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International Economic & Energy Weekly

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30 August 1985

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DI IEEW 85-035
30 August 1985

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International Economic & Energy Weekly

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Indicators

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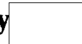

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7 **Iraq: Higher Oil Exports Will Not Solve Financial Problems** 25X1

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Austerity measures introduced under the IMF's guidance during 1983-84 cut Portugal's current account deficit—from $3.2 billion in 1982 to about $500 million last year—but serious structural problems remain. 25X1

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Iraq: Higher Oil Exports Will Not Solve Financial Problems

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We do not expect any significant improvement in Iraq's financial situation next year because increased oil export volumes will largely be offset by reduced aid from Saudi Arabia and Kuwait, lower oil prices, and increased debt service obligations. Iraq has been rescheduling debts and arranging new loans based on expectations of higher oil revenues from a new pipeline through Saudi Arabia and planned expansions through Saudi Arabia and Turkey. Moreover, Iraq's stubborn push to increase oil exports is likely to add strong downward pressure on oil prices. Financial difficulties compound Baghdad's frustration over its inability to bring Iran to accept a peace settlement and will encourage more Iraqi strikes on Iranian economic targets, such as Khark Island.

Iraq: Foreign Payments, 1986 *Billion US $*

	1985 [a]	Small Oil Price Fall [b]	Large Oil Price Fall [c]
Foreign exchange requirements			
Imports (including invisibles)	15.0	15.0	15.0
Principal payments on debt	3.0	3.5	3.5
Sources of foreign exchange			
Export revenues (over 90 percent oil)	11.1	15.1	12.3
Arab aid	3.0	1.1	0.7
Rescheduling and new credits	3.9	2.3	5.5

[a] Projected.
[b] Assumes an average of 1.65 million b/d oil exports, spot oil prices of about $24.50 per barrel for Iraqi crude, and Arab oil aid averages 120,000 b/d.
[c] Assumes 1.65 million b/d oil exports, spot oil prices of about $20.00, and Arab oil aid averages 100,000 b/d.

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Imports and Rescheduling Debts

After slashing imports in 1983, Baghdad has settled on annual imports of about $15 billion that, for political reasons, they are reluctant to cut further. Baghdad wants to avoid the political risks of economic austerity on a populace where most families have experienced a war casualty. In addition to weapons expenditures, this spending level allows the government to provide a reasonably comfortable supply of consumer goods, some expensive perks—such as imported automobiles—to military and government officials, and a scaled back, but still substantial, development program.

War-related disruptions of oil exports, a soft oil market, and military spending have forced Iraq to borrow from its trading partners to finance imports. This occurred despite $30 billion in economic aid from Arab allies and a drawdown of $29 billion in Iraqi foreign assets since 1980. Non-Arab debts currently total about $8.5 billion mostly in two-year loans. Saudi crude oil sales on Iraq's behalf have fallen from 180,000 b/d in 1984 to about 100,000 b/d in the first half of this year, Since early 1983,

Baghdad has also been receiving the cash equivalent of 248,000 b/d from sales of Kuwaiti and Saudi Neutral Zone crude. In July, however, these payments were cut by at least one-half because of falling Neutral Zone production, according to the US Embassy in Kuwait.

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Baghdad failed to meet some debt payments due last April, and continues to borrow to meet its financial needs:

- In July Baghdad settled its most difficult rescheduling negotiations when Japanese firms agreed to defer most of an estimated $700 million in debt payments due this year until 1987, according to the US Embassy in Baghdad. While a

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common front failed as individual firms made concessions, the Japanese refused to accept payment in oil.

- A West German official told the US Embassy that new financing is likely for the $200 million due in October. West Germany is also reluctant to accept payment in oil.

- Press reports indicate that Yugoslavia has agreed to reschedule $1 billion owed by Baghdad and take payment in oil. The oil will be valued at official prices that, in effect, reduce Iraq's obligation because of the gap between official and market prices. Other East European countries may also settle their debts with oil.

In addition to rolling over old loans, Iraq is seeking new loans to help tide it over until oil revenues rise. that Iraq is seeking a medium-term loan for several hundred million dollars.

Moreover, Baghdad continues to insist that companies engaged in development projects either arrange financing or accept oil as payment for the contract.

Banking on Oil

We believe lender willingness to provide funds stems from Iraqi assurances that it will increase oil exports. bank officials in West Germany and Japan remain optimistic about Iraq's eventual ability to pay

US bankers told the US Embassy in Baghdad they are considering credit offers.

Iraq is determined to increase its oil production and exports. Iraq's Deputy Petroleum Minister recently told US diplomats that Iraq will increase its oil exports to 2 million b/d as quickly as possible with or without an increase in its 1.2 million b/d OPEC quota—Iraq consumes about 300,000 b/d. Iraq currently exports just over 1 million b/d through its pipeline through Turkey and another 100,000 b/d by truck through Jordan and Turkey. Iraq plans to increase exports by 500,000 b/d when its pipeline through Saudi Arabia reaches full capacity early next year; as much as 300,000 b/d could be flowing through the line by October. Moreover, Baghdad has shown a willingness to sell or barter oil at whatever price is necessary to move it.

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Although Baghdad will probably be unable to export 2 million b/d before 1987, it is pursuing several means—in addition to the Saudi pipeline—that could allow exports of 1.8 million b/d by next spring. that Baghdad plans to use drag-reducing chemicals to raise the flow of oil through the Iraq-Turkey pipeline by 400,000 b/d. We suspect, however, that Iraq will not be able to sustain a flow rate increase of more than 200,000 b/d, and even this level would risk damage to the pumps. Press reports indicate Iraq is buying more trucks and wishes to expand exports by an extra 100,000 b/d. priority railway projects under construction in northern Iraq are for exporting oil to Turkey, although we have no information on when or how much could be moved by

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Beyond 1986, Baghdad plans additional pipeline capacity which would permit a total of 3 million b/d in exports in 1989. (Should the war end, an additional 1 million b/d could be exported through the Persian Gulf within six months.) Press reports indicate that construction should begin this fall on a second pipeline through Turkey, which will parallel the first and have a capacity of 500,000 b/d. Construction is expected to take 18 months. The second phase of Iraq's pipeline through Saudi Arabia is also moving ahead, and would enable Iraq to export a total of 1.5 million b/d through Saudi Arabia by 1989.

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Outlook

Iraq's drive to increase exports will not stop even if oil prices fall further. Iraqi officials have said it is up to others, especially the Saudis, to support oil prices. Riyadh's declaration that it would abandon its role as OPEC's swing producer if others do not share the burden of price support, however, makes it likely that increased Iraqi exports will place strong downward pressure on oil prices

Despite continued political support of Iraq's war effort, the level of Arab aid will decline further. We believe Arab oil aid will average 120,000 b/d next year despite statements by Kuwait's Oil Minister that all oil aid would end when the Iraq-Saudi pipeline opens. We expect that Saudi Arabia will phase out its bilateral oil aid when the Iraq-Saudi pipeline approaches full capacity, but Kuwait and Riyadh will continue providing Neutral Zone oil aid through the end of 1986. Arab donors, however, will probably not press Baghdad to repay its huge debts to them for several years, if ever.

