



Directorate of
Intelligence

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International Economic & Energy Weekly



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16 March 1984

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DI IEEW 84-011
16 March 1984

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

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**International
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Weekly**

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Synopsis

1 **Perspective—Prospects for the EC Summit**

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EC leaders probably will at best make limited progress toward solving the Community's budget crisis at their scheduled summit in Brussels on 19-20 March. The most likely outcome of the meeting will be a political commitment to undertake broadly defined reforms, with the details left to the next EC summit in June.

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15 **Japan: Shifting Role of Tax Incentives**

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Japan's use of special tax measures to promote the development of selected industries has been constrained over the past several years by budgetary stringency and the increased involvement of interest groups in the formulation of Japanese tax policy.

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19 **Argentina: Attempting To Resolve the Debt Crisis**

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Argentina faces a crucial payments deadline on 31 March with US bank creditors on its overdue interest charges. Although there are several roadblocks to a solution, we believe the problem could be worked out. Beyond the near-term crunch, however, upcoming bank rescheduling talks are likely to be difficult.

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23 **Gray-Market Arms Scams**

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The international gray arms market, involving the purchase and movement of weapons on other than a government-to-government basis, lends itself to a variety of fraudulent arms deals. Iran—having few reliable military suppliers—has often been the target for many of these scams.

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27 **Yugoslavia: Persistent Inflation Problems**

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Yugoslavia's lack of success in controlling inflation—over 40 percent last year—was the major failure of its 1983 economic stabilization program. Because few steps have been taken to deal with systemic problems, rapid inflation is likely to persist in 1984, threatening both living standards and last year's gains in the competitiveness of Yugoslav exports.

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Perspective***Prospects for the EC Summit***

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EC leaders probably will at best make limited progress toward solving the Community's budget crisis at their scheduled summit in Brussels on 19-20 March. The most likely outcome of the meeting will be a political commitment to undertake broadly defined reforms, with the details left to the next EC summit in June. The Ten appear to be nearing compromise on several of the most controversial issues, which should at least enable them to avoid a fiasco similar to last December's Athens summit. The leaders believe that, if they again fail to begin straightening out the Community's financial morass, the EC could begin to atrophy. Budget compromises will have to be made by all members if the Community is to avoid running out of money this fall.

French President Mitterrand—who holds the rotating EC Presidency for the first half of 1984—has staked his prestige on the outcome of the summit and has spent much of the last two months shuttling between Community capitals trying to forge a political consensus. The results of his consultations have been closely guarded, but most EC officials appear cautiously optimistic that there has been sufficient progress to clear the way for some compromises in Brussels. Significantly, France—traditionally the most obstructionist EC member—now appears more willing to accept changes in the way the Common Agricultural Policy guarantees minimum farm prices. Most in the Community welcome Mitterrand's zeal and have willingly entrusted to him the chore of orchestrating a breakthrough.

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Reining in agricultural spending will certainly dominate the complex agenda at Brussels. The leaders will consider proposals agreed to by Agricultural Ministers on 13 March to reduce costly milk overproduction by taxing surpluses, and final approval to cut output—with some exceptions for hard-pressed members like Ireland—appears likely. They may also move toward phasing out the Community's complicated system of agricultural exchange rates by eliminating over the next three to five years the compensation West German farmers get to offset the strong Deutschmark. At British and German insistence, the heads of government will discuss more far-reaching proposals to tie the growth of agricultural spending to the growth in EC revenues, but the political clout of EC farmers makes any early agreement unlikely.

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Financing the EC budget will also be a major topic of debate, and virtually all Community members now support boosting revenues by increasing the share of value-added tax payments passed to the Community. An increase in the VAT ceiling—from 1.0 percent to 1.4 percent of each members' VAT proceeds—appears to be the most likely outcome.

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[Redacted] Some compromise that satisfies the United Kingdom—perhaps a five- to seven-year renewable provision that ties members' payments to their share of Community GDP—will be necessary, but it does not appear that enough groundwork has been done to settle this thorny problem at Brussels.

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[Redacted]

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On other issues, Mitterrand will probably use the chairmanship to air some of his foreign policy concerns. France has backed recent proposals to strengthen European defense cooperation through a revitalized Western European Union. EC foreign ministers have also recommended issuing a statement urging improved East-West relations and encouraging the Soviet Union to return to the START and INF talks. France may also press for a firm timetable for Spanish and Portuguese entry into the EC. The leaders may use these foreign policy questions to project a united front, despite continued internal problems.

[Redacted]

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Decisions on the more technical aspects of budget reform probably will be left for the June EC summit in Paris, which will be an equally crucial test of Community resolve. Over the intervening months, experts—who were excluded from Mitterrand's bilateral meetings—will have to hammer out concrete proposals for implementing whatever political decisions are taken at the March summit. The Commission has already begun resurrecting earlier proposals for determining fair budget shares. Agricultural ministers will be asked to deal with sectoral overproduction, especially in grain and dairy products. Finance ministers will be charged with drawing up schemes for keeping Community spending within budget constraints.

[Redacted]

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Whatever actions are taken—either at the Brussels or Paris meetings—are unlikely to involve radical EC institutional reform. We believe that changes in the EC will continue to be piecemeal and represent minimal consensus among the 10 diverse members. The Common Agricultural Policy will remain the centerpiece of the EC, and costly agricultural overproduction will continue to plague the Community. As a result, the EC will face continued pressure to export surplus farm products, and US-EC agricultural trade competition in third markets is unlikely to abate in the near future.

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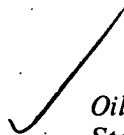
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Briefs

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Oil Market Remains Stable

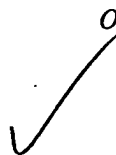


Energy

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The oil market remains relatively calm. Spot prices in recent days have declined to levels recorded in late February—prior to unconfirmed reports of Iraqi attacks against tankers near Khark Island. Most spot crude prices are at or below official prices, with Arab Light at \$28.65 per barrel, 35 cents per barrel below official prices. Although [redacted] concerned about an oil supply disruption, there is no sign that oil companies, refineries, or end users are making a major effort to increase inventories. Worries about Middle East oil supplies, however, may be preventing further price erosion in a generally weak market [redacted]

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OPEC Price Decline

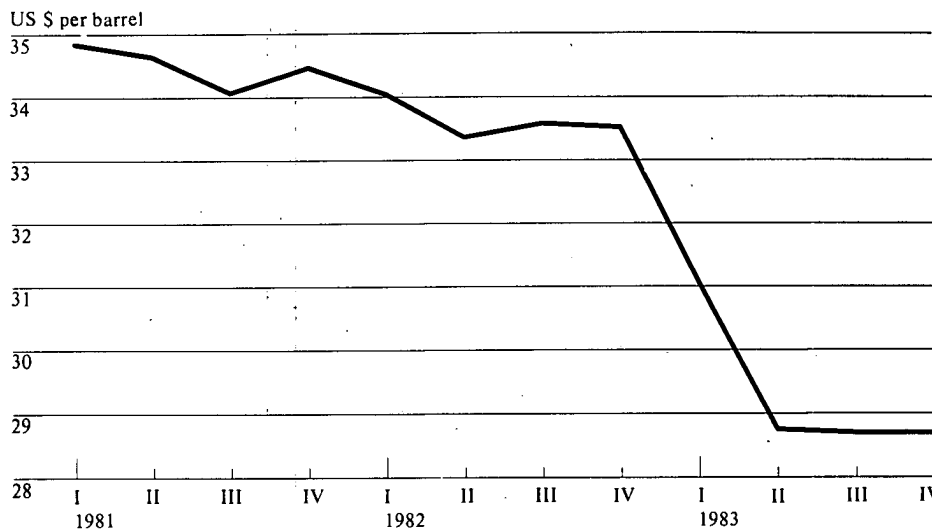


OPEC's official sales price per barrel averaged \$29.31 in 1983, about 15 percent below 1982 and over \$5 per barrel below the 1981 price. OPEC experienced its first significant official price drop in March 1983 when the cartel's benchmark price fell from \$34 to \$29 per barrel. If nominal oil prices remain stable throughout the year, as most forecasters now expect, 1984 will mark the fourth consecutive year of falling real oil prices. [redacted]

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OPEC Average Official Sales Price, 1981-83



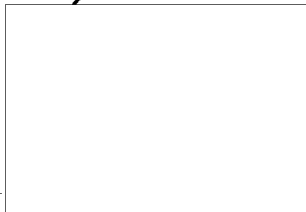
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European Electric Utilities Reduce Oil Use



