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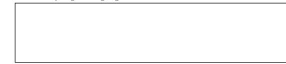

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International Economic & Energy Weekly

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23 May 1986

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Synopsis

1 **Perspective—USSR: Facing Hard Currency Shortages**

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3 **USSR: Economic Impact of the Chernobyl' Accident**

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Preliminary analysis of the Chernobyl' nuclear accident indicates that direct damage to the Soviet economy will be relatively minor. Nonetheless, the potential loss of electric power this year could put a crimp in General Secretary Gorbachev's hopes to get the new five-year plan off to a fast start in 1986.

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7 **Central American Core Four: Troubled Small Debtors**

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The external debts of the Central American Core Four countries—Costa Rica, El Salvador, Guatemala, and Honduras—are small, but the burden of repayment weighs heavily on their equally small economies.

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11 **India: Pace of Economic Liberalization Slows**

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Prime Minister Gandhi, prompted by a growing trade deficit, a tight budget, and domestic political problems, has moved to slow the pace of economic liberalization. Gandhi is modifying his approach to protect the country's hard currency reserves and deny his opposition a rallying point and will look increasingly to Western governments for financial support.

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15 **French and Japanese Industrial Policy: Diverging Impacts on the Electronics Industry**

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Although both the Japanese and French electronics industries have been nurtured by a wide range of government policies, the Japanese industry has emerged as a world leader while the French industry has failed to make a major impact on the global electronics market. Japan, in our judgment, will build upon its current strengths, while continuing French lags in electronics may lead Paris to tighten protection for the sector, including calls for higher EC tariffs on electronics products.

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Perspective

USSR: Facing Hard Currency Shortages

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Low energy prices, domestic oil production problems, and a depreciating dollar will substantially reduce the Soviets' ability to import Western equipment, agricultural goods, and industrial materials for the rest of the decade. The decline in Moscow's hard currency import capacity—most likely on the order of one-third—comes at a time when General Secretary Gorbachev may have been counting on increased inputs from the West to assist his program of economic revitalization. Assuming some increase in debt to the West, substantial annual gold sales, and an $18 average price per barrel for Soviet crude oil and oil products during 1986-90, we estimate that Moscow faces the prospect of real imports falling to levels comparable to those of the mid-1970s.

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The Chernobyl' nuclear accident, although troublesome, may not have a large impact on the Soviets' hard currency position. Immediate costs focus on a few selected Western imports—such as robots—needed to deal with the accident and the neglible export losses resulting from the EC ban on food. Over the longer term, hard currency losses could rise if Moscow needs to cut hard currency oil sales to divert fuel to thermal power stations.

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Since late last year purchasing activity has slowed, and planned purchases are now being scaled back. The cutbacks appear to be across the board and are even affecting imports of equipment for oil and gas fields. In addition to dealing with the immediate scarcity of hard currency, this strategy allows the leadership time to implement a more coherent import program—one that reflects the long-term nature of the problem. Gorbachev faces a difficult time in choosing among competing demands for foreign exchange:

- ***The Modernization Program.*** While the success of the program hinges on internal factors, the lofty goals imply that some highly specialized imports from the West for such sectors as energy, machine tools, microelectronics, and telecommunications must be continued, if not increased. Import cuts in key intermediate goods, in turn, could strain already taut production schedules.

- ***Consumer Welfare.*** A cutback in hard currency agricultural imports would reduce availability of such commodities as meat, vegetable oil, coffee, cocoa, and some fruits and—depending on the size of the grain crop—could slow domestic production of meat, milk, and eggs.

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There are several areas where Moscow could take action to counter the adverse impact of the import cuts:

- ***Economic Initiatives.*** Soviet planners will need to revise the five-year plan to account for reduced imports. Moreover, they might consider bolder economic reforms to carry out Gorbachev's ambitious capital renewal policy without drawing heavily on resources slated for defense.

- ***Western Involvement in the Soviet Economy.*** Even before the fall in oil prices, Soviet planners, including Gorbachev, were reportedly considering altering the nature of the relationship between Soviet entities and Western firms to enhance the effectiveness of the technology and equipment imports. They recently have shown an interest in joint ventures entailing Western profit sharing and managerial presence, closer engineering and production consultations with Western firms, and the creation of more training facilities with Western participation.

- ***Political Relations With the Developed West.*** We believe the Soviets will consider ways—short of real concessions on significant political or security issues—to foster a climate conducive to attracting Western involvement in the Soviet economy. Possible actions include toning down anti-US rhetoric, relaxing restraints on Jewish emigration, and allowing expanded intra-German ties. Flexibility would be strongly constrained, however, by an expressed Soviet policy aim of reducing long-term vulnerability to Western economic leverage.

- ***Relations With Eastern Europe.*** Moscow is likely to increase pressure on its East European allies to fill some of the gap in hard currency imports; it may also divert some of its oil exports away from the region. But Eastern Europe is not in a position to provide the scale of support the Soviets require.

- ***Relations With the Third World.*** Moscow's policies toward the Third World, including its clients, are not likely to be significantly affected. Except for Cuba, the hard currency component of military and economic aid traditionally has been minimal. We expect the Soviets to be more agressive on the international arms market, including an increased willingness to offer state-of-the-art arms and provide military technicians.

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USSR: Economic Impact of the Chernobyl' Accident

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Preliminary analysis of the Chernobyl' nuclear accident indicates that direct damage to the Soviet economy will be relatively minor. Although the cost of the evacuation, decontamination, cleanup, imports of technical equipment and medical supplies, and some permanent resettlement will be large—perhaps as much as 25 billion rubles direct damage to agriculture, industrial facilities, and the environment will be limited to a fairly small area. Nonetheless, the potential loss of electric power this year could put a crimp in General Secretary Gorbachev's hopes to get the new five-year plan off to a fast start in 1986.

The Human Costs

Preliminary calculations suggest workers and firemen at the reactor site and local residents who were drawn to the area by the fire—perhaps as many as 200 to 300 persons—received potentially lethal doses of radiation. As of 21 May, the death toll was 15—13 from radiation and two from the explosion. Additional deaths among the heavily irradiated victims are expected in the next several weeks. Onlookers near the site would have inhaled considerable airborne radioactivity and may be among the hospitalized victims, who, according to Gorbachev, numbered 299 on 14 May. People within 5 kilometers (km) of the site who were exposed to the initial radioactive plume could have received substantial doses of radiation. An additional 25,000 to 30,000 persons who were exposed may have received enough radiation to show mild symptoms such as nausea, and these people will be at risk for future cancers.

The accident also forced a large-scale relocation of many in the area. As of 13 May, Moscow acknowledged that 92,000 persons had been evacuated from a 30-km zone around the plant. We estimate the population of this area to be 150,000 to 180,000, including the two towns of Pripyat' and Chernobyl' and the surrounding rural population. It is likely that many fled on foot—some with their livestock—before vehicles arrived. In addition to the official evacuees, thousands of persons, mostly women and children, have left Kiev and other cities outside the 30-km area.

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It is difficult to estimate the cost of the evacuation, but assuming military units were involved, little incremental cost would accrue to the Soviets. Volunteers are housing many of the evacuees; and, if existing housing is properly decontaminated, residents could begin returning within months. The Soviets reportedly are applying a polymer to the immediate area that can later be removed, taking contamination with it. The roofs of buildings are also being coated to prevent rain from washing radioactive debris into drainage systems. It is likely that permanent relocation will be required for some of the population. Indeed, in some areas, the evacuees are already being put to work.

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Impact on Agriculture

The initial plume of radioactivity appears to have passed over an area covered largely by forests and swamps. Not more than 15 to 25 percent of the crop and pasture land in the Chernobyl' region would have been seriously affected. Soviet data show that the region accounts for a minuscule share of total Ukrainian farm output. Damage to farming regions beyond the immediate area of the accident is likely to be minimal. Because harmful levels of contamination are localized, we do not anticipate substantial, long-term effects on international commodity supplies or trade.

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What Happened in Chernobyl'?

Our best estimate of the cause of the accident is that the reactor power suddenly surged, producing superheated steam. A reaction between superheated steam and zirconium-alloy fuel cladding produced hydrogen gas. The gas built up until it exploded, damaging the reactor and leading to fuel melting and a fire in the graphite. The destruction of the reactor hall allowed large quantities of radioactivity to escape. The explosion reportedly knocked out the radiation alarm system, and officials at the site did not learn of the high levels of radioactivity until hours later. Two and possibly three persons were killed by the explosion, and at least 35 people at the site, including some of the firemen who responded, were exposed to lethal doses of radiation. Helicopters were used to drop sand, lead beads, clay, dolomite, and boron into the burning reactor. The fire was finally extinguished on 11-12 May.

The livestock sector may be more seriously disrupted in the area. Indeed, we have already seen reports of livestock being slaughtered because of high radiation levels. Soviet press reports however, indicate many livestock were evacuated along with the population. Livestock that ingested contaminated feed before being evacuated should survive if quickly switched to clean feed. Except for milking cows, radioactive isotopes not excreted by these animals would be localized in organs generally not consumed by humans, such as the thyroid, and in bones. Some pastureland beyond the evacuated area may have to be taken out of use until radiation drops to acceptable levels, putting pressure on local supplies of stored feed.

The local dairy industry will be most seriously affected because cows consuming radioactive feed concentrate radioiodine—the main contaminant—in their milk. Cows fed contaminated feed will produce hazardous milk for several weeks after switching to clean feed. Soviet dairy authorities will have to not only monitor the milk but also assure that condemned milk does not reach black-market channels.

Local Effects of Radiation on Agriculture

The effects on farming activities near the site are likely to be varied. Although the affected area contains very small quantities of grain and sugarbeets, winter grains planted last fall and sugarbeets that are just emerging have been exposed to radioactive particles settling on leaves. Some of this radiation will be incorporated into the plants. Lightly contaminated grain may be mixed with clean grain during milling to dilute any harmful effects, but any heavily contaminated grain will have to be collected and disposed of. Sugarbeets exposed to radiation would tend to concentrate radioactivity in their roots and will likely have to be destroyed.

According to US experts, spring grains and vegetables can be planted in areas of light contamination because most of these crops—with the exception of sunflowers—do not absorb radiation through their roots. Danger to humans, however, could result from contaminated dust raised by machinery in fields during planting, subsequent field operations, and harvesting. Thorough monitoring and decontamination of workers, equipment, and crops in the areas adjacent to the evacuated zone will be necessary, slowing field work. Even in those areas where contamination is light, crops could suffer some losses if normal spring field operations are delayed. Workers may be kept from the fields as a safety precaution or diverted to cleanup operations. Growing seasons in the USSR are short, and harvests are frequently disrupted by the early onset of winter.

