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International Economic & Energy Weekly

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13 April 1984

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13 April 1984

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International Economic & Energy Weekly [redacted]

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[redacted] 25X1

[redacted] 25X6

33 **Nigeria: Running Short of Time** [redacted] 25X1

Unless the Buhari government soon puts together a politically and economically viable austerity program, which we believe is unlikely, domestic unrest and increased coup plotting are inevitable. [redacted] 25X1

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37 **China: Energy and Economic Growth** 25X1

Weakness in China's supply of energy has already forced Beijing to make major changes in the country's long-term political and economic policies. China's need for new technology, both to explore and develop new energy resources and to improve the efficiency of energy use, is one of the most important motivations for Beijing to strengthen commercial links with the Western world, particularly the United States. 25X1

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Perspective

US Involvement in China's Energy Sector [redacted]

President Reagan's visit to Beijing comes at a time when the energy sector is developing into one of the best venues for mutual cooperation between China and the United States. [redacted] 25X1

[redacted] 25X1

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China has good reasons for wanting to increase the flow of Western technology and capital into its energy sector. We anticipate, and this is reflected in many Chinese policy statements, that, even with this new technology, pressures on China's energy supplies will increase through the rest of the 1980s:

- Offshore oil production may not be available soon enough to offset an expected decline in production from the country's large but mature onshore oilfields.
- Coal production, because it is being counted on to substitute for oil wherever possible, will be hard pressed to provide the energy needed to fuel economic growth.
- Electricity shortages, caused by insufficient investment in recent years and surging demand, may become the most critical short-term constraint to economic growth. [redacted] 25X1

Beijing must resolve these and other potentially divisive problems if satisfactory economic growth is to be attained. Since 1978, China has made exceptional progress in improving the efficiency with which its economy uses energy. This has allowed fairly rapid economic growth and a large increase in energy exports despite slow and erratic increases in the production of energy. Unlike most countries, China has done this without sharp increases in energy prices. [redacted] 25X1

Two important decisions now being debated are whether to reduce or even eventually eliminate petroleum exports—20 percent of the country's foreign exchange earnings—and how to build the political consensus that is needed to increase domestic energy prices sharply. [redacted] 25X1

The government's ability to channel energy supplies toward industry should allow the economy to increase at a modest 4- or 5-percent rate through the 1980s—slower than in the past but faster than that initially planned by Beijing. We doubt, however, that the much faster growth presently expected by Beijing for the 1990s can be achieved without putting undue strain on the energy sector. 25X1

The Chinese appear anxious to promote still closer linkages with US energy firms and will continue to pressure the US Government for maximum latitude in technology transfer issues. Many Chinese leaders, however, still hope only to borrow this technology from the West in order to learn it quickly and regain energy self-reliance in the decade ahead. This is particularly true within China's very large and politically powerful energy industries. 25X1

The depth of cooperation with the West—and China's long-term ability to meet its energy requirements—is critically dependent on large oil discoveries being made in China's offshore regions. Should the Western firms that are scheduled to drill dozens of wells this year not find the oil deposits they expect, China may have to decide between importing oil in the 1990s—at great expense to the country's international financial position—or returning to the more self-reliant and isolationist policies of the past. 25X1

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Briefs

Energy

Oil Market Trends

[redacted]

Despite tension in the Middle East, sluggish oil consumption has kept oil prices soft in recent weeks. Spot prices for most Middle East crudes are $0.10 to $0.50 per barrel below official prices, while North Sea and Light African crudes are at or near official prices. Oil sales in the United States rose during the first quarter, reflecting increased industrial activity and colder-than-normal weather. In contrast, February oil sales in Italy and France dropped by about 3 percent and 7 percent, respectively, following sharp gains registered in January. Data from the International Energy Agency indicate inventories fell by only about 1 million b/d during the first quarter—considerably less than oil companies had anticipated. If companies attempt to pare high inventories, oil prices could face renewed downward pressure during the coming months. [redacted] 25X1 25X1

Iran and Japan Negotiate Oil Contracts

[redacted]

[redacted] Iran is prepared to offer Japanese traders favorable prices and terms to renew oil contracts that expired last month. As an added incentive, Tehran may be willing to increase imports from Japan at the expense of West Germany and other countries, which are not buying as much oil as Tehran expected. Iran's overtures may win over the Japanese, who have been holding out for price concessions and, to a lesser extent, for opportunities to increase exports to Iran. [redacted] 25X1 25X1 25X1

Japan should not experience serious problems arranging for the delivery of Iranian oil, barring an Iraqi attack on Khark Island or Iraqi airstrikes on shipping in the Persian Gulf. Press reports indicate Tehran has deposited $100 million into a London bank to insure all tankers loading oil at Khark Island. Iranian insurance coverage and an oversupply in the world oil tanker market will encourage shippers to continue loading oil at Khark Island. The press reports that the Japanese are chartering foreign flag vessels to transport Iranian oil, however, because the Japanese Seamen's Union has refused to load tankers stopping at Khark Island, following recent Iraqi attacks on shipping. [redacted] 25X1

OPEC Barter Trade Arrangements

[redacted]

OPEC members are making increased use of barter trade, primarily because they fear further oil price cuts could get out of control, and the slump in the oil market has left them short of hard currency.

- Libya is marketing 30 percent of its current oil production through barter deals. 25X1
- Iran is trading oil for a wide variety of military and civilian goods.
- Nigeria and Great Britain reportedly are negotiating an exchange of 22 million barrels of oil for construction work. 25X1
- Iraq has used oil to pay for French weapons. [redacted]

OPEC countries also are offering nonpetroleum products in barter agreements. Ecuador is swapping foodstuffs for industrial and consumer goods. Indonesia reportedly has exported nonoil products worth $765 million in the past two years through barter deals. Venezuela is trading finished aluminum for Jamaican bauxite. The role of barter is likely to expand until the global economy improves. [redacted] 25X1

United Kingdom Steps Up Onshore Petroleum Exploration

[redacted]

In a move to accelerate the pace of onshore oil and gas exploration, the UK Department of Energy has announced a new onshore licensing system that is parallel to the licensing procedure for offshore areas. London apparently wants to explore options that could help offset projected declines in British North Sea oil production. The government will begin to offer onshore areas in regular licensing rounds, possibly beginning this June, rather than on an ad hoc basis. Moreover, the government will authorize six-year exploration licenses and five-year appraisal permits. Although the United Kingdom currently produces only 5,000 b/d of oil onshore, prospects of increasing production from areas such as Wytch Farm—where production is projected to reach 40,000 b/d by 1987—and lower drilling costs have renewed industry interest in onshore areas. [redacted] 25X1

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Canadian Petroleum Association Updates Forecast

[redacted]

At the request of Canada's National Energy Board, the Canadian Petroleum Association (CPA)—an independent industry group including most of the major oil companies operating in Canada—has updated its forecast of indigenous oil and natural gas supplies through 1995. The CPA estimates that, under present economic and operating conditions, Canada's oil production capacity will decline from about 1.5 million b/d in 1984 to 1.2 million b/d in 1995. Conventional crude oil production is expected to decline rapidly over this period, and, by the mid-1990s, oil sands projects and production from future tertiary recovery projects probably will account for about one-half of total oil production. CPA's projection excludes any oil from Canada's "frontier" areas because of technical, jurisdictional, and fiscal constraints. In addition, the association forecasts Canadian natural gas supplies to be ample to meet projected domestic requirements and existing export commitments. [redacted] 25X1

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[redacted]

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International Finance

Brazil's Export-Driven Growth Strategy

[redacted]

Brazil's vigorous drive to expand exports has begun to yield results, which, if sustained, will help support an economic recovery. Repeated devaluations of the cruzeiro, continuing fiscal and credit incentives, and major export promotion campaigns—coupled with rising foreign demand—enabled Brazil to increase its first-quarter 1984 export earnings to $5.6 billion, 21 percent 25X1 greater than the same period last year. Manufactured and semimanufactured goods accounted for the major share of the increase. The Brazilian Government hopes that a continued rise in export revenues, helped by large sales of soybeans and other agricultural products, will soon permit the easing of import restraints on raw materials and capital goods and spur an industrial recovery 25X1 in the second half of 1984. [redacted]

We believe Brasilia may use its improved export performance to attempt to exact more generous terms from foreign bankers in debt talks and thus help sustain a recovery. Because of the $2.4 billion first-quarter trade surplus, the 25X1 government's economic team is more confident that Brazil will achieve the $9 billion trade surplus target under its IMF program and substantially increase 25X1 its precariously low foreign exchange reserves. [redacted]

Peruvian IMF Program Threatened

[redacted]

Mounting political and social pressures prompted Peruvian President Belaunde to dismiss Finance Minister Rodriguez Pastor last month and to ease the government's strict austerity measures. A continuation of restrictive government policies in the wake of last year's poor economic performance—a 12-percent decline in GDP and 125-percent inflation—produced a nationwide 25X1 general strike and a strong public outcry against the IMF in March. In response to rising popular opposition to austerity policies, President Belaunde last week appropriated an additional $120 million in public funds to be used with foreign development financing for public-sector infrastructure projects. Moreover, he again reshuffled his Cabinet on 10 April and, we believe, will allow a further relaxation of austerity measures in coming weeks. [redacted] 25X1

