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

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17 January 1986

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17 January 1986

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

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17 January 1986

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**International
Economic & Energy Weekly**

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Synopsis

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**International
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Perspective

Western Europe's High-Technology Policy Still Lacks Direction [Redacted]

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West European cooperative programs to improve technological competitiveness remain a mixture of ambitious goals and modest achievements. Most West European leaders consider European-wide cooperation necessary to bridge the "technology gap" vis-a-vis the United States and Japan. They have had difficulty, however, arranging funding and setting aside short-term national interests. Consequently, many of Western Europe's high-technology research programs—in particular, ESPRIT, RACE, BRITE, and, more recently, EUREKA—take shape slowly. They lack the specific product goal that was characteristic of Airbus and the European Space Agency's (ESA) Ariane—two projects generally cited as West European successes. Moreover, companies will continue to face problems translating technological advances into commercial products unless further steps are taken to create a unified West European market. [Redacted]

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ESPRIT—the EC program in information technologies—highlights the difficulty of getting West European companies to work together. A committee of businessmen and academics recently pointed to progress on several projects and on setting European standards for computer software but could cite no major technological breakthroughs. The program still has not established an overall data transmission system because of disagreement on what equipment to use. Companies, in any case, are reluctant to share technical information with research partners that are competitors outside ESPRIT. Also, firms from the less-advanced EC countries are seeking to upgrade their technology through ESPRIT and are focusing on technology sharing rather than cutting-edge research. Several firms probably are using the program to finance marginal research they would not do without government support. [Redacted]

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RACE—an EC initiative to create a unified West European telecommunications network by the end of the century—almost certainly will face severe funding difficulties. The program is in a preliminary phase but spending is slated to rise steeply once it formally begins. With EC officials already struggling to finance the current research budget, the major expenditures envisioned for RACE may be cut back sharply. In addition, RACE faces an uphill battle against traditional procurement practices that heavily favor domestic producers. EC efforts to harmonize technical standards across member countries for telecommunications equipment, for example, have been ineffective. BRITE—the EC program to apply advanced technology to traditional industries—is also unlikely to get the funding needed to carry out its aims. [Redacted]

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For EUREKA—the latest European-wide high-technology initiative—the major West European countries are trying to emulate the ESA approach by keeping it out of the EC framework. They also wish to make it a program for product development rather than fundamental research. Western Europe—including non-EC countries—has approved the general concept of EUREKA and has selected 10 preliminary projects, but its funding, organization, and aim are still being worked out. If EUREKA focuses on a few key areas of dual-use technology, it could bolster West European competitiveness in the civilian and defense sectors. Nonetheless, political differences are likely to slow the program, and funding problems may transform it into a series of measures designed merely to spur joint ventures among West European firms. The common perception of EUREKA as an alternative to participation in SDI research underscores the ambivalence of West Europeans toward joint projects with their main industrial rivals. West Europeans want the technological spinoffs of such cooperation, but fear that their best scientists will wind up working for non-European competitors. [redacted]

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Despite mixed results to date, some progress on West European research cooperation and creation of a more unified West European market seem likely. West European countries already are moving toward the following goals: elimination of intra-European trade barriers by 1992, greater deregulation of capital markets, provision of tax incentives to innovative firms, and the development of European-wide technical standards. The outlook for accomplishing these aims is brighter now than just a few years ago, but implementation will be a long process. [redacted]

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West Germany: Changes in Telecommunications Policy

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Bonn has proposed several modest changes to its telecommunications policy following a US fact-finding mission in December on the West German telecommunications market. While these changes are an encouraging first step, the United States will pursue further market-opening measures. The United States, as well as France and Japan, has been eager to increase sales to the West German telecommunications market—the largest in Western Europe, but one that has remained relatively closed to foreign suppliers. We believe that West German fears of protectionist legislation in the US telecommunications sector prompted their recent concessions. West German telecommunications officials probably hope these incremental concessions will defuse pressure for more fundamental reforms. A closed US market would hurt West German equipment manufacturers, who view the United States as a major export market. [redacted]

Bundespost must first have their equipment tested and certified by the Bundespost's Central Telecommunications Licensing Office to ensure compatibility with the public network. This licensing group only considers certification requests from West German citizens and firms, or a foreign firm with an established subsidiary in West Germany. The working committee that sets the technical standards against which all products are tested is funded by and composed of this same group of supplier firms. [redacted]

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The US Embassy confirms that US telecommunications firms have been adversely affected by Bundespost regulations and practices. A large US computer company reports that it could not get sales approval for a digital private branch exchange for two years because the Bundespost had not written a regulation to cover the new technology. In another case, a US data base supplier was not permitted to offer its product to customers of the public switched network because of the Bundespost monopoly on all domestic dial-up networks. [redacted]

The Deutsche Bundespost-Industry Relationship

West Germany's postal and telecommunications authority, the Deutsche Bundespost, has come under increasing criticism both at home and abroad for its continuing monopolistic hold over telecommunications. The Bundespost's monopoly is part of the West German constitution and gives the Bundespost exclusive rights to establish and operate public telecommunications systems. A high degree of cooperation exists between the Bundespost and its four major West German electronics and telecommunications equipment suppliers: Siemens, Standard Elektrik Lorenz, Telenorma, and Deutsche Telefonwerke. These firms supply roughly 90 percent of the Bundespost's annual procurement, which in 1984 totaled over \$5 billion. In addition, the Bundespost often works out product specifications in advance with these favored suppliers. [redacted]

German Responses to US Concerns

The West Germans have made it clear that they feel no pressure to follow the US lead in large-scale deregulation of the telephone system. They did offer the following general responses to US questions on existing Bundespost policies:

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- *Liberalization.* There is a significant amount of domestic interest in reexamining the role and structure of the Bundespost. A high-level independent commission composed of business, industry, and political leaders is currently examining the options for a new telecommunications policy, and will report its recommendations to the government in 1987.

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Bundespost certification procedures have also worked to the advantage of domestic supplier firms. According to Embassy reporting, all vendors to the

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- *Trade.* West German officials claim they are puzzled by simultaneous US moves toward liberalization and protectionism. In light of the pending US legislation, such as the Danforth and Wirth-Florio telecommunications bills, the US charge that the West German market is closed does not impress the German telecommunications authorities. In addition, the West Germans pointed to the US trade surplus in the telecommunications sector as an indicator of West Germany's open markets.
- *Prospects for Competition.* West Germany justifies its monopoly practices on political and legal grounds. Because the Bundespost is charged by law with providing a public service, it must make telecommunications services available at the same price to all users. This results in considerable interregional subsidies. The Bundespost stated that fulfilling its social mandate is therefore inconsistent with the introduction of competition.
- *Standards.* A Bundespost representative explained that the West German standards-setting committees mirror the technical committees of the International Standards Organization (ISO). These committees are voluntary organizations funded by the major West German electronics and telecommunications companies. As a member of the European Community, West Germany is also intent on working toward a common European standard for telecommunications products and network interface, which limits their ability to respond directly to US appeals.
- *Procurement of telecommunications equipment.* A Bundespost spokesman claims that Bundespost procurement is nondiscriminatory, with domestic and foreign firms treated equally. Foreign firms have generally received positive consideration by the Bundespost when they offer a product not usually included in the West German firms' product lines.

Liberalizing Measures

Despite these differences of opinion, the West Germans offered the US delegation a list of eight liberalizing measures at the conclusion of the

Proposed Changes in West German Telecommunications Policy

<i>Category</i>	<i>Proposed Measure</i>
<i>Procurement</i>	<p><i>US firms will be allowed to participate in Bundespost tenders offered through the EC. The West Germans are opening 10 percent of terminal equipment procurement for purchase outside West Germany.</i></p> <p><i>The Bundespost will support efforts to initiate discussions between the United States and the EC aimed at reaching agreements in the new GATT round regarding coverage of telecommunications equipment under the government procurement code.</i></p>
<i>Type approval</i>	<p><i>The approval procedures of the Central Telecommunications Licensing Office will be expedited.</i></p> <p><i>The Bundespost will consolidate all of the type approval procedures into one regulation.</i></p>
<i>Enhanced services</i>	<i>After harmonization of tariffs (in 1988) the Bundespost will liberalize the provision of enhanced services.</i>
<i>Customer premises equipment</i>	<p><i>The technical specifications for private branch exchanges will be revised to permit greater approval flexibility. The mandatory leasing of the primary telephone instrument from the Bundespost will be eliminated in 1988. Technical specifications for modems will be revised and harmonized.</i> <input type="text"/></p>

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conference. Among these changes, West Germany now will open 10 percent of government contracts for telecommunications equipment to foreign firms by offering them through EC channels. West Germany has also pledged to support US efforts to include telecommunications equipment under the government procurement code of the GATT in the upcoming round. Should the code be revised to include telecommunications equipment, the Bundespost would be required to consider foreign and domestic bids equally. In the area of enhanced services, including high-speed data, data base retrieval services, and information processing, the Bundespost has hinted that in 1988 following tariff harmonization—the standardization of West German communications charges—it will allow the private sector to compete in the enhanced services market. The Bundespost has also offered two measures to help simplify the type approval process necessary for meeting technical standards. [redacted]

Unanswered Questions

These changes to current telecommunications policy represent some progress but still leave several points unclear. On the issue of terminal equipment procurement, Bonn has not stated whether the 10-percent share means a guaranteed percentage of foreign purchases or merely the percentage of tenders that will be published outside West Germany. Moreover, we do not know the range of terminal equipment products to be included under this measure. For 1988, when provision of enhanced services may be liberalized, it was not stated whether the private-sector firms must be located in West Germany. An important barrier to the liberalization of enhanced services is West Germany's policy of tariff harmonization through volume charging. Volume charging, which prices according to the amount of data transmitted, could make the provision of enhanced services unprofitable for private firms. Moreover, the timetable for the implementation of the liberalizing measures is uncertain. The government commission investigating telecommunications issues will not report its recommendations on a new policy framework until 1987. By leaving December's proposed changes

West Germany: Projected Growth in Terminal Market

Thousands of units

	1985	1990 ^a
Telephone	31,000	36,000
Telex	160	170
Teletex	72	72
Facsimile	22	50
Videotex	35	1,750
Cable TV	525	4,000
PCs	250	4,000
TVs	24,000	25,000

^a Projections.

[redacted]

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unscheduled, the Bundespost may be trying to avoid a potential conflict with the commission's report. [redacted]

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Good Timing

These West German policy changes may be a response to domestic and international pressures for deregulation of the telecommunications industry. Following the AT&T breakup and the privatization of NTT in Japan, many traditional post and telecommunications monopolies in Western Europe are reconsidering their structure. We believe additional pressure to reevaluate Bundespost policies is coming from domestic groups and the EC Commission.

[redacted]

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Strong differences exist between the German Economics Ministry, which favors free trade, and the Bundespost, which is eager to hold on to its monopoly. The West German delegation was cochaired by these two ministries. There also is pressure from the EC Commission for West Germany to liberalize the provision of customer premises equipment,

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particularly modems. The customer premises equipment market, which includes telephones, desktop terminals, printers, and other peripherals, is expected to show significant growth in the next few years. West Germany had long defined modems as part of the network and not as customer premises equipment, allowing the Bundespost to tightly control modem sales and specifications. We believe the announcement that the Bundespost "has the intention of liberalizing and harmonizing the requirements for modems" is a response to EC concerns. Nonetheless, the EC, while supporting efforts to establish a unified European telecommunications market, is critical of US attempts to negotiate bilaterally with member states. [redacted]

West Germany's willingness to discuss regulatory and market issues attests to the growing domestic interest in telecommunications reform. Continued reform of the Bundespost's monopoly, however, will depend chiefly on a strong political consensus in West Germany. Whether or not this consensus can be achieved remains to be seen. Nonetheless, between thorough reform of the Bundespost's monopoly and the present highly restrictive regime, we believe there is room for some accommodation of US concerns. [redacted]

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Outlook

We believe that further liberalization of the customer premises equipment market is likely, but we do not expect any significant policy changes before the 1987 report is issued. Other opportunities for US vendors may come in enhanced services such as time sharing, electronic mail, and local area networks after 1988. Freedom for private firms to offer these services over the public switched network, however, depends on a limiting of the Bundespost monopoly. If the monopoly were limited, the Bundespost might offer only the basic telephone service and supply the physical network.

