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International Economic & Energy Weekly

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6 September 1985

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6 September 1985

International Economic & Energy Weekly [redacted] 25X1

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3 **Libya: Qadhafi's Prospects for Survival** [redacted] 25X1

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19 **International Financial Situation: Political Update** 25X1

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International Economic & Energy Weekly

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Perspective

Western Europe in a Rut

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Western Europe is in the fourth year of economic recovery—a recovery, however, characterized by tight fiscal and monetary policies, slow growth, industrial stagnation, and continual increases in unemployment. Average real GDP growth was 0.7 percent in 1982, 1.4 percent in 1983, and 2.4 percent in 1984, but is likely to remain stuck at less than 2.5 percent this year and next. Unemployment in the region now averages 11 percent, up from 8.2 percent at the beginning of the "recovery" from the 1980/81 recession. Even looking at individual countries reveals no dynamic performers: the British economy, the strongest of the Big Four, almost certainly will grow by no more than 3.5 percent this year. At best, the major economies would do well to keep jobless rates from climbing still higher. 25X1

There are some bright spots. Although growth rates are lagging, domestic sources of expansion are more important than they were last year when exports, especially to the United States, accounted for almost one-half of growth. Private consumption and investment have picked up a little in line with the rise in real incomes and the drop in inflation. Interest rates in Western Europe have fallen as US interest rates and the dollar have come down, thereby promising further increases in domestic demand. 25X1

The most remarkable aspect of the region's economic performance is that West European governments—and electorates—are convinced that traditional macroeconomic policies to boost growth would actually worsen the long-term health of their economies. West German Finance Minister Stoltenberg, for example, last month defended Bonn's tight fiscal and monetary policies as the best possible under current economic conditions and on several occasions rejected moving up tax cuts scheduled for 1986 and 1988. Stoltenberg's views of the proper policy mix—which appear to have been directed toward criticism from abroad—were generally accepted in West Germany and elsewhere in Western Europe as obvious. 25X1

The economic imbalances that developed as many West European governments tried to spend their way out of the oil-induced recessions of the 1970s played the major role in creating the current consensus. Governments saw their spending rise from about one-third of GDP to about one-half while joblessness and inflation continued to grow. The 1982 collapse of French President Mitterrand's expansionary program helped convince most leftwing parties as well that fiscal and monetary stimuli would not solve West European economic problems. Thus, by the early 1980s, West European governments almost all agreed that high employment and rising living standards could not be sustained with high inflation and large budget deficits; a few governments—including the British, the West German, the Danish, and the Dutch—even became convinced that the size of government was stifling economic growth. 25X1

Another theme emphasized by West European governments is that slow growth is caused in part by the wrong mix of industries—something expansionary economic policies cannot fix. West European governments see such traditional industries as steel and textiles declining as demand drops and competition from LDCs rises. The ambitious, but still vague, EUREKA program proposed by Paris exemplifies the interventionist response to deciding which industries have a future. Another approach being tried in the United Kingdom, France, and West Germany is lowering barriers to setting up new companies by promoting a venture capital market and cutting redtape. 25X1

Given steady, if unspectacular, growth, almost all West European governments are likely to continue on their present course in the belief that the foundations for future growth are being laid. They will continue to reject suggestions that more expansionary policies—boosting government spending, raising money supply growth, or cutting marginal tax rates—could be adopted because they think that such policies would delay the restructuring of their economies. Electorates are likely to go along with present economic strategies for the time being. The Big Four governments, however, all face national elections during 1986-88 and will come under increasing pressure to do more on the employment front. 25X1

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Libya: Qadhafi's Prospects for Survival

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Domestic opposition to Libyan leader Qadhafi continues to grow. Signs of an erosion in Qadhafi's political base of support include renewed plotting by military officers and more widespread grumbling about deteriorating economic conditions. Qadhafi's response to these developments has been to align himself more closely with hardliners. He shows no inclination to rein in the extremists, curtail costly foreign adventures, or backtrack on his unpopular economic socialization programs, all of which could broaden his base of support. His refusal to compromise any aspect of his revolution or to make any effort to improve local economic conditions in the face of declining oil revenues only enhances the prospect of his ouster by dissidents, the military, or by fellow clan members in a preemptive move to protect their own positions.

The Faltering Economy

Libya has weathered the soft oil market by cutting back sharply on imports, scaling back the Five-Year Plan (1981-85), slowing payments to suppliers, and resorting to oil barter deals. Despite producing about 150,000 b/d of crude oil above Libya's OPEC quota of 990,000 b/d, total export earnings are projected to remain at about $11 billion this year. Imports probably will fall to $7 billion, leaving a current account deficit of about $1.2 billion for 1985—a slight improvement from the $1.5 billion deficit last year.

While oil market conditions have prompted the government to reassess development goals, work on several prestige projects continues, although on a delayed schedule. Heading the list is the $11 billion Great Manmade River, a grandiose project to bring water from southern Libya to arid coastal regions. Completion of this project, along with that of other large-scale development programs—the multi-billion-dollar steel mill at Misratah, an aluminum smelter at Zuwara, and the large petrochemical facility at Ra's al Unuf—is to be delayed for several years to conserve an estimated $3.5 billion in foreign exchange. 25X1

Defense spending has been the last area to feel the pinch of declining revenues. Qadhafi came to power through a military coup, is well aware that the military poses the greatest threat to his regime, and will be careful to continue to meet the needs of the military. We estimate that military imports will decline to about $1.6 billion this year from their peak of $2.8 billion in 1982, but most of the drop reflects the completion of deliveries under existing contracts. 25X1

Domestic Unrest

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The regime's efforts to deal with Libya's economic decline have placed a growing burden on the population. An increasing number of Libyans in Tripoli are complaining about an unprecedented deterioration in living conditions. 25X1 Shortages of food, water, and electricity have become a way of life. 25X1 Long lines at state-run stores are increasingly common, generating sporadic disturbances that have resulted in several deaths. an emerging 25X1 consensus among Libyans that Qadhafi's social experiment has failed and that change is needed. 25X1 25X1

These grievances probably are aggravated by Qadhafi's 25X1 continual exhortations to revolutionary activity, which further undermine the sense of security Libyans are seeking in their daily lives. In July, for example, Qadhafi ordered Western musical instruments in Libya destroyed as part of a new attack on symbols of Western culture. In addition, dissatisfied Libyan university students sent Qadhafi a memorandum in which they linked expenditures for misguided foreign adventures to the current economic difficulties. Many Libyans apparently are holding Qadhafi personally responsible for excesses committed by his loyalists in enforcing his revolutionary dictums, [redacted]

