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International Economic & Energy Weekly

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31 October 1986

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31 October 1986

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International Economic and Energy Weekly [redacted] 25X1

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Late Item

OPEC in the Aftermath of Yamani's Ouster [redacted] 25X1

The dismissal of Shaykh Yamani as Saudi Oil Minister implies that Riyadh will probably promote more of a "Saudi first" policy in future OPEC meetings, starting with the next meeting in December. [redacted] 25X6

[redacted] 25X6

Oil industry forecasters, however, believe demand for OPEC oil will be close to current OPEC output, because oil companies have unusually large inventories that can be drawn down at faster than normal rates. If the Saudis, who are already producing over their quota, attempt to maintain production at or above current levels of 5 million b/d, and Iran is able to bring production to near its quota, prices would probably erode and could approach $10 per barrel or go even lower. [redacted]

OPEC's Task Next Year 25X1

OPEC will have a difficult time holding together its production-sharing agreement in the near term. Other members would have to make greater sacrifices to accommodate any stronger Saudi demands, or face the prospect of a major price war. The group is still deeply split on priorities; the wealthier Arab producers—led by Saudi Arabia—want to hold on to market share and implicitly are willing to let prices fluctuate; the others prefer altering output to support prices. Moreover, the group no longer has a swing producer willing to adjust supply to meet seasonal demand changes. Without a swing producer, OPEC will have to adjust its output several times a year, which may prove too burdensome. Tensions between Riyadh and Tehran may also increase [redacted] 25X1 25X1

Major Uncertainties

Any major change in oil prices over the next several years will probably result from OPEC members acting unilaterally, and there is considerably more risk of prices falling than rising. If oil demand falters or if other members are unwilling to concede to any Saudi demands, OPEC overproduction could lead to a rapid unraveling of the agreement. If the Iran-Iraq war ends in such a way that permits both nations to increase oil exports—both probably would—to pay for reconstruction and debts, any agreement would be undermined. [redacted] 25X1

The only prospect for prices to rise significantly in the near term is if a major oil supply disruption occurred. The probability of such an occurrence is low but cannot be ruled out. Recent Iraqi attacks, for example, have lowered Iranian oil export capacity substantially, and Tehran may respond by more aggressive attacks on tankers transiting the Persian Gulf. [redacted] 25X1

[redacted] 25X1

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Synopsis

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Most East European regimes believe that solutions to many of their problems lie in increased trade with the Western economies. 25X1

3 **Eastern Europe: Outlook for Joint Ventures With the West** 25X1

Despite the increased interest in joint ventures, the East European regimes are reluctant to take the steps that we believe are necessary to attract Western firms, both for ideological reasons and fears of foreign intrusion in their economies. In particular, until the governments adopt more liberal laws regarding profits and operations, efforts to entice Western companies will produce minimal success. 25X1

7 **Eastern Europe: Prospects for Trade With Developing Countries** 25X1

Eastern Europe continues to seek expanding commercial relations with developing countries, particularly in light of the region's deteriorating competitiveness in developed country markets. Financial problems on both sides, however—particularly in the developing countries—will retard expansion of trade. 25X1

11 **The Libyan Economy: Qadhafi's Achilles' Heel** 25X1

Libya's economic decline is the greatest potential threat to the regime of Libyan leader Qadhafi. Discontent has yet to erupt into widespread popular protests, but, unless conditions unexpectedly improve next year, Qadhafi is likely to face further unrest that may well prove beyond the control of his pervasive security forces. 25X1

17 **Japan: Increasing International Cooperation in Science and Technology** 25X1

Tokyo's increased funding in recent years of "fundamental research and development" projects reflects Japan's concern that an inadequate technological base will impair its ability to maintain competitiveness and that Tokyo will be increasingly excluded from sharing in Western technology. 25X1

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Perspective

Eastern Europe: Seeking To Rebuild Economic Ties to the West 25X1

Eastern Europe's economic relations with the West are showing new life, after five years of stagnation. Apparently, most regimes believe that solutions to many of their problems lie in increased trade with the Western economies. Imports from the West are up sharply this year for the first time since 1980. Most countries are seeking expanded access to Western markets through approaches to GATT, the EC, and the European Free Trade Association, and have liberalized joint-venture laws to attract Western capital without adding to debt. 25X1

The impetus for this interest lies in the region's stagnant economies, which desperately need modernization:
- Growth rates remain generally low, despite some recovery from the economic crisis of the early 1980s.
- The cuts in investment made in recent years must be reversed to improve productivity and revive long-term economic growth.
- Development of science and technology is a key part of the new five-year plans. 25X1

The moderate successes some countries have had in strengthening their financial positions—as well as certain fortuitous external developments—have aided the revival of Western ties. The region's preoccupation with managing debt over the last five years has paid off in reduced debt burdens and improved borrowing opportunities for several countries. Lower interest rates, a fall in the dollar, and a reduced need for food imports in the northern countries because of record agricultural output have further helped trade and financial positions. Financially strapped countries such as Poland, however, have been unable to capitalize on these opportunities. 25X1

While East European–Western economic relations may be on a cyclical upswing, any gains will be slow. The success of Eastern Europe's effort to rebuild economic ties to the West depends upon how well the regimes use Western imports to strengthen their economies. Although the regimes recognize the risks of large import programs after the debt crisis of the early 1980s, most still pay only lipservice to the need for internal economic reform to bolster efficiency and competitiveness. Export performance remains disappointing and the troubled debtors—Poland, Yugoslavia, and Romania—continue to stagger from one rescheduling to another. Generally, the countries are still inclined to look for simpler fixes such as joint ventures, countertrade, trade with LDCs, or pressure to remove EC trade barriers. 25X1

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Movement in the economic arena, however, remains tied to the overall East-West political climate. Eastern Europe has taken some steps to show its interest in better political ties. While Eastern Europe followed the Soviet line in blaming the United States for the failure of the Reykjavik summit, the regimes have stressed the importance of a continuing dialogue. Other individual initiatives include:

- The general amnesty for political prisoners in Poland, in part aimed at inducing the West to lift sanctions and provide economic aid.
- Romania's grudging concessions on human rights in order to retain most-favored-nation status with the United States.
- Positive signals by generally hard-line Bulgaria, including an agreement to aid the US in drug enforcement and apparent adherence to a pledge to halt arms shipments to Nicaragua. [redacted] 25X1

Soviet attitudes, however, will ultimately determine the pace and direction of East European ties to the West. Significantly, the Soviets have somewhat tempered their harsh rhetoric of the early 1980s against economic dealings with the West, in recognition of the Bloc's need for Western technology. Moscow is itself showing interest in joint ventures with the West, and in joining GATT. The USSR accepted the EC's precondition on bilateral agreements between the Community and Bloc states to revive the EC-CEMA talks. Nonetheless, Moscow still issues periodic warnings about the risks of allowing too much Western influence through economic ties. Moreover, the region's opportunities for dealing with the West may be restricted by Moscow's demand for better quality goods and closer CEMA cooperation in developing new technology. [redacted] 25X1

[redacted] 25X1

Eastern Europe: Outlook for Joint Ventures With the West 25X1

Most East European countries [1] have amended or formulated new joint-venture legislation in the past year to increase their access to new technology and boost hard currency exports while minimizing expenditures of hard currency. Despite the increased interest in joint ventures, the East European regimes are reluctant to take the steps that we believe are necessary to attract Western firms, both for ideological reasons and fears of foreign intrusion in their economies. In particular, until the governments adopt more liberal laws regarding profits and operations, efforts to entice Western companies will produce minimal success.

Experiences Differ by Country

The experience of Western firms participating in joint ventures varies by country. Some regimes, particularly Hungary and Yugoslavia, appear receptive to joint ventures and have implemented increasingly favorable legislation. Others, especially Poland, Romania, and Czechoslovakia, remain cautious in encouraging joint ventures. Only East Germany has shown no interest, in large part because it is extremely wary of any foreign involvement in the economy. Furthermore, East Berlin's strong financial position and access to Western markets through inter-German trade reduce the need for this type of cooperation.

Hungary has the most successful and liberal joint-venture law in Eastern Europe allowing a wide spectrum of activities, including banking and tourism. The 1972 law was strengthened in 1982 to permit more decisionmaking freedom for the Western partner. Earlier this year, the law was amended to reduce the profits tax for the first five years to 20 percent—one-half the rate paid by Hungarian enterprises—then 30 percent after five years. In priority sectors, such as pharmaceuticals and electronics, firms enjoy a tax holiday for five years and pay 20 percent thereafter. In addition, the government allows firms to purchase locally supplied raw materials and energy at subsidized prices, and to pay workers at the lower Hungarian labor costs and in local currency. 25X1

Joint ventures in ***Yugoslavia*** enjoy some advantages not available in other East European countries, but substantial problems remain. The government allows Western companies to establish majority positions in joint ventures in almost every sector. It also has mandated a liberal treatment of profits, with taxes at only 10 percent in all republics. Western firms, however, fear cost overruns caused by a triple-digit inflation rate and delays in receiving equipment and raw materials. Joint enterprises are subject to some of the same import restrictions and limitations on hard currency access that face Yugoslav firms. 25X1 25X1

Bulgaria has had little success in attracting Western firms for joint ventures, despite a seemingly flexible law that gives a joint-venture contract approved by the Council of Ministers the full force of law overriding other legislation. Western firms are discouraged, however, by the slow and often confused managerial decisionmaking process and restrictions on the use of hard currency earnings. 25X1

Czechoslovakia is the most recent East European country to approve the concept of joint ventures, but several problems already hinder their development. 25X1 The vague legal basis permitting joint ventures, including uncertainty over the rights of Western partners and the lack of specifics covering management, administration, and repatriation of capital and profits, are likely to discourage Western participation. Resistance by hardline elements in the leadership may inhibit efforts to make these ventures attractive, although increasing Soviet interest in joint ventures may quiet the opponents. 25X1

[1] Includes Yugoslavia. 25X1

Eastern Europe: Joint Ventures

	Bulgaria	Czechoslovakia	Hungary	Poland	Romania	Yugoslavia
Year permitted	1980	1985	1972	1976	1971	1967
Number	8	1	50	0 [a]	10	187
Permits Western majority ownership	yes	no	yes	no	no	yes
Permits Western profit repatriation	yes	yes	yes	yes	yes	yes
Profit tax rate *(percent)*	20 to 30	50	20 to 30	50	40	10
Tax free period *(years)*	3	0	5 [b]	2	1 to 2	0
Types of joint ventures	Machinery, consumer goods, and chemicals	Electronics	Banking, tourism, machinery, and manufacturing	NA	Machinery and textiles	Machinery, mining, and agriculture

[a] Excludes "Polonia" firms.
[b] Joint ventures in priority sectors.