Net electricity generation for the European Economic Community rose 1.3 percent to 888 billion kWh, the energy equivalent of 6 million b/doe, during the first nine months of 1983 compared with the same period a year ago. Despite the increase in electricity generation, oil consumption by European electric power plants fell by 27 percent to 560,000 b/doe. Increased nuclear and hydroelectric generation more than made up for the decline in oil-fired generation, rising 235,000 and 45,000 b/doe, respectively. High utilization rates in nuclear, coal-fired, and hydroelectric plants, however, leave little room for additional declines in oil consumption by European utilities in the near term. We believe oil consumption may even rise as the spreading economic recovery pushes up peak-load electricity demand and requires use of additional oil-fired capacity. [redacted]

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Oil Exploration Resumes in Sudan

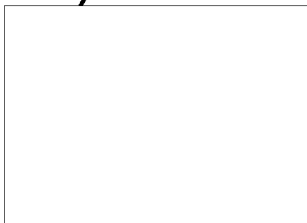


Chevron will resume limited exploration in Sudan, outside of the volatile south where the major oilfields are located. The company suspended its operations in early February following a rebel attack on its main camp. In return for Chevron's token presence, the government has signed an agreement that relieves the company of any responsibility to work the southern concession area. The French oil company Total plans to resume exploration in southern Sudan in April. Total shut down its operations in February following rebel threats but was never attacked. [redacted]

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Malaysia Accelerates Crude Oil Production



Last month Kuala Lumpur announced plans to increase oil production to 470,000 b/d in 1984, a 25-percent jump in output that would match last year's gain. Malaysia is boosting petroleum exports—the country's largest foreign exchange earner—in an effort to reduce the anticipated \$2.4 billion current account deficit and to slow the rapid growth of foreign borrowing. [redacted] petroleum production is nearing its roughly 480,000-b/d ceiling. Although output can be maintained at this level for a few years, doing so would rapidly deplete Malaysia's approximately 2.6 billion barrels of known oil reserves and lead to a sharp drop in production by 1990. [redacted]

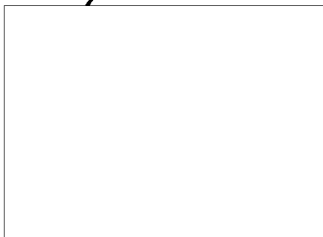
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Gulf Canada Up For Sale



Standard Oil of California (Socal), which is in the process of acquiring Gulf Oil, intends to sell the company's Canadian assets to assist in financing the purchase, according to press reports. The decision to sell Gulf Canada is also based on Socal's expectation that Ottawa—through its Foreign Investment Review Act—would not allow the 60-percent interest in Gulf Canada now held by Gulf Oil to pass into the hands of another foreign owner. Gulf Canada is heavily involved in Canada's frontier oil exploration, as well as in conventional oil production, refining, and marketing. The domestic purchase of the company—Canada's fourth-largest oil producer—would raise overall domestic ownership of the oil and gas industry from 34 percent to 39 percent. [redacted]

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The Canadian private sector already has shown interest in Gulf Canada, but, according to a press report, it may have difficulty obtaining financing to cover the estimated US \$2.7 billion purchase price. We expect the private sector to

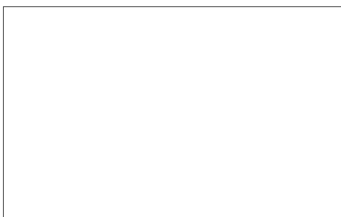
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raise the required funds, but if it cannot, Ottawa may attempt to purchase the company through state-owned Petro-Canada, a move already being urged by the economic nationalists in the government. Gulf Canada would be attractive to Ottawa because it would complement and expand existing Petro-Canada capabilities. Petro-Canada would then become the largest oil company in Canada.

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Canadian Venture Gasfield Reserves Prove Disappointing

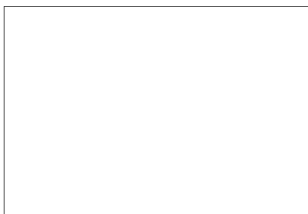


On the basis of disappointing results from two appraisal wells recently completed on the Sable Island Venture gasfield, Mobil has announced that development could be delayed by as much as two years because reserves in the Venture structure alone appear insufficient to warrant development. The company remains optimistic that cumulative gas reserves in surrounding areas will support a gas development project, however, and cites extremely promising seismic results on the southern end of the Venture structure and on the adjoining Olympia field. New development options probably will be examined, and the company has now set a "sliding target" date of 1988 for initial production. As a result, application for a license to export any gas deemed surplus to Canadian requirements probably will be delayed until sufficient reserves are proved. Although several US buyers have expressed interest in purchasing gas exported from Sable Island, it is still uncertain whether any gas could be delivered to the US market at prices competitive with alternative fuels.

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Canadian Supreme Court Rules on Offshore Dispute



The Canadian Supreme Court has unanimously ruled in favor of Ottawa in the longstanding dispute with Newfoundland over ownership and control of the offshore area that includes the Hibernia oilfield. The recent ruling is limited to this particular area, but another case dealing with the broader question of jurisdiction over all offshore resources is pending before the court. Development of the Hibernia field, which is believed to contain as much as 2 billion barrels of oil, already has been delayed two to three years because of the federal/provincial dispute. Ottawa probably will encourage the oil companies involved with the project to move ahead quickly with development plans in view of the ruling, but we expect Newfoundland Premier Peckford to continue to resist concluding a revenue-sharing agreement until after the upcoming Canadian elections. Given the continuing uncertainties on federal and provincial taxes and royalties and the projected \$10 billion cost of developing Hibernia, we expect the oil companies to avoid committing financial resources to the project until these issues are resolved.

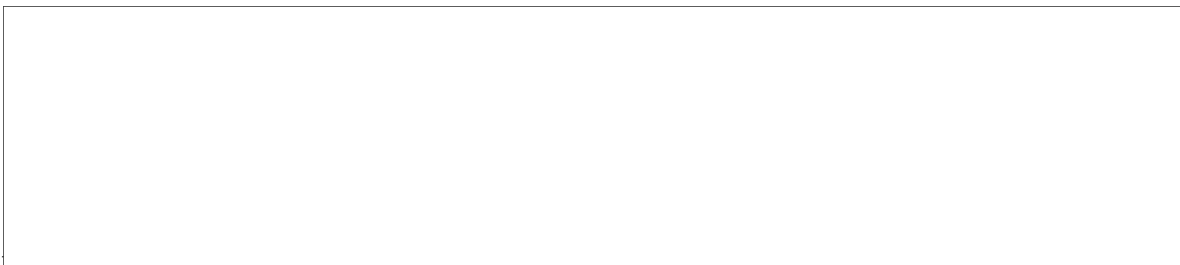
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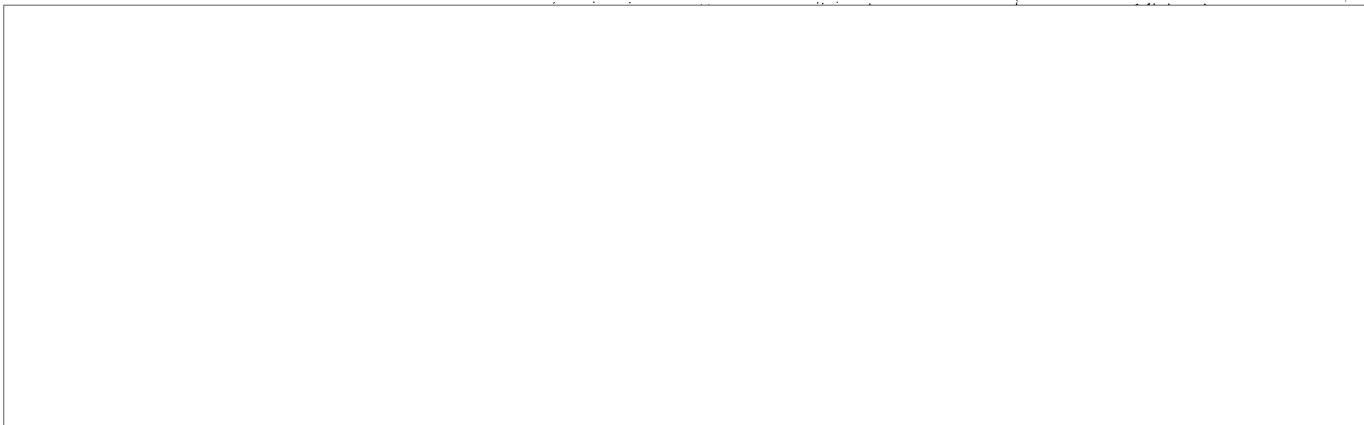


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UK Oil Production Forecast

[Redacted] British oil production will range from 2.3 to 2.7 million b/d in 1984, including approximately 160,000 b/d of natural gas liquids (NGLs). Total UK oil production approximated 2.4 million b/d in 1983, and we believe actual 1984 output will be near the high end of the forecast range. Production of NGLs—which increased more than 40 percent in 1983—is expected to increase an additional 20 percent in 1984. Although British oil production is expected to hold roughly steady in 1985, the forecast indicates that crude production will decline approximately 10 percent per year from 1986 to 1988; NGL output is projected to hold roughly steady over this period. The British estimates—which are about 10 percent higher than official projections of a year ago—are in line with recent industry forecasts. [Redacted]

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UK Oil Production Forecast

Million b/d

1983 ^a	2.4
1984	2.3 to 2.7
1985	2.3 to 2.7
1986	2.1 to 2.6
1987	1.8 to 2.4
1988	1.7 to 2.4

^a Preliminary.