The new initiatives are likely to strain Peru's relations with the IMF and international creditors. Lima has received half of the $200 million in new bank loans arranged last year as a result of its February IMF letter of intent, 25X1 [redacted] The remaining $100 million scheduled for disbursement before the end of May will be in jeopardy if the Peruvians fail to stick to their IMF program. Despite Lima's assurances, we are skeptical it will meet its IMF policy targets because the recent budget appropriations probably will cause the deficit to exceed the IMF ceiling. [redacted] 25X1

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Global and Regional Developments

EC To Limit Imports of US Farm Products

The EC Commission notified the GATT last Friday of its intention to curb imports of US-produced feed grain substitutes that now enter the Community duty free. The Commission plans to impose tariffs on corn gluten imports exceeding 3 million tons and distillers dregs and germ cake imports exceeding 1.5 million tons. Last year the United States exported 3.4 million tons of corn gluten to the EC, and the American feed substitute sales to the Ten totaled $500 million. The Commission argues that these cheap imported feeds aggravate the EC agricultural glut by displacing domestic grain and encouraging dairy surpluses. 25X1 25X1

The Commission has invoked GATT Article XXVIII, which provides for consultations with the injured party. As compensation to the United States, the Community may offer to eliminate the variable levy it now charges on corn imported for the manufacture of starch. If the United States and the Community do not reach a compensation agreement within 90 days of GATT notification and the Community presses ahead and imposes new duties, the United States will be free to retaliate. Should the EC succeed in raising tariffs on feed grain substitutes, the move could encourage the Community to lift zero bindings on other agricultural goods such as soybean products, which accounted for over $3 billion in US exports to the EC in 1983. 25X1

Australia Looking To Cut Auto Protectionism

Prime Minister Hawke announced last week that Canberra intends to lower the automobile industry's high protection level to boost the industry's sagging competitiveness and hold down consumer prices. The Australian auto industry presently enjoys a 57.5-percent tariff, quotas which restrict imports to 20 percent of the market, and an 85-percent local content requirement for domestically manufactured passenger vehicles. Hawke's move will trim quotas and reduce tariffs by two-thirds, down to the average rate of protection for manufacturing. We believe Hawke will face considerable opposition to the new policy from the auto industry, organized labor, and even some members of his Cabinet. He probably will be forced to settle for smaller reductions as he advances the legislation in the months ahead. 25X1 25X1

National Developments

Developed Countries

Greek Businessmen Attack Government Policies

The Greek business community is in an uproar over a proposed trade law that would regulate prices and profit margins based on a complex formula involving interest rates, tax indexes, inflation, and the general state of the economy. The law also introduces new distribution and marketing regulations, and establishes a state import-export agency. This latest strain in relations between the government and the business community comes on the heels of a strong condemnation of government policy by Greek industrialists, who claim the government is ideologically hostile to private enterprise. The industrialists have 25X1

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been careful to avoid directly criticizing Prime Minister Papandreou or National Economy Minister Arsenis, apparently because they still hope to influence policy. [redacted] 25X1

Greek private investment has been declining since 1980, and, as the economy deteriorates, a growing number of private firms are experiencing serious financial difficulties. With unemployment currently about 8 percent and rising, the government has responded by taking over several "ailing enterprises" to prevent bankruptcies and save jobs. The interventionist policies of Papandreou, however, have many businessmen convinced that Athens intends to nationalize nearly all private industry, and the proposed trade bill reinforces this perception. Without a reverse in policies, private investment will remain depressed and economic growth stagnant. [redacted] 25X1

Less Developed Countries

Chilean Economic Moves

Although Chile's new economic team is publicly calling for only cautious reflation to avoid a confrontation with international lenders, more expansionist economic measures are likely to be taken. The Economy Minister has promised publicly to reduce unemployment without jeopardizing IMF targets by helping construction and agriculture and providing domestic firms with debt relief. [redacted] the Finance Minister—a political ally of Interior Minister Jarpa, who favors a quicker recovery—has privately stated that inflation could be allowed to double to reduce unemployment. [redacted] 25X1 25X1 25X1

The reactivation measures publicly announced thus far will decrease unemployment gradually but are unlikely to produce the public perception of a strong recovery that is necessary to reduce political discontent. More aggressive economic policies, however, could upset negotiations for a $780 million loan from foreign bankers. Nonetheless, in view of President Pinochet's strategy to undercut support for the protest movement, we believe the new economic team is likely to opt for a more rapid recovery and will seek increased official borrowing to support its efforts. [redacted] 25X1

Indian Port Strike Ends

A compromise wage agreement initialed 10 April has ended a 26-day dockworkers' strike, the longest and most costly in Indian history. Roughly half of India's foreign trade—including exports of perishable cargo and imports of fertilizer and capital goods—were halted, although military personnel facilitated unloading of crucial petroleum and edible oil products. Port congestion resulting from the strike will hinder economic activity for several months. [redacted] 25X1 25X1

Communist

Soviet Foreign Trade Surplus Increases

Recently published Soviet data indicate that the USSR's foreign trade surplus increased last year. Moscow reduced its assistance to the East European nations by cutting its trade surplus with them. Nonetheless, the Soviets' trade surplus with Communist countries as a group increased slightly.

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A decline in imports from the developed Western countries allowed Moscow to increase its trade surplus with non-Communist countries, despite the slow growth of Soviet exports. Soviet purchases of grain and other agricultural products fell as a result of improved harvests in 1982 and 1983. Most of the reduction was in imports from the United States. The USSR was able to increase export earnings from non-Communist countries for the second year in a row, despite a drop in world oil prices. The Soviets raised oil exports to the West by 150,000 barrels a day to about 1.7 million barrels, primarily by reexporting oil they obtained from OPEC nations. Arms sales are second only to oil as a hard currency earner but may have declined for the year because of a drop in sales during the last quarter.

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Soviet Foreign Trade *Billion US $*

	1982			1983		
	Exports	Imports	Balance	Exports	Imports	Balance
Total	**87.2**	**77.8**	**9.4**	**91.6**	**80.4**	**11.2**
Communist	47.1	42.5	4.6	50.9	45.5	5.4
Eastern Europe	36.3	33.6	2.7	39.4	37.2	2.2
Other	10.8	8.9	1.9	11.5	8.3	3.2
Non-Communist	40.0	35.3	4.7	40.7	35.0	5.7
Developed West	26.0	26.1	−0.1	26.5	25.3	1.2
Less Developed Countries	14.0	9.2	4.8	14.2	9.7	4.5

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Hungarian Economic Reforms

Hungarian officials have told the US Embassy that some of the new economic reforms, which are likely to be presented for approval at a party plenum in mid-April, already have been watered down. Nonetheless, central planners close to the proposals say that the reforms will give workers more voice in the selection of managers and managers more freedom to determine prices, wages, and investment. The proposals are complex, and some party leaders are concerned about popular reaction to possible higher prices and job losses. Budapest also sees a need to persuade its allies that its search for greater economic efficiency will not undermine the party's authority.

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North Korea May Sell Gold To Pay Debts

[redacted]

Recent large gold shipments by P'yongyang may be tied to debt repayment and efforts to restore trade financing from West European sources. Since defaulting on its debt to the West in the mid-1970s, P'yongyang has used gold exports to help fund imports from Western countries. In the first quarter of 1984, North Korea shipped at least 5.8 metric tons of gold worth about $70 million at current market prices to West Germany; this is the largest quarterly gold shipment by P'yongyang during the past decade. [redacted] 25X1 25X1

North Korea almost certainly will have to resume debt payments to secure future import financing, and we believe recent gold shipments may be used to service debts. In the last year, P'yongyang has approached several West European countries about expanding trade and obtaining economic assistance. In February, Austria agreed to extend new credits for purchases of power plant and steel mill equipment—contingent on P'yongyang's repaying its outstanding $200 million debt, [redacted] North Korea also is reported to have begun making monthly payments on its debt to Sweden, its favored supplier of mining equipment. [redacted] 25X1 25X1

Chinese Plans To Transfer S&T Personnel

[redacted]

The State Council on 27 March authorized a new plan for transferring scientists and engineers from government departments to key construction projects in order to more effectively use skilled personnel. The plan calls for assigning personnel from various ministries, the Chinese Academy of Sciences, and Liaoning and Jiangsu Provinces to energy, communications, and other major projects. Most of the first group of 363 scientists, to be transferred this summer, will be assigned to coal projects. [redacted] 25X1 25X1

The new plan reflects China's need to use scientific and technical personnel to support economic development. Shortages of skilled technicians have hampered progress on projects, particularly in the more remote minority regions where China claims that over 60 percent of key construction projects under the Sixth Five-Year Plan are located. Until now, government departments in urban areas have refused to transfer scientists even when their talents were underutilized. In implementing the plan, Beijing will face resistance from scientists reluctant to leave urban areas. Beijing has adopted a number of incentives to encourage scientific personnel to work in rural and remote areas, including special salary allowances and the establishment of new schools in remote areas to educate their children. [redacted] 25X1

Summit Issues: Big Six Interest Rates

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This is the first of several articles that in the coming weeks will examine economic issues affecting the countries participating in the London Summit on 7-9 June.