Baghdad should be able to maintain a $15-billion import level next year as long as there is only a small decline in oil prices. The 1985 payments gap was largely closed by rescheduling debts and some additional credits. We project Iraq will have a smaller need for rescheduling and new credits next year—assuming no large fall in oil prices. Nonetheless, Baghdad could find it more difficult to reschedule payments after promising this year that such requests were temporary until its new pipeline was finished.

If oil prices fall significantly Iraq's financial position would deteriorate sharply. Faced with even larger debt payments in 1987, Iraq would face politically risky import cuts. This would pose a major dilemma for Saudi Arabia and Kuwait. Both want to avoid conditions that would threaten the regime in Baghdad, but with lower oil revenues they would be tempted to allow Iraq a thinner economic margin.

With little chance of rapid economic improvement, we believe Baghdad's frustration over its inability to bring Iran to accept peace will continue to grow.

Diversification of its export routes and higher exports may encourage more Iraqi strikes on Iranian economic targets, such as Khark Island. Moreover, should Iraq succeed in stopping Iranian oil exports this would help shore up oil prices and make room for increased Iraqi exports. Indeed, Iraq's Oil Minister was quoted last week in the Iraqi press as saying that the destruction of Khark would help restore stability to the world oil market.

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Latin America: Faltering Export Performance

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Latin American countries blame their declining export revenues this year on external factors beyond their control, especially low commodity prices and protectionism. In addition, however, their own governments' delays in devaluing currencies are also reducing their competitiveness. The continuing setbacks in the export markets will lead to slower economic growth as well as increasing difficulties in making payments on foreign debts.

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Key Latin American Debtors: First Half Export Performance

	Billion US $		Percent Change [a]
	1st Half 1984	1st Half 1985	
Brazil	12.5	11.6	−7.3
Mexico	12.8	11.0	−14.0
Argentina	4.6	4.1	−10.0
Venezuela	8.0	6.5	18.2
Chile	2.0	1.9	−6.6
Peru	1.5	1.5	−5.0

[a] Derived from unrounded data.

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Recent Setbacks

Reports from US Embassies indicate that most Latin American countries suffered declines in exports during the first half of 1985:

- Mexican exports were down 14 percent from the same period last year, reflecting the 14-percent falloff in oil sales and drops in agricultural, manufacturing, and mining exports.
- Moreover, Venezuela and Ecuador—maintaining oil prices above world market levels—lost sales, causing their overall exports to decline.
- A dropoff in key manufactured exports—especially steel, orange juice, and shoes—left Brazil with an overall reduction in export earnings of 7 percent.
- Argentine exports fell an estimated 10 percent amid dropping world grain prices.

The region's smaller debtors recorded export declines of 5 to 10 percent over the period. Based on official trade statistics, Chile's exports fell 7 percent while Peru's were off 5 percent, both victims of falling fishmeal and copper sales. A drop in prices for tin and other mineral products contributed to Bolivia's export slump.

Underlying Factors

Latin American governments have blamed lower world commodity prices for their drop in export earnings. According to IMF statistics, overall commodity prices fell nearly 13 percent in the first quarter of 1985 from the same period last year. Additionally, financial press reports indicate the strong dollar—to which Latin American countries peg their exchange rates—is responsible for the decline in export sales to Western Europe and Japan. Moreover, sales to the United States have leveled off—after brisk increases last year.

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While terms of trade have moved against Latin debtors, their trade policies also have contributed to the export decline. US Embassy reports indicate that some of the region's debtors are slowing devaluations in an attempt to suppress domestic inflation, and these policies are undermining their export competitiveness. Although Mexico, Argentina, and Chile depend on periodic minidevaluations to try to keep their exchange rates in line with domestic inflation, they have decreased their daily rate of depreciation to moderate the impact of import price increases on the cost of living. Similarly, Brazil and Peru have slowed the pace of their

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devaluations in 1985, in an effort to match domestic inflation. Bolivia's failure to devalue, in the face of raging inflation, has left its exchange rate substantially overvalued as measured by the premium the dollar fetches in the black market.

Thus far, the Latin American debtors have covered their export shortfalls primarily by reducing imports and drawing down reserves. On the basis of US Embassy reports, Mexico drew down $3 billion or 35 percent of its gross reserves in the first half of this year, while Chile tapped $500 million. Brazil, Peru, and Colombia have adjusted their external accounts by reducing imports. In addition, the drop in world interest rates to a seven-year low has saved the major debtors $2.0-2.5 billion in service payments this year and thus helped prevent export losses from translating into resurgent cash problems.

Outlook

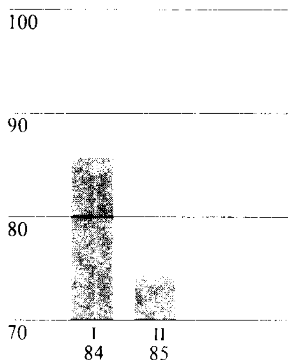
With the major forecasting services projecting similar world economic trends for the second half of this year, we believe Latin exports will continue to falter. We now project that the current account position of the key Latin American debtors [1] will swing from a $3.7 billion surplus in 1984 to a $6.3 billion deficit this year. In the face of this large deterioration in the payments postion we believe some debtors will be unable to rely on reserve drawdowns and import cuts because such policies have drawn increasing fire from domestic sectors already upset over slowing economic growth. This discontent will likely encourage pressures for additional debt relief. For example, press reports indicate Mexico will approach bankers for another rescheduling by the end of the year. Argentina and several other countries already are recommending that the Cartagena group push for an interest capping or relending scheme to take the debt reform initiative away from Castro.

