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International Economic & Energy Weekly



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3 May 1985

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

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**International
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Weekly**

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Synopsis

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| 1 | Perspective—Implications of Third World Economic Prospects <input type="text"/> | 25X1 |
| | We believe moderate improvements in economic performance will enable Third World governments to “muddle through” the next five years. In our judgment, these Third World economic prospects have several important economic and political implications for the industrialized West. <input type="text"/> | 25X1 |
| 3 | Persian Gulf Banking: The Slowdown Continues <input type="text"/> | 25X1 |
| | Slower economic activity in the Gulf and the 1982 Kuwaiti stock market crash have left many local and foreign banks in the region burdened with bad debts. Gulf financial problems could spill over into other financial markets as a result of US and West European bank exposure in the region. <input type="text"/> | 25X1 |
| 7 | Malaysia: Pitfalls of Privatization <input type="text"/> | 25X1 |
| | Over the past year Malaysia has begun moving ahead with its highly touted program of privatizing selected state enterprises as a means of easing budget deficits and foreign borrowing strains. Public-sector spending will remain high as the ambitious industrialization program offsets any savings from privatization. <input type="text"/> | 25X1 |
| 11 | Mexico: Limited Impact of the New Banking Laws <input type="text"/> | 25X1 |
| | Mexico’s recently published guidelines for the nationalized banking system are designed to increase the authority of the Central Bank to make monetary policy, to stimulate the small private parallel financial market, and to reaffirm the nationalized banks’ domination of the financial sector. We believe, however, that Mexico will fall short of these goals. <input type="text"/> | 25X1 |
| 15 | Israel: Economic Development of the Occupied Territories <input type="text"/> | 25X1 |
| | Continued Israeli military occupation has held back the economic development of the West Bank and Gaza Strip even though Arab residents of the occupied territories have benefited somewhat. <input type="text"/> | 25X1 |
| 19 | Cambodia: 1984/85 Rice Shortfall <input type="text"/> | 25X1 |
| | We estimate that Cambodia’s 1984/85 rice harvest will decline for a second straight year to 1.4-1.5 million metric tons—the smallest since 1979/80. Despite a smaller crop, we do not expect widespread food shortages during the coming months, because a substantial part of the rice shortfall will be made up by other foods. <input type="text"/> | 25X1 |

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Perspective**Implications of Third World Economic Prospects** []

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We believe moderate improvements in economic performance will enable Third World governments to "muddle through" the next five years. With varying degrees of policy compromise, the LDCs should be able to maintain their economic austerity programs and avoid dramatic political or economic upheavals. According to several private forecasts, economic growth in the LDCs will likely average between 4 and 5 percent annually through 1990. This would be a marked improvement over the depressed pace of the past few years but still well below that of the 1960s and 1970s. Concurrently, consumer price inflation is expected to slow; higher exports will help reduce current account deficits; and external debt will rise more slowly. []

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In our judgment, these Third World economic prospects have several important economic and political implications for the industrialized West:

- **Trade.** An improved LDC trade surplus means the United States and other industrial countries will have to absorb increasing amounts of Third World exports. Trade frictions will grow, especially if export-oriented Latin American and Asian countries make greater use of subsidies and other trade-distorting measures. In addition, the newly industrialized countries pose a potential threat of becoming an alternative supplier of sensitive, high-technology products to Communist countries by the end of the decade.
- **Finance.** Although no major financial crises are expected to emerge during the latter half of the decade, the need for periodic financial rescue packages will continue, and their use probably will broaden to such second-tier debtors as Egypt and Colombia. The investment incentives implemented by the Third World are not expected to attract a substantial amount of foreign direct investment. As a result, we believe the Third World's demands for concessional aid particularly by Sub-Saharan Africa will heighten.
- **Interest Groups.** In our judgment, the developing countries will increasingly divide into relatively small blocs or ad hoc groups with common economic problems and press the industrial countries to adopt policies that are tailored to their members' unique conditions. The Cartagena group of Latin American debtors is one such group. Others could crystallize around aid and industrial country protectionism. These special interests could lead to growing regionalism as the Latin American countries concentrate on debt; the Africans, on aid; and the Asians, on protectionism. []

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The growth projections, moreover, are sensitive to several external factors. The most disruptive would be heightened protectionism or a slowdown in industrial-country growth. Aware that their economic prospects depend in large measure on US economic performance, we believe the Third World countries will bring increasing pressure on the United States to manage its economy with international economic goals in mind. Specifically, they will call for reduced interest rates, lowered US trade barriers, and tolerance of continued protection of their own markets, particularly in new areas such as services.



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Persian Gulf Banking: The Slowdown Continues

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Slower economic activity in the Gulf and the 1982 Kuwaiti stock market crash have left many local and foreign banks in the region burdened with bad debt. Concurrently, depressed financial markets have heightened regional competition, forcing increased bank insolvency and mergers. Continued recession, coupled with intensified regional instability, could severely damage the Persian Gulf banking sector. Gulf financial problems could spill over into other financial markets as a result of US and West European bank exposure in the region. Although individual Gulf governments probably could act to stabilize the situation before a collapse occurs, it might accelerate their drawdown of foreign reserves.

Emerging Strains

The turnaround in the Gulf states economies since 1980 has reversed the condition of many Gulf banks. Lower oil revenues have stunted Gulf economic development; the Iran-Iraq war has closed two large markets to development lending and trade finance; and, as a result, regional bank profits have slumped:

- For 1983, UAE commercial bank assets declined slightly after a previous three-year average increase of 40 percent. The National Bank of Abu Dhabi (NBAD) reported profits in 1983 at about 60 percent of the 1982 level, and we believe 1984 profits were no better. Khalij Commercial Bank was badly shaken by loan losses in 1982. Large deposits and capital injections helped it survive, but competitors are still unsure of its prospects.
- In Saudi Arabia, the National Commercial Bank (NCB)—the second-largest Arab bank in terms of assets—recorded a second year of declining profits in 1984. Several smaller Saudi banks have recorded similar declines, and the US Embassy

expects more to follow. Commercial bank assets rose less than 4 percent during 1983-84 with NCB recording no increase.

- For Kuwait, total assets were down 4 percent in 1984. Sharply lower profits forced banks to slash dividends to shareholders by two-thirds or more. Even these reduced dividends were paid only because of bankers' fears of shaking confidence in the system.

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A major contribution to the fall in profits was the increase in the number of nonperforming loans—mainly to construction companies and individuals. As property values have plunged, loans that were previously adequately secured are now vulnerable. The Saudi Government's refusal to bail out the Shobokshi construction group left \$400 million in unpaid loans to domestic and foreign banks. An Abu Dhabi institution is rumored to have at least 50 percent of its loans nonperforming. In addition, the takeover of the Emirates National Bank (ENB) by the Union Bank of the Middle East (UBME) was the result of ENB carrying \$55 million in doubtful loans. Foreign lending has also caused problems. Recently, the Dubayy Bank, previously owned by the Galadari family, had to be purchased by the UAE Government as a result of that bank's ill-timed real estate investment in Singapore.

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The collapse of the Souk al Manakh—the Kuwaiti unofficial stock market—is still looming heavily on regional Gulf bank balance sheets. According to press reports, as the government has declared reductions in the collectible value of debt backed by shares in the Manakh crisis, the capital of even some blue-chip Kuwaiti firms fell by 50 percent early last year. As a result, the value of the collateral held by banks against these firms' loans,