The Chernobyl' power plant is located just north of the Kiev Reservoir, which supplies the bulk of the drinking water for the Ukraine's capital. Some radiation was undoubtedly carried to the reservoir

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by winds and by the two major rivers feeding it—the Pripyat' and the Dnepr. Fish, particularly freshwater shellfish, taken from these waters will also require monitoring for some time. The Soviets are building a 30-meter concrete wall into the ground around the complex to contain any contaminated runoff or groundwater seepage. Soviet environmental authorities, however, maintain that regular water samples are being taken from the Kiev Reservoir and that they show levels of radioactivity below established norms. [ ]

Local Industry

An inventory of industrial facilities within the 30-km zone around the reactor reveals only a small number of civilian plants, including two concrete products plants, a machine-tool plant, perhaps 10 food-processing sites, three textile mills, and a railroad repair yard. [ ] several of these facilities have been shut down—probably as a result of the evacuation order. How long they will be affected remains an open question, depending on the degree of contamination and how quickly the Soviets want to resume their operation. Moscow has already discussed bringing reactor units 1 and 2 at Chernobyl' back on line as quickly as possible, but local industry may not have such a high priority. [ ]

In all likelihood, the accident disrupted—at least temporarily—electricity supplies beyond the 30-km area. All industries suffer problems in the event of brownouts or blackouts, but the largest users of energy—metals processing, cement, food processing, and chemicals—would be hardest hit from resulting damage to machinery and products in process. We have no information to date regarding specific disruptions in electric power supplies to local industry. In addition to electricity, industrial facilities depend on water for cooling and processing. If irradiated water is used in processing, some end products could be affected, particularly in the chemical and food sectors. [ ]

Electricity Supplies

The shutdown of the four 1,000-megawatt (MW) reactors at Chernobyl' will probably have a wide range of effects. During the summer lull in electricity demand, the Soviets will be able to compensate for most of the power losses associated with Chernobyl' by using other generating capacity more intensively. Beginning in September, however, the upsurge in demand for electricity probably will eliminate most of the painless adjustment mechanisms. Moreover, [ ] two reactors at Kursk identical to the damaged one at Chernobyl' may not now be operational. We cannot be certain whether these other reactors are completely shut down or are operating at reduced power levels for safety reasons. Moreover, if they are in fact shut down, it is unclear that the Chernobyl' accident was the reason. Moscow, however, probably would not disrupt the economy further by shutting down the remaining nine graphite-moderated, boiling-water reactors (RBMK) similar to those at Chernobyl' unless the cause of accident is judged to have stemmed from basic design faults. [ ]

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The confirmed shutdowns at Chernobyl' and the likely shutdowns at Kursk—assuming the latter reactors remain out of service for the remainder of the year and the power is not made up from other plants—would reduce Soviet electricity output in 1986 by about 25 billion kilowatt-hours (kWh), roughly 1.5 percent of the annual total. The impact, however, is concentrated on two power grids that would experience losses of about 10 percent. Power cuts of this magnitude, although unlikely, could seriously affect key economic activity in the Ukraine and Moscow regions. We believe the Soviets will attempt to ease the impact by drawing electricity from adjoining grids, and possibly from more distant grids in the Urals and Kazakhstan. Moscow may also request that Czechoslovakia, Bulgaria, Romania, and Poland reduce imports of electricity from the Ukraine—roughly 20 billion

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kWh was sent to these countries in 1985. Cutting exports to Eastern Europe, however, may not be a politically attractive way to ease the crunch.

The Soviets could compensate for the loss of electricity over the next several months if they forgo maintenance—normally scheduled for the summer—at power plants using fossil fuels and operate them at full winter capacities. Moscow has already reported that one generating unit at a thermal power plant in Kiev, normally held in reserve at this time of the year, is now operating at full capacity to partially compensate for the loss of Chernobyl'. Seven other power plants in the Ukraine—four hydroelectric and three thermal—are also reported to be working at full capacity.

Increasing output at conventional plants, however, is only a stopgap measure. Maintenance must still be performed, and if it is not finished by winter the Soviets will be hard pressed to meet the surge in electricity demand that will take place then. In any event, domestic supplies of fossil fuels will have to be supplemented with increases in domestic fuel production and possibly with imports, such as additional coal from Poland. The additional fuel required to offset the loss of the Chernobyl' reactors would amount to perhaps 150,000 barrels per day oil equivalent and half again as much if the other two reactors remain shut down. If domestic fuel oil supplies are used to generate replacement electricity for these six reactors, at the expense of exports of oil to the West, hard currency losses would amount to $100 million per month at current prices.

The Chernobyl' disaster is likely to result in some setback to the USSR's nuclear power program. The Soviets currently have 28,300 MW of nuclear generating capacity, supplying some 11 percent of their electricity. Moscow's plans call for expansion of nuclear capacity to 70,000 MW by 1990, boosting the nuclear share of total electricity output to more than 20 percent. The accident may prompt the Soviets to at least put construction of new RBMK reactors on hold temporarily. The Soviet decision to allow placement of nuclear plants closer to populated areas to supply centralized district heating systems—including one in Kiev—could be reexamined.

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Central American Core Four: Troubled Small Debtors

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The external debts of the Central American Core Four countries—Costa Rica, El Salvador, Guatemala, and Honduras—are small, but the burden of repayment weighs heavily on their equally small economies. For each of the four nations, relations with creditors are strained, and political leaders perceive their problems as receiving short shrift from the international financial community and creditor governments. Solutions to the region's debt troubles—including calls for a possible joint position to increase leverage with foreign creditors—will be a major topic of discussion at the Central American presidential summit in Guatemala on 24-25 May.

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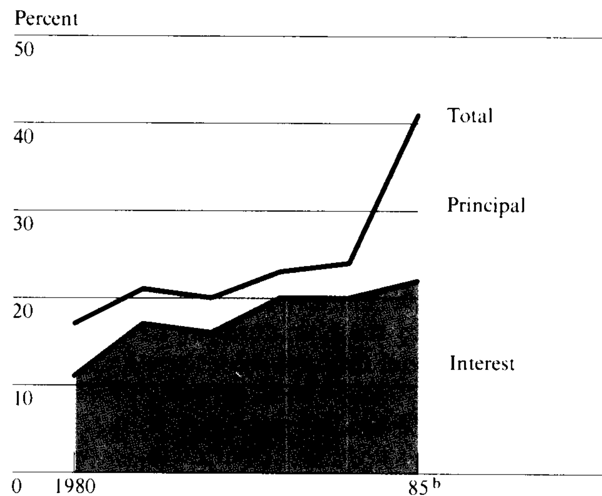
Core Four: Aggregate Debt Service Ratios, 1980-85 [a]



[a] Debt service as a percent of exports of goods and services.

[b] CIA estimate.

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Small Debts, But Bigger Burden

The Core Four's foreign debts are small relative to most other LDCs, especially those in Latin America. Only Costa Rica owes more than $3 billion, and the four nations together owe only about $11 billion, placing their collective debt roughly on a par with Peru or Colombia. Brazil and Mexico, by comparison, each owe over $100 billion. Nonetheless, the debts are a strain on the region's cash-starved economies. While Core Four real GDP declined 5 percent between 1980 and 1985, and the region's persistent current account deficit worsened, debt service obligations nearly doubled. As a result, the Four's debt service ratio has more than doubled since 1980 to 41 percent last year—equal to the Latin American average. In addition, as Core Four political leaders are quick to point out, their debt is higher as a share of GDP than Latin America as a whole—53 percent compared with 48 percent for Latin America.

Individual Country Situations Grim

Despite both Paris Club and commercial bank reschedulings in 1983 and again last year, ***Costa Rica*** remains mired in debt troubles. San Jose had won both an IMF standby arrangement and a World Bank structural adjustment loan last year, but failure to comply with agreed economic performance targets and policy reforms stalled both Fund and Bank disbursements. Without the IMF and World Bank money, Costa Rica was unable to make an interest payment to banks last month and fell into default on its 1985 rescheduling agreement, according to US Embassy reports. Just days afterward, San Jose declared a temporary moratorium on foreign debt payments and publicly advised domestic banks to withdraw funds held overseas to avoid a possible freeze of assets by lenders. President Arias, who took office the day after the moratorium was announced, is committed to working with the IMF

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and World Bank, according to US Embassy reports, but it probably will be months before agreements with the Fund, Bank, and commercial creditors are back on track. Meanwhile, San Jose faces the risk of cuts in its trade credit lines as debt arrearages, which now exceed $110 million, grow by $50 million each month the moratorium lasts.

Almost all of ***El Salvador***'s external debt is owed to foreign governments and multilateral financial institutions, largely on concessional terms. Nevertheless, falling exports and rising repayment obligations combined to increase the nation's debt service ratio fivefold since 1980 to 43 percent last year. Debt relief will be difficult to achieve. Roughly half of San Salvador's $325 million debt service due this year is owed to the multilateral institutions, which do not reschedule. The largest payment is to the IMF, followed by the Interamerican Development Bank (IDB). Relief from much of the other half of 1986 obligations—those owed to foreign governments—would be possible through a Paris Club rescheduling, but President Duarte almost certainly lacks the domestic political support needed to reach the prerequisite formal agreement with the IMF. El Salvador is some $120 million in arrears to foreign creditors, including the United States.

Before 1980, ***Guatemala*** pursued a cautious debt policy, with most of its debts on concessional terms from multilateral and bilateral creditors. More recently, however, the country has increasingly turned to market-rate foreign commercial borrowing to cover foreign payments gaps, driving debt service obligations up to 37 percent of export revenue last year, compared to just 8 percent in 1980. As a result, foreign banks now are Guatemala's second-biggest creditor after the IDB. Payments problems also have resulted in roughly $490 million in external arrearages, mainly on payments for imports, according to IMF data.

Central Bank officials last month began discussing debt relief with foreign bankers. Cerezo's recent economic moves, however, which include public-sector wage hikes and plans for huge increases in government employment, run counter to conciliation with the IMF and relief from creditors.

