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# International Economic & Energy Weekly



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18 October 1985

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18 October 1985

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

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*Comments and queries regarding this publication are welcome. They may be directed to [Redacted] Directorate of Intelligence, [Redacted]* 25X1

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**International  
Economic & Energy Weekly**

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**Synopsis****Perspective—Japan's Growing Trade Surplus: What Can Tokyo Do?**

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There probably is little Tokyo can do—short of sharply restricting exports—to keep the trade surplus with the United States much below its current \$45 billion annual rate over the next year. Nonetheless, we believe Tokyo could take a number of steps—in the form of a coordinated program—to slow and perhaps reduce its trade surplus with the United States within two to three years.

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**EC-Japan: Growing Trade Tensions**

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West European leaders are becoming increasingly frustrated with Tokyo over Japan's growing trade surplus with Western Europe, the concentration of Japanese exports in manufactures sensitive to the West Europeans, and the unwillingness of Tokyo to open up Japanese markets to EC exports.

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**South Africa: Impending Debt Negotiations**

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Talks involving South African financial officials and the country's major creditors are scheduled to begin next week. We expect a rescheduling agreement will be forthcoming, but recalcitrance on the part of the South Africans or a new political or economic shock could unravel the proceedings.

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**Venezuela: Economic Controls Limit Growth**

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Venezuela's reliance in recent years on economic controls has allowed it to protect itself from some, mostly short-term, economic blows, but at the cost of more fundamental distortions in the structure and efficiency of the economy. Despite some recent loosening of controls, we believe President Lusinchi plans only to tinker with the current system rather than implement the broad economic liberalization that business says it wants.

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**Latin America: Continued Danger From Inflation**

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Popular discontent with price rises and the resultant declines in living standards have recently led most Latin American governments to implement tougher anti-inflationary measures. We doubt they will succeed in bringing down high inflation, which we believe will continue to impede economic recovery and to alienate the middle and lower classes.

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**CEMA's Troubled Consumer Goods Industries: A Soviet Perspective**



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Faced with chronic shortages of common consumer items and production bottlenecks, Moscow is calling on its CEMA allies to increase exports of finished consumer goods. Eastern Europe, however, may be hard pressed to meet Soviet expectations for soft goods because production prospects to the year 2000 appear bleak.



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**International  
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18 October 1985

**Perspective*****Japan's Growing Trade Surplus: What Can Tokyo Do?***

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In his meeting with President Reagan next week, Prime Minister Nakasone will probably insist Japan is doing all it can to reduce its trade surplus with the United States. Nakasone is likely to cite the recent acceleration in planned tariff cuts, easing of product and certification standards, the joint currency intervention begun last month, and measures to expand domestic demand currently under discussion in the Diet. The Prime Minister is also likely to stress planned increases in foreign aid and defense spending as examples of Japan's growing role in the international community.

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There probably is little Tokyo can do—short of sharply restricting exports—to keep the trade surplus with the United States much below its current \$45 billion annual rate over the next year. Even export restrictions might prove ineffective for products, such as automobiles, in which price increases could offset the drop in export volume. At the same time, a number of studies by US academics suggest that, if Tokyo were to remove all of its trade barriers, its imports would increase by at most \$5-10 billion—with no guarantee that most of this would go to US firms. The easing of some agricultural barriers over the past year, for example, has resulted in sharply increased imports from Australia. Moreover, even if currency intervention is successful in a sustained strengthening of the yen, it will probably take 12 to 15 months before the impact shows up in trade statistics.

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Nonetheless, we believe Tokyo could take a number of steps—in the form of a coordinated program—to slow and perhaps reduce its trade surplus with the United States within two to three years. Measures to stimulate Japanese domestic demand would have the most visible impact on the trade balance over the medium term, in our view. Stimulative measures would boost economic growth—thus raising imports—and also absorb some of the excess domestic savings now flowing abroad and depressing the value of the yen. Tokyo could:

- Cut taxes or implement tax credits to encourage consumer spending, housing construction, and domestic infrastructure investment.
- Revise its monetary policy to provide easier credit for housing and consumer goods, while being careful not to reduce Japanese interest rates enough to accelerate the capital outflow.
- Expand government spending on public works or social insurance programs.
- Accelerate efforts to open its market and liberalize its financial sector.
- Embark on longer-term measures to reduce the high savings rate and increase domestic consumption and investment—such as reducing or eliminating the tax exemption on personal savings.
- Adopt policies designed to reorient private investment from productivity-enhancing plant and equipment toward domestic infrastructure.

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Tokyo could also encourage the Japanese private sector to accelerate actions that may ease the trade imbalance in the next few years. Japanese automobile and electronics companies are stepping up equity investment in the United States to circumvent possible export restrictions, reducing their future need to export such products. Japanese securities firms—fearing an eventual sharp fall in the dollar—may soon cut back on the purchases of US stocks and bonds, even if the interest rate differential remains. This would ease downward pressure on the yen. [redacted]

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Political realities in Japan—including the commitment to reducing the deficit without tax increases and powerful opposition to changing the central role of savings in the Japanese economy—make large-scale adoption of public-sector measures unlikely any time soon. Nonetheless, concern in recent months over possible US trade restrictions has led Tokyo to consider some of these proposals, especially domestic demand expansion, more seriously than in the past; some minor tax cuts and housing incentive measures may be adopted in the current Diet session. Fear of US actions has eased a bit in the past few weeks, however, with the perception of Japanese officials that Congress is now less likely to pass stiff protectionist legislation aimed at Japan. [redacted]

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### EC-Japan: Growing Trade Tensions

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West European leaders are becoming increasingly frustrated with Tokyo over Japan's growing trade surplus with Western Europe, the concentration of Japanese exports in manufactures sensitive to the West Europeans, and the unwillingness of Tokyo to open up Japanese markets to EC exports. An EC-Japan trade ministerial meeting next month in Tokyo probably will not produce enough results to ease West European concerns. In the meantime, Community members continue to take protectionist steps to keep the pressure on Tokyo to do more.

West Europeans have added to the deficit problem by ignoring the Japanese market, preferring to concentrate on their larger, more familiar EC market. With high Community unemployment and slow economic growth, EC countries are now more willing to tackle the Japanese market. Their efforts, however, have been hampered by inept marketing, impatience in developing ties to Japanese wholesale and retail distributors, and failure to meet the standards of the quality-conscious Japanese consumers. In addition, Japanese nontariff barriers—licensing procedures, product standards, the retail distribution system, and attitudes toward foreign products—contribute to the low level of EC exports to Japan.

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### EC-Japanese Trade

Western Europe's trade with Japan has grown more lopsided in the last few years. Last year the Community's deficit with Japan was a record \$10.9 billion, or fourfold the amount nine years ago and nearly equivalent to the EC's total trade deficit. The deficit has grown steadily since 1980—despite a 40-percent appreciation of the yen against the West European currencies—and the 1985 figure will be on a par with, or slightly exceed, the 1984 deficit. According to our econometric model, barring a recession in Western Europe, the bilateral deficit would climb to \$12 billion in 1986 and \$13 billion in 1987. Excluding intra-Community trade, purchases of Japanese goods now account for 6.5 percent of EC imports, while sales to Japan amount to only 2.5 percent of total EC exports.

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In addition to the growing deficit, West Europeans are also concerned about the increasing concentration of Japanese exports in machinery and transportation equipment—mainly autos. Since 1980, their share of EC imports has risen from 54 percent to 64 percent. In 1984, autos, stereos, computers, cameras, and ships accounted for 44 percent of EC imports from Japan up from 31 percent in 1980. West Europeans argue that this product concentration has contributed to the problems faced by some EC industries, such as the British motorcycle and German camera industries. West European governments are especially concerned about the impact of foreign competition on traditional industries with large work forces—machinery, autos, and shipbuilding—and on those areas where they hope to improve competitiveness, particularly in high technology and electronics.

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The Japanese have been able to overcome the exchange-rate factor through aggressive export policies. Since profits from sales to the United States have generally been good, the Japanese also have been willing to cut profit margins in Europe to maintain market share. Low prices on Japanese photocopiers, typewriters, excavators, and ball bearings have led to recent dumping investigations by the European Commission.

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**European Community-Japanese Trade***Million US \$*

	1975			1984		
	Exports	Imports	Balance	Exports	Imports	Balance
<b>European Community</b>	3,408	6,006	-2,598	8,543	19,403	-10,861
West Germany	1,137	1,658	-521	2,649	6,621	-3,973
United Kingdom	810	1,471	-661	1,522	4,675	-3,153
Netherlands	214	726	-511	434	1,816	-1,381
Belgium-Luxembourg	162	509	-348	459	1,349	-891
Greece	39	336	-297	76	791	-715
France	500	699	-199	1,237	1,936	-699
Denmark	146	216	-69	878	937	-58
Ireland	34	58	-24	239	247	-8
Italy	365	333	32	1,049	1,032	17

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**EC Response**

Without trade restrictions, Japanese penetration of the EC market would be even higher. France, for example, restricts the import of Japanese cars to only 3 percent of its market, while Italy allows just 2,500 Japanese cars to be imported per year. As a result, Japanese cars account for 10 percent of the EC market, compared to about 20 percent in the United States.