Gulf Banks in the Arab Top 100:^a 1983 Growth Rates

| Rank ^b | Bank | Assets ^c (million US \$) | Percent | | |
|-------------------|---|--|---------|----------------|------------------------|
| | | | Assets | Earnings | Capital Asset Ratio |
| 2 | National Commercial Bank, Saudi Arabia | 14,624 | 0 | -5.7 | 5.5 |
| 8 | Riyadh Bank, Saudi Arabia | 9,252 | 17.3 | -4.0 | 10.5 |
| 9 | National Bank of Kuwait, Kuwait | 9,046 | 14.0 | 15.0 | 6.0 |
| 11 | Arab Banking Corporation, Bahrain | 8,762 | 11.0 | -6.3 | 11.7 |
| 13 | Gulf International Bank, Bahrain | 7,434 | 20.3 | 12.4 | 6.1 |
| 14 | Gulf Bank, Kuwait | 7,088 | 14.6 | 6.9 | 6.8 |
| 15 | Commercial Bank of Kuwait, Kuwait | 6,552 | 8.4 | 4.7 | 6.2 |
| 16 | National Bank of Abu Dhabi, UAE | 6,132 | -3.2 | -40.4 | 8.1 |
| 19 | Alahli Bank of Kuwait, Kuwait | 5,728 | 16.6 | 12.3 | 6.4 |
| 26 | Bank of Kuwait and the Middle East, Kuwait | 3,530 | 1.3 | 13.6 | 6.8 |
| 27 | Saudi American Bank, Saudi Arabia | 3,473 | 14.2 | 1.4 | 9.6 |
| 30 | Al Bank Al Saudi Al Fransi, Saudi Arabia | 3,180 | 15.8 | 18.2 | 7.3 |
| 32 | Kuwait Finance House, Kuwait | 2,731 | 40.4 | -19.9 | 4.4 |
| 35 | Burgan Bank, Kuwait | 2,344 | 22.9 | 10.9 | 7.9 |
| 38 | Bank of Bahrain and Kuwait, Bahrain | 2,291 | 1.1 | 0 ^c | 10.5 |
| 39 | Bank of Oman, UAE | 2,205 | -1.4 | NA | 5.9 |
| 41 | Albank Alsuadi Alhollandi, Saudi Arabia | 2,079 | 3.5 | -13.2 | 7.2 |
| 42 | Saudi Cairo Bank, Saudi Arabia | 2,057 | -16.2 | 62.1 | 4.2 |
| 43 | Arab National Bank, Saudi Arabia | 1,984 | 14.4 | -5.8 | 12.3 |
| 44 | National Bank of Dubayy, UAE | 1,948 | 30.5 | 56.5 | 15.9 |
| 45 | Saudi British Bank, Saudi Arabia | 1,892 | 9.4 | -8.0 | 8.8 |
| 47 | Arlabank International, Bahrain | 1,723 | -21.0 | -7.0 | 13.1 |
| 52 | National Bank of Bahrain, Bahrain | 1,492 | 26.4 | 9.9 | 10.0 |
| 53 | Saudi Investment Bank, Saudi Arabia | 1,459 | -8.8 | -66.9 | 3.9 |
| 54 | Bank Al Jazira, Saudi Arabia | 1,409 | 12.4 | 0.2 | 7.9 |
| 57 | United Gulf Bank, Bahrain | 1,289 | 27.2 | -31.8 | 19.6 |
| 58 | Arab Bank for Investment and Foreign Trade, UAE | 1,280 | 5.9 | -17.4 | 5.9 |
| 59 | Gulf Riyad Bank, Bahrain | 1,269 | 2.1 | -14.1 | 2.5 |
| 62 | Dubayy Bank, UAE | 1,132 | 7.4 | -42.6 | 5.5 |
| 68 | Middle East Bank, UAE | 969 | -1.4 | 1.1 | 5.8 |
| 69 | Khalij Commercial Bank, UAE | 965 | 18.0 | 0.6 | 10.0 |
| 72 | Union Bank of the Middle East, UAE | 865 | -28.7 | NA | 14.0 |
| 79 | Arab Asian Bank, Bahrain | 605 | 4.1 | -2.0 | 11.8 |
| 85 | National Bank of Shurjah, UAE | 530 | 28.3 | 26.5 | 19.1 |
| 87 | Emirates Commercial Bank, UAE | 463 | 12.6 | 4.1 | 16.1 |
| 89 | Kuwait Asia Bank, Bahrain | 449 | 87.1 | 71.1 | 26.7 |
| 93 | Investment Bank for Trade and Finance, UAE | 442 | 13.6 | 2.4 | 11.0 |
| 97 | Bahrain Middle East Bank, Bahrain | 392 | 218.7 | -42.0 | 29.9 |
| 100 | Al-Ahli Commercial Bank, Bahrain | 364 | 8.1 | -72.7 | 13.1 |

^a None of these banks are in the Global Top 100. Total results for 1984 unavailable. We, however, feel 1984 will mirror 1983 with the exception of Kuwait.

^b The Arab Top 100 from *The Banker* magazine, December 1984.

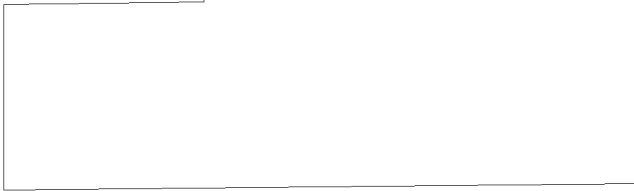
^c Adjusted for abnormally high profits in 1982.

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as well as the borrower's ability to pay, is questionable. Press reports indicate that nonperforming loans comprise 30 to 50 percent of most Kuwaiti bank portfolios.



possible. Also, the UAE has recently limited foreign banks to eight branches to curb competition. The Arab Asian Bank in Bahrain was recently taken over by the Middle East Financial Group of Luxembourg, according to Embassy reports. In addition, many banks in Bahrain have scaled down operations and reduced credit lines. In Kuwait, the government is planning a merger between Burgan Bank and the Bank of Kuwait and the Middle East.

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Competition, Mergers, and Regulation

Lack of lending opportunities is creating intensified domestic and regional competition among Gulf banks that is likely to lead to a wave of mergers. In an effort to provide more business for domestic banks and prevent the internationalization of the riyal, the Saudi Arabian Monetary Agency (SAMA) is moving to reduce competition to Saudi banks by offshore banking units (OBU) in Bahrain. Saudi Arabia currently is the prime outlet for OBU lending. Since mid-1984, however, offshore banks must request permission to participate in riyal syndications in Saudi Arabia and may be forced to pay a withholding tax on interest paid by Saudi borrowers. SAMA followed these restrictions by recently issuing money market instruments designed to draw riyals back to Saudi banks.

Gulf governments now are trying to enforce rules requiring timely and accurate reporting by banks in order to examine debt problems. Even so, many financial institutions in the region have yet to divulge their 1984 results. Gulf banks generally shun government interference, especially in Kuwait and the UAE. Bank-owning families in the UAE have strong ties to Emirate rulers who make banking decisions. The Central Bank plays a minor role, usually employing moral suasion to influence banks.

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Outlook and Implications

A \$5.5 billion capital outflow during the first half of 1984 forced the UAE Central Bank to issue local currency-denominated CDs to commercial banks earlier this year in a less than successful attempt to draw deposits from Bahrain. Recently the Central Bank started to require all banks operating in the UAE to place with it on a weekly basis an interest-free deposit equal to 30 percent of any placement or loans made to nonresident banks. Kuwait reportedly had more success in controlling capital outflows with the implementation of a two-tier exchange rate regime in 1984.

We expect another poor financial showing for Gulf banks in 1985 largely because of the continuation of the regional recession and the Iran-Iraq war. Profits probably will decline as banks continue to make provisions for bad debts. In addition, competition among banks will ensure a narrow spread between interest rates paid to depositors and those charged for loans—further squeezing profitability. Larger Gulf banks are beginning to look for other markets in Asia and some have opened offices in Europe and the United States. Smaller banks, however, probably will be at the mercy of economic conditions in the Gulf.

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Stiff competition among Gulf banks probably will cause more to fail or leave the region this year. As a result, central banks are encouraging more mergers and buyouts. Embassy reports indicate that a consolidation of three or four banks appears imminent in Abu Dhabi and another two-bank merger is

The Gulf recession is cutting into US and European bank profits as well. According to press reports, one US bank reported a \$70 million quarterly loss last year largely because of the Shobokshi bankruptcy. Further bankruptcies could aggravate problems in

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other financial markets. Embassy reporting indicates that US branches are increasing their reliance on banking services to generate revenues until commercial activity resumes. Even though US banks have a competitive edge over Arab banks in providing services, there may not be enough business for all.

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Weaker banks probably will continue to fail, but mergers with healthier institutions and government buyouts probably will avoid a total loss of confidence in the banking systems. Should failures markedly increase, however, troubled banks short on capital might need Central Bank support, and efforts to support the system could require a substantial liquidation of Gulf government reserves. In addition, an increase capital flight from the region could lead to drawdowns of foreign assets to maintain regional liquidity.

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Malaysia: Pitfalls of Privatization

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Over the past year Malaysia has begun moving ahead with its highly touted program of privatizing selected state enterprises as a means of easing budget deficits and foreign borrowing strains. Divestiture, however, is constrained by the New Economic Policy (NEP) that limits the economic participation of the country's large Chinese minority and foreign investors in favor of the Malays—the largest, but most economically backward, ethnic group. In the near term, we believe Kuala Lumpur will have to provide a large portion of the investment capital needed to ensure Malay participation in privatization even though such financial support has been largely responsible for the high budget deficits. Over the longer term, public-sector spending will also remain high as an ambitious industrialization program offsets any savings from privatization. We believe that Kuala Lumpur under pressure of these budget strains will seek foreign investment—most notably from Japan and the United States—to help underwrite its development program.

