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International Economic & Energy Weekly

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25 October 1985

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International Economic & Energy Weekly

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25 October 1985

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International Economic & Energy Weekly

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Synopsis

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3 **Sanctions Against South Africa: Bark Worse Than Bite**

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19 **North Yemen: Banking on Newfound Oil**

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Last year's discovery of oil by a US firm has significantly enhanced the long-range prospects for North Yemen' economy. The government, however, faces the challenge of keeping the country afloat until oil revenues start flowing.

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23 **Tanzania: Nyerere's Legacy of Economic Decline**

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President Julius Nyerere, who steps down as President of Tanzania on 4 November leaves behind a moribund economy operating near subsistence levels. Restoration of economic growth is unlikely in the near term because the country has depleted its foreign exchange reserves, relies heavily on foreign assistance, and remains far from an agreement with the IMF.

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Perspective

International Commodity Programs Foundering

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Intergovernmental programs such as the UNCTAD international commodity agreements and the EC's Lome Convention are failing to soften the blow of low commodity prices on LDC export earnings. Furthermore, few, if any, officials in the international commodity community foresee a significant turnaround in commodity prices before 1990.

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Having been largely overpowered by the magnitude of the commodity price decline, progress within UNCTAD on commodity issues is at a near standstill. The few international commodity agreements that contain price provisions all have uncertain futures. The tin, rubber, and cocoa agreements face difficult renegotiations over the next couple of years, and the coffee agreement is plagued with disputes between various factions—not just between producers and consumers. The sugar agreement now exists only on paper after prices collapsed last year. Other proposed UNCTAD programs, such as the Common Fund to boost prices or compensatory financing to aid exporters, are languishing.

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The new five-year Lome agreement between the EC and the African, Caribbean, and Pacific (ACP) states—primarily Western Europe's former colonies—does little to attack the earnings problem. EC aid for proposed LDC mineral investment projects will be put to more rigorous tests, and benefits to EC industry will be given higher priority. The ACP commodity earnings stabilization program has been reworked, and EC control over funds will be stricter. Moreover, the level of funds available to offset ACP earnings shortfalls remains almost the same as the previous Lome agreement—despite lower ACP earnings and the temporary depletion of funds for the program in 1982.

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LDC exporters' special access to protected Western commodity markets also is eroding. Mediterranean exporters of fruits and vegetables are in danger of losing their preferential access to EC markets when Spain and Portugal—also major producers—join the Community next year. Moreover, while the EC is likely to continue to allow ACP sugar to enter its protected market, it will continue to dump massive amounts of cheap sugar on the world markets, depressing earnings for those LDCs without special arrangements. Sugar exporters with special access to the US market have also faced reductions in their quotas over the last several years.

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Market forces are likely to play a greater role in commodity markets as the international commodity programs wither. Indeed, most changes being proposed within the commodity organizations reflect a growing recognition of the

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importance of underlying supply and demand factors. In this more market-dominated environment, the large, efficient commodity producers—such as Brazil—could thrive. In contrast, the earnings of many smaller LDCs will be more at the mercy of commodity price swings. Realization of this fact by the LDCs has itself undermined intergovernmental programs. As a result, LDC unity on commodity issues shown prior to the 1980s is now being buffeted by the "every man for himself" attitude. While this will mean better balanced markets in the 1990s, the shakeout will be painful for commodity-dependent LDCs.

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Sanctions Against South Africa: Bark Worse Than Bite

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In the past six months, most industrialized nations have responded to political developments in South Africa with economic sanctions against Pretoria. These have been primarily symbolic measures aimed at sending a political message rather than inflicting real economic hardship. Nonetheless, the sanctions will have some impact:

- Pretoria is likely to lose some revenue earned from Krugerrand exports in the short term, but has alternatives it can implement, if need be, to shore up reserves.
- South Africa will find it more difficult to obtain computers and other sensitive imports for the nation's security forces.

Taken as a whole, however, sanctions and the threat of additional actions have added to eroding banker and foreign investor confidence in South Africa. Major clashes between demonstrators and South African police or the arrest of another black antiapartheid leader will likely prompt a number of countries to impose stiffer measures.

Sanctions and Their Impact on South Africa

At last count, some 68 countries have attempted to pressure South Africa by imposing a wide range of sanctions. Such measures include restricting exports and imports, halting government programs that promote bilateral trade, banning new investment, and reducing cultural, scientific, and military contacts. A few of the sanctions have been specifically directed against apartheid. For example, the sale of computers and other goods to South African security forces has been banned by Australia, Austria, Canada, the European Community (EC), Finland, Japan, and the United States. Some governments have established codes of conduct intended to promote equal employment opportunities within their country's South African subsidiaries. Bans on Krugerrand imports are aimed at crimping South Africa's export earnings while having a minimal economic impact on the black population.

Most of the sanctions have been symbolic, with little direct economic cost to either party. For example, South Africa sells only about $67,000 worth of Krugerrands to Australia annually. Likewise, the EC's ban on oil exports to South Africa amounts to a loss of only $30 million, in 1984. In the short run, even bans on new investment, some of the toughest sanctions yet imposed, are probably negligible because little new foreign investment would have been forthcoming in the face of South Africa's deep economic recession.

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Direct Impacts

Krugerrand Exports. Sales of Krugerrands earn Pretoria about $500-600 million annually. Over time, gold coins minted in other countries probably would replace Krugerrand sales. To circumvent these bans, South Africa probably will either sell bullion or increase its gold collateralized borrowings from international banks to shore up reserves.

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Imports of Sensitive Products. Most Western nations have restricted sales of so-called sensitive products—for example, computers and military-related items—to South Africa's security forces. Although these restrictions will make importing such products more difficult and costly, we believe Pretoria will be successful in obtaining needed equipment either through purchasing goods from countries without bans, or by circumventing these restrictions—in the past Pretoria has weathered oil and arms embargoes through illegal acquisitions and domestic production. Many Western countries have also restricted new nuclear contracts, but new regulations limiting nuclear sales are likely to have a minimal short-run effect because most countries have been restricting new sales for the past couple

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South Africa: Sanctions Scoreboard

	Import Restrictions	Export Restrictions	Investment Restrictions	Loan Restrictions	Export Finance or Insurance	Other	Comment
United States	Ban or Krugerrands and armaments imports.	Ban on nuclear goods or technology and computers for security forces and agencies enforcing apartheid.		Ban on loans, except those used to "improve lives of black South Africans."		Require US companies in South Africa to adhere to code of conduct.	
Australia	Ban on Krugerrands. Embargo on government contracts over $13,000 with South African companies.	Ban on petroleum and petroleum products, computer hardware, and other products used by South African security forces.	Suspension of Government of Australia investment in South Africa, and South African Government investment in Australia.	Voluntary	Export financing ban.	Voluntary code of conduct for firms.	Sanctions expected to have little effect— petroleum and computer exports negligible and Krugerrand imports less than $67,000 annually.
Austria	Voluntary bank restrictions on Krugerrand imports.	Ban on computer exports and assistance by state enterprises in nuclear projects. Ban on weapon exports.	Ban on new investment by state enterprises.	No government loans gurantees for exports to South Africa.			Minimal effect—total Austrian trade with South Africa was only $142 million in 1984.
Canada	Krugerrand sales "discouraged." Acceptance of UN embargo on South African arm sales.	Voluntary for crude oil and refined products. Mandatory for computer sales to security forces and agencies enforcing apartheid.		Voluntary on new loans.	Termination of export insurance.	Voluntary code of conduct for firms. Mandatory ban on air traffic to and from South Africa. Abrogation of double-taxation agreement.	Canada sells virtually no crude oil or refined products to South Africa—Krugerrand competes with the Canadian Maple Leaf.
Japan	Government guidance against Krugerrand sales.	Ban on computer sales which might assist South African military or police.	(See comment.)	"Guidance" against extension of commercial loans.	Insurance fees raised 20 percent.		Japan has banned direct investment in South Africa for 30 years. Japan imports about $50 million worth of Krugerrands annually.
Nordic countries [1]	Importers urged to find other suppliers. Ban on weapon and Krugerrand imports.	Ban on new nuclear sales and computer equipment. Nordic exporters urged to find other markets.	Ban on new investment.	Ban on new loans and any participation in international loans.	No government support of trade with South Africa.	Cessation of commercial flights to and from South Africa.	
Sweden	Krugerrands, fruits, and vegetables banned. Government "discouraging" imports of other goods.	Recommendation: exporters seek alternative markets.	1979 freeze on investments tightened.			Cessation of commercial flights to and from South Africa.	Import and export restrictions still require approval by Parliament. Since 1979 all new investments and loans banned.

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South Africa: Sanctions Scoreboard (continued)

Norway	Fruits and vegetables. All imports from South Africa subject to licensing.	Licensing of all trade, ban on crude oil exports.	(See comment.)			Cessation of commercial flights to and from South Africa. Registration of all Norwegian ships calling on South Africa.	Compulsory registration is designed to stem the flow of oil to South Africa—Norwegian tankers carry between one-third and one-half of Pretoria's oil imports. Investment in South Africa has been blocked since 1976.
Finland	Ban on government purchases from South Africa and recommendation that municipalities also refrain from buying South African products.	Ban on leasing, trade in patents and licenses, computers, and nuclear exports.	Ban on investment.	Ban on new loans.			All measures still require approval by Parliament, which will debate the issue this week. Voluntary restrictions have eliminated 80% of imports from S. Africa.
European Community [b]	Arms and paramilitary equipment.	Oil, new nuclear collaboration, and equipment for police and armed forces.				Voluntary code of conduct for firms with subsidiaries in South Africa.	Actions symbolic since no crude oil exported by the Community to South Africa—France barred new nuclear supply contracts in 1983. The United Kingdom initially withheld approval of EC sanctions.
EC members	Gradual phase out of coal imports by 1990 (Denmark).		Ban on new investment (France and Denmark). Suspension of official support for investment in South Africa (Belgium).		Limits on export insurance (West Germany and the Netherlands).	Cessation of commercial flights to and from South Africa (Denmark).	France prohibited Krogerrand imports since late 1960s.
Commonwealth Countries [c]	Voluntary ban on Krugerrands and arms.	Voluntary ban on computer sales to South African security forces, new nuclear equipment and technology, and oil exports.		Voluntary ban on government loans.		Voluntary ban on government funding of trade missions to South Africa.	If no progress is visible toward dismantling apartheid within six months, additional measures will be considered. London probably agreeded to the ban on Krugerrands in exchange for mild sanctions by the Commonwealth similar to the EC's measures.

