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International Economic & Energy Weekly

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7 November 1986

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DI IEEW 86-045
7 November 1986
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International Economic & Energy Weekly 25X1

7 November 1986

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International Economic & Energy Weekly 25X1

Synopsis

1 **Perspective—Increasing Soviet Involvement in the World Economy** 25X1

In the past several months, the USSR has embarked on a wide-ranging campaign to increase its role in international economic affairs. The course of future Soviet activity in the world economy will depend, in large part, on Soviet decisions regarding the role of Western technology and equipment in Gorbachev's modernization drive. 25X1

3 **USSR: Seeking a Broader International Economic Role** 25X1

In the last several months, Moscow has launched a spate of initiatives that portend an increase in the breadth and depth of Soviet participation in international economic and financial arenas. The success of these initiatives, however, will, in large part, hinge on Moscow's willingness to increase the role of Western technology in Gorbachev's modernization drive to accept Western managerial involvement and corporate ownership in the domestic economy, and to expand the acceptable level of hard currency indebtedness. 25X1

7 **Soviet Consumer Services: Prospects for Change Under Gorbachev** 25X1

Despite the leadership's highly publicized commitment to boost Soviet living standards, the new focus on industrial modernization limits its ability to increase the share of labor or investment devoted to services. Although an expansion of the role of the private sector could boost quality and output of services, the economic and political obstacles to such measures suggest that change will be slow in coming. 25X1

11 **India-USSR: Continued Economic Relationship Despite Strains** 25X1

The falling value of Soviet oil exports to India and India's interest in Western high technology have produced some strains in the economic relationship, but hard currency constraints facing both countries provide a powerful incentive to increase their bilateral trading relationship. 25X1

17 **Egypt: Coming to Terms With the IMF** 25X1

Faced with rapidly growing debt arrearages and depleted cash reserves, Cairo has begun negotiating with the IMF over terms for a standby program. Protracted negotiations or, even worse, a deadlock over the terms of an agreement will increase the probability of sizable defaults—only with extensive new assistance from the United States or Saudi Arabia could Egypt muddle through. 25X1

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Perspective

Increasing Soviet Involvement in the World Economy 25X1

In the past several months, the USSR has embarked on a wide-ranging campaign to increase its role in international economic affairs. Recent Soviet moves include the restructuring of its foreign trade apparatus, proposing new forms of economic cooperation with Western firms, and applying to participate in GATT. These initiatives reflect, in part, a new generation of Soviet leaders who are willing to consider alternate tactics in the pursuit of their economic goals. The sharp drop in hard currency revenues from energy exports has probably added further impetus to Soviet interest in new trade and financial avenues. 25X1

The course of future Soviet activity in the world economy will depend, in large part, on Soviet decisions regarding the role of Western technology and equipment in Gorbachev's modernization drive. Rhetoric aside, the leadership will probably spend the next year or two assessing domestic programs—shifts in investment priorities, management reorganizations, and the discipline campaign—before reconsidering their conservative positions regarding reliance on foreign technology, Western participation in the economy, and the willingness to substantially expand indebtedness to the West. Gorbachev's new managerial team also needs the time to acquire the experience and expertise necessary to move confidently ahead into international financial areas. 25X1

Until the Soviets settle on a long-term economic strategy vis-a-vis the West, we can expect cautious but steady expansion of their economic activity in the international arena. Even a gradual expansion of activities in the near term, however, could have important repercussions on US policy interests:

- Increased cooperation with Western firms is likely to improve Soviet assimilation of Western technology at given enterprises, although diffusion throughout the economy will remain difficult. Moreover, joint ventures established outside the USSR or subsidiaries of joint ventures in third countries could give Soviet technicians greater access to controlled technology.

- Greater Soviet involvement in international trade and financial markets would make it easier for Moscow to hide the level of its financial activities through the use of numerous instruments, such as interbank deposits, or borrowing from nonbank institutions and banks that do not report their international lending.

- A higher level of Soviet activity in the international economy—especially multilateral forums—will provide Moscow with new opportunities for political activism. In addition, a larger number of Soviet officials in the West increases the potential for KGB activity. 25X1

Regardless of the level of Soviet economic links to the West, an increased Soviet understanding of international financial and commercial markets carries a risk that Moscow may attempt to manipulate these markets to the detriment of US national security interests. The West has been moving rapidly toward globally integrated financial and commodity markets and this, along with the sharp rise in transaction volume and relative inexperience of many of the players, has created a potential for an international crisis precipitated by one or more shocks to the system. We believe that the probability of Soviet misuse of the system would be small as long as the USSR's growing involvement is paying off in economic and even political dividends. Indeed, to the extent that these activities tie the USSR closer to the world economic community, the West probably benefits because it gives the Soviets a greater stake in working to solve problems within the system. Moscow's stake, nonetheless, is not likely to weigh heavily in Soviet decisions where political and strategic interests are involved. 25X1

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USSR: Seeking a Broader International Economic Role [redacted] 25X1

In the last several months, Moscow has launched a spate of initiatives that portend an increase in the breadth and depth of Soviet participation in international economic and financial arenas. Many of these actions have received widespread publicity—the application for participation in GATT, the restructuring of the foreign trade apparatus and new regulations on joint ventures, and the unexpected settling of outstanding Czarist bonds. In addition, the Soviets are quietly working with Western banking and trading institutions to expand the range of financial instruments available to finance Soviet hard currency imports. The success of these initiatives, however, will hinge, in large part, on Moscow's willingness to increase the role of Western technology in Gorbachev's modernization drive, to accept Western managerial involvement and corporate ownership in the domestic economy, and to expand the acceptable level of hard currency indebtedness. The Soviets, however, are likely to move cautiously with ad hoc adjustments to current policy, and, unless Moscow abandons its conservative approach to both domestic economic and foreign trade policy, the results will probably be unimpressive. [redacted] 25X1

Soviet Motivations

Moscow's recent initiatives to expand economic links to the West probably result from the interaction of several factors:

- The emergence of new senior economic managers who are more action-oriented individuals and realize that new tactics must be used to meet Soviet economic challenges, particularly modernization and accelerated growth. Such activism goes hand in hand with a revamped foreign policy apparatus that is taking a more dynamic approach to Soviet economic and international affairs.

- The reorganization of key domestic economic sectors and the foreign trade apparatus to streamline the bureaucracy to respond to Moscow's economic challenges. The new trade policy team probably realizes that Soviet goals have been frustrated in the past by conservative and ideologically constrained approaches and, in general, by a relative ignorance of the operations of the international financial and commercial markets.

- The desire to develop a competitive Soviet export sector for manufactured goods that has increased pressure for Soviet representation in international economic organizations. Moscow probably feels that its current reliance on raw material exports for the bulk of its trade earnings leaves it vulnerable to fluctuations in world commodity prices and is at odds with its level of economic development.

- The recent reduced level of hard currency earnings from both oil exports and arms sales. This has probably also driven the Soviets to explore alternate sources for financing imports. [redacted] 25X1

Reorganizing the Foreign Trade Apparatus

In late September, the Soviets announced a major overhaul of the Ministry of Foreign Trade (MFT). More than 20 ministries and 70 large associations and enterprises are to be granted authority to conduct trade directly with their foreign partners as of 1 January 1987. Under the proposed plan, the ministries and production associations themselves will have foreign trade organizations placed under their jurisdiction, many of which will be transferred from the MFT. [redacted] 25X1

Breaking the MFT's monopoly over foreign trade is clearly an effort to expand exports of manufactured goods by strengthening the link between producers and world markets. In addition, it is designed to improve import efficiency by giving end users more say in contract negotiations—under the current system, price considerations of the foreign trade organizations often win out over technical specifications. While the MFT will continue to control a large portion of exports, purchasing authority for most imports may fall to the various ministries. [redacted]

At present, it appears likely that distribution of hard currency to cover imports will continue to be centrally determined, with Vneshtorgbank (VTB)—the Soviet Bank for Foreign Trade—playing a larger role, including the extension of hard currency credits. Failure to meet export targets, however, will result in a reduction in hard currency allocations. Selected ministries and enterprises will be able to spend up to 90 percent of export earnings for imports—although the US Embassy indicates that this will pertain only to above-plan exports. [redacted]

Joint Ventures with the West

Moscow is likely to complement increased end user autonomy with the capability to conclude joint ventures with Western firms. A framework for joint enterprises with other members of CEMA has recently been introduced, and the Soviets appear willing to offer similar business opportunities to the West. High-level Soviet officials have mentioned the possibility of joint ventures with Western firms on numerous occasions, [redacted]. The Soviet leadership has passed a decree that will permit up to 49-percent foreign equity and allow for some management control, repatriation of profits, and other provisions to make such ventures attractive to Western firms. [redacted]

The Soviets probably see several advantages to such arrangements:

- Partnership with a Western firm would provide access to established markets and trademarks that could make it easier to sell Soviet-made goods in the West.
- Quality control by the Western partner would help assure that products meet world-market standards.
- A long-term equity relationship with a Western firm could allow for updating of production lines to keep up with changing Western demands and technology.
- Joint ventures would also allow for transfer of technical know-how related to organization and management of production and the use of advanced technology that are not easily transferred through traditional equipment purchases. 25X1
- Such arrangements would allow for the transfer of Western technology at little or no hard currency cost to the Soviets until after production begins. [redacted] 25X1

Increased Financial Sophistication

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Gorbachev's financial managers are clearly interested in taking full advantage of the wide range of Western financial markets and instruments in an effort to improve the effectiveness of Soviet borrowing activities. Past financial managers were extremely conservative in their dealings with the West—relying heavily on Eurocurrency borrowings and government-backed credits. Now, VTB and Soviet-owned banks in the West are adopting a more sophisticated approach:

- Swapping debts with other banks to diversify their portfolios.