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International Finance



*Possible Colombian
Debt Servicing
Disruptions*

Colombia's deteriorating financial position probably will result in its failure to make some debt service payments in the next few months. The US Embassy reports the seasonal drop in coffee earnings is larger than normal, and foreign exchange controls appear ineffective in holding down imports. Moreover, there are some indications that capital flight is increasing despite tight foreign exchange controls. Bogota is having little success in obtaining new foreign credits. A source of the US Embassy reports there is resistance among commercial bankers to provide part of a \$370 million loan cofinanced by the World Bank.

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Global and Regional Developments

EC Adopts High-Technology R&D Program

The EC research ministers recently agreed to implement the European Strategic Program of Research and Development in Information Technology (ESPRIT). Formal adoption had been blocked since last December by the United Kingdom and West Germany because of budgetary considerations. Both countries acquiesced after they received guarantees from the Commission that the program would not increase already planned research spending through the end of next year. The total program is scheduled to cost \$1.3 billion over the next five years. Only one-half the expense, however, will be charged to the Community's budget; the other half will be borne by private industry and academic institutions. [redacted]

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Although the Community touts the program as the key to improving its competitive position in information technology vis-a-vis the United States and Japan, the impact is likely to be considerably less. ESPRIT will only fund basic research in advanced microelectronics, software technologies, advanced information processing, office systems, and computer-integrated manufactures. We expect EC countries will continue to experience difficulties bringing commercial applications of such research into production. [redacted]

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Chile's Copper Earnings Threatened

A petition for import relief filed with the International Trade Commission by US copper producers could further damage Chile's troubled economy. Domestic copper producers in the United States are seeking an import quota of 300,000 to 350,000 metric tons per year of refined and blister copper over the next three to five years. In 1983, US copper imports reached an estimated 600,000 tons, with Chile—the world's largest copper producer—supplying almost 40 percent. Since 1979, US copper imports from Chile have nearly doubled. During the same period the US copper industry, battered by high production costs and low prices, has been forced to shut down mines and refineries and to lay off thousands of workers. [redacted]

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Chile depends on copper for 45 percent of its export earnings, with roughly one-third of this amount accounted for by sales to the United States. Chile, whose foreign debt is about \$20 billion, could see its copper exports decline by 100,000 tons per year if US quotas are imposed. Even at current low prices of between 65 and 70 cents per pound, Chile could lose more than \$140 million in

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export earnings. Santiago could try to offset some of its loss by increasing copper sales to Western Europe and Japan, but this would tend to drive copper prices still lower, lessening the return to Chile and other debt-troubled LDC exporters, such as Zambia and Zaire. [redacted]

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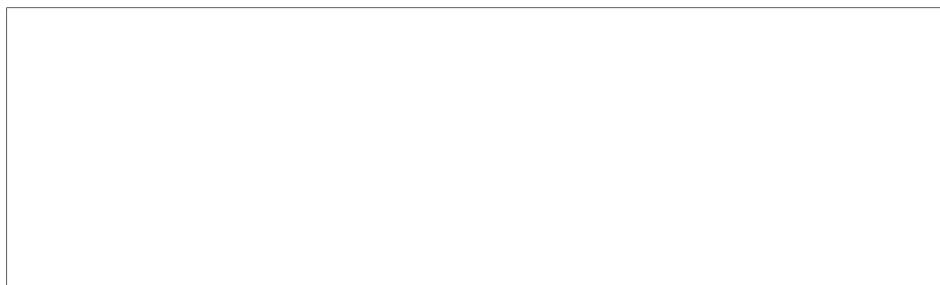
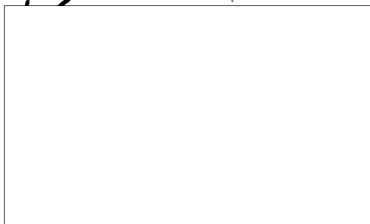
Italian Company To Build Plastics Plant in the Soviet Union

The USSR has signed a letter of intent with an Italian firm to build a 10,000-metric ton-per-year polycarbonates plant. According to a spokesman from Montedison SpA, the deal is worth \$40-50 million. The plant will use polycarbonate technology initially developed jointly by Montedison and the USSR and later improved upon by the Soviets. [redacted]

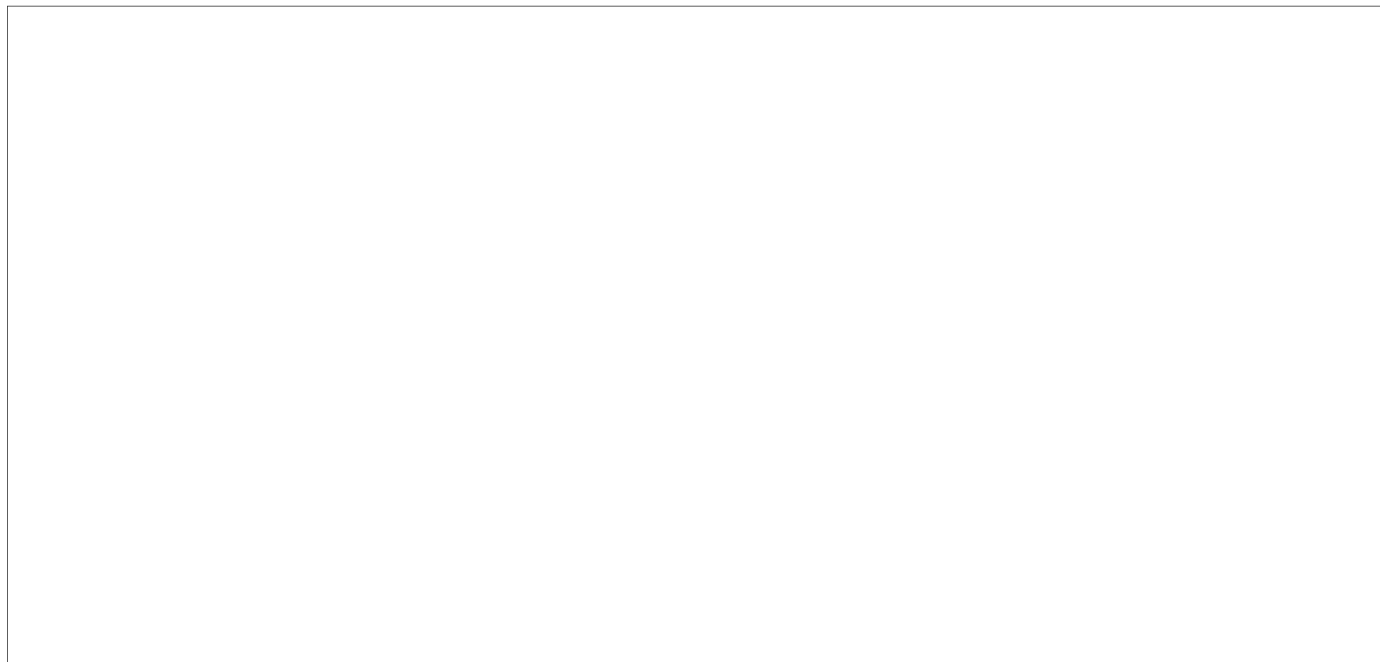
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East European Hard Currency Trade Surplus Grows

Eastern Europe more than doubled its hard currency trade surplus to \$4 billion in 1983 as Western reluctance to extend credits forced the region to reduce imports for the third consecutive year. Last year's 3.5-percent fall in nominal imports, however, was much less severe than the cuts of nearly 15 percent in both 1981 and 1982. The first increase in exports since 1980—due largely to

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resales of Middle Eastern oil—helped limit the import reductions. Yugoslavia reduced its deficit to the lowest level in 10 years and accounted for most of the improvement in the region's trade balance. Only East Germany, which posted a large increase in imports, and Bulgaria, which suffered a slump in exports, experienced decreases in their trade surpluses.