[a] Nordic countries: Norway, Sweden, Denmark, Finland, and Iceland.
[b] European Community countries: Belgium, Denmark, France, Italy, Luxembourg, the Netherlands, Ireland, Greece, United Kingdom, West Germany, Spain, and Portugal.
[c] The United Kingdom plus 48 former colonies and territories.

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South Africa: Top Five Trading Partners, 1984 [a]

Million US $

Imports		Exports	
Total	16,942	Total	14,689
Of which:		Of which:	
West Germany	2,343	United States	2,626
United States	2,299	Japan	1,579
Japan	1,850	West Germany	1,455
United Kingdom	1,640	United Kingdom	1,317
Italy	525	France	653

[a] All figures f.o.b.

of years. The nuclear restrictions applied by the EC in mid-September are largely symbolic because France—the only significant EC supplier of nuclear technology to South Africa—has barred new nuclear contracts with South Africa since 1983. Continuation of the nuclear-sales ban may hamper Pretoria's plans to build a second nuclear power plant in the 1990s, however.

Broader Implications

Although the bans on new loans and investments that have been imposed so far will have little direct impact, sanctions have contributed to the erosion of foreign investor confidence in South Africa that triggered the exodus of some foreign companies and spawned the recent financial crisis. In the past year, 18 US companies—three times the number a year earlier—have halted all or part of their South African operations and others have scaled down their operations South Africa's three-month moratorium on debt principal repayments damaged the country's credit reputation and, as a result, Pretoria will find it more costly to secure foreign loans and trade financing. Higher cost foreign credit probably will contribute to keeping domestic interest rates high and—compounded by corporate disinvestment—will slow economic growth.

The imposition of sanctions by Western countries, however, will not prompt the white regime to accelerate its program of limited reform. The government's longtime "stand firm" approach to external pressure has always been viewed favorably by most white voters. President Botha probably believes, justifiably, that his strong support from whites would erode quickly if they thought he was weakening under pressure from foreign countries and restive nonwhites. In fact, the right wing, which has become increasingly anti-US, may be able to exploit the sanctions issue to gain new support. Although many blacks have applauded the limited measures as a sign of growing Western awareness of their plight, they believe the sanctions are inadequate to pressure the white government and may delay or preclude stronger Western actions.

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Sanctions Outlook

We believe that Australia, France, and the Nordic countries will impose additional sanctions unless Pretoria takes significant steps toward dismantling apartheid. Australia is calling for further action, according to US Embassy reporting, and—along with Afro-Asian members of the Commonwealth—pressed the issue during last week's Commonwealth Conference. The French, the driving force behind EC sanctions, are likely to support calls for UN sanctions and additional measures by the EC, as well as take action on their own. Norway, Sweden, and Denmark are calling for comprehensive sanctions by the United Nations, but may adopt some new measures independently.

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Barring heightened violence or government repression within South Africa, the British and West Germans probably will be able to prevent any additional sanctions by the European Community. London's opposition stems from its significant economic ties, which the Thatcher government does not want to endanger at a time of high domestic unemployment. London's initial reservation to EC

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sanctions was probably dropped only in an effort to forestall more extreme actions by the United Nations or at the Commonwealth Conference. The Commonwealth's mild voluntary sanctions probably represent a victory for Prime Minister Thatcher who resisted stronger mandatory measures at the conference. Traditional West German resistance to future sanctions has hardened following Bavarian leader Strauss's denouncement of Bonn's agreement to the EC measures. Swiss refusal to use economic sanctions to achieve political goals, combined with their important trade relationship with South Africa, is likely to ensure that Switzerland remains the only major industrialized nation not to impose sanctions.

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Japan, Canada, Spain, Belgium, Italy, and the Netherlands appear to be pursuing a wait-and-follow strategy. These countries almost certainly will not advocate additional sanctions, but may adopt measures to avoid the appearance of supporting the white-minority regime. Japan's recent actions came considerably after other Western nations enacted measures. Similarly, Spain, Belgium, Italy, and the Netherlands are likely to take further action only if a consensus forms within the EC.

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Eastern Europe: Boom Market for Syndicated Lending

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East European borrowing from Western banks has rebounded sharply this year. The region raised $2.8 billion in syndicated loans on increasingly favorable terms in the first 10 months of 1985—a sharp turnaround from the early 1980s when bankers slashed lending to the East. Japanese and Arab banks have played a leading role in new lending, while the importance of US and West European banks has fallen. Lenders have become more inclined toward Eastern Europe because of improved hard currency trade performance in the region over the past two years and a lack of comparably attractive investments elsewhere. Borrowers have taken advantage of favorable loan terms to restructure debt, build reserves, and cover shortfalls in hard currency earnings this year.

Widening Circle of Borrowers

The number of East European countries returning to the syndicated market has grown quickly this year, and many of the loans have been oversubscribed.[1]

- East Germany secured a $500 million loan in March; in June it obtained a consortium loan for $600 million.
- Hungary in June tapped Western banks for the bulk of an $800 million World Bank cofinanced loan and Japanese banks for an additional $400 million since January.
- Bulgaria borrowed $200 million in July and $120 million in October.
- Czechoslovakia borrowed $100 million from a Western bank consortium in July.
- Four commercial banks extended an $80 million bridge loan to Romania in May

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Only Yugoslavia and Poland, which still require debt reschedulings, remain shut out of the syndicated loan market.

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Japanese and, to a lesser extent, Arab banks have played a prominent role in the upswing in new lending. Japanese banks, looking to diversify their loan portfolios, have taken the lead or jointly managed 41 percent of the loans to Eastern Europe this year, as compared with 18 percent in 1979.

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increased competition from Japanese banks in the lending market has pushed down interest rates on loans to Eastern Europe. In contrast, US banks have managed 15 percent of this year's loans to the East, down from 20 percent in 1979. This parallels the decline in overall US exposure to Eastern Europe. Many US banks that have managed recent loans to the region have been mainly interested in earning the management fees and have tried to sell off their portions of the loans quickly to limit exposure.

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Western Bank Motives

The lack of comparably attractive lending opportunities elsewhere largely explains the willingness, and, in some cases, even eagerness of Western banks to resume lending to Eastern Europe. The financial positions of East Germany, Hungary,

[1] Oversubscription occurs when participating banks offer funds in excess of the original loan amount.

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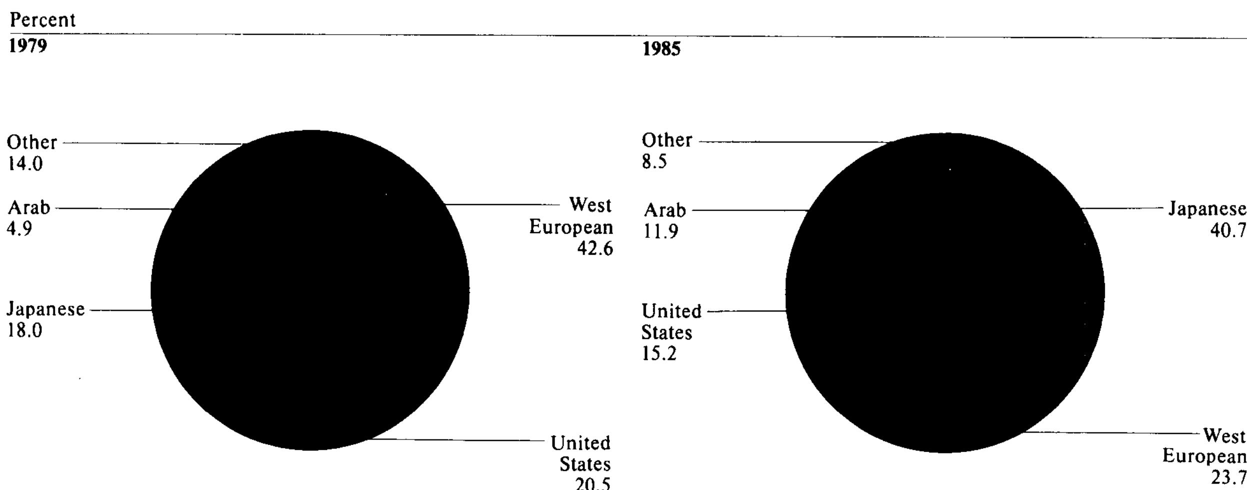
Management of Syndicated Loans to Eastern Europe, 1979 and 1985



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Bulgaria, and Czechoslovakia seem relatively more secure than those of many LDCs, especially in Latin America, where bankers feel overexposed. As a result, not only has the absolute amount of Eastern Europe's borrowing increased, but also its share of bank lending to countries outside the OECD—13 percent so far this year, as compared with 6 percent in 1976 and 10.5 percent in 1979.

Eastern Europe's hard currency trade surpluses in 1983-84 and some easing of East-West tensions have been the major factors encouraging bankers to look more favorably on the region. The East European borrowers have also substantially cut their debt since 1980, and, except for Romania, they have avoided rescheduling. Having made deep cuts in their East European exposure in 1981-83, banks now feel they have elbowroom to respond to loan requests from the more creditworthy countries. Some bankers—particularly in Western Europe and Japan—believe East European imports from the West will rise with the launching of new five-year economic plans for 1986-90, and they want to reestablish ties to the better credit risks.

Western banks have been particularly receptive to loan requests from East Germany and Hungary for additional reasons. East Germany, besides running sizable trade surpluses, boasts the strongest record of economic growth in Eastern Europe since 1982. Banks also value the West German umbrella for East Berlin, which Bonn demonstrated by guaranteeing two large West German bank loans during East Germany's liquidity squeeze. Finally, banks have found East Berlin a lucrative loan market because of the regime's acceptance of relatively high interest rates—recent loans have carried higher spreads over LIBOR than those for most other Bloc countries. The East Germans apparently prefer to have their loans oversubscribed at higher interest rates than to obtain the most favorable terms.