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Honduras' debt service ratio is the lowest among the Core Four, but its relations with creditors nevertheless are strained. IMF data and US Embassy reports indicate Tegucigalpa often falls in arrears to the multilateral development banks, to which it owes about one-third of its debt. Although the country has avoided a comprehensive rescheduling of bilateral official debts, some bilateral debts have been rescheduled on a case-by-case basis each year since 1980. Relations with foreign commercial banks remain especially difficult. The government-guaranteed debt to foreign banks amounts to only $226 million, 8.5 percent of the total debt, but much of this sum is in arrears, and rescheduling talks have dragged on since 1982. The departing Suazo administration broke off negotiations late last year—aborting a draft accord—to avoid committing the new Azcona government to an agreement it did not participate in. Talks resumed recently, but both sides have redrawn their bargaining positions, and interest payments have become as much as 190 days past due, portending still lengthier negotiations.

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Debtors' Talk: Joint Positions

Core Four leaders are well aware of their lack of financial leverage with foreign creditors and perceive themselves as being ignored in negotiations with an international financial community that pays greater attention to the larger debtors. They point to the stiffer terms—particularly higher interest rates—of their debt rescheduling deals and are concerned the Cartagena Group and the US initiative on debt are not taking their interests into account. The Core Four leaders reason that creditor concessions are more important for their new and fragile democracies than for the rest of Latin America because the risk of political instability is greater, according to US Embassy reporting.

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Core Four: External Debt

	Total Debt (million US $)		Total Debt Service (million US $)		Debt Service Ratio [a] (percent)	
	1980	1985 [b]	1980	1985 [b]	1980	1985 [b]
Core Four	**5,827**	**11,447**	**791**	**1,566**	**16**	**41**
Costa Rica	2,386	4,100	316	550	26	55
El Salvador	830	2,100	100	335	8	43
Guatemala	1,045	2,598	145	475	8	37
Honduras	1,566	2,649	230	206	24	30

[a] As a share of exports of goods and services.
[b] CIA estimate.

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Like the Cartagena Group, Core Four representatives agreed at a conference last year to exchange information about their experiences in debt negotiations and to explore joint bargaining positions as a way of boosting their leverage with creditors. The Core Four vice presidents reaffirmed these goals at a San Jose meeting last month, and the next opportunity for discussion will be the Central American presidential summit this weekend in Guatemala. The debt issue is one of four agenda items for the meeting. The diversity of the nations' respective financial situations and Nicaragua's attendance at the summit may make effective common positions difficult to find, but, even if no concrete plan for joint action emerges, increased calls for burden-sharing by creditors are likely.

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Implications for the United States

Default by any single Core Four country, and even the region as a whole, is far from capable of triggering an international financial crisis. US commercial bank exposure to the Core Four is only about $830 million, according to US Federal Reserve data, compared to over $20 billion for either Mexico or Brazil alone. Global commercial bank exposure to the region is only about $2 billion, according to Bank for International Settlements statistics.

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From the Core Four's point of view, however, the burden of debt repayment obligations will remain serious. IMF and World Bank data indicate debt service for the Core Four will continue at current levels at least through 1987. In turn, the region's leaders can be expected to increase pressures for debt relief, possibly focusing on the US Government—creditor for about 14 percent of the four nations' debts. US financial relations with the region might be aggravated by cutoffs of new US assistance to El Salvador, which remains as much as 11 months in arrears on some US debt. Under the provisions of the Brooke Amendment, US military and development assistance would be suspended if El Salvador fell more than one year behind on repayments to the United States. Finally, the United States also should expect commercial banks to continue to pressure the Core Four, especially Costa Rica, to use US cash disbursements to service commercial loans.

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India: Pace of Economic Liberalization Slows

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Prime Minister Gandhi, prompted by a growing trade deficit, a tight budget, and domestic political problems, has moved to slow the pace of economic liberalization. The change is signaled in part by this year's government budget, which focuses on traditional support for welfare programs and includes measures to slow the growth in imports. Gandhi has not abandoned his efforts to promote economic growth by liberalizing the economy, but is modifying his approach to protect the country's hard currency reserves and deny his opposition a rallying point. Gandhi will look increasingly to Western governments for financial support to maintain imports he feels are necessary to upgrade India's technology and productivity.

Gandhi's Economic Reforms

When Rajiv Gandhi took over as Prime Minister he sought to transform the Indian economy into a more dynamic and competitive force through liberalization measures. His strong belief that less bureaucratic meddling and more competition in the private sector would spur modernization, limit corruption, and ease strains on the government budget prompted him to accelerate liberalization moves begun several years ago under his mother. Manufacturers in several industries may now set up new operations, expand capacity, and vary their product mix without seeking government permission. He also relaxed antimonopoly legislation and lowered corporate and personal tax rates.

In return, Gandhi, through the 1985-89 plan, called for the private sector to assume 52 percent of total investment, compared with 47 percent under the previous plan. More major projects were to be funded as joint ventures and in areas long closed to private-sector participation. Private companies, for example, have been invited to invest in telecommunications equipment, power generation projects, six proposed gas-based fertilizer plants, and road construction projects.

Import policy changes combined safeguards for domestic manufacturers with efforts to promote modernization and exports. Import licensing was eased on some industrial machinery, and a new duty-free import scheme was offered for exporters. New Delhi promised easy access to imported technology and simplified procedures for employing foreign technicians. The government even emphasized that foreign equity investment—previously tolerated but not encouraged—would be welcomed in electronics and oil exploration.

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Gandhi's policy reforms have fueled an atmosphere of optimism in the business community and led to expectations of even more liberalization measures. Businessmen have been looking for additional deregulation and tax reforms to make long-term investments more attractive.

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Increasing Constraints on Gandhi

Several economic and political factors are now beginning to affect Gandhi's ability to maintain the pace of liberalization he undertook in his first year in office. The trade deficit for the fiscal year that ended on 31 March (FY 1985) exceeded $6 billion, at least $1.8 billion greater than FY 1984. Preliminary trade data indicate nonpetroleum imports increased by about 20 percent while nonpetroleum exports increased by only about 8 percent. Stagnant domestic crude oil production and a 7-percent growth in oil consumption led to the first increase in net oil imports in five years.

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A record current account deficit has raised outcries among Gandhi's critics and fear among his supporters that India's foreign reserves will once again deteriorate. The government has been able to preserve foreign reserves near last year's level of $6 billion through aid inflows and increasing its foreign debt burden. Aid disbursements were about

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India: Estimated Balance of Payments, 1981-85 [a] *Million US $*

	1981	1982	1983	1984	1985
Current account [b]	**−3,025**	**−2,795**	**−2,770**	**−2,160**	**−3,700**
Trade balance [b]	−6,855	−6,000	−5,690	−4,470	−6,300
Exports f.o.b.	8,660	9,605	9,600	10,560	10,100
Imports c.i.f.[b]	15,515	15,605	15,290	15,030	16,400
Net invisibles	3,830	3,205	2,920	2,310	2,600
Capital account	**628**	**3,299**	**3,652**	**2,423**	**3,700**
Of which:					
Aid disbursements	1,833	2,211	1,989	1,763	2,000
Grants	595	560	514	463	450
Loans	1,238	1,651	1,475	1,300	1,550
Nonconcessional loans [c]	858	887	1,378	1,450	1,700
Nonresident deposits	179	592	558	610	1,200
Change in reserves	**−2,397**	**504**	**882**	**263**	**0**

[a] Fiscal year beginning 1 April of the year stated.
[b] Excluding military.
[c] Medium and long term only, including IBRD.

the same as the last five years, but the grant component has continued to decline while concessionary loans have increased. New Delhi has also tempered somewhat its historic reluctance to borrow from international money markets, increasing nonconcessionary borrowing to $1.7 billion. Nonresident Indians, attracted by high interest rates, deposited an estimated $1.2 billion in Indian banks, almost double the FY 1984 amount.

The rising budget deficit also is severely curtailing the government's ability to follow through on domestic liberalization measures. The budget deficit in each of the last two years reached record levels that exceeded $3 billion annually, about 6 percent of the government expenditures. Growing defense spending, rapid increases in the cost of subsidies, particularly for fertilizer, and rising debt service allow the government little latitude to experiment with tax reform or grant additional incentives to the industrial sector. Moreover, the financial constraints are forcing inefficient government-owned industries to compete with the private sector for capital. Price increases for food, petroleum, and fertilizer announced in February were an important step toward reducing subsidies, but this year's budget deficit is still likely to be near the levels of the last two years.

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Political problems also are constraining Gandhi in his pursuit of additional liberalization measures. Criticism that tax cuts and industrial policies implemented last year have favored the upper and middle classes has led opposition leaders as well as some Congress Party members to contend that Gandhi has abandoned the socialist direction of the country. Some politically influential industrialists, long accustomed to operating in a protected environment, have begun to complain about losing sales to foreign suppliers. Internal dissension in the Congress Party, and the fear of more electoral losses, the unresolved problem with the Sikhs in Punjab, and the domestic concerns with the insurgency in Sri Lanka have forced Gandhi to devote more time to political issues and become more cautious about stirring up additional controversy over economic liberalization.

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Changing the Tone and Pace

Gandhi's response to the problems he faces was reflected in the government's budget for the current fiscal year. Total government expenditures are projected to grow by only 5 percent to $43 billion, but focus on programs with immediate popular appeal. The government has provided for a 65-percent increase in funding for social welfare programs such as employment, education, housing, and rural development.

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The budget was a disappointment to the business community and prompted a sharp drop in the stock market. The government plans to cover much of the increase in expenditures by raising import duties and other indirect taxes. The increase in import duties, while aimed primarily at luxury items, represents a backpedaling on import liberalization

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measures enacted last year. In addition to the revenue raising aspects of import duties, the government hopes to discourage some imports to slow the deterioration in the trade balance and respond to the complaints from influential industrialists of foreign competition.

The imposition of other indirect taxes also is likely to cut into the liberalization process. Small industry, automobiles, and electronics—the fastest growing sectors and those benefiting most from the liberalization process—are all likely to be hurt. Some taxes on the textile industry, cut last year as part of a textile policy aimed at increasing productivity, efficiency, and competition, were moved up again. The government also reversed its earlier tax policy on a wide variety of consumer durables, making everything from cars to television sets and refrigerators more expensive.

Some government liberalization policies that sought to facilitate increased production through easier and quicker access to foreign inputs and technology also are being revised. Liberal imports of technology and expansion of capacity have led to some redundant imports and excess production for the domestic market. The automobile policy, hailed as the model for other areas of industry, already has been modified. Other consumer durable industries, particularly those that do not contribute to exports, also are being reviewed.