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Eastern Europe: Examples of Joint Ventures

	Western Country	Western Company	Year Signed	Amount Invested *(thousand US $)*	Western Share *(percent)*	Type of Venture
Bulgaria	Japan	Fanuc	1981	660	50	Service numerically controlled machine tools
Czechoslovakia	Denmark	Senetec	1986	2,000	NA	Produce measuring equipment
Hungary	Portugal	Amorim and Irmaos	1984	675	25	Produce bottle corks
	West Germany	Schwarzkopf	1985	400	66	Produce soap and cosmetics
Romania	France	Citroen	1977	26,000	36	Produce and distribute small passenger cars
Yugoslavia	Austria	Semperit	1971	6,600	28	Produce radial tires

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Romania has experienced little success in attracting Western joint ventures, because of the many restrictive clauses in its laws and its poor economic condition. Some firms have had to import raw materials because the needs of joint-venture firms are not considered in the economic plan. The government also requires firms to pay for workers in hard currency while workers receive only 40 percent of the salary in local currency. A representative of a West European firm participating in a joint venture complained that poor management and shortages at the plant result in operations at 12 percent of capacity and with a high rate of assembly faults.

Poland's joint-venture laws, despite their highly publicized changes, remain among the most restrictive in Eastern Europe and are unlikely to attract many Western firms.[2] The new law allows capital repatriation and applies no taxes until the third year of operation. The Western firm, however, must sell 15 to 25 percent of all earned hard currency to the state at overvalued exchange rates, and the Ministry of Finance must issue permission for all economic transactions. Many businessmen, according to the Western press, are indifferent to the new law because past frequent changes in regulations make them wary of doing business in Poland. They also hesitate to invest in a country where raw material supplies are notoriously unreliable, the tax system is continually altered, and economic and political stability cannot be assured.

Problems Remain for Western Firms

Western firms generally face difficult negotiations over the terms for joint-venture deals because their goals often conflict with regime objectives. In many cases, Western firms hope mainly to gain access to domestic markets in the partner country or to other CEMA markets with repatriation of profits in hard currency. The Western partner, however, generally has little interest in exports to hard currency markets that would compete with its production facilities in the West. Eastern demands for state-of-the-art technology are often a barrier to the establishment or continuation of a joint venture because of Western government export controls or the partner's unwillingness to share the most competitive technologies. 25X1

Many joint ventures, once launched, have proved unsuccessful because of inadequate regime support. Because these ventures frequently fall outside the formal economic and trade plans, obtaining adequate domestic supplies of suitable quality presents a problem. Also, the venture may not be able to sell output to other CEMA markets. In addition, sales to domestic or other CEMA markets often result in payment in goods that can be resold to the West for hard currency only after substantial time and financial commitments. Other aspects such as the calculation of employee wages and acceptable work standards are also sources of controversy between the firm and the regime. 25X1

The poor economic and political situation in some countries, the unfavorable business climate, and the lack of stable legal regulations, particularly concerning management and repatriation of profits, make joint-venture deals a big gamble with a small jackpot. For example, if a venture proves too profitable for the Western partners, the regime will sometimes modify

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Rationale for Joint Ventures

East European regimes see joint ventures as a means to acquire Western goods and technology essential to modernization without adding to already large hard currency debts. These ventures can also:
- *Expand hard currency exports through sales by Western intermediaries.*
- *Replace hard currency imports or augment domestic supplies.*
- *Provide access to Western production and management techniques.* 25X1
- *Offer help in completing unfinished investment projects and utilizing slack capacity.* 25X1

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[2] Separate regulations apply to "Polonia" firms, a special type of joint venture, that can be formed only by foreigners of Polish heritage.

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the terms or laws under which it was established. As a result, some firms may adapt fairly well, but others discontinue operations after the two- or three-year tax holiday offered by most countries. 25X1

Outlook for Joint Ventures

Difficulties in doing business in Eastern Europe will discourage many Western joint ventures, until Eastern countries are willing to make major changes in economic policy. Unrealistic exchange rates and large discrepancies between domestic and world prices are key stumblingblocks to Western participation. The replacement of central allocation of supplies with negotiated supply contracts and greater acceptance of wage incentives to boost worker productivity, are also needed to improve the business climate. Nonetheless, even with policy changes, most Western firms will remain wary of capricious changes in their legal rights, especially concerning the repatriation of profits and investment. 25X1

The Soviet role is pivotal in the future of joint ventures for Eastern Europe. The regimes are likely to proceed cautiously until it becomes clear what limits Moscow believes should be placed on these activities. For that reason, the region will watch Moscow's movement on joint ventures with interest. According to the US Embassy in Moscow, the USSR will allow 49-percent Western ownership and repatriation of profits. The framework for establishing joint ventures, however, does not appear to go beyond most East European legislation, and Moscow is likely to run into similar difficulties in attracting Western investment. Nonetheless, prospects for increasing a firm's access to the Soviet market could spark greater Western interest than currently in the smaller East European domestic markets. Gorbachev may allow the region to adopt a more flexible joint-venture policy as a testing ground for possible Soviet initiatives. Such acquiescence could elicit a Soviet demand that Eastern Europe provide more assistance in helping Gorbachev meet his modernization goals. 25X1

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Eastern Europe: Prospects for Trade With Developing Countries

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Eastern Europe [1] continues to seek expanding commercial relations with developing countries, particularly in light of the region's deteriorating competitiveness in developed country markets. Moreover, the prospect of stagnant Soviet deliveries of raw materials and energy is intensifying Eastern Europe's search for alternate sources of supply. Financial problems on both sides, however—particularly in the developing countries—will retard expansion of trade. Nonetheless, even where commercial advantages are few, political and strategic motives will sustain the efforts of some Bloc regimes to strengthen economic ties to the Third World.

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Eastern Europe: Cumulative Trade With Developing Countries, 1981-85 [a]

Million US $

	Exports	Imports	Balance
Bulgaria	9,386	3,860	5,526
Czechoslovakia	6,789	3,539	3,250
East Germany	6,624	4,455	2,169
Hungary	5,158	4,327	831
Poland	7,222	3,853	3,369
Romania	11,886	14,197	−2,311
Yugoslavia	9,267	11,648	−2,381

[a] Exports and imports are on an f.o.b. basis except for Hungarian and Yugoslavian imports, which are on a c.i.f. basis.

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Trade Trends

In the 1970s Eastern Europe rapidly expanded its trade with the Third World. Imports rose 24 percent annually from 1970 to 1980. Growing East European demand for raw materials and fuels as well as large price increases on these goods prompted the import surge. Barter deals and East European efforts to generate hard currency to offset trade deficits with the developed West caused exports to grow nearly as quickly.

Trade has languished in recent years, however. East European sales have tumbled since 1983 when debt problems forced many developing countries to slash imports; more recently, plunging oil prices have tightened the financial squeeze on LDC oil exporters, Eastern Europe's leading Third World customers. Similarly, the East Europeans have curtailed hard currency purchases to conserve foreign exchange to service sizeable debt obligations and manage persistent financial problems.

Although the LDCs account for a relatively small share of Eastern Europe's trade (about 30 percent of the region's nonsocialist trade and 10 percent of its total trade), these ties remain valuable to the Bloc. Third World countries buy East European manufactures that are unmarketable in the West. Partners in the Middle East and North Africa are especially lucrative markets for turnkey industrial plants, construction and other technical services, and arms. In return, the East Europeans secure raw materials and oil to supplement Soviet deliveries. Furthermore, we believe some Bloc countries use these ties to advance Soviet political objectives in the Third World in return for economic assistance and other favors from Moscow.

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While Eastern Europe maintains commercial relations with more than 100 developing countries, trade generally is concentrated on a small number of partners, particularly those in the Middle East and North Africa. The exchange of East European engineering and construction projects, military hardware, and finished goods for oil yields significant trade surpluses for most Bloc countries. While Brazil and India are

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[1] Including Yugoslavia

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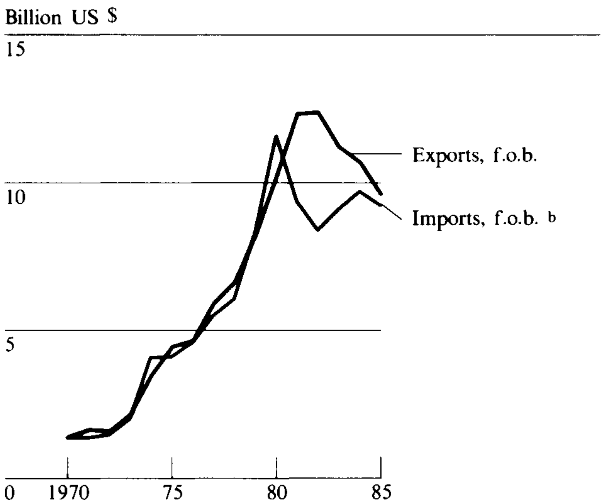
Eastern Europe: Trade With Developing Countries, 1970-85 [a]



a CIA data include Yugoslavia.
b Hungarian and Yugoslavian data are c.i.f..