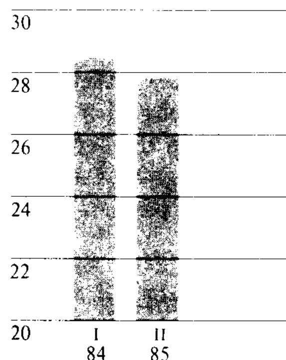
For the longer run, some countries are beginning to recognize that, as has been the case historically,

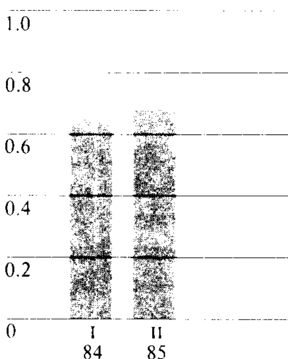
[1] The key debtors comprise Argentina, Brazil, Chile, Mexico, Peru and Venezuela

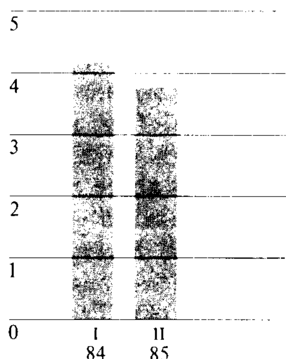
International Commodity Prices

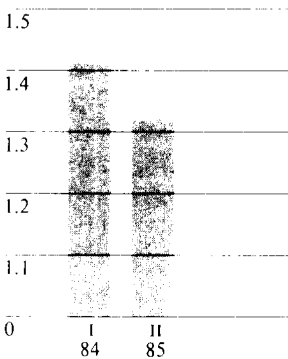
Note scale change

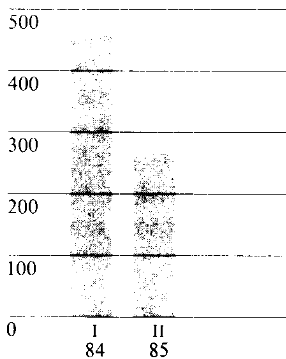












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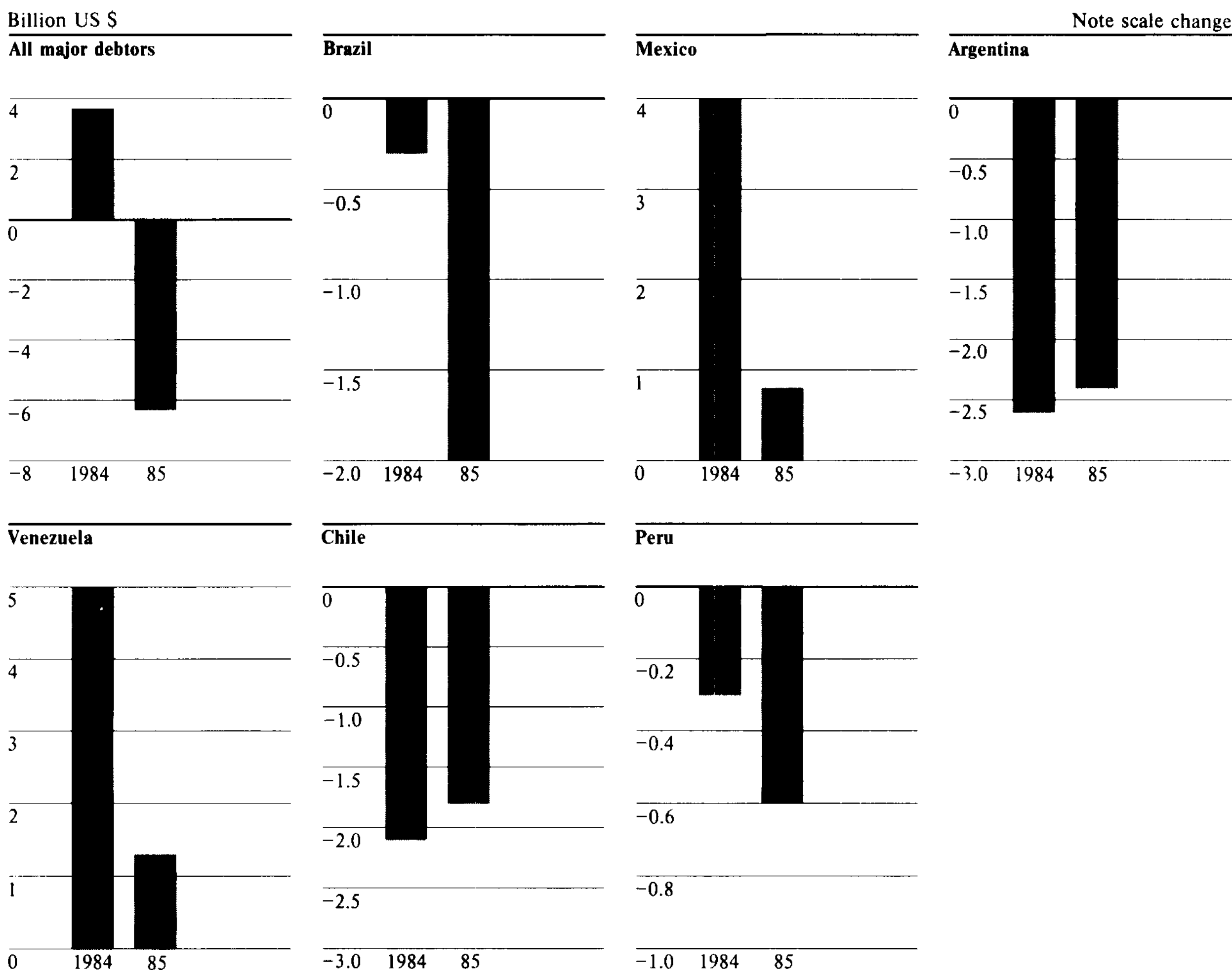
Latin American Debtors: Current Account Balance



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export promotion policies could again be an engine for economic growth and financial solvency. Several governments are moving to provide new incentives to exporters. Argentina has announced it will reduce or remove some export taxes, and Chile has revitalized its export promotion efforts. Meanwhile, Peru and Mexico recently have announced more aggressive exchange rate policies, while the new Bolivian Government is promising massive devaluations to revive exports. Nevertheless, in our view, heightened concern over controlling inflation and the backlash from competing domestic interests probably will lead Latin governments to backpedal on these efforts at trade reform. As a result, halfhearted efforts will fail to stem the export decline and will leave Latin debtors vulnerable to a resurgence of debt servicing difficulties

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Portugal: Economic Problems Persist

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Austerity measures introduced under the IMF's guidance during 1983-84 cut Portugal's current account deficit—from $3.2 billion in 1982 to about $500 million last year—but serious structural problems remain. The collapse of the coalition government in June, parliamentary elections this fall, and campaigning for the presidential elections in 1986 make it almost certain that Lisbon will be unable to adopt economic reforms necessary to continue the improvement in its international financial position.

Belt-Tightening Under the IMF

The Soares government negotiated a $480 million standby program with the IMF in 1983 after hard currency reserves dwindled to less than two weeks of imports. The new IMF standby program aimed primarily at curbing domestic demand and spurring exports. Prodded by the Fund, Lisbon devalued the escudo 12 percent in June 1983, after a 2-percent devaluation three months earlier. The terms of the program obliged Lisbon to slash the combined budget deficit of the government and public-sector enterprises, slow domestic credit growth, hold down public-sector wage increases, and raise interest rates and prices of subsidized goods. The government also promised to trim investment by state-owned companies, curb their borrowing needs, tie budgetary subsidies to restructuring programs, and undertake a structural adjustment program with the World Bank.