Dissatisfaction with Qadhafi since the beginning of the year is finding expression in various ways. [redacted] anti-Qadhafi literature recently surfaced again in several Libyan cities and that graffiti has even appeared on walls near Qadhafi's headquarters in Tripoli. Security crackdowns following the Libyan exile attack on Qadhafi's headquarters in May 1984 previously had stifled such activity. These activities are in addition to disturbances among the Berber minority in northwest Libya, at least one assassination attempt against Qadhafi, quashed coup plotting by military officers, the apparent sabotage of a Libyan military installation, and instances of open "counterrevolutionary" decisionmaking by local officials earlier this year. [redacted]

Regime Countermeasures

Qadhafi almost certainly perceives an increasing threat of a coup. [redacted] roundups and interrogations of suspected dissidents have grown. Security forces almost certainly are closely monitoring the activities of military officers—as many as 80 may have been executed last March for their involvement in the first military coup plot in two years. [redacted] Those whose continued stay is not approved will be ordered home; those refusing presumably will face death. [redacted]

[redacted]

[redacted]

Prospects

Qadhafi in the past has temporarily compromised some of his radical principles to ease discontent, but his increasing reliance on youthful extremists in the revolutionary committees now limits his room to maneuver. Indeed, his recent speeches and actions indicate that he remains personally determined to sustain his revolution and to support foreign radicals. [redacted]

[redacted]

If Qadhafi continues to reject compromise, he will need, at a minimum, a hefty boost in oil revenues to reduce the current climate of discontent. Any hope for increased oil demand and higher prices, however, run counter to oil market trends. Moreover, unilateral Libyan attempts to boost oil sales would only put further downward pressure on prices and threaten the fragile OPEC discipline that remains. [redacted]

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We doubt that recent attempts by Qadhafi's supporters to blame shortages of consumer goods on hoarding and mismanagement by local "fat cats" will satisfy many Libyans. Some Libyans may even take to the streets in protest if economic conditions continue to worsen. [redacted] 25X1

For the moment, the exiles alone probably have the capability to conduct successfully only isolated sabotage operations. Nevertheless, the dissidents probably hope to launch another attack on Qadhafi in the near future to capitalize on his unpopularity as well as on their increased foreign support. If the dissidents have well-positioned supporters in the military willing to assist, we assess their chances of toppling Qadhafi are better than even. [redacted] 25X1

[redacted] 25X1

The Smaller Persian Gulf States: Growing Need for Adjustment

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The small, conservative Arab states of the Persian Gulf have entered a period of growing economic, political, and subversive challenge. In Bahrain and Kuwait, popular discontent is on the rise, fed by the impact of declining oil revenues, unfulfilled political and economic expectations, and the greed of the ruling families. At the same time, continued subversive activity, such as the assassination attempt on the Amir of Kuwait in May and recently discovered arms smuggling in Bahrain and Qatar, test the regimes' ability to protect themselves. Although major political upheaval is unlikely in the near term, Gulf leaders do not seem to be coming to grips with the long-term implications of the threats caused by their declining economies and the increased potential for subversion.

Feeling the Pinch

Gulf citizens are beginning to criticize the ruling families for failing to implement policies to deal with the economic hard times currently hitting the region. Since their peak in 1980, oil revenues in the smaller Gulf states—Kuwait, Bahrain, United Arab Emirates, and Qatar—have fallen by 35 percent. During the last three years, businesses throughout the region have failed, Kuwait has suffered a stock and real estate market crash, and Bahrain has seen several bank closures and the collapse of its real estate market. According to various US Embassy reports, many in the Gulf are criticizing the ruling families for unfair business practices, corruption, and wasting declining government resources.

Bahrain. Further oil price declines will severely strain Bahrain's economy and raise serious political problems for the ruling Khalifa family. Bahrain has already depleted much of its oil reserves and depends on its richer Gulf neighbors, particularly Saudi Arabia, to provide a large share of its revenues. Foreign exchange reserves have fallen by almost $350 million since 1981 to $1.4 billion and are now sufficient to cover only five months of imports. US Embassy sources report that unemployment and underemployment, particularly among the island's large Shia community—more than 70 percent of the population—already have risen to worrisome levels. The number of poor in Bahrain is growing, and many are complaining about the loss of jobs to expatriates. The US Embassy in Manama reports that many Bahrainis are grumbling about the Khalifa family's lavish spending habits, malfeasance, and the diversion of scarce financial resources from needed social projects to military purchases. 25X1

Thus far, the ruling family has ignored most suggestions that it curb its extravagance. We believe this cavalier attitude is weakening support for the regime, even among its traditional circle of Sunni supporters. Calls for a return to representative government are surfacing—the national assembly was suspended in August 1975—and some Embassy contacts are urging that the United States use its leverage with the regime to bring about a return to some form of popular participation as a way to enhance stability. 25X1

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Kuwait. Kuwait is in the best position to ride out the current period of economic stress. With more than $70 billion in foreign assets and a relatively small population, officials have room to maneuver, despite the sharp fall in oil revenues and stagnant domestic economy. Criticism of the government's handling of the economy and charges of favoritism in doling out compensation for the 1982 stock market crash, however, are on the rise. 25X1

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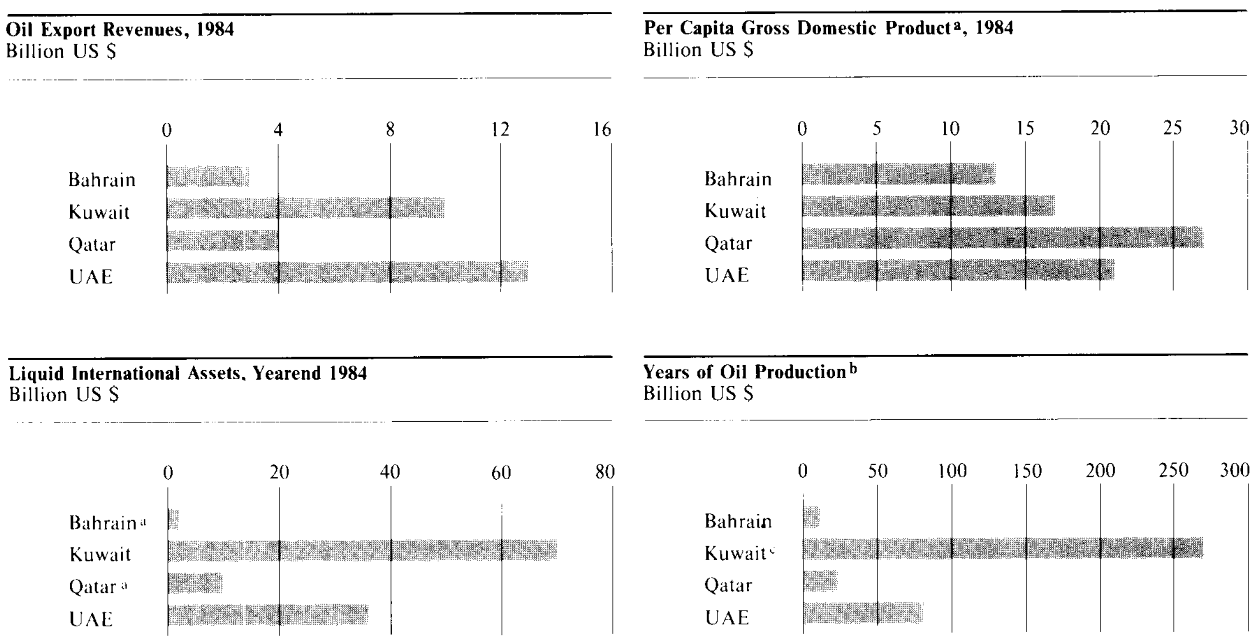
The ruling Sabah family faces a far sterner challenge on the political front. Since the February elections, members of the National Assembly have charged the government and individual ruling family members with mishandling the economy and malfeasance. They are joined by other critics who