Basic Philosophy Unchanged

Slowing the pace of liberalization, however, does not appear to reflect a fundamental change in Gandhi's economic philosophy. We believe he is trying to consolidate his gains while at the same time denying the opposition a political issue and avoiding a drawdown in foreign exchange reserves. The Finance Minister has reiterated the government's commitment to liberalization measures, including domestic price adjustments, reduced subsidization of uncompetitive industries, and imports of capital goods necessary to continue the modernization process. Gandhi has indicated India will continue to welcome foreign investment in specific technological areas.

Automobile Industry Left Hanging

The automobile industry represents one area where liberalization moved too fast for New Delhi. In January 1985 the government announced that it intended to allow the automobile industry more flexibility to adjust capacity and product manufacturing. All of the domestic manufacturers hoped to sign foreign collaboration agreements to modernize their product lines. In February of this year, however, after keeping manufacturers guessing for six months, the government quietly put all these projects on hold.

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The foreign exchange cost of expanded foreign collaboration was the primary reason for the government's action.

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the arrangement between the government-owned automobile company, Maruti Udyog, and Suzuki of Japan could cost the country more than $400 million of foreign exchange in the next few years. The collaboration program called for 45-percent local content at the start, progressing rapidly to 95 percent; but Maruti has managed just over 30 percent.

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most indigenous components are themselves assembled imported materials. The Finance Minister also has cited growing petroleum consumption as a reason for halting more car ventures. Some critics, however, are charging that liberalization and modernization in the private-sector automobile industry is being held back because it would threaten the government carmaker.

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The latest blow to the automobile industry was the tax hike imposed by the new budget. While the Finance Minister stated the day after the budget was released that car prices would come down as the result of tax changes, the opposite was true. The cost of India's poor man's car, the Maruti, is expected to increase from $5,000 to $6,000 as a result of tax changes in the budget.

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We believe Gandhi also remains committed to liberalization out of necessity. Much of the Indian industrial sector has become stagnant and inefficient because of government control and lack of competition. The public sector in particular has shown little return on capital investment. The last five-year plan fell 18 percent short of planned expenditures primarily because state enterprises could not provide the necessary resources. India will need more efficient management and greater productivity, especially from the private sector, to achieve its five-year goal of 5-percent average annual economic growth.

Implications for Western Countries

Opportunities for developed countries to sell high-technology items as well as other capital goods will be reduced, if the slowdown in liberalization continues. Import purchasing decisions by Indian Government agencies are likely to be even more time consuming and will give greater weight to price and financial terms, even in high-technology areas. Exporters who have long-established ties to Indian firms will suffer less than newcomers, because New Delhi usually considers import history when allotting licenses to Indian businessmen.

We expect New Delhi to push for more Western aid and concessional financing to continue the liberalization process without incurring a heavier debt burden. New Delhi has already begun a heavy lobbying effort to at least maintain its current level of funding from multilateral financial institutions. The level of US aid is likely to face additional criticism if New Delhi's repayment of principal and interest on past loans continues to exceed new loans and grants. New Delhi will also look to Western governments and businessmen to come up with creative financing to alleviate the short-term foreign exchange burden of importing foreign technology and capital goods. India might also look to greater equity participation by foreign businessmen to cover some of the costs of capital imports.

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French and Japanese Industrial Policy: Diverging Impacts on the Electronics Industry

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Although both the Japanese and French electronics industries have been nurtured over the past three decades by a wide range of government policies, the Japanese industry has emerged as a world leader, while the French industry has failed to make a major impact on the global electronics market.

Japan, in our judgment, will build upon its current market strengths and expand its research capabilities in the years ahead. In contrast, continuing French lags in electronics may lead Paris to tighten protection for the sector, including calls for higher EC tariffs on electronics products. Moreover, French firms facing increasing competition from the US and Japanese industries may be forced to seek joint ventures, licensing, or outright technology purchases as they attempt to become competitive.

Similar Policies—Different Outcomes

Although Japan and France have employed a similar mix of targeting measures to support their electronics industries, the programs have varied both in the way policies were applied and in the goals they were designed to achieve. Both the French and Japanese Governments have sheltered the industry from foreign competition, supported R&D activities, granted preferential access to capital, and provided preferential procurement. Tokyo, however, has consistently focused its support on enhancing the competitiveness of Japanese firms in the global marketplace, while French policy has been designed to support technological independence for defense as well as civilian electronics. French policy also differs in that the government, rather than the private sector, has largely determined industry structure and the range of product development.

Under MITI leadership, Japanese policy changed as the industry grew. Our review of Japan's industrial policy indicates that early attention was focused on protection of the infant industry from foreign competitors. As the industry strengthened, MITI began to fund a broad range of R&D activities and instituted programs to spur purchases of Japanese electronics equipment. Tokyo's actions to create demand for domestic electronics products—particularly the buy-Japanese procurement policies of Nippon Telegraph and Telephone (NTT)—were, we believe, crucial to the early success of the industry. more than 90 percent of NTT's purchases over the last two decades have come from four major Japanese electronics firms. In addition, Tokyo has used tax policy and targeted loans to promote demand for domestically produced electronics goods and to encourage expansion of the production base.

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In contrast to Japan, France has continually tinkered with the structure of the industry—almost all the leading French electronics firms have undergone a continuing series of government-directed restructurings, realignments, mergers, or nationalizations. For example:

- In the 1960s, Paris created a "national champion" in computers by merging two firms to create Compagnie Internationale pour l'Informatique (CII).
- In the 1970s, CII was merged with Unidata—a Siemens/Philips joint venture—but pulled out two years later and merged with Honeywell-Bull.
- In the 1980s, Honeywell was bought out, CII-Honeywell-Bull was nationalized, and the newly named Groupe Bull was ordered to focus solely on computers.

We believe that the continuing upheaval caused by French intervention in the structure of its electronics industry has been a major reason its firms have

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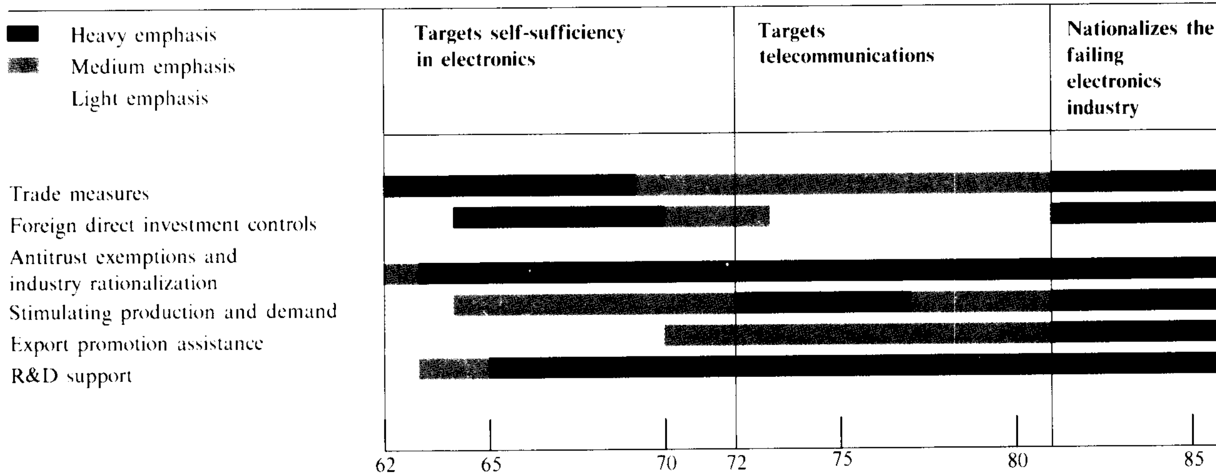
France: Government Support for the Electronics Industry, 1962-85



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failed to become competitive. Moreover, because these moves frequently eliminated domestic sources of competition, the French firms operated in a protected domestic market and became too reliant on government subsidies. As a consequence, French firms have not been forced to develop the technical strength or product offerings necessary to compete in international markets.

Where Japan had a full range of support policies, French support of the electronics industry has been concentrated largely in a series of R&D plans. Paris often budgeted massive funding for these plans but then failed to meet promised allocations. For example, the "Electronics Network" project was a five-year, $20 billion project begun in 1982; by 1985, the project had spent only $6 billion and was not renewed. Moreover, industry observers note that the French programs lacked consistency and did not establish close ties within the French research sector. In addition, France failed to establish a central agency—similar to MITI—that could effectively coordinate research findings and financing to the electronics sector.

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Future French Support in Doubt

Despite several new tax and loan incentives—similar to early Japanese policies—to spur the electronics sector, we believe that Paris is backing away from its close support of the industry. The newly elected Conservative government has promised to denationalize the electronics industry, a move that will once again upset the established structure. Moreover, recent policy maneuvers by Prime Minister Chirac—including the abolition of the Ministry of Research and Technology—indicate that aid to industrial research and EUREKA [1] may fare poorly under his leadership. Chirac has promised to cut back sharply state support for research and aid to industry as a measure to reduce budget outlays and the government's role in directing business activity. Moreover, his budget adjustments for 1986 have severely reduced financing to

[1] EUREKA is the French-initiated European-wide program to pool resources in R&D.