Malaysia, Incorporated

Despite a record of good economic growth—average annual GDP growth was more than 6 percent into the 1980s—Malaysia has in recent years experienced increased financial strains. Record budget deficits have resulted from steadily rising government expenditures—because of industrialization and NEP-sponsored programs—and reduced export revenues because of low commodity prices. These deficits have been exacerbated by a rising debt service burden as foreign debt has more than tripled since 1980, reaching an estimated \$22 billion in 1984.

Efforts to ease financial strains have resulted in major cuts in direct development spending since 1981, when the budget deficit hit a record 22

The New Economic Policy

The New Economic Policy (NEP) is a 20-year program aimed at achieving greater economic parity between Malaysia's ethnic groups. It was instituted in 1971 following racial rioting between Malaysia's main ethnic groups, the poorer Malays who constitute 55 percent of the population and the Chinese who account for 35 percent. Since independence in 1957, the Malays have held the political power, but the Chinese along with foreign investors dominated the economy.

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A primary objective of the NEP is to restructure Malaysia's corporate sector by 1990 to reflect 30-percent ethnic Malay ownership, 40 percent other Malaysian, and 30-percent foreign ownership. At the inception of the NEP, Malays held a scant 4 percent of the nation's corporate wealth. To help raise the Malays corporate stake, the NEP set up trust agencies to act as proxies for the Malay community in acquiring shares and establishing new enterprises on their behalf. In 1983 these agencies held \$2.3 billion in trust for the Malays—a major factor in boosting Malay ownership to nearly 20 percent.

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Despite the substantial progress Malays have made under the NEP, it is likely that many of the equity targets will not be achieved by 1990. This would damage the prestige of any government in office and would be particularly harmful if the Mahathir government is still in office because his idea of an affirmative action program for ethnic Malays is the philosophical underpinning of the NEP. As a result, we believe the Malay leadership will find it necessary to push back the NEP targets and continue the policy into the next decade.

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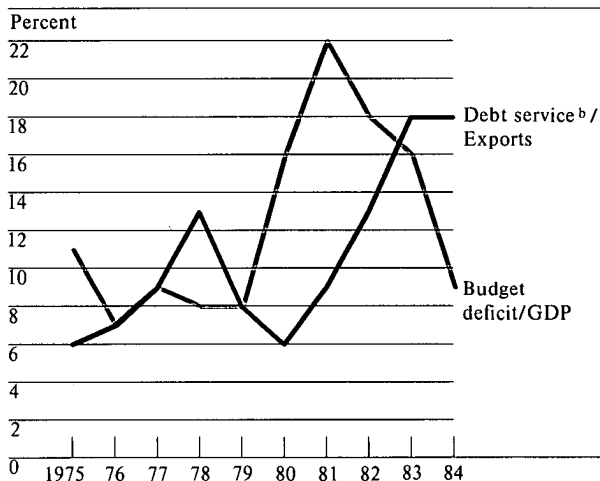
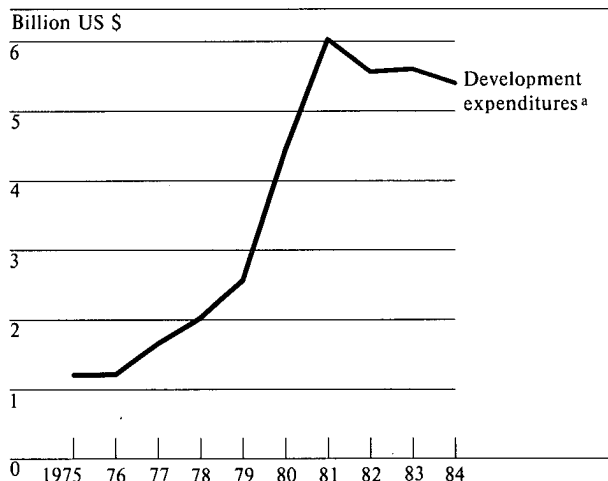
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Malaysia: Public-Sector Growth, 1975-84



^a Expenditures on Malaysia's 19 off-budget agencies (Petronas, MAS, Hicom, etc.) are excluded. In 1984 these agencies represented an additional \$1.6 billion in public authority spending.

^b Debt servicing as a share of export earnings; 1975-78 excludes short-term debt repayment.

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percent of GDP. As a longer run policy to deal with these strains, Prime Minister Mahathir in 1983 adopted a program of privatization under the theme of "Malaysia, Incorporated." This policy is Mahathir's concept of the country as a corporate entity with the government providing the policy framework and infrastructure, although the private sector provides all commercial expertise. Malaysia, Incorporated is part of Mahathir's "Look East" policy based on his conviction that Malaysia should emulate the Japanese model of close cooperation between government and the private sector. [Redacted]

The Privatization Agenda

Mahathir's concept of privatization includes selling state enterprises and permitting private-sector participation in sectors formerly monopolized by the government. The government, however, does not plan to divest itself totally of all the enterprises

targeted for privatization—Kuala Lumpur plans to retain a minority stake in the national airline. [Redacted]

- The enterprises already sold or slated for sale are:
- TV 3, a commercial television channel, added to the government-owned systems.
 - Airod, a military aircraft maintenance and repair facility.
 - Malaysian Airline System (MAS).
 - Telecoms, the telephone system.
 - Port Klang container facility.
 - Bernama, the national news agency.
 - Tourist Development Corporation.
 - Electric and water utilities.
 - A gas pipeline project of Petronas, the national oil corporation. [Redacted]

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The program so far has had mixed success. The commercial television channel begun last April has proved profitable. In fact, later this year the station plans to add a new transmitter to extend its coverage to the wealthy Singaporean market.

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The major test will come later this year with the divestiture of three of the government's largest assets—MAS, Telecoms, and the Port Klang container terminal. The government is eager to sell 60 to 70 percent of its stake in MAS by early 1986. With more capital, MAS would be able to add new domestic and international routes, also helping to promote the nation's tourist industry. In anticipation, MAS signed an agreement last March for joint operations with a US airline for direct flights to the United States and is currently negotiating with the United Kingdom and West Germany for landing rights.

Telecoms is the largest and most complicated scheme currently under way. It requires the valuation and transfer of government staff, assets, and liabilities to a government corporation, including separate land title transfers negotiated with individual states. Moreover, Telecoms is already committed to a \$4.2 billion capital expenditure program over the next five years for which financing will have to be arranged under its new corporate status. Kuala Lumpur hopes to convert the utility from a government department to a wholly owned government company by yearend, followed by its transfer into private hands in 1987.

Potential Problems

Privatization will be constrained by the goals of the NEP to increase Malay participation in the economy. We believe the government will be forced to underwrite a large portion of the ownership share for the capital-short Malay community.

[Redacted] the govern-

ment plans to provide loans to Malay businessmen that can be repaid when the newly private companies become profitable.

Although favoring Malays in privatization projects would boost their lagging progress on the NEP's corporate ownership goals, Kuala Lumpur must balance this with opportunities for the Chinese community. Already worried that choice public enterprises might be transferred to Malays, the Associated Chinese Chambers of Commerce and Industry of Malaysia is closely monitoring the situation. If they believe the Malay leadership is disregarding their interests, the Chinese could desert the national coalition in the next general election in favor of the opposition Chinese party. We believe Mahathir probably will permit Chinese participation up to the 40 percent ceiling imposed by the NEP because he needs the Chinese vote to maintain his governing coalition.

Although foreign participation is also limited under the NEP, the government recently indicated its willingness to permit higher foreign participation in privatization projects where foreign expertise is required or sufficient domestic capital cannot be raised. In fact, Mahathir may find it politically more acceptable to relax the NEP guideline on foreign ownership than to allow greater Chinese participation. He can promise to increase Malay ownership when sufficient domestic capital is accumulated.

Kuala Lumpur also faces opposition from civil service unions, despite government guarantees that no one transferring to the private sector will lose money, seniority, or retirement benefits. The telephone union, for example, has demanded continued low-cost government loans and a 3-percent pay increase in anticipation of the sale of the telephone system. Although it is unlikely that these and similar demands by other unions will be met, union slowdowns and protests are likely and may slow the government's timetable.

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A Shrinking Government Role?