Two consecutive years of large hard currency trade surpluses are beginning to improve Eastern Europe's standing with bankers. Easier borrowing conditions will probably produce some increase in imports from the West. The upswing in lending, however, will be neither immediate nor large, and Eastern Europe will probably run another hard currency trade surplus of some \$3 billion this year. To increase imports significantly, Eastern Europe needs economic recovery in Western Europe to generate large gains in exports. Sustainable export gains, however, are not likely without improvement in the competitiveness of their goods.

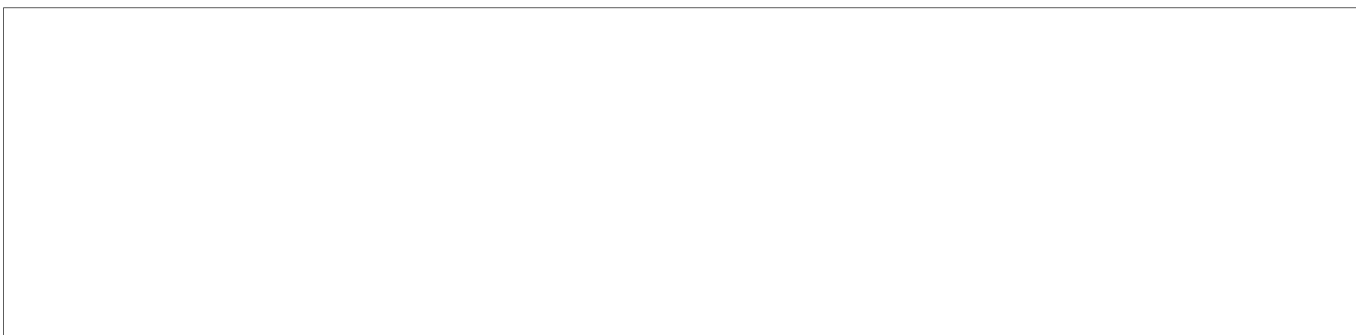
East European Hard Currency Trade

Billion US \$

	Exports		Imports		Balance	
	1982	1983	1982	1983	1982	1983
Total	36.8	37.8	35.0	33.8	1.7	4.0
Bulgaria	3.3	2.9	2.6	2.4	0.6	0.5
Czechoslovakia	4.1	4.1	3.6	3.4	0.5	0.8
East Germany	7.8	8.0	6.3	6.9	1.5	1.1
Hungary	4.9	4.8	4.1	4.0	0.8	0.9
Poland	5.0	5.6	4.6	4.6	0.4	1.0
Romania	6.2	6.1	4.7	4.5	1.5	1.6
Yugoslavia	5.5	6.3	9.1	8.1	-3.5	-1.8

National Developments

Developed Countries



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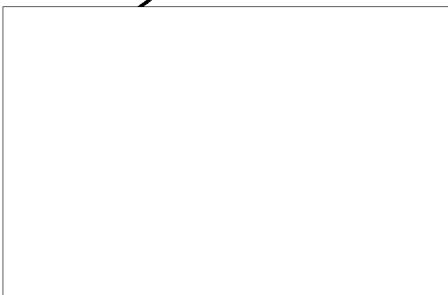
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Israeli Wage Increase



Private-sector employers and the Histadrut, the labor union organization that represents virtually all Israeli workers, have agreed to increase monthly salaries by 8 percent. The agreement, reached on 6 March, is retroactive to 1 February. The wage boost attempts to compensate workers for an erosion in real wages caused by accelerating inflation. The increase will undercut the government's policy of reducing real wages—and thereby dampening domestic pressures—in order to improve the balance of payments and to control inflation.

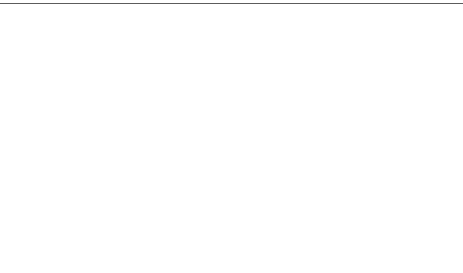
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Less Developed Countries

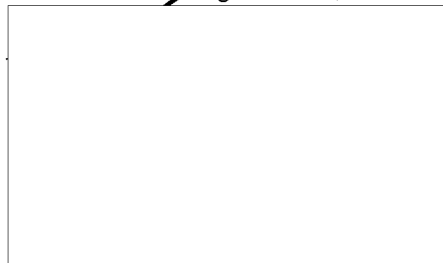
Strikes Temporarily End in El Salvador



Employees in the public sector have returned to work, but they are threatening to strike again if their demands are not met. The US Embassy reports that labor-management negotiations continue and that one union is asking for a 25-percent increase in wages, well above the 10 percent specified by the government's new wage decree. Although most of the unions currently involved are affiliated with the leftist labor front, labor leaders claim that democratic unions also may strike. Democratic labor has endorsed Christian Democratic presidential candidate Duarte, and continuing labor strife at this stage of the presidential campaign probably would benefit rightist candidates. If the situation gets worse, the Army may intervene. This would give the insurgents a propaganda windfall just before the elections on 25 March.

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Guatemala's New Budget



Guatemala's recently announced budget for 1984 reflects two main objectives—maintaining austerity and protecting the military's position during the transition to civilian rule. Military outlays will rise over 25 percent, and debt service payments will nearly double. The Ministries of Economy and Agriculture will absorb the necessary cuts to keep the overall public budget roughly

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constant in nominal terms. Actual spending probably will decline due to revenue shortfalls and borrowing constraints reached with the IMF. Although the military will receive enough money to make further progress against the insurgents, fiscal stringencies, combined with soft export markets and investor wariness, suggest that Central America's largest economy is unlikely to resume growth this year. [redacted]

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Cotton Crop Helps Chad's Economy

This year's raw cotton crop—Chad's major export earner—reached a record 140,000 metric tons and could earn more than \$100 million if it can be moved to foreign markets. Favorable weather and the perseverance of southern farmers are largely responsible for the bumper crop. Although President Habre has sent additional forces to the area to ensure the cotton makes it to market, we expect the dissidents to step up attacks on storage areas and transportation routes. These moves could lead to increased fighting in the south as each side tries to protect its interests, perhaps preventing much of the crop from reaching foreign markets. [redacted]

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Liberian Private-Sector Difficulties

Monrovia's financial problems and ill-conceived government policies may cause foreign businessmen to reevaluate the wisdom of doing business in Liberia. The country's liquidity crisis—largely caused by chronic budget deficits—threatens the dollar-based banking system. Cash flow shortfalls and government inability to cooperate with the companies in the iron ore sector, which accounts for 60 percent of exports and 25 percent of GDP, are threatening the survival of all three major producers. Despite a recent upturn in prices, the rubber industry—Liberia's second-largest exporter—is suffering similar problems, and producers expect to record sizable losses again this year. The banking, iron ore, and rubber industries are also worried that official harassment of insurance companies will inhibit these companies' ability to underwrite their assets or service their claims. Continued problems in the private sector could cause companies to pull out, increasing unemployment and causing social unrest that could undermine the scheduled transition to civilian rule in 1985. [redacted]

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New Singapore Budget Emphasizes High Technology

Prime Minister Lee Kuan Yew is using Singapore's 1984 budget to spur high technology and expand Singapore's international financial role. The budget, announced last week, encourages venture capital investment in high technology and broadens the eligibility rules for accelerated depreciation of capital equipment. It permits entrepreneurs to write off up to half of their investment in new high-technology ventures within the first three years of operation if the venture incurs losses. Moreover, eligibility for accelerated depreciation will be extended beyond manufacturing firms to include service-oriented firms, such as computer services and banks. The strategy reflects Lee's emphasis on developing new industries both to counter competition from lower cost neighboring countries in traditional fields, such as textiles, and to stay a step ahead of protectionist barriers used by industrial countries to shelter their established industries. [redacted]

