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International Economic & Energy Weekly

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Synopsis

1 **Perspective—*Pressures for Another Oil Price Decline*** 25X1

The dramatic drop in spot oil prices in recent weeks has renewed pressure on official oil prices. 25X1

13 **The Midyear Oil Market Update** 25X1

OPEC oil production rose sharply over year-earlier levels in first-half 1984 because of a strong increase in non-Communist oil consumption in major countries and maintenance of higher-than-expected inventory levels. High stock levels and uncertainty about continued oil consumption growth, however, probably will cause OPEC to maintain production near the cartel's ceiling of 17.5 million b/d for the next few months to prevent further downward oil price pressure. 25X1

19 **Western Europe: Vulnerabilities to a Persian Gulf Oil Cutoff** 25X1

Western Europe remains dependent on Persian Gulf oil, but is less vulnerable to a short-term cutoff than it was during the 1979 oil crisis. 25X1

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31 **Nigeria's Military: Difficult Times Ahead** 25X1

Economic hard times are straining the already delicate fabric of Nigeria's armed forces. We expect Nigeria's political climate to become increasingly volatile as military leaders strive to contain the political fallout from the country's economic decline. 25X1

35 **International Financial Situation: Creditor Attitudes** 25X1

Although commercial bank creditors continue to endorse the present strategy for resolving debt problems on a case-by-case basis, the banks are signaling a more flexible attitude in dealing with debtors. 25X1

25X1

37 **Ecuador: Economic Challenges for the New Administration** [redacted]

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After taking office on 10 August, President Leon Febres-Cordero will encounter significant economic hurdles in attempting to balance heightened expectations for economic recovery with the need to sustain adjustments under an IMF-supported loan program. [redacted]

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[redacted] 25X1

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3 August 1984

Perspective

Pressures for Another Oil Price Decline [redacted]

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The oil market remains weak despite some rebound in non-Communist oil consumption in first half 1984. Overproduction by OPEC members in the second quarter—particularly Saudi Arabia—in response to heightened concerns of a supply disruption in the Persian Gulf added to excess oil supplies. Oil companies began curtailing purchases after realizing that inventories had reached higher-than-desired levels, particularly in the absence of a disruption. As a result, spot crude oil and product prices have fallen sharply in recent weeks:

- Spot prices for benchmark Arab Light crude were quoted at $27 per barrel at the end of July—$2 below its official price—while prices for Nigerian Bonny Light and UK Brent crudes fell to about $3 below their official prices.
- West Texas Intermediate—the most important crude traded in the US market—declined from $30.80 in early June to $27.85 around the end of July, more than $2 below its posted price. [redacted] 25X1

The dramatic drop in spot oil prices in recent weeks has renewed pressure on official oil prices. The USSR—which typically adjusts its selling price to reflect sustained changes in spot prices—recently announced a "temporary" reduction of $1.50 per barrel in the contract price for its crude oil exports to Western Europe. In addition, several US oil companies lowered posted prices, some by as much as $2 per barrel. Deteriorating oil prices apparently also sparked rumors that Nigeria and Iran had refused to abide by their production quotas and were withdrawing from OPEC. Both countries officially denied the reports. [redacted] 25X1

Under present market conditions, we believe that cartel members must quickly and jointly reduce output and halt price discounting if they expect to maintain the current OPEC price structure. As usual, Saudi Arabia remains the key to OPEC price stability. In the past, Riyadh has shown its willingness to live with temporary significant reductions in its output in order to support official oil prices. Preliminary data indicate that Saudi oil production in July fell about 1 million b/d from June's level of 5.5 million b/d. [redacted] 25X1

Riyadh had increased output before OPEC's midyear meeting in part to exert downward pressure on prices and preclude the need to undertake a major renegotiation of production quotas. A more pronounced decline in Saudi output—at least through the next few months—may be required to reassure oil market participants that Riyadh has not abandoned support of the $29 benchmark price. Press reports indicate, however, that Saudi Oil Minister

Yamani was overruled by the King and Defense Minister Prince Sultan in his attempt to implement a larger production cut. Prince Sultan—third in line to the Saudi throne—reportedly pressed hard to maintain oil production at a high level in order to provide sufficient oil to barter for 10 Boeing 747 jumbo jets. [redacted] 25X1

The increase in oil consumption this year has been less than some OPEC members had hoped. With no major turnaround in sight, we believe OPEC must show production restraint now to avoid a challenge to the cartel's current oil price structure in the coming weeks. Further reductions in US posted prices would place extreme pressure on British official prices. The British National Oil Company (BNOC) obtained only reluctant acceptance of its proposed freeze on third-quarter prices, and several customers reportedly will seek to reopen contract negotiations this week. [redacted] BNOC is 25X1
already selling 250,000 to 300,000 b/d of oil on the spot market and probably will have to sell even more oil on the spot market if additional contracts are terminated. Any reduction in British oil prices—particularly for Brent crude—could force a price cut by Nigeria, which sells comparable quality oil. [redacted] 25X1

Although we expect OPEC will be successful in propping up the current price structure over the short term—largely because of Saudi output restraint—a number of factors could cause the market to remain weak into 1985. A decision by oil companies to liquidate the additional oil stocks that have accumulated since early this year combined with expectations of slower economic growth in 1985—as projected by the OECD—could again delay the long-predicted increase in demand for OPEC oil and would make it increasingly difficult for the organization to maintain current prices. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

UK and Norway Moving Toward Deal on Sleipner Gas

[redacted]

The United Kingdom and Norway have moved closer to completing the North Sea Sleipner natural gas deal for 12-14 billion cubic meters a year after a meeting between Alick Buchanan-Smith, the UK Energy Minister, and Kaare Kristiansen, his Norwegian counterpart. According to US Embassy reporting, an agreement between British Gas Corporation and Statoil, the Norwegian state oil company, could be concluded before the end of August. 25X1 [redacted] there is sufficient flexibility in the draft contract provisions on volume, price, and pipeline capacity for an agreement to be reached soon. 25X1 Parliamentary approval will be required in both Norway and the UK. 25X1 London has dragged its feet on Sleipner terms since February, and has considered purchasing Dutch gas, largely as a means of pressuring Norway. If negotiations break down, further delays could cause Oslo to postpone negotiations for gas sales from other fields that will need to be developed to limit Soviet gas sales to Western Europe in the 1990s. [redacted] 25X1

Renewal of San Jose Oil Assistance Agreement

[redacted]

Venezuela and Mexico are expected to announce today that they will continue selling oil to nine Cental American and Caribbean countries on concessionary terms for another year. To reflect falling oil consumption in recipient countries, Mexico and Venezuela will cut volumes available by 25 percent, to some 125,000 b/d, according to US Embassy reports. Five-year credits for 20 percent of the oil bill will remain at 8-percent interest. We expect Mexico and Venezuela to insist that the recipients use a portion of the credits in donor countries to offset some of the costs of oil aid. Indeed, Caracas will now demand that one-half of their credit cover purchases of Venezuelan goods and services. [redacted] 25X1

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The recipients, already struggling with foreign exchange shortages, will be concerned that the new credit arrangements limit their access to dollars. We expect many to ask for payments delays or other concessions. Mexico City recently granted Guatemala a 90-day payment extension for oil deliveries in response to a special request by the Foreign Minister. We believe Guatemala also has petitioned Venezuela for financial relief. According to press reports, Jamaica asked Venezuela earlier this month to delay payments on some of its debt, including past-due interest payments on oil credits, and will now approach Mexico City for rescheduling. But we expect no new financial concessions for Nicaragua. Caracas still refuses to provide Managua with oil under the accord until it can pay for previous deliveries. Mexico City probably will continue to supply Nicaragua at current levels—6,400 b/d—without requiring full payments. [redacted] 25X1

Uruguay Purchases Soviet Oil

[redacted]

Uruguay has agreed to purchase 900,000 barrels of oil from the Soviet Union over the next six months to secure an alternative supplier to Iran and to maintain trade relations with the Soviet Union. [redacted] 25X1 [redacted] 25X1 Uruguay has experienced delays in receiving shipments of Iranian oil. The new Soviet oil deliveries will cover one-quarter of Uruguay's needs and will help Montevideo balance its trade account with Moscow. During the first quarter of this year, Uruguay's imports from the USSR were less than $200,000 while exports were $22 million. [redacted] 25X1

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[redacted]

Kuwait-Sharjah Pipeline Proposal

[redacted]

Kuwait and the United Arab Emirates sheikdom of Sharjah are considering construction of two pipelines between their countries, [redacted] 25X1 [redacted] 25X1 The proposal reportedly calls for an oil pipeline from Kuwait to the Sharjah town of Kalba on the Gulf of Oman and a natural gas pipeline from Sharjah's Sajaa field to Kuwait. The project would take at least two years to complete, and its estimated cost of $300 million would be paid by Kuwait. [redacted] 25X1

[redacted] 25X1

The project would give Kuwait an alternative oil-export route bypassing the Strait of Hormuz. It also would enable Sharjah to export some of the 14 million cubic meters per day of gas that is currently being flared; Kuwait would use the gas in its developing petrochemical industry. [redacted] 25X1

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Soviet Gas-Marketing Successes Continue

[redacted]

The Soviet Union has successfully concluded three new natural gas sales contracts since the beginning of the year. Terms of the contracts demonstrate Soviet price flexibility and Moscow's intention to expand natural gas exports. Agreements with Finland, Austria, and Italy have been concluded at prices below those for fuel oil, and sales from these contracts are expected to provide Moscow with around $1 billion in hard currency annually by 1990. The

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Soviets are negotiating with Turkey, Greece, and Sweden. Soviet discussions with Belgium led the Netherlands' Gasunie to cut industrial gas prices to Belgium's Distrigaz by 15 to 20 percent for three months. The Soviets are contemplating construction of another pipeline through Bulgaria and Romania to supply 2-5 billion cubic meters of natural gas annually to Turkey and Greece. Discussions are also under way on possible Soviet gas sales to Sweden as well as to Japan. We expect the Soviets to continue to engage in aggressive gas-marketing efforts. [redacted] 25X1

[redacted]

USSR: New Gas Export Agreements in 1984

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	Importer	Year of Peak Delivery	Billion Cubic Meters Per Year	Comment
February	Finland	By 2000	1.8	Price will not be linked solely to crude oil prices.
March	Austria	By 1989	1.5	
May	Italy	1990	4.4-5.5	Lowest price (about $3.60/million Btu) yet granted to any purchaser since the 1979-80 oil price hikes.
		1992-2008	4.8-6.0	
June	Turkey	Late 1980s	2.0-5.0	Moscow agreed in principle to deliver gas at below the price of fuel oil.
July	Romania	1988-90	0.5	Bucharest will supply some equipment and manpower for gas development.