Since 1982 West European governments have taken an increasingly tough position on trade issues with Japan. The EC in 1983 enacted a long list of nontariff restrictions covering vehicles, video recorders, TVs, machinery, and other goods. Most recently, the EC Commission boosted the import duty on VCRs by 6 percentage points to 14 percent; the action was timed to coincide with the expiration of the restraint agreement with Japanese VCR producers. The Europeans are probably willing to impose more costly tariffs if Japanese sales of VCRs in the Community greatly exceed last year's quota of 2.25 million units.

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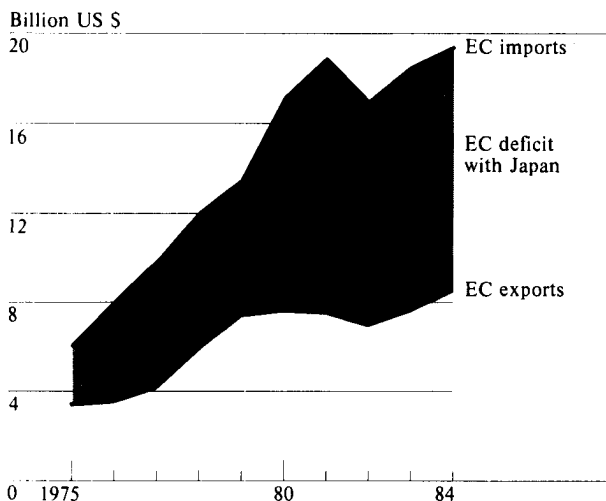
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**EC: Trade With Japan, 1975-84**



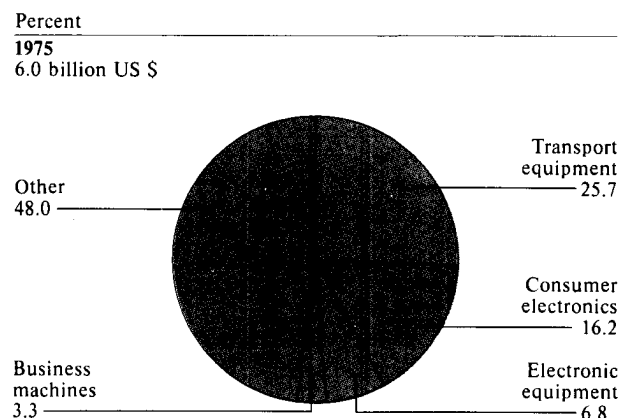
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**Japan's Response: Too Little, Too Late**

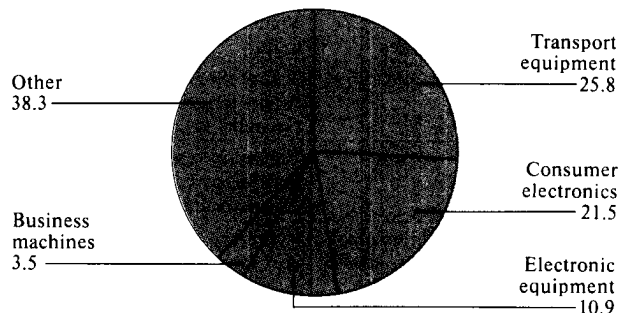
Japanese efforts this year to reduce trade tensions with the Community have been unsuccessful and backfired in one case. Japan and the EC in January set up the Trade Expansion Committee (TEC) as a trial forum to resolve trade problems, mainly through increasing EC exports. Instead of lowering tensions, the TEC has become an additional source of Community irritation with the Japanese, making an extension beyond 1 February 1986 doubtful. Two TEC meetings have been held thus far and, according to US Embassy reporting, the EC delegates are "extremely unhappy" because there has been "no progress on anything."

The EC's evaluation of Japan's "action program"—the latest effort by Tokyo to soften foreign criticism of Japanese import restrictions—has been largely negative. The tariff reduction portion, which consisted of reductions by 20 percent or more on a list of 1,800 items, was viewed by

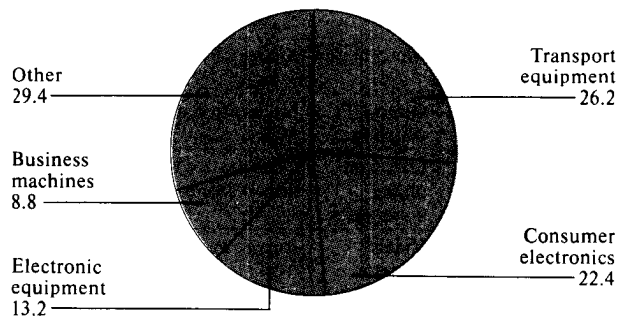
**EC: Imports from Japan, by Type**



1980  
17.1 billion US \$



1984  
19.4 billion US \$



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**EC and Member Countries:  
Major Restrictions  
on Japanese Products**

	Country	Product	Measure
1953	Italy	Autos	2,500 vehicle import quota.
1977	France	Autos	3-percent market share limit.
1978	UK	Autos	"Unofficial" agreement between British auto industry and Japan's. Same measure imposed on light-commercial vehicles in 1981.
1982	France	Color TVs and radios	Voluntary quotas.
		Motorcycles	Surveillance and administrative guidance to importers.
		Video cassette recorders	Various restrictions, e.g., "customs formalities" and prior import reporting.
1983	EC-wide	Video cassette recorders	Voluntary restraint of 2.25 million units in 1984 (3.95 million in 1983).
		Color TV tubes	Voluntary restraint of 900,000 units.
		Color TVs	Voluntary restraint through an export forecast by Japan (West Germany in 1981).
		Autos	Voluntary restraint through export forecast by Japan (West Germany and Benelux in 1981).
		Numerically controlled machine tools	Voluntary restraint through export forecast by Japan.
		Light-commercial vehicles	Moderation of exports by Japan.
		Forklifts	Moderation of exports by Japan.
		Motorcycles	Moderation of exports by Japan.
		Quartz watches	Moderation of exports by Japan.
		Italy	Cast iron piping accessories
1984	France	Video cassette recorders	Import monitoring (a priori).
1985	France	Hi-fi equipment and motorcycles	Import surveillance.
	UK	Numerically controlled machine tools	Interindustry agreements.

[Redacted]

Community leaders as modest and directed more toward the United States. A recent EC Commission study noted that agricultural products, chocolate, biscuits, leather, and shoes—products of particular interest to the EC—were not included. Tariff reductions on wine and spirits, which the Community has long sought, will not be effective until 1987. In addition, the study concluded that the action program's measures dealing with the more important nontariff barriers will not have much effect on the trade deficit. Nakasone's efforts to sell the action program when he visited Western Europe in July failed to ease West European concerns, and, partly as a result, EC Commission President Delors proposed holding a ministerial-level meeting in November to discuss EC-Japanese relations. [Redacted]

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**Outlook**

Community officials probably will make the flaws they find with the action program and lack of progress in TEC the dominant topics of the November meeting. We expect little to come out of the discussion to satisfy the EC's major complaint—the growing trade deficit. Tokyo's major concern in the short run is its trade relations with the United States—the largest market for Japan—making any major new trade concession for the EC doubtful at this time. [Redacted]

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Japanese intransigence on trade liberalization will likely draw more protectionist responses from the West Europeans, as well as complicate the way to GATT negotiations next year. Without serious market-opening measures, Japan faces more tariff increases, more antidumping actions, broader use of voluntary export restraints, and other similar restrictive actions on the part of the West Europeans. Continued consultations in the TEC may produce results in a few areas—most likely Japanese promises to increase foreign investment in Western Europe. Japanese direct investment—primarily auto plants—in the EC now totals \$7.7 billion, up 42 percent from 1982. Nevertheless, the

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West Europeans are growing more weary and will probably look to the upcoming GATT round as a more persuasive forum to rein in the Japanese.

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We believe West European leaders would be receptive to any coordinated effort to put pressure on Japan to open its markets. Both Washington and the Community, however, are wary of actions by the other which might divert more Japanese exports to their markets. As a result, any major protectionist measures implemented by the Community, or a member country, probably would increase protectionist sentiment in the United States. [Redacted]

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**South Africa:  
Impending Debt Negotiations** [redacted]

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Talks involving South African financial officials and the country's major creditors are scheduled to begin next week, but Pretoria has already acknowledged it likely will extend its four-month moratorium on principal repayments before rescheduling can be completed. South Africa's long-term debt strategy appears to revolve around paying a premium to keep credit lines open with West European banks while gradually paying off creditors uninterested in maintaining their current South African exposure. We expect a rescheduling agreement eventually will be forthcoming, but recalcitrance on the part of the South Africans or a new political or economic shock could unravel the proceedings.