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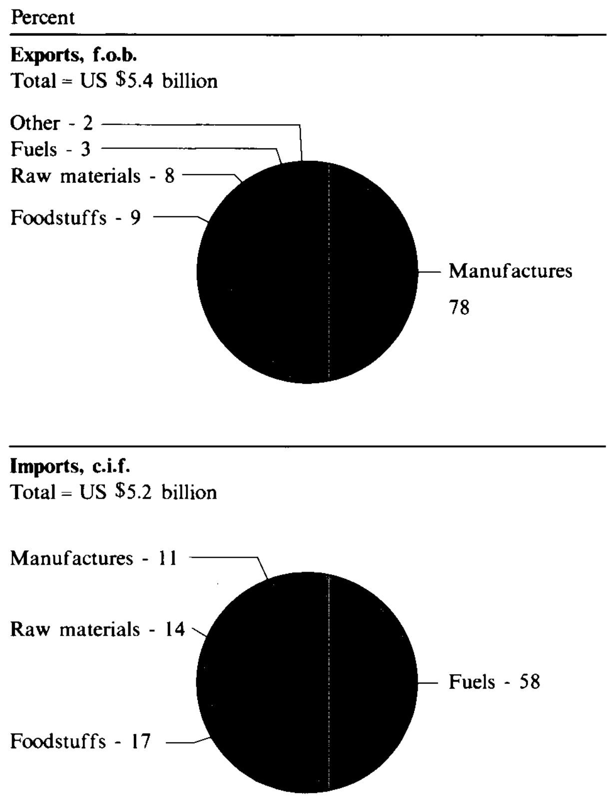
Eastern Europe: Trade With Developing Countries, by Commodity, 1984 [a]



a Excluding Bulgaria, East Germany, and Romania for which data are not available. Data include Yugoslavia.

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also major Third World trading partners, Eastern Europe's commercial ties to Asia and Latin America generally are limited, with a trade deficit resulting from large imports of raw materials and foodstuffs. Trade with Sub-Saharan Africa is even less developed, although some Bloc countries are important suppliers to Marxist-oriented regimes in the region.

Incentives for Increased Ties

Slumping sales in Western markets and the persistent need for hard currency have pushed Eastern Europe to seek new and expanded markets in the Third World. Developing countries frequently pay in hard currency or in goods such as oil, which most East European countries then refine and reexport to the West for hard currency. From 1980 to 1985 the region earned $4-7 billion in hard currency annually from reexports of oil. Most East European countries—except Romania and Yugoslavia—have maintained hard currency trade surpluses with the Third World in the 1980s to help offset deficits with developed countries.

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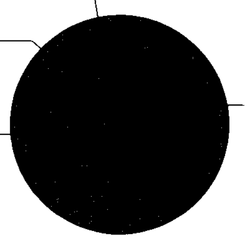
Hard currency shortages in developing countries usually make them more willing than developed countries

Eastern Europe: Trade With Developing Countries by Region, 1985 [a]

Percent

Total = US $15.2 billion



[a] Data include Yugoslavia.

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East European Arms Transfers

Arms sales account for more than 15 percent of Eastern Europe's exports to the Third World, totaling $9.6 billion over the 1981-85 period. East European arms deliveries—including some advanced weapons—consist mostly of ground forces equipment, but also ammunition, communications equipment, vehicles, and quartermaster supplies. Developing countries purchased one-half of the region's arms exports last year, and Middle Eastern and North African states bought 80 percent of this share. Principal clients were Iraq and Libya—each receiving one-third of Eastern Europe's arms deliveries to the Third World last year, respectively—followed by India, Syria, and Iran. Czechoslovakia, Romania, and Yugoslavia have been the biggest suppliers. 25X1

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While it is difficult to discriminate between political and economic motives for arms trade, we believe that Eastern Europe's prime motive is economic. The region usually requires payment in hard currency, and terms generally are stiffer than those of the USSR, suggesting little, if any, implicit aid. Romania's drive to earn hard currency through expanding arms sales has actually impeded efforts to modernize its own forces, and this may apply to other East European countries to some degree. Although financial difficulties in oil-producing countries make arms sales a less lucrative source of hard currency than in the past, these countries will remain significant clients because of their emphasis on domestic defense and security concerns and continued tensions in the region. 25X1

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to conduct countertrade. Such deals may allow the East Europeans to conserve hard currency for purchasing sorely needed capital equipment in the West. In addition, some agricultural products and industrial materials can be obtained from the developing countries on a barter basis instead of on a cash basis from developed countries. According to the OECD, countertrade already accounts for as much as 30 percent of trade between the Soviet Bloc and developing countries, and this share probably will grow. Moreover, the USSR's economic problems and demands for more balanced trade with its Eastern allies may force Eastern Europe to depend on Third World countries for more of the raw materials traditionally supplied by the Soviets.

Impediments to the Relationship

Significant obstacles stand in the way of expanded East European–Third World trade. Cash shortages in developing countries have caused problems for several Bloc countries in receiving payment for exports. As a result, the East Europeans have become more reluctant to extend trade credits to some particularly unreliable partners.

Czechoslovakia has refused to sign new trade agreements with Syria—despite Soviet pressure—and Libya because of their payments record. Prague still supplies weapons, training, and hardware maintenance on credit, although Hungary and probably some other Bloc countries now demand cash payment from Syria for military goods. Romania frequently 25X1
has blamed its liquidity problems this year on failure of several Third World partners to meet payment and delivery schedules. 25X1

Outlook

While the most financially strapped Third World countries will tend to play down the poor quality of East European manufactured goods, the more affluent countries will continue to view the Bloc as a less preferred supplier. The region's lack of desirable exports will sharply limit its ability to purchase machinery from the newly industrializing countries, as alternatives to Western suppliers. Furthermore, Moscow's demands for more and better goods from its Eastern neighbors may reduce further the supply of desirable products available for export to the LDCs.

Despite these problems, the lack of better alternatives will push Eastern Europe to persist in its efforts to develop commercial relations with the Third World. Both East European and developing countries would prefer closer ties to the developed West to acquire new technology and state-of-the-art machinery. Both parties, however, share financial problems, Western reluctance to engage in countertrade, the difficulties of marketing goods of poor quality and product design, and what they perceive as protectionism in the developed West. Both parties may try to rely on each other for more trade in products where substitutes—such as low-technology machinery and food products—exist to save cash for purchasing products available exclusively in developed countries.

Eastern Europe will continue to attempt to boost ties and lure partners away from potential Western suppliers by offering some goods and services at prices and payment terms favorable to most developing countries. The East Europeans hope that their experience with projects suited to developing countries' needs, in addition to lower costs, will entice clients to look East rather than West. They also hope that some industrial cooperation agreements will pay long-term dividends by increasing demand for East European equipment and services. Nonetheless, the East Europeans must contend with efforts by several partners to reverse their own trade deficits or increase their surpluses with the region.

Even where the economic payoff may be minimal, most East European regimes see a favorable political spinoff from a commercial presence in countries of political and strategic importance to the countries in the Bloc. While not the principal motivation, this benefit alone could maintain some regimes' interest in ties to the Third World.

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The Libyan Economy: Qadhafi's Achilles' Heel [redacted] 25X1

Libya's economic decline is the greatest potential threat to the regime of Libyan leader Qadhafi. The oil-dependent economy has been hit hard by the world oil price slump; without a major boost in prices, Libya will earn only about $4.9 billion from oil this year—about one-half last year's total and less than one-fifth peak 1980 receipts. Living standards have sunk far below oil-boom levels, but Qadhafi has offered little more than revolutionary rhetoric to soothe the populace. He has not adopted low-cost measures, such as temporary imports of food and other essential goods, that could buy valuable time for the regime. Discontent has yet to erupt into widespread popular protests, but, unless conditions unexpectedly improve next year, Qadhafi is likely to face further unrest that may well prove beyond the control of his pervasive security forces. A weakened security service would remove a major impediment to a move against the regime by disaffected elements in the military. [redacted]

Economic Hard Times

The Libyan economy is almost totally dependent on oil. Petroleum accounts for nearly 50 percent of GDP and virtually all export receipts. As a result, the country has been hard hit by the weak world oil market. Petroleum earnings so far this year, in fact, are at their lowest level in nearly 15 years. Production currently is averaging about 1 million b/d, Tripoli's OPEC quota. [redacted]

We believe the oil slump is causing the Libyan economy to register its poorest performance in five years—growth is down nearly 10 percent from last year's depressed rate—and the slowdown is hurting living standards. Libya's previously enviable standard of living was once regarded as one of the hallmarks of Qadhafi's regime. Various open sources indicate GDP per capita—though still quite high at about $6,500—is now only two-thirds the 1981 level. Moreover, although these same sources report unemployment is not yet a problem in this sparsely populated country, inflation is running at a record 17 percent. [redacted]

Increased financial constraints have hampered key development projects. [redacted] 25X1 the Zwara aluminum smelter project has been put on hold for at least four years and may be canceled. In addition, the steel mill under construction at Misratah may be shelved if a foreign partner cannot be found. Open sources indicate the $800 million second phase of the Sirte fertilizer complex has also been mothballed. [redacted] 25X1 progress on Qadhafi's flagship project, the Great Man-Made River, has slowed. [redacted] 25X1

The Libyan Oil Sector

The Libyan oil industry has weathered so far the disruptions caused by the freezing of its US assets in January, the imposition of increasingly tough US export sanctions since February, and the termination of all US oil company operations in June. The Libyan sales organization, Brega International, has successfully used marketing tactics such as netback deals and price discounts to maintain its market share. [redacted] 25X1 25X1 most Libyan oil is still sold to Western Europe, although some shifts by country have occurred. West German imports, for example, fell almost 30 percent during the first half of the year as compared to the same period in 1985 while Italian imports rose nearly 30 percent. Sales to Communist countries including Bulgaria, Romania, and the Soviet Union also have increased. As much as one-third of Libyan crude exports are on a barter basis—largely in payment for Soviet Bloc arms. In addition, South Korean and Turkish construction firms are also accepting Libyan crude for work on projects in Libya. Libyan deliveries to Belgium reflect the South Korean firm Dae Woo's purchase of a Belgian refinery to process Libyan crude. [redacted] 25X1

Libya has managed to sidestep most US oil-related export restrictions, [redacted] 25X1 Spare parts are available either