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- Trying out more sophisticated financial instruments, such as "note issuance facilities" and acceptance financing. 25X1
- Making unprecedented moves in world bond markets. For example, in August VTB agreed to invest $3.2 million in a yen-Eurobond issue, marking the first entry of the USSR into the international bond market. 25X1

These moves probably indicate Moscow's interest in marketing its own bonds, a cheaper source of long-term funds than syndicated borrowing. The recent settlement with the British on Czarist bonds in default since 1917 removes a longstanding impediment to the issuance of Soviet bonds. [redacted] 25X1

As part of its decision to broaden its financial dealings, the Soviets are moving aggressively to build the requisite expertise and access. They have reportedly initiated numerous seminars and bilateral meetings to learn more sophisticated banking and finance techniques. Moscow has also recently opened a subsidiary of its London bank in the Cayman Islands to issue new financial instruments, and appears to be attempting to expand its network of banks into Japan, and Kuwait.

Interest in Multilateral Economic Institutions

The Soviets are also exploring the possibilities of expanding ties to a number of multilateral institutions. Despite the recent rebuff by the ***GATT,*** Soviet interest in eventually becoming a member probably remains keen. Moscow apparently hopes that membership in GATT will be more likely once its foreign trade reorganization is in place and believes membership will expand its general knowledge of world economic conditions, provide trade opportunities, and make Soviet exports eligible for reduced tariffs. The Soviets may also believe that GATT membership would make them less vulnerable to economic sanctions.

Although there has been some reported interest in joining the ***IMF*** and ***World Bank,*** Soviet officials have denied any intention of seeking membership. The USSR rejected IMF membership as too restrictive after participating in the Bretton Woods meetings in 1944. In particular, the USSR was unwilling to give up autonomy in determining its own trade and exchange rate practices, did not agree with the gold subscription requirements, and refused to release sensitive economic data such as gold reserves and balance-of-payments information. Moscow's position has probably softened somewhat, but it still sees the costs as far outweighing benefits at the moment.

The Soviets have been interested in establishing formal ***EC-CEMA*** ties since the early 1970s and have actively pursued this goal since the CEMA Summit in June 1984. While economic and trade issues probably were an important Soviet motive in earlier years, the present effort has a more pronounced political flavor. Moscow clearly wants some form of official EC recognition for CEMA to enhance its status within the international community. 25X1

Outlook

With the reorganization of the foreign trade apparatus already under way, the Soviets' next major move is likely to be in the area of joint ventures. The first 25X1 joint-venture contracts could be signed within the next few months, but substantial progress along these lines may be slow. There is still considerable uncertainty among midlevel Soviet officials, who deal regularly with Western businessmen, over what, exactly, joint ventures will entail. While some Western firms may be willing to make a relatively small investment to gain entry into the Soviet market, most are likely to take a wait-and-see attitude. Years of dealing with cumbersome Soviet bureaucracies, shoddy Soviet manufactures, and unimpressive results from joint ventures with other socialist countries will make most businessmen wary. Even Western enthusiasm for joint ventures in China—the Communist country with the most liberal regulations—has recently waned. 25X1

Even if impediments to successful joint ventures can 25X1 be overcome, the level of investment is likely to be too small to have much of an impact on Soviet exports of manufactured goods. Nor will the recent changes in the foreign trade apparatus likely have much success in expanding exports. Although they will probably improve the operation of trade by removing the MFT as a cumbersome middleman, the changes do not remedy the lack of domestic incentives for producers, the distorted price structure, and the inadequate technological base. In addition, depressed earnings from traditional exports will severely constrain purchases of foreign equipment that could compensate for some of these shortfalls. 25X1
25X1

As long as Moscow maintains its conservative approach toward reliance on Western technology, a major role for the USSR in the international financial arena is also unlikely. The Soviets will probably become more adaptable to new financial instruments and more flexible in the management of their assets. Nonetheless, the present limitations on Moscow's hard currency earnings, coupled with some vestiges of traditional Soviet conservatism, are likely to restrict any large-scale speculative approaches to financial management. [redacted] 25X1

The Soviets will continue their approaches to selected international organizations for both political and economic reasons. GATT membership will probably remain a key economic goal for the USSR, but GATT's concerns over compatibility will still plague Soviet prospects despite recent reorganization efforts. The Soviets will also pursue a formal EC-CEMA arrangement, but probably with expectations of only minimal economic gains. [redacted] 25X1

[redacted] 25X1

Soviet Consumer Services: Prospects for Change Under Gorbachev [redacted] 25X1

General Secretary Gorbachev has made the improvement of consumer services [2] a prominent part of his highly publicized commitment to boost Soviet living standards. The new leadership's focus on industrial modernization, however, limits its ability to increase the share of labor or investment devoted to services. Although an expansion of the role of the private sector could boost quality and output of services, the economic and political obstacles to such measures suggest that change will be slow in coming. [redacted] 25X1

Consumer Services in the USSR Today

In Gorbachev's Soviet Union, where criticism of economic performance is the order of the day, few sectors provide as much ammunition for the leadership's attacks as that of consumer services. Premier Ryzhkov frankly acknowledged the problem in a December 1985 speech in which he labeled the state of basic services as "embryonic." [redacted] 25X1

The leadership's concern is well founded. Although per capita availability of services has roughly doubled in the past two decades, per capita expenditures on consumer services amount to roughly one-fourth of the level Soviet economic planners regard as the "rational" standard of consumption.[3] [redacted] 25X1

Even in the largest Soviet urban areas, service outlets tend to be scarce. For example, Moscow, a city of more than 8.5 million people, has fewer than 4,000

USSR: Real Per Capita Consumption, 1971-85 *Percent*

	Average Annual Growth		
	1971-75	1976-80	1981-85
Total consumption	**2.6**	**1.9**	**1.0**
Personal care and repair seervices			
Total (includes private sector) [a]	4.4	4.1	3.1
State sector only [b]	6.8	5.8	4.2

[a] As is true of all activity in the so-called second economy, estimates of the value of privately provided services are necessarily imprecise. We estimate that the private sector currently provides more than one-fourth of the total based on data for private services of 5-6 billion rubles given in *Izvestiya*, 19 August 1985. We assume a per capital growth rate of these services of 1 percent annually, which seems consistent with the rise in money incomes. We have no other data on the trend in supply of private service.
[b] Adjustments to official data include removal of services sold to enterprises and institutions and addition of the cost of materials used in providing services. 25X1

[redacted] 25X1

service enterprises. The picture is even bleaker in rural areas, where per capita consumption of services is 60 percent of the urban level. The multitude of consumer complaints appearing in the Soviet press makes it clear that the quality of state-provided services also leaves much to be desired. [redacted] 25X1

The state of the services sector in large measure reflects severe underinvestment in services—services received less than one-half of 1 percent of state investments in 1966-80, according to a 1983 Soviet journal—and there is no evidence that its share increased in 1981-85. Despite its labor-intensive nature, the service sector has also been a stepchild with respect to the supply of labor. According to Soviet

[redacted] 25X1

[2] The services we assess in this article correspond roughly to the US definitions of "personal services," "automotive repair services," and "miscellaneous repair services." These include laundry, drycleaning, barber, beautician, and public bath services; repair of clothing and consumer durables; and a variety of other services such as rentals of consumer durables. [redacted] 25X1
[3] Soviet planners set "rational norms" for consumption. These norms set standards for how much an average Soviet citizen should consume in food, housing, clothing, and other goods and services. They generally represent a comfortable living standard, albeit a lower one than in the West. [redacted] 25X1

Laundry Service—Soviet Style

Checking on complaints of poor-quality services in Orenburg, several Soviet reporters visited a laundry, and then described for their readers what they found:

- The first thing they did was hand us a razor blade and needle. After managing to cut the buttons off the coats we had brought to be cleaned, we began sewing on the tags we had been given. The people, about 40, in the line behind us began to raise a fuss and urge us to hurry.

- We barely finished our sewing when the clerk disappeared into the back room. . . . When she returned 15 minutes later, she didn't even look at our coats. She tossed them into a single pile on the floor, next to some greasy quilted jackets.

The journalists did not reveal how their experience ended, but, presumably, they got their coats back, unlike some Moscow consumers who wrote local papers complaining that state laundries had lost their clothes. [redacted]

statistics, about 2.4 percent of state workers (some 2.8 million persons) are employed in furnishing consumer services, up from 2.1 percent in 1970. In contrast, [redacted] an estimated 17-20 million private-sector service workers—legal and illegal—provide personal services, largely on a part-time basis. [redacted]

Deficiencies in quality and variety of services also reflect the perversity of Soviet success indicators, which judge enterprise performance by fulfillment of output targets imposed from above. The distortions tend to be particularly severe in consumer services, where the gap between what is advantageous for the producer and what is satisfying for the consumer is especially wide. For example, service enterprises:

- Concentrate on providing high-cost services, even if they are not in demand. High-cost services are the quickest path toward fulfillment of targets for total sales.

- Produce for bulk consumers rather than individual consumers. Service outlets are authorized to sell services and a limited amount of goods to institutions such as hospitals, hotels, and factories. The share of sales to institutions has been rising, even though official policy has decreed its decline.