In Hungary's case, bankers are counting strongly on Budapest's reform program to improve the efficiency and competitiveness of the economy. Hungary's good relationship with the IMF—which lent it nearly $1 billion in 1982-84—has added to

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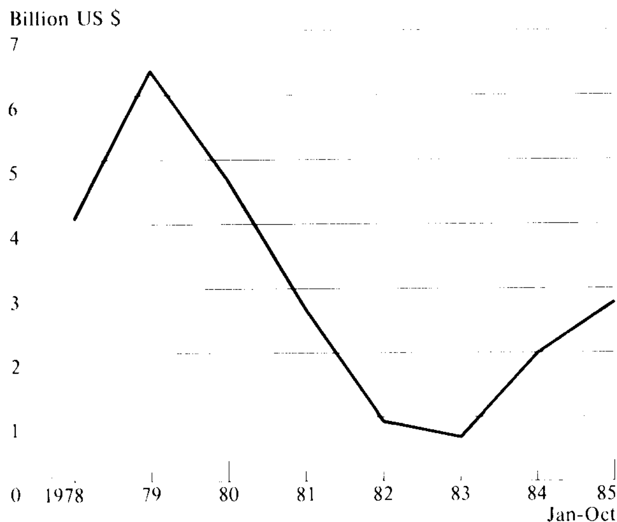
Syndicated Loans to Eastern Europe, 1978-85



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banker confidence. Moreover, banks have been eager to participate in World Bank cofinancing loans because they believe that Bank involvement guarantees that the loans are exempt from rescheduling should Budapest run into repayment problems. Japanese banks have been particularly attracted by the apparent security of these deals.

In Romania's case, however, new lending has been less than voluntary. Recent loans have stemmed largely from the bankers' desire to avoid another round of reschedulings. Disappointing export performance earlier this year seriously reduced Romania's foreign exchange reserves. Leading creditor banks concluded that Bucharest needed a major loan to cover large payments due in October under its rescheduling agreements.

Reasons for Borrowings

The East Europeans initially used the borrowings to repair some of the damage to their financial positions caused by the credit crunch. They took advantage of the longer maturities and lower interest rates to replace more expensive short-term debt accumulated in 1982-83. Borrowers also used the funds to boost reserves and build financial cushions against another cutback in lending to the region. East Germany and Czechoslovakia returned to the loan market to reestablish their credit ratings. For example, East Germany continued to raise new credits even though it had not drawn down all its previous borrowings and sought oversubscribed loans as proof of its financial strength. In contrast, the more recent borrowing initiatives by Hungary, Bulgaria, and Romania have resulted from shortfalls in hard currency earnings caused by poor trade performance this year.

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Outlook

The borrowing trend is likely to continue, at least in the short run. Even countries with no immediate plans to draw down the funds will probably continue to exploit the continued shortage of lower risk LDC borrowers. In addition, some East European countries may plan more borrowings to finance an increase in Western imports as they enter the new cycle of five-year plans. Some countries may see the need to import more capital goods to redress import cutbacks in the early 1980s and meet modernization requirements resulting from Soviet pressure to improve the quality of exports to the USSR.

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Still, an extended downturn in the region's economic health or deterioration in East-West relations could reverse the trend. While this year's slump apparently has not alarmed banks, lenders—and even borrowers—may become reluctant if trade performance continues to slide. The current enthusiasm among bankers for Eastern Europe may cool when it becomes apparent that these countries have done little to produce the sustained growth in exports needed to pay for more imports. Failures by Poland, Romania, and Yugoslavia to meet obligations under rescheduling agreements might sour

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some bankers on the entire region, but such a spillover seems much less likely than in 1981. A more serious threat to Eastern Europe's ability to obtain new loans might result from a reemergence of severe payments problems in the LDCs.

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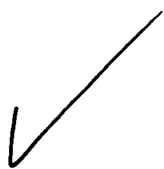

Malaysia: The Push for Economic Parity Falls Short [1]

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Since 1971 Malaysia's economic strategy has been governed by the New Economic Policy (NEP), an ambitious social restructuring program directed at boosting Malay participation in the Chinese-dominated economy. Declining economic growth in recent years has slowed the NEP's progress and, in our judgment, makes it likely that its 1990 goals will not be met. Ironically, Prime Minister Mahathir, once considered a Malay chauvinist, could become the scapegoat for the NEP's failure to deliver if he is still in office because his concept of affirmative action for Malays is the philosophical underpinning of the NEP.

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A Strong Start Weakens

By 1980, the NEP had made impressive strides in achieving greater economic balance largely because a buoyant economy, growing 8 percent annually through the 1970s, financed the restructuring. Government expenditures—underpinned by trade revenues and oil exports—rose nearly 20 percent annually during the period and funded increases in numerous NEP-oriented programs. Kuala Lumpur used a large portion of this spending increase to acquire equity capital for establishing a Malay commercial and industrial base. Large investments in development programs to benefit rural Malays were also made.

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Global recession, however, dampened Malaysia's economy in the early 1980s, slowing economic growth to just over 6 percent annually through 1984—compared with the 7.8-percent average annual rate that government officials said was necessary to keep the NEP on track. Growth in 1985 is expected to slip to 5 to 5.5 percent, according to the US Embassy.

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The New Economic Policy

Kuala Lumpur embarked on the New Economic Policy (NEP) in 1971, following racial rioting between Malaysia's main ethnic groups—the Malays who constitute 50 percent of the population and the Chinese who account for 35 percent. Set for 20 years, its objectives were to eradicate poverty and restructure employment and corporate equity in favor of the economically backward Malays.

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The ambitious social restructuring objectives of the NEP essentially call for the advance of rural and urban Malays into modern activities at all levels of employment and ownership. In order to achieve the stipulated shifts in economic roles, Kuala Lumpur at the outset decided to use quasi-government-agencies as proxies for the capital-short Malay community. In this role, the government has established commercial and industrial enterprises and acquired corporate equity in trust for the Malays.

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To minimize non-Malay resistance to this policy, the goals of the NEP are not pursued through outright redistribution but as an outgrowth of a rapidly expanding economy. On paper at least, Malay economic advance occurs as the Malays are granted the lion's share of the opportunities generated by economic growth. Preferential treatment for the Malays increases their share of the economy, but does not necessarily reduce the absolute size of non-Malay wealth.

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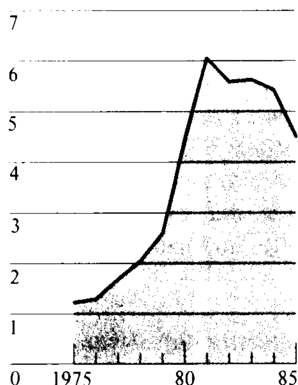
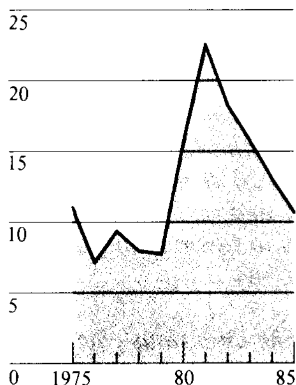
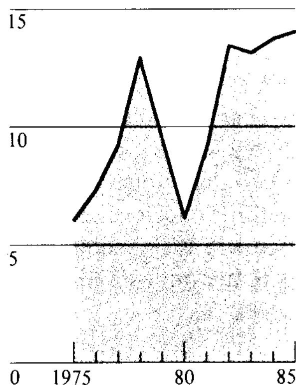
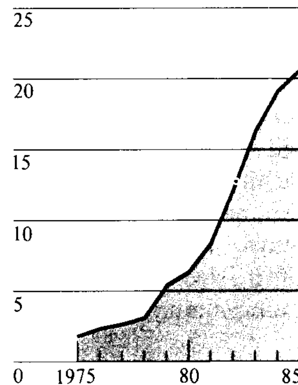
Malaysia: Development Spending and Debt, 1975-85

Note scale change









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

[b] 1975-78 excludes short-term debt.
[c] 1975-78 excludes short-term debt.

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Depressed international commodity prices—especially for oil, tin, and rubber—substantially reduced both export earnings and the government's trade-based revenues. By 1982 the current account deficit had risen to $3.4 billion—13 percent of GNP—a drastic downturn from a surplus of nearly $1 billion just three years earlier.

Mahathir's first reaction to these strains was to boost foreign borrowing to maintain the pace of the NEP's progress. As a result, Malaysia—which entered the 1980s with one of the smallest foreign debts in Asia—turned into one of the most aggressive foreign borrowers among developing countries. Its foreign debt doubled between 1979 and 1982 to $12 billion.

Austerity and the NEP Clash

Confronted with rising federal budget deficits in the early 1980s, Mahathir reversed the upward trend in development spending and implemented a program of fiscal austerity. Mahathir also introduced more radical policies to ease budget deficits and foreign payments strains. Because these policies relax strictures on non-Malay employment and ownership, they have been controversial:

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- ***Privatization.*** Mahathir's ambitious privatization agenda is certain to conflict with the goals for increased Malay participation in the economy because the capital-short Malays, unlike Chinese and foreign interests, are unable to purchase a substantial share of newly privatized enterprises. Moreover, government agencies established to promote Malay ownership will also be constrained.

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- ***Foreign Equity Revisions.*** Last July, Kuala Lumpur announced changes in the foreign equity regulations to encourage more foreign investment. The new rules link the foreign partner's equity ceiling—previously limited to 30

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percent—with the export level of the project.[2] These more lenient guidelines will allow increased foreign investor participation, but at the risk of crowding out Malays.

- ***Amending the Industrial Coordination Act.*** Kuala Lumpur has also announced a reexamination of one of the cornerstones of the NEP—the Industrial Coordination Act (ICA). Under the ICA, the Ministry of Trade and Industry is empowered to impose conditions—including equity and employment structure, location, and the use of Malay distributors—on firms which employ more than 25 persons and exceed $100,000 in capital. A recent World Bank/United Nations study, however, proposed that Malay employment and equity participation goals would be best accomplished through financial incentives. We believe any such move would incur substantial opposition within the Malay community and among organized labor.

Mahathir's Dilemma

We believe Mahathir's alterations in the framework of the NEP reflect not only the need for fiscal restraint and increased private investment, but also indicate a fundamental shift in his attitude toward it. He deplores the "welfare mentality" the NEP has generated among Malays and has privately expressed disappointment with their failure to exploit the opportunities available under the NEP. To counter this attitude, he seems intent on pushing his Look East policy, which is an attempt to inculcate a Japanese-style work ethic into the Malay community.

Disillusion with the NEP he so strongly advocated is a dilemma for Mahathir as he faces a major decision concerning its future. Despite his belief that the Malays themselves are largely responsible for the failure of the NEP to reach its targets, the shortfall will be politically damaging to the Mahathir administration. We believe Mahathir will have to choose among three policy options to limit adverse repercussions.