[redacted]

**Preparations for Debt Talks**

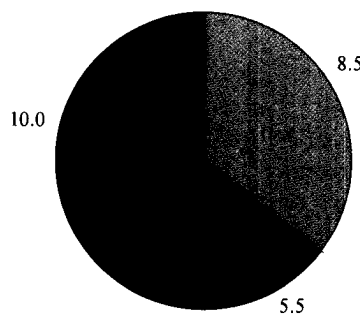
South Africa's commercial bank creditors seem resigned to a rescheduling of the country's \$14 billion in short-term debts, and both Pretoria and creditor banks are preparing for negotiations. [redacted] initial talks are scheduled to begin in London the week of 21 October. Pretoria has advised banks it will need to extend its four-month moratorium, however, to gather the necessary data for a rescheduling. Unlike the Latin American debtor countries, most South African borrowers are private banks and firms, making tabulation of the total debt more difficult. Pretoria must gather data from some 50,000 South African individuals and businesses on their foreign liabilities, according to the US Embassy. [redacted]

On the South African side, Director General of Finance Chris Stals will lead the country's newly formed Standstill Coordinating Committee, which will gather data on the debt, represent Pretoria in debt negotiations, and adjudicate disputes under the moratorium. Although lacking the international stature of Reserve Bank Governor Gerhard de Kock, Stals probably has a keener grasp on the

**South Africa: Total Foreign Debt  
by Length of Maturity\***

Billion US \$

- Due in 6 months or less
- Due in 6 to 12 months
- Due in more than 12 months



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\* Estimated as of October 1985. US banks are owed \$3.5 billion of the \$14 billion due in 12 months or less.

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[redacted] mechanics of international finance, making him better suited for the technical talks with foreign bankers. [redacted]

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The organization of foreign bank creditors is less clear. Debtor nations and commercial banks traditionally have negotiated reschedulings face to face. Many bankers are leery of appearing to help South Africa out of its crisis, however, and Pretoria sought to defuse the political tension by appointing an intermediary between the country and its creditors. [redacted] Fritz Leutwiler, former president of Switzerland's central bank and of the Bank for International Settlements, has agreed to act as mediator. [redacted]

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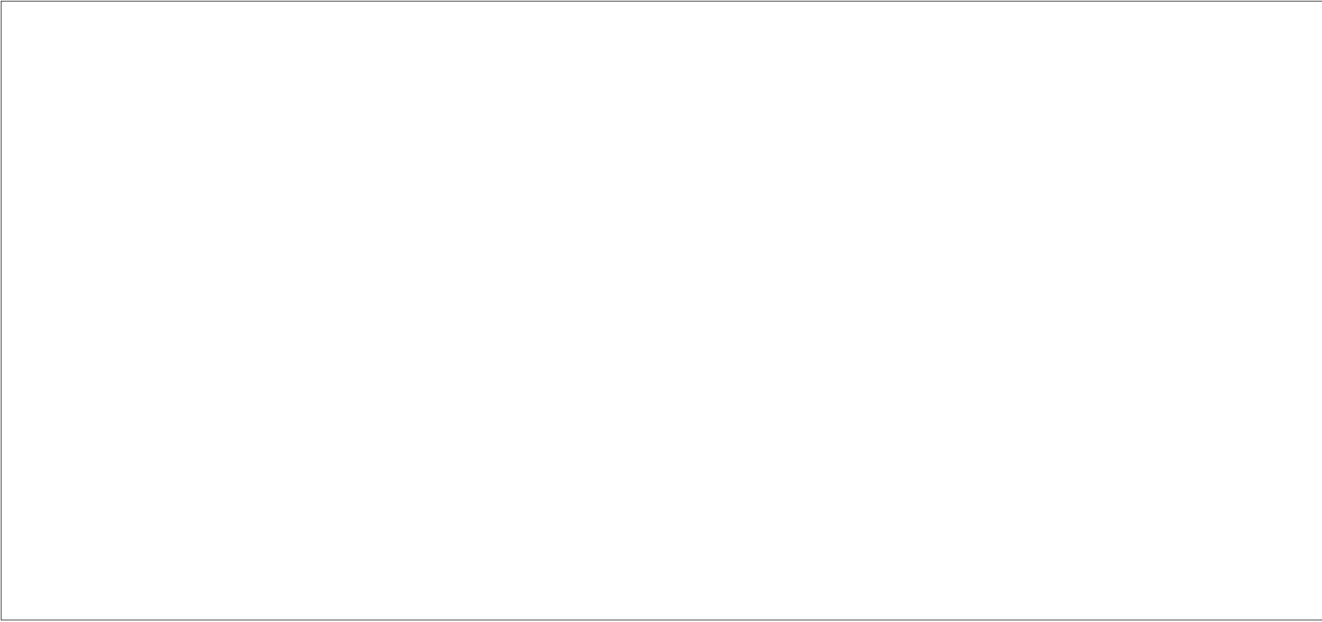
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The definition of Leutwiler's role remains murky, however, and some international banks are encouraging formation of a bank advisory committee to negotiate on their behalf. The committee method—using a geographically balanced representation of key creditor banks—has been used with the debt-troubled Latin American countries since 1982 and is the method with which bankers are most comfortable. [redacted] a major Swiss bank is assuming leadership of the creditor banks, after several other banks refused the position. This would be the first time a US bank will not lead a major international private debt rescheduling. [redacted]

Even if foreign banks organize into a traditional advisory committee, they still may be hesitant to bargain directly with Pretoria. In this case, Leutwiler might be required to shuttle between South African officials and foreign bankers at separate—even if nearby—locations. We believe Leutwiler's primary value will not be in substantive negotiations, however, but rather as a focus for outside attention, thus deflecting criticism from the commercial banks. [redacted]

**Domestic Concerns:  
Complicating the Negotiations**

Economic austerity measures—imposed in August 1984 to reduce South African inflation and over-

seas borrowing by cutting import demand—have pushed the economy into a severe recession. These measures, which included a record 25-percent prime lending rate and restrictions on consumer borrowing, failed initially to cut foreign debt as intended. According to US Embassy sources, South African banks profited from the high domestic interest rates by borrowing cheaply abroad to lend at home. [redacted]

[redacted] Meanwhile, the deepening recession added to tensions in black townships by raising unemployment rates and lowering real wages. The riot-torn eastern Cape Province was hit especially hard as high prime lending rates and restrictions on consumer borrowing hurt the sales of the local automobile industry. [redacted]

Pretoria has responded to growing black unemployment and the bankruptcy of many white businesses by gradually easing restrictive policies as the economy bottomed out. The prime rate has fallen to 18.5 percent. Late last month Pretoria announced projects to create jobs, assist small businesses, and provide additional food relief. Credit restrictions and automobile sales taxes also were reduced slightly. In our judgment, the measures probably

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will keep the economy from slumping further but will do little directly to reduce black unemployment—now running at more than 25 percent. [redacted]

Although we believe South Africa and foreign banks eventually will reach agreement on a rescheduling package, we cannot rule out developments on both sides that might set back debt negotiations and possibly compound Pretoria's financial troubles over the short term. While the large money center banks seem willing to go along with a rescheduling, a disgruntled smaller bank could demand immediate repayment of all its loans. Publicity over such a move would put pressure on other creditors to be less accommodating and further complicate banks' efforts toward a unified bargaining position. In addition, a new political or economic shock in South Africa remains a possibility. The arrest of another key antiapartheid leader, another major clash between demonstrators and police, or new controls on international capital flows might result in still further cuts in the country's credit lines. Moreover, continued vacillation by Pretoria—which already has wavered on the categories of debt included under the standstill and also recently backdated the moratorium by five extra days—could draw a hostile response from foreign bankers. [redacted]

South African officials clearly recognize that measures to stimulate the economy will raise import demand and complicate debt negotiations by leaving less foreign exchange for debt repayment. Pretoria last month raised customs duties on goods not covered under GATT (about 55 percent of South African imports) by 10 percent. The \$200 million in expected revenues will be used to fund the job creation program. The growth of import demand also will be slowed by the weak value of the South African rand—now worth about 40 cents compared to 90 cents in 1983—and the higher cost and more limited availability of trade credit. [redacted]

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**Near-Term Outlook**

The domestic economic situation probably will cause Pretoria to approach the debt talks cautiously. Although some influential Afrikaner businessmen probably favor a tough stance in the debt rescheduling talks—including a tacit threat to renounce the debt altogether and go it alone—the government appears committed to repayment, though at a pace it feels will not unduly penalize its domestic economy. South African officials believe that their country will have to repay less than half of its current debt before new credit will be offered. Meanwhile, South Africa borrowers are paying premiums to maintain current credit lines with West European banks, [redacted]

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[redacted]

[redacted]

[redacted]

**Venezuela: Economic Controls**  
**Limit Growth** [redacted]



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Venezuela's reliance in recent years on economic controls has allowed it to protect itself from some, mostly short-term, economic blows, but at the cost of more fundamental distortions in the structure and efficiency of the economy. Tight controls have enabled Caracas to shore up the foreign payments account and hold inflation in check, for example, but they also hastened the reduction of private-sector investment and enlarged the public-sector role in the economy. Despite some recent loosening of controls, we believe President Lusinchi plans only to tinker with the current system rather than implement the broad economic liberalization that business says it wants. Thus, we project continued near-term economic stagnation for Venezuela, bleak prospects for trade and investment, and some risks for creditors even under the imminent multiyear debt rescheduling agreement. [redacted]

granted only for debt payments and "essential imports" such as foodstuffs, machinery, and spare parts, while other goods and capital outflows incur the highest rates. [redacted]