We believe that Kuala Lumpur will achieve much of its privatization agenda in the next few years, but it is unlikely that this will substantially reduce government budget expenditures because of plans to extend loans to guarantee Malay participation.

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Only over the longer term will the government recover some of its costs as Malay loans are repaid and concessions to unions expire. [Redacted]

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We believe that Kuala Lumpur will use any savings accruing from privatization to increase financing of a renewed industrialization program that it intends to announce during the next few months. The proposed industrial projects probably will be established in cooperation with private-sector participation, thus increasing public-sector investment. The centerpiece of the current industrialization drive is the much ballyhooed production of a Malaysian car—the “Proton Saga”—even though it will be a money-losing proposition. Mahathir recently announced that the auto industry would lose almost \$14,000 on each car manufactured during the first year of production.¹ This suggests to us that government plans for privatization will result largely in a shift of government funds to such subsidized industrialization projects. Thus the government’s role in the economy will continue and possibly increase with little lasting effect on the public-sector budget deficit. [Redacted]

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¹ The first cars are due off the production line in September. [Redacted]

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Mexico: Limited Impact of the New Banking Laws



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Mexico's recently published guidelines for the nationalized banking system are designed to increase the authority of the Central Bank to make monetary policy, to stimulate the small private parallel financial market, and to reaffirm the nationalized banks' domination of the financial sector. The reforms have been welcomed by local businessmen and the international financial community

In part, the new legislation was adopted to reassure the IMF that Mexico was committed to controlling public spending and containing growth in the money supply. We believe, however, that Mexico will fall short of these goals. The government retains significant veto power over Central Bank policy. Moreover, growth of the parallel financial market as a lower cost alternative to bank credit for the private sector will be limited.

ment can no longer borrow directly from the Bank of Mexico by selling it securities. Instead, the Central Bank sets its federal financing limit each January. For 1985, for example, credit to the federal government is to increase only 17 percent over 1984, a cut in real terms of about 43 percent at first-quarter inflation rates. In addition, the Central Bank will extend to the government a revolving credit equal to 1 percent of consolidated federal income—an estimated \$740 million for 1985. Meanwhile, sales of bonds to the public will improve the ability of the Bank of Mexico to control the money supply. Finally, to limit the political factor in choosing the director general of the Bank of Mexico, a person must have at least five years of senior financial management experience to be appointed.

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Wrangling Over the Guidelines

The nationalization of commercial banks by the Lopez Portillo administration in September 1982 created many uncertainties for the financial system. After more than two years of debate over the role of private financial institutions such as brokerage firms and insurance companies, the government published new banking laws on 1 January 1985. The President reportedly personally intervened to break a deadlock between the Ministries of Finance and Budget and Planning over allowing the nationalized banks to own shares in nonbank financial companies. De la Madrid sided with Budget and Planning, which favored a prohibition on ownership for bureaucratic reasons.

The autonomy of the Bank of Mexico, however, remains quite limited. The President, who is reflatting the economy because of political pressures, retains broad discretion in appointing or forcing the resignation of the Central Bank director. Moreover, this official is not of Cabinet rank and reports to the Finance Minister. Additionally, the government can easily circumvent limitations on internal financing because only congressional approval is required to raise the ceiling.

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Parallel Financing Gets Modest Boost

The President's decision to bolster the role of private brokerage firms and insurance companies has been widely applauded by businessmen. They have little confidence in nationalized banks and hope the reform will lower borrowing costs—real interest rates jumped from strongly negative to positive rates in 1982-84. Rather than borrow exclusively from banks, the business community

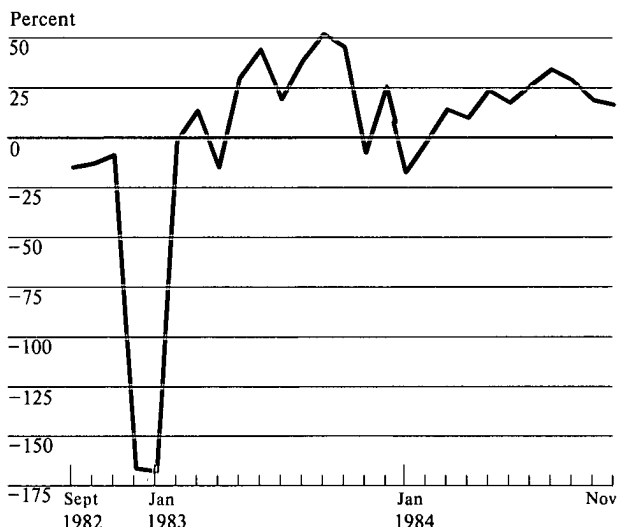
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Central Bank Strengthened

The new bank regime increases the monetary authority and political independence of the Bank of Mexico but primarily on paper. The central govern-

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Mexico: Real Effective Interest Rates^a



^a The real effective interest rate equals the difference between the effective interest rate and the inflation rate. The effective interest rate includes nominal interest rate plus additional costs such as loan fees and compounding interest when loans mature in less than one year.

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increasingly turned to the private parallel financial market as bank interest charges rose. Parallel market credit extensions leaped from virtually nothing in 1982 to over \$1 billion in late 1984,

Private stockbrokers are the backbone of the parallel financial market. After divestiture by the nationalized banks, the number of brokerage firms rose by six to 30. Stockbrokers obtain funds primarily through trade in government and private securities. Moreover, these firms' frequent contact with corporate treasurers allows them to broker loans between companies in surplus and deficit cash positions. In addition, brokerage companies issue commercial paper directly to the public at an interest rate that last year averaged an estimated 8 percentage points under bank financing. According to the financial press, for the first time Chrysler's Mexican subsidiary raised peso financing equal to \$10.5 million in August 1984, and three months later the Ford subsidiary in Mexico began selling peso debentures also totaling some \$10 million.

Mexico: A Glance at the Brokerage System

The brokerage system is gradually increasing in importance. In the late 1970s the Mexican securities market began expanding as the oil boom and introduction of new financial instruments encouraged diversification from traditional mining stocks. Mexico's 30 licensed brokerage firms had combined assets totaling \$76 million in September 1984. Ten brokerage houses account for over 80 percent of this capital and its associated profits. Only one of these brokerage houses was formerly bank owned. By mid-1984 the brokerage system was managing approximately 1.3 trillion pesos (about \$7 billion), which is equivalent to almost one-fifth of bank saving deposits, according to the Embassy.

At present, treasury bills (known as Cetes) account for over 90 percent of the financial transactions carried out by Mexican stockbrokers. Introduced in 1978, Cetes are used by the central government to finance its budget deficit. These highly liquid instruments carry interest rates slightly higher than those on short-term time deposits, and can be repurchased by the government when it wants to restrict the money supply. Brokers trade in other money market securities, including three-year petrobonds issued by the state oil monopoly and backed by oil. They carry a fixed interest coupon, are protected from peso depreciation, and offer the possibility of capital gains if the price of oil increases. In 1980 commercial paper was introduced to the securities market and a year later brokers were allowed to start trading letters of credit, or bankers' acceptances, issued by individual companies.

Stockbrokers also trade the stocks of over 200 companies registered on the Mexican stock exchange. Since 1982 no new stocks have been issued. Most stocks traded represent steel, cement, chemicals, mining, electronics, automobile products, and retail companies; many are subsidiaries of foreign companies. In 1975 the government mandated that all registered securities be traded on the Mexican stock exchange, thereby eliminating over-the-counter transactions.