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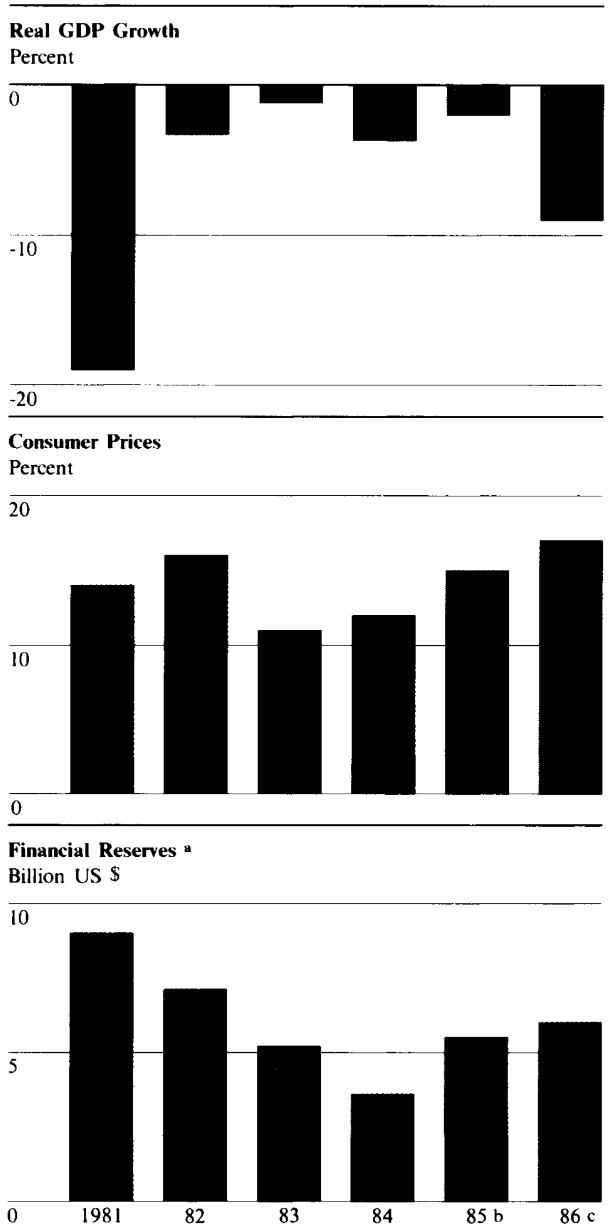
Libyan Economic Indicators, 1981-86



a End of period, excluding 3.6 million ounces of gold.
b Estimated.
c Projected.

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Libyan Petroleum Exports, 1985-86

	Estimated Exports of Crude Oil and Products *Thousand b/d*		Growth of Estimated Exports of Crude Oil and Products From Previous Period *(percent)*
	Jan-Jun 1985	Jan-Jun 1986	Jan-Jun 1986
Total	**1,002**	**1,070**	**6.8**
OECD countries	853	915	7.3
Italy	262	337	28.6
West Germany	205	148	−27.8
Spain	66	125	89.4
France	49	60	22.4
Greece	64	46	−28.1
Netherlands	46	32	−30.4
Turkey	52	42	−19.2
United Kingdom	49	51	4.1
Switzerland	27	36	33.3
Austria	18	26	44.4
United States	2	0	−100.0
Canada	8	0	−100.0
Portugal	0	0	NA
Belgium	3	8	166.7
Japan	1	1	0
Sweden	1	3	200.0
Communist countries	123	135	9.8
Bulgaria	44	70	59.1
Romania	27	30	11.1
Yugoslavia	44	20	−54.5
Soviet Union	8	15	87.5
Other countries	26	20	−23.1
South Korea	15	7	−53.3
Syria	5	10	100.0
Morocco	3	0	−100.0
Sudan	3	3	0

25X1

from existing stockpiles in country or from numerous foreign suppliers in Western Europe and Asia. These foreign connections also supply Libya with essential oilfield services. The Italian company AGIP is developing the large offshore Bouri Field for the Libyans that probably will begin production in 1987 at an estimated rate of 75,000 b/d. The multinational oilfield service company, Schlumberger, continues to play an important role in servicing the industry. [redacted]

The departure of US companies has not materially changed the functioning of the oil industry. The Libyan National Oil Company has maintained five production companies, although they have changed the names of two of the former American-run firms. Nonetheless, the industry remains heavily dependent on foreign oil technicians and workers. Libyan nationals control the top managerial positions, but North Americans and West Europeans provide most of the technical and supervisory personnel while Asians perform the manual labor in the oilfields. Approximately 300 to 400 US citizens were still working on oil facilities in Libya as of late June 1986, [redacted]

Qadhafi's Actions

Qadhafi's response to the deteriorating situation has been to demand more sacrifices from the populace. [redacted] the Libyan leader has slashed civil service salaries by 45 percent and cut back government employee housing allowances by 55 percent. Moreover, [redacted] mandatory retirement in the government is now enforced at 60 years old and all promotions have been frozen. [redacted] several new taxes have also been levied in addition to hefty income, retirement, and social security taxes already in place. [redacted]

Not even the military has proved beyond the reach of Qadhafi's cost-cutting measures. Hardware purchases still receive high priority, but the military has lost many longstanding privileges. [redacted]

The Economy and the Man in the Street

Reduced oil earnings have made shortages of essential goods and services commonplace for the average Libyan. Food imports are at their lowest level in seven years, and there are long lines for most staples. [redacted] *other goods such as light bulbs, soap, and shampoo often cannot be found in the markets. Moreover, what is available—shoes, bedding, and some clothing—is of inferior quality. As a result, the local black market,* [redacted] *is rapidly becoming the principal source of luxury goods and many commodities.* [redacted]

[redacted] *financial shortfalls have hampered the government's ability to provide basic government services. Electricity in affluent sections of Tripoli is off for several hours a week, while in the poorer neighborhoods it is often out for days at a time. Water in Tripoli is sometimes brackish and pressure is low. Trash bins are emptied about once a month. Even education and health care—the pride of Qadhafi's social revolution—are in trouble. According to the US Embassy in Brussels, all preschool and primary schools have been closed and instruction has been turned over to parents.* [redacted] *although there is no shortage of medical personnel—most are East European expatriates—there is a severe shortage of medical supplies.* [redacted]

The shortage of foreign exchange has cut imports of spare parts and raw materials to only one-fourth the 1981 peak. Approximately 30 percent of offices and apartment buildings in Tripoli are either abandoned for lack of repair or uncompleted because of shortages of spare parts. Pepsi Cola was unavailable in the summer because of a lack of aluminum for the cans. Libyan cigarettes are difficult to obtain now because the manufacturing plant is short of paper. [redacted]

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[redacted]

Libya: Current Account Balance, 1985-87 *Billion US $*

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	1985	1986 [a]	1987 [b]
Current account balance	1.0	−2.9	−3.0
Trade balance	0.7	−0.2	−0.7
Exports, f.o.b.	11.0	4.9	4.3
Imports, f. o.b.	6.3	5.1	5.0
Net services	−3.3	−2.4	−2.0
Grants	−0.4	−0.3	−0.3
Reserve position	5.5	6.0 [c]	3.0

[a] Estimated.
[b] Projected.
[c] Reflects $3.1 billion investment income from Fiat sale.

[redacted] 25X1

Popular Reactions

Qadhafi's inability or unwillingness to improve living conditions is focusing increasing attention on him as the root of economic decline. [redacted] 25X1 antiregime graffiti and pamphlets and limited demonstrations are becoming more and more common in urban areas and on college campuses. [redacted] 25X1

Of more potential concern for Qadhafi is that he is alienating a broader spectrum of the Libyan military. Qadhafi spent considerable time last summer mending fences with various military units, but what support he currently has could easily evaporate if economic grievances are not acted on. So far, Qadhafi's pervasive and effective security forces have kept in check any potential plots to oust the regime. [redacted] 25X1

Looking Ahead

Although Libya's financial outlook has deteriorated, Qadhafi's economic policies still are unlikely to change a great deal. The Libyan leader has some powerful remedies at hand to alleviate quite large financial shortfalls without changing his basic policy direction:

- Foreign exchange reserves still total roughly $6.6 billion including the $3.1 billion Tripoli received from the sale of its shares in Fiat.
- Tripoli could liquidate other overseas investments, which reportedly have a book value of about $1 billion—their market value is probably much higher.
- Qadhafi could increase production to 1.6 million b/d to boost earnings.
- He could tap the international financial market for loans; [redacted] 25X1 25X1

To maintain maximum flexibility, we believe Qadhafi will probably draw down reserves somewhat and allow payments arrears to mount. We estimate payments arrears will exceed $5 billion by yearend, including at least $1 billion to the Soviets. Qadhafi views these arrears as useful leverage to extract political and other concessions, particularly from Libya's West European trading partners. [redacted] 25X1

The primary question is how far Qadhafi can push the population, in general, and the military, in particular, on austerity. Most educated Libyans are aware of the financial windfall available to the regime from the sale of the Fiat assets. Expectations almost certainly will be high in Tripoli and other Libyan cities for major improvements in the availability of consumer goods. To the extent that these expectations are not met, and Qadhafi is seen as squandering money on terrorism and other unpopular foreign adventures, popular dissatisfaction could result in increasing incidents of antiregime activity. [redacted] 25X1 [redacted] 25X1 Qadhafi already has lost virtually all popular support outside of a small cadre of revolutionaries and his security services. The ability of the security forces to cope with increasing disgruntlement could weaken their resolve and provide the opportunity for disaffected elements in the military to make a move against the regime. [redacted] 25X1

[redacted] 25X1

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Japan: Increasing International Cooperation in Science and Technology

25X1

Tokyo's increased funding in recent years of "fundamental research and development" projects reflects Japan's concern that an inadequate technological base will impair its ability to maintain competitiveness and that it will be increasingly excluded from sharing in Western technology. As a result, Tokyo is removing legal barriers to foreign participation in Japanese research and is starting a number of programs intended to increase both fundamental R&D and international scientific and technical cooperation. Although recently proposed fundamental research and internationalization programs are small, we believe that the shift toward fundamental research will increase opportunities for mutually beneficial S&T cooperation between Japan and Western countries.