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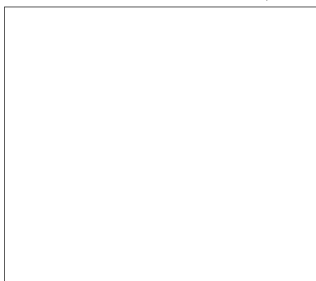
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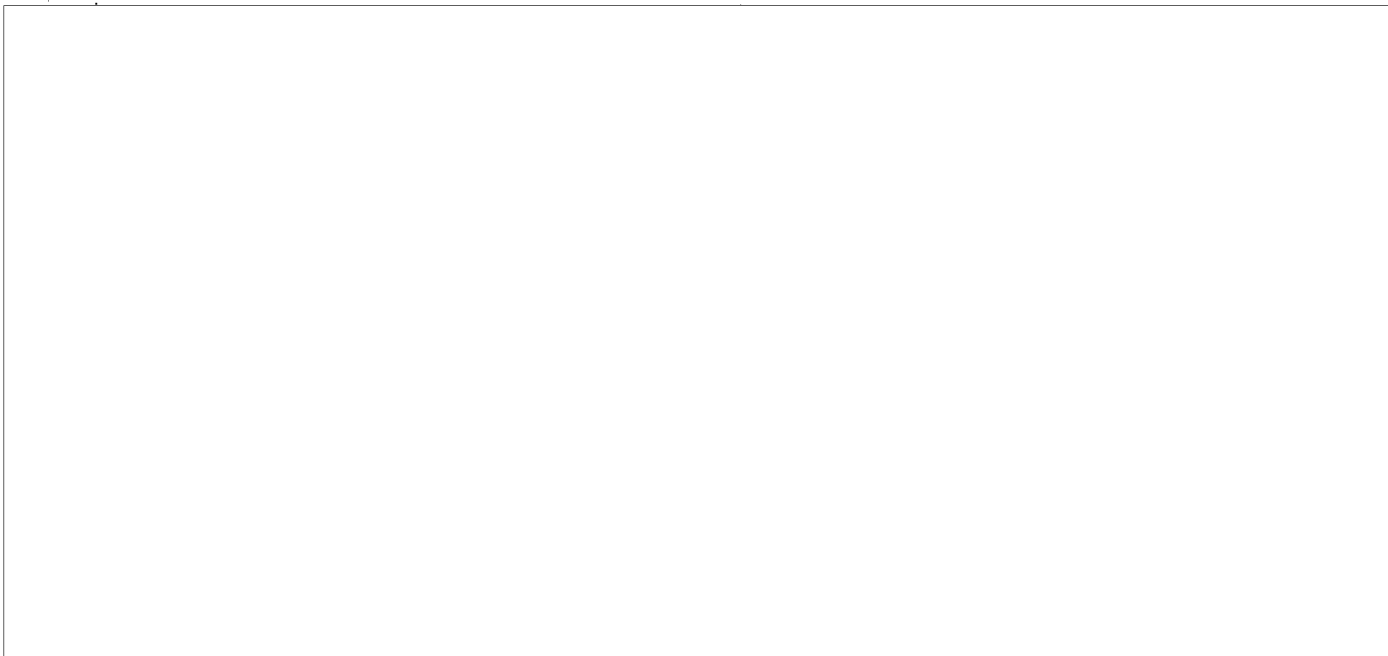
*Severe Storm Damage
in Madagascar*



Madagascar's agricultural sector, which accounts for about one-third of GDP and more than 80 percent of exports, was recently hit hard by cyclones that left over 13,500 people homeless. The island's rice crop—the main dietary staple—suffered extensive damage, according to US Embassy reporting, along with peanut, manioc, sugar cane, and cotton fields in scattered areas. Although crop losses for coffee, cloves, and vanilla—the country's major foreign exchange earners—are not known, if they prove significant, the troublesome current account deficit will seriously deteriorate. Many irrigation networks, farm-to-market roads, agricultural storage facilities, and communications systems also have been destroyed, disrupting production and distribution activities and isolating various parts of the island. The Malagasy Government is turning to various donors, including the United States, for emergency assistance to help repair physical damage, prevent widespread food shortages, and meet public health requirements. 

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Japan: Shifting Role of Tax Incentives

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Japan's use of special tax measures to promote the development of selected industries has been constrained over the past several years by budgetary stringency and the increased involvement of interest groups in the formulation of Japanese tax policy. Tax incentives—equal to about 6 percent of corporate tax revenues during 1966-75—have declined to less than 3 percent last year. Through the 1960s, tax benefits were designed mainly to help basic materials and manufacturing industries become competitive in world markets. Today, tax incentives are targeted not only at growing export industries, but also at domestic utilities, depressed industries, and companies operating in underdeveloped areas. These broader national objectives reflect, in large part, more vociferous demands from other sectors of the economy.

Tax incentives in the 1950s and 1960s were designed mainly to spur economic growth at almost any cost. Special tax measures supported development of technologies considered crucial to Japan's economic development, modernization of industries to reduce production costs, and promotion of exports. MITI's foremost objective in the 1950s and early 1960s was the development of heavy industries such as steel, electric power, shipbuilding, chemicals, and petrochemicals. The high-priority industries enjoyed relatively low tax burdens—under 4 percent of the value added—in contrast to the 4.7-percent average for all industries. Industries producing consumer goods, such as automobiles, were largely ignored.

Shifting Priorities

Increased calls over the past decade for government action on a wide range of issues has limited MITI's ability to pursue industrial policy through tax incentives. Environmental protection, correction of

regional inequalities in economic development, and improvement of housing and welfare facilities have become major objectives. In addition, the higher cost of oil since 1973 and Japan's heavy dependence on Persian Gulf suppliers have dictated the diversion of government financial assistance to the development of alternative energy sources and suppliers. High energy costs also have undermined the economic viability of energy-intensive, basic materials industries such as aluminum refining, petrochemicals, pulp and paper, chemical fertilizers, and cement. As a result, MITI must assist these industries' capacity reduction efforts, which further dilutes its ability to aid selected growth industries.

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Rapid increases in government spending during the period of economic expansion have led to large budget deficits. Since the late 1970s, efforts to close the gap between revenues and spending have limited the number of special tax incentives. As a result, industries' savings from these incentives have become less important as industries have expanded.

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Tax Incentives

There are three major categories of tax incentives benefiting corporations—special depreciation, tax-free reserves, and tax credits. These measures will cost the national treasury 258 billion yen (\$1.1 billion) in lost revenues in the fiscal year ending this month, with special depreciation accounting for about 60 percent of the total. Special depreciation measures generally favor small business, while R&D-oriented credits and deductions favor big

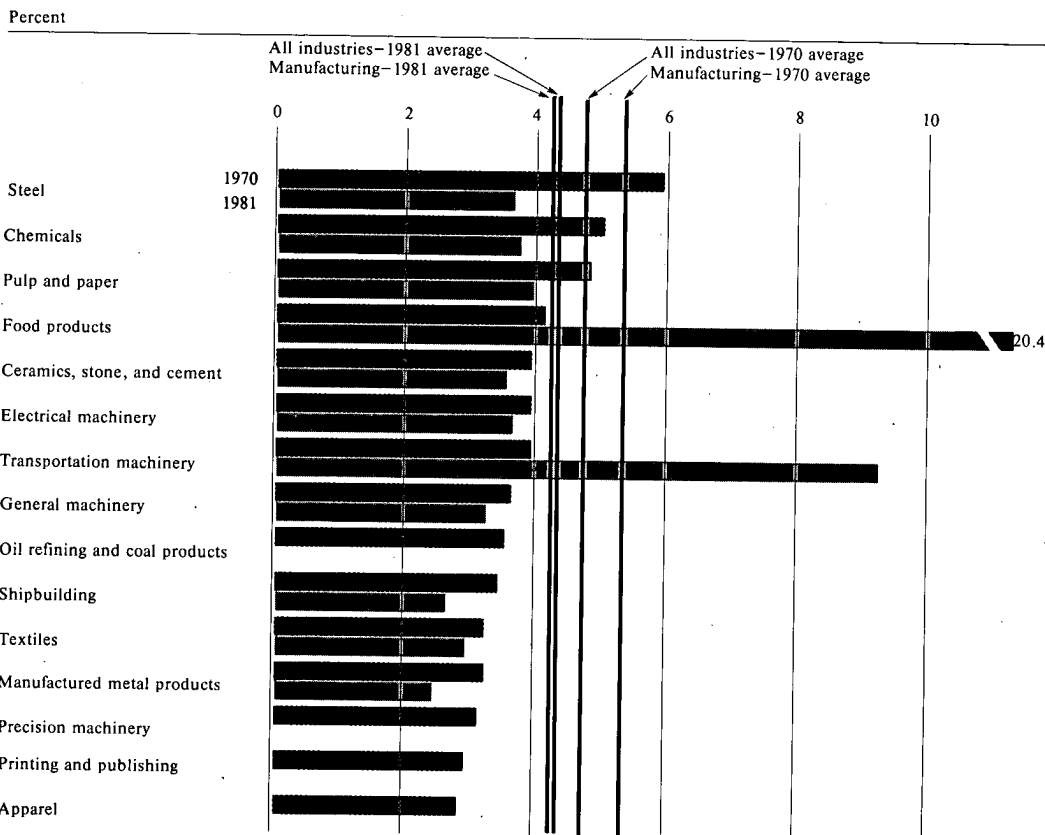
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Japan: Tax Burden as a Share of Value Added, by Manufacturing Industry, 1970 and 1981^a

^a Fiscal year (April-March).