[redacted]

The

Bundespost is likely to continue to oppose the limitation of its monopoly, because potential lost revenue may diminish subsidization of basic phone service. [redacted]

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South Africa: Prospects for Debt Negotiations

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Proposals by South Africa and bank creditors to reschedule \$14 billion in currently frozen debts are far apart, but President Botha's speech opening Parliament later this month probably will contain enough positive elements to keep debt negotiations going. In addition, Pretoria's recent decision against widening its debt moratorium and restraint on foreign currency controls suggest a desire to begin the long return to normal international financial relations. Even with progress in debt talks, however, South Africa probably will become increasingly economically isolated as long as unrest continues.

Status of Negotiations

After last October's brief and inconclusive first meeting between South Africa and its commercial bank creditors, both sides agreed to meet again in November. South Africa's debt mediator, Swiss banker Fritz Leutwiler, postponed the meeting until early this year, however, probably in the hope that a decline in black unrest or possible progress on reform after the South African Parliament convenes this month would improve Pretoria's standing with the international financial community. With no possibility of a debt rescheduling accord before South Africa's self-imposed 31 December deadline on its debt repayment moratorium, Pretoria last month unilaterally lengthened the debt standstill until 31 March.

Despite its lengthening of the moratorium, Pretoria resisted adding other loans to the standstill—which many local observers had expected. With almost half the country's loans being repaid normally, and interest payments continuing on credits included in the standstill, South African officials had indicated the moratorium was yielding little foreign exchange breathing space—fueling concerns that additional debts would be drawn into the moratorium net. Pretoria's decision probably reflected a desire to

Downside Risks

South Africa is poised for a weak recovery this year with about 3 percent real GDP growth. Sustaining the upswing beyond 1986, however, probably would require successful negotiations with foreign creditors to reschedule the \$14 billion in debts that are now frozen. Failure to do so, or to avert tougher sanctions, will lower growth prospects over the next few years, adding to tensions in black townships, where over 1,000 people have died in 16 months of rioting.

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A strongly negative foreign reaction to Botha's speech could bring on tougher sanctions and move South Africa more rapidly toward a siege economy. The exchange value of the South African rand probably would fall sharply, leading Pretoria to move quickly to set a fixed exchange rate, further limit imports and overseas payments, and probably reschedule foreign debt unilaterally. Foreign companies would skirt foreign exchange controls, for example, by overcharging South African subsidiaries for products.

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Under these extreme circumstances, the decline in foreign and domestic business confidence probably would kill South Africa's tepid recovery, leaving the economy to plod along for several years, with an increasing number of skilled whites leaving in the face of declining economic opportunities. In turn, declining black living standards would influence many of them to accept the argument of militants that majority rule is needed to secure economic gains.

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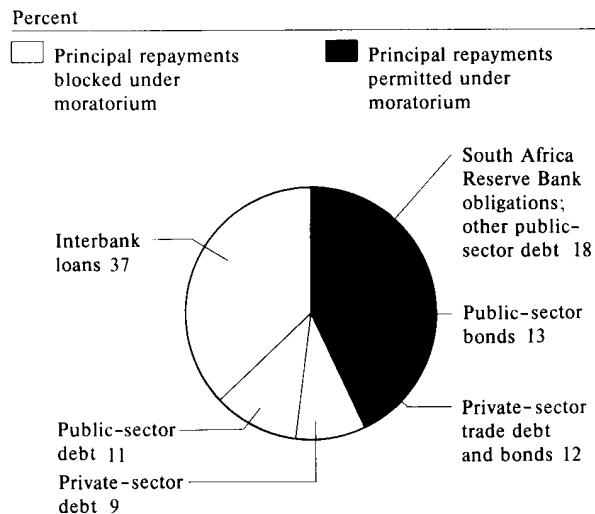
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South Africa: Foreign Debt Structure^a



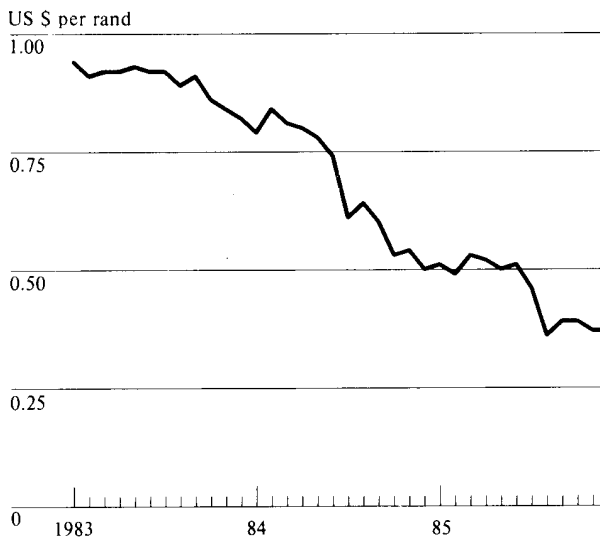
^a Structure of the estimated \$23.7 billion foreign debt as of August 1985.

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avoid further piquing creditors, expedite a debt accord, and begin the long return to normal international financial relations. [redacted]

Pretoria also has shown restraint in its approach to tightening foreign currency controls. With the value of the South African rand still under downward pressure—despite central bank intervention, the debt moratorium, and the reintroduction last September of a penalty rate for capital outflows—many South African economists expected Pretoria to peg the exchange rate to the dollar. Instead, the government only modestly tightened currency controls. Exporters are now obliged to convert foreign currency earnings to rand within seven days of the delivery of goods, while the Central Bank, in its

South Africa: Exchange Rate Trends, 1983-85



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role as the marketing agent for South African gold mines, now will retain the foreign currency earned from gold sales, paying the mines in rand. [redacted]

Debt Proposals Far Apart

South Africa's first debt rescheduling plan, presented in December, essentially proposes to extend the current debt moratorium until 1990. In an attempt to make this suggestion more palatable to foreign creditors, Pretoria's plan would allow them to roll over maturing blocked loans to new South African borrowers, or to transfer the frozen funds to South African banks and obtain in return five-year promissory notes [redacted]

Not surprisingly, bank creditors have dismissed Pretoria's proposal as unrealistic, according to [redacted] US Embassy reports. In addition

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to the economic considerations, foreign banks also continue to face the dilemma of balancing a solution to South Africa's financial crisis against a desire to avoid being viewed as cooperating with Pretoria. [redacted] bank creditors have put forth their own debt plan, which calls for South Africa to repay 10 percent of frozen debts by yearend. Bankers would then review the country's financial position before determining a repayment plan for 1987. [redacted]

[redacted] banks also suggested Pretoria consider a Paris Club rescheduling of foreign-government-guaranteed debt—primarily trade credits exempt from the current standstill—but Pretoria so far has been careful to avoid entangling foreign governments in the debt standstill, and in our view would do so only under extreme financial pressure. [redacted]

Pretoria's proposed four-year standstill probably is intended partly to signal to bankers that the country will not cave in to foreign pressures, but it may also reflect caution about the rate at which the country can repay. [redacted]

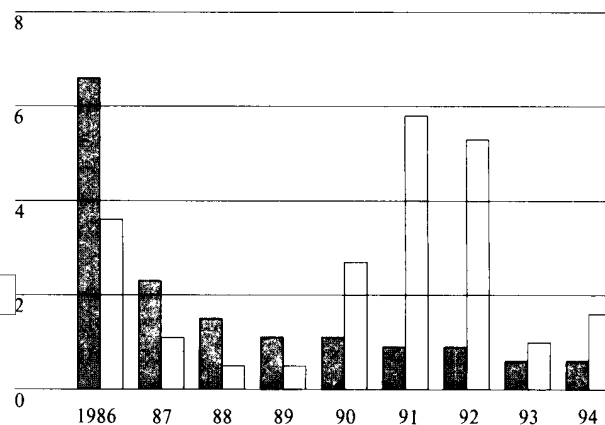
[redacted] debt repayment obligations not covered by the moratorium could place heavy strains on the foreign payments position this year. South Africa probably posted a healthy \$2 billion current account surplus for 1985, but, with increased imports likely to accompany the modest economic upswing expected this year, the 1986 surplus could be pared to about \$1.7 billion. Against this, about \$2 billion in trade credits plus another \$1.6 billion in other loans outside the moratorium fall due this year. [redacted]

Reserve Bank Governor de Kock is optimistic that most expiring trade credits will be renewed, but US Embassy and press reports indicate South African commerce is feeling the pinch of curtailed trade lines. [redacted]

South Africa: Pretoria's Debt Rescheduling Proposal, 1986-94

Billion US \$

■ Current maturity schedule □ Maturity schedule under South African rescheduling plan, including \$8.3 billion in 1985 maturities



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Outlook

Despite the pressure of debt rescheduling talks and threats of stronger Western economic sanctions, President Botha almost certainly will not announce reforms sufficient to placate most foreign critics when he opens Parliament on 31 January. His speech probably will contain enough positive elements, however, to keep debt negotiations going. One area of possible concession is modification of the law that empowers the government to reserve certain residential and business areas for whites, mixed-race Coloreds or Indians, although Botha will not scrap this law altogether. The banks have little to gain by breaking off debt talks as long as

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public pressure is manageable and South Africa remains current on its interest payments. Pretoria, for its part, probably recognizes bankers' political sensitivities and may be willing to negotiate on the basis of last month's bank proposal. [redacted]

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Even with progress in the debt negotiations, however, South Africa probably will become more economically isolated as long as the unrest continues. After a likely one-year debt rescheduling expired, South Africa and its creditors probably would be faced in subsequent negotiations with even greater pressure for major political concessions. Meanwhile, continued unrest probably would spark new calls for tougher Western economic sanctions. [redacted]

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[redacted] measures to insulate South Africa from foreign economic pressures include building a natural-gas-to-oil conversion plant, creating phony export and import companies to avoid trade restrictions, and promoting a security-related domestic electronics industry.

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[redacted]

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**Sri Lanka: Economic Problems
and Communal Conflict**

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The conflict between the Tamil minority and a Sinhalese majority in Sri Lanka, rooted in deeply contested political and ethnic issues such as power sharing and the preservation of distinct and separate cultures, is becoming increasingly costly to the national economy and the economic well-being of both groups. So far, Tamil areas in the north and east have been hit hardest, but the insurgents are threatening tea exports, Sri Lanka's major foreign exchange earner, and other economic targets in the Sinhalese south. Defense spending is cutting into funds available for development and welfare, and investment, tourism, and aid are falling. At the same time, competition between Tamils and Sinhalese for land, employment, and development is intensifying. Although the economic outlook would improve if a peace settlement is reached, structural inefficiencies, external debt, and the dependence on world commodity prices would still severely hamper development.

The insurgency has had its greatest impact in the economically backward Northern and Eastern Provinces, where most of the fighting has taken place and where most Tamils live. Embassy reports indicate that Tamil insurgent attacks on infrastructure targets, such as roadways, railroads, and port facilities; repeated robberies of banks and businesses; and the general collapse of civil order have crippled economic life in Jaffna, the major city in the north. Products normally supplied from Jaffna to the rest of the country—fish, salt, and cement—are in short supply throughout Sri Lanka.

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Fishing, a major part of the economy in the north, has been hit hard. Sri Lanka's total fish catch dropped by 23 percent in 1984, and the government estimates another 10-percent decline for 1985. Coastal fish catches in the northern and eastern regions have suffered from the increased Sri Lankan naval surveillance, Army attacks on fishing villages, and the flight of Tamil fishermen to India.

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The Economic Cost of Insurgency

The two-and-a-half-year-old insurgency is exacerbating the problems already facing the Sri Lankan economy. We estimate that the economy grew by less than 4.5 percent last year—the lowest level since 1977—in large part because of stagnant tea production and declining output from public-sector industries. Private domestic and foreign investment has been deterred by a decline in the number of lucrative investment opportunities, an overvalued exchange rate, a deteriorating infrastructure, and government backsliding on liberalization measures. The current account deficit more than doubled in 1985 because of falling tea prices and a growing services deficit.

Blocked transport links with Colombo and periodic militant attacks on rice farmers have disrupted production, milling, and marketing in the north and east, resulting in near famine conditions in parts of the Eastern Province. The government imported 200,000 metric tons of rice in 1985 to bolster national stocks.