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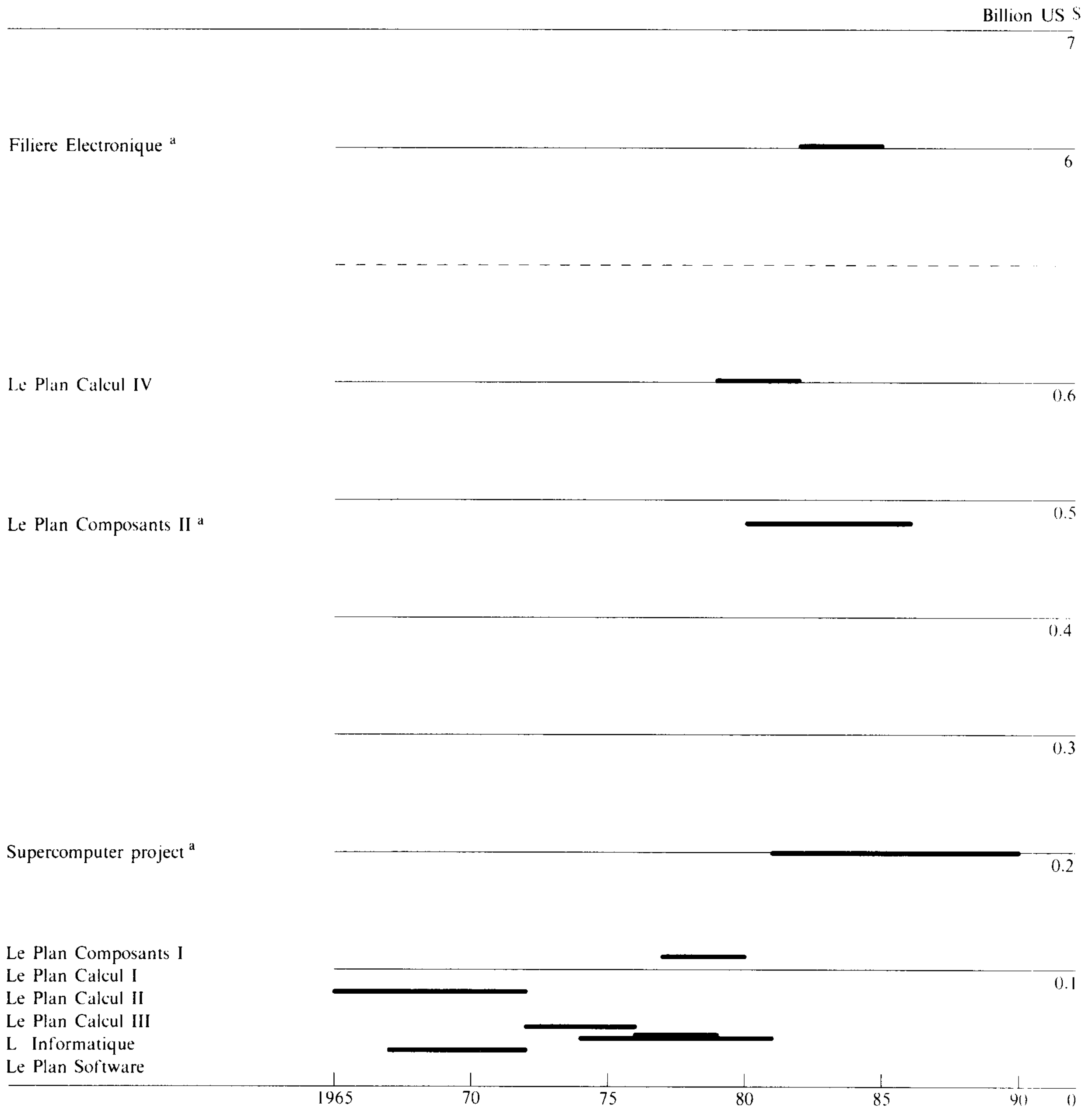
France: Major Government-Funded Computer Development Programs, 1965-90



[a] Estimated.

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the National Center for Scientific Research (CNRS), which under President Mitterrand's plan was spearheading electronics research and was to be the center of France's EUREKA effort. Without Paris's leadership and seed funding, EUREKA's primary function of coordinating advanced European research may be seriously threatened.

Outlook

As Japanese firms have gained in competitiveness, the need for direct government support has declined. In recent years, MITI has shifted its focus from applied research with near-term commercial applications to fundamental research in technology basic to the electronics sector. Indeed, Tokyo is already initiating programs to support R&D in the next generation of electronics technology. The government also has increased its export promotion measures, including export financing, loan guarantees, and export insurance.

The coming denationalizations of the French electronics sector will have both positive and negative impacts on the industry. On one hand, we expect that the leading French firms will concentrate their efforts on product offerings in areas where they have a strong technical base. At the same time, however, these firms have come to depend on government support, and we believe that the transition to a more competitive environment will not be easy. French firms, facing more technically sophisticated competition from US and Japanese firms, may be forced to seek joint ventures, licensing, or outright technology purchases as they attempt to become competitive. In the defense-related sector, we believe that Paris will continue to seek technical independence in electronics and may be willing to continue to support the sector in the future through subsidies and preferential procurement.

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Briefs

Energy

Iran Increasing Oil Exports

Recent Iranian cuts in oil prices indicate Tehran is capitulating to market pressures and making good on threats to increase exports in the absence of an OPEC agreement to lower production. Tehran's unwillingness to lower prices had caused many customers to cancel purchases and had reduced exports to about 1.4 million b/d. Iran wants to increase oil exports by some 600,000 b/d, and since the end of April has given price concessions to major customers. Tehran's bid to increase exports is an admission that it has failed for the present to persuade OPEC, and particularly Saudi Arabia, to reduce production and shore up oil prices. Higher output will give Iran an edge over Iraq, which has little capacity to increase exports, and may help arrest the recent slow rise in world oil prices. Iran may have difficulty sustaining higher exports, however, if technical and personnel problems persist or if Iraqi attacks on oil export facilities become more effective.

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Saudi Reaction to Shipping Attacks

Recent Iranian attacks on Saudi ships in the Persian Gulf have apparently led owners to try to make their ships less vulnerable to attack. says owners are altering routes, using partially loaded ships that can pass through shallower waters, and ordering some ships to delay entering the Gulf. According to the US Embassy, the attacks have had little effect on Saudi oil liftings, but Saudi officials are worried they will lose customers if ships cannot be protected. has deflected a request from one oil company to begin an Iranian-style tanker shuttle service, may begin escorting vessels to and from its ports. Riyadh will do whatever is necessary—including military action—to reassure oil and shipping companies and to defend Saudi interests. They probably hope that making this clear to the Iranians will end the attacks and will continue to avoid such partial solutions as the establishment of a shuttle. The surplus of shipping capacity worldwide cuts Iran's chances for success. If oil companies reduce liftings, however, the Saudis probably would lower prices to compensate buyers for the additional risk.

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China Buys Indonesian Oil

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China has purchased 1.5 million barrels of oil from its rival oil supplier Indonesia, according to the Hong Kong press. The $20 million deal comes 10 months after Beijing and Jakarta agreed to resume direct trade links, which were severed in 1967. [25X1] Indonesia quietly lifted its ban on oil exports to China in early January to allow for a possible swap in which Indonesian oil would be exported to southern China in exchange for northern Chinese oil that Jakarta would sell to Japan, cutting transport costs for both sides. Both sides may also see oil trade as a way to reduce counterproductive competition for markets and to encourage their deadlocked talks on opening trade offices. China imported only $45 million in petroleum and petroleum products in 1985, while exporting over $6 billion. Indonesia was the biggest loser from Beijing's price cutting to increase oil sales to Japan last year. [25X1]

Bolivia's Natural Gas Sales to Argentina

La Paz and Buenos Aires have agreed on new contract terms for Argentina's purchase of Bolivian natural gas. The agreement, according to the US Embassy, provides for the purchase of 2.3 billion cubic meters of gas at $3.65 per million Btu's—15 percent less than the previous price. The terms represent a compromise: in exchange for accepting a price equivalent to $20.51 per barrel of crude oil, Buenos Aires will pay only 24 percent of the total $296 million in cash, with food aid and an open trade credit making up the difference.

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International Finance

New Brazilian Debt Concessions

Brazil plans to make major concessions to foreign creditors to complete stalled debt rescheduling negotiations. The US Embassy indicates that the government will honor most of the $450 million debt of three failed banks, ending a contentious dispute that has caused half of Brazil's private creditors to block the tentative rescheduling accord reached in March. [25X1]

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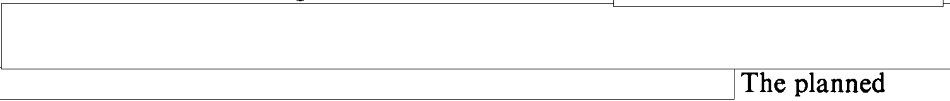

The planned retreat from tough, nationalistic negotiating positions probably reflects Brasilia's fear of economic reprisals. Most private foreign banks probably will ratify this year's debt agreement, but they—and official creditors—are likely to continue insisting on some role for the IMF in future reschedulings.

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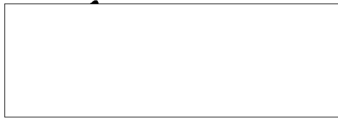
Algeria Coping With the Oil Price Slump



According to Embassy reporting, Algiers is responding to an anticipated 39-percent drop in hydrocarbons earnings by cutting government operating expenses by 11 percent and development spending by 26 percent. These reductions are projected to cut imports by at least $2 billion. After failing to raise a $500 million syndicated loan earlier this year, Algiers is now trying to float a $300 million loan. Despite more realistic terms, at least one major US bank believes Algeria will again have difficulty subscribing the loan because of bankers' continued reluctance to increase their exposure in oil-driven economies. Embassy reporting indicates bankers believe Algeria will have to borrow about $2 billion this year. Even with additional funds and a cut in imports, we believe the country could still face a current account deficit of as much as $2 billion. Algeria would have little choice but to draw down its roughly $3 billion in foreign reserves, which leaves almost no cushion for an even greater financial crunch next year. 25X1

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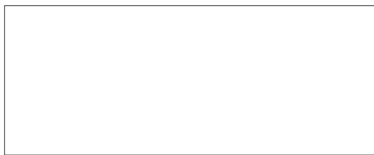
Iraq's Credit Problems Grow Worse



Iraq's continued failure to make large debt payments to official and commercial lenders is rapidly reducing Baghdad's access to further financing and increases the likelihood that major creditors will adopt a unified approach to the problem. 25X1 France—Baghdad's major creditor—has suspended short- and medium-term export credits because of Baghdad's failure to make a $120 million debt payment last month. Iraq also has missed several payments on letters of credit used to finance French military purchases, according to the US Embassy in Baghdad. The Embassy also reports that Japan's export credit agency has restricted loans to Iraq while Tokyo evaluates Baghdad's financial position. 25X1 25X1 the Arab-owned Gulf International Bank—a major lender and one-seventh owned by Iraq—will not increase its debt exposure to Baghdad. Several of Iraq's creditors, including the French, discussed coordinated action last week during a general Paris Club discussion. Even if some agreement is worked out, Iraq still will have difficulty financing imports and obtaining the large commercial loans it needs. 25X1

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Debt Relief for Mozambique

Romania, one of Mozambique's major creditors, recently announced that it will reschedule $40 million of Mozambique's bilateral debt. The debt to be rescheduled was part of a $70 million credit granted in 1981. The Romanian action comes just one month after Sweden canceled much of its commercial debt with Mozambique. Maputo has a total debt of $2.4 billion and, despite this relief, payments problems will persist as long as vital transportation and farming sectors continue to be disrupted by Mozambican insurgent attacks.