Smaller Persian Gulf States: Growing Challenges



[a] Estimated.
[b] Proven oil reserves, yearend 1984 at 1984 rates of production.
[c] Excludes Neutral Zone reserves.

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want to make the Cabinet more responsive to the Assembly. The Assembly may try to force a confrontation with the government this fall when it begins its investigation of Oil Minister Ali Khalifa and his role in Kuwait Petroleum Company's ill-fated purchase of the US-based Santa Fe Corporation.

The Sabah government is unhappy with the Assembly's sharp attacks but is unlikely to close down the National Assembly as it did in 1976. No matter how obstreperous its behavior, the Assembly is a useful political safety valve. The Sabahs are more likely to sacrifice an additional Cabinet member and may even strip Crown Prince Saad al-Abdallah of his Prime Minister post. The family apparently believes Saad's position has been compromised by popular criticism that he was responsible for the stock market crash and for security failures associated with terrorist attacks this spring. 25X1

The United Arab Emirates. The decline in oil revenues has not yet seriously affected the UAE, but we believe that it could become a problem in the next three to five years. Still, the government drew down reserves in 1984 to cover revenue shortfalls, and probably will dip into this $36 billion cushion again if necessary. 25X1 25X1

The most immediate issue is political bickering among the ruling families of the federation. President Zayid, the 70-year-old ruler of Abu Dhabi, is still popular. Embassy reporting, however, indicates that Zayid's fellow rulers are disturbed that he is disengaging himself from decisionmaking even in Abu Dhabi and that Crown Prince Khalifa has taken advantage of his father's frequent foreign travel to assume control of daily decisionmaking both in Abu Dhabi and the federal government. According to Embassy reporting, Khalifa's determination to prevent corruption in military procurement and his rejection of demands for business bailouts and expensive infrastructure projects is making him unpopular in Abu Dhabi and the UAE as a whole. [redacted]

Qatar. Qatar has some internal problems but does not appear to be at serious risk from an economic downturn. Oil revenues have declined by 35 percent since 1981, prompting Doha to cut the current budget by an equivalent proportion. Doha, however, has relatively large international reserves—$10 billion—that could serve as a cushion against further oil price declines. It also has the smallest population and the highest per capita income of the Gulf states. [redacted]

Nonetheless, criticism of the Amir is increasing because he spends large sums of money on highly visible personal pleasures—the Embassy reports that spending on palaces is approaching a quarter of Qatar's annual oil income. If austerity measures become necessary to counter the decline in oil revenue, we believe that public disaffection, particularly among unemployed youth, would grow. [redacted]

Subversive Threat

The economic downturn in the Gulf is providing an atmosphere for dissent—and subversion. Despite enhanced security measures by the Gulf countries over the last few years, subversive activity has increased:

- Since the 1983 bombings of the American and French Embassies and government installations, Kuwait has suffered five other major terrorist attacks. Radical Shias, who allegedly were members of the Iranian-backed Dawa Party, were responsible for the 1983 bombings and may have conducted the hijacking of a Kuwaiti airliner in December 1984 and the attempt on the Amir's life. Security authorities suspect that Damascus was responsible for the bombings of two crowded cafes in June 1985. 25X1

  [redacted] the number of Bahraini Shia being recruited by Iranian-sponsored dissident groups is growing and that prominent Shia families in Bahrain are funding the groups. One such group, the Islamic Front for the Liberation of Bahrain, was responsible for a coup attempt in 1981. 25X1

- UAE diplomats abroad have been the target of terrorist attacks. [redacted] Iranian-backed 25X1 Shia groups have representatives in the UAE, and [redacted] UAE 25X1 authorities had arrested five armed Iranian nationals who were reportedly targeting the US Embassy and UAE Government officials and installations.

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- There have been no reported terrorist attacks in Qatar. In 1983, however, an arms cache was 25X1 uncovered, and members of the state police force were implicated in a Libyan-sponsored plot to assassinate a Gulf leader during the Gulf Cooperation Council summit meeting. [redacted] 25X1

Prospects

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Gulf leaders do not seem to be coming to grips with the long-term implications of the threats caused by their declining economies and the increased potential for subversion. With the exception of Bahrain, they still can rely on large international reserves to 25X1 offset further economic declines. [redacted] [redacted] both the rulers and the populace view the gloomy economic picture as a temporary phenomenon and refuse to acknowledge the 25X1 need for long-term economic adjustments. Nonetheless, we believe that popular expectations—which have risen during the oil boom years—will soon clash with the reality of economies whose oil revenues are unlikely to rebound before the end of the decade. [redacted] 25X1

As declining oil revenues force most people to reduce their living standards, we believe there will be growing criticism of the ruling families for taking an inordinate share of the national wealth. Charges of royal corruption by themselves will not lead to the overthrow of the families but could become a rallying point for dissidents. [redacted]

Except in Kuwait, the ruling families are ignoring the growing complaints from the business community and the upper and middle classes about the lack of political participation. Rulers continue to count on family councils, links to allied wealthy families and tribal groups, and the security services to keep the peace. We believe all the ruling families would resort to heavyhanded repression to prevent an erosion of their political power. [redacted] 25X1

Traditionally, when the ruling families in the Gulf have felt threatened by popular discontent, they have replaced the ruler with another member of the family or shifted power among the top decision-makers. If the current recession continues and popular discontent increases, the families in Kuwait, Bahrain, Qatar, and the UAE probably will shuffle leadership posts now held by the families and add some commoners to the government. Such changes, however, would only be cosmetic. [redacted] 25X1