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firms, resulting in a surprisingly uniform tax burden by industry. As a result, the incentive to channel investment into particular industries is diluted:

- **Special Depreciation.** In contrast to special depreciation measures of the past, which favored MITI-designated "important" industries, current measures serve many purposes, including environmental concerns, small business interests, energy-saving efforts, and promotion of underdeveloped areas. The industries MITI would most like to develop are not the primary beneficiaries. Electrical machinery, for example, which includes the favored computer, telecommunications equipment, and semiconductor fields, ranks only seventh among the listed industries, behind apparel,

printing and publishing, textiles, and shipbuilding, among others.

- **Tax-Free Reserves.** Tax-free reserves—corporate earnings upon which taxes are deferred—continue to benefit some of the growth industries but are now used to support development of a wider range of industries. For example, the largest beneficiary is currently the electric power industry—which plays the central role in Japan's efforts to develop alternate sources of energy.
- **Tax Credits and Deductions.** Special credits and deductions provide benefits to large firms, especially those involved in research and development.

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Because of the decline in size of all tax benefits, however, the advantages are insignificant compared with those offered in the United States.

The biggest tax credit is for incremental research and development expenditures, which will cost an estimated \$162 million in FY 1983. A National Science Foundation study estimates that a similar US credit produces a \$2 billion annual tax incentive. [redacted]

The Politics of Balance

The increasing number of beneficiaries of tax incentives reflects the widening circle that now influences tax policy. [redacted]

The Bureaucracy. Within MITI the various bureaus act as proponents of their own clients in the annual formulation of policy guidelines. For example, the Small and Medium Enterprises Agency pushes incentives for small business, the Basic Industries Bureau works on behalf of steel and chemicals, and the Machinery and Information Industries Bureau promotes the electronics, computer, and machinery industries. As a result, MITI itself supports tax incentives that benefit a broad spectrum of industries. [redacted]

Although MITI may take the initiative in proposing a special tax incentive, revisions of the Special Tax Measures Law are actually drafted in the Tax Bureau of the Ministry of Finance (MOF). The MOF takes into account requests from MITI, other ministries, and interest groups such as the Japan Chamber of Commerce. Closing the gap between revenues and expenditures, however, is the first priority of the MOF, and political considerations dictate that the effort be concentrated on the revenue side. The Finance Ministry has tried to reduce the size and number of special tax measures benefiting business because this is one of the easiest ways to increase revenues. [redacted]

The Tax Advisory Commission. Tax Bureau officials submit their list of alternative policies to the Tax Advisory Commission. The commission is composed of former government officials, academic experts on public finance, journalists, bankers,

businessmen, union leaders, agricultural representatives, and local politicians. The commission serves as an arbiter among diverse interest groups and as a builder of consensus on broad questions of tax policy. [redacted]

The Taxation Research Council. A small group of politicians from the ruling Liberal Democratic Party, dubbed the "tax mafia" by the Japanese press, plays a key behind-the-scenes role in setting tax policy. Because many of the politicians involved are former Finance Ministry bureaucrats, they share the concern of that Ministry and the Tax Advisory Commission for fiscal restraint. As politicians, however, they also recognize the value of tax incentives for politically popular programs such as housing, small business, and regional development. [redacted]

The council collects proposals to revise the tax laws from interest groups such as the Federation of Economic Organizations and the Central Association of Agricultural Cooperatives. Last fall, approximately 1,000 items proposed by some 150 organizations were included in a listing put together by the council. The listing is given to the Tax Bureau for item-by-item review. Each item is marked to indicate acceptance, rejection, or the need for further consideration. The council then reviews the bureau's grading and may call in Finance Ministry officials to explain a decision. On some items the council may force the bureaucrats to change a ruling. [redacted]

Interest Groups. Special interest groups lobby during public hearings held by the Tax Advisory Commission each fall and influence members of the LDP Taxation Research Council. [redacted]

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The growing number of special interest groups influencing tax policy formulation is illustrated by one measure slated for inclusion in the revisions of the Special Taxation Measures Law for 1984. The measure increases initial depreciation for new machinery by 30 percent in designated high-technology industries in areas for which an official development plan has been approved. Because of political pressures, the list of designated industries tends to become too long to be truly selective. Industries earmarked under the current Extraordinary Measures Law for the Promotion of Machinery and Information Industries, for example, include textile machinery, industrial sewing machines, farm tractors, and lumber-processing machinery, in addition to integrated circuits and communications equipment. [redacted]

Other Tools of Industrial Policy

The declining effectiveness of tax incentives to assist particular industries has prompted MITI to place greater emphasis on alternative approaches. In recent years MITI has, for example, identified fine ceramics and biotechnology as fields of vital importance to future industrial development and established special offices to find ways to assist these industries. To promote the computer industry, MITI is attempting to push legislation through the Diet which would ensure Japanese manufacturers access to the operating systems of foreign computers sold in Japan. Without such access, Japanese companies will have difficulty wresting market shares away from foreign competitors. [redacted]

We do not believe that MITI will be able to compensate completely for the limitations on the effectiveness of special tax measures with other tools. The pressures that lead to the dispersion of tax subsidies among a wide spectrum of industries affect other tools as well. For example, broader political considerations prevent the concentration of budgetary subsidies—at about \$2 billion a year, the most important of the tools used today—and loans from official institutions to high-priority industries. The computer and semiconductor industries, which MITI has been promoting for over a decade,

receive a share of the \$5 billion in funding directed toward the manufacturing industry proportionate to their share of total output. Moreover, the manufacturing industry takes a backseat to agriculture, forestry, and fisheries—key constituencies of the LDP—which received 48 percent of the \$18 billion allocated in FY 1983 for industry and technology-related programs. The transportation and communications sector receives 21 percent—primarily to cover the deficit of Japan National Railways. [redacted]

The same inconsistency between the professed objectives of industrial policy and the actual distribution of benefits exists in the case of official financing. Of the \$90 billion that government financial institutions are authorized to loan out in the fiscal year beginning this April, 25 percent will be for housing, 19 percent for small business, and 14 percent for environmental improvement. The diversity of objectives in general also is present in the lending programs of the Japan Development Bank and the Small Business Finance Corporation, the institutions established specifically as instruments of industrial policy. [redacted]

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Argentina: Attempting To Resolve the Debt Crisis

Argentina faces a crucial payments deadline on 31 March with US bank creditors on its overdue interest charges. Although there are several roadblocks to a solution, we believe the problem could be worked out, perhaps on the basis of progress toward an IMF agreement. If the issue is not resolved, US banks would face substantial earnings losses.

Beyond the near-term crunch, upcoming bank re-scheduling talks are likely to be difficult. The Argentine Government has stated that it will not accept rescheduling terms that appear either to impinge on national sovereignty or inhibit the growth potential of the economy. We believe there is considerable room for a breakdown in discussions with banks, which could lead Argentina to take a hardline approach and limit ties with Western countries. We cannot rule out the possibility that Argentina will repudiate its debt.

Immediate Problem

Unless Argentina pays by 31 March all overdue 1983 interest payments—estimated to total from \$600 million to \$750 million—many of their loans will be in arrears longer than 90 days. This will force US banks—under current US banking regulations—to reclassify about one-half of their \$8.4 billion Argentine loan portfolios as nonperforming.

We believe the Alfonsin administration is unlikely to deplete its foreign exchange reserves—now less than \$1 billion—or sell gold to meet the March deadline. Doing either would leave it vulnerable to charges by the Peronist opposition of a sellout to the international financial community. Argentina could, however, make a partial payment. The administration is hoping to repeat the solution to a similar problem in December 1983, when bankers

granted Buenos Aires the first \$500 million tranche of a \$1.5 billion medium-term loan, ostensibly as a show of support for the newly elected Alfonsin government. The Argentines agreed to return the entire amount of the disbursement plus enough of their own reserves to cover the first \$350 million payment against a \$1.1 billion bridge loan and to bring interest payments current through 13 October.