[redacted] 25X1

New Soviet-Romanian Gas Project

[redacted]

Romania and the Soviet Union signed an agreement in Moscow on 19 July for the joint development of a natural gas field in Soviet Turkmenia. Under the agreement, Romania will supply equipment and manpower for the project and will receive 500 million cubic meters of gas annually in addition to its current imports of 1.5 billion cubic meters a year from the USSR. Work on the project is scheduled to begin this year and last until 1988. [redacted] 25X1

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Although Romania and the USSR have discussed joint resource development in recent years, the agreement marks the first time Romania will supply labor for an energy project in the USSR. Bucharest reportedly has also agreed in principle to participate in future Soviet oil and mining projects. Moscow's refusal to supply oil on concessional terms and the financial problems hampering Romania's trade with the West have probably led Bucharest to begin investing in Soviet projects in exchange for energy deliveries. Even with the planned increase, however, Soviet deliveries will account for only about 5 percent of Romania's annual gas consumption. [redacted] 25X1

International Finance

Cartagena Working-Level Meeting Delayed

[redacted]

The technical meeting of Cartagena Signatories scheduled for 2-3 August in Buenos Aires has been postponed until 13-14 August. The date was reportedly pushed back to give the new President of Ecuador an opportunity to appoint his country's representatives, according to Embassy reporting. Differences of opinion also exist among participants on the purpose and agenda of the meeting, which is to be held at the deputy minister level and precede the September meeting of foreign and economic ministers. [redacted] 25X1

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Nigerian Offer to Insured Creditors

[redacted]

The Central Bank of Nigeria this week announced a proposal for refinancing arrearages on officially guaranteed trade credits. The plan is essentially a repeat of the terms and conditions offered last April to holders of $4-6 billion in uninsured trade credits. The Central Bank would issue six-year promissory notes bearing interest at 1 percentage point above LIBOR to trade creditors with debts insured by governments or export credit agencies. We estimate Lagos is behind on payments totaling nearly $3 billion to insured creditors. 25X1 [redacted] 25X1

This is the latest in a series of moves designed to ease Nigeria's foreign exchange shortage, and it is likely to prove unsatisfactory to the official creditors. Government creditors have voiced increased dissatisfaction with Lagos's failure to meet principal or interest obligations on short-term trade debt and last week addressed a stern statement to the Minister of Finance calling the current situation "unacceptable" and rejecting any attempt to force creditors to accept promissory notes. The statement, issued by the Paris Club chairman, reiterated official creditor insistence on multilateral rescheduling negotiations within the context of an IMF-supported economic adjustment program. [redacted] 25X1

[redacted] 25X1

Ivory Coast Reschedules Commercial Debt

[redacted]

Abidjan reached agreement with the London Club steering committee to reschedule $750 million late last week, according to US Embassy reporting. In addition, banks have agreed to provide $125 million in new money in 1984 and will remain open to the possibility of additional funding for 1985. Abidjan's commercial debt rescheduling closely follows a Paris Club rescheduling of $350 million in official debt earlier this month and helps pave the way toward disbursement of an $82 million IMF standby facility approved in May. [redacted] 25X1

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Moroccan Debt Rescheduling Languishes

[redacted]

Government officials are worried about the delay in completing a rescheduling agreement with commercial banks covering about $500 million in 1984 obligations. The Moroccans are resisting the banks' requirement that the Moroccan Central Bank guarantee repayment to the extent of its foreign exchange holdings. The Prime Minister has petitioned governments in key creditor countries, including the United States, to help resolve the problem, and has stressed to US Embassy officials in Rabat that continued trouble with American banks will adversely affect US-Moroccan relations. Another high-level Moroccan official has expressed concern that the commercial rescheduling delay may compromise negotiations on official debt rescheduling for 1985 and 1986. Although most of Rabat's 200 commercial creditors so far have maintained short-term credit lines, the level has not been increased since last October, and some bankers are reluctant to continue these credits. A reduction in short-term credit would be a major blow to Morocco's shaky financial position. [redacted] 25X1

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Yugoslav Skirmish With Commercial Banks

[redacted]

Yugoslavia's failure to provide financial information and its attempt unilaterally to develop an economic adjustment program for 1985 has caused its commercial bank creditors to cancel their first meeting on a new debt rescheduling, [redacted] The 1983 and 1984 bank refinancing agreements require Belgrade to report regularly on balance-of-payments performance, and the creditors are insisting on new data as a condition for beginning discussions on rescheduling. The banks also have told Yugoslavia that IMF involvement in the country's economic program is imperative. [redacted] 25X1 25X1 25X1

Yugoslav officials may be making a risky effort to seize the initiative on refinancing negotiations. Belgrade is pressing for a multiyear rescheduling on concessionary terms, and some officials want to minimize IMF involvement. An attempt by Yugoslavia to outmaneuver its creditors would jeopardize Belgrade's improving relations with the banks and seriously complicate negotiation of a new rescheduling agreement. [redacted] 25X1

Implications of Mirage 2000 Purchase by Peru

[redacted]

The purchase of 26 Mirage 2000 fighters for $650 million may placate the military, but is jeopardizing Peru's foreign financial support. The US Embassy reports that the accord for this purchase, which has been under negotiation for over two years, was concluded after Paris agreed to forgo the downpayment and finance the deal over 12 years. Lima has been stalling on a proposal to buy 16 Blackhawk helicopters from a US firm, arguing that the purchases would violate IMF debt and deficit targets. Coming on the heels of Peru's failure to meet interest payments to foreign banks on 5 July, the deal will make bankers more reluctant to extend new credit. It also could threaten Lima's compliance with IMF performance criteria, increasing the likelihood of another foreign exchange shortage in the coming months. [redacted] 25X1

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Guatemalan Foreign Exchange Difficulties

[redacted]

The suspension in June of Guatemala's IMF standby agreement because of a rising budget deficit is putting pressure on the government's meager foreign exchange holdings. Foreign Minister Andrade recently secured from Mexico credits for oil purchases even more generous than those granted under the San Jose Accord. Nonetheless, [redacted] the government is considering the imposition of fuel rationing. Meanwhile, Guatemalan officials took a step toward devaluation by quietly authorizing coffee and cotton exporters to sell some of their foreign exchange earnings in the black market. This move, however, will spur demands from other exporters for similar treatment and may cause them to withhold foreign exchange in expectation of future permission to use the free market. Moreover, official acceptance of dual exchange rates technically violates Guatemala's standby agreement with the IMF and could make it harder for the government to reach a new accommodation with the Fund. [redacted]

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Global and Regional Developments

Tokyo Boosts Arguments for Domestic Satellite Development

[redacted]

According to the chief of Japan's Science and Technology Agency, Japan must develop "100-percent-Japanese" satellites to avoid the types of failures now plaguing foreign-produced components in Japan's weather and broadcast satellites. The camera-drive systems in two weather satellites have malfunctioned, and two of three transponders in Japan's first direct-broadcast satellite have failed. [redacted] Japanese industry blames the major US parts supplier for problems with the broadcast satellite. [redacted] [redacted] the breakdown may have resulted from changes the Japanese made in the configuration of the transponders to fit a smaller satellite that could be launched by a Japanese rocket. [redacted]

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Tokyo has strongly resisted purchasing foreign satellites for reasons of national security and pride in its national space program, and will probably use the failures of satellite components to bolster the arguments. In addition, the recent problems may persuade some Japanese companies who wanted to buy foreign satellites to more actively support the domestic program, lessening US ability to persuade Tokyo to allow foreign satellite purchases. [redacted]

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Large Yugoslav Aircraft Order

[redacted]

The US Embassy in Belgrade reports that the Yugoslavs want to begin discussions with the US Export-Import Bank and US commerical banks about guaranteed financing for the purchase of up to 24 Boeing 737-300 aircraft. To meet its immediate need for aircraft, the Yugoslav national airline, JAT, expects to sign a contract with Boeing soon to lease and eventually purchase two jets for delivery in 1985. JAT, an important hard-currency earner for Yugoslavia, plans to order the additional aircraft in 1986-89 to overhaul its fleet. [redacted]

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Boeing is facing stiff competition for the JAT orders from the West European

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Boeing is facing stiff competition for the JAT orders from the West European Airbus consortium. The Yugoslavs apparently will give Boeing the 1985 contract for two aircraft because Airbus cannot begin delivering its comparable A-320 jets until 1988. Boeing also has agreed to increase its purchases of Yugoslav-made 737 parts—currently running at $6 million per year—to help offset the costs of the aircraft. Yugoslav officials claim, however, that they will choose Airbus for the subsequent orders unless Boeing can match the 8.6-percent interest rate allegedly offered by the West Europeans. Moreover, according to Embassy sources, West German political leader Franz Josef Strauss has been pressing senior Yugoslav officials to block the JAT-Boeing deal and buy the Airbus. [redacted] 25X1

Outlook Dim for Tea Agreement

[redacted]