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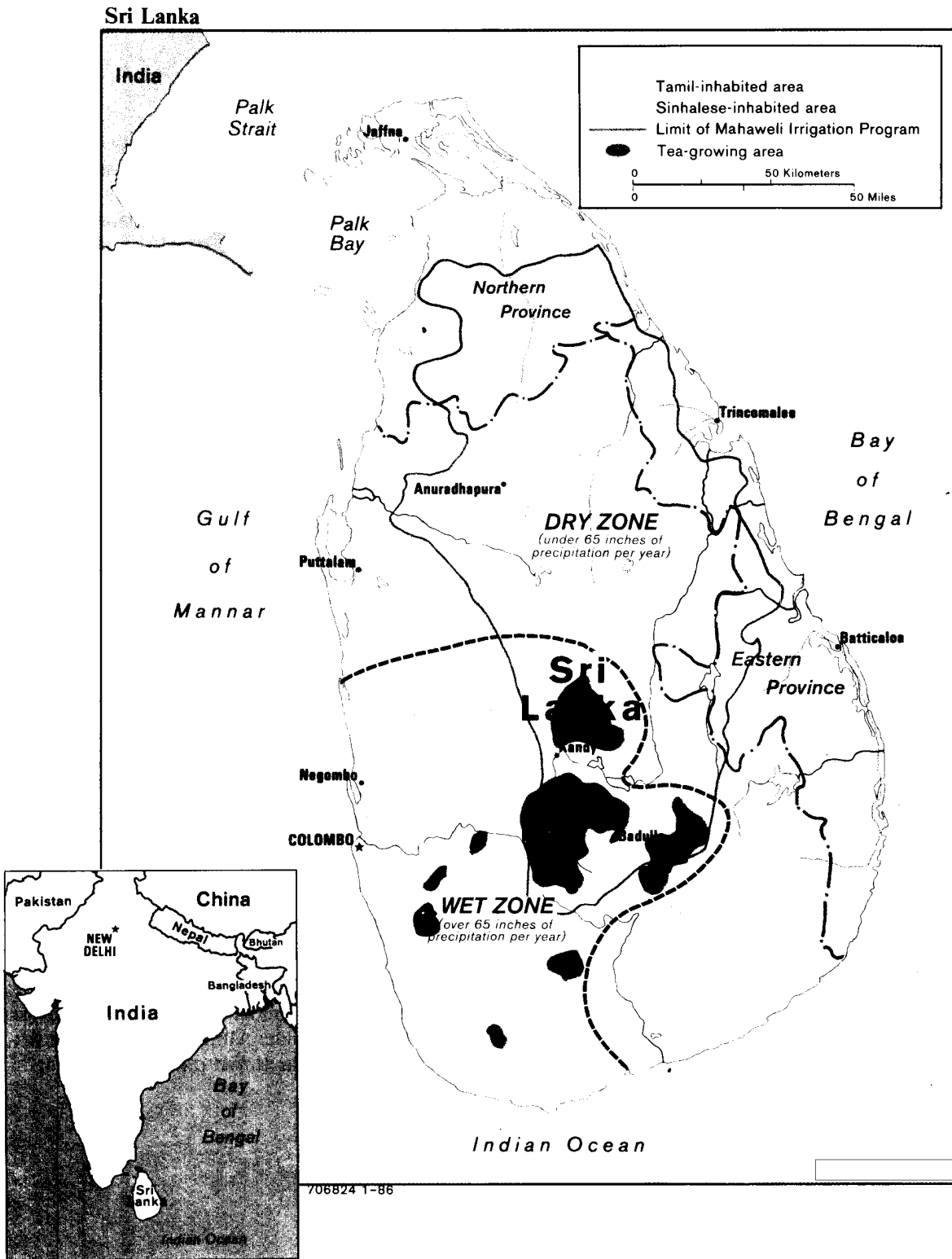
Tamil militants have recently begun at least one form of economic warfare against the central government. One group in January 1986 claimed to have contaminated an undetermined quantity of Sri Lankan tea with cyanide. Although no poisoned tea has yet been found, the threat prompted a major

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Sri Lanka: Balance of Payments, 1980-85

Million US \$

	1980	1981	1982	1983	1984	1985 ^a
Current account	-798	-610	-732	-644	-220	-570
Trade account	-987	-818	-983	-856	-436	-750
Exports, f.o.b.	1,065	1,065	1,013	1,062	1,475	1,260
Tea	374	335	305	353	620	370
Garments and textiles	109	156	168	201	296	375
Imports, c.i.f.	2,051	1,883	1,996	1,918	1,911	2,010
Services, net	52	6	-14	-61	-62	-100
Of which:						
Tourist receipts	111	132	147	127	115	90
Interest payments	-59	-121	-128	-173	-180	-190
Private transfers, net	137	203	265	274	277	280
Overall balance	-216	-31	-20	0	304	-20

^a Based on CIA estimates and preliminary data from the Government of Sri Lanka.

[Redacted]

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Australian purchaser to cancel imports of Sri Lankan tea; other buyers are also assessing their purchases. Tea trade accounted for approximately 30 percent of Sri Lanka's 1985 export earnings.

[Redacted]

Program has been reduced, and the budget for 1986 indicates additional cuts will be made in development. [Redacted]

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Growing Spending Strains

The cost of the counterinsurgency effort has begun to cut into economic development. Following several supplementary appropriations from Parliament in 1985, total allocations for defense reached about \$230 million—85 percent greater than the original budget and almost 170 percent more than in 1984. Defense expenditures—more than half of which are earmarked for Army and police pay—are now the second-largest item in the budget and account for 10 percent of government spending, compared to 3 percent in 1982. Spending on some rural development projects, public-sector industries, social welfare programs, and the Mahaweli Development

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Foreign Investment, Aid, and Tourism

Although the militants have not yet launched attacks against foreign companies operating in Sri Lanka, the general instability has taken a toll on foreign investment. The government maintains that

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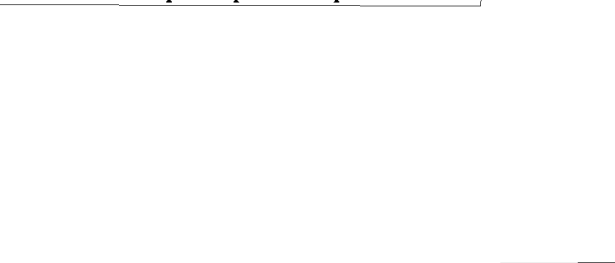
Sri Lanka: Approved Industrial Investments That Include Foreign Participation *Number of Projects*

	1979	1980	1981	1982	1983	1984
Greater Colombo Economic Commission	40	44	18	16	13	15
Outside Greater Colombo Economic Commission	NA	55	51	45	56	41

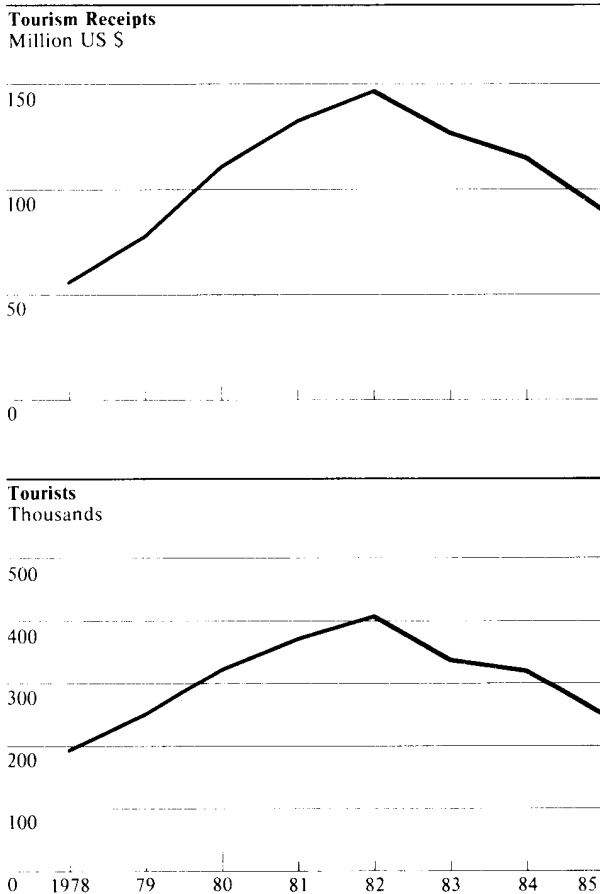
foreign investors continue to show interest in Sri Lanka, but admits their numbers have been reduced. [redacted] potential foreign investors in the important textile sector are reluctant to begin new projects, and the US Embassy reported that a West German-Swiss partnership withdrew a \$10 million commitment to a construction project in Trincomalee in mid-1985 in the wake of growing guerrilla operations in the Eastern Province. [redacted]

The communal conflict has also caused some cuts in foreign aid. Diplomatic reporting indicates Canada—a major donor to the Mahaweli Irrigation Program—decided in early 1985 to withhold funds earmarked for the next stage of the irrigation network to protest alleged human rights violations by government security forces. In 1984 Saudi Arabia, another major donor to the Mahaweli Program, withheld a \$50 million installment because Colombo had accepted Israeli security assistance. [redacted]

Lobbying efforts by Tamil support organizations in Western Europe threaten to harm Colombo's relations with its principal European donors. [redacted]



Sri Lanka: Tourism, 1978-85



^a Based on January–November arrivals.

[redacted]
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The tourist industry, held up not long ago as the success story of Asian tourism, has been a major casualty of the insurgency. Earnings have declined from a peak of almost \$150 million in 1982—before the conflict worsened—to less than \$100 million in 1985. The total number of tourists declined from 407,000 in 1982 to about 320,000 in

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1984, and arrivals from January to November 1985 were about 20 percent lower than the corresponding period in 1984. [redacted]

Economic Issues in the Communal Conflict

The insurgency is fueled in part by Tamil perceptions of Sinhalese economic discrimination. Tamils claim that, since the early 1970s, successive Sinhalese governments have denied Tamil areas a fair share of central government development outlays, restricted access to government jobs, and denied Tamils the benefits of newly irrigated lands. In our view, the failure of the Jayewardene government over the last four years to address these economic grievances and to fulfill promises of limited autonomy to Tamil areas has heightened Tamil frustrations and strengthened Tamil civilian support for the insurgency. Prospects for reconciliation of these issues are dimming as overall economic performance lags. [redacted]

The settlement of newly irrigated lands is the most divisive economic issue. Jayewardene's decision in 1977 to accelerate the Mahaweli Program is part of the government's desire to find new land for Sinhalese farmers by irrigating sparsely populated areas of Sri Lanka's extensive dry zone. Mahaweli is intended to provide increased domestic food production and promote production of traditional cash crops for export—both important political demands of the government's Sinhalese constituency. [redacted]

Tamils argue publicly that Colombo's land settlement policy perpetuates economic discrimination, leaving Tamil farmers to cultivate the economically less viable lands. Embassy reports indicate that, while new Sinhalese settlements have drawn frequent insurgent attacks, the militants have not yet attacked the Mahaweli Program's network of canals and dams, suggesting they are reluctant to sabotage an economic asset that could be vital to Tamils. [redacted]

More Problems Down the Road

We see two possible scenarios for the Sri Lankan economy in 1986. In the first and slightly less likely scenario, Indian mediation efforts could lead to a partial settlement between the government and moderate Tamil groups that would grant some political autonomy to Tamils, but not enough to defuse hardliner demands for a separate state. Such a settlement would have only a limited positive impact on the Sri Lankan economy. In our view, Colombo would be forced to maintain high levels of defense expenditures to protect against militants who rejected the settlement, as well as to rebuild the central government presence in the Northern and Eastern Provinces. As a result, we doubt that investors and tourists would return quickly. [redacted]

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The second and more likely scenario entails a collapse of negotiations and a resumption of full-scale fighting. Under these conditions, the economic costs of the insurgency to the government would grow. Damage to Sri Lanka's agricultural output, fish catch, economic infrastructure, tourist industry, and foreign investor and donor confidence would become more pronounced. The government would probably continue its military buildup, forcing higher budget deficits and further cuts in economic development programs. [redacted]