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The private long-term capital market, nevertheless, remains relatively small. The capitalization of privately owned stockbrokers is still only about one-tenth that of the banks, according to the Embassy. Brokerage firms spun off from the nationalized banks added little to total assets. The third-largest stockbroker was not returned to private ownership because its parastatal status, as part of SOMEX, a state investment bank, predated the bank nationalization. [redacted]

Bank Nationalization Reaffirmed

The new bank laws reaffirm the nationalized banks' domination of the financial sector. Only nationalized banks are allowed to receive deposits from the public. As multiservice institutions, they also continue to extend mortgages and issue securities for long-term funding of priority projects. Although the new laws reduced reserve requirements from 50 to 10 percent, the banks are also required to increase the share of credits to priority areas such as the budget deficits, housing, and agriculture. [redacted]

We believe the legislation will allow nationalized banks to increase their financial role. For example, the failure to make the SOMEX brokerage house a private firm creates a legal precedent other state-owned banks can follow, according to the Embassy. The new laws also authorize banks to acquire up to 10 percent of the paid-in capital of industrial companies; acquisitions up to 25 percent of a firm's equity can be approved by the Finance Ministry. If the banks take advantage of this provision, it could reverse the government's recent return to private ownership of the companies that had been held by banks at nationalization. [redacted]

Outlook

The bank reforms may help the government increase private-sector confidence in the financial sector. In our judgment, return of bank brokerage houses to private ownership will ease private-sector concern that Mexico City is planning to expand its

Mexico: Leading Brokerage Houses, September 1984 *Million US \$*

| | Capital | Profits |
|------------------------|---------|---------|
| Inverlat | 18.9 | 1.1 |
| Inversora | 13.0 | 0.9 |
| SOMEX | 5.9 | 1.5 |
| Operadora | 5.8 | 1.3 |
| Stock development | 4.2 | 2.2 |
| Mexican stock exchange | 2.9 | 1.3 |
| Bancomer ^a | 2.8 | 0.1 |
| Invest-Mexico | 2.6 | 0.5 |
| Madero | 2.4 | 0.3 |
| Finamex | 2.4 | 1.5 |
| Others | 14.6 | 1.8 |

^a Five other brokerage houses formerly bank owned are Atlantico, Banpais, Bancreser, Comermer, and Cremi.

[redacted]

control over industry. Businessmen may also feel more confident that the President prefers government regulation, not public ownership, to control the economy. [redacted]

Serious obstacles remain to translating the bank reforms into long-term economic gains; much will depend on Mexico City's willingness to fully carry out the laws. Recent electoral and drug-related violence and high inflation already are constraining parallel financing and spurring capital flight. At the same time, the public sector is still squeezing private business from bank credit markets. Moreover, the President's retention of a veto over monetary policy and the potential for the banks to be used for political patronage suggest to us that inefficiencies in the banking system will be difficult to reduce. [redacted]

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Israel: Economic Development of the Occupied Territories [redacted]

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Continued Israeli military occupation has held back the economic development of the West Bank and Gaza Strip, even though Arab residents of the occupied territories have benefited somewhat. The occupation regime—by Israeli design—discourages economic ventures that might compete with those in Israel or lay a foundation for an independent state. Employment opportunities—the major benefit for occupied territory residents—are declining in Israel's slack economy. Meanwhile, the loss of worker remittances as Palestinian guest workers in other Arab countries return is adding to the regions' economic malaise. [redacted]

Minimizing expenditures extends to indirect costs. Israeli governments have consistently thwarted those West Bank and Gaza initiatives—such as the production, processing, and marketing of citrus fruit—which they perceive will harm Israeli economic competitors. Defense Minister Rabin recently told some Knesset members that “no permits will be given for expanding agriculture or industry that may compete with the State of Israel.” Political factors also influence this policy. Control of West Bank economic projects allows the Israelis to rein in Palestinian activity that might provide financial support to the PLO as well as establish an economic infrastructure for a future Palestinian state. [redacted]

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Occupation Economics

Israel has no “grand design” for the economic development of the West Bank and Gaza but is seeking to minimize the economic burden of the occupation. To this end, Israeli authorities have acted over the years to integrate the economic activity of the two territories with that of Israel while avoiding formal annexation. Israel has made use of relatively cheap Arab labor but has excluded the occupied territories from the extensive and costly Israeli social welfare network. [redacted]

Improved Living Standards

Israel's economic policies provide some benefits for the Arab residents of the occupied territories. Israel allows nearly 90,000 laborers from the West Bank and Gaza to work in Israel, thus helping combat disguised unemployment. In addition, West Bank and Gaza farmers have adopted more productive agricultural methods as a result of exposure to highly developed farming techniques employed in Israel and the Jewish settlements. Productivity has advanced markedly since 1967, according to official Israeli statistics, through the introduction of chemical fertilizers, pesticides, improved seeds, and mechanization. Israeli industrial investments have been helpful but modest, focusing primarily on the establishment of subsidiaries for industries based in Israel proper or the improvement of subcontracting arrangements. [redacted]

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Israel's success in minimizing its occupation costs is reflected in West Bank/Gaza expenditure data. Israeli statistics show that until the 1983/84 fiscal year most municipal outlays in the West Bank and Gaza were covered by revenues generated within the territories. Those not covered were more than offset by sizable trade surpluses Israel runs with these two territories. Moreover, large expenditures for developing the region's infrastructure, such as expanding roads, communications lines, and power supplies, improve the lot of the local residents but are largely aimed at enhancing Israel's access to the areas for security reasons and tightening links between Jewish settlements and Israel proper. [redacted]

The most highly visible result is improved living standards in the West Bank and Gaza. Real incomes have grown and so has consumption. Not

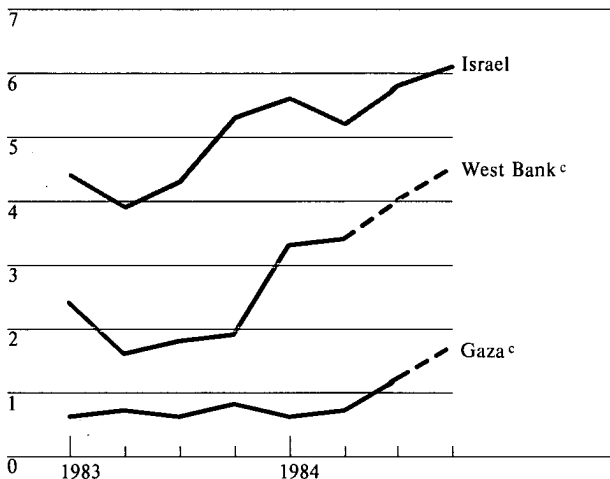
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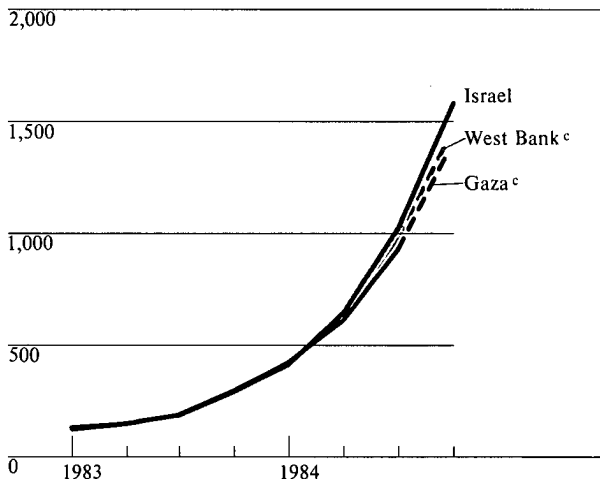
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Economic Trends: Israel, the West Bank, and Gaza, 1983-84^a

Percent Unemployment



Consumer Price Index^b



^a Source: Official Israeli Statistics.

^b Fourth quarter 1982=100.

^c Third and fourth quarters 1984 are CIA estimates for the West Bank and Gaza.

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only has the provision of basic necessities—especially housing—improved, but also per capita consumption of most consumer durables has risen dramatically. Indeed, the lot of the average West Banker has improved markedly, probably at a faster pace than it would have under Jordanian benign neglect. Gaza's gains have been impressive, but less so than the West Bank's, largely because approximately one-third of the population still lives in refugee camps.

Stagnant Domestic Economy

The problem with these economies is that, although the populace is much better off, the improvement is largely due to external trade and worker remittances. Foreign economic relations—especially those with Israel—are the linchpin of the economies of the West Bank and Gaza:

- Net imports of goods and services account for over one-fourth of resource use in both of these economies. Trade with Israel comprises about 80

percent of West Bank trade and 90 percent of Gaza trade.

- About half of the West Bank labor force is employed in foreign countries. Of these, Israel hires about half, with the rest employed in Jordan and the Gulf states. Workers in Gaza have fewer opportunities to work in Arab states, but roughly one-third work in Israel.
- Wages remitted from those working abroad comprise nearly half of total hard currency earnings for both territories, while other transfer payments—primarily external aid—provide an additional 15 percent.

This buoyant activity contrasts sharply with domestic economic progress. Economic growth probably has stagnated in the past few years in both areas, due largely to little or no growth in the industrial sector. Israeli occupation policies, the continued uncertainty over the region's political future, and

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**Gaza and the West Bank:
Balance of Payments, 1983**

Million US \$

| | Gaza | West Bank |
|------------------------------|--------|-----------|
| Current account ^a | 47.0 | -39.0 |
| Trade balance | -159.6 | -255.4 |
| Exports | 170.2 | 212.6 |
| Israeli | 144.6 | 129.9 |
| Imports | 329.8 | 468.0 |
| Israeli | 302.6 | 415.8 |
| Net services and transfers | 206.6 | 216.4 |
| Net wages | 242.0 | 295.3 |
| Net capital movements | -47.0 | 39.0 |

^a Excludes transactions with the Sinai and between the West Bank and Gaza.

