Debt rescheduling negotiations between Ecuador and commercial banks have reached a standstill. 25X1 Quito has returned to its hardline stance in the negotiations, requesting a retiming of interest payments and lower interest rates. The Bank Advisory Committee met last week without Ecuador's economic team, but failed to come up with a new proposal, insisting that a new agreement is contingent on Quito supplying previously requested cash-flow data. In the interim, Ecuador has failed to make January and February interest payments totaling $80 million. Central Bank officials argue that a drawdown of foreign exchange reserves—currently $131 million, their lowest level in recent years—is politically unacceptable. In response to Ecuador's payments halt, several US banks have cut short-term credit lines. Although President Febres-Cordero has publicly discounted the possibility of a debt moratorium, growing economic and political pressure may prompt Ecuador to take unilateral action. 25X1

Egyptian/IMF Negotiations in Holding Pattern

Implementation of an IMF-endorsed standby program for Egypt is now unlikely for at least several more months. Negotiations between the Fund and Cairo reportedly have produced a signed letter of intent that will not be presented to the IMF executive board until early May. A number of unresolved questions remain, including details of exchange rate unification and a specific date for energy price increases. President Mubarak's recent decision to call an election in April for the People's Assembly has reduced the government's willingness to proceed with the politically sensitive program. Moreover, Egypt's improved foreign exchange earnings, resulting from higher oil prices, and renewed financial assistance from the Arab Persian Gulf states probably have convinced Mubarak that he now has more breathing space. Without agreement on a program, however, a formal debt rescheduling cannot take place and Egypt's economic outlook will remain precarious. 25X1

International Trade

Japan Gives Final Position on Export Credit Issue

At the January meeting of the OECD Export Credit Group, most members agreed in principle to substantially increase discipline over tied aid credits—a major US goal. The minimum grant element will rise to 30 percent for LDCs—50 percent for LLDCs—in July 1987 and to 35 percent in July 1988. The proposal also

includes a differentiated discount rate (DDR) system to better reflect the actual cost of providing aid. The formula used calls for a 50-50 weighted average between the market rate and the 10-percent discount rate for July 1987; in July 1988, the formula will change to a 75-percent weight for the market rate. Japan and Switzerland did not agree but are considering the proposal. [redacted] 25X1
[redacted] Japan is willing to raise the minimum grant element and to use a DDR system, including the formula, for 1987 but disagrees on the 1988 formula, preferring a two-thirds/one-third weighted average. [redacted] 25X1 25X1 25X1
[redacted] Meanwhile, the Swiss are willing to agree to the proposal, provided that members will commit to reviewing the issue of export credit interest rates in the near future. [redacted] 25X1

Global and Regional Developments

China Proposing Development Study for Hong Kong

China's top official in Hong Kong, Xu Jiatun, has proposed that a Western consulting firm coordinate a series of studies designed to keep Hong Kong's economy competitive with others in the region. [redacted] 25X1
[redacted] Xu wants the studies to set guidelines for industrial modernization and integration of new technologies, examine the curriculum at Hong Kong's universities, and plan the creation of more high-tech jobs. China is anxious to involve British officials and local businessmen in the studies to help calm investor fears that Hong Kong's economy is deteriorating in anticipation of the 1997 reversion to Chinese control. In recent years, Hong Kong's electronics, textile, and other light industries have lost business to South Korea, Taiwan, and Southeast Asia because Hong Kong has higher production costs and has lagged technologically. [redacted] 25X1 25X1

Jordanian-PLO Joint Fund Meeting

The Jordanian-PLO committee that met last week to distribute a $9.5 million Saudi contribution agreed to fund some projects on the West Bank, but the two parties made no progress toward increased cooperation on the Middle East peace process. [redacted] PLO Chairman Arafat believes Saudi Arabia will provide a total of about $28 million directly to the joint fund but will not contribute to King Hussein's separate West Bank development initiatives. According to the Embassy, Prime Minister Rifai worries that such Saudi donations will complicate Jordan's efforts to limit contact with the PLO. Hussein does not want the committee to take a political role that would jeopardize his own efforts to win Palestinian support on the West Bank. He is determined to avoid a dialogue with Arafat until Arafat accepts UN Security Council Resolutions 242 and 338. Renewed Saudi efforts to secure a PLO-Jordanian reconciliation through donations to the joint fund, however, are likely to inflate the importance of future meetings. [redacted] 25X1 25X1

ASEAN Reaction to Soviet Economic Overtures

The Soviet Union's increasing economic overtures to the ASEAN countries over the past year—part of Moscow's larger effort to expand its influence in the region—so far have yielded few tangible results. Indonesia, for example, like other ASEAN members, continues to resist agreements on economic projects, especially ones that would involve any Soviet presence. In late 1986, for example, the Soviets proposed a joint project for the construction of toll roads in Indonesia—a priority project for Jakarta—but Indonesia declined the offer. [redacted] 25X1
[redacted] the Soviet initiatives are designed to divide member countries. 25X1
While we are not certain this perception reflects Moscow's primary intent, we believe it is indicative of the distrust ASEAN members have of the Soviets. If other ASEAN officials believe they are being manipulated, Moscow's initiatives may backfire [redacted] 25X1