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In either scenario, the most hardline Tamil groups are likely to attack economic centers in the Sinhalese south in a bid to force further concessions from Colombo. [redacted]

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Moreover, sabotage of foreign-owned

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businesses or attacks on hotels in the south could erode Sinhalese confidence in the regime and jeopardize the country's efforts to rejuvenate its economic liberalization and diversification programs. The Tamil militants are also likely to continue to attempt to disrupt Sri Lankan tea exports. [redacted]

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Even if a comprehensive peace settlement is reached, overall economic performance is unlikely to improve significantly any time soon. Economic growth will continue to be plagued by insufficient investment. The government has not shown the will to reform and broaden the tax base; it is likely to continue to rely on inefficient export and import taxes. The economy will remain heavily dependent on the world prices of agricultural commodities, which show no sign of a dramatic increase. Government protection and structural inefficiencies continue to plague public-sector industries and deter new foreign investment. Repaying the large debt will continue to be a burden at least for the remainder of the decade. [redacted]

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Continuing violence, whether the result of an untidy settlement or widespread new fighting, is likely to cause Sri Lanka to turn more to the United States and other Western nations for foreign aid to offset mounting defense expenditures and a worsening foreign payments position. Even if the insurgency subsides, Colombo will almost certainly request additional development assistance from the United States and other lenders and donors to help fund recovery costs and to meet international debt commitments. [redacted]

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International Gas Markets: A Year of Progress [redacted]

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The year 1985 saw a major expansion of demand and trade in both West European and Asian gas markets. Gas deliveries under existing contracts with the USSR rose about 17 percent over year-earlier levels. As a result of substantial progress in the negotiations over the sale of gas from the giant Norwegian Troll field, however, the outlook for indigenous West European gas production—as an alternative to Soviet supplies—is much more optimistic now than it was a year ago. We believe, however, that this improved outlook still could be undercut by declining energy prices, especially if oil prices collapse during 1986. In East Asia, on the other hand, several liquefied natural gas projects continue to be promoted as alternatives for satisfying projected demand requirements in Japan, South Korea, and Taiwan. It appears that the Soviet Union will be making a major effort to obtain a commitment from Tokyo this year for the purchase of gas from Sakhalin Island. [redacted]

Indigenous Supply. The year opened in an atmosphere of growing pessimism as an apparent British Gas Corporation decision to purchase gas from Norway's Sleipner field in the North Sea collapsed as a result of London's objections to the terms of the agreement, its impact on the UK balance of payments, and upward revisions in estimates of UK gas reserves. Development of Sleipner consequently has been deferred. [redacted]

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London is expected to reenter the import market for natural gas within a few years, despite the official position that indigenous supplies will be sufficient to meet future demand. These imports could come from Sleipner, but, should a cross-channel pipeline be constructed linking Britain to the continental pipeline system, gas imports from the Soviet Union cannot be ruled out. [redacted]

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The European Gas Market

Demand. We estimate consumption in Western Europe during 1985 grew about 7 percent over year-earlier levels, due in large part to continued substitution for oil, the unusually cold European winter, and some modest improvement in the West European economies. For the year, consumption reached a record level of approximately 235 billion cubic meters (bcm), according to our estimates. The greatest increases were recorded in:

- Italy, where consumption is rising to accommodate the volumes contracted from both the USSR and Algeria.
- Austria, which is taking planned increases in Soviet gas.
- The United Kingdom, where natural gas usage continues to expand in the residential and commercial market.
- France, where attractive pricing for industrial uses has permitted consumption of competitively priced contracted Soviet supplies. [redacted]

With the collapse of the Sleipner sale, many observers believed that the likelihood of development of the Troll field, far larger and more costly to develop than Sleipner, had been diminished. In May, however, negotiations for the sale of Troll gas to a consortium of continental gas buyers began, and [redacted] they are progressing well, despite the fact that price terms have not been settled. According to Embassy reporting, a contract for as much as 15 bcm of gas annually, beginning in the mid-1990s, may be signed this year. If agreement can be reached, this first phase of Troll production could meet about 7 percent of expected continental gas demand in 2000. While sales at this level would still allow some increase in Soviet contracts by the end of the century, they would also enable the West Europeans to meet their International Energy Agency commitment to limit supplies from any non-OECD source to less than 30 percent of consumption. Should negotiations for the sale of

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Secret**West European Gas Production,
Consumption, and Imports, 1985 ^a***Billion cubic meters
(except where noted)*

	Production	Consumption	Gross Imports			
			Total	Source	Amount	Share of Total Consumption (percent)
Total	180.3	233.8	116.1	Netherlands	32.4	14
				USSR	35.3	15
				Norway	26.2	11
				Algeria	20.1	9
				West Germany	1.1	NEGL
				Libya	0.9	NEGL
				Denmark	0.1	NEGL
Austria	1.3	5.8	4.5	USSR	4.5	77
Belgium/Luxembourg		10.0	10.0	Netherlands	6.5	65
				Norway	2.0	20
				Algeria	1.5	15
Denmark ^b	0.3	0.2				
Finland		0.8	0.8	USSR	0.8	100
France	6.2	30.1	23.9	Algeria	8.1	27
				Netherlands	5.6	19
				USSR	8.0	27
				Norway	2.2	7
Greece	0.1					
Italy	13.6	35.7	22.1	USSR	8.0	22
				Algeria	9.1	25
				Netherlands	4.8	13
				Libya	0.2	1
Netherlands ^b	73.6	41.2	3.0	Norway	3.0	7
Norway ^b	27.0					
Spain	0.2	2.3	2.1	Algeria	1.4	61
				Libya	0.7	30
Switzerland		1.6	1.6	Netherlands	0.5	31
				West Germany	1.1	69
United Kingdom	41.5	55.0	13.5	Norway	13.5	25
West Germany	16.5	51.1	34.6	Netherlands	15.0	29
				USSR	14.0	27
				Norway	5.5	11
				Denmark	0.1	NEGL

^a Consumption minus production may not equal imports, because of losses in production and transmission, exports and reexports, and/or storage programs.

^b Net exporter.

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Troll gas founder, Moscow, as the lowest cost supplier with spare export capacity, is well placed to increase its gas sales substantially. [redacted]

In midyear, the Dutch reached agreement with their French, West German, Italian, Belgian, and Swiss customers to extend the current contracts, due to expire in the early 1990s, until after the turn of the century. This revision occurred as part of normal three-year contract renegotiations. The new contracts ensure that Dutch gas will continue to account for about 20 percent of other continental gas users' consumption during the remainder of this century, and preclude the purchase of significant amounts of additional Soviet gas. Unless the Dutch again revise their estimates of remaining gas reserves, their current policy is to phase out exports when these extended contracts expire. [redacted]

Price Developments. Natural gas prices continued to fall in Western Europe as a result of oversupply and the general decline in energy prices. The current Dutch price, for example, fell to about \$3.50 per million Btu, compared to a peak of over \$4.00 per million Btu in late 1983. Market pressures also forced Moscow to lower its gas prices to comparable levels, and both Norway and Algeria are expected to follow suit in ongoing negotiations. West European buyers of Norway's Statfjord gas, which began flowing on 1 October, are pressing Oslo for price cuts when full contract volumes become obligatory on 1 February 1986. The original price for Statfjord gas when the contract was signed in 1981 was \$5.50 per million Btu, but clauses linked to oil prices have since reduced it to about \$4.55 per million Btu. In order to move the gas during a four-month testing period, the Norwegians discounted the price by 20 percent to a level roughly comparable with prevailing Dutch and Soviet gas prices. Industry sources suggest that, if the Norwegians insist on returning to the \$4.55 price on 1 February, the buyers will either invoke hardship clauses in their contracts that allow price renegotiation or submit the matter to binding arbitration. [redacted]

Imports. Soviet gas exports to its current West European customers—Austria, Finland, France,

Ekofisk Subsidence Problem

Complicating any Norwegian gas assessment is the subsidence problem at the main Ekofisk production complex. Troll development may hinge on correction of this problem because the Ekofisk complex is a key link in the West European gas distribution system. Subsidence occurs when a petroleum reservoir compacts as a result of the withdrawal of oil and gas from a structure. As the Ekofisk platform sinks, equipment on the lower deck is threatened by waves. Following a determination in June that the seabed had already sunk about 2.5 meters, scheduled deliveries were reduced by 25 percent until October 1987 to allow time to correct the problem. We estimate that the maximum shortfall to the continent will be about 3.5 bcm annually, and the operator is scrambling to obtain additional gas from Statfjord or perhaps Heimdal, either to make up the shortfall or to use for reinjection to stem the subsidence, according to Embassy reporting. Norway's European customers are using reduced Ekofisk deliveries as leverage in Troll negotiations in an attempt to obtain better contractual and security provisions, according to the trade press. Norway, moreover, is concerned that this incident is damaging its image as a reliable supplier, according to industry journal reports. [redacted]

Italy, and West Germany—increased by about 17 percent in 1985 to over 35 bcm and may have earned Moscow roughly \$4 billion in hard currency. Soviet gas now covers about 25 percent or more of the consumption requirements of these five countries, but no more than 14 percent of total energy requirements for any of the group. As scheduled under a 1981 contract, Moscow became the sole supplier of natural gas to West Berlin in October. No new gas contracts were signed during

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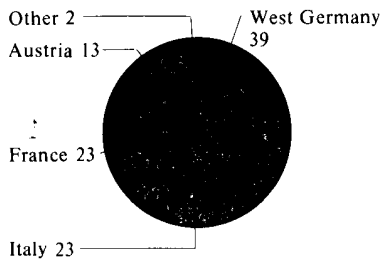
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Secret**West Europe Gas Trade: Selected Export Sources, 1985**

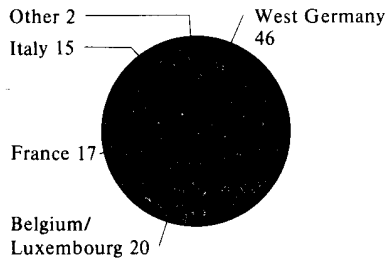
Percent

Soviet Exports

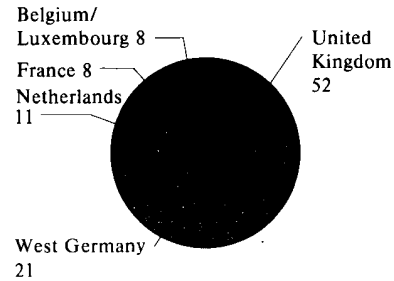
35.3 billion cubic meters

**Dutch Exports**

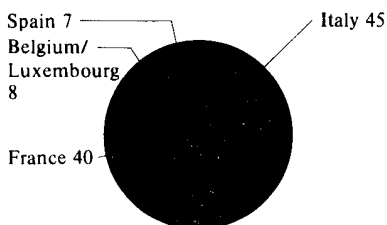
32.4 billion cubic meters

**Norwegian Exports**

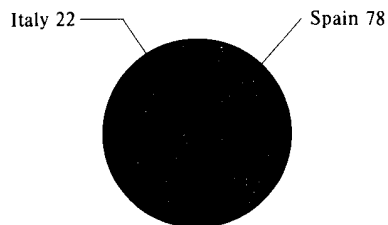
26.2 billion cubic meters

**Algerian Exports**

20.1 billion cubic meters

**Libyan Exports**

0.9 billion cubic meters



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the year, however, despite frequent discussions with Turkey and talks with Greece:

- Turkey has agreed in principle to buy 1.5 bcm of Soviet gas beginning in 1987, rising to 6 bcm per year by 2000. According to Embassy reporting, Ankara may soon sign a 20-year contract that could earn Moscow up to \$750 million annually at current prices if deliveries reach peak levels.
- Negotiations with the Greeks for an initial 2 bcm per year of Soviet gas, rising to 4 bcm per year by 2000, began in late November.

If Turkey and Greece agree to purchase Soviet gas, each will be nearly 100-percent dependent on Moscow for their gas supplies, although gas accounts for only about 5 percent of their total energy requirements.