We believe that the present high level of real interest rates is holding back the economic recovery in Western Europe and retarding economic growth in Japan and Canada. Both nominal and real interest rates in the Big Six countries presently are higher than the rates that existed at the start of the 1976 recovery. While nominal rates in the Big Six are now up an average of about one-half a percentage point, real rates are about 4 percentage points higher on average than they were in 1976. The high level of real interest rates is related, in part, to large government budget deficits. If Big Six governments attempt to reduce budget deficits, real interest rates might fall, but in the short run these countries probably would suffer lower output and employment.

Interest Rate Trends

Nominal interest rates in the Big Six have been declining for more than two years, although the trend in West Germany and Canada appears to have flattened out over the past few quarters. Despite the general downward movement, nominal interest rates remain high by historical standards—at least 1 percentage point higher than the 1965-83 average.

Real interest rates—the more important determinant of investment—are also higher than usual in the Big Six. In all of the major countries these rates are several percentage points higher than the average since 1965. They are even higher relative to the rates that existed at the start of the 1976 cyclical upturn in Western Europe.

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- **West German** real interest rates are presently about 3 percentage points higher than when the economy began to recover from the 1974/75 recession. Although the real rate is much less than it was two years ago, it is still high relative to the average rate over the 1965-83 period.

- **French** real interest rates were above 5 percent in early 1983, but by the fourth quarter had dropped down to 4 percent. This rate is well above the −1.3 percent recorded in the first quarter of 1976—the beginning of France's mid-1970s recovery. The current rate is about twice the average rate experienced in the 1965-83 period. 25X1

- The **British** real interest rate was nearly 6 percent in early 1983 but has since dropped to 4.4 percent. This is still more than 4 points higher than at the beginning of the UK recovery in the third quarter of 1976. The UK rate is down substantially from the 7.1-percent peak (fourth-quarter 1981), but it is roughly 2 to 3 percentage points higher than the 1965-83 average.

- **Italian** real interest rates are currently 4.5 percent, far higher than the 1965-83 average and 5.5 percentage points higher than the rate existing in the beginning quarter of the 1976 recovery.

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- **Japanese** real interest rates at present are the highest among the Big Six, but the 4-percentage-point spread between the current rate and the 1976 rate is the second lowest in the group. The present rate is far above the 1965-83 average.

Measuring Real Interest Rates

The real interest rate on a loan is usually defined as the nominal interest rate minus the expected rate of inflation over the period of the loan. Unfortunately, price expectations are not measured directly and must be inferred from other data—usually the actual inflation rate experienced in the recent past. There is no general agreement on how to do this, however, and the results can vary depending on the procedure used and on the price index chosen. [redacted]

For this study we assumed that the GDP deflator is the best index of inflation. We then considered three different measures of price expectations and thus developed three different measures of real interest rates:

- *Measure 1: The expected inflation rate is assumed to equal the actual inflation rate over the last year. This is the easiest measure to use, but its concept of price expectations is naive. It currently tends to give higher estimates of the real rate than the other measures.*

- *Measure 2: The expected inflation rate is assumed to equal the average inflation rate over the last four years.*

- *Measure 3: Expected changes in the inflation rate are assumed to be reflected in the difference between the nominal levels of short- and long-term interest rates. Theory suggests that other factors—such as a risk premium—also affect the difference between these two rates, but these other factors are assumed to equal a constant 1-percentage-point differential. The real interest rate is calculated by subtracting the current inflation rate, expected changes in the inflation rate, and a constant 1 percentage point from the nominal long-term interest rate.* [redacted]

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Although we believe Measure 3 best identifies the perceived level of real interest rates—and have used it throughout our analysis—we found that all three measures led to similar conclusions:

- *Real interest rates are now considerably higher than at the beginning of the 1976 recovery.*
- *Real interest rates are much higher than the average rate during the 1965-83 period.* [redacted]

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- **Canadian** real interest rates of almost 6 percent are down sharply from their peak but remain far above either the near-zero rate of 1976 or the long-run average. [redacted]

Impact on Growth

We believe the present level of real interest rates is an important factor holding back economic growth in the Big Six. [redacted]

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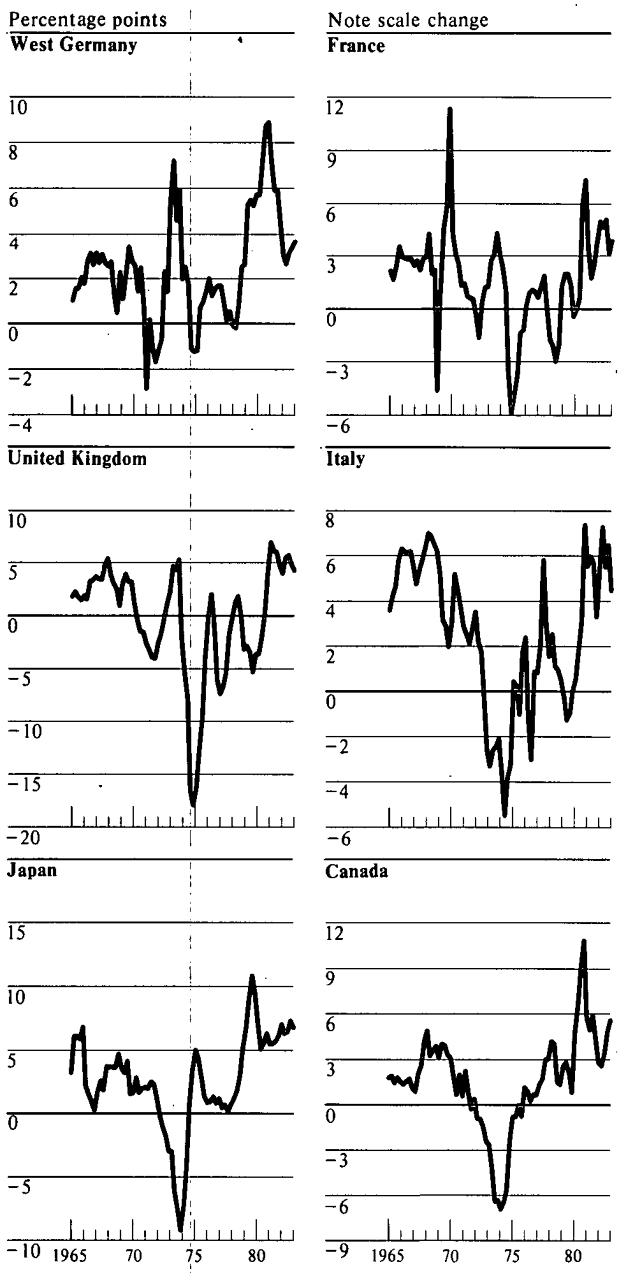
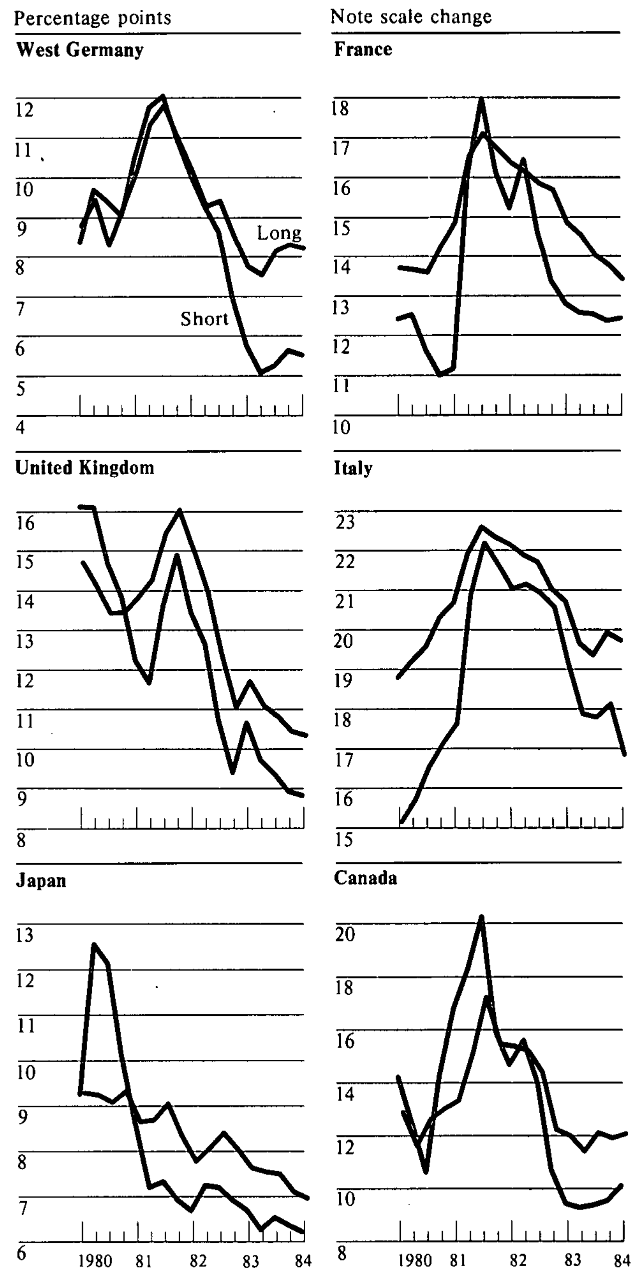
Big Six: Real Interest Rates, 1965-83[a]



[a] Quarterly data.

