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International Economic & Energy Weekly

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International Economic & Energy Weekly [redacted] 25X1

Synopsis

1 **Perspective—Dim Future for International Commodity Agreements** [redacted] 25X1

In recent negotiations of major international commodity agreements—cocoa, coffee, and rubber—consuming countries have insisted on greater adherence to market price trends—keeping prices lower in today's glutted markets—and a number of producing nations are accepting the demands. [redacted] 25X1

3 **Japan: Is Tokyo Serious About Boosting Domestic Demand?** [redacted] 25X1

Prime Minister Nakasone has generated little domestic support for reorienting economic policy despite his ringing endorsement six months ago of the Maekawa Commission's proposals for reducing the economy's dependence on exports. [redacted] 25X1

[redacted] 25X6

11 **Nigeria: Launching Economic Reforms** [redacted] 25X1

After five years of resisting significant economic adjustment in the face of plunging oil revenues, Nigeria recently has embarked on an economic reform program to pave the way for a reconciliation with its official commercial creditors. Nevertheless, the anticipated financial relief will not compensate fully for the halving of oil export earnings this year, and President Babangida's government will probably face growing political pressure to extract more concessions from creditors, or even to unilaterally limit debt payments and abandon the reform effort. [redacted] 25X1

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15 **El Salvador: Economic Impact of the Earthquake** 25X1

The earthquake that struck San Salvador last month—leaving an estimated 1,000 dead and more than 10,000 injured—will further burden a government beset by severe economic problems and a destructive seven-year insurgency. In large measure, El Salvador's ability to recover from the earthquake—while maintaining its war effort—will be dependent on the government's success in generating new sources of development assistance and on continued economic and military aid from the United States. 25X1

19 **Increasing Consolidation in the International Telecommunications Industry** 25X1

The global telecommunications industry is undergoing a period of rapid change as firms struggling to reduce R&D costs and increase global sales are turning to international joint ventures, mergers, and other cooperative agreements. 25X1

[redacted] 25X1

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Perspective

Dim Future for International Commodity Agreements [redacted] 25X1

In recent negotiations of major international commodity agreements—cocoa, coffee, and rubber—consuming countries have insisted on greater adherence to market price trends—keeping prices lower in today's glutted markets—and a number of producing nations are accepting the demands. This is in sharp contrast to past negotiations, where LDC producers demanded high support prices and frequently found allies among many developed consumer countries who viewed the agreements as a form of aid. We believe that this trend toward agreements that respect market trends will continue in the foreseeable future. [redacted] 25X1

Four commodity agreements are technically in effect under the UNCTAD Integrated Program for Commodities. In the past year, however, the International Tin Agreement collapsed, negotiations for renewal of the International Natural Rubber Agreement stalled, and efforts to stabilize surging prices under the International Coffee Agreement failed. Only the International Cocoa Agreement was successfully renewed this past summer to run through 1989. Most observers feel its new market-oriented price adjustment mechanism will be a model for other agreements. [redacted] 25X1

The shift in the negotiating environment toward consuming country insistence that market trends drive commodity agreements reflects the psychological and monetary toll of the tin agreement collapse. In addition the inability of commodity agreements to stabilize prices has pushed consumers to reconsider the economic mechanisms of the agreements. Moreover, the general decline of commodity prices from their 1980 peak in the face of oversupply has only been worsened by attempts to prop up prices for producers' benefit. As a result, most consuming nations will not support any new agreements with price distorting provisions but may continue to support the existing commodity agreements if they are made more market responsive. [redacted] 25X1

The failure of international commodity agreements will take its toll on some countries while aiding others. High-cost producers, such as Bolivia for tin, will face elimination from the market because they are unable to compete at lower unsupported prices. In contrast, emerging, efficient producers such as Brazil will reap benefits as markets weed out less efficient producers. Producers of cocoa and rubber, such as Ghana and Malaysia, initially will be adversely affected by the release of the bufferstocks placing downward pressure on prices. Lower prices, however, may slow inroads being made by substitutes into commodity markets. Meanwhile, consumers will benefit from the lower prices. [redacted] 25X1

[redacted] 25X1

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Japan: Is Tokyo Serious About Boosting Domestic Demand?

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Prime Minister Nakasone has generated little domestic support for reorienting economic policy despite his ringing endorsement six months ago of the Maekawa Commission's proposals for reducing the economy's dependence on exports. The momentum for turning growth inward, never strong, slowed considerably over the summer as Nakasone focused on domestic politics and Tokyo's concern over imminent protectionist measures waned. Because the Japanese do not anticipate across-the-board trade restrictions or a severe and prolonged recession—despite the stronger yen—Tokyo is unlikely to make a concerted effort to stimulate domestic demand anytime soon. Moreover, many Japanese strongly believe that economic growth cannot be maintained by a reliance on domestic demand. Japanese leaders who hold this view want to implement those Maekawa recommendations that enhance international competitiveness while channeling Japan's massive trade surpluses into programs, such as foreign aid, that can reap public relations benefits.

The Maekawa Recommendations: A Rocky Start . . .

Last spring Nakasone hailed the report of the Maekawa Commission—his blue-ribbon panel on trade policy—as the first of many Japanese steps to reduce the economy's dependence on exports. Many of the panel's recommendations only replayed previous trade proposals, but the report contained one novel element—a preamble suggesting Japan set as a goal the reduction of its current account surplus to an "internationally harmonious" level. Although stopping short of recommending that Tokyo end its six-year campaign of fiscal austerity, the commission proposed reforms to increase domestic spending on goods and services, reducing the need for Japanese business to seek foreign markets. The Maekawa report was successful—from Tokyo's perspective—in muting US and EC criticism of Japan's trade practices before and during the Tokyo economic summit in May.

In the ensuing six months, however, we have seen little evidence that the ruling party, key ministries, or leading businessmen have embraced the basic message—that Japan must encourage a shift away from exports to the domestic market. As a case in point, Tokyo has still not adopted as official policy a reduction of the current account surplus to "preserve international harmony." Recent US Embassy reporting suggests that a special advisory committee chaired by former Bank of Japan Governor Maekawa may recommend a surplus reduction target by yearend, but we doubt that Tokyo will abandon its longstanding opposition to numerical targets. 25X1

. . . But Selective Implementation

Tokyo is moving ahead on several of the Maekawa proposals for reasons having little to do with sparking domestic growth. These steps will probably do more to enhance Japan's international competitiveness than to reduce its trade surplus. Government bureaucrats and politicians, for example, have used the report's recommendations to argue for implementing items long on their agendas: 25X1

- The Japanese plan to begin a wide-ranging ***reform of the tax code*** next year, but the US Embassy notes little relationship between tax reform and the Maekawa proposals. The planned combination of income tax cuts and indirect tax increases will probably result in little net stimulus to the economy.

- MITI's ***industrial restructuring program*** is designed to phase out uncompetitive segments of the steel and textile industries and to shift the resources to more productive, but not necessarily domestic-market- oriented, sectors.

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Japan: Common Themes of Recent Trade Packages, 1982-86

Measures Proposed for Study or Implementation	May 1982	January 1983	October 1983	April 1984	December 1984	April 1985	July 1985	Maekawa Report
Tariff cuts	X	X	X	X	X	X	X	X
Standards and certification improvements	X	X	X	X		X	X	X
Low-cost import financing	X		X			X		
Financial liberalization			X				X	X
Expanded agricultural imports		X		X			X	X
Improved distribution system	X							X
Increased government procurement of foreign goods		X					X	
Housing incentives			X					X

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- Tokyo is drafting a new ***five-year plan for the coal industry*** that recommends cutting its already small domestic production by one-third to reduce high government subsidies. Moreover, the relatively high cost will discourage increased Japanese imports of US coal.

- Japanese companies are increasing ***overseas investment***—a process accelerated by the strong yen. MITI sees this as a counterpart of industrial restructuring as well as an outlet for funds generated by the trade surplus. Growing overseas investment also suggests Japanese companies see continued weak domestic demand and therefore anticipate better profits elsewhere.

Measures more likely to expand domestic spending—such as substantial tax reduction, increased public investment, tax incentives for housing, and liberalization of the heavily subsidized agricultural sector—show little sign of being implemented soon. 25X1

Maekawa Over the Long Haul

Over the next year, the Maekawa framework is most likely to survive as a tool for managing the US-Japan economic relationship. Recent discussions in government ministries and the ruling party—which have focused largely on the public relations aspects of the Maekawa proposals—support this view. After Nakasone steps down as prime minister—his current term expires in October 1987—the overall Maekawa package will probably fade away, as have many other reports by Japanese study groups. In fact, the bias in favor of other, more widely supported policies that would contribute to the demise of the Maekawa approach is striking. In particular, the underpinnings of Japan's current economic policy—marked by a focus on budget austerity and small government—remain strong:

- Keidanren, the prestigious big business organization, continues to hold that the private sector would not be able to generate an acceptable level of economic growth in the face of the higher taxes needed eventually to pay for deficit financing.