Economy Minister Grinspun suggested in January that a foreign bank consortium disburse the remaining \$1 billion of the medium-term loan without a firm IMF accord. Argentina would then return the entire disbursement plus enough of its reserves to make a second \$350 million bridge loan payment and bring interest payments current through yearend 1983. Grinspun pointed out that this plan of action would remove the time pressure on the banks and free him to concentrate on his goal of obtaining formal IMF and Paris Club accords and a comprehensive bank rescheduling by 30 June.

In mid-February, the US Embassy reported that the committee of foreign lenders was willing to disburse the remaining \$1 billion but only if the IMF's Managing Director recommends that the Executive Board approve Argentina's proposal for an economic adjustment program. On the chance that such an arrangement could be reached, the advisory committee would prepare an interim financing arrangement.

On the basis of talks to date and the apparent Argentine tactic of postponing comprehensive planning to gain maximum negotiating flexibility, it is not possible for Grinspun to have a firm IMF letter of intent in time to allow a disbursement of bank funds by 31 March. For example, Grinspun has yet

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Alfonsin's failure to lay out a comprehensive set of economic policies during his three months in office has enabled a hardline group on debt to form within his Radical Party and encouraged them to assert their views. We believe this group would seize upon any confrontation with banks or the IMF to further enhance its position. If these fervent nationalists—led by Aldo Ferrer, president of the Bank of the Province of Buenos Aires—are able to publicize tough tactics by foreign bankers, we believe they could create sufficient domestic pressure to force Alfonsin to further stiffen his demands. [redacted]

the hardliners support a negotiating position that includes a grace period for both interest and principal, capitalization of interest arrears, interest rates below those charged to Brazil and Mexico, and limitation of debt service to 15 percent of export earnings. If banks do not meet these terms, the nationalists are likely to propose debt repudiation and a limiting of economic ties to many Western nations. [redacted]

The extent of support for an ultranationalist approach within the President's inner circle is still not clear. Some Argentines believe the tough talk is a psychological ploy. [redacted]

[redacted] Although we agree with the US Embassy that a hardline approach does not now reflect official policy, strident rhetoric could lead to increased demands for a tough political stance by the Alfonsin government. [redacted]

Argentina is widely recognized as the major debtor with the best ability to walk away from its debt. It is a substantial food exporter to the Soviet Bloc, ensuring a large foreign earnings base to pay for necessary imports. It is also nearly self-sufficient in petroleum. Regional pressures on Alfonsin to assume leadership among Latin American debtors have already surfaced. Should a breakdown in talks with lenders strengthen the hand of hardline nationalists, we believe Alfonsin would be receptive to a more radical approach. [redacted]

[redacted]

Indicators of Radical Action on Debt

- *Confrontation and impasse on negotiations with the bank advisory committee.*
- *Campaign by the Argentine Government to build public support for handling debt negotiation position, for example, street demonstrations.*
- *Movement of official funds—including gold—to safehavens.*
- *Movement by President Alfonsin to assume a leadership role among Latin American debtors. In particular, look for Argentine initiatives at upcoming conferences such as the IADB meeting in Uruguay later this month.*
- *Increasing public statements by hardliners who refuse to follow Alfonsin's more moderate line on the foreign debt issue. [redacted]*

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Gray-Market Arms Scams [redacted]

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The international gray arms market, involving the purchase and movement of weapons on other than a government-to-government basis, lends itself to a variety of fraudulent arms deals. Identifying such transactions is often difficult but is an important element in monitoring arms transfers. These fraudulent deals—or scams—frequently involve small, disreputable brokers, operating under the cover of several front firms. These individuals usually offer unrealistically high quantities of virtually unobtainable equipment and seek both large advance downpayments and long delivery schedules. Iran—having few reliable military suppliers—has often been the victim of many of these scams. [redacted]

Because of its secretive nature, the international gray arms market is used by recognized governments, established manufacturers, private dealers, and a variety of terrorist, insurgent, and criminal groups to buy and sell large quantities of weapons through unofficial—and often illegal—channels. The weapons most commonly traded on the gray market are small arms, although [redacted] heavy machineguns; recoilless rifles; mortars; a wide variety of artillery munitions; telecommunications equipment; and spare parts is also available. In addition to such equipment, however, gray-market dealers have sought to broker the sale of large quantities of such advanced weapon systems as Exocet missiles and Cobra helicopter gunships [redacted]

Offers for this kind of expensive materiel have traditionally been made to pariah states—such as Libya and South Africa—or to embargoed nations at war—such as Argentina during the Falklands crisis. Recently, many such offers have been made to Iran, which has been one of the most active buyers on the international gray arms market since the beginning of its war with Iraq. [redacted]

Recognizing Scams

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Gray-market scams frequently exhibit one or more discernible characteristics. Although any offer of large quantities of hard-to-obtain ordnance from any source should be viewed with skepticism, the offer of such equipment by a small, obscure firm or individual is even more suspicious. [redacted]

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Individual arms brokers offering weapons on behalf of several firms are also suspicious. Small-time dealers probably negotiate on behalf of allegedly different firms in order to impress clients with the scope of their contacts or to maintain access to a potential buyer after an initial deal has fallen through. [redacted]

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[Redacted]

Another sign of a possible scam is the request for a large downpayment coupled with a long delivery schedule—intended, no doubt, to allow the broker sufficient time to abscond with his money. [Redacted]

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Similarly, cases of two or more firms operating out of the same office are suspect. Gray-market swindlers may establish phony intermediaries and front companies to insulate themselves from a customer who may seek revenge after realizing that he has been cheated. Multiple firms at the same address are even more suspicious when the firms claim a foreign incorporation that cannot easily be verified.

[Redacted]

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[Redacted]

Gray-market dealers seeking to set up a scam will frequently attempt to convince the client of the need to act quickly, either by claiming that his own option to buy will expire soon or by implying that the equipment could end up in an opponent's possession. [Redacted]

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Another good indication that a gray arms negotiation may be a scam is the request by the supplier for a large downpayment prior to the delivery of any goods. [Redacted]

Offers of both hard-to-obtain and readily available equipment suggest that some dealers may seek to "bait and switch" by seeking a downpayment for hard-to-acquire, advanced ordnance in the hope of supplying other, less sophisticated equipment at a later date. [Redacted]

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Iran: A Target

[Redacted]

Although we do not know how much money Iran has lost as a result of fraudulent gray-market deals, we believe that the amount had reached several hundred million dollars by the end of 1982. [Redacted]

[Redacted] The revolutionary government had halted practically all official arms buying activity, and established procurement channels had been abandoned. As a result of the loss of traditional contacts with the United States and Europe, an embargoed Iran entered the international gray-arms market, where hundreds of private dealers and would-be agents offered to broker the sale of all manner of military equipment for the new regime. [Redacted]

[Redacted]

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Although arms dealers worldwide have attempted to sell arms to Iran, most appear to reside or operate in West European countries such as Portugal, Spain, West Germany, Austria, and, especially, Switzerland—the latter presumably because of its prominence as an international banking center and its favorable incorporation laws. Some offers from these dealers appear credible and involve relatively small quantities of small arms, munitions, and other expendables that are readily available on the international gray-arms market. Other offers appear to be frauds, however, with small-time dealers proffering unrealistically large quantities of sophisticated and virtually unobtainable weapon systems at exorbitant prices. [Redacted]

Although we expect that gray-market dealers will continue to offer advanced military equipment to Iran, we believe that Iranian procurement officers are becoming sufficiently cautious to discriminate between credible and improbable offers. We expect that gray-arms market brokers will continue supplying conventional small arms and munitions to Iran as well as to any other client with sufficient cash to pay for them. They are unlikely, however, to find another customer as willing and able to advance large sums of money in return for the promise of advanced equipment—until the next international crisis or arms embargo creates a seller's market for such ordnance. [Redacted]

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Yugoslavia: Persistent Inflation Problems

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Yugoslavia's lack of success in controlling inflation—over 40 percent last year—was the major failure of its 1983 economic stabilization program. Despite Belgrade's compliance with tight monetary targets established with the IMF and a price freeze in effect through July, prices were rising at an annual rate of 100 percent by the end of the year. Although administrative price increases to reduce subsidies and devaluation of the dinar contributed to inflationary pressures, the chief factors are rooted in the Yugoslav system of wage and price formation and monetary and credit arrangements. Since few steps have been taken to deal with these systemic problems, rapid inflation is likely to persist in 1984, threatening both living standards and last year's gains in the competitiveness of Yugoslav exports.