The world's major tea exporters—Sri Lanka, India, and Kenya—failed at meetings last month in Geneva to move any closer to the creation of an International Tea Agreement (ITA). The major stumblingblock to an agreement is the size of export quotas. Both India and Sri Lanka are pushing for quotas based on historical market shares, while Kenya, with record tea export earnings in 1983 and a vibrant young tea industry, is seeking a quota that would allow for considerable export growth. We doubt that Kenya will change its position unless prices decline sharply. Nairobi has been unhappy with its export quota under the International Coffee Agreement and may want to avoid any limits on its tea exports. Kenya's position, along with the failure of sugar producers to negotiate a new sugar agreement in June, reflects a shift by key LDCs away from participation in commodity agreements incorporating price-stabilization measures. [redacted]

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National Developments

Developed Countries

Tokyo Sets Another Tight Budget

[redacted]

The Japanese Cabinet this week approved budget ceilings for JFY 1985 that are designed to control persistent deficits and will allow an overall government-spending increase of less than 1 percent. Although most ministries face a 10-percent cut, Defense—with a spending-increase cap of 7 percent—and foreign aid—with a ceiling of 11 percent—are major exceptions. The ceilings provide guidelines for budget planning, which concludes in December with Cabinet approval of a final draft. [redacted] 25X1

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The Defense Agency ultimately may not win the full 7-percent increase, but Tokyo probably hopes the ceiling—double what the Finance Ministry has pushed for—will win points in Washington. It will probably touch off sharp criticism at home from the press and opposition parties. The persistent weakness of the yen vis-a-vis the dollar, which is boosting the contribution of foreign demand to growth, has aided Finance Ministry efforts to hold down spending. The Ministry is trying to fend off demands for stimulative economic measures by casting doubt on their effectiveness. Prime Minister Nakasone's political rivals probably will continue to blame his austere fiscal policy for slower growth and trade friction. [redacted] 25X1

New Israeli Economic Policies Threatened

[redacted]

Finance Minister Cohen-Orgad threatened in an interview published on 27 July to impose new austerity policies. He said that if the Histadrut, the large trade union organization, would not join in a "social compact," he would impose a wage-price freeze by decree. During the freeze, the government would submit $1 billion in budget cuts, primarily in defense and welfare. As an incentive to the Histadrut, Cohen-Orgad implied that subsidies would not be reduced as rapidly if it joined in an agreement. Cohen-Orgad also said that the shekel will depreciate at the same rate as inflation. [redacted] 25X1 25X1

The Histadrut is unlikely to go along with such a plan, particularly not before a new government is formed. If Cohen-Orgad imposes a temporary wage-price freeze under emergency powers, the Knesset would then have to pass legislation within three months or the freeze would expire. Cohen-Orgad would like to implement austerity policies along the lines he advocated in the interview, but he also may be trying to demonstrate control of the situation to keep his job if Likud forms a new coalition government. Likud needs the support of Ezer Weizman to form a new government, and Weizman has expressed a willingness to take Cohen-Orgad's finance portfolio. [redacted] 25X1

Australian Deflation Rules Out Wage Hike

[redacted]

Australia's falling prices are proving a mixed political blessing for Prime Minister Hawke. The CPI—the basis for determining wage increases under Hawke's price-and-incomes policy—fell nearly 1 percent at an annual rate during the first six months of 1984. As a result, government and union leaders believe the next national wage adjustment—scheduled for October—will be shelved, and that there will be no wage increases until April 1985 at the earliest. Unions have said that their continued support of the wage accord will depend on the government's acceptance of tax cuts in the August budget debate. This puts Hawke in a bind because he is trying to reduce the government's $6.6 billion budget deficit but wants to retain labor support as he prepares for early elections—expected late this year or in early 1985. [redacted] 25X1 25X1

Less Developed Countries

Multiplying Financial Problems in Nicaragua

[redacted]

Signs of deterioration in the Nicaraguan Government's finances and in popular living standards are multiplying. US Embassy sources report that the junta already has used up all the foreign exchange it earned from the harvest season that ended in May. To finance its immediate needs, the government has resorted to selling crops—probably at a discount—that will not be harvested until November. [redacted] 25X1
[redacted] should Nicaragua fail to sign a new agreement or to 25X1
make any payments by the end of 1984 the banks may try to attach Nicaragua's meager foreign assets. [redacted] 25X1

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In recent public speeches, junta members have emphasized the need for civilian sacrifices, and the populace is suffering from the economic decline. The US Embassy reports that market shelves are bare of such basic items as beans and rice, even in some agricultural areas, and that much larger grain imports will be needed soon. Growers claim that the shortage is due partly to the fighting in areas normally used to grow basic grains. A particularly severe fuel crunch also forced several industrial plants to close down temporarily in July, [redacted] 25X1

Unable to alleviate the immediate problems, the government has responded by: mounting a propaganda campaign to convince the populace that economic times were worse under Somoza; delaying implementation of the sharp food-price hikes announced in June; and stepping up land distribution in the central highlands. Moreover, Managua has decided to treat all economic information as classified, according to the US Embassy. Despite the regime's claims that national problems are the fault of US policy, the populace appears to lay the blame for its declining living standards primarily at the government's doorstep. [redacted] 25X1

Mexican Army Receives More Money

[redacted]

President de la Madrid's administration, still concerned about potential domestic unrest, has appropriated an extra $16 million in the budget to create up to 20 new Army battalions, [redacted] When completed, this action will add some 12,000 troops to the force, which until recently numbered 95,000. At least three units have formed since January, and an unusually strong recruitment campaign in the media is under way. [redacted] 25X1 25X1

The military, traditionally one of the first groups to suffer budget cuts in times of economic difficulty, has done relatively well during the past two years because of the President's security worries. Nonetheless, total defense spending remains at less than 4 percent of budget outlays. Increased intelligence collection against domestic dissidents and more active monitoring of refugees and Guatemalan guerrillas along the southern border probably make the personnel increase necessary. The expansion, however, is likely to be slow; until this year only 20 new battalions were established under the military's modernization program begun in 1970. [redacted] 25X1 25X1

Salvadoran Budget Problems

[redacted]

Rising salaries triggered by labor unrest are eroding government finances and reducing the chances for an IMF accord. After striking postal workers won pay raises in early July, the Assembly approved substantial wage hikes for all public employees. Another round of increases could follow if leftist efforts to provoke additional public-sector strikes succeed. The new salary hikes and lower-than-expected tax revenues have pushed projected internal borrowing needs well beyond the $130 million ceiling that the IMF stipulated during last year's unsuccessful loan negotiations. The rising deficit, coupled with President Duarte's resistance to a devaluation, are dimming prospects for an IMF 25X1 loan this year. Instead, Duarte is pressing for an increase in El Salvador's US sugar quota and a relaxation of US insistence on partial devaluation as a condition for economic assistance. [redacted] 25X1

Argentine Beef Exports Drop

[redacted]

Argentina's beef exports for 1984 are expected to earn around $300 million, down $80 million from 1983 and the lowest since 1975. The decline contrasts sharply with the pickup in overall Argentine exports expected this year. It largely reflects reduced imports by the European Community (EC)—a major Argentine market. Competition from subsidized EC beef exports and competitively priced Brazilian and Uruguayan beef in Middle Eastern markets also have played a role in the downturn. Partially offsetting the decline in beef exports to the EC and the Middle East are increased shipments to the Soviet Union. [redacted] 25X1 25X1

South Korean Efforts To Slow Imports

[redacted]

South Korea will soon impose tariffs of up to 60 percent on 14 items that were recently freed from import restrictions. The government is using the discretionary powers in its liberalization policy announced earlier this year to stem a deteriorating current account deficit. The deficit after six months was $1.1 billion—$100 million greater than the planned level for all of 1984. Seoul has also announced measures to curb oil consumption by 10 percent and to strengthen regulatory control and supervision of imports. Cognizant of its position as the fourth-largest LDC debtor, Seoul believes a favorable current account position is essential to continued access to foreign capital. We believe South Korea remains committed to reducing imports barriers, but further deterioration in the current account or increased protectionist measures in major trading partners could lead to more restrictive import policies. [redacted] 25X1 25X1

Bangladesh Rice Purchases

[redacted]

Bangladesh [redacted] agreed in principle to buy 1.5 million metric tons of rice from Thailand during 1985-87. This move to tie down future Thai supplies probably is motivated by concern over the coming fall harvest; floods last spring destroyed an estimated 700,00 tons of expected domestic production. Dhaka also may be concerned about tight world rice stocks, which stand at a 10-year low and are expected to fall further before next summer. [redacted] 25X1 25X1 25X1

Tourism Boom in Seychelles

[redacted]

The US Embassy reports that almost 20 percent more tourists arrived in the Seychelles during the first six months of 1984 compared with the same period last year. The government's aggressive advertising campaign and cut-rate package tours, the upturn in the world economy, and a more stable political environment are responsible for these improvements. Although tourism directly and indirectly accounts for almost one-half of GDP and foreign exchange revenues in the Seychelles, we believe that the current upswing probably will not be sufficient to pull the economy out of the doldrums. Increasing capital flight, low export earnings, decreased foreign assistance, and lagging private investment will offset the tourism gains. [redacted] 25X1 25X1

The Midyear Oil Market Update [redacted] 25X1

OPEC oil production rose sharply over year-earlier levels in first half 1984 because of a strong increase in non-Communist oil consumption in major countries and maintenance of higher-than-expected inventory levels. High stock levels and uncertainty about continued oil-consumption growth, however, probably will cause OPEC to restrain production near the cartel's ceiling of 17.5 million b/d for the next few months to prevent further downward oil-price pressure. Some OPEC members probably will push for an increase in the organization's production quota if, as we expect, demand for OPEC oil reaches about 20 million b/d in the fourth quarter. Saudi Arabia, for its part, will be reluctant to discuss new quotas and will probably keep its output high enough to keep the market soft. [redacted]

Selected Countries: Trends in Inland Oil Consumption, 1984 [a]

Percent Change Over Same Period a Year Earlier

	First Quarter	April	May
United States	7.0	2.6	8.8
Japan	10.4	10.8	4.4
Canada	−0.5	5.0	7.9
France	2.1	−0.1	−17.4
Italy	0.4	1.6	12.6
West Germany	−0.6	−1.4	NA

[a] Measured as sales of refined petroleum products. Except for the United States, figures exclude bunkers, refinery fuel, and losses.