[2] Projects involving nonrenewable natural resources are not included.

Extend the Deadline. His most likely response is simply to extend the NEP into the Sixth Malaysia Plan (1991-95) by pushing back the target dates and continuing preferential treatment for the Malays. This is probably the most politically acceptable solution for Mahathir and the rest of the Malay leadership. In addition, we believe this option would create only minimal opposition among the Chinese.

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Mahathir is not yet committed to an extension, maintaining that it would be premature at this point. Even if the NEP is extended, we believe its role will diminish in the longer term as Mahathir works to wean the Malays from the "handout mentality."

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Let the NEP Expire. Although it is unlikely, in our view, this option cannot be discounted if Mahathir is still in office. According to the US Embassy, Mahathir is much less content than his predecessors with the mechanical focus on increasing percentages of Malay ownership in quasi-governmental companies. We believe the prospects for expiration would increase in the event of a drastic downturn in the international economy during the next few years. If the NEP were to expire, however, we believe Mahathir would leave in place certain structural aspects—such as university quotas for Malay students and preferential treatment in government contracts—which enterprising Malays could exploit.

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Go For Broke. As its least likely choice, the Mahathir government could attempt to achieve the NEP agenda on schedule by a "go for broke" strategy in the 1986-90 plan. Such an effort, however, would require massive government financing and lead to worsening budget deficits and accelerated foreign borrowing. The financial impact, in our view, would probably undermine Malaysia's good international credit standing and risk leaving its external accounts vulnerable to an international economic downturn. It would, moreover, directly conflict with Mahathir's austerity policies of the past three years.

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Potential Fissures in the Malay Community

A diminished role for the NEP could provoke new communal tensions, in our judgment. The emergence of a Malay middle class since 1971 has brought many Malays into the economic mainstream but, according to the US Embassy, left many more behind. With the current leadership more closely identified with the new class of urban, well-educated Malays, we believe rural Malays probably would seek a political voice more closely aligned with their own interests. Such a realignment would reduce the traditionally strong rural support for Mahathir's party, the United Malays National Organization, and strengthen the attraction of its main—but thus far ineffective—rival for the Malay vote, the fundamentalist Islamic party.

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The Malay community now believes that, under the NEP, two important aspects of culture—Islam and Malaysian as the national language—are accorded the status they deserve. Under a watered down version, however, perceptions of increasing secular influences within Malaysian society might precipitate calls—from both the newly prosperous urban Malays as well as the more traditional rural Malays—for stricter adherence to Islamic principles.

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North Yemen: Banking on Newfound Oil

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Last year's discovery of oil by a US firm has significantly enhanced the long-range prospects for North Yemen's economy. The government, however, faces the challenge of keeping the country afloat until oil revenues start flowing. We believe that President Salih will be able to guide the economy through the tough times it will face over the next three years, in part by relying on the private sector that maintains large cash holdings. In addition, Salih probably will implement further austerity measures and try to arrange advanced payment from Western firms for future oil production. His most difficult task, and one at which most leaders of new oil exporting countries have failed, will be offering the Yemeni people some early benefits of the oil find without raising popular expectations too high.

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Developing the Oil Find

The Hunt Oil Company first struck oil in July 1984,—the only find to date—and initial estimates from this find put North Yemen's production potential at 200,000 b/d. Since then, Sanaa has launched an aggressive campaign to discover other oil resources. It has awarded or is preparing to give concessions—both onshore and offshore—to Hunt, BP, Exxon, the French National Petroleum Oil Company Total, and Amoco. Only three small areas remain to be leased. BP is just beginning exploratory drilling operations and the others are still involved with preliminary arrangements.

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Sanaa's initial goal is to meet domestic energy needs. To reduce its $300-million annual import bill for petroleum products, Sanaa has awarded a contract for a 10,000 b/d refinery project to Hunt. The refinery—expected to be operational by next October—will satisfy almost one-half of North Yemen's domestic requirements

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Exports of crude will require pipeline and terminal facilities—initial oil exports probably will not begin until 1988. In June, Bechtel made a formal proposal to build the 400-kilometer Ma'rib to Salif pipeline, with an initial capacity of 100,000 b/d and a potential capacity of 400,000 b/d. In addition, various West European, Japanese, and South Korean firms are interested in subcontracts for the terminal and pipeline. The participation of these firms would enhance the possibility of obtaining project financing.

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To facilitate North Yemen's oil development, Sanaa elevated the state-owned Yemen Oil and Mineral Corporation (Yominco) to ministerial status last August. Ahmed al-Mohani, current North Yemen Ambassador to Saudi Arabia, will reportedly be the new Minister of Petroleum. The appointment of Mohani—who was educated in the United States—probably will work to the advantage of Western oil firms in North Yemen. It also is likely to help ease the tensions between Saudi Arabia and North Yemen that developed after the Hunt oil discovery near their disputed border.

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Worsening Economic Straits

Although oil-related activity has not provided immediate relief to the troubled economy, expectations of North Yemenis have begun to rise. The

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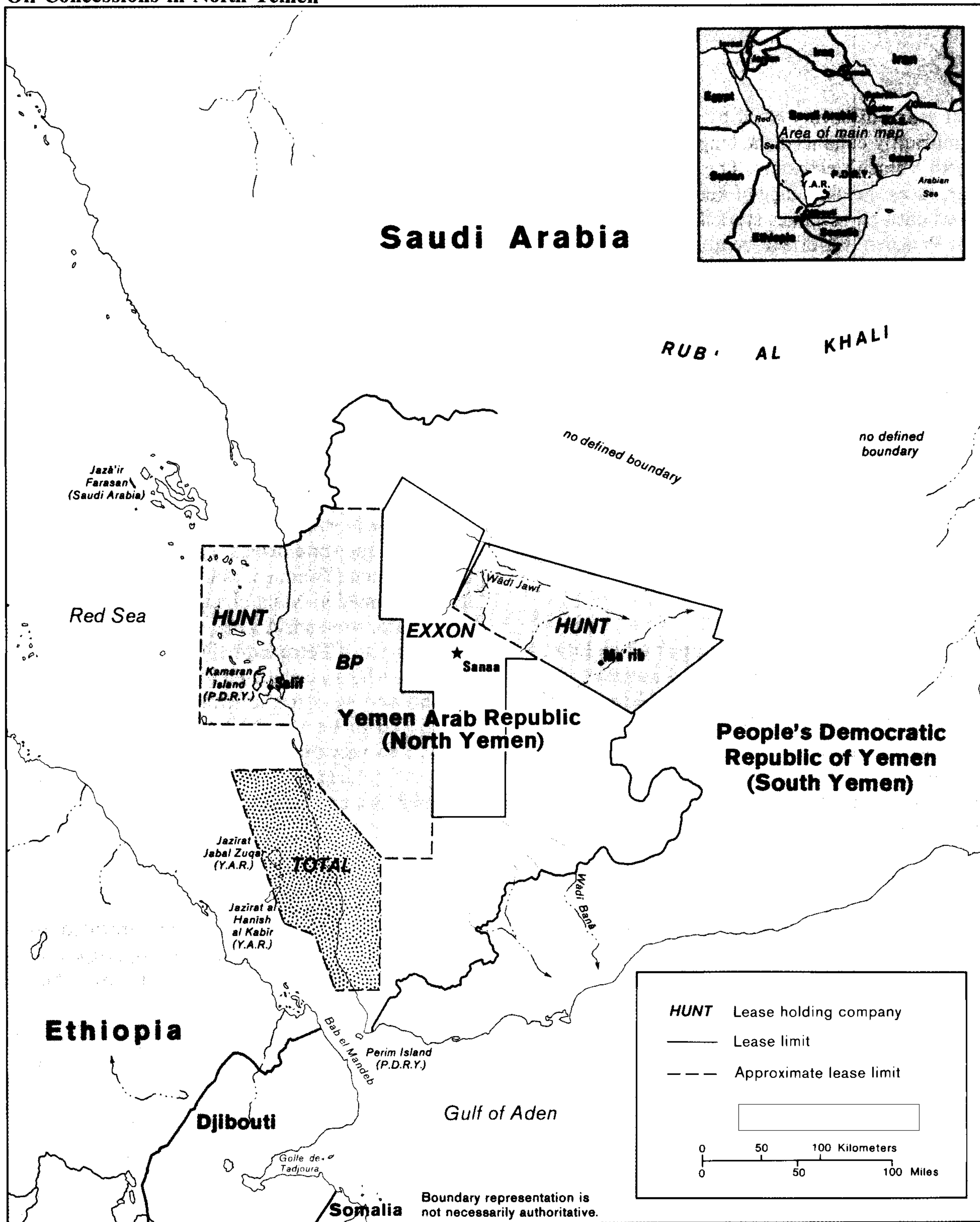
Oil Concessions in North Yemen



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economy faces continued current account and budget deficits, as well as an average inflation rate of 20 percent per year. Sanaa is dependent on foreign aid to cover the trade gap, but aid funds are less than one-third of their 1982 levels and are not likely to rebound in the near future because of the impact of declining oil revenues on North Yemen's Persian Gulf benefactors. In addition, foreign exchange reserves have fallen to $290 million and are now sufficient to cover only two months of imports.

Worker remittances, which provide much of the country's foreign exchange, are likely to decline. Yemeni workers have begun to return from Saudi Arabia because of the contraction of the Saudi economy. Although many returning workers hope to find lucrative jobs in North Yemen's oil sector, opportunities in this field are not yet widely available. While North Yemen's private sector still maintains a surplus of capital, Yemenis hold a major share of their assets in cash outside the banking system. This continues to be a source of frustration to economic policy makers who are unable to mobilize these resources for economic development.

The Government Reacts

Sanaa has implemented a series of austerity measures over the past year to deal with the deteriorating economic situation. Despite the government's fears of fueling inflation and public discontent, Sanaa floated the riyal last April. It hoped to encourage a drop in imports that would enable it to ease the politically unpopular import restrictions imposed in 1983. The new measures have not been in place long enough to determine whether they will prove successful.

In August, the government moved to attack inflation. It closed six of Sanaa's larger grocers for violating government retail price guidelines. It also directed all "mixed-sector" businesses to move their bank accounts—5 percent of all commercial bank deposits—from private commercial banks to the government-controlled Yemen Bank for Reconstruction and Development (YBRD). The goal is to restrict the lending base of the commercial banks, thereby cutting growth in the money supply.