Big Six: Recent Trends in Nominal Interest Rates, 1980-84[a]



[a] Quarterly data.

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Big Six and US Real Interest Rates

Percent

	Average 1965-83		Peak Since 1976	4th Quarter 1983	Rate at the Beginning of Economic Recovery in 1976
	Mean	Median			
West Germany	2.2	1.8	8.9 (1981 III)	3.7	1.0
France	1.7	2.0	7.4 (1981 III)	4.0	−1.3
United Kingdom	0.1	1.8	7.1 (1981 IV)	4.4	0.1
Italy	2.6	2.9	7.4 (1981 III)	4.5	−1.0
Japan	2.6	2.5	10.9 (1980 II)	6.8	2.8
Canada	1.6	1.8	10.9 (1981 III)	5.6	0
United States	2.2	2.3	6.9 (1982 I)	5.7	0.1

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Big Six: Impact of a 3-Percentage-Point Decline in Real Interest Rates

Percentage-point change from baseline

	Change in Real GNP Growth Rate		Change in Real Private Consumption Growth Rate		Change in Real Fixed Investment Growth Rate		Change in Unemployment Rate	
	1984	1985	1984	1985	1984	1985	1984	1985
Big Six	**1.3**	**1.1**	**1.3**	**0.8**	**3.4**	**2.1**	**−0.4**	**−0.8**
West Germany	1.3	1.6	1.5	1.0	4.2	4.1	−0.6	−1.5
France	1.0	1.2	0.8	1.0	3.1	2.0	−0.4	−0.9
United Kingdom	1.1	0.3	1.7	0.3	3.3	−0.3	−0.3	−0.5
Italy	1.1	1.4	0.6	1.3	3.0	4.4	−0.1	−0.4
Japan	1.5	0.7	1.3	0.6	2.2	1.1	−0.3	−0.4
Canada	1.5	1.0	1.5	1.0	7.7	1.5	−0.3	−0.7

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Egypt's Military: Impact of Economic Difficulties

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Egypt's tight foreign financial situation has led to a guns-versus-butter debate within the Cabinet, and President Mubarak already has requested bilateral debt relief on military loans from the United States. Foreign payments difficulties and a debt crisis could threaten Egypt's longer term military modernization program and restrict benefits for armed forces personnel. Should Egypt ultimately be forced to take austerity measures—perhaps under IMF auspices and as part of a debt rescheduling exercise—the government would risk urban unrest that might test the military's loyalty to Mubarak. Cairo is trying to avoid these difficulties by deferring hard decisions, but its options are becoming increasingly limited.

Importance of the Military

- *The military is the ultimate guarantor of political order and the source of most of the country's top leadership. The military also backs up the police and Ministry of Interior forces in the event of serious domestic unrest.*

- *By Middle Eastern standards, the Egyptian officer corps is a stable and professional force. Its middle-class composition contributes to this stability by imparting a degree of uniformity to its social, economic, and political goals.* 25X1

- *The military is the most disciplined institution in Egypt and has a strong sense of corporate identity.* 25X1

The Military's Role

The Egyptian military remains the most important political force in Egypt. Its direct involvement in decisionmaking, however, has declined since the late 1960s, when military officers constituted over half the Cabinet. Now the officer corps exerts influence mainly as a powerful silent partner whose opinion limits the extent to which any President can redirect Egyptian policy. Mubarak—an Air Force officer before becoming Sadat's Vice President—seems inclined to follow the policies that have the broadest support within the military: a nonradical approach to domestic problems, a generally pro-Western albeit still nonaligned foreign policy, and adherence to the Egyptian-Israeli peace treaty.

Peace with Israel and an emphasis on economic development have altered the status and objectives of the armed forces. We believe the military's present goals include:

- Replacing worn-out and obsolete Soviet equipment with new Western weapons.

- Restructuring the armed forces into smaller, more mobile units.

- Restoring the prestige enjoyed by the armed forces following the 1973 war. Many Egyptians now question the need for a large army in the absence of a direct military threat from Israel.

- Regaining economic and social status for military personnel. Under Sadat's "Open Door" economic policies, goods available for top military officers and only a few others in society—good housing, cars, and television sets—are now more widely available. 25X1

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The Military and the Economy

The Military Budget. Official budget data for Egyptian FY 1983-84 (July-June) show military expenditures of $2.5 billion—about 13 percent of government expenditures and nearly 9 percent of GDP. These percentages are well below the peak in 1972, when military spending was 33 percent of government outlays and 15 percent of GDP. As in most Third World countries, however, military spending data are incomplete. The available data are not broken down into specific categories, and they appear to omit purchases of foreign equipment. [redacted]

Cairo's attention in recent years has swung away from the military toward domestic economic concerns. The military's share of the budget has been shrinking because of the importance placed on public-sector investment and provision of consumer subsidies. Nonetheless, the government's budgetary decisions have not affected imports of weapons, and the military appears to have considerable freedom to set its own spending levels. [redacted] a select group of Cabinet members each year "examines" the military budget; by implication, these ministers have little power to influence military spending directly. [redacted]

Foreign Military Purchases. The Egyptian armed forces have depended on foreign credits or grants to finance major arms purchases. In the 1960s and early 1970s, the USSR provided about $4 billion in low-interest loans for weapons purchases. As relations with the Soviets deteriorated, Egypt began to receive assistance from oil-rich Arab states to fund procurement of weapons from Western countries. Starting in 1979, the United States provided long-term credits or grants under the FMS program. Most purchases from other Western countries, particularly France, appear to be financed by medium-term credits. [redacted]

Defense Industries and Sales. Military factories produce small arms, ammunition, spare parts, vehicles, and other equipment for the Egyptian armed forces and for export. The factories receive operating subsidies from the government. Cairo is pursuing coproduction arrangements with foreign firms to produce fighter aircraft and tanks, but the lack of funding is a major problem. [redacted]

Egypt exports both armaments produced in its factories and rehabilitated Soviet equipment from its stockpiles. We suspect Egypt has sold at least $1 billion, and perhaps considerably more, in armaments since early 1981, primarily to Iraq. These sales are funded by Saudi and other Arab aid to Baghdad. Egyptian officials refuse to discuss the financing of sales, although a senior Central Bank official implied to a US Embassy officer last year that the Central Bank does not receive the proceeds. 25X1 We suspect that the military has used a large share of these earnings for non-US weapons purchases and retains most of the rest, turning funds over to the Central Bank only when there is insufficient foreign exchange to service the military debt. 25X1 [redacted]

Civilian Projects. Since the mid-1970s, the Egyptian military has become involved in a wide range 25X1 of economic endeavors in an effort to increase its self-sufficiency and to justify its continued large size during peacetime. 25X1 In 1979 the Ministry of Defense created the National Service Projects Organization (NASPO) to organize, administer, and implement these civilian projects. 25X1 Official Egyptian reports and press accounts claim, for example, that NASPO has done significant work on sewer lines and the telephone system. The military reportedly now supplies 65 percent of its own food, prints school textbooks, treats civilians at military hospitals, operates a pharmaceutical factory, and is 25X1 building apartments for military personnel. President Mubarak's frequent visits to projects have assured wide publicity. [redacted]

Although military conscripts and noncareer officers 25X1 appreciate the opportunities to gain skills and earn pay bonuses, senior officers believe that military participation in agriculture and construction lessens the prestige of the armed forces, lowers the morale of professional soldiers, and diverts attention from the primary mission of defense. These activities probably will retain popular support, however, as long as they remain free of corruption, are 25X1 perceived as benefiting the public, and continue to be viewed as more efficient than the public sector. [redacted] 25X1

Morale

The government has tried to use enhanced perquisites to maintain military morale in the face of reduced peacetime promotion prospects, the scarcity of housing, the failure of pay to keep pace with inflation, and the decline in the economic status of the military relative to other Egyptians. These perquisites include:

- New apartments for officers on favorable financial terms.
- A subsidized vehicle purchase program offering officers new Mazdas or Fiats with no downpayment, no import taxes, and 1-percent interest on loans.
- Half fare on commercial transportation, and a proposed shuttle bus system to provide military personnel free transportation throughout Cairo. [redacted]