Source: Official Israeli Statistics.

the inherent business conservatism of the local inhabitants have stymied industrial initiatives. Capital investment remains a small share of the regions' economies and is dominated by residential construction. [redacted]

Most growth has been in small cottage industries or tourist-oriented enterprises. Well over 90 percent of industrial enterprises in the West Bank and Gaza employ less than 10 workers. Even agricultural output probably has suffered despite its good record because of occupation measures facilitating land expropriation, the deprivation of water resources, and the imposition of restrictions on sales of agricultural products to Israel or Israel's traditional markets. [redacted]

Bleak Outlook

Prospects are poor for indigenous economic development in the West Bank and Gaza as long as their status remains in limbo. These areas are most likely to suffer in the near term, given the unpromising

outlook for the economies of the countries upon which they depend:

- Israel's austerity probably will continue for at least another year. Construction, which employs over half of the West Bankers and Gazans, is slowing considerably.
- The poor oil market is hurting the Gulf state economies, forcing many Palestinian workers, especially the more highly skilled and educated, to return home. A Bank of Israel study showed that the number of Palestinians leaving the West Bank for jobs in the Gulf had dropped to a handful by the end of 1984.
- The Jordanian economy cannot absorb many workers; it also depends heavily on remittances from its citizens working abroad. King Hussein has limited the influx of Palestinians and, like the Israelis, has discriminated against the import of Palestinian goods. [redacted] 25X1
[redacted] 25X1

Other sources of outside revenue are few. The one other significant inflow is the approximately \$100 million annually assigned to the Jordan-PLO Joint Fund for the Occupied Territories under the terms of the Baghdad Accord of 1978. Few of the signatories have kept current on their payments, and it is uncertain whether the fund has been adequately managed. The Consulate in Jerusalem reports that what few funds remain are destined for existing Joint Fund institutions and not new projects. In addition, the region faces the prospect of reduced funding from the UN Relief and Works Agency (UNRWA). Although that agency is hoping to avoid reducing its services, the General Commissioner recently told [redacted] that such an event is likely if current deficits are not covered. This would severely affect the Gaza Strip, not only because of the services UNRWA supplies to the refugee camps there, but also because it is a major employer. Finally, while funding from private, voluntary organizations appears to be picking up, it remains limited, disorganized, and subject to Israeli controls. [redacted] 25X1
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The impact of economic difficulties in Israel, Jordan, and the Gulf already have generated growing unemployment in the occupied territories. Israeli statistics show some increase but understate the problem. US Embassy reporting and press articles attest to numerous signs of the worsening labor market in the West Bank, such as fewer busloads of workers heading westward each day as well as informal surveys of the unemployed. [redacted]

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The nest egg that West Bank and Gaza workers have acquired will not last long, and unemployment compensation is nonexistent for many. In addition, Israel's rapid inflation has not spared the West Bank and Gaza, further eroding what incomes remain. These Palestinians have few job options open at home. Even if some chose to return to agriculture, the US Embassy quotes agricultural experts as saying that many fields vacated in the West Bank would require at least two years to become productive again. The West Bank and East Jerusalem press report that numerous Palestinian industrial concerns are closing because they cannot compete with heavily subsidized Israeli goods.

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In sum, attempts to "improve the quality of life" in the occupied territories by laying the economic foundations for such improvements are moving very slowly, if at all. Despite signs of increased flexibility on the part of Prime Minister Peres and other Labor Party figures in the National Unity government, the philosophy remains one of reacting to outside proposals rather than actively pursuing developmental initiatives. The newly formed Jordanian Government has stated its desire to boost its role in the West Bank but also acknowledges that financial constraints limit what it can do. Private initiatives occasionally emerge but are impeded by the inertia of all involved parties. [redacted]

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**Cambodia:
1984/85 Rice Shortfall** [redacted]

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We estimate that Cambodia's 1984/85 rice harvest will decline for a second straight year to 1.4-1.5 million metric tons—the smallest since 1979-80. The entire shortfall is from the predominant rainy-season rice crop heavily damaged by floods. Nevertheless, we believe that the crop was not as severely devastated as the Phnom Penh regime claimed late last year when requesting food aid from the Food and Agriculture Organization (FAO) of the United Nations. Despite a smaller crop, we do not expect widespread food shortages during the coming months, because a substantial part of the rice shortfall will be made up by other foods. In our view, Cambodia's food problem will not result in a further exodus of refugees to Thailand. [redacted]

1984/85 Crop Shortfall

The Cambodian regime has claimed that drought last July and August, followed by sudden, heavy floods in August and September, would cut output of the 1984/85 rainy-season rice crop to below 900,000 tons, some 40 percent less than a year ago.¹ [redacted] meteorological data, and other reporting corroborates Cambodian claims of a rice shortfall, but we believe that Phnom Penh's assessments of weather problems overstated the amount of rice destroyed. Although the regime reported a disastrous decline—463,000 hectares—in rainy-season rice area, we estimate that about 56,000 hectares, or less than 5 percent of the total rice area, was destroyed. We believe that rainy-season rice production will reach 1.2 million tons, about 20 percent below the 1983/84 level. [redacted]

¹ The Cambodian regime also made claims of a serious rice shortfall during the 1983/84 crop season, citing drought and flood damage similar to this year's reports. Provincial sowing totals, however, reached planned levels, and some reports from Cambodia, Vietnam, and the Soviet Union put rice output as high as 2 million tons as compared with almost 1.7 million tons officially announced. [redacted]

Rice Cultivation in Cambodia

Sowing and harvesting operations in Cambodia extend through most of the year because the country uses many rice varieties with different length growing seasons. Rainy-season rice, accounting for 90 percent of annual production, is planted from June through November, and the bulk of harvesting takes place from December through February. Dry-season rice, grown mainly in a few provinces, is planted from November through March, for harvest from February through April. Rainy-season rice yields average 1.1 metric tons per hectare, and dry-season rice yields average 1.6 metric tons per hectare, because of more sunlight, more controlled watering, and less disease. Cambodia's rice yields have traditionally been poor in relation to other countries'. A labor force with low technical skills, shortages of draft animals, fertilizer, seeds and equipment, and a deteriorated irrigation network contribute to low yields. Moreover, the collectivized system provides little incentive for peasants to produce. Historically, flooding is the major factor behind annual production variability. [redacted]

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Because planting of the dry-season rice has only recently been completed, the size of this crop cannot yet be estimated accurately. This year's plan of 190,000 hectares is ambitious, but the shortfall in rainy-season production should have spurred sowings of 120,000 to 160,000 hectares. Abundant water reserves combined with increased availability of high-yield hybrid rice seeds could boost yields, resulting in a dry-season crop ranging from 216,000 to 320,000 tons, up from last year's output of 208,000 tons. [redacted]

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Cambodia: Paddy Rice Crops ^a

| | 1980/81 | 1981/82 | 1982/83 | 1983/84 | 1984/85 |
|------------------------------------|---------|---------|---------|------------------|-------------|
| Rainy-season rice | | | | | |
| Planned area (thousand hectares) | 1,500 | 1,700 | 1,600 | 1,600 | 1,700 |
| Harvested area (thousand hectares) | 1,232 | 1,300 | 1,545 | 1,358 | 1,237 |
| (percent of plan) | 82 | 76 | 97 | 85 | 73 |
| Yield (metric tons/hectare) | 1.19 | 1.00 | 1.16 | 1.08 | 0.98 |
| Production (thousand metric tons) | 1,466 | 1,300 | 1,788 | 1,467 | 1,216 |
| Dry-season rice | | | | | |
| Planned area (thousand hectares) | 123 | 150 | 165 | 155 | 190 |
| Harvested area (thousand hectares) | 88 | 149 | 135 | 105 | 120-160 |
| (percent of plan) | 72 | 99 | 82 | 68 | 63-84 |
| Yield (metric tons/hectare) | 1.30 | 1.72 | 1.60 | 1.79 | 1.8-2.0 |
| Production (thousand metric tons) | 115 | 256 | 216 | 208 ^b | 216-320 |
| Total rice | | | | | |
| Planned area (thousand hectares) | 1,623 | 1,850 | 1,765 | 1,755 | 1,890 |
| Harvested area (thousand hectares) | 1,320 | 1,449 | 1,680 | 1,463 | 1,357-1,397 |
| (percent of plan) | 81 | 78 | 95 | 83 | 72-74 |
| Yield (metric tons/hectare) | 1.20 | 1.07 | 1.19 | 1.14 | 1.06-1.10 |
| Production (thousand metric tons) | 1,581 | 1,556 | 2,004 | 1,675 | 1,432-1,536 |

^a Area, yields, and production for 1980/81 are FAO estimates, and the same data for 1984/85 are CIA estimates. All other data are from Cambodian announcements. Total 1979/80 rice production was announced at 565,000 tons from an area of 771,000 hectares. Numbers have been rounded.