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Caracas now controls foreign investment in line with the Andean Pact's Decision 24, which puts limits on the share of foreign ownership and the remittance of capital or profits abroad. Recently, changes have been made to encourage greater foreign investment, especially in construction, agriculture, tourism, and export industries, but the US Embassy views these improvements as modest. [redacted]

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**Growing Reliance on Controls**

Since 1982, Caracas has increasingly resorted to a wide range of restrictions to manage the economy. Tough foreign exchange controls were adopted to cut imports and stop capital flight to prevent a cash crisis, according to the US Embassy. Despite frequent promises to loosen economic restraints, Lusinchi, since taking office in 1984, has continued to use them to combat specific problems. [redacted]

Domestically, the government sets prices, minimum wages, and interest rates. Strict price controls cover 135 basic necessities, while other price hikes require 60-day notice. The government argues against across-the-board wage increases in the private sector and sets the minimum wage annually. The Central Bank establishes interest rate ceilings on bank loans and caps rates paid to depositors to assist mortgage lenders and spur depressed construction. [redacted]

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Externally, Venezuela now regulates most foreign transactions to conserve its foreign exchange reserves and stimulate production of import substitutes. US Embassy reports and the financial press indicate that imports are limited by outright bans, prior licensing rules, stiff luxury tariffs, and multiple exchange rates.<sup>1</sup> The lower exchange rates are

The government also frequently intervenes in the operations of such enterprises as banking and auto production. To stabilize the shaky banking system, the government recently required all banks to join a new deposit insurance fund. In the auto industry, which is mainly under private control, Caracas dictates the number of models allowed, minimum volume of production, percent of local content, and export requirements. [redacted]

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<sup>1</sup> Currently the foreign exchange authority, RECADI, administers rates of 4.3 and 7.5 bolivars per US dollar, and the Central Bank maintains a managed "free-market" rate of about 14 bolivars per dollar. [redacted]

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**Venezuela: Recent Economic Performance, 1982-85**

**Uneven Results**

We judge that the principal accomplishment of controls has been protection of the foreign payments position. Bankers report that capital flight—which drained an estimated \$35 billion in 1972-83—has largely ceased under the tight controls. Moreover, the Central Bank reports imports in 1984 were down more than 40 percent from 1982 levels, to less than \$8 billion, resulting in a turnaround in the current account from a 1982 deficit of \$4 billion to a \$5 billion surplus in 1984. Official reserves have climbed above \$14 billion, although there are significant interest arrears on the private debt. Bankers have been impressed by these payments improvements and have agreed to a multiyear rescheduling, now close to final signing.

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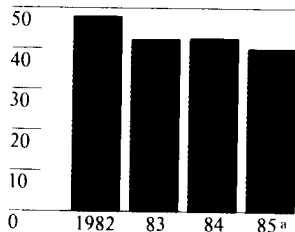
Despite the external benefits, we judge that controls have weakened domestic productivity, thereby heightening future economic vulnerabilities. Since 1982, for example, two of four tire producers—Uniroyal and General Tire—have closed down, complaining to US Embassy officials that price controls and import restraints eroded their profitability. As a result, Venezuela has had to supplement domestic production with imports of tires. Many basic foodstuffs cannot be produced profitably because of price controls. Food processors, for example, now grow their own tomatoes—and import to meet growing demand—because domestic prices provide no incentive for farmers to grow and sell tomatoes in volume.

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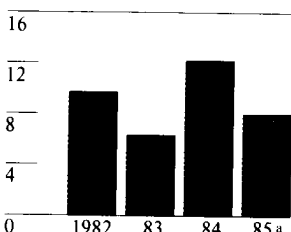
Press and US Embassy reports reveal that these distortions have provoked widespread private-sector complaints. Venezuela's industries are considered to be less efficient under controls because they face less import competition and are forced to use lower quality local inputs. At the same time, recent narrow profit margins and stagnant demand undermine their ability to modernize. In this environment, private investment dropped in 1984 to less than \$1 billion—57 percent below its 1982 level—and will likely fall further this year. As investment has declined, production in the private sector—autos, construction, housing, and appliances—has

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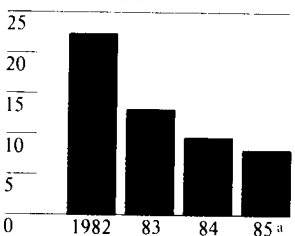
**Public Investment**  
Billion Bolivars



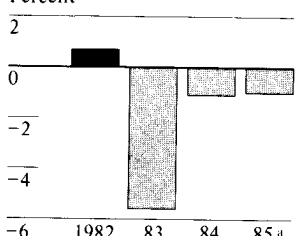
**Inflation**  
Percent



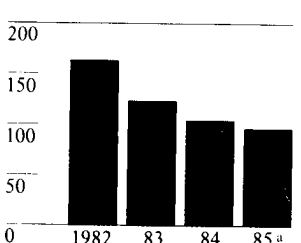
**Private Investment**  
Billion Bolivars



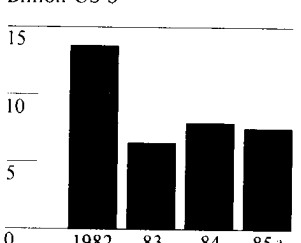
**Real GDP Growth**  
Percent



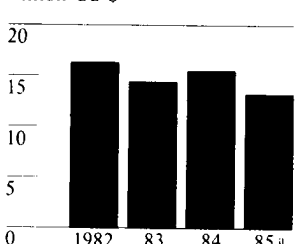
**Auto Sales**  
Thousand Units



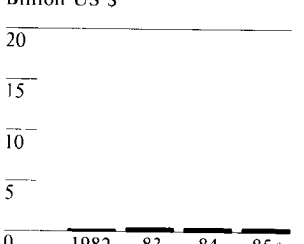
**Imports**  
Billion US \$



**Public Sector Exports**  
Billion US \$



**Private Sector Exports**  
Billion US \$



<sup>a</sup> Estimated.



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**Current Debate on Controls**

*Although Lusinchi verbally supports the necessity for decontrol, in practice, he has adopted more regulation to combat short-term economic problems. A major concern is to hold imports down to protect the payments position, thereby encouraging foreign bankers to conclude the debt rescheduling. By holding prices stable, Lusinchi hopes to consolidate labor support for his government, temper business criticism, and avoid domestic unrest.* [redacted]

*Venezuela's businessmen also criticize public investment as preempting areas of profitable opportunity, and doing so poorly. They blame lack of initiative and inefficiency in state enterprises, most of which have sharply underspent their investment budgets recently.* [redacted] *The recent announcement that coal would be mined only by the public sector added to this criticism, leading some to call for a private role in state industries.* [redacted]

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*His strategy, however, is precipitating growing popular discontent over depressed living standards, and business objections to controls have become more frequent. A recent opinion poll indicates that approval of the government is dropping sharply despite Lusinchi's high personal popularity. Private-sector leaders and the financial press regularly contend that controls stifle incentive, import barriers hurt production efficiency, and redtape clogs the system. Venezuelan businessmen also argue that controls favor multinational firms, which can deal better with bureaucracy, and contribute to increasing corruption.* [redacted]

*Nonetheless, public opinion appears to support regulation of the economy. The US Embassy and press reports indicate many believe business complaints are self-serving and fear sharp price rises and foreign domination of local industries if controls are lifted. Administration officials also have criticized the private sector for failing to respond to government "favors," such as preferential exchange rates to pay private debt, wage restraints, and price hikes to offset cost rises. Yet, private investment has not revived, capital abroad has not returned, and Lusinchi has publicly voiced his deep disappointment.* [redacted]

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also contracted. Combined with the falloff in oil revenues, Venezuela's GDP has shrunk nearly 7 percent since 1982. [redacted]

**Outlook and Implications**

The collapse of private investment has forced the Lusinchi administration into greater reliance on public spending to spark recovery. The public sector now accounts for 83 percent of total investment, mainly in the oil, steel, aluminum, and electricity sectors. Domestic and foreign businessmen indicate that price distortions introduced by controls—plus overstaffing—have led to large-scale production inefficiencies. Public investment is also leading to greater reliance on exports of primary products to meet debt obligations. Oil and other public-sector primary exports—mainly iron ore, steel, and aluminum—now account for 97 percent of export revenue. [redacted]

On the basis of Lusinchi's record of merely streamlining regulations, we believe he will retain controls with only modest loosening. Lower oil income will likely lead him to rely even more heavily on import and exchange controls to protect the foreign payments position. To ensure politically acceptable low inflation plus a stable exchange rate, price controls are also likely to remain. Administration concern over depressed construction activity will impede interest rate deregulation. [redacted]

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Continued controls, lower oil income, and the lack of business confidence will spell further declines in real GDP growth in 1985 and 1986. While inflation

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will be held in check, unemployment will probably rise, although slowly. Economic revival will depend on public spending, particularly investments by state firms, as private-sector production continues to languish. With exports hurt by a weak oil market and private-sector stagnation, we foresee the current account surplus shrinking to only \$500 million in 1986.