Despite these benefits, we believe most officers and enlisted men consider themselves undercompensated in comparison with their civilian colleagues. According to US Embassy reporting, the armed forces have had difficulty recruiting and retaining highly skilled personnel because much more money can be made in the private sector or abroad. Many servicemen have great difficulty supporting their families on military pay alone. [redacted] 80 percent of Army officers with the rank of major or above pursue some form of outside commercial activity. Many enlisted men hold second jobs despite formal prohibitions against this practice, and absenteeism is a major problem. Many officers seek hardship or overseas postings to receive the associated bonuses. [redacted]

Civilian resentment of military perquisites is growing. [redacted] the provision of automobiles and low-cost housing is particularly irritating. [redacted] some members of the People's Assembly would like to discontinue such perquisites, which they view as Defense Minister Abu Ghazala's way of enhancing his popularity in the military at public expense. We believe, nonetheless, that the government will try to maintain, and perhaps expand, the special benefits as long as economic circumstances permit. [redacted]

Egypt: Current Account Balance [a] *Billion US $*

	1982	1983 [b]	1984 [c]
Current account balance	**−2.4**	**−2.2**	**−2.5**
Trade balance	−5.0	−5.5	−5.8
Exports, f.o.b.	3.6	3.5	3.6
Oil	2.3	2.2	2.3
Imports, c.i.f.	8.6	9.0	9.4
Net Services	2.6	3.2	3.2
Receipts	5.4	6.3	6.5
Remittances	2.1	2.8	3.0
Suez Canal	0.9	1.0	1.0
Tourism	0.6	0.7	0.7
Other	1.8	1.8	1.8
Payments	2.9	3.1	3.3
Unrequited transfers	NEGL	0.1	0.1

[redacted]

[b] Preliminary.
[c] Estimated.

[redacted]

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Economic Prospects

Egypt's foreign finances are tight. Official nongold reserves of about $800 million would cover barely one month of imports, but Cairo so far has been able to avoid debt rescheduling and recourse to the IMF. The government has limited imports, adjusted exchange rates to attract more worker remittances, and increased both oil production and the volume of oil exports to offset the impact of lower prices. Moreover, Egypt has benefited from lower import prices, particularly for food, and from US economic and military aid. We project Egypt's current account deficit in 1984 will be about $2.5

billion—close to the level of the past two years.

With limited foreign exchange reserves and a debt service ratio already exceeding 30 percent of foreign earnings, Cairo will have difficulty putting off an economic adjustment program much longer. Imports, particularly of food, will continue to rise, while slower growth is expected in earnings from remittances, the Suez Canal, and tourism. An adjustment program would entail reductions in government spending and probable hikes in prices of subsidized energy and food. The Mubarak government fears—with good reason—that these steps would produce negative political repercussions; memories remain fresh of the 1977 riots in Cairo sparked by bread price hikes.

An end to the Iran-Iraq war probably would hurt Cairo's immediate economic interests. Cairo could lose profitable arms sales to Iraq. Moreover, peace between Iran and Iraq would enable these countries to boost oil exports, further depressing world oil prices. Conversely, Egypt would benefit from sharply higher oil prices should the fighting spread and reduce oil exports from the Persian Gulf.

Egypt: US Foreign Military Sales Financing *Million US $*

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Fiscal Year	Loans	Grants
Total	**4,575**	**2,225**
1979-81	1,500	0
1981 supplement	550	0
1982	700	200
1983	900	425
1984	925	425
1985 proposed	0	1,175

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US Aid and FMS Debt

Military assistance from the United States has enabled Egypt to modernize its armed forces without placing an immediate foreign payments burden on the economy. In addition, the amount and quality of US military equipment provided are seen by Egyptians as a measure of the regime's wisdom in shifting from reliance on the Soviets to the West. Since US FY 1979, the United States has provided nearly $4.6 billion in FMS credits and slightly more than $1 billion in grants for military purchases. For US FY 1985, the administration has proposed a military aid program of $1.175 billion, all of it in grants.

The US assistance program has supplied a wide range of sophisticated weapons. US equipment delivered or on order include F-16 and F-4 fighter aircraft, C-130 transport aircraft, CH-47 helicopters, M-60A3 tanks, I-HAWK surface-to-air missile batteries, air defense radars, and E-2C airborne warning and control aircraft. Planned purchases and deliveries of US weapons extend through the end of the decade and will require continued high levels of US FMS financing or funds from some other source.

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The FMS loans, however, are generating a new set of problems. Since March 1983, Egypt has repeatedly been in arrears on its interest payments, although never by more than 60 days. Although there is a 10-year grace period on principal repayment on these 30-year loans, interest due has risen to about $380 million in Egypt's current fiscal year. Although this only accounts for one-tenth of the total debt servicing burden, the FMS payments have become the focus of Egyptian debt relief efforts and a major issue in US-Egyptian relations. During Mubarak's Washington visit in February, he requested a moratorium on FMS payments or rescheduling at lower interest rates. Although he did not repeat earlier threats to stop FMS payments in July, he argued that Egypt cannot afford to repay these loans and still pursue an ambitious economic development program.

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Similar requests for military debt relief have been made of China—which reportedly has rescheduled—and France—which has not. In addition, Egypt has not been servicing its roughly $4.0 billion Soviet military debt since President Sadat unilaterally declared a moratorium in September 1977. Some payments on obligations to Islamic countries have been frozen since formal ties were severed following the peace treaty with Israel in 1979.

Domestic Implications

We believe economic problems will make it increasingly difficult for Cairo to simultaneously modernize the military, maintain benefits for military personnel, pursue an ambitious economic development plan, and retain generous consumer subsidies. There is already an intense debate on military versus economic priorities within the Cabinet between Prime Minister Muhi al-Din and Defense Minister Abu Ghazala. Mubarak's sympathies probably lie with the military, but we believe he will expect the military to accept spending cutbacks more readily than urban consumers. Mubarak tends to rely on Muhi al-Din on economic issues, and the Prime Minister's opposition to rapid and extensive economic reforms reinforces the natural caution of Mubarak, who has no chief economic adviser and who approaches economic decisions principally in terms of the short-term political risks involved. Moreover, civilian economic austerity measures would risk disturbances that the military might be reluctant to quell and could test the military's loyalty to Mubarak.

Mubarak and the Egyptian leadership have a considerable stake in keeping the guns-versus-butter debate confined within the government. Egypt is expanding political participation—parliamentary elections are scheduled for next month—and opposition politicians will exploit any opportunities to cite economic mismanagement. A public debate could raise disturbing questions over the military's role in the economy and politics.

Implications for the United States

Egypt's heavy dependence on US military, economic, and diplomatic support has provided the United States with significant influence over Egyptian policies. Cairo's ability to be responsive to US wishes, however, is constrained on subjects that involve strong counterpressures from domestic and 25X1
moderate Arab opinion including relations with Israel and the need for more rapid economic reform. 25X1

Should economic difficulties generate discontent within the military or the general population, we believe Mubarak will have even greater incentive to resist Washington's recommendations on economic reforms. In such circumstances, strong pressure for reform is apt to be counterproductive; Mubarak will seek to avoid charges that he is subservient to a foreign power. At the same time, Egypt still will seek sophisticated US weapons as well as bilateral relief on FMS interest payments and a continuation of generous aid. Cairo probably will also expect the United States to help Egypt by influencing the IMF, commercial banks, Saudi Arabia, and other donors to assist Egypt. In the event of a major economic crisis, there will be a strong temptation—on the part of the government as well as its 25X1
opponents—to blame the United States for failing to support Egypt adequately. 25X1

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Nigeria: Running Short of Time

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Nigeria's three-month-old military regime has done little to deal with underlying economic problems, and the deteriorating economy threatens to erode domestic support for the Buhari government even before Lagos can begin economic rescue measures. Creditors remain reluctant to implement any rescheduling until Nigeria reaches agreement with the International Monetary Fund. The regime has renewed negotiations with the Fund for a $2.4 billion Extended Fund Facility, but Lagos's unwillingness to devalue remains the major stumbling-block. While Lagos is lobbying hard among OPEC members to win an increase in its official oil production quota, it continues to exceed its 1.3 million b/d OPEC quota by about 300,000 b/d. Unless the Buhari government soon puts together a politically and economically viable austerity program, which we believe is unlikely, domestic unrest and increased coup plotting are inevitable.

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Nigeria: Foreign Financial Projections, 1984 *Billion US $*

	Without IMF Agreement	With IMF Agreement and Debt Rescheduling
Trade balance	5.1	5.1
Exports	15.7	15.7
Oil [a]	15.2	15.2
Imports [b]	10.6	10.6
Net services	−3.3	−3.7
Freight and insurance	−1.4	−1.4
Investment income	0.1	0.1
Gross interest on external debt	1.6	2.0
Other services	−0.4	−0.4
Current account balance	1.7	1.4
Debt repayments (principal)	2.7	2.7
Short-term arrears	7.5	0
IMF disbursements	0	0.5
Financial gap	**8.5**	**0.8**

[a] Assume oil production of 1.4 million barrels per day in January and 1.6 million b/d thereafter with oil prices of $30 per barrel and domestic consumption of 200,000 b/d.
[b] IMF import estimate for 1984. The government claims—unrealistically in our view—that it will hold imports to $4.6 billion.