In response to the austerity measures, Lisbon's trade deficit shrank by more than one-half during 1983-84, with a fall in imports accounting for most of this improvement. A cumulative 26-percent drop in import-intensive real gross fixed capital formation resulted from tighter fiscal and monetary policies and difficulties in borrowing abroad. The steep decline in real wages also curtailed import demand. At the same time, lower real wages, devaluation, and an upturn in world trade fueled a 32-percent increase in export volume during 1983-84.

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Serious Economic Problems Remain

Despite a good showing on the current account, fundamental problems continue to plague the large state-owned sector of the economy. Lisbon has yet to correct the damage done to public-sector enterprises' financial positions through misguided government policies. These firms account for 18 percent of gross fixed capital formation, 14 percent of value added, and 40 percent of domestic borrowing. The government now owes these companies $2.5 billion—equivalent to nearly 13 percent of Portugal's GDP. Back payments owed to the state electricity company alone account for about $1 billion. The remainder primarily represents back payments owed by the Supply Fund. The Supply Fund is designed to subsidize public enterprises by using revenues from taxes on petroleum products to pay state firms the difference between domestic controlled prices and the actual cost of purchasing or producing goods. As the planned subsidies under this scheme far outstripped tax revenues, the Supply Fund quickly accumulated a huge debt to state enterprises.

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According to World Bank estimates, the public-sector enterprises themselves have amassed another $1.2 billion in arrears to nationalized banks, the private sector, and other government entities. These arrears have, in turn, weakened private-sector firms' finances. Domestic borrowing by state companies has been partly to blame for Lisbon's failure to comply with the IMF's ceiling on public-sector domestic credit growth, and the crowding out of private-sector investment.

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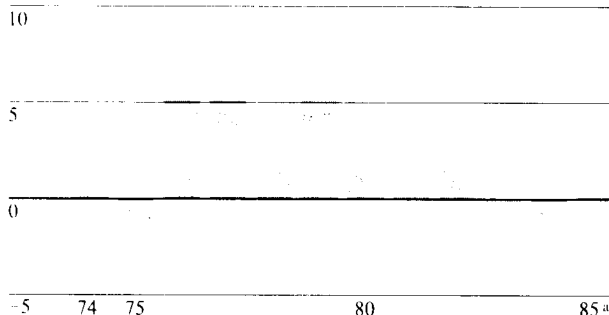
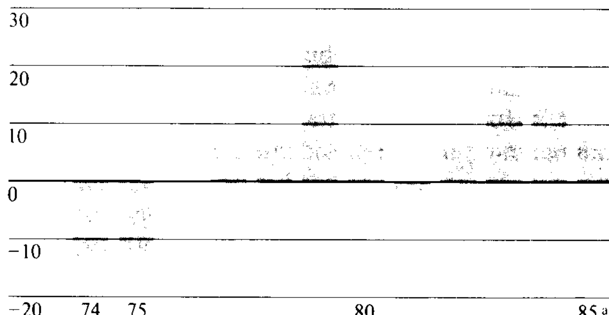
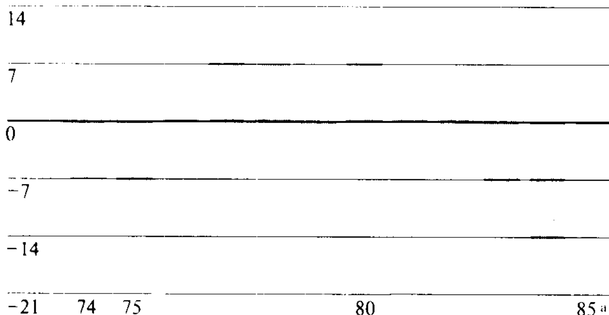
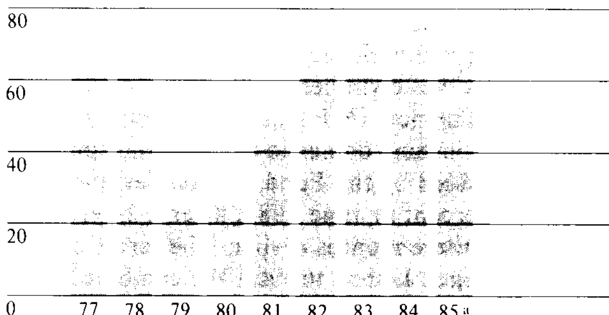
Portugal: Economic Indicators

Percent

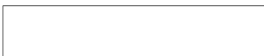








[a] Projected.



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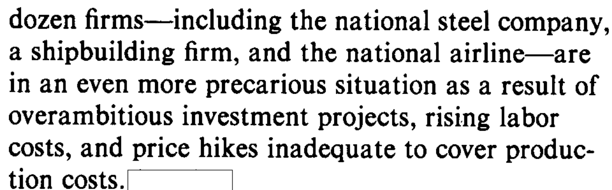

In addition, state enterprises have been hurt by inappropriate borrowing, pricing, and investment decisions. Previous governments used state enterprises as a front for current account financing by compelling these firms to borrow beyond their own needs and obtain short-term loans to finance essential imports such as food and petroleum. As a result, state firms' borrowing accounted for more than half of the growth of foreign debt, which more than doubled as a share of GDP during 1980-84 to 78 percent. Four import monopolies hold nearly 90 percent of Portugal's short-term debt and all but one are suffering liquidity problems. Another half dozen firms—including the national steel company, a shipbuilding firm, and the national airline—are in an even more precarious situation as a result of overambitious investment projects, rising labor costs, and price hikes inadequate to cover production costs.

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Lisbon has made only limited progress in paring the combined budget deficits of the government and state enterprises; last year the deficit jumped back to 17 percent of GDP from 15 percent in 1983

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Portugal: Current Account, 1980-85

Million US $

	1980	1981	1982	1983	1984 [a]	1985 [b]
Current account balance	**−1,251**	**−2,850**	**−3,245**	**−1,640**	**−472**	**−500**
Trade balance	−4,206	−5,194	−4,833	−3,076	−2,029	−1,850
Exports, f.o.b.	4,575	4,088	4,108	4,569	5,210	5,350
Imports, f.o.b.	8,781	9,282	8,941	7,645	7,239	7,200
Services, net	−45	−544	−1,092	−735	−638	−650
Of which:						
Net tourism	859	777	609	591	724	750
Interest payments	733	1,109	1,370	1,196	1,348	1,400
Transfers, net	3,000	2,888	2,680	2,171	2,195	2,000
Of which:						
Worker remittances	2,931	2,832	2,599	2,151	2,157	1,950

[a] Preliminary.
[b] Projected.

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because of rising subsidies to state-owned firms and shortfalls in tax revenues. A decision to postpone introducing the valued-added tax and the government's failure to cut investment programs in state enterprises—particularly in the electricity company—almost certainly will raise the deficit.