- Produce goods rather than services. For example, shoe repair shops prefer to make and sell shoes rather than repair them. Soviet statistics indicate that production of goods now accounts for about 40 percent of the sales of service enterprises. [redacted] 25X1

In the judgment of Soviet officials and economists, the deficiencies of the state service sector impose serious political, economic, and social costs. Among them:

- Soviet consumers spend an estimated 40 billion man-hours annually shopping for goods and services with about one-half that time spent standing in lines or traveling to and from the service shops. Because few shops stay open after normal working hours, the time lost is often work time.

25X1

- The scarcity of household services adds to the already heavy burdens borne by Soviet women and contributes to marital and family problems. Soviet calculations indicate that women can rely on the state service sector to assist them with only about 3 percent of household chores. 25X1

- The lack of consumer services in rural areas and remote regions of the country makes it difficult for farms and factories in those areas to attract and retain skilled workers. 25X1

- The scarcity and poor quality of state consumer services reportedly fosters rampant corruption. This contributes to a mood of cynicism and apathy among the populace that, in turn, lowers worker productivity and undermines public respect for law and order. [redacted] 25X1

Searching for a Solution

There are no easy solutions to the sector's problems. Evidence suggests that the regime is hoping to boost the output and quality of services on the cheap. For example, the Politburo last year approved the Consumer Goods and Services Program, which calls for ambitious growth in sales of services of 40 percent by 1990 and 140 to 150 percent by the year 2000. The program, however, does not provide the resources needed to meet these goals. Instead, attainment of the program's goals depends on gains in efficiency not previously achieved and on administrative measures similar to those that have failed in the past.

Some Soviet economists have advocated a more radical approach: allowing the private sector to play a broader role in providing services as has been done for years in Hungary and East Germany. Soviet press comments indicate that the private sector already provides more than one-fourth of all personal care and repair services. As one Soviet economist has acknowledged, service in the private sector is often of better quality and takes about half the time. Economist Abel Aganbegyan, an informal adviser to Gorbachev, has been a prominent advocate of adopting the East European model.

Aganbegyan and other advocates of expanding the private sector have encountered strong opposition from officials who see dangerous social and political consequences attending any such moves. Conservative officials have specifically warned that measures of the sort proposed by reform minded economists could result in:

- Loss of state control over resource allocation decisions.
- Diversion of workers from labor-short state industries to more lucrative opportunities in the services sector.
- "Unjustifiably" high incomes by service-sector workers.

One compromise solution had been the use of collective contracts that make workers responsible for costs but also allow them to retain a large share of profits. Press reports indicate, however, that collective contract arrangements in services and other sectors have encountered many obstacles limiting their impact. For example, contracts stipulate that management is to provide the collective with necessary supplies, but managers have little control over sources of supply outside the enterprise. Frequent supply disruptions often stop work in the collectives and prevent them from earning the large amounts they anticipated. 25X1

Given the formidable ideological barriers to anything that smacks of individual private activity, it is not surprising that reform-minded economists have tried to find a way to get around these barriers. Several recent press articles have called for reviving cooperatives that played a large role in the economy during the 1920s. Proponents argue that cooperatives would provide a quick fix for the service sector while requiring few additional resources and avoiding the undesirable side effects that conservatives argue would accompany a large-scale expansion of private activity. Allowing cooperatives a larger role would also have an advantage from the perspective of national prestige: in taking this road the Soviets could argue that they are drawing on their own experience of the 1920s and therefore developing a distinctively Soviet model rather than imitating the Chinese or the Hungarians. 25X1

Gorbachev's public remarks indicate that he favors such approaches. While in Khabarovsk in September he called for a search for new forms of "individual work activity" in the service sector and raised the issue of reviving cooperatives. Also, in remarks to Leningrad party workers in May 1985, he suggested that the regime should take a more "realistic" attitude toward the activities of individuals moonlighting in the service sector. 25X1

Outlook

While Gorbachev and other officials would prefer to improve the existing system first, past attempts to adjust plan indicators and managerial incentives in the state service sector have done little to improve performance. Furthermore, the new leadership's commitments to industrial modernization limit its ability to increase the share of labor or investment devoted to services. 25X1

Movement to increase the role of personal initiative may become increasingly attractive if, as we believe, efforts to improve the system on the cheap fail to produce a major improvement in consumer services. In fact, according to a recent publication of the Supreme Soviet, legislation to encourage citizens' individual labor in services will be released by the end of the year. Arrangements designed to stimulate personal initiative will have little effect, however, if they are not accompanied by effective steps against some of the planning and management problems that have stymied past attempts at reform in services and other sectors. Problems that would have to be addressed include:

- ***Ensure operating autonomy***. Overregulation by central planners and ministerial officials often deprives the collective contract of its incentive effect. The same fate could befall cooperatives and even private individuals if they are not given sufficient independence to run their businesses profitably and serve their customers well. This would include the power to expand operations, control the number of employees, and adjust prices to reflect supply and demand.

- ***Provide facilities and supplies***. Chronic shortages of materials and equipment make it difficult for any type of enterprise to operate profitably. Creation of adequate legal sources of supply will be essential to success of contract, cooperative, or individual operations.

- ***Increase incentives***. Private operators working legally are now required to pay 60 to 65 percent of their profits to the state in taxes. New arrangements to encourage individuals to operate legally rather than underground would have to make provisions for a more equitable tax rate. The regime would also have to set the level of taxes or deductions from profits of cooperatives and contract collectives at a reasonable level and prevent planners and managers from adjusting it upward if the incentive effect of those arrangements is to be maintained. 25X1

In view of the serious economic and political obstacles to personal incentive measures, change will probably be slow in coming. 25X1

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India-USSR: Continued Economic Relationship Despite Strains [redacted]

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Economic issues are likely to rank high on the agenda during Soviet General Secretary Gorbachev's visit to New Delhi in late November. The falling value of Soviet oil exports to India and India's interest in Western high technology have produced some strains in the economic relationship, but hard currency constraints facing both countries provide a powerful incentive to increase their bilateral trading relationship. Gorbachev is likely to push New Delhi to step up imports of arms, machinery, and equipment. New Delhi probably will press Moscow to honor its import commitments and refrain from trading practices that cost India hard currency. Regardless of the outcome of the visit, we expect the economic relationship to remain strong. India needs to increase exports to the Soviet Union to pay for Soviet military equipment already purchased and to meet its overall export targets. The Soviets will seek ways to use the economic ties to maintain their close political relationship with India. [redacted]

The Economic Relationship

The Soviet Union—neck and neck with the United States as India's largest commercial trading partner—had a total two-way trade of slightly less than $3.7 billion in 1985. The value of bilateral trade grew by an average of almost 20 percent annually between 1970 and the early 1980s, largely because of growing Soviet oil deliveries and higher oil prices. The growth in trade has leveled off in the last few years as the Soviets cut back on purchases of Indian agricultural products and consumer goods to correct the large trade imbalance that had developed in India's favor during 1981-82. [redacted]

The Soviet Union has become more important to India as a trading partner in the last decade. Exports to the Soviet Union as a share of total Indian exports

Origins of the Indo-Soviet Economic Relationship

Soviet willingness to finance major public-sector industrial projects following Indian independence stimulated economic cooperation between Moscow and New Delhi. Machinery and equipment accounted for one-half to three-fourths of Indian purchases from the Soviet Union during the mid-1950s to the mid-1970s as New Delhi built up its heavy industrial base. The public-sector projects built with Soviet collaboration now account for roughly 40 percent of India's steel output, 80 percent of metallurgical equipment, 40 percent of mining equipment, 55 percent of heavy power equipment, 35 percent of oil extraction, 40 percent of oil processing, and 10 percent of power generation. Nevertheless, these projects are considered by many Indian economists as inefficient—partly because of the poor quality of the equipment. [redacted]

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Growth in bilateral trade had nearly stalled by the mid-1970s, according to US Embassy officials, because Indian purchases of Soviet goods were not sufficient to sustain a rapid growth in Soviet imports of Indian goods. Indian manufacturers had reached a point where they could supply much of the country's requirements for machinery and equipment. A new phase in New Delhi's economic relations with Moscow began in the mid-1970s when the Soviet Union agreed to sell India more petroleum. Several increases in the quantity and price of petroleum provided Moscow with higher rupee earnings, financing a rapid growth in trade in the early 1980s. [redacted]

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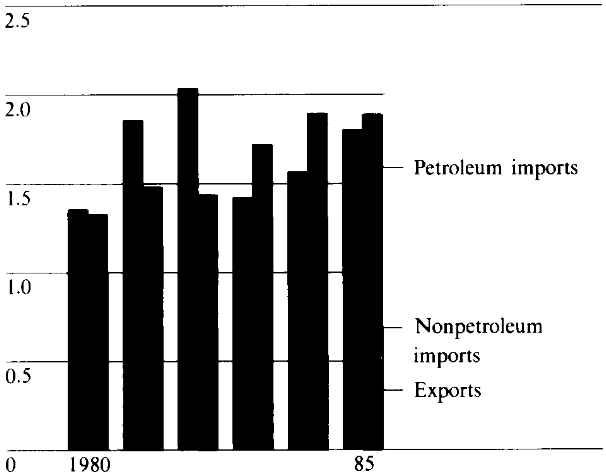
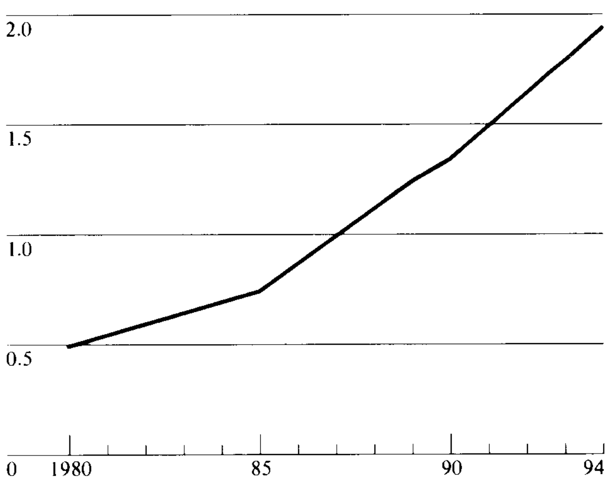
India: Trade Relations With the USSR, 1980-94

Billion US $

Commercial Exports and Imports [a]



Estimated Payments for Military Imports [b]



[a] May include some unspecified military items.
[b] Projections exclude payments for contracts signed in 1986.