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Algerian gas deliveries to Western Europe, on the other hand, rose only 7 percent, with all of the increase the result of a 30-percent rise in deliveries to Italy through the Trans-Med pipeline. Although Algeria and Spain ostensibly settled their liquefied natural gas (LNG) contract disagreement early in

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the year, shipments remained constant at about 1.5 bcm. Madrid had agreed to purchase 3.2 bcm per year at a price of about \$3.90 per million Btu.

Algeria also began renegotiating its natural gas contracts with Belgium and Italy at the end of the year, with France to follow during 1986. The process is expected to be difficult and to drag on for at least six months. With gas prices falling in Western Europe, Algeria is under considerable pressure to agree to a more realistic price to retain its European customers. Industry sources estimate that Algerian gas costs European customers as much as \$1.00 more per million Btu than gas from alternative suppliers. Brussels is seeking either a cut in price or a stretching-out of contracted volumes over additional years, while Rome is asking for a reduction in price, now that the Italian Government subsidy on Algerian gas has been removed.

The Asian Market. This market is dominated by Japan. We estimate that Japanese consumption totaled about 40 bcm in 1985, an increase of about 11 percent, largely as a result of new gas-fired electric power generating facilities coming on stream. While Tokyo's anticipated gas needs are covered until the mid-1990s, new projects are under consideration for the years thereafter. At midyear, representatives of eight Japanese utilities initialed a contract with six Australian suppliers to import 8.5 bcm of LNG annually beginning in 1989. This Northwest Shelf project is currently under construction.

Still under active consideration by the Japanese are future LNG supplies from the United States, western Canada, the Soviet Union, and others.

Recent Japanese press articles allege that Tokyo and Moscow are about to conclude an agreement on the long-delayed Sakhalin gas project. Japan reportedly will import 4.3 bcm of gas a year,

Japanese Gas: Production, Consumption, and Imports, 1985

	Total (billion cubic meters)	Share of Total Consumption (percent)
Consumption	41.5	
Production	2.5	6.0
Imports	39.0	94.0
Indonesia	21.1	50.8
Brunei	7.2	17.3
Malaysia	6.4	15.4
Abu Dhabi	2.9	7.0
United States	1.4	3.4

beginning in 1995, and finance 50 percent of the project's construction cost.

The US Embassy in Tokyo says that Japan's Trade and Foreign Ministries, the private Japanese consortium for the project, and the utilities all have strongly denied the press reports. The utilities probably will not make a final commitment to take the gas until a formal price agreement is reached. Should bilateral relations warm, the Trade and Foreign Ministries may urge the utilities to begin negotiations on price, quantity, and delivery.

South Korea has joined the ranks of Asian importers of LNG, with first deliveries from Indonesia expected this month. Indonesian supplies are contracted to expand to 2.8 bcm annually. According to the trade press, South Korean gas consumption could eventually rise to over 7 bcm per year in the 1990s. Construction of an LNG receiving terminal is under way in Taiwan, with a contract for 2.1 bcm per year of Indonesian LNG expected to be signed

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soon. Some industry observers see LNG demand in Taiwan rising to as much as 10 bcm per year in the 1990s. Future growth in the Asian market is expected to be readily met by expansion of existing or planned LNG projects.

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Outlook and Implications

While the outlook for West European gas security has improved, we believe that falling energy prices could undercut the gains of the past few years. In the current market, buyers may delay concluding contracts hoping to negotiate better terms at a later date. Furthermore, a significant price decline could make expensive North Sea gas development projects uneconomic, opening the door to greater Soviet imports. If the Troll negotiations are unsuccessful, West European gas-consuming countries may face difficulty in living up to their International Energy Agency commitment not to become unduly dependent on non-OECD producers. In the Asian market, Japan and other LNG importers are well placed to secure additional LNG from a variety of suppliers in the Middle East, Asia, North America, and Australia. Because of the abundance of proposed projects, US firms will face stiff competition in their attempts to market Alaskan natural gas.

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Israeli Exports: The Challenge of EC Expansion

Israel's export sector faces new challenges in the wake of the accession of Spain and Portugal to the European Community (EC). The vital EC market accounts for roughly 15 percent of Israel's GDP and for about one-third of total Israeli exports. Recent promises by EC leaders to maintain traditional trade patterns with Israel will only partially allay the concerns of Israeli exporters. To improve the long-term outlook for export growth to the EC, Israeli producers must reduce production costs to make their export goods more competitive.

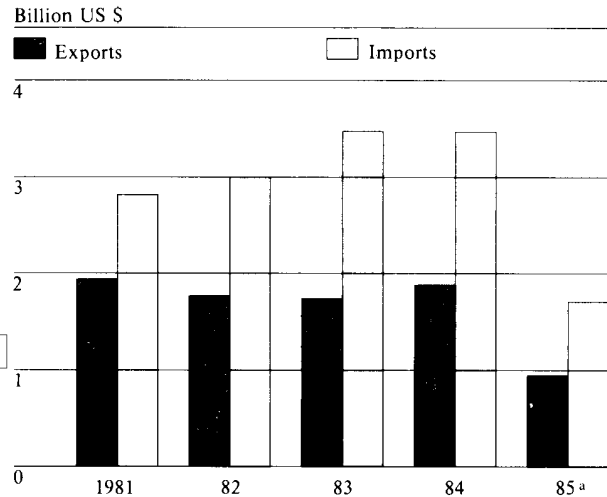
Recent Developments

According to press reports, EC foreign ministers formally agreed in late November 1985 to begin negotiating new trade and cooperation agreements with 11 Mediterranean countries, including Israel. The negotiations are scheduled for sometime this spring—with the agreements to be effective over a four-year period—and will focus on lowering tariffs on Israeli agricultural exports to preserve their competitive position in the EC market. At the end of the four years, the EC Commission will decide whether these arrangements need to be modified to maintain Israeli market access.

The commitment to begin negotiations was a victory for Israeli officials who had lobbied intensively over the past year for protection of their EC market share following the entry of Spain and Portugal. These efforts culminated with Vice Prime Minister Shamir's barnstorming trip to Europe last summer, during which he gained support from some government officials for trade concessions. According to press reports, the West German and Dutch Governments were particularly adamant in insisting that a trade arrangement between the EC and Israel be reached before accession.

The negotiations are vital to Israel, which conducts over one-third of its total trade with the EC. Israel has sharply pared its overall civilian trade deficit

Israel: Exports to and Imports From the EC, 1981-85



^a Data for the first half of 1985.

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during the past two years, but export growth to the EC has been stagnant. Indeed, Israel's trade deficit with the EC remains significant—averaging \$1.4 billion between 1980 and 1984. This poor performance may be attributable in part to the high value of the US dollar, in which many Israeli export goods are quoted.

The Agricultural Sector

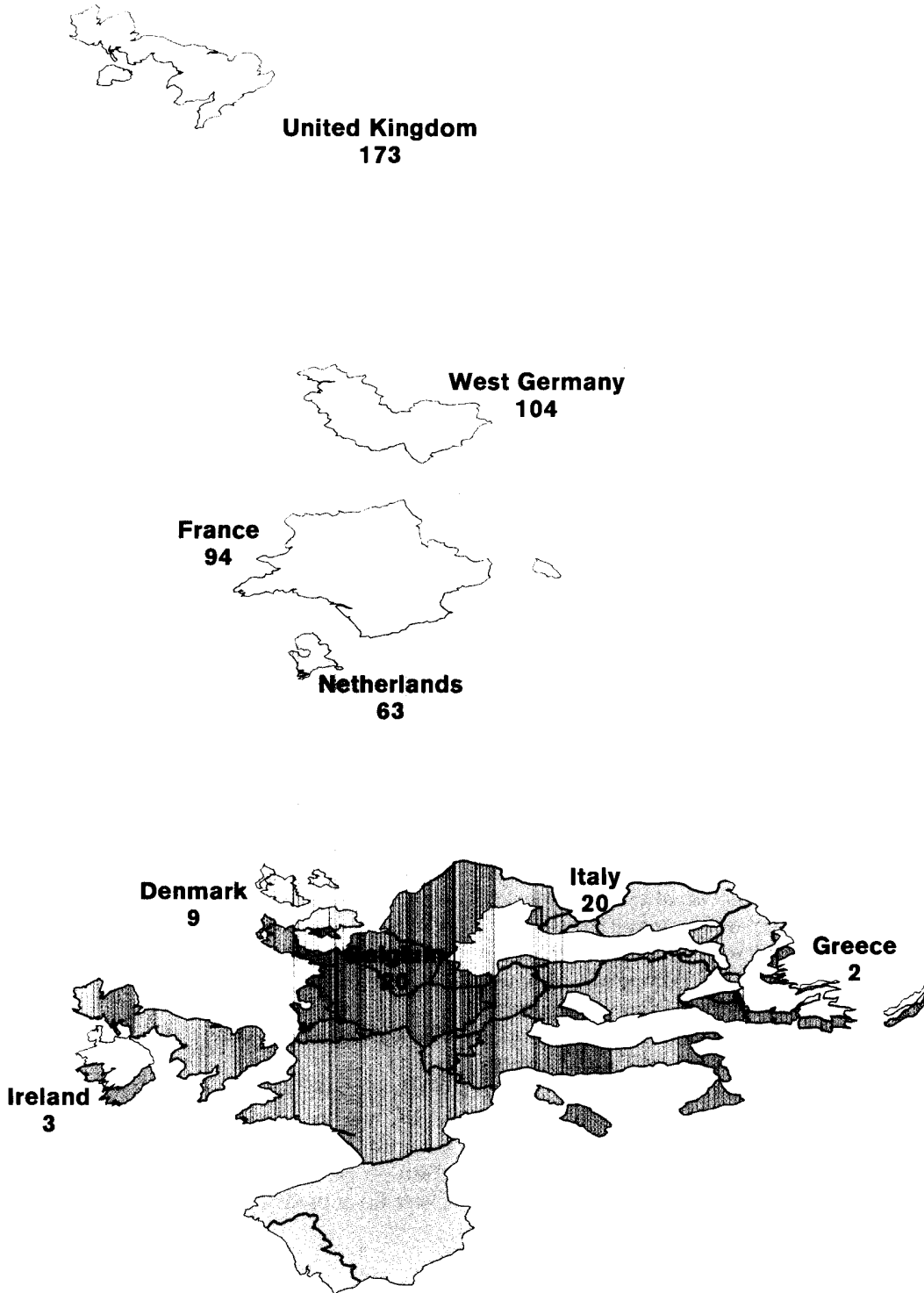
While virtually all of Israel's export sectors depend on EC markets, their dependence is most pronounced in farm products—EC members purchase about 75 percent of Israel's agricultural exports. These farm product purchases totaled \$488 million

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17 January 1986

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Israel: 1984 Agricultural Exports to the EC^a



^aExport figures are in millions of US dollars.

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in 1984 and accounted for the employment of 15,000 to 20,000 workers—roughly one-fifth of Israel's total agricultural labor force. [redacted]

The Israelis are particularly concerned about competition from Spain and Portugal in citrus and vegetable exports. Israel's avocado exports to the EC totaled \$46 million in 1984, and orange exports totaled \$37 million. Currently, Israel enjoys a cost advantage in avocado production over Spain and Portugal. This advantage, however, may deteriorate unless Israeli farmers are willing to implement improvements in production technology to maintain their advantage. [redacted]

Israeli farmers are further concerned with the EC's progress toward agricultural self-sufficiency. Spain's winter orange crop, for example, may bring the EC much closer to self-sufficiency in orange production, damaging Israeli prospects for additional growth in orange exports to the Community. [redacted]

On the other hand, cotton exports—whose 1984 value surpassed citrus and vegetable exports—may get a shot in the arm from the entry of Spain and Portugal. These two countries imported about \$63 million worth of uncombed cotton from Israel in 1984, with Portugal importing about \$58 million. With lower tariffs for shipments to Spain and Portugal, these sales may help offset declines in other agricultural commodity exports. [redacted]

Other Key Industries

Israel is also concerned about its textile and clothing industry, although these exports are less threatened by Spanish and Portuguese competition. Exports of clothing and other apparel to the EC totaled about \$196 million in 1984. These exports are of higher quality and appeal to a more upscale market than Spanish and Portuguese goods. Israel's efforts to increase sales to the EC of lower quality textile goods, however, may be harmed because of Israel's relatively high input costs—especially for labor—which make Israeli export prices less competitive than those of Spain and Portugal [redacted]

Prospects for increased sales to the EC of high-technology items such as laser surgery equipment, diagnostic medical instrumentation, and fiber-optic communications equipment—in which Israeli firms are at the forefront of world technology—are favorable. The entry of Spain and Portugal will give Israeli goods an additional boost as these two countries bring their tariffs in line with Community levels. Exports of resistors to the EC, for example, should greatly increase and in the process provide additional employment opportunities for Israeli workers. Israel also will soon have the capacity to produce computer chips—from initial design through production—which should further brighten the outlook for high-technology exports to the EC. [redacted]

Outlook

The proposed current accord with the EC will provide only a temporary reprieve for Israel. For many industries it may only help preserve the status quo, which has not been particularly good. To expand export sales to the EC would require several fundamental changes. For agriculture:

- At present, two separate boards handle export merchandising. Merging these boards would help reduce operational costs.
- Accelerating the trend toward greater automation would reduce the reliance on labor for gains in production. Since 1970, Israel's net agricultural capital stock has increased at an annual rate of 0.9 percent, while labor has decreased 0.4 percent annually.