The agricultural sector is increasingly adding to Portugal's foreign payments problems as well. Yields have fallen since the 1974 revolution because of land seizures, uncertainties of property ownership, and drought. The country is now highly dependent on imported food even though about one-fifth of the population is employed in the farm sector. Since 1973, production of wheat and rice has dropped 20 percent, and grain imports have doubled to 12 percent of total imports. Purchases of foreign grain now account for 69 percent of total food imports, as compared with 46 percent in 1973.

Entry into the EC is certain to boost the cost of Portugal's agricultural imports. While Lisbon currently imports nearly all its grain from non-EC countries, it has agreed to purchase 15 percent from more expensive EC suppliers during the first five years of membership. Afterwards, the Community preference system will come into effect, obliging the Portuguese to apply import levies on agricultural imports from third countries to raise prices to the EC level—and to transfer the levies to the EC. These levies could amount to $125 million per year for corn imports alone, according to World Bank estimates

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Government Efforts

The Soares government initially moved quickly to introduce reforms in compliance with its IMF program. Lisbon began to reform its Byzantine tax system and inefficient labor market, drew up a plan to restructure the financial system, and announced concrete steps to redress the financial straits of some public-sector enterprises—such as laying off workers at a loss-making shipyard and scaling back investment plans for the state steel plant. The

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program, however, has lost momentum amid internal political squabbles and disagreements on economic policy. In particular, Soares' own Socialist party has been reluctant to support measures that might cut into its working-class support. Negotiations with the World Bank for a structural adjustment loan have stalled because of opposition to the Bank's demands for institutional reform and the government's failure to repay arrears to the state electricity company. Decisions on agricultural development programs and agrarian and labor reform bills also have been paralyzed by the unraveling of the coalition.

We expect little progress in the near term on Portugal's structural economic problems either under the caretaker government or the next government—elections will be held this fall. The new government will almost certainly be reluctant to address the problem of overstaffing in state enterprises as have been past governments. Hiring at state firms since the 1974 revolution has reflected political needs and has been aimed at keeping employment pressures—created by the return of an estimated 700,000 expatriates from Portugal's former African colonies—within acceptable levels. To eliminate surplus labor, the World Bank reckons public-sector firms would have to shed between 10 and 40 percent of their workforce. We expect that layoffs of this magnitude would generate more political heat than any political party would be willing to face. Lisbon is unlikely to make much headway in reforming the agricultural sector because of its poor record of utilization of World Bank agricultural credits, limited ability to provide matching funds to obtain EC regional development aid, and Communist opposition to reform in the south

The Domestic Outlook

Portugal's economy probably will show only a few bright spots this year. Real GDP growth is likely to pick up to about 1 percent, compared with a 2-percent decline last year, mainly because of a gain in both private and public consumption. Inflation is expected to drop from 29 percent to 20 percent and real wages should rise about 2 percent. On the other hand, the difficult financial position of many firms and crowding out by public-sector enterprises suggest that investment will decline slightly.

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Financial Implications

Although the recovery this year probably will hold the current account deficit to about $500 million, Lisbon is likely to face a new round of foreign payments problems, perhaps as early as 1986. A generally expected slowdown in world trade and a tax on emigrants' deposits almost certainly will lead to slackening exports and declining worker remittances. EC accession next year probably will cause Portugal's trade deficit to widen because of a shift to higher priced EC cereals and the effects of phasing out nontariff barriers and lowering high tariffs on competitive Spanish goods. Because of delays in program approval and domestic budgetary strains, we expect Portugal to be unable to obtain enough regional aid from the EC to offset the increase in its import bill. If Lisbon primes the pump before the elections as we expect, looser fiscal policy will aggravate this trend because Portuguese import demand is highly sensitive to changes in income.

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According to the Embassy, the IMF anticipates a deterioration of Portugal's current account deficit that will be serious enough to prompt Lisbon to seek another IMF program. The Embassy reports that Fund officials are willing to provide assistance again, despite Portugal's failure to abide by domestic credit limits during each of its standby programs since 1977. The next stabilization program is more likely to be an extended three-year program to address Portugal's structural economic problems. They would require a less severe tightening of domestic demand but would probably give the Fund more leverage in encouraging economic reforms.

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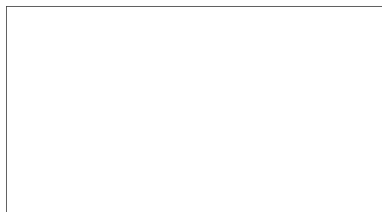
Briefs

Energy

World Gas Production Rises



World gas production in 1984 rose nine percent over 1983 levels to a record 1.7 trillion cubic meters. The USSR continued as the largest producer—587 billion cubic meters (bcm)—and the largest exporter—68 bcm. Of total world production, about 200 bcm was traded internationally by pipeline or as liquefied natural gas (LNG). Pipeline trade rose 8 percent, mainly due to increased sales by the USSR. Continental West European countries received about 32 bcm of Soviet gas in 1984, or nearly 20 percent of their total gas consumption. LNG trade rose by 16 percent to 48 bcm, and Indonesia replaced Algeria as the leading LNG exporter. Increased deliveries to Japan from Indonesia and Malaysia more than offset reduced Algerian LNG sales to US customers and the stretchout of deliveries to France.

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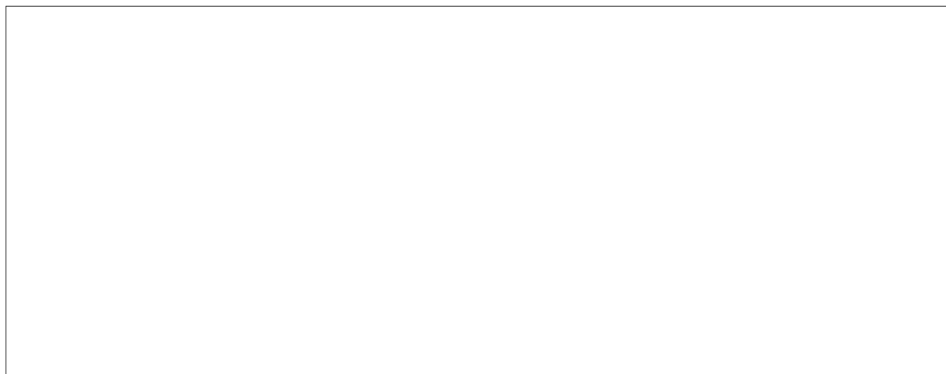

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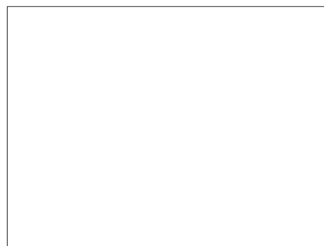
International Finance

South African Financial Problems



US Embassy sources report concern over political uncertainties in South Africa has led many West European, Japanese, and US banks to reduce the availability of short-term credit and to demand repayment of most existing loans as they come due. South Africa reportedly has some $7 billion in loans due for payment in the next six months. Even with a prospective current account surplus, Pretoria has only about $500 million in liquid assets and $2 billion in gold holdings, according to recent IMF data. South African banks had been turning to European banks to diversify away from a heavy reliance on major US banks, A growing reluctance by bankers to extend maturing loans and provide short-term credit could soon result in unmanageable financial strains. Pretoria probably would be forced to approach the IMF for assistance, a move that would trigger strong international opposition.