Shifts of power within the ruling families would not significantly affect the Gulf states' relations with the United States. These new governments would remain pro-Western in outlook. In order to stave off public disaffection, however, the Gulf governments probably would distance themselves from Washington in a bid for renewed popular support. 25X1
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OECD Export Credit Negotiations— Limited Progress Expected [redacted]

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The OECD Export Credit Group will continue to make some progress toward reducing official export credit subsidies at this month's meeting in Paris, but we believe that significant changes are not likely to occur. Rather, the stage will be set for further negotiations on control over the use of tied aid credits,[1] interest rates, and the membership of advanced developing countries in the Export Credit Arrangement. At most, greater restraint on the use of tied aid credits may result if France can be pressured to succumb to the interests of the other OECD countries. [redacted]

Tied Aid Credits

The primary agenda item for the 16-20 September meeting will be tied aid credits with the focus on the use of blended credits—the combination of concessional and nonconcessional export financing. While the EC argues that tied aid credits provide needed economic assistance to developing countries, such credits can distort trade by using a small grant element to undercut minimum interest rate guidelines. France, in particular, began using tied aid credits as another way to subsidize exports as minimum interest rates under the Arrangement were increased. Most of the tied aid credits are in profitable sectors such as power, transportation, and telecommunications equipment. Most of these credits have also contained a low grant element of 20 to 30 percent, suggesting a goal of promoting exports as opposed to providing developmental assistance. [redacted]

Trying to control the use of tied aid credits, Arrangement members made it more costly for governments to use them. The minimum grant element was raised to 20 percent in 1982 and 25

[1] Tied aid credits—commonly referred to in the United States as mixed credits—are financing packages which combine aid funds with nonconcessional export financing from private or official sources. The term "tied aid credits" also refers to a single development aid loan with a low level of concessionality. [redacted]

The Arrangement

Attempting to limit expensive export credit competition, the OECD member countries agreed in 1978 to the "Arrangement on Guidelines for Officially Supported Export Credits." The Arrangement specifies guidelines for minimum interest rates and maximum credit lengths for government-supported export credits based on the relative wealth of borrower countries. In response to the increasing gap between market and subsidized rates, minimum interest rates were increased between 1980 and 1982: 25X1

- *Minimum interest rates are now composed of a basket of market long-term bond rates for the United States, West Germany, the United Kingdom, France, and Japan. The rates are adjusted semiannually if the new composite rate has moved by at least 0.5 percentage point since the last change. Also, the commercial interest reference rate (CIRR) system was introduced in 1983 to set rates for currencies of countries with low domestic interest rates, such as the yen, Swiss franc, and deutsche mark.*

- *Borrower countries are classified into three categories: I (relatively rich), II (intermediate), and III (relatively poor). Credit terms are easiest for poorer countries, even though their loans are riskier. As a result of US efforts, a plan has been devised to automatically reclassify countries. If implemented, this would bring several countries, including Singapore and Hong Kong, into Category I. Special sector agreements cover credit terms for ships, power plants, and satellite ground stations. An agreement on large civil aircraft was reached in July between the United States and the EC. The Arrangement excludes agricultural commodities.* [redacted] [redacted]

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percent in April 1985. Increases in the minimum grant element have not deterred the participants from trying to use tied aid credits. Actual commitments declined sharply in 1983 reflecting the LDC debt crisis and the worldwide recession but offers of such credits have risen steadily as competition for exports intensified.

The EC, led by France, rejects the 1983 US proposal, supported by several other OECD countries, to increase the minimum grant element to 50 percent. According to diplomatic reports, the EC claims this would reduce aid flows to developing nations. Progress at July's Export Credit Group meeting included: (1) agreement on a more comprehensive definition of tied aid credits and (2) improved transparency—or information-sharing—procedures requiring a longer prior notification period. Participants may now call for face to face consultations on tied aid credit offers if they have a complaint.

Tied Aid Credit Users[a]

Percent
Total: 10.8 billion US $

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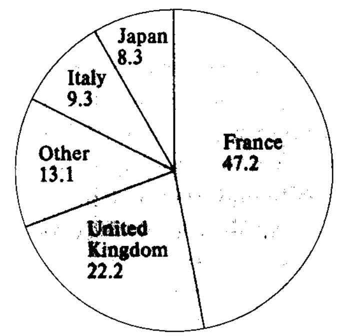

[a] OECD Development Assistance Committee data, tied aid credit commitments (1981-84 first half).

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Other Issues

Discussion of interest rate issues will center on setting rates, known as commercial interest reference rates (CIRR), for the currencies of countries with low interest rates, such as Japan. Participants are dissatisfied with the current CIRR system and will discuss a study's recommendations to improve the system. Members will also negotiate on possible sector agreements on credit terms for small aircraft and agricultural products. The United States, however, does not support an agreement on agriculture without parallel negotiations on agricultural export price subsidies.

The participants also will examine ways to bring new members, particularly advanced developing countries—including South Korea, Indonesia, Mexico, and Brazil—into the Arrangement. OECD members are concerned because some of the developing countries have begun to offer official export credits at rates lower than the Arrangement's minimum rates.

Outlook for Progress

We believe little, if any, substantive progress will be made on tied aid credit discipline during the September meeting. The EC, pressed by the French, will probably try to downplay the trade distorting impact of tied aid credits in order to avoid further control. In particular, we believe the EC will respond to the US proposal for a 50-percent minimum grant element by arguing that the new transparency procedures for tied aid credits need a longer trial period or have eliminated the need for additional discipline. France, moreover, may wish to avoid discussing further changes in discipline and subsidy reduction under the Arrangement until a decision has been made on the revisions to its export credit program. At best, the OECD members may be able to negotiate a moderate increase in the minimum grant element.

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Participants' Positions on Tied Aid Credits

France

Accounting for slightly less than one-half of tied aid credits supplied by the members of the Arrangement, France has been the stumblingblock in efforts to reduce subsidies. Paris typically provides only a small grant element to its tied aid credits. By targeting transportation, power, and telecommunications equipment, France hopes to spur its economic growth through exports. Paris, however, is considering a major overhaul of its export credit program to reduce the cost of export subsidies to the budget, according to US Embassy reporting.

Italy

Italy's tied aid credit program is modeled after the French, but is constrained by limited resources. Italy accounts for slightly more than 9 percent of total tied aid credits. According to diplomatic sources, a Ministry of Foreign Affairs official has been instructed to support France's position on tied aid credits in the EC council meetings, although he pledged to support the United States

The United Kingdom and West Germany

Great Britain and West Germany have traditionally sided with the United States in support of reducing subsidies. The two, however, face increasing pressure from commercial interests at home. London provides one-fifth of all tied aid credits, but Bonn has not been a significant player. The United Kingdom recently stepped up efforts to provide soft credit terms to promote exports, for example, to China. 25X1

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Japan

Japan publicly sides with the United States in support of increased discipline and transparency in tied aid credits, according to US Embassy reporting from Paris. Tokyo, however, is always looking for loopholes in the Arrangement to enable Japan to subsidize its exports. Japan accounts for slightly more than 8 percent of all tied aid credits. 25X1

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The participants will continue efforts to improve the CIRR system. Standardizing the methodology setting CIRRs should begin to reduce complaints about the operation of the current system. Although progress may be made toward an agreement on credit terms for small aircraft, it is unlikely that an understanding will be reached on agriculture, given the US demand for parallel talks on agricultural price subsidies.