25X1

[redacted] 25X1

Recent Trends

Consumption Patterns. Led by strong increases in the United States and Japan, non-Communist oil consumption rose approximately 3 percent over year-earlier levels in first quarter 1984, the first quarterly increase since 1980. US and Japanese oil consumption rose 7 and 10 percent, respectively. Consumption trends in other industrialized countries varied widely; we estimate that oil consumption in Western Europe in the first quarter showed little change from year-earlier levels, in part because of sluggish economic growth and the continued strength of the US dollar. Although information on current trends in LDC oil use is limited, we estimate that total LDC oil consumption fell slightly early this year as declining consumption in Latin America and Africa more than offset increased demand in the Far East. Preliminary data indicate that non-Communist oil consumption rose about 2 percent over year-earlier levels in the second quarter; most of this increase again occurred in the United States and Japan. [redacted]

Inventory Adjustments. We estimate that non-Communist oil stocks were drawn down at a rate of about 2 million b/d in the first quarter of this year, as compared with a normal seasonal rate of about 2.5 million b/d. In our judgment, uncertainty over the size and duration of the rebound in consumption—combined with uncertainties over the situation in the Persian Gulf—caused some companies to be more cautious about liquidating inventories. We estimate that oil stocks increased by 1.2 million b/d in the second quarter—approximately the normal seasonal rate but 0.5 to 1 million b/d higher than most forecasters had expected. As a result, non-Communist oil stocks on land at the end of June stood at about 4.1 billion barrels, or 94 days of forward consumption. Commercial inventories represented about 3.5 billion barrels, most of which are working inventories or compulsory stocks mandated by government or IEA emergency reserve

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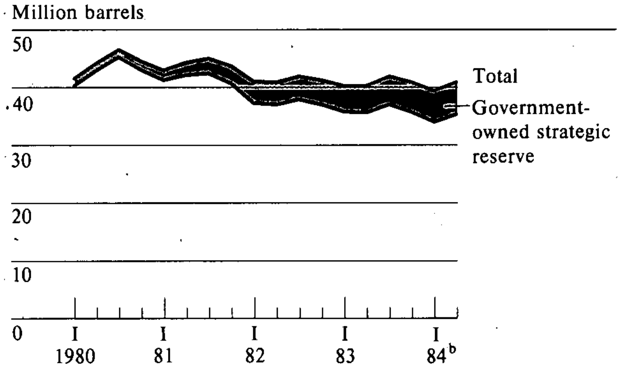
Non-Communist Primary Oil Stocks on Land, 1980-84[a]



[a] End of quarter.
[b] Estimated.

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OPEC: Crude Oil Production, 1984 [a]

Million b/d

	Quota	First Quarter	April	May	June
Total	**17.5**	**18.1**	**18.2**	**17.7**	**19.2**
Algeria	0.725	0.6	0.6	0.8	0.7
Ecuador	0.2	0.2	0.2	0.2	0.2
Gabon	0.15	0.2	0.2	0.2	0.2
Indonesia	1.3	1.5	1.5	1.5	1.5
Iran	2.4	2.3	2.4	2.1	2.4
Iraq	1.2	1.0	1.1	1.1	1.1
Kuwait	1.05	1.0	1.0	0.9	1.0
Libya	1.1	1.2	1.2	1.1	1.3
Neutral Zone	b	0.5	0.4	0.4	0.4
Nigeria	1.3	1.5	1.4	1.2	1.3
Qatar	0.3	0.4	0.4	0.4	0.4
Saudi Arabia	c	4.8	4.8	4.7	5.5
United Arab Emirates	1.1	1.3	1.3	1.3	1.3
Venezuela	1.675	1.8	1.8	1.8	1.8

[a] Preliminary.
[b] Neutral Zone production is shared equally between Saudi Arabia and Kuwait and is included in each country's production quota.
[c] Saudi Arabia has no formal quota; it acts as a swing producer to meet market requirements.

[redacted] 25X1

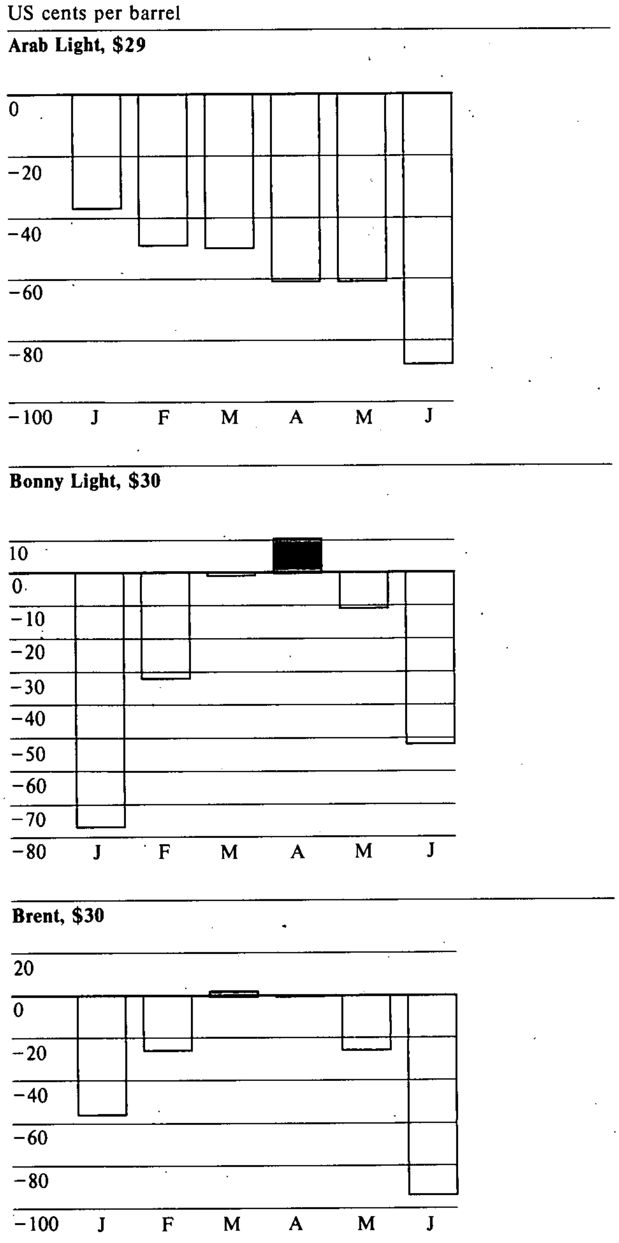
obligations. [redacted] 25X1 [redacted] 25X1 the only inventories immediately available to help offset a supply disruption are about 100 million barrels of surplus commercial stocks, about 60 million barrels of Saudi stocks, and an unspecified part of the 560 million barrels of oil in the United States, Japan, and West Germany held as strategic government stockpiles. [redacted] 25X1

Production Trends. Non-OPEC oil supplies including natural gas liquids and net Communist exports approximated 25.5 million b/d in first half 1984, an increase of 1.2 million b/d over year-earlier levels. Increases in output in the North Sea and Canada accounted for 600,000 b/d of the gain, and production increases in the non-OPEC LDCs added another 500,000 b/d to non-OPEC supplies. Despite press reports of delivery problems early in the year, we estimate that net Communist exports averaged 1.6 million b/d in the first half of the year, up 100,000 b/d from year-earlier levels. [redacted] 25X1

OPEC oil production averaged 19.1 million b/d in first half 1984, including 1 million b/d of natural gas liquids. A sharp increase in Saudi crude oil production to 5.5 million b/d in June pushed total OPEC output for the month to 20 million b/d and added to downward pressure on spot prices immediately prior to the OPEC meeting. Several other OPEC countries including Indonesia, Qatar, Kuwait, Libya, Venezuela, and the United Arab Emirates also contributed to market weakness by exceeding their production quotas by 100,000 b/d or more. [redacted] 25X1

Price Developments. The realization that oil inventories rose more sharply in the second quarter than most industry forecasters had anticipated, combined with continued high OPEC production, forced spot crude and oil product prices down steadily in July. The spot price for Arab Light

Spot Oil Market: Difference From Official Prices, 1984 [a]



[a] Monthly averages.

[redacted]

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crude fell almost $1 per barrel over the month to $27 per barrel—$2 below its official price. UK Brent and Nigerian Bonny Light crude prices declined to $27 and $27.60 per barrel, ending the month at approximately $2.50 to $3.00 below their official prices. Spot prices in the Rotterdam market were at their lowest level for the year in late July, and spot prices for West Texas Intermediate in the US market fell well below its posted price of $30 to $27.85 per barrel. [redacted] 25X1

The OPEC Ministerial Meeting. Against this background of weakening spot oil prices, OPEC oil ministers meeting in Vienna on 10 July reaffirmed the current $29 per barrel benchmark price and the cartel's production ceiling of 17.5 million b/d. Despite earlier hopes by some members for an increase in OPEC's overall ceiling and in individual allocations, only financially pressed Nigeria received special consideration. Saudi Arabia reportedly agreed to reduce its production by 100,000 b/d and 150,000 b/d in August and September, respectively, to allow Lagos to exceed its production quota of 1.3 million b/d by those same amounts. Other OPEC members, however, agreed to adhere strictly to their individual quotas and official prices. In addition, the ministers named a special delegation to visit major non-OPEC oil producers to urge these countries to show production restraint. [redacted] 25X1

The Near-Term Market Outlook

The Base-Case Forecast. In our base-case forecast, we expect non-Communist oil consumption to show an increase of about 1.5 percent from year-earlier levels in the last half of 1984. This scenario assumes normal weather patterns and economic growth of about 3 percent in the OECD. On the basis of these assumptions, we expect non-Communist oil consumption to approximate 43.7 million b/d in the third quarter, and then increase to 46.2 million b/d in the fourth quarter. This projection is in line with most recent industry forecasts we have reviewed. [redacted] 25X1

25X1

Non-Communist Oil Supply and Demand *Million b/d*

	1983	1984				
		Preliminary		Projected		
		First Quarter	Second Quarter	Third Quarter	Fourth Quarter	**Total**
Consumption [a]	44.1	46.4	43.6	43.7	46.2	**45.0**
Stock Change	−1.0	−2.0	1.2	0.6	−0.3	**−0.1**
Production [b]	43.1	44.4	44.8	44.3	45.9	**44.9**
Non-OPEC	24.5	25.4	25.6	25.6	25.8	**25.6**
OPEC	18.5	19.0	19.2	18.7	20.1	**19.3**

[a] Excludes refinery gain.