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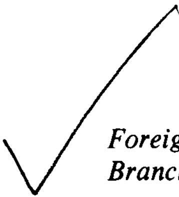

Foreign Bank Branch in China

Beijing has announced that it will allow a Hong Kong bank to be the first foreign bank to establish a branch in China since 1949. The branch, to be opened in the Shenzhen Special Economic Zone, will provide foreign exchange loans, handle foreign trade transactions, and offer foreign currency deposits to foreigners. The branch must follow strict state guidelines in setting interest rates on loans and deposits, however, and can offer foreign currency only at the Chinese official exchange rate. Other banks reportedly are interested in establishing branches in the Special Economic Zones, and Beijing is likely to grant approval soon. Many foreign bankers remain wary, however, because of restrictions on bank activities and potential problems in remitting foreign currency earnings. Beijing may hope that, by limiting foreign banks branches to the Special Economic Zones, it can gain experience from, while limiting the influence of, foreign banks.

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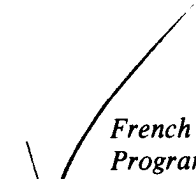

French Export Credit Program Overhaul

France is considering a major overhaul of its export credit program to reduce the cost of export subsidies to the budget, according to the US Embassy. Finance Minister Beregovoy would also like to simplify and give a market orientation to France's export programs, as well as increase autonomy for the banks and exporters in export finance. Beregovoy intends to announce the changes in the coming weeks. While details are lacking, the mixed credit program apparently will remain. France may wish to avoid discussing subsidy reduction at the 16-20 September OECD Export Credit Group meeting in Paris until the final decision on the future of its export credit program is made.

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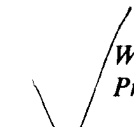
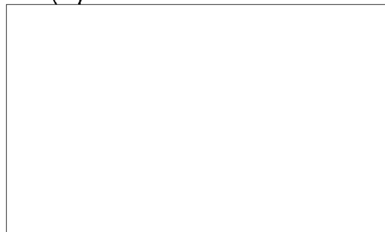
Global and Regional Developments



West European Progress on EUREKA



France, West Germany, and the United Kingdom are coordinating more closely on EUREKA—Western Europe's initiative on civilian high-technology research—in anticipation of the meeting of West European foreign and research ministers on 5 and 6 November. French and West German research experts will meet next week to discuss possible projects. In the near future London will host a conference of financial experts from West European industry. According to press reports, Paris will appoint Yves Sillard, a former head of its space agency, to organize EUREKA activities in France. Bonn and Paris undoubtedly wish to avoid additional discord and delays at the November meeting by sorting out beforehand a list of EUREKA projects on which participating governments can move ahead quickly. With EC and national research budgets already strapped, the British probably hope their conference will stimulate private funding and test industry's support for EUREKA.

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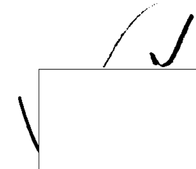

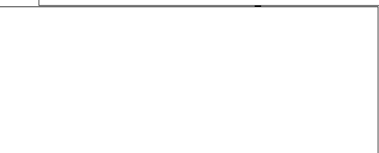

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economic growth accelerated. Nonetheless, the anticipated pickup in the US economy later this year should help Canadian exports and thereby ensure that Canada will achieve a record surplus with the United States for 1985 as a whole

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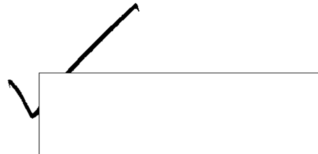

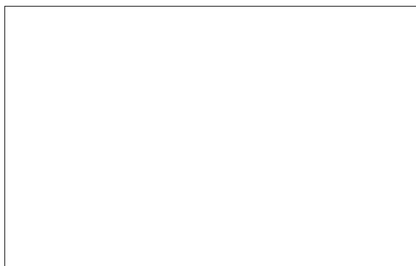

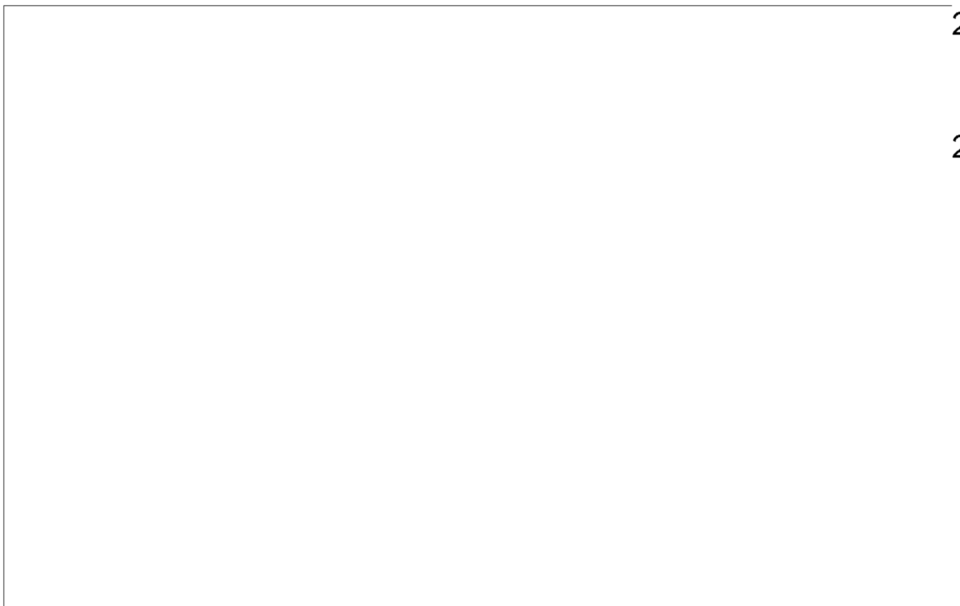

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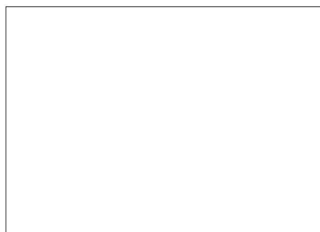
Tough Talk on UK Energy Technology Policy