The OECD Secretary General, along with the developed country participants, is concerned that the invitations to proposed members should be worded so that inclusion in the Arrangement cannot be interpreted as a step toward membership in the OECD itself. A Secretariat official reportedly believes that South Korea would accept an invitation to join the Arrangement, given Seoul's demonstrated interest in it. He was uncertain about Indonesia and Mexico but felt that Brazil would probably refuse to join.

Progress on tied aid credits beyond September's meeting will continue slowly, given the Arrangement's cumbersome negotiating process and France's intransigence. We believe that pressure for more control of tied aid credits will increase because of the cost of export subsidies to governments in a time of budget cutbacks. If the use of tied aid credits declines as a result of more discipline, we believe there will be complaints from the developing countries which have become used to concessional financing. 25X1

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Official Development Assistance: Growing Importance to LDCs [redacted]

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Official development assistance (ODA) to developing countries and through multilateral institutions has become relatively more important to the LDCs in view of sharp cutbacks in commercial bank lending. Last year, ODA accounted for 40 percent of the total financial flow [1] to LDCs, and for the least developed countries—which have almost no access to commercial credit markets—ODA comprised 90 percent of external resources. We expect recent moderate increases in ODA flows to continue over the next few years as donors make special emergency contributions to Africa while also expanding their regular aid disbursements. [redacted]

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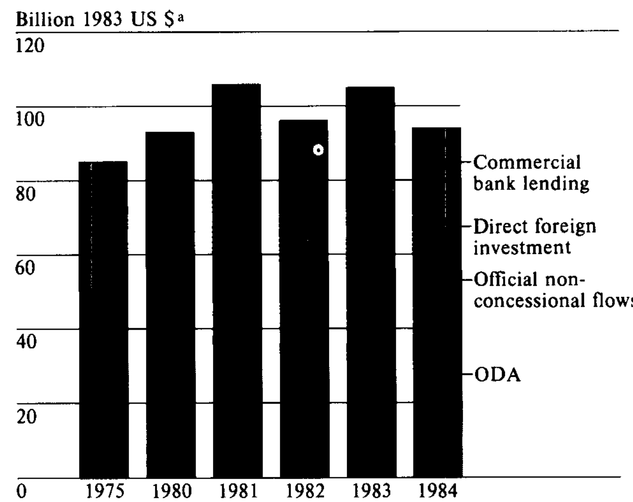
Net Financial Flows to LDCs in Selected Years, 1975-84



[a] Data adjusted to eliminate exchange rate fluctuations.

[redacted]

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Results in 1984

According to data recently published by the OECD, net disbursements of ODA from all sources totaled $38 billion [2] in 1984, in real terms this represented a 5.5-percent increase from 1983 and was only slightly below the 1981 peak. Lower oil revenues forced OPEC countries to cut their assistance to $4.6 billion, half the level in 1980. This decline was more than offset, however, by a 7-percent real increase in aid by the OECD Development Assistance Committee (DAC) countries, which provided over $29 billion. [redacted]

Italy posted last year's largest increase in ODA, boosting its assistance by 39 percent. Italy's aid program has grown the fastest over the past five years, up 22 percent at an average annual rate following Rome's 1980 decision to rapidly expand its development assistance. Finland, France, and Japan also have posted consistently large increases. Sweden, New Zealand, and the United Kingdom, in contrast, have been trimming their ODA disbursements. UK disbursements, in particular, have dropped 6 percent annually on average since 1979 in dollar terms. In sterling terms, however, UK aid levels have remained stable. [redacted]

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The DAC's official target for individual member aid disbursements is 0.7 percent of GNP, but only four of the 17 DAC countries met that level in 1984. The Netherlands reclaimed its top position under this criterion by donating 1.0 percent of its GNP last year, followed by Norway, Denmark, and Sweden. While US aid disbursements ranked last in 1984 on a GNP-proportional basis, US ODA flows remain by far the world's largest. [redacted]

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[1] The total comprises ODA, commercial bank lending, direct investment, and nonconcessional official lending. [redacted]

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[2] Data are calculated in constant 1983 dollars and at 1983 exchange rates. [redacted]

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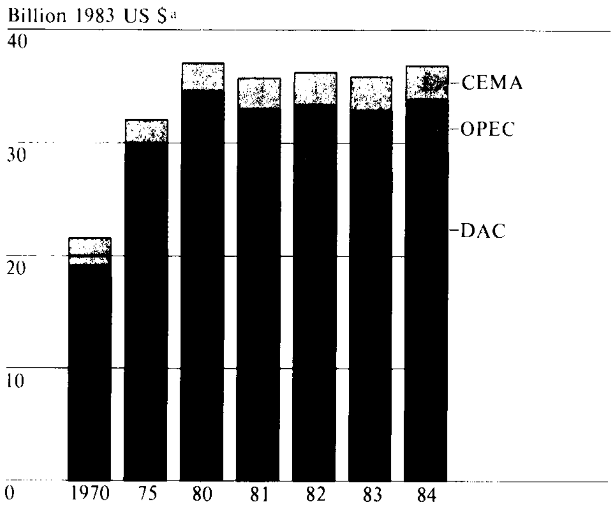
ODA Net Disbursements: DAC, OPEC, and CEMA Donors, 1970-84



[a] Data adjusted to eliminate exchange rate fluctuations.

[redacted]

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Top Ten Donors: Net Disbursements of ODA, 1984

	Million US $	Percent of GNP
United States	8,700	0.2
Japan	4,300	0.4
France	3,790	0.5
Saudi Arabia	3,310	3.3
West Germany	2,780	0.4
USSR	2,450 [a]	0.2 [a]
Canada	1,600	0.5
United Kingdom	1,430	0.3
Netherlands	1,270	1.0
Italy	1,100	0.3

[a] OECD data used for comparison. Intelligence Community estimates, based on differing definitions of aid flows, are substantially higher.