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Sanaa has begun considering additional measures to deal with the budget deficit—$400 million this year. Although the government has expanded revenue collection in recent years, the US Embassy estimates that it collects only about half the revenues owed it. Sanaa will try to tighten tax compliance, especially the payment of customs duties that comprise half of all government revenues. Sanaa is also considering increased taxes and user's fees for government services. On the expenditure side, the government will cut capital spending programs and public-sector employment, and closely audit expenditures. The poor administrative capabilities of North Yemen's civil service and the decentralization of tax collection, however, will constrain Sanaa's ability to use tax increases as a means of increasing revenues. Moreover, further budget cuts, while easier to implement, are likely to be politically unpopular.

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Outlook

Until oil revenues begin to flow, President Salih will have to grapple with the challenges created by continuing economic problems and rising popular expectations. Because most of the initial returns from oil production will be used to make payments on debts incurred for oil development projects, Salih will be unable—at least initially—to bolster his power base by distributing the benefits of economic growth to a broad spectrum of the population. Limited public discontent, sporadic strikes, and complaints about government inefficiency probably will continue.

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Still, there are economic and societal factors that will help the government muddle through this period of stress. The "mattress money" of the private sector will serve as a buffer to Yemeni

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families and probably will help mitigate their frustrations over economic difficulties. In addition, the Yemeni business community—which has contributed about half of the resources for the country's development plans—generally supports the government, and probably will continue to do so because of the stability Salih's regime has brought the country.

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The Hunt oil discovery and the activity of other US oil firms has improved US–North Yemeni relations. The oil discovery has enhanced Salih's power, and we believe that the political stability that his regime has brought advances US interests. Over the next five years, Salih probably will increasingly look to the United States for financial aid to support the economy until oil revenues are realized. North Yemen's satisfaction with the developing relationship with the United States, the oil find, and the presence of US military equipment in North Yemen's inventory—as well as Sanaa's growing dissatisfaction with Soviet military equipment—creates possibilities for further military purchases from the United States. Moreover, the success of Western firms in finding oil in North Yemen will not be lost on South Yemen where the Soviets have long been unsuccessfully exploring for oil. The contrast between Western success in the north and Soviet failure in the south may move Aden to open additional oil concessions to Western firms.

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Tanzania: Nyerere's Legacy of Economic Decline

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President Julius Nyerere, who steps down as President of Tanzania on 4 November, leaves behind a moribund economy operating near subsistence levels. Although Nyerere's successor, Vice President Mwinyi, is likely to try to initiate domestic policy reforms as he did while President of Zanzibar, he will be hampered by the near total breakdown of the country's infrastructure, a thriving unofficial economy, low productivity, and 25- to 30-percent inflation. All of these have been firmly ingrained by chronic currency overvaluation, mismanagement of state-run enterprises, and negative real producer returns. Restoration of economic growth is unlikely in the near term because the country has depleted its foreign exchange reserves, relies heavily on foreign assistance, and remains far from an agreement with the IMF.

Nyerere's Policy Failures

In our view, however, Nyerere's socialist domestic policies, starting with the self-sufficiency concept of Ujamaa, have been the primary cause of the country's economic decay. In addition, Tanzania, which began independence with a diversified agricultural export economy, has suffered reverses from its military intervention in Uganda from 1978-82, droughts in the 1970s that made it a net food importer, and the two oil price shocks.

We believe the Ujamaa village development program, launched in 1967, set in motion the decline in agricultural production. Peasants were relocated to unfamiliar and underdeveloped areas, but the government failed to support the program adequately. From the beginning, the government was unable to provide the transportation to ship crops to market and to provide necessary agricultural equipment, pesticides, and fertilizers. Moreover, Tanzania's four-year involvement in Uganda diverted manpower and money from the program. The experiment was abandoned in the early 1980s.

Government interventionist policies have also put a damper on production. Artificially low producer prices—set periodically by the government—provide negative real returns to farmers, discouraging production for both the domestic market and export. Real GDP fell during 1981-83 and posted only minimal gains last year. Shortages of goods in state-run stores, particularly in urban areas, has encouraged black-market activity. The 90 percent of the population that is engaged in agricultural production is increasingly turning to subsistance farming.

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The government-owned enterprises, which control almost all legal trade, have long been one of the biggest drains on the economy. Their ever-spiraling operating costs have absorbed rising percentages of profit.

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the Tanzanian Sisal Authority, according to US Embassy reporting, has failed to purchase and market goods adequately and has provided little incentive to workers; at the same time, it has allowed production and maintenance to decline sharply. These businesses have frequently not paid farmers at all for their crops.

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An overvalued currency has made Tanzanian commodities considerably less competitive on the world market. Thus, Tanzania finds it difficult to earn hard currency for purchases of oil, chemicals, seed, and machinery and is unable to pay debts to oil suppliers and international lenders. Debt service last year was equal to about 75 percent of exports of goods and services. Nyerere's continued resistance to devaluation was the major obstacle to an IMF standby agreement last spring, and further negotiations are not likely to resume any time soon,

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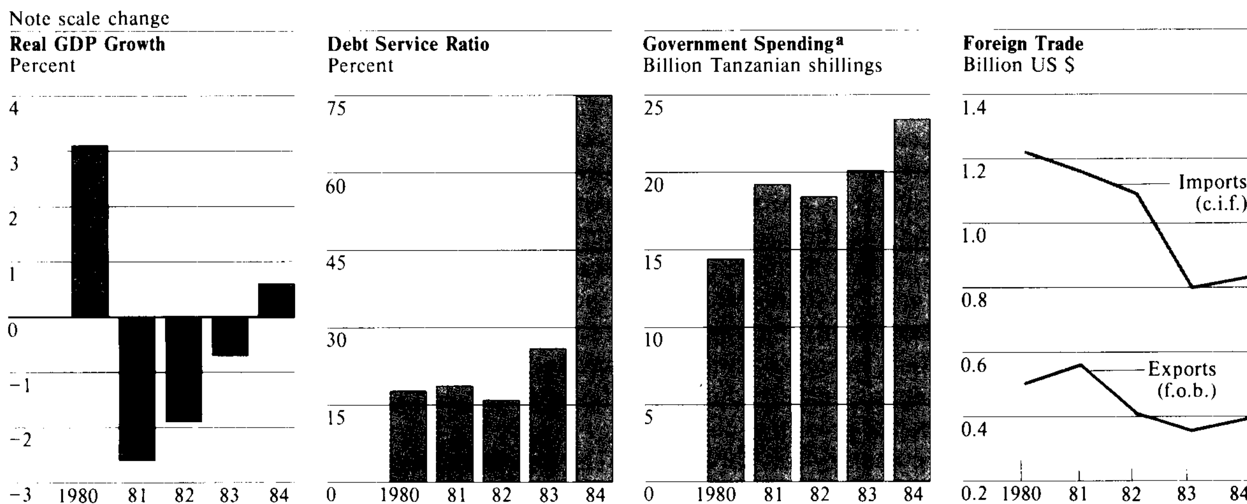
Tanzania: Selected Economic Indicators, 1980-84



[a] Total central government expenditure and net lending.

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Impact on Society

The economic downturn has severely damaged the country's fragile infrastructure. Even the much vaunted socialist medical and health care services have deteriorated, according to US Embassy reporting, and malaria and other endemic diseases are again on the rise. The transportation sector operates erratically; schedules of the Chinese-built Tazara railroad linking Tanzania and Zambia are determined by available fuel supplies, according to press reporting. Road repair and maintenance of the congested facilities at the port of Dar es Salaam are neglected, and potential revenue from port activity is often lost because of theft of goods waiting transshipment or spoilage in warehouses and on wharves, according to press reports. 25X1

The economic slide has fostered a subculture of corruption. The military loses thousands of dollars yearly from stolen payrolls, weapons, clothing, and food. Peasants smuggle food across the Kenyan border to sell or to barter for soap or cooking oil. According to press reports, in Dar es Salaam and other larger cities, meals in restaurants are obtained faster and cheaper by bribing the waiter to steal from the kitchen. 25X1

Mwinyi's Prospects

Pragmatists in the government already are pressing Mwinyi to institute economic reforms when he takes over the presidency. Mwinyi, a lackluster party stalwart who was a compromise choice of the country's sole political party, favors the current Chinese development model and trade liberalization measures he enacted on Zanzibar. He lacks a solid base of support on the mainland, however, and we believe he will proceed with caution for the first six to 12 months he is in office. Moreover, the cynical attitude that permeates the lower classes probably will make it difficult to gain their support for economic reform. 25X1

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While no cabinet changes will be made until after the inauguration on 4 November, Minister of Finance Msuya, will likely be retained in the new government. He has been a supporter of such policies as an IMF agreement, devaluation, trade liberalization, producer price increases, and reorganization or privatization of some state-run enterprises. Defeated presidential contender Salim may also prove to be a valuable ally if Mwinyi chooses to press ahead with reforms. Salim has been Prime Minister since 1984 and was previously Foreign Minister, but his role in the new government is unclear.

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The success of any new public policies will hinge to a great extent on the degree of Nyerere's influence over the new President and the political strength of senior party members, who still cling to Nyerere's tenets of African socialism. Nyerere will continue as party chairman, with de jure authority over the President until 1987, when that position will again be combined with the presidency, as under Nyerere.

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Meanwhile, Mwinyi will be dealing with party and government bureaucracies formed under his predecessor's long tutelage. Although Nyerere's socialist policies have been disastrous, we believe his philosophy and charisma have earned him many followers who remain loyal to his inspiring, if naive, economic rhetoric.

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Briefs

Energy

OPEC Production Update

OPEC crude oil output in September averaged 15.1 million b/d, a 300,000-b/d increase from August levels. Continued weak oil demand, however, kept production about 1 million b/d below the organization's self-imposed ceiling. Iraqi attacks on Khark Island reduced Iranian exports, but Saudi Arabian and Nigerian production increases more than offset the decline.