- Japanese bureaucrats and politicians believe Tokyo must slow the growth of the national debt now to prepare for the onslaught of additional payments to support a rapidly aging population in the 1990s. These views were strongly represented this summer in the final report of the Administrative Reform Council, the group largely responsible for "selling budget austerity." 25X1

Key Maekawa Recommendations: A Report Card

Recommendation	Impact [a]	Comment
Expand domestic demand		
Boost housing construction and public works	Reduce	Current pump-priming plan contains a few minor housing incentives. FY87 budgets may contain modest increases in public works spending.
Stimulate consumption by tax cuts, higher wages, and shorter hours	Reduce	Little sign yet of consumer-led recovery. Lower oil prices and strong yen have not had major impact on consumer prices. Planned tax cuts may have little impact on consumer spending because people expect a comparable indirect tax.
Transform the industrial structure		
Rationalize depressed industries, including textiles and coal	Reduce	Political pressure and special interest groups slowing plans to phase out uncompetitive industries, such as some textiles. New industrial restructuring law likely to enhance competitiveness rather than encourage firms to switch to the domestic market.
Ease restrictions on agricultural imports, except rice and wheat	Reduce	Most controversial Maekawa recommendation; Nakasone has expressed interest in reforming the price support system for wheat and rice, but any change would be gradual and long term.
Encourage outward foreign investment	Unclear	Tokyo has provided a few tax and loan incentives, but the primary impetus for foreign investment—especially in the United States—appears to be a combination of protecting export markets, exploiting new technological developments, and taking advantage of the weak dollar.
Improve market access		
Implement 1985 action program designed to ease import barriers	Reduce	Sticking to action program timetable. Imports of manufactures—especially intermediate goods from Asian NICs—have risen briskly.
Streamline distribution system	Reduce	No substantive action taken. Lack of competition within the multilayered distribution system has kept retail prices of imports from falling in line with yen appreciation.
Currency stabilization and financial liberalization		
International cooperation on exchange rates	Unclear	Policymakers and major corporations expect a yen in the range 150 to 160 per dollar. Some businesses are planning for 130 yen despite recent US-Japan agreement.
Further liberalize financial markets	Increase	Extensive moves in recent months to liberalize capital outflows. Continued foot-dragging on allowing overseas financial institutions into the Japanese market reflects Tokyo's concerns over the stability of the banking system.
Increase international cooperation		
Expand imports from LDCs	Unclear	Yen appreciation has boosted imports of intermediate goods such as steel from South Korea and Brazil. However, progress in raising imports of commodities or final manufactured goods from LDCs has been minimal.
Expand foreign aid	Unclear	Tokyo has adopted the goal of doubling aid in the next seven years—in dollar terms. If the yen remains strong, Tokyo should have little trouble meeting this goal. Strong yen would make success likely but would increase burden on LDC yen debts.
New GATT round	Unclear	Tokyo supports most US positions but is wary of agricultural negotiations.
Fiscal and monetary management		
Implement fiscal policy flexibility	Reduce	Economic slowdown has generated calls for temporary stimulus but desire to shrink the public sector remains.
Abolish tax-free interest for small savers' accounts	Unclear	Tokyo's Tax Advisory Council recommended low tax on interest income as part of 1987 tax reform. Proposal faces tough political opposition.
Use monetary policy to expand domestic demand	Unclear	The Bank of Japan cut discount rate for the fourth time this year on 1 November. Lower interest rates are aimed principally at weakening the yen.

[a] Our judgment of the likely trade impact of the Maekawa proposals—if implemented—on the current account balance.

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Japanese Economic Prospects: How Bad Are They?

The yen's strength is conditioning Japanese economic prospects for 1986, making it virtually impossible for Japan to achieve the government's official forecast of 4-percent real GNP growth, much less to rival the 4.5 percent achieved last year. Indeed, we expect economic growth to slow to approximately 2 percent this year, the worst performance since 1975. Our pessimism is widely shared by private forecasters in Japan and reflects the toll the strong yen is taking on the foreign sector's contribution to growth, which in recent years has amounted to more than one-half of the total.

- *Despite Japanese manufacturers' willingness to lower the yen prices of their goods in an attempt to maintain overseas sales, Japanese export volumes have been declining gradually for the past six months. Price and quantity decreases are cutting manufacturers' earnings and production. This in turn is forcing export-related manufacturing firms—such as auto and electrical appliance manufacturers—to trim investment spending considerably.*

- *In addition, lower import prices are drawing in intermediate goods, such as steel from the Asian NICs, which also hurt Japanese manufacturing. Imports of US manufactures have not increased much, however.*

Domestic demand, moreover, has not yet risen to compensate for the yen's deflationary impact on trade and growth. Low wage settlements have dampened private consumption, and Tokyo's austere fiscal policies have limited the stimulus provided by the public sector.

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The major question now is whether, over the next year or two, the Japanese economy will adjust sufficiently to a 150-yen-to-dollar exchange rate to allow growth to return to the more politically palatable 3-percent level. At present, most observers expect it will—a judgment with which we concur. Although weak exports will continue to restrain growth in 1987, we anticipate domestic demand will rebound somewhat. Simulations done using our econometric model of Japan suggest that real GNP will increase about 3 percent next year. The current account surplus will probably fall to about $75-80 billion from the projected $85 billion this year. (We expect the Japanese Government is looking at similar numbers, as our model is based on one built by Tokyo's Economic Planning Agency). Underlying the relatively upbeat forecasts are assumptions that real incomes will rise as a result of yen appreciation and that investment in non-export-related industries—such as services and gas and electric utilities—also will steadily increase.

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Despite general agreement that Japan will probably—given time—be able to digest a strong yen, some private forecasters are bearish about prospects for next year. Mitsubishi Research Institute, for example, recently lowered its 1987 real GNP forecast to 1.7 percent, or 0.5 percentage point below its prediction for this year. If Mitsubishi is correct in its assessment that 1987 will be worse, Tokyo will face some tough macroeconomic policy decisions.

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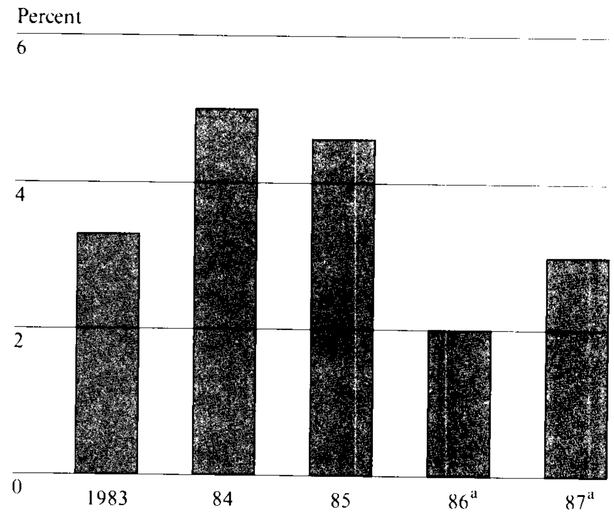
Moreover, there is a school of thought that argues that Japan cannot afford to rely largely on its domestic market to generate growth as it approaches a critical demographic and economic juncture created by the "graying" of the population. Saburo Okita, former Foreign Minister and a respected economics authority in Japan, is the most prominent advocate of this view. Okita argues that institutional and cultural factors, such as the high savings rate, keep domestic spending well below the level needed both to approach full employment and to support productivity-enhancing investment. In his view, growing exports represent the only alternative to slow growth and rising unemployment. To fend off criticism from Japan's trading partners, Okita argues that Japan must recycle its trade surpluses as increased foreign aid and overseas investment.

Japan: Growth in Real GNP, 1983-87



[a] CIA projection.

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Outlook

Some economists argue that the recent appreciation of the yen—up roughly 50 percent against the dollar over the past year—sets the stage for a macroeconomic policy shift, but we disagree. Despite the fact that yen appreciation is clearly hurting the economy today, Japan—in our view and that of most observers—can adjust as effectively to the strong yen as it did to the energy shocks of the 1970s.

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Although some additional fiscal stimulus is likely in the attempt to ease the impact of the strong yen, the overall approach will probably remain fiscal austerity. We expect any additional spending to be temporary and to concentrate on public works—such as roads and bridges—that would minimize the long-term costs associated with pump priming. Depending on the tactics of the political opposition, the ruling party and Finance Ministry might also agree to accelerate planned income tax cuts and perhaps delay the introduction of a revenue-enhancing indirect tax, hoping the net effect would encourage consumer spending. The impact on the economy of such moves would be minor, in our view.

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If we and the Japanese who expect the economy to pick up by mid-1987 have underestimated the negative impact of yen appreciation, a reorientation of economic policy toward domestic growth could occur. Under tougher circumstances, the departure of Nakasone—a staunch supporter of budget austerity—may make it easier for others to advocate policies, including fiscal stimulus, to offset the loss in export sales. Nakasone's likely successors, with the possible exception of former Finance Minister Takeshita, are not as philosophically wedded to fiscal conservatism. If gloomy economic prospects coincide with a sharp upsurge in protectionism, the move to foster domestic growth would gain considerable ground.