[redacted] 25X1

Importance of ODA

ODA continues to be focused on Asia and Africa, where most countries have limited access to private sources of funds and rely heavily on official flows. Together, Asia and Africa receive more than two-thirds of Western ODA. Egypt, India, Indonesia, and Bangladesh remain the key beneficiaries of DAC assistance, as well as being the top recipients of Western multilateral ODA. The Soviet Bloc, in contrast, concentrates its aid on Vietnam and Cuba. Over 85 percent of OPEC's aid is allocated to Arab neighbors such as Syria, Jordan, and Sudan. [redacted] 25X1

About two-thirds of total ODA is directed to development projects in the recipient countries. For the least developed countries, these flows are essential to undertake the investments in public utilities, agriculture, education, and health needed to increase GNP and exports—projects they are too poor to pay for alone. Because these projects yield returns only after 10 years or more, these poor countries must rely on the concessional terms of ODA to finance such long-term investments. [redacted] 25X1

Although project financing is important, most low- and middle-income countries are also experiencing immediate balance-of-payments and domestic budget problems. In these circumstances, direct assistance not tied to specific projects would help stabilize the economy by financing critical imports to maintain existing plants and equipment; DAC members, however, have allocated only about 10 percent of ODA in recent years for general financial assistance. In contrast, more than half of all OPEC ODA goes for general support, and less than 20 percent for project financing. [redacted] 25X1

Outlook

We expect total ODA to increase by about 4 percent in nominal terms in 1985, as DAC members make special emergency contributions to Sub-Saharan Africa while continuing to expand their

Top Ten Recipients:
Net Disbursements of ODA, 1983 [a]

	Million US $	Current Account *million US $*
India	1,720	−2,780
Egypt	1,456	−785
Israel	1,345	−2,240
Vietnam	1,287	−926
Bangladesh	1,072	−77
Sudan	964	−220
Syria	956	−815
Cuba	901	... [b]
Indonesia	744	−6,338
Pakistan	742	25

[a] OECD data.
[b] Comparable data unavailable.

[redacted]

regular aid activities. The average ODA/GNP ratio will remain near 0.4 percent. For 1986, we expect another comparable increase. These estimates depend on several assumptions:

- For countries that have adopted specific GNP-tied targets—Denmark, France, the Netherlands, and Sweden—ODA prospects depend directly on continued economic recovery.
- For countries which have adopted medium-term aid programs—West Germany, Italy, and Japan—budgetary constraints would not significantly affect planned aid increases.
- The key OPEC donors—Saudi Arabia, Kuwait, and UAE—probably will avoid further deep cuts in their cash contributions. [redacted]

The ODA outlook for Japan, France, and West Germany is one of continued growth to fulfill the medium-term programs each has adopted. Although Japan likely will fall short of its plan to double ODA during 1981-85 compared to 1976-80, we expect Tokyo to adopt another ambitious five-year aid plan, and to maintain ODA growth at about 10 percent annually in coming years. France decided in 1981 to achieve the 0.7-percent target ODA/GNP ratio by 1988. France would have to boost aid by about 12 percent each year to reach this target, but we believe Paris will make strong efforts to attain its goal. West Germany also has adopted the 0.7-percent ODA/GNP goal, but without a specific deadline. We expect Bonn will have little difficulty meeting the 3.5-percent aid increases in 1985 and 1986 called for in its ODA program. [redacted] 25X1

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[redacted] 25X1

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International Financial Situation: Political Update

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We believe recent difficulties in implementing economic reforms indicate that a number of debtor countries face a moderate to serious threat of political unrest over the next 12 months. Leaders in these countries are likely to attempt to defuse such problems by retarding or reversing the pace of economic reform.

In a few countries, there have been significant changes in political and economic situations. For example, President Garcia of Peru—playing to his domestic supporters—has linked interest payments on foreign debt with export earnings, a move that will make an agreement with creditors difficult. Garcia's initiative will also make it more difficult for other Latin leaders, such as President Alfonsin of Argentina, to sell their austerity programs domestically.

Elsewhere, Mexico's President de la Madrid has instituted budget cuts in an attempt to redress Mexico's financial troubles. The cuts—which are temporary and probably will prove insufficient to keep Mexico within IMF targets—were made necessary partly by the spate of spending preceding the recent midterm elections. Mexican officials know, however, that these spending cuts and other measures designed to promote efficiency in Mexico's industrial sector are opposed by labor. In fact, organized labor officials have already cautioned de la Madrid that they will have a more difficult time holding the rank and file in line if the three-year drop in living standards is not reversed.

In Nigeria, the drop in oil export earnings and the resulting continued economic difficulties played a key role in the recent coup. General Babangida, Buhari's successor, is deeply concerned with Nigeria's lack of economic progress and may find support—at least initially—for a new agreement with the IMF. 25X1

Coming to grips with Nigeria's myriad economic problems will be difficult even if negotiations with the IMF start soon. 25X1

Prime Minister Junejo of Pakistan announced the transition to civilian government to coincide with the lifting of martial law by 1 January. The effects of a deteriorating foreign exchange situation and related cutbacks as well as increased Shia militancy are cause for concern and could postpone both the lifting of martial law and the elections. 25X1

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In other debtor countries, longstanding governments are facing formidable opponents. President Marcos faces increasing opposition in the Philippines, especially from Communist insurgents. Continued economic decline has prompted a sharp increase in labor strikes and has probably provided greater receptivity for the Communist front groups among low- and middle-income Filipinos. Most notable among Manila's current economic woes is the 11-percent drop in export earnings due to weak international markets and a rigid exchange rate. Although Marcos has survived the fallout from the Aquino assassination, continued economic problems—in addition to the deteriorating political environment—will bolster the insurgency and increasingly cause problems for him in the scheduled 1986 local and 1987 presidential elections. 25X1

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In Chile, pressure from far-left groups could prompt President Pinochet to reinstate the recently lifted state of siege, which would erode much-needed bilateral and multilateral financial support. A rash of bombings and protests followed the recent revelation of police responsibility for killing Communists in March. The lifting of the state of siege in early June was instrumental in securing commitments for World Bank and IMF support, but a resumption of the crackdown could slow disbursements. 25X1

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Briefs

Energy

Industrialized Countries Reliance on Persian Gulf Oil

The recent attacks against Khark Island by Iraq has renewed concern about oil flows from the Persian Gulf region. Persian Gulf countries are now exporting about 7.5 million b/d, accounting for about one-fifth of total non-Communist oil supplies. Of this, some 6 million b/d flow through the Strait of Hormuz with the remainder shipped via pipelines from Saudi Arabia and Iraq to the Mediterranean and Red Seas. In first-quarter 1985, Western Europe, Japan, and the United States relied on the region for about 18 percent, 58 percent, and 4 percent, respectively, of their total oil imports. Although Western 25X1
Europe's reliance on the region has declined in recent years, several countries remain heavily dependent on Persian Gulf oil. Italy, Greece, Portugal, and Turkey received from 33 to 80 percent of their oil supplies from the region during first-quarter 1985. As a result, we expect these countries would have the greatest difficulty lining up alternative supplies in the event of a disruption in the Persian Gulf. 25X1