Tokyo's New S&T Direction

Tokyo's goal is to establish an indigenous R&D infrastructure and technology base for Japan's future industries. According to the Council for Science and Technology (CST), Japan's S&T policymaking and oversight body, this objective is to be achieved by increasing the amount of "fundamental research" performed—past Japanese R&D efforts have focused on improving existing technologies. Nonetheless, the choice of "fundamental research" rather than basic science as a theme continues Japan's traditional emphasis on engineering rather than on scientific aspects of research. The CST argues that, because fundamental research requires more "creativity" than Japanese industry or government laboratories have shown in the past, increased interaction between industry, Japanese universities, [1] and foreign researchers is needed.

The primary motive for Tokyo's change in direction, in our estimation, is concern that rapid improvement in Japanese industrial technology cannot be sustained by incremental improvements in technology or by importing technology. Having equaled Western capability in technologies believed critical for its future economic growth, Japan can continue to advance rapidly only by making basic technical contributions. Tokyo also fears that access to Western technology will be reduced. For example, the European Community's ESPRIT program, linking academic and government researchers to manufacturers, is cited as part of a trend toward excluding Japanese firms from Western R&D. 25X1

As evidence of Tokyo's concern, S&T spending has had relatively high priority in recent budgets. In a period of budget reductions for most discretionary programs, government S&T funding has been nearly constant. On the basis of Ministry of Finance guidelines, we believe that this pattern will continue through FY 1987.[2] Without increased funding, the shift toward fundamental research will continue to be financed by cuts in other S&T programs, accompanied by efforts to attract industry support.

25X1

25X1

Fundamental Research Projects

Among the R&D-supporting ministries competing to introduce fundamental research projects, MITI has been the most aggressive. Its major fundamental programs include:

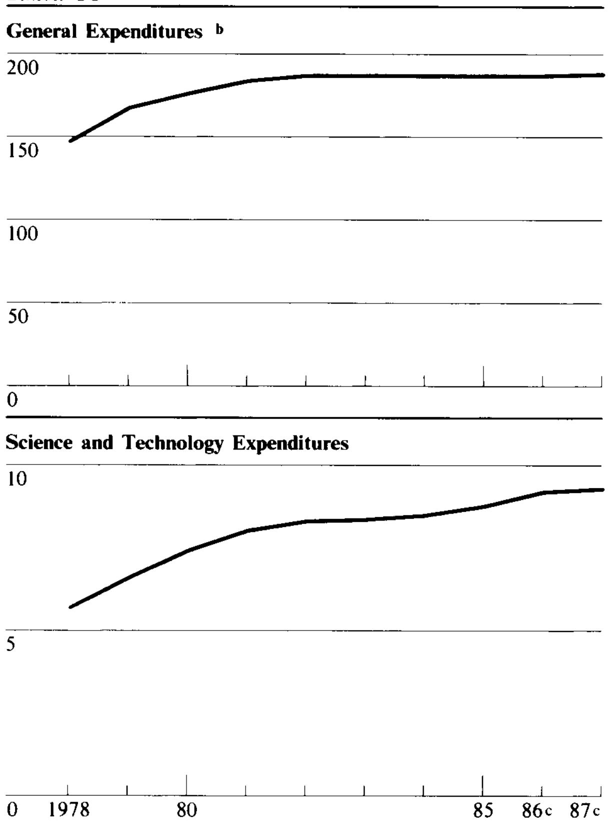
- The ***Next Generation Technology R&D Program***—begun in 1981—is encouraging cooperation between firms (often with 50-percent funding) and offering access to the 16 MITI research labs. Next Generation projects concentrate on new materials, new electronic devices, and biotechnology methods—technologies believed to be critical to future industry. 25X1

[1] The Prime Minister's Ad Hoc Committee on Education Reform has been studying, since 1984, how to encourage creativity in university research and in education at all levels.

[2] Japan's fiscal year is 1 April–31 March. 25X1

25X1

Japan: General and Science and Technology Expenditures, 1978-87 [a]



[a] Fiscal period beginning 1 April of stated year. Data converted at 175 yen per dollar.
[b] Central government expenditures excluding debt service and allocations to local governments.
[c] Projected.

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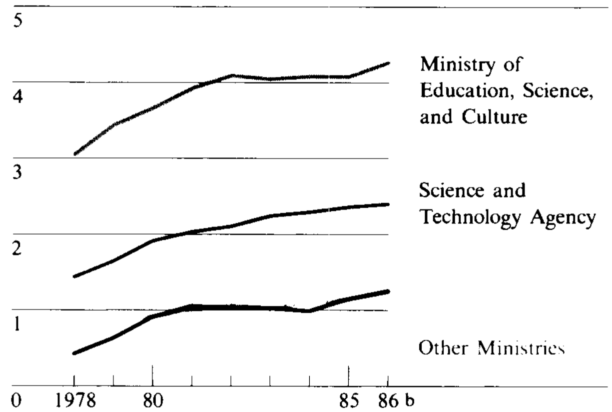
Japan: Science and Technology Expenditures, by Agency, 1978-86 [a]



[a] Fiscal period beginning 1 April of the stated year. Data converted at 175 yen per dollar.
[b] Projected.

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- The ***Key Technology Center*** (Key-Tech), cosponsored with the Ministry of Posts and Telecommunications (MPT), offers 70 percent of capital funding or soft loans for projects in its targeted technology areas.
- MITI is sponsoring a series of regional ***Centers for Cooperative Research*** under a 1985 law to increase industry-university collaboration on long-term industrial research. 25X1

Japan's Science and Technology Agency (STA), which primarily supports R&D for major nuclear power and space projects, is increasing its support for fundamental research, mainly through the Institute of Physical and Chemical Research (RIKEN), the National Research Institute for Metals, and the National Institute for Research in Inorganic Materials. A new RIKEN life science center in Tsukuba has begun operating and a materials research center in Kansai is under discussion. STA has funded, since 1981, the ***Exploratory Research in Advanced Technology*** (ERATO) program for five-year fundamental research projects. The 12 actual or proposed ERATO projects, each employing 20 to 30 researchers, also focus on fundamental research in materials, electronics, and biology. 25X1

25X1

The Ministry of Education, Science, and Culture, (MOE), with the largest S&T budget in Japan and traditional dominance in basic science, is promoting fundamental research through improved industry-university cooperation. Japanese academics, however, have traditionally resisted contact with industry. As a result, MITI and STA, with more experience in marshaling industry funding, have seized the fundamental research initiative. [redacted]

Ministries with more limited mandates are also shifting toward fundamental research. MPT is using funds from Key-Tech to take over fundamental telecommunications research from the recently privatized Nippon Telegraph and Telephone Corporation. MPT's efforts feature a new research center—the Advanced Telecommunications Research Institute (ATR). The Ministry of Agriculture, Forestry and Fisheries (MAFF) has begun a ***Center for R&D on Bio-Industrial Technologies,*** structurally similar to Key-Tech, to support agriculturally related biotechnology research. [redacted]

International Cooperation Programs

Tokyo is attempting to broaden Western research participation in Japan—currently contacts are primarily through Japanese nationals studying or working abroad. Foreign presence in Japan has been impeded by language and cultural barriers, by the absence of assistance to foreign researchers, and by laws limiting foreign researchers access to government-sponsored facilities. Many of these barriers are being lowered by legal changes and by some small programs to encourage foreign researchers to work in Japan. [redacted]

MITI and MPT, because of their commercial development orientation, have historically discouraged foreign participation in their research programs. In 1986, MITI for the first time allowed foreign participation in its research laboratories. According to the Key-Tech Center's promotional literature, its projects are open to foreign corporate participation; press sources indicate that ATR includes the Japanese affiliates of three US computer firms. The Key-Tech Center also sponsors a fund—the Japan Trust—to support individual foreign researchers in Japan. [redacted] 25X1 MITI has also proposed the ***Human Frontier Program,*** promoted as a large—perhaps $20 billion over 20 years—international research program in life sciences. Despite extensive publicity for Human Frontiers, which we believe represents a high-level commitment to establish an international program in life science, it has not yet received substantial funding. 25X1 [redacted] 25X1

MOE, the principal Japanese participant in international scientific programs, has been the most open of the three major S&T ministries. Since 1982, foreigners are eligible to hold long-term staff positions in national universities. Tsukuba University, a national university, recently began a program to train foreigners in technical Japanese. In addition, MOE has an agreement with the French and West German Governments to support their researchers while they work 25X1 in Japan. [redacted] 25X1

STA, particularly in its fundamental research efforts, has been relatively open to foreign participation. About 5 percent of the ERATO researchers have been foreign. Within RIKEN, STA has begun a ***Frontier Research Program,*** working on life and materials sciences, with approximately one-third of its 35 scientists to be foreign. This program includes housing and other cultural support for foreign participants. Under 25X1 a new law, foreigners are allowed to hold positions (other than director) in STA laboratories. [redacted]

Implications for International Cooperation 25X1

We believe that Tokyo's new S&T policy direction will substantially increase the openness of Japan to international cooperation. Recent changes will probably have only a small impact on the content of Japanese research or its international orientation in the next few years, but the long-run effects of these changes could be large. These changes signal that the government will support fundamental research in the future, particularly in new materials and materials processing. They also signal that government laboratories and firms will be expected to improve foreign contacts, both to benefit Japanese industry and to address complaints that Japan is closed to international cooperation. [redacted] 25X1

The shift toward fundamental research will, in our view, increase opportunities for mutually beneficial international cooperation in R&D. Japan's fundamental research projects are likely to require more contact with Western science than traditional projects that rely on refining existing technology. According to press reports, European officials are concerned that Tokyo is structuring cooperative programs to obtain these benefits without offering Western researchers comparable access. We believe that Tokyo, while preferring such uneven exchange, is willing to provide access to fundamental research results—which Western researchers are likely to find increasingly valuable. [redacted] 25X1

[redacted] 25X1

Latin America: Public Opinion on the Debt [1]

25X1

Public opinion in several Latin American countries demonstrates realism about the causes of financial problems and support for government policies to resolve the debt problem. Although little public support exists for repudiating external debt, poll results suggest that Latin Americans want new debt policies to ease the region's financial plight. In particular, Latin Americans desire longer repayment periods and limits on debt service payments, which probably will become key planks in future negotiations with creditors.