The textile and clothing industries also must move toward capital-intensive operations, reducing dependence on labor for additional growth. Ongoing structural changes in the textile industry that are reducing the number of firms but increasing individual firm size will permit greater economies-of-scale. [redacted]

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Although policies aimed at boosting exports are widely endorsed, political realities are likely to hinder quick movement on this front. The Israeli public has tolerated six months of relatively tough austerity, but patience may be wearing thin. The current difficulty in further cutting next year's budget suggests the government may soon ease up on austerity. In addition, US Embassy reporting indicates that Prime Minister Peres is still searching for a way to call for a new national election or form a new, Labor-led government without Likud before he trades places with Likud leader Shamir next October. Because economic policies needed to boost exports would add to Israeli unemployment—already at a record rate of almost 8 percent—Peres is very likely to refrain from pushing for such measures in the near term.

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Briefs

Energy

Spot Oil Price Developments



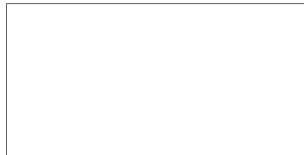
Spot crude oil prices dropped by over \$1 per barrel last week, to as low as \$24 per barrel, as supplies continued to outstrip demand. [Redacted]

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[Redacted] Prices for most crudes are now more than \$2 per barrel below average 1985 prices and down \$5 per barrel from late November levels. Mexico, Venezuela, and Egypt have lowered their prices in response to competitive market pressures—Mexico is considering a more flexible market-related pricing policy, according to press reports. Both OPEC and non-OPEC production soared in the fourth quarter of 1985 and arrival of a significant portion of this oil in the consumer market will put additional downward pressure on prices during the next several weeks. [Redacted]

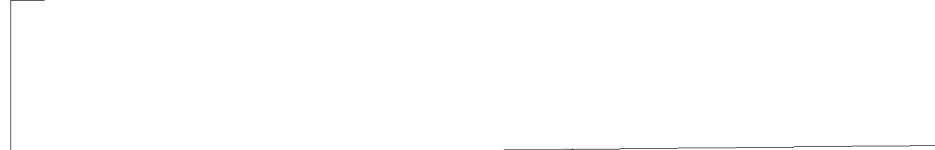
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Iranian-Brazilian Oil Barter Problems



Iran and Brazil will meet in late January to resolve an oil price dispute that has caused Brazil to restrict liftings of Iranian oil. Under a \$425 million barter agreement signed last July, Brazil takes 32,000 b/d at spot prices and 13,000 b/d at official prices. [Redacted]

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Development of Beaufort Sea Closer



A recent Gulf-Canada test well in the Beaufort Sea indicated a potential capacity of over 35,000 barrels per day, which, in combination with nearby deposits, brings the Beaufort region to the threshold of development. Production in the Beaufort field, however, requires the construction of a 650-kilometer pipeline to northern Alberta. Because of the pipeline's cost, the harsh climate, and environmental concerns, a significant long-term decline in oil prices probably would threaten development, despite the promising tests. In that case, the major oil firms almost certainly would attempt to persuade Ottawa to subsidize the Beaufort project. Though budgetary constraints would weigh in their decisions, we believe Ottawa would probably provide some funding to further its goal of developing the Arctic. [Redacted]

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Blunder at Giant Soviet Oilfield



[Redacted] Lyantor Oilfield, a giant oilfield in western Siberia, indicates that some gas separators have been replaced with water separating equipment and that there has been a significant increase in the oilfield's water storage capacity. These changes mean that some of the wells at

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Lyantor are now producing large quantities of water and proportionally less oil, probably due to an overzealous and mismanaged water injection program. Moreover, these water problems have occurred in half the time it took at other west Siberian fields where water injection was used. Evidence of water injection problems at Lyantor shows that, even at their newest oilfields, the Soviets continue to emphasize high initial production rates, irrespective of adverse consequences for ultimate oil recovery. This policy has exacted high costs; in 1984 increasing amounts of water production at Soviet oilfields was a major factor leading to the first annual decrease in Soviet oil production since World War II. [redacted]

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Australian Coal Exports Continue To Rise

Australian coal exports in 1985 are estimated to have hit a new high of more than 87 million metric tons, up 14 percent over 1984 volumes. At these levels, Australian coal exports will, for the second consecutive year, top exports by the United States—historically the world's largest coal exporter. Steam coal exports to Japan rose 34 percent compared with year earlier levels while shipments to Western Europe increased by about 5 percent. Coking coal exports also rose—but by only 3 percent. Australian coal producers are expected to benefit from some importers' decisions to stop purchasing South African coal. [redacted]

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France Finds Coal To Replace South African Supplies

Atic, the French coal-buying agency, has signed a three-year contract to purchase 1 million metric tons of coal annually from Colombia beginning in 1986 as well as a contract to buy 200,000 tons of coal from a Canadian company in the first quarter of 1986. Both suppliers gained entrance to the French market after Paris announced its refusal to renew expiring South African coal contracts for 3.9 million tons a year. At annual rates, these new contracts replace about half of the South African imports. France is not expected to seek additional contracts as nuclear power continues to replace coal in the electricity sector. [redacted]

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New Pakistani Coal Find

A large coal deposit recently discovered in Chitral adds to Pakistan's estimated coal deposits of more than 1 billion metric tons—102 million tons are proved reserves—according to press reports and official sources. Despite these reserves, Pakistan mined only an estimated 2 million tons in FY 1983/84, and coal accounts for only 7.4 percent of the country's energy supply. Coal development has been slow because of a lack of infrastructure—such as good roads to some remote deposits—poor-quality deposits, and few thermal power plants. Pakistan faces serious and growing energy shortages that are likely to further disrupt both agricultural and industrial production, but lacks the technical and financial resources that would be required to exploit its coal reserves. [redacted]

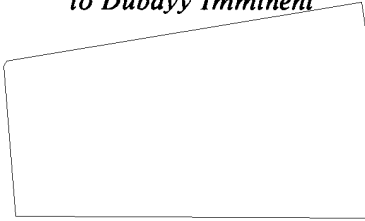
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17 January 1986

UAE Gas Flow to Dubayy Imminent

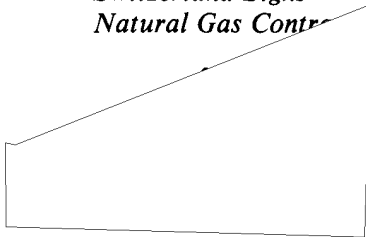


Natural gas is due to start flowing this month from fields in Sharjah to industries and utilities in Dubayy, according to the Sharjah government. Up to 2 million cubic meters per day will be delivered under the terms of a deal signed last May, and volumes could be expanded to nearly 3 million cubic meters daily. According to the trade press, the price is estimated at \$1.25 per million Btu. Sharjah is expecting 1986 revenues from the Dubayy purchase to amount to \$25 million. [redacted]

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Switzerland Signs Natural Gas Contract

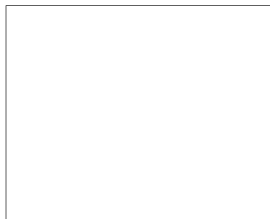


Swissgas and West Germany's Ruhrgas have agreed on a new long-term natural gas supply contract to the year 2005. Deliveries of North Sea gas from Ruhrgas will run at an annual volume of about 600 million cubic meters per year, with an option to increase to 1 billion cubic meters annually. The present Swissgas-Ruhrgas contract, signed in 1977, expires in 1988. As of that date, Ruhrgas will also begin deliveries of 360 million cubic meters per year of Soviet gas, or about 18 percent of Switzerland's gas needs. West German and Dutch natural gas currently meet about 8 percent of Switzerland's total energy consumption and gas requirements are expected to be fully covered to the end of the century and partially thereafter. [redacted]

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Shifting Japanese Interest in Sakhalin Gas Project



Recent Japanese press articles alleging that Tokyo and Moscow are about to conclude an agreement for developing the long-delayed Sakhalin gas project may be overly optimistic. Japan reportedly will import 3 million tons of LNG a year, beginning in 1995, and finance 50 percent of the project's construction cost. The press reports also name the Kansai and Chubu Electric Power Companies as having agreed to take some of the gas. The US Embassy in Tokyo, however, says that Japan's Trade and Foreign Ministries, SODECO (the semiprivate Japanese consortium for the project), Kansai, and Chubu all have strongly denied the press reports. [redacted]

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[redacted] If Moscow has officially pushed the initial delivery date back from 1990 or 1991 to 1995 or beyond, however, we believe the utilities may be more agreeable, but any prospective settlement still would be subject to tough price and quantity negotiations. [redacted]

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International Finance

Iraqi Debt Rescheduling Likely



The weak oil market probably will cause Iraq to seek another debt rescheduling in 1986 to help avoid cuts in military and civilian imports. According to the US Embassy, Iraq has roughly \$1.5 billion in debt payments due to Western creditors this year. Most is owed to France, West Germany, and Japan, and much of this was originally rescheduled in 1984. Several of Iraq's Western creditors met last month to discuss a unified approach, but failed to reach agreement, according to the US Embassy in Paris. As a result, Baghdad is likely to be successful in rescheduling its 1986 debt bilaterally; both France and Japan reportedly believe they can get a better deal by negotiating with Iraq individually rather than through the "Paris Club." [redacted]

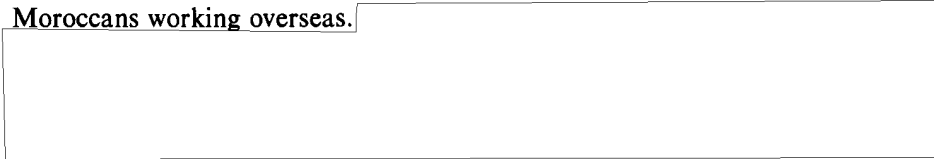
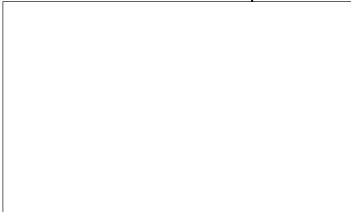
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*Moroccan Problems
With Creditors*

Morocco failed last week to meet the second deadline of commercial creditors on a downpayment of \$83 million, the initial sum due under a rescheduling agreement signed last October. The US Embassy says Morocco hopes to pay within a week and has requested a meeting to discuss the program. Rabat claims the problem is the result of unexpectedly low remittances from



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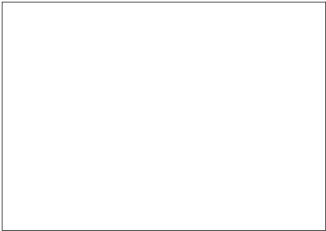
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Collapse of the rescheduling agreement would jeopardize Rabat's \$200 million IMF standby loan. According to the Embassy, Morocco is already in trouble over its failure to meet IMF targets on spending. Even if Rabat is able to honor agreements with the banks and the IMF, its economic options will remain severely constricted without a marked improvement in its management of the economy and in the world market for phosphates.