International Finance

South African Response to Debt Crunch

Pretoria's four-month suspension of overseas debt repayments and reintroduction of penalties for the withdrawal of foreign capital probably were intended to buy time to negotiate debt restructuring, but will add to the cost of future loans. Some two-thirds of the South African debt of about $20 billion comes due in the next 12 months, and political uncertainties have led some foreign banks to press for repayment. Despite a strong current account surplus and a ratio of debt to GDP lower than that of most major debtor nations, the debt crunch and Pretoria's extreme measures to solve it probably will prolong South Africa's economic slump. Pretoria is likely to try to reduce its foreign debt by maintaining tight credit policies to hold down imports and sustain a current ac- 25X1
count surplus. Economic recovery, however, probably requires a significant increase in the world price of South Africa's mineral exports, particularly gold, that accounts for half of export earnings. 25X1

Portuguese Financial Reform Package

The Ministry of Finance and the Bank of Portugal have agreed on a financial reform package aimed at increasing private investment and reducing the burden of the budget deficit on the domestic banking industry. With inflation expected to fall this year, nominal interest rates have been lowered to reverse the steady decline in real private investment since 1980. We do not expect an economic recovery until 1986, however, when increased domestic demand and improved EC market access stimulate manufacturing activity. Bank profits will likely improve as the government begins issuing treasury bills to help 25X1
finance the budget deficit. The nationalized banks, which have been forced to

lend to the government at below market rates, will now be able to increase lending to the private sector at better rates of return. Lisbon expects to finance about 40 percent of the budget deficit with treasury bills this year and to progressively increase this share until most of the deficit is financed with this instrument. [redacted] 25X1

IMF and World Bank Loans to Bangladesh Delayed

[redacted]

A senior Bangladesh Government official told US diplomats that $280 million in loans from the IMF and World Bank are being delayed because Dhaka has not followed through on several promised economic reforms. The government recently reversed its agreement to implement new taxes and salary cuts for government employees, costing Dhaka an estimated $45 million in anticipated revenues. It also has allowed private credit to expand faster than the IMF target. Negotiations on loan terms will continue, but Dhaka will be reluctant to undertake austerity measures at a time when it is trying to set the stage for national elections. Without the loans, foreign exchange reserves—estimated at $360 million, equal to about six weeks' imports—will fall even more. [redacted] 25X1 25X1

Islamabad Moves To Resolve Financing Problems

[redacted]

Pakistan's Finance Ministry has arranged a $150 million, five-year loan from a group of five international banks. The interest rate—seven-eights of a point over LIBOR for the first two years and one point over for the final three years—is higher than the rate on a similar $125 million loan obtained last year. Although two US banks are participating, several other US banks declined because of concerns over Pakistan's creditworthiness. [redacted] a US bank [redacted] recently lowered Pakistan to its lowest credit rating category, primarily because of the recent decline in Pakistan's foreign exchange reserves. In a separate move to help finance the government's budget deficit, Islamabad is allowing banks to loan 100 percent of the purchase price of special national fund bonds at 4 to 5 percentage points below the market rate. Previously, the banks were limited to a maximum of 75 percent at the market rate. US Embassy sources indicated that bond sales probably would exceed—by perhaps $100 million—the target of $300 million by 31 August. The financing changes have allowed the government to disguise its bank borrowing, but may add to inflationary pressures. [redacted] 25X1 25X1 25X1 25X1

More Bulgarian Borrowing

[redacted]

Bulgaria is arranging its second loan syndication in three months, according to the US Embassy. The Japanese-led loan is for $100 million on favorable terms—eight-year repayment and an interest spread of three-eighths percentage point over LIBOR. Western observers believe that lenders' enthusiasm will increase the final total for the loan to more than $200 million. The two credits are the first loans to Bulgaria by Western banks since 1979. Declining hard currency trade earnings, agricultural shortages, and the threat of a second energy crisis this winter probably contributed to Sofia's decision to seek new credits, despite its concerns about increased borrowing. [redacted] 25X1 25X1

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UK Rail Strike Vote Weakens Unions

The vote last week by British railway workers to reject a nationwide strike further weakens the union movement. Newspapers are describing the vote—which most political observers had believed would be affirmative—as a devastating blow to railway union leaders. Unlike the miners, the railway leaders had decided to hold a prestrike ballot to abide by trade union laws passed in 1984. Union leaders were opposing plans to eliminate some jobs. The railway workers' decision added to tensions at this week's annual meeting of the Trades Union Congress, already troubled by splits in the miners' union. Prime Minister Thatcher's government will view the ballot as vindicating its union legislation, which is designed to reduce the number of walkouts. Thatcher is likely to cite the vote as evidence that the British people approve of her efforts to break down barriers to economic efficiency.

Greek Economy Worsening

Prime Minister Papandreou presented a bleak picture of the Greek economy in a major speech at Greece's largest annual trade fair last weekend. He said that Greece's 17-percent inflation rate and its approximately $15 billion foreign debt must be reduced, hinting that austerity measures are in order and that some key labor gains—including wage indexing—may have to be adjusted. Papandreou is likely to try to moderate his inflationary election-year wage policy, but he probably will face strong resistance from labor, especially the large Communist unions. The worsening economy also is likely to put pressure on Papandreou to improve relations with the United States and other Western allies. Greece depends heavily on them for bank loans, and its need to borrow will be growing.

Less Developed Countries

Seoul Moves To Boost Economy

Seoul is cautiously loosening its austere monetary and fiscal policy to reverse a broadly based economic slowdown—real GNP growth was a meager 2.7 percent in the second quarter and 3.2 percent for the first half, the lowest gain in four years. The cornerstone of pump-priming measures is a $281 million supplementary budget, passed late last week, which will boost government spending on construction by $242 million. The balance will go to welfare programs. In addition, Seoul has earmarked $531 million to bolster investment in manufacturing sectors, such as autos and electronics. These high-growth areas are dominated by large conglomerates that, until an easing of credit controls last month, were unable to finance many of their expansion plans. Seoul has also increased export financing, reduced redtape, and is aggressively devaluing the won to help spur exports. With the abandonment of monetary targets, M2 grew at a 15-percent annual rate in June. 25X1

Economic policy makers, however, have avoided "quick fix" options that would risk a return to high inflation and a deteriorating foreign payments position. Nonetheless, forces largely outside Seoul's control will shape second-half economic growth and, in our judgment, the measures announced so far will have little immediate effect if demand for Korea's exports remains flat. While economic technocrats have been the target of criticism from the press, the opposition party, and conservatives in the bureaucracy, international bankers' confidence in their ability to manage the economy remains firm. Calls to abandon austerity will likely intensify, but we believe major policy changes are unlikely. Seoul may slow market-opening measures to quiet domestic criticism, but such moves may prompt retaliation by major trading partners. 25X1