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Nigeria: Launching Economic Reforms [redacted] 25X1

After five years of resisting significant economic adjustment in the face of plunging oil revenues, Nigeria recently has embarked on an economic reform program to pave the way for a reconciliation with its official and commercial creditors. Since September, Lagos has initiated a second-tier foreign exchange market, liberalized trade controls, and taken steps to reduce its bloated bureacracy. Such reforms were outlined in a letter of intent signed with the IMF last September and could lead to a formal standby agreement by yearend. Meanwhile, the World Bank, official bilateral creditors, and commercial lenders are at various stages of agreement on new loans and debt reschedulings. Nevertheless, the anticipated financial relief will not compensate fully for the halving of oil export earnings this year, and Nigeria almost certainly will suffer continuing economic stagnation and a further decline in living standards. Unless oil prices rebound significantly in 1987, President Babangida's government probably will face growing political pressure to extract more concessions from creditors, or even to unilaterally limit debt payments and abandon the reform effort. [redacted]

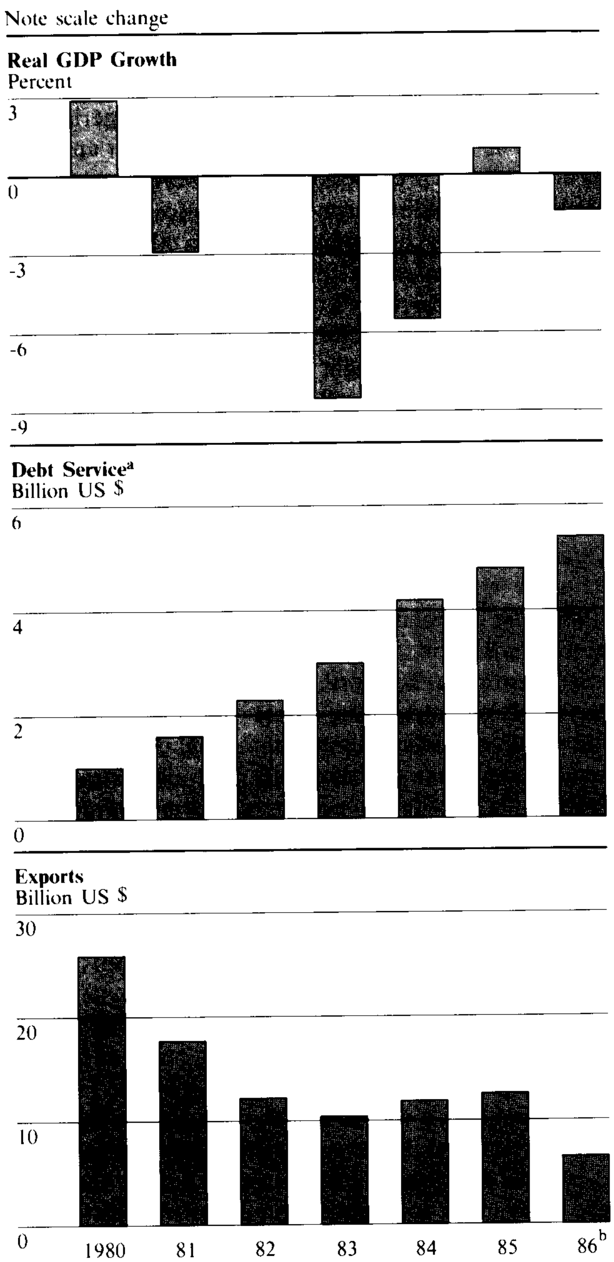
Long Road to Reform

Nigeria has suffered a critical foreign payments problem over the past five years. Oil exports—which account for more than 95 percent of foreign exchange earnings—have dropped from $25 billion in 1980 to an estimated $6 billion this year. At the same time, payment obligations on Nigeria's $20 billion external debt have risen steadily to more than $5 billion per year, according to the US Embassy. Three successive governments, including the present Babangida regime, had attempted to muddle through without implementing an IMF program, the usual prerequisite for obtaining commercial and official debt reschedulings. Since 1981, imports have been slashed by about 70 percent, foreign exchange reserves drained by over 80 percent, and domestic fiscal policy tightened because of the cash-flow bind. The austerity contributed to a cumulative 15-percent drop in real GDP, shortages of basic goods, and rising unemployment. [redacted] 25X1

Lagos, however, avoided making other adjustments—primarily devaluing its currency—that were recommended by the IMF and other creditors. Nigerian officials had stated throughout the crisis that an IMF program was a prescription for upheaval, because a devaluation would sharply increase prices for foods and other basic commodities. [redacted] 25X1
[redacted] the government did not want 25X1
to correct the currency's overvaluation, because it provided opportunities for illegal profiteering. Although Babangida sought a popular mandate to negotiate with the Fund shortly after he assumed power in a coup last year, a torrent of public criticism forced him to back away from the IMF option by December, according to the US Embassy. [redacted] 25X1

Nigeria's foreign payments situation became unsustainable with the sharp drop in oil prices in early 1986, and the regime announced in January that it would seek to limit debt service to 30 percent of export earnings. By April, Lagos had halted most payments on outstanding letters of credit, obtained a standstill on medium-term commercial debt payments, and begun to reassess its go-it-alone strategy. 25X1
Babangida unveiled an economic reform program in June that significantly resolved longstanding obstacles to an IMF accord, but publicly avoided the issue of a possible Fund agreement. According to the Embassy, the proposed reforms triggered only a mild popular reaction, and the government subsequently pursued intense behind-the-scenes consultations with the IMF, the World Bank, and other creditors. In September, the regime announced it had signed a letter of intent on an economic adjustment program with the IMF and would seek a formal standby agreement. Officials publicly claimed, however, that the IMF had merely consented to a program conceived by Lagos, and that the government would not actually borrow the money available under a standby. According to the US Embassy, this announcement also drew little hostile response from the public, and by the end of the month Lagos began implementing the long overdue reforms. [redacted] 25X1

Nigeria: Selected Economic Indicators, 1980-86



[a] Data for 1986 are obligations.
[b] Estimated.

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The Reform Package

The centerpiece of Nigeria's program is a second-tier foreign exchange market, intended to gradually devalue the currency, which officially traded at more than three times the black-market rate. Foreign exchange for all uses other than official debt payments is sold at weekly auctions, which so far have resulted in a 56-percent devaluation. The fixed first-tier rate also has been devalued by 24 percent since late September. The IMF reports that Lagos plans to merge the two systems by mid-1988, after which all transactions would occur at a unified, floating rate. The Embassy reports that financial officials took steps to reverse some of the decline in the second-tier rate, however, after it plummeted by 70 percent in early October, and have pledged to alter the rate again if it becomes "unacceptable." Prices for some consumer goods did jump by as much as 200 percent because of the devaluation, according to the Embassy, but this did not provoke any significant popular backlash. 25X1

The government also has taken steps to liberalize its trade policy. The Embassy reports that Nigeria's graft-ridden import licensing system, which had been used to allocate scarce foreign exchange, is being dismantled with the advent of the second-tier market. Lagos also repealed a 30-percent import surcharge—helping offset some of the inflationary effects of the devaluation—and lowered tariffs on a range of goods. A ban on imports of many agricultural commodities remains intact, however, in an effort to encourage greater domestic production. Other aspects of the reform program include plans to reduce government involvement in the economy. According to the Embassy, Lagos already has abolished some agricultural marketing boards and consolidated its rural development agencies. IMF reports indicate that the government plans to divest a number of parastatals and to reduce subsidies for those it retains. 25X1

Reconciling With International Creditors

The IMF letter of intent and the understanding that a formal standby arrangement will soon follow have opened the door for new loans and debt reschedulings with commerical and official creditors. Although the

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London Club of commercial bankers had consented to a standstill on medium-term debt payments last April, they balked for months at providing new money and rescheduling debt unless Lagos signed, and drew money from, an IMF standby. According to Embassy reporting, IMF and World Bank officials accepted Babangida's argument that domestic political conditions precluded actual borrowing from the Fund and helped convince bankers to require only that a standby agreement be signed. As a result, the London Club steering committee agreed last week to lend Nigeria $320 million, reschedule $1.5 billion in medium-term debt falling due this year and next, and convert an estimated $2-3 billion in overdue payments on letters of credit into medium-term debt, according to US officials [redacted]

This preliminary agreement with commercial creditors will allow disbursement of a $450 million World Bank loan to help fund the second-tier market. The Embassy reports, however, that the IMF has put off consideration of a standby until a "critical mass" of Nigeria's commercial lenders—probably 80 to 90 percent—participate in the new money package offered by the London Club steering committee, a process that may not conclude before yearend. Moreover, the final $100 million disbursement of a $250 million bridge loan provided in October by official bilateral creditors, including the United States, and negotiations for a Paris Club debt rescheduling await final approval of the IMF accord. [redacted]

Outlook

We believe Lagos is likely to reach final agreements with all official and commercial creditors by early 1987 and will probably continue its economic adjustment program through the year. The potential financial relief, however, will not compensate entirely for this year's slide in oil prices, which will cost Nigeria almost $6 billion in export revenues. Although the recent reforms will allocate foreign exchange resources more efficiently and encourage the long-term development of nonoil exports, Nigeria's economic fortunes will remain closely tied to fluctuations in the world oil market. At current production levels, a change of $1 per barrel translates to $400 million in annual exports, whereas nonoil exports will continue earning less than $1 billion annually for the remainder of the decade, according to IMF projections.