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have increased from 12 percent or less in the late 1970s to more than 20 percent in the early 1980s. The increase in import share, while less dramatic, has grown from 7 percent to about 10 percent in the same period. 25X1

The trading relationship in nonmilitary goods consists largely of an exchange of Soviet petroleum for Indian agricultural products and consumer goods. Crude oil and petroleum products have accounted for about 70 percent of Moscow's nondefense exports to India over the last three years and averaged roughly 40 percent of India's net oil imports. India has consistently resisted a major increase in the import of Soviet manufactured goods, contending that its own industry can satisfy most of these needs. 25X1

The Soviets are the biggest buyers of a number of Indian products, with some industries almost wholly dependent on the Soviet market. The Soviet Union became the largest customer for India's tea last year, purchasing 40 percent of Indian exports. In one district, Darjeeling, the Soviets buy 65 percent of the annual tea production. Almost 90 percent of woolen knitwear manufactured in the Punjab goes to the Soviet Union. Sales of cosmetics also are heavily dependent on the Soviet market. 25X1

Indian exports play an important role in New Delhi's military relationship with the Soviet Union. We believe Indo-Soviet bilateral agreements call for an Indian surplus in commercial trade to be used to finance New Delhi's purchases of Soviet military equipment. Several Indian officials have indicated that Indian military payments are taken into account when planning trade adjustments to achieve an overall balance. India has bought more than $9 billion in Soviet arms since 1979. Annual payments to Moscow for arms already purchased will probably increase from an estimated $600 million in 1985 to at least $1.8 billion by 1994. 25X1

The Soviet Union, on the other hand, is not dependent on Indian trade for any critical imports or markets. New Delhi accounts for less than 5 percent of Moscow's trade. 25X1
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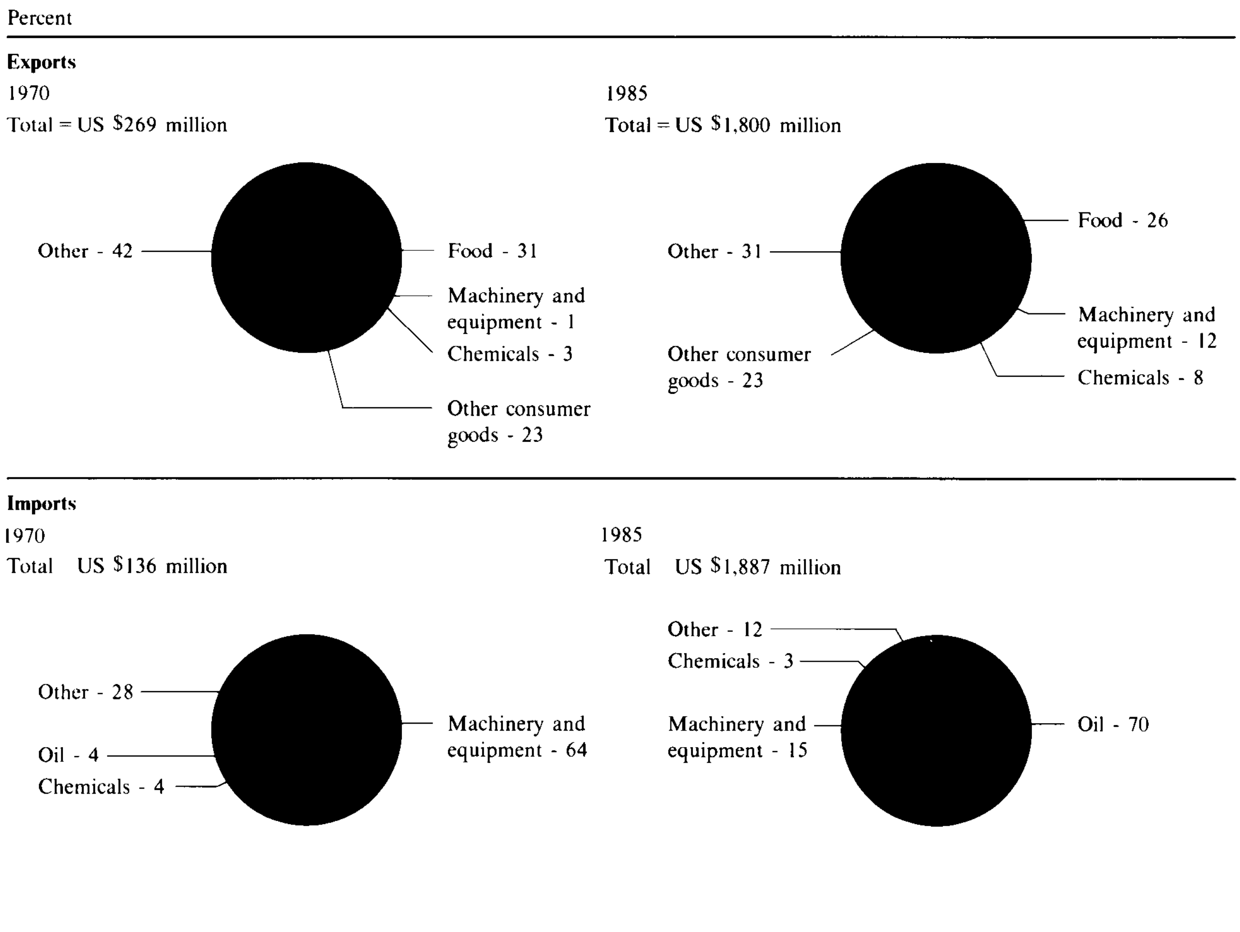
India: Trade With the USSR, by Commodity, 1970 and 1985



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Last December, India and the Soviet Union signed a new trade agreement that calls for as much as a doubling in bilateral trade over the next five years. The agreement set a two-way trade target for this calendar year of $4.1 billion—Indian exports of $2.2 billion and imports of $1.9 billion—an increase of about 10 percent in total trade over 1985. The trade pact also extends the longstanding arrangement under which India pays for its imports in nonconvertible rupees and provides favorable credit terms to Indian importers of Soviet machinery and other equipment.

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Strains in the Relationship

While maintaining a balance in bilateral payments is an objective of the trade protocols, the difficulties in achieving that goal have introduced new tensions in the relationship during the past few years. India's indebtedness to the Soviet Union has increased. Soviet trade statistics indicate that, in the last six years, India's exports to the Soviet Union exceeded imports

Rupee Trade

India's economic relations with the Soviet Union are governed by an agreement to balance all bilateral payments for imports, exports, and debt. All transactions, whether commercial or military, are handled in Indian rupees through the Indian banking system; neither party has any need to pay nor opportunity to earn hard currency.

In 1978 Moscow and New Delhi agreed to make periodic adjustments in the rupee-ruble rate on the basis of changes in the value of the Indian rupee in terms of a specified basket of currencies. The variable exchange rate helps protect Moscow against a decline in the purchasing power of rupees India pays under long-term contracts and for debt servicing. In July the Reserve Bank of India announced a 3-percent devaluation of the rupee in terms of the ruble. The current exchange rate is 13.37 rupees per ruble compared with the earlier rate of 12.96.

by less than $300 million compared with about $700 million in the years 1974-79. We estimate that annual payments due Moscow from 1980-85 for military equipment alone ranged from $350 million to $600 million compared with $150-350 million from 1974-79. India met or exceeded the level of imports from the Soviet Union specified in the trade protocol while Moscow fell below its quota for purchasing Indian exports. Many Indian officials were concerned that, if this trend continued, India would have a difficult time repaying its military debts to the Soviet Union.

Nonetheless, in the short run, India should have little problem meeting its debt payments to the Soviet Union. This year, lower oil prices are swinging the imbalance in India's favor and could lead to a decline in the value of total imports from the Soviet Union. We believe the Soviets lowered the price of their oil to India—by about 50 percent—to market levels after protracted negotiations last spring. This change could save India up to $750 million at the level of deliveries scheduled for 1986. Reflecting the decline in oil prices, the value of total Indian imports from the Soviet Union during the first half of 1986 was down 40 percent from the same period in 1985.