In remarks probably reflecting London's position, a British Energy Department official reiterated to US Embassy officers last week that the policy—which favors British-based firms in granting contracts for technology used in offshore oil and gas development—does not discriminate against US firms. He said London wants the "new" technologies—required for the development of deepwater and marginal North Sea fields—to be centered in UK-controlled firms to foster a competitive British offshore services industry. The official admitted, however, that the British also want to place technology "outside the umbrella of US Government extraterritorial reach." He said he understands US firms are amenable to forming joint ventures with British partners in order to meet London's goal. He stressed that US Government efforts to challenge the policy at an OECD committee meeting next month would harden the British position. The EC Commission raised the issue of discrimination against non-British firms with London earlier this summer, but apparently has for the moment been appeased by promises to change the wording of guidelines for future licensing rounds

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Spain to Maintain Austerity

Madrid's draft budget proposal for 1986 reflects Finance Minister Solchaga's intention to adhere to the austerity program launched in 1982. Government spending is targeted to fall about 1 percent in real terms, assuming an 8-percent inflation rate next year. To curb expenditures, Madrid plans to cut real public-sector wages, pare down government employment and lower

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interest payments on public debt. It may also raise workers' contributions to social security. The government estimates revenues will increase 4.6 percent in real terms, based on real GDP growth of 2.5 percent. According to these projections, the budget deficit will fall to 4.3 percent of GDP, versus 4.5 percent this year. Although this plan almost certainly will generate criticism within the Socialist party—particularly because it could cost votes in next year's general election—we expect few changes in the final version of the budget.

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Portuguese Telecommunications Controversy

Lisbon's exclusion of ITT and AT&T from the last stage of negotiations for a $1-2 billion telecommunications project has caused a dispute that will likely force the government to reconsider its decision. Portuguese officials limited final bidding—to supply a digital exchange system for the nation's telephone network—to Siemens of West Germany and CIT/Alcatel/Thompson of France because their bids were 40 to 50 percent lower than US bids. The US firms were suspicious of the European cost calculations and have called for an independent audit. At the same time, they have sought US embassy help to pressure Lisbon into reopening the negotiations. Although far from settled, the controversy is unfolding in a favorable direction for the US companies. The internal battle among ministers in the caretaker Socialist–Social Democratic government will likely postpone the contract award until after the October legislative elections which will increase the chances of the new government reopening the competition to all four firms.

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Less Developed Countries

Changes in Brazil's Economic Team

President Sarney's naming of Dilson Funaro to replace Finance Minister Dornelles probably will prove popular at home but is likely to heighten difficulties with creditors abroad. The press reports that Funaro is an associate of Planning Minister Sayad, who has opposed tough austerity measures. Funaro is a supporter of private enterprise and has criticized IMF policies as harmful to Brazil's interests. The new appointments almost certainly will make already stalemated negotiations with the IMF more difficult and will reduce the chances for an early agreement on bank debt rescheduling. Sarney's continued opposition to tight austerity measures probably will boost his popular standing before the November elections. By selecting his own Finance Minister, Sarney has gotten a tighter grip on the Cabinet and will strengthen Sarney's standing with the Brazilian Democratic Movement Party, the senior partner in the coalition government.

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Salvadoran Private-Sector Unrest

President Duarte's already strained relations with the private sector have worsened following recent decrees that restrict profits on food items, pharmaceuticals, and auto parts. The business community has threatened a general strike over what they claim are new precedents for government intervention in the economy. In an effort to defuse the situation, Duarte suspended the decree for a 15-day cooling-off period and is meeting with private-sector representatives to discuss ways to make the profit margin controls more palatable. Deep

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divisions over principle remain, however. Even if a compromise is reached, serious damage has been done to the improving investment climate that was helping to sustain the tentative economic recovery begun last year. 25X1

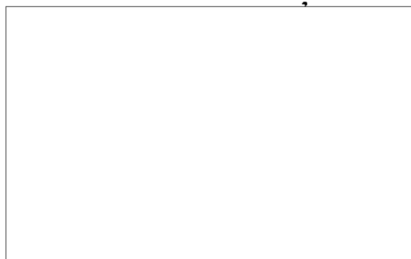
Libyan Agriculture Hurt by US Embargo

The sharply reduced flow of US parts and expertise to Libya since the 1982 US trade embargo has had its greatest impact on Tripoli's priority agricultural development program, In great demand is US expertise on large, pivot irrigation systems, essential to reverse declining productivity in desert areas. Dairy herd losses have exceeded 50 percent at some facilities since 1982 because of poor nutrition maintenance, a service formerly provided by US agricultural technicians. Libya may increase the 400,000 b/d of oil set aside for barter purchases of equipment and expertise—especially from Austrian, French, and Spanish firms. says that Libya plans a joint venture facility to produce up to 500 pivot units annually which would require US-origin computer hardware and software. Tripoli will probably be even more aggressive in looking for ways to circumvent US restrictions on providing agricultural spare parts and technical assistance. 25X1 25X1 25X1 25X1 25X1 25X1

Libyan-Maltese Maneuvering Continues

Economic benefits anticipated by both Tripoli and Valletta from various technical and financial arrangements have not materialized, The US Embassy in Valletta reports that Tripoli has supplied a large part of Malta's crude oil needs at concessional rates and is providing some jobs in Libya and work for the nation's depressed shipyards. The Maltese, however, are not satisfied. Meanwhile, the Libyans are distressed over Prime Minister Bonnici's resistance to Qadhafi's requests for expanded military ties. Nevertheless, Bonnici probably will try to extract more economic benefits from Qadhafi, primarily to reduce Valletta's burdensome unemployment problem before elections scheduled for 1987. Qadhafi will continue the relationship as long as he perceives a chance for a Libyan military presence on the island to enhance Tripoli's ability to monitor US military activities in the central Mediterranean. 25X1 25X1 25X1 25X1

Tunisia Revises Import Policy



Tunis is expanding government control over all imports in its drive to contain burdensome trade and budget deficits. Tunis anticipates that the new regulations will trim $100 million off the projected $720 million current account deficit. The US Embassy reports that the government hopes to forestall devaluation of the dinar, a measure which many Tunisian officials advocate as a more direct, and ultimately necessary, means of dealing with the deficits. Regulatory officials, however, have no clear directions on policy implementation. Trade controls in place since April already have resulted in businessmen criticizing Prime Minister Mzali's economic management. Additional restrictions almost certainly will further alienate wealthy and middle-class Tunisians, a key political constituency for Mzali if he is to emerge as President Bourguiba's successor. 25X1 25X1

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Saudi Arabia Delinquent on French Arms Payments

This has led to a slowing of construction and training activity. operations at some facilities have been limited and that no agreement is in place for long-term maintenance support from France. The Navy has been hard hit by defense budget cuts–

however, is unlikely to curtail its arms sales programs because of the funding constraints.