[b] Includes natural gas liquids and net Communist exports.

[redacted] 25X1

Our analysis indicates that non-OPEC oil supplies will approximate 25.6 million b/d and 25.8 million b/d in the third and fourth quarters, respectively, a gain of about 200,000 b/d from average output in the first half of the year. This assumes that non-OPEC oil producers, except Mexico, produce nearly at capacity levels for the balance of the year. Our base-case forecast, which includes a 200,000-b/d increase in strategic inventories, assumes a 600,000-b/d increase in oil stocks in the third quarter and a fourth-quarter stock drawdown of about 300,000 b/d. Our inventory forecast, which is generally in line with industry estimates, indicates a fourth-quarter stock reduction that is substantially less than the normal seasonal rate of about 1 million b/d. [redacted] 25X1

As a result, we expect demand for OPEC oil—including natural gas liquids—to approximate 19.4 million b/d in the last half of the year. Because of the normal seasonal decline in oil consumption and the higher-than-expected second-quarter stock increase, however, demand for OPEC oil in the third quarter probably will approximate only about 18.7 million b/d. We believe OPEC will have to restrain crude production through the early fall to near its production ceiling of 17.5 million b/d to avoid further downward pressure on oil prices. Under this scenario, we expect Saudi Arabia—in its role as OPEC's swing producer—to reduce its output to about 5 million b/d as long as other OPEC producers generally adhere to agreed-upon production levels. [redacted] 25X1

Forecast Uncertainties. A number of factors could alter our base-case oil consumption forecast:

- Weaker-than-anticipated economic performance in the OECD could dampen the increase in OECD oil consumption in the second half. We estimate that a 1-percentage-point difference in OECD economic growth could change consumption by roughly 500,000 b/d.

- A resolution of the coal miner's strike in the United Kingdom in the near future could lower projected West European oil consumption by about 200,000 b/d.

- The OECD base-case economic forecast assumes unchanged nominal exchange rates through the end of the year. A fall in the value of the dollar, however, could lower real oil prices in Europe and help spur an increase in West European oil consumption.

- Colder or warmer winter weather could alter projected consumption levels by as much as 500,000 b/d. [redacted] 25X1

A change in industry perceptions about events in the Persian Gulf or expectations about future non-Communist oil consumption probably would alter projected inventory patterns. A weaker-than-expected third-quarter inventory buildup and a higher fourth-quarter stock drawdown would significantly decrease our base-case estimate of demand for OPEC oil in the second half of the year. In our judgment, this is the one element of our forecast—and of most industry forecasts—most susceptible to change because of uncertainties over events in the Persian Gulf and because of the current pressure on oil prices. [redacted] 25X1

OPEC Production Quotas

Demand for OPEC oil of 20.1 million b/d—our base-case forecast—in the fourth quarter probably will cause some members vigorously to pursue an increase in OPEC's production ceiling. Indeed, according to press reports, the Kuwaiti Oil Minister has indicated that he expects demand for OPEC oil to be strong enough in the second half of the year to justify a special OPEC meeting in October to discuss a quota increase. Because most member countries—particularly Nigeria, Venezuela, and the UAE—are likely to argue strongly for a quota increase, such discussions could become contentious. [redacted] 25X1

So far, OPEC has avoided the controversial issue of a reallocation of individual production quotas, primarily because of actions taken by Saudi Arabia. Increased Saudi oil production that added to market weakness before July's OPEC meeting, and special concessions for Nigeria that avoided any formal increase in Lagos's quota, indicate Riyadh's reluctance to deal with this issue. Until market conditions clearly indicate a sustained growth in consumption, we expect the Saudis to maintain output at sufficiently high levels to cause market weakness and dissuade other members from pushing demands for higher quotas. Riyadh, however, probably will continue to be flexible on overproduction by particularly hard-pressed OPEC members in order to maintain OPEC unity. [redacted] 25X1

[redacted] 25X1

Western Europe: Vulnerabilities to a Persian Gulf Oil Cutoff [redacted]

25X1

Western Europe remains dependent on Persian Gulf oil, but is less vulnerable to a short-term cutoff than it was during the 1979 oil crisis. Some West European countries still rely heavily on Gulf production, and the region as a whole still imports 25 percent of its oil from the Gulf, compared with 50 percent in 1979. Moreover, West European oil stocks are insufficient to cover requirements in the event of a lengthy disruption. Excess production capacity in countries outside the Persian Gulf, however, currently amounts to almost 3 million b/d and could help cover a supply shortfall. [redacted] 25X1

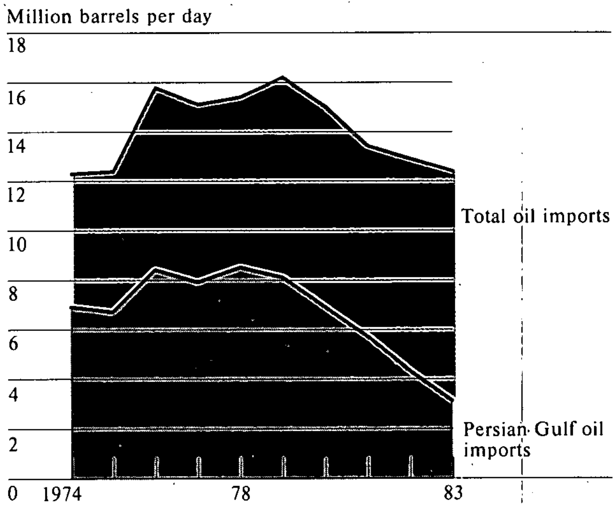
The West Europeans believe that the United States would intervene to keep Persian Gulf oil flowing and therefore that any interruption would be brief. Although several of the International Energy Agency (IEA) countries are now willing to consider the early use of oil stocks in an emergency, we believe that many would react to a short-term disruption by imposing demand-restraint measures. [redacted] 25X1

A complete and prolonged shutoff of the Persian Gulf would result in serious problems for Western Europe because of the impact on world oil prices. We estimate that, if oil exports from the Gulf were cut off for a year or more, world oil prices would rise to $65 to $70 a barrel. Assuming no accommodating shifts in government policies, West European economic growth would be cut by about 2 percentage points, and unemployment would increase by 800,000, thus threatening the region's tentative economic recovery. [redacted] 25X1

Declining Oil Dependence on the Gulf

Western Europe has sharply reduced its dependence on Persian Gulf oil in recent years. In 1979, Western Europe imported roughly 8 million b/d, or 50 percent of its oil, from the Gulf states. By 1983, the West Europeans had cut these imports by more than half, to about 3.1 million b/d—25 percent of total West European oil imports. The Gulf countries' share of total West European energy supplies plunged from 31 percent in 1979 to about 13 percent last year. [redacted] 25X1

Western Europe: Oil Imports, 1974-83



[redacted] 25X1

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Although the recession and energy-conservation efforts cut West European oil consumption 20 percent over the period of 1979-83, imports from the Gulf states also dropped because:
- Domestic oil production increased.
- Oil supplies were diversified.
- Other forms of energy were substituted for oil.

Western Europe: Dependence on Persian Gulf Oil Imports, 1983

Percent

	Persian Gulf as a Share of	
	Oil Imports	Oil Consumption
Western Europe	**25**	**27**
Turkey	74	70
Portugal	51	55
Greece	41	58
Italy	40	43
Spain	37	39
France	31	32
United Kingdom	21	12
Netherlands	18	47
Austria	15	13
West Germany	13	13
Denmark	13	14
Belgium/Luxembourg	12	22
Finland	9	11
Norway	6	3
Switzerland	6	6
Sweden	4	5

[redacted]

Indigenous West European crude oil production rose more than 50 percent over the period. The United Kingdom, which accounts for 70 percent of West European production, boosted output from 1.5 million b/d in 1979 to 2.3 million b/d last year. Norwegian production increased 52 percent. At the same time, imports from Mexico soared from 11,000 b/d in 1979 to more than 400,000 b/d in 1983, while imports from the Soviet Union increased 31 percent. Moreover, oil is playing a slightly smaller role in European energy supplies. In particular, the share of nuclear power has risen from about 3 percent of total energy consumption in 1979 to about 7 percent. [redacted]

Several individual countries, however, remain heavily dependent upon the Persian Gulf region. Turkey, Italy, Greece, and Portugal each receive between 40 percent and 74 percent of their oil imports from the Gulf states. By comparison, imports from the Persian Gulf represent only 2 percent of US oil requirements. [redacted] 25X1

Availability of Alternative Oil Supplies

West European vulnerability is also reduced because alternative supplies are available on short notice. Excess capacity in countries outside the Persian Gulf amounts to 3 million b/d. In addition, about 15 percent of the 10 million b/d exported by the Persian Gulf countries moves via pipeline to the Mediterranean and Red Seas. If shipping on the Gulf were disrupted, the pipelines could transport another 1 million b/d, and we believe Saudi Arabia would step up pipeline deliveries. [redacted] 25X1