Moscow, however, is putting pressure on New Delhi to offset lower oil prices by increasing purchases of other Soviet goods. The Soviets are threatening to hold down future purchases from India; imports from India for the first half of 1986 already were down 15 percent from the same period last year. Trade talks in June aimed at setting a timetable for a doubling of Soviet textile imports from India ended inconclusively and offered little more than a continuation of current levels. 25X1

Another Indian complaint is that Soviet purchases can vary from year to year, destabilizing parts of India's economy. For example, last year's increase in tea purchases allowed the Soviets to hold off purchases this year, contributing to depressed prices for Indian tea exports, according to Indian press reports. 25X1

India would also like to minimize the indirect hard currency costs it incurs because of certain Soviet trading practices. Moscow imports some Western 25X1 goods through Indian firms, paying in rupees while the Indians bear the hard currency costs. In addition, the Soviets reexport Indian goods to the West for hard currency in direct competition with Indian exports, undercutting India's hard currency earnings. 25X1

Prime Minister Gandhi's emphasis on modernizing India's economy through increased imports of Western technology probably is Moscow's major concern about the future of the economic relationship. Indian officials and businessmen have for several years resisted Soviet pressure for a major increase in imports of machinery and equipment because of poor quality. 25X1 Gandhi's interest in Western high technology and New Delhi's signing of a memorandum of understanding on technology transfer with the United States have increased Soviet concerns that Indian commercial ties to the West will grow at Soviet expense. 25X1

Accommodations

Both sides are working to sustain economic ties. Last year Gandhi signed a $1.2 billion Soviet aid agreement that provides India with a low-interest loan to

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purchase Soviet goods and services. The new agreement apparently marks a shift of Soviet financial support away from Indian manufacturing industries to emphasis on thermal power stations, coal mining, and oil exploration—areas in which Moscow has a better chance in competing with the West. [redacted]

The Soviets also are trying to adjust to Gandhi's call for more private-sector involvement in economic development. About 90 percent of Moscow's imports come from India's private sector, but almost all of its exports go to the public sector. The Soviets are now looking into joint ventures with Indian companies as a way to increase exports to India's private sector. An India-USSR Chamber of Commerce and Industry was set up last year to promote Indo-Soviet cooperation in the private sector. [redacted]

Concern over the potential of lost sales to the Soviet Union has prompted New Delhi to look for new ways to offset lower oil prices and to replenish the Soviet's rupee funds. An Indian trade delegation to Moscow in August agreed to increase purchases of urea, woodpulp, and, for the first time, bought a large amount of ammonia. [redacted]

Outlook For the Relationship

The Gorbachev visit to New Delhi will focus on improving Indo-Soviet economic relations. The hard currency constraints facing both countries provide a powerful incentive for increased bilateral ties. Moscow could increase purchases of consumer goods and manufactured items and New Delhi could import more raw materials and semifinished goods and cover a larger part of its military debt without resorting to hard currency expenditures. The Soviets are willing to make some concessions to solidify the political relationship. Moscow has continued concessionary aid to New Delhi at a time when Western countries are hardening the terms of their loans. [redacted] 25X1

New Delhi will have to increase exports to Moscow to meet economic growth targets and larger payments for purchases of Soviet military equipment. India's current five-year economic plan is pegged to a 7-percent average annual increase in total exports. Tight world markets will force India to work hard to increase trade with Moscow if it is to meet this target.

[redacted] 25X1

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While the incentives to expand commercial trade are strong, we do not see a doubling in Indo-Soviet trade by the end of the decade. Lower world prices for oil and other raw materials as well as ample world supplies are likely to hold down the value of Indian imports from the Soviet Union. We see no major upswing in imports of Soviet equipment, as India looks to the West for sophisticated technology and services for its important growth industries. The private sector, now given more responsibility for stimulating economic growth, has frequently indicated it 25X1 does not want to increase purchases of Soviet equipment. Moreover, New Delhi will have to expand and diversify its hard currency exports and seek Western loans and aid to pay for Western technology. [redacted] 25X1

[redacted] 25X1

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Egypt: Coming to Terms With the IMF

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Faced with rapidly growing debt arrearages and depleted cash reserves, Cairo has begun negotiating with the IMF over terms for a standby program. Resolution of the differences separating Cairo from the IMF, however, may prove difficult. President Mubarak remains fearful that full compliance with Fund-proposed reforms will provoke civil disorder and provide new impetus to the Islamic fundamentalist opposition. Protracted negotiations or, even worse, a deadlock over the terms of an agreement will increase the probability that Egypt will default on debt obligations, drying up short-term credit facilities and forcing sharp cuts in imports. This would leave the government unable to maintain adequate levels of subsidized goods for the population and could contribute to the political unrest Cairo is attempting to avoid. In the absence of an IMF agreement, Egypt will turn to the United States and Saudi Arabia for the extensive new assistance that will be necessary if it is to muddle through.

Earnings Picture Remains Bleak

Egypt's hard currency earnings began to plummet early this year following the dramatic decline in world oil prices. Oil revenues netted only $315 million during the first six months of the year, a 66-percent decline over the same period last year. Despite a reported third-quarter rebound to 154,000 b/d, crude sales remain well below the 200,000- to 250,000-b/d range that had prevailed over the past several years. Moreover, an overly rigid pricing policy is likely to once again place Egyptian crude at a price disadvantage during the fourth quarter if the oil market remains soft. Cairo's oil revenues are unlikely to exceed, by our estimate, $1 billion during 1986, compared with $2.4 billion in 1985.

A decline in most other sources of foreign currency earnings has exacerbated Egypt's financial crunch. Remittances from expatriate workers, the single-largest hard currency earner, also appear to be declining; according to Egyptian Government statements, at least one-fourth of Egypt's 2.2 million expatriate workers returned home this year while others, according to press reports, have suffered pay and benefit cuts. More important, the portion of remittances flowing into official government coffers—as opposed to unofficial deposits held outside the banking system—may be declining even more rapidly, spurred on by a 40-percent differential between the free or black-market exhange rate and the government's best offer rate. 25X1

Tourism, another major hard currency provider, has also experienced a sharp decline. Official Egyptian data show tourist earnings off 43 percent during the first half of 1986 compared with the same period last year. Adverse publicity surrounding terrorist incidents in the Middle East and the Cairo police riots in February appear largely responsible for the downturn. Barring further outbreaks of terrorism, tourism may begin to recover slowly, but not nearly enough to offset losses in much larger oil and remittance earnings. 25X1

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Financial Deterioration Accelerates

Indications that Egypt is drawing closer to an actual default continue to mount. In October, international banks with significant loan exposure in Egypt were reporting arrearages on supplier credits of nine to 10 months, compared with six to seven months in March and April. Many banks dealing with Egypt have been cutting credit lines over the past year, some by as much as 80 percent. In a similar move, the French official government export credit agency recently announced a downward revision of Egypt's credit line because of a rapid increase of arrearages and the threat of default on obligations totaling $180 million. 25X1

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Major Points of Contention

Egypt's attempts to portray the differences separating it from the IMF as minimal are misleading and ignore significant areas of disagreement. Some of the more important differences are:

- ***Exchange Rate Reform.*** *The Egyptian Government proposes to unify the commercial bank rate with the prevailing free market rate over a 12- to 18-month period. The IMF contends that this slow movement will delay an increase in worker remittances, not stimulate exports enough, and not promote capital inflows. It is likely to recommend that the free market rate be applied to all transactions in the commercial bank pool starting January 1987 and that the Central Bank pool be moved into the unified market as soon as possible.*

- ***Interest Rates.*** *Cairo does not believe higher interest rates are necessary. Higher rates, it maintains, would discourage private investment and would encounter the strong opposition of Islamic groups. The IMF, on the other hand, argues that higher interest rates on domestic deposits are needed to attract worker's remittances as well as to slow down the growth of credit and reflect the real cost of capital.*

- ***Energy Prices.*** *Egyptian officials plan to undertake energy price adjustments over the next five years so that domestic prices for petroleum products will be at international levels by 1992. The IMF, while not explicitly opposed to a gradual increase in energy prices, would probably favor a shorter time frame, perhaps three years. In addition, it maintains that major increases in fuel oil, diesel, and kerosene prices must be passed through the entire economy, including the public sector.*

- ***Agricultural-Sector Policies.*** *In spite of some progress in restructuring agriculture and raising procurement prices, the incentive structure is still biased toward such crops as fodder, fruits, and vegetables at the expense of cotton, rice, and other crops in which Egypt has a comparative advantage. Such distortions and disincentives would have to be removed so that farmers receive full world-market value for their crops.*

- ***Industrial-Sector Policies.*** *Public-sector industry operations are still hampered by controls over pricing and employment as well as over centralized decisionmaking. Under an IMF-endorsed program, the government would have to commit itself to a basic restructuring of public-sector industries, including more decentralized management to include greater plant manager control over hiring and output prices.* [redacted] 25X1

[redacted] have expressed surprise at how long Egypt has been able to avoid major import cuts despite its extremely adverse international financial position. [redacted] [redacted] Cairo has tapped the capital reserves of the state petroleum company to meet short-term financial obligations, a move that, if true, could have damaging long-term effects on oil exploration and development in Egypt. Cairo has also reportedly benefited from higher prices in the refined petroleum product market, with refueling of aircraft at Cairo Airport—one of the busiest in the Middle East—a prime money earner. In addition, [redacted] the Mubarak government has drawn heavily on the foreign currency assets of the commercial banking system, a policy that could, if pushed much further, undermine depositor confidence and precipitate a run on the banks and massive capital flight. [redacted] 25X1 25X1 25X1 25X1 25X1

While Egypt has muddled through, we believe that unless Saudi Arabia or some other major donor steps in with large-scale financial assistance within the next six months there is a strong likelihood that Cairo will default on major portions of its international debt. [redacted] the contraction 25X1 in short-term credit lines that began last year and accelerated midyear is finally working its way through the import financing system, and shortages of essential imports could materialize by early next year.