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*Sudanese
Financial Problems*

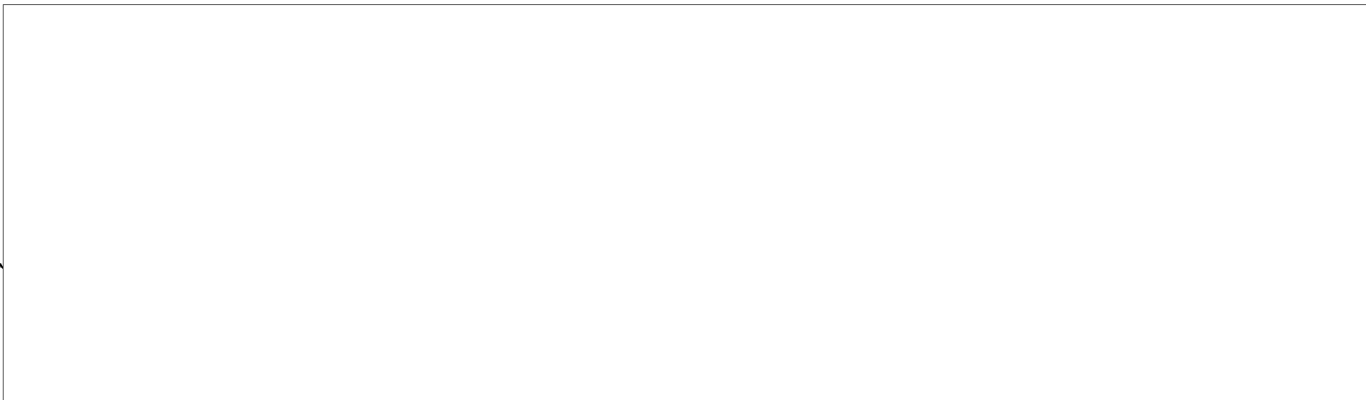
Sudan's failure to repay by 1 January \$1.9 million in US debt obligations now more than 12 months in arrears has triggered a Brooke Amendment cutoff of all new US economic and military assistance. Meanwhile the IMF will postpone, at least until 3 February, a decision to declare Sudan ineligible for further Fund assistance. To avoid the IMF cutoff Khartoum reportedly will have to make partial payment on its arrears of over \$200 million to the Fund and must also implement some of the policies favored by the IMF. Scraping together a partial payment to the Fund may, in part, explain Khartoum's delay in meeting the minor Brooke Amendment payment. Fulfilling the requirement for policy reforms will be difficult given the recent change in Finance Ministers and the political turmoil and indecision existing within the transitional government as elections approach in April.



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Global and Regional Developments



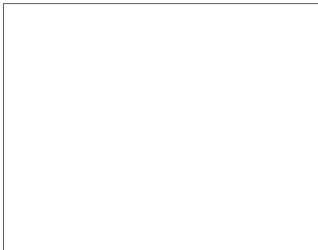
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*India-Pakistan
Economic Agreement*



India and Pakistan agreed last week to establish the groundwork for improved economic ties. The agreement seeks to more than double government-controlled commodity trade, renew the limited private trade Pakistan suspended in 1978, increase cross-border communications, and start joint industrial ventures in each country. Bilateral trade peaked near \$100 million in 1981 but has since dropped to an estimated \$50 million for the year ending in June and now accounts for less than 1 percent of each country's annual trade. [redacted]

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[redacted] both countries are considering ways to collaborate in international economic forums and to avoid double taxation in order to encourage cross-border investment. Many Pakistani officials and businessmen fear India's competitive trade advantage, however, and, without sustained high-level political pressure, overall growth in trade will probably be slow. [redacted]

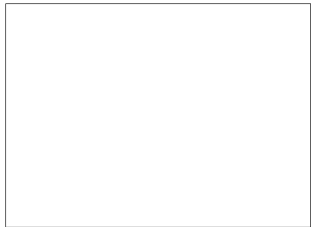
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*Eastern and Southern
Africa Preferential
Trade Area*



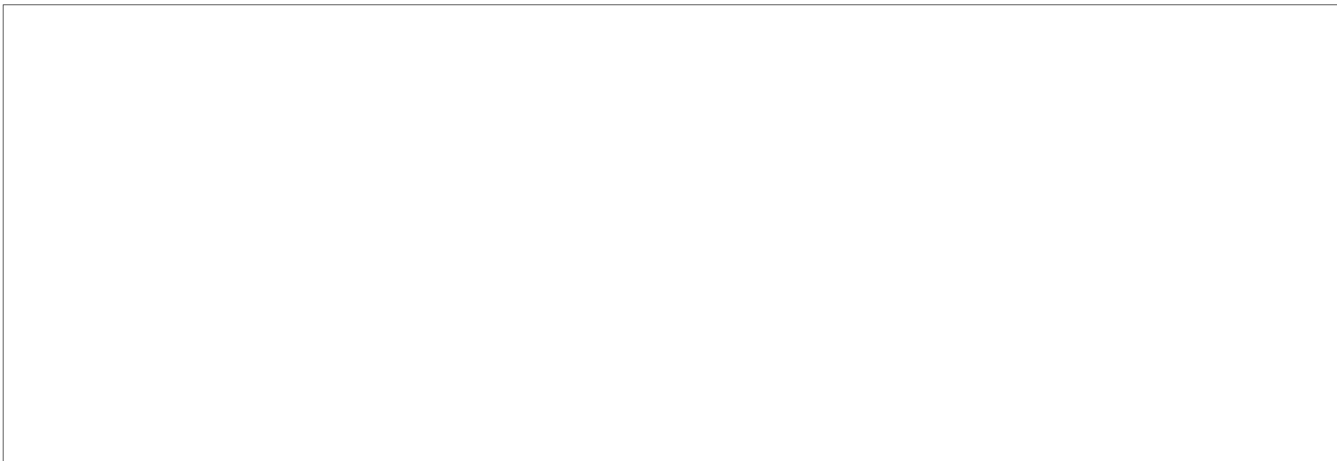
According to US Embassy reporting, the mid-December Summit meeting of the Preferential Trade Agreement for Eastern and Southern African states (PTA) in Lusaka, Zambia, was poorly attended by heads of government and yielded few results. Only four leaders of the 15 PTA member countries—Burundi, Tanzania, Zambia, and Zimbabwe—participated. As a result, no decisions were taken on outstanding major issues such as a proposed reduction in the minimum level of local ownership for firms benefitting from preferential tariffs and the development of a framework for the reduction of nontariff barriers. Members did agree, however, to establish a PTA Trade and Development Bank, effective this month. We believe only slow progress toward economic integration is likely, because the political links between PTA members are fragile at best. [redacted]

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National Developments

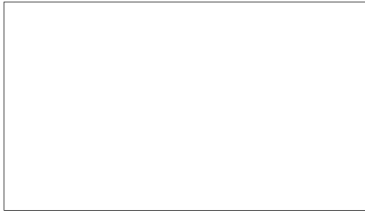
Developed Countries



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*Japanese-US
Fishery Talks
Stalled*

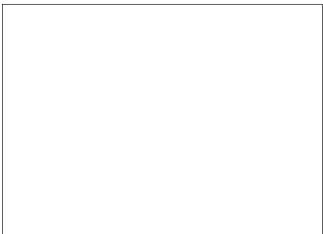


During talks on 8 and 9 January, Washington's proposal to ban Japanese fishing of Alaskan-spawned salmon in the Northern Pacific met stiff resistance from the Agriculture Ministry. Tokyo disputes the US claim that annual Japanese catches of 30 million salmon include 1 million spawned in Alaskan rivers, countering that the figure is only 400,000. Japan also objects to linking the salmon issue to Japanese fish allocations within the US 200-mile economic zone. A quick settlement does not appear likely and the US Embassy warns that the issue may blossom into a major political quarrel. Japanese fishery organizations are considering suspending imports of US fishery products in retaliation—Japan bought about \$680 million, or 57 percent, of US fish exports in 1984. Tokyo may try to placate the politically powerful industry with limited measures if a settlement is not reached.

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*Japan Proposes
Pacific Space
Launchsite*



An official of Japan's ruling Liberal Democratic Party last month proposed establishing an international space launchsite in the Pacific Basin as well as teaching and research facilities devoted to space development. The official made a pitch for US involvement by pointing out the usefulness of an equatorial launchsite for the US space shuttle. We believe government and business leaders will support the launchsite proposal because it would allow Japanese companies to further investigate commercial uses of space—such as materials processing—without paying the full launch costs.

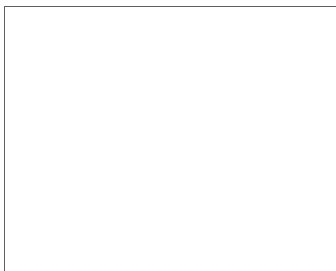
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Prospects for such a project are uncertain, however, given the problem of finding a suitable site.

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*Canadian Dollar
Continues
Downward Drift*



Attempts by Canada's central bank to alleviate downward pressure on the Canadian dollar by raising interest rates are apparently failing. In recent weeks the Bank of Canada has intervened in exchange markets—estimated intervention was US \$800 million in December—and last week raised the discount rate more than one-half percentage point to 10.21 percent. In addition, the major banks have raised the prime rate twice in the past week to 11 percent. Nonetheless, despite a temporary strengthening, the Canadian dollar on Tuesday hit a new low against the US dollar. Economists are citing Ottawa's inability to substantially cut its budget deficit, a discriminatory foreign investment policy, and the likelihood of another large current account deficit in the fourth quarter, to explain the recent pressure on the Canadian dollar. If downward pressures continue, Ottawa may soon be forced to abandon its attempts to prop up its currency because of fears that higher interest rates will slow growth and boost unemployment.

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Less Developed Countries

*Brazil Maintaining
Unsafeguarded
Nuclear Research*



The director of a major Brazilian center for nuclear research has announced a 10-percent federal reduction in personnel funding for 1986, [redacted]

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[redacted] The Nuclear and Energy Research Institute—IPEN—is responsible for unsafeguarded, indigenous research projects in uranium enrichment, laboratory-scale fuel reprocessing, and design of a planned submarine propulsion reactor. The IPEN director very likely will continue to use his influence to protect these research efforts. [redacted]

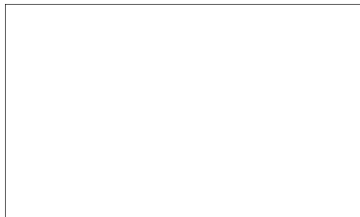
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[redacted] Despite the personnel funding cut at IPEN—a result of broader Brazilian fiscal austerity—Brasilia maintains a strong commitment to indigenous nuclear research. [redacted]

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*Mexico's Honda
Decision*

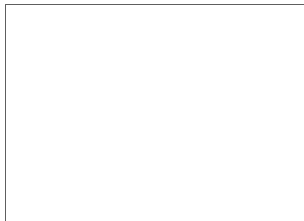


Mexico's recent decision authorizing a 100-percent Honda-owned motorcycle plant is the first indication that the de la Madrid administration intends to keep its latest promise to open the economy to direct foreign investment. In return for waiver of the usual 49-percent foreign ownership limit, Honda is expected to create some 1,700 jobs and generate exports of \$100 million by 1992. In addition to the jobs and foreign exchange, Mexico City probably hopes to acquire advanced technology and satisfy international creditor calls for needed structural adjustments. For its part, Honda will be able to take advantage of relatively cheap Mexican labor and probably hopes to improve its position in the US market. [redacted]

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*Nicaraguan Currency
Mismanagement*



The Sandinistas have further tightened their grip on domestic currency flows with new regulations that attempt to force private companies to use government-controlled bank accounts—instead of petty cash—for government-approved transactions. Managua has justified the move by citing growing black-market activity, soaring inflation, and excess currency in circulation. The new policy is also designed to boost deposit levels—banks occasionally have shut down for lack of currency—and to facilitate tax collection. As a result, many private farmers and small businesses plan to close their accounts to avoid the tax auditors, according to US Embassy reporting. The new regulations will probably backfire. Any increases in bank deposits from larger companies will likely be offset by individuals and small businesses closing their accounts. Businesses unable to obtain materials via the black market may close, adding to a drop in exports and further undermining private-sector activity. Moreover, any strengthening of the cordoba due to reduced supply will be countered by a probable rise in capital flight. [redacted]

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Key Debtor LDCs: Real Exchange Rates