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In this no-growth, public-sector environment, investment opportunities will remain unattractive. A sharp fall in oil earnings could complicate debt repayments, even under the multiyear rescheduling agreement. Such a development would force heavy—and politically embarrassing—use of foreign exchange reserves and lead to strong devaluation pressures and defaults on private-sector debt repayments.

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**Latin America:  
Continued Danger From Inflation** [redacted]

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Inflation has been high in Latin America throughout the past few decades and continues at an accelerated pace. The region is home to four of the five countries whose consumer price increases topped 100 percent last year. Popular discontent with price rises and the resultant declines in living standards have recently led most of the region's governments to implement tougher anti-inflationary measures. Nevertheless, we believe several countries—Argentina, Bolivia, Brazil, and Peru—will remain vulnerable to rapidly accelerating inflation that could threaten their nascent democracies. Moreover, we doubt most other Latin countries will succeed in bringing down high inflation, which we believe will continue to impede economic recovery and to alienate the middle and lower classes. [redacted]

We believe the President's willingness to use the military to quell unrest and the likelihood of sustained armed forces support over the next few months indicate that he will not back down on major elements of his economic program, but its severity is likely to result in continuing confrontation with radical labor factions. Moreover, positive action on promises to slash the deficit and reform the monetary system will be needed to secure the confidence of the business community. [redacted]

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**Current Inflation-Fighting Policies**

Latin American governments have spent the last two years grappling with foreign payments difficulties but neglected to focus on tough inflation-fighting programs. Heightened sensitivity to public discontent with inflation, combined with a desire to secure IMF support in order to obtain debt re-scheduling and new money from international bankers, has led most of the region's governments to renew emphasis on controlling inflation. [redacted]

*Argentina's* annualized price increases rose beyond 1,000 percent in June. US Embassy reporting indicates that subsidies to unprofitable state enterprises were largely responsible. President Alfonsin declared that inflation was a threat to democracy and announced drastic stabilization measures including a temporary price and wage freeze, spending cuts to balance the budget, a new currency, and a promise not to print money to finance spending. According to opinion polls, over two-thirds of the population approve of Alfonsin's program, and a one-day general strike by labor to protest austerity did not receive widespread support. [redacted]

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**Shock Treatment.** In *Bolivia*—with the world's highest inflation—consumer price increases hit an annualized rate of 14,000 percent in July, according to the US Embassy. With the collapse of fiscal discipline and the economy in shambles, in August, the new President, Paz Estenssoro, launched a frontal attack on deficit spending. He curtailed subsidies to nonprofitable public enterprises, imposed a four-month freeze on public-sector wages, devalued the peso by 93 percent, and lifted controls on prices and interest rates. Thus far, Paz Estenssoro has stood firm, even in the face of labor unrest.

**Orthodox Stabilization.** *Ecuador* is battling inflation under the auspices of an IMF adjustment program based on strict fiscal discipline. President Febres Cordero is pressing reforms that include devaluations, a relaxation of price controls, and the decontrol of interest rates. While these reforms are likely to cause a slight increase in inflation to 30 percent this year, we believe Febres Cordero's dedication to tight monetary control and free-market policies will lead to lower rates thereafter.

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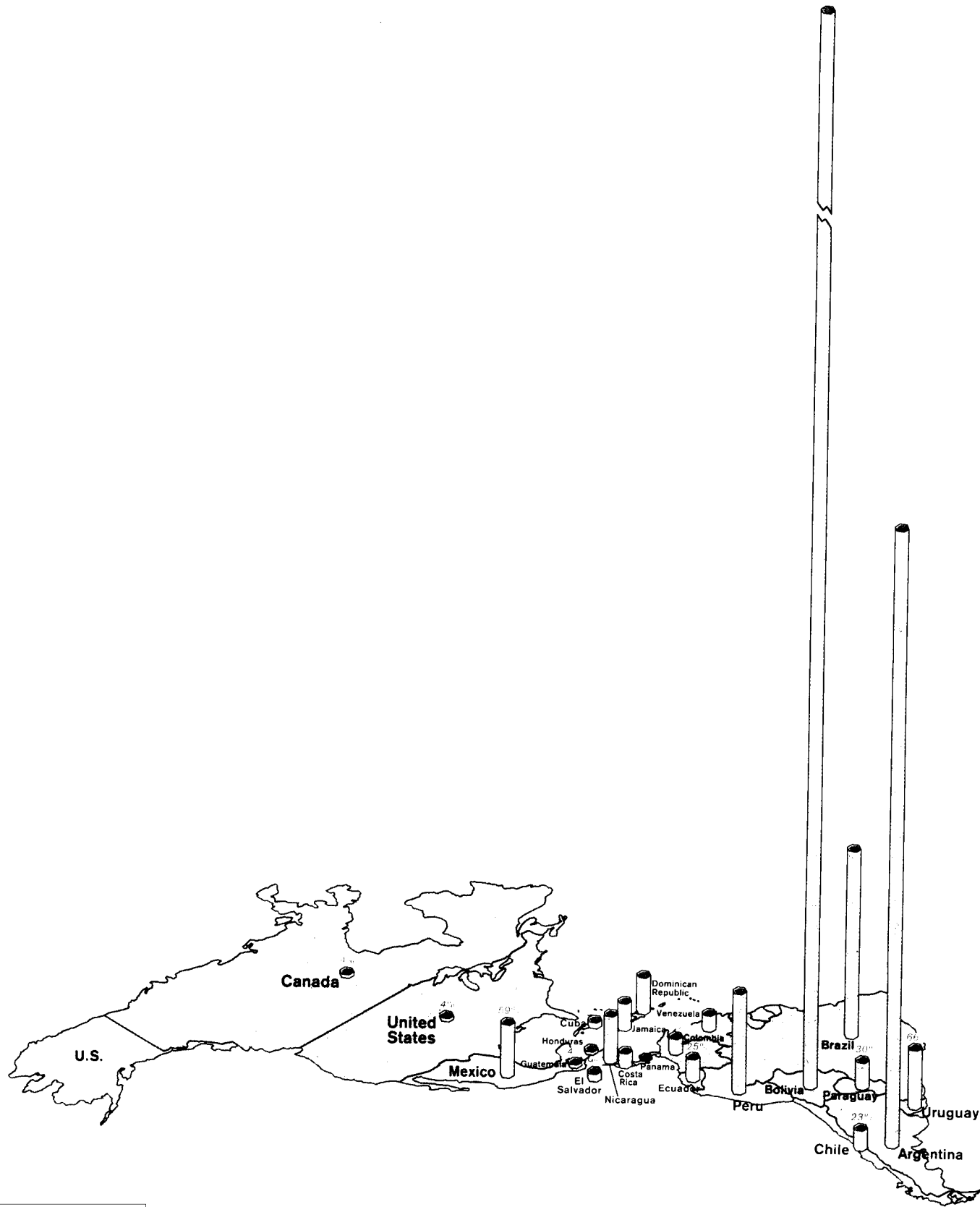
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Western Hemisphere Inflation Rates, 1984



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Similarly, *Chile* has agreed to lower the budget deficit and tighten monetary expansion to hold inflation to 25 percent under its recently enacted Fund program. Nevertheless, devaluations and economic disruptions from the earthquake last March caused prices to rise at a 37-percent rate during the 12 months ending in August. Moreover, the US Embassy reports that Santiago's recent expansion of the money supply to help quell domestic unrest will cause additional inflationary pressures in the future. [ ]

In contrast, *Venezuela* and *Colombia* have each enacted self-imposed stabilization programs. Caracas is running a budget surplus and using price controls to keep inflation below 10 percent this year. Nonetheless, the government has decided to eliminate preferential exchange rates, and may reflate the stagnating economy to assuage labor concerns. Such moves would probably cause some higher, but still manageable, inflation. Long accustomed to low inflation and shocked by some private forecasts of a 40-percent rate this year, Colombia is instituting price controls. According to US Embassy reports, Bogota has also cut public spending, resisted wage increases, lifted import restrictions, and increased taxes in an effort to reduce inflationary momentum. [ ]

*Mexico's* inflation is rising, and public discontent is growing in the face of declining real wages. Mexico City recently announced an austerity package that includes government hiring freezes, spending cuts, and the sale of state-owned enterprises, as well as import liberalization and peso devaluation. We believe, however, that these measures will not be fully implemented as political pressures will likely compel the government to focus on reconstruction in the wake of the recent earthquake. A stop and go approach to austerity is likely to result in higher inflation. Similarly, *Uruguay's* President Sanguinetti has publicly stated that tough economic adjustments need to be subordinated to consolidating democracy and appeasing labor. His growth-oriented policies, based on public-sector investment, are likely to exacerbate the country's 66-percent inflation, despite pledges to the IMF. [ ]

**Consumer Prices:**

Percent

**Average Annual Growth**

	1960-69	1970-79	1980-84
World	4	10	13
Industrialized countries	3	8	8
Non-oil-exporting Latin America	22	35	91
Argentina	22	133	313
Bolivia	6	16	352
Brazil	46	31	125
Chile	29 <sup>a</sup>	174	22
Mexico	3	15	56
Peru	10	27	84
Venezuela	1	7	13

<sup>a</sup> 1964-69.