[redacted] 25X1

In the absence of a sustained rebound in oil prices next year, the economy almost certainly will remain stagnant, and living standards will continue to decline. Moreover, even with anticipated reschedulings, debt service payments are likely to remain onerous. Babangida probably will be tempted to start drawing money from the expected IMF $790 million standby and may request further reschedulings and increased lending from other creditors. [redacted] 25X1

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The regime has encountered little domestic resistance to its program so far, but will probably feel growing pressure over the next year from the military, disaffected urban elites, and other interest groups to demonstrate some visible benefits from its new policies. Economic decay contributed to the downfall of the two previous governments and almost certainly could significantly weaken Babangida's grip on power. If the regime becomes increasingly preoccupied with combating threats to its survival, it could decide to revert back to a go-it-alone economic policy, impose unilateral limits on debt service payments, and abandon the fledgling reforms. [redacted] 25X1

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El Salvador: Economic Impact of the Earthquake

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The earthquake that struck San Salvador last month—leaving an estimated 1,000 dead and more than 10,000 injured—will further burden a government beset by severe economic problems and a destructive seven-year insurgency. Although the disaster probably will limit economic growth in the next two years and increase the risk of instability, it also may encourage an exodus of refugees from the overcrowded capital and foster greater cooperation between the government and the private sector. In large measure, El Salvador's ability to recover from the earthquake—while maintaining its war effort—will depend on the government's success in generating new sources of development assistance and on continued economic and military aid from the United States.

Earthquake Reconstruction

The need for investment capital and credit will be enormous in a country where private investment historically has been depressed and the public sector has absorbed a large share of credit resources. Preliminary assessments by US officials indicate that losses—primarily damage to property—may exceed $1.3 billion.

The government's reconstruction plan focuses on housing—the most pressing need and the most likely source of popular unrest. The program will be administered by a committee, composed of government-appointed representatives from the armed forces, labor, the private sector, the municipality, and the central government. The plan, funded by $50 million in supplemental US assistance, is designed to stimulate the economy in the short term—by generating employment and restarting local economic activity—until more permanent rebuilding efforts begin. Financing currently available to start long-term reconstruction consists of funds reprogramed from planned projects. These include $30 million from the Inter-American Development Bank for health and infrastructure projects, a $10 million education loan from the World Bank, and $25 million from West Germany.

Earthquake Damages

Housing: *About 250,000 people—some 20 percent of San Salvador's population—are homeless. Most of the 50,000 families affected were among the city's poorest residents, with no financial stake in rebuilding their homes—a factor that will further complicate reconstruction efforts.*

Government facilities: *Forty government buildings suffered extensive structural damage and 14—affecting six ministries—are now uninhabitable.*

Infrastructure: *The damages to water, sewer, electric, and telecommunications facilities total over $10 million, according to preliminary government estimates. Except for some continuing water shortages, basic services have been largely restored. More than 150 kilometers of underground water pipes will have to be replaced, and many streets and bridges will need repairs.* 25X1

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Hospitals and schools: *Three of the city's major hospitals require extensive or complete reconstruction. Preliminary Embassy estimates indicate that costs to rebuild and reequip these facilities will be $100 million. Schools will also require major reconstruction, with repair costs estimated at $15 million.*

Private sector: *Some 160 commercial establishments were destroyed or damaged, and an additional 300 large buildings will require restoration, according to US Embassy reporting. Preliminary estimates indicate that the private sector suffered losses totaling $675 million, largely uninsured.*

Military: *Embassy and defense attache reporting indicates that military facilities were hit hard. The Embassy estimates that approximately three-fourths of command facilities in the capital area were destroyed. Preliminary estimates of reconstruction costs exceed $100 million.*

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Increased Economic Burden

The earthquake will probably have a negative impact on economic growth for the next several years. The Central Bank's estimate for real GDP growth in 1986—1.3 percent before the earthquake—has been scaled back to 0.6 percent, and we believe the actual figure will be closer to zero. Potential growth in 1987 and 1988 will depend on San Salvador's ability to attract new foreign aid and investment. In our opinion, it seems unlikely that the average annual 3-percent growth—needed to reverse the decline in per capita income—will be possible during the next two years of reconstruction, even under optimal conditions. Although the earthquake had little impact on the agricultural sector, production of traditional crops remains depressed because of low world prices, a lack of investment, and the effects of the insurgency. 25X1

The earthquake will exacerbate fiscal and foreign payments problems, while significantly increasing inflationary pressures—the inflation rate is currently about 30 percent. The budget deficit—forecast at $100-160 million at midyear, according to the US Embassy reporting—will be further strained by the need to replace government facilities while providing essential services. The need for massive amounts of imports to facilitate reconstruction will further weaken the current account, and put additional pressure on an already overvalued exchange rate. Embassy forecasts before the earthquake projected a foreign payments deficit for 1986 in excess of $200 million. 25X1

Although reconstruction eventually will provide many new jobs, unemployment is likely to increase substantially in the short term. The widespread damage to the informal economy—street vendors, workshops, and stores—has hit poor and unskilled workers the hardest. USAID reports that preliminary surveys indicate as many as 20 percent of the heads of households in affected areas may lose their jobs. 25X1

El Salvador: The Earthquake Recovery Program, 1986

Program	Amount *(million US $)*	Description
Employment generation/clean up	4	20,000 affected persons—hired and supervised by private firms—to clear rubble.
Credit for rehabilitation of small enterprises	10	Loans to be used for reconstruction or repair of buildings, replacement of tools and machinery, working capital, or suppliers' credit.
Housing		
Temporary shelter	12	Provide shelter and sanitary facilitis for up to one year for 20,000 renter families.
Building materials	3	Purchase and deliver building materials—tin roofing, lumber, and nails—for up to 10,000 squatter families.
Home repair/reconstruction credit	16	Special line of credit to over 8,000 families with homes or home sites to finance repairs or begin reconstruction on existing property.
Repairs to public services	5	Upgrade temporary hospital facilities, provide temporary school shelters, restore utilities, and repair roads.

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Opportunities and Challenges for the Government

Despite the destruction and the economic burden of recovery, the disaster may benefit the economy over the long term. Initial infusions of earthquake relief may enable San Salvador to gain access to new sources of foreign development aid, a prospect heightened by the regionwide strengthening of democratic processes. 25X1

Longstanding housing and unemployment problems in the capital may be eased somewhat by displaced persons returning to the countryside. Embassy reporting indicates that as many as 10 percent of the homeless—the majority were slum dwellers—have already left the capital or moved in with relatives. In our view, the earthquake destruction may alleviate population pressures caused by refugees if the government is able to guarantee the safety of people returning to former combat areas. 25X1

The government will have to balance resource allocation between reconstruction needs in the capital and rural development programs in the countryside. President Duarte has assured armed forces commanders that funds for the military's civic action program—designed to restore services and rebuild former combat areas—will not be diverted to the capital. In addition to attracting the newly displaced from San Salvador, a continued commitment to rural civic action will aid in retaining would-be job seekers who had considered moving to the capital in search of reconstruction work, the US Embassy reports. [redacted] 25X1

The earthquake also has created new opportunities for reconciliation between the government and the private sector. Embassy reporting indicates unprecedented cooperation between these two historic foes in the aftermath of the disaster. Duarte moved quickly to involve businessmen in the relief effort, tasking them with receiving and accounting for all aid contributions. We believe that current levels of good will are unlikely to persist as normal affairs resume. Nonetheless, an opening exists to eliminate some of the rancor that has characterized the government–private-sector relationship—a prospect that would significantly improve the chances for economic recovery. Opposition to Duarte from the business community and the political right could increase, however, if they perceive his reconstruction plan is aimed at enhancing his popularity or is fostering greater public dependency on government programs at the expense of private enterprise. [redacted] 25X1

Perceptions that the government is not doing all it can for earthquake victims could quickly lead to greatly increased popular unrest. Insurgents and sympathetic front groups are actively accusing the government of corruption and misconduct in its handling of the earthquake, according to the US Embassy. Failure to meet the expectations of the displaced for new and better housing and improved delivery of services could fuel popular concern about the administration's incompetence and dishonesty. [redacted] 25X1

So far, San Salvador's performance in disaster relief matches the Guatemalan Government's quick, competent, and honest handling of relief efforts following the 1976 earthquake, which caused far more damage. Guatemala City was helped, however, by a rapidly expanding economy—a luxury that El Salvador does not enjoy. In contrast, widespread perception of government insensitivity and gross corruption following the devastating earthquake in Nicaragua in 1972 is widely believed to have been a major factor in the Sandinistas' eventual victory over Somoza. [redacted] 25X1

Implications for the United States

San Salvador will continue to look to the United States, not only to sustain current levels of economic and military assistance, but also to provide supplemental aid for reconstruction. In particular, we expect that the armed forces will ask the United States to increase military aid to help replace damaged facilities and will petition Washington to pressure the civilian government to maintain its focus on the war effort. [redacted] 25X1

US efforts to support the government could be seriously undermined if the government is perceived to be inefficient or corrupt in its reconstruction efforts. Unrest fueled by guerrilla propaganda or the activities of rebel front groups—especially among the displaced in the capital—would increase the possibility of instability or radical change. [redacted] 25X1

[redacted] 25X1

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Increasing Consolidation in the International Telecommunications Industry [1] 25X1

The global telecommunications industry is undergoing a period of rapid change as firms struggling to reduce R&D costs and increase global sales are turning to international joint ventures, mergers, and other cooperative agreements. Over the last decade, the cost of developing switching technology—the cornerstone of the public communications network—has mushroomed while the time between generations of switching systems has shortened considerably. In addition, the battle among switch suppliers for a potential $90 billion in sales through 1990 to national telephone authorities and other telephone companies has intensified. We believe that West European and Asian firms are seeking joint ventures with US telecommunications firms because of the strength of US switching technology and the size of the US market.

The Coming Shakeout in Switching Equipment

We believe that consolidation among the major telecommunications corporations [2] will continue, particularly in Western Europe, where eight manufacturers are competing in a region that constitutes only 30 percent of the world market. The same pressures will surface in Japan where the privatized Nippon Telegraph and Telephone (NTT) will be less likely to sustain three major Japanese suppliers.