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OPEC: Crude Oil Production, 1985 *Million b/d*

	Quota	First Half	Third Quarter	August	September
Total	**16.00**	**16.0**	**14.9**	**14.8**	**15.1**
Algeria	0.66	0.7	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2	0.2
Indonesia	1.19	1.2	1.2	1.2	1.1
Iran	2.30	2.4	2.2	2.4	2.1
Iraq	1.20	1.3	1.4	1.4	1.4
Kuwait [a]	0.90	1.1	1.0	1.0	1.0
Less share of Neutral Zone		0.9	0.8	0.8	0.8
Libya	0.99	1.1	1.1	1.1	1.1
Nigeria	1.30	1.5	1.3	1.3	1.5
Qatar	0.28	0.3	0.3	0.3	0.3
Saudi Arabia [a]	4.35	3.4	2.7	2.4	2.8
Less share of Neutral Zone		3.2	2.5	2.3	2.6
United Arab Emirates	0.95	1.1	1.1	1.1	1.1
Venezuela	1.56	1.6	1.5	1.5	1.5

[a] Neutral Zone has no production quota; output is divided between Saudi Arabia and Kuwait and included in their country quotas.

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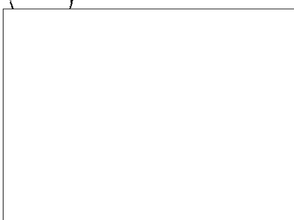
Spot Oil Market Trends



The spot oil market has been calm since some crude prices rose sharply in early October in response to the last effective Iraqi attack on Khark Island, the slowdown in Soviet exports to the West, and falling US oil inventories. North Sea Brent crude prices, which jumped to $29.05 per barrel in early October, have dropped in recent weeks and now stand at $28.15. Arab light and Nigerian Bonny Light are now selling at $27.80 and $28.75 per barrel, 20 cents below and 10 cents above respective official prices. Rising oil production in October will likely cause spot prices for key OPEC crudes to weaken. Saudi exports are up, reflecting the first sales through new product pricing arrangements, and Iraqi sales have also increased since the opening of the new spur to the Saudi East-West pipeline. In the absence of further supply increases, however, higher consumption during the winter heating season should keep prices from falling sharply.

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Romanian Energy Emergency Declared

President Ceausescu last week imposed a state of emergency in the energy sector, fired the minister and deputy premier responsible for electrical power production, and put the military in charge of running the entire power system. Military command teams are to take control of thermal power plants and punish civilian employees for any failure to obey orders to maintain production schedules. The move reflects Ceausescu's desperation over the effect of energy shortages on the economy this year, but it will probably do little to augment the supply of electricity. Coal production is far below planned targets and snarls in traffic have interrupted coal deliveries. Ceausescu's coercive style has become more pronounced as the economy has deteriorated this year.

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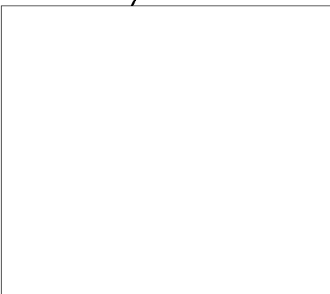
International Finance

Latin American Reaction to Debt Initiative



Latin American debtors generally have welcomed the US initiative on debt presented in Seoul, but they doubt that it will be enough to solve the region's financial problems. High-ranking officials in Brazil, Mexico, and Argentina view the proposal as a sign that the United States recognizes the need of debtor countries to restore economic growth and to obtain more foreign capital. They are particularly encouraged by US intentions to promote substantially increased lending by multilateral institutions and by commercial banks. None of the region's debtors have voiced opposition to the initiative, although Peruvian Finance Minister Alva Castro reaffirmed Lima's position that the debt-related functions of the IMF should be eliminated. Considerable Latin skepticism exists, however, about the initiative's potential to ease the region's financial burden. Most Latin American debtors probably will await firm commitments from the multilateral institutions or commercial banks before offering stronger endorsements. They also will seek further information about the prospects for increased donor contributions to the World Bank, World Bank guarantees for commercial lending, and cofinancing between the World Bank and commercial banks. Meanwhile, the concern that the initiative leaves the issue of interest payment burdens unresolved may prompt the debtor countries to increase pressure on creditors to defer interest or place a cap on interest payments.

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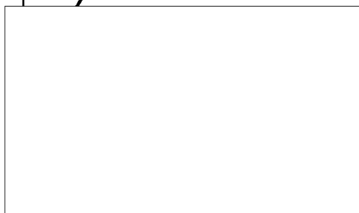
Japanese Financial Liberalization Setback



The Finance Ministry publicly announced Monday it is canceling plans to issue its first short-term bonds—similar to US treasury bills—this year. The recent decline of interest rates for long-term bonds to below that of three-month bills makes it advantageous for the Finance Ministry to stick with traditional instruments when it refinances 2.3 trillion yen ($9 billion) worth of national bonds next month. We believe the announcement indicates that, despite earlier fears of a debt-refunding crunch beginning in 1985, Tokyo will have little trouble rolling over bonds in the near future,

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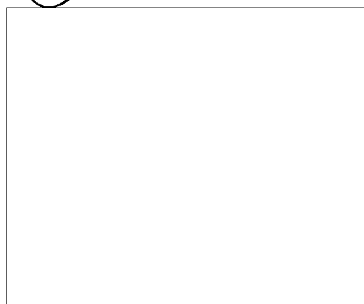
Disappointing Yugoslav Trade Performance



Yugoslavia is falling short of IMF targets for hard currency balance of payments performance this year. Despite improvements in recent months, poor trade results early this year and smaller-than-expected growth in tourism saddled Belgrade with a current account deficit of $77 million for the first seven months of 1985, as compared with a surplus of $225 million for the same period last year. The Yugoslavs also suffered a $393 million drain on the capital account. To cover shortfalls, Belgrade has had to draw down its hard currency reserves to a level comparable with that during its liquidity crisis in 1982. Although its performance apparently improved in August, Belgrade is unlikely to meet the IMF targets of an $880 million current account surplus and a $200 million increase in reserves for this year. Belgrade may try to cut back imports, but this would probably depress industrial performance. Failure to achieve the IMF goal will hurt prospects for both the multiyear rescheduling agreement from Western governments and an end to close IMF supervision, which Belgrade hopes to negotiate next year.

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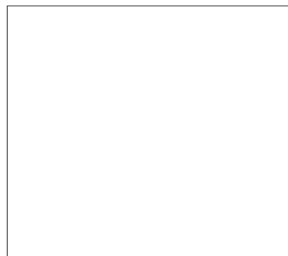
Global and Regional Developments

Japanese Exporters Liberalize Credit Terms to Cuba



Japanese firms have begun to allow Cuba two years to pay for goods, according to the US mission in Havana—a decision that has already helped increase Japanese exports. Although MITI only provides export credit insurance for six months on shipments to Cuba, the mission reports many exporters are assuming the risk for longer-term financing themselves or arranging for private export insurance. Last month, a Japanese company won an $800,000 contract to sell steel conveyor belting to Cuba

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We believe Japanese firms will continue their extended credit policy as long as Havana maintains an acceptable payment record. In our view, the advantage Japanese firms now enjoy will increase over the next year as Havana must begin to repay their rescheduled Western debt.

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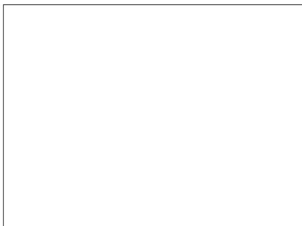
EC-US Dispute Over Wheat Trade



The EC intends to file a complaint with the GATT against the US export support program for wheat in response to the US decision to begin an action against EC wheat export subsidies. The EC contends that US subsidies have undercut world prices, whereas EC subsidies only close the gap between international and domestic prices. Bilateral consultations are unlikely to produce a solution, and the dispute probably will be referred to a GATT panel by the end of the year. The dispute almost certainly will complicate EC-US negotiations on other agricultural trade problems, including the EC's preferential treatment for imports of Mediterranean citrus and its production subsidies for Community fruit canners. The US complaint will increase EC fears about the way agricultural subsidies will be treated in the new GATT round. It also is likely to intensify debate within the EC on reform of the Common Agricultural Policy and on how to cut cereal production.

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EC-US Citrus Dispute Deadline Nears

EC member states have failed to come up with proposals to resolve the dispute with the United States over EC trade preferences for citrus fruit, despite a US imposed deadline of 31 October. According to Embassy reporting, the EC Commissioner for External Relations may suggest on his own initiative that the deadline be dropped and discussions on citrus continue in exchange for meeting US demands on a separate dispute involving canned fruit. Washington is seeking EC compliance with a GATT panel finding that EC preferences for citrus imports from Mediterranean countries have hurt US exporters. The EC, however, is politically committed to protect the interests of key Mediterranean trading partners—such as Morocco, Tunisia, and Israel—after Spain and Portugal join the Community in January. As a result, the Commission probably will be unable to deal with US demands directly until spring 1986 when negotiations to amend the current Mediterranean preference agreements are completed. Italy and Greece—concerned about protecting their own citrus growers—are delaying agreement on EC Commission proposals to guarantee the current Mediterranean share of the EC citrus market. In order to try to satisfy US demands, the EC is likely to offer the United States largely symbolic concessions—such as a reduction in grapefruit tariffs or expansion of the reduced-tariff season for US oranges—or may propose concessions on other products, such as almonds. Should the United States increase tariffs on EC pasta as a result of EC failure to meet the October deadline, the Community almost certainly would retaliate against imports of US lemons and walnuts.

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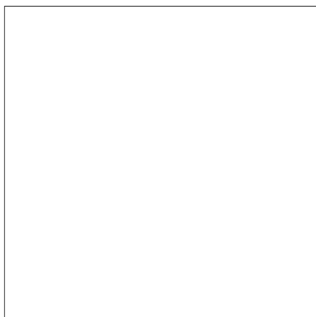
Mixed Preliminary Results for the CBI



The Caribbean Basin Initiative (CBI) so far has been unable to stem the region's decline in export earnings, but has made a promising start in diversifying the production and export bases of the 21 CBI-designated countries. Embassy reporting indicates that during 1984, the first year of the program, 268 export-oriented investments worth about $200 million and more than 31,000 jobs were created. The region's larger economies—the Dominican Republic, El Salvador, Jamaica, Honduras, and Panama—reaped the most benefits. US imports of products under the CBI increased 6 percent during this period. Nevertheless, total US imports from these countries dropped 18 percent during the first half of 1985 largely because the region's exports remain dominated by petroleum, sugar, coffee, and bauxite/alumina—products that have experienced sluggish world demand, low prices, and, since 1984, sizable US disinvestment in the region.