**Price Controls.** President Sarney of *Brazil* has imposed temporary price controls to attack the triple-digit inflation that has plagued the country for four years. He remains reluctant, however, to undertake the structural reforms needed to address the root causes of inflation. Brasilia's inadequate public-sector spending cuts and rapid monetary expansion continue to impede a new Fund agreement. Moreover, according to the US Embassy, the recent Cabinet shuffle indicates decreasing emphasis on controlling inflation in favor of increased development spending. [ ]

*Peru's* recently inaugurated President Garcia has declared cutting inflation—which reached an annualized rate of 184 percent in August—his number-one economic priority. He is instituting a comprehensive set of price controls, and US Embassy reports indicate the measures have stopped inflation in its tracks. Although Garcia plans a government hiring freeze, a reduction of management jobs in state enterprises, and budget cuts to restrain

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future price rises, he also has promised to boost real wages and initiate new social welfare programs. In the long run, we believe Garcia's disjointed economic policies will cause declines in production and a shift of goods into the black market, fueling de facto inflation. [redacted]

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**Continued Progress in Doubt**

Although several US econometric services are forecasting that Latin American inflation will soon begin a gradual descent, we are less sanguine about the prospects for inflation abating. We believe, for example, that lack of followthrough on adjustment programs may cause a resurgence of inflation in Mexico, Chile, Colombia, and Uruguay. Unless price controls are followed by comprehensive restructuring and stabilization programs, Brazil and Peru will, in our view, be vulnerable to a rapid acceleration of inflation next year. In addition, we believe a return to hyperinflation is possible in Bolivia and Argentina, should their programs unravel. Only in Venezuela and Ecuador are we confident that inflation will be kept under control.

[redacted]

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Although persistent high inflation erodes a country's economic dynamism, Latin American governments will face political risks if they undertake strict economic reform measures. Steps to break inflation may be viewed as a sellout to the IMF and a threat to middle-class interests, and engender active opposition. Moreover, austerity measures are likely to alienate the poor. Such measures will be especially difficult to implement in a country such as Brazil, where prolonged recession has lowered living standards and where the Sarney government possesses a weak political base. Finally, financial constraints may result in cutbacks in military spending that could impede efforts to control insurgent activity and heighten military resentment of civilian government. [redacted]

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**CEMA's Troubled Consumer Goods Industries: A Soviet Perspective** [redacted]

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Faced with chronic shortages of common consumer items and production bottlenecks, Moscow is calling on its CEMA allies to increase exports of finished consumer goods.<sup>1</sup> [redacted]

[redacted] however, Eastern Europe may be hard pressed to meet Soviet expectations for soft goods—textiles, clothing, shoes, and other wearing apparel—as production prospects to the year 2000 appear bleak. [redacted]

**A Neglected Industry**

Although CEMA countries lead in the production of cotton textiles and leather footwear, [redacted]

[redacted] they lag far behind the West in output of most other soft goods. During the 1970-83 period, CEMA soft goods industries posted the lowest growth rate of all industrial sectors, reflecting a low priority in resource allocation and a weak commitment—despite official rhetoric—to improving light industrial output. Production grew slowly in the late 1970s before stagnating—and, in a few cases, declining—in 1981-83. [redacted]

[redacted] CEMA's sluggish performance during the late 1970s and early 1980s to several major factors:

- **Inadequate Raw Materials.** Declining harvests and production problems forced the USSR, CEMA's major supplier of raw materials, to limit deliveries of cotton, leather, and chemical fibers. Moscow turned to international cotton markets to prop up Eastern Europe's production of cotton textiles, but was thwarted and angered by Eastern Europe's reexport of the raw material to the West.

<sup>1</sup> CEMA—the Council for Mutual Economic Assistance—is made up of the USSR, Poland, East Germany, Czechoslovakia, Hungary, Bulgaria, Romania, Mongolia, Cuba, and Vietnam. [redacted]

***The USSR's Long-Term Consumer Goods Program***

*As a supplement to the Food Program, work began on the Long-Term Nonfood Consumer Goods and Services Program Toward the Year 2000 under General Secretary Andropov. Discussion of the program continued under the Chernenko leadership. Completion and publication was long delayed, however, by debate about where to find the resources to support the program. Statements in the Soviet press published during Chernenko's tenure showed that the areas to be addressed would include footwear, personal care, and repair and telephone services.* [redacted]

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*General Secretary Gorbachev, faced with the task of providing incentives for improved worker performance in order to revitalize the economy, recognizes the need to increase availability and quality of consumer goods and services. His anti-alcohol campaign has heightened the urgency for such increases: if sales of alcohol are reduced, the public will have extra cash on hand, contributing to the problem of excess purchasing power.* [redacted]

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*The consumer goods program was finally approved by the Politburo in September. Details were released last week. Ambitious goals are set for output of items such as consumer durables and soft goods, and for services including communications, public transport, housing repair, and personal care. Soviet commentary on the program suggests that gains are to come largely from more efficient use of existing resources.* [redacted]

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**CEMA: Average Annual Growth of Selected Soft Goods Production <sup>a</sup>** Percent

	1971-75	1976-80	1981-83
Textiles	2.5	1.2	0.1
Cotton	2.0	1.2	0
Wool	2.7	0.8	-1.7
Silk	4.9	2.7	2.4
Knitted outerwear	5.5	2.4	-0.1
Knitted undergarments	3.9	3.2	0.1
Hosiery	3.0	2.8	2.3
Leather footwear	1.7	1.4	0.5

<sup>a</sup> Does not include Vietnam.



**CEMA: Per Capita Production of Selected Soft Goods as a Percent of Soviet Consumption Norms <sup>a</sup>**

	1970	1983	1990	2000	
				Low <sup>b</sup>	High <sup>c</sup>
Textiles	72.6	78.7	96.7	85.2	110.0
Cotton	88.1	93.1	103.2	NA	109.0
Wool	81.5	83.2	99.6	91.9	102.4
Silk	49.3	68.9	96.7	85.4	141.2
Knitwear	43.4	56.0	66.6	NA	81.2
Knitted outerwear	NA	NA	NA	68.0	NA
Knitted undergarments	NA	NA	NA	61.5	NA
Hosiery	67.3	86.2	99.2	NA	109.6
Leather footwear	84.6	90.3	90.7	NA	91.0

<sup>a</sup> The working group applied the Soviet consumption standard to other CEMA countries.

<sup>b</sup> Projections based on current—although unspecified—growth rates of production. East European projections include exports and accordingly overstate these CEMA-wide totals.

<sup>c</sup> Projections based on draft target growth rates for the Soviet Long-Term Consumer Goods and Services program.



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• **Insufficient Investment.** Changes in investment policy left soft goods producers in the region with a lower share of total investment, and diminished funding has been directed to retooling instead of new construction to expand output. A decision to keep soft goods machinery in production past their standard lifespan in order to meet output goals led to an increase in breakdowns. This was aggravated by concomitant declines—with the exception of Czechoslovakia—in the region's light industrial machine-building production.

• **Declining CEMA Trade.** A shift in East European exports of consumer goods to hard currency markets exacerbated shortages of soft goods, particularly in the USSR.

• **Failure of CEMA Cooperation.** The CEMA members have yet to conclude or to implement a number of economic cooperation agreements to expand the output and variety of natural and synthetic raw materials and specialized equipment.

CEMA countries for 1990 and 2000. Projections show total production increases for CEMA soft goods by the year 2000, but at best only modest per capita growth. Under both scenarios, forecasts of per capita production of key soft goods fall below established Soviet consumption norms.<sup>2</sup> Leather footwear and knitwear represent areas of particularly sluggish growth. The lower set of projections probably are more realistic.

<sup>2</sup> The Soviets have established "rational norms" for consumption. These norms set standards for how much an average Soviet citizen should consume in food, housing, clothing, and other goods and services. They generally represent a comfortable living standard, albeit a lower one than in the West.

**The Road Ahead: Continued Stagnation**

Based on data provided by the CEMA Permanent Commission for Light Industry and Soviet organizations, the working group produced two pessimistic estimates of per capita output of soft goods in

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**Prescription for Improvement**

Recommendations to avert this dismal production outlook focus on the well-worn theme of increasing CEMA coordination. High priority is to tap new sources of raw materials. East European countries expect their needs for textile fibers to exceed availability of supplies from their domestic production and Soviet exports by 50 percent in 1990. Possible sources of additional imports include the poorer CEMA countries—Vietnam, Mongolia, and Cuba. [redacted] recommends that CEMA:

- Seek out raw materials on LDC markets.
- Step up existing scientific programs to develop new chemical fabrics and to make use of raw material byproducts.
- Finance joint investments to construct spinning mills in the Soviet Union. [redacted]

It also recommends modernization of the capital base. Not only has past industrial strategy failed, but it has resulted in increased dependence on Western machinery and equipment. To avoid further reliance on the West, CEMA should:

- Complete and rapidly implement stalled agreements on producing specialized machinery to relieve shortages of textile and footwear equipment and upgrade technology. If these agreements are not pushed through by 1986, light industrial machine-building enterprises will not begin work on these sought-after specialized machines until the next decade.
- Coordinate purchases of new technology from the West to avoid duplication.
- Establish a separate group to coordinate CEMA-wide planning in other industries involved in soft goods production, including agriculture, light industrial machine building, and the chemical industry [redacted]