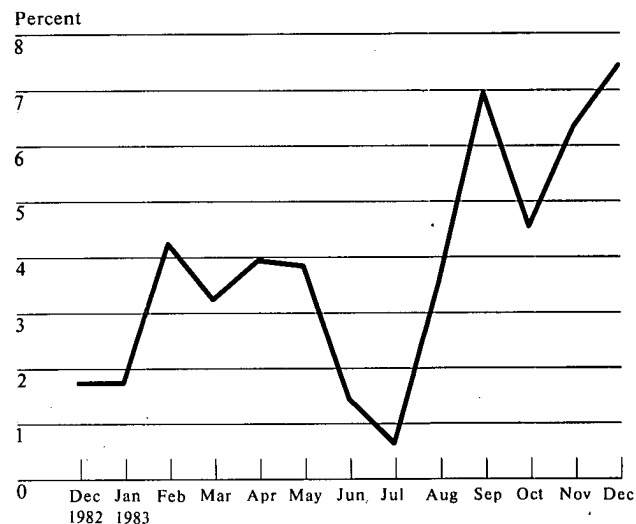
Price Trends

Double-digit price rises at both the producer and the retail level have become the norm in Yugoslavia since the early 1970s. Some Yugoslav officials have put the blame on rising world prices of raw materials and energy, especially oil.

about one-fourth of the 20-percent inflation recorded in 1979 was due to higher import prices. Even in the absence of these external factors, however, Yugoslavia's cost-of-living index has continued to soar, rising nearly 35 percent annually during 1980-82.

The cost of living last year climbed a record 42 percent. A price freeze helped stabilize industrial prices and moderate consumer price increases through the first half of the year. Following the lifting of the price freeze in August and the continued depreciation of the dinar—policies demanded by the IMF—retail and producer prices rose sharply. By the end of the year, the cost of living was rising at an annual rate of 100 percent. Food prices—heavily weighted in the cost-of-living

Yugoslavia: Monthly Increase in Cost of Living



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index—were a major source of inflation, reflecting higher import prices, some agricultural production difficulties, and government attempts to reduce subsidies. The government also boosted prices of other consumer essentials, such as energy, rents, and railway fares, in order to comply with agreements made with the IMF.

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Sources of Inflation

Yugoslavia's chronic inflation has resulted from Belgrade's desire to spur economic growth. Investment, in particular, played a key role in the late

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1970s; real investment grew at an average 8.8-percent annual rate in 1975-79. Several factors accounted for this surging investment, including easy access to foreign borrowing, lax domestic monetary policy, and negative real interest rates, which made borrowing an attractive option for Yugoslav enterprises. The investment boom ended in 1981 when Yugoslavia agreed to restrict demand under an IMF program. [redacted]

Because Yugoslavia's six independent regions and two autonomous provinces operate independently, investment and production frequently are duplicated, leading to inefficiencies and more costly goods. In addition, regional governments discourage the flow of goods to other republics, creating local monopolies that have no incentive to keep a lid on prices. Moreover, the government's policy of subsidizing firms that would otherwise go bankrupt—in part, to keep unemployment down—introduces yet additional cost pressures. [redacted]

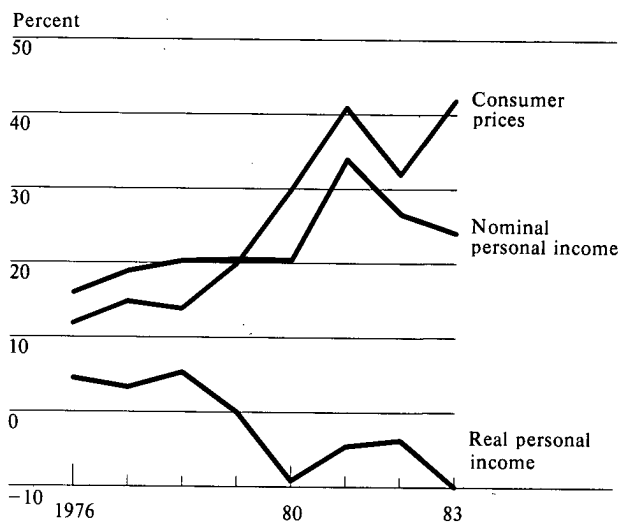
Embedded in the Yugoslav economic system is a continuous wage-price spiral that maintains the momentum of inflation. Workers' self-management councils have voted wage increases in excess of productivity gains. As unit labor costs have risen, management protected profit margins by raising prices. In 1981-83, these costs rose nearly 30 percent per year. [redacted]

Anti-Inflation Policies Fail

Tito's decentralization of the economy left Belgrade with few viable policy options with which to fight inflation. Federal government expenditures are small, and therefore fiscal policy has little impact. Moreover, most discretionary budgetary powers are delegated to the individual republics and provinces where strong vested interests and power groups ensure continued spending. [redacted]

Decentralization also has weakened the role of the central bank and put regional banks essentially under the control of local enterprises. Monetary policy often has merely abetted the rapid growth policies. Although Belgrade met the strict money supply target agreed to with the IMF last year,

Yugoslavia: Inflation and Personal Income Trends, 1976-83



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enterprises evaded the curbs by extending loans to one another to maintain overall liquidity—a move they traditionally take when the money supply is restricted. In addition, the purchasing power of large private holdings of foreign exchange has increased as the dinar has been devalued. [redacted]

Impact on Balance of Payments

Yugoslavia's creditors are concerned that hard-won improvements in Belgrade's current account may be eroded if Yugoslavia fails to control inflation. Last year Belgrade ran a current account surplus of nearly \$300 million, the first surplus since 1976 and a sharp improvement from the \$1.4 billion deficit recorded in 1982. The government hopes to increase the surplus to \$800 million this year, and even the more cautious IMF is projecting a surplus of around \$500 million. [redacted]

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Belgrade pared nearly \$2 billion off its trade deficit last year, reducing it to \$1.8 billion. Imports plummeted 16 percent, while exports grew nearly 8 percent, largely due to the redirecting of sales away from traditional CEMA markets toward hard currency markets. Yugoslav officials project another healthy cut in the deficit this year, essentially by boosting exports 20 percent and allowing for a modest recovery in imports.

If Belgrade tries to fight inflation by allowing the dinar to appreciate in real terms, the current trade surplus will be difficult to sustain. As prices of Yugoslav goods rise—and are not offset by dinar depreciation—their competitiveness on international markets will decline, and the goods will be consumed in the home market. In addition, import demand will increase because of relatively cheap prices. The IMF estimates that the dinar effectively appreciated 18 percent in November and December. As a result, a major devaluation is included among the IMF conditions for a 1984 standby agreement.

Domestic Implications

Worker morale—and thus productivity—will continue to be hurt if no progress is made in controlling inflation. Most Yugoslavs have come to expect steady improvements in their standard of living, but workers' real incomes have declined 25 percent since 1979. The full impact has been greatly mitigated by other sources of income, such as moonlighting, worker remittances, and generous social payments and allowances. Evidence is growing, however, that even these supplemental sources of income are dwindling and that people are now drawing down their savings. In addition, import curbs have produced serious shortages of gasoline, coffee, sugar, soaps, and other consumer goods. The net effect has been an estimated real drop in consumption of 3 percent since 1980.

Although Yugoslav workers increasingly perceive inflation to be a major threat, consumer reaction thus far has been restrained. Strike action has increased, but incidents of more serious unrest have

Yugoslavia: Trends in Real Effective Exchange Rates, 1970-82^a



^a Trade weighted against a basket of 16 competitors.

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been few. Worker morale continues to plummet and is hurting productivity—output per worker has fallen 3.5 percent annually the past two years. President Planinc of the Federal Executive Council has stated that the standard of living can drop no further without exhausting the patience of the populace.

Dim Prospects for Inflation

Inflation is likely to accelerate in 1984 despite Belgrade's determination to slow the pace. This year's target of only 15 percent will not be met for a variety of reasons, including:

- IMF insistence that the current price freeze imposed at the end of 1983 be lifted as a condition of a new standby arrangement.
- Continuing inflationary pressure generated by 1983 price increases as they work through the system.

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- Further devaluation of the dinar.
- Growing pressure from workers to reverse the decline in real wages.

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Most important, few steps have been taken to correct the systemic deficiencies that boost prices. Yugoslavia's problems with inflation will be corrected only if Belgrade imposes financial discipline on Yugoslav enterprises that are now sheltered from competition and financial accountability. Implementation of such measures, however, remains politically difficult because of the opposition of vested regional interests.

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External pressure from multilateral and commercial banking institutions may be the only force able to move Belgrade toward remedial policies. Parochial regional interests are so strong that the government is likely to continue ineffective controls designed to lessen the damage caused by inflation without attacking its sources as long as external financing is available.

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