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Largely because of the precipitous drop in exports, a number of Caribbean and South American leaders have openly criticized progress under the CBI. Leaders of the Caribbean Community, during their annual summit meeting this summer, complained that the CBI is insufficient to meet the needs of the region, especially the smallest islands. According to Embassy reporting, Jamaica's Prime Minister Seaga has privately stated that he cannot continue to publicly support the Initiative unless faster progress is made soon. The Secretary General of the Latin American Economic System also recently complained that the CBI has failed to promote development and sets too many military and political preconditions for designation as a beneficiary.

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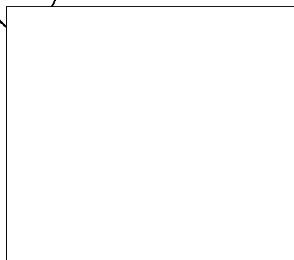
British Push Exports to Latin America



To boost exports and prolong the life of the current economic expansion, the Department of Trade and Industry (DTI) has begun a marketing campaign designed to help British manufacturers find export markets, particularly in Latin America. The DTI in conjunction with two business groups will help exporters find potential Latin American buyers. DTI has identified six sectors in which British firms should do well—chemicals, machinery for special industries, non-electrical machinery, electrical power and switchgear, other electrical equipment, and scientific instruments. British trade offices in Latin America have already identified chemical buyers and put them in touch with British exporters. A preliminary version of the program last year contributed to a 16-percent increase in exports to Latin America in the first half of 1985 as compared to the same period last year. While the $2 billion worth of annual exports to Latin America account for only about 2 percent of total British exports, London is eager to develop this market to offset shrinking sales to the Middle East and hopes to eventually double exports to the region.

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India-Bangladesh Agree on Sharing Water

Prime Minister Gandhi and President Ershad agreed on a formula to settle problems on sharing water at the recent Commonwealth summit in The Bahamas. The US Embassies in New Delhi and Dhaka report the two leaders decided to extend for three years a 1982 agreement on sharing water from the Ganges River and to set up a joint commission to study ways to increase the flow of the river. The study is to be completed in a year, after which Gandhi and Ershad will meet again to work out a new agreement. The two sides have conflicting ideas on how to increase the river's flow, however, and negotiations within the joint commission probably will take longer than a year.

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National Developments

Developed Countries

New Japanese Study Group on Trade Imbalance

The Japanese Government last week established a high-level committee of government, business, and labor representatives to study structural remedies for Japan's growing trade surplus. We believe Tokyo has decided to supplement its current strategy—gradual market opening combined with modest expansion of domestic demand and limited exchange rate intervention—in an attempt to head off eventual US and EC trade restrictions. Although the committee's role is not yet clear, it will probably review ways to alter the export orientation of the country's industrial structure, according to the US Embassy, as well as examine methods of international cooperation to ease the trade imbalance. The Embassy believes Prime Minister Nakasone may use the new committee's report at the Tokyo summit in May to argue for more formalized currency market intervention and possibly some macroeconomic policy coordination among summit partners.

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Impact of Yen Appreciation on Autos and Steel

Tokyo press reports indicate that Toyota, Nissan, Honda, and possibly others are watching the exchange rate very closely, while the chairman of Nissan is quoted as stating that Japanese automakers will need to raise prices because of the stronger yen. In yen terms, the value of auto exports to the United States have fallen about 10 percent over the past month, and profits have been cut even more. Because of cutthroat competition at home, the United States is the automakers major source of profits needed to finance large-scale capital investment and R&D programs. A similar profit squeeze is also affecting Japanese steel producers who already have informed customers of price increases of about 10 percent on steel exports to the United States beginning in January 1986. Such a move would aid US steel producers' efforts to raise prices. The large integrated US producers have announced significant increases on certain products for next January while some minimills are already putting somewhat smaller raises into effect for part of their product line.

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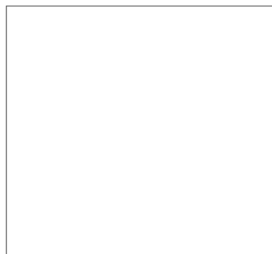
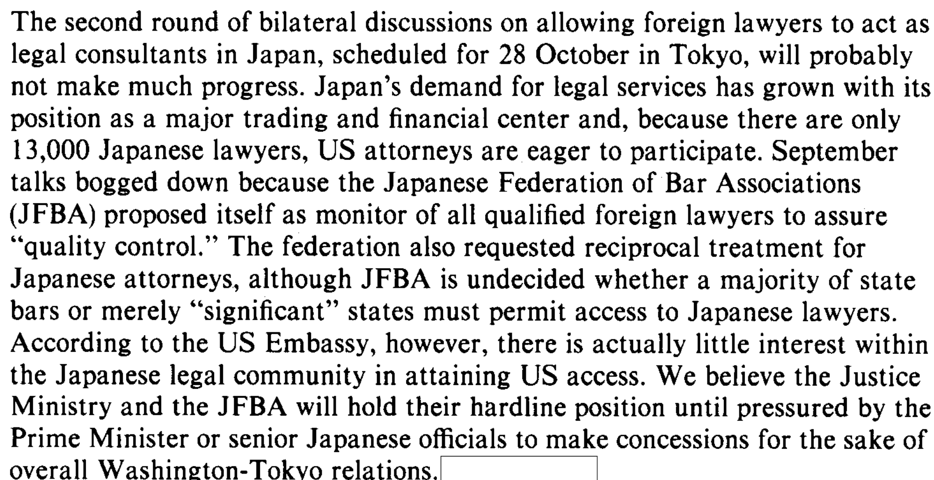
Japanese-US Talks on Legal Services





The second round of bilateral discussions on allowing foreign lawyers to act as legal consultants in Japan, scheduled for 28 October in Tokyo, will probably not make much progress. Japan's demand for legal services has grown with its position as a major trading and financial center and, because there are only 13,000 Japanese lawyers, US attorneys are eager to participate. September talks bogged down because the Japanese Federation of Bar Associations (JFBA) proposed itself as monitor of all qualified foreign lawyers to assure "quality control." The federation also requested reciprocal treatment for Japanese attorneys, although JFBA is undecided whether a majority of state bars or merely "significant" states must permit access to Japanese lawyers. According to the US Embassy, however, there is actually little interest within the Japanese legal community in attaining US access. We believe the Justice Ministry and the JFBA will hold their hardline position until pressured by the Prime Minister or senior Japanese officials to make concessions for the sake of overall Washington-Tokyo relations.

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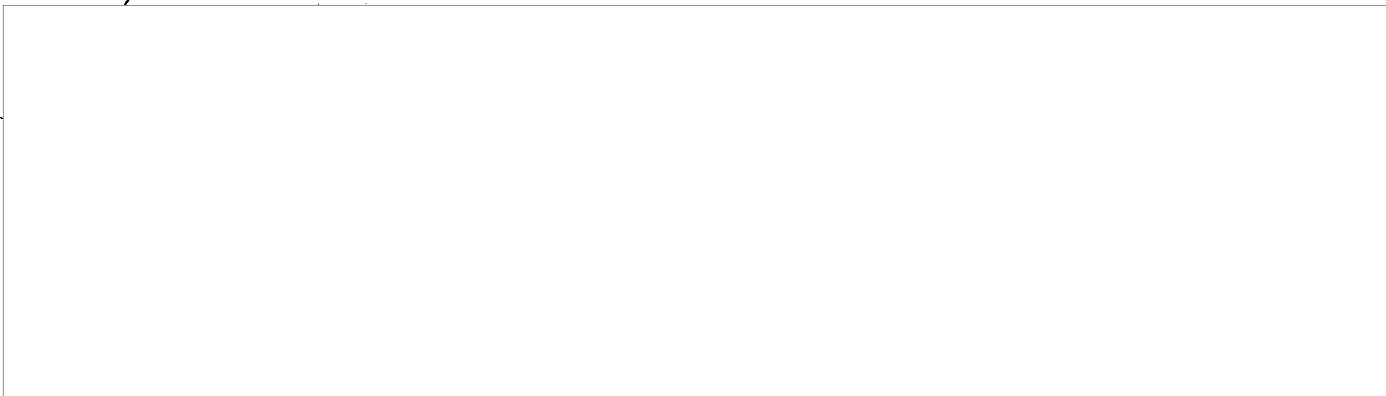

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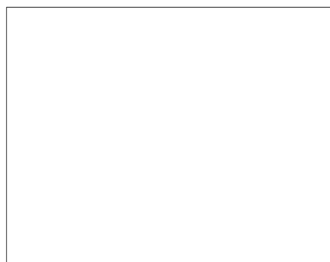
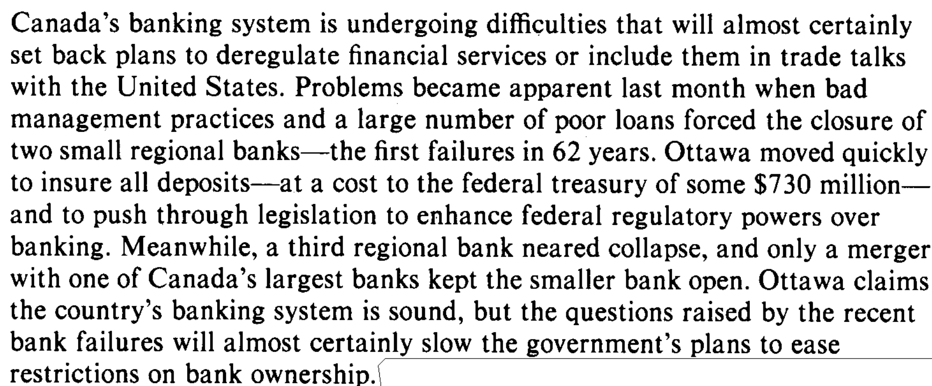
Canadian Banking Difficulties Continue





Canada's banking system is undergoing difficulties that will almost certainly set back plans to deregulate financial services or include them in trade talks with the United States. Problems became apparent last month when bad management practices and a large number of poor loans forced the closure of two small regional banks—the first failures in 62 years. Ottawa moved quickly to insure all deposits—at a cost to the federal treasury of some $730 million—and to push through legislation to enhance federal regulatory powers over banking. Meanwhile, a third regional bank neared collapse, and only a merger with one of Canada's largest banks kept the smaller bank open. Ottawa claims the country's banking system is sound, but the questions raised by the recent bank failures will almost certainly slow the government's plans to ease restrictions on bank ownership.