Increased competitive pressure on switch manufacturers comes in part from changing technological and market forces:

- ***High development costs***. According to industry experts, the latest generation of digital switching equipment costs approximately $1 billion to develop over about a 10-year period. Roughly 70 percent of this cost is for software.

- ***Shortened product cycles***. Industry trends show that sophisticated demands from users, the technological push toward digitization, and the momentum of deregulation are pressuring manufacturers to produce upgraded equipment in 10 to 15 years. Previous generations of switching gear had a replacement schedule of 30 to 40 years. While new features can be added to existing switching equipment, the required software modification is expensive and time consuming.

- ***Reduced profit margins and overcapacity***. Slower market growth is also putting competitive pressure on switch manufacturers. 25X1

Many industry experts believe a minimum of 10 to 12 percent of global sales is necessary if a manufacturer is to stay competitive in the digital switch market. In our view, those suppliers that fall short will probably consider reducing their involvement in the switch business, securing extensive government support, or seeking a strategic partner. 25X1

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Motivations and Strategies

Companies electing to stay in the switch business with minimal government support will most probably rely on international linkages. AT&T, Philips, and Northern Telecom are among the most active firms in forming telecommunications ventures. We believe the two strongest motivations for telecommunications firms to team are technology sharing and market access. 25X1

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Technology Sharing. In the last six years, West European telecommunications equipment manufacturers have concluded several agreements with US firms and brought US technology into the European market. Today, the AT&T-Philips venture, called APT, markets the US firm's top-of-the-line central office switch in the Netherlands, capturing 65 percent 25X1

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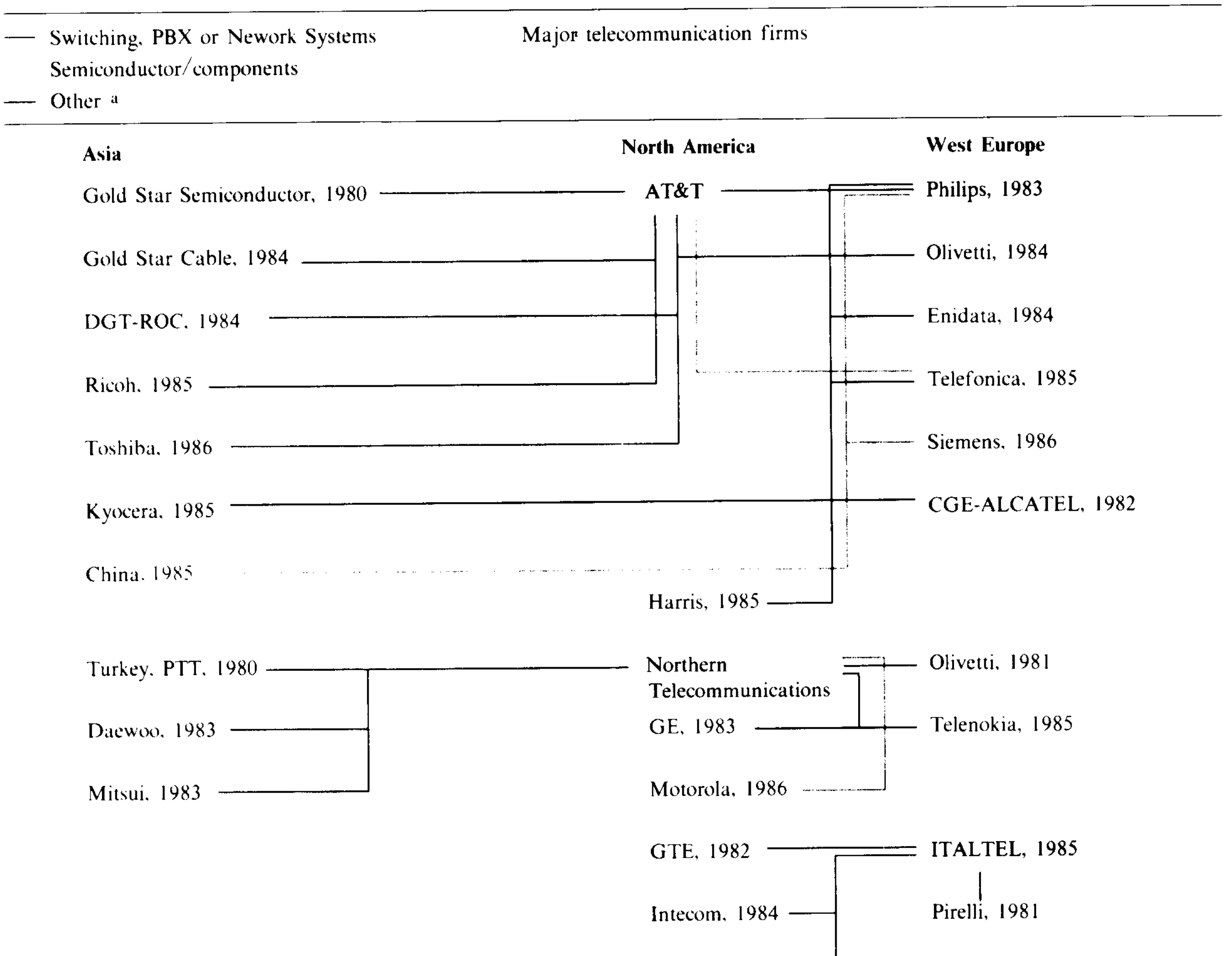
[2] The major telecommunications equipment manufacturers are, by country: Northern Telecom (Canada); CIT-Acatel (France); Siemens (West Germany); Italtel and Telettra (Italy); Fujitsu, Hitachi, and NEC (Japan); AT&T-Philips (Netherlands); L. M. Ericsson (Sweden); AT&T, GTE, IBM, and ITT (United States); GEC and Plessey (United Kingdom).

Selected Linkages in the Telecommunications Industry, 1986



a Other ventures in telecommunications equipment include optical fiber development, data communications equipment production, or radiotelephone equipment production.

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[redacted] 25X1

of the market. According to US Embassy reporting, the GTE-Italtel venture, Italcom, has become a regular supplier to the Italian Post Telegraph and Telephone (PTT) authority and enjoys a 20-percent market share there. Compagnie Generale d'Electricite (CGE)—which is pursuing a joint venture with ITT—at one time led Europe in digital switching technology through its affiliate Alcatel. Now that technology is more than 10 years old. Some industry analysts speculate that the French company could not afford the research required for a new line of switches, and thus sought a partner, ITT, with an established advanced product. [redacted] 25X1

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Partnership Terminology

Among the variety of business activities between firms are:

- ***Joint ventures*** *in which new companies are formed to manufacture or distribute a product jointly.*
- ***Original equipment manufacture*** *(OEM) agreements, in which one company manufactures the product and another company handles sales, distribution, maintenance, and service.*
- ***Research and development agreements*** *in which companies jointly perform research and develop new technologies and products.*
- ***Equity positions*** *in which firms own portions of other companies.*
- ***Licensing agreements*** *in which one company pays another for the right to produce the other's proprietary products.*
- ***Cross licensing agreements*** *in which companies license each other for their respective products.*

Other cooperative agreements include technology transfer in the form of patent exchanges and technical assistance. [redacted]

Market Access. Agreements for market access are designed to achieve the minimum market share necessary to remain competitive. These agreements frequently involve switch manufacturing technology or component/semiconductor technology sharing by the foreign firm in exchange for entering the local market. Demand for telecom equipment is expected to total some $90 billion through 1990, with the United States and Canada purchasing $50 billion, Western Europe $30 billion, and Japan $10 billion, [redacted] a viable strategy entails a competitive position in two of the three regions. [redacted]

The most widely connected West European firm is Philips. Philips's most significant partnership in telecommunications is the APT effort to adapt US switching systems to the European market. Moreover, Philips has a longstanding presence in many Third World countries, thereby adding to AT&T's potential sales. Separately, Philips continues to pursue its business in data communications systems in the United States, mobile radio with French and Spanish partners, and components in Europe and the Far East. [redacted] 25X1

Of all the major foreign switch manufacturers, Northern Telecom probably has the best market position in Japan, having concluded in 1986 the first foreign, multiyear, multiswitch contract with NTT. [redacted] 25X1

[redacted] 25X1

Northern Telecom also enjoys a strong number-two position in the North American switching market and has concluded other agreements largely for market access. Switching and microcomputer partnerships with smaller firms in Japan, Turkey, and Finland are examples. [redacted] 25X1

Going It Alone. Japanese telecommunications companies—Fujitsu, Hitachi, and NEC—in general do not enter into foreign partnerships in telecommunications. The major Japanese telecom companies do, however, cooperate extensively with each other in the early stages of both research and manufacturing, often under NTT sponsorship. Fujitsu's only current joint venture in telecommunications—the acquisition of GTE's Business Systems Division, which makes PBXs—is more a vehicle to enter the US market. NEC, the premier Japanese telecommunications company, has no significant ventures in switching to date. We believe reluctance by the Japanese switch manufacturers, Fujitsu and NEC, to expand beyond the Japanese market through technology-sharing relationships may delay their success as global switch suppliers. In addition, foreign vendors are making some headway in Japan and NTT has begun procuring on a more competitive basis. [redacted]