Index: 1980=100

	1980	1983	1984				1985			
			Year	I	II	III	IV	I	II	III ^a
Argentina	100	67	72	68	76	79	71	70	67	60
Brazil	100	107	116	111	110	117	123	128	112	109
Chile	100	93	96	93	95	100	95	97	90	79
Colombia	100	121	115	115	114	116	115	119	109	99
Indonesia	100	100	100	99	99	101	102	103	101	98
Malaysia	100	113	118	116	116	120	118	117	115	111
Mexico	100	75	92	85	90	93	98	104	109	92
Nigeria	100	130	178	154	178	196	185	184	172	168
Peru	100	105	104	109	105	105	101	93	87	73
Philippines	100	103	116	112	113	117	120	133	129	123
South Korea	100	101	99	97	97	100	101	102	97	92
Venezuela	100	133	96	110	85	94	101	108	109	109

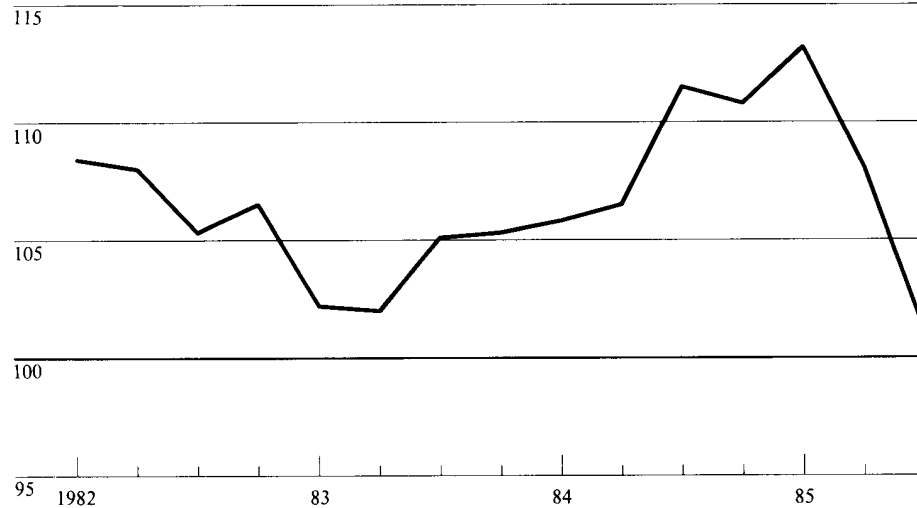
^a Estimated.

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Key Debtor LDCs: Average Real Exchange Rates, 1982-85

Index: 1980=100



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17 January 1986

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Sharp Real Depreciations in Key Debtor Exchange Rates

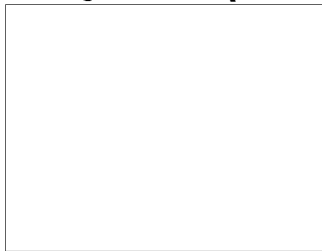


Key debtor real exchange rates have depreciated sharply from their peak in the first quarter of 1985. This has resulted primarily from the rapid depreciation of the US dollar, to which most of their currencies are tied. For many of these countries, this has reversed the real appreciations recorded in 1984 and helped to restore trade competitiveness. We expect a continued real depreciation of debtor exchange rates this year, although at a slower pace than last year. In combination with an expected bottoming-out of export prices, this should help boost the export earnings of these countries in 1986. [redacted]

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Oman Moving Against Corruption



Recent personnel changes suggest that Sultan Qaboos is cracking down on flagrant corruption amid growing concern over lavish government expenditures and falling oil prices. He unceremoniously sacked the powerful head of the Royal Court [redacted]

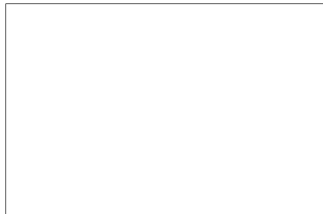
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[redacted] Qaboos also recently removed Minister of Communications Al Busaidi. US officials in Muscat say Al Busaidi was allegedly awarding contracts to firms in which he had financial interests. The changes will hearten Omani nationalists, who have bridled at Qaboos's tolerance of corruption, but it will do little to curb government spending. Muscat has already withdrawn about \$900 million from its general reserve fund to cover spending on the Gulf Cooperation Council summit and National Day celebrations last November and may be forced to borrow to finance current expenditures. [redacted]

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Indonesian Budget Slashed

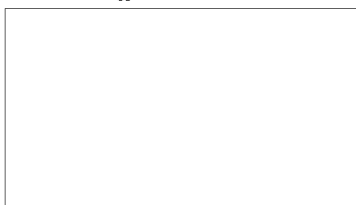


In anticipation of an additional 14-percent decline in oil and gas revenues for fiscal year 1986, which begins on 1 April, President Soeharto last week announced sharp cuts in the federal budget. At \$19.4 billion, the new budget represents an 11-percent decrease over the previous fiscal year—the most austere budget since the early 1970s. It includes a cut of 22 percent in development spending, the first such cut since 1969. The new budget represents intensified efforts to rein in the estimated \$3 billion current account deficit and keep the country's \$37 billion foreign debt in check. According to US Embassy reporting, however, Jakarta's revenue projections may be optimistic because its forecasts are predicated on \$25 per barrel oil. The severity of the budget cuts in any case raises serious doubts as to Indonesia's ability to achieve 5-percent real growth over the next three years—a rate just sufficient to stem the rising tide of unemployment. [redacted]

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Malaysian Financial Scandal May Affect Elections



Prime Minister Mahathir continues to delay release of the politically sensitive final report on the Bank Bumiputra financial scandal. According to [redacted] the US Embassy, who has read the report, it may cause serious damage to Mahathir's government. [redacted]

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[redacted] Mahathir probably will be

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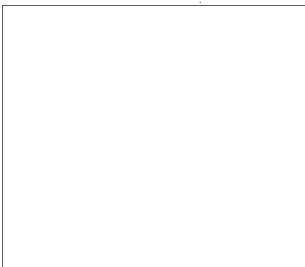
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forced to call elections within the next three months in the face of increasing public pressure on him to disclose the report. In addition, information potentially damaging to his administration may emerge when a key figure in the case goes on trial in Hong Kong in March. [redacted]

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Communist

Good Year for the East German Economy

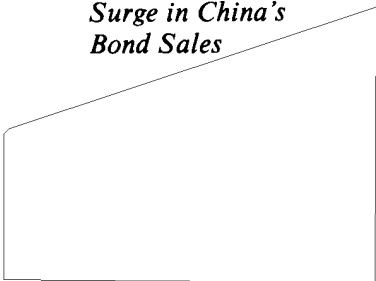


According to official statistics, national income growth in 1985 remained strong although the 4.8-percent increase fell short of 1984's unusually large 5.5-percent rise. Industrial production climbed 4.5 percent. The government credited most of the gains to improved efficiency: labor productivity climbed 8.4 percent by East German measures while unit costs fell 2.5 percent. We estimate that East Germany's hard currency trade surplus reached \$600-800 million and that hard currency debt again declined. The improved external position probably contributed to the regime's decision to boost investment by 23 percent. Limited information suggests that real personal consumption probably rose modestly. The acceleration of growth in the second half of the year—national income through June was only 4.1 percent above the previous year's level—suggests that East Berlin can achieve its 1986 growth target of 4.4 percent. [redacted]

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Surge in China's Bond Sales



Chinese sales of bonds on the Tokyo market jumped from approximately \$10 million in 1984 to nearly \$1 billion in 1985, making China the largest foreign borrower in the Japanese market. Offerings in yen-denominated bonds were made by the Bank of China, China International Trade and Investment Corporation (CITIC), and several provincial-level groups. CITIC also floated over \$100 million in US-dollar-denominated bonds in Tokyo and sold nearly \$50 million worth of deutsche-mark-denominated bonds on the West European market. The issues generally received excellent ratings and were discounted slightly or not at all. [redacted]

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China Rescues Failing Hong Kong Bank



China has agreed in principle to take over a financially troubled Hong Kong bank—the first such takeover since signing the accord to regain the territory. According to press reports, Beijing agreed to buy majority ownership in the Ka Wah Bank for an estimated \$125 million only after attempts to find other buyers fell through. China also recently offered publicly to help other Hong Kong banks with liquidity problems. Beijing previously invested in several other troubled Hong Kong firms but relied on the Hong Kong Government to take over failing banks in 1983 and again last June. Beijing is anxious to promote confidence and stability in Hong Kong's financial system. With the transition under way, Beijing probably will find it increasingly necessary to back up with cash its words of support for Hong Kong's economy. [redacted]

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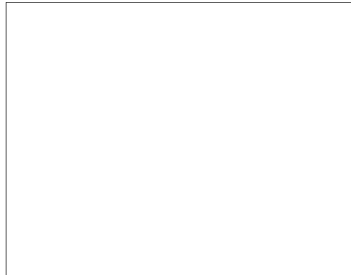
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17 January 1986

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*Chinese Export Delays
Worry Cotton Buyers*

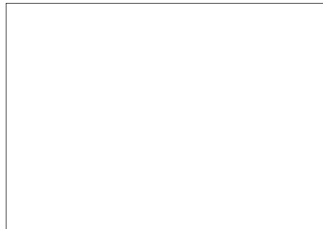


Shipment delays and contract defaults by Chinese cotton exporters have forced their customers to look for alternate suppliers. [redacted] the defaults resulted from overselling of high-quality cotton by the China National Textiles Import and Export Corporation (CHINATEX). Shipment delays of up to four months are being attributed to Chinese port congestion and dependence on a single rail line linking the western high-quality cotton growing area to the east coast ports. Undesirable bale size and high moisture content are additional negative factors. Japanese and Canadian cotton spinners, previously attracted by the low Chinese prices, are worried about dwindling stocks. [redacted]

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*China Forms Venture
Capital Company*



China last week unveiled its first venture capital corporation, Venturetech, formed to concentrate investment on information technology, microelectronics, biotechnology, new materials, and other high-technology areas. Two individuals founded Venturetech after studying venture capital in the United States and selling the idea to the State Council last year. [redacted]

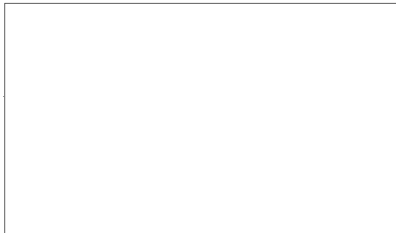
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[redacted] Venturetech will underwrite projects likely to result in marketable technologies. This is another step in Beijing's ongoing efforts to introduce market mechanisms to its industrial sector. Beijing has been studying how Australia, Canada, and the United States use venture capital to finance high-technology, high-risk projects. [redacted]

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*China To Reform
Personnel Management*



Beijing has formed a leading group for job title reform to coordinate implementation of a new personnel management system for China's professional and scientific talent. The group will be under the direction of Song Jian, Minister in Charge of the State Science and Technology Commission (SSTC), and will include representatives from the Ministry of Labor and Personnel, the State Education Commission, and the SSTC. The planned reforms will increase the mobility of skilled personnel, link pay to performance, and eliminate lifelong tenure and seniority. Although the reforms would improve the work environment and speed promotion for competent workers, past attempts to change personnel management have met resistance. Enterprises would probably reject any attempts to deprive them of skilled workers, and individuals would likewise protest efforts to relocate them to the rural areas that are chronically short of talent. [redacted]

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17 January 1986

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*Vietnamese Approach
Japan for Oil
Development Expertise*

Hanoi is seeking ways to bypass COCOM restrictions and Tokyo's policy of withholding official financial aid from Vietnam in order to obtain private foreign participation in offshore oil exploration, according to a Japanese press report. Hanoi is proposing that a Japanese oil company develop Vietnam's offshore fields on a commission basis and, the press report speculates, the Vietnamese will try to use Soviet aid funds for Japanese and Western technology to speed up development of Vietnam's oil resources in the Vung Tau region as well as in waters from Cam Ranh Bay to the Tonkin Gulf. The press report adds that the Japanese firm is checking with US oil companies to determine if the plan would violate COCOM restrictions. Officials of the Japanese firm told US Embassy officials they are considering the Vietnamese proposal, but deny they are seeking cooperation from US oil companies.

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