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French Aerospace Firm Seeks US Partner

Messier Hispano Bugatti (MHB) is looking for a US partner MHB is a subsidiary of the government-owned Snecma engine combine and the sole supplier of landing gear for Airbus aircraft. The move aims at gaining access to US advanced technology and to US markets, especially those of the big jet aircraft manufacturers. MHB's founder and Snecma are willing to go as far as offering a substantial minority stock position to a US company. The US company would benefit by gaining access to European sales especially to Airbus Industrie, which are being closed to US companies as rapidly as European suppliers can be qualified.

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Greek Government Response to Labor Unrest

Prime Minister Papandreou has expelled eight labor leaders from his PASOK party, according to press reports. The eight had joined the Communists in calling for a nationwide strike in opposition to the economic austerity program announced last week which will reduce the real income of workers. In Athens, only about 20,000 workers responded to the call. The expulsions reflect Papandreou's determination to maintain tight control over the party and to stifle leftwing criticism of his economic policies. At a party Central Committee meeting last month, Papandreou laid the groundwork for the expulsions by accusing dissident unionists of pursuing narrow economic ends at the expense of the national interest.

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Less Developed Countries

Indian Farmers Protest Gandhi's Economic Policies

The Gandhi administration's economic liberalization moves have drawn their first major public protest from farmers. The US Embassy reports that early this month 50,000 farmers rallied in Maharashtra State to hear a powerful rural leader decry Prime Minister Gandhi's economic policies as "pro rich." Farm leaders from other states, some opposition politicians, and a key militant union organizer supported the attack on textile, cotton, and sugar price policies. Backed by opposition parties, the farm leader has launched a "civil disobedience" campaign. Over the past five years, rising production costs and sagging farm prices have spawned successful "middle-class" farm protest movements for higher crop prices and subsidies. If a sustained campaign develops, with labor union and opposition party support, New Delhi may well be forced to reexamine some of its recent efforts to liberalize the economy.

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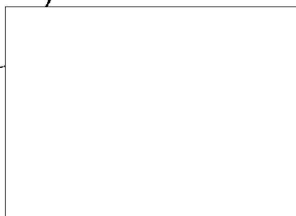
Pakistani Price Rises



The US Consulate in Karachi reports that consumer prices in that area show a sharp 13.5-percent increase since April and a 20-percent rise over last year. Prices normally tend to decline during the autumn. Led by rises in essential commodities—cereals, vegetables, meat, kerosene, and sugar—the higher inflation, in part, reflects administered price increases, local government wage indexation, and a 5-percent surcharge on imports. Although price movements in Pakistan's major city are insufficient to establish a national trend, we expect that Islamabad's massive domestic bank borrowing, deregulation of edible-oil trade, increased support prices for cereals, and higher energy prices will likely fuel nationwide inflationary pressures over the next year.

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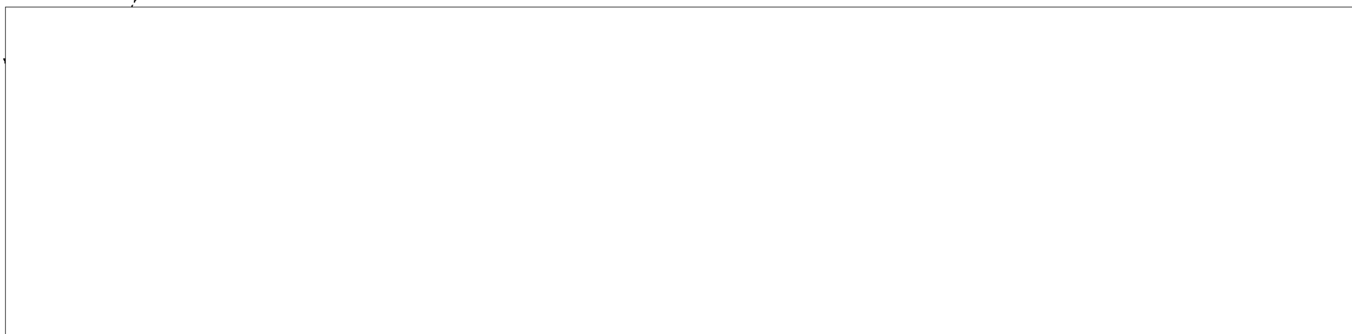

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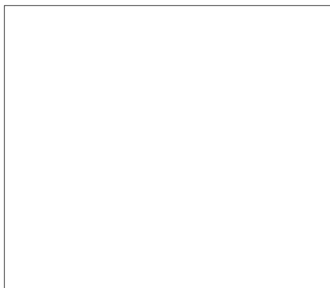
Communist

Soviet Task Force on Economic Reform



A Soviet task force on economic reform is reportedly considering measures to promote competition among industrial firms, increase labor productivity, and legalize private activity in consumer services. This advisory group agrees that some type of business mechanism—other than market pricing—is needed to make Soviet industry more efficient. It also agrees that enterprise managers should have more control over staffing and payroll. One member contends that tolerating a 2-percent unemployment rate would advance both these goals. He also suggests that industrial firms be allowed to choose their own suppliers and that noncompetitive enterprises be reorganized. He says the task force is studying ways to legalize a large number of consumer services currently available only on the black market. The decision to establish a task force to prepare recommendations on such politically sensitive subjects is significant and indicates that Gorbachev is looking for specific ways to back up his calls to improve economic performance. Although the task force is reportedly under pressure to come up with recommendations, the leadership probably will not take quick action on permitting unemployment, expanding the private sector, or other controversial issues. It is more likely to initiate small-scale experiments while assessing the economic gains from measures already put into place.

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Pravda Discussion of Capitalist Incentives

A recent article on modernization commenting favorably on the technological benefits of Western-style competition suggests a broadening of the current discussion on economic reform. The author, a member of the Soviet Academy of Sciences, argues that the "law of the jungle"—even though exploitative—is a powerful force for technological advancement and improved product quality. He states that Western enterprises, which operate under the principle of "survival of the fittest," are forced to produce quality products efficiently or run the risk of being overtaken by their competitors. He claims that because Soviet defense industry—confronted by the competitive threat of US defense programs—works on this principle, its level of technological development and the quality of output are superior to that on the civilian side. He also asserts that the military exerts "powerful influence" over the quality of the products it receives and that the civilian economy could benefit from this type of consumer-producer relationship.

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The article generally elaborates on the strategy outlined in General Secretary Gorbachev's major policy address of 11 June, but its acknowledgment that capitalist competition spurs technology and improves quality is new. The benefits of Western-style competition for the Soviet economy probably would be considerable, but the relative success of the defense industry is better explained by benefits not easily shared with the civilian sector.

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Soviet Foreign Trade Minister Replaced

TASS announced Saturday that Deputy Minister of Foreign Affairs Boris Aristov had replaced 77-year-old Minister of Foreign Trade Nikolay Patolichev, the third high-level personnel change in the economic sphere in a week. Patolichev, who retired for health reasons, held the post for 27 years. Aristov has no formal background in foreign trade and is primarily a longtime party official, but he has—like new Gosplan Chairman Talyzin—extensive experience in East European affairs. This appointment thus supports recent Soviet policy statements emphasizing increased trade and economic integration within CEMA. This continues General Secretary Gorbachev's pattern of bringing outsiders into key ministerial positions. Gorbachev's economic agenda requires a more aggressive approach to management than Patolichev probably was willing or able to provide. Heightened rumors of corruption within the Ministry of Foreign Trade probably portend further personnel and policy changes in the Ministry.

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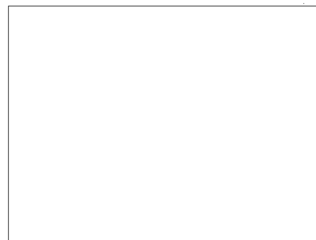
USSR Reorganizing Machine-Building Industry



Last week the Politburo approved the creation of a bureau within the Council of Ministers to coordinate the work of the various machine-building industries. The new bureau reportedly is to have the power to issue binding decisions and reallocate resources among the ministries. There are currently 11 machine-building ministries in the civilian sector and another nine engaged primarily in military production. It is unclear which ministries will be affected or whether the powers given to the new bureau will enable it to function more successfully than did a similar unit set up for the agro-industrial sector in 1982. General Secretary Gorbachev had earlier called for a major shakeup of the ministerial bureaucracy to reduce its size, eliminate overlap, and remove superfluous layers. The creation of the new bureau may be a move designed to prepare the way for bolder steps later, but if Gorbachev stops here it will only worsen problems.

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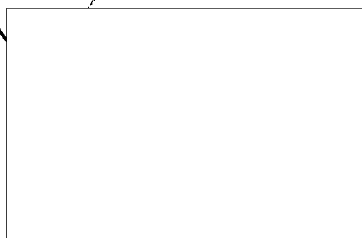
Bulgarian Ministerial Changes



The Bulgarian State Council decreed changes in the Cabinet last Friday, three days before General Secretary Gorbachev's visit. All involved the economy. Ivan Iliev, an aide to party leader Zhivkov, replaced Stanish Bonev as chairman of the State Planning Committee and as deputy prime minister. Reflecting growing concern about the economy, First Deputy Prime Minister Aleksandrov, a fast-rising Zhivkov protege and close friend of the Soviet Ambassador, was named to head a new party-state Committee on Energy Problems. The new appointments are in part a response to repeated Soviet criticism this year of Bulgarian economic inefficiency and corruption. Other changes may be in the works.

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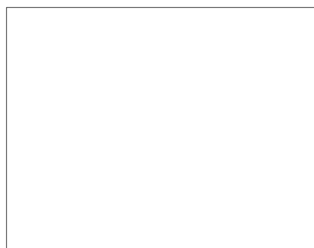
Beijing Tightens Up Helicopter Procurement



Beijing's new Capital Helicopter Corporation (CHC) will centralize foreign helicopter procurement in a single corporation responsible for military and civilian helicopter acquisition throughout China.

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Capital Helicopter, a subsidiary of the Civil Aviation Administration of China, reports directly to the State Council—the highest level of China's central government. The new company recently bought 17 civilian Westland helicopters from the United Kingdom and plans to acquire an equal number of the military version.

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