Coming to Terms With the IMF

A growing sense of urgency characterizes the Egyptian Government's efforts to achieve agreement with the IMF over the terms of a standby program. As recently as eight months ago Egyptian officials saw little need for an IMF-endorsed reform program. According to Foreign Minister Abdul Meguid, Cairo's stated goal now is to achieve a standby by mid-December—a deadline most financial observers feel is unrealistic. We believe this major reversal in policy is due, in part, to Cairo's own bleak reassessment of its financial position.

Cairo's basic game plan in negotiating an IMF standby almost certainly is to secure a major economic assistance package with minimal concessions on its part. While such a policy is rational from the standpoint of leaders whose focus remains on preserving domestic order, it suggests a less than wholehearted commitment to the necessity for fundamental reform. As a result, achieving a consensus on the conditions of a standby will be difficult. This will be particularly true if the IMF insists, as is likely, on implementation of some measures before funds are disbursed.

A fundamental point of contention between the IMF and Egyptian officials revolves around the interrelated nature of the reforms themselves. Fund officials stress, correctly we believe, that for a reform package to work all facets of the program must be introduced simultaneously. In this way each element reinforces the other, creating a ripple effect throughout the economy.

It is this issue of timing more than any other that is likely to become the most hotly debated point in the negotiation over a standby. The concept of several major policy adjustments being introduced simultaneously is alien, we believe, to Mubarak's instincts. Instead, his regime espouses the importance of gradualism in introducing change and continues to seek piecemeal implementation of reform. Gradualism may have considerable merit from the perspective of political stability; it is unlikely, however, to ignite the economy and propel it into a period of self-sustained growth. 25X1 25X1

Should negotiations between the IMF and Cairo drag on or, even worse, falter, the capability of Egypt's official economy to meet the population's demand for low-cost goods and services will rapidly erode. Short-term credit facilities, already severely contracting, would virtually dry up, forcing Egypt to finance imports out of already inadequate export earnings. Egypt's large and dynamic parallel economy cannot provide an adequate cushion if the official economy falters. Without major reforms, the government has little access to these resources and it is the government, not the private economy, that underwrites the extensive system of subsidies and price controls. 25X1 25X1

Outlook

If negotiations over a standby stall, Cairo is likely to seek US intervention in pressuring the IMF to adopt a more "realistic" negotiating stance. Such entreaties are likely to become more frequent and forceful as Egypt's economic situation deteriorates. Egypt also will almost certainly ask the United States for further bilateral assistance. We do not exclude the possibility that Mubarak or his aides will, in desperation, threaten to undo some elements of the US/Egyptian special relationship if aid is not forthcoming. 25X1 25X1

Economic adjustments in line with the IMF's present conditions for a standby, on the other hand, would risk an escalating series of strikes and street disturbances, and we are skeptical about the Mubarak regime's commitment to the terms of a standby program if civil disorder breaks out. Cairo would be strongly tempted to rescind important components of the program. Should this occur, the flow of IMF and other multilateral funds contingent on the standby 25X1

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would be suspended. Debt rescheduling under the Paris Club, if not completed, would be similarly affected. The Egyptian Government would, more than likely, turn again to foreign donors—particularly the United States—for emergency relief, citing the threat of political instability as transcending economic considerations.

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Briefs

Energy

Spot Oil Market Developments

[redacted]

Spot oil prices have been volatile during the past several weeks in response to both events and market fundamentals. Prices for several key crudes dropped by nearly $1.00 per barrel following the conclusion of the OPEC meeting on 22 October, then increased a week later on the news of Saudi Oil Minister Yamani's ouster and 25X1 his replacement's call for an OPEC target price of no less than $18 per barrel. In recent days, prices have again slipped on the belief that the market remains oversupplied and that significantly higher prices are only possible if OPEC comes up with a workable production allocation scheme for 1987. A number of producers, including the Saudis and the Mexicans, have offered $0.50 per barrel discounts on recent shipments. North Sea Brent and West Texas Intermediate crudes are now selling at about $14 and $15 per barrel, respectively. Market conditions remain uncertain given the large inventory buildup that took place during the second and third quarters of this year. In the coming weeks, inventory drawdowns and the seasonal increase in demand will determine if OPEC can increase production without seriously undermining prices. [redacted] 25X1

Venezuela Developing Heavy Oil Belt

[redacted]

The Venezuelan state oil company (PDVSA) is experimenting with a water injection process to develop the heavy oil belt north of the Orinoco River—one of the world's largest and least developed hydrocarbon deposits. [redacted] 25X1

[redacted] 25X1

Venezuela is keenly interested in such sales, because they consider the water-heavy oil emulsion a nontraditional energy source falling outside their OPEC quota. Other OPEC members are almost certain to challenge this as an attempt at quota evasion. [redacted] 25X1

Indonesia Postpones Nuclear Power Plant

[redacted]

Jakarta has postponed building its first nuclear power plant for financial and safety reasons. The Director General of the National Atomic Energy Agency told reporters last month that construction would be difficult to justify in light of the 25X1 depressed oil-based economy. He also attributed the delay to doubts over nuclear plant safety in the light of the Chernobyl' accident. Despite the postponement, he claimed the government is committed to continuing nuclear research with foreign technical assistance, as well as with the cooperation of the International Atomic Energy Agency. Even if oil prices rebound soon, however, Jakarta will probably first restore funds for other shelved programs—such as thermal and hydroelectric power and transportation systems—before allocating resources to such long-range programs as nuclear power. As a result, Indonesia is unlikely to meet its goal of having a nuclear power plant operating before the year 2000. [redacted] 25X1

International Finance

South Korea Reduces Foreign Debt

[redacted]

South Korea plans by yearend to reduce its officially estimated $47 billion foreign debt—the fourth largest among LDCs—by $1.2 billion. Moreover, [redacted] 25X1 Seoul may refrain from borrowing until mid-1987, despite the availability of favorable terms, including Japanese bank offers of rates below 25X1 LIBOR. Seoul believes the reduction is possible because most economic analysts in South Korea expect a $3.5-4 billion current account surplus this year, the first since 1977, according to the US Embassy. They also realize that a rebound in oil prices, the dollar, and interest rates could reverse the surplus and make the debt reduction a one-shot deal. Despite Seoul's longstanding policy of reducing short-term debt—from $12.4 billion in 1982 to less than $10 billion last year—South Korea's need for export financing will probably shift the focus to retirement of older, high-interest, medium-term loans. While South Korea's annual $6.5 billion debt service will not be greatly affected, the Chun government may gain politically because foreign debt has been a prime target for opposition sniping. The government's move to limit borrowing probably will increase outside pressures for faster financial market liberalization. Foreign bankers, who profit from arranging Seoul's forays into international financial markets, will be anxious to expand into new financial activities currently off limits to foreigners. [redacted] 25X1

Global and Regional Developments

Latin America's Dwindling Foreign Investment

[redacted]

Foreign direct investment in Latin America is dropping sharply this year, at a time when worsening trade balances and cuts in new lending are squeezing debtor country foreign exchange positions. According to our calculations, direct investment—including reinvested earnings as well as new capital inflows—in the region 25X1 from abroad will fall below $3 billion compared with $4 billion in 1985 and nearly $8 billion in 1981. Economic disincentives and political uncertainties are both hampering new investment. In Brazil, for example, the largest Latin beneficiary, foreign investment is expected to plunge from $1.2 billion last year to about $750 in 1986, the lowest total in 15 years, according to recent Brazilian statistics. The US Embassy reports that multinational corporations are concerned about growing economic nationalism—particularly calls for expanding market reserve protection—and are deferring investment decisions pending a clearer view of future government economic policy, including the elimination of price controls. Substantial declines in foreign direct investment in other leading recipients—Mexico, Argentina, and Colombia—reflect restrictive government policies, weak regional market conditions, guerrilla activity, and diminishing opportunities for converting debt to equity. Most Latin governments are hoping for substantially greater foreign investment, but we judge that widespread nationalist political sentiment in the region will limit them from taking more than modest steps to liberalize their foreign investment regulations. [redacted] 25X1

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Indian-Chinese Science Cooperation Considered

[redacted]

A report prepared by a delegation of leading Indian scientists, including the Chairman of the Science Advisory Council to Prime Minister Gandhi, has recommended Sino-Indian collaboration in several areas of research, including lasers, electronic materials, plant tissue culture, and seismology. The scientists, 25X1 who visited China last July as guests of the Chinese Academy of Sciences, were reportedly impressed by China's rapid progress in S&T over the last eight years, according to Embassy reporting. They acknowledged that the Chinese had surpassed them in a number of areas—including those proposed for cooperation. Their impression that Chinese institutes are well equipped and have strong links to industry is in marked contrast to comments by Western observers, and probably reflects the limited scope of their visit as well as the comparatively poorer facilities in India. We do not expect either government to endorse formal S&T cooperation, however, because of bilateral strains over mutual accusations of border violations and the September Sino-Pakistani nuclear cooperation agreement. [redacted] 25X1

Cuban Nuclear Cooperation Agreements

[redacted]