Although Moscow won grudging commitments from its East European partners at the June 1984 CEMA Summit to provide more and better consumer goods, we have seen no mention of specific levels. The working group—giving the first hint of

Soviet demands—called for East European soft goods exports to the USSR to increase by the year 2000 by one-third over 1981-85 levels. In Moscow's view, the East Europeans have adequate reserves to meet these Soviet requirements. To pave the way for this heightened trade with Eastern Europe, the report recommends:

- The standing CEMA Commission on Foreign Trade develop incentives to stimulate intra-CEMA exports, and to redirect trade with the West to the USSR. 25X1
- CEMA Foreign Trade Ministers draft measures to improve the assortment of goods in direct trade between CEMA soft goods producers and retail traders. 25X1
- Imposition of stricter sanctions for the delivery of poor quality goods and a reduction in prices for less desirable products. 25X1
- Simplified coordination of CEMA consumer goods agreements and contracts. [redacted] 25X1

It is too early to make conclusive judgments, but we believe Moscow will adopt these modest proposals for greater CEMA integration. These could be marginally helpful, but are no substitutes for change in Soviet priorities and increased investment. General Secretary Gorbachev may instead focus on other consumer problem areas—such as food—where the prospects are not as gloomy as they are for soft goods. [redacted] 25X1

**Soviet Reaction**

According to a US Embassy source, the assessment sparked sharp debate in the formulation of Moscow's Long-Term Consumer Goods and Services program. There was little apparent disagreement with the report's analysis or projections, but participants clashed over how to solve the industry's problems. Increased investment apparently was the major bone of contention, with key members of the State Planning Committee (Gosplan) unwilling to shift scarce funds from other sectors. Indeed, Gorbachev will be hard pressed to find the resources 25X1

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needed to pursue his stated goals of modernizing the heavy industrial base and maintaining his commitment to defense and at the same time providing investment to boost consumption levels. The General Secretary's program implies that growth in consumer-oriented investment during 1986-90 could fall by some 60 percent compared with 1981-85. [redacted]

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### Implications for Eastern Europe

We believe this report signals new Soviet toughness toward Eastern Europe, which can expect additional pressure to expand its support for the USSR's soft goods industry and redirect its trade with the West. Harsh criticism of the East Europeans and a desire to minimize resistance to programs for increased CEMA integration and trade, however, make it likely that the report—even in a diluted version—will remain in Soviet internal circles.

[redacted]

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With poor prospects for its own soft goods production, Eastern Europe is likely to resist Moscow's demands. Stagnating living standards and subsequent strains on political stability in the region have placed narrow limits on cuts in consumer goods supplies to the East European populace. Nor can the area—in light of its debt problems—face the loss of hard currency earnings from sales to the West. [redacted]

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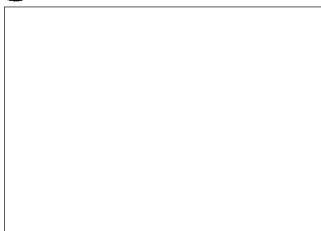
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**Briefs**

*Turkey-USSR Natural Gas Contract Expected*



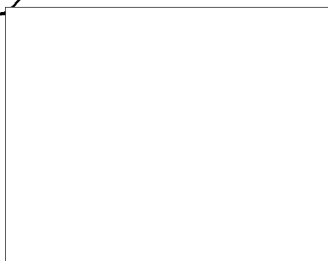
**Energy**

Ankara is expected to sign a 20-year contract soon for the delivery of up to 6 billion cubic meters per year of Soviet gas beginning in 1987, according to Embassy reporting. At current prices Moscow could earn up to \$750 million annually if deliveries reach peak levels. Revised plans now call for a significant portion of the gas to serve the residential and commercial sectors. Ankara has no plans either to provide additional gas storage facilities in the first five to 10 years of the contract or to require industrial consumers switching to gas to maintain the ability to use other fuels. This contract will make Ankara vulnerable to interruptions in Soviet gas deliveries that are expected to meet 95 percent of Turkish gas needs, albeit only 5 percent of total energy requirements. Residential users would be hit hardest because they are unlikely to have alternative sources of energy. The expense and inconvenience of installing a domestic pipeline grid to serve the residential and commercial market are likely to delay acceptance of full contract volumes.

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*Mexican Private-Sector Debt Obligations*



**International Finance**

The Mexican private sector—unlike the government—has not used the earthquake as an excuse to defer repayments on its roughly \$20 billion debt. Despite this positive sign, payment difficulties are likely to emerge late next year. [redacted] only negligible principal payments are due this year, and only \$200 million will be required next year. In FY 1987-90, however, principal obligations will jump substantially under agreements with foreign commercial banks. [redacted] Mexican Government officials believe that Mexico City will be unable to guarantee adequate foreign exchange to cover private-sector debt repayment needs and already has begun to pressure foreign banks to agree to more lenient repayment terms. International bankers, [redacted] believe private-sector repayments will have to rescheduled by the end of next year. [redacted]

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**Global and Regional Developments**

*Japanese Auto Makers Strengthen Footholds in Taiwan ✓*

Nissan, Toyota, and Mitsubishi are strengthening their tieups with Taiwanese auto makers. Nissan owns 25 percent of Yue Loong, Taiwan's top auto maker, Toyota is seeking a 5-percent interest in Kouzui Motors, Ltd., and Mitsubishi Motors wants to acquire a 25-percent share of China Motor Company.

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[redacted] Japanese auto makers plan to use Taiwan as a base for the expansion of indirect exports. According to press reports, Japanese auto makers generally believe that Nissan will start exporting to the United States through Taiwan within the next few years. One report, however, indicates that Yue Loong may begin to assemble Nissan's popular 1.0 liter "March" model for export to the United States as early as the end of 1985.

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[redacted]

[redacted]

[redacted]

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**National Developments**

**Developed Countries**

*Reductions in Japanese Semiconductor Capital Expenditures ✓*

Japanese semiconductor makers are adjusting their investment plans in reaction to the continuing slump in the US semiconductor market and increased trade friction with the United States. During September, the major Japanese semiconductor makers reduced projected capital expenditures for FY 1985 for the second time. The reductions range from 10 percent to 40 percent from their original plans. To counter US charges of overinvestment, in some cases payments for equipment and new purchases are being deferred to next year.

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[redacted]

[redacted] We believe, however, that the major reason for Japanese cutbacks in investment is the decline in both Japanese semiconductor exports to the United States and in the prices of their major exports, 64K and 256K DRAMs. [redacted]

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*West German* ✓  
*Unemployment Still*  
*High*



West German joblessness remains stubbornly high as new labor force entrants offset healthy employment increases. The September unemployment rate held steady at 9.4 percent but remains at a record level. Some 165,000 new jobs have been created since mid-1984, but the labor force is increasing even faster. Not only are large numbers of young people entering the labor force for the first time, but workers long out of the market gradually are returning as economic recovery continues. Bonn—projecting 3-percent real GNP growth next year—expects a slight decline in the number of unemployed, which would brighten the Kohl government's prospects heading into the January 1987 election.

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*New Greek Austerity*  
*Measures* ✓

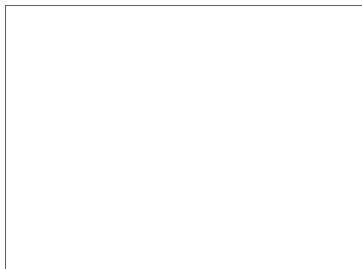


The austerity measures announced by Prime Minister Papandreou late last week probably do not go far enough to reverse Greece's deteriorating balance-of-payments situation or to deal with problems in the domestic economy. The new measures include a 15-percent devaluation, a tighter policy on wages, and new restrictions on imports. The US Embassy reports that the government also wants to strengthen price controls and to reduce the large public-sector deficit. The measures are aimed at reducing the current account deficit, paving the way for a possible loan from the EC, and avoiding the need to request a rescheduling of foreign debt. Total foreign debt will top \$16 billion this year, and the current account deficit is likely to surpass the record of \$2.4 billion in 1981. Both the conservative opposition New Democracy party and the Communists have criticized the new policies as harmful to workers. The Communists have threatened to use their disproportionate strength in the labor unions to fight the new policies, clearly a warning of possible strikes.

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*Indian Economic*  
*Reforms* ✓



**Less Developed Countries**

Prime Minister Gandhi's efforts to boost government revenue and private investment are showing signs of success. Indian monetary officials believe tax revenue will be 20 percent higher this year. In addition, private businessmen have boosted new investment following government easing of licenses in several industries, and the stock market continues to boom. The higher tax revenue and booming stock market indicate that his incentive program—including cutting taxes, easing government restrictions on private production, and relaxing antimonopoly laws—and a crackdown on tax evasion have struck a responsive note with the middle class and corporate leaders. Government officials estimate more than \$4 billion will surface from the underground economy this year. Critics, however, continue to charge that Gandhi's liberalization moves are widening the gap between the rich and poor. Gandhi must also watch for signs that some businessmen, particularly those with political influence, may withdraw support for his programs if they suffer from increased domestic or foreign competition.