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Soviets Increase Control Over Afghanistan's Civilian Airlines

Soviet pressure has resulted in the merger of Afghanistan's international carrier, Ariana, with the domestic line, Bakhtar. The newly formed airline will be under direct government control and will be headed by the former president of Bakhtar. Afghanistan sold its DC-10 last spring and is now negotiating the sale of its remaining Western aircraft, two Boeing 727s they will be replaced by Soviet TU-154s. This will provide Afghanistan some hard currency, remove the embarrassment of Western aircraft in a state run enterprise, and allow the Soviets to more closely control the airline. Flight crews for the new Soviet aircraft are reportedly carefully screened by the Afghan intelligence service and given heavy doses of indoctrination to reduce defections. These changes are not likely to have any effect on the Western sanctions on Afghan aviation imposed in response to the 1981 hijacking of a PIA flight to Kabul.

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Taiwan's New Finance Minister

Robert Chien became Taiwan's new Finance Minister last week following the resignation of Loh Jen-kong. The Ministry's mishandling of what may be Taiwan's worst financial scandal—the failure of the Tenth Credit Cooperative bank and related businesses of the Cathay Group earlier this year—had been widely criticized. Before Chien's appointment, a senior Kuomintung official told AIT officers that Chien himself might be "slightly tainted" by the scandal, but that his conservatism and close ties to the Prime Minister clearly made him the front-runner. Chien, a 15-year veteran of the Central Bank, now faces the difficult task of trying to resolve the still unfolding scandal. He will probably move cautiously on reform of Taiwan's financial structure. He advocates tight restrictions on personal and business credit and a strong link between the dollar and Taiwan's currency. Chien, 56, is the older brother of Fred Chien, Taiwan's unofficial representative in Washington

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Communist

Soviets Order US Wheat

the Soviets have ordered 600,000 metric tons of US wheat, reportedly worth about $77 million and scheduled for delivery between late September and November. Moscow will take advantage of depressed US wheat prices to meet and exceed their

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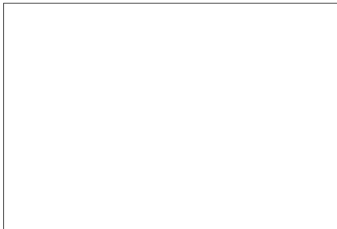
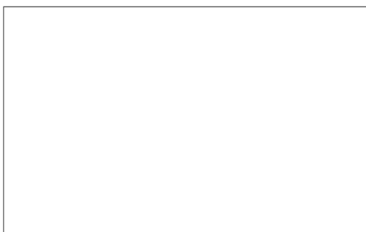
outstanding obligations under the Long-Term Grain Agreement. The Soviets have not purchased US wheat since March 1985, but, to meet their obligations, they would have to buy another 500,000 tons and ship the entire 1.1 million tons by 30 September. The Soviets have cited the relatively high price as a reason for their reluctance to buy US wheat. Nonetheless, the stated price on this grain is substantially above prices the Soviets have recently paid for French wheat. 25X1

Italian Firm Wins Soviet Contract for Coal Slurry Pipeline



According to a Western news service, the Italian firm Snamprogetti Spa has received a contract to provide process technology and engineering services for a 250-km coal-slurry pipeline in the USSR. The pipeline project—reportedly valued at about $250 million—will transport 3 million metric tons of coal annually from a mine in the Kuznetsk coal basin to a power plant in Novosibirsk. Although the Soviets have been working on developing coal-slurry technology since 1978, they lack the necessary expertise in all major aspects of direct-burning, coal-slurry pipeline systems. Direct burning of coal slurry requires state-of-the-art technology, and long-distance transport has not been demonstrated on a commercial scale. 25X1 if the technology proves economically and technically feasable, the USSR may undertake the construction of a high-capacity (25 million tons-per-year) coal-slurry pipeline from the Kuznetsk coal basin to the Urals and European USSR. 25X1

Prospects for East European Grain Production



Grain production for the region this year is estimated at 104 million metric tons, the fourth consecutive good crop. Poland, East Germany, and Czechoslovakia are expected to have bumper crops. Growing conditions have been less favorable in Hungary and Yugoslavia, but above-average harvests are still within reach. In contrast, Romania and Bulgaria are headed for below-average grain production. Prolonged drought in both countries heavily damaged winter grains and has reduced prospects for corn. The successful harvests should enable the grain-importing northern countries—Poland, East Germany, and Czechoslovakia—to keep their purchases at the low levels of recent years, helping to maintain hard currency trade surpluses. For the southern countries—which push grain exports to earn hard currency—trade prospects are mixed. Hungary should be able to maintain its grain exports. Yugoslav corn exports should more than offset the cost of wheat Belgrade may have to buy to cover a shortfall resulting from the decreased wheat area this year. The US Embassy in Sofia reports that Bulgaria, usually a wheat exporter, is now trying to buy wheat. In Romania, lack of credit will limit wheat purchases, while the disappointing corn crop will reduce exports and further strain domestic supplies. 25X1

China Plans Joint Computer Center in Hong Kong

China's Ministry of Petroleum, a US firm, and a Chinese-controlled Hong Kong electronics company have agreed to set up a computer center in Hong Kong to process seismic data for China's petroleum industry 25X1 The project involves five IBM 3083 mainframe computers, which 25X1 25X1

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are controlled under US and COCOM guidelines. Although the US firm will own the computers initially, that ownership will be transferred to the Chinese in the future. The partners reportedly selected Hong Kong as the site to improve prospects for obtaining export licenses, and this is likely to be an effective means of bypassing export controls.

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Chinese Computer Network Planned

China's Ministry of Railways plans to set up a nationwide computer network using US equipment and technology. The Ministry reportedly intends to procure 300 US minicomputers as well as large amounts of networking equipment and software through a Hong Kong company in which it has controlling interest. The Ministry is also negotiating for US fiber optics technology to connect the computers with high-speed data communications links. Although computerized reservations, scheduling, and track control are needed to expand rail capacity, this project would also contribute to the military data communications capabilities. The military would probably assume control over the railroads' computer network in a time of need and may, in fact, be directly involved in the rail project.

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Western China Told To Speed Development

A recent conference on the development of China's 11 western provinces has highlighted growing inequities between western and coastal areas. Sparsely populated, underdeveloped, but strategically important, China's western regions are languishing under Beijing's current policy of directing development funds and foreign investment to coastal areas. Beijing is sensitive to criticism of the growing inequities, but is unwilling to divert scarce central resources except for specific energy and transportation projects. Western provinces are instead being encouraged to use local resources to improve and diversify the region's livestock-based economies, develop tourism, and increase trade with coastal areas. Although the region's foreign trade potential is limited, northwest provinces will benefit from growing cross-border trade with the Soviet Union. China is also seeking Western assistance to develop the region's oil reserves.

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