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Outlook

We believe firms that can operate on a global basis will be in the strongest position to survive industry consolidation, in the absence of extensive home market protection. Foreign sales are needed to help defray continuing switch development costs as well as to facilitate technology exchange, product complementarity, and market access. 25X1

Telecommunications officials predict that major firms not linked into a consortium or a major partnership in the next 5 to 10 years will see a decline in their competitive positions. The formation of large telecommunications partnerships—and the departure of some companies from the business altogether—indicates the shakeout predicted by industry experts is under way. Currently, England's Plessey and GEC and Sweden's Ericsson have not concluded any major telecommunications partnership arrangements. 25X1

We believe the greatest consolidation will take place in Western Europe where fragmented national markets and country-specific technical standards have kept any one firm from a dominant position. Although European firms in search of technology make attractive partners for US firms in search of markets, at the same time they represent US know-how, production, and employment moving overseas to support these ventures. This is one aspect of partnering the Japanese and others have sidestepped by going it alone. 25X1

West European and Asian firms will probably continue to seek US telecommunications firms as partners in telecommunications ventures because of the strength of US switching technology and the size of the US market. There is as yet, however, an apparent absence of cooperation between Europe and Asia. As consolidation and limited competition come to domestic markets in Europe, we believe Japan could offer attractive technology and market opportunities. 25X1

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Briefs

International Finance

Egyptian-IMF Negotiations Approaching Crunch Point

The IMF team visiting Cairo has warned Egyptian officials that they must quickly present new and more far-reaching economic reform proposals to avoid an impasse over a standby agreement. Fund representatives reportedly are also insisting that Cairo abandon its gradualist approach and adopt major policy adjustments simultaneously, which the Egyptian Government adamantly opposes. Nonetheless, Egyptian officials have promised a new reform draft by this weekend—before the IMF delegation leaves—to keep standby prospects alive. Prospects for a satisfactory Egyptian response, however, are not bright. Even if Cabinet experts can agree on reform measures, the package will need Mubarak's approval, and the President fears that resulting price increases will lead to widespread political unrest. Persuading him will require a concerted effort by the Cabinet and Prime Minister Sidqi and time—which Egypt may not have. 25X1 25X1

Mexican Capital Flight Measure Proves Disappointing

The savings instrument created by the Mexican Government to battle capital flight—the pagafe—has had little success since its introduction four months ago. The device was created by the Treasury to stem capital flight and encourage domestic savings by adjusting returns to movements in the controlled exchange rate. Pagafe yields, however, are not competitive with those on savings deposits in the United States. Moreover, failure to keep exchange rate adjustments in step with inflation also has hurt sales. In fact, only 33 percent of pagafes offered were sold in September and none were purchased in October, according to the US Embassy. In our view, Mexico City is unlikely to raise yields on pagafes enough to discourage citizens from pursuing US investment opportunities. 25X1 25X1

Portugal Plans Early Debt Repayment

Portugal's improving current account balance has paved the way for the second early repayment this year of some of the country's $16.6 billion foreign debt. Bank of Portugal Governor Tavares Moreira announced that the government will take advantage of the projected $1-1.3 billion current account surplus to repay the $190 million outstanding on a 1980 loan ahead of schedule. Lisbon reduced its foreign debt in the first half of 1986 to the same level as in December 1985 and has cut its debt service burden by $1.7 billion. Lower oil prices have been a major factor in the current account improvement—Portugal's oil import bill fell 57 percent in the first half of 1986 compared with the same period last year. The decline in the US dollar has also helped because more than one-half of the foreign debt is denominated in dollars. We believe that improving external conditions will probably sustain a current account surplus through 1987. Given the government's intentions to strengthen Portugal's credit rating, we expect Lisbon to continue its efforts to restrain the growth of its foreign debt. 25X1 25X1

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International Trade

Criticism of US Trade Investigations

Washington's decision last year to initiate unfair trade practice investigations—Section 301 cases—is prompting increased criticism from trading partners. Brasilia claims the case against its Informatics Law is an attack on its national sovereignty and development goals. Seoul was highly indignant about the insurance and intellectual property rights cases because it believed it was making progress toward liberalization. Both countries maintain that the investigations may actually have slowed progress toward opening markets by weakening domestic support for reform. Many LDCs have charged that the government-initiated cases elevate disputes to a political level and spare countries less dependent on US trade. Increasing numbers of GATT members say the policy undermines GATT by supplanting the multilateral process with domestic dispute settlement procedures. Future 301 cases are likely to cause many GATT members to complain that the new round commitment to freeze and dismantle protectionist measures precludes new investigations. Moreover, countries will be especially reluctant to make concessions on key issues, such as intellectual property rights, that will be negotiated in the new GATT round.

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Status of 301 Cases, 1985-86

Country	Case	Status
Japan	Semiconductors	Agreement reached
	Tobacco	Agreement reached
Brazil	Informatics	Discussions ongoing
South Korea	Insurance	Agreement reached
	Intellectual property rights	Agreement reached
Argentina	Soybeans	Discussions ongoing
EC	EC enlargement	Interim agreement /discussions ongoing
Canada	Fish	Agreement reached
Taiwan	Customs valuation	Agreement reached
	Beer, wine, and cigarettes	Retaliation planned/discussions ongoing

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Global and Regional Developments

West Germany Proposes East-West Economic Conference

The West German Economics Ministry has endorsed the idea of a conference on East-West economic cooperation in a study commissioned by the Chancellor's office, . The report outlined several possible formats: a follow-on to the CSCE review meeting in Vienna next spring, a meeting sponsored by the UN Economic Commission for Europe, or one completely independent. Potential topics include technology transfer and industrial cooperation. The study

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has been endorsed by the Foreign Affairs and Finance Ministries. Kohl may have seen a German-proposed conference as a way to build his image in international relations prior to the January 1987 national election. Foreign Minister Genscher probably planned to call for the conference when he addressed the recent CSCE conference last week. However, a similar proposal by Soviet Foreign Minister Shevardnadze left him to merely second Moscow's suggestion. Given the high-level interest in Bonn, the government is likely to continue pushing for the participation of key Allies, including the United States. [redacted] 25X1

West German Reaction to US-Japan Exchange Rate Agreement

[redacted]

Bonn's reaction to the recent US-Japanese agreement on exchange rates and economic policy has been cool and calculated to distance Bonn from any similar proposals. Bundesbank Vice President Schlesinger emphasized that West German willingness to coordinate interest and exchange rate policies was limited by the economy's already excessive liquidity. West Germany is making its contribution to world economic adjustment, he argued, by permitting the money supply to overshoot its target. Bundesbank President Poehl and Economics Minister Bangemann disparaged the use of purely monetary measures to redress large bilateral trade imbalances, with Bangemann claiming that attempts to set exchange rate zones will inevitably fail. Poehl and Finance Minister Stoltenberg placed the US-Japanese agreement in the context of Japan's particular economic situation. They argued that Japan's discount rate cut is defensible because growth is slowing in Japan and because its "excessive" export orientation has resulted in a bilateral surplus with the United States that is much larger than the West German–US surplus. [redacted] 25X1 25X1

Turkey Reportedly Weighing EC Membership Bid

[redacted]

Prime Minister Ozal reportedly is considering applying for Turkish membership in the EC by 1 December, but a reluctant Community is unlikely to offer more than minor concessions or a promise to begin the membership process. [redacted] 25X1 [redacted] the Turks may see early application as a way in which the anticipated EC decision to renege on the free circulation of Turkish labor throughout the Community—because of high unemployment in Europe—might be postponed and the issue renegotiated.The EC, still adjusting to the addition during the past five years of Greece, Spain, and Portugal, looks unfavorably on an application by a large, relatively undeveloped country at this time. Some member states also harbor lingering doubts about Turkey's record on human rights, political stability, and non-Christian, non-European orientation. Entry would also be costly to Turkey in the short term—few of its protected industries are prepared to face full European competition. EC members would probably allow Greece to take the lead initially in squelching a Turkish bid—a role Athens has indicated it is willing to play—but probably will eventually offer minor concessions or promise to begin negotiations and transitional arrangements leading to membership—taking up to 20 years—to avoid alienating the Turks. Ankara would resent any response implying permanent second-class status and would distance itself from EC members in other forums, such as NATO. If the EC can convince Turkish officials it will seriously consider eventual membership, Ozal might be willing to wait until the 1988 Turkish parliamentary campaign to press the issue. [redacted] 25X1 25X1 25X1

France Slowing Weapons Deliveries to Iraq

According to the US Embassy in Baghdad, France is slowing some weapons deliveries to Iraq because of Baghdad's foreign currency shortage. During a meeting of the French-Iraqi Joint Economic Committee earlier this month, Iraq said it would not be able to meet French requests for payment on delivery unless shipments were stretched out over a longer period. The slowdown is unlikely to hamper Iraq's war effort. Baghdad has adequate military supplies, and France is unlikely to severely restrict shipments. Although France has rescheduled Iraqi civilian debt due this year, Paris is taking a harder line on the nearly $2 billion in military debt because of Baghdad's failure earlier this year to make several payments. 25X1 25X1