Cuba reportedly has concluded nuclear cooperation agreements with India and Argentina, reflecting Havana's growing concern over the safety of its nuclear power program as well as political motives. [redacted] 25X1
[redacted] the agreement with Argentina that was to have been signed during 25X1
President Alfonsin's visit to Cuba on 18-19 October will involve training of Cuban nuclear technicians in safety and protection practices. The agreement not only suggests that Havana is more concerned about nuclear safety since the Chernobyl' accident, but also represents an attempt to expand bilateral ties to Buenos Aires. Details of the agreement signed with India, reported by Caribbean press on 19 October, are not yet available, but the accord probably is aimed at demonstrating Cuba's solidarity with the Nonaligned Movement and increasing Havana's stature in the world. Neither agreement appears to involve the transfer of sensitive technologies, or to signify any decrease in Havana's reliance on the Soviet Union for its nuclear program. [redacted] 25X1

National Developments

Developed Countries

Japanese Concern About Technology Loss

[redacted]

Japan's National Police Agency is seeking increased resources in order to reduce the high level of technology diversion to the Warsaw Pact nations. [redacted] 25X1 the police want tighter controls on Soviet Bloc 25X1 activities to thwart what they regard as disturbingly high levels of technology 25X1 transfer. [redacted] the inability of the police to monitor Warsaw 25X1 Pact visitors closely and industry's failure to recognize the strategic value of many dual-use technologies. With the budget for next year now under review, the National Police Agency apparently is hoping to strengthen its current program of encouraging expulsions of Eastern Bloc diplomats suspected of technology theft and providing briefings to Japanese industry on Soviet collection activities. The agency is also attempting to wrest responsibility for investigations of suspected COCOM violations from MITI. Principal authority to stop illegal trade, however, which is the Bloc's primary channel for technology acquisitions from Japan, remains firmly with MITI. Police oversight of foreign visitors is also constrained by Japan's lack of an espionage law. The ruling Liberal Democrats are scheduled to submit a new espionage bill next month, but it will face stiff opposition resistance, even though it is narrower in scope than one defeated last year. [redacted] 25X1

West German Growth Prospects Uncertain

[redacted]

Concern about prospects for growth may increase pressure on Bonn to stimulate the economy [redacted] several regional West German 25X1 economists believe GNP growth next year could be only 2 to 2.5 percent—less than the 2.8 percent estimated by West Germany's five leading economic 25X1 institutes. [redacted] the economists believe export growth will be 25X1 much weaker than projected; as a result, expansion in 1987 will be even more dependent on domestic spending. Most economists, however, expect the surge in domestic demand to dissipate sometime next year. If growth slows, Finance Minister Stoltenberg is said to be willing to reexamine Bonn's plan to enact tax reform in 1989. Bonn is not likely to expand the scope of tax reform or implement it a year early, however, unless growth slows markedly by spring. Moreover, the Bundesbank probably will not enact monetary measures to stimulate the economy until it can drain the financial system of the excess liquidity that built up this year. [redacted] 25X1

Impending Shakeup in French Trade Ministry

[redacted]

A high-level shakeup in the Direction des Relations Economiques Exterieures (DREE) is likely within the next three to six months, [redacted]. 25X1 Philippe Jurgensen, who is closely tied to the previous Socialist government, is likely to be removed as Director and replaced by Francois David, a former DREE 25X1 official who is currently staff director for Trade Minister Michel Noir. David, in turn, is likely to be replaced by Jean-Pierre Landau, currently number-three man at the DREE in charge of multilateral affairs and a key French point man on the new GATT round. The departure of Jurgensen, [redacted] has long been seen as inevitable. The choice of David as his successor indicates that trade policy will probably be left in the hands of professionals who have come up through the ranks in the DREE. In addition to the DREE changes, France's lackluster trade performance could increase pressure on Trade Minister Noir, a political appointee who has little experience in trade affairs and has won little respect from DREE professionals. Prime Minister Chirac would probably like to retain Noir but could assign him to another ministry if criticism grows. [redacted] 25X6 25X6 25X1

Sweden's Public-Sector Strike Aftermath

[redacted]

The month-long public-sector strikes that ended on 30 October highlighted growing strains between the Social Democratic government and its union allies. The strikes began when both the unions and the employers rejected a mediator's "final" offer. Last month, however, the government moved to reach a settlement, saying it would make room in the budget for public-sector real wage increases. Despite a fear of inflation and a commitment not to raise taxes, the government agreed to increase its wage bill by 15 percent—roughly the same proposal it rejected in September. Although the unions conceded to postponing the pay parity issue until 1988, they did obtain a pay hike for lower paid workers 50-percent larger than was offered in September. The strike—the third in the public sector in 18 months—demonstrates increasing problems within the Swedish collective bargaining system. Despite the mediator mechanism, the negotiations effectively pitted the Social Democratic government against its nominal trade union allies. In the end, the government felt forced to give ground on its policy of wage and government spending restraint—the core of its anti-inflation strategy—to demonstrate its prounion credentials. Moreover, the private-sector unions have become increasingly critical of their public-sector counterparts. The private-sector unions realize that past public-sector wage increases have led to higher government expenditures, higher taxes, and increased inflation, which in turn stymie private-sector real wage increases. [redacted] 25X1 25X1

New Zealand Government Riding High Despite Economic Woes

[redacted]

New Zealanders' optimism about their economy contrasts markedly with forecasts of a fourth-quarter contraction—GDP has declined for the past nine months—rising inflation, and growing unemployment. According to recent polls:

- The largest share of respondents since September 1985 believe the economy will be better 12 months hence. 25X1
- More New Zealanders are satisfied with the current state of the economy than at any time since Prime Minister Lange was elected in July 1984.
- Support for the Labor government's handling of the economy has risen to 48 percent, the highest approval rating since October 1985.

Inflation during the third quarter, however, reached a 15-month high of 14 percent at an annual rate, and almost certainly will increase this quarter because a national sales tax is being implemented. Unemployment, above 4 percent, is high by New Zealand standards, and New Zealand economists predict it will top 5.5 percent next year. [redacted] 25X1

Less Developed Countries

Brazil's Weakening Trade Position

[redacted]

A deterioration of Brazil's trade balance this year probably will lead to the first sizable current account deficit since 1983 and increase pressures for substantial economic adjustments. In our judgment, Brazil's vaunted trade surplus will decline 25X1 from last year's $12.5 billion to $11.5 billion, largely because of a major dip in export earnings since May. We project a fall in exports below $25 billion in 1986 largely due to low prices for primary commodities, robust domestic demand for consumer goods, and a prolonged freeze of the exchange rate against the dollar that reduced price competitiveness. Meanwhile, Brazilian imports in 1986 may slightly exceed last year's $13.2 billion as sharply increased purchases of food and capital goods more than offset a $2.5 billion cut in oil imports. To deal with the eroding trade position, the government probably will resume aggressive devaluations and take steps to cool domestic demand. The 1.8-percent devaluation last month, although insufficient to match domestic price increases, may signal such a new policy. There is some risk, in our judgment, that Brasilia may reject such adjustments as politically infeasible and adopt a more strident stand with creditors in its quest for major cuts in annual debt payments. [redacted] 25X1

Brazil Adjusts the Cruzado Plan

[redacted]

President Sarney will announce adjustments to the Cruzado Plan—his anti-inflation program—before Brazil's congressional and gubernatorial election on 15 November, [redacted] The local press is decrying 25X1 growing food shortages, rising inflation, and the halt in investment, prompting Sarney to consider price increases on some foods in short supply and new moves to encourage savings. A final decision on details has not been made, [redacted] 25X1 but the President believes his willingness to make tough decisions shortly 25X1 before the election will improve his standing with the public. Sarney probably is worried about growing discontent among voters and declining business confidence. Price hikes will sit well with the business community but will do little to alleviate the shortages before election day. They risk a popular backlash against ruling-coalition candidates, particularly from middle-class voters, who have overwhelmingly supported Sarney's coalition in the past. [redacted] 25X1

Mexico Looks To Boost Automotive Exports to the United States

[redacted]

US and other foreign automotive firms with plants in Mexico are planning to expand exports of vehicles and parts to the United States. The automakers are responding to weak domestic sales brought on by the dismal state of the Mexican economy. For its part, the Mexican Government hopes that the auto sector will 25X1 spark an industrial upturn through its export actions. We believe that a sharp rise in exports would require sizable foreign investment to update product offerings. In addition, Mexican exports face tough competition from Japan as well as from other developing countries such as South Korea and Taiwan. [redacted] 25X1

Zaire Backpedaling on Economic Reform

[redacted]

Zaire's ruling party last week proposed sweeping economic policy changes that may jeopardize IMF and World Bank programs. The US Embassy reports that party leaders recommend limiting Zaire's debt service payments, returning to a fixed exchange rate, and reimposing trade restrictions. Although President Mobutu is not formally obligated to implement these proposals, he has endorsed them in principle. He has also demoted the Prime Minister, who has been closely identified with the current reform effort. The IMF and the World Bank have suspended disbursements pending official clarification of Kinshasa's economic policy intentions, according to the Embassy. The new proposals cap months of growing frustration with more than three years of IMF-backed austerity. Mobutu may be trying to renegotiate current agreements and probably is not prepared to abandon all cooperation with the multilateral institutions. The IMF and the World Bank are unlikely to relax significantly their conditions for credit, however, increasing the possibility that Mobutu will choose a go-it-alone strategy by next year. [redacted] 25X1 25X1

Seychelles President Reacts to Currency Crisis

[redacted]