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Manila To Meet With Bilateral Aid Donors

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Manila's major aid donors—including the IMF, World Bank, the United States, and Japan—will meet next week in Tokyo with senior Philippine officials to discuss the strategy and financing of an economic recovery program. The discussions will help shape Manila's negotiations with the IMF for a new balance-of-payments loan that Manila considers the key to a rapid economic recovery, according to State Department reporting. Press reports indicate that Manila's recovery program will include proposals to dismantle agricultural marketing monopolies and restructure the ailing financial system, both longstanding demands of the IMF and World Bank. Firm commitments of new aid are likely to fall far short of the $2 billion Manila reportedly anticipates. In addition, according to US Embassy reporting, Manila and its donors will disagree over measures to deal with this year's projected $1.9 billion budget deficit and to liberalize foreign trade. Moreover, Finance Minister Ongpin will have a difficult time selling a program of budget austerity and trade liberalization to most of Aquino's closest advisors. They are leery of the short-term costs such policies impose on consumers and small businessmen and ultimately on Aquino's popularity.

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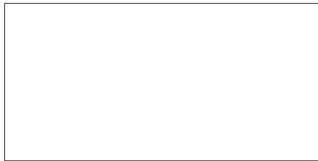
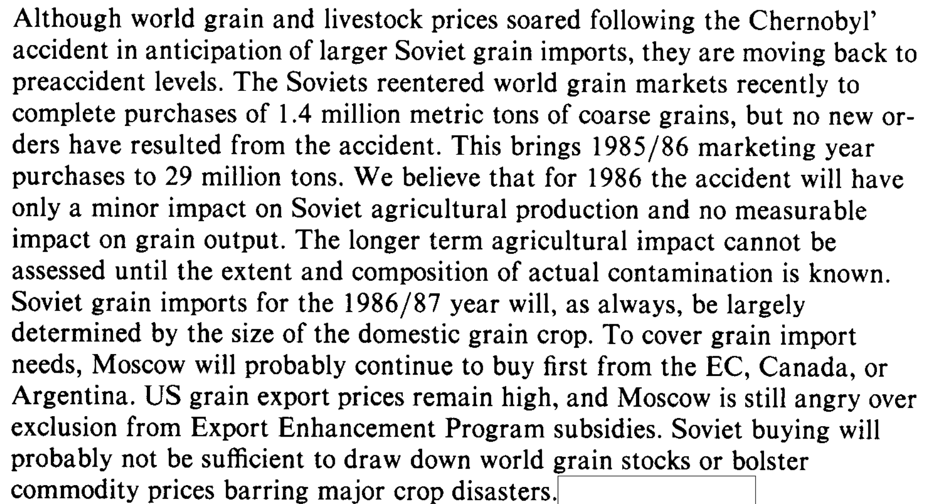
Global and Regional Developments

Grain Market Reaction to Chernobyl'





Although world grain and livestock prices soared following the Chernobyl' accident in anticipation of larger Soviet grain imports, they are moving back to preaccident levels. The Soviets reentered world grain markets recently to complete purchases of 1.4 million metric tons of coarse grains, but no new orders have resulted from the accident. This brings 1985/86 marketing year purchases to 29 million tons. We believe that for 1986 the accident will have only a minor impact on Soviet agricultural production and no measurable impact on grain output. The longer term agricultural impact cannot be assessed until the extent and composition of actual contamination is known. Soviet grain imports for the 1986/87 year will, as always, be largely determined by the size of the domestic grain crop. To cover grain import needs, Moscow will probably continue to buy first from the EC, Canada, or Argentina. US grain export prices remain high, and Moscow is still angry over exclusion from Export Enhancement Program subsidies. Soviet buying will probably not be sufficient to draw down world grain stocks or bolster commodity prices barring major crop disasters.

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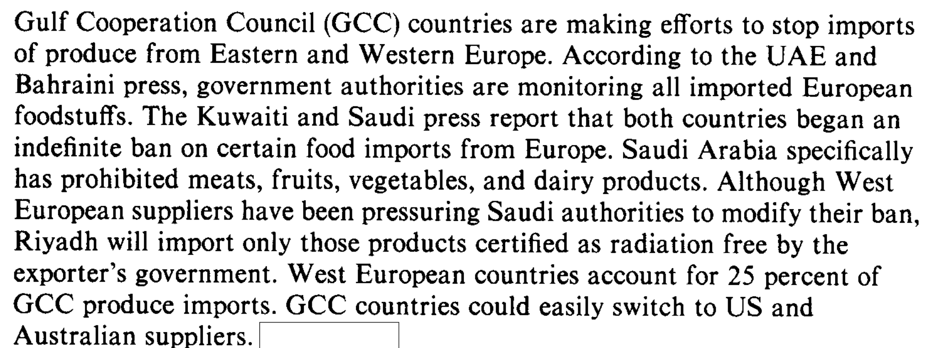
GCC Reaction to Chernobyl'



Gulf Cooperation Council (GCC) countries are making efforts to stop imports of produce from Eastern and Western Europe. According to the UAE and Bahraini press, government authorities are monitoring all imported European foodstuffs. The Kuwaiti and Saudi press report that both countries began an indefinite ban on certain food imports from Europe. Saudi Arabia specifically has prohibited meats, fruits, vegetables, and dairy products. Although West European suppliers have been pressuring Saudi authorities to modify their ban, Riyadh will import only those products certified as radiation free by the exporter's government. West European countries account for 25 percent of GCC produce imports. GCC countries could easily switch to US and Australian suppliers.

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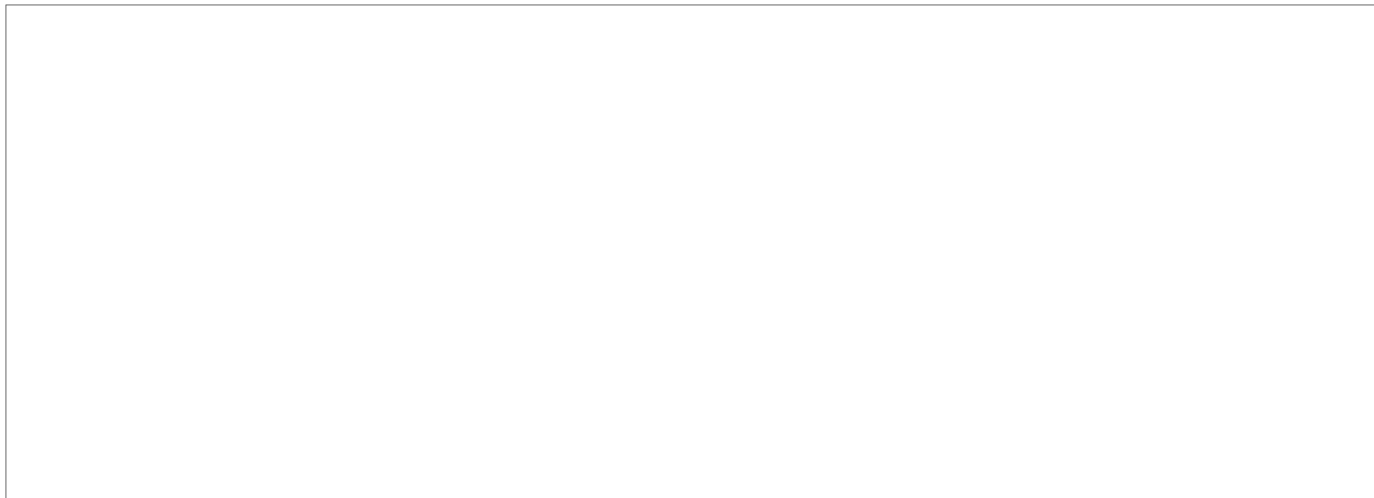

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Airbus A320 Commercial Bank Funding

A consortium of French banks headed by state-owned Paribas has recently agreed to lend Aerospatiale some $51 million to finance a small part of the development costs of the new Airbus A320 aircraft. For past A300 and A310 programs, the French Government provided all the necessary development funds, but budget constraints are forcing Paris to turn to commercial sources for some of the funds. Under the agreement, the interest and principal will be repaid by a levy of 2 percent on the A320 sales price to be paid in full with the delivery of approximately 120 aircraft. We believe the move represents the beginning of increased efforts by Airbus to acquire funds from the private sector for the development of future programs, including the $2.5 billion needed for the A330/A340 programs. Likewise, British Aerospace, which is pressing London for up to $675 million in launch aid for the A330/A340 wing, may begin to explore new ways to tap the commercial market, particularly as it moves toward privatization.

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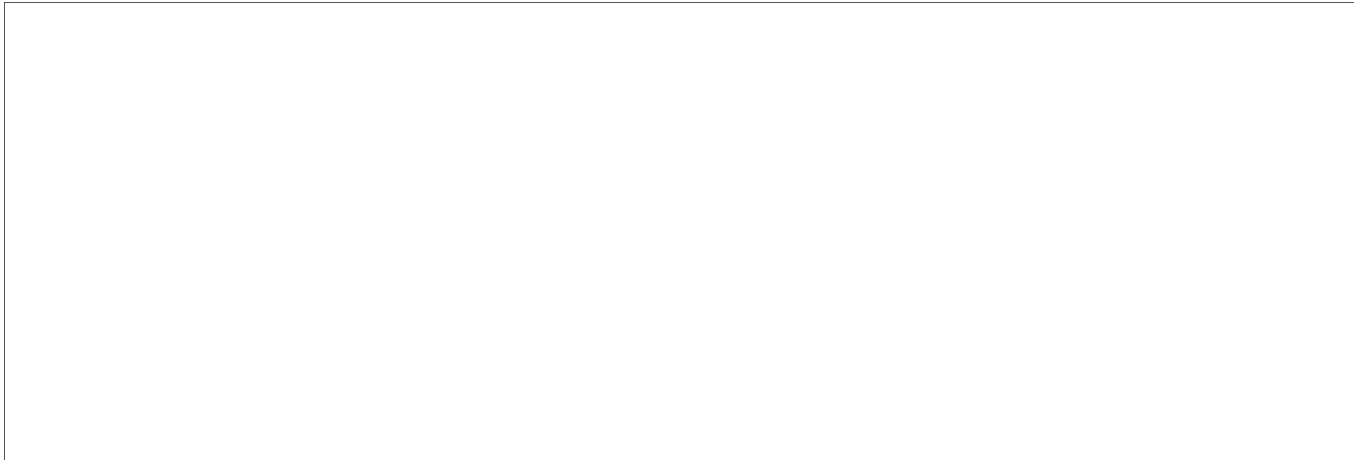

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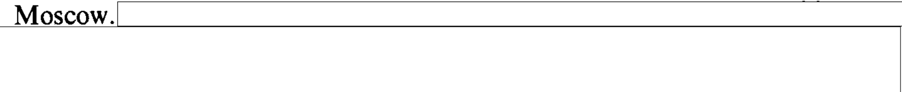
Nicaragua Receiving Economic Support From Peru

Following Peruvian President Garcia's recent call for Latin American countries to help Nicaragua rebuild its war-torn economy, Lima announced a $27 million financial support package for Managua in mid-May. Peru will provide $20 million in trade credits, and reschedule some $6.5 million in Nicaraguan debt obligations. The deal was made possible by a Soviet-Peruvian agreement allowing one-half the trade credits to be applied against Lima's debt to Moscow. 