South Korea Promotes Aircraft Industry

Seoul has targeted the creation of an aerospace industry as one of its strategic goals and already has given a mandate to an engineering effort to design the country's first domestically produced aircraft—a small piston engine plane. Currently, South Korean firms only assemble aircraft engines and fabricate fuselages. The government has established a high-level committee to prepare a long-term development plan for the industry, including financial and tax benefits for firms manufacturing aircraft parts. As a further stimulus, Seoul will require foreign manufacturers to buy Korean aircraft parts as a condition for aircraft sales to Korea. Seoul also will seek technical assistance through joint ventures particularly with US firms. 25X1 25X1

South Korea's advance into the aviation industry is part of a broad effort to foster technology-intensive industries, including semiconductors, computers, telecommunications, autos, and machine building. Private firms, spurred by government incentives, are sharply boosting R&D expenditures. Weaknesses in domestic technological capabilities and shortages of skilled labor, however, pose obstacles to achieving government targets. 25X1

Saudi Arabia Cuts Health Spending

Riyadh plans to drastically cut Ministry of Health expenditures under its austerity budget for FY 1985/86. Health care spending—traditionally spared the budget ax—will decline to $2.5 billion, down 26 percent from its FY 1984/85 level. The Ministry of Health reportedly has announced that free care will be available only to Saudis and North Yemenis—2.7 million expatriates of other nationalities will be charged for these services. It has called for a 60-percent reduction in pharmaceutical purchases. The Ministry also has begun to replace Western physicians and staff with relatively cheaper 25X1

Pakistanis, Thais, and Filipinos. Operations and construction will absorb 41 percent of the Ministry's cuts and plans to build 36 new hospitals this fiscal year probably will have to be stretched out or canceled. These cuts will have a serious effect on the quality of medical services provided. [redacted] 25X1

Iran's Import Slide

[redacted]

Sagging oil sales and low foreign exchange reserves have forced drastic reductions in Iranian imports since the beginning of the year and led to a bitter debate within the government. Imports in the first quarter of 1985 from OECD countries—about two-thirds of total imports—were down 46 percent from the same period in 1984. According to Iranian trade data, total imports in June were 43 percent lower than a year earlier. Growing shortages of spare parts and raw materials have caused already depressed industrial output to fall even further, according to press reports. Members of the Consultative Assembly—Iran's parliament—recently charged Prime Minister Musavi's government with financial mismanagement and passed a bill imposing severe restrictions on expenditures of foreign exchange. More political conflict is likely as stricter limitations on transfers of foreign currency and confiscation of profits from sales abroad heighten dissatisfaction within the powerful merchant class. [redacted] 25X1 25X1

Another Record Indian Foodgrain Crop Likely

[redacted]

Another record foodgrain crop is likely in the 1985/86 (July/June) crop year, bringing problems as well as advantages. The US Embassy reports that rainfall during the southwest monsoon has been normal or above normal in over 90 percent of India's major foodgrain growing regions. Besides the probability of an adequate monsoon, crop production will be enhanced by increased irrigation, rising fertilizer use, and the rapid spread of high-yielding seed varieties. Another record crop, however, will aggravate acute storage problems and depress already sagging farm prices as well as push up food subsidies that reached over $900 million in FY 1984/85. A bumper crop will also add increased urgency to New Delhi's efforts to promote agricultural exports, particularly wheat to the USSR and Middle East. [redacted] 25X1 25X1

Grenada's Investment Problems

[redacted]

As Grenada approaches the second anniversary of the US-led intervention, the country's inability to attract significant foreign investment is compounding the island's severe economic problems. The country desperately needs new investment to ease the government's serious liquidity problems and to reduce the island's 35-percent unemployment rate. The government has tried to promote new investment by selectively offering tax breaks and other incentives. Grenada's investment climate, however, is hurt by weak infrastructure, an inadequately trained labor force, and vivid memories of the country's political instability, according to US Embassy reporting. As a result, the government is considering additional measures to lure foreign business. If the poor economic situation persists, public support for the Blaize government could be seriously undermined. [redacted] 25X1 25X1

Communist

Continued Stagnation of the Hungarian Economy

The Hungarian economy remained in the doldrums during the first half of 1985. Industrial production grew only 0.4 percent over the level of January-June 1984—well short of this year's target of 3 percent. Only the energy, chemical, and machine-building sectors posted small gains. Harsh winter weather and continued cutbacks in investment caused major declines in construction, 13 percent, and building materials, 7 percent. Falling prices for agricultural exports cut hard currency earnings slightly from the level of the first six months of last year, while increased purchases of energy boosted imports by 16 percent. As a result, the hard currency trade balance showed a deficit of $100 million compared with a $300 million surplus for the same 25X1 period last year. Although Budapest has raised large loans from Western banks this year, continued poor economic results could reverse the recent improvement in Hungary's financial position 25X1

China Encouraging Wheat Exports

Beijing plans to begin exporting domestically produced summer grain—largely wheat—according to a senior Ministry of Commerce official. The Chinese have made some small wheat sales this year, although these were actually reexports of US and Australian wheat. China is encouraging provinces to export grain in order to earn foreign exchange and reduce stockpiles. Most sales have been of corn, but with Beijing's encouragement northeastern 25X1 provinces may begin to compete with US sales to Japan, South Korea, and the eastern Soviet territories. The quantities sold will be limited, however, by China's transportation problems and port congestion. 25X1

China Codifying S&T Reforms

China announced last week that it was drafting new legislation governing science and technology management. At a national conference, S&T Minister Song Jian said the laws will cover such topics as the rights of scientists and technology transfer. The legislation—to be drafted by a committee under the State Science and Technology Commission—will standardize and institutionalize S&T reforms announced by the Central Party Committee in March. China has been implementing changes in S&T management on an experimental basis for several years, but bureaucratic resistance and confusion have 25X1 slowed the pace of reform. Giving the measures the force of law reemphasizes Beijing's commitment to the changes. 25X1

Beijing Divesting Small Businesses

Ownership of nearly 55,000 small businesses—nearly 70 percent of the total—has been transferred from the state to individuals and collectives since the State Council launched small business reform last year. According to the Ministry of Commerce (MOC), these changes in management have generally resulted in improved efficiency and larger incomes for employees. Despite encouraging results, some conservative leaders oppose small business reforms as a step back from socialism. A MOC official recently complained that some businesses have not reinvested sufficient funds and have distributed all profits to their workers, while others have switched lines of business without permission. To counter these trends, the MOC plans to issue new regulations on finance, taxes, and labor management for private enterprises.

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