^b 1983/84 Cambodian data for its dry-season rice crop is inconsistent. Using the area and yield shown, dry-season production would be 188,000 tons instead of 208,000 tons reported.

Impact of the Rice Shortfall

Assessment of whether a total rice crop of 1.4-1.5 million tons will result in serious food shortages in Cambodia is complicated by the lack of an exact population figure—we believe that the total population is 6-7 million—and by disagreement on the size of an “adequate” ration.² Using a population of

² The FAO uses, as a minimum emergency ration, an individual rice requirement of 12 kilograms per month. Although such a ration will sustain life, it is not sufficient for persons doing farm labor. Phnom Penh has stated a minimum requirement of 14 kilograms per month. An 18-kilogram monthly ration is considered the ideal amount to support physical labor.

6.5 million, and a milled rice ration of 13 kilograms per month—midway between the FAO and Phnom Penh estimates of an adequate ration—our projected 1984/85 rice output would result in a milled rice ³ deficit of roughly 200,000 to 250,000 tons.

³ To calculate the amount of milled rice available from total rice production, a 15-percent seed and loss factor is subtracted, and the remainder is multiplied by a 0.63 milling factor.

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Although milled rice availability seems likely to fall below the estimated minimum needs, we believe other food crops, fish, and game will partially offset this shortfall. For example, using Phnom Penh's 1984/85 production estimates for corn, cassava, and sweet potatoes, our estimated rice deficit could be cut to approximately 135,000 to 190,000 tons. Other crops, such as vegetables, bananas, sugar, and coconut, will also alleviate some rice shortages.

[redacted]

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In our view, the food problem in Cambodia will not be a major cause of further exodus of refugees to Thailand. Furthermore, the recent outflow of refugees from camps along the Thai-Cambodian border—as a result of the heavy fighting—will not alter the demand for food inside Cambodia because international relief agencies have been providing food assistance to most of these refugees for several years.

[redacted]

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Briefs

*Spot Oil
Market Trends*



Energy

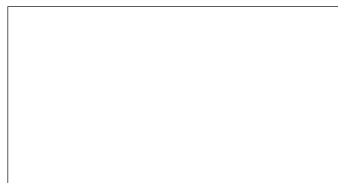
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Spot prices for most crudes and oil products have edged lower in recent weeks. The spot price for Arab Light crude declined about 20 cents per barrel during April to \$27.55—compared with its official price of \$28 per barrel—while the spot price for UK Brent dropped 80 cents to \$27.25 per barrel. Declining prices reflect continued weak oil consumption. According to recent IEA data, non-Communist consumption has averaged about 1 percent below year-earlier levels so far this year. Rising production from several non-OPEC suppliers including the North Sea, Oman, and Egypt also have kept spot prices soft.



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*Refinery Capacity
Shifting—Literally*



A 180,000-barrel-per-day refinery at Belford-Haven, United Kingdom, is being disassembled and moved to the coast of Ajman in the UAE where it will be reassembled by a Belgian firm. A \$90 million financing package will be approved once a contract for the refinery's feedstock, most likely from Abu Dhabi's Upper Zakum field, is finalized. [redacted] the oil purchase can be discounted—probably about \$2 per barrel—since the sale is between Emirates. This discount will enable sales of refined products below market prices and provide Abu Dhabi further opportunity to produce oil above its OPEC allocation. This move is part of a trend toward further emphasis on product marketing by OPEC countries that is putting additional downward pressure on oil prices. [redacted]

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*Australian
Oil Prices*



The Hawke government announced last week that it would resist mounting political pressure to change Australia's seven-year-old oil pricing system to offset three months of rapid currency depreciation. Therefore, the domestic price of oil will increase by about US \$6.60 per barrel, which could raise gasoline prices 13 percent. Harsh criticism has come from leftwing members of the ruling Labor Party—both in Parliament and in the state governments. Explaining the decision not to phase in the price increase or reduce excise taxes, Energy Minister Evans said that Canberra must be seen as willing to make politically tough decisions on the economy. The decision on oil prices and the simultaneous announcement of a US \$650 million budget cut are probably responsible for a firming of the Australian dollar at the end of last week. [redacted]

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International Finance

Breakthrough on the Philippine Financial Rescue Package

A key roadblock to Manila's long-delayed financial rescue package has been removed by the agreement this week between the commercial banks and a major Saudi bank on conditions governing its participation in the new loan package. An additional barrier was also removed by Manila's assurance that foreign banks would receive overdue loan payments from a local fertilizer company. Signing by Manila's commercial creditors is now scheduled in New York later this month. Although the signing will pave the way for \$925 million in new bank loans, disbursements can be made only if Manila is in compliance with its IMF program. Manila failed to meet the December and March economic targets, and its next test of performance targets will come at the end of May. Until a Fund decision on compliance—expected in June—the Philippines will continue to husband its declining foreign exchange reserves by restricting imports and postponing debt service payments.

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National Developments

Developed Countries

West German Economic Forecast

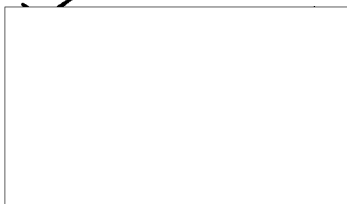
In their semiannual joint forecast, West Germany's five major economic research institutes project 2.5-percent real GNP growth and a slight increase in joblessness this year. The forecast is somewhat more pessimistic than most other recent projections. The prediction of a 0.3-percentage-point increase in unemployment, to 9.4 percent is particularly at odds with the official government forecast that unemployment will slip under 9 percent. Foreign demand will again be the main source of growth. West German economic vitality seems increasingly dependent on the external sector, while the domestic economy moves on a slow track.

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West Germany Upping R&D Spending

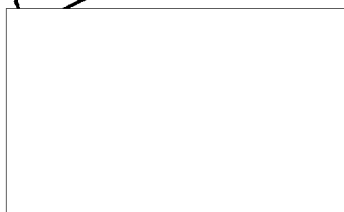


West German Government and business are stepping up R&D spending this year as part of what Economics Minister Bangemann is hailing as "a new technology offensive." According to a Battelle Institute study, real 1985 R&D spending will rise at least 4 percent. Gains in the early 1980s averaged only 1.3 percent. This year's increase will about match the expected US gain—both countries already devote 2.8 percent of GNP to R&D (public and private) versus 2.6 percent for Japan. Bonn's emphasis on R&D is clearly reflected in this year's budget—although overall federal spending is projected to rise only 1.2 percent, R&D funding will grow more than 8 percent.

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Spanish Social Security Reform

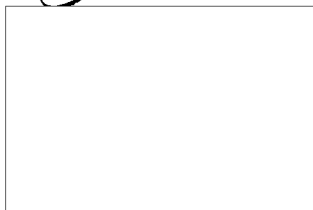


Union opposition may delay government efforts to overhaul Spain's social security program—a source of escalating employer costs. Madrid has proposed reducing expenditures by adjusting pension calculations and changing eligibility requirements for retirement and disability benefits. Government officials agree on the immediate need to curb the growth of social security expenditures but have not settled on the size of the pension cuts. The gradually aging population, sharp real wage gains after 1974, and layoffs have prompted a rapid rise in pension benefits, and a projected 30-percent jump in pensioners by 1990 threatens the present system. Although the Socialist trade union has rejected any benefit cuts and threatened a demonstration, the government has offered to compromise only on eligibility changes. Elections next year make further reforms to shift more of the social security burden onto workers unlikely.