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Foreign Financial Picture

Lagos favors an informal rescheduling of its officially guaranteed short-term arrears, which probably range between $2 billion and $3 billion. Lagos is pushing official credit agencies in Paris, London, Bonn, and Washington for a six-year loan with two-and-a-half years' grace at 1 percentage point above LIBOR; credit agencies favor less generous terms. Lagos also adamantly opposes payment of additional interest on the arrears.

Nigeria is attempting to reschedule its $3-5 billion in unguaranteed trade arrearages as well. Lagos recently reversed its position and now appears willing to hold discussions with some 350 uninsured creditors represented by Morgan Grenfell, a British-based bank, but significant differences over terms remain. Uninsured creditors want Nigeria to:
- Treat their claims like other medium-term debts.
- Accept a coordinating agent bank to act on their behalf.
- Pay interest on some loans that have not been serviced for as long as two years.
- Provide assurances that they will be paid when the notes fall due.

Conflicts over the terms and the validity of some claims are likely to produce further negotiating delays, although we continue to believe a compromise—perhaps in conjunction with an agreement on guaranteed credits—is possible.

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We believe the "IMF question" has become a potentially explosive domestic political issue. There is little support for an IMF agreement within Nigeria, and the government has pledged itself not to take any steps that would "undermine" Nigeria's sovereignty or independence. Although the government may attempt to finesse the issue by agreeing with the IMF to a phased "adjustment" rather than a one-shot devaluation, the military fears devaluation under any guise risks a popular backlash. Nonetheless, without an IMF agreement, it is doubtful Nigeria can reschedule its debts.

Lagos may hope a loan from Saudi Arabia and possibly a loan syndication led by the Hong Kong and Shanghai Banking Corporation could allow Nigeria to avoid having to comply with IMF conditions. Saudi Petroleum Minister Yamani's visit to Lagos last February and a return visit to Riyadh by Nigeria's number-two man, Brigadier Idiagbon, have helped fuel rumors that a Saudi loan may be in the offing. We have no evidence, however, that either agreement is close or, in particular, that Saudi Arabia is willing to commit the resources needed to help Nigeria out of its economic mess. Even so, we believe the increasingly desperate military regime may hope that a Saudi loan and the Hong Kong–based loan would allow them to delay addressing critical problems such as the overvalued naira and trade restrictions. 25X1

To boost exports, the Buhari government is seeking an official increase in its OPEC oil production quota of as much as 500,000 b/d. Production is already averaging about 1.6 million b/d—300,000 b/d above Nigeria's current OPEC ceiling. Lagos is lobbying for Saudi and Libyan support for a higher quota, even though a decision cannot be made officially until the next OPEC ministerial meeting in July. In the meantime, OPEC members have been turning a blind eye to Nigeria's overproduction. Although Lagos has announced it will cut production back during the second quarter to keep within its quota, we believe the Buhari government may be trying to convince the Saudis to come through with the loan or to give more forceful support for Nigeria's production quota increase. 25X1

Even if Lagos is granted an increase in its OPEC production quota and is able to sustain increased output, an IMF agreement and debt reschedulings still will be essential to begin turning the economy around. In addition to $5-8 billion in short-term arrears, debt service on Nigeria's medium- and long-term obligations will exceed $4 billion this year. Barring debt relief and extreme import cuts, Nigeria's financial gap could top $8 billion in 1984. 25X1 On the other hand, should Lagos reach agreement with the IMF and accomplish both reschedulings, the financial gap would be reduced to under $1 billion, an amount we believe might be covered by additional borrowings abroad. 25X1

Domestic Realities

Although senior officers now appear to better understand the gravity of Nigeria's international financial difficulties and the limited options open to them, we believe they are more concerned with finding ways to patch the domestic economy. The

US Embassy reports that food is available in most markets, but the selection is often limited and prices for many staples are now beyond the reach of the average Nigerian. Prices for rice and chicken, for example, are three times what they were in late 1983. Drought and lack of foreign exchange to purchase imports could produce even higher prices and perhaps even food shortages in some areas over the next several months.

Drought—particularly in the northern states—has accelerated the long-term decline in food output and contributed to price increases. Grain production is down 30 percent from last year, while an epidemic has ravaged Nigerian cattle herds for the last 18 months, destroying at least 15 percent of total stock. Egg and chicken production are down because of lack of feed grains.

Crop losses will hurt the country's processing industries. For example, about 80 percent of cotton for the textile industry—Nigeria's largest private employer—will have to be imported this year. Most import-dependent industries are operating at 25 to 30 percent of capacity, and many companies have had to lay off between one-fourth and one-half of their workers. More businesses will have to close this year due to the lack of import credits.

Government Moves

The Buhari government's indecisiveness in the face of worsening economic conditions is rapidly tarnishing its image at home as well as abroad. Efforts to force market prices down and ensure a steady supply of food have had only marginal and temporary effects, while alienating powerful traders.

Some stopgap government actions taken to cut costs and stretch limited foreign exchange earnings have only made domestic problems worse. Buhari has ordered that deficit spending cease at both federal and state levels, forcing governments to lay off more civil servants and contractors. Many state employees have faced delays of several months in salary payments. Local grumbling has increased as state military governors have been forced to reduce public services while reintroducing unpopular school fees and local taxes. 25X1

Moreover, the government is unable to point to better economic times ahead. Buhari, for example, took a hard line during discussions with the newly elected labor leadership, noting that Nigeria was "essentially bankrupt" and that workers could expect no improvements. 25X1 Although striking Nigeria Airways pilots recently backed down when the government began mass firings, there is little public tolerance for harsh austerity measures. 25X1

Buhari also has stated his intention to limit imports to about $4.6 billion this year—half of last year's already drastically reduced level. We doubt Nigeria will be able to hold anywhere close to this figure. 25X1 According to the US Embassy, about $2.3 billion is needed just to pay for food and agricultural raw materials to keep people adequately fed and industries running. 25X1 Nigeria needs another $9-10 billion to import industrial raw materials to reopen factories and to provide greater employment.

Political Fallout

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Buhari recognizes that worsening domestic economic conditions—especially growing unemployment, consumer goods shortages, and rising prices—could spark domestic unrest and encourage coup plotting. Lacking ready solutions, the government has tried to shift attention from economic concerns to the financial misdeeds of some 475 former civilian officials now under arrest. Even this tactic has backfired, according to the US Embassy, by raising questions about the financial dealings of current leaders—including Buhari—when they 25X1 served in the previous military government. The Nigerian press has contributed to a growing xenophobia by sensationalist reporting of supposedly illegal economic activities by foreign companies operating in Nigeria. More recently, the government also has raised the specter of an invasion financed by exiled followers of former President 25X1 Shagari.

Although the exact level of support for the regime is difficult to gauge, the government's failure to move beyond promises of economic relief is already raising serious questions among the public and the military about the government's competence. Actions taken by senior officers thus far have kept plotters off balance, but junior- and middle-level grumbling over their superior's indecisive leadership is likely to intensify as the domestic economy worsens. Furthermore, the show of senior officer unity displayed to date is likely to fray as the government becomes desperate in its search for economic solutions. Intensifying criticism of the government's drift soon may tempt some senior officers to portray Buhari as the problem and could persuade them that a change at the top is needed.

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China: Energy and Economic Growth [redacted] 25X1

To address the problem of energy shortages that have increasingly become an obstacle to China's economic growth, Beijing is seeking to double by the year 2000 both energy output and the efficiency of energy use, hoping to quadruple GNP by that date without the need for importing energy. Beijing's strategy evolved in the late 1970s when it became apparent that Soviet-style growth driven by heavy industry—without the Soviet Union's huge energy resources—could prove disastrous. [redacted]

Since 1978 Beijing has dealt with its energy problems on three fronts:

- It has attacked the country's wasteful energy consumption habits by restructuring industry, closing inefficient plants, and placing quotas on energy use. Political considerations and a lack of flexibility in its price system have prevented China from raising energy prices sharply, the single most effective measure taken by other countries to curb energy consumption. Nevertheless, the program has been successful; energy consumption increased by only 2 percent per year between 1978 and 1982, while industrial growth averaged slightly more than 7 percent annually.

- Higher priority, at least in theory, is now being given to energy exploration and development, but Beijing apparently has not been satisfied with results. There have been few indications that the long-term decline in proven oil reserves has been stemmed, and capital-intensive hydroelectric and nuclear projects have been slow to move out of the planning phase.