Limited US Role in Eurofighter

The board of directors of the European Fighter Aircraft consortium has established bidding regulations that effectively eliminate US companies from participation except for development of its radar system. According to a US attache in Bonn, the regulations require all companies on the bidders list to be from consortium nations. Others may submit proposals only through companies in consortium nations, and they must agree to full manufacture within those countries and to full disclosure of any restrictions on technology transfer and export. According to the attache, knowledgeable West German defense officials and US businessmen believe the regulations reflect strong British influence. The new regulations—obviously calculated to avoid US restrictions on technology transfer—will probably eliminate from competition a US-built engine currently under consideration. London is likely to continue insisting that the new fighter remain as European as possible, despite the fact that a partnership of US and British electronics firms is the prime contender to produce the fighter's radar. 25X1 25X1

Tokyo Vague on Promises of Philippine Aid

President Aquino's visit to Japan gained her the clear support of a major regional ally but only one firm commitment for new funding—$250 million for a coal-fired power plant. In addition, Prime Minister Nakasone promised Aquino a grant of $150 million and suggested that Tokyo would increase its annual lending package—$300 million last year—but details are still being negotiated. Manila probably intended its unrealistically high aid request of $1.6 billion only as a starting point in the negotiations. Aquino probably accepts Tokyo's funding package as the best deal possible. She will try to use Nakasone's strong personal support to offset public doubts about her leadership and threats of military intervention. Japanese businessmen are not likely to increase their investments in the Philippines until the political climate improves. 25X1 25X1

Saudis Withhold Oil Payment to Jordan

Saudi Arabia's apparent failure to carry out its promise to pay the bill for oil Jordan imported last year has placed Amman in a financial bind. The US Embassy in Amman says Riyadh has told King Hussein it will not pay Aramco for oil Jordan imported through the Trans-Arabian Pipeline during the last half of 1985. The bill—which Amman claims it has regarded as an outright Saudi grant—amounts to about $195 million, including interest. Riyadh, concerned about its slumping 25X1 economy, may intend to withhold money for new Jordanian programs until oil revenues recover. If Jordan has to pay the bill, it may abandon a proposal in the 1986 budget—which already faces a projected deficit of more than $500 million—to spend $30 million on the King's ambitious West Bank development plan. Jordan also would be forced to draw down its foreign exchange reserves, which had fallen to about $280 million at the end of August—equivalent to only two months' imports. King Hussein undoubtedly will go to Riyadh soon to plead for an oil grant, which the Saudis ultimately are likely to provide. [redacted] 25X1

Japan Trying To Sell Oil Rigs to Vietnam

[redacted]

Two of Japan's largest trading companies—Mitsui and C. Itoh—are competing to sell oil rigs for use in Vietnam's offshore oil and natural gas exploration project, [redacted]. The rigs were originally designed for use on the Soviet Union's Sakhalin oil and gas project, which has been indefinitely postponed. C. Itoh is offering to purchase oil from the Vietnamese project if Hanoi buys its rigs, and Mitsui is offering to participate in the project directly by buying out Moscow's share—a development that Mitsui executives have been interested in for several months. Both companies are presently negotiating with Hanoi but realize that Moscow will have a large say in any deal. Despite Vietnam's debt problems, C. Itoh and Mitsui appear enthusiastic about doing business with Hanoi and anticipate a profitable future trading with Vietnam [redacted] 25X1 25X1 25X1

Indonesia To Buy Chinese Coal

[redacted]

Indonesia plans to import 400,000 metric tons of anthracite coal from China for a power plant currently fueled by Australian coal. Arranging a countertrade with Beijing has been difficult, however, because [redacted] Jakarta insists that China buy Indonesian cement at a price Beijing considers too high. Jakarta hopes that China will eventually supply up to 50 percent of its coal imports, nearly all of which now come from Australia. The coal agreement with China is part of broader efforts by both countries to increase bilateral trade. Nonetheless, [redacted] continued ill feeling towards Canberra over Australian press articles last spring on corruption in Indonesia's First Family is also prompting Jakarta to find other suppliers. [redacted] 25X1 25X1 25X1 25X1

Cuba Pushing Commercial Ties to Brazil

[redacted]

Since the resumption of full diplomatic relations in late June, Cuba has moved energetically to promote economic ties to Brazil. Cuban Foreign Trade Minister Cabrisas, who spent much of October in Brazil exploring commercial opportunities, told the Brazilian press that he expected trade in 1987 to reach $60-100 25X1 million. The Cubans apparently are looking to Brazil as a source of technology, equipment, and raw materials that are otherwise inaccessible, and as a partner for joint ventures and other types of economic cooperation. Although some Brazilian firms are exploring opportunities, Cuba's severe hard currency shortage, its limited range of exports, and Brasilia's reluctance to offer Havana trade credits, will keep commercial exchanges low, in our judgment. [redacted] 25X1

[redacted] Brasilia is unlikely to agree to a $100-200 million trade credit sought by the Cubans. A Brazilian Foreign Ministry official recently told the US Embassy that he was under no illusion that credits to Havana would be repaid and expected the Central Bank to oppose them. However, we believe political advisers in Brasilia see a modest credit line to the Cubans as a low-cost gesture to the Brazilian left. [redacted] 25X1 25X1

National Developments

Developed Countries

Japanese Semiconductor Makers Cut Costs

[redacted]

Japanese semiconductor manufacturers now appear determined to hold the price of memory chips as low as possible, a strategy we expect will discourage all but the strongest competitors from entering or staying in the worldwide memory market. 25X1
[redacted] major Japanese producers began discontinuing use of 6- and 8-inch wafers in August in favor of the 4- and 5-inch wafers they had been planning to phase out. [redacted] continued use of smaller wafers would lower equipment costs and improve efficiency because distortion and warping has held down Fujitsu's yields from 6-inch wafers. With lower manufacturing costs, the companies can ask for a reduction in the fair market value for memory chips exported to the United States under the terms of the US-Japanese semiconductor agreement signed in September. [redacted] use of 4- or 5-inch wafers on existing 256K DRAM assembly lines would justify prices of $2 to $3 per chip. [redacted] 25X1 25X1 25X1 25X1 25X1 25X1

Japanese Structural Adjustment Law Proposal

[redacted]

Last week MITI approved draft legislation to satisfy Prime Minister Nakasone's desire to submit a structural adjustment bill to the Diet session beginning in January, [redacted]. To meet the deadline, MITI restricted the focus of the legislation and avoided the politically sensitive issue of chronically depressed industries, such as shipbuilding and aluminum. But some aspects of the bill, which must gain Finance and Labor Ministry approval before going to the Diet, may still prove controversial. For example, measures to ease the regional and employment effects of the strong yen on industry, although appealing to Liberal Democratic Party politicians, run counter to the Finance Ministry's austerity drive. In addition, proposed measures giving MITI greater control over Japanese industrial structure matters—as yet unspecified—are likely to meet industry opposition. [redacted] 25X1 25X1 25X1

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Disappointing French Trade Balance

Trade Minister Michel Noir recently conceded that France's foreign trade account will be in rough balance for 1986. This is a sharp retreat from earlier government projections of a trade surplus of more than $2.7 billion, following a $2.6 billion deficit in 1985. The shortfall has come about despite lower energy import prices that saved France $10 billion compared to last year. French imports have been boosted by strong internal demand, while France's export markets, particularly West Germany, have not been growing as expected. Noir stated that he does not expect any significant trade improvement until the autumn of 1987, but this may be wishful thinking. Nongovernment projections foresee continued strong import growth that may swamp any improvement in export sales.

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New Belgian Labor Leader

In early November Willy Peirens, a longtime Flemish labor activist, was elected president of the powerful Catholic Labor Confederation (CSC/ACV) effective August 1987. The CSC/ACV—which represents 1.3 million workers—has close ties to the centrist Flemish Social Christian Party (CVP) and current Prime Minister Wilfried Martens. As president, Peirens will ensure Catholic labor's continued support of the CVP-led coalition, thus contributing to the stability of a government frequently shaken by squabbling between Belgium's linguistic communities. Well disposed toward the United States, he will also be able to help sell controversial US trade and security policies to labor. As a labor moderate, Peirens favors dialogue rather than confrontation with management. He rose through the rank and file and, while not given to flamboyant oratory, he has a reputation for delivering on his commitments.

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Spanish Inflation Accelerates

The 1.1-percent increase in September's consumer price index brings Spain's annual inflation rate to 9.5 percent, 1.5 percentage points above Madrid's yearend target. The news has prompted the government to lower the official prices of petroleum products, and Madrid is now looking at ways to moderate food prices—which jumped 2.2 percent in September. One option under consideration is to increase the domestic supply of fruits and vegetables—probably by increasing imports from North Africa—to relieve the upward price pressure caused by Spain's rising exports of these goods to the EC. Officials will also probably turn to the EC for a better marketing arrangement for the allocation of US feedcorn resulting from the US-EC interim solution to the enlargement dispute. This agreement has led to imports of higher priced corn to Spain while cheaper corn is shipped to Northern Europe. We expect inflation to be 8.5 to 9 percent by yearend, which is certain to make it more difficult for Madrid to achieve its goals of maintaining wage moderation and reducing the 6-percentage-point inflation differential with its EC partners.