In addition, oil stocks provide a short-term cushion for Western Europe. Existing land-based stocks of 1.1 billion barrels are equivalent to 100 days of forward consumption, according to the IEA. Due to technical factors, however, roughly half of these stocks would be unavailable for use in a disruption. Tankers in transit, although not as readily accessible as land-based stocks, would provide supplies for another 30 to 40 days. Saudi Arabia has also built up stocks in tankers outside the Persian Gulf that probably would be released in the event of a Gulf disruption. We estimate this Saudi reserve at about 60-65 million barrels, about a week's net oil flow from the Gulf. [redacted] 25X1 25X1

Economic Impact of a Gulf Oil Cutoff

A short-term disruption in Persian Gulf oil exports would probably have little effect on West European economies, but if the cutoff were complete and long lasting, the impact would be severe. Simulations with our Linked Policy Impact Model indicate that such a cutoff would quickly drive the world price of 25X1

Estimating the Impact of a Cutoff in Persian Gulf Oil Imports

We used our Linked Policy Impact Model to measure the economic impact on Western Europe of a jump in prices due to a prolonged interruption in Persian Gulf oil supplies. For our simulation we assume a net loss for a year of 5 million b/d—the amount of oil currently exported by the Persian Gulf countries less the total of excess capacity that does not flow through the Strait of Hormuz. To balance supply and demand, oil prices go up 130 percent, from $29 per barrel to $67 per barrel. [redacted]

Our conclusions depend on key parameters estimated econometrically—such as energy prices and income elasticities in each country—as well as on assumptions about policy responses to an oil shock and how quickly oil exporters use large earnings increases to boost purchases from Western Europe and elsewhere. In our scenario we assume:

- *Government expenditures on consumption and investment remain constant in nominal terms.*
- *The money supply in each country and real interest rates remain constant while nominal interest rates increase.*
- *OPEC countries spend nearly 60 percent of their estimated additional oil-export revenues—$80 billion—on additional imports in the first year of higher oil prices.*
- *Oil inventories of non-Communist countries are drawn down at an average rate of 500,000 b/d over the course of the cutoff.* [redacted]

oil up to around $65 to $70 a barrel, even assuming a fairly substantial drawdown in inventories. If the cutoff and the high oil prices lasted for a year, West European real GDP would fall about 2 percentage points in comparison with our baseline forecast. Real GDP is now expected to increase by about 2.2 percent this year and 2.4 percent in 1985; a lengthy interruption thus would threaten the West European economic recovery. It would also boost unemployment, the most serious single economic problem in Western Europe. Under our scenario, unemployment—already at record levels—would rise by 800,000, or about 0.6 percentage point, to roughly 12 percent. A substantial hike in oil prices would also boost inflation and worsen the combined current account. We estimate inflation would be 4.4 percentage points higher than our baseline case, and that the current account balance for all of Western Europe would deteriorate by nearly $5 billion. [redacted] 25X1

Policy Response

For the moment, Western Europe is not particularly concerned about an interruption in Persian Gulf 25X1 oil imports. The prevailing consensus in Western Europe is that the United States would take action to keep Persian Gulf oil flowing, and hence any shortfall in oil supplies would be temporary. A small oil price increase resulting from a brief disruption in oil imports would probably have little impact on either economic trends or policies. Although several IEA countries are now willing to consider the early use of stocks, many West European countries probably would respond by imposing demand-restraint measures and stepping up imports from other sources. France, in particular, believes drawing on emergency oil stocks is a measure of last resort. [redacted] 25X1

To cope with a long-term disruption in Persian Gulf supplies, Western Europe would probably adopt policies similar to those used during previous oil crises. Within the European Community (EC), export licenses probably would be required to ship oil 25X1 across national boundaries. The EC commission would use this system to prevent one country that allowed oil prices to rise from siphoning oil from other member states that were applying price controls. In addition, consultations would be held regularly to coordinate demand-management measures. [redacted] 25X1

Although the IEA recently agreed to use stocks to inhibit excessive oil price increases in the event of a major supply disruption, most West European

Western Europe: Impact of a One-Year Cutoff in Persian Gulf Oil Exports [a]

Percentage points
(except where noted)

	Change in Real GDP Growth	Change in Current Account Balance (*billion US $*)	Change in Inflation Rate	Change in Number of Unemployed (*thousands*)	Change in Unemployment Rate
Western Europe	**−2.1**	**−4.9**	**4.4**	**826**	**0.6**
United Kingdom	−0.8	11.6	2.0	52	0.2
France	−3.6	−5.2	4.6	245	1.0
West Germany	−1.5	1.4	4.6	186	0.7
Italy	−4.7	−9.6	4.5	128	0.6
Other	−1.4	−3.1	5.0	215	0.3

[a] World oil price rises to $67 a barrel in this scenario.

[redacted] 25X1

countries do not have adequate stocks to participate meaningfully in a coordinated stock drawdown. Under the terms of the IEA agreement, these countries would have to take actions, including demand restraint, to help share the burden of a disruption. Countries such as Italy that are heavily dependent on Persian Gulf oil probably would press for quick implementation of the IEA emergency allocation system to more evenly distribute the shortfall among the 21-member countries, including the United States. [redacted] 25X1

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Nigeria's Military: Difficult Times Ahead [redacted]

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Economic hard times are straining the already delicate fabric of Nigeria's armed forces, which have been governing since a senior officer coup last December. The current government—headed by Maj. Gen. Muhammadu Buhari and dominated by his fellow northern Muslim officers—appears increasingly bewildered by the magnitude of Nigeria's economic problems and is in constant fear of being ousted by disgruntled soldiers. We expect Nigeria's political climate to become increasingly volatile as military leaders strive to contain the political fallout from Nigeria's economic decline. [redacted]

Any regime in Nigeria must be responsive to the attitudes and ambitions of the officer corps and the military's increasing equipment and training needs. The ability of senior officers to ameliorate discontent in the military, however, is being weakened by worsening economic conditions. In our judgment, senior officers will continue to pay lipservice to the goal of strengthening and modernizing the armed forces, but there is little likelihood of significant improvement in the overall capabilities of the armed forces. [redacted]

The Military Inherits Chaos

Nigeria is in the midst of its worst economic crisis since independence in 1960, partly because of the world oil glut. Nigerian oil production—which provides 95 percent of foreign exchange receipts and 80 percent of government revenues—has fallen from 2.3 million b/d in 1979 to a range of 1.3-1.6 million b/d in 1984. Oil revenues—which peaked at $24 billion in 1980—are estimated at $15 billion this year. With export earnings plummeting, Nigeria's imports are dropping sharply. Most sectors of Nigeria's import-dependent economy have been crippled by the lack of imported raw materials and most development projects have been halted. [redacted]

The need to meet a growing debt-servicing burden is adding to the military's domestic woes. Extensive borrowing by former President Shagari's civilian government is now causing Lagos to spend a large portion of its export revenues on servicing its debt. Nigeria's debt service on its medium- and long-term debt will exceed $3 billion this year. In addition, Lagos thus far has been unable to clear up its $6-9 billion in short-term arrears, and this is impeding its ability to import. [redacted]

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Running From Economic Reality

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Buhari and his fellow senior officers promised swift and decisive action to revive Nigeria's economy after they seized power, but they were unaware of the magnitude of the problem. Early pronouncements stressed that more prudent management and the return of ill-gotten gains by former civilian politicians were the keys to economic recovery. Senior officers quickly set out to "control" the economy by forcing powerful traders to release hoarded goods and lower prices. At the same time, senior officers sought to reassure international creditors that Nigeria would honor its financial obligations and follow through on negotiations with the IMF. [redacted]

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25X1

After eight months in power, however, the regime appears increasingly adrift and unsure of what economic correctives to adopt. While the ruling military council now appears to recognize that there are no "quick fixes," responsibility for charting a long-term economic-recovery plan remains unassigned. In our view, the Buhari regime makes most economic decisions in a crisis atmosphere, attempting to minimize the short-run political impact of its actions. As a consequence, the government has been sending contradictory economic

25X1

signals by its conflicting policy statements. In the critically important oil sector, for example, the managing director of the national oil company and the federal minister for petroleum often find themselves at odds over what production policies the government should pursue. [redacted]

The government has taken some steps to bring spending in line with reduced revenues, but these moves have made life more difficult for most Nigerians. Since seizing power, the government has purged as many as 50,000 bureaucrats from federal and state civil services, reduced spending on already inadequate public services, frozen wages, and reintroduced several unpopular taxes and fees. Moreover, the government's efforts to set import priorities and gain better control of foreign exchange allocation have been undermined by bureaucratic inefficiency and persistent corruption. [redacted]

The Buhari government has been similarly unsuccessful in sorting out Nigeria's tangled international financial situation. Its refusal to devalue the naira, liberalize trade restrictions, or modify domestic petroleum subsidies continues to block an IMF agreement and stall negotiations with Nigeria's foreign creditors. In July the regime obtained a temporary 150,000-b/d increase in its 1.3 million-b/d OPEC quota, but will have difficulty selling the added production unless it cuts prices. Moreover, Lagos's efforts to secure bilateral assistance—from countries such as Saudi Arabia—hold little promise of success. [redacted]

Political Mission and Military Priorities

Nigeria's military views itself as the guarantor and protector of national unity, and the final arbitor of political power. Although the second-largest military force in black Africa—behind Ethiopia—the armed forces' prolonged involvement in politics has undermined its capability to respond to an external threat or to maintain a high level of readiness. The problems plaguing the military—endemic to most Third World countries—have been compounded in Nigeria by the rapid expansion and contraction of personnel. The military grew rapidly from 7,000 at independence in 1960 to over 250,000 during Nigeria's 1967-70 civil war to its present strength of about 130,000. [redacted] 25X1

25X1

Nigeria's military establishment is beset by the same political, social, ethnic, regional, and religious divisions that characterize the society at large. Although the precise ethnic composition of the military is unknown, southern—particularly Yoruba—and minority tribesmen from the Middle Belt region historically have found themselves in competition with largely Muslim Hausa-Fulani northerners. These tensions are heightened by personal ambitions and rivalries among the highly politicized officer corps. [redacted] 25X1