The Sources of the Debt Problem

Latin Americans mostly blame their country's debt problems on their own government policies. About 75 percent of the Argentines, Colombians, and Uruguayans thought that domestic inflation fueled by government deficits is an important cause. In Argentina and Uruguay, excessive spending by military governments is also cited by at least 10 percent of the respondents, and a strong majority thinks that the losses of state-owned enterprises also contributed to the growth of foreign debt. Among elite groups in Colombia, 42 percent believe internal factors are primarily responsible.

Although Latin Americans generally give domestic factors the largest role in creating the debt problem, they feel that external causes also have contributed to their predicament:

- In ***Colombia,*** more than 75 percent believe that the world economic recession and high US interest rates of the early 1980s were major causes, and two-thirds say that protectionism is important.

- About 70 percent in ***Argentina*** and ***Uruguay*** cite trade barriers and high US interest rates, while slightly more than one-half also attribute the increase in debt to the world economic slowdown. About two-thirds say that imprudent lending by international banks is another important cause of the debt problem.

- ***Dominicans*** think that low prices for their exports were the most important cause of their external debt problem. 25X1

In contrast, Brazilians disagree on the causes of their country's financial problems. 25X1

Views on Current Adjustment Policies

Respondents to the polls strongly support most of the policies that their governments are now following to manage the debt burden. For example, Latin American respondents want to expand exports, although they are more divided on the benefits of reducing imports. Nonetheless, devaluation of the currency is widely opposed, probably because of the loss of purchasing power and national prestige despite the competitive advantage that it would give exports. Typically, there are mixed signals on fiscal policy—budget cuts are favored but without reductions in consumer subsidies. 25X1 25X1

Trade Policies. Large popular majorities—ranging from 66 percent in Brazil to 89 percent in the Dominican Republic—favor increasing exports; 95 percent of the Colombian elite agree that more exports would help the economy. Almost 70 percent of the Argentines and 60 percent of the Dominicans think restricting imports would help, but only 45 percent of the Brazilians and Uruguayans agree. In

[1] This article is based on recent polls commissioned by the US Information Agency (USIA). Over the past 12 months, USIA conducted polls on attitudes toward the debt problem in Argentina, Brazil, Colombia, the Dominican Republic, and Uruguay.

25X1

Colombia, opinion is evenly divided about more restrictions on imports, but 56 percent of the elite respondents believe that import restrictions would help the economy, with university student leaders and journalists the strongest supporters. 25X1

Fiscal Policy. Large majorities—ranging from 61 percent in Uruguay to 88 percent in the Dominican Republic—favor reductions in government spending as a way of resolving the financial pinch. Support for cutting government subsidies on consumer items and services is weaker, however. Almost 80 percent of the Dominicans—and one-half the Argentines and the Colombians—think reduced subsidies would help the economy. A plurality in Brazil favors cutting subsidies, but in Uruguay 45 percent of the respondents oppose cuts in consumer subsidies, with only 22 percent supporting subsidy cuts. 25X1

Relations With Creditors. From a low of 62 percent in Brazil to a high of 86 percent in the Dominican Republic, respondents favor asking international banks for longer repayment periods. The Latin Americans polled are more divided about the efficacy of adopting economic adjustment policies recommended by the IMF. About 45 percent in Brazil and Colombia—which do not now have IMF programs—oppose a Fund role, while about 25 percent are in favor. In Colombia, 71 percent of the elite oppose an IMF program. President Barco reflected these views when he told the press in September that he does not want the IMF to continue to monitor the economy as closely after December. Almost 55 percent in Argentina and Uruguay oppose adopting a Fund program, while less than 20 percent think an IMF program is a good idea. In the Dominican Republic, 67 percent are against adopting IMF-endorsed policies in exchange for help in paying the debt. 25X1

25X1

Implications

On the basis of the USIA polls, we believe that Latin American governments probably would be able to tap a wellspring of support for new debt policies and thus

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The USIA Opinion Surveys

Starting in late 1985, the US Information Agency commissioned Latin American polling companies to conduct opinion surveys on the debt problems facing Latin American economies. The results represent the views of those who claimed to have heard about their country's debt problems. The errors of estimate for the sample populations range from 1.6 to 3.7 percentage points at the 95-percent confidence limit. 25X1

Argentina*: Interviews were conducted with 1,400 adults selected at random in the six largest cities in November 1985; 88 percent had heard of Argentine debt problems.* 25X1

Brazil*: The sample consisted of 1,502 adults in six major cities, which included a subsample of 300 people with some university education to make the survey comparable to polls commissioned by USIA in other Latin American countries. Interviews were conducted in October 1985; only 81 percent knew about foreign debt issues—the lowest share in any of the polls.* 25X1

Colombia*: In Colombia, the first survey—conducted in April and May 1986—polled the opinions of 1,014 adults in the four largest cities; 90 percent knew something about the debt. The second poll, conducted in May and June 1986, surveyed the views of 750 respondents—business executives, professionals, journalists, labor leaders, educators, and student leaders.* 25X1

Dominican Republic*: Interviews were conducted with 1,000 adults in Santo Domingo and Santiago in November and December 1985; 95 percent of the sample had heard about the debt problem.* 25X1

Uruguay*: In October 1985, 1,000 adults in the three largest cities were interviewed, with 96 percent aware of the foreign debt problem.* 25X1

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will bargain harder for eased repayment terms on their commercial debt in the future. About one-half the respondents in the five countries favored canceling any IMF agreements that require austerity measures, with about 20 percent opposed to abrogation. Instead, Latin American respondents think that getting loans from the World Bank would improve their countries' debt positions. Although majorities in each country—ranging from 52 percent in Uruguay to 79 percent in Colombia—believe that refusing to pay the debt would worsen the economic situation, large majorities favor placing a ceiling on the amount paid in debt service. In Colombia, 58 percent of the respondents think a ceiling on repayment would help their economy, while 24 percent disagree. A larger share of Dominicans than other Latin Americans—75 percent—support a debt service ceiling. In Argentina, Brazil, and Uruguay, about two-thirds think a limit would help their economies, while less than 10 percent believe that it would hurt economic performance. Additionally, about 60 percent of Argentines, Dominicans, and Uruguayans think a 10-year grace period would help the debt situation, although small pluralities of Brazilians and Colombians feel that such a policy would worsen their financial plight. [redacted] 25X1

On a more positive note, the polls indicate Latin Americans may actually favor implementing policies proposed under the Baker Plan to improve the condition of their economies. For example, substantial majorities think that encouraging foreign investment in their economies would improve their financial situation. Argentines and Dominicans have the strongest consensus in favor of increased foreign investment, while Colombians and Uruguayans also strongly support encouraging investment. A majority of the Colombian elite also believe that swapping foreign debt for equity in domestic companies would help the economy, with only labor union leaders opposed to the scheme. In contrast, a plurality of Brazilians—40 percent—feel that more foreign investment would worsen the financial condition of the economy. [redacted] 25X1

[redacted] 25X1

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Briefs

Energy

Iran Presses To Repair Oil Export Facilities

[redacted]

Tehran is pressing to repair the damage recently inflicted by Iraq on Khark Island and other oil facilities. The loss of oil revenues—exports probably will fall from 1 million b/d in September to as low as 700,000 b/d in October—is seriously limiting Iran's ability to support both the war and its faltering economy. In 1985 exports from Khark averaged 1.5 million b/d. Iran has installed floating hoses to allow loading from one berth of the T-jetty at Khark and additional hoses are being installed to reopen another berth. Iran also has four single-point mooring bouys with a total loading capacity of 2 million b/d located off Ganaveh. [redacted]

25X1

25X1

International Finance

Iran and Iraq Expand Search for Foreign Exchange

[redacted]

War costs and the impact of recent Iraqi attacks on Iranian oil exports have prompted Tehran to ease its longstanding policy against foreign borrowing. [redacted]

25X1

25X1

Tehran's interest in securing foreign credit underscores the economic stress the regime is experiencing. [redacted] 25X1

For its part, Iraq has increased its liquid cash reserves by about $800 million since August so that it can make payments to military and civilian creditors. Iraq sold at least $300 million worth of gold reserves over the last several months. Moreover, Iraq has received about $500 million in cash from Saudi Arabia since early September. Baghdad probably will use the aid money for military purchases and the proceeds from the gold sales to meet overdue debts to civilian suppliers and commercial banks. According to the US Embassy in Baghdad, a US company last week threatened to stop work on the Baghdad South power plant unless Iraq makes an overdue payment within 30 days. [redacted]

25X1

Costa Rican Debt Maneuvering

[redacted]

San Jose appears to have moderated its confrontational approach toward its foreign creditors by making its first payment to commercial banks since July. The $5 million payment of overdue interest was made before a meeting with commercial lenders last week—bankers had refused to meet until a token interest payment was made. 25X1 Embassy reporting indicates that Costa Rica, while unable to pay all interest arrearages—which total some $60 million—has stated that it will pay as much as $5 million each month as a sign of good faith. Despite the optimism generated by Costa Rica's action, San Jose and its creditors remain far apart on a new rescheduling agreement. President Arias has publicly called for a rescheduling over 25 years, with a seven-year grace period. Negotiations are likely to be further complicated by the lack of progress in restoring Costa Rica's IMF program, suspended earlier this year because of repeatedly missed performance targets. The threat of creditor retaliation—including possible seizure of assets—probably will keep Costa Rica at the negotiating table. San Jose probably believes, however, that continued foot-dragging will yield better terms and will pressure the United States to provide additional assistance. [redacted] 25X1

Tanzania Delays Progress Toward Reform

[redacted]