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Increased Food Donations for Afghan Refugees

Donations to the World Food Program's (WFP) 1986 relief program for Afghan refugees in Pakistan have increased over 1985 levels—reversing declining international support for the program. In 1985, total wheat pledges declined about 5 percent from the previous year, and Islamabad was forced to release 90,000 metric tons from its own stocks to meet refugee needs. Wheat donations for 1986 should increase by 10 percent, according to Embassy reporting, and donations of other commodities are expected to rise as well. Although pledges of 361,000 tons of wheat meet WFP goals for 1986, they fall well short of the 500,000 tons that Islamabad estimates is needed this year to support the 2.6 million registered and over 300,000 unregistered Afghan refugees. On the basis of these figures, Pakistan will probably again be forced to supplement WFP donations, making the refugees a continuing burden on the Pakistani economy. 25X1

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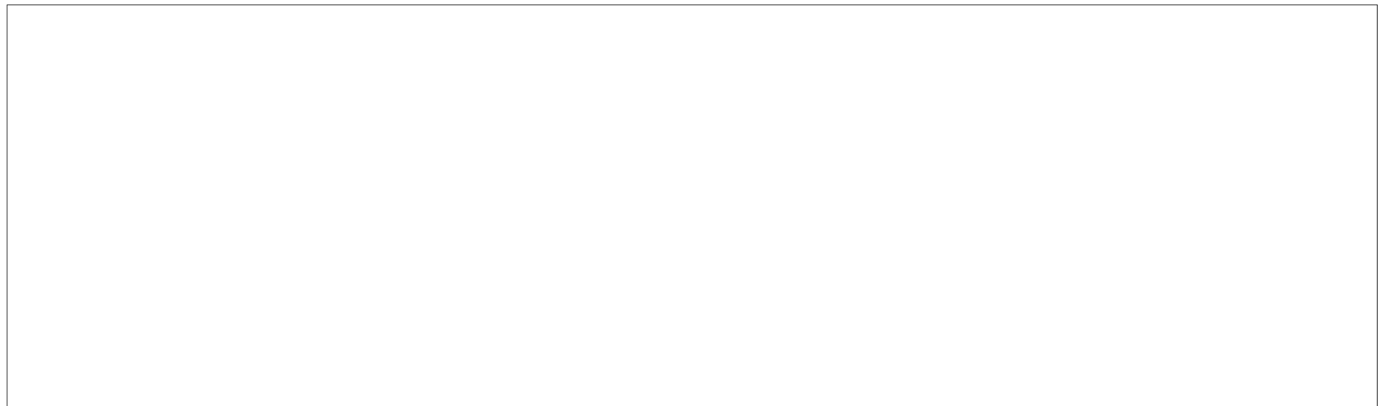
National Developments

Developed Countries



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Tighter Control of Tokyo Offshore Banking Facility

A recent press report indicates that Finance Ministry guidelines for the proposed Tokyo international banking facility will be stricter than potential investors had hoped. The facility—expected to open in late 1986—is one of the liberalization measures agreed to in the 1983 Yen/Dollar Accord. The proposed guidelines apparently will limit the level of interaction between the domestic Japanese and offshore markets, enabling the Finance Ministry to retain most of its present control over the domestic money supply. Foreign securities transactions and certificates of deposit issues would also initially be prohibited, further limiting the appeal of the proposed facility. 25X1

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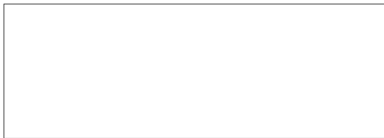
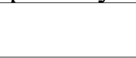
Libya Trying To Recover Frozen Assets From London Bank



Libya has taken steps to recover blocked assets in the London branch of a major US bank, raising concerns in Britain about the extraterritorial reach of US sanctions. The Libyan Arab Foreign Bank—wholly owned by the Libyan Central Bank—is suing the London branch for nearly $300 million, money that the Libyans claim they had instructed the US bank to transfer from New York to London. The case is apparently the first of its kind since Washington froze Libyan assets in January and could strain US-UK relations because of the hazy nature of the laws governing US bank assets outside US territory. Although several similar cases arose during the Iranian crisis in 1980, none came to trial to establish any legal precedent. Bank of England officials told US Embassy officers that the matter should be left to the courts, and the officials probably hope the case can be resolved without undercutting US sanctions.



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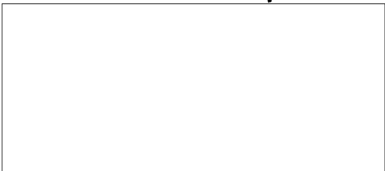
UK Report Urges Better Relations With Moscow



A report released this month by the Foreign Affairs Committee of the House of Commons recommends that Britain broaden official contacts with the Soviet Union. The committee outlined several specific proposals in the diplomatic and economic spheres to help relieve tensions and increase commercial opportunities. The recommendations include a reciprocal relaxation of controls on the movement of diplomats in London and Moscow, reappointment of a science counselor to Moscow to upgrade research contacts, use of British influence to keep the COCOM list to a minimum, and making Russian language a major educational priority. Prime Minister Thatcher is eager to continue the gradual improvement in bilateral relations witnessed since Gorbachev came to power and may take action on some of these proposals during the expected visit of Foreign Minister Shevardnadze to London later this year.

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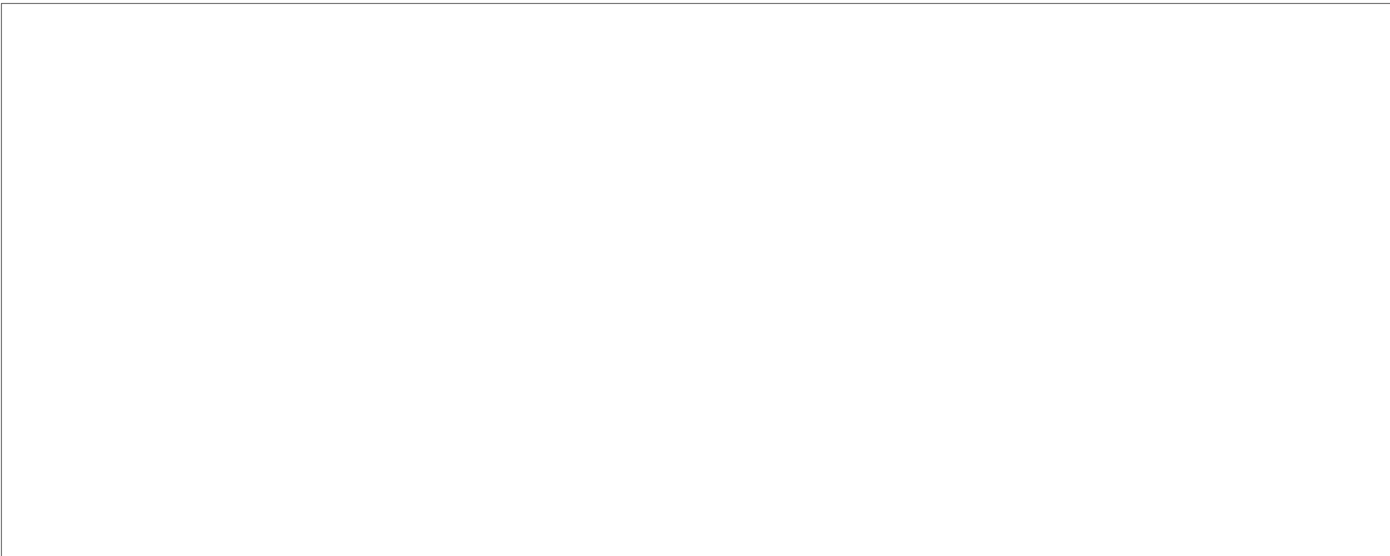

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Italy Considers Controls on Foreign Investment

Prime Minister Craxi's Socialist Party is drafting legislation that would require the government to be notified of the foreign purchase of Italian firms with capital above $20 million or net sales of $67 million at least five days prior to completion of the deal. The draft bill does not clearly describe the government's power to prohibit such sales, but firms failing to comply on notification could forfeit their right to government assistance for five years. Legislation aimed at controlling foreign investment is proposed periodically in Italy, and Craxi's concern over Libyan ownership of Italian firms apparently has prompted this latest attempt. Craxi claims only to have learned of Tripoli's recent purchase of the Tamoil refinery and its 900 service stations through the news media. Under the proposed law, the government could block direct investment only from non-OECD countries. A similar bill introduced in 1984 to control all foreign investment received little support, and there is likely to be much opposition to the present draft legislation. The main business organization, Confindustria, has already voiced its objections.

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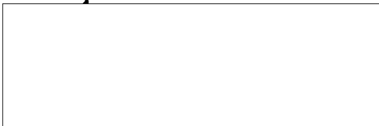
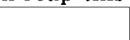
Italy Considering Adopting New Lira



The Italian cabinet agreed in principle last week to adopt a new lira worth 1,000 old lira—a symbolic measure economically, but a political boost for Socialist Prime Minister Craxi. Although several efforts at currency reform have failed, Treasury Minister Goria believes Parliament will pass his legislation this summer because of the improved inflation outlook in Italy, and he hopes to have the new lira in circulation by early 1987. Since prices are likely to be rounded upward during the currency changeover, it is important to introduce the new lira while inflation is falling. Inflation in April dipped to its lowest level in 13 years. The currency change will not correct any of Italy's continuing economic ills—such as the huge budget deficit—but probably will create the impression that Craxi is addressing the problems. The other parties in the cabinet, reluctant to let Craxi reap this credit, probably will drag their feet before passing the legislation. 