Brazilian Firm To Sell Fiber Optics to Soviet Union

Despite official denials to the US Embassy, the Brazilian firm ABC XTAL is about to complete a sale of indigenously produced optical fiber to the Soviet Union. Brazilian press accounts peg the deal at $17 million and claim that it results from ABC's participation in a 1985 Brazilian trade exposition in Moscow. The deal may require approval under US export regulations because ABC XTAL uses US-origin production equipment. The Soviets may well propose a countertrade arrangement, but the Brazilians may insist on payment in hard currency. In any case, the Soviets are likely to follow through with the deal because the Brazilian firm probably is offering a better price than the Soviets would receive from US, Japanese, or European manufacturers. Additionally, Moscow would benefit from closer economic relations with a non-COCOM member as a source of high technology. [redacted] 25X1

Cuban-Nigerian Trade Initiatives

Cuba reportedly is seeking to increase bilateral trade with Nigeria. [redacted] 25X1
[redacted] the Cuban Ministry of Foreign Trade is making arrangements 25X1
to extend the tour of duty of the Cuban trade official based in Lagos by at least six months. The extension suggests that Havana sees special merit in increasing trade with Nigeria at a time when the Foreign Trade Ministry is substantially curtailing its overseas operations and recalling trade officials because of budgetary constraints. Trade between Cuba and Nigeria has been negligible despite a 1981 bilateral economic cooperation accord and a 1984 agreement on fishing, sugar, and livestock development. [redacted] Cuba plans to 25X1
build a new pesticide plant, a prefabricated housing plant, and a fertilizer plant in Nigeria. Diplomatic relations between the two countries have been proper but not close, and Nigeria has not considered Cuba an important ally because of its limited ability to help with Nigeria's economic problems. In our judgment, Havana sees an opportunity to improve trade with Nigeria at a time when the low hard currency reserves of both countries make barter or countertrade agreements more attractive. [redacted] 25X1

National Developments

Developed Countries

[redacted] 25X6

[redacted] 25X1

25X1

Setback in Japanese Supercomputer Marketing

NEC recently lost a supercomputer sale to Honda Motor Company because of the lack of currently available applications software for the NEC machine. [redacted] 25X1

[redacted] 25X1

This setback for NEC clearly illustrates 25X1 the problems facing Japanese supercomputer suppliers. Now that the Japanese can produce competitive hardware, they must bolster their own software offerings, as well as attract the attention of independent supercomputer software developers. NEC may turn to foreign suppliers of supercomputer software to increase the availability of software compatible with their machines. [redacted] 25X1

25X1

Australia's Current Account Gap Widens

Australia's $860 million January current account deficit—more than double the shortfall registered in December—resulted largely from an 18-percent drop in export earnings, according to the US Embassy. This performance reverses two consecutive monthly improvements and indicates that Australia's two-year economic slide has not bottomed out. The latest trade figures will probably increase pressure on Prime Minister Hawke—especially from the hard-pressed business and farming communities—to take stronger actions to make Australia's high-cost exports more competitive, including holding down labor costs. In our judgment, Hawke will face considerable resistance from trade unions and from within his own Labor Party to any measures aimed at capping wages, especially with the annual inflation rate now on the order of 10 percent. Hawke may temporarily dodge the political fallout from the latest current account figures as the opposition coalition remains divided over leadership and tax issues, but, in the absence of any improvement, the dismal economy will be the toughest issue he has to address in the election that must be held by April 1988. 25X1

New Zealand's Election Year Economy Bleak

Prime Minister Lange's party will probably face elections this September with a troubled economy. Interest rates climbed above 25 percent in February and inflation—which reached 18 percent in 1986—was the second highest among industrialized nations. In addition, the New Zealand dollar has fallen against the Japanese yen—increasing the cost of machinery and automotive products from New Zealand's largest supplier—while rising against both the US and Australian dollars, depressing exports to its largest foreign markets. The US Embassy reports that the number of unemployed—already the highest in nearly 50 years—will almost certainly continue to increase, and, in our judgment, cost Lange votes. Government plans to privatize several public agencies in April will affect one-third of all public employees, many from key rural electorates. Lange has ruled out any last-minute pump priming because of Wellington's $3.4 billion budget deficit in 1986—up 16 percent from the previous year—and a more than $16 billion foreign debt equal to more than 60 percent of national output. 25X1