Economic hard times notwithstanding, the current government has promised to take decisive action to modernize and upgrade military capabilities. In particular, the current regime has acknowledged that it needs to: 25X1

- Continue paring the military to what is believed to be its optimum strength of between 80,000 and 100,000.
- Recruit a younger and more literate military force.
- Increase training, which suffers from a lack of purpose, coordination, and funding.
- Purchase more modern weaponry while improving the availability of spare parts, upgrading maintenance, and establishing more dependable communications links. [redacted] 25X1

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Impact of Recent Austerity

The extent to which austerity has hurt the armed forces remains unclear. Soldiers still enjoy better living standards than their civilian counterparts, but inflation and rising civilian unemployment are adding to the already sizable number of extended-family members who depend on a soldier's paycheck. Thus far, economic realities have not tempered the Buhari government's promises to buy more modern weaponry, upgrade training, and improve soldiers' living conditions. The government's May 1984 budget, for example, allocates 9.3 percent of total spending to defense, while the deposed Shagari government recommended 10 percent. In our judgment, while senior officers recognize the importance of adjustments, they are unwilling to slash military spending given their concerns about forestalling a coup attempt by more junior officers. [redacted]

As a consequence, the government continues to make military decisions on a piecemeal basis with little apparent concern for long-range economic consequences. The regime, for example, has decided to proceed with the controversial purchase of Jaguar aircraft from the United Kingdom despite reservations about the cost of the contract negotiated by the Shagari government. Similarly, the regime is attempting to improve training by upgrading the newly named Armed Forces University—formerly the Nigerian Defense Academy—to a degree-granting institution. The government also has launched a campaign to eradicate illiteracy in the enlisted ranks, which is perhaps as high as 70 percent. The regime has threatened to expel those who fail to achieve literacy in a specified time, even though this would add to unemployment. [redacted]

Economic Squeeze Poses Dangers

Despite Nigeria's currently dim economic outlook and political uncertainty, we expect no major changes in defense policies or spending as long as senior officers maintain control. We judge that senior officers believe they have little choice but to continue with stopgap policies designed to placate demands from more junior officers. The regime is more likely, in our judgment, to pursue a few "big ticket" purchases—particularly for the Air Force—while scaling back and canceling some smaller contracts as evidence of the military's bearing its share of economic hard times. Promises of improved training—partially to gain the support of less senior officers—will be highly publicized, but, in our view, will be difficult to achieve given current economic realities. [redacted]

In the near term, we doubt there will be significant improvements in the military's overall ability to respond to internal and external threats. In our judgment, the military will be distracted from its professional missions, as long as it exercises direct political power. The squeeze on government revenues also will hurt. Projects such as the Defense Industries Corporation designed to make Nigeria largely self-sufficient in small arms production will 25X1 remain high on the government's priority list but probably will receive little funding. [redacted] 25X1

Although spending cutbacks are required for economic stabilization, senior officers—well aware of the threat of a junior- or middle-grade officer coup—are unlikely to make sweeping changes in the military's composition or organization. Wholesale retrenchments could provoke more coup plotting and would add to already high unemployment. Instead, we believe military leaders will continue to retire and shuffle officers of suspect loyalty as need be, while giving high priority to ensuring that salaries are paid on time and that food and housing needs are met at minimally acceptable levels. Even so, we believe that the regime will be unable to shelter the military from economic adversity, particularly 25X1 enlisted men whose families are being hurt by the contracting economy. [redacted] 25X1

As economic stringencies worsen, senior officers comprising the Buhari regime face a struggle in countering the impression that they constitute a 25X1 "privileged class." [redacted] growing perceptions among junior- and middle-grade officers—and we believe in the enlisted 25X1 ranks as well—that the current leadership is corrupt, though not yet on the scale on their civilian predecessors. In our view, ostentatious wealth—which all past governments have exhibited—during a time of economic crisis will harden attitudes of frustrated junior- and middle-grade officers. It will also widen the gap between better paid senior officers and those struggling to make ends meet in the enlisted ranks. [redacted] 25X1

25X1

As the Army is drawn more heavily into politics, including responsibility for maintaining public order in the face of economic decline, we expect force readiness to decrease. Serious logistic and maintenance problems—particularly spare parts shortages—will be aggravated by declining availability of foreign exchange. [redacted] 25X1

Political Outlook

In our judgment, Nigeria's military is likely to become even more politicized and divided as long as it remains in power. In particular, we believe senior officers will find it increasingly difficult to maintain discipline over junior- and middle-grade officers disillusioned and frustrated by the inability of the present government to make good on its economic and political promises. [redacted] 25X1

In our view, the best the current government can hope for in the short run is to keep frustrated junior officers off balance and in check, while cushioning the impact of continued economic decline on the military. Although this could give the impression that Nigeria is "muddling through," we see little prospect that any government will be able to carry out more far-reaching economic reforms essential for longer term political stability. [redacted] 25X1

[redacted] 25X1

International Financial Situation: Creditor Attitudes [redacted] 25X1

Although commercial bank creditors continue to endorse the present strategy for resolving debt problems on a case-by-case basis, the banks are signaling a more flexible attitude in dealing with debtors. Creditors are openly considering, and in a few cases implementing, previously rejected actions such as multiyear reschedulings, rescheduling without an IMF-supported program, and capping of interest rates. Concerned with the quality of their loan portfolios, commercial banks also have developed a secondary market for swapping LDC loans. [redacted]

Multiyear Reschedulings

Commercial banks and Western governments have publicly stated their willingness to consider multiyear debt reschedulings for major debtors that have made economic adjustments. By rescheduling several years of principal repayments coming due instead of the usual one year's repayments, creditors seek to eliminate bunching of repayments and to avoid the usually long and arduous renegotiation process each year. The major drawbacks to the multiyear rescheduling plan in the eyes of creditors are how to enforce austerity during the rescheduling period and the fact that it does not ease the burden of rising interest rates. [redacted]

The only countries that creditors are considering for multiyear reschedulings are Mexico and Brazil. Negotiations between Mexico and its bank advisory committee began in mid-July, with the Mexicans requesting a rescheduling of all principal falling due in 1985-90. The banks, however, prefer inclusion of a large portion, but not all, of 1985-88 principal repayments. Disagreements also exist regarding the type of debt to be included, the rescheduling terms, and the role of the IMF as a monitor of the agreement. [redacted] 25X1

[redacted] expect Brazil to open negotiations with its bank advisory committee this fall. Embassy reporting indicates, however, that Brazil will wait to see the terms that Mexico obtains in its agreement and then request similar treatment from the banks. Bankers are greatly concerned with the issue of precedence, which will lengthen the Mexican negotiations and thus postpone the Brazilian talks. [redacted] 25X1 25X1

Rescheduling Without an IMF-Supported Program 25X1

Creditors consistently have required that a country seeking debt relief have an IMF-supported program in place before any negotiations. A break in this policy recently occurred when commercial banks agreed to commence rescheduling talks with Venezuela on 23 July. Although Venezuela has not implemented an austerity program under the guidance of the IMF, Fund representatives commented favorably in July on Caracas's self-imposed economic adjustment efforts. In addition, Venezuela is not requesting any new money from banks and has a relatively high level of foreign exchange reserves. [redacted] 25X1

The fear of setting a precedent by rescheduling without an IMF program remains with bankers even though Venezuela's economic situation is much stronger than that of other major Latin debtors. [redacted] other countries will closely watch the Venezuelan talks and will seek similar treatment. Argentina has requested a rescheduling without an IMF program in place but has met stiff resistance from banks. [redacted] 25X1 25X1 25X1

[redacted] 25X1

[redacted] Bankers are particularly worried about the consequences if Brazil or Mexico reject an IMF role in the debt strategy. [redacted]

Capping of Interest Rates

A technique for reducing the LDCs' interest burden that has been proposed by debtors and some financial observers involves the capping of interest rates. Banks have been firmly against such a move because of the possibility of pushing the lending rate below the banks' cost of funds, which would cut sharply into earnings. Moreover, if interest payments are capitalized—converted into principal—under this technique, banks face regulatory problems and are increasing their exposure to the borrowing country. [redacted]

A slight change in banker attitudes toward interest capping was evidenced, however, by a recent loan to Paraguay. The $15 million loan, cofinanced by the World Bank and commercial banks, was signed in June and contained a capping provision. If LIBOR exceeds 12 percent in the last five years of the 10-year credit, the loan's maturity would be extended. The World Bank would finance the extension of the maturity. [redacted] 25X1

Commercial banks probably will continue to refuse to cap interest rates on loans unless, as in the Paraguay loan, official creditors or institutions issue some sort of guarantee to finance the amount exceeding the cap. [redacted] an IMF special fund is being considered to lend to countries hard hit by interest rate increases; this fund would be organized somewhat like the 1974 IMF Oil Facility, which provided assistance to countries to offset higher oil import costs. Unless such a program is established or guarantees are given, however, most observers do not expect interest capping to become a widespread practice. [redacted] 25X1

Secondary Market for LDC Loans 25X1

In the past 12 to 18 months, a secondary market for bank loans to developing countries has evolved as a means for banks to upgrade their loan portfolios. [redacted] many large US banks have engaged in this activity, although to different degrees. The main portion of the secondary market involves the swapping of loans between banks to balance the banks' exposures to individual countries. The loan swap often occurs between a US bank and a domestic bank in a debtor country as a way of reducing foreign exchange risk or transfer risk. [redacted] 25X1 25X1 25X1 25X1

US bankers are cautious in their dealings on this secondary market because of the watchful eyes of the US bank regulators. Since these loans often are traded at a discount, questions are raised about their quality. No formal data are available on the volume and details of these transactions, and bankers generally will only admit which countries' loans were involved. [redacted] bankers do not see the secondary market becoming very large because of the asset quality concerns. [redacted] 25X1 25X1 25X1