- Of the most interest to the United States and other foreign countries, Beijing has opened important segments of its once highly protected energy industries to Western and Japanese investment. In a remarkable turnaround, the Petroleum, Coal, and Electric Power Ministries, once bastions of Mao Zedong's ideology of self-reliance, have become leading proponents of Western investment in China. Projects already under way will, in our opinion, foster long-term commercial links between China and the non-Communist world. Although China's goals imply 7-percent annual growth rates for the economy, we believe a 4- to-5 percent annual growth rate is more likely. [redacted] 25X1

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China's Energy Supply

China produced about 700 million metric tons of coal equivalent commercial energy in 1983, up 5 percent from 1982. Energy output in the past five years, however, has increased at an average annual rate of only 2 percent, in marked contrast to the 6-percent annual growth registered in the preceding two decades. The steady erosion of coal's share of energy supply that occurred during 1950-78, however, has been reversed. Coal's share of energy output rose from 70 percent in 1978 to 71 percent in 1983. Petroleum, with output flat for the past six years, now provides 22 percent of national energy supply, down about 2 percentage points since 1978. Hydropower has gained steadily to provide about 5 percent of the country's energy, while natural gas has declined to only about 2 percent. Although China ranks third in world energy output, Chinese per capita energy production ranks in the bottom one-third worldwide. [redacted] 25X1

China's Sixth Five-Year Plan (1981-85) and less definite but widely quoted long-range plans indicate that energy output will continue to grow slowly through the end of the century. Our energy projections, [redacted] fall slightly short of Beijing's general guidelines for doubling the availability of energy by

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China's Energy Production [a]

	1980	1981	1982	1983	1985 [b]	1990 [c]	2000 [d]
Total million metric tons, coal equivalent	**637**	**632**	**668**	**702**	**725**	**855**	**1,151**
Coal							
Million metric tons	620	620	666	700	740	900	1,150
Million metric TCE	442	442	475	500	527	641	821
Oil							
Million metric tons	106	101	102	106	100	105	150
Million metric TCE	152	145	146	151	143	151	214
Gas							
Billion m^3	14.3	12.7	11.9	12.1	12	12	18
Million metric TCE	19	17	16	16	16	16	24
Hydropower							
Billion kWh	58.2	65.5	74.4	87.8	95	115	187
Million metric TCE	24	27	30	35	39	47	77
Nuclear power							
Billion kWh	0	0	0	0	0	0	36
Million metric TCE	0	0	0	0	0	0	15

[a] We use the Chinese definition of coal equivalent energy to aggregate various energy types. One metric ton of coal equivalent energy (TCE) is defined as the amount of fuel that is required to provide 7 million kilocalories of heat energy. It is equivalent to 1.4 tons of raw coal, 0.7 ton of crude oil, 752 cubic meters of natural gas, and 413 kilowatt hours of electricity. [redacted] 25X1

[redacted] 25X1

the year 2000. They imply growth rates of 3 percent a year through the rest of the century. [redacted]

Achievement of these energy production targets will require a sharp boost in investment. Energy investment now accounts for about 45 percent of industrial investment, and Beijing's efforts to control its overall investment outlays have adversely affected the energy sector. Beijing reduced state investment in energy development from 11.4 billion yuan—roughly $6 billion—in 1978 to only 9.0 billion yuan in 1981 and 10.2 billion yuan in 1982. Data for 1983, however, indicate a sharp rebound. Energy investment probably reached close to 13.6 billion yuan for the year, up about 35 percent from 1982. The largest increases went to the electric power industry. [redacted]

Demand for Energy

China has slowed the rate of increase in energy consumption in the last five years, despite fairly rapid economic growth. Energy consumption increased at an annual rate of 2.0 percent from 1978 through 1982 while national income increased at a 6.2-percent rate. This energy elasticity of national income of 0.32 is in sharp contrast to an elasticity of 1.47 for the Chinese economy from 1965 to 1978. [redacted]

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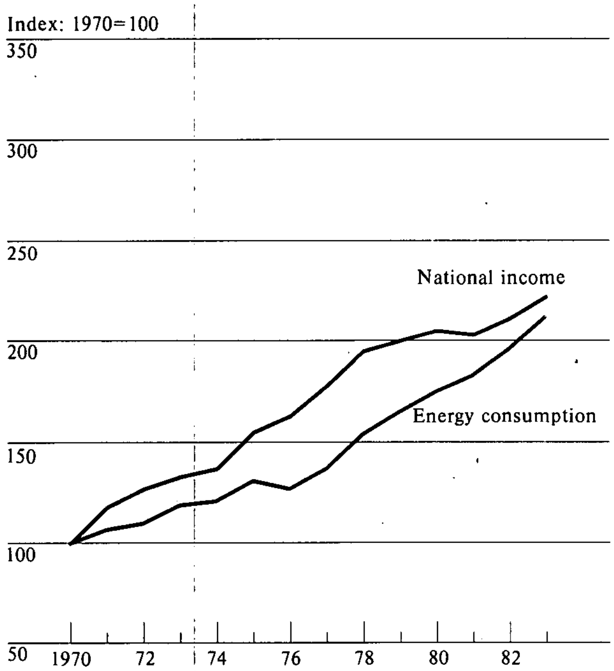
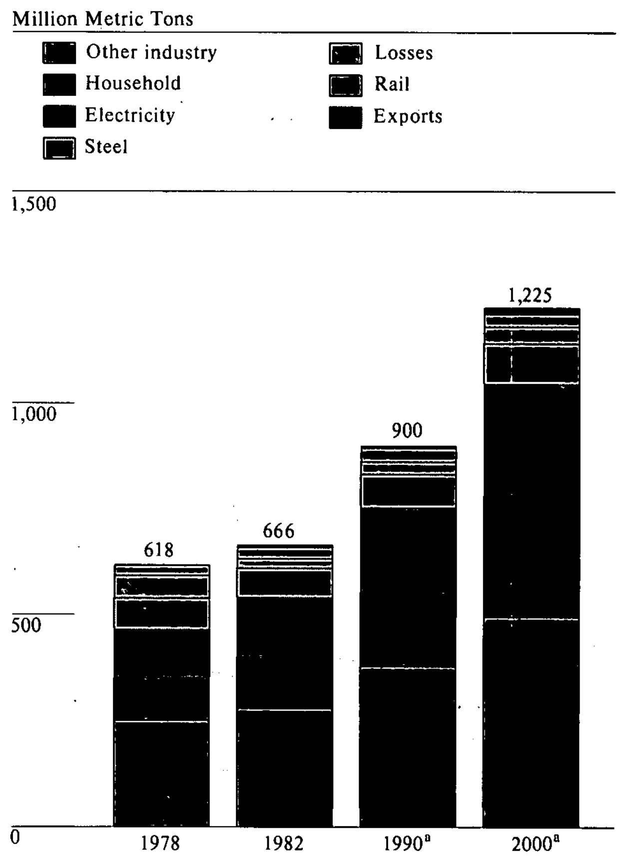
Most observers, inside China and in the West, doubt this low elasticity can be maintained. Much of the improved energy use between 1978 and 1982

China: Energy Consumption and Economic Growth, 1970-1983



China: Coal Consumption, 1978-2000



[a] Projected.

[redacted] 25X1

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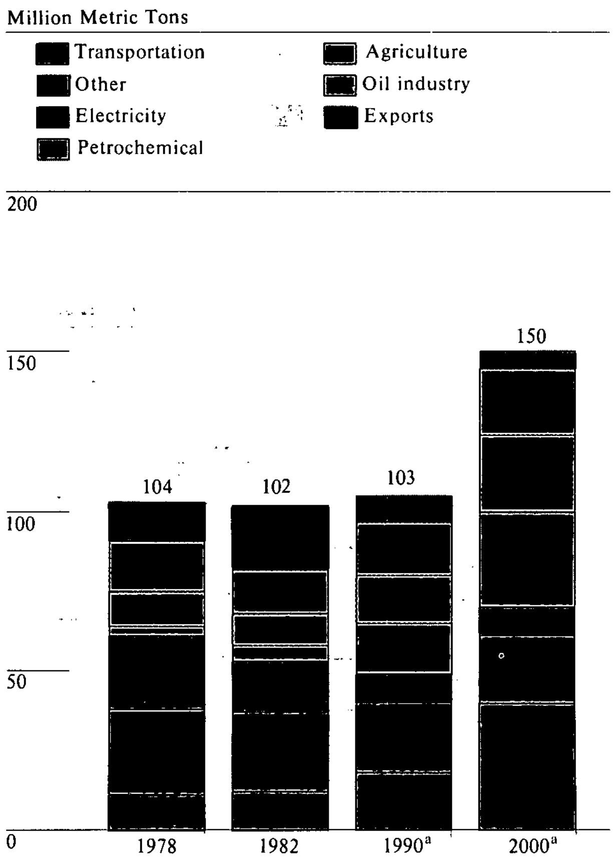
was the result of economic restructuring caused by rapid growth in energy-efficient light industry and agriculture and very slow growth in energy-intensive heavy industry. Beijing officially attributes two-thirds of the energy savings to these structural changes and only one-third to conservation. [redacted] 25X1

Our study of Chinese energy demand—based on analysis of the key energy-consuming industries—suggests that the Chinese economy will have an overall energy elasticity of between 0.65 and 0.70 for the remainder of the 1980s and the 1990s—that is to say that energy consumption will increase between 65 and 70 percent as fast as national income. This is smaller than what is expected for most major countries and much smaller than China's historical record. We are optimistic, however, only because we believe the Chinese Government will continue to exert great control over the use of energy—particularly oil and electricity. [redacted]

We expect the use of oil to increase only 45 percent as fast as national income in the 1980s but then rise to a rate of 80 percent as fast in the 1990s as opportunities for switching to coal are reduced. This still will allow substantial growth in the petrochemical industries. Coal consumption will

China: Oil Consumption, 1978-2000



a Projected.

increase about 75 percent as fast as national income in the 1980s, falling to 60 percent in the 1990s, with a large part of the increase going to the electric power industry. For electric power itself, we agree with Chinese estimates that electricity consumption will increase at the same rate, if not faster, than national income.