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*Somalian Shipwreck—  
A Chemical Timebomb*

Mogadishu remains in peril from a chemical- and oil-laden freighter partially sunken in its harbor. An estimated 200,000 oceanside residents face the danger of major explosions, fires, toxic fumes, and smoke from the ship's hazardous substances. Further dangers to the local population include exposure to carcinogenic substances. A Dutch salvage firm has contracted to remove the wreckage and clean up the shore. Its equipment should arrive in Mogadishu around 20 October, but the 4 to 6 weeks' salvage operations could be disrupted during the monsoon season. Closure of the port for the estimated monthlong cleanup would hurt the country's weakened economy. Mogadishu is the most important of Somalia's three commercial ports. It handles two-thirds of the country's imports and 5 percent of the exports. Moreover, US humanitarian and other programs would be disrupted. [redacted]

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*Results of the  
Soviet Plenum*

**Communist**

The results of the party Central Committee plenum yesterday indicate General Secretary Gorbachev is preparing to move ahead forcefully with his economic agenda. The Central Committee approved drafts of the new party program, party statutes, and the release of draft directives of the five-year plan for 1986-90. In his speech, Gorbachev said that it had not been easy to reach agreement on the new plan and complained of problems created by officials still bound by inertia. He set an ambitious goal for growth in annual national income through the year 2000 of almost 5 percent—a marked improvement over the 3-percent rate achieved in 1979-84. The growth target is to be met in part by improving management, worker incentives, and economic efficiency. Gorbachev's criticism of economic cadres and the consolidation of his new economic team suggests that further personnel changes are ahead in the Council of Ministers. Although the plenum appears to be giving Gorbachev a green light for proceeding with his economic agenda, its failure to remove additional Brezhnev holdovers from the Politburo and Secretariat may be a sign of lingering political resistance. Both reportedly are on the General Secretary's hit list. [redacted]

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*Soviet Planning  
Chief Replaced*

The retirement this week of Nikolay Baybakov, 74, who has headed the State Planning Committee (Gosplan) for 20 years, will give General Secretary Gorbachev a freer hand in implementing his economic agenda. Replacing him is Nikolay Talyzin, who was simultaneously promoted to First Deputy Premier, a step higher than his predecessor. Baybakov, a Brezhnev-era appointee, was a staunch advocate of strong centralized economic controls and traditional priorities. He may have been involved in high-level controversy over the draft economic plan for 1986-90 and the guidelines for the period up to the year 2000 because his retirement comes on the eve of a Central Committee plenum scheduled to discuss the draft. Former Premier Tikhonov may also have opposed the general thrust of Gorbachev's program. As Premier, he would have been the speaker to address that subject at the plenum. Talyzin represents a break with the past because of his relative youth and lack of experience in national economic planning. His promotion indicates he is a member of Gorbachev's team. [redacted]

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18 October 1985

*Industrial  
Modernization Plans  
Continue*



A terse domestic announcement reports that the Politburo recently examined a draft program for the "chemicalization" of the Soviet economy in the 1986-2000 period. Among the program's main points are a substantial increase in production of fertilizers, pesticides, plastics, and synthetic fibers. The Central Committee and the Council of Ministers also passed a resolution to increase capacity and to broaden use of modern equipment and technology in the nonferrous metals industry during the 12th Five-Year Plan (1986-90). These moves are further evidence that the Soviets view a modern, efficient industrial base as crucial to the success of Gorbachev's modernization program. Earlier this year, the Central Committee and the Council of Ministers adopted a program for the re-equipping of the ferrous metallurgy industry. These sectors, however, will face stiff competition for additional investment, especially from energy, agriculture, and machine building.

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*Praise for East German  
Economic Management*

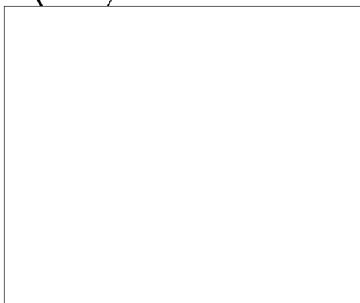


A recent article in *Pravda* by East German leader Erich Honecker is yet another sign that the leadership in Moscow may be looking to East Germany as a model for economic management reform. The long article on East Germany's strong economic performance addresses the success of the *kombinat* system—the grouping of enterprises and research organizations for specific production tasks. They have assumed major production responsibilities, but not at the expense of tight central control. Honecker also praises the combines for promoting more efficient use of resources and speeding the introduction of technological advances into the production process—major themes in Mikhail Gorbachev's prescriptions for the Soviet economy. Gorbachev also praised the *kombinat* system and other East German economic management practices in two speeches last spring, and his close economic adviser Abel Aganbegyan underlined in an article last August the combines' role in promoting technological innovation. Of all the models available to Soviet planners within the socialist community, the East German example is probably the most attractive because of its demonstrated ability to boost economic performance without decentralization or other radical reform.

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*East German Economic  
Growth Accelerates*



East Germany last week reported that economic growth accelerated in the third quarter and that by the end of September all major economic indicators met, or exceeded, plan targets. During the first nine months of 1985, national income was 4.4 percent higher than the same period last year—equal to the annual goal. Weather-related problems early this year had held growth to 4.1 percent during January to June. Industrial growth was 4.5 percent through September. Gains in efficiency provided the key source of growth, as East Berlin announced a 7.9-percent increase in labor productivity and a 2.2-percent cut in unit production costs. Meanwhile, the government recently raised its estimate of this year's grain harvest to 11.6 million metric tons, its second consecutive record crop. The acceleration of growth suggests that most full-year targets probably will be overfulfilled. With hefty hard currency reserves and projected trade surpluses with both East and West, East Germany likely will maintain its position as Eastern Europe's standout economic performer.

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**East European-Soviet Trade, 1984-1985***Million rubles*

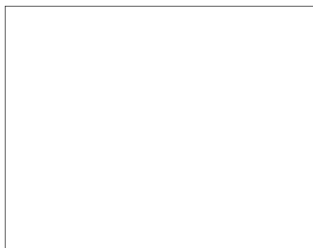
	1984		1985
	1st Half	Full Year	1st Half
<b>Total</b>			
Exports	15,170	30,478	15,953
Imports	16,237	32,393	16,368
Trade Balance	-1,067	-1,915	-415
<b>Bulgaria</b>			
Exports	2,823	5,608	2,912
Imports	3,174	6,124	3,156
Balance	-351	-516	-244
<b>Czechoslovakia</b>			
Exports	2,996	6,017	3,246
Imports	3,346	6,591	3,317
Balance	-350	-574	-71
<b>East Germany</b>			
Exports	3,772	7,367	3,821
Imports	3,583	7,481	3,710
Balance	189	-114	111
<b>Hungary</b>			
Exports	2,042	4,434	2,280
Imports	2,266	4,321	2,207
Balance	-224	113	73
<b>Poland</b>			
Exports	2,594	5,297	2,611
Imports	2,916	6,069	3,089
Balance	-322	-772	-478
<b>Romania</b>			
Exports	943	1,755	1,083
Imports	952	1,807	889
Balance	-9	-52	194



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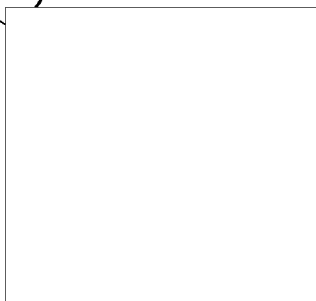
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*Eastern Europe's Trade Deficit With the USSR*



A sharp drop in Eastern Europe's trade deficit with the USSR during the first half of 1985, as compared with same period last year, was the result of slower growth of Soviet exports and of Moscow's pressure to balance trade. The East European trade deficit with the Soviets fell by 60 percent. Poland was the only country with a larger deficit. Soviet exports picked up slightly in the second quarter, but deliveries for the six-month period remained about the same as in the first half of 1984. Imports from Eastern Europe increased 5 percent. The trade deficit—now at its lowest level at midyear since 1976—reflects Soviet efforts to pressure Eastern Europe to increase exports. Although Soviet exports may pick up in the second half, the deficit for the year is almost certain to be much lower than last year's total. The boost in exports to the USSR from Romania, Hungary, and Czechoslovakia coincides with a drop in their exports to the West, suggesting stronger efforts by these countries to comply with Soviet demands. The rising deficit in Poland reflects special treatment by the Soviets in consideration of Warsaw's economic difficulties.  25X1

*Chinese Economy Still Overheated*



Official Chinese statistics show that the economy is continuing to grow at a rapid pace, with industrial output increasing 21.1 percent faster during the first three quarters of this year than in the corresponding period last year. Energy output rose by almost 11 percent—because of new oil finds and reforms in the coal industry. The exceptionally rapid growth this year has aggravated longstanding economic bottlenecks. Although the industrial growth rate is down slightly from the January-June level, the decline can be attributed more to the normal third-quarter slowdown than to remedial measures. Despite the rapid growth in energy production, China's serious energy shortage continues, and its failure to expand rail transport has made it difficult to utilize its growing stock of coal. The overheated economy has been caused in large measure by an inflationary surge in capital investment—45 percent during the first half of 1985—and by a hike in the cost of labor of more than 20 percent.  25X1

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