[redacted] 25X1

Ecuador: Economic Challenges for the New Administration [redacted]

25X1

After taking office on 10 August, President Leon Febres-Cordero will encounter significant economic hurdles in attempting to balance heightened expectations for economic recovery with the need to sustain adjustments under an IMF-supported loan program. Despite likely opposition to his free market economic policies from labor and leftist political parties, solid backing from the military and influential business community probably will enable Febres-Cordero to implement most of his programs. We believe there is a good chance that his programs will gradually spur recovery, reduce inflation, improve the external accounts, and strengthen the five-year-old democratic process. [redacted]

Febres-Cordero Takes Charge

A conservative businessman, Febres-Cordero gained nationwide attention in the last few years while serving in congress and exposing corruption in government. Unlike many of his Latin American counterparts, he is a firm adherent of free market economic policies and believes they are essential to spur economic growth. He believes that imposition of fiscal austerity and reforms in monetary and exchange-rate policies, along with free market principles, will restore domestic and foreign business confidence, resuscitate the stagnant industrial sector, and revive nonoil exports. Determined to reduce the government's role in the economy, Febres-Cordero plans to eliminate basic commodity subsidies, decrease regulation, liquidate state monopolies, and reorganize the state petroleum industry to encourage efficiency. To fulfill his campaign pledges to provide low-cost housing and increase employment, he intends to funnel government assistance to the private construction industry. We believe that Febres-Cordero will also court foreign investors. At a recent meeting with bankers in New York, the President publicly sought foreign investment in mining, petroleum exploration, tourism, agriculture, and export industries. [redacted]

Febres-Cordero's Economic Team

The new economic team, drawn mainly from the business community, is ready to impose its own brand of free market policies that allow for some government intervention. Carlos Emanuel, the leading candidate to head the central bank, favors free market pricing policies, a reduction in the role of the state, and a floating exchange rate. Francisco Swett, the architect of Febres-Cordero's economic plan, is slated to run the Finance Ministry. He believes in positive real interest rates, a floating currency, and the elimination of gasoline subsidies. 25X1 *Other team members, however, are less oriented to free market reforms. Javier Neira, the possible industry minister, for example, prefers a gradual phasing out of subsidies to national industry rather than a direct dismantling.* [redacted] 25X1

Current Situation

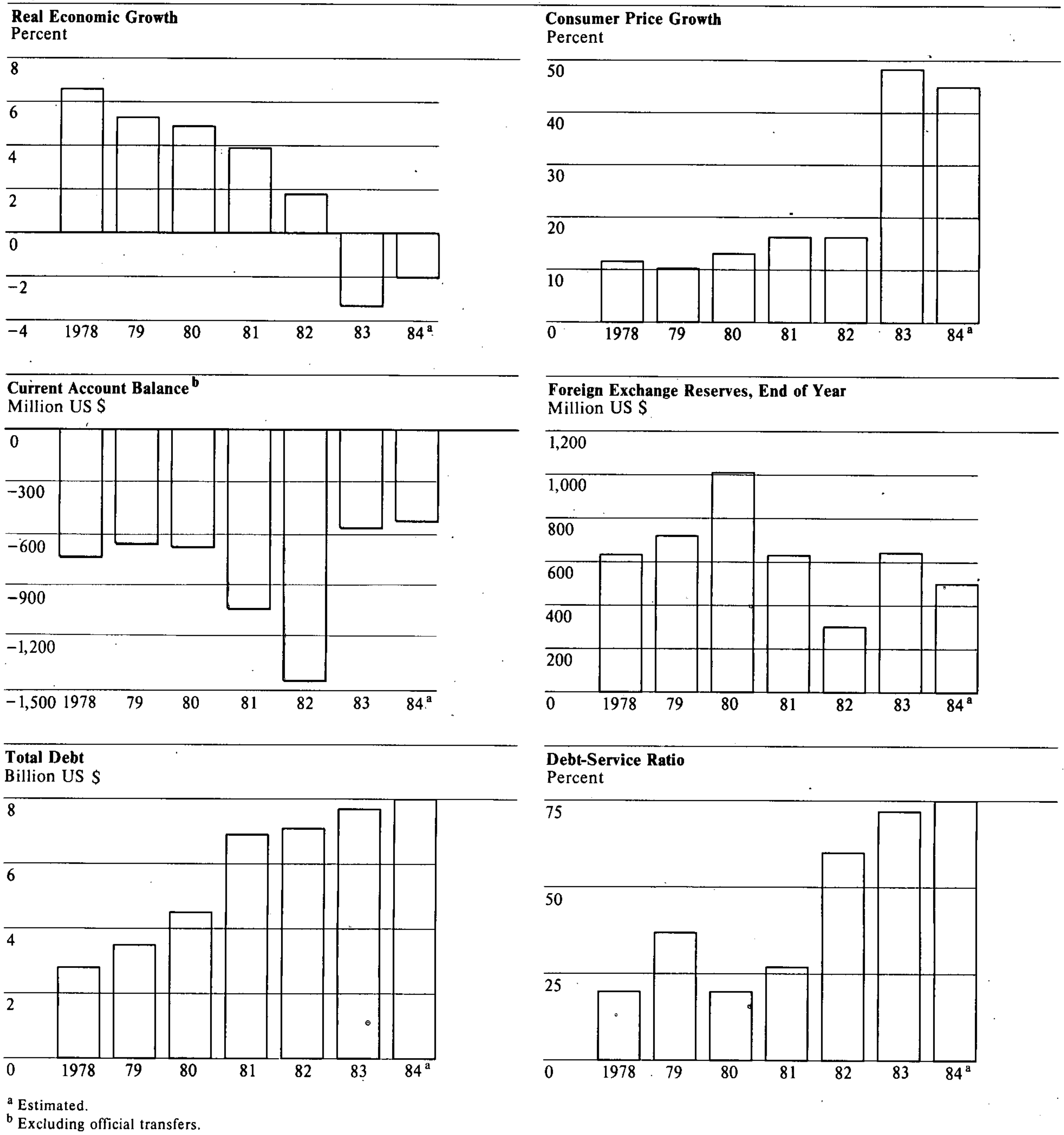
Febres-Cordero's most immediate challenge will be the issue he targeted in his campaign—the sluggish economy. Central Bank projections indicate that the economy contracted 3 percent in 1983, the result of austerity policies that slowed domestic demand, and a steep decline in agricultural production because of adverse weather. The manufacturing and construction sectors remain depressed and half of the labor force reportedly is idle or underemployed. Inflation is running at 45 to 50 percent, close to record levels in 1983. [redacted] 25X1

An overvalued exchange rate, weak world demand for Ecuador's exports, and hikes in international interest rates are impeding improvement in the external accounts. There has been a slight recovery

25X1

Ecuador: Selected Economic Indicators, 1978-84

Note scale changes



[a] Estimated.

[b] Excluding official transfers.

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in the trade balance because imports have remained constrained. Although Ecuador is the third-largest oil exporter in Latin America, the slack international oil market is preventing any substantial increase in oil export earnings, and traditional exports—sugar, coffee, cocoa, and bananas—are suffering from an overvalued currency, export taxes, and rising production costs. Interest payments on the $8 billion debt will take about one-third of export earnings this year and higher interest rates will cut into export gains. [redacted]

Relations With Bankers

Febres-Cordero will benefit from his predecessor's efforts to stabilize the economy. US Embassy reporting indicates that Quito remained in compliance with the IMF program that expired in late July and, [redacted] has already secured an interim agreement with bankers to reschedule the 1984 debt. Bankers, however, refused to provide new loans before the inauguration, causing Quito to run up $200 million in arrears. The IMF probably will require an elimination of these arrears before approving a new standby. [redacted]

Febres-Cordero favorably impressed bankers during his recent visit to the United States, [redacted] He surprised them, however, by putting Quito's new loan requirements for 1984 and 1985 at $600 million—double the amount estimated by his predecessor. During the meetings, Febres-Cordero also indicated that he would seek lower interest rates on foreign credits to ease payments constraints. [redacted]

Prospects

In our view, the new President will move promptly to meet these economic challenges, although his policies will probably be resisted by several key interest groups. To reduce the budget deficit, Febres-Cordero will attempt to shrink the large state sector—half of total public expenditures—and reduce subsidies by increasing gasoline and food prices. Such price increases are likely to spur labor unrest. We believe that Febres-Cordero's substantial backing from the military and the business community will counterbalance opposition from labor and leftist political parties, at least during his first six months in office. [redacted] 25X1

We believe that Febres-Cordero's approach, even if accompanied by some backpedaling, will gradually improve Ecuador's economic prospects and strengthen the five-year-old democratic process. 25X1 Recent Central Bank estimates project a slight increase in economic activity this year, mainly because of normal weather and increased oil production. The current account deficit is expected to contract as exports rise and imports remain constrained. Rising agricultural output will ease price pressures, enhance purchasing power, and boost exports. We believe that, by early 1985, improved business confidence, the elimination of an overvalued exchange rate, and increased construction activity will provide momentum for economic recovery. [redacted] 25X1 25X1

We believe Quito will secure the $100 million IMF standby agreement it seeks. There is also a good chance that Ecuador will obtain loans from international development agencies, such as the World Bank and the Inter-American Development Bank. These funds will enable the government to modernize infrastructure without an increase in domestic spending. In addition, they will help soften the political impact of austerity by creating jobs. [redacted] 25X1 25X1 25X1 25X1 25X1

The generally favorable reaction to Febres-Cordero from foreign creditors and businesses bodes well for his plans to obtain new loans and direct investment. Next month the new administration's team will return to the United States to conclude the 1984 debt-refinancing plan [redacted] Although we believe negotiations for new loans will be difficult, creditors are encouraged by the halt in capital flight since Febres-Cordero was elected. Some US regional banks are reluctant to increase their loan exposure, but are willing to keep trade credit lines open. [redacted] 25X1 25X1 25X1 25X1

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