Tanzania so far has kept within IMF-prescribed credit and spending ceilings, [redacted] and regularly devalued its currency. 25X1 President Mwinyi's directive postponing review of the medium-term economic recovery plan, however, [redacted] could damage the reform process. [redacted] 25X1 [redacted] the government probably will remain below the IMF spending target 25X1 at least through the end of the year, thanks largely to an offsetting Swedish grant. [redacted] 25X1 delays in approving the recovery program, and a continued arrears buildup could jeopardize badly needed aid—including disbursements from the Fund—and signal a serious effort by party ideologues supported by Party Chairman Nyerere to derail Mwinyi's reform efforts. [redacted] 25X1

International Trade

Nicaraguan-US Embargo Dispute Continues

[redacted]

Nicaragua, dissatisfied with a recent GATT panel decision not to take action on the US trade embargo, will ask that GATT member countries recommend the embargo be lifted, offer Nicaragua concessions for its losses, and discuss the legal justification for the US action. The panel determined it could not find that the embargo nullified or impaired Nicaragua's GATT benefits; it did not address the 25X1 legal justification for the action, as Nicaragua had requested. Nicaragua [redacted] is unlikely 25X1 to gain much support. Members do not want to alienate the United States and believe GATT should address only the effects of this type of action, rather than the motivations behind it. They also want to avoid injecting a political atmosphere into the GATT forum. [redacted] 25X1

25X1

25X6

GATT Defers Bulagrian Membership

GATT members rejected Bulgaria's claim that it is a developing country and should be allowed to participate in the upcoming round of multilateral trade negotiations. They also put off its request for a working group to examine its application for membership. Bulgaria has been a GATT observer since 1967 and many GATT members believe that Bulgaria has not used that time to bring its economy closer to compliance with GATT rules. Sofia claims that during the past year it has instituted substantial economic reforms, but GATT members say the reforms have produced few concrete results. While Sofia clearly believes membership is in its own best interest, Moscow is almost certainly encouraging them in an effort to increase access to GATT. By refusing to recognize Bulgaria as a developing country, GATT members have effectively blocked Sofia's participation in the Uruguay Round, but they may reconsider setting up a working party if Bulgaria acknowledges its status as a nonmarket economy and presents tangible evidence of economic reform. Acceptance of a working party would not bind them to ultimately support Bulgarian membership. 25X1

25X1

Intra-ASEAN Trade

[redacted] 25X1

Despite preferential trade arrangements, member countries account for only about 7 percent of total ASEAN imports, having fallen dramatically in recent years from $12 million in 1982 to $5 million in 1985. In response, ASEAN has undertaken several initiatives to improve regional trade: liberalization of tariffs; standstill and rollback of nontariff barriers within ASEAN; preferential treatment of intra-ASEAN investments and joint-venture projects; greater cooperation in commodities, shipping, banking, insurance, and tourism; and harmonization of national development plans and targets. Nonetheless, most members of ASEAN are disappointed in intra-ASEAN economic cooperation, and it is unlikely that these measures will make inroads on their strong trade ties to the West—particularly the US market that accounts for 60 percent of ASEAN sales to the world. [redacted] 25X1

ASEAN Countries: Intra-ASEAN Imports,[a] 1976-85 *Million US $*

	1976	1978	1980	1982	1984	1985
ASEAN	3.4	4.4	8.8	12.1	8.9	4.8
Brunei	0.1	0.2	0.5	0.4	0.4	0.2
Indonesia	0.2	0.2	0.3	0.2	0.1	NEGL
Malaysia	1.4	1.8	3.7	4.4	4.9	3.8
Philippines	0.1	0.2	0.3	0.5	0.2	0.2
Singapore	1.0	1.2	2.9	5.4	2.6	NEGL
Thailand	0.6	0.7	1.1	1.2	0.7	0.5

[a] Data are c.i.f.

[redacted] 25X1

Global and Regional Developments

Vietnam Stepping Up Trade With South Korea

[redacted]

Vietnam is trying to expand trade with hard currency countries by tapping the $30 billion South Korean import market. [redacted] 25X1
[redacted] Hanoi is selling "large" quantities of coal to 25X1
several South Korean firms to help offset declining sales to Japan. Japan, which took about one-third of Hanoi's total coal exports of $35 million in 1985, is shifting 25X1
some purchases to China. [redacted] the coal sold to South Korea is shipped 25X1
directly from Vietnam, [redacted] 25X1
[redacted] South Korean firms in turn are capturing a larger share of the Vietnamese 25X1
market by supplying textiles and industrial goods at prices Japanese firms reportedly cannot match. [redacted] 25X1

Tin Producers Seek Higher Prices

[redacted]

Indonesia, Malaysia, Thailand, Australia, Bolivia, Nigeria, and Zaire, the members of the Association of Tin Producing Countries (ATPC), held a series of meetings last week in Jakarta on establishing voluntary production quotas in an attempt to force tin prices higher. According to the Executive Secretary, the ATPC 25X1 realizes the need to keep production down in the face of the continuing world surplus. Officials from Brazil and China also attended the meetings. The ATPC would like to persuade Brazil and China to become members—China reportedly favors the idea. These meetings were held approximately one year after the collapse of the International Tin Council and after the London Metals Exchange refused to continue supporting tin prices. [redacted] 25X1

National Developments

Developed Countries

Canadian Grain Export Problems

[redacted]

Canada will be hard pressed to meet all of its international grain commitments unless favorable weather holds in the Great Lakes and west coast longshoremen settle their continuing labor dispute. Current commitments include a new agreement 25X1 with the Soviet Union calling for the export of 2.2 million metric tons through December, with another 4.5 million tons expected by July. Despite shipping a record 1 million tons of grain in the five days after Thunder Bay longshoremen ratified a new contract, moving the 5 million tons now on hand through the Great Lakes before the mid-December freeze poses a problem. Because west coast shippers have backed out of talks before the 7 November end of their 30-day truce with the longshoremen, British Columbian ports—which handle about one-half of Canada's grain exports—are likely to be shut down again to bulk loadings. [redacted] 25X1

[redacted]

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British Monetary Policy Speech

Chancellor of the Exchequer Lawson's annual Mansion House speech on monetary policy disappointed financial markets because it gave no hint of a policy change—such as joining the EMS—that would confirm London's continued commitment to fighting inflation. Market analysts are concerned that the rapid growth in money and credit aggregates will lead to a pickup in inflation, now running at 3 percent. Pointing out that the monetary base remains within its target range, Lawson insisted the government will take whatever action is necessary to contain inflation, although raising interest rates again would be politically difficult. The chancellor defended the recent hike in base lending rates to 11 percent as necessary to keep monetary growth under control and to reduce pressure on the pound. Both Lawson and Bank of England Governor Leigh-Pemberton, who also spoke at the Mansion House, reassured bankers that sterling's recent depreciation was necessary to reduce the pressure on the current account from this year's oil price fall but said they are unwilling to let the pound decline further. Their comments clearly were designed to strengthen sterling and avoid the need for another interest rate hike.

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Increasing Calls for West German Tax Changes

The five leading West German economic institutes have again urged Bonn to advance tax cuts now scheduled for 1988 to maintain the resurgence in consumer demand to prolong West Germany's recovery as the trade surplus declines. The $4-5 billion tax reduction—the second half of a package begun in 1986—is designed to reduce the progressivity of the income tax system. OECD estimates indicate it will boost GNP by 0.3 percentage point and not increase inflation, but the total package will do little more than compensate for the increase in fiscal drag since 1981. Meanwhile, the Free Democratic Party (FDP), the junior coalition partner in Bonn, has also recently voiced impatience with Chancellor Kohl's Christian Democrats for their hesitancy in promoting comprehensive tax reform. At an FDP conference last week, former Finance Minister Lambsdorff called for eliminating many deductions in exchange for sharply lower rates and criticized Finance Minister Stoltenberg for not relying more on tax reform as a tool of

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economic policy. We expect Bonn to reject any acceleration of the 1988 tax cuts. Moreover, coalition disagreements could delay passage of tax reform in the next legislative session if, as we expect, Chancellor Kohl's government wins January's election. [redacted] 25X1

Bonn Offers To Assist Huge Housing Firm

[redacted]

Construction Minister Schneider recently signaled Bonn's willingness to furnish additional aid to the giant Neue Heimat housing conglomerate. In September, Neue Heimat's owner, the West German trade union federation, unexpectedly sold most of the firm's assets—about 190,000 housing units—for the nominal sum of one deutsche mark to a West German businessman with little or no experience running such an enterprise. The sale has deeply embarrassed the labor unions, and hurt the union-supported Social Democrats in Bavaria's recent state election. Bank shares on the Frankfurt stock exchange fell after the sale, reflecting the impact a Neue Heimat bankruptcy would have on West German real estate values. Fearing a bankruptcy is still possible, Bonn is trying to protect both its exposure—roughly $450 million in loan guarantees—and that of Neue Heimat's creditors. Both Schneider and Economics Minister Bangemann have supported the new owner's plan to sell some of the units to existing tenants to restore profitability, a process they believe will be aided by the more favorable tax laws affecting housing that take effect on 1 January. They have also suggested that Bonn might help the sale of units by providing accelerated depreciation or additional housing allowances. [redacted] 25X1

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New Portuguese Foreign Investment Code

[redacted]

Portugal's new foreign investment code—prompted by the EC accession requirement to bring foreign investment regulations in line with EC rules—aims to simplify the delay-ridden approval process. Investments must be registered with the government, but will be approved automatically if the Foreign Investment Institute does not object within 60 days. Similarly, the Bank of Portugal has 30 days to decide on foreign capital transactions, after which they also will be automatically approved. The new code is welcomed by foreign investors—long discouraged by Lisbon's redtape—although there is some skepticism about Lisbon's ability to implement it. The government, however, is very eager for foreign capital and technology and has indicated its intention to administer the code as flexibly as possible. We expect delays to occur in the initial stages, but the new code is a major step toward liberalizing Portugal's approval process and is likely to lead to increased foreign investment. [redacted] 25X1

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Iceland's Prime Minister Celebrates Robust Economy

[redacted]