Implications

If China maintains an annual 5-percent economic growth rate, we foresee no major energy gaps, but there will be a definite tightness in the energy balances that will force Beijing to make tough decisions in allocating energy supplies. These projections suggest there will be little room for energy exports—currently more than 20 percent of China's foreign exchange earnings. Unlike the World Bank, however, we do not believe China will have to import oil unless the offshore exploration program brings on line substantially less than the 50 million tons of annual capacity (1 million b/d) expected by major oil companies. In the near term, a shortage of electric power appears to be the most likely constraint on economic growth. 25X1

Economic growth faster than 5 percent would, we believe, quickly cause serious energy shortages unless China was prepared to import substantial volumes of energy. If our estimates of coal, oil, and electric power demand prove accurate, the 7-percent annual rate of economic growth envisioned by Beijing would require major adjustments:

- The elimination of oil exports even to the point of repurchasing—in effect importing—the offshore oil that the Western oil companies expect to take out as their profit share.
- Resolving a 100-million-ton shortfall in annual coal supplies by 1990.
- Coping with a further 15- to 20-percent shortfall in electricity supplies. 25X1

By the same token, long-term annual economic growth of only 3 or 4 percent would probably not run into an energy constraint. Energy exports could be kept at current levels and perhaps even increased. 25X1

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Beijing Faces Tough Choices Ahead

Weakness in China's supply of energy has already forced Beijing to make major changes in the country's long-term political and economic policies. The 25X1 measures taken so far have helped to push China's economy away from its Stalinist and Maoist heritage and have made it somewhat closer to Western-style economies. Western capital and technology is now being employed in ways that the leadership's

China: Energy Balances Forecast [a]

	1978	1982	1990	2000
	Million Metric Tons			
Coal				
Production	618	666	900	1,150-1,300
Consumption [b]	618	662	894	1,210
Net exports	1	5	5	−60 to 90
Oil				
Production	104	102	105	150
Consumption	92	81	97	145
Exports	13	21	8	5
Foreign company share [c]	0	0	3	10
	Billion kWh			
Electric power				
Production [d]	257	328	482	786
Consumption [e]	257	328	482	786

[a] Assumes a 5-percent annual increase in national income.
[b] Includes losses and stockbuilding.
[c] Includes both capital recovery and profit oil.
[d] Assumes capacity increase of 5 percent per year; fuel is taken into account in coal and oil consumption.
[e] Power demand assumed to increase at least as fast as national income—5 percent.

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Maoist predecessors would have considered "exploitationist." Offshore oil is the most dramatic example, but Western and Japanese firms are increasingly becoming involved in everything from onshore seismic surveys to nuclear power development.

We believe China's energy balances will continue to tighten through the rest of the decade, thus strengthening China's need to cooperate with the West. At the same time, Beijing will have to make difficult and politically divisive decisions. These may threaten the leadership consensus that has allowed Beijing to take bold action on the importation of Western capital and technology and to accept the unavoidable "capitalist" influences that come with it. This danger will be intensified if major programs—such as the offshore exploration effort—are unsuccessful. 25X1

At the least, hard choices will have to be made in several areas over the next decade. In particular: 25X1

- The relatively modest but steady growth that we believe is possible without major energy problems will require Beijing to consider its investment programs carefully. In the electric power sector, Beijing must decide whether to emphasize long-term, capital-intensive hydroelectric and nuclear power development or faster and cheaper coal-fired capacity. In oil exploration, it must decide

China: Energy Exports

	1978	1979	1980	1981	1982	1983
Exports (*million metric tons*)						
Petroleum	13.5	16.4	17.5	18.4	20.5	NA
Crude oil	11.3	13.4	13.3	13.8	15.2	15
Products	2.2	3.0	4.2	4.6	5.3	NA
Coal	3.1	4.6	6.3	6.6	6.4	6.4
Exports (*billion US $*)						
Total exports	10.16	13.49	18.94	21.54	23.50	NA
Energy exports	1.34	2.63	4.62	5.01	5.14	NA
Petroleum	1.24	2.45	4.36	4.67	4.79	NA
Crude oil	0.96	1.75	3.01	3.29	3.40	NA
Products	0.28	0.70	1.35	1.38	1.39	NA
Coal	0.10	0.18	0.26	0.34	0.35	NA
Energy share (*percent*)	13	19	24	23	22	NA

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whether to emphasize areas where discoveries can be exploited quickly or areas—such as the Tarim Basin—that may have more extensive deposits but would take decades to exploit. In coal mine development, Beijing must determine whether to continue the rapid development of small, non-state-owned coal mines or whether to step up investment in large, state-owned, mining operations.

- China's energy prices, by almost all accounts, do not reflect market realities. To preserve price stability, Beijing has held energy prices relatively constant since the 1950s despite clear changes in domestic and international supply and demand conditions. Numerous articles in Chinese economic journals now attack what their authors see as poor decisionmaking based upon an irrational price system. Beijing is formulating a sharply higher schedule of energy prices, the increases will probably come in stages so they will not create too large a shock, but obviously they will not be welcomed by the public.

- China's ability to increase oil exports during 1978-82 is remarkable, given the slow growth in oil output. Crude oil and petroleum products now contribute over 20 percent of export earnings and are a major factor behind the country's strong financial position. Our analysis suggests, however—and this judgment is increasingly reflected in Chinese energy journals—that China may have to phase out oil exports by 1990. This would allow domestic consumption to rise by the 2-percent annual rate that we calculate will be necessary for a 5-percent rate of economic growth. 25X1

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- An issue that we believe will come to the forefront later this decade and in the 1990s is the limited degree to which China's commercial and modern energy supplies are allocated to direct household and personal use. Of the total energy consumed by households for heating, cooking, 25X1 25X1 and lighting, only 17 percent is provided by what are considered "modern" energy sources—coal and electricity. Most of the rest is provided by agricultural wastes and firewood. [redacted] the rural energy situation is "an exceedingly unfavorable development in China's rural economy and is of extreme inconvenience to the peasants' livelihood" and [redacted] it is a matter of "urgency" to find ways to resolve the grave shortage of rural energy supplies. [redacted]

Implications for the United States

China's need for new technology, both to explore and develop new energy resources and to improve efficiency, is one of the most important motivations for Beijing to strengthen commercial links with the Western world. China, we believe, sees the United States as the best source for much of this technology and makes access to it a pivotal consideration in its official dealings with the United States. This technology can form a relatively stable underpinning for China's opening to the United States. Beijing did not, for instance, allow the mid-1983 political and economic controversies with the United States to hamper the offshore oil contract negotiations occurring during the same period. [redacted]

There are a number of areas in which energy technology is already forging important commercial links between the two countries:

- Offshore oil, where a dozen US firms are taking the lead in exploring China's promising South China Sea continental shelf. If successful, this exploration will lead to long-term—up to 35 years—commitments by the firms to work in China.
- Onshore oil, where China is purchasing US technology to maintain output at mature fields.
- Technology for the generation and transmission of electric power, where US firms are becoming involved in upgrading China's obsolete equipment. 25X1 25X1 25X1
- The coal industry is also creating a demand for US production equipment. [redacted] 25X1 25X1

Two areas of potential cooperation—contingent upon solving difficult investment and political problems—are hydroelectric and nuclear power development. [redacted] 25X1 25X1

In most of these areas China believes the United States holds the most desirable technology. US firms, however, usually meet fierce competition from West European and Japanese firms. China, moreover, has proven adept at playing competitors against each other. This competition will probably become more intense, particularly over the financing of energy projects, an area in which the United States appears at considerable disadvantage. [redacted] 25X1

Despite prospects for an advantageous commercial relationship for the United States, China's energy issue could create problems as well. A willingness to experiment with more capitalistic, decentralized economic policies and a general openness to foreign trade and investment are key features of the government's modernization strategy. [redacted] Beijing's leadership is concerned that, if energy shortages were to retard the process of economic growth severely, a marked change in leadership policy could result. Our analysis suggests, however, that, with carefully chosen policies that limit the increase in energy consumption, and with only average luck in discovering new oil resources, China can maintain a reasonable economic growth rate that will limit the need for major policy reversals. [redacted] 25X1 25X1 25X1 25X1 25X1

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