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Sweden Nervous About Inflation

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Stockholm's concern about recent increases in inflation forced the government to reach agreement with farmers last week to postpone food price increases until next year. The Social Democrats calculated that the scheduled price increases under Sweden's farm program would fuel inflation, which hit annual rates of 3.6 percent in August and 4.1 percent in September. If inflation does not recede to 3.2 percent by year's end, unions will be able to invoke a contractual clause that permits them to renegotiate their agreements. The nine-month-old Carlsson government would like to avoid more labor clashes—like the recently ended public-sector pay disputes—that have strained relations between the Social Democrats and their union allies. The government is attempting to balance its prounion reputation with efforts to control inflation and prevent erosion of Sweden's international competitiveness. Sweden must avoid any general price increase during November and December if inflation is to remain below the 3.2-percent trigger. 25X1

Less Developed Countries

Brazil's Dangerous Monetary Policy

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We believe that Brazil's easy money policies are cutting short the success of its Cruzado Plan. Brasilia has slowed expansion of the money supply and the monetary base since July, but rapid growth early in the year will result in a 300-percent rise in these aggregates in 1986, according to Brasilia's own projections. The economic authorities contended that a surge in the money supply was necessary to support anticipated increased savings and investment in the new low-inflationary environment. As official statistics became available this fall, however, monetary authorities discovered that the increased cash was not being held in cruzado assets—real savings remain at their depressed pre-Cruzado-Plan level—but being spent on durable goods and speculative investments. In addition, there are indications that increased subsidy payments and a larger-than-anticipated public deficit are spurring growth of the money aggregates—the same factors that have traditionally fueled the inflationary spiral. So far, the tightened monetary policy and resultant higher interest rates have had little effect on consumer demand and inflationary expectations, according to the US Embassy. Moreover, with the government's borrowing requirements projected to remain high, Brasilia probably has little hope of meeting its recent pledge to limit monetary expansion to 20 percent during the last quarter of 1986. Consequently, we believe Brazil faces a strong resurgence of inflation if price controls are eased next year. 25X1

Higher Colombian Inflation Looming

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Inflation, fueled by rising domestic food prices and the coffee windfall, is once again becoming a problem for the Colombian economy. Inflation had slowed in recent months largely because of lower food prices, caused by increasing illegal food imports from Venezuela and Ecuador encouraged by the overvalued exchange rate. Although the short-lived drop in food prices temporarily offset inflationary pressures stemming from the sharp rise in money in circulation, it also discouraged domestic production of staples competing against smuggled powdered milk, poultry, eggs, and rice and created shortages of other food products. By the end of October, food prices had rebounded above the level of the past three years. Inflation could hit a record 30 percent in the first half of next year, and thus provide a major test for President Barco's economic strategy. 25X1

Paraguay's Stalled Economic Reforms

President Stroessner has failed to implement any of the reforms—particularily of the overvalued exchange regime that encourages black-market activities—under the stabilization program announced in September. The US Embassy reports that 25X1 battles between the finance and economy ministers and Stroessner's perception that a devaluation is a sign of political weakness have paralyzed economic policymaking. Moreover, the current economic system provides lucrative opportunities for graft by high-level officials. According to press reports, business and labor groups—initially enthusiastic about the measures—have begun to denounce Asuncion's economic ineptitude. Furthermore, anticipation of a devaluation has virtually halted foreign sales and accelerated imports, adding to an unsustainable trade deficit. Asuncion's indecisiveness has also led to threats by the Inter-American Development Bank and the World Bank, to halt disbursements after 1 January 1987. Asuncion will probably acquiesce to a devaluation by year's end—though less than what is needed—but we doubt that the government will draft coherent fiscal, monetary, or investment policies before next summer. 25X1

Uruguayan Economic Growth Continues

While Uruguay's economic activity remains below peak levels, we expect the recovery that began late last year to continue through 1987. According to the US Embassy, external factors such as lower international interest rates, the weaker US dollar, and the sharp drop in oil prices stimulated most of the projected 25X1 3.6-percent economic growth this year. Domestically, higher real wages, increased domestic demand, and fewer strikes boosted productivity. In addition, the press reports that Montevideo eased debt service requirements by rescheduling commercial loans and increased exports by negotiating regional trade accords, particularly with Brazil. Nonetheless, fluctuating exchange rates and depressed agricultural prices could undercut expanding export sales. Moreover, the US Embassy reports that the Central Bank is issuing currency to buy up dollars, thereby depreciating the peso and encouraging exports in the short term. Along with the onerous fiscal deficit, this could negate Montevideo's other efforts to control inflation over the coming year. 25X1

New Syrian Tax Measures

Damascus is focusing on tax collection to reduce its budget deficit. New programs are aimed at collecting lost customs duties on smuggled home appliances, and higher taxes on automobiles and real estate. Owners of the country's estimated 400,000 illegal televisions have been given a grace period to register their sets and pay the duty. The US Embassy reports a positive response and estimates up to $30 million in revenue gains. A possible new tax on air conditioners could net Damascus $2 million. The Ministry of Economy and Foreign Trade is expected to take control of all automobile sales, acting as a broker to ensure payment of taxes and title fees. Finally, Damascus will collect new taxes based on the appraised value of commercial real estate, which reflects recent price increases. The new taxes appear evenly distributed and will probably improve government finances and may stem the annual inflation of more than 100 percent.

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Lebanese Pound Falling Faster

The Lebanese pound fell sharply last week on Beirut's foreign exchange market. It closed at almost 69 pounds per US dollar, falling 7 percent in one trading day. The pound has fallen 75 percent this year, after a 60-percent decline last year. Banking sources of the US Embassy attribute the rapid decline in past weeks to eroding confidence in the pound among the Lebanese population—there are few significant economic changes and the security situation is unchanged. Many resident holders of bank accounts are probably shifting into special dollar-denominated accounts, which explains the rapid deterioration vis-a-vis the dollar. In addition, speculation probably rose following the disappearance of a Lebanese wheat dealer who had $28 million in debts to three major Beirut banks. Although the pound will probably remain weak, a symbolic political event such as the resumption of cabinet meetings could reverse the slide.

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Japanese Bank Expects Indonesian Rescheduling

A leading Japanese bank reportedly expects Jakarta to reschedule its foreign debt in late 1987. The bank calculates that a possible $3 billion drop in Indonesian exports this year will seriously impede Indonesia's ability to service its nearly $40 billion foreign debt. Combined with the collapse of world oil prices earlier this year, most nonoil commodities exports are also suffering from low prices; and Indonesia has not had much success in boosting sales of its uncompetitive, high-cost manufactured goods. Even after factoring in the impact of the recent rupiah devaluation, the bank estimates that the current account deficit will reach $4 billion this year and swell to $7.5 billion in 1987. Moreover, because much of Indonesia's foreign debt is denominated in the appreciating yen, the devaluation will raise debt service payments to $6 billion annually, an amount equal to 40-percent of projected export earnings.

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Thai External Accounts Improve Dramatically

According to press reports, some Bank of Thailand officials expect a spectacular improvement in the country's external accounts this year. The Bank projects the trade deficit to decline by about 80 percent from last year, to $610 million, because of strong manufactures export growth and lower prices for imported oil. Further, the Bank calculates that this trade performance will swing the current account from a $1.6 billion deficit in 1985 to a $75 million surplus, the first in two

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decades. Despite the improvement in Thailand's external position, we believe that real economic growth this year is likely to gain only slightly from a postwar low of 4 percent last year, because most of Thailand's business activity remains depressed and large budget deficits limit the use of fiscal stimulus to boost consumer demand. [redacted] 25X1

Thailand's New Price Supports for Rice

[redacted]

We believe that the $227 million package to support domestic rice prices recently announced by Bangkok is likely to fail and seems certain to intensify tensions within Prime Minister Prem's coalition government. The new package is similar to 25X1
other unsuccessful efforts since 1980, when Prem took office. [redacted] 25X1
[redacted] the primary aim is to increase farmers' incomes by 25X1
boosting purchases and prices early in the harvest season. Measures include $192 million for cheap loans to millers, $23 million for government purchases and for storage, and $12 million for direct export subsidies. We estimate, however, that the package at best could finance the stockpiling of only 10 to 15 percent of the main season crop, an amount unlikely to significantly affect producer prices. [redacted] 25X1

Communist

Increasing Soviet Gold Sales

[redacted]

[redacted] the USSR has sold an estimated 25X1
250 metric tons of gold through August of this year, earning Moscow nearly $3 billion. The Soviets are attempting to avoid depressing gold prices by using 25X1
techniques that hide the level of their sales. These techniques include frequent sales and purchases, using all the gold exchanges; direct sales to customers; and complicated gold swaps. However, large Soviet gold sales during early-to-mid-October caused the price to fall and prompted Moscow to retreat from the market, [redacted] The Soviets are likely to earn an additional $2.5 bil- 25X1
lion over last year from higher gold prices and increased sales, which may reach 400 tons—more than double last year's 190-ton mark. These revenues will help offset their declining oil earnings, which are projected to drop about $4 billion this year. Moscow is likely to continue heavy selling next year, but it will probably not be able to market another 400 tons without depressing prices. [redacted] 25X1

China Exhibits Military Goods for Export

[redacted]

China held its first international military equipment exhibition last week in Beijing. All six of China's defense industrial ministries displayed products, which ranged from ammunition to reconnaissance equipment and even included models of satellite launch vehicles, a nuclear submarine, and China's F-8-2 fighter 25X1
aircraft. More than a dozen other countries also displayed their wares, but we believe the show was held primarily to promote Chinese military exports. In fact, press reports indicate that most of the foreign visitors were from Third World countries in the market for armaments. China has openly displayed military equipment at other international exhibits—the Paris and Farnborough Air Shows, for example—and is looking to military exports as one means of financing its ambitious modernization program. We estimate that China has earned more than $1 billion already this year from its growing arms export business. [redacted] 25X1

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