Economic advisers have convinced President Rene that the government's high capital expenditures are to blame for the country's severe foreign currency shortage [redacted]. Rene reportedly has informed his cabinet that he is now prepared to reduce capital spending, close or sell some inefficient parastatals, and restrict imports. In addition, Rene may indirectly devalue the country's currency by removing its link to the SDR. Although receipts from tourism, the main source of foreign exchange, have risen since 1983 to a record $47 million last year, local banks and businessmen are having trouble obtaining hard currency from the Central Bank for new letters of credit or ones already approved. Although the proposed moves would help alleviate some of the Seychelles economic problems, Rene has a poor track record in implementing reforms and his willingness to adopt politically risky measures in light of a recently alledged coup plot is questionable. [redacted] 25X1 25X1 25X1

King Hussein Addresses the Jordanian Economy

[redacted]

King Hussein's 1 November speech focused on ways to reactivate Jordan's badly slumping economy. The economic situation is worsening as all important external sources of income—Arab aid, worker remittances, and export earnings—continue to decline. Moreover, foreign exchange reserves now are the equivalent of less than six weeks' imports at the current rate, according to the US Embassy. Shrinking export earnings have pushed many businesses, particularly in agriculture and construction, to the brink of bankruptcy, and, more disturbingly, contributed to growing unemployment. To counter these trends Hussein proposed government assistance to agriculture, industry, and construction, including price supports, concessionary loans, export incentives, and vocational training. Without new infusions of aid, however, the likely decline in external earnings over the next two years will force Amman to constrain the economy further. Additional austerity may generate labor discontent, especially among the unemployed workers returning from abroad and West Bank Palestinians. Declining revenues may also disrupt Jordanian funding of the West Bank portion of its development plan, which Amman sees as a way of promoting the peace process among moderate Palestinians. [redacted] 25X1 25X1

Iranian Government Criticized in Official Press

[redacted]

A recent editorial in a government-controlled newspaper stridently criticized the regime's handling of the economy. The article attacked the government for failing to deal with inflation, unemployment, and falling production and expressed concern that these difficulties might threaten popular support for the regime. It also claimed that press censorship had contributed to anxieties over shortages of food and fuel and had encouraged rumormongering. The editorial is the harshest public criticism that the government has allowed. It probably reflects growing concern among Iranian leaders about the economy plus an effort to prod the regime into being more candid about current difficulties and to prepare for severe shortages this winter. Although no faction was singled out for criticism, the publication of the article may reflect factional fighting over economic policies and dissatisfaction with the cost of the war. [redacted] 25X1

25X1

Pakistani Efforts To Increase Cotton Exports

[redacted]

Pakistan's subsidized raw cotton exports have undersold many world producers this year—including the United States—but Islamabad is troubled by delays in deliveries that have irritated major buyers, [redacted] 25X1
[redacted] Islamabad has increasingly targeted traditional US export markets—notably South Korea, Taiwan, Japan, and Western Europe—since China ceased Pakistani cotton imports in 1984. China had been Pakistan's largest cotton export market. Islamabad tasked its Cotton Export Corporation (CEC) in early 1986 to expand export markets and the CEC has budgeted over $125 million for export subsidies. CEC officials freely admit that they will do whatever it takes to sell Pakistan's surplus cotton, even if world prices remain low. The US Agricultural attache has revised his forecast for Pakistan's cotton exports upward in light of this year's expected bumper crop. In 1985, raw cotton sales accounted for almost 10 percent of total Pakistani exports. [redacted] 25X1 25X1

25X1

Malaysia Selling Local Shares to Foreigners

[redacted]

Kuala Lumpur, in an effort to trim its budget deficit and bolster private investment—key elements in the government's economic recovery strategy—is approving the sale of locally owned shares of Malaysian corporations to foreigners. The decision was foreshadowed last spring when Prime Minister Mahathir suspended Malay capital ownership targets under the New Economic Policy, despite the risk of intensifying ethnic Malay fears that they will be left further behind economically by the government's efforts to deal with the economic slump. Last week the government sold 15 percent of its shares in the national airline, Malaysian Air System, to foreign investors, according to the US Embassy. In October, Malaysia's Sime Darby, ASEAN's largest private conglomerate, sold up to 10 percent of its holdings in two subsidiaries to major international investors. [redacted] 25X1

25X1

Leading Indonesian Businessman Comments on Devaluation

[redacted]

Indonesian tycoon and presidential financial adviser Liem Sioe-Liong—reputedly the sixth-wealthiest man in the world—believes that the rupiah devaluation in September has hurt the government's credibility and damaged prospects for foreign investment, [redacted] Liem, who indicated that he is transferring capital abroad, believes that rising prices and uncertainty over future economic policies discourage foreign investors. His views on the devaluation 25X1 25X1

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almost certainly reflect concerns in the domestic business community. For example, the US Embassy reports that the devaluation, which came after repeated government denials, has eroded confidence in the Soeharto regime's ability to cope with Indonesia's economic slump. Liem's pessimism, however, probably also reflects financial losses he suffered because of devaluation. Unlike Soeharto family members who, according to the US Embassy, allegedly purchased US dollar futures hours before the currency adjustment, Liem reportedly converted $140 million to rupiah just prior to the devaluation. Dispite Liem's apparent bitterness, we believe his remarks are significant because of his longstanding business ties with the President and his dominant role in Indonesian financial circles. [redacted] 25X1

Impact of Solomon Islands Budget Austerity

[redacted]

The Solomon Islands Government has sharply pared back spending because of declining tax revenues from copra, timber, and palm oil exports. Some of the spending cuts have long been needed; for example, the government hiring freeze should help the Finance Ministry's campaign to reduce the bloated and inefficient public service. Honiara is also reducing travel and foreign training for government personnel. Other cuts hit at US interests—a 50-percent reduction in the subsidy for the Solomon Islands Broadcasting Corporation eliminates the daily broadcasts of VOA-supplied programs and news. In addition, according to US Embassy officials in Port Moresby, the austerity measures appear to rule out participation by the Solomon Islands in US military training programs. [redacted]

25X1

25X1

Communist

US Firm Assists in Assessing Chinese Aircraft

[redacted]

Chinese aircraft engineers are working side by side with their US counterparts at a US aerospace company evaluating the performance of China's Y-7 aircraft and comparing it with all other comparably sized transports now in operation worldwide. Early test results—which show that the 52-seat Y-7 performs poorly in virtually every category—may convince the Chinese that making the Y-7 an acceptable, airworthy aircraft for the world market would be more costly than they anticipated. Furthermore, a comparison of the characteristics of Y-7 parts and components is expected to prove that many Y-7 components are much heavier than those of similar aircraft. Still, the aircraft's overall performance could be improved significantly—although not to world standards—by reducing the weight of selected components. Nonetheless, the Civil Aviation Administration of China (CAAC) is on record as favoring Western aircraft. CAAC has only 15 Y-7s in its inventory—largely a result of political pressure—and another 40 on order. Moreover, China's aeronautics ministry—the builder of the Y-7—has explored coproducing either the 36-seat Canadian De Havilland Dash 8-100 or the 42-seat French-Italian ATR-42. Coproduction of either aircraft would advance China's commercial aviation sector and eventually provide an aircraft suitable for the world market. [redacted]

25X1

25X1

China Seeking US Aircraft Equipment

[redacted]

China is negotiating a $10 million contract with a US firm to design and build new constant speed drives to power accessories on its Trident passenger jets. Without new drives, these jets—which compose 20 percent of China's passenger jet inventory—will not be operable after 1988 or 1989. The Chinese probably will 25X1
view the purchase as cost effective because the Tridents primarily carry foreign tourists—an important source of hard currency. [redacted] 25X1

China Upgrading Aluminum Plant

[redacted]

China is upgrading the 25,000-metric-ton-capacity Baotou Aluminum plant in Inner Mongolia to 70,000 tons. The Chinese plan to increase aluminum production to reduce their dependence on imports and conserve foreign exchange. Because aluminum is an electricity-intensive industry, China also is working to bolster 25X1
electric power capacity in the region. A new coal mine at Shenfu, 200 kilometers from Baotou, will fuel a 23- to- 28-megawatt power plant nearby. In addition, a rail spur is under construction to transport as much as 5 million tons of coal from Shenfu to Baotou, which may also fuel electricity generation for the aluminum and other local plants. [redacted] 25X1

Cuban Hard Currency Situation Deteriorating

[redacted]

With prolonged debt rescheduling talks exacerbating Cuban foreign payments problems and with no increase in Soviet hard currency assistance expected, President Castro appears to have little choice but to eventually tighten economic austerity. Negotiations with commercial creditors stalled when Havana rejected 25X1
the creditors' offer in September of a $60-70 million package and insisted it needed at least $300 million in new loans to cover planned imports this year. [redacted] Havana may try to negotiate its July 25X1
rescheduling agreement with the Paris Club in hopes of reversing the commercial creditors' decision not to commit any new funding. In any case, we believe Havana faces a major crunch on its Paris Club payments by the end of this month. [redacted] many Western traders are reviewing lending policies 25X1
after experiencing payment problems with the Cubans. [redacted] 25X1

Cuban policymakers appear to be planning spending cuts, probably under the assumption of little immediate hard currency relief. [redacted] 25X1
[redacted] Havana is planning to postpone all but emergency imports until spring 25X1
1987. [redacted] Havana 25X1
may have to resort to such measures as redirecting domestic food for export, conserving more fuel for reexport, and slowing some industrial production. Increased austerity, however, is likely to raise the level of domestic dissatisfaction already exhibited in escalating antisocial activity. [redacted] 25X1

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