Less Developed Countries

Colombian Trade Policy Changes

Bogota is beginning to adjust its trade policies for fear that declining world coffee prices may bring a sudden halt to its current economic boom—possibly before the end of 1987. The government hopes to stimulate new exports by offering incentive payments through its Export Promotion Fund to exporters of nontraditional goods. At the same time, the Barco administration has decided to hold imports at current levels—$345 million per month—rather than allow them to rise to $380 million as previously contemplated. Further adjustments may be necessary. The Finance Minister recently told the local press he now expects coffee prices to drop to as low as $1.16 per pound, instead of the $1.30 rate previously projected. He predicted, however, that this decline will be partially offset by increased exports of petroleum, coal, and nontraditional products. [redacted] 25X1

Zimbabwe Facing Economic Contraction in 1987

Zimbabwean bank and university studies forecast that foreign exchange shortages will cut economic growth from 1.3 percent in 1986 to a negative 3 percent in 1987, according to the US Embassy. Reacting to an increase in the debt service ratio, the government reduced foreign exchange allocations to private businesses by 38 percent at the beginning of 1987. Debt service will consume about one-third of export earnings during 1987 and 1988, according to Finance Minister Chidzero. Foreign exchange shortages also stem from rising transport costs for imports, an increase in outflows of profits and dividends in 1986, and growing costs of maintaining more than 5,000 troops in neighboring Mozambique to battle the insurgency there. [redacted] 25X1

New Rupiah Devaluation by Indonesia Possible

[redacted] President Soeharto is considering devaluing the rupiah by up to 30 percent soon after the parliamentary elections in April because of government forecasts that budget revenues will be only half of the target level. This would be the second major currency realignment in eight months and, in our judgment, would underscore the depth of Indonesia's economic crisis. Last September Jakarta devalued by 31 percent against the US dollar. [redacted] Soeharto apparently is concerned that deficit spending would unsettle foreign creditors and believes that another devaluation is the only way to generate additional revenues needed to avoid more budget cuts. In our view, however, without a sharp and sustained rise in oil prices, Jakarta's domestic and external financing needs can only be eased through additional budget cuts or a foreign debt rescheduling. On the latter score, [redacted] Trade Minister Saleh believes that some limited form of commercial debt rescheduling will be necessary this year because recent large infusions of bilateral and multilateral aid are not sufficient to meet Indonesia's budgetary requirements. [redacted] 25X1

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Indonesian Economic Policy Infighting

[redacted] the sharp decline in government oil revenues is exacerbating the longstanding feud between the economic reformist "technocrats" and the group of younger engineers and scientists—the so-called protectionists—aligned with State Minister for Research and Technology B. J. Habibe. The technocrats, whose policies have been responsible for much of Indonesia's economic growth over the past two decades, are concerned that the protectionists will succeed in diverting scarce government resources away from regional development projects toward expensive, high-tech endeavors ill suited for Indonesia's depressed economy. [redacted] a recent presidential ruling, exempting high-tech ventures from various import controls, seems to indicate that the protectionist's influence in economic policy-making is increasing. In the absence of a sustained recovery in world oil markets, a diminution of the technocrats' role in economic policymaking could jeopardize Jakarta's reputation with foreign creditors who have been hoping that the technocrats will succeed in promoting additional trade liberalization policies. [redacted] 25X1

Communist

Bulgaria's Limited Economic Recovery

Bulgaria has reported a sharp economic recovery in 1986 and says that it met or exceeded most plan targets. Senior leaders secretly berated economic officials during the year, [redacted] and a number of economic officials, including the entire senior management of the chemical industry, were fired for mismanagement. While we estimate 2-percent Bulgarian economic growth, following a nearly 1-percent decline in 1985, the rebound was due largely to good weather that boosted agricultural output. Industrial growth showed only slight improvement and hard currency trade registered a $900 million deficit after several years of surplus. Trade problems and shortfalls in investment are hampering the critical economic modernization drive. Sofia probably put the best face on 1986 statistics, hoping to stave off renewed Soviet criticism and gain time to experiment with its own brand of limited economic reform. The Bulgarians are also eager to impress the West in an effort to attract joint ventures and enhance Bulgaria's bid for GATT membership. [redacted] 25X1

Expulsions Cripple North Korean Illegal Trade Channels in Western Europe

The 1986 expulsion of seven key North Korean diplomats from West Berlin has seriously impaired the North's ability to conduct illegal trade with Western Europe, and could adversely affect legal trade there as well, [redacted] 25X1
The diplomats, from P'yongyang's East Berlin Embassy, were expelled from West Berlin by order of the Allied Command for illicit arms transactions—diverting Hughes helicopters and spare parts to North Korea. Until the expulsions, West Berlin has been, [redacted] the hub of North Korea's illicit trade 25X1
with Western firms. Since then, the combination of a reported December 1986 P'yongyang directive prohibiting their diplomats from entering West Berlin, the hesitation of Western businessmen to travel to East Berlin, and the heightened scrutiny by the Allied Command has, at least for the near term, left the North few options for continued illegal trade with Western Europe. P'yongyang is considering using Vienna as an alternative, probably for arms transfers and acquisitions of Western technology, [redacted] 25X1

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