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Portugal Attempts To Reform Labor Laws



Strong labor opposition and a potential break in party ranks may force the Soares government to weaken recently proposed legislation aimed at reducing labor market rigidities. The draft labor laws would allow companies to lay off workers made redundant by better equipment and would provide fired workers an indemnity—but not the right to return—if the courts found they were dismissed unjustly. This legislation would require an amendment of constitutional guarantees of job security, which makes a revision of the bill likely. The Socialist UGT trade union has threatened to join Communist workers in demonstrations, stage a nationwide strike, and withhold support for Soares in this December's presidential elections if the bill is passed as written. If Lisbon backs down, attempts to restructure will remain handicapped, and efforts to increase productivity with labor-saving devices will continue to be discouraged. Moreover, a heavily watered-down bill could actually make the labor market more rigid with its new restrictions on temporary hiring—a practice increasingly used to circumvent prohibitions on firing regular employees.

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Less Developed Countries

New Soviet-Mozambican Economic Accords

The USSR and Mozambique have signed a series of agreements on economic and technical cooperation, according to TASS. The accords cover assistance in coal processing, ship repair, fishing, and reconstruction of railroads and electric lines in southern Mozambique.

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[redacted] Moscow probably sees the extension of new economic aid to the hard-pressed government as a means of limiting the political aspects of President Machel's opening to the West for trade and aid. The agreements are modest, however, especially in comparison with the level of Moscow's military aid to Maputo.

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Indonesia's Slow Start on Tax Reform

Jakarta's ambitious tax reform program is off to a rough start. [redacted] President Soeharto has declared assets of only \$800,000, and Mrs. Soeharto has made no declaration under the amnesty program for declaring previously undisclosed assets.

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[redacted] The new value-added tax is causing confusion among business firms in addition to increasing prices. Moreover, there are delays in rebates to exporters and some major loopholes in the regulations, according to the US Embassy. Tax reform, in our view, will succeed only if the government can win the cooperation of a public and business sector not accustomed to paying taxes honestly—a questionable prospect.

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Afghanistan's Crop Disaster Averted

Widespread rains since late March have replenished Afghanistan's critically low irrigation reserves, averting a crop disaster. Afghanistan produces some 85 percent of its food and industrial crops on irrigated land. There probably now is enough water to sustain the crop of winter wheat—Afghanistan's principal food grain—until harvesting begins in late May. Prospects are less favorable for summer crops such as corn, rice, and cotton because irrigation reserves are expected to run dry before the plants mature in late summer. The amount of damage will depend on what stage of growth the plants are in when the water is exhausted.

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Venezuela's Foreign Investment Reforms Hung Up

Caracas hopes to liberalize some restrictions on foreign investment, but the Cabinet is still stalling in face of domestic political resistance. Foreign investment inflows have stagnated in the 1980s as Venezuela—in accord with the Andean Pact investment code—enforced stringent profit restrictions and limits on foreign ownership and management. The US Embassy reports that the Lusinchi administration is developing new rules guaranteeing dollar repatriation. Caracas is receiving some criticism on its plans to expand foreign ownership rights and allow private-sector participation in the oil industry from domestic firms fearing increased competition and from nationalistic groups resisting changes in the oil nationalization laws.

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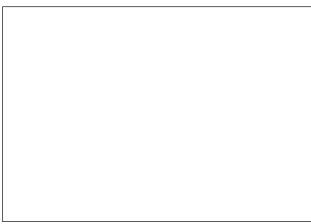
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The US Embassy believes achieving political support for the revisions will be difficult, despite widespread recognition of the need for new investment. Moreover, foreign investors are still waiting for clear signals on the administration's willingness to ease price, import, and foreign exchange controls for new ventures. Consequently, we believe new direct investment gains will remain modest, dashing Lusinchi's hopes that renewed inflows will play a major role in solving Venezuela's deepening recession. [redacted]

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Structural Adjustment Begins in Costa Rica



Last month's IMF standby agreement provides San Jose with \$54 million, primarily to reduce the current account deficit and replenish foreign exchange reserves. On 16 April the World Bank approved an \$80 million structural adjustment loan, which is aimed at expanding nontraditional exports to new markets outside the Central America region. To secure the loan, San Jose promised to continue its gradual reduction in export taxes and to reduce the public sector's role in the economy. In a third accord, Paris Club members' agreed on 22 April to reschedule Costa Rica's \$190 million debt due in 1984, 1985, and mid-1986. The generous terms of this agreement will considerably ease the debt service burden—currently about 40 percent of total exports—and reduce austerity pressures as the general election approaches early next year. [redacted]

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Poland's Poor First-Quarter Results



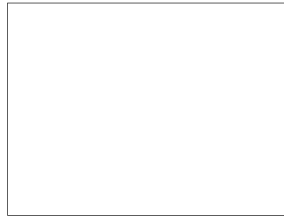
The Polish economy has started 1985 with its worst economic performance in three years due mainly to the effects of a cold winter. Hard currency exports declined 12.8 percent and imports 3.4 percent, resulting in a first-quarter trade surplus of only \$250 million compared with \$360 million for the same period last year. Industrial production stagnated, with output in the extractive industries 5 percent below that in the comparable 1984 period. Cold weather also led to declines in construction and transportation of 9 and 15 percent, respectively. Although some weather-related losses can be made up, Poland already has lowered its 1985 hard currency export targets. As a result, likely cuts in industrial imports may depress output in some sectors later this year. [redacted]

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Romanian Economic Growth Prospects



Despite Bucharest's energy conservation program announced in mid-January, the effects of large-energy shortfalls—brought on by a severe winter and a virtual lack of energy stockpiles—are still reverberating through the economy. We estimate that industrial production in the first quarter may have dropped by as much as 7 percent compared with first quarter 1984. Steel production has been particularly hard hit, and shortages of steel, in turn, are hampering other industrial sectors, including those concentrating on exports. Although a "catch-up" program may succeed in making up the first-quarter losses, overall prospects for economic growth this year are slim. Nevertheless, by continuing

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to give priority to hard currency exports, Romania may still be able to match last year's successful export performance. The leadership's determination is evidenced by its willingness to inflict more austerity on the population, which has just endured the most severe winter and the worst food and energy shortages since the immediate postwar period. [redacted]

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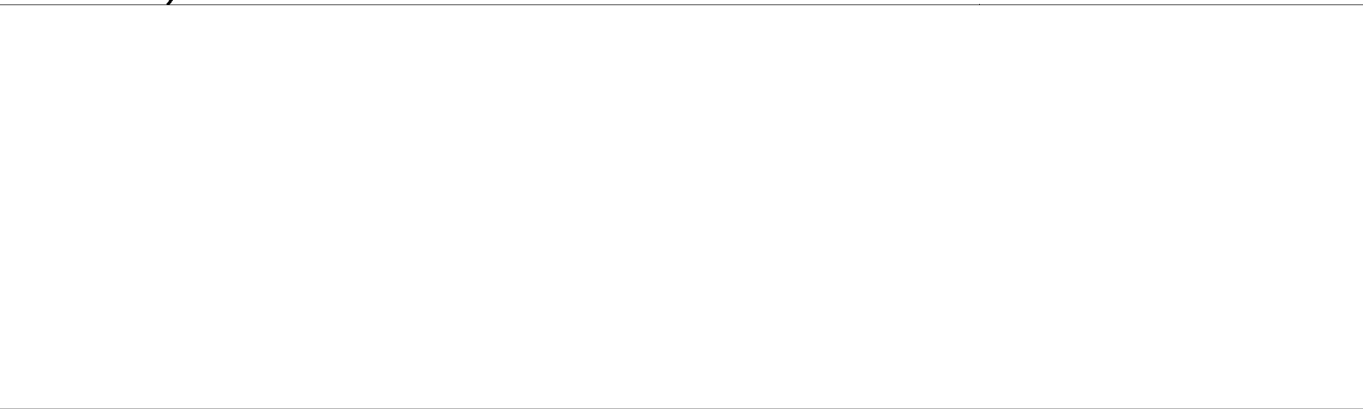
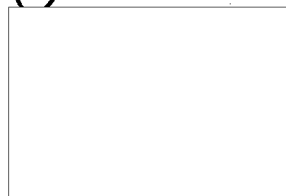
*Plans for 1985
Chinese Grain
Production*

[redacted] China's 1985 grain production target is 405 million metric tons, 2 million tons less than the record 1984 harvest. The area planted to grain is expected to decrease by 2.5 million hectares, but officials hope higher yields will offset the potential 15-million-ton loss. Under newly adopted agricultural policies, farmers may plan their own crop mix, and many farmers are shifting from grain to more profitable cash crops. Although the media have exhorted peasants not to reduce grain production, the agriculture official insists the state will not interfere with the farmers' planting schedule. [redacted]

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