Prime Minister Hermannsson is hailing a buoyant domestic economy to boost his coalition government's chances in the national election due by April 1987. In his annual statement to parliament on 16 October, the Prime Minister gave his Progressive-Independence coalition credit for the single-digit inflation rate expected for 1986—compared with more than 80 percent in 1983—and for accelerating economic growth, which is forecast at 5 percent for the year. Hermannsson also sought to reassure parliament that his government would be able to manage remaining problems such as the government budget deficit, high real interest rates,

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and the large foreign debt—about 55 percent of GDP. Reykjavik's successes in controlling inflation and in boosting growth probably will endure through the runup to the election, but continued improvements depend on the fragile accord achieved in February between the government and unions over a package of anti-inflation measures. Hermannsson must still deal with accusations that he buckled under US pressure in settling whaling and military cargo shipping disputes, and with setbacks his Progressive Party suffered in May municipal elections. Nonetheless, worker support for the conservative Independence Party will be bolstered by strong real wage gains and will weaken opposition claims that they are the true "workers' parties." 25X1

Israel Deregulates the Oil Industry

In response to the slide in world oil prices, Tel Aviv plans to begin deregulating its oil industry. The government had already cut its price for domestic oil earlier this year. The US Embassy reports that the first steps consist of breaking the domestic oil market cartel and of creating a more flexible pricing system—these could be 25X1
implemented as early as January. Also, the Ministry of Energy will permit oil companies and industries to buy up to 10 percent of their petroleum product requirements on the international market rather than from government-owned refineries. Israel now believes its refineries are strong enough to compete with international producers. Finance Minister Nissim supports the plan, but it must still be formally approved by two economic committees. If the initial stages of the plan are implemented successfully, Tel Aviv probably will allow the oil companies to increase their purchases of foreign petroleum products and move further to liberalize domestic prices. Lower prices at the pump would benefit Prime Minister Shamir, and he will probably be able to withstand criticism from the oil companies. 25X1

Australia Negotiating New Wages Agreement

Next week, unions will review a new government proposal for conducting wage negotiations and, with national elections necessary within the next year, the Hawke government will have to decide how far it can push the new proposal without antagonizing its important trade union constituency. Under the current 25X1
system—established in 1983 by an agreement between the Hawke government and the major trade union organization to reduce industrial strife—a federal Arbitration Commission twice a year recommends wage increases for each occupation category, based largely on inflation. Canberra is now urging unions to reach agreements at the company and industry level—an approach designed to improve the competitiveness of Australia's manufactures on the world market. For their part, union leaders are giving the new proposal serious consideration, according to Embassy reporting, because Australia's economic slowdown and export slump have hardened employer opposition to indexing wages to inflation. Nevertheless, union leaders almost certainly will face difficulties persuading their members that the arbitration system should be abandoned. In the last six months, even when facing bitter strikes, employers have resisted most attempts by individual unions to gain wage increases outside the current system. 25X1

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South African Reactions to Sanctions

[redacted] 25X1

Pretoria's reaction to US sanctions so far has been limited primarily to denunciations of the United States and a few practical steps to circumvent sanctions. Foreign Minister Botha has said, however, that pressure by South African farmers who have lost US markets would lead to a ban on South African imports of US grain. To help circumvent sanctions, Pretoria last month omitted from its foreign trade report the usual breakdown of trade by country and product. The government-owned South African Transport Service last week announced that it will no longer release statistics on cargoes or on the names, destinations, and origins of ships using South African ports. Pretoria evidently sees no advantage in precipitate retaliation against the United States, but it will probably make measured responses such as a lawsuit on behalf of South African Airways over pending US suspension of landing rights. The government will continue to monitor the policies of neighboring states closely, however, and will not hesitate to use the leverage derived from its regional economic dominance. The withdrawal of the US corporations will reinforce perceptions among South Africans that their economy is becoming increasingly isolated from the West, but it will probably not have an immediate effect on business confidence. The government is probably convinced that its program of limited reform will not placate critics and that it must concentrate on assisting businesses to evade sanctions. [redacted] 25X1

Less Developed Countries

[redacted] 25X1

Colombian Tax Policy Changes

[redacted] 25X1

The Barco administration last week proposed a major tax reform to broaden the tax base, simplify the system, and reduce evasion. The new bill includes an offer of amnesty to encourage repatriation of funds illegally exported by Colombian businessmen and drug traffickers during 1983-85—a period of high inflation and frequent devaluation. If enacted, the amnesty, combined with tighter foreign exchange controls in Peru and banking reforms in Panama—where much drug money has traditionally been deposited—probably will encourage some narcodollars to return to Colombia, adding to inflationary pressures. Although some foreign observers may interpret the proposal as a softening in the government's antinarcotics efforts, Barco, who remains committed to drug control, probably sees the reform simply as a way to inhibit capital flight. [redacted] 25X1

Malaysia's Spiraling Budget Deficit

Kuala Lumpur's budget for next year will cut development spending in an attempt to deal with the ballooning deficit, according to the US Embassy. The government, nevertheless, projects that the overall deficit will jump by two-thirds to an unprecedented 19 percent of GNP. Kuala Lumpur anticipates real economic growth of no more than 1 percent through 1987. To avoid further depressing the economy, the Finance Ministry proposes no tax increases. The budget suggests that the policy of redistributing the national wealth in favor of ethnic Malays under the politically controversial New Economic Policy will be further slowed. Prime Minister Mahathir has already suspended portions of the NEP, including regulations about foreign ownership, in an effort to encourage foreign investment and to promote economic recovery. The large increase in the deficit will intensify the concerns of Malaysia's foreign creditors because Kuala Lumpur intends to finance some of it by adding to its $20 billion foreign debt. 25X1

Indonesia Announces Additional Economic Reforms

Jakarta has announced a series of economic measures that include dismantling six import monopolies and eliminating or reducing a wide range of import duties. These measures, designed to increase the efficiency of domestic industries and promote nonoil exports, complement the 31-percent devaluation in September. Two striking omissions from the list of import monopolies slated for elimination are plastics and steel—both are tied closely to President Soeharto. Moreover, according to press reports, only a small share of Indonesia's imports are controlled by the targeted monopolies. According to US Embassy reporting, Indonesia's foreign donors regard the policies as a realistic attempt to cope with the country's oil-driven economic slump. We believe, however, that Jakarta has yet to demonstrate the resolve needed to deal with the downturn and with the chronic deficiency and corruption of the Indonesian economy. 25X1

Communist

Soviet Crackdown on Falsified Economic Reporting

General Secretary Gorbachev appears to be using a crackdown on the falsification of economic data to put pressure on political opponents and recalcitrant regional officials. A Central Committee resolution published last week censured the Ministry of Automotive Industry and the party chiefs of Moldavia and a Ukrainian oblast for allowing those under them to falsify data on plan fulfillment, to pay illegal wages and bonuses, and to distort reporting on fulfillment of contract obligations. The party chiefs were officially reprimanded, and the Minister of Automotive Industry and five senior Moldavian party officials were fired. The government is probably concerned that fraudulent reporting, always a problem to some degree, could spread as the pressure to meet Gorbachev's modernization and acceleration goals intensifies. Targeting Moldavia and the Ukraine—two former Brezhnev strongholds—strongly suggests Gorbachev also has political motives for the resolution. 25X1

Bulgarian Economic Mismanagement Under Fire

Bulgaria has begun a Soviet-style crackdown on economic mismanagement and corruption. Two press reports in recent weeks criticized by name midlevel officials for improprieties or for blocking government economic decisions. One report noted that an official it named would be prosecuted. The government last week also 25X1 formed a national commission to investigate wayward officials and recommend sanctions. This is the harshest and most far-reaching criticism of economic officials since party leader Zhivkov demoted several economic policy makers last fall in response to Soviet criticism. The new moves may also be intended to placate Moscow, but in any event they divert responsibility for an expected disappointing 25X1 yearend economic performance from the top Bulgarian leadership. Official public criticism—and probably dismissals—of midlevel economic officials almost certainly will increase and may even reach top-level economic policy makers.

China's Grain Output Rises

China's reform leaders will use the projected 3-percent increase in grain production this year to claim success for market-oriented policies in the rural sector. Preliminary Chinese estimates indicate that grain production will total 390 million metric tons, about 10 million tons more than last year but well below the record 25X1 407 million tons in 1984. Disruptions caused by reforms in China's procurement system have not been ironed out—a senior Chinese specialist recently told the US Embassy that farmers are not fulfilling purchase contracts this year, forcing the state to buy higher priced grain from China's free market. Conservative opponents sharply criticized reform leaders last year when new policies—elimination of mandatory grain procurement quotas, removal of controls on prices of nonstaples, encouragement for peasants to expand rural industries—and poor weather caused a drop in grain production. Reformers responded by increasing the incentives. Beijing's recent decision to make up contract shortfalls with state purchases from the free market—rather than by reimposing quotas—indicates the reformers remain committed to reducing administrative interference in agriculture.

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China Promotes Technology Policies

Beijing recently underscored its determination to direct the development of technology by publishing a policy paper on China's technology. According to press reports, the document details policies for developing 12 priority areas: energy, transportation, telecommunications, agriculture, consumer goods, machinery, material handling, construction materials, urban construction, town and township construction, housing, and environmental protection. It calls for developing technologies appropriate to industrial needs and for combining high technologies such as electronics with more traditional ones. Publication of the paper, and of a complementary report on science and technology policy in September, is intended to provide clear guidance on Beijing's technology priorities to bureaucrats and managers, many of whom have been slow to embrace technology development programs. Although the papers were produced through consultation with experts from government, research, and industrial organizations, how well these groups will work together to implement the policies remains to be seen. Moreover, problems such as inadequate investment funds, poor use of equipment, and lack of skilled workers will continue to hamper China's technological advancement.

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China Centralizing Road Traffic Control

The State Council has directed the Ministry of Public Security to draft laws and regulations on traffic safety and management in an effort to ease the crowded and often chaotic conditions on Chinese highways. The road sector already handles nearly 40 percent of the total volume of passenger traffic—excluding the millions of bicycles—but only about 10 percent of the total freight volume. The central government probably hopes that, with Public Security departments responsible for local inspection and toll stations and for controlling roadside activities that tend to spill onto and block roadways, traffic flow will improve and freight volume will increase.

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