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Less Developed Countries

Brazil's Emerging Economic Problems

Brazil's two-month-old anti-inflation plan is fraying around the edges, providing an opportunity for President Sarney's opponents to renew protests. Sarney's plan met initial success: March interest rates dropped, the stock market boomed, and the official price index declined for the first time in memory. The US Embassy reports that consumers, earlier treated to a wage hike, went on a spending spree. [ ] Brasilia is having trouble managing the program. Spot shortages appeared in April and growing numbers of firms are dodging the price freeze by repackaging products, according to the US Embassy. A recent survey shows planned business expansion remains low. In addition, the recently announced $900 million public-sector deficit in March is dampening expectations that inflation will be controlled, according to the US Embassy. The cruzado is now trading unofficially at 40 percent below its official value against the US dollar—an indicator of waning public confidence. Consumers, expecting prices to rise soon, are withdrawing savings and increasing credit use to fuel their buying. Labor leaders are criticizing the plan in the press, and wildcat strikes have resumed. Sarney probably will try backstage political maneuverings to prevent protests while his economic advisers adjust the stabilization program. Nevertheless, Brasilia is reluctant to make the extensive budget cuts needed to cool demand before the November elections. Price controls are also extremely popular and difficult to remove. Brasilia will probably reduce demand by tightening credit terms and improve supply by increasing imports or cutting business taxes.

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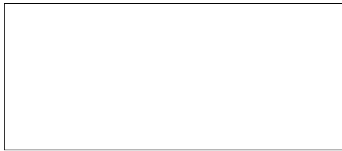
Rising Mexican Inflation Rate



Recently released first-quarter government figures indicate that Mexican inflation could top 100 percent this year if the government continues using expansionary monetary policy to finance its growing budget deficit.

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US Embassy officials report that the Central Bank is circulating new currency more rapidly than banks can unpack it. The recent inflation trend is likely to spur additional capital flight, increase pressure on the government for new wage hikes, and increase resistance to planned price rises on government subsidized goods and services. In addition, the high inflation rate will push domestic interest rates up, adding to the already elevated costs of financing the burgeoning budget deficit, and also force a more rapid devaluation of the peso, which would boost import costs.

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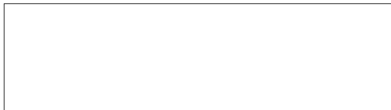
More Export Problems for Sudan



Sudan faces a further reduction in exports despite the easing of the drought this year. Exports of cotton and sesame will be hampered by low world prices and continued pest infestation of the crops. Livestock sales, a potentially strong export, will be limited as farmers rebuild herds devastated by the drought last year. Moreover, the government's resistance to correcting an overvalued exchange rate is making trade unprofitable. This growing export crunch will exacerbate the government's already serious foreign exchange shortage and further limit Khartoum's ability to meet skyrocketing debt payments and maintain critical imports.

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Zimbabwean Farm Prices Provoke Discontent

A new price structure for agricultural commodities announced recently by Harare is meeting with widespread dissatisfaction from the country's farmers. The new prices for most commodities fall short of the substantial rise in costs farmers have experienced in the last year—farm wages alone have gone up by over 30 percent. Harare hopes that minimal price increases for some crops will depress production incentives and cut surpluses that have led to significant storage problems. Highlighting the displeasure of the agricultural community, Zimbabwe's three farmers' unions have, for the first time ever, issued a joint statement expressing concern over the government's new pricing policy.

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New Issue of Pakistani Bonds

Pakistan reopened sales of National Fund Bonds (NFBs) on 15 May, but the new issue probably will not raise sufficient revenues to cover the growing budget deficit. According to the US Embassy, NFBs—one of the three bond schemes introduced last year—are designed to reduce the deficit, which totaled more than $2 billion in FY 1986. To attract funds, the bonds provide anonymity to buyers, exempt interest from taxation, and can be used as loan collateral. Although sales of NFBs have done well—more than $1 billion has been raised so far—shortfalls in tax revenues may still force Pakistan to look to the domestic banking system for budget financing, thereby increasing the risk of higher inflation and crowding out credit for the private sector. Moreover, the new NFBs will add to the debt servicing burden in future budgets.

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More Deregulation in Pakistan

Islamabad last month removed price and distribution controls on the fertilizer industry as part of its gradual policy of privatization and deregulation. According to the US Embassy, these moves will reduce fertilizer subsidies—about $90 million in FY 1985—encourage private-sector production, and attract domestic and foreign private investment. The removal of price controls is not expected to increase fertilizer prices in the short term because of excess domestic capacity in the industry, but prices will continue to be monitored to ensure stability. If prices for fertilizer and edible oils begin to rise, however, the government might curtail its deregulatory efforts to appease the political opposition.

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Sri Lankan Defense Spending Increases

Colombo recently announced a $140 million increase in military spending. This is the second increase in two months—the first totaled $100 million—and would double the original defense budget figure for the current fiscal year. The additional funds will be diverted from rural development projects and will be used to buy military equipment, according to press reports. The increase has pushed defense to 19 percent of government spending, compared to 3 percent in 1982. Meanwhile, low prices for tea—which accounts for over 30 percent of the country's export earnings—and growing military imports will continue to aggravate Sri Lanka's trade deficit, which reached $520 million in 1985. Until the Tamil insurgency is settled it is likely that spending on development programs, public-sector industries, the Mahaweli irrigation project, and some social welfare programs will experience additional cuts.

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Burma's Rising Debt Service Ratio

With no significant increase in exports likely, Burma's debt service payments will absorb almost two-thirds of its foreign exchange earnings this year, up from 50 percent last year, according to US Embassy estimates. Foreign exchange reserves are equal to only about one month of imports. Burma has had to turn increasingly to short-term commercial borrowing to finance imports, but banks are starting to resist further expansion of such borrowing. If Burma cannot meet its repayment obligations, it will probably seek the help of such key donors as Japan, West Germany, the United States, and Australia rather than submit to conditionality which would probably accompany a general rescheduling.

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Thailand Cutting Rice Export Target

Thailand has reduced its target for rice exports this year by about 7 percent to 4 million metric tons. Thailand, which earns roughly 15 percent of its foreign exchange from rice exports, expects to lose sales as a result of increased price competition arising from the US Food Security Act as well as the continuing decline in the world rice market. To counter this loss, Thailand will attempt to sell lower grades of rice at prices with which the United States cannot compete. Bangkok also plans to lobby Washington to reduce the impact of the US legislation on its exports. Nonetheless, Thailand is likely to face weakening world rice demand at falling prices for the rest of the decade, according to World Bank estimates.

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Hong Kong Consolidates Its Stock Exchanges

In an attempt to increase supervision of the often unruly securities market, the Hong Kong Government merged the colony's four stock exchanges in April. To protect investors, regulations now require brokers to show substantial liquid assets and listed companies to submit fuller financial disclosure statements. Banks are now banned only from trading stocks with each other, and this restriction will be lifted in October 1987. In addition, the government in May established a stock index futures market that caters to institutional investors. The government hopes these measures will help attract more investment from abroad as well as from small local investors. Many local investors have been sending an increasing share of their savings overseas because of of the market's volatility and worries over the reversion of Hong Kong to Chinese sovereignty.

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Indonesia's First Car

Indonesia's first domestically designed and engineered automobile reflects a successful effort to emphasize the labor-intensive strengths of the economy. Unlike most Indonesian manufactures, the two-wheel-drive van probably will be price competitive despite the requirement to use high-cost domestic steel. The car has a sticker price of about $9,500 compared with $15,000 for a similar Japanese vehicle, according to US Embassy reporting. The manufacturer believes it has the capacity to produce 5,000 cars annually for the domestic market. If the company can hold the line on prices, we believe the new car could serve as a prototype for the kind of labor-intensive industrial development Indonesia needs to diversify the oil-based economy.

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South Korean Auto Exports

Hyundai Motor Company has sharply increased the number of cars it plans to sell in the United States this year. Hyundai plans to ship 140,000 to 170,000 units to the United States in 1986, up from the earlier target of 100,000. Strong sales in March and April—almost 23,000 units—were close to the rates needed to reach the new goal. In the future, South Korea's other automobile companies, Daewoo and KIA, each plan to ship 80,000 small cars to the US market in 1987, all to be sold under US manufacturers' nameplates. These three automakers will have the capacity to produce a total of 600,000 units by the end of 1986, and the capacity is scheduled to increase to about 1 million units in 1987.

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Communist

Soviet Resolution on Light Industry

The USSR Council of Ministers on 24 April adopted a resolution on improving the production of consumer goods. The resolution elaborates on enacting the new system of industrial management throughout light industry. This management mechanism was to take effect in all of light industry in 1986 but has apparently been delayed until 1987. The publication of the resolution is part of Gorbachev's campaign to assure consumers of high-level concern with their plight. The new method of management has not proved successful in solving the industry's problems with unreliable suppliers and lack of responsiveness to consumer demand because it continues to limit enterprises' choice of suppliers and to emphasize plan fulfillment. The new system increases rewards for meeting contracts and raises penalties for nonfulfillment, but enterprises will continue to concentrate on meeting the goals of central planning rather than on satisfying the consumer.

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Eastern Europe's Hard Currency Trade Balance

Eastern Europe's surplus in hard currency trade plunged last year to $3 billion, reversing the four-year upward trend. Exports fell 3 percent as prices for agricultural goods softened, and bad weather reduced production in most countries. The redirection of some exports to the USSR probably contributed to the fall in hard currency sales. Imports surged 5 percent because of emergency purchases of energy and grain and increased purchases of capital goods and raw materials probably planned to redress cutbacks made during the 1981-83 financial crisis. Particularly poor performance nearly erased Hungary's surplus and put Bulgaria into deficit. This year, Western bans on food imports from the region in the wake of the Chernobyl' accident will further weaken trade prospects. Trade problems will complicate debt servicing by Romania, Poland, and Yugoslavia and may discourage bank lending to the other East European countries.

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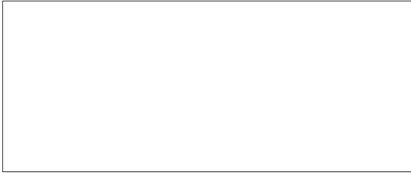
China Reinstates Canceled Hydroproject



The Wuqiangxi hydropower project, canceled twice in the last decade for budget and geologic problems, is again under construction, according to Chinese press reports. Scheduled for completion in 1994, the dam will supposedly have 1,200 megawatts (MW) of power capacity, compared with original plans for 1,750 MW. Government officials have stressed Wuqiangxi's benefits in flood control as well as in generating electricity. China may be using concessionary financing from Japan to build the dam; before its second cancellation, Wuqiangxi was one of China's first recipients of low-cost loans from Japan's Overseas Economic Cooperation Fund. If that funding is reactivated, it will restrict China to Japanese suppliers for most equipment